

Big Inflation Coming

Late 2008's [stock panic](#) has certainly had a complex and multifaceted impact on popular psychology. Mindsets and outlooks that were scoffed at as recently as 6 months ago have suddenly become fashionable. One of the more intriguing is the meteoric rise to prominence of the *deflation* thesis.

The growing legions of deflationists see an unstoppable depression-like deflationary spiral approaching like a freight train. They cite some convincing data. The stock markets have been cut in half in just a year. In the past 6 months, some key commodities prices fell farther and faster than they did in the entire Great Depression. House prices are down by double digits across the nation, with no bottom in sight. And credit is a lot harder to come by today than in any other time in modern memory.

In light of these universal falling prices, how could we not be entering a sustained deflationary period? The case may seem airtight, but I'd like to offer a contrarian view in this essay. Believe it or not, despite 2008's price collapse there is plenty of overlooked evidence suggesting big *inflation* is coming. You won't hear much about this on CNBC, but it could have a big impact on your investments in the years ahead.

Inflation and deflation are purely *monetary* phenomena. Inflation is not just a rise in prices, lots of things can drive prices higher. Inflation is the very specific case of a rise in general price levels *driven by* an increasing money supply. If the money in an economy grows at a faster rate than the pool of goods and services on which to spend it, general prices are bid higher as a result. Only money creates inflation.

Consider this example. You live in a small town in rural Texas with 10k people and 3k houses. A small local explorer discovers a gigantic new oilfield, an elephant. Within months your town's population swells to 20k as a major oil company partners with the explorer to start developing the find. House prices skyrocket as 20k people compete for only 3k houses. Is this inflation? No, it is pure supply and demand. Its driver was not monetary in nature.

Similarly deflation is not just falling prices, but falling prices *driven by* a contraction in the money supply. It is true that most modern economists would add contracting *credit* to this definition as well, but money is very different from credit. Would you rather receive a gift of \$100k cash or a new \$100k credit line? While you can spend both, money is *very* different from credit which is short-term debt.

Carrying the Texas town illustration farther, imagine oil prices fall by 90% in the years after the big discovery. The oilfield work dries up and there is a mass exodus of people. House prices collapse. Is this deflation? Of course not, it is

pure supply and demand as well. Lower local demand for houses drove down prices, not a contraction in the greater money supply. This distinction is very important to keep in mind.

We witnessed a stock *panic* in late 2008, an exceedingly rare event. The dictionary definition of this is “a sudden widespread fear concerning financial affairs leading to credit contraction and widespread sale of securities at depressed prices in an effort to acquire cash.” Panics are [bubbles in fear](#) which drive investors to liquidate everything they can at any price. They get so scared they only want to hold cash.

When all investment assets are sold heavily in a short period of time, prices naturally collapse. But this is not deflation if it is not driven by a contraction in the money supply. For stocks, commodities, and houses, prices fell sharply in the second half of 2008 because there was a sudden huge oversupply relative to demand. Many more investors wanted out than wanted in, so prices plunged. They had to fall until a new equilibrium was reached, low enough to retard supply (investors too disgusted to sell anymore) and raise demand (from other bargain-hunting investors).

Now the deflation argument is strongest for houses because most buyers borrow to buy houses. So the stock panic's impact on credit availability definitely hurt the housing market. But the degree of impact is debatable. Sure, borrowers needed to be more creditworthy and put more cash down in late 2008 than in 2006. But the stock panic scared people so much that they may have slowed house purchases anyway even if banks were begging to give them easy loans like in 2006. Panics breed extreme economic fear, and extreme economic fear greatly slows big purchases no matter how easily they could be made.

Acknowledging that debt-financed house prices are a special case that may indeed be deflationary (contraction of credit), I am focusing on stocks and commodities in this essay. From October 2007 to November 2008, the flagship S&P 500 stock index plunged 51.9%. About 4/7ths of these losses snowballed in just 9 weeks during the stock panic. From July 2008 to December 2008, the flagship Continuous Commodity Index plummeted 46.7%. Almost half of this mushroomed during the stock panic.

