

THE GUIDE TO UNDERSTANDING DEFLATION

Robert Prechter's most important teachings and warnings about deflation from 2002 to 2010.

By Robert R. Prechter, Jr.

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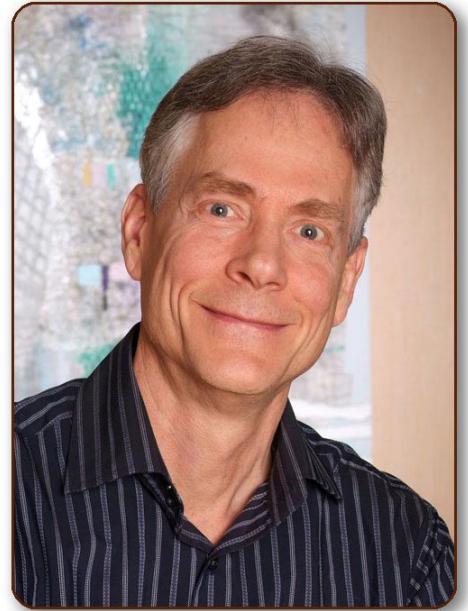
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About the Author

Robert Prechter is president of Elliott Wave International, the world's largest independent financial forecasting firm with a focus on technical analysis. He has written 14 books on finance, the first being *Elliott Wave Principle* with A.J. Frost in 1978, which forecasted a 1920s-style stock market boom. His 2002 New York Times bestseller, *Conquer the Crash*, predicted the current debt crisis. The second edition was published in 2009.

Prechter began his professional career in 1975 with Merrill Lynch and started providing Elliott wave analysis of the financial markets a year later. In 1979, he founded Elliott Wave International and began publishing his monthly market letter, *The Elliott Wave Theorist*. He has been described as "one of the premier timers in stock market history" by *Timer Digest*, "the champion market forecaster" by *Fortune* magazine, "the world leader in Elliott Wave interpretation" by The Securities Institute, and "the nation's foremost proponent of the Elliott Wave method of forecasting" by *The New York Times*.



Besides being a market analyst, Prechter is also a social theorist who has developed a new science of history and social prediction, called socionomics. He founded the Socionomics Institute and the Socionomics Foundation to support research in the field.

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Excerpted from *Conquer the Crash*

Chapter 9:

When Does Deflation Occur?

Defining Inflation and Deflation

Webster's says, "Inflation is an increase in the volume of money and credit relative to available goods," and "Deflation is a contraction in the volume of money and credit relative to available goods." To understand inflation and deflation, we have to understand the terms money and credit.

Defining Money and Credit

Money is a socially accepted medium of exchange, value storage and final payment. A specified amount of that medium also serves as a unit of account.

According to its two financial definitions, *credit* may be summarized as *a right to access money*. Credit can be held by the owner of the money, in the form of a warehouse receipt for a money deposit, which today is a checking account at a bank. Credit can also be *transferred* by the owner or by the owner's custodial institution to a borrower in exchange for a fee or fees — called interest — as specified in a repayment contract called a bond, note, bill or just plain IOU, which is *debt*. In today's economy, most credit is lent, so people often use the terms "credit" and "debt" interchangeably, as money lent by one entity is simultaneously money borrowed by another.

Price Effects of Inflation and Deflation

When the volume of money and credit *rises* relative to the volume of goods available, the relative value of each unit of money falls, making prices for goods generally rise. When the volume of money and credit *falls* relative to the volume of goods available, the relative value of each unit of money rises, making prices of goods generally fall. Though many people find it difficult to do, the proper way to conceive of these changes is that the value of units of money are rising and falling, not the values of goods.

The most common misunderstanding about inflation and deflation — echoed even by some renowned economists — is the idea that inflation is rising prices and deflation is falling prices. General price changes, though, are simply *effects*.

The price effects of inflation can occur in goods, which most people recognize as relating to inflation, or in investment assets, which people do not generally recognize as relating to inflation. The inflation of the 1970s induced dramatic price rises in gold, silver and commodities. The inflation of the 1980s and 1990s induced dramatic price rises in stock certificates and real estate. This difference in effect is due to differences in the social psychology that accompanies inflation and disinflation, respectively, as we will discuss briefly in Chapter 12.

The price effects of deflation are simpler. They tend to occur across the board, in goods and investment assets simultaneously.

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The Primary Precondition of Deflation

Deflation requires a precondition: a major societal buildup in the extension of credit (and its flip side, the assumption of debt). Austrian economists Ludwig von Mises and Friedrich Hayek warned of the consequences of credit expansion, as have a handful of other economists, who today are mostly ignored. Bank credit and Elliott wave expert Hamilton Bolton, in a 1957 letter, summarized his observations this way:

In reading a history of major depressions in the U.S. from 1830 on, I was impressed with the following:

- (a) All were set off by a deflation of excess credit. This was the one factor in common.
- (b) Sometimes the excess-of-credit situation seemed to last years before the bubble broke.
- (c) Some outside event, such as a major failure, brought the thing to a head, but the signs were visible many months, and in some cases years, in advance.
- (d) None was ever quite like the last, so that the public was always fooled thereby.
- (e) Some panics occurred under great government surpluses of revenue (1837, for instance) and some under great government deficits.
- (f) Credit is credit, whether non-self-liquidating or self-liquidating.
- (g) Deflation of non-self-liquidating credit usually produces the greater slumps.

Self-liquidating credit is a loan that is paid back, with interest, in a moderately short time from production. Production facilitated by the loan generates the financial return that makes repayment possible. The full transaction adds value to the economy.

Non-self-liquidating credit is a loan that is not tied to production and tends to stay in the system. When financial institutions lend for consumer purchases such as cars, boats or homes, or for speculations such as the purchase of stock certificates, no production effort is tied to the loan. Interest payments on such loans stress some other source of income. Contrary to nearly ubiquitous belief, such lending is almost always counter-productive; it adds costs to the economy, *not value*. If someone needs a cheap car to get to work, then a loan to buy it adds value to the economy; if someone wants a new SUV to consume, then a loan to buy it does not add value to the economy. Advocates claim that such loans “stimulate production,” but they ignore the cost of the required debt service, which burdens production. They also ignore the subtle deterioration in the quality of spending choices due to the shift of buying power from people who have demonstrated a superior ability to invest or produce (creditors) to those who have demonstrated primarily a superior ability to consume (debtors).

Near the end of a major expansion, few creditors expect default, which is why they lend freely to weak borrowers. Few borrowers expect their fortunes to change, which is why they borrow freely. Deflation involves a substantial amount of *involuntary* debt liquidation because almost no one expects deflation before it starts.

What Triggers the Change to Deflation

A trend of credit expansion has two components: the general willingness to lend and borrow and the general *ability* of borrowers to pay interest and principal. These components depend respectively upon (1) the trend of people's confidence, i.e., whether both creditors and debtors think that debtors will be able to pay, and (2) the trend of production, which makes it either easier or harder *in actuality* for debtors to pay. So as long as confidence and productivity increase, the supply of credit tends to expand. The expansion of credit ends when the desire

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or ability to sustain the trend can no longer be maintained. As confidence and productivity decrease, the supply of credit contracts.

The psychological aspect of deflation and depression cannot be overstated. When the social mood trend changes from optimism to pessimism, creditors, debtors, producers and consumers change their primary orientation from *expansion* to *conservation*. As creditors become more conservative, they slow their lending. As debtors and potential debtors become more conservative, they borrow less or not at all. As producers become more conservative, they reduce expansion plans. As consumers become more conservative, they save more and spend less. These behaviors reduce the “velocity” of money, i.e., the speed with which it circulates to make purchases, thus putting downside pressure on prices. These forces reverse the former trend.

The structural aspect of deflation and depression is also crucial. The ability of the financial system to sustain increasing levels of credit rests upon a vibrant economy. At some point, a rising debt level requires so much energy to sustain — in terms of meeting interest payments, monitoring credit ratings, chasing delinquent borrowers and writing off bad loans — that it slows overall economic performance. A high-debt situation becomes unsustainable when the rate of economic growth falls beneath the prevailing rate of interest on money owed and creditors refuse to underwrite the interest payments with more credit.

When the burden becomes too great for the economy to support and the trend reverses, reductions in lending, spending and production cause debtors to earn less money with which to pay off their debts, so defaults rise. Default and fear of default exacerbate the new trend in psychology, which in turn causes creditors to reduce lending further. A downward “spiral” begins, feeding on pessimism just as the previous boom fed on optimism. The resulting cascade of debt liquidation is a deflationary crash. Debts are retired by paying them off, “restructuring” or default. In the first case, no value is lost; in the second, some value; in the third, all value. In desperately trying to raise cash to pay off loans, borrowers bring all kinds of assets to market, including stocks, bonds, commodities and real estate, causing their prices to plummet. The process ends only after the supply of credit falls to a level at which it is collateralized acceptably to the surviving creditors.

Why Deflationary Crashes and Depressions Go Together

A deflationary crash is characterized in part by a persistent, sustained, deep, general decline in people's desire and ability to lend and borrow. A depression is characterized in part by a persistent, sustained, deep, general decline in production. Since a decline in production reduces debtors' means to repay and service debt, a depression supports deflation. Since a decline in credit reduces new investment in economic activity, deflation supports depression. Because both credit and production support prices for investment assets, their prices fall in a deflationary depression. As asset prices fall, people lose wealth, which reduces their ability to offer credit, service debt and support production. This mix of forces is self-reinforcing.

The U.S. has experienced two major deflationary depressions, which lasted from 1835 to 1842 and from 1929 to 1932 respectively. Each one followed a period of substantial credit expansion. Credit expansion schemes have always ended in bust. The credit expansion scheme fostered by worldwide central banking (see Chapter 10) is the greatest ever. The bust, however long it takes, will be commensurate. If my outlook is correct, the deflationary crash that lies ahead will be even bigger than the two largest such episodes of the past 200 years.

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Financial Values Can Disappear

People seem to take for granted that financial values can be created endlessly seemingly out of nowhere and pile up to the moon. Turn the direction around and mention that financial values can disappear into nowhere, and they insist that it is not possible. “The money has to go *somewhere*...It just moves from stocks to bonds to money funds...It never goes away...For every buyer, there is a seller, so the money just changes hands.” That is true of the money, just as it was all the way up, but it’s not true of the *values*, which *changed* all the way up.

Asset prices rise not because of “buying” *per se*, because indeed for every buyer, there is a seller. They rise because those transacting agree that their prices should be higher. All that everyone else – including those who own some of that asset and those who do not – need do is *nothing*. Conversely, for prices of assets to fall, it takes only *one* seller and *one* buyer who agree that the former value of an asset was too high. If no other bids are competing with that buyer’s, then the value of the asset falls, *and it falls for everyone who owns it*. If a million other people own it, then their net worth goes down even though they did nothing. Two investors made it happen by transacting, and the rest of the investors made it happen by choosing not to disagree with their price. Financial values can disappear through a decrease in prices for any type of investment asset, including bonds, stocks and land.

Anyone who watches the stock or commodity markets closely has seen this phenomenon on a small scale many times. Whenever a market “gaps” up or down on an opening, it simply registers a new value *on the first trade*, which can be conducted by as few as two people. It did not take everyone’s action to make it happen, just most people’s inaction on the other side. In financial market “explosions” and panics, there are prices at which assets do not trade at all as they cascade from one trade to the next in great leaps.

A similar dynamic holds in the creation and destruction of credit. Let’s suppose that a lender starts with a million dollars and the borrower starts with zero. Upon extending the loan, the borrower possesses the million dollars, yet the lender feels that he still owns the million dollars that he lent out. If anyone asks the lender what he is worth, he says, “a million dollars,” and shows the note to prove it. Because of this conviction, there is, in the minds of the debtor and the creditor combined, two million dollars worth of value where before there was only one. When the lender calls in the debt and the borrower pays it, he gets back his million dollars. If the borrower can’t pay it, the value of the note goes to zero. Either way, the extra value disappears. If the original lender sold his note for cash, then someone else down the line loses. In an actively traded bond market, the result of a sudden default is like a game of “hot potato”: whoever holds it last loses. When the volume of credit is large, investors can perceive vast sums of money and value where in fact there are only repayment contracts, which are financial assets dependent upon consensus valuation and the ability of debtors to pay. IOUs can be issued indefinitely, but they have value only as long as their debtors can live up to them and only to the extent that people believe that they will.

The dynamics of value expansion and contraction explain why a bear market can bankrupt millions of people. At the peak of a credit expansion or a bull market, assets have been valued upward, and all participants are wealthy – both the people who sold the assets and the people who hold the assets. The latter group is far larger than the former, because the total supply of money has been relatively stable while the total value of financial assets has ballooned. When the market turns down, the dynamic goes into reverse. Only a very few owners of a collapsing financial asset trade it for money at 90 percent of peak value. Some others may get out at 80 percent, 50 percent or 30 percent of peak value. In each case, sellers are simply transforming the remaining future value losses to someone else. In a bear market, the vast, vast majority does nothing and gets stuck holding assets with

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low or non-existent valuations. The “million dollars” that a wealthy investor might have thought he had in his bond portfolio or at a stock’s peak value can quite rapidly become \$50,000 or \$5000 or \$50. *The rest of it just disappears.* You see, he never really had a million dollars; all he had was IOUs or stock certificates. The idea that it had a certain *financial value* was in his head and the heads of others who agreed. When the point of agreement changed, so did the value. Poof! Gone in a flash of aggregated neurons. This is exactly what happens to most investment assets in a period of deflation.

A Global Story

The next four chapters present a discussion that will allow you to understand today’s money and credit situation and why deflation is due. I have chosen to focus on the history and conditions of the United States because (1) I have more knowledge of them, (2) the U.S. provides the world’s reserve currency, making its story the most important, (3) the U.S. has issued more credit than any other nation and is the world’s biggest debtor, and (4) to discuss other countries’ financial details would be superfluous. If you understand one country’s currency, banking and credit history, to a significant degree you understand them all. Make no mistake about it: It’s a global story. Wherever you live, you will benefit from this knowledge.

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Excerpted from *Conquer the Crash*

Chapter 11:

What Makes Deflation Likely Today?

Following the Great Depression, the Fed and the U.S. government embarked on a program, sometimes consciously and sometimes not, both of increasing the creation of new money and credit and of fostering the confidence of lenders and borrowers so as to facilitate the expansion of credit. These policies both accommodated and encouraged the expansionary trend of the 'Teens and 1920s, which ended in bust, and the far larger expansionary trend that began in 1932 and which has accelerated over the past half-century.

Other governments and central banks have followed similar policies. The International Monetary Fund, the World Bank and similar institutions, funded mostly by the U.S. taxpayer, have extended immense credit around the globe. Their policies have supported nearly continuous worldwide inflation, particularly over the past thirty years. As a result, the global financial system is gorged with non-self-liquidating credit.

Conventional economists excuse and praise this system under the erroneous belief that expanding money and credit promotes economic growth, which is terribly false. It appears to do so for a while, but in the long run, the swollen mass of debt collapses of its own weight, which is deflation, and destroys the economy. Only the Austrian school understands this fact. A devastated economy, moreover, encourages radical politics, which is even worse. We will address this topic in Chapter 26.

A House of (Credit) Cards

The value of credit that has been extended worldwide is unprecedented. *At the Crest of the Tidal Wave* reported in 1995 that United States entities of all types owed a total of \$17.1 trillion dollars. I thought it was a big number. That figure has soared to \$29.5 trillion at the end of 2001, so it should be \$30 trillion by the time this book is printed. That figure represents three times the annual Gross Domestic Product, the highest ratio ever.

Worse, most of this debt is the non-self-liquidating type. Much of it comprises loans to governments, investment loans for buying stock and real estate, and loans for everyday consumer items and services, none of which has any production tied to it. Even a lot of corporate debt is non-self-liquidating, since so much of corporate activity these days is related to finance rather than production. The Fed's aggressive easy-money policy of recent months has cruelly enticed even more marginal borrowers into the ring, particularly in the area of mortgages.

This \$30 trillion figure, moreover, does not include government guarantees such as bank deposit insurance, unfunded Social Security obligations, and so on, which could add another \$20 trillion or so to that figure, depending upon what estimates we accept. It also does not take into account U.S. banks' holdings of \$50 trillion worth of derivatives at representative value (equaling five full years' worth of U.S. GDP), which could turn into IOUs for more money than their issuers imagine. Is it not appropriate that you are now reading Chapter 11?

Figures 11-1 through 11-4, along with Figure 7-6 [not shown], show some aspects of both the amazing *growth* in credit – as much as 100 fold since 1949 – and the astonishing *extent* of indebtedness today among corporations, governments and the public, both in terms of total dollars' worth and as a percent of GDP. There are so many measures revealing how extended debtors have become that I could dedicate a whole book to that topic alone.

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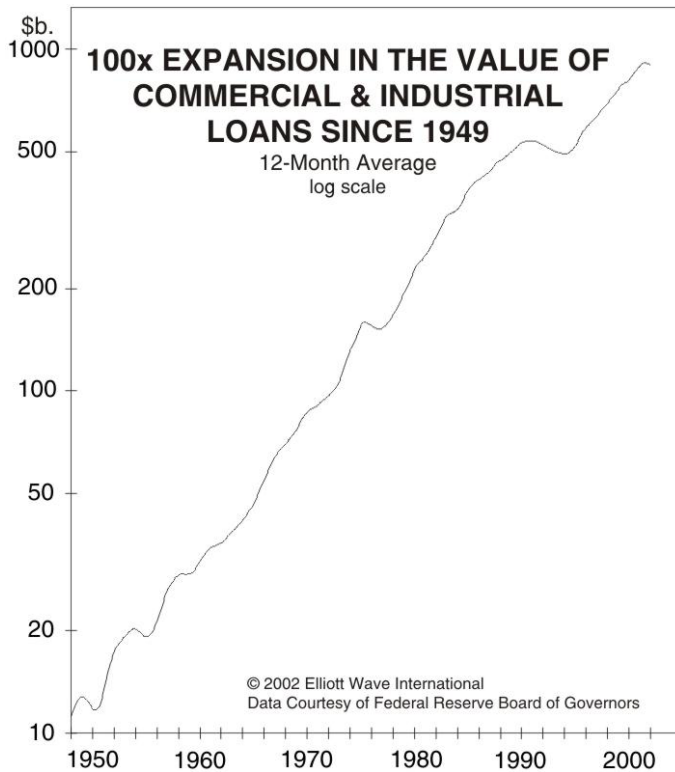


Figure 11-1

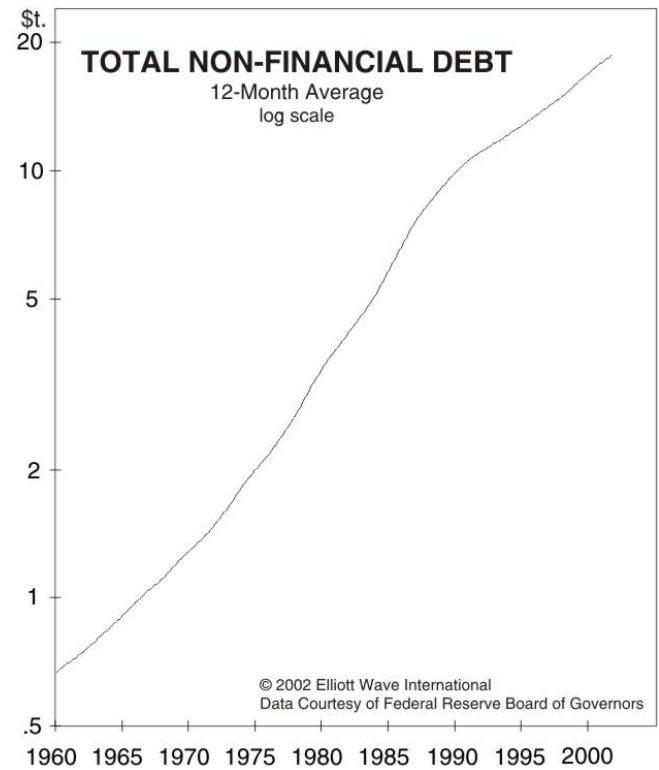


Figure 11-2

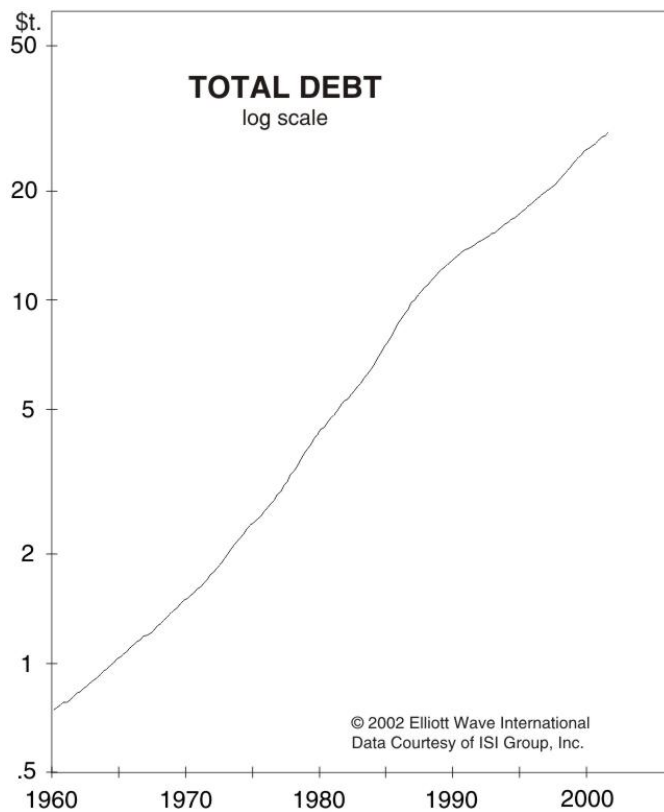


Figure 11-3

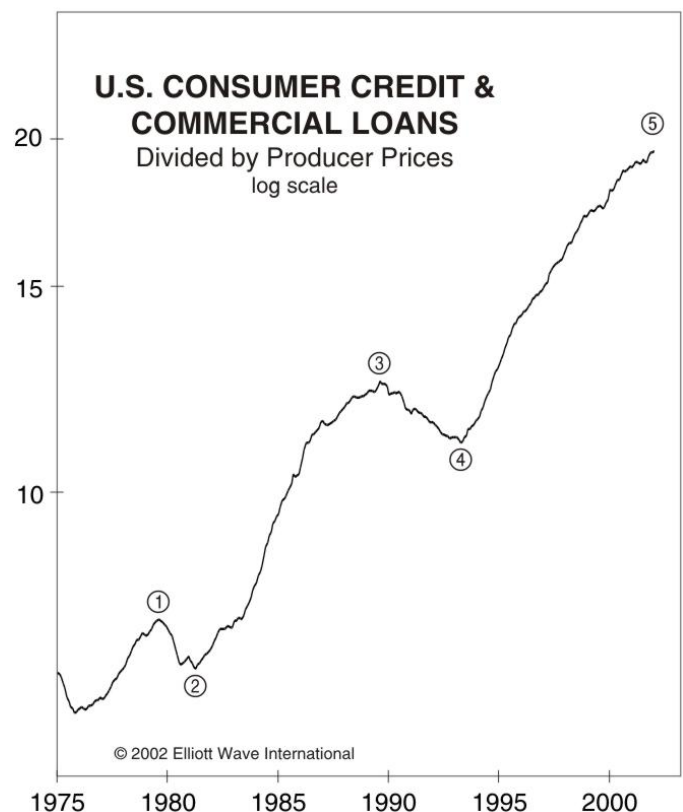


Figure 11-4

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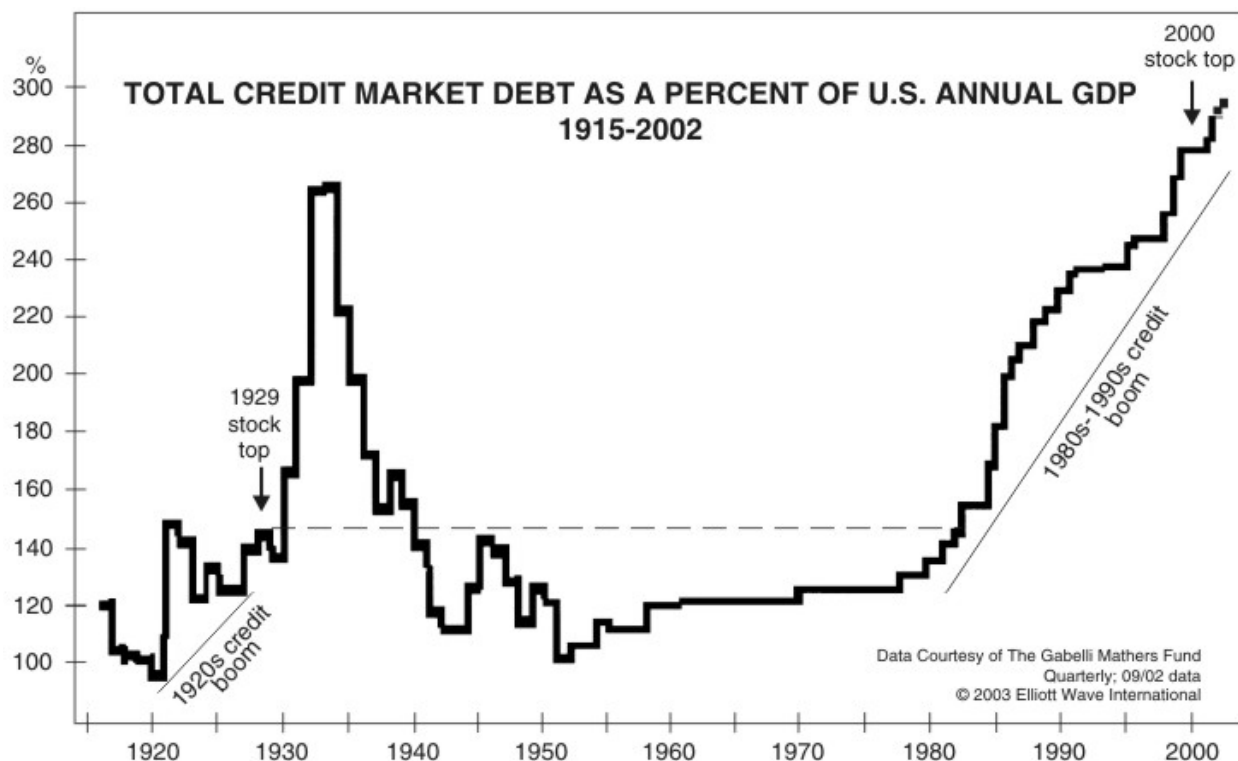


Figure 11-5

Runaway credit expansion is a characteristic of major fifth waves. Waxing optimism supports not only the investment boom but also a credit expansion, which in turn fuels the investment boom. Figure 11-5 is a stunning picture of the credit expansion of wave V of the 1920s (beginning the year that Congress authorized the Fed), which ended in a bust, and of wave V in the 1980s-1990s, which is even bigger.

I have heard economists understate the debt risk of the United States by focusing on the level of its net debt to foreigners, which is just above \$2 trillion, as if all other debt we just “owe to ourselves.” But every loan involves a creditor and a debtor, who are separate entities. No one owes a debt to himself. Creditors in other countries who have lent trillions to the U.S. and their own fellow citizens have added to the ocean of worldwide debt, not reduced it. So not only has there been an expansion of credit, but it has been the biggest credit expansion in history by a huge margin. Coextensively, not only is there a threat of deflation, but there is also the threat of the biggest deflation in history by a huge margin.

Broader Ideas of Money

It is a good thing that deflation is defined as a reduction in the relative volume of money and credit, so we are not forced to distinguish too specifically between the two things in today’s world. Exactly what paper and which book entries should be designated as “money” in a fiat-enforced debt-based paper currency system with an overwhelming volume of credit is open to debate.

Many people believe that when they hold stock certificates or someone’s IOUs (in the form of bills, notes and bonds), they still have money. “I have my money in the stock market” or “in municipal bonds” are common phrases. In truth, they own not money but financial assets, in the form of corporate shares or repayment

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contracts. As we will see in Chapter 19, even “money in the bank” in the modern system is nothing but a call on the bank’s loans, which means that it is an IOU.

There is no universally accepted definition of what constitutes “the money supply,” just an array of arguments over where to draw the line. The most conservative definition limits money to the value of circulating cash currency and checking accounts. As we have seen, though, even they have an origin in debt. Broader definitions of money include the short-term debt of strong issuers. They earn the description “money equivalents” and are often available in “money market funds.” Today, there are several accepted definitions of the “money supply,” each with its own designation, such as M1, M2 and M3.

The mental quality of modern money extends the limits of what people *think* is money. For example, a futures contract is an IOU for goods at a certain price. Is that money? Many companies use stock options as payment for services. Is that money? Over the past fifteen years, a vast portion of the population has come to believe the oft-repeated phrase, “Owning shares of a stock fund is just like having money in the bank, only better.” They have put their life’s savings into stock funds under the assumption that they have the equivalent of a money account *on deposit* there. But is it money? The answer to all these questions is no, but people have come to think of such things as money. They spend their actual money and take on debt in accordance with that belief. Because the idea of money is so highly psychological today, the line between what is money and what is not has become blurred, at least in people’s minds, and that is where it matters when it comes to understanding the psychology of deflation. Today the vast volume of what people consider to be money has ballooned the psychological potential for deflation far beyond even the immense monetary potential for deflation implied in Figures 11-1 through 11-5.

A Reversal in the Making

No tree grows to the sky. No shared mental state, including confidence, holds forever. The exceptional volume of credit extended throughout the world has been precarious for some time. As Bolton observed, though, such conditions can maintain for years. If the trend toward increasing confidence were to reverse, the supply of credit, and therefore the supply of money, would shrink, producing deflation. Of course, that is a big “if,” because for half a century, those wary of credit growth in the U.S. have sounded warnings of collapse, and it has not happened. This is where wave analysis comes in.

Recall that two things are required to produce an expansionary trend in credit. The first is expansionary psychology, and the second is the ability to pay interest. Chapter 4 of this book makes the case that after nearly seven decades of a positive trend, *confidence* has probably reached its limit. Chapter 1 demonstrates a multi-decade deceleration in the U.S. economy that will soon stress debtors’ *ability to pay*. These dual forces should serve to usher in a credit contraction very soon.

Wave analysis can also be useful when applied directly to the realm of credit growth. Figure 11-4 is a plot of consumer credit and commercial loans divided by the Producer Price Index to reflect loan values in constant dollars. It shows that the uptrend in real credit value extended to consumers and businesses has traced out five waves since the major bottom of 1974. This is nearly the same picture that we see in stock market margin debt (Figure 7-4). Plots of the credit expansion’s rate of change show that the growth in credit is running out of steam at multiple degrees of trend, which is what the analysis in Chapter 1 reveals about the economy. The downturn, it appears, is imminent if not already upon us.

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If borrowers begin paying back enough of their debt relative to the amount of new loans issued, or if borrowers default on enough of their loans, or if the economy cannot support the aggregate cost of interest payments and the promise to return principal, or if enough banks and investors become sufficiently reluctant to lend, the “multiplier effect” will go into reverse. Total *credit* will contract, so bank deposits will contract, so the supply of *money* will contract, *all with the same degree of leverage with which they were initially expanded*. The immense reverse credit leverage of zero-reserve (actually *negative-reserve*) banking, then, is the primary fuel for a deflationary crash.

Japan's deflation and its march into depression began in 1990. Southeast Asia's began in 1997. Argentina's has just made headlines. The U.S. and the rest of the nations that have so far escaped are next in line. When the lines in Figures 11-1 through 11-5 turn down (the first one may already have done so), the game will be up.

How Big a Deflation?

Today, under what is left of bank reserves, there are \$11 billion on reserve at the Fed plus \$45 billion in cash on hand in banks' vaults. This \$55 billion total covers the entire stock of bank credit issued in the United States. This amount equates to 1/100 of M2, valued today at \$5.5 trillion, and 1/550 of all U.S. debt outstanding, valued today at \$30 trillion. If we generously designate the U.S. money supply to include all Federal Reserve notes worldwide, totaling just under \$600 billion, these ratios are 1/10 and 1/55.

Of course, since the dollar itself is just a credit, there is no tangible commodity backing the debt that is outstanding today. Real collateral underlies many loans, but its total value may be as little as a few cents on the dollar, euro or yen of total credit. I say “real” collateral because although one can borrow against the value of stocks, for example, they are just paper certificates, inflated well beyond the liquidating value of the underlying company's assets. One can also borrow against the value of bonds, which is an amazing trick: using debt to finance debt. As a result of widespread loans made on such bases, the discrepancy between the value of total debt outstanding and the value of its real underlying collateral is huge. It is anyone's guess how much of that gap ultimately will have to close to satisfy the credit markets in a deflationary depression. For our purposes, it is enough to say that the gap itself, and therefore the deflationary potential, is historically large.

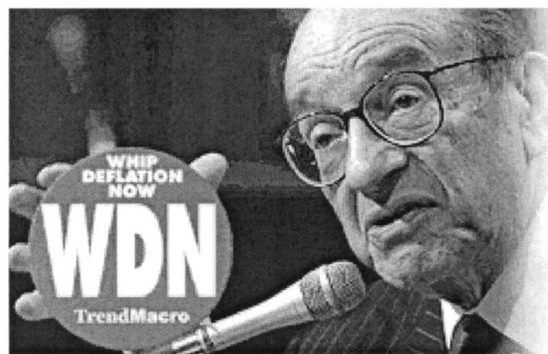
Although the United States is the world leader in fiat money and credit creation, a version of the story told in this and the preceding chapter has happened in every country in the world with a central bank. As a result, we risk overwhelming deflation in every corner of the globe.

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Excerpted from the January 16, 2003 Elliott Wave Theorist

DEFLATION: ONCE MORE INTO THE BREACH

Conquer the Crash quoted decorated experts from all corners of the economics profession who had declared in preceding months and years that the notion of deflation occurring was “utter nonsense,” a preoccupation of “small children,” a virtual impossibility with odds of happening equal to those of “being eaten by piranha.” A year later, opinion remains much the same, but one thing has changed: People have been writing and talking about deflation in a volume not seen since the 1930s. They have become focused not simply upon denouncing the thought but upon outlining the reasons for inflation’s inevitability or outlining battle plans for defeating the deflation that they do not expect. This report will investigate the validity of myriad “no deflation” arguments.



courtesy TrendMacrolytics

The first thing we might ask is, “If the prospects for deflation are so remote, why are so many financial writers wasting so much ink on it?” While a few economists have openly expressed concerns about deflation, everyone from Fed governors to bankers to university economists to financial magazines to your local newspaper is assuring us that deflation won’t – or can’t – happen. Few were prompted to defend the certainty of perpetual inflation in the 1950s, 1960s, 1970s, 1980s or 1990s. It was simply taken for granted. The only possible answer for this change is that indeed there are subtle signs of a pending deflation, and pundits are charging themselves with explaining them away. It reminds me of the repeated insistence over the past five years that “dividends don’t matter,” “P/Es don’t matter” and “book value doesn’t matter” with regard to the stock market. The more people insist that it is true, the more you can be sure that it isn’t.

