GOLD & ENERGY ADVISOR

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"Why an All-Out Depression Would Still Mean Hyperinflation!"

"The economy is sinking fast. The government's desperate attempts to reinflate have failed so far.

"Last month I wrote that we're headed for an historic hyperinflation in the US. But many readers have asked if we're headed toward a depression instead. My answer: even if a depression arrives, we'll still experience massive inflation in certain assets—an unprecedented combination that few are expecting.

"Bye-bye to the dollar, euro, yen, etc... Hello one-world economic unit!"

James DiGeorgia, Editor

- **Signs of deflation in the US economy**
- **Meanwhile, the US money supply has more than doubled in just 4 months!**
- **During the Great Depression, which investment class went up by over 88 percent? The answer will surprise you!**

One year ago, in the January 2008 *GEA*, I wrote this: "Few have noticed—yet—but there's big trouble brewing in real estate. I think the changes in the national housing market will be one of the biggest investment stories this year."

You know what happened next. The subprime-backed securities market collapsed, which blew up several major financial institutions and crashed the stock market.

Now our entire economy seems to be threatened. Everyone is asking: how will the crisis play out in 2009? Will our economy be hit with inflation, or deflation?

More and more, it seems the answer will be neither. Not in the sense they're usually understood, anyway.

Everybody is looking back to the Depression for clues about what will happen next. But in the 1930s, the Fed didn't have the broad scope of powers it does now.

Back then, the Fed could only tinker with monetary policy. Once rates were down to zero (as they effectively are today), Fed officials could only watch helplessly as the economy fell off a cliff.

Today, it's different. A month or so ago, the Fed announced it was unleashing "quantitative" techniques. Rather than trying to manage fiscal policy, the Fed would now manage the quantity of money in the economy.

Translation: the printing presses are now cranked up to full speed.

Last month, I predicted a massive wave of inflation would hit the dollar in 2009. This month, we'll discuss the (seemingly) opposite scenario: what if I'm wrong, and the US economy slides into a deflationary depression instead?

We'll start by examining…

Why Deflation is a Terrifying Prospect

Deflation can be loosely defined as a strengthening of the currency. It manifests itself as a falling level of prices for most things throughout the economy.

Few things can frighten economists and central bankers as much as deflation. Even a massive hyperinflation might be preferable.

Once a deflation starts, it tends to accelerate. As prices fall, consumers notice. Quite reasonably, they begin to defer their purchases wherever possible. (After all, the item might be cheaper in the future.) So they save their money instead of spending it.

Of course, this suppresses demand. So prices fall even further, which suppresses sales even more.

Businesses start to fail. Unemployment starts to rise.

Meanwhile, debtors can fall behind on their loans, despite making payments on time. Since their debts are denominated in a strengthening currency, the debts grow (in terms of purchasing power) over time.

So debtors start to default. This causes creditors to tighten their credit standards. Credit becomes harder to obtain, further suppressing economic activity.

Before long, the economy is spiraling downwards, accelerating as it goes.

And that's why everybody in Washington is scared right now. More and more, we see…

Signs of Deflation All Around Us

US consumer spending has declined for the first time in 17 years. People are starting to save instead of spend—the personal savings rate climbed from 0.5 percent in 2007 to 2.8 percent in November 2008.

In a related statistic, the most recent report of US household debt shrank from the previous quarter. This is the first time this has ever occurred.

That's why in December, retail sales fell 1.7 percent year on year. This occurred despite all the huge holiday discounts and inventory clearance sales you saw advertised.

Meanwhile, unemployment has jumped up to 7.2 percent. The government reported that 524,000 jobs were lost in December. The number of Americans drawing unemployment benefits has grown to the highest levels since 1982.

Overall in 2008, 2.6 million jobs were lost.

Grim statistics are everywhere. For example, new orders for manufactured goods (a key economic indicator) plunged by 6 percent in October and another 4.6 percent in November.

Thanks to all the problems businesses are experiencing, the commercial real estate market is tanking too. Delinquencies on commercial mortgages are surging, nearly doubling during the last quarter.

Of course, residential real estate is even worse. In November, existing-home sales plummeted by 8.6 percent from the prior month. The S&P Case-Shiller index has now fallen 23.4 percent from its peak in mid 2006.

