THE NATIONAL INVESTOR

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September 2004 “For where your treasure is, there will your heart be also.”—Matthew 6:21 **Special Issue**

Understanding The Game

As the last decade—and millennium—were drawing to a close, it seemed as though the mighty capitalistic American economy had reached its destiny. Growth and job creation were surging. The U.S. stock market was reaching new heights. Interest rates and inflation were relatively tame. The U.S. dollar—the world’s reserve currency—stood out as the paper that everyone wanted; and its value also moved inexorably higher.

It seemed as though the good times would never end. Even the Y2K scare proved to be much ado about nothing; and after we flipped our calendars to the Year 2000 and learned all was still well with the world, the party briefly continued.

But then the landscape for investors began to change; and has continued to do so radically during the last four or so years. The historic bull market in stocks that carried us throughout most of the 1980s and 1990s breathed its last. Following its March, 2000 peak, the high-flying Nasdaq began losing its air at an accelerating rate. Initially, the broader market withstood the bleeding in technology, Internet and telecommunications stocks. Soon, however, even many of the value-oriented issues that bucked the initial trend were caught up in the selling.

What resulted for a while was the worst three-year period for the stock market in six decades. From 2000-2002, the Standard and Poor’s 500 Index shed 39% of its value. This eclipsed the 34.2% loss that same measure suffered from 1939-1941.

Just as has happened during virtually all the prior major downturns in the stock market, the investing intelligentsia groped for reasons why their party had been so rudely crashed. Through early 2000, most everyone was a hero or a genius—or both. Now, the “experts” had turned into goats.

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A paltry 6% of respondents in a recent poll at least came close to the truth, when they blamed Fed Chairman Alan Greenspan for the woes of the last few years

AN EARLY "WAKE-UP CALL"

Early on in what was the first phase of my involvement in the investment world, I learned a hard lesson as to why it was CRITICAL for anyone in my position to understand the nature of not only the Federal Reserve itself, but how the central bank's actions have *predictable effects* on the economy and markets.

Back in 1979, fresh out of high school and at the ripe old age of 18, I was recruited by a local financial planning firm in my home town of Binghamton, New York. In the Fall of that year, I obtained the necessary licenses to become involved in the insurance and investment world. Eventually, I became a general securities principal and helped supervise representatives of my growing firm, most of whom were old enough to be my parents, if not in some cases my grandparents. A bright future seemed to be ahead of me in an exciting industry.

As much as we all referred to ourselves as "financial planners," we were, in the end, salespeople. Sure, we had many competitive advantages; but in the end, we wanted—just like anyone before or since—to sell those investment products that would make us heroes to our clients.

For a while when I started, I was a hero. I had in particular been coached to sell one particularly hot mutual fund which was capitalizing on the late-1970s surge in commodity prices and related stocks. In 1979, this particular fund went up by over 30%; and in 1980, the increase was 60%. While such double-digit returns became fairly commonplace in the last part of the 1990s they were virtually unheard of back then; so you can imagine how happy our clients were that we'd had the wisdom to put them in this fund!

Naturally, we continued to sell this fund based on its incredible track record. But then something started to go wrong; namely, the same mutual fund shares that seemed to be going up monthly for so long (if not weekly) began to *decline*. Weeks then turned into months of losses. I felt anxious, and somewhat helpless.

I felt helpless because nobody was able to come up with an understandable reason for me as to why this previously hot mutual fund was now taking on gas. I asked my good buddy who was a wholesaler for that fund what was happening. I asked colleagues. I asked the partners who owned the firm I worked for. To a man, they all gave me the same answer. "Don't worry, markets always go up over the long run," I was told. "You don't want to try to time the market." "You need to have faith in the fund's management team." Etc., and etc. (Have *you* heard that from *your* broker over the last few years?)

Looking back on this period of time, the reason why this particular fund (and many like it) would have suffered was so predictable that it annoys me even to this day that none of us had either the understanding or initiative to get our clients out of harm's way. As history shows, then-Federal Reserve Chairman Paul Volcker resolved that he was going to kill off that particular bout of commodity price inflation by whatever means necessary. He raised interest rates to unprecedented levels, choking off credit creation and removing the fuel that had taken oil to near $40 per barrel, and gold—albeit briefly—to over $800 per ounce. Both began to sink; and with them, the stocks of those companies producing and selling the commodities. Just the kind of stocks our favorite, previously hot mutual fund was *still* heavily invested in.

That policy change by Chairman Volcker was the most dramatic of any Fed chief in the central bank's history to that point. That I was not equipped to 1) understand the ramifications of that change in policy and 2) protect my clients' gains when it became necessary gnawed at me. I never did get a sensible explanation as to why the losses our clients suffered could not easily have been foreseen and, therefore, avoided.

Thus, I became resolved to learn and understand "The Game" of Fed policy and our monetary system, so as hopefully *never* to be caught unawares like that again. Over the last two decades, I have not only learned "The Game," but have been privileged to share what I have learned in a positive way with untold thousands of people. I am happy and proud that you, the reader, now have that opportunity as well.

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As usual, the search has not yet led to the right answer. In a poll conducted recently by America Online—participated in by some 250,000 people—members were asked the question, "Whom do you blame most for the poor economy and bad markets of the last three years?" The answers were:

25% -- President Bush
19% -- President Clinton
15% -- Greedy CEO's
9% -- Dishonest companies
7% -- Dishonest analysts
6% -- Fed Chairman Alan Greenspan
5% -- Greedy investors
5% -- Other
4% -- Terrorists
4% -- Ineffective regulators
2% -- Foreign competition

It stands to reason that when only a precious few anticipated that the landscape was about to change dramatically for investors as we moved into 2000, few today—even with the benefit of hindsight—can figure out why. After all, when even Fed Chairman Greenspan himself seems to have lost his grasp on reality, I guess it follows that mere mortals will fare no better.

Though long since having been granted sainthood by investors (to add to his knighthood status conferred a while back by Queen Elizabeth) "The Maestro" to some of us has nevertheless been a man who has himself often seemed adrift and unsure of what is really going on the world he rules. In hindsight, we all know a stock market bubble unlike any seen since the 1920s was created by the Fed Chairman during the 1990s. Yet he never seemed to admit what he was doing. Sure, on a few occasions he managed to publicly talk in hypothetical terms about it, such as in his famous December, 1996 speech when he asked the rhetorical question, "How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the last decade?" But for the most part, Greenspan is a man who is fighting both history and the laws of mathematics as he attempts to ameliorate the consequences of irrational exuberance's fallout here in America.

Since the end of 2002, a dose of tax cuts, enormous stimulus by the Fed and the accumulation of record amounts of both public and private debt have led to a false prosperity. Stocks have enjoyed a cyclical upswing; though it is one that now appears to have ended earlier this year. The economy is said to be doing well; yet Main Street doesn't seem to have the confidence that many on Wall Street have regained. Especially as we're in the home stretch of an election year, the rhetoric and the bovine feces are flying as various camps hold forth on their perception of the future of the American economy.

Will we return to the good old 1990s? Are stocks still "good for the long run?" Will the so-called housing bubble collapse? Is the world irreversibly changing?

To answer these questions and others, we must first deal with some basics, upon which we will then build.

UNDERSTANDING OUR FRACTIONAL RESERVE SYSTEM

As I have told audiences countless times, investors—and Americans generally—lack one basic yet incredibly important understanding when it comes to finance. We talk about the rising value of our home. We recently have spoken in less glowing terms about the falling value of our stock portfolios. Gasoline, food and health care costs are rising. For some, future retirement incomes seem in some doubt.

The one common denominator in these and so many related discussions is a unit of measure called the U.S. dollar. You would think it would behoove the citizenry, or at least those economists and financial gurus claiming to guide the hoi polloi, to have an accurate grasp of just what a dollar is, where it comes from, how it is managed and all the rest. Yet very, very few understand the core characteristics of these dollars they hold, earn, or seek to accumulate somehow over time. It's little wonder, therefore, that the great majority of Americans are so adrift.

"*All the perplexities, confusion and distress in America arise, not from defects in the Constitution or confederation, not from want of honor or virtue, so much as from downright ignorance of the nature of coin, credit and circulation.*"

--President John Adams

Many of you reading this are familiar with the above quote. Like similar ones, it is often used by "hard money" advocates to call for a return to some type of gold standard for U.S. currency, if not for a wholesale return to using physical gold and silver coin in our economy. It's been my observation over the years, though, that the larger context and meaning of Adams' statement—and its particular application to today's economy and monetary system—has not been fully understood, even by some students of monetary matters. Most observers, serious though they may be, often lose sight of the nature of the "money," we use today (i.e.—credit) the process of its creation and the methods by which it is controlled in what, to me, is a relatively unimportant issue of what *substance* money is.

There is nothing magical about the craft of what some, including the Fed itself, call *fractional reserve banking* (a "craft" it can indeed be called.) Money creation is a deliberate, definable process; its volume and price are fairly identifiable. Few have been able to put all of the pieces together, though and identify—*and understand*—"The Game," and how it works. As the British economist John Maynard Keynes wrote in his 1920 book entitled, The Economic Consequences of the Peace, "not one man in a million" is able to diagnose the intricacies of central banking, its inflationary component, and how over time it robs the masses of wealth.

We're about to increase those odds.

When we do—once you understand what follows—you will immediately have more insight into what makes this whole mechanism called the U.S. economy work than does your local banker. You'll have a much better idea of which way the financial markets and interest rates are going than does your most tenured local stock broker (who, if he or she is like most, is nothing more than a glorified salesman anyway.) And, of course, you'll be in a better position than most to generate profits in your investments and, just as importantly, to know how to preserve them as well.

To understand it all, we must first understand what we use *as money*; what it is, where it comes from, how it comes into being, etc... For the purposes of this report, at least, it makes no difference whether what we use AS money is gold, silver, paper, bookkeeping entries, or numbers on a computer screen. Once we fully understand the way in which our dollars are "born" and subsequently work their way into and through the economy and markets in a fractional reserve system, we'll be far better equipped to understand all the things going on around us, including in our portfolios.

I like to use simple analogies whenever I can in trying to convey an important point. *This is especially true when attempting to teach the process of money creation.* In doing seminars, radio, writing and otherwise sharing this critical understanding over the years, my favorite prop has been an ordinary deck of playing cards. When possible, I'll take four people and place them at a table. I am the "banker"; thus, I have the ownership and ultimate control of the deck.

To show how what we use as money today (essentially, *bank credit*, called dollars) comes into being, and how it works, I deal each of the four people at the table five cards. I inform them that they have until this evening to play one or a number of games among themselves with those cards, provided they play by some general rules that I establish.

