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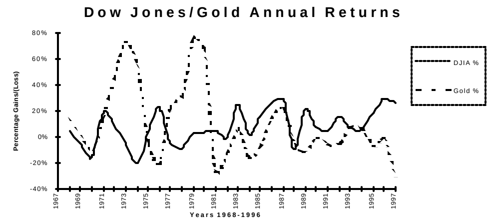
Gold



& Technology Stocks

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Ian Gordon Reviews His Deflationary K-Winter Thesis

Ian Gordon

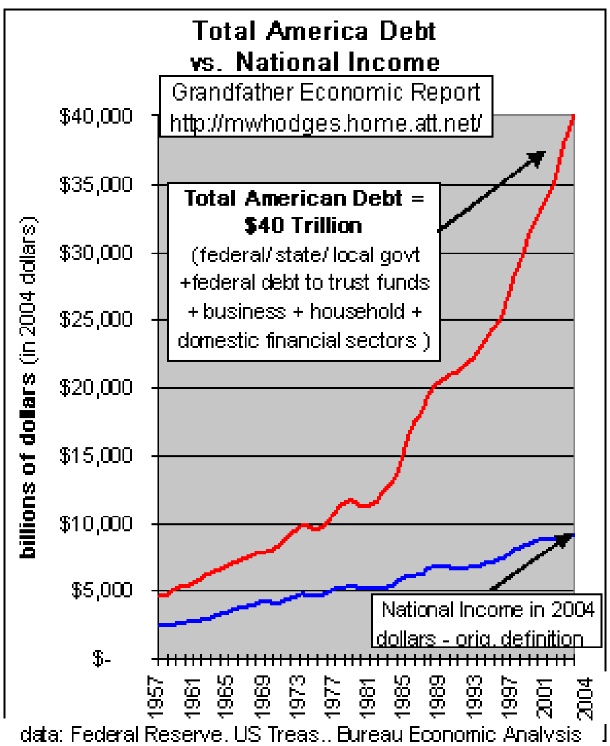
Between January 1, 2000 and September 30, 2005, our Model Portfolio gained 122% while the S&P 500 actually lost 16.4%. An investment of $1,000 in *J Taylor's Model Portfolio* during that time would have grown to $2,220 while that same investment placed in the S&P 500 would have shrunk to $836. Being human, your editor would like to take credit for this performance but such boastfulness would be misplaced because whatever correct market calls I have made have resulted from the collective wisdom of many different independent thinkers. Of all those who have helped me in constructing our investment philosophy, none have been more influential than my good friend, **Ian Gordon**. From the first time that Ian sent me his newsletter back in 1998, I have found his well-reasoned fundamental and historical approach to investing to be most compelling. Since then I think it is fair to say I have become one of Ian's leading supporters, especially with respect to his Kondratieff-cycle theory.

Ian has believed we are poised for a devastating deflationary collapse of our monetary system and a major depression akin to or worse than that of the 1930s. As a good, compassionate human being, Ian certainly isn't wishing for that to happen. But his study of history tells him a major credit contraction is all but inevitable and that when the most devastating portion of the Kondratieff cycle, (which he has labeled the Kondratieff Winter) pays us a visit, it will drastically reduce the standard of living we in the west have become accustomed to over the past several generations. Helping us prepare for a world of high unemployment, massive debt defaults and plummeting incomes is what Ian's work is all about. Unfortunately, I'm afraid he is right —that we are nearing a deflationary collapse. That is why Ian's views are published more often than most others in our weekly messages.

It has been more than six years since our first interview with Ian and more than five years since the stock markets peaked. Yet, on the surface, signs of inflation more than deflation still abound. So we thought it would be a good idea to interview Ian once again to see if his views have changed. Thankfully he agreed to allocate his valuable time to talk to us again. Because many of our subscribers are very interested in Ian's theories I sent out an email invitation to you to question him directly. Many of you did send in your questions, many of which Ian has answered in the following dialog. Does Ian hold fast to the Kondratieff deflation ideas he first talked about in 1999? If so, just where does he think we are now in terms of the impending deflationary collapse. I trust you will benefit if not enjoy Ian's "doomsday" answers that follow.

TAYLOR: Ian, we first interviewed you back on June 11, 1999. At that time you talked of the imminent demise of the equity markets. That turned out to be an excellent call. The decline in the equity market was to have been the start of the contraction phase of the Kondratieff Winter. Although stocks have declined, we have not seen anything like the kind of cataclysmic decline in stocks and the economy that was supposed to follow, according to your dire warnings. As I recall, you were talking about a 2000 Dow and a $2,000 gold price and major unemployment akin to or worse than we experienced in the 1930s. To be sure, gold has had a fair rise from a very undervalued $259.70 when we first talked to you. And stocks, as measured by the Dow, have come down from their all-time high, but not really by a whole lot. In fact, the Dow is still above 10000. So five years later, gold and the Dow are a long way from $2,000 and 2000, respectively. Do you still hold the view that we are heading for a major deflationary depression now as you did then? If so, how do you justify that view, especially in light of the Fed's promise to pump huge amounts of money into the system to avoid anything like the deflation Japan has suffered through, not to mention the much worse depression you envision?

GORDON: Jay, I'm not sure that I ever said that the Dow and gold would meet at $2000. I do think that gold has an exceptional chance of meeting and even surpassing that price level. As for the Dow, if it is to repeat its experience of 1929-1932, which was the previous winter bear market, it could fall to anywhere between 1300 and 500 points. The fact that it really has not collapsed is due in part to the panic actions of the Federal Reserve. Rates were lowered from 6% to 1% in panic, and massive amounts of money were injected into the economy. Investors now believe that the price of stocks goes up forever. They didn't think that way at the start of the great bull market in 1982. They hated stocks, and there were next to no mutual funds plying their wares then. That's always the way at the start of any great bull market—there's little interest, because these bull markets invariably follow bear markets. And at the end of the bull market, everyone believes. And, yes, I still stand by my view based on our position in the Kondratieff Cycle that we are indeed heading for a dreadful deflationary depression akin to or probably worse than that of the previous Kondratieff winter, 1929 to 1949. It's all on account of DEBT, which now stands at $40 trillion.



