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Towards Hyperinflation?

> The surest way to ruin a man who doesn't know how to handle money is to give him some.
>
> *George Bernard Shaw*

INTRODUCTION

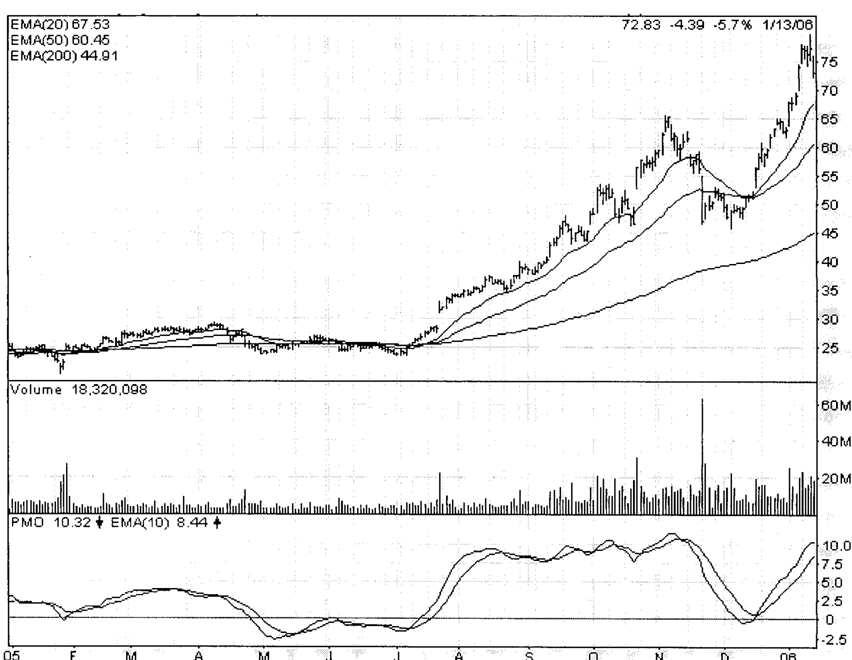
I hope my readers had as fortuitous a holiday season as I had. Shortly before Christmas I read Russell Napier's new book, *Anatomy of the Bear — Learning from Wall Street's Four Great Bottoms* (see below). I stopped over in Bahrain and Dubai while en route to Switzerland, where I skied for ten days. On New Year's Eve, I purposefully avoided over-indulging, as the next day I wanted to be able to ski as well as Bode Miller — in my opinion, the greatest alpine skier since Jean-Claude Killy and skiing's answer to courageous rap superstar Eminem (whose real name is Marshall Mathers III, and whose music even a non-rap fan like me can enjoy).

After my skiing holiday I travelled to the US, where for the first time in many years I was greeted by a friendly US immigration officer. This put me in a good mood for the annual *Barron's* roundtable, which is put together by the witty and scathing Alan Abelson and is always an interesting meeting of investment minds. The roundtable lasts for a full day and is quite demanding, in the sense that one has to try and avoid making a total fool of oneself. I am usually seated next to Fred Hickey, the wonderful editor of the *High-Tech Strategist*. And while I cannot speak for Fred, I sense that he and I are outclassed by the other participants in the roundtable. To our right usually sit Art Samberg of Pequot fame and Abby Cohen, who despite her fame has remained extremely humble and kind. To our left are the investment legend John Neff and the king of bonds, Bill Gross.

In general this year, the mood at the roundtable was quite positive for equities with the exception of Fred Hickey, who presented a very thorough and dim view of the high-tech sector and whose recommendations included shorting SanDisk (SNDK) — an excellent idea, I thought (see Figure 1), as well as myself and my friend Felix Zulauf, who expressed our concerns about global imbalances. One remark caught my attention. If I remember well, it was John Neff who argued that since hedge funds were largely momentum players, when some earnings disappointment hit the stock of a company, that stock would drop far below fair value and provide contrarian investors with an opportunity to buy a bargain. Along with Citigroup, one of Neff's recommendations was to buy Hunstman (HUN — see Figure 2).

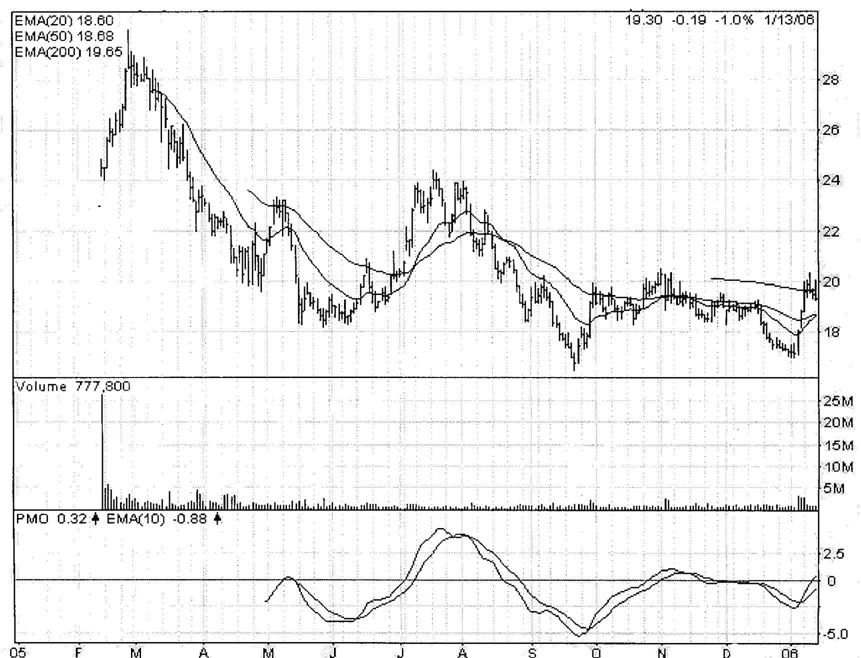
A further two observations that I thought to be relevant were made by two successful hedge fund managers. Art Samberg lamented that two of his stock picks for 2006, which he had prepared at the end of 2005 and which were both foreign stocks, had already appreciated since the end of 2005 by 30% and were therefore no longer very attractive. As the day drew to a close, Felix Zulauf remarked that for the first time ever, several

Figure 1 **SanDisk Corp. (SNDK), January 2005 – January 2006**



Source: www.decisionpoint.com

Figure 2 **Hunstman Corp. (HUN), January 2005 – January 2006**



Source: www.decisionpoint.com

members of the roundtable had offered several foreign stock picks for 2006. (Rolls-Royce was mentioned twice.) But, as I have mentioned, the overall mood was constructive; most participants felt that the US stock market, having underperformed foreign stock markets in 2005, would outperform in 2006 and therefore they belonged in the "10% to 20% upside stock market club" for 2006. I was intrigued that none of the other participants mentioned geopolitical issues, the threat of a bird flu pandemic, Africa, or the fact that India, a country of more than a billion people, now (according to *Forbes*) has 27 billionaires and that the collective net worth of its 40 richest people is quadruple that of China's 40 richest. According to *Forbes*' data, the collective net worth of India's billionaires stood at US$106 billion, compared with just US$26 billion for their Chinese counterparts. (Leading the list of the richest Indians is steel tycoon Lakshmi Mittal with a net worth of US$20 billion, followed by Wipro's Azim Premji with US$11 billion.)

Nowadays, *Barron's* restricts the recommendations the roundtable participants can make to about five ideas, but I shall list the stocks I was prepared to recommend further below.

Shortly before leaving New York for Asia, I received from Robert Blumen (robert@RobertBlumen.com), who has contributed to this report in the past, an excellent, very thorough, but rather frightening analysis of "Bernankeism". (Robert's article is reprinted on pages 5–11 of this report and is a must-read.)

RUSSELL NAPIER'S ANATOMY OF BEAR MARKETS

Russell Napier's *Anatomy of the Bear — Learning from Wall Street's Four Great Bottoms* is an excellent read and easy to digest. (The book is available from Amazon.com or from CLSA directly. Contact victoria.tang@clsa.com.)

Conventional wisdom has it that great market bottoms, which offer once-in-a-lifetime buying opportunities, occur after a devastating bear market. In this context, the following events usually spring to investors' minds: the 1929–1932 bear market in US equities; the collapse in the US bond market between 1970 and 1981, when yields on 30-year US Treasuries rose from 6% in 1970 to 15.84% in September 1981 and sent bond prices tumbling; the 1973–1974 Hong Kong stock bear market, which brought the Hang Seng Index down by 90% to its December 1974 low at 150; the great sugar bear market, which sent prices down from 70 cents per pound in 1973 to 2.5 cents in 1985; or the Japanese bear market post-1989, when the Nikkei dropped from 39,000 to less than 8,000 in April 2003. Moreover, major market lows are associated by investors with total despair and panic among market participants, depression in the asset class that was subjected to the bear market, bankruptcies in that sector, and overwhelming negative sentiment.

