THE BIG SECRET ON WALL STREET

The End of America

How Inflation Destroys Civil Society

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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In America, inflation began with violence.

In October 1690, the Puritans of the Massachusetts Bay Colony launched a raid on their prosperous (and French Catholic) neighbors to the north. Led by Sir William Phips, the colonists' expeditionary force numbered 2,500 and traveled to Quebec aboard 32 ships.

Phips was a man of his time. As a sea captain and treasure hunter, he recovered a huge treasure from a sunken Spanish galleon, which made him rich and powerful. What made him popular was killing witches.

The previous spring, Phips had seized Port Royal, the Acadian capital (present day Nova Scotia), on behalf of the British Crown, with 700 soldiers. Even though the town surrendered without a fight, Phips allowed his men to sack and plunder the town… which made a substantial economic impact on the Massachusetts economy.

In the fall, the colonists launched a larger expedition to raid Quebec. Confident in their ability to plunder the French, they hired thousands of additional soldiers, on credit.

Alas, Quebec's leader, Count Frontenac, knew they were coming. He prepared the city's defenses, building a stockade and mounting cannons. When Phips demanded the town's surrender, Frontenac famously replied: "I have no reply to make other than from the mouths of my cannons and muskets."

What followed was the typical fog of war. The colonists' attack was stymied by, among other challenges, "a lack of rum." Phips' flagship Six Friends was heavily damaged when it ran out of ammunition, leading to the end of the assault. After two days of fighting, a prisoner exchange was negotiated, and the colonists' fleet returned to Boston, empty-handed. While only 150 soldiers died of their wounds, more than 1,000 died of smallpox.

The survivors were hungry, cold, and armed. They were also owed a lot of money. The expedition racked up 5,000 pounds in debt (roughly 10,000 ounces of silver) – a fortune at the time.

Phips tried to borrow the money to pay his men from Boston's merchants, but they doubted the Colony's credit, and wouldn't lend. Instead, in December 1690 the colonial government printed 7,000 pounds worth of paper money and paid off the soldiers. To gain acceptance of this new form of money (the first paper money ever issued in the New World), the Massachusetts Bay Colony made a two-fold pledge: first, that the notes would, in time, be redeemed for specie (silver or gold) at full face value, and, second, that absolutely no more notes would be printed.

What happened next is instructive. It has been repeated, in one way or another, by every subsequent government that has chosen to print money to pay its debts.

At first, the new notes gave the local economy a big boost. But… strangely… after a short boom of around two months, there was a terrible crash. All the gold and silver in the colony seemed to disappear. And, as the exchange value of the notes plummeted, there was an economic crisis.

To quell the panic, another issue of new notes had to be printed in February 1691. This issuance, because of the falling value of the notes, had to be much larger (40,000 pounds) to achieve the same economic impact as the first.

COVID Witches

Facing a growing crisis, Phips and the head of the church, Increase Mather, went to England to negotiate for more support with the new British monarchs, King William and Queen Mary. They needed a new charter, as the former King James II had been deposed. And they were hoping for a charter that would bolster their own authority. They returned to New England in the spring of 1692 with additional financial support. And Phips was named Governor. But the new charter greatly expanded the right to vote, granting the franchise to virtually every man in the colony.

How did Phips and Mather adjust to the new political reality? What's the best way to manipulate voters? Fear.

Phips and Mather needed to focus the electorate on something they feared more than poverty. But the colonists dealt with real and terrifying threats every day – like smallpox, Indian raids, and pirates. What's scarier than these things? What did the Puritans fear more than anything else? The devil. Puritans were consumed with a fear of going to hell. To them, the devil was a very real threat. They ascribed natural phenomena – like sickness – to witches and demons. Mather had come to power with a book about witchcraft that he published in 1684. Time to dust it off…

Phips and Mather got back to Boston on May 14, 1692.

