The Casey Report

Investing Ahead of the Crowd

Volume V, Issue 1 / January 2012

In This Month's Issue…

Click on the link to jump directly to an article.

Introduction
David Galland sets the stage for this month's edition

2012 Forecast: The Year of Currency Wars and Central Bank Printing
Bud Conrad reflects on 2011 and makes his predictions for 2012

Life in the Twilight Zone
Doug Casey and David Galland discuss what the new year may bring

How to Invest
An update on our recommended investments

The Data Farm
A collection of data worth your attention

Obama Watch: Above the Law
Don Grove on the separate set of rules for our overlords

End Note
A closing comment by Doug Casey

When the Rock Meets the Hard Place

Dear Reader,

In addition to the customary warm greetings and best wishes for the new year, I would like to extend a special welcome to those of you who are new to the Casey Report, of which there are quite a few this month.

As you get settled in for what we hope will be a long relationship, I want to make sure that you are aware of the archives for this service, a tremendous resource you now have full access to.

Spend as much time as possible perusing the archives, as they provide the underpinning arguments for our outlook on the economy and major investment markets. I would especially bring to your attention last month's edition as it provides Doug Casey's irrefutable case for the bankruptcy of the US government, as well as Bud Conrad's latest analysis on the intractable problems being faced by the Eurozone nations.

The use of terms such as "irrefutable" and "intractable" in regards to the dismal trap that the world's debt-soaked sovereignties have built for themselves is deliberate. Examining the hard data, as we have, it is clear that the US and most of the world's advanced economies remain trapped between a rock and a hard place, something we have been warning our readers of for years. To quote just one example:

> As we have predicted for many months now, caught between a rock and a hard place – in this specific instance, a collapsing economy or a highly inflationary response that damns the dollar – the Fed has chosen the latter course. In spades.
>
> ***The Crisis Continues, Bud Conrad, The Casey Report, Nov. 2008***

This week, the new head of the European Central Bank, Mario Draghi, let it slip that he is considering following the Fed's policy of suppressing interest rates as a possible move to save the Eurozone. This is, of course, nothing more than a continuance of the race in competitive currency devaluation, the reigning monetary policy of central banks the world over.

In his article for this edition, **2012 Forecast: The Year of Currency Wars and Central Bank Printing**, Bud Conrad, Casey Research chief economist, shares his latest notes on the currency wars and other challenges facing the world in 2012, and updates his forecasts for the year ahead.

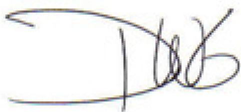
Elsewhere you'll find an interview I conducted with Doug Casey titled **Life in the Twilight Zone**. As you'll read, Doug is far less optimistic about the outlook for 2012 because, as he points out in our conversation, the world's governments persist in pursuing actions that are not only wrong but exactly the opposite of what they should be doing. There will be consequences.

In addition, you'll find our usual features, among them **How to Invest**, with updates on our suggested ways to take advantage of the powerful trends now in play, including a new contrarian investment for you to begin nibbling at.

There is, of course, much more, but in the interest of brevity, I'll let you enjoy the process of discovery on your own.

It should be a very interesting new year. Rest assured we'll be at your side every step of the way.

Sincerely,



David Galland
Managing Editor

Back to Table of Contents

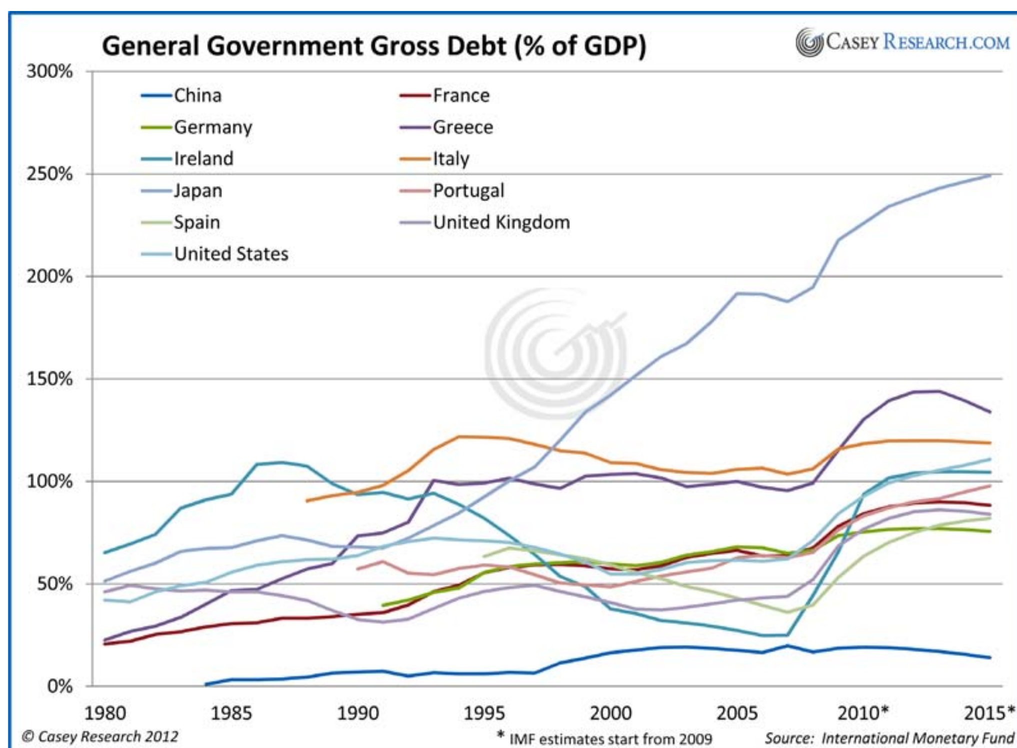
2012 Forecast: The Year of Currency Wars and Central Bank Printing

By Bud Conrad

The following article contains a loosely connected collection of my observations as we enter what promises to be a particularly interesting, and challenging, new year. By the time you get to the end of it, you will have a clear picture of where I believe the major economies are headed, as well as their currencies and primary investment sectors.

Setting the stage, we are where we are today because the governments of the world, operating on fiat currency systems, have been allowed to print an excessive quantity of currency units and expand their debt to historic levels. Once the deficits become too large and the outstanding debt of the government approaches or exceeds its GDP, confidence in both the currency and the issuing government begins to erode, setting the stage for further crisis.

The scenario now unfolding in the weaker countries of Europe is nothing new. Quite the opposite; it was entirely predictable given the structural flaws in the euro, a fiat currency not only backed by nothing but by no one. As the countries in Europe and elsewhere increasingly turn to competitive devaluation, deficit spending and money creation in an attempt to improve their economies, the number of sovereign nations in trouble will rise. Most countries' debt-to-GDP ratios are at record levels, and projections from the IMF – which are likely to be understated – suggest they will continue to print and spend.



The powerful trend in motion is that central banks are flooding the world with digital money, though the consequences haven't been evenly distributed. For instance, while the US is creating dollars at an astounding rate, the dollar's reserve status has – so far – helped it to avoid the same degree of pain as other currencies.

The problems caused by fiat money and irresponsible government are widespread. Consider the effect on asset pricing: what exactly is a reliable measuring stick for monetary value? After all, when a currency unit is backed by nothing, and it can be created out of thin air in unlimited quantities with nothing more than a few key strokes, how can you derive a true value? And if you can't derive a true value for the currency unit, how, then, can you value anything priced in those units?

The Dollar as Safe Harbor

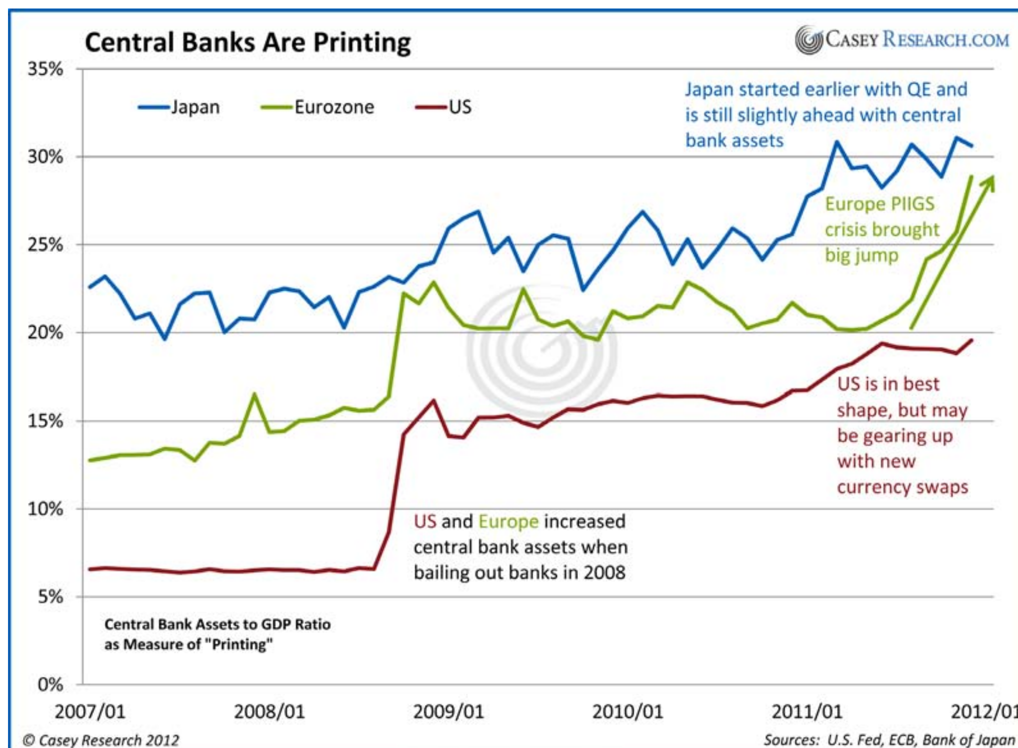
When the dollar had an anchor of convertibility to gold, it was used as the basis for all currencies and for world trade. Without the convertibility, it is no different from any other fiat currency. The reckless and wanton monetary and fiscal policies of the US government are, finally, beginning to reveal that the emperor has no clothes. That is indicated by the growing list of important countries initiating bilateral agreements between each other with the express purpose of eliminating the use of US dollars in their trade arrangements. The most important of these new agreements is between Japan and China, which will begin using their own currencies in settling trades and even buying each other's government bonds. Such actions are part of the currency wars and reflect a change in attitude towards the dominance of the dollar.

When you look at the actions of the world's central banks, however, it is clear that they are all willing to engage in excessive money creation to support expanded levels of government spending and debt creation. In our perspective, the idea that governments are trying to buy their way out of a debt crisis by taking on more debt seems ludicrous, but only because it is. Powerless to change these wrong-headed policies, all we can do as investors is to take the steps that make the trend our friend. You'll find some thoughts on that later on in this article, as well as elsewhere in this edition.

The following chart shows the central bank assets of the big three currencies of Europe, the United States and Japan. As an explanation of the term, every central bank has a balance sheet summing up all its assets and liabilities. The sum of all its assets is the broadest measure of its actions to create money, liquidity, loans and all the actions it takes in trying to support an economy. The main asset historically was Treasuries held against the liability of currency in circulation, but in today's complex world that is no longer the case as central banks have been willing to purchase toxic loans (including in the US, where the Fed purchased massive quantities of suspect mortgage-backed securities).

As you can see, at the onset of the current credit crisis, the US and Europe dramatically expanded their assets in an attempt to soften the blow to the economy. While the spike in Japan was not quite as acute, that is only because it began from a higher base – the Japanese central bank has been creating money and taking on debt for a longer period of time, and so its central bank assets were already larger than those of the US and the European Central Bank (ECB).

Viewed at this level, the US actually looks stronger than the other two, as its ratio of central bank assets to GDP is smaller. The treaties that limited Europe's central bank from expanding the money supply have been blatantly ignored as Europe is moving very aggressively in an attempt to support its system as it not so slowly unravels.



Endgame for the Euro as Now Constituted?

It is probable that the Eurozone is already in a recession, but conditions will worsen as tax hikes and austerity measures take a toll. Hiking taxes in the midst of a recession makes growing out of the debt burden more difficult. Confirming a likely recession and the fact that even the strong countries of Europe will feel the impact, German factory orders in November dropped the most in nearly three years.

In last month's article, I discussed my analysis that the euro is likely to fall toward $1.10, and I remain comfortable with that forecast. Likewise, I continue to expect more than one of the weaker countries will leave the euro currency – with Greece a near certainty and Portugal only a couple of steps behind. Stating the obvious, the recession will be negative for European stocks and bonds, in time potentially creating opportunities as good issues fall with the tide. With youth unemployment in Spain already at 40% and austerity measures being enacted in Greece and elsewhere that will have a further negative impact on the standard of living, expect more social unrest.

Asia Will Head to Recession as Exports Fall

The Eurozone crisis will affect Japanese and Chinese exports to the continent, which will slow to the point of creating recession in Asia as well. China and Japan's response to further economic slowing will be to continue their money printing. While that could keep the dollar strong in relative terms, provided the Fed hasn't overdone its own quantitative easing at that point, the key takeaway is that central bank printing will be worldwide. This will result in the potential for interest rate spikes in individual countries, as investors lose confidence in the banking system and the currency.

One implication of an Asian recession is that the prices of commodities won't rise as much because of slowing demand.

US GDP Will Reflect Weak Recession

I am expecting a slowing in the (real) economy of the United States, as new jobs still aren't being created, and in this election year, another expensive new stimulus program is unlikely. The US already has a burdensome all-inclusive debt of 350%. The US has not really recovered from the crisis of 2008, and the government debt is still growing.

While there have been a smattering of brighter economic numbers thanks to the huge government stimulus since 2008, the growth in real GDP has been anemic compared to the growth in debt. I think there is much more price inflation than the price deflator says (or CPI, if you want to use that number). Using a more realistic level of price inflation than that used by the government would likely indicate that the country remains locked in recession. My prediction for 2012 is that actual private-sector economic activity as measured by growth in real GDP will decline by 1%. Using more realistic numbers for price inflation, I suspect the decline would be closer to 4%.

Interest Rate Effects

I expect the rise in prices will be faster than the rise in nominal interest rates. That's because the Fed and other central banks working in concert with the Fed will print money to buy a significant portion of new US government debt. That means that the real rate will drop further into negative territory. That could be supportive to real estate and to stocks in nominal terms, despite the likely economic slowing. Because of the artificial suppression of rates, I no longer expect housing prices to fall despite the large inventory of unsold houses.

While there may be some temporary gains to be had from the Fed's low interest rates, they will come at the cost of increasing monetary inflation as the Fed will be forced to continue buying a substantial amount of Treasuries. In addition, current interest rates are so low that they do not foster productive economic activity. Savers are penalized while banks are able to use cheap money to make profitable investments. These prolonged, ridiculously low rates just promote further misallocation of capital, which ultimately only makes the situation worse.

War and Oil

The US government's deficits could grow further should the US become involved in a yet another war, this time with Iran. Unfortunately, this appears to be the current path. The wars in Iraq and Afghanistan cost $3 trillion, and Iran has the potential to be on a similar scale. In an election year, the budgetary implications of a new war would normally be considered political suicide for incumbents, but stepping stones are already in place just as they were ahead of the attacks on Iraq.

Among those stepping stones, President Obama has signed a law dictating even more harsh sanctions on anyone buying Iranian oil or doing business with Iran's central bank. Those new sanctions are scheduled for implementation in about six months. In response, Iran's parliament said it that it was preparing a bill that would prohibit all foreign warships from entering the Persian Gulf unless they received permission from the Iranian navy. Iran's increasingly bellicose tone has coincided with a US-created currency crisis for the rial that has forced the Iranian government to intervene to prop it up.

It appears we may already be at war as evidenced by the Stuxnet virus, assassinations and large explosions aimed at disabling Iranian military capabilities. An all-out shooting war is not guaranteed, but the risk of one hasn't been this high since the Iranian hostage fiasco. Until one or both sides step back, a war remains just one small provocation or mishap away.

Meanwhile, the threat of another war will continue to weigh on the economy because it will reduce any political appetite for serious military cutbacks. Failing to substantively address US spending on the military ensures that US deficits will remain high. Should a war break out, the price of oil will soar along with those deficits.

What's Going on with Gold?

