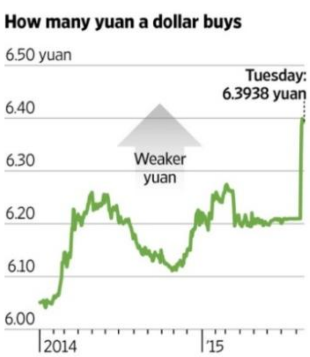
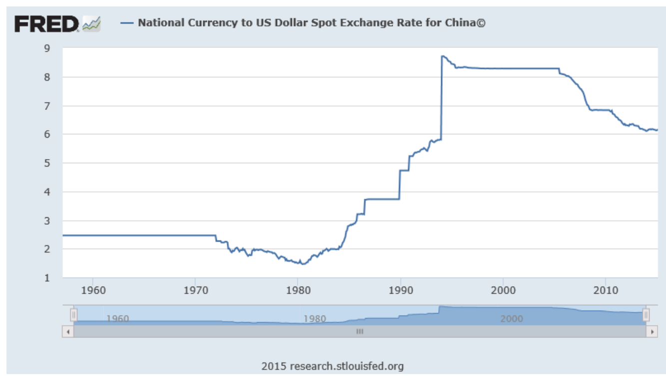
Does recent yuan devaluation castrate Fed rate hike and open door for QE4 (and much, much more)? 8/23/15
10-year Treasury: 2.04%; S&P 500: 1970.89; Oil: $40.33; Gold: $1,160; Silver: $15.32 (8/21/15 quotes)

The yuan, the buck, statism, and the crumbling rule of law:
China's centrally planned economy is reaping the harvest of sustained mismanagement and rampant misallocations. Central planning-spearheaded cap ex, which has accounted for roughly half of the nation's GDP growth for about a decade, has resulted in countless white elephants and ghost cities across the Middle Kingdom more than it has given that nation a productivity boost. This fact is also captured by Chinese debt, which has mushroomed from $2.1trn in 2000 to $28.2trn in 2014, far in excess of nominal GDP growth over the same time period as depicted by a debt-to-GDP ratio that went from 121% in 2000 to 282% in 2014. Meanwhile, on the back of decades of higher labor force participation rates enabled by Beijing's 1978 one-child policy, China's old-age dependency is set to rocket from 11% in 2010 to 38% by 2050. One could argue, without addressing that nation's severe environmental degradation issues, that China's communist business model "has run out of tarmac."

Is the Chinese Politburo thus looking to revisit currency devaluation vis-à-vis the US dollar via the printing press and beyond? To get a historical perspective, let us not forget that an aggressive policy of yuan devaluation, which helped set the stage for Chinese industrialization, saw the Chinese currency fall by 75% against the US dollar between 1981 and 1994 and by 33% from December 1993 to January 1994 alone.



