Turning Inflation Into Wealth Mini-Course

Reading Eleven:

The $2 Million Opportunity

MortgageSecretPower.com

Estimating The Opportunity

The premise of this course is that because inflation represents a redistribution of both real wealth and of tax benefits, an individual can choose to make inflation an opportunity rather than a problem. As we close out the main section of the course, this then begs the question: how big of opportunity are we talking about?

There are many reasons to fear for the future of the dollar, ranging from current trade deficits, to having an almost untested $450 trillion financial derivatives market that is 30 times the size of the United States economy (with subprime mortgage collateralized securities representing a smallish test of this unregulated new world), to being a major oil importer when the future may hold limited supplies and unlimited demand from global competitors. The true danger of these risks is as yet unknown, but there is another category of inflationary risk that isn't really a risk at all – for it merely represents what has already been promised, in great detail.

In today's reading we will search for our opportunity to profit from inflation by examining this quite certain danger. We will ask two basic questions: What is the total cost of all United States retirement promises and expectations? What are the implications for the dollar? To answer these questions will involve taking five steps:

1) Start with the well-publicized figure of $500,000 per household for the present value of government retirement promises;
2) Subtract out the below poverty line households
3) Subtract out the past retirement age households
4) Add in the cost of cashing out pensions, IRAs and Keoghs
5) Convert from current dollars to total dollars

When we add those simple steps together, we will find that our answer is an impossible sum – if the dollar in the future is worth anything close to a dollar today. Far too many dollars have been promised for the resources that will available – meaning doom for the dollar. Representing a major societal problem – that can be turned into potentially lucrative individual opportunities for building wealth on a long-term and tax-advantaged basis, through using the tools explained in this course.

The Big Picture

The chart below is a rough blueprint for retirement related expenses over the years ahead. Call it the Baby Boom's promises to itself, which the Boomer's have done their best to legally obligate their descendents to pay for in as many ways as possible:

Boomer Retirement Wealth Promises & Expectations

All-In Costs Per Non-Boomer, Above Poverty Line Houshold

Line	Category	Total Dollars	Current Dollars
(1)	Social Security, Medicare & Debt	$118,000,000,000,000	$59,000,000,000,000
(2)	Boomer Retirement Wealth Expectations	$44,000,000,000,000	$22,000,000,000,000
(3)	(less double-counting of State & Local govt. pensions)	-$2,000,000,000,000	-$1,000,000,000,000
(4)	Total Boomer Wealth Expectations & Government Debts	$160,000,000,000,000	$80,000,000,000,000
(5)	Number Of Households	111,000,000	111,000,000
(6)	Households Below Poverty Line	11,000,000	11,000,000
(7)	Number Of Households Above Poverty Line	100,000,000	100,000,000
(8)	Ratio of Working Age Population To Retiree Population, 2027	2 to 1	2 to 1
(9)	Simple Adjustment For Boomer Households	-33,000,000	-33,000,000
(10)	Adjustment For Younger Boomers Still Working, 2010-2046	35%	35%
(11)	Net Adjustment for Boomer Households	-21,450,000	-21,450,000
(12)	Non-Boomer Households Above Poverty Line	78,550,000	78,550,000
(13)	Government Retirement Promises Cost Per		
(14)	Household, Including All Households	$1,063,063	$531,532
(15)	Government Retirement Promises Cost Per		
(16)	Non-Boomer Households Above Poverty Line	$1,502,228	$751,114
(17)	Boomer Retirement Wealth Expectations Per		
(18)	Non-Boomer Households Above Poverty Line	$534,691	$267,346
(19)	Boomer Wealth & Government Promises Cost Per		
(20)	Non-Boomer Households Above Poverty Line	**$2,036,919**	**$1,018,460**

The above is a ballpark illustration, which combines 40 and 75 year models that are based on different assumptions. It paints the big picture in broad strokes, and should be interpreted broadly as well -- $1.5 to $2.5 million per household.