But, as Russell Napier shows in *Anatomy of the Bear*, the key element in undervaluation can also be a period of time "when the advance in stock prices has failed to keep pace with the economic and earnings growth" within the system. Napier shows, for instance, that at the market low in 1921 the Dow Jones Industrial Average was no higher than it had been in 1899 — 22 years earlier — while nominal GDP had increased by 383% and real GDP by 88%! Similarly, by August 1982, the Dow Jones Industrial Average was no higher than it had been in April 1964, and was down by 70% in real or inflation-adjusted terms. According to Napier, August 1982 represented the fourth-best buying opportunity for US equities in the last century, aside from 1921, 1932, and 1949.

The important message one might take from Napier's book is that it usually takes a long time — about 14 years — for stocks to travel from overvaluation to undervaluation, and that the nominal low in stock prices isn't always the best time to buy equities. What is more important is the real level of equity prices and various valuation parameters that indicate deep undervaluation. Thus, while the Dow Jones bottomed out on December 9, 1974 at 570, and stood at 769 at its August 9, 1982 low, in

real terms the Dow had lost another 15% since the 1974 low. Moreover, Napier exposes another myth — that stock market lows lead the economic recovery by six to nine months, and that at major market lows the news is universally bearish — by showing that, in 1982, an economic improvement and better news in the media led the stock market recovery by a few months.

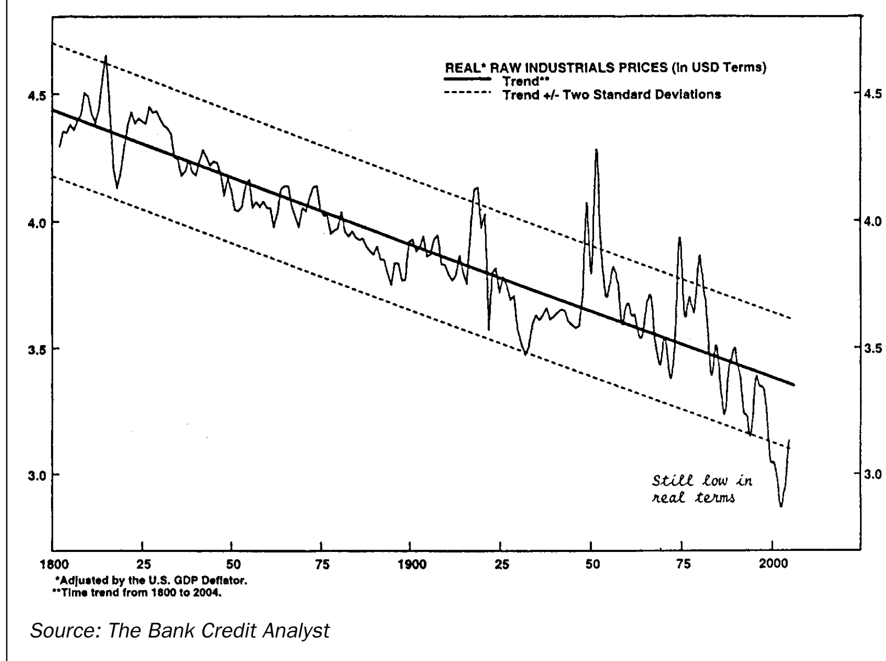
I think Russell Napier has filled a void with *Anatomy of the Bear*, since, to my knowledge, it is the first book to trace, with many pertinent insights, the swings from undervaluation to overvaluation and back to undervaluation, of US stock prices over the past 100 years. The book also provides much food for thought. If equity prices swing back and forth between overvaluation and undervaluation, other asset markets such as real estate, commodities, and bonds will do the same. Thus, I suppose that, in the same way that US bonds were grossly overvalued in the 1940s, Japanese bonds were grossly overvalued in June 2003, when the yield on JGBs had declined to less than 0.50%. At the same time, the April 2003 low for the Nikkei Index at less than 8,000 may have been the best buying opportunity in Japan of this generation. In fact, the 2003 lows in Japanese equity prices and interest rates have similarities to the 1940s' lows in US equities and interest rates. After the 1940s, US stocks rallied into 1973, but bond prices collapsed into 1981. Similarly, the stock market rally in Japan, which began in 2003, could last for many years and be accompanied by a significant bear market in Japanese bonds, which would drive local institutions and Japanese households out of their overweight bond and cash positions, which benefited during the 1990s' deflation, and into equities and real estate. Moreover, if, as Napier explains, 1921, 1932, 1949, and 1982 provided outstanding buying opportunities for achieving subsequent high returns that tended to last for a minimum of eight years (1921–1929), but usually for much longer (1982–2000), then I suppose that — taking the late April 2003 low of Japanese equities as a generational low — the bull market in Japanese equities could easily last until at least 2010 or even longer, and in the process significantly outperform US equities.

Another lesson from Napier's book could very well be that other Asian equity markets, relative to other assets, remain grossly undervalued despite their post-1998 recovery. After all, many Asian stock markets, whether in US dollar terms or in real terms, are still down by more than 50% from the highs reached between 1990 and 1994.

Lastly, if, as Napier outlines, it takes about 14 years for equities to make the journey from overvaluation to undervaluation, the severity of the commodities bear market from 1980 to the turn of the millennium — about 20 years — is evident. Put into the proper perspective, in real terms (inflation-adjusted) commodity prices were, in the 1998–2001 period, at the lowest level in the history of capitalism (see Figure 3). And, although some industrial commodity prices may suffer from a significant phase of profit taking in 2006, given the fact that commodity bull markets tend to last anywhere from 20 to 30 years, we may just be at the beginning of an extended rise in the price of natural resources.

There is another point I should like to add to Russell Napier's excellent study, which I strongly recommend investors to read. In a world of rapid monetary and credit expansion, an undervaluation of the Dow Jones might occur, with a Dow Jones at 36,000, 40,000, or 100,000 or more — a stock price level that was predicted by several analysts in 1999. How so? At present, the Dow is at around 11,000 and the price of gold is at $550. Let us assume that, as a result of Mr. Bernanke's more efficient paper money printing machine (incidentally, a machine that has been in operation since the formation of the Federal Reserve Board in 1913 and which accounts for the dollar's 92% loss in purchasing power since then), the Dow Jones rises to 36,000 in the next few years. (It won't take another 100 years for the US dollar to lose another 92% of its purchasing power; more likely is 10 to 20 years.) If this were the case, the price of gold could rise from $550 to $3,600, which would bring down the Dow/gold ratio from currently about 20 to 10; or, in an extreme case, gold could rise to 36,000, which would bring down the Dow/gold ratio to only 1 (as was the case in 1932 and in 1980 — see Figure 4).

Figure 3 **Real Raw Industrials Prices, 1800–2004**



Source: The Bank Credit Analyst

Figure 4 **Dow/Gold Ratio, 1900–2004**

Source: www.sharelynx.com

Thus, in nominal terms, the Dow would have trebled from the present level, but lost significantly in real terms — a possibility that I regard as very likely. In this respect, we shouldn't forget that during the German hyperinflation period between 1919 and 1923, share prices rose sharply in paper mark terms but tumbled in dollar terms (then a strong currency), because the rate of the paper mark depreciation against the US dollar exceeded the local share appreciation. Thus, by October 1922, an index of shares in local paper mark terms had increased from 100 in 1918 to 171 billion, while in dollar terms the same index had dropped from 100 to 2.72! Needless to say, the 1918–1923 German hyperinflation was devastating for paper mark cash and bond holders.

Now, I am not necessarily predicting that we shall soon experience hyperinflation rates in the US, but the following piece on "Bernankeism" by Robert Blumen strongly suggests an inflationary bias. After all, and as I have maintained in the past, should the Dow Jones and the US housing market decline by 10%, it is very likely that the money printing presses would be put into high gear in order to fight asset deflation. I may also add that, while US investors are euphoric about the strong rise of the stock market so far this year (the S&P 500 is up 3.15% as at this writing), in foreign currency terms the performance is less superb. Thus, in Swiss Franc terms the S&P 500 is up only by 0.13%, and it is down in British Pound terms by 0.23% and by 0.17% in Japanese Yen terms.

Unconventional Measures: Bernankeism and the Destruction of the Dollar

Robert Blumen, E-mail: robert@RobertBlumen.com.

This article was originally given as a talk at the *Burton S. Blumert conference on Gold, Freedom, and Peace*, a benefit for LewRockwell.com.

In 2002, then-Fed Governor Benjamin Bernanke burst into our monetary consciousness with his printing press speech. His fine work earned him the honorary title "helicopter commander". While largely a background figure since then, his recent appointment to succeed Alan Greenspan as Fed chair makes this an ideal time to review Dr. Bernanke's views on monetary policy, and to speculate about what his chairmanship will bring.

Since the Fed emerged from its near-death experience in the 1970s, it has largely — and misleadingly — been identified with the label "inflation fighting". Against this backdrop, it is notable that Dr. Bernanke's research and speaking have dealt predominantly with the subject of deflation.

While his infamous address before the National Economists Club, titled "Deflation: Making Sure 'It' Doesn't Happen Here" (2002), has been endlessly reported and debated, more revealing and less well known are Dr. Bernanke's many speeches on deflation between 1999 and 2004, and a series of research papers on the same subject produced by the then-Fed governor and a number of his colleagues.

I have identified 14 papers and speeches dealing with deflation (see the references section), seven by Dr. Bernanke and seven by other Fed governors and staff economists. These materials are all available for public download on the Fed's website. To steal a line from columnist Dave Barry, "I'm not making this up."

