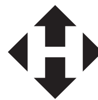
UNCHARTED

Your Guide to Investing in the Age of Uncertainty

By Andrew Packer



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First Edition

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Packer, Andrew.
Uncharted : your guide to investing in the age of uncertainty / by Andrew Packer. — 1st ed.
p. cm.

ISBN 978-0-89334-895-3 (pbk.) — ISBN 978-0-89334-897-7 (e-book)

1. Investment analysis. 2. Portfolio management. 3. Investments. I. Title.
HG4529.P33 2012
332.6—dc23
2012027217

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FOREWORD

Why You Need this Guide

By Bob Wiedemer

The global economy is stalled in an unprecedented fiscal and monetary sea. Five years after the start of the financial crisis, which burst a housing bubble and nearly took down the financial system, no clear path to prosperity remains.

Some countries have tried austerity, which sacrifices necessary growth to pay down the excesses. Others have tried to stimulate the economy, but fickle and timid consumers haven't taken the bait. Meanwhile, the causes of the crisis haven't been addressed. The same problems that got us into this mess could still occur again — and soon.

Investors, meanwhile, must now read between the lines of every politician's promise and central bank statement. Any future government plan can have huge and immediate implications for the markets.

While we are truly in uncharted waters, the world continues to move on. Investors must rebuild decimated retirement portfolios.

But there's a problem.

Ask ten different investors what their method or "style" is, and

you'll likely get at least ten responses, if not more.

There are many who claim to know the secrets to investment success. Some focus entirely on some small niche in the markets and patiently wait. Others take a more expansive and global view. Some focus entirely on what makes a successful company successful, and others look entirely at the numbers.

Whatever styles or combinations are used, all investors are looking to do one thing: achieve excellent results in investing relative to the risk they take on.

In *Uncharted*, Andrew Packer reveals the fragile and unique situation that pervades the globe right now.

He then ties together the main threads necessary to create a successful investment tapestry — rigorous analysis, a global macroeconomic view, and the psychological behavior of the people who make up the market — and combines these elements in a way that accentuates the best of each of these investment strategies while minimizing their downsides.

INTRODUCTION

Here Be Dragons

"To map out a course of action and follow it to an end requires courage."

— *Ralph Waldo Emerson*

INVESTING IS BOTH an art and a science.

In a way, it reminds me of antique maps. They're fascinating, and since they weren't mass-produced and measurements were often inaccurate, they (literally) illustrate the best of art and the best of mankind's early attempt at accurately recording knowledge.

Think about it: The shapes of familiar countries and continents on an antique map aren't quite right. They're more jagged or out of proportion. Early maps left unexplored territory to future explorers. On some of them was the Latin phrase: *Hic sunt dracones . . . Here be dragons.*

While some may interpret this literally, it was (at least in later years) meant more symbolically. Dragons were the great unknown . . . ignorance . . . the *real* monster to be slain by brave explorers.

Today, we've mapped the heights of the Earth. We're mapping the depths of the ocean and using incredible telescopes to peer further and with greater detail beyond our solar system. There is little left on Earth to explore in terms of new land, new territory, and new cultures. Gone are the days of the great expedition where a group of men can

embark on a journey to find what's beyond the last-known mountain peak or horizon.

But, still, we face the uncertainty of the future. Even with no new land to discover, mankind continues to make tremendous scientific and technological progress. We find ways to do more with less. That prospect alone has tremendous investment implications. A new development could render one of the darling stocks of Wall Street obsolete. Indeed, in the investment world, fraught with sudden fortunes and sudden reversals, the future is the great unknown.

For example, at the start of 2008, oil prices stood at over $90 per barrel. By midsummer they had surged to $147. By the end of the year, however, oil prices had plummeted to under $40. It was easy to see rising prices continue or to see prices fall once they had moved up in such a parabolic fashion. But listening to the talking heads on CNBC or reading the pages of the *Wall Street Journal* at the time, you might have thought it was completely unpredictable and that investors would just have to deal with these extreme changes by simply staying the course and ignoring these short-term "gyrations."

Wall Street is no different. That's partly by design — millions are employed on Wall Street to keep the average investor constantly putting money to work. In some years, investing — especially in stocks but more recently in commodities and real estate — is seen as the road to endless, and more importantly, *easy* prosperity.

In other years, it has been a recipe for ruin. But we had a good run before it ended, right? And either way, the "house" (i.e., your brokerage firm or bank) always wins, whether it's with your commission dollars or with trillion-dollar taxpayer-funded bailouts.

