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THE "YOU MAY NOT KNOW REPORT"™

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Is the Federal Reserve Cornered?

There is an old idiom that describes the position in which the Federal Reserve now finds itself. "Painting yourself into a corner" comes to mind.

The Farlex Dictionary of Idioms describes painting yourself into a corner or boxing yourself into a corner as "to create a predicament or unpleasant situation for oneself whereby there are no or very few favorable solutions or outcomes".

The Urban Dictionary doesn't define "painting yourself in a corner", but it does define the word "screwed" as "being in a hopeless state or condition without a chance for redemption".

No matter the words used to describe the position that the Fed now finds itself in, suffice it to say that problems are now appearing to which there is no solution. Or to be more precise, not all the problems can be solved.

Attempting to solve problem number one makes problem number two worse and trying to solve problem number two simply exacerbates problem one. As I'll discuss in this short piece, from my perspective the Fed is in a position that one of these problems will undoubtedly be a persistent, even unsolvable problem.

Let's begin with the economy.

Despite a few politicians insisting otherwise, the economic news is dismal. The recent Chicago PMI numbers plunged to depression levels.

If you're not familiar, the Chicago PMI is the Chicago Purchasing Managers' Index. It tracks business data. If the index number reported is over 50, the economy is expanding. If the index number reported is less than 50, the economy is contracting.

The most recent PMI number reported was 35.41 as noted by the chart.

This from the "Zero Hedge" piece[1] from which the chart was taken:

Looking at the report we find the following:

- *Business barometer fell at a faster pace;* ***signaling contraction***
- *New orders fell at a faster pace;* ***signaling contraction***
- *Employment fell at a faster pace;* ***signaling contraction***
- *Inventories fell at a faster pace;* ***signaling contraction***
- *Supplier deliveries fell at a slower pace;* ***signaling contraction***
- *Production fell at a slower pace;* ***signaling contraction***
- *Order backlogs fell at a faster pace;* ***signaling contraction***

Did nothing rise? One thing did:

- *Prices paid rose at a slower pace;* ***signaling expansion***

So we have not *just a depression, but a* ***stagflationary depression*** *in which everything else is going to hell, except prices: they keep on rising.*

New orders were down, employment was down, inventories were down, supplier deliveries were down, production was down, and order backlogs were down. The only thing that was higher were prices.

If you've been a longer-term reader of this report, you know that I have been forecasting stagflation for a couple years. While we were initially inching in the direction of stagflation, we are now moving in that direction steadily. Consumer prices are rising but the real economy is contracting.

That last point is extremely important – the real economy is contracting. I AM NOT referring to the GDP, or Gross Domestic Product numbers. That measure of economic output includes government spending as well as private sector data.

To get a clear picture of the real economy, one needs to pull out government deficit spending. While government deficit spending is added to GDP numbers, it's not in any way economic growth any more than taking cash advances on a credit card is income.

Make no mistake, government deficit spending is cash flow generated by borrowing against future production but it's not real growth.

Past guest on my radio program, Mr. Alasdair MacLeod, who is Head of Research at Goldmoney, commented on this very topic in a piece that he wrote recently[2] (emphasis added):

> *Margaret Thatcher said something on the lines that socialism fails when it runs out of other people's money. We appear to have reached that point. Rapacious tax policies are now reducing their yield. We are now sliding down the after-end of the Laffer curve. The economic force which drives any economy is being strangled by the burden of government.*

(Note: The Laffer curve illustrates a theoretical relationship between rates of taxation and the resulting levels of tax revenue. The Laffer curve assumes that no tax revenue is raised at the extreme tax rates of 0% and 100% and there is an optimum percentage rate of taxation somewhere in the middle that results in maximum government tax revenue.)

