THE LONG WAVE ANALYST
BOLDER INVESTMENT PARTNERS
FORWARD WITHOUT FEAR
Ian Gordon Economic Forecaster & Interpreter of the KONDRATIEFF CYCLE

Those who cannot remember the past are condemned to repeat it. Santayana

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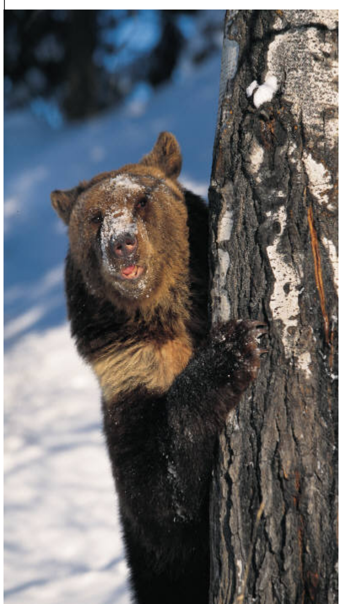
WINTER WARNING



I have long outlined that a Kondratieff winter is the season when debt is cleansed from the economy. This process is always very painful. In the previous Kondratieff winter, "From 1929 to 1932 in the US, there were 85,000 business bankruptcies and 10,000 commercial bank failures. Nine million personal savings accounts were eradicated. National Income (GDP) dropped from $81 billion in 1929 to $41 billion in 1932. Unemployment rose from 3 percent to 25 percent. Hourly wages declined 60 percent, dividends 50 percent and salaries 40 percent. The value of construction fell from $10.8 billion to $2.9 billion during these four years. Housing starts dropped to 93,000 in 1933, one tenth of what they were in 1925." The Long Wave Analyst, Vol. 1, Issue 1. Jan/Feb 1998.

The onset of winter is always signaled by the peak in stock prices of the huge autumn bull market. So it was in 1837, 1873, 1929 and I have argued that the fourth Kondratieff winter started in 2000 when the DJIA peaked at 11,750. (See The Long Wave Analyst Special Report, www.thelongwaveanalyst.ca)

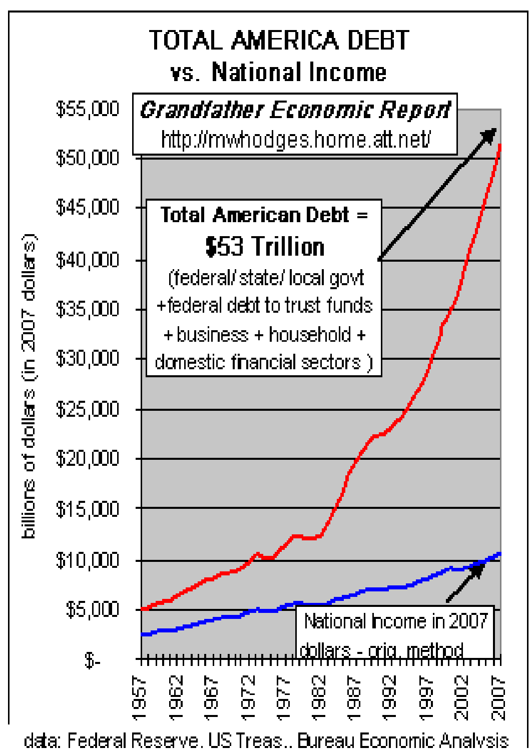
If the debt cleansing following the 1929 stock market peak was a horrible experience to those living through it, this time the process is likely to be far more excruciating, the magnitude of debt is massively greater than it was in 1929.

Total debt in the United States is now $53 trillion. All of this debt is now suspect. The process of debt unwinding begins with the weakest debt, which in this case has been sub-prime debt, and then wends its way through the entire debt spectrum. Thomas Paine, the American Revolutionary wrote, "credit is suspicion asleep." 'Suspicion' is now wide awake and very nervous.

Who in their right mind would lend money to the United States for a 30 year term at less than the going rate of inflation? Obviously many countries and many individual investors are doing just that. Perhaps it's a case of old habits die hard. How can the United States ever repay its $9.2 trillion debt except by a continual debasement of the dollar?

