Приветствие Komrade: Price Controls are a Good Thing, Da?

-J. Kevin Meaders, J.D, CFP®, ChFC, CLU

March, 2010 - Can price controls be a good thing? For those who don't remember back to World War II, there were price controls and government rationing of basic goods like milk, bread and butter. Some may even remember when it was illegal for anyone but the government and her agencies to own gold[1]. That's right: it was simply illegal to own gold. The government essentially confiscated your gold, and paid you the going rate. Oh, not the market rate of course, the government-assigned rate. It's like eminent domain over your hard assets—first real estate, then gold.

Obviously, gold was more valuable to the government than what they "bought it" for; otherwise they wouldn't have gone through the trouble of fudging the Constitution to obtain it. Needless to say, many people weren't too keen on the idea, since they had primarily bought gold for their own personal economic security. Of all things, why would the government want gold? The answer is really very simple: When all else fails (meaning, when all other currencies fail) gold becomes the reserve currency of choice. Why? Many reasons, but mainly because you can't make it out of thin air. It's LI-MI-TED.

I want you to think for a moment about what you know about the United States Treasury. Now think about what you know about the Federal Reserve System. If you're like most people, you might not have a clear understanding about what it is that these two entities actually do, and how they interact with one another. Admittedly, it is quite a complex system.

Now think back to how you felt when you first read the title of this paper: "Price controls" How does that strike you? I would venture to say that most Americans—myself included—would be quite appalled by government-imposed price controls. And yet it is the price of the most important commodity in our society that is actually being controlled: money itself.

The Federal Reserve controls the amount of money – that is, US dollars – that is available in the system. The system is the global economic banking conglomerates right down to the dollars in your pocket. Right now, China is perhaps the single largest holder of US dollars in the world[2]. But understand, they don't actually have any dollar bills, nor do they have any gold represented in dollars, nor do they have anything 'real' represented in dollars. All they have is a bunch of I.O.U.s printed on nice, fancy paper. The problem is… you and I are similarly situated, as long as we are invested in US dollars.

Now go back to what you know about the Fed and the Treasury. The Treasury issues all kinds of debt—short-term bills, intermediate-term notes, and long-term bonds. Each has a different

[1] But for exceptions like gold coins with a separate numismatic value, war medals, etc.
[2] I say "perhaps" because much of this information is secretive. Governments often buy and sell incognito.

name, but they're all just IOUs from the Treasury. Whenever the government needs money—and the trend is that they need more and more—the United States Treasury issues notes, bonds and bills (i.e. debt) to different entities like domestic banks and other nations' central banks. Sometimes, and more and more often, one of the largest purchasers of US debt, believe it or not, is the Federal Reserve Bank.

Yes, the United States Federal Reserve Bank buys United States debt from the Department of the Treasury. Wow, doesn't *that* sound like a shell game. Can you guess how they buy this debt? They buy this debt with money that they simply create. They don't even bother to print the money—it's all done with computers. Since the Federal Reserve Bank regulates, among other things, the amount of US dollars that are in circulation, the Fed can just create dollars at will.

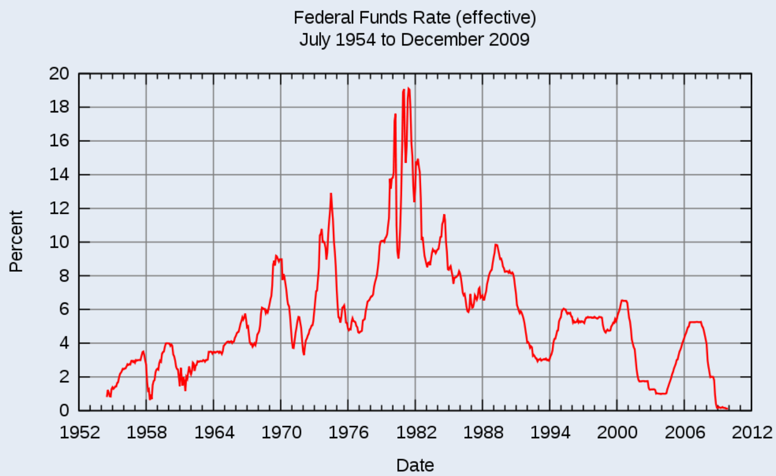
You may know that I have twin sisters. Whenever someone would bring home one toy to be shared and used equally between the twins, we all knew that we were in for a really uncomfortable next 48 hours. Why would that be? Supply and demand. Both demanded the toy, and yet there was only one.

