



## Q4 2011 Review and Commentary

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*“There is no means of avoiding a final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency involved.” - Ludwig von Mises (1881-1973), Austrian School economist*

### Paradise Borrowed

*Our Collective Journey from Thrift to Profligacy*

**Charles B. Atwill, CFP®**

IN A REUTERS [ARTICLE](#) PUBLISHED last October, former U.S. Treasury Secretary Larry Summers provided a rare – and candid – glimpse into what he *really* thinks about the global debt crisis (*emphasis mine*):

“The central irony of financial crisis is that while it is caused by too much confidence, too much borrowing and lending and too much spending, it can only be resolved with more confidence, more borrowing and lending, and more spending.”

This mainstream view of fostering economic growth through perpetual increases in money supply and credit is sometimes likened to the plight of “The Junkie.” The first “fix” creates good feelings and euphoria. Over time, more frequent and larger doses are required to create the same effect until, eventually, no amount of the drug (in this case new money and credit) provides an adequate high. Two paths lie ahead for The Junkie:

- Quit (and suffer terrible withdrawals – but ultimately survive)
- Continue (and, in time, die from the effects of chronic abuse)

Our current path, the continuation of an exponential growth of debt, will eventually lead us to a day of financial

reckoning. Though it might still be possible to avoid such an event, in order to know where we are going – we must first know where we have been.

### Humble Beginnings

In the earliest days of our experiment as a constitutional republic, the debate over “a national debt” created a schism within the cabinet of George Washington. On one side, Alexander Hamilton argued that the establishment of a national debt (as well as a federally chartered national bank) would bind the States together under a common financial yoke, and therefore act as a uniting force.

Thomas Jefferson took the other side of the argument, expressing grave concerns about the dangers of placing too much fiscal authority in one central government. His concerns were perhaps expressed best by Benjamin Franklin, warning that “When the people find that they can vote themselves money, that will herald the end of the republic.”

This debate raged in the U.S. for the better part of the 19<sup>th</sup> century. For most of that period, federal government debt never exceeded 40% of GDP (compared to 100%+ today). In fact, there was no national debt in 1835, as President Andrew Jackson’s administration paid it off in full.

While debt was not a significant issue for the U.S. in the 19<sup>th</sup> century, the form of our money was. From the Revolutionary-era “Continental” to the Union’s “Greenback” of Civil War vintage, we experimented with a variety of “paper substitutes” for money. Regardless of the particular version in circulation, gold and silver remained the ultimate

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medium of exchange. Paper could *represent* wealth; gold and silver *were* wealth.

### A Hotel in New Hampshire

In July of 1944, as the Second World War raged on, delegates from the Allied nations met at the Mount Washington Hotel in the quiet town of Bretton Woods, New Hampshire. While the intent of the gathering was to bring economic order and aid to a post-war world, the result was the establishment of a new global monetary regime.

As it appeared that an Allied victory was almost certain – and that the U.S. was the principal architect of that victory – its position at the bargaining table was quite strong. The popular economic theory at the time, developed in large part by British economist John Maynard Keynes, promoted the benefits of a global currency regime, ostensibly to reduce the potential for international conflict that often began over currency and trade disputes. The theory derided the use of gold as a monetary standard, as it limited the supply of money and expansion of credit.

The delegates agreed to a compromise solution, whereby the U.S. dollar would be internationally convertible to gold and – in practical terms – become the world’s *reserve currency*. The benefits conferred by that are many. Chief among them is the now unfettered ability to borrow in our own currency and print money. The end of the Bretton Woods Agreement in 1971 marked the beginning of what economist Irving Fisher referred to as a “debt supercycle.”

### Post-War Expansion

Having achieved military and monetary hegemony, the U.S. set out on an expansionary course not unlike that of its progenitor, Great Britain. Just as the British Navy guaranteed safe passage and trade throughout the four corners of the globe, and the Pound Sterling represented a universally accepted medium of exchange – the U.S. now found itself without commercial or military equal.

With the Great Depression a distant memory, and a strong monetary wind at its back, the U.S. share of global wealth grew at a tremendous clip. Underpinning this growth was a confidence in the strength of the U.S. financial system, the pre-eminence of the dollar, and a rising tide of credit that – in nominal terms at least – has no equal in history. The age of U.S. consumerism was heralded by the ability to pur-

chase cars, homes, appliances – quite literally everything – on credit.