It's a bit of a contradiction. These extreme moves in the market are at odds with what Wall Street tells investors. We're told to be sensible and own investments for the long term, but we end up acting like tourists at a Las Vegas craps table. We *intend* to be investors, we really do! But we seem to go to extremes: either we play the game, or we stand around counting our chips.

Either way, we don't get ahead because we take on too much risk and lose it all *or* because we don't take enough risk and lose our investment capital to inflation and transaction costs.

It's clear the traditional approach to investing today is far from rational. We chase returns. We stick with the crowd. We assume we can't all be wrong; so it's rational to invest in the market at all times (but we'll diversify in case an individual investment has a specific problem). It's safe in nature, but in investing, herding is a tactic that gets investors slaughtered like cattle.

That's especially true for American investors. The rapid change from an invincible consumer economy, robust with an ever-rising housing market to the subsequent collapse and nonexistent economic growth of the years following the 2008 market crash have hurt each and every citizen.

Homes can no longer serve as ATMs. No longer can we go to the grocery store or gas pump without increasing concern about rising prices. No longer can we go to our jobs day-in and day-out without wondering if (or even *when*) the ax will fall.

Indeed, our overreliance on easy-money policies, buckets of debt, and the willingness to meddle in affairs around the globe have sapped America of our once great financial might.

Our recovery process will be long and arduous. We will have to learn at some point (perhaps even soon) that we will simply have to do without things like bloated government pension plans, a vast array of medical and retirement benefits, and a global military organization.

But we are not there yet. Rather, we are living in an uncomfortable transition period — and most Americans have *no* idea how to handle it. It's like being on a ship in the eye of a hurricane — the storm isn't over, even though things are eerily quiet. That's when you need to keep your head about you and keep your map handy. It may be needed sooner than you think.

Americans are pulling retirement account funds (if they saved them in the first place) to meet their living expenses today. After nearly two years of paying down debt, we're going back to credit cards. For some, it means funding necessities rather than luxuries. For others, it's just a way of pretending their way out of hardship.

In short, those who haven't saved properly and don't understand the fundamentals of investing simply have little left. They can't be optimistic about the future because they don't see a way out of their troubles today.

Many investors simply chase returns. They get burned when markets correct. They lack the perspective, focus, and emotional determination to profit from the markets consistently.

Make no mistake — markets are the great humbler of men, and there will be inevitable losses. It is how we handle them that counts.

The first section of this book looks at these problems in more detail. Problems include current investment strategies and theories driving investment selection and the psychological drive that leads to substantial overvaluation or undervaluation. By understanding the problems the markets face, you'll be able to better cope over the next few years as an investor.

From analyzing, in the second section of this book, what works in investing and what doesn't, we'll find a better way forward. This approach is based on a careful study of market behavior and simple valuation techniques. When used correctly, it can make the difference from following the herd to outperforming the market consistently, year after year, *no matter what happens*.

In the third section of this book, we'll explore specific opportunities for investors to profit today from the continued monetary mayhem wreaking havoc on markets.

By the end, you'll know how the investment herd works, a better way to consistently find profitable opportunities, and specific ways to profit in today's market while honing your investment skills. As with any skill, it must be learned, practiced, and used in a variety of situations to be truly mastered.

That's something I've been working on since my study of the markets began in my childhood, and I'm still finding blind spots. As you'll read later on, my successes outnumber my mistakes — but, because I've learned so much more from my mistakes, I don't mind the occasional "lesson." I'll teach you some of those lessons, both good and bad, in Appendix A of this book.

No investor is perfect, but true perfection in investing is learning to quickly recognize opportunities, navigate potential dangers, and minimize mistakes. As for the perfection of never making a mistake, dream on!

Many investment books describe methods for allegedly beating the market that often come up short. Some emphasize companies with

high growth. Some emphasize a company's current value. Others emphasize stocks that are going up . . . for the simple reason that they're going up!

All these strategies are simple and easy to understand. But they lack the perspective to fully realize the tremendous transfer of wealth happening today due to short-sighted government and monetary policies around the globe.

Investors following any one of these approaches at a given time without looking at the bigger picture expose themselves to a tremendous risk of losing substantial amounts of money. Simply put, it's using an obsolete guide, an outdated map.

Investors need a rational approach to investing, today more than ever.

Of course, the age we're living in makes the long term seem like a crapshoot between a glorious paradise and a scene from *Mad Max* or any movie set in a dystopian future. That's okay, because the excitement about investing comes from trying to analyze and predict the future. It's the quality of those predictions that ultimately determines gains and losses.

