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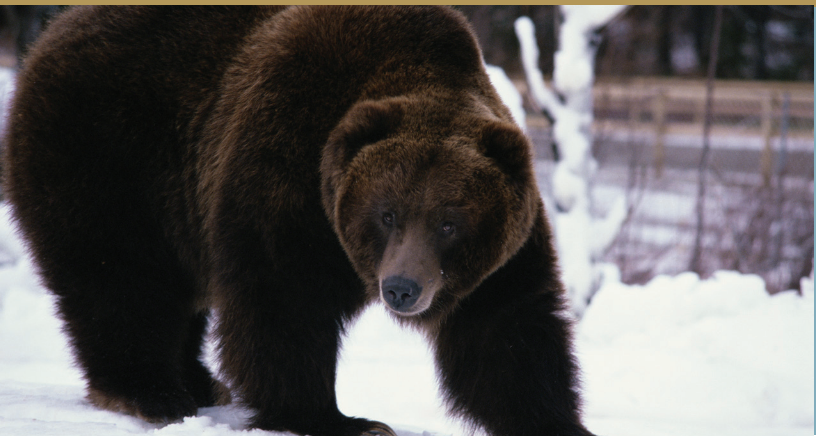
LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



Hope Springs Eternal in the Human Breast

What future bliss, God gives not thee to know,

But gives that hope to be thy blessing now.

Hope Springs Eternal in the Human Breast:

Man never is, but always to be blest

This headline quotation is excerpted from 'An Essay on Man' by English poet Alexander Pope (1688-1744) and published in 1734, as a rationalistic attempt to use philosophy in order to "vindicate the ways of God to man." Mr. Pope probably never envisaged this quotation of "Hope Springs Eternal" from his poem, ever becoming such a popular and universal reference point down through the ages. Indeed, whether the subject be man's health, fortune, or just his dreams; as a way of life most people naturally tend to hope for the best. So it is with the topic of individual wealth and riches, gleaned from equity and fixed income investments in the form of capital gains, dividends and coupons. Whether by their own research and knowledge or via the advice of an investment advisor, all investors load their portfolios with securities from which they expect to reap financial rewards. However, since the marketplace can be fragile and risky, while providing no certain guarantees; to varying degrees, all investment portfolios are enshrouded in a well-spring of hope.

While hope in the beneficial progress of financial and economic events appears to be well placed during the spring, summer and autumn of the Long Cycle (1949-2000 in the current cycle), it invariably fails in the winter of the cycle, because it is based upon economic expectations that have been prevalent and will, supposedly, continue to exist. However, during the Long Wave winter the beneficial progress made in the economy and in the investment markets during the three previous seasons, is drastically reversed and hope cannot undo the economic and financial catastrophe that winter entails.

This winter economic disaster is and always has been caused by an enormous and unmanageable debt burden, most of which has been accumulated during the Long Wave autumn. We have often written that debt would be the undoing of the economy and the financial system. Now, the debt chickens are coming home to roost in almost every country in the world and the financial systems in most of these countries are beginning their collapse. Within such an economic environment, any hope for a return to the immediate past 'season of mists and mellow fruitfulness' (See below *) is both false and misplaced.

