Volume 4 | Issue 1
January 2002

LONGWAVE group

ECONOMIC AND FINANCIAL ANALYSIS BASED ON THE LONGWAVE PRINCIPLE

LONGWAVE ANALYST

THE GREAT DEPRESSION

Once in khaki suits,
Gee, we looked swell,
Full of that Yankee doodle-de-dum.
Half a million boots went sloggin' though Hell,
I was the kid with the drum.
Say, don't you remember, they called me Al-
It was Al all the time.
Say, don't you remember I'm your pal-
Brother can you spare a dime.
E.Y.(Yip) Harburg 1932. Music by Jay Gorney.

Closed! Los Angeles, 1931. Scenes like this were repeated in almost every city in the US over the next two years Will it happen again?

The Lords of Creation, Allen, Frederick Lewis, 1935

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Introduction

"I'm afraid, every man is afraid." - Charles Schwab, April 1932

My last letter was headlined with one of Yogi Berra's famous sayings, 'Déjà vu all over again?' May 2001. The question mark was deliberate, because I felt there was still a degree of uncertainty whether we had reached the 4th Kondratieff winter or not. Eight months have now passed and the events which have occurred since reinforce the conclusion that we are in our economic winter.

As I wrote then, the Kondratieff winter is always signaled by a peak in stock prices. It has been two years since US stock prices peaked. For the past two years prices have been lower at the end of the year than they were at the beginning. So yes, stocks have been in a bear market for the past two years and that fact confirms the start of the Kondratieff deflationary depression. It is true that the stock market peak has not been followed by a crash in stock prices, which would serve to confirm the peak in prices, unless, of course one argues that Nasdaq prices were the crash. From peak to valley the Nasdaq lost 75% of its value, and that index was the one most related to the speculative fever that gripped stocks throughout 1999 and into early 2000.

But stocks are once more in vogue and there exists a renewed stock market fervour. But the speculative frenzy is over. Evidence of this is the huge decline in brokerage revenues, the dearth of advertising by discount brokerage firms, and the large decline in margin debt. The enthusiasm for stocks is muted and reminiscent of the same type of enthusiasm that returned to the stock market in early spring of 1930. This tempered investment enthusiasm was supported by the official view. In January 1930, Treasury Secretary Lamont in outlining his forecast for the year pronounced, "I see nothing in the present situation that is either menacing or warrants pessimism. During the winter months there may have been some slackness in employment, but hardly more than at this season every year. I have every confidence that there will be a revival of activity in the spring and during the coming year the country will make steady progress." Or "Ten million more persons are now at work than were employed in 1921… The shock of deflation in security prices has largely been absorbed in three months. The danger of a long depression appears fairly over, with every evidence of an early renewal of the upward march (of prosperity)." Julian Barnes, Chairman, US Chamber of Commerce.

"See winter comes to rule the varied year, sullen and sad."

James Thomson (1700-1748)

By April 1930, the Dow Jones Industrial Average had clawed its way back to 294, or less than 90 points from its September 1929 peak. But that was it; from that point onward, the stock market started its inexorable slide to a bottom far below the point from whence the great bull market had begun. Nevertheless throughout 1930 the optimists, who were definitely in the majority maintained their relentless cheerfulness. Even as the stock market began to disintegrate again and unemployment started to rapidly increase; plus it was obvious that the world was already in the grip of a recession, if not something worse, the optimists refused to throw in the towel. Hoover himself advised the Chamber of Commerce on May 1st 1930, "I am convinced that we have passed the worst and with continued effort we shall rapidly recover."

Similar optimism is pervasive throughout the United States, today, based upon an uptrending stock market and a slight uptick in economic activity. This misplaced optimism, now and as it was then, is based upon a lack of understanding of the root causes of the problem. These are excessive credit/ debt and fundamental differences between an economic recession and a depression. Unfortunately, what lies ahead of us now, as it did in 1930, is a Long Wave deflationary depression, which will be far more destructive than a typical inventory-reducing recession.

If you know where you have been and where you are, you will know where you are going, or as W.D.Gann wrote, "History repeats itself. That is what I have always contended,-that in order to know and predict the future of anything you only have to look up what has happened in the past and get a correct base or starting point." Gann, W.D. Tunnel Thru the Air, Copyright 1927. Reprinted Lambert Gann Publishing Co. Pomeroy, Washington, 1990. P.75. Our understanding of the Kondratieff cycle has stood us in good stead in anticipating the most probable course of future economic and market events. We were able to recognize the dot.com mania for what it was, the beginning of the end of the great autumn bull market. We know that we have now entered the 4th Kondratieff winter. Using our knowledge of past Kondratieff winters, we are well positioned to determine the most likely courses for economic and market events at this time. They are not optimistic.

Now is the winter of our discontent

- Richard III, Act I, Scene I

The Dow Jones Industrial Average peaked on the 14th January, 2000 at 11,750 and the Nasdaq reached its peak two months later at 5,132. These two highs signaled the end of the Kondratieff autumn and the beginning of winter. We have now been in a bear market for two years and are likely to endure at least another three years of falling stock prices. Indeed, the worst is still before us. If the peak in prices had been followed by a crash, as happened in 1929, it would have been easier to conclude that stock prices had indeed peaked. But, even during the first few months of 1930, as stock prices rebounded from their 1929 crash lows, the feeling predominated that the crash was simply a temporary aberration and that prices would soon regain their previous highs. A similar bullishness pervades investment analysts' thinking today. But this time, it really is different and stock prices are not going to return to the levels seen in early 2000, for many, many years, because:

1. The peak of the bull market in stocks was accompanied by excessive and 'irrational exuberance,' which is only evident at the peak of speculative manias such as the South Sea bubble, the Dutch tulip bubble, John Law's Mississippi scheme, the 1921-1929 stock market bubble, the gold and silver price mania of 1979-1980 and the Japanese stock and real estate bubble of the 1980's. Every Kondratieff autumn stock market peak has been characterized as a bubble. The bubble has burst and as much as the Federal Reserve would like to reinflate the market, it cannot. Why?

2. The crowd euphoria which always accompanies a bubble has been silenced. Too much money has been lost in stocks and too much time has passed since that communal feeling of investment omnipotence.

