By Not Risking Anything You May Risk Even More!

Marc Faber

**If you think health care is expensive now,
wait until you see what it costs when it's free!**
P. J. O'Rouke

Government is the great fiction through which everybody endeavors to live at the expense of everybody else.
Frederic Bastiat

In all the more advanced communities, the great majority of things are worse done by the intervention of government, than the individuals interested in the matter would do them, or cause them to be done, if left to themselves.
John Stuart Mill (1806–1873)

The price of apathy towards public affairs is to be ruled by evil men.
Plato

I think one of the big mistakes people make is to equate inflation with consumer price increases. Inflation is an increase in the quantity of money and credit. It can then manifest itself in many different ways: commodity, house, stock, art, and collectible price increases or in rising wages and consumer prices. This is the easy part to understand. What is more difficult for investors to grasp (and to forecast) is that when the quantity of money and credit increases, different sectors of the economy and of asset markets can become "inflated" at different times and frequently in rapid succession. This makes the successful navigation through inflationary periods a very tricky occupation. Just as an example: Here we have oil prices, which have rebounded from $ 32 at the end of December 2008 to over $ 70 (and are up from $10 in 1998), at the same

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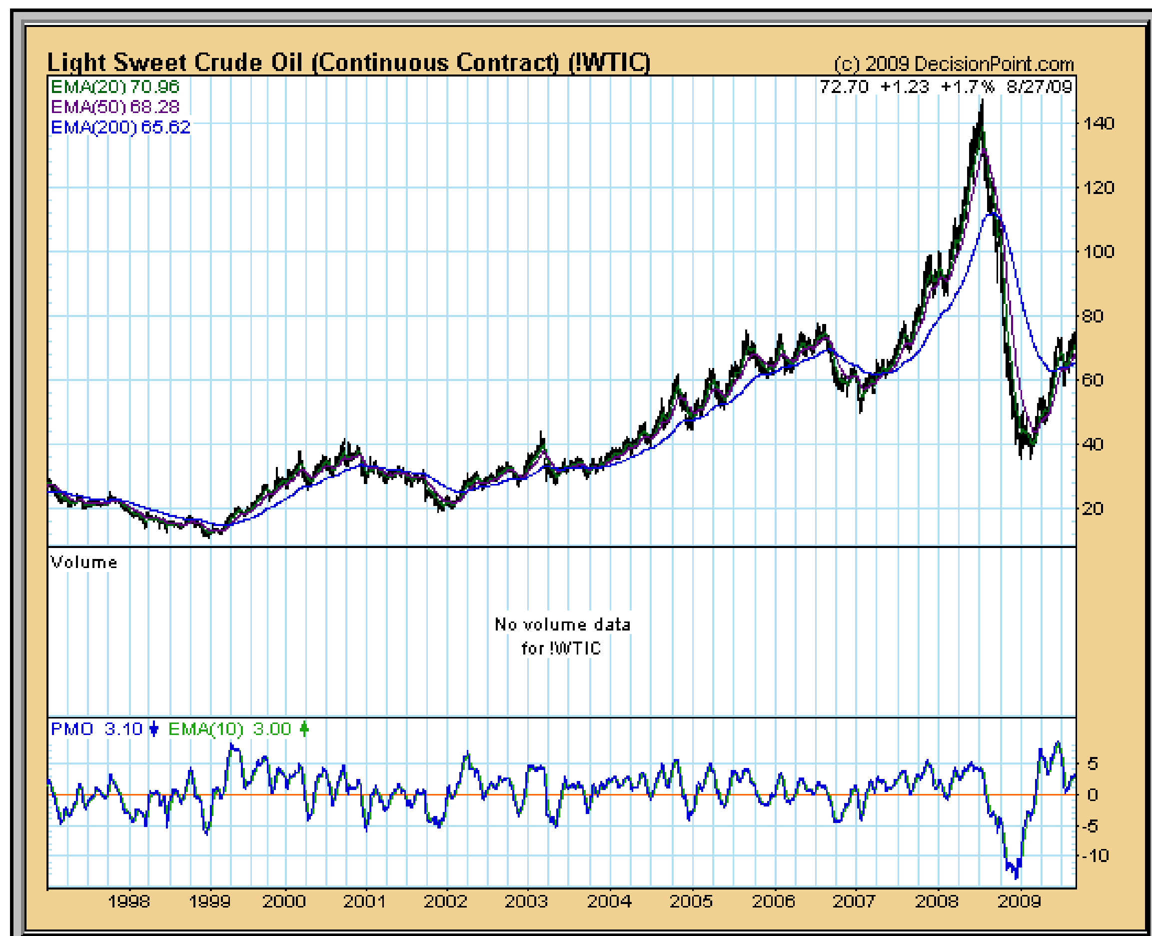
time natural gas prices are hovering near lows for this decade (see Figures 1 and 2).

Figure 1: Crude Oil Prices, 1997 - 2009



Source: www.decisionpoint.com

Surely, it is academically interesting to discuss for hours whether we are in a "deflationary" or "inflationary" economic environment. The different views on this issue have become extremely polarized with the deflationists maintaining that equities and commodities will collapse (a strategist I know believes the CRB will tumble from currently 260 to 100 and that oil will decline to $20) and that government bonds will rally. The believers in higher future inflation rates on the other hand argue that large fiscal deficits and expansionary monetary policies will boost selected asset prices and eventually flow into rising consumer prices and lead to higher interest rates. But, as I have tried to show by comparing oil with natural gas prices, in an economic system some prices may be rising