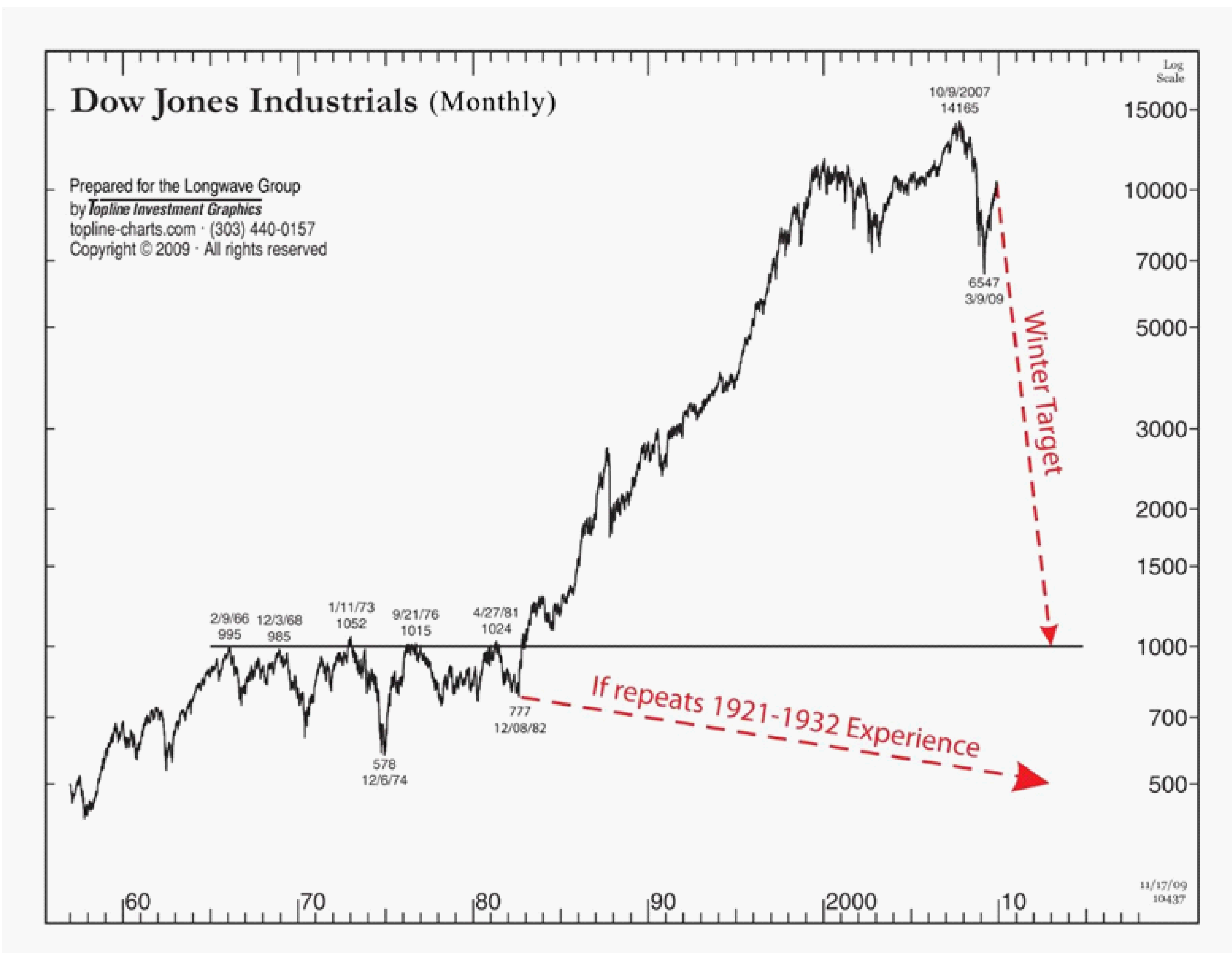
For the most part, expectations for the future of the financial markets are based upon investor confidence in the traditional safe haven investment securities of the past, coupled with an understanding in the direction of the economy. If investors become uncertain about the underlying forces influencing the securities markets and become unwilling to take any risks due to their lack of conviction, they tend to retreat to the sidelines and raise the percentage of the cash position in their portfolios. Such is the growing trend currently unfolding in the markets.

The Perceived Sanctity of 'Safe Haven' Investments

By nature, the world's fixed income markets can be unfair, fragile and there are no guarantees. Until recently, the 'AAA' sovereign debt credit rating of the United States of America was deemed inviolable by the majority of bond investors and fund managers in the developed world. So, most observers were quite shocked to learn that Standard and Poors (S&P) would have the audacity to downgrade the U.S. credit rating to 'AA' (High). In our Winter Warning, September 22, 2008 – The Die Is Cast – The Flight to Folly, we warned: "as a result of soaring debt levels … a potential downgrade of U.S. Treasurys from their current AAA (stable) credit rating" could ensue.

Subsequent to the downgrade, many fixed income fund managers and media commentators have been quick to point out that U.S. Treasury yields have actually declined across the 30-year maturity range of the curve: "so bond investors must be deeming the U.S. to still be a top-rated credit." Verily, not only have U.S. Treasurys responded positively to the worsening outlook for the U.S. economy, but also, last week the Federal Reserve Open Market Committee (FOMC) announced it would be keeping the current record low range of the Federal Funds rate at 0-0.25% for another two years. In point of fact, lower yields for outstanding U.S. Treasury issues represent only short-term reactions in the marketplace. As the U.S. debt to gross domestic product (GDP) ratio increases towards 10% in terms of its annual deficit and 100% in terms of its accumulated national debt level, ultimately, Treasury yields will move higher unless the overall U.S. debt picture markedly improves. The above, notwithstanding, at Long Wave Analytics, we think it is reasonable to surmise that before year end, Moody's Investors Service will have joined S&P in downgrading America's sovereign debt credit rating.

