Magellan Planning Group, Inc.

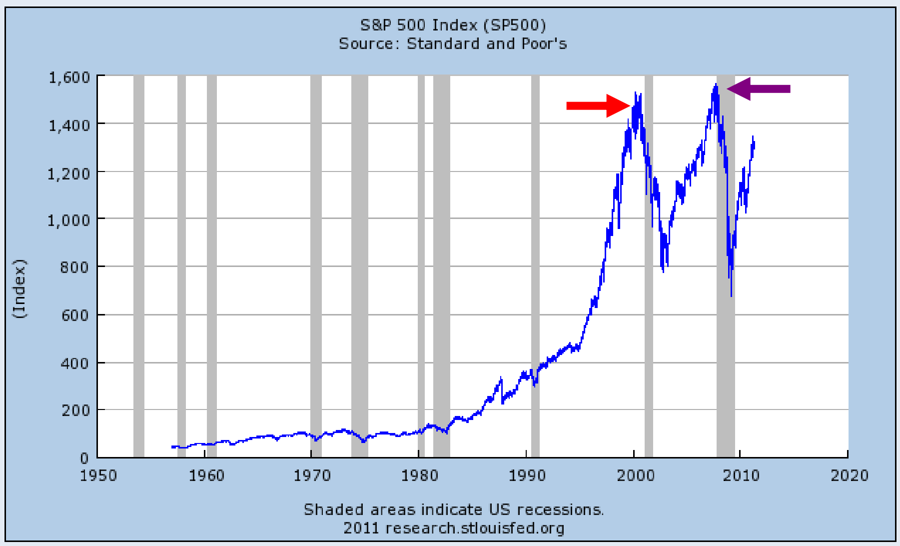
# Charting the Course to $7 Gas

*by J. Kevin Meaders, J.D., CFP®, ChFC, CLU*

**April, 2011** - Sometimes you feel like a chart; sometimes you don't. Since my last epistle didn't include any charts at all (amazingly), I'm getting even now. And sometimes, well, you've just got to see it to believe it.

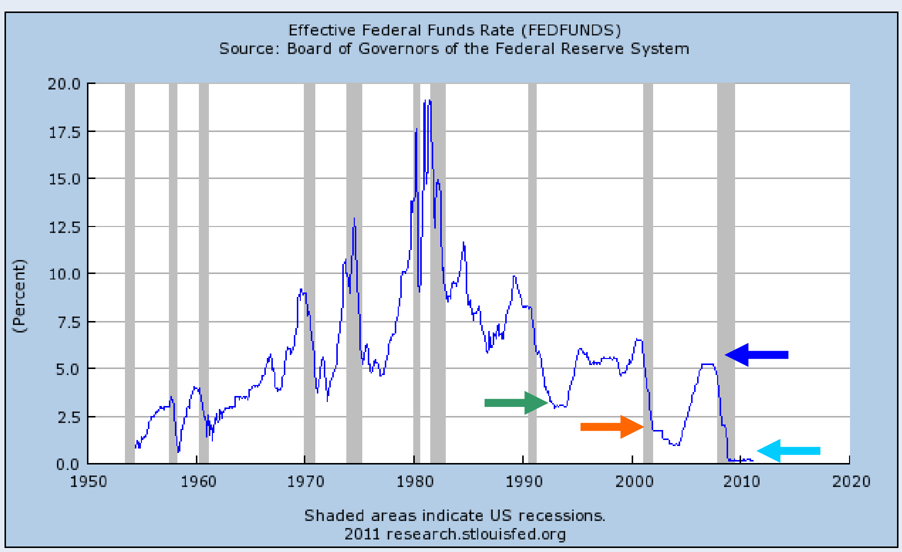
Let's go back to the beginning of the current crisis—yes, it is *still* a crisis for many millions of Americans who have no job, ruined their credit, filed bankruptcy, lost their home, and lost their lifestyle. Shanty towns have popped up all over America, though rarely gaining media exposure.

