Economic Downward Spiral: The Next Big Wave of Deflation is Upon Us

By Michael Schmidt
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It looks like the next big wave of deflation is upon us. Looking at some key fundamentals, we see the labor market is again shredding jobs (652,000 in June), the money supply is contracting at levels not seen since the Great Depression and the US Federal Governments finances are in complete disaster. We stand on unbelievably shaky ground right now and this time around there isn't any room for another massive fiscal stimulus from a soon to be impotent Federal Reserve. It appears that a good amount of mainstream economists and financial journalists are finally recognizing that the worst may still be to come. This comes from Ambrose Evans-Pritchard of the Telegraph earlier this week, "Let us be honest. The US is still trapped in depression a full 18 months into zero interest rates, quantitative easing (QE), and fiscal stimulus that has pushed the budget deficit above 10pc of GDP".

As we watch the various stock indexes begin their slow and inevitable decline, it appears that no amount of monetary stimulus or meddling from the Fed can stop the next leg down. Liquidity is rapidly fleeing the financial system. Again, as Pritchard notes, money market funds declined 37% in the month of May, something that has never happened before. Although the Federal Reserve no longer publishes the total money supply figure (M3), many well respected economists including John Williams of Shadowstats, reconfigure the data based on previously used computation methods. For the three month period ending in April, the money supply in the US (M3) fell at what amounted to a 9.6% annually, something not seen since the Great Depression. As the money dries up from the stimulus driven "economic recovery" of 2009, it appears 2010 will be marred by another round of credit contraction.

What's worse is that the US Government may be unable to respond in a similar manner as in 2008, mainly because our government's finances are in complete disarray. The sad truth is that the US Treasury needs continued support from foreign central banks, much more than they need us. With the Federal Government running a $1.8 trillion dollar deficit this year, and with large deficits for many years to come, we need international investors and foreign central banks to continue their appetite for Treasury bonds. It appears that they may have finally had their fill. Besides the obvious economic disincentive of holding a depreciating asset, these investors now have less money to pump back into the coffers of the US Treasury. China recently announced they are removing the artificial currency peg to the US dollar, and will allow the yuan to appreciate gradually against an already struggling greenback. This again from Ambrose Evans-Pritchard,

> " When China allowed the yuan to rise in July 2005 the move triggered a slide in US Treasury bonds, with knock-on effects on US mortgage and corporate debt … Yuan revaluation is likely to dampen China's export growth and slow

> the pace of reserve accumulation, reducing the need to recycle money into foreign bonds."

With economic activity drastically lower over the past 3 years, it appears foreign central banks are unable to cushion our ever increasing deficit.

Even the international political situation is much different as well. With the recent calls from the UN for a new international reserve currency to replace the dollar, the situation has never been more tenuous for the US financial leadership. From the UN's World Economic and Social Survey 2010:Retooling Global Development, it states "A new global reserve system could be created, one that no longer relies on the United States dollar as the single major reserve currency… The dollar has proved not to be a stable store of value, which is a requisite for a stable reserve currency." Given that the IMF already has an international currency, SDR (Special Drawing Rights), the writing may be on the wall for the US dollar. It appears sooner rather than later, the dollar will be ditched in favor of another fiat currency, this time one purely international in scale.

When we factor in all of these recent developments, we see that there is only one place to go for the US economy. All the cheerful talk of recovery over the past year is slowly slipping into a more somber and realistic tone. With the apparent correction taking place in the stock market, there doesn't appear to be many places to hide if you are an investor. As it always has been, it appears gold and silver are the only legitimate places to park your money as we prepare for the next leg down.

Michael Schmidt *was a financial representative at Fidelity Investments where he traded securities and helped customers with their investment and retirement accounts. You can read more of his articles at http://www.examiner.com/x-25578-Cincinnati-Economy-Examiner or reach him at Michael.schmidt1985@yahoo.com.*

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Articles by: **Michael Schmidt**

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