August 2011

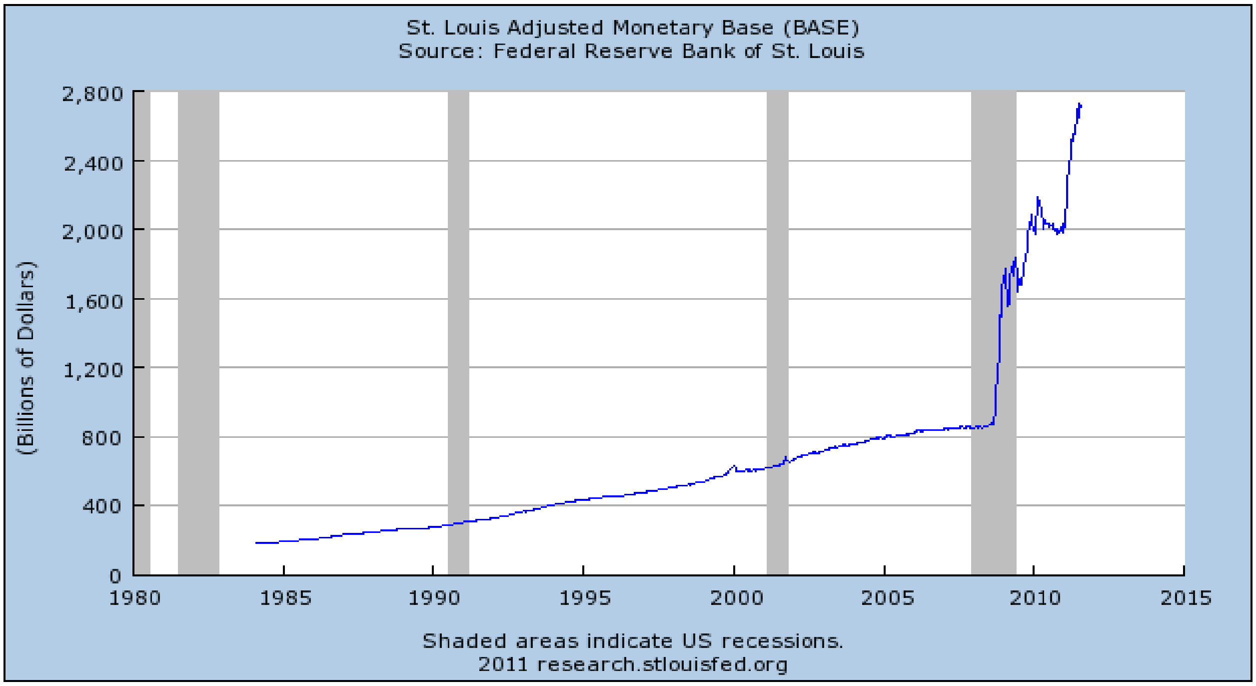
Inflation Nation

Last month I wrote "Cross Currents" to try and quell client's desires to take on more risk. I was getting the sense that investors were hearing the siren song of high returns without risk and I had to help protect them from the rocky coast. I wrote, "There is a good chance that many of the world's stock markets have seen their highs for the year. How long the U.S. economy continues to grow without much help from emerging markets remains a big question mark for me. My best advice is to be patient in these frustrating markets and **don't take unnecessary risks**."

The S&P 500 closed at 1,339 on July 1st and closed at 1,286 on August 1st. Many people attribute stock's weakness to the debt ceiling debate. I think they are off. The government bond market and dollar index are not showing any concerns that a deal doesn't get done. I believe the weakness in equities is coming from the realization that you can't lend a government more money to get them out of debt and slowing global macro data (China PMI, ISM, Chicago PMI, home sales). Consider that on 7/29, **the government revised their estimate of Q1 GDP by 79% from 1.9% to .4%.** That is an extremely wide margin of error. The first estimate for Q2 GDP is 1.3%. This is not the healthy economy that many were expecting to be able to grow from underneath huge deficits and debt.

In this month's letter, I want to address a risk that I don't think clients appreciate enough--the risk of lost purchasing power. Very few people lie awake at night for fear of inflation because it usually happens so slowly that we barely notice it. I have found that the average investor is overly concerned of market risks and not concerned enough about inflation. 2008's drop and last year's flash crash are both etched in our minds. Market risk is like a tsunami coming at your beach house. Inflation risk is like erosion that destroys your property over many years. The former is in your face; the latter is more ambiguous.