Tens of millions have been ripped from the middle class back down into the poverty from whence their parents or grandparents had climbed.




Make no mistake: It is not capitalism that got us here; it is government interventionism and central banking—the Fed.

The first two charts we're looking at are the S&P 500 Index (top) and the Effective Federal Funds Rate (bottom). Our current economic state of affairs began with the internet bubble (Red arrow), which itself was exasperated by an earlier Fed funds easement. (Green arrow).




After the bubble burst in 2000, Alan Greenspan sought to prop up the "irrational over-exuberance" against which he himself had cautioned by dropping interest rates—artificially, of course—from 6.5% down to barely 1% in 2002. (Orange arrow).

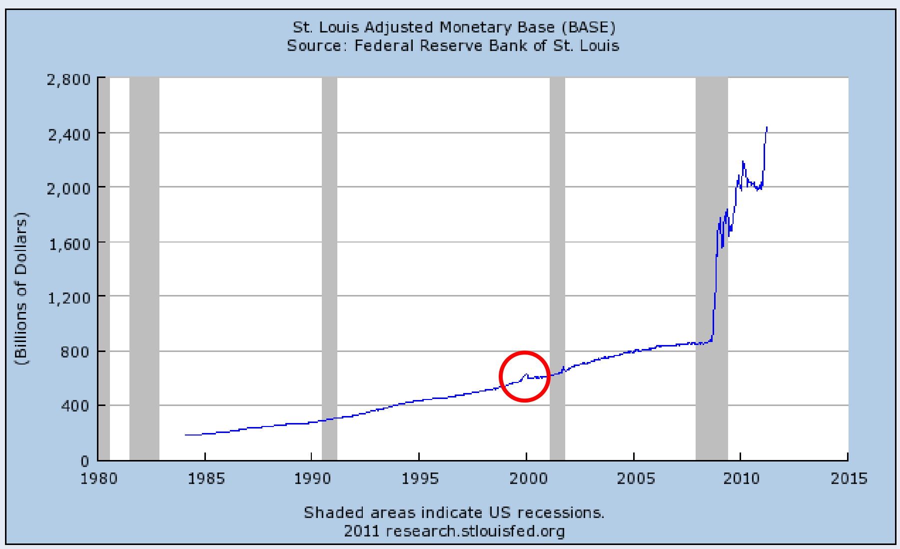
The whole idea here was to encourage corporate (and private) spending by lowering the cost of borrowing money. This "cost" was much lower than it otherwise would have been in a truly free market, where interest rates are set by the supply and demand of money. Today, a free market interest rate environment is simply a dream—it's illusory—it doesn't exist. The Fed, rather, simply creates as much supply as it wants, and then hopes foolish risk-takers will take the bait. Indeed, millions did.

Enter the housing boom. Maybe you remember the 1% LIBOR interest-only adjustable loans? How completely, unrealistically optimistic (or gullible) did you have to be in order to buy into an adjustable mortgage when interest rates were at an all-time low?

In any event, the loose money policy and low interest rates drove the real estate market to new, all-time highs, with record low unemployment and a false feeling of risk-free risk-taking. (See purple arrow – top chart on first page).

Sure enough, inflation hit, the Fed raised rates, those ARMs adjusted upward, people couldn't sell their house for what they owed, and then record foreclosures ensued. All the while, the banks responsible for the bad loans get bailed out by the taxpayer, and the bank executives get to keep their multi-million dollar bonuses. Hooray.

But that's not the end of it. Once the housing bubble burst, our masters at the Fed (primarily Komrad Bernanke) decided to drop rates to zero (Light blue arrow, bottom chart on first page) and to inflate the money supply beyond all recognition.