The future is the great unknown. While I've tried to be thorough, with all the rapid financial developments and ways the market can be manipulated, events will change. *But that's fine, because investing is a journey, not a destination.* Many changes will be scary and unforeseeable. Many developments, however, will be similar to problems we've seen before. Some changes will even be for the better.

So it's time to take control of your financial future, to do it yourself, and to move beyond trusting someone who's paid a commission to make the decisions for you — to move beyond trusting the government when they say that a problem has been "contained" or that "this time it's different."

So read on and watch your step . . . here be dragons.

1

Modern-Day Alchemy
Turning Cash into Trash

"You are an alchemist; make gold of that."
— William Shakespeare, *The Life of Timon of Athens*

During the Middle Ages, a group of men called alchemists performed numerous experiments. For some, the goal was to find a chemical mix that would stop aging. For others, it was to find a way to turn lead and other base metals into gold.

This search for a magical *kimia* (the Persian word for "elixir," later morphed into the word "alchemy," to turn lead into gold) never panned out.

Not only is this process still scientifically impossible, but it's in the world's best interest that such a creation never occur.

After all, alchemists struggled to create *more* value from *less* value. Turning the world's supply of lead into gold would vastly increase the amount of gold in the world. It would go from being a *precious* metal into a *common* metal. Gold would lose its value as a monetary metal through the inflation of the supply of gold. Instead of one gram of gold, one might need five pounds of the stuff to buy a loaf of bread!

While alchemists toiled with rudimentary experiments to increase the world's amount of gold, monarchs and sovereigns around the world stumbled onto a much more efficient way to create something

out of nothing — through currency. By the year 1565, a new word had come into circulation: debasement. Meaning to decrease the value of coins by increasing the amount of base metal within them, debasement also carries decidedly negative connotations. The word debasement is still used in modern times to remove a high honor, such as a knighthood in Great Britain.

At a time before printing presses, money was mainly gold and silver coins. Rulers learned quickly they could decrease the value of those coins by "clipping" the coins' edges and thus reducing their size. Monarchs could keep the gold saved by this process and enrich themselves.

Of course, such processes don't work. When coins got lighter or smaller or made of less valuable metal, it simply took more of them to purchase the same number of goods.

In other words, debasement led to inflation. More of the lesser-value coins were needed to make purchases. Older coins with higher precious metal content disappeared from circulation.

Alchemists failed in their work. But sovereigns, empowered by the threat of force, managed to do what the alchemists couldn't — impose inflation and destroy the value of currency.

Today, sovereign nations, like their kingly predecessors, look for ways to increase their wealth without working for it. But instead of doing their own work, they've outsourced it to today's modern-day alchemists — central bankers.

Of course, it isn't completely outsourced. Central banks such as the Federal Reserve may claim independence, but their structure and oversight typically binds them to the government in power. Don't let the periodic spats between a central bank and its government fool you. Since they're largely one and the same, such arguments are nothing more than posturing.

Nevertheless, the irrational belief that central bankers can "manage" an economy and "smooth out the economic cycle" is very much akin to the beliefs of ancient alchemists that there was a secret to turning lead into gold.

The difference between the alchemists and today's central bankers is clear: The alchemists knew they hadn't found what they were looking for yet. Unfortunately, central bankers think they already know!

Ironically, today's modern banking system comes from the role of goldsmiths during the Renaissance. Given the value of the gold they worked with, they employed guards, had top-of-the-line safes, and safeguarded their metal in other ways.

Naturally, this safety presented another business opportunity — merchants could leave items under the protection of the goldsmith — for a small fee, of course. Later this extended back to the very gold they made. When the gold was dropped off, the goldsmith would issue a receipt. In time, with enough gold on hand with the goldsmith, receipts could circulate instead of the gold.

Some astute goldsmiths realized that only a fraction of the receipts outstanding would be redeemed at any one time. By creating receipts in excess of other people's gold, they could enhance their earning power, and none would be the wiser . . . unless they went too far.

Today, the process is similar. A new bank deposit is lent out, with only a fraction of the capital staying at the bank as a reserve.

There is, of course, one key difference. Instead of having gold in the vaults of banks around the country, we have dollars. What's the difference? The difference is between something and nothing.

According to the Federal Reserve's pamphlet ***Modern Money Mechanics***: "In the United States, neither paper currency nor deposits have value as commodities. Intrinsically, a dollar bill is just a piece of paper, deposits merely book entries . . . What, then, makes these instruments — checks, paper money, and coins — acceptable as face value in payment of all debts and for other monetary uses? Mainly, it is the confidence people have that they will be able to exchange such money for other financial assets and for real goods and services whenever they choose to do so."[1]

Without the backing of gold, the Fed has no limitation on what they can print or how much of it. We are no longer held by the anchor of prices in gold terms.