Phips – an orphan, a treasure hunter, and a soldier of fortune – was not a religious man. But now, with a new royal charter in hand, Phips made ostentatious displays of piety: he halted his swearing-in ceremony to faithfully observe the Sabbath. And on May 27, less than two weeks after returning from England, Mather and Phips created a special new court, with jurists selected from the leaders of the new colonial government, to deal with the rising specter of… witchcraft.

Porter & Co.

In June the new court began hanging witches, mesmerizing the colony. Among the gruesome deaths that followed was that of Giles Corey, an 81-year-old man who was pressed to death by Captain John Gardner. It took him three days to die as heavy irons were laid on top of him, slowly crushing him. He was crushed, as opposed to hung, because he refused to cooperate with the court. That meant he couldn't be convicted of a felony, which prevented the government from seizing his land. (Killing witches was good business for the government.)

Before the Phips raid on Quebec, there was approximately 200,000 pounds of silver money in the colony. By 1711, 740,000 pounds of paper money had been issued by various colonial governments, including an enormous 500,000-pound issue by Massachusetts to pay for, you guessed it, another failed expedition to sack Quebec!

Prices continued to rise. And, despite various efforts to control the money supply, by 1748, 2.5 million pounds worth of paper money had been printed in the colonies. Prices had increased 10-fold.

Sound familiar? Government takes on debt it cannot finance with legitimate means. Government prints money, which provides a short-term economic boom. And Gresham's Law ensues: the bad money forces out the good, as people wisely hoard bullion and spend paper. Another crash follows. Still more money must be printed. The cycle continues. And each cycle causes more and more economic dislocation. The government is trapped: if they stop printing, the economy will collapse. If they keep printing, inflation will destroy civil society.

Why? One major problem is wages can't keep pace with inflation. Various schemes and regulations must be instituted to try and limit the damage to the middle class. In Maryland, in 1733, when the colony decided to print 70,000 pounds worth of new paper money, 30,000 pounds were given away, in equal allotments, to each inhabitant of the colony. Of course, back then, nobody had college loans.

Another appeasement technique is the granting of additional political rights, like universal suffrage for men in the colonies. We don't think the colonists would have understood gay marriage, transgender rights, anti-racism or the ESG movement... but maybe if they printed enough money, for long enough.

But the most powerful technique for controlling the population and limiting the political blowback for inflation is simply fear. Bankrupt governments facing the collapse of their paper currencies almost always use fear to manipulate the population. What's the first thing Phips and Mather did when confronting their crisis? Hang 20 witches and preach about the devil being in the colony. You can imagine Increase Mather saying from the pulpit: "*we're all in this together*." Or "*20 witches to flatten the curve*."

And when did a new strain of flu become "Covid" – an imminent threat to the entire world? Only after the Federal Reserve tried to reduce the size of its balance sheet and return to normalized interest rates in 2018. When it realized it had to continue printing, Covid became an existential threat to the world that required massive new government powers, an abandonment of the First Amendment (the right to free assembly), health privacy, and virtually every financial norm. The Fed's balance sheet then doubled.

The Beginning of the End of America

Our current spate of money printing began in 1998 with the bailout of hedge fund Long-Term Capital Management.

A modern-day Phips, the founder and leader of LTCM, John Meriwether, was powerful because he'd found treasure – not off the coast of Florida, but in the financial markets. Meriwether earned billions for Salomon Brothers trading bonds. Together with two Nobel Prize-winning economists, Myron Scholes and Robert Merton, the founders of LTCM were widely recognized as being the smartest men in finance.

And their hedge fund was wildly successful – at first.

They earned 40% a year, seemingly without any volatility. How? They capitalized on having access to very low-cost sources of funding. Many of the investors in the fund were the leading executives of Wall Street's top banks.