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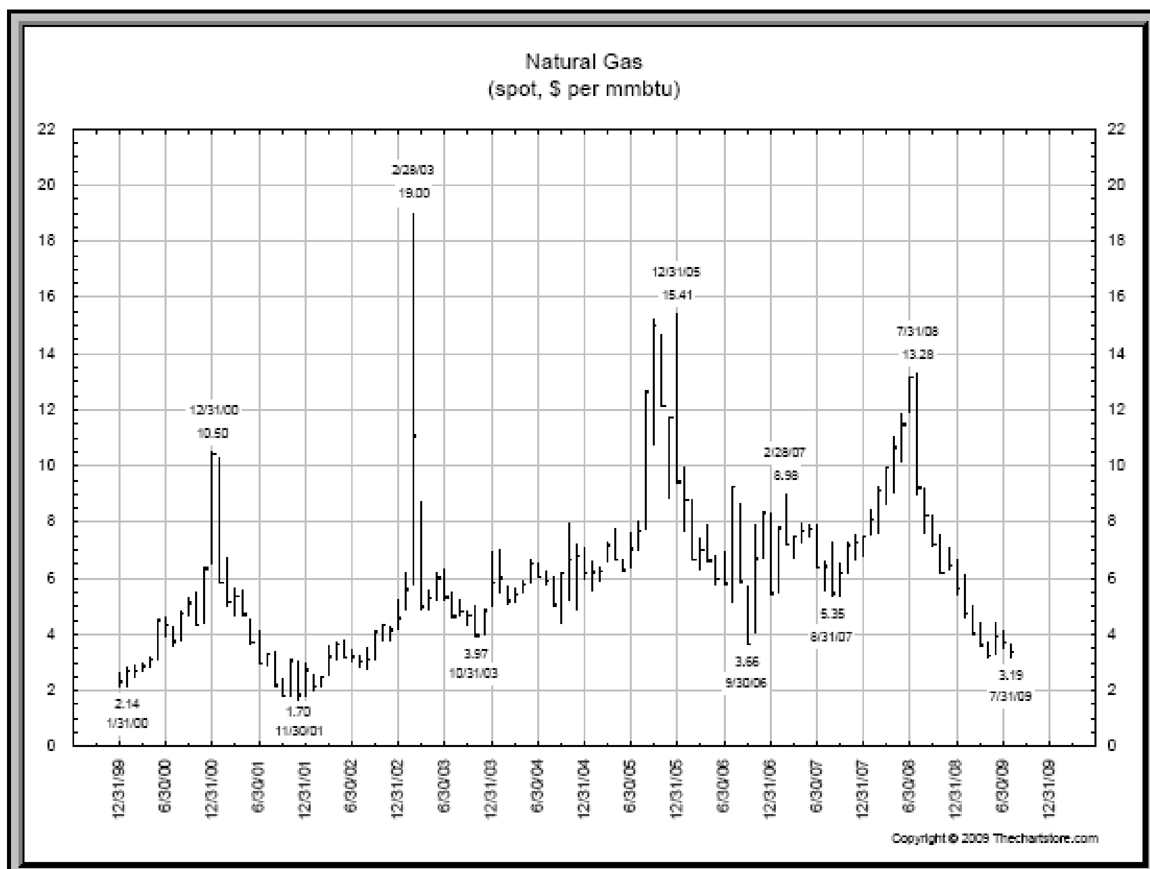
while others decline. This process is continuous and particularly evident in the price movements of various asset classes when there are massive excess capacities, which constrain new capital investments, and zero interest rates, which force cash holders to "speculate" in the one or the other asset class.

Figure 2: Natural Gas Prices, 1999 - 2009



Source: Ron Griess, www.thechartstore.com

The deflationists are probably right when they argue that based on the still dismal economic conditions some price increases, such as the rise of the S&P 500 from 666 to over 1000, do not make any sense. That may be true, but equally I could turn around and say that the recent asset price movements make perfect sense. Yes, the economy is still weak, but when central banks print money, the resulting excess liquidity will flow somewhere (see Figure 3).

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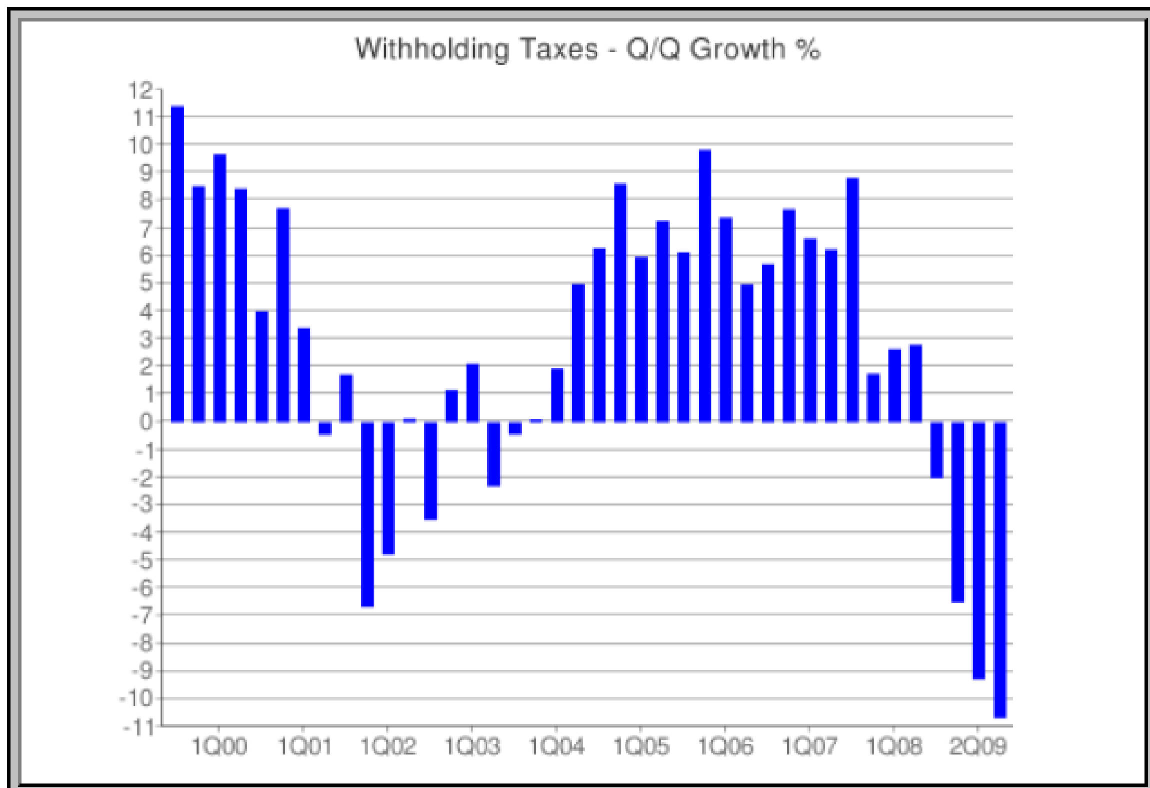
Figure 3: With Withholding Taxes Still Declining, Where Is the Economic Recovery?