The loneliness of the unequivocal and bearish deflationist is hard to overstate. When I traveled to New York last October, I was told by reporters that they knew of only one other serious deflationist, Stephen Roach of Morgan Stanley. According to *The Wall Street Journal*,¹ the Fed’s jawboning has recently caused him to modify his stance. The only other staunch deflationist I know is A. Gary Shilling, author of *Deflation: How to Survive and Thrive in the Coming Wave of Deflation* (McGraw-Hill, 1999), who still forecasts “a decade of deflation.” Gary argues, however, that the deflation will be mild and beneficial, not immense and destructive. While he may turn out to be correct, he is certainly not bearish. Because of this situation, I have been unable to find a published article explaining the weaknesses in the inflationists’ arguments and demonstrating that a destructive deflation is likely. If you can’t find something, you have to make it yourself; thus this report. While *Conquer the Crash* anticipated and answered many of these arguments, the recent rash of commentary on the assurance of continued inflation seems to require a renewed response. Here are my answers to the arguments extant today.

“There Is No Evidence of Deflation Currently in Force”

“Deflation,” headlines a financial publication, “of which there is none.”² There are two responses to this reasonably correct assertion. First and directly to the point, the lack of deflation currently is irrelevant. The basis for forecasting is not a current indication of a trend change, because then it would not be forecasting. Econo-

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mists always wait until a new trend is well entrenched and then tell you that the change occurred six months ago. A forecaster studies the precursors of trend change and then takes a stance in advance of the event. That's what EWI's deflation essays of 1998-2002 and *Conquer the Crash* have been doing. That the money supply is not contracting is of zero value in the debate of whether or not it *will* contract.

Second, there is a great deal of evidence that deflation is already impacting the economy selectively. The notable rises in bankruptcies, debt downgrades, delinquent loan payments, foreclosures, zero-percent loans, zero-downpayment loans, office vacancies and home equity borrowing unequivocally point to pressures from debt and over-spending, which I believe are precursors to deflation. The relentless decimation of junk bond values over the past five years portends depression, which implies deflation. The erratic but persistent fall in the Producer Price Index is a precursor to deflation. In November, the Labor Department reported that 40 percent of all goods and services were cheaper than they were a year ago. According to the Federal Reserve, the bursting of the stock bubble has wiped out more than \$9 trillion of mentally perceived value, which means mentally perceived purchasing power. While only conjecture at this point, I think that the real estate bubble peaked in 2002, after four years in which total mortgage debt rose an amazing 50 percent. As happened with the stock market, the real estate market may take a year to erode slowly while people argue about what's going on, but a few years from now, a new downtrend in prices should be clearly evident.

The fact that deflation — a decrease in the overall supply of money and credit — has yet to begin simply means that the all-time record 87 percent drop in the Fed's discount rate last year freed up enough credit to fuel the housing boom and thereby keep the total volume of credit barely rising for another year. That stimulus is spent. The question remains: What do you *forecast*?

“Debt Is Not as High as It Seems”

A bullish economist recently argued that the level of total debt is overstated, implying that the credit bubble and therefore the threat of deflation are mild. He makes a case that “financial” debt *doesn't count* because adding it to the total gives double weight to other loans. If, for example, a home buyer borrows from a finance company, which in turn borrows from a bank, the latter “financial” loan doesn't count because the overall chain of transactions is really just one loan — a loan from the bank to the homeowner — through an intermediary. This assertion is offered to counter the power of a graph shown as Figure 11-5 in *Conquer the Crash* (reproduced and updated as Figure 1). A few journalists have been seduced to treat this claim as if it were some grand, conclusive insight, admitting that they, too, “sad to say,”³ were duped into an unwarranted concern. There are many responses to this argument.

The first answer is, “So what?” If the stewards of this and similar graphs (which include The Bank Credit Analyst, Bridgewater Associates, Ned Davis Research and the Gabelli Mathers Fund) were to factor financial debt out of the entire data series, it would, I suspect, produce much the same picture. You would still see a debt bubble in the 1920s and another one, *a larger one*, today. The implication that debt is the highest in the nation's history would be the same. The absolute level doesn't matter.

Bulls resist this conclusion by asserting that financial debt today is a greater percentage of the total than it was earlier in the century, which would mean that non-financial debt as a percent of GDP would not be as high as it appears today *relative* to the 1920s. One problem is that they have not substantiated that assumption. Financial debt certainly existed in the 1920s, when investors, for example, could buy stock on 10 percent margin

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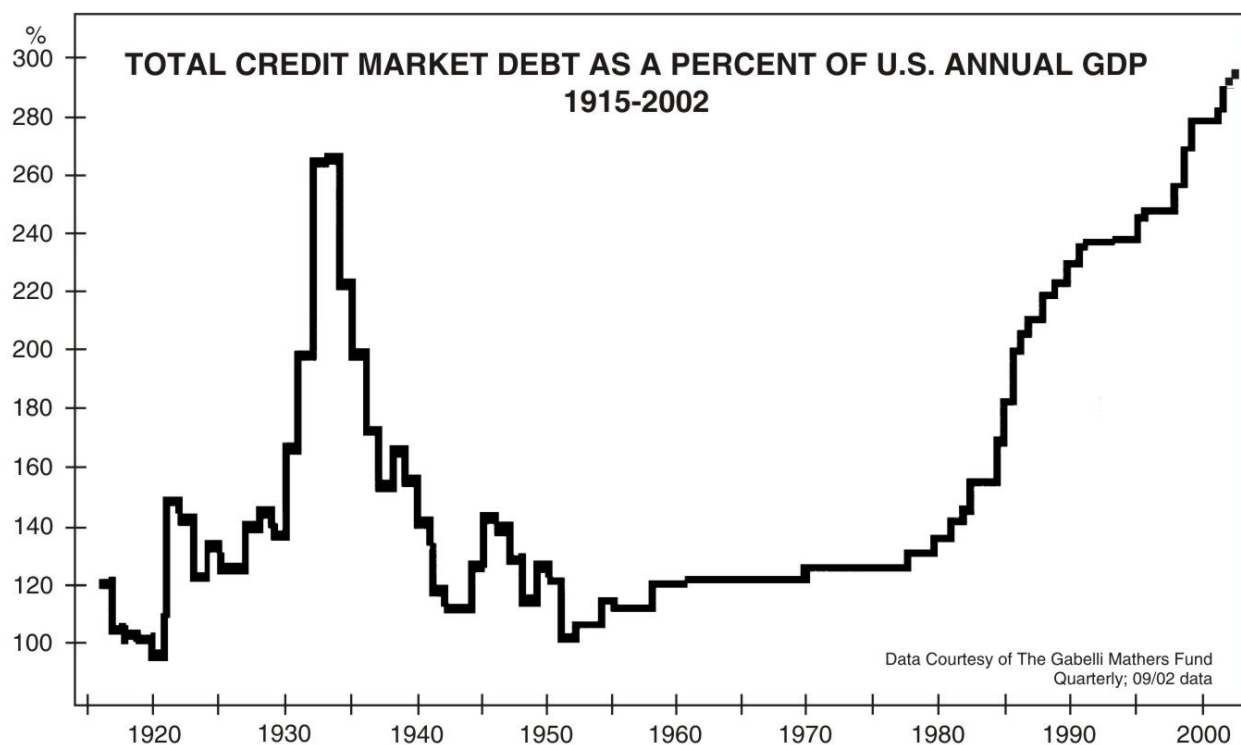


Figure 1

by borrowing the money from brokers, who would borrow much of it from banks, thus creating “financial” debt. Ninety percent is a lot to borrow, much more than today’s 50 percent margin limit allows, and margin debt rose tenfold in the 1920s. How the numbers then would actually compare to those of today is strictly conjecture until someone makes all the proper adjustments and produces a substitute graph.

If one were to go to the trouble of making such a graph, would it really show anything significantly different? No. If 1/3 of today’s debt is financial, and, say, only 1/6 of 1929’s debt was financial, then the graphed line in modern times would slip by just 1/6 of its current level, hardly enough materially to change the implications of Figure 1.

People who give this graph short shrift seem to think that the former peak occurred in 1929, but it didn’t; it occurred in the midst of the Great Depression, *after* the 1929 high. If we compare the levels of 1929 and 2000, each time the stock market topped, we find that the debt load recently is *much* higher, in fact *double* the level in 1929, as you can see in Figure 2. If from 2000 the ratio is to soar the same amount that it did from 1929 through the Great Depression’s peak, then we will soon see the line on this graph rise past 500 percent of GDP!

There is a more subtle point to make. The very fact that countless finance companies are in the loan business tells you that debt financing has permeated the culture to a degree way beyond that of the 1920s. Many loans would not be made were it not for those finance companies. Fannie Mae and Freddie Mac, for example, make loans to people that otherwise might not be able to borrow. Banks lend to FNM and FRE in cases where they would decline to lend to the ultimate borrower. Many financiers may be middlemen, but they serve to grease the skids for bales of credit. To expand upon a point that Ned Davis recently made, if a borrower goes under, the lending intermediary may go under, in which case the bank may go under, in which case the insurance company

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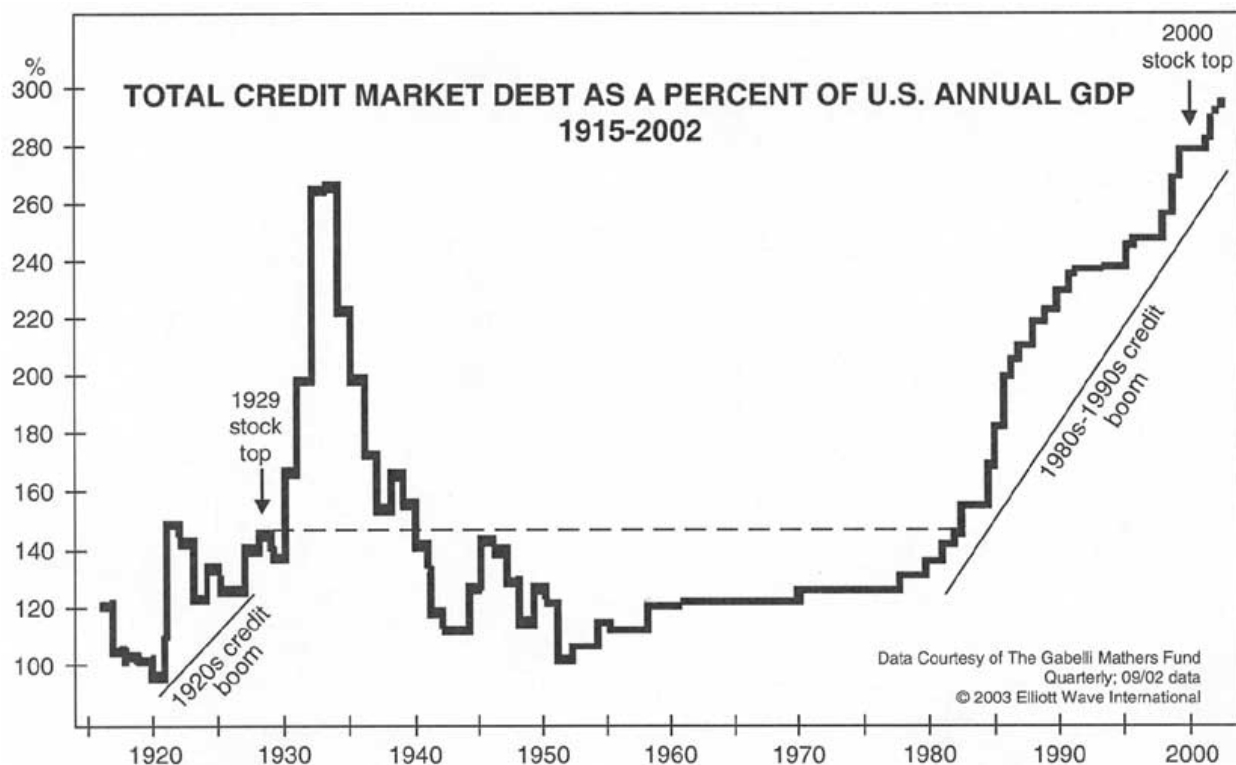


Figure 2

that guaranteed the bank loan may go under. In fact, any one of these entities can go bankrupt (simply from profligacy, for example) before everyone down the line from it does, in which case, that entity's creditors will be induced to move down the line recalling credit. To ignore the pyramid of dependence in today's credit situation is to ignore a vitally important aspect of the deflationary danger. To dismiss it all as "double counting" is cavalier, to say the least.

If we were to pursue the "double counting" idea to its extremity, we could, quite cleverly, reduce the entire debt supply from \$30 trillion not in the bulls' wimpy fashion to \$20 trillion but to about 1/400 of that amount. Let's start with the U.S. core money supply, which is \$55 billion worth of domestic greenbacks in banks and at the Fed. When a bank makes a loan, that money is deposited in (i.e., *lent to*, legally speaking) other banks, which in turn lend the money again. This "multiplier effect" is potentially infinite. (For reasons why, see Chapter 10 of *Conquer the Crash*.) Why not count all these as one loan? After all, as long as the debt is secure all the way down the chain, then it's just the same money, lent through many "intermediaries." Voila! "Don't worry; all we have is \$55 billion worth of domestic debt. It's just cycled through many entities." I hope you can see that the risk of default exists all the way down the line. To conclude, I see no reason to abandon the position that *total debt is total debt, and all of it matters*.

People who offer "low debt" arguments are *bulls* on stocks, inflation and the economy. Consequently, whether consciously or otherwise, they neglect to mention many factors that are unrepresented in Figure 1. *Conquer the Crash* listed some of them:

This \$30 trillion figure, moreover, does not include government guarantees such as bank deposit insurance, unfunded Social Security obligations, and so on, which could add another \$20 trillion or so to that figure,

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depending upon what estimates we accept. It also does not take into account U.S. banks' holdings of \$50 trillion worth of derivatives at representative value (equaling five full years' worth of U.S. GDP), which could turn into IOUs for more money than their issuers imagine.⁴

So when bullish economists attempt to debunk the debt problem, they become selective. They focus on one aspect of it and ignore many other factors. If I were as biased as such writers, I would add all of the above-implied debt to Figure 1 and show current dollar-denominated liabilities at 1000 percent of GDP, not 300 percent. It would be an easier position to defend than that taken by the bulls, because we know unequivocally that there were negligible Social Security obligations, bank deposit insurance and derivatives in the 1920s.

The attempt to debunk the all-time historically high level of debt worldwide is akin to arguments trying to dismiss the historically extreme P/D, P/E and P/book ratios: They are selective and designed to rationalize the problem away. A curmudgeon might call them dangerous.

“War Will Bail Out the Economy”

Many people argue that war will bring both inflation and economic boom. Wars have not been fought in order to inflate money supplies. You might recall that Germany went utterly broke in 1923 via hyperinflation yet managed to start a world war 16 years later, which was surely not engaged in order to inflate the country's money supply. Nor are wars and inflated money supplies guarantors of economic boom. The American colonies and the Confederate states each hyperinflated their currencies during wartime, but doing so did not help their economies; quite the opposite. With respect to war, the standard procedure today would be for the government to borrow to finance a war, which would not necessarily guarantee inflation. If new credit at current prices were unavailable, either the new debt could not be sold or it would “crowd out” other new debt. The U.S. could decide to inflate its currency as opposed to the credit supply. As explained in *Conquer the Crash*, doing so would be seen today as a highly imprudent course, so it is unlikely, to say the least. If it were to occur anyway, the collapse of bond prices in response would neutralize the currency inflation until the credit markets were wiped out. Despite these arguments, I concede that war can be so disruptive, involving the destruction of goods and the curtailment of commercial services, that the environment from the standpoint of prices could end up appearing inflationary. To summarize my view, the monetary result may not be certain, but an inflationary result is hardly inevitable.

There is in fact a reliable relationship between monetary trends and war. A downturn in social mood towards defensiveness, anger and fear causes people to (1) withdraw credit from the marketplace, which reduces the credit supply and (2) get angry with one another, which eventually leads to a fight. That's why *The Elliott Wave Theorist* has been predicting both deflation and war. You cannot cure one with the other; they are results of the same cause.

“Deflation Will Cause a Run on the Dollar, Which Will Make Prices Rise”

This is an argument that deflation will cause inflation, which is untenable. In terms of domestic purchasing power, the dollar's value should rise in deflation. You will then be able to buy more of most goods and services. It is unknown how the dollar will fare *against other currencies*, and there is no way to answer that question other than following Elliott wave patterns as they develop. From the standpoint of predicting deflation, the dollar's convertibility ratios are irrelevant. There may well be a “run on the dollar” against foreign currencies, but it would not be because of deflation. I think the impulse to predict a run on the dollar comes from people who own a

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lot of gold, silver or Swiss francs. They feel the '70s returning, and so they envision the dollar falling against all of these alternatives. If deflation occurs, a concurrent drop in the dollar relative to other currencies would be for other reasons. Perhaps the dollar is overvalued because it has enjoyed reserve status for so long, which might make it fall relative to other currencies. If this is what you expect, what are you going to buy in the currency arena? The yen? Japan has been leading the way into the abyss. The Euro? Depression will wrack the European Union. Maybe the Swiss franc or the Singapore dollar. But these are technical questions, not challenges to deflation or domestic price behavior.

“Consumers Remain the Engine Driving the U.S. Economy”

Only producers can afford to buy things. A consumer *qua* consumer has no economic value or power. The only way that consumers who are not (adequate) producers can buy things is to *borrow* the money. So when economists tell you that the consumer is holding up the economy, they mean that expanding *credit* is holding up the economy. This is a description of the *problem*, not the solution! The more the consumer goes into hock, the worse the problem gets, which is precisely the opposite of what economists are telling us. The more you hear that the consumer is propping up the economy, the more you know that the debt bubble is growing, and with it the risk of deflation.

“The Fed Will Stop Deflation”

This is the big kahuna, which, as we will see, is actually an oversized hot air balloon. In recent weeks, the handful of economists who had been entertaining the thought of deflation have rushed to change their minds. The Fed's tough talk, which we will explore in a moment, has prompted a mass defection from the skimpy deflationist camp. A Wall Street Journal headline from December 30, 2002, reads, “‘Reflation’ Comes Into Focus as U.S. Struggles to Battle Deflation.”⁶ (Never mind that there isn't supposed to *be* any deflation.) What, exactly, has “come into focus?” Reflation “refers to government efforts to pump up — or reflate — an economy that is stuck in a slump by flooding that economy with money.” The implication is that this is something new, but it's the same old wizard with the same old machine. The Fed has been flooding the economy with credit since 1933. Its latest move was to lower the discount rate from 6 percent to 0.75 percent! Now, we are being told, the Fed *will* flood the system with money? If you think about it, you can see that *this very contention is an admission that last year's record drop in rates was ineffective*. The article leaves out the *how* of the matter, but the mere assertion that reflation is the goal has been sufficient to change opinion. “Some economists who have been beating deflation drums are doing an about-face,” says the WSJ. “The reflation talk has many economists rethinking which way they believe the economy is tilting in this see-saw battle between rising and falling prices.” A chief economist at a major brokerage firm is quoted as saying, “The Fed saw the beast that we've been talking about for months and months and declared that it's going to kill the beast.” Yes, the Fed has embarked upon a “full-scale frontal assault on the perils of deflation,” says another chief economist. Its “very radical rhetorical change” portends “a global reflation program,”⁷ says a widely read financial magazine. To sum up the situation, “The financial community is talking more about reflation...it is the thing to watch in 2003.” Borrowing from Nixon's famous phrase about Keynesians, “We're all inflationists again.”

Why did this transformation come about? I believe that it is due primarily to the good feelings associated with the stock market rally dating from July/October. It's a mediocre rally, but with it, optimism has soared to

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the limit. The basis for the *rationalization* of those feelings is recent Fed jawboning. The Fed hasn't actually *done* anything, but its tough talk has beaten back deflation worries. What exactly has the Fed said that has so impacted the mindset of the financial community? Let's start at the beginning.

"Since at least 1997, the Fed's professional staff has been studying deflation," says The Wall Street Journal.⁸ It ramped up its "studying" in the fall of 1999, when officials met in Woodstock, Vermont to discuss how they would respond to the threat of deflation in the unlikely event that it should arise. Since then, curiosity has apparently turned to concern. In January 2002, the Fed "devoted a chunk of [its] policy meeting to the subject."⁹ Last September, minutes of an FOMC meeting expressed concerns about "negative real policy interest rates."¹⁰ A more direct commentary came in November, when the Fed lowered interest rates partly because "A failure to take an action...would increase the odds of a cumulatively weakening economy and possibly even attendant deflation."¹¹ Apparently, says The Wall Street Journal, this is "the first time that threat appears to have played a role in the central bank's policy moves."¹²

Two months ago, Chairman Greenspan called prospects for deflation "extraordinarily remote."¹³ On December 19, 2002, Greenspan said unequivocally, "*The United States is nowhere close to sliding into a pernicious deflation.*"¹⁴ That's the assertion. Yet he also says, "recent experience understandably has stimulated policymakers worldwide to refocus on deflation and its consequences, decades after dismissing it as a possibility so remote that it no longer warranted serious attention." What "recent experience" that might be, since we are "nowhere close" to deflation, he does not say.

Greenspan cites "rapid advances in productivity [per man-hour]" as anti-deflationary, but if that were true, then given the rapid advances in productivity over the past three years, we wouldn't be having a debate about deflation, would we? The fact is that productivity increases during depressions because people get laid off, and remaining workers put in more effort to cover the slack. In arguing that a new bubble won't develop, he says, "It is difficult to imagine stock prices of most well-established and seasoned old-line companies surging to wholly unsustainable heights," as if that is some remote future potential. The fact is that blue chip stocks have already been subject to a mania, one so intense that at its peak, the DJIA yielded only 1.5 percent annually in dividends, half the rate at the 1929 high. The blue chip S&P 400 Industrials yielded just *one* percent at the top. Arguing that a bubble won't develop soon is a red herring; it's already happened.

The Chairman goes on to make some excellent points, which ironically show how likely deflation is to begin (or continue). He says, "The recovery, however, ran into resistance in the summer, apparently as a consequence of a renewed weakness in equity prices."¹⁵ In other words, the next decline in equity prices will also lead to economic contraction. Further, "Cash borrowed in the process of mortgage refinancing, an important support for consumer outlays this past year, is bound to contract at some point." Yes, and it is probably doing so right now. "The overall cost of business capital has clearly declined, inducing in recent weeks increased issuance of bonds of all grades and halting the runoff of commercial paper and business bank loans." In other words, people are piling blocks onto the debt pyramid. Since this recent bond-buying trend is due to increased optimism and low short-term interest rates, both of which have limits, it is only a near term trend. His next comment is amazing to read but a bit long, so I will paraphrase it: Yes, [he says,] debt and debt service are at all-time historical highs, but the debt is spread so thoroughly throughout the system, through so many companies and individuals, that the "risk level" is lower than it would otherwise be. That's akin to saying (as countless experts did in the late 1990s) that because shoeshine boys, Beardstown Ladies and elevator operators are buying stocks, the market has

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become more stable; the opposite is true. Greenspan adds, "Corporations...have reduced their near-term debt obligations by issuing bonds." In other words, they have traded "pay soon at 3 percent extra per year" for "pay much later at 5 percent extra per year." Good luck to them and their creditors. The Fed has also stated that it believes today's 30-year mortgages are a stabilizing factor, since homeowners of the 1930s generally had five to ten-year mortgages. I think this is backward. The longer people stretch out their debts, the larger share of their futures they have hocked. In the early stages of Japan's deflation, Tokyo's condo dwellers were taking out mortgages that stretched over two generations. Like zero percent financing, it amounted to free money lent to people with no actual prospect of paying it back. Once creditors reach that point and then realize they won't be paid, credit inflation has gone as far as it can go, and the trend changes to deflation. That is almost surely where the U.S. stands today.

Greenspan asserts, "If deflation were to develop, options for an aggressive monetary policy response are available." He gives no examples, presumably because he feels that Fed Governor Ben S. Bernanke said quite enough on that topic the previous month.

Bernanke, an alumnus of both Harvard and MIT who is now an economist at Princeton, agrees with the vast majority of economists and pundits that "the chance of significant deflation in the United States in the foreseeable future is extremely small." He purports to explain, "The sources of deflation are not a mystery. Deflation is in almost all cases a side effect of a collapse of aggregate demand [for goods and services]." He makes no mention of why demand (by which he means bids for goods and services) can collapse, either because it is a mystery or because he wants to avoid saying so. The true source of deflation is system-wide bankruptcies induced by the contraction of a prior credit bubble. Without the preceding bubble, "demand" would never "collapse."

Bernanke is a social mechanist. He thinks that if you pull one monetary lever on the left of the macroeconomic machine, the lever on the right will go down, too. The "stability" of recent decades he attributes to "flexible and efficient markets for labor and capital" (which must have suddenly gone missing during 1835-1842, 1929-1932 and in Japan since 1990) and "the heightened understanding by central bankers and, equally as important, by political leaders and the public at large of the very high costs of allowing the economy to stray too far from price stability." Presumably, he is excluding price stability in stocks, property and Beanie Babies from that general category. Regardless, the idea that politicians and the public are enlightened about macroeconomics is nonsense. Disinflation makes central bankers look smart, when in fact, it is the natural trend of the psycho-monetary cycle and results from society-wide ignorance of macroeconomics.

Greenspan rightly warns, "Weaving a monetary policy path through the thickets of bubbles and deflations and their possible aftermath is not something with which modern central bankers have had much experience." Bernanke has had no experience with deflation at all, yet as a leader of the supposed enlightened, he boldly presents all his answers for the threat of deflation. He spends a couple of pages advocating policies to force down long term interest rates by decree and to convert government debt from long term to short term, which taken to its ultimate conclusion means to convert T-bonds into T-notes and then into T-bills and finally into cash notes, a circuitous route to simple money printing. I'm not sure who would buy such debt paper if confidence were to erode, and Bernanke doesn't address the question. He apparently doesn't think about such things. He has his hands on the levers, and he knows which ones to pull. Read about the more drastic measures for yourself (ellipses omitted; italics in the original):

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The U.S. central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief. It is true that once the policy rate has been driven down to zero, a central bank can no longer use its *traditional* means of stimulating aggregate demand[, but it] has most definitely *not* run out of ammunition. Deflation is always reversible under a fiat money system. The U.S. government has a technology called a printing press that allows it to produce as many U.S. dollars as it wishes at essentially no cost. Under a paper-money system, a determined government can always generate higher spending and hence positive inflation. Of course, the U.S. government is not going to print money and distribute it willy-nilly (although as we will see later, there are practical policies that approximate this behavior). To stimulate aggregate spending when short-term interest rates have reached zero, the Fed must expand the scale of its asset purchases or, possibly, expand the menu of assets that it buys. We can take comfort that the logic of the printing press example must assert itself, and sufficient injections of money will ultimately always reverse a deflation. Unlike some central banks, and barring changes to current law, the Fed is relatively restricted in its ability to buy private securities directly. However, the Fed [could] offer fixed-term loans to banks at low or zero interest, with a wide range of private assets (including, among others, corporate bonds, commercial paper, bank loans, and mortgages) deemed eligible as collateral. The Fed can inject money into the economy in still other ways. For example, the Fed has the authority to buy foreign government debt, as well as domestic [municipal] government debt. Potentially, this class of assets offers huge scope for Fed operations, as the quantity of foreign assets eligible for purchase by the Fed is several times the stock of U.S. government debt. The government could increase spending on current goods and services or even acquire existing real or financial assets. If the Treasury issued debt to purchase private assets and the Fed then purchased an equal amount of Treasury debt with newly created money, the whole operation would be the economic equivalent of direct open-market operations in private assets.¹⁶

Can you see why economists and financial writers of all types have panicked and embraced the idea that inflation is inevitable and deflation impossible? They have met the Wizard of Oz in person, and he is impressive!

He is also delusional. Can you imagine the laughingstock that the Federal Reserve System would become if its “assets” consisted of defaulted mortgages, bonds of bankrupt companies and municipalities, IOUs of shaky foreign governments and stock certificates of companies no longer in existence? Can you imagine the panic that would ensue to escape a monetary system with such assets as its reserves?

Bernanke's primary problem is that the only object he thinks exists is the monetary ledger, an inanimate balance sheet. He does not consider the responses of actual people and markets to his proposed policy actions, which will result in unintended consequences. Here is what *Conquer the Crash* says on this subject:

With these thoughts in mind, let's return to the idea that the Fed could just print banknotes to stave off bank failures. One can imagine a scenario in which the Fed, beginning soon after the onset of deflation, trades banknotes for portfolios of bad loans, replacing a sea of bad debt with an equal ocean of banknotes, thus smoothly monetizing all defaults in the system without a ripple of protest, reaction or deflation. There are two problems with this scenario. One is that the Fed is a bank, and it would have no desire to go broke buying up worthless portfolios, debasing its own reserves to nothing. Only a government mandate triggered by crisis could compel such an action, which would come only *after* deflation had ravaged the system. Even in 1933, when the Fed agreed to monetize some banks' loans, it offered cash in exchange for only the very best loans in the banks' portfolios, not the precarious ones. Second, the smooth reflation scenario is an ivory tower concoction that sounds plausible only by omitting human beings from it. While the Fed could embark

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on an aggressive plan to liquefy the banking system with cash in response to a developing credit crisis, that action itself ironically could serve to aggravate deflation, not relieve it. In a defensive emotional environment, evidence that the Fed or the government had decided to adopt a deliberate policy of inflating the currency could give bondholders an excuse, justified or not, to panic. It could be taken as evidence that the crisis is worse than they thought, which would make them fear defaults among weak borrowers, or that hyperinflation lay ahead, which could make them fear the depreciation of all dollar-denominated debt. Nervous holders of suspect debt that was near expiration could simply decline to exercise their option to repurchase it once the current holding term ran out. Fearful holders of suspect long-term debt far from expiration could dump their notes and bonds on the market, making prices collapse. If this were to happen, the net result of an attempt at inflating would be a system-wide reduction in the purchasing power of dollar-denominated debt, in other words, a drop in the dollar value of total credit extended, which is deflation.¹⁷

In other words, the human mind is not a machine, and people are not easily predictable. For example, it is taken for granted that low interest rates are supposed to help the debt situation, right? Read this:

Money fund yields, which currently average 1.52%, trade in line with interest rates. The rates, which are near historical lows, are driving investors out of money funds and into higher-yielding but riskier long-term-bond funds, experts say.¹⁸

Investors are jacking up the risk of their holdings because interest rates on safe debt issues are low, moving out of the frying pan and into the fire. According to Fitch Ratings, nearly 50 percent of the \$100 billion worth of "speculative grade" debt issued from 1997 through 1999 has already gone into default. Yet desperate investors, many of whom depend upon interest income to live, are buying more of the stuff and risking their shirts. Did the Fed intend that outcome when it jammed rates lower? Are low rates helping the debt situation and the deflation threat or making it worse? Are you sure?

Greenspan more specifically addresses the problem of unintended consequences when he laments what to him was an unforeseen consequence of a *prudent* central bank policy over the past 20 years: "It seems ironic that a monetary policy that is successful in inducing stability may inadvertently be sowing the seeds of instability associated with asset bubbles [i.e.,] the apparent market tendency toward bidding stock prices higher in response to monetary policies aimed at maintaining macroeconomic stability." Let's put aside for the moment that the Chairman is saying that the Fed is to be faulted only for being so darn good at its job of engineering stability, a highly debatable stance. His broader point is crucial: *We don't know how people will react to what we do.* Bernanke seems to think that hitting the "fast forward" button on greenback printing presses is some kind of isolated act that would simply add a few zeroes to the national ledger as needed, with no psychological effects at all, no attempt by anyone to protect his finances in response. This sterile view of society is a policymaker's dream and just as illusory. In fact, the financial world would go berserk if the Fed followed Bernanke's prescriptions. Even if he got in shape by arm wrestling Greenspan every week, he would be exhausted from turning the crank on the

TOM TOLES / Washington Post



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printing press fast enough to try to outrun the selling of panicked bond investors. A falling bond market would mean rising interest rates, the opposite of what the Fed would be trying to achieve. If rates were held down by fiat in such an environment, it would mean the immediate end to the market for new Treasuries, creating instant deflation. As I explain in *Conquer the Crash*, it's a Catch-22 situation. Deflation will win.

It is easy to envision many other unintended consequences that would occur if Bernanke were allowed to put his policies into place. For example, white-collar crooks would pour out of the woodwork in such numbers as to dwarf the S&L debacle. "Hey, Billy Buck! The Fed is paying good money — cash green! — for bad debt. Quick, have your company borrow \$100 mil from my bank, stash it in the Caymans, and then declare bankruptcy. I can have the truck here the next day with a new hundred mil. Then just change your company's name, and we'll do it again!" Immoral policies breed immoral responses.

The ultimate consequence of theft by monetary debasement is far worse than just financial chaos. Let's allow John Crudele of The New York Post to make this point for us:

The printing press image is a hot button with economists because that's exactly what the Germans did in the 1920s when that country was faced with huge budget deficits because of World War I. After it printed enormous amounts of currency, that country's inflation became rampant, leading to an image that everybody from the war generation remembers — the German people in the 1920s having to bring wheelbarrows full of money to the store for groceries. Those economic problems eventually led to the political upheavals in Germany that brought Adolph Hitler to power. Enough said? Bernanke should shut up.¹⁹

If Bernanke believes that his policies will generate stability, then I can't wait to read his memoirs. Were Bernanke's policies begun today, they would in fact initially accompany a crushing credit deflation and then cause a currency hyperinflation. If they were begun years from now at the bottom of the deflation, then only hyperinflation would result.