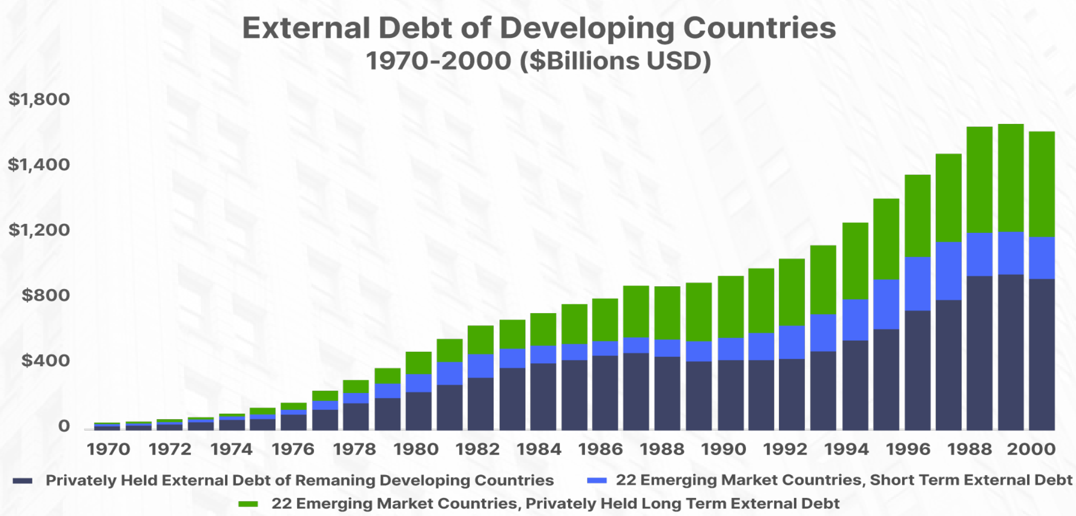
By using enormous position sizes, enabled by extreme amounts of leverage – LTCM was responsible for roughly 5% of the global trading in fixed income – LTCM could make reliable profits through arbitrage. The firm would simultaneously sell and buy bonds with similar financial characteristics to capitalize on tiny differences in prices across the world's markets.

No one else *could* make these trades because no one else had the capital (hundreds of billions), the computing power, the database of global bond inventory, or the algorithms to scan for relative value trades across virtually every market in the world, in real time.

Oh, and no one else *would* make these trades, because in virtually every position, the upside was infinitesimal... but the downside, in the event of a default, was cataclysmic.

One of the many repeating themes of paper money is the inevitable decline of liquidity as Gresham's Law inevitably requires more and more money to be added to the system, and bad money forces out good.

A Short, Sad Primer on Bad Money



Used with permission of the international Monetary Fund, from How Private Creditors Fared in Emerging Debt Markets.

In the 1990s, the "bad money" was emerging market bonds.

In the 25 years prior to 1998, the 22 countries known as "emerging" economies had seen their external debt loads grow 10-fold, far outpacing economic activity. Beginning in 1995 with the Mexican peso crisis, virtually every emerging market in the world suffered a currency collapse, a debt default, or both. Long Term Capital Management held a highly leveraged position in Russian domestic government bonds when the Russian government defaulted in August 1998, leading to massive losses.

So... what happened? Much like when the colonial army got back to Boston, instead of suffering their losses, LTCM's backers appealed to the government. And $3.6 billion in new money was created by a consortium of 14 banks, led by the Federal Reserve.