Source: Matt Trivisonno Blog and Bill King

Excess liquidity can boost consumption, capital spending, wages, or assets such as equities and commodities. But when the economy is flat on its back, when large excess capacities exist, and when unemployment is still increasing, excess liquidity will not flow into consumption and capital spending. Instead, it will either migrate into cash or some other asset classes such as stocks, bonds, and foreign currencies. Seems logical and, as I explained on numerous occasions before, the weaker the economy is, the more some asset prices will increase provided the money printing press runs at an accelerating rate. In this respect it is also interesting to look at the composition of savings in the US. According to Doug Kass, the top 1% of income earners who received 23.5% of total personal income in 1997 (the last year the data is available) had a savings rate of 5.2% of the country's personal income. So, based on the July personal savings rate of 4.2%, the bottom 99% of income earners had a savings rate of minus 1.3% in July (see Figure 4). (The bottom 99% of income earners had 76.5% of national income and negative savings of

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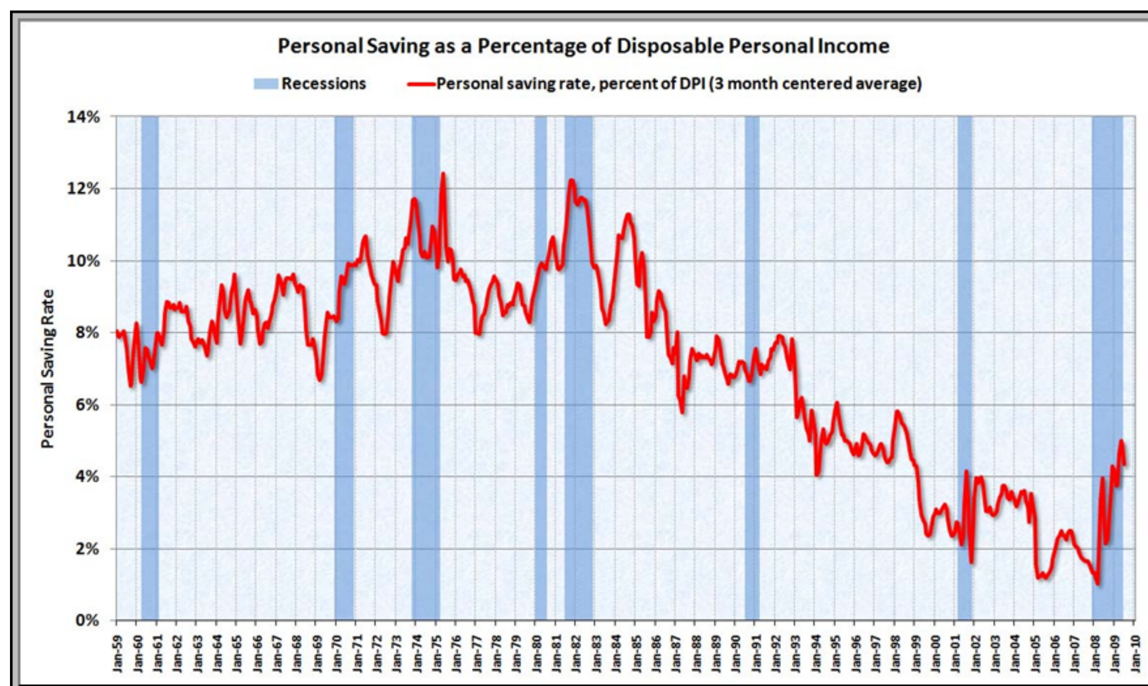
$87.1 billion based on remainder from the savings of the top 1% of income earners.)

Figure 4: Personal Savings Are Rising, but not for the Majority of Households



Source: www.calculatedriskblog.com

Now, given that wealth, incomes, and savings are so concentrated, it easy to see that the top 1% or 5% of the income earners and wealth owners will speculate in the one or the other asset class with gusto. With average savings of more than $300,000 annually, the top 1% of income earners can afford to take a punt here and there. These 1% top income earners also talk to each other and have the same investment advisors and, therefore, the money will tend to flow into whatever asset class that shows the most upside momentum - irrespective of whether the price increases seem to make much economic sense or not. I should add that the 1% of the top asset and income earners is also the prime beneficiary of the government's bailout packages and easy monetary policies. This 1% of income earners and wealth owners also has every interest to manipulate and talk up the stock market before dumping its positions onto the unsuspecting public (this is not a criticism but a fact).I mentioned above that momentum investing (read excessive speculation) is driving

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some asset prices up irrespective of whether or not price increases appear to make any economic sense. In this respect I am sure that many investors must have been surprised by the huge price increases in stocks like AIG, Citigroup, Fannie Mae, Freddie Mac, and other financial stocks of questionable viability (see Figure 5).

Figure 5: Citigroup, 2005 - 2009

Source: www.decisionpoint.com

But on second thought the price increases of some of these busted financials do make some sense. Here we have a government that was prepared to provide funds to these institutions at practically no cost. And should these institutions experience further problems, more funds will be made available. We also have a money printer at the Fed who is determined to fight deflation at all costs with extraordinary monetary measures, which I should add, lack any transparency. Now, this should provide for a relatively favorable profit environment for financial

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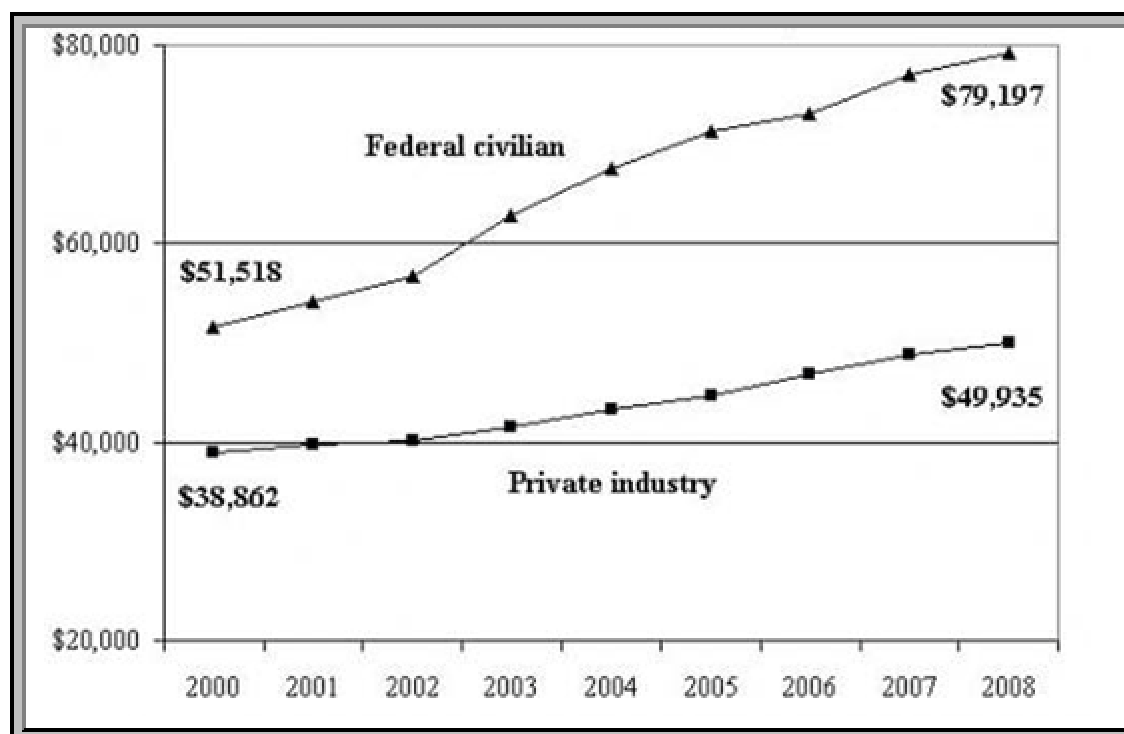
companies, which are too big to fail with, however, one proviso. Although financials could surprise even further on the upside, this will only be possible for as long as the government itself remains solvent! This is a very tall assumption indeed. First of all, the government, which is relentlessly expanding, pays itself far too much in terms of wages and benefits compared to the private sector (see Figure 6).