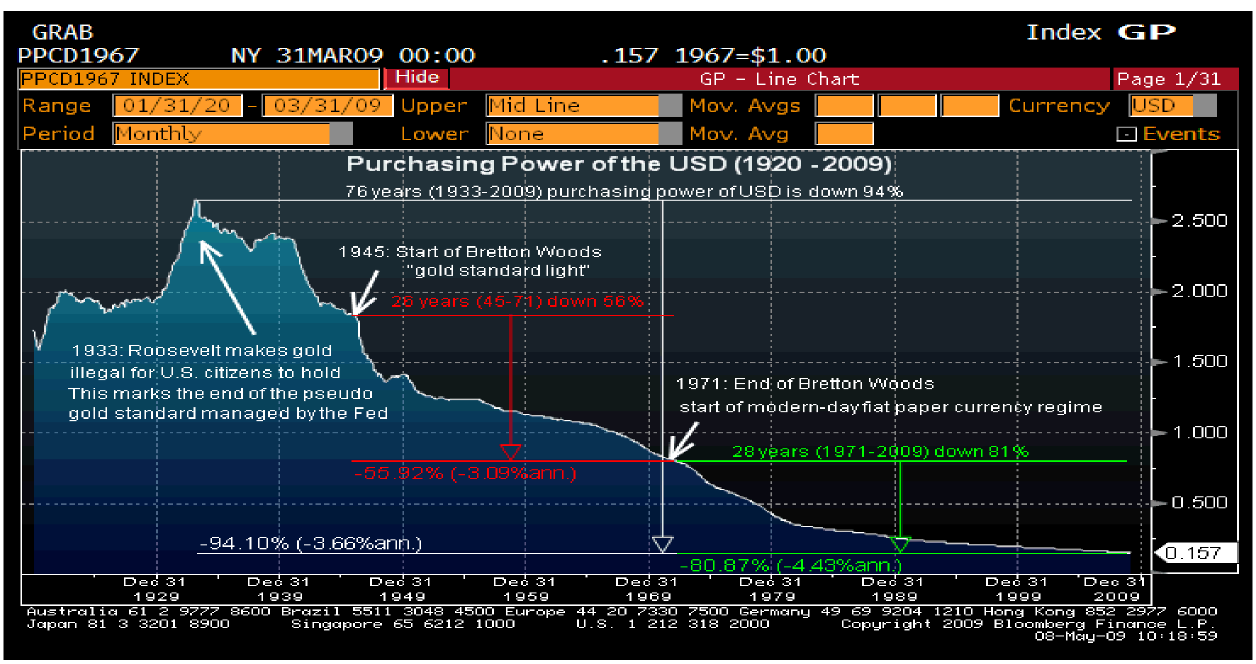
The word inflation means to expand. When we inflate our tires, we are expanding the air inside the tire. When the government prints money, they are expanding the money supply causing the price of goods to rise. The rise in prices is a symptom of the real inflation (expanding money supply). Central Bank currency debasement has the exact same effect as the mafia counterfeiting Federal Reserve notes. The inflation helps out the Government/Mafia and the first beneficiaries of the extra dough (banks, military industrial complex). By the time the average man sees the extra money, prices have already robbed him of his purchasing power. Below is a chart of the U.S. monetary base created by the St. Louis Fed. As you can see they are always expanding the money supply which increases prices. This is how you "lower taxes" and fight three wars at the same time. Inflation is a tax. The increase from $800 billion to almost $2.8 trillion since 2008 should make you very afraid.