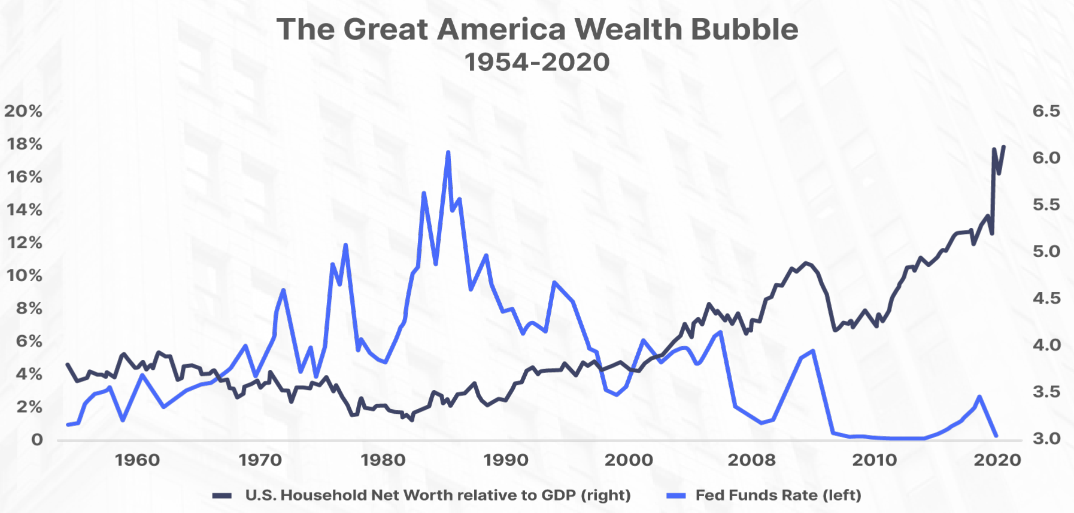
It was the first time the U.S. government had intervened directly to prevent credit losses by private investors since the creation of the world's current monetary regime, the all-paper, U.S. dollar standard. It would not be the last.

About 10 years later, in 2008, the "bad money" was subprime mortgage bonds, on which Wall Street banks had gorged themselves over the previous several years, creating an enormous economic boom led by real estate prices.

The resulting bailout was 10,000 times bigger than that of Long Term Capital Management. Looking at all of the direct bailouts, debt guarantees, mortgage purchases, and central bank swaps, the mortgage crisis saw $30 trillion in new money and credit.

Judging from history, we all should have known what would happen next.

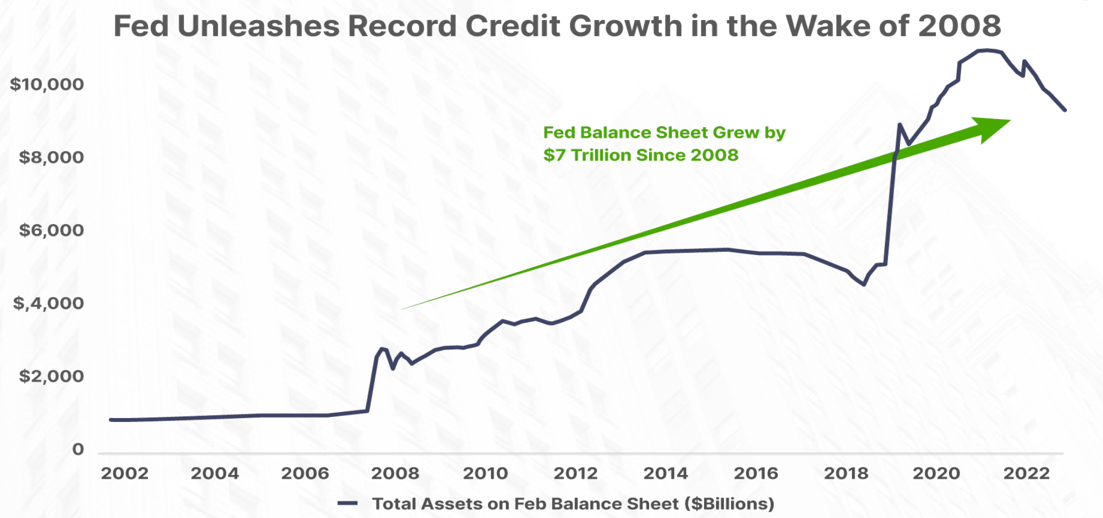
As the chart below (from *The Price of Time* by Edward Chancellor) shows, the late 1990s (and the bailout of LTCM) marks the beginning of America's "super bubble," where household net worth, as denominated in dollars, became completely untethered to any real, underlying economic activity. And with each new cycle of boom, bad money, and bust, the resulting printing of new money would grow ever larger.