While the pullback in precious metals in the fall of 2011 was an unpleasant development – partially because they are my biggest investment – even the 20% pullback in gold was entirely within range of a normal secular bull market correction. However, given the unprecedented scale of deficit spending and money creation in the world's leading economies, the pullback seems overdone.

In my opinion, there has been a change in what drives precious metals. By late summer, both of my predictions for gold and silver had been exceeded, with gold reaching $1,925 per ounce and silver brushing close to $50 an ounce in the spring. Readers of my past analysis know all the reasons for the strong performance – extreme government deficits, quantitative easing and so forth.

Given that nothing has really changed, the upside momentum seemed set to continue, albeit with normal corrections and periods of consolidation along the way. But by the end of 2011, gold was only up 10% on the year at $1,574 per ounce, and silver at $28 was actually down a small amount. So what caused the steep decline from the 2011 peaks, in the face of continuing worldwide government deficits and the complete economic rout of some of the weaker Eurozone countries?

I'll review some of the specific technical indicators and potential effects on the market, and then I'll dig more deeply into the meaning of the fiasco of MF Global's demise. Most of the following charts are from the very extensive Sharelynx.com website, so I thank my friend Nick Laird who put that together.

Those watching the global markets closely see quotes of gold and silver changing by the minute throughout the day. Most of us don't think about how that price was generated; it is, in fact, defined by the nearby futures contract as it trades actively throughout the day on various bourses around the globe.

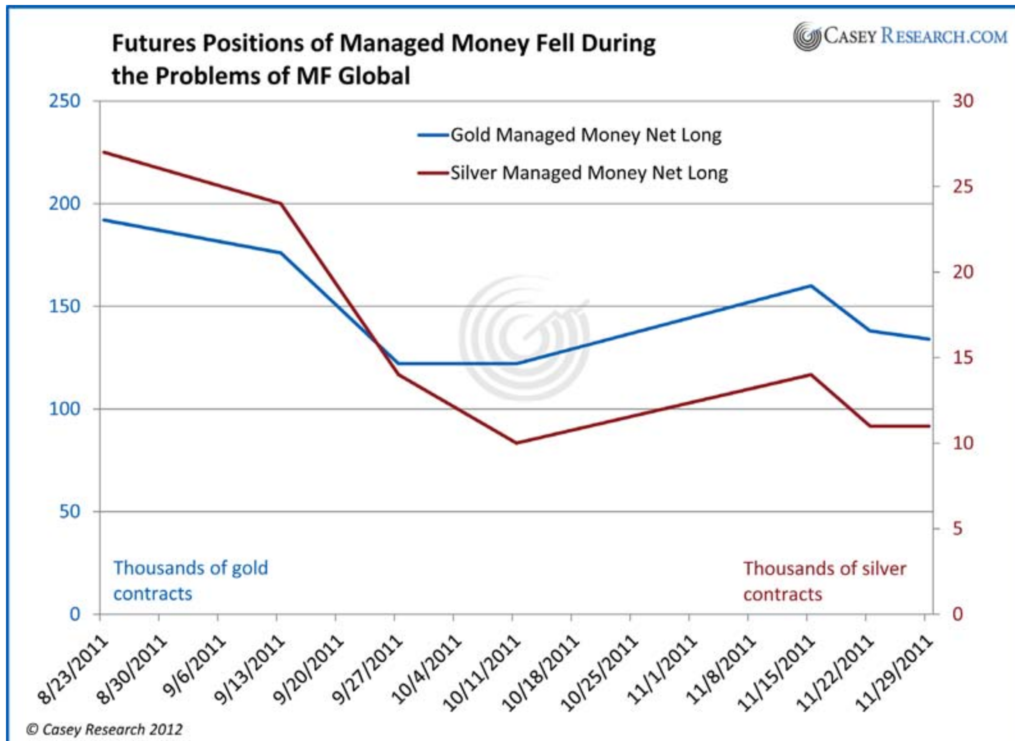
As shown in the next chart, the "open interest" in gold, or number of futures contracts outstanding, is plotted against the actual gold price. Open interest is one of the indicators that traders use to confirm their opinions about the market. You can see a large drop in open interest in 2008 when gold and gold stocks dropped more than most traders expected. You can see another fall in open interest in 2011, which is consistent with the correction in gold at year-end. This most recent drop is slightly ominous because it indicates less enthusiasm among futures traders about the prospects for gold.

To get a better fix on the events of the second half of 2011, I pulled the following chart and added a few notes about events that occurred around the collapse of MF Global, one of the largest and most important firms in the futures industry. There is little question that the dramatic failure of such a large firm – the seventh-largest corporate bankruptcy in US history – damaged confidence in the whole futures market system and almost certainly played a role in gold's weakness in the second half of 2011.

I'll have more to say on MF Global separately, but for now will focus on the consequences of its failure for gold. We can see that open interest in gold (represented by the red line) dropped a bit around the time news about MF Global broke. We can also see the correlation to the price of gold (represented by the multicolored red and blue line that uses the right-hand scale) as the implications of the abnormalities of the MF Global collapse on long-established precedents in futures markets became better understood. Of course, with fewer contracts outstanding, the volume of trades also declined toward the end of 2011.

The next chart shows the same information for silver, and the drop-off in open interest is even larger. When viewed in a longer-term historical context, the depressed level of open interest is actually a negative indicator for the price of silver.

The Commodity Futures Trading Commission (CFTC) keeps track of the number of contracts held by different classifications of traders. Commitments of Traders (COT) analysis gives traders indications of whether particular segments are long or short the market. In a bull market for precious metals, large speculators are usually taking long positions, helping to drive the markets higher and providing a useful indicator about the general direction of the market. During the second half of 2011, the bullish opinion of the large speculators declined noticeably. There is a subset of these large speculators called *Managed Money*, and the chart below shows that their long positions for both gold and silver dropped rather dramatically in the second half of 2011.



Another very important force affecting futures markets in 2011 relates to the fact that futures are traded on margin, with traders typically required to put up a relatively small amount of money. That leverage allows traders to greatly amplify their profits (or losses) from the price action of the underlying commodity. In calm markets, the margin requirement can be as little as a twentieth of the total contract value (thus, the cost of controlling a hypothetical futures contract on a $100 barrel of oil could be as little as $5. If the barrel rises in price to $105, you effectively make 100% on your money… or vice versa).

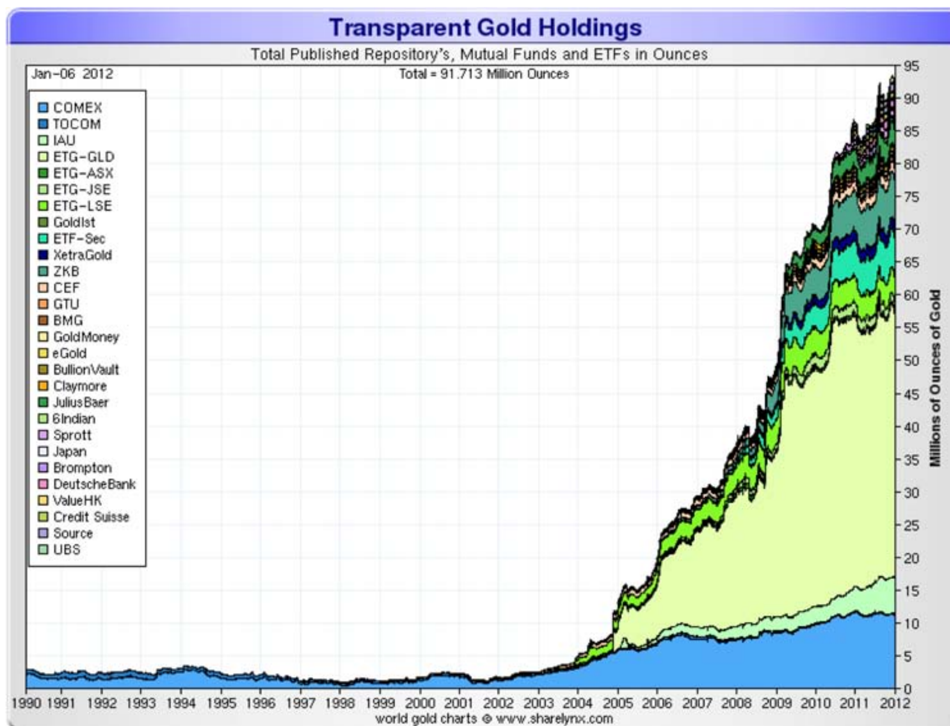
As the price of a commodity rises or becomes more volatile, however, it is standard practice for the operators of the futures exchange, in this case the CME Group, to raise the margin requirement on that commodity. They do so in an attempt to ensure that there are adequate funds available to cover losses in a market that has become susceptible to excessive speculative froth.

In the middle panel of this next chart, you can see the required margin for gold over the last few years. The top panel shows the gold price, and the bottom panel shows the margin as a percentage of the value of the contract. Not surprisingly, the requirement for speculators to put up more money on margin than usual is a negative for the market and price. To the right of the chart, you can see the relatively higher margin requirements that were inaugurated in 2011.

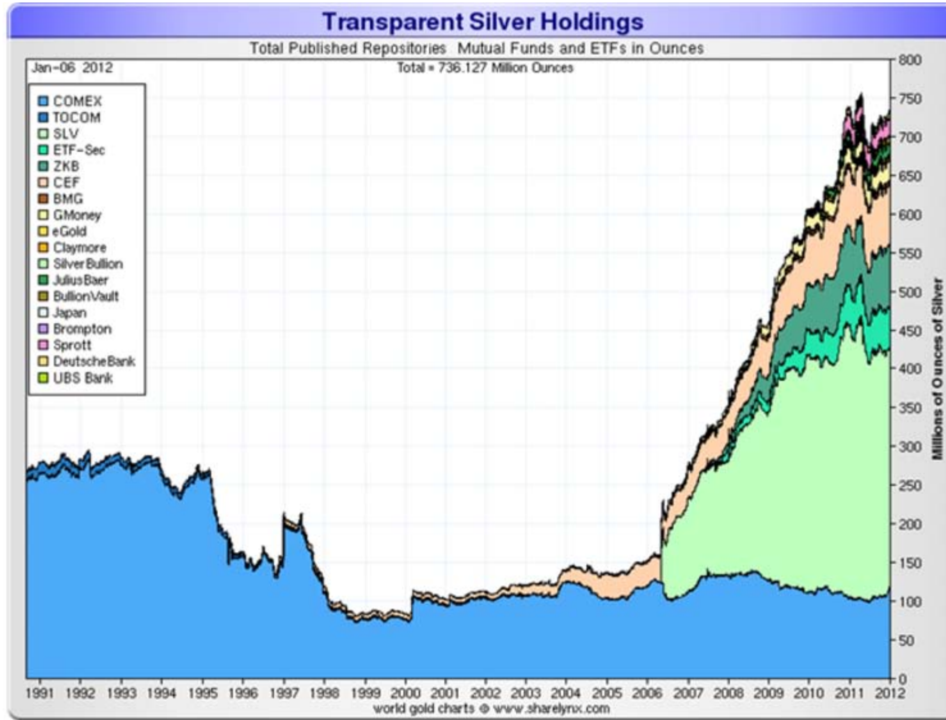
The margin hikes for silver are even more dramatic. As silver was heading towards almost $50 per ounce in the spring, a series of five margin hikes over a very short period reduced speculators' influence on the market, and prices fell. Margin hikes continued even as the price of silver was collapsing rapidly. Critics of the silver market action questioned if the CME was deliberately trying to drive the price of silver lower, but the CME again hiked margins in the fall, adding to the downward pressure. Over the course of 2011, margins for one silver contract were raised from $5,000 to $25,000, a fivefold increase.

As noted above, this was around the time that markets were shaky because of lack of confidence in MF Global, and there were rumors about whether the exchange had enough metal in its warehouses to deliver it to futures market participants (such as Sprott) who actually intended to take delivery of physical metals rather than roll over or close their contracts. While not as extreme as the circumstances that drove silver to $50 in the 1970s when the Hunt brothers were active in the market, in 2011 forces other than standard supply and demand or long-term economic conditions were important factors in the price action of silver.

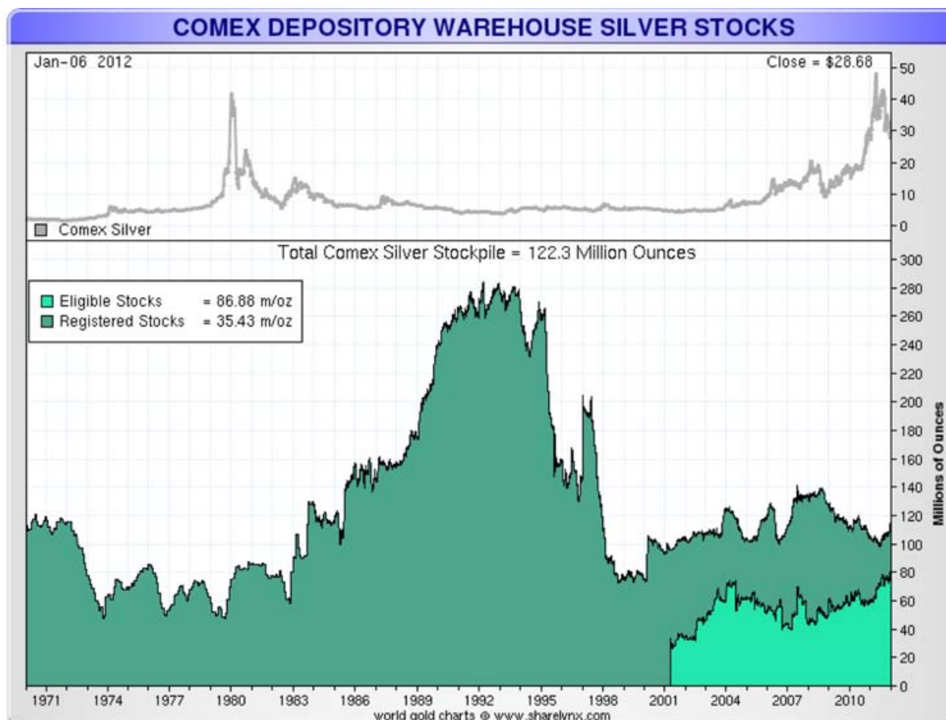
To complete the picture and help us understand precious metals in a historical context, the following three charts show changes in the storage of investment gold and silver over the longer-term history of these markets. The first shows gold holdings and the dramatic growth of the holdings held by ETF funds since 2004. Today the biggest gold ETF, GLD, shown in a pale green, holds almost as much gold as all the other warehouses combined. The holdings of the COMEX exchange (now part of the CME Group), which formerly accounted for the vast majority of storage, is now but a fraction of the total.



Silver shows the same accelerating warehouse holdings by various ETFs.



A longer-term history of the warehouse holdings of the CME Group shows a decline from a peak in 1992 of almost 300 million ounces of silver to approximately 120 million ounces today. When we compare this to the open interest of 500 million ounces – 100,000 contracts of 5,000 silver ounces each – we see that if too many market participants wanted to take delivery of the silver, the exchange would have difficulty delivering. This discrepancy is much debated, but almost never does it become a problem because the actual deliveries are typically only a very small percentage of the total contracts traded before final delivery day. In fall 2011, however, there was an active campaign advocating taking delivery of the physical metal.



These pictures are intended to help put the precariousness of the futures market in perspective, as that market is one of the most important factors in determining the price of any given commodity, including the precious metals.

As mentioned, high leverage is a key feature of futures markets. That leverage, however, exposes the market to inherent risk that the amounts of physical metal being held in warehouse stocks don't line up with the metals controlled by the outstanding futures contracts. This is why the derivatives (futures) markets are called paper markets, as contrasted with the physical markets for bullion and coins. Historically, gold and silver have been the real money, and their supply does not grow dramatically, particularly in the warehouses of the exchanges where the most active trading and price discovery traditionally occurs.

In my opinion, the long-standing operations of the futures markets may be about to change. To understand why, and the implications of such changes, we need to peel back the layers on the very serious collapse of MF Global, the biggest of the futures clearing houses.

MF Global Hurt the Futures Market Price Discovery

By now, you are almost certainly already familiar with the basics of the MF Global shock, where customers had their supposedly protected segregated accounts pulled away from them. Or how accounts were transferred out of MF Global to other brokerages, but only after the cash was first stripped from them. Without money in the account, margin calls were issued to customers not because they had made bad trades, but rather simply because they held positions and the firm that had inherited their account from MF Global needed to cover margin. Thus the clients were forced to either close their positions prematurely or wire more money to a new brokerage firm they didn't know.

