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THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING

The Economic and Financial Outlook for 2011

In our Economic Outlook for 2010, published last February 1st. we stated: "The year 2010 will likely introduce the second chapter of the economic depression".

Obviously, this scenario did not unfold within the time frame that we had anticipated, as global gross domestic product (GDP) posted modest gains, mostly as a result of continued government stimulus programs; such as renewed quantitative easing by the U.S. Federal Reserve. "However, as we discussed in our Winter Warning publication of January 11, 2010, Its The Debt, Stupid, indebtedness is the economic killer. Debt hasn't disappeared; in fact, in most sectors of the global economy, it's bigger than ever."

Similarly, we predicted: "the initial unraveling of the world monetary system, which is based upon fiat or paper currencies." That process, certainly, did have its beginnings in 2010 with the sovereign debt crisis coming to a head in Greece and Ireland. It is our view that the monetary crisis will worsen considerably in 2011 bringing about the failure of the European monetary system.

Obviously, "we are confident in our assertion that the initial stock market recovery highs have already been posted" was also a premature forecast, since the Dow Jones Industrial Average (DJIA) closed the year at 11,577.50 points. Our prediction of a severe contraction in the volume of world trade did not come to pass. However, our political forecast that "the U.S. mid-term elections in November are likely to prove a disaster for Democratic incumbents" proved to be right on the money. Our prognostication that "the U.S. Federal Reserve is likely to come under increasing scrutiny and public vitriol, culminating in its demise a century after its birth in 1913" was on the money. We think that scrutiny will intensify during 2011. Our prophecy regarding "China as the world's largest creditor nation, emerging as the strongest financial, economic and political power in the world" is still evolving inexorably, in that direction. Our conviction was that 2010 would witness "a huge move from paper money into gold and probably into silver as well, driving precious metals prices considerably higher. Precious metals share prices should perform even better than the metal prices themselves, as they did in the 1930s" was particularly prescient; as gold bullion was up 28% , silver 76% and gold shares (The HUI) increased by 31% year over year.

We will now outline our economic and financial forecast for 2011.

In his book America's Great Depression, Murray Rothbard quotes Dr. Benjamin Anderson who referred to 1931 as "the tragic year." "The year 1931, which politicians and economists were sure would bring recovery, brought instead a far deeper crisis and depression." Rothbard, Murray. America's Great Depression, Richardson and Snyder, NY, 1963. P. 227.

One would have to say that as we enter 2011, the degree of confidence is similar to that experienced at the onset of 1931. Confidence in the outlook for the world economy is growing and no more so than in the United States; “The government’s latest measures to bolster the economy have led many forecasters to express new optimism that the recovery will gain substantial momentum in 2011” Yahoo News December 24, 2010. We will repeat our premature prognostication of 2010, which succinctly summarizes our outlook for the world economy in 2011-“The year 2010, (now 2011) will likely introduce the second chapter of the economic depression. The first chapter began in July, 2007 with the failure of two Bear Stearns hedge funds and the subsequent second installment of the bear stock market in October 2007. This was followed by the collapse of the subprime mortgage market and the failure of the banking system, principally in the United States and Great Britain. Massive government bailouts appeared to breathe new life into the financial system, the economy and the stock market in 2009. However, as we discussed in our Winter Warning publication of January 11, 2010, ‘It’s the Debt, Stupid,’ indebtedness is the economic killer. Debt hasn’t disappeared; in fact, in most sectors of the global economy it’s bigger than ever. Debt will be the catalyst for the economic and stock market collapses that we anticipate in 2010. (Now 2011)

All our work is based upon the Long or Kondratieff Cycle. We are always looking for particular past historical economic and financial events that are similar to the events of today. In that way we can anticipate the probability of future events. To that end we believe that future historians might well refer to the year 2011 as the ‘tragic year’ because the events of 1931 are strikingly similar to the problems now unfolding throughout the world and then as now, the problem was an international debt problem, particularly evident in Europe. “Particularly dramatic was the financial and economic crisis in Europe, which struck in that year (1931)” p.227

