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The CJ Investment Newsletter

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The Purchasing Power of Money

Purpose

The *CJ Investment Newsletter* deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

The CJ Growth Strategy (back page) has been an ongoing aggressive growth model portfolio since 1/98. Its results continue to be tracked herein.

Quick Look

Market	Next Expected Move

- The Purchasing Power of Money (PPM) is described herein, as well as why it matters to you, particularly now.

Opening Notes

In the 11/2011 CJ Newsletter, I discussed the price of a 1968 and a current Dodge Charger. From the letter: "…you could buy a new 1968 Dodge Charger R/T for about $4,000 – give or take a couple of hundred. The ballpark is right. Now, such a car could cost $27,000 - $46,000, depending on the options. That is about 7 – 11 times more than in 1968." Why? I'm hoping you'll understand why *and* what this means to you after reading this letter.

While I actually thought out the concepts in this letter myself, I don't want to present them as breaking "new ground." That thought was revealed as untrue as soon as I did a little research into the first Austrian economic treatise I looked at – Rothbard's.[1] Rothbard rightfully devotes a large amount of verbiage to this huge (and hugely important) subject. His approach was somewhat different – and much broader – than what is written here. Nonetheless, while not breaking "new ground," it's nice to know my thinking was

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in alignment with one of the great economic theoreticians of all time. I did not find anywhere in my review of Rothbard where my thinking could be considered in error. The Purchasing Power of Money (PPM) was the phrase Rothbard used to refer to this concept.

The Purchasing Power of Money (PPM)

While PPM exists and is at any one point in time in a single place finite, it simply can't be measured without using some tortured math. Since the measurement is only for that one point in time in that one place and changes for all other circumstances, it's probably not worth the trouble to attempt a precise measurement.

That doesn't mean we can't benefit from looking at how changes in PPM can be predicted *qualitatively*, what the causative relationships are, and what they can logically indicate to the economy as a whole. There are rules and principles in play, even if exact measurement is impossible. Those who understand and apply these (Austrian) rules can predict logical outcomes and act appropriately, that is to say, economically.

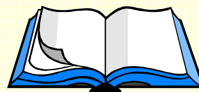
In order to act economically regarding PPM, we need to make a concerted effort to differentiate between the *nominal* value of money and its *true* value – PPM. Is there a *reasonable* explanation for a new Charger costing that much more that *doesn't* involve the decline in the PPM?

Austrian principles are often *not equational*. While there are a few equations in the laws and principles, most of the meaningful equations calculate statistics and benchmarks used for evaluation and comparison. *Austrian laws and principles use economic relationships to describe logical outcomes (results) from causes applied.*

Alfred Marshall (a famous pre-Keynesian economist) postulated equilibrium in his works. Lord Keynes based much of his work upon Marshall's, but particularly this postulation. Keep in mind, *you don't have to postulate something you can prove exists in the real world.* In my (hopefully considered) opinion, much inaccurate and tortured math is used to both support this concept and/or as a result of it. Ludwig von Mises wrote an excellent article explaining this. Contact me if you would like a link to it.

It is our failure to consider the change in PPM that allows others, most commonly our own government and central bank (the Fed) to rob (or tax) us of a significant portion of our wealth without our even being aware of it – *something they count on*. Were the population aware of how most or all of the changes in PPM work to their detriment and are almost completely caused by governmental and Fed actions, I suspect:

- The outrage of the populace would quickly bring those governmental practices to a halt and
- Our economy would begin the long –and permanent – process of healing. Let's hope the patient isn't already too sick to survive.
- There would be *no* inflation and, generally, the trade (business) cycle would either cease (eventually) or become a relatively insignificant factor in the economy.



Recommended Reading

This month's reading recommendation and footnote references are:

[1]Rothbard, Murray N., Man, Economy and State with Power and Market, Scholar's Edition, Ludwig von Mises Institute (2004)

Rothbard specifically addresses the Purchasing Power of Money (PPM) in Chapter 11, but Chapter 12 on government intervention and the entire included Power and Market book are inextricably intertwined with PPM.