The bad news is that Mr. Bernanke's speech is the program of a moderate compared to statements from some of the social engineers who deem themselves worthy of advising the Fed. Their recommendations are prompted by problems with Bernanke's ideas, at least as far as he pushed them, as identified by none other than some of the Fed's own strategists:

Fed economists, who studied these strategies in late 2000, were skeptical. If interest rates were zero, then even if the Fed did pump banks full of cash by purchasing government securities, the banks would have little profit incentive to risk lending out the money — the return from leaving it in their vaults would be the same. Indeed, the Bank of Japan has tried this "quantitative easing" for the past year, and the economy is still in a slump. Driving down the dollar would fail if other countries tried to depreciate their currencies, too."²⁰

In other words, they are saying, Bernanke's prescriptions won't work because *people* are involved, and they are prone to reactive behavior. Ah, but that's only if you aren't devious enough! As dramatic as Bernanke's solutions are, those expressed at the Fed meeting in the fall of 1999 are even more shocking for their combination of cavalier authoritarianism and radical obliviousness to potential human responses. Here is what The Wall Street Journal reported about that meeting:

At Woodstock, researchers brainstormed about possible ways the Fed could spur spending, such as adding a magnetic strip to dollar bills that would cause their value to drop the longer they stayed in one's wallet. Other proposals, some possibly not legal, were for the Fed to lend to private companies or buy things such as stocks, real estate or even goods and services, such as used cars. Marvin Goodfriend, a top economist at

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the Richmond Fed, proposed at the Woodstock conference that a way to stimulate the economy if interest rates are already at zero is to levy a fee on banks that keep cash on deposit with the Fed rather than lending it out, and to find a way to make the currency worth less the longer it goes unspent – thus the magnetic strips. When someone deposited a bank note, a “carry tax” would be deducted according to how long it had been since it was withdrawn.²¹

So much for money being a store of value. Can you imagine the Fed proudly showing foreign governments its 10,000-acre used car lot to assure them of the dollar's collateral backing? In this context, I just love such terms as “brainstorm” and “top economist,” which in this case mean “fantasize” and “dreamer.”

But wait. Doesn't it strike you as incongruous that an agency that has been *entrusted with managing the nation's money* must call a conference to brainstorm things in the first place? Aren't they supposed already to know what they're doing? As you might guess, I'm not surprised. In discussing the myth of “potent directors,” *The Wave Principle of Human Social Behavior* describes a hilarious scene from 1998 in which President Clinton's “top advisors” are summoned to “a late-night huddle” while Clinton “phoned Treasury Secretary Robert Rubin, fly-fishing in Alaska” to brainstorm what Clinton saw as “the worst financial crisis in half a century.”²² He wanted “bold solutions as big as the problem” from “Washington's ‘best and brightest’ economic minds” to halt the Asian meltdown. He got bupkus, and the crisis played itself out as if – shockingly – no economic geniuses had “brainstormed” at all! Imagine the *petulance* of those Asian economies in ignoring them!

Do you really think *any* of the Fed's schemes will work? Before you answer that question, you might ask yourself how its last “sure cure” has performed. For about ten years now, the Fed and prominent economists have repeatedly – and arrogantly – asserted that Japan's persistent deflation resulted from the central bank's error in *not lowering interest rates fast enough*. The Fed assertively avoided making *that* mistake, jamming U.S. rates down a record amount in record time in 2001-2002, to their lowest level in over 40 years. The Fed's monetary strategists applied the one big lesson that they were so certain mattered most – the one that was sure to work – and what has happened? The stock market is lower, and the economy is weaker than it was at the start of the program! Deflation is so *petulant* in ignoring the planners, isn't it?

All these bankers are wrong about the true error committed and the actual lesson to be learned. The significant monetary errors attending the Great Depression were not committed from 1929 to 1933. They were committed from 1914 to 1929. To admit the true error and lesson would be to condemn the very existence of fiat money and central banking. The initial error was committed by Congress in granting one bank a monopoly on the country's money. That monopoly has allowed personal greed and political ambitions to foster seven decades of easy credit. Easy credit has in turn created an unsustainable debt load throughout the society. *Nothing* can relieve that load except what has always done so: a deflationary collapse. You cannot avoid the consequences of easy credit, just as you cannot avoid the consequences of taking amphetamines for months on end. The true lesson for society is, *don't create monopoly mechanisms that foster easy credit*. I have yet to hear a decorated economist admit the actual problem. Perhaps when the dust settles, after the damage is done, it will happen.

As *Conquer the Crash* asked well before the impotence of the Fed's program to lower interest rates was anywhere near apparent, “*Then what?*” Well, Bernanke supposes to have told us “then what,” but he hasn't. The solutions to the debt bubble suggested by the Fed's advisors are all rationalistic concoctions, proposed in isolation from the consideration of real-world consequences. I suspect that Japanese central bankers are among those who do consider such consequences. The Wall Street Journal reports, “In July 2000...foreign central bankers and academ-

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ics urged the Bank of Japan to conquer deflation by using the drastic and largely untried step of printing yen to buy government bonds or dollars. The Japanese rejected the advice.”²³ Forget the absurd claim that currency printing, which has ruined countless governments and populations over the past 300 years, has been “largely untried.” The Bank of Japan knows — probably because it has studied the results of taking that step — that there are snakes in that basket.

In a report composed two years ago but released December 20, 2002, the day after Greenspan’s speech, some staffers at the Fed rejected almost all of Bernanke’s prescriptions, for essentially the same reasons spelled out in *Conquer the Crash*. Read the following excerpts from a WSJ article and see if they sound familiar [emphases added]:

One section of the report for the first time highlights why the Fed would be reluctant to buy the debt of the government-sponsored enterprises.... Fed Chairman Alan Greenspan has argued that the implicit government guarantee behind [Fannie Mae, Freddie Mac and the Federal Home Loan Bank] is a subsidy, which enables them to attract a disproportionate share of investment capital. The latest report goes further, by suggesting they are a source of risk to the entire financial system. “The implicit subsidy no doubt has supported the [agencies’] large scale of operations, which, in turn, may be seen as posing a significant systemic risk,” the report says... *The report suggests that giving the Fed’s imprimatur to Fannie Mae or Freddie Mac by buying their debt would make matters worse.* “Some market participants might believe that the government would be even more inclined to support [the companies] in the event of financial problems.” The Fed holds more than \$600 billion in Treasury bonds and bills to back the money supply and influence interest rates. *It is permitted to own the companies’ securities but since 1997 has declined to buy more and holds just \$10 million today.*

Among other alternatives to Treasuries, the report appears to find the most merit in federal funds and Euro-dollar deposits...and foreign-government debt, *though choosing which to buy “could be sensitive politically and financially.”* The Fed report also explores buying stocks but warns they expose the Fed and “thus the taxpayer” to *much greater risk of loss* than with debt securities. If the Fed purchased some companies’ stock, it could also favor those firms *at the expense of others*, the report cautioned. The Fed report sees merit in commercial paper and corporate bonds [this was in 2000, when companies debt ratings were higher], but warns *the Fed would have the delicate task of choosing particular issuers over others....*²⁴

See the problem? It’s a complex world, and every supposed simple solution is fraught with consequences. If you read the above lines carefully, you will see what I meant when I said, “The Fed is a bank.” It doesn’t even want to buy the debt of partially government-guaranteed enterprises! The report also frets about a “greater risk of loss” from stock purchases. Its writers would feel this way about buying all the risky paper that Bernanke proposes to buy. There is no way that Fed officials will buy junk paper unless and until the social pain gets unbearable and political pressures force it to choose a terrible policy in response to public demand to “do something.” For such policies to be successful even temporarily would also require a police state to prohibit people from escaping the system. To be sure, we are heading in that direction, but we are still a long way from that point.

In contrast to the conclusion quoted at the outset of this section, I expect that *deflation* is the thing that we will be watching in 2003. The temporary *reflation* that economists are now projecting began in 2001 and is already ending. Society remains entrenched in the early stages of a long term deflationary psychology. Did you notice that the federal government recently declined to guarantee a loan to United Airlines? Why didn’t it just follow Bernanke’s prescription and welcome a chance to buy a boatload of bad debt? Deflation is a state of mind, not

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a matter of juggling a ledger. The era of promiscuous credit is hanging on by its fingernails. Congress will not let the Fed inflate the currency until deflation has run its course. Then we will probably get hyperinflation. But it's one thing at a time! My best guess is that until the deflation reaches bottom, the Fed, aside from lowering interest rates, will do exactly what it did from 1929 to 1932 and essentially what the Bank of Japan has done since 1990: nothing.

Recent Quotes from Nobel Laureates, Fed Chairmen and Other Experts

"Ignore the Ghost of Deflation. What does not make for good contingency planning is the recent alarmism about 'deflation.' Apart from Japan, the world has not seen deflation for 70 years...." ²⁵ – October 10, 2002

"Deflation is an overblown worry, in our opinion. The question [is] whether governments can still do to money what they have usually been able to do to it." ²⁶ – October 25, 2002

"The good news is that monetary policy never runs out of power." ²⁷ – October 29, 2002

"If you believe we are headed for deflation, you have conveniently filtered economic facts and history to support this notion. How can anyone believe there is going to be deflation? Even Robert Prechter comes to the conclusion that a deflationary depression is coming in his otherwise excellent book *Conquer the Crash*. Believe in Ghosts, Goblins, Wizards and Witches if you will...but don't believe in deflation occurring anytime soon." ²⁸ – October 30, 2002

"There's a much exaggerated concern about deflation. It's not a serious prospect. Inflation is still a much more serious problem than deflation. Today's Federal Reserve is not going to repeat the mistakes of the Federal Reserve of the 1930s. The cure for deflation is very simple. Print money." ²⁹ – November 6, 2002

"Fed officials and most private economists still think deflation is highly unlikely. Deflation doubters say the U.S. won't suffer deflation again because the Fed won't let it." ³⁰ – November 11, 2002

"The United States is nowhere close to sliding into a pernicious deflation." ³¹ – December 19, 2002

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Excerpted from the February 20, 2004 Elliott Wave Theorist

SECULAR DEFLATION AND THE END OF A CYCLICAL REFLATION

Jaguar Inflation

I am tired of hearing people insist that the Fed can expand credit all it wants. Sometimes an analogy clarifies a subject, so let's try one.

It may sound crazy, but suppose the government were to decide that the health of the nation depends upon producing Jaguar automobiles and providing them to as many people as possible. To facilitate that goal, it begins operating Jaguar plants all over the country, subsidizing production with tax money. To everyone's delight, it offers these luxury cars for sale at 50 percent off the old price. People flock to the showrooms and buy. Later, sales slow down, so the government cuts the price in half again. More people rush in and buy. Sales again slow, so it lowers the price to \$900 each. People return to the stores to buy two or three, or half a dozen. Why not? Look how cheap they are! Buyers give Jaguars to their kids and park an extra one on the lawn. Finally, the country is awash in Jaguars. Alas, sales slow again, and the government panics. It must move more Jaguars, or, according to its theory – ironically now made fact – the economy will recede. People are working three days a week just to pay their taxes so the government can keep producing more Jaguars. If Jaguars stop moving, the economy will stop. So the government begins *giving Jaguars away*. A few more cars move out of the showrooms, but then it ends. *Nobody wants any more Jaguars. They don't care if they're free. They can't find a use for them.* Production of Jaguars ceases. It takes years to work through the overhanging supply of Jaguars. Tax collections collapse, the factories close, and unemployment soars. The economy is wrecked. People can't afford to buy gasoline, so many of the Jaguars rust away to worthlessness. The number of Jaguars – at best – returns to the level it was before the program began.

The same thing can happen with credit.

It may sound crazy, but suppose the government were to decide that the health of the nation depends upon producing credit and providing it to as many people as possible. To facilitate that goal, it begins operating credit-production plants all over the country, called Federal Reserve Banks. To everyone's delight, these banks offer the credit for sale at below market rates. People flock to the banks and buy. Later, sales slow down, so the banks cut the price again. More people rush in and buy. Sales again slow, so they lower the price to one percent. People return to the banks to buy even more credit. Why not? Look how cheap it is! Borrowers use credit to buy houses, boats and an extra Jaguar to park out on the lawn. Finally, the country is awash in credit. Alas, sales slow again, and the banks panic. They must move more credit, or, according to its theory – ironically now made fact – the economy will recede. People are working three days a week just to pay the interest on their debt to the banks so the banks can keep offering more credit. If credit stops moving, the economy will stop. So the banks begin *giving credit away*, at zero percent interest. A few more loans move through the tellers' windows, but then it ends. *Nobody wants any more credit. They don't care if it's free. They can't find a use for it.* Production of credit ceases. It takes years to work through the overhanging supply of credit. Interest payments collapse, banks close, and unemployment soars. The economy is wrecked. People can't afford to pay interest on their debts, so many bonds deteriorate to worthlessness. The value of credit – at best – returns to the level it was before the program began.

See how it works?

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Is the analogy perfect? No. The idea of pushing credit on people is far more dangerous than the idea of pushing Jaguars on them. In the credit scenario, debtors and even most creditors lose everything in the end. In the Jaguar scenario, at least everyone ends up with a garage full of cars. Of course, the Jaguar scenario is impossible, because the government can't *produce* value. It can, however, *reduce* values. A government that imposes a central bank monopoly, for example, can reduce the incremental value of credit. A monopoly credit system also allows for fraud and theft on a far bigger scale. Instead of government appropriating citizens' labor openly by having them produce cars, a monopoly banking system does so clandestinely by stealing stored labor from citizens' bank accounts by inflating the supply of credit, thereby reducing the value of their savings.

I hate to challenge mainstream 20th century macroeconomic theory, but the idea that a growing economy needs easy credit is a false theory. Credit should be supplied by the free market, in which case it will almost always be offered intelligently, primarily to producers, not consumers. Would lower levels of credit availability mean that fewer people would own a house or a car? Quite the opposite. Only the timeline would be different. Initially it would take a few years longer for the same number of people to own houses and cars – *actually* own them, not rent them from banks. Because banks would not be appropriating so much of everyone's labor and wealth, the economy would grow much faster. Eventually, the extent of home and car ownership – *actual* ownership – would eclipse that in an easy-credit society. Moreover, people would *keep* their homes and cars because banks would not be foreclosing on them. As a bonus, there would be no devastating across-the-board collapse of the banking system, which, as history has repeatedly demonstrated, is inevitable under a central bank's fiat-credit monopoly.

Jaguars, anyone?

Excerpted from the August 24, 2005 Elliott Wave Theorist (written at the peak in real estate prices)

The Credit Supply Is About To Begin a Major Deflation

The June 28 issue of “Bullion Buzz” quotes investment guru Jim Rogers as saying, “Anyone who thinks there will be deflation does not understand twenty-first century central banking. There may well be a deflationary collapse later, but before that happens the government will print money until the world runs out of trees.” Of course, Jim is a legendary market analyst, but it is rare to hear him take a stand against the minority view. In this case, his words can pertain to only about half a dozen people in the United States, with the other 299,999,994 of them siding with Jim. They are, moreover, putting their money where their mouths are, buying stocks, commodities, gold and property and borrowing money at an unprecedented rate on the conviction that it will consistently lose value. Usually the crowd is wrong, and this is a big crowd.

At this point, dollar-denominated debt has reached \$37.3 trillion. The economy has little basis on which this ocean of debt will be repaid. With investment markets poised to fall across the board, the United States, and probably most of the world, is on the cusp of a great deflation. The credit supply will contract, and despite ubiquitous professional and popular belief to the contrary, there is nothing that the Fed can do about it. (See Chapters 11 and 13 in *Conquer the Crash*.) By the time the central bank gets around to printing money as opposed to offering credit, the devastation will have run its course.

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Excerpted from the November 17, 2005 Elliott Wave Theorist

The Coming Change at the Fed

The consensus appears to be that the long term expansion in the credit supply will continue or even intensify under the Fed chairmanship of Ben Bernanke. One reason many people share this belief is their recollection of Bernanke's November 2002 speech, "Deflation: Making Sure 'It' Doesn't Happen Here," in which he likens the Fed's printing press option to dropping money from helicopters. There are reasons to believe, however, that the outcome will not be as the majority expects.

One reason that Bernanke is likely to preside over a deflation in credit is that everyone believes the opposite. Investors have poured money into commodities, precious metals, stocks and property in the belief that if anything is certain, it is death, taxes and inflation. When the majority of investors thinks one way, it is likely to be wrong. This is basic market analysis.

But how can the majority be wrong this time, when Bernanke had vowed to shower the banking system with liquidity given any deflationary threat? Of course, people *always* ask such questions as a trend matures, whether the market is oil in 2005 ("How can oil go down when world production has peaked for all time?"), gold in 1980 ("How can gold go down with all this inflation?"), stocks in 2000 ("How can stocks go down in a New Economy?"), the dollar in 2004 ("How can the dollar go up when we have this huge trade deficit?") or inflation ("How can we have deflation? Bernanke won't allow it."). There is always a "fundamental" reason to believe that the trend will accelerate; that's what gets people fully committed. We truly need not provide any other answer, but we can.

A more complex answer begins with the understanding that analysts constantly confuse *credit* creation with *money* creation. In fact, just today an essay became available on the Internet that includes a presumptuous edit of a statement by the dean of Austrian economics, Ludwig von Mises. In *Human Action* (p.572), Mises said, "There is no means of avoiding the final collapse of a boom brought about by credit expansion." This statement is true and undoubtedly reads as intended. Yet the author of the article felt compelled to explain von Mises, with the following insertions: "There is no means of avoiding the final collapse of a boom brought about by [bank] credit [and therefore money] expansion." First, a credit boom does not have to be financed by banks. As Jim Grant recently chronicled, railroad companies financed one of America's greatest land booms, which, as Mises predicted, went bust. Second, credit is not money. Economists speak of "the money supply" as if they were referring to money, but they are not; for the most part, they are referring to credit. The actual supply of dollar-denominated money, legally defined in today's world, is Federal Reserve Notes (FRNs), i.e. greenback cash. That money provides a basis for issuing credit. Credit may seem like money because once extended, it becomes deposited *as if it were cash*, and the depositor's account is credited with that amount of money. But observe: the account is only *credited* with that amount of money; the *actual* money upon which that credit is based is not in the account. Every bank account is an I.O.U. for cash, not cash itself. Needless to say, the \$64.3 billion in cash in U.S. bank vaults and at the Fed is insufficient backing for the 38 trillion dollars worth of dollar-denominated credit outstanding, not to mention at least twice that amount in the implied promises of derivatives. The ratio is about 1 to 600. This ratio has grown exponentially under the easy-credit policies of the Fed and the banking system.

When credit expands beyond an economy's ability to pay the interest and principal, the trend toward expansion reverses, and the amount of outstanding credit contracts as debtors pay off their loans or default. The

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resulting drop in the credit supply is deflation. While it seems sensible to say that all the Fed need do is to create more money, i.e. FRNs, to “combat deflation,” it is sensible only in a world in which a vacuum replaces the actual forces that any such policy would encounter. If investors worldwide were to become informed, or even suspicious, that the Fed would follow the ‘copter course, it would divest itself of dollar-denominated debt assets, causing a collapse in the value of dollar-denominated bonds, notes and bills. This collapse would *be* deflation. It would be a collapse in the dollar value of the outstanding credit supply.

Contrary to popular belief, neither the government nor the Fed would wish such a thing to happen. The U.S. government does not want its bonds to attain (official) junk status, because its borrowing power is one of the only two powers over money that it has, the first being taxation. The Fed would commit suicide by hyper-inflating, because Federal government bonds are the *reserves* of the Fed. That’s why it is called “the Federal Reserve System.” U.S. bonds are the source of its power. As long as the process of credit expansion is done slowly, as it has been since 1933, people can adjust their thinking to accommodate the expansion without panicking. But by flooding the market with FRNs, the Fed would cause a panic among bond-holders, and their selling would depress the value of the Fed’s own reserves. The ivory-tower theory of unlimited cash creation to combat a credit implosion would meet cold, harsh reality, and reality would win; deflation would win. Von Mises was exactly right: “There is no means of avoiding the final collapse of a boom brought about by credit expansion.” Observe that he said “no means.” He did not say, “No means other than helicopters.”

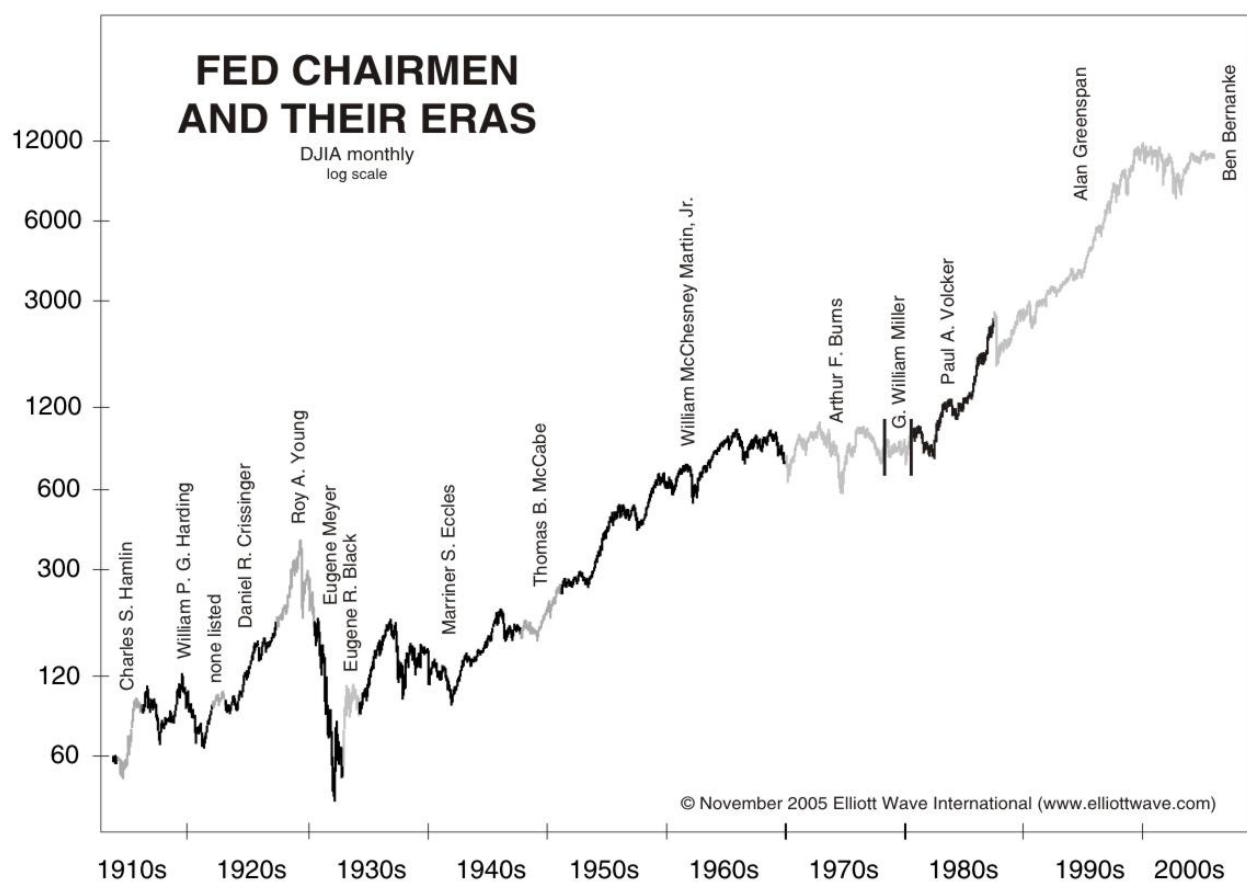


Figure 1

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Bernanke's plan, according to articles, is to aim for a 2% annual inflation rate. "Bernanke has called that the Goldilocks idea: not too hot, not too cold. The just-right spot..."¹ He is convinced that such a policy is all the economy needs to keep it steady. Clearly, Bernanke is a firm believer in the idea that the economy is a machine, whose carburetor simply needs fine-tuning to get it to run smoothly. Economists, deep believers in the potency of social directors, are convinced that "monetary policy...moves the entire economy."² There is no room for "animal spirits" as far as this idea is concerned. Because of this proposed targeting plan, Bernanke is expected to act "More openly. More methodically. More predictably."³ Well, Ben might aim to do those things, but society, the economy, the credit supply and the stock market do not behave in such a manner. When you think you have them under your thumb, they have *you*.

That's enough theory. Let's look at some history. Public figureheads have a way of representing eras. This is certainly true of entertainment icons and politicians. The history of Fed chairmanship implies a similar tendency for changes of the guard to coincide with changes in social mood and therefore stock prices and the economy. Figure 1 depicts our social-mood meter—the DJIA—since the Fed's creation in 1913, marked with the reigning chairmen according to a list on the Fed's website.

The first chairman, Hamlin, presided over a straight-up boom. As it ended, Harding took over and presided over an inflationary period that accompanied a bear market, exiting just as a new uptrend was developing. Crissinger took over at the onset of the Roaring Twenties, and Young presided over the boom, the peak and the rebound into 1930. Meyer took over just as confidence was collapsing and left the office in early 1933 at the exact bottom of the Great Depression. The next three chairmen struggled through the choppy years of the 1940s. Then Martin presided over virtually the entire advance from the early 1950s through 1969, exiting just before the recession of 1970. Burns and Miller presided over a bear market and exited as the new uptrend was developing. Volcker, after weathering an inflation crisis, presided over the explosive '80s. Greenspan has presided over the manic '90s and the topping process. *The next chairman will have his own era.* Given the eras that have immediately preceded the coming change in leadership, the odds are that this new environment will be a bear market.

The chairmanships of 1967 to the present are remarkably like those of 1913 to 1930. Figure 2 shows the two eras, with the latter time expanded variously to show the similarities in form. When we place the chairmen on this graph, we can see that

Martin = Hamlin,
Burns = Harding,
Miller = none listed,
Volcker = Crissinger
Greenspan = Young.

If this progression continues, then

Bernanke = Meyer,

the man who presided over the "deflationary collapse" years of the Great Depression.

Most economists don't accept cycles as valid. I think that the correlation between the social-mood environments of waves IV and V in the 1910s-1920s and waves IV and V in the 1970s-1990s, and their changing representatives (see *Beautiful Pictures*), is not coincidence.

Like most economists, Bernanke doesn't accept the idea of the causal power of waves of social mood. He therefore believes, for example, that the Fed engineered the boom of the 1980s and 1990s. He also thinks, as do most

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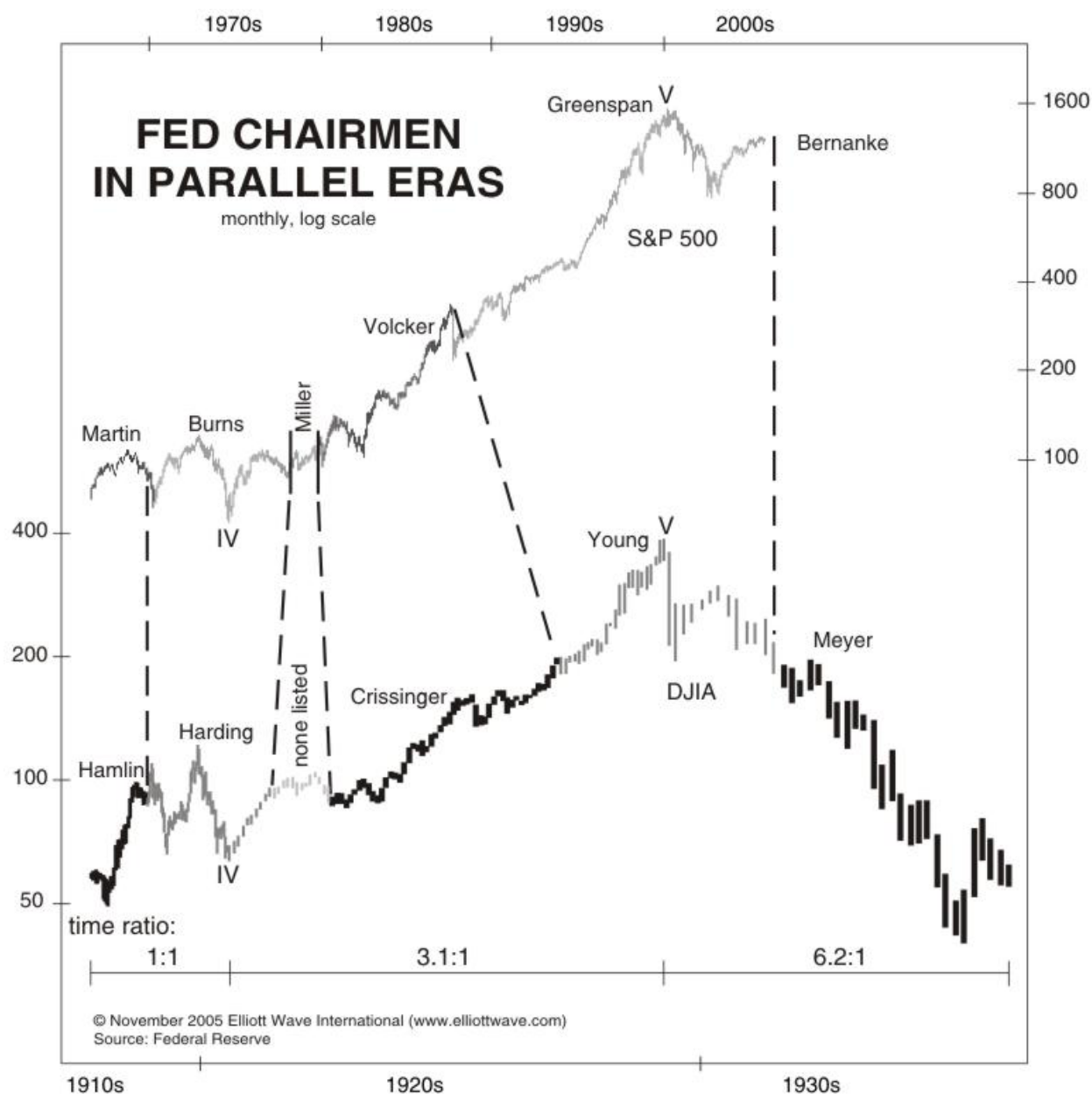


Figure 2

economists, that the Fed's freshman errors in the early 1930s caused the Great Depression. Essayist Fred Shostak reminds us that at the Conference to honor Milton Friedman's 90th birthday on November 8, 2002, Bernanke promised the Friedmans that the Fed now understands how to keep the machine in tune. He said, "I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, *we won't do it again.*"⁴ That's quite a promise, and it might have some validity if the underlying premise of the Fed's power were correct. But social mood *will* "do it again," and there is nothing that Bernanke can do about it. He reiterated this guarantee in his acceptance remarks at a press conference on October 24, saying, "I will do everything in my power to ensure the prosperity and stability of the U.S. economy."⁵ "Everything in my power" equates to nothing when it comes to reversing social trends.

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Like the entrenched belief in continued inflation, there is a widespread expectation of smooth sailing under Bernanke. Summing up the prevailing view, an economist says, "Bernanke is universally admired and respected by people who have seen him on the inside of that institution. The bottom line is that this is excellent news for the Fed and for the economy."⁶ A nationally known economist adds, "We need a Fed chairman who is steady, solid and sticks to basics. Ben Bernanke is the right person at the right time."⁷ This general conviction will set up the vast majority to be fooled and ruined. There is a vocal minority who views him as a potential disaster, but the only danger they see under his leadership is excessive inflation. With virtually everyone prepared for either good times or severe inflation, bad times and deflation will catch them all off guard.

It is not the case that Fed chairmen are either fools or geniuses, as their records appear to imply. They do, however, preside over eras that make them appear to be one or the other. I am firmly of the opinion that Ben Bernanke, well educated by Harvard and MIT though he is, and fine fellow though he may be, is doomed to suffer a historically bad image as chairman of the Federal Reserve. If for some reason he leaves the post prematurely, his immediate successor(s) will suffer that fate. The trend in social mood will continue to determine the chairmen's degree of success, not the other way around.

As to Bernanke's qualifications, I must demur from the accepted view that he understands the economy and markets at some genius level. On August 31, 2005, Reuters issued this statement:

Bernanke said the bond market's reaction to the hurricane, pushing market-set interest rates lower, showed more concern about the potential hit to growth than to the risk of a broad inflation surge due to soaring energy prices. "I think that is a vote of confidence in the Federal Reserve," the former Fed governor said. "People are confident that inflation will be low despite these shocks to gasoline and oil prices. Looking forward... reconstruction is going to add jobs and growth to the economy," he added.

In four short sentences, Bernanke, in my humble opinion, expresses six erroneous ideas:

1. The bond market did not *react* to the hurricane. There is no evidence that any market reacts to natural disasters. This idea is a myth that derives from the natural human tendency to default to mechanical models of social causality.
2. Markets have never translated natural disasters into "concern about the potential hit to growth." You cannot pick out hurricanes, tornadoes, floods, city fires or blackouts on a chart of stocks, bonds, oil or anything else.
3. The idea that any two-point move in the bond market is "a vote of confidence in the Federal Reserve" is ludicrous. One would then have to believe that every two-point setback during the year is a vote of non-confidence in the central bank.
4. People are *not* "confident that inflation will be low." They are buying homes at a record pace, certain of price gains. Investors are bullish on oil, gold, silver, commodities and REITs. The public is convinced that gasoline prices will stay up.
5. "Shocks to gasoline and oil prices" do not make inflation rise. Price rises due to shortages have nothing to do with inflation, much less do they have a causal inflationary role in general as Bernanke implies by the word "despite." Inflation is due to the expansion of money and/or credit, period.
6. The destruction of any useful item, even a screwdriver, much less the mass destruction of infrastructure, does not "add jobs and growth to the economy." It *detracts* from the economy. The French economist

Frederic Bastiat exposed this erroneous idea over a century and a half ago. (To learn more, just type "Bastiat, broken window fallacy" into Google search.)

Bernanke will surely reign in a bear market when every decision he makes will be seen as dumb. But as this example shows, maybe that perception won't be due entirely to declining social mood.

NOTES

1 Kanell, Michael. (2005, October 25). "Bernanke likely to set target for inflation, work to hit it." *Atlanta Journal-Constitution*, p. A10.

2 Ibid.

3 Ibid., p. A1.

4 As quoted in Shostak, Frank, "What should we expect from Bernanke now that he is the Fed's chairman?" www.brookesnews.com/053110bernanke.html, 10/31/05.

5 Shell, Adam. (2005, October 25). "Markets applaud Bernanke's nomination." *USA Today*.

6 Kanell, Michael. (2005, October 25). "Bernanke likely to set target for inflation, work to hit it." *Atlanta Journal-Constitution*, p. A10.

7 Laffer, Arthur. (2005, October 26, 2005). "Ben Bernanke is the Right Person at the Right Time," *The Wall Street Journal*.

