

## Chapter One



# Let's Do the Time Warp Again

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### *What Happened to Our Purchasing Power?*

THE NEW YORK TIMES “Week in Review” section over Memorial Day weekend 2008 reprinted a cartoon from the *Atlanta Journal-Constitution* showing a single-family house roped to the roof of an SUV. In the image, the hapless driver explains to a puzzled passerby, “I couldn’t afford a fill-up so I bought a house instead.”

It's comical because of its incongruity, but the realities that inspired it are anything but laughable. I'd call it gallows humor, and the dark side is dark indeed.

Unless I'm terribly wrong—and my predictions have been uncannily accurate in the past—skyrocketing gasoline and food prices and plummeting home sales are among the early symptoms of fundamental economic problems that are too advanced to be reversible and grave enough to profoundly impact the living standards of most Americans for years to come.

In the chapters that follow, my focus will be on where to put your money at a time when the American economy is flat broke and the wealth creation is happening elsewhere. To appreciate the urgency and cogency of my advice, however, you've got to understand what went wrong and how much worse it's going to get. That's what this chapter is about.

In my book *Crash Proof: How to Profit from the Coming Economic Collapse* (John Wiley & Sons, 2007), which was published when all seemed quiet on the economic front, I set forth in detail my contrary position that "The economy of the United States, long the world's dominant creditor, now the world's largest debtor, is fighting a losing battle against trade and financial imbalances that are growing daily and are caused by dislocations too fundamental to reverse."

Observing that the bulk of the deterioration had occurred, almost unnoticed, in the short space of two decades, a period that most Americans experienced as prosperity, I compared the 2006 economy to a giant bubble in search of a pin. Real estate prices had risen to absurd levels, driven by a reckless Federal Reserve, artificially low mortgage rates, lax and sometimes fraudulent lending practices, and massive speculation. Trade and budget deficits were huge, persistent, and growing; and the national debt, payable in large part to our trading partners, had reached dangerous levels. Aggressive monetary policy was initially showing up in rising asset prices not reflected in the consumer price index (CPI). Consumer debt was fueling consumer spending that the government was misrepresenting as legitimate economic growth signifying a healthy economy. The dollar was already losing altitude and poised to head into a tailspin.

In general, the American economy was on a course toward either stagflation—a combination of recession and inflation reminiscent of the 1970s—or, worse, hyperinflation, similar to what happened to Argentina early in this decade, when a middle class literally went to bed well-fed and happy and then woke up threatened with poverty.

## The Healthy 1950s

To understand the why and how of what happened to the American economy, take a look back at a time when it was rosy with good health, the postwar 1950s.

With pent-up demand from wartime shortages and with everybody having babies, consumer spending was strong, manufacturing was thriving, and economic growth was at an all-time high. The savings rate was positive, providing investment capital for new industries like aviation and electronics. Unemployment was well in check. Blue collar wages and white collar incomes were rising, and the housing industry was booming. Inflation was low (an obsession of President Eisenhower) and fiscal discipline kept interest rates moderate. The stock market gained. The national debt was negligible. The federal budget was tightly controlled and generally in balance. Much more was exported than imported, and the balance of trade had large surpluses. (A note to economic purists: The *current account*, which term is frequently used synonymously with the *trade account*, was running deficits. That was because the current account comprises, in addition to the trade account, the *financial account*. In the 1950s, the financial account reflected the Marshall Plan and other recovery-related foreign aid, foreign direct investment, and military investment abroad. The current account deficit was not deleterious to the country's economic health.)

The dollar, the world's reserve currency following the Bretton Woods agreements in 1944, was backed by gold and in strong demand, and the United States Treasury held better than 60 percent of the world's foreign currency reserves.

So the 1950s economy was robust, but still there were harbingers of challenges to come. The first credit card, for example, was issued in 1950 and by the end of the decade, consumer credit had become an important part of the economy. Although manufacturing production was the dominant factor in economic growth, the service sector, which paid lower wages and produced little that was exportable, was gaining importance as the number of service employees surpassed the number producing goods by mid-decade. Massive government spending for highways, airports, and social welfare programs was causing huge tax increases.

## The Coming Economic Collapse

Fast-forward now to early 2007 when my book *Crash Proof: The Coming Economic Collapse*, was published.

