MONEY, MARKETS & MILESTONES

A PUBLICATION OF VAGABOND INVESTORS
April 5, 2011

Special Report:
Riding The Dollarcoaster!

Inside The April Special Report Issue

The global economy is in a serious danger. That is no news. In fact, the publicly available figures that anyone can look up for themselves have been deeply disturbing for several years. Some of the figures only became worse after the recent financial crisis hit. Some have rapidly become so alarming, that we decided to issue this special report at a short notice.

As always, we will provide simple and clear-cut investment observations to protect and profit from one of the greatest crises (opportunities) of the century! Make no mistake, perhaps the greatest event in the financial history of the century is about to take place. The fundamentals are clear. It's the timing that is always irritatingly difficult.

Which figures are we talking about? They are the ones that have been bad for decades and have become worse year after year. Yes, we are talking about the US trade and budget deficit, rapid inflation and the ever-distant collapse of the dollar as a reserve currency, which inevitably looms ahead. This report has repeatedly contended that the US dollar cannot maintain its position as a reserve currency, because the US practically in a state of default. The fact that the Federal Reserve buys some 70% of all new Treasuries should speak for itself.

It has become so normal to be alarmed about these trends that nobody takes them seriously anymore. Well, at least almost nobody. It's like with the Japanese Fukushima nuclear accident. As soon as it became old news, we stopped worrying about it. The difference between Fukushima and the US is that the US and its citizens are progressively in a worse condition whereas something can be done to Fukushima.

Those of you that are our regular readers know that we have warned about the dollar crisis before as have so many others. Yet, recently things have leaped forward closer to the explosion point.

This report has continuously stressed that in addition to financial crises we would see riots on streets and geopolitical tensions tighten. Some of our fellow financial colleagues thought we called a long shot back then. Yet there have been fights and protests in Indiana, Ohio, Kansas and Wisconsin, to name a few. Around the globe, there have been massive protests, overthrown governments and even a new war has broken out in Libya.

Radical changes are taking place right before our eyes as the prices of oil, food, and other commodities like cotton, copper, sugar, corn, cocoa, wheat, aluminum and steel skyrocket.

It should be clear that most Americans will not know what to do as necessities become ridiculously expensive. Most have absolutely no protection against their savings being wiped out by rapid inflation. They have no idea how it will affect their savings, investments, and retirement. Should banks close their doors and credit cards stop working, angry masses with their legal (and illegal) arms will find their ways in the streets. Nearly 44 million Americans are on food stamps. That is some 14% of the entire population.

Oil is up more than 50% from 2010. Silver, cotton and coffee are all up more than 100%. Tin prices soared 90%. More than 70% more expensive is what. Butter and sugar are more than 40%. Only natural gas, eggs and chickens are less expensive now than a year ago.

The root cause of this problem is not only increasing demand in Asia, although it cannot be overlooked. One significant reason is the enormous money printing in the US, which is rooted in the colossal debt burden of the country.

Debts don't just disappear. Bailouts don't solve root problems but cause new ones. The debt bubble was not erased in the crisis but merely transferred from the private sector to the public sector. The US government has been borrowing so much money that soon it will no longer be able to pay even the interest on these loans. This is bad news for the dollar as a reserve currency.

US income tax receipts total roughly $900 billion annually. Corporate taxes are some $200 billion annually. The current annual deficit is nearly $1.3 trillion. It is considerable that even if the US doubled its tax revenue, it would still be running a deficit of more than $100 billion. Note that the US government counts all $865 billion of payroll taxes as current income. This is a neat trick, since those taxes are supposed to be funding the future liabilities of Medicare and Social Security, but they're spending all that money now. If a private corporation did the same thing, its executives would soon be watching the world behind bars.

The fact is that the Federal budget cannot be balanced by taxes. No matter how high taxes become and how much we would like to believe that higher taxes in the rich would solve the problem, it's stupid thinking at best and seriously delusional at worst. Even it all US citizens were taxed 100% of their income, it would still not be enough. The US government would still have to keep borrowing.

The Federal Reserve is of course manipulating interest rates down. The interest rate at which the US government can borrow money is less than 1.5%. Currently the US government is paying about $200 billion a year in interest. The most disturbing question is this. What happens when interest rates rise to, say, 6%? That would mean that $850 billion or 77% of tax receipts would be spent on only the interest, let alone principal. This is based on current debt, which the US owns right now, not including any future debts that will of course occur.

Some pundits are keen to point out that the US cannot default because it can always print more money. They have the Federal Reserve which can buy even more Treasuries and flood the market with freshly printed dollars. Therefore, all debts can be repaid.

They are right. The only problem is the value of the dollar. **Most people do not understand that the money printing can only continue as long as the US dollar remains the world's reserve currency.** But who would accept such a currency? Mr. Bernanke, having graduated from the Zimbabwean School of Economics, stands happily behind his money printer, ready to print, print and print. Debts can be paid with printed dollars, but the dollars will not be worth anything.

The demand for dollars from the rest of the world has greatly benefited the US economy. It has simply allowed Americans to consume more than they produce and save less than they invest. But as the US dollar loses its place as the world's reserve currency, nobody wants to hold large holdings of dollars.

One could argue that China still gladly accepts dollars. Let us consider that argument for a while. After all, they hold more dollars than anyone else. *Reutres* recently ran an article, which stated:

"*Dollar dominance is sowing the seeds of financial turmoil, and the solution is to promote new reserve currencies, a Chinese government economist said in a paper published on the eve of a G20 meeting about how to reform the global monetary system.*

Although not an official policy statement, the paper by Xu Hongcai, a department deputy director at the China Center for International Economic Exchanges, offered a window onto the domestic pressures bearing on Beijing to move away from a dollar-centric global economy."

