

Big Inflation Coming 2

At the height of the stock panic in late November, the flagship S&P 500 stock index had plunged 49% year-to-date. Fully 2/3rds of this decline happened in the 9 weeks leading into the panic lows! Naturally the psychological impact of such an epic selloff was utterly massive. Fear exploded to unprecedented extremes.

A stock panic is a bubble in fear, and succumbing to this overwhelming fear leads to irrational selling near lows. But interestingly at the time, investors failed to recognize this truth. They sold aggressively, and they wrongly assumed their selling was *rational*. Of course the only thing that would warrant a 38% loss in the stock markets in just over 2 months was a new depression. So depression fears mushroomed.

With a depression comes deflation, so deflationary theories became widely accepted in December and January. Yet there was one big problem. Deflation is purely a *monetary* phenomenon. If prices of anything are falling simply for their own intrinsic supply-and-demand reasons, and not as a consequence of monetary contraction, then it is not deflation. In reality, the money supply was skyrocketing in the panic.

With the Fed ramping the US dollar supply far faster than the pool of goods and services on which to spend it, inflation was inevitable. Relatively more dollars bidding on relatively fewer things means higher general prices, the formula is simple. I wrote an essay on the [big inflation coming](#) in January, when deflation fears reigned supreme, using the Fed's own data to highlight the staggering monetary growth.

Saying it was inflation that was coming, not deflation, was extraordinarily controversial just 5 months ago. You would not believe the firestorm of flak I weathered for pointing out the threat of inflation. Being contrarian never wins friends. But not surprisingly, today the consensus view on money is shifting to an inflationary bias. With a more receptive audience not blinded by fear, I thought I'd update this analysis.

Sadly inflation is woefully misunderstood in popular culture. People tend to think it is simply "rising prices", but this is incorrect. The formal dictionary definition of this word is "a persistent, substantial rise in the general level of prices related to an increase in the volume of money and resulting in the loss of value of currency". The key is the rising prices *have to be* driven by an increasing money supply.

Consider an example. If the Fed doubles the money supply and hence gasoline prices ultimately double, this is inflation. More dollars are bidding on the same amount of gasoline, driving up its nominal price. But if some calamity takes Saudi Arabia offline, and gasoline prices double, that has nothing to do with

inflation. Supply contracted sharply, demand remained constant, and hence prices rose. These are two different scenarios leading to the same outcome, but only one is inflation.

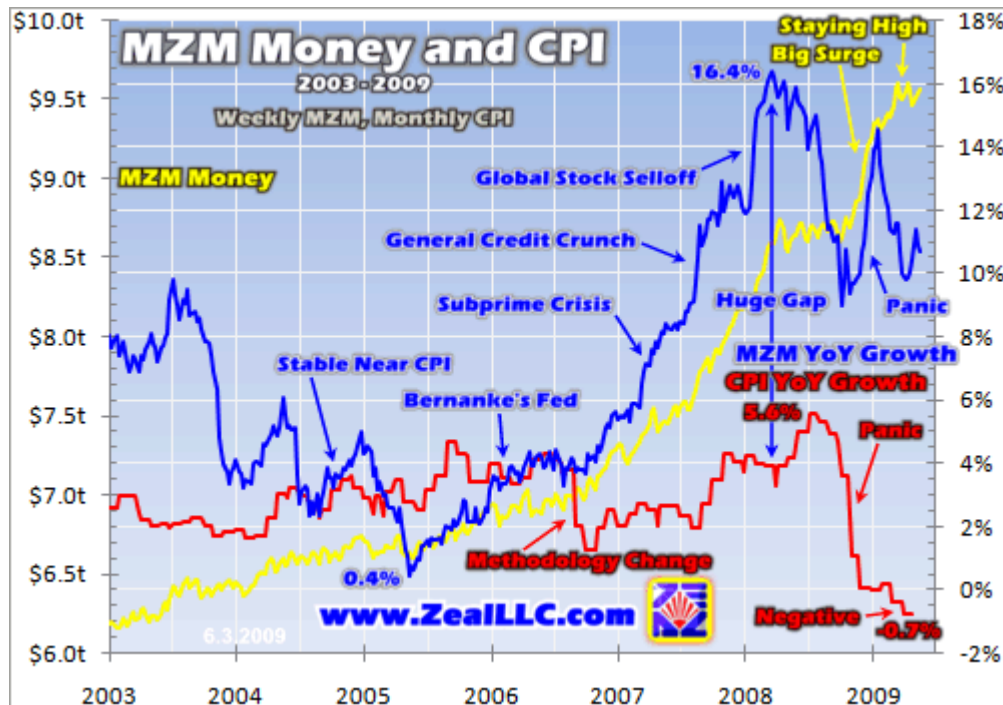
And the reality is the prices of everything are derived from a complicated mix of the supply and demand of any particular item and the supply and demand of money itself. So usually a given price increase has a commodity supply-and-demand-driven component as well as a separate money-driven component. This is why it is notoriously hard to measure inflation and why average folks have a tough time understanding it.