3. At their peak, stock market values were at extremes never seen before in history and significantly

higher than values prevalent at the peak during 1929. Contrary to what 'new era' thinkers say, values do matter, because they are the essence of price.

4. Stock price values are now at even greater extremes than they were at the stock market peak, because even though prices have fallen, profits have fallen even more. No new bull market has ever started from these extreme values; nor from these feelings of optimism. New bull markets start when prices and values are very low and the word 'stock' is an anathema to everyone. In short, the next bull market will start when CNBC is no longer on the air, because no one has watched it for a long time and the bookstores will no longer carry a huge selection of books about investments.

5. The Nasdaq, which was at the forefront of the speculative excess, has fallen 75% from its peak. Essentially, there is no chance that this index will regain that record level for many, many years.

6. The economy is rapidly deteriorating and stock prices, ultimately, reflect the health of the economy and in particular, the profitability of companies, which are part of the overall stock market. Profits are getting worse and bankruptcies are rampant.

7. The US economy is built on a mountain of debt, and for it to keep growing requires even more debt. Despite the munificence of the Federal Reserve, that is just not going to happen. Bankruptcies are increasing exponentially. Enron was the largest corporate bankruptcy in US history and in the past year there have been many other venerable US companies filing Chapter 11 documents. The US consumer is hopelessly in debt and has no savings as a fallback. The increasing likelihood of job losses means he is in no position to add to his debt load. Even if he were, banks are tightening their lending practices and are already incurring massive write-offs for bad loans.

8. The US economy is driven 70% by the US consumer, who has already given his all. He is, literally, spent. Without the US consumer, the US economy cannot be revived

Every age has its folly, some project or fantasy into which it plunges, spurred on either by love of gain, the necessity of excitement or the mere force of imitation.

Charles Mackay

Extraordinary Popular Delusions and the Madness of Crowds, London 1841

9. The Japanese stock market, once the largest in the world is in its 13th year of a bear market, which has seen prices fall 75%. With the Japanese economy now in dramatic decline, their market has farther to fall. Japan is likely to exacerbate the growing economic problems around the world.

10. The entire world is now in a deepening recession, which encourages trade protectionism (steel, textiles and lumber); and that serves to further weaken the world economy.

11. 'Don't fight the Fed'. That old maxim has worked all the way through the expansion phase of the Kondratieff cycle, but now we are in winter and it is not working any more. Just as it failed to work following the crash of 1929. Since January 2001, the Federal Reserve has cut interest rates 11 times

and yet New York stock prices ended the year lower than they had been when the cuts started; the economy, far from picking up, continues to deteriorate.

The overwhelming evidence is that the peak in stock prices has long since passed, which means that we have now entered our Kondratieff winter. There can be no revisiting the speculative autumn. Each Kondratieff season follows its predecessor in its proper sequence, just like the four seasons of the year. The Kondratieff winter allows the economy to refurbish itself through the elimination of debt, either through default, bankruptcy or voluntary liquidation. This process is deflationary and inevitably results in an economic depression.

Debt and Repayment

The Depression has started and the process of debt elimination is underway. On November 30, 2001, The New York Times reported, “As the number of bankruptcy filings by public companies surges to a record, companies are increasingly being forced to liquidate instead of reorganizing.” Even before the Enron bankruptcy ($62 billion), a record 230 public companies with more than $182 billion in assets, have filed for bankruptcy, which is more than twice the assets liquidated during the year 2000.

There is a limit to the amount of debt which an economy can carry and still continue to function. When that limit is reached, it is invariably followed by a crash and a long period of liquidation. In the 1930s, the most severe stage of liquidation was from 1929 to 1933. It started with the stock market crash, which was followed by a sharp contraction in international lending and international trade in 1930 and 1931. In the latter half of 1931, the international debt system collapsed and was followed by a general moratorium on international debt. During the final stage of the crisis, which began in 1932, the entire US banking system failed and ended with every commercial bank in the US closing in March, 1933. This process of debt liquidation continued into the late 1940’s.

Japan, which has been in its Kondratieff winter since its stock market peak in December 1989, has since been experiencing a debt liquidation process. Unlike the US experience in the 1930s and 1940s, when a major portion of debt was eliminated in the early years of the depression, Japan’s process seems to be accelerating into the latter stages of its winter. The US experience is likely to be similar to that of Japan, because the Federal Reserve will do everything it can to shield the economy from this process. In 1980, the Federal Reserve received the power to monetize anything under the Monetary Control Act. This included corporate debt and even the debt of foreign governments. But, in the end, all this will mean a more painful process. It will endure longer than it might have done, had the inevitable process been allowed to take its natural course, as was the case during the last Kondratieff winter.

The financial collapse of Argentina should serve as a vivid example of what can happen when governments and international bodies like the IMF delay the natural outcome of a country overextended by debt. A cynic might suggest that the delay through additional lending was done to protect large US banking interests. But Argentina is now in a state of chaos, bankrupt and with no visible means of support. What will happen to the Argentine banks once they reopen the doors? They will be bankrupt, too.

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The Japanese Experience

Japan's experience during its current winter should serve as the blueprint for what is likely to unfold in the US over the next several years.

How quickly we forget that in the late 1980's, Japan's economy was heralded as sine qua non. Eight of the ten largest banks in the world were Japanese. The Nikkei Index was advancing towards 40,0000. It was argued that this level simply reflected the supremacy of Japanese industry. The Nikkei was trading in excess of 60 times earnings, but this was apparently inconsequential, because it was believed, given the superiority of Japanese technology, that Japanese profits would continue to multiply forever. Japanese management was seen as an example which, if emulated, would produce similar industrial success throughout the Western world. Japanese real estate was valued at levels that defied any sense of reality. The acreage surrounding the Emperor's Palace in Tokyo was valued at more than all the land in the State of California. But until the bubble burst on December 28, 1989, the argument posed was the same as every argument which has been voiced to justify any bubble; that is to say, 'this time it is different.' Of course, it is not any different. All bubbles consist of exactly the same properties. These include plenty of money, huge crowd participation and speculative greed, which overcomes all reason.

"Japan enters 2002 lurching from on-off recession to outright depression"

"Japan enters 2002 lurching from on-off recession to outright depression. Nominal gross domestic product is falling at a rate of 5% a year — 3.5% real, plus 1.5% deflation. The corporate sector is stuck in a classic debt/deflation trap, unable to pay down excessive real debt. The banks have negative equity and cannot lend and the government debt/GDP ratio is mounting inexorably towards default. " Lex, Financial Times, Jan 5-6 2002.

