Today, we have bad news and good news.

The good news is that there will be no 25-year recession. Nor will there be a depression that will last the rest of our lifetimes.

The bad news: It will be much worse than that.

“A long depression” has been much discussed in the financial press. Several economists are predicting many years of sluggish or negative growth. It is the obvious consequence of several overlapping trends and existing conditions.

First, people are getting older. Especially in Europe and Japan, but also in China, Russia and the US.

As we’ve described many times, as people get older, they change. They stop producing and begin consuming. They are no longer the dynamic innovators and eager early adopters of their youth; they become the old dogs who won’t learn new tricks.

Nor are they the green and growing timber of a healthy economy; instead, they become deadwood.

There’s nothing wrong with growing old. There’s nothing wrong with dying either, at least from a philosophical point of view. But it’s not going to increase auto sales or boost incomes – except for the undertakers.

Second, most large economies are deeply in debt. The increase in debt levels began after World War II and sped up after the money system changed in 1968-71.

By 2007, US consumers reached what was probably “peak debt.” That is, they couldn’t continue to borrow and spend as they had for the previous half a century. Most of their debt was mortgage debt, and the price of housing was falling.

The feds reacted, as they always do... inappropriately. They tried to cure a debt problem with more debt. But consumers were both unwilling and unable to borrow. Their incomes and their collateral were going down. This left corporations and government to aim only for their own toes.

Central banks created more money and credit – trillions of dollars of it. But since the household sector wasn’t borrowing, the money went into financial assets and zombie government spending. Neither provided any significant support for wages or output. So, the real economy went soft, even as the cost of credit fell to its lowest levels in history.

Third, the developed economies have been zombified. The U.S., for example, is way down at No. 46 on the World Bank’s list of places where it is easiest to start a new business. And only one G8 country – Canada – even makes the top 10.

Paperwork. Expenses. Regulation. High taxes. High labor rates. Entrenched competition with aging, loyal customers. All are endemic from Boston to Berlin to Beijing.

Leading industries – heavily controlled and regulated, including defense, education, health, and finance – are practically arms of the government. All are protected with high barriers to entry and low expectations. Competition is barely tolerated. Innovation is discouraged. Mistakes are forgiven and reimbursed.

Meanwhile, the masses are encouraged to become zombies too, with generous rewards for those who 1) do nothing, 2) pretend to work, or 3) prevent other people from doing anything. After all the zombies, cronies and connivers get their money, there is little left for the productive economy.
The Solution Begins When Markets Crack

Typically, these problems – too much debt, too many zombies, and too many old people – lead to financial crises. Then, they are “solved” by either inflation or depression. And the solution begins when markets crack.

Markets never go up forever. Instead, they go up, down and even sideways. They breathe in and out. And after sucking in air for the last 30 years, US financial assets are ready to exhale. Legendary asset manager Bill Gross comments:

> When does our credit-based financial system sputter/break down?
> When investable assets pose too much risk for too little return.

Not immediately, but at the margin, credit and stocks begin to be exchanged for figurative and sometimes literal money in a mattress.

When that happens, problems begin to take care of themselves, in one of two ways...

A quick, sharp depression wipes out the value of credit claims. Borrowers go broke. Bonds expire worthless. Companies declare bankruptcy. The whole capital structure tends to get marked down as debts are written off and financial assets of all kinds lose their value.

Or, under pressure, the feds print money. Debts are diminished as the currency loses its value. The zombies still get money, but it is worth less. Inflation adjustments cannot keep up with high rates of inflation. Pensions, prices and promises fade.

Either way, the slate is wiped clean and a new cycle can begin.

But what rag will clean the slate now?

The Beginning of the End

In early May 2015, our proprietary short-term stock market indicator has turned starkly negative, as shown below:

The near-term outlook is clearly darkening. Based on simple regression-to-the-mean logic, our model now suggests that the “most likely” course for U.S. stocks through the end of the summer is a loss of more than 6%.

As to the long-term outlook...

The bad news is much worse.

The logic of the “long depression” is simple: aging populations, debt, zombification – all of which slow growth.

How many old people and zombies do you need before an economy comes to a halt?

Nobody knows. But the drag from debt is observable and calculable.