Dow 1,000 Is Not An Unreasonable Target



During recent weeks, stock markets around the world have declined sharply from their spring peak levels, amid heightened levels of volatility which the media fondly term “roller coaster” markets. Baffled by the sell offs, reporters on TV financial channels CNBC and BNN have been interviewing equity traders, portfolio managers and investment advisors in an attempt to unearth the reason “why the Dow Jones Industrial Average (DJIA) is plunging again.” As equity market- oriented investors, these guests attempt to put a positive spin on the situation noting that: “corporate earnings have been good, corporate balance sheets are healthy and the U.S. Federal Reserve is extending its easy monetary policy.” Many remain bullish on the outlook for the equity markets because “this is just a correction and investors should buy on market weakness.” Since the DJIA bounced off its low point in March 2009, it has been propped up by easy monetary policies and quantitative easing initiatives by the U.S. Federal Reserve; as well as billions in various stimulus packages from the Obama administration. In other words, the U.S. government has been intervening in what is a natural long-term bearish economic cycle by issuing more debt, which only serves to exacerbate the problem. Hope for a better economy in America is being crushed by massive debt.

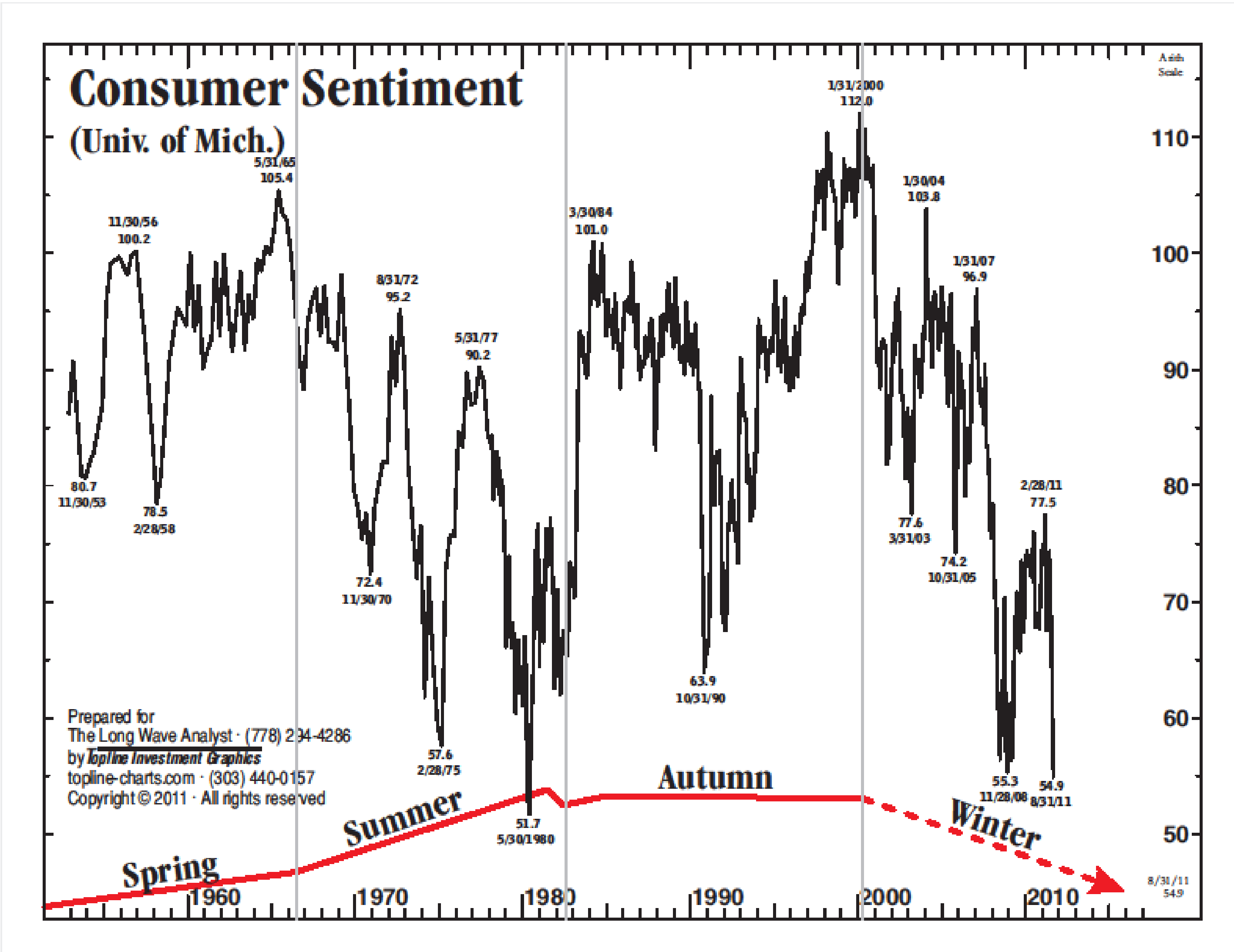
The huge autumn stock bull market, 1982-2000, saw the Dow Jones Industrial Average gain almost 11,000 points, which was equivalent to a gain of 1500%. That kind of huge gain has never been experienced in any of the previous autumn stock bull markets. By comparison, the third Kondratieff autumn stock bull market, 1921-1929, gained only 595%. In November 1928, W. D. Gann in his ‘Outlook for 1929’, in which he forecast the 1929 stock market crash and the ensuing stock bear market, wrote that the decline (bear market) must be in proportion to the advance (the preceding bull market). The bear market decline of 1929-1932 dropped the Dow 89%. In other words, an 89% decline was in proportion to a 595% advance. What percentage decline would it take to be in proportion to the 1500% advance experienced between1982 and 2000? Clearly it must be greater than the 89% correction experienced in the previous winter, so ‘Dow 1,000 is not a silly number.’

