By the time a fund manager or economist discovers he has no talent for investments and economics, he is too successful to give it up!

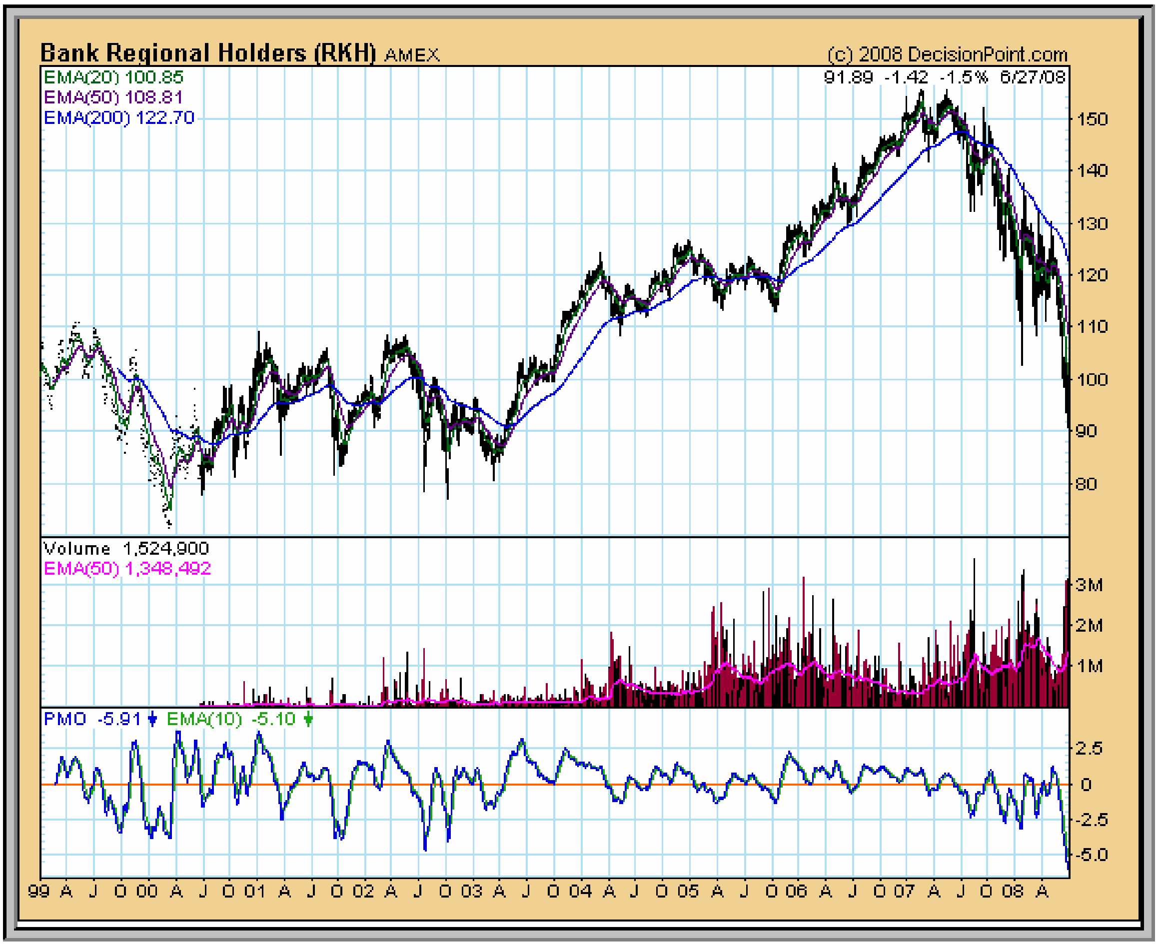
Marc Faber

„Remember the definition of a stock that has fallen 90%: one that's fallen by 80% and then halves“.

Gerard Minack

What truly amazes me is the number of analysts and strategists who have issued buy recommendations on financial stocks for the last 9 months. AIG was a great buy at $70, at $50 and at $35. Now it is at $27! Same story for Citigroup, which is now down from a high of $57to $17! More recently, the weakness in financial stocks has been spreading to regional banks – some of which will certainly go out of business (see Figure 1).

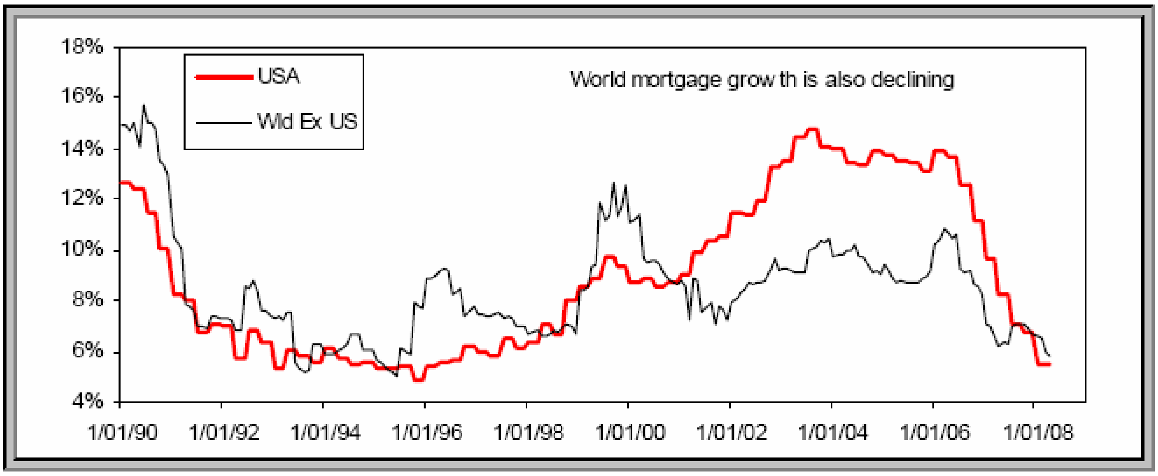
Figure 1: Regional Banks – Another Disaster in the Wings!



Source: www.decisionpoint.com

What seemingly escapes the attention of some pundits is that in an environment of decelerating credit growth and de-leveraging, financial institutions, which operated on huge leverage and still do, are extremely vulnerable to declining asset prices (see Figure 2).

Figure 2: World Mortgage Growth (Percent Y-o-Y) slowing down everywhere!

