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Powell Retires the Word "Transitory" When Discussing Inflation

By Dennis Tubbergen

When Federal Reserve Chairman Jerome Powell first used the word "transitory" to describe inflation, I suggested that the Fed Chair's assessment of inflation was wrong, and that inflation was here to stay until the policy of creating massive amounts of new currency changed.

And, should this policy of currency creation or quantitative easing stop, it will still take some time for inflation to subside given the time lag of 18 to 24 months between the time that currency is created and the point that inflation emerges.

Color me cynical, but I also believe that Mr. Powell knew that inflation would not be transitory when he made the statement that consumer price inflation would be a blip on the screen. And even now, as the Fed Chair reverses course on the transitory narrative, he is not pointing to currency creation or quantitative easing as the cause of the inflation.

This[1] from "Danske Bank":

We believe Fed Chair Jerome Powell's comments today and yesterday mark a policy U-Turn. Powell highlights some very important things

- *COVID-19 outbreaks are inflationary in nature, as they "reduce people's willingness to work" causing a prolonged period with supply-chain disruption. We have been arguing for a while that it also adds to the inflationary pressure by keeping goods consumption elevated. A new outbreak in the US is now ongoing and the omicron probably adds to uncertainty.*
- *CPI inflation reached 6.2% y/y in October, the highest in more than 30 years, and long term inflation expectations from the University of Michigan consumer survey are now 3.0%, which is above the 2004-2007 average. These, together with high wage pressure, are likely the reason why Powell said that it is time to "retire" the transitory term.*
- *Fed Chair Powell said "it is therefore appropriate, in my view, to consider wrapping up the taper of our asset purchases, perhaps a few months sooner", clearly a hawkish shift from earlier this year when Powell was not "thinking about thinking about" tightening monetary policy. We know the Fed likes to work by consensus and even more dovish-to-neutral members like Clarida and Daly have argued that along the same lines.*

Will the Fed really taper as the Chair has indicated?

I have my doubts for reasons that I will outline in this month's "You May Not Know" Report.

Three Choices – All Bad

Stepping away from the rhetoric and looking at the math behind the currency creation, one reaches an inescapable conclusion – should the Fed follow through on the taper and cease currency creation or quantitative easing, a deflationary period unlike anything any of us have ever seen will quickly materialize.

Our team has been preparing clients for this to the best of our ability by suggesting that a nest egg be divided into two classes of assets; this is at the core of the Revenue Sourcing™ planning strategy. Have one class of assets that are stable with the goal of protecting these assets from the deflationary environment that will have to emerge and one class of assets that have the objective of protecting from inflation.

To properly frame this conversation, we need to define inflation and deflation. Inflation is an expansion of the money supply while deflation

is a contraction in the money supply.

Rising prices are a symptom of inflation and collapsing prices are a symptom of deflation.

The last major deflationary period experienced by the United States was the 1930's and it was devastating for those who lived through it. Stock prices fell 90%, real estate prices collapsed, and unemployment soared.

A little-discussed fact about the 1930's is the money supply expansion or the inflationary period that preceded the deflationary period now referred to as The Great Depression.

After the Federal Reserve was established in 1913, the backing of the US Dollar by gold was reduced from 100% to 40%[2]. The math tells us that the currency supply increased by 250%. That led to easy credit and massive levels of debt. During the 1920's, this debt accumulation created an environment of prosperity that was artificial and illusionary.

Despite modern day Keynesian economists insistence to the contrary, debt cannot accumulate indefinitely. At a certain point, debt levels reach the point that they cannot be serviced.

As I've discussed in the past and since 2011 in the book "Economic Consequences" debt accumulation is limited by production. Here is an example to make the point.

Let's assume you and your neighbor are both in the market for a new car. You go to the dealership and pay cash for your car but your neighbor finances her car. You, by paying cash for your car, are spending past production. To have the cash to purchase the car, you had to go to work and produce and then save some of that production to be deployed later.

Your neighbor by financing her car, needs to go to work and produce so she can make the payments on the car. When purchasing her car, your neighbor is spending future production.

The indisputable economic fact is this: future production is limited or finite so debt accumulation must also be limited or finite.

In the 1920's, the prosperity illusion continued until debt accumulated to the limit. Once debt accumulation could no longer be supported by future production, the deflationary period ensued along with all the economic ugliness that accompanies such periods.

At the time of the financial crisis, now more than a dozen years ago, it seems obvious to me that we had reached the limit as far as debt accumulation was concerned.

