The American Dream! Dream on!

Marc Faber

"The Treasury bail-out plan (the mother of all moral hazard bail-outs) is socialism for the rich, the well-connected and Wall Street; it is the continuation of a corrupt system where profits are privatized and losses are socialized".

Prof. Nouriel Roubini

According to Bloomberg, "Pakistan investors stormed out of the Karachi Stock Exchange, smashed windows and cursed regulators after the benchmark index fell for a 15th day, the worst losing streak in at least 18 years (see Figure 1). 'I have lost my life savings in the last 15 days and no one in the government or regulators came to help us,' said Imran Inayat, 45, a protester and a former banker who retired early and said he lost 300,000 rupees ($4,175) on the market."

Figure 1: Karachi Stock Exchange, 2000 – 2008

Source: Bloomberg

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Best of all, Kauser Javed, who heads the Small Investors Association, said that "we demand that all stock prices be frozen at current levels. People have sold their assets in the last 15 days to meet payments and if things continue this way, you will start hearing of suicides. The regulators always favor big brokers and investors."

Normally, one would laugh about the story above, which is so typical of the behavior of small investors (this especially since the Karachi market is down only by 34% from its peak 15,739 in early 2008 and still up several-fold over the last three years). Small investors enter the markets after a long bull run because they have heard from a bar girl, taxi driver or from a neighbor that they bought some stocks and made some money. So, "imitation," which is one of the principal drivers of human action, follows and stocks are acquired without any knowledge of the risks, the markets and of the fundamentals. Nothing new! This happens in every investment mania and when the bust comes somebody else (the government, foreign investors, large sophisticated speculators, the oil price etc.) needs to be blamed because it would never occur to the individual in a mass that he is only himself to be blamed for the losses.

However, there is less to laugh when in a advanced economy and well-developed capitalistic system, such as the US, (seemingly) educated government officials and financial experts do seem to think that some asset markets like real estate, bonds and equities should only move up in value but when they decline they need to be supported through all kinds of market interventions (manipulations). But not only that, the Fed by endorsing monetary policies, which keep short term interest rates below the rate of inflation (the true rate of price increases not the bogus CPI published by the BLS) and through an extremely lax regulatory environment actually encourages reckless speculation which leads to bubbles in sectors, with which the Fed can create the illusion of wealth (phantom wealth) such as in equities (Nasdaq 1999/2000) and in homes (2005/06). But, God Almighty, when bubbles burst, which created the illusion of wealth and which are in the blurred eyes and confused heads of the Fed never supposed to deflate, then – and this is the best part – the **symptoms of the problem**, which are the falling asset prices must be boosted with the medication which led to the speculative excesses and the bubble in the first place. The inconsistency of the Fed is evident when one considers that on the one hand the Fed, the Treasury and other policy makers encourage bubbles which create the illusion of wealth. On the other hand they want to stamp out bubbles, which visibly erode consumers' purchasing power, such as soaring energy prices and speculative excesses such as naked short selling, which drive prices down

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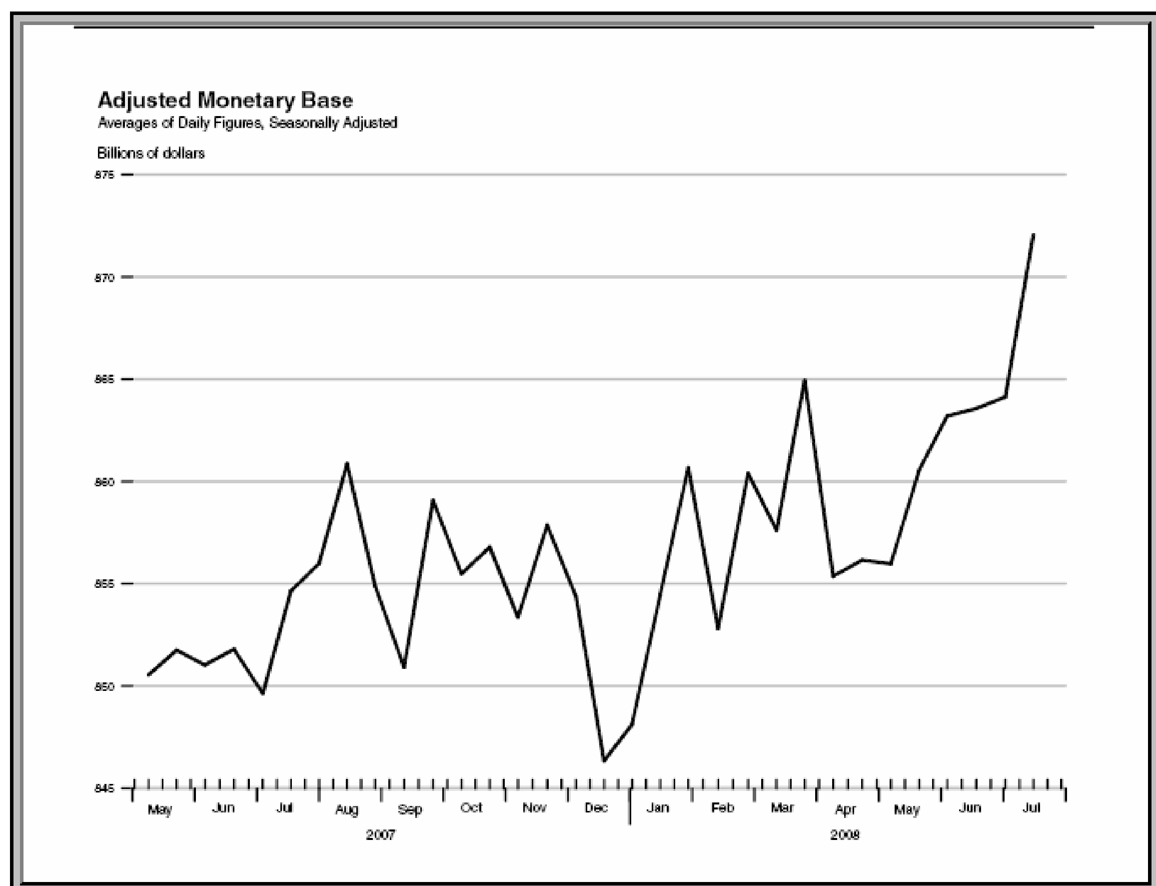
(mind you, I suppose these policy makers would welcome short sellers of oil…). I may add that naked short selling has always been illegal but was tolerated by the SEC – run by Christopher Cox, another very confused and compromised individual – as long as stocks went up….

