Turning Inflation Into Wealth Mini-Course

Reading One:

Inflation Pickpocket

MortgageSecretPower.com

Inflation is not an even game, it is not a fair game, and we are not all in this boat together. For inflation is not about destroying everyone's wealth – it is about redistributing that wealth, and if you don't understand this, then it will likely be your wealth that will be getting redistributed.

ACT ONE: Smooth Economic Sailing

To illustrate how inflation redistributes wealth, we will use a simple morality play with two investors, in three acts. Peter is our virtuous hero, for he understands that a penny saved is a penny earned. Peter has been diligently saving for retirement, and that saving has taken two forms. The first was paying down all his debts, and the second was building up retirement assets. So Peter contributed to society through his work, was paid for his contributions, controlled his spending, responsibly deferred his gratification, and built up $100,000 in hard-earned savings.

Scott is our irresponsible villain. Scott is not the kind of guy who appreciates the wisdom of being debt-free, indeed, Scott doesn't assign any moral implications to how he manages his money at all. Scott has a use for $100,000, he sees that Peter has the money ready for investment, so Scott borrows $100,000 from Peter.

So, in the smooth economic waters of the present, virtuous Peter has a $100,000 asset with no debt, and irresponsible Scott has a $100,000 debt.

(Both hero and villain happen to be Baby Boomers, for there are aspects of this play that are particularly appropriate for investors of the Boomer generation. However, the lessons apply to all investors, and indeed, some aspects are even more applicable for many investors outside the United States than they are for American investors.)

ACT TWO: Picking The Pocket

The Boomers start to retire, and begin simultaneously trying to convert their bountiful paper wealth supply of dollar denominated investments into a quite limited supply of real goods and services, even as government deficits reach all new levels in attempting to pay for Social Security and Medicare. The Chinese and Japanese stop buying US treasury bonds (and thereby stop supporting the dollar), and instead directly buy oil, which is in much tighter supply than it used to be. The US scrambles to simultaneously find buyers for the Boomer's securities, buyers for the bonds needed to pay for Boomer retirement promises, and hard currency to buy oil from exporters that will no longer accept dollars. (A concise description of some complex issues, but this is a short play and illustration, not an econometric model.)

The dollar drops 90%.

The former dollar is now only worth ten cents. What you used to be able to buy for $1 now costs $10. Whichever way you care to look at it, 90% of the former value of the dollar is gone. And so is 90% of the value of the debt which Scott owes Peter.

In real (inflation-adjusted) terms, the $100,000 investment that constituted Peter's loan to Scott is now only worth $10,000. So Peter has lost $90,000 of his investment, in purchasing power terms. Scott, on the other hand, no longer owes $100,000 in real terms. He only owes $10,000 in inflation-adjusted terms, meaning his personal purchasing power is $90,000 ahead in real terms of where he started (or $900,000 ahead of where he was in nominal terms, keeping in mind that it now takes a dollar to buy what ten cents used to).

By borrowing $100,000 in pre-inflationary dollars, and paying back (in full) $100,000 in post-inflationary dollars, Scott has used inflation to redistribute $90,000 in real wealth out of Peter's net worth, and into his own net worth. By better understanding that inflation destroys debts even as it destroys dollar assets, Scott has used inflation to take $90,000 directly from the virtuous and cautious Peter, just as effectively as if he had picked Peter's pocket.

ACT THREE: Real Assets & Pieces of the Pie

To more fully understand what happened and how Peter was separated from his net worth, let's take a closer look at our "villain", Scott, and the chart below. Like everyone else who knows how to read a newspaper, Scott was aware that there were huge economic issues associated with paying for the retirement of the Baby Boomers.

As a regular reader of contrarian financial education websites, Scott was further aware that the easiest way of reneging on debts was to inflate the currency. If the politicians of this generation make easy promises that will be too expensive to possibly pay in the future – the politicians of the next generation merely inflate the currency (while "managing" the official indexes). This means that a nation (or corporation or individual) legally pays in full in contractual terms what has been promised, but those payments are only worth a small fraction of what the original debt was.