The scale of the printing is most apparent in the growth of the Federal Reserve's balance sheet.

Our central bank printed trillions over the last 20 years to finance the bailout of Wall Street in 2009, and then again in 2011 to help solve the European debt crisis, and then, most recently, to finance the battle over COVID witches. *Each successful wave of printing was bigger and bigger.*

And following each expansion, the interest offered on government debt was lower and lower.

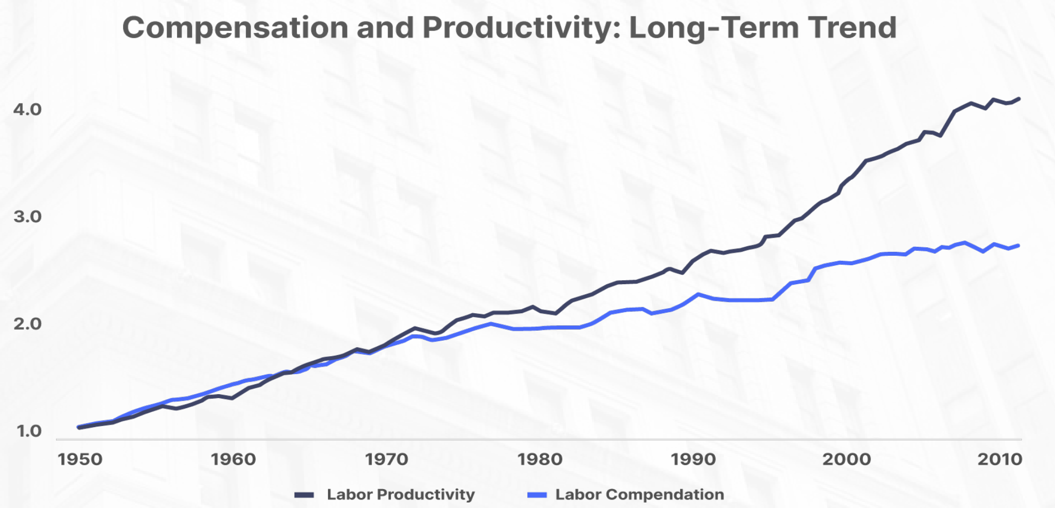


Source: FRED | St. Louis Fed

The result is a monetary system that bears little direct relationship to the allocation of real assets or services.

Deadly Paper

Consider the impact on wages. Since the beginning of the paper dollar standard in the 1970s, as money and credit began to expand well beyond physical limits, the value of wages became untethered to gains in productivity.



Source: BLS Labor Productivity and Costs dataset for the nonfarm business sector

Paper money is devastating to the middle class, whose wages have declined massively relative to the soaring value of assets. That's extremely dangerous for civil society. It creates the very real impression in the general population that the economy (and therefore the government that controls it) is illegitimate.

This is why paper money and major inflations always presage the most violent forms of populism and revolution – from the witch trials, to the rise of the Nazis, to the storming of the U.S. Capitol in 2021.

Perhaps the bigger problem, however, is that paper money is an enormous subsidy for the state. It sets the stage for virtually unlimited government budgets. That encourages people to use the government in all kinds of ways that are extremely destructive for civil society – like starting wars, whether that's raiding Quebec or invading Iraq.

Paper money and the lack of any fundamental limit to credit and money, also leads to unrealistic projects to reorder our domestic society – because no social benefit is unaffordable. The "war on poverty" and the "war on drugs" were both launched as the U.S. switched to a pure paper currency in the 1970s.