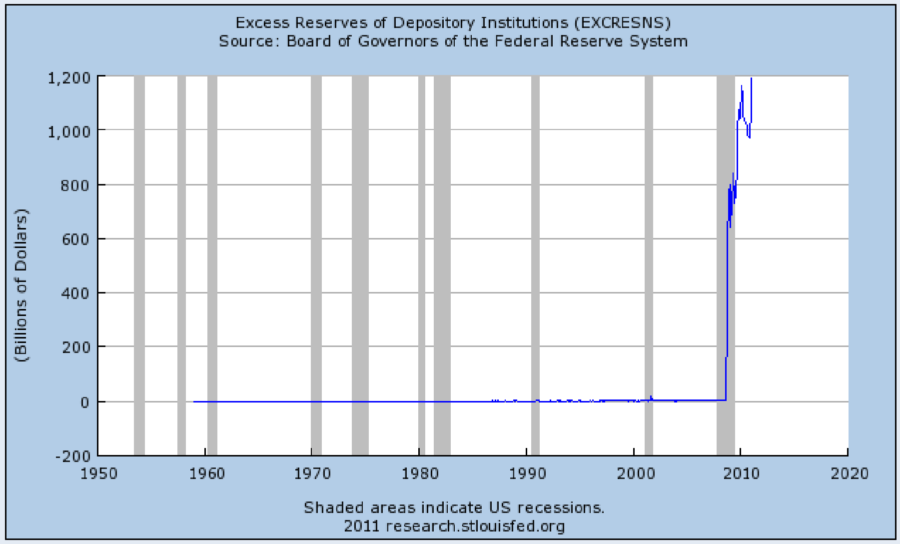

The chart to the right is the Fed's monetary base. Note the vertical movement during and after the Depression of 2008: An increase from $800 Billion and change to just over $2.4 Trillion.

This is the most worrisome chart I have ever seen. By comparison to what Bernanke has done, take a look at the blip that Greenspan caused back after the dot-com bust in early 2000, noted with a red circle above. This is not the kind of comparison that makes it to CNBC or the front page of the Wall Street Journal. If 1% interest rates and that small Greenspan monetary increase back in 2000 caused the boom and ultimate crash of 2008, then what will be the ultimate result of our current extended course of 0% interest rates and a 300% increase in the monetary base?

There is an answer, but it's not good. To quote Professor Mises, the economist who actually predicted our current plight over 60 years ago: "There is no means of avoiding the final collapse of a boom brought about by credit [or monetary] expansion. The alternative is only whether the crisis should come sooner as the result of voluntary abandonment of the further credit expansion, or later as a final and total catastrophe of the currency system involved."[1] The end result seems fixed; the only question that remains is what happens between now and then—no easy task.

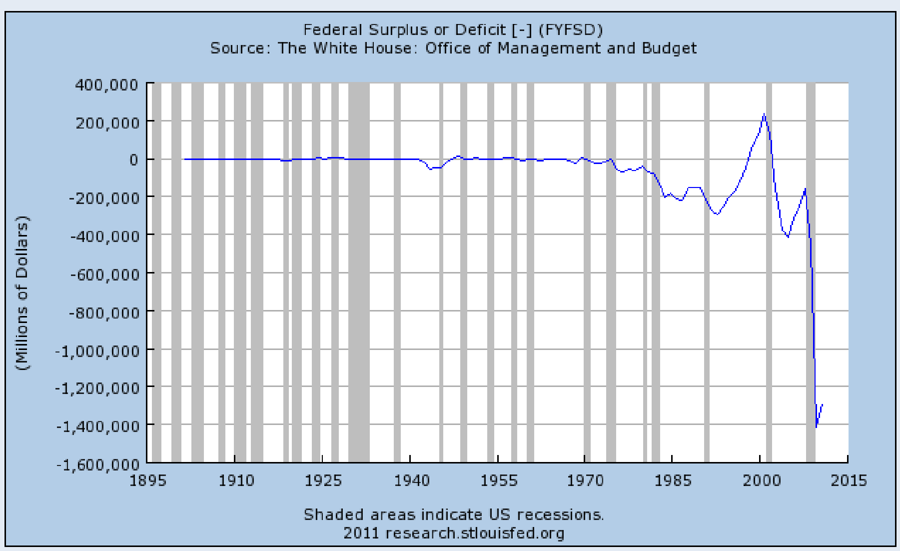
Even though the Fed funds rate has been at zero, and even though the Fed has created enormous amounts of fiat money, most of that money remains at the banks. Take a look at the chart below.