As it happens 2011 is 80 years from the events that occurred in 1931. Those of you who have read ‘This Is It’ will know that I placed a great deal of emphasis on Gann cycles to give me the confidence to predict that the big bull market would end in 2007-“So, all of Gann cycles forecast a stock market crash for this year.” While stocks didn’t crash in 2007, they did peak in October of that year and were down about 1,000 points by year end. They crashed in 2008. For Gann, the most important cycle was the 20-year cycle and any multiple or derivative of that number. The year 2011 is four times twenty from the events of 1931, ‘the tragic year.’ Thus, I am confident in predicting that the events of 2011 will closely parallel the economic and financial events of 1931.

There is another yearly anniversary that matches with 2011 and that is the end of the deep recession and the stock bear market bottom, both experienced in 1921. These events were the catalyst to begin the great autumn stock bull market of 1921-1929. Therefore, 1921 was a pivotal year for dramatic change. It, too, being 90 years ago, lends emphasis to the notion that 2011 will be a year that ushers in a dramatic economic downturn.

The collapse of the world monetary system will likely begin in 2011, just as it did in 1931. The origins of the collapse will likely be in Europe, which is where it all started in 1931.

The biggest calamity that had its origins in 1931 was the collapse of the world monetary system. In mid-May the largest Austrian bank, the Kredit-Anstalt, suffered a run. A large international contingent, including J P Morgan, the Federal Reserve Bank of New York and the Bank of England granted the bank many millions of dollars without success. Eventually the Austrian Government voted a $150 million (U.S.) guarantee. However, the Austrian Government’s credit was by then worthless and the Government declared national bankruptcy by going off the gold standard. Shortly thereafter, Germany followed in Austria’s footsteps.

It was enough. Now it became a matter for the remainder of Europe to determine which country or countries would follow Austria’s and Germany’s lead.

Almost all countries abandoned the gold standard at the onset of the First World War. After the war a quasi-gold standard system was adopted at the Genoa Conference in 1922. Britain returned to the new monetary system in 1925 but at the pre-war parity of a pound being equal to $4.86 (U.S.). Clearly, Britain was not the same country as she had been before the War, nor was the United States; Britain was a major debtor nation, whereas the United States was by then the world’s largest creditor nation.

It became clear to many people and many nations that the British pound was overvalued relative to the U.S. dollar thus, they determined to swap their pounds for British gold. This had the effect of forcing Britain off the gold-exchange standard in September 1931 and effectively destroyed the world monetary system.

At this time, it is clear that many European nations are now facing a similar dilemma to that experienced by the European debtor nations in 1931. In this case, do they abandon the Euro and save themselves or do they stay in the Euro and allow the rich members to bail them out at great cost, not only in monetary terms, but also, regarding their political independence? So far, Greece and Ireland have made the latter choice. This year, it is very likely that a European country in debt trouble will opt for the former selection, which is to abandon the Euro. Once one country has made that choice the floodgates will open, in part driven by speculators. Several European countries will find such a choice the lesser of two evils. As in 1931, it will only take one or two relatively unimportant countries to bring down an entire monetary system, which in this case is the Euro.

Let's see if we can somehow demonstrate a probable parallel this year with the breakdown of the gold-exchange standard system in 1931. In May 2011, a European country facing an unresolvable debt problem, turns down assistance from the Euro nations and the IMF, opting for debt default instead. (Could that country be Ireland, even though the country has already accepted a bailout?). Anyway, in short order Greece and Portugal will follow.

Speculators now drive-up interest rates of the other European significant debtor nations like Spain and Italy, squeezing these two countries out of the Euro.