A review of the most important points from these sources outlines a consistent point of view on deflation. While Governor Bernanke is not the only member of the anti-deflation wing at the Fed, the chair-in-waiting has emerged as the most prominent advocate of this new agenda. His leadership merits the name "Bernankeism" for this policy program.

Upon reading the source materials, three main tenets of Bernankeism emerge. I will describe them and illustrate with examples in the Fed's own words. The three are: prevention is better than cure, learn the lessons of history, and the possibility of "unconventional measures".

PREVENTION IS BETTER THAN A CURE

The first principle of Bernankeism is that it is better to prevent deflation than to attempt a cure after the disease has set in.

The basis of the Bernanke school's thinking on deflation is the standard (mainstream) macroeconomic view that consumer spending (not saving) drives economic activity, and that insufficient consumer spending is the cause of recessions. According to this view, when recession strikes, inflation is called for.

Inflation works in three ways. One, by lowering real prices when nominal prices are for some reason "stuck" at above-market-clearing levels; and two, by threatening a continued erosion in the purchasing power of cash, inflation motivates anti-social cash hoarders to spend, thus providing the missing stimulant to economic activity. A third is through so-called "wealth effects": when asset prices inflate, people misperceive the inflation as true wealth and then increase their spending.

Deflation is so dangerous, according to Dr. Bernanke, because it is a self-reinforcing process that is very difficult to reverse once it has begun. They start from the true observation that when people spend less, prices fall. They then reason that when prices fall, people become increasingly reluctant to spend (and businesses to invest) because they anticipate that prices will continue to fall. People start to hoard cash, planning to buy tomorrow when things are cheaper. The less people spend, the more prices fall, and the more that people hoard. In the grip of cash hoarding, according to Bernankeism, the entire economy would spiral down, as all spending ground to a halt.

For an example of this view, I will cite the research paper titled "Monetary Policy and Price Stability" (1999) (by Fed research staffers):

> If economic activity is weak or contracting and interest rates hit the zero bound, a dangerous dynamic can be set in motion. Falling inflation, or even escalating deflation, would increase real rates of interest. As this depresses aggregate demand further, downward pressures on prices would raise real interest rates further: The economy would potentially face a downward deflationary spiral.

Governor Bernanke and his accomplices are obsessed with something known as "the zero bound problem". Eight of the 14 papers and speeches that I examined deal with this problem either as their main point or in passing.

The zero bound comes about as follows. The Fed commissars concern themselves largely with controlling a single rate of interest, the Fed Funds rate. This rate can be lowered only to near zero, but not to zero or below, because no one would buy a bond that had a zero or negative yield; they would hold cash instead. This poses a problem for the central banker determined to inflate: if the Fed

Funds rate hit zero (or near-zero, as it did with Japan), inflation cannot be accelerated by cutting the Fed Funds rate. In these circumstances, the Fed's inflation program would be frustrated.

For this reason, Bernankeism advises the central bank to avoid the zero bound problem by creating a constant state of pleasant and benign inflation of around 2–3%. This will keep the economy a safe distance away from the dangerous precipice beyond which lies deflation, and gives the Fed room to cut rates.

For an example of their thinking, I cite a speech titled "An Unwelcome Fall in Inflation" (2003). Dr. Bernanke states:

> I hope we can agree that a substantial fall in inflation at this stage has the potential to interfere with the ongoing U.S. recovery, and that in conceivable — though remote — circumstances, a serious deflation could do significant economic harm. Thus, avoiding a further substantial fall in inflation should be a priority of monetary policy. To my mind, the central import of the May 6 statement is that the Fed stands ready and able to resist further declines in inflation; and — if inflation does fall further — to ensure that the decline does not impede the recovery in output and employment.

LESSONS LEARNED FROM HISTORY

The second principle of Bernankeism is that central bankers must heed the lessons of history. According to the papers and speeches, the Fed's fear of deflation is based on the two great 20th-century failures of central banks to inflate: America's Great Depression and the Case of Japan in the 1990s.

Dr. Bernanke accepts Milton Friedman's theory of the Great Depression. In the Freidman view, a contraction of the money supply brought about by loan defaults and then bank failures turned what would have been an ordinary recession into the Great Depression. This catastrophe could have been avoided had the Fed *inflated sufficiently*. The Friedmanites depict a Federal Reserve System ideologically paralysed by the so-called liquidationists.

A recent front-page story in *The Wall Street Journal* delved further into the pending chairman's views on the Depression.

> For decades, many economists and policy makers thought the Depression was the inevitable consequence of excess investment, flawed corporate governance and speculation in the 1920s, culminating in the 1929 stock-market crash. That view was reinforced by John Kenneth Galbraith's 1955 book *The Great Crash, 1929*.
>
> Milton Friedman and Anna Jacobson Schwartz upended that view in 1963. In *A Monetary History of the United States, 1867–1960*, they argued that the Depression was far from inevitable, but brought about by an "inept" Federal Reserve. First, they said, the Fed foolishly raised interest rates in 1928 to end speculation on Wall Street, causing a recession the next year that precipitated the crash. Then, it let thousands of banks fail and the money supply shrink. In part, it thought weak banks should be allowed to fail. It also feared that lower interest rates might lead foreigners to dump dollars, straining the currency's link to gold.

Our next Fed chair, in a speech given in honour of Milton Friedman (2002), expressed contrition on behalf of central bankers everywhere in saying, "I would like to say to Milton and Rose: Regarding the Great Depression. You're right, we [the Fed] did it [caused the Depression]. We're very sorry. But thanks to you [Friedman], we won't do it again." The Fed has learned its lesson.

The Depression has also shown that central banks should adopt an "asymmetrical" attitude toward asset bubbles. Smile on the way up, and then, try to reinflate them on the way down. From the same *WSJ* article.

> … addressing the Fed's Jackson Hole, Wyo., conference in 1999, Mr. Bernanke and Mr. Gertler said the Fed should raise rates if rising asset prices fuel inflation, but not to prick a bubble. "A bubble, once pricked, can easily degenerate into a panic," they said. When the bubble eventually collapses on its own, the Fed should cut interest rates to limit the damage to the financial system and the broad economy.

and:

> The Depression, he contends, has taught the importance of avoiding both deflation — that is, generally falling prices — and inflation. It has also shown the threat that falling asset prices — such as, potentially, in housing — and weakened banks can pose. Most important, it shows the damage the Fed can do when it follows wrong-headed ideas.

The failure of Japan's central bank to inflate its economy out of the mess following the bursting of the 1980s' stock and real estate bubbles comes in a close second to the Depression in the Bernanke manual for deflation fighters. Four of the 14 Fed speeches deal mostly or entirely with Japan's attempt to inflate its way out of a series of recessions that followed their bust. Despite successive Keynesian-stimulus public-works programs (that have nearly paved the entire island of Japan into a parking lot), several years of a near-zero short-term interest rate, and a massive program of foreign exchange intervention that has left the BOJ holding hundreds of billions of dollars worth of US Treasuries, the BOJ has been unable to generate much inflation at all.

To cite one of many examples, in a speech titled "Preventing Deflation: Lessons from Japan's Experience in the 1990s" (2002) (a paper by four Fed staff economists) we read:

> We conclude that Japan's sustained deflationary slump was very much unanticipated by Japanese policymakers and

observers alike, and that this was a key factor in the authorities' failure to provide sufficient stimulus to maintain growth and positive inflation. Once inflation turned negative and short-term interest rates approached the zero-lower-bound, it became much more difficult for monetary policy to reactivate the economy.

UNCONVENTIONAL MEASURES?

The term "conventional measures" figures prominently in much of the Fed's discussion. "Conventional measures" is a term from the central banker's dictionary. These measures consist of essentially two things: controlling the short-term Fed Funds rate, and purchase and sale by the Fed of government securities by its so-called Open Market Committee.

The lesson of Japan, according to Bernankeism, is that when the powers of a central bank are limited to "conventional measures", the central bank may not be able to prevent deflation, nor to fight it once it has taken hold. In the Fed's view, Japan *tried* conventional inflation measures to their utmost. However, because the deflation caught them by surprise or perhaps due to the inherent limitations of conventional measures, the BOJ's efforts were too little, too late.

The third principle of Bernankeism is the necessity of "unconventional measures". Inflation is always the answer (according to these thinkers), but they are afraid that it may be nearly impossible to bring it about when they most need it. Suppose that the Fed found itself fighting a stubborn deflation. If conventional measures had been tried and failed, and with the US on the brink of following Japan down the road to a long and painful deflationary morass, what would be the alternative?

I quote Dr. Bernanke himself from a paper titled "Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment" (2004). When the economy is at the zero bound, "a central bank can no longer stimulate aggregate demand by further interest-rate reductions and must rely on 'non-standard' policy alternatives." What does he mean by "non-standard"? This is what passes for "thinking outside of the box" among central bankers.

The reader of the Fed's papers and speeches will find a series of increasingly exotic plans for the dollar. From beginning to end, these methods range from the merely unsound to the bizarre and terrifying.