Take a look at the chart on this page (below). It is a chart of the Fed Funds rate.

The Fed Funds rate is set by the Federal Reserve and is the rate of interest that member banks pay for overnight loans. The Fed Funds rate is a good barometer of interest rates in general.

Notice at the time of the financial crisis, that interest rates were reduced to zero percent where they have pretty much remained. Despite zero interest rates, borrowing did not increase to the point that more money was created, because the debt was at the limit.

In response, the Fed began the temporary program of "quantitative easing" or currency creation. Since currency wasn't being loaned into existence, the Fed decided to create currency and inject it into the economy.

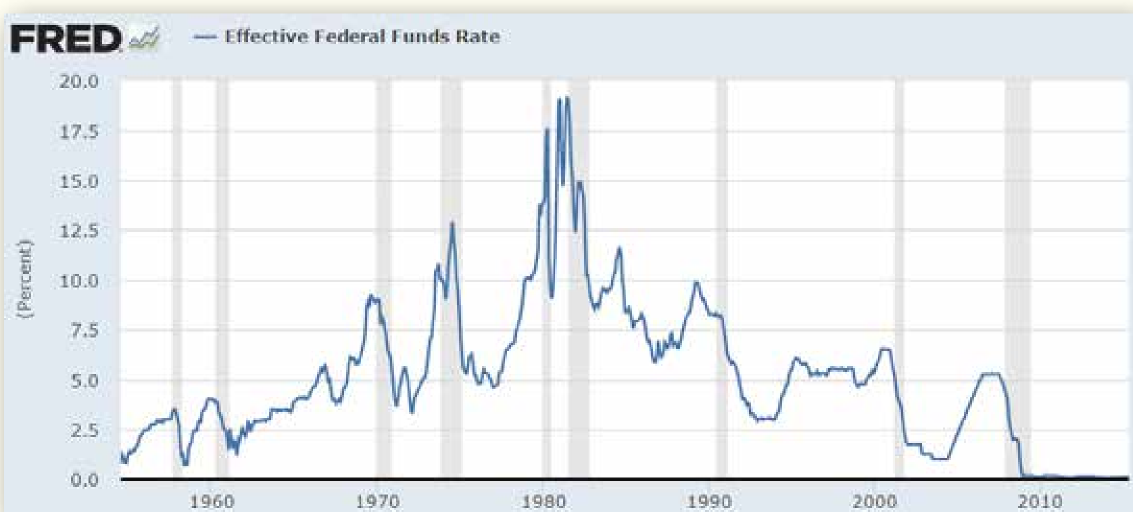
A period of prosperity followed. But now inflation is popping the prosperity illusion bubble and the Fed is changing the narrative.

But, the reality of the economic math is sobering as I discussed on a recent "Headline Roundup" webinar.

The harsh reality is the Fed cannot stop quantitative easing unless the Federal Government's budget is balanced or is a lot closer to balanced than it is presently. The numbers don't lie.

Take a look at the screenshot (page 5, bottom) taken recently from USDebtClock.org. This website tracks US Government debt, the operating deficit and tax revenues.

Notice that the actual US Federal operating deficit is about $3 trillion. Spending is a re-



markable $7 trillion and tax revenues are $4 trillion. That means that $3 trillion needs to be borrowed to allow the federal government to operate.

Many still believe that the operating deficit is being funded by borrowing from Japan, China and other countries around the world. While that was once true, it is no longer.

Total US debt owned by Japan is $1.26 trillion and total US debt owned by China is $1.07 trillion[3]. Total debt owned by the two countries is about $2.33 trillion. That's only enough to fund the deficit for about 8 months!

Given the state of US finances presently, it probably comes as no surprise that China, Japan and other countries who have traditionally been purchasers of US Treasuries are no longer lining up to buy them. This[4] from "Asia Times":

A specter is haunting the markets – the specter of a US $4 trillion Treasury funding requirement for 2021. The Fed is now the last buyer standing in the world's biggest fixed income market, buying virtually all of the massive issuance of federal debt, as we noted in our March Chart of the Day.

The deficit hasn't been this big since World War II, but there's a difference. The American public financed the deficit of the 1940's with Liberty Bonds. Now the Federal Reserve is financing on its own balance sheet.

Foreigners, who took up a great deal of Treasury debt during and after the Global Financial Crisis of 2008-2009, have stopped buying Treasuries. China, the largest official holder of US government bonds, isn't motivated to bail out America at the moment.