Scott was in fact just as responsible a saver as Peter, which is how he built his own $100,000 in savings. Because he saw inflation coming, unlike Peter, Scott put his savings into solid, real assets of the sort that withstand inflation (such as cash flow producing properties, precious metals and other contrarian assets). Because Scott understood economics, he was happy to take Peter's loan as well, particularly at an interest rate that was only slightly above the then low rate of inflation. Scott took that money, and purchased another $100,000 of hard assets. Scott's pre-inflation combined position was $200,000 in real assets, and $100,000 in dollar debts, for a net worth of $100,000.

Scott further understood that, ultimately, dollars are symbols and resources are reality. He understood that what he needed in retirement wasn't actually electronic symbols in a brokerage statement -- but the right to convert his savings into goods and services so that he would be able to enjoy a comfortable lifestyle. So Scott prepared the chart below:

Inflation Pickpocket

Before

	Starting Assets	Starting Debt	Starting Net Worth	Starting Share of G & S
Peter	100	0	100	50.0%
Scott	200	100	100	50.0%
Total	300	100	200	100.0%

After 90% Loss in Value of Dollar

	Ending Assets	Ending Debt	Ending Net Worth	Ending Share of G & S
Peter	10	0	10	5.0%
Scott	200	10	190	95.0%
Total	210	10	200	100.0%

G & S = Goods & Services

As can be seen above, Peter and Scott each start with an equal net worth, and an equal claim on goods and services, meaning that each has an equal right to goods and services in retirement. The ending bottom line, however, is Scott owns 95% of the rights to the goods and services, and Peter only owns 5%. So Peter spends his 70s cleaning tables at a fast food restaurant, while Scott enjoys a verandah suite on frequent cruises.

And the most nefarious part of this little confidence scheme? The mark never realized what happened to him. Because Scott repaid Peter in full, as contractually promised. While sweeping floors, Peter frequently shook his head about the irony of his investing well in an investment that paid him back, and yet losing the purchasing power of his net worth to the same inflation that claimed the retirement assets of nearly all of his friends. Never realizing that Scott had quite deliberately used inflation to take $90,000 of that net worth.

A Deliberately Offensive Story

What a horrible ending to a perfectly lousy story! The virtuous and debt-free hero makes a good investment that is repaid in full, but still must spend his golden years cleaning up after teenagers. Meanwhile the villain is cruising around the world as a reward for his fiscal irresponsibility. If you are feeling a bit outraged and perhaps even offended by the way the story is presented and how it turns out – good! For that means you are learning a crucial but little understood lesson about inflation right now by reading an article, instead of learning it by losing much of your net worth in the future.

For good reason, there is an enormously powerful paradigm right now, this morality play that many of us were raised with, that says savings are good and debt is bad. These are heartland values, the kind I was raised with as well, and there is powerful truth to them in ordinary circumstances. However, there is an unspoken assumption underlying this view of savings and debt: the currency is stable, assets and debts each maintain their value, and a dollar is a dollar. The problem is – it isn't. With powerful inflation, what a dollar is changes every year (and every month), and that turns our morality play upside down.

The problem is that most of us want to be the “mark” in the little three act play above. We want to be debt-free, particularly coming into retirement. We want to have substantial portfolios of stocks and bonds, just like the financial columnists all preach. We want to be responsible, to pay as little money as possible in debt service – so that our financial assets are working for us, instead of us working for our creditors. Good, solid truths – all of which add up to being like Peter and having the maximum possible exposure to losing the value our dollar denominated savings if major inflation does occur, with no hedge or portfolio insurance to protect us, with no ability to even partially offset those losses through profiting from the inflation driven destruction of the value of our debts. We have a burning desire to walk down dark alleyways with 20 dollar bills hanging from every pocket. Which is exactly what we will be doing if major inflation returns, and there are powerful reasons to believe that it will.

Changing The Names

“Peter” and “Scott” were used to make the play personal, and hopefully something the reader can more easily relate to than abstract economic principles. The story could happen just the way shown, with one individual making a loan to another. However, it is far more likely in today’s world that the financial “system” will be standing between Peter and Scott. For instance, Peter could be investing in bonds, and Scott could be borrowing via a home mortgage (the historical way in which millions of “Scotts” made a great deal of money the last time inflation rampaged in the 1970s, at the same time that the stock and bond investing “Peters” of the world were getting badly burned). Taken together however, the picking of the pockets will work the same basic way for the Peters and Scotts of the world, even if their transactions are not directly with each other.