Excerpted from the June 16, 2006 Elliott Wave Theorist

WE APPEAR TO BE THE ONLY ADVOCATES OF A DEFLATION-DEPRESSION SCENARIO

A prominent deflationist throws in the towel. Another looks for “good deflation.” Bears on commodities expect the economy and stock market to boom. Bears on the stock market and the economy expect gold and silver to soar. A flood of articles insists that the stock market is being “spooked by inflation” even as silver crashes 30 percent, gold 20 percent and copper 25 percent. The Fed agrees and vows to “fight inflation” with higher interest rates. Economists are looking at lagging indicators such as gasoline prices and warning of more inflation to come. But rising commodity prices are typically the result of past inflation, not gauges of future inflation. The question is what the major event will be, and as far as I can tell Elliott Wave International is the only firm that houses analysts warning of an inevitable, full-scale, economically devastating *deflation*. You can bet that when it is in full swing, dozens or hundreds of commentators will claim that they warned of deflation, and our voice will be lost in the clamor. But unless we’ve missed some important names somewhere, it appears that we were the only ones still making this case—strenuously—right through last month’s top in the speculative complex and since. In fact, at the peak of the frenzy in April and May we were issuing *sell signals* on metals and the stock market (see brief summary below). These were not our first, we readily confess, but neither are we capitulating to the force of the crowd. In fact, the opposite is true: the further the credit balloon inflates, the surer we are that it will pop.

For a long time there have been signs of an *impending* deflation. Now there are signs that deflation has arrived. Japan is leading the way. Its monetary base has fallen dramatically since the beginning of the year (15 percent in the past two months according to USA Today). Stock markets around the world have suddenly fallen 10 to 50 percent. Commodities that were soaring have reversed violently. Real estate is now in a “buyers’ market,” when there are buyers. The investment binges of the past three years are *not* the story; they are the *precursor* to the story. The big story is in the subtitle to *Conquer the Crash—How To Survive and Prosper in a Deflationary Depression*. The biggest event that the history books will record is not the jumps in investment markets from 2003 to 2006 but the across-the-board collapse that is about to follow.

In 2004, Pete Kendall and I wrote an article for Barron’s in which we argued that all investment markets had begun moving together, not contra-cyclically as they had in the past. We theorized that late in the credit and economic cycle, liquidity is the motor of all investment markets. We showed a graph of the major markets, including stocks, junk bonds and precious metals, and called them “all the same market.” Of course, two years ago people thought that our claim was crazy because markets would have to be crazy to move all together. But markets *are* crazy, and predicting such events requires understanding that markets are impulsive and patterned, not rational, and that they go through similar expressions of the same cycle of psychology over and over. The extent and duration vary, but the essence is always the same.

The flip side of markets going up together is that when the reversal comes they all go *down* together. We have been predicting this event for way too long, but it finally seems to be upon us. The wild speculation supported by the expanding, inverted pyramid of credit is exhausted. Five-wave movements of major proportion are completed and behind us. Parabolic moves have ended. Valuations that prompted thieves to focus on stealing copper wire recall the days in late 1979 when people hoarded pennies. Such activities are signs of an extreme overvaluation. If it were just a matter of pricing in inflation, then there would be no point in stealing; everything would be

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going up proportionately. I would like to point out here that silver at \$9.50 is still down over 80 percent from its peak in January 1980. It is perhaps the single worst investment of the past 26 years, despite a quarter century of continuing credit inflation. Is the silver market crazy? Not this time. I think it is pricing in (unconsciously by mood, not consciously by reason) the coming depression. The silver bugs who spent the past three years writing essays on how silver is in short supply worldwide and needs to go to \$200/oz. have once again trapped their clients into taking massive losses. The public doesn't buy copper, but it does buy hedge funds, and the hedge funds are long copper big time. We'll soon see how that one turns out. I still believe that the metals will be a super buy at the bottom of the developing depression. But if you bought into the latest run-up, you won't be able to afford to buy any of them at the low. Cash is going to be king, so make sure you have some.

The problem today is that not some individuals or corporations or governments but the entire *system* is saturated with credit. Worse, much of the credit is propping up other credit, and this *nth*-generation credit is propping up the financial markets. When the financial markets go down, IOUs will come due. Conversely, when IOUs come due, markets will go down. People who must finance debt to maintain their standard of living will soon be selling *everything and anything* to stay afloat. When people on the edge are strapped, they will sell their investments to pay the interest on their debts. If they won't do it themselves, their creditors will do it for them. Banks are already repossessing homes at a furious pace. In Georgia, April foreclosures were up 300 percent from April 2005. This is only the beginning.

A reader asks, "Can we get stagflation instead of deflation?" *No, we can't.* This is not the 1970s; it's the 2000s. By the guideline of alternation alone we know that this cycle will not act like the last cycle. Nor is it acting like the last cycle. There is a blatant difference between now and the '70s: while commodity prices have had big run-ups, *so have stocks; so have bonds; so have junk bonds.* This condition alone is so anomalous to the 1970s that it should put the army of replay advocates on warning.

Pundits tell us, "We are in a hyperinflation, like 1920s Germany." *No, we are not.* In the early 1920s, the Allies told Germany to pay reparations that Germany couldn't afford. It found a practical solution in printing marks. The inflation of the past 73 years is not primarily currency inflation but credit inflation. Credit can implode in a deflationary depression; currency cannot. Once currency is printed, it's out there for good. Some people argue that the Fed *will* print currency at a hyperinflationary rate. But that's a guess at best, and so far all we have seen is the same old game of facilitating credit. Perhaps the Fed ultimately will resort to runaway currency printing, but before then it will try to keep the monetary system afloat and the government's bonds—its own reserves—valuable. This is the period in which deflation will strike. After it is obvious that credit stimulation has failed, hyperinflation may be a "last resort," but I stress the word *may*. In the 1930s, it was no resort at all; the Fed opted to stay healthy instead. So before hyperinflation even *might* become a threat you should be able to get wealthy betting on the downside. Even if you don't wish to speculate in that direction, you can get wealthy simply by maintaining your money and then employing it at the bottom. But in a system-wide collapse, this task will not be easy. That's why I wrote a whole book about how to do it.

Because of the tremendous, unprecedented build-up in credit, the deflation will probably be swift. So many debtors are on the margin of survival today, and so many others are right behind them, that once the weakest hands default, the dominoes will fall fast. When it hits, the whole system will succumb. Banks will fail. Insurance companies will fail. Many values that people think they own—in the form of mutual funds, stock portfolios, bond portfolios, commodity-index funds, bank accounts, insurance contracts, real estate, etc.—will evaporate.

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Economists are convinced that the Fed can “fight” inflation or deflation by manipulating interest rates. But for the most part, all the Fed does is to follow price trends. When the markets fall and the economy weakens, the price of money falls with them, so interest rates go down. When the markets rise and the economy strengthens, the price of money rises with them, so interest rates go up. The Fed’s rates fell along with markets and the economy from 2001 to 2003. They have risen along with markets and the economy since then. Regardless of the Fed’s promise to keep raising rates, *you can bet that the price of money will fall right along with the markets and the economy*. Pundits will say that the Fed is “fighting” deflation, but it will simply be lowering its prices in line with the others. It is highly likely that the next eight years or so will test the nearly universally accepted theory—among bulls and bears alike—that the Fed can control anything at all. The Great Depression made it look like a gang of fools, as will the coming deflationary collapse. We have predicted unequivocally that the new Fed chairman will go down as Hoover did: the butt of all the blame, and if you are reading the newspapers you can see that it’s already started. “When Bernanke Speaks, the Markets Freak” (San Jose Mercury News, June 10, 2006); “Bernanke is being blamed for spooking Wall Street” (USA Today, June 7); “Bernanke to blame for volatility” (Globe and Mail, Canada, Jun 13, 2006). The new chairman had a brief honeymoon (which we also predicted), but it’s already over. By the way, I heard his commencement speech at MIT last week, and in it he spoke eloquently of the value of technology and free markets. But he also opined that economists have successfully applied technology to macroeconomics. We believe that the collective unconscious herding impulse cannot be tamed, directed or managed. In our socionomic view, the Fed cannot control the mood behind the markets, but rather, *the mood behind the markets controls how people judge the Fed*. We’ll ultimately find out who’s right.

Many institutional investors think they are safe because they are in various ways “insured.” Investment-insurance schemes, typically involving options hedging, will fail spectacularly. In this Supercycle bear market, prices will fall so hard at the center of the decline that portfolio managers who sold puts and calls as a hedge will have to scramble to buy back the puts, which will soar in price far more than the calls will fall in price. Many managers will have to sell underlying assets to afford to buy back their puts, which will pressure the market further. The stock market never crashes *up*, so this is a one-way risk. Back in 1997 Kate Welling (<http://www.weedenco.com/research/welling.html>; highly recommended) conducted an interview with Andrew Smithers, who spelled out quite clearly why the financial markets might be able to accommodate individual risks via insurance schemes but never *systemic* risk. (Thanks to Tony Cherniawski of *The Practical Investor* for reminding us of the link: <http://home.ddc.net/ygg/inv/gamma.htm>.) When rock climbing, it might be possible to have a single buddy as death-fall insurance, but if 50 climbers are all roped together, the system is in danger and so are all the climbers. When everyone buys insurance against financial loss, the insurers can’t possibly pay. I am disgusted with the insurance and banking industries for selling contracts that they cannot possibly honor in a system-wide collapse. They still think that only one bank might fail, or only one broker or trader. Many weak bonds received A ratings in the 1990s because the issuers purchased “insurance.” What a joke. The supposed insurance will be so much dank air in a depression. Why? Well, where do you think the insurers have invested their assets? It’s in all the same investments in which their leveraged clients are invested! They own real estate, consumer loan packages, stocks and bonds. What will they use to pay off clients in a crash? As CTC says, do not rely on any form of insurance to pay off in a depression. Yes, bears wrote some good stuff back in 1997. That’s also when we published “Bulls, Bears and Manias,” which is available as a chapter in *Market Analysis for the New Millennium* (see www.elliottwave.com/books). Nine-year-old essays by bears are not only still valid but they are also more applicable than ever.

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And don't think there has been a great stock market advance since that time. The S&P 500 index is essentially unchanged from July 1998 to now. And that's in *dollar* terms! In real terms, of course, it's far lower.

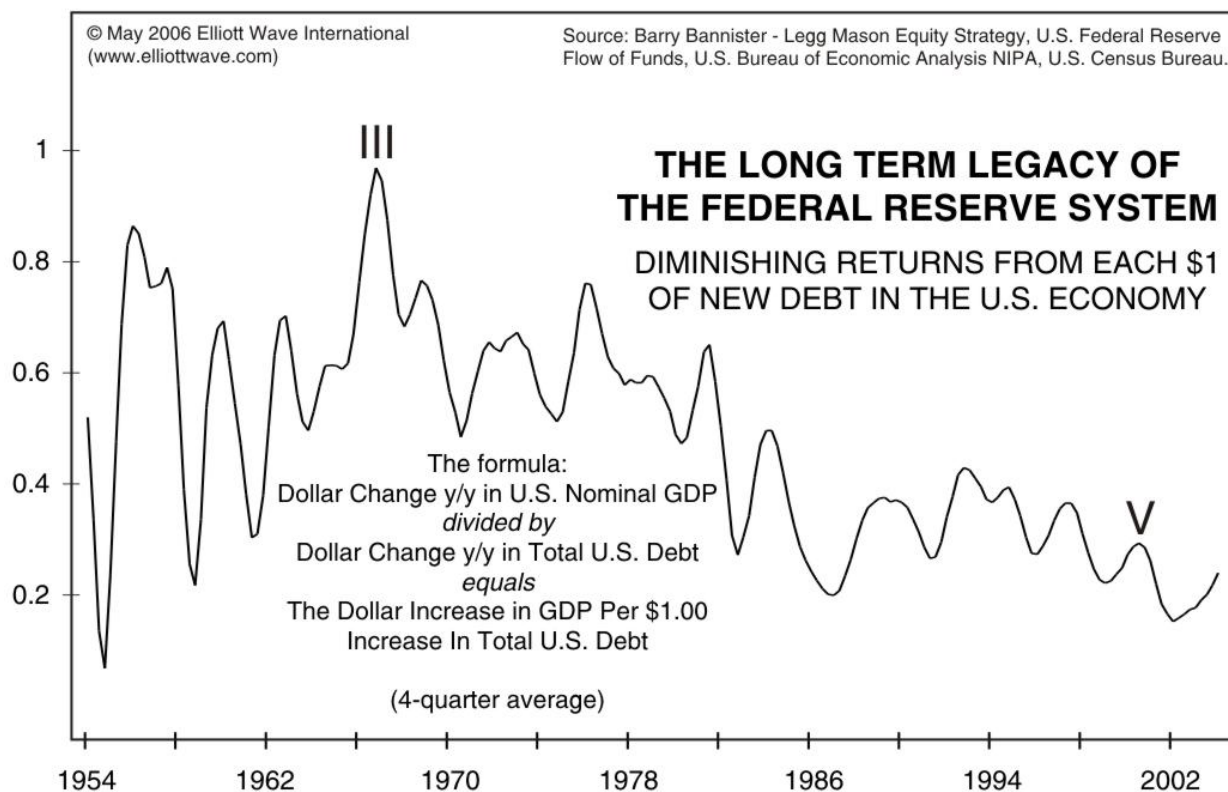
Some have asked whether they should buy puts for wave (3) of ③ down. Well, it might work, but what if the sellers can't pay? This bear market will be a quagmire of risk. Just ask owners of the Rogers International Raw Materials Fund, who lost money not because they were wrong but because someone couldn't pay. In this case the problem was fraud, so there are guilty parties. In the case of a system-wide default, no one will accept blame, and the government will probably try to get its banker and broker friends off the hook. The individual investor, as always, will be the biggest loser. For those positioned just before the third wave down, a "long put" position could prove to be a great speculation, but if you decide to try it, use only a small portion of funds and be sure to sell them into the "heat" of the decline, when put options are soaring on fear alone, as they did on October 19 and 20, 1987. Hours later, on a sharp bounce off the low, they can drop to 1/3 of their peak prices. If you are a speculator, futures are easier to manage, but even they are not guaranteed. To maintain market integrity, brokers will have to be especially vigilant to close out under-margined accounts. If they don't, the system will have trouble paying off the winners. Keep an eye on the Commitment of Traders report. As long as the commercials are net short, we can be sure that the shorts will be paid. When the "large speculators," i.e. the hedge funds, and the "small traders," i.e. the public, get net short, the chances will dim that the shorts will be paid. When silver was soaring in late 1979/early 1980, the longs did not get paid. The exchange changed its rules to allow liquidation of existing positions only; the longs outnumbered the shorts, so when liquidation began, the market collapsed. Insiders rarely lose. There is also political risk. Politicians can buy votes by railing against unpatriotic short sellers and legislate against them.

How did we get to this dangerous point? The answer is that Grand-Supercycle-level optimism fueled credit expansion. Creditors have to be optimistic to expect debtors to pay, and debtors have to be optimistic to think that they can pay. Record debt requires record optimism. We already know that governments in collusion with central banks have fueled bank credit. But banks fuel consumer credit, and...debt has permeated society out to the very edges of viability. *Marginal debtors are the very bedrock of the whole system.* The double irony is that (1) marginal debtors are about to expand their numbers, and (2) it won't help the system but will kill it, because most of the marginal debtors will morph into bankrupt debtors.

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Excerpted from the December 15, 2006 Elliott Wave Theorist (audio transcript)

This is a terrific graph. It shows you how much bang for the buck the Fed is getting out of its credit—for each dollar of new debt how much you get out of the economy. Way back in the late '60s, it was one for one. Here it's about 0.2 for 1, so for every new dollar of debt that's being taken on, only 20 cents of new production is occurring. So debt is beginning to surpass the value it gives to the economy.



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Excerpted from the March 23, 2007 Elliott Wave Theorist

The Biggest Mistake

The most important thing to understand about the financial environment is that *credit is not money*. Stock enthusiasts say that “liquidity” will keep the boom going; precious metals and commodity bugs say that “inflation” will continue to rage; and real estate investors rely on “creative financing” to keep prices rising. Every one of these investment stances depends upon inflation, and every proponent for them is convinced that inflation is an endless, one-way process. Currency inflation can continue indefinitely, but extensive credit inflation never does; it always implodes. The American economy—indeed most of the world economy—suffers primarily not from currency inflation but credit inflation.

The financial markets are signaling an end to credit inflation. Most bonds are rated junk. The leading commodities—oil, copper, gold and silver—have topped. Real estate is crashing. Banks are tightening mortgage requirements. The stock market has turned down. All these investments had benefited from the most aggressive and extensive credit inflation in history. Now they are beginning to respond to the first days of the biggest contraction in credit ever. But hardly anyone understands this process. Most economists call the current situation a “Goldilocks” economy, where everything is just right. This is an irresponsible position, but it is also inevitable because by definition optimism accompanies major stock market peaks. A vocal minority sees the severe dislocations in debt, deficits and speculation. But instead of warning of a collapse in prices these economists advocate owning commodities, precious metals, real estate, oil company shares, mining shares and other resource stocks, all of which are to rise in the environment of perpetual inflation that they envision. In other words, there is almost no one who advocates holding safe, interest-bearing cash equivalents as protection from the developing credit implosion and a source of profit while everything else goes down. The only book I know of to advocate this position is *Conquer the Crash*.

Credit inflation is the expansion and even the pyramiding of IOUs. Investors issue IOUs to buy stocks, corporations issue IOUs to expand business, consumers issue IOUs to buy houses and cars, and governments issue IOUs as if they were throwing beads from a Mardi Gras float. The longer the process continues, the more IOUs come to be regarded as assets, meaning that borrowers then use them as collateral for more borrowing. As investment prices rise, they, too, become collateral for more loans. And on it goes, until it doesn't. When the house of (credit) cards begins to fall in on itself, the trend turns from inflation to deflation. That's when creditors turn their focus from lending to collecting and when debtors turn their focus from borrowing to repaying. But by this time there are too many IOUs, and debtors cannot service them, much less repay them. Falling asset values and economic contraction thwart efforts to honor the loans. Debtors begin to default. When that happens, the game is up.

Credit deflation is the most devastating financial event of all. It is rare, and that is why it confounds so many analysts. The wrong vision leads to confusion. Under the Goldilocks vision, no one can understand why stocks would fall. Under the inflationary vision, no one can understand why real estate or commodities would fall. An article in the Financial Times (March 6) says of the latest sell-off in gold, “The performance of gold has been the most difficult to explain. Traditionally, the precious metal is considered a safe haven in times of uncertainty and risk aversion and it normally rises when equity markets fall. In fact gold prices have fallen more than 7 per

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cent over the past week.” What’s wrong with this view is that the supposed “tradition” is baloney. Gold doesn’t reliably go up when other things are going down. Gold has been following the stock market on the upside for three years. If a coincident advance was not an anomaly, why is a coincident decline? In fact, gold and silver have been going up and down with the Dow even on a daily and intraday basis. This is not inconsistent action; the only inconsistency is with the theory that gold and silver are always contracyclical and therefore effective disaster hedges. Sometimes they are, and sometimes they aren’t, but one thing is for sure: They are not deflation hedges, and deflation is what we face.

The following excerpt, from a March 8 article in the Toronto Star, expresses the difference between currency inflation and credit inflation. You can feel the looming default disaster throughout this description:

The city’s debt level is skyrocketing and Toronto is falling further and further behind on much-needed repairs, city council was told yesterday as members approved this year’s capital budget. “It’s difficult for many people to fathom how deep in debt we are, how much deeper in debt we’re going, and how at the end of this plan we have (room for) no further debt that we can take on,” Councillor David Shiner said yesterday.

Still, following a day of acrimonious debate, councillors endorsed a \$1.432 billion budget that includes everything from a \$3.7 million program to calm neighborhood traffic and add bike lanes, to \$2.9 million for a new meeting room at city hall and more office space for Mayor David Miller’s staff. Miller called it a “city building” budget. But several councillors said the city is flirting with big trouble by more than doubling its debt and failing to dig into a huge backlog of repair projects ranging from eroding roads to Toronto Zoo improvements.

City officials said Toronto’s debt was \$1.7 billion in 2005 but will increase to more than \$2.6 billion this year and is expected to balloon beyond \$3.1 billion by 2011. This year, the city will spend 12.6 per cent of its property tax revenues on debt servicing. That figure is expected to rise to 15.4 per cent by 2011. Shiner said the city’s debt servicing will cost every Toronto household roughly \$2,352 over the next five years. “Many people don’t know how they’re going to afford that, and we don’t have a plan to pay for it,” he said.

But Miller told reporters at the end of the day, “It’s a very good budget.”

This is a microcosm—and a conservative one at that, involving no leverage or derivatives—of what’s happening everywhere. The size of today’s credit bubble is so huge that it dwarfs, by many multiples, all previous bubbles in history. The developing deflation will be commensurate with the preceding expansion, so it will also be the biggest ever. Staying in traditional investments—stocks, real estate, commodities and most corporate and municipal bonds—will surely prove to be a deadly decision. It’s not the “Goldilocks” 1950s. It’s not the inflationary 1970s. And it’s not a “business as usual” extension of the 1980s-1990s bull market. It’s 1929 times ten. Those who can’t see the difference will suffer the consequences. Those who see it — this means *you* —will survive and prosper.

The Role of the Fed

Most people envision the central bank as a currency inflation machine, a “printing press.” But most of the time, the central bank is not inflating by way of its press. It does create currency inflation when it monetizes government debt. It facilitates credit inflation when it panics and lowers its lending rate to below market levels. As bad as these practices are, their extent pales in comparison to the fact that the Federal Reserve System is a structure that allows banks to engage in credit inflation. Without the Fed, they couldn’t get away with it. The

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Federal Reserve's paper-money monopoly actively fosters inflation, but once that system is in place, most of the time the Fed plays a passive role in fulfilling the demands of banks for credit, which fulfills the demands of borrowers for credit. Many economists say that the Fed manages the rate of inflation at X percent a year, but this view leads to two errors. First is the belief that once inflation happens, it is permanent. But it is not; credit expansions lead to collapse. Second is the belief that the Fed is in control. It seems to be in control, and that illusion makes investors complacent about the prospects for deflation; in fact, it makes them militantly deny even the possibility. But the Fed is not in control, and the coming crash will prove it.

The Illusion of Control

Mike Whitney's website, The Market Oracle, reports that the Plunge Protection Team has put on its superhero outfits:

The Working Group on Financial Markets, also known as the Plunge Protection Team, was created by Ronald Reagan to prevent a repeat of the Wall Street meltdown of October 1987. Its members include the Secretary of the Treasury, the Chairman of the Federal Reserve, the Chairman of the SEC and the Chairman of the Commodity Futures Trading Commission. Recently, the team has been on high-alert given the increased volatility of the markets and, what Hank Paulson calls, "the systemic risk posed by hedge funds and derivatives."

I have no doubt that the PPT exists. Financial powers concocted similar schemes in the collapse of 1929. The question is whether this gang of four and their bags of credit can actually change the direction of the stock market. I don't think so, but we'll find out eventually. It will be good to keep in mind some of the market's history with respect to crashes. I have a rare item: a book of graphs of the Dow's daily ranges going back 100 years. It shows that when the market crashed in September and October, 1929, the Dow did not go straight down. It had huge intraday rallies, most of which were reversed by day's end. I suspect the same kind of action during wave c. When the inevitable breathtaking rallies occur, I'm sure we will hear that the PPT is behind them. And maybe it will be. But the rallies will come at the right junctures in the wave pattern, and they won't change the major trend. (For more on the PPT, see pages 367-368 of *The Wave Principle of Human Social Behavior*.)

Excerpted from the April 30, 2007 Elliott Wave Theorist

Investors Are Buying More with IOUs Than Money

When I wrote *Conquer the Crash*, outstanding dollar-denominated debt was \$30 trillion. Just five years later it is \$43 trillion, and most of the increase has gone into housing, financial investments and buying goods from abroad. This is a meticulously constructed Biltmore House of cards, and one wonders whether it can stand the addition of a single deuce. Its size and grandeur are no argument against the ultimate outcome; they are an argument for it.

Figure 1 depicts just one isolated aspect of the debt bubble as it relates directly to financial prices. In 1999, the public was heavily invested in mutual funds, and mutual funds had 96 percent of their clients' money invested in stocks. At the time I thought that percentage of investment was a limit. I was wrong. Today, much of the public has switched to so-called hedge funds (a misnomer). Bridgewater estimates that the average hedge fund in January had 250 percent of its deposits invested. This month the WSJ reports funds with ratios as high as 13 times. How can hedge funds invest way more money than they have? They borrow the rest from banks and investment firms, using their investment holdings as collateral. So they are heavily

leveraged. And this is only part of the picture. Much of the money invested in hedge funds in the first place is borrowed. Some investors take out mortgages to get money to put into hedge funds. Some investment firms borrow heavily from banks and brokers to invest in hedge funds. As for lenders, the WSJ reports today, "...the nation's four largest securities firms financed \$3.3 trillion of assets with \$129.4 billion of shareholders' equity, a leverage ratio of 25.5 to 1." So the financial markets today have been rising in unison because of leverage upon leverage, an inverted pyramid of IOUs, all supported by a comparatively small amount of actual cash. This swelling snowball of borrowing is how the nominal Dow has managed to get to a new high even though it is in a raging bear market in real terms: The expansion in credit inflates the dollar denominator of value, and the credit itself

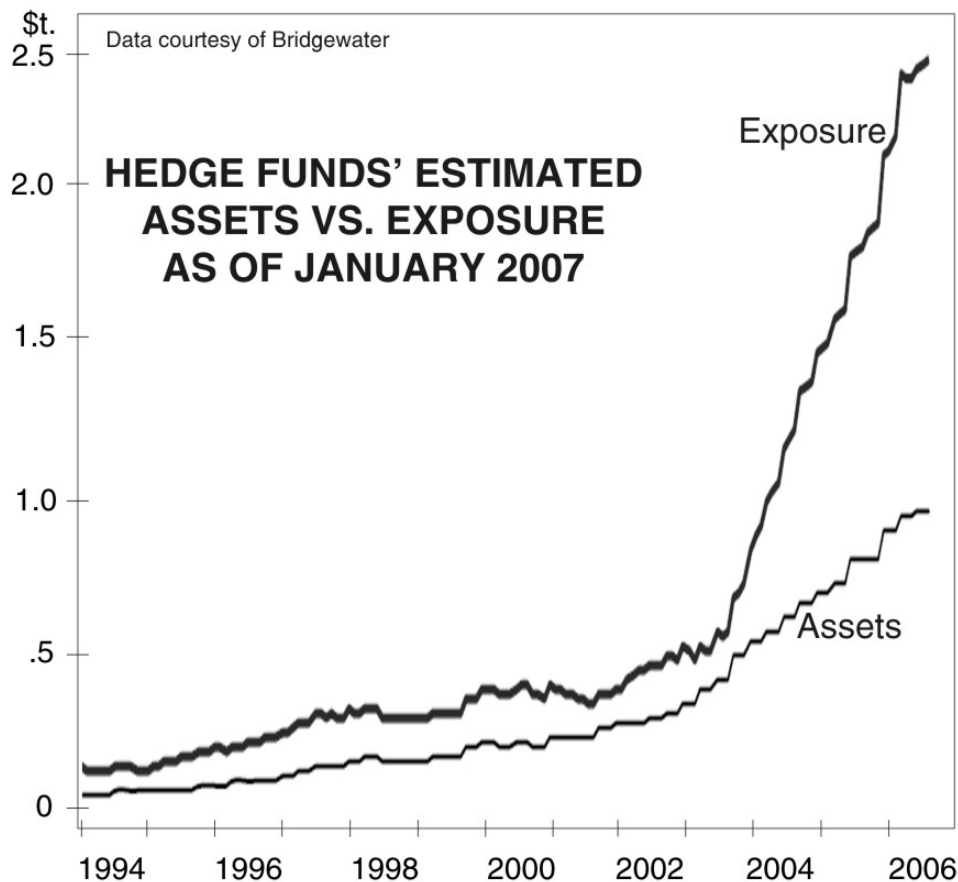


Figure 1

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goes to buying more stocks, bonds and commodities. The buying raises prices, and higher prices provide more collateral for more borrowing. And all the while *real stock values*, as measured by gold, have quietly fallen by more than half! Seemingly it is a perpetual motion machine; but one day the trend will go into reverse, and the value of total credit will begin shrinking as dollar prices collapse.

The investment markets are only part of the debt picture. Most individuals have borrowed to buy real estate, cars and TVs. Most people don't *own* such possessions; they *owe* them. Credit card debt is at a historic high. The Atlanta Braves just announced a new program through which you can finance the purchase of season tickets. Can you imagine telling a fan in 1947 that someday people would take out loans to buy tickets to a baseball game? Instead of buying things for cash these days, many consumers elect to pay not only the total value for each item they buy but also a pile of additional money for interest. And they choose this option because they *can't afford* to pay cash for what they want or need. Self-indulgent and distress borrowing for consumption cannot go on indefinitely. But while it does, the "money supply"—actually the *credit* supply—inflates. But it is all a *temporary* phenomenon, because debt binges always exhaust themselves.

As far as I can tell, virtually everyone else sees things differently. Countless bulls on stocks, gold and commodities insist that the process is simple: the Fed is inflating the "money supply" by way of its "printing press," and there is no end in sight. The Fed is indeed the underlying motor of inflation because it monetizes government debt, but the banking system, thanks to the elasticity of fiat money, manufactures by far the bulk of the credit—*credit*, not cash. If you don't believe credit can implode and investment prices fall, then why did the housing market just have its biggest monthly price plunge in two decades, and why is the trend toward lower prices now the longest on record? If you don't think credit and cash are different, then why are the owners of "collateralized" mortgage "securities" beginning to panic over the realization that their "investments" are melting in the sun? Lewis Ranieri, one of the founders of the securitized mortgage market, recently warned that there are now so many interests involved in each mortgage that massive cooperation among lawyers, accountants and tax authorities will be required just to make simple decisions about restructuring a loan or disposing of a house, i.e. the collateral, underlying a mortgage in default. In the old days, the local bank would suss things out and come to a quick decision. But now the structures are too complex for easy resolution, and creditors are hamstrung with structural and legal impediments to accessing their collateral. The modern structures for investment are so intricate and dispersed that a mere recession will trigger a systemic disaster. When insurance companies and pension plan administrators realize that they can't easily and cheaply access the underlying assets, what will their packaged mortgages be worth then? And what will happen to the empty houses as they try to sort things out? This type of morass relates to *debt*. Cash is easy; either you have it or you don't.

The gold and silver markets know the difference between money inflation and credit inflation. Gold has made no net progress in the past year and in fact for the past 27+ years. Silver is languishing, still trading 75 percent below its high in *dollar* terms, making it by far the worst investment of the past quarter century. Flat-out currency inflation would have a powerful tendency to show up immediately in gold and silver prices. Credit is another matter. Gold prices reflect the fact that an increase in debt is not the same as an increase in cash. New cash is here to stay; debt expansion can morph into contraction. Thriving creditors, moreover, do not want metals; they want interest. And credit is voracious, eating up debtors' capital at a rate of 5 percent a year. When the debtors become strapped, they sell other assets, including gold, to get cash to pay their creditors. Eventually, creditors with falling income due to default will join the ranks of those with less money to buy things. But most investors don't see it

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our way; in April, for the second time in wave b, the DSI reached 90 percent bulls among traders in both gold and S&P! When else in history has it happened? Try *never*. Although the past few years show that there can be periods of exception, markets usually do not reward a lopsided bulk of investors with the same outlook.

But there is a much more important event for believers in perpetual inflation to explain: the trend of *yields* from bonds and utility stocks. In the 1970s, prices of bonds and utility stocks were *falling*, and yields on bonds and utility stocks were *rising*, because of the onslaught of inflation. But in the past 25 years bond and utility stock prices have gone *up*, and yields on bonds and utility stocks (see Figures 2 and 3) have gone *down*. Once again, this situation is contrary to claims that we are experiencing a replay of the inflationary 19-teens or 1970s. Those investing on an inflation theme cannot explain these graphs. But there is a precedent for this time. It is 1928-1929, when bond and utility yields bottomed and prices topped (see Figure 4) in an environment of expanding credit and a stock market boom. The Dow Jones Utility Average was the last of the Dow averages to peak in 1929, and today it is deeply into wave (5) (see Figure 5) and therefore near the end of its entire bull market. All these juxtaposed market behaviors make sense only in our context of a terminating credit bubble. This one is just a whole lot *bigger* than any other in history.