Japan, the largest incremental buyer, is out of the market. Private investors don't want to own US bonds because it's dicey to hedge the currency risk. The problem erupted last March, as "Asia Times" reported at the time, and foreigners have shunned the Treasury market since. The falling dollar hasn't helped matters.

With the Fed acting out not only as the buyer of last resort but the only big buyer, liquidity is vanishing in the Treasury market, and that's dangerous.

The very important point here is that the Fed is now the only large, significant buyer of US Government debt. As you all know, the Fed simply creates the currency to buy the debt.

It's also important to point out that the banks mentioned in the article are the intermediaries. Banks buy US Government debt and the Fed buys the debt from the banks.

If the Fed does taper, where will the funding for the operating deficit come from?

There are no buyers for US Government debt. If there are no lenders, then the only alternative is to cut spending and finally deal with the debt which will hurl the country into another deflationary environment.

This brings me to the three choices mentioned above to deal with the operating deficit:

1. Raise taxes
2. Cut spending
3. Keep on creating new currency

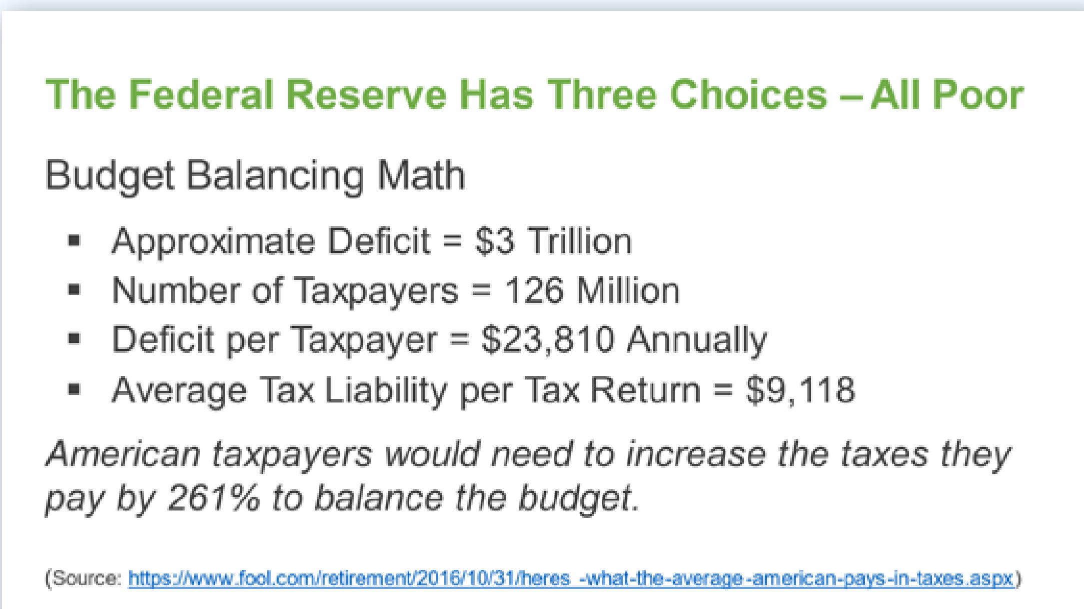
Let's begin by looking at raising taxes as an option to close the budget deficit which would allow the Federal Reserve to proceed with the taper. This slide (this page, bottom) from one of my recent "Headline Roundup" webinars explains the situation.

There are 126 million tax returns filed in the United States. The current average federal tax liability per tax return is $9,118. The current federal operating deficit is $3 trillion. Dividing the operating deficit by the number of tax returns, one arrives at the conclusion that each taxpayer would need to ante up an additional $23,810 annually to close the budget gap and balance the budget.

Working the number backward with a couple of assumptions, we can see the impact that might have on a taxpayer. Based on a married, filing jointly tax return, a tax liability of $9,118 would require taxable income of $79,300. Assuming a standard deduction taken on the tax return, that would mean adjusted gross income of $104,400.

Out of this $104,400, the taxpayer is paying Social Security and Medicare tax of $7,987, federal income tax of $9,118 and state income tax. In my home state of Michigan, that would be an additional $3,370 in taxes. That's total tax of $20,475. To balance the budget this taxpayer would need to increase total tax payments to $44,285.

