The Currency Crisis and Debasement

What You Need To Know To Manage Your Investment Risk

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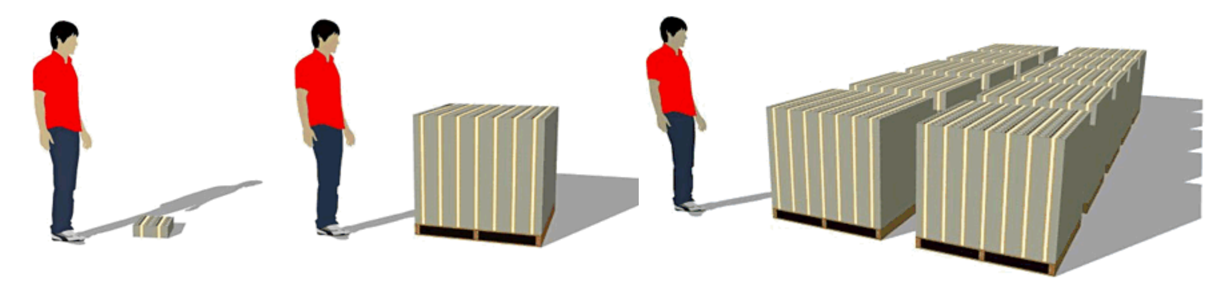
There has been much talk recently about our country's finances. Some now question the long-term viability of the United States with booming budget deficits and a national debt that is growing by leaps and bounds monthly. The national debt level was just raised to almost $12.5 Trillion. Yes, **trillion**, not billions. What is a trillion dollars? It is 1,000,000,000,000, or more simply, a one followed by 12 zeros. It's a thousand billion. It's one million million. All these zeros will drive you crazy over time! The trouble with a $12 trillion debt is the interest carrying costs can be very costly and will, over time, take up a good amount of the annual budget.

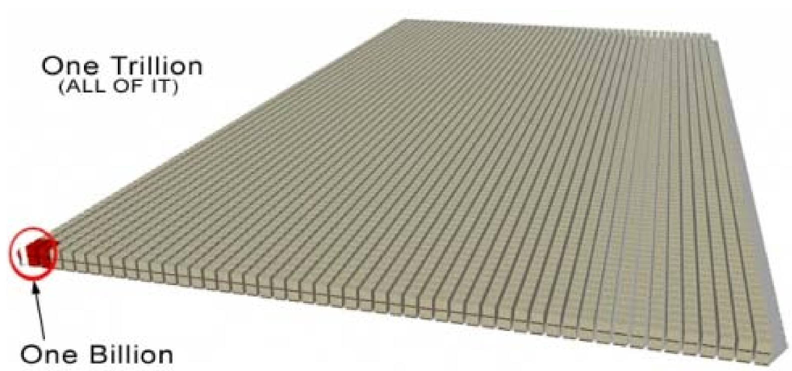
Visual Representation of One Trillion Dollars



$1 Million Dollars
(100 packets of $10,000)

$100 Million Dollars
(on a standard pallet)

$1 Billion Dollars
(10 pallets of $100,000,000)



$1 TRILLION DOLLARS
(Notice the little guy on the left and that those pallets are doublestacked? Note the comparison to $1 Billion Dollars.)

Source: PageTutor.com

Here is a bit of history on the country's national debt relative to our economy (all amounts in trillions):

	National Debt	US GDP	Debt/GDP
December 2009	$12.3 Trillion	14.4	85%
December 2005	8.2 Trillion	12.3	67%
December 2000	5.8 Trillion	9.7	59%
December 1980	.93 Trillion	2.7	34%

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In 29 years we have taken the U.S. national debt from less than $1 trillion to over $12 trillion (a 12-fold increase). What is really troubling is that the ratio of debt to GDP has exploded over the last 29 years from 34% to over 85%. So during this 12 fold expansion of debt we have only expanded GDP 5.3 times. We are growing debt at twice the rate of growth of the U.S. economy. This is obviously a troubling situation. Further, our country has Medicare and Social Security obligations that are not funded (so called "off-balance-sheet commitments") that some experts estimate to be more than $30 trillion. So the real United States debt may in fact be between $40-$50 trillion, or more than three times our Gross Domestic Product.

Why should investors be both troubled and concerned about this issue?

First, all entities have a borrowing limit or maximum capacity that they cannot exceed. Even the United States with its premier reputation globally must maintain a viable fiscal situation. Most will think these issues only apply to countries like Iceland, Greece, Spain and Portugal – the current weak sisters. You cannot be more wrong. Think back to a period of time 100 years ago when the United Kingdom was know as the British Empire. Yes – they were an empire. What are they today – much less of an empire and actually no one would call them an empire; they are now just one of the large developed countries with a large debt balance just like the United States. Here is a description of the British Empire from over 100 years ago:

> *"At its apogee, around 1900, the British empire was the largest ever known, reputed to* ***cover a quarter of the world's land area, and a fifth of its population****. Like all mighty oaks, this one had a tiny origin. It grew out of the seafaring voyages of the Tudor age. The first British colony was Virginia, settled in 1585, but not for long. A ship returning four years later found that the colonists had disappeared. In 1607 the colony was re-established, and survived. Other places were also colonized, especially some Caribbean islands. Trading posts were established in India.*
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> *It was mainly a commercial empire, run by chartered monopoly companies, and defended by the Royal Navy. Britain made sure its benefits accrued to her exclusively, by a series of Navigation Acts passed in the mid-17th cent. to prevent the colonies dealing with anyone else. The Seven Years War saw Britain take control of much of India (1756-7). That marked the peak of what later came to be called the 'first' British empire, which came to an end with the rebellion of the thirteen American colonies in 1776."*
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> Gold: Once and Future Money
> Nathan Lewis (2007)

What was the undoing of the British Empire? Like all things that get too big, they lost their way – and eventually the finances followed. Today like the United States the United Kingdom is in hock and has about 80% of GDP as debt. Being big and dominant does not protect against poor financial management or lack of financial discipline. During the past ten years, it looks like the United States is on the same track that the United Kingdom took many years ago and then became much less relevant in the world. This process can be stopped, but it looks like the current forces are close to unstoppable.