I also inform them that when I return each player will be obligated to repay me; not five cards, which was the amount of the "principal" I loaned, *but six cards.* After all, the cards are mine; I am entitled to a profit, or "interest," for loaning them to each of the players. Thinking that they each might have a reasonable chance, since they're all experienced card players, they agree.

Oh, and one final condition. If any of the four is unable to pay me six cards when I return, I will be the new owner of their home.

More often than I care to tell you, it's taken quite a while for anyone in the audience to tell me what is *fatally wrong* with this scenario. Of course, you all know already...*I did not put enough cards on the table!* I don't care how good these four card players are, nor does it matter that their very lives might even be forfeited if they are unable to repay the debt. Simple mathematics dooms at least one of these sorry individuals to losing his or her home.

Of course, it would be cruel and heartless of me to foreclose on this person; after all, the "luck of the draw" doesn't always go your way. Therefore, I'll make him a deal (and SUCH a deal at that.) He now owes me six cards (we'll say for sake of this discussion that the other three wiped him right out.) I'll loan him the six cards with which to "roll over" his debt; but now, he'll owe me *eight* in the end. "No problem," he says to himself, "I need only come up with two more. My luck is bound to change!"

And so, the game goes on, and on, and on...but it cannot—and will not—go on forever. When the total debts owed me by the card players, including their interest, is always greater than the total number of cards in the game, there will always be at least some debt.

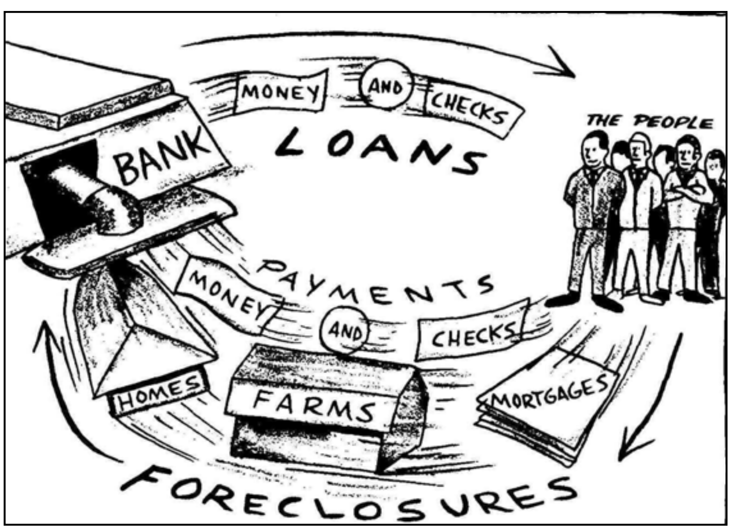
Now, let's relate that analogy to real banking itself. In an old *Newsweek* magazine story on the Federal Reserve system, that publication stumbled upon but then dropped a critical truth of fractional reserve banking. In its February 24, 1986 issue, in a piece entitled "Making Money Out Of Thin Air--The Fed Is The Economic Equivalent of The Kremlin" their reporter Bill Powell reported, "The Fed controls the supply of money banks have to make loans...With the stroke of a few computer keys, the Fed creates money out of thin air, adding funds, known as reserves, to the (local) bank. The bank is able to lend out those reserves several times over, creating even more money."

So, in part through what is known as its "open market operations," the Fed thus generally sets the amount of money that commercial banks can loan--money created literally *"out of thin air."*

It is these funds--multiplied several times over--that local banks loan into being each day in the form of business, personal, mortgage, credit card and assorted other loans. *That is how what we use as money--bank credit created out of thin air--comes into existence.*

But getting back to our card analogy, here's the punch line.

Let's suppose that you and nine other people go to the bank and take one-year loans of $10,000.00 each. The banker puts a total of $100,000.00 in circulation, correct? If he requires 10 per cent interest over the course of the year, you must each pay him back $11,000.00, for a total of $110,000.00, right? Do we not have the same problem as our card players? If there has not been sufficient numbers of dollars created and loaned into circulation to pay both the principal and interest, can all of these debts ever be repaid? The answer is clearly no.



Hopefully you see the situation, but now pay especially close attention...

As time marches on, the banker (actually, the entire system, up to and including the Federal Reserve) must continue to make loans—to increasing numbers of people, and in increasing amounts—to keep the whole game going. As you hopefully see already, *principal* amounts previously loaned are all that is out there for everyone to use to make payments of both principal *and interest*. NOTHING has ever been put into circulation to make interest payments on all our public and private debts—do you see that, my friend? We all, public and private sectors alike, compete for money that has been "created" previously as principal amounts of loans. *As the debt load has grown, it's all the system can do through its E-Z-money policies just to keep the majority of Americans whole enough to merely service their debts.*

Our fractional reserve system is doomed to failure of some kind—just as every prior manifestation of such a system has ultimately collapsed. That our dollars (credit) are of a fiat variety (not backed by or redeemable in any substance) is truly secondary to the fatal flaw that such a monetary system as we have eventually collapses under its own weight (and accumulated, unpayable interest.)

Many years ago, Robert Hemphill—who served as credit manager for the Federal Reserve Bank of Atlanta—summed this all up by saying the following:

"If all loans were paid, no one would have a bank deposit, and there would not be a dollar of currency in circulation. This is a staggering thought. We are completely dependent on the commercial banks. Someone has to borrow every dollar we have in circulation, cash or credit. If the banks create ample synthetic money, we are prosperous; if not, we starve. We are absolutely without a permanent money system. When one gets a complete grasp upon the picture, the tragic absurdity of our hopeless position is almost incredible—but there it is. It (the money problem) is the most important subject intelligent persons can investigate and reflect upon. It is so important that our present civilization may collapse unless it is widely understood and the defects remedied very soon."

"CONSUMERISM" DIDN'T COME ABOUT BY ACCIDENT

With the benefit of the foundational information on how our fractional reserve system works in the preceding pages, let's spend a few minutes addressing "consumerism."

Many of you, as I, have had occasion to visit with older relatives in particular who talk about how things were back in "their day." Life was much simpler in many respects. One of the evidences of this is just how much debt was not only sparingly used, but was once actually scorned by our parents and grandparents.

Apart from a home mortgage, members of generations past worked and saved their money. From their earnings, they bought a washer-dryer. A television set. A new car. If their particular middle-class job paid especially well, maybe even a few luxuries—a boat, a summer cottage, a vacation—could be afforded. In every instance, though, virtually all of these items, needs and wants alike, were purchased after folks had *first* worked for and earned their money.

Today, the average American does things in reverse. Armed with offers too tempting to pass up for a fist full of credit cards, a line of credit drawing on their home equity and similar mechanisms, today's American consumer spends money at a far greater rate than past generations. Short of working for the money first, however, most today go into debt to buy the latest gizmos, gadgets and such (more of which fall into the "want" category than "need.") They do so not only because the credit is so easily obtainable, but because they have the underlying optimism that the great American economy will never let them down.

Our parents and grandparents look at this kind of behavior in horror. Among other things, they feel that today's generation has become too materialistic, if not downright decadent. To be sure, there's a lot of truth to this.

However, what one and all miss as the discussion of today's consumerism usually revolves around "values" is a deeper—and, in fact, much simpler—dynamic. In short, now that you understand The Game of fractional reserve banking, you should be able to recognize that the behavior of consumers today is *more a question of simple mathematics.*

Simply put, the fractional reserve system would collapse if new debt weren't continually being taken on. Copious and ever-growing amounts of debt need to be created in order that consumers, businesses and government can 1) service existing debt, and 2) buy more stuff, much of which they don't need. By this means, the system, which can only exist on credit creation and rising debt loads, continues.

Well beyond a sign of how our values as a nation have changed when it comes to money, debt and materialism, today's consumer behaves as he (or she) does because it has become an everyday, accepted part of life. Further, such behavior is both taught and encouraged by the system: the banks, corporations, their Madison Avenue advertising agencies and all the rest. Yes, technological advances and the economy's remaining creative impulses have brought us more and better products and services with which we can live a better life; and I do not disparage any of that. But the system's *need* to push us all farther into debt by borrowing and consuming *so much* is what is chiefly at work here.

On that score, we've seen a proliferation in recent years of ways in which Americans can more easily go into hock. It used to be that, for a mortgage, one needed to accumulate, say, 20% in cash of the purchase price of a home. Armed with this, the average person could walk into the local bank and borrow the other 80%. The bank figured that since it was not risking the entire amount (and assuming the applicant had a sufficient income to make the mortgage payment) the risk was one worth taking for the return (interest.)

Today, it's common for someone to be able to buy a home with no money down. Further—if your credit and payment history is sufficiently strong—you can even borrow more than the value of the home itself! For years now many banks have made "125% mortgages" or home equity loans available. If your home is worth $200,000, for instance, the bank will loan you $250,000.

To keep the fractional reserve system humming along we also have the means today to take out mortgages where no principal payments are required, at least initially. By these devices, many more homes can be sold to new buyers who would not be able to afford them via a conventional note where payments including interest and principal would have them in over their heads. The same effect occurs with adjustable-rate mortgages, where homes become "more affordable" that otherwise are not, because the bank charges a lower rate of interest tied to what market rates are. Everything here is hunky-dory to some extent provided, of course, that interest rates don't rise significantly and lead to payments becoming unmanageable.

Not only does the banking industry have to "force" greater levels of marginally serviceable debt onto the public to keep The Game (and the housing bubble) in tact, but it has now graduated to prodding consumption elsewhere in similar ways.

Faced with a plunge in new car sales following 9-11 and the subsequent recession, Detroit was desperate to goose sales. In the intervening time, we've seen all manner of incentives designed to get Joe Sixpack to buy a new car, truck or S.U.V. Given the "no interest til Jesus comes," big cash rebates and the rest, Joe has happily obliged; and until recently, car sales were going through the roof. More cars have been moving, more debt is being incurred, and the gimmicks to keep up a decent level of sales (*that* has sure changed for the worse in the last few months, though) have gone on.