When we remove the direct personal component then, does this change your view of the comparative morality? Is Scott being somehow a bit shady when he accepts the terms of a loan that is freely offered from a large and sophisticated financial institution that is in the business of lending? If Scott accepts the loan because he has a five or ten year horizon while the executives at that financial institution are only looking to the next quarter or year – is that indicative of a shortcoming on Scott’s part? Or does that merely mean that Scott is intelligently looking after his own self-interests?

Enhancing The Value Of This Reading

This is very early in the sequence, and the intended application of this first reading is to start adjusting your perspective a bit. Should you wish to help that process along, you may wish to separately print out page 6 of this reading, which is the chart that we reviewed earlier. Then every time you see a media article that makes you worry about the long-term value of the dollar – take another look at the chart. Look at how Peter started off with an asset and the rights to 50% of the real wealth (goods and services), and how he ended up with only 5%. Look at how Scott carefully selected the right debt and asset combination, and went from 50% of the real wealth to 95%. Review item by item, before and after, as you study how Peter’s asset and

Scott's debt in an environment of high inflation led to Scott ending up with 90% of what used to be Peter's net worth. Think about the implications for your personal financial plan. Thoroughly understanding the chart could very well make the difference between comfort and a slashed standard of living when it comes to your own investments and retirement.

Your second suggested application is: **don't rush into any decisions!** A few readers have misinterpreted these readings as preaching the wonderful virtues of going into debt – but we are not doing so, because debt isn't always good. The current subprime mortgage debacle is just one example of how too much debt can destroy people. Indeed, the next time that powerful inflation hits, it can be safely predicted that being in the wrong kinds and amounts of debts will devastate millions of households, whether it is their credit cards, variable rate mortgages, or both.

No, one of the main points of our little "morality tale" is to illustrate the dangers of oversimplification. For instance, a simple approach could be if you want financial safety, then financial assets are always good and debts are always bad. A quite common approach, but as illustrated with Peter – the results of this simplistic approach will be absolutely devastating for tens of millions of retirees if inflation is how Boomer retirement promises are paid.

Debt can be prudent and lucrative, or foolhardy and reckless – the difference is in the specifics. Kind of like some stocks can make you a millionaire, others will financially destroy you, it's all in the specifics – except the differences between good and bad debt are more objective and understandable.

If A Link To This Reading Was Given By A Friend

If you found this article because of a friend's recommendation, then you should know that it is the first of three "eye-openers" that start a free mini-course on Turning Inflation Into Wealth. Much more information on the course and the benefits of the course to you are available by following the link below.

http://mortgagesecretpower.com/Mini%20CourseB.htm

Should you choose to subscribe, a link to the second eye-opener will arrive in your e-mail inbox in another day or two, and it will show you how the government can use inflation to help itself to your net worth, through converting your after-tax assets into pre-tax income. We'll show how the Dow Jones average can reach 75,000 – and a conventional investor can still lose 73% of their net worth to the one-two combination of government taxes on government created inflation.

Our third eye-opener starts where the first two leave off, and essentially says: "so the problems are that inflation redistributes wealth in deeply unfair and little understood ways, and government tax policy is blind to inflation? What a fantastic opportunity!" We'll show how in an inflationary future you can turn adversity into personal wealth. Using the government's inflation blindness, you can convert an everyday opportunity that is widely available today, into a powerhouse that generates after-tax and after-inflation benefits equivalent to a conventional investment returning 27% per year.

The three eye-openers are just the beginning, and from there we will go on to explore such subjects as finding out how millions (accidentally) turned inflation into wealth in the past, discovering how an understanding of inflation may be your secret weapon if real housing prices fall in your market, the hidden costs of sending extra money in with your monthly mortgage payments, as well as learning how you can go from paying real taxes on illusory profits to illusory taxes on real gains.