Sadly, even draconian tax increases of this mag-



nitude won't solve the fiscal problems. There is still debt to pay down and other government programs that are severely underfunded. Professor Lawrence Kotlikoff, a past guest on my radio program, has stated that the fiscal gap of the United States is more than $200 trillion.

If we do some more math and divide the fiscal gap of $200 trillion by the 126 million tax returns filed each year, we conclude that each taxpayer has an additional liability of $1,587,000 to pay down the debt and bring these programs to full funding.

If we were to amortize that liability of $1,587,000 over 30 years at 3% interest, the resulting annual payment would be $80,292!

Adding that payment to the taxes required to balance the budget and we find annual payments are required of a taxpayer in the amount of $124,577 on income of $104,400!

The point is that this problem cannot be solved via tax increases. The fiscal gap and the operating deficit have grown into monsters that cannot be tamed.

And, while there is political rhetoric being promulgated about a billionaire tax and taxing unrealized capital gains, these are not workable policies; it's just rhetoric.

The slide reproduced on this page from one of my recent "Headline Roundup" webinars tells the story.

The total wealth of US billionaires is about $4 trillion. Confiscating 100% of the wealth of the billionaires only covers the budget deficit for 1.3 years and does nothing to pay down the debt.

From this brief discussion, we can safely conclude that these fiscal problems cannot be solved via tax increases alone. And, I haven't even discussed the economic damage that tax increases of this level would cause.

That brings us to the second choice. Cutting spending. Again, given that the Fed is the buyer of last resort of US Government debt, and given that the financial problems are too large to be solved via tax increases, the only way the Fed can taper significantly is to have the Washington politicians cut spending.

If you revisit the photo of the US Debt Clock

above, you'll see that the current operating deficit is 41% of expenditures.

Remarkably, for every $100 the government spends, it collects tax revenues of just 59 dollars, that means the other 41 dollars has to come from a lender. As we've discussed that lender is now largely the Federal Reserve.

Can you imagine for a moment the impact of a decrease in government spending of 41%? For discussion's sake, let's assume this cut was across the board.

That's a 41% cut in government healthcare spending, Social Security, military, education, etc. Focusing on Medicare spending alone which was $696 billion in fiscal year 2021[5], that is a cut in spending of about $285 billion!

We could continue this discussion in every category of spending, but you get the idea. Over the years, collectively, the Washington politicians have overspent and overpromised.

This will make the coming deflationary period extremely painful.

I would be remiss if I didn't briefly discuss private sector debt too. Fed policy as well as similar easy money policies pursued by other world central bankers have allowed private sector debt levels to increase to nosebleed levels as well.

The slide on this page, again from one of my "Headline Roundup" webinars, illustrates that globally, when combining private sector debt with government debt, the total is now a mind-boggling $300 trillion.

When this mammoth debt bubble unwinds, it will make the deflationary climate that much more intense.

Let's assume for a moment that spending is cut across the board by 41%. That just balances the budget, it does nothing to pay down debt or solve the fiscal gap.

Taking the $200 trillion fiscal gap and amortizing it over 30 years at 3% interest, one concludes that annual payments of $10 trillion are required!

Look at the US Debt Clock chart again (page 8, bottom). Assuming spending is cut 41% (which would reduce tax revenues significantly, something that we have not discussed), where does

one find another $10 trillion EACH YEAR to pay down the debt and solve the fiscal gap problem?

The short answer is that promises made will not be promises kept. The math doesn't lie.

If raising taxes can't solve these problems and since spending cuts would quickly cause a depression, the Fed has only one option. Continue currency creation which is what I believe they will do.

This will likely lead to the 'crack up boom' that Austrian economist Ludwig von Mises warned us about. The editorial board at Coin Stove wrote a piece that explains a crack up boom very well. Here are some excerpts from the piece[6]:

> *A crack up boom is the last stage of a fiat currency before it dies. During this stage a government is not able to balance the budget and there is severe debasement (money printing). As a result there is hyperinflation of the currency and drastically higher prices for everyday goods. Society is destroyed with hunger, disease and death.*
>
> *From the outside things look fine, almost great if you had to look exclusively at charts. However being on the ground gives an entirely different picture on what is truly going on. It looks good because everyone is buying and selling, it gives the illusion of prosperity and a booming economy.*
>
> *This couldn't be further from the truth. The economic activity is not for production which would imply a healthy economy. The population would be buying and selling basic goods like food to survive. This is really uneconomic activity.*
>
> *A crack up boom does not just happen overnight, it can take years or even decades to get to the point where there is suspicion of its beginnings. It only happens to fiat currencies when they are not anchored to anything like for example a gold standard. There is no record of a fiat currency ever surviving.*
>
> *Additionally governments and central banks work together and set out executing some ill-conceived financial decisions that ultimately lead to a currency's demise. One of the warning signs of an imminent crack up boom*

