Elliott Wave International

Independent Investor eBook

The groundbreaking and powerful book that teaches investors how to think independently

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Independent Investor eBook

Independent Investor eBook Update: How To Invest During a Long-Term Bear Market

Preface to the Update of the Independent Investor eBook

Being an independent investor never goes out of style — whether the markets are bullish or bearish. When we first published this Independent Investor eBook in 2007, we intended to give our readers a solid grounding in the contrarian method, so that they would be equipped to succeed in any kind of market.

Our No.1 investing rule to live by: When everyone else sells, the independent investor starts buying; conversely, when everyone else buys, the independent investor knows that it's time to sell.

In these brief essays, Bob Prechter helps investors recognize that the conventional wisdom most people subscribe to will only lead them to invest in the same way the herd is investing — which is to say, not wisely.

The markets looked bullish when this eBook first came out, so our hope was that we could prepare independent thinkers for a change. We believed that a bear market of grand proportions was on its way. We also knew that it would take guts to prepare for it. Since then, a major bear market arrived, which managed to catch most investors off-guard. Except for those who read and heeded this eBook.

Even within a larger bear market, though, the markets can rally and start to convince investors that a bull market is back. We don't want you to be fooled like the rest of them. We want you to think for yourself. To that end, we've updated this Independent Investor eBook with new insights from Bob Prechter about how to invest during a long-term bear market. These six new chapters should keep you ahead of the herd and more in control of your own destiny, during a big downtrend as well as during the inevitable rallies within the bear market.

Susan C. Walker
Update Editor

Introduction

Following the news headlines to make sense of the markets is like relying on a rear-view mirror at a fork in the road. In other words, it's *crazy* to think that following the price of oil today is the best way to make money in stocks tomorrow. So, too, is dissecting every word from the Fed as basis for your investments. Although these commonly held views are often called rational, they're far from it.

The fact is, there's nothing rational or "efficient" when it comes to backward-looking financial market fundamentals. That's where the *Independent Investor* ***eBook*** **wields its value,** exposing these assumptions for what they really are: Wall Street myths disguised as reality.

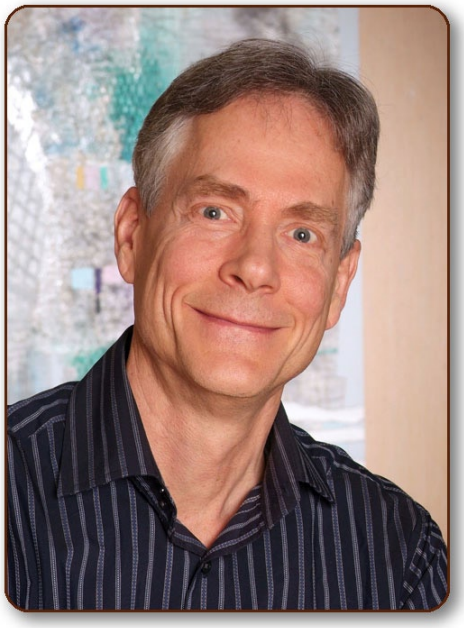
The reports you and your friends will receive in the *Independent Investor eBook* will challenge conventional notions about investing and explain market behaviors that most people consider "inexplicable."

And don't forget, as a Club EWI member, you have access to additional free resources on your Club EWI homepage: **www.elliottwave.com/club**

I know you will enjoy the *Independent Investor eBook*. Each chapter was handpicked from some of the most groundbreaking and eye-opening reports in the history of Elliott Wave International.

Robert Folsom
Your Club EWI Manager

About the Author



Robert R. Prechter, Jr., CMT, began his professional career in 1975 as a Technical Market Specialist with the Merrill Lynch Market Analysis Department in New York. He has been publishing *The Elliott Wave Theorist*, a monthly forecasting publication, since 1979. Currently he is president of Elliott Wave International, which publishes analysis of global stock, bond, currency, metals and energy markets. He is also Executive Director of the Socionomic Institute, a research group.

Mr. Prechter has won numerous awards for market timing, including the United States Trading Championship, and in 1989 was awarded the “Guru of the Decade’’ title by Financial News Network (now CNBC). He has been named ``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*.

Mr. Prechter is author, co-author and/or editor of 15 books, including *Elliott Wave Principle – Key to Market Behavior* (1978), *R.N. Elliott’s Masterworks* (1980), *The Wave Principle of Human Social Behavior and the New Science of Socionomics* (1999), *Conquer the Crash* (2002), *Pioneering Studies in Socionomics* (2003), and *How to Forecast Gold and Silver Using the Wave Principle* (2006).

1 What Really Moves the Markets?

From *The Elliott Wave Theorist*
May and June 2004

What Really Moves The Markets?

If you said "the news," you're in for a big surprise. This remarkable study presents very compelling arguments in favor of other, real reasons behind market fluctuations. Read what those reasons are.

This report originally appeared in the May and June 2004 issues of *The Elliott Wave Theorist*, Robert Prechter's monthly market analysis publication.

See if you can answer these four questions:

1) In 1950, a good computer cost $1 million. In 1990, it cost $5000. Today it costs $1000. **Question: What will a good computer cost 50 years from today?**

2) Democracy as a form of government has been spreading for centuries. In the 1940s, Japan changed from an empire to a democracy. In the 1980s, the Russian Soviet system collapsed, and now the country holds multi-party elections. In the 1990s, China adopted free-market reforms. In March of this year, Iraq, a former dictatorship, celebrated a new democratic constitution. **Question: Fifty years from today, will a larger or smaller percentage of the world's population live under democracy?**

3) In the decade from 1983 to 1993, there were ten months of recession in the U.S.; in the subsequent decade from 1993 to 2003, there were 8 months of recession. In the first period, expansion was underway 92 percent of the time; in the second period, it was 93 percent. **Question: What percentage of the time will expansion take place during the decade from 2003 to 2013?**

4) In 1970, Reserve Funds kicked off the hugely successful money market fund industry. In 1973, the CBOE introduced options on stocks. In 1977, Michael Milken invented junk bond financing, which became a major category of investment. In 1982, stock index futures and options on futures began to trade. In 1983, options on stock indexes became available. Keogh plans, IRAs and 401k's have brought tax breaks to the investing public. The mutual fund industry, a small segment of the financial world in the late 1970s, has attracted the public's invested wealth to the point that there are more mutual funds than there are NYSE stocks. Futures contracts on individual stocks have just begun trading. **Question: Over the next 50 years, will the number and sophistication of financial services increase or decrease?**

Observe that I asked you a *microeconomic* question, a *political* question, a *macroeconomic* question and a *financial* question.

Trend Extrapolation

If you are like most people, you extrapolated your answers from the trends of previous data. You expect cheaper computers, more democracy, an economic expansion rate in the 90-95 percent range, and an increase in financial sophistication.

It appears sensible to answer such questions by extrapolation because people default to physics when predicting social trends. They think, "Momentum will remain constant unless acted on by an outside force." This mode of thought is deeply embedded in our minds because it has tremendous evolutionary advantages. When Og threw a rock at Ugg back in the cave days, Ugg ducked. He ducked because his mind had inherited and/or learned the consequences of the Law of Conservation of

Momentum. The rock would not veer off course because there was nothing between the two men to act upon it, and rocks do not have minds of their own. Earlier animals that incorporated responses to the laws of physics lived; those that didn't died, and their genes were weeded out of the gene pool. The Law of Conservation of Momentum makes possible our modern technological world. People rely on it every day. Despite its use in so many areas, however, it is inapplicable to predicting social change. For most people in most circumstances, the proper answer to each of the above questions is, "I don't know." (Socionomics can give you an edge in social prediction, but that's another story.)

The most certain aspect of social history is dramatic change. To get a feel for how useless—even counterproductive—extrapolation can be in social forecasting, consider these questions:

1) It is 1886. Project the American railroad industry.

2) It is 1970. Project the future of China.

3) It is 1963. Project the cost of medical care in the U.S.

4) It is 1969. Project the U.S. space program.

5) It is 100 A.D. Project the future of Roman civilization.

In 1886, you would have envisioned a future landscape combed with rail lines connecting every city, town and neighborhood. Small trains would roll around to your home to pick you up, and a network of rail lines would help deliver you to your destination efficiently and cheaply. Super-fast trains would make cross-country runs. You could eat, read or sleep along the way.

Is that what happened? Would anyone have predicted, indeed *did* anyone predict, that trains in 2004 would often be going *slower* than they did in 1886, that they would routinely jump the tracks, that they would be inefficient, that they would have little food and few sleeper cars, that the equipment would be old and worn out?

In 1970, the Communist party was entrenched in China. Over 35 million people had been slaughtered, culminating in the Cultural Revolution in which Chinese youths helped exterminate people just because they were smart, successful or capitalist. Would anyone have imagined that China, in just over a single generation, would be out-producing the United States, which was then the world's premier industrial giant?

In 1963, medical care was cheap and accessible. Doctors made house calls for $20. Hospitals were so accommodating that new mothers typically stayed for a week or more before being sent home, and it was affordable. Would anyone have guessed that forty years later, pills would sell for $2 apiece, a surgical procedure and a week in the hospital could cost one-third of the average annual wage, and people would have to take out expensive insurance policies just in case they got sick?

In the space of just 30 years, rockets had gone from the experimental stage to such sophistication that one of them brought men to the moon and back. In 1969, many people projected the U.S. space program over the next 30 years to include colonies on the moon and trips to Mars. After all, it was only sensible, wasn't it? By the laws of physics, it was. But in the 35 years since 1969, the space program has relentlessly regressed.

In 100 A.D., would you have predicted that the most powerful culture in the world would be reduced to rubble in a bit over three centuries? If Rome had had a stock market, it would have gone essentially to zero.

Futurists nearly always extrapolate past trends, and they are nearly always wrong. You cannot use extrapolation under the physics paradigm to predict social trends, including macroeconomic, political and financial trends. *The most certain aspect of social history is dramatic change*. More interesting, social change is a self-induced change. Rocks cannot change trajectory on their own, but societies can and do change direction, all the time.

Action and Reaction

In the world of physics, action is followed by reaction. Most financial analysts, economists, historians, sociologists and futurists believe that society works the same way. They typically say, "Because so-and-so has happened, such-and-such will follow." The news headlines in Figure 1, for example, reflect what economists tell reporters: *Good economic* news makes the stock market go up; bad economic news makes it go down. But is it true?

JANUARY 15, 2004 · USA TODAY

Good economic news propels markets

MARCH 2, 2004 · USA TODAY

Good economic news inspires buying

Figure 1

Figure 2 shows the Dow Jones Industrial Average and the quarter-by-quarter performance of the U.S. economy. Much of the time, the trends are allied, but if physics reigned in this realm, they would always be allied. They aren't. The fourth quarter of 1987 saw the strongest GDP quarter in a 15-year span (from 1984 through 1999). That was also the biggest down quarter in stock prices for the entire period. Action in the economy did not produce reaction in stocks. The four-year period from March 1976 to March 1980 had not a single down quarter of GDP and included the biggest single positive quarter for 20 years on either side. Yet the DJIA lost 25 percent of its value during that period. Had you known the economic figures in advance and believed that financial laws are the same as physical laws, you would have bought stocks in both cases. You would have lost a lot of money.

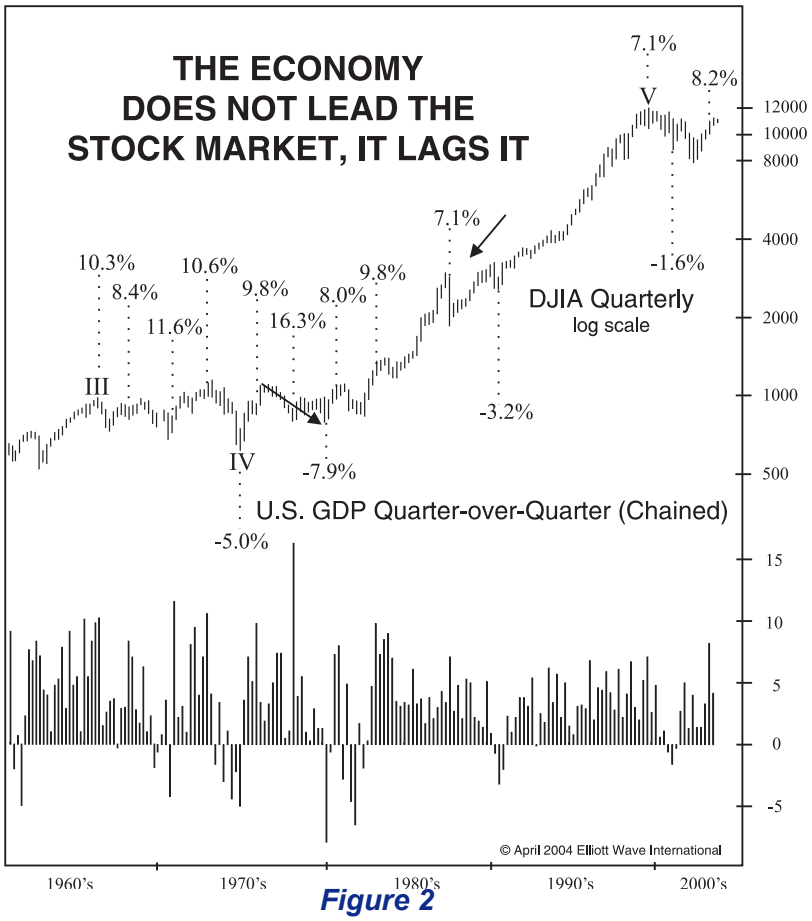


Figure 2

Figure 3

Figure 3 shows the S&P against quarterly earnings in 1973-1974. Did action in earnings produce reaction in the stock market? Not unless you consider rising earnings bad news. While earning rose persistently in 1973-1974, the stock market had its biggest decline in over 40 years.

Suppose you knew for certain that inflation *would* triple the money supply over the next 20 years. What would you predict for the price of gold? Most analysts and investors are certain that inflation makes gold go up in price. They view financial pricing as simple action and reaction, as in physics. They reason that a rising money supply reduces the value of each purchasing unit, so the price of gold, which is an alternative to money, will reflect that change, increment for increment.

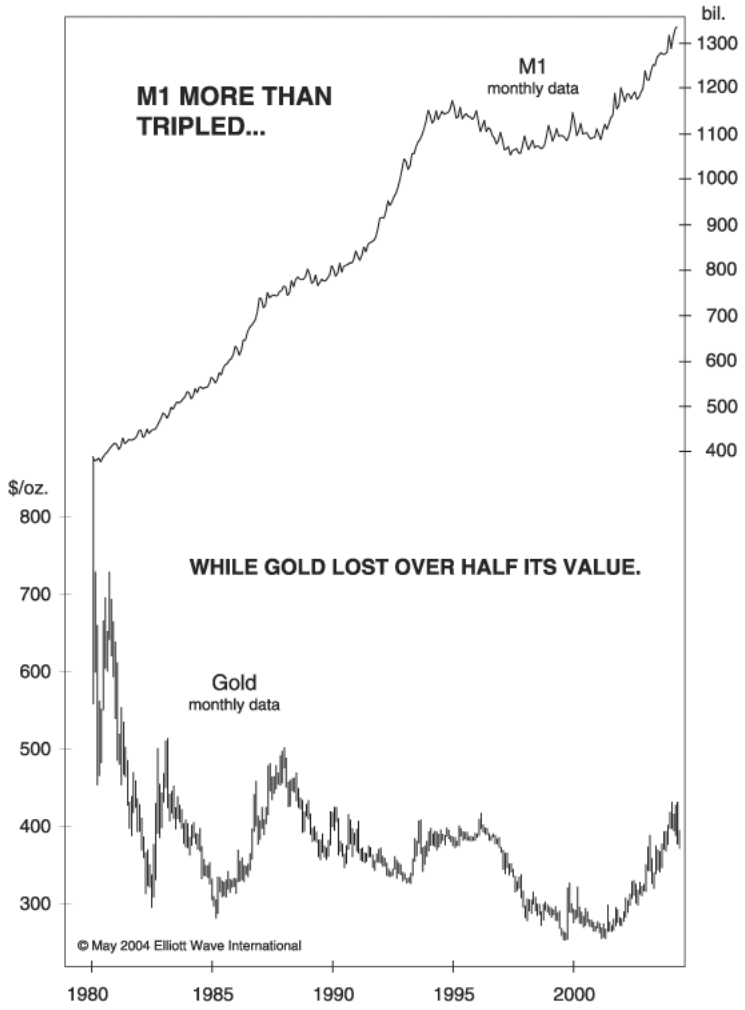


Figure 4

Figure 4 shows a time when *the money supply tripled yet gold lost over half its value*. In other words, gold not only failed to reflect the amount of inflation that occurred but also failed even to go in the same direction. It failed the prediction from physics by a whopping factor of six, thereby unequivocally invalidating it. (I was generous in ending the study now rather than in 2001, at which time gold had lost over two-thirds of its value.)

It does no good to say — as we sometimes hear from those attempting to rescue the physics paradigm in finance — that gold will follow the money supply *"eventually."* In physics, billiard balls on an endless plane do not eventually return to a straight path after wandering all over the place, including in the reverse direction from the way they are hit. (What physics-minded investor, moreover, can be sure that gold should follow the money supply rather than vice versa? Is he certain which element in the picture should be presumed to be the action and which the reaction? Maybe a higher gold price increases the value of central banks' gold reserves, letting them support more lending. Cause and effect arguments are highly manipulable when using the physics paradigm.)

We do know one thing: Investors who feared inflation in January 1980 were right, yet they lost dollar value for two decades, lost even more buying power because the dollar itself was losing value against goods and services, and lost even more wealth in the form of missed opportunities in other

markets. Gold's bear market produced *more than a 90 percent loss* in terms of gold's average purchasing power of goods, services, homes and corporate shares despite persistent inflation! How is such an outcome possible? Easy: *Financial markets are not a matter of action and reaction.* The physics model of financial markets is wrong.

Cause and Effect

In the 1990s, a university professor sold many books that made a case for buying "stocks for the long run." In a recent issue of *USA Today*, he told a reporter, "Clearly, the risk of terror is the major reason why the markets have come down. We can't quantify these risks; it's not like flipping a coin and knowing your odds are 50-50 that an attack won't occur."[1]

In other words, he accepts the physics paradigm of external cause and effect with respect to the stock market but says he cannot predict the *cause* part of the equation and therefore cannot predict stock prices. The first question is, well, if one cannot predict *causes*, then how can one write a book predicting effects, i.e., arguing that stocks will go up? Or down or sideways? A second question is far more important. We have already seen that economic performance, earnings and inflation do not necessarily coincide with movements in apparently related financial markets. In fact, the two sets of data can utterly oppose each other. Is there any evidence that dramatic news events that make headlines, such as terrorist attacks, political events, wars, crises or any such events are causal to stock market movement?

Suppose the devil were to offer you historic news a day in advance. He doesn't even ask for your soul in exchange. He explains, "What's more, you can hold a position for as little as a single trading day after the event or as long as you like." It sounds foolproof, so you accept. His first offer: "The president will be assassinated tomorrow." You can't believe it. You and only you know it's going to happen. The devil transports you back to November 22, 1963. You short the market. Do you make money?

Figure 5 shows the DJIA around the time when President John Kennedy was shot. First of all, can you tell by looking at the graph exactly when that event occurred? Maybe before that big drop on the left? Maybe at some other peak, causing a selloff?

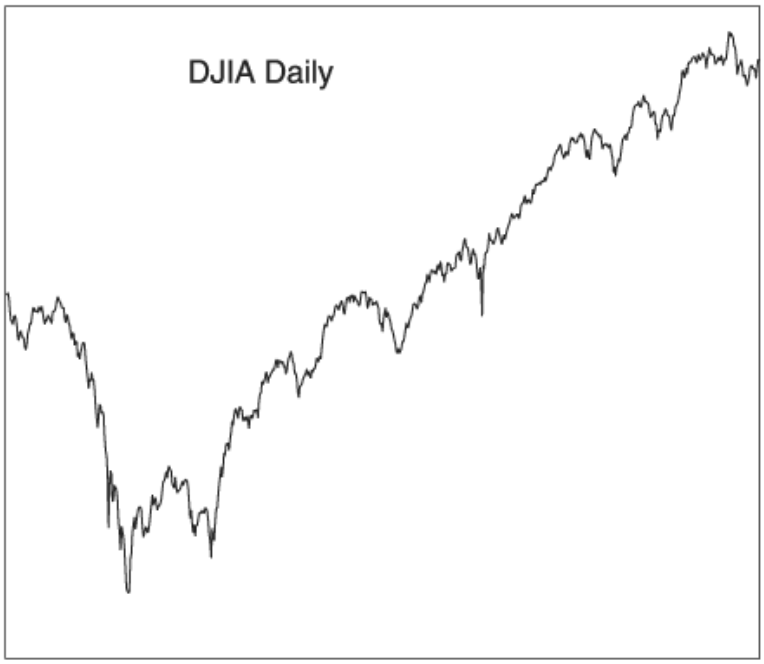


Figure 5

The first arrow in Figure 6 shows the timing of the assassination. The market initially fell, but by the close of the next trading day, it was above where it was at the moment of the event, as you can see by the second arrow. You can't cover your short sales until the following day's up opening because the devil said that you could hold as briefly as one trading day after the event, but not less. You lose money.

You aren't really angry because after all, the devil delivered on his promise. Your only error was to believe that a presidential assassination would dictate the course of stock prices. So you vow not to bet on things that aren't directly related to finance. The devil pops up again, and you explain what you want. "I've got just the thing," he says, and announces, "The biggest electrical blackout in the history of North America will occur tomorrow." Wow. Billions of dollars of lost production. People stranded in subways and elevators. The last time a blackout occurred, there was a riot in New York and hundreds of millions of dollars worth of damage done. How more directly related to finance could you get? "Sold!" you cry. The devil transports you back to August 2003.

Figure 7 shows the DJIA around the time of the blackout. Does the history of stock prices make it evident when that event occurred? After all, if markets are action and reaction, then this economic loss should show up unmistakably, shouldn't it? There are two big drops on the graph. Maybe it's one of them.

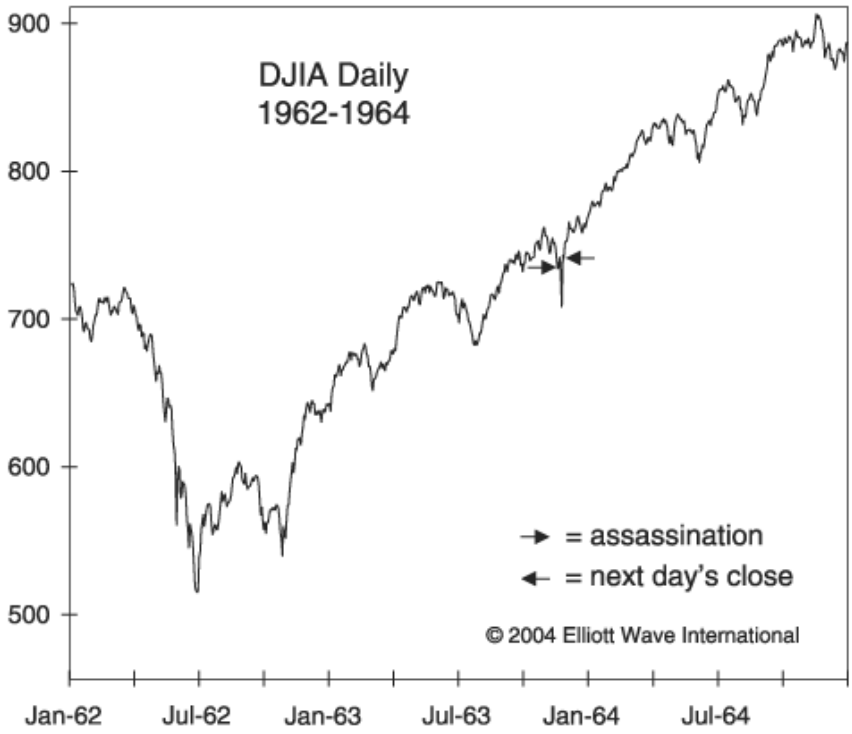


Figure 6

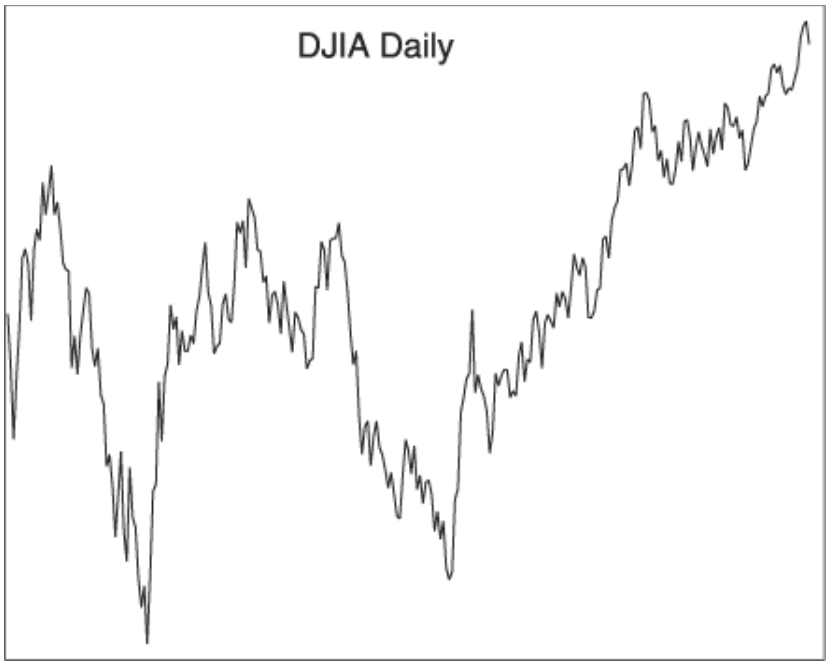


Figure 7

The arrow in Figure 8 shows the timing of that event. Not only did the market fail to collapse, *it gapped up the next morning!* You sit all day with your short sales and cover the following day with another loss.