And stock markets around the world have been hammered. The S&P plunged by 39 percent in 2008. Japanese stocks finished down by 42 percent. German shares fell by 40 percent. And the list goes on.

Manufacturing has cratered all over the globe. The Institute for Supply Management's new-orders index has sank to its lowest level ever. Of the 18 industries included in the index, not a single one reported any growth.

No surprise then that global trade has also taken it on the chin. The latest figures from the Commerce Department show that US imports and exports fell by 18 percent over four months. This is unusual even in a recession, and will make it all the more difficult to get out of the crisis.

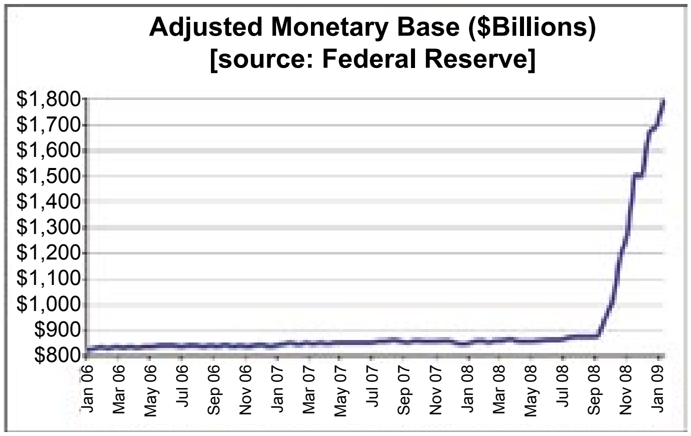
And the outlook for the near future gets worse every day. For example, Standard & Poor's has calculated that about $758 billion in corporate bonds will come due in 2009. Almost all this debt will have to be refinanced—and thanks to the mostly-frozen credit markets, this will occur at *much* higher rates than the companies are currently paying.

As House Majority Leader Steny Hoyer recently said, "Nobody's crying wolf here. The wolf is at the door."

Desperately Trying to Reinflate the Economy

As I mentioned before, the Fed has been forced to resort to "quantitative" techniques.

Last month, I discussed how the government was starting to hyperinflate our money supply. This breathtaking expansion has continued.



The monetary base has more than doubled in just four months. Over a year's time, this is an *eightfold* expansion.

This is an 'economic stimulus' beyond the wildest dreams of the most die-hard Keynesian. So why isn't our economy turning around?

Because the money isn't circulating as the Fed wants. A lot of the money has gone into Treasuries. A lot of the rest is being saved rather than spent or lent out.

And that last point is important. Until the credit markets open up again, the economy will continue to sink.

So why is credit still so tight?

Well, the Associated Press recently tried to find out. It contacted 21 large banks that have received at least $1 billion in federal bailout funds. The AP asked what the banks had done with the money.

None of the banks would give a specific answer. Here are some of the replies the AP received.

From JPMorgan Chase: "We've lent some of it. We've not lent some of it. We've not given any accounting of, 'Here's how we're doing it'. We have not disclosed that to the public. We're declining to."

From the Bank of New York: "We're choosing not to disclose that." (The spokesman then added, "I just would prefer if you wouldn't say that we're not going to discuss those details.")

From Morgan Stanley: "We are going to decline to comment on your story."

From Comerica Inc.: "We're not sharing any other details. We're just not at this time."

The nation's banks have been given big piles of cash to encourage them to start lending, so that the credit markets will thaw. And it's true that the credit markets aren't quite as bad now as they were in October (although that's not saying much).

But the vast majority of that cash has been squirreled away rather than being lent out. As James Wells III, CEO of SunTrust Banks, said, "As long as the current uncertain and challenging economic environment persists, maintenance of capital at elevated levels is desirable."

In just the last four months, the Fed has created and injected $930 billion into our money supply. Apparently, that's not enough.

And the Fed has promised to create *as much money as needed* to solve the economic crisis. So the presses continue to run 24/7.

THE GOLD AND ENERGY ADVISOR

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Eventually, the tsunami of liquidity will have its effect. Bank balance sheets will balloon to the point where banks start lending again. Businesses and consumers will feel flush enough to start spending again.