The Fed's role in today's alchemistic process is simple: It sets reserve ratios and interest rates. If the Fed feels that banks are being too loose with their low reserve ratio, they may ask them to keep more cash on hand.

By changing interest rates, which has historically been one of the Fed's main tools (a current rate target of 0–0.25 percent interest makes for a poor tool right now), the Fed sets the market on the rate that money is lent out.

With lower rates, the Fed hopes to spur individuals to take on debt to buy homes, purchase cars, take out business loans, and so forth. By raising rates, the Fed hopes to curtail new lending.

Of course, the Fed can't do it alone. Again, according to ***Modern Money Mechanics***, "The actual process of money creation takes place primarily in banks."[2]

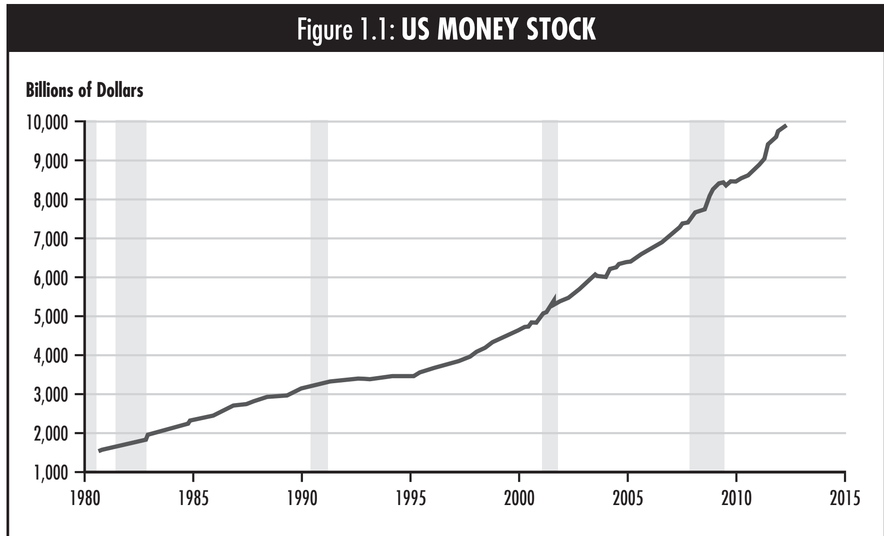
The key word in that statement is *primarily*. The US Treasury, in conjunction with the Bureau of Engraving and Printing, creates our paper currency, measured in M1 money supply. What the banks do is create new money through new debt.

Simply put, we have gone from a monetary system based on a limited, hard-to-find but easy-to-store metal (gold) and replaced it with easy-to-print money, thus conjuring up debt. In order to create money today, we must create debt. Either a bank must make a loan and create a new account for that loan money to exist in, or the Fed must purchase Treasurys so the US Treasury can print dollars.

Take a dollar bill out of your wallet. We all know the text it says on the front: "This note is legal tender for all debts, public and private." Well, what's a note? In financial-speak, a note is nothing more than evidence of a debt. Whether more paper bills are printed or whether accounts are created electronically, money today comes into existence via debt.

As a side note, silver has also been a part of monetary systems throughout history. Today, it is primarily an industrial metal but is still considered a valuable component in a sound monetary system by an ardent few. If you collect old currency, as I do, you may find an old US bill imprinted "Silver Certificate." They look like dollar bills but assure the holder that the US Treasury has one ounce of silver in their vaults. Go ahead; see if the US Treasury will give you silver for it.

Today, this paper-based system remains on life support following a massive credit bubble from 2003–2007 that collapsed spectacularly



Source: Board of Governors of the Federal Reserve System | 2012 research.stlouisfed.org

Money stock has been constantly rising since the early 1980s, but the trend first accelerated in the late 1990s before rising at an even higher rate since the financial crisis struck in 2008.

in 2008–2009. Money creation, when measured in M1, is increasing. That's due to more physical currency in circulation.

But that's misleading about the overall money supply, since the primary driver of monetary growth has been the banking system and the creation of new loans. Consequently, a rise in M1 money supply isn't necessarily an indicator of higher inflation ahead.

When the full money supply, both M1 currencies and M2 bank loans are taken into account, we can see that the trend of an increasing supply of money has itself increased. In Figure 1.1, we can see that M2 has started rising rapidly since early 2009 when extraordinary measures were taken to bail out the banking system and keep the economy afloat.