With their positions closer to the buzz, the big traders recognized early that something was up and so had largely moved out of harm's way before MF Global actually blew up, leaving mostly smaller traders holding the bag with still undetermined losses. Regardless, the resulting chaos hurt the confidence of the entire community of futures traders, with many going on the record that they would never trade futures again.

The structure of the futures market is such that there are only a handful of large clearing members, of which MF Global was the largest, as well as a large number of small introducing brokers that deal with the public. Before the MF Global fiasco, it was commonly understood that futures traders had never lost a dime due to irregularities or bankruptcies involving a futures broker.

It was the role of the exchange to ensure that all trades and underlying practices within brokerages were structured so the money held by traders in segregated accounts would be safe. That myth is now shattered. So far, there has been no satisfactory explanation as to how MF Global managed to misplace $1.2 billion in client money, with both the firm's former CEO John Corzine and the bankruptcy trustee saying they can't find it and don't know where it went.

All brokers that trade on futures markets are required to pass the Series 7 exams, but former Governor of New Jersey Corzine was out of the financial industry for 12 years prior to taking over at MF Global and had not taken the required exams. Instead, he was given a waiver by FINRA. This is important because the big trades that went wrong were put together by Corzine. For evidence that those trades were poorly conceived, look no further than the speed with which the losses destroyed the company. The collapse was so rapid that Corzine didn't even have time to fire-sell the company before running out of money and being barred from any further trading activities. That triggered the need to seek the protection of bankruptcy. Five days later, Corzine resigned.

For the record, the Commodities Futures Trading Commission (CFTC), which was charged with regulating MF Global, is headed by Gary Gensler, an employee at Goldman Sachs during Corzine's tenure there as CEO. And another oddity in the regulatory environment surrounding MF Global: the firm became a Primary Dealer in early 2011 – meaning it was among just a handful of firms authorized to buy and sell US Treasuries at auction and act as counterparty to the Fed's Open Market operations. Yet, unlike other Primary Dealers, MF Global alone was not regulated by the Fed. I guess it never hurts to have friends in high places, but to even a casual observer this all looks far too friendly.

There's more.

The trade that destroyed MF Global was that $6 billion in European debt would be a safe investment, but instead it collapsed in value. While I have not been able to confirm the hard data, a number of people in the industry believe the company had leveraged this bad bet by a factor of *35 times*.

JPMorgan made off with $600 million of MF Global cash after bankruptcy had been declared, another breach in normal protocol. Whether it should have gone to customers is now the subject of a lawsuit.

Raising more than a few eyebrows is that the government supported JPMorgan's rationale for running off with the cash when the bankruptcy judge and the Fed helpfully defined MF Global as a "securities brokerage firm" rather than a "commodities/futures brokerage" firm. This is important because in a bankruptcy of a securities brokerage, the creditors (JPMorgan) move to the front of the line ahead of the customers. In a commodities/futures brokerage bankruptcy proceeding, however, customers would go to the front of the line. MF Global had 50,000 futures accounts but less than 400 security accounts. In my opinion, this machination is yet another example of how corrupt the crony politics in the US has become.

This begs the question, just what is JPMorgan, and from where does its obvious influence with the government stem? Well, for starters, they are the world's biggest holder of derivatives – including, according to the Office of the Comptroller, $119 billion in gold derivatives and $19 billion in "other" precious metals derivatives. That also makes the firm the world's largest holder of precious metals and gold derivatives. Dealing in derivatives requires added risk, as seen in JPMorgan's total credit exposure to risk-based capital, which at 300% is considerably higher than the 200% of most big banks.

The bank has had a long association with precious metals. In fact, in the 1990s it was the leader in creating hedge agreements with mines that wanted to forward sell their metal, helping to depress prices. They are known for being short large amounts of precious metals, despite the steady rise in gold and silver prices over the last decade, giving rise to allegations of conspiracy in trying to keep the metals prices tamped down. Coincidentally, this also helps prop up the fiat currency competition.

In March of 2011, JPMorgan became a depository for the CME, authorizing them to hold gold, platinum and palladium for delivery against precious metals contracts traded on the COMEX and NYMEX. The latest report shows them as holding 2.9 million ounces of gold or 26% of the COMEX warehouse deposits of gold. They also hold 3.3 million ounces of silver, or 10% of the COMEX inventory. Along with HSBC, JPMorgan provides holding facilities for the massive quantities of gold of the GLD ETF.

In my opinion, the scale and complexity of the relationships and arrangements that include JPMorgan give rise to the potential for any number of conflicts of interest, double counting or outright fraud.

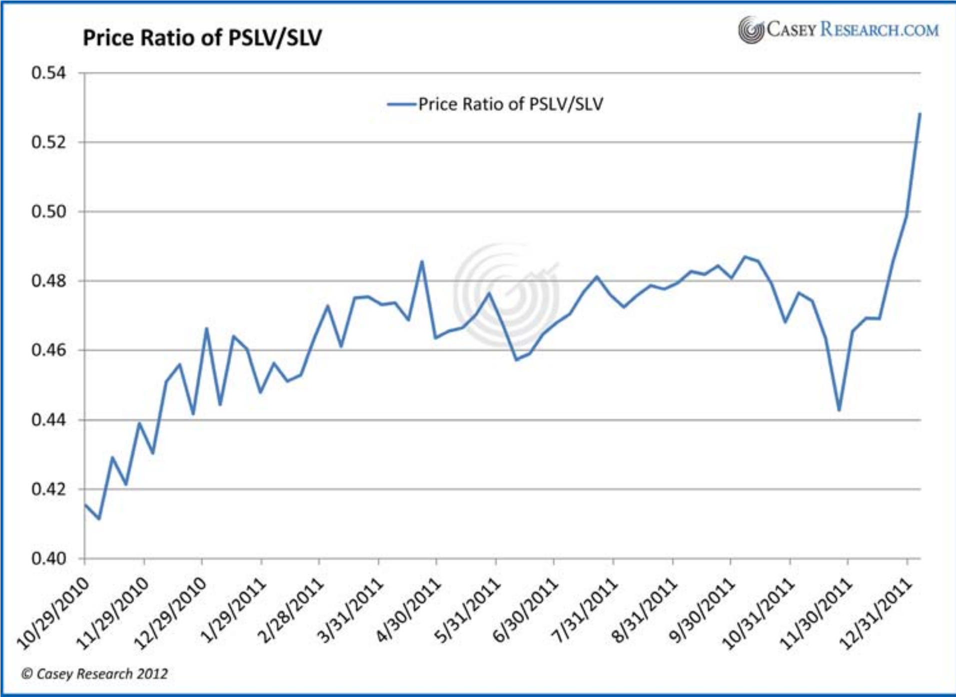
It certainly provides fodder for those who see conspiratorial aspects of the government's actions that serve to depress the futures market activity that had, before MF Global's collapse, been so supportive of higher precious metals prices. Sticking with the observable facts, we know JPMorgan got its money out of MF Global, maybe even driving it to ruin. We also know that JPMorgan was a client of the bankruptcy trustee's law firm as recently as 2010. And we know that CFTC Chairman Gary Gensler failed to properly audit MF Global and failed again by not closing and transferring customer accounts before bankruptcy. It's all too cozy for my taste, and for others who trade futures and who are similarly outraged at the situation.

Meanwhile, thousands of farmers, ranchers and independent traders don't have access to money they believed was securely housed in segregated accounts. This is unacceptable and should never have been allowed. That the exchange hasn't stood behind the clients who were burned has done serious damage to the ongoing viability of the conduit of futures markets. Similarly, the government has not stepped in to maintain the functioning of the futures market, in stark contrast to the famous bazooka of $600 billion that Hank Paulson provided the too-big-to-fail banks, which are now handing out big bonuses to their management teams.

The Market Will Change Going Forward

Going forward, I believe that the determination of silver prices will increasingly be derived from transactions in the physical market and decreasingly from the futures market, now that the latter has been shown unworthy of trust.

Confirmation that two distinct markets may be emerging can be seen in the comparison of the Sprott Physical Silver Trust (PSLV), which holds only the physical metal, to the Silver ETF (SLV) which has greater flexibility in the nature of its holdings. The following chart is a ratio of the two. It gives an indication of the premium people are willing to pay for physical silver over the paper silver of the ETF:



As you can see, PSLV has moved from .410 to .528, representing a premium of 29% over the less tangible SLV, a clear indication of investor preference.

This reflects, I believe, that gold and silver markets are being driven not only by concern over government's out-of-control spending, but also by investors looking for safety for some of their savings. While they still want the sound money of gold and silver, they have become increasingly attuned to the insecurity of the futures market exposed by MF Global and the capricious issuance of margin changes. This is not an easy environment in which to predict precious metals prices, as the market is being manipulated. Yet, trying to make reasonable forecasts about the direction of key markets is essential to setting investment strategy, so we must soldier on.

Stepping back from the trenches, the macro-view remains that extreme government printing in Europe, Japan, China and the US signal continued debasement of the fiat currencies that compete with gold as money. Of course, the world's governments are not without certain resources in defending their interests – and avoiding a wholesale collapse of the global fiat monetary system is clearly in their best interest. Making forecasts about what actions the world's largest governments, especially the US, might take in trying to stave off a further crisis in confidence, is nigh impossible. Again, that uncertainty makes it even more challenging to forecast where the metals will trade a year from now.

All we can really do, therefore, is to look to the fundamentals – and those fundamentals are that the deficits being run by world governments continue apace, and that alone is very supportive of higher precious metals prices. So after this current correction, I expect the trend for higher prices to continue. Stated another way, we haven't seen the peak in precious metals.

Absent an overhaul of futures markets that repairs investor confidence, demand for physical assets (coins and bars) is likely to stay high and move ahead of the futures (paper gold) markets in the first half of the year. I suspect that regulators will work to reconstruct the necessary safeguards to return confidence to the futures market, but that it will take at least a year, knowing how complex the situation really is.

One consequence of mistrusting the futures market is an expanding demand for the physical metals that should give coins and bullion a lift. Supporting that contention, the coin prices are not falling in sync with the prices quoted on futures markets. In fact, as with the Sprott fund, premiums are increasing. We will also keep an eye on the outflow of the big metals ETFs, because as unallocated accounts, they are subject to increased concerns over safety.

In comparing silver and gold, silver's steeper open interest declines along with concerns over slowing industrial demand make it more vulnerable. Even so, its correction has been far more severe than that of gold, and so it is likely to continue as the more volatile of the two – popping even more sharply to the upside upon a return of more positive investor sentiment. Holding a mix of both metals continues to make sense to us.

We also believe that the stars are aligning favorably for a period of outperformance by the mining shares as their price has been lagging bullion more than usual over the last year, resulting in the possibility for strong appreciation as the precious metals markets regain their upward momentum.

Moving along, I will review how last year's forecasts worked out and update my forecasts for 2012, but first I want to take just a moment to name my candidate for the financial event most likely to produce a negative "surprise" in 2012. I put the word surprise in quotes because it should come as a surprise to no one – but will surprise most – that the endgame for Japan's fiscal crisis is approaching.

2012: The Year of Japan's Reckoning

Japan has the worst government deficit of the developed world. It has survived due to a variety of factors, including its export surplus, investment diversification in successful foreign operations, and a tradition of personal savings that has provided funds internally in support of massive government spending.

I believe in 2012 we are going to see a sea change in the situation. In no particular order:

- The trade surplus is almost gone.
- The cost of rebuilding after the March 11, 2011 tsunami has further increased demands for government spending.
- The country's reliance on imported oil, which has gone up in order to offset the loss of nuclear power in electric generation, along with stubbornly high oil prices further damages the trade surplus and will contribute to higher deficits.
- Meanwhile, as the population continues to age and people are forced to spend more and save less in order to support themselves, the Japanese government will increasingly turn to foreigners for future borrowings. That's likely to drive interest rates higher, and once that starts, the feedback of the cost of higher rates on what is already the world's largest debt as a percentage of GDP will create even bigger deficits.

While there is more to the story than that, my contention is that though the crisis in the Eurozone dominated the news in 2011, I think Japan's problems are just as serious and have the potential to make that troubled country the new headline story. With the problems identified in my prior articles on China and Europe, I conclude that the dollar is likely to rise in comparison, even if not in relation to the true money (gold).

Last Year's Predictions

The following table compares my predictions for 2011 against actual year-end results. There were a number of wins not reflected in the hard numbers, including both my on-the-record expectation that the economy would remain sluggish despite the big deficit spending and my prediction that the Fed would undertake additional quantitative easing during the course of the year. The call to be in precious metals and energy as opposed to broad stocks was also on target.

	Dec-2010	Change	Dec-2011 projected	Dec 2011 actual		Green Right. Red Wrong. Gold Half Right.
Foundation Forces						
GDP Q3 (Real 2005 $B)	$13,139	2%	$13,402	$13,332		Q3/Q3 comparison
Budget Deficit (B)	$1,293	0	$1,293	$1,299		
Current Account Ann (B)	$436	15%	$500	$592		3 quarters of 2011 annualized
Unemployment %	9.4%	0%	9.4%	8.6%		
CPI	1.4%	2.6%	4%	3.4%		
Investment Predictions						
Gold	$1,421	25%	$1,800	$1,574		Hit $1,900 before drop
Silver	$30.60	30%	$40	$28		Hit $50 before drop
10-Year Treasury	3.30%	1.5%	4.80%	1.90%		
Fed Funds	0.12%	0%	0.12%	0.12%		
Energy Crude $/bbl	$92	15%	$105	$101		
Nat Gas $/M btu	$4.24	18%	$5.00	$2.98		
Commodity Prices (CCI)	630	15%	725	563		Did rise to 691
Stock Market (S&P 500)	1,258	10%	1,375	1,257		Rose +10%. Changed to -10%
Dollar Index	73	0%	73	80		
Euro	1.33	−5%	1.26	1.29		Euro crisis predicted
Japan Gov Bond	1.2%	0.8%	2.0%	1.0%		
Housing Price (Case Schiller 10)	157	−5%	150	154		

10 right	59%
5 wrong	29%
2 half right	12%
11 right	65%

While gold and silver exceeded my projections during the year, they fell back by the end of the year, so I'm only taking half credit for them. I was wrong on interest rates rising, even though the official government numbers for CPI rose noticeably. Crude was up but only modestly. I take credit for being right on stocks as the flat performance for the year was consistent with my view that the stock market in 2011 was not likely to experience either a boom or crash. I was wrong on natural gas, the CCI commodity index and the dollar. I expected the euro to weaken, which it did toward the end of the year. My target last year for the euro has now pretty much been met two weeks after the end of the year. As the euro fell, the dollar rose, squeezing commodity prices.

I summarize my predictions as 65% correct, not my best ever, but still more right than wrong. Considering the special challenges of today's tumultuous economic and investment environment, not too bad. Let's see if we can do better for 2012.

2012 Look Ahead

As you will see in my updated forecasts for 2012, I am forecasting neither an extreme crash nor a powerful economic rebound, as the major economies of the world will remain constrained by too much debt. Likewise, a lack of robust recovery will serve to keep the monetary inflation of central banks neutralized, and so I don't see 2012 as the year we'll experience extreme price jumps across the board. That said, the continued high levels of deficit spending and debasement of fiat currency units will provide support for alternatives such as gold and silver, so I expect them to do just fine.