China Will Save Us

Obviously, what these invitees are missing in their micro-reasoning is the macroeconomic picture. The Chinese economy has been growing exponentially for years, creating massive bubbles in real estate and bad bank loans. Moreover, according to the Privateer: “As for Chinese demand for Aussie raw resources, it is obvious that this already starting to wind back. In June 2011, Australia posted a trade surplus of $2.05 billion (AUD). This was the eighth time that a monthly trade surplus has been above the $2 billion (AUD) mark – all of them driven by Chinese demand. Even so, the trend of the Australian balance of trade is inexorably down. In 2009-2010, Australian exports increased by $44 billion (AUD). In 2010-2011, that figure dived to $22.4 billion (AUD).” Hope for a U.S. economic recovery translates into hope that the Chinese economy will continue its breakneck expansion. But that hope will be crushed when the Chinese bubble bursts. Speculators, who are counting on continued Chinese economic expansion by investing in various commodities will also pay the price for their wishful thinking.

The Waning Confidence of the American Consumer

The chart below of the Thomson Reuters / University of Michigan preliminary index of U.S. consumer sentiment depicts a decline to a reading of 54.9 in August from a level of 63.7 in July, reflecting a negative conviction in the domestic economic outlook not seen since May 1980. The survey, taken during the protracted debate in Congress over the raising of the U.S. statutory debt limit, prompted survey director Richard Curtin to comment: “Never before in the history of the surveys have so many consumers spontaneously mentioned negative aspects of the government’s role. This was more than the simple recognition that traditional monetary and fiscal policy measures were largely spent. It was the realization that the government was unable or unwilling to act.” Moreover, during the Kondratieff winter, the most enduring of the four economic seasons, consumers will strive to restrain spending and reduce their debt; fearful of either losing their job, or perhaps even their place of residence. Representing over 70% of the demand factor in the U.S. economy, the American consumer has become ‘tapped out’ under the weight of a personal burdensome debt load and continuing high level of unemployment. As of last May, a record-breaking 45.8 million Americans were participants in the Supplemental Nutritional Assistance Program – a total rapidly approaching an average of one million people per state.



O Put Not Your Trust in Princes, nor in any child of man; for there is no help in them. For when the breath of man goeth forth, he shall turn to his earth: and then all his thoughts perish.