As I mentioned in an earlier report, I am just speechless at the current extremely questionable practices, price manipulations, inconsistent policies, cover-ups, fraudulent behavior, which are all too common, as well as the total lack of transparency (coming so shortly after Enron blew up) by financial firms, the government and its agencies. No wonder has consumer confidence plunged while the popularity of Congress is at an all time low! Moreover, it should come as no surprise that the credibility of Mr. Bernanke and Mr. Paulson have been badly tarnished. Still, we need to give these two gentlemen some credit: they are good at interventions into the free market and at printing money (see Figure 3)

Figure 3: US Adjusted Monetary Base, 2007 - 2008



Source: Federal Reserve Bank of St. Louis

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In terms of market intervention it became evident on July 16 that the government would essentially ensure the survival of Fannie Mae and Freddie Mac and that the SEC would ban the naked short selling of some financial stocks (not of all stocks). This coincided with earnings of Wells Fargo, which were perceived by the ever optimistic investment analyst crowd to be better than expected and bingo – a huge rally followed which lifted Wells Fargo shares within two days by 40% and Fannie Mae by almost 100% (see Figure 4). Noteworthy was that the rally lifted the most heavily shorted financial stocks far more than the least shorted financial stocks. Noteworthy is also that whereas Fannie Mae rose within three days of its low by 98% it is still down by more than 80% from its all time high.

Figure 4: Fannie Mae, 2007 – 2008

Source: www.decisionpoint.com

But, it should be clear that, as Thomas Donlan pointed out in Barron's, "Fannie and Freddie and the whole mortgage mess represent capitalism at its worst - the Invisible Hand in the taxpayer's pocket. First, it pays out bonuses and benefits to politically connected big shots. Then, it takes

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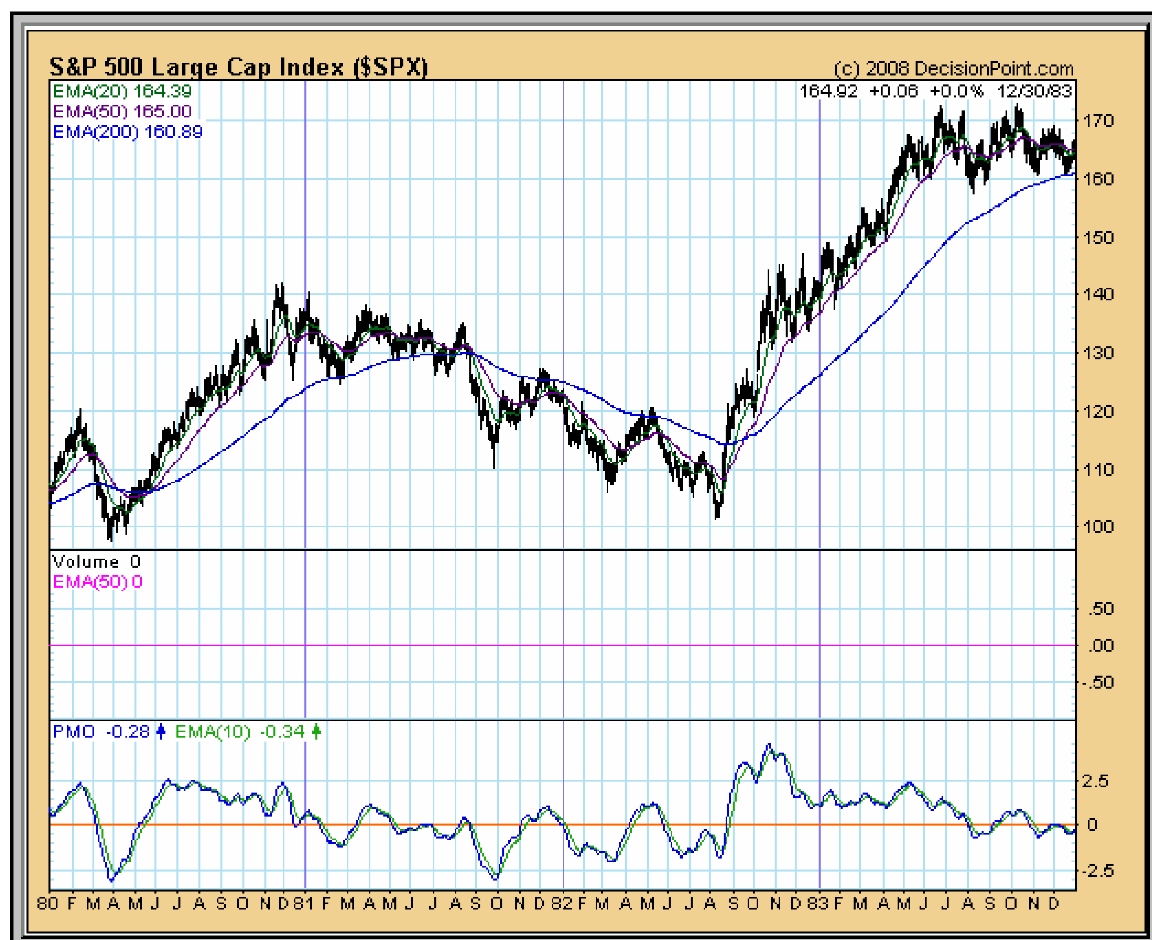
money from some citizens to redress the bad investments of others. It's the classic 'mixed economy,' in which rewards are private and risks are socialized."