> *Consequently, with mandated welfare and other expenses increasing, hope that economic growth will reduce budget deficits are misplaced. Estimates for budget deficits in nearly all high-tax jurisdictions will turn out to be overly optimistic. This has important implications for inflation which are currently being ignored by everyone from governments, central banks, and down to investors.*
>
> *Take the situation in the USA. As recently as February, the Congressional Budget Office forecast a budget deficit of $1,507 billion for the current fiscal year. Yet, in the first six months, the deficit was already $1,100 billion, according to the US Treasury's own figures. But this fails to explain the pace of borrowing. According to the US Debt Clock, US national debt is $34.77 trillion today, an increase of $1,600 billion this fiscal year so far.* ***At this rate it will be $2.4 trillion by end-September, nearly a trillion over the CBO estimate. It represents 9% of GDP, raw unproductive credit driving GDP higher and creating an illusion of a strong economy.***
>
> *I suspect the budget deficit could turn out to be even worse, partly because it is a presidential election year, partly because the debt ceiling is not in place until January 2025, and partly* ***because the productive economy is already in recession. This last assumption is based on simple arithmetic. If, according to the Bureau of Labor Statistics GDP grew by 4.5% in the year to last March, allowing for a budget deficit injection of 9% means the private sector actually contracted by 4.5%.***
>
> *A rough and ready calculation perhaps, but it is important to understand that not only is the expansion of non-productive government debt concealing the true economic situation, but it is also debasing the currency. And currency debasement becomes reflected in higher prices. In other words, the inflation of CPI is not over.*

This is the Fed's big conundrum or where they are painted into a corner.

Inflation is continuing, and deficit spending by the government is one of the main reasons why. At the same time the real economy, absent government deficit spending, is contracting.

That is the textbook definition of stagflation; a contracting economy combined with higher consumer prices.

If the inflation problem is to be effectively attacked, the Fed will be required to keep interest rates where they are at the very least. It's more likely that they will have to raise interest rates. And, the Washington politicians will have to balance the budget or at least come a lot closer to a balanced budget. Those actions will accelerate economic contraction and stagflation will transform to deflation mirroring the economic environment experienced by Americans in the 1930's.

On the other hand, should the Fed attempt to lend support to a contracting economy, the inflation problem gets worse.

Simply put, the Fed cannot solve both problems.

It's my belief from my study of history that the Federal Reserve and the current crop of politicians will do what policymakers and politicians have always done historically. They'll continue currency creation, easy money, and deficit spending citing the need to stimulate the economy.

Ironically, that's what got us to this point.

So what should you do moving ahead?

Have some tangible assets, have a solid retirement income plan that errs on the side of being conservative, and fasten your seatbelt. To use an airline analogy, we will likely experience a lot of turbulence in the relatively near future.

Currency Creation Widens the Wealth Gap

Inflation benefits those with assets.

If you own real estate, stocks, or gold, inflation drives up the nominal price of your property.

On the other hand, if you don't have assets, and you find yourself living paycheck-to-paycheck, inflation is a killer.

The data and news point to a widening wealth gap in the United States. This from "Investopedia" reporting on credit card data obtained from a survey by the St. Louis Federal Reserve[3]:

Credit cards have become the new emergency fund for many consumers.

- *More than half of U.S. households held credit card debt in 2022, according to the most recent review of consumer finances by the Federal Reserve of St. Louis.*
- *Lower-income households are disproportionately burdened by credit card debt, a recent analysis of the consumer finance study found.*
- *Those at the bottom of the income distribution tend to have higher credit card debt ratios, possibly because they may have less cash and savings and fewer desirable loan choices.*
- *For many Americans, credit cards have become the new emergency fund, the analysis suggested.*

Slightly more than half of U.S. households held credit card debt in a recent analysis of Federal Reserve Bank of St. Louis consumer data, but that debt isn't evenly distributed.

Research on the 2022 Survey of Consumer Finances (SCF) conducted by the St. Louis Fed found that households headed by people with lower income are disproportionately burdened by credit card debt.

While many lower income households are struggling with debt and meeting their day-to-day living expenses, the wealthy are in bidding wars for household help. Starting salaries for housekeepers in Palm Beach, Florida are now at $150,000 annually plus benefits. This[4] from "CNBC":

Housekeepers in Palm Beach and South Florida are cleaning up, with salaries often topping $150,000 and bidding wars between mansion owners becoming common, according to staffing companies.