Over the last three decades, approximately $33 trillion in excess debt has been contracted – above and beyond the traditional ratio to income – in America alone. And growth rates have fallen in half.

That’s because dollars that would otherwise support current spending are instead used to pay for past spending. Our old debts have to be retired with current income.

The money doesn’t disappear, of course. Some goes to creditors who spend it. Some comes back as capital investment, which is a form of spending. But as credit shrinks, generally, so does the economy.

And that brings us to the impossible situation we’re in now.

In order to get back to a healthy ratio – say approximately $1.50 worth of debt for every $1 in income – you’d need to erase all that excess that has already been contracted. In other words, you’d have to take $1 trillion out of the consumer economy every year for the next 33 years.

It would be the longest and deepest
depression in US history.

**A Credit Crisis, Complete with Howling, Whining, Finger-Pointing**

Take a trillion out of the U.S. economy and you have a 4% decline in GDP. Then, as the economy declines, the remaining debt burden becomes even heavier.

Try to pay down debt and it becomes harder and harder to pay down. You stop buying in order to save money. Your local merchants lose sales. Then they try to cut expenses, and you lose your job.

In other words, no “steady state slump” is possible.

When the credit cycle turns, it will not be a gentle slope, but a catastrophic cliff... a credit crisis, complete with howling, whining, finger-pointing... and more clumsy rescue efforts from the feds.

As we said yesterday, there are two solutions to a debt crisis. Inflation or deflation.

Central banks can cause asset price inflation. But it is not always as easy as it looks. Consumer price inflation requires the willing cooperation of households.

With little borrowing and spending from the household sector, credit remains in the banks and the financial sector. Asset prices soar. Consumer prices barely move.

U.S. consumer price inflation over the last 12 months, for example, was approximately zero.

The assumption behind the “long depression” hypothesis is that central banks cannot or will not be able to cause an acceptable or desirable level of consumer price inflation. As a result, the economy will be stuck with low inflation, low (sometimes negative) growth and low bond yields.

But what about deflation? If inflation won’t reduce debt, why not let deflation do the job?

**Deflation Works!**

We’ve been exploring how the credit bubble resolves itself. Inflation? Deflation? Are we locked in to a long, long period of stagnation, slump and economic sclerosis?

First, we give you our long-term forecast.

“Long-Term Market Forecast

May 7, 2015

-9.8% -4% +2%

-10% +8% +12%

-10% +2%

www.bonnerandpartners.com

“This is the most negative ever,” says our chief number cruncher Stephen Jones. It shows a loss of 9.8% every year for the next 10 years. In other words, our mean-regressing, debt/demography-adapted model seems to be pointing to a long depression.

But an average loss of 9.8% per year over 10 years can happen in a number of different ways. Little by little. Or in one savage blow.

A foreshadow of the long depression crossed the planet like a total eclipse of the sun twice in the last 100 years.

The first time was America’s Great Depression. You know that story. Stocks crashed. Businesses went broke. People lost their jobs. Banks failed. Events were following the typical depression script, which probably would have bottomed out and recovered within a couple of years – as happened in the depression of 1921.

But then, the federal government stepped in. It froze prices, including the price of labor. It cut off trade. It blocked liquidations. It arrested the progress of the correction.

Murray Rothbard analyzed the policies of the Hoover and Roosevelt administrations in his 1963 classic, America’s Great Depression. He showed how government, trying to stop the Depression, actually prevented it from
The Bill Bonner Letter

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The short, quick deflationary shock – which should have slashed bad debt, bad businesses, and bad investments – turned into a long, agonizing slump. The Depression, which should have been over by 1933, continued until the 1940s and was only ended then by the biggest public works spending program in history – World War II.

This, by the way, did not actually make people better off economically, but it “put people to work” and largely disguised the drop in living standards which that war and the Depression had caused.

The second long depression was in Japan, following the crash of its stock market in 1990. It has now been a quarter of a century since that crash. Japanese GDP has scarcely advanced, as you can see in the following chart:

The blame for the long-ness of the depression can be placed squarely on the government. To this day, it continues to meddle in the economy – essentially forestalling a genuine cleanup of bad debt.

