



# THE CASEY REPORT

*Investing Ahead of the Crowd*

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Dear Readers,

Here at Casey Research, we think a fundamental understanding of the government's role in the economy is crucial to spotting investable trends. In fact, I doubt there's another investment research organization that expends nearly as much effort understanding the machinations, and the very nature, of government as we do.

It's not, I can assure you, because we find Washington's antics amusing (though, inadvertently, they certainly can be). Rather, it is because there is no bigger actor in the economy than government.

The validity of dedicating research time to understanding government and its likely actions is confirmed by unwavering forecasts of the current crisis, years before it occurred. By contrast, most of the "best and brightest" got slapped upside their collective heads. In my view, any analyst, corporate executive, or member of officialdom who didn't see the housing bubble materialize in response to Alan Greenspan's loose monetary policy should be ridden out of town on a rail. (Instead, many are now hard at work in the Obama administration or still at the helm of what's left of the financial institutions they ran into the ground.)

Once the housing bubble was identified for what it was, no advanced calculus was required to conclude it must collapse. Likewise, understanding the nature of the political class allowed us to recognize, well in advance, that government would feel compelled to do "whatever it takes" in an attempt to keep the bubble intact. That's because the idea of actually doing "nothing," the topic of Terry

Coxon's article in this edition, and letting the market operate freely to resolve misallocations of capital is as foreign to the modern U.S. politician as it would have been to a Comrade Commissar answering to Stalin.

**"There is an old saying, 'You can only tell the true character of a person by observing their actions when they are broke or drunk.' For a government, you want to observe their actions when they are broke and have an overwhelming majority."**

Given the scale of the housing bubble and the associated one in derivatives – the two largest in history – so must be the response. And the government hasn't disappointed, committing as it has to a level of spending that is breathtaking – now closing in on \$9 trillion, even though we are only in relatively early days – a topic Bud Conrad expounds on in his article "**Crisis Horizon**".

## What Now?

For some months now, our own Bud Conrad has been forecasting a 2009 federal government deficit of \$2 trillion or more. On the very day that I write you, Team Obama released their proposed budget, which calls for a deficit of \$1.75

trillion. But the real number is actually \$2.5 trillion, because that's how much they will have to borrow to get through the fiscal year (the difference being the amount of imputed value the government is randomly assigning to the \$750 billion in toxic assets it plans to buy).

And, seemingly forever, we have been forecasting that, push come to shove, the government will raise taxes on the "rich." There's a lot of that in Obama's budget as well, with increases in personal income taxes and even on capital gains, despite the plethora of studies demonstrating that taxing risk capital is counterproductive. And, it's an especially bad idea at a time when businesses need all the capital they can get their hands on – in no small part because the government's black hole-like spending is sucking in all that's available. Never mind all that, responds Team Obama, capital gains taxes are "fair" and so we should have them.

By some very credible calculations, high net worth U.S. taxpayers will see their taxes ratchet up by as much as 40% over the next few years. As the U.S. still tends to provide policy leadership to other governments of the world, expect this sort of naked wealth grab to go global.

There is an old saying, "You can only tell the true character of a person by observing their actions when they are broke or drunk." For a government, you want to observe their actions when they are broke and have an overwhelming majority.

## What's Next?

So, as predicted, we have a bubble economy in steep collapse, with the government manning all the monetary pumps in an at-

tempt to keep it inflated. Annual deficits in the trillions are now all but locked in for the next few years... and maybe beyond. Taxes are on the rise, as is the global populism and protectionism that is standard practice in troubled times.

Going forward, this business of forecasting gets a bit more challenging. If for no other reason than the U.S. is not alone in its sinking ship. Will the Chinese hold on to their dollars? Will they hold on to them even as the U.S. deficits top \$2 trillion this year... and then the next year... and then the year after that, too? Will Israel, or even the U.S., attack Iran? Will Pakistan see a revolution? Mexico fail? Will the Eurozone collapse? Will the latest experiment in fiat currencies come to a chaotic end? Will soaring unemployment lead to social unrest – a topic Doug Casey discusses in “**Street Fighting Man**,” the lead article for this edition?

Paradoxically, forecasting what the handlers of the world's largest economy, the United States, are likely to do – and which they are now doing – is the easiest part of the calculation. That's because, up to a point, the U.S.

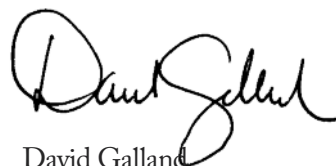
government can make its own bed and then insist the rest of the world jump into it. But there is a point past which the empire falls, as all that have come before can attest.

The global economy is the Webster Dictionary definition of a complex system: unpredictable in the extreme. There are simply too many variables. Even so, by observing that virtually all the major governments are now following the same expansionist script, we can draw reasonable conclusions... that inflation is a near certainty. And that the crisis will be deep and prolonged, if for no other reason than the efforts so far do little or nothing to support private enterprise. In some cases, such as increasing capital gains taxes, the government is actively working to retard commerce.

Beyond those conclusions, there is another potential outcome, though it is no sure thing at this early stage. And it is this: as the tsunami of money begins to sweep away what remains of the economy in a runaway global inflation, intelligent and influential people might, just might, remember the more stable days of the pure gold standard.

At least that way, when we look back on this disaster in our dotage, we'll be able to say that something good came of it, and that we have left our great-grandchildren something other than a mountain of debt.

And now, on that optimistic note, it's on to this month's edition.



David Galland  
Managing Editor

P.S. We had planned to include in this edition a comprehensive interview with commodity pros Dave Hightower and Terry Roggensack, but as I related in my weekly column, I clumsily managed to erase the recording. As we have been unable to reschedule the do-over interview in time for this edition, it will be brought to you next month. I can assure you, it will be worth the wait. And next time, I will be using *two* recorders!

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# Street Fighting Man

By Doug Casey

Longtime readers know my standard response to questions about the severity of the Greater Depression: It's going to be worse than even I think it's going to be. "Coming Collapse" books will undoubtedly accumulate into an entire genre in the next few years, as they did a generation ago. This time it's not just fear mongering, although things won't get as bad as in James Kunstler's book *The Long Emergency* and certainly not as rough as in the movies *Road Warrior* or *I Am Legend*. But it's a good bet that a lot more is going to change than just some features of the financial system. Let's engage in a little speculation as to the shape of things to come.

I've long believed that this depression would not only be much different but much worse than the unpleasantness of the '30s and '40s. In those days, only a few people were involved in the financial markets; now almost anyone with any assets at all is a player. In those days, there were no credit cards, consumer debts, or student loans; now those things are ubiquitous. It's true that nobody will lose any money because of bank failures this time around; instead, everybody is going to suffer a loss from a collapse of the U.S. dollar, which is much worse.

In the '30s and '40s, the U.S. population was still largely rural in character, including people living in the cities. The average American was just off the farm and had a lot of practical skills as well as traditional values. Now he has skills mainly at paper shuffling or in highly specialized technologies, and it doesn't seem to me that the values of hard work, self-reliance, honesty, prudence, and the rest of the Boy Scout virtues are as common as they once were. In those days, the U.S. was a creditor to the world and the world's factory to boot; now there are perhaps 8 trillion dollars outside the U.S. waiting to pour back in, and the country is now all about consuming, not producing. Even with what the New Deal brought in, there was vastly less regula-

tion and litigation, leaving the economy with much greater flexibility to adjust and innovate; today, few people do anything without consulting counsel. Of course things are immensely better

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today than 80 years ago in at least one important way: technology. I love technology, but unfortunately, improvements in that area do nothing to prevent an economic depression or many of the ancillary problems that will likely accompany this one. In fact, it can be a hindrance in some ways.

So, accepting the premise of a depression (which was fully explored in the last two issues), let's examine some of its likely consequences.

## Civil Unrest

I've puzzled over who will go into the streets as the depression deepens and when they'll do it. Nikolai Kondratieff, of Long Wave fame, was of the opinion that the natives tend to get restless at economic peaks (like the late 1960s, when riots broke out all over the world) and at economic troughs (like the 1930s, when the same thing happened). His reasoning is not dissimilar from that of Strauss and Howe. At peaks, people are just feeling their oats, which can evidence itself domestically in riots inspired by rising expectations, and internation-

ally in optional sport wars, like that in Viet Nam. Such peak-time disturbances are troublesome but don't really threaten society. That's largely because when times are good, people feel they have a lot to lose and they believe things can get even better. In prosperous times, people don't usually feel like overthrowing the government or transforming the basis of society.

Not so at economic troughs. People believe they have little to lose, they're eager to hang those they believe responsible for their problems, and they'll listen to radical or violent proposals. We're now just entering what will likely be the worst economic trough since the Industrial Revolution.

But why do humans tend to riot when the going gets rough? How can they think that solves anything? Do they believe it's going to make their jobs or money reappear? Perhaps I ask that question only because I can't see myself rioting. You and I might discount the thought of Americans going wild, because we wouldn't likely join them. But we're not, I suspect, the average American. People, throughout history, have always been prone to violence when times get tough. Is there any reason that should change now?

Recently, there have been — really for the first time in this downturn — reports of large, angry demonstrations all over the world. The UK, France, Eastern Europe, now China. If a place like Iceland, as placid and homogeneous as any in the world, can blow up, then any place can. And probably will.

A rioter is typically an angry person looking for vengeance because he blames someone else for his problem. So far, rioters seem to be directing their attention at governments. Correct target, of course, but they don't have the rationale quite right. They're not angry because governments inflated the currency, promoted



fractional reserve banking, and nurtured all the cockamamie socialist programs that caused this crisis. Not at all; they rather liked all that. They're angry only because their governments haven't adequately protected them from the consequences of what they did. So as conditions worsen, we can expect governments worldwide to pull out absolutely all the stops to show they're "doing something." And round up scapegoats to satisfy the mob and divert anger from themselves.

I fully expect civil unrest to spread everywhere, simply because the depression will spread everywhere. It will be worst in places that have been most overextended, most debt leveraged, most urban, and have the largest numbers of unemployed workers — the U.S., Europe, and China.

In the last couple of generations, most rioters in the U.S. have been students who basically just raise some hell on their campuses and inner-city blacks who burn down their own neighborhoods. Maybe the students who've wasted a huge amount of time and money in gender studies and sociology will get angry as they figure out they're not going to have jobs when they graduate — forget about making \$100,000 plus as an investment banker. Maybe blacks, who have apparently been hurt the worst by subprime lending and still may be the last hired and first fired, will take to the streets. Maybe. But I think it's more likely the turn of the Mexicans and other Latinos. They're the ones raided by *la migra* and stopped at checkpoints, whether they're legal or not. They're the ones who may be implicated in the wave of violence flowing up from northern Mexico. There is a real strain of revanchist nationalism throughout their community that hopes for the *re-conquista* of lands the Anglos stole in the 19th century. And they have all the other problems you might expect with an ethnic underclass.

But will ordinary middle-class Americans riot? I don't expect it until later in the game. Union members will be treated well by the Obama regime. And

most whites live in the suburbs; it's tough to get people who live in detached houses out into the streets. Ozzie and Harriet just don't seem likely to burn down their house, even if the bank owns it. Besides, a lot of the parents are on Prozac and their kids on Ritalin. Of course, on the other hand, most of the people who perpetrated mass murders over the last 25 years were on some type of psychiatric drug.

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Is there a catalyst that could turn your neighbors into a mob? Two possibilities are gun control and higher taxes, discussed below. But my guess is that riots will be headed off by the police, who are far more numerous, militarized, and better equipped than ever before, and by the military itself. You may think the cops and the military (and today most cops are ex-military) would never turn on their fellow citizens, but you'd be wrong. Cops and soldiers are far more loyal to their colleagues and their organizations than they are to either some constitution or, absolutely, the mob that's throwing bricks and bottles at them. They are also among the forces pumping in for gun control.

## Gun Control

This issue is potentially explosive. Although, sadly, gun culture in the U.S.

isn't nearly what it was even a generation or two ago, it's still pretty strong in some regions. Most states make the open or concealed carrying of handguns a simple matter, and there's evidence lots of people are taking advantage of it. Personally, I find it hard to fathom the psychology of people who want to disarm society. From a strictly practical point of view, the idea of having to engage in hand-to-hand combat, half naked, with an intruder in the middle of the night is most unappealing. Especially since the odds of that happening are going way up in the near future. Everyone should have a gun in his nightstand, at a minimum.

But that's only a fraction of what gun ownership is really about. A free person should have the right to possess whatever he desires. End of story. And only slaves, or those with a slave mentality, comply with no thought of resistance when they're told what they can or cannot own, especially if compliance means disarming themselves.

I've often wondered what would have happened in Germany after *Kristallnacht* if every Jew had been armed. None were, of course, because strict gun control had been imposed shortly after Hitler came to power, and like good little lambs, the population complied with the law. But my guess is that few would have defended themselves against the Gestapo anyway. Partly because they would have figured they were certain to get into serious trouble if they resisted, and partly because they couldn't imagine the fate that actually awaited them. It wasn't until the Warsaw Ghetto uprising in 1944, very late in the game, that people could finally read the writing on the wall and summoned the courage to fight.

If you follow these things, you'll note that there's been a lot of buzz about severe firearms regulation since Obama's inauguration. Bills are being discussed about things like a national firearms registry, reinstituting the so-called "assault weapons" ban, requiring secure locks on all weapons, prohibiting the import of ammunition, and levying a substantial tax on ammunition, among other things. No outright prohibition, because they

know that would catalyze gun owners. But they keep dialing up the pressure, moving toward a de facto ban.

I'll guess there are at least two to three million Americans who adhere to a couple of succinct mottos: 1. You can have my gun when you pry it from my cold, dead fingers, and 2. It's better to be tried by twelve than carried by six. This is a group that could catch fire at some point. But I don't think it's imminent, simply because the chances of outright prohibition of gun ownership are slim. The analogy of the frog in a gradually heating pot is apt. The taxpayer must also feel like a frog.

## Tax Revolt

State and municipal governments all over the country are operating with rising outlays and radically declining incomes and so are running large deficits that add to their already massive debt. Since they can't print dollars, they'll raise taxes further, as New York and California have recently done. Most people don't have any philosophical objection to taxes; they accept them, considering them part of the human condition, like disease or death. That's unfortunate, of course, in that taxation is neither moral nor necessary. But such fine points of philosophy absolutely never enter the public debate.

What will be debated is the level of taxation. The last time we had widespread agitation on taxes was during the last serious recession, in the late '70s. The result was things like Prop 13 (which capped property taxes in California for some homeowners) and the Reagan tax reforms.

I expect there will be serious whining about taxes this time around as well, but little will come of it. To start with, like every other organism on the planet, government puts its own interests first; society comes in a distant second. Actually a distant third, after powerful individuals who are wired to politicians and bureaucrats, and groups that hire the right lobbyists. Every level of government is more desperate for money than ever. Your

taxes are going through the roof, and you're going to see lots of new ones. Don't expect any support from *Boobus americanus*. About half don't earn enough to pay income tax. Most are net tax beneficiaries. And low taxes have somehow become associated with the late disastrous crack-up boom and the corrupt Bush regime. So a popular tax revolt looks like a real long shot.

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At the same time, a portion of the productive people in the country feel genuinely resentful at having to subsidize the losers and ne'er-do-wells. What are they going to do? I think they have only two alternatives. Tax evasion, which is both hard and increasingly risky, since the IRS will be hiring plenty of freshly unemployed financial workers. And expatriation. My guess is that scores of thousands of Americans are going to make “the Chicken Run” (as Rhodesians called it) in the next few years.