Proud Japan is in economic disarray as it enters the 13th year of its Kondratieff winter. Its once pre-eminent banking system is in a state of paralysis, caused by an accumulation of bad debts, which were put in place during the heady days of autumn against values, which at the time seemed appropriate, but in retrospect were ridiculous. Its mighty manufacturing industry kept afloat by a once buoyant US consumer, is beginning to feel the effects of the early days of a US winter. And Japan's Government, which was in 1990 the wealthiest government in the world, has been laid low by its fight to sustain the Japanese economy in the midst of a savage, once in a lifetime, winter. Its debt has been downgraded to virtually junk status and, at 140% of GDP, is the worst in the industrialized world. This is reflected in the value of the Yen, which is falling precipitously. The once mighty Nikkei Dow, reflecting the superiority of Japanese manufacturing, stood close to 39,000 in late December 1989, but is now valued at only 25% of its former level. It is likely that this index will eventually fall to the low 4000's, much as the Dow Jones Industrial Average fell to the low 40's in 1932. "The scale of the economic challenges facing Japan was highlighted by new data that showed the country's deflationary spiral was intensifying. Prices in Japan fell for the 15th consecutive month in December, underlining the government's apparent inability to reverse the worst bout of deflation in an industrialized economy since the Second World War." Financial Times, January 12-13, 2002.

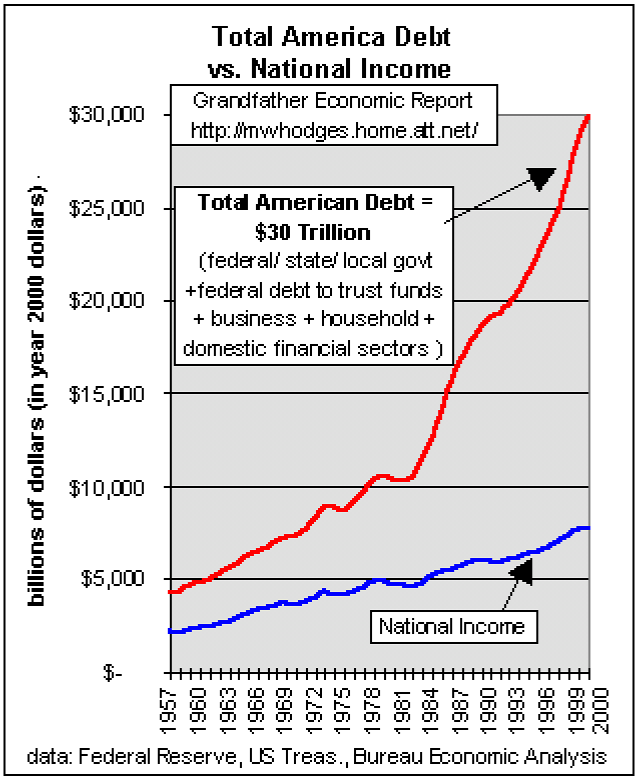
Why should we in North America consider that we are immune from the ravages of deflation now afflicting Japan? Our investment bubble and debt closely paralleled that of Japan in her Kondratieff autumn and the consequences are likely to be similar.

The Japanese winter experience lies ahead of the US, and like Japan, the US will fight the devastation of this Kondratieff season tooth and nail. But it will be to no avail, because the purpose of the Kondratieff winter is to cleanse the economy of its debt so that it can start refreshed in spring. “And if the US is once again the motor of the world economy this year, Japan may prove a serious drag, exporting deflationary pressure globally.” Lex F.T. Jan 5-6 2002.

Personally, I am very sad to see the economic misery which is unfolding in Japan. I have visited that country twice and have spoken about the Long Wave in Tokyo and Osaka. I have a profound respect for the people; their decency and honesty are without compare. They are a beautiful people caught in a vicious debt spiral. Thank goodness most of them have savings, which will sustain them through, what is likely to be, the worst of their winter directly ahead.

The US Experience

Speaking of debt, the US is the world’s largest debtor nation. Total debt in the US, which has been growing at an exponential rate, is now $30 trillion ($23 trillion private debt and $7 trillion government debt); representing $108,401 for every man, woman and child in the country. Behind this $30 trillion of debt, it is assumed that there will be $30 trillion of goods and services to be delivered sometime in the future. This debt has been growing much faster than the economy. In 1929, debt versus GDP in the US was at a record level of 131% but, by the end of 1999, that record had been left far behind when debt versus GDP reached an astronomic 269%. The growing disparity between debt and GDP is evidenced by the fact that in 1957, a dollar of debt produced .54 cents of national income, whereas today, a dollar’s worth of debt produces only .26 cents of national income.



The principal proponents of this huge debt bubble have been the State Sponsored Enterprises, like Fannie Mae and Freddie Mac, which have provided copious funds to purchase homes or refinance existing homes. "From the end of 1997 through September 30, 2001 (15 quarters), total GSE assets and mortgage/ asset-backed securities expanded by a stunning $4 trillion, or 75%, while GDP over this period increased $1.9 trillion, or about 22%….Never has the creation of non-productive debt so dominated a credit system. What is going on here?" www.prudentbear.com, Doug Noland, December 28, 2001.

In reality, the Federal Reserve is replacing the traditional lenders, the banks, in an effort to keep the economy afloat. But the game is over. The US is in its Kondratieff winter and now the piper must be paid.

There is not a sector in the US which has not participated in the huge debt bubble that has evolved over the past 50 years. Thus, government, corporate and consumer debt are all at record levels, which have been accelerating at a frenzied pace over the past three or four years. Government debt has stabilized during the past two years, due to unprecedented capital gains taxes and strong employment. But that is a thing of the past since government debt, including Federal, State and Municipal is once again accelerating to the upside, while the economy begins its inexorable slide into depression.
There are two significant differences between Japan and the United States at this stage of the Kondratieff cycle and they are both detrimental to the US. The first is that the US is the largest debtor nation in the world. Entering the last Kondratieff winter she was the world's largest creditor nation. That distinction is now Japan's. Secondly, US consumers are approaching this Kondratieff winter with no savings in the bank as a safety valve against rising unemployment. Meanwhile, Japanese consumers possess 30% of the world's savings or $13 trillion. They are much better positioned to withstand the onslaught of winter,

and their savings will be the capital which will propel Japanese industry when Spring eventually arrives.