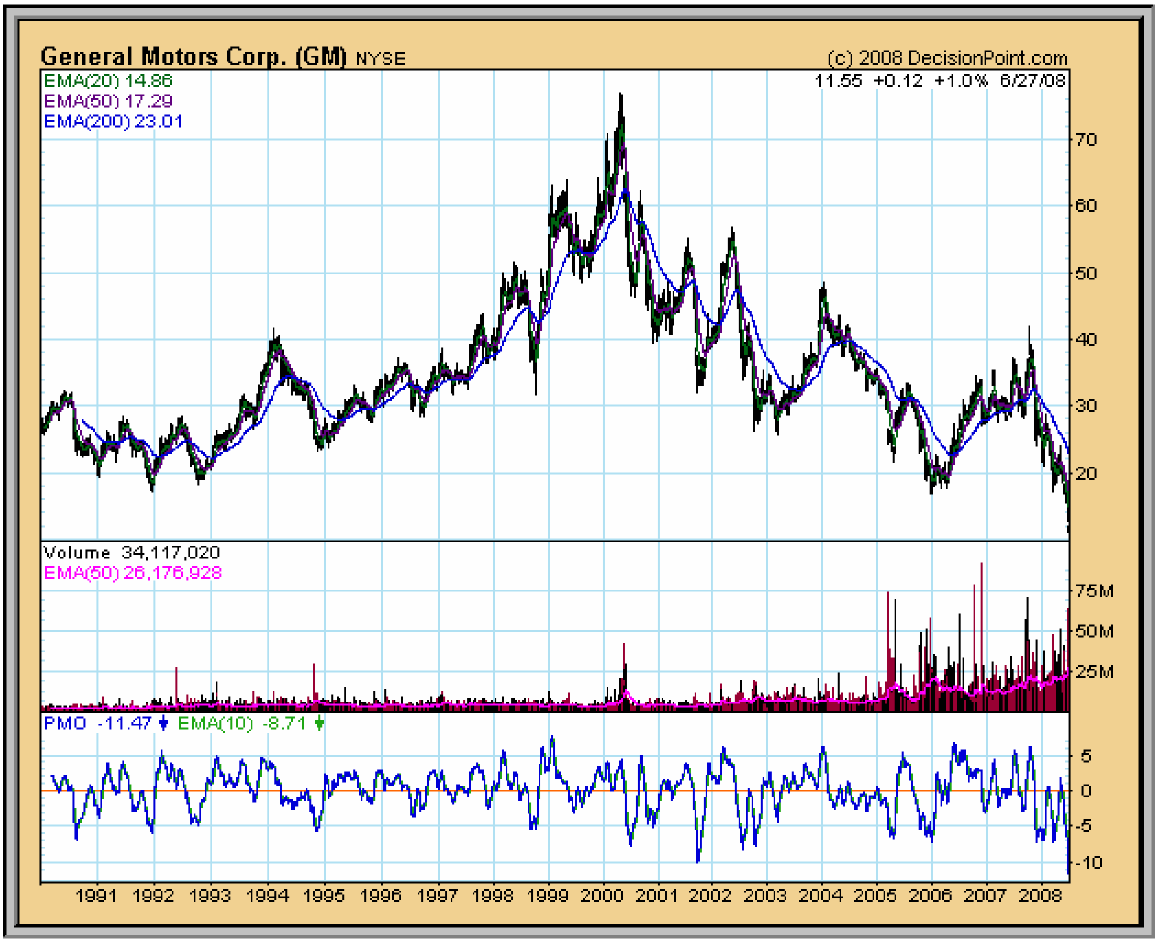


Source: Bridgewater Associates

In interviews, I am frequently asked what my best investments were and what investments were the worst I had made. By far the worst investment in my life was to lend money to friends. It has been a 100% write-off without exception. Now you may think that I move in bad company. This is certainly true, but interestingly enough, the friends I lost most money with were all from good families, had university education and moved around with ease in the high society – in retrospect I think they were all perfect “Hochstaplers” (high class impostors and swindlers – in short the types you commonly find among Wall Street executives, government officials and the government agencies’ staff, or to be more specific at the Fed). The second worst investment I made was in 1985. I recommended buying Texan banks as a contrarian play. At the time Texan bank stocks had declined by 95% in value. Subsequently and without exception they all went down to zero. The third worst investment I may have made was to recommend buying the US$ last month – albeit with a tight stop loss order, which by now would have been executed (see also below). All I wish to bring across is that a) you should not think that I know much more than you do and b) the fact that a stock or for that matter any asset market including a currency which has declined by 60% or even 90% does not make it necessarily a great buy! Kirk Kerkorian –

not exactly a naïve and novice businessman – (seven richest American who started with nothing) thought General Motors to be a bargain at around $30 and bought close to 10% of the outstanding shares (he sold his shares in the meantime). But with the shares now at a 53-year low (!!!!) he was clearly wrong about GM's potential but shrewd enough to get out in time (current price $11 see Figure 3).

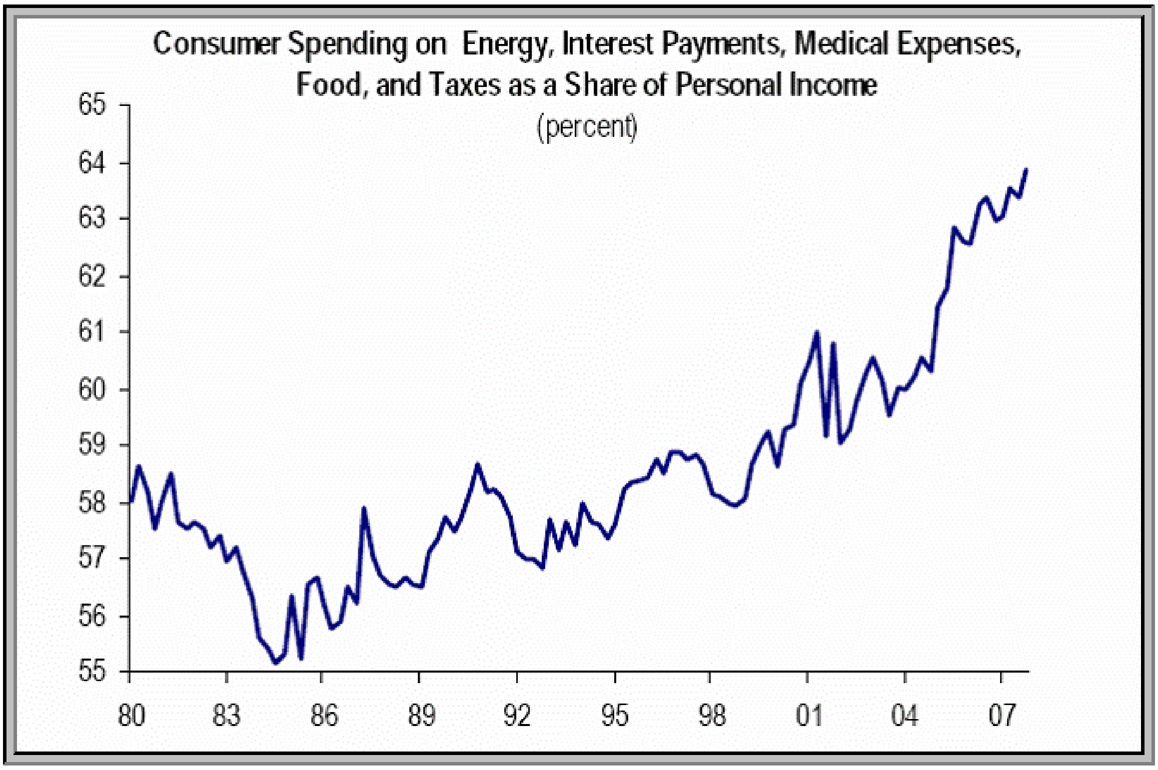
Figure 3: Will the Economy and the Stock Market follow GM?



