

## OUR FORECAST - DEBT DEFLATION

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The following is a general guide to what will take place during a debt deflation scenario, which we believe is underway right now. Again, we must emphasize that our position on this matter is very much in the minority. There is both bad news and good news concerning this minority stance in regards to the markets. The bad news is that until our minority position gains wider acceptance the markets will not act as we expect. The good news is that this state of affairs allows us the time and price to invest wisely for future gains that we expect. For example, at today's prices our investment vehicle of choice has the potential to deliver a total return of approximately 50%. The time frame is uncertain, but a 1.5 to 2 year period seems about right.

The following is a portion of a recent paper done by the Cato Institute that describes in layman's terms our expectations:

*"The prospect of a debt deflation begins when a central bank pushes interest rates below where the market would have set them. This is exactly what the Federal Reserve did. In July 2003, the Fed funds interest rate target was pushed to a record low of 1%, where it stayed for a year. This set off a credit boom which fueled a massive increase in leverage. Over the past year, we have witnessed financial stress, a stampede to deleverage and an economic slowdown.*

*These events could be the precursors of a classic debt deflation. It would take the following course:*

- *Debt liquidation would lead to distress selling.*
- *As loans are paid off, a contraction in demand deposits would ensue.*
- *This would slow down the velocity of money circulation.*

- *This would cause a fall in the general level of prices.*
- *This would lead to a further fall in the net worth of businesses and an increase in bankruptcies.*
- *A fall in profits, often resulting in losses, would also occur.*
- *This would lead to a reduction in output, trade and employment.*
- *These losses, bankruptcies, and unemployment would generate pessimism and a loss in confidence.*
- *These waves of pessimism would result in more hoarding and further reductions in the velocity of money circulation.*
- *The debt deflation process would eventually run its course, but only after asset prices have hit bargain basement levels.*

*Economists of the Austrian school of economics term this type of debt deflation a "secondary deflation". If the forces of a secondary deflation are strong enough, a central bank's liquidity injections are rendered ineffective by what amounts to private sector sterilization. When people expect prices to fall, their demand for cash increases and soaks up central bank liquidity injections. This phenomenon characterized Japan's economy during most of the 1990s."*