SUBSCRIBER QUESTION: Is there anything that the Fed or the government could possibly do that would stop the Kondratieff winter? What would you do at this point to avoid the K-winter if you had the power to make or influence policy? Thanks, Ken Wenz

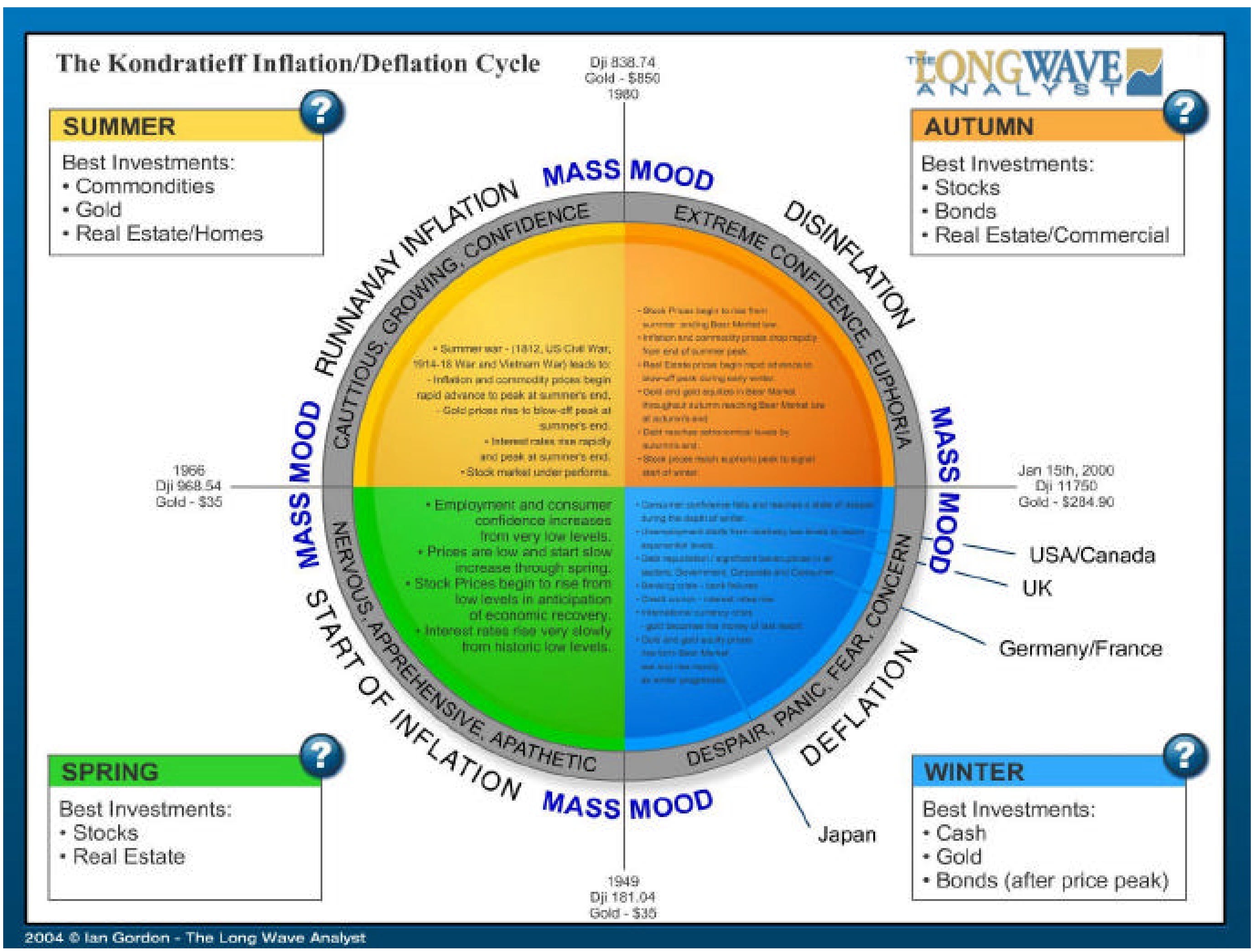
GORDON: They've been trying. What do you think all those panic rate cuts were and all that money that they've printed if it wasn't to try and arrest the down draft? Cast your mind back a few years; what was the Fed talking about? Wasn't Bernanke promising to drop dollars from helicopters to arrest deflation? So they've been successful in the short term, but that success has come at a terrible price and that price is a massive increase in debt, a huge bubble in real estate, and an overvalued stock market. I don't think there's anything that I could do to stop the horrendous outcome. The sooner these massive imbalances are allowed to correct, the less painful the correction. Remember, Greenspan was ruminating about irrational exuberance as far back as 1998, when the Dow was about 6600 points. A correction at that point would have been far less painful than the one we should expect now. But on account of his efforts to keep the party going, debt has more than doubled. Now there's just too much debt and too much greed throughout the economy. Remember the Kondratieff winter's purpose is to wring debt out of the economy. That process is going to be very, very painful. It will mean massive bankruptcies (Ford and GM are all but there, the airlines are there), severe dislocation in the banking system (6000 banks failed between 1929 and 1933); and a horrendous unemployment rate. In the depths of the last depression, 25% of the American workforce was unemployed. It's difficult for most people to imagine how horrible this is going to be, because on the surface everything seems so normal, but underneath, the massive debt bubble is about to tear the economy apart.

SUBSCRIBER QUESTION: Will American financial institutions, especially the stock markets, futures markets, Fed, and private banking institutions, continue into the "Winter" in, more or less, their current forms? If not, will it be advisable at some point(s) for individuals to convert financial assets to actual precious metals hoards and secure same as best as they can?