Of course, the question which is on every investor's mind is whether the explosive rally, which unfolded after July 16, is the beginning of a new bull market the way the explosive rally on August 21, 1982 led to a long term bull market (see Figure 5)

Figure 5: S&P 500, 1980 - 1983



Source: www.decisionpoint.com

There are several reasons to seriously doubt that we are at the beginning of a powerful bull market such as we were in 1982. For one, in 1982, the US stock market was no higher than it had been in 1964 and it was down in real terms by more than 75% from its 1966 high. In fact, in 1982, measured in gold terms (in "real" real terms – not in real terms using the

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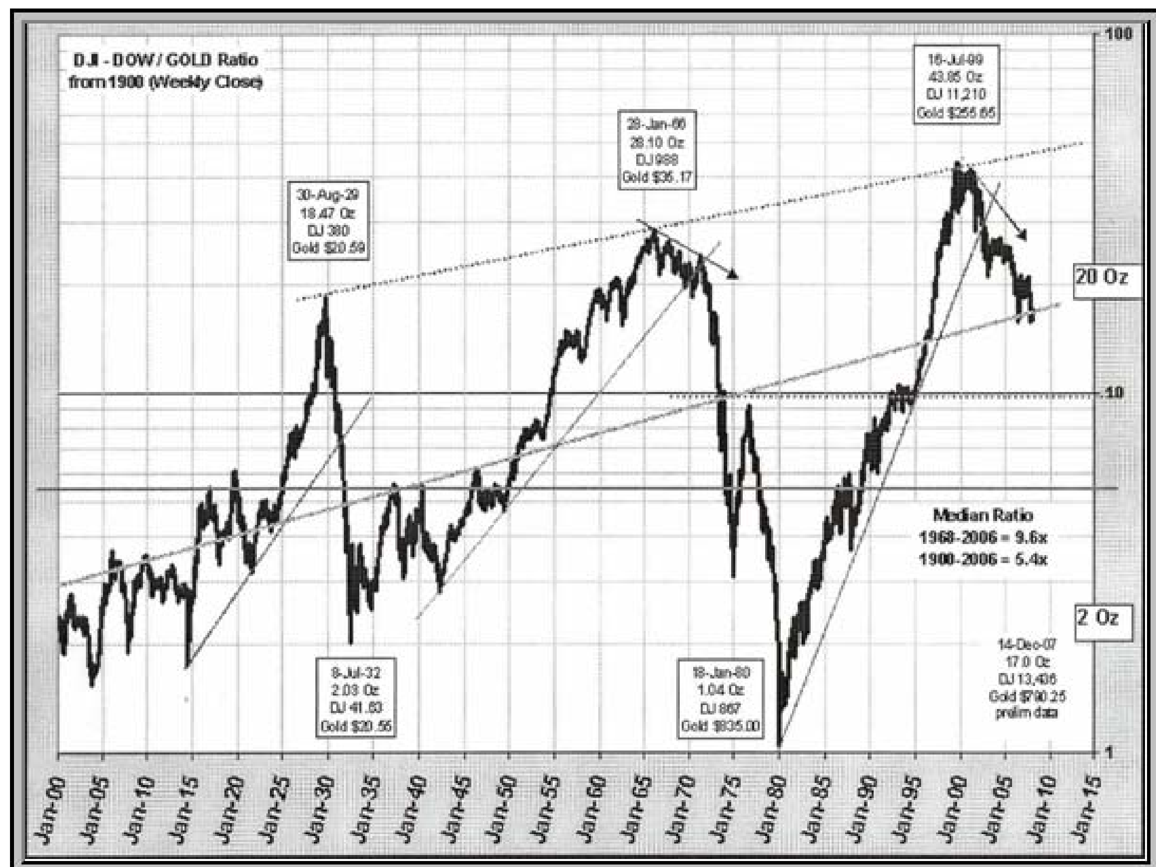
doctored CPI) the Dow Jones was lower than it had been in 1932 following the 90% bear market 1929 -1932 (see Figure 6)

Figure 6: Dow Jones Purchasing Power of Gold, 1900 – 2007



Source: Ian McAvity

So, whereas in 1966, one Dow Jones Industrial Average bought 28 ounces of gold, in 1982 it bought less than two ounces of gold (in 1980, one Dow Jones only bought one ounce of gold). At present the Dow still buys 12 ounces of gold and although this is down from its purchasing power of 44 ounces in 2000 (yes, the Dow has lost in gold terms or in "real" real terms 72% since 2000!), it is far from where stocks usually bottom out after major secular up-trends end. In this respect, I should like to attract my dear readers' attention to the fact that financial assets and gold move in very distinctive long-term trends. In the last 110 years the trend is very clearly defined by six major phases: 1900 – 1929: stocks outperform gold by a wide margin. 1929- 1932: gold outperforms equities. 1932 -1966: stocks outperform gold. 1966 – 1980: gold outperforms equities. 1980 – 2000: equities outperform gold. 2000 - ????

