

ECONOMIC AND FINANCIAL ANALYSIS BASED ON THE LONGWAVE PRINCIPLE

LONGWAVE ANALYST



A FEW SMALL GLITCHES IN THE ROAD

This is how U.S. President Clinton dismissed the Asian crisis last November and he was not alone in his underestimation of the impact that the crisis would have on the world economy. Around the world governments are facing currency crises of varying degrees. Recently, the South African rand has come under attack and in late June, Pakistan devalued only three months after Credit Suisse First Boston rated Pakistan only a moderate risk.

Weak commodity prices appear to be playing a significant role in the growing list of countries resorting to currency devaluation. Commodity prices dropped 11% in the second half of last year and have started to fall again since May. This has had a major impact on any country dependent upon commodity exports for its national revenue. The subsequent decline in revenue has meant that "there is less construction activity, a scarcity of trade finance and rising import costs in national currency terms."¹ This is the experience throughout Latin America, the Middle East and many countries in Africa, including South Africa. Most importantly, however, falling commodity prices have greatly exacerbated the problems facing Russia. While North America and Europe have dismissed the Asian problems as regional, significant problems in Russia will have serious financial and political implications for the world at large.

Meanwhile, the West seems impervious to the growing financial disasters elsewhere in the world. The U.S. economy has been leading Europe into an era of expanding growth while Asia, which until last year was the world's strongest economic region, slides into a depression. Japan is already in a severe recession, which is impacting upon the rest of Asia by reducing Japanese demand for Asian goods. The falling yen is contributing to increased Japanese competition, which is particularly onerous for South Korea and Taiwan. Stock markets in Asia have been routed, while in the West they have been experiencing unprecedented gains. There really are only two possible, but diametrically opposed, outcomes to this paradox. The first is that Japan turns its economy around which helps to lift the most damaged Asian economies from the bottom. This in turn renews investor confidence in that region, which is the spark to a widening economic recovery. The second sees the yen continuing to lose ground against the U.S. dollar; China lets the renmimbi fall and the Hong Kong dollar peg fail. This leads to a fresh round of devaluations and economic collapse.

The Gathering Storm

It all started in May 1931. There was a run on the Kredit-Anstalt bank in Austria, brought about by French demands for the repayment of short term debts. International assistance was insufficient to control the damage, so that by the end of May the Austrian Government voted a \$150 million (U.S.) guarantee to the bank. By then, the Austrian government's credit was worthless and the bank failed, followed by the Government itself, which declared national bankruptcy by going off the gold standard. The Austrian difficulties led to runs on banks in Hungary, Czechoslovakia, Romania, Poland, and Germany. Nowhere was the problem more acute than in Germany, which was weighed down with war reparations and a close financial relationship with Austria. By June, an international credit was arranged and the French agreed to a moratorium on German reparations. However, it was not enough: the banking crisis deepened and, by July, Germany was seeking to borrow \$1 billion (U.S.). Governor Norman maintained that the Bank of England had "already lent quite as much as is entirely convenient in Austria, Hungary and Germany to avoid financial collapse."²

In mid-July, the currency attack shifted to Sterling. One theory for this was that holders of Sterling were worried by the extensive foreign holdings of the British currency. (A similar situation exists today with the dollar.) Despite official assurances, the attack on Sterling continued unabated, and in September Britain was forced off the Gold Standard. Almost immediately the pound fell by 25%. Great Britain's move was followed by some 25 other countries, largely within the Empire, Scandinavia, and Eastern Europe. Traditional British trading partners such as Argentina, Egypt and Portugal also devalued. The currency attack then shifted to the Yen and within three months the Bank of Japan lost Y675 million in gold, so Japan suspended the gold standard in December 1931.

The Bank of France began converting U.S. dollars into gold, soon after the British suspension. The reasons given to the Federal Reserve were that the French Central Bank had sold gold forward to Belgium and Switzerland and the 'considerable' losses that the Bank of France had sustained on its balances held in London. From mid-September to the end of October more than \$750 million (U.S.) in American gold was shipped to Europe. In typical fashion, the Federal Reserve responded to the loss of gold by raising administered interest rates. In the Spring of 1932, the French purchase of U.S. gold for dollars continued, but then subsided until the Presidential election of Franklin Roosevelt in November, which was greeted by a sharp lack of enthusiasm abroad and a belief that America would repudiate the gold standard. Indeed, on January 31, 1933, Henry Wallace, the designated Secretary of Agriculture in the new cabinet said, "the smart thing would be to go off the gold standard a little further than England has."³ This led to a further run on American gold, not only by European Governments, but also, by American citizens themselves, who had become distrustful of the dollar. In March, the United States halted gold exports. The world currency crisis that had started less than two years before had humbled the mighty dollar.

There are several points which should be noted about this particular crisis:

1. Individuals and countries alike had a choice between holding any particular currency or converting it to gold at a fixed price.
2. Many countries and individuals chose to purchase gold with their paper currencies, even though

those currencies were fully convertible into gold. They trusted the real thing, rather than the promises of their governments. Most governments broke their promises anyway.

3. National interests take precedence over international responsibility. Countries adopt a beggar-thy-neighbour attitude.

4. Once an attack began on any particular currency it was almost impossible to stop it. There was huge international support for the currencies of Austria, Great Britain and Germany, but to no avail.

5. Investor perception about how a country will respond to a national problem plays an important role in their investment strategies.