"Third time's the charm," says the devil. You reply, "Forget it. I don't understand why the market isn't reacting to these causes. Maybe these events you're giving me just aren't strong enough." The devil leans into your ear and whispers, "Two bombs will be detonated in London, leveling landmark buildings and killing 3000 people. Another bomb planted at Parliament will misfire, merely blowing the side off the building. The terrorist perpetrators will vow to continue their attacks until England is wiped out." He promises that you can sell short on the London Stock Exchange ten minutes before it happens and even offers to remove the one-day holding restriction. "Cover whenever you like," he says. You agree. The devil then transports you to a parallel universe where London is New York and Parliament is the Pentagon. It's September 11, 2001.

Figure 9 shows the DJIA around that time. Study it carefully. Can you find an *anomaly* on the graph? Is there an obvious time when the shocking events of "9/11" show up? If markets reacted to "exogenous shocks," as billiard balls do, there would be something obviously *different* on the graph at that time, wouldn't there? But there isn't.

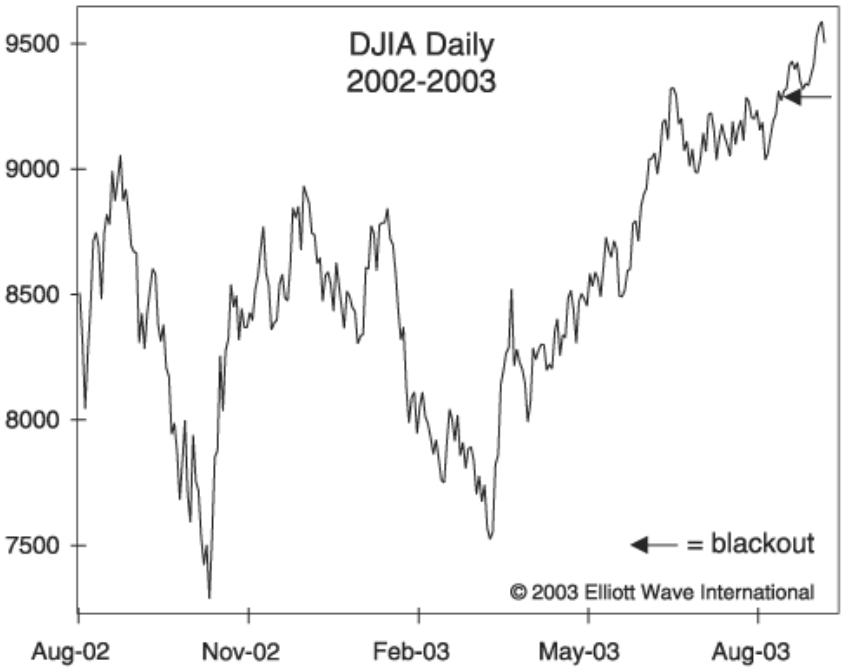


Figure 8

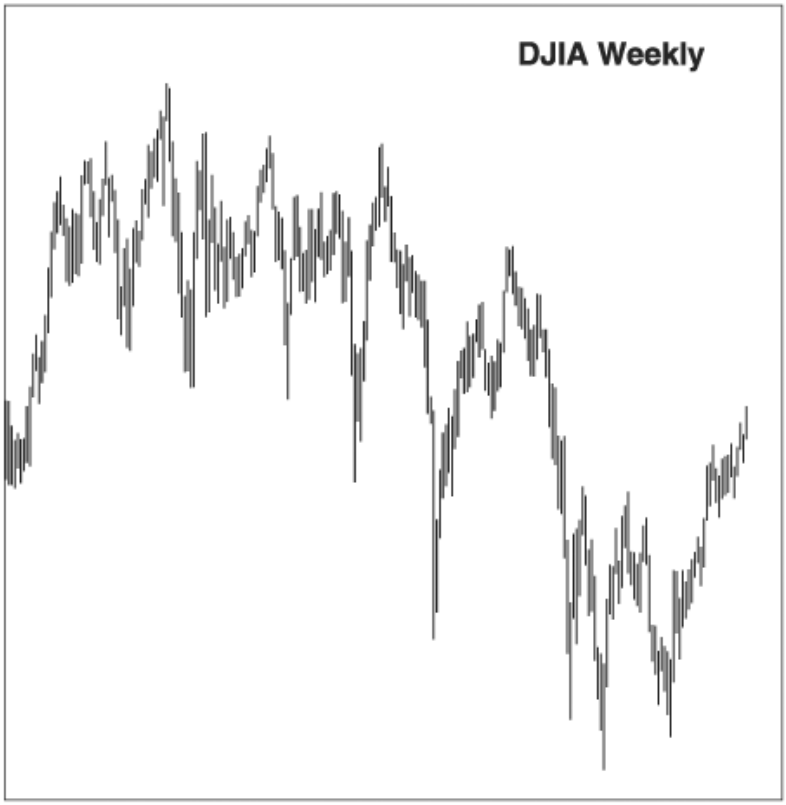


Figure 9

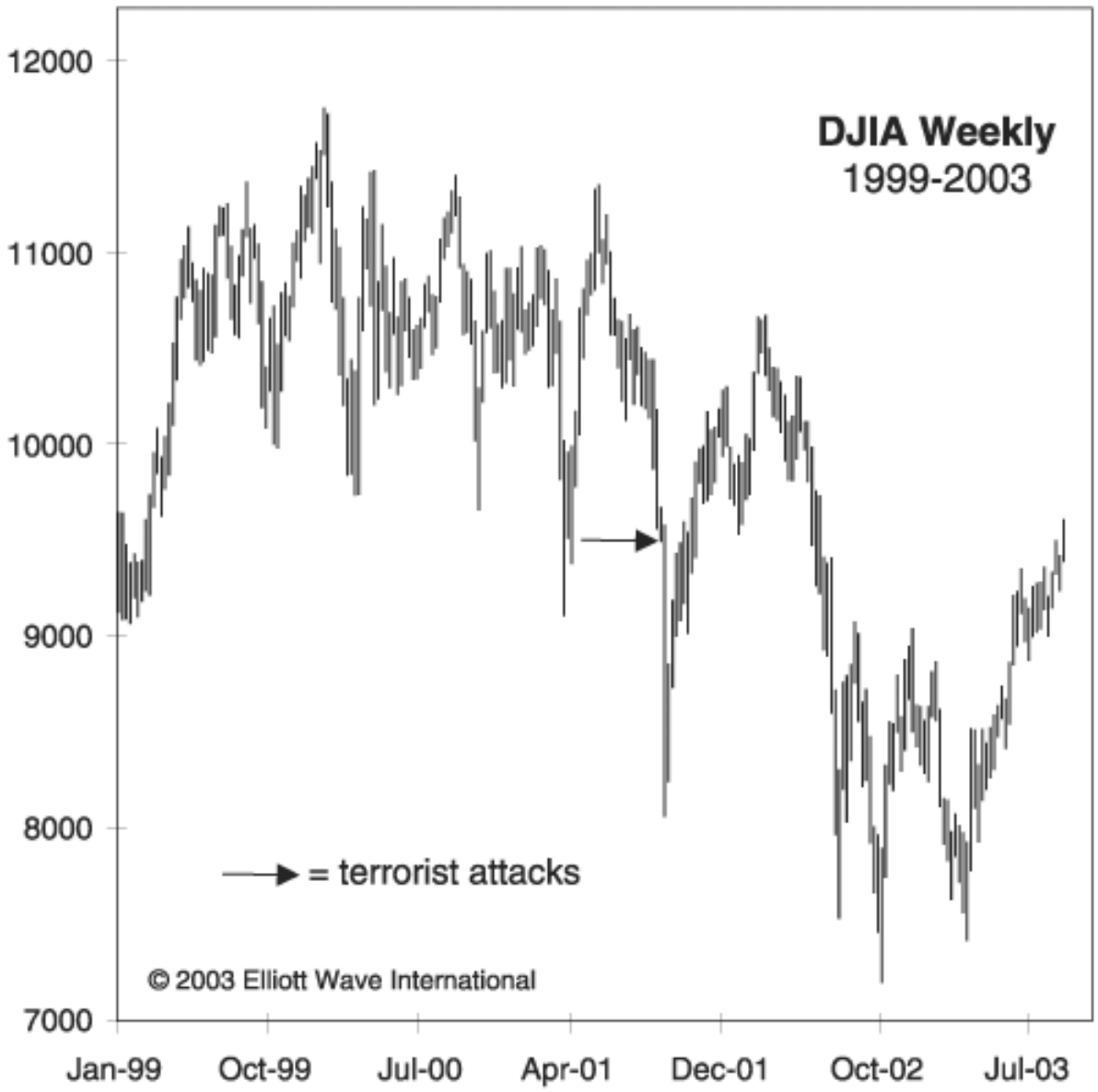


Figure 10

Figure 10 shows the timing of the 9/11 terrorist attacks. You may recall that authorities closed the stock market for four trading days plus a weekend. Question: Was it a certainty that the market would re-open on the downside? No! Some popular radio talk-show hosts and administration officials advocated buying stocks on the opening just to "show 'em." You sit with your massive short position, and you are nervous. But you are also lucky. The market opens down, continuing a decline that had already been in force for 17 weeks. You cheer. You're making money now! Well, you do for six days, anyway. Then the market leaps higher, and somewhere between one week and six months later you finally cover your shorts at a loss, disgusted and confused. If you are an everyday thoughtful person, you decide that events are irrelevant to markets and begin the long process of educating yourself on why markets move as they do. If you are a conventional economist, you don't bother.

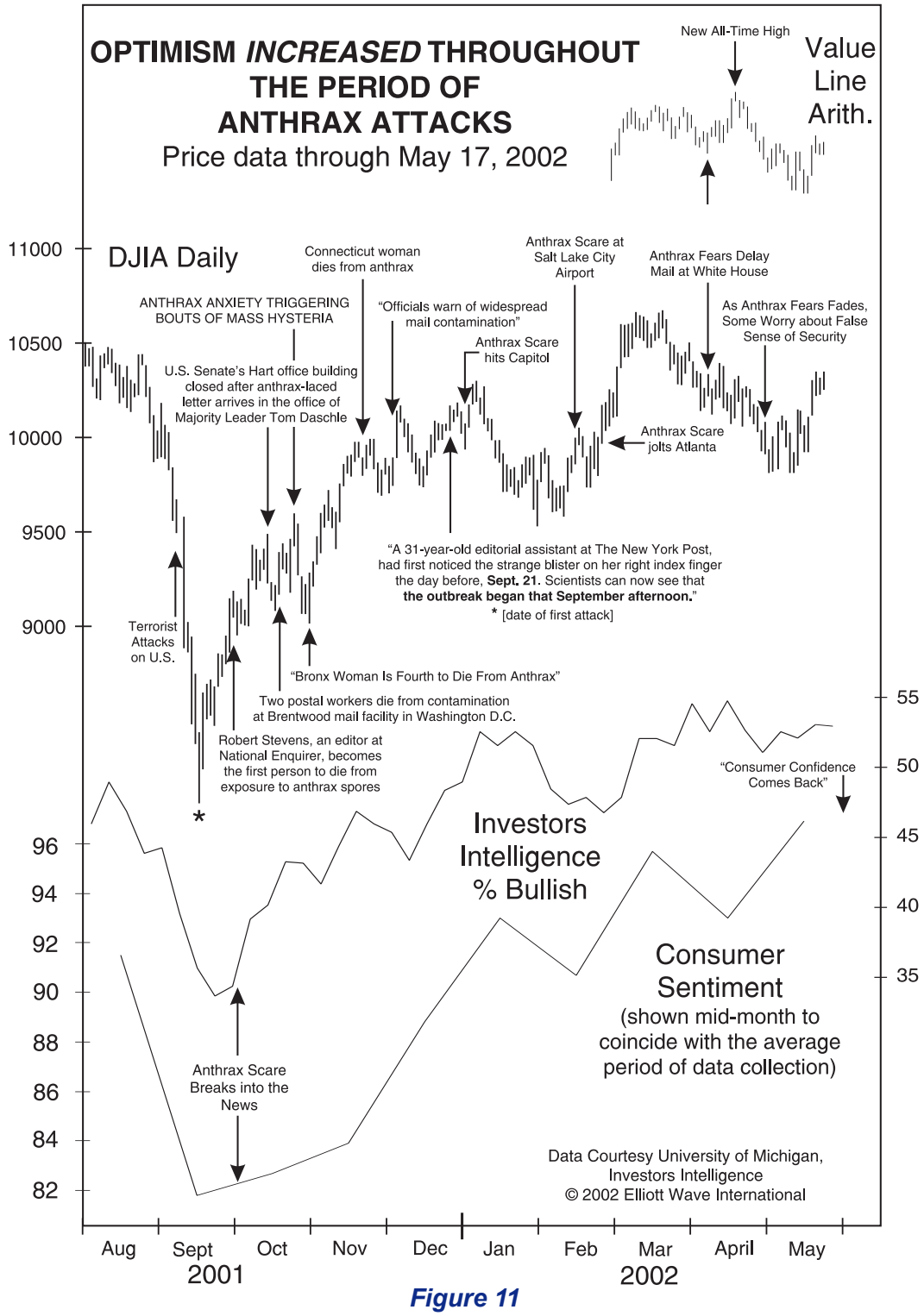


Figure 11

In case you still think that terrorism is a factor somewhere in the falling markets of 2000-2002, please read "Challenging the Conventional Assumption About the Presumed Sociological Effect of Terrorist News," which is reprinted in *Pioneering Studies in Socionomics*. It shows unequivocally that the terrorist events and related fears of that time encompassed a period when the market mostly went up and consumer sentiment improved. The graph that accompanies that study is reproduced here as Figure 11.

Now think about this: In real life, *you don't get to know about dramatic events in advance*. Investors who sold stocks upon hearing of the various events cited above did so because they believed that events cause changes in stock values. *They all sold the low*. I chose bad news for these exercises because it tends to be more dramatic, but the same irrelevance attaches to good news.

Since knowing dramatic events in advance would produce no value for investing, *guessing* events is an utter waste of time. There are no "inefficiencies" related to external causality that one may exploit.

If news is irrelevant to markets, how can the media explain almost every day's market action by the news? Answer: *There is a lot of news every day*. Commentators don't write their cause-and-effect stories before the session starts but after it ends. It's no trick to fit news to the market after it's closed. I am writing this paragraph the day after stocks had a big down day. The news at 8:30 a.m. yesterday was *good*, a "stronger-than-expected 1.8 percent jump in March retail sales." How, then, did this morning's newspaper, relying on cause and effect, explain yesterday's big drop? (Remember, it's easy to play games with cause and effect under the physics paradigm.) Here is the headline: "Rising-Rates Scenario Sends Stocks Reeling."[2] This and other articles present the following ex-post-facto consensus reasoning: Investors appear to have decided that the good news that the economy is "starting to accelerate" *might* mean higher interest rates, which *would* be bearish *if* it happened. This contrived conclusion is doubly bizarre given the century-long history of interest-rate data, which (as the next section will show) belies such a belief. How, moreover, does one explain the fact that the stock market opened *higher* yesterday, in concert with the standard view of such news being "good"? There was no more big news that day. Had there been some "bad" news immediately after the opening, such inventive reasoning would not have been required. The "reason" for the rout would have been obvious, just as it was on the previous down day of this size, on which terrorists conveniently bombed trains in Spain. (Let me guess. You think that this example of news causality makes sense, don't you? Sorry. Did I mention that the U.S. stock market—fully apprised of the news—rallied until *noon* that day before selling off?)

Another Example of Rationalization, Ripped from the Headlines

Almost every day brings another example of rationalization in defense of the idea that news moves markets. The stock market rallied for half an hour on the morning of April 20, peaked at 10:00 a.m., and sold off for the rest of the day. Almost every newspaper and wire service claims that the market sold off because "Greenspan told Congress that the nation's banking system is well prepared to deal with rising rates, which the market interpreted as a new signal the Fed will tighten its policy sooner rather than later."[3] Is this explanation plausible?

Point #1: Greenspan began speaking around 2:30, but the market had already peaked at 10:00.

Point #2: Greenspan said something favorable about the banking system, not unfavorable about rates. A caption in *The Wall Street Journal* reads, "Greenspan smiles, markets don't."[4] The real story here is that the market went down despite his upbeat comments, not because of them.

Greenspan's Hint on Rate Jolts Markets

—*Wall Street Journal*, April 21, 2004

Possible rate increase sends stocks reeling

—Wednesday, April 21, 2004

Point #3: Greenspan's speech was not the only news available. Most of the other news that day was good as well. As the AP reported, profits of corporations were good and "most economists don't expect the Fed to raise rates at its next meeting." So if news were causal, then on balance the market should have risen.

Point #4: The Fed's interest rate changes *lag* the market's interest rate changes. Interest rates had moved higher for months. Even if Greenspan had stated (which he didn't) that the Fed would raise its Federal Funds rate immediately, it would have been no surprise.

Point #5: Greenspan said nothing that people didn't already know, so while the fact of the speech was news, there was no news in the *content* of the speech.

Point #6: The simultaneously reported fact that "most economists don't expect the Fed to raise rates at its next meeting" contradicts the argument for why investors sold stocks. If economists don't believe it, why should we think that anyone else does?

Point #7: Greenspan *did not say* that rates would go up.

Point #8: We have no data on the history of stock market movement following mere *hints* of a possible rates rise, which means no data on which commentators could justifiably base an explanation of the market's apparent reaction to such a hint, if in fact there was one.

Point #9: *There is no evidence that a rise in interest rates makes the stock market go down*. In 1992, the Federal Funds rate was 3 percent. In December 1999, it was 5.5 percent. The Dow didn't go down during that time; it *tripled*. Rates also rose from the late 1940s to the late 1960s, during almost all of which time there was a huge bull market. Ned Davis Research has done the research and found that in the 22 instances of a single rate hike since 1917, "the Dow was always *higher*…whether three months, six months, one year or two years later."[5] In other words, if interest rates truly cause market movements, then a rate rise would be *bullish*. According to Davis, it takes a series of four to six rate increases to hurt the market, and that's if you allow the supposed negative causality to appear up to twelve months later! So even accepting the bogus claim of causality would mean that investors would have had to read into Greenspan's optimistic comment on the banking system a whole series of four to six rate rises, after which *maybe* the market would go down within a year after the final one! (The truth is that rising central-bank rates are usually a function of a strong economy, so many rate increases in a row simply mean that an economic expansion is aging, from which point a contraction eventually emerges naturally. Interest rates, like all other financial prices, are determined by the same society that determines stock prices. It's all part of the flux within the same system. Changes in interest rates are not an external cause of stock price movements, just as stock price movements are not an external cause of changes in interest rates.)

So why did so many people conclude that Greenspan's speech made the market go down? They didn't *conclude* it from any applicable data; they *just made it up*. The range of errors required for people to concoct such "analysis" is immense, from an inapplicable chronology to contradictory facts to an utter lack of confirming data to a false underlying theory. Yet it happened; in fact, it happens every day.

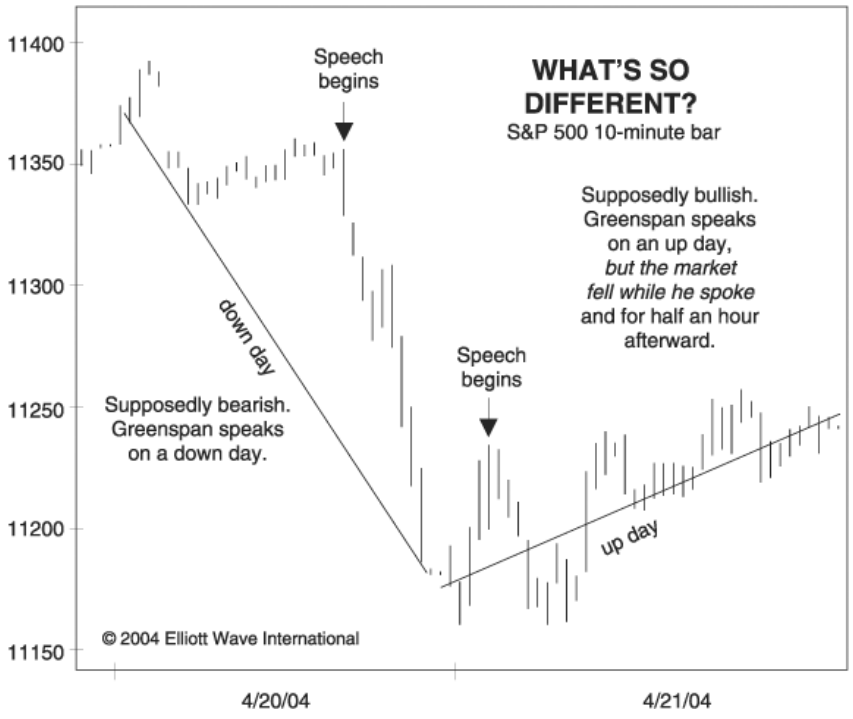
Quiz: What does this sentence from the AP article mean? "Worries that interest rates will rise sooner rather than later have distracted investors from profit reports this earnings season." Answer: It simply means, "The market went down today." There is no other meaning in all those words.

Had the market instead gone up on April 20, commentators would simply have cited as causes the numerous optimistic statements in Greenspan's address, i.e., "deflation is no longer an issue," "pricing power is gradually being restored," "inflation is "reasonably contained," labor productivity is

"still impressive," etc. There were, in fact, no — zero, none — negative statements about markets, the economy or the monetary climate in his address, which is why commentators — in order to maintain their belief in news causality — had to resort to such an elaborate rationalization to "explain" the day's price action.

> But wait. The market went up the next day, April 21. Let's see what the explanation was then: Appearing this time before the Joint Economic Committee of Congress, Greenspan reiterated that interest rates "must rise at some point" to prevent an outbreak of inflation. But he added that "as yet," the Fed's policy of keeping interest rates low "has not fostered an environment in which broad-based inflation pressures appear to be building." Analysts took that to mean the Fed might not be in such a hurry to raise short-term rates, the opposite of their reaction to his testimony to the Senate Banking Committee on Tuesday.
>
> — *The Atlanta Journal-Constitution*, April 22, 2004[6]

We read that Greenspan "reiterated" his comments; in other words, *he said essentially the same thing as the day before*, yet investors "reacted" to the statements differently and did "the opposite" of what they had done the day before.



We *know* that this argument is false. How do we know? We know because once again we take the time to look at the data. Here is a 10-minute bar graph of the S&P 500 index for April 20 and 21. On it is shown the time that Greenspan was speaking. Observe that the market fell throughout his speech on April 21. It rallied after he was done. So his speech did not make the market close up on the day. It's no good saying that there was a "delayed positive reaction," because that's not what happened the day before, when stocks were falling throughout the speech and for the rest of the day thereafter. Such ex-post-facto rationalization is common but never consistent. The conventional presumption of causality demanded an external force that made the market close up on the day, and, as usual, it manufactured one. An article that put the two days' events side by side reveals how silly the causal arguments are:

> NEW YORK — Stocks ended higher Wednesday despite Federal Reserve Chairman Alan Greenspan's acknowledgment that short-term interest rates will have to be raised at some point. The gains came a day after stocks had sold off sharply when Greenspan said pricing power was improving for U.S. companies, sparking inflation fears.
>
> — *USA Today*, April 22, 2004[7]

One interviewee stated the (false) conventional premise: “Wall Street was in a less hysterical mood than yesterday with Fed Chairman Alan Greenspan being more expansive in his view of the economy,” i.e., the news changed investors’ mood. The socionomic view is different: People’s mood came first. Greenspan’s words did not make people calm or hysterical; people’s calm or hysterical moods induce them to buy or sell stocks, and then they rationalize why they did. Since there is no difference in the news items on these two days, our explanation makes more sense. It is also a *consistent* explanation, whereas news excuses are typically contradictory to past excuses and the data.

Those offering external-causality arguments, by the way, include economists and market strategists, people who supposedly spend their professional lives studying the stock market, interest rates and the economy. Yet even they barrel ahead on nothing but limbic impulses, sans data and sans correlation, because *it seems to make sense*. It does so because most people’s thinking simply defaults to physics when analyzing financial events. But when we take the time to examine the results of applying that model, we find that it is not useful either for predicting or explaining market behavior.

Another interesting aspect of financial rationalization is that in fact there is virtually never any evidence that people actually bought or sold stocks *for the reasons cited*. The fact that people actually sold stocks on April 20 or bought them on April 21 because of these long chains of causal reasoning is dubious at best. Had you asked investors during the rout why they were buying or selling, would they actually have cited either of these convoluted interest-rate arguments? I doubt it. Most people buy and sell because the social moods in which they participate impel them to buy and sell. A news event, any news event, merely provides a referent to occupy the naive neocortex while pre-rational herding impulses have their way.

This is what’s happening: When news seems to coincide sensibly with market movements, it’s just coincidence, yet people naturally presume a causal relationship. When news doesn’t fit the market, people devise an inventive cause-and-effect structure to make it fit the day’s market action. They do so because they naturally default to the physics model of external cause and effect and are therefore certain that some external action must be causing a market reaction. Their job, as they see it, is simply to identify which external cause is operating at the moment. When commentators cannot find a way to twist news causality to justify market action, the market’s move is often chalked up to “psychology,” which means that, despite the plethora of news and ways to interpret it, no external causality could even be postulated without exposing an overly transparent rationalization. Few proponents of the physics paradigm in finance seem to care that these glaring anomalies exist.

Read again carefully the newspaper excerpt quoted above. If you at some point begin laughing, you’re halfway to becoming a socionomist.

A Model That Cannot Predict Financial Events

Let’s ask another question of our believers in the cause-and-effect physics model of finance. What was the cause in August 1982 of the start of the strongest one-year rally in stocks since 1942-1943? (Was it the bad news of the recession? No, that doesn’t make sense.) What was the cause in early October 1987 of the biggest stock market crash since 1929? (Don’t spend too much time trying to figure this one out. An article from 1999, twelve years later, says, “Scholars still debate the reason why” the stock market crashed that year.[8])

Can you imagine physicists endlessly debating the cause of an avalanche and feeling mystified that it happened? Physicists know why avalanches happen because they are using the right model for physics, i.e., physics, incorporating the laws and properties of matter and physical forces. The crash of

1987 mystifies economists because they are using the wrong model for finance, i.e., physics. They are sure that the crash was a reaction, so there must have been an external action to cause it. They can't find one. Why? Because they are using the wrong model of financial causality.