GORDON: Every institution, including governments, and every person will be affected by the Kondratieff winter to a degree. The amount that each will be affected will be directly related to the amount of debt that each carries. The lending institutions will be affected by the amount of bad credit that they have assumed as the winter gets underway. As for the stock market, it is likely to be every bit as bad as the autumn bull market was good. Remember that stock prices reflect the relative health in the economy. A Kondratieff winter portends a deflationary depression on a similar scale to that experienced in the 1930s and maybe worse, because this time the debt is much larger, and, more importantly, the U.S. is losing its financial and economic leadership. This distinction always passes to the world's greatest creditor nation, as it did in 1931, when the U.S. took over leadership from Great Britain. That transition was seamless, because the two nations were good friends and cooperated closely in economic and financial affairs. The power is now moving to the East. **It is important that individuals reduce their debt as quickly as possible and invest in cash and gold, to offset the pain of winter**.

SUBSCRIBER QUESTION: If our currencies were still pegged by gold today, I'm sure that we would have deflation. But how can you be sure that the Kondratieff cycle has not ended in 1971? Kondratieff died before and perhaps he would have changed something in his theory, especially for the winter season! So why don't you create a new Kondratieff cycle (the Ian Gordon cycle!) that takes into account the new monetary system? Best regards, Léonard Sartoni, Switzerland

GORDON: While the gold standard did indeed restrict governments' ability to withstand the depression, that restriction forced Great Britain off the gold standard in September 1931. This ushered in the demise of the world monetary system. We are experiencing a similar monetary crisis today, as the reserve currency status of the dollar is ending. Why would the cycle have ended in 1971? It is not only an economic cycle, but also an investment cycle, a crowd mood cycle, an inflation/deflation cycle, and a savings cycle, and many other cycles are also contained within the Kondratieff cycle. Four events occur at the end of summer and herald the onset of autumn. Autumn is always the Kondratieff season in which stocks, bonds, and real estate make the largest price gains of the entire cycle. These four events are: a peak in commodity prices, a peak in interest rates, a bear market in stocks, and a recession. These occurred between 1980 and 1982 and in the previous cycle between 1920 and 1921. The same events happened in the first two cycles as well. So the cycle certainly continued into 1982 and indeed into 2000 when the great autumn stock bull market peaked. This peak in prices ushered in the Kondratieff winter, as did the peak in stock prices in 1929. Perhaps you feel that the unrestricted ability of the central banks to print money can offset the Kondratieff winter. I hope I will provide an answer on that later.



SUBSCRIBER QUESTION: Please give us your thoughts on the best type of investments that employers can offer employees in their 401k plans. These investments should be less risky than the general market, but still produce a decent return. Also, what are your thoughts about energy stocks and gold for 2006? Chris Gebhart

GORDON: As I answered earlier, the Kondratieff cycle is an investment cycle. There are appropriate investments for each of the seasons. Thus, for spring, stocks and real estate offer the best returns. Summer is always the inflationary season in the cycle, and appropriate investments are real estate again, commodities, things, and gold. Autumn is the disinflationary season and is always accompanied by the biggest bull market in stocks, bonds, and real estate of a lifetime. When that great stock market peaks, the deflationary/depression winter begins and it's time to get very defensive. Thus, gold and cash should be the investments of choice; gold, because it takes on its traditional role as money of last resort.

As the economy worsens, the price of gold rises, because fear increases. So 2006 should be worse than 2005, and, ergo, the gold price should be higher. If the economy gets worse, as the Kondratieff winter predicts it will, the demand for energy will decrease, and so should prices.

SUBSCRIBER QUESTIONS: Thanks very much for the opportunity to ask Mr. Gordon questions. I have three questions. Thanks again and take care. Sincerely, Ken Anderson, U.S. Coast Guard.

1. What is your opinion on how high gold is going on this current run, then how far down [do you] believe it could drop before resuming another rise from the bottom?

GORDON: Gold is the investment of choice in the Kondratieff winter, and this season is in its early stages. As the economy unwinds and the financial system comes under increasing duress, the price of gold will rise much higher. While I do use charts to determine the shorter-term price moves, I don't usually act on what I see, because my strategy for gold is buy and hold and wait for the big, big move. That being said, I compiled some intermediate-term charts on gold, the HUI, and some gold shares in June this year. These charts are on my Web site (www.thelongwaveanalyst.ca). Gold should meet resistance near $500 and correct from that level. Through $500, the chart suggests a move to $740 on this intermediate move.

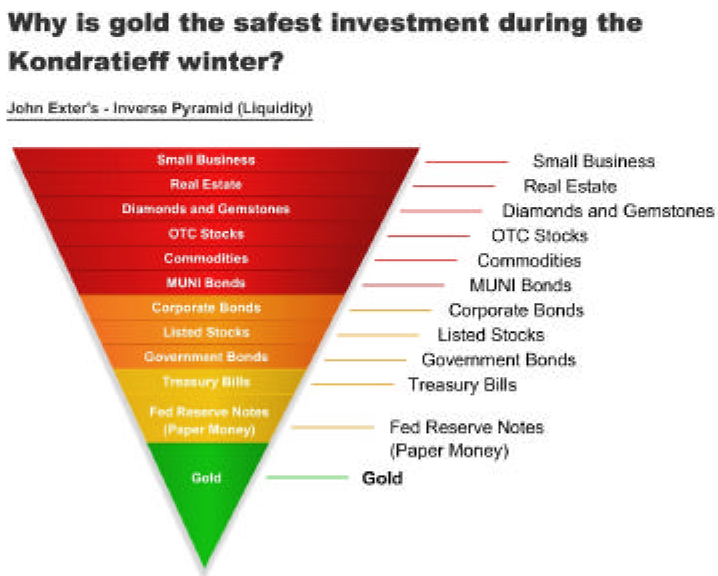
2. Why are mining share prices currently suppressed, relative to gold bullion prices? When will mining share prices catch up?