If the private sector became enamored with credit, the political class raised its use to an art form. The benefits of attracting voters with programs, paid for with borrowed money, were particularly irresistible to career politicians whose “livelihoods” depended on dispensing favors, expanding the social safety net, and defending national interests in every corner of the world. While politicians promised “progress” financed with debt, a credulous electorate simply failed to understand that the “free lunches” being promised were, in fact, anything but free.

During most of the 20<sup>th</sup> century, we borrowed from the future to finance a standard of living that was the envy of the world. In 1947, total U.S. debt – public and private – was estimated to be 150% of our Gross Domestic Product. That is to say, for every \$1.00 of economic production, there was approximately \$1.50 of domestic debt. **Today, that number exceeds 350% debt-to-GDP.** As the bills came due – public and private – we simply borrowed more and kicked the proverbial can down the road. After all, to borrow a line from the songwriter Robert Earl Keen, “...the road goes on forever, and the party never ends.”

### The Party Ends

The credit bubble finally burst in the Fall of 2008. Trillions of dollars of capital evaporated; credit all but stopped flowing. Since financial markets abhor a vacuum, the U.S. Federal Reserve flooded the system with new money in an effort to replace lost capital and re-establish the flow of credit. Concurrently, the U.S. federal government borrowed and spent trillions in an effort to “stimulate” the economy. *Real* interest rates in the U.S. were taken below 0% (when adjusted for inflation) – and according to the Fed – **will now remain there through 2014.** No effort has been spared to re-inflate the bubble economy.

And when previous rounds of monetary stimulus wear off (as with junkies), a new and larger dose will follow – bringing fewer benefits and more side effects (inflation). The law of diminishing returns does not exempt economics.

### Commonwealth Lost?

If Benjamin Franklin’s warning about citizens demanding treasure (i.e., “free lunches”) from the government is correct, perhaps we are approaching the nadir of this grand

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experiment in self-governance. Human nature being what it is, the path of least resistance – once discovered – is immeasurably difficult to leave. The collective delusion that wealth and domestic tranquility can be borrowed into existence is so ingrained in our culture that, to suggest otherwise, is – at best – considered economic heterodoxy. Politicians who favor thrift over profligacy risk an even more ignominious fate: unemployment.

Whether or not we alter our course, like The Junkie, the path ahead will likely be difficult. The decisions we are now making about our fiscal course have existential consequences for our constitutional republic. The graveyard of failed nation-states is littered with the corpses of once-proud countries that were unwilling to resist the temptation of living richly in the present at the expense of future

solvency. If the current fiscal crises going on around the world are merely met with “*more confidence, more borrowing and lending, and more spending*”, then our *real* challenges have only just begun.

**Note:** For further reading on this subject, three recently published books I have found to be indispensable are:

***Inflated: How Money and Debt Built the American Dream*** by R. Christopher Whalen

***This Time is Different: Eight Centuries of Financial Folly*** by Carmen Reinhart and Kenneth Rogoff

***Currency Wars: The Making of the Next Global Crisis*** by James Rickards

None of these books qualifies as a great “beach read” - but if you made it this far, you just might find them interesting!

## Economic and Capital Markets Outlook

**Justin D. Harris, AAMS®**

IN OUR SUMMER 2010 ISSUE OF *Quarterly Observations*, we introduced the following timeline for the global debt crisis that we would like to reiterate:

**Phase 1: Financial Crisis (2007-2008)**

**Phase 2: Economic Crisis (2008 - present)**

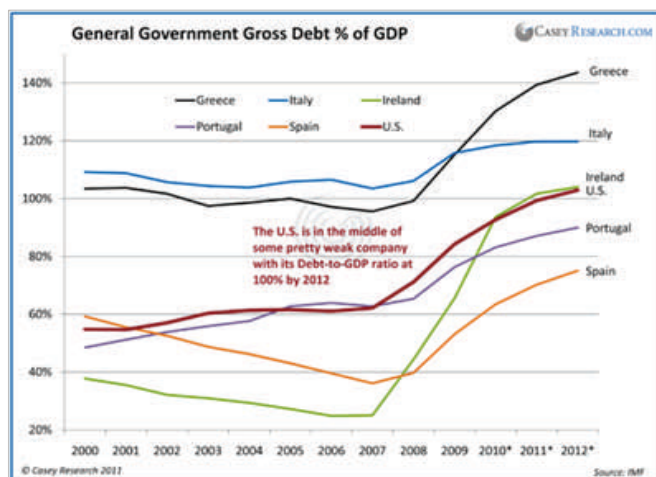
**Phase 3: U.S. Dollar Crisis (2011-2013 estimate)**