The paper titled "Monetary Policy and Price Stability" (1999) introduces some of the more mild of the so-called alternatives. The first of these tools is to expand the menu of assets that the Fed could purchase through its open market operations. The Fed's current structure limits its activities to the purchase of short-term US Treasury bonds. When the Fed can no longer lower short-term interest rates, long-term rates are the next obvious target. Among their options for lowering long bond yields are: the purchase of long-term US Treasury bonds, writing interest rate option contracts, purchasing foreign exchange reserves (in an attempt to lower the exchange rate of the dollar), and purchasing private-sector securities such as stocks and bonds. The measures described in this paper would involve massive Fed intervention in US financial markets.

If the above methods were not sufficient to "stimulate aggregate demand", the Fed could loan money into existence, accepting as collateral almost any private-sector asset whatever. In the paper titled "Monetary Policy and Price Stability", we find:

> A central bank can also attempt to spur private aggregate demand by extending loans to depositories, other financial intermediaries, or firms and households. By making the loan, the central bank turns an asset that may be illiquid for the lender into a liquid asset. This may be particularly helpful in spurring aggregate demand should the financial sector be under stress and in need of liquefying its assets.
>
> In the United States, the Federal Reserve currently lends only to depository institutions. But in contrast to the limited type of securities the Federal Reserve can purchase, it can accept as the security for a loan virtually any security that the Federal Reserve Banks themselves deem acceptable. And in fact, the Federal Reserve accepts mortgages covering one- to four-family residences; state and local government securities; and business, consumer, and other notes. These notes can be open market securities such as corporate bonds and commercial paper or can be commercial and industrial loans extended by banks, for example.

The measures described so far rely on loaning money into existence in order to generate inflation. This channel depends on the willingness of borrowers to borrow the cheap money that the Fed prints. But what if borrowers won't borrow? Don't worry, say the Bernankeists, we will print the money and distribute it.

From the paper titled "Monetary Policy When the Nominal Short-Term Interest Rate is Zero" (2005), in a section with the ludicrous title "Wealth Creation", we find:

> In ordinary circumstances, monetary policy exerts its stimulative impact in part through increasing the financial wealth of the public — such as producing capital gains in bond and equity markets. If, at the zero bound, the Federal Reserve had already taken what actions it could to raise bond and equity prices, it might look to other tools it has to increase the public's wealth. One tool commonly attributed to the Federal Reserve, at least in theory if not by the Federal Reserve Act, is that of conducting "money rains".
>
> Money rains are a clean way to study theoretically the effects of increases in the supply of money. In practice, it seems a bit difficult to envision how the Federal Reserve could literally implement a money rain — that is, give money away either through

directly disbursing currency to the public or by disbursing it through the banking system. The political difficulties that are likely to arise from the Federal Reserve determining the distribution of this new wealth would be daunting.

The above plan aims to decrease the value of each dollar by increasing the quantity in circulation. But what if the Fed prints but people are unwilling to spend? The next weapon in their arsenal is to make money pay a negative rate of interest. While that sounds difficult, in the paper titled "Monetary Policy in a Zero-Interest-Rate Economy" (2003), two Fed economists explain how:

> No one would be willing to hold any asset that pays a negative nominal rate, as long as zero-interest money is available as a store of value. The strategy for eliminating the zero bound, therefore, is to make money pay a negative nominal interest rate, by imposing some type of "carry tax" on currency and deposits.
>
> It's easy to envision such a system with regard to deposits at the Federal Reserve or transactions deposits at banks; for the most part, the technology to implement such a system is already in place. A tax or fee on Reserve deposits of 1 percent per month, for example, would mean that those deposits, in effect, pay a nominal interest rate of roughly minus 12 percent.
>
> The technological difficulty lies mainly in imposing such a tax on currency. In the 1930s, Irving Fisher of Yale University, one of the greatest [sic] American economists, proposed such a system, in which currency had to be periodically "stamped", for a fee, in order to retain its status as legal tender. The stamp fee could be calibrated to generate any negative nominal interest rate that the central bank desired.

If "aggregate demand" has not been sufficiently stimulated by the above measures, the Bernanke Fed stands ready to play its final card: the direct monetisation of goods and services. From the same paper, under the heading "The Goods and Services Solution", we read:

> Why not have the Fed just conduct an open market purchase of real goods and services? Even more so than exchange rate intervention, this strategy would represent a direct stimulus to aggregate demand.
>
> As posed, though, the strategy has a major drawback: it violates the Federal Reserve Act. The Fed isn't authorized to purchase goods and services, apart from those needed for the operation of the Federal Reserve System.
>
> The strategy can be implemented, however, by coordination with fiscal policy-makers. The Federal government, for example, could purchase goods and services and finance the purchase with new debt, which the Fed in turn would buy — in technical terminology, the Fed would "monetize" the resulting debt.
>
> By coordinating with fiscal policy, the Fed could even implement what is essentially the classic textbook policy of dropping freshly printed money from a helicopter.

The *Financial Times* of March 25, 2002 ran an article titled "Fed Considered Emergency Measures to Save Economy". The paper reported:

> The US Federal Reserve in January considered a variety of "unconventional" emergency measures to be taken if cutting short-term interest rates failed to arrest a US recession and prevent Japanese-style deflation. One of those steps may have been a plan to buy US stocks.

According to the reporter, an unnamed source was quoted as follows:

> the Fed "could theoretically buy anything to pump money into the system" including "state and local debt, real estate and gold mines — any asset".

These "unconventional measures" all have two things in common: one, that they are more inflationary than the conventional central bank policies; two, that they are among the most absurd, bizarre, and preposterous monetary crank schemes ever proposed by anyone calling themselves an economist. Not to mention that some of these plans are illegal (according to existing Fed regulations), though who doubts that, in a crisis, this would be ignored?

BERNANKEISM: FRAUD OR MENACE?

Setting aside the legal and technical issues, another question remains: Do they really mean it? Or is this just a lot of musings by academic economists with time on their hands? Too many boys with toys? Is Bernankeism a serious plan? Or is it an orchestrated propaganda campaign?

In attempting to answer that question, we must not forget that everything the Fed says must be looked at as propaganda. In the realm of media relations there is surely nobody on the planet whose utterances are more scrutinised than the Fed. The mere possibility of the removal of the word "measured" from the statements accompanying recent rate increases has spawned an entire body of analysis and commentary. A Google search on "removal of the word measured" yields over 500 hits.

The Fed is well aware of this and it can only be assumed that calculation plays a large part in their artifice. Every statement by a Fed governor is without doubt carefully crafted and vetted as a part of its overall message. The Fed's management of the media, dubbed by some the "Open-Mouth Committee", is a key part of the manipulation of public opinion that preserves the Fed mystique.

Even the Fed itself is not secretive about their use of opinion management. One of Bernanke's papers, "Monetary Policy

Alternatives at the Zero Bound: An Empirical Assessment" enumerates "using communications policies to shape public expectations about the future course of interest rates" as one of the three main types of non-standard policies. And in "Central Bank Talk and Monetary Policy", we read:

> Although effective communication by the central bank is always important, it becomes especially important when the rates are near zero. Indeed, when the proximity of the zero bound prevents further rate cuts to stimulate the economy, talking about future policy actions may be one of the few tools at the central bank's disposal by which to influence conditions in financial markets.

Austrian economist Professor Joseph Salerno has identified modern macroeconomics as a "fiat profession", a manufactured discipline whose purpose is to legitimise inflation among academics, and whose development has been funded by the centralised national states that wish to use inflation as a means of funding their profligate spending. Seventy years after Keynes, macroeconomic inflationism has become so entrenched in the economics profession that it has formed the basis for the education of all university-trained economists.

When false ideologies have been sufficiently entrenched, propaganda no longer depends on deliberate lies. Sincerely held beliefs by properly trained experts are sufficient. Dr. Bernanke is most probably a true believer. Unlike Alan Greenspan, who got his start as a forecaster and consultant before becoming a government employee, Dr. Bernanke is a leading figure in the fiat macro profession, and his eminence in this academic field pre-dates his appointment to the Fed.

I have no doubt that the authors of the Fed studies would like to implement their plans, if the conditions played out the way that their theories describe. But how likely is it that the United States will see a long cash-building deflation, slowly falling consumer prices, and nominal interest rates near zero? Not very!

A few Austrian School economists and assorted contrary thinkers (no doubt many readers of this publication among them) recognise that the Greenspan reign has been one of rampant inflation. That this has escaped notice is only because the Greenspan-era inflation has produced asset bubbles, rather than rising consumer prices.

As we reach the end game of the Greenspan era, it has become difficult to find an asset that is not over-priced. Even at the time of the 2002 deflation scare, the housing bubble was well under way. A recent five-part series in the *Wall Street Journal* titled "Awash in Cash: Cheap Money, Growing Risks" documents the inflation of nearly all asset classes around the world, from the erosion of risk premiums in stocks and bonds to the explosion in price of timberland. Dr. Faber wrote at the beginning of last year that, for the period 2003–2004, "the reflationary policies of Mr. Greenspan have managed to boost all asset classes, including stocks, bonds, real estate, the art market, and commodities", a trend that continued throughout most of 2005.