Figure 6: Average Wages, Federal Civilians Compared to Private Industry, 2000 – 2008



Source: Clusterstock, (newsletter@businessinsider.com)

According to Cato-at-Liberty, since 2000, Federal average pay is up 55%, compared to just 29% wage growth in the private sector (according to a recent release from Rasmussen Reports, a government job remains "the top employment choice in today's economic environment").

Secondly, the interest payment on the government debt runs currently at about $350 billion per annum (or 3% of GDP). With the government debt exploding it is likely that the interest payment will double in the next five years to over $700 billion (even under the optimistic assumption that interest rates will not increase). Therefore, sooner (which is what I believe) or later, an ever increasing quantity of government debt will have to be issued just to pay the interest on the existing government debt. In

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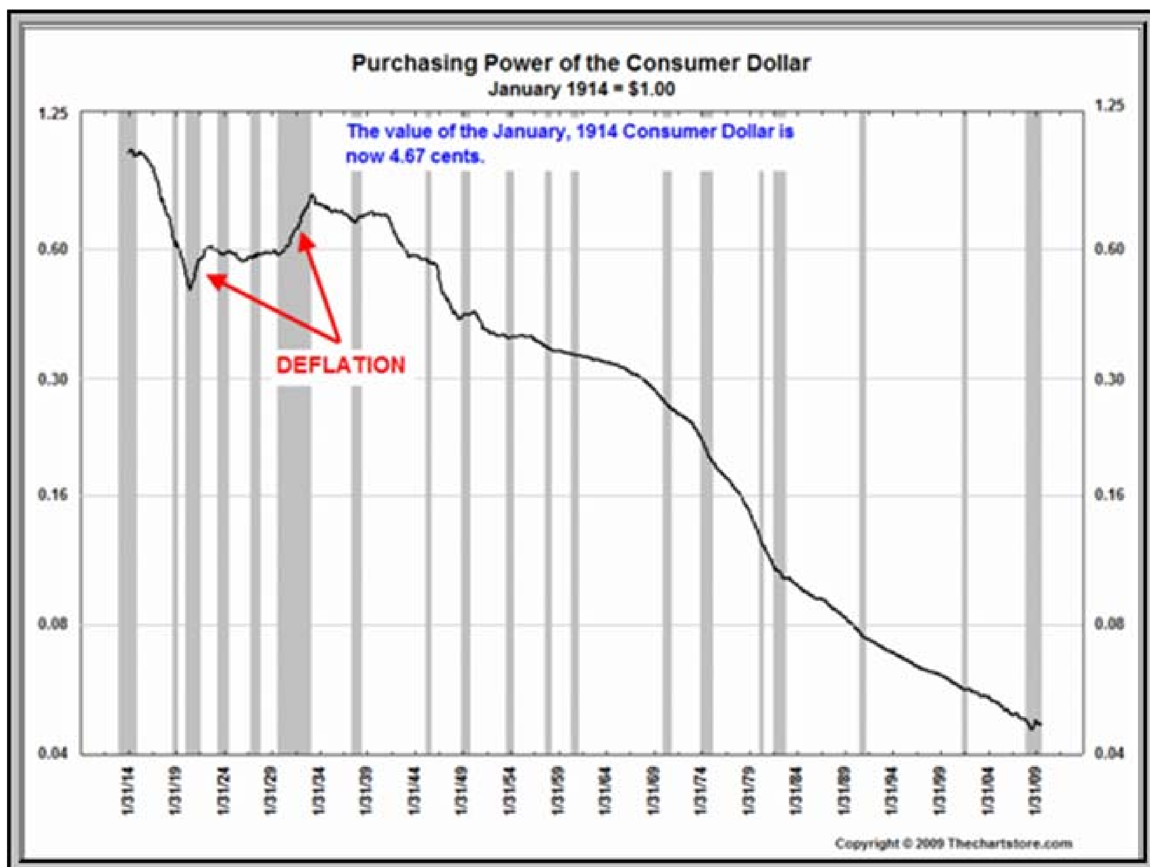
other words, within the next five years the US government will essentially be running a Ponzi scheme, which inevitably leads to a further depreciation of a currency's purchasing power and will eventually lead to a complete collapse of the system (see Figure 7).

Figure 7: Purchasing Power of the US Dollar likely to Collapse!



Source: Ron Griess, www.thechartstore.com

In order to get out of this Ponzi type of system the government could increase taxation (on the wealthy of course), cut government expenditures, or monetize the debt. Under the Obama administration it is likely that government expenditures will increase further (certainly they will not decline) and, therefore, we should expect a combination of higher taxes and further massive debt monetization in the future. The problem with higher taxes on the wealthy is of course that the top 1% of the nation's income earners already paid in 38.4% of the nation's taxes, the top 5%, including the top 1%, paid in 58.8% of the nation's taxes, and the top 10%, including the top 1 and 5%-ers, paid in 69.7% of the nation's