GORDON: I've given this paradox much thought. The prices of gold shares, particularly the juniors, by and large peaked in December 2003. The price of gold was approximately $390 then. It's now $475. That's a rise of 22%. Over the same time, the price of copper has increased 80%, and energy prices are up 100%. Hence, relative to metals and energy, gold prices have declined. Speculative money has left gold shares, particularly the juniors, for the metal, energy, and alternative energy stocks, and these have enjoyed spectacular returns. Now the economy is undoubtedly slowing, and the demand for these commodities will slow, too, as will price. The slowing economy will also contribute to an increasing interest in gold. Thus, money will start to move out of the metals and energy stocks back to gold and gold stocks.

3. What's [your] best guess for the approximate year when the Kondratieff Winter will be at its worst? And what will the national and global economic picture look like when that time arrives?

GORDON: The depths of the last winter were reached in the spring of 1933, when President Roosevelt closed all the banks. Those that were deemed insolvent were closed forever and those that were considered secure were re-opened after the bank holiday. The unemployment rate stood at about 25%. Stock prices had bottomed a year earlier with the Dow down 90% from its September 1929 peak. Thus, from top to bottom took less than four years. It's more than five and a half years since the autumn stock market peak, and stock prices are nowhere near their bear market bottom. They have been rejuvenated by a panicked Federal Reserve that has reduced interest rates from 6% after the stock market peak to just 1% at the recent low and a massive injection of money into the banking system. These two measures have also added huge amounts to consumer debt, and much of this debt has been injected into consumer purchases that have re-jigged the economy. The largest amount of debt has gone into the housing market, which has become an unsustainable immense speculative bubble. The question is, therefore, how long can the Fed keep the party going? Not for long it seems. It has been forced to raise interest rates in the face of rising inflation. Rising interest rates have always been the kiss of death to the stock market. To compound it all, energy prices have soared, impacting on consumer discretionary spending. U.S. government spending is out of control. Consumer confidence is falling to new lows, and the economy is in trouble. Regardless, the Fed promises even higher interest rates. Once the damage becomes apparent, panic could well set in, and stock prices could crash. Thus, the next wave down should be much quicker and more vicious than the initial down wave. This would suggest that the bottom might well be seen three or four years from now. As to how the bottom will appear, we have the last winter bottom to guide us. It will not be pretty. Unemployment will be rife, bankruptcies will be rampant, housing and stock prices will have reached unimaginable lows, the financial system will be in dire straights, and there is a threat of massive civil unrest.

SUBSCRIBER QUESTION: Are mutual funds that specialize in gold and precious metals expected to do well during the Kondratieff winter? An example of such a fund is the Scudder Gold and Precious Metals Fund, SCGDX. Any information along these lines will be of interest. Regards, Glenn Fritsche



GORDON: Most people haven't a clue about gold, and that includes many managers running gold mutual funds. I can't speak to the Scudder Gold and Precious Metals Fund, since I don't know it. Nor will I speak good or bad about any other gold fund and its managers, including those that I do know. But there are some fund managers who understand gold very well, and these are the managers that I would seek out. Gold in the Kondratieff winter becomes the asset of choice, because of the economic and financial chaos that prevails. In other words, it becomes the money of choice, better even than cash (see John Exter's inverse pyramid on your left).

During the Kondratieff cycle, there are two seasons when gold performs well. These are the inflationary summer and the deflationary winter. Gold always performs when stocks don't, and vice versa. Hence, stocks perform in the spring as the economy starts its relatively debt- and inflation-free growth, and stocks again perform well (actually, outstandingly well) in the disinflationary autumn. Therefore these two seasons are for investing in stocks and not for investing in gold, whereas summer and winter are times to be invested in gold and not in stocks. It's that simple. One more thing about gold funds, I like the managers that have a strong junior gold component in their funds. The juniors provide the best leverage to a rising gold price.

SUBSCRIBER QUESTION: Jay, Thanks for your willingness to incorporate questions from the subscriber base. I am curious as to Ian's timing expectations about when gold and gold shares will "take off." It is my understanding that Robert Prechter, a like-minded deflationist, believes that the gold price will fall along with everything else (except the dollar) at the onset of the next leg down in the bear market and as the economy transitions from inflation to deflation. At some point thereafter, he believes gold will have its day in the sun, but not before it loses considerable value from the current valuation at $465/oz. Based on these timing expectations, how would [Ian] allocate a portfolio today in terms of asset class (specifically, what portion would be dedicated to gold)? Also, what in price range does he expect gold to bottom out before the major rise? God bless and keep up the good work! Kris M. Kirby, Navigant Capital Advisors, LLC.

GORDON: Both the metal and the stocks have already taken off. The HUI has risen better than 600% in five years, and the price of gold is up about 80% over roughly the same period. The performance of some of the juniors has been even more outstanding. But the correction in these since December 2003 has been more acute. Regardless, the returns have been excellent, and that's just the beginning. So far, only the smart money has been in gold—Like Bernard Baruch in 1928, buying as much as he could of gold companies like Alaska Juneau Mines, because he could see what was about to happen.

The next stage for gold is when the broader public recognizes the price move and joins the party. The trouble is that so many financial advisors just don't get it and continue to advise that stocks are where you want to be and that gold is merely a "barbarous relic." That's one reason that the general stock market continues to perform as well as it does. But that's about to change. At the Dow's peak, it took about 44 ounces of gold to buy it. Now it takes only 22 ounces to buy the Dow. Where would you rather have been invested these last five years? And as I said at the prelim to these questions, that figure is going to come down to a 1 to 1 relationship or even lower.

