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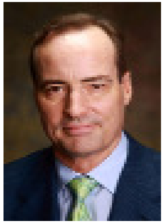

The Solution to Our Runaway Debt: Deflation and Saving...not Inflation and Stimulus

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Author of *The Great Depression Ahead*

Voters in town halls are near rioting over health care reforms that they suspect might take away choice and at the same time dramatically increase government deficits. Baby boomers have seen their retirement accounts and housing values plummet simultaneously over night – bringing into question their ability to ever retire – just as they move into their 50s and beyond, a natural stage of life where people save more and spend less. Most Americans think the stimulus programs went too far, but when faced with a debt and banking crisis the obvious answer is for a government to strongly stimulate and borrow to avoid a depression, right? Maybe not.

What if a good old-fashioned depression is exactly what our economy needs? How could adding more debt to a debt crisis be the solution? History clearly shows that depressions eliminate massive amounts of debt in a short period of time – as long as the government doesn't try to help too much and ease the pain! Severe downturns and depressions are like the bankruptcy process that is a cornerstone of creative destruction in business. Chapter 11 allows companies to restructure excess debts so that they can grow again rather than be permanently saddled with debts from past mistakes or simply outright fail.

Bubble booms are always followed by deflationary periods or depressions with no exceptions in modern history. The bubbles maximize the innovation and experimentation in new technologies and business models, then the depressions quickly eliminate the excess speculation and debt that came with that while shifting market share to the few companies, like Google or Goldman Sachs, that got it right. Those companies then gain market share and lower costs which make new technologies even more mass affordable. It was no accident that the greatest mass prosperity boom in western history followed the Great Depression and World War II. Once bubbles go to extremes they always deflate – again, no exceptions. And they usually deflate back to where they started, or even a bit lower. The Dow would have to fall to around 3,800 and housing prices would have to drop back to where they were somewhere between 1996 and 2000.

Depressions don't erase long term progress, they merely restore the economy back to balance so that it can grow again, continuing to benefit from technology cycles of progress. It generally takes years to go through this process. Depressions and business/bank shake-outs like the one we are in and the 1930s are not a horrible mistake to be avoided, they are instead part of the long term innovation process just like the bubble booms that catapult new technologies into the mainstream (like 1995 – 2007 and 1914 – 1929). Because these cycles of boom and bust take many years instead of months or days, many economic pundits don't understand the power of this process and how much it is actually adding to our future progress.

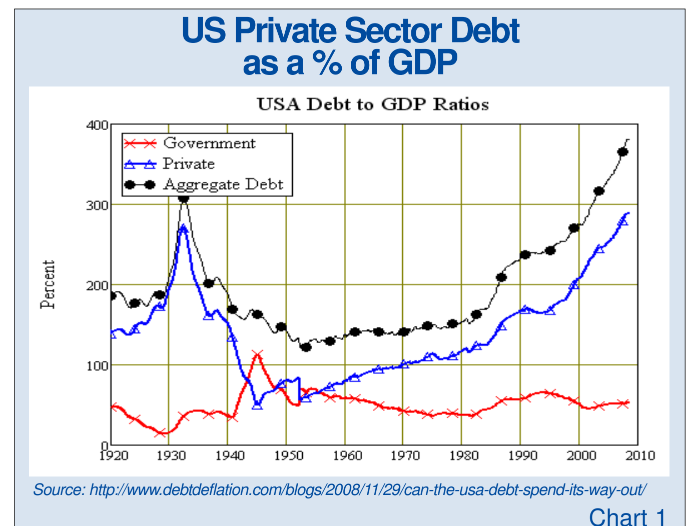

Chart 1

Chart 1 shows public and private debt ratios over the last century. There was a a bubble in private debt into the Roaring 20s that deleveraged greatly in the 1930s and 1940s. Back then Keynesian economics, which

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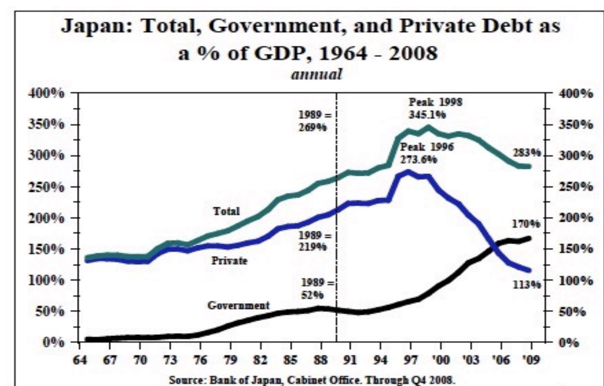
recommends that the government offset slowdowns in the private economy, was not yet in favor, so the government did not aggressively try to stop the process. Private debt levels deleveraged dramatically while government debt to fund moderate stimulus in the Great Depression and then World War II rose much less so. Now we have an even greater bubble in private debt — and government debt is rising at mach speed with the most aggressive stimulus plan in history!