But the biggest danger to your personal freedom and your wealth, as well as to the U.S. as a whole, is likely to be war.

## War

It always impressed me as odd that while Obama ran on a platform of ending the pointless and counterproductive adventure in Iraq, he wanted to ramp up the war in Afghanistan. What possible reason could anyone have for wanting to fight an optional war in what may be the most backward and xenophobic place on the planet? Even if every Afghan made a

personal pledge of Death to America (which they eventually will, thanks to the occupation), who cares? Who cares if the Pygmies of the Ituri Rainforest or the Yanomamö of the Amazon join them? It's strange that no one ever questioned Obama on this nonsensical and contradictory policy.

Now it seems he's very slow in leaving Iraq. I expect the reason is that the U.S. has built elaborate bases the size of small cities that they're loathe to leave, partly on general principles and partly because they might be needed to attack Iran or Pakistan. The Obama regime is literally asking for trouble in both places. And partly because he knows that the collaborators set up to run the Iraqi government will promptly be deposed, and probably executed, by whoever might win the civil war that would ensue if the U.S. really left. The USG is apparently set on having a stooge in charge of both Iraq and Afghanistan.

The National Security State has a life of its own. Renditions haven't been stopped. Guantanamo still operates, as do other overseas prisons holding thousands. Military spending not only won't be cut, it will likely rise.

Wars start for all kinds of reasons. But tough economic times probably rank number one as a cause. The 1930s were a natural overture for the '40s. Politicians like to find a foreign enemy to blame problems on. Theft of foreign resources can seem like a good idea. And part of the economic mythology fabricated by the malevolent and repeated by the ignorant is that WWII cured the last depression.

Will there be another 9/11? It's a good bet, but there's no way it will involve airplanes; the 50,000 zombies employed by TSA serve absolutely no purpose except to accustom Americans to being treated like prisoners. One possibility is the surreptitious placement of one or more nuclear devices in U.S. cities. As Pakistan disintegrates, their nuclear arsenal may fall into quite irresponsible hands. Or, perhaps, devices could be procured in a number of ways from Russia, India, Israel, or

North Korea. Another, much more likely scenario is a repetition of what happened in Mumbai recently. A small force of dedicated and well-armed operatives could create unbelievable havoc in a U.S. city or in several at once. And probably will. Americans just don't appreciate how little people in the Islamic world like having aggressive, blue-eyed teenagers kick their doors down in the middle of the night, among other pranks.

You may be thinking that, with the American military the most powerful in the world, it's not about to lose a war. I question that. The bloated military is a major factor in bankrupting the U.S., and a bankrupt country can't win a war. Its \$6 billion carriers, \$1 billion B-2s and \$400 million F-22s are all built to fight a kind of enemy that no longer exists. They're sitting ducks for massive numbers of cheap missiles and jihadists that can swarm them where they're parked. The military wanted to fight WWI with cavalry and WWII with battleships. They're seemingly doomed to a repeat performance in the next major conflict.

In short, everything on this horizon looks very grim for a long time to come. Incidentally, the U.S. military is by far the world's largest single consumer of oil.

## Peak Oil

There hasn't been much discussion of this since oil has come down from its July 2008 peak near \$150 to its recent low of close to \$30. Longtime readers know I'm philosophically quite reluctant to give credence to any theory that would seem to imply we can run out of anything. I come down firmly on the side of Julian Simon. Which is to say resources are essentially infinite, and technology and capital can solve almost any problem in the material world. That said, there are problems that need to be solved. One is presented by the geological theory of M. King Hubbert, who predicted in the 1950s that the production of light sweet crude in the continental U.S. would go into irreversible decline by the early '70s. He was correct. He also predicted that the same would happen on a worldwide basis in the first decade

of this century. It now appears production has maxed out at about 80 million barrels a day and is headed down.

**“American culture revolves around the car. The car facilitated the growth of suburbs and exurbs, shopping malls and big boxes, most of which will become completely uneconomic with the rapid decline of the car.”**

This isn't the time or place for a detailed discussion of why and how this is true. It's certainly not the end of the world, as some appear to believe. Just a major inconvenience. Practically infinite power is available from a wide variety of sources, starting with nuclear. The problem is that oil is a particularly concentrated, convenient, and (in the past) cheap source, so the entire world's economy has been built around it. It will take a decade or so to adjust to the much, much higher prices that will be needed to bring consumption into balance with production. And absolutely everything that relies on oil is going to become much more expensive — especially transportation (for obvious reasons) and food. Food is interesting in that mass production is highly mechanized and oil intensive, as well as fertilizer and pesticide intensive — which again rely on hydrocarbons. The oil-food problem is aggravated by so much of what we eat being shipped very long distances.

Anything is possible, of course, but I think the most likely scenario is simply a large reorientation in patterns of production and consumption as a result of \$200 oil. This would be tough enough by itself. But it's going to put tremendous extra strain on the average American at exactly the time he's already under maximum strain from a shrinking economy.

Right now things aren't so bad, because energy prices are low. The depression has cut oil consumption and, conveniently, prices as well. That's taken a lot of pressure off the average American's pocket book and at a felicitous moment. And prices may stay low for a year or so as people the world over economize. But oil consumption doesn't need to rise to put pressure on the price; from here, the main pressure is likely to come from falling supply, not rising demand. So oil prices are likely to start heading up, for strictly geological reasons, even as the depression grows deeper. That will prove most uncomfortable. And will have significant consequences for two mainstays of U.S. culture: cars and suburbia.

## Collapse of Suburbia and the Car Culture

Suburbs are creatures of the automobile. I've been a car buff my entire life. I love cars for their technology. I love them because they're fun. But most of all, I love them because even more than the ship, the train, and the airplane, they liberate the average person to — cheaply and quickly — go anywhere he wants, whenever he wants. They've made it possible for people to break the mold of the medieval serf tied to the community he was born into. I don't think cars are going to disappear, but the internal combustion engine is, as a result of Peak Oil, on its way out. I suspect battery power will start rapidly replacing gasoline and diesel. The problem lies in the transition, which is going to be expensive, considering the huge sunk investment in the current technology. There's going to be an interim period, when people can't afford to drive their pickups, SUVs, or practically anything else hundreds of miles a week to distant work places and kids' soccer games or on promiscuous shopping trips. But neither will they be able to afford a new electric car.

American culture revolves around the car. The car facilitated the growth of suburbs and exurbs, shopping malls and big boxes, most of which will become completely uneconomic with the rapid decline of the car. That's entirely apart from the suburbs and exurbs being ex-



actly where people already can't make their mortgage payments. And can't afford to shop. They can't get by even at current bargain oil prices in the \$40 to \$50 range. It's going to be much tougher when gas is \$8 a gallon; if they can get a job, they're going to have to live within a few miles of it.

Entirely apart from that, people aren't going to be buying much stuff to store in the houses they can't afford. As George Carlin pointed out in his famous routine about "Stuff"

(<http://www.youtube.com/watch?v=MvgN5gCuLac>), that's what houses are for — storing stuff. And people are going to be liquidating what they have, not buying more, when they won't even have a proper place to store it. I'd hate to be in the furniture business over the next decade. Even if unemployment weren't going much higher.

## Unemployment

The official numbers say unemployment is 7.6%. But just as the definition of inflation keeps evolving to accommodate a number that looks better than the reality, the same is true for unemployment figures. John Williams's Shadow Government Statistics ([www.shadowstats.com](http://www.shadowstats.com)) computes the figures the way the government used to — mainly by adding back in part-time workers and those considered "discouraged." They show 17.5% as the historically comparable unemployment figure.

Society has been living above its means for well over a generation, long enough to ingrain unsustainable patterns of production and consumption in the economy. Did everybody need/have a personal trainer 20 years ago? Was "shopping" a major recreational activity in the days before everyone had a pocketful of credit cards? Do all kitchens really need granite counter tops? I think not. As people cut down to the bare basics to enable themselves to rebuild capital, millions and millions more workers are going to have to find other things to do. And, while they're figuring out what, cut back their consumption drastically as well.

I suspect the readjustment will push unemployment to at least the levels of the Great Depression, which would mean going past 25%. But some will argue: "Yes, but we now have a safety net to catch the fallen. That will make it less serious." No, it will make it more serious and more prolonged as well. The so-called safety net consumes capital that could have been used productively. It decreases the urgency for each person of finding a solution to his own problems. And it has given people a false sense of

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security, leaving them to save less for a rainy day. The looming collapse of things like Social Security and Medicare will be a bigger disaster than all the banks failing. The Social Security "trust fund," which has been a swindle, a Ponzi scheme in slow motion, and a moral wrecking ball almost from its beginning, is going to go much deeper into the red. Before they collapse, Medicare, Medicaid, and their cousins will be expanded by some form of free care for the legions of the newly unemployed. Will doctors and nurses be made indentured servants (such as through mandatory voluntary community service) to provide care for everyone who may need it? Perhaps not as long as taxes can be raised further on the middle class.

Sorry this has all been so gloomy so far. Now that the mood is set for recounting

all the problems that are going to beset us, some of you are probably saying to yourselves: "Yes, and that's on top of global warming."

## Global Smarming

This is on just about everybody's list of Big Problems. Except mine. I'm not a professional climatologist, or even an amateur, so I lack any technical qualifications for commenting on the subject — like almost everybody else who does, prominently including Al Gore. But my guess is that in the next decade, the global warming hysteria (and that's exactly what I believe it is) will be viewed, with embarrassment, as one of the great episodes in the history of the delusions of the crowd.

Have you noticed that "global warming" is gradually being supplanted by "climate change"? The fact is that the earth's climate has been changing constantly for at least 500 million years and has generally gotten much cooler over that time. It has certainly warmed since the end of the last Ice Age, 12,000 years ago, and was much warmer than now at the height of the Roman Empire. It cooled during what became known as the Dark Ages, warmed again during medieval times (when grapes grew in Greenland and northern England), and cooled again during the Little Ice Age (which ended about 200 years ago). During the '70s, as you may recall, some magazines ran cover stories featuring glaciers intruding into New York City. And for the last ten years, it appears the Earth has been cooling, although that's not widely reported. Change is a constant when it comes to the climate, and warmer is generally better.

Is the science "settled" on the subject? The very concept strikes me as ridiculous, in that science is rarely "settled" on anything short of it being proclaimed a law of nature. And, contrary to popular opinion, it seems most scientists with credentials in the field are either agnostic on the question or debunk the proposition of anthropogenic global warming. But the intellectual climate is such that most scientists are afraid to

question out loud the reality of warming. Since almost all funding today comes from politically correct sources, namely the government and foundations, the money goes to those who are known to be looking for the “right” answers. Science has been corrupted.

Of course man can change the environment. But our power to do so is trivial next to the sun, volcanism, cosmic rays, and the churning ocean. None of those forces gets any mention in the popular press, which fixates on carbon, which has replaced plutonium as public enemy #1. Carbon may be the basis of life on earth, but it’s supposed to be our new enemy nonetheless. The masses, who don’t even know carbon is a “natural” element and think the periodic table is a piece of antique furniture now feel guilty about breathing, because exhaled breath is a source of CO<sub>2</sub>.

Interestingly, a rise in atmospheric carbon dioxide levels doesn’t precede but follows, by several hundred years, phases of global warming. Everything you hear about saving the planet through carbon credits is as ridiculous and counterproductive as recent disastrous programs to turn corn into ethanol. In any event, carbon dioxide’s effects as a greenhouse gas are completely overwhelmed by those of water vapor. God forbid anyone warns the public of the numerous dangers posed by compounds like dihydrogen monoxide (also known as hydroxic acid).

As a lifelong science buff, I find the whole subject quite interesting and am tempted to do an article on it. The reason I mention it here, however, is that the global warming hysteria, as opposed to possible cyclical global warming itself, has serious economic consequences. The chances are excellent that governments will direct scores of billions of dollars into further research, devising computer projections of catastrophe to come, and fighting the presumed warming. Much more serious are laws they’ll pass in the war against carbon (and methane, which amounts to a war against cattle and sheep), which could retard the economy by hundreds of billions of dollars. Most

serious, in the long run, is likely to be a discrediting of science itself in the eyes of the common man once anthropogenic warming is exposed as a giant false alarm.

**“As always, there’s a bright side. Obama will be a one-term president. And, as middle- and upper-middle-class Americans come to see the government less as a cornucopia — that’s inevitable, because the cupboard is empty — they’ll start to see it ever more as a predator.”**

It’s actually been quite a while since I’ve gotten an outraged letter canceling a subscription. I expect and will welcome (even though it makes my excellent partner, David Galland, roll his eyes) furious letters for denying Anthropogenic Global Warming. But writers, do me a favor, in the interest of intellectual honesty. And also because I always like to learn something new. Give me a reference as to why you’re a believer. Please don’t include *Al Gore* or any tertiary news reports as evidence.

## The Political Future

We can be quite confident the economic future is going to be grim. The military future, ugly and busy. The social future, turbulent. So is it reasonable to expect politics as usual? That would be rather anomalous. Especially since the trend towards much more State power, centered strongly on the executive, has been in motion, and accelerating, for at least four generations in the U.S., even during the best of times. No surprises there. That is pretty much what observers of history

from at least Plato on would expect.

In that America is recently deceased and only the United States survives, I see no reason that the trend won’t continue accelerating, to be supercharged by the next Black Swan that might land. After the next real, fabricated, or imagined 9/11-style incident occurs or major war begins, it will be surprising if a state of emergency isn’t declared. Perhaps martial law in the U.S. will, perversely, provide the impetus needed to “bring the troops home,” in that they’ll be needed more in the U.S. than in Fuhgedaboutistan or wherever.

I leave the practical implications of that entirely to your imagination. But to maintain what little will be left of domestic tranquility at that point, the authorities will almost certainly feel compelled to round up dissidents, potential troublemakers, “un-American” activists, Constitutionalists, vocal malcontents, libertarians, and the usual suspects generally. It seems inevitable to me, and I’d prefer to be somewhere else when it happens. I’m loathe to make outlandish political predictions, if only because the inevitable isn’t necessarily the imminent. But if the U.S. survives the current crisis in its present form, I’ll be surprised.

As always, there’s a bright side. Obama will be a one-term president. And, as middle- and upper-middle-class Americans come to see the government less as a cornucopia — that’s inevitable, because the cupboard is empty — they’ll start to see it ever more as a predator. The government will become increasingly delegitimized in the eyes of what’s left of the middle class. But what will they do? If they still have a home in the suburbs or a condo in the city, they’re not going to burn it down like the poor. I’m not even sure they’ll riot. But they will seethe discontent. New affinity groups will coalesce. And they’ll wait until something really catalyzes them. Is another revolution possible? Why not? The U.S. is just another country at this point.

I’m convinced that the nation-state,



which is to say countries with governments based on geography, is on its way out fairly soon. And good riddance. Perhaps the U.S. will be among the first. What form of social organization will replace it? That will be the subject of an article soon to come.

In the near future, though, there will be a struggle between the best features of what little is left of America and the worst elements of humanity, whom we have in some abundance.

## Emigrants and Sociopaths

Americans no longer appear to be a special breed. Of course absolutely every nation likes to think it's a special, better breed — the Chinese, the Japanese, the British, the French, the Germans, absolutely everybody. It's a stupid but universal conceit, like the one putting God (presumably Yahweh) on their side during a war.