By then, the nation had undergone a radical transformation in terms of its economic infrastructure and its economic behavior. A service-based economy had largely supplanted one based on manufacturing that was now at a competitive disadvantage to producers in Asia and elsewhere

who were less burdened by regulation, high taxes, and mandated worker benefits. America had become a nation of consumers, and producers were disappearing.

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Reflecting that reality, the balance of trade was running huge deficits, with imports exceeding exports by some \$800 billion annually. Federal budget deficits ranged between \$300 billion and \$400 billion yearly, caused by trillions of dollars of government spending for the Iraq and Afghanistan wars, entitlement programs, debt service, and other expenses. The national debt, owed in large part to China and other trading partners, exceeded \$9 trillion, a staggering and unrepayable figure yet only a small part of the overall debt picture. Unfunded liabilities, such as Social Security, veteran benefits, and loan guarantees, raised total government obligations to over \$50 trillion. Foreign currency reserves held by the United States Treasury declined to a mere 1 percent of world

reserves, ranking the United States behind Libya, Poland, and Turkey.

The stock market, following the longest bull market in history, was still overvalued, even though a bubble in the (mainly) NASDAQ-listed dot-com issues had finally burst in 2000. This caused a short-lived technical recession, which the Federal Reserve quickly replaced with an even larger bubble, this one in residential real estate.

So to say the United States government was operating on borrowed money and dangerously dependent on foreign suppliers and lenders was to make the understatement of the new millennium. On a personal level, the American population was up to its eyeballs in debt and the national savings rate had just turned negative for the first time ever. The real estate bubble, the biggest speculative mania in United States history, had just burst, though few seemed to notice. The dollar was in a steep decline and on a path to collapse, but the economy was too vulnerable to risk raising rates.

Still, the government economic leaders said not to worry. Consumer spending was strong, and increases in the gross domestic product (GDP) reflected healthy economic growth, they said. Moreover, we were told, household net worth was at an all-time high, reflecting the strength of the real estate market and steady growth of home equity.

## Doctor Doom

With a new book to plug, I was appearing more than ever on CNBC and other TV venues, where I gave bearish symmetry to panels of experts who were almost invariably bullish. CNBC dubbed me “Doctor Doom.”

To peals of the old horse laugh, I argued until I was blue in the face that all the happy talk was an ominous misreading of the realities. As fellow panelists cited GDP growth as evidence of a strong economy, I countered that 70 percent of GDP was consumer spending on imported goods using borrowed money. That, I argued, was not wealth creation as the term *economic growth* implied, but wealth destruction. It was not as though we were importing capital goods to be used to produce consumer goods that could be sold here or abroad for profit. It was consumer goods we were importing, and we were sending the profits over there.

Where I really took heat, though, was on the subject of real estate. Real estate had become a sacred cow, the wholesome driver of the twenty-first century economy. I dared argue that real estate had become a speculative episode of terrifying proportions whose inevitable crash would reach every corner of the economy.

Home equity was fool’s gold being mistaken for wealth, I warned, and with 47 percent of the new jobs created in the preceding six years being directly related to home



construction, and consumer spending a function of home equity extractions, housing-related wealth effects, and temporarily low teaser rates on adjustable rate mortgages, an entire economy was riding on the obviously naïve assumption that values would rise indefinitely.

Speaking as a minority of one, I predicted then (read *Crash Proof* if you don't believe me) that the subprime market would soon collapse and spread to the general mortgage market and then become an economy-wide credit crisis. I also said inflation would mean crude oil, which I had started buying at less than \$20 per barrel and which was around \$60 in late 2006, would rise above \$100 a barrel and go higher, which has since happened. I called gold, which was around \$650 an ounce when my book came out, a "supreme buying opportunity" when others were calling a top. In March 2008, it was flirting with \$1,000 an ounce and, I believe, ultimately will head much higher. I predicted that other precious and industrial metals and agricultural commodities would also rise, and they have risen spectacularly. As of this writing, silver and platinum have skyrocketed. Over a 52-week period, soybean prices are up 90 percent and wheat 150 percent.