The mass wealth migration to Florida from New York and other high-tax states has created record demand for household staff in elite Florida enclaves — especially Palm Beach. Demand for butlers (now called "hospitality managers" or "estate managers") as well as nannies, chefs, drivers and personal security has surged, according to staffing agencies.

It's the shortage of housekeepers, however, that has created the biggest mess for wealthy homeowners. Many of the wealthy emigres to Florida bought big homes and now need people to clean them. Hotels, resorts and businesses are also vying for cleaning staff. The result: Typical pay for housekeepers has rocketed from about $25 an hour in 2020 to $45 or $50 an hour today, according to some agencies.

"I have been placing staff for 30 years, and I've never seen anything like this," said April Berube, founder of The Wellington Agency, which places household staff in Palm Beach, Miami, New York and other locations. "We've seen such a boom from people relocating, especially Palm Beach and Miami."

In Palm Beach, housekeepers with experience in wealthy homes are typically making between $120,000 and $150,000 a year, along with 401(k) plans, health care and benefits, including overtime.

"For housekeepers it's wonderful," Berube said. "For us it's extremely difficult. It's a severe shortage."

Melissa Psitos, founder of Lily Pond Services, said she recently had a Florida client hoping to hire a housekeeper for $75,000 a year. They ended up paying $110,000, which was reasonable for the market. Executive housekeepers, who often help direct a staff of other housekeepers and laundresses, can make even more. Psitos said she knows one head housekeeper in Palm Beach who makes $250,000 a year, including overtime, and travels with the family to their various homes.

Worldwide Debt Now Tops $315 Trillion

Worldwide debt has now reached a level never seen - $315 trillion. That's according to the Institute of International Finance. This story[5] was reported on "CNBC":

The world is mired in $315 trillion of debt, according to a report from the Institute of International Finance.

This global debt wave has been the biggest, fastest and most wide-ranging rise in debt since World War II, coinciding with the Covid-19 pandemic.

"This increase marks the second consecutive quarterly rise and was primarily driven by emerging markets, where debt surged to an unprecedented high of over $105 trillion—$55 trillion more than a decade ago," the IIF said in its quarterly Global Debt Monitor report released in May.

Around two-thirds of the $315 trillion owed originates from mature economies, with Japan and the United States contributing the most to that debt pile.

The IIF identified stubborn inflation, rising trade friction and geopolitical tensions as factors that could pose a significant risk to debt dynamics, "putting upward pressure on global funding costs."

Since debt is a drag on an economy, I expect more stagflation (as noted above) if current policies continue. A more fiscally responsible approach would likely lead to almost immediate deflation; that's one of the reasons I expect current policies to continue and for the current stagflation trends to accelerate.

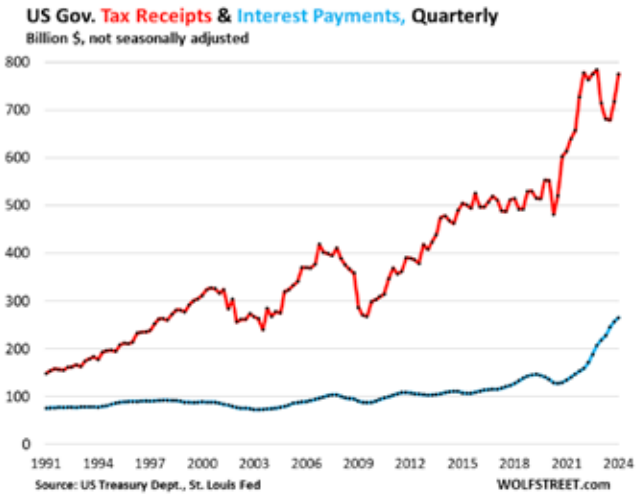
The US Government's Interest Nightmare

Interest on the US Government's debt is rising quickly. In the first quarter of 2024, interest payments on the debt of the US Government rose 21% year-over-year.