Source: www.decisionpoint.com

Now, all I want to say is that if one of the shrewdest businessmen and asset shufflers could misjudge the merits of GM so badly (google Kirk Kerkorian - not necessarily a nice man but certainly an astute investor - for his fascinating biography) we should have no confidence in calling a low for financial stocks. In fact, I see the financial problems spreading to the real economy. How so? Lending standards are tightening everywhere. At the same time prices of necessities are rising. The consumer, therefore, has to spend an increasing portion of his income on necessities and is forced to reduce his discretionary spending (see Figure 4).

Figure 4: Higher Costs of Necessities = Less Discretionary Spending!



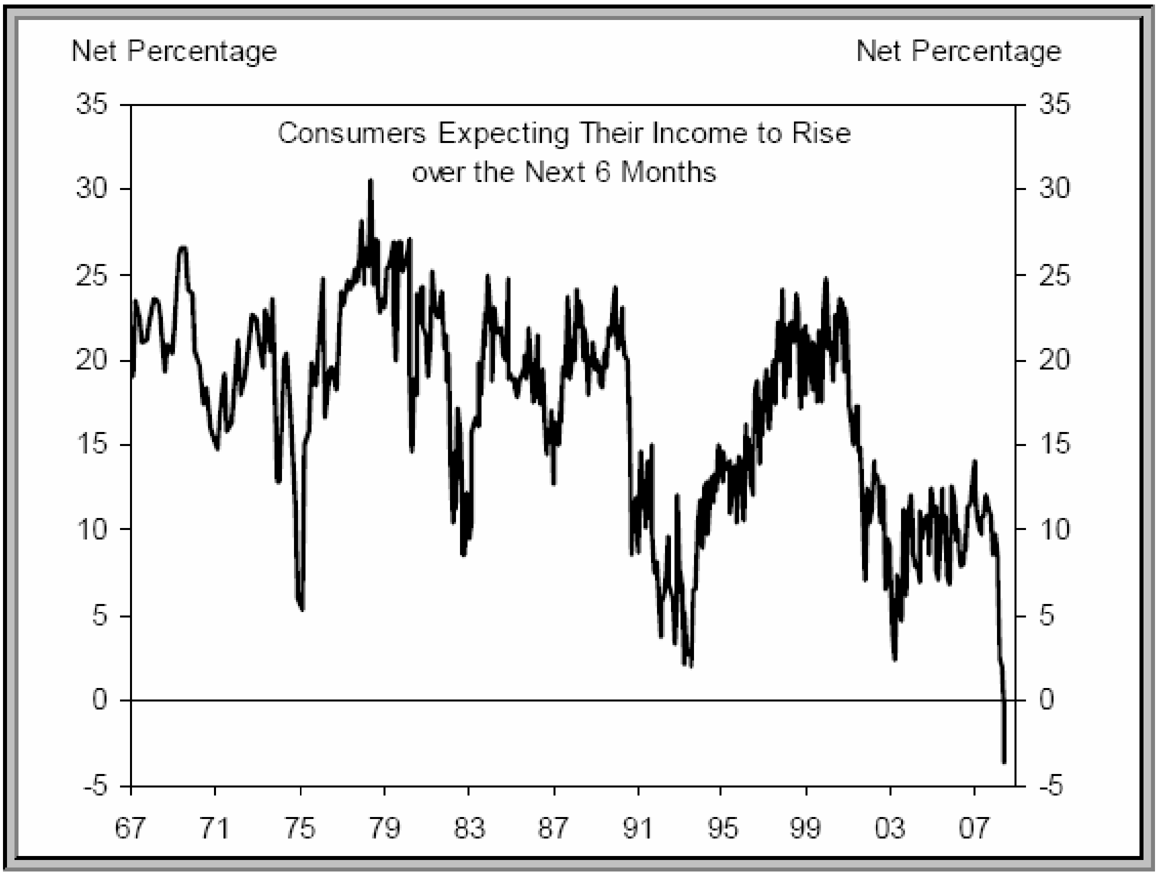
Source, David Rosenberg, Merrill Lynch, Federal Reserve Board

I may add that rising prices of non-discretionary items are an even larger problem for low income earners such as we find in most emerging economies and among more than 50% of the US population. According to Joachim Fels of Morgan Stanley, "50 of the 190 or so countries in the world now have inflation running at double-digit rates. Almost all of these are EM economies. As the double-digit inflation club includes six out of the ten most populous states in the world, 42% of the world's population, or 3 billion consumers, are now experiencing double-digit price increases. As a consequence, many EM central banks are likely to tighten policy (further). However, multiple constraints – first and foremost currency and growth considerations – are likely to prevent a massive global tightening. And global policy is very loose to start with. **Sustained high inflation is bad for long term growth. Thus, there is reason to worry about the continuation of the economic success story in EM countries that have high inflation, are unable or unwilling to**

tighten policy sufficiently, and are commodity consumers rather than producers" (emphasis added).

It should, therefore, not come as a surprise that consumer sentiment in the US and in emerging economies is at record lows (see Figure 5).