Bud Conrad's Estimates for 2012				
	Dec 2011 actual	% change	Dec-2012 projected	Comment
Foundation Forces				
GDP Q3 (Real 2005 $B)	$13,332	-1%	$13,199	Mild Recession in 2012
Budget Deficit (B)	$1,299	0%	$1,299	Continuing; no fix in sight
Current Account Ann (B)	$592	0%	$592	Same; oil dominates, and Asian prices might rise
Unemployment %	8.6%	0%	9%	Same, or rise in recession
CPI	3.4%	10%	3.7%	Eventually higher with currency printing
Investment Predictions				
Gold	$1,574	25%	$1,968	$2,000 seems low but 25% is big jump
Silver	$28	25%	$35	MF Global, slowing world economy
10-Year Treasury	1.90%	40%	2.7%	I think this should be 4%
Fed Funds	0.12%	50%	0.18%	Fed has promised ZIRP, and world goes along
Energy Crude $/bbl	$101	20%	$121	If full war w/ Iran, $200
Nat Gas $/M btu	$2.98	35%	$4.02	Big supply drove price down
Commodity Prices (CCI)	563	0%	563	Europe slows Asian demand
Stock Market (S&P 500)	1,257	0%	1,257	Unexciting from weak recession
Dollar Index	80	12%	90	Dollar isn't strong, other currencies weaker
Euro	1.29	-15%	$1.10	Euro crisis continues
Japanese Yen	78	15%	90	Japan's huge government debt and borrowing
Japan Gov Bond	1.0%	70%	1.7%	This is still low
Housing Price (Case Schiller 10)	154	0%	154	Housing looks flat with low rates

Signing off, I would like to add the caveat that the world's most powerful governments haven't yet run out of ammunition as they fight to retain the status quo despite unprecedented challenges, and so I don't believe 2012 will be the year that the whole house of cards comes tumbling down, despite the world remaining on very thin ice. Even so, the risk of a panic has rarely been more heightened, which argues for us as investors to remain cautious with our personal finances and in how we structure our portfolios.

When the rock and the hard place ultimately meet – and they will – there will be a ton of opportunities to play catch-up for your portfolio. For now, however, caution remains the watchword.

Back to Table of Contents

Life in the Twilight Zone

An interview with Doug Casey

One of the more enjoyable side benefits of being a part of Casey Research has always been the regular conversations with Doug Casey, my business partner and friend of several decades now. Usually those conversations have less to do with business and more with the big philosophical questions of life as we know it.

Even so, as this is the first edition of The Casey Report for 2012, I decided to call Doug to get his outlook for the new year on record. Following is a lightly edited transcript of our call.

David Galland

DG: Doug, with the benefit of hindsight, what were the things in 2011 that surprised you the most?

DC: Actually, nothing surprises me because as somebody with solipsist tendencies, I tend to think it's all just a creation of either my own imagination or, perhaps more accurately, the common imagination of all the people out here, so anything's possible. Even so, it wasn't as wild and crazy as things might have been. I'll reserve that for this year, which I think is going to get much more interesting.

What about you? As you think back, was there anything that happened in 2011 that was really noteworthy?

DG: It seemed like there was a lot of consolidation, though 2011 was certainly when the wheels started coming off in Europe. So I guess Europe was the big story of the year. And that helped the dollar rally, like we said it would back in May. If it hadn't, it would have been headed straight into the trash bin, so I guess you could say that Europe's problems were a positive for the US as it took some pressure off the Treasury auctions as everyone scrambled for safety.

Speaking of the strength of the dollar, if you look at the chart for the last couple of years, it seems like the dollar might be getting a bit toppy here. Something to keep an eye on. But back to the question, in hindsight 2011 turned out to be sort of a non-event with the US stock market ending the year flat and gold higher but not dramatically so.

DC: Yep, no markets boomed, and no markets really busted that I can think of. Unfortunately, I think the Mayans are going to be right and all kinds of bad things are likely to happen in 2012, as they predicted they would. Unfortunate, because a lot of people are going to look at it from a mystical point of view as opposed to mere coincidence. Regardless, it seems to me that it's absolutely inescapable that almost everything that can go wrong will go wrong in 2012. And there are a lot of things that can go wrong at this point.

DG: It's funny, but just today a friend wrote me and said they were getting burned out on all the crisis stuff. That they didn't want to hear about the crisis anymore.

DC: They must have been channeling my own thoughts.

DG: Well, the case could be made that the numbers look better – that there are definitely signs of a recovery. Weak signs, sure, but signs nonetheless. Yet the big fundamental issues underlying the crisis – the debt and the deficits for starters – haven't been dealt with.

DC: I guess the question is, what can they deal with? What can they do? As I've said, everything that the government is doing is not just the wrong thing but the opposite of the right thing, and so they're not cutting the deficit. In fact, the deficit is likely to expand this year, and that means even more government debt, and there's already plenty of that. And at the same time they're increasing debt, they're not decreasing regulation, they're actually increasing regulation pretty much across the board.

Regardless, with the Federal Reserve now the main buyer of US government debt, the result is inevitably going to be much higher levels of inflation, so I don't actually see the argument for a so-called recovery. Especially since interest rates are as low as they can possibly go, which induces everybody who can possibly borrow to borrow and discourages people from saving, which is the only ultimate answer to the problem.

The stock markets are at artificially high levels, and the bond market is in bubble-type territory. When the bond market rolls over, that's going to take the insurance companies and pension funds down, which people are not thinking about. And it's going to be the final nail in the coffin of the real estate bear market, which is not over yet by any means. So I don't see these arguments for a so-called recovery of the economy.

DG: While there are some small signs of a recovery, and people don't want to think in terms of the long crisis getting longer, the foundation of the entire financial system seems broken at this point. Even so, while it's beyond a cliché at this point, it's also true that the market can stay irrational longer than you can stay solvent.

For example, if you look just at the debt and the deficits, there is no way in hell you can rationalize that US interest rates would be at historic lows – no way – and yet they've been stuck there. And because they've been stuck at such low levels, people naturally think they are going to remain there forever. And they might argue the point by pointing to the persistently low rates in Japan that have stayed down for a couple of decades, despite the country's ridiculous amount of debt. So, why can't that happen here?

DC: Well, I guess if it has happened in Japan, it could conceptually happen here. But the problem with that argument is that what's going on here isn't unique to the United States. Japan's in gigantic trouble, China's in gigantic trouble, and so is Europe, so this is a worldwide phenomenon. That makes it an entirely different and more dangerous breed of beast.

DG: If there's any comfort in this, it might be that now that people are donning the rose-colored glasses and seeing recovery, it actually maintains our credentials as contrarians. And as Rick Rule likes to say, these days you're either a contrarian or a victim.

Looking at how overvalued the stock and bond markets are should be signaling people to look for the exits, not to buy more. Bonds in particular are clearly in a huge bubble and will get slaughtered when interest rates rise, as they inevitably will. Worse, the vultures will come home to roost as the cost of servicing all the debt begins to steadily tick up, and that can only be devastating to the economy. Yet people want to believe in the recovery, so I guess what I'm saying is that the contrarian view here is that you might want to fasten your seatbelts because the crisis has really not even begun yet.

DC: Well, that's my view, that's what I think is the correct view on these things, absolutely.

DG: Even so, governments do have a tremendous amount of power, and they can do all sorts of incredible things that would otherwise be illegal if a private enterprise did them. They can do whatever they want at this point, so the hard part, of course, is judging what actions they might take next and at what point those actions are likely to stop being effective in keeping the house of cards from toppling.

DC: No question, they have a monopoly on the use of force to get their way, that's the nature of government as an entity. Besides, the average chimpanzee out there believes in them and thinks that the government possesses some type of a magic cornucopia that can solve these problems. So yes, I guess things can continue on as they have a while longer, but I don't let that bother me. In my personal life, I do what I think everybody in the economy should do, which is to say produce more than they consume and save the difference.

As long as you do that, you'll be fine because you won't have to go into the market and engage in wild speculations trying to second guess what's going to go on. Personally, I'm just looking for things that are very likely to happen and try to take advantage in ways that don't entail taking more risk than I can handle. So, as I get surplus capital, I'm happy to buy gold and silver.

Even though they're not cheap anymore, I can make a very good case as to why they're going higher. But even if I'm wrong, I can at least be sure that they're not going to be defaulted on if we have a deflation, or dry up and blow away if we have the raging inflation I expect.

So that's good, and I'm trying to position myself in speculations that I think will become bubbles, like well-selected mining stocks and the cattle market, which I think is going to remain an excellent place to be for long-term capital. If I could see a dozen other different things, I'd mention them right now, but I actually don't think that there are at this point.

DG: What would change your mind about gold? What would you make you think twice about owning gold?

DC: I think if it really became widely popular. I'm not talking about people in the media making snarky observations about it when only a few years ago they didn't even know it existed. I'm talking about indications that the broad public was actually getting involved in gold, and there is no indication of that whatsoever.

But even if you were to conclude that gold is too expensive just now, you are still left with the problem of finding someplace else to put your money. Are you going to leave it in dollars, which are a ticking bomb and a hot potato? You can't put it into real estate at this point because that's going nowhere and will only get hurt further once interest rates start to rise. Besides, it's very hard to get positive cash flow from any piece of real estate these days. You can't own bonds, you can't own stocks, you can't own cash flows, so what do you do with your money?

DG: Obviously, by the time that everyone is talking about gold, prices will be a lot higher. But what's the driver between where we are today and the day when gold becomes all the rage? A lot of readers are watching the gold market, as they should because they've got a big vested interest in it, so this is an important discussion.

I guess we could look at it from the flip side, pointing out that until we see real positive interest rates, the gold bull market should remain intact. As it seems unlikely that interest rates can really go up by any amount without the Fed fighting it tooth and nail by showing up at the Treasury auctions with helicopters stuffed with freshly minted currency units, I guess there is a backstop of sorts on gold.

DC: That's right, and once the trillions of dollars that have been created and are just sitting there in the banks start coming out and are being re-lent, inflation is going to take off. In my view, before this is over, interest rates are going to have to go up to at least the levels they were in the early '80s before they'll have the effect that you're talking about on gold. So I'm not worried about that at all.

So I'm really not concerned about owning gold. Or, for that matter, not even so much about the economic stuff. I think the really important stuff in 2012 is going to be political and military in nature. The odds of starting a war with Iran, which the government has been threatening to do for decades now, seem to me to have been going up pretty rapidly recently. That would have serious consequences, but even if that doesn't happen, it's clear to me that all over the world, not just in the US, all these governments are turning into police states.

DG: While I try to be optimistic about such things, it's getting hard not to agree with that assessment. Yet, the idea that the world is trending toward totalitarianism is a sort of big-picture bogeyman that most people just can't get their heads around. It's so far outside of their experience in this day and age that I think most people would probably discount that notion.

DC: The thing is, once a government agency or bureaucracy is created, its mandate is to survive and grow, and that's what they do. The TSA is a perfect example of that phenomenon. All the new financial reporting rules that serve to make foreign banks and brokers reluctant to do business with Americans are perfect examples of that.

DG: Which are really just sort of de facto exchange controls, yes?

DC: Oh, yes, there's no question, and it's happening all over the world. But for the average person in most Western countries whose lifetime has been fairly pleasant, all these developments are viewed as just another little blip on the screen. But it's not, it's a major and accelerating change of trend.

DG: Who would have thought we would ever see the sort of legislation included in the new defense authorization bill that formalizes the government's policy of imprisoning people without a trial. While there was a lot of debate about whether it applies to citizens or not, that seems to me to be almost a moot point. The fact that they would keep anybody without trial and allow renditions to continue is well past the point of being worrisome. But the situation is becoming endemic. One of the things that really caught my eye recently was a video of a TSA checkpoint set up in Savannah, Georgia to screen people as they got off a train.

DC: Yes, I don't think I ever saw that, actually.

DG: It's mindboggling – they're doing the whole TSA screening thing, making people empty their pockets and patting down kids and all that. You have to wonder what would happen if you got off a train in Savannah, Georgia and they tried to put you through a screen and you refused? What are they going to do, stick you back on the train? How does this sort of thing differ from the whole "Your papers, please" thing?

DC: There is no difference, and there's going to be more of it. And something like attacking Iran could quickly cause things to get out of control, as at that point they're capable of locking the country down like a gigantic prison. Eventually it's absolutely guaranteed to happen, and it's going to be very unpleasant. But relatively few people are giving this trend more than a passing thought. Instead, everybody is thinking about the markets right now.

On that topic, it's worth noting that market bottoms come around only when nobody is thinking about the markets and nobody even cares about the markets, and we're a long way from that today. I'm trying to get myself into the psychological mindset of not thinking about the markets because they're not worth thinking about right now because there are absolutely no bargains anywhere.

That's a genuine fact – there are no bargains anywhere today. The likelihood is that when the public psychology changes because of these geopolitical things and they've got something serious to worry about, people will forget about the markets and there's going to be a selloff of all kinds of things.

Combined with the world becoming less productive because of all these things, a lot more people are going to be forced to live off their capital as opposed to creating more. I know this isn't very helpful for people who are still thinking, "Oh, I want to make money. I want to double my net worth," and who are looking for good ideas. My answer to that is, forget about doubling your net worth. If you can just keep what you have or, maybe by the time this is over, keep even half of what you have, you're going to be way ahead of all your friends and neighbors.

DG: Talking about valuations, after the big selloff in 2008, some stocks got relatively cheap, but did they ever actually get cheap in terms of sort of classical metrics?

DC: The Dow Jones historically has been cheap when it's yielded 6%. At the bottom of the last depression, it actually yielded 12% and lots of major stock markets in the world, when they collapsed, yielded a lot more than that. The worst situation I'm personally aware of was the South African gold stocks in 1976 when the average dividend yield was probably about 35%, with some of them yielding 60% and 70% in current dividends even after dividends had been cut. So that's how bad it can get.

Using more recent examples, in 1974 the average dividend yield of the stocks that make up the Value Line index, which includes stocks that don't usually even pay dividends, was 7.8%. And as late as the mid '80s, you had three major stock markets – Spain, Belgium and Hong Kong – that were yielding 12-15% in current dividends. And their dividends went up from there.

DG: For the record, the dividends for the S&P 500 are currently running something like 2.8%, a level you'd expect to see in an overvalued market.

DC: Historically, that's no bargain. It looks expensive relative to interest rates, but interest rates are as low as they can possibly go, at least if you assume the bottom is 0. That's why I have been saying that nothing is cheap today. I'd like somebody someplace to show me a bargain. Even if they showed me a business that's a bargain, I'd be concerned that as the general standard of living goes down, there's going to be a lot more unemployment. That means there will be a lot less consumption, and that's going to hurt the earnings of businesses, or at least those businesses that aren't manufacturing stuff for the US government.

DG: Speaking of government, I think people thought that when deficits went over a trillion dollars that they would remain at that level only temporarily, as part of fixing the economic problems. In your Casey Report article last month, you showed that the government's obligations have reached the point now where it's almost impossible for it to claw back to anything close to a balanced budget.

DC: It's literally impossible.

DG: And so, as hard as it is for most people to believe, the new reality may be that the deficits are only going to get worse from here. I think people need to get their head around that point, and especially the implications for interest rates, the value of the currency and the future of the economy.

DC: Yes, exactly. If somebody can show me a way out, I'd like to see it. Not that there's any possibility of Ron Paul being elected, but even if he were elected, there's absolutely nothing even he could do to turn things around.

DG: Which returns us to why gold remains one of the few asset classes that investors can take some comfort in just now.

DC: I can't repeat this often enough: gold is the only financial asset that is not simultaneously somebody else's liability, and you simply can't trust anything out there today.

DG: More than ever, because of course the government can change the rules at any time. Then there are the problems with the futures markets and the derivatives and all the other complexities surrounding counterparty risk.

DC: Exactly. The answer is to make maintaining your capital your highest priority. And I can't think of any other place besides gold that better serves that purpose. Bonds are out, stocks are out, currency is out, real estate is out. They are going to be taxing the hell out of real estate because that's where the obvious wealth is, so what are your alternatives?

DG: Well, given that things in Europe seem like they are going to come to a head in 2012, and Japan and China are both looking problematic, maybe the dollar won't be such a bad place to be? As Marin Katusa likes to say, "Like all the currencies, the dollar may be toilet paper, but at least it's 2-ply toilet paper."

DC: I think gold is a better answer than the dollar, quite frankly.

DG: Sure, but it's a different answer, and most people wouldn't want to move 100% of their portfolio into gold. Besides, with inflation still relatively moderate, cash is not a bad place to park some funds at this point. Would you agree with that?

DC: Yes, but just for the in-between time. You've got to treat it as a hot potato that could burn your hands at any minute.

DG: Good point. Any other quick thoughts before we sign off?

DC: No, just that I think that the big risk this year is going to be political, both domestically in the United States and internationally. I mean, that's the real big risk, and it's going to be reflected in the markets, which is one reason why the markets are likely going to be much more dangerous than they've even been in the recent past.

DG: Given the political connection to the risks you see, I suspect you continue believing investors should look to diversify their assets among different countries. If nothing else, by doing so, at least you lower your risk of getting stuck in the single country that's gone sideways.

