Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool on any article or visit www.djreprints.com

* See a sample reprint in PDF format
* Order a reprint of this article now

BARRON'S

INTERVIEW | SATURDAY, JULY 21, 2012

Coming: The End of Fiat Money

By LESLIE P. NORTON

Stephanie Pomboy, founder of MacroMavens, sees the world hurtling toward a day in which money will again be backed by gold or other hard assets. Until then, she also sees plenty of trouble.

"Hear Me Now, Believe Me Later," was the title of two separate and prescient pieces penned by Pomboy, an economist and founder of the MacroMavens research boutique. One, published in March 2006, foretold the disastrous costs of the housing bubble. The second, somewhat later, laid out the consequences of the bubble's "financial echo." Today, Pomboy predicts something more draconian: the demise of fiat money—currencies that aren't backed by anything other than government decrees that they have value.

We checked in with her last week, as central banks around the globe weighed more easing and as Fed chief Ben Bernanke described to Congress the headwinds facing the U.S. economy, including the automatic tax increases and spending cuts set for year end, called the "fiscal cliff." With the Fed being the biggest buyer of Treasuries, Pomboy thinks the 40-year-old fiat system will crack within five years.

Barron's : *What don't investors anticipate today?*

Pomboy: That the Fed will be a presence in the Treasury market for a long, long, long time. Some believe that, with another round of quantitative easing, we move forward, emerge from the morass, and the need for further intervention will dissipate. But the Fed is really the only natural buyer of Treasuries anymore. It will have to continue to monetize Treasury issuance at the same time all the other major developed economies—from the Bank of Japan to the Bank of England to the European Central Bank—are doing the same. Pursue that to its natural conclusion, and you see the inevitable demise of fiat money. To look at our policies and not be concerned about the risks to our currency would be dangerously naive.

One step at a time. When is the next round of QE?

Enlarge Image

Bernanke left the door wide open to moving when the data mandate. I believe it will happen before the next election. The one success the Fed has achieved with its postbubble, postcrisis stimulus is reinflating financial assets. To watch the S&P 500 go down every day is to watch it be undone. The Fed is trying to engineer a wealth effect, so high-end consumers spend, so companies catering to them will hire and increase capex, [capital expenditures] and—lo and behold!—the seeds of a sustainable

Ray Ng for Barron's

"If tax rates move back to prior levels, I definitely think the economy goes back into a recession—and likely a severe one." -- Stephanie Pomboy

recovery will be sown. It hasn't played out like that. They have financial-asset inflation and high-end consumer spending. The logjam is that corporations are disinclined to increase hiring and expand.

Which accounts for the fat margins investors love.

Cost-cutting has been a huge driver of those margins, but what is still underappreciated is that, if you look at the recovery in GDP since before the crisis, 83% of the increase is explained by higher prices. Only 17% is from an increase in demand. That explains the profit margin story. Companies have been able to pass on higher prices, even in the most discretionary forms of consumer spending. If you look at retail sales, actual units sold are lower than they were before the crisis. It's entirely an inflation story on the retail sales side. Consumers aren't buying more because they feel great. They are spending more because the prices have gone up. But now consumers are reaching their limits. Since June 2010, households have drawn down savings. But in the past three months, they've put $65 billion back into the cookie jar, which suggests that they've reached their threshold. Middle-income consumers are also adjusting to the new realities of living within a budget. **Wal-Mart** [ticker: WMT] is attracting a broader audience. And you have a troubling slowdown at the high end, since financial assets are starting to teeter. As you see the fraying fortunes of these high-end retailers, and low- and middle-income consumers tighten their budgets, there's urgency for the Fed to act.

That sounds bad.

Well, consumers won't shut their wallets overnight. It's just that the rules of prior recoveries don't apply anymore. We've got secular deleveraging and a slower pace of consumer spending, a broad deceleration in nominal spending growth, for as long as it takes households to feel more comfortable with their balance sheets. It's a muddle-through scenario. On the corporate side, if they can no longer pass on higher prices, the margin squeeze intensifies. If the Fed at the same time introduces quantitative easing again, commodity price pressures might reaccelerate, squeezing margins further. Right now, the estimates for growth, even as they come down, are probably too high. Ditto for profit growth.

What happens if we go over the fiscal cliff?

If tax rates move back to prior levels, I definitely think the economy goes back into a recession—and likely a severe one. If there's a permanent deal, it's bullish, although in no way repealing the secular deleveraging and deflationary forces in the economy. A temporary deal would yield an economy in paralysis, much like what we've seen over the past year. On the other hand, if fiscal policy makers actually enacted some favorable policy, it could be the thing that staves off the demise of fiat money. If the data get really bad, there will be some sense of urgency to enact stimulative measures, rather than have corporations and high-end consumers staring down the barrel of a gun next year. That's a very low-odds prospect.

What happens if Mitt Romney wins?

In theory, it provides a more favorable backdrop for the U.S. economy and financial markets, but it remains to be seen what he can really do and how aggressive he is. Companies aren't sitting on $2 trillion in cash because they can't think of anything better to do; they are getting negative returns after inflation. Were they to open their wallets, albeit slowly, the seeds of a sustainable recovery would be sown. Perversely, the worse the data gets, the

higher the odds of a positive outcome.

There will be a backlash against the current administration and policy mix. But obviously, despite how negative the data has been recently, it doesn't look like we'll see a change in Washington. Companies in the entire postwar period have never increased hiring when profit growth is decelerating. A Romney victory with bold incentives might change that, but the more profit growth slows, the lower the odds that incentivizing companies with tax measures actually bears fruit.