And I predicted that the dollar would keep plunging. With the euro now worth over half again as much as the dollar, there are shops on New York's Fifth Avenue preferring payment in euros. Euros are also being accepted

by retailers in the ultra-chic Hamptons. Others are making it on volume from shoppers who fly over from Italy, take a room at the Hotel Pierre, buy (with cheap dollars) shoes that came from Italy in the first place, fly back, and count their savings. (Even allowing for a little hyperbole, things have gotten that crazy.) It can't last.

If making so much of how accurate my predictions have been seems immodest, let me assure you that bragging rights are not my motive. It's all in the way of establishing credibility so you'll take the predictions and recommendations I make later in this book seriously.

In fact, there is one prediction I made that was wrong, or let's say premature. I said interest rates, which were being kept unsustainably low, thus keeping the real estate bubble inflated and adding to inflation elsewhere, would rise sharply. As I write this, long-term rates are still artificially low, meaning bond prices are artificially high. (In the bond market, prices and yields move in opposite directions.) So let me make that prediction again. Bonds are a bubble soon to pop. However, while the government has not seen a significant increase in its borrowing cost, for the private sector it is a completely different story. Mortgage interest rates have already risen, particularly for those with little to put down, low FICO scores, or undocumented incomes, or those seeking jumbo mortgages. These increases will be that much more dramatic once

the bond market bubble finally bursts. In addition, corporate borrowing costs have risen, particularly for lower-rated issuers, and credit card rates are rising, as is interest on student loans. More important, not only is private credit getting more expensive, but it is increasingly harder to come by. As to the credit crunch, shell-shocked lenders, saddled with losses on existing debt, have turned off the credit spigots. Home equity lines of credit are being canceled and credit card limits reduced, and the secondary market for nonconforming mortgages and student loans is becoming practically nonexistent.

In any event, I don't think it's brain surgery to predict that a playboy who is without a job and living the high life on credit card debt is going to run into trouble. Why, then, is it not just as obvious that a nation that, *on a chronic basis*, consumes more than it produces; imports the difference, running up huge external liabilities in the process; borrows rather than saves; and spends the borrowed money on nonproductive consumer goods and services, is going to hit the same wall as the playboy?

There is, of course, one huge difference: A nation can create money and the individual cannot. But the more money it prints, the less purchasing power the money will have. The end result for the offending nation will be the destruction of its economy by massive inflation.



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Inflation is on everybody's mind, yet widely misunderstood. This is all the more troublesome as inflation figures so prominently in the escalating economic crisis in nearly all its manifestations. In Chapter 2, I explain how inflation, which to most people is the same as the consumer price index and within safe limits, could so quickly and inconspicuously have become a threat of cataclysmic significance.

### **2010 UPDATE**

Despite the freakish dollar reversal between mid-2008 and early 2009 that I covered in my Prologue to this edition, and more recent problems devaluing the euro, I strongly believe the dollar's downward trend relative to most other major currencies, which resumed later in 2009, will continue and that further countertrend rallies of the magnitude that occurred in 2008 are highly unlikely.

## The Real Estate Bubble Bursts

The first signs I detected that the real estate bubble was finally leaking air were early in 2007 as homebuilders and mortgage lenders reported disappointing first quarter results and lowered their income projections for the year. However, I first started warning about the bubble itself, and the dire consequences for our economy once it burst, several years before that.

The results reflected, I believe, buyer skittishness prompted by the rise to 5.25 percent in mid-2006 of the federal funds rate, the reference point for mortgages and other interest rates. That was the highest federal funds rate since the real estate boom began, and the reaction gives an indication of just how little it took for an overextended public to go from exuberance to caution. Imagine the reaction, especially when home equity dries up, to a rise in rates sufficient to bring down inflation and put a floor beneath the dollar.

By early spring 2006 the real estate slowdown began to be felt in other areas of the economy, such as capital goods orders, and options and futures prices began anticipating additional stimulative cuts in the federal funds rate.

The most ominous signs, however, were rising default rates in the subprime sector of the mortgage market, which

accounted for \$600 billion or 20 percent of all mortgages in 2006. These mortgages, nonqualifying for Freddie Mac or Fannie Mae and often made with no down payment, no income documentation, and at teaser rates adjustable at significantly higher reset rates in the future, were arranged by mortgage brokers and then sold off to packagers that pooled and securitized them. The mortgage-backed securities were then repackaged as derivative securities called *collateralized debt obligations* (CDOs) that were structured in ways that got them investment-grade bond ratings. They were then sold directly to banks, hedge funds, and other institutions that were attracted by their high yields, which were a trade-off for their lack of liquidity. The institutions carried them at values based on sophisticated mathematical modeling rather than real supply and demand.