These extraordinary measures go beyond the traditional role of setting interest rates. The Federal Reserve began buying up "toxic" mortgages, particularly subprime debts; made investments to stopgap financial companies (banks from giants like Citigroup and Bank of America all the way down to regional banks); and even loaned money to insurance companies like AIG and automakers under the Troubled Asset Relief Program (TARP).

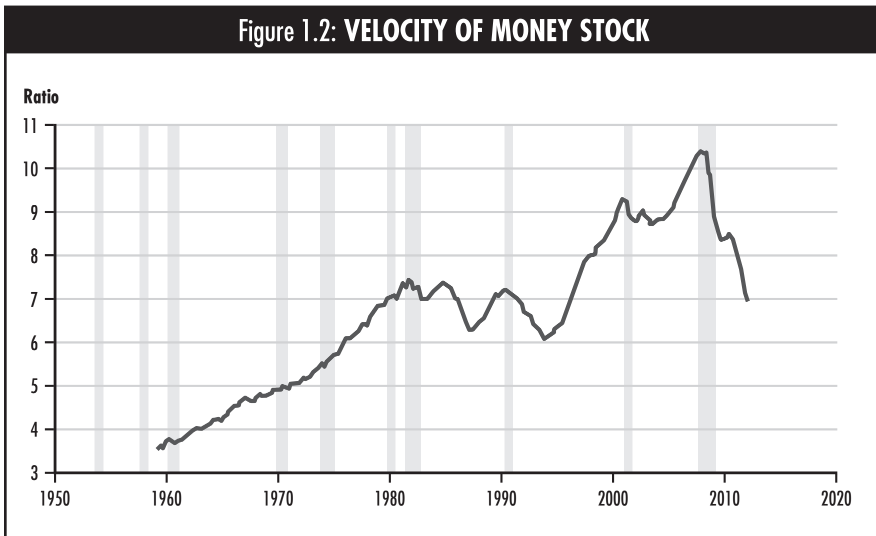
The Fed has continued to make purchases of Treasurys under quantitative easing (QE) programs, during Operation Twist (when it sold short and medium-dated government bonds and bought long-term government bonds to keep interest rates low), and when other assets reach maturity. This has allowed the Federal government to run trillion-dollar deficits every year since 2008 without a massive explosion in interest rates.

It's a long process that still has a way to go, although it's likely that there will be periods where the trend slows down, such as during a credit crunch or because of fears of recession.

I'm basing that conclusion on the continual decline in the *velocity* of money. Velocity is a measure of how many times the same dollar can be used to purchase the same number of goods. Today's falling velocity rate, as seen in Figure 1.2, tells us that the rise of physical currency in M1 is not likely to have an inflationary effect.

The falling velocity of money means that banks and consumers are hoarding money. That's bad for a consumer-based economy because falling velocity indicates that more money is being saved rather than spent. Money supply can increase dramatically before inflation really ramps up.

Figure 1.2: **VELOCITY OF MONEY STOCK**



Source: Board of Governors of the Federal Reserve System | 2012 research.stlouisfed.org

Since the start of the recession, the velocity of money has drastically fallen. Simply put, every dollar in circulation isn't being used in as many transactions as it used to be, offsetting the growth of the money supply.

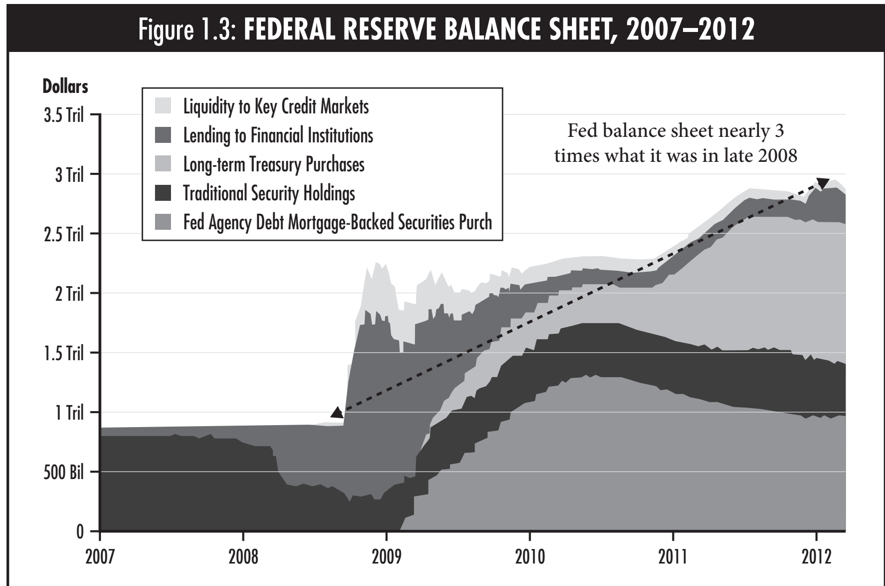


Figure 1.3: **FEDERAL RESERVE BALANCE SHEET, 2007–2012**

Source: www.mybudget360.com

At the height of the financial crisis, the Federal Reserve stepped in to purchase toxic assets. Since 2011, it has been gradually reducing these assets and investing the proceeds in Treasurys instead. In 2011, the Fed bought more than half of all new debt issued in the United States.

