

## Taking the Pulse of American Wealth

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There is a major battle brewing on planet Earth that has nothing to do with weapons or physical fighting. It is a most interesting battle that will likely change the shape of global financial dominance here on Earth for generations to come. One side has been happy to have this battle, while the other does not even realize it is in a major war. Here are the players:

The World Producers and Savers: East Asia, China, Japan and  
OPEC hydrocarbon exporters.

versus

The World Consumers and Borrowers: The United States.

In 2006, the United States had a goods deficit of more than \$800 billion. Americans borrow \$2 billion a day from the world savers who, of course, expect to be repaid. To look at it another way, the U.S. borrows 80 percent of the world's savings to finance its conspicuous lifestyle. We Americans are 5 percent of the world's population, but we consume 30 percent of the world's goods. One of the many ways we do this is to use our homes as a cash cow. Hard working Asian and oil-producing countries consume much less than they produce. Americans, on the other hand, produce much less than we consume.

The savers and borrowers do have something in common, however. The producers/savers are happy to receive dollars, and the consumers/borrowers are more than happy to print them. The obvious problem is that this cannot go on forever or foreign companies will own our entire wealth. When we withdrawal dollars from our various "ATMs," (a.k.a. our homes) we are essentially directly depositing them into the coffers of the world's producers and savers. When our ATM runs dry, be prepared for major lifestyle changes.

## **The Weakening Dollar Matters**

Most Americans have read or heard about this issue, but they don't realize we are fighting the economic conflict of our lifetime and losing fast for two reasons. First, Americans are blinded by the illusion of stock market wealth and purchasing power. Second, few in America care about the free-falling value of the U.S. dollar. The mighty dollar has tumbled during the past five years and is likely to keep falling.

When it comes to the global financial markets, those who view value through the eyes of reality typically earn wealth from those who view value through the fog of illusion.

## **The Illusion of Dow Wealth**

Many Americans smile each time they see an increase in the equity value of their broker accounts due to the Dow making new highs month after month. This gain in wealth is an illusion second to none because there is one important number that is missing from monthly statements. It is the real value of the Dow after factoring in the collapse of the U.S. dollar global purchasing power parity index. What the American public sees each month is the value of the nominal Dow, which is an illusion of wealth.

Let's do a Dow "real money index" reality check. Simply take the Dow nominal value, which is what someone sees in his or her monthly statement and multiply it by the U.S dollar trade-weighted index. Reader, before we do this, please make sure you are sitting and prepared for a disturbing piece of reality. In 2000, the Dow top was 11,700 nominal x 1.24, which was the dollar trade-weighted index. This equals 14,508 global purchasing power parity (GPPP) points. In 2007, the Dow at 13,500 nominal multiplied by a dollar index of 0.81 equals 10,935 GPPP points. That's a 25 percent real stock market decline!

Despite its recent eclipse of 14,000, the Dow (after accounting for the collapse of the U.S. dollar) now buys more than 30 percent fewer euros than it did back in 2000 when it was priced at approximately 11,700. It also buys 35 percent fewer gallons of milk, 40 percent fewer bushels of corn or wheat, 65 percent fewer ounces of silver, 70 percent fewer barrels of oil, 80 percent fewer pounds of copper and so on. Do the simple math and figure out what the Dow will buy today in terms of other necessities such as housing, insurance, college tuition or hospitalization. Anyway it's measured, the Dow value that most Americans view as great wealth today is worth far less than it was in January 2000. What about the Nasdaq real money "invisible" crash? Let's take a look:

- In 2000, Nasdaq tops at 5,000 with a dollar-weighted index of 1.24:  $5,000 \times 1.24 = 6,200$  pts
- In 2006, Nasdaq is at 2,500 with a dollar-weighted index of 0.81:  $2,500 \times 0.81 = 2,100$  pts
- $6,200 - 2,100 = 4,100$  GPPP points for a 66 percent decline in real money terms.

This is reality! The bottom line is that while the Dow is in a bull market in nominal value terms, it is in a strong bear market in real money terms.

### **Understanding the Dollar**

The dollar is a "faith-based" currency. The unsystematic world monetary system we live in today is a new arrangement. Up until 1971, the dollar was collateralized by gold. If you were a central bank, \$35 would get you an ounce on demand. The system worked until the U.S. started to run out of bullion. On Aug. 15, 1971, Richard Nixon took America off the gold standard and the dollar became uncollateralized. Exchange rates started to float, to sink or to become pegged.

Governments made it up as they went along and still do in many respects today.

I have been trading currencies for around 15 years. For the average person, an easy way to understand how and why currencies are valued against each other as they are is to think of them as different publicly traded companies. For example, there is typically plenty of demand for the stock of a growing, solid company. This demand creates higher valuations for the stock, which leads to wealth and strong buying power for the company.

