Pilgrim, Prepare Thyself

By The Mogambo Guru

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"Unsustainable," say economists.

"Bubble," say the sourpusses.

"Buy," say the lumpeninvestoriat.

The average investor cannot bear an opportunity to lose money. He looks at a bubble like a starving cannibal at a fat tourist. The rest of us look on, too, not knowing whether to be appalled or amused.

"Housing prices hit a record in July," reports the LA Times.

"House sales hit record in July," comes the news from Toronto's Globe & Mail.

"Shanghai property prices soar," says a source from China. Apartments rose 18% during the first 7 months of the year, with their sharpest increase in July, our source continues. In the best neighborhoods, the annual rate of increase is running at 172%.

Bu…bu…bu…bubble!?

The Dollar Standard has had its effect all over the world. The flood of dollars first blew up the bubble in Japan in the 1980s…and then bubbles in Thailand…and Malaysia in the early '90s…and then in the U.S. stock market in the late '90s…and now in real estate…and especially, Chinese real estate.

These events seemed almost unrelated at first. But now, the pattern is becoming more obvious. The Dollar Standard allows Americans to spend more than they can afford. Foreign nations, seeing their opportunity, hustle to get a piece of the action. Before long, they are selling more to the U.S. than they buy from her. They are left with dollars in their pockets. What can they do with them? Build more factories! Buy more stocks! Lend, borrow, spend!

The resulting boom attracts more and more capital from overseas and gathers momentum until it has turned into a bulging bubble…which, sooner or later, blows up.

Why don't the bubbles stop? Because the source of them is still gushing up more and more dollars. And now the world economy depends on them. China, for example, has gotten in the habit of selling to Americans…who pay in dollars…which it then uses to build more factories, pay more workers…and buy more U.S. Treasury bonds. And when this peculiar economic arrangement comes to an end, most of the world will go into a gloomy secular recession/depression – much like what Japan has been through over the last 13 years. No politician or central banker wants that to happen…so they fight it with everything they've got. And all they really have is – guess what? – more dollars. To a world suffering from too many dollars and too much credit, they come with more!

In the week of August 4th, the U.S. money supply, as measured by M3, went up by $50 billion dollars. We had to rub our eyes when we saw the figure – we could scarcely believe it. But there it was…more evidence that if the world economy does sink into deflation, it won't be for lack of effort on the Fed's part.

Which is not to say that the Fed will avoid deflation.

Inflation begets deflation, we remind you. By inflating the world economy with dollars, the Fed has created huge debt and huge capacity. Sooner or later, prices fall…for there is just so much stuff people can afford to buy.

The Fed, aided and abetted by the credit industry, tries to keep people buying with lower interest rates…and ever- looser credit policies (we read in the paper that interest- only mortgages are becoming common…and that the average automobile is financed for more than 4 years) but this too begets its own perverse reward. The debt bubble must deflate, just like all the rest of the Fed's bubbles. When interest rates rise – as they have begun to do – the burden of debt becomes heavier and consumers must cut back their spending and pay down their debt. Many people will not be able to pay their debts; they will default, causing further default and bankruptcies up and down the credit chain.

As we said, this pattern is now becoming unmistakable – even to economists. But inside this Devil's Brew is the wild and mysterious dollar itself. How long will people accept these pieces of paper as though they were real money? How far down will it go? What will happen to the world financial system when its reserve currency collapses?

If anyone knows, he is not working here at the worldwide headquarters of the Daily Reckoning.

Over to you, Eric…

Eric Fry, freshly returned from the Agora Wealth Symposium…

- The Dow added 130 points last week to 9,322, while the Nasdaq jumped 3.5% to 1,702. The gold price also continued its sparkling advance by gaining $6.90 to $363.80 an ounce. But woe is the bond market, as Treasury prices resumed their stunning two-month collapse and bond yields soared to fresh one-year highs – the 10-year Treasury note yield rocketed to 4.52% last Friday from 4.19% the prior Friday.

- Last week, while one half of the Daily Reckoning's Paris brain trust built sand castles in Brittany and the other half retreated to his castle in Ouzilly, the New York contingent eschewed such regal pastimes…opting instead to mingle with his fellow commoners in San Francisco. Together, the commoners convened at the Agora Wealth Symposium to study and debate how they might extract an extra sou or two from the grudging financial markets.

