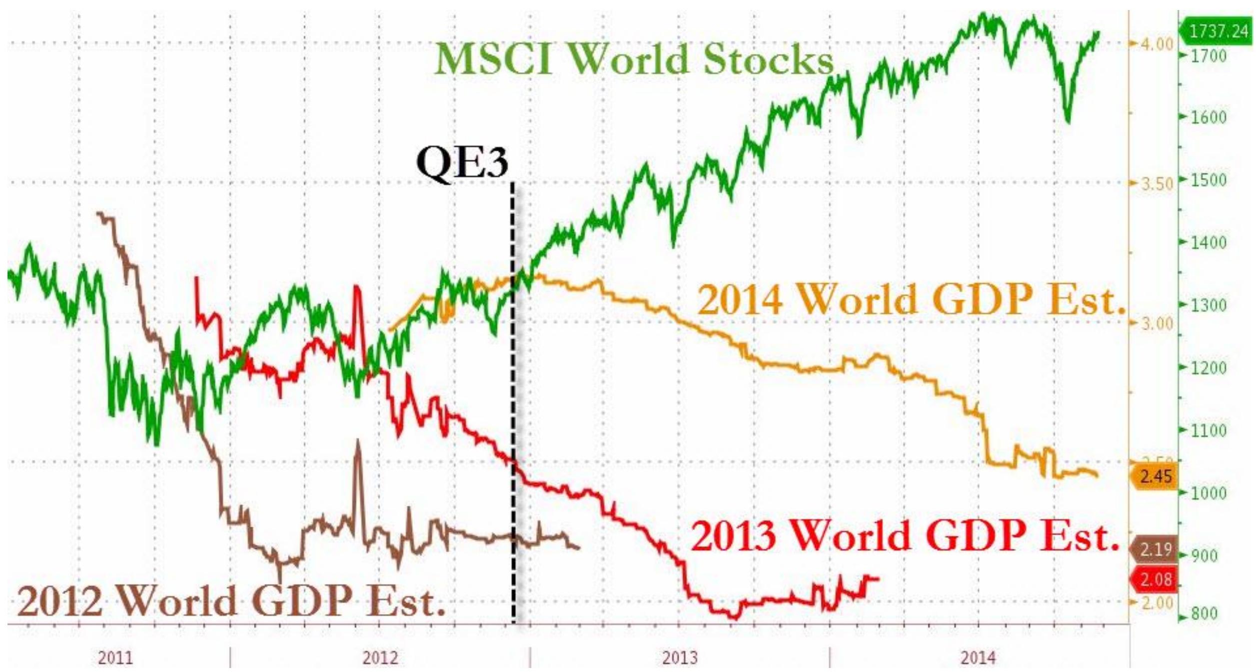
Economic & Market Update, December 2014

Currency Wars

By Richard Morey

This is the most interesting – and disturbing – time we are ever likely to witness in the world economy. The only positive thing I can see is that the safe bond investments we own for our clients at Secure Retirement have done well this year and remain positioned to do even better in the short to intermediate term.

The last six weeks have been one of the strangest periods ever seen for the markets. Stocks came roaring back are dropping in mid-October based on four developments: 1) Here in the United States one of the Federal Reserve Presidents (James Bullard) came out and said the economy may be so weak we will need to print more money, 2) The day after we stopped printing money, Japan announced they are going to print three times more than we were doing – because their economy has entered another recession, 3) The head of the European Central Bank, Mario Draghi, announced they will do anything they have to in order to stop their economy from sliding into another recession (in the north) and depression (in the south), and finally 4) China announced they are lowering interest rates to try to stop their real estate bubble from bursting and a large number of their corporations from going bankrupt. And based on these four developments, stocks around the world went up? The following chart summarizes the lunacy going on in the world stock market versus the world economy. It shows the stocks around the world rising while the world economy continues to weaken markedly:



While this chart highlights the irrationality of stocks going up, it clearly shows why bonds have also been going up this year. Bonds almost always go up when the economy goes down, so this is rational. But in a rational market stocks never go up as the world economy sinks – until now when the entire world believes central banks can solve all problems through printing trillions and trillions of new money. However, markets can only stay irrational for so long, as eventually they move based not upon delusional psychology but on economic reality. In other words, sooner or later this will end very, very poorly for the stock market.