Where once Japan was the envy of the world, she is now derided as a country that failed to halt a recession that has evolved into a depression. So we shall see how well the arrogant American bureaucrats and their economic advisors cope with a Kondratieff winter in the US.

A History of Credit

Despite its unprecedented size, the current US debt bubble is no different from any other as far back as the ancient world. For as long as there have been institutions that could create credit, there has always been a means to inflate credit. Such institutions existed in ancient Egypt and Babylon. In those days, credit was advanced to finance the planting and harvesting of crops, or for the outfitting of ships for trading voyages. The amount of credit given was registered on clay tablets, which acted as money and which brought prosperity, as the money was being spent. Successful harvests and trading voyages were paid off in kind, at a fixed percentage.

While the great empires of the ancient world enjoyed a complex trade and employed sophisticated systems of credit to finance this trade, before 700 BC, they did not have any official money or currency. On a local level, trade was transacted by means of simple barter. For large scale enterprises credit was readily available. The effects of credit expansion and credit contraction were the same then as they are now. If the crops failed or the ships were lost at sea, the loans could not be repaid and there was great distress in the land, because the lenders had been promised payment in terms of real goods. Those who were expecting to receive payment in goods suffered a decline in real wealth. They essentially suffered an economic depression.

It is the same today. Behind the $30 trillion in debt outstanding there is presumed to be $30 trillion of goods and services to be delivered to the lenders at a future date. “Anyone who lends hard-earned dollars and does not expect to get something real in return is a fool indeed, having sold his labour for nothing. Temporarily, he may accept more dollar credit as interest, but ultimately those dollars must be redeemable in real goods or services—or they have no value at all.” Hoppe, March 1988. P.26

Behind the $30 trillion in debt outstanding there is presumed to be $30 trillion of goods and services to be delivered to the lenders at a future date.

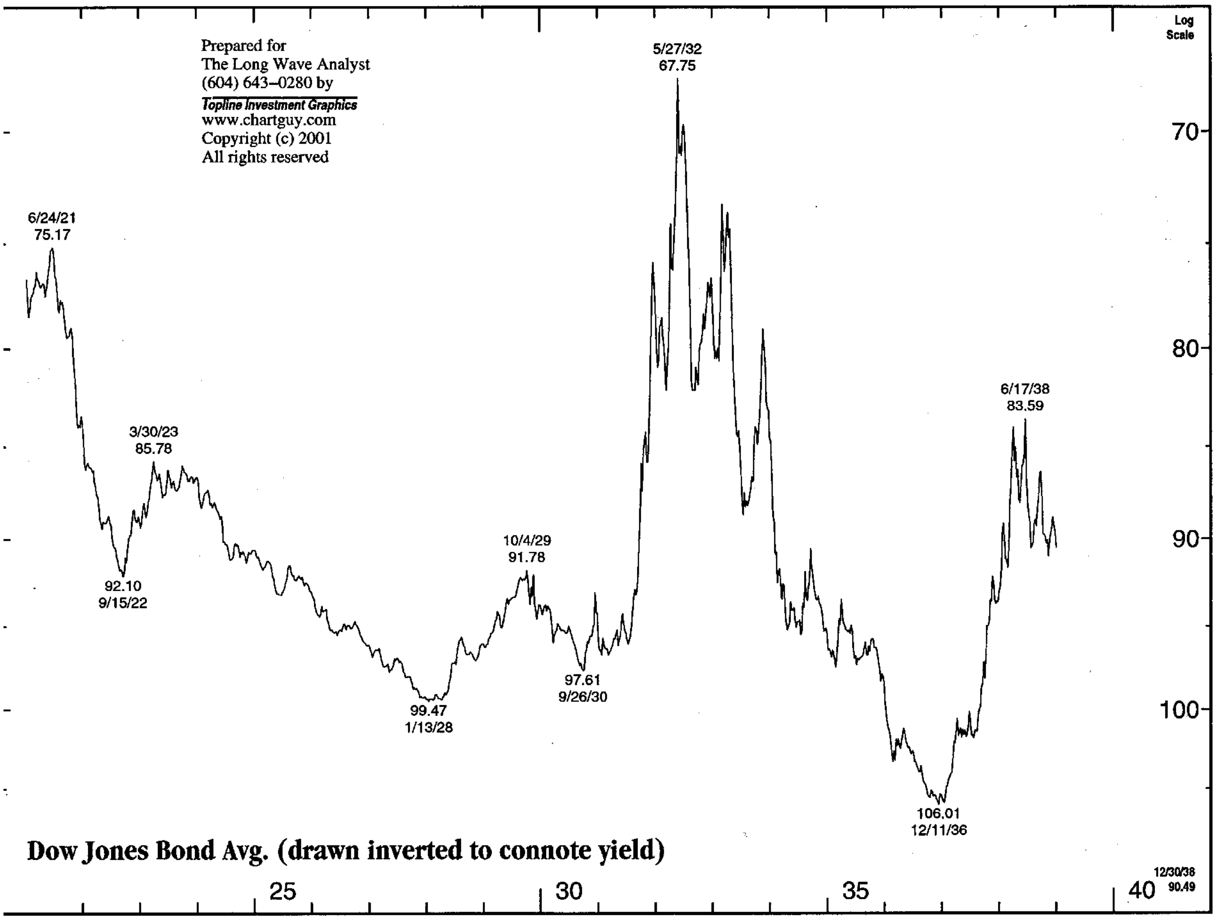
What has been inflated in the Kondratieff Wave upswing, as well as all previous Long Wave upswings, is not currency, which normally accounts for only 2% to 3% of the total purchasing medium, but credit. And credit inflations always end in a deflationary collapse. The more that credit is expended, the more its quality declines, which means that an ever increasing amount of credit outstanding becomes less and less likely to be repaid in full, or to be repaid at all. All credit bubbles must inevitably self-destruct. The collapse of a credit bubble begins gradually and subtly, lulling the majority into a false sense of confidence. We are at that point now, the early point of the Kondratieff winter, when the rising tide of bankruptcies is viewed as a phenomenon of a small recession, which is now all but over.

