The Long Wave Analyst

'An Opportune and Strategic Investment Approach'

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The Long Wave Analyst is an investment strategy based upon historical analysis and interpretation of the "Kondratieff Cycle". Fax interpretation available between publications on significant market developments.

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Ian Gordon

The End of the Plateau Period . . .

In my last market letter, I argued that we are currently approaching the end of the Plateau period of the Long Wave. It is important to remind readers that the Plateau period is characterized by increasing speculation in stocks, bonds and real estate. In Japan, the end of the Plateau period was reached in late December 1989, when the Nikkei topped at 39,000. This was followed by a stock and real estate market crash, which reduced the value of the Nikkei by almost 65%; and the value of Japanese real estate by almost 80%. In Japan, markets now look poised to dive even lower. The previous Long Wave plateau period in the United States occurred between 1921 and 1929. This period, like all Plateau periods before and after, was distinguished by an increasing orgy of speculation that ended in the stock market crash which played a major part in the subsequent depression.

Some readers of the first issue of The Long Wave Analyst have suggested that instead of either being in or being on the verge of the deflationary/Depression stage of the Long Wave cycle, we are in fact just coming to the conclusion of that period. They cite the Japanese deflation that has been ongoing since 1990, the very high unemployment that most of Europe has experienced throughout the 1990's, and the South-East Asian crisis as evidence of an end, rather than a beginning of the depression stage of the Long Wave. Kondratieff defined the Long Wave as an international phenomenon. Certainly, North and South America have experienced nothing like an economic depression. While Japan has experienced slower growth, some bankruptcies and asset deflation, unemployment, although growing, has not assumed depression-like levels. South Korea and much of South-East Asia, are only now beginning to experience localized economic depression. Plateau periods typically end in a stock market crash, exploding the investment bubble, which has grown to an unsustainable size during this time. This happened in Japan in the early 1990's and has just recently occurred throughout most of Asia. Only Europe and the Americas await a similar fate. The Depression stage of the Long Wave eradicates debt accumulated during the Expansion and Plateau phases. This is now happening in Japan and throughout most of Asia. Debt levels in Europe and the

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Americas remain high, buoyed by margin purchases in the stock markets. Following the Depression phase, consumer confidence, the stock market and the economy revive from a very low level. This is not the case anywhere at this time. Indeed, stock markets and consumer confidence are, if not at all-time highs, close to those high levels throughout Europe and the Americas. In my opinion, this is irrefutable evidence that the entire world is either in, or about to enter the Deflationary/Depression stage of the Long Wave. The end of the Plateau period in Europe and the Americas will almost certainly be signaled by a stock market crash.

In this letter, I have spent some time describing the current situation in Asia and Japan, because I am reasonably confident that this region is not only entering the depression/deflation stage of the long wave, but that it will also be the catalyst which will bring the rest of the world into the same stage of the cycle.

The enormous overvaluation of the US stock market poses a very real threat to the world financial system. A recent edition of the Economist Magazine[1] explored this bubble and cited four characteristics of a bubble economy:-

1. Over-valued share prices. The Economist points out that share prices in real terms (prices after inflation) have risen 825% since 1982, which is even larger than the 730% real return during the 1920's.
2. Mergers, which are at record levels. Deals amounting to $957 billion were announced last year, which was significantly above the previous record of $352 billion registered in 1988.
3. Frothy property markets. In New York recently, bids were $180 per square foot, which is twice the price paid for a comparable site six months ago. In 1997 commercial rents rose more than 20% in San Francisco, Boston and Dallas.
4. A rapid expansion of the money supply, which is currently growing at more than 9% per annum.

Four characteristics of a bubble:
1. Over-valued share prices;
2. Corporate Mergers;
3. Frothy property markets;
4. Rapid growth of the money supply.