With inflation expectations rising, and actual inflation already here in rising food and energy prices, there is some risk of deflation without continual Fed asset purchases. If the Fed were to stop buying or reinvesting assets on its now expanded balance sheets, banks could again face the falling asset price and liquidity issues that they faced in 2008.

As you can see in Figure 1.3, prior to 2008, the Federal Reserve's balance sheet was comprised almost entirely of Treasury holdings. While the Fed is still actively purchasing Treasurys, new assets on the balance sheet, billed as "temporary" have become a permanent fixture. Not only that, by providing a clearinghouse for these assets above their true market value, the Fed has allowed banks to shift their bad debts off to taxpayers.

The first round of quantitative easing began in earnest in early 2009. The Fed started buying up so-called "toxic" mortgage-backed securities (MBS). It should be no surprise that once these toxic assets disappeared from the balance sheets of banks, much of the fear and uncertainty in the marketplace dissipated.

It's also no surprise that the start of the Fed's asset-buying program put a "floor" on financial markets. In the two years since, we've seen a stunning turnaround in markets, all thanks to the so-called "Bernanke put." This is simply an extension of the "Greenspan put" espoused by Bernanke's predecessor.

Basically, when markets appear jittery, the Fed chairman can issue a statement reminding everyone that the Fed stands willing to pump in money. This worked infamously well after the 1987 stock market crash. As credit-impaired companies like Bear Stearns were collapsing in 2007 and 2008, however, such statements alone had started to lose their value. More action was needed; hence the Fed bought up bad housing debt instead of its usual diet of Treasurys.

Nevertheless, the Bernanke put today has quite a premium: The Fed's balance sheet has grown by over $2 trillion (a 250 percent increase) since the start of the crisis. Many troubled assets have simply become the liabilities of the taxpayer, rather than the corporations that created them!

Indeed, by the time this book goes to print, the real size of the Federal Reserve's balance sheet won't matter. On September 13, 2012, the Fed announced their biggest initiative yet: QE3. This third round of quantitative easing, unlike its predecessors, isn't for a set amount of money. Rather, the central bank will begin buying $40 billion in assets each month in an attempt to bring down high unemployment.

In other words, the Fed hopes to help stimulate the economy and avoid the potential chaos of the economy slipping into another recession.

Yet this open-ended money printing brings to mind the kinds of rampant money creation that results in hyperinflation. But with the US economy still showing anemic growth at best, such a hyperinflationary act won't occur immediately — but the stakes are surely raised.

The Goal Is Stability, the Result Is Chaos

While the goal of alchemists was to create gold, the goal of the Fed was to "promote . . . stable prices."[3] Created as the belated result of the

Panic of 1907, it was thought that a central bank could bring an end to the periodic manias that swept through markets.

So, to determine if these modern-day alchemists have succeeded in their goal, we need simply look at how price levels have varied since the Federal Reserve came into being. Thankfully, we have a century of data for the Fed. There's also data going back as far as colonial times, but the further back we go the more unreliable it gets.

So, let's use the post–Civil War era (1870–1913) chart as a representative sample (see Figure 1.4).

It's plain to see that the Fed's initial efforts to promote price stability weren't successful; there were some pretty wild swings from extreme inflation to extreme deflation.

Following the end of the gold standard in 1933, periods of deflation, which worked to undo prior inflation and bring prices back in line, went the way of the 8-track player. For the baby boomer generation, inflation has been the normal investment climate, except for the recent credit crisis.