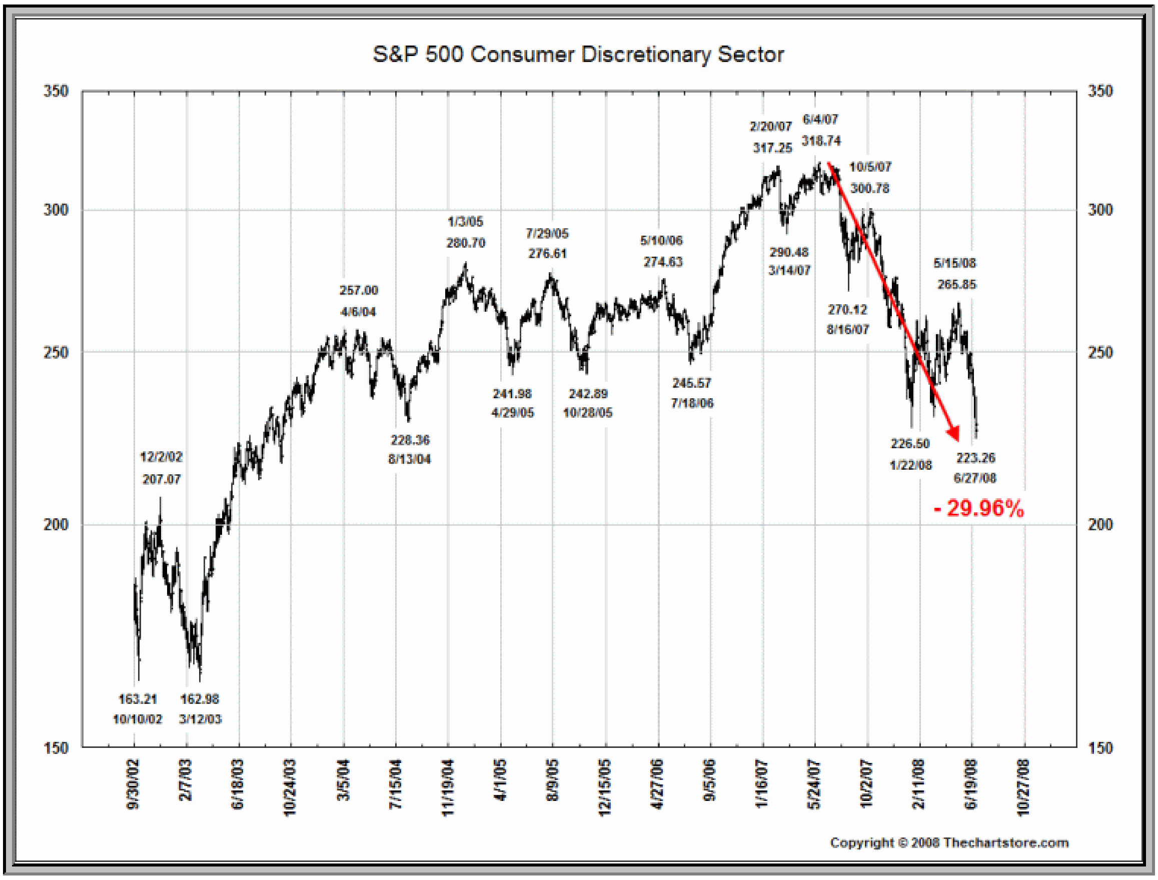
Figure 5: Extremely Negative Sentiment about Income prospects!



Source: Conference Board, Goldman Sachs Economic Research

Two observations: It should be evident from the personal experience of my readers that current cost of living increases exceed income gains for more than 90% of the world's population (in my humble opinion for 99.9% of the world's population because even the asset shufflers experience now declining incomes and wealth. Currently, only very few Oligarchs and oil sheiks enjoy rising incomes). Hence, real incomes are declining just about everywhere but more so in low income emerging economies than in the industrialized world. Soaring food and energy prices hit people with a per capita income of less than US$1,000 per year far more than people with a per capita income of US$50,000. Still, even in more advanced economies, declining real incomes and soaring prices for necessities are hurting even the well-to do (see Figure 4 and Figure 6).

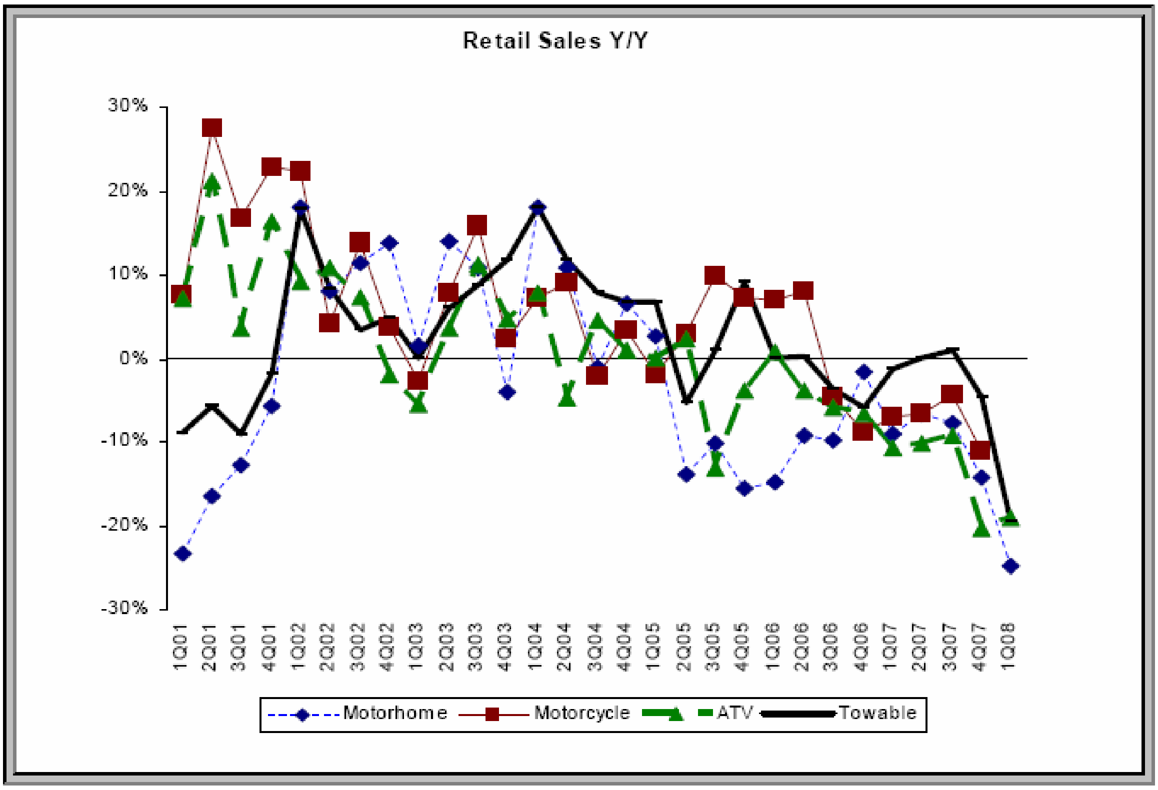
Figure 6: Discretionary Consumer Stocks are a better Indicator of Consumption Trends than Government-Controlled Economic Statistics!



Source: Ron Griess, www.thechartstore.com

That the more affluent class, which is also leveraged to the hilt, is suffering from lower disposable income and in particular from declining asset prices is evident from sharply declining sales of big ticket items (see Figure 7).