- In response to the all-important question: "Where is the stock market heading next?", a large percentage of those assembled responded, "Up." An equally large percentage answered, "Down." The remainder believed that the market would either go up first, then down…or down first, then up.

- Happily, very few of the symposium's speakers bothered with such fruitless financial Gnosticism, although some of them tossed out predictions just for the fun of it. The always-controversial Dan Denning, editor of Strategic Investment, predicted that the Dow would hit 7,825 – "Exactly," he joked – within the next six months.

- Dan also predicted the "end of the world as we know it"…timing uncertain. Dan admitted that he had provided a similarly apocalyptic forecast last year, and allowed that he might do so next year. In other words, his doom and gloom outlook is more a philosophical framework for investing than a Nostradamus-style prediction.

- Helpfully, Dan provided a series of trades by which to prosper from our imminent collective demise. He advocated bearish positions on long-dated Treasury bonds, as well as on various stock market sectors that are sensitive to rising interest rates – homebuilders and mortgage lenders being prominent examples.

- Dan suggested to the audience, as he has been suggesting to his readers, that they establish such positions via exchange-traded funds, a.k.a., ETFs. "For example," said Dan, "one way to play the upcoming collapse of the housing market would be to buy put options on the Housing Sector Index (HGX)."

- Denning also expressed a fondness for bearish positions on "IEF," which is the Lehman Brothers 7-10 year Treasury note fund.

- Denning concluded his remarks with his most titillating prediction: "Later this year, Hillary Clinton will declare her candidacy for President. She will run against George Bush and defeat him in the 2004 elections, after which 25% of the people who are sitting in this room will pack up their possessions and join Bill Bonner in France as exiles."

- Despite his flair for the bizarre – like wearing a green sarong in Paris – Dan Denning is actually a very reasonable fellow. One evening, over a glass of wine (Dan's third, your New York editor's first) in the elegant lobby of the Fairmont Hotel, Dan volunteered, "You know what would help people to become much more intelligent investors?…If they imagined that they were on the hook personally for a company's losses, and not just in line to share in its prosperity."

- "Hmmm…nice idea," came the response.

- "I just got this idea," Dan continued, "by reading Robert J. Shiller's book, 'The New Financial Order.' Here, take a look at this passage about the origins of limited liability companies in America." Writes Shiller: "Before the passage of this law, investors could in principle lose their homes, life savings, and everything else, and even conceivably end up in debtors' prison, simply by owning a few shares in a company that later fails."

- "Wow, you're right about this, Dan," said your New York editor. "If all investors were to adopt this mindset, the stock market would be a very different place…So let's bring back debtors' prisons and restore order in the stock market. What do you say?"

- "I'm in!" said Dan.

Bill Bonner, back in Ouzilly…

*** We are on vacation.

We have gathered the family here in rural France and are enjoying life. At least, that was the idea. It was why we bought the place. Each summer, we said to ourselves, we would follow the French example. We would take the month of August off…and invite all the family to come and stay. Then, we imagined the happy sun-lit days…gaily scraping the paint off rusty shutters or collecting green beans from the garden…and the long evening meals…outside on trestle tables…with all the family in one place…and plenty of red wine.

What is the point of it, otherwise? Why bother with all this 'getting and spending' if you have no time left to spend time with the people that matter to you most?

And so they came…all six children…mother-in- laws…nieces…nephews…brothers and sisters…friends…friends of friends…and a few people of whom no one seemed able to identify the provenance. And the children brought their boyfriends…and girlfriends…who then had friends…and relatives of their own..

