



FINANCIAL SENSE EDITORIALS

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DEPRESSION, DEBT IMPLOSION, GOLD, AND PROSPERITY

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Deflation and Depression theories debunked

Through the years I have read a multitude of articles and books with one extreme point of view or another regarding impending economic doom. Everything from impending goldilocks prosperity to imminent 1930s depression is floating around in bookstores these days.

The deflationists argue that when debt is issued at increasing levels, there comes a point when we cannot service the debt, and eventually resort to selling everything we have – bonds, stocks, houses, cars – to raise dollars to pay debt. In this scenario, deflation occurs as money aggregates shrink by debt repayments, people hold off purchases knowing goods will get cheaper, and workers will be laid off as there is no demand.

Five years ago when Dow was 8,000, I talked to Mr. Ian Gordon, who based his 1,000 Dow target on this deflation premise. Buy gold, he says, because it's the ultimate money during times of world depression and deflation.

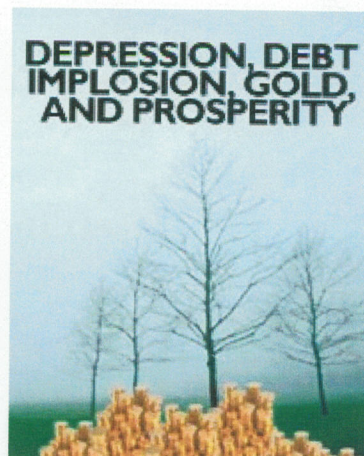
Well, he was wrong on the Dow. But he was right on gold, for the wrong reason. Gold rises in tandem with rising fear of price inflation, not fear of deflation. Gold and deflation simply do not go together. Why would you buy gold when your dollar is appreciating in value?

Deflationists and Depressionists are often the same bunch. They eagerly anticipate some specific back-breaking straw, an event that triggers the debt implosion, with the world blown back to stone ages and streets filled with riots and violence. I like to bring up two contrarian points to this view:

1. The worst possible event that could trigger debt implosion has already occurred, with demand for the multi-trillion US mortgage debt market suddenly and completely dried up. Yet the world has gone on with business as usual.

In the last four weeks, we have witnessed the worst financial event in the US over the last 50 years. The subprime mess shook the US financial system to the core, as it directly affected the marketability of the \$30 trillion+ US debt market.

Would you touch beef (US debts) again knowing there is a significant quantity of mad cow disease (subprime) going around?



The significance of this dwarfs the recent events of 9/11, LTCM, the dot.com bubble burst or the more distant events of the 1987 crash and the 1970s oil embargos.

To avoid the default of 10 million households and the systemic collapse of major banks such as Countrywide, The Fed and US government had no choice but to bail out.

a. For lenders and investors, central banks are lending unlimited amount of money to troubled outfits on renewable terms with faulty mortgages as collateral. Fannie May and Freddie Mac are buying increase mortgage purchase to troubled outfits.

b. For borrowers, Mr. Bush is working with banks and set to "forgive" certain amount of mortgages. The Fed is lowering interest rates to lessen the burden despite oil and commodities prices reaching all time high.

Investors see such inevitable and destructive path for the dollar and it should be no surprise that gold has broken through \$730 and oil has reached a new high at \$83.

2. Debt is a man-made virtual feature with limited, localized effect.

Can you honestly see Safeway running out of food or corporate America such as McDonalds or 3M stop growing? The world is forever going forwards, not backwards. Remember debts are man-made features, existing in a virtual world, serving to facilitate the transfer of ownership of real assets. While debt implosion may cause localized social instability, the disruption does not affect technological or intellectual capacities, or the existence of hard assets. All the houses, cars, planes, and technologies are still here regardless of the fate of the dollar.

What I am saying is, people outside of US hardly noticed any difference with the US debt implosion taking place in full view. I was in Thailand for a three day break and the immigration lines at the airport were full of mainland Chinese. What subprime problem so they say.

In my view, the dollar losing its reigning status would affect the global economy mildly and swiftly, as the loss of purchasing power by the dollar merely facilitate transfer of wealth of dollar holders to other fiat currency holders, and the owner of hard assets. If the party has to end for the dollar, it just means that the party is starting somewhere else.

Co-existence of Prosperity and Gold's rising popularity?

The topic linking gold to prosperity deserves a long discussion on its own. Here let me point out that Gold has risen from \$250/oz to \$720/oz in six years while the global economy has grown the fastest since WWII according to The Financial Times, this goes to show that a Gold bull and prosperity can happily co-exist without a doom and gloom outcome. With an increasing global middle class and ever-expanding fiat money aggregate, I don't see the rising gold and economic trends reversing anytime soon.

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