I used to fancy Americans actually could be a cut above simply because they're all the progeny of emigrants, and there are at least three reasons emigrants tend to be the "best" kind of people — at least from the point of view of someone who values freedom. First, emigrants tend to be more enterprising than their neighbors at home, willing to leave everything they have to pursue opportunity. Second, they tend to be harder working, since they know they'll get nothing they don't earn from strangers in a new land. Third, they tend to be anti-political, since political elites and conditions are usually what caused them to emigrate in the first place. Whether these things are because of a genetic predisposition or whether it's simply a cultural artifact within some families and groups, or both, I think it's a fact.

From the founding of the country, America has always had a strong emigrant ethos, and that's one of the things that has made it different and better. But all things degrade and revert to the mean with the passage of time. The country is now a fugitive from entropy.

Another reason for taking a pessimistic view is that — notwithstanding the point I made above — there's no reason not to believe there's a fairly uniform distribution of sociopaths across time and space, including in America today. All countries, in all eras, have them — but in good times, they stay under their rocks. Who would have guessed that the Germans of the last century, who had much more than their share of writers, composers, philosophers, scientists, plain middle-class shopkeepers, and a well-educated, orderly population would have

**"There are two ways people can relate to each other: voluntarily or coercively. The government is pure coercion, and sociopaths are drawn to its power and force."**

bred the Nazis? The Turks in the '20s, the Russians in the '20s and '30s, the Chinese in the '50s and '60s, the Serbs in the '90s, the Rwandans... It would be easy to recount dozens of recent examples of perfectly ordinary countries that have gone bonkers. The fact is that your neighbor or your mailman, who pets his dog, hugs his kids, and plays softball on the weekends, might exhibit a much less appealing, indeed an appalling, side when social conditions change.

You've, of course, heard of the Milgram experiment, wherein researchers asked members of the public to torture subjects with electric shocks, all the way up to what they believed were lethal levels. Most of them did it, after being assured that it was "alright" and "necessary" by men in authority.

The problem arises when a society becomes highly politicized. In normal times, a sociopath stays under the radar. Perhaps he'll commit a common crime

when he thinks he can get away with it, but social mores keep him reined in. However, once the government changes its emphasis from protecting citizens from force to initiating it with laws and taxes, those social mores break down. Peer pressure and moral opprobrium, the forces that keep a healthy society orderly and together, are replaced by regulation enforced by cops funded by taxes. And sociopaths start coming out of the woodwork and are drawn to the State, where they can get licensed and paid to do what they've always wanted to do. It's very simple, really. There are two ways people can relate to each other: voluntarily or coercively. The government is pure coercion, and sociopaths are drawn to its power and force.

After a certain point, a critical mass is reached. The sociopaths who are naturally drawn to government start to dominate it. They reset the social mores of the country they control. And it's game over. I suspect we're approaching that point.

## A Happy Note

There's no telling how bad things will actually get. The worst thing that could happen is a major war. But, barring that, what's happened in Zimbabwe, surprisingly, actually offers cause for some optimism. I was last there a couple of years ago, when, although it was a disaster, it hadn't descended into the absolute catastrophe that's going on now. Still, with draconian taxes, regulations, and hyperinflation, life goes on. Plumbers, electricians, and mechanics still repair things. Farmers still grow things — albeit on a much smaller scale. Stores still stock merchandise, even if there's not much of it. And I just heard yesterday from an ex-Zimbabwean that some of his friends there still play polo. And Zim is about as bad as it gets. But maybe it's also reason for pessimism. Why, out of the whole damned country, wasn't there at least one man with the courage to shoot Mugabe?

Look at Eastern Europe. After a horrible depression that lasted from about 1930 to 1990, the whole region blossomed in the space of a decade. It went

from the grimmest dystopia, a veritable hologram of Mordor itself, to being almost indistinguishable from Western Europe. It shows how quickly things can improve, as long as there isn't a backdrop of purposeful stupidity. Try as governments may to destroy it, there's an immense amount of capital that the world has built up over the past few centuries. Individuals and small groups will continue building their capital everywhere, notwithstanding any kind of State action. The pace of technology should

continue, if not accelerate.

As someone who always looks at the bright side, the final bit of good news I can offer you in this extraordinarily troubled milieu is that things are likely to be very interesting, even quite exciting, over the years to come. Notwithstanding the well-known Chinese curse, I'm not completely averse to interesting times. For one thing, you don't have to be adversely affected by them; they set up opportunities for greater profits than even the



wildest bull market. They will also give some reality to what is probably my favorite rock song: The Rolling Stones' *Street Fighting Man*. It used to be the bump music for my radio talk show ten years ago. Both the show and the song used to outrage middle-class Americans nationwide. Turn up your speakers (as Ed Steer is often wont to advise in his daily blog, "And then there's this...").

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# Crisis Horizon

By Bud Conrad

It's time to call the global crisis what it is: the worst financial collapse since 1929. That's no surprise to readers of this service, who have been amply warned over the last five years. But now even government officials, after trying to ignore the facts on the ground for the last couple of years, are admitting the truth of the matter.

Now that it's here, we turn our attention to trying to discern, "How bad can it get?" and "How long can it last?"

While such questions can never be answered with anything approaching absolute certainty, there are methods that can be used to assess what may lurk over the horizon. With that goal in mind, this article focuses on – and then expands upon – the recent work of two economists who painstakingly analyzed a substantial number of previous banking and currency crises in an attempt to derive potentially useful lessons. I have then taken their data and applied them to the current circumstances to see where we are, relative to those other experiences.

As you'll see, the data reveal the average depth and duration of various aspects of the crises examined (unemployment, GDP declines, stock price corrections,

etc)... as well as the "worst" case for each of those aspects.

Before getting to those data, however, let me be clear that we view the current crisis as anything but "average." The problems are systematic, in that they are global in nature and are negatively affecting virtually all aspects of economic activity. That said, at this point in time we believe that it is unlikely we'll match or exceed the worst case for each of the individual measures analyzed, though knowing the worst case from a historical perspective gives us a strong compass point to keep a very close eye on.

These data are not meant to offer a prediction but rather something akin to a beacon of light to see what is reasonable and what is very extreme.

## The Data

The data are from a study called "The Aftermath of Financial Crises" by Carmen M. Reinhart of University of Maryland and Kenneth S. Rogoff of Harvard University. In their study, the authors summarize the results of a broad sampling of banking crises, with between 13 to 22 crises analyzed for each of the variables.

The Reinhart/Rogoff study is based, in turn, on data extracted from an even more comprehensive study of events in 66 countries, titled "This Time Is Different: A Panoramic View of Eight Centuries of Financial Crises," by the same authors.

I've summarized the findings from the latest study in the table below:

"What Happened in Serious Crises?"			
	U.S.	Other Crises	
	So far	Average	Worst
Housing	-25.0%	-35.5%	-54%
Stocks	-51.1%	-55.9%	-90%
Unemployment increase in % from bottom	3.2%	7.0%	23%
Real per capita GDP	-1.5%	-9.3%	-28%
Cum % increase in public debt (Debt)	30.0%	86.0%	175%

The economic measures in the left column show how far the U.S. situation has deteriorated so far. The next columns show the averaged historical deterioration and the worst case of the crisis analyzed.

I then applied these data to calculate the levels that the U.S. could reach if it follows the path of the historical examples. The projected level is based on the measure analyzed, either from the **peak** prior to the downturn (e.g., the S&P 500)... or from the **bottom** prior to the downturn (e.g., the lows in unemployment). Thus, as you can see in the table here, the S&P 500 has already dropped from its October 2007 peak of 1565 down to 766, as this is being written in late February 2009. If this crisis was to end up being only “average,” then it would drop to 690.

If, however, the worst case of a 90% drop were to occur, as it did in Iceland last year, then the S&P 500 would trade down to the shocking level of 157. For further reference, if the current crisis were to cause the stock market to fall as sharply as in the Great Depression, the S&P would touch 469.

## Duration of Crisis

The analysis of previous crises also examined the *duration* of the various crises, calculating the number of years it took for each of the measures analyzed to reach their nadir during the event. As you can see in the summary table below, it took 3.4 years, on average, for the stock market to fall from the peak to the bottom. In the worst case, it took five years. With the recent peak in the S&P 500 occurring in October 2007 – just a year and a quarter ago – the crisis is likely to have some time to go before reaching even an average duration. More specifically, if this crisis turns out to be just “average,” we would not expect to see the low before the first quarter of 2011.

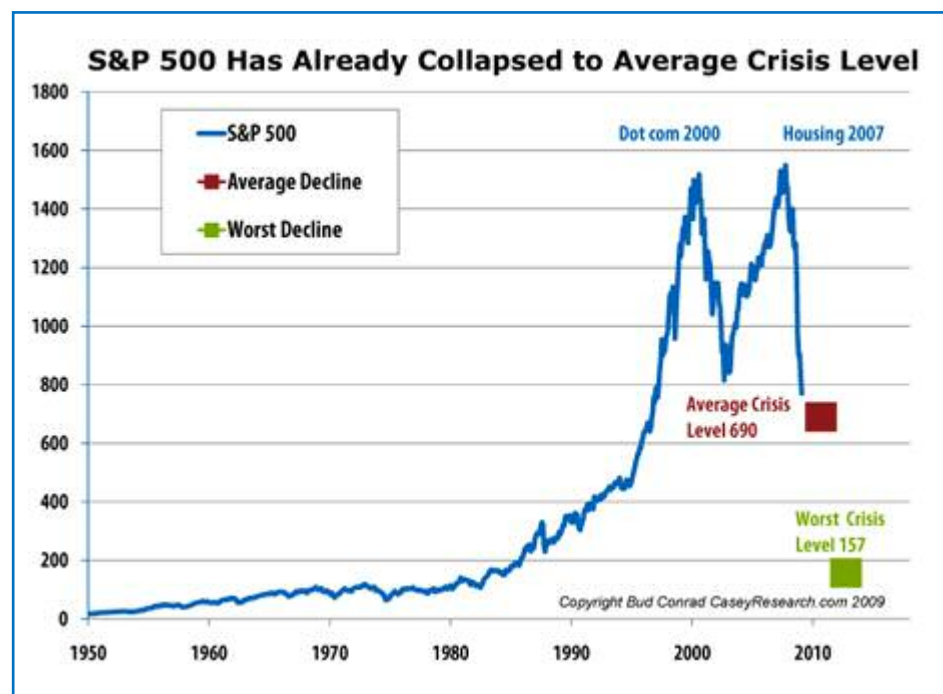
## The Crisis Horizon in Pictures

Charts of the above calculations give a visual perspective on the range of possi-

Crisis by the Numbers	Measured at		What If Like Other Crises	
	Peak or Bottom	Today	Average	Worst
Case-Shiller House Price	226	162	146	104
S&P 500	1565	766	690	157
Unemployment rate	4.4%	7.6%	11%	27%
Per capita real GDP	\$38,609	\$38,029	\$35,018	\$27,798
Public debt \$ B	\$5,000	\$6,500	\$9,300	\$13,750

## Time to Bottom from Peak

	Years from Peak	Average	Worst	What If Like Other	
				Average	Worst
Housing	2.7	6.0	16	2012	2022
Stocks	1.3	3.4	5	2011	2012
Unemployment	2.0	4.8	11	2012	2018
Real per capita GDP	1.3	1.9	4	2009	2011
Public debt (Debt)	1.3	3.0	3	2010	2010



ble outcomes. With that in mind, following is a series of charts, along with a few observations.

## The Stock Market

The stock market has already fallen by 50%, and so is now approaching the average level of decline. But it is still a long way from reaching the 90% decline Ice-

land's stock market experienced last year, or the 70% drop of the Great Depression here in the United States.

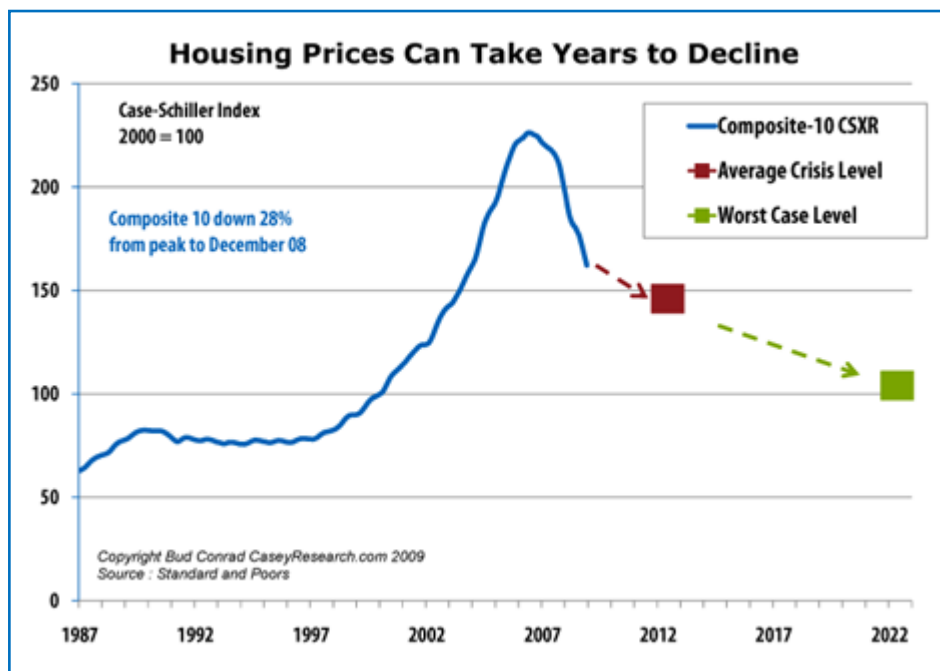
Where do we think the stock market is likely to head from here? With the severity of the drop so far, a bounce on hopeful news is entirely within the realm of possibility. Yet, given the abundance of evidence that the economic problems are



far from over, we would conclude that any rebound is likely to be fleeting, and that we still have further to go on the downside.

## Housing Prices

Housing prices as measured by the Case-Shiller index shot up in concert with Greenspan's cutting of interest rates to 1% in 2003. As you don't need us to tell you, those prices have fallen back, but the big inventories of unsold properties say we are not yet close to a bottom. As you can see, a real estate collapse can be akin to a slow-motion traffic accident, often times stretching out over several years. Typically, the bottom in housing comes last out of the five measures analyzed here.

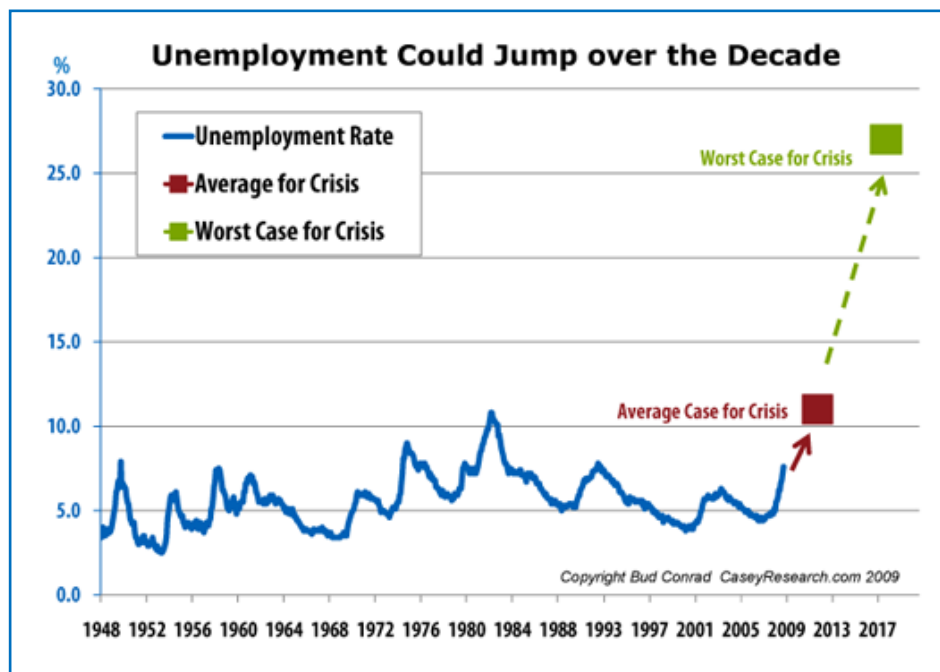


## Unemployment

Unemployment has continued rising from its low in March 2007 of 4.4% and is now estimated at 7.6%. It could head much higher as the unemployment rate tends to lag the other measures discussed here, and those measures are still in decidedly negative territory. It's unlikely we'll reach the worst case, which would require adding another 19 points to the current rate to get to 27%, if for no other reason than that the government would almost certainly step in with additional large public works programs before it would let things get that bad.