6. Confidence in a country and its respective currency is important to maintain currency stability.

7. Perception and confidence can turn on a dime.

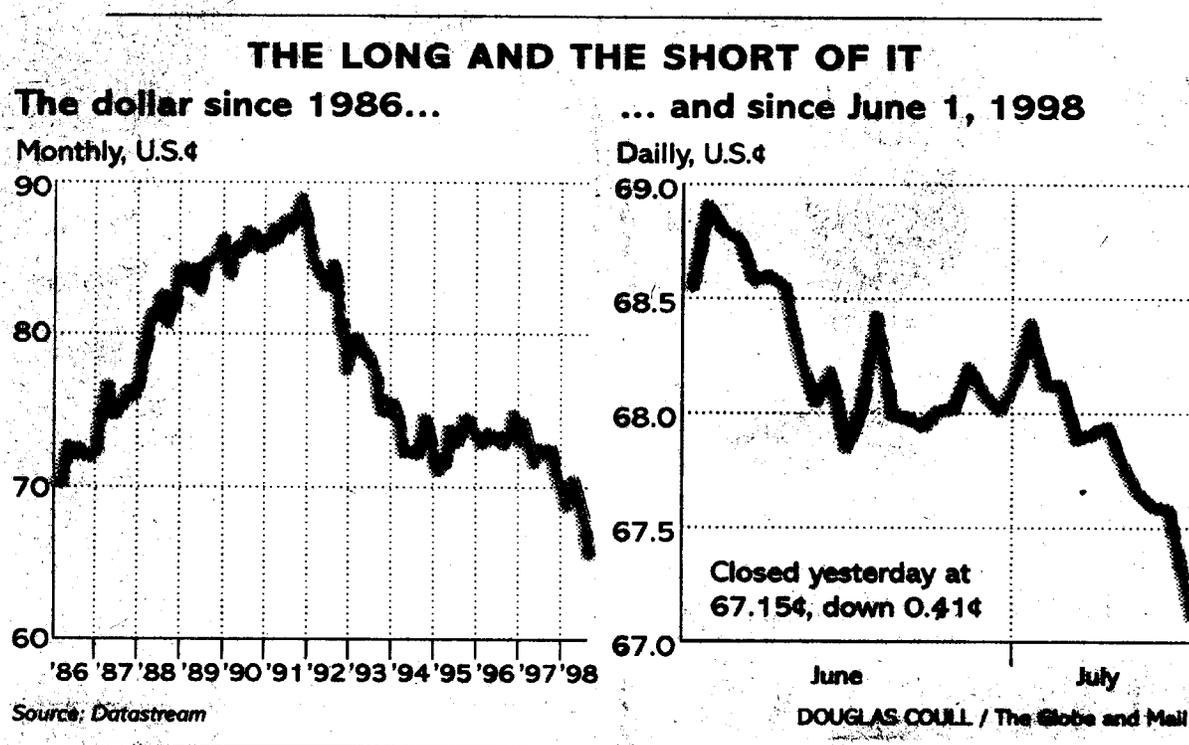
8. A national currency crisis can quickly turn into an international phenomenon, particularly, if there is a currency peg. During this particular crisis it was the peg to gold which was the undoing of so many currencies. In the present crisis it is the peg to the dollar that is the cause of all the problems so far.

On July 2, 1997, Thailand unpegged the Baht from the U.S. Dollar and the Bhat fell 20% against the dollar. This started a currency maelstrom, which is yet to play itself out. Within six months most of the Asian countries had devalued their currencies and their economies have been thrown into a widening recession, which the Financial Times has called "Asia's Great Depression".⁴

It is expected that the Indonesian GDP will decline by 13% this year, Thailand's by 6% and Malaysia's by 2%. Capital flows to Thailand, South Korea, Malaysia, Indonesia, and the Philippines have all but ceased, since creditor confidence has been eroded. Real wages have collapsed, government finances are tight and the dollar value of exports are increasing marginally. Bad loans in the banking system are still growing and Sathit Uthaisri, the group executive vice president of Bangkok Bank recently said, "It is nearly impossible in this environment to turn non-performing loans into good ones."⁵ "Now the world is getting worried about round three of the Asian crisis," says Neil Mckinnon, an independent hedge fund advisor.⁶ This next round might very well see another bout of competitive devaluations instigated by China, where a rapidly slowing economy is cause for grave concern.

Meanwhile, the ripple effect of that seemingly innocuous devaluation by Thailand one year ago is being felt around the world. While the problems in Asian countries have been compounded by the Japanese banking crisis, which has resulted in a credit crunch in that region, the commodity-producing countries elsewhere are feeling the squeeze as the dollar value of their exports is being rapidly depleted by a declining world demand. Nowhere is this more apparent than in Russia, where its principal export, oil, has dropped in price by 30%. Now, South Africa is weakening and the rand has been devastated by speculators smelling blood. The economy is slowing and unemployment in the country is running at 30 to 40%. Inflation is rising and the government has few foreign reserves with which to defend the rand.

In South America, the effects of lower commodity prices are beginning to have their effect on traditionally weak economies. In Chile, which has been considered the region's best example of a free market system, lower copper prices are beginning to take their toll. Argentina, Brazil and Mexico are also being hurt by lower commodity prices. Even in Canada, which has traditionally benefited from its proximity to the United States, the 'Loonie' has been falling to new record lows. Once the American economy starts to contract, the Canadian dollar will be hit by the double whammy of falling commodity prices and declining exports to its biggest export market.