It is amazing investors are actually ignoring risk when all the central banks around the world say they are confronting something called deflation, defined as falling prices throughout an economy. They consider deflation to be the biggest single risk to an economy, and indeed deflation only occurs in the world economy during bona fide depressions – not run of the mill economic recessions but actual Depressions with a capital D. So investors believe the central banks can protect them from all risk even as those central bankers are saying they are working frantically to keep the world economy from falling into the abyss. As an investor, that would certainly give me pause before pressing the button to buy any risky asset!

Now it would take a small book to explain why the best economists presently believe the central banks are looking at the risk of deflation in the exact wrong way, but I'll do my best to summarize the main points. The central bankers believe prices are going down (the definition of deflation) as consumers are not spending enough money today because they believe prices will be lower in the future. The central bankers are therefore printing massive amounts of money and keeping interest rates near zero, believing some of the newly-printed money will trickle down to consumers who will then spend more. And they believe low interest rates will encourage more people to borrow and spend. This is what you would read in most economic textbooks, but economists looking at the real world see an entirely different picture.

First, prices of most things consumers purchase definitely are not going down in price. To the contrary, key expenses such as food, health care, and education have been rising dramatically. At the same time, wages continue to either stagnate or fall. When you add it all up, you see consumers are not restraining their spending because they think the things they buy will be cheaper if they wait but because they began with too much debt and their incomes are not keeping up with the increased prices of most of the things they need to buy. Printing money does absolutely nothing to alleviate this situation, and keeping interest rates at nothing does not lead to more borrowing and spending when consumers already have too much debt.

On the other hand, energy and other basic materials (such as steel, copper, minerals and other natural resources except food) have indeed been plummeting in price. But lower gas prices certainly is not a problem for consumers, and the prices of natural resources overall are not falling due to consumers putting off purchases in hopes of lower future prices but because the world economy is slowing down. In fact, energy, steel, copper, and other natural resource prices almost always go down significantly shortly before the world economy enters a recession.

So deflation is not the problem that needs to be fixed at all costs. To the contrary, consumers who begin with too much debt are spending less than needed for economic growth because the prices of what they actually purchase are going up while their incomes aren't rising.

In defense of the central bankers, I am fairly certain they know all this, but they need a viable excuse to print more and more money and keep interest rates at zero. Given how scary the word deflation is to everyone who studies economics, if you say you are acting to prevent deflation few challenge your actions. So why are the central bankers really continuing to print money and keep interest rates at or near 0%? I am afraid the only rational answer is quite cynical. First, printing money and keeping interest rates at or near 0% is wonderfully profitable to those closest to the "spigot," i.e. the institutions who can get their money directly from the central banks. This only applies to a handful of entities – in the United States a small group of the very largest Wall Street banks. Secondly, printing huge amounts of brand new money can keep serious economic imbalances from erupting into crisis – until those imbalances become so large the system simply must collapse.

I could go on and on describing the economic imbalances confronting the world economy at this time. These challenges have been described in detail in previous *Economic & Market Updates.* The single largest problem is too much worldwide debt (examined in-depth in our *Economic & Market Update* for October of this year (which you can find at www.secureretire.com). Total debt – for a nation, a company, or individual – absolutely slows down economic performance until corrected. Unfortunately, our response to having too much debt has been to dramatically increase debt. We had a debt crisis in 2008-2009, and since that time total debt worldwide has shot up by a jaw-dropping 40%! Please do let me know if you can explain how a debt crisis can be solved by piling on much more debt. At the same time, central banks have embarked on reckless money-printing schemes to try to cover up the basic debt dilemma. This certainly is not the first time in history countries have decided printing money was the easy solution to a difficult problem. If it actually worked this time it would be the first time in history out of control money-printing did not end in economic tears.

Due to investors' inexplicable blind faith in the central bankers, the prices of risk assets (stocks, high-yield or junk bonds and, in some areas of the country, real estate) have risen far beyond their fair value. But the more debt that is piled on, the more money that is printed, and the higher risk assets rise in price, the more economic suffering we will have when the house of cards comes tumbling down.