Bank credit (money) is created when people and organizations go into debt and it is expunged when they get out of debt. When the debt is excessive and based upon largely fictitious assets, its liquidation can be quite violent and involuntary. This results in a rapid collapse of total money supply. That is why debt is deflationary.

Following the 1929 stock market crash, the Federal Reserve frantically tried to restart the credit inflation, just like it is doing now. Interest rates were cut from 6% in August 1929 to 4.5% by mid-November, just as the first phase of the crash was ending. By the end of 1930, the discount rate had fallen to 2%, and after that it dropped to 1%, where it remained for 8 years. “But cheap credit was no panacea, and as interest rates were pushed down by the Fed, the willingness of banks and other institutions to lend money also declined. Saddled with huge portfolios of frozen loans, the banks saw no point in taking additional risks for such insignificant returns. Thus another idea that seemed logical to economists and politicians (with little sense of reality) turned out to be fatally flawed. But that will not, I am sure prevent the Fed and the government from trying it once again.” Hoppe, Donald. The Kondratieff Wave Analyst, December 1987. P.135. That is exactly what the Federal Reserve is doing again and the effect is similar to what it was then.

Buying bonds is a bet on the future value of money.

In spite of the efforts of The Federal Reserve following the 1929 stock market crash, bank deposits fell by about 30% between 1929 and 1932 and there were huge declines in the values of stocks, bonds, real estate and commodities. In fact, currency in circulation actually increased after 1929. What contracted so severely was bank credit.



The Credit Crunch of 1932 - How It Impacted Interest Rates

This collapse of credit causes the deflation of values, a contraction of demand and the dumping of surplus properties and inventories at sacrifice prices; together with a sharp and prolonged rise in unemployment; all of which are typical of a depression.

Once the credit bubble starts to deflate there is little recourse for the Federal Reserve because, to expand credit, you must have willing lenders and willing borrowers. However, when the scramble to get out of debt and to salvage a portion of the outstanding debt starts, there are simply no more willing or credit worthy borrowers left. A credit crunch begins when a large number of borrowers, each desperate for cash, try to tap a rapidly diminishing pool of credit. Long-term interest rates rise when investors flee from long-term bonds to the shortest terms and most liquid cash equivalent, such as Treasury Bills. Thus, the only place to be invested at the approach of a credit crunch is in short-term highly-liquid depository accounts.

When long-term interest rates start to rise, at the onset of the Kondratieff winter, it will be explained as the bond market looking ahead to an economic recovery. This explanation will act as an incentive to equity investors, who will want to buy stocks in anticipation of the recovery. Unfortunately, the explanation will be wrong. Rising interest rates at this time will not be forecasting an end of the recession. But they will be forecasting a deepening recession as the credit crunch unfolds. We are at that point now, precisely.

Long-term government bond yields are rising and we have been told that the end of the recession is at hand. The latest US News and World Report cover trumpets "2002 Economic Report-Business Bounces Back. Growing Signs of a Recovery. How to Cash in."

The yield spread between US short-term bonds and long-term bonds is widening; so is the yield spread between US long-term bonds and corporate bonds. In the latter case, the difference now stands at a record 3.5% versus 1.75% only a year ago. This is strong evidence that the credit crunch is gathering momentum. Higher interest rates in the face of a weak economy are going to place an added burden on debtors and bankruptcies are sure to increase.

A credit crunch is a severe temporary shortage of money or credit, evidenced by a rapid and extreme rise in interest rates.

"When credit is expanded beyond the point of any possible repayment, it becomes a 'bubble' - a pure fantasy without substance. Every credit bubble ultimately collapses and leaves those who bought 'shares' in the fantasy with nothing. When credit expansion 'vastly outpaces' real economic growth, the excess becomes a claim, not on real assets, but on imagery assets. And the bubble finally bursts when everyone belatedly realizes that the claims on the economy have become so excessive that it is obviously impossible for the economy to convert those claims into any kind of reality. At that point there is a mad scramble (panic) to salvage what can be salvaged and all the outstanding claims are substantially devalued with many being wiped out all together." Hoppe, Donald. December 1985. P.136.

Is it Inflation or Deflation?

This is a very important question, which must be answered, because the two are completely opposite and so too are the appropriate investment choices. Only gold performs well under both monetary phenomena. Investments that perform well during inflationary times are commodities and real estate. Whereas, during deflation gold, which serves as money, and cash (short term deposits) is the only investment of choice.

Those who argue for inflation and there are many, point to the copious amounts of money being poured into the economy by a frightened Federal Reserve. Thus, their contention is that overzealous money printing always leads to inflation and so it generally does. It leads to a demand for goods, or in the autumn, a demand for investment vehicles, which eventually overwhelms supply. Thus, it becomes the classic definition of inflation, which is 'too much money chasing too few goods'.

In the Kondratieff winter, however, the generous supply of money is eventually overwhelmed by losses. Consider that US Non-Government debt now totals somewhere in the region of $24 trillion and that excludes all the debt outside the US, such as Argentina, Brazil, Turkey, the Philippines, Indonesia, etc., which impacts the US. If only one half of that debt defaults, it would be a monumental task for the Federal Reserve to overcome. This does not even take into account losses which have already been sustained in the stock market and are very likely to be sustained in the future. Nor, does it even consider the huge US real estate market, which will soon start to engender losses, which promise to be enormous. If the Federal Reserve were to try and offset these impending losses by printing new money, it would face the wrath of its creditors. Most US debt held outside the US would be sold, which would force domestic interest rates to obscenely higher levels. As I have argued earlier in this report, debt is deflationary and the US Federal Reserve is unlikely to overcome that fact.

Regarding the prospect of too few goods being available; on the contrary, there is a huge oversupply. Mal-investment is a major problem of the Kondratieff autumn and that means the world has too many factories producing too many automobiles, too many microchips, too many computers, too many shoes; just too much of all goods; not only too many goods, but also, too much of all the commodities.

Thus, the Kondratieff winter faces a classic '*deflationary depression',* caused by 'too little money chasing too many goods.'

Each phase of inflation or deflation exists in each Kondratieff season.

