Part 1 – Deflation of the currencies and ultimately the US dollar will boost the ultimate currencies, gold and silver, to new highs

Currencies are the ultimate benchmark of your wealth especially in the intertwined world we are living in

Currencies are in my point of view the ultimate benchmark of your wealth especially in a world that has become so intertwined that differences in currency rates affect all of us, think strongly increased world trade, foreign earnings, travel and pricing of real estate.

And it will become clear later in this article why this understanding is so important especially when we have deflationary forces influencing everything from goods to interest rates to currencies. There will be only one currency that will be able to preserve our capital and that will gold and silver. Whilst the ruble fell out of bed the people that had gold and silver maintained the same purchasing power! Gold and silver are the big constant, unchanged value! Because it can’t be diluted and manipulated, it can’t be multiplied using a printing press. Ultimately gold and silver are the spill of our financial system. Gold and silver only really perform when the reserve currency falters. They are each other’s mirror image. If the reserve currency is fundamentally strong there is no reason for gold to be strong and visa versa.

Greenspan and Bernanke created a debt bubble of historic proportions

Following the 2001 tech crash the US economy was “rescued” by Greenspan lowering interest rates, which then created the bubble in the housing market, which subsequently resulted in the QEs and is now creating a worldwide debt bubble we have never seen before. Greenspan and Bernanke have been creating bubble after bubble! Estimates are that worldwide debt has reached a level of approximately $300trn whilst derivatives (of which 60%+ are interest rate derivatives) are believed to amount to a quadrillion dollars or $1,000trn.

Looking at the historic low 10y interest rates we are clearly in a debt-deflation period whereby the economies are pulled down by the overwhelming debt and where low interest rates don't do the trick anymore and neither do the stimulus measures. We have reached the end of the road.

Deflation is taking hold in Europe with the 30y bund yield now below 1%, money doesn't have any value anymore!!!

On January 30 it was announced that deflation across the 19 countries that use the Eurozone currency is gathering pace. In January, prices in the Eurozone were 0.6% down on their levels a year ago. The figure shows the Eurozone heading deeper into deflationary territory from December, when prices were 0.2% down on the year before.

A large contributor to falling prices is the cost of energy, with oil prices down 50%+ since the middle of last year, energy prices plunged 8.9% in January. If food and energy are stripped out of the calculations, Eurozone prices were still rising at an inflation rate of 0.5%, down from 0.7% the month before though confirming a downward trend.

On the heels of the last German deflation figures and EU's wide deflation prints and the ongoing tumble in inflation expectations the rush for the safety of German bunds continued pushing yields down. Inflation in Germany fell below zero for the first time since October 2009, according to preliminary estimates from statistics agency Destatis, as prices dropped by 0.3% in the year to January. As a result the 30Y German bund yield plunged under 1%, a record low. In my point of view these record low interest rates are basically telling us that money doesn't have any value anymore!

While the German economy is strong enough to weather a spell of falling prices, deflation threatens to create havoc in weaker members of the currency area.

As we know on January 22 the European Central Bank (ECB) announced it will inject Euro 1.1trn into the economy as of March 2015. Though in my opinion the chances of success will be very limited. When deflation takes hold it is very difficult to reverse.

Why does QE doesn't have the desired effect

Demand for money to invest in the real economy does not pick up when unusually low rates are lowered further. If you can't tempt people with interest rates at 2% why would they change their mind when interest rates get reduced to 1.5%? The question is if low interest rates don't do the trick why would QE, pumping more money in the economy, do the trick? If there is no confidence your investment will payoff why would you take the risk? This gradual loss of confidence has been expressing itself in an unprecedented plummeting velocity of money since 2006. Money is not going around creating the multiplier effect. In fact I believe the ultra low interest rates and QEs have a negative multiplier effect, they are destroying wealth because they are inflating the wrong assets and goods.

As mentioned a big problem is that although newly created money by central banks does inflate prices, the central planners can't control which prices will increase or when it will happen. Instead of consumer prices rising, the price inflation may go into other areas, as determined by millions of individuals making their own choices. Today we can find very high prices for stocks, bonds, educational costs, medical care and food, non-that really benefit the middle class.

The Fed's real goal is to make sure there is no opposition to the money printing press they need to run at full speed to keep the financial markets ("confidence") afloat. What other choice does the Fed have? Imagine what the flipside will be with all bond and equity prices being destroyed. The central banks could theoretically go bankrupt, because they are huge investors in the equity and bond markets, people will see their pensions wiped out a la Enron and we will go into an economic winter which will be the ultimate consequence. We are between a rock and a hard place.