If you are worried about the debt we are going to hand to our children (not to mention grossly unaffordable housing), you should be fighting a government stimulus plan that won't work anyway as massive numbers of baby boomers predictably save more instead of spend as their kids leave the nest. We shed massive amounts of private debt in the 1930s as well as brought down real estate costs and interest rates. Consumers and businesses should be restoring their balance sheets after the greatest credit and real estate bubble in modern history. How could all of that not be good for the economy long term?

Private and Government Debt, Japan



Source: Van Hoisington and Dr. Lacy Hunt Chart 2

As we forecast in the late 1980s, Japan saw its own debt and real estate bubbles begin to collapse in the early 1990s. Japan's Keynesian response is illustrated in **Chart 2**. Government debt rose nearly as much as private debt fell, leaving Japan with extremely high total debt ratios that are still in place today – and it has the fastest aging and shrinking population in the world, which is already disastrous for future growth and standard of living. Japan's experience should signal the end of Keynesian economics in an aging western world. Let's hope the U.S. doesn't follow – and we think it won't for several reasons:

1. Japan had the luxury of being a net creditor to the world (as did the U.S. in the 1920s and 1930s) and the rest of the world was booming, hence, it could stimulate its economy without retaliations by foreign creditors and its export industries could still expand.

2. The U.S. is the largest net debtor nation in the world (unlike in the 1920s and 1930s) and will have to answer to major foreign creditors like China, Japan and Saudi Arabia who may refuse to fund our bonds if we go too far with our stimulus and deficits – and we are instigating a worldwide downturn that kills our export industries.

3. Interest rates are rising with fears of inflation down the road from the massive stimulus (even though we won't see inflation due to deleveraging of debt). Rising interest rates in the next year will severely raise the costs of massive government borrowing and puncture the fragile housing recovery, although interest rates will come back down afterwards.

4. Baby boomer savings trends and continued real estate and business loan defaults (continuing even in this fragile recovery) will tank the economy by next year despite massive stimulus, and hence, voters, foreign nations and investors will lose confidence in the stimulus approach and worry more about rising deficits and debt loads.

5. Baby boomers may do a little catch up spending near term, including the "Cash For Clunkers" program, but they will retreat rapidly back into a savings mode, first out of a natural and predictable demographic trend and then increasingly due to fear of a failing economy again and their retirement prospects.

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So what should you do to protect your retirement assets and your family? Sell stocks in this bear market rally that will fail likely by early September of this year and sell any unnecessary real estate while the markets are bouncing ever so mildly. Inflation is not the worry, deflation is! Bubble booms are always followed by deflation (again, no exceptions) as asset values fall across the board and massive amounts of loans are written off by lenders. This occurs despite government stimulus and borrowing as the private sector deleverages faster than the government can react – just ask the Japanese. In 2008 household net worth fell by over $12 trillion dollars and our forecast is that we will see at least double that in the next few years. That outweighs the most aggressive estimates of government stimulus programs thus far at $5 trillion with potentially more to come – but there is much more deleveraging of assets and debt ahead as well.

In 2010 and 2011 we are going to see deflation, not inflation — and a depression, not a recovery or even a double dip recession. Holding safe cash and T-bills while all assets —- real estate, stocks and commodities – continue to fall is the best protection. Aggressive investors can simply short the stock market without using leverage and benefit from the next great stock crash from late 2010 into late 2011.

For those worrying about a crash in the U.S. dollar, it has already happened. The retirement of debt and a failing economy where imports fall faster than exports creates a positive environment for the U.S. dollar for the coming months and maybe years – not to mention very extreme oversold readings on the dollar in early August – which is bullish. So, this is not the time to diversify into the Euro or Swiss Francs. Gold and oil may see one last crisis rebound into late this year or early next year after retreating a bit more into late August or early September, but into 2010 commodities in general will be heading down again as well. The worst of the economy and unemployment is likely to come in early to mid 2011 with a potential hangover into 2012 before a more sustainable recovery is possible.

The households and businesses that have cash, cash flow and credit will benefit from the greatest sale in financial assets of our lifetime!

We will ultimately see another concerted global boom from the 2020s forward, but not as bubbly as the last one from 1983 into 2007. It will be more like the 1950s and 1960s, but more concentrated in Asia, especially India. China will start to age more like Europe by 2020 while the U.S. holds its own demographically. Unfortunately the economic clout of Europe, Russia and East Europe will fade due to quickly aging populations.

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