Line (1) begins with a fairly well known figure, from a *USA Today* article in May of 2007, that showed that the unfunded expenses of paying for future government retirement promises was $59 trillion, or about half a million per household (the same study referred to in the "Seizing Your Assets To Cover Retirement Promises" reading, link below). The $59 trillion is not the total expected expenses, but the excess over the revenues our current tax structure is estimated to generate, after an economic growth estimate.

http://www.usatoday.com/news/washington/2007-05-28-federal-budget_N.htm

That $59 trillion is shown in the “Current Dollar” column of our chart, because it is inflation-adjusted, meaning much of the assumed value of the dollar has already been destroyed in getting there. This is routine for the presentation of future societal costs, as what we want to get to is “real wealth”, that being goods and services, so we adjust out the anticipated inflation. However, our objective in this article is to understand the impact of future promises upon the value of the dollar, so we don’t want to start with a footnoted assumption that half the value has already been destroyed. We therefore make a rough (and quite conservative) adjustment to bring the total back to dollars before inflation. A 3% level of inflation will drop the value of a dollar in half over a little more than 20 years, so we multiply the half destroyed dollars by two, and come up with $118 trillion in dollar promises, in the “Total Dollar” column. (As discussed below in footnote (1), the chart combines two models with differing terms and other assumptions. Painting with broad strokes and assumptions is appropriate when looking at future retirement obligations, as the details can’t be known in a number of crucial areas.)

The Boomers are of course counting on much more from the generations behind them than just Medicare and Social Security, however, they want their pensions, IRAs and Keoghs cashed out as well. Using some reasonably conservative assumptions, that total comes to about another $44 trillion (or $22 trillion in half destroyed dollar terms). The link below leads to a 50 page report which demonstrates the calculation of that $44 trillion total, based on underlying Census Bureau and Federal Reserve household statistics:

http://the-great-retirement-experiment.com/pamphlets.htm

After adjusting for a bit of double-counting of state & local government pensions, the total dollar amount comes to a whopping $160 trillion that future retirees expect the generations behind them to pay, with most of that total consisting of legally binding promises. Even when we destroy half the value of the dollar in advance, we are still looking at a figure of $80 trillion in current dollars. Those numbers are so high that are almost impossible to comprehend. For perspective, we could say $160 trillion is 3 times the size of the total global economy, and it represents promises that only about 1% of the world's population (US retirees) have made to themselves. Other than saying it's fantastically high, it is hard to derive meaning from figures like that.

USA Today tried to make these vast numbers more understandable by putting them into per household terms. Take the $59 trillion in current dollars, divide it by all 111 million household in the United States, and you come up with each household needing to pay over $500,000, if retirement promises are to be met (not including private pensions and retirement accounts). Remember – this is assuming that half the value of the dollar has already been destroyed. If you are comparing to the dollars you have in your bank and investments accounts right now – total obligations work out to over $1 million per household (line 14 of the chart).

The government has promised to pay benefits representing a cost of $1 million per household. What has already been promised is

obviously impossible if a dollar is worth a dollar. It's also impossible if a dollar is worth fifty cents, as in the *USA Today* projections, for we can't expect the average household to come up with half a million dollars. To make the impossible into the possible – is going to require doing a much more effective job of destroying the dollar than merely cutting it's value in half, as we will review a bit later. But before that, we're going to have to do a better job of determining what the real costs per household are going to be. For, unfortunately, the *USA Today* number included too many households, and too few expenses – the full picture is much worse.

Per Census Bureau statistics, there are indeed 111 million households in the US, but 11 million of them are below the poverty line. They are not able to pay for themselves in full, let alone bear the tax burdens of cashing out others. So we drop down to 100 million households able to pay, as shown in line (7).

Next, the implicit assumption within all households paying for retirement expenses, is that the retirees are paying for their own expenses, in some sort of endless circle, where they pay themselves so they can pay themselves so they can pay themselves. From a currency perspective, tapping some retirees to pay for promises to less wealthy retirees is quite likely at some point, but when we look at goods and services, the games end. The retirees need goods and services, the non-retired will be producing the goods and services, and by 2027 we will be down to about two people of working age for every one person of retirement age.

So we adjust down by 33 million in line (9), but that is too much, because the youngest Boomers will still be working after the oldest Boomers have retired and even passed away. So we adjust back for Boomers still below retirement age in lines (10) and (11), and find that over the next forty years or so, an average of about 21 million Boomer households will be past retirement age, and not providing the goods and services they will need to consume in retirement. (This adjustment is one of proportion, rather than purely numbers of households. Yes, new households will be entering the workplace, yet, there is no getting around the heart of the demographic problem, which is the steady decline down to two workers for every person of retirement age over the next twenty years.)