Source: Thomson Reuters

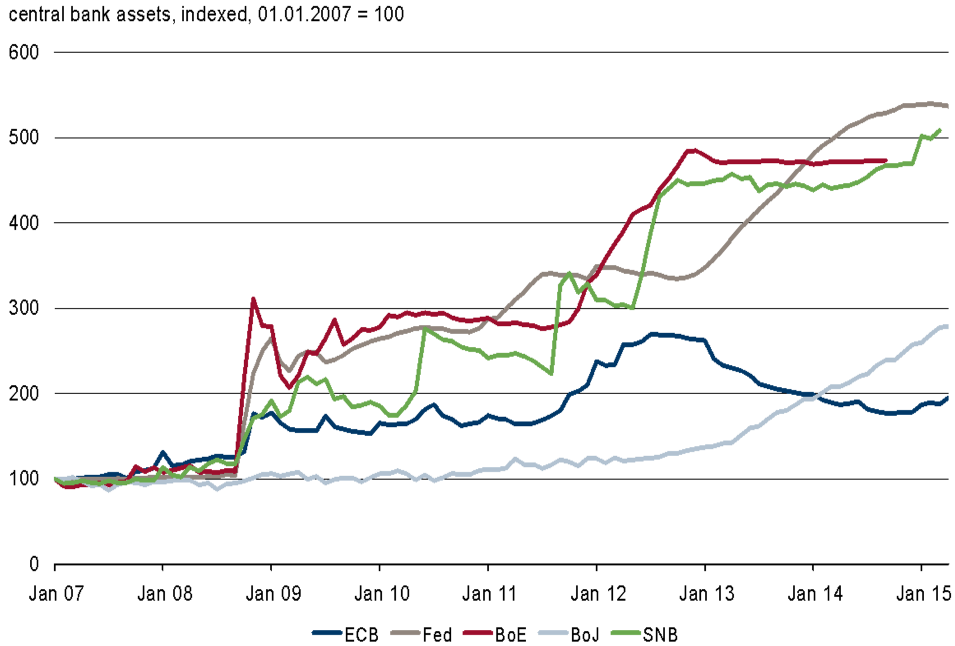


Source: Fed https://research.stlouisfed.org/fred2/series/CCUSSP02CNM650N

Plus, the yuan-dollar peg is giving China an undesirably strong currency vis-à-vis most of its trading partners. This is thanks to the dollar's pronounced global strength since mid-2014 on the back of (fabricated, thanks to materially understated inflation) claims of recovering US growth. It is also due to cessation of overt QE by the Fed (member banks may have been filling the void via off-balance sheet derivatives or other, less than transparent, structures). Finally, and perhaps most significantly, the market has bought into the "headline news" and, as a result, expectations of higher US interest rates -- the fed-funds rate has been at virtually zero since December 2008, so the bar has been set unprecedentedly low -- have been pushing up the trade-weighted value of the US dollar:

Source: https://research.stlouisfed.org/fred2/series/DTWEXM

In a nutshell, the buck is up 25% in one year in a moribund global economy and a weakening, not strengthening, US economy (more details below). The nations not pegged to the dollar are thus facing much higher dollar-based borrowing costs, including numerous troubled European economies as well as key emerging market nations. With global debt continuing to rise substantially in excess of rapidly decelerating global GDP growth, sharply heightened domestic currency-based borrowing costs could help push the global economy into a recession. This economic growth "wet blanket" is all the more troublesome when it is combined with the long failed Keynesian/statist policies in countries/regions such as Japan, the UK, the EU, the US, and India. Statism the world over has been extended via a plethora of rule of law and productivity denuding regulatory and tax disincentives on the on hand, and via unparalleled global central bank balance sheet expansion on the other hand:



Sources: Datastream, Credit Suisse

US and global economic strength, weakening property rights, and rising cronyism:
Let us take a closer look at the US economy. Let us count some of the ways in which the US economy has been anything but "robust," statistical obfuscation (or worse) doled out by government officials notwithstanding:

1. The labor force participation rate is at a 38-year low
2. Hundreds of thousands of applicants that have failed to find work are disappearing from labor force monthly
3. The ranks of full-time (with benefits!) employees are typically dropping by hundreds of thousands per month
4. Stagnant real median household income (still down compared to 1999) based on CPI, lower household income using "real world" inflation; in a nutshell, Americans' disposable income peaked in the mid '70s.
5. Lingering weakness in US retail sales and outright contraction of same in June
6. H1:15 durable goods orders were down 2% year-over-year; capital goods orders were down 3.4% in H1:15
7. Production contracted in Q1:15 with pronounced weakness carried into Q2:15
8. A rising inventory to sales ratio
9. Currently lower real quarterly S&P 500 sales than in Q4:07!
10. Consumer sentiment, while up, is still at levels which have historically often been associated with recessions (Large downside revisions to 2012 and 2013 US economic activity; statistical upside biases "corrected")

Clearly, neither the US nor the world economy has been or will be sprouting "Keynesian green shoots." Instead, virtually the whole world is gasping on an increasingly toxic, debt-laced, yield starvation-based, fiat money, fiat government cocktail -- cronyism enabled by financial repression and property rights/liberty repression -- that has been to the detriment of the people while enriching and empowering an increasingly lawless ruling class using the instrumentalities of the law to achieve despotic power and wealth at the expense of society and a republican/representative form of government (for recent flavor, consider that in late 2014 Congress put taxpayers on hook for more than $300 trillion in potential future derivative losses by US money center banks).