The Kondratieff cycle is, among other things, a cycle of inflation/deflation. Each phase of inflation or deflation exists in each Kondratieff season and one phase follows the other just like the seasons themselves. So, spring is always the season of benign inflation. Inflation increases in the summer and rises to a peak to coincide with the end of summer. The rate of inflation falls in autumn, already heralding the onset of deflation, which comes to the fore in early winter. (See centrefold chart)

In deflationary times, the prices of all commodities fall, simply because the world is in an economic depression and demand is stifled. In 1988, when the Asian crisis was at its height, the price of a barrel of oil fell to $10 US, because demand in that region fell in conjunction with the depressed economy. If that is what happened then, to what level will the price of oil fall when the entire world enters its Kondratieff winter; or the price of diamonds, copper, zinc, nickel, coffee, wheat, etcetera? Prices are likely to be considerably lower, just as they were between 1929 and 1933. (See centrefold chart)

If commodity prices are going to fall during this winter, what are the prospects for silver and gold? I will turn to the experience of these two precious metals in the last depression for an answer.

Silver

During both the previous two Kondratieff down-waves the price of silver responded poorly to the growing depression. That is not to say that 'this time it will be different', but I am always hesitant to bet against history, particularly when I know that we are repeating the same phase of the long wave.

In 1873, the US abandoned its bi-metal (gold and silver) monetary system in favour of an exclusive gold backed monetary system. This system had been adopted by Great Britain shortly after the end of the Napoleonic wars. Between 1867 and 1874, silver was demonetized by Germany, the United

States, Sweden, the Netherlands and Japan. In the early 1880's France, Italy and three other European nations gave up bimetallism and based their currencies on gold.

In the US western states huge deposits of silver as well as gold had been discovered in the 1870's, so there was a reluctance to give up on silver entirely. Subsequently, this became a hot political issue that survived into the next Depression. But the US reduced the official price of silver in 1873 when it abandoned the metal as a monetary base. When the European countries also forsook silver, its price plummeted.

Following the 1929 stock market crash, silver performed just like any other commodity, its price collapsed. By 1932, the price had fallen to 25 cents an ounce from its peak in 1929 of 60 cents. But silver mining was an important activity in the US, and the dominant one in several western states. The senators from these states wielded considerable power and they convinced President Roosevelt to include a role for silver within the US monetary system. Subsequently, this role was enacted through the Silver Purchase Act of 1934, which in effect nationalized the silver market in the US. Under the terms of the Act all newly-mined silver had to be sold to the Treasury. All silver bullion in the possession of private individuals or corporations not required for commercial or industrial use also had to be surrendered to the Treasury. The initial purchase price was set at 50 cents an ounce. Later, it was raised to 90 cents and then to $1.29 an ounce, where it remained until 1963, when silver was denationalized.

Gold

As the financial crisis in the early 1930s deepened, there was a flight to gold. Initially, there was a panic to get out of collapsing securities (both stocks and bonds) and into shortterm assets, such as bank deposits, T-bills, commercial paper and paper currency. But as the crisis worsened, and the failure rate of banks and other financial institutions reached alarming levels, widespread fears began to arise about the safety of the banking system itself and about the integrity of paper currency.

The second stage of the crisis (April 1931-March 1933) saw the great rush to gold. "Foreigners cashed in not only their American stocks and bonds, but also their dollars and hauled American gold away by the boatload. Americans converted their paper dollars and bank deposits into gold coins and stashed them in mattresses, hid them in basements or in attics or took them on one-way trips to Bermuda or the Bahamas. By July of 1932, Treasury Secretary Mellon secretly informed President Hoover that the Treasury, the Fed and the banking system were being drained of gold at such an accelerating rate that a collapse of the gold standard was imminent, and if the US went off the gold the dollar itself would suffer a severe decline in the foreign exchange markets." Hoppe, January 1986. P.9

This flight to gold, ultimately, forced the European nations, and then the US to abandon the gold standard.

The key thing to remember is that there was a flight to gold. This had nothing to do with fear of inflation, since the crisis was one of deflation and debt liquidation. It was simply the recognition that gold is the only financial asset that is not someone else's liability, and therefore, the only financial asset that cannot be defaulted and become worthless. Foreign central banks exchanged their holdings of US dollars and US debt for gold and individuals first liquidated their other assets for dollars and then exchanged their

dollars for gold.
There is only one difference this time, while gold is still not someone else's liability, the price now is not fixed as it was then, because the world was on a gold standard and dollars could be exchanged in almost any US bank for $20.67 an ounce. Now, the price of gold fluctuates according to the law of supply and demand. So unlike the 1930's the flight to gold now will result in rapidly rising prices.

In previous letters I have already shown that as the stock market climbed towards its peak in 1929, savvy investors were accumulating gold shares in anticipation of the impending economic turmoil. The great financier, Bernard Baruch, admitted later that he had been purchasing shares in Alaska Juneau mines since 1928.

Owners of these gold shares reaped a spectacular harvest. From a low of $65 in 1929, Homestake Mines rose rapidly to reach a high of $544 by 1936. Also, from 1929 to 1936, Homestake paid a total of $171 in dividends, which was more than twice the price of the stock in 1929. Other gold mining shares performed in a like manner. So the best investment position in 1929 would have been short common stocks and long gold mining shares.

"Gold in the ground is just as good as gold in the bank. In fact, the only way you can safely hold a claim on a large quantity of gold is through the purchase of shares in gold mining companies with large ore reserves." Donald Hoppe

The huge demand for gold in the 1930's created a new gold rush, which resulted in a dramatic revival of the whole gold mining industry. Thousands of individual Americans and Canadians rushed to areas of previous gold discoveries, hoping to strike it rich or at least scratch out a living, prospecting or panning for gold. According to the US bureau of Mines there were some 9000 operating gold mines in the US in 1940. Many of them were small marginal operations, but some of the new mines were substantial.

Given that the price of gold is no longer constrained by a gold standard, the price for it is likely to soar, as investors bail out of paper assets including paper money (which is overburdened by debt) and panic into gold. The prices of gold shares will emulate the metal itself and should perform even better than they did in the 1930's, when the price of gold was fixed initially at $20.67 an ounce and then raised by only 69% to $35 an ounce.