We are now down to about 79 million households that are above the poverty line, and won't be (on average) over retirement age themselves. When we compare this number of households that will be effectively paying to the total government costs – then the total comes to a staggering $1.5 million per household (line 16). Even when we assume the destruction of the half the dollar to put it in the present value terms, then adjusting for below poverty line households not paying their share, and retiree households not paying for their own benefits, brings the total up to three quarters of a million per household.

Then we need to add in the costs of cashing out all the private pensions and retirement savings. The dollars to cash out those pensions and the associated goods and services will need to come to come from somewhere – and that somewhere is the productively

working rest of the economy, which is our 79 million households above the poverty line and below the retirement age. This adds another full half million dollars per household (it will cost you a mere quarter million if you pre-assume that half the value of your dollars have been destroyed). It is also worth noting that most private pension promises aren't really private, as the federal government guarantees pension payments through the Pension Benefit Guaranty Corporation. This means that from a taxpayer's perspective, the government has effectively issued a standby guarantee for private pension investment performance for the entire nation.

As shown on line 20, our total is now a staggering $2 million per household, when we include all the retirement expenses, and look only at households "able" to pay. A promise that will be impossible to keep – so long as a dollar in the future is worth anything close to the value of a dollar today. Which brings us back to the central flaw in the USA Today study, a flaw with profound implications for all of our long-term investments.

A Failure To Connect The Inflation Dots

To understand how the impossible becomes the possible (and by definition – it must), we have to remember something fundamental that too many economists have been leaving out of their long-term projections – the inflation rate is not independent of the dollar. Inflation rates don't exist in some independent, mathematical universe, where we can assume the recent past will endlessly repeat itself – rather, inflation is the rate of change in the exchange rate

between symbols and reality, and inflation is therefore the mechanism through which symbols will be forced to converge with reality.

There are fundamental limits on reality, with reality being the amount of resources that a society is producing at any time. There are no limits (unfortunately) on symbols, with the amount of dollars that can be created at any one time representing a decision about symbols, rather than resources. So, if the promised symbols get out of whack with the reality of actual resources – it is the symbols which must do the adjusting necessary to bridge the gap. Which brings us to the chart below:

Using Inflation To Make
The Impossible
Into The Possible

Expenses In 20 Years

Rate Of Inflation	Obligation Per Household	Inflation-Adjusted Obligation	Value Of A Dollar
0%	$2,000,000	$2,000,000	$1.00
3%	$2,000,000	$1,107,352	$0.55
5%	$2,000,000	$753,779	$0.38
8%	$2,000,000	$429,096	$0.21
10%	$2,000,000	$297,287	$0.15
15%	$2,000,000	$122,201	$0.06
20%	$2,000,000	$52,168	$0.03
30%	$2,000,000	$10,524	$0.01

I think we can all agree that $2 million per household is not reasonable. If we pick a long-term inflation rate of 3% as being reasonable because it roughly corresponds to the recent experience of

one nation – then it still leads to an impossible outcome of over $1 million per household (which also brings us back to current dollars). Which then means that 3% is also an impossible inflation assumption. An outcome of $750 thousand per household looks impossibly high as well, meaning that a 5% inflation rate is impossibly low. (There is implicit index "management" in this chart, as discussed below.)

However, once we raise our inflation assumption to 8%, then we are down below the *USA Today* projection, with "only" $429,000 per "able" household. A feat we accomplish by dropping the value of the dollar to 21 cents within the next 20 years. Interestingly enough, we are now approximately in the recent historical range for US inflation, and we can see what kind of results that scenario can have on investment returns. In June of 1972 the DJIA stood at 929 and exactly ten years later, over a decade where inflation averaged 8.7%, the index was at a level of 812. Adjusting for the dollar losing 57% of its value over those 10 years, that means the index lost 62% of its value over a ten year period, in "real dollar" or purchasing power terms (exclusive of dividends).

Unfortunately, that scenario may turn out to be too optimistic for current circumstances, for $429,000 is still way too high. The average US household owes a total of about $112,000 in total debt. Let's say that it is reasonable that total payments per household over the decades ahead will be equal to roughly the value of their current debts. When we look that up on the chart – a 15% rate of inflation does indeed bring the total inflation-adjusted obligations per household down to $122,000. With a side effect of making the dollar worth 6 cents within the next 20 years. (The $112,000 used in the

USA Today article isn't really comparable with the $122,000 figure, as the first is debt balance and the second is total "debt" payments. That said, when we remember that the $122,000 per household is on top of all current income taxes, Social Security and Medicare, as well as mortgage, car, credit card and other debt payments, then it may be pushing the limits of what can be done.)