Whether it is the Fed or the Mafia counterfeiting, the results are the same. research.stlouisfed.org/fred2/series/BASE

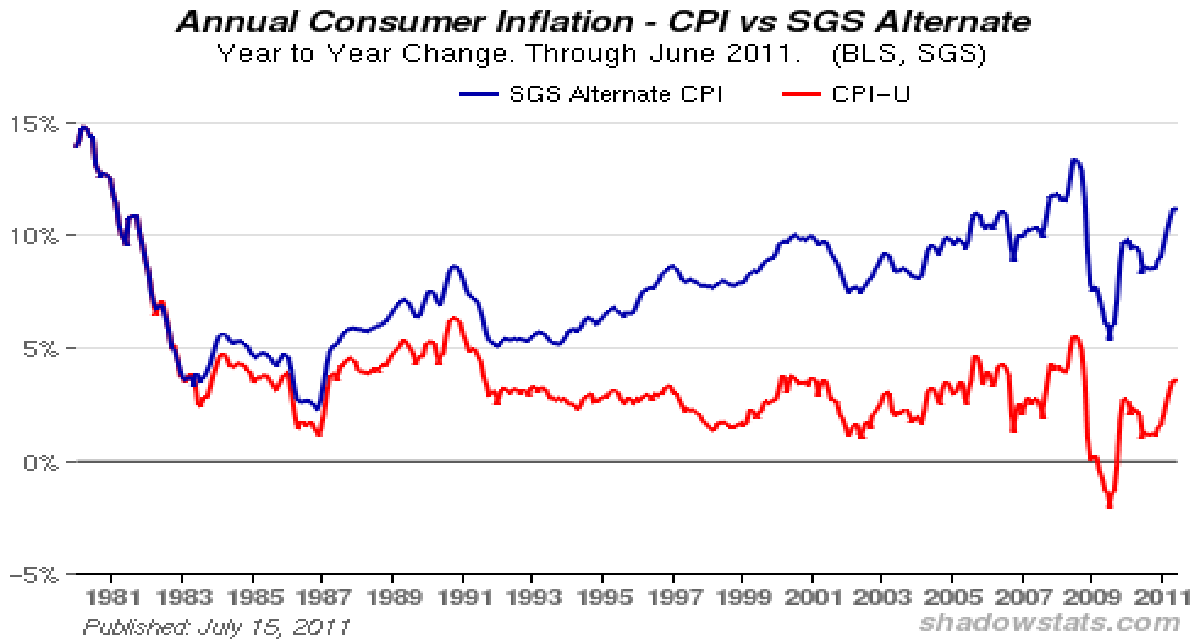
I keep some 10 cent 1975 stamps in my office to remind clients of the risk of inflation. Even though the US Postal Service is billions in debt and operating at a loss, a first class stamp now costs 44 cents. If you do the math, that is a compound increase of 4.2% per year on stamps which is a good estimate of what your other costs have increased since 1975.

If a 65 year old wants to retire on $4,000 per month and prices rise at 5% per year compounded for the next 10 years, this person will need $6,516 per month to buy what she used to buy for $4,000. At a 10% compounded increase that is $10,375 per month! Since 1913 when the Federal Reserve Act became law, inflation has robbed a dollar 94% of its purchasing power. I suspect it will not take 98 years for the next 94% decrease in purchasing power.



The Federal Reserve System is a destroyer of the dollar. Source: http://zerohedge.blogspot.com/2009/05/annihiliation-of-dollars-purchasing.html