Lest our readers think this is sounding sensational and I be accused of being a fear mongerer, remember the central bankers themselves are all saying they must continue (and increase in the cases of Japan, the Eurozone and China) their monetary experiments to stop deflation. And they themselves all say deflation equals depression.

But it gets worse! First a bit of recent history. After the Federal Reserve Board stopped printing money in June of 2011, over the next three months the stock market proceeded to lose over 15%. As a result, the Fed decided to first extend the length of the bonds they were purchasing and then resumed printing in September of 2012. Since that time stocks have gone up, and the world's historic economic imbalances have grown exponentially. If you had asked me when QE III began what would be the most likely pinprick that would eventually pop the stock market bubble and lead to an exceptionally difficult resetting of the world economy, one of my first guesses would have been a currency war. Of course, there is a laundry list of events that could pop this bubble, but it made sense a currency war would be near the top of the list given the fact the most unusual economic activity during this period has involved unprecedented money-printing. Printing huge sums of new money leads to the currency being printed to go down relative to currencies not being printed with wild abandon. As of October 31, it looks as if we may indeed have a currency war – which is nearly guaranteed to lead to massive losses in stocks and a severe global recession (at best).

A currency war exists when countries attempt to force the value of their own currency to lose value in relation to other currencies. It is a form of monetary suicide, as the countries involved are actively trying to gut the value of their own money. Given the dire results of a currency war, why would any country take this course of action? First, they only engage in a currency war when they are truly desperate. The motivation is to lower the value of their own currency so their exports drop in value versus their export competitors. For example, if a currency were to drop by 50% relative to another currency, this means the exports of the country whose currency drops are now 50% lower in price to foreign buyers. So having your currency drop in value means your country can now dramatically increase your exports, which can lead to a potentially large increase in your country's sales to the rest of the world. This *could* result in a virtuous cycle in which your major corporations sell much more, leading them to hire more workers and thereby increasing your country's economic growth.

Fittingly, on Halloween Japan fired the first shot in what may be a true currency war. In last month's report I explained how the Japanese economy is irrevocably dead. They have nearly 250% debt to GDP growing at 10% a year. It is impossible for them to ever raise enough tax revenue to pay off this debt (over a quadrillion yen!). However, since they can print yen they are simply going to print it all and give the yen they borrowed from their citizens back. In the process, the yen will collapse in value. It has already dropped approximately 25% in the last year versus most other currencies, and this is only the beginning.

With the yen dropping like a rock, Japanese exports are getting cheaper and cheaper relative to the products being exported by China, the Eurozone and the United States. Unfortunately for Japanese citizens, Japan imports over 60% of everything they consume. Import prices have skyrocketed, so while their multinational corporations have been able to increase their exports, consumers have been hit by dramatically rising prices at the same time their incomes continue to stagnate. As a result they have now entered another recession.

While Japan has fired the first shot, China almost has to respond. China is now growing more slowly than they have at any point in over 20 years. They have a real estate bubble, an unknown but massive amount of bad debt and major companies who will be bankrupt if the economy doesn't turn around soon. They also have a populace that will soon become very restless if their economy should not just grow more slowly but actually begin to contract. So China has to engage in this currency war with Japan, and they are likely to respond in a big way. China has the financial resources and size to fight a currency war quite seriously. But in order to engage in this war their first shots must also be directed at the United States, as their currency is presently essentially pegged to the U.S. dollar. China is now just beginning to do what will be required to get their currency to lose value as much or more than Japan's yen is falling. South Korea will likely follow suit.

Then we have the Eurozone. Since the Eurozone remains deeply troubled, with huge unemployment and a banking system that remains essentially bankrupt, they simply cannot afford to lose the competition to export their products to the rest of the world due to the yen being so low in price. Unfortunately for the Eurozone countries, the types of actions they would need to take to participate in a currency war with Japan – and China and South Korea – are completely illegal according to the treaties that govern their monetary union. The Eurozone is therefore in deep trouble. They can either follow their own laws, in which case the yen will continue to fall so much versus the Euro that Euro-based exports will no longer be competitive, or they can try to break their own treaties – treaties Germany takes seriously. Given the tenuous economic situation throughout the Eurozone, a currency war definitely could be the straw – or we should say boulder – that breaks their back. A currency war could very likely lead to the Eurozone breaking apart, with Germany refusing to continue participating in a dysfunctional monetary union when their own export-driven economy is in danger.