Instead of allowing the bad debt to be written off and reduced, policymakers have added more and more debt over the entire 25-year period so that today, Japan’s government is the most indebted in the world.

And now Japan is running out of time and money. Its aging population is no longer saving for retirement; now retirees expect to spend those savings. This means that the government can no longer count on financing from Japan’s savers. Now it must return their money.

But how? It has no money to give them. Like the U.S., it has been running budget deficits for years.

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Japan’s economy is in a crisis. It’s been two years since the Shinzo Abe government began its stimulus program. But wages are actually lower today than they were when it began. And this is happening against a backdrop of falling labor supply; the labor pool is expected to shrink by 20% over the next 25 years. The main goal of the stimulus program was to raise Japan’s inflation rate. But you could multiply the last 12 months of price increases by nine and still not reach the government’s 2% target.

In the U.S., too, inflation has been disappearing as fast as good manners. In the last 12-month period, consumer prices were approximately flat. And that is despite a 400% increase in the Fed’s assets – the nation’s money foundation – over the last six years.

If that kind of money printing doesn’t cause an increase in the CPI, what would? We’ll come back to that question in a minute.

Cheap Credit Keeps the Wheels Turning

If inflation can’t be counted on to reduce the world’s debts, what about deflation?

The feds fear it, loathe it and try to prevent it every way they can. But deflation works. It knocks down sales, prices, and employment, forcing borrowers into bankruptcy. Then, their debts are worthless.

Alas, in a zero-rate world, the banana peels disappear from the sidewalks. It is almost impossible to go broke, default, or fall on your face.

Grant’s Interest Rate Observer told the story of one company: Radio Shack. The company lost the plot back in 2007, says Grant’s. The Onion satirized its chief executive, Julian Day, putting the following words in his mouth:

There must be some business model that enables this company to make money, but I’ll be damned if I...
know what it is.

But Radio Shack stayed in business – borrowing ever more money as its credit rating declined from BB- to D (or “junk”) over the following eight years. Finally, it bit the dust in February of this year.

There’s nothing like unlimited cheap credit to keep the wheels turning – slowly. In 2009, a grim year for American business, 60,837 firms declared bankruptcy. In 2014, there were 26,983 bankruptcies.

What is surprising is not that there were so few, but that there were so many. When you can borrow for nothing… or close to nothing… why does anyone ever default?

Of course, not all firms have equal access to the free money. The little guys go broke. The big guys stay in business. The economy stays alive, but on life support.

The big limitation of this system is that as the slump worsens, prices fall and real interest rates actually go up. That is, the feds may lend at zero, but if prices are falling, the effective, real borrowing rate may rise.

The authorities would be “zero bound,” unable to take nominal rates below zero and unable to keep the real price of money at nothing.

Until recently, it had been presumed that rates could not sink below zero. People would not pay for the privilege of holding cash in a bank or a bond; they would just take the cash and hoard it.

But all over the world, central governments have begun a “war on cash” designed to force people to use credit, rather than cash. The feds can monitor, tax, and control credit. They can even force you to pay for the privilege of having it.

The European Central Bank and the Swiss National Bank already require depositors to pay for storing money. And beginning this week, JPMorgan Chase began charging depositors a “utilization fee” to hold their money.

Meanwhile, economists are advocating taxing cash or even, like Harvard economics professor Ken Rogoff, making it illegal. France has already made it illegal to pay bills of more than 1,000 euros with cash. And the U.S. requires financial industry workers – such as bank tellers – to rat out customers by filing “suspicious activity reports” on anyone who comes in with what they consider an inappropriately large amount of cash.

Why the “war on cash”?

Partly to control you. And partly to control the economy. If they can create a NIRP world – with negative nominal interest rates – they may be able to keep the credit flowing to cronies and zombies, maintaining the economy in a coma for many years.

Businesses that should go broke will have access to credit. Speculators will still make money. Governments will continue to print money and borrow it from themselves. The zombies will throw rocks and bottles every once in a while, but they will still get their cash and the system will survive.

Long, drawn-out depressions are caused by governments.

The politicians respond to today’s capital interests, not tomorrow’s. Today’s retirees vote. Today’s stockholders give campaign contributions. Today’s cronies control the power and money of today’s society.