Since separating out price effects is virtually impossible, it makes far more sense to look at the *cause* of inflation. That is money supplies increasing at faster rates than the underlying economy. If you think of price inflation as smoke, an effect, then why not look for the fire that creates it, the cause? This fire is excessive monetary expansion. When a fire initially flares brightly, there might not be smoke right away. But there sure will be if it keeps burning!

Only a central bank can directly affect the base money supply. Yes, commercial banks can expand credit through fractional-reserve banking, but credit is not money. Credit is just access to someone else's money. If I offered you a \$100k check as a gift, you'd be pretty excited. If I offered you this same \$100k as a loan, you wouldn't be. Money and credit are very different beasts, so don't make the mistake of assuming credit contraction automatically means general deflation.

The place to look for coming inflation, the fire that is going to produce the smoke, is in the Fed's own money-supply data. I'll start with a broad measure of the US money supply, money of zero maturity. MZM is a liquid monetary measure that includes all currency, checking accounts, savings accounts, and money-market accounts redeemable on demand. It does not include CDs and other time deposits.

This first chart graphs the raw MZM data in yellow along with the absolute annual growth rate of MZM in blue. For reference, the year-over-year growth rate in the Consumer Price Index is also included. While the CPI is horribly flawed for a variety of reasons, it remains the most widely accepted measure of inflation today. But it ignores the cause, monetary growth, and tries to filter out effects, rising prices.



The Fed, or any central bank running a fiat currency not backed by gold, really only has one single power. It can inflate. Inflation, growing the money supply, is the Fed's response to *everything*. Sometimes it inflates more, sometimes less, but it is almost always inflating. It is very rare to see money supplies contract, and even in these isolated cases it is only for a trivial amount over a very short period of time.

Back in the mid-2000s, MZM growth was stable near CPI growth. In 2004 and 2005, YoY MZM growth averaged 3.1% while YoY CPI growth averaged 3.0%. Also, note above that prior to mid-2006 the CPI direction generally mirrored that of MZM growth. If MZM growth rates were increasing, so were the CPI's. And vice versa. But in 2006, a couple major events sowed the seeds for the massive MZM/CPI disconnect we are seeing today.

In early 2006, Ben Bernanke took over the helm of the Fed. An academic, he had a long record of being pro-inflation. He believes the Great Depression happened because there wasn't enough inflation, so if he was ever thrust into a crisis he would ramp the money supplies rapidly to try and avert it. Late in 2006, the CPI's calculation methodology was changed. Rising prices would be more aggressively edited out of this index so "inflation" would remain at politically-acceptable levels for Washington.

Bernanke's mettle was soon tested with the subprime mortgage crisis in early 2007, the general credit crunch in late 2007, and the global stock selloff in early 2008. The Fed's response was typical, it did the only thing it could do. It rapidly increased the rates of monetary growth. Stable at 4% when Bernanke took

office, absolute annual MZM growth soon ballooned to 8%, 12%, even 16% in early 2008! The Fed was flooding the system with new fiat dollars.

Thanks to the CPI's methodology change, this surge in money was not being reflected in this index. Yet choosing not to measure something properly does not mean it doesn't exist. The surging MZM growth was readily apparent in commodities prices. The basic raw materials are the first prices to be driven higher by more money bidding on them, it takes time for these prices to flow through to the finished goods the CPI measures. Of course commodities [surged mightily](#) in early 2008, partially as a result of this inflation.

Even though the Fed tried to rein in the MZM explosion of late 2007, it was soon confronted with the stock panic. So it responded the only way it knows how to this new crisis, again it flooded the system with more dollars created out of thin air. And as you can see above in the yellow line, even though the stock panic is long over the Fed hasn't even attempted to withdraw any of this inflation. MZM remains near record highs!

Since the beginning of 2008, absolute annual MZM growth on a weekly basis has averaged 12.9%! This is a staggering expansion rate. Remember the old Rule of 72 from college finance? At this 13% compounded growth rate something will double in 5.6 years or so. Indeed since Bernanke took over, MZM has ballooned by 40%. This incredible deluge of money has to go somewhere.