This Biblical reference from Psalm 146 warns people to be wary of those in authority who may possess a shallow perspective and driven by the pursuit of their own agendas, could lead many an investor down an unrewarding path. Historically, within the macro-world of investments and related financial entities, there has rarely been a shortage of self-serving entrepreneurs in both the private and public sectors. Indeed, if an investor isn't inclined to be skeptical, he/she runs a great risk of being gullible. The current economic downturn which began to unfold in earnest during 2007 is a classic illustration of many thousands of investors worldwide who based their investment strategies on the false promises of authoritative figures, culminating in their hopes and plans being dashed to the ground.

The Maestro Couldn't Spot a Bubble in a Bathtub

"The recent rise in the home ownership rate to over 67% in the third quarter of this year owes, in part, to the healthy economic expansion with its robust job growth. But part of the gains have also come about because innovative lenders, like you, have created a far broader spectrum of mortgage products and have increased the efficiency of loan organizations and underwriting. Ongoing progress in streamlining the loan application and origination process and in tailoring mortgages to individual home buyers is needed to continue these gains in home ownership." Alan Greenspan (the Maestro): economist, consultant and chairman of the U.S. Federal Reserve Board from 1987 to 2006, addressing America's Community Bankers on November 2, 1999.

When Chairman of the Federal Reserve Board, Alan Greenspan managed and implemented U.S. monetary policy according to his treasured set of econometric models, which he had acquired and trusted over the years. He was a poor listener and as such, directed Federal Open Market Committee (FOMC) meetings with tunnel vision, incapable of embracing a macroeconomic view or recognizing a bubble "until after it had burst", as he once admitted. Obviously, a legend in his own mind, Mr. Greenspan thought that he wasn't always right, but he was never wrong.

In Ian Gordon's Longwave special edition published in November 2007, entitled 'This Is It', the introduction read as follows: "This is it. The Kondratieff winter is now underway in earnest and nothing can stop it. The huge credit expansion initiated by the Maestro, the former Federal Reserve Chairman, Alan Greenspan, has now reversed. The ensuing credit contraction will be devastating. It will take down creditor and debtor alike and will result in a destructive and frightening deflationary depression."

"Expanding the American Dream of Home Ownership Must Continue to be Our Mission, not solely for the purpose of benefiting corporate America, but more importantly, to make our country a better place." – Angelo R. Mozilo: Co-founder and former chief executive officer of Countrywide Financial, Washington D.C. in February 2003.

"In 2003, however, Mozilo's company was still very much the envy of the mortgage industry. Between 1994 and 2004, Countrywide's annual earnings had rocketed from $180 million (U.S.) to $2.2 billion (U.S.). Shareholders watched with delight as their stock jumped fivefold over the period. Where most of his non-bank mortgage lending rivals had gone out of business with the collapse of Subprime 1.0, Mozilo hadn't just survived, he had flourished. Mozilo, too, was a beneficiary, pocketing $43 million (U.S.) in salary and bonuses over those years. His stock compensation was even more generous, allowing him to cash in more than $400 million (U.S.) in shares during his tenure at the company. In business circles, Mozilo was a rock star, regularly receiving standing ovations at speeches he made to mortgage industry groups." -- Reckless Endangerment by Gretchen Morgenson and Joshua Rosner.

Ultimately, Countrywide's decline was as spectacular as its rise. At the time the financial crisis struck, the company was fortunate to receive a takeover offer from the Bank of America of $2.8 billion (U.S.) in July 2008; at which time Mr. Mozilo left the company. However, in June 2009, the U.S. Securities and Exchange Commission (SEC) filed civil fraud and insider trading charges against Mr. Mozilo and two other former corporate executives. In October, Mr. Mozilo agreed to repay $45 million (U.S.) in ill-gotten gains and $22.5 million (U.S.) in civil penalties as part of a settlement with the SEC, **in which he admitted no wrongdoing**. How ridiculous is that?

Now we learn of a new complaint filed in the New York State Supreme Court in Manhattan by the insurer AIG, still largely owned by taxpayers after $182.3 billion (U.S.) of federal government bailouts, is suing Bank of America Corp. for $10.5 billion (U.S.) of losses incurred from a "massive fraud" on mortgage investments. AIG alleges it suffered the losses on $28 billion (U.S.) of investments and its Countrywide Financial and Merrill Lynch units of misrepresenting the quality of mortgages placed in securities and sold to investors: "Defendants were engaged in a massive scheme to manipulate and deceive investors, like AIG, who had no alternative but to rely on the lies and omissions made." Moreover, New York Attorney General Eric Schneiderman has asked a New York State court judge to allow him to intervene in the recent $8.5 billion (U.S.) settlement between Bank of America and certain New York mortgage-backed bond investors, calling the proposed deal "unfair and inadequate" and "procedurally and substantively flawed." Mr. Schneiderman related that he was acting "to protect the marketplace and the interest of investors, who were harmed by the widespread misconduct."