Paper money leads to a bull market in government insanity: *The U.S. is now spending more than $100 billion a year on food stamps, even though obesity is our country's greatest health risk*. And there's no better example of paper-financed government hubris than the "war on drugs." Surely after Prohibition's utter failure (here and everywhere else around the world), wise leaders would question the notion of giving government control over the most private and complicated areas of our private lives. But did they? Not a chance.

Paper money also gives unprecedented power to "the money changers." Before the 2008-2012 bailout of Wall Street, BlackRock, Wall Street's largest firm, had $500 billion of assets under management. It grew 10x after the bailout, to $5 trillion in assets under management.

Today, following the COVID witch hunt, and the massive money printing that enabled it, BlackRock controls $10 trillion – roughly 50% of annual U.S. GDP.

Never in the history of the United States has one firm, led by one man (CEO Larry Fink), controlled wealth equal to half our GDP. Or even 10% of it. What if the ideas that Larry Fink holds are wrong? He's the leading and most powerful proponent of the ESG movement and wants to ban all fossil fuels by 2050. But, with so much capital under his control, who can stop him?

Paper money is also dangerous because it's very hard to avoid the economic consequences of asset bubbles, even when it's clear that general inflation is underway. For people who need a place to live, it hardly matters that housing prices are inflated – they have to live somewhere. For people who are retired, it hardly matters that corporate bonds have been in an enormous bubble, because they need income to survive.

But worst of all, as the monetary system becomes detached from economic reality, it can no longer perform its most important, core function – which is to guide production in the most efficient way possible. Prices convey information across our entire, enormously complex economy. Prices are what inform entrepreneurs and other value creators what to make, and what to stop making.

This, the growing inefficiency of our economic engine, is the greatest weakness of our “financialized” economy. Just as the availability of virtually unlimited credit leads governments to take on projects (like war and social experiments) that are inherently destructive, virtually unlimited funding for corporations leads to malinvestment.

These are investments that are made *despite* the invisible hand of supply and demand, such as renewable energy investments that make our power grid both vastly more expensive and less reliable. How many billions have been lost already on solar power? Would these investments have been made in an environment of free market interest rates and sound money? Absolutely not.

How can you track how far America has traveled on its descent into total financial collapse?

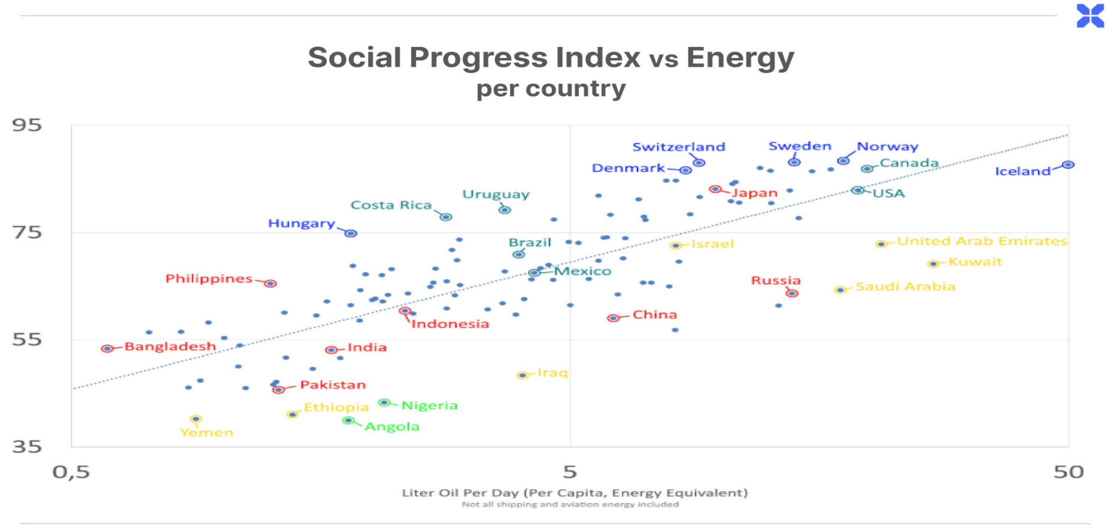
We think the best way to measure the growth of the real economy isn’t stock prices or even GDP figures, which have been impossibly warped by the ongoing inflation.