Theoretically, if money-supply growth didn't exceed underlying economic growth there wouldn't be any inflation. This is why the gold standard is such a brilliant solution to money. The [natural mining rate](#) of gold almost never exceeds the natural growth rate in the global economy. But of course the US economy hasn't even come close to growing 40% since early 2006 when Bernanke came to power or at a 13% rate since early 2008.

In fact, per the US government's own GDP data, since early 2006 the US economy has only grown 11.0%, a far cry from the 40.4% the Fed has grown MZM over this span. And since early 2008, GDP is actually dead flat at 0.4% while MZM money has soared 16.8%. In both cases the excesses are pure inflation, new dollars created out of thin air that are now chasing a relatively smaller pool of things. Higher general prices are the inevitable result.

And boy, if you *exist* you know this! Over the past several years, have your costs of living risen or fallen? Is your food at grocery stores and restaurants getting cheaper or more expensive? Are your utilities bills and insurance costs rising or falling? Do you feel like you have more disposable income after necessary expenses or less? We all see this relentless and very real inflation no matter what the government statisticians try to tell us. The nominal cost for existence just keeps rising and rising thanks to the Fed.

Now if MZM has averaged 13% annual growth since early 2008, then why has the CPI gone negative? There are a couple reasons. First, the CPI is designed to intentionally lowball inflation. Its custodians filter out rising prices and overweight the rare falling ones, like computers. Washington wants a low CPI read because it reduces non-discretionary government expenditures on welfare programs indexed to the CPI. This gives politicians more money for their pet projects. Wall Street wants a low CPI read because high inflation is [bad for the stock markets](#).

But the primary reason the CPI plummeted was due to the stock panic. If you don't remember how scared people were in late November and early December, go back and read the big newspapers from then at your local library. Thanks to sensationalist mainstream-media coverage, average Americans really believed a new depression was upon them. I've reported tons of hard stats on this in our subscription newsletters since the panic. Americans radically reduced spending, hoarding cash for the worst case.

Remember that the prices of everything are a function of supply and demand. As demand for goods plunged, desperate retailers cut prices to spur sales and clean out inventories. It was this dynamic, a plunge in consumer demand, that drove the falling consumer prices the government emphasized. General prices did not decline because money shrunk. There never was any deflation despite the CPI!

If the raw money-supply data isn't enough for you, consider the Continuous Commodity Index. The CCI is an equally-weighted geometrically-averaged basket of 17 key commodities. It bottomed in early December as the stock panic ended. Since then, it has surged 31.3% higher. Now there is no way global commodities demand grew by a third in just 6 months. The rise since the panic was driven by a combination of investment demand as well as more dollars bidding on commodities, inflation.

If I ended this essay here, investors would have plenty of reasons to deploy capital in investments like commodities that thrive in inflationary times. Our subscribers have already earned *big* gains in this sector since the panic. But amazingly, this high sustained MZM growth is minor compared to the primary inflation threat. Even though it is going to drive huge gains in my investments, this next chart really frightens me.

The narrowest measure of money supply is known as the monetary base, or M0 (zero). M0 is simply currency (paper dollars and coins) in circulation, currency in bank vaults, and reserves commercial banks have on deposit with the Fed. M0 is critical because it is the base of all money we use for daily transactions. It is also the base from which fractional-reserve banking multiplies. M0 growth has the most direct impact on inflation of all. Its raw numbers are shown in red and its year-over-year growth rates in blue.



For 48 years prior to the stock panic, absolute annual M0 growth averaged 6.0%. And this was within a tight range that seldom exceeded 10%, and even then only for short spells. Why? The Fed, at least before Bernanke, knew that excessive growth in the monetary base would rapidly lead to price inflation. Growing M0 too fast is playing with fire, very dangerous.

The only notable event in M0 in a half century was the pre-Y2k ramp, a brief period of 15.8% growth ahead of the date rollover and all its big unknowns. Yet Greenspan realized how dangerous this was, even for a crisis, so within a year M0 was actually shrinking a bit as he tried to soak up all that excess pre-Y2k liquidity. Interestingly, some economists believe this Y2k M0 ramp helped drive the vertical final few months of the tech-stock bubble and that the subsequent rapid slowing in M0 growth accelerated its bust.

M0 growth was trending lower in 2008, averaging 1.2% in its first half. This is one of the main reasons inflationary expectations were fairly low prior to the stock panic despite the record commodities prices last summer. But then the stock panic erupted and the Fed panicked, getting swept away in the fear. Bernanke decided to inflate far faster than has ever been witnessed in the Fed's entire history since 1913.