Inflation, Disinflation and Deflation Defined

The Kondratieff Wave clearly defines the cyclical move from inflation, to disinflation, and then to deflation. This process lasts approximately 60 years; with inflation lasting approximately half that time and disinflation and deflation taking roughly 30 years to work their way through the economy. (see Figure 1)

INFLATION is defined as too much money chasing too few goods — an excess of demand over supply. It is caused by an 'easy money' policy of the Central Bank, which provides an environment of low interest rates and cheap credit to the banking system. During an inflationary period, it is very easy to obtain credit from a bank; cars are financed, mortgages are easily obtained, and everyone appears more wealthy. There is plenty of employment as companies struggle to meet the demand for the goods that everyone wants to buy. Wages increase as firms vie for qualified workers and trade unions negotiate favourable wage contracts, which usually contain a cost of living clause guaranteeing supplementary pay increases in line with the rate of increase in inflation. The only people who seem to be hurt by inflation are those living on fixed incomes, such as pensioners. The cost of almost everything rises during inflationary times, including commodities, which are used in the manufacture of finished products. Like most things, inflation gets carried to an extreme. High interest rates kill the boom and contribute to a healthy correction in the stock market. The recession that follows saps consumer confidence and interest rates start a steady decline. During the last Long Wave inflation period interest rates in the US peaked near 15% in 1981, while year over year inflation

Figure 1 - The Cycle

rose to more than 14%, also in 1981. Year over year inflation today stands at 1.4%, which is a significant decline and interest rates are around 6%.

DISINFLATION is simply a declining rate of inflation. Prices are still increasing each year but at a diminishing rate. Thus, from 1981, the rate of annual inflation has fallen from 14% to only 1.4% today. Following the recession at the end of the inflationary peak, a somewhat unnerved Central Bank starts to lower interest rates in an attempt to get the economy out of recession. During the latter stages of an inflationary period, companies engage in a huge amount of capital spending, building paper mills, steel mills, chemical plants, automobile plants, and so on, all to satisfy an ever-increasing demand for consumer goods. Thus, when interest rates decline, the money is not funneled into an already overexpanded capital goods market, but rather is employed in the purchase of stocks, bonds and real estate. The move into investments starts cautiously, but gathers momentum as prices increase. Today we have reached a stage, comparable with September 1929, where escalating share prices have lured anyone who wants to be invested in stocks, into the market. A stock market break will usher in the beginning of the next stage of the economic cycle.

DEFLATION is caused by the rapid destruction of wealth caused by the collapse of the investment markets, which brings to an abrupt end the disinflationary period of the long wave. Like inflation, deflation feeds upon itself. As much as inflation and disinflation are characterized by increasing consumer confidence, deflation is distinguished by a rapid fall in confidence which results in a dramatic fall in prices and rising unemployment. Japan appears to be entering a deflationary spiral; consumers are refusing to buy, in spite of huge savings, because they have lost confidence in the economy and the banking system. As a result Japanese unemployment is rising.

It is important to understand why inflation, disinflation and deflation tend to follow each other in sequence. These definitions are enough to convince me that we are rapidly approaching the end of the disinflationary period, which is principally distinguished by an overheated stock market. The end could come at any time and should be signaled by a stock market crash, which precipitates the commencement of the deflationary trend.

The Asian Currency Crisis

In Indonesia many thousands are fleeing the Country in the hopes of finding work elsewhere. President Suharto seems determined to salvage as much as he can of his family's investments, while his country sinks deeper and deeper into the morass of escalating prices coupled with growing unemployment. This is the kind of environment from which revolutions are spawned. The International Monetary Fund and Indonesia have recently announced an agreement, which has been viewed by most observers as a victory for the President, following a breakdown of a similar pact signed in January. A Western diplomat reported that "the economy deteriorated too alarmingly quickly; the international community realised it couldn't afford to see Indonesia go over the brink, and the deal just had to go through."[2] This does not mean that Indonesia will not go over the edge. Indonesia has an estimated $74 billion of corporate foreign debt overhanging the world's banking system. It appears that these banks, which include among others, Chase Manhattan, Deutsche Bank, and Bank of Tokyo may be forced to write-off up to 70% of this debt. But most of these creditor banks will be reluctant to force the issue should Indonesia once again balk at implementing the IMF imposed monetary reforms. Indonesians, themselves, are in a rush to withdraw their savings from a host of suspect banks, after the government suspended operations of some banks.

The West has become somewhat blasé about the currency crisis which has afflicted many of the Asian economies over the last nine months or so. Most of these currencies have rebounded, as have the stock markets since foreign fund managers have ventured back into the region. In the first quarter, Jakarta was up 35%, Seoul 28%, Bangkok 23%, Kuala Lumpur 21% and Manila 20%. This optimism was boosted by South Korea's return to the capital markets in early April when a bond issue was oversubscribed by more than four times and which raised more than $7 billion.