The Bear Stearns collapse is the beginning, not an end, to this growing debt crisis. Why did JP Morgan pay so little? Bear Stearns book value was $84 billion and JP Morgan paid only 2% of this value. Why? Was Bear Stearns loaded to the gills with valueless paper? It admitted to $28 billion of the so called level 3 assets. But was there more? If so, what about all the other banks? Have they overpriced the value of their toxic paper?

Perhaps the answer for such a bargain might be found in the large book of financial derivatives that Bear Stearns owns.



The notional value of derivatives are now in excess of $600 trillion. Most banks worldwide are participants in this market. But by far the biggest player is JP Morgan.

If any one corporation invested in derivatives goes bankrupt it causes a ripple effect among other participants in the derivatives chain, which could affect their solvency. Thus, no player can be allowed to fail. A Bear Stearns bankruptcy could have brought down many other banks. “It can hardly be a coincidence that the bail out was routed through JP Morgan” Alf Field.

Anyway, Bear Stearns shareholders took it on the chin. Joe Lewis, the British billionaire, who bought stock last August has been knocked out with a billion dollar loss.

Bear Stearns was born in the last Kondratieff great autumn stock bull market and survived the winter depression of the 1930s, but died at the onset of the 4th Kondratieff winter depression.

A year ago, last November, in London, I gave a talk to a group of investors which I titled, “Why a depression is all but inevitable.” The basis for my conclusion was our position in the Kondratieff cycle-winter, and the massive debt bubble. I was almost ridiculed by the audience for my outlandish position. I talked to the same group again, this January, and they were much more understanding of my position.

But now there is more and more talk about depression. I speak of the economic sort although that can be a significant contributor to the psychological disorder.

On Friday we were playing golf and stopped at the snack shack for some warm refreshments. While we were eating, the lady who had served us was listening to our conversation, which was centered on the economy and the Bear Stearns crisis. She told us that she felt that an economic depression was coming. We agreed.

On March 15, 2008 the National Post published a story from Bloomberg News. The Title read “Bush looking like Hoover.” Of course President Hoover was in the wrong place at the wrong time, taking office in March 1929.

In the January 2003 edition of The Long Wave Analyst, I wrote a piece entitled, “The Depression Presidents-Bush and Hoover.” In my comparison of these two Presidents I stated, “Unfortunately, the Kondratieff winter has now overtaken President Bush. The affluence built on a mirage of debt, and the flows of money from foreign sources are evaporating, just as they did after the stock market crash in 1929. President Bush is faced with a depression as least as severe as that which faced Herbert Hoover-a depression that robbed the competent Hoover of a second presidential term.”

The US housing market goes from bad to worse. February was the 26th consecutive month of year-on- year foreclosure increases. In that month according to a story in Bloomberg on March 13th, 2008, “U.S. home foreclosure filings jumped 60 percent and bank seizures more than doubled.”

“Nevada led the nation with the highest foreclosure rate in February. Filings rose 68 percent last month to 6,167 from the year earlier period. One in every 165 households there was in default or foreclosure, RealtyTrac said.”

“California had the second highest rate with one in every 242 households. Florida was third with one in every 254.”

According to RealtyTrac, there are likely to be between 750,000 to 1 million foreclosures this year.

This can only get worse as the economy weakens, which will throw increasing numbers of Americans out of work.

We are at just the beginning of the real estate bust, which typically starts with the most vulnerable borrowers. It will spread to the more able borrowers and also into the commercial sectors, because banks don’t want to lend on real estate.

The Federal Reserve is desperately trying to contain the growing crisis. “Fed takes boldest action since the Depression to rescue US mortgage industry,” trumpeted Ambrose Evans-Pritchard in an article in London’s Daily Telegraph written on March 12th 2008. “The US Federal Reserve has taken the boldest action since the 1930s, accepting $200 billion of housing debt as collateral to prevent an implosion of the mortgage finance industry and head off a full-blown economic crisis.”
www.telegraph.co.uk

The Central Bank has also extended its borrowing facilities beyond the banks to investment banks, and has of course back stopped JP Morgan in its take out of Bear Stearns by injecting $30 billion into JPM. Not bad; JP Morgan puts up a quarter of a billion dollars worth of its stock to buy Bear Stearns and the Federal Reserve gives it $30 billion. But of course JP Morgan is a part owner of The Federal Reserve.