In October, the scariest month of the panic when the S&P 500 plummeted 27% in less than 4 weeks, the Fed suddenly expanded the monetary base by \$224b. This was a 25% surge in a single month, just insane. And it led M0 to rocket to its highest YoY growth rate ever by far, up 36.7%! But the Fed was just getting started in its unprecedented inflationary campaign.

In November it grew M0 by another 27% over the prior month, yielding 73.0% YoY growth. In December it again grew M0 by 15% MoM leading to a mind-boggling 98.9% YoY gain. In 4 short months, the Fed had literally *doubled* the US monetary base! Something like this has never even come close to happening before, so we are deep into uncharted inflation territory here.

By late December this information slowly started to leak out and contrarians who have studied monetary history were appalled. Was the Fed mad? Bernanke responded to these growing criticisms in Congressional testimonies, promising that the Fed would remove its “accommodation” (a euphemism for inflation) as soon as possible. Even though the Fed has *never* shrunk the money supply noticeably, Wall Street curiously took Bernanke at his word.

So every month since the panic ended in mid-December, when the VXO fear gauge fell back out of panic territory, I’ve been watching M0. In 3 of the 4 months since (May data isn’t out yet), the Fed has actually grown M0 further! In January, February, March, and April, the absolute annual M0 growth rates weighed in at 106.0%, 88.5%, 97.9%, and 111.0%! And in April alone M0 surged to a new all-time record high. And by late April the stock markets had already rallied 29%, yet the Fed was still rapidly growing M0.

Friends, this data is flabbergasting! How can the monetary base double in 4 months, *and stay doubled* for almost 6 now, and have no impact on real prices? The monetary base is our transactional cash we use to buy everything. Even checking accounts are directly tied to it, although the mechanism is beyond the scope of this essay. The Fed has not only failed to start contracting M0 post-panic, but it is still growing it.

Nothing like this has ever happened before, not even in the 1970s during the last inflation scare. So the inflationary impact of a doubling of narrow money in 4 months will certainly be serious. Exacerbating this effect, as consumer spending recovers and bids on now-depleted inventories of consumer goods, prices will also be rising for pure supply-and-demand reasons. This will be perceived as inflation by most people, so we’re probably facing a perfect storm of inflation.

As inflation really takes root in a way everyone can easily see, inflationary expectations will soar and investors will seek assets that thrive in inflationary times. Of course this means commodities, primarily gold and silver. At Zeal we’ve been deploying in ahead of this trend since the end of the panic. Our trading results have already been awesome, but we haven’t seen anything yet compared to what will happen to our trades once inflationary expectations start scaring mainstream investors.

In our latest [Zeal Intelligence](#) monthly newsletter at the end of May, our 12 open stock trades had average unrealized gains of 37%. Our 4 new long-term

investments added in November near the panic lows had average unrealized gains of 103%. Our 17 open stock trades in our [Zeal Speculator](#) weekly alert service had average unrealized gains of 53% as of the latest issue on June 2nd. All these trades are elite commodities stocks that will thrive in inflationary times. And thanks to the Fed, big inflation is coming.

Unfortunately most mainstream investors are still sitting on the sidelines in cash, too wounded from the panic to even think about stocks again. But this [ostrich approach](#) will prove disastrous. The kinds of inflation this M0 ramp portends will steamroll cash, rapidly eroding its purchasing power. As mainstreamers realize this, the capital that will flood into commodities and their producers' stocks should be breathtaking. [Subscribe today](#) to get in the game and ride this unprecedented event higher with us!

The bottom line is the panic money-supply growth in the US has been very excessive, running at multiples of economic growth. And in the case of narrow M0 money, the doubling in 4 months is literally unprecedented. It scares me. With so much new money in the system, and the Fed totally unwilling to undo this terrible inflation over the 6 months since, rapidly rising prices are inevitable.

We're on the verge of the first inflation scare of the modern era, a time when epic panic buying into hard assets and their producers is increasingly likely. Investors who ignore these dire tidings will probably get crushed by the inflation. But investors who prudently study the dangers and deploy their capital to thrive in them will make fortunes. Mark my words, the money-supply data shows big inflation *is* coming.

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June 5, 2009

So how can you profit from this information? We publish an acclaimed monthly newsletter, [Zeal Intelligence](#), that details exactly what we are doing in terms of actual stock and options trading based on all the lessons we have learned in our market research. Please consider joining us each month for tactical trading details and more in our premium Zeal Intelligence service at ... www.zeallc.com/subscribe.htm

Questions for Adam? I would be more than happy to address them through my private consulting business. Please visit www.zeallc.com/adam.htm for more information.

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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