And then the full effects of the inflation will hit. That's why I continue to expect…

Deflation, and Then Hyperinflation

Portfolio Update

In Update #628, we issued hedging instructions for subscribers who own Energy Exploration and Production ETF (symbol XOP) and Berry Petroleum (BRY). On XOP, we sold the Feb. $35 calls (symbol XOABI). On BRY, we sold the Feb. $10 calls (BRYBB).

In Update #629. we issued instructions for subscribers who sold the APA Jan. $80 calls (APAAP), the EAC Jan. $22.50 calls (EACAX), the APC Jan. $40 calls (APCAH), and the BBG Jan. $20 calls (BBGAD). We rolled up APAAP to the Feb. $80 calls (APABP). We rolled up EACAX to the Feb. $22.50 calls (EACBX). We rolled up APCAH to the Feb. $40 calls (APCBH). We rolled up BBGAD to the Feb. $20 calls (BBGBD).

In Update #630, we issued instructions for subscribers who sold the OXY Jan. $55 calls (OXYAK), the PXD Jan. $20 calls (PXDAD), the TLM Jan. $10 calls (TLMAB), and the XTO Jan. $40 calls (XTOAH). We rolled up OXYAK to the Feb. $60 calls (OXYBL). We rolled up PXDAD to the Feb. $20 calls (PXDBD). We traded up TLMAB to the Feb. $10 calls (TLMBB). We traded up XTOAH to the Feb. $40 calls (XTOAH).

In Update #631, we issued hedging instructions for subscribers who own Noble Corp. (NE), Suncor Energy (SU), ConocoPhillips (COP), Devon Energy (DVN), and Gulf Island Fabrication (GIFI). For NE, we rolled up our Jan. $27.50 calls (NNDAY) to the Feb. $27.50 calls (NNDBY). For SU, we rolled up the Jan. $25 calls (SUAE) to the Feb. $25 calls (SUBE). For COP, we rolled up our Jan. $55 calls (COPAK) to the Feb. $55 calls (COPBK). For DVN, we rolled up our Jan. $75 calls (DVNAO) to the Feb. $75 calls (DVNBO). For GIFI, we sold the Feb. $15 calls (GQIBC) against our position.

In Update #637, we recommended 100 shares of Devon Energy (DVN) for the GEA2 portfolio. For both portfolios, we sold short the DVN Feb. $55 put (DVNNY) at about $4.10.

By most measures, we're currently experiencing a deflation. And throughout modern history, deflationary spirals are very difficult to escape.

But modern history has never seen a central bank so determined to print *as much money as needed*, in as many ways as are needed.

Even the US government has been unable to spend money as fast as the Fed is printing it. (Unbelievable, but true!)

So the Fed is using the new cash to buy everything it can: CDOs, mortgage-backed securities, commercial paper, commercial real estate paper, money market paper, student loans, credit card debt, auto loans, bank stocks, small business loans, mortgage bonds, municipal bonds (as proposed by the Obama transition team)… the list goes on and on.

The Fed is injecting money into the economy any way it can. Pretty soon we'll see eBay auctions being won by a user named "helicopter_ben."

In just four months, the Fed has poured almost $1 trillion into the economy. And there's a lot more coming.

So this is a good time to ask…

How Much is $1 Trillion, Anyway?

A trillion is a million millions. It's a 1 with twelve zeros after it.

Since a dollar bill weighs about one gram, one trillion dollar bills would weigh **1,103,500 tons**.

A trillion dollars is more than the GDP of every other country in the world except the top twelve (US, Japan, Germany, China, the UK, France, Italy, Spain, Canada, Brazil, Russia, and India).

As the *Wall Street Journal* recently pointed out, Thomas Jefferson bought the entire Louisiana Purchase for only $261 million in today's dollars. The Panama Canal cost $7 billion. The entire Apollo space program, adjusted for inflation, cost only $140 billion (and it took 11 years to spend it all).

Other than World War II—the biggest expenditure in US history—only two other expenses have come close to the Fed's recent $1 trillion spree.

Dwight Eisenhower's interstate highway system took 35 years and cost $114 billion. In 2008 dollars, that's about $800 billion.

And the Marshall plan (rebuilding Europe after World War II) cost $755 billion in today's money.