No External Causality

> The model is wrong because it assumes that each element of the social scene is as discrete as billiard balls. But they are not. Here is a pertinent passage from *The Wave Principle of Human Social Behavior*: When dealing with social events, what is an "external shock"? What is an "outside cause"? Other than the proverbial asteroid striking the earth, which presumably might disrupt the NYSE for a couple of days, or the massive earthquake or destructive hurricane that we repeatedly observe does not affect financial market behavior in any noticeable way, there is in fact, in the social context, *no such thing as an outside force or cause*. Every "external shock" ever referenced in finance is in fact an internal event. Trends in the stock market, interest rates, the trade balance, government spending, the money supply and economic performance are all ultimately products of collective human mentation. Human minds create these trends and change both them and their apparent interrelationships as well. It is men who change interest rates, trade goods, create earnings and all the rest. All social events, whether a rise in interest rates, a drop in the stock market, or even a war, are the result of collective human mentation. To suggest that such things are outside the social phenomenon under study is to presume that people do not communicate (consciously or otherwise) with each other from one aspect of their social lives to another. This is not only an unproven assumption but an absurd one. All financial events, indeed all social movements, are part and parcel of the interactive flux of human cooperation. All such forces are intimately commingled all the time. Yet to the conventional analyst, each is as detached a cause as a cue stick striking a billiard ball. It is this error that so profoundly undermines the conventional approach.[9]

The more useful model of social (including financial) causality is socionomics, the theory that aggregated unconscious impulses to herd conform to the Wave Principle, a patterned robust fractal. In this model, social actions are not causes but rather effects of endogenous, formologically determined changes in social mood. To learn more about this new model of finance, see the April and May issues of *The Elliott Wave Theorist* and the two-volume set, *Socionomics*.

Many people, by the way, dismiss the Wave Principle as impossible because they think that news and events move the market. We have shown that this notion is highly suspect. I hope that the demonstrations offered in this and the previous issue remove a primary impediment to a serious exploration of the Wave Principle model of financial markets.

A Stone's Throw

This discussion about the natural tendency of people to apply physics to finance explains why successful traders are so rare and why they are so immensely rewarded for their skills. There is no such thing as a "born trader" because people are born — or learn very early — to respect the laws of physics. This respect is so strong that they apply these laws even in inappropriate situations. Most people who follow the market closely act as if the market is a physical force aimed at their heads. Buying during rallies and selling during declines is akin to ducking when a rock is hurtling toward you. Successful

traders learn to do something that almost no one else can do. They sell near the emotional extreme of a rally and buy near the emotional extreme of a decline. The mental discipline that a successful trader shows in buying low and selling high is akin to that of a person who sees a rock thrown at his head and refuses to duck. He thinks, I'm betting that the rock will veer away at the last moment, of its own accord. In this endeavor, he must ignore the laws of physics to which his mind naturally defaults. In the physical world, this would be insane behavior; in finance, it makes him rich. Unfortunately, sometimes the rock does not veer. It hits the trader in the head. All he has to rely upon is percentages. He knows from long study that most of the time, the rock coming at him will veer away, but he also must take the consequences when it doesn't. The emotional fortitude required to stand in the way of a hurtling stone when you might get hurt is immense, and few people possess it. It is, of course, a great paradox that people who can't perform this feat get hurt over and over in financial markets and endure a serious stoning, sometimes to death. Many great truths about life are paradoxical, and so is this one.

NOTES:

[1] Shell, Adam. (March 23, 2004.) "Fear of terrorism jolts stock market," *USA Today*.

[2] Walker, Tom. (April 14, 2004.) "Rising rates scenario sends stocks reeling," *The Atlanta Journal-Constitution*, p.D5.

[3] Associated Press, "Possible rate increase sends stocks reeling," *The Atlanta Journal-Constitution*, p. C5. May 21, 2004.

[4] The real story here is that the market went down *despite* his upbeat comments, not because of anything he said.

[5] Walker, Tom, "Stocks plunge on Greenspan's rate-boost hint," *The Atlanta Journal-Constitution*, April 21, 2004.

[6] Walker, Tom, "Greenspan soft-pedals on rates; market rebounds," *The Atlanta Journal-Constitution*, p. F4.April 22, 2004.

[7] Shell, Adam, "Greenspan calms jittery investors," *USA Today*, April 22, 2004.

[8] Walker, Tom, "Identifying sell-off trigger difficult." *The Atlanta Journal-Constitution*, p. F3. August 6, 1998

[9] See page 325 in *The Wave Principle of Human Social Behavior*.

2 Remember the Enron Scandal?

From *The Elliott Wave Theorist*
June 2002

Remember the Enron Scandal?

Some of you may remember it too well, if you owned Enron stock. The financial media claimed that the scandal caused irreparable damage to investor confidence. But did you know that market optimism actually increased as the scandal developed? Impossible, you say? See the evidence for yourself.

This report originally appeared in the June 2002 issue of *The Elliott Wave Theorist*, Robert Prechter's monthly market analysis publication.

The Socionomic Insight

The socionomic insight is that the conventional assumption about the direction of causality between social mood and social action is not only incorrect but the opposite of what actually occurs. Socionomics is based on the principle, developed by deduction from the existence of the Wave Principle and by induction from the chronology of market behavior and other social actions, *that social mood determines the character of social events*.

As previous studies demonstrate, rising stock trends do not improve the public mood; an improving social mood makes stock prices rise. Economics do not underlie social mood; social mood underlies economics. Stock trends do not follow corporate earnings; corporate earnings follow stock trends. Politics do not affect social mood; social mood affects politics. Demographics do not determine stock market trends; the social mood that determines stock market trends determines demographics. Styles of popular art and entertainment do not affect the social mood; the social mood determines the popularity of various styles of popular art and entertainment. War does not impact stock market trends; the mood that governs stock market trends determines the propensity for war. And so on. All economic, political and cultural developments are shaped and guided by the Wave Principle of human social behavior. It is the engine of everything from popular fads and fashions to the events of collective action that make history.

Conventional belief is the opposite of the above insight. It is solidly entrenched and pervasive almost to the point of ubiquity. It is deeply intuitive and utterly wrong.

The conventional mind sees social events as causes of social mood. Few ever ask the causes of the events themselves. Those who do simply assign the cause to other events.

The Counter-Intuity of the Socionomic Insight

I continually marvel at how counter-intuitive the socionomic insight is. For the entire time of my professional career, I have been comfortable with the central implication of technical analysis, which is the primacy of market form over extramarket events such as economics and politics. (I eventually discovered to my dismay that technicians rarely accept this implication and believe that various random, unpredictable "fundamentals" are behind the market's patterns, which is a contradiction.) Yet even I find myself upon occasion having to work hard at dispelling contradictory old thought patterns in order to re-establish mental integrity on the more difficult challenges of the socionomic insight. My first real challenge came from the claim that "demographics" determined stock price trends. I knew the claim had to be incorrect, and it took only a few days of research to debunk it. But it was only during the course of that pursuit that I began to formulate the proper response: that if indeed there were any correlation at all, *the causality had to be in the other direction*. The result was the 1999 study, *Stocks and Sex*, which shows exactly that. My latest — and greatest — challenge to date has been the proper conception of the Federal Reserve Bank's role in the causality of monetary trends, which I will discuss in an upcoming report.

The average person's resistance to the socionomic insight is so formidable that it compares to having one's view of existence challenged. I believe that the reason for this resistance is the easy naturalness of the idea of event causality: It works in physics, so people assume that it must operate in sociology. This deeply rooted assumption is stronger than piles of evidence to the contrary.

Let me give you an example of how strong this resistance is. On April 25, 2002, I was pleased to address the Sixth Congress of the Psychology of Investing, sponsored by the Massachusetts Mental Health Center, which is a major teaching hospital of Harvard Medical School. Attendance ran the gamut from academics and psychiatrists to Wall Street professionals and private investors. After presenting the Wave Principle and explaining its social effects, numerous attendees commented that the presentation had changed their perspective on markets and social causality.

The following day, I attended the final half hour of the afternoon, in which attendees were given the opportunity to ask questions of that day's panel. The final question of the day was, "The Enron scandal has deeply discouraged investors; when can we hope that this black cloud hanging over the stock market will go away?"

Several respondents — both from the panel and the audience — answered the question as if it were valid. Not a soul in the room challenged the questioner's assumption.

A week later, *USA Today* and doubtless countless other newspapers and magazines were trumpeting the same theme. "Scandals Shred Investors' Faith," declared a front-page headline. Begins the article, "A drumbeat of corporate misdeeds has helped crush stock prices and eviscerate pension plans."[1]

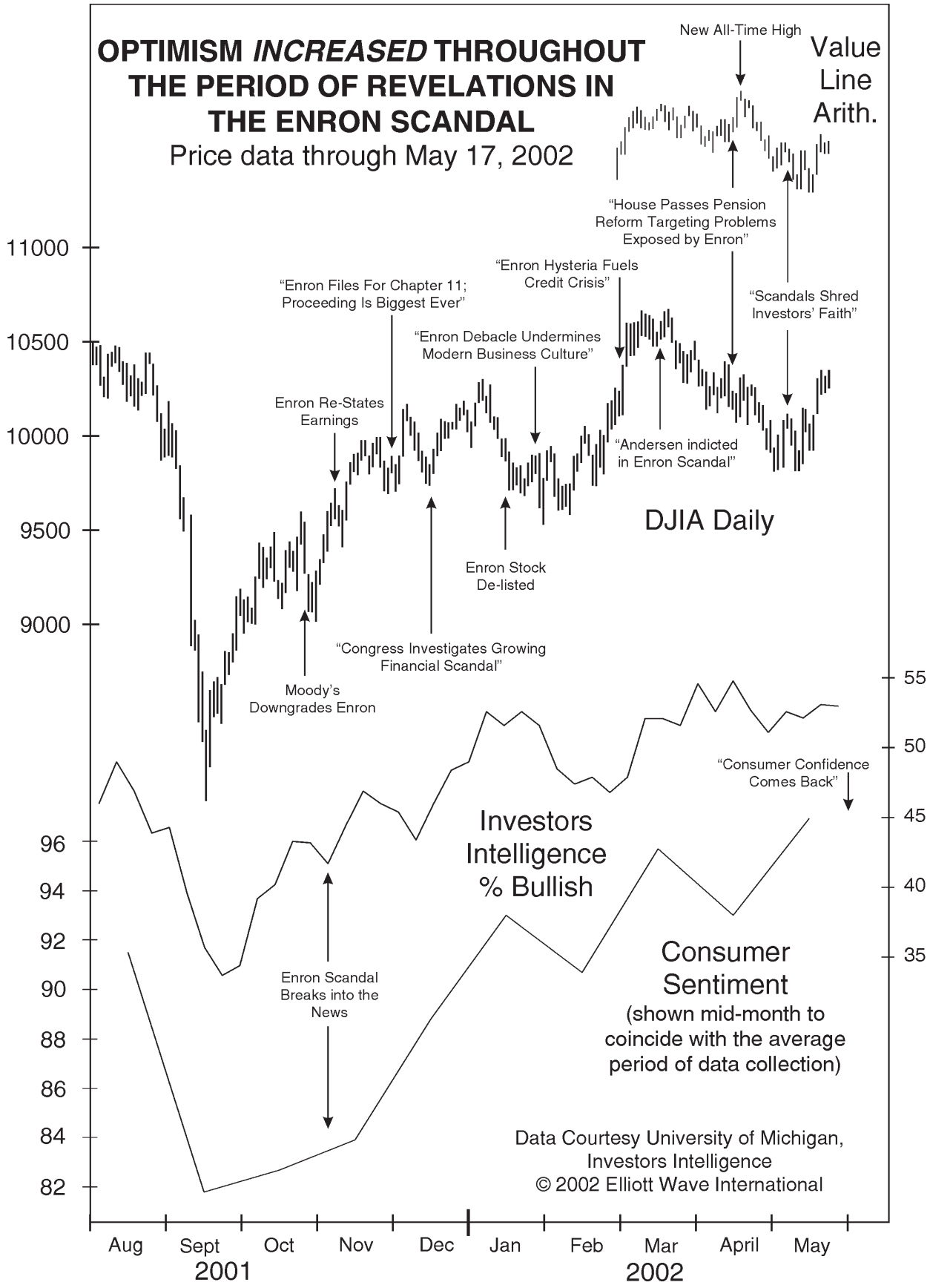
If you recognize the socionomic insight as a *principle*, you need know nothing about the situation. You can formulate the proper response immediately. Before reading further, would you like to give it a try? Remember, the socionomic insight is that the conventional assumption about the direction of social mood vs. event causality is the *opposite* of what actually occurs. I will make your task easy by re-stating the assumption that the questioner held: "The Enron scandal discouraged investors." Can you state its opposite in terms of causality?

The Significance of the Enron Scandal

Did the Enron scandal discourage investors? *No, discouraged investors precipitated the Enron scandal*. Many readers undoubtedly will balk at accepting the principle behind this formulation without their own tedious process of induction via repeated examples. To aid in that process once again, we must disprove the questioner's and media's false premise and demonstrate the validity of the socionomic stance.

First, let us define scandal not as misdeeds themselves, which can occur in secret. Scandal is the recognition of misdeeds, the outry of recrimination and the public display of interest and outrage.

The premise is revealed as utterly false when we observe, despite virtually everyone's feelings to the contrary, that (1) investors in general knew nothing about Enron's malpractices prior or anytime during the stock market's decline, and (2) *throughout the drama of the Enron scandal, the market advanced, and related psychological indicators improved*. Figure 1 shows the stock market's progress, two measures of optimism and the key events surrounding the Enron scandal. It is abundantly clear that as the Enron scandal developed, *investor and consumer psychology improved, and stock prices rose.* Therefore, it is utterly false that the Enron scandal "discouraged investors."


OPTIMISM *INCREASED* THROUGHOUT THE PERIOD OF REVELATIONS IN THE ENRON SCANDAL
Price data through May 17, 2002
New All-Time High
Value Line Arith.
"House Passes Pension Reform Targeting Problems Exposed by Enron"
"Enron Hysteria Fuels Credit Crisis"
"Scandals Shred Investors' Faith"
"Enron Files For Chapter 11; Proceeding Is Biggest Ever"
"Enron Debacle Undermines Modern Business Culture"
Enron Re-States Earnings
"Andersen indicted in Enron Scandal"
DJIA Daily
Enron Stock De-listed
"Congress Investigates Growing Financial Scandal"
Moody's Downgrades Enron
"Consumer Confidence Comes Back"
Investors Intelligence % Bullish
Enron Scandal Breaks into the News
Consumer Sentiment
(shown mid-month to coincide with the average period of data collection)
Data Courtesy University of Michigan, Investors Intelligence
© 2002 Elliott Wave International
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2001
2002

Figure 1

Anyone who posits event causality in this instance is boxed into a corner. Given the facts before our eyes, he has no choice but to conclude that the Enron scandal was bullish for stock prices and that it caused investors' mood to improve![2]

I would like to proceed directly to what would seem to be an obvious statement: that such a conclusion is ridiculous. Incredibly, though, I cannot say it. Why? Because conventional analysts *actually proceed directly to such absurd conclusions repeatedly as a matter of course*. For example, *The Wave Principle of Human Social Behavior* relates a news report of an analyst who watched the stock market rally despite revelations of President Clinton's misbehavior and came to the conclusion that presidential sex scandals are bullish! Economists have reviewed the temporal proximity of war and economic recovery, and they assert, almost to a man, that war is good for the economy. If economists can argue that the most destructive activity of man is a positive force for economic well being, then conventional thinkers will have no trouble devising an argument as to why financial scandals are bullish. I can do it myself; such rationalization is easy.

The only antidote to such perversity is the socionomic insight. War is not causal to any aspect of social mood; it is a *result* of a deeply negative social mood. Likewise, the Enron scandal was not causal to any aspect of social mood whatsoever; it was a *result* of a change in social mood.

Figure 2 demonstrates the chronology that supports this statement. As you can see, the stock market fell for many months prior to the scandal breaking. This meter of social mood showed increasing negativity — involving conservatism, suspicion, fear, anger and defensiveness — all of which went into precipitating the Enron scandal. As the CEO later explained, increasing conservatism affected the company's derivative positions, bear markets triggered "exit clauses" that allowed partners to their deals to withdraw their funds, and increasing fear and suspicion prompted them to do it. Throughout 2001, the company's stock retreated, removing support for financing. The house of cards built upon confidence collapsed.

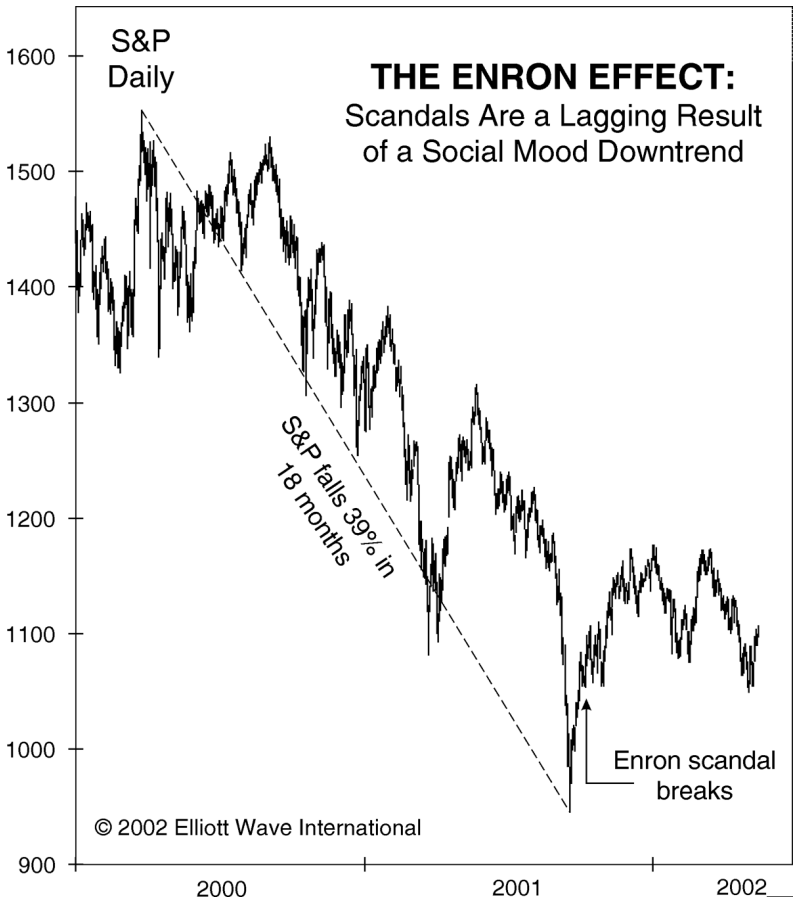


Figure 2

By the time the *results* of that negative mood trend brought the Enron scandal to light, the negative mood trend was already over. The S&P 500 completed five waves down on September 21, and it was time for the largest rally since the high in March 2000 (as forecast in *The Elliott Wave Theorist* on September 11). During that rally, these particular consequences of the downward mood trend became manifest.[3]

Now we know for sure: The Enron scandal did not "discourage investors" or "shred investors' faith" *one bit*. Their level of faith rose during the scandals. It did not "crush stock prices and eviscerate pension plans," either. Stock prices rose during the scandals. All the hand wringing and ink spilling on this presumption has been a waste of time and energy.

To make a subtler point, "corporate misdeeds" are not even to blame for the bear market that *preceded* the eruption of the Enron scandal. Corporate misdeeds were in full flower throughout the 1990s, yet no scandals erupted. In fact, those very misdeeds — Ponzi-like accounting practices — can be credited with *raising* stock prices and *fattening* pension plans to the same extent that they can be blamed for crushing and eviscerating them. The proper amount of credit for both trends in stock prices is zero. The credit goes to a change in mass psychology. Various accounting irregularities were in place for years, and they were reported from time to time, sometimes in major journals, *but during the bull market, few cared*. There was consistent *misbehavior* for a decade, but there was *no scandal* until well after the trend changed. While the trend was up, people ignored the phony accounting; when the trend turned down, they began to investigate it. When the trend was up, psychology supported the illusion of corporate health; when the trend turned down, psychology caused corporate health to deteriorate rapidly. Again, the formulation of causality is the opposite of the conventional belief: Corporate misdeeds did not crush stock prices; crushed stock prices finally drew back the curtain on corporate misdeeds. What, then, caused corporate misdeeds to expand so greatly in the first place? The mass psychology of the stock mania, which was unskeptical to an extreme, invited and even rewarded companies for "creative accounting." It was the psychological environment of the bull market that led companies to dare to mislead in the first place.

The Power of Socionomic Prediction

Figure 2 at least sets the chronology of the true cause and effect with respect to the Enron scandal. It falls short of proving it, of course, as the other option regarding causality is that the two events (and all the others we have explored) are unrelated. An important aspect of science is the ability of a hypothesis to predict. Using the socionomic insight, could anyone have predicted the flood of accounting and corporate scandals that has so far climaxed with the revelations regarding Enron?

The answer is yes. Moreover, someone did.

At the height of the stock mania and during the months thereafter, Pete Kendall of Elliott Wave International went on record in *The Elliott Wave Theorist* (EWT) and *The Elliott Wave Financial Forecast* (EWFF) identifying the end of the line for what we dubbed "bull market accounting standards" and the beginning of a climate of scandal and recrimination. That emerging climate decimated images of all kinds of heroes, from corporate CEOs to economists to brokerage firm analysts to accountants, to name just a few. The ensuing commentary[4] shows the predictive advantage of the socionomic perspective in the area of corporate scandal (emphases added):

> **September 16, 1998**
>
> The discovery of "fictitious revenue" at Cendant Corp. [first reported just 13 days after the all-time peak in the advance-decline line on April 3, 1998] is part of a slow awakening to the realization that the fundamentals of many companies, weak as they have become, are not even what they purport to be. Financial improprieties at Sunbeam, Oxford Health, Green Tree Financial, Boston Chicken and Mercury Financial have also been reported…. The emerging shift in social mood is beginning to shatter the collective financial delusion. *These stories can*

"now be told" because people are disposed to listen to them. As the bear market unfolds, many more "scandalous" cases will be revealed.

October 1, 1999

Accounting standards have eroded as the bull market has aged. The flip side of these papered-over cracks in the fundamentals is that in a bear market they will be an enormous weight on growth. Combined with the unprecedented global economic dependence on a rising U.S. stock market, the likelihood is that they will exert their drag with stunning speed.

February 25, 2000

The bull market's attendant accounting gimmicks will get a lot more ink as the blinding light of the new era gives way to sober reflection and recrimination.

May 26, 2000

Financial Shenanigans Coming to Light: Some of the lame excuses for optimism are being outed. As *The Elliott Wave Theorist* noted in our 1998 Special Report on the relative weakness of the fundamentals in Cycle V vs. Cycle III, "the enduring psychological coercion of the bull market" has compensated for Cycle V's obvious fundamental shortcomings with the general acceptance of accounting standards that overstate the quality of companies' financial performance. The exposure of fallacious bull-market bookkeeping has been a subject of ongoing discussion in EWFF. For our purposes, the importance is not the transgressions themselves, but the timing of their discovery and repudiation. This process has accelerated in the wake of the NASDAQ's retreat. There is now "growing concern among accounting professionals that many companies are relying on financial alchemy to burnish their results." Instead of peripheral corporate players and outright fraud, the charges of "financial engineering" are now being leveled against stalwarts like Microsoft, Dell and Cisco Systems for *accounting practices that have been known to be in place for years*. Less than a month after Cisco was tabbed as the new stock-market bellwether, its aggressive acquisition strategy was profiled as a "modern house of cards" in *Barron's*. Days later, Cisco's reported earnings, which surpassed analysts' expectations by one cent for the *12th* straight quarter, failed to produce the usual upside pop.

June 30, 2000

Last month, we reported that the exposure of slack bull market accounting standards and outright frauds was worth watching as an indication that the "return to sobriety" was gaining ground…. It turns out that Cendant's accounting shenanigans date all the way back to its initial public offering in 1983. As columnist Floyd Norris notes, "For investors, the most interesting question is not whether [the firm's founder] will go to jail. It is how this fraud managed to go on so long." The answer, according to a professor of accounting who has studied a report on Cendant's bookkeeping practices, is that *"auditors were fooled because, in some measure at least, they wanted to be fooled." This, at bottom, is the thesis of socionomics. The social mood dictates how people treat real data. From 1983 through 1999, public mood was in a bull market. This year, it all changed, and so has the socially perceived reality.*

A steady stream of big-time financial scams gave the world its first hard look at the scale of financial fraud that bull market psychology had refused to expose. On June 15, reports revealed the "largest securities fraud sting in history," as the FBI arrested 120 people and broke up "a ring of organized crime on Wall Street" that has been operating for *five years*. When the Royal Bank of Canada was charged with stock manipulation, a Toronto paper said, the "practice of manipulating stock prices and pension fund performance has been suspected for so long, the only real surprise is that Canada's largest bank got caught first." This acceleration in the size and scope of fraud exposure is exactly what *The Elliott Wave Theorist* has said we should expect in a post-mania environment.

September 1, 2000

Many of the bull-market accounting gimmicks that we have covered in recent issues of EWFF are also alternate forms of financial leverage…. The trend poses "systemic, long-term risk" to companies' debt ratings, says one specialist. *All it took was a two-month decline of 16% in the Dow to expose this weakness. The same practices that goosed the numbers on the way up will drag them down in a bear market.*

December 1, 2000

It turns out that GE massages its numbers. *Money* magazine even reported in November that GE's earnings consistency is "a charade." Even "fans" are asking about the "confusing but apparently legal gimmicks" GE has used "to achieve its vaunted consistency." As *The Elliott Wave Theorist* pointed out in September 1998, this "discovery" of questionable bull market accounting standards is exactly what we should expect in the early stages of the bear market. In reaching GE, the last of the original Dow companies, the emerging financial skepticism goes a long way toward confirming that the stock market's long-term topping process is behind us.