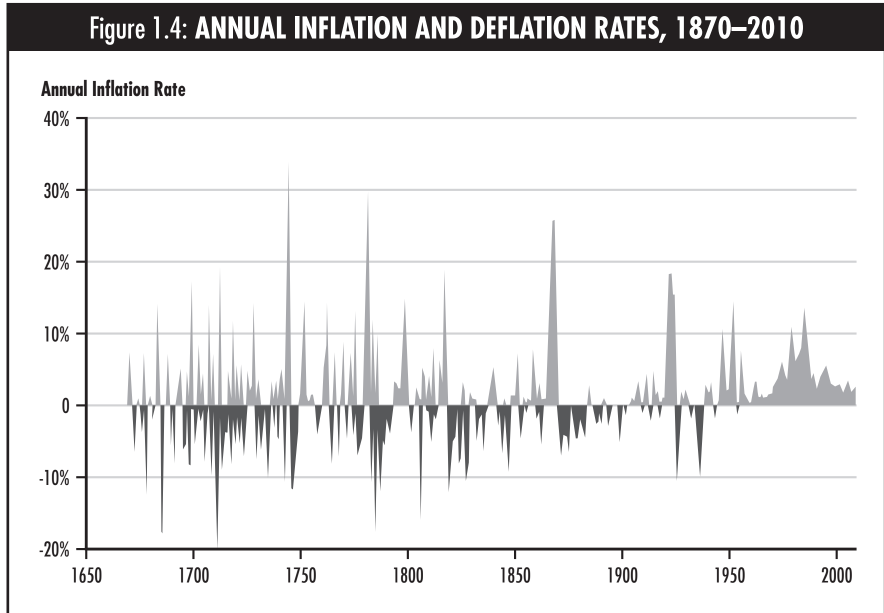


Figure 1.4: **ANNUAL INFLATION AND DEFLATION RATES, 1870–2010**

Source: CPI

Since the inception of the Federal Reserve, periods of deflation have become less frequent. Consistent, low levels of inflation have led to the dollar's 97 percent devaluation since 1913.

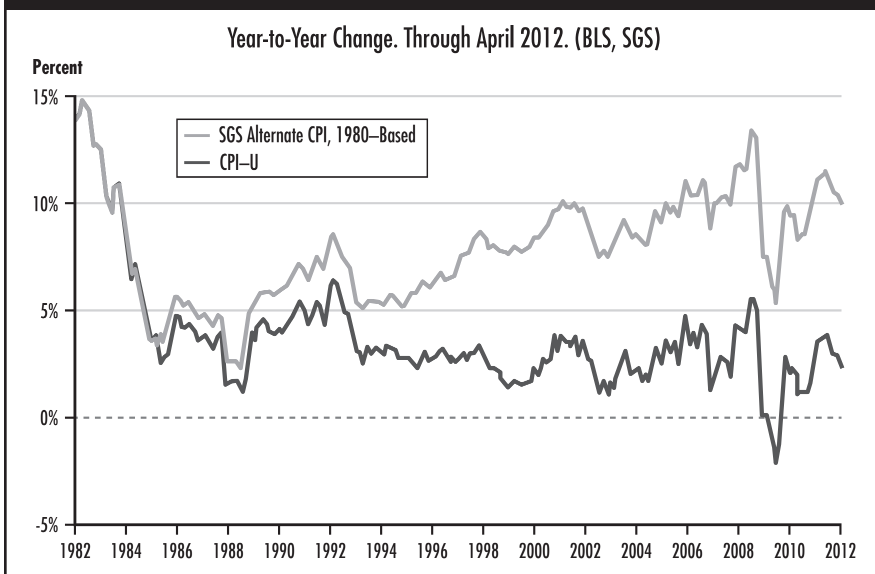
Without the wild swings of severe deflation, even a policy of mild, persistent inflation can be hugely damaging. Measured by the Consumer Price Index (CPI), prices in 2011 are roughly double of that in 1986. Not bad for a quarter century, right? Only if you exclude the cost of housing, energy, substitute steak for chicken, and make other adjustments.

In fact, thanks to the Bureau of Labor's "moving the goalposts" of the CPI, inflation has been substantially understated for twenty years. With the same weightings used in 1990, today's inflation rate is substantially closer to 10 percent — more than double the current CPI level!

Economists and investors tend to watch the CPI numbers closely to see if inflation is ramping up or cooling. But it should be clear to anyone that today's CPI simply does *not* tell the whole story, and in some cases may be completely disconnected from reality (see Figure 1.5).

By any measure, it's clear that the Fed is incapable of meeting its goal of producing price stability. With nearly a century of data behind

Fig. 1.5: **ANNUAL CONSUMER INFLATION: CONSUMER PRICE INDEX (CPI) VERSUS SHADOW GOVERNMENT STATISTICS ALTERNATE**



Published: May 15, 2012 | Courtesy of ShadowStats.com

Using older methodologies for calculating inflation, today's ultralow rates of inflation actually appear to be closer to 10 percent per year.

us, we can say with certainty that the central bank has not maintained price stability.