Think about that. The Fed has already created more money than the cost to create the entire US highway system. More money than was necessary to rebuild *an entire continent*, which was smoldering rubble after a devastating World War.

And the printing presses are still running as you read this.

Yes, Bernanke has promised—*promised*, mind you—to drain all that liquidity back out of the system once the economy recovers.

But as I discussed last month, that won't happen. The Fed's economic indicators look backwards, not forwards. Their actions tend to lag the economy.

Plus, a Democratic Administration with a Democratic Congress will *not* pull the plug on an inflationary boom, especially after all the contraction we're currently experiencing.

Famed analyst James Grant wrote about this recently in the *Wall Street Journal*. He said, "The seasons of finance are unpredictable. Prescience is rare enough in the private sector. It is almost unheard of in Washington. The credit troubles took the Fed unawares. So, likely, will the outbreak of the next inflation. Already the stars are aligned for a doozy. Not only the Fed, but also the other leading central banks are frantically ramping up money production."

Even during normal business cycles, the Fed usually holds down the gas pedal too long. As just one example, the Fed kept its target interest rate at a mere 1 percent during 2003-2004, even while GDP growth shot up to an annual rate of 7.5 percent.

And we also have to consider…

The Resurrection of Keynesian Economics

Big-government socialist J.M. Keynes is dead now, but his ideas live on.

Keynes preached that government spending—lots and lots of government spending to increase aggregate demand—was the cure for every economic ill. His ideas were popular for decades, but most economists eventually realized that they inevitably produced inflations and currency collapses. Part of the Reagan Revolution was a move away from Keynesian policies.

But then the markets crashed in 2008. And you could hear the big-government socialists cheering.

The 'economic left' has long derided free-market capitalism. The current market troubles are, for them, proof that they were right all along.

Perhaps the most prominent example is Paul Krugman, who recently won the Nobel Prize in Economics. He says the Great Depression lasted as long as it did because the government *didn't interfere enough in the economy*.

Even a free-market bastion like the *Wall Street Journal* is running articles with titles like, "The New Old Big Thing in Economics." It quoted a Brookings Institution economist who said, "The situation is so severe that we're all Keynesians again—Keynesians in the foxhole… It really is such a difficult time that we're going to need to use whatever ammunition we have."

Not Just One Crisis

Our economy's freefall is taking up most of the news today, but there are other urgent crises to consider too.

For example, Pew Research just released a study on the country's transportation infrastructure. Many of our roads, highways, and bridges need to be fixed immediately, before any more tragedies occur (like the collapse of the Interstate 35 bridge in Minnesota).

Here's an excerpt from the report:

"The numbers are staggering. More than one in four of America's nearly 600,000 bridges need significant repairs or are burdened with more traffic than they were designed to carry, according to the U.S. Department of Transportation.

"A third of the country's major roadways are in substandard condition—a significant factor in a third of the more than 43,000 traffic fatalities each year, according to the Federal Highway Administration. Traffic jams waste 4 billion hours of commuters' time and nearly 3 billion gallons of gasoline a year, the Texas Transportation Institute calculates.

"Dams, too, are at risk. The number of dams that could fail has grown 134% since 1999 to 3,346, and more than 1,300 of those are 'high-hazard', meaning their collapse would threaten lives, the Association of State Dam Safety Officials (ASDSO) found. More than a third of dam failures or near failures since 1874 have happened in the last decade…

"'Much of America is held together by Scotch tape, bailing wire and prayers', said Donald F. Kettl, director of the Fels Institute of Government at the University of Pennsylvania.

"Fixing these problems and others threatening the nation's critical infrastructure would cost $1.6 trillion—more than half of the annual federal budget, the American Society of Civil Engineers (ASCE) estimates. And that doesn't include what it will cost for new capacity to serve a growing population."

Somebody better tell the Bureau of Engraving and Printing to hire some more workers. We need to print another $1.6 trillion dollars…

The Judge Business School at the University of Cambridge is starting the Keynes Society. This is to "revive the sense of pragmatic creativity which seems so lacking, and so necessary at the moment."

In another *WSJ* editorial, Thomas Frank wrote a glowing recommendation for Congressional candidate Thomas Geoghegan, who is a "true reformer" and "an unrepentant New Dealer."

Even the International Monetary Fund is recommending all governments boost spending immediately by at least two percent.