What Government Controls – And What It Doesn't

There is of course a problem with the perspective above – retirees are expecting real wealth in the form of goods and services, rather than just dollars. Meeting those expectations at the levels promised by the government will indeed be impossible, unless economic growth reaches all new levels. The government doesn't actually control economic growth, the private sector does. Therefore – absent an extraordinary long term surge in productivity growth rates – the promises will need to be broken in substance, and the government likely won't have much choice about that. However, it would highly inconvenient for all levels of government and the large corporations to legally break the retirement promises.

Therefore, there will be an overwhelming incentive for the government to meet the promises in form though not in substance, through using what it does control. Which is both the supply of dollars – and the indexes which are used to determine the fulfillment of inflation-indexed promises. Slash the value of the dollar and dollar denominated promises can be met. Slash the value of the official index versus the real value of the dollar, have the official rate of inflation be substantively less than the real rate, have the difference

between the two rates compound over the years ahead, and the indexed promises are met. With meetings occurring in form through what the government does control, albeit not in substance with what the government does not. (With the side effect of drastically boosting tax revenues through inflation taxes as covered in the reading "Seizing Your Assets To Cover Retirement Promises".)

(The chart in the section above is an illustration which does implicitly show index "management" by the government, with differing real and official inflation rates. Our $2 million total comes from assuming a 3% official inflation rate. If real inflation is 3%, then we get real costs in current dollars, which is $1.1 million per household, in that simplified example. As we then increase our inflation assumptions by going down the chart, what we are doing then is increasing the differential between official and real inflation, which decreases the cost of meeting inflation-indexed promises.)

It all comes back to the very basics. We've promised more dollars than there are resources to back them up. Too many dollars chasing too few resources means inflation. The sum of our promises is an extraordinary $2 million or so (give or take half million) per household of working age and above the poverty line. Which means we will need an extraordinary amount of inflation to reconcile dollar promises and actual resources.

Economics Are Not Impersonal

There is one more factor that is routinely left of the long-term projections, that goes right back to Adam Smith and the very

foundations of modern economics. People act in their own self interests. Let's say you are a younger worker, there are tens of millions of Boomers trying to collect money from you, and you are looking at the chart below:

How Much Do You Want To Pay?

Expenses In 20 Years

Rate Of Inflation	Obligation Per Household	Inflation-Adjusted Obligation	Value Of A Dollar
0%	$2,000,000	$2,000,000	$1.00
3%	$2,000,000	$1,107,352	$0.55
5%	$2,000,000	$753,779	$0.38
8%	$2,000,000	$429,096	$0.21
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20%	$2,000,000	$52,168	$0.03
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The chart is of course identical to the previous one, other than the title. The change in title may, however, show the single greatest danger to Boomer retirement wealth expectations. If you are a younger worker, and you are in control of the economy – how much will you want to pay?

Two basic principles of economics come into play here. The first is that inflation generally redistributes wealth from creditors to debtors. A second and related basic principle, is that big bursts of inflation usually redistribute wealth from older people to younger people. The older portion of the population typically owns a

disproportionate share of the money, as they have been saving and investing for many years. When the value of the dollar plummets, the value of all their previous savings and years of works plummets along with it. Worse, retirees or workers late in life won't typically have the years of income at new price levels needed to replace there losses – so they now face a future of impoverishment, their savings permanently destroyed.

This destruction of the value of the savings is a substantial benefit to many younger workers. They are more likely to have debts than substantial savings, so the inflation may improve their real net worth, as more debts are wiped out than assets. They rely on their current incomes to support their spending, and because their incomes rise with inflation, they do not take a hit in their ability to consume. Indeed, because they now have less competition for homes, cars, meals and other goods from the retirees (for the retirees have been impoverished), the current workers are able to enjoy more consumption than they could before the inflation occurred.

When we add motivation and people acting their self-interests to the feature, then the case for the destruction of the dollar grows stronger still. Without a high rate of inflation – we have the largest attempted intergenerational resources grab in US history, as the Boomers attempt to collect exponentially compounded returns on their own work product over the previous decades, by using both their private dollars and the public promises they have made to themselves through current laws, to take huge bites out of the current goods and services that will be produced by the younger workers in the future.