It wasn't long before it became a rule that you could never bring home only one toy; you always had to bring home two toys and, in fact, it was better for everyone if these two toys were exactly identical. Each twin needed their own toy and that toy needed to be exactly the same or else conflict would surely arise.

Even then it became obvious that a devaluation of the value of the single toy was needed in order to procreate peace. By having only one toy, the value of that toy skyrocketed to a point where negotiations broke down and violence ensued. With the addition of every new toy, however, the value of each of the other toys dropped. Money works the same way: the more money there is, the less each unit of that money is worth.

So the Federal Reserve Bank is a lot like a parent bringing home more and more toys—adding so many toys that each one becomes worth less and less.

No new goods or services are being created - <u>the value to the government is the lag time it takes from the time the government spends the money to the time the money has a chance to filter through to the end consumer</u>. That's you.



Source: Federal Reserve Bank of New York 2/25/2010

This is a chart of the Fed Funds Rate, the god-like rate that sets all the other interest rates. This rate, as you may know, is set by a board of governors, currently headed by Ben Bernanke, formerly headed by Alan Greenspan. Ben and friends use myriad indicators to determine where to set rates and how much liquidity—extra money—is needed to continue to try to prop up business valuations. It's not a very popular stance to go on the record as opposing some new job stimulus package. Political suicide.

And so more rhetoric leads to more government action, which leads to more restrictions on free market economics and the inefficient (at best) and blatantly corrupt (at worst) allocation of otherwise useful capital. Inevitably, just like 2000-2002 after the dot-com boom and 2008 after the real estate boom, the market works to correct artificial intervention. This is normal, expected, and even welcomed. What is unwelcome is what usually happens next: more government intervention.

You would be wrong to blame free market principles for any of these busts, and to a large extent any of these massive booms. The booms are artificially exacerbated by government-created money, and the result is and will always be a loss of confidence in the value of the base currency. When things get really bad, like now, the Fed creates and injects more money into the system. Only this time, the banks are hoarding all the money and not lending it out. In just two years, the total bank cash reserves on hand has climbed from $42 Billion to more than $1.1 Trillion![3]

You may notice from the chart that there seems to be a trend, especially when compared to market performance. Essentially, after the stock markets drop, the Fed lowers rates. Then, after the markets recover, the Fed Board raises rates again to battle the very thing which they caused - inflation. Late again, as always; the quintessential reactionary inclination.

Naturally this invites a correction and sometimes a crash, as in 2008. To try to correct it, the Fed lowers rates again and creates yet more money. And so the cycle continues, but with greater and greater ferocity until sustainability is breached. [How might one know when that is? A topic for another time.]

You may also notice that the Fed Funds Rate is currently at an all-time low. I am now convinced—in my opinion—that the loose money doctrine and government interventionism during the early 2000's led to the great recession of 2008[4]. Hopefully the approach we're currently implementing won't lead to another "correction," but some economists, particularly of the Austrian School, warn otherwise.[5]

So, the obvious question at hand is how does all this nonsense affect you? Well, as you can see, the Fed Funds Rate depicted in the chart above is at a historic low and, in my opinion, must sooner or later be increased. Other things we know are that one of the basic principles of bonds is that as interest rates rise (which obviously they must) the value of bonds will generally fall, all other things being equal. We also know that the term of a bond, or the period of time remaining before a bond can either be called or mature, helps to set the severity of this new price move. The longer the term, the greater the severity.

In addition, the devaluation of the dollar will (in my opinion) naturally occur, not only vis-à-vis other currencies, but also in relation to hard assets like commodities and precious metals. As I explained above, inflation has not yet occurred simply because the banks refuse to loan money out and put it into circulation. Also, not unexpectedly but surely out of character, Americans have taken to paying off debts and increasing their savings rate.