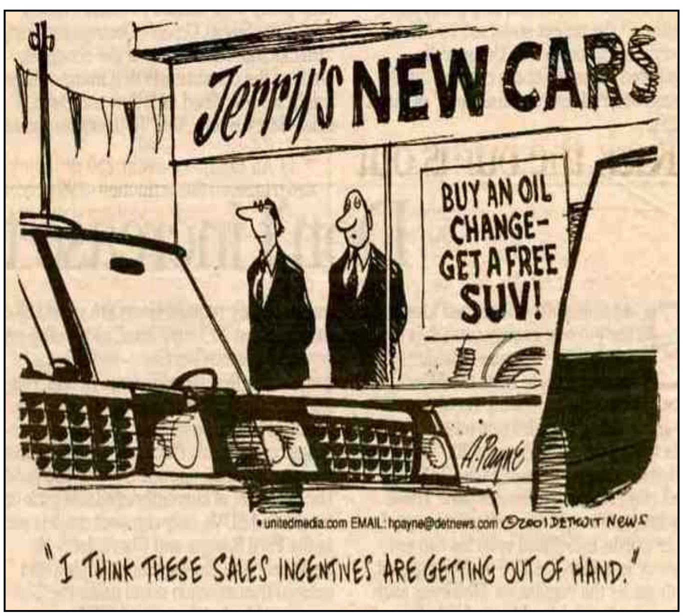
Even department and furniture stores…computer makers…and others are getting into the act. In almost every Sunday paper now, you'll find the majority of merchants pitching "no payments til 2005" or even (I kid you not!) 2006 in a couple I've seen recently.

Far from being benevolent, all these merchants—whether they are selling homes, cars, computers or shoes—are simply *doing what they have to do* to keep the fractional reserve system going a while longer. In the end, though (unless you believe that the housing bubble is going to keep growing indefinitely AND that stocks are going to commence a new multi-year bull market) the U.S. consumption-driven economy is doomed. This is for two reasons that should be obvious.

First, the consumer is finally getting worn out. I have likened the current plight to the following analogy: Let's say that you and I go out to the nicest restaurant in town, and really put on the dog. We get the nicest entrees, have the before and after dinner drinks, dessert and all the trimmings.

About the time we think we're going to explode, the waiter comes with the check. About the time I'm trying to move my body enough to take it from him he pulls it back and says, "We're sure happy that you enjoyed the meal so much. The total bill comes to $100.00. But before you pay it and leave, the chef asked me to tell you that he still has a lot of food left in the kitchen that he doesn't want to throw away.

"So, if you'll stay here and order dinner again before you leave, we'll only add another $10.00 to your ticket. May I start you off with a cocktail. . .?"



I don't know about you, but I can't eat another thing. I don't care if they *give* us another meal. Consumers are in the same boat; they have all bought new homes, refinanced it a time or two, bought three new cars, the latest upgrade for their computer and more—most of it on credit. As the automakers are now starting to discover, all the price cuts and incentives in the world don't change the fact that consumers are pretty well *stuffed*.

And, there's a second problem here which, in the grand scheme of things, worries me even more where the long-term outlook is concerned for America's consumers and, therefore, our economy and financial markets. *That problem is the recent stagnation in wage growth and the prospects for more of the same (or worse) in the future.* It's bad enough that Americans have gone from working and saving before making expenditures to the present situation where most borrow first and pay later. To the extent that the ability to ultimately pay off all this crap is based on future earning ability, the picture is dire. Thanks to the fact that America's leaders—both in public office and in corporate boardrooms—have long since embraced the ultimately destructive regimen of so-called free trade, middle class jobs in America, with their attendant middle class incomes, have been vanishing. More and more today, your fellow citizens are losing a $60,000 per year job and having to take two new ones paying a *total* of far less.

When you remember that consumer spending accounts for roughly two-thirds of overall economic activity in America—and when you realize that consumers' ability to take on endless amounts of new debt has peaked—you can come to no other conclusion than that we face a road ahead of us that (if we're lucky) will be similar to what Japan has endured for nearly 15 years. (NOTE: For a lengthy but extremely well-thought-out and presented look at the possible scenarios ahead for the U.S. economy and markets, check out "Japan, Argentina, Weimar or Muddle?" by Jim Willie, CB. It's archived on the "Other Experts" page of our web site.)

THE "WEALTH EFFECT"

Now, I know that it sometimes seems as though our economy's custodians are merely witless economists and political whores who are blithely leading the America we know and love to ruin. And if you think that, your views are not without foundation.

However, these people are not *completely* stupid. The bankers, for instance—led by the most famous (soon, maybe to be infamous) central banker of all time, Alan Greenspan—know that consumers need a little help in keeping The Game going for them, even beyond the E-Z-credit regimen they've constructed.

Thus, in recent years, Greenspan and Company have sought to foster an environment where the "growth" in individual and family balance statements would effectively add to consumers' ability to keep buying more and more "stuff." This has been accomplished in two ways.

First, the long-running bull market on Wall Street of the 1980s and 1990s added trillions of dollars to the balances of millions of Americans' retirement plans and brokerage accounts. Second, particularly as stocks' ability to add to Americans wealth and, thus, spending started to take it on the chin, another bubble was accelerated; that of the housing market. We'll take a quick look at these separately.

LOOKING FOR INFLATION IN ALL THE WRONG PLACES

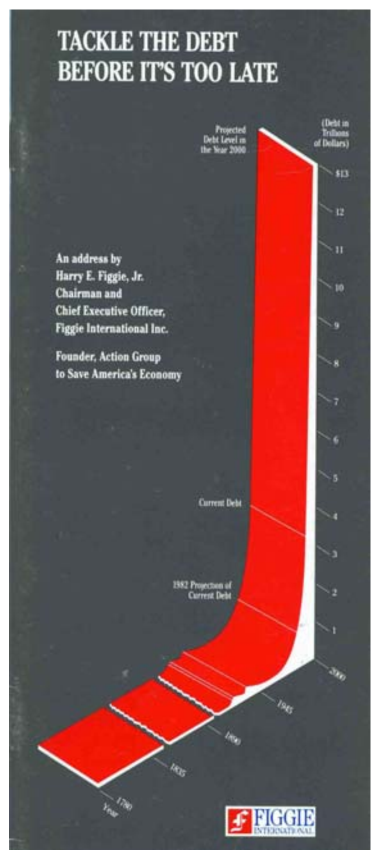
The commodity price inflation, soaring interest rates and debt woes of the late 1970s for a while seemed to be bringing the world economy to the brink of disaster. Entire nations—especially in Latin America—were defaulting on their external debts. Those nations' monetary and fiscal policies had resulted in skyrocketing inflation and interest rates which, after a while, ran into the hundreds of percentage points. Things were a mess; and, ultimately, it was a massive U.S.-led bailout (do you remember the so-called Brady Bonds?) that averted greater disaster for a while.

At the same time, some were sounding the alarm bells that the U.S. might be next. As we moved into the decade of the 1980s America's total national debt was getting ready to cross the $1 trillion mark. Our financial condition was rapidly deteriorating.

Soon after becoming president, Ronald Reagan made an early attempt to rein in the federal government's finances. He set up what was called "The President's Private Sector Survey on Cost Control," soon dubbed the Grace Commission for short after its head, industrialist J. Peter Grace. The commission's job was to identify ways in which waste, fraud, cost overruns and all could be sliced from the federal budget, and to otherwise make recommendations on how America could be run more like a corporation and less like how a drunken sailor behaves.

Sadly, few of the commission's recommendations were ever enacted. Yet this episode in trying to rein in the federal government did manage to create a "prophet" of sorts.

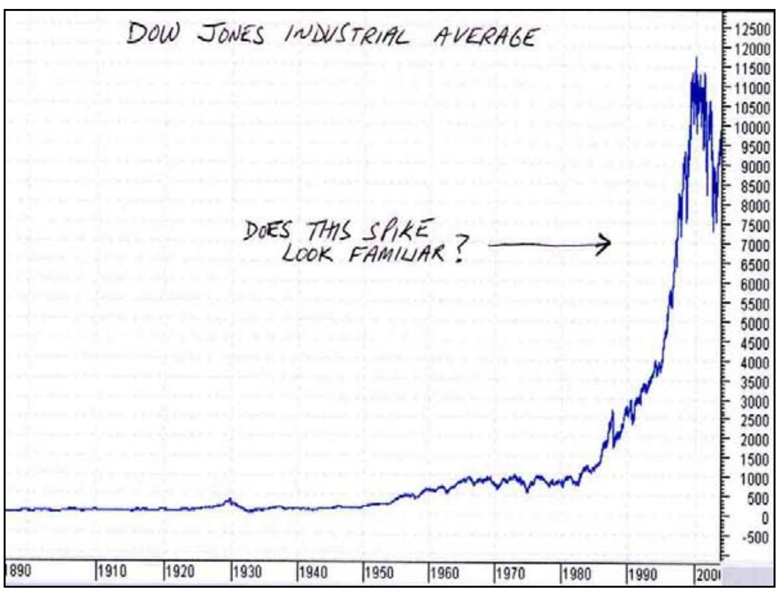
He was Harry E. Figgie, Jr., Chairman of Figgie International, a Fortune 500 company. Figgie was appalled at all he learned during his service on the Grace Commission, and increasingly became convinced that America was headed for a fiscal train wreck much the same as what the Latin American countries had only recently experienced. He became a crusader calling for fiscal discipline, and a prophet in warning that, at some point, the United States faced the same kind of hyperinflation that had been suffered by these other nations.



Figgie took out full-page ads in numerous newspapers, detailing how inflation rates in particular in these Latin American countries had first crept higher, then accelerated and, finally, spiked almost uncontrollably as the only means to service debts in them ended up being a massive inflation of credit. Inflation exceeded 600% in Argentina, 200% in Brazil and a Weimar Germany-like 11,000% in Bolivia. Figgie's ads were replete with charts graphically portraying the dizzying numbers, and warning that America was in for the same.

The man was on a mission, sincerely concerned that his country could economically fall apart. Simultaneously, others with less noble motives turned up their own rhetoric (quite often pointing to Figgie's warnings) about the impending hyperinflation and all the rest, which naturally included pitches for various products and services designed to insulate their audience from the ill effects. No matter the motivation, such forecasts certainly seemed reasonable, if not inevitable.

Yet a funny thing happened. As the 1980s—and then the 1990s—wore on, debt levels spiked sharply higher, just as Figgie had predicted. Now, for example, the official level of the U.S. national debt is nearly $8 trillion. Depending on whose numbers you believe, the real level of Uncle Sam's I.O.U.'s when you consider unfunded liabilities and the rest is way more than this. So, Figgie's prediction that the total federal debt would reach $13 trillion by the year 2000 may not have been off after all; and if anything, understates the *real total*.



Missing, however, was the attendant rise in inflation rates, let alone hyperinflation. In fact—and I'm sure much to the astonishment of Figgie and others—inflation and interest rates both generally trended downward during those 20 years. Incredible; or, maybe not.