Value managers are finding that there are no values to be found. In two recent *Barron's* articles profiling renowned value managers, Charles de Vaulx (heir to Jean-Marie Eveillard at First Eagle) and Irving Kahn respectively called attention to the lack of real value in US markets. Quoting de Vaulx:

> Five years ago, the beauty was we had a bifurcated, two-tier market with very expensive growth stocks and tech stocks on the one hand and quite a few cheap small and mid-cap value stocks on the other. That gap has disappeared, so everything looks quite expensive in the U.S.

Worldwide overpriced assets is the result of the asymmetric policies towards asset bubbles espoused by Bernanke and Greenspan. While academic macroeconomists and central bank researchers conduct a heated debate about whether the central banks should prick bubbles or just let them run out of steam on their own, the question of their origin is politely ignored or passed off to a pathology of investor behaviour.

The inconvenient fact is that bubbles do not "just happen", nor are they an outgrowth of "irrational exuberance". In a market for credit that reflects the true scarcity of real funding, an investment boom that increased demand for credit — in reality, a demand for scarce real resources — would drive up interest rates. It is only because the central banks maintain a supply of credit at a fixed interest rate that the market's mechanism for stopping asset price bubbles before they start is defeated.

Without the natural rise in interest rates due to the scarcity of savings, increasing demand for credit can be accommodated while interest rates remain low, as long as the credit is channelled into asset markets. Asset bubbles are inflation by another name. Ignoring the inflation that created the preconditions for deflation is a rationalisation for a permanent state of inflation.

Assets are only of value to the extent that they facilitate the production of final goods. From an Austrian School perspective, the economic problem resulting from two decades of asset price inflation is that the *relative* prices of financial assets, compared to final goods, are far out of line with the real cost of capital.

The real cost of capital must be seen not in terms of bond yields, but in terms of the scarcity of the means of funding investment projects via the sacrifice of possible consumption opportunities. In the absence of the interest rate price fixing practised by central bankers, in a fully privatised banking system this cost would be accurately reflected by interest rates. Credit expansion can, for a time, create the illusion that there is more real funding available for investment projects than actually exists, and a corresponding overvaluation of capital assets.

However, while liquidity pumping can push up asset prices, it does not create any more real savings. One way or another, the relative prices of assets representing claims on future production, expressed in terms of ratios to the prices of final goods, must be realigned to reflect actual scarcities. That is, asset prices must fall in relation to consumption goods.

There are two paths that will lead to this result: one, a crash of cascading debt defaults that would take down stocks, housing, and surely result in a systemic crisis for the US banking system; the other: an accelerating consumer price inflation (or even hyperinflation), in which the prices of end goods catch up with the elevated prices of financial assets.

Note that I do not include a "soft landing" scenario, consisting of a gradual deflation of the asset bubbles with moderate inflation and economic growth that over a period of time will accomplish the needed realignment. Once bubbles stop inflating, they must lose air because a bubble is a configuration of relative prices that is not consistent with real scarcities, and the tendency of market forces is always to correct this type of discrepancy. Bubbles must inflate, or collapse. As the Austrian economist von Mises wrote:

> There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.

While neither path is particularly appealing, the Bernankeists at the Fed are aware that they must inflate or die. In spite of protests to the contrary, no one knows the score better than Alan himself, who has staved off the collapse several times during his tenure by flooding the markets with liquidity when the system threatened to unravel. Greenspan's admission of the possibility of a financial collapse was first revealed by Lawrence Parks in his book, *What Does Alan Greenspan Really Think?* Greenspan's knowledge is also proved by the release, after the five-year sliding wall, of late 1990s' Fed meeting minutes. FOMC transcripts from the 1996 meetings show that, contrary to Greenspan's statements at the time to the effect that a bubble cannot be identified until it has burst, the Greenspan Fed *was* aware that the stock market was in a bubble.

What is the rationale for the choice of hyperinflation over deflation? Does Bernanke believe that he can engineer a soft landing? Or do they truly believe that deflation is more harmful than inflation? Some of the papers cited above suggest that the Fed economists suffer from the belief that rising asset prices represents the creation of real wealth.

From this false premise, the false conclusion follows that asset deflation is wealth destruction. The idea that asset bubbles are beneficial because the corresponding wealth effects increase consumption implies that collapsing bubbles are harmful because they drive the wealth effect in reverse.

Thinking as they do that asset *deflation* is the problem and must be prevented at all costs, it is evident that when conventional measures no longer work, the central bank must be ready to print money and buy the assets. This process may have already begun. There has already been speculation that anomalously large bond purchases from Caribbean sources that have shown up in this year's flow of funds data from the Fed are a cover for Fed purchases of Treasury debt.

From an Austrian point of view, a deflationary correction is a healthy process, bringing markets back in line with economic reality and enabling production to proceed more in line with the actual scarcity of funding. Many economists of the Austrian School would side with economist Friedrich Hayek on this point, who wrote:

> It is, however, rather doubtful whether, from a long-term point of view, deflation is really more harmful than inflation. Indeed, there is a sense in which inflation is infinitely more dangerous and needs to be more carefully guarded against. Of the two errors, it is the one much more likely to be committed. The reason for this is that moderate inflation is generally pleasant while it proceeds, whereas deflation is immediately and acutely painful.... The difference between inflation and deflation is that, with the former, the pleasant surprise comes first and the reaction later, while, with the latter, the first effect on business is depressing. There is little need to take precautions against any practice the bad effects of which will be immediately and strongly felt; but there is need for precautions wherever action which is immediately pleasant or relieves temporary difficulties involves much greater harm that will be felt only later.... It is particularly dangerous because the harmful aftereffects of even small doses of inflation can be staved off only by larger doses of inflation. Once it has continued for some time, even the prevention of further acceleration will create a situation in which it will be very difficult to avoid a spontaneous deflation.... Because inflation is psychologically and politically so much more difficult to prevent than deflation and because it is, at the same time, technically so much more easily prevented, the economist should always stress the dangers of inflation. (Hayek, *The Constitution of Liberty*, pp. 330–333, cited by Joseph Salerno, *Quarterly Journal of Austrian Economics*, vol 6, no. 4)

Bernanke faces a precipice: he is worried about the aftermath of multiple bubbles, but the relevant comparison is to Argentina, not Japan. He is worried about deflation, but the problem is multiple collapsing asset bubbles, not slowly falling prices of goods and services. The Fed stands ready to monetise anything and

everything, yet they cannot openly state that they are playing this game without risking a run on the dollar and a collapsing bond market. Bernankeism represents the final stand of central banking against the forces of economic reality.

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BULLISH ABOUT EVERYTHING

I regard the current investment scene as most unusual, in the sense that everybody is very positive about one or another asset class. Equity fund managers around the world are positive about equities in both the developed economies and in emerging markets, while commodity traders are positive about commodities, gold bugs about precious metals, property developers about real estate prices, art aficionados about art prices and collectibles, and bond investors about bond yields declining further. This universal bullishness about all asset classes is uncommon. If we look at the 1970s, investors were, by and large, positive about the energy and mining sector, but cautious about equities, and negative about bonds and the US dollar. Then, in the 1980s, shortly before the 1987 crash, investors turned very positive about equities, but remained cautious about bonds and had given up on Latin America. After the 1987 crash, the investment community focused largely on Japan and the Asian emerging markets and remained very cautious about the US, with the result that, by 1990, many financial institutions had more money invested in Asia than in the US. Then, in the late 1990s, investors loved the TMT sector, while hardly anyone paid any attention to commodities. Asia, Russia, and "old economy" stocks and bonds were also shunned.

However, because of the fact that since October 2002 all asset classes have appreciated in value, and also because of the belief in the famous "Greenspan put" as well as the prospects of "Bernankeism", sentiment among investors is now universally positive about all assets appreciating further. So, as a sceptic and contrarian investor, I am deeply concerned about this "continuous asset inflation" consensus amidst a benign "consumer price inflation" scenario. For instance, as a casual observer, I am stunned by the boom that is going on in the Middle East and in the Middle Eastern stock markets. All the symptoms in Saudi Arabia, the United Arab Emirates, and Quatar point towards phase three of my emerging stock market cycle theory, during which markets make a major top before a huge collapse follows. But what will deflate the booming economic and financial conditions in the Middle East? A collapse in oil prices, or war?

What about the investment boom in China's real estate markets and the continuous enormous industrial capacity expansion? Is a collapse of the Chinese economy imminent?

In St. Moritz, where I spent my Christmas holidays, prices for luxury condominiums in the centre of the village have skyrocketed. (Lakshmi Mittal, India's richest man, bought a house about two years ago in a prestigious location.) A few years ago, nobody would have believed that prices for condominiums in the village centre would rise to between US$1,800 and US$3,000 per square foot, and that a beer at the Palace Hotel King's Club would cost US$28! As my friends at Gavekal Research pointed out in their excellent book *Our Brave New World* (www.gavekal.com), "being rich has never been so expensive and staying rich is going to get more exorbitant by the day". In New York, hotels are packed full and room rates have risen sharply over the last two years as several hotels have been converted to condominiums.