In September 2011, Germany abandons the Euro and the entire European Union monetary system collapses.
The stronger Euro nations, like Germany and France have an ulterior motive for ensuring that high debtor nations like Greece, Ireland, Portugal and Spain remain in the monetary union and that is because of the huge amount of sovereign debt that is on the books of their respective banks.

Let's take Ireland as an example. During the credit crisis last year, the Irish government guaranteed not only the deposits, but the bonds of the Irish banks. These guarantees amount to about 30 percent of GDP and are predominately given to German, French and British banks. "Irish taxpayers are in effect bailing out not only their own banks, but also banks all across Europe. "John Maudlin, Interest Rates/ Global Debt Crisis January 15, 2011.

Once the Euro begins to unravel it leaves the member states' banks exposed, not only to the debt of sovereign states, but also to bank debt other than their own debt. That is why the Federal Reserve and JP Morgan were so anxious to bail out the Kredit-Anstalt bank in 1931. They knew if they failed that a European debt collapse would bring about the collapse of the US banking system, which was the principal lender in the region. That is precisely what happened following the failure of the Kredit-Anstalt bank; the European debt bubble collapsed which brought about the failure of the US banking system between 1931 and 1933. Now it is, largely, the turn of the European banks to feel the pain of the debt collapse in Europe.

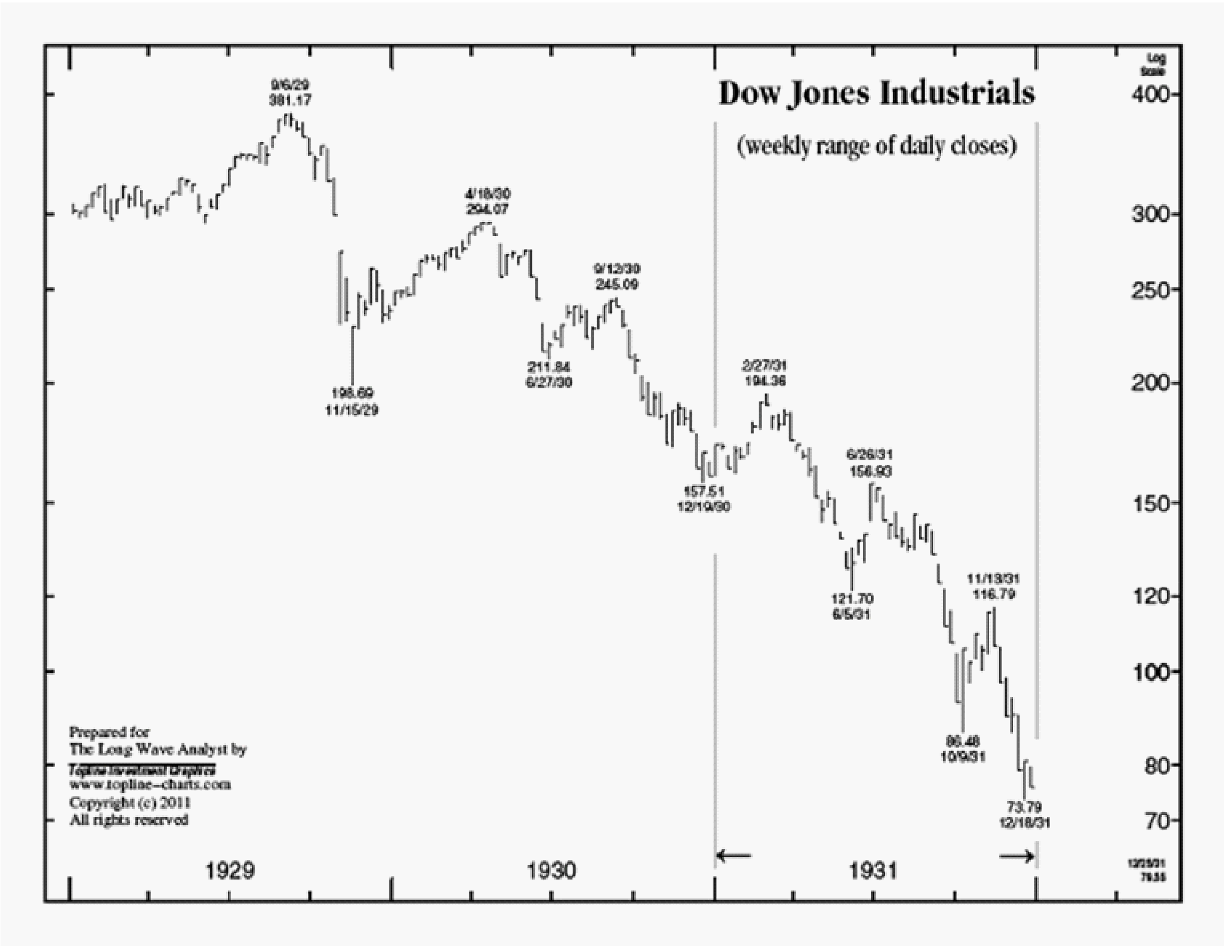
American stock investors are as bullish as they have been in a long time. "Bullish sentiment, expectations that stock prices will rise over the next six months, rose 13.1 percentage points to 63.3% in the latest AA11 Sentiment Survey. This is the highest level of optimism since November 18, 2004. This is also the 16th. consecutive week that bullish sentiment has been above its historical average of 31%, the longest such streak since 2004." Charles Rotblut