With this as a backdrop, can anyone truly claim that the same cronies that occupy Wall Street, K Street, the US Chamber of Commerce, the nation's C-Suites, the Congress, the White House under President Obama, the Supreme Court of the United States or SCOTUS, and the Federal Reserve Board will revisit sound money and the rule of law/stout property rights (by the way, the above is playing out in similar fashion in Europe and Japan)? The answer is obviously "absolutely not." It's hard to let go -- much less voluntarily relinquish, without a strong conscience and stout commitment to the civil society -- of the massively increased compensation and power that rapidly spreading "codified" lawlessness and cronyism has been bestowing on the elitist leeches. In fact, this rarified group has been able to richly avail itself of taxpayer subsidies, pork, and bailouts while the average citizen and small businessman have had to struggle to stay employed/in business as they attempt to cope with rising taxes, soaring healthcare costs, double-digit increases in electricity costs, and cancerous growth in regulatory and tax complexity.

Sometimes some specific "cronyism in action" cases to help drive home the anti-societal malignancy of it all:

"… So was his (Tom Steyer's) Proposition 39 in California which, at yet further cost to the taxpayer, was supposed to have created 11,000 new "green jobs" a year. In fact the true figure has been closer to 600 green jobs a year, each costing $175,000 – and quite likely killing many more real jobs than the fake ones it created.

The same applies, of course, to George Soros and this grisly-sounding moral preener from Virginia Tom Clarke – both of whom, as Steve Milloy notes, have bought heavily into coal of late, despite both having a long track record of campaigning against fossil fuels and of bigging up their environmental credentials.

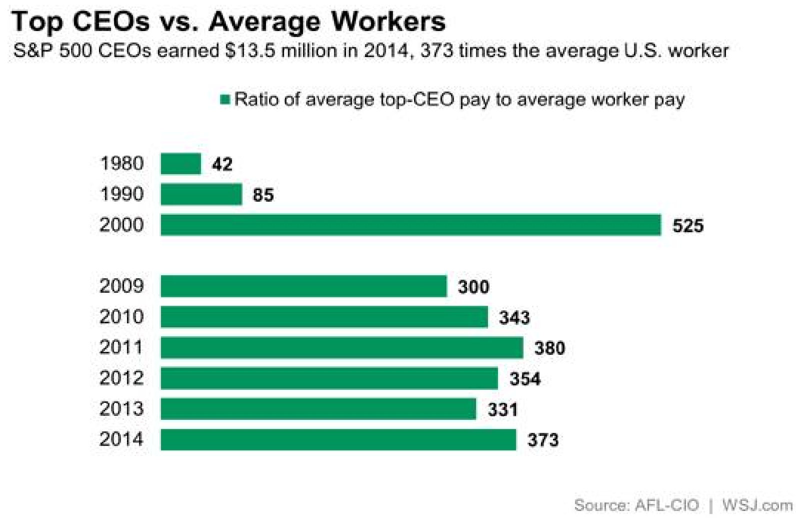
Let's take a step back and try to put some perspective on what is going on here.

A cabal of favoured businessmen with close ties to the ruling regime has been presented with a heaven-sent opportunity to buy up valuable businesses at fire sale prices which were driven to rock bottom levels as a direct result of policies created by that ruling regime.

When this happens in banana republics we shrug our shoulders because this is what you expect of banana republics.

When it happened in Hitler's Germany, Mussolini's Italy, and in the aftermath of the break up of the Soviet Union, likewise."