The Fed’s massive money creation and panic reduction in interest rates has done little to halt the debt debacle, but has done much to harm the dollar, which has now fallen to new lows. Henry Paulson (I refuse to call him Hank), the US treasury Secretary continues to offer the old platitude of his belief in a strong dollar, but does anyone believe him anymore?

Countries whose currencies are tied to the dollar, and this includes many of the countries in the Middle East , are facing intolerable inflation. This may force them to cut the tie in favour of a basket of currencies. Kuwait has already done this. Any such concerted action would force a huge dollar sale.

Iran has already rejected payments for oil in dollars in favour of Euros and Yen. Perhaps that is why Iran is now America’s public enemy number one.

The US Dollar Index-Monthly Chart

Chart Courtesy of Reuters

On the day (March 11th) that the Federal Reserve pumped $200 billion into the economy, stocks rose in a joyous salutation lifting the Dow Jones Industrial Averages by more than 400 points. This is not rational. After all, if that kind of money has to be injected into the banks, don’t people realize that there must be big trouble out there? Apparently not, because stocks still are performing remarkably well, even though bank stocks are getting clobbered.

But of course there is the Plunge Protection Team or as it would like it to be known, ‘The Working Group on Financial Markets.’ The powerful men who make up this group are charged with ensuring that the stock market does not crash. To this end, any hint of duress in stock prices is immediately addressed. Eventually, stock prices will reflect the reality of the economy.

It's hard to imagine, but there are some indications that stocks may be putting in a bottom. Martin Armstrong's 8.6 year cycle is calling for a bottom this weekend, and thereafter a rise in prices into May next year. Studnicki's Turning Point letter comes to a similar conclusion, using Elliott Wave analysis. The venerable Richard Russell, using Dow Theory, points to the non-confirmation by the Transportation index as a reason to suspect a bottom in stock prices.

The price of gold has crossed $1000 per ounce and has now already gained 20% this year.

Yesterday, Monday, March 17th, was an interesting day in as much as the price of all commodities dropped hard, this included the prices of precious metals, with the exception of the gold price, which rose $5 per ounce. Is gold finally taking on its historic role as money of last resort?

Gold Comex Futures-Monthly Chart

Chart Courtesy of Reuters

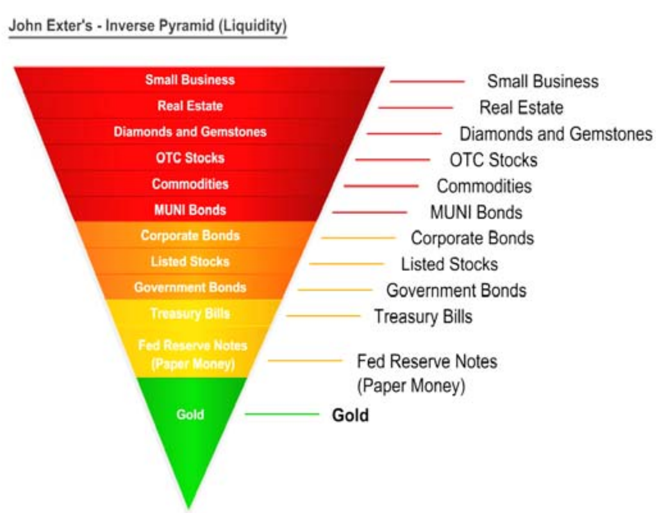
During debt deflation, gold is the ultimate liquid asset. John Exter's chart is a reminder of this fact.

All debt, and that includes government bonds might under the present circumstances move towards the more illiquid portion on the pyramid.

