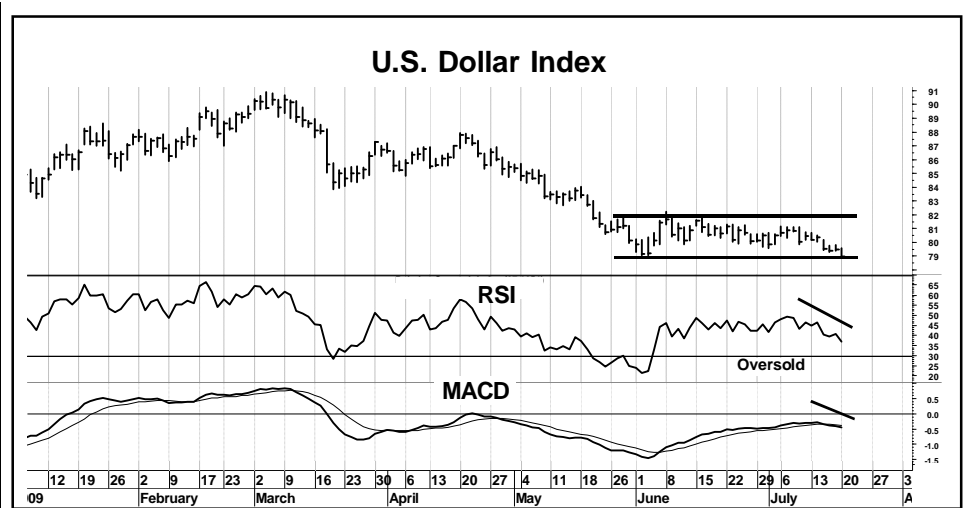


## Inflation Versus Deflation



**The next issue will be published August 5.**

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Is the U.S. dollar going to stay in this trading range forever? If it does, gold will likely stay put as well. MACD and RSI are neutral, but both are turning down as I write this. I am going to defer to our Rydex Dollar Trading Program (Page 2, online update) and merely say that its last signal was a sell. Until the U.S. Dollar Index reaches 81.17 or higher basis September, I will stick with a negative outlook.

Looking back to early June, the dollar bounced off an oversold low. It has not been able to make much of that on the up side - only an initial burst and then a stall within a trading range for the past two months. Frankly, I would enjoy a last ditch rally here because it would push gold back some, and I would dearly like to add to my gold positions. Even so, I think time is running short, and the cycles and other technicals are hinting that the next major move will be up in gold.

Most of our gold stocks have not hit their most recent downside buy prices, but we were able to buy **Royal Gold** (RGLD-OTC) at our price of \$38.00 on July 8. For now, you should just hang on to what you have. I will update the downside buy prices again in the August letter if called for.

My fundamental reason for a negative outlook on the U.S. dollar is a world war that I see developing. This one is not a competition between troops on the battlefield, but rather a competition between countries for financing. Things are going to heat up big time. All in all, there is just not enough money available to finance a worldwide bailout.

Do not underestimate the power of Bernanke's helicopters or the dollar's somewhat premier advantage in the world. The dollar will not always be the world's reserve currency ... but it is for now. We have the advantage in a war to borrow money. Nevertheless, the world needs over \$5 billion in new government

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financing over and above the demands of the private sector – corporations, individuals, etc. This is new financing on top of what is already being borrowed. It doesn't take a math whiz to see that the money is not there unless something changes drastically. My bet is that the most startling change will be higher interest rates.

There are more deleveraging and economic problems ahead, and our government will respond with more dollars. If they run out of lenders, the Fed will step in as the lender of last resort, which is their patriotic "duty." It will all be inflationary in the end. This brings us to a look at the inflation versus deflation argument.

The basis of the deflation argument is that private debt is disappearing through default or deleveraging faster than the government can replace it with public debt. The jury is out on this race, I admit; but my money is on the government. They have the biggest hammer. However, the direction of the prices of goods and services in the future will not be homogeneous.

There are a lot of things that consumers do not want or need and that they can ill afford. The prices of these items will fall. Housing-related items - be that construction supplies (lumber, etc.) or furnishings - will not find much demand, and prices will fall. Clothing (which is in serious over supply), expensive restaurant meals, foreign automobiles that are now built to satisfactorily last 200,000 miles with little problem, and "foo-foo" impulse items like ShamWow's will all find few buyers. Dollar stores will become dime stores once again. Folks will be more apt to buy used items, especially cars and other durable, big ticket items. Unnecessary services will suffer. People will clean their own houses and mow their own lawns. The vacation business and states like Montana that rely on tourism would be wise to adjust their expectations.

The retail industry has been designed to sell what folks do not need, and that is going to change. Excess, non-essential inventory will sit on the shelves and collect dust until the 100,000 square foot box stores close and a new retail vision takes over. Frankly, I think that vision includes a major shift to online commerce. Margins will suffer some in this strategy, but survival will be enhanced. WalMart needs to make a few adjustments, but they are close to having it right. It remains to be seen if they can continue to grow their profits, however. They need to focus on survival.

On the other hand, those items that we have no choice about using or bills we have no choice about paying will grow more expensive. Insurance costs will rise, health care costs will rise, and education will be more expensive. Your taxes are not going to fall. Increasingly scarce raw materials finding increasing demand elsewhere in the world are going to become pricier, and energy costs will continue to increase. Thus, pricing is going to be a mixed bag. What can be done without will be sacrificed to pay for that which cannot be done without. In the meantime, the dollar will continue to sink, along with the rest of the fiat currencies of the world as nations vie within a swirl of economic chaos to fund their rescue programs.

Chaos is why gold does well in deflationary times as well as in inflationary times. I include gold as a tangible asset (which it is), but I tend to toss all tangibles into the "commodity" category. Gold is not only a commodity – it is also money. Gold has been money for thousands of years. As the globe's economic and financing crisis evolves over the next few years, savvy folks are going to begin escaping fiat currencies and opt for real money. Paper will be shunned in deference to tangibles. Dollars will be the quintessential "paper" asset while gold is ... well, there is no other way to say it. Gold is money. Gold, a dependable store of wealth for time immortal, is always turned to and hoarded when times get tough.

Government stimulus will be absorbed and may provide temporary improvement, but there is nothing out there that I can see that can fuel a sustained economic recovery. The Obama rally seems to have gotten some traction again of late, and both our Nasdaq Slow Tracker model and Palio timing model are now positive, as reported on the online updates. The Slow Tracker will turn negative if the Nasdaq Composite falls to 1,727 or lower. However, the Obama rally is now on borrowed time and will lead to a high in August. The August high will mark the culmination of the move off the March lows. The next significant move in the averages will be down to new lows. Use strength to liquidate paper-related assets.

*Where should you go with your money?* First, shun the U.S. dollar, common stocks, and bonds. Buy what folks need – energy. As confidence in "money" fades, gold will continue to do well. It does very well during times of crisis, and there are more mishaps to face as this year wanes - tragedies in financials in particular and in the economy in general.