And sometimes a picture is worth a thousand words (is that nine-fold increase in CEO comp compared to average worker pay over the past 34 years really primarily shareholder value-added/meritocracy-based?):



The implications of the rise and rise of fiat money and fiat government:
The global elitists are not going to give up their racket, i.e., the status quo! Instead, they will double down on the very anti-wealth of nations, anti-representative government trajectory that has so empowered and enriched them. Financially speaking, this means we are likely to see:

- Ever bigger competitive currency devaluations
- Bigger QE rounds (recent BOJ and ECB initiatives a preview of coming attractions)
- A return to overt QE by the Fed
- Even more outrageous bank bail-in and Wall Street bailout legislation written for the cronies
- More monetary authorities moving to limit cash withdrawals from savings/checking accounts (to avoid "runs")
- Customer deposits in banks increasingly having the little-known legal status of "unsecured creditor funds" in the US and elsewhere in the OECD (conclusion section, p. 7 of report)
- Government seizure of pension fund assets, …

… and all kinds of accelerating economic and financial tyranny, until enough investors lose confidence in fiat money, or until enough people, a la the Greeks, are too impoverished or disenfranchised to continue to accept the increasingly fascist fiat currency status quo. That impending day of reckoning, which is drawing closer daily, will challenge the increasingly fiat financial/political world order while triggering a flight out of increasingly debased fiat money into both relatively scarce real assets and real money (silver and gold), as experience has shown repeatedly. It could also sadly trigger a finger-pointing war(s), which could raise the scarcity and thus the value of vital scarce assets and precious metals further still.

Let's briefly review the monetary aspects associated with our ever more prevalent fiat money, fiat government trajectory. The increased proclivity to spend paper money before it loses value, or it gets misappropriated, will eventually drive the money multiplier higher, as occurred in the 1970s. This will "levitate" money supply growth thanks to massive monetary base (balance sheet) expansion by the world's central banks over the past nearly seven years (page 2), consistent with what history has shown us.

It is little understood, in today's Keynesian world, that the path to hyperinflation has always been through fiat money-enabled debt mountains and asset valuation bubbles. Those bubbles pop, and recessions occur/recur. The huge debt overhangs remain, yet the assets they are tethered to fail to generate the requisite income with which to service growing debt obligations. Central banks soon need to print more money/purchase more debt to keep banks from going under. Plus, it takes ever more debt to generate GDP growth in a debt-laced, property rights-suppressed economy. This leads to a point of no return, i.e., perpetual central bank balance sheet expansion.

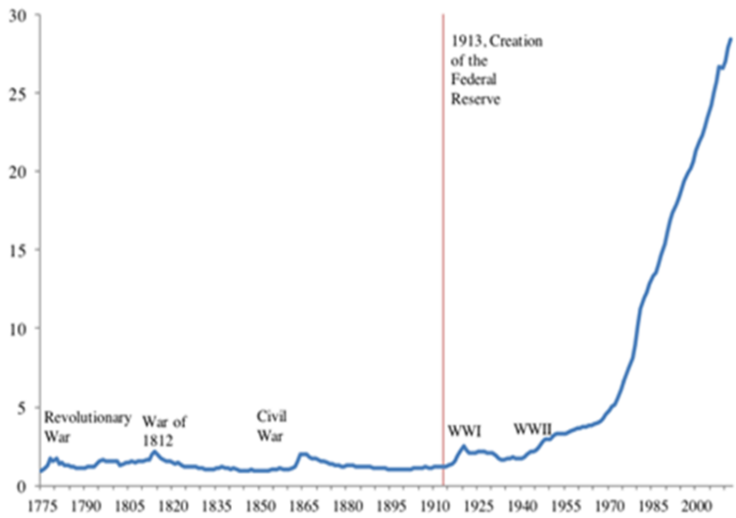
Meanwhile, the pivotal free market sector suffers under lethargic demand thanks to protracted income weakness and due to the increasing costs of doing business, a P&L double-whammy that is responded to by corporations unable to avail themselves of cronyism with workforce attrition and reduced investment. So real economic activity remains under pressure and public sector deficits widen thanks to expansive welfare benefits, which have remained rapidly growing "off-balance" liabilities around the globe thanks to, you guessed it, political expediency.

This then creates an even greater urgency for central bank intervention, lest those ever bigger securitized loan portfolios/bonds on banks' balance sheets either drop in value or suffer higher default rates. Banks, which typically feature equity capital that is but 5 – 10% of the same institutions' balance sheets, can't stand much in the way of loan portfolio writedowns or lower bond prices (the financially failing US fracking industry has been given over $500bn in capital) prior to losing their equity base, i.e., declaring bankruptcy. Therefore, central banks, which are similarly exposed, keep printing more money, and are thus facilitating more debt creation in a system already drowning in debt, to "save the system!"