Figure 7: Retail Sales of Big Ticket Items

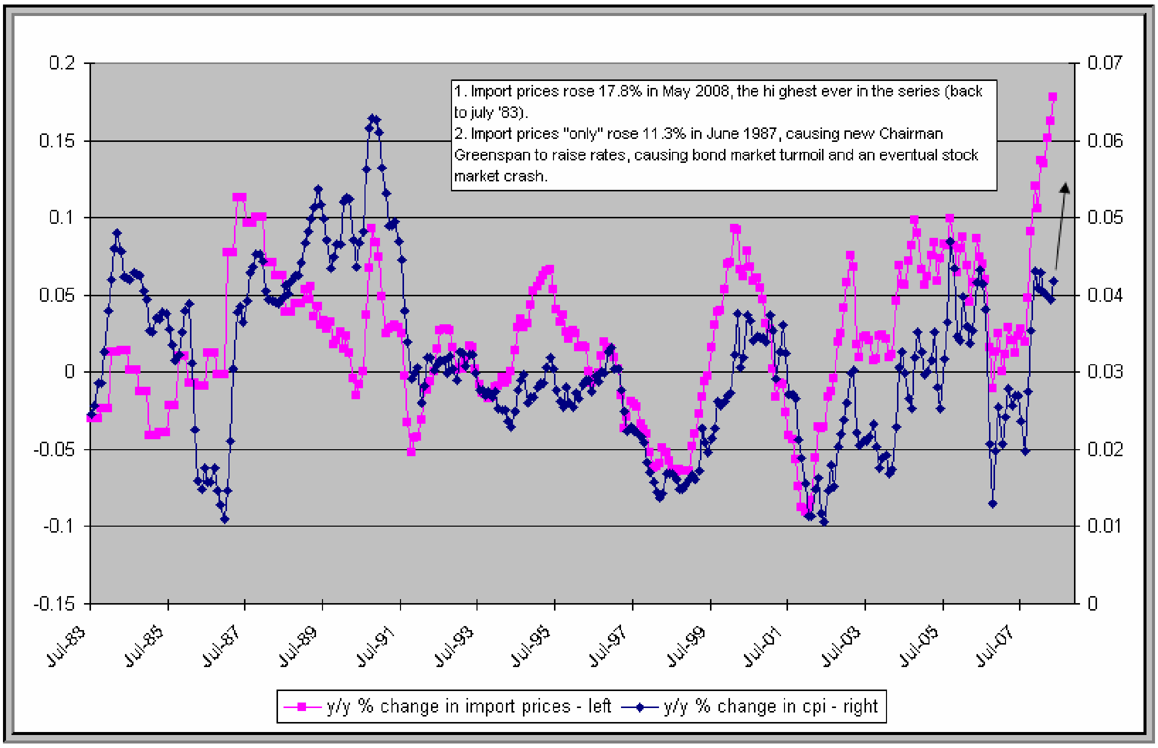


Source: Citigroup

According to Bloomberg, Brunswick, the manufacturer of bowling equipment and recreational boats will close 12 plants and dismiss as many as 2,700 workers after **U.S. power-boat sales fell to the lowest in more than 40 years**! According to Brunswick's CEO, a shrinking U.S. job market, surging fuel prices and declining home values reduce consumers' ``ability and desire'' to buy boats, billiard tables and fitness equipment. He added that, **"we are not assuming that these pressures will abate any time soon.''** Also, according to the AAA, the number of travelers over the
U.S. Fourth of July holiday will decline for the first time this decade. According to AAA, 40.5 million people will travel over the Independence Day weekend July 4-6, a 1.3 percent decrease from a year earlier (the number of air travelers over July 4th will probably fall 2.3 percent to 4.5 million).

The second observation I wish to make is that Mr. Bernankehas badly damaged the economy of millions of Americans in order to bail out a few Wall Street clowns who operated with a leverage of between 20 and 30 to 1. Americans are suffering - because of Mr. Bernanke's irresponsible monetary policies - from low deposit rates on their accumulated savings (negative real interest rates) and from soaring food, energy and import prices, which all reduce their real incomes (see Figure 8).

Figure 8: Soaring Import Prices Courtesy of Helicopter Ben!

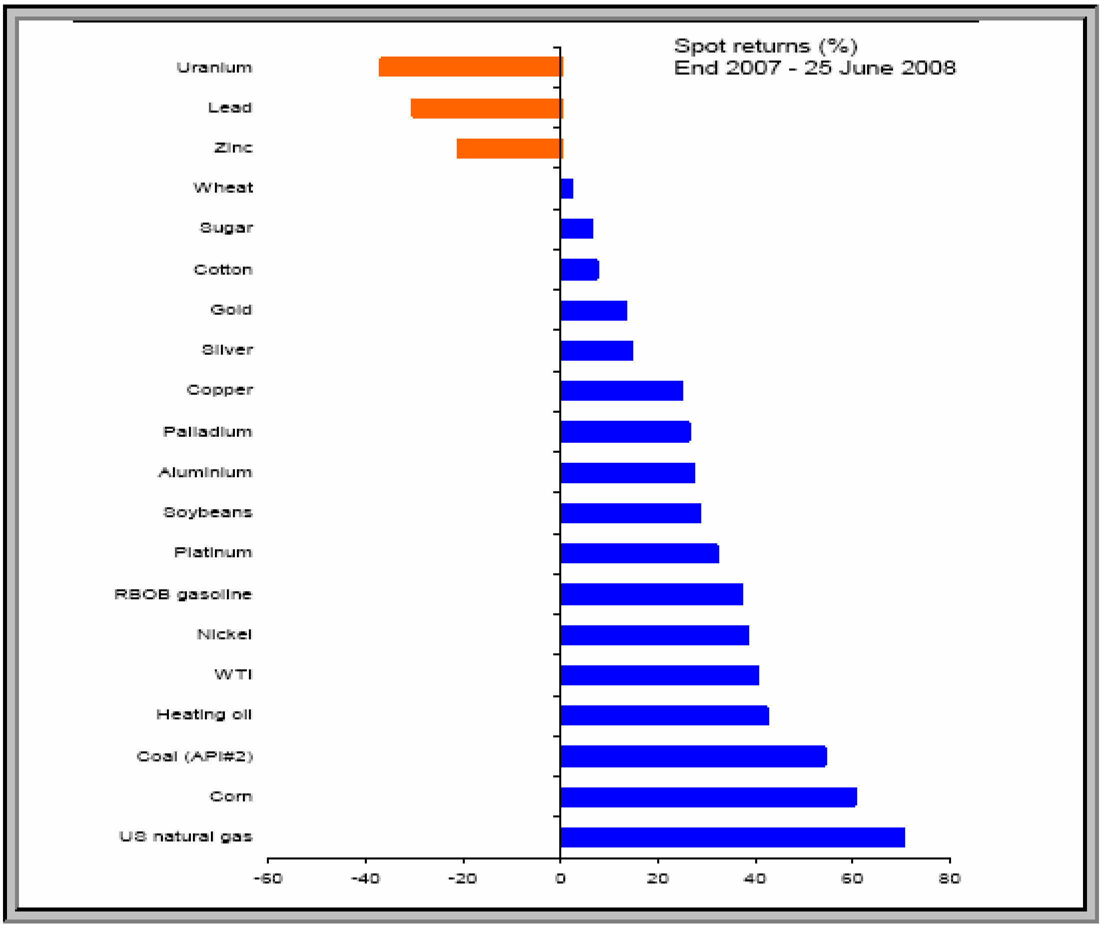


Source: Lee Markowitz

But Mr. Bernanke deserves at least one credit point. He has succeeded where America has largely failed – namely in boosting US exports. Not exports of goods and services but exports of inflation around the world thanks to the US trade and current account deficit which flood the world with approximately $ 800 billion annually! If there was a price for total incompetence in international economics Mr. Bernanke would win it by miles.