Overall, however, this newly-found confidence seems misplaced, but is indicative of the investment euphoria that is currently gripping everybody except the Japanese. The American economist, Paul Krugman, who has been skeptical about the so-called Asian miracle for some time warns those who might be tempted by an apparent Asian currency revival. "The Asian story is really about a bubble in, and subsequent collapse of, asset prices in general, with the currency crisis more a symptom than a cause." [12] The bad news is likely to continue as the effects of last year's crash work through the system. Thai and Korean companies are faced with the painful process of restructuring in order to rebuild their balance sheets. Some banks in these two countries already look expensive. Analysts are keeping a wary eye on Malaysian banks too as they adjust to a slowing economy. Simon Ogus, SBC Warburg Dillon Read's chief economist recently forecast that growth in Thailand and Indonesia during 1998 would be negative 11.1 and 11.4%, respectively.[12] In South Korea, workers who until January of this year, believed that they had a job for life are being made redundant at the rate of 10,000 per day. There are now more than 1.5 million South Koreans out of work, laid off by the 100 companies that go bankrupt daily. These wretched people receive meagre social benefits and the country has recently allocated Won 8,000 billion [$5.8 billion] to boost these social benefits and provide job training schemes. One indication of rising despair in South Korea is the huge increase in the number of suicides, which are now averaging about 25 a day, or 36% more than last year.This picture, printed recently in the Globe & Mail, graphically outlines the magnitude of the problem in South Korea. It is likely that similar stories are being experienced throughout most of Asia.

THE HARDER THEY FALL — South Korean Suh Sang-rok learns how to properly carry a tray during a waiter training course at a large hotel in central Seoul. Mr. Suh was once chairman of the now-collapsed Sammi group, which was among South Korea's largest conglomerates. He began his training early this week and feels fortunate to find a job in troubled economic times.

(YUN SUK-BONG/Reuters)

It remains to be seen how China responds to currency devaluations in the region, which have effectively made the Yuan uncompetitive. There are already indications that the Chinese economy is slowing dramatically. Industrial production during the first quarter of the year was down sustantially and workers in loss-making state-owned enterprises are being made redundant in increasing numbers. At present the Government is committed not to devalue; but, increasing unemployment which adds to social tension, might yet force the Government's hand. Should China devalue, then the Hongkong Dollar would be allowed to flow simultaneously.

While most of South-East Asia struggles with the ramifications of the currency crises, the critical problem not only for the Region itself but for the entire World is the probable effect that all this will have on an already weakened Japan.

Japan

"We will not trigger a worldwide recession from Japan." Ryutaro Hashimoto, Prime Minister. December, 1997[13]

"The Japanese economy is currently facing its most difficult time ever. I am concerned that if Japan falls into a deflationary spiral it would affect the Asian economies. In that case, not even the US economy would be able to maintain its healthy state", said Norio Ohga, Chairman and Chief Executive of Sony Corporation recently. He then went on to liken Ryutaro Hashimoto to Herbert Hoover, the U.S President at the onset of the last Great Depression. "If you look at what Hoover was saying at the start of the great depression and what Mister Hashimoto is saying at the moment, they are very similar."[12]

The Prime Minister, like President Hoover, cannot be held personally responsible for Japan's woes. The problems are far deeper and many were spawned during Japan's bubble phase of the 1980s. They are not simple, and contrary to Western opinion, responsibility for the mess is not entirely Japan's. In the 1980's, The United States 'encouraged' Japan to adopt an easy monetary policy in the face of a deteriorating dollar. The price that Japan has had to pay for this neighbourly advice has been the bubble economy and its subsequent crash. There can be little wonder that Japan now turns a deaf ear to much of the gratuitous advice that it receives from the United States regarding how it should reflate its sagging economy. Mr. Koji Omi, the Minister of Economic Planning said in an interview recently, "we are determined to make our best efforts to stimulate domestic demand by all means, however, we will take our own measures, in our own way."[12] Nevertheless, Tokyo announced its sixth high-profile stimulus package on April 10th, which amounted to Y16,000 billion (US $125 bn), which included Y4,000 billion (US $31.25.bn), in tax cuts. While Western economists were clamouring for a tax cut, the amount proposed is on the low end of the scale.