Source: Datastream Douglas Coull / The Globe and Mail

Russia

The flight from the Russian Rouble is not entirely attributable to the Asian crisis although events there have encouraged a flight to quality. From an entirely different perspective, however, events in Asia have hurt Russia's exports, which are still largely commodities. There is a growing danger that the Rouble will be devalued. In that case, most eastern European countries would be forced to follow suit. This would trigger a new banking crisis, which would likely spread to Western European banks, particularly German banks. The following table outlines the countries whose banks have the largest exposure in billions of U.S. dollars to Russia.

Germany	\$30.5
United States	\$7.1
France	\$7.0
Italy	\$4.3
Austria	\$3.6
Netherlands	\$2.2
Total outstanding loans from Western banks	\$72.2

Source: Bank for International Settlements.

This German exposure is as big as that country's exposure to five of the most troubled Asian countries. The weakening Deutsche Mark reflects German exposure to the explosive Russian financial and political situation.

The Financial Times recently reported, "Russia is on the verge of a financial disaster. Every day it seems, the country needs an even bigger loan from the International Monetary Fund to stave off the rising risk of a massive rouble devaluation."⁷ This sentiment was echoed by Larry Summers, the U.S. Deputy Treasury Secretary: "Russia's problem has the potential to become in turn, Central Europe's and the world's."⁸ Russia's gross foreign exchange reserves were only \$14.6 billion (U.S.) at the end of May, which covers less than three months imports, and is only 11% of external debt and 3% of GDP (Gross Domestic Product). This means that Russia has precious little with which to counter a run on the rouble.

The rumour contained in a spate of Russian newspaper reports is that the executives of the major energy companies are seeking a devaluation of as much as 50%. Such a massive devaluation would be catastrophic, severely impairing the credibility of the central bank, which would lead to even more political uncertainty and much higher inflation. Such a devaluation would almost certainly cripple the majority of the more than 1,700 Russian banks which are small and poorly capitalised. Most of these banks have not attracted a large deposit base, but have profited from speculation in currency, debt and equity markets.

Holger Mueller, a banking analyst with Fleming UCB, the Moscow-based investment bank, estimates that Russian banks were speculating wildly in the currency markets last year, with forward contracts worth more than \$355 billion (U.S.) in place by the beginning of 1998. This is more than three times the combined assets of the entire banking system. While the Russian banks have reduced their exposure this year, there is still a danger that a 50% devaluation would destroy the entire banking system, except for Sherbank, the State savings bank. The Financial Times, June 25, 1998.⁹ The recent downgrading of Russia's sovereign debt credit rating by Moody's Investment Service Inc. and Standard and Poor's Corp. puts Russian bonds in the same investment category as the Dominican Republic, Turkey and Brazil. Still, investors flock to the issues looking for a high yield, while maintaining a belief that the Group of Seven Nations will support the country through its financial crisis. Russia has already borrowed \$4.75 billion (U.S.) this year.

Despite the huge appetite for Russia's bonds, there are some who have their doubts. Barry Allan, who

manages \$400 million (U.S.) of high yield corporate and government bonds for Altimira, says “I don’t believe it’s a buying opportunity right now. The potential for default in Russia is probably higher than anywhere else in the world.”¹⁰ These soaring interest rates are having a disastrous effect on an already mountainous budget deficit. Meanwhile, Russia is seeking up to \$20 billion (U.S.) to weather its latest financial crisis. \$10 billion (U.S.) of this is supposed to come from the IMF, which over the past three years has already loaned Russia \$9 billion (U.S.). Many of the conditions set by the IMF for the loans have not been undertaken and it is not unreasonable to expect future conditions, based upon future loans, will also largely be ignored. In Moscow, it is widely assumed that if the rouble were to become rubble, President Yeltsin’s days would be numbered. That scenario would have all kinds of unpredictable effects, none of which are comforting to ponder. It was under similar financial circumstances that Adolf Hitler rose to power in Germany in 1931.

Already President Yeltsin is facing increasing pressure, even from his former staunch supporters, the Coalminers, who have been protesting on Moscow streets. Many public sector workers have not been paid and worker protests have been supported by the hardline Communist parliamentarians who are trying to impeach the President. Business leaders and newspaper editors are joining the growing throng calling for Mr. Yeltsin’s resignation. This leadership turmoil adds to the lack of foreign confidence in Russia’s ability to implement the economic and taxation reforms required to bring the financial crisis under control. Failure to arrest the growing financial disaster in Russia will almost certainly lead to an international political and financial nightmare scenario.

Late News - July 14, 1998

The Financial Times reported today that the IMF will rescue Russia with an \$11.2 billion (U.S.) aid package. An additional \$1.4 billion (U.S.) will be paid by Japan and the World Bank. If existing programmes are included, Russia will receive \$22.6 billion (U.S.) before the end of 1999. This international support

Even if they are imperfect, it is essential that the Duma approve the tax reforms, or Russia will remain ungoverned, and ungovernable.¹⁷

package came after the United States put heavy pressure on the IMF to help stabilize Russia’s collapsing financial markets. “It is intended to boost the rouble, strengthen the budget and enable the government to reduce the crippling levels of domestic interest rates.”¹¹

Will this be enough? I do not share the initial confidence expressed by some commentators. Augusto Lopez-Claros, chief Russian economist for Lehman Brothers, said after the announced bailout package, “There is a general sense that the Russians are going to turn the corner.”¹²

Once in motion, an international currency crisis tends to play out to a depressing conclusion, in spite of international attempts to defuse the situation by throwing money at it. Psychologically, the country affected by the crisis suffers from a growing sense of despair, as unemployment rises and interest rates remain high. The Russian crisis is not an isolated phenomenon, but is a part of a growing international currency malaise.