Instead, to track the real underlying economy we measure per capita energy consumption.

The Magic Energy Bullet

As societies become wealthier, more productive, and more efficient, more energy is consumed per person. Energy is almost a perfectly “elastic” commodity: the cheaper it can be produced, the more it will be consumed, with virtually no limit to potential demand. Thus, in wealthier societies, energy consumption is higher than in poorer countries.

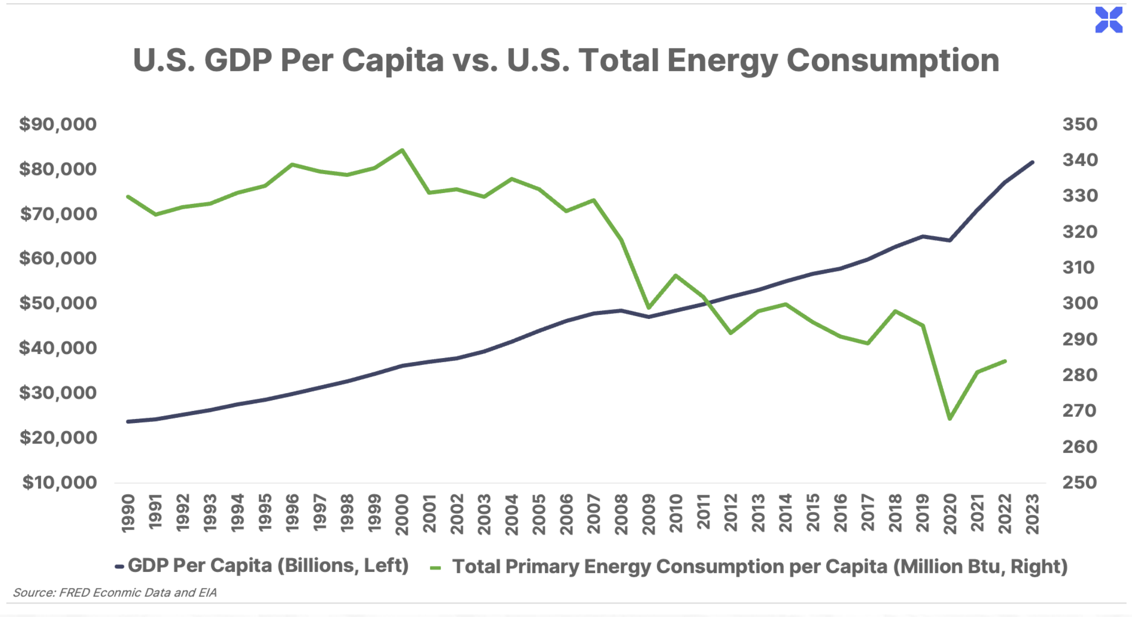
There are, of course, some outliers, like Iceland. Thanks to its virtually unlimited, cheap geothermal power, the average person in Iceland consumes more energy, per year, than anyone else in the world, except the people of Qatar. But as the chart below shows, using energy consumption per capita offers a very good objective assessment of real wealth.