In that newsletter, we wrote: “*the economic crisis has been evolving into a sovereign debt crisis with substantial cracks emanating from the European financial system. We believe it is only a matter of time before the U.S. faces its own sovereign debt crisis, which in turn, leads us directly into this:*” ...a U.S. dollar crisis.

Fast forward to February 2012, and we see that the European debt and banking crisis dominated the financial markets in the second half of 2011 making the intractable U.S. debt situation seem immaterial by comparison.

In reality, nothing has changed fundamentally for the U.S. **(see chart in next column)**. From a basic math standpoint, the U.S. is at least as bad off as Europe. And Europe’s overwhelming debt problem is still festering beneath the surface in the global banking system.

Importantly, what *has* changed since the end of November 2011 regarding the global debt predicament is the monetary policy response to the global solvency crisis.



Source: [Casey Research](#)

**Key Point:** Excessive government debt leads to money-printing by central banks, which leads to a weakening currency. A weakening currency causes a loss of purchasing power and lower relative living standards. Central banks now appear to be engineering a new round of inflation.

### Monetary Policy Update

The second half of 2011 was characterized by central bank *inaction* as policymakers took a break to watch the European debt crisis unfold without providing the banking system with another publicly announced round of “quantitative easing” (money-printing). This inaction

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## Economic and Capital Markets Outlook *(continued)*

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lasted until only December, as global markets convulsed violently through the third and fourth quarters, liquidity in the European banking system dried up, and insolvent banks loaded with bonds of insolvent European countries came under funding pressure. Re-enter the central banks.

**First**, after Thanksgiving, the U.S. Federal Reserve took coordinated emergency measures to provide dollar liquidity to Europe via currency swaps:

### Fed, central banks slash dollar borrowing costs

November 30 (MarketWatch) -- "The U.S. Federal Reserve slashed the cost of emergency dollar loans to foreign banks as the world's major central banks took coordinated action to prevent Europe's debt crisis from triggering a global liquidity crunch.

The moves were announced in statements issued simultaneously by the U.S. Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan, the Bank of Canada, and the Swiss National Bank."

**Second**, the European Central Bank (ECB) initiated a three-year emergency lending program for the banks called a "Long Term Refinancing Operation" (LTRO), which was also designed to indirectly funnel liquidity to insolvent periphery nations such as Greece and Italy through the banks.

The sheer scale of the underlying liquidity problem affecting Europe was reported by Bloomberg in December:

### ECB to Lend Greater-Than-Forecast \$645 Billion as Banks Line Up for Funds

December 21 (Bloomberg) -- "The European Central Bank will lend euro-area banks a record amount for three years in its latest attempt to keep credit flowing to the economy during the sovereign debt crisis.

The Frankfurt-based ECB awarded 489 billion euros (\$645 billion) in 1,134-day loans today, the most ever in a single operation and more than economists' median estimate of 293 billion euros in a Bloomberg News Survey. The ECB said 523 banks asked for the funds, which will be lent at the average of its benchmark interest rate -- currently 1 percent -- over the period of the loans...

Europe's debt crisis has increased the risk of government and bank defaults, making institutions wary of lending to each other and driving up the cost of credit. The ECB is trying to ensure that banks have access to cheap cash for the medium term so that they can keep lending to companies and households. In addition to the longer-term loans, the ECB has widened the pool of collateral banks can use to secure the funds."

**Third**, a few weeks ago on January 25, the U.S. Federal Reserve's Federal Open Market Committee (the committee that makes decisions about interest rate targets and monetary policy) issued the following two very significant remarks regarding policy changes (bold emphasis ours):

1. "In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--**are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.**"
2. "**The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation.** The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. Communicating this inflation goal clearly to the public helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant economic disturbances."