If anything, our business cycles have gotten increasingly leveraged and extreme as a result the Fed providing liquidity "to stabilize the markets." All that means is that real value is destroyed to create the illusion that things aren't so bad.

The bottom line is this: persistent inflation gives debtors a windfall reduction in the value of the debt they owe.

Talk about alchemy! The dollar has turned from a gold-backed security into something backed by nothing more than perception. Perception wins in the short term. Economic reality wins in the long term.

In the long term, events cannot continue as they have. Eventually faith in the dollar will falter as it continues to get weaker. The government cannot infinitely run trillion-dollar deficits. The Federal Reserve must keep interest rates low to ensure the government can finance its debt — or else it will have to buy more and more, fueling inflation in the process.

One way or another, alchemy results in disaster, chaos, and squandered resources. If it were one lone alchemist in some medieval lab, the consequences would only be disastrous to one man. Alas, today's alchemy is global, reaching into the lives of billions.

The medieval alchemists created one benefit: By recording their experiments and the results, they may have laid the foundation for today's scientific method. Today's central bankers, however, have little to show other than how *not* to try and manage something as complex and intricate as the world's economy.

In a way, the world of the Middle Ages was the first age of currency debasement. In this first age, it was simple to hoard old coins with higher gold and silver content and use the newer ones of lesser value in trade.

For a brief period of human history, industrialization and the gold standard led to price stability *and* exceptional prosperity. As part of that prosperity, individuals can fractionally own entire companies in the form of stocks. They can own bonds and other financial assets that had previously been reserved only to an extremely wealthy few.

Along the way, the world has abandoned the stability of the gold standard. Our money system today is backed by nothing more than promises to repay. This is known as a *fiat* system.

Today, we find ourselves in a new age of currency debasement. Coupled with a more diverse series of assets, you will have to be more nimble and selective in your investment decisions ahead of the debt crises and currency crises that the unstable fiat money system breeds.

Investing passively in the market through a strategy of "buy and hold" has become more difficult (but not impossible). Why? Because the prospect of higher inflation in the future has the potential to eat away almost all positive returns.

The value of your money is beyond your control. It is set by central bankers, far removed from the daily problems of making ends meet at a time when gas prices are on the rise and food prices have surged. Simply saving money, already difficult for many financially strapped Americans, won't be enough. Over time, that money will lose its purchasing power, perhaps rapidly, perhaps gradually, but it *will* lose consistently.

But don't take my word for it. Most investors worth their salt are constantly looking for ways to find and invest in a way to take advantage of inflation, rather than subject themselves to the hidden tax it truly represents.

As Warren Buffett, a major worrier about the prospect of inflation, once pointed out, "The arithmetic makes it plain that inflation is a far more devastating tax than anything that has been enacted by our legislature. The inflation tax has a fantastic ability to simply consume capital. It makes no difference to a widow with her savings in a 5 percent passbook account whether she pays 100 percent income tax on her interest income during a period of zero inflation or pays no income taxes during years of 5 percent inflation. Either way, she is 'taxed' in a manner that leaves her no real income whatsoever."[4]

Alas, at times in the years ahead, we may *all* find ourselves in the awkward position of facing taxes in well in excess of 100 percent, once inflation is factored in. That's why every investor needs a plan to deal with inflation over the long haul. The recent bouts of deflation experienced since the start of the financial crisis will eventually become

forgotten memories, as central bankers would rather tolerate modest inflation than deal with *any* deflation.

We know that the current fiat system will face more major crises. Factor in the coming tsunami of entitlement spending for the Baby Boomers, and it's clear that the foundations of America's economy today are unsustainable. We simply don't have the resources to handle an unexpected or unknown economic shift.

You need both the intellectual capacity to reason past these crises and the ability to make rational decisions to avoid the kind of emotional entrapment that destroys returns as well. Most of all, we must beware today's alchemists: central bankers in highly indebted countries are determined to turn their cash into trash.

WRAP-UP

Why Investors Face a Chaotic World and Why That Isn't New

- Mankind has long struggled to create value where there is none. In the Middle Ages, it was via alchemy. Today, it's done through the manipulation of fiat currencies.
- While this manipulation may create the illusion of prosperity in the short term, it creates long-term problems. The global economy is still suffering the "hangover" from too much liquidity over the past few decades.
- Ostensibly, such schemes are created under the guise of creating stability. Instead, things are more chaotic than they would have been had there been no interference in the first place.
- Modern-day alchemy generally risks higher inflation rates, which can be devastating. Liquidation of prior bad decisions, however, means that there's a tug-of-war at place right now between inflation and deflation.