The Original Question

I was having a discussion with a smart and informed friend of mine recently, who also happens to be a "gold bug" (To quote Jerry Seinfeld: "Not that there's anything wrong with that."). Long-time clients and readers will recall that clients & I bought and sold gold and silver miners and ETF's from about 2001 through 2008 or 2009, at which time my technicals suggested that gold was peaking and we got out. Clients & I stayed in silver (profitably) longer because of its chart, but eventually sold it, too. As it turns out, I wish I had required a "stronger" suggestion prior to getting out of gold. If you wish to hear more about that, please call me and we can discuss it.

My friend and I were discussing the current economy, the politics affecting it, the Euro and a host of relevant issues, including gold's and silver's recent price declines and their future prospects. Eventually, I made the statement that, most likely, even if gold declined in price, any loss incurred would be nominal and not economic. Needless to say, I was asked to back up that statement, as I should have been.

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We explained inflation many times in the past using the “Scales of Justice.” Space dictates I not do that here, but examples can be found in past *CJ* letters on TCM’s website. If you can’t find it, call and I’ll explain. The important point is that there is an equation that defines the relationship between money supply and GNP:

- GNP/Money Supply = Monetary Velocity or
- GNP = Money Supply * Monetary Velocity

One can then take the further step of drawing the following relationship (Δ means “change in”):

Δ Money Supply in % causes equal Δ GNP in %

The last piece before application relates to the effects on prices generally after complete absorption of increased or decreased money supply. At the M3 level (fully absorbed), we can consider the distortions due to uneven absorption to be minimized, so the Δ Money Supply in % can also be applied to individual goods or services, with the proviso that the application will be close, but not necessarily exact.

Let’s apply this to the current situation, assuming a 9% reduction in M3 due to a decreased multiplier effect (rounded):

	M3	Spot Gold
	$15.00 T	$1,750
9% Decline	< 1.35>	< 158>
New Price	$13.65 T	$1,592

The “catch” is that the $158/oz *nominal* loss in gold is not an *economic* loss. The value of fiat US$’s can and does change at the whims of our government – until enough voters figure it out that the pols supporting those policies can no longer be elected. Commodities, and, in particular, gold are subject to the laws of supply and demand. The purchasing power of gold will generally only change if there is a change in its demand and/or supply, such as:

- an increase in demand from a new medical use, causing a price increase or
- an increase in supply such as a major new (and cheap) source of supply, causing a price decrease or
- a decrease in supply from exhausted mine reserves not bearing out, causing a price increase.

In fact, used opportunistically, this “loss” in the price of gold could actually provide an economic *gain* if the losses are written off for tax purposes, providing a reduction in tax, adding additional funds to the sale price. Of course, you actually have to *sell* the gold and there are a couple of other restrictions, but the principle holds.

The point is, the purchasing power of gold is not affected much by money supply manipulations by interfering governments, although its nominal price certainly is. ***Government manipulations can only affect the*** **nominal** ***price of nonmonetary items, not their true purchasing power value***. In fact, one should not even think of the price of the good or service changing. *What’s changing is the value of the monetary units in which the good/service is measured.*

Finally, in the case of inflation, it is vitally important to realize that purchasing power doesn’t just “vanish” for everyone equally when M0 is expanded. First, the government (who accesses the money before it is absorbed into the economy) *receives the full PPM of the currency before the money becomes diluted.* Then the largest (Fed corresponding) banks, receive a little less, and so on until the additional money is fully absorbed at the M3 level (where most of us live), by which time the decline in PPM is fully expressed. ***The purchasing power was*** **de facto** ***stolen in the absorption process by those “closest to the Fed teat.”***

Wisdom from the Past

Perhaps the best way to close this letter is with some appropriate quotes from guys much smarter than I am.

From Mises: “Recurring economic crises are nothing but the consequence of attempts … to stimulate economic activity by means of additional credit.”

From Henry Hazlitt: “Today is already the tomorrow which the bad economist yesterday urged us to ignore. The long-run consequences of some economic policies may become evident in a few months. Others may not become evident for several years. Still others may not become evident for decades. But in every case those long-run consequences are contained in the policy as surely as the hen was in the egg, the flower in the seed."

Even from Lord Keynes: “There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million can diagnose.”

From Mises: “The important thing is not whether a doctrine is orthodox or the latest fashion, but whether it is true or false.” The meaning of his statement is that his accurate doctrine acts like a map, helping us locate where we are and, from there, providing a path that helps guide us towards our goals.

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