Some economic historians blame rising interest rates into 1929 for the crash that ensued. Those who do must acknowledge that the Fed's interest rate today is at almost exactly the same level it was then, having risen steadily—and in fact way more in percentage terms—since 2003. So even on this score the setup is the same as it was 1929. Remember also that in

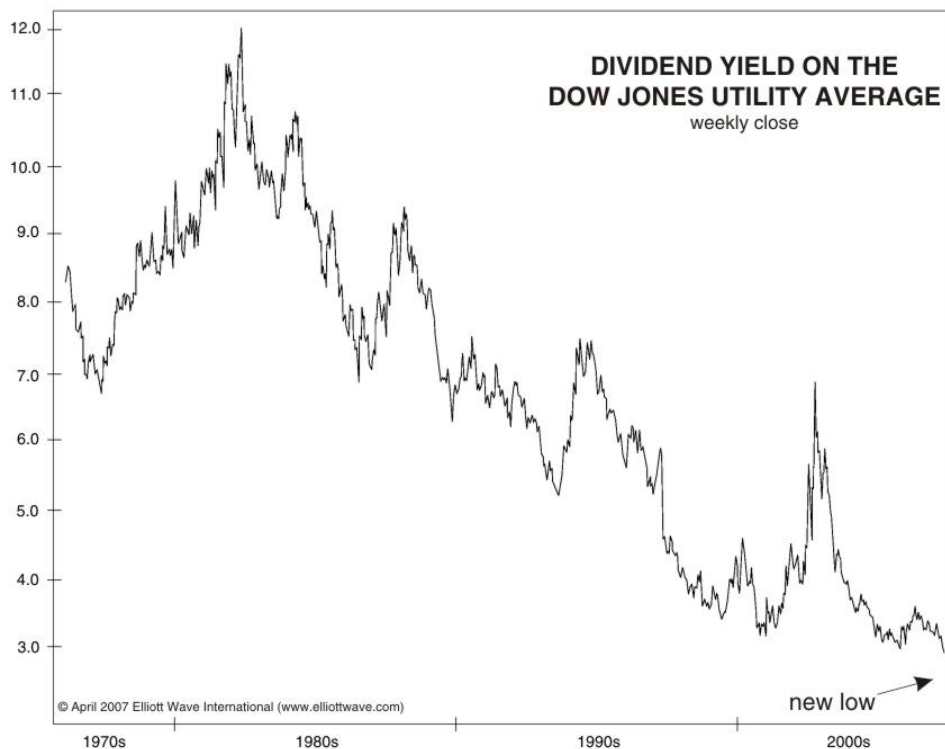


Figure 2

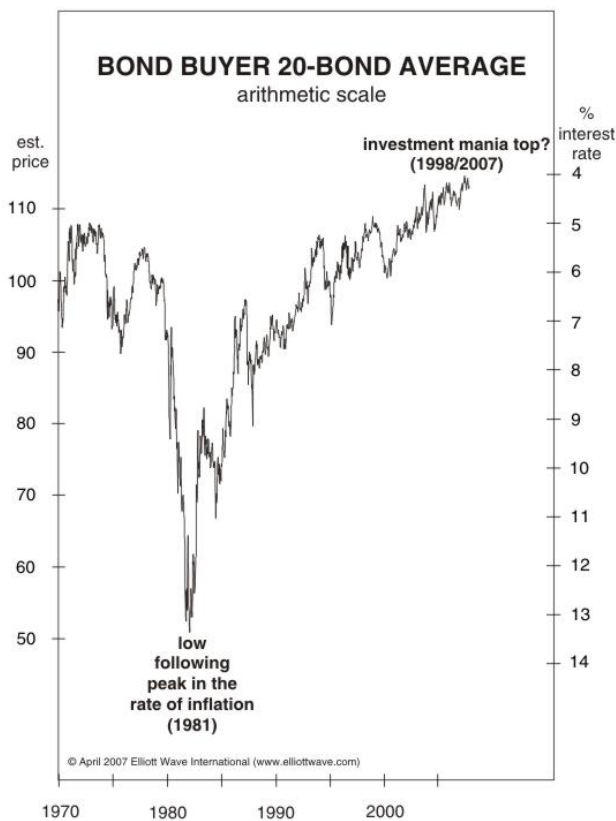


Figure 3

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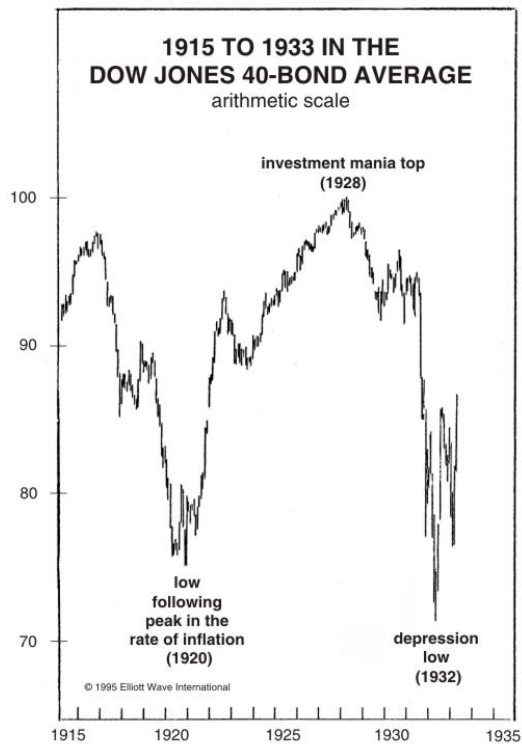


Figure 4

1926 the Florida land boom collapsed. In the current cycle, house prices nationwide topped out in 2005, two years ago. So maybe it's 1928 now instead of 1929. But that's a small quibble compared to the erroneous idea that we are enjoying a perpetually inflationary goldilocks economy with perpetually rising investment prices.

As to whether the Fed can induce more borrowing by lowering rates in the next recession, we will have to see, but evidence from the sub-prime and Alt-A mortgage markets as well as ratios like the one in Figure 1 suggest more strongly than ever that consumers' and investors' capacity for holding debt is maxing out. I see no way out of the current extreme in credit issuance aside from the classic way: a debt implosion.

Nevertheless, we must also recognize the fact that the market is a dynamic system. It does not seek equilibrium or revert to a mean. It has no limits as oscillators do. Optimism and pessimism are not bounded. So hedge funds *could* go to 3x leverage, or 5x, or 100x. Total dollar-denominated debt could go to \$50t., or \$60t., or \$400t. And the Dow could go to 20,000. But further credit expansion would merely mean postponement of the implosion, not negation. The size

of the bubble will simply relate to the size of the collapse.

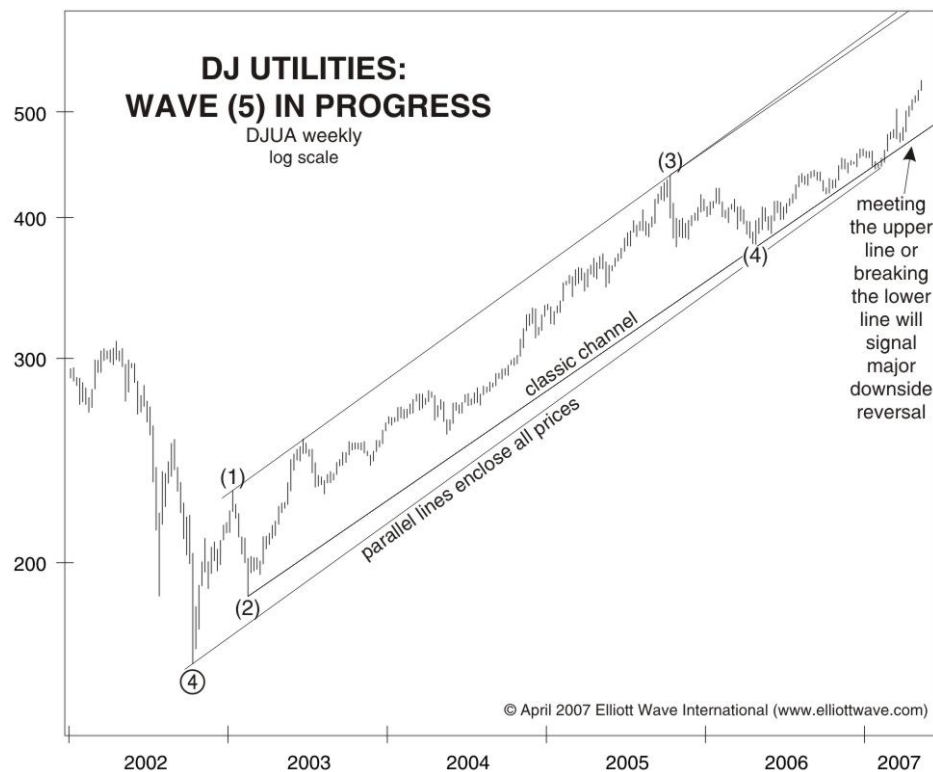


Figure 5

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Excerpted from the July 13, 2007 Elliott Wave Theorist (written at the all-time peak in DJI plus DJT)

The Credit Crunch

In light of recent developments in mortgage-backed bonds, please take a moment to read this excerpt, especially the underlined portions, from *Conquer the Crash*:

Chapter 15: Should You Invest in Bonds?

If there is one bit of conventional wisdom that we hear repeatedly with respect to investing for a deflationary depression, it is that long-term bonds are the best possible investment. This assertion is wrong. Any bond issued by a borrower who cannot pay goes to zero in a depression. In the Great Depression, bonds of many companies, municipalities and foreign governments were crushed. They became wallpaper as their issuers went bankrupt and defaulted. Bonds of suspect issuers also went way down, at least for a time. Understand that in a crash, no one knows its depth, and almost everyone becomes afraid. That makes investors sell bonds of any issuers that they fear could default. Even when people trust the bonds they own, they are sometimes forced to sell them to raise cash to live on. For this reason, even the safest bonds can go down, at least temporarily, as AAA bonds did in 1931 and 1932.

Conventional analysts who have not studied the Great Depression or who expect bonds to move “contracyclically” to stocks are going to be shocked to see their bonds plummeting in value right along with the stock market.

The Specter of Downgrading

The main problem with even these cautionary graphs is that they do not show the full impact of downgrades. They show what bonds of a certain quality sold for at each data point. Bonds rated AAA or BBB at the start of a depression generally do not keep those ratings throughout it. Many go straight to D and then become de-listed because of default. Figure 15-1 does not take the price devastation of these issues into account. Like keepers of stock market averages who replace the companies that fail along the way, keepers of the bond averages of Figures 15-2 and 15-3 stand ready to replace component bonds whose ratings fall too far. As scary as they look, these graphs fail to depict the real misery that a depression inflicts upon bond investors.

High-Yield Bonds

When rating services rate bonds between BBB and AAA, they imply that they are considered safe investments. Anything rated BB or lower is considered speculative, implying that there is a risk that the borrower someday could default. The lower the rating, the greater that risk. Because of this risk, Wall Street, in a rare display of honesty, calls bonds rated BB or lower “junk.” They appear to have “high yields,” so people still buy them.

That very yield, though, compounds the risk to principal. In a bad economy, companies and municipalities that have issued bonds at high yields find it increasingly difficult to meet their interest payments. The prices of those bonds fall as investors perceive increased risk and sell them. The real result in such cases is a low yield or a negative yield, particularly if the issuer defaults and your principal is gone.

Today's “High-Grade” Bonds

Don't think that you will be safe buying bonds rated BBB or above. The unprecedented mass of vulnerable bonds extant today is on the verge of a waterfall of downgrading. Many bonds that are currently rated investment grade will be downgraded to junk status and then go into default. The downgrades will go hand-in-hand

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with falling prices, so you will not be afforded advance warning of loss. When the big slide begins, I doubt that the rating services will even be able to keep up with the downgrades at the rate that they will be required.... As we will see in Chapter 25, you cannot rely on bond rating services to guide you in a crunch.

Chapter 25: Reliable Sources for Financial Warnings

Safety Ratings for Financial Institutions

The most widely utilized rating services are almost always woefully late in warning you of problems within financial institutions. They often seem to get news about a company around the time that everyone else does, which means that the price of the associated stock or bond has already changed to reflect that news. In severe cases, a company can collapse before the standard rating services know what hit it. When all you can see is dust, they just skip the downgrading process and shift the company's rating from "investment grade" to "default" status.

Examples abound. The debt of the largest real estate developer in the world, Olympia & York of Canada, had an AA rating in 1991. A year later, it was bankrupt. Rating services missed the historic debacles at Barings Bank, Sumitomo Bank and Enron. Enron's bonds enjoyed an "investment grade" rating four days before the company went bankrupt. In my view, Enron's bonds in particular were transparently junk well before their collapse. Why? Because the firm employed an army of traders in derivatives, which is an absolute guarantee of ultimate failure even when it's not a company's main business.

Sometimes there are structural reasons for the overvaluation of debt issues. For example, investors buy the debt offerings of Fannie Mae, Freddie Mac and the FHLB because they think that the U.S. government guarantees them. It doesn't. [Worse,] the bonds that these companies issue are exempt from SEC registration and disclosure requirements because they are simply presumed to be safe. Managers of these companies are going to be utterly shocked when a depression devastates their portfolios and their earnings. Investors in these companies' stocks and bonds will be just as surprised when the stock prices and bond ratings collapse. Most rating services will not see it coming.

Today the mortgage market is leading the charge in our scenario. The latest news reports tell not only of the devastation to debt portfolios but also of the worthlessness of the rating services for protecting investors and even their complicity in covering up the collapse in the true value of many mortgages.

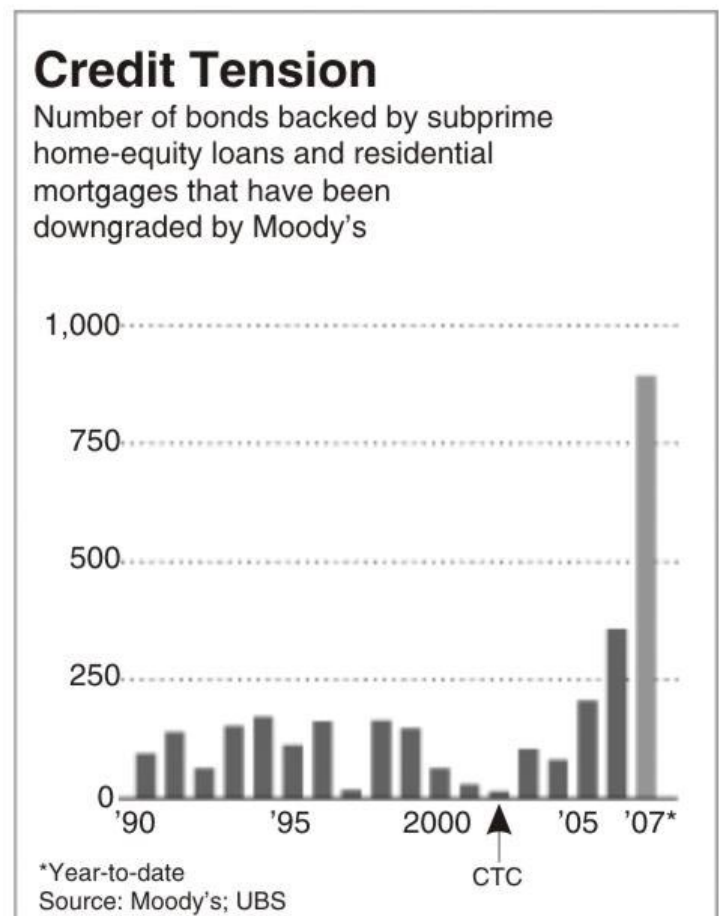


Figure 2

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Conquer the Crash was finished in March 2002. Look at Figure 2 and notice that the fewest debt downgrades of the decade occurred that year. As CTC said, as an investor you cannot wait until problems are obvious to act; by then it's too late. You have to anticipate problems and then get out of the way before they happen.

As for the price of mortgage debt, Figure 3 tells the story, thanks to the diligence of Markit Group Ltd., whose work has brought some transparency to this field. The lower line denotes the price of subprime mortgages, and the middle line shows prices of "alt.-A," the mid-grade mortgage paper. The top line prices prime mortgages, the ones whose payers have some equity and a good source of income. But these graphs rely on dealers for prices, and many of these mortgages are not trading. So even these data do not show the true extent of losses. There is a big lag between what everyone in the industry suspects is the real price and what happens to the index. As Pete Kendall says, "It's a surreal world where prices are lagging actual values."

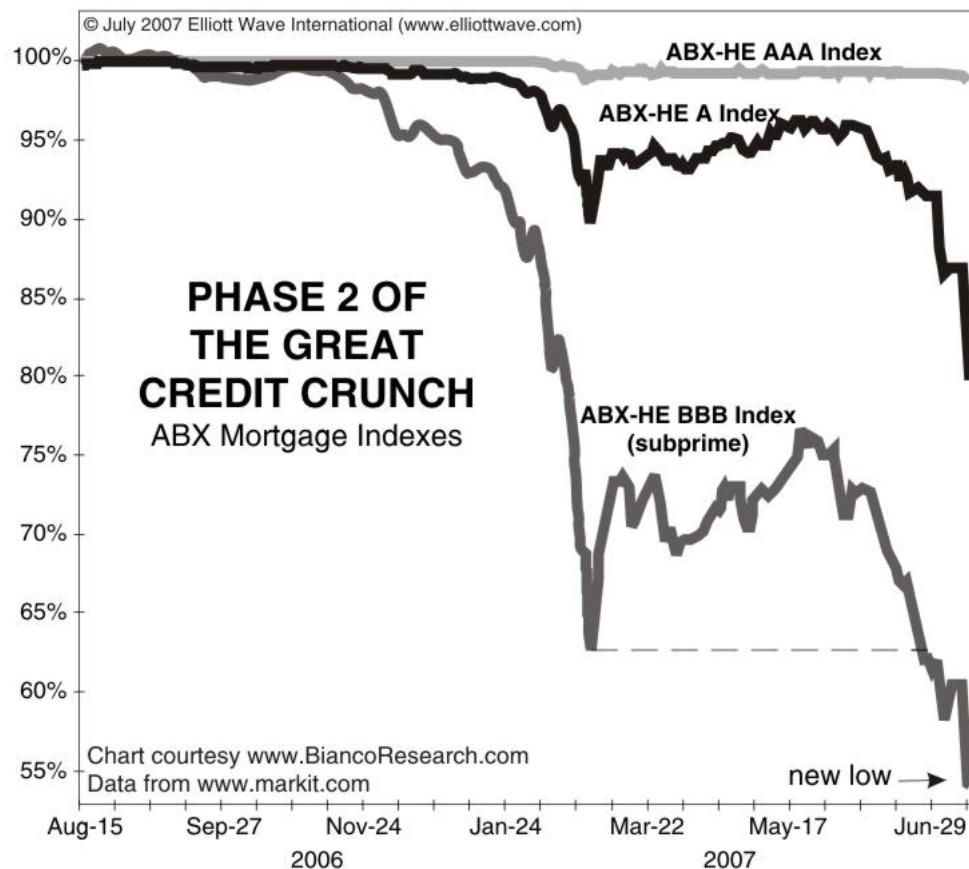


Figure 3

The rating services fulfilled their usual role:

Fortune July 5 2007: 11:16 AM EDT (Fortune Magazine) [excerpt]

The three credit-rating agencies - Standard & Poor's, Moody's (Charts), and Fitch - may be the next ones to see their good names dragged through the mud. The reason? Ohio attorney general Marc Dann is building a case against them based on the role he believes their ratings played in the marketing of risky mortgage-related securities.

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"The ratings agencies cashed a check every time one of these subprime pools was created and an offering was made," Dann told Fortune, referring to the way the bond issuers paid to get their asset-backed securities (ABSs) and collateralized debt obligations (CDOs) rated by the agencies. [So they are] among the people who aided and abetted this continuing fraud," adds Dann.

Ohio has the third-largest group of public pensions in the United States, and they've got exposure: The Ohio Police & Fire Pension Fund has nearly 7 percent of its portfolio in mortgage- and asset-backed obligations.

Moody's says that Dann's accusations are nonsense. "We perform a very significant but extremely limited role in the credit markets. We issue reasoned, forward-looking opinions about credit risk," says Fran Laserson, vice president of corporate communications at Moody's. "Our opinions are objective and not tied to any recommendations to buy and sell." She further points out that while some securities have lost significant value, none have actually defaulted.

Dann and a growing legion of critics contend that the agencies dropped the ball by issuing investment-grade ratings on securities backed by subprime mortgages they should have known were shaky. "The rating drives everything," adds Sylvain Raynes, a former Moody's analyst and currently a principal at R&R Consulting, a firm that examines these securities.

Regardless of whether a lawsuit materializes, the ratings agencies already seem to be policing themselves. Of the pool of securities created from 2006 subprime mortgages, Moody's has downgraded 19 percent of the issues they've rated and put 30 percent on a watch list.

Here is an addendum from a Bloomberg report from July 11:

"I track this market every single day and performance has been a disaster now for months," said Steven Eisman, who helps manage \$6.5 billion at Frontpoint Partners in New York, during a conference call hosted by S&P yesterday. "I'd like to understand why you made this move now when you could have done this months ago."

But readers of *Conquer the Crash* are not surprised, and *we didn't own any such debt*.

Some readers of *Conquer the Crash* took exception to this statement, from Chapter 9:

[F]inancial values can disappear into nowhere.... The "million dollars" that a wealthy investor might have thought he had in his bond portfolio or at a stock's peak value can quite rapidly become \$50,000 or \$5000 or \$50. *The rest of it just disappears*. You see, he never really had a million dollars; all he had was IOUs or stock certificates. The idea that it had a certain financial value was in his head and the heads of others who agreed. When the point of agreement changed, so did the value. Poof! Gone in a flash of aggregated neurons.

This warning is being borne out today. Read this excerpt from a Bloomberg news report of July 11:

As delinquencies on home loans to people with poor or meager credit surged to a 10-year high this year, no one buying, selling or rating the bonds collateralized by these bad debts bothered to quantify the losses. Now the bubble is bursting and *there is no agreement on how much money has vanished*: \$52 billion, according to an estimate from Zurich-based Credit Suisse Group earlier this week that followed a \$90 billion assessment from Frankfurt-based Deutsche Bank AG.

Do you see that line, "*money has vanished*"? It's not really money; it's financial value, but it didn't move from one asset to another. It just disappeared.

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Excerpted from the August 26, 2007 Elliott Wave Theorist

Can't Buy Enough...of That Junky Stuff, or, Why the Fed Will Not Stop Deflation

We hear it every day: "What about the Fed?" The vast majority of investors and commentators seems confident that the Fed's machinations make a stock market collapse impossible. Every hour or so one can read or hear another comment along these lines: "the Fed will provide liquidity," "the Fed is injecting money into the system," "the Fed will be forced to bail out homeowners, homebuilders, mortgage companies and banks," "the Fed has no choice but to inflate," "the government cannot allow deflation," "the Fed will print money to stave off deflation" and any number of like statements. None of them is true. The Fed is not forced to do anything; the Fed has not been injecting money; the Fed does have choices; the government does not control deflationary forces; and the Fed will not print money unless and until it changes its long-standing policies and decides to destroy itself.

A perfect example of one of these fallacies recently exposed is the widespread report in August that the Fed had "injected" billions of dollars worth of "money" into the "system" by "buying" "sub-prime mortgages." In fact, all it did was offer to stave off the immediate illegality of many banks' operations by lending money against the collateral of *guaranteed* mortgages but only *temporarily* under contracts that oblige the banks to buy them back within 1 to 30 days. The typical duration is 3 days. Observe three important things:

1. The Fed did not give out *money*; it offered a temporary, collateralized *loan*.
2. The Fed did not *inject* liquidity; it offered it.
3. The Fed did not lend against worthless sub-prime mortgages; it lent against *valuable* mortgages issued by Fannie Mae (the Federal National Mortgage Association), Ginnie Mae (the Government National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation). The New York Fed is also accepting "investment quality" commercial paper, which means highly liquid, valuable IOUs, not junk.

As a result:

1. The Fed took almost no risk in the transactions.
2. The net liquidity it provided—after the repo agreements close—is zero.
3. The financial system is still choking on bad loans.
4. Banks and other lending institutions must sell other assets to raise cash to buy back their mortgages from the Fed.

These points are crucial to a proper understanding of the situation. The Fed is doing nothing akin to what most of the media claims; like McDonald's, it is selling not so much sustenance as time, in this case time for banks to divest themselves of some assets. But in the Fed's case, that's all it's selling; you don't get any food in the bargain.

As I have said before, the Federal Reserve may be large and complex, but it is a bank. It has private owners: member banks, whose shareholders can be anyone. (For an excellent primer, see http://www.libertyunbound.com/archive/2004_10/woolsey-fed.html.) The Fed's stockholders exploit the banking system through access to easy loans and the Fed's 6%-guaranteed stock dividends. Member banks do not want to see their nurturing enterprise destroyed. Although Bernanke probably received distress calls from mortgage lenders, he probably also

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got calls from prospering member banks saying, “Don’t you *dare* buy any of that crap and put it in the long-term portfolio.” Nor is it likely to do so. Member banks may make mortgages and lend to consumers, but the Fed doesn’t; comparatively, it’s highly conservative.

In the early 1930s, as markets fell and the economy collapsed, the Fed offered loans only on the most pristine debt. Its standards have fallen a bit, but not by much. Today it will still lend only on *highly reliable* IOUs, not junk. And it doesn’t even want to own most of those; it takes them on only temporarily as part of a short-term repurchase agreement.

The Fed’s power derives from the value of its holdings, which are primarily Treasury bonds, which provide backing for the value of the Fed’s notes. What would a Federal Reserve Note be worth if it were backed by sub-prime mortgages? The real value of U.S. Treasury debt is precarious enough as it is, but at least it has the taxing power of the government behind it. But if the Fed bought up the entire supply of sub-prime mortgages, its notes would lose value accordingly. So will the Fed bail out mortgage companies, as the optimists seem to think? No, it won’t. Those who think the Fed will buy up junk with cash delivered by helicopter are dreaming.

Ironically, of course, the Federal Reserve System and the federal government—both directly and via creations such as privileged mortgage companies and the FDIC—have *fostered* all the lending and the junk debt that resulted. But these entities want only to benefit from the process, not suffer from it. As we will see throughout the bear market and into the depression, the Fed is self-interested and will not brook losses in its portfolio. Those who own the bad loans, and perhaps some foolish government entities that try to “save” them, will take losses, but the Fed won’t.

One might imagine various schemes by which the government would guarantee such mortgages, but if it did, the mortgages would in effect become Treasury bonds. The problem, as others have pointed out, is that government guarantees on bad debt would simply encourage more of it. Unless the government decides to freeze the mortgage lending industry, which would have its own devastating repercussions, it cannot pull off a bailout scheme.

What must the banks do with their “grace period” of a few days that the Fed’s repo agreements provide? They have to *raise the cash to buy back the IOUs that the Fed agreed to hold for them*. How does a bank raise money? By selling assets. Thus begins the downward spiral: Contracting credit causes asset sales, which cause collateral values to fall, which causes lenders to curtail lending, thus contracting overall credit, which causes assets sales, and so it goes. Thus, the Fed is not staving off deflation; at best, it may have helped—momentarily—to make it more orderly. But the selling of assets has begun regardless.

One of the Fed’s just-accessed “tools” is its authority to suspend various lending restrictions. As Fortune (August 24) just reported, a week ago the Fed, in an unprecedented move suggesting growing panic, suspended the limit on the percentage of capital that Citigroup and Bank of America can lend to their affiliated brokerage firms. With that permission, these banks immediately raised their loans from the previous maximum of 10 percent of their total capital to an enormous 30 percent, and they have permission to go higher if they want. Observe that the Fed did not lend to the brokers. It merely authorized these banks to do it. The banks, though obviously desperate to shore up their brokerage divisions, just as necessarily believe that their loans will be paid back, which means that they are bullish on the stock market and most other financial markets. But what will happen when markets fall further and the banks’ depositors get wind of the fact that their money has been lent to speculators with leveraged market positions? The Fed, which greased the loan scheme by financing the loan

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to these banks (not the brokers) through its discount window, now has a claim on these banks' assets. It will be utterly fascinating to see what the Fed decides to do when these big banks finally call the Fed and say that if it calls in its loans, they will go bankrupt. I'm betting that the Fed, perhaps after a few more frantic calls to other creditors for help, will eventually call in the loans anyway.

Does the Fed have secret tools to stave off deflation? Yes, to the same extent that Hitler, hiding in a bunker in 1945, had secret weapons to stave off the Allies. The Fed has only one tool: to offer credit, and its arsenal is depleted because it will offer credit *only on terms good to itself*. And borrowers will borrow only if they think they can pay back the debt after selling assets. You can bet that the Fed is lending only to banks that it believes have the necessary assets to survive its loans' repayment provisions. If not, well, it will be the FDIC's problem. The Fed is not engineering a system-wide bailout; it is just re-arranging deck chairs.

Interest rates are higher than they were in 2002. Many people say that the Fed therefore has lots of room to bring rates down and keep the economy inflated. Do lower interest rates cause recovery? No, they simply reflect a crashing market for credit. The market makes interest rates rise and fall, and the Fed's rates typically just follow suit. Sometimes central banks force the issue, as when the Fed in the final months of 2002 lowered its discount rate to 0.75 percent, staying a bit ahead of the decline in T-bill yields. But its systematic rate drops didn't stop the S&P from losing *half its value in 31 months*. When the Japanese central bank lowered rates virtually to zero in the 1990s, doing so likewise did not prevent Japanese real estate prices from imploding and the Nikkei from proceeding through its *biggest bear market ever* by a huge margin. Rates near zero, then, did not constitute a magic potion. Zero was simply the price of loans at the time; nobody wanted them. So the "room" the Fed presumably has may or may not matter. If the market decides to take rates to zero or below, the Fed will simply follow and then have no power.

The Fed does not "inject" liquidity; it only offers it. If nobody wants it, the inflation game is over. The determinant of that matter is the market. When bull markets turn to bear, confidence turns to fear, and fearful people do not lend or borrow at the same rates as confident ones. The ultimate drivers of inflation and deflation are human mental states that the Fed cannot manipulate. The pattern of the stock market's waves determines the ebb and flow of these mental states, and now that a bear market has begun, nothing will stop the trend toward falling confidence and thus falling asset prices, credit deflation and economic depression.

The truth is that the Fed's supposed tools of adding liquidity, such as the limit suspension just granted to the big New York banks, are formulas for total disaster. The terrible secret is that every one of the Fed's tools is nothing but a mechanism to make matters *worse*. Just because it has taken 74 years to get to the point at which this fact is once again about to become obvious does not mean that it wasn't true all along. The Fed is short-sighted, and its schemes to foster liquidity for short term crises have served, and are continuing to serve, to insure the ultimate collapse of most of the nation's banking system. The storm clouds are getting dark, so that time may have arrived.

The market is certainly poised for a panic. Confidence has held sway for 2½ decades, during which time investors have become utterly unconcerned with risk. They hold a number of misconceptions that foster such complacency. The day the Fed lowers one of its rates or engineers a major temporary loan and the stock market goes down anyway is the day that investors will become utterly uncertain of what they believe about market causality, and panic will have no bridle. Sadly, Ben Bernanke will be blamed for the debacle, when all he will have been guilty of is serving an immoral monopoly, bad timing and failing to understand the forces at work. The third item pertains to almost everyone.

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The Fed Is Not Smart Enough To Stop Deflation, Even If It Could

The dab of grease on the gears in the form of the recent discount-rate cut did not come as part of the Fed's normal policy. According to a Bloomberg article of August 17, the surprise discount rate cut was "an extraordinary policy shift." In other words, *the Fed did not know what the hell was going on*. It was caught off guard and had to react. In fact, right through July the Fed's spokespeople were all saying that the number one threat to the economy was inflation! Like virtually all futurists, the Fed's economists extrapolate trends to derive forecasts. They never look at underlying indications of coming trend *change*. That's fine; it helps those of us who at least try to do so. But the idea that the Fed comprises a group of masterminds who "get it" at some deep level and can thereby control things is miles off the mark. For more on this theme, see the "Potent Directors Fallacy" discussion in *The Wave Principle of Human Social Behavior*.

A Deflationary Spiral

It is beginning to dawn upon people how a deflationary spiral works. As explained in *Conquer the Crash*, to satisfy creditors, debtors will sell all they can, even their best assets, to raise cash. That's one reason why gold and silver are not going up. When the sub-prime mortgage market crashed, guess what: other bonds, including supposedly safe municipal and corporate bonds, also fell. Most commentators believe that forced liquidation is the only reason that perfectly good investments fell in price. As one report dated August 24 said, "There's really no credit-related reason behind the decline." But CTC is on record predicting that a large portion of currently outstanding corporate and municipal debt will become worthless. Every trend has to begin somewhere, and its ultimate outcomes are never evident at the start of a move. By the end of the price decline in these bonds, when a bit of glue on the back of them will aid their use as wallpaper, observers will finally postulate why the bear market started in the first place. Even if most of the recent price declines are due to forced sales, those sales in turn are decreasing the total value of investments, which in turn will curtail individuals' and companies' economic activity, which will lead to an economic contraction, which will stress the issuers of such bonds to the point that they will be unable to make interest payments or return principal. In other words, whether investors understand it now or not, the forced sale of bonds is itself enough reason to sell them also on the basis of default risk.

Despite my description, this process is not linear. Every step of the way seems to have an immediate causal precursor, but like credit inflation, credit deflation is in fact an intricate, interwoven *process*, whose initial impetus is a *change in social mood* from optimism toward pessimism. If you are still on the fence about this idea, ask yourself: What changed in the so-called "fundamentals" between June and August? The answer is: *absolutely nothing*. Interest rates did not budge; there were no indications of recession; there were no changes in bank lending policies; there were no chilling government edicts. *The only thing that changed was people's minds*. One day sub-prime mortgages were a fine investment, and the next day they were toxic waste. There was no external cause of the change; it was an endogenously caused and regulated change, as all aggregate financial changes are. According to socionomic theory, the stock market is a sensitive indicator of such changes in mood. This is why EWT has continually said that the financial structure will hold up *as long as the stock market rises*. A downturn occurred in mid-July, and its consequences in terms of negative social mood are becoming swiftly evident. Remember, C waves (see *Elliott Wave Principle*, Chapter 2) are when optimistic illusions finally disappear and fear takes over. Sounds like now.

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Excerpted from the October 19, 2007 Elliott Wave Theorist

Falling Interest Rates in This Environment Will Be Bearish

You cannot pick up a newspaper, turn on financial TV or read an economist's report without hearing that the Fed's latest discount-rate cut is bullish because it indicates the Fed's decision to "pump liquidity" into the system. This opinion is so completely wrong that it is hard to believe its ubiquity.

First of all, the Fed does not "decide" where it wants interest rates. *All it does is follow the market.* Figure 17 proves it. Wherever the T-bill rate goes, the Fed's "target rate" for federal funds immediately follows. That's all there is to it. If you refuse to believe your eyes, then listen to the chairman; Alan Greenspan is very clear on this point. On September 17, a commentator on CNBC asked, "Did you keep the interest rates too low for too long in 2002-2003?" Greenspan immediately responded, "The market did." Rates were not "too low" or the period "too long," either, because the market, not the Fed, made the decision on the level and the time, and the market is never wrong; it is what it is. If investors in trillions of dollars worth of U.S. Treasury debt worldwide had demanded higher interest, they would have gotten it, period.