Consider if you will that the Dow repeats its 1929-1932 experience (there's no reason to suspect that it won't) and loses 90% from its peak; that would take it down to the 1200 level. Would gold be at $1200 then? I don't think so, given the chaos that these stock market numbers suggest. The price of gold would be much higher. I have a great deal of respect for Mr. Prechter, but I think he treats gold as a commodity in the deflationary winter, which clearly it is not. It becomes the money of choice.

Just prior to leaving office, President Hoover was informed by his Treasury Secretary that the U.S. was running out of gold because of the enormous demand. I don't see anything different this time, and gold is in demand, given the price rise that we've already seen. And that price is now rising against all currencies. Gold is in the process of decoupling its relationship with the dollar. Thus, I don't agree with Mr. Prechter, and I wouldn't be holding my breath for a significant correction in the price of gold before stepping in. That's not likely to happen.

As for your choice of assets in this very traumatic period of the cycle, you want to protect yourself by owning cash and gold. What portion of each is very much determined by your personal investment profile, your risk tolerance, the amount of confidence that you have that we are indeed in the depression/deflation winter of the Kondratieff cycle, and the degree of your acceptance of the likely outcome.

SUBSCRIBER QUESTION: I would just like a more detailed explanation on how deflation will arrive with the Fed's ability to raise the money supply almost at will. I understand that if money supply is increased through the banking system that that process involves debt, and how that process can cause deflation as debtors pay off and/or default on that debt. However, the money supply, if I am correct, can also be increased quite directly, outside of the banking system, and, thus, without increasing debt. If the money supply in increased this way, as it has been, how can this excess money not cause more inflation, or, at least, avoid deflation? Love this issue, Stephen – NYC based hedge fund manager.

GORDON: Under the terms of the Monetary Control Act of 1980, the Federal Reserve has been empowered to monetize almost anything. Indeed, shortly after 9/11, a Federal Reserve spokesman suggested that the Bank had considered buying stocks, bonds, and even gold mines to arrest any panic. That suggests to me that they are already interfering in these markets. So, you are right to consider that in the event of a credit deflation that the Fed would start to overtly purchase anything to offset the deflationary panic. But that presupposes that they will recognize the crisis before it develops; otherwise, the collapse will completely get away from them. It also would require a massive infusion of money to bail out consumers, corporations, governments, and the stock and bond markets. This would frighten the holders of U.S. dollars, perhaps setting off panic selling, and resulting in a huge increase in interest rates. Anyway, we're not talking chump change here, but trillions of dollars. Following the collapse in 1929, under the charter at that time, the Federal Reserve was allowed to monetize only gold and commercial paper. However, the simultaneous collapse of stock prices, business activity, and international debt from 1929 to 1933 was so severe that not only was gold withdrawn from the banking system by frightened depositors, but the supply of commercial paper also contracted, rapidly leaving the Fed with nothing to monetize.

SUBSCRIBER QUESTIONS: Dear Mr. Taylor, my name is Tom Attig. Mr. Gordon is a very bright man. And the long-wave, Kondratieff view is persuasive. I am wondering if you could ask him the following three questions:

1. To what extent and how will the entry of the U.S. economy into the full chill of the Kondratieff winter directly or indirectly impact the economies of other nations, e.g., Canada, Australia, Europe, Asia? (I have in mind that the Japanese winter of more than the last decade seems not to have drawn other economies down in its wake.) But will a U.S. winter be more ominous for the world economy as a whole because it, and its currency, is larger and as the world's reserve currency is more widely used in the global economy?

GORDON: If you think I'm bright, you obviously weren't at school with me. But thank you. The U.S. economy is approximately 30% of the total world economy. It's enormous. When it falls into its deflationary depression stage, it will destroy the entire world economy. That is to some extent why the world is cooperating with the United States in buying her debt in spite of the outlandish profligacy of the nation. The Japanese winter has so far been relatively benign because the rest of the world hasn't yet entered the depression in a meaningful way. Canada in particular will suffer grave consequences, because more than 70% of our exports go to the United States. Kondratieff wrote that the cycle was a worldwide phenomenon. It's difficult to see how any country could escape the winter once the U.S. goes down. The days of the U.S. dollar as the world's reserve currency are numbered, much as the British pound lost this status in 1931.

2. Do you see the inevitable unwinding of the winter season as likely to occur very rapidly, or agonizingly slowly as was the case in Japan?

GORDON: So far, the winter has been very slow. The onset of winter is always signaled by a peak in the great autumn stock bull market. That happened almost six years ago. But I think when things begin to unravel in the United States (and that may well be starting now), the pace will quicken, because the Federal Reserve will have run out of ammunition to take on the huge mass of problems that it will be facing.

3. What is your advice about the best places to be invested in anticipation of the approaching K-winter? In gold and gold stocks, as Mr. Taylor advises? Any other good places? And what about investments in other economies, e.g., Canada, Australia, Europe, or Asian?

GORDON: The K Wave winter is not approaching; it's already here. Under the circumstances, we must protect ourselves by investing in cash and gold. Investments are not recommended in the economies of other countries, because they'll be going down, too.

SUBSCRIBER QUESTION: Is there one particular signal that would be the key to the Kondratieff winter? How would you position your fund if that be the case? If your funds were all in U.S. dollars, how would you protect yourself? Regards, Richard Roles. Matt 6:33 ("But strive first for the Kingdom of God and His righteousness and all these things will be given to you as well.")

GORDON: The signal for the Kondratieff winter is the peak prices for the autumn stock bull market. As I've said above, you must protect yourself by holding the most liquid of assets in a deflationary depression, and these, according to John Exter, are cash and gold.

SUBSCRIBER QUESTION: I have 100% of my 401K money in a money market. How do I protect the value of this money in case we have K-winter ahead? 401K plan management does not believe in GOLD or commodity sectors, and I cannot take this money out till 65 (30 years away). I just wonder what will happen to my hard savings 30 years from now? Thanks.