This chart represents the amount of money our nation's banks keep on deposit with the Federal Reserve. So you see, the newly created money is being held by the banks, who instead of loaning it out to folks who would like to refinance their house and businesses who might expand and hire (which is what the Fed intended), they (the banks) just redeposit the free money back with the Fed, and earn massive amounts of interest.




What?! Are you kidding me?! The banks got bailed out from billions of dollars in bad loans that *they* issued, then got literally $1.2 Trillion (as you can see from the chart above) of free money that they then turned around and invested in Treasuries, the interest on which is one of Obama's biggest line item budget expenses. Are we living in an Ayn Rand novel? How would *you* like to get free money to invest, the interest on which is guaranteed by the government's taxation authority—and guns?

And speaking of the budget, this is the second scariest chart I've ever seen: The Federal Deficit, which now surpasses $1.4 Trillion, annually! Note that the chart is denominated in *millions*.




Unless Congress cuts spending dramatically (which I doubt), the Fed will continue to buy Treasuries to fund our deficit with money that is created out of nothing, just like the Weimar Republic did after World War One. The end result is a collapse.

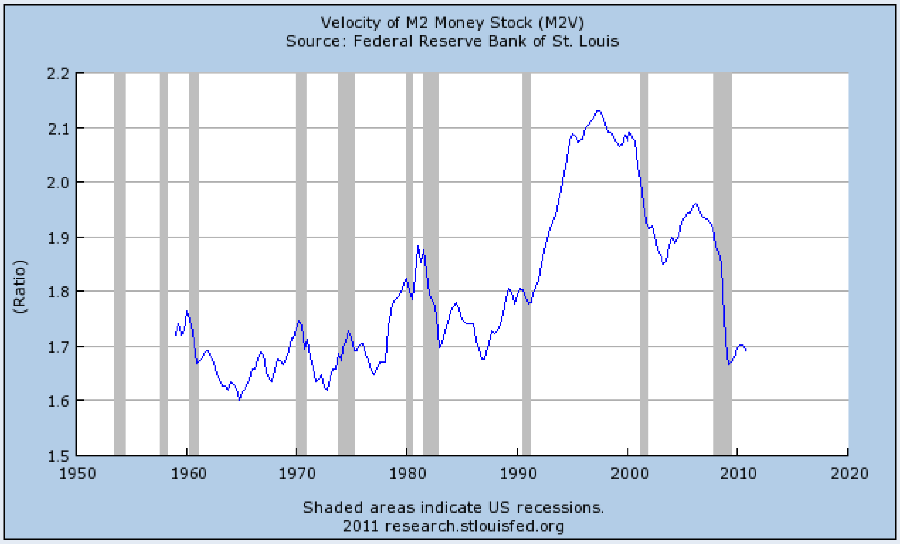
[1] *Human Action: A Treatise on Economics*, Ludwig von Mises, 1949.

Not to throw more fear on the fire, but recently the "Godfather of Bonds," Bill Gross, who manages over $1 Trillion, sold every single Treasury his firm owned because, according to a shareholder letter he recently published, "Unless entitlements are substantially reformed, I am confident that this country will default on its debt; not in conventional ways, but by picking the pocket of savers via a combination of less observable, yet historically verifiable policies – inflation, currency devaluation and low to negative real interest rates." I would say it has already begun.