Looking closer to home, here in the United States I certainly hope we sit this war out. If we don't also try to kill the value of our currency we definitely will see our exports plummet. This is more than a little troublesome, as nearly 50% of our corporate profits are due to international sales. If we don't participate in this currency war, the U.S. dollar will be the one major currency that goes up dramatically versus the yen, the euro, and the Chinese yuan (also called the renminbi). U.S. corporate sales and earnings will plummet. Also, we will be importing massive deflation – and unemployment – from the other major economies. The deflation will come from the fact we will be able to export goods and services from these other countries at greatly reduced prices. In order to compete domestically, our companies will be forced to either lower their prices or lose out on sales. Unemployment will accelerate as our companies downsize to account for the fact they will not be able to compete on price with the other countries.

On balance, the United States is positioned to come out of a currency war in better shape than the other major economies. On the surface we will definitely "lose" any currency war. Despite our huge debts and slow growth, we are still better off than Japan, China and the Eurozone. But a rising dollar is already beginning to weaken our export growth, a trend likely to not only continue but accelerate in coming months. As a result, the United States will be in recession if and as a currency war occurs. Our recession should, however, be less severe than the others.

Unfortunately there is one wild card that could once again bring down our financial system. Our largest Wall Street banks have sold ***tens of trillions*** of dollars worth of credit default swaps guaranteeing to protect institutional investors around the world against risk. These banks have guaranteed against

European bond markets losses as well as losses due to changes in the value of currencies. In a true global currency war our banks may be on the hook to compensate financial institutions around the world for trillions of dollars of losses. Warren Buffett once called credit default swaps “financial weapons of mass destruction.” In 2008 the insurance giant AIG suffered the largest losses on Wall Street when they lost approximately $180 billion on their credit default swaps through which they had guaranteed against losses in subprime mortgages. That figure may be dwarfed by the losses our banks incur in a currency war.

Now it gets really difficult to predict the endgame of a global currency war. This is because there has been exactly one global currency war in all of history, which occurred beginning in 1930, so we do not have many examples to try to figure out what will occur. In general, there are a few things we can predict with some degree of confidence. In a currency war global trade can come to a standstill. With currencies moving up and down in relation to each other by large amounts literally overnight, it becomes quite dangerous for companies to engage in international trade. This is because companies will be unable to predict how much their international sales and purchases will be worth on a day-to-day basis, as changes in currency values directly impact how much companies will make or lose whenever they make a sale or purchase in another currency. Plus, one way to “win” in a currency war is to levy large tariffs on imports from the other countries manipulating their currency down. This also dramatically slows down international trade.

Another thing we can say with confidence is that a global currency war has no winners, only losers to varying degrees. Unfortunately, emerging markets are basically guaranteed to be “collateral damage” in a currency war. Over the last five to six years $7 ***trillion*** has been borrowed – by governments and corporations – in U.S. dollars and invested in emerging markets. With borrowing costs so low here in the United States, this practice has made a lot of sense financially. Overall, emerging markets have been in far better financial shape than the major economies (i.e. the U.S., Eurozone, China and Japan). Their growth rates have been much higher and their government debt levels much lower. As a result of their superior financial positions, loans to emerging market companies pay significantly higher interest while direct investments in emerging market stocks have much higher upside potential. So $7 trillion dollars has been loaned out by Wall Street to emerging market companies. When you can borrow U.S. dollars at very low interest rates and invest in higher-growth companies in emerging markets, borrowers have been able to generate excellent profits.

This all changes in a currency war if the U.S. dollar is the “loser,” i.e. the dollar continues to go up relative to other currencies. As that occurs, those who borrowed U.S. dollars begin to lose money as their currencies fall relative to the dollar. In fact, in that scenario much of the $7 trillion that has been loaned out and invested in emerging markets may be liquidated and repaid quickly. With so much money leaving their economies, emerging markets will crash – hard. In order to prevent this, these countries will have to do whatever it takes to keep their currencies high in relation to the U.S. dollar. This means they will have to raise interest rates and avoid all types of quantitative easing. But if they succeed and their currency stays strong enough to keep their U.S. dollar investments from being repatriated, they will no longer be able export their products when competing with Japan, China and/or the Eurozone. In other words, emerging market economies get decimated no matter what they do, despite the fact they have the best growth prospects and most prudent finances.