More than anything else deflation is a state of mind

In general inflation is associated with economic growth whilst deflation is linked to falling growth. More than anything else I believe deflation is a state of mind stemming from overwhelming debt, a stagnant housing market (U.S. homeownership fell to a 20-year low of 63.9% in the fourth quarter of 2014), no wage growth, limited (mostly low pay) full time job opportunities due to outsourcing and technological improvements and no life improving opportunities on the horizon that create this loss of confidence that feeds on itself.

The servicing of the large debt levels prevents the money from being spent on economic growth. Unemployment evolves and authorities reduce interest rates in order to lower debt-servicing costs and stimulate economic growth. Low yields don't necessarily mean more lending to the real economy (I am not talking about the 1% economy). People have lost hope and don't believe they can better their life. As a result consumers don't spend, in other words whatever QE the governments undertake to stimulate the economy their measures won't work. As QEs in the US and Japan have shown the only thing that QEs do is inflate the asset classes that don't benefit the middle class directly, equities and bonds.

Like lemmings at the cliff's edge, central banks seem steeped in denial of the risks they face. Quantitative easing isn't up to the task of restoring sustainable growth and therefore will not reverse the state of mind of deflation.

How does deflation expresses itself in goods and money?

Deflation expresses itself in different ways and I would like to make a distinction how deflation manifests itself in goods and currencies. Deflation in goods expresses itself in price declines in nominal money terms whereby for example oil goes from $100/bbl to $45bbl because of weakening demand. And we are also witnessing the accompanying effects of this weakness in the GDP figures and the employment situation. Credible studies show that over the last few years, at least a third of U.S. GDP growth (and a large portion of growth in high-paying jobs) came from the expansion of the U.S. energy industry.

U.S. based employers announced plans to cut 53,041 jobs in the month of January, a rise of 63% from last month, outplacement firm Challenger, Gray & Christmas said Thursday. Over 21,000 of those cuts were directly attributable to the recent decline in oil prices, the report said. There were 42% more layoffs in the energy industry in January than the sector cut in all of 2014 put together.

Deflation in money expresses itself in a devaluation against other currencies

When we witness deflation in a currency we don't see the nominal denomination of the money diminishing (say a $100 note doesn't suddenly read $80) though we will see the currency devaluing against a basket of foreign currencies, basically the currency will show what its relative value, its purchasing power (how many goods you can buy), is against other world currencies.

In fact when we see deflationary effects unfolding we initially see the money becoming temporarily worth "more" in the country where it is legal tender because goods are getting cheaper in nominal terms ($3 instead of $4) and the money maintains the same nominal value of say $100 despite the fact that it should also become worth less because of the deteriorating economy. Though subsequently with people struggling to pay their debts, as a result of a deteriorating economy, the money of a country becomes worth less and less and devalues in purchasing power nationally as well as internationally.

Today we witness these deflationary currencies (Yen, Euro, oil and EM currencies) devaluing especially against gold and the US dollar which index has shown a parabolic climb rising by 18.7% from 80 in July 2014 to 94.25 February 4, 2015

Currencies ultimately express the strength of the economy and thus determine your purchasing power vis a vis other currencies. Think the revaluation of the Swiss franc and the US dollar, which allows holders of these currencies to import goods at much cheaper prices and thus increase their purchasing power. Though it should be emphasized that at the same time as a consequence they also import deflation through lower priced imported goods expressed in their currencies.

