

## A MULTIPLE CHOICE QUESTION

“Which one of the following best describes the economic outcome that might be experienced in the years to come?”

- A) Inflation
- B) Deflation
- C) Hyperinflation
- D) All of the above

To this day I occasionally wake up with sweats from dreams of school days past where I am sitting for a test but am not prepared. And sadly, I do not believe most investors are really prepared for what might lie ahead. So considering the multiple choice question above, what is your answer? Let’s briefly discuss each one in turn before I provide mine.

**Inflation** has been explained as a rise in the cost of goods and services. But in reality, that is the *effect*. The *cause* is the devaluation in the *buying power* of a stated currency. So therefore, sellers of goods and services require *more* of that stated currency to make up for the loss of buying power as it devalues. For instance, as more credit is created in the system without a corresponding increase in the amount of goods and services, the value of the currency declines and consumers see that through a rise in prices. This is what has been witnessed for the past several decades.

**Deflation** has been explained as what happens when there is a scarcity of money. As credit increases so often do debts. People borrow money when times are good expecting to be able to pay it back with future earnings. But after a credit bubble pops, it is typical for commerce to slow and incomes to decline. With less income it becomes more difficult to reduce or pay off debts that continue to rise due to compounding interest rates. Most items decline in price and cash gains in buying power.

**Hyperinflation** has been explained as a *currency* event. Many people believe it happens during good economic conditions, but in reality it happens during the depths of bad economic conditions. The cause for hyperinflation is a *loss of confidence* in the currency of a nation. If people no longer trust the value of the currency, they begin hoarding “good” money and get rid of the “bad” money. This is known as Gresham’s Law, and can be witnessed in Rome in 240AD, Weimar, Germany in the 1920’s and Zimbabwe this decade.

So what’s my answer? Maybe surprisingly, mine is D) All of the above. Why? Here are my thoughts. Right now we have inflation (ignore the government’s currently low CPI readings – have you noticed the rising cost of food, energy, health care? Inflation is low they say? Please?) The next one is hard because there is no way to know precisely *if* deflation or hyperinflation *will* occur, and *if* they do, *which* will occur *first*. Then, *when* might a change occur?

Positioning your investments for these conditions can be very challenging, as what you might do during one is completely opposite of what you might do during the other. For instance, when experiencing deflation it might be best to have lots of cash and long-term government bonds, while shunning stocks, precious metals, and real estate. But if you experience hyperinflation, it might be best to have lots of stocks, precious metals, and real estate, while shunning cash and long-term bonds. This second scenario is what I referred to in last month’s article when commenting on the one situation that I envisioned that could cause the stock market to rise in the future.



Jeffrey D. Link