March 28, 2001

Considering the size of the NASDAQ's bubble and its inexorable, year-long decline, the attacks on Greenspan, CNBC and Wall Street analysts constitute a relatively serene response so far. Ironically, a rally might never be accomplished by an escalation in the attacks. The preliminary breaks from the mania in 1997 and 1998 illustrate how this delayed response works. In 1997, many emerging markets actually peaked in the first half of the year and fell out of bed in October as the U.S. market joined in. Once the bottom was actually in, the IMF became the focal point of an international backlash. On December 2, 1997, *The Wall Street Journal* reported on a sweeping wave of "resentment." "From Thailand to South Korea, casualties of the region's market meltdowns are casting blame far and wide." In October 1998, after the worst of another selling wave was over, we were treated to criticism over the bailout of Long-Term Capital Management and a Congress that roiled with demands for the regulation of hedge funds. As the market rallied on, the storm dissipated. [Perhaps one] reason for the delay is that the economy lags the stock market, and people don't reach their peak of anger until they are buffeted by the economy.

June 29, 2001

The Witch Hunt Takes Flight: In matters of survival, particularly those that are defined by highly subjective human interactions, the rational faculties of the neocortex are no match for the emotion-based survival instincts that inhabit the limbic system. The expanding controversy over accounting standards is a perfect example of the same brains [later] taking the opposite view based on the demands of survival. As of late 1990, many thousands of analysts altered the tenets of the profession to a point at which book value, dividends, profits and total earnings *did not matter*. Contending otherwise was grounds for dismissal; in fact, analysts lost their jobs because they refused to adopt the new standard. Now, however, succeeding in the same job requires a single-minded devotion to judging earnings. The change revolves around a very specific event at a very specific time. On March 10, 2000, the direction of the NASDAQ switched from up to down, and the influence of social mood on millions of limbic systems reversed. On the approach to that high, the accountants themselves were consumed with hope and denial. Afterward, the essence of the job became to doubt the numbers. USA Today's June 22 story notes, "accounting experts, analysts and academics" all agree, "companies are twisting the numbers to show better results." Numerous bull market instruments, like corporate stock buybacks, splits and stock options, which EWFF and *The Elliott Wave Theorist* said would have "an equal and opposite effect in a downtrend," are now getting all sorts of bad press (see March 1999 EWT and May and June 2000 issues of EWFF). Within the last few weeks, newspapers report, "Share Buybacks Hit a Wall of Fear," and stock options have "turned the investing world upside down." In an unexpected twist, "repricings" have created "a perverse incentive" for employees to "hold stock prices down."

It is no coincidence that as the backlash gathers steam, analysts and other economic thinkers are a special point of focus. In 1999, economists --scratch that; we mean *bullish* economists -- emerged as the new "superstars of academia." Now a Newsweek column calls economics "the illusion of knowledge" and reveals, "Economists are clueless." In June, Congressional hearings were conducted to dissect the inaccurate opinions of securities analysts. A team of professors from four major California universities produced a paper showing that the stocks analysts liked the most fell 31% in 2000, while their least favorable recommendations rose 49%! The detailed analysis calls into question the "usefulness of analysts stock recommendations." As we said months ago, this is not news. Has there has ever been a time when *average* Wall Street analysis has been useful as anything more than a contrary indicator? The news is how much of the academic and media firepower that supported Wall Street notions is now directed against Wall Street. This defrocking appears to be an inevitable response to the reversal of a mania. As *The Wave Principle of Human Social Behavior* points out, people tend to "live in the limbic system, particularly with respect to fields such as investing where so few are knowledgeable and the tendency toward dependence is pervasive." This was at least doubly true in the mania, as even the most highly developed neocortex was at a loss for prior experience to draw upon. The failed images of the previously bullish social mood now induce jilted investors to destroy the advisors upon whom they have grown so dependent. It is fascinating to see how much sense the neocortexes of the attackers can make as this limbic-based process plays itself out.

November 30, 2001

Enron Corp.'s imminent [bankruptcy] will easily be the largest bankruptcy ever, topping the old record (Texaco in 1987) by almost 70%. The "forensic accountants" have been called in to sort out a mess that will lead on to a *seemingly endless series of financial catastrophes.*

February 1, 2002

All Enron, All the Time: "Twenty minutes ago, the only topics on the nation's radar screen were Afghanistan and terrorism. Now there's Enron," says a USA Today column on "How Enron Stole Center Stage." One of the big mysteries is why the public suddenly cannot get enough dirt on Enron. "A few years ago, it would hardly have seemed possible," Business Week notes. "The nation's attention, from the halls of Congress to Main Street, has been riveted on an accounting scandal, a subject so abstruse it rarely makes the front page." But there it is on page 1, day after day after day. The Enron scandal and its recent "spread to other large, complex companies" shows that investors are waking up to what they did not want to know during the bull market.

March 1, 2002

What's Beyond Enron: Last month, we showed how perfectly the Enron scandal fits the blueprint for a Grand Supercycle-degree bear market. This month, the river of recriminations broke its banks. The potential for a flood of Enron-style revelations into virtually any sector of the economy is signaled by word that the Federal Reserve is "stepping up" its scrutiny of securitized, credit-card debt and mortgages as well as a Fortune expose that offers investors "More Reasons to Get Riled Up." *Fortune* points out that Enron's $63 billion in market losses is nothing compared to the $155 to $423 billion in market cap that disappeared from 10 other firms. *"Let's get mad at them, too,"* says the magazine. *"Let's put our anger and righteous outrage in all the places they belong."*

Meanwhile, Enron has evolved into what one Washington attorney called "an eerie financial witch hunt" that is comparable to the Salem witch trials. The still-expanding demand for dirt on Enron is apparent by its arrival on the cover of the National Enquirer. The tabloid claims to have the "untold story" in its latest issue. When it comes to Enron, however, the only story the media has left untold is what's driving the fascination.

Mr. Kendall thus predicted in no uncertain terms that the consequences of the approaching — and then the developing — bear market would result in accounting scandals increasingly hitting the newspapers. (Note that this is a double forecast: both for a bear market and its social results in this regard.) Thus, socionomics once again predicted the character of upcoming events, events that have since led to dramatic congressional hearings, anguished public outcry and of course, the classic conventional error in assigning causality. Thanks to the intrepidness of one of the writers of the above-quoted *USA Today* article of May 2, 2002, Kendall was provided space to summarize the correct stance on the rash of scandals and recriminations. Here are the relevant excerpts:

> Peter Kendall, co-editor of newsletter *The Elliott Wave Financial Forecast*, says a bear market often reveals the worst excesses of a bull market. "Everything that was revered on the upside is a target in a bear market." Those excesses have to be corrected before the public regains its confidence. Typical features

of the so-called recrimination phase: reviled CEOs. “Those who had Teflon in the bull market have Velcro in the bear market,” Kendall says. In 1929, the chief target was Richard Whitney, president of the New York Stock Exchange. Kenneth Lay, former CEO of Enron, may be the current target.

Reform and regulation are one step to regaining the public’s confidence. But that often happens well after much of the damage is done to investors’ trust. “The government takes steps after the horses have left the barn,” Kendall says.[5]

We socionomists are few in number. Were this a developed science with many practitioners, an astute socionomist might have listed Enron specifically as being one of the companies likely to explode in scandal. One financial ratings firm in April 2001 placed Enron on its “Corporate Earnings Blacklist” and cited the company as being “highly suspect of manipulating its earnings reports, so the hints were there.”[6] An alert socionomist who knew, as we did, that corporate accounting scandals were in a rising flood might have filled in the blanks and anticipated this specific manifestation of the socionomic dynamic, although certainly not its ultimate position as the premier poster-child of manipulative accounting.

Toward a New Understanding

People have a tendency to ask questions such as, “Are you saying that had the trend in social mood not changed, the Enron scandal would not have come to light?” The short answer is yes, but the questioner is missing an important point. It is crucial to understand that while the precipitation of Enron’s financial meltdown and the revelation of its shaky accounting practices were due to forces behind the new negative social-mood trend, the precondition of their very existence was the psychological forces behind the old positive social-mood trend. Had the rose-colored glasses of optimism not clouded investors’ vision in the first place, no company would have been able to survive practicing such shenanigans. During the 1990s, countless companies practiced them, and they were actually *rewarded* for it.

Socionomists were able to predict the eruption of scandals for two reasons: (1) because we knew that the euphoric optimism of the positive social-mood trend was inducing individuals and corporations to take huge financial risks and simultaneously inducing observers to turn a blind eye to improprieties and (2) because we knew that the qualities of a negative social-mood trend would reverse both of those forces. Believers in the conventional assumption of event causality, in contrast, were caught blindsided, as usual.

While the conventional error of thought regarding social mood causality is nearly ubiquitous, a few thinkers in history have derived the correct posture on this question, at least to a limited degree. For instance, Thomas Paine observed, “Panics bring things and men to light, which might have lain forever undiscovered.” In other words, panic is causal; scandals are a result. It is time for social scientists to accommodate this view and to embrace the greater socionomic insight that lies behind it.

Corporate accounting scandals are only one area of social behavior among dozens that we at Elliott Wave International have successfully predicted. To cover them all would take several books. While this report details just a single example of what socionomists can do, it also elucidates a principle of social forecasting that anyone can learn to apply. A practiced artisan in this field can predict the headlines in countless areas.

Quiz

You can do this. On May 2, 2002, the same day that newspapers blamed the Enron scandal for shredding investors' faith, another front-page article about arson and a gun battle at the Church of the Nativity in Bethlehem (West Bank) declared, "Church Battle, Fire Inflame Passions."[7] What is the socionomically inspired, i.e., the causally correct, formulation for that headline?

Now that you have formulated the correct headline, you should be able to see the value of the socionomic perspective not only in understanding what is going on in the world but also in the realm of forecasting. Had you been privy to a meter of the local social mood in this instance, you could have predicted the character of the events that resulted.

Endnotes:

[1] Waggoner, John and Fogarty, Thomas, "Scandals shred investors' faith," USA Today, May 2, 2002, p.1

[2] Any economist who bothers to view the relationship between the U.S. trade deficit and the stock market or the economy faces the same dilemma. The two trends move together in near lock step, opposing the ubiquitous presumption to the contrary. For chart and discussion see Prechter, Robert, The Wave Principle of Human Social Behavior and the New Science of Socionomics, pp. 377-380.

[3] Further evidence of the power of social psychology to rule social events and social visioning is the amazing fact that the aspect of the scandal over which investors and politicians were most enraged was phony. Newspapers reported endlessly that the "big shots" at Enron got out of the stock while the poor employees were "locked in." In truth, employees could have gotten out whenever they wished, except for a brief period of 16 days during which the stock slipped an additional four points from 13 to 9, on its year-long descent from 83 down to 0.57, at which time it was de-listed in January 2002. The restriction, moreover, was not a punitive policy but a technical consequence of the company's turning over management of its pension plan to another firm. Investors in Enron stock, employees included, lost a lot of money because they were imprudent and foolish, just as countless other investors have lost money. The psychological desire of investors to redirect blame for their decision not to sell is stronger than facts.

[4] The Elliott Wave Theorist, (September 16, 1998 Special Report) The Elliott Wave Financial Forecast, (October 1, 1999, February 25, 2000 Special Report, May 26, 2000, June 30, 2000, September 1, 2000, December 1, 2000, March 28, 2001, June 29, 2001, November 30, 2001, February 1, 2002, March 1, 2002)

[5] See Endnote 2.

[6] Weiss Ratings, Inc.; www.weissratings.com

[7] Gee, Robert W., "Church Battle, Fire Inflame Passions," The Atlanta Journal-Constitution, May 2, 2002, p.1

3 The Myth of the "New Economy" Exposed

From *Conquer the Crash*
Published May 2002 and June 2004

The Myth of the "New Economy" Exposed

The New Economy is supposed to be the nucleus of growth and investment opportunity. But before attaching such high hopes to it, has anyone really studied the facts and evidence regarding the "The New Economy"? We have.

This classical report comes from Chapters 1 and 4 of Bob Prechter's bestselling book, *Conquer the Crash*. In 2002, *Conquer the Crash* was the No. 1 Business bestseller on the *Wall Street Journal* bestsellers list and the No. 1 investing book on Amazon.com.

Part I of this classic report shows the truth about the current U.S. economic situation and **Part II** describes practical ways you can protect your money in a deflationary depression.

Part 1: A Myth Exposed

How many times over the past decade have you heard glowing reports about the "New Economy"? Hundreds, maybe thousands of times, right? Those of you who have been living on a desert island or who are reading this book fifty years from now can experience the same thing vicariously through **Figure 1-1**, which displays the accelerating frequency with which the global media have been referring to the "New Economy" year after year. It's been everywhere. Economists celebrate the broadening "service economy" and proclaim that economic growth in the new Information Age has been "unprecedented" in its vibrancy, resilience and scope. Rhetoric is cheap. Evidence is something else.

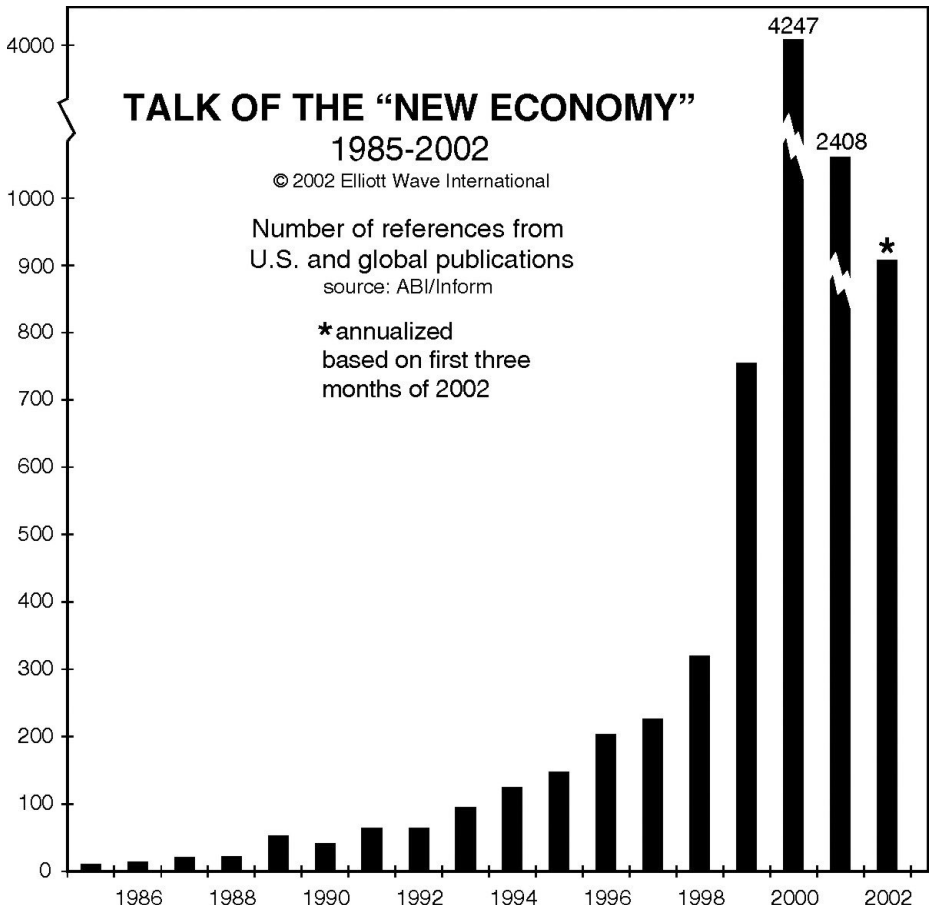


Figure 1-1

What would you say if you discovered that *we have not had anything near a New Economy*, that all that talk is a lie? This chapter is going to show you that the vaunted economic expansion of recent decades in the world's leading economic power, the United States — much less the rest of the world — is far less impressive than you are being led to believe.

First take a look at **Figure 1-2**, which depicts the U.S. stock market from its low in 1932 during the Great Depression all the way to the present. This graph delineates five phases — or "waves" — of rise and fall.

The notes on the chart summarize a shocking fact: The economic expansion during the latest phase, wave V, which lasted from 1974 to 2000, was demonstrably weaker than that during the preceding rising phase, wave III, which lasted from 1942 to 1966. Both periods sported a persistent bull market in stocks that lasted about a quarter century, so in that sense, they are quite similar. One noticeable difference is that the DJIA gained only 971 percent during wave III but a remarkable 1930 percent during wave V, *twice the amount*. This tremendous bull market in stocks in wave V is the great "boom" that people feel in their bones. Yet as you are about to see, the economic vigor and financial health of wave V, the one that has received so much radiant press, failed to measure up to those of wave III by every meaningful comparison.

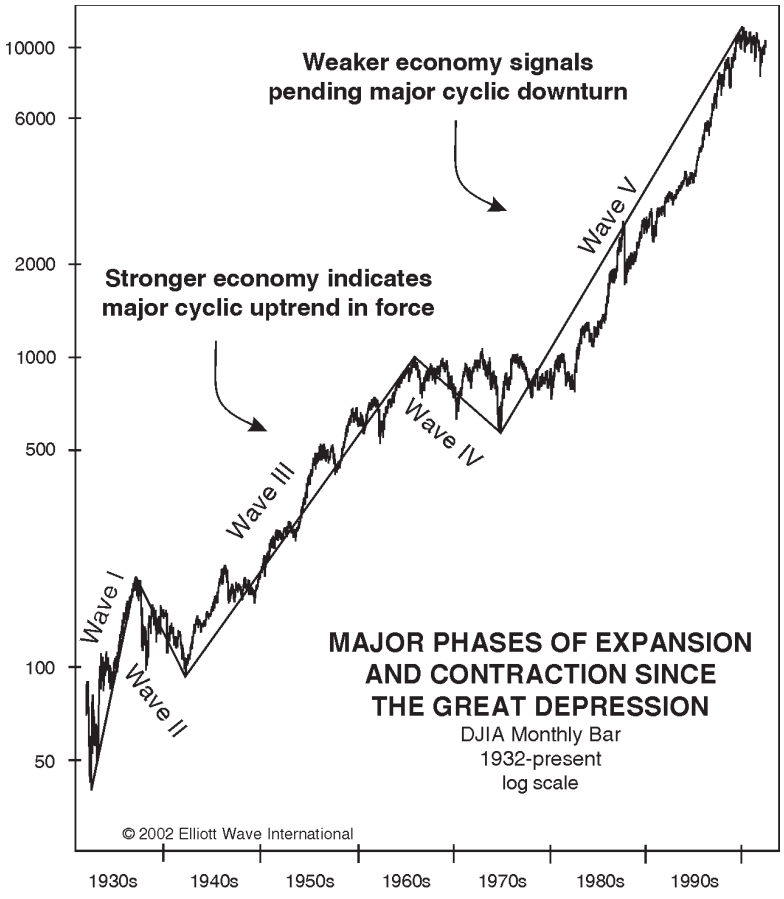


Figure 1-2

Please go through the following citations one by one. (Economists do not have all the data from the 1940s, so in some cases, our data for wave III begin later.) After you absorb this information, we will set to the task of finding out what it means.

Comparative Measures of Economic Health

(see Figure 1-3)

Gross Domestic Product

- In wave III, from 1942 to 1966, the average annual real GDP growth rate was **4.5** percent.
- In wave V, from 1975 through 1999, it was only **3.2** percent.

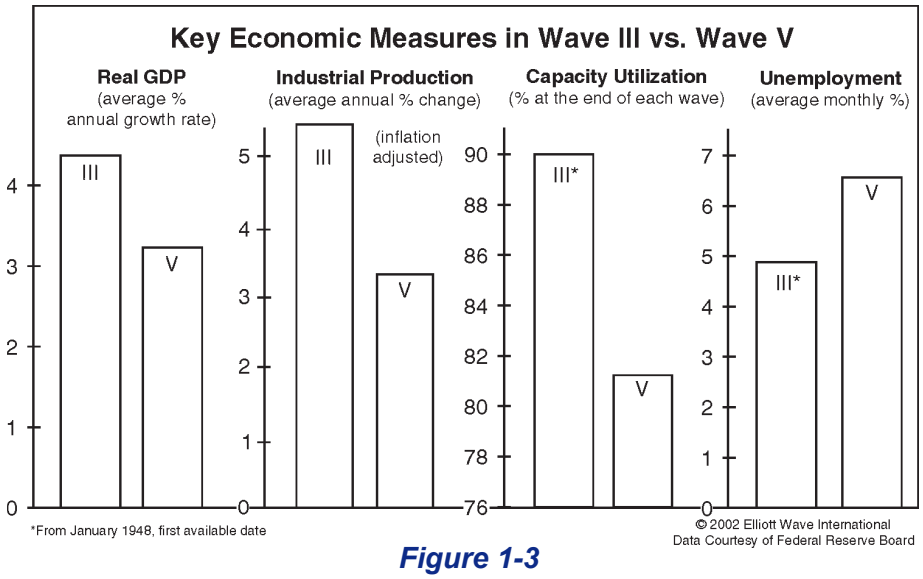


Figure 1-3

Industrial Production

- In wave III, the average annual gain in industrial production was **5.3** percent.
- In wave V, it was only **3.4** percent.

Combining GDP and industrial production figures, we may generalize from the reported data that the economic power of wave V was one-third less than that of wave III.

Capacity Utilization

Factories' capacity utilization depicts the energy of an economic expansion compared to the infrastructure's ability to handle it.

- In wave III from 1948 (when figures became available), capacity utilization rose 22 percent to **91.5** percent in June 1966 and stayed high through the late 1960s.
- In wave V, capacity utilization was net flat, peaking in January 1995 at **84.4** percent. U.S. plants were producing at only 82.7 percent of capacity at the ensuing peak in June 2000.

Unemployment Rate

This is an economic measure of ill health.

- In wave III from 1948 (when data became available), the monthly average of the unemployment rate was **4.9** percent.
- In wave V, it was **6.6** percent.

Comparative Measures of Debt, Deficits and Liquidity

(see Figure 1-4)

To grasp the full measure of the underlying weakness of wave V's "fundamentals," one must look beyond economic figures to the corporate, household and government balance sheets that underlie those results.

Households' Liquid Assets

- At the end of wave III, households' liquid assets were **161** percent of liabilities.
- At the end of wave V, households' liquid assets were **93** percent of liabilities, meaning that they had *less cash on hand than they had liabilities*.

Federal Debt

- At the end of wave III, federal debt was **43.9** percent of GDP.
- At the end of wave V, it was **58.6** percent.

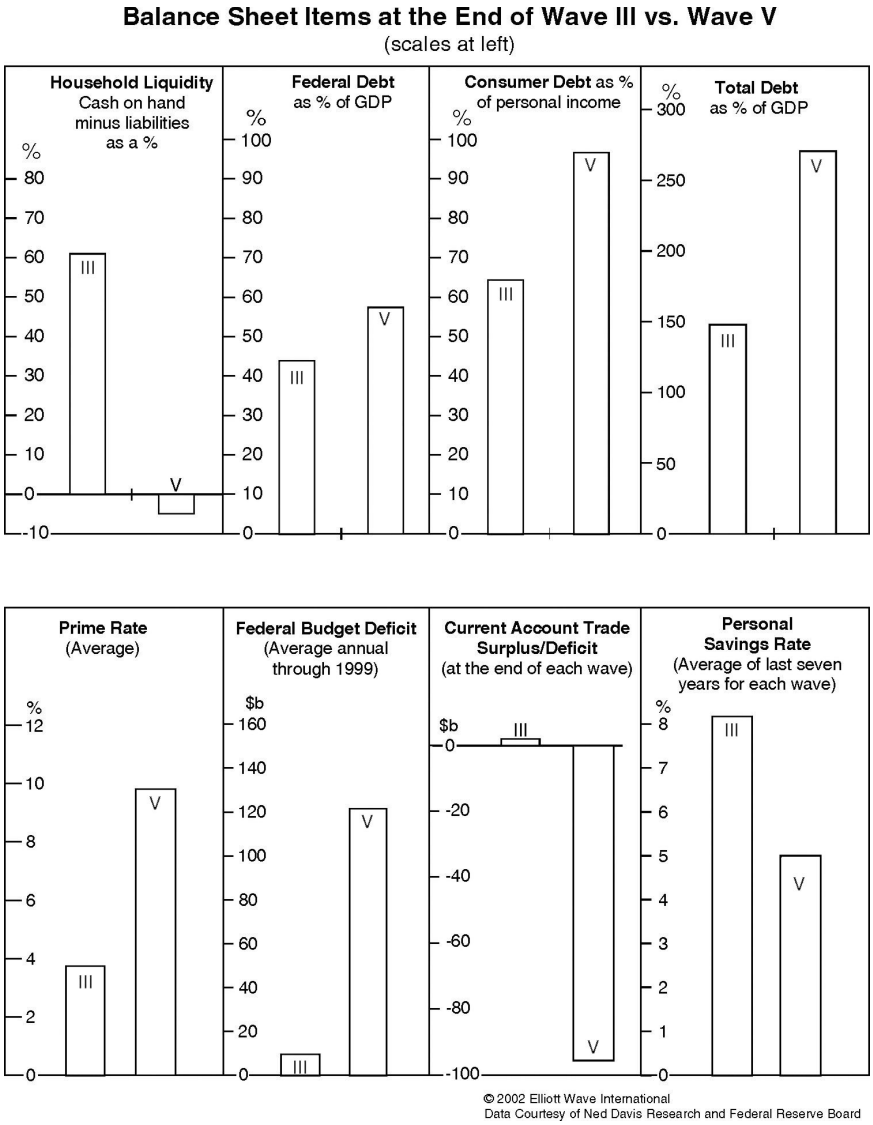


Figure 1-4

Consumer Debt

- At the end of wave III, consumer debt was **64** percent of annual disposable personal income.
- At the end of wave V, it was **97** percent.