Second, *falling interest rates are almost never bullish.* All you have to do to understand this point is look at Figure

18. Interest rates fell persistently through three of the greatest bear markets in history: 1929-1932 in the Dow, 1990-2003 in the Japanese Nikkei, and 2000-2002 in the NASDAQ. The only comparably deep bear market in the past 80 years in which interest rates rose took place in the 1970s when the Value Line index dropped 74 percent. Economists all draw upon this experience, but they ignore the others. Today's environment of extensive investment leverage and an Everest of debt in the banking system is far more like 1929 in the U.S. and 1989 in Japan than it is like the 1970s. Why is a decline in interest rates bearish in such an environment? *Because it means a decline in the demand for credit.* When people want less of something, the price goes down. The recent drop in rates indicates less borrowing, which means that the primary prop under investment prices—the expansion of credit—is weakening. That's one reason why stock prices fell in 2000-2002 and why they are vulnerable now. This

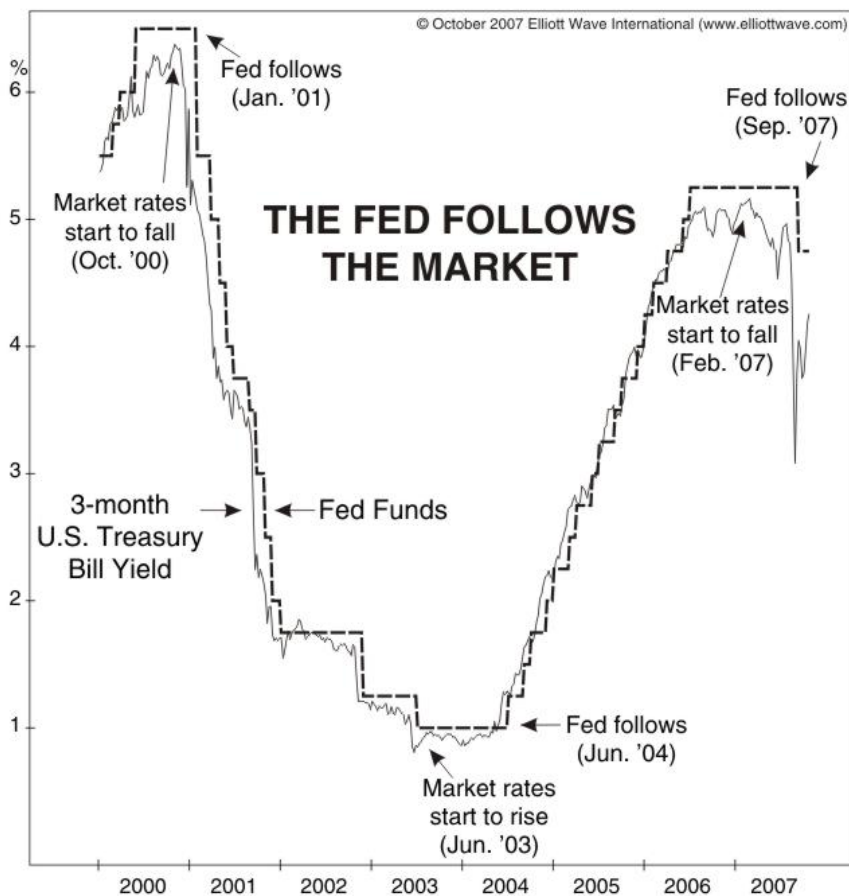


Figure 17

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is the *opposite* of “pumping liquidity”; it’s a *slackening* in liquidity.

The Big Bailout Bluff

Last week, a consortium of the USA’s three largest banks—Citigroup, Bank of America and JP Morgan Chase—agreed to create a super fund (called M-LEC) of \$80 billion “to buy distressed securities from SIVs [Structured Investment Vehicles].” Of course, like the Fed’s loans for only the very best paper, the super fund will buy only high-quality mortgages, not the sub-prime or Alt-A stuff.

Do you think this plan will work? First let’s examine what the SIVs did to get themselves in trouble. As AP (10/16) reports,

The SIVs used short-term commercial paper, sold at low interest rates, to buy longer-term mortgage-backed securities and other instruments with higher rates of return. With the seizure of the credit markets, many SIVs had trouble selling new commercial paper to replace upcoming obligations on older paper.

Their plan, in other words, was the equivalent of a perpetual motion machine: “Money for Nothing,” as the song title goes. But the world does not work like that. Oversized interest rates often mean that the investment is in fact sucking money out of principal. Sometimes investors can get away with the gambit for awhile, but eventually *somebody* pays the bill. The collapse in sub-prime mortgages and in the commercial paper that supported them has simply adjusted the value of the principal to make up for the outsized returns that these investors got over the past five years. But guess what: The money that banks owe on their commercial paper didn’t change. Sounds like trouble. And here is what are they are doing about it:

This time around, the banks hope to not only prevent credit problems from spreading, but also are bailing themselves out. (AP, 10/16)

This idea is the equivalent to trying to levitate yourself by pulling on your legs. These banks are going to offer more commercial paper to buy mortgage assets; in other words, they are going to borrow more short-term money in order to buy long-term assets from themselves! That is, if they can borrow the money in the first place. One of the casualties in the rout was the commercial paper market; investors are realizing that it backs a lot of lousy mortgage debt, so they are backing away from investing in the commercial paper that backs the mortgages.



Figure 18

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The last time banks colluded to hold up an entire market was October 1929. It didn't work.

If you have any exposure to illiquid mortgage investments, look upon this superfund as a gift. As soon as these banks pledge to buy one of your long-term, mortgage-backed securities, *sell it to them*.

What collateral will these banks use to back the \$80 billion in commercial paper they hope to sell to finance this scheme? They can't use mortgages, because the market doesn't want them. As one article says, "Analysts say that investors have all but stopped buying SIV-affiliated commercial paper." Will the new commercial paper become obligations of the banks? There appears to be no other alternative. In other words, depositors' money may end up backing this paper. One thing seems certain: The banks are digging themselves deeper into a hole. If you still have deposits in debt-laden banks despite our entreaties, you might want to take this late opportunity to move them. For suggestions on where to deposit funds for safety, see *Conquer the Crash*.

On July 9, the CEO/Chairman of Citigroup said, "When the music stops, in terms of liquidity, things will be complicated." Now wait a minute. We keep hearing that the Fed will shore up all their debts with perpetual liquidity, so how do you explain this comment? Answer: The bankers know better. Liquidity, formerly the solution, is now the problem, and the bankers know it.

The only solution that bankers, regulators, politicians and the Fed can think of is to do more of what they did to get into the problem in the first place: create more debt. They know of no other response. When the big bankers met via conference calls, "Besides hearing from senior executives from each of the big banks, the group also sought ideas from others." In other words, they are flailing for a solution to a problem that has no solution aside from taking measures to make it worse. I still think there is no better analogy to a system-wide credit binge than a person who keeps going only by gulping down amphetamines. He will collapse if he stops taking them, but if he keeps taking them he will ultimately die. Bankers always choose to ingest more speed. Their choice is to collapse now or die later. They always choose later. But they cannot avoid the inevitable result.

Speaking of the inevitable result, Bloomberg reports that a mortgage fund managed by Cheyne Capital Management Ltd. has just announced that it will fail to pay the interest immediately due on the commercial paper it issued to buy mortgages. Here's the problem: If it tried to pay the interest, it would have to sell assets to raise the money. If it were to sell assets in an illiquid market, they would fall in value, making the collateral in the fund worth less. I'll bet this company can't wait for that call from the managers of the new super fund, that is, if it owns any top-rated mortgages.

Can you see how exquisite the conundrum is for the "investors" who lent money to this firm? If they ask for their rightful interest, their principal will fall. If they don't ask for interest, they have no income. If they can't sell the assets, in truth they have no principal.

The emperor has no clothes, but so far the stock market floats merrily unconcerned in a haze of unprecedented optimism. Someday that optimism will melt as fast as it did in the mortgage market.

Excerpt from the December 14, 2007 Elliott Wave Theorist

HIGH NOON FOR THE FED'S CREDIBILITY

On one end of the dusty street stand five outlaws: the Federal Reserve, the Bank of Canada, the Bank of England, the European Central Bank and the Swiss National Bank. On the other end of the street stands the monster that they created and nurtured in their global lab. The outlaws have opened with a barrage of bullets. But the only bullets they have are made of the monster's very substance: debt. Every bullet that hits him only makes him stronger. And now the monster is beginning to draw his gun, and it's a bazooka. He is taking aim. The monster is about to overcome his makers.

Last Chance Saloon

The world's "big five" central banks—the Federal Reserve, the Bank of Canada, the Bank of England, the European Central Bank and the Swiss National Bank—have just made the announcement of their lives. Apparently working all night on Tuesday-Wednesday, the Fed arranged all these players' cooperation in order to come up with a plan to bolster confidence among the world's creditors and borrowers. The Wall Street Journal (12/13) calls it "the biggest coordinated show of international financial force since Sept. 11, 2001." As a result, before Wednesday's U.S. stock-market opening, this consortium of money monopolists announced to the world that it would provide billions of dollars worth of "liquidity" in the form of low-cost, one-month loans to qualified banks with high-quality collateral, essentially presenting them free passes to make money in the LIBOR market and elsewhere. In this one blazing statement broadcast worldwide, it seems that the dream/nightmare of believers in perpetual inflation has come true: With unlimited fiat credit at their disposal, the world's central banks are proudly *coordinating* a drive to create more inflation.

But the seems is different from the is. If these central banks had pledged to exchange their IOUs indiscriminately and permanently for any and all other debts, they would indeed have created permanent inflation. But this new plan is just another repo deal, in which the borrowing banks still have to pay back the money, with interest, in 28-30 days. What's more, weak debt is not acceptable collateral; these central banks are willing to hold only the good stuff, and then only for a month. As EWT has argued many times, there has been no indication whatsoever that the Fed is about to begin swapping its IOUs for subprime mortgages or any other junk paper. They will accept only good debt, and only for 30 days. Very little has changed.

Nevertheless, this is probably the single most important central-bank pronouncement yet. *But it is not significant for the reasons people think.* By far most people take such pronouncements at face value, presume that what the authorities promise will happen and reason from there. But the tremendous significance of this seismic engagement of the monetary jawbone is that *if this announcement fails to restore confidence, central bankers' credibility will evaporate.*

At least that's the way historians will play it. But of course, the true causality, as elucidated by socionomics, is that *an evaporation of confidence will make the central bankers' plans fail.* The outcome is predicated on psychology. If wave c of the bear market has begun, nothing the Fed does will engender confidence. On the contrary, everything it does will be interpreted, in the trend toward negative social mood, as something bad. The Fed's failures will not create fear; fear will create the Fed's failures.

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Increasing fear manifests in certain behaviors. For one thing, bankers become fearful of lending. Recent surveys show a dramatic change in bankers' willingness to lend. Many of them have raised the size of required down payments on a house from zero to 20-30 percent. On the other side, investors become fearful of borrowing. For example, hedge funds that have amassed huge portfolios of bad mortgages were powerfully leveraged, some as much as 30 to 1. A small increase in fear has already induced many of them to pare back their leverage. Depositors' fear is also a factor. Just a few weeks ago the Local Government Investment Pool run by the Florida State Board of Administration, which held the assets of many state government organizations, had such a run that it suspended withdrawals. Does anyone think that its current and former depositors will blithely add more money to this fund just because the Fed says it can make more credit available? Well, it *could* happen. But if the trend is now toward greater fear in society, it won't. One of the most entertaining articles in recent memory is one from Bloomberg on December 4, about the fund in Florida. The portion underlined will be suitable for framing:

On Nov. 30, an advisory panel of local governments in the Florida pool held a conference call with members of the State Board of Administration. The SBA put out a "Preferences Survey" for discussion, and Question No. 1 was "What percent of your current holding would you withdraw in December 2007, if it meant you would receive 99 cents on the dollar?" The next three questions were exactly the same, except with 98 cents on the dollar, 95 cents on the dollar and 90 cents on the dollar. The municipal officials on the call would have none of it. They want 100 cents on the dollar. Anything less, they said, would be unacceptable.

News flash for these investors: *You can't tell the market what you will or won't accept. It tells you.* Another line in the article expresses the problem correctly, failing only in expressing the futility of a solution:

They were a pretty conciliatory and reasonable bunch. They kept saying that what was needed was to restore confidence and trust in the fund.

Good luck changing the mood of the crowd.

Just look at how psychology, not conventional wisdom, expressed its dominance on the very day of the dramatic announcement: It seemed obvious to everyone what should happen in response to the knowledge that more central-bank credit was available. Gold and silver should soar. Oil should double overnight. Stock markets around the world should leap to the skies in anticipation of Dow 1,000,000. But as Granville used to say, "What is obvious is obviously wrong." Did any of the obvious things happen? No. *The opposite happened.*

But not right away. Investors, saturated with blind faith in the inflationary powers of central bankers, caused the S&P futures contract to gap up a huge 34.5 points. Six minutes later, the temporary euphoria was over, and the market started to sell off. Shockingly, stocks of banks, which the Fed's announcement was designed to help most, led the reversal and by noon were down on the day. Although the averages closed up, the bank stocks didn't. The very next morning (yesterday), gold and silver, which had barely moved on the great Fed announcement, cracked below their early December uptrends, as the U.S. dollar took off in its biggest two-day rally since June to extend what is now the biggest rally in a year.

As Gomer Pyle used to say, "Su-prise, su-prise, su-prise!" *But we at Elliott Wave International are not surprised at these events.* We have been surprised only by how long it has taken to get here. The only question remaining is how long it will take the bulk of the financial world to realize that the Fed is running out of ammo.

If the stock market has one more high coming, the Fed will temporarily look smart again. But a break of the August low will lead to the perception that the Fed's machinations have stopped working. When that happens,

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the reasoning that supports investors' faith in perpetually rising investment prices will melt, and those wrapped up in the credit balloon will rush to the exits. Fearful borrowers will scramble for dollars to pay off their loans. Fearful lenders will refuse to roll over loans and demand dollars as final payment. The only way to satisfy these urges will be to *sell stuff*.

Would you be surprised to learn that Wednesday's news and wild market action have a precedent? They do. In the stock market collapse of September-November, 1929, consortiums of banks announced several times that they were pooling resources to prop up stock prices. They failed. But today's central banks are many multiples bigger than the biggest banks of 1929, and they have unlimited credit and no real-money standard. They are nothing less than super-banks, which can create credit from nothing; *all a customer has to do is ask for it*.

Ah, but that's the problem. Someone has to ask. The expansion of credit depends on willing and able borrowers. Debtors have to trust the future well enough to borrow—and pay back with interest—the credit the central banks have to offer. The root of today's systemic dilemma is not *mechanical*, as the monetary engineers believe, but *psychological*. Bernanke thinks he can pull switches to prevent deflation. But you can't pull switches on a crowd. It pulls switches on *you*.

It is true that today's lending institutions dwarf those of 1929. But this is not a solution; *it's the problem*. They are the very reason that the market top of 1999-2007 is many multiples larger, in both extent and duration, than the 1929 top. People have their logic backwards. Bigger banks don't save markets from bubbles and crashes; they just make bubbles and crashes bigger.

When the Fed's credibility withers in the environment of a bear market, the monster will have overpowered his makers, and the gunfight will be over.

A Mystery: If Money is Loose, Why Are the Debt Markets in Distress?

Is money tight or loose? Most people would laugh at this question and say that, with the Fed being so "accommodating," money is obviously loose. But that is not my view. The Fed has always followed the T-bill rate when setting its discount rate and Fed funds target. From its February 2007 high, the U.S. T-bill rate has fallen 2.33 percentage points, but the Fed has lowered rates only one percentage point. Aside from the lower rates in its new repo auction scheme, it is still charging more than a full point above the T-bill rate, which is more than it normally would charge for its loans. The reasons are instructive.

The first reason for the slow rate reduction is that professional and public opinion is angry at the Fed for having fostered, through its role as lender of last resort, the bubble of loose money that supported the real estate mania and its sour resolution. So the Fed has decided that it wants to appear conservative and responsible by lowering rates slowly, even though the market rate for T-bills calls for a faster reduction. In other words, the Fed is sensitive to criticism and is therefore subject to outside opinions. This is not the way monetary engineering is supposed to work, is it? The public's emotions and opinions are not supposed to affect its decisions. But they do. That's just one of the problems with monetarism.

The second reason for the slow rate reduction is that inflation has raged up to this point, so many among the Fed's governors, quite naturally, fear inflation. But past and future trends are two different things. Inflation has raged, but deflation is next. Yet it takes a historian, not an economist, to see it coming. The Fed, then, is reacting to the past. Today's announcement of the biggest monthly jump in the Consumer Price Index in over two years is the kind of news that fans inflation fears even after they are no longer valid. The CPI lags all other

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indicators of inflation. To make policy based on the CPI is to be behind the curve. Home prices are already falling, and if the U.S. dollar and precious metals have reversed trend, they will be leading indicators of the real problem: deflation. So the Fed is basing its conservatism on old news, keeping money tight and not realizing that it is doing so.

But hey, I'm all for it. Whatever hastens the debt implosion so we can get past it and—one would hope—rebuild a valid (i.e. free market) monetary system is welcome.

Another Mystery: With Inflation Raging and the Dollar in Free-Fall for Six Years, Why Are T-Bill Rates So Low?

I met with a group of smart analysts a few months ago, and the one thing they agreed made no sense was the low interest rates on U.S. Treasuries. Many investors and analysts believe that the market has been inexplicably blind for several years and that these rates must soar. Well, sometimes markets do seem to ignore the obvious only to move in the anticipated direction later. But at other times, it is the participants who don't get it. I think this is one of those times.

One answer to the mystery is that we are in the "winter" portion of the Kondratieff economic cycle, which is when interest rates on good debt fall to their lows. That's what has been happening in Japan since 1990, and it is happening here, albeit more slowly.

But most people are not satisfied with cyclical explanations, so let's try another tack. I think the market "understands" that the inflation of recent years is not so much currency inflation as *credit* inflation. This is a crucial difference, because credit can disappear. I think the market is priced for an approaching debt implosion. Even though the dollar can't buy much now, surviving dollars will soon buy more, and anyone who has the foresight to keep his money *in debt that does not fail* will be wealthy in a kingdom of paupers. So 4%-5% rates on Treasuries is a perfectly good return on IOUs that will almost surely survive the credit collapse. When much of this debt, which is falsely perceived as money, disappears, remaining dollars will be valuable. Soon even a one percent return will be welcome, as it was in 2002-3 and as it has been in Japan.

Conquer the Crash is on record forecasting that interest rates will trend *lower*—probably to near zero—for bonds that will remain AAA, and *higher*—in many cases to infinity—for bonds that are at risk of default, a category that includes most currently outstanding consumer, corporate and municipal debt. I believe this process has already begun. T-bill rates fell hard in 2007, and shortly thereafter rates on sub-prime mortgages soared and in cases of default have already reached infinity. So I do not think the market is stupid. I think it agrees with my book.

Excerpted from the September 12, 2008 Elliott Wave Theorist

The “Impossible” Is Happening

The subtitle of *Conquer the Crash* is *How To Survive and Prosper in a Deflationary Depression*. Calling for deflation is still a distinctly minority opinion, which is as it should be. Meanwhile, the process that so few thought was even remotely possible is wiping out a lot of financial value. Almost every trend is down, except for the U.S. dollar. “All the Same Market” is back, this time on the downside. (See charts, page 3.) Smells like deflation spirit.

The Collapses of Fannie and Freddie: No Surprise Here

(Note: Fannie Mae peaked at \$89.38 in December 2000.)

“Government home loan institutions such as Fannie Mae and the Federal Home Loan Bank are apparently considered so safe that investors are routinely buying their debt at below the rate of Treasuries.”—February 1994 EWT

“The problem with real estate is that once the plug is pulled for good, liquidity dries up, making it too late to take action.”—May 2000 EWFF

“[I]n the coming downturn, Fannie Mae and Freddie Mac, ‘the government sponsored enterprises’ that have pushed home ownership into the depths of the population, will be extremely vulnerable.... Fannie Mae and Freddie Mac will be getting the worst of the downturn from every angle. To stay on top of this debacle, keep an eye on Fannie Mae’s stock price.”—March 2002 EWFF

“Managers of these companies are going to be utterly shocked when a depression devastates their portfolios and their earnings. Investors in these companies’ stocks and bonds will be just as surprised when the stock prices and bond ratings collapse. Most rating services will not see it coming.”—*Conquer the Crash*, March 2002

“Another stock that EWFF has been tracking as a proxy for real estate is Fannie Mae. In March, we were looking for one more new high, but Fannie’s break of 75 suggests that it has also entered a long-term decline.”—August 2002 EWFF

“Fannie Mae and Freddie Mac, for example, make loans to people that otherwise might not be able to borrow. Banks lend to FNM and FRE in cases where they would decline to lend to the ultimate borrower. To ignore the pyramid of dependence in today’s credit situation is to ignore a vitally important aspect of the deflationary danger.”—January 2003 EWT

“Despite one of the biggest housing booms in the history of the United States, the story behind the accounting irregularities at Fannie Mae has only gotten worse.”—August 15, 2005 STU

“For several years we’ve talked about the poor market action in Fannie Mae (FNM), the grease that helps the housing market flow. Over the past several weeks the stock is breaking below trendline support that has contained the stock for the past 5+ years. There is a lot of ‘air’ beneath prices and the downside potential of this stock is large.”—September 12, 2005 STU

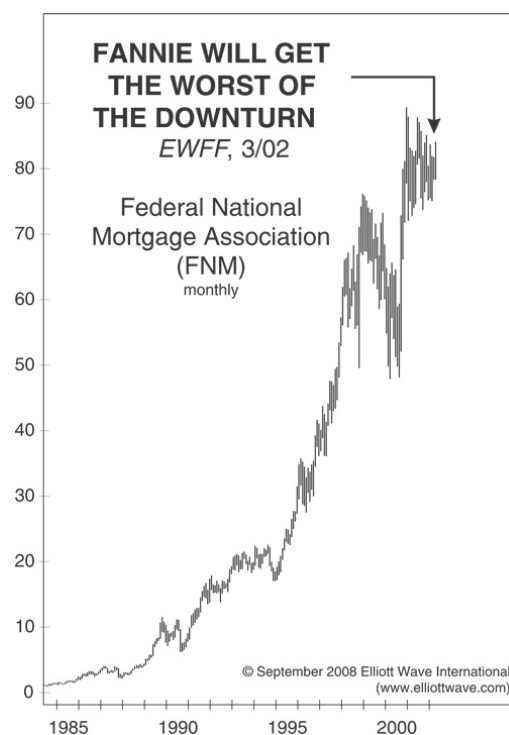


Figure 1

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But the statement we are most proud of is this one—made a year *before* the real estate mania ended—about Fannie Mae stock, when it was trading at 72:

“It may survive the bear market, but probably not without a complete round trip to \$1 a share, which is where it was at the beginning of the bull market.”—July 2004 EWFF

But we were generalizing. On August 20, I showed a log chart of FNM on Pimm Fox’s show on Bloomberg TV and asked rhetorically why bears were still so willing to short it after it had fallen 90 percent. The answer: A short seller could still make *another* 90% on his money by shorting the stock even at that price. After it fell from \$89.38 to \$8.94, it could fall 90 percent again, to \$0.89. That’s exactly what it did. Fannie’s low so far is 65 cents. Only one of our forecasts remains, and, despite the government’s announcement of a bailout, we’re sticking to it:

“Fannie Mae and Freddie Mac will shut down.”—October 2003 EWT

The Fed’s “Uncle” Point Is in View

Chapter 13 of *Conquer the Crash* is titled, “Can the Fed Stop Deflation?” The answer given there was an emphatic *no*. In barely a year the faith—and that’s what it was—in the Fed’s inflating power has pretty much died. CTC quoted *The Wizard of Oz*, and now anyone can see that there is no magic: just a man yanking on levers and blowing smoke. Back in 1929, consortiums of big banks, using their depositors’ money, tried to save the debt-laden stock market. They failed. This time, the new consortium was bigger: the Federal Reserve. But CTC anticipated the end of that game, too: “The bankers’ pools of 1929 gave up on this strategy, *and so will the Fed if it tries it.*” It is finally becoming obvious to everyone that the Fed is failing in extending its bag of tricks to stop deflation. The Fed’s balance sheet now contains more than 50 percent mortgage and other bank debt. Perhaps the Fed is willing to blow the rest of its AAA assets in the form of Treasury bonds, but somewhere between now and then is the Fed’s uncle point. The markets, however, are not so dumb as to wait for it. They can already see the end of that road, and they are moving now, ahead of it.

The Last Bastion against Deflation: The Federal Government

Now that the downward portion of the credit cycle is firmly in force, further inflation is impossible. But there is one entity left that can try to stave off deflation: the federal government.

The ultimate source of all the bad credit in the U.S. financial system is Congress. Congress created the Federal Reserve System and many privileged lending corporations: Fannie Mae, Freddie Mac, Ginnie Mae, Sallie Mae, the Federal Housing Administration and the Federal Home Loan Banks, to name a few. The August issue cited our estimate that the mortgage-encouraging entities that Congress created account for 75 percent of all U.S. debt creation with respect to housing. For investors in mortgage (in)securities, the ratio is even greater. Recent reports show that these agencies, which have been stealing people blind by taking interest for nothing, account for a stunning 82 percent of all securitized mortgage debt. Roughly speaking, the government directly encouraged the indebtedness of four out of five home-related borrowers. As noted in the August issue, it indirectly encouraged the rest through the Fed’s lending to banks and the FDIC’s guarantee of bank deposits. These policies allowed borrowers to drive up house prices to absurd levels, making them unaffordable to people who wanted to buy them with actual money. Proof that these mortgages are artificial and the product of something other than a free market is the fact that while Germany, for example, has issued mortgage-backed securities with a value equal to 0.2 percent of its annual GDP, the U.S. has issued them so ferociously that their value has reached 49.6 percent

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"ALL THE SAME MARKET" RESUMES, ON THE DOWNSIDE

daily data



Figure 2

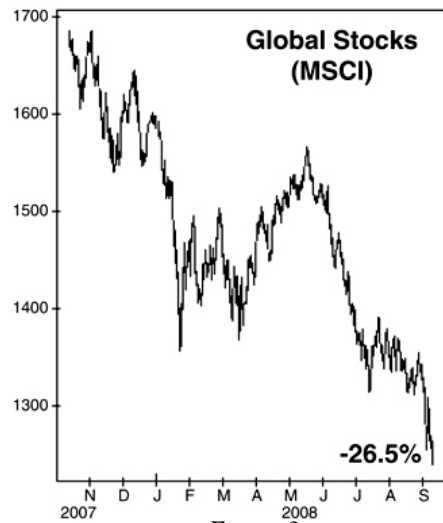


Figure 3

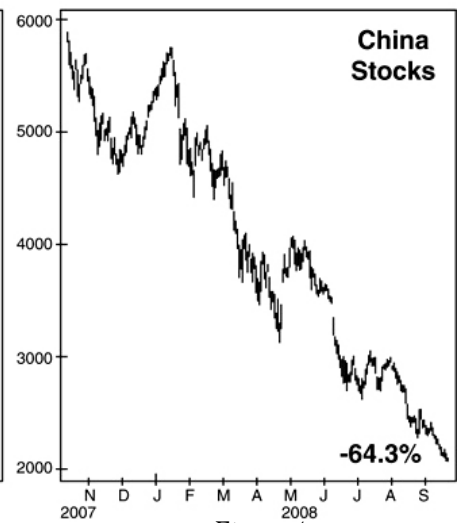


Figure 4



Figure 5

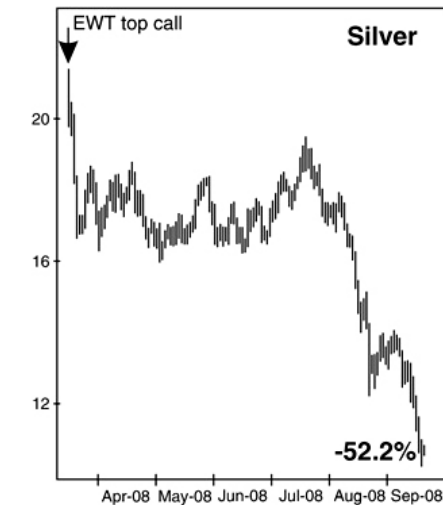


Figure 6

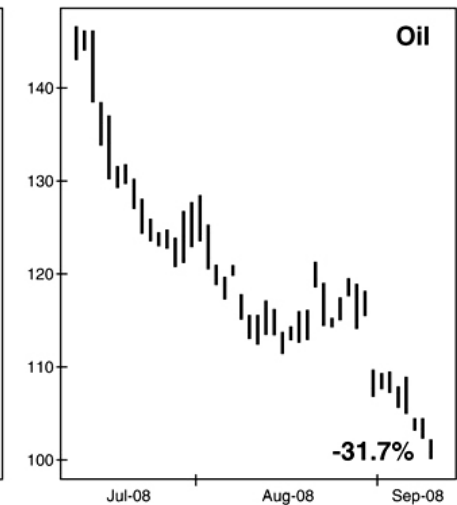


Figure 7

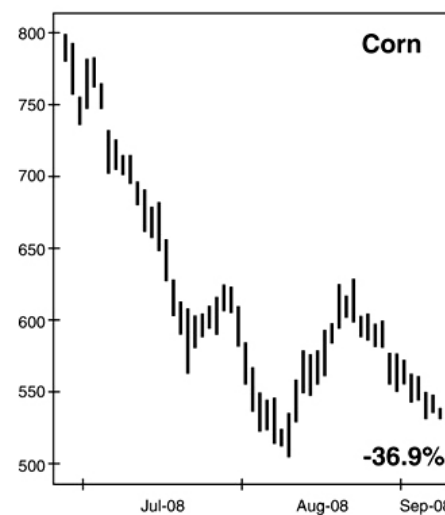


Figure 8

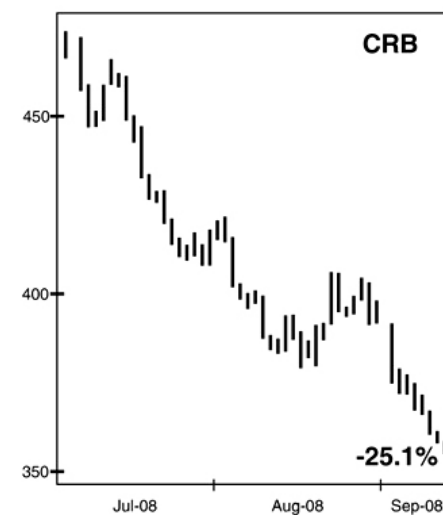


Figure 9



Figure 10

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of annual GDP, a multiple of 250 times Germany's rate, and that is not in total value but only in value relative to the U.S.'s much larger GDP. (Statistics courtesy of the British Treasury.)

Well, the ultimate source of this seemingly risk-free credit still exists, at least for now. When Bernanke & Co. met in the back rooms of the White House in recent weekends, he must have said this: "Boys, we're nearly out of ammo. We have \$400b. of credit left to lend, and we have two percentage points lower to go in interest rates. The only way to stave off deflation is for you to *guarantee* all the bad debts in the system." So far, government has leapt to oblige. One of its representatives strode to the podium to declare that it would pledge the future production of the American taxpayer in order to trade, in essence, all the bad IOUs held by speculators in Fannie and Freddie's mortgages for gilt-edged, freshly stamped U.S. Treasury bonds.

Now, what exactly does that mean for deflation? This latest extension of the decades-long debt-creation scheme has essentially exchanged bad IOUs for T-bonds. This move does not create inflation, but it is an attempt to stop deflation. Instead of becoming worthless wallpaper and 20-cents-on-the-dollar pieces of paper, these IOUs have, through the flap of a jaw, maintained their *full, 100 percent* liability. This means that the credit supply attending all these mortgages, which was in the process of collapsing, has ballooned right back up to its former level.

You might think this shift of liability is a magic potion to stave off deflation. But it's not.

Believers in perpetual inflation will ask, "What's to stop the U.S. government from simply adopting all bad debts, keeping the credit bubble inflated?" Answer: The U.S. government's IOUs have a price, an interest rate and a safety rating. Just as mortgage prices, rates and safety ratings were under investors' control, so they are for Treasuries. Remember when Bill Clinton became outraged when he found out that "a bunch of bond traders," not politicians, determined the price of T-bonds and the interest rates that the government must charge? If investors begin to fear the government's ability to pay interest and principal, they will move out of Treasuries the way they moved out of mortgages. The American financial system is too soaked with bad debt for a government bailout to work, and the market won't let politicians get away with assuming all the bad debts. It may take some time for the market to figure out what to do about it, but as always, there is no such thing as a free lunch. The only question is who pays for it.

The Fed is nearly out of the picture, so the consortium of last resort, the federal government, is assuming the job of propping up the debt bubble. It is multiples bigger than any such entity that went before, because it can draw on the liquidity of American taxpayers and clandestinely steal value from American savers. So the question comes down to this: Will the public put up with more financial exploitation? To date, that's exactly what it has done, but social mood has entered wave c of a Supercycle-degree decline, and voters are likely to become far less complacent, and more belligerent, than they have been for the past 76 years.

An early hint of the public's reaction comes in the form of news reports. In my lifetime, I can hardly remember times when the media questioned benevolent-sounding actions of the government. Articles were always about who the action would "help." But many commentators have more accurately reported on the latest bailout. *USA Today's* headline reads, "Taxpayers take on trillions of risk." (9/8) This headline is stunning because of its accuracy. When the government bailed out Chrysler, no newspaper ran an equally accurate headline saying, "Congress assures long-run bankruptcy for GM and Ford." They all talked about why it was a good thing. This time, realism and skepticism (at a later stage of the cycle it will be cynicism and outrage) attend the bailout. The *Wall Street Journal's* "Market Watch" reports an overwhelmingly negative response among emailers. Local newspapers' "Letters" sections publish comments of dismay and even outrage. CNBC's Mark Haines, in an interview on

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9/8 with MSNBC, began by saying ironically, "Isn't socialism great?" This breadth of disgust is *new*, and it's a reflection of emerging negative social mood.

Social mood trends arise from mental states and lead to social actions and events. Deflation is a social event. Ultimately, social mood will determine whether deflation occurs or not. When voters become angry enough, Congressmen will stop flinging pork at all comers. Now the automakers want a bailout. Voters have remained complacent about it so far, but this benign attitude won't last. The day the government capitulates and announces that it can't bail out everyone is the day deflationary psychology will have won out.

Lending vs. Banking

Every now and then EWT revisits the question of credit and the U.S. banking system. It is a difficult subject, and every time you can understand a little more of it, the clearer my long-standing argument for deflation becomes.

Let's start with a question. Suppose you owned title to \$50,000 held at a safekeeping institution. Then a neighbor asks to borrow \$40,000 from you on the promise of paying you back \$42,000 a year later. You agree, so you go to the safekeeping institution, withdraw \$40,000 and give it to your neighbor in exchange for an IOU for \$42,000, payable in a year. If someone were to ask you, "How much money do you have in the bank?" you would say, "\$10,000." Now let's change the scenario to the modern banking system. This time, you deposit \$50,000 into a bank. Your neighbor calls the bank and asks it for a loan of \$40,000, and the bank lends *your* money to the neighbor. Now if someone were to ask you how much money you have in the bank, you would say, "\$50,000."