What does a return to Keynesian policies mean for the US? A return to the 1970s.

Remember double-digit inflation? Remember the "misery index" (inflation plus unemployment) shooting up past 20 percent? Remember skyrocketing gold prices?

They're about to return with a vengeance—especially when you consider…

The Coming Backlash Against the Dollar

Ironically, as the US economy has dived into the toilet, the US government has actually benefited.

As investors and financial institutions have fled to safety, US Treasuries have been the destination of choice. This has driven down interest rates, and therefore, borrowing costs for the US government.

But this is temporary. Once the economic crisis is past, the tsunami of capital that flooded into Treasuries will rush out again.

Nobody in their right mind wants to own dollars or dollar-denominated investments long-term. Even before Obama's big stimulus package, the government is officially running a $1.2 trillion deficit this year. (Of course, that number includes the usual accounting fraud of including excessive Social Security and Medicare collections as income, so the true number is much higher.)

No, investors and institutions were forced into dollars and Treasuries because they're safe (over the short term). But once better alternatives become available again, it's bye-bye dollar.

As Robert Catalanello (head of foreign exchange for the Americas at Calyon in New York) recently commented, "By being so aggressive, the Fed has really signaled significant weakness in the US economy. As a result, why do you want to hold the currency, really?"

The US government now spends a jaw-dropping 24.9 percent of national GDP. Once Obama's stimulus is added, that number will shoot up to about 27.5 percent.

These are banana-republic numbers. In fact, the major ratings agencies are starting to quietly warn that the United States' credit rating is going to be downgraded soon.

A few months ago, John Chambers (the Chairman of S&P's Sovereign Ratings Committee) said the AIG bailout had "weakened the fiscal profile of the United States." And he was only referring to the $85 billion bailout—which was before the Fed created $930 billion from thin air.

I think the only reason Treasuries are still rated AAA is because the agencies are afraid of the political fallout that will occur once they assign a proper grade. But pretty soon, they'll be forced to acknowledge the obvious.

Any nation that spends more than a quarter of GDP (and on what?), while doubling its money supply in just four months, is not an AAA credit risk. If anything, it's a rerun of the Weimar Republic.

That's the bitter irony of the current crisis. Once it's finally resolved, and markets operate smoothly again, and the dollar is no longer benefiting from a 'flight to safety', then the greenback is going to get pounded.

I think this is one of the reasons we're starting to see…

Demand for a One-World Currency

Socialists have wanted a global currency for decades. But a shocking new development is that supposedly free-market thinkers are now calling for it too.

One of the last places I expected to see this happen is the *Wall Street Journal*. But on January 2, the 10th birthday of the euro, the *WSJ* ran an editorial endorsing the idea.

Here are some excerpts:

"The euro's great achievement has been to provide a stable means of exchange for the world's largest single market. Currency risk was ended, and transaction costs cut for anyone doing business in eurozone countries… Travel was made easier, as was trade and investment. Interest rates fell… The creation of a single European Central Bank (ECB) has better insulated monetary policy from political manipulation.

"The monetary trauma of the last 10 years hasn't come from the euro but instead from its volatility against the dollar… This volatility imposes huge costs on global commerce. The greenback's 18% decline against the euro in the last 10 years is effectively an 18% price increase on all goods to the US from the eurozone. Sharp and unpredictable exchange-rate movements lead to the misallocation of capital and mistaken business judgments.

"Robert Mundell, the Nobel laureate and intel-

Congress Quietly Prepares to Raise Your Taxes to Crushing Levels

Democratic leaders in Congress have imposed new rules on how the House of Representatives does its business.

As the *Wall Street Journal* explained, "Tax increases will now be easier to pass, because opponents will not be allowed to offer a simple motion to strike any increase without making up for the 'lost revenue'. In addition, tax cuts are more difficult, because they cannot be offset with spending cuts. The new rules will mean that the only way to push for a tax cut will be to propose a tax increase elsewhere."

In addition, the new rules strangle the usage of "motions to recommit"—a procedure allowing the minority party to block outrageous acts by the majority. Republicans have been using motions to recommit to block tax increases that were snuck into other bills. But this century-old tradition, meant to ensure bipartisanship in Congress, is now history.

