

Today's Notes:

1. STEALTH TAX : THE NEW NORMAL

1. STEALTH TAX ...

"But who can say how much is endurable, or in what direction men will seek at last to escape from their misfortunes?"

"Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. . . . As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.

"Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."

John Maynard Keynes, *The Economic Consequences of the Peace* (p. 235-6): 1920

It has been said that only two things are certain in our world. They are Death and Taxes. To that we now advocate adding another - Gold. All the gold ever mined is somewhere on the planet. All the paper currency ever printed is not. We contend that gold is a universal constant like death and taxes because inflation is somewhere in our future. The US has no choice and the rest of the world realizes this

Warren Buffet recently suggested we have avoided the worst of the crisis but that we are still in uncharted territory (August 18, 2009 NYT Op Ed)

"The United States economy is now out of the emergency room and appears to be on a slow path to recovery. But enormous dosages of monetary medicine continue to be administered and, before long, we will need to deal with their side effects. For now, most of those effects are invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself.

To understand this threat, we need to look at where we stand historically. If we leave aside the war-impacted years of 1942 to 1946, the largest annual deficit the United States has incurred since 1920 was 6 % of gross domestic product. This fiscal year, though, the

deficit will rise to about 13 % of G.D.P., more than twice the non-wartime record. In dollars, that equates to a staggering \$1.8 trillion. Fiscally, we are in uncharted territory.”

As a result our net debt will increase about 1% per month. This means that US debt will reach 56% of GDP. There is a point, of course, at which the level of debt relative to GDP becomes unsustainable. At that precise tipping point the US will lose its currency clout and some of its global power. Mr. Buffet concludes,

“An increase in federal debt can be financed in three ways: borrowing from foreigners, borrowing from our own citizens or, through a roundabout process, printing money. Let’s look at the prospects for each individually — and in combination. ”

So this is where we are headed. Make no mistake. There is no fourth way. At some point a combination of these three financing alternatives will be used. The reassurances from Central bankers at Jackson Hole ring hollow. The real reason that President Obama’s lead economic advisor Larry Summers was not appointed to head the Fed is that no one wants that daunting responsibility. This is now Dr. Bernanke’s anchor for better or worse.

Even if the \$400 billion current account deficit is taken up willingly by China, Japan and the BRICS, Americans manage to save \$500 billion (no doubt impacting the 70% US consumer economy, Mr. Buffet notes that **Washington must find another \$900 billion to finance the \$1.8 trillion of debt it is issuing in its spate of fiscal largesse.** He says,

“Washington’s printing presses will need to work overtime.”

Dr. Bernanke believes in inflation targeting. He has publicly said that 10% inflation may be acceptable. The only real question therefore, as we seem to sink ever so slowly in deflationary quicksand, is whether or not our central bankers can actually inflate us out. I am certain that they will do their best in that effort.

Government expenditures according to Buffet are 185% of receipts. Either taxes must increase or spending decline. Neither of these actions is acceptable to politicians, at least on the first go round. Just look at the two recent fiscal plans (total \$1 trillion) loaded with pork and earmarks. No politician is going to opt for higher taxes or reduce spending initially.

Therefore inflation, the silent and stealthiest of all taxes, acknowledged by both Keynes and Lenin, is a sure route. As Buffet suggests, *“the dollar’s destiny lies with Congress.”* Will we ever find a leader that leads on this issue? We must eventually bite the bullet in this country and restore fiscal prudence.

Debt is fine as long as asset values and incomes increase – but that has not been the case in Canada and the US. What would happen today if the Fed pushed interest rates to 15% to clear the system out? Fed Chair Paul Volcker did just this in earlier years. Inflation is anathema to China. Japan’s new government wants to tie itself geopolitically and economically closer to the BRICS.

Inflation is not a threat today. Once again the Yen and the dollar are stronger across the board indicating deflationary winds are blowing. But Mr. Buffet admonishes,

“Legislators will correctly perceive that either raising taxes or cutting expenditures will threaten their re-election. To avoid this fate, they can opt for high rates of inflation, which never require a recorded vote and cannot be attributed to a specific action that any elected official takes.”

PIMCO’s Paul McCulley recently noted,

“The ‘new normal’ for the North Americans will include heightened government regulation, lower consumption, slower growth and a shrinking global role for the U.S. economy. U.S. growth rates will slow to around 2 % over the next several years. Nominal gross domestic product will be 3 to 4 % as we move forward and inflation will be around 2 %.” Bond market super returns are finished.”

Given the weekend elections in Japan this shift to a ‘new normal’ would appear to be underway. It would appear that like China, Japan fears the worst regarding US inflationary future. Once again we suggest that hard assets should be acquired on weakness as a store of value. Once de leveraging and excess capacity is eliminated (will we ever bite this bullet?) inflation with all its many tentacles will return. Please be apprised.

The legions of over optimistic television commentators, must take note. All the hype about returning to where we were will be a mirage. The recent bank crisis may be in hibernation. But the dénouement is perilous and potentially worse than what we have seen. The purchasing power of your dollars is threatened. Slower growth, higher inflation and a ‘new normal’ for North Americans is in the cards. Be prepared.

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