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It is unlikely that Japanese consumers will use this money to go a buying spree. The Japanese maintain one of the highest savings rates in the world, approximately US $14 trillion and they have not been rushing out to spend any of it. In fact, household spending fell 4.5% in March, the fourth decline in as many months. Most analysts agree that any measures are unlikely to revive the economy. Alexander Kinmot at Morgan Stanley Dean Witter in Tokyo, said: "Providing more money is like giving heroin to an addict. It does not make any sense." Japan has already spent more than one trillion dollars since 1992 in stimulus packages. Most of this money, like the Hoover and Roosevelt New Deal of the 1930's, has been spent on massive public works programmes including new bullet trains, subway lines, roads and docks. Japan has been building new bridges at the rate of 160 kilometres a year during the past five years and has already planned to build a further 120 dams in addition to the 376 already completed. As Nikita Kruschev is reported to have said, 'politicians promise a bridge where there is no river'. These programmes have kept Japanese construction companies and their suppliers busy, but they have failed to restart the economy. Japanese construction companies employ 11% of the workforce, but they are also in the biggest mess.

Nominal interest rates are close to zero, where they have been since 1995, but credit conditions have been tightening and companies are being depleted of capital. Jesper Koll, an economist at JP Morgan Stanley fears that Japan may be locked in a deflationary spiral, caused by increasing corporate bankruptcies, which compound the bad loans already on the books of most Japanese banks. These same Japanese banks are struggling under what is estimated to be Y77,000 bn (US$590 Million) of problem loans. As corporate bankruptcies rise, banks tighten credit further, which forces more bankruptcies 'It is only a small step from rising bankruptcies to rising unemployment, which will lead to a shortfall in demand expectations and yet another round of bankruptcies.'[3] In the year ending March 31, liabilities of large companies that went bankrupt surpassed 9.9 trillion Yen (US $70 billion).

When Norio Ohga warned that that 'Japan was on the verge of collapse', many Japanese agreed with his pronouncement and were deeply pessimistic. Seiya Osumi, who manages a small Tokyo steel pipes supplier, says "I think all company managers have lost their passion and confidence. So many scandals have been exposed recently. Companies that have always relied upon politicians in the past just don't know what to do. I hope the younger generation will be able to rebuild the economy in a different way."[12] Bankruptcies are beginning to take an increasing toll on workers' jobs. In the quarter ending March 1998, there were 4901 bankruptcies in Japan, which is a 28.1% increase over the same period last year. During the same period, 44,745 workers lost their jobs—an increase of 29.7%. It is estimated that 180,000 Japanese will lose their jobs this year. Unemployment has increased to a record level of 3.6% , in a country where until very recently, employment was guaranteed for life. The tradition of life time employment meant that workers who became surplus to the firm's requirements were usually not fired, but were given a nominal title, a desk by the window, and no work to do. There are an estimated two million of these so-called 'madogiwa-zoku' (the tribe by the window). The lifetime employment system is beginning to dismantle as the recession deepens and the 'madogiwa-zoku' are now the first out the door as companies restructure. In the last quarter of 1997, domestic demand was falling at an annual rate of 4%; industrial output fell 3.3% between January and February; and retail sales fell at an annual rate of 7.1%. Car sales dropped 15% in the year ending this March, and are likely to fall even further this year. Not only is demand falling at home but, also, Asia accounts for 40% of Japanese exports, which will be severely curtailed due to the growing financial disaster in that region.

It is only a small step from rising bankruptcies to rising unemployment, which will lead to a shortfall in demand expectations and yet another round of

The accumulated deficit by the Japanese government during the post-bubble years is bigger than the GDP. When the pension liabilities are added, the deficit is twice as large as GDP. Just servicing that debt takes the biggest slice out of the budget -- 22%, which is larger than education, national defence and pensions combined. This could pose a serious problem to a government already trying to spend its way out of a financial mess. Currently only 3.6% of its workforce is out of work, but how would the government cope if 20% are unemployed? At the height of the 1930's depression, up to 25% of the workforce was on the dole in the US. The unemployment problem is only beginning in Japan and the situation can only get worse as the credit crunch starts in earnest.