As many of you know, there are measurement issues when comparing employment rates over a long period of time: the government has made numerous adjustments to the calculations used over the years. If the same calculations were used today as were used in the Great Depression of 1929 – the worst case, as shown here – then today's figures would be significantly higher than reported, as much as 11%.

Looking forward, it's hard to see where new employment is going to come from to replace the jobs now being lost: the U.S. has relatively little manufacturing left, its financial services sector is on its back, and real estate-related businesses,



the powerhouse industry of recent years, are likely to be in a long-term slump.

In fact, the only readily identifiable growth industry in the years just ahead appears to us to be in government, hardly a positive. Speaking of which...

## U.S. Government Debt

The more easily predicted measure is the increase in government debt, the result

of governments with fiat currencies printing up new debt in an attempt to counteract the economic slowing. Outstanding U.S. federal government debt has already jumped a trillion dollars in the last two quarters, and, based on the various plans announced so far, another \$2 trillion in new borrowings is expected in 2009.

As you'll see in the chart on the next page, the time lags from the beginning

of the crisis to the average and worst-case levels are indicated as being roughly the same – about three years from the beginning of the crisis. This is because, unlike other measures analyzed, there is no finite point at which increases in government debt cease. Thus, the data was evaluated using a fixed measuring point, and the average and worst levels calculated at that point.

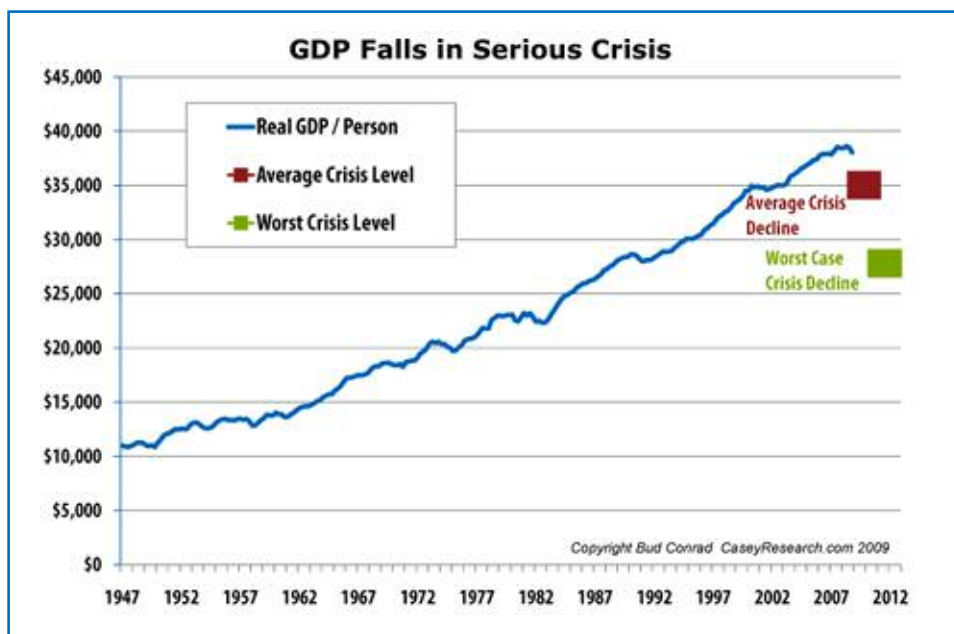
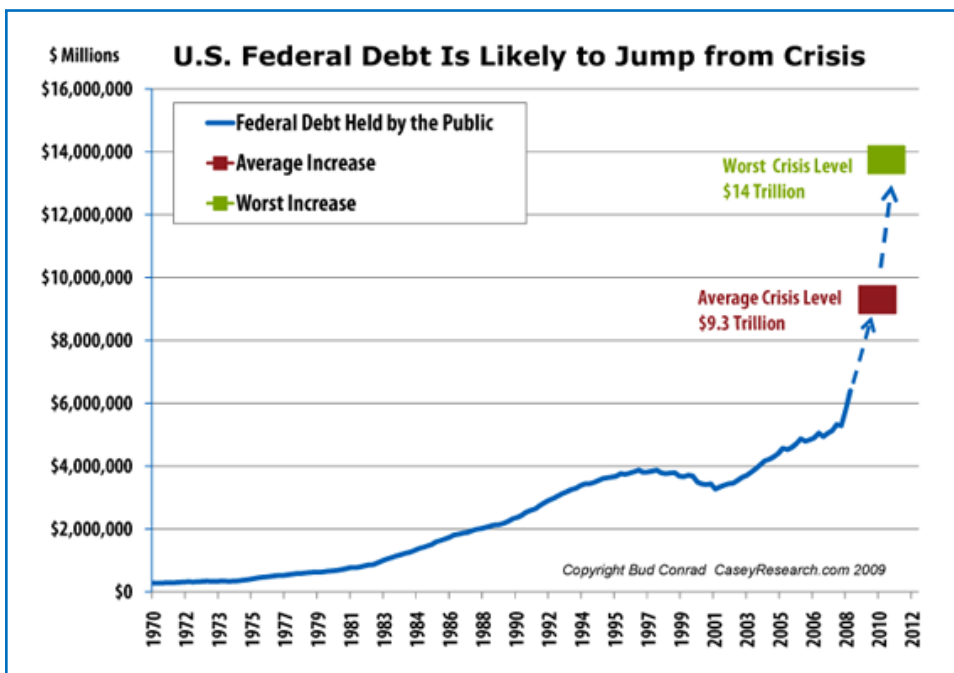
Looking over the historical record, we are not surprised to find that the U.S. is breaking no new ground by expanding government debt; that has been the default mode in many other crises. The surprise may very well be – given the aggressive levels of stimulus in the current crisis, with promises of much more on the way – that we could see U.S. federal debt approaching the worst-case level in the next three or four years.

The implications are relatively straightforward; a secular trend for higher interest rates as the Treasury tries to attract buyers for its debt; the introduction of new and elevated tax schemes (Obama's just released budget calls for increased taxes on high-income earners); and a ratcheting up of the Fed's highly inflationary monetary policies. On the latter front, as the U.S. is unable to pay down these debts in current dollars and is unlikely to outright default on its many obligations, the only option left is to diminish the debt over time through the hidden taxation of inflation. Expect it.

## Gross Domestic Product (GDP)

GDP, the summary measure of the broader economy, is usually relatively stable, as much of the activity is not prone to sharp economic swings. To wit, while discretionary items such as balloon rides in Napa may see a quick fall-off in activity, non-discretionary expenses are less sensitive: people still have to eat, clothe, and provide shelter for themselves.

While the chart indicates that a worst-case slowdown has not occurred for a long time, the feedback of a large number of people being thrown out of their houses and losing jobs in the current crisis provides anecdotal evidence



that we are facing a worse-than-average slowdown.

In the case of the Great Depression, a worst case by any unit of measurement, GDP was nearly halved, falling from \$104 billion to \$56 billion. That extreme is mitigated somewhat by the deflation in the depression, which boosted the value of the money then in circulation – the opposite of what happens in an inflation.

This time around, the government is attempting to make up for the fall-off in personal spending by engaging in a

spending spree of its own. To a yet undetermined degree, that spending will help buffer the impact on GDP – but it will simultaneously debase the currency. Even so, should the downturn result in just an “average case” decline of 11% in U.S. real per capita GDP, it would have very serious consequences. That level of decline is not at all out of the question: on an annualized basis, Japan's GDP fell by 11% in the quarter ending December 2008.

Regardless, a further deterioration in GDP is foreordained — the question

now is whether it will be just bad or a disaster.

## Crisis Horizon: Some Conclusions

The global economic situation continues to deteriorate on all fronts.

Housing prices, a fundamental component of the current crisis, are down 28% from their bubble peak in 2006 but still have a ways down to go to get back to their pre-bubble levels. As we have discussed, even an average downturn will mean that housing remains a problem for several more years. An increasing number of houses come back to the market through foreclosures, so the inventory of houses for sale is still growing. Exacerbating the problems are that a great many homes were sold with adjustable rate loans that are going to reset over the next few years. Unless, of course, the government steps in to stave off those resets... a "solution" that carries with it a separate set of problems.

Also on the topic of housing, a fundamental new problem is that, through its directly or indirectly controlled agencies – Fannie Mae, Freddie Mac, and the FHA – the government has become the *de facto* sole housing lender left standing in the United States. Dismantling those structures and reinvigorating the private lending sector – a prerequisite to a housing bottom occurring – will not be simple or accomplished in a short period of time.

Making things worse, we continue to expect very serious problems in the commercial real estate sector.

The stock market is approaching a 50% decline, the average of what has been observed in past crises. For stocks to rise, corporations need customers to create sales and profits. In the current slowdown of housing prices, domestic consumers can't borrow to extend their spending. Additionally, retaliatory responses to the "Buy American" provision of the latest stimulus coupled with the paradoxical global move into U.S. dollars as a safe harbor – which keeps the dollar stronger than competing fiat currencies –

means that the U.S. will not be able to export its way out of this crisis either.

Further slowing in U.S. corporate activities and profits means additional increases in unemployment, establishing a negative feedback loop that pushes corporate profits – and stock prices – even lower. The only growth trend at this point is in

**"The combination of declining business activity, coupled with declining levels of household income, will result in declining tax revenues, increasing the budget deficit beyond the size of the new bailout programs."**

government bailouts, which are in high gear, indicating we'll experience the serious growth of outstanding debt seen in other crises. The elevated levels of government borrowing required to fund that spending are absorbing all available credit from foreigners, directly competing with business in need of the new financing that will be required to expand the economy. The combination of declining business activity, coupled with declining levels of household income, will result in declining tax revenues, increasing the budget deficit beyond the size of the new bailout programs. State and municipal governments across the nation are already being confronted with large shortfalls in their budgets, shortfalls that will only widen as the crisis worsens.

The combined business slowing and jobs contraction assure that the GDP will decline. Components of GDP having to do with necessities like food and shelter will continue to bump along regardless of the economic conditions, but the lack of growth in GDP could extend for years as it did in Japan and as it did after the 1929 stock crash.

## Inflation/Deflation

As the recession/depression will be with us for years, it's important to revisit the question of the possible role of inflation on the longer-term outcome.

Given that we are currently in a deflationary phase, it is easy to dismiss the case for inflation – and many do. We think that is a mistake. Even a summary tabulation of the unprecedented increases in government debt at this relatively early stage in the crisis make a compelling case for higher inflation, if for no other reason than that it shows clear intent on the part of the government to spend "whatever it takes" to offset the deflationary forces now stalking the land.

That is not to downplay the complexity of predicting inflation: the details are found in ongoing analysis at Casey Research and have been published in previous editions of this and other Casey publications. To summarize, the current deflation is real but will be limited by the forceful actions of the government and Federal Reserve to assure availability of credit and to bail out as many participants as can be accommodated until there is an obvious loss of confidence in the dollar.

As to when that confidence will be lost, no one can forecast a precise turning date, but the persistent strength of gold and silver – arguably the only sound forms of alternative currency – suggest that the trend is now in motion against fiat currencies, including the U.S. dollar. Added anecdotal evidence comes from almost weekly announcements that major foreign holders of dollars are trading billions of those dollars for more tangible equity in mining, energy, and other companies engaged in the production of commodities.

That the current administration and Reserve Bank are committed to printing enough money to debase the dollar is not in doubt, and it has long been our expectation that this would be the path chosen. That is a fundamental reason we have consistently recommended gold, well before the excessive bailouts became policy.



## What to Do Now

In an article such as this, most economists would conclude by sharing their prescription for what Obama and the Fed “should” do. I won’t bother, because they wouldn’t listen anyway. And besides, that is not the purpose of our research, which is entirely designed to help you understand and therefore properly position yourself for what is to come. That we don’t have any connections to government, brokerage houses, banks, or any other institutions that could bias our research should, we hope, be of some comfort to you.

And that research paints a dismal story of years of economic stagnation. In our view, the trend is now firmly established for dollar debasement, a debasement that will eventually overwhelm the deflationary pressures from collapsing asset values. Therefore, don’t listen to the happy faces on CNBC spouting off, for the umpteenth time since this crisis began, that *now* is the time to jump back in and buy stocks. It isn’t.

## Nothing

*By Terry Coxon*

We don’t yet know how many trillions will be swallowed up by the government’s rapidly breeding herd of stimulus-bailout-help!help! measures. But additional bold steps are sure to come, some already in R&D and others to be invented on the fly to answer each new wave of bad news. Expect price tags suitable for proving how serious and determined the authors are.

The doubts that meet each new plan – does it really need to be that big... hasn’t something like that been tried before... is it smart to keep wrong-headed decision makers in high places... isn’t too much debt at the heart of the problem... if you don’t know what causes inflation, are you sure you know what causes babies – are all answered with the same rhetorical question: “We can’t just do nothing, can we?”

Be extremely skeptical when you hear some pundit pronouncing that this piece of short-term good news or another is an “all clear” signal. Until we start seeing a systematic improvement in the economic fundamentals – for example, an upward movement in consumer confidence – the only signal the economy will be hearing is that of a runaway train coming straight at it.

We will, of course, continue to help you monitor the important data and keep an eye out for valid indicators of a stabilizing economy. Retail sales, unemployment claims, risk spreads, and other leading indicators will need to begin moving in the right direction before we’ll take any comfort that a recovery is underway.

But we are far from that point, and still very much in the grips of an interrelated and collapsing global economy.

The opportunities in this environment remain, in our opinion:

- Gold as a safe position against



continuing weakness in the fiat currencies.

- Investments that make money on the rise in interest rates; a rise that will become inevitable as the debasement of those currencies accelerates.
- As we cover elsewhere in this letter, more speculative-minded investors can look to short various “at risk” companies, particularly those in the financial services.

In time, we’ll look to take positions in the key commodities – and the companies involved in bringing those commodities to market. These should offer spectacular upside as they eventually, and invariably, rebound from today’s greatly oversold levels.

As the spate of recent news confirms, the Chinese aren’t waiting to take their positions in the resource companies but are acting now. Food for thought?

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**“Training people to be crazy wasn’t what the U.S. government set out to do when it ended the dollar’s convertibility to gold in 1973. But it turned out to be one of the results.”**

Yes, we can. But we won’t, because the decisions about our wealth and our freedom are being made by career politicians, for whom stepping aside is the only truly unacceptable plan. Nonetheless, even though the idea of government doing nothing in the face of credit crisis, bank insolvencies, and recession has been

reduced to a hypothetical, such a policy deserves a little exploring, since it can tell us something about where all the big-dollar solutions coming out of Washington are likely to lead.