In so doing, central banks invariably destroy debt-based fiat money as economic participants shed a poor store of value in favor of scarcity assets, which can't be printed into worthlessness. The inevitable outcome if we fail to return to sound money and the rule of law in the near future: hyperinflation superimposed on top of a declining real economy, also called a "banana republic" trajectory. When this comes to pass, how will the great asset valuation reset compare with previous fiat currency swan songs?

Speaking of swans, the yuan devaluation may end up being the "black swan" that spawns an unparalleled, overt QE response by the Fed, thereby unleashing an unheralded global money printing contest that will extend, and render "vertical," the Fed's dollar debasement history (and that of every other fiat currency):

Figure 1. Consumer Price Index, United States, 1775-2012
(level, 1775=1)



Sources: Bureau of Labor Statistics, Historical Statistics of the United States, and Reinhart and Rogoff (2009).

Most of the rest of the world's major central bankers already have their electronic printing presses humming along in overdrive, including the ECB, the BOJ, and the BOC. Let's say there is no fed funds hike around the corner, and relatively soon thereafter, initiation of QE4 by the Fed in response to a flagging economy and a swooning stock market (it wouldn't be the first time). At such a juncture, the gullible investors that couldn't see beyond the fabricated US economic statistics couldn't miss the fact that the US growth emperor wears no clothes. This should drive the trade-weighted value of the greenback down sharply, stoking US inflation. Would a crashing dollar be welcomed by the choking economies of Europe or Japan, for example? Or would a sharply correcting dollar be met by an unparalleled global money printing contest that would seal the fate of today's fiat money, fiat government system, thereby hugely reducing the value/purchasing power of paper currencies, bonds, and many stocks, especially high P/E equities? Can any rational investor be faulted for considering the establishment of satellite allocations that help insure against, and even capitalize on, the foreboding valuation reset implications of our fiat money, fiat government trajectory going "supernova?"

Opportunities for strategic investors:
Fiat currencies have lasted only 27 years on average. The post Bretton Woods (dollar gold standard) era turned 44 years old this month. History may not repeat precisely, but it rhymes, for we repeat the same mistakes our predecessors have made. You, dear reader, should consider allocations that take a portion of your investable portfolio assets out of fiat currencies and out of counterparty risks (don't buy certificates or other synthetic structures mimicking the underlying assets, buy the underlying via diversified stock holdings that aren't kept in "street name!") and into scarce and vital assets. Leading the pack: dense energy and ag assets as well as physical gold and silver held outside of the banking system to circumvent bail-in and misappropriation risks. Asset values in these vital arenas are under pressure, which is a cyclical, secular, and asset price manipulation-based "triple-decker" buying opportunity, in our view.

On the oil front, with the world losing roughly 6% of output annually thanks to sustained major oilfield depletion juxtaposed against nominally positive 2015 oil consumption growth, the Saudis have allegedly been selling oil futures on a massive scale: "OPEC Sovereign Wealth Funds Shorting Oil | Dr. Kent Moors". Contrast this "dry barrel manipulation" with the growing, multi-decade divergence between new oil discovery and oil consumption and our stark dependency on increasingly expensive to extract fossil fuels to sustain our leveraged output/GDP (one barrel of oil =11 years of field labor by one person!), and you have an attractive strategic oil asset buying opportunity with oil currently at $40.33 a barrel:

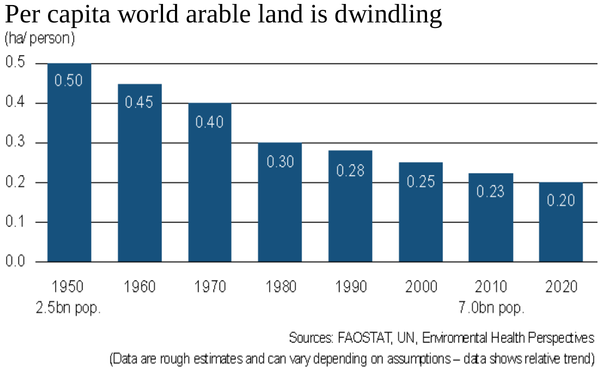
Year	Bn of barrels of oil found globally	Bn of barrels of oil used globally	Annual surplus/deficit
1930	10.0	1.5	8.5
1964	48.0	12.0	36.0
1988	23.0	23.0	0.0
2005	5.5	30.5	-25.0
2010	6.0	32.0	-26.0