Wolf Richter had this[6] to say on the topic:

We know from other data that tax receipts in Q2 have been solid so far, including that the national debt hasn't budged in months from $34.6 trillion, despite the relentless surge in deficit spending, and that the balance in the government's checking account, the TGA, spiked to over $950 billion in the days after April 15 as a result of tax payments coming in.

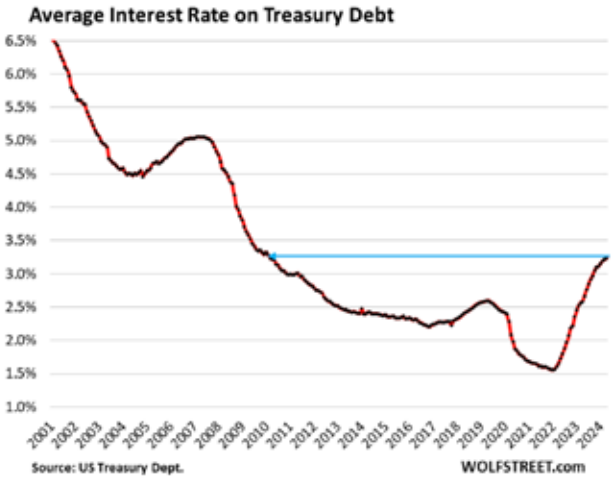
Interest payments by the government on its gigantic and ballooning pile of debt surged by $46 billion (+21%) year-over-year in Q1 to $264 billion (blue).



In the 20 years between 1995 and 2015, interest payments barely rose despite the debt that kept ballooning because interest rates kept falling as part of the 40-year bond bull market that ended in August 2020.

The measure of tax receipts here is what's available to pay for regular government expenditures, including interest payments. The measure is total receipts minus contributions to Social Security and other social insurance, that are paid specifically by contributors into those programs and are not available to pay for general expenditures. This metric of tax receipts was released on May 30 by the Bureau of Economic Analysis as part of its Q1 GDP revision.

The debt that the government needs to pay interest on has surged at a mindboggling pace in recent years.



The higher interest rates are working themselves gradually into the national debt each time an old maturing Treasury note or bond is replaced with a new Treasury security, and each time the government issues new debt to fund the new deficit.

Short-term Treasury bills roll over all the time, and their interest rates have been at 5%-plus for over a year. Now, nearly 22% of the $26.9 trillion in marketable Treasury securities outstanding are T-bills that the government paid an average of 5.36% in interest on in April.

So in April, the average interest rate that the Treasury department paid on all its marketable and nonmarketable securities – on the whole $34.6 trillion schmear – was 3.23%. That's still low, and it will keep rising as the current yields are working themselves into the pile of debt. But it was the highest since early 2010.

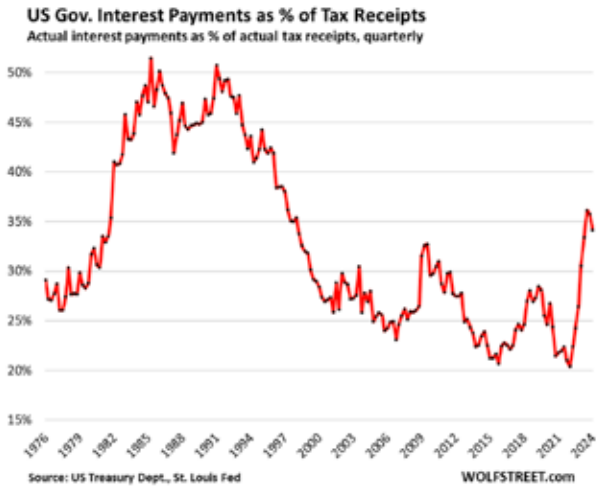
It's not interest payments in a vacuum that matter, but interest payments in relation to tax receipts. Inflation and growing employment, both, inflate tax receipts. Inflation does so by inflating taxable wages, and growing employment does so by more workers earning taxable wages.