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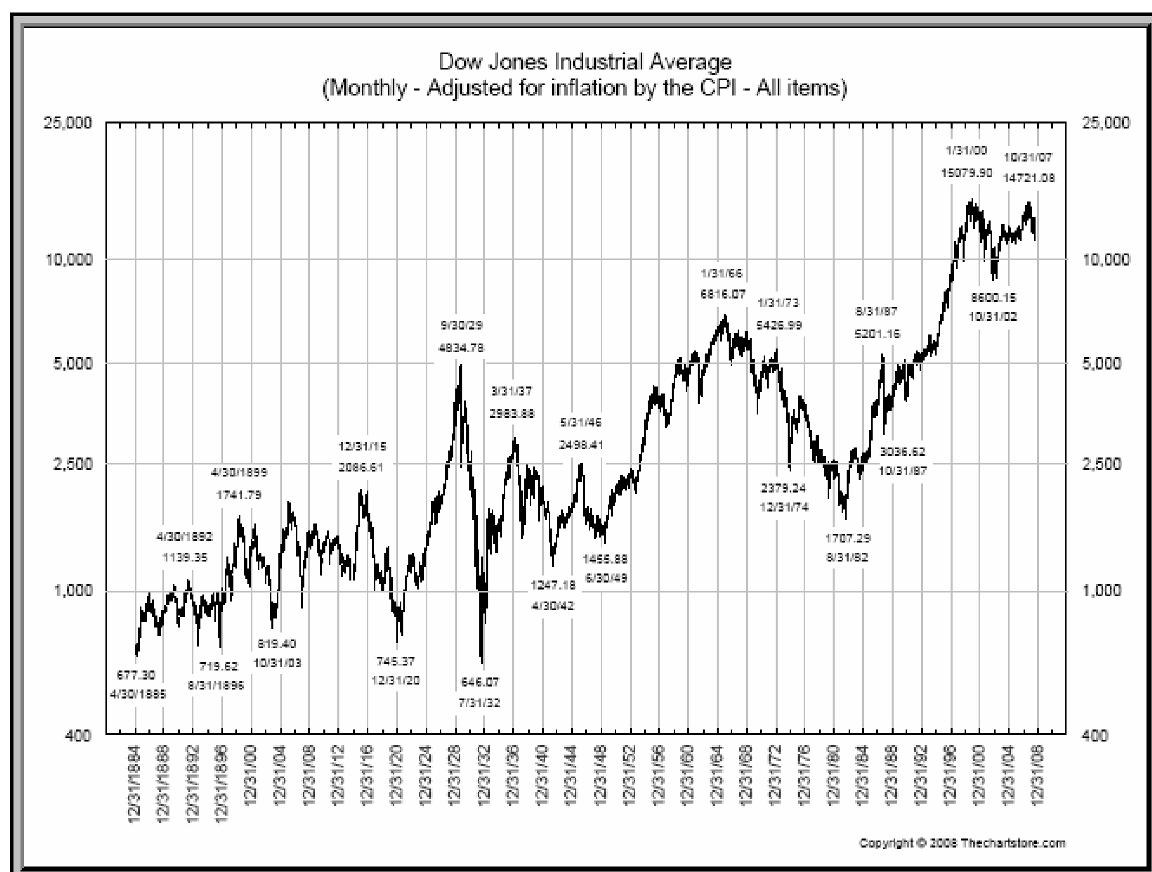
gold outperforms equities. In one instance the outperformance of gold lasted only two years (1929-1932) but the outperformance was massive indeed. But in general the trends, once, in place, last a long time. Given that the median Dow/Gold ratio between 1900 and 2006 was 5.4 (see Figure 6) the Dow's current purchasing power of 12 ounces of gold is still relatively high. In other words, gold or inflation adjusted the Dow is still expensive (see Figure 7)

Figure 7: Dow Jones Industrial Average, 1885 – 2008, Inflation Adjusted



Source: Ron Griess, www.thechartstore.com (a highly recommended chart service).

Simply put, in 1982, stocks were dirt cheap (P/E 7, dividend yield 7%) whereas now stocks are still pricey. Moreover, aside from so many other conditions, which were far more favorable in 1982 (debt-to-GDP only 130% compared to current debt-to-GDP of 350% ex unfunded liabilities,

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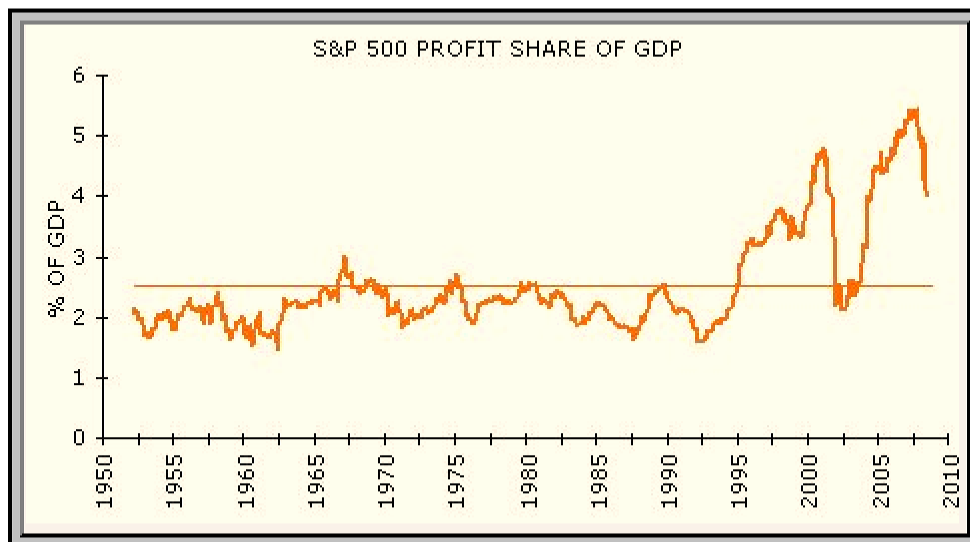
saving rate of 12% versus current saving rate of zero, mutual fund cash positions of almost 15% compared to 4% now, etc) commodity prices and interest rates - the latter were then at over 15% on long- term Treasuries compared to around 4% now - were about to enter long term down-trends that would lift the valuation of equities, boost corporate profit margins and lift corporate earnings. However, these conditions no longer exist today! Interest rates will only decline further if there is a deflationary bust – not exactly a positive for equities. Also, whereas commodities could decline quite sharply in the near term should global demand collapse (major economic slump) the long term trend would seem to be on the up, courtesy of money printer Ben and stock manipulator Hank. Lastly, whereas in 1982 corporate profit margins were at depressed levels, today they still seem to be – from a historical perspective – close to record levels (see Figure 8)

Figure 8: S&P Profit Share as a Percentage of GDP, 1950 – 2008



Source: Gerard Minack, Morgan Stanley

So, all in all, I very much doubt that the current stock market strength is the beginning of a long-term uptrend. Quite on the contrary, I suspect that the weakness we have experienced in financial shares over the last 12 months or so will spread to other sectors of the market, which have so far held up well (see Figure 9).