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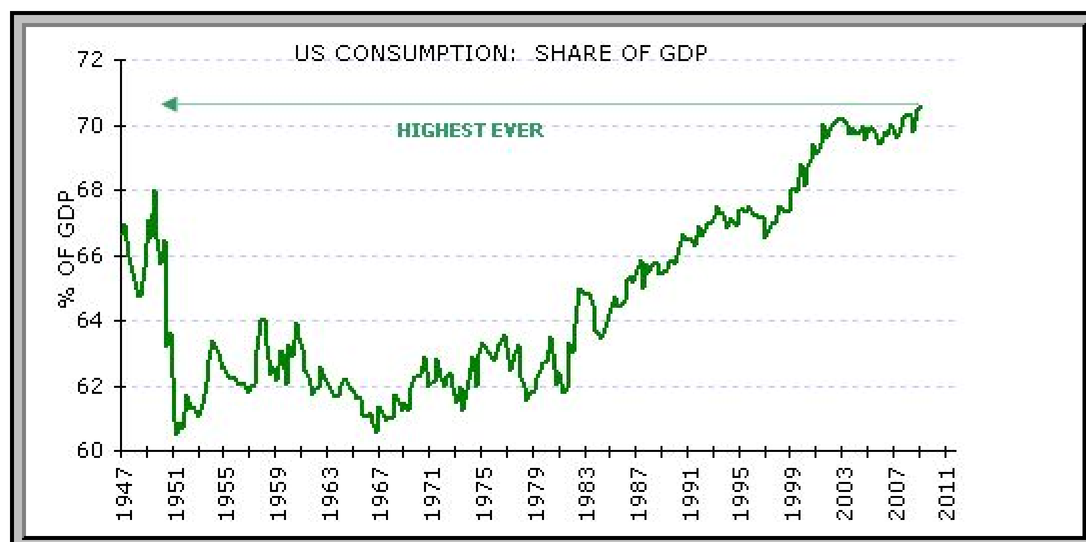
taxes. Shockingly, the bottom 50% of income earners only paid 3.2% of total taxes (figures are for 2005 and are provided by Dennis Gartman, dennis@thegartmanletter.com). Therefore, if the government decides to increase taxes on the rich, it may be counterproductive in as far as they will leave the US for lower tax jurisdictions (from the emails I get I can tell my readers that many wealthy families are thinking about this issue). Increasing taxes on the bottom 50% of income earners would also be counter productive since US economic policy measures are aimed at stimulating consumption (cash for clunkers, etc.) in order to avoid an economic collapse. Since consumption is already far too high relative to GDP (and is likely to trend lower), tax increases on lower income groups would wreak havoc on the consumption-dependent economy (see Figure 8).

Figure 8: Can Taxes be Increased When Overconsumption Rules?



Source: Gerard Minack, Morgan Stanley

So with government expenditures unlikely to be cut and with modest tax revenue increases (additional taxes on the rich will yield very little additional revenues), I think that further massive fiscal deficits accompanied by additional monetization of the government's debt will be the order of the day. (Paul Krugman: "As I said, deficits saved the world. In fact, we would be better off if governments were willing to run even larger deficits over the next year or two…..we should be doing more, not less, to support the economy".)

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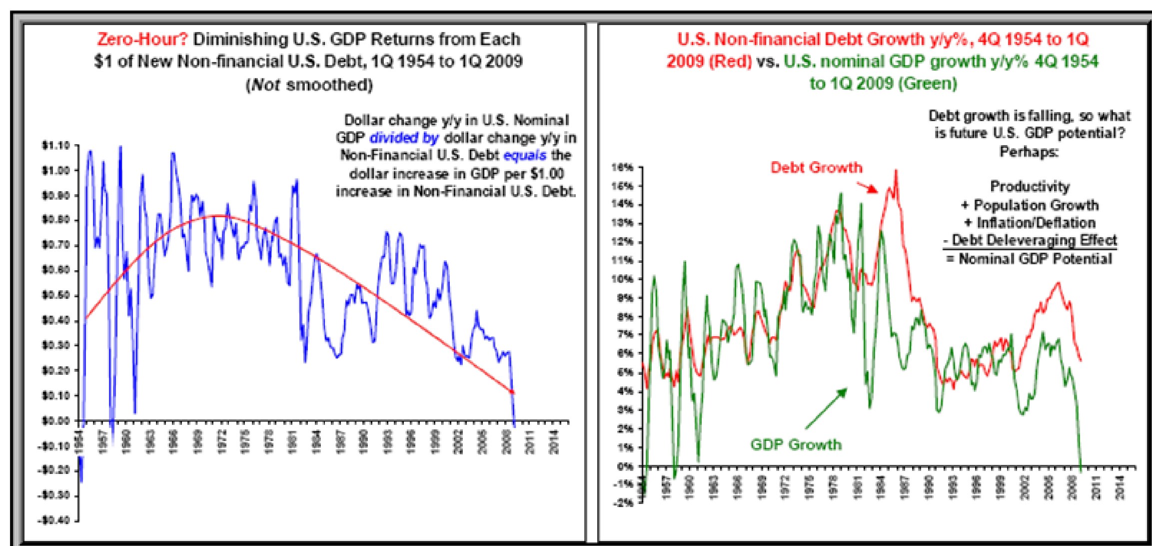
Not that such deficits and debt monetization will cure the ills of the real economy (see Figure 9). Additional debt growth will have practically no impact on real GDP. As my friend Barry Bannister notes, “while fiscal stimulus plays a role in maintaining near term GDP growth, we do not believe growth can be sustained without a strong private sector contribution. **Government has not historically been an efficient resource allocator, so prolonged fiscal stimulus is something to fear, in our view**” (emphasis added).

Figure 9: Diminishing Returns From Debt Growth



Source: Barry Bannister, Stifel Nicholaus

The long-term investment implications of these dire economic and financial conditions (and I am not talking here about the next three months) should be clear: the US dollar will trend down, cash will perform poorly, standards of living for the median household will continue to decline, equities will perform better than bonds as price increases will in time accelerate, residential real estate has probably bottomed out (does not mean it will appreciate much), and commodities and especially precious metals will continue to perform well or at the very least maintain their purchasing power.

In the short term, asset markets may, however, perform counter to these long term trends. A friend of ours, Jay Kaeppel, who publishes reports under Kaeppel’s Corner at www.Optionetics.com (he is also the