So what are the negative consequences of the current financial trend?

1.) First, if a country prints more currency to manage their affairs, this results in **higher inflation**. This is what most developed countries are doing today.

2.) Secondly, and most importantly, the **value of the country's currency becomes less valuable due to inflation. Let's call this currency debasement (inflation and loss of value related to financial weakness).** Over time inflation is a killer of currency value.

3.) Finally, **the cost of borrowing will eventually rise.** This becomes tricky because when the cost of borrowing rises it becomes much more difficult to repay the borrowing. A vicious cycle can develop. We are seeing that today with Greece. Greece is paying a much higher rate on new debt as a result of its weak finances. We have seen the disastrous results of this among many large public companies in the past 24 months – General Motors, Lehman Brothers, Merrill Lynch, AIG Insurance and many others have been forced into mergers with other large financial companies or have simply become extinct.

If you want to understand how governments financial mismanagement over time usually leads to currency crisis I highly recommend a book by Nathan Lewis (2007) entitled *"Gold the Once and Future Money."* Nathan Lewis does an excellent job of highlighting how countries manage over time through a lack of financial discipline the debasement of its currency. I have quoted a few instances below to give you an example of the excellent history provided in the book. The common denominator to all of history is that all governments almost universally act irresponsibly to debase their currency.

Here are two extraordinary quotes out of hundreds of examples: the first one in Roman times, and the second one an often-cited period of time in Germany during the 1800s.

1.) "Roman coinage began to be debased under the rule of Nero (AD 54-68) with the content of money being reduced from 100% silver to 90% silver. The trend continued in AD 193-210 when the silver content was reduced to 50%. So in a period of 150 years a 50% debasement was put into effect."

2.) In Germany in 1918, the mark had fallen from 4.2 marks to the dollar to about 8 markets per dollar as Germany's inflation began to rise. The government ran the printing presses to meet money demands which were especially difficult. By 1921 the mark had fallen to 184 marks per dollar. In 1922 the mark continued its decent to 7,350 marks per dollar and in November 1923 the mark had crashed to 4.2 trillion marks per dollar. *In 1924 Germany decided to return to the gold standard*.

> ***Neither state nor bank have ever had the unrestricted power of the issuing of paper money without abusing that power***.

Lewis's book has shown me that experience over two thousand years has shown that neither state nor bank have ever had the unrestricted power of the issuing of paper money without abusing that power. The temptation to cover up a lack of discipline with an inflationary debasement can be intense. As a result it is actually quite commonplace throughout history. A brief illusion of economic health will be created, then a period of higher inflation will be experienced. Is there any doubt that the developed economies of the world today including United Kingdom, the Euro zone, and the United States are all on this path. **Investors must be aware that this can be devastating to an investment portfolio that is not positioned properly.** Recommendations for investors looking to invest successfully in a period of higher inflation and currency weakness:

1.) **Emphasize countries with financial strength**. Move a significant portion of your funds to countries with strong finances, and hence, strong currencies. Countries like **China, Brazil** and maybe even **India** today are in stronger financial condition than many of the developed economies.

2.) **Invest only in shorter term fixed-income investments.** Our advice is to keep bond purchases no further out then 3-6 years on average. This limits the risk of sharply higher interest rates. No one knows for sure when much higher inflation will come, however it is likely we will see higher interest rates in the coming 2-4 years.

3.) **Invest in equities to maintain your portfolio's purchasing power.** Many think inflation is terrible for equities, contrarily inflation is one of the reasons why we choose to allocate funds to stocks. Companies have a wonderfully adaptive way of being able to adjust to inflation. Over time stocks held higher returns than bonds because they can and do adjust to higher levels of inflation.

4.) **Invest in Gold and Precious Metals.** Gold is one of the few real assets that have over thousands of years been able to maintain its purchasing power. In years past, many countries had currencies that were linked to gold and backed up by gold. The reason this was done was so that citizens would have confidence in the currency. In our financial world of fiat currency and lack of discipline today we may find that some years down the road, some may again call for a return to the gold standard.

Proposed Allocation for Growth-Oriented Investors

Equities

45%	Emerging Economies Equities (China, India and Brazil)
15%	Natural Resources (Oil, and energy related)
24%	Growth-Oriented Equities (technology, health and others)

Gold, Precious Metals and Alternatives

12%	Gold
2%	Platinum
2%	Nickel
100%	Total

In summary, our confidence in central bankers and governments has faltered and we are now aware that many developed economies like the United States are on an irreconcilable path to financial weakness. We believe there is a chance for many governments to change and develop financial discipline. We are hopeful that changes can be made and new disciplines will be instituted. However, if history is any guide to human behavior our financial future in the United States may be a difficult one. Investors today need to take a very real and hard look at the issues raised in this article and they need to protect against further erosion of our currency's purchasing power. Investors need to act today in three areas to insure against the coming changes:

1.) **Keep fixed-income purchases short in duration**, no more than 3-6 years.
2.) Allocate **equity investments to countries with strong currencies** that are growing. Allocate significant parts of your equity allocation to China, India and Brazil.
3.) **Invest in equities since they have the ability to maintain purchasing power** in periods of higher inflation.
4.) **Invest a significant weighting 10-12 percent in gold and precious metals** as they will help offset the currency debasement now being plied on governments across the globe.

About the author of this article:

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