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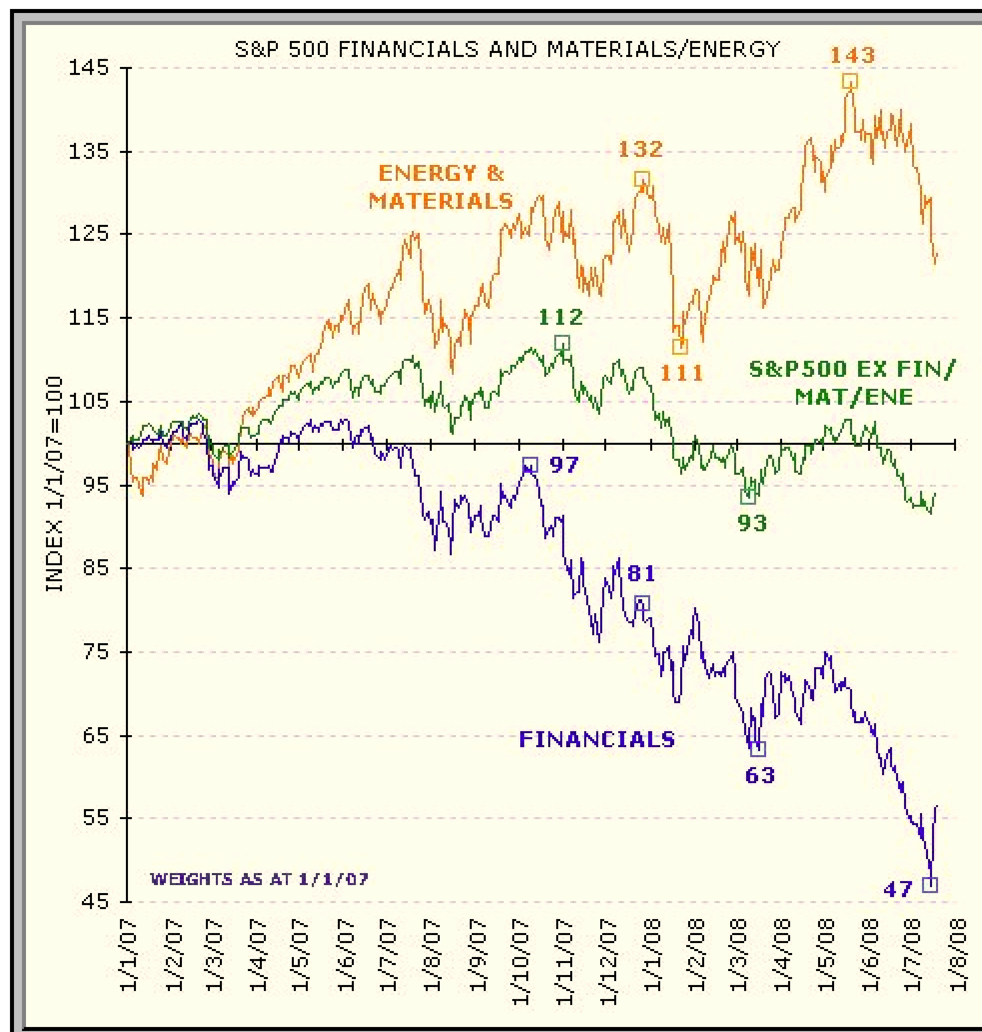
Figure 9: Financials and Non-financial US Equities



Source: Gerard Minack, Morgan Stanley

As can be seen, since the beginning of 2007, the S&P ex financials is hardly down because of the strength in energy and material shares. However, because of an unprecedented slowdown in credit growth, which is occurring despite the Fed and the Treasury Department's interventions, I expect the weakness in the financial sector to spread eventually to just about every sector of the equities market (see Figure 10).

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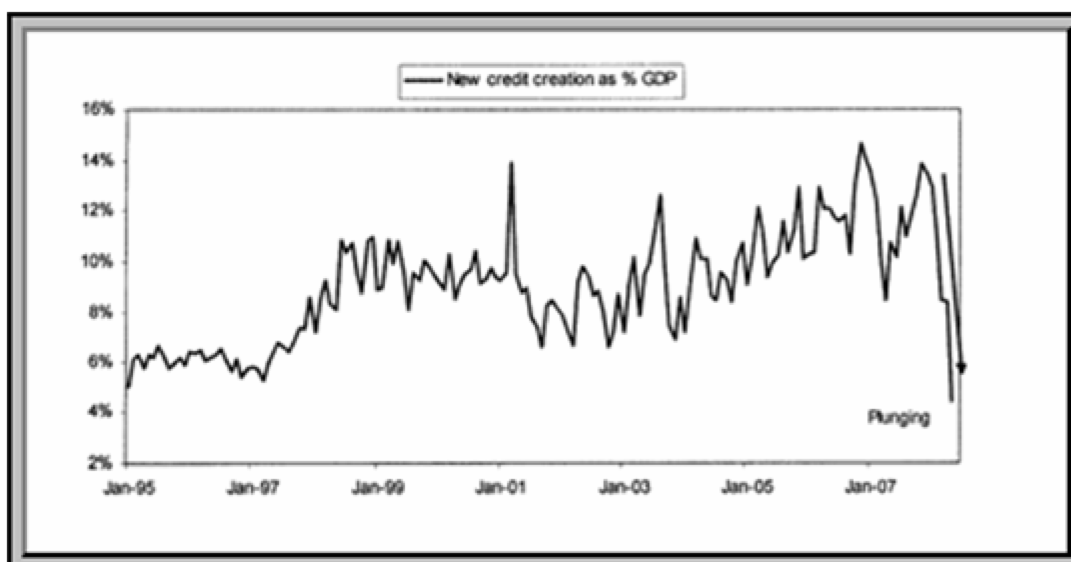
Figure 10: Unprecedented Collapse in New Credit Creation (as Percent of GDP), 1995 – 2008.