Sources: BP, Weeden & Co, Dr. Colin Campbell, Macro Strategy Partnership

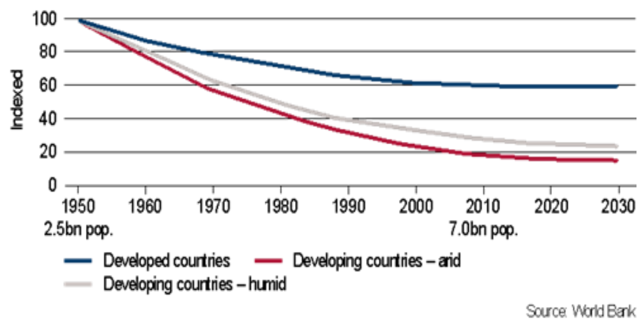
(On the pummeled coal front -- coal is the world's second largest, fastest growing source of energy -- strategic investors should consider an allocation that provides them with the same rock bottom pricing that green crony capitalists have engineered for themselves to great effect; in short, ride the thugs' coattails and help stabilize/recapitalize vital clean coal technology/affordable coal energy in the process for the benefit of society.)

On the ag front, consider the following charts as a "scarcity primer" against a backdrop of broadly declining agribusiness valuations:

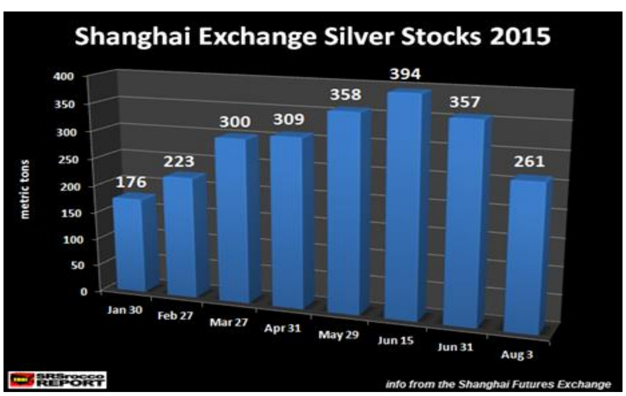
Per capita world arable land is dwindling

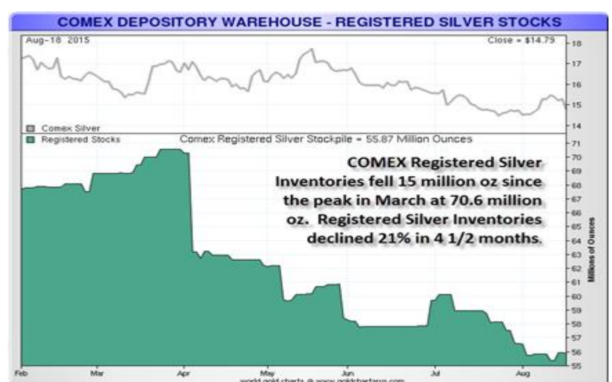


Indexed per capita water availability compared to 1950



On the silver front, amidst record investor demand for the white metal and copious evidence of [unprecedented paper silver shorting]() and [the related price suppression](), we take note of loss making mines in this tiny $14bn industry on the one hand, and plunging silver stocks (inventories) on the other:





Source: http://srsroccoreport.com/stunning-one-day-decline-in-shanghai-futures-silver-inventories/stunning-one-day-decline-in-shanghai-futures-silver-inventories/

Risks:

A deepening global recession and/or sustained asset price manipulations may continue to depress the valuations of both scarcity assets and precious metals. Either of these two occurrences would provide for an even more attractive strategic purchasing opportunity for said assets, in our view, but would lead to unrealized capital losses of uncertain duration on current purchases of said assets for long-term investors.