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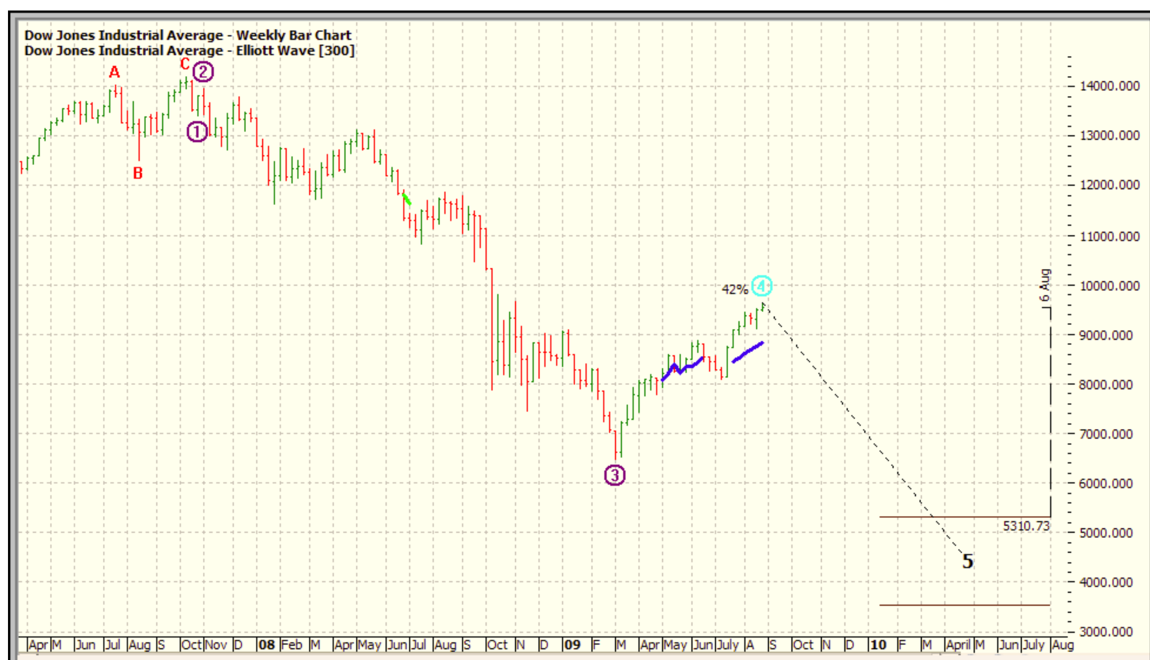
author of a book entitled "Seasonal Stock Market Trends"), sent me a chart which represents the views of the Elliott wave followers (not necessarily his view). The Elliott Wave followers believe that the ideal rebound targets for the S&P 500 and the Dow Jones have been reached and that we are headed straight to below 5000 on the Dow Jones (see Figure 10). As I have opined before, I doubt we shall see new lows for the equity markets in nominal (or dollar) terms. As soon as the S&P 500 drops below 900 we shall have further stimulus packages and further monetization, which would likely support equities and be negative for the US dollar (see also Mr. Krugman's view above).

Figure 10: Elliott Waves Point Toward Dow Below 5000!



Source: www.ProfitSource.com

Also, whereas I pay attention to what the Elliott Wave followers and specifically Robert Prechter's views are, and also believe in waves in business (business cycles) and in asset markets, I very much doubt that the waves can be precisely labeled. Still, on one point I agree with Robert Prechter. Investors' sentiment seems to be very optimistic about further stock price increases (see Figure 11).

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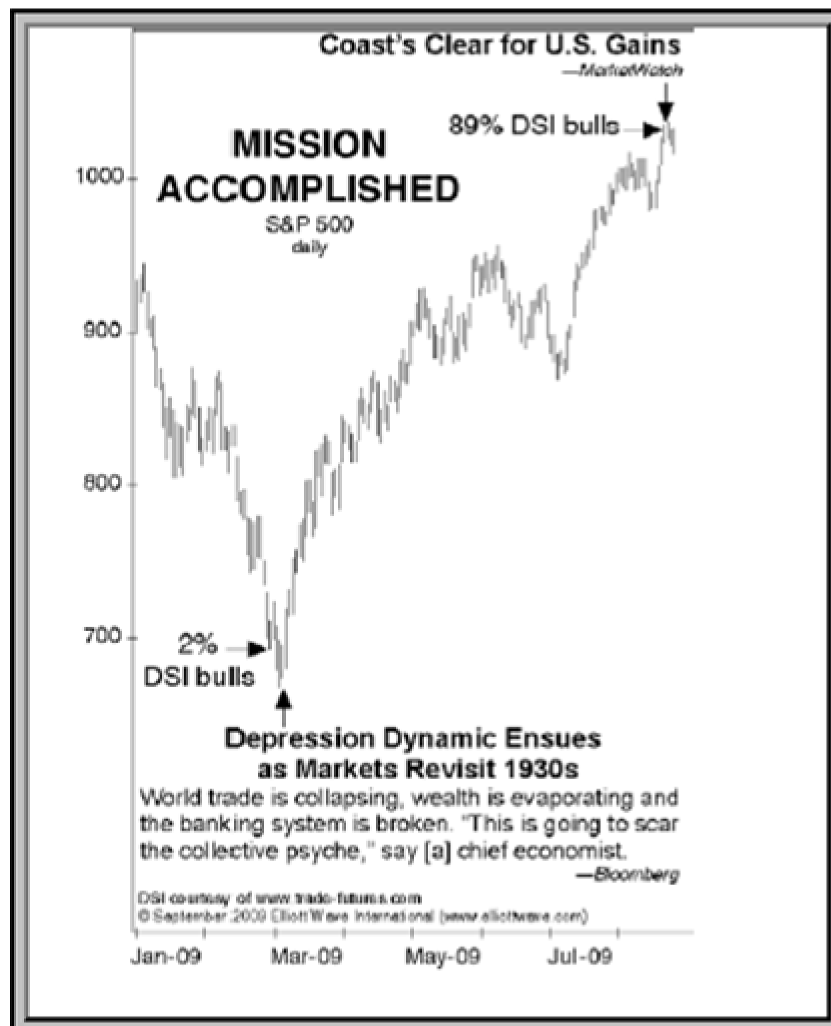
Figure 11: From Extreme Pessimism to Extreme Optimism



Source: www.elliottwave.com

Prechter points out that the Daily Sentiment Index (trade-futures.com) recently reached 89% stock bulls, which was "the polar opposite of an almost non-existent bullish camp (2% bulls) at the Primary wave low in March" (see Figure 11). Prechter adds that "DSI optimism topped out at 88% at the Cycle wave **b** peak in October 2007" and that "August (2009) also brought a host of declarations of imminent recovery by everyone from George Soros, the IMF, Abby Cohen, more than 90% of economists polled by the Wall Street Journal and 75% of 2004 asset managers surveyed by Merrill Lynch."

I should add that the Dogs Of The Dow investor sentiment survey shows that as of last week 71.1% of investors polled were Bulls for the next

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twelve months whereas only 18.4% were Bears (www.dogsofthedow.com). At the same time I need to point out that most investment advisory services either expect a stock market correction in September (seasonally the weakest month of the year) or a resumption of the bear market. I would, therefore, not rule out further near-term increases in stock prices to be followed by a more meaningful correction to follow in October. Supportive of the argument that stocks will decline shortly is the extreme consensus on the US dollar (see Figure 12).

Figure 12: Bullish Consensus about the US Dollar at an Extreme Low!

Source: www.elliotwave.com and www.trade-futures.com

As I have explained before, whenever the US dollar weakens, equities have a rising trend, and when the US dollar strengthens, equities tend to decline. So if one were to believe in a US dollar recovery, a correction in

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equities should be expected. I should like to stress that big moves in asset markets are likely to occur shortly. The Euro made a first high - following its March 4 low at 1.24 against the US dollar - at 1.4347 on June 3 and now we are still at 1.43 against the US dollar (see Figure 13).