As you can see here with this long-term chart of the Dow Jones Industrial Average, we indeed did have the kind of hyperinflation in the 1980s and 1990s that we should have had, given the explosion in newly-issued credit all around. *The trouble was, everyone was looking in the wrong place for it!* By a variety of means (the discussion of even a few of them would require a separate newsletter just by themselves, so you'll have to take my word—and history—for it) the massive monetary inflation and debt creation of the 1980s and 1990s did lead to hyperinflation—**in the stock market.**

Having to leave for another time a detailed discussion about the "how" of this, let's talk about the *why*. That's more important for our present purposes, anyway. Simply put, the Fed sought to and did create what came to be known as the *wealth effect*. By successfully directing the lion's share of the increase in dollars into the stock market, the central bank caused prices to soar on Wall Street. There were a few notable hiccups along the way, most notably in the Crash of 1987; but for the most part, investors' wealth swelled during the late, great bull market.

As this whole regimen became more engrained and almost took on a life of its own, it should have become clear to the many bearish pundits perennially forecasting a collapse that stocks would continue rising to one absurd new height after another. I used to get a kick out of going to various hard money and preparedness-type shows and being the only one there predicting that 1) stocks would keep rising and that 2) precious metals would for the most part remain mired in the doldrums. I didn't say these things just to be different; I simply pointed out the kinds of things I'm covering herein and—as the venerable Richard Russell would say—*I called things as I saw them, not as I thought they should be.* When you understand The Game—and how this wealth effect was feeding and extending it—you could come to no other conclusion.

Thus, rising share values on Wall Street made many Americans feel richer. They bought even more, often on credit. After all, some felt, by the time they retired their 401(k) plan would have become SO huge that they would be able to finish paying off their second home, their vacation home, the boats and the other toys.

It worked like a charm. Previously, Americans had graduated from working for their money first and then buying something, to borrowing and spending now in the hopes that their future earnings would bail them out. Now, millions were going deeper into hock than ever, taking on even more obligations and buying more stuff based not only on the current value of their portfolios, but in anticipation that their tech stocks would continue to go up 50% per year until Judgment Day.

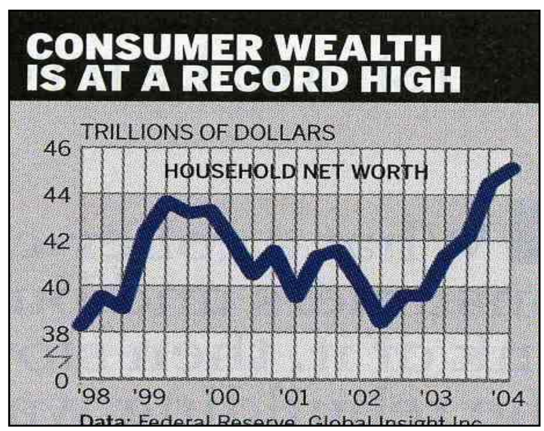
It was fun while it lasted; but as we know, stocks aren't performing the tricks they once did. Many a retirement plan has been changed over the last few years, as investors who had become far too giddy—and taken on more than they could reasonably handle—began to unwind purchases as their portfolios shrank. What's a central banker—and one who needs to keep activity moving along—to do?

HOUSING PICKS UP THE BATON

As the new bear market gained a firmer grip on things, Greenspan was faced with arguably the greatest dilemma of his long tenure at the helm of the central bank. Particularly after the shocking attack of September 11, 2001, the recession and the subsequent credit crunch that was starving Corporate America, it increasingly looked as though the jig was finally up for the fractional reserve system. A scenario akin to what Japan faced following the bursting of its stock market bubble was staring us in the face.

It was decidedly an emergency; especially given not only the fact that consumer spending accounts for two-thirds of America's output, but further given that—to a great extent—America's consumers are carrying much of the world on their shoulders. We were long since past the time when Americans' incomes alone could come anywhere near maintaining such a pace; the added consumption from rising stock prices slowing so markedly threatened to lead to a full-fledged *plunge* in spending and, thus, in the global economy.

The last resort was to create another bubble to reinvigorate the wealth effect. Greenspan has created that bubble in housing prices. By taking interest rates down to multi-generational lows—and abetted by the banking system's generosity in writing all kinds of mortgages with easy terms and payment arrangements—Greenspan has pushed up the value of residential real estate at a steady pace. Lower interest rates mean that the average home buyer (we'll forget for the time being how this is skewed by ARMs, interest-only notes and the rest) can afford a higher-priced home. Thus, the strong demand has pushed homes to those higher levels.



The surge in real estate prices over the last few years has helped rebuild some of the phantom wealth lost in the stock market's decline. With some help from Wall Street's cyclical rally of 2003, in fact, the rise in real estate values has helped bring Americans' assets back up to and, now, slightly ahead of their peak in 2000. As was the case during the growing bubble in stocks, Americans are tapping this wealth in their real estate via refinancing, home equity lines of credit and more. As one pundit quipped a while back, the average American family's home has become an ATM machine, which can be tapped almost at will to keep one and all consuming at a sufficient rate to keep The Game plodding along further.

The $64,000 question is when the housing bubble will meet the same fate as that of the bubble on Wall Street. The stakes are far higher, as many more people will be immediately and directly impacted as compared to the damage that the stock market decline wrought.

None of us have the answer to that, including Yours Truly. There are signs that housing has already peaked, even if prices overall are still high. But that real estate in at least a good part of the country will ultimately decline is without question. To illustrate—and dispel a popular myth—I'll leave this particular subject (for now) with the following:

One of the reasons given by those minimizing the possibility of a housing decline (or collapse) is that demographics favor real estate. The population is growing, is more able to afford a home (for now, anyway) and, after all, everyone needs a place to live. So the housing market can't possibly unravel, can it?

Ask the Japanese.

In that relatively small island nation, it was also said—as their stock market bubble was leaking—that real estate couldn't also go down. Japan is a "wealthy" first world country, whose people also all need roofs over their heads.

Just like here, Japan's real estate market continued rising for quite a while following the 1989 peak in the Nikkei. But then real estate started taking on gas as well; and today, residential property is down by 50-60% from its peak. It was not because a bunch of people left the country and, therefore, lightened up the "demand" side of things. Instead, it was merely a function of money and credit.

Yes, everyone still wanted and needed a roof over their head. That wasn't the problem. *The problem was that the level of debt required to hang onto real estate became unserviceable.* One by one, people in shakier financial circumstances had to "trade down." As they did and there were more sellers than buyers, prices had to come down to keep up with the amount of debt that could reasonably be handled as deflation's grip intensified in that country. It became a vicious circle, and largely unstoppable (do you see why Greenspan and Company are so panic-stricken over the prospect of deflation *here*?)

Lest you think we can avoid a similar fate (ultimately we won't) the statistic I'll leave you with is that the population density in Japan is 17 times larger than in the United States. So if that favorable demographic advantage didn't keep real estate prices from falling over there, what chance do we have of averting a similar outcome? None. This does not mean that all real estate in America will decline; but most of it will. The most seriously affected will be 1) those markets most dependent on middle class workers and their ability to service mortgages, and 2) those markets where real estate has risen most dramatically in the recent past by investors speculatively "flipping" properties.

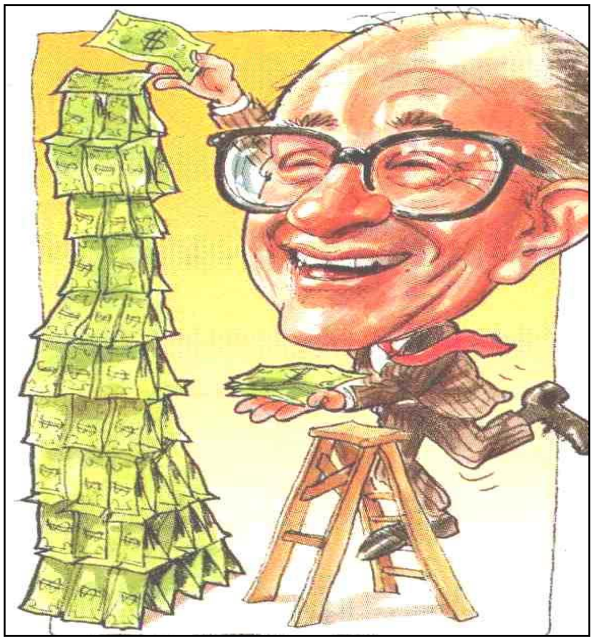
DERIVATIVES—THE LAST, SPECTACULAR HURRAH?

Greenspan and his fellow doomed policy makers have stretched things about as much as they can where the American consumer is concerned. The stock bubble is unlikely to be reinflated over an extended period of time; *at best*, we'll have a "sideways market" for some time to come. Real estate shows signs of peaking; and without *much* lower interest rates still (unlikely at least in the near term) has done about all it's going to do to help consumers keep The Game going.

Never fear, though. Just as could be said when the ability to split the atom and use its power was discovered, Greenspan has come up with something as useful and beautiful as it is potentially deadly.

Now, it would be inaccurate to say that The Maestro actually invented the many kinds of financial instruments that have come to be known as *derivatives* (though it could be true in at least a few specific cases.) What he has done, though, is to give these things a rapidly-growing role in the cause of keeping The Game going; something he regards increasingly as his crowning achievement, but which others view with horror.

As the name implies, derivatives are financial instruments *derived from* some underlying asset or security. To give a simple (and early) example of a form of derivative, we could look at a stock option. That is a contract to buy or sell a certain stock, at a certain price, by a certain date. It is not in and of itself a reflection of actual ownership in the underlying company, which can be evidenced only by that company's stock itself. However, the option carries a certain value based on various factors until its expiration date, when it becomes worthless.



In recent years, derivatives have become more numerous, creative, complex—and potentially deadly. These bets, just like options, "derive" their value from the expected future price movements of some commodity or financial asset: oil, wheat, stocks, bonds, or what have you. Unlike many of the simpler kinds of derivatives, though, many of the newfangled varieties contain extraordinary leverage, allowing writers and holders of these contracts to create and then control vast quantities of so-called *notional value* with little underlying capital. *As an illustration, the failed hedge fund Long Term Capital Management reportedly controlled derivative contracts at one point with a notional value of some $1 trillion, even though LTCM had investment capital of only $5 billion.*

The market for derivatives is much to the financial markets as the stock and housing wealth effects were to consumers. *In this case, though, it's the wealth effect on steroids.* The notional value of derivatives has exploded in just the last few years. In 1990, according to Randall Dodd of the Washington, D.C.-based Derivatives Study Center (www.financialpolicy.org) their face/notional value was $2.9 trillion. Through just the end of 2002, they had ballooned to a mind-numbing $127.6 trillion.