How is this possible? The bank is simply a middleman, brokering the loan between you and your neighbor, and taking a fee to do it, yet somehow you think you still have \$50,000. Someone might point out that yes, \$40,000 is gone from the bank, but the deposits are pooled, so the first person in the door can always get his money. You, for example, could go to the bank tomorrow and withdraw \$50,000. That's true, but *everyone in the pool* thinks he has the money shown in his bank book, and that is obviously false. At latest count, U.S. banks report \$6.942t. in deposits and \$6.945t. in loans. In other words, the average bank in the U.S. has lent out 100 percent of its deposits. The money is *not there*. It is *lent out*. (Some banks have *more* loans than deposits, others less, because while deposits can move—so far, at least—banks can get stuck with illiquid loans. It used to be that when a large depositor left a loaned-up bank, the bank would sell off loan agreements to raise the cash to pay him. But today there is almost no market for mortgages. See the problem?) If your bank has a billion dollars on deposit but all of it is lent out, then it has no money. But if one were to poll all the depositors, their combined statements would indicate that, as a group, they think there is a billion dollars in the bank. So 100 percent of their belief is a fantasy. That is also the amount of potential deflation, if all the borrowers were immediately to default.

Confusion comes about due to a magical word: *deposit*. This word makes it *sound* as if you have placed your money in the bank for safekeeping. But what you have actually done—as courts have confirmed—is to *lend* your money to the bank so it can, in turn, lend your money to your neighbors and split the interest with you. It is a speculative business, not a safekeeping institution. In reality, a bank book should not list "money on deposit" but "money lent to our bank, to be paid on demand unless we run short."

Loan upon loan escalating through the banking system has created the bulk of the inflation in the system. But this inflation holds up only as long as all the loans backing the money listed in all the bank books are still good. If all the borrowers were to find that they could not pay back the banks, then the purchasing power that everyone *thought* he had would evaporate into the nothingness it truly was.

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This outcome seems hard to grasp, so let's go back to the original scenario. Your neighbor calls you up after a year and says, "Sorry, chum, but I invested the money and lost it. I can't pay you back." O.K., how much money do you have in the bank? Answer: You still have \$10,000. But you already knew your balance, so it's no big surprise. In the modern banking world, if 90 percent of borrowers were to default, the bank with \$1b. on deposit would have to admit to having only \$100m. worth of loans on hand. Most depositors would be shocked to discover that for every dollar they thought they had "in the bank," they in fact have only ten cents' worth of IOUs and not a penny of actual money. Contrast this outcome with the case of the direct loan. In that situation, you, the lender, knew the score every step of the way: You took a risk with his neighbor and it didn't pay off. Those are the breaks. In the modern banking system, almost no one knows the score. Even those who do understand the situation, from having seen "It's a Wonderful Life" a dozen times, rarely worry, because Congress, by creating the Fed as a lender and the FDIC as a supposed insurer, support the illusion that no losses are possible. This is a system with massive "systemic risk," which means in effect that huge illusions can melt away in a flash if the "system" fails. The modern banking system has no option *but* to fail. Its very design, in fostering the illusion of riskless lending, insures that ultimately a huge portion of the creditors someday will wake up broke.

In the direct-lending scenario, moreover, you consciously *decided* to take the risk. You could have chosen to keep your money safe. Indeed, because the risks are crystal clear and honestly represented, many would have done just that. But that option does not exist as an institutional service today, because with fiat money, *holding is losing*, at least for all but the rare, brief periods of deflation. So, almost nobody does it. People "keep their money in a bank" and think it's the same thing as "a bank keeping their money." But it isn't. To put it another way: The time-worn phrase "Money in the bank" really means "*money not in the bank.*"

If a depositor were to ask a banker, "Where is my money?" the proper answer would be, "It's gone." If he were to press on and ask, "What, then, do I own?" the banker should say, "Shares in a bunch of IOUs." Deflation, then, simply makes manifest something that is already true—the money is gone—but the obligation to pay it disappears only in the case when borrowers can't pay up. That's a rare thing, which is why deflation is a rare thing.

MORE Q&A: RIGHTING SOME MISCONCEPTIONS ABOUT THE LATEST BAILOUT

Now that the government is bailing out Fannie and Freddie...

The government is *not* "bailing out Fannie and Freddie." If these companies were allowed to fail, all that would happen is that creditors would divvy up their assets and sell them off, taking their lumps in the process. The speculators in credit default swaps (CDSs) who were *right* would justly win their bets, and the losers would have to pay. If the losers over-promised, they would have to sell off their own assets. So whom are the feds bailing out? They are bailing out the *creditors* who bought the IOUs that these companies created and the *insurers* who collected premiums on insurance against a fall in the value of Fannie and Freddie's mortgages and mortgage-backed bonds. The guilty parties won't have to pay, and the Chinese government, the "top foreign holder of Fannie Mae and Freddie Mac bonds," won't have to learn a lesson about investing. Politicians are shifting all that greed and stupidity onto the innocent, the by-definition prudent, American taxpayer and saver. To be even more precise, the government is bailing out the *dumbest* creditors. Smart ones got out early. As EWFF reported

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in July 2004, "The European Central Bank has already eliminated its holdings of bonds issued by Fannie and Freddie and urged other European banks to do the same." Only the dumbest investors own this stuff, and the government is disallowing them from learning something useful. In exchange, it is teaching taxpayers and savers a brutal lesson in civics.

Wasn't the bailout necessary to save the financial system?

Government officials and newspaper editorials, even those from skeptical writers, have been unanimous in claiming that a bailout, no matter how unpleasant, was "necessary." But this is nonsense. The only thing that has changed, the only thing the government can ever change, is who pays. A week ago, people on the hook were speculators who voluntarily took responsibility for losses when they grabbed the opportunity for gains. In fact, they have already booked years of gains, in the form of interest payments, along the way. Now, those on the hook are people who had nothing to do with the transactions in the first place. This bailout will drain money from people who are solvent and thereby damage the financial system more in the long run. Producers and savers are the very people upon whom recoveries depend. By shifting the losses onto them, the government has now assured the ultimate devastation of the entire financial system. The bailout is not just unnecessary; it is another disaster.

Isn't it shocking that Fannie and Freddie became such colossal failures?

Two contrary answers: (1) It isn't a surprise; and (2) they are not failures. A newspaper's editorial states about Fannie and Freddie, "They were destined to fail the moment they were conceived." This statement is true, indeed keenly insightful, in the financial sense. We at EWI can prove its validity from our own calls for this very event to occur. All one has to be able to do is recognize the endgame of a monumental fraud. But the idea that these companies failed is *not at all true* in the political sense, and politics provided the impetus to create these companies. Fannie and Freddie have been the *third-largest spenders on lobbying efforts and "campaign contributions" to Congressmen*, lavishing millions of dollars on them over the past 40 years. It's not chump change: "Fannie and Freddie were mobbed up with well-connected lobbyists on Capitol Hill, who spent \$170 million over the last decade...." (Dallas Morning News, 9/10) All the while Fannie and Freddie were pushing debt, Congressmen got re-elected at a rate of nearly 100 percent. So Fannie and Freddie have been blazing successes for politicians. Therefore, it is not true that they were "destined to fail." It is not even true that they failed. They succeeded spectacularly at what they were designed to do.

Don't many banks and funds have supplemental insurance to protect themselves?

Tons of it. Insurers have written \$62 trillion worth of credit-default swaps. Banks have private deposit insurance. But you have to understand: These seeming guarantees have been part of the problem, because they have given speculators a false sense of security. Insurers wrote them when they believed the system was risk-free. CDSs became speculative vehicles, and the liabilities at this point are way too big to cover. Additionally, many of the deals are complex and nearly opaque as to who owes what to whom. Insurance is always available when there is nothing to fear, but it goes away when big trouble looms. A subsidiary of Warren Buffett's Berkshire Hathaway company just announced (9/10) that it will stop offering supplemental deposit insurance to the 1500 banks it was covering. As you can see, it offered the insurance to make money, not to protect banks. Now that banks need protection, there is no more insurance. Still, one can hardly blame an insurance company for getting out of the business. Insurance is supposed to provide a way for prudent people

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voluntarily to socialize their risks. But when profligacy puts everyone at risk, insurance is impossible. In a depression, insurance companies stop insuring because they fail. Washington Mutual bank, reportedly in trouble, is 7.5 times as big as the biggest bank that's ever failed in the U.S. Buffet is just acting ahead of the disaster. The government never acts ahead of disaster, so when the FDIC stops providing insurance, it will be because it has no choice.

Now that Fannie and Freddie are covered, the worst is over, right?

Read this article (AJC, 9/6):

Effective Oct. 1, an initiative that helps home buyers with down payments will no longer exist. That's because one of the provisions of the Housing and Economic Recovery Act of 2008 signed into law in July was the elimination of seller-funded assistance on Federal Housing Administration-backed mortgages.

FHA loans require buyers to have a down payment, one of the largest barriers to home ownership, said Ann Ashburn, president of AmeriDream, a Maryland-based nonprofit that helps buyers pull the money together through seller assistance. Ashburn estimates that almost 40 percent of new home buyers use such programs, which receive no federal subsidy. But lawmakers axed the programs because a number of FHA borrowers who went into foreclosure in the past year had down payment assistance.

Current home buyers must have their FHA loan applications approved before Oct. 1 to use the seller assistance programs.

The ironies here abound. (1) It's called the "Housing and Economic Recovery Act," yet it bans selling houses to flat-broke people, who in 2004-2007 were the engine of the housing boom. (2) When the seller gives "down payment assistance," it is in fact *fraud*, because the FHA requires a down payment, which means it expects buyers to have a bit of cash. The so-called "assistance" just launders the payment into the mortgage. (3) The writer calls a down payment "one of the largest barriers to home ownership." What? If you can't afford a down payment, you don't own anything, much less a home. Generally speaking, being broke is indeed "one of the barriers to ownership." Are there any others? (4) The FHA obviously knew all along that this fraud was going on, as "almost 40 percent of new home buyers use such programs." (5) Stop the presses: "a number of FHA borrowers who went into foreclosure in the past year had down payment assistance." (6) The FHA is *still* rushing to underwrite these mortgages before the deadline occurs! Countrywide had nothing on the FHA, which has been *giving away mortgages*. My point? The FHA, the Federal Home Loan Banks and the Government National Mortgage Association (Ginnie Mae) are still feverishly operating, and for that matter so are Fannie Mae and Freddie Mac. By the way, don't worry too much about prospective buyers. As one of the article's interviewees assures us, "Don't get me wrong, there are a number of great city and state programs that offer down payment assistance."

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Excerpted from the November 19, 2009 Elliott Wave Theorist

Continuing—and Looming—Deflationary Forces - Part 1

The Fed and the government quite effectively advertise their efforts to inflate the supply of money and credit. But deflationary forces, to most eyes, are invisible. I thought I would point some of them out.

Banks Are about 95 Percent Invested in Mortgages

Figure 3, courtesy of Bianco Research, shows that U.S. banks used to be fairly conservative, holding 40 percent of their assets in Treasury securities. This large investment in federal government debt, the basis of our “monetary” “system”, served as a stop-gap against deflation. In 1950, even if mortgages had been wiped out by a factor of 80 percent, banks still would have been 50% solvent and 40% liquid. Today, banks hold federal agency securities (backed mostly by mortgages), mortgage-backed securities (meaning complicated packages of mortgages), plain old mortgages that they financed themselves, and a few business loan contracts. If these mortgages become wiped out by a factor of 80 percent, which in turn would cause many of the business loans to go into default, the banks will be only about 22% solvent and 1% liquid. I believe the coming wipeout will be bigger than that, but let’s be conservative for now. The point is that, unlike Treasuries, IOUs with homes as collateral can fall in dollar value, and such IOUs are pretty much the only paper backing U.S. bank deposits. The potential for deflation here is tremendous.

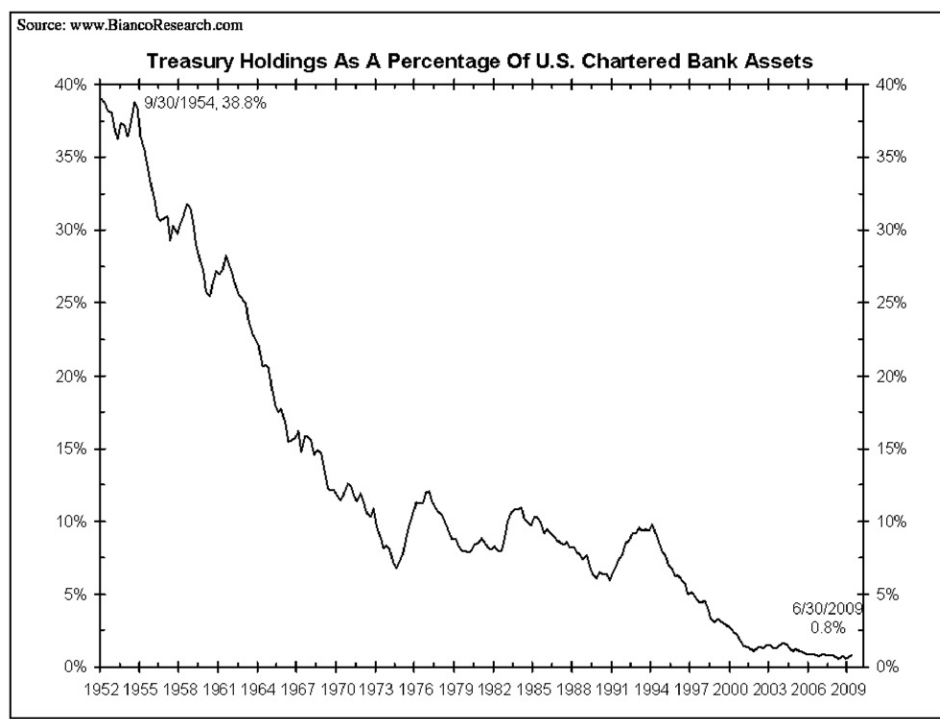


Figure 3

More Mortgages Are Going Under

It has been well publicized recently that commercial real estate has been plunging in value as business tenants walk away from their leases, leaving properties empty. Zisler Capital Partners reports, “Returns were negative for the past five quarters, the longest streak since 1992. Property prices have fallen by 30 percent to 50 percent from their peaks. Much of the debt is likely worth about 50 percent of par, or less.” (Bloomberg, 11/11) Needless to say, the fact that commercial mortgages are plunging in value is stressing banks even further, which in turn restricts their lending. This trend is deflationary.

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Banks Have Lent to the Wrong People for Decades

Figure 4 shows something amazing about banks' lending to small businesses. Most people would focus on the trend of this line, which is down to its lowest level since the interest rate crisis of 1980. Indeed, this is another indication of deflation. But look at where the line is compared to the "zero" line. What this chart tells us is that for at least 3½ decades, banks have under-lent to the one sector—business—that can create profits to pay them back. Businesses report that since 1974, ease of borrowing was either *worse* or *the same* as it was the prior quarter, meaning that—at least according to business owners—loans have been increasingly hard to get the entire time. This means that banks were shunning businesses in order to lend to *consumers* who wanted to buy homes, cars, furniture and who-knows-what on their credit cards. As explained in *Conquer the Crash*, the only loans that are traditionally categorized as "self-liquidating" are *business* loans, because businesses *make money* to pay them off. Consumer loans have no basis for repayment except the borrower's prospects for employment and, ultimately, collateral sales. Consumers *consume*, so whatever they buy with borrowed money *loses value* over time, whereas successful businesses *gain value*. As bank-credit and Elliott-wave expert Hamilton Bolton pointed out half a century ago (see CTC, p.89), the biggest financial crises come from the unsustainable expansion of non-self-liquidating loans. And today, there are more such loans outstanding than ever before, by many multiples. Banks' concentration in non-self-liquidating loans is bad news for debt repayment. The trend away from business loans, moreover, is accelerating. Figure 5

(WSJ, 11/11) shows that banks are choosing to invest new money in federal agency debt—which is all consumer debt—and Treasury debt. Creditors are finally coming to realize that individual debtors' means of repayment are evaporating, which implies future deflationary pressure within the banking system.



Figure 4

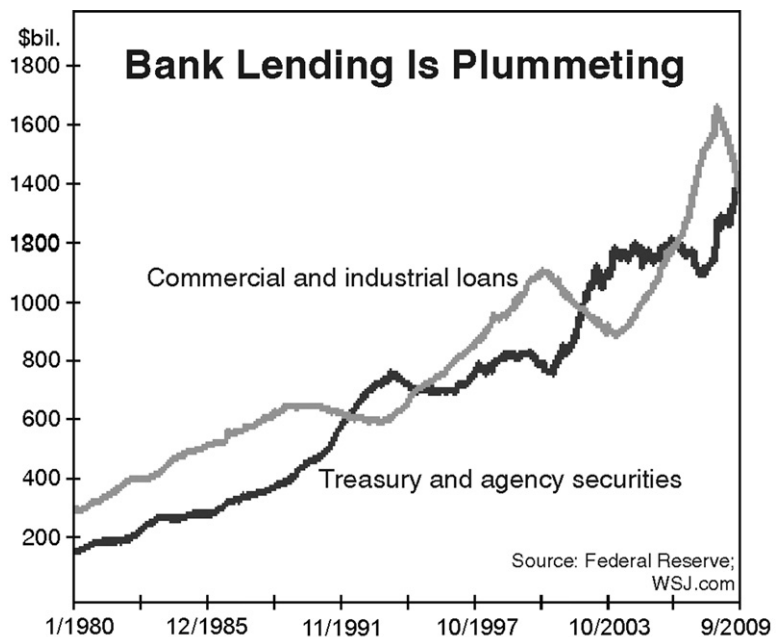


Figure 5

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Private Lenders Have Left the Building

The federal government is the proximate cause of the entire mortgage-credit bubble. When it formed its mortgage-creating “government sponsored enterprises” (GSEs), such as the Federal Home Loan Banks, Ginnie Mae, Fannie Mae and Freddie Mac, it assured the long-term destruction of the mortgage market, much as the Medicare bill in 1965 assured the long-term destruction of the health care market. Politicians always promise, and seemingly believe in, free lunches. But someone always pays more when government gets involved. Today the mortgage market is so broken that private funding accounts for only about ten percent of new mortgages. Fully 90 percent of them are created, funded or “guaranteed” (another myth soon to be exploded) by one of the government’s pet agencies. Figure 6 shows that there is only one group of mortgage lenders left: the GSEs. Government doesn’t run anything to benefit customers; it runs things to benefit itself. In order to buy votes by appearing magnanimous, it forces these GSEs to continue lending to broke people. But without the profit motive in the business of lending, there will ultimately be less lending. Graft, red tape and the pied piper (who always gets paid one way or another) will see to that. This long term drift toward full government control—as in the medical industry—is heading inevitably to a collapse of the industry and therefore, in this case, to a deflationary conclusion.

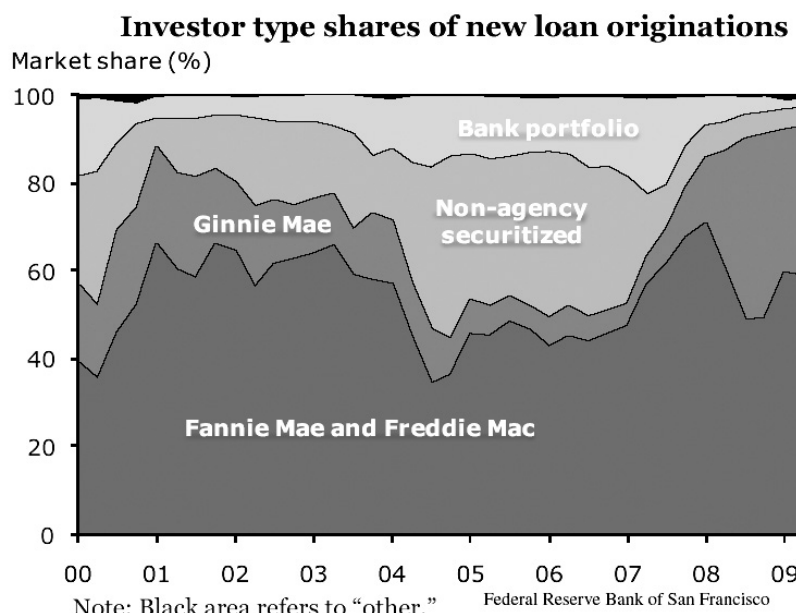


Figure 6

People Are Walking away from Their Homes and Mortgages

Great numbers of people are ceasing to pay their mortgages, *even if they have the money to pay them*. When people walk away from their mortgages, they are reneging on a promise to pay the interest on the loan. This means the money that your friends and relatives (no EWT subscriber should have any significant amount of money in a typical bank) have deposited in (i.e. lent to) their respective banks is becoming increasingly tied up in mortgages that are earning nothing at all. Normally, a bank can go after mortgage defaulters’ other assets, because, after all, a loan is a loan. That is, unless some government says it isn’t. A number of state governments have been willing to sell their banks’—and therefore their depositors’—health down the river for votes. In these states, banks can lend someone \$500,000, but they can’t tap the borrower’s assets to *collect* all the money owed to them; all they can do is take possession of the home that the borrower bought with the money, even if doing so does not cover the value of the loan. The so-called “non-recourse-loan” states are as follows: Alaska, Arizona, California, Connecticut, Florida, Idaho, Minnesota, North Carolina, North Dakota, Texas, Utah and Washington. Homeowners in these states can cheat their banks, with a pat on the head from the legislature. *Do not keep even your everyday spending money in any bank in these states unless its balance sheet shows a far lesser percentage of mortgages on its books than has the average bank.* (The new edition of CTC has an updated list of the safest banks per state.)

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Refusal to pay *interest* is deflationary. When banks can't collect fully on their loan *principal*, as is the case by law in the above-named states, it is deflationary. Even in states where banks can go after other assets held by borrowers, default is still deflationary if the borrowers are broke. The reason is that, in all these cases, the value of the loan contract falls to the marketable value of the collateral, and a contraction in the value of debt is deflation.

Some people who walk away from their mortgages purposely damage the homes when they leave. New businesses have sprung up to take on the job of cleaning up the houses that former occupants trashed as they left. Angry defaulters are stripping coils out of stoves, pulling electrical wiring out of walls, ripping fixtures out of bathrooms, yanking seats off of toilets, punching holes in walls and leaving rotting food in the fridge. (AP, 8/9) Such actions, and the threat of more such actions, lower the value of the collateral behind mortgage debts, thereby lowering the value of mortgages, which is deflationary.

Bank Lending Standards Have Stayed Restrictive

As people default on mortgages, banks are tightening lending standards. Figure 7 shows that banks loosened credit standards from late 2003 through the summer of 2007. By the end of that time, you could borrow money if you were breathing and could operate a ball-point pen. Banks have been tightening credit standards ever since. The rate of tightening peaked in October 2008, but the graph shows that over the past year various banks have either left their new, tighter standards in place or continued to tighten their standards further. Across the board, it is harder to get a loan, and it's staying that way. Lending restrictions reduce the credit supply. This condition is deflationary.

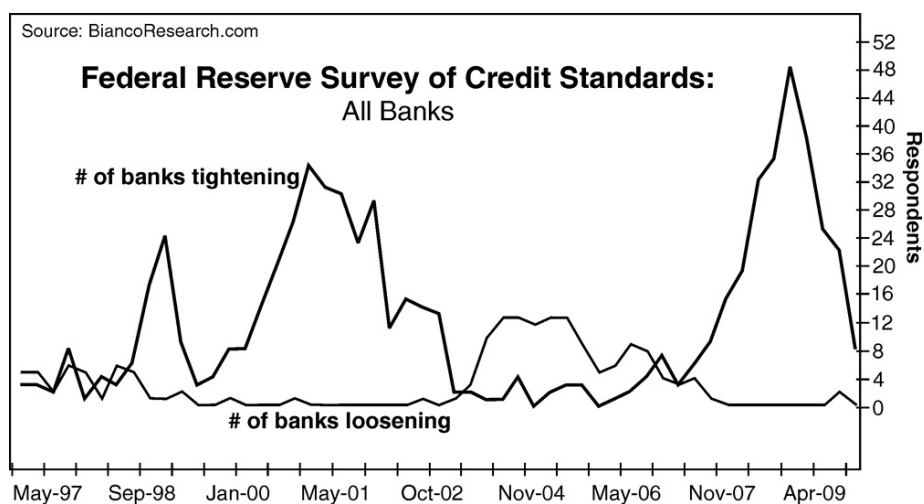


Figure 7

Banks Are Cashing Out of the Credit-Card Business

Articles have revealed that banks are doing everything they can to get credit-card debtors to pay off their cards. They are raising penalties and rates, lowering ceilings and otherwise bugging their clients to pay up, one way or another: Transfer your debt to another bank's card; default; pay us off; we don't care which. And it's working. Through September, consumers have paid down credit card balances for 12 months in a row. Figure 8 shows the new trend. The credit-card business was another formerly humming engine of credit that is sputtering. You might call the new program "cash from clunkers," and it is deflationary.

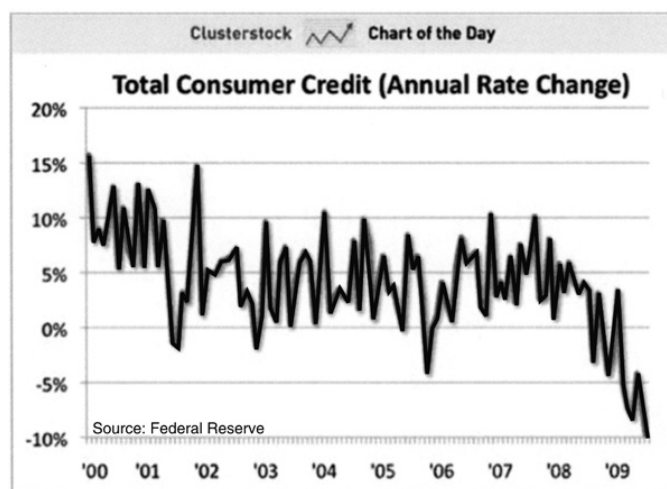


Figure 8

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LBO Debt Is Becoming an Albatross for Creditors and Providing a Disincentive for Banks To Lend

The Economist (10/29) reports, "Nine of the ten largest buy-outs in history occurred between 2006 and 2007, averaging \$30 billion each. *Four-fifths of that was borrowed.*" As shown in Figure 9, this is another engine of inflation that has ground to a halt. The "private equity" that provided the initial fuel for the binge, and the bank credit that was the 80% ethanol additive, have disappeared. The contraction in this activity is highly deflationary.

But it gets worse. An article on ZeroHedge.com tipped us to a report by Moody's titled "\$640 billion & 640 days later: how companies sponsored by big private equity have performed during the U.S. recession." The study shows that of the ten largest leveraged buyout (LBO) deals since 2007, four have already defaulted and two are "in distress" despite the recovery, which means they are likely to default as well. So, just in this small group, there is nearly half a trillion

dollars worth of IOUs heading for the dump. The LBO craze was a great focal point of excitement that led banks to lend at huge leverage to finance corporate takeovers (often so buyers could suck the companies dry, but that's another topic). The LBO-IOU train wreck is itself deflationary, because the value of outstanding IOUs is falling. But with LBO creditors facing disaster, *fear* of later default will limit *future* debt creation through LBOs as well.

There's more: "Between 2011 and 2014, there is roughly half a trillion in LBO debt maturing. Add that to the \$1.5 trillion in bank debt due for rolling, and the roughly \$3 trillion in CRE [commercial real estate] debt that is also supposed to be refinanced, and one can see how the [authorities] will need to find a way to roll about \$5 trillion in debt without the benefit of securitizations." Since 2003, EWT has projected 2014 as one of the most likely years for the end of the bear market in stocks (see illustrations in the June 2007 and May 2008 issues). If stocks fall into that year, there is no way that most of this debt will be rolled. So, whatever LBO debt hasn't failed yet will fail soon enough. "Private equity will return to basics: smaller deals with more cash upfront," says one industry rep. See that secret word in there—*cash*? That's what people want now, and that impulse is deflationary.

Bank Lending Continues To Collapse

With lending standards ratcheting higher, credit-card borrowers retiring debt, LBOs losing their luster and banks' loans going bad, it's no wonder that overall bank lending is contracting. Figure 10 shows that bank lending is continuing to collapse. And it is doing so during the so-called "recovery"! Can you imagine what this line will look like during the rest of Cycle wave c down?

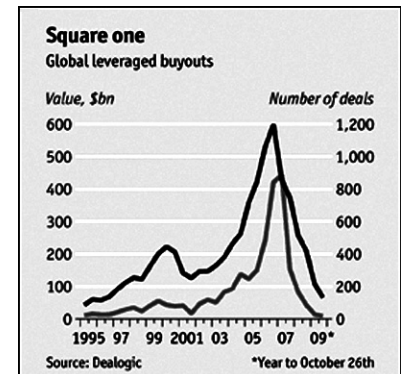


Figure 9

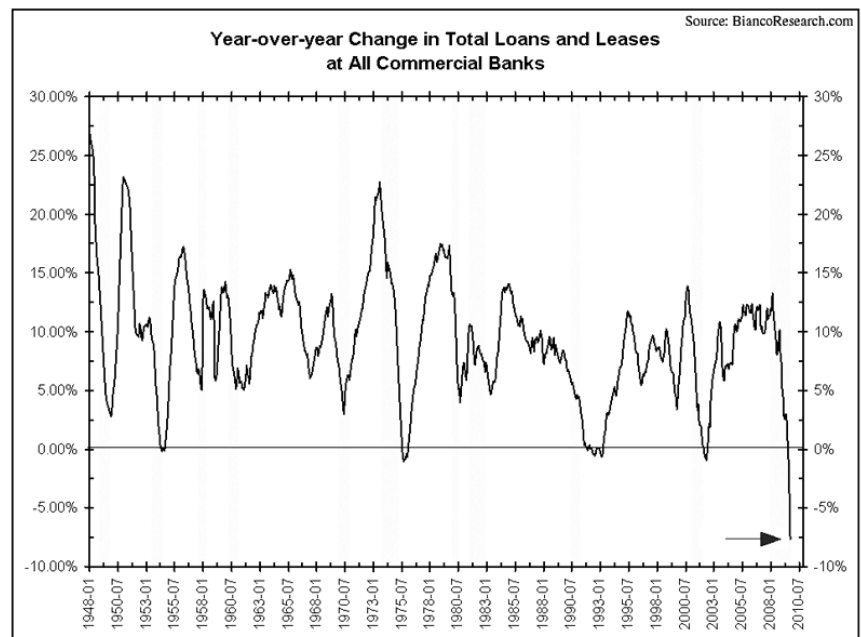


Figure 10

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Banks Continue To Fail

Despite the expansion in liquidity and the recovery in financial markets since March, banks are still failing at a rate of about one a week. Very recently, the rate has abated somewhat. But this may not be the good news it seems. According to a recent article,

Some in the industry believe the slowdown, rather than being a sign of improving industry prospect, has more to do with strains on the Federal Deposit Insurance Corp.'s insurance fund, insufficient staff to manage bank takeovers and saturation in the market for distressed assets and dead banks. (AJC, 10/25)

In other words, the FDIC *can't handle the load*.

The Banking Index of stocks led the broad market down in 2007-2008. That index peaked in October, ahead of the Dow and S&P, and promptly fell 16 percent (see Figure 1). This downtrend says that the rate of bank failures is going to increase. The FDIC's attempts to handle the crisis will be interesting to observe.

The FDIC Anesthesia Is Wearing Off

Perhaps the single greatest reason for the unbridled expansion of credit over the past 50 years is the existence of the Federal Deposit Insurance Corporation, another government-sponsored enterprise created by Congress. The coming rush of bank failures is an outcome made inevitable the very day that Congress created the FDIC. The reason is that the creation of the FDIC allowed savers to believe that their deposits at banks are "insured" against loss. But the FDIC is not really an insurance company. No enterprise, absent fraud, could possibly insure all the banking deposits in a nation. Nor does the FDIC do so, despite its claims. The FDIC is like AIG, the company that sold too many credit-default swaps. It contracted for more insurance than it could pay upon. Because depositors *believe* the sticker on the door of the bank, they have abdicated their responsibility to make sure that their banks' officers handle their deposits prudently. This abdication allowed banks to lend with impunity for decades until they became saturated with unpayable debts. Today, most banks are insolvent, and the FDIC is broke. This condition is deflationary for three reasons: (1) Banks are coming to realize that the FDIC cannot bail them out in a systemic crisis, so they have become highly conservative in their lending policies, as described above. (2) The main way that the FDIC gets its money is to *dun marginally healthy banks* for more "premiums" (meaning transfer payments) to bail out their disastrously run competitors. The more money the FDIC sucks out of marginally healthy banks, the less money those banks have on hand to lend, which is deflationary. (3) The banks that have to cough up all this money will become more impoverished at the margin, so banks that otherwise might have survived a credit crunch will be thrown even closer to the brink of failure. This is another deflationary risk. A friend of mine whose family owns a bank told me that the FDIC recently raised its 6-month assessment from \$17,000 to \$600,000. In the FDIC's latest announcement, it is considering requiring banks to pre-pay three years' worth of "premiums," i.e. triple the normal annual fee in a single year. It will be a miracle if the money lasts through 2010. When these funds are gone, the FDIC will have two more options: to issue its own bonds and pressure banks to buy them; and to tap its "credit line" of up to half a trillion dollars with the U.S. Treasury. It's the same old solution: take on more new debt to back up failing old debt. More debt will not cure the debt crisis.

Meanwhile, the FDIC is contributing to the deflationary trend. It has "tightened rules on required capital levels," which forces banks' loan ratios to fall; and it has "extended its extra monitoring of new banks from the first three years of operation to seven years" (AJC, 11/19), meaning that banks will now have to wait four additional years before they can go crazy with loans.

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State Regulators Are Restricting Lending, Too

But wait. Maybe banks won't be able to go crazy even after four years, because state regulators are also piling on the restrictions: "The prevalence of risky and improper lending practices at small banks in Georgia, including a technique called 'loan stacking,'" i.e. lending even more money to developers who can't pay off a loan, "prompted state regulators to tighten regulations governing lending limits earlier this month." (AJC, 11/19) So governments at both levels are clamping down on lending.

States Are Broke and Approaching Insolvency

While state "regulators" clamp down on profligate banks, the same states' legislatures continue to blow money. For years, state governments have been spending every dime they could squeeze out of taxpayers plus all they could borrow. (The lone exception is Nebraska, which prohibits state indebtedness over \$100k. Whatever Nebraska's official position on any other issue, by this action alone it is the most enlightened state government in the union.) But now even states' borrowing ability has run into a brick wall, because the basis of their ability to pay interest—namely, tax receipts—is evaporating. Figure 11 shows that states' taxation rackets are beginning to fail. The goose—the poor, overdriven taxpayer—is dying, and the production of golden eggs, which allowed state governments to binge for the past 40 years, is falling. The only reason that states did not either default on their loans or drastically cut their spending over the past year is that the federal government sucked a trillion dollars out of the loan market and handed it to countless undeserving entities, including state governments. "It's hard to imagine what happens when stimulus money runs out," says a budget expert. (USA, 10/29) But it is not at all hard to imagine what will happen. *Conquer the Crash* imagined state insolvency seven years ago. The breezy transfer of money from innocent savers to state spenders is going to end, and when it does, states will cut spending and "services" drastically. They will also default on their debts, which will be deflationary.