These boom conditions as reflected in the "rich people's" economy are certainly not associated with great buying opportunities for assets and, in fact, remind me of the conditions I saw in Japan in the late 1980s (before the asset crash of the 1990s) and in Asia before the 1997 crisis. In both cases, Japan and Asia, when the boom came to an end, the most leveraged players (mostly the rich, who had successfully capitalised on rising asset prices during the boom with high gearing) were the hardest hit.

As Robert Blumen pointed out above,

> … while liquidity pumping can push up asset prices, it does not create any more real savings. One way or another, the relative prices of assets representing claims on future production, expressed in terms of ratios to the prices of final goods, must be realigned to reflect actual scarcities. That is, asset prices must fall in relation to consumption goods.
>
> There are two paths that will lead to this result: one, a crash of cascading debt defaults that would take down stocks, housing, and surely result in a systemic crisis for the US banking system; the other: an accelerating consumer price inflation (or even hyperinflation), in which the prices of end goods catch up with the elevated prices of financial assets.

The deflationists, such as Robert Prechter and Gary Shilling — a minority, I might add — certainly have a point in believing that "a crash of cascading debt defaults" will "take down stocks, housing, and surely result in a systemic crisis for the US banking system", as Robert Blumen suggests as one possibility in order to bring down asset prices in relation to consumption goods. In his *Insight* report of November 2005, Gary Shilling (www.agaryshilling.com) argues that

> … history shows that the great disconnect between the real world and financial markets will be closed sooner or later, and probably violently. Housing prices will no doubt fall substantially nationwide, and that could destroy enough net worth to shift the good deflation of excess supply we foresee to the bad deflation of insufficient demand. And meaningful cracks in house prices will end U.S. consumers' quarter-century borrowing-and-spending binge and launch a saving spree…. A major global recession, or worse, could well result as Americans no longer buy the world's excess goods and services and export-led countries in Asia and Europe suffer. In these circumstances, stocks could probably fall well below the 2002 lows.

As an aside, Gary Shilling's November 2005 *Insight* report is recommended reading, as Gary deals there with "Greenspan's Legacy". Having personally known Alan Greenspan for 35 years, Gary offers an excellent review of the Fed chairman's achievements. He concludes that,

> … declining inflation made his tenure easy. He didn't aggravate anyone by stopping speculation. Indeed, by bailing out speculators, creating confidence in his leadership and trust that the Fed really is in control of financial markets, he encouraged speculators to take even bigger risks…. Greenspan appears to be a flesh and blood human being who was extremely lucky with timing [due to the disinflationary forces, notably declining commodity prices and the entry of China into the global economy, that accompanied his tenure as Fed chairman — *ed. note*]. The prospective next Fed Chairman, Ben Bernanke, is also a mere mortal, but will not inherit such fortunate circumstances. Indeed, Greenspan's legacy will no doubt force him to deal with some very difficult problems.

Our regular readers will know that I am leaning towards the view that under "Bernankeism", the US will attempt to inflate its way out of any future problems that might arise from declining asset prices. But this doesn't mean that within a rising long-term trend for asset prices, meaningful short-term setbacks cannot occur. Grant Noble (gnoble@sbcglobal.net) recently commented on a speech by Timothy Geithner, president of the New York Fed, in which Geithner made some unusual comments. (The speech is available at www.newyorkfed.org/newsevents/speeches/2006/gei060111.html.) According to Noble, Geithner first spouted "the usual lying pap" on low-core inflation and why long rates are so low:

> Inflation excluding food and energy, however, has been quite moderate, in part due to very modest growth in unit labor costs…. Expectations of future inflation have fallen, and there appears to be confidence in continued stable, low inflation. Credit spreads and measures of future volatility derived from financial market data have fallen, suggesting that investors and savers expect the greater realized stability in growth is likely to endure. Real interest rates at longer horizons have remained relatively low, reflecting at least in part that the global supply of savings has increased relative to demand for investment.

But after this requisite "party line crap", Noble contends that Geithner went on to announce the end of the "Greenspan Put":

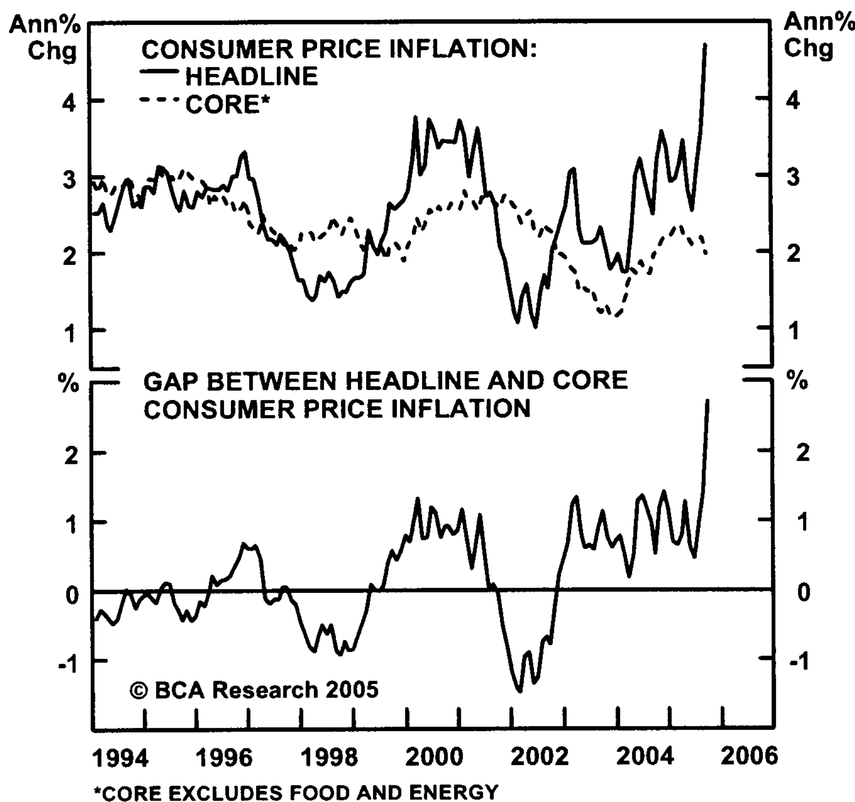
> That said, monetary policy still has to take into account the impact of significant movements in asset values on output and inflation. Financial asset prices, by their nature, allocate resources between the present and the future and thereby affect consumption, investment and future growth. History provides us with numerous examples in which significant movements in asset prices have had sizable effects on the path of output relative to potential and on price stability…. Of course central banks must always be prepared to respond when factors threaten to push aggregate demand away from aggregate supply and impact the inflation outlook. Movements in asset prices certainly have the potential to be one of those factors, and the implications of this approach apply in both directions. In other words, central banks have to be prepared to adjust policy when past asset price increases could be a significant factor putting upward pressure on aggregate demand, as well as when past declines threaten to reduce output relative to potential. Although the potential case for adjusting policy applies in both directions, the implications for policy may differ. Because some asset prices may fall more abruptly than they rise, and because the effects of downward moves in asset prices on demand may be larger due to the greater negative impact of deflation on the net worth of borrowers — witness the United States in the 1930s or Japan in the 1990s, **the case for adjusting monetary policy in response to negative asset price shocks is commonly considered more compelling than in the alternative context. But this does not mean that monetary policy should generally ignore the effects of increases and only respond to observed declines in asset prices. The test should be the size and circumstances of the asset price moves and their impact on the forecast relative to the central banks' objectives, not the direction of the asset price move** [emphasis added]…. Consider the case in which it seems prudent for the central bank to incorporate an assumption for a significant move in the rate of change in future asset prices into its forecasts for output and inflation. If the central bank's assumption is that asset prices are likely to fall over the forecast horizon, perhaps in the wake of a sustained rise in those prices, then it might in turn forecast a softer path for aggregate demand. These changes in the outlook might imply a lower expected path for the target rate than would have been implied by a different assumed path for the behavior of asset prices. If it turns out that the anticipated fall in asset prices does not materialize, the policy constructed under the assumption of a decline will likely have been too easy, and that might itself contribute to further rises in asset prices.

Grant Noble's interpretation is that Geithner is keen to defend the bond market and is not concerned about the stock market. Grant Noble:

> That means short rates are going higher whether you like it or not because the inflated stock market has helped spur inflation that will eventually kill bonds and further rev gold (the arch enemy of the paper currencies that we use to manipulate the world).

My interpretation of Timothy Geithner's speech, however, is slightly different. Yes, the Fed will continue to increase short-term interest rates in baby steps for as long as the housing market and the stock market rise. But, in my opinion, should the Dow no longer rise or decline by 300 points, the Fed will stop raising rates. Moreover, should the housing and share market decline by 5%, Fed fund rate cuts would almost inevitably follow. I am therefore of the view that, under Bernankeism, the adjustments Robert Blumen talked about will occur as a result of "an accelerating consumer price inflation (or even hyperinflation), in which the prices of end goods catch up with the elevated prices of financial assets". In this respect, it is interesting to note that, as *The Bank Credit Analyst* showed in its November 2005 issue, "the gap between headline and core consumer price inflation" is at its widest (see Figure 5). **The question is, of course, whether headline inflation (which includes energy and food prices) will decline again towards core inflation, or whether core inflation will eventually rise towards headline inflation.** Another question should be whether the concept of core inflation shouldn't be abandoned altogether, because the typical household's cost of living increases are not reflected by core inflation but headline inflation. (A pensioner in the UK recently sent an angry letter to the *Financial Times* complaining that the government's inflation figures were bogus, and showing that his cost-of-living expenses had risen by at least 10% over the past 12 months.)