Finally, this is one of the most dangerous times in history to have a currency war. This is due to the fact the four major economies have printed trillions and trillions of dollars worth of new currency in the last few years. This is like starting a fire you know may burn down the forest after you have covered the ground with a foot of dried kindling.

Given all the above, the reaction of world stock markets the day Japan fired the first shot in a currency war was truly astounding. Stock markets around the world roared that day because investors were so relieved Japan was going to print unlimited amounts of yen beginning the day after the U.S. stopped our printing presses (at least for now). Along with deflation, a currency war is pretty much the worst thing that could happen to the world economy and stock markets. If only one or two countries engage Japan in this war the global economy will enter the worst time since the Great Depression. If everyone joins in the fight the end result may very well be another global depression. And stock investors think this means they should buy more stocks – stocks that are already priced far, far above their underlying value?

Sometimes these days it seems those who actually see economic reality are living in an alternate universe. Since the stock market turned back up back up on October 22 the global economy has continued to deteriorate. And the worse it gets, the more stocks go up! While this is disturbing on one level – primarily because so much economic suffering is now "baked in the cake" – as an investment advisor who is absolutely dedicated to protecting and growing our retirement accounts the prudent and intelligent path forward is actually clear. This is because there are exactly two assets nearly guaranteed to both protect our principal and deliver high returns whenever sanity returns to the markets:

1) The single most certain winner in a currency war and/or whenever the historic economic imbalances present everywhere begin to be resolved are longer-term U.S. government bonds. Despite our nation's unsustainable and imprudent financial debts and policies, by far the safest place for investors around the world to put their money are our government bonds. Even though the misinformed masses believe our bond prices are far too high at this time, right now essentially bankrupt countries such as Japan, Spain, and France are paying less interest than our much safer bonds.

   The end result of all the above will probably be worldwide panic on the part of investors. As the panic strikes, investors around the world (including here in the United States) are going to rush to purchase U.S. government bonds, driving their yield much lower and their prices much, much higher.

   The closest scenario similar to what is likely to occur is 2008. In that year the two pure government bond funds we own for our clients Secure Retirement, the iShares 7-10 Year Treasury Bond exchange traded fund and the Wasatch-Hoisington U.S. Treasury mutual fund, gained 17.91% and 37.77% respectively. In addition, all of our other bond funds usually move in the same direction as these two pure government bond funds. They are unlikely to make as much, but if and when any of the scenarios described in this report occur, every single fund we own should at worst hold steady and most likely all will be profitable.

2) The other asset highly likely to deliver large gains would be gold. In particular, a currency war is the perfect situation for gold to excel. Gold is essentially an alternate currency, but one which cannot be devalued. In a currency war countries are consciously trying to lower the value of their own currency, so gold would be expected to roar in that scenario.

   In most of our Secure Retirement accounts we have a small allocation to gold, averaging only 3-4% of the total (though some clients who are more disposed towards owning gold have larger allocations). Gold prices have moved in a very odd manner in the last few months, going down in price even as we now have the largest shortage of physical gold available in over a decade. We recently prepared a special report on both the short and longer-term gold market for clients for whom we do own more gold. Should you wish to receive this report, please let us know and we will send you a copy.

Summary

Please keep in mind we cannot predict *when* the economic problems described in this report will occur, nor can I predict the severity of the problems that come to light. In fact, the currency war may not even transpire. Perhaps Japan will decide to pull back on their money-printing, or perhaps China and the other countries will decide not to retaliate. Numerous uncertainties remain, and many of the details are probably ultimately unknowable. However, we do know the world economy is slowing down. We know the dollar continues to rise relative to other currencies, which is already reducing our corporate sales and profits from exports. We also know U.S. government bond prices are substantially lower at this time than those of numerous (mostly European and Japanese) countries' bonds. As a result, our government bonds should do well even if the dire predictions contained in this report either never come to pass or take many months to come to fruition. For the stock market, we know for sure stocks are far, far higher than their underlying value. While we do not know when this will change, at this point there is a 100% probability the stock market will end up with huge losses before we are through this economic cycle. We also know our accounts at Secure Retirement will go up as this occurs.