DC: Exactly, though there really are no good places to put your assets today because all these countries are going the wrong way, but you're forced to do it. That's the whole problem, we're in the twilight zone.

DG: Good title, I think I'll use it.

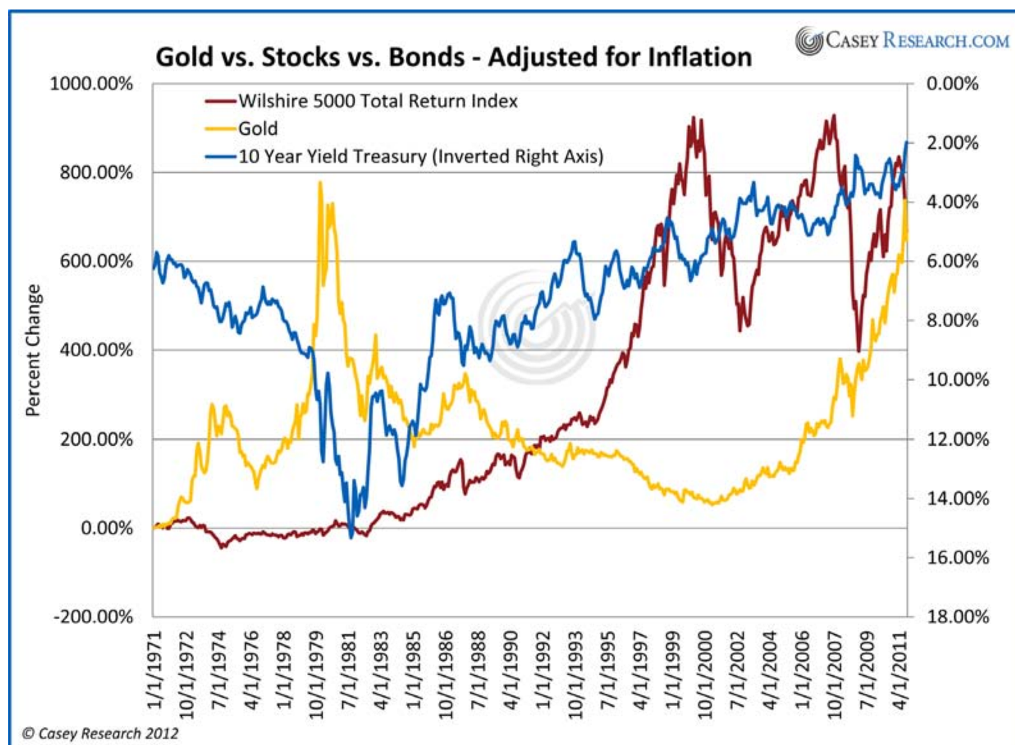
Back to Table of Contents

How to Invest

Our monthly look at ideas to keep your portfolio aligned with the bigger trends.

Benjamin Graham, author of *The Intelligent Investor* and *Security Analysis* as well as mentor of Warren Buffett (among other uber-successful investors), is correctly respected as one of history's most knowledgeable investors. Over a career spanning 1915 to 1956, he refined his investment theories, in time becoming known as the father of value investing.

According to Graham, while no one can tell the future, there are periods when the valuations of stocks and bonds would deviate from fair value by becoming excessively over- or undervalued. To take advantage or reduce risk, investors would alter their portfolio allocations accordingly. A quick look at a long-term chart supports Graham's theory:



The chart above illustrates the relative performance of stocks, bonds and gold since 1971. Stocks and gold are adjusted for inflation, and bonds are represented on the right axis by the inverse of their yields. Clearly, in 1980 gold had become relatively overvalued and stocks extremely undervalued in 1981. Bonds lagged stocks as the economy began to improve in the mid-1980s, but as that improvement accelerated, it was clear that bonds, too, were undervalued, setting up an equally long bull run.

Gold, while included in our analysis, is conspicuously absent from Graham's stocks or bonds asset allocation model. We can hardly blame him; ownership of more than a small amount of gold was outlawed for most of Graham's adult life and career. Banned for private ownership by FDR in 1933, it wasn't re-legalized until late 1974. Graham passed away in 1976, so there is a clear gap in his experience during periods in which gold was unmistakably a better investment than either stocks or bonds.

In those periods, particularly 1976-1981 and 2001-today, the record is unequivocal that gold was the place to be. Of course, there are also periods where gold is an awful investment; if you had bought gold anytime in the early '80s, you would've been waiting over two decades for a positive return.

All of which makes us wonder: if Graham had lived to witness the two great bull markets in precious metals during the last 30 years, would he have updated his allocation models to include gold?

We can never know.

We can know, however, that given Graham's outsized influence on investment theory, there is little question that his lack of experience with gold, and therefore its absence from his observations, has had a profound effect on the way that most investment professionals view the yellow metal. This, in our opinion, goes a long way toward explaining the persistently low esteem in which gold is held by the mainstream investment community. And, as a consequence, its widespread failure to even consider it as an asset class.

A couple of takeaways. First, perhaps now you can stop wondering why your broker and the talking heads on the financial media continue to misunderstand gold as a portfolio holding. More importantly, however, is that it is important to long-term investment success to accept that intelligent portfolio allocation needs to include the three broad categories of investment – stocks, bonds *and* gold (plus cash), with the amounts allocated to each guided by relative valuation.

With that thought in mind, glance back up at the chart and note that today – right now – is an almost unprecedented period when all three asset categories are expensive at once.

All of which brings us to the purpose of this regular monthly feature, namely to identify suitable investments given the big trends we see as being in motion. Elsewhere in this edition, Bud Conrad discusses these trends – trends that make us want to hold almost no bonds and few stocks. This leaves us with a higher-than-usual allocation to cash and, because of the external factors related to a growing loss in confidence in global fiat monetary systems, gold.

That said, it is important to constantly challenge your own assumptions, and so we begin the New Year by doing just that as regards precious metals – perfect timing, given the recent correction gold and silver have experienced.

Gold and Silver

The elation gold investors felt upon watching gold briefly top $1,900/oz. in August has predictably and fully succumbed to nervousness; gold's peak-to-trough plunge now registers at 20%, within reach of the largest drops of 27% experienced during this bull market (there have been two on that scale). These swings are commonplace in precious metals, but with a hefty 1/3 of our assets in gold and silver investments, it's impossible not to sweat a bit.

To keep things in perspective, let's take a step back from the swinging pendulum of investor sentiment and reexamine our premise starting with the question: have the fundamental drivers of gold changed? The following questions will lead us to the answer:

1. Have the sovereign deadbeats taken credible steps to reduce their historic levels of indebtedness or their unpayable social obligations, or are the deficits continuing to pile up in the false hope of resolving the debt-induced crisis by going further into debt?

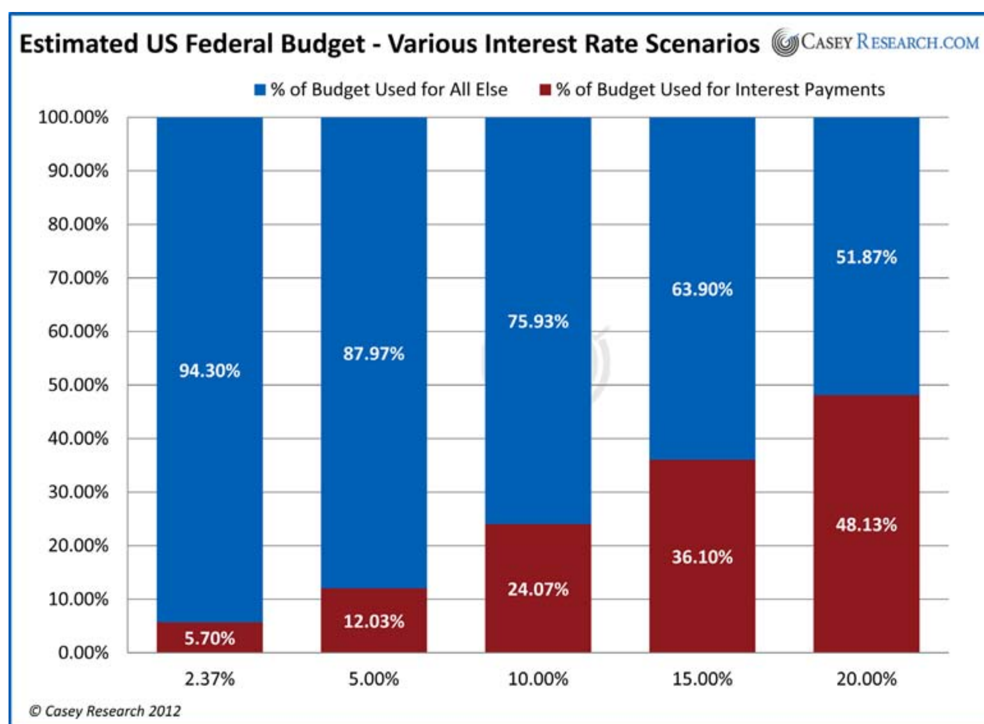
2. Have the world's major central banks ceased, or at least slowed, debasing their currencies at astounding rates?

3. Has the growth in gold demand from investment banks, central banks and small investors slowed?

4. Are historically low US interest rates sustainable, given the country is up to its eyeballs in debt and continuing to run trillion-dollar deficits? What are the consequences to the economy – and in terms of money printing – of the Fed trying to keep those rates suppressed, or trying to "fix" the economic ruin that will be caused if they rose to anything near historic norms?

These questions are, of course, meant to be rhetorical, because it is clear that fundamentals for gold as a preferred form of money – an asset that is not simultaneously someone else's obligation – remain solidly intact. As we don't expect the politicians and central bankers to take the painful steps required to clear the market of the consequences of years of poor policy and the resulting malinvestment until they are forced to by circumstances beyond their control, gold remains a core holding.

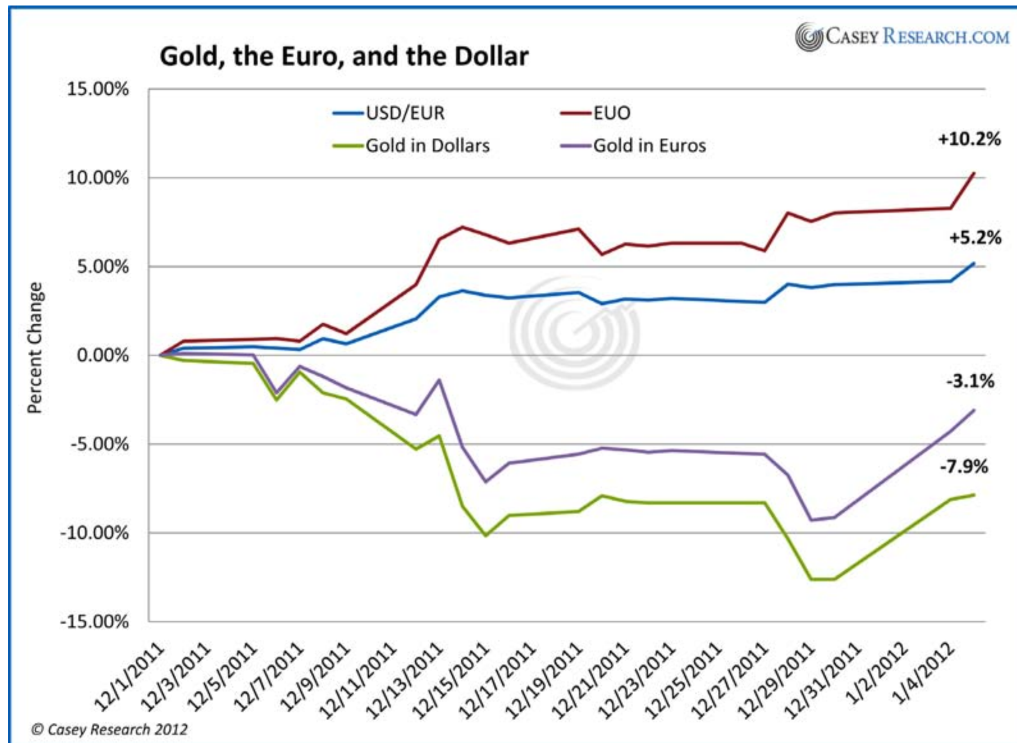
To drive the point home, the following chart estimates the percentage of the US government's budget that would be devoted to interest payments in various rate environments. In 2010, the average interest rate on all federal marketable securities was just 2.37%, so interest payments were a manageable 5.7% of the budget. But if rates were to simply return to historical norms of around 5%, 12% of Uncle Sam's budget – almost *half a trillion* dollars – would be needed just to service debt. Furthermore, these figures actually paint an impossibly rosy scenario, because they're based on the *current* US debt. The US will most assuredly continue borrowing money, raising the principal and interest payments of the federal debt ever further.



In sum, our advice is unsurprising: hold on tight and stay the course. Provided our core thesis remains intact, periods of volatility are of no consequence – as long as you don't panic and sell on a dip, therefore locking in a loss. Keeping gold's recent move in perspective; even with the recent correction, the yellow metal was still up 10% in 2011, its 11th consecutive year of gains.

If you've got the funds and fortitude, consider averaging down your costs by purchasing more precious metals. But as always, don't allocate more than 1/3 of your assets to precious metals; diversification allows us to sleep well at night, even in gold's rough months.

On another note: thankfully, our losses in gold were substantially tempered by our euro hedge. Last month, in anticipation of a flight-to-dollar safety in the wake of a euro crisis, we recommended shorting the euro by buying EUO, effectively pricing a portion of our gold in euros rather than dollars. It turned out to be a good move.



Since the beginning of December, gold priced in dollars has plummeted 7.1%, while gold priced in euros has fallen a far less painful 3.1%. In that time, the dollar has risen 5.2% against the euro, while our double-leveraged vehicle, EUO, has risen 10.2%. If you hedged 20% of your precious metals position with EUO, you cushioned the overall blow by about 3% – not huge, but it certainly blunts the short-term pain.

That said, we're **closing our position in EUO** this month. Though the euro likely has further to fall, leveraged ETFs can be very fickle, and are meant as short-term holdings only. Happily, we nailed the timing, as the euro plummeted through most of December, so we're eliminating the risk and closing our position with a **9% gain in one month**.

For readers with the appetite to ride EUO a little bit longer, just remember that EUO tracks the inverse of 200% of the *daily performance* of the euro vs. the dollar, meaning that if the euro begins bouncing up and down instead of continuing its one-way descent, the gains could quickly evaporate.

We're not the only ones tuned in to the problems of the euro. The investment world is acutely aware that the Eurozone is in deep trouble, and European stocks have taken a major hit lately. Naturally, as contrarian investors, this piqued our interest and so we searched this month for an undervalued European company, one unjustifiably dragged down by the PIIGS' problems. We like what we found.

New Investment Recommendation

Telecom Italia S.p.A. ADR (NYSE.TI)

Executive Summary: TI, one of the largest telecom companies in Europe, generates a large portion of sales from emerging markets in Latin America, which should continue to drive growth. The company has been undeservedly dragged down by the European sovereign debt crisis and is attractively valued.

The Trade: Buy 20% of your desired allocation of TI under $9. Then average your acquisition cost and mitigate the potential for further sell-offs on euro crisis news by purchasing an additional 20% tranche every 4 to 6 weeks. Price target of $16 to $18 in 24 to 36 months.

Key Financials:

Information listed in USD. 1 USD = 0.77 Euros on 1/5/12

Current Price (close 1/5/12)	$10.52
Market Cap	$20.4 billion
Revenue (12 months ending 9/30/11)	$29.82 billion
TTM EPS (Diluted – 12 months ending 9/30/11)	$0.43
Forward P/E Ratio (price/diluted EPS)	6.4
Price to Book Value	0.61
Long-term Debt to Equity (12 months ending 9/30/11)	130.4%
Current Ratio (12 months ending 9/30/11)	0.97
Dividend Yield	5.67%
Short Interest Shares	390.08K
Beta	1.12

With market-roiling announcements coming out of Europe on a seemingly daily basis, it's no wonder that many fundamentally strong European companies are priced at a discount. We scoured these undervalued companies, looking for ones that generate a significant portion of sales outside of the Eurozone, specifically in emerging markets.

Our recommendation, **Telecom Italia (NYSE.TI),** does just that. Headquartered in Italy, TI is one of the largest telecommunication companies in Europe and provides fixed and mobile telecom services in Italy, Brazil and Argentina. TI is Italy's industry leader in fixed-line and broadband services, with a 34.6% market share at the onset of 2012.