All currencies are collapsing in favor of the US dollar by default

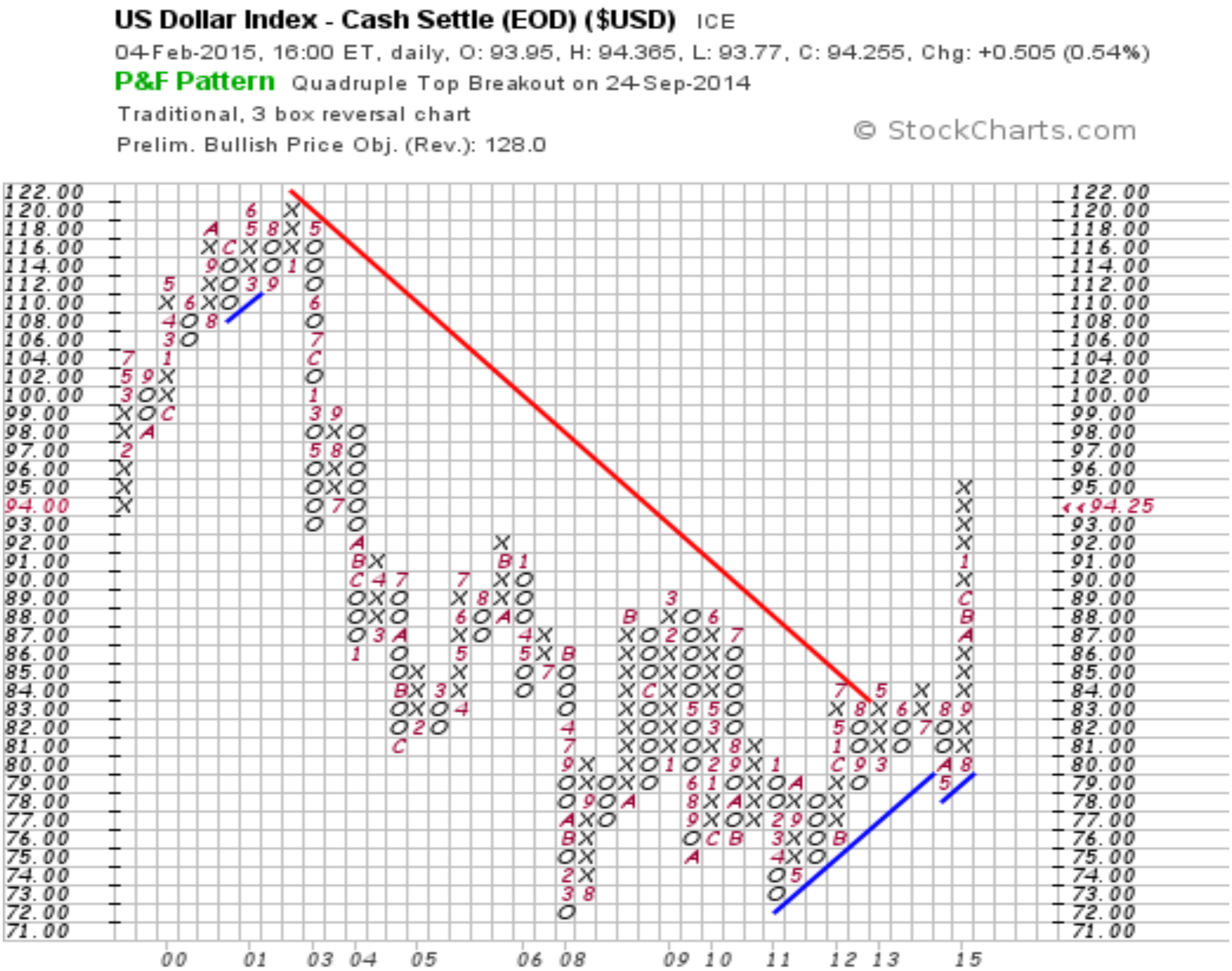
Next to important world currencies weakening such as the Yen and the Euro, following their QEs, we just saw the Mexican Peso back over 15 against the US for the first time since March 2009 whilst the Brazilian Real is also tanking (back near 10-year lows) following weakness in emerging market sentiment.

Following the QE announcement by the ECB between January 22 and the high on Friday January 23 the Euro fell by 4.3% from 1.16 to 1.11 against the dollar whilst the USD Index (representing a basket of world currencies Euro 57.6%, Yen 13.6%, Pound 11.9%, C$ 9.1%, SKr 4.2%, CHF 3.6%) climbed a remarkable 3.25% in 36 hours.

I want to emphasize that this is A MOVE BY DEFAULT into the dollar because investors can't park their money anywhere else than the dollar (and gold and silver) especially considering the fact that the Euro is the currency with the highest combined value of cash in circulation in the world, and the second most traded currency in the foreign exchange market behind the American dollar. Based on IMF data the U.S. dollar's share of global foreign currency reserves was around 61% and the euro's 24% at the end of the second quarter 2014. Next to the fact that the US dollar is the reserve currency and there is the perception that the Fed could raise interest rates (though the trends in the 10y and 30y interest rates tell you differently).

Anyway what I would like to stress is that a 3.25% move in any currency is a monster move let alone when it is the reserve currency Index that moves so much. We also see increased volatility in oil with movements of 8% up or down on a daily basis and swings in the Dow Jones and S&P500 of 1%-2%. Not a good sign.

Just imagine the amounts of money that are involved in lifting the reserve currency! Next to the fact that these monster moves in general are very distorting especially with respect to the EM countries we should take into account that it is often these kind of parabolic moves that end a trend, no matter up or down. In the end all parabolic moves end badly. Although according to the point and figure chart for the USD index the upward way could be free to 120 it should also be noted that any further strength in the USD could be seen as a bad sign because it means that all other currencies are falling by the wayside!


US Dollar Index - Cash Settle (EOD) ($USD) ICE
04-Feb-2015, 16:00 ET, daily, O: 93.95, H: 94.365, L: 93.77, C: 94.255, Chg: +0.505 (0.54%)
P&F Pattern Quadruple Top Breakout on 24-Sep-2014
Traditional, 3 box reversal chart
Prelim. Bullish Price Obj. (Rev.): 128.0
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94.25
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