And all of them fear one thing more than any other: the future.

They all know they will die, and that the process of capitalism is creative destruction – today’s wealth owners must be stripped of their money and power so that tomorrow’s generations can take over. And that’s why government’s essential role is to look into the future and prevent it from happening.

This is just another way of saying that governments will always try to stop depressions, because depressions are creative destruction in action.

Capitalism chops down today’s trees so that tomorrow’s saplings can get some air and light.

But trying to stop creative destruction does not stop the future. It just changes it. Instead of a dynamic, honest and growing economy, we get stagnation, economic gangrene and financial rigor mortis. Long depressions, in other words.

Don’t Expect the Fed to Sit Tight

As we have seen, Japan has already had a 25-year slump. The U.S. is now in Year 8 of its slump, with fragile growth at only half the rate of the last century. They could get better… or worse.

Negative rates could keep the cronies in business. The slump itself – combined with peak debt and 500 million Chinese laborers – could keep inflation in check.

But the point comes when investors see that the risk of loss (because something can always go wrong) is greater than the hope of gain. That moment must be approaching in the U.S. stock market. Prices are near record highs, even as the economy flirts with recession.

One day, perhaps soon, we will see stocks falling – as much as 1,000 points in 24 hours.

Jacking up the stock market has been the Fed’s singular success. Activism has been its creed. Interventionism is its
modus operandi. It will not sit tight as the market falls apart and the economy goes into recession.

Instead, it will announce QE 4. It will try to enforce negative interest rates. And it will move – as will the Japanese – to “direct monetary funding” of government deficits. That is, it will dispense with the fiction of “borrowing” from its own central bank. It will simply print the money it needs.

The U.S. Fed of 1930 was not nearly as ambitious and assertive as the Fed of 2015. In the ’30s, it watched as the economy chilled into a Great Depression. As Ben Bernanke told Milton Friedman, “We won’t do that again.”

It couldn’t if it wanted to. Back in the ’30s, consumer debt had barely been invented. Most people still lived on or near farms, where they could take care of themselves even if the economy was in a depression. Few people had credit. Instead, they had savings. There were no food stamps. No disability. No rent assistance. No zombie industries. No student debt. No auto debt. No cash-back mortgages. And cash was real money, backed by gold.

Today, a long depression in the U.S. would be unbearable. The public couldn’t stand it. Six out of ten households live paycheck to paycheck. Can you imagine what would happen if those paychecks ceased?

Supposedly, the U.S. economy is still growing... with the stock market near record highs. Yet, one out of every five households in America has not a single wage-earner. Among inner-city black men, ages 20-24, only 4 out of 10 have jobs. Half the households in the U.S. count on government money to make ends meet. And 50 million get food stamps. What would happen to the cities – and the suburbs – in a real depression?

What would Janet Yellen do? Would she repeat the words of Andrew Mellon in 1929 to “liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate... it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people.”

Mellon was just suggesting that creative destruction be allowed to do its job. He was the last Treasury secretary to make such a forthright and honest comment. Thenceforth, Treasury secretaries and central bank governors could no longer accept the tough love of a free enterprise economy. They had to offer bogus rehab and claptrap therapy. They had to stop creative destruction. They had to “tell it like it wasn’t” because that’s the way people wanted it. They had to pretend to make a better world by improving the market economy.

We Need Another Mellon

Today, a central banker or Treasury secretary who let deflation purge the rottenness from the system would be dismissed before sundown. Too much wealth, too many reputations, too much power and status depend on the continuation of the credit expansion. Instead of a Mellon, we will have a Greenspan, a Bernanke, or a Yellen. And we will soon find out whether Mr. Bernanke spoke the truth in 2002 when he said:

We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

Threatened with deflation, the authorities will want to turn the tide in the worst possible way. What’s the worst way to stop deflation? With hyperinflation.

Yes, we may suffer a year or two more of sluggish growth... or even deflation. Stocks will crash and people will be desperate for paper dollars. But sooner or later, the feds will find their feet and lose their heads.

Most likely, the credit-drenched world of 2015 will end... not in a whimper of deflation, but in a bang. Hyperinflation will bring the long depression to a dramatic close long before a quarter of a century has passed.