March 23, 2011

Undermining the Dollar

"Inflation is caused by too much money in the system chasing too few goods"
Lu Feng, Director of Peking University's Macroeconomic Research Center

Mr. Feng uttered the above statement in February after China announced their consumer prices rose 4.9% in January compared to January a year ago. Their food component alone jumped 10.3%. What Mr. Feng articulated would appear to be pretty obvious. Countries have inflation for two reasons:

1. Production of goods and/or services is greatly diminished and produces shortages
2. Too much money is created by the government

<u>What exactly is QE2 and how does it affect us individually?</u>

In October of 2010, the Federal Reserve proposed a 2nd round of quantitative easing, which the press immediately dubbed as QE2. In effect, the Fed has determined that our economy, as measured by job creation, new construction, and overall business investment is not recovering at a rate they consider acceptable. Their solution is a plan to buy government bonds over the next several months, 600 billion dollars worth. Their goal is to lower interest rates, and push inflation a little higher (the officially stated rate of inflation is currently around 1% per year, and their plan is to let it move to around 2%). Naturally they hope this will boost the economy, but, by any past measure it is a staggering purchase of bonds.

Massive government deficits are creating an almost insatiable need for more and more money and the most recent budget submitted by the President plans for a deficit of an estimated 1.6 trillion. <u>Our government is now borrowing about 40 cents of every dollar it spends.</u> When a country borrows money by issuing a bond, that bond is not backed by tangible wealth. Rather, it is the promise to pay based upon future tax revenues. Individuals, institutions, or other nations who loan the money (i.e. buy the bonds), must have faith and believe that promise is solid and will be fulfilled. Countries that have regularly purchased our bonds in the past are now becoming reluctant to continue at the same rate. California based PIMCO, run by Bill Gross, is one of the largest bond buyers in the world. In February, they announced a reduction of US bond holdings to 12%. Then on March 12th they confirmed they had eliminated all their holdings in Government bonds. When normally active bond buyers begin to become apprehensive, somebody needs to take up the slack. It's never good to hold an auction where nobody comes. Enter the Fed!

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So where does the Federal Reserve get all this money to buy bonds? It is done through a rather complex system of crediting bank reserves. They can credit member bank accounts with a few strokes of a computer. In essence, they have an unlimited checkbook. On March 15, 2009, Fed Chairman Ben Bernanke appeared on 60 Minutes. Here are direct quotes from him: ***"So, to lend to a bank, we simply use a computer to mark up the size of the account that they have with the Fed, so it's much more akin to uh, although not exactly the same, but it's much more akin to printing money than it is to borrowing*** (meaning banks borrowing)***."*** 60 minutes question: "You've been printing money?" Bernanke: ***Well, effectively. And we need to do that, because our economy is very weak and inflation is very low."***

Now, let us fast forward almost two years later, December 2010 - 60 Minutes again – same interviewer – same Fed Chairman Bernanke, this time discussing QE2. Bernanke says: ***"One myth that is out there is what we are doing is printing money. We are not printing money. What we are doing is buying treasuries to lower interest rates."*** 60 minutes question: "Can you act quickly enough to keep inflation from getting out of control?" Bernanke: ***"We can raise interest rates in 15 minutes if we have to."*** Question: "You have what degree of confidence in your ability to control this?" Bernanke: ***"100%."***

The United States is the largest economy in the world, and there is a great deal to be said about the momentum of our financial system. If large amounts of money are created today, it does not mean we will feel the effect tomorrow, next week, or even next month, but rest assured we will eventually suffer the consequences. The Knock Nevis (Seawise Giant) is one of the largest oil tankers in the world. It is the length of five football fields, and when fully loaded draws 86 feet of water. If suddenly a barrier loomed ahead in the water, the pilot would need to be aware of it when it was 6 miles away, because that's how long it takes to stop. Our economy has something in common with the Knock Nevis, and now that we are on track with a pattern of continually spending far more than our revenues, it is a difficult momentum to reverse.

The question that is popping up with more frequency is, "Will the dollar continue to be the world's Reserve Currency?" This is the currency held by large central banks and other financial institutions and is used as the medium of exchange to pay off international debt obligations, or to purchase important world commodities such as oil and gold. In order to maintain the status of Reserve Currency, the issuing nation must be perceived to maintain high standards of fiscal discipline. Up through World War II, this honor belonged to the British Pound. However as the United Kingdom progressively increased the gap between spending and income, things began to change, and change rapidly. At the end of the war, more than 16% of Britain's debt was held by foreign investors. (As of January 2011, 31.6% of US debt is held in foreign hands).

Britain's demise as a world power was rapid. For many, many years the following phrase was true, "The sun never sets on the British Empire." <u>In 1945, Winston Churchill sat at the Yalta Conference as an equal</u>; a member of the big 3 nations of the world along with Roosevelt and Stalin. But in only dozen years, the United Kingdom had given up the following countries: Bangladesh, Burma, Egypt, Eritrea, Ghana, India, Israel, Jordan, Malaysia, Newfoundland, Pakistan, Sri Lanka, & Sudan. The UK is nowhere near the world power it had once been.

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Can our leaders in the US reverse this trend? The answer is – "yes." Do we believe they will do it? The answer – "highly unlikely." There are three solutions to the problems caused by a government spending more than its income:

1. Cut Spending
2. Increase taxes
3. Lower the value of the currency by printing more of it; i.e. inflation

Number three is clearly the most politically palatable. Unfortunately, in the long run, the people most harmed are those who can least afford it. We are back where we started. Debasement of a nation's currency translates to inflation.

In 1966, at age 40, Alan Greenspan wrote a four page article called <u>Gold and Economic Freedom</u>. It is both convincing and succinct. In it he makes some very powerful statements:

- "Under a gold standard, the amount of credit that an economy can support is determined by the economy's tangible assets."
- "The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit. They have created paper reserves in the form of government bonds which-through a complex series of steps-the banks accept in place of tangible assets and treat as if they were an actual deposit."
- "**In the absence of the gold standard, there is no way to protect savings from confiscation through inflation."**

We believe that the direction our nation is taking, chronic deficit spending, assisted by the Federal Reserve, is ultimately very destructive to our currency. As a result, it strongly influences the choices and direction of our investments. While we are always searching for companies with strong balance sheets and solid earnings growth potential, we also plan to maintain a certain percentage of our investments in asset-based companies. These may include precious metals, energy and timber related stocks. Commodity based companies should prove valuable in an inflationary environment. In addition, there are investments we wish to avoid, such as long-term bonds or other fixed income instruments that have maturities of more than 5 years.

In the past, swapping cash for assets such as real estate, commodities, precious metals & jewels, and <u>stocks</u> has proven beneficial in countries with a weakening currency. Does the weakening of the US dollar mean that it is bad for the stock market? <u>Absolutely not!</u> Selectively chosen stocks not only represent ownership of assets, but an increasing ability to earn.

Sincerely,

J. Michael Hard | Benjamin M. Hard | Andrew M. Hard

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