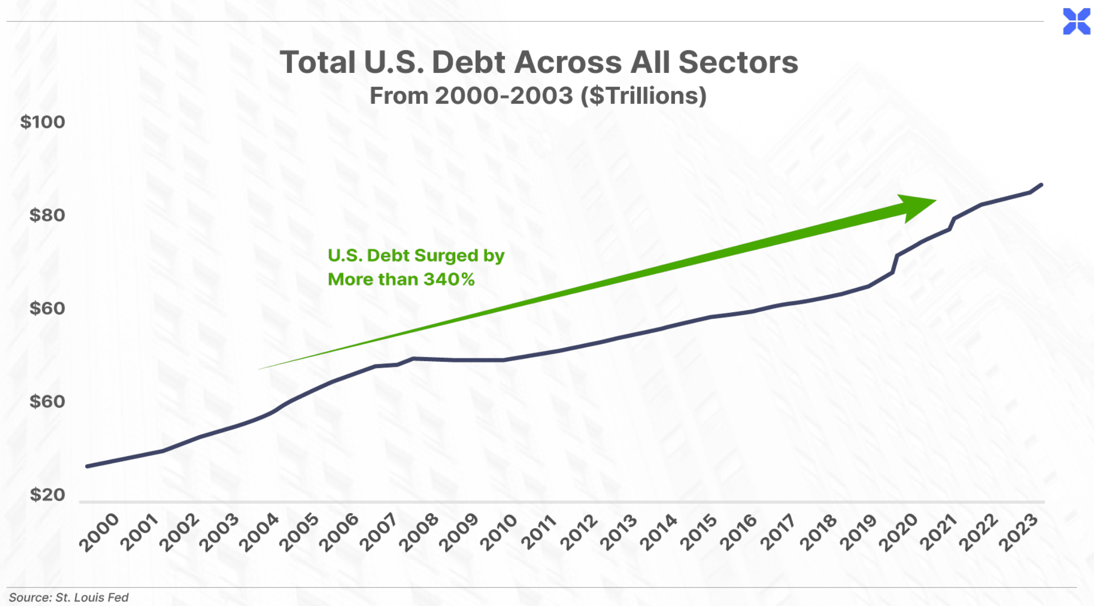


In America, energy per capita peaked in 2000, at 350 mmBtu, just before the collapse of the tech bubble. It's since declined almost 20%.

Meanwhile, GDP, as measured in ever more rapidly printed dollars, has more than doubled.

Has America's standard of living doubled in the last 20 years? No way. But our debts sure have – they more than tripled, from less than $30 trillion to $98 trillion.





The size of these debts, relative to the real size of our underlying economy (as measured by per capita energy consumption) have gone from a factor of 82 (highly indebted) to a factor of 310. You can think of these factors as being the "real" debt-to-GDP ratio. No country survives a debt load more than 100% of GDP without either a massive devaluation or a debt default, or both.

So, in the short term, the U.S. dollar might be the "winning" paper currency. Compared to Europe, our economy is in better shape, thanks to our energy independence. The overwhelming financialization of our economy means that our government will continue to overreach, that our society will continue to be plagued by massive income inequity and social unrest, and that our economy will grow progressively less efficient as malinvestment grows.

Sooner or later, this massive credit bubble will deflate and the paper-money currency that enabled it will collapse. The only question is when. And how many people will die first. Our advice: Try not to end up like poor Giles Corey.

What happens after the eventual demise of paper money?

Bitcoin is a cryptocurrency that's created at the nexus of computation and energy. Limited to only 21 million coins (but divisible into virtually limitless fractions), Bitcoin could become a much better, new global reserve currency. It is hard to imagine the world's governments will ever willingly give up the incredible power of their printing presses. But it could happen if the dollar standard collapses, and the advantages of sound money become readily apparent to the average person.

We recommend holding both gold and Bitcoin, as the two most widely recognized and accepted forms of "real" money, instead of saving in dollars. We believe that Gresham's Law will continue to drive the price of those forms of money higher relative to the dollar.

With regards to the current situation in the markets, it seems likely to us that sooner than most people expect, the Federal Reserve will not only have to lower interest rates once again, it will, almost surely, have to reinstate "quantitative easing" – printing money – to prevent a financial collapse.

Thus, we do not expect inflation to end. Quite the contrary. We can see that there are many parts of our economy that lack badly needed capital investments. When the Fed is forced to ease, the parts of our real economy that have been starved for capital will see soaring prices.