Deflationists argue these price drops are proof of deflation, and most people today believe this. But they are only deflationary if they were driven by a contraction in the money supply. Stocks and commodities are generally cash markets. Credit such as stock margin can be used, but it is trivial relative to the market sizes. And real commodities purchased for industrial uses are paid for in cash or near-cash (short-term trade loans), not multi-decade loans like houses. So the money supply during 2008's slides is the key.

If available money to spend indeed contracted, then the deflationists are right about seeing deflation in 2008. But if the money supply fell by less than stocks and commodities plunged, was flat, or even grew, then deflationists are wrong. When prices fall simply because demand declines (too much fear to buy anything immediately), this is merely supply and demand. If money didn't drive it, then it isn't deflation.

This first chart is updated from [an inflation essay](#) I wrote last May (where it was explained in depth). It shows the broad MZM money supply (yellow), the annual growth in MZM (blue), and the annual growth in the Consumer Price Index (red). There are all kinds of problems with the CPI, but it remains the most-accepted definition of "inflation" on Wall Street even though it measures prices and not the money supply.



Since the deflationists believe the plunges in stocks (since October 2007) and commodities (since July 2008) are deflation, this time frame is where we will focus. MZM, or money of zero maturity, is a broad measure of the liquid money supply in the economy. It measures all currency, checking accounts, savings accounts, and money market funds redeemable on demand. It does not include CDs and other time deposits.

Starting in October 2007 when the US stock markets began sliding into [cyclical-bear mode](#), year-over-year MZM growth was running 11.9%. There were 11.9% more US dollars available to spend in October 2007 than in October 2006. This soared to 16.4% YoY growth by March 2008. The growth rate then slowed considerably in Q3'08 to 9.0% at worst, and then accelerated again during the

panic to 12.6% in late December. Overall, average annual MZM growth since the stock slide started measured 13.1%!

Since the commodities slide started in July 2008, annual MZM growth on a weekly basis has averaged 11.6%. It never shrunk! If the broad US money supply always grew by at least 9% over the period of these sharply lower prices the deflationists cite, and averaged 12% to 13%, then how on earth could the stock slide or commodities slide be deflationary? Prices didn't fall because there was less money available to spend on stocks and commodities, but because demand plunged relative to supply.

Deflation is *exclusively* monetary in nature. And since mid-2007 when the general credit crunch started unfolding, the Fed has grown broad money by the fastest annual rates seen since the aftermath of the 9/11 terrorist attacks. This fact is indisputable. Without a shrinking money supply, negative growth rates, there is no basis for declaring deflation. Redefining "deflation" to mean something it is not doesn't make it so. I can rail all day about the sun really being black, not white, but that doesn't make the sun black.

Now if you work on Wall Street, you probably believe the CPI gospel. Surely our benevolent government wouldn't lie to us about inflation, would it? Actually it has huge incentives to *underreport* inflation. Inflationary expectations hurt the stock markets, and weak stock markets hurt the economy as the stock panic abundantly proved. Scared citizens are not only harder to rule over, but they won't vote for politicians' reelections and they won't be able to shoulder as big of tax burden to pay for politicians' grand spending plans.

And then there are those pesky income-redistribution entitlements that take away spending from politicians' pet projects. Most of these are indexed to CPI inflation. Politicians want to bribe constituents for votes with pork, not pay more of "their" money in mandatory transfer payments. A higher reported CPI means higher non-discretionary spending on social security and other entitlements. So the government has all kinds of reasons to underreport inflation and it does.

Thus the CPI is a joke, riddled with statistical sleights of hand deliberately designed to downplay rising prices. In addition it measures *the effect*, rising prices, and not *the cause*, a growing money supply. True monetary inflation is almost always higher than the CPI's custodians lead investors to believe. Nevertheless, Wall Street wants to believe the CPI nonsense so the CPI still has mainstream credibility even when it should have none.

Even though it is perpetually understated, the CPI still makes a mockery of the deflationists' arguments on the recent sharp stocks and commodities declines. Since October 2007, the CPI has averaged 3.9% annual growth. It peaked at a very *inflationary* 5.6% year-over-year in July 2008 as commodities prices topped. While it did plunge in the panic, it was still positive throughout the whole thing.

4.9% YoY in September, 3.7% in October, 1.1% in November, and 0.1% in December.