But sooner or later investors will grow weary of earning nothing in cash and they will realize that the only prospect of beating inevitable inflation is by investing in international stock markets.

[3] Jan 2008 to Jan 2010. Aggregate Reserves of Depository Institutions and the Monetary Base, New York Fed.
[4] Congress also shares much of the blame by forcing banks to finance sub-prime mortgages with zero down.
[5] For more information, I would refer the inquisitive to the Ludwig von Mises Institute, www.mises.org.

This is nothing new, and in fact, we are essentially forced into such action lest our dormant dollars lose value due to the silent but ever-present decay of inflation.

When investors do finally return, they will likely return in droves "because investors have $3.17 trillion in money-market funds and may return to stocks after putting 16 times more money into bonds since last March."[6] Helpless to change world events or fiscal or monetary policy, we can only plan around such realities.

For our purposes, we have an opportunity to take advantage of certain circumstances that we believe will produce expected results within 6 to 18 months. Please note that there is no guarantee these occurrences will come to pass, but it is our opinion that there is more likelihood than not.

1. Global Inflation.
2. Devaluation of the dollar (and other major currencies).
3. Rising interest rates.
4. Falling bond values.
5. Short-term global crisis with the Euro.
6. Short-term global crisis with Iran.
7. Thereafter, a 4 to 6 year bull market.
8. Sometime thereafter, a global depression potentially worse than what we've recently experienced.

I don't really see any way around any of these assumptions unless things change dramatically. As I mentioned in my last letter, there are some signs that the Fed knows about the inflation possibility and is moving to absorb some money. But unless we get our out-of-control spending in check, I fear it will be too little too late.

In the interim, we could certainly see stock prices take another tumble (or two), albeit temporary. The bottom line is—going back to the Fed Funds chart once more—that every interest rate dip is followed by an interest rate rise when the market has boomed beyond the "inflation" comfort zone.

Easy money drives investment where prudence otherwise wouldn't, and at volumes that can't be supported indefinitely—but it can be supported for a while; and as much money as the Fed's "created" it may be supported for some time to come, perhaps even six to seven years. Because our purchasing power is likely to erode, it is more crucial than ever to be invested in the equity markets, which is a historical hedge against inflation. In my humble opinion, however, we are creating another bubble with yet worse fiscal and monetary policy, which is why it will be more important than ever to pay attention to warning signs in the future.

The standoff between Israel and Iran has been put on hold while the U.S. and her allies try to convince a reluctant China to back new, more aggressive UN sanctions. They won't work of course, but a military strike *feels* much better with the authority of a united Security Council. China is the only holdout.

---

[6] *S&P Rally Slowed by Fastest Cash Depletion Since 1991*. Bloomberg. March 3, 2010

The U.S. sent its top commander to Israel recently to give the Israeli military a firm red light and to coordinate action once the sanctions fail to work[7]. The Europeans and the U.S. are trying to convince the Saudis to pump more oil to offset China's loss of supply from Iran. Last week, Israel sent a delegation to China[8]. Practically on the same day, Iran announces its new 2000 pound bombs are ready for testing[9]. Again, it's only a matter of time.

Geopolitical crises come and go, and I doubt stocks will give more than a pausing breath to the Iranian crisis. Indeed, it may create an opportunity as oil and basic materials spike. Irrespective of geopolitical events, the main driving factor going forward will be essentially a Fed-forced inflation of stock prices; not necessarily real, but real enough.

No, price controls are never good, and will always distort free-market valuations. Since our very money is the object of control, all other goods, services, and foreign currencies must adjust relative to it. Luckily for us, the writing on the wall is so clear that we can't miss it.

[7] US's Top Brass Target Israel, Asia Times. March 2, 2010.
[8] *China to Consider Imposing Sanctions on Iran, Haaretz Says,* Bloomberg. March 1, 2010
[9] *Iran to Test 'New Generation' of 2,000-Pound Bombs,* Bloomberg. March 1, 2010

About J. Kevin Meaders

kevin@magellanplanning.com

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.

4170 Ashford Dunwoody Rd. NE, Suite 480
Atlanta, GA 30319
404-257-8811