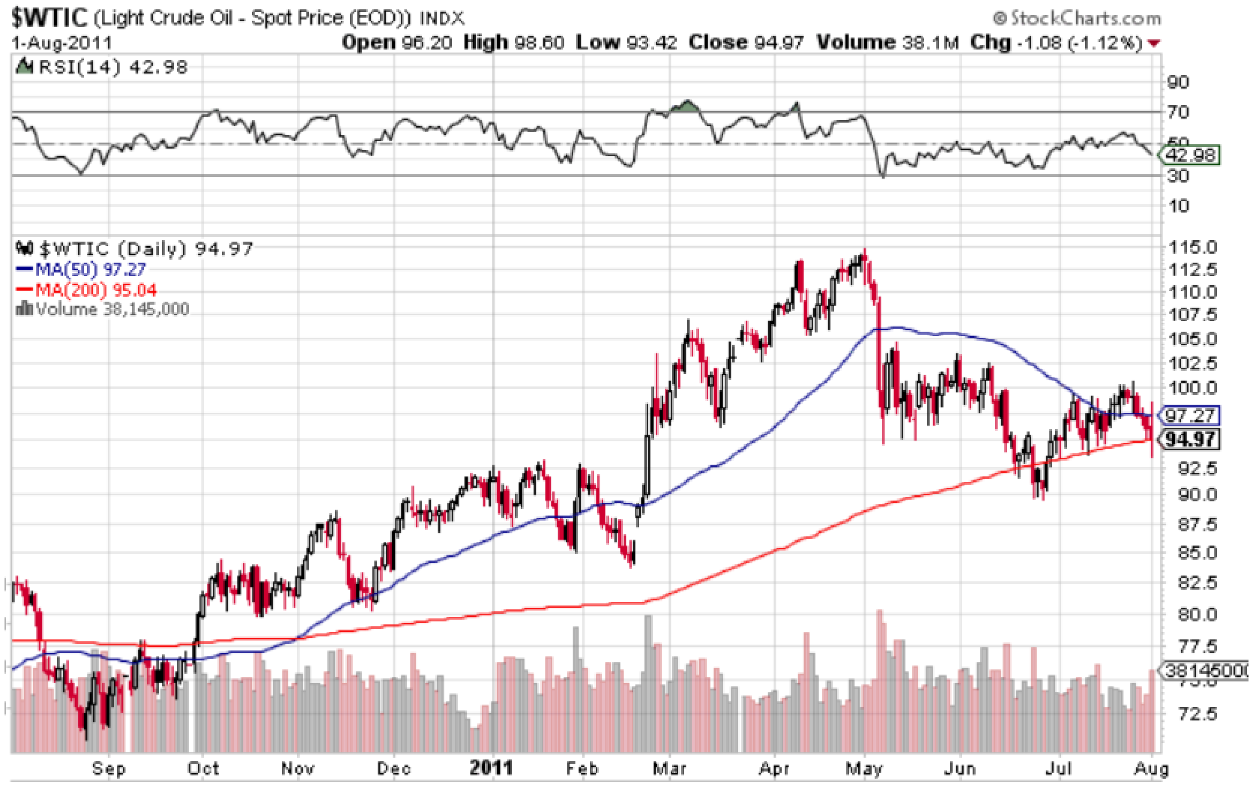
I must confess that I love John Williams' www.shadowstats.com. If I were King, I would make him an offer that he couldn't refuse to head the Bureau of Labor Statistics. Each month, he collects data and calculates the consumer price index based on the 1980 methodology the government used to implement. If you haven't read my newsletter Cooked Books, it is a good place to get more information on how the Boskin commission changed the calculation to artificially lower the "official CPI" so that they could rob seniors of their increases. The latest CPI from the government was reported that prices increased by 3.6% year over year.[1] Below you can see the ever widening gap in the "official" CPI and the 1980 methodology. According to John Williams, inflation is up 11% over the last 12 months!



John Williams, you should run the BLS. Source: www.shadowstats.com

Does that sound unbelievable? Look at a grocery bill from a year ago. How much did your health insurance go up this year? What percent did your child's tuition raise? Below is a chart of oil. The price of oil affects almost everything because you need oil to farm and transport goods. As you can see below. West Texas Crude was $70 per barrel last summer. Today it is $95. That is a 36% increase. You may not think inflation went up 11% in the last year, but you surely can't believe that it was only 3.6%. As Marc Faber recently said, "Bernanke is a murderer of the middle class." He is the most dangerous person in the world and the people of the United States can't even vote him out of office. Unfortunately he is protected from voters and appointed by our (s)elected officials. Ben Shalom Bernanke (armed with his printing press) is the most dangerous man in the world today.

[1] http://www.bls.gov/cpi/cpid1106.pdf



If oil is up 36% in the last year, what was your personal CPI? Source: StockCharts.com