The initial result of this bailout will be to convert Russia's short-term debt into U.S. dollars, which will effectively reduce interest rates on the debt. By swapping rouble debt for dollar debt, Russia has assumed a considerable foreign exchange risk, which may return to haunt investors if the rouble is eventually devalued. It will also be difficult to convince the Communist dominated Duma to approve spending cuts and to introduce tax reforms, which will enable the country to effectively collect taxes. Russia is targeting to reduce its budget deficit to 2.8 percent of GDP next year from 5.6 percent this year. This must cause additional pain to the country's long-suffering citizens.

The U.S. Investment Markets

In these newsletters I constantly refer to the U.S. stock market in 1929. I do not select that period out of a morbid fascination for catastrophe, rather because that event ended the plateau period of the Kondratieff cycle and the plateau period is followed by the deflationary/ depression stage of the long wave. By my reckoning, we are at a similar stage in the long wave cycle once again, and I have produced many arguments in previous issues to support my view.

In 1921, the Dow Jones Industrial Average bottomed at 63.90 points following a two-year bear market, which had seen the Dow lose close to 50% from the high of 119.62 points in 1919. The ensuing bull market was a typical plateau period market characterized by growing speculation, which took the Dow to a top on September 3, 1929, at 381.17 points for a bull market gain of 497%. The October crash cost the Dow 50% and what followed was a bear market of unprecedented proportions which took the DJIA down to a low of 41.22 points on July 8, 1932 (89% below the high). This was as low as the stock market had been since 1897 and, more importantly, it was 35% below the level of 63.90 points, which was the low from which the plateau period bull market began its upward course.

In 1982, the Dow Jones Industrial Average bottomed at 776.92 points ending the bear market that typically follows the expansion phase of the Kondratieff Wave. Following this bear market, the stock market has risen almost 1,100 percent, which is more than double the move of the Dow in the previous plateau. Such an incredible move should of itself act as a warning that a top is at hand. If this is not precise enough, then the unprecedented values of the market itself should serve as a warning. The Dow Jones Industrials are now trading at six times book value. The Dow has traded above 2.8 times book only twice: 1929 and 1987. It now takes \$65 (U.S.) to buy \$1 (U.S.) of dividends. At significant market tops during this century, it required an average of \$30 (U.S.) to buy \$1 (U.S.) in dividends. The price earnings ratio is at 24 times. This number is artificially low, because it fails to take into account the rich directors' options, which are a part of most corporations' pay packages; nevertheless, it is higher than it was in 1987 and close to the highest it has ever been.

The deflationary aspects of a stock market crash should be apparent. A stock market crash instantly destroys wealth. The present value of all stocks trading in the United States is approximately \$17 trillion (U.S.). Following the crash of 1929, the destruction of wealth in America played an important part in the ensuing depression. The end of the plateau period has always, in the past, been signaled by a stock market crash.

