The deflation monster has arrived

By Chris Martenson, 17 January 2016

As we've been warning for quite a while (too long for my taste): *the world's grand experiment with debt has come to an end. And it's now unraveling.*

Just in the two weeks since the start of 2016, the US equity markets are down almost 10%. Their worst start to the year in history. Many other markets across the world are suffering worse.

If you watched stock prices today, you likely had flashbacks to the financial crisis of 2008. At one point the Dow was down over 500 points, the S&P cracked below key support at 1,900, and the price of oil dropped below $30/barrel. Scared investors are wondering: *What the heck is happening?* Many are also fearfully asking: *Are we re-entering another crisis?*

Sadly, we think so. While there may be a market rescue that provide some relief in the near term, looking at the next few years, we will experience this as a time of unprecedented financial market turmoil, political upheaval and social unrest. The losses will be staggering. Markets are going to crash, wealth will be transferred from the unwary to the well-connected, and life for most people will get harder as measured against the recent past.

It's nothing personal; it's just math. This is simply the way things go when a prolonged series of very bad decisions have been made. Not by you or me, mind you. Most of the bad decisions that will haunt our future were made by the Federal Reserve in its ridiculous attempts to sustain the unsustainable.

The Cost Of Bad Decisions

In spiritual terms, it is said that everything happens for a reason. When it comes to the Fed, however, I'm afraid that a less inspiring saying applies: 'Everything happens for a reason – sometimes the reason is you're stupid and make bad decisions'.

Yes, it's easy to pick on the Fed now that it's obvious that they've failed to bring prosperity to anyone but their inside coterie of rich friends and big client banks. But I've been pointing out the Fed's grotesque failures for a very long time. Again, too long for my tastes.

I rather pointlessly wish that the central banks of the world had been reined in by the public before the crash of 2008. However the seeds of their folly were sown long before then:

The pattern in monthly charts of the S&P 500. A relatively minor market slump in 1994 was treated by the then Greenspan Fed with an astonishing burst of new money creation -- via its 'sweeps" program response, which effectively eliminated reserve requirements for banks. That misguided policy created the first so-called Tech Bubble, which burst in 2000.

The Housing Bubble

The next move by the Fed was to drop rates to 1%, which gave us the Housing Bubble. That was a much worse and more destructive event than the bubble that preceded it. And it burst in 2008.

Then the Fed (under Bernanke this time) dropped rates to 0%. The rest of the world's central banks followed in lockstep (some going even further, into negative territory, as in Europe's case). This has led to a gigantic, interconnected set of bubbles across equities, bonds and real estate -- virtually everywhere across the globe.

So the Fed's pattern here was: fixing a small problem with a bad decision, which lead to an even larger problem addressed by an even worse decision, resulting in an even larger set of problems that are now in the process of deflating/bursting. Three sets of increasingly bad decisions in a row.

The amplitude and frequency of the bubbles and crashes are both increasing. As is the size and scope of the destruction.

The Even Larger Backdrop

The even larger backdrop to all of this is that the developed world, and recently China, have been stoking growth with debt, and have been doing so for a very long time.

As practically everybody can quickly work out, increasing your debts at 2x the rate of your income eventually puts you in the poor house. As I said, it's nothing personal; it's just math.

But somehow, this math escaped the Fed's researchers and policy makers as a problem. Well, turns out it is. And it's now knocking loudly on the world's door. The deflation monster has arrived.

The only possible way to rationalize such an increase in debt is to convince oneself that economic growth will come roaring back, and make it all okay. But the world is now ten years into an era of structurally weak GDP and there are no signs that high growth is coming back any time soon, if ever.

The entire edifice of debt-funded growth

So the entire edifice of debt-funded growth is now being called into question -- at least by those who are paying attention or who aren't hopelessly blinkered by a belief system rooted in the high net energy growth paradigms of the past.

At any rate, I started the chart in 1970 because it was in 1971 that the US broke the dollar's linkage to gold. The rest of the world complained for a bit at the time, but politicians everywhere quickly realized that the loss of the golden tether also allowed them to spend with wild abandon and rack up huge deficits. So it was wildly popular.

As long as everybody played along, this game of borrowing and then borrowing some more was fun. In one of the greatest circular backrubs of all time, the central banks and banking systems of the developed world all bought each other's debt, pretending as if it all made sense somehow.

Charts show how hopelessly entangled the worldwide web of debt has become. Yes, it's all made possible by the delusion that somehow being owed money by an insolvent entity will endlessly prevent your own insolvency from being revealed. How much longer can that delusion last?

The terminal sign of a major credit bubble

All of this is really just the terminal sign of a major credit bubble -- a credit era, if you will -- drawing to a close.

I will once again rely upon this quote by Ludwig Von Mises because apparently its message has not yet sunk in everywhere it should have:

"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."
~ *Ludwig Von Mises*

Well, the central banks of the world could not bring themselves to voluntarily end the credit expansion – that would have taken real courage.

So now we are facing something far worse.

Why The Next Crisis Will Be Worse Than 2008

I'm not just calling for another run of the mill bear market for equities, but for the unwinding of the largest and most ill-conceived credit bubble in all of history. Equities are a side story to a larger one.

It's global and it's huge. This deflationary monster has no equal in all of history, so there's not a lot of history to guide us here.

At Peak Prosperity we favor the model that predicts 'first the deflation, then the inflation' or the "Ka-Poom! Theory" as Erik Janszen at iTulip described it. While it may seem that we are many years away from runaway inflation (and some are doubting it will or ever could arrive again), here's how that will probably unfold.

Central banks will opt for *doing something*

Faced with the prospect of watching the entire financial world burn to the figurative ground (if not literal in some locations), or *doing something*, the central banks will opt for *doing something*.

Given that their efforts have not yielded the desired or necessary results, what can they realistically do that they haven't already?

The next thing is to give money to Main Street.

That is, give money to the people instead of the banks. Obviously puffing up bank balance sheets and income statements has only made the banks richer. Nobody else besides a very tiny and already wealthy minority has really benefited. Believe it or not, the central banks are already considering shifting the money spigot towards the public.

You might receive a credit to your bank account courtesy of the Fed. Or you might receive a tax rebate for last year. Maybe even a tax holiday for this year, with the central bank monetizing the resulting federal deficits.

Either way, money will be printed out of thin air and given to you. That's what's coming next. Possibly after a failed attempt at demanding negative interest rates from the banks. But coming it is.

This "helicopter money" spree will juice the system one last time, stoking the flames of inflation. And while the central banks assume they can control what happens next, I think they cannot.

Once people lose faith in their currency all bets are off. The smart people will be those who take their fresh central bank money and spend it before the next guy.

In Part 2: Why This Next Crisis Will Be Worse Than 2008 we look at what is most likely to happen next, how bad things could potentially get, and what steps each of us can and should be taking now -- in advance of the approaching rout -- to position ourselves for safety (and for prosperity, too)

Click here to read Part 2 of this report (free executive summary, enrollment required for full access)