Total Debt as a Percent of GDP

- During wave III, from 1949 to 1966, total credit market debt as a percentage of GDP slipped slightly from **151** percent to **148** percent.
- In wave V, it rose from **172** percent to **269** percent.

Prime Rate

- In wave III, the prime rate of interest, the cost of money for the highest quality corporate borrowers, averaged **3.74** percent.
- In wave V, it averaged **9.66** percent, nearly three times as high.

Federal Budget Deficit

- In wave III, federal budget deficits were not sustained. The only consecutive years of deficits were in the war years of 1942-1946. The average annual federal deficit was less than **$9** billion.
- In wave V, the annual federal deficit averaged **$127** billion, which is far greater even when adjusted for inflation.

Current Account Trade Figures

- At the end of wave III, the U.S. showed a net Current Account trade surplus of **$1.3** billion.
- At the end of wave V, the Current Account showed a record deficit of **$96.2** billion.

Personal Savings Rate

- In wave III, the personal savings rate followed a fairly flat trend, bottoming at **6.5** percent of disposable personal income in February 1969.
- In wave V, the personal savings rate dropped persistently, falling to a record low of **0.5** percent in March 2000.

U.S. Balance Sheet (not shown)

- At the end of wave III, the U.S. was a net **creditor**.
- At the end of wave V, the U.S. was a net **debtor**, owing a record $2 trillion more to foreigners than it is owed.

These figures, dramatic as they are, do not reveal the full extent of wave V's inferior relative performance because both the government's economic reports and corporate accounting methods changed during wave V in such a way as to overstate wave V's economic vigor. If we adjusted for those cosmetic alterations, most of these figures would reveal an even greater dichotomy between the two periods. If we begin wave V's figures in 1982 to put the expansion in the best possible light, they change little and in a few cases are worse. If the Dow were to manage a new high in coming months, we would have to add the weak economic and financial figures of the past two years to wave V's average performance, which would drag it down even more. So you see, *it has not been a New Economy after all* but rather a comparatively lackluster one.

Economic Deterioration During the Final Decade of Wave V

The economic expansion waned not only on a long-term basis but also on a near-term basis, *within* wave V. While real GDP stayed fairly steady throughout the bull market, some measures showed a subtle but persistent slowdown in economic vibrancy. For example, average annual corporate profit growth fell from **10.8** percent in the first 15 years of the bull market to **8.8** percent in the 1990s, a decline of about **20** percent. From the stock market's low in September/October 1998 through the third quarter of 2000 (the peak of economic performance for that period), profit growth averaged only **4.6** percent, revealing further slowing as wave V crested.

Portent of Reversal?

Collectively, these statistics reveal that the economic advance in the United States has been slowing *at multiple degrees of scale*, a trend that is still manifest today. A continuation of this trend will mean that the expansion that resumed in October 2001 will be the briefest and weakest yet.

The persistent deceleration in the U.S. economy is vitally important because, in my opinion, it portends a major reversal from economic expansion to economic contraction. Chapter 5 will expand upon the reasons for this conclusion. As we are about to see, though, we need not rely on hypothesis alone. The 20th century provides two great precursors to the current situation.

The U.S. in the 1920s

If you recall your economic history, you know that a phrase in vogue in the 1920s was that the economy had entered a "New Era." Economists of the day, as President Hoover ruefully recalled in his memoirs, gushed over the wonderful economy, just as they are doing today. Were the Roaring 'Twenties truly a New Era, or was such talk a spate of hype spurred by the good feelings associated with a soaring stock market?

According to data from Professor Mark Siegler of Williams College (MA), from 1872 through 1880, the annual inflation-adjusted Gross National Product of the United States rose from $98 billion to $172 billion, a **68** percent gain. From 1898 to 1906, real GNP rose from $228.8 billion to $403.7 billion, a **56** percent gain. In contrast, from 1921 through 1929, during the Roaring 'Twenties, GNP in the supposed "New Era" rose from $554.8 billion to $822.2 billion, only a **48** percent gain. This latter performance was particularly poor given that the *stock market* enjoyed a greater percentage rise from 1921 to 1929 than it had done in any equivalent time in U.S. history.

Similarly to today, the economy of that time failed to keep pace with the advance in stock prices *and* under-performed the prior expansion. The aftermath was the Great Depression.

The Japanese Experience and Its Implications

If you are over 20 years old, you surely remember the "Japanese Miracle" of the 1980s. The country's products were the best in the world. Its corporate managers lectured and wrote books on how they did it, and the world's CEOs flocked to emulate their style. The Japanese Nikkei stock average soared, and foreign investors poured into the "sure thing." Was the Japanese economy truly miraculous, or once again were economists ignoring economic statistics and simply expressing the good feelings associated with its stampeding stock market?

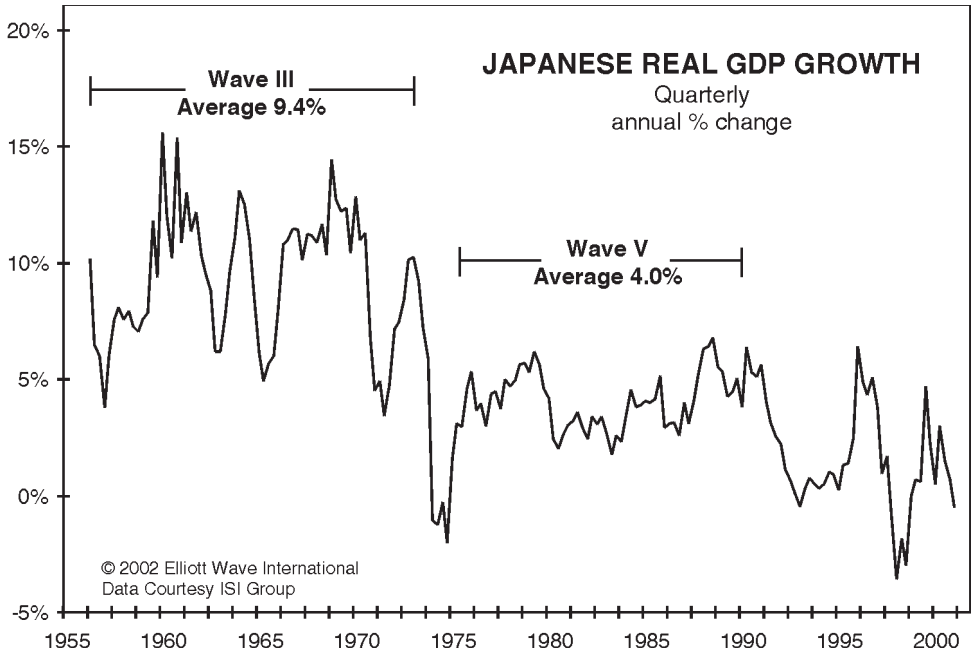


Figure 1-5

Figure 1-5 shows real GDP growth in Japan from 1955 to the present. Notice that Japan's growth from 1955 through 1973 was extremely powerful, averaging **9.4** percent per year. But its economic growth from 1975 through 1989 averaged only **4.0** percent per year. This relatively poor economic performance coincided with a record-breaking stock market boom. Just as in the U.S. in the 1920s, the economy in Japan's celebrated years failed to keep pace with the advance in its Nikkei stock index *and* under-performed the prior expansion. This double dichotomy signaled an approaching reversal of multi-decade importance in both stock prices and the economy. Since the top of its own "wave V," the Nikkei stock index has plunged 70 percent, the economy has had three recessions in a dozen years, and the banking system has become deeply stressed. As we will see in Chapter 8, this downtrend isn't over yet.

A Naked Emperor

The "New Era" of the 1920s ended in a bust. The "Japanese Miracle" of the 1980s ended in a bust. Is that what will happen to today's "New Economy"? We have already gotten a hint of the answer. The next seven chapters will provide a definitive reply to that question.

When historians return to this time, I suspect that they will discover the slow but persistent regression in both U.S. and worldwide growth over the decades in the latter half of the twentieth century and wonder why so few recognized it as a signal of the coming change.

Part II: The Position of the Stock Market Today

Figures 4-1 through 4-3 display my interpretation of the stock market's wave position today at three degrees of trend. Once again, I am keeping these illustrations and explanations as simple as I can. Many fascinating nuances attend these structures, and you will be well rewarded for taking the time to study them via Elliott Wave International's publications if you are so inclined. Suffice it for now to say that the foregoing conclusions are consistent with the analysis of the main wave practitioners of the past century: R.N. Elliott (1871-1948), Charles J. Collins (1894-1982), A. Hamilton Bolton (1914-1967) and A.J. Frost (1908-1999). Their published works on the subject — along with my own — are available in their entirety (aside from a handful of Elliott's lost "market letters") for review at elliottwave.com/books.

Figure 4-1 shows the uptrend of a postulated "Grand Supercycle" wave Ⓘⅈⅈⅈ from 1784 (plus or minus a decade; records are sketchy) to the present. As you can see, its broad strokes seem to trace out a five-wave structure. I have left the preceding bear market of 64 years in British stock prices on the chart to show that the advance arose from the ashes of a bear market of corresponding degree, wave Ⓘⅈ.

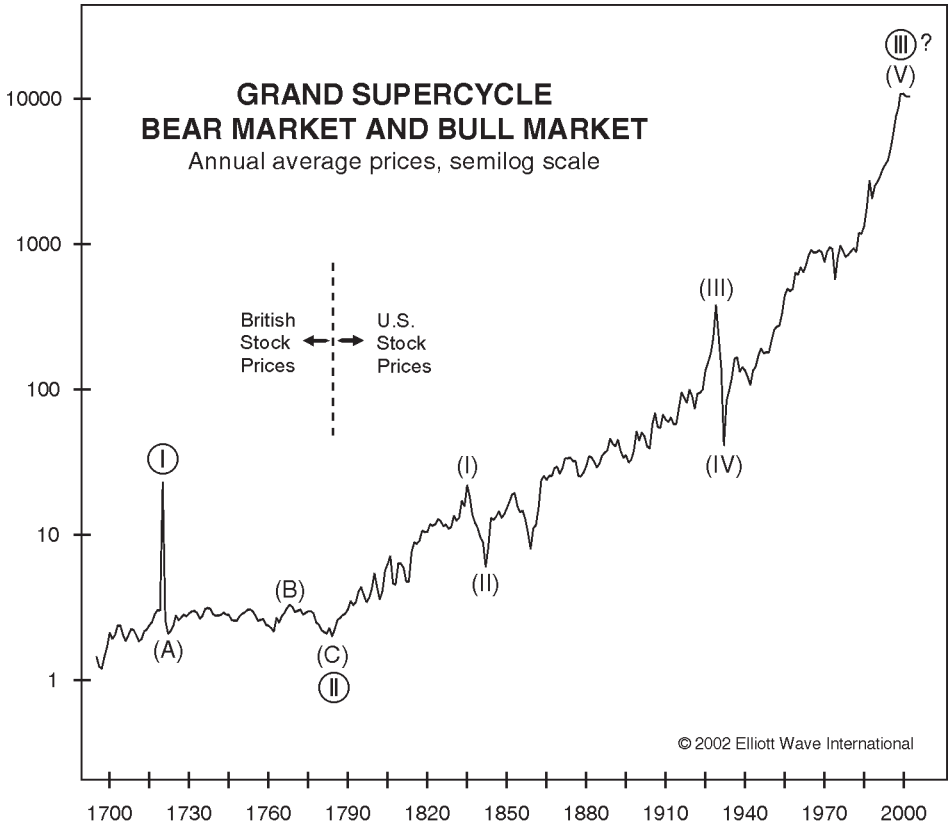


Figure 4-1

Figure 4-2 shows the detail of the fifth wave from Figure 4-1, "Supercycle" wave (V), which was born in 1932 at the bottom of the biggest bear market since the 1700s. As you can see, it is easily identified as a five-wave structure, which emerged from the ashes of a bear market of corresponding degree, wave (IV). As Chapters 5 through 7 will show, this labeling is definitive.

Figure 4-3 shows the detail of the fifth wave from Figure 4-2, "Cycle" wave V, which began in 1974 at the bottom of wave IV, the biggest bear market since the one that ended in 1942. As you can see, the rise can be labeled as five completed waves, and in this case, they form a trend channel. Although I would like to be able to assert that Figure 4-3 is definitive, certain nuances of wave identification allow a slight chance that the Dow could make another new high within Cycle wave V. In that case, the final rally, currently underway, will be brief and short.

My summary of these pictures, then, is that the uptrend from around 1784 is *probably* five waves, the uptrend from 1932 is *definitely* five waves, and the uptrend from 1974 is *very probably* a completed five waves. To conclude, then, here is what we have: A bull market that has endured since the time of the Great Depression is definitely ending, and its termination could well mark the end of an uptrend of one degree larger, which has endured since the founding of the Republic.

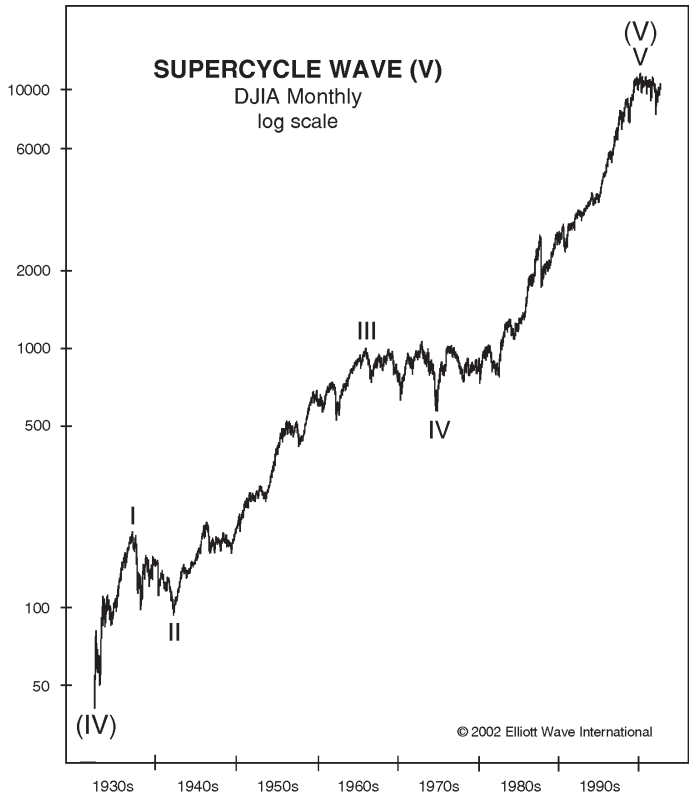


Figure 4-2

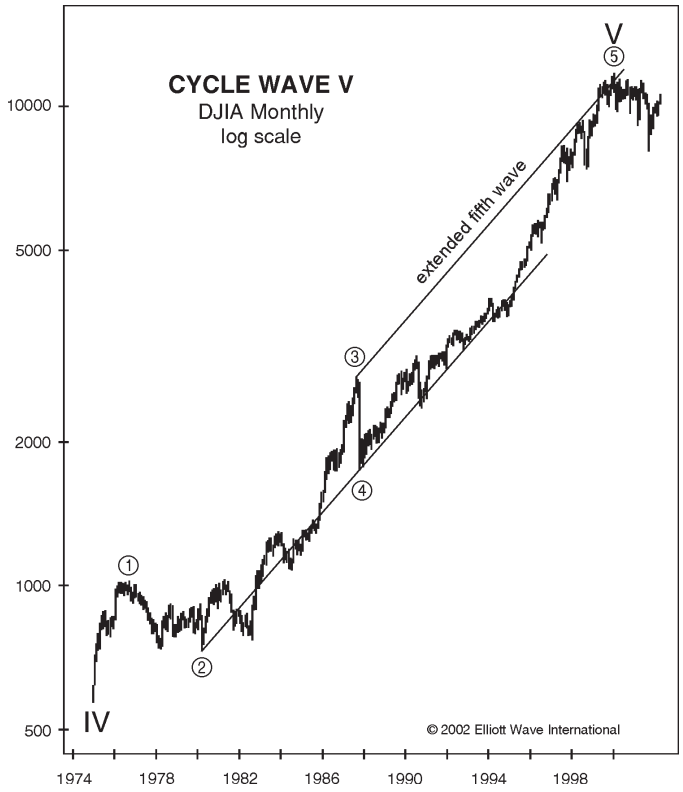


Figure 4-3

Specific Renditions of the Stock Market Fractal

The last time that the stock market formed a fifth wave of Cycle degree was in the 1920s. That's why Elliott-wave forecasts from November 1978 and September 1982 specifically called for the emerging bull market to "parallel the 1920s." (See *Elliott Wave Principle*, Chapter 8 and Appendix.) Although the two waves in Figure 4-4 are quite different quantitatively in terms of both duration (8.05 vs. 25.1 years) and extent (596.5% vs.

1929.6%), you can see that their forms are strikingly similar. If you apply your calculator to the figures just quoted, you will also discover that the lower graph rises 3.2 times the percentage gain of the upper graph in 3.1 times the time. In other words, their overall rates of ascent are essentially identical. If someone had showed you these two data series — unmarked — under the guise that they were concurrent, wouldn't you agree that they were correlated? In my opinion, the similarities between the two advances are not coincidental. This form is an expression of how mass psychology progresses in Cycle degree fifth waves that contain extended fifth sub-waves, apparently an ideal setting for an investment mania.

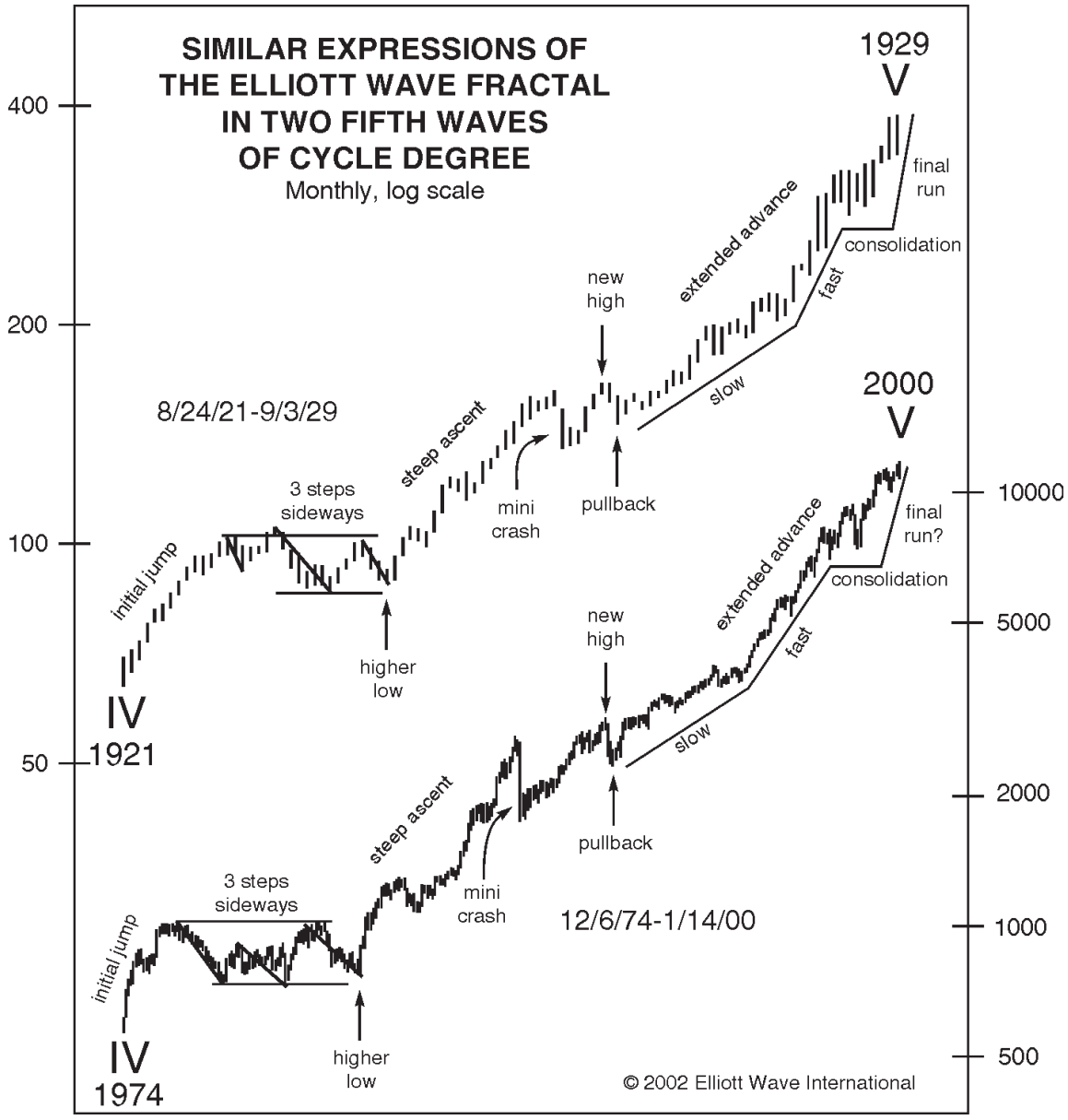


Figure 4-4

Worldwide Stock Values

The long-term Elliott wave position and outlook are hardly confined to the United States. The World Stock Index, which reflects the total value of stocks worldwide, also shows five waves up from 1974 and portends a major decline. The wave labeling in Figure 4-5 is slightly more detailed, showing Intermediate and Primary degree subdivisions.

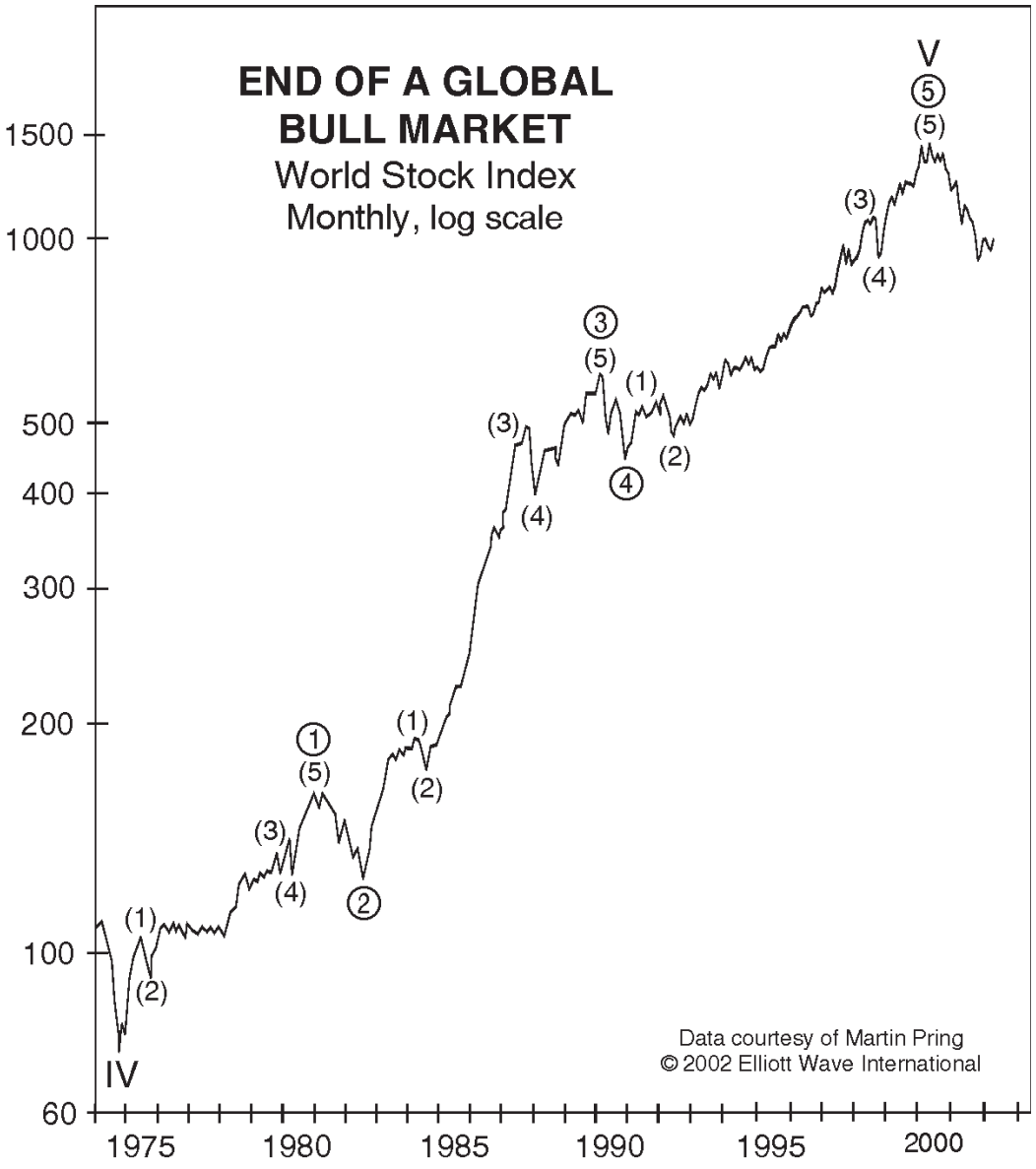


Figure 4-5

A Final Selling Opportunity in the Making

Immediately after the terrorist attack of September 11, 2001, the U.S. stock market was shut down. The entire country, not just the investment community, was in a panic. That day, my publication, *The Elliott Wave Theorist*, issued a forecast diagram of the Standard & Poor's 500 Composite Index. It called for the index to fall just a bit further and then begin the largest rally since it topped in March 2000. Six trading days later, the stock market bottomed and turned up.

You can see in Figure 4-6 why I made that forecast. In September 2001, the S&P Composite (along with the Wilshire 5000 and other indexes) was clearly finishing *five waves down*. If you re-examine Figure 3-1, you will see that a pattern of five waves down from a bull-market high always calls for a bear-market rally in an up-down-up pattern and then a resumption of the larger downtrend. The S&P's five waves down, then, called for a corresponding three-wave rally, which began on September 21, six days after the market re-opened.