The G7 countries met in Washington in the middle of April, and of particular concern to all of them was the weakness of the Japanese economy and particularly the Yen. The G7 seems desperate to prevent a new outbreak of the contagion in the crisis-hit economies of South-East Asia. Countries in the region send a large share of their exports to Japan and a falling Yen will prompt many of them into a new round of devaluation. Not only is a weak Yen trouble for South-East Asia, but also for the United States, where there is growing concern about the burgeoning trade deficit with Japan. In the first two months of the year the trade deficit between the two countries was $9.6 billion, or more than 12% higher than the deficit in the first two months of 1997.

As I have alluded earlier in this piece, the crucial problem facing Japan is a crisis of confidence. Once confidence is lost, it is only rebuilt slowly and painstakingly. During the 1930's the United States faced ten years of high unemployment and a lack of collective confidence. Not only did the Second World War get everybody back to work, but it also showed the American people that they could engineer and build exceptional armaments and that their fighting forces were as good as anyone's. Thus, when the War ended, a renewed American confidence took the World into a new Expansion Phase of the Long Cycle. While the Japanese stock and real estate markets topped in late December 1989, the extent of the wealth loss and the damage to the Japanese banking system has been somewhat masked by an economy which has been maintained by an economic boom outside Japan. Many of the Asian economies have now started their Long Wave Deflationary/Depression stage, which will add to Japanese woes. It remains to be seen how long the West can remain oblivious to the financial maelstrom spreading out of Asia. Given the Western stock markets bubble, my guess is that before this year is out we shall see a shock that will cause a stock market crash, which in turn will be the harbinger of new worldwide deflation and depression.

Japan Nikkei Dow Index
Chart Source: The Notley Information Service

The rise of the Nikkei Dow from 1982 to 1989, closely paralleled the Dow Jones Industrials from 1921 to 1929 (see Chart on Page 10). It is crucial that 14200 hold; otherwise, a fall to 5000 is possible. Remember that from 1929, the Dow dropped 90% from its high of 381 to its bottom at 44.

Gold

I believe there are two reasons for the recent increase in the gold price. The first is due to a slowing of European Central Bank selling. The second reason is purely conjecture on my part, but I am reasonably confident that it is because individuals in South-East Asia and particularly Japan are beginning to hoard gold as a hedge against a continuing monetary and banking crisis. It is difficult to forget the picture of a Japanese woman emerging triumphant from the ruins of her house following the Kobe earthquake, clutching a metal teapot, which supposedly held a number of gold coins, representing her savings. If this woman was any indication of Japanese savings philosophy at that time, imagine how much more gold the average Japanese will be hoarding in these very uncertain financial times.

"When the world credit crisis began in October of 1929, there was first a flight from questionable securities into strong securities. The second phase saw an intense liquidation of inventories and commodities. The third phase involved the liquidation of commercial real estate, houses and farms, both through foreclosures and sacrifice sales at a fraction of prior values. The fourth stage was the flight from banks into cash and gold (which ultimately caused the whole U.S. banking system to collapse) and the fifth and final phase was the flight from the dollar into gold.[4] This perspective of the situation at that time relates to the situation in the United States. The Japanese experience today is somewhat different. By the time the flight from the US dollar occurred there were no currencies of any repute in which investors, particularly US investors, could seek a safe haven. Today Japanese and Asian investors can still buy US dollars and to lesser extent Swiss Francs or British Pounds as their safe-haven currencies. Of course many of them have been doing just that for some time, as evidenced by an extremely strong US dollar and the amount of US debt held by foreigners. Following the 1929 crisis US investors moved in the fourth stage of their panic 'out of banks into cash and gold'. Given the shaky Japanese and East Asian banking system it is probably correct to assume that investors in these countries are doing just as their frightened US counterparts were doing during the initial stages of the previous deflationary/depression more than 65 years ago; that is, hoarding cash and gold. After all gold is as good as cash and is instantly convertible into US dollars. Gold, however, is a better form of money than even the US dollar. Because it is the ultimate money and has been viewed as such since biblical times. Gold is still recognised as the international financial asset that is not someone else's liability. It cannot be defaulted. Whenever the US dollar falls in value gold rises against it, because it becomes cheaper in other currencies and because it is viewed as a hedge against the dollar, which is world's reserve currency. That gold is currently increasing in value against a rising dollar is indicative of an underlying strength and gives further credence to the theory that Japanese and Asian investors are beginning to accumulate the precious metal.