GORDON: Actually, in a deflationary depression, the value of cash increases as prices fall. So cash is a smart investment of choice. If you can't put physical gold in your 401K, what about buying some of the companies that produce it or even explore to find it? Look at the chart of Homestake versus the Dow on my Web site (www.thelongwaveanalyst.ca) by clicking "Long Wave Presentation" and scrolling through. It's not a bad history lesson anyway.

SUBSCRIBER QUESTION: Does Mr. Gordon agree with the dollar-short, strengthening senior currency theory put forth by Richard Russell and Bob Hoye, and if so, does he see the dollar strengthening against most other currencies, or just stronger in U.S. purchasing power? Also, what's his best estimate as to the mechanism and timing of the eventual demise of the fiat dollar as we now know it? Thank you, Mr. Taylor, for your continuing efforts to see beyond the smoke and mirrors and drag us subscribers kicking and screaming into the real world in which we live. H. D. O'Neal

GORDON: I have a great deal of respect for both these gentleman. I know that when Britain left the gold standard in 1931, which precipitated the world monetary crisis during that time, the value of the pound rose. And it's easy to see that the amount of dollar debt could indeed lead to a rise in the value of the dollar. On the other hand, it is also easy to see a massive sell-off of dollars from foreign debt holders. This would obviously have a negative impact on the dollar's value. And I don't think it really matters one way or the other to the overall scheme of things, which are now on the brink of disaster. I can't remember who said that all fiat currencies eventually return to their intrinsic value, which is zero. This is the first time in 5000 years that the entire world has been subjected to fiat money. There isn't a good currency among the lot, but the dollar is as bad as it gets on account of debt and future obligations, which in total are close to $90 trillion. There's no way that that can ever be paid. So one has to expect some kind of monetary re-organization, but when, I don't know. What I can say is that when the depression hits, government obligations will increase dramatically, whilst income through taxes will fall precipitously, compounding the federal and state governments' debt problems. This suggests that the dollar will go even lower, particularly against gold.

SUBSCRIBER QUESTION: Jay, can you ask Ian what assurance is there that gold [physical] will be allowed to be held as a hedge against inflation or deflation? My fear is that it may be outlawed again. BOB HOWLETT, Ph.D. (**Editor's Remark** – Bob is a very kind hearted, retired professor of statistics)

GORDON: Obviously, I don't know. What I do know is that when times get desperate, governments act to seize wealth. After private gold holdings were outlawed in the United States, anyone wanting to access a safety deposit box had to do so in the presence of an IRS agent. Your gold purchases should be undertaken as privately as possible. But the government didn't seize gold shares, and they performed outstandingly.

SUBSCRIBER QUESTION: What trigger events do you see coming down the pike that indicate we are continuing to head into the winter cycle?

GORDON: The economy is the key, and what drives that is the U.S. consumer. Watch things like consumer confidence levels, their spending, lay-offs, bankruptcies (Delphi this weekend), housing statistics (i.e., new and existing sales), debt problems, and of course the stock and bond markets. Just get a feel for whether things are getting worse or getting better and how much worse or better. I know what I see. Don't trust official numbers, they're usually baloney. Read. I like the *Financial Times* and the *Economist* and good newsletter writers who write from an independent perspective, like Jay, Jim Willie (*The Golden Jackass*), and of course the venerable Richard Russell (dowtheoryletters.com). Go to Web sites, like gold-eagle, 321gold, financialsense.com, lemetropolecafe, prudent bear. I like Marshall Auerbach's columns and my own thelongwaveanalyst.ca. Learn to think for yourself. Have the courage of your convictions, which are based on your knowledge. For the most part, keep your opinions to yourself, otherwise you might be swayed. Remember Lord Keynes:"I change my opinion only when the facts change." Don't think for a moment that the powers that be will rescue you. They are not the solution; they are the problem, and their hubris knows no bounds. The only solution that the Federal Reserve can have is to throw money at the problem, and we all know where that's gotten us.

JIM ROGERS – "LEAD IS BETTER THAN GOLD!"

Ian, Jim Rogers sent the following e-mail message to me several months ago when I forwarded a pro-gold e-mail from my friend Dr. Larry Parks to him.

"Jay, please tell Larry and all the rest that there will certainly be a day for gold when it will outperform lead and other things. Every dog will have its day.

"But lead has outperformed gold over the past 30 years, the past 25 years, the past 20 years, the past 15 years, the past 10 years, the past 2 years, and the past 1 year. Keep hanging on to a loser since it will do well some day, but that has not been a good way to make money for decades. Gold may even outperform lead for a while now. But sugar will outperform gold, as will coffee, wheat, and a few other things. And please tell Larry hello and give him my best."

Ian, as you know, Mr. Rogers thinks we are in the early stages of a commodity bull market that has another 10 or 15 years to run. You also know I agree with you that the K-winter is coming; but in the meantime, as we both know, gold shares have not provided us with much to cheer about since around January 2004, although over the past few weeks, they have done better. Because I need to keep my subscribers happy and renewing their subscriptions, and because we are clearly in at least a cyclical bull market for commodities, I have chosen to adopt a more aggressive pro-inflation policy in my Model Portfolio, and that has allowed me to avoid losses in my portfolio that I would have suffered had I stayed strictly with gold and gold shares over the past couple of years.

But I am nervous about a sudden decline in global economic demand that could trigger the beginning of the K-winter freeze-up and suddenly send commodity prices lower. We have set up an Inflation/Deflation Indicator with 17 variables geared at giving us a weekly reading on which is gaining the upper hand, inflation or deflation. So far, since January 1, inflation is winning the day. I know you are betting on deflation and have not really thought much about protecting yourself against a declining currency. But what would you suggest we look at so we can, on short notice, exit from our inflation plays when the K-winter freeze hits us? Or would you simply suggest we do as you and stick with gold and gold shares no matter what?

