

TOO MUCH DEBT CAUSES DEFLATION, NOT INFLATION WEB BUZZ 2009.08.17

The seeds of deflation are growing each day while most investors anguish over potential inflation.

The seeds are sprouting into a debt deflation cycle for the U.S. economy, a serious economic development not seen since the 1930s where debt feeds deflation and vice-versa. Deflation is a reduction of the general price level in an economy. It results from an oversupply of economic goods relative to demand and right now supplies of everything from cars and houses to flight capacity and human labor are outstripping the demand for them.

This debt deflation cycle was first identified by Irving Fisher in 1933. Irving Fisher was America's first important economist who studied previous depressions including ones that occurred in 1837, 1873, and 1929-33. He concluded that depressions are caused by over-indebtedness and deflation. By the way, the Austrian economists add that over-indebtedness is caused by a too-easy monetary policy.

Fisher originally believed that there would be no depression in the 1930s and as a result lost most of his family's fortune in the stock market. Later on in 1933 he came up with his Debt Deflation Theory which he concluded was the cause of the Great Depression. Most other economists thought — and still think — deflation resulted from it.

*Sidebar: Go to any modern day textbook on economics and see where the author talks about any debt let alone excessive debt. They don't. Thus we ask - how in the world could they, the textbook economists, ever predict a depression anyway? One can read Irving's paper *The Debt-Deflation Theory of Great Depressions* by going to the [St. Louis Fed website](#). As noted above, Fisher was the most prominent economist in the U.S. during this time frame,*

yet he lost his family's fortune prior to his realization of what was really taking place during the Depression. I ask you: could that happen to those who are banking on inflation now?

There seems to be little question that the severe decline in the growth of gross domestic product in the United States is moderating. On the other hand, the extreme intervention of the federal government in the business world along with the financial condition of the consumer almost assures a lackluster recovery or none at all. It is estimated that during calendar year 2009, government spending will account for more than 35% of this country's GDP. Only during WWII has this happened before. For the longer term, the economy will be hobbled by this intervention of the federal government.

What has taken place since the onset of the present recession has been a propping up of those who have failed which is being paid for by those who have been successful. This is no way to run a railroad, much less an economy. Our nation has a debt problem and politicians are trying to solve it by borrowing even more and by forgiving the offenders.

We believe the markets, both stock and bond, have yet to reflect this inconvenient truth in their values. Recently we have seen a decent recovery in stocks as well as in less than AAA quality bonds. In our opinion, these market recoveries are fleeting and much overvalued. We would expect this truth to become apparent within the next 6 to 9 months when the shape of the recovery, if any, becomes as flat as the Kansas prairie. Long-term U.S. government bonds remain the asset of choice. We remain fully invested in these securities.

We are often asked what would cause us to change our mind. Is there a smoking gun out there that would require us to change our opinion? Frankly, we think this cake is already baked. Maybe if China and Japan solds all of their U.S. government securities the price of U.S. long government bonds would

cave. However two things should negate that occurrence in short order: (1) the U.S. on a world scale is too big to fail like Citigroup on a national scale (2) a large spike upward in interest rates would devastate whatever recovery we might attain causing a rush to safety. Keep in mind that on a real basis (minus inflation or plus deflation) the long government bond is approximately 6% now.