They have been praised by Greenspan as a means by which major financial institutions can "offload risk," create even more artificial wealth and, in general, make the financial machinery operate smoothly. Their need has become so acute in order to keep The Game going that Greenspan has sternly rebuffed various Congressional attempts to gain some regulatory oversight over this market, which many have underlying anxieties over.

Among other things, Greenspan undoubtedly hopes that the massive "wealth" generated in the capital markets by the explosion in derivatives' notional value will somehow trickle down through the financial and corporate structure, and keep everyone solvent. So far, it's working to some extent—but the risks are extremely high of an accident. Lest you forget (and Greenspan apparently has) LTCM's failure almost single-handedly brought down the financial markets, literally requiring an emergency 2:00 a.m. meeting in the office of former Federal Reserve Bank of New York chief Bill McDonough to avert a catastrophe. That there are *hundreds* of LTCMs out there doesn't seem to cost The Maestro a minute's sleep.

It's one thing to have the wealth effect for consumers lose its punch at a relatively slow and (usually) manageable rate. It's quite another if one or more LTCMs go belly-up and, with them, a few trillion or so instantaneously vanishes into the nether regions. There's our predicament, or at least our potential one; a derivatives blow-up that might still serve as Greenspan's Waterloo one of these days.

For better or worse, as one writer recently put it, derivatives are accumulating in our macro-economic atmosphere like some sort of financial chlorofluorocarbon. Are they as inert as Greenspan and banks like J.P. Morgan would have us believe? Or are they an inherently unstable compound that, like nitroglycerine, can explode if shaken a bit? No one knows.

Berkshire Hathaway Chairman Warren Buffett puts it more bluntly. "Derivatives are financial weapons of mass destruction," he said in his latest annual report to shareholders. "The dangers are now latent—but they could be lethal."

Whatever the case, the market for derivatives is, I feel, the Last Act of Greenspan's "New Economy." What more can be done to keep The Game going (and growing) I can scarcely conceive; at least, where the United States' economy is concerned. Whether it happens quickly or slowly. . . a quick, sharp pain or a slow, dull ache. . .it looks like it's all downhill from here.

DIVERSIONS

By now, you know the mechanics of our fractional reserve system. You can now see how, over time, our economy and financial structure have become stretched…increasingly speculative…and ultimately doomed to a very nasty outcome.

The Powers that Be do not want the average American to have such an understanding. It suits them to have the odds remain as long against the citizenry really beginning to understand The Game as what Lord Keynes once identified. Perish the thought—as the reformer Nehemiah once did—that blame would be affixed precisely where it belongs; on the "rulers and nobles" who have enslaved the population through debt, as well as on our debt-money system itself.

Thus, we are going through a sometimes entertaining but completely off-point game of playing "pin the tail" on who's responsible for the unwinding that began back in 2000. Of course, the answer never comes; instead, Republicans blame Democrats, Democrats blame Republicans, and so on.

The investing natives are restless, though. Few are willing to admit that *they* were irresponsible in the first place for chasing the stock market bubble. The financial services industry by and large also does not want to admit that they ignorantly led millions of sheep to a shearing. They want and need some "red meat" thrown to them by the same system that has created this mess; and the system is only too happy to oblige to help keep attention diverted from the real issues.

Thus, we've recently been treated to much the same type of environment as once existed during and immediately after the French Revolution. The guillotine has not been employed; at least, not yet. Instead, the masses have been treated to a number of high-profile prosecutions of "aristocrats" intended to humiliate and punish 1) those who allegedly benefited disproportionately from the stock market bubble, 2) caused other investors to lose money in their brokerage accounts and retirement plans and 3) were otherwise inviting targets for a system intent on proving to the public that it is "doing something."

The culprit that has provided the most fodder has been Enron. Many have particularly enjoyed beating President Bush over the head with his ties to the company and its former head Kenneth Lay (one of several past executives who has been indicted for various crimes,) ignoring as they do that the former energy trading giant was also a major benefactor of former President Bill Clinton.

Virtually everyone, though, misses the most critical fact about Enron's collapse. As I pointed out in my January, 2002 issue immediately following the company's bankruptcy filing ("The Real Reason Behind Enron's Collapse," archived on my web site under "Essays and Articles,") it was not because the company had engaged in price gouging for natural gas in California, nor that the company's officials were inherently crooked.

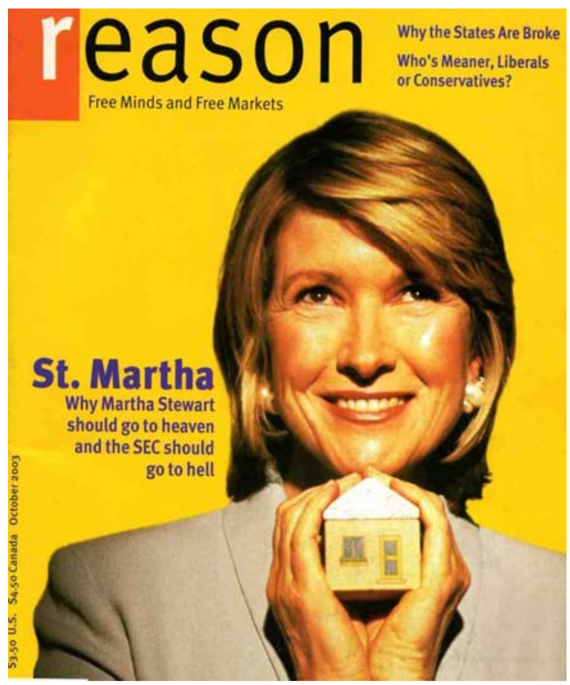
Instead, Enron collapsed because it had been transformed into a giant hedge fund. To boost its assets (which at the company's peak involved an interesting array of derivative contracts in areas far removed from energy) and share price the company entered into a variety of financial market dealings which—for as long as the overall bubble was still inflating—were fine and dandy. Complicit in all of this were the company's various enablers; many of the leading banks and brokerage firms on Wall Street who made it possible for Enron to become a derivatives-laden house of cards. These enablers racked up many millions of dollars worth of fees in the process of making both themselves and Enron's management seem like financial geniuses.

All you hear now, though, is how it was Enron's management that is to blame for the company's implosion; and that of the retirement savings of many of the company's employees and others. Seldom if ever do you hear anything about how it was the very casino-like financial system created and presided over by Alan Greenspan which not only allowed Enron to do what it did, but encouraged and profited from it. In fact, a few of us contend that Enron was one of the vehicles by which the financial system kept the bubble from losing air any sooner or faster than it did, as Enron's various multi-billion dollar derivatives transactions for a time kept the prices of certain financial assets even more artificially inflated than they were already.

I for one am eagerly awaiting the upcoming trial of former C.E.O. Lay, in the hope that at least some of the system's own culpability—up to and including the Federal Reserve itself—comes out. I can't say I'll be holding my breath, though.

MARTHA ANTOINETTE

This brings us to Martha Stewart, whose recent prosecution brought back memories of Leona Helmsley. You may remember her; the woman dubbed New York's "hotel queen" who was convicted and jailed a number of years ago on various tax charges. A key part of her "prosecution," much of which was slickly conducted in the media, painted a very disparaging picture of Mrs. Helmsley as arrogant, a snob and all the rest who deserved to be brought down a couple notches if for no other reasons than…well…because she was arrogant, a snob (and rich.)



In much the same way, "Martha Antoinette" was painted in the news media as arrogant, a snob (and, we all know, even wealthier than Mrs. Helmsley.) This was intended to turn public opinion against the domestic diva though, refreshingly, it did not have nearly the success that the personal insults and demonization directed against Mrs. Helmsley did.

In the grand scheme of things, Ms. Stewart's allegedly having sold a few shares of Imclone stock on a tip from an insider via her broker would hardly have been worthy of a mention in the press, let alone a federal prosecution. Had such an incident happened during the late bull market, I don't believe anything would have come of it. Here again, though, the system needs to offer up an "aristo" here and there as millions of investors either look for scapegoats supposedly responsible for their brokerage account balances having shrunk or—in Martha's case—as they want to see someone "privileged" punished for, arguably, benefiting from the kind of advice from her broker that everyone else wishes *they* had.

The selective prosecution of Martha Stewart and the incredible hypocrisy of the system (as evidenced specifically by the U.S. Securities and Exchange Commission) was eloquently laid out in the October, 2003 issue of *Reason* magazine in a lengthy commentary by Michael McMenamin. In a great piece of outside-the-box investigative journalism—the kind you never find these days in the controlled

Establishment press—the writer discussed many of the intricacies and contradictions in Ms. Stewart's prosecution. Where the supposed harm done to the markets or other investors by such "insider trading" as she was accused of is concerned, McMenamin compared Stewart's actions to those of one-time financial market kingpin Ivan Boesky. He wrote:

"In its heart of hearts, even the S.E.C. knows insider trading doesn't hurt the markets. Remember the financier Ivan Boesky? Back in the 1980s, Boesky agreed to pay a record $100 million in penalties for trading on inside information purchased from the Drexel Burnham Lambert investment banker Dennis Levine. The Wall Street Journal estimated that Boesky had made more than $200 million in profit from Levine's information. By cutting a deal, the S.E.C. let Boesky keep half of his illicit profits.

"But wait, it gets better. Before the S.E.C. announced the settlement, it allowed Boesky to cut his trading partnership's liabilities by $1.3 billion through a series of government-sanctioned insider trades. S.E.C. Chairman John Shad later told a House committee that the market wasn't hurt by those trades because it bounced back after a one-day loss. So keeping $100 million in ill-gotten gains and executing insider trades totaling more than $1 billion are both OK if the S.E.C. says so.

"Yet Martha Stewart got nailed for saving $45,000 without breaching a fiduciary duty to anyone . . ."

Now, none of the above is to suggest that there have not been misdeeds, or even crimes, committed by some who gamed the system. My argument instead is that this type of activity has, in reality, gone on all the time. During the long bull market, it was either covered up or forgotten about. Now, it's an issue in a few hand-picked cases not because the government wants to punish a few people here and there, but because it *needs* to divert attention from the real issues.

Will The Game—fractional reserve banking and all its excesses—ever be pointed out as the cause and enabler of all the above, let alone of the carnage in the U.S. economy and markets that is *still to come*?

WHERE DO WE GO FROM HERE?