We are by nature contrarian, because we believe that 'the crowd' is invariably wrong. We know that the crowd can be right for a long time and it's not wise to consistently take the opposite trade against it. What we look for are markers that suggest to us that the crowd is soon going to be wrong. Hence, in 1999 and 2000, we were advising our readers to get out of the general stock market and buy gold and gold shares. In 2007, in our publication 'This Is It', we warned of an imminent crash in stock prices and a collapse in the banking system.

So, how will the US stock market fare during this initial stage of a worldwide monetary collapse, which begins in Europe but certainly won't end there? We have already made note of the bullish outlook, as proffered by most pundits, for stocks in 2011. We beg to differ. For our part, we couldn't be more bearish. Certainly, we are as bearish now, as we were in November 2007 when we published 'This Is It'. Now, we are not saying the collapse in stock prices is imminent. The Fed is just making too much money available to the banks for that to happen without some external catastrophic event, like the failure of the Euro for instance.

Regardless, we don't see US stock prices higher beyond April of this year. Then we see the catastrophic Elliott Wave 3 down. This will take US stock markets below their March 2009 lows, maybe not this year, but certainly by 2012, which is a hugely important year for the stock market and possibly the year in which stocks reach their final low. ('why,' will be divulged early next year in our outlook for 2012). Since we've already shown that the world monetary crisis had its beginnings in 1931, it behooves us to remind you how the stock market performed in that year. Quite simply, it was the worst performing stock market on record, worse than the crash of 1929 which saw the Dow lose almost 50% in just thirteen weeks.

The Dow Jones Industrial Average opened 1931 at 170 points and rallied to a high of 194 points by February 24th. (Remember that day, it might be important!) From that day on, it was virtually straight down for stock prices with a low for the year being reached on December 17th. at 74 points. From high to low for the year, the drop in prices amounted to 62%. To put that into perspective, the crash of 2008 took the Dow down 39% from high to low during the year.



In previous Winter Warnings we have drawn your attention to the increasing and very serious problem of state and municipal debt. This year that problem is likely to turn into a nightmare.

Undoubtedly, the most serious immediate threat to the U.S. economy in 2011 is the probable bankruptcy of dozens of municipal governments; as well as possible state governments and state agencies. From Camden, New Jersey to Hamtramck, Michigan to Vallejo, California; all state and local governments are now being forced to pay sharply higher borrowing costs as the Wall Street Journal reported last week: "With the market for municipal bonds tumbling, cities, hospitals, schools and other public borrowers are scrambling to refinance tens of billions of debt this year, another sign that the once safe market is under duress." The American municipal government bond market totals $2.9 trillion (U.S.) and is already collapsing.