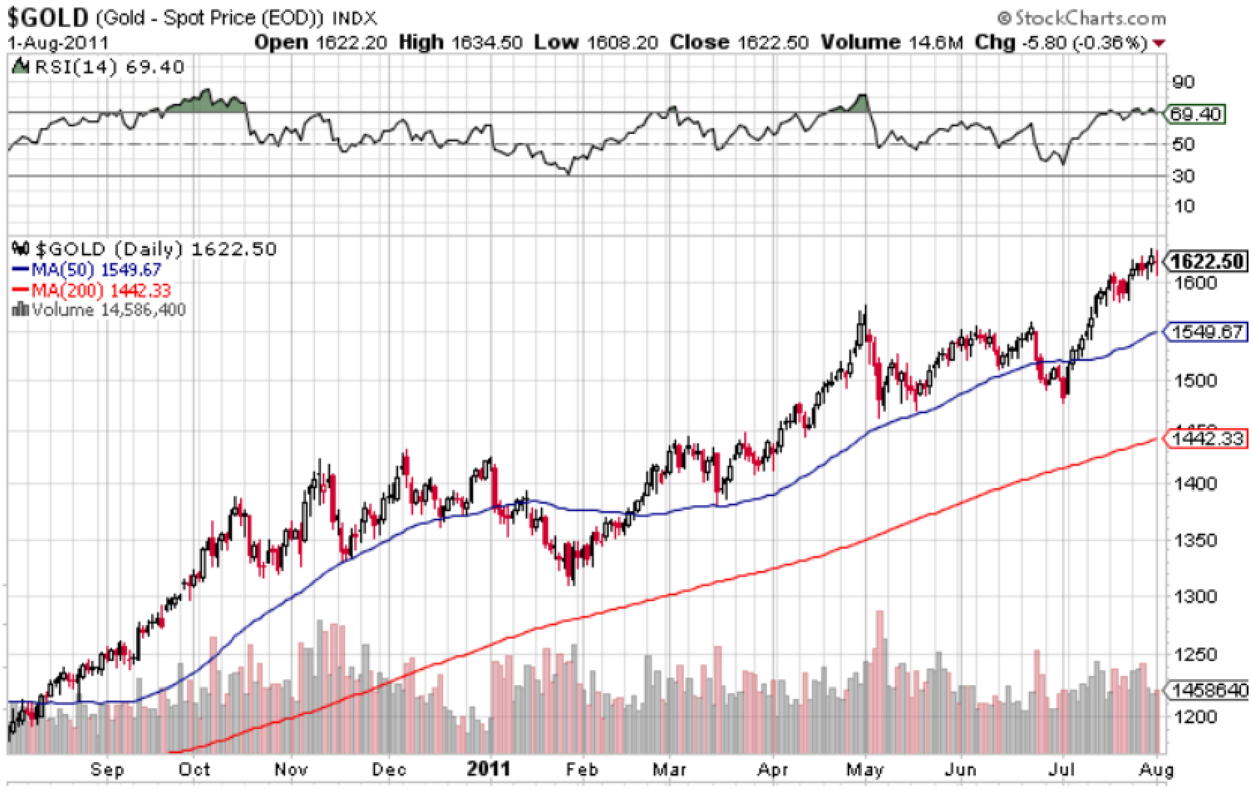
Markets

In late April/early May, the Chicago Mercantile Exchange increased the amount of margin required to hold futures contracts on silver five times in two weeks by 84%. That means if you needed $10,000 to hold a position in silver, you were required to put up an additional $8,400 in your account to hold the same number of contracts. The margin clerk's relentless attack helped drive the price of silver from $49.75 to $32.32 in a matter of days. In sympathy, gold dropped only 7% from $1,576 to $1,462.

The media went into a frenzy trying to find all of the "dollar bugs" and lovers of paper money to tell their poor audiences that gold and silver were in a bubble. The media blitz was enough to get several clients to call me and ask if it was time to sell their precious metals.

I advised clients to hold their positions because the long term charts still looked very constructive on the metals. As the precious metals bull market progresses, it is important to expect higher volatility. Higher prices will also make it *feel* more volatile. When gold was $300, a $100 move in the price of an ounce was a 33% move. At $1,620, a $100 move is only a 6% move. As famed investor, Richard Russell, likes to say a bear is a scary animal, but so is a bull. Bull markets do a lot to buck you off and scare you out of your position. Very few people that bought gold at $250 an ounce have had the mental fortitude that it takes to stay with this investment.

On August 15, 2011 the US gets to "celebrate" its fortieth anniversary of being off the gold standard. Since the evil Richard Nixon removed the dollar from the its last tie to gold, thousands have died in senseless wars, the government has expanded parabolicly, and global debt has ballooned to levels impossible to pay. Thanks for putting your own interests of getting re-elected over those of the rest of the world Tricky Dick.



Gold hits $1650 an ounce. Bubble? Are you kidding me? Source: StockCharts.com

Last month I came across an excellent four minute video that makes the case for a gold standard. It can be watched here: http://www.youtube.com/watch?v=RvL_Dm2d99A. Have a great month.

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