The hole in the plan – is that the attempted grab is necessarily a claim on symbols, rather than directly on real goods and services. The workers who are producing the real wealth of the future will have an overwhelming incentive to slash the value of that symbol (the dollar) – because they don't have the assets to lose, but they have all the benefits to gain. From the perspective of the following generations, the question will not be how much they are capable of paying – but how little they can get away with paying. With inflation being a fundamental economic force that the following generations will use to fend off the Baby Boom's attempted resource grab.

If You Can't Beat Them – Join Them

The retirees of the future have expectations for symbolic wealth in retirement that likely greatly exceed actual resources that will be available. Too many people attempting to cash out too much paper wealth over a period of decades will have all too of predicable results on the value of the paper wealth, whether we call it dollars, stocks, bonds, or government retirement plans. The first and most obvious step then is to choose to invest in the reality of tangible assets rather than symbols.

In combination with the tangible asset step, there is a second step to take as well, whether you are a Boomer, or older or younger – and that is to change your alliance. Instead of being part of a vast herd of Boomers marching in lockstep towards a future of broken retirement and investment promises – change your investment strategy so that you will be profiting from the upcoming promise breaking. If it is in the economic self-interest of the generations

behind the Boomers to destroy the value of the symbols – then change your choice of allies, and align yourself with the self-interests of those who will be paying for the Boomer's retirement promises.

It truly does boil down to common sense. The impossible is approaching fast, and we each have the choice of positioning ourselves so that our financial well-being depends on impossible promises being kept – or positioning ourselves so that we will profit from those impossible promises being broken. As you decide, do keep in mind that some of the most lucrative long-term and tax-advantaged opportunities to profit from inflation that have been available for decades can be found right now, but, by the time resurgent inflation is the headlines – the easy arbitrage opportunities will be long gone.

Inflation Arbitrage

The next reading will be devoted to exploring those easy arbitrage opportunities that currently exist. (This was originally one reading, but was split for reasons of length.)

If A Link To This Reading Was Given By A Friend

If you found this article because of a friend's recommendation, then you should know that it is the _____ reading in a free mini-course on Turning Inflation Into Wealth. Much more information on the course and the benefits of the course to you are available by following the link below.

http://mortgagesecretpower.com/Mini%20CourseB.htm

(1) Ballpark Estimates & Broad Strokes

There are a number of simplifications involved in the chart above, and this is appropriate, because there is no getting away from the guesswork involved. First, we are discussing humans and human behavior, not a neatly predictable mathematical model. There are important questions, such as: when will people retire on average? How long will they live before they get sick? How long will they live after they get sick? What role will immigration play, and will it increase or decrease the wealth available for retirees? Will technological progress ramp the economy up to fantastic levels – or will the depletion of oil and other resources in combination with increasing global competition for those resources slash our economic growth rates? What will be the economic growth rate of a geriatric society?

There are some other very broad strokes used in the chart. The USA Today study is based upon a 75 year term and includes non-Boomer retirees in both the near and long term, and the Boomer retirement investments on a 40 year term. The USA Today study is net of projected taxes, the Boomer study is not. The present value rates differ. (The difference in term is not as important as it might appear at first glance, as a dollar 50 or 60 years now from has very little value in present value terms.) Rather than getting artificially precise then, a better summary might be to say $1.5 to $2.5 million per household able to pay, rather $2 million per household. With that entire range likely spelling doom for the dollar.

There is another broad stroke that characterizes all these long-term studies. They assume that a way is found to slash the growth rate in medical expenses. Otherwise the 1-2 combination to date of a rapidly growing number of seniors, accompanied by a simultaneous exponential growth in medical expenses per senior, with each series growing at a rate faster than the economy, will destroy the economy. A solution is therefore always assumed – but the problem is, nobody knows what that solution is at this point.

When you add it all up – you could have a field day talking about what has been left out, and the changes that would be desirable to the chart. And you would be right. The problem being you end up with an econometric model understandable only by a few PhDs, much like the modeling that has been done to date. Unfortunately, econometric modeling has been pretty much worthless when it comes to predicting moderate economic changes in direction even one or two years down the road, let alone one of the largest economic changes the modern world has seen. The problem is that the assumptions you must make as you add each layer of complexity, necessarily end up dominating the model. As one example, assuming that the unproven "Efficient Market Hypothesis" is true would be a routine starting point, with that assumption then dominating and determining the results of the entire model. So you end up with something nobody understands – and it doesn't work anyway. This chart is intended therefore to simply illuminate the nature of the broad problem, rather than purport to be a detailed prediction about the unknowable.

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