Source: Money and Markets

The above chart is the municipal bond exchange traded fund (ETF) – the S&P National AMT – Free Municipal Bond Fund (MUB). It is currently enduring one of the worst price crashes in municipal bond history. The total outstanding debt, including unfunded pension liabilities of America's states and cities is $6 trillion (U.S.) – about 2.5 times their tax base and 40% of U.S. gross domestic product (GDP). In California, where the projected budget gap is $25 billion (U.S.) or 30% of the state's budget, Governor Jerry Brown has just instituted a 10% pay cut for most state employees and recalled 40,000 taxpayer funded cell phones. Illinois has recently announced an increase in corporate taxes and state income taxes, but is still 6 months behind in payments to contractors, service providers and other creditors. In New York State, Governor Andrew Cuomo is mulling 10,000 to 12,000 state employee layoffs to be announced later this week. The State of Nevada is already delinquent on millions of dollars in transfers to school districts and school superintendents are now warning that the state's entire educational system is in danger of collapse. In Idaho, after two years of deep spending cuts, state officials are now admitting they have exhausted all debt solutions. On and on it goes, state after state!

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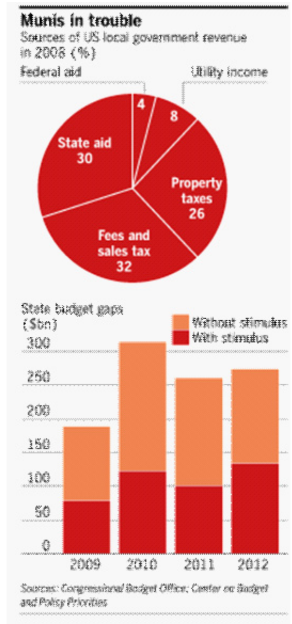

Unlike cities, American states are barred from seeking protection in federal bankruptcy court. Any effort to change that status must clear high U.S. constitutional hurdles because the states are considered sovereign. Beyond their short-term budget gaps, some states possess deep structural problems, such as insolvent pension funds, that are diverting money from essential public services, like education and health care. According to the New York Times, some members of Congress fear it's just a matter of time before a state seeks a financial bailout. Accordingly, policy makers are working behind the scenes to draft legislation enabling states to declare bankruptcy and obtain relief from their monstrous debts, including unfunded pensions.

Paul Maco, former chairman of the Securities and Exchange Commission's Office of Municipal Securities, commented: "All of a sudden, there's a whole new risk factor. At present, the fear of destabilizing the municipal bond market with the words 'state bankruptcy' has proponents in Congress working in the shadows. The mere introduction of a state bankruptcy bill could lead to some kind of market penalty, even if it never passed, such as higher borrowing costs for a state resulting in downward pressure on the market value of its bonds." Last week, the Center on Budget and Policy Priorities released a report warning against a tendency to confuse the states' immediate budget gaps with their long-term structural deficits. Neither, has a draft bill been put in circulation, nor, has any member of Congress yet declared his/her sponsorship of a bill.

In our predictions for 2010 we stated, "We believe that the calamitous experience of the United States of the 1930s will be China's experience commencing in 2010; that is an economic depression and a collapse in the banking system". We were wrong, but we are prepared to suggest that 2011 may be the year that China faces the baptism of fire that we predicted would be her lot in 2010. We reiterate the points that we made about China in our 'Outlook for 2010.'