If gold rises in inflationary times, it absolutely soars when the major countries of the world are consumed by deflation. This is something very few people understand, but it really is quite simple. Think of gold as the ultimate international currency, something that any individual anywhere can use as money in times of trouble. Deflation is invariably a part of a credit and banking crisis, brought about by a massive loss in confidence in a country's economy. This loss of confidence is transferred to the country's currency, which quickly loses value against other currencies and gold.

The story on gold is that it is a pure financial asset when the financial systems problems are getting worse. [9]

Currently, the US dollar enjoys a reputation 'as good as gold', but is it? If the US stock market crashes, as I think it will, there will be a flight out of the dollar and dollar-denominated investments. Once investors have lost confidence in the dollar, there is no international currency except gold that can replace it as a safe store of value. Since the world supply of gold is limited, demand will outstrip supply, forcing prices dramatically higher.

The American Bubble

"Nobody rings a bell at the top of the market."-Market Adage

The vast majority of investors are conditioned into believing that the future is an extrapolation of the present and that the Bull Market in North American equities will continue unabated. Their confidence is manifested by the enormous amount of money pouring into mutual funds and by the bullish consensus figures published each week in Barron's. The 'Bullish Opinion' published by *Consensus Index* stood at 80% in the middle of April, which is a number that cannot be sustained for long. Markets reach the top when everyone who wants to own stock has finished buying and there is noone left to buy. At that point, just a small amount of selling can have a disastrous affect on prices.

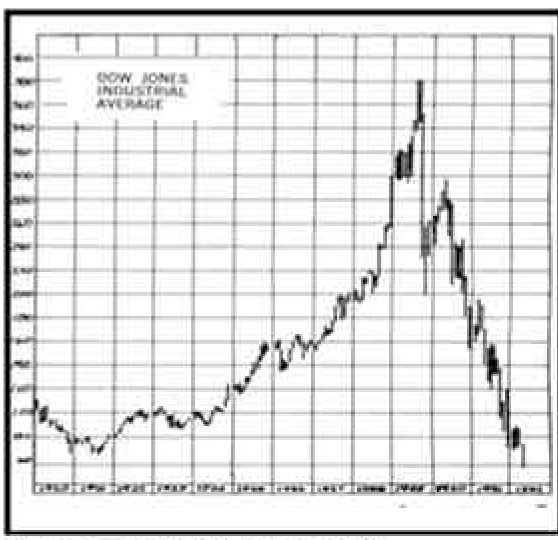
One week before the devastating stock market crash of October 29th, 1929, Thomas Lamont, a senior partner at the House of Morgan, wrote to President Hoover, "The future appears brilliant. It is this future which the stock market has been discounting…..we have the greatest and soundest prosperity, and the best material prospects of any country in the world. Our national resources, our selected population, our great domestic market, our efficiency and our capital supplies make our securities the most desirable in the world. The whole world (including notably, and on a large scale, Chancellor Snowden's British compatriots) has wished to buy our stocks and is pleased to lend money at attractive rates."[10]

The sentiment fits the current situation in the US. Perhaps the only difference between now and then is that this time the Bubble is even bigger, which makes the situation even more dangerous. Bubbles are the product of easy money during the Long Wave Plateau period. The American share price boom has been given air by excessive monetary growth of almost 10% over the past year. The story was the same in the 1920's. Writing in Forbes Magazine in 1927, Richard Schabacker declared that "There can be little doubt , regarding the steep rise in stock prices since 1921, that the underlying cause for such advances has been easy money."