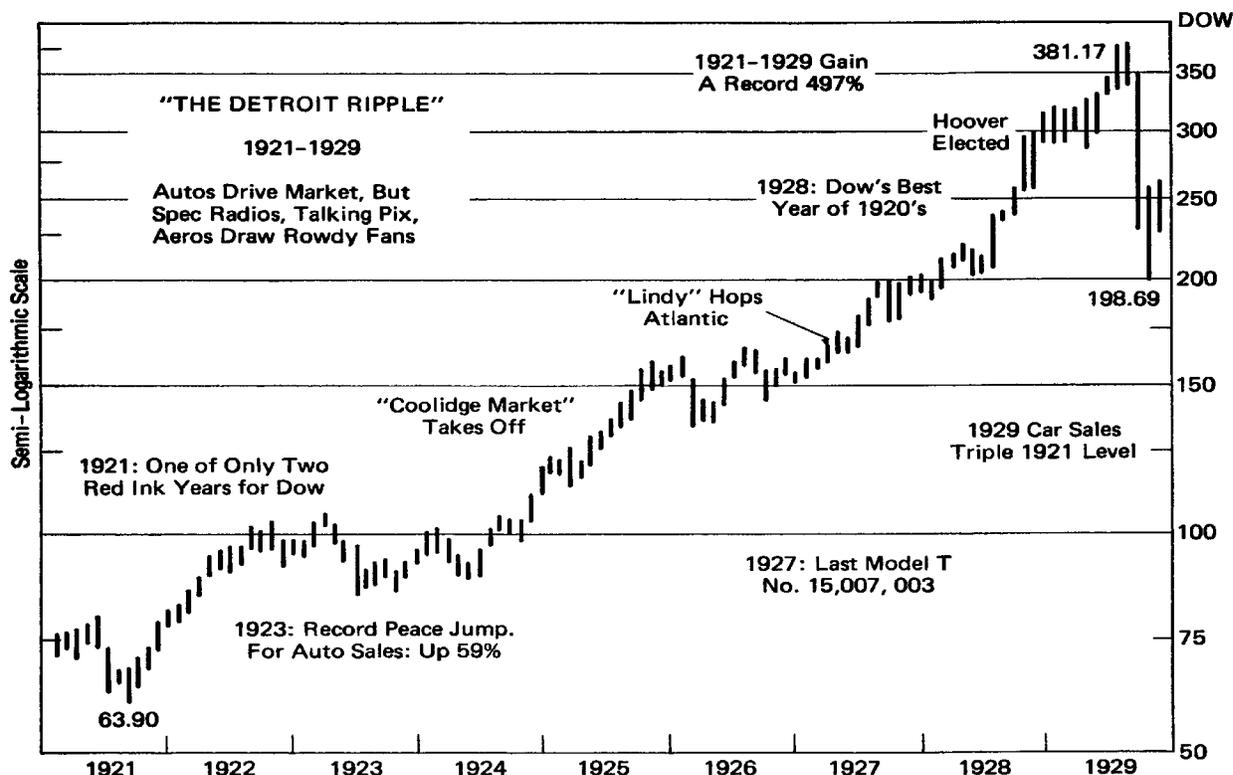


Figure 3.2 Dow Jones Industrial Average, 1921–1929

101 Years on Wall Street, J. Dennis Brown, p 126

Gold

“If you have to choose between trusting to the natural stability of gold and the natural stability and intelligence of the members of the government. And with due respect to these gentlemen, I advise you, as long as the capitalist system lasts, to vote for gold”. George Bernard Shaw

Gold’s principal role in the world is to be the money of last resort; i.e., when the value of paper money collapses, as it is now doing all over the world, gold replaces paper as a store of value. No paper money has ever withstood the test of time and government ineptitude. The U.S. dollar, which is currently viewed as a safe haven currency, has lost 90% of its purchasing power since 1900. It is likely that the dollar will lose this status just as it did in the 1930’s, when it was far more deserving of its premier rating. Then, the U.S. was the world’s largest creditor nation with a miniscule budget deficit. Today, the U.S. is the world’s largest debtor and possesses a budget deficit well in excess of \$5 trillion (U.S.). In 1929, the crash on Wall Street eventually took its toll on the mighty gold-backed dollar.

In the previous two issues, I have written what Donald Hoppe contends were the five phases to the evolving world currency crisis of 1929 to 1933. It is important to review them and measure them against the present currency crisis:

1. *Flight from questionable securities into strong securities.* There have been major declines in all the world stock markets except those of western Europe and North America; that is, money has flowed from the Asian and other developing markets into the traditional markets and stronger economies of Europe and, in particular, into the American market.

2. *Intense liquidation of inventories and commodities.* Commodity prices are dropping, which is indicative of rapidly falling demand brought about by the growing economic contraction in Asia. Since the Asian crisis started one year ago, commodity prices have dropped 20% in price.

3. *Liquidation of commercial real estate, houses and farms, both through foreclosures and sacrifice sales at a fraction of former values.* Japanese real estate values have already fallen some 80% from their 1990 highs. Prices in Hong Kong and elsewhere in Asia are beginning a downward spiral caused by the weakening economies in that region.

4. *Flight from banks into cash and gold.* Japanese and Indonesian civilians are hoarding cash for fear of a banking collapse and there is evidence that they are also hoarding gold. There has been a persistent rumour circulating on the Internet that the Japanese Government itself recently purchased 400 tons of gold, the only way that the country could effectively hedge against its massive U.S. dollar holdings.

5. *Flight from the dollar into gold.* At this stage of the crisis, money from around the world has been flowing into the dollar. "Here in Chile, once considered the region's economic fortress, corporations and banks have been selling the local currency, the peso, heavily in recent days. They have been hoarding U.S. dollars for fear that the peso may devalue further than it has already as a result of trade pressures."¹³ During the gold standard crisis, money initially flowed into the dollar. It soon became apparent, however, that the crash on Wall Street had to a large extent destroyed the wealth of American citizens and this in turn was having a serious effect on the entire U.S. banking system. U.S. citizens started to hoard gold and cash and foreign countries started to turn in their dollars for U.S. gold, which could be exchanged for \$20 (U.S.) per ounce.

Gold and Deflation

***I value
everything by
bullion.¹⁸***

***Nathan Mayer
Rothschild, 1810***

Gold is the only commodity that rises in value during times of deflation because it assumes its real commodity purpose, which is to act as money. Most people assume that gold goes up during times of inflation because all commodities are rising in price, due to increasing demand. The demand for gold, however, is not based upon increased industrial usage, which is minimal anyway, but because gold acts as a hedge against the depreciating value of the currency. While some experts recognize this monetary role during times of inflation, they assume that during deflation the value of money rises and that the price of gold drops accordingly. This is not the case, because deflation destroys the

underlying paper money. One has only to witness the current effect of deflation on the Asian currencies or the Japanese Yen to understand that this is the case. Meanwhile, the U.S. enjoys a period of relative economic stability and the dollar is the main beneficiary, but when deflation comes to the United States, the dollar will no longer retain its safe haven status and gold will almost certainly become the currency of choice.

Can the United States escape the deflationary spiral that is spreading around the globe? While anything is possible, the United States has its own set of problems, not the least of which is a rising tide of consumer debt, an extremely overvalued stock market, and a huge negative trade imbalance.

The U.S. Dollar

Since the Bretton-Woods convention, the U.S. dollar has for the most part been considered a safe haven currency. This mystique is built upon shaky foundations since the United States is the world's largest debtor nation and there have been several instances since Bretton-Woods that the U.S. dollar has fallen out of favour.