Now, it would be unfair to blame solely Mr. Bernanke for exporting inflation around the world via soaring commodity prices which hit, as indicated above, low per capita income countries far harder than high income countries (see Figure 9).

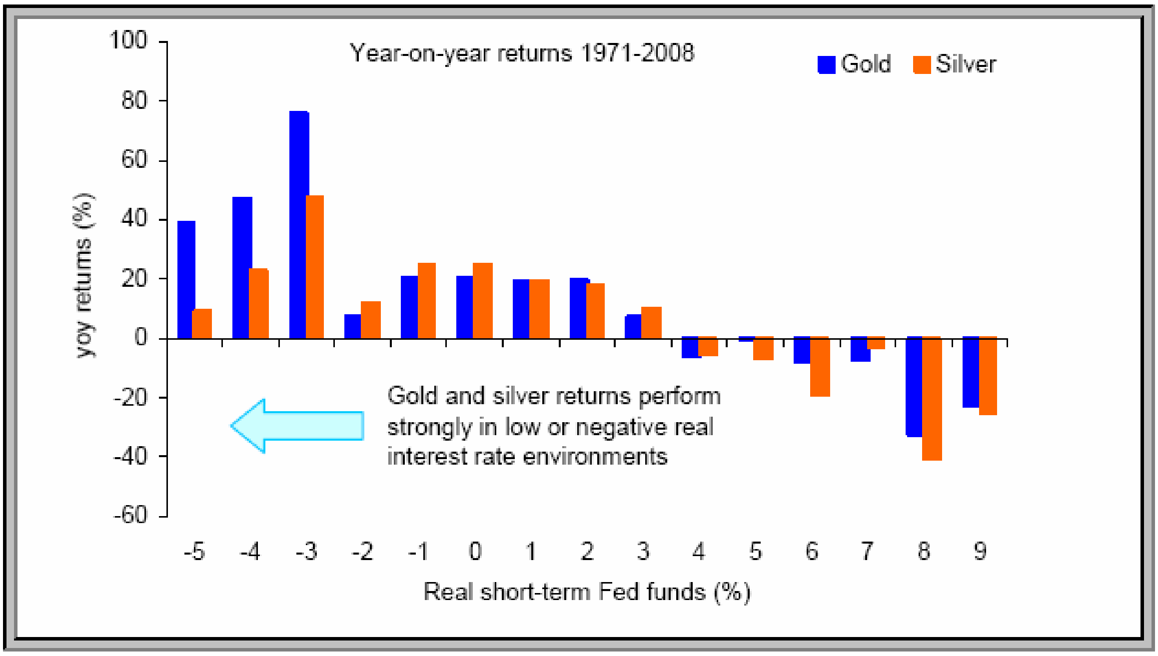
Figure 9: Commodity Spot Returns Year-to-Date



Source: Michael Lewis, Deutsch Bank

But it should be evident even to a non-economist or a Federal Reserve Board Member that an environment of negative real interest rates is particularly favorable for hard assets to increase in price and to produce a series of different bubbles in different sectors of the economy and asset markets (NASDAQ in 2000, housing in 2006, and now commodities). Figure 10 clearly shows that gold and silver (but also other commodities) perform particularly well when real interest rates are negative (see Figure 10).

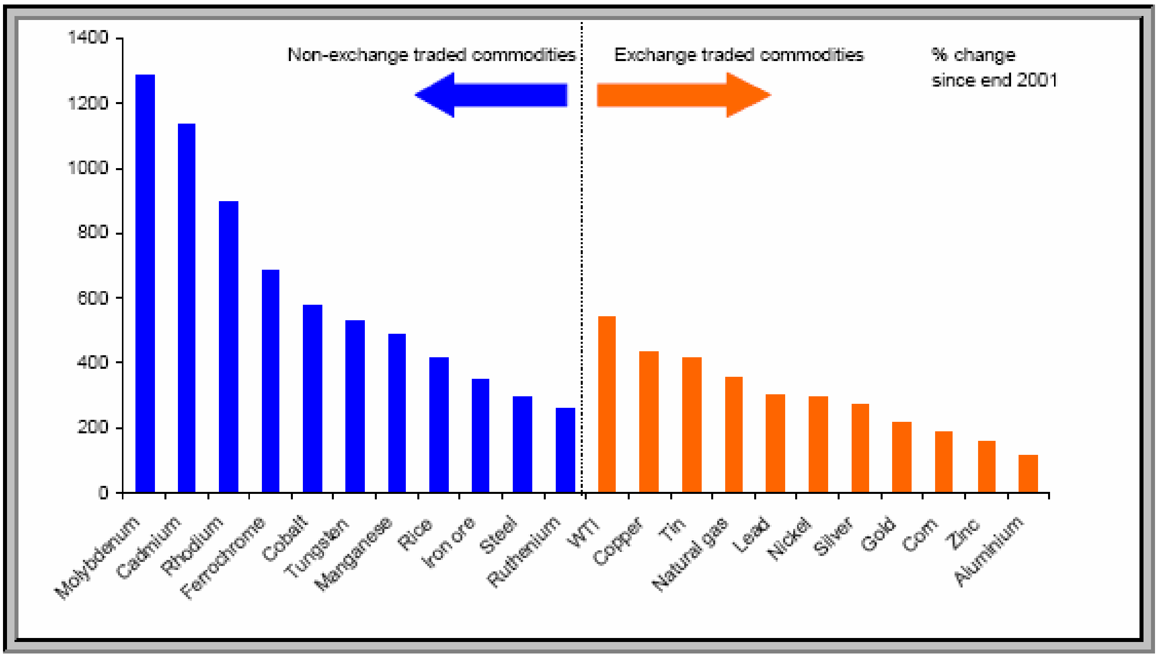
Figure 10: Gold and Silver Returns amidst Negative and Positive Real Interest Rates.



Source: Michael Lewis, Deutsche Bank

But as one could expect, government officials and fund managers who were short commodities or simply do not understand the difference between gold, other commodities and washing machines now blame the speculators for the rise in prices. Of course for these people who are indeed suffering from acute economic sophism speculation was most welcome as long as it drove up the NASDAQ, the housing market and financial stocks through an almost unbelievable increase in leverage (credit). But when commodity prices increase it does not fit within their faulty and abstruse economic models. But what is interesting is that non-financially traded commodities (for which there are no public futures markets or ETFs) have in general out-performed financially traded commodities (see Figure 11).

Figure 11: Performance of Financially and non-Financially Traded Commodities, 2001 – 2008



Source: Michael Lewis, Deutsche Bank

I may add that gold has had a minor bull market so far when compared to other commodities and when compared to the bull market in the 1970s (see Table 1).