In other words, the Chinese are smart. They are rightly worried about their assets. As any smart people, they are constantly looking for ways to shift the balance of their assets away from the dollar. The quicker the better. They are already doing it as they are shifting their dollars into assets that benefit from the rise of commodity prices.

Even the IMF has proposed replacing the US dollar with their SDRs (Special Drawing Rights). SDRs represent potential claims on the currencies of IMF members. They can be converted into any currency, based on a basket of currencies. The IMF has also proposed creating SDR-denominated bonds, which would reduce central bank's dependence on US Treasuries. The IMF also suggested that certain assets such as oil and gold, which are traded in US dollars, could be denominated in SDRs.

Arab states, along with Russia and China, are also considering denominating commodity prices in something else than the US dollar.

The fact is, the world is increasingly less interested in holding dollars. Even in the US, the state of Ohio has proposed that gold and silver could be used as a form of money.

Perhaps it sounds distant that hyperinflation could occur in the US. After all, nothing similar has happened in the West since German printed itself into hyperinflation in the 1930s, right? The US cannot default, right?

There are many ways for a country to default. One way is to not pay the principal back. Another is to not pay the interest back. Yet another is to print money to pay debt. This, history tells us, will eventually cause an overnight collapse of the currency – once the rest of the world loses confidence in the currency.

In fact, the same thing happened to Great Britain in the 1970s. Most people do not know that the British Sterling was the reserve currency for nearly 200 years for most of the 18th and 19th centuries. The British Sterling lost 14% overnight. It made everything in Brain much more expensive in the coming years. In 1975, inflation in Britain was 26.9% in a single year. Britain had been a superpower for 150 years, but when they started intentionally devaluing their currency, things went down the gurgle, as they say.

Bloomberg News recently reported the following:

"The U.S. will reach its $14.29 trillion legal debt limit no later than May 16 unless Congress acts before then, Treasury Secretary Timothy F. Geithner said today, and he warned of "severe hardship" for Americans if lawmakers fail to act."

By failing to act Mr. Geithner means by not raising the legal bar for federal debt, of course. Interestingly, it's no different from a bartender who says that his client has no other option but to keep on drinking.

"Default would cause a financial crisis potentially more severe than the crisis from which we are only now starting to recover," Geithner said. "For these reasons, default by the United States is unthinkable.""

Perhaps unthinkable, but not impossible. In fact, it's becoming more likely every day.

The Bloomberg article then gets to its juiciest part. Read carefully.

"Geithner said in his letter today that spending cuts can't provide the cash needed now, and he warned that the Treasury's projections won't change in a way that would give Congress extra time. He also said it would not be "viable" for the U.S. to sell gold, financial investments or student loans.

"There is no alternative to enactment of an increase in the debt limit," Geithner said. He said that increasing the limit "does not increase the obligations we have as a nation; it simply permits the Treasury to fund those obligations that Congress has already established. *(emphasis added)"*

The dollar crisis scenario has to be taken into account in all of our investments, as it offers very lucrative investment opportunities. Let's look at tangible ways to protect your portfolio as well as to profit from this likely scenario.

The overall consequences for global growth are somewhat hard to predict. It is crystal clear that the goal of changing the reserve currency is not to destroy the global economy but rather to save it. However, it might easily lead to destruction in the US and in the countries that are not prepared to the dollar collapse and are simultaneously highly dependent on exports to the US.

In case your base currency is US dollar, we urge you to open a foreign bank account and deposit some money there. Physical gold and silver are likely beneficiaries even though we are a bit cautious with these due to the storage problems linked to them, especially large amounts of silver.

Consider being LONG on the following: Gold, silver, gold and silver mining companies with proven reserves. Strong currencies like Singapore dollar, Canadian dollar, Swiss Franc and EUR despite the structural problems in the Euro zone. US companies that have major portion of their sales from outside US will perform relatively well. Asian stocks should perform relatively well, but we are a bit hesitant to place our bets heavily on equities in case of a global systemic shakeout.

Then again, observe being SHORT on the following: Long-term US Treasury bonds, US dollar nominated Municipal Bond ETF's, US dollar, US Companies that produce products to US markets and are dependent on raw material that need to be imported to US.

We need to emphasize one thing. If you short these assets, you need to have your base currency in something else than USD. For example use CHF, CAD or EUR as a base currency. The short naturally will benefit not only from the drop of the shorted asset but the devaluation of the US dollar as well.

Our own Long-Short trade is constructed as follows: Long on GLD, GDX, GDXJ, SIL and short TLT, CMF (using CHF as base currency).

You may want to take your positions outright or use options. We will use some deep in the money leaps for longs. We will also add some leverage for the short side by purchasing far out-of-the-money-puts on TLT (in addition to shorting it). These positions should not perform badly even though the almost inevitable dollar crisis would somehow miraculously be avoided.

Yours truly does not place their bets based on luck. We like to keep our eyes open and our fingers quick on the keyboard. But time is running out, so we think it's best to take the necessary precaution seriously and do it in time. Meantime, we have a framed a one dollar bill and hanged it in the wall.

Next to it stands the one hundred trillion Zimbwean dollar bill.

MONEY, MARKETS & MILESTONES

Author & Publisher Subscriptions & Enquiries

JAAKKO SAVOLAINEN **Email: mmm@theMMMreport.com**

MATIAS SAVOLAINEN **Website: www.theMMMreport.com**

Reader Comments: comment@theMMMreport.com