Initially the government and Wall Street dismissed the developing subprime crisis as being contained. However, in a commentary posted on my europac.net web site in March of 2007 entitled “Do Not Uncork the Champagne Just Yet,” I wrote, “With the apparent blessing of the Fed, Wall Street can now borrow a page from the Las Vegas promotional playbook and claim that ‘what happens in subprime stays in subprime.’ Unfortunately, like an out-of-work showgirl with a folder full of embarrassing photos, the problems with subprime will soon show up on

everyone's doorstep." Later that year Jim Grant of *Grant's Interest Rate Observer* humorously observed that those who proclaimed that the subprime problems were contained were right only to the extent that the problems were contained to the planet Earth.

It was this kind of default-prone paper that later caused massive write-offs at institutions like Citigroup, which got a \$7 billion cash infusion from Abu Dhabi, and Bear Stearns, which was purchased in May 2008 by JPMorgan Chase with the help of the Federal Reserve. Rather than being contained, subprime problems were just the tip of a huge iceberg, the totality of which has yet to surface even now.

Contrary to Wall Street and government assurances and consistent with my forecast, subprime foreclosures spread into the prime mortgage market, affecting lenders of all types and allied businesses such as bond insurers, government-sponsored entities like Freddie and Fannie, bond-rating agencies, and, not least of all, consumers who have been deprived of the home equity they naively regarded as wealth. As consumers are faced with soaring oil and food costs and now limited to funds available on their credit cards (the next crisis), businesses like The Sharper Image and Linens 'n Things have filed for bankruptcy; airlines are in deep trouble, as are automakers and countless other businesses dependent on consumer credit and travel.

Consumer credit is another meltdown waiting to happen. Delinquencies are on the rise in auto loans, many of which are secured by SUVs and other gas-guzzlers having reduced resale values; student loans, where the tarnishing of traditionally good repayment records is a clear sign of too much borrowing; and credit card debt, which is approaching \$1 trillion. Aggressively marketed by issuers charging loan-shark rates, credit cards have become veritable ATMs for people who, with an attitude of impunity, borrow their available credit knowing they can never repay. Perhaps they assume they'll be bailed out like the victims of predatory mortgage lenders, whose loans often paid off credit card debt, but in the meantime their continued spending keeps consumer demand higher than it should be. Like subprime mortgages, credit card, auto loan, and student loan paper is bought and securitized by private firms, eventually becoming asset-backed bonds carried at theoretical values on the books of hedge funds and institutions.

What is now happening in the airline industry is another harbinger of things to come and reflects the lower standard of living that average Americans will be forced to suffer. As the dollar loses value against other currencies, and as citizens of those countries experience rising real incomes relative to Americans, the cost of air transportation



relative to incomes will rise sharply in America as it falls elsewhere. As middle-class Chinese, Russians, and Indians take to the skies for the first time, middle-class Americans will be earthbound, as the jet fuel formerly used to power our planes will instead be used to power theirs.

The problem currently confronting our airline industry is not merely that jet fuel prices are too high, but that poorer Americans can no longer afford the higher ticket prices that would enable the airlines to absorb those higher prices. The industry will therefore have to contract to the point where it will be small enough to operate profitably. With fewer planes in the air, airlines will finally have real pricing power, and the resulting sky-high ticket prices will restrict air travel to those wealthy Americans still able to pay the freight. This will pave the way for major expansions of foreign carriers, as wealthier citizens abroad take to the skies in our place.

The concept of demand destruction domestically and demand creation elsewhere, while causing domestic consumer prices to rise to levels that will force malls and big-box retailers to shut down, will actually bring prices down in other cases. College tuitions, kept artificially high as a direct result of the wide availability of student loans, for example, will collapse as the market for such loans evaporates and fewer people attend college.