It has been said that a bubble is invisible to everyone inside the bubble. This would include every individual and institution invested in stocks, bonds and real estate. What is so frightening is that they have so much confidence in the inevitability of a rising stock market. Most individuals are invested through mutual funds, which they believe cannot lose money over the long term. These funds are managed by professionals, who have excellent credentials and investment savvy. They are not gods, however, and like everybody they can be caught up in the euphoria of the moment. John Kenneth Galbraith put it aptly when he said, “Financial genius is a rising stock market.” During the 1920s the investment gods were people like J.P.Morgan, Billy Durant, Jacob Raskob, Irving Fisher and others. None of them anticipated the crash and most of them were left much poorer as a result of it. Today’s investment heroes are the mutual fund managers and investment stratagists at the major US brokerages. One man in particular stands out as an investment genius; his name is Warren Buffet. Mr Buffet takes great pride in subscribing to the theory of value investing as defined by Benjamin Graham in the 1920’s. Unfortunately Mister Graham failed to follow his own advice losing 20% of his equity portfolio in 1929 and a further 50% in 1930. Mister Graham later recalled that prior to the crash he and the legendary Bernard Baruch “agreed that the stock market had advanced to inordinate heights, that the speculators had gone crazy, that respected investment bankers were indulging in inexcusable high jinks, and that the whole thing would have to end one day in a major crash”. [6]

***Still thou art blest compared wi’ me!
The present only toucheth thee: But och! I backward cast my e’e
On prospects drear.
An’ forward, tho’ I canna see,
I guess an’ fear.[8]***

There is virtual unanimity of opinion on the part of these investment managers that the Dow will rise to 10,000 this year and 12,000 in 1999. The stock market is up 15% already this year, which takes its total rise over the past two years to an enormous 65%. Already, this stock market has become the most expensive in history, and New York stocks are now valued at $15 trillion. Yet investors are flooding the market with money at the rate of $1.7



Dow Jones Industrial Average 1920-1929
Source: Anatomy of a Crash, Traders Press, p.60

Note that the Dow Jones Industrials plunged to 44 pts lower than the 66 pts. from which the Dow start the 1921-1929 Bull Market. A repeat of that type of action would take the Dow below 770 - the point from which the current bull market started in August 1982.

billion a day, so that there is now more money in mutual funds than there is in deposits in the US banks. What is more alarming is the amount of margin that is now in the stock market. Margin debt is growing at an alarming pace and is now twice as high as it has ever been. This year it has grown more than 40% over last years pace. As bad as this is , it does not measure bank loans against share ownership, nor does it take into account the enormous amount of money that homeowners have borrowed to buy shares against the equity in their homes. Margin calls are at best unpleasant for those who receive them and at worst traumatic for those who do not have the money to cover. A large amount of margin overhanging the market is very unstable. In 1929 the high margin position in the market was a major contributor to the market crash. If a margin call is not answered the stock position is sold out, which of course adds to the selling pressure in the market.

The trouble with bubbles is that both banks and investors throw caution to the wind. The trouble with extreme leverage is that it provides the impetus to a panic when a market starts to drop.

Interest Rates

Interest rates are the price of credit (loanable funds). Money is simply a commodity and

US Bonds
Chart Source: The Notley Information Service

By 1933, interest rates rose above the level they were at at the top of the Inflationary Cycle in 1921. If that is repeated during this depression phase, rates in the US will rise higher than they did in 1981 — over 15%.

like any commodity, it is based upon the laws of supply and demand. When the demand for money is greater than the supply, interest rates rise, and vice versa. During the initial stages of the deflationary depression interest rates rise, because shaky businesses and cash strapped governments scramble for money. Money itself is scarce, since the stock market crash that precedes the depression destroys wealth. Given that demand is high and supply is low, interest rates must rise, in spite of a drastically weakening economy.

This is exactly what happened between the stock market crash in October 1929 and the end of the gold crisis in 1932. As I showed in the last issue, long-term interest rates in the United States were higher in 1932 than they had been at the top of the previous inflationary cycle in 1920. That is why we do not recommend buying bonds at this juncture of the long wave cycle. High quality bonds should be purchased at the top of this anticipated peak in interest rates.

Conclusion

The end of the Disinflationary period of the Kondratieff Long Wave is invariably signaled by a stock market crash. Such respected publications as the Economist and the Financial Times have become increasingly concerned about the US bubble economy. Indeed, The Economist's lead article in the April 18th-24th publication was titled 'America's bubble economy'. The Financial Times has made many references about the same subject. Martin Wolf recently wrote an extensive article in the Financial Times titled 'How Bubbles Burst'. Many people think that the Asian crisis will bypass the US and Europe. In fact it is contributing to western asset overvaluation. It is virtually impossible to let the air out of a financial bubble gently . That is why investors should take warnings of a bubble very seriously.