In the mid-2000s, Angelo Mozilo was quite the piece of work. Often interviewed on General Electric's financial channel CNBC, Mr. Mozilo tried hard to project a suave, debonair business image and was never reluctant to boast about his managerial acumen. Indeed, Mr. Mozilo would not hesitate to warn competitors that he would eventually drive them out of business. He was going to take over everything. Ultimately, Mr. Mozilo's mindset lost touch with reality when he began to believe his own line of bull and became consumed by his rapacious greed.

"Markets will rise and fall, but this is the United States of America. No matter what some (rating) agency may say, We Have Always Been and Always Will Be a Triple-A Country." – U. S. President Barack Obama, Washington, D.C. August 8, 2011.

Warren Buffett goes one step further when he recently remarked, "If they had an AAAA, I would put the US Treasuries in AAAA status." This is the man, who also paraphrased J. P. Morgan's famous remark "Don't sell America short." It's all well and good to love your country, but when that love cannot recognize the country's fundamental problems it is merely blind love. The trouble is that Warren Buffett has become an investment icon to millions of investors around the world, who hang his every word.

Yesterday, U.S. President Barack Obama blamed a Standard and Poors (S&P) downgrade of the United States' sovereign debt credit rating to 'AA' (High) on political gridlock. President Obama said he would offer his own recommendations for fixing the deficit problem and cited again the need to raise taxes on wealthier Americans and make modest adjustments to popular, but expensive entitlement programs. The President called upon Congress to extend the payroll tax cut and unemployment benefits, saying if this was not done soon, it will lead to one million fewer jobs and lower economic growth (GDP). President Obama stated that America's (debt) problems are "imminently solvable" but that political gridlock has made compromise extremely difficult and has contributed to a picture of economic uncertainty. The President said he hopes S&P's downgrade will give U.S. lawmakers a new sense of urgency to confront long-term (government) deficit spending and reiterated he did not believe the reductions could be achieved with spending cuts alone. A joint bipartisan congressional committee, to be formed under the legislation passed last week which averted a government default, is to report its recommendation in late November regarding $1.5 trillion (U.S.) in spending cuts over the next decade. According to a Democratic aide, Senate Majority Leader Harry Reid (D-Nev.) has selected Senator Patty Murray (D-Wash.) to co-chair the 12-person committee; as well as Senators Max Baucus (D-Mont.) and John Kerry (D-Mass.).

At Longwave Analytics, where we take issue with President Obama is the mindset that America's debt problems are "imminently solvable" and that America will always be a triple-A country. In point of fact, as far back as September 2008, we alluded to the possibility of America losing her coveted 'AAA' sovereign debt credit rating. By the time the presidential elections roll around in November of next year, America's national debt will likely approximate $16.5 trillion (U.S.). Can anyone actually conceive the country paying off such a staggering burden of debt? Sadly, with politicians placing partisan party agendas ahead of the country's agenda, leadership in Washington is well on the downslope!

Again quoting from This Is It: "Politicians believe that they have the power to overcome the downside or the depression stage of the long-term economic cycle. That is because they are possessed with massive arrogance and because they have been, so they think, able to overcome every economic downturn that occurs during the process of the cycle … but the depression stage of the cycle, which is synonymous with winter, cannot be curtailed and will run its course, despite the best efforts of mere mortals to intervene. Human intervention in the natural process of the cycle only serves to make matters worse, or at the least leads to unintended consequences. Presidents Hoover and Roosevelt could do nothing to circumvent the depression of the 1930s."

We turn to our mentor, W. D. Gann, to show the futility of trusting and hoping in our leaders to bring us back to the promised land. In November 1928, Gann published his outlook for 2009 and this is his introduction to that publication, "This year (1929) occurs in a cycle which shows the ending of the bull campaign and the beginning of a prolonged bear campaign. The present bull campaign has lasted longer than any previous campaign in the history of this country. The fact that it has run longer and prices have advanced to such abnormal heights means that when the decline sets in it must be in proportion to the advance. For the year 1929 will witness some sharp, severe panicky declines in many high priced stocks."