In attempting to build on all of the preceding and divine the future, we need to be careful of several things. First, just as Harry Figgie and others for *years* misunderstood how the explosion in credit creation and debt of the 1980s and 1990s would be manifested in a completely different way than they'd envisioned, we must avoid being so sure or smug about how things will eventually turn out that we are blinded to reality. In spite of the FACT that The Game is ultimately doomed to suffer a nasty fate, I have nevertheless always said we must never underestimate the ability of a central bank to inflate its way out of trouble. To be sure, Greenspan's ability to do so is diminishing; as many like to say, he's used up most of his ammunition now. But it probably isn't completely gone.

Whatever the future holds (and further along still, I'm going to throw a BIG monkey wrench into most people's perceptions of things) there are, I think, a few things we can hang our hats on now:

The 1990s are over! – I mean that in a figurative as well as, obviously, a literal sense. To the point, "buy and hold" investing is gone again. At the least, we are in for many more years of the kind of secular bear markets we've "enjoyed" in the past. Stocks are likely to continue working lower, net, for quite a while; but in between, wide swings will allow wise investors opportunities for trading.

The last time we had a market like what we may be in now (again, if we're lucky and don't fall completely off the cliff) was between 1966 and 1982. On their own, stocks did nothing for those 16 or so years. In between, though, cyclical swings as measured by the S&P 500 were as follows:

10/66-11/68	+48%
11/68-5/70	- 36%
5/70-1/73	+73%
1/73-10/74	- 48%
10/74-11/80	+126%
11/80-8/82	- 27%

Now, investors need, at least to some extent, to be market timers; or in the alternative to find a good one to advise them. *And this is not only true where stocks are concerned; I expect to see much the same kind of volatility continue where the bond market is concerned as well.* Yields on long-term Treasuries have gyrated wildly in the recent past; plunging one minute and then spiking the next. This also provides opportunities for judicious traders.

Over time, we'll be trying to play both sides of these swings as best as we can; jumping into the Pro Funds Rising Rates Opportunity Fund (RRPIX) when it looks like rates are headed up (and bond prices lower,) and into funds like the American Century Target 2030 (ACTAX) when it looks like rates will fall, and bond prices rise.

Economic growth will slow dramatically – Unless Fed Chairman Greenspan gets a new wealth effect-inducing bubble going in something else (tulip bulbs, baseball cards, used game boys?) AND gets the majority of the nation to join in, the great consumer-driven economy has seen its best days. I almost laugh when I hear some pundits compare the present time with 1982, the dawn of a great "expansion." No expansion starts unless there is pent-up demand from consumers; and today's consumer is not pent up, he's *spent up*.

Corporate profit growth has peaked – The strong rebound in corporate profits from their depths of late 2001-early 2002 has run its course. A variety of competitive pressures, rising costs, debt loads and more are beginning to squeeze; and earnings growth rates which in the last few quarters have been 20% or more year-over-year are predicted to slow to the low-to-mid single digits by early 2005.

As a result, even those corporations currently flush with cash are being darned slow about spending it. This means further weakness where companies down the food chain who depend on healthy capital spending budgets are concerned. It also means that the number of new quality jobs created will continue to be sub-par.

A credit crunch is ahead – Alan Greenspan can make virtually unlimited credit available; but if lenders are not willing to lend, it does no good. Businesses learned this in the strange 2001-2002 recession we had, when bleak prospects made the availability of affordable credit to some sectors (telecom and energy in particular) almost non-existent.

Since then, conditions have improved remarkably. The better environment has been evidenced by the demand for so-called junk bonds; high yielding corporate debt. Investors' belief over the last 24 months or so that the economy would improve and, therefore, that business risk had been reduced caused a stampede into this kind of paper, and great returns for the public (the average high-yield mutual fund, for example, returned 25% in 2003.)

The next problem, though, is likely to be a credit crunch affecting consumers. Even prodded by Greenspan, banks and mortgage companies—

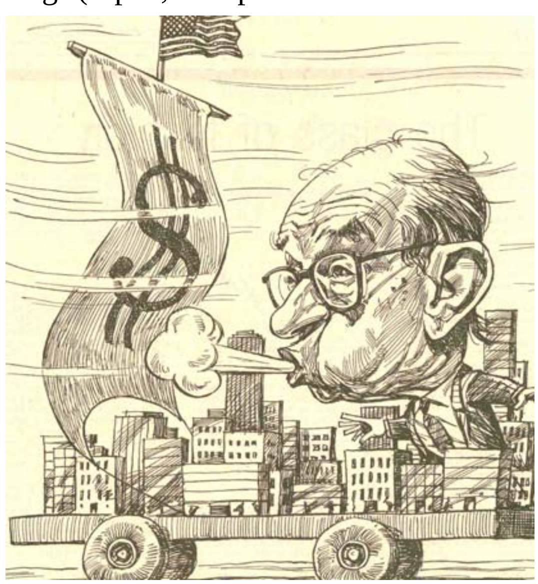
faced with rising delinquencies and a new record in personal bankruptcy filings of nearly 1.8 million annualized—will shortly get tired of letting new, cheap credit flow like water. Once that happens, consumer spending (i.e.—borrowing) will be squeezed even more, with negative effects through the economy and stock market.

Wants versus needs – Investors have only started to learn (generally the hard way) over the last few years that, in the end, the soundest companies to invest in are those which supply peoples' *needs*. Whatever form the Great Unraveling takes, most people will still get up in the morning and go to work. They'll buy groceries. Heat their home. See their doctor. Buy gasoline. And so on.

Gone with the 1990s is the environment where almost any type of stock could be bought. Now, we'll need to focus especially on those superior companies who supply the citizenry's needs, and which do so more efficiently and with better profit margins than their peers. In most any market environment, these will do well; especially those companies which pay dividends, which are now coming back into favor and respect among investors.

THE GREAT INFLATION – DEFLATION DEBATE

Central to answering the question most accurately as to where we're heading (Japan, Argentina, Weimar or Muddle? as Jim Willie CB asks) is the subject of whether *inflation or deflation lurks ahead.* Being able to answer that question accurately will make all the difference in the world.



If the answer is inflation, then bonds will be the financial kiss of death as they were, for example, in the 1970s. Stocks in such an environment would probably hold their own, with shares of commodity producers likely among the best performers. Hard assets themselves would likely continue their bullish trend of the last two to three years.

If deflation is our fate, essentially the opposite would be expected by most people. Bonds would rally, with yields perhaps falling even lower than their levels of mid-2003. Stocks would most likely sink, as would virtually everything else, including most commodities.

Whenever I'm asked the question, "Do you expect to see inflation or deflation down the road?" my answer is generally *yes*. Both of them, actually. This is where I begin to diverge from the more static discussion going on among a number of my colleagues right now, most of whom think it needs to be all one way, or all the other.

My views pretty much coincide with those of Dan Denning, of *Daily Reckoning* fame (for more information, visit www.dailyreckoning.com.) In a piece which I happen to have archived along with other great stuff on the "Other Experts" page of my web site ("The Unintended Consequences of Globalization") he argues persuasively that we'll have both inflation and deflation in the years ahead as Nature takes its course with our hyper-leveraged economy.

Essentially, he believes that those assets most dependent on debt will deflate in value/price, as the debt load required to be serviced in order to keep those assets near their present prices becomes unmanageable. Real estate, of course, heads up that list. In addition, I expect we'll see increasing numbers of sales of unnecessary/expendable items as consumers increasingly feel the need to raise cash, and/or get out from under payments for things they don't really *need*. In the years ahead, what would by today's standards seem incredible bargains will be available; not only for real estate in certain areas, but for boats, cars, all-terrain vehicles and lots more.

At the same time, those assets *not* dependent on debt or debt service, at least to the same extent as the above, may well go up in price; dramatically in some cases. As the Fed attempts with all the vigor it can possibly muster to inflate its way through this deflation to help soften the blow, keep the number of bankruptcies and foreclosures below the critical level that would lead to major social unrest and all, the value of the U.S. dollar is bound to suffer. By extension, prices of most key commodities priced in dollars will rise, leading to inflation in those products (much as we've seen over the last couple of years already.)

As Jim Willie CB points out in his excellent piece which I referred you to earlier, there are some key things you need to be aware of in trying to handicap the chances for either inflation or deflation; and the likely outcome for the financial markets. On the surface, one might be best to, *longer term*, bet on a Japan-style outcome. Yet there is one HUGE difference between Japan as it lurched into deflation and had to take interest rates down to basically nothing, and what the U.S. would be faced with. Simply put, Japan did not need to get anyone from outside its borders to "ratify" its policies.

America, however, is in hock to everyone and his brother. Foreigners currently own some $3 trillion worth of U.S. government debt. Most believe that, faced with declining interest rates, a declining currency and a stagnating (if not contracting) economy, foreigners would want to get out. This could conceivably lead to a *collapse* of the currency, soaring interest rates and—all other things being equal—the more accurate fulfillment of Harry Figgie's original prophecy.

Now, let's get to that "monkey wrench" I mentioned a moment ago. . .

THE WORLD TURNED UPSIDE DOWN

The world has become a more puzzling, uncertain and dangerous place. For the first time in most of our lifetimes, U.S. soil has been attacked. We are in a deepening quagmire militarily in Afghanistan (unraveling anew, in case you hadn't heard) and Iraq. Iran might be next on the list as President Bush decides who in his "Axis of Evil" to strike next. There is the ever-present possibility that terrorists could strike anew at any place, and at any time.

Apart from all this, though, there are some deeper changes that have started to occur in the world where economic and financial matters are concerned. From the way crude oil is priced to the changing policies toward U.S. government debt that have started manifesting themselves in places like Japan and China, a "changing of the guard" in an economic sense has started. It is a process that will most likely play out over a number of years. In the end it will lead to a kind of world that the average American today cannot even conceive of, let alone anticipate and plan for with his investments and lifestyle.

None of us alive today has ever dealt with an economic and market environment that did not have at its core somehow one important anchor. And that, my friends, was that—though there were transient occasions since World War 2 when there were some interruptions—*the world, in the end, has revolved around the United States of America.*

In a military sense, it has been American might and muscle that, for the most part, have kept most of the world a safer place. Sure, there have been small flare-ups, wars and their attendant "police actions." Yes, there are uncomfortably many of these kinds of things going on right now. Yet nobody can deny that America's formidable military strength and resolve won the Cold War, have kept historically volatile Europe free of conflict, and have otherwise created an environment of relative stability.

America's economy has for several decades been the world's largest. U.S. consumers, though they have dangerously built their seeming prosperity on mountains of debt, have nevertheless contributed to economic activity elsewhere by consuming so much. It can truly be said that, especially in recent years, Americans have virtually carried the entire world on their backs.