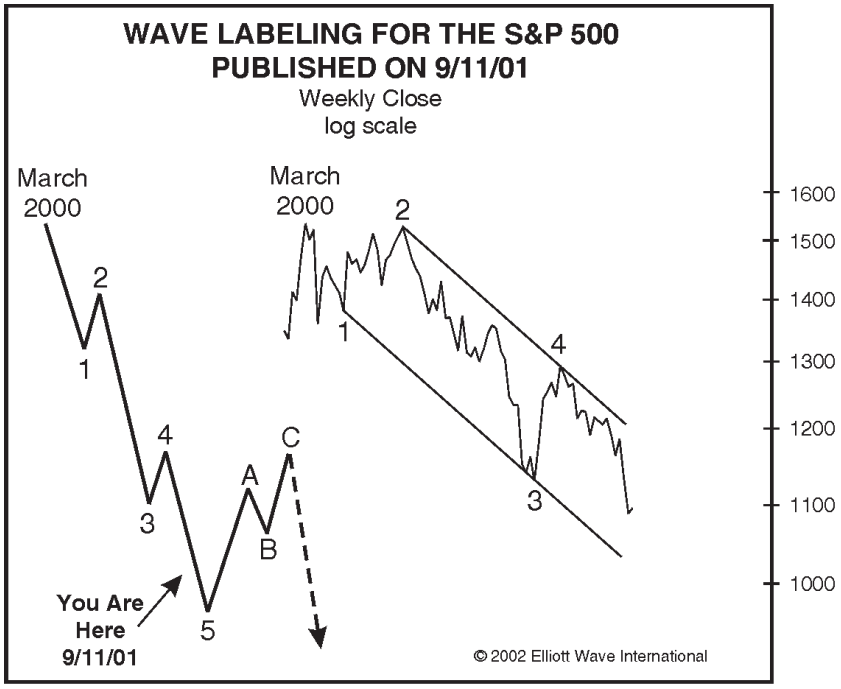


Figure 4-6

Most segments of the market are still advancing here near the end of the first quarter of 2002 as I put the final touches on this book. The S&P and the Wilshire 5000 indexes have continued to follow the expected path, as you can see in the updated graph of the S&P in Figure 4-7, and the Dow has climbed back above 10,000.

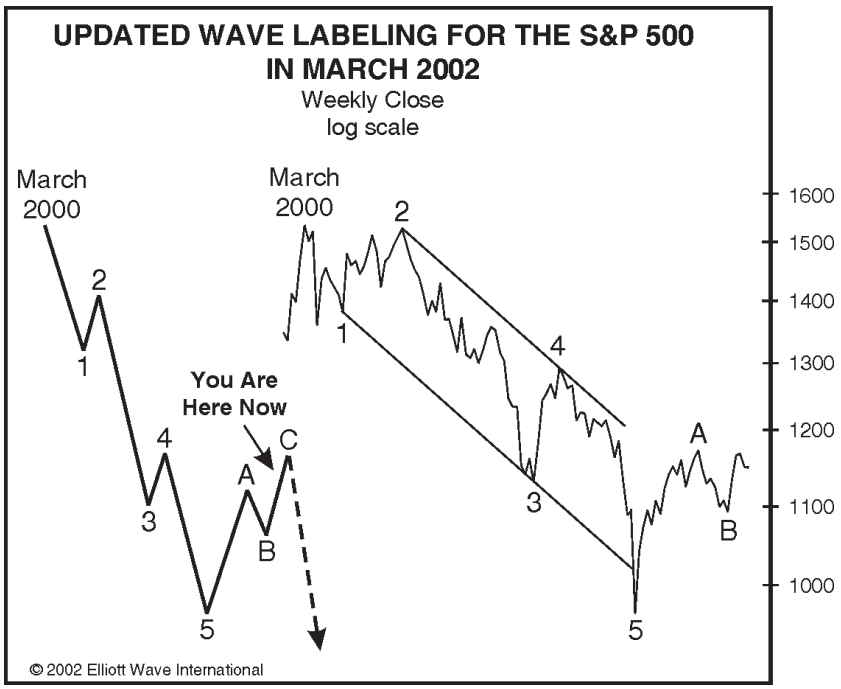


Figure 4-7

This rally has been strong enough in selected secondary issues to propel two stock averages, which are constructed so as to reflect this bias, to new all-time highs, as you can see in Figure

4-8. While the first quarter of 2000 presented a whale of a selling opportunity for the S&P and the NASDAQ, the current rally is creating one just as good for many sectors of the market. Releasing this book into the heat of this rally should provide maximum benefit to you.

Further upside potential is nothing more than a near-term consideration. What you need to care about is the major reversal that is about to impact your financial health dramatically. The following three chapters demonstrate the extremely high probability that the larger advancing wave depicted in Figure 4-2 — the one that began seven decades ago — has run its course.

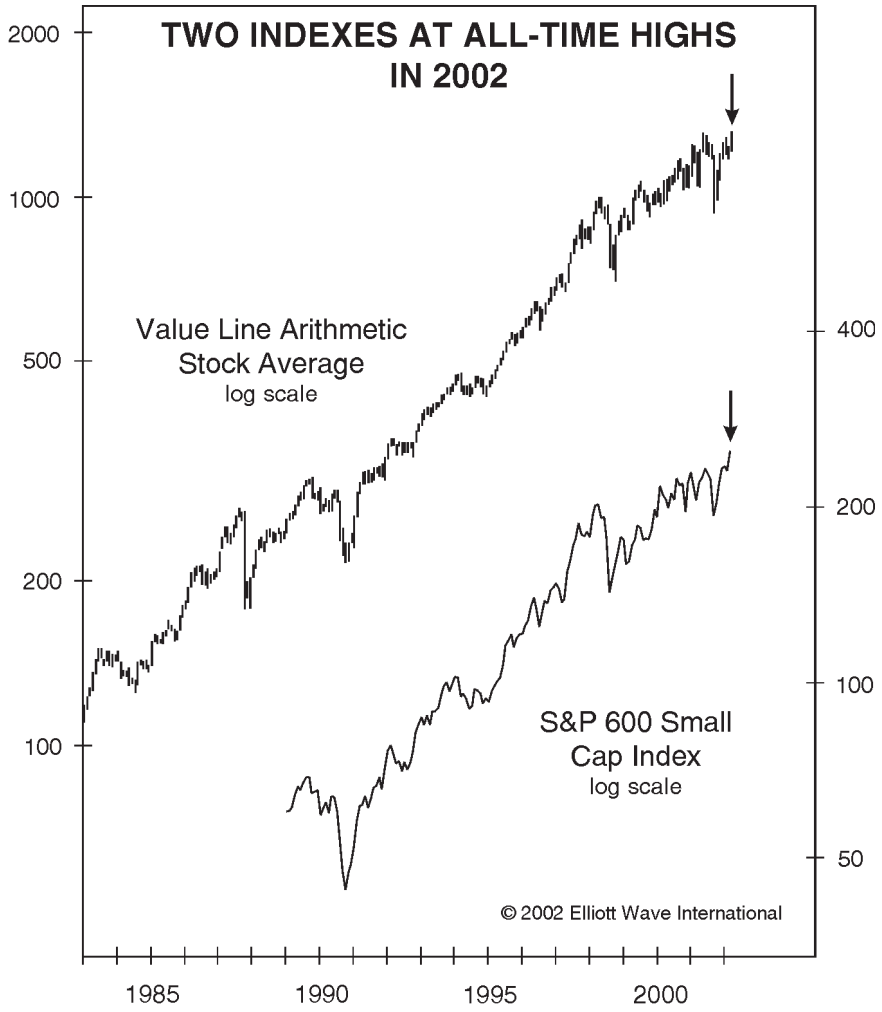


Figure 4-8

4 The Biggest Threat to the "Economic Recovery" is ...

From *The Elliott Wave Theorist*
April 2002, February 2004, November 2005

The Biggest Threat to the "Economic Recovery" is ...

No, it's not inflation. Or global terrorism. Or high oil prices. Read this surprising report and learn what *you* can do to protect your money.

This report originally appeared in the April 2002, February 2004 and November 2005 issues of *The Elliott Wave Theorist*, Bob Prechter's monthly market analysis publication.

CAN THE FED STOP DEFLATION?

Consensus Opinion Concerning Deflation

Seventy years of nearly continuous inflation have made most people utterly confident of its permanence. If the majority of economists have any monetary fear at all, it is fear of inflation, which is the opposite of deflation. Two of the world's most renowned economists have reiterated this fear in recent months in *The Wall Street Journal*, predicting an immediate acceleration of inflation.

As for the very idea of deflation, one economist a few years ago told a national newspaper that deflation had a "1 in 10,000" chance of occurring. The Chairman of Carnegie Mellon's business school calls the notion of deflation "utter nonsense." A professor of economics at Pepperdine University states flatly, "Rising stock prices will inevitably lead to rising prices in the rest of the economy." The publication of an economic think-tank insists, "Anyone who asserts that deflation is imminent or already underway ignores the rationale for fiat currency — that is, to facilitate the manipulation of economic activity." A financial writer explains, "Deflation…is totally a function of the Federal Reserve's management of monetary policy. It has nothing to do with the business cycle, productivity, taxes, booms and busts or anything else." Concurring, an adviser writes in a national magazine, "U.S. deflation would be simple to stop today. The Federal Reserve could just print more money, ending the price slide in its tracks." Yet another sneers, "Get real," and likens anyone concerned about deflation to "small children." One maverick economist whose model accommodates deflation and who actually *expects* a period of deflation is nevertheless convinced that it will be a "good deflation" and "nothing to fear." On financial television, another analyst (who apparently equates deflation with falling prices) quips, "Don't worry about deflation. All it does is pad profits." A banker calls any episode of falling oil prices "a positive catalyst [that] will put more money in consumers' pockets. It will benefit companies that are powered by energy and oil, and it will benefit the overall economy." Others excitedly welcome recently falling commodity prices as an economic stimulus "equivalent to a massive tax cut." A national business magazine guarantees, "That's not deflation ahead, just slower inflation. Put your deflation worries away." The senior economist with Deutsche Bank in New York estimates, "The chance of deflation is at most one in 50" (apparently up from the 1 in 10,000 of a couple of years ago). The President of the San Francisco Fed says, "The idea that we are launching into a prolonged period of declining prices I don't think has substance." A former government economist jokes that deflation is "57th on my list of worries, right after the 56th — fear of being eaten by piranhas." These comments about deflation represent entrenched professional opinion.

As you can see, anyone challenging virtually the entire army of financial and economic thinkers, from academic to professional, from liberal to conservative, from Keynesian socialist to Objectivist free-market, from Monetarist technocratic even to many vocal proponents of the Austrian school, must respond to their belief that inflation is virtually inevitable and deflation impossible.

"Potent Directors"

The primary basis for today's belief in perpetual prosperity and inflation with *perhaps* an occasional recession is what I call the "potent directors" fallacy. It is nearly impossible to find a treatise on macroeconomics today that does not assert or assume that the Federal Reserve Board has learned to control both our money and our economy. Many believe that it also possesses immense power to manipulate the stock market.

The very idea that it *can* do these things is false. Last October, before the House and Senate Joint Economic committee, Chairman Alan Greenspan himself called the idea that the Fed could prevent recessions a "puzzling" notion, chalking up such events to exactly what causes them: "human psychology." In August 1999, he even more specifically described the stock market as being driven by "waves of optimism and pessimism." He's right on this point, but no one is listening.

The Chairman also expresses the view that the Fed has the power to temper economic swings for the better. Is that what it does? Politicians and most economists assert that a central bank is necessary for maximum growth. Is that the case?

This is not the place for a treatise on the subject, but a brief dose of reality should serve. Real economic growth in the U.S. was greater in the nineteenth century without a central bank than it has been in the twentieth century with one. Real economic growth in Hong Kong during the latter half of the twentieth century outstripped that of every other country in the entire world, and it had no central bank. Anyone who advocates a causal connection between central banking and economic performance must conclude that a central bank is harmful to economic growth. For recent examples of the failure of the idea of efficacious economic directors, just look around. Since Japan's boom ended in 1990, its regulators have been using every presumed macroeconomic "tool" to get the Land of the Sinking Sun rising again, as yet to no avail. The World Bank, the IMF, local central banks and government officials were "wisely managing" Southeast Asia's boom until it collapsed spectacularly in 1997. Prevent the bust? They expressed profound dismay that it even happened. As I write this paragraph, Argentina's economy has just crashed despite the machinations of its own presumed "potent directors." I say "despite," but the truth is that directors, whether they are Argentina's, Japan's or America's, *cannot* make things better and have *always* made things worse. It is a principle that meddling in the free market can only disable it. People think that the Fed has "managed" the economy brilliantly in the 1980s and 1990s. Most financial professionals believe that the only potential culprit of a deviation from the path to ever greater prosperity would be current-time central bank actions so grossly stupid as to be beyond the realm of possibility. But the deep flaws in the Fed's manipulation of the banking system to induce and facilitate the extension of credit will bear bitter fruit in the next depression. Economists who do not believe that a prolonged expansionary credit policy has consequences will soon be blasting the Fed for "mistakes" in the present, whereas the errors that matter most reside in the past. Regardless of whether this truth comes to light, the populace will disrespect the Fed and other central banks mightily by the time the depression is over. For many people, the single biggest financial shock and surprise over the next decade will be the revelation that the Fed has never really known what on earth it was doing. Make sure that you avoid the disillusion and financial devastation that will afflict those who harbor a misguided faith in the world's central bankers and the idea that they can manage our money, our credit or our economy.

The Fed's Final Card

The Fed used to have two sources of power to expand the total amount of bank credit: It could lower reserve requirements or lower the discount rate, the rate at which it lends money to banks. In shepherding reserve requirements down to zero, it has expended all the power of the first source. In

2001, the Fed lowered its discount rate from 6 percent to 1.75 percent, an unprecedented amount in such a short time. By doing so, it has expended much of the power residing in the second source. What will it do if the economy resumes its contraction, lower interest rates to zero? *Then what?*

Why the Fed Cannot Stop Deflation

Countless people say that deflation is impossible because the Federal Reserve Bank can just *print money* to stave off deflation. If the Fed's main jobs were simply establishing new checking accounts and grinding out banknotes, that's what it might do. But in terms of *volume*, that has not been the Fed's primary function, which for 89 years has been in fact to foster the *expansion of credit*. Printed fiat currency depends almost entirely upon the whims of the issuer, but credit is another matter entirely.

What the Fed does is to set or influence certain very short-term interbank loan rates. It sets the discount rate, which is the Fed's nominal near-term lending rate to banks. This action is primarily a "signal" of the Fed's posture because banks almost never borrow from the Fed, as doing so implies desperation. (Whether they will do so more in coming years under duress is another question.) More actively, the Fed buys and sells overnight "repurchase agreements," which are collateralized loans among banks and dealers, to defend its chosen rate, called the "federal funds" rate. In stable times, the lower the rate at which banks can borrow short-term funds, the lower the rate at which they can offer long-term loans to the public. Thus, though the Fed undertakes its operations to influence bank borrowing, its ultimate goal is to influence public borrowing from banks. Observe that the Fed makes bank credit more available or less available to two sets of *willing borrowers*.

During social-mood uptrends, this strategy appears to work, because the borrowers – i.e., banks and their customers — are confident, eager participants in the process. During monetary crises, the Fed's attempts to target interest rates don't appear to work because in such environments, the demands of creditors overwhelm the Fed's desires. In the inflationary 1970s to early 1980s, rates of interest soared to 16 percent, and the Fed was forced to follow, not because it *wanted* that interest rate but because debt investors demanded it.

Regardless of the federal funds rate, banks set their own lending rates to customers. During economic contractions, banks can become fearful to make long-term loans even with cheap short-term money. In that case, they raise their loan rates to make up for the perceived risk of loss. In particularly scary times, banks have been known virtually to cease new commercial and consumer lending altogether. Thus, the ultimate success of the Fed's attempts to influence the total amount of credit outstanding depends not only upon willing borrowers but also upon the banks as *willing creditors*.

Economists hint at the Fed's occasional impotence in fostering credit expansion when they describe an ineffective monetary strategy, i.e., a drop in the Fed's target rates that does not stimulate borrowing, as "pushing on a string." At such times, low Fed-influenced rates cannot overcome creditors' disinclination to lend and/or customers' unwillingness or inability to borrow. That's what has been happening in Japan for over a decade, where rates have fallen effectively to zero but the volume of credit is still contracting. Unfortunately for would-be credit manipulators, the leeway in interest-rate manipulation stops at zero percent. When prices for goods fall rapidly during deflation, the value of money rises, so even a zero interest rate imposes a heavy real cost on borrowers, who are obligated to return more valuable dollars at a later date. No one holding money wants to pay someone to borrow it, so interest rates cannot go negative. (Some people have proposed various pay-to-borrow schemes for central banks to employ in combating deflation, but it is doubtful that the real world would accommodate any of them.)

When banks and investors are reluctant to lend, then only *higher* interest rates can induce them to do so. In deflationary times, the market accommodates this pressure with falling bond prices and higher lending rates for all but the most pristine debtors. But wait; it's not that simple, because higher interest rates do not serve only to *attract* capital; they can also make it flee. Once again, the determinant of the difference is market psychology: Creditors in a defensive frame of mind can perceive a borrower's willingness to pay high rates as desperation, in which case, the higher the offer, the more repelled is the creditor. In a deflationary crash, soaring prices for bonds mean that creditors fear default.

A defensive credit market can scuttle the Fed's efforts to get lenders and borrowers to agree to transact at all, much less at some desired target rate. If people and corporations are unwilling to borrow or unable to finance debt, and if banks and investors are disinclined to lend, central banks cannot force them to do so. During deflation, they cannot even *induce* them to do so with a zero interest rate.

Thus, regardless of assertions to the contrary, the Fed's purported "control" of borrowing, lending and interest rates ultimately depends upon an accommodating market psychology and cannot be set by decree. So ultimately, the Fed does not control either interest rates or the total supply of credit; the market does.

There is an invisible group of lenders in the money game: *complacent depositors*, who — mostly by default — have been letting banks engage in whatever lending activities they like. Under pressure, bankers have occasionally testified that depositors might become highly skittish (if not horrified) if they knew how their money is being handled. During emotional times, the Fed will also have to try to maintain bank depositors' confidence by refraining from actions that appear to indicate panic. This balancing act will temper the Fed's potency and put it on the defensive yet further.

In contrast to the assumptions of conventional macroeconomic models, people are not machines. They get emotional. People become depressed, fearful, cautious and angry during depressions; that's essentially what causes them. A change in the population's mental state from a desire to expand to a desire to conserve is key to understanding why central bank machinations cannot avert deflation.

When ebullience makes people expansive, they often act on impulse, without full regard to reason. That's why, for example, consumers, corporations and governments can allow themselves to take on huge masses of debt, which they later regret. It is why creditors can be comfortable lending to weak borrowers, which they later regret. It is also why stocks can reach unprecedented valuations.

Conversely, when fear makes people defensive, they again often act on impulse, without full regard to reason. One example of action impelled by defensive psychology is governments' recurring drive toward protectionism during deflationary periods. Protectionism is correctly recognized among economists of all stripes as destructive, yet there is always a call for it when people's mental state changes to a defensive psychology. Voting blocs, whether corporate, union or regional, demand import tariffs and bans, and politicians provide them in order to get re-elected. If one country does not adopt protectionism, its trading partners will. Either way, the inevitable dampening effect on trade is inescapable. Another example of defensive psychology is the increasing conservatism of bankers during a credit contraction. When lending officers become afraid, they call in loans and slow or stop their lending no matter how good their clients' credit may be in actuality. Instead of seeing opportunity, they see only danger. Ironically, much of the actual danger appears as a consequence of the reckless, impulsive decisions that they made in the preceding uptrend. In an environment of pessimism, corporations likewise reduce borrowing for expansion and acquisition, fearing the burden more than they believe in the opportunity. Consumers adopt a defensive strategy at such times by opting to save and conserve rather than to borrow, invest and spend. Anything the Fed does in such a climate

will be seen through the lens of cynicism and fear. In such a mental state, people will interpret Fed actions differently from the way that they did when they were inclined toward confidence and hope.

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 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.

The myth of Fed omnipotence has two main countervailing forces: the bond market and the currency market. With today's full disclosure of central banks' activities, governments and central banks cannot hide their monetary decisions. Indications that the Fed had adopted an unwelcome policy would spread immediately around the world, and markets would adjust accordingly. Those adjustments could not only negate but also *outrun* the Fed's attempts at undesired money or credit expansion.

The problems that the Fed faces are due to the fact that the world is not so much awash in money as it is awash in *credit*. Because today the amount of outstanding credit dwarfs the quantity of money, debt investors, who always have the option to sell bonds in large quantities, are in the driver's seat with respect to interest rates, currency values and the total quantity of credit, which means that they, not the Fed, are now in charge of the prospects for inflation and deflation. The Fed has become a slave to trends that it has already fostered for seventy years, to events that have already transpired. For the Fed, the mass of credit that it has nursed into the world is like having raised King Kong from babyhood as a pet. He might behave, but only if you can figure out what he wants and keep him satisfied.

In the context of our discussion, the Fed has four relevant tasks: to keep the banking system liquid, to maintain the public's confidence in banks, to maintain the market's faith in the value of Treasury securities, which constitute its own reserves, and to maintain the integrity of the dollar relative to other currencies, since dollars are the basis of the Fed's power. In a system-wide financial crisis, these goals will conflict. If the Fed chooses to favor any one of these goals, the others will be at least compromised, possibly doomed.

The Fed may have taken its steps to eliminate reserve requirements with these conflicts in mind, because whether by unintended consequence or design, that regulatory change transferred the full

moral responsibility for depositors' money onto the banks. The Fed has thus excused itself from responsibility in a system-wide banking crisis, giving itself the option of defending the dollar or the Treasury's debt rather than your bank deposits. Indeed, from 1928 to 1933, the Fed raised its holdings of Treasury securities from 10.8 percent of its credit portfolio to 91.5 percent, effectively fleeing to "quality" right along with the rest of the market. What actual path the Fed will take under pressure is unknown, but it is important to know that it is under no *obligation* to save the banks, print money or pursue any other rescue. Its primary *legal* obligation is to provide backing for the nation's currency, which it could quite merrily fulfill no matter what happens to the banking system.

Local Inflation by Repatriation?

Other countries hold Treasury securities in their central banks as reserves, and their citizens keep dollar bills as a store of value and medium of exchange. In fact, foreigners hold 45 percent of Treasury securities in the marketplace and 75 percent of all $100 bills. Repatriation of those instruments, it has been proposed, could cause a dramatic local inflation. If in fact investors around the world were to panic over the quality of the Treasury's debt, it would cause a price collapse in Treasury securities, which would be deflationary. As for currency repatriation, if overall money and credit were deflating in dollar terms, dollar bills would be rising in value. Foreigners would want to hold onto those remaining dollar bills with both hands. Even if foreigners did return their dollars, the Fed, as required by law, would offset returned dollar currency with sales of Treasury bonds, thus neutralizing the monetary effect.

Can Fiscal Policy Halt Deflation?

Can the government spend our way out of deflation and depression? Governments sometimes employ aspects of "fiscal policy," i.e., altering spending or taxing policies, to "pump up" demand for goods and services. Raising taxes for any reason would be harmful. Increasing government spending (with or without raising taxes) simply transfers wealth from savers to spenders, substituting a short-run stimulus for long-run financial deterioration. Japan has used this approach for twelve years, and it hasn't worked. Slashing taxes absent government spending cuts would be useless because the government would have to borrow the difference. Cutting government spending is a good thing, but politics will prevent its happening prior to a crisis.

Understand further that even the government's "tools" of macroeconomic manipulation are hardly mechanical levers on a machine; they are subject to psychology. Have you noticed the government's increasing fiscal conservatism over the past decade? Even Democrats have been voicing the virtues of a balanced budget! This is a sea change in *thinking*, and that is what ultimately causes trends such as inflation and deflation.

Endgame

The lack of solutions to the deflation problem is due to the fact that the problem results from prior excesses. Like the discomfort of drug addiction withdrawal, the discomfort of credit addiction withdrawal cannot be avoided. The time to have thought about avoiding a system-wide deflation was years ago. Now it's too late.

It does not matter how it happens; in the right psychological environment, *deflation will win***, at least initially. People today, raised in the benign, expansive environment of Supercycle wave (V), love to quote the conventional wisdom, "Don't fight the Fed." Now that the environment is about to change, I think that the cry of the truly wise should be, "***Don't fight the waves***."**

Currency Hyperinflation

While I can discern no obvious forces that would counteract deflation, *after* deflation is another matter. At the bottom, when there is little credit left to destroy, currency inflation, perhaps even hyper-inflation, could well come into play. In fact, I think this outcome has a fairly high probability in the next Kondratieff cycle.

When a government embarks on a policy of currency hyperinflation, such as the Confederate States did in the 1860s, Germany did in the early 1920s or France did after World War II, the monetary path is utterly different from that of deflation, but ironically, the end result is about the same as that of a deflationary crash. At the end of hyperinflation, total bank accounts denominated in the hyperinflated currency are worth far less than they were, sometimes nothing at all. Total debts have shrunk or disappeared because the notes were denominated in depreciated money. In the severest cases, even the money disappears. In this sense, even with hyperinflation, the end result is the destruction of money and credit, which is deflation.

The Markets Will Signal Inflation

Despite my thoughts on the matter, I recognize that international money flows are massive, central bankers can be ingenious, and politics can be volatile. Perhaps there is some way that inflation, whether globally or locally, could accelerate in the immediate future. How can you tell if my conclusion about deflation is wrong and that inflation or hyperinflation is taking place *instead of* deflation?

There are two sensitive barometers of major monetary trends. One is the currency market. If the price of the dollar against other currencies begins to plummet, then the market either fears dollar inflation or that the value of the dollar will not hold up in a climate of waning confidence. The other, which is more important, is the gold market. I hope to recommend gold at lower prices near the bottom of the deflationary trend...