The new Democratic leaders have made their intentions clear. Apparently, taxes are going to shoot up to levels not seen since Jimmy Carter.

...While Destroying the Housing Market

The politicians in Washington are also promising to pass a mortgage "cram down" law. This would allow judges to write down the principal on a mortgage if the homeowner declares bankruptcy.

This is an unbelievably stupid idea. Would you invest in a security whose face value could be reduced on a whim at any time? This would blow up the secondary market for mortgage securities—the instruments whose problems started the entire economic crisis we're currently in.

It doesn't take a Ph.D. economist to see what this would do to the market. Mortgages would start trading as, in effect, unsecured debt. That means mortgage rates would start to approach standard market rates for unsecured debt.

What will happen to the housing market when mortgage rates shoot up to the same levels as credit cards?

lectual father of the euro, has argued plausibly that a major catalyst for the escalation of the financial panic in September and October of 2008 was the sudden if temporary rise of the dollar against the euro after a year of rapid decline The deflationary impact presented banks with larger losses on their dollar assets…

"For Mr. Mundell—and former Fed Chairman Paul Volcker—the lessons point to the eventual need for a single global currency."

I've already used the word "irony" several times in this issue, but I have to apply it again here.

Big-government thinkers are calling for a global economic structure where currencies don't float against each other. But *we used to have a system like this*—and governments hated it!

Back when the West was on a gold standard, there were no currency fluctuations. Every major currency was pegged to gold. Therefore, the currencies couldn't float relative to each other.

Was this a boon to Western nations' economies? Yes. Did this boost international trade? Yes, absolutely.

So why did the politicians hate it so much? Because it enforced fiscal discipline!

Politicians want to have their cake and eat it too. They want to eliminate currency-exchange fluctuations, while avoiding the discipline required by the gold standard.

Will US leaders sacrifice our sovereignty, and join Europe, Japan, and the rest into a one-world economic system? There's certainly a growing trend in that direction. But whether they do or they don't, one thing is clear…

Gold is Simultaneously Your Best Defense and a Spectacular Opportunity

Unlike many gold analysts, I don't automatically recommend gold no matter what the markets are doing.

For example, in 1997 I left the prestigious *Silver & Gold Report* to start my *21st Century Investor* family of publications. I saw the huge changes that were about to hit the markets, so I shifted my attention away from precious metals. (And I guided my readers to many years of successful profits.)

But at the current time, I think gold is a must for every portfolio. Not your entire portfolio, but 15 to 20 percent of it.

At worst, this is "wealth insurance," to protect you against financial disasters that can strike the more conventional parts of your portfolio. At best, it might be the most profitable part of your portfolio over 2009 and 2010.

Will the US government continue to inflate our money supply? If so, we'll see a repeat of the late 1970s—when inflation hit double digits and gold exploded up by 486 percent in just five years.

Will the US economy fall into depression instead? If so, gold should still do well. In 2008, while assets overall got whacked by deflation (US stocks lost some $8 trillion in market cap), gold actually went up for the year.

Even during the Great Depression, when everything else deflated, gold went *up* by 88 percent!

From 1930 to 1936, the US economy experienced a 19.3 percent deflation. But gold's purchasing power went up by 88.2 percent instead. (Its price rose by 68.9 percent, and the purchasing power of the dollars in its price rose by 19.3 percent.)

Will the US join other countries in a global currency? Then gold is your best protection against the politicians and central bankers who hate fiscal discipline so much.

But what if the answer is "none of the above"? What if somehow, the government pulls off a miracle? What if Obama and Bernanke restore the US economy to business as usual, avoiding both inflation and deflation?

Then we'll see a return to the economy we were enjoying before 2008's crash. An economy where gold almost tripled in just five years.

And before 2008, government deficits were "only" $551 billion per year. Now we're up to $2 trillion or so. How can gold *not* do well under these conditions?

Summary: in my opinion, with the current economic conditions, investors should protect their portfolio with 15 to 20 percent gold. This is enough to protect against market disruptions, and even to profit handsomely if hyperinflation occurs.

That leaves 80 percent or so of your portfolio for other investments, including energy stocks. With everything else that's going on, these stocks have been largely ignored… but that doesn't mean our energy problems have gone away. Just the opposite is true.

More on that in future issues!