Source: Bridgewater Associates

The problem with re-stimulating credit growth is that, as David Rosenberg so well puts it, "lowering the funds rate hasn't really accomplished a thing". According to Rosenberg, "the general level of private sector interest rates has backed up 70 basis points since May, and is actually now (at 6.85%) back to levels prevailing before the Fed began to cut the funds rate last September" (see Figure 11). "Talk about pushing on the proverbial string. The Fed has sliced the overnight rate by 325 basis points over a ten month span, potentially sacrificing its inflation-fighting credentials along the way (not in our eyes, but certainly in others), and there has been no net beneficial effect at all on the overall credit market. In over two decades of experience on the Street, let's just say I have never seen this condition before, and Bernanke has only read about it (and remember what era he is an expert in)"

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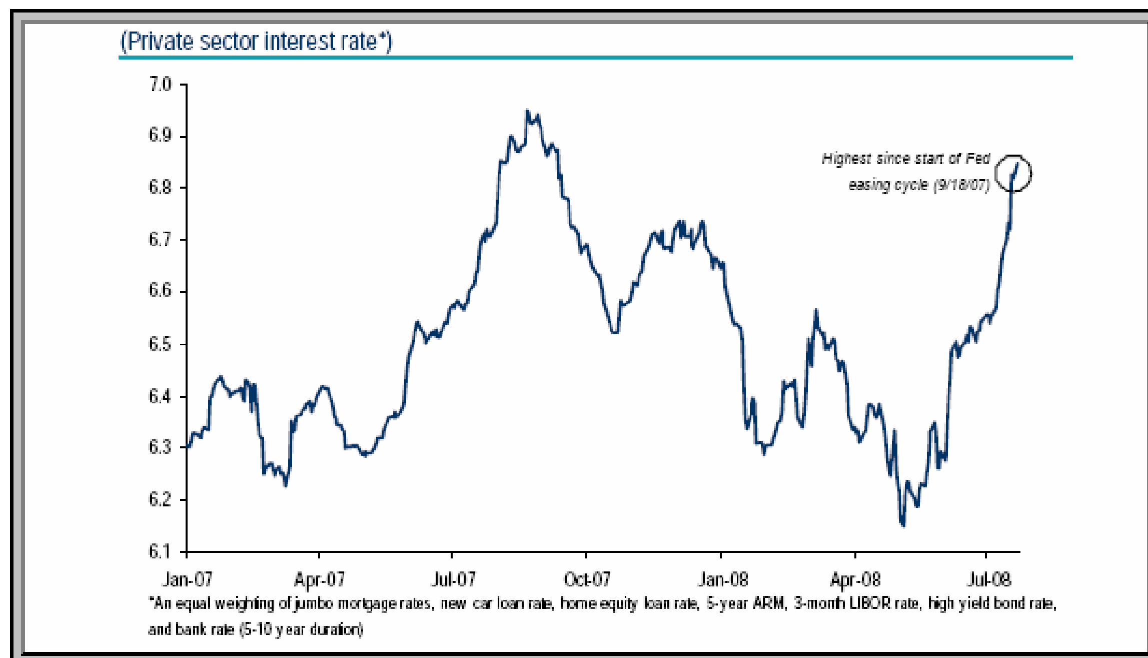
Figure 11: Monetary relief not filtering through to private sector



Source: Haver Analytics, David Rosenberg, Merrill Lynch

The current situation is exactly as a friend of mine, Eric Hermann, President of FH International Asset Management, described it in a recent email he sent me: "I was just re-reading your particularly delightful July 1st edition of the GB&D and wanted to make two points with respect to the Fed's "loose" monetary policy, which extends artificially low cost funding in artificially large quantities to certain lucky beneficiaries (banks, investment banks). These happy few beneficiaries are not passing on their subsidized cost and availability of funds to their customers. We American taxpayers are instead facing expensive cost of borrowing and restricted amounts of available credit from these same financial institutions. In other words, the Fed is writing a massive check to the shareholders of the commercial and investment banks. This subsidy would produce an uproar if the government were transparent about its existence and size, but the Washington politicians cleverly characterize the transfer of wealth from the taxpayer to the shareholders of Fed supported financial institutions as 'saving the financial system'".

Well put, and by "writing a massive check to shareholders of the commercial and investment banks" the Fed is not addressing the cause of the problem, which is excessive debt and leverage – aside from a rotten and conflict ridden financial sector - but simply shifting "private sector"