Figure 13: Euro against the US Dollar, 2008 – 2009

Source: www.decisionpoint.com

Similarly, whereas the S&P 500 rose by 43% between March 6 and June 15 of this year, thereafter it increased to its current level of 1028 by just 7.75%. At the same time, while financial stocks (see Figure 5) have been very strong, many shares such as resource stocks including Newmont Mining are lower than they were in early June (see Figure 14). Newmont is down 16% from its high (it was down 26% at its July low), oil shares (XOM, CVX, MRO, COP) are no higher than in early June, and the

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Shanghai Stock Exchange Composite Index is at the same level it stood in mid June (but down 18% from its early August peak).

Figure 14: Newmont Mining, 2008 – 2009

Source: www.decisionpoint.com

I am mentioning this because there are many investors who, having missed the strong rally between March and June of this year, are constantly wondering whether they should enter the stock market now or wait for a correction. Rather than paying too much attention to stock indices I would follow the price movement of individual shares. If buying is the objective, I would purchase equities that have already undergone a correction.

As I explained above, I believe that the Fed will print money and that the Obama administration will implement further stimulus packages

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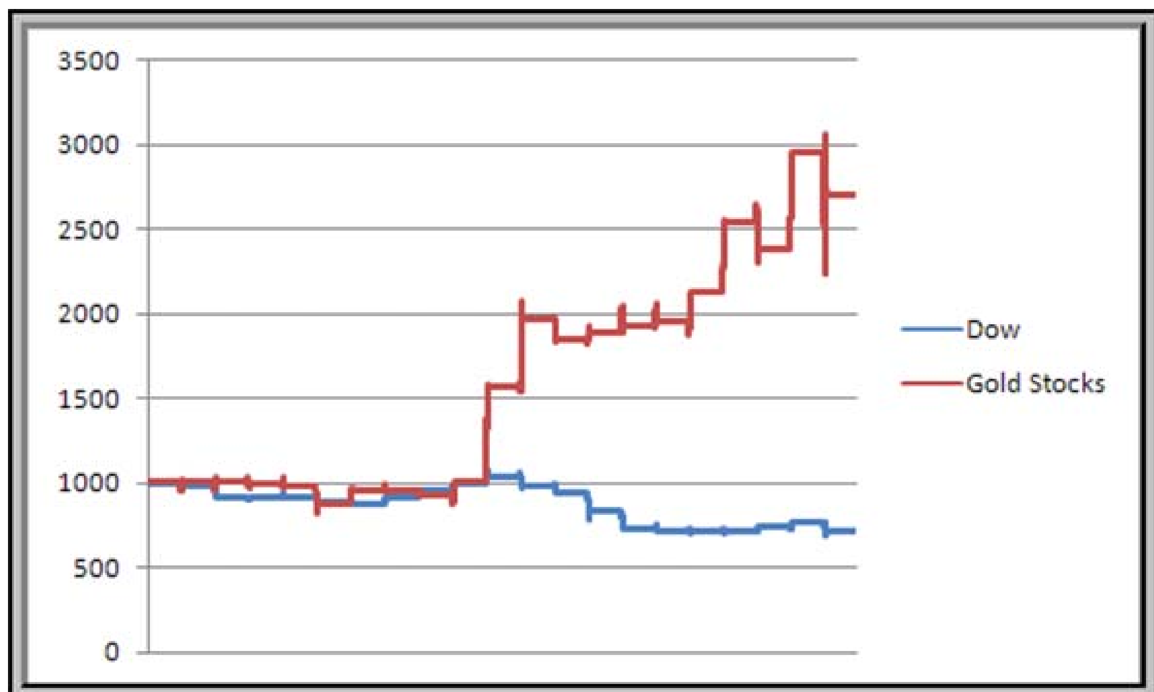
should the economy fail to recover meaningfully and should asset market weaken again. And in the context of these inflationary policies I believe that over the next ten years stocks will perform better than cash and bonds. Therefore, I would maintain at least some exposure to equities. But I also pointed out that September is seasonally the weakest month of the year for stocks. Jay Kaeppel (see above and www.Optionetics.com) shows the difference in the performance of $1000 invested in the Dow Jones and of $1000 invested in gold shares between September 1 and September 30 (see Figure 15).

Figure 15: Growth of $1000 Invested in Gold Stocks versus $1000 Invested in the Dow Jones since 1989 during the Month of September



Source: Jay Kaeppel, www.Optionetics.com

I am alluding to this phenomenon because similar to the Euro, gold prices have traded largely sidewards since February of this year (see Figure 16).

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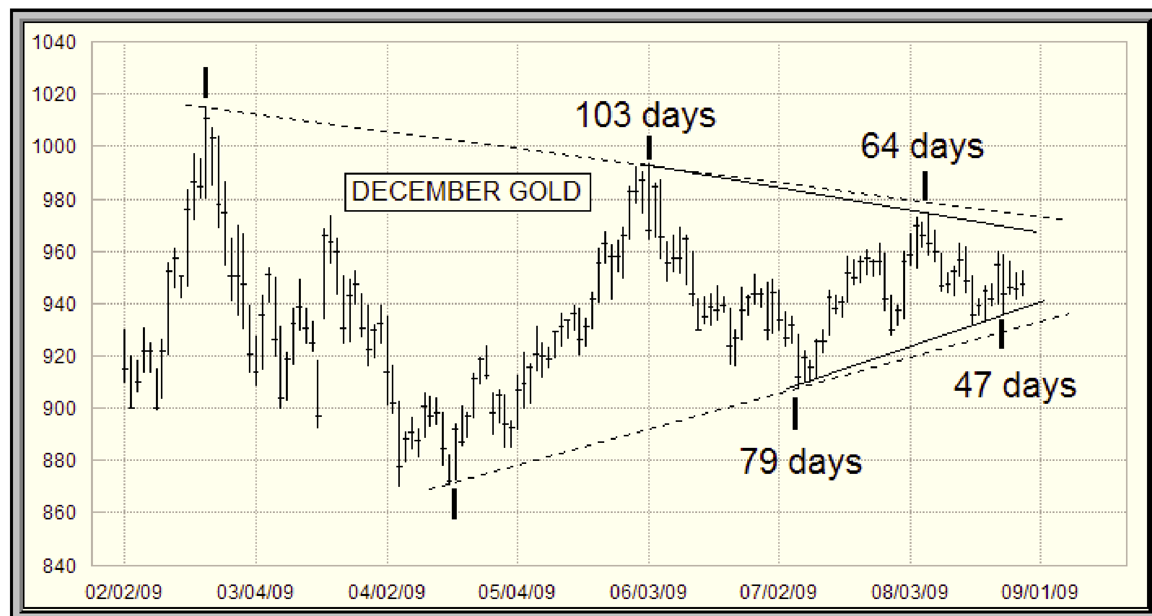
Figure 16: Gold Prices about to Break Out – but in which Direction?