## Background

It’s possible to train people to be crazy. If you’re acquainted with a psychotherapist (socially, of course), ask him to explain how it’s done. Training people to be crazy wasn’t what the U.S. government set out to do when it ended the dollar’s convertibility to gold in 1973. But it turned out to be one of the results.

Untethered from the gold standard, the Federal Reserve was free to create new dollars whenever it saw fit. But the policy it drifted into wasn’t steady inflation, day in and day out, it was rescue infla-

tion. The Fed would step up the expansion of the money supply whenever it saw a risk of widespread defaults in credit markets. The unintended effect was to train both lenders and borrowers, by repeatedly rescuing them from damaging defaults, to appraise financial risk unrealistically and to regard what is in fact a source of danger as a manageable nuisance. It made the managers of financial institutions functionally crazy, and the longer rescue inflation continued, the worse they got. (When you read about investment bankers running a business with 30-to-1 leverage and tell yourself, "Those people must be crazy," you've got it about right. But they weren't born that way. They were trained.)

That's how the credit crisis was nurtured. And here is what the government has done about it so far.

**August 2007.** The credit crisis is just going public. Commercial banks, investment banks, and other financial institutions are waking up to the reason they were getting such great returns on junk paper – it really is junk. To ease the shock, the Federal Reserve begins a vast and unprecedented program of swapping out Treasury securities from its own sizeable (nearly \$1 trillion) investment portfolio in exchange for the embarrassing and worrisome securities that seem to be paralyzing the lending departments of the banks that own them. A novel approach, and not really inflationary, since no new cash is produced.

**September 2008.** Lehman Brothers informs the Federal Reserve that the novel approach, admirable though its inventiveness might be, isn't working and drops dead in front of Ben Bernanke's desk. The Fed abandons the hope of a non-inflationary remedy and begins a vast and unprecedented program of expanding the monetary base (buying Treasury securities and other IOUs in the open market with brand-new dollars).

**October 2008.** President Bush signs a vast (\$700 billion) and unprecedented bailout bill. It has been sold to Congress

as a measure to help banks survive and keep lending, but the details are vague in the extreme, leaving the secretary of the Treasury with the authority to use the money for almost anything, including, if he should find it advisable, "for carrying on an undertaking of great advantage; but nobody to know what it is."

**"...what would have happened if George Bush, Ben Bernanke, Nancy Pelosi, Harry Reid, Barney Frank, and Barack Obama had done nothing? It would have been spectacular, a mass die-off of the incautious."**

Other vast and unprecedented programs have followed, including tens of billions for any car company willing to drive (not fly) to the teller window, hundreds of billions to get messy home mortgages house-trained, and unspecified megabillions for Timothy Geithner's proposal to unburden banks of bad assets through a plan of great advantage but nobody to know what it is.

And today, 20 months after the doctors started scribbling prescriptions, most markets continue down, the economy is still shrinking, and worries are still growing.

Now roll the tape back to August 2007. What would have happened if the U.S. government had simply kept its long-standing commitments (in particular, protecting FDIC-insured deposits and preventing the money supply from shrinking) and otherwise had done nothing? No good-asset-for-bad-asset swaps, no wild expansion in the monetary base, no bailouts, no arranged marriages with taxpayer-financed dowries for failing institutions.

Nothing.

If that sounds extreme, perhaps you'll find it a little more acceptable if I put it this way: what would have happened if George Bush, Ben Bernanke, Nancy Pelosi, Harry Reid, Barney Frank, and Barack Obama had done nothing?

It would have been spectacular, a mass die-off of the incautious. Bear Stearns, Morgan Stanley, and other practitioners of ultra leverage, including perhaps Merrill Lynch, would have folded. When you borrow to carry \$30 of investments for each \$1 of company capital, it only takes a 3.4% drop in the prices of your assets to put you under water. And when you're getting that 30-to-1 leverage through overnight borrowing, even a whiff of doubt can make it impossible to roll over your financing from one day to the next. Either way, you're out of business.

From there, the trouble would have fanned out. The firms just pronounced dead were counterparties to trillions of dollars in derivatives. The investors on the other side of all those deals (largely banks, insurance companies, and other brokers) would have been left holding the bag. Some of them would have failed, and all that survived would have been left weakened and living in fear.

Growing mortgage losses would have forced Fannie and Freddie (and also Countrywide Financial) into bankruptcy, which would have turned their trillions in outstanding bonds into junk debt, doing great injury to the banks, insurance companies, and other investors that held them. Citibank and Wachovia would have gone under. And with Fannie, Freddie, and Countrywide gone, the biggest sources of mortgage money would be unavailable, which would have turned the housing market from a corpse into a mutilated corpse. AIG, which had turned itself into a sink of follies by insuring other companies against losses on junk debt, would also have joined the departed – and the companies that had been depending on AIG credit insurance would have gotten sorted out between the failed and the merely damaged.

Bank of America, having been spared the irresistible invitations to acquire Countrywide and Merrill Lynch, might be in much better shape than it is today.

With a hundred-car pile-up in the financial sector, lending to businesses and consumers would have shriveled, and the rest of the economy would have slipped into a depression. No more General Motors. No more Chrysler. Ford maybe.

And those are just the big names. Tens of thousands of other companies would have gone out of business. Most others would have laid off workers. The unemployment rate would have moved deep into double digits. With so many companies cutting inventories to raise cash for survival, the wholesale price index would have gone off a cliff, and the consumer price index also would have slumped.

It's an ugly picture, with pain and hardship for millions of people and grave worries for the rest. But before you start preparing thank-you notes for the good people in Washington who've acted so boldly, consider this:

If they had done nothing, the whole sorry business might be over by now. Without the promise of rescue and blow-softening, events would have moved quickly. The collapse of the over-leveraged financial companies would have started soon after credit market jitters began in August 2007. (Leverage built on overnight borrowing invites swift justice.) The disaster in the financial sector might have been over by the end of that year or soon after. The year 2008 would have seen the wave of layoffs and bankruptcies in operating companies and the fall in wholesale and consumer prices.

A simple process would have brought the contraction to an end. With the prices of most things falling, the real value of the money in everyone's pocket would be rising. That would continue until large segments of the population came to feel cash rich and started spending. Dollars appreciated in value, not dollars newly printed, would finance the recovery.

**“If they had done nothing, the whole sorry business might be over by now. Without the promise of rescue and blow-softening, events would have moved quickly.”**

And it would be a thoroughly healthy recovery, because the bankruptcy proceedings that came before it would remove the billion-dollar bunglers of recent years from positions where they can make expensive mistakes. Decision making about the allocation of capital would fall to the survivors, who, by their survival, had proven their ability and readiness to decide wisely.

There is precedent for this. In the depression of 1920-1921, for example, wholesale prices fell by nearly one half, and most of that fall occurred in a period of just six months. It was a violent experience, with widespread bankruptcies, but it was over in a year and a half. It ran fast because the government did so little to try to stop it. Nancy Pelosi hadn't been born yet.



So much for the hypothetical. Instead, with all the government efforts to make things right, we have:

- An economy that continues to contract;
- A continuing mystery as to which banks are solvent and which are not;
- Financial institutions still under the control of individuals who've proven they should be doing something else;
- Car companies on apparently permanent life-support at taxpayer expense;
- A retarded decline in housing prices that is extending, by years, uncertainty as to how severe mortgage losses are going to be;
- A flock of new government programs that will continue to soak up billions of dollars per year long after the recession is over;
- A vast and unprecedented (that again) increase in the basic money supply, which is jet fuel for price inflation;
- A vast and unprecedented increase in peacetime government borrowing, which, when the recovery begins, will trap the government in a choice between letting interest rates rise (and risk choking off the recovery) and continuing to inflate the money supply (and kiss runaway price inflation on the mouth).

Yes, it does seem cruel to do nothing when disaster is unfolding. But consider the likely consequences of the alternative.

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# How to Invest

## Key Points

- **Politicization of Economy Gaining Traction.** Our concerns about elevated levels of government economic interference are validated on a daily basis. With U.S. bailouts rapidly approaching \$9 trillion (better than twice the cost of WWII on an inflation-adjusted basis) and a steady stream of calls for more regulations, more government programs, and more taxes on the productive elements of society, the trend is gathering momentum.

As government programs have long life cycles, the spate of new government initiatives are best viewed as kudzu-like plantings that will grow and become more pernicious with each passing day. Persistent future inflation is being sown and taking root. The effect of politicizing the economy is that when the recession ends, the economy will be ambulatory but not robust. The weakness of the recovery will be one more invitation to continue with monetary inflation.

- **Trillions in cash on the sidelines.** Uncertainties around what government may or may not do next only add to existing investment insecurity, serving to keep money on the sidelines rather than being deployed into private enterprise, the sole real hope for the global economy. "Safe harbor," government-guaranteed issues such as Treasuries remain popular, squeezing out capital that would otherwise go into corporations, and keeping yields down. This situation is likely to persist for awhile longer, offering investors a window of opportunity to get positioned for the higher interest rates that must result from the unprecedented levels of stimulus.
- **Call it a Depression?** Even Paul Volcker and George Soros now concur that the economic situation is deteriorating and is the worst seen since the Great Depression... and maybe even worse than that. As the current depression – and it's getting harder and harder not to call it that – is global in scale, the world is particularly susceptible to an "accident," an unforeseen event that sends markets screaming lower. The collapse of the Eurozone? An attack on Iran? A trade war with China? Anything is possible.

As in the 1930s, ominous signs of protectionism, including the "Buy American" provisions in the latest U.S. stimulus package, are beginning to appear. At this stage, "hope for the best, but plan for the worst" strikes us as appropriate. As does selectively looking for shorting opportunities, though only through positions that are well supported with excess margin.

Gold Gaining Favor as an Alternative Currency. Soaring investment in physical gold and gold ETFs is an early indicator that investors are once again viewing gold for its properties as a monetary metal. Gold is now trading at all-time highs against all the major fiat currencies, with the exception of the U.S. dollar (and it is not far from breaking that record as well). With government stimulus just now ramping up, and on a global basis, we see nothing – short of possible outright confiscation – that will detract from gold's status as the ultimate safe harbor in this crisis. While no one can say that the global experiment in fiat currency will come to an end anytime soon, the odds of that being the case have never been shorter.

- **The Bottom May Be in Sight for Critical Commodities.** Base metals and energy commodities are likely to remain under pressure for awhile longer, due to the reflexive action of traders confronted with the onslaught of bad economic news. Even so, there are fundamental reasons that a bottom, followed by a buying opportunity, may be on the horizon, including (a) they have already been deeply sold off; (b) many commodities are now selling at or below their cost of production – commodities producers, adept at adjusting to changing prices for their products, are canceling projects and idling production; (c) much of the global stimulus spending is earmarked for infrastructure spending, which will favor commodities such as copper, and; (d) the Chinese are actively building stockpiles and trading U.S. dollars for large metals projects. As bad as the economic situation may get, the demand for basic commodities will continue, albeit at reduced levels. Once demand looks poised to intersect supply, the bottom will be put in and a healthy rally will materialize.

## Short Interest Rates

As expected, the new administration continues to pour fuel on the fire with the new bailout packages. The mounting federal deficits that will be the result of this reckless spending will eventually have to be financed one way or another, though the problem will most likely be solved with printing presses. Regardless, financing the upwards of a \$2 trillion annual deficit will require interest rates much higher than today's current rates. In anticipation, we have recommended

that subscribers get positioned in funds that will benefit from rising rates.

Although we initially entered into these funds too early, they appear to have bottomed out at the end of 2008 after some short-term yields actually went negative. Year-to-date through February 25, 2009, the 30-year T-bond has risen 76 basis points, the 10-year T-bond 47 bps, and the 3-month T-bond 22 bps. These movements are only incremental and nothing compared to what we expect to

see when the inflationary pressures actually kick in.

Nonetheless, our inverse fund recommendations have had a decent performance in 2009 as a result. Year-to-date, the **ProFund Rising Rates Opportunity (RRPIX)** and **Rydex Inverse Government Long Bond Strategy (RYJUX)**, which track the inverse of the daily price movements on long-term T-Bonds, are up 13% and 9% respectively. The fund that tracks the inverse of the 10-Year

Treasury, the **ProFund Rising Rates Opportunity 10 (RTPIX)**, is up a less exciting 2% on the year.

We continue to recommend adding to your positions in these funds, looking for a big rally to emerge later this year.

## Buying Gold

Investment demand for gold has accelerated in the beginning of 2009. Since January 2, the SPDR Gold Shares ETF has increased its gold holdings by 32% or nearly eight million ounces of gold, and mints around the world are reporting similar sharp increases in demand:

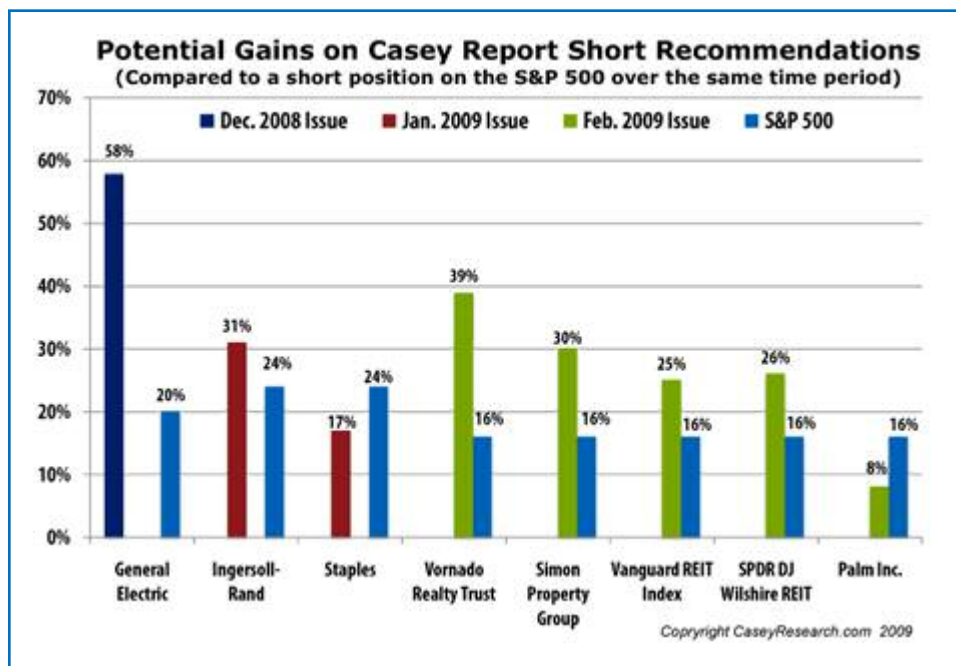
The US Mint has sold 193,500 ounces of its popular American Eagle gold coin in the first seven weeks of this year, the same amount it shipped during the whole of 2007 and about the same as in the first six months of last year. ([Financial Times February 25, 2009](#))

We expect investors will continue to pour into physical gold and gold stocks in the months and years to come as the crisis intensifies and the fiat currencies continue to be wildly debased by their issuing central banks. Continue building a core position in physical gold when you get a chance and wait for dips to buy into gold stocks.

### Market Vectors Gold Miners ETF

**(GDX):** (\$32.90, Gain 57%) Maintain position, buy on dips. This ETF tracks a broad range of gold- and silver-producing companies, although heavily weighted towards the larger gold miners. It's an easy "one-stop shop" way to gain leverage in the gold market and remains one of our core recommendations.