A High Degree of Complexity

Stocks are not registering a Supercycle top like that of 1929 but a *Grand* Supercycle top. This means that the ultimate — if not the immediate — consequences will be more severe and more confounding than the consequences of the 1929-1932 crash. As Chapter 5 of *At the Crest of the Tidal Wave* explains, the entirety of Grand Supercycle wave (should last a century and comprise two or three major bear markets with one or two intervening bull markets. My outlook for deflation pertains primarily to the first bear market. Because in some ways the financial world is in uncharted waters, this analysis may not have all the answers.

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?

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 s tored 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?

Phony Lore

Speaking of credit contraction, the ubiquitous bias against the idea of deflation is so powerful that since *The Elliott Wave Financial Forecast* first alerted readers (in the October 31 issue) that the money supply was shrinking, we have received numerous emails explaining to us why this deflation did not actually occur. Their argument is, "The money supply fell because people used up that money to buy stocks." That's baloney. Money does not disappear when people buy shares of a company. The seller gets it. The same thing happens when you buy a box of nails at Wal-Mart.

In a credit-based money system such as we have, the supply of money rises and falls as a function of the expansion and contraction of the overall supply of credit. In this case, the supply of credit contracted by over two percent between September and December. This is news because it hasn't contracted this much, over any period of time, for 60 years. What's happening is that lenders and debtors are retiring loans. (The two reasons why they are doing so are explained on pages 90-91 of *Conquer the Crash*.)

I can understand how people can misunderstand money; it is a highly complex issue. But I cannot understand how people can make an argument that blatantly contradicts the entire experience of the past 20 years, when the money supply rose persistently right along with the stock market. If there were any validity to the argument, then wouldn't the money supply have been falling during that time? At first I refused to address this notion because I could not imagine that anyone but a few novices would fall for it. But it became so widespread that I had to comment. For a more detailed explanation of such matters, see Chapter 9 of Conquer the Crash.

Is Cash Already Better Than Debt?

During deflationary times, cash becomes the most desired financial asset as standard investments fall in price, even as far as zero due to bankruptcy and default. In the second edition of Conquer the

Crash, I explained why the Fed would be loath to use its final one percentage point leeway in lowering the federal funds rate:

> The U.S. has a thriving money-market fund industry, which costs at least ½ percent of assets per year to administer. As it stands now, investors are getting extremely low returns from money-market funds. If the Fed were to let its funds rate drop to zero, investors' return after fees could go negative, which would make holding cash more attractive than holding debt, a situation the Fed surely wants to avoid. The monetary system appears to have reached the point at which those pesky reactionary forces discussed in Chapter 13 will come into play if the Fed tries any more "deflation-fighting," no matter what the mechanism.

Is holding cash already becoming more attractive than holding debt? On January 21, the Daily Reckoning website ran an article by Gary North. While North has been predicting financial apocalypse (hyperinflation, Y2K, etc.) for 30 years and berating deflationist newsletters (all one of them) as recently as July, he seems to be the only long-time inflationist who took the recent drop in the money supply seriously. The result is a fine piece of work. Reviewing the charts of various components of the money supply, North concludes that the nation's small savers are withdrawing their money from banks in the form of currency. The reason, he says, is that the average annual yield in bank savings accounts has plummeted to 0.4 percent per year, which is negligible. The reward to a small saver for putting cash to work in the underground economy, thereby avoiding taxes, outweighs the value of interest earned on bank deposits. It gets interesting when you realize, as detailed painstakingly in Chapter 10 of Conquer the Crash, that currency is the capital base of the banking industry. From that base, all loans are made, again and again. As North explains, when savers withdraw currency and keep it, banks must call in loans to maintain their reserves at an acceptable level. Every dollar of currency withdrawn retires many times that amount in loans that have "multiplied" throughout the banking system. Thus comes about a contraction in the overall "money supply" (which in fact is mostly the short-term credit supply). North zeroes in on the irony: "The Fed decided to stimulate the economy in 2001 by pumping in new money. Lo and behold, this policy is now backfiring[, creating] an anomaly: a fall in the money supply…." This irony and many more have been inevitable. As patiently explained in Conquer the Crash, the Fed has no inflationary options. Every decision it makes, every act it takes, will serve the cause of deflation. This fact pertains not just to bringing the federal funds rate down but also to the extreme idea of "printing money," which is generally a misnomer but if actually attempted would also aggravate deflation. (If you are curious as to why, read page 130 of Conquer the Crash.)

I disagree with North in his conclusion, based on the flat monetary base, that "right now, Fed policy looks neutral," that the Fed is "not pushing on a string," "not pumping in new money," "not inflating" and in fact "pulling reserves out of the system." The Potent Directors Fallacy (see pages 365-370 of *The Wave Principle of Human Social Behavior*) is evident here. The Fed has done, and is still doing, everything it can to inflate the system. It is failing, which is different from succeeding at not inflating. My guess is that the monetary base statistic is not contracting very much because most of the currency that the Fed manufactures – all of which is computed in the monetary base — goes overseas and does not contribute to the reserves of U.S. banks.

"There is no pattern that makes sense," says North. "According to the economic models I am familiar with…. The charts at present do not seem to conform to any theoretical framework of economic explanation that I see in newsletters or the financial press." But of course, the pattern makes perfect sense given the proper theoretical framework. Someone please forward a copy of Conquer the Crash to Gary, because I would like to have just one ally to agree with me that deflation is inevitable, deflation is here, and deflation will be not "mild," "good" or "benign" but devastating.

Money Supply Follies

The Elliott Wave Theorist said in December, "Do you think perhaps that the Fed has cast a worried eye on the trend of M3? You bet it has." Think about this: Although the big drop in the money supply is like an elephant in the room, the Fed has not once commented on it.

By the way, the figures for January show that while M1 and M2 are still below their highs, a rapid climb in M3 has retraced the entire late 2003 drop. Or did it? Welling@Weeden reports that a "pair of gimlet-eyed Fed watchers" discovered that the rise in January's M3 figure was due primarily to a change in the Fed's accounting method. Using the old accounting, M3 rose only about one-half percent in January. A spokesman for the Fed says that the latest figures were inadvertently inaccurate and will be recalculated. So despite recent reports, the contraction remains intact.

What does the decline in the money supply mean for the stock market? Here is a suspicion that I aired years ago, in the March 1987 Elliott Wave Theorist:

> The strongest and most popular "fundamental" argument in favor of rising gold prices is the chart showing the growth in the money supply since 1982. It's certainly an amazing rise. However, it is people who spend and invest the money (a fact that "laws of physics" thinking ignores), and to date the net investment in commodities has been negative. So where is the money [effect showing up]? I doubt it is coincidence that the stock market, as measured by the Dow Jones Industrial Average, is up in percentage terms almost exactly the same amount as M1 from August 1982. As long as money is available, the current financial boom will remain intact. Perhaps it will be when the M1 line turns down that the crash in stocks and most bonds will be upon us.

The M1 line turned down last September [2003].

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 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."

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.

Sources

[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.

5 The "Efficient Market Hypothesis"

From *The Elliott Wave Theorist*

April 2004

The "Efficient Market Hypothesis"

Economists have tried to cram financial markets and financial behaviors into a model dubbed, "Efficient Market Hypothesis" — otherwise known as the Law of Supply and Demand. Despite the fact that it doesn't really fit finance, it remains Wall Street's primary theory of how financial markets operate.

Is there a better model of financial behavior? Get the answer in this April 2004 report from Bob Prechter's monthly market analysis publication, *The Elliott Wave Theorist*.

The Financial/Economic Dichotomy

Utilitarian economic transactions are governed by the Law of Supply and Demand, which operates among rational valuers to produce objective values for goods and services. Economists have long tried to cram financial markets into this model, dubbing it the Efficient Market Hypothesis. Even to a casual observer, though, it quite obviously doesn't fit finance. Prices for stocks do not act like prices for shoes and bread. They race up and down at all degrees of trend and do not consistently reflect any objectively calculated value. Over the past century, the prices that investors have been willing to pay for a dollar of dividends from the DJIA has differed by more than ten times; prices for a dollar of S&P earnings have differed by over nine times; prices for a dollar's worth of S&P 400 corporate book value has differed by over 30 times; and the multiple for an annual percentage point of yield via S&P 400 stock dividends as opposed to via the same companies' corporate bonds has differed by more than 20 times.[1] This history makes — and has always made — a mockery of the Efficient Market Hypothesis. Traditional economic theory, then, does not offer a useful model of finance. What is not so well known is what model of financial behavior should replace EMH. Before answering that question, we need to understand two key differences between economic behavior and financial behavior.

Difference #1: The Relationship of Price to Demand

In economics, lower prices tend to bring about an increase in sales. An example is the fact that more computers are selling at $1000 apiece than sold at $5000 a decade ago or at $1m. half a century ago. As prices have fallen, sales have risen. Conversely, a rise in prices tends to curtail sales. For example, when gasoline prices go up, some people carpool and take public transit or behave in other ways that cut back on the purchase and consumption of gasoline.

Figure 3 on page 3 displays the price regulator at work with respect to demand in utilitarian economic transactions. Price differences relate to demand in this way because for the most part people, who are motivated to survive and thrive, apply their conscious reason to the task of maximizing the utility of their money. "If I spend too much on fashions," thinks a rich person, "I may not have enough to pay for my cool condo." A poor person thinks, "If I spend too much on clothes, I may not be able to eat." When people violate this guide to behavior by, for example, wasting their money, then those with a lot of money fail to thrive and those with little money may fail to survive. Maximizing the utility of money is economically advantageous for people of limited means, which is everybody.

In finance, prices do not regulate behavior in this manner. Take a look at Figure 1, which shows the U.S. public's holdings of stock against the prices at which those stocks sell. Observe that as prices fall, investors do not increase their percentage holdings of stock; they decrease it. Conversely, as prices rise, investors do not curtail their percentage of stock holdings; they increase it. In other words,

the relationship of price to demand finance is the opposite of that in utilitarian economics. Surely people in their role as investors have the same motivation to survive and thrive as they do in their role as consumers of goods and services. But if they were applying their reason to the task of maximizing the utility of their investment funds, then one the two graphs in Figure 1 would be inverted. People would hold more stock a bottom and less stock at a top. But this is not what they do; it is the opposite of what they do.

In the marketplace for goods and services, the volume of sales also moves inversely to prices. High prices reduce sales volume, and a "liquidation sale" moves more product off the shelves. The volume of trading in financial markets, however, tends to fluctuate in the same direction as price. As prices rise, volume also tends to rise; as prices fall, volume also tends to fall. Figure 2 shows this tendency over an 80-year period. Again, behavior in financial markets is the opposite of that in the marketplace for goods and services. (The main situation which volume rises in a falling market is during a panic. This rise in volume, however, is not due to rising demand to own stocks, as it would be the market for utilitarian goods. It is due to the rising desire to disown stocks, which again is the opposite of what occurs in the marketplace for utilitarian goods.)

Therefore, investors in the aggregate do not act reasonably to maximize the utility of their money when participating in financial markets. What means are they using? What mechnism are they using? And what is the result? Figure 4 poses these questions, which we will answer after reviewing the second key difference between economics and finance.

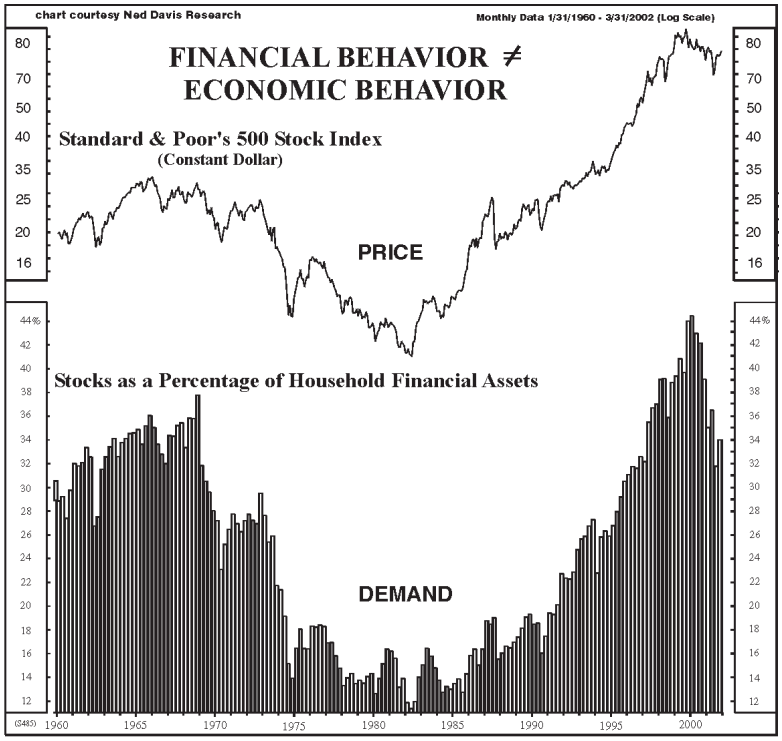
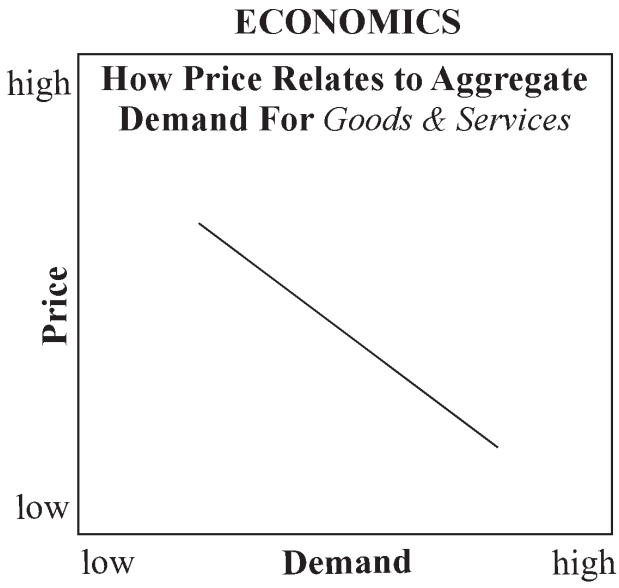
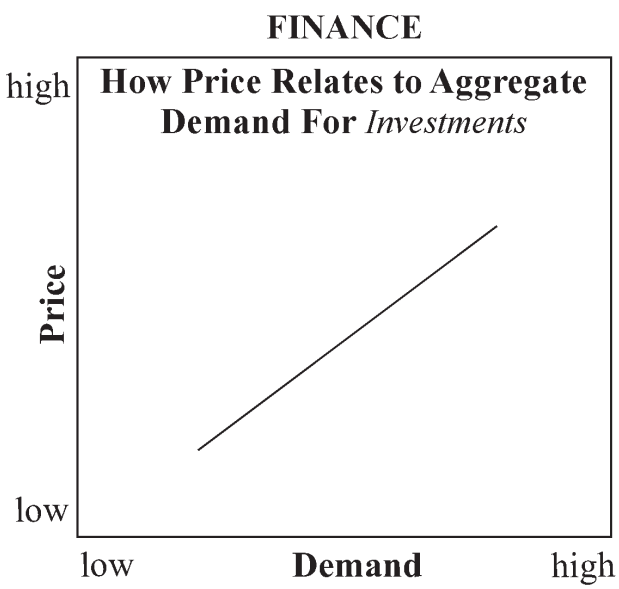


Figure 1

Figure 2



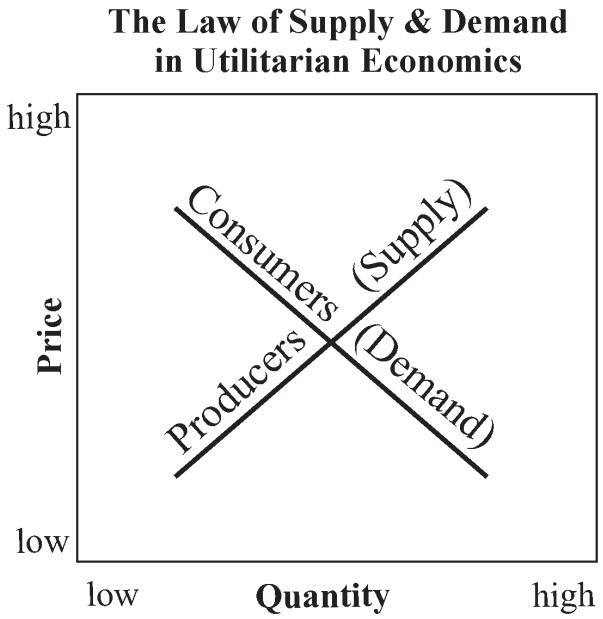


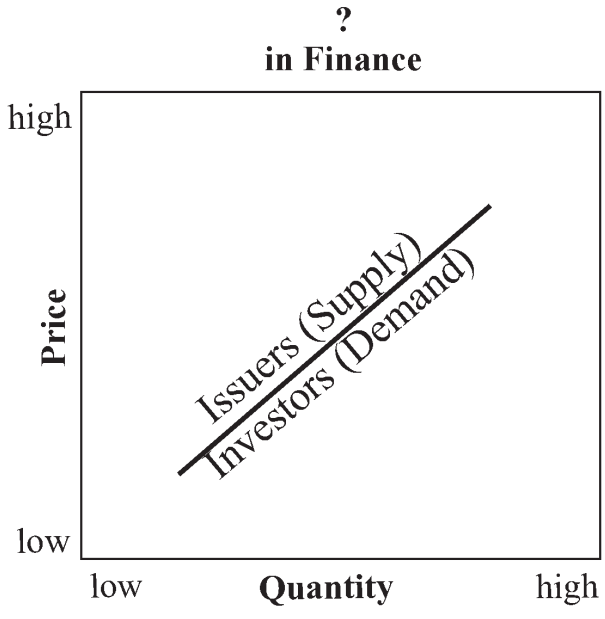
Motivation (goal): Survive and Thrive
Means: Maximizing Utility
Mechanism: Conscious Reason
Result: Survive and Thrive

Figure 3

Motivation (goal): Survive and Thrive
Means: ?
Mechanism: ?
Result: ?

Figure 4





Features: Rational Valuation
Equilibrium
Objective Values

Figure 5

Features: ?
?
?

Figure 6

Difference #2: Balanced vs. Unbalanced Market Forces

Figure 5 depicts the famous Law of Supply and Demand, which regulates prices in the marketplace for utilitarian goods and services. In this case, we consider the motivation not only of buyers but also of sellers. Producers of goods and services desire to get as much money as they can for their products. The higher prices are for products in the marketplace, the more producers are motivated to produce them. Conversely, the lower those prices are, the more consumers are motivated to buy them. These conflicting desires create a balance, arbitrated by price. At some price, enough producers are motivated to produce enough products to satisfy demand from enough consumers so as to create a price for the product that is reasonable to both parties.

The Law of Supply and Demand is based upon the motivation, shared by producers and consumers alike, to survive and thrive. Both parties use reason to maximize the utility of their resources. The opposing desires of producers and consumers create a balance of forces on the buy and sell sides of the transactions, which creates equilibrium in prices. Values are objective because reason determines them.

In finance, there is no such balance. Issuers of stock, such as new business ventures and corporations desiring cash, as well as sellers of IPOs and secondary offerings, come to the marketplace and, like their counterparts in the production of goods and services, act as if they are thinking, "The higher the price, the more I'll offer." Investors, unlike their counterparts in economic transactions, act as if they are responding, "The higher the price, the more I'll buy." Can you imagine buyers of shoes and food behaving in this manner?

Because the Law of Supply and Demand does not regulate the financial marketplace, there is no balance of forces that prices can arbitrate. Figure 6 poses five questions: What dynamic is operating in finance? Does that dynamic rely on the application of reason? Does it produce equilibrium? Are the resulting values objectively determined? If not, what are its features?

A Better Model

A better model of financial market behavior is the Wave Principle, which appears to be governed by an unconscious herding impulse in human beings, as postulated in Chapter 8 of The Wave Principle of Human Social Behavior. Unconscious herding explains human behavior in the financial realm that is anomalous to economic theory. The motivation behind both types of behavior — financial and economic — is the same as that for all evolved behaviors: to survive and thrive. In finance, however, the mind is operating differently. Buyers in a rising market appear unconsciously to think, "The herd must know where the food is. Run with the herd and you will prosper." Sellers in a falling market appear unconsciously to think, "The herd must know that there is a lion racing toward us. Run with the herd or you will die." Investors are conscious only of the powerful feelings that attend these unconscious thoughts and the rationales that they foster. If such thoughts were conscious, rational people would see through and ignore the false reasoning and instead buy low, sell high and get rich.

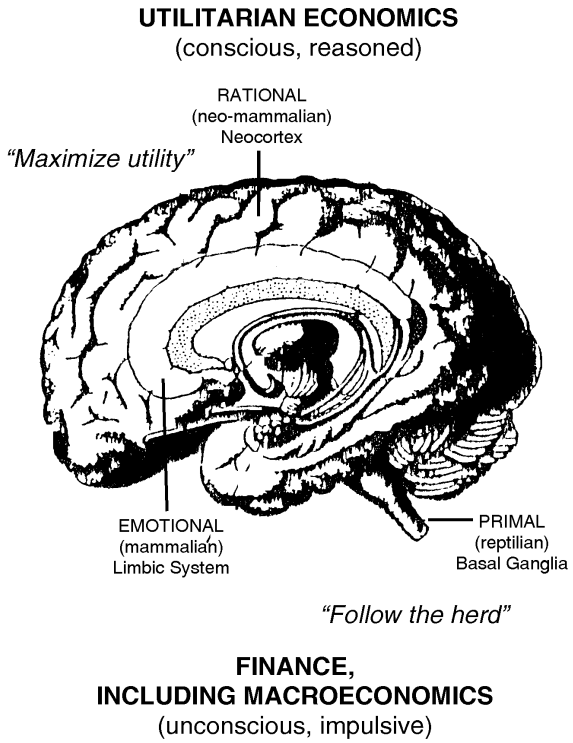
Some researchers have posed the question of financial market behavior in terms of a quest for understanding varying risk preferences. This is an excellent question, but it can be answered only from a socionomic perspective. The academic discussion to date has proved fruitless because it derives from the paradigm of utilitarian economics in being based upon the notion that investors for some unexplained yet rational reason are willing to take on more risk as prices rise. This idea is incorrect because aggregate investors' means of thought is not reason but impulsion. In both cases — buying in an uptrend and selling in a downtrend — investors in the aggregate are acting unconsciously to reduce

risk, thanks to the emotionally satisfying impulse to herd. Objectively, risk increases in both cases. But herding is not objective; it is impulsive, so greater risk is actually perceived as less risk. This paradoxical discrepancy between reasonable and actual investor behavior accounts for the information in Figure 1.

When are people prone to herding? People herd under various circumstances, one of which is uncertainty. When people are certain about something, they usually act accordingly; when they are uncertain, they typically default to a herding impulse inherited from lower animals through evolution. When humans don't know, they are impelled to act as if others do, and because sometimes others actually do know, herding increases the overall odds of survival.

EMH postulates that investors are never uncertain about current values. According to that model, investors simply revalue markets rationally as new information — all of which they know and understand in terms of its relationship to share values — becomes available. (Does that describe how you feel when you invest?) But as Alan Greenspan said recently about central banking, "Uncertainty is not just an important feature of the monetary policy landscape; it is the defining characteristic of that landscape."[2] If those anointed with the power to decree a national interest rate feel chronically uncertain, one may rest assured that the average investor is something less than perfectly informed, knowledgeable and confident. The fact is that every day in finance, investors are uncertain. So they look to the herd for guidance, not realizing that most others in the herd are just as uninformed, ignorant and uncertain as they are. Because herds are ruled by the majority, not the wise, financial market trends are based on little more than the shared mood of investors — how they feel — which is the province of the emotional areas of the brain, not the rational ones.

The rational areas of the brain do play a role in the herding process. They provide rationalization. Without this service, the herding impulse would encounter resistance from the dictates of reason. But research shows (see Chapter 8 of The Wave Principle of Human Social Behavior) that unconscious forces are fast and powerful. They developed through eons of evolution and have kept countless species alive. People unaware of the power of these forces simply employ their reason to excuse the actions that their unconscious impulses impel them to take. This is what most investors, money managers, economists and media commentators do. If a statement about market causality appears to make sense, they use it as a "reason" for their views and actions. As several of the discussions and studies in Socionomics indicate, however, adequate data can disprove every supposed reason for adopting an opinion on the stock market that relies on causes outside the market. The irrelevance of outside forces applies to economic reports, wars and peace treaties, terrorism, elections,



This diagram is adopted from an original conception by Paul Montgomery of Universal Economics. This diagram is not meant to be a precise rendition of the physiology involved in thought or specifically to endorse fully the theory of brain function espoused by Paul Maclean of NIMH, despite its utility in socionomic discussion. It is meant to imply biologically, evolutionarily and mentationally discrete yet cooperative areas of conscious vs. unconscious brain function, wherever they may actually be located.