is when a country's dept [sic] *goes above and beyond the GDP numbers.*

A crack up boom is not necessarily linear, but there could be short time frames when there is some relief from the high inflation. The first part of the boom starts to happen slowly until the last stage where inflation goes parabolic. For example Weimar Germany's hyperinflation spanned 10 years from 1913 to 1923. The worst of it was in the last 2 years.

Usually there are signs of the beginning stages of a crack up boom. There is usually a mania where rationality gets thrown overboard and assets are bought up for insane prices.

This is already occurring. Here are some examples.

Many millennials collected Pokémon cards in the late 1990's and early 2000's. These collector cards were traded in schools all across the country. Collector Dani Sanchez recently had this to say about the skyrocketing value of these cards[7]:

"Vintage cards have skyrocketed in value. A sealed box of Pokémon cards from the early 2000s or late 90s retailed at around $100. [That same box would cost] $20,000, $30,000 or even $50,000 today. It's insane."

The stock market is another example, though it's had some struggles as this issue goes to print. Since the Federal Reserve began the process of Quantitative Easing or currency creation, the Dow has nearly tripled in value, moving from about 12,000 to about 34,000.

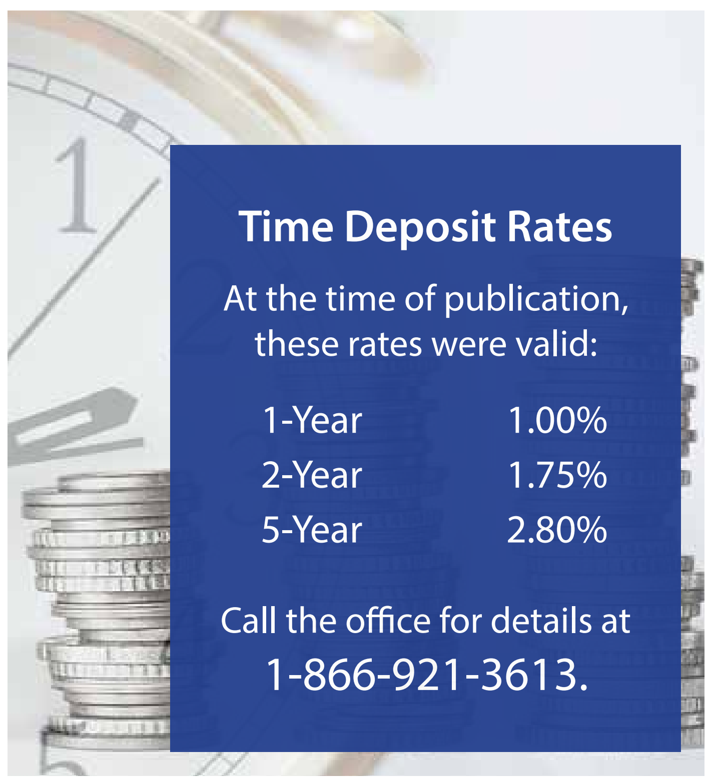
As I have pointed out in the past, this is deceiving. Pricing the Dow in gold has one concluding that much of this upward price move can be attributed to the devaluation of the US Dollar.

According to Haggerty[8], a classic car insurer, the average price for a 1960's muscle car manufactured in the United States has nearly doubled since 2014. This from their website discussing price activity over the last year:

The rise in Hagerty's Muscle Car Index continued through the summer achieving an all-time high. The rise was spurred on greatly by Hemi MOPARs. Most notably Hemi Cuda Convertibles gained in value by 79% after an exceptional example crossed the block this spring. GM muscle also saw notable gains with 70 Buick GS455 convertibles gaining 20 percent and 425-horsepower 64 Impala SS 409 Convertibles gaining 52 percent.

Outside of the component cars, the muscle car market has been surprisingly active. Previously steady cars like the 67-69 Camaro SS gained 14 percent on average and 68-70 Dodge Charger R/Ts gaining 28 percent. Such broad gains in value like this have not been seen since before the 2008 crash.

The crack up boom is now looking more likely.



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