Part and parcel of the world being "tilted" toward the U.S. has been the establishment of

U.S. capital markets as the largest and most liquid in the world. People and even governments the world over have shoveled endless amounts of money into U.S. financial assets, giving an even greater aura to the United States as the great engine of wealth creation in the world.

As one sage once put it, though, "Whatever can't last, won't." As the above scenario and America's being the consumptive center of the universe has endured, major imbalances have been built up. For years, pundits of all stripes have speculated as to when the "tipping point" would come, when America could no longer accumulate such massive internal and external debts; and, further, when others in the world would smell trouble—*or greater opportunity elsewhere, perhaps at home*—and begin to change their behavior towards America.

Early answers to these questions—and warnings to the wise—are starting to come in. For a long time, the United States pretty much had its way with O.P.E.C. a cartel which controls a fair amount of the world's oil reserves and shipments. Though consumers in other countries pay far more, we always managed to thwart the usual laws of supply and demand by consuming disproportionately more oil than anyone else on the globe—but by being able to buy it at the cheapest prices.

No more.

There are many reasons why the price of this key commodity has surged recently, not the least of which is that worldwide demand, led by China, is also surging. Given this environment, O.P.E.C. exporters no longer have to kowtow to one large customer (the U.S.) and always jump to meet its demands. There are other players in the game now; other customers. And as far as O.P.E.C. is concerned—especially if the value of the U.S. dollars used to pay for their product is declining—*they want more of them*.

Thus, we don't carry quite the weight we once did; and as time goes on, we're going to have to compete more energetically for oil supplies in high—and growing—demand. This means rising prices, squeezed profit margins for many businesses, and falling living standards and less disposable income for America's consumers.

Here's another change. Back in the Spring, Japanese officials surprised currency traders by suggesting that their long and heavy intervention in the currency markets designed to keep the yen from appreciating too drastically was coming to an end. Make no mistake, said the Bank of Japan; it will still intervene if and when necessary to arrest any sudden or overly sharp yen rallies versus the greenback. However, the signal was clear; an orderly appreciation of the yen was something the BOJ was now resigned to, if not welcoming.

As we all know, the Japanese have been buying boatloads of Treasury securities and otherwise keeping the yen in check in order to best protect *their* interests. All things being equal, that nation has been best served until now by keeping its citizens employed in the many export-oriented businesses that have fed the American consumer economy. In the recent past, though, signs have been increasing that Japan's own consumer economy has been revived. Further, it has been doing increasing amounts of business with other nations in the Asian region; most notably, China. The time has started to approach when there is sufficient opportunity for that island nation both at home and elsewhere in Asia that they don't need to deal on such a large scale with customers who can only buy their products if the seller loans them the money with which to do so.

The country I'm watching more closely than any of them right now, though, is China. As that nation of well over a billion people has developed an even more incredible appetite now for imports, inflationary pressures have grown; so much so that some are suggesting China has become a "bubble," whose rapid growth is unsustainable, at least in the near term. That may well be. However, what better way to take some of the inflationary pressure away than by "giving in" to the U.S. and finally allowing its currency to strengthen versus the U.S. dollar?

The irony here—even more so than with Japan having already moved in this direction—is absolutely incredible. For some time now, politicians of both parties have sought to cover their systematic dismantling of America's domestic economy on behalf of corporations by blaming China (just as they used Japan as a scapegoat in the 1980's.) "If only China would get rid of its unfair currency peg to the dollar and allow the yuan to rise," they tell us, "we wouldn't have such a trade imbalance. Exports would soar. We'd have an even playing field." And so on.

There's an old saying that one should be careful of what one wishes for—because one just might get it! One of these days, China will finally reveal some mechanism by which it will allow its currency to become valued more highly versus the dollar; whether that means it will re-set its peg, tie the yuan to a basket of some kind or whatever the case may be remains to be seen. But that country is already tiptoeing in that direction, as I commented on in the August issue.

Particularly if such a thing were to occur before the November election, President Bush will undoubtedly claim a major victory in having finally succeeded in cajoling the Chinese into being more "fair" and in opening the door to greater U.S. competitiveness.

Almost nobody will understand the true meaning of such a move, however. First, it will demonstrate China's belief that the previously insatiable American consumer is finally about "full," and that the best days of exporting gobs of cheap goods to America are over. Second, it will ratify China's own growth story; one that is likely to play out over many years to come, but perhaps with some future geopolitical tension thrown into the mix as China flexes its bigger muscles. Finally, the combined Japan/China moves will translate into soaring costs for everything priced in U.S. dollars which will, of course, most acutely affect Americans.

Far from being the good news that Junior will present it as, such a move by China would really represent the beginning of the end for America's days as the world's leading economic power. Economically, we could face a depression. The dollar prices of commodities would soar; again, this would most acutely affect Americans (the good side of that would be that American investors with healthy positions in those commodities would prosper.) Not only that, but consider that this could lead to a broader inflation, as the prices of all that Chinese stuff you buy at Wal-Mart would immediately rise by 10%, 20% or God knows how much. Sadly, though, that would not be enough to revive our own textile and other industries; so we'd have to grin and bear it.

While these events would fairly rapidly lead to our decline as an economic power and major player in the world, China would arguably be just as rapidly on the upswing. Having changed its outlook to that of an importer, and its economy to one trying to foster domestic consumption for its growing middle class, having a stronger currency will have greased the skids. China would further be in the position with a strong currency to most successfully compete for and be able to afford the many commodities it now imports, whose price rises are stoking inflationary dangers.

The reality, dear friends, is that the world has only just begun to turn upside down for America. We no longer dictate every element of the global economy and prices as we once did in order to maintain our own advantage. It will get much worse.

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MAKING LEMONADE OUT OF LEMONS

A while back, I received the following letter from a subscriber; one I think is appropriate to use in not only answering his question, but dealing with the broad issue of "what do we do?" in light of the predicament we appear to be in:

Most of my most recent attention has been on the shaky dollar and our country's apparent attempt to borrow itself into oblivion. My question: What does oblivion look like? A corollary question: Can we do anything to change oblivion?

That is, if the U.S. continues its deficit financing and expansion of government and the worst happens – will it look something like this? Foreign governments stop buying our debt, interest rates shoot through the roof, unemployment increases dramatically, there is rioting in the streets, Social Security and Medicare collapse, pension plans can only pay pennies on the dollar and once subordinate countries take pot shots at Americans wherever we go.

If the above paints a reasonably accurate picture of a "worst case scenario," what are our options as individuals and as a nation? We cannot merely stock up on gold and watch our neighbors and countrymen freeze to death or die of starvation. I guess what I'm getting at is that just saving yourself (and family) won't make very much difference when the rest of the country is in the crapper. Are we trying to get a nest egg in precious metals just to eke out a barely surviving existence? Or is there any chance that our lives could not be much different from what they are now . . ?

There! I feel better. Hope I haven't depressed you too much.

None of us know exactly what the future holds; only our Heavenly Father has such knowledge. Nevertheless, we can try to extrapolate from where we are today to try to get some handle on where we are likely to go economically in the coming years, based on all you've read to this point. And almost any way you slice it, the picture looks bleak.

That America will decline as the world's major economic power does not seem to be in question. I do tend to think—as I said in the last section—that at least part of this process will indeed include (as the subscriber suggests above) other countries effectively beginning to "shun" the United States. That could include China deciding that it will indeed revalue its currency, so as to be better able to afford and obtain increasingly scarce resources. It may also well include them, Japan and others deciding that they no longer wish to hold U.S. assets. As economic pressures and those on various nations' working classes intensify, it could include more in the way of trade wars. I am fairly amazed that we have not seen more of this already.

I fear in the end that many other nations, regardless of what we think they "owe" us for our past benevolence, protection, loans and more, will in both fear and frustration throw away the U.S. like a wet dishrag. Think about it for a minute. America holds a mere 5% of the world's population. Yet we consume 25% of the world's oil production. We consume disproportionately large quantities of most other resources. We require nearly 80% of the world's excess savings just to maintain our rate of consumption and "growth" and, as you now know, to keep The Game going for the bankers, at least here in the U.S.

Whatever can't last won't.

FIRST THINGS FIRST

As I'll discuss farther along as I begin to wrap this report up, I have long been irritated that many pundits and folks selling survival or preparedness-type products and doodads concentrate *too much* on a kind of "hunker down" mentality. I regularly poke fun (but always try to do so in a spirit of love) at those who think the way to handle themselves is simply to accumulate plenty of dehydrated food, water, gold, silver and firearms. After that, these folks will for the most part lock themselves in from friends, family, neighbors and the general public and simply wait for (take your pick) Armageddon, the Rapture, black helicopters, foreign troops or space aliens.

I do believe it is wise that everyone be able to successfully answer the question I have asked audiences for years every time I begin a lecture on the economic landscape. That question is, "If tomorrow morning you woke up and the world as you knew it had disappeared overnight, would you be able to cope?"

Underlying this are many "sub-questions." Do you have sufficient food, water and other provisions to be able to meet your family's needs? Can you protect yourself? Do you have items that can be used as money to barter with?

On that last item, most recommend that you have at least a modest amount of physical gold or silver bullion on hand with which you could trade if everything else had unraveled, and we had started using Alan Greenspan's scrip as toilet paper. (By the way, NEVER let yourself get talked into buying so-called rare coins for this purpose.)

You need not confine yourself only to these precious metals. Be creative; especially if you live outside a city and have barns, sheds or other places where you could store other types of items that people need on a daily basis; items which are easily tradable in small units. An old friend of mine back in upstate New York, for example, used to keep a few sheds full of things like hand tools, nails, screws, rope, roll after roll of "The Handyman's secret weapon" (you other Red Green fans will know I mean duct tape) and more. And as I always like to quip to those thinking you need a BIG pile of gold, I'll challenge you to a wager. You stock up on gold coins, and I'll stock up on tobacco and whiskey. If things unravel, we'll both have to barter with these things; and I'll bet you that I get more action!

SUSTENANCE

We could all get by in a pinch without swapping our current vehicle for a new one with two TV screens and a DVD player. We also might be able to do without getting our children and grandchildren the latest video games (most of which they shouldn't be playing, anyway.) We could survive without a lot of things. *But we still need to eat.*

Things as basic as food and water are given precious little thought by most people. Yet—*even if we don't have an economic meltdown*—there is reason to be concerned. Supplies of many foodstuffs are in the hands of a relatively small number of giant agricultural corporations. As with many other goods, they'll sell them to the highest bidder. In case you didn't know, China is having some trouble in feeding its population. Might it have so much difficulty that it tries to muscle its way into a bigger share of U.S. production; a share so large that what is left for Americans becomes somewhat scarce and/or increasingly expensive?