**Buy Silver:** The price for silver is now reaching levels that are getting more attractive by the day. This precious metal has been punished for its industrial uses in a stagnating economy, but we expect investor demand for silver as a monetary metal will soon supersede absent industrial demand. Consider taking a position



in the **iShares Silver Trust** (NYSE.SLV). Look for more on silver in next month's issue.

There's no way of knowing exactly when the trillions of dollars in cash and stowed away in Treasuries will make their way back into the markets. The signs for a recovery have yet to materialize as the market continues to discount any notion of the Obama bailouts' success. Companies have reported dismal fourth-quarter earnings, and the outlook for 2009 isn't bright. As a result, some of the best opportunities over the last few months have been on the short side of the market.

After identifying a number of successful shorts in insurance (MBIA), banks, and housing, in recent issues of **The Casey Report**, we have focused on companies that will need to refinance massive amounts of debt in 2009. Following is a chart of the short recommendations made in the last few editions, versus the benchmark of the result you could have had by simply shorting the broader S&P 500.

While we will continue to advocate a "see a profit, take a profit" approach to finances (and if you are a conservative investor, don't hesitate to take a profit on these positions – starting with excellent three-month gains in GE), we remain

confident that our current open short positions offer far more upside than downside at this point. As with any short position, however, you must have sufficient excess capital available to cover a rally that goes against you, a minimum of 20%. That way, you will not be chased out of the position on any reversals.

**Here's the list of the short recommendations we are continuing to follow:**  
**General Electric** (NYSE.GE). Initially shorted December 3, 2008 at \$18.13. Current price: \$7.60. This was our early recommendation in our "Short the Big Debtors" section back in December when GE had a market cap of \$170 billion and \$708 billion in liabilities. Today GE has a market cap of \$95 billion and \$684 billion in total liabilities, giving it plenty of room to continue its downward spiral.

**Ingersoll-Rand** (NYSE.IR) Initially shorted January 5, 2009 at \$18.88. Current price: \$12.99. After an aggressive \$9.6 billion acquisition of the Trane air conditioning systems business in June 2008, Ingersoll-Rand became highly leveraged at exactly the wrong time. At the end of 2008, IR still had \$5.1 billion in total debt, which includes just under \$1 billion in commercial paper liabilities and a \$750 million bridge loan facility

that expires in June 2009. The company has large credit facilities to cover any shortfalls in refinancing their short-term debt, but neither option involves eliminating their large debt position.

**Staples (NASDAQ:SPLS)** Initially shorted January 5, 2009 at \$18.53. Current price: \$15.29. Staples is another shorting candidate as result of an aggressive acquisition in 2008. The Corporate Express acquisition expanded Staples' stake in the European office supply markets for a total cost of \$4.4 billion. While we are still waiting for the company's latest quarterly report, the \$1.5 billion of debt they have to refinance by July 2009 and \$948 million in commercial paper liabilities lead us to believe there is plenty of downside for Staples.

**Vornado Realty Trust (NYSE.VNO)** Initially shorted February 4, 2009 at \$49.39. Current price: \$30.13. This commercial-focused REIT will be at the heart of the collapsing commercial real estate bubble with over 100 million square feet of commercial properties in New York City, D.C., and Chicago. The \$1.40 per common share loss in the fourth quarter of 2008 is only the start for this company, as occupancy rates should plummet in 2009.

**Simon Property Group (NYSE.SPG)** Initially shorted February 4, 2009 at \$42.16. Current price: \$29.96. This REIT has 262 million square feet scattered in 386 properties in North America, Europe, and Asia. The Simon Property Group is more focused on retail operations with large shopping malls, outlet centers, and big-box retailers. Simon Group kept its \$0.90 dividend throughout 2008, but the rapidly declining retail market should start taking its toll on the company in 2009.

**Vanguard REIT Index ETF (NYSE Arca.VNQ)** Initially shorted February 4,

## Investment Portfolio Composition: As of December 31, 2008

(Figures in Millions of \$)

### Fixed Income Securities

	Allstate Corp		CNA Financial Corp	
	Fair Value	Unrealized Net Gain and Losses	Fair Value	Unrealized Net Gain and Losses
U.S. government and agencies	\$4,234	\$962	\$2,862	\$68
Municipal	21,848	(1,717)	8,557	(1,142)
Corporate	27,627	(3,413)	12,993	(2,263)
Asset-backed securities	3,860	(2,459)	9,670	(1,906)
Commercial mortgage-backed securities	3,846	(1,994)		
Mortgage-backed securities	4,492	(334)		
Foreign government	2,675	469		
Redeemable preferred stock	26	(10)	72	(25)
<b>Total fixed income securities</b>	<b>\$68,608</b>	<b>\$(8,496)</b>	<b>\$34,154</b>	<b>\$(5,268)</b>

2009 at \$29.74. Current price: \$22.40. This ETF tracks the MSCI US REIT Index, which holds a variety of different REITs, although not entirely focused on commercial properties. Vornado Realty and Simon Group are part of the core holdings, but shorting this ETF is shorting the entire real estate sector.

### SPDR DJ Wilshire REIT ETF

(NYSE Arca.RWR) Initially shorted February 4, 2009 at \$32.72. Current price: \$24.12. This ETF is similar to the Vanguard REIT ETF, but it tracks the Dow Jones Wilshire REIT Index.

**Palm Inc. (NASDAQ.PALM)** Initially shorted February 4, 2009 at \$7.98. Current price: \$7.32. After rallying back from a December low of \$1.14 to over \$7.80 on the back of a new smartphone, we recommended shorting PALM. Aside from falling consumer and corporate spending that puts this stock in jeopardy, PALM is also tied up in patent infringement lawsuits with its new product.

As discussed in the [February 2009 issue](#), there is an inherent flaw with investing in leveraged short-selling ETFs over the long term, but for an aggressive short-term strategy, consider the **Rydex Inverse 2x S&P 500 Fund (RSW)**. This ETF should match double the inverse of the S&P 500 on a daily basis, but if you hold on for an extended period of time, its performance will be skewed. The best scenario for this fund is taking a position before a few days of consecutive drops in the S&P index. The **ProShares Short S&P 500 ETF (SH)** is worth looking

into for a less aggressive way to short the index, although this ETF is also problematic in meeting long-term objectives.

In terms of "new business," last-year subscribers were able to earn big returns thanks to Bud Conrad's excellent call to short bond insurer MBIA. We now return to the insurance industry, for another bite at the profit apple.

## Short Insurance Companies

Insurance companies operate on a similar principle as banks. They collect premiums on the policies they issue and then make a profit by investing the money in supposedly low-risk investments. As we saw with AIG, the risk management for insurance companies has been no better than for the large financial institutions and banks. After an injection of \$85 billion in AIG last September and then upping the ante to \$150 billion in November, regulators are now struggling with how to deal with the company as its losses continue to mount.

AIG, a former powerhouse but now just a hollow shell, is a frontrunner for what's ahead in the insurance industry. Insurance companies have been marking down huge losses on their investment portfolios for the third and fourth quarters of 2008. The losses haven't gone entirely unnoticed as most of these stocks are off by more than 50% from their 52-week highs, but the write-downs have only just begun and, in our opinion, are leaving plenty of opportunity for in-



vestors looking for shorts. For this month's issue, we are recommending two candidates in the insurance industry that are sitting on mounds of risky asset-backed debt: **Allstate Corporation** and **CNA Financial Corp.**

**Allstate Corporation** (NYSE.ALL, \$18.47, MCap: \$9.9 B, SO 536 M, [stock chart here](#)) is an insurance conglomerate providing 13 major lines of insurance, including auto, property, life, and commercial through the Allstate Protection segment of the business. They also provide retirement and investment products and banking services through the Allstate Financial segment.

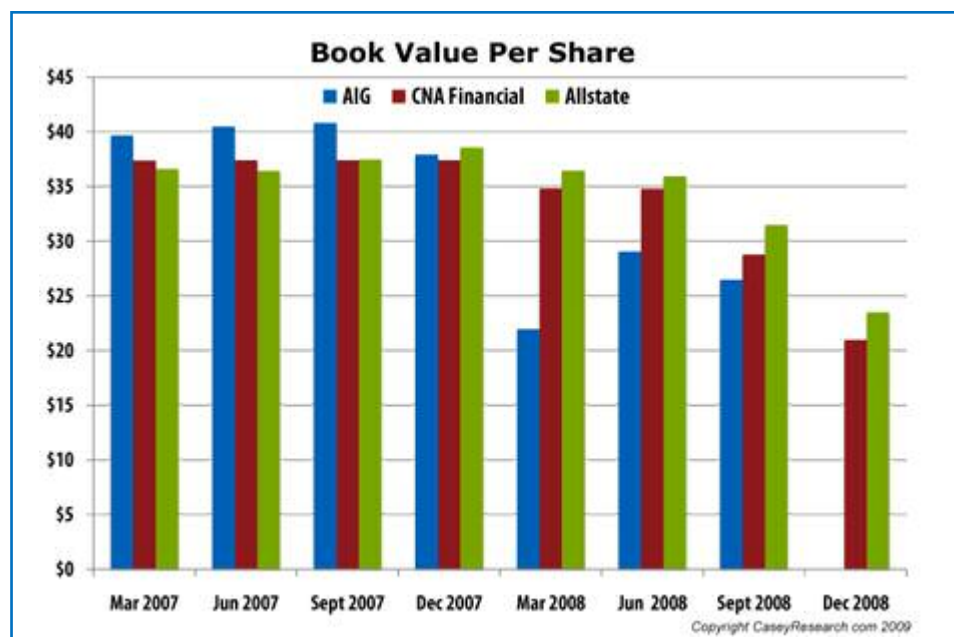
As you can see in the table above, 18% of Allstate's fixed income securities are tied up in asset-backed and mortgage-backed securities. They already estimate \$4.7 billion in unrealized losses related to asset-backed securities, and the table doesn't include another \$10 billion in mortgage loans or \$2.8 billion in equity securities that they estimate have an unrealized loss of \$332 million.

**CNA Financial Corp** (NYSE.CNA, \$8.47, MCap: \$2.2 B, SO 269 M, [stock chart here](#)) is an insurance agent offering various lines of commercial insurance, specialty lines, surety, marine, and other property and casualty insurance policies.

Of CNA's \$34 billion investment portfolio, 28% is related to asset-backed securities of which they estimate \$1.9 billion in unrealized losses. The asset-backed securities break down to \$408 billion in mortgage-backed securities, \$5.9 billion in collateralized mortgage obligations, \$47 million in collateralized debt obligations, and the remaining \$2.2 billion in other asset-backed securities.

Earnings for both CNA and Allstate turned negative in the third quarter of 2008 whereas AIG's losses started in December of 2007.

And the same can be said for the book



value of these insurers as their assets deteriorate.

The bottom in real estate is nowhere in sight, continuing to cause big problems in valuing the illiquid assets held by the insurance companies, a situation that will only be compounded by the impending collapse in commercial real estate. While the market has already punished these stocks for the losses they've taken in asset-backed investments, until the market finds a bottom,

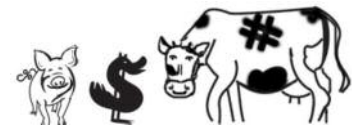
these companies will continue in a vicious cycle of having to write down losses, resulting in their share prices being marked down by the market. As bad as things have been for the insurers, they are going to get worse as these – and others in the industry – struggle to generate cash flows in a down economy at the same time the value of their core assets steadily erodes.

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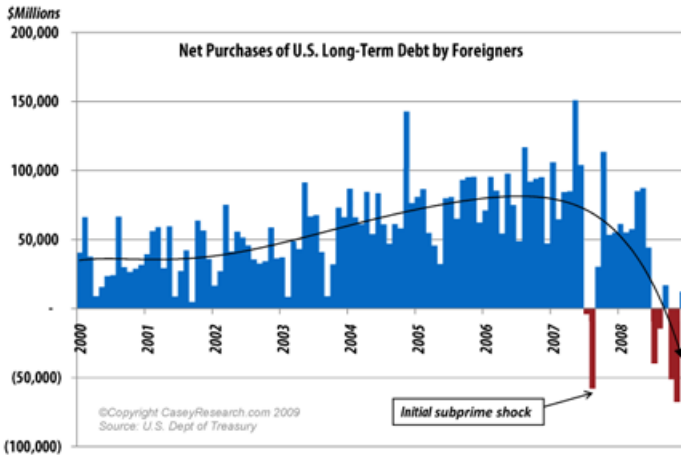


# Casey's Data Farm

A monthly collection of useful data about trends in motion.

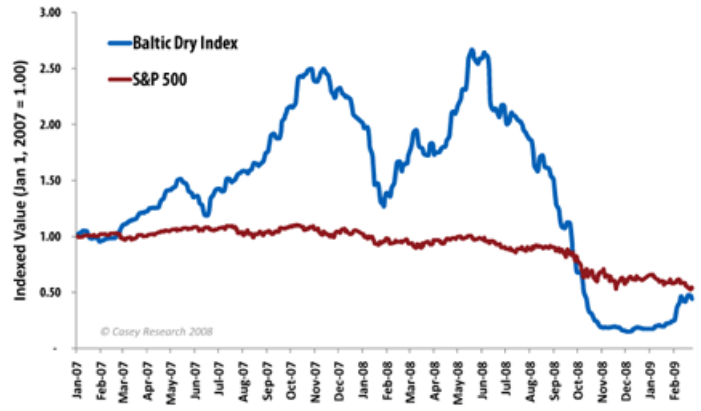


## An Uptick of Foreign Buying of Treasuries in December But the Trend Is Still Intact

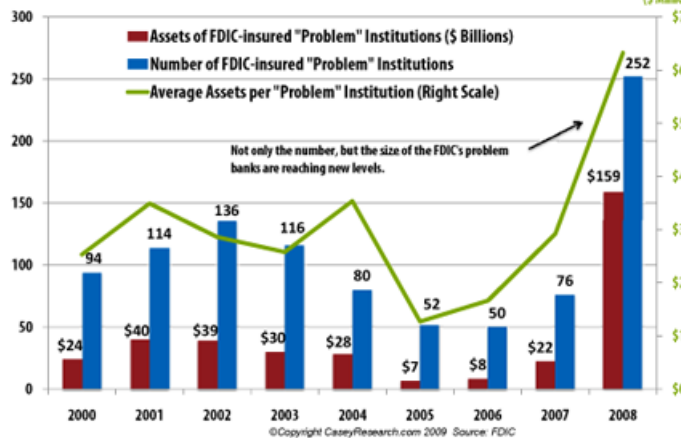


## The Baltic Dry Index Moving Away from Doldrums

After spending months at unsustainably low levels, this leading indicator of economic activity recovered to a new level. Not exactly a comeback -- probably more of a correction.