Although the Italian market currently generates nearly two-thirds of the company's revenue, that figure is declining as TI shifts its focus to emerging markets, particularly Latin America, where the mobile subscriber base is expected to increase by 7.9% in 2012. TI expects both the Brazilian and Argentinian markets to drive growth in coming years.

Since TI's expansion into Brazil in 1998, the company has become Brazil's second-largest telecom provider in terms of revenue, and its Brazilian operations account for 24% of TI's total sales. With Brazilian demand for wireless services up 19% from a year earlier and high-speed Internet subscriptions up 22% over the same period, Brazilian consumers provide TI with plenty of opportunities to increase sales. In fact, Brazilian mobile subscribers are increasing in number so rapidly that the Brazilian government is planning to auction off three additional airwaves to telecom companies to satisfy increasing demand.

TI's second source of expansion, Argentina, should also continue its stellar growth. Accounting for 11% of TI's total revenue, the Argentinean division saw revenue grow 27.4% in 3Q11 on the back of average revenue per user increasing 16%. Since the global economic recession of 2008-2009, the Argentine economy has rebounded, and the IMF projects Argentina's real GDP to grow 4.6% in 2012.

One characteristic that sets TI apart from other geographically diversified telecoms is the firm's ability to manage its debt load while continuing to expand operations and maintain a healthy stock of cash. For example, Telefonica (TEF), one of TI's chief rivals and the largest telecom in Brazil, sports a debt-to-equity ratio of nearly 600%. In contrast, TI's debt-to-equity ratio is only 214%, and the company has managed to pay down 5.3% of its long-term debt since 2Q10. TI has paid off this debt while maintaining its significant cash reserves, currently about €5 billion.

On the downside, there are risks within the emerging South American market. Since middle- to upper-class consumers are the main users of mobile and broadband services (especially value-added services), an economic squeeze would temporarily hurt TI's sales in the region. However, the company's fundamental strength and geographic diversification should allow it to weather economic storms.

Also of note, Argentina's government has been increasingly mischievous of late, as demonstrated by Argentinean President Cristina Fernández's decree that energy and mining companies repatriate their foreign revenues. We'll keep an eye on this situation, but thankfully, TI is not headquartered in Argentina, so the danger is reduced.

Shares of TI trade as American Depository Receipts (ADRs) on the NYSE. ADRs allow investors to purchase shares of non-US companies on a US exchange and trade just like shares of US-domiciled companies. Each TI ADR equals 10 shares of Telecom Italia stock.

ADRs also add currency risk to the investment equation. TI's profits are in euros and must be translated back to dollars, so while a euro devaluation is bad for our investment, it will also make TI's services abroad cheaper and more attractive, so increased growth should offset a portion of the foreign currency losses.

With a dividend yield of 5.67% and an attractive valuation, we believe TI will net market-beating returns in the next two to three years. That being said, Europe's woes are far from over, and as a result, TI's share price could fall further in the short term. To harness potential price weakness, we recommend buying one tranche of 20% of your desired allocation under $9/share, then purchasing an additional 20% tranche every four to six weeks.

The Speculator's Corner

Significant News and Updates on Open Positions

Assured Guaranty (AGO) April 2012 Puts @ $10.00 Strike (AGO120421P00010000): AGO has rallied relentlessly on speculation of a possible lawsuit with JPMorgan. The stock has met resistance at its August high of $14.32, and we're hoping that it fills the gaps left during its rally. Hold the position.

Deutsche Bank (DB) April 2012 Puts @ $30.00 Strike (DB120421P00030000): Shares of DB continue to be under pressure. Our April puts are still doing very well, trading at a price of $3.30 when recommended as a Buy Below $2.75. The stock has been performing quite poorly, falling on days when similar stocks have rallied, so we are optimistic that DB will trade lower still. Hold the position.

M&T Bank Corporation (MTB) April 2012 Puts @ $50.00 Strike (MTB120421P00050000): MTB has participated in the Santa Clause rally, rising to its 200-day moving average, which is also its October high. For now, MTB has been rejected from that level, but we'll be watching closely. Hold the position.

US Brent Oil Fund (BNO) April 2012 Calls @ $78 Strike (BNO120421C00078000) / iShares iBoxx $ High Yield Corporate Bond ETF (HYG) March 2012 Puts @ $85 Strike (HYG120317P00085000): Brent crude has rallied strongly since the beginning of the new year, in large part due to the EU ban on Iranian oil. Our calls are now in the money, but not yet near our target price. HYG has rallied in the past month as well, finally meeting resistance at $90.00. Technically, HYG looks like it has topped out, and we hope to see it move lower this month. Hold both legs of this position.

DBA: Left Behind

By Aaron Bedrick

> **Executive Summary:** Agricultural commodities were one of the few asset classes that did not participate in the recent broad market rally. We see this relative weakness as an opportunity to initiate long exposure.
>
> **The Trade:** Buy January 2013 calls on the Deutsche Bank Agricultural ETF (DBA) at the strike price of $28.00 (DBA130119C00028000) when the options are trading below $2.50. Sell the calls at the target price of $7.50.

The final weeks of 2011 and the first few weeks of 2012 have seen a fierce "Santa Claus" rally in most risk assets. Equity indices approached (and some touched) levels that had not been seen since the global selloff in August. Crude oil traded to $103.89, a price not reached since June 2011. But while the rising market tide lifted most boats, a few were left behind, most notably agricultural commodities.

We've been eyeing agricultural futures for some time as a candidate for a speculative long position, so the recent selloff piqued our interest. Technically, agricultural futures have been getting absolutely crushed while most other commodities have been rallying. We believe that this disconnect will be short lived. Fundamentally, we're particularly attracted to agricultural commodities because they have a major, unique, long-term advantage – everyone needs to eat.

Also supporting our fundamental case are both long- and short-term weather forecasts; we've just rung in 2012 with the driest, warmest first week ever on record. This is apparently due to the most extreme jet stream configuration ever recorded in December 2011. According to meteorology expert Dr. Jeff Masters:

"The soils will dry out much earlier than usual without a deep snow pack to protect them, resulting in a much earlier onset of summer-like soil dryness. Water availability may also be a problem in some regions of the west due to the lack of snow melt."

An increasing number of crop reports are indicating that we may be at the beginning of a multi-year drought. This is bullish for agriculture, as poor harvests mean scarcity and higher crop prices.

As a proxy for agricultural commodities, we like DBA, the Deutsche Bank Agriculture ETF. This fund owns agricultural futures, and its share price tracks the prices of those futures contracts. Its biggest holdings, from largest to smallest, are sugar, cattle, coffee, cocoa, corn, soybeans, lean hogs, wheat and cattle feed. The futures contracts are constantly being "rolled forward," meaning that expiring contracts are continuously sold and replaced with contracts expiring further in the future. DBA is widely used by investors as a hedging tool against other positions, so it is very liquid.

Back to the technical merits of this trade: the divergence between agriculture and other asset classes is now approaching extreme levels. We can best see this by looking at spread charts, which plot a ratio of the same dollar amounts of two different assets against each other.

The first chart above describes a portfolio that is equally weighted long DBA and short SPY, the S&P 500 Index ETF. We are approaching 2011 lows and are not far from the all-time lows of 2010. The second chart depicts a portfolio that is long DBA and short DBC, the Deutsche Bank Commodity ETF, which holds mainly energy and base metal futures. This chart is very similar to the first; we are quite close to 2011 lows and not far from the 2010 all-time lows.

While we won't be spreading this trade, examining the spreads provides useful information and allows us to better understand the price of DBA within the context of the broader market. Effectively, these spread charts tell us that money has been flowing out of agricultural commodities and into equities and other commodities.

We recommend buying the January 2013 calls at the strike price of $28.00 when they are trading below $2.50. We're targeting a move in DBA's share price up to the 2011 highs of $35.54, which would put the calls about $7.50 in the money. We estimate the calls would be worth about $7.90 in this scenario, for a risk/reward ratio of over 1:3.

Remember, this risk/reward ratio implies risking the entire premium and taking a full loss on the options should they expire worthless. As with all options trades we've previously recommended in *The Speculator's Corner*, we do not intend to exercise these options. We will sell them outright if the price of the option reaches our target.

We believe this is an excellent opportunity to get ahead of a major shift upward in agricultural commodity prices, and the risk/reward ratio of 1:3 is enticing. As always, this is a highly speculative trade and should only be undertaken by experienced traders with speculative capital.

The Casey Report Portfolio

THE CASEY REPORT PORTFOLIO[1]							
INVESTMENT	**Ref. Date[2]**	**Symbol**	**Current Recommendation**	**Price at Issue**	**Price 1/9/12**	**Price Target**	**Gain / (Loss) %[3]**
GOLD & SILVER							
Buy Gold		-	**Buy**	$937.50	$1,607.45	-	71%
Buy Silver		-	**Buy**	$17.56	$28.97	-	65%
Central Fund of Canada	10/5/2009	CEF	**Buy**	$12.98	$20.01	-	54%
		T.CEF.A		$13.90	$20.50	-	47%
Please see above for discussion of gold and silver.							
Market Vectors Gold Miners ETF	11/1/2008	GDX	**Buy on Weakness**	$57.00	$53.65	-	-6%[4]
Precious metals equities followed physical precious metals downward this month. With the dollar still climbing, both gold and GDX may fall further still. Should you want to increase your allocation to GDX, use this price weakness to accumulate larger positions. Dollar cost averaging, in which you buy a portion of your position every few weeks, is a great way to harness a low average price. We recommend purchasing 20% tranches of your desired allocation every 4-6 weeks.							

THE CASEY REPORT PORTFOLIO[1] *continued*							
INVESTMENT	**Ref. Date[2]**	**Symbol**	**Current Recommendation**	**Price at Issue**	**Price 1/9/12**	**Price Target**	**Gain / (Loss) %[3]**
ENERGY PLAYS							
Vanguard Energy ETF	7/6/2010	VDE	**Buy on Weakness**	$97.17	$103.17	-	6%
Oil continues to outperform other commodities, and the recent escalation of threats between Iran and the US only solidifies this trend. Should Iran actually follow through on its threat to close the Strait of Hormuz, the price of oil will explode upward. Continue to accumulate shares of VDE on weakness.							
AGL Resources Inc.	7/20/2011	AGL	**Buy**	$41.28	$41.04	$50	2%
AGL's merger with Nicor is now complete, as evidenced by the combined company's nifty new ticker, GAS. Former AGL shareholders will notice they received a small dividend on December 16, which synchronized the two former companies' dividends. Going forward, proliferation of natural gas should provide AGL with growth potential, and in the meantime, we're happy to collect the 4%+ dividend.							
EMERGING TRENDS							
American Water Works Company Inc.	8/11/2011	AWK	**Buy on Weakness**	$31.16	$31.82	$38 - $42	3%
December was a quiet month for AWK; its next significant event is a conference call on January 18 in which AWK will discuss 2012 earnings guidance. We'll analyze that call in February's Casey Report.							
Brasil Foods SA (ADR)	10/13/2011	BRFS	**Buy on Weakness**	$20.29	$19.63	$24-$28	-2%
The only significant headline from BRFS this month was an announcement of its plan to swap some assets with those of rival Marfrig. When the merger was approved, we knew BRFS would need to divest some assets in order to satisfy Brazilian regulators, so this was expected. Since last month, BRFS's underlying price actually changed very little; the 4% price decrease in our ADR is actually the result of USD strengthening against the Brazilian real (BRL). We still recommend buying BRFS on price weakness.							
GLOBAL DIVERSIFICATION							
iShares MSCI Chile Investable Market Index Fund	2/3/2011	ECH	**Buy**	$70.83	$59.29	-	-15%
Global X FTSE Norway 30 ETF	2/3/2011	NORW	**Buy**	$15.93	$12.63	-	-21%
Relative US strength has been the main story recently, and as a result both ECH and NORW have underperformed. However, the US economy is still seriously structurally flawed and saddled with unsustainable debt; Chile and Norway, on the other hand, have fundamentally strong, export-driven economies. Don't let the whims of other investors lead you astray - both Chile and Norway are excellent long-term investments.							

THE CASEY REPORT PORTFOLIO[1] *continued*							
INVESTMENT	**Ref. Date[2]**	**Symbol**	**Current Recommendation**	**Price at Issue**	**Price 1/9/12**	**Price Target**	**Gain / (Loss) %[3]**
EUROPEAN CRISIS							
ProShares UltraShort Euro	12/8/2011	EUO	**Sell**	$19.07	$20.86	-	9%
Please see above for our Sell recommendation of EUO.							
Telecom Italia S.p.A. (ADR)	1/10/2012	TI	**Buy below $9**	$10.38	$10.38	$16-$18	0%
Please see above for recommendation of TI.							
INTEREST RATES							
ProFunds Rising Rates Opp Inv	7/1/2008	RRPIX	**Buy**	$17.88	$8.05	$49	-55%
ProShares Short 20+ Year Treasury	6/9/2011	TBF	**Buy**	$41.50	$31.86	$61	-23%
Interest rates remain depressed, and with Europe's problems growing worse, the US may continue as a safe haven in the near future. As a result, we'll likely be waiting a bit longer for rates to bounce off historic lows. Use this as an opportunity to average down your acquisition cost in anticipation of eventual rising rates.							
DIVERSIFY CASH							
Norwegian Krone	6/3/2010	NOK	**Buy**	0.1542	0.1666	-	8%
Canadian Dollar	6/3/2010	CAD	**Hold**	0.9542	0.9766	-	2%
With the dollar back from the dead, our preferred foreign currency hedges took another hit this month. Fluctuations in the currency markets are to be expected and, since we primarily hold these positions to diversify our cash, are not worrisome. Continue to diversify your cash between the NOK, CAD and USD; our favored method of doing so is with EverBank Currency CDs.							
[1] This sheet represents our current portfolio recommendations and is not a comprehensive track record. [2] Reference date is the release date of the publication when the recommendation was originally made in The Casey Report. [3] Includes Dividends [4] We also hold a free ride position in GDX, which we recommended for purchase on 1/14/2010 and recommended a free ride on 4/14/2011. We netted a 28% gain upon taking the free ride, which is not included in GDX's performance above.							

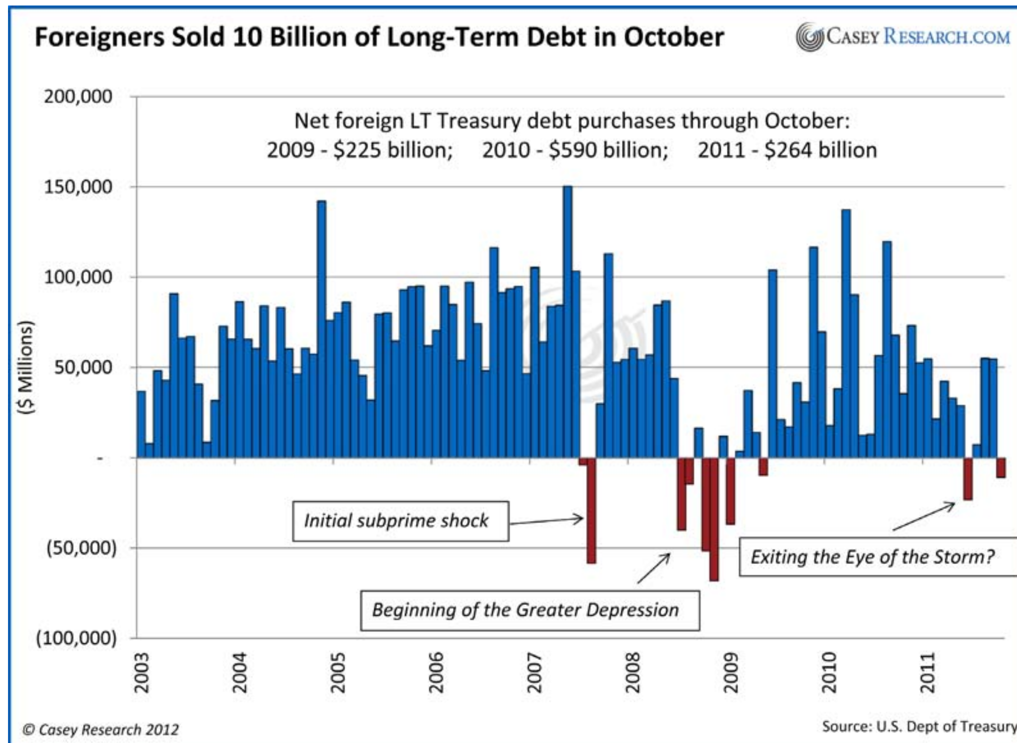
***Portfolio Page Updates:** Get the latest on your companies by regularly visiting the portfolio page on our website, or click here.