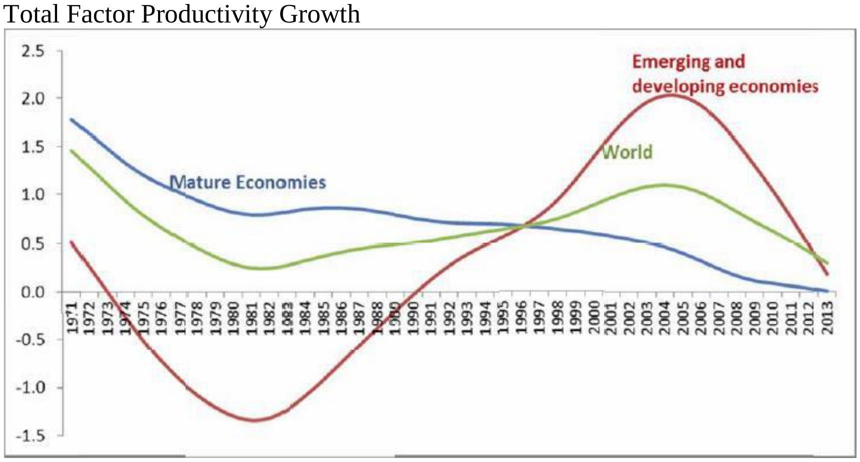
Conclusion:
Whether it ends up being the yuan devaluation, or some other "black swan" event, that triggers a global money printing supernova is actually a tertiary matter. In other words, it's less a matter of if, or exactly how, or precisely when the current paper money financial system implodes. It's more a matter of positioning accounts for a large asset revaluation -- debt-based fiat currencies, bonds, and high P/E stocks will get repriced to bring implicit inflation and default risks back into asset pricing -- with an adequate allocation in non-substitutable scarcity assets and precious metals. Such assets tend to be negatively correlated to so called "traditional asset classes, so they are great portfolio diversifiers/"smoothers;" such assets have historically protected purchasing power amidst ongoing, and likely soon heightened, currency debasement; and, last but not least, such assets, most of which are currently under material valuation pressure either thanks to "statist manipulations" or for cyclical (recessionary) reasons, stand to bestow on strategic investors potentially substantial capital gains over time.

The laws of economics eventually trump politics, especially when the latter is increasingly removed from sound money and stout adherence to a rule of law. Sadly, this is the global path we're on.

Sound money allows investors and entrepreneurs to focus on financing and building "the best mousetrap at the lowest cost" instead of focusing their efforts on staying ahead of inflation, which throttles productivity. The rule of law is fundamental to vigorous property right protections. Those protections assure individual liberty in that the individual gets to keep the vast majority of the fruits of his/her labor (the Bible indirectly refers to 90% via tithing). Vigorous property rights also provide for the incentives necessary to entertain and to commit to sizable capital and business risks. Combined, sound money and a robust rule of law facilitate the very invisible hand of Adam Smith that bestows the best possible wealth of nations' trajectory upon a country and its true sovereigns, the people. The same constructs also nurture the civil society, i.e., "responsible freedom" and the means to make it possible.

As we continue to stray ever further from a righteous path, as is clearly evidenced by deteriorating global productivity trends (an economic/societal "thermometer"), the arguably most appropriate question is will we be revisiting a more virulent iteration of the 1970s' stagflation, or will we enter a global economic/financial/political apocalypse known as hyperinflation accompanied by a shrinking world real economy? Sadly, the globe's much more leveraged economy combined with plummeting productivity (please see chart below) points to the latter as the more likely outcome. Caveat emptor.

Total Factor Productivity Growth



Sources: Andy.Lees@macrostrategy.co.uk, U.S. Conference Board

For more ideas and depth about scarce real asset-based, real money-endowed portfolio diversification prior to a potentially unparalleled asset valuation and currency reset, please see our blog, report, and video sections of the site (www.dkanalytics.com).

Greetings,
Dan Kurz, CFA
DK Analytics
dan_34135@yahoo.com