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The world's access to credit has been curtailed by problems associated with defaulting mortgages in the United States. Potentially, this is a very serious development. For a very long time, the world has been permitted to run on an unrestricted supply of credit due to the prolonged debt and deficit policies of the United States. The credit crunch is akin to restricted blood flow in the arteries. Eventually, there will be a mild or severe case of cardiac arrest. Now that you have the diagnosis, it should come as no surprise that this form of financial hypertension is no stranger. To our dismay, the credit malfunction has resurfaced at an elevated level of risk. In terms of our AARP framework, the introduction of additional risk gives us cause to react and modify the ways in which we allocate and protect. We hate to sound like a broken record but...

## WELCOME BACK MY FRIENDS TO THE SHOW THAT NEVER ENDS

It is easy to mistake debt for wealth. For most of the last 10 years, tens of millions of Americans have tapped into their home equity and credit cards for discretionary cash. When one is flush with cash, no matter the source, a feeling of wealth is exuded. In this respect, the US Government and American taxpayers have lost their financial bearings and are wandering in the wilderness. Two fundamental tenets of capitalism are that debts always have to be repaid and that wealth is what remains after all debt is repaid. Whether the debt repayments arise from honest money or counterfeit money is a central concept in strategies designed to accumulate and preserve wealth. We feel that is important for our readers to grasp this concept.

You may have heard the term "credit bubble." It describes an environment characterized by easy access to someone else's money. This is best illustrated by low or zero interest rates on big-ticket consumer purchases (including homes financed with adjustable rate mortgages) and lax to non-existent underwriting standards on mortgages, installment loans and credit cards. Credit bubbles are extremely popular with politicians as voters generally feel like the financial winds are at their backs. They have gotten both a free lunch and a free ride and these types of gratuities generally get politicians re-elected.

A deflating credit bubble is a politician's worst nightmare and we are on the cusp of one. The hallmark of most credit bubbles is that homes and condos are built with reckless abandon due to their sudden affordability to the masses. The pendulum swings too far and results in too much supply. Any combination of a softening job market, escalating prices for essential goods and services and re-sets of adjustable rate loans leads to a sudden loss of purchasing power and monthly payments become a stretch, leading to defaults. That is exactly where we are today.

There are 3 possible governmental responses to the deflating credit bubble. The doors are:

### **1. Fix the leak at all costs and do not allow the system to drain any of its excesses ...**

This response will encompass very aggressive monetary stimulus over the next 6-12 months to forestall a perceived avalanche of debt defaults followed by an economic crash landing. Assuming this stimulus works, money supply aggregates likely would reach or exceed 20% growth rates. This is a prelude to hyperinflation and ultimately could undermine social order in ways that are difficult to imagine. Massive injections of money will create new asset bubbles. Since old bubbles seldom are revisited, the replacement bubbles likely would be geared toward the protection of purchasing power. The likeliest candidates would be strong currencies vis-à-vis the US Dollar,

assets that are in relatively tight or fixed supply and growth stories in the new era Industrial Revolution nations. High-quality long-term fixed income investments would benefit if interest rates were slashed down as a means to deliver the monetary stimulus. Under this response, many investments will hold their own in the short run but should do poorly in the long run. A high rate of inflation is like cancer. It eats away at healthy cell tissue until chemotherapy and radiation treatments are introduced. The eventual cure is rooted in a world of pain and the cure is never guaranteed.

## **2. Tolerate a slow steady leak and partially drain the system of its excesses ...**

This response will encompass a moderately strong monetary stimulus, tempered by the belief that the possibility of hyperinflation could pose a threat to social order and would be a questionable price to pay for preventing economic dislocation and pain. If this stimulus works, we can expect a bumpy landing with a noticeable economic downturn in North America, Europe and Japan. There will be shallow contagious effects in the new era Industrial Revolution nations. Under this response, many investments will contract in the short run and should muddle through in the long run.

## **3. Tolerate an even larger leak and completely drain the system of its excesses ...**

This response will encompass a fairly mild monetary stimulus. The possibility of hyperinflation would be judged to be a very dangerous threat to social order and would be too high a price to pay for preventing economic dislocation and pain. This low-key stimulus will lead to a hard landing with a deep economic downturn in North America, Europe and Japan. There will be deep contagious effects in the new era Industrial Revolution nations. Many investments will be hit hard in the short run but should prosper in the long run.

So which will it be? Our money is on Door #1, which is to fix the leak at all costs. Unfortunately, we are being forced to react given a very opaque set of economic facts and political motives. We must take our best shots and be flexible to rapidly changing circumstances. However, it always has been our belief that the huge tabs that are coming due for military campaigns and entitlement stewpots and now subsidies to the financial system are going to be satisfied by money creation (counterfeiting) and obligatory donations (taxes). This is not capitalism. It is the advance of socialism. In the days of true capitalism, the bills got paid by raising the levels of a nation's productivity and savings. Today, this is a more apt description of China and its Asian neighbors, not to mention India.

By now, you have heard of the recent near-collapse of Britain's Northern Rock Building Society, a major mortgage lending and savings institution. The Bank of England effectively guaranteed all bank deposits in England as it stepped in to save Northern Rock from a full-scale bank run and collapse. Is there much doubt that the Federal Reserve will do the same in a similar circumstance? Ask yourselves where the money will come from. Will your purchasing power stand up to the onslaught of counterfeiting and taxes? Will you remain in your financial comfort zone?

Please keep your eyes wide open. The view may not be pretty but it could get much worse if you don't begin to react to the institutionalized encroachments on your purchasing power and standard of living.