In the late 1960's, countries could still exchange their dollars for U.S. gold at the official price of \$35 (U.S.) per ounce. At that time the U.S. was heavily engaged in the Vietnam War and many countries became fearful that the United States would inflate the dollar to pay for the war, so they began to sell dollars in exchange for U.S. gold. This heavy selling of the dollar forced President Nixon to renounce the final vestiges of the gold standard in 1971.

Between 1978 and 1979, the dollar again came under attack and lost almost 50% of its value against other leading currencies. Inflation was approaching 15% and the U.S. Government under President Carter was being humiliated by a small band of Iranian zealots.

During the early 1980's, the U.S. dollar rose to an uncomfortable level. In 1985, U.S. Treasury Secretary Baker secured an agreement with four major trading partners of the U.S. to reduce the dollar's value. This agreement effectively cut 30% off the value of the dollar and was the fuel that ignited the Japanese bull stock market.

Around the world, the U.S. dollar has become the currency of choice, which is not only reflected in its rising value against other currencies, but the record highs recorded by U.S. stocks and bonds. Behind this euphoric scene lies a huge indebtedness, currently in excess of U.S. \$1 trillion. This is principally owed to the Japanese and Chinese which puts the future of the dollar in the hands of nervous foreigners.

“Everybody ought to be rich”

This was the title of an article written by John Raskrob for the Ladies Home Journal in 1928. Raskrob had already managed to achieve what he was preaching to the women of the United States, having

made tens of millions of dollars in the markets. His idea was that ordinary Americans could participate in the stock market by pooling their money, which would be managed by a professional money manager. The idea had already been spawned in Great Britain in the mid-nineteenth century and the New York Stock Trust, organized in 1889, was the first American version of this type of company. It was not until 1921, with the organization of the International Securities Trust of America, that the modern securities

**Mutual Funds
have become
the bank
deposits of the
nineties¹⁹**

trust company emerged. Between 1927 and 1930 more than 700 similar trusts were formed. In 1929, new trusts were appearing at the rate of one per day. Some 265 of these trusts were organized by Wall Street brokerage houses and they became the darlings of the investing public, who paid more than \$3 billion (U.S.) into these trusts in 1929. At the height of the bull market in 1929, investment trusts had assets in securities holdings worth approximately \$4.5 billion (U.S.). “By the end of the decade it was difficult to pick up a newspaper or magazine without finding some article about the easy road to financial security via investment trusts and all supported

by pages and pages of ads for investment trusts.”¹⁴ Many trusts became hot issues. Shenandoah was offered at \$17.50 (U.S.) in late July, 1929 and closed at \$42 (U.S.) the same day. This was a new investment trust record. In September of that year, the public was buried with \$640 million (U.S.), which included a million shares of Lehman Corp. at \$104 (U.S.). “It was the final madness. ‘Professional Management’ would take decades to recover its reputation.”¹⁵

Mutual funds were spawned from the investment trusts of the 1920’s and were sold under a similar principle, which is the pooling of money under the investment care of a professional manager. Just as investment trusts had done in the 1920’s plateau period, mutual funds in this plateau period have grown at an exponential pace; indeed, there are now more funds in the United States than there are stocks listed on the New York Stock Exchange.

The Long Wave suggests that we are almost at the culmination of the plateau period. The end is invariably signaled by a stock market crash. In that event, it is likely that mutual funds will do for their investors what the investment trusts did for theirs one generation ago.

Conclusion

“The wise see trouble coming from afar.” Lao Tse

In researching for The Long Wave Analyst, I read a considerable number of books, newspapers and business newsletters. On the basis of this research, I aim to devise a comprehensive investment strategy based upon the Kondratieff Cycle, not only for my readers but also for myself. I believe that my approach is the first of its kind. There are other writers who make reference to Kondratieff and many of them believe that we are entering the period of deflation/depression but, to my knowledge, none have developed an investment strategy that is exclusively tied to Kondratieff. The key to devising an investment strategy based upon the Long Wave is to know precisely where we are on the Wave. In my first letter, I detailed the map, which should help pinpoint our location. There are really only three stages of the Kondratieff Cycle and their characteristics which are important to understand. Allow me to reintroduce them to you.

The Expansion Phase: It is about thirty years in duration. This period starts from a low level of consumer confidence, which begins to build as the economy expands. Personal debt is negligible and inflation is low. As the economy expands, prices start to rise and debt begins to build. Interest rates rise in conjunction with a rising rate of inflation. The stock market rises in keeping with a growing economy. Towards the end of this phase inflation is skyrocketing, bringing interest rates to unprecedented levels. The expansion phase ends with a peak in interest rates and a fairly significant stock market correction.

The Plateau Phase: This typically lasts about ten years (the current plateau period in Europe and North America has already lasted 17 years). It is characterized by a growing speculation in stocks, bonds and real estate, which is created by a huge expansion of credit. The speculative frenzy feeds upon itself with the feeling that the economic boom will last forever. Obviously, it does not, and the end is signaled by a stock market crash as in 1873 and 1929 in America and 1989 in Japan.