The English translation of what the Fed said is this:

1. Expect short-term *nominal* interest rate targets to remain near 0% for three more years. *Real* interest rates (nominal rate - inflation rate) should remain *negative* in the near-term, penalizing prudent savers, bond investors, and retirees living on fixed income streams.
2. Explicit inflation targeting by the Fed to stimulate nominal economic growth is now out of the policy bag. How communicating a goal of creating inflation (by increasing the money supply and devaluing the U.S. dollar) helps keep "inflation expectations firmly anchored" is beyond us. We do not think this policy is going to make China particularly happy. [**Note:** We highly recommend the new book *Currency Wars*, by James Rickards, on economics and national security].
3. The U.S. debt and annual deficits are being exacerbated by structural economic weakness and high unemployment. The U.S. debt (\$15+ trillion) has grown too big to be funded solely by bond market investors. The Fed will need to keep printing money as the U.S. Treasury bond buyer of last resort to keep interest rates low.

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# Economic and Capital Markets Outlook (continued)

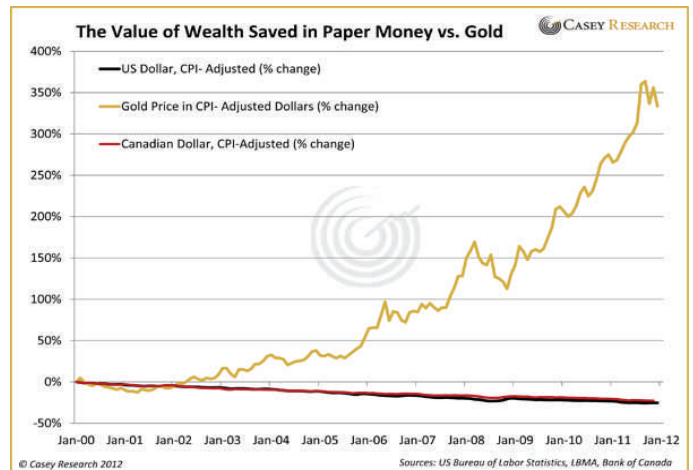
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## Key Points:

- Expect more “cost-push” inflation. In order to keep interest rates near 0% and target inflation, the Fed may be required to print *another* \$2+ trillion by expanding its balance sheet and creating new base money supply.
- The primary cause of a rising gold price is negative real interest rates. With global central banks engaged in a policy of “financial repression” (buying sovereign bonds to fund deficits and keep interest rates low), the price of gold has risen to reflect currency debasement. In dollar terms, the gold price has risen **150%** since the financial crisis began in 2008. Under current monetary policy, we anticipate gold will continue to rise.



When adjusted for changes in the popular consumer price index (CPI), both the U.S. and Canadian dollars have *lost* about 25% of their value since 2000 -- primarily as a result of loose monetary policies that helped fuel the housing and debt bubble after the prior stock market bubble burst in 2000. Gold’s real purchasing power has increased by nearly **350%** during the same time period.



Source: [Casey Research](#)

## Our 2012 Outlook

If the second half of 2011 was characterized by relative central bank *inaction*, it appears that 2012 is shaping up to be the opposite. Central banks are now taking *action* to combat the sovereign debt crisis with more monetary inflation.

As reported recently by Bloomberg, the world economy is saturated in debt with the bulk being owed by the U.S., Europe, and Japan:

### World’s Biggest Economies Face \$7.6 Trillion Bond Tab as Rally Seen Fading

January 3 (Bloomberg) -- “Governments of the world’s leading economies have more than \$7.6 trillion of debt maturing this year, with most facing a rise in borrowing costs.

Led by Japan’s \$3 trillion and the U.S.’s \$2.8 trillion, the amount coming due for the Group of Seven Nations and Brazil, Russia, India, and China is up from \$7.4 trillion at this last year, according to data compiled by Bloomberg. Ten-year bond yields will be higher by year-end for at least seven of the countries, forecasts show.”