GORDON: The Kondratieff cycle has many cycles within it, and one of these is an inflation/deflation cycle. At the beginning of spring (1949), inflation is very benign. The economy has been beaten up in the winter, but slowly starts to rise. This gradual increase in economic activity quickens as spring develops and inflation starts to slowly increase. When spring turns to summer, inflation really starts to pick up, because there's always been a war in the Kondratieff summer, and this war has always been financed by an increase in the money supply.

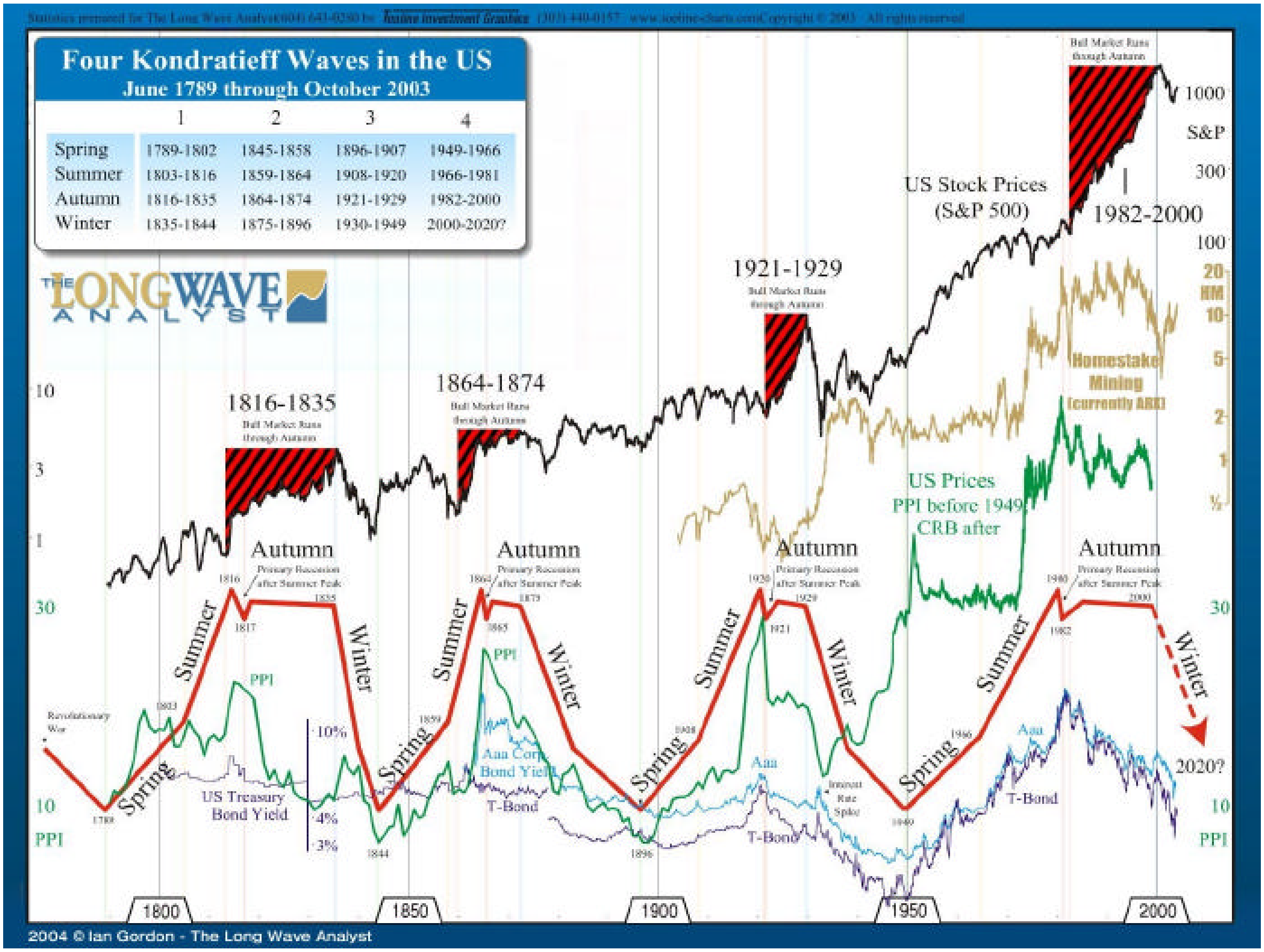
In the first cycle, the summer war was the War of 1812; in the second summer it was the U.S. Civil War; in the third summer, it was World War I (1914-1918); and in the current cycle, it was the Vietnam War. Summer ends with an inflationary peak. This and a peak in interest rates, a bear market in stocks, and a recession are the signs that autumn is beginning.

Autumn is always the season for the biggest bull market in stocks, bonds, and real estate of the entire cycle, indeed of a lifetime. Remember 1921-1929, or more recently, 1982-2000. And autumn is always the season of disinflation or falling inflation. Winter begins when the great stock bull market ends, as it did in 2000 and in the previous cycle 1929. As winter gets underway, the disinflation of the autumn turns to outright deflation.

This hasn't happened yet (to the contrary, we are experiencing large commodity inflation), but it will. It's best to understand how the credit bubble starts to blow apart. Then I think we can understand how deflation starts. As always, let's look to the previous winter to guide us. The causes of the last depression were entirely attributable to the great credit expansion that started in 1914 as a result of World War I and gathered pace throughout the 1920s.This credit expansion peaked in July 1929. Almost everyone, and this includes the American financial establishment, believes that the primary cause of the Great Depression was a tight money policy initiated by the Federal Reserve about year prior to the Crash of 1929 and continued relentlessly during the critical years of the early 1930s. These same people reason that to avoid a depression all the Fed has to do is keep money easy and keep the credit expansion going, much as is being done today. The tight money theory is simply not true. What is true is that bank deposits fell by about 30% between 1929 and 1932, and of course there were huge declines in the values of stocks, bonds, commodities, and real estate. But this was not on account of a Fed tight monetary policy. Au contraire. Following the Crash of 1929, the Fed frantically tried to restart the credit inflation, with cheap money and open market purchases of government securities.