Per the CPI, the rate of headline inflation is slowing. This is not deflation. Deflation is shrinkage. Slowing yet still growing inflation is *disinflation*. They are very different beasts. The deflationists not only want to redefine deflation as falling prices independent of money, which is silly based on many centuries of history that defined it as purely monetary, but they have confused disinflation with deflation. They ought to buy some dictionaries to see what words really mean before they embarrass themselves further.

Regardless if you consider inflation from a monetary-growth cause standpoint or a CPI effect standpoint, there has not yet been a single data point of deflation despite stock prices and commodities prices getting sliced in half. We may see deflation yet, anything can happen in the markets. But so far it is a myth. It was plunging demand driven by a bubble in fear that hit prices, not a shrinking money supply.

Another relevant misconception along these lines is that falling investment prices reduce money. This isn't true. The money supply is *totally independent of* investment levels. Plunging asset prices do not destroy money despite some fringe deflationists actually making this argument. They claim that since stock, commodities, and house prices have fallen, money is being destroyed. But this is not how money works in the real world.

Imagine an investor buys stock for \$10k. To receive his shares, his broker transfers \$10k of money from his account to the seller's. The seller now has \$10k, the buyer now has shares. The money simply *changed hands*. Then a stock panic hits and the shares plunge 50%. The investor's fear gets the best of him so he frantically liquidates these shares for \$5k. A new buyer's broker transfers \$5k from the buyer's account to the investor's. Did the investor's original \$10k of cash get destroyed in this stock plunge?

Of course not. The original seller could have taken that \$10k and parked it in a bank. He could still have the \$10k if he wasn't in the assets that plunged in price when demand evaporated during the stock panic. Money is a *medium of exchange*. Rising asset prices don't create it in an aggregate sense and falling asset prices don't destroy it. Sure, you can get a bigger *share* of the overall money pool if your assets are rising in price, but only the central bank can affect the size of that money pool. You and I can't.

Which brings us to the title of this essay, big inflation *coming*. While the deflation thesis is easily refuted for stocks and commodities, the actual money-supply data the deflationists perpetually ignore offers more insights. During the stock panic, central banks around the world panicked. They fear deflation too, so they started cranking up the printing presses at phenomenal rates. The epic deluge of money

they unleashed is going to filter into the real economy and drive up general price levels.

You can see this above in MZM growth. The US economy is *shrinking* thanks to the panic, there are less goods and services on which to spend money. Yet simultaneously the Fed is recklessly ramping broad money at double-digit rates. Sooner or later relatively more money will be bidding for relatively less goods and services, which will drive up prices. You simply can't have 10%+ MZM growth without seeing big inflation eventually. The Fed last did this in late 2001 (panicking after 9/11) which helped initially kick start the commodities bulls.

As if 13%+ annual growth in broad money wasn't inflationary enough, I can't believe what is happening in narrow money. M0, the narrowest measure, is usually called the monetary base. It is simply currency (coins and paper dollars) in circulation and in bank vaults plus reserves commercial banks have on deposit with the Fed. These reserves are critical because they are the base from which all other forms of money such as checking accounts are created. The monetary base directly controls the ultimate size of fractional-reserve banking.

Until late 2008, I hadn't looked at M0 for years. Why? Even the Fed isn't foolish enough to change it too much. For decades it has traveled in a tight range between about 2% and 10% annual growth, with a pre-panic average since 1960 of 6.0%. M0 growth less real economic growth is one of the most basic measures of inflation. If M0 grows at 6% and the underlying economy at 3%, then there is relatively 3% more money available to spend on goods and services. This is inflation.

I was reading a book last month that discussed the monetary base's direct impact on inflation. So I decided to take a look at M0 again. I could not believe what the data showed, I almost fell out of my chair it was so mind-blowing. Per the Fed's own data, we have just witnessed the most inflationary event in modern history. This crazy monetary base chart will make even the most rabid deflationist very uneasy.



M0 has gone parabolic! Year-over-year in December 2008, it was up 98.9%! This is so shocking it defies belief. In late September as the stock panic started, it had grown by 9.9% over the past year. By October, this rate ballooned to an all-time high of 36.7%. In November, it rocketed again to 73.0%. And in December, it surged up to the staggering 98.9% you can see above. Ben Bernanke's Fed has *doubled* the monetary base in a single year! Holy cow.