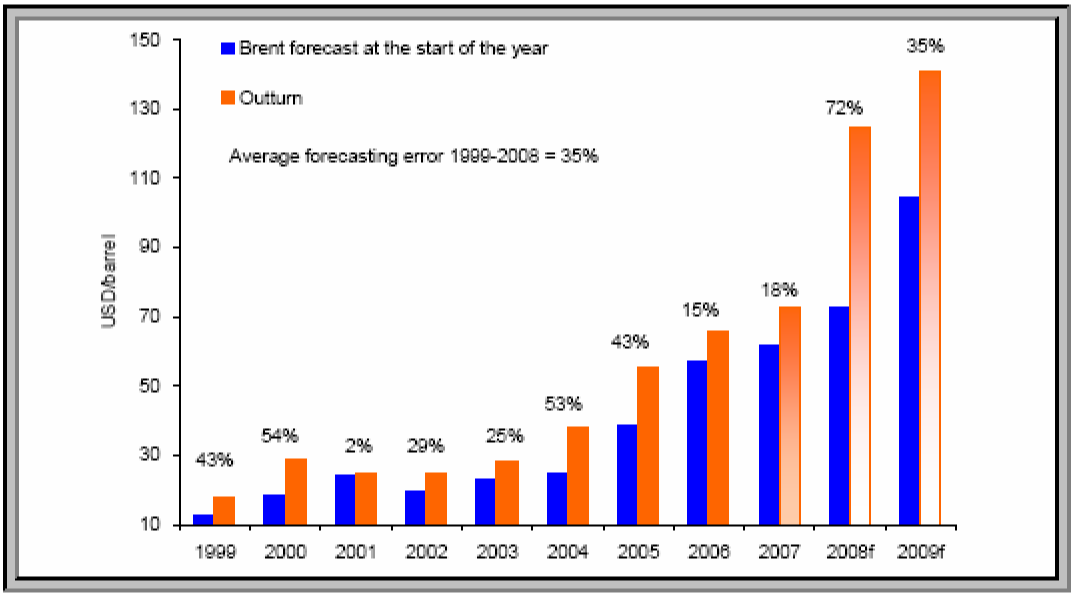
Table 1: Current Gold Bull Market in Perspective

	Low USD/oz	High USD/oz	Magnitude (% change)	Duration (months)
Aug-71 to Feb-75	35.4	183.9	419%	42
Aug-76 to Jan-80	103.5	850.0	721%	41
Jun-82 to Feb-83	296.8	509.25	71.6%	8
Feb-85 to Dec-87	284.3	499.8	75.8%	34
Apr-01 to Mar-08	**255.6**	**1,003.0**	**292%**	**84**

Source: Michael Lewis, Deutsche Bank

One more point: That the Fed chairman has not the foggiest idea about commodity cycles is not surprising. However, that the community of analysts continuously underestimated the increase in oil prices since 1999 (oil bottomed out in 1998) says enough about the skills of analysts and of strategists (see Figure 12). As can be seen, the average forecasting error since 1999 has been 35% but seems to have increased in recent years….

Figure 12: Oil Forecasting Error among the Analyst Community!



Source: Michael Lewis, Deutsche Bank

Investment Observations

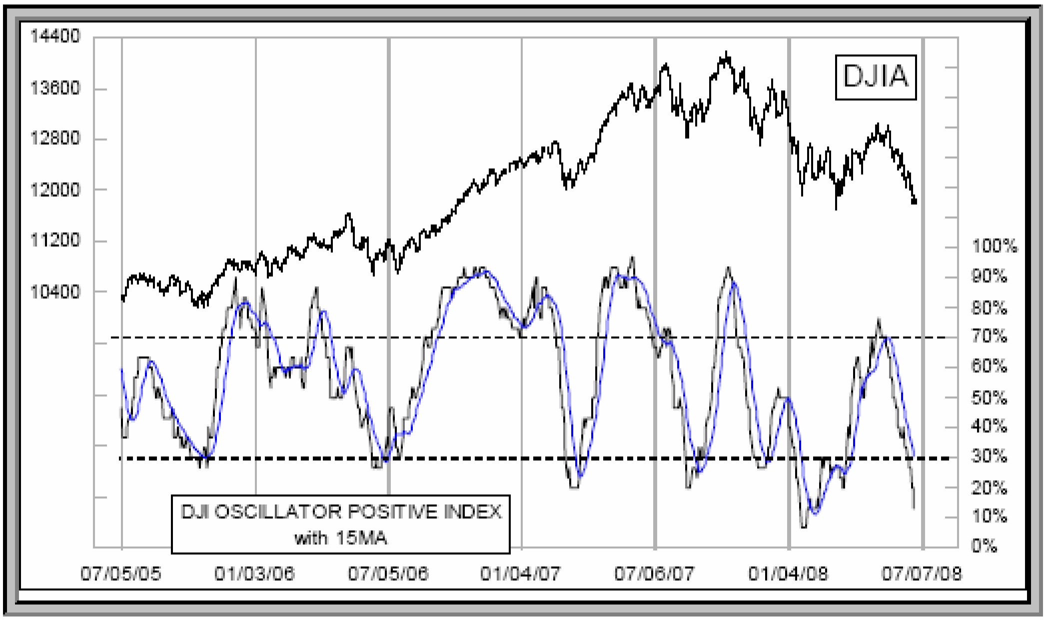
Last month's report recommended to go long US dollars with a tight stop. This recommendation is now withdrawn and a neutral position of US dollars against other currencies is recommended. I may, however, depending on interest rate movements and a further tightening of global liquidity at any time reenter the market and establish a long US dollar position.

Although I have warned that gold could decline in a corrective move to around $ 800 I think the possibility of missing another strong upward move outweighs the relatively modest downside risk. With Mr. Bernanke at the Fed and either Mr. Obama or Mr. McCain becoming the next President of the US, gold will undoubtedly move higher.

Unleveraged gold positions are recommended whereby a decline to around $800 could still happen, particularly if oil prices should retreat.