The Deflationary/Depression Phase: This lasts for approximately 20 years. Deflation cleanses the economy of the massive debt accumulated during the expansion and plateau periods. This is what is now happening in Japan and Asia and will almost certainly happen in Europe and North America. The Long Wave does not stay out of sync for any length of time and debt elimination is almost certainly international in scope. Indeed, one good reason that debt liquidation has not yet arrived in western countries is because the IMF has effectively bailed out banks and investors in the west, who lent to financially strapped Asia and Russia. The effect of this debt elimination is to cause wholesale bankruptcies, which increases unemployment and significantly reduces demand. This results in deflation and depression. "What turned the sharp recession of 1930 into the Great Depression in 1931 was the spread of the credit collapse internationally."¹⁶

On the basis of these short definitions, it seems clear to pinpoint our position as nearing the end of the plateau period. This is one of the most painful investment periods of the Kondratieff cycle, because there are limited options and it is difficult to leave an exciting bull market. Leave we should, because when the party gets rowdy people get hurt. It is not easy to envisage a bear market, let alone a market crash, when all we have experienced for the last eight years is a rising bull market, which has made many investors very wealthy, at least on paper. In November 1989, Japanese investors were in much the same position, their stock market had risen more than 500% in eight years and their economy was the envy of the world. How could anything go wrong? But it did go wrong and in less than one year the Nikkei stock average was 50% lower than it had been on December 28, 1989. There are several recent similar examples to draw from in Asia. The Hang Seng index, for example, has already lost more than 50% in less than a year.

The Kondratieff Cycle cannot accurately predict the length of time that each cycle takes to complete. Indeed, Nikolai Kondratieff himself estimated that the first two cycles which he was able to measure were 54 and 42 years long. However, the cycle can be a precise investment tool, and currently points to the culmination of the plateau period. This is the time to be invested in cash (T Bills) and gold, and a time to be out of stocks, bonds and real estate.

Last Minute Notes

US Stock Market: While we are nervous to predict further upside for the Dow Jones Industrial Average, technical indicators suggest that this is indeed the case. The Daily Chart of the DJIA infers that there are another 12 days or so left before indicators turn back down again. These 12 days could give a spike signal to the 9,500 level.

On the weekly chart, the MACDI is turning to the upside, but has yet to give a buy signal.

So, short-term, we are still bullish and for the medium-term, we are neutral.

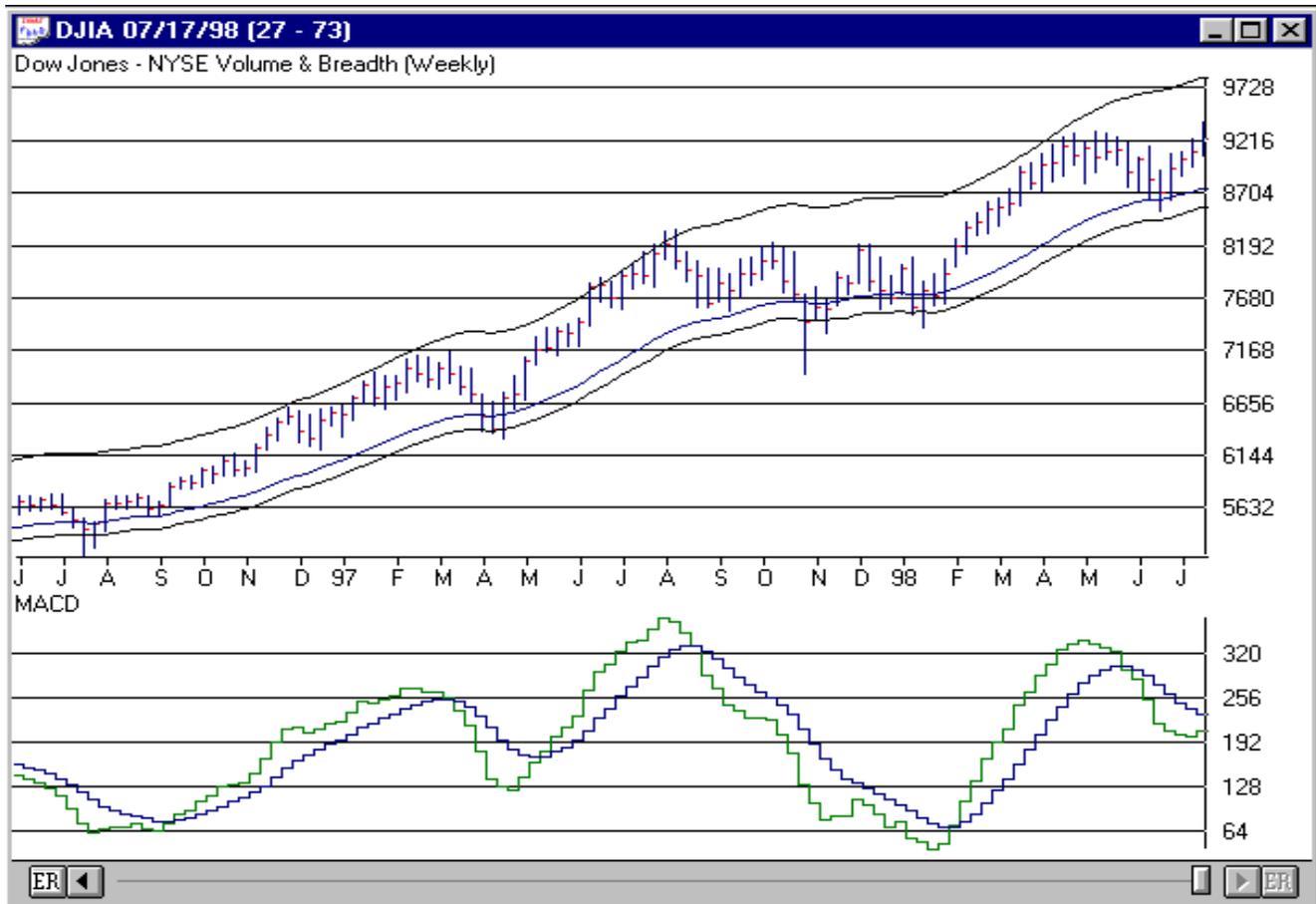


Chart Source: AIQ Charts

Meanwhile, the breadth of the market is poor, and many stocks have declined by more than 20% from their recorded highs. This is symptomatic of a broadening top formation, which leaves us much more nervous about the eventual outcome of this market.