Back to Table of Contents

Casey's Data Farm

A monthly recap of data worth paying attention to.

Foreign Purchases Are in the Red Again

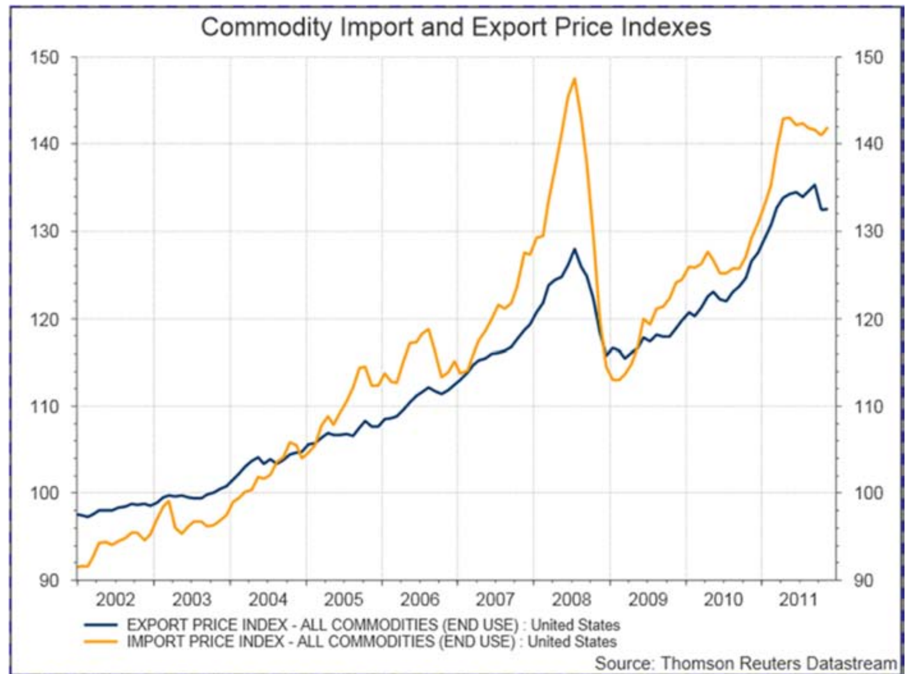


Last month, we noted that with all of the market turmoil, Treasury purchases should have been much stronger. Simply, with trouble in Europe, the numbers for August and September should have gone through the ceiling; instead, purchases were mediocre.

With the October data now available, our suspicions of much weaker foreign demand for Treasuries, hidden by the flight to safety, are confirmed. As soon as the US stock market began to show signs of life – the DJIA rose from a low of 10,650 on October 4 to 12,229 by the end of the month – US Treasury purchases by foreigners dropped precipitously. Based on the latest data, foreign demand for Treasuries is again back in the red with $10 billion net sales.

After QE2, Fed Chairman Bernanke had some luck on his side. As soon as the program ended, troubles in Europe caused many investors to flee into Treasuries, but now that move is winding down. Are we going to remain in the red going forward? That's doubtful. Though the euro situation has calmed, it's far from resolved, and investors will likely flee to Treasuries for safety again. Even so, recent actions in the Treasury market expose a very precarious situation for US interest rates (and, therefore, bond holders and the broader economy) in that anything resembling a persistent recovery in equities will almost certainly lead to a flight out of low-yielding Treasuries, resulting in either higher rates or even more monetization by the Fed as the buyer of last resort.

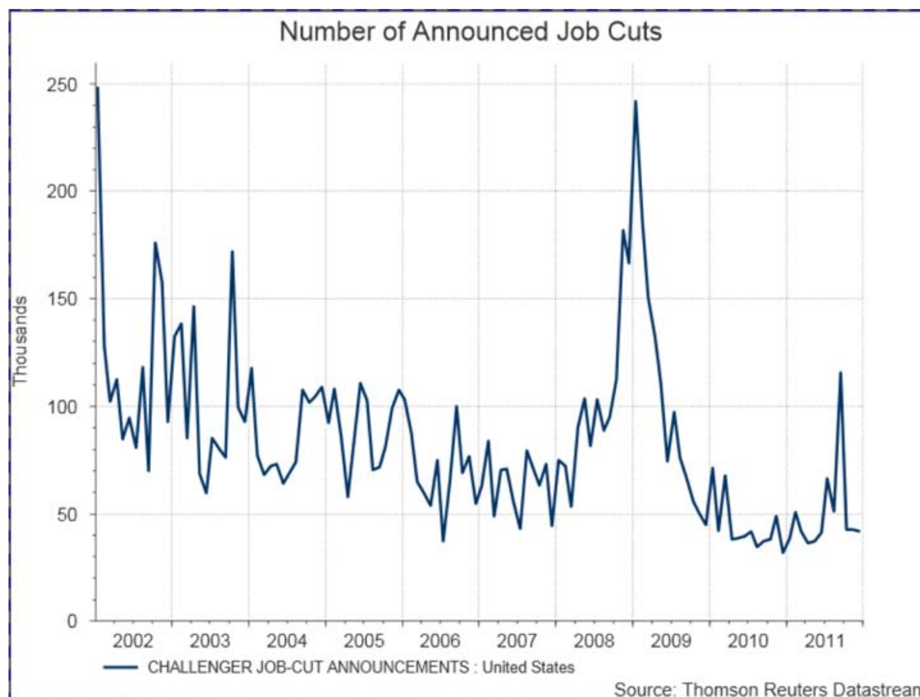
Are Higher Commodity Prices Hurting or Helping the United States?



With oil once again hovering around the $100 mark, you might be wondering how higher oil and other commodity prices affect the US economy. The answer might seem obvious with oil, but don't forget that the US exports plenty of commodities as well. As a result, discerning whether higher commodity prices are good or bad for the US is no simple task. The chart above helps provide an answer as it shows both export and import price indexes for all commodities.

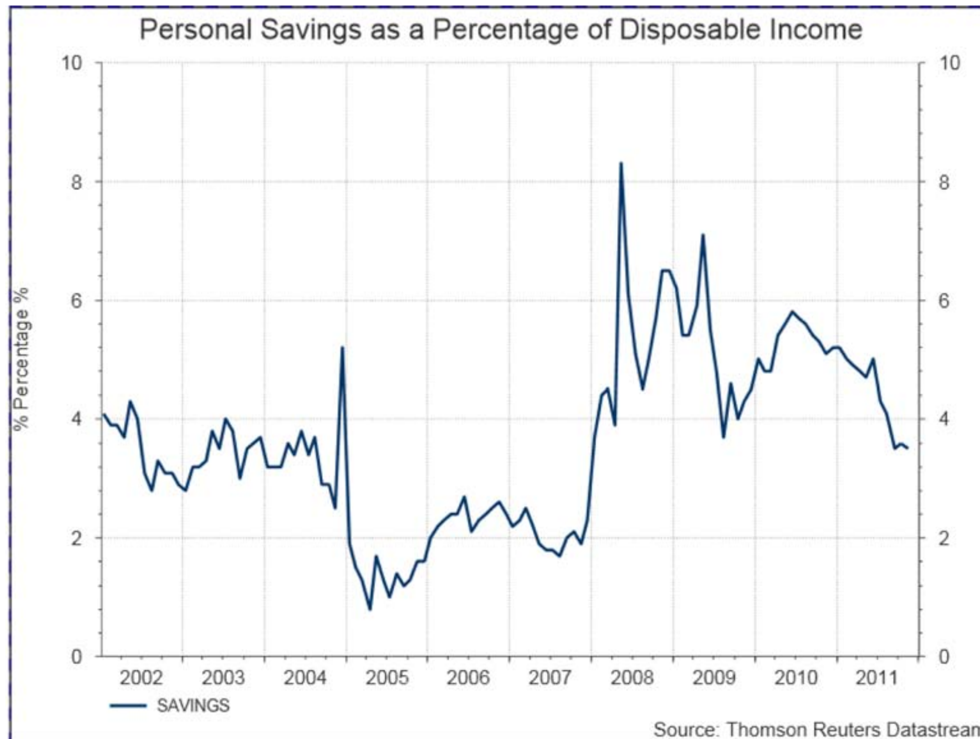
During the 2008 crash, oil was beaten down so badly that the import price index was pushed below the export index. While the gap subsequently widened, by late 2010 it had again closed. Unfortunately, in 2011 the gap between import and export prices again expanded – due to oil's rise at the same time, certain key US commodity exports faltered – and is nearly at its widest point in a decade. Bottom line: Higher prices are a net negative on the US economy going into 2012.

A Worrying Spike in Job Cut Announcements



Large-scale job cut announcements have been decreasing since 2008 but are now making a comeback. From numerous big financials cutting thousands of jobs to the recent news that Kmart and Sears were closing a total of 120 stores, there has been a noticeable rise in job cut announcements. In late 2011, the numbers saw the biggest jump since the crash. So, while the unemployment numbers might be slightly improving in the most recent BLS report, this spike in job cut announcements could signal another wave of bad unemployment numbers ahead.

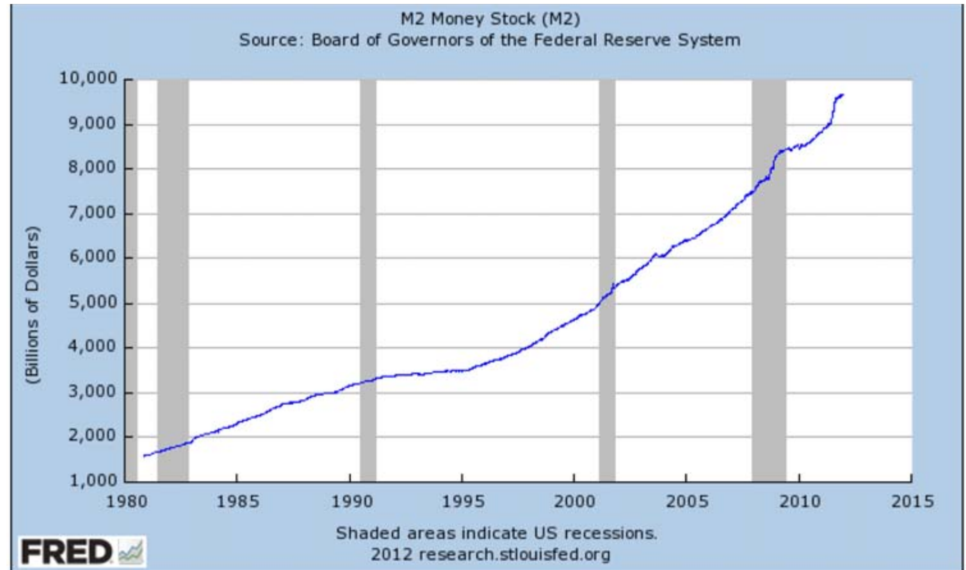
Percentage of Personal Savings Decreases



The rate for personal savings is still nearly double the peak of the boom, but it has been meandering downward. Nonetheless, many pundits claim the savings rate must fall further to promote economic recovery. Exactly how low do they want the savings rate? Apparently, these mainstream economic gurus won't be satisfied until consumers drive themselves into debt again. According to the mentality of Bernanke and other Keynesians, the only way to achieve recovery is to create another bubble. They don't realize that the economy can stabilize as consumers deleverage their personal balance sheets and get their finances in order. After all, the saving of today is the spending of tomorrow.

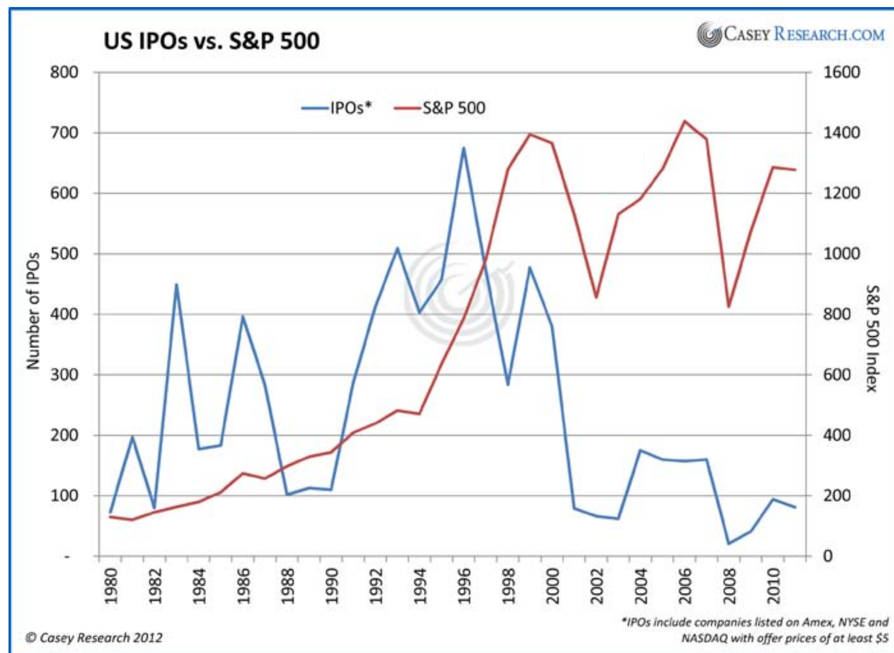
The Money Supply Keeps Rising

Six months ago, you couldn't check the financial news without hearing something about QE2 and the possibility of a third quantitative easing on the horizon. However, with Europe in the spotlight, those Federal Reserve headlines have faded into the background. But just because the Fed is not prominent in the news cycle doesn't mean that the printing presses have ceased to run.



As the chart above shows, the money supply has continued to go vertical. Though some investors are concerned with possible deflation on the horizon, a quick look at this chart should dispel those fears. Bernanke is pumping all of this money into the system just as a stimulus, but imagine what would happen if deflation actually became a threat? The left axis on this chart would need to be readjusted several inches upward to make room for additional trillions the Fed would pump into the system.

US IPOs Continue Their Slump



During times when healthy economic conditions prevail and allow a resultant general uptrend in equity markets, the number of Initial Public Offerings (IPOs) will increase until the point that there is a rush for companies to IPO, a clear sign the market is overheated.

With that background, the chart here is concerning for two reasons. First, it indicates, based on IPO levels, that the economy is not recovering. In fact, after a short rise in IPOs, we're once again headed downward. Furthermore, we're still below pre-2008 levels. Though equity markets have performed reasonably well since 2008, that hasn't translated into new companies going public as would normally be the case.

Our second concern is a much longer trend. Notice that US IPOs have been in a major slump since 2001. That's due to a deeper issue than the economy alone. Prior to 2001, foreign companies needed US listings to grab any sort of attention and, as a result, capital. But now institutional investors are more informed and knowledgeable about emerging markets, and local economies have strengthened. As a result, foreign companies no longer need to list their shares on US markets to raise capital. Abiding by SEC regulations isn't cheap, and listing in their home countries circumvents those costs. Due to a growing global market, our stock exchanges are losing their competitive edge. This trend isn't likely to reverse anytime soon.

Back to Table of Contents

Obama Watch

Above the Law

By Don Grove, Casey Research Washington Correspondent

We enter this presidential election year with the public's opinions of our elected representatives at historic lows. A Rasmussen poll at the end of 2011 found that just 5% of likely voters rate Congress as doing a good or excellent job. Sixty-eight percent viewed Congress's job performance as poor. Barack Obama scores a paltry negative 17 on Rasmussen's Presidential Approval Index. That failing grade is calculated by subtracting from the 24% of the nation's voters who strongly approve of Obama's job performance 41% of the nation's voters who strongly disapprove. Our disenchantment with those chosen to govern our country reflects a pervading sense that, among other failings, they hold themselves above the law.

The President

The president and his Attorney General, Eric Holder, have simply neglected, or even refused, to enforce or abide by laws they don't like. In a blatant display of crony capitalism, Obama moved his United Auto Worker friends ahead of secured Chrysler bond holders in violation of bankruptcy law and the 5th Amendment's Takings and Due Process protections.