Higher interest rates themselves boost tax receipts because they generate taxable income, not only on the $26.4 trillion in marketable Treasury securities, but also in savings accounts and CDs, money market funds, corporate bonds, etc. American households and businesses hold many trillions of dollars of these interest-bearing assets. We've looked at the holdings of households: $3.6 trillion in money market funds, $1.1 trillion in CDs of less than $100,000, and $2.4 trillion in CDs over $100,000. In addition, households earn inter-

est from their other bond holdings, from bond funds, etc. They all generate taxable income, when two years ago, during the 0%-era, they generated very little taxable income.

So the ratio of interest payments as a percent of tax receipts answers the question: To what extent are interest payments eating up the national income.

In Q1, interest payments as a percent of tax receipts dipped to 34.1%. It was 36.1% in Q3, the highest since 1997. In Q4 2023, the ratio had also dipped. In both quarters, tax receipts jumped in dollar terms more than interest payments.



In Q2, the ratio may dip further. And then in Q3 and Q4, the thing will turn around again and shoot higher.

In the 15 years between 1982 and 1997, the ratio was higher than today; and in the 10 years between 1983 and 1993, it ranged from 45% to 52%.

Back in the late 1980s and early 1990s, interest payments were eating up about 50% of the national tax revenues, and the US was careening toward a serious crisis. It wasn't until then that Congress, which decides fiscal matters, had a come-to-Jesus moment and dealt with the ballooning deficit, further helped along by the budding Dotcom Bubble at the time, which generated huge capital gains, employment, and wage growth.

Interest payments jumped to 3.8% of GDP in Q1, the worst since 1998 (the ratio is figured apples-to-apples: quarterly interest expense not adjusted for inflation, not seasonally adjusted, not annual rate; divided by quarterly GDP of $6.93 trillion in current dollars, not adjusted for inflation, not seasonally adjusted, not annual rate).

This is relentlessly heading in the wrong direction at a disconcerting pace.

Is This a Bubble?

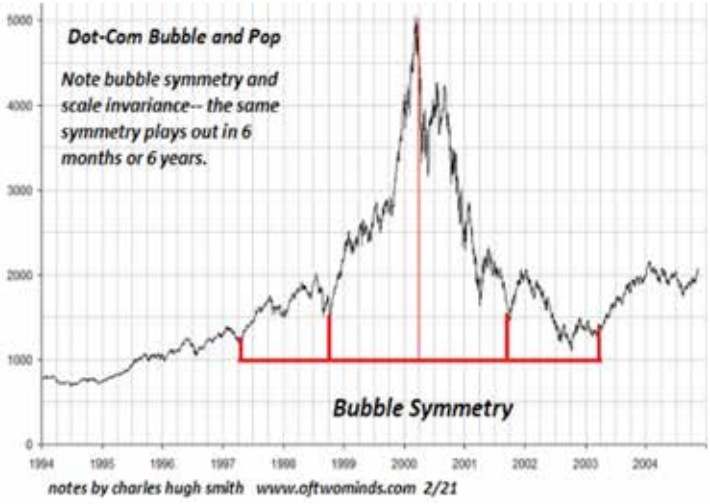
I have learned a couple of things about price bubbles over my career in the financial industry.

One, bubbles tend to be symmetrical when charted, taking about as much time to unwind as they do to build.

And, two, bubbles are typically recognized as bubbles only after they have collapsed.

Charles Hugh Smith recently published a piece[7] about the NASDAQ market and his opinion that it is probably in a bubble. He makes a couple of observations about bubbles that confirm my own opinions on the topic:

> *In bubble symmetry, the decline phase is the mirror-image of the manic boost phase, in both time and amplitude. For example, the NASDAQ's dot-com bubble rose from around 1,100 in early 1997 to a peak above 5,000 in early March 2000, a rise of about 3,900 over three years.*
>
> *The bubble-pop phase lasted about three years and covered a decline/round-trip back to around 1,100: a decline of about 77%. The first chart below shows the remarkable symmetry of the bubble's ascent and collapse.*
>
> *Scale invariance refers to the similarity of a 600-point bubble that arises in six months to a 6,000 point bubble that arises over 6 years: if we add a zero to the number of months (time) and the number of points (amplitude), the bubbles retain the same characteristics. Put another way, a speculative mania that lasts a week shares the same characteristics of a speculative mania that lasts a month and one that lasts a year.*