Figure 5 **Headline and Core Consumer Price Inflation, 1994–2006**



Source: The Bank Credit Analyst

AN ATTEMPT TO DRAW SOME INVESTMENT CONCLUSIONS

If I look very simplistically at the world, the following observations spring to mind.

There are markets in the global economy that are glutted, while in other markets relative shortages are evident. There is plenty of sand in the desert and plenty of sea water in the sea. There is also plenty of paper money floating around, especially US dollars, and paper money's supply is limitless. Conversely, there are markets where relative shortages do exist. There is a limited supply of precious metals, oil, and other commodities. There is also a limited supply of caviar, truffles, and Park Avenue, Mayfair, and St. Moritz properties. Therefore, over time, it would seem to be logical that markets which are glutted and where the supply can be increased at discretion (paper money) will depreciate compared to markets where the supply is limited.

This isn't to say that markets where we find relative scarcities cannot decline in price. New inventions, political events, and shifting tastes can change the demand or even increase supplies. Moreover, central banks could reduce the supply of money, in which case the price of money will tend to appreciate against other commodities.

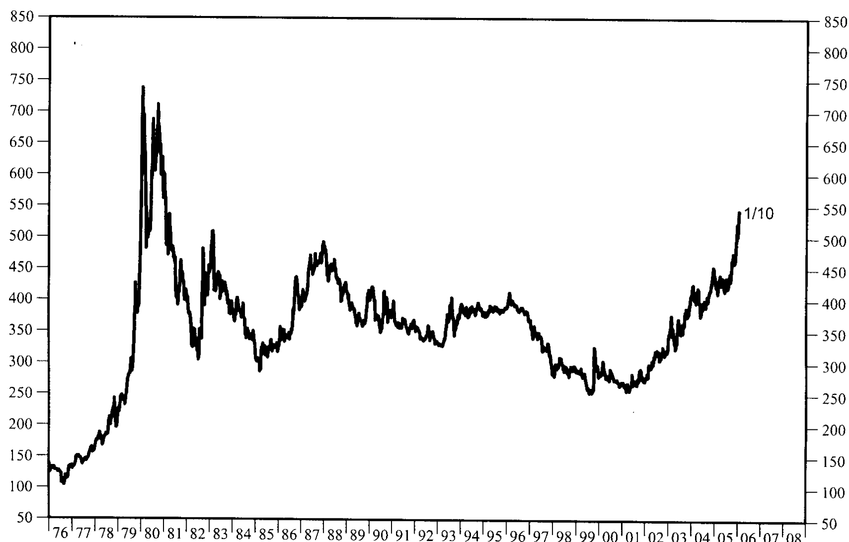
However, it should be evident that with asset prices being as elevated as they are at present, and with the debt level we have in the system, significant monetary tightening, as Paul Volcker undertook in 1979–1981, is simply out of the question — even if core inflation were to accelerate considerably. As Robert Blumen showed, Bernankeism will be very responsive to asset price declines. Moreover, extraordinary monetary measures in order to support asset markets are a distinct possibility. In addition, while Timothy Geithner, president of the New York Fed, could be considered a "hawk", it is obvious that he views "**the case for adjusting monetary policy in response to**

negative asset price shocks" to be "**more compelling than in the alternative context**" (the alternative context being rising asset prices). Simply put, the Fed will only very timidly address soaring asset prices, but it will flood the market with money should asset prices decline meaningfully. In this respect, it is important to understand that there will be a time when additional money printing will fail to stimulate consumer demand (declining real personal incomes as a result of headline inflation significantly exceeding wage increases for an extended period of time). **Heavy monetisation will then only lead to soaring asset prices in real terms whose supply is very limited.** Maybe the recent strong rise in the price of gold is an omen of things to come. (Since Mr. Bernanke was appointed Fed chairman in November 2005, its price has risen from US$470 to over US$550 — see Figure 6.)

A reader of this report, Pierre Vohl, kindly sent us two tables compiled by the *Contrary Investor* (www.ContraryInvestors.com) which show that monetary policy is gradually losing its effectiveness in terms of economic growth in the US (see Tables 1 and 2). However (and this is important for the outlook of industrial commodity prices, which are economic sensitive), strong US monetary and debt growth continues to stimulate demand in emerging economies, which could lead to still higher prices for oil and other industrial commodities whose supply is relatively limited.

I shall add one observation regarding the recent high total credit market debt and M3 increases. In the 1960s it would have been unthinkable that debt and money supply would ever increase at the present rate. Therefore, we cannot rule out that debt growth and money supply growth will accelerate in the future by far more than we now think to be possible.

Figure 6 **Gold Spot Price (dollars per ounce), 1976–2006**



Sources: www.yardeni.com; www.oakassociates.com

Table 1 **US GDP and Total Credit Market Debt (US$ billions)**

Decade	Increase in GDP	Increase in Total Credit Market Debt Outstanding	Dollars of Credit Market Debt Growth for Each New Dollar of GDP Growth
1950s	$ 161.9	$ 286.5	$ 1.77
1960s	491.4	752.2	1.53
1970s	1,655.9	2,791.4	1.69
1980s	2,923.8	8,544.1	2.92
1990s	3,935.2	12,379.0	3.15
2000s	3,081.5	13,623.5	4.42

Source: www.ContraryInvestor.com

Table 2 **US GDP and M3 (US$ billions)**

Decade	M3 Growth	Increase in GDP	Growth in M3 for Every Dollar of GDP Growth
1960s	$ 316.3	$ 491.4	$ 0.64
1970s	1,192.8	1,655.9	0.72
1980s	2,268.2	2,923.8	0.76
1990s	2,474.7	3,935.2	0.63
2000s	3,547.0	3,081.5	1.15

Source: www.ContraryInvestor.com

So, given the above-outlined monetary policy options and the current universal bullishness of investors about all asset prices increasing further in value, what should a contrarian investor do?

Should investors bet that asset prices will take a tumble in a bout of "bad deflation", as Gary Shilling and Robert Prechter suggest and, therefore, liquidate their stocks, properties, commodities, and art objects, and go into cash?

It is important here to focus on the most widely held of all beliefs —

the mother of all consensuses, which is that consumer price inflation will remain low and that interest rates won't rise significantly. That this is "**the consensus**" is evident from the low bond yields we find around the world.

So, the contrarian investor should first sell bonds here or on any rebound expecting consumer price inflation and interest rates to rise. On first sight, a rise in interest rates would not be favourable for asset markets and could lead to some weakness. But under Bernankeism, any weakness in asset prices would be addressed by the Fed — and presumably by other central banks around the world — with expansionary monetary policies. This would most likely stabilise asset markets and, in fact, would likely boost them further. But, under these circumstances, would asset markets rise in **real terms**? And what are "real terms" in the first place? Assuming the Dow Jones increases in a year by 10% while US inflation is 5%, the Dow would have risen in real terms by 5%. However, if in the same year the US dollar weakens against another important currency by 20%, by how much did the Dow appreciate in real terms? I suppose one could argue that, in this instance, the Dow would have lost 10% in real terms. What I am driving at is that in a world of monetary and credit expansion, it's not all that simple to measure real terms.

Possibly the best option would be to measure all price increases against the price of gold because of its relative scarcity. So, if the price of an asset increased at a faster rate than the price of gold, then we would have a "real" price increase; whereas if the price of an asset increased at a slower rate than the price of gold, we would have a decline in price in "real terms".

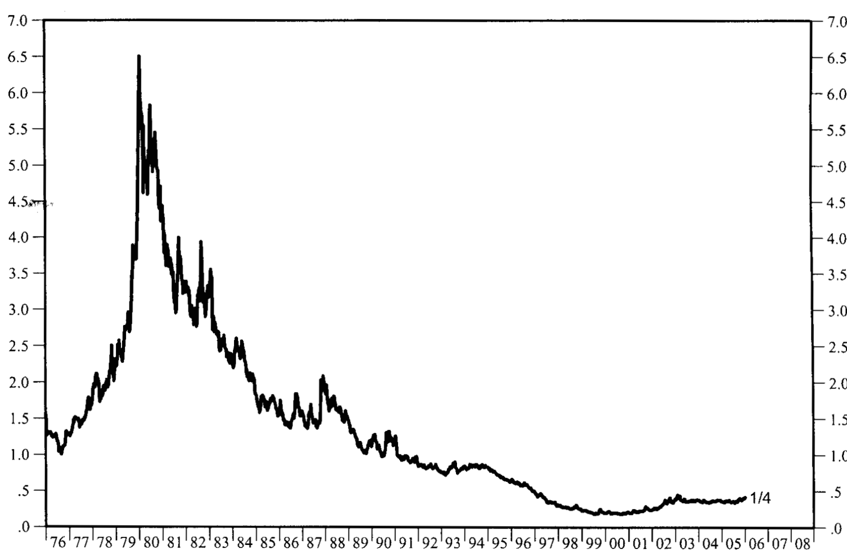
While not perfect, this methodology has several advantages. Measuring asset price movements against gold would show that between 1980 and 2000, financial assets performed superbly, as bond and equity prices rose rapidly while the gold price declined. Thereafter, however, financial assets such as equities, but especially cash and bonds, declined against gold — a trend I expect to continue under Bernankeism.