**"So what can we do about it? And how does this affect me and my money?"** Did I just hear you ask that? Well, good question. Since I don't have the space or the time to go into detail here (and it would bore you anyway), suffice it to say that booms and busts are easy to understand and predict if you reject the current prevalent Keynesian School of economics and look to the Austrian School. *For more information on the Austrian School, please visit www.mises.org*.

Most people have heard of the "wheelbarrow inflation" of the Weimar Republic in Germany; but many are surprised to learn that the Austrians actually had it worse than the Germans. They, more than anyone, understand the dangers and perils of central banking and runaway inflation. History has been down this very same road many, many times, and the result is always the same.

Thus, we can learn from the Austrian experience and their economists' reasoning—which reflects realism and historical facts, and not flights of academic fancy. Though I run the risk of dramatically oversimplifying the method, essentially you want to be more aggressive in a monetary expansion phase and more conservative in a monetary contraction phase. It sounds easy, huh? In reality it is impossible to time the market to the day or even the month, but our experience in 2000 and 2008 has shown that it *is* possible to be correct to within a 12 to 18 month period. The key is knowing what signs inevitably show themselves, and taking heed.




As a prime example, one of the chief indicators we monitor in addition to those above is the velocity of money. This can vaguely be analogized to how quickly a dollar moves from one hand to another, but it is much more than that.

Every time you deposit a dollar into your checking or savings account, your bank can then lend that dollar out to ten other people, essentially creating ten more dollars out of your one dollar deposit. This is called the Mandrake Mechanism and it is part of the problem of expanding credit, because your dollar is leveraged 10 to 1. This exponentialism of money in the banking system creates vast profits for the banks, but also vast losses when a run ensues (the true reason the Federal Reserve System was created—to bail out the banks).

So here's a recap:

1. The Fed has tripled the money supply and reduced interest rates to zero.
2. A stronger economy is trying to get off the ground but can't because all the newly created money is being retained by the banks in reserve.
3. Eventually the banks will start lending again and the velocity of money will increase.
4. When that occurs, inflation will begin to show signs that even Bernanke can't ignore, and he will respond by raising rates.
5. Eventually, increased velocity, inflation, high oil prices, and interest rates will conspire to crash the market again. And we start the whole thing over again—if we can.

The job for us at Magellan Planning Group is to capture as much of this bull run for our clients as possible without exposing them to too much risk, all the while keeping an eye out for conditions that will collapse the next bubble yet to come, and then protecting the earning by moving into cash and resistant—even adverse—positions. People love to compare returns, but seldom do they compare risk. For us, risk is the first question—something our retired clients appreciate.

With the tripling of the money supply, cold mathematics would imply that eventually prices would likewise triple—once the new money has made it out into the economy. Thus, $3.50 gas becomes $10.50 gas. Clearly the math is not as easy as that, since really no one (especially Bernanke) can predict what will happen, but if history is any guide, then all of a sudden, $7 gas seems like a deal.

I know this is a great deal of information, and not very positive at that. But at Magellan Planning Group, it's our job to think about these things. We think we've got a good feel on what to expect—thanks to the Austrian School—and at least we can somewhat prepare for the coming boom, and the subsequent bust.

## About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through ING Financial Partners (member SIPC).

## About Magellan Planning Group

www.magellanplanning.com

Magellan Planning Group was established in 2000 to provide a service uniquely tailored to the needs of our affluent Atlanta community. We concentrate on *personalized* retirement planning through tri-disciplinary coordination:

- Financial planning with our Certified Financial Planner™ to prepare a retirement plan that takes into account your needs and expectations. We are a fee only asset management firm with a $500,000 minimum relationship.

- Estate planning with our in-house Attorney-at-Law to determine and prepare the documents needed to minimize family liability and maximize privacy. (www.magellanlegal.com)

- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

Our relationship doesn't begin and end with the preparation of a plan and the appropriate documents. We establish close personal relationships with our clients and their families and maintain those relationships through regular 'check-ups', market commentaries and educational Lunch & Learns.

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