Oh…it was almost too glorious…

But this year, the weather turned vile. The temperature rose to nearly 40 degrees centigrade…which was over 100. Every day, we closed all the windows, and shutters, and curtains, trying to keep out the hot midday air. There, in the dark, the parents lay about as though they had come down with consumption and been sent to the tropics for a cure. The children didn't know quite what to do with themselves. They would have normally gone down to the pond to catch frogs…or played badminton or croquet on the lawn…or taken a ride on the bicycles. But it was too hot, so they stayed indoors and played board games, or chess, or just got on everyone's nerves…

And there was Donovan in the kitchen. He too came as the friend of a friend, and showed himself particularly at ease in the kitchen…and so he was hired to help keep this vast menagerie fed. Donovan is Swiss (his parents were fond of a certain Anglo-Irish balladeer in the ’60s). He speaks a few words of English. But French is his mother tongue. And there he was, sweat dripping from his nose…a cigarette in his mouth…ashes and perspiration falling into the soup…children running about underfoot…and finally Donovan seemed to lose his temper. He had been trying to listen to Verdi on the radio, but Henry was strumming a guitar…Annabelle was chattering to no one in particular…and Edward seemed to be doing skateboard stunts next to the porcelaine de Limoges.

All of this activity in the kitchen just seemed like too much for him. He is an artist, after all. He picked up a meat cleaver and began cleaving it in the children’s direction. They had noticed this tendency towards violence in Donovan before…and all decided to beat a quick retreat out the kitchen door.

But all of that is behind us now. The Feast of the Assumption came on Friday…and, as everyone in rural France knows, it brought a dramatic change in the weather. The days are suddenly cool and cloudy.

Edward shifted his stunts to the veranda, where he has already sustained a gash over his left eye when the skateboard attacked him. Henry is still hacking away at the guitar…but outside. Sophia’s boyfriend and Jules are trying to fix an old motorbike. And a whole group has gone off to visit the chateaux of the Loire valley.

Everyone is outside except your editor. Loyal to his post, he continues to write to you, dear reader…and from time to time (and here he lets you in on a secret) – he longs for September.

*** "I’ve never seen it like this," said Pierre on Saturday.

He was referring to the way the hot weather and drought had dried out the trees. The grass has turned brown and is now covered with gold leaves that crackle underfoot. It is strangely beautiful, especially in the evening, when the low sun passes through dried-out leaves and sends a yellowish light out over everything.

The Mogambo Guru applies the rule of 72 to the expanding supply of US dollars…and tumbles into a catatonic stupor.

PILGRIM, PREPARE THYSELF

Last week in Zimbabwe, their currency, the Zimbabwe dollar, fell to 6,000 to the U.S. dollar. Back a few years ago, it was trading almost to a par with the U.S. dollar.

I know that you think I am going to work myself into a fit of hysterical outrage about the situation in Zimbabwe, but I am not. It’s been going on for years already, and we have the pretty exact same thing happening right here in the USA, so what’s new, eh?

Rather, what I am going to do is to use it as an object lesson in the power of gold. When the Z$ was selling at par with the US$, gold was, let’s say, three hundred bucks an ounce, give or take.

Suppose you, being the genius Zimbabwean dude or dudette that you are, correctly foresaw the coming collapse of the Z$, and you cleverly converted all your Zimbabwe money into ounces of gold. You paid Z$300 per ounce. Of course, by being a "gold bug," you had to endure the taunts and ridicule of your neighbors and family members.

Fast forward to today. What is that ounce of gold worth?

Zimbabwe Dollar: $1.8 Million per Ounce

The answer is Z$1,800,000 per ounce. Now, to the ordinary man on the street, an investment that turns 300 currency units into 1,800,000 currency units is a home run! A hands- down winner of any investing competition you can name! Compounding that over twenty freaking years, it comes out to an annual return of 54.5%! Even compounding that over forty years, forty freaking years, it STILL comes out to 24.3% per year!

Jeez, Louise! What more can you ASK from a damn investment?

But, as you are aware, it is just another example of money illusion. A loaf of bread that used to cost one Z$ now costs, one must assume, somewhere around Z$6,000, and that is why most Zimbabweans are starving and grumpy. So in terms of sheer wealth, you, as a clear-thinking Zimbabwean of genius and foresight, are not really any richer when wealth is computed in loaves of bread. But gold sure kept you from being poorer! Unlike the persons who trusted the fiat currency known as the Zimbabwean dollar, who ARE poorer, and are now desperately and literally starving and on the verge of revolution, you circumvented the whole disaster. How special.

Now, you spend your days thinking about how you suffered when everyone made fun of you as a ‘gold bug,’ and now you now get to ridicule them for being ‘fiat currency bugs,’ and you are dissatisfied how that just doesn’t seem to have the requisite biting acid sound that you were looking for, and it sounds kinda stupid, too.