Between January 1960 and August 2008, the 48-year pre-panic average M0 growth rate was 6.0% and the range was pretty tight as you can see above. 10% growth rates were rare and often preceded sharp gains in commodities prices (mid-1970s, late 1970s). The Y2k scare led to the highest monetary-base growth rate ever to that point, 15.8% as the Fed prepared for an expected run on currency. Yet that is now dwarfed by the unprecedented parabolic explosion in M0 seen during late 2008's stock panic.

That Y2k spike's aftermath is interesting too. By January 2000, the Fed knew the world wasn't going to end. Yet it took it *over a year* to try and take out some of that excess liquidity, and it was a feeble effort. M0 growth didn't go negative until December 2000, and this modest and brief 2-month episode was the only shrinkage seen in the monetary base since 1961. So even if the Fed tries to reverse its doubling of M0 after it stops being scared of deflation, it isn't going to happen overnight. The money supply will be *much* larger going forward.

How did such a crazy inflation spike happen? After Bernanke's Fed foolishly ran interest rates to zero to try and force investors out of Treasuries and back into stocks, it ran out of conventional ammunition to fight the panic. So it started

buying securities directly, which is purely inflationary. When you buy a bond, you have to first raise the cash to do it. When the Fed buys a bond, it literally creates the money out of thin air with the stroke of a keyboard. Every security the Fed buys is paid for with pure inflation, new money.

Sure, the Fed can shrink the monetary base if it resells these securities. When the Fed sells back a bond, the buyer pays the Fed money which then effectively vanishes. It shrinks M0. So while the Fed *could* undo this inflationary superspike, Bernanke's dismal pro-inflation record suggests it is highly unlikely to happen. This easy-money Fed is loath to ever shrink money even when the economy is contracting, so I don't have any hopes that this doubling of M0 is going to be undone anytime soon, if ever.

When a central bank doubles the monetary base in a matter of months, a lot more money is going to be flooding into the real economy. It will compete for finite goods, services, and investments, driving up prices. And even if the Fed awakens from its madness and starts shrinking M0 rapidly, there is still going to be a lot more money around in 2009 than there was in 2007 or 2008. Major inflation is coming.

So what's an investor or speculator to do? Ride the coming inflationary wave. Some of this deluge of new money will flow into beaten-down stocks and commodities. I like both since they were driven to such irrational prices in 2008. And of course the champion investment in inflationary times is gold. It has phenomenal [supply-and-demand fundamentals](#) of its own totally independent of this coming inflation which will be like throwing rocket fuel on a fire.

At Zeal we refuse to drink the deflationist Kool-Aid as long as central banks are rapidly growing money supplies. We are positioning our capital for the big inflation the money supplies are portending, not some deflationist fantasy. We've been aggressively buying gold, silver, and the stocks of their best producers since the depths of the stock panic in late October. The gains have already been excellent, but are nothing compared to what will happen once Wall Street finally realizes inflation is what it should have been fearing all along.

We publish an [acclaimed monthly newsletter](#) that distills all our ongoing research into real-world trading recommendations. [Subscribe today](#) and learn how to thrive in these challenging markets. We also just published a deep new [fundamental report](#) profiling our 12 favorite gold-producing stocks. With this sector still very undervalued relative to gold today because of this silly deflation scare, the opportunities in gold stocks now are awesome. [Buy your report](#) today and start getting deployed ahead of the mainstream herd!

The bottom line is inflation and deflation are and always have been purely monetary in nature. Supply and demand can drive prices all over the place, but it is only a changing money supply that can truly spawn inflation or deflation. And

the money-supply data is crystal clear. The Fed is growing the fiat-dollar supply by frightening rates, all the way from double-digit broad-money growth down to a scary *doubling* of the monetary base!

This means *big* inflation is coming, it's already baked into the pipeline. Too distracted by deflationists who have no dictionaries and hence don't even know what the word "deflation" really means, Wall Street hasn't realized the real threat is inflation yet. But when it does, capital should rapidly flood into investments that thrive in inflationary times. Of these, gold remains the king. Its bullish potential in the years ahead is vast.

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Thoughts, comments, or flames? Fire away at zelotes@zeallc.com. Due to my staggering and perpetually increasing e-mail load, I regret that I am not able to respond to comments personally. I will read all messages though and really appreciate your feedback!

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