Silver on the other hand failed to perform as a monetary metal in the two previous Kondratieff depressions. This suggests that silver might perform just as poorly this time too. But there are some reasons that provide optimism for higher silver prices. The principal reason is that silver may once again be viewed as 'poor man's gold'; more so, given the huge price ultimately projected for gold, which may put it out of the reach of small investors. Also, during the 1930's, silver was in everyday usage as money, so plenty of it was hoarded, buried in the backyard, or hidden in basements. Today, coinage is made from base metals.

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	HOMESTAKE MINING		DOME MINES		Dow Jones Industrials
	Stock Price	Dividend	Stock Price	Dividend	
Low 1929	$65	$7.00	$6	$1.00	381.17 High
High 1930	$83	$8.00	$10 3/8	$1.00	157.51 Low
High 1931	$138	$8.45	$13 ½	$1.00	73.79 Low
High 1932	$163	$10.60	$12 7/8	$1.30	42.22 Low
High 1933	$373	$15.00	$39 ½	$1.80	50.16 Low
High 1934	$430	$30.00	$46 ¼	$3.50	85.51 Low
High 1935	$495	$56.00	$44 7/8	$4.00	96.71 Low
High 1936	$544	$36.00	$61 ½	$4.00	143.11 Low
High 1937	$430	$18.00	$57 ¼	$4.50	113.64 Low

The Difference between a Recession and a Depression

A recession is the result of an excessive accumulation of inventories at the wholesale and retail levels, and a temporary illiquidity in the area of short-term consumer credit.
Recessions, routinely, occur approximately every 4 to 7 years in a market-based economy. This is called the business cycle and it is caused by the cumulative errors and misjudgments of merchants who overstock in anticipation of increased sales and consumers who overextend themselves and have to curtail purchases. It does not take long before excessive inventories are sold and consumer liquidity is restored. Thus, all the recessions of the current Kondratieff cycle have displayed these characteristics. Even the 1974 to 1975 recession and the 1981 to 1982 recession, although severe by post World War II standards, were not seen as a threat to long term credit, nor were there any real anxieties about the banking system or the security of international debts.

“We are in a global recession, but an unusual one, given conditions of global oversupply not seen since the 1880’s (The 2nd Kondratieff winter) or the 1930’s (The 3rd Kondratieff winter). These are circumstances of low inflation and weak profits. This is fundamentally different from the normal recessions in recent decades, which have been triggered by government policies aimed at chocking off excess demand in the context of high inflation and temporarily booming profits.” Barry Riley, Financial Times, Jan 5-6, 2002.

“Bubbles are generated by excessive growth of debt, and they typically blow up in the stock and property markets.”

In a depression, the capital goods sector of the world economy is involved. Illiquidity occurs over the much larger area of long-term credit and on a much larger scale than in a recession. The whole world is overcome by a depression because the international debt system seizes. While over-investment in excessive inventories and consumer credit can generally be worked off in a relatively short period of time without excessive or prolonged distress. Over-investment in capital goods includes buildings such as factories, specialized technologies and entire transportation and communication systems; and takes decades to develop. The huge over investment in the capital goods sector, quite naturally takes years to be absorbed or consolidated. This is why the depression takes so long to run its course and the repercussions are so horrendous.

As if this were not enough; illiquidity in long-term credit and international debt, which has accrued as a result of an entire generation's stupidity and excesses, takes years to correct.

"This is fundamentally a post-bubble crisis. Bubbles are generated by excessive growth of debt, and they typically blow up in the stock and property markets. While they are inflating they create apparently free wealth and great political windfalls, usually credited at the time to an economic miracle, and never to financial recklessness. When they collapse though, they destroy consumer confidence, sharply raise the cost of capital for companies, and expose banks and bond investors to substantial baddebt risks." Barry Riley, Financial Times.

Most economists would argue what we are now experiencing is just a simple recession, which will be over once the excess inventories and temporary consumer credit illiquidity are worked off. "Judging by the state of data releases, and digging through them, you almost get the sense that the recession has emerged as yesterday's story." David Rosenberg, chief economist at Merrill Lynch, Canada. December 29th, 2001. Or how about this for sheer bravado? We said a month ago that this would be the smallest downturn tied to a recession ever. I think we were pessimistic." David Benson, Chief Economist, Fannie Mae as reported in The American Banker, Dec 21, 2001.

In a like mode, by the spring of 1930, many observers were cautiously optimistic. "Hoover himself, in a statement that would haunt him, proclaimed to the US Chamber of Commerce on May I, 1930; 'I am convinced we have passed the worst and with continued effort we shall rapidly recover.' The following month he told a delegation from the National Catholic Welfare Conference that their pleas for further expansion of federal public works programs were 'sixty days too late. The depression is over." Kennedy, David. Freedom from Fear; the American People in Depression and War. 1929-1945. P.58

Conditions that Precede a Long Wave Depression

1. Massive overbuilding in the capital goods sectors.
2. An unprecedented increase in debt at all levels, public, corporate and individuals.
3. Severe credit problems in international debt.
4. An era of extremely reckless speculation followed by a stock market crash-'the worst crash in more than 50 years'.
5. A boom and bust in agricultural commodities and farm land, resulting in great distress in the agricultural sector, with many failures and foreclosures.
6. Troubles in the banking system with a rising curve of bank failures, beginning several years before the stock market crash.
7. A sharp rise in protectionist sentiment caused by increasing foreign competition and poor trade figures.

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8. Producers in raw materials -oil, minerals and agricultural products - caught in a squeeze between high production costs and low prices, aggravated by huge surpluses and excess productive capacity. Cartels (OPEC) and quota agreements prevalent in efforts to hold down production and hold up prices (they always fail in the end).
9. Retail stores jammed with merchandise, luxury items in heavy oversupply, pricecutting and discounting rampant.
10. Huge rise in real estate prices during prior decade. Massive speculative building boom. Real estate market glutted with commercial and office properties.
11. Great increase in the number of people employed in the financial sector-stock brokers, bond salesmen, investment advisors, financial planners, fund managers, in-house traders, security analysts, etc.
12. Financial mania and speculative boom of prior decade not limited to one or two countries but worldwide.

Hoppe, Donald. The Kondratieff Wave Analyst. February 1988. P.17

Note that Donald Hoppe wrote his list of conditions for a depression almost 14 years ago, and all of them have now come to pass.