Where is the justice, eh?

Leaving Zimbabwe, which is probably good advice, we traverse the cold Atlantic Ocean back to the good old USA, and we turn our attention to the U.S. dollar, and see how THAT currency unit is faring. It’s going down. And now we note how the price of gold is faring against the dollar. It’s going up.

Zimbabwe Dollar: Double the Money

Why? Here’s a pot-shot at the answer: Doug Noland, that brilliant dude who makes his living over at The Prudent Bear unearthing economic factoids that turn the blood of thinking humans into stone, has looked at the numbers and concluded, and I quote, "The money supply has now doubled since May 1995."

Just like that.

In a little over eight years, the money supply has, let me check that quote again, doubled. So how does that famous Rule of 72 go? The one financial planners use to figure out how quickly their clients will go broke? Oh yeah, divide 8 into 72 to see what that figures out to as some annual percentage. Ok, grabbing the calculator and the instruction book we look up "How to divide one number by another" and, over the next half hour or so we manage to successfully divide 72 by 8 and get, let me check that number again, ummm, 9%.

So the money supply, by the Rule of 72, has been increasing at 9% per year. Not content with that, we seek a second opinion, and use 2 as our future value, 1 as the present value, the period equal to 8, and solving for the exact compounding interest rate, it is also about 9%, maybe a little more.

Or, in a different way, we nervously note that the class is almost over, and so I cleverly sum up by picking up a piece of chalk and writing numbers at random all over the blackboard, at the same time as I say, in a ridiculous clipped Austrian accent as my pathetic way of showing solidarity with Arnold Schwarzenegger, an Austrian who is running for the governor of California, "Zee money supply ist compounding at der 9%, und der GDP ist expanding by less dann 2%, ja? Und zo der prices, vitch vee will call 'Der price X at time T sub-N,' MUSSEN be rising at, over der geshlugginer long term, der price inflation at 7%, nicht wahr?"

Zimbabwe Dollar: A Constant 7% Inflation

Students later recalled that my face suddenly went ashen at the prospect of a few years of 7% price inflation. As they left the room, it seemed as if I had slipped into a catatonic state, and I stood there transfixed by the horror of what I had just written.

The night janitor would later make the statement that he repeatedly saw me bent over my desk as he went about his janitorial duties in the otherwise-deserted building, working with a calculator through the night, the desk and the floor covered with a layer of coffee cups and cigarette butts and reams of discarded scraps of paper with scribbled numbers all over them, looking more and more haggard and depressed, endlessly calculating and re-calculating the price of Oreo cookies at the end of each period of retirement at a constant 7% inflation. To see me moaning and groaning at the results would have broken your heart.

So, since incomes are not sufficient to live on anymore, and destined to get worse, I can only say "Pilgrim, prepare thyself." Brace yourself for calls for a higher minimum wage, 'living wages,' more protectionist legislation, more tax rebates, more taxes and fees, more deficits, etc. It is that 'etc.' that is so scary, as it is an umbrella term for any and every way that the government can intervene in the workings of the economy. I shall assume that you are aware of the results of a government intervening in an economy, and I will wait for your hands to stop shaking in fear. Feeling better now? Actually, that's the GOOD news.

The bad news is that, after all these decades of the government getting bigger and bigger, the government IS the economy.

Regards,

The Mogambo Guru
for The Daily Reckoning

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P.S. "Counties, cities, towns and villages across the country will continue to have little choice but to borrow to meet essential project needs," Mr. Noland notes, "even if they do cut back on other spending."

To be sure, long-term municipal issuance is, and I quote, "on target for yet another record-breaking year." The record of $357.1 billion was set just last year. About three thousand dollars in new debt, increasing the debt burden for every private-sector worker in the country by over $3,000 each.

Mogambo Sez: The Chinese have placed an order for a billion chip-implanted ID cards for the citizens. This is truly the beginning of the ascendancy of the Chinese economy, as all they needed was a way to get credit extended to enable the gigantic pent-up demand. And now they have it. Americans, ask not for whom the bell tolls, for it tolls for thee.