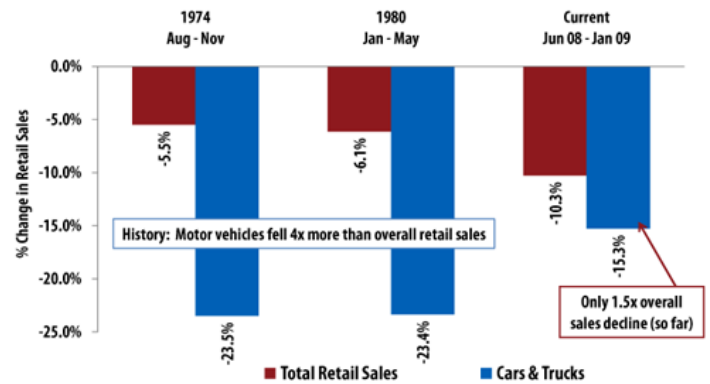


## The List of "Problem" Banks Continues to Grow

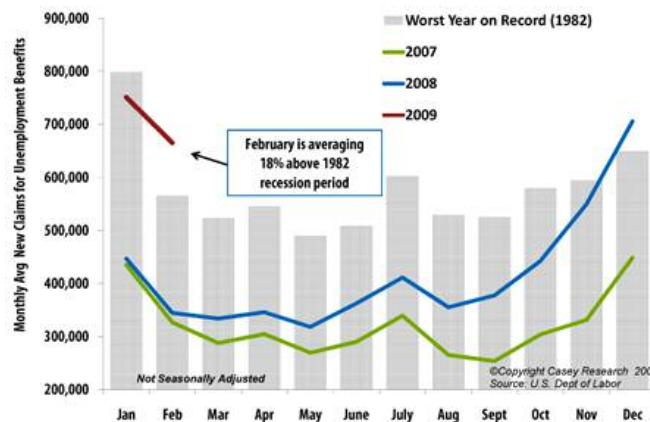


## U.S. Retail Sales Drop 10% -- Cars & Trucks Likely to Drop Further

Only twice over the last 40 years have retail sales fallen anything close to the current drop-off. Both times, motor vehicle sales fell at 4 times the rate of the total sales decline.



## U.S. Unemployment Claims Continue to Set Records



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# Obama Watch

In which we watch, closely, the actions versus the words of the new administration for signs of what's coming next...

## Hellbent for Leather

By Donald Grove, Casey Research  
Washington Correspondent

I had selected this heading for an earlier edition of the *Obama Watch*, but David Galland stayed my hand. "Let's give the new president a chance," David suggested. Fair enough. I think it is now fair to say, however, that Obama has indeed pulled out all the stops and is swinging for the bleachers, doubling down, going for broke. Nor does he make any bones about his intention to continue throwing money at these problems until they go away. He could miraculously preside over a resurgent economy but could also slip away infamously after a single term in 2012 when eloquent rhetoric gives way to economic reality. Meanwhile, this administration's policies leave us awash in fiat money. That makes a stash of real money critical to economic survival.

Since the last edition of this column, the president has signed into law H.R. 1, the \$787 billion economic stimulus bill. Like its pork-laden predecessor, last October's \$700 billion Wall Street bailout bill, this piece of legislation has something for everyone, but there's more. In quick succession, we've seen government guarantees for "zombie banks" that are essentially insolvent, a rescue plan from the Fed and Treasury to leverage more than \$2 trillion to buy up toxic assets (unconvincingly presented as part of the "Financial Stability Plan" by Treasury Secretary Tim Geithner on February 10), we saw the stimulus bill signed on February 17, then a \$275 billion housing bailout package the next day, and now the promise of a \$634 billion down payment on universal health care, and more unspecified, increased spending for education

and energy. The mind boggles.

The president has done little to rein in a spendthrift congress. As Louisiana Governor Bobby Jindal noted in his response to Obama's address before a joint session of Congress, the stimulus bill will "saddle future generations with debt." Jindal asked: "Who among us would ask our children for a loan, so we could spend money we do not have, on things we do not need? ... It's irresponsible." Indeed.

**"Jindal asked: 'Who among us would ask our children for a loan, so we could spend money we do not have, on things we do not need? ... It's irresponsible.' Indeed."**

## State of the Union

After weeks of warnings of impending doom that finally saw Congress send the bloated monster of a stimulus bill waddling over to the White House for his signature, Obama shifted back to his trademark message of hope and inspiration in what has been compared to a "State of the Union" address to a joint session of Congress on February 24. He promised to invest in energy, health care, and education—"the three areas that are absolutely critical to our economic future." He said, "I reject the view that says our problems will simply take care of themselves; that says govern-

ment has no role in laying the foundation for our common prosperity." He asked Congress to "join me in doing whatever proves necessary ... to ensure that a crisis of this magnitude never happens again [and] to move quickly on legislation that will finally reform our outdated regulatory system. It is time to put in place tough, new common-sense rules of the road so that our financial market rewards drive and innovation, and punishes short-cuts and abuse." It is not clear whether such reform applies just to the private sector or extends to the Fed, Treasury, and Congress itself.

## Fiscal Responsibility

The president hosted a "fiscal responsibility summit" on February 23 and promised to cut the federal budget deficit in half from \$1.3 trillion to \$533 billion in four years—yet we are given few specifics as to how we are going to pay for all this or where a promised \$2 trillion in savings will come from. There was talk of a peace dividend if and when we pull out of Iraq, but that is offset by the president's commitment to fight the Taliban in Afghanistan where he is deploying 17,000 new troops.

His budget outline, unveiled February 26, anticipates raising \$646 billion from a carbon cap-and-trade program, but that program has to be viewed as essentially a carbon tax that will be passed on to consumers. His budget anticipates saving \$9.8 billion by reducing farm payments, but early opposition from both sides of the aisle make those savings look improbable. He plans to "save" by ending the Bush tax cuts for the



wealthy and by limiting charitable deductions. Roberton Williams from the Tax Policy Center said that limiting charitable deductions would “just reduce the amount of giving.” Hold on. Obama’s new OMB director Peter Orszag said the recovery act contains “\$100 million to support non-profits and charities as we get through this period of economic difficulty.” In any case, there is something fundamentally flawed about treating discontinued tax breaks as “savings.” Whose money is it anyway? According to House Minority Leader John Boehner (R-OH), “This budget makes clear that the era of big government is back, and the Democrats want you to pay for it.”

Judd Gregg, thankfully back in his role as the fiscally conservative ranking member of the Senate Budget Committee, said, “We’re taking four steps back in the deficit fight, and then we’re only taking two steps forward.” Echoing the repeated warnings of former Comptroller General David Walker, Orszag admitted that “we’re on an unsustainable fiscal course.”

In January, Obama warned of “trillion-dollar deficits for years to come.” That’s probably an understatement. While Obama acknowledged in his February 24 speech a “responsibility we have to our children” not to “pass on to them a debt they cannot pay,” he disowned “the massive debt we’ve inherited” even as he laid out policies that dwarf his predecessors’ profligacy.

sors’ profligacy.

Japan passed ten stimulus packages over eight years, to no avail. Obviously governments aren’t very good at this. Individuals acting in their own self-interest are, but as F.A. Hayek wrote, “The more the state plans, the more difficult planning becomes for the individual.”

### “Nobody Messes with Joe”

The president is actually having some trouble spending the money fast enough but has assured us that at least it will not be wasted. He has put Vice President Joe Biden in charge of “tough, unprecedented oversight” of the fiscal stimulus plan. Working with Joe to keep a tight grip on the purse strings will be former Department of Interior Inspector General Earl Devaney, who will head the “Recovery Act Transparency and Accountability Board.” The emphasis seems to be on spending as much as not wasting money, however. “I’ll tell you what,” Joe told a gathering of Cabinet Secretaries at the first Recovery Plan Implementation Meeting, “the moral disapprobation of this office will be used if the money is not being out there spent. I’m going to go on television and say, ‘We gave so-and-so X amount of dollars, and nothing is happening. Why hasn’t it happened?’”

### Can’t We All Just Get Along?

The Obama administration’s aspirations for bipartisanship have

fallen on hard times. The stimulus bill initially came out of the House without a single Republican vote in support. In the Senate, the two Maine Senators, Republicans Olympia Snowe and Susan Collins crossed the aisle with Arlen Specter (R-Pa) to give the Democrats a 61-vote majority and avoid a filibuster. Judd Gregg (R-NH) nearly became Obama’s commerce secretary but withdrew in light of “irresolvable conflicts . . . such as the stimulus package and the Census.” Gregg, who in 1995 voted to abolish the Commerce Department, if confirmed, would have been the third Republican in Obama’s cabinet. Obama has since named former Washington Governor Gary Locke, a Democrat, to the post. Finally, bipartisanship is sparse in the House, which passed, largely along party lines, a \$410 billion omnibus appropriations bill, loaded with about 9,000 earmarks.

### Adult Supervision

In his inauguration speech, Obama said “the time has come to set aside childish things.” If he is serious about fiscal responsibility and cutting the budget deficit, some childish notions like man-made climate change, achieving energy independence with biofuels, wind, and solar collectors, and special treatment for union labor during an economic crisis are going to have to go.

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# Casey's Chronicles

A collection of comments and observations on the passing parade.

## Watch Out Below

By David Galland

As we were preparing to go to press, I had a long talk with über-successful real estate entrepreneur Andy Miller of Miller-Frishman (see archived interviews with Andy, TCR 09/08 and 12/08) that I wanted to share with you. The purpose of the call was to talk through some of the details related to Andy's presentation at our upcoming **Crisis & Opportunity Summit**, being held March 20 – 22 at the Four Seasons in Las Vegas (there are a handful of seats left, but just a handful. [More information here.](#))

During the conversation, Andy related to me how he has just come out of a series of meetings with senior officials at a number of America's largest banking institutions. His appraisal of where things now stand in real estate and the general economy is that we are about to undergo an economic downturn unlike any this country has ever experienced. To say that he is profoundly pessimistic would be a gross understatement. And, worse, he can back up his dire forecasts with hard facts and data – which he'll do at the Summit in Las Vegas.

To name just one point he touched on, there is nothing in any legislation, bailout, even discussion on a policy level, that addresses the devastating problems in the jumbo market (generally, houses valued in excess of \$417,000, unless in a specially designated "high cost" area, in which case the conforming value can rise to \$625,000). Yet, there are great swaths of the country where virtually all of the houses fall into the non-conforming jumbo category. With no government program to backstop the loans, as Fannie, Freddie, and the FHA do for smaller loans, and no real clarity on valuations at this point in the housing collapse, most banks are unwilling to lend any more than 50% of the value on these houses. Thus, if you want to buy a \$2

million home in California, the bank is going to require you to reach into your pocket for the first \$1 million. While those sorts of transactions will occur, they're relatively rare. Here in the New England ski resort that serves as galactic headquarters for Casey Research, the high-end market is completely frozen.

**"His appraisal of where things now stand in real estate and the general economy is that we are about to undergo an economic downturn unlike any this country has ever experienced. To say that he is profoundly pessimistic would be a gross understatement."**

For now, homeowners are unwilling to drop their prices, but as the costs of property taxes and maintenance meet up with other, more pressing financial needs (say, due to a lost job or a stock portfolio wipeout), a widespread price capitulation will have to occur, sending yet another shock wave through the economy.

And then there's the matter of commercial real estate, which Andy sees as entering a severe crisis, probably within a 6- to 9-month time horizon. As there are billions of dollars worth of bonds linked to commercial real estate, buried in individual and institutional investment portfolios, this is another economic time bomb with serious ripple potential. (See "How to Invest" for our update on ways to play commercial real estate on the short side.)

Andy is not, by nature, a negative person

– but he is a very smart and very successful individual. And his credentials as a business forecaster are impeccable, proof of which is that he unloaded the majority of his properties before the crisis hit, and that last year at our Scottsdale Summit, he accurately forecast that Fannie and Freddie would be effectively nationalized and that 10-year Treasury yields would fall (they have, but he is now expecting them to reverse course dramatically).

His warnings about what's coming — which mirror our own — are well worth paying close attention to. We'll do what we can to help you prepare, but first and foremost, take this relatively quiet time in the markets to further clean up your affairs, reduce expenses, and reduce exposure to financial risk. Rough sailing ahead.

## Between a Rock and a Hard Place

By Donald Grove, Casey Research  
Washington Correspondent

The Subcommittee on Energy and Mineral Resources of the House Natural Resources Committee held a hearing Thursday, February 26, 2009 on H.R. 699, the "Hardrock Mining and Reclamation Act of 2009." The purpose of the bill is: "To modify the requirements applicable to locatable minerals on public domain lands, consistent with the principles of self-initiation of mining claims, and for other purposes." This bill was reintroduced in January by its longtime champion, House Natural Resources Committee Chairman Nick Rahall (D-WV), and is virtually the same as H.R. 2262, which was passed by the House in 2007, but then stalled in the Senate. The bill will probably be passed again by the House. Senator Jeff Bingaman (D-NM) is committed to getting a bill (not necessarily like the House bill) revising the 1872 Mining Act through his Committee on Energy and Natural Resources.

The bill is unlikely to survive a Senate floor vote, however, since Senate Majority Leader Harry Reid (D-NV) is up for reelection in 2010.

The Hardrock Mining Law of 1872 was intended to help open up the West and promote utilization of domestic copper, gold, and silver reserves in particular. Uranium was not an issue then. Miners in the U.S. still do not pay federal rent or royalty for hardrock mining on public lands. Key features of the proposed legislation include a royalty on mine production (gross or net is in dispute), environmental standards for exploration and production, and funds for clean-up.

Chairman Jim Costa (D-Cal) noted that the economy was in much better shape when this bill was last before this subcommittee and questioned whether it was appropriate to place new restrictions on mining companies during a global financial crisis.

Ranking member Doug Lamborn (R-Colo) cautioned against sending U.S. jobs overseas and becoming dependent on foreign mineral supplies. He explained that mining was already subject to a panoply of environmental laws, including CERCLA, clean air and water standards, and NEPA, and that the public could participate in the permitting process. He pointed out that smart-grid and transmission lines called for in the president's stimulus plan require mined metals like copper. He compared the loss of American jobs and wealth from restricting mining to the debate over offshore oil.

Nick Rahall said other countries charge miners royalties, but not the U.S. He said gold was at record highs, around \$1,000 per ounce, and that profits might even go up (let's hope so). The Congressional Research Service found that the vast majority of mining on federal lands was gold mining. Rahall said that the mining industry would like to have this cloud, this "outdated boondoggle," removed so they could plan effectively. (Undoubtedly, it would like to have Rahall's long-standing threat removed.) Chairman

Costa said he knew of over 40 hearings on reforming the 1872 Mining Law over many years.

**"...most countries experience a decline in exploration when gross royalties rise above 5%... this bill proposes 8%, which would be the highest in the world."**

Doc Hastings (R-Wash), ranking member on the main committee, echoed the sentiments of Doug Lamborn. We should not drive mining jobs overseas and cannot always be saying "no" to new energy and mining operations. Congressman Dean Heller (R-NV) from Elko appeared as a witness. He explained how the economic well-being of Elko depended on gold mining. He said it was not unusual to have high gold prices with a weak economy. He said he believed President Obama that we will come out of this economic downturn and that gold prices would come down, but he didn't say when. He said he had proposed an amendment to the bill to impose a royalty of 5% of net income instead of 8% of gross. He said that the mining industry agrees that there needs to be some kind of movement and agreed to discuss with Nick Rahall a variable rate royalty, since cyclical prices of minerals vary.

Former DOI Solicitor John Leshy testified that the 1872 Mining Law was "out of step." He said gold is almost entirely used to make jewelry and that gold mines shut down during the war because they had no strategic value. Oil and gas, timber, hunters, anglers, all pay for what they take from public lands, as does the rest of the world. He cautioned that there are inadequate environmental protections; mines slip through regulatory gaps, and taxpayers are on the hook for

clean-up when things go wrong. He said gold prices skyrocketing means the industry is thriving as never before (maybe also in large part from reduced oil prices). Meanwhile, he said, the western U.S. tops the list for minimal hardrock mining regulation in the world. Doug Lamborn asked about the fact that most countries experience a decline in exploration when gross royalties rise above 5% and that this bill proposes 8%, which would be the highest in the world. Leshy characterized 8% as "modest" compared to 12% royalties on oil and gas. Lamborn noted that gold mining is not especially profitable. Leshy said the outlook for gold was bright because gold prices stay high during a depression.