There are other companies, however, such as Enron a few years back, that operate under mass illusion. When the public became aware of Enron's fraud, everybody sold the stock, which eventually went to zero, and the company filed for bankruptcy. What happened to the main people responsible for the Enron illusion and fraud? One is serving a long prison sentence, and the other died of a heart attack during court proceedings. The Enron illusion was nothing more than risk disguised as opportunity.

Currencies are valued the same way. The perception of growth and higher interest rates for a country will encourage global investors to buy that country's currency, which in turn drives up the value of that currency. The higher the value of the currency, the greater the country's real global purchasing power parity. If the U.S. and its currency were a publicly traded company today, the U.S. would be considered much more of an Enron than a Microsoft. The currencies of the world producers/savers are the Microsofts of the world. Global currency players seek safe and strong

returns on their investments; the U.S. dollar is not in that position, and the currency markets have been telling us this for years.

### **Gold as a Measure of Value**

Gold has been the world's real money for 2,000 years. In 1932, a man could buy a nice suit for \$20. We were operating under the gold standard back then. An ounce of gold, for example, cost \$21 in 1920. Today, \$20 will not even buy a decent tie, let alone a good suit, but an ounce of gold will still buy a very nice suit.

The increase of paper money (printing money) leads to inflation. Inflation leads to higher interest rates. Rising interest rates mean a weak bond market, and a weak bond market leads to a weak stock market. This is a simple road map based on the past 120 years.

How many ounces of gold (real money) does it take to buy the Dow? In 2000, the Dow was at 11,700 and gold cost \$250 an ounce. The ratio of the Dow value to the price of gold was 47-to-1 for values in 2000. In 2007, the Dow is at 14,000 and gold costs \$740 an ounce. But in 2007, the Dow/gold ratio is 19-to-1. Did the Dow change? No, it's an index of 30 stocks. Did gold change? No, it's an inert element. What changed is the purchasing power of a fiat dollar to buy each asset class.

Instead of asking at what level is the Dow trading, investors should ask themselves at what level is the real Dow trading? This may be a radical difference from what people hear from traditional media. They want to have a televised party each time the Dow makes a new nominal high. The reason no one discusses the issues brought up in this article is because no one wants a party when the Dow declines in real money terms.

Whether talking about long-term prosperity in financial markets, the true benefits or dangers of food, or the health of personal relationships, the common denominator in achieving the best outcome lies in one's ability to identify the difference between reality and illusion. In the financial markets, quantifying supply and demand objectively allows someone to consistently discover true valuation.

### **Supply and Demand Analysis In Action**

In Figure 1, the 10-year Treasury note activity is shown next to the U.S. dollar during the same period. On the global scene, money managers are attracted to currencies with high levels of interest rates. Area A on the 10-year Treasury note represents a price level where supply exceeds

demand. This is because price declines from level A only when there are more sellers than buyers at level A. The first time price revisits that level is at point B, and price declines as expected. When Treasury prices fall, interest rates rise amid their inverse price/yield relationship.

Looking at the U.S. dollar side of Figure 1, area A represents temporary price stability, which gives the appearance of supply and demand equilibrium. The advance in price from A indicates that A was actually a price level where demand for U.S. dollars greatly exceeded supply of them. The initial advance from that level can only happen because of a supply and demand imbalance at price level A. In other words, many more willing buyers of U.S. dollars exist than sellers at that level. Therefore, when price revisits level A for the first time at point B, price is revisiting a level where demand greatly exceeds supply.



In any market, when price is at a level where demand greatly exceeds supply, price advances. At the same time that interest rates began to increase, the U.S. dollar was beginning to turn higher from the demand level. Remember, higher interest rates attract foreigners to buy dollars (demand). This plays out on price charts all the time—and well in advance for traders whose points of view are based in reality.

A secular bear market has existed since 2000 in the “real money” Dow, Nasdaq and S&P indexes in terms of global purchasing power parity. The model of printing dollars and nearly free credit is

not the model that built America, but it is certainly a model that can destroy it. If the U.S. cannot sustain its global purchasing power parity, our standard of living will fall rapidly. In many ways, it already has. Illusion teases reality. Traders should not let the shadow of illusion darken the reality of a trend that soon may very well change their standard of living.

### **Protect Yourself**

Here are simple steps traders, like you, can take to turn illusion into reality and prosperity:

- Don't ignore currency risk. Learn about currencies as much as possible. When you can quantify supply and demand in the currency markets and take the simple and appropriate action, none of the issues in this article will ever affect you. They will only affect those who cannot quantify supply and demand in the currency markets.
- Buy gold, gold futures or a gold ETF when gold prices decline to objective demand levels. In other words, when gold declines to a price level where demand exceeds supply, trade paper money.
- Stop using homes as ATMs.
- Most important, teach children these lessons so that they grow up more like the producers/savers and less like us in America—the consumers/borrowers.

— *end*

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