Is the US already in recession? There is still some debate on that point. US budget deficit numbers indicate quite conclusively that the recession is already underway. The deficit in February was a record $175.6 billion. The real culprit for this monstrous record was the fall in tax receipts. These dropped by 12.1% from a year ago; that is, from $120.31 billion to $105.72 billion.

This is the problem for all levels of government. As the economy worsens, tax receipts fall and expenses rise (think welfare, unemployment expenses).

Why is gold the safest investment during the Kondratieff winter?



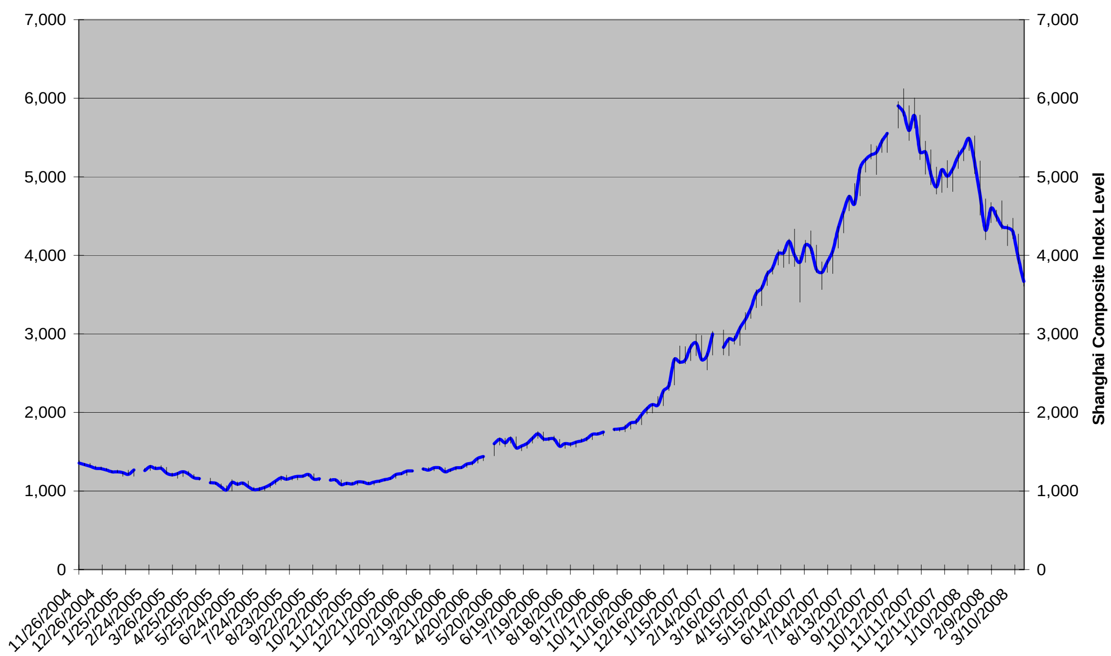
US municipal governments are already having trouble raising money and the tax receipts are falling as housing foreclosures start to bite. Municipalities will cut back spending. Apparently in some places in Ohio they are already reducing the police forces.

States, too, are facing a reduction in their tax receipts. California will be running a huge budget deficit.

Eventually, as the recession turns to depression, taxes will have be raised from a significantly reduced tax base.

One thing that appears to have escaped investor attention is the bear market that is already underway in China. The Shanghai Index is plummeting and lots of money has been lost. It will probably get a lot worse.

Shanghai Composite Index (Weekly)



The parabolic rise from just above 1000 points at the beginning of 2006 to its peak on October 2007 at 6124 amounted to a increase of 480% in just 20 months. In just 5 months the Index has given up 41%; what's this telling us?

Last minute flash… As this letter was going to the press (Wednesday 19 March, 2008 - 9:00am), the gold price was down $60. I am convinced, that this has been orchestrated by the Powers that Be (The Federal Reserve and Treasury). The price of gold cannot be allowed to rise. A rising gold price would refute their claims that they have everything under control.

They do not have everything under control. A credit crisis once in motion, will not be arrested until it has reached its calamitous conclusion.

Until next week…

Ian A. Gordon