Later, Congressman Martin Heinrich (D-NM) said he was born in Fallon, NV, and that his father and grandfather were miners but that he could see the need for mining reform. He asked Sheri Eklund-Brown from Elko why hardrock mining was treated differently than oil and gas. She explained that oil and gas, like coal, can be used pretty much as it comes out of the ground. Hardrock mining involves much greater development and processing costs. It takes tons of ore to get an ounce of gold.

Robin Nazzaro, director of Natural Resources and Environment for the U.S. Government Accountability Office, said there was no requirement to reclaim mines on public lands until 1981. She said \$260 million has been spent over ten years on cleaning up abandoned mines, but that there is a \$50 billion clean-up problem, including open shafts, arsenic-contaminated tailings, and degraded environments. She said it was unfair to lay that on taxpayers. She said federal agencies don't even catalogue the clean-up problems because they know there is not enough money to deal with them. She said GAO has reported a need for mining reform for decades. She noted that states charge a royalty or a functional royalty in the form of taxes. In the case of uranium, a charge on net smelter returns.

Mr. James ("J.T.") Reynolds, former su-



perintendent of Death Valley National Park in California, said park personnel and visitors were at risk from unsafe former mining areas, including unstable slopes, open shafts, and cyanide (I believe, however, that cyanide dissipates quickly into the air and becomes harmless).

Jim Starr, county commissioner, Gunnison County, Colorado, testified that mining may not be the highest and best use of land. He said water was critical and must be protected from contamination by mining operations. Somewhat incongruously, he noted

that the availability of water will decrease because of climate change. He explained that, under the outdated 1872 Mining Law, public land could be patented for \$5 per acre and that, as with railroad land grants, millions of acres of federal land was divested and fell into private ownership (gasp!). He asked rhetorically if we would do the same with toll roads and answered, of course not. (I actually think private landowners have proven to be better custodians and that public lands suffer from the tragedy of the commons). Finally, Sheri Eklund-Brown, chair of

the Elko County Board of Commissioners, said at the county level, the love affair with mining is more like a marriage. She said Elko residents and the mining companies care about clean air and water. They all live in and around Elko and raise their children there. She told Doug Lamborn that the mining companies were the best neighbors they could have, that they were part of Elko County. She said, "Without mining, our community would be failing and coming back here for a stimulus package."

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## Questions for Casey

A collection of your questions, edited only lightly for clarity, with our answers.

**Q:** I don't disagree with you that gold is increasing due to its perception as an inflation hedge, but I do have the following questions.

**Question One:** Is inflation insurance (i.e., gold purchasing) really necessary? Even if the USA does print money, would they print in excess of all the wealth destroyed and continually destroyed daily in real estate and equity and fixed income markets in the USA? The recent run-up in gold prices seems to be because of more and more demand from institutions and individuals as a hedge against inflation, but are their concerns really warranted?

**Terry Coxon answers:** Since last September, the Federal Reserve has doubled the size of the monetary base by buying Treasury securities and lesser grades of paper and by extending credit to banks. The size of M1 (currency in circulation plus checking deposits held by the public) is now 15% higher than it was 12 months ago, which is an extraordinarily high rate of growth. The Fed is likely (virtually certain) to continue on the path of monetary inflation until the recession bottoms out. Then it will continue for a while longer, for fear of letting a rise in interest rates choke off

the recovery. If, this time around, extraordinary price inflation fails to follow on the heels of extraordinary monetary inflation, it will be the first such failure in the history of paper money.

**"The U.S. government does own a large gold reserve. But since the dollar isn't convertible into gold (or anything else), those reserves have no influence on the dollar's value."**

**Question Two:** Why is the US dollar continually going up? Obviously there is demand for US dollars. Even if the USA prints obscene amounts of dollars, so long as there are others in the world who want those dollars, inflation should be kept at bay. And from the looks of it, other world economies are in as bad or worse shape than the USA, and therefore US dollars seem to be the "least worst" place to park cash.

**Terry Coxon replies:** You've answered the question. The dollar has been appreciating against other currencies, most notably the euro and the pound, because the inflation outlook for most foreign currencies is even worse than for the dollar. But that still leaves the dollar as a poor alternative to tangible assets, such as gold, whose value can't be inflated away.

**Question Three:** Isn't the US government one of the biggest owners of gold reserves in the world? If gold goes up, shouldn't this also increase the value of the US dollar?

**Terry Coxon continues:** The U.S. government does own a large gold reserve. But since the dollar isn't convertible into gold (or anything else), those reserves have no influence on the dollar's value.

**Question Four:** Do you have any idea of how many dollars were lent in terms of residential and commercial real estate loans in the USA? Wouldn't it just be cheaper for the US government to simply grandfather and guarantee every current home and commercial real estate loan out there? And ask financial institutions to actually do

some proper underwriting for all future loans?

**Terry Coxon responds:** Total mortgages outstanding are about \$15 trillion dollars – far more than the government has proposed spending on all its stimulus bailout programs so far. So a universal mortgage guarantee from the government could be very expensive. And how would it work? With all mortgages guaranteed, the lenders wouldn't care about defaults; they would simply hand the no-pay loans over to the government. That would leave millions of bad loans for government employees to sort out. It would be in the hands of people who couldn't get jobs at the Post Office to negotiate new terms with borrowers or make decisions about foreclosing. The plan might not work.

If you think that asking banks to be more careful in the future will do any good, go ask. They don't listen to me.

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**Question:** As a geologist, and not an economist, I am confused by the inflation-deflation debate. It appears logical to me that “quantitative easing” must devalue a currency and consequently, manifest itself as inflation (a seemingly limitless supply of “paper notes” spread over a limited supply of “stuff”). A baked-in-the-cake scenario, as the Casey team might say. Then I read the latest Casey Report comparing the current crisis with Japan's “lost decade.” It notes that an excess \$250b was poured into their reserves between 2002 and 2005 and nothing happened! Now, four years later, Japanese interest rates still bump along below 1%. Where did that “stimulus” go – the carry trade, pork barrel projects?

The Japanese example therefore appears to provide only limited guidance as to what the future may hold. Today's “cake” obviously needs more than one ingredient to determine whether it rises (inflates) or collapses (deflates). Extra ingredients are not in short supply, most of them are tainted (if not

toxic) and, in their panic, governments have abandoned any pretence at using a recipe. Anything can happen!

**I applaud the efforts of the Casey team in attempting to interpret the knee jerks, nervous tics (and in the case of our own Gordon Brown, fingernails bitten to the quick) of those who pretend to “manage” our economies, but have you considered adding psychologists (or maybe a chef or a witchdoctor) to your team?**

**Bud Conrad replies:** Your question on deflation/inflation is well asked, and we have had long debates within our team at Casey Research about the situation and the long-term projections. You are absolutely right to point out that there are many ingredients required to bake the cake. In the short term, we are in the worst recession or depression we have seen at least since the 1930s. The collapse of debt through default and the related slowing of what I call aggregate demand creates a very strong deflationary pressure. You see that in the price of oil, real estate, and stocks.

But we all see the huge bailouts as very inflationary in the longer term because of the unprecedented (there's that word again) size. The Fed has never before in its history – stretching all the way back to 1914 – done anything nearly so dramatic as it has of late, doubling its balance sheet in just four months. The federal budget deficit of \$2+ trillion this year is quadruple the previous year, and a record since WW II. Excess reserves, monetary base, money supply are all screaming that Bernanke's avowed great experiment will eventually have its expected effect of destroying the dollar.

Add into the mix the cost of the latest stimulus... the reduction of tax revenues that occurs in recession... new federal programs for health care and other pet causes that serve to increasingly advance the socialization of America... and the case is made for weak international competitiveness and dollar collapse.

An important reason that the banks'

bailouts and stimulus have not been inflationary so far, despite their size, is that most of the money creation comes from banks multiplying money in loans that get deposited and flow throughout the economic system. We have a serious limitation on that money expansion due to banks holding the cash they get their hands on, not making new loans, in what has been called “pushing on a string.” The Fed can give money to banks, but they will stop its multiplying if they don't lend, and right now they have more losses than they want to admit, making them at risk to being declared insolvent, and borrowers of top quality don't want to borrow. This becomes the ingredient that will keep the expansion of overall money slow in 2009.

There is another, extremely underappreciated problem that the U.S. has, that Japan didn't: we are the world's biggest debtor. Japan was probably the world's biggest creditor as it entered its “Lost Decades.” Thus, if foreigners wanted to “cash in” their dollars by buying U.S. assets, the accumulated foreign holding of \$7 trillion could flood our money supply. They haven't done that yet, so there is only a potential danger, like what hung over Argentina or the Asian countries before 1997.

These are not the usual times, and most economists, including Bernanke and Paulson, didn't see the size of the problems that we at Casey Research have been describing for years, so I'm not sure economists really have all the answers, including me. The Casey team agrees that the deflation situation is parallel to Japan and 1929, but with a completely paper (fiat) currency, the policy actions we are witnessing are, as we expected, now far more extreme. In time, we believe the deflationary pressures will be overcome by inflation, and maybe sooner than most expect. Gold is, of course, our main recommendation for that long-term inevitability.

In conclusion, if we add a little of your suggested chef and ignore the witch doctor, we see inflation returning and debate when, with a feeling that by the end of

2009 fears of deflation will be turning back to fears of inflation. In the longer term, there is no doubt that the current government actions will lead to very large inflation and perhaps even dollar collapse.

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**Question:** In the last Casey Report, you listed the minimum investments for RRPIX as \$15,000 and RYJUX as \$25,000, but when I go through Scottrade, they have given me minimum investments for RRPIX as \$5,000 and RYJUX as \$2,500. Why the discrepancy?

**Jake Weber responds:** The minimum investments listed are for opening individual investor accounts directly with ProFunds or Rydex. If you open a personal account with ProFunds, the minimum investment is \$15,000, but once you've opened an account, you can break up the \$15,000 into any of the funds offered through ProFunds. The same applies for Rydex funds, except the minimum amount to open account is \$25,000.

If you go through a financial professional such as Scottrade, the minimum investments will be lower but with an additional expense for 12b-1 marketing fees. The minimum investment for the ProFunds Rising Rates Opportunity Fund (RRPIX) is \$5,000 for a non-IRA account or \$4,000 for an IRA. If you go this route with RRPIX, then the expense ratio increases by 1% to cover 12B-1 fees, bringing the total expense ratio to 2.51%.

For the Rydex funds, the minimum investment through a financial intermediary is \$1,000 for an IRA and \$2,500 for non-IRA accounts, with a deferred sales charge of 1% upon redemption of your account. This additional charge will bump up the expense ratio on the Rydex Inverse Government Long Bond Strategy (RYJUX) to 5.97%.

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**Question:** I have read in another respectable newsletter that while money supply has increased as a result of governments doing one stimulus after another, the key argument is that *Money Velocity* (as evidenced by economic transaction flows) has dropped more significantly and hence inflation is not going to happen — in fact, deflation is the expected result.

My understanding was that if money is printed but fails to circulate (hence, velocity) for any reasonable chain of economic transactions, then deflation will simply result. This is much like what's happening with the excess bank reserves currently being held at the Fed and not being lent out as intended (as part of the original \$700 billion Bush rescue package).

**Can you shed more light on this issue in an easier-to-understand explanation against the "Money Velocity" argument supporting deflation? What needs to happen on velocity (if any) to trigger the inflation that Casey Research forecasts?**

**Terry Coxon answers:** Lower money velocity is not a force to be reckoned with because it's not a force at all. It's simply a calculated number. The income velocity of money is the income for the entire economy during the year (or other period) divided by the average size of the money supply during the period. As a matter of arithmetic, a decline in velocity might come about through an increase in the money supply or through a slowdown in aggregate income.

Velocity ordinarily slows as a recession begins, since the essence of a recession is a decline in aggregate income. But the fall in velocity doesn't cause the recession, it reflects the recession. Later, when the economy recovers, velocity rises — but, again, not as a cause but as an effect.

In the current recession, calculated velocity has fallen especially sharply because, in addition to the decline in income, there has been rapid growth in the money supply. It has been the

changes in income and money supply that have produced the drop in calculated velocity, not the other way around.

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**Question:** When you suggest purchasing gold, are you talking about physical gold or opening an account like GoldMoney or...? What do you recommend? What gold I have is by way of GLD in IRAs and a gold CD purchase though EverBank a few years back, and I would like to focus more on actual gold purchase. Lastly, since money markets are worthless, where would you suggest parking emergency funds?

**David Galland responds:** Gold investments come in different flavors, each related but with different roles to play. If you're looking to preserve wealth against the risk of currency depreciation and general market chaos, you are looking for gold bullion held in a secure location where you can easily get at it. Gold bullion in smaller-denomination coins or bars is an asset that has no risk of a counterparty default, it is portable, divisible, and globally acceptable, so that should form the bulk of your physical holdings. Of course, if you keep it around the house and then brag to all your friends and relatives that you own gold, you're just asking for trouble. So, mum is the word, and keep your gold in a safe location (a safety deposit box in a well-capitalized bank will do until and unless we start seeing straws in the wind about confiscation).

As for GLD and other forms of electronic gold, they are convenient as trading vehicles, but as you can't reach out and touch the gold they represent, they require accepting counterparty risk. As for emergency funds, short-term Treasury bills or even cash in a safe deposit box or in bank accounts will do for now. You can and probably should also keep enough cash around the house to cover a month or two of emergency expenses, but again, mum's the word.

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**Question:** In his weekly write-up, John Mauldin mentioned a secret European finance minister document estimating the total write-down of European banks to be 25 trillion dollars. I have no idea what the real number is, but I suspect that bank write-downs will greatly exceed the market capitalizations of the banks, and the problem will be twice as big and twice as difficult to deal with on the eastern side of the North Atlantic. "Europe" gets to choose between printing their way out of the mess as a group, or simply letting the weaker na-

tions default (or abandon the EMU).

**Accepting this, I think that shorting European government bonds is potentially a more profitable interest rate play than shorting US Treasuries. Specifically, I'm looking for a recommended fund or index to short European government bonds, and maybe a recommendation of which countries offer the most potential for disaster.**

**Bud Conrad answers:** Yes, Europe is in worse shape than the U.S., but the losses on the books of European banks

aren't likely to be anything like \$25 trillion. Ambrose Evans Pritchard recently did a nice job of recapping the Eastern European disaster that is about to befall Austria and other European countries ([read it here](#)). I would think that government bond shorts might make money, but bonds are not the most vulnerable asset. Like those in the U.S., they are unlikely to go into default and are still seen as a safe haven against non-government bonds and stocks, so they would seem not to be the best alternative.

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## End Quote

*By Doug Casey*

I've always been a huge fan of Ayn Rand and feel privileged to have met her just a few months before her death in 1982. Her short book of essays, *The Virtue of Selfishness*, is probably the most important single book I've ever read (followed by the Tannehills' *Market for Liberty*). The only nit I'd pick with her is that she actually didn't go far enough in some ways...

She was spot-on, however, in predicting what was going to happen in the U.S.

You owe it to yourself to read *Atlas Shrugged* if you haven't already done so.

*"When you see that trading is done, not by consent, but by compulsion — when you see that in order to produce, you need to obtain permission from men who produce nothing — when you see money flowing to those who*

*deal, not in goods, but in favors — when you see that men get richer by graft and pull than by work, and your laws don't protect you against them, but protect them against you — when you see corruption being rewarded and honesty becoming a self-sacrifice — you may know that your society is doomed."*

—Ayn Rand, *Atlas Shrugged* (1957)

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