Source: Tom McCLellan, www.mcoscillator.com

According to Tom McClellan, editor of The McClellan Market Report, gold's range-bound price movement cannot go on forever, "and the coiling of price movements implies that we will soon see a ramping up of volatility in gold prices. People don't seem to be talking about gold much on CNBC (aside from the coin commercials), another sign that a big move one way or the other could catch most people unaware." I agree, some big moves in asset markets are coming and I lean toward the view that gold will break out on the upside. The only problem I have, however, is to reconcile my relatively positive view about the price of gold (and other precious metals) with a rebound in the US dollar and a correction in equities. Of course what could happen is first a rebound in the US dollar and a brief correction in gold and equity prices before these short term trends – driven by further monetary easing – reverse, and gold (as well as other commodities) and stocks move up again in tandem.

Among commodities, the least inflated asset is natural gas (see Figure 2 –hog prices are also slowly moving into a buying range). In the Gloom Boom & Doom report I recommended not to play a natural gas price recovery by buying the US Natural Gas Fund (UNG), but through the purchase of Pioneer Natural Resources (PXD) and First Trust ISE Revere Natural Gas Index Fund (FCG). An Indian reader of ours suggested

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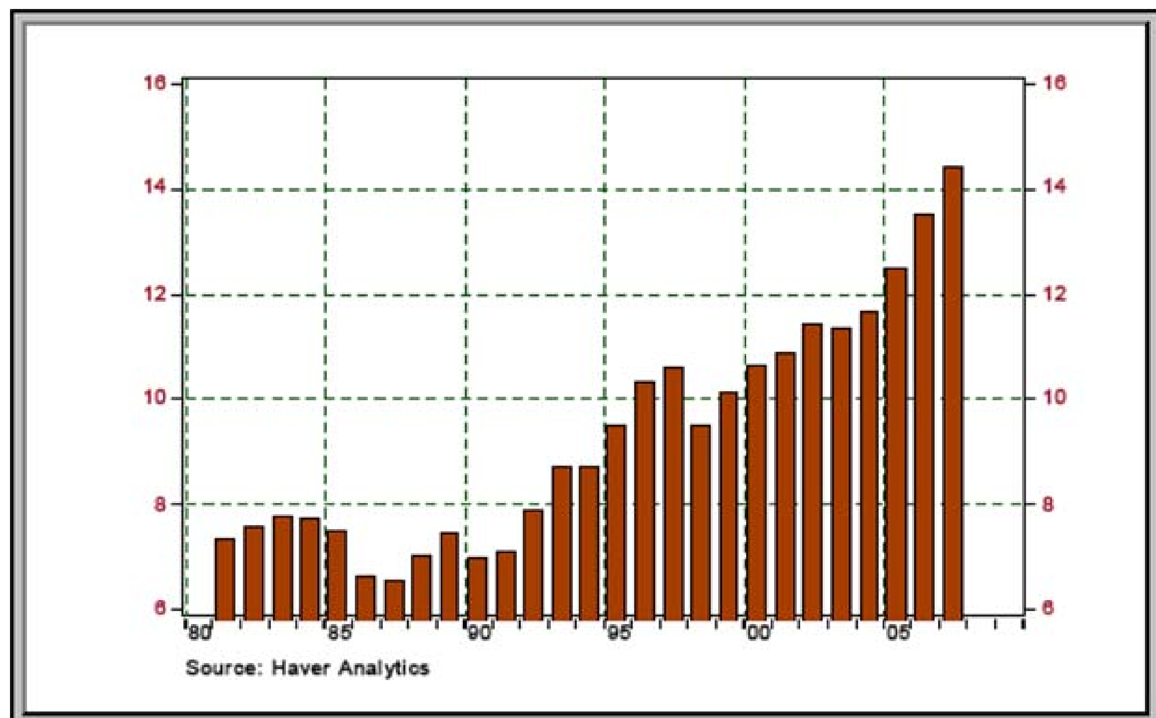
playing natural gas by owning BP (BP), ConocoPhillips (COP), and Chesapeak Energy (CHK – very depressed).

For equities, my favorite investment destination remains Asia, and I continue to find inexpensive equities around the region - in particular in Thailand. Growth in Asian economies will continue to outpace growth in the western world and in most countries stocks have a higher dividend yield than local bond yields (see Figure 17).

Figure 17: Asian Emerging Economies' GDP as Percent of the World



Source: Paul Kasriel, Northern Trust

In the past I recommended property-related shares including REITs such as Ascendas REIT (AREIT SP), Ascott REIT (ART SP), First REIT (FIRT SP), Suntec REIT (SUN SP), CapitaCommercial Trust (CCT SP), and ARA REIT (ARA SP), Swire Pacific (19 HK), Sun Hung Kai Properties (HK 16), and Samui Airport REIT (SPF TB). Recently I also invested or increased positions in Thai Beverage (THBEV SP), Thai Airways (THAI TB), Quality House Property Fund (QHPF TB), Bangkok Aviation Fuel Services (BAFS TB), Golden Land (GOLD TB) and Home Product Center (HMPRO TB). (I also took some profits in shares, which had raced ahead and were overbought.) One of the reasons I like Asian property companies and related shares is that higher tax rates in the UK

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and the US will drive many people away (Mark Twain: "The only difference between a tax man and a taxidermist is that the taxidermist leaves the skin").

And where better to settle than in Asia! That said I am also somewhat concerned that Asian stock markets along with other emerging markets are near-term significantly overbought (see Figure 18). I am very cautious!

Figure 18: MSCI Emerging Market Index, 2001–2009

Source: Gerard Minack, Morgan Stanley

There are some people who believe that we investment advisors and fund managers should know everything and that our forecasts should always be accurate. The forecasting record of economists, strategists, and analysts is extremely poor. As the late Peter Bernstein observed, "in their

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calmer moments, investors recognize their inability to know what the future holds. In moments of extreme panic or enthusiasm, however, they become remarkably bold in their predictions: they act as though uncertainty has vanished and the outcome is beyond doubt. Reality is abruptly transformed into that hypothetical future where the outcome is known. These are rare occasions, but they are unforgettable: major tops and bottoms in markets are defined by this switch from doubt to certainty."

With his permission, I am enclosing a report by Thorsten Polleit entitled "Inflation Breeds Even More Inflation." Thorsten is an Honorary Professor at the Frankfurt School of Finance & Management. This report was also published by the Mises Institute (www.mises.org). For anyone interested in economics and specifically in the Austrian School of Economics it is well worth a read!

Finally, a recent interview I had in Australia:

http://www.ritholtz.com/blog/2009/08/marc-faber-on-lateline-business/

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