In the US, a very large number of stocks have just recently made new yearly lows including AIG, GE, Citigroup, JPMorgan Chase, Bank of America, Wachovia, MGM Mirage, Wynn Resorts, Weyerhaeuser, FedEx, Callaway Golf, International Paper, United Technologies, Boeing etc. As a result, the stock market has become from a near term perspective very oversold (see Figure 13)

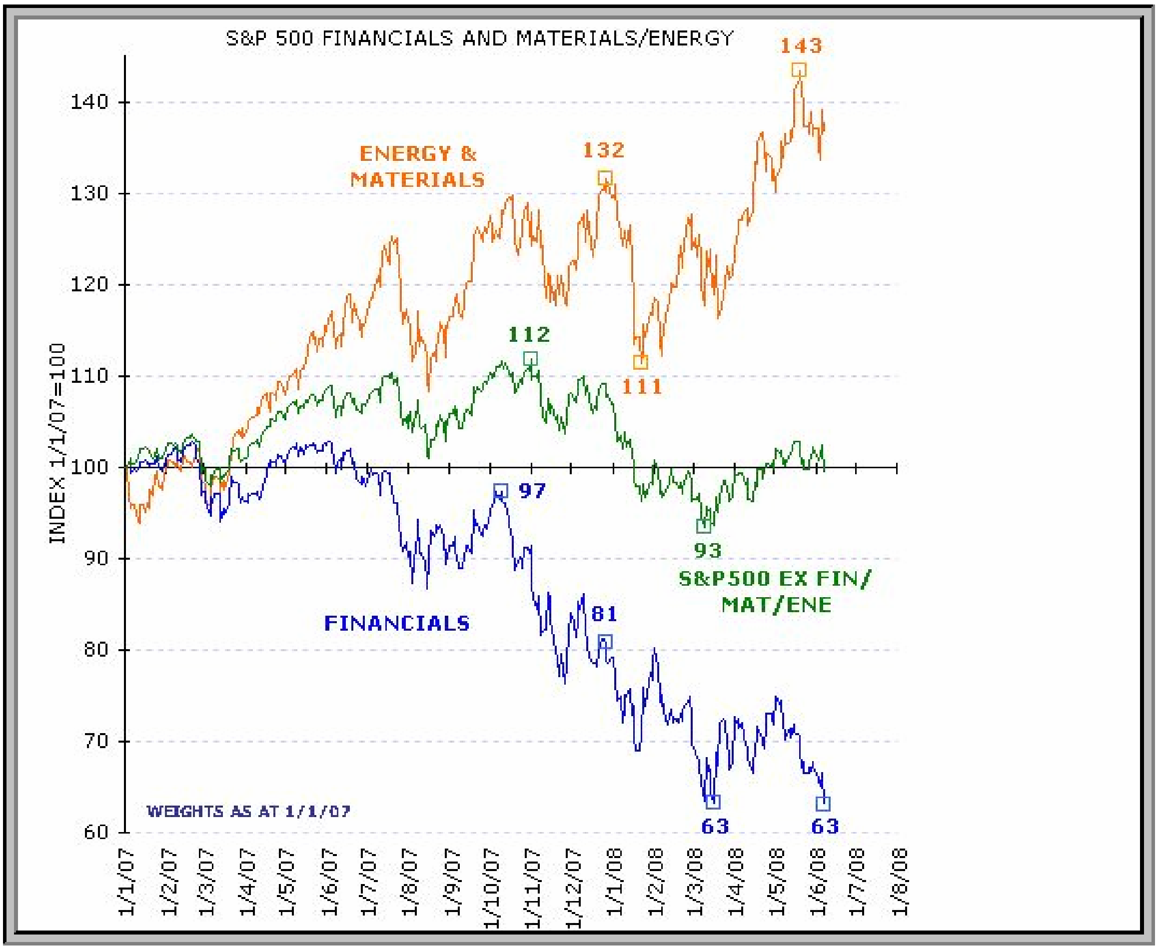
Figure 13: Dow Jones Industrial Average Oscillator Indicating a Deeply Oversold Condition.



Source: Tom McClellan, the McClellan Market Report, (tom@mcoscillator.com)

However, before a more meaningful low can be reached a large number of stocks, which were until recently strong, need to break down. I am thinking here in particular of stocks such as Apple, Research in Motion, Amazon, IBM, Google, and material and energy and related shares. As can be seen from Figure 14, the stock market's weakness has been concentrated among financial stocks although it has been spreading recently to other sectors as indicated by the growing list of new lows.

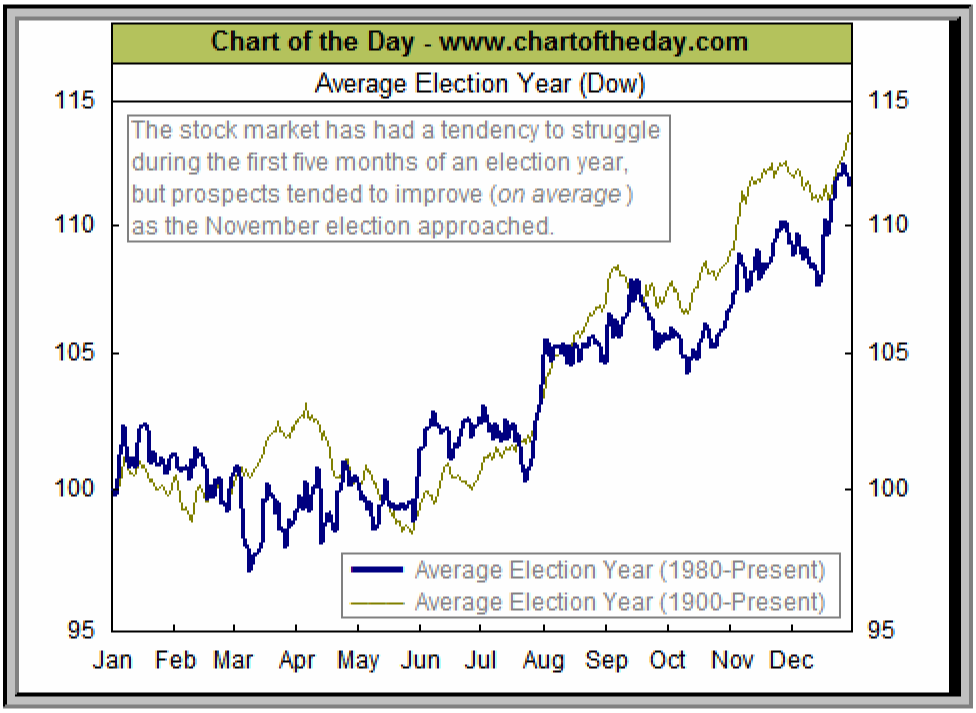
Figure 14: Strongly Diverging Performance will need to be closed by the Overall Market succumbing to the Weakness in Financial Stocks.



Source: Gerard Minack, Morgan Stanley

It should also be noted that in a bull market prices can remain in over-bought territory for a very long time (NASDAQ 1998 – 2000). The same is true in a bear market: Prices can remain oversold for a very long time or the oversold position can be corrected through a series of brief but sharp bear market rallies (I should also mention that before the stock market crashed on October 19, 1987 by 21% in one day an oversold position already existed). Still, as mentioned in last month’s report, the period between June and the end of July is characterized by seasonal strength and a rebound to between 1350 and 1380 is possible. In addition, in Election Years, the stock market tends to perform somewhat better in the second half of the year (see Figure 15). However, when I look at the two presidential candidates I have serious doubts that the stock market will like either one of them!

Figure 15: Performance of Dow Jones Industrial Average in Election Years.



Source; www.chartoftheday.com

In sum, I expect the global economy to weaken far more than is currently expected and corporate earnings to disappoint badly. As a result, I would look to sell into rallies – in particular technology and cyclical stocks and emerging market equities.