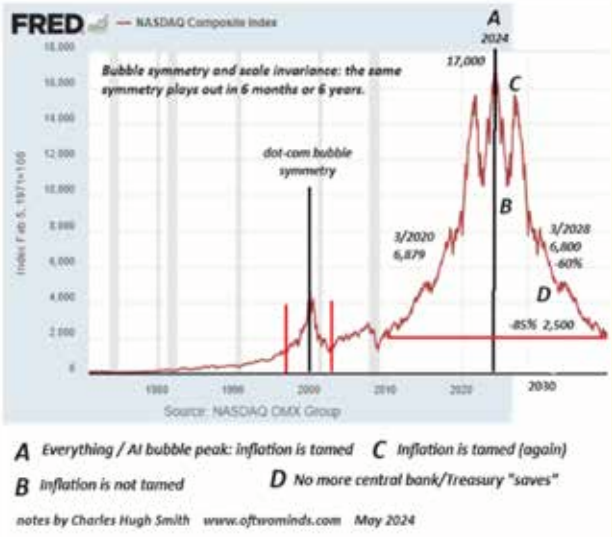
Pulling back to look at the NASDAQ index from 1990 to the present, what's striking is the modest scale of the dot-com bubble of 1997-2002. What looked like an almost unimaginably lofty peak in 2000 (5,048) now looks like a pipsqueak bubble compared to the current heights (17,032). (See chart, bottom left.)

Also noteworthy is the time it took to reclaim the heights of the dot-com bubble. Almost 17 years passed before the index definitively topped its 2000 high of 5,048. But if we measure the purchasing power of $5,000 in 2000 and adjust for officially measured inflation from 2000 to 2018, the index had to top $7,360 to match the 2000 peak, a number it did not reach until early 2018--18 years after the peak.

Given that the index crashed back to 6,879 in March of 2020, it can be argued that the index didn't definitively surpass the 2000 high until 2020, fully 20 years after the dot-com peak. That is a soberingly lengthy passage of time to recover the full value of cash invested at the very top of the bubble.

Now let's project bubble symmetry on the current NASDAQ bubble. Below, right, is a FRED (St. Louis Federal Reserve) chart which doesn't use nominal price but sets the value of the index on 2/5/1971 at 100. The basics of time duration and amplitude are essentially identical with the nominal price chart.

If the index follows the symmetry of the 2000 bubble, then we can anticipate a 60% decline by 2028 to the 2020 lows around 6,800. The full retracement of the bubble would occur by about 2032-33 with a decline to the base of the bubble, around 2,500--an 85% drop from the 2024 peak.



July 2024 Special Report

Mid-Year 2024 Forecast

During the month of July, we are offering a free report titled, "Mid-Year 2024 Forecast"

The July special report provides the forecast for the economy and investing markets from some of the brightest and respected voices. In the July report, you'll get the forecast for the rest of the year and beyond for stocks, bonds, gold, and the general economy from author and investor, Jim Rogers; cycles analyst, Dr. Charles Nenner; founder of the Financial Survival Network, Kerry Lutz; and best-selling author and economist, Harry Dent.

I'll give you my take too.

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As inflation rages and fiat currencies like the US Dollar lose purchasing power, gold and silver can be a great way to preserve purchasing power.

Look at this example.

When Richard Nixon eliminated the convertibility of the US Dollar to gold in 1971, an ounce of gold sold for $35 per ounce and the average cost of a new home was $25,000. At that time, you could buy a new home for $25,000 in cash or 700 ounces of gold.

Fast forward to the present. The average cost of a new home is $380,000. The $25,000 that once bought a home fifty years ago is now not even a down payment on an average new home.

However, the 700 ounces of gold that used to buy a new home now buys 4 average new homes.

Given the current rampant inflation, doesn't make sense to consider metals in your portfolio? IRA, Roth and even 401(k) funds may be used. Visit **Densmore.PreciousMetalsBuyersGuide.com** to get a free precious metals investing guide.

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