## A Hair of the Dog: Paulson and Bernanke to the Rescue

I do a weekly commentary for clients on my web site, and in February 2008 I wrote one titled “Upping the Inflation Dosage.” Referring to the Fed’s cutting rates by 325 basis points from 5.25 to 2 percent, and the Bush administration’s \$150 billion emergency economic “stimulus” package, I said:

Now that rate cuts alone are proving insufficient, mainly because banks are now so overloaded with questionable collateral and shaky loans that few can consider acquiring more assets or extending additional credit, the government is opting for a more direct approach. By printing money and mailing it directly to the citizenry, the “stimulus plan” cuts out all the financial middlemen and administers the inflation drug directly to consumers.

I pointed out that mailing checks straight to the taxpayers instead of channeling money through the banking system meant that consumers could bid up consumer prices immediately. This avoids the usual time lag when the Fed’s expansions of the money supply, such as the \$436 billion injected recently, have to filter through the asset markets before eventually affecting consumer prices. I’m being sarcastic, of course, but the point is valid.

The message, in any event, is that efforts to combat recession through stimulus measures mean more money

chasing a given supply of goods. Being the very definition of inflation, that simply pushes up prices while doing nothing to improve underlying economics. It is amazing how Congress can actually pass economic stimulus packages that merely stimulate inflation, and then hold hearings to investigate why oil prices are rising. It adds insult to injury when our government creates a problem and then compounds it by wasting even more taxpayer money trying to determine its cause!

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Nor should taxpayers be cheered by the Fed's announcement that it would swap \$200 billion of Treasury debt for \$200 billion of mortgage-backed securities owned by Wall Street firms, or its agreement to fund up to \$30 billion of Bear Stearns' "less liquid assets" as part of the deal whereby the firm avoided bankruptcy by selling out to JPMorgan Chase. In both instances treasuries are

being exchanged for bad paper, and in all likelihood there will more cases like it. In the end, Americans will be on the hook for the losses, either directly through higher taxes or indirectly through more inflation.

## The Outlook

The coming decade will witness a radical transformation of the American economy, marked by rising inflation, higher interest rates, and soaring commodity prices, coupled with a weakening dollar; declining markets in stocks, bonds, and real estate; and recession. Asset-based wealth creation and home equity, the cornerstone of the good times during the bubble years, have been revealed as shams, and the economy will have to return to its traditional roots of saving and producing rather than borrowing and consuming.

In my view, there is a real possibility that a new administration in Washington will confront its economic challenges with New Deal-type programs that will only exacerbate the damage and turn the current recession into a repeat of the Great Depression, only with consumer prices rising instead of falling. As I write this in mid-2008, the government still claims the U.S. economy is not in recession. This absurdity is premised on not having two consecutive quarters of negative economic growth, the widely accepted definition of recession. With the automobile, airline, and housing industries in outright collapse and our banking and financial

system on government life support, grim reality once again conflicts with government fantasy.

## 2010 UPDATE

Instead of encouraging savings that would lead to capital investment, the production of exportable goods, and the eventual restoration of sound economic fundamentals, the Obama administration, just as I predicted, is doing the opposite. Government spending, aimed at stimulating consumer spending, like the alcoholic's hair of the dog or the heroin addict's fix, will at best result in the temporary illusion of recovery. Perniciously, such a pseudo signal that the recession is over and recovery is afoot will contribute to a renewal of complacency and resistance to sacrifice. That will make fundamental economic reform, even in the unlikely event our leaders decide to undertake it while there is still time, politically unfeasible.

The real collapse is still to come.

## Parting Words

We are entering perilous times—a recession I predict will last well into the next decade and a cataclysmic upheaval of the American way of life as we know it. The bursting of the real estate bubble has made America's fundamental economic problems worse and

*(continued)*

put us on a course where recession and inflation are inevitable and hyperinflation is a distinct possibility. Various economic stimulus policies of the Fed and the administration may buy some time but will make inflation, which is now an international problem caused by America, a much greater problem. The dollar's decline will continue even though interest rates will inevitably rise.

Therefore a totally nontraditional investment approach is required, which begins with getting out of the United States dollar and into commodities, precious metals, and equities in foreign countries where wealth is growing and currencies are appreciating against the dollar. My goal in writing this book is to share, in detail, my investment approach to help you weather and, yes, even profit from the coming storm.