"When the time cycle is up, neither Republican, Democrat, nor our good President Hoover can stem the tide. It is natural law. Action equals reaction in the opposite direction'.

W.D.Gann 1928

The problem is that that most professional investors are equipped with, at best, 20-year databases. This time frame only covers the typical recessions of the Kondratieff expansion phase. "The apparently rational (and low-risk) approach is to assume that these recent patterns will be repeated. For this reason most professional fund managers are positioned to benefit from a Vshaped recession (which would also happen to benefit their own businesses, whereas another leg of the bear market might prove disastrous in many cases."

"Those 20-year databases show that recovery from late 20th century recessions has been triggered by the ending of an inventory correction, followed by an upturn in capital investment, led by growth companies and eventually by retail spending as consumer sentiment recovers."
"….But the overhang of surplus capacity, even in growth sectors, threatens capital investment over an extended period. As for consumer spending, it has already been booming and seems much more likely to subside than surge farther." Barry Riley, F.T. 5-6 Jan. 2002.

In his last article for the Financial Times, Barry Riley says it all. Without saying the dreaded 'D' word, he confirms that this is something very different from past recessions. We know that it is no ordinary recession, coming as it does at the start of a Kondratieff winter and given the enormous debt load which overhangs the economy, the huge losses already sustained in the stock market and about to be encountered in the real estate market. What we are facing is a typical and debilitating Kondratieff deflationary depression, which is likely to have been made worse because of the undisciplined Federal Reserve, which believes that printing money is the answer to all financial problems. But, the problems themselves were created by the supposed remedy.

Conclusion

If the experts and the politicians do not know the difference between a recession and a depression, how on earth is the general public supposed to know? It does not. Moreover, consumers are being fed harmful information, which keeps them in stocks and keeps them spending money that they do not have. How is this for sound and deep economic advice from William McDonough, President of the Reserve Bank of New York? "What we dearly want is for Americans to behave like Americans-to do the patriotic thing and go out and spend. Even more important, what we need is for the business community to stop contemplating its collective navel and get busy investing."

The payback will be very painful.

The crowd is always dependent upon leadership. Unfortunately, the current leaders have led the crowd into an economic maelstrom. But who else are they to believe? These leaders were there for them and gave them confidence during the latter stages of the great bull market. And the crowd does not know whom to now believe. If they were so right then, how can they be so wrong now? The crowd is, in fact, leaderless, but still clings to any official pronouncement in the hope that everything will be all right.

When the severity of the situation comes to light, the crowd will turn on its former leaders, just as it did following the 1929 crash. When people like Richard Whitney, the president of the New York Stock Exchange at the time of the crash and Samuel Insull, the utility magnate, and others were sent to jail and Andrew Mellon, the Secretary of the Treasury was impeached.

There will be many false dawns and official pronouncements suggesting that the 'recession' is over. But it will take years to unwind the excesses that have been built into the economy throughout the term of this Long Wave cycle. The pay back will be very painful. It will encompass a vicious bear market in stocks, bonds and real estate, made all the more painful, because of the numbers of investors who have been drawn into these mediums in the preceding bull market and by the extent of the bull markets' rise. It is likely that the bear market losses will be approximately equal to the bull market gains Herbert Hoover expected as much when he wrote in his memoirs "Our overpriced stocks and real estate were bound to come down; and the degree of down is influenced by the degree of up-which means a descent from overvalue to undervalue. The boom had lifted securities and real estate far up and, to this degree was to deepen further the slump by the downward swing."

The bear market in stocks will be nothing like the past three bear markets of this Kondratieff cycle. It will be significantly worse, because this is the end of the Kondratieff cycle bear market. The bear markets in 1966, 1972-74 and 1981-82 were Kondratieff recessionary bear markets and the adjustment in stock prices were relatively tame and reflected the quiet upward movement in prices that preceded them. This bear market will reflect the extent of the bull market price move (777 points –August 1982 to 11,750 points –January 2000), and the extreme speculation which carried stocks to their ultimate peak. As I wrote in my last letter, if the bear market is to repeat the experience of the previous Kondratieff autumn bear market (1929-1932), stocks will lose approximately 90% of their value, which would take the DJIA to 1300. Using another measurement from the last Kondratieff cycle we can establish a Dow downside target of approximately 500 points. This would reflect the difference between where stock prices ended the 1932 bear market (42 points) and the point from which the great autumn bull market

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started in 1921 (66 points).

"If you can talk with crowds and keep your virtue, Or walk with Kings— nor lose the common touch, If neither foes nor loving friends can hurt you, If all men count with you, but none too much; If you can fill the unforgiving minute, With sixty seconds worth of distance run, Yours is the earth and everything that's in it, And—which is more–you'll be a Man, my son."

Rudyard Kipling
IF

Wherever prices ultimately stop declining, will be significantly below what the vast majority are expecting at this time. In fact most of them believe that a new bull market has started, just as they did in the spring of 1930. "Money managers are looking for doubledigit returns from Canadian, US and international equity markets this year, according to an annual survey done by Towers Perrin, the management and human resource consulting firm." None of the 71 investment firms surveyed - 48 Canadian and 23 foreign – expect negative returns from the markets in 2002. The Globe and Mail, January 10th, 2002. Needless to say, I was not asked.

As the depression deepens, the pace of unemployment will quicken, caused by a growing tide of bankruptcies and a much slower pace of business generally. Given the magnitude of the debt and the bankruptcies, which are likely to accrue, the US banking system will almost certainly experience difficulty, similar to the Japanese banking problems, now reaching their climax.

The real estate market, which is only now beginning to feel the tremors of the recession in the commercial end, will ultimately be devastated. The mass bankruptcies and high unemployment will cause a crash in prices. Those people who have been lured by the GSE's into borrowing on their home equity will soon see this equity vanish. They will not be happy.

The Kondratieff Winter, which portends a period of extreme distress, lies in front of us. Should we believe it or should we put our faith in our politicians and bureaucrats to save the day? Since 1998, my knowledge of the Kondratieff cycle has helped me to understand the likely course of economic and market events, which have unfolded as anticipated. Because the Kondratieff cycle has been such an accurate predictor, why abandon it now and leave yourself in the hands of the very people who have created this mess?

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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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”Those who cannot remember the past are condemned to repeat it.” Santayana