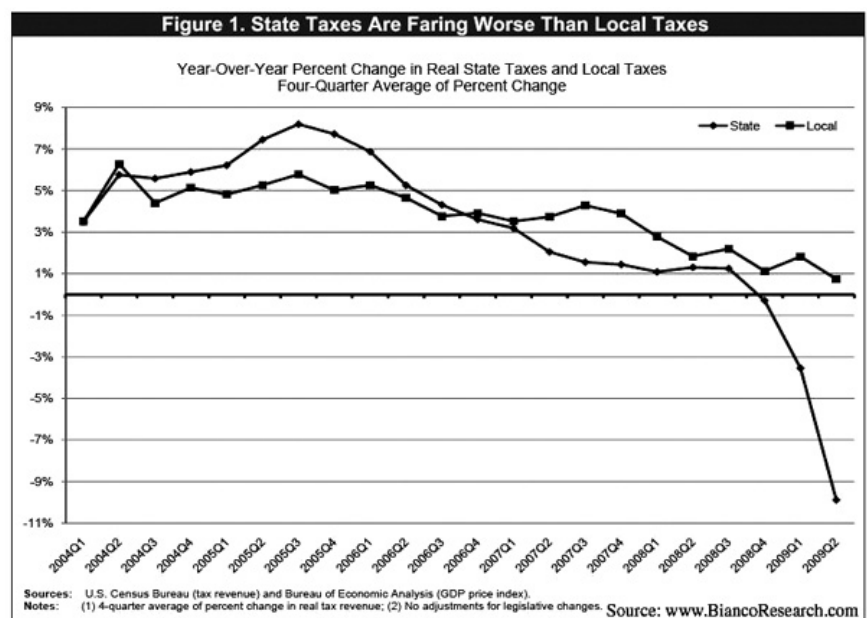


Figure 11

[to be continued]

Excerpted from the December 18, 2009 Elliott Wave Theorist

Continuing—and Looming—Deflationary Forces – Part 2

[continued from the November issue]

Government Is Hampering the Appraisal Process

When there were no statutory rules for real estate appraisals, lax appraisers played an important role in the credit bubble. After years of allowing appraisers to overvalue real estate until the bubble popped, the Federal Housing Administration drafted new, strict rules, called the Home Valuation Code of Conduct, which went into effect in May. The aim was “to reduce the pressure on appraisers to produce the sort of inflated home values that helped justify ever-bigger home prices and mortgage loans in once white-hot markets.” (AJC, 10/21) But surprise: The bill has some “unintended consequences.” Appraisers are losing business, because it is now illegal for them to engage the people with whom they have worked for years and years. Appraisals are taking longer to get, and desperate homeowners are being shut out of deals that could save their mortgages. Says one loan broker, “The people in Washington don’t know what the hell they’re doing.” But that’s inaccurate. Consider: As a result of the new regulations, “appraisal management companies—some owned by major banking firms—are gaining market share as more lenders outsource the task. “It’s like a bonanza,” says an independent appraiser. “They [the banks] hit the lotto.” In other words, the FHA instituted a bank-bailout plan of its own. Regardless, the end result is another ball and chain on another crucial supporter of the real-estate-based credit bubble: your neighborhood over-appraiser. This change is deflationary.

Congress Will Soon Hamper Lenders and Borrowers inside and outside of the Banking System

Credit inflation raged when the government claimed it was “regulating” the banking industry while simultaneously encouraging lending imprudence through the FDIC and by forcing banks to provide mortgages to “disadvantaged” people, who are now defaulting in droves. After creating this mess, Congress is preparing to “solve” the problem by slamming on the bank-lending brakes. The House has just passed the “Wall Street Reform and Consumer Protection Act,” a 1,136-page rust-infuser for the engine of banking-system inflation. Its “sweeping legislation [will] dramatically change how American banks are regulated.” The House and Senate have been contemplating different versions, but essentially the ultimate bill will do pretty much the following things:

- Create a single federal bank regulator, the Financial Institutions Regulatory Administration.
- Create a Consumer Financial Protection Agency to monitor and prevent banks from overcharging customers for fees on credit cards, mortgages and other products.
- Give shareholders more say on bank executives’ compensation.
- Add regulations on hedge funds. (AJC, 11/11)
- Create a mechanism for government to dissolve huge globally interconnected banks.
- Provide first-ever regulation of derivatives and other financial instruments.
- Require banks to set aside more capital in reserve.
- Tighten supervision over credit-rating agencies who sold out investors.
- Rein in excessive speculative investment on Wall Street. (McClatchey, 12/12)

An executive director at the Community Bankers Association of Georgia said that these Congressmen want to create a “dictatorship” over his industry. He is correct, but the dictatorship is in fact much wider in scope than

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just covering the banking industry; it extends to borrowers such as hedge funds and lenders such as mortgage companies. Every one of these provisions will *curtail lending*, just as the government's involvement in railroads 100 years ago curtailed rail service and its involvement in the health industry today curtails health care. Curtailing lending is deflationary.

The provision in the bill that will prevent banks from "overcharging" customers for overdrafts is also deflationary. "Overdraft fees have long been a profit center for banks...they are now the industry's single-largest driver of consumer fee income. In 2009, banks are expected to reap a record \$38.5 billion from overdraft and insufficient-funds fees." (USA, 11/13) Banks make money from two things: *fees* and *interest*. The less they make from fees, the more they will have to charge for interest. Higher interest charges will discourage borrowing, which is deflationary.

Hedge funds contributed mightily to inflation in the mid-2000s by talking banks into lending them up to 30 times leverage on their holdings. If the bill passes, hedge funds will be forced into debt retirement, which is deflationary.

This new bill, moreover, is just the opening blast of the coming regulatory freeze. On November 12, 1999, when the orthodox top of the Grand-Supercycle-degree uptrend was only two months away, President Clinton signed a bill, passed by Congress at the behest of bankers, to repeal the Glass-Steagal act of 1934. This change allowed commercial banks once again to engage in investment banking, a practice that earlier legislators blamed for the 1929 crash and the ensuing depression. This "Financial Services Modernization Act" act freed bankers to use their depositors' masses of funds to provide leverage to speculators on a scale never before imagined and to pay themselves huge fees for the service, which in turn motivated them to provide more credit. Now, Bloomberg (11/12) reports that House Rep. Paul Kanjorski is introducing legislation that will (1) re-impose the restrictions of the Glass-Steagal Act and (2) give the Secretary of the Treasury dictatorial power "to force the major [financial] institutions to reduce their size or restrict the scope of their activities," as the Secretary himself put it in testimony. So Congress, which accelerated the inflationary mess by repealing the Glass-Steagal Act, is now going to accelerate deflationary forces by shutting down the easy-credit mills that it jolted into being just a single decade ago.

Yet another bill—this one more cute than draconian—is working its way through Congress: "The House voted Wednesday to extend \$31 billion in popular tax breaks, including an income tax deduction for sales and property taxes, to be financed with a *tax increase on investment fund managers* and a *crackdown on international tax havens [and] cheats*." (AP, 12/10) The lure of riches through managing investment funds, and by speculating in financial markets with money made available through tax evasion, were two of the motors of the speculative binge. Is it not clear, even in such small ways, how social mood is changing, how politicians are expressing it, and how it is deflationary?

Congress Will Soon Hamper Insurance Companies

In October, "A House panel voted...to regulate for the first time privately traded derivatives, the kind of exotic financial instruments that helped bring down Lehman Brothers and nearly toppled American International Group." (AP, 10/15) Credit-default swaps were the bedrock of the final binge of credit expansion from 2002 to 2007. These swaps allowed lenders to believe that they were protected from their worst lending decisions. The market has already made pariahs out of these instruments, but as soon as the government begins restricting them by law, no company in its right mind will want to issue them, and no potential creditor without them will want to lend to marginal borrowers. This is another legislative change borne of negative-mood psychology, and it is

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deflationary. Needless to say, "Federal regulators have argued for a tougher proposal." The head of the Commodity Futures Trading Commission wants "legislation that covers the entire marketplace without exception and to ensure that regulators have appropriate authorities to protect the public." The CFTC wants the kind of power that the Fed and FDIC always had to protect the public from bad bank loans and that the SEC always had to protect the public against Ponzi schemes. None of this regulation will help the public, but it will shut down the inflationary activities of insurance companies.

Congress May Soon Hamper Investors

In order to attempt to pay for the final-destruction-of-health-care bill currently before the Senate, some lawmakers are proposing to tax income from "capital gains, dividends, interest, royalties and partnerships" earned by "wealthy Americans," which by their starting definition means any couple earning more than \$250k/year (USA, 11/13). The hope of some return is the main reason that people who have saved money choose to invest it. If this proposal goes through, major incentives to invest will be kicked out from under people. Selling investments because of additional tax burdens will cause prices to fall, which will be deflationary, because stocks, bonds and real estate serve as collateral for loans.

Government Meddling Is Deflationary, Even When It Is Designed To Be Inflationary

Here is one hilarious article:

WASHINGTON – Faced with sluggish progress in its foreclosure-prevention effort, the Obama administration will spend the coming weeks cracking down on mortgage companies that aren't doing enough to help borrowers at risk of losing their homes. Treasury Department officials said Monday they will step up pressure on the 71 companies participating in the government's \$75 billion effort to stem the foreclosure crisis. They will start this week by sending three-person "SWAT teams" to monitor the eight largest companies' work and requesting twice-daily reports on their progress. The program, announced by President Barack Obama in February, allows homeowners to have their mortgage interest rate reduced to as low as 2 percent for five years. As of early September, only about 1,700 homeowners had finished all the paperwork and received a new permanent loan. (AP, 12/1)

So, after ten months, the federal government, with all its power, has been able to cajole only 1700 homeowners in the entire country into filling out the paperwork to get a sweetheart mortgage deal. Maybe the problem is that homeowners realize that a 2 percent loan on \$500,000 when the house is worth only \$280,000 is not as sweet a deal as walking away from the loan. But the funniest part of the plan is the idea that demanding companies to provide twice-daily written reports will streamline things! Wait; there's more:

Lenders face "consequences" that may include sanctions and monetary penalties if they fail to perform under the Home Affordable Modification Program, the Treasury said today in a statement without being specific. (Bloomberg, 11/30)

Now consider: With this degree of government meddling and uncertainty, would anyone in his right mind start a mortgage-loan business now? No. So over the long run this program is self-defeating and deflationary.

The Last Big Mortgage Writer Is Going Broke

The very agency that imposed the strict new rules on appraisals, as if it is some sort of wise Solomon, is itself drowning in debt. The Federal Housing Administration's loan portfolio has become leveraged to a 50-to-1 ratio. A few more defaults, and the ratio will be infinite. If the FHA were a bank, the FDIC would close it. And you thought Fannie Mae and Freddie Mac were the only culprits. The New York Times reports,

20 percent of F.H.A. loans insured last year—and as many as 24 percent of those from 2007—face serious problems including foreclosure. The agency now insures roughly 5.4 million single-family home mortgages, with a combined value of \$675

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billion. In addition, these loans are bundled into mortgage-backed securities and guaranteed through the Government National Mortgage Association, known as Ginnie Mae. That means the taxpayer is responsible for paying investors who own Ginnie Mae bonds when F.H.A.-backed mortgages hit trouble. Many of the loans the F.H.A. insured in 2007 and last year are now turning delinquent, agency officials acknowledge. The loans made in those two years are performing “far worse” than newer loans, dragging down the whole portfolio, Mr. Stevens of the F.H.A. said in an interview. The number of F.H.A. mortgage holders in default is 410,916, up 76 percent from a year ago, when 232,864 were in default, according to agency data. “The FHA appears destined for a taxpayer bailout in the next 24 to 36 months,” Edward Pinto, a former Fannie Mae executive, said in testimony prepared for the hearing. (NYT, 10/9)

Now get this: Despite the soaring rate of default—which is plaguing an incredible *one-fourth* of mortgages written by the FHA just two years ago—the agency is *still writing mortgages at a frenetic pace*:

Since the bottom fell out of the mortgage market, the F.H.A. has assumed a crucial role in the nation's housing market. The F.H.A. is insuring about 6,000 loans a day, four times the amount in 2006. Its portfolio is growing so fast that even F.H.A. backers express amazement. Down payments are as low as 3.5 percent. Real estate agents in some hard-hit areas say every single one of their clients is using the F.H.A. “They’re counting their pennies, scraping up that 3.5 percent.” (NYT, 10/9)

To be blunt, the FHA is the only reason that housing sales have shown a blip up in the latest quarter. But don't worry about all of its red ink; after all, your government representatives aren't worried. Barney Frank, the Massachusetts Democrat who chairs the House Financial Services Committee, said in an interview that the defaults were, in essence, collateral damage (pun intended). He said, “I don't think it's a bad thing that the bad loans occurred. It was an effort to keep prices from falling too fast. That's a policy.” Mr. Frank seems not to be concerned that shifting private debt to the government will ultimately destroy the mortgage market, not to mention ultimately the currency upon which his paycheck is drawn.

Why is the FHA's mad rush to lend money to marginal borrowers potentially deflationary? As soon as the FHA runs out of foolish broke people who want to buy homes at inflated values, or, alternatively, as soon as voters have enough of this “policy,” U.S. housing sales, currently being bolstered almost entirely by an agency that is literally throwing away the public's money, will come to an abrupt halt. Don't take my word for what will happen when the FHA finally stops what it is doing. Just ask a member of Congress: “The F.H.A. has stepped into the void left by the private market,” Representative Maxine Waters, Democrat from California, said at the hearing. “Let's be clear; without F.H.A., *there would be no mortgage market right now.*” (NYT, 10/9)

The Coming Deflationary Pressure on the Government

The federal government is the last borrower and debt guarantor in the system, and it has been going berserk in playing these roles. Its breakneck pace of writing new mortgages and of guaranteeing bad debt has replaced private-market mechanisms over the past year. Despite the government's breathtaking spending and unprecedented level of debt, it is still considered a “good” borrower because it can tax its citizens. Fed Chairman Bernanke's greatest achievement was not the measly \$1.25t. of debt that he arranged to have the Fed monetize; it was convincing the government to shift the burden of debt default from the speculators and creditors to taxpayers. Let's see how these programs are faring:

Treasury Secretary Timothy Geithner said today the government is unlikely to recoup its investments in insurer American International Group Inc. or the automakers General Motors Co. and Chrysler Group LLC. The Government Accountability Office yesterday said that U.S. taxpayers will lose \$30.4 billion from the auto-industry bailout [and another] \$30.4 billion in AIG. (Bloomberg, 12/10)

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The Secretary calls these schemes “investments,” which is absurd. No one, including taxpayers, made an “investment.” Congress simply bought auto-workers’ votes with taxpayer money. Had all of these companies gone bust without the bailout, the creditors and stockholders, people who took risks to make profits, would have liquidated the companies’ assets and taken the losses themselves. Other companies would have bought the assets and continued employing people—though likely fewer of them—to make cars and sell insurance. But, instead, taxpayers are out \$60.8 billion. *Congress does not care.* It got what it wanted. But *at some point*, probably late in wave ③ down, voters will get mad enough start demanding that Congress stop spending their money at such a pace.

Raising Margin Requirements Is Deflationary

An EWT reader recently received this notice from his broker:

Dear Valued Client,

We want to let you know that effective December 1, 2009, the Financial Industry Regulatory Authority (FINRA) is implementing increased customer margin requirements for leveraged Exchange Traded Funds (ETFs). FINRA believes these higher margin levels are necessary in view of the increased volatility of leveraged ETFs compared with their non-leveraged counterparts. We will change our margin requirements [from 30%] to 60% for double-leveraged ETFs and 90% for triple-leveraged ETFs.

One may debate about the advisability of various margin levels, but it is clear that raising margin requirements reduces the leverage in the financial system, and that’s deflationary. This change is an expression of increasing *caution*, which is borne of a trend toward negative social mood.

Congress Will Soon Hamper the Fed

Everyone talks about how the Fed can just “print money” at will, as if no one will ever get in the way. It has indeed been monetizing a lot of debt recently to bail out its buddies in the banking industry. But at some point actual human beings—the ones who participate in social mood trends—get involved and muddy the waters. Bloomberg (10/30) reports that an angry Congressman, who happens to be “the ranking member of the House Oversight and Government Reform Committee,” has sent letters to the New York Fed and AIG demanding to see all of their correspondence regarding the Fed’s payoff on AIG’s credit-default contracts, which amounted to using \$62 billion to cover 100 percent of all of the bad bets placed by “Goldman Sachs Group Inc., Societe Generale SA and Deutsche Bank AG” *over the objections of AIG*, which wanted to negotiate a lower payout. Spokesmen for the New York Fed and AIG “declined to comment.” The negative trend of social mood that produced the Watergate scandal of 1974 is at work once again. Political actions such as this will hamper the Fed’s ability to bail out the biggest gamblers among its friends, a.k.a. “to provide liquidity to distressed institutions.”

Another Bloomberg report tells of more mischief to come:

Frank, a Massachusetts Democrat and the committee chairman, said in an Oct. 7 interview he wants to review the “whole governance structure” of the Fed next year. In April, Dodd and Shelby won passage, by a 96-2 vote, of a non-binding resolution calling in part for an “evaluation of the appropriate number and the associated costs” of Fed district banks. Representative Ron Paul, a Texas Republican who has called for abolishing the Fed, has gained 307 co-sponsors for legislation to require an audit of the central bank. (Bloomberg, 10/30)

Since then, the audit-the-Fed bill has morphed into an amendment to the massive bill to regulate the financial industry that is making its way through Congress. Obviously, the Fed today has a lot more than a pack of neo-Austrian economists to worry about. It has Congress to worry about, and there is no more destructive body on the face of the earth.

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The Fed Will Soon Hamper Itself

The market for “securitized debt” is as dead as an armadillo on a Texas state highway. So why is the market holding on?

Here is one reason: “Through TALE, the Federal Reserve lends cheap money to investors such as hedge funds as long as they use it to buy securities backed by credit card, car loans and other sectors earmarked for support.... 70 per cent of the \$134bn of new deals this year [are] backed by TALE.” (FT, 12/9) But when the consumer debt begins to implode again, even hedge funds will not want it, and either they will try to sell the stuff, which won't work, or they will go bust, with IOUs to the Fed on their books. At some point, the Fed will have to stop this particular shenanigan.

A bigger reason why debt securities haven't crashed is that the Fed all year has been swapping its direct loans to institutions for securitized mortgages. (See Figure 3.) Why is it taking this unprecedented step? Last year, the Fed held mostly IOUs from financial institutions, and those IOUs were backed by whatever the institutions had in their portfolios. This strategy didn't work too well. A recent report sheds some light on the poor quality of some of these assets:

A \$29 billion trail from the Federal Reserve's bailout of Wall Street investment bank Bear Stearns ends in a partially deserted shopping center on a bleak spot on the south side of Oklahoma City. The Fed now owns the Crossroads Mall, a sprawling shopping complex at the junction of Interstate highways 244 and 35, complete with an oil well pumping crude in the parking lot—except the Fed does not own the mineral rights. The Fed finds itself in the unusual situation of being an Oklahoma City landlord after it lent JPMorgan Chase \$29 billion to buy Bear Stearns last year. That money was secured by a portfolio of Bear assets. Crossroads Mall is the only bricks and mortar acquired through bailout. The remaining billions are tied up in invisible securities spread across hundreds, if not thousands, of properties. It is hard to be precise because the Fed has not published specifics on what it now owns. The only reason that Crossroads Mall has surfaced is that it went into foreclosure in April.

The value of the [Fed's] commercial loan holdings has already been written down to \$4.4 billion. In part, this decline in value is because two other pieces of the Bear Stearns collateral—Extended Stay Hotels, and the GrandStay Residential Suites Hotels in Oxnard, California —have sought court bankruptcy protection.

Losses are potentially at taxpayer's expense because the Fed generally makes a fat annual profit running the country's payments system and other operations, and any losses reduce how much it can pay out to the U.S. Treasury, and hence taxpayers. (Reuters, 10/21)

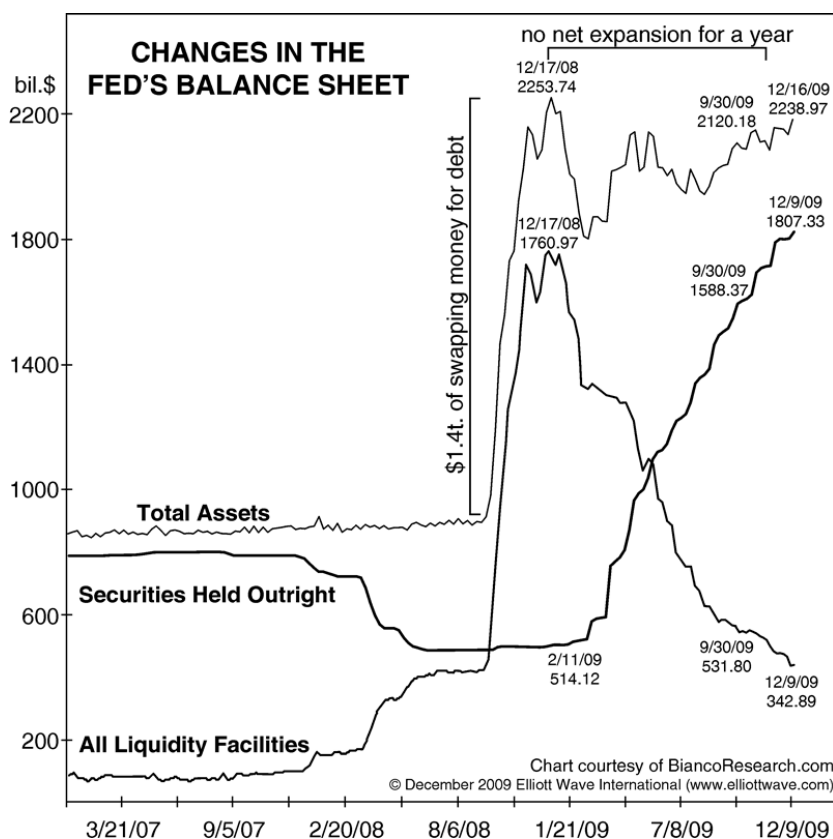


Figure 3

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Perhaps reacting to such developments, the Fed switched its strategy to the outright buying of securitized debt, comprising mostly government-guaranteed mortgages. During 2009, it exchanged \$1 trillion worth of direct loans to financial institutions—which were backed by those institutions' assets—for an equivalent amount of outright-owned debt securities. The intent of this program is to sop up mortgages from the market and to keep interest rates on mortgages low so that private borrowers can get low rates from banks. But in buying up mortgages, the Fed may have done something stupid. Holding IOUs from financial firms seems to be a safer way to go, because the Fed could always have written the loans with highly favorable terms to itself, so that it could require the institution to sell enough assets to make good on the loan. During crunch time, the Fed could have chosen to extend the maturities of such loans while expanding the institutions' obligations behind them. But the Fed's new policy of providing liquidity by accumulating a portfolio of owned securities has put the central bank in the same position as any other doofus whose portfolio is full of dubious IOUs, which is to say: at the mercy of the marketplace. True, it is currently making a nice 4% annualized profit on these holdings. But any downward adjustment in asset prices will directly affect the value of the Fed's portfolio.

There is another twist to the situation. James Bianco informs us, "banks are required to cover Federal Reserve losses," which means that any losses it incurs "will hit the entire banking system." (Bianco Research, 12/3) So with its asset-buying scheme, the Fed is juggling fire with both hands: It is gambling with its own health and that of the entire banking system. It always amazes me that people think the Fed can make losses disappear. The Fed hopes that a mere recession has ended and that recovery will improve the value and liquidity of the debt it owns. But this is a *depression*, and the bill for lunch will end up on the table for someone to pay. That someone may turn out to be the Fed, and if so, ultimately the very banks that the Fed is trying to help.

This situation is deflationary, because the Fed's experience in owning mortgages should have the effect of making members of the Fed *more conservative*. Some Fed governors already dislike the new portfolio that the Fed is holding: "Federal Reserve Bank of Philadelphia President Charles Plosser said the central bank should limit the securities on its balance sheet to Treasuries." (Bloomberg, 10/21). Plosser, a former professor, is "among the strong internal critics of the Fed's efforts." He worries, quite accurately, that the Fed may have trouble exiting its mortgage-backed securities, whether because of market pricing, politics or both. The Fed might have been comfortable lending more money to institutions if they had recourses for payment. But if the Fed incurs losses, it is doubtful that the Board will approve many more trillion-dollar acquisitions of mortgage debt. Such investments, if allowed to continue, will ruin the Fed. By following this aggressive policy move during 2009, the Fed has set itself up to do in 2010 just what the big bankers did in 1929: holler "uncle."

I would not be surprised if by the end of the bear market the Fed owns more Treasuries than anything else, just as it did throughout the collapse of 1929-1932. It's an interesting conundrum. If the Fed keeps buying mortgages, it will commit suicide. If it doesn't, the politicians will probably kill it for having been self-interested.

The Fed's Presumed Inflation Since 2008 Is Mostly a Mirage

Many commentators talk about inflationary forces running rampant. We all know that the Fed created \$1.4 trillion new dollars in 2008. It has told the world that it will inflate to save the monetary system. So that is the news that most people hear.

But the Fed's dramatic money creation in 2008 only *seems* to force inflation because people focus on only one side of the Fed's action. Even though the Fed created a lot of new money, it did not affect the total amount

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of money-plus-credit one bit, because the other side of the action is equally deflationary. When the Fed buys a Treasury bond, net inflation occurs, because it simply monetizes the government's brand-new IOU. But in 2008, in order for the Fed to add \$1.4 trillion new dollars to the monetary system, it *removed* exactly the same value of IOU-dollars from the market. It has since retired some of this money, leaving a net of about \$1.3 trillion. So *investors*, who previously held \$1.3t. worth of IOUs for dollars, now hold \$1.3t. worth of dollars. They are no longer debt investors but money holders. The net change in the money-plus-credit supply is zero. The Fed simply *retired* (temporarily, it hopes) a certain amount of debt and replaced it with money. In fact, if the Fed is to be believed, it desperately wants to sell the rest of these (in)securities and retire the new money. I doubt it will happen, but it doesn't much matter to inflation either way.

In currency-based monetary systems, the creation of new banknotes causes—indeed forces—inflation. Likewise, the monetization of new government debt creates permanent inflation practically speaking. (Theoretically, the government could retire its debt, but it never does.) But when the Fed simply swaps money for previously existing debt, there is no net change in the amount of dollar-based “purchasing power” on the planet.

The theory among monetarists is that these new dollars are hot money that creditors can now re-lend. Thus, it will multiply throughout the banking system. At first it might seem that new money in banks' hands should be more powerful for creating inflation than the previously-held FNM mortgages. But this is not the case, because the main thing for which the Fed wants banks to lend out the new dollars is *new mortgages*. Today, bankers and other creditors are afraid of mortgages, and they don't want new mortgages any more than they want the old ones. In the mortgage-intoxicated, pre-2008 world, there would have been little significant difference in the paper, because banks were creating new dollars any time they wanted by taking on new mortgages. In the mortgage-repelled, post-2008 world, guess what: there is still little significant difference in the paper, because virtually the only thing banks can use it for is to fund mortgages! The only other outlet for the Fed's new money is to fund market speculation, which is one reason why the stock and commodity markets rose.

What is *very* different—as predicted in *Conquer the Crash*—is the desire of lenders to lend and of borrowers to borrow, which has shriveled dramatically. This abrupt change resulted from the *change in the trend of social mood* at Supercycle degree that took place between 2005 and 2008, when real estate, stocks and commodities peaked along with the ability of the banking system to write one more mortgage without choking to death.

Evidence for this case is in Figure 4. Even though the Fed has swapped over a trillion dollars of new money for old debt, the banks

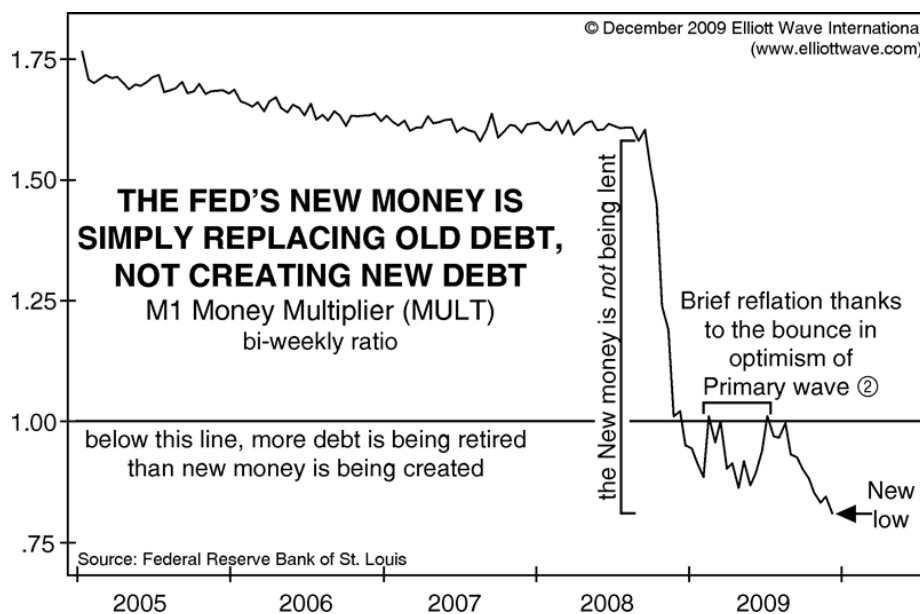


Figure 4

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aren't lending it. Primary wave ② allowed the money multiplier to rally to zero, but that trend ended around August, when the real Dow (Dow/gold) peaked out. The money multiplier is back in negative territory, which means that there is more debt being retired than there is new money being created. In other words, deflation is winning.

The bottom line is that the Fed hasn't created much inflation over the past two years. The only reason that markets have been rallying recently is that the *Elliott wave form required a rally*. In other words, in March 2009 pessimism had reached a Primary-degree extreme, and it was time for a Primary-degree respite. The change in attitude from that time forward has, for a time, allowed credit to expand again. But the Fed and the government didn't force the change. They merely accommodated it, as they always have. They offered unlimited credit through the first quarter of 2009, and no one wanted it. In March, the social mood changed enough so that some people once again became willing to take these lenders up on their offer.

When credit collapses again during the wave ③ downtrend, we at Elliott Wave International will no longer have to keep "making the case" that the Fed is impotent. It will be clear once again, just as it was in 2008. When Primary wave ④ causes the market to rebound from a much lower level, pundits will undoubtedly tell us once again that the Fed has succeeded in causing a turnaround. The reason that most people's reasoning on such matters keeps changing is that their thought processes with regard to financial markets never do change. They continually rationalize the stock market's actions based on changes in their mood and their mental default to exogenous cause.

Excerpted from the June 18, 2010 Elliott Wave Theorist

Recent correspondence to EWI has served up additional questions about deflation:

Q: Some people believe that a process of de-leveraging is happening, but they do not believe in the deflation theme.

A: It's the same theme. The "money supply" is virtually all credit. De-leveraging reduces the total volume of credit, which is deflation.

Q: A key point is the policy of Quantitative Easing (QE), whereby central banks trade new money—created out of thin air—for old debt. It seems that monetary easing will lead to moderately rising financial asset prices due to QE inflation and a resulting weak dollar.

A: If that were true, then Japan would be awash in inflation. All QE has done there is to add miserable uncertainty and water-torture slowness to the deflationary process. Despite massive intervention over two long decades, its stock market is down 75% and its real estate prices are down 50%. The same thing is starting to happen here. David Rosenberg of Gluskin Sheff is one of the few deflationists around. On May 11, after the post-flash-crash bounce, he said, "It's a sad deflationary reality when a trillion dollars can only buy you 400 points on the Dow. What can the politicians do for an encore?" We know the answer: borrow and lend, borrow and spend, faster and faster. But when credit, not money, is the medium, these reckless policies cannot fail to result in a deflationary crash. It will be interesting to see what the Fed's governors do when some issuers of the debt it owns stop paying interest and threaten to default on principal. I doubt they will take it lightly. And I don't think they will take on even riskier stuff.

Q: Don't you think that without QE and massive government spending there would be a much rougher, more deflationary outcome?

A: This type of argument has two sides. One could argue that central bank and government policies will lead to greater debt-related panic later than what might have happened otherwise. If creditors lose confidence in German and American sovereign debt, look out.

Q: It seems that the question isn't whether it'll work; it's whether the political winds will shift to prevent the Fed from pursuing an adequate QE policy.

A: If the political winds shift to prevent further QE, then the policy won't have worked. I argued in my book that the trend toward negative social mood will ultimately stymie the Fed and the government's ability to generate more credit. The new trend is already manifesting. The Fed has QE'd only \$1.4t., and already people are up in arms about it.

Q: What's wrong with QE?

A: What's right with it? QE shifts the burden of IOU failure from wildly speculating creditors onto innocent people.

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Q: I mean, why will QE prove ineffective?

A: QE already seems to be ineffective, wouldn't you say? Bank credit is contracting. Commodity indexes are 50% below where they were in 2008, *before* the record QE. And the dollar is nearly back to where it was in early 2009. None of the believers in omnipotent monetary authorities and their pledges to inflate saw any of *those* changes coming. Meanwhile, we couldn't see how it could turn out any other way. The largest inverted debt pyramid in the history of the world is the reason that QE won't work. The future is already fully mortgaged.

Q: Recently credit spreads have been widening. I suppose that is a sign that something isn't working.

A: For sure! Creditors are sobering up. They are beginning to be concerned that central banks won't buy up every IOU on the planet, so they are trying to figure out which ones to jettison. That's why prices for credit default swaps are edging up, too.

Q: But the Fed could buy a lot more.

A: Yes, it could. Today's buying consortium of the Fed and the government is gargantuan, as both entities have the privilege of stealing from producers and savers. But I think it's just a bigger version of the bank consortium of 1929, which promised to keep stock prices up but failed. Buying into a bear market that's bigger than you are is suicidal. I think this consortium will fail, too. A Grand Supercycle bear market is going to be stronger than the government and the Fed combined.

Q: But the whole inflation case seems so logical.

A: Exogenous-cause logic always seems compelling. But the true underlying cause of financial and macroeconomic trends is waves of social mood. When inflation returns, it will be because people regain their optimism and start borrowing and lending again, not because someone in power pulled the right lever.



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