Also consider the issue of food safety. In case you didn't know, we now import much of the food we eat; this is especially true where fruits and vegetables are concerned. I regularly talk to people who have no idea of the extent to which we have gutted our agricultural industry, on top of steel, textiles, and all the rest. Not only does this present a potential problem when it comes to supply, but what about the *safety* of the food we eat?

Importing food from Mexico, South America and elsewhere has created an impossible situation. Very little of the food we import can be checked for safety, let alone quality; it's humanly impossible given the enormous quantities. I have been amazed that with all of the talk of terrorism and potential terrorism that we have not *already* seen efforts to "attack" the food we import. If a terrorist or other malcontent wanted merely to "mess" with our heads, he could merely sprinkle some foreign substance on crates of tomatoes, oranges, strawberries or what have you, news of which would cause a panic. I believe such a thing is inevitable, and is the price we all will pay for allowing our leaders over a period of time to sell us out.

Everyone reading this should have at least some "stockpile" of food. Ideally, if you live where you have sufficient space in which you can grow your own garden, it's best (and healthiest!) to grow your own food. Preferably, you should use seeds that come from non-hybrid stock, so as to be able to save your own seed year after year. To learn more about this, I recommend you visit www.arkinstitute.com and www.bountifulgardens.org. Both will not only sell you seeds, but have a wealth of information available.

If you are unable to do such a thing, you'll need to find a company that will sell you food in bulk. Even if you live in a big city, chances are you can find a food cooperative of some kind reasonably close, where you can stock up on large quantities of things like wheat, dried beans, corn, lentils, and more. What we have done for years here is to always keep a good supply of these and other foodstuffs on hand. Depending on how they're packaged and stored, we'll use them after a while and replace them with fresh items.

If all else fails, you can contact one of the many companies which make pre-packaged dehydrated food available, together with other self-help items. One I personally am acquainted with and which I consider to be a good, quality and honest organization is The Survival Center in McKenna, Washington, which you can learn more about by going to www.survivalcenter.com.

"BE A JOSEPH"

It has long saddened (and occasionally angered) me to see so many good people who know all about our financial, moral and social plight as a nation, can wax eloquent about the "conspiracy" to destroy America and all the rest—and yet they do nothing to plan for how to cope with such a thing beyond their own four walls. I think it was Edmund Burke who once said that "The only thing necessary for evil to triumph is for good men to do nothing." Many good people have even been encouraged by some to, in effect, become hermits.

One of the reasons I am often more at ease with "liberals" or progressives, if you will, is that they have the heart and wisdom to be community-minded. Conservative Christians used to be more that way; and hopefully will be again some day.

Many people not handicapped with having been so consumed by conspiracy theories and the rest that they become scared of their own neighbor have the sense already to be making plans for future possible calamities that include more people than themselves. I already mentioned food co-ops above. JOIN ONE! If nothing else, you'll meet new friends, learn new ideas, and have taken this one step toward building a network of people in your own area, so that you can rely on one another when the feces hits the fan.

Also, whenever you can do it, support locally-managed farmers markets or individual family farmers. I always enjoy going to such things, where I can buy baked goods, produce, and any number of crafts directly from the producer. No middleman is involved. No banker gets a cut. This is commerce as it should be!

Many farmers markets now have their own web sites, so you can do a Google search and find one in your area (for an example of how unique and, at times, even visionary these things can be, check out www.ithacamarket.com, the web site of one of my favorite markets located back near my home town.)

Joining with people such as all the above, you could (as my dear friend and new marketing director Steve Carr, who you can learn more about at www.honestmoneygroup.com) "be a Joseph." As did Jacob's son, you can use your knowledge of what the future holds to help other people prepare. You can help build your nearest co-op or farmer's market. You can wake up your friends and get them to join in. I challenge you that if you have the time and some means to do this, you *should* do it.

MONETARY ALTERNATIVES

Though they get only occasional mention in the media, there already exist a number of monetary alternatives that far-sighted people have created over time. These serve many purposes. In some cases (unfortunately) they have been little more than unworkable "protests" against the Fed. Happily, though, many go beyond this and, among other things, are there available to more people than you might think, in the event that the banks' money one day becomes of little use.

By far, my favorite version of an alternative currency are those various *community currencies* that are operating in scores of local areas now. The "flagship" of these are called *Ithaca HOURS.* For a dated but nevertheless comprehensive look at this, check out the archived article "The Future of Money" on the "Essays and Articles" page of our web site. This group's web site is www.ithacahours.com. To learn more generally about community currencies—and perhaps find one that's in operation near you—check out www.localcurrency.org and www.smallisbeautiful.org.

There are many other forms of monetary alternatives as well, some based on precious metals. Some of these even allow you to electronically accumulate and store gold (keep in mind here, therefore, that positions in such things should be viewed as something to do *beyond* having physical precious metals in your possession, which in my opinion comes first.)

Leading the effort toward digitalizing gold for electronic commerce and storage has been James Turk, well-known Editor of the *Freemarket Gold and Money Report* (www.fgmr.com) and founder of GoldMoney.com.

"Imagine buying a book online with gold," Mr. Turk's brochure says. "It can be done today with GoldMoney. At present, the World Wide Web conducts commerce via credit cards and bank wires. Credit cards come with fraud, high fees, charge-backs and arbitrary restrictions. Bank wires are inefficient, slow and expensive. GoldMoney removes the risks and expense by using a disciplined, simplified system of gold currency."

By depositing as little as $50 at a time in your GoldMoney account you can have a store of real money for future use. When you send in funds, Greenspan's scrip is converted into grams of gold (there are 31 grams to an ounce) which are stored in a vault in England owned and operated by one of Europe's leading secure storage firms. Plus the gold is insured by Lloyd's of London.

To get a LOT more details and to open your own GoldMoney account, go to www.goldmoney.com, or call (866) 311-3447.

A COMING CATHARSIS – BUT WILL IT LEAD TO REVIVAL, OR A DARK AGE?

The years ahead will be challenging for us all. For investors, the landscape will be radically different. However, I like what economist Marc Faber said a while back. Talking about how we are just starting to go through some major changes—and how few others "get it" yet—he quipped that, "This post-bubble environment is the most exciting investing environment of the past 20 years." From the perspective of an investor who understands what I have written—and has the means and wisdom to take advantage of the many curves that are going to be thrown our way ahead—the landscape, though risky, is also very promising.

Beyond this, though—as we look at the broader issue of our economy and our very way of life and civilization—I can come to no other conclusion than that we're in for tough times. *The question is, when America has sunk low, lost its standing in the world or even collapsed, what will follow?*

What we *don't* want to have happen is for the same cretins and traitors who got us into this mess to convince America that THEY are the ones to get us out of it. This is one of the reasons why I am so adamant that the many good, informed people out there (such as you who are reading this report) DO SOMETHING beyond sitting at home on top of your dried food, gold, guns and the rest. It's best, easiest and most effective to prepare your community for what is likely ahead. Some day, when it's time to rebuild America, it will be best to start from the ground up. Thus, if NOW you are helping effect the kinds of local commerce, barter, community currencies, farmers markets and all, you and your colleagues might well be the ones who in your area will be the next leaders!

As you begin to talk with people and know more of them, have patience. That is something I have tried to learn over the years. It's easy to dismiss everyone else as idiots who should never have taken on so much debt, or who deserve what they get because they didn't vote for *your* favorite candidate. That's not the right attitude because, in the end, God will primarily hold those who led us into this mess responsible.

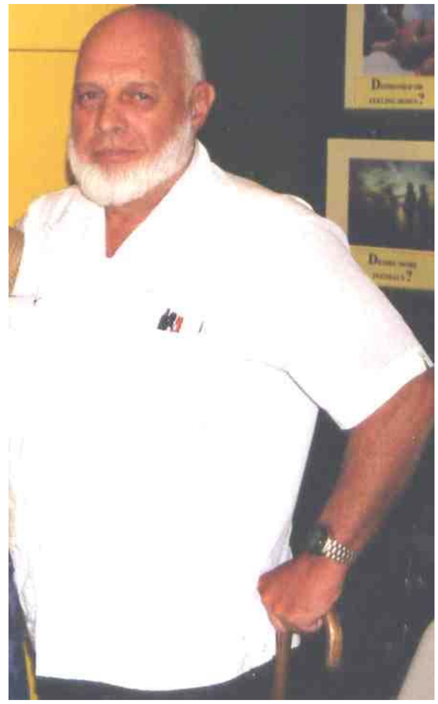
Consider the story of Nehemiah. He found his kinsmen in much the same state as Americans are in today. People were so far in debt that they had to mortgage their property to pay taxes, and even sell their children into slavery. The people were crying out over their plight. But did Nehemiah say to any of them, "Well, stupid, you should have known better than to accept all those no interest for 6 months offers?"

No, he didn't. Instead, he blamed the rulers and nobles. They were the ones who knew how that era's version of the same Game we now play really works. He turned the people against their leaders with such conviction that if John Ashcroft had been alive then Nehemiah would have been summarily locked up. Fortunately for Nehemiah, though, the people were ready. They had sunk far enough. They were ready to repent and, collectively, turn back to God's laws which—had they been followed in the first place on such matters—would have prevented the mess the people found themselves in.

Americans are not yet ready for this. The average person will have to be scavenging food on the roadside, or start having all their possessions foreclosed on before he/she is. When that time comes, there will be two main roads we can take: one, as we read in Nehemiah, will lead to national repentance, revival and a return to God's laws. The other would lead us to the kind of increased tyranny that makes John Ashcroft's emerging police state now look like the purest form of liberty.

Which road we take may, at least in part, be in YOUR hands.

IN MEMORIAM



Several months back, I received the sad news that a friend and mentor had passed away in a tragic, freak accident. Carl Gorton was a man who spent most of his life attempting to teach others. I first learned of him better than 20 years ago, when I read a special edition newspaper he published called *The Revelator*. It was one of the first comprehensive looks I had at our monetary system. Beyond the usual diatribe against the Fed and pining for "hard money," it was visionary, containing the first references I had even read at the time to how to set up local currencies and barter systems.

` Carl was a "Joseph." His last few years—when I was privileged to jump start a relationship that had been dormant for many years due to both our relocations and travel—were spent evangelizing over things like food, water and personal safety. In particular, he had become fascinated with *aquaponics*, a system where one can raise fruits, vegetables and even fish in a closed system which requires much less space than a conventional garden.

Though suffering much of his life from a severe physical handicap, he never allowed dust to settle on him. He was always looking for ways to teach God's people. He was a great example and inspiration to me.