You clearly need to reduce taxes across the board and have a friendly regulatory environment. The key is to do something permanent: Companies need to feel this is a fundamental shift. Given the economic backdrop right now, here and in Europe, it's not the time to be tightening fiscal policy. I have a weakness for the Laffer Curve, that ultimately a tax cut to corporations, and sustaining the present tax system for consumers, would be a long-run positive and a step in reducing the government's role in the economy, which has been enormous over the past four years.

You recently wrote an entire piece about the importance of the Bank of Kazakhstan. Why?

Economics is so dull! You have to inject a little levity when you can. We know that the Bank of China, India, and major emerging-market economies have been slowly diversifying out of their dollar reserves into hard assets. When you get to the point that the Bank of Kazakhstan is thinking: "We really need to figure out a way to diversify out of dollars," it is a pretty profound statement about the quality of the dollar. Here in the U.S., it doesn't seem like any investor is concerned about the risk of the demise of fiat money. I'm sure most people think I should be fitted for a straitjacket.

The real urgency for QE is not the economic outlook, but that the Fed has made itself the only natural buyer of Treasuries; during QE2 they were 61% of the market. At the peak of the housing bubble and globalization nirvana, foreigners absorbed 82% of Treasury issuance; today, it's 26%. While we are enjoying a short flight-to-safety bid, courtesy of Germany's Angela Merkel and the euro-zone crisis, that's not a sustainable financing strategy. Now people are paying for the privilege, after inflation, of owning that paper. We have over $1 trillion annually in Treasury issuance, and our foreign creditors are buying $300 billion. That's being absorbed by the flight-to-safety bid, as hedge funds cover short positions and bond managers extend duration.

Our creditors have limited diversification choices, too.

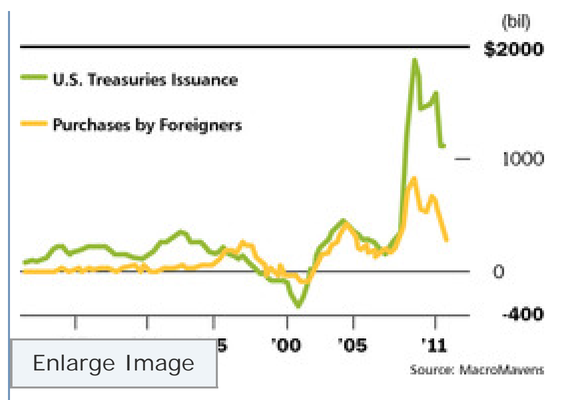
Changed Dynamics

Foreigners once were the prime buyers of U.S. Treasury securities, accounting for 82% of purchases. Now, they account for just 26%, and the Federal Reserve is the No. 1 customer.

Well, they're now recycling dollars into hard assets. Conveniently, commodities trade in dollars. The thing that makes hard assets so alluring is their finite supply. All these central banks are going to discover they can't amass commodities as rapidly as the Fed, ECB, and BOE can debase their currencies. That's why we are speeding toward hard money.

What triggers it, and when does it happen?

It could happen in a couple of ways. One, the inflation rate in the U.S. picks up and the Fed finds itself forced to continue



quantitative easing, because it must absorb the Treasury funding slack, despite rising headline inflation. At which point it's obvious to everyone that the Fed is buying Treasuries because it is slavishly monetizing the expansion of the government. That would be such a naked dollar-debasing tactic it might impel the Bank of China to say: "Look, we demand a capital-preservation guarantee." They made that threat almost two years ago. Instead of enforcing it, they've accelerated their diversification out of our paper. And in conjunction with Russia, they are working on trading in non-dollar transactions.

I don't see it in the next 12 months. I think a five-year time horizon is very, very realistic. I envision a gold-backed currency system. We are going back to hard money, rather than a fiat system where debtors can silently default by inflating their debts away.

How does the demise of fiat money affect investors?

There would be a knee-jerk negative reaction, but when the dust settled, it would be clear we were actually moving into a responsible policy. The realization that we are going down this road will be very bearish for stocks and bonds with the exception of Treasuries, which the Fed will continue to cap. You will have immediate and dramatic increases in commodity prices and inflation expectations.

I would own gold versus developed-market currencies. You want to be long emerging-market creditor currencies, versus developed-market debtors. Oil would be an absolute-return asset: Central banks are amassing strategic resources like oil. Companies tied to mining and commodity production are absolute-return areas.

One relative-return play is to overweight large-cap multinationals that benefit from having consumers outside the U.S. and underweight small-cap U.S.-centric companies. Another play on the budget-conscious U.S. consumer versus fraying high-end activity is overweighting Wal-Mart versus **Nordstrom** (JWN). On the credit side, maybe underweighting a junk composite versus a triple-A-rated corporate composite, or even underweighting junk versus an emerging-markets bond composite.

Until then, what happens to our markets?

Since 2002, I've been bullish on gold and on Treasuries and generally negative about stocks. Over that stretch, on an inflation-adjusted basis, stocks have gone exactly nowhere, gold has gone up a ton, and Treasury yields have gone from 5% to 1.5%. In general, we have diminishing marginal returns on each round of QE. I would see a high of 1400 on the S&P 500 and, should we go over the fiscal cliff, a low of 500. [The S&P was recently 1377.]

On the bond side, there's not a lot more money to be made. I wouldn't be short, because the Fed will really work to maintain rates at those levels. The highest-quality corporate yields may compress further. I'm concerned about junk, where spreads are hovering at 2005 lows. Is it reasonable for junk companies to borrow at the same rate when unemployment is higher and GDP and consumer spending growth are lower?

Thanks, Stephanie.

E-mail: editors@barrons.com

Copyright 2011 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our **Subscriber Agreement** and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit **www.djreprints.com**