We at the height are ready to decline. There is a tide in the affairs of men, which taken at the flood, leads on to fortune; Omitted, all the voyage of their life is bound in shallows and in miseries. On such a full sea, we are now afloat, And we must take the current when it serves. [7]

Followers of the Kondratieff Wave know that an investment bubble is characteristic of the disinflationary period of the cycle. They also know that the end of each previous disinflationary period was marked by a stock market crash. Donald Hoppe listed the following ten signs of an impending crash:

1. Record breaking trading volume.
2. Heavy sales of mutual funds.
3. Rise in margin loans to all-time highs.
4. Great public interest in speculation
   - Focus of public's attention
   - Front page news stories about market gains.
5. Euphoric attitude toward speculation, with unrealistic expectations and predictions
   - Stocks selling at high P/E ratios and low yields.
6. Excessive issues of new securities and frequent secondary distributions.
7. Sharp breaks quickly recovered
8. Widespread delusions about the future. Unwarranted confidence in the light of existing problems.
9. Price advances turn exponential (stock prices appear to be going straight up)
10. Warnings about dangers of speculation ignored. Those who warn of such dangers ridiculed or accused of "sabotaging the recovery"[14]

These signs are obvious in the current market and, therefore, I believe the danger of a stock market crash is very real.

Next Issue:

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MUTUAL FUND MANIA & EUROPEAN MONETARY UNION

Investment Strategy

(See Figure 1 - The Cycle - P. 3)

The move from the disinflation cycle to the deflation cycle of the Long Wave is invariably caused by a crash in equity markets. There is plenty of evidence to suggest that this is imminent. Therefore, I recommend:

Footnotes and Credits

[1] The Economist, April 18th-24th 1998.
[2] Financial Times, Gwen Robinson, April 9th 1998.
[3] The Sunday Times, 5 April, 1998.
[4] Hoppe, Donald . The Donald J.Hoppe Analysis January ,1985 Page 11
[5] Abrahams, Paul. Finacial Times. Tuesday April 21st 1998, Page 1
[6] It was a very good year, extraordinary moments in stock market history. Martin S Fridson, John Wiley and Sons, 1998. P90
[7] Shakespeare, William, Julius Caesar
[8] Burns, Robbie, from 'To a Mouse'
[9] Coxe, Donald
[10] Dafoe
[11] Thomas, Gordon & Morgan, Witts-Max - The Day the Bubble Burst, Hamish Hamilton, London, 1979, P331
[12] Financial Times, March/April 1998
[13] Financial Times, December 1997
[14] Hoppe, Donald, The Kondratieff Wave Analyst, July 1986 P80.

Some in
clandestine
companies
combine;
Erect new stocks
for trade beyond
the line;
With air and
empty names
beguile the
town,
And raise new
credits first, then
cry our doom;
Divide the
empty nothing
into shares,
And set the
crowd together
by the ears.[10]

[May 8, 1998]

? ? The sale of all positions in equities and equity mutual funds;

? ? The sale of long-term bonds in anticipation of a currency crisis;

? ? The purchase of Treasury Bills and other secure short-term money instruments to preserve capital;

? ? The purchase of gold and gold equities as a small percentage of the total investment portfolio.

Readers may call me at 1-888-388-3885 for my recommended gold equity portfolio.

Chart Source: AIQ Charts

Last Minute Notes

Dow Jones Industrials - Close 9055

In my last newsletter, which I wrote when the Dow Industrials were at 8370, I predicted that the Index would rise to 8800-9000. It has exceeded that. However, it now appears that an intermediate top has formed. This will be confirmed by a weekly close below 8750. Any break of this level could take the Dow down to 7600. I have tried to warn readers that a crash is the likely outcome given the extreme bullishness in the market. In that event, 7600 looks like a likely first-stage target. Resistance is at the 9300 level. There is a chance that the 8750 will hold and one further run into July could take the Dow to new highs. Such a move is unlikely to be confirmed by other stock indices.

Chart Source: AIQ Charts

TSE Gold Index - Close 7091

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