Moreover, measuring everything in gold terms would also, at some point, satisfy the deflationists who believe in a debt contraction. If the gold price soared to where I think it might go, in gold terms total credit market debt could indeed be reduced. And while Gary Shilling and Robert Prechter might be right in expecting stocks to sell off and take out the October 2002 low, it should be noted that in gold terms the Dow Jones has already declined below its 2002 low (see Figure 4).

In the end, investors anticipating more asset inflation could be right, as well as the contrarian who would now liquidate all his assets and move into cash. Under Bernankeism, all asset prices — except bonds — could continue to appreciate, but cash could do even better. However, I don't mean paper money cash, but cash in the world's hardest currency — gold. **In fact, I believe we are moving back towards a gold standard.** But not a gold standard introduced by some central bankers; rather, a gold standard created by the market. When in every country the public realise that the value of cash deposits and other financial assets have declined against the price of gold (gold prices rising), there will be recognition that only gold serves as a store of value followed by a universal rush to move out of cash into bullion. (In 2005, gold prices rose in every currency.) But at what price will this universal rush into bullion occur? If every man, woman, and child in the world were to move some of his cash into one gram of gold every year, it would equate to an annual demand of 6,000 tons, which would be two-and-a-half times the annual supply of about 2,500 tons. Therefore, the new market-induced gold standard will lead to sharply higher prices — in particular, against financial assets (see Figure 7). Therefore, **investors are advised to accumulate gold and other precious metals now or on any weakness**.

Based on the aforementioned, it would appear that from a risk-reward point of view, the US dollar and US bonds are the least attractive assets. Investors should focus on assets that are in relatively short supply, such as precious metals. **In fact, I would argue that a good long-term strategy that will never fail is to buy what central bankers are selling (gold below US$300, and up to the present day) and to sell what central bankers are accumulating (US dollars and US dollar bonds).**

Figure 7 **Gold Cash Price Relative to S&P 500, 1976–2006**



Source: Ed Yardeni, www.oakassociates.com

For investors who are required to own financial assets, I continue to recommend a significant overweight position in Asian high-dividend-paying stocks. A huge wealth transfer from the US to Asia is under way as a result of the US current account deficit, which is largely offset by current account surpluses in Asia. Consequently, we should expect Asian asset price increases to outperform US asset prices. This outperformance is likely to occur as a result of higher property and stock price increases in Asia than in the US, as well as through Asian currencies rising over time against the US dollar. A list of high-dividend-paying Asian stocks that (unlike bonds) would provide at least some hedge against a further depreciation of the purchasing power of paper money includes in **Malaysia:** Berjaya Sports Toto Berhad (BST MK), Fraser & Neave Berhad (FNH MK), SP Setia Berhad (SPSB MK), Malaysian Oxygen Berhad MOX MK), IOI Properties Berhad (IOIP MK); in **Vietnam:** Vinamilk; in **Singapore:** Singapore Press Holdings (SPH SP), SIA Engineering (SIE SP), Suntec REIT (SUN SP), Macquarie MEAG Prime REIT (MMP SP); and in **Thailand:** Rojana Industrial Park (ROJANA TB), Ticon Industrial Connection (TICON TB), Thai Reinsurance (TRE TB).

Due to the high yield of the Taiwanese and Malaysian stock markets compared to local bonds, we continue to like Taiwanese and Malaysian equities (EWT and EWM).

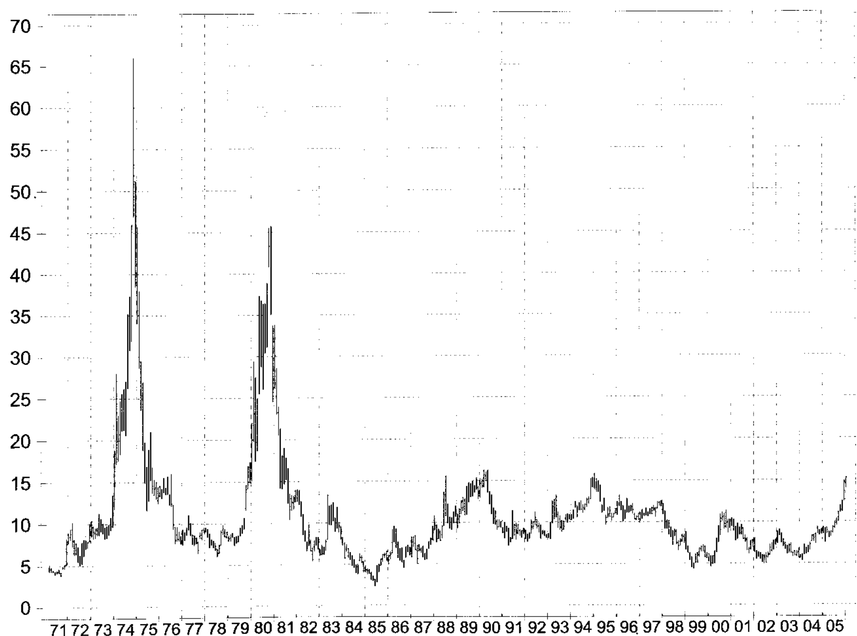
As mentioned in previous reports, I would maintain an overweight position in US pharmaceutical shares such as Pfizer (PFE), Merck (MRK), and Schering Plough (SGP).

Two years ago, I became interested in **sugar** and actually recommended its purchase on numerous occasions. Sugar moves seldom, but when it moves the amplitude of the move can be huge (see Figure 8). Purchases are recommended with tight stops.

Lastly, I have recommended the purchase of volatility on previous occasions. Last year the Volatility Index increased twice by more than 50% (see Figure 9). **I expect volatility to increase far more under the new Fed chairman — especially given the universal bullishness we are encountering at present.** Therefore, investors should look for opportunistic entry points in the VIX (see Figure 9).

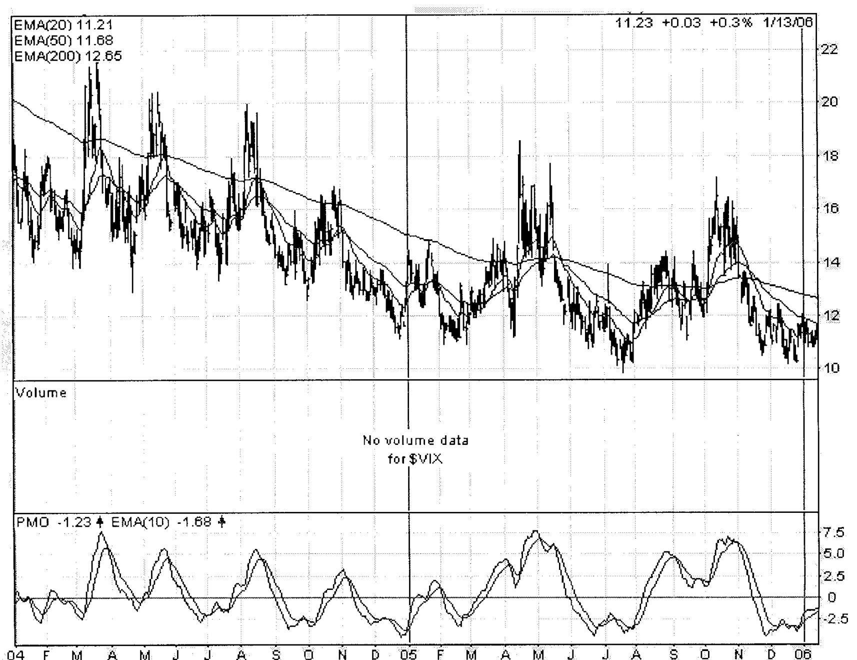
This report started with a quote from George Bernard Shaw: **"The surest way to ruin a man who doesn't know how to handle money is to give him some."** I would like to add to those words the following: **"The surest way to ruin a currency and a society is to have a central banker with the power to print money and to take extraordinary monetary measures."**

Figure 8 **Monthly Nearby Sugar #11 (NYBOT), 1971–2006**



Source: www.mrci.com, Moore Research Center, Inc.

Figure 9 **Volatility Index – New Methodology ($VIX), January 2004 – January 2006**



Source: www.decisionpoint.com

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Author & Publisher
DR MARC FABER

Research Editor & Subscription
LUCIE WANG

Copyeditor
ROBYN FLEMMING
E-mail: robynfle@bigpond.net.au

Subscriptions and enquiries
MARC FABER LTD
Unit 3311–3313, 33/F Two International Finance Centre, 8 Finance Street, Central, Hong Kong
Tel: (852) 2801 5410 / 2801 5411; Fax: (852) 2845 9192;
E-mail: markus_fab@pacific.net.hk; Website: www.gloomboomdoom.com

Design/Layout/Production
POLLY YU PRODUCTION LTD
Tel: (852) 2526 0206; Fax: (852) 2526 0378; E-mail: pollyu@netvigator.com