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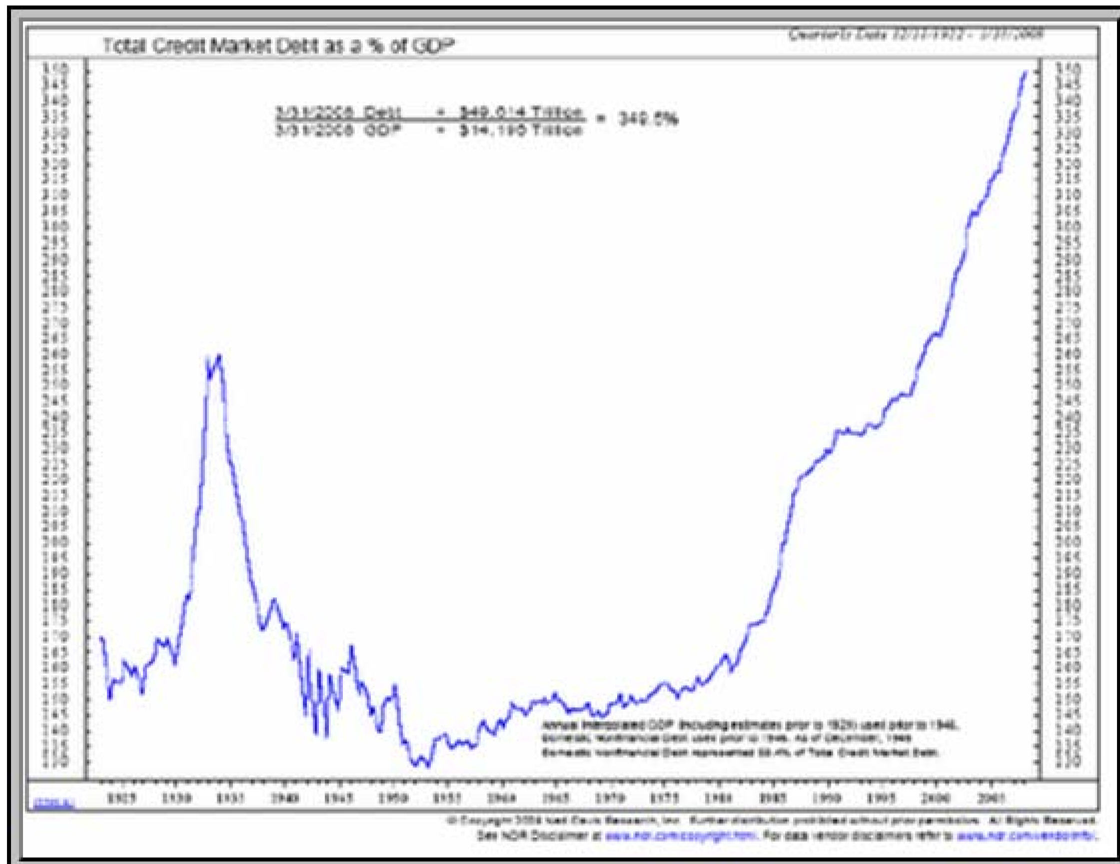
liabilities to the government (the taxpayers). The problem is best exposed by Figure 12!

Figure 12: Total Debt-to-GDP Ratio up from 130% in 1980 to 350%!



Source: Ned Davies Research

Aside from excessive and poor-quality debt there is another problem, which in my opinion will keep equities from entering another powerful uptrend at present, and it relates to earnings transparency. Take Crocs, a manufacturer and designer of fashionable shoes. After its stock had declined from a high of $75 last October to $9 the company recently announced that it now expects earnings per share of 3 cents to 7 cents for the second quarter, significantly lower than the 42 cents to 47 cents per share previously expected. The brilliant stock analysts had according to Thomson Financial projected EPS of 41 cents for the second quarter….

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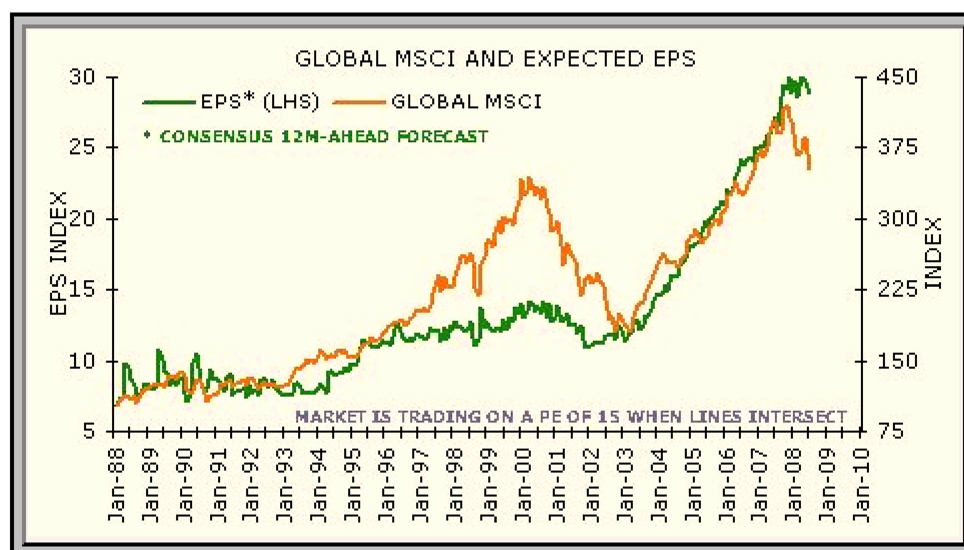
The stock subsequently fell another 50% and trades now at $4.50! As I often said before, the stock market is a far better forecaster than some financial analyst who just listens to and reports in thick research reports the lies management dishes out periodically in order to boost a company's share price. I am mentioning this because whereas the MSCI Global is already down by more than 20% from its high (and some markets are down far more) the consensus earnings estimates by analysts and strategists have hardly declined (see Figure 13).

Figure 13: Consensus 12-Months Forward Earnings Estimates and MSCI Global, 1988 – 2009



Source: Gerard Minack, Morgan Stanley

The bulls' argument is of course "that everybody knows that the forecasted earnings are too high" and that, therefore lower earnings "have already been fully discounted by the stock market." That may be to some extend the case but I very much doubt – as I have shown with the Crocs example – that potentially very poor earnings and no earnings recovery in 2009 have been fully discounted.