"China today is very similar to the United States of the 1920s. Like the U. S., China's industrial growth has been exceptional and exports have been aided by an undervalued currency. Today, China is the world's largest creditor nation, as was the U.S. in the 1920s and corporate and consumer debt is unbridled. We believe that the calamitous experience of the United States of the 1930s will be China's experience commencing in 2011; that is an economic depression and a collapse of the banking system. Following her 'baptism of fire', China should emerge, as did the United States, as the strongest financial, economic and political power in the world." While we were wrong in forecasting China's debt bubble collapse in 2010, we maintain that such a collapse is imminent.

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We have warned our readers many times that it is impossible for any person or group of persons to change the natural course of economic and financial cycles. While such interference may delay the inevitable, it merely intensifies the subsequent action. Hence, President Clinton's action to repeal Glass-Steagall intensified speculation in the markets leading to the unprecedented bubble in Tech and Dot-com stocks. This resulted in the stock market crash beginning early in 2000. Alan Greenspan's actions to change the course of events following that stock market crash, by flooding the banks with money and lowering the Fed Funds rate to 1% contributed to the huge housing bubble and fraudulent action on the part of the banks that led to the collapse of the housing bubble and the effective bankruptcy of most of the major US banks. That crash precipitated Tarp and Quantitative Easing, with the goal of reigniting the stock market bubble. Those actions, too, are destined to bring about a major collapse both in the economy and the stock market which we believe will begin this year. We have been bullish on gold and gold stocks since 2000, because we know that during the Kondratieff winter, these mediums are the choice investments of people who are frightened by the prospective unwinding of the massive debt bubble. The price of gold has closed higher every year since 2001 and we expect that this record will be maintained in 2011. Accordingly, we are bullish on gold stocks, anticipating that they, too, will be an attractive paper alternative to actual ownership of the metal. As for silver, we are not as bullish as our friend Eric Sprott. We do not believe that the silver relationship to gold will come down to 16 to 1. Gold, in our opinion, is still the primary alternative money to fiat paper. Notwithstanding, we believe that silver will become an attractive monetary alternative to gold, primarily because of the price differential. Thus, the price of silver and silver stocks should also enjoy significant appreciation during 2011.
Our Top Ten Junior precious metal companies for 2011.

Brian Hestor, our advisory geologist and I have selected the following ten junior precious metals companies, which we believe have potential to offer significant share price appreciation during 2011. The companies are listed in alphabetical order and those companies marked by an asterix *are already included in my or my wife's portfolio.

Company	Symbol	Location of properties	Gold Assets	Price (1)	MktCap($m)
African Queen*	AQ/V	Mozambique, Ghana, Kenya	-	$0.62	$30.1
Atlanta Gold*	ATG/V	Idaho, Ontario	450,000 oz	$0.15	$21.75
Barkerville Gold*	BKH/V	Cariboo BC	850,000 oz- growing	$1.47	$82.3
Eaglecrest	EEL/V	Bolivia, Colombia	-	$0.36	$20.6
Evolving Gold	EVG/V	Wyoming, Nevada	Growing	$1.15	$147.2
Freegold Ventures*	FVL/T	Alaska	850,000 oz (non 43-101)	$0.52	$19.4
Lincoln*	LMG/V	Nevada, Cal, Mexico	680,000 oz-growing	$0.24	$20.0
PC Gold*	PKL/V	Pickle Lake, N. Ontario	Growing	$0.78	$51.6
Pelangio*	PX/V	Ghana, N. Ontario	Growing	$1.02	$126.3
Temex*	TME/V	N. Ontario	1.2 m oz-growing	$0.365	$36.0

(1) Share price as at December 31, 2010.

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Here are some other companies that could perform well this year- Alexandria Minerals (AZX-V), Andean Gold* (AAU/V) Currie Rose* CUI/V, Fire River Gold* (FAU/V), Full Metal Minerals* FMM/V, Garibaldi* (GGI/V), Gold Bullion(GBB/V), Golden Alliance* (GLL/V), Golden Goliath* (GNG/V), Nulegacy* (NUG/V), Trelawny (TRR/V), Windstorm* (WSR/V).

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