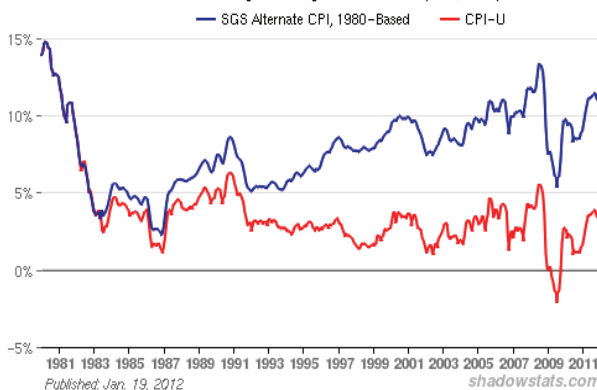
The world’s over-indebted financial system can deleverage in only one of two ways:

1. Through natural market forces and debt deflation or

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- With the real-world inflation rate (not the personal consumption expenditures index that the Fed references) *already* running around **10% per year** (see [shadowstats.com Annual Consumer Inflation chart below](#)), consumers, savers, investors, and retirees should be very aware of the economic effects of monetary policy being pursued so far in 2012.

**Annual Consumer Inflation - Official vs SGS (1980-Based) Alternate**  
 Year to Year Change. Through Dec. 2011. (BLS, SGS)



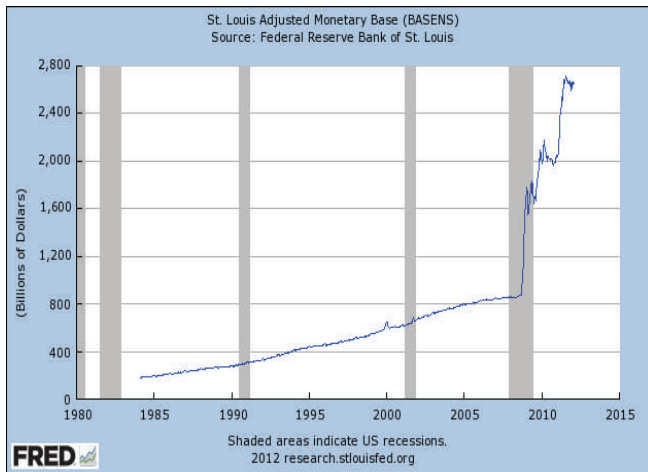
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2. Through an increase in monetary inflation

Extreme volatility across all financial markets and asset classes since 2007 has taught an important lesson:

- **the only thing that now matters to investors and the markets is what the four largest central banks -- the Federal Reserve, the European Central Bank, the Bank of Japan, and the People's Bank of China -- will do regarding monetary policy.**

A dramatic expansion of the monetary base created by the Fed since the crisis began in 2007 is shown below:



For additional data, we recommend a recent article entitled "[Living In A QE World](#)", written by James Bianco of Bianco Research, posted at The Big Picture blog.

**AFCG's Investment Strategy**

Since we believe that debt and deficits *do* matter and universal laws of economics have not yet been repealed, we continue to help clients plan and invest for a global debt default cycle with an inflationary policy response.

Our tactical asset allocation (TAA) strategy for the current market environment has exposure to gold/silver, hard asset stocks, and inflation-protected income from non-U.S. bonds, energy securities, and allocation funds:

<u>Asset Class</u>	<u>AFCG Absolute Return Models</u>	
	<u>Global Growth</u>	<u>Global Income</u>
<i>Growth Equities:</i>	25%	10%
<i>Income Equities:</i>	10%	10%
<i>Allocation Funds:</i>	15%	25%
<i>World Bonds:</i>	15%	25%
<i>Cash:</i>	10%	10%
<i>Gold Bullion:</i>	10%	10%
<i>Silver Bullion:</i>	<u>15%</u>	<u>10%</u>
<b>Total:</b>	<b>100%</b>	<b>100%</b>

**Sources:**

1. U.S. Federal Reserve Board ([www.federalreserve.gov](http://www.federalreserve.gov))
2. StockCharts ([www.stockcharts.com](http://www.stockcharts.com))
3. Bloomberg News ([www.bloomberg.com](http://www.bloomberg.com))

4. Casey Research ([www.caseyresearch.com](http://www.caseyresearch.com))
5. MarketWatch ([www.marketwatch.com](http://www.marketwatch.com))
6. The Big Picture ([www.ritholtz.com/blog](http://www.ritholtz.com/blog))
7. Federal Reserve Bank of St. Louis ([www.stlouisfed.org](http://www.stlouisfed.org))

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- ◆ Modular Financial Planning
- ◆ Total Wealth Planning (TWP™)
- ◆ Qualified Retirement Plans

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