<u>Currency</u> increased in 1929; what contracted so severely was bank credit. Credit is created when people, corporations, and governments go into debt. It is extinguished when they get out of debt. When an excessive amount of debt is created and collateralized with largely inflated assets, its liquidation when triggered is usually involuntary and violent. It is this liquidation that is the cause of the rapid collapse of the total credit money supply. This in turn causes the collapse of demand and the dumping of surplus properties and inventories at sacrifice prices and the sharp rise of unemployment, which is typical of a

depression. The only way you can keep a credit bubble from collapsing is to keep inflating, which is exactly what the Fed is doing now. But there is always a limit to credit inflations. Eventually, there are no credit-worthy borrowers remaining, because credit has been stretched to outrageous limits. Then the entire credit system begins to fail as it becomes increasingly obvious that a substantial part of it will be defaulted. Once credibility is lost, creditors scramble to salvage what they can.



And that, Jay, is why debt is the cause of deflation. We are just about there. Inflation cannot last much longer, because confidence in the entire credit system is being eroded by the increasing level of bankruptcies and the ridiculous levels of consumer debt. Watch out for the largest credit bubble of all—watch out for real estate.

TAYLOR: Here is another view from Jim Rogers that he sent to me during August 2004, complaining about my deflationary views. I would like to get your response, if you don't mind?

"I still find it hard to conceive that you still go on about deflation when commodity prices are up 155% over the past 6 years. That is 'deflation'? Then what is inflation?"

To be fair to Rogers, commodity prices have continued to climb a lot since august 2004. But how would you answer him now, because I'm sure he feels the same now as he did a year ago.

GORDON: Some of that price rise is directly attributable to Mr. Rogers. He is a very influential and persuasive man, and his past investment record is peerless. Thus, his inflationary stance has created a huge following. So a lot of money on his advice has flowed to commodities, and, obviously, this has positively impacted price. I'm not saying that's the only reason and that it's the biggest reason for the price rise. Clearly the growth in China and her demand for raw materials, in sync with this growth, have had a major impact on the price. And the fact that the dollar is down about 40% from its peak has also contributed to the rising prices. Be that as it may, if you believe that commodity prices are going to continue to rise, you have to believe that the worldwide economy is going to continue to perform. That's where I beg to differ. The high oil prices are already negatively impacting the U.S. economy. With no savings to buffer them from the slowdown, and with higher energy and credit costs, the U.S. consumer will have to retrench, which will add to the slowdown. "Katrina" could well be the "tipping point" for America's next Great Depression. By 1933, U.S. GNP had fallen by almost 50%. Under similar circumstances this time around, America would be self sufficient in oil. When the world's largest economy fails, the world economy fails too. Thus, worldwide demand for commodities would virtually come to a halt. Prices under these circumstances would be crushed. The Asian Crisis occurred only seven years ago; demand for oil in that sector of the world dropped dramatically, causing the price of oil to fall from $20 to $10 per barrel. At that time, the cover of the *Economist* suggested that the oil price could go to $4; yesterday SE Asia, today the world.

TAYLOR: You have always been more bullish on gold and gold shares than silver and silver shares. Do you still hold the view that gold will perform better during the K-winter freeze-up than silver and silver shares?

GORDON: I have to say that I'm still more comfortable, vis-à-vis gold versus silver in the Kondratieff winter. For silver, it all depends on whether it will be viewed as a monetary or industrial metal. In the early 1930s, its price dropped along with all the other commodities. The price only rose after President Roosevelt made it a strategic metal so as to employ the U.S. silver miners in such states as Colorado, Idaho, Nevada, New Mexico, and California. Thus, the U.S. garnered a huge hoard of silver, which it began to sell off in 1966. The U.S. Government no longer has any silver, and, of course, this is one of the arguments posed by the silver bulls for a rise in price, on account of the lack of aboveground supply. The other day I was carrying a 1-oz. gold panda in my pocket, its value $470. I thought that to have an equivalent value in silver I would need to have about 60 1-oz. coins in my pocket. That would be tough. That being said, I don't want to rain on the silver enthusiasts' parade. I am sympathetic to their arguments. So just in case it takes on the role of poor man's gold, as well it might, given the probable ridiculously high price of gold, I do own silver and one particular silver stock.

TAYLOR: Ian I know we could go on much longer here, but I believe you have answered the main issues related to your K-winter thesis. As I said in your introduction, you have been of enormous help to me in helping us construct an investment strategy that has been quite successful in "beating the market Hopefully civil tranquility in Canada and the U.S. will prevail for at least a few more years so that we can meet a few more times for dinner in Vancouver or Calgary or Toronto." Many thanks to you for that and best wishes to you, your wife Jan and son Duncan as we all baton down the hatches in preparation for the storms and tumultuous times ahead.

GORDON: Jay, thank you very much for letting me answer these great questions. I have enjoyed the time that I've spent, and I hope your readers find this helpful.

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Editor's Note about Ian's Charts: It may be difficult for you to read the 4 Kondratieff Wave Chart and the Inflation/Deflation Chart that illustrates the best investments for each Kondratieff season. However, when you renew your subscription or send us a check for $10 to Taylor Hard Money Advisors, Inc., we will mail via the postal system a "hard color copy" of both of these charts to you. The actual hard copies of these charts are much easier to read. Also, you can easily view these charts extremely well if you visit Ian's web site at www.thelongwaveanalyst.ca. In fact, a step by step explanation is given on on Ian's site that is outstanding in terms of explaining Ian's Kondratieff cycle theory.