Since I get so many questions about "whether one should buy financial stocks" I should like to remind our readers that when a bubble bursts it usually takes a long base building period before a sector comes back to

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life. In the case of pharmaceutical companies such as Bristol Myers (BMY), their stocks' sharp decline was followed by a lengthy period during which a long term base was established from which a new bull market could emerge (see Figure 14). Still, I concede that following its low in 2002 the stock of BMY almost doubled. But the point is that to have bought it even at its low was a poor investment given the strength in the market between October 2002 and October 2007.

Figure 14: Bristol Myers Squibb, 1995 – 2008

Source: www.decisionpoint.com

The same applies to the high tech sector (see Figure 15). If you bought Cisco right at its low the investment was rewarding – especially if you sold the stock at its November 2007 high of $34, but how many investors did that?

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All I wish to say is that once a bubble bursts - (Japan 1989, NASDAQ 2000) and now the credit bubble - the leadership usually changes.

Figure 15: Cisco, 1997 - 2008

Source: www.decisionpoint.com

Consequently, whereas it is possible and actually quite likely that financial stocks will double from their lows the problem is that given the lack of transparency about the quality and value of their assets and poor earnings visibility we do not know for certain whether financial stocks have already made a major low. As a result, am not particularly tempted to buy Citigroup and its domestic and foreign peers (see Figure 16).

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Figure 16: Citigroup: A lengthy Base Building Period to be Expected before the Next Sustained Advance

Source: www.decisionpoint.com

Originally, I had expected a summer rally to get underway and to last from late June to late July. The rally came with some delay and began July 16th from an extremely oversold position and amidst a record short position. Now, while I think that it is quite possible that stocks will rebound another 10% or so in order to move the investment community once again into the bullish camp, it is also likely that after a rebound equities will move once again lower as it becomes evident that the global economy is in recession with dire consequences for corporate earnings. I would, therefore, use stock market rebounds around the world as a selling opportunity.

In an environment of tightening global liquidity, which in theory should be favorable for the US dollar, it is also likely that commodities and

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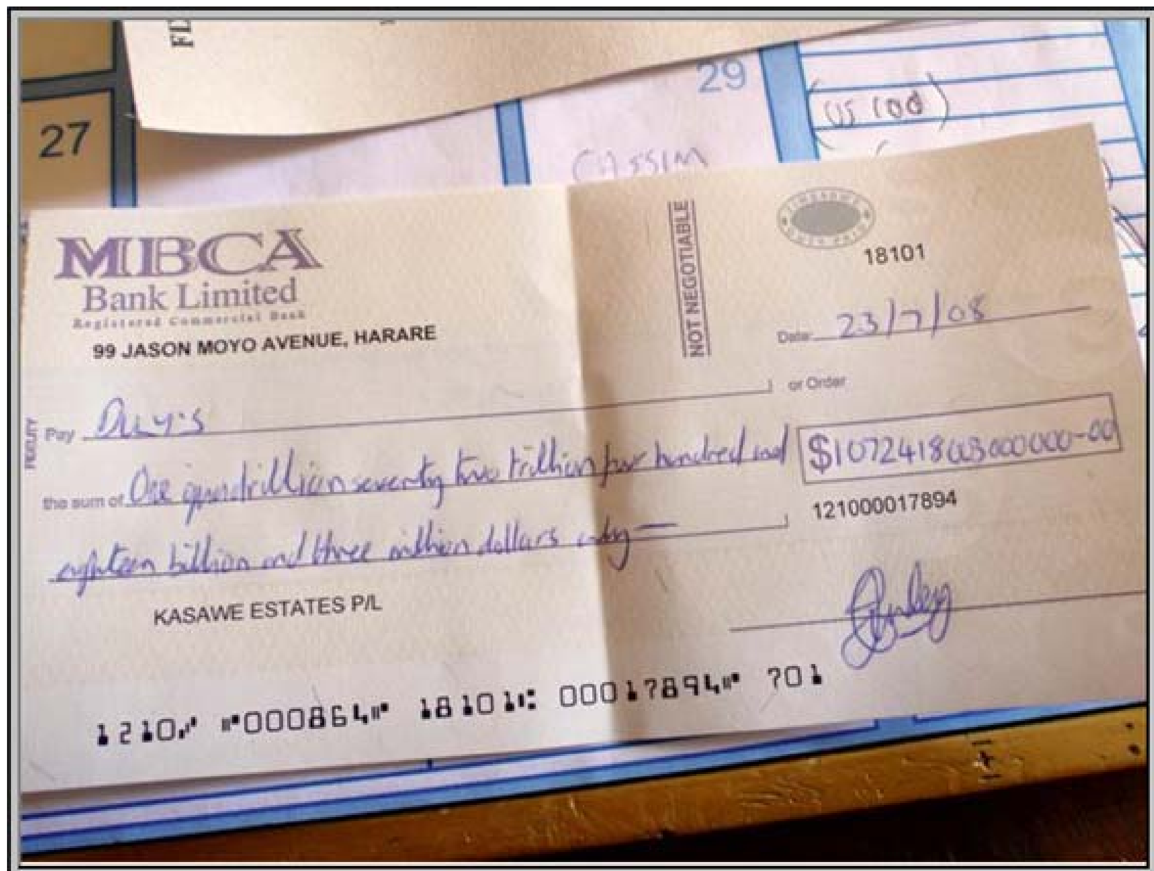
commodity related stocks and related currencies will move lower in the second half of 2008.

I still like gold in a safe deposit box – especially if I look at Figure 3 and at Figure 12 and at the picture below, which was sent to me by my South African friend Faizal Kalla – but I wished gold would break down to around the $800 level in order to provide a better entry point.

Figure 17: From Robert Mugabe with Best Wishes to Ben Bernanke



Source: Faizal Kalla

Finally, since I am frequently asked for career advice by some of my young readers and about short term buy and sell signals from everybody, I have reprinted a letter a friend of mine, Richard Lawrence, recently sent to his investors. I think it is well worth reading because Richard's disciplined value oriented investment style has proven to be extremely successful in the long run.

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