Support on the weekly charts is 8,500; a close below this number would give an important sell signal.

TSE Gold Index: Gold stocks continue to underperform, and will probably do so until sentiment for the U.S. dollar changes to negative.

Short-term indicators are rolling over, which suggests a further sell off, which could take the TSE Gold Index back to the short-term lows at 5,660.

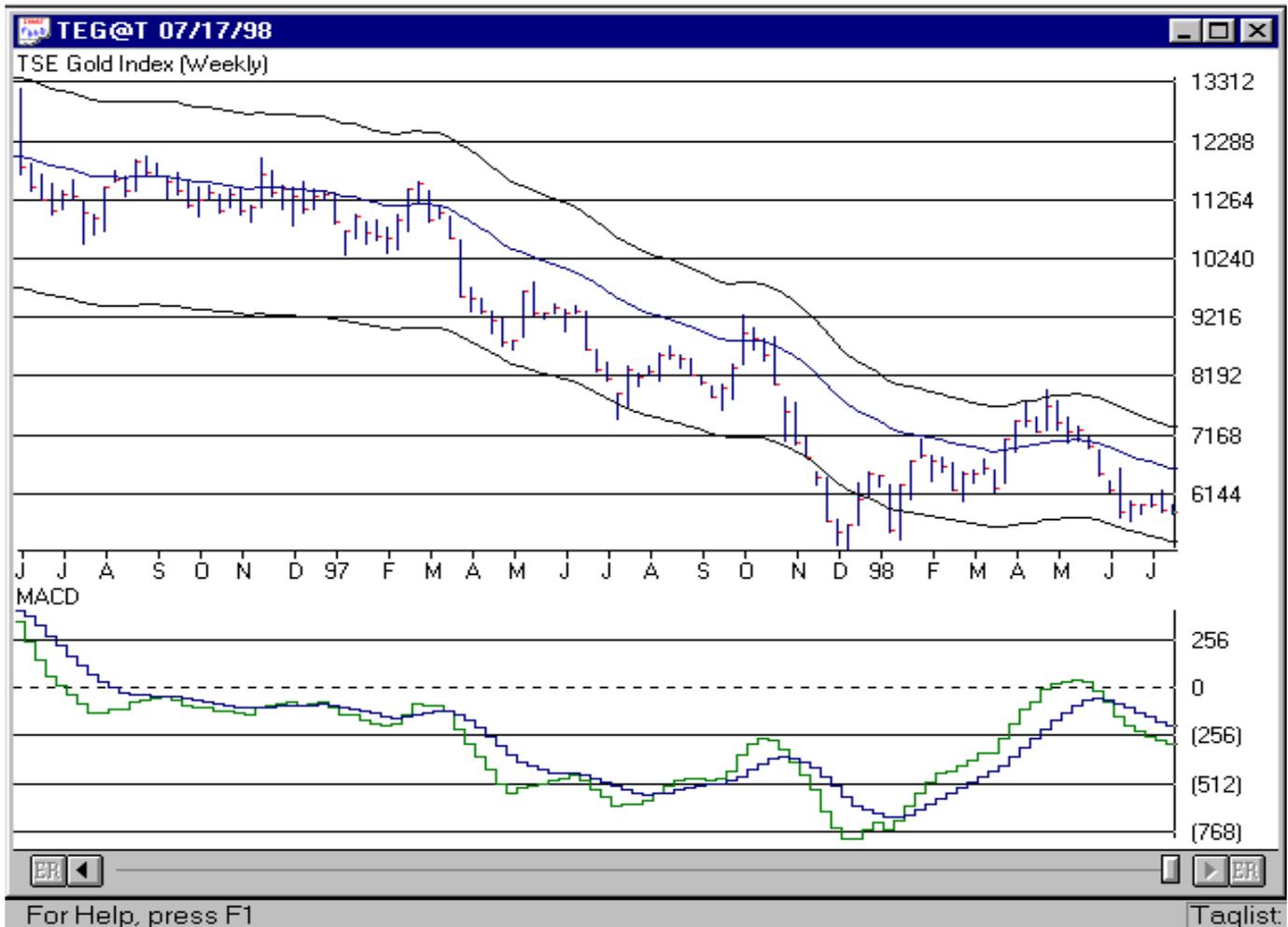


Chart Source: AIQ Charts

Of more concern are the intermediate indicators which appear to have given a buy signal in May and have since turned to the downside. This suggests another test of the lows below 5,200.

We will get mildly excited if 6,210 is exceeded, and more enthusiastic on a closing break above 7,950. Unfortunately, we expect our downside targets to be met first.

Footnotes and Credits

- 1 Robin Chote, Daniel Dombey, The Financial Times, Page 17, July 2nd, 1998.
- 2 Kindleberger, Charles. The World In Depression, 1929-1939. University of California Press, 1986. P.153.
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