Later in the same publication he wrote, “When the time cycle is up, neither Republican, Democrat, nor our good President Hoover can stem the tide. It is natural law. Action equals reaction in the opposite direction. We see it in the ebb and flow of the tide and we know that from the full bloom of summer follows the dead leaves of winter.” The time cycle is ‘up,’ 2011 is eighty years following the tragic year of 1931, and the dead leaves of a Kondratieff winter have returned.

Summation

As is evidenced by the recent sharp decline in the Dow Jones Industrial Average (DJIA) and in stock markets around the globe, we are witnessing a rapidly slowing economy in the United States, a moribund economic situation developing in the Euro zone and continued economic stagnation in Japan; as the longwave winter cycle intensifies and is fuelled by the world being awash in debt. It is now 80 years (four 20-year cycles identified by the late W.D. Gann) since the tragic year of 1931 when the world’s economic system crashed. History is on the verge of repeating itself.

Citizens in many countries, particularly in the United States have been coddled for a long time into believing that governments can solve all their problems. Sadly, they are still being led astray by government promises which cannot possibly be fulfilled in terms of Medicare, Medicaid and Social Security. Moreover, while tax reform is desperately needed, political gridlock and polarization present significant headwinds to any meaningful progress.

Whether we focus on former Federal Reserve Chairman Alan Greenspan obsessing over his cherished econometric models; or whether we cite the lack of due diligence by Ken Lewis (now retired), former Chief Executive Officer of the Bank of America, in his takeover of Angelo Mozilo’s Countrywide Financial, which was already under investigation by the Federal Bureau of Investigation (FBI); both contributed to the demise of the U.S. housing market and subsequent soaring unemployment levels.

At Longwave Analytics, we have given up hope in any recovery in the U.S. economy. Our hope rests with gold reasserting its traditional role as money. In an August 10th. report from Frankfurt-based Deutsche Bank, Michael Lewis, senior commodities research analyst asserts: “We believe the main beneficiary of super low interest rates in the United States, a weak U.S. dollar, a view that central bank holdings in the U.S. dollar are still excessive and ongoing questions over the stability of the financial system, will be gold.”

Finally, we witness a U.S. President in denial – “We will always be a triple-A country” – who, lacking the leadership skills to steer America down a stable economic highway to prosperity, will probably succumb to the fate of a one-term presidency.

* To Autumn , John Keats 1795-1821
Season of mists and mellow fruitfulness!
Close bosom friend of the maturing sun;
Conspiring with him how to load and bless
With fruit the vines that round the thatch-eaves run;
To bend with apples the moss’d cottage trees,
And fill all fruit with ripeness to the core;
To swell the gourd, and plump the hazel shells
With a sweet kernel; to set budding more,
And still more, later flowers for the bees,
Until they think warm days will never cease,
For summer has o’er-brimmed their clammy cells.

Who has not seen thee oft amid thy store?
Sometimes who ever seeks abroad may find

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Thee sitting careless on a granary floor,
Thy hair soft-lifted by a winnowing wind;
Or on a half-reaped furrow sound asleep,
Drowsed with the fume of poppies, while thy hook
Spares the next swath and all its twined flowers;
And sometimes like a gleaner thou dost keep
Steady thy laden head across a brook;
Or by a cider-press with patient look,
Thou watchest the last oozing hours by hours.

Where are the songs of Spring? Ay where are they?
Think not of them, thou hast thy music too,-
While barred clouds bloom the soft-dying day,
And touch the stubble-plains with rosy hue;
Then in a wailful choir the small gnats mourn
Among the sallows, borne aloft
Or sinking as the light wind lives or dies;
And full-grown lambs loud bleat from the hilly bourn;
Hedge crickets sing and now with treble soft
The redbreast whistles from a garden-croft
And gathering swallows twitter in the skies.

Autumn is the Kondratieff ‘feel –good’ season, made possible by the biggest bull market in stocks, bonds and real estate of the entire cycle. Those who live in hope of a return to the Long Wave autumn will see their hopes dashed by the ensuing frigid and desperate winter. The next Long Wave autumn is perhaps fifty years in the future.

Written By: Ian Gordon & Christopher Funston

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