If the president is free to ignore these laws, why would investors want to be secured creditors? Obama is unapologetic about sidestepping Congress in violation of the separation of powers embodied in our Constitution, the highest law of the land. For example, when Congress did not enact cap-and-trade legislation, Obama imposed regulation of greenhouse gases through his own Executive Branch Environmental Protection Agency. When the Senate would not approve Obama's nominees to the National Labor Relations Board or the Dodd-Frank Act's Consumer Financial Protection Bureau, Obama installed his nominees by recess appointment, even as the Senate deliberately remained in pro forma session specifically to prevent those appointments.

Richard Cordray, new CFPB director, with Barack Obama

Congress

Members of Congress are largely subject to the same laws as the rest of us, yet they get away with actions that would land lesser citizens in jail. For example, members and their staff trade on information only available to them as legislators; in essence, they're the ultimate insiders.

In his book, *Throw Them All Out*, Peter Schweizer writes that he "was troubled by the fact that the political elite gets to play by a different set of rules than the rest of us." He concluded that "political party and political philosophy matter a lot less than we think. Washington is a company town, and politics is a business. People wonder why we don't get more change in Washington, and the reason is that the permanent political class is very comfortable. Business is good."

Article I, Section 5 of the Constitution gives each congressional chamber authority to "determine rules" and "punish its members for disorderly behavior and, with concurrence of 2/3, expel a member." Pursuant to this provision in the Constitution, the House of Representatives adopted the Code of Ethics for Government Service into its Ethics Rules. Clause 8 of that Code provides that "any person in government service should [n]ever use any information coming to him confidentially in the performance of governmental duties as a means for making a private profit." This is not, however, a law under which members or their staff can be prosecuted. It is only a rule, enforceable internally by the House Ethics Committee.

House ethics rules are rarely, if ever, enforced. Even when they are enforced, the penalty is likely to be a slap on the wrist. In a recent example of legislators holding themselves above the law, the House Ethics Committee determined that New York Congressman Charlie Rangel, the former chairman of the powerful House Ways and Means Committee and 40-year veteran of the legislature, was guilty of 11 ethics violations. Those included misuse of his elected office to raise money for a center that would bear his name, misuse of a rent-controlled apartment and failing for 17 years to file tax returns or pay taxes on Dominican Republic rental property. Rangel showed his contempt for costly hearings about his ethics violations by walking out on them.

Charlie Rangel (D-NY)

The House ultimately voted 333-79 to censure Rangel. A censure is basically a public reprimand. Rep. G.K. Butterfield (D-NC), a member of the ethics committee, tried to reduce the penalty to a simple written reprimand such as was imposed on Joe Wilson (R-SC) after he called the president a liar during Obama's 2010 State of the Union Address. Butterfield's effort failed, but it was notable for the insight it provides to Congress' image of itself as a privileged class.

As she took her new post as speaker of the House in 2006, Nancy Pelosi (D-CA) promised that "this leadership will create the most honest, most open and most ethical Congress in history." Four years later, she was reading the censure resolution against Rangel as he stood in the well of the House chamber. Rangel asked to speak briefly after Pelosi completed her 30-second rebuke. He said he thought the ethics charges were politically motivated and added that his life would ultimately not be "judged by this Congress."

Rangel said, "I just would want all of you to know that in my heart I truly feel good." When he finished speaking, Rangel was given a standing ovation by his colleagues. Although he had to pay the back taxes, he was not required to pay any penalties or interest.

Pelosi's own hands aren't clean, either. She was speaker of the House and invested heavily in a Visa IPO when the Credit Card Fair Fee Act cleared the House Judiciary Committee. Visa and the other credit card companies strongly opposed the bill, which otherwise had strong public support. Shockingly, on Pelosi's watch, the bill never made it to the House floor for a vote.

Although the Senate has its own Ethics Committee, the Code of Ethics for Government Service has not been adopted by the Senate, so it does not apply to senators or their staff.

One of the few places where congressional immunity is spelled out is the Constitution's "Speech and Debate Clause." Article I, Section 6 provides:

> They shall in all Cases, except Treason, Felony and Breach of the Peace, be privileged from Arrest during their Attendance at the Session of their respective Houses, and in going to and returning from the same; and for any Speech or Debate in either House, they shall not be questioned in any other Place.

The purpose of the clause is to prevent legislators from being arrested and possibly prevented from voting based on their unpopular political views. It seems the clause has been widely invoked, particularly by members traveling to and from Capitol Hill, but its acceptance by law enforcement may be on the decline. Although the clause may not shelter members of Congress from drunk driving, according to D.C. law, members are exempt from parking tickets when on "official business."

The Supreme Court has interpreted the Speech or Debate Clause to mean that members of Congress and their staff may not be prosecuted for their "legislative acts." "Legislative acts" include speeches and debates on the floor of either chamber, voting, preparing committee reports and conducting committee hearings, but do not include accepting a bribe to influence a vote or misappropriating funds. Members have been shielded from employment discrimination suits by the Speech or Debate Clause.

Members have used the speech and debate defense to limit and sometimes curtail investigations. Rep. Peter Visclosky (D-Ind) invoked the Speech and Debate Clause when federal prosecutors investigated his role in obtaining earmarks for lobbying firms' clients in exchange for contributions. The indictments of Rick Renzi (R-Ariz) for attempting to benefit financially from a land deal were challenged under the Speech and Debate Clause. In 1994, Daniel Rostenkowski (D-Ill), another former chairman of the House Ways and Means Committee who succumbed to the corrupting influence of power, misappropriated an allowance for hiring a clerk. He used it to pay employees for personal services rather than for official work. Rostenkowski argued, unsuccessfully, that he could not be prosecuted because the allowance was for a legislative activity.

Congressman William Jefferson (D-LA) was indicted on 16 charges of corruption by a federal grand jury, involving an alleged $400,000 in bribes and $90,000 in cash found in Jefferson's freezer. The federal District Court for DC ruled that an FBI raid on Jefferson's congressional office was legal and rejected the claim of both Jefferson and the House Bipartisan Legal Advisory Group that the search violated the Constitution's Speech or Debate Clause.

DDC Chief Judge Tom Hogan explained that members of Congress are "generally bound to the operation of the criminal laws as are ordinary persons." He said that the Speech or Debate Clause does not "make Members of Congress super-citizens, immune from criminal responsibility." Hogan said that Jefferson's interpretation of the Speech or Debate privilege "would have the effect of converting every congressional office into a taxpayer-subsidized sanctuary for crime."

Standing back from an array of individual ethical and criminal violations by its members, we can see that Congress as a body holds itself above the law. Congress has abdicated important duties. It has not passed a binding budget resolution, as required by law, for almost three years. Notwithstanding its failure to prepare this required roadmap for spending, Congress has still spent money like a drunken sailor. Its spending has been haphazard – typically based on endless continuing resolutions and omnibus spending bills so massive that no one could adequately review them before their passage, especially given the practice of submitting these hefty tomes at the 11th hour. The Congressional Research Service reports that Congress has not passed all of its appropriations bills on time since 1997. This reckless spending is punctuated by frantic struggles to raise the debt ceiling.

Dual Standard

Laws that apply to us commoners often give the government a pass. Actions that at first blush would appear to amount to robbery, extortion or counterfeiting and seem to be clear violations of the federal Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. Section 1961, and the Hobbs Act, 18 U.S.C. Section 1951, are permissible and business as usual for government actors.

Consider, for example, that the term *robbery* means "the unlawful taking or obtaining of personal property from . . . another, against his will, by means of actual or threatened force, or violence, or fear of injury, immediate or future." Similarly, extortion means "the obtaining of property from another, with his consent, induced by wrongful use of actual or threatened force, violence, or fear, or under color of official right." When the government does these things, it is presumably not unlawful or wrongful. Governmental power, by its nature, is legalized extortion. Public officials, when entrusted with that power, often succumb to the temptation to wield it for their own personal benefit.

Extortion "under color of official right" is the term that applies when a government agent receives personal benefit from his threats or actions. In *Wilkie v. Robbins*, 551 U.S. 537, 564-65 (2007), the United States Supreme Court rejected a landowner's claim that federal agents were engaged in extortion under the Hobbs Act. The Court explained that "the Hobbs Act does not apply when the National Government is the intended beneficiary of the allegedly extortionate acts." Thus, if a plaintiff claims that extortion "under color of official right" resulted in a benefit to the government, rather than a personal benefit to the government agent, no extortion has occurred.

Richard Maybury has observed that "political power corrupts the morals and the judgment." The line between political power applied through faithful public service and breach of trust may seem hazy to those who cross it. Elected officials who believe they know what's best for their constituents may convince themselves that what would otherwise amount to bribery is justified in the quest for reelection.

This reasoning easily leads to special favors for friends and cronies and the largely accurate perception by voters that elected officials are whores for sale to the highest bidder and that those officials no longer work for the voters who elected them. A case in point is the growing list of Obamacare waivers issued prominently to Obama's labor union cronies. Big labor played a big role in getting the bill passed and has now been paid off with Obamacare exemptions for over half a million union members. Nancy Pelosi, as speaker of the House, was a primary architect of Obamacare. Favored businesses in her California congressional district have received more Obamacare waivers than any other congressional district in the country.

Meanwhile, those who do not enjoy the immunities of elected office or close ties to those who do find themselves at ever greater risk of running afoul of a massive, growing, irrational and often incomprehensible body of law. We are justifiably wary, for example, of provisions in the recently enacted National Defense Authorization Act for Fiscal Year 2012 that seem to allow for the indefinite detention without charge or trial of "covered persons." Could that be me, or you? Hard to say – so hard, in fact, that Congress deliberately opted to leave it to the courts to sort out the meaning of this vague legislation. Terrorism is an evolving term, not well defined. Can any of us who are not public officials or well connected to them conduct our affairs so as to ensure that we will not be whisked away in the night?

Promises and Trust

Article VI of the Constitution requires that "The Senators and Representatives before mentioned, and the Members of the several State Legislatures, and all executive and judicial Officers, both of the United States and of the several States, shall be bound by Oath or Affirmation, to support this Constitution." They all take the following oath:

> I, [name], do solemnly swear (or affirm) that I will support and defend the Constitution of the United States against all enemies, foreign and domestic; that I will bear true faith and allegiance to the same; that I take this obligation freely, without any mental reservation or purpose of evasion; and that I will well and faithfully discharge the duties of the office on which I am about to enter. [So help me God.]

This is a presidential election year. We will elect a president and in doing so empower him to direct the workings of the vast and now disproportionately powerful executive branch. We will elect 1/3 of the members of the Senate and the entire House of Representatives and look to them to rein in the president. These people are by oath bound to uphold the Constitution. They are our trustees and fiduciaries, and we must hold them to the high standards that define those roles. They must be loyal. They must not abdicate their responsibilities. They must not sustain a conflict of interest and especially must not profit personally at the expense of, much less to the further detriment to, the beneficiaries. They must generally administer the trust in the best interest of the beneficiaries, not their own.

The rule of law is fundamental to an advanced, civilized society. Those chosen to govern our country should not be above the law.

A Closing Election-Year Thought

Mark Twain's fictional character, Pudd'nhead Wilson, observed that "It could probably be shown by facts and figures that there is no distinctly native American criminal class except Congress."

In all fairness, that criminal class should encompass government broadly, including all three branches. It would still more fairly also encompass the electorate that empowers that criminality by falling again and again for the perennial campaign promise: "I will give you what you want and make someone else pay for it."

Don Grove is our Washington, D.C. correspondent. Don casts a jaundiced eye upon the activities of Congress, the White House, and the courts from his front row seat in the nation's capital where he is an attorney in federal practice and a managing partner in his law firm. He is admitted to practice in Maryland, Washington, D.C., and Tennessee and is admitted to the bar of the U.S. Court of Federal Claims, the U.S. Court of Appeals for the Federal Circuit, the U.S. District Court for the District of Columbia, and the U.S. Supreme Court. Don is a champion of limited government in the belly of the beast.

Back to Table of Contents

End Note

A closing comment by Doug Casey

I'm in Argentina at the moment. Well, actually at the beach in Uruguay, the country across the River Plate that's really like a small, quiet, backward province of Argentina (see my 2008 article on Uruguay). In any event, the moderator of a luncheon group that I attend most Thursdays when I'm in Buenos Aires sent me a word definition that I haven't previously seen.

We've all heard of democracies – even though real democracies haven't existed since ancient Athens, or at least since medieval Iceland. There are plenty of republics where the *hoi polloi* decide who, among candidates with sufficient media coverage, will in turn decide how much they should be taxed and regulated. We know about oligarchies – countries with a rule of the few, like Burma, and some would argue the US. There may be a meritocracy here and there, like perhaps Singapore. There are quite a few autocracies, like Cuba, Venezuela and half the countries in Africa. There are hereditary monarchies, some real (like Brunei, Saudi Arabia and North Korea) and some pretend (like Britain).

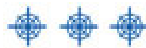
But those descriptions don't tell you much about what is really going on and have a lot of overlap in any event. In essence, most political systems are best described as kleptocracies to one degree or another. Argentina is an outstanding example, and a relatively benign one, where people go into the government strictly to steal as much as they can and otherwise leave you alone. It's much, much more dangerous and intrusive when they go into government for your good, as opposed to their own.

In any event, my friend introduced me to a new word that accurately – more than kleptocracy – describes the typical system in North America and Europe. This is the *Ineptocracy*.

You can Google this recently coined word. Please read this definition over slowly, and several times. It's extremely well thought out.

Ineptocracy (in-ep-toc'-ra-cy): a system of government where the least capable to lead are elected by the least capable of producing, and where the members of society least likely to sustain themselves or succeed are rewarded with goods and services paid for by the confiscated wealth of a diminishing number of producers.

Back to Table of Contents



The Casey Research web site, *Casey's Investment Alert, Casey's International Speculator, BIG GOLD, Casey's Energy Confidential, Casey's Energy Report, Casey's Energy Opportunities, The Casey Report, Casey's Extraordinary Technology, Conversations With Casey, Casey's Daily Dispatch and Ed Steer's Gold & Silver Daily* are published by Casey Research, LLC. Information contained in such publications is obtained from sources believed to be reliable, but its accuracy cannot be guaranteed. The information contained in such publications is not intended to constitute individual investment advice and is not designed to meet your personal financial situation. The opinions expressed in such publications are those of the publisher and are subject to change without notice. The information in such publications may become outdated and there is no obligation to update any such information.

Doug Casey, Casey Research, LLC, Casey Early Opportunity Resource Fund, LLC and other entities in which he has an interest, employees, officers, family, and associates may from time to time have positions in the securities or commodities covered in these publications or web site. Corporate policies are in effect that attempt to avoid potential conflicts of interest and resolve conflicts of interest that do arise in a timely fashion.

Any Casey publication or web site and its content and images, as well as all copyright, trademark and other rights therein, are owned by Casey Research, LLC. No portion of any Casey publication or web site may be extracted or reproduced without permission of Casey Research, LLC. Nothing contained herein shall be construed as conferring any license or right under any copyright, trademark or other right of Casey Research, LLC. Unauthorized use, reproduction or rebroadcast of any content of any Casey publication or web site, including communicating investment recommendations in such publication or web site to non-subscribers in any manner, is prohibited and shall be considered an infringement and/or misappropriation of the proprietary rights of Casey Research, LLC.

Casey Research, LLC reserves the right to cancel any subscription at any time, and if it does so it will promptly refund to the subscriber the amount of the subscription payment previously received relating to the remaining subscription period. Cancellation of a subscription may result from any unauthorized use or reproduction or rebroadcast of any Casey publication or website, any infringement or misappropriation of Casey Research, LLC's proprietary rights, or any other reason determined in the sole discretion of Casey Research, LLC.

Affiliate Notice: Casey Research has affiliate agreements in place that may include fee sharing. If you have a website or newsletter and would like to be considered for inclusion in the Casey Research affiliate program, please email us at http://www.caseyresearch.com/affiliate/. Likewise, from time to time Casey Research may engage in affiliate programs offered by other companies, though corporate policy firmly dictates that such agreements will have no influence on any product or service recommendations, nor alter the pricing that would otherwise be available in absence of such an agreement. As always, it is important that you do your own due diligence before transacting any business with any firm, for any product or service. © 1998-2011 by Casey Research, LLC.