Figure 7

corporate earnings, scandals, Fed actions and the movements of other markets. None of these classes of events has a leading relationship to stock price movement. To the extent that a relationship may exist (with the direction of influence being the opposite of that traditionally assumed), it is a lagging one and therefore unforecastable without reference to the stock market, making it useless for stock market forecasting. This irrelevance reveals the immense power of the unconscious: It can impel a human being to spout nonsense about stock-market causality day after day and not realize it. Unconscious impulses and emotions are so strong that even when confronted with conflicting data, most people will go on believing that their pet reason of the season — or at minimum the underlying idea that outside forces and objective values propel the stock market — is valid. In this regard, once again the contrast between financial and economic behavior is stark. As The Wave Principle of Human Social Behavior puts it, "Most investors can quickly rationalize selling an investment because its price is falling or buying it because its price is rising, but there is not a soul who desperately rationalizes doing with less bread because the price is falling or who drives his car twice as much because the price of gasoline has doubled."[3]

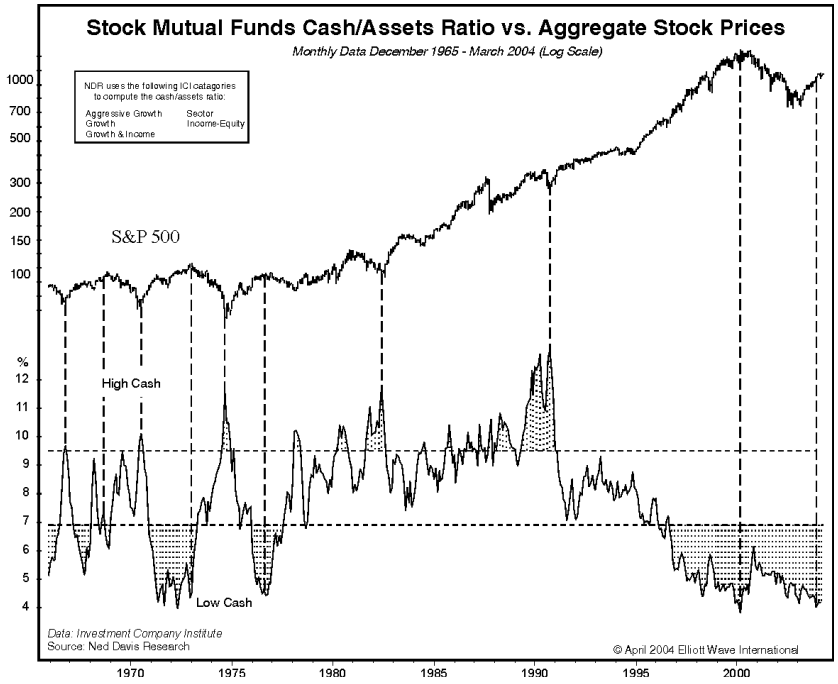


Figure 8

Figure 7 sums up the differences in the mental origins of human behavior in utilitarian economic settings and in financial settings. In the former, people reason calmly. In the latter, they herd.

With this model in mind, we can explain why professional money managers, in the aggregate, fail to beat the market. It is not because the market is random; it is because in the aggregate, professionals are herding, just like most other investors. This is not conjecture. Figure 8 shows that at good prices for buying, stock-fund managers have high levels of cash, and at good prices for selling, they have low levels of cash, exactly the opposite of what they should be doing for maximum return.

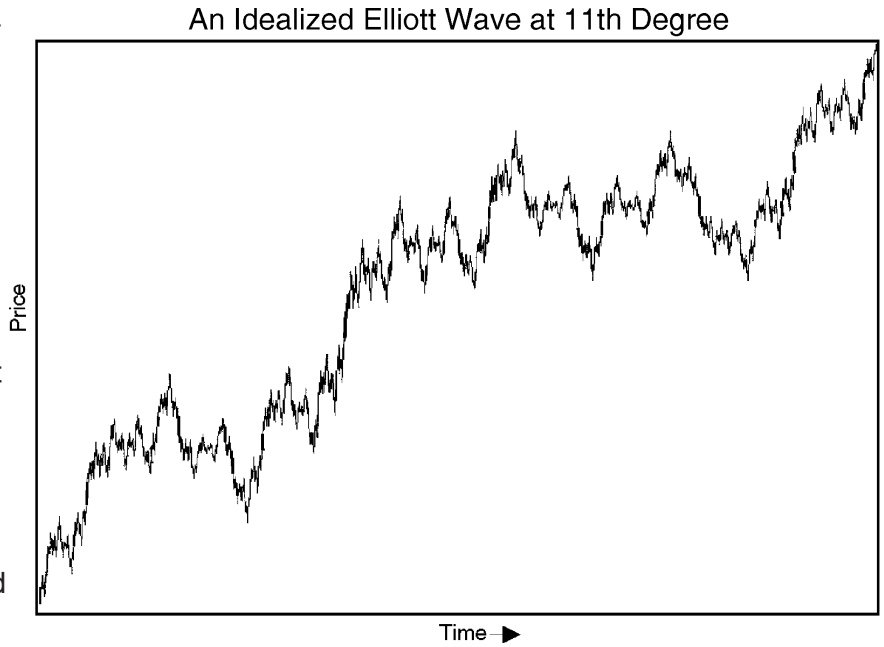


Figure 9

Economics has its law of global effect, called the Invisible Hand. Finance has its law of global effect, too: the Wave Principle. In both economics and finance, ironies abound between individual motivation and global result. In economics, people act to further their own ends, and in doing so, they bring service, prosperity and a measure of stability to society. In finance, people act to further their own ends as well, but in doing so, they create a global fractal of price trends as well as ceaseless dynamism, infusing the human social experience with a wondrous complexity. In neither role are individuals striving to bring about these global results.

The Wave Principle is a patterned fractal. Does it make sense that herding would create a pattern? Yes; it is obligatory. Unconscious thought cannot be random, as that would mean no thought at all. Unconscious thought must occur in patterns particular to it. Shared unconscious thought would have to produce a global pattern. Aggregated herding impulses take the form of the Wave Principle. Figure 9 is an 11th-degree iteration of a single idealized Elliott wave. Although the fractal in this illustration is self-identical rather than displaying the varied self-similarity of an actual Elliott wave, it nevertheless fairly well depicts the "look" of a real financial market because — as research has begun to reveal — it is the proper model.[4]

A Successful Forecast

The idea that herding derives from a different part of the brain from where reason takes place has made a successful forecast. In February 2003, I met with Dr. Greg Berns, a researcher from Emory University, who has access to an MRI machine that a subscriber to *The Elliott Wave Theorist* purchased for the school. In an email sent prior to the meeting, I suggested testing the following idea:

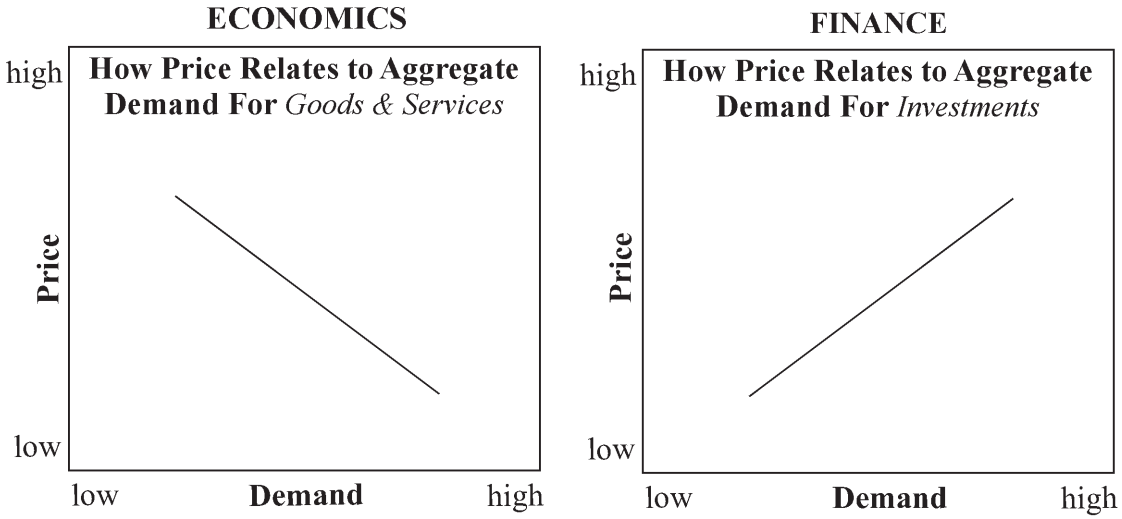
The idea is to test whether information about what a crowd is doing with respect to a task assigned to a subject influences which areas of the brain the subject employs to complete the task. The question is whether people have an impulsive drive to join a crowd and if so, where the origin of that impulse lies within the brain.

Broad Hypothesis 1: When alone, a subject will calmly apply his cerebral cortex to a task involving mathematical calculation and deliver a predictable response. He will experience little or no pre-rational brain perturbation. When supplied with the information that a crowd disagrees with his initial conclusion, he will experience perturbation from the pre-rational portions of his brain, i.e., the limbic system and/or primitive brain stem, which will influence his ultimate response and cause him to adjust his answer in the direction of the crowd's conclusion.[5]

The idea that a different part of the brain would become engaged when making decisions in a group situation is not a self-evident proposition. It could just as well be argued that given information about the opinions of others a person would use the reasoning portions of his mind to take those opinions into account, weighing them simply as a fact to be considered.

Berns designed an experiment to test the thesis, and the results bore out the essence of the prediction: When performing mental tasks, subjects did access a different part of the brain when opinions of others were introduced into their deliberations. As Forbes reported:

Lemminglike, she usually went along with the majority view, even when it was wrong. Her brain scan shows why: A change in perceptual processing. By measuring relative degrees of activation in the parietal lobe, an area involved in integrating visual images, and in the prefrontal

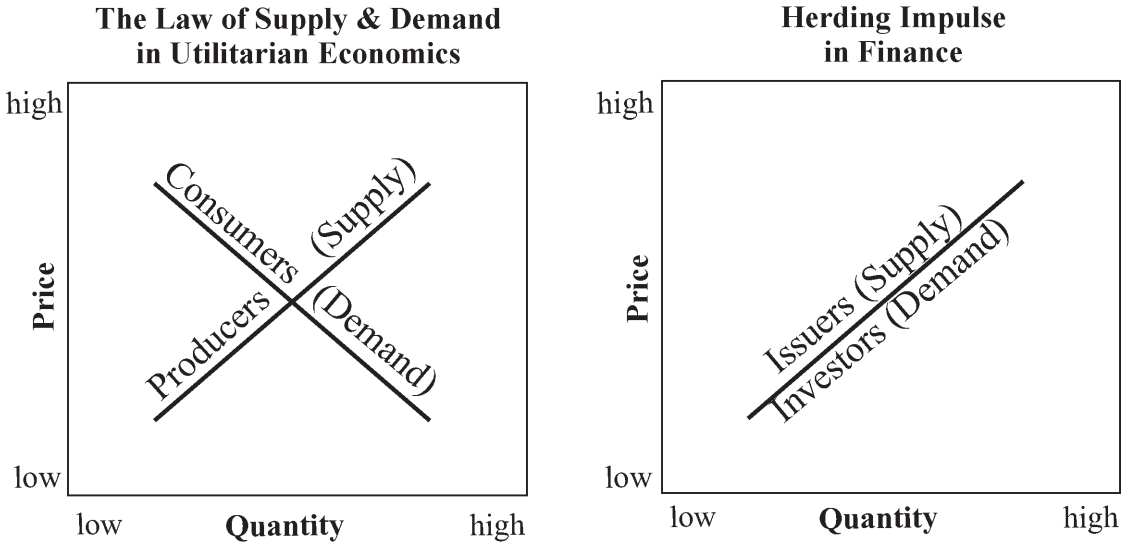


Motivation (goal): Survive and Thrive
Means: Maximizing Utility
Mechanism: Conscious Reason
Result: Survive and Thrive

Figure 10

Motivation (goal): Survive and Thrive
Means: Herding
Mechanism: Unconscious Reason
(Ultimate Result) Result: Losses

Figure 11



Features: Rational Valuation
Equilibrium
Objective Values
Aggregate Governor: The Invisible Hand

Figure 12

Features: Pre-Rational (Impulsive) Valuation
Dynamism
Subjective Values
Aggregate Governor: The Wave Principle

Figure 13

cortex, where decision making takes place, Berns says, he could determine that the group changed what the reporter perceived.[6]

The EMH model would not have considered such a prediction. The socionomic model did, and it was successful.

Filling in the Blanks

Given our model of finance, we can now express more fully the economic/financial dichotomy. Figures 10 and 11 display the idea that although people's motivation in a financial setting is the same as that in an economic setting, their means and mechanism are different. The means to this goal are herding, and the mechanism they employ is unconscious impulsion.

Is success the result of herding behavior? No, the ultimate result of buying high and selling low is losses. So the long-term result of such behavior is not thriving but failure. In rare cases, even a person's survival may be challenged: Some people go bankrupt from financial speculation, and a few commit murder or suicide.

Most people don't know how consistently investors lose money in financial markets. They think that everyone else is getting rich. The only people who know the true extent of financial losses that the public endures are those working in the IRS and in the back offices of brokerage firms. Why? Because most people are too embarrassed to tell the truth, and brokers don't want them to know it. Neither does the IRS, which makes money from annual gains while forcing taxpayers to shoulder their annual losses.

Some numbers tell the real story. An analysis of Federal Reserve data by professor Edward Wolff, a New York University economist, reveals that two-thirds of American households failed to increase their retirement wealth "at all" from 1983 to 1998 despite that fact that in this period stocks enjoyed their biggest bull market ever.[7] Moreover, the retirement wealth of the median household during that time actually fell 13 percent. Given that dismal performance during a huge bull market, you can imagine how investors typically ravage their finances during a bear market. In 1909, a broker using the pseudonym Don Guyon wrote a small book called One-Way Pockets. He was utterly mystified as to why, after a full cycle of rise and fall after which stocks were valued just where they were at the start, all his clients lost money. His answer, in a nutshell, is herding. His clients felt fearful at the start of bull markets and so traded in and out constantly. At the market's peak, they felt confidently bullish and held much more stock "for the long run," behaving just as our friends in Figure 1 did.

Figure 13 argues that the herding impulse, not the Law of Supply and Demand, operates in financial markets. The results of herding are not rational valuation, equilibrium and objective values but pre-rational (impulsive) valuation, dynamism and subjective values. The governing principle of aggregation is not the Invisible Hand but the Wave Principle. (Taking Montgomery's lead, I use the term pre-rational as opposed to irrational because our unconscious mind is not irrational; its purposes, though typically not consciously sensed, are oriented toward a positive goal. The problem of inefficacy arises when the unconscious mind improperly employs this blunt instrument of self-preservation in financial settings.)

Addressing Some Misconceptions

Behavioral economists have made great headway in demolishing EMH, but their theoretical base is still mired in the economic model of finance, so they propose "anomalies" to EMH due to human inconsistencies in applying reason involving overreaction, inappropriate valuation, calm vs. panic, etc. But humans are quite consistent in utilitarian economics, and they are likewise consistent when

it comes to finance. Economics produces a consistency of equilibrium governed by the Law of Supply and Demand. Finance produces a consistency of dynamism governed by the Wave Principle.

Market efficiency vs. non-efficiency is a false dichotomy. The question is not whether the stock market is efficient but what it is efficiently doing. Utilitarian markets are efficient at expressing useful information. Financial markets are efficient at expressing the herding impulse.

Contrasting Models of Finance

EMH (Economic) Model	WP (Socionomic) Model
1. Objective, conscious, rational decisions to maximize utility determine financial values.	1. Subjective, unconscious, pre-rational impulses to herd determine financial values.
2. Financial markets are random.	2. Financial markets are patterned.
3. Financial markets are unpredictable.	3. Financial markets are probabilistically predictable.
4. Financial markets "tend toward equilibrium" and "revert to the mean."	4. Financial markets are dynamic and do not revert to anything.
5. Investors in financial markets typically use information to reason.	5. Investors in financial markets typically use information to rationalize emotional imperatives.
6. Investors' decisions are based on knowledge and certainty.	6. Investors' decisions are fraught with ignorance and uncertainty.
7. Changing events presage changes in the values of associated financial instruments.	7. Changing values of financial instruments presage changes in associated events.
8. Economic principles govern finance.	8. Socionomic principles govern finance.

While it may appear that rising prices in financial assets attract buyers, I believe that there is no such influence. If buying made prices go up and rising price made people buy, we would have a positive feedback loop between prices and investors' actions. Because trends in prices stop and reverse continually, there can be no reinforcing feedback loop. The Wave Principle suggests that shared mood is endogenous and formological,[8] so there can be no feedback loop on that basis, either. Therefore I conclude that prices are irrelevant to the herding dynamic and do not regulate it. Prices are simply an epiphenomenon of an unconscious, impulsive, subjective valuation. Waxing optimism produces rising prices, and waxing pessimism produces falling prices. That's all there is to it. This is why the heading under "Finance" in Figure 11 reads, "How Price Relates to Aggregate Demand…," not, "How Price Affects Aggregate Demand…." In economics, prices are powerful; in finance, they are (in the aggregate) irrelevant. They are merely a gauge of investor psychology, which derives from social mood.

I have heard economists — often brilliant ones — insist that financial markets are no different from markets for shoes and bread. I wonder how one of them would react if he walked into a shoe store and the manager rushed up and told him to "double up" because prices had skyrocketed last week or recent customers warned him to stay away because prices had been collapsing. What would he think if he attended a cocktail party (as Mr. B below) and got involved in the following conversation?

A: "Psst! Whaddaya thinka shoes?"

B: "Huh?

A: "Are you buying or selling?"

B: What do you mean?

C (overhearing): "I'm bullish Hush Puppies, myself."

A: "Yeah? Well, I'm long wing-tips. They're gonna fly!"

D (joining in): "Fine, but you gotta realize, if shoes are gonna go, socks are going next."

A: “Good point! I’d better load up on socks.”

D: “Yep, Argyles are set to run. Hey, what do you think, bub?”

B: “Huh?”

Many academic theorists contend that stock prices “revert to the mean.” But there is no stock-price mean that isn’t arbitrary or constantly changing, so stock prices have nothing constant -- no value, no equilibrium, not even a series of multiple equilibria -- to which to revert. If participants in financial markets were rational, efficient and fully knowledgeable, as EMH proposes, stock price movement would look different from the way it does. Company share prices would trend mostly sideways, with near-vertical jumps and drops to a new plane of equilibrium whenever new information came out. That is not how stock prices behave. They run wildly in one direction and then the other, every minute, hour, day, week, month, year and decade. Without the governing influence of the Law of Supply and Demand, without the conflicting purposes of buyers and sellers, financial prices are free to fly unfettered wherever our aggregated unconscious herding impulses take them. The result is not equilibrium but unceasing dynamism. This dynamism at all degrees could not be better represented than by the fractal structure of the Wave Principle model of financial markets, which has the added bonus of another aspect compatible with history: an implied overall progress in humanity’s enterprise.

Contrasting EMH with WP

The reigning — if battered — model of financial markets (EMH) derives from (micro) economics. The model that will supplant it as a better description and predictor of financial market behavior is the Wave Principle (WP), the model allied with socionomics. Here is a list of the key differences between these two models. In my opinion, the field of economics is properly much smaller than it purports to be. The field of socionomics owns the rest of the territory.

Point #7 may require some clarification for those not yet introduced to socionomics. The socionomic hypothesis is that social mood trends are endogenous and provide the impetus for social action. This statement is in direct contrast to the accepted view that social actions (whether economic, political or cultural) cause changes in social mood. For more on this subject, please read the two-book set, *Socionomics*.

Overlapping Fields

The dichotomy between financial and economic behavior is not as clean-cut as we might like. Sometimes herding invades the economic sphere, such as when people bid up the price of raccoon hides as coonskin caps become popular or when they fly to London to buy a Cabbage Patch Kid in time for Christmas. Conversely, sometimes reason can trump the herding impulse in finance, when an investor or trader is well informed about his own impulses and the impulsive nature of financial markets. Indeed, the socionomic model of finance is the only one that explains persistently successful outliers such as Paul Tudor Jones, Dick Diamond and Marty Schwartz, who make money every year (in one case every month) trading futures. EMH cannot account for these people. (They trade far too often to be called lucky winners of a random lottery.)

Despite the occasional overlap between these two fields, our socionomic thesis is still informative: When the conscious mind rules, people maximize utility and markets seek equilibrium. When the unconscious mind rules, people herd and markets are dynamic. The first state is common in markets for utilitarian goods and services; the second state is common in markets for financial assets.

Summary

I recall a story (but have forgotten the source) of a 19th-century medical conference in which speakers proposed differing theories of the human stomach. Those trained in chemistry said it was akin to a chemical beaker; those trained in biology said it was like a Petrie dish; physicists said that the correct model was a blast furnace. A physician who had studied the stomach his whole professional life rose to the podium and demurred, "It is a stomach, gentlemen, a stomach." Likewise, I would like to suggest that the stock market is not a random walk or chaos or billiard balls or a game or a machine or an economy. It is a stock market, ladies and gentlemen, a stock market.

Notes

[1] See graphs, Chapter 6, Conquer the Crash.

[2] Greenspan, Alan, (August 29, 2003). Remarks at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming.

[3] See Chapter 20, The Wave Principle of Human Social Behavior.

[4] For more on the Wave Principle, see Chapters 1 through 6 of The Wave Principle of Human Social Behavior. For more on herding, see Chapter 8. For more on finance vs. economics, see Chapter 20.

[5] Prechter, Robert, (January 30, 2003). Private email to Dr. Gregory Berns, Associate Professor of Psychiatry and Behavioral Science, Emory University, and Jim Richards.

[6] Wells, Melanie, (September 3, 2003). "In Search of the Buy Button," Forbes.

[7] Wolff, Edward, (May 2000). "Recent Trends in Wealth Ownership," Jerome Levy Economics Institute Working Paper No. 300.

[8] I.e., form-governed. See pp. 399-400 of The Wave Principle of Human Social Behavior.

Independent Investor eBook Update:

How To Invest During a Long-Term Bear Market

6 What's the Best Investment During Recessions: Gold, Stocks or T-Notes?

From *The Elliott Wave Theorist*
March 2008

What's The Best Investment During Recessions: Gold, Stocks or T-Notes?

The knee-jerk answer to the question, "What's the best investment during recessions?" is, "Gold, of course." But once you take the time to do the research, as we did, you will find out what the real answer is.

This report originally appeared in the March 2008 issue of *The Elliott Wave Theorist*, Robert Prechter's monthly market analysis publication.

Gold and Recessions

I have often read, "Gold always goes up in recessions and depressions." Is it true? Should you own gold because you think the economy is tanking? Whenever we hear some claim like this, we always do the same thing: We look at the data.

The first thing to point out is that gold did not make a nickel of U.S. money for anyone in any of the recessions and depressions from 1792, when the gold-based dollar was adopted, through 1969, a period of 177 years. Well, to be precise, there was a change in the valuation in 1900, when Congress changed the dollar's value from 24.75 grains of gold, the amount established in 1792, to 23.22 grains, a devaluation of just six percent total over 108 years. The government did raise the fixed price from $20.67/oz. to $35/oz. in 1934, but that action occurred during an economic *expansion*, not during the Depression. In 1968, gold finally began trading away from the government's fixed price. Even then, it slipped to a lower price of $34.95 on January 16 and 19, 1970. So the idea that gold always goes up in recessions and depressions is already shown to be wrong. It did not go up in terms of dollars in any of the (estimated) 35 recessions or three depressions during that period.

What almost always does happen during economic contractions is that the value of whatever people use as money goes up as prices for goods and services fall. When gold is used as money, its value in terms of goods and services goes up. But gold can't go up in dollar terms when gold and dollars are equated. So no one "makes money" holding gold under these conditions. It is a fine point: What tends to go up relative to goods and services during economic contractions is *money*, and when gold is officially money, that's how it behaves. What we want to know is how gold behaves in recessions and depressions when it is *not* officially accepted as money.

Many gold bugs say that because gold was a good investment during the Great Depression, it is a "deflation hedge." EWT addressed this topic in *At the Crest* (p.357) and *Conquer the Crash* (pp. 208-209). At the time, government fixed gold's price, so it didn't go up or down relative to dollars. Gold was a haven during that time, the same as the dollar was, since they were equated by law. But gold served as a haven because its price was fixed while everything else was crashing in price during the period of deflation. Gold bugs like to claim that gold would have gone up during that period had it not been fixed, but the crashing dollar prices for all other things suggest that in a free market gold, too, would have fallen. It would have fallen, however, from a *higher level* given the inflation of 1914-1929 following the creation of the Fed. So gold became worth more in dollar terms than it was in 1913, which is why it began flowing out of the country. In 1934, the government finally recognized the new reality by raising gold's fixed price. Since 1970, markets have been in a large version of 1914-1930, except that gold has been allowed to float, so we can clearly see its inflation-related, pre-depression gains.

Observe that gold's price remained the same for a Fibonacci 21 years after the Fed was created in 1913; it was revalued in 1934. Then it held *that* value for 35 (a Fibonacci 34 + 1) years, through 1969. So aside from the revaluation of 1934, the inability to make money holding gold during recessions,

depressions, or any time at all save for the day of the revaluation in 1934 held fast for 56 (a Fibonacci 55 + 1) years following the creation of the Fed. So even after Congress created the central bank, no one made money holding gold in a recession or depression for two generations.

In 1970, things changed dramatically. Investors lost interest in stocks and preferred owning gold instead, for a period of ten years. The same change occurred again in 2001, and so far it has lasted seven years. But, as we will see, recession had nothing to do with either of these periods of explosive price gain in the precious metals.

The period of time one chooses to collect data can make a huge difference to the outcome of a statistical study. If we were to show the entire track record from 1792, gold would show almost no movement on average during economic contractions. If we were to take only 1969 to the present, it would show much more fluctuation. To give a fairly balanced picture, combining some history with the entire modern, wild-gold era, I asked Dave Allman to compile statistics beginning at the end of World War II. This is what most economists do, because they believe "modern finance" began at that time and that things have been "normal" since then. It's also when many data series begin. So our study fits the norm that most economists use. It also provides results entirely from the Fed era, making it relevant to current structural conditions.

Table 1 shows the performance of gold during the 11 officially recognized recessions beginning in 1945. Although one could make a case for different start times, we took the 15th of the starting month and the 15th of the ending month as times to record the price of gold. The results speak for themselves. Even though it is accepted throughout most of the gold-bug community that gold rises in bad economic times, Table 1, compiled by Dave Allman, shows that such is not the case.

The only reason that the average gain for gold shows a positive number at all is that gold rose significantly during one of these recessions, that of 11/73-3/75. The average gain for all ten of the other recessions is 0.16 percent, almost exactly zero. The median for all 11 recessions is also zero. If we omit the five recessions during which the price of gold was fixed, the median gain is 3.09 percent.

Thanks to the one big rise, gold gained 8.8 percent per recession on average. But could you have realized any such gain? The answer is no, because the transaction costs even in the most liquid gold investments are at least two percent per trade, or four percent round trip. With these transaction costs included, gold gained 4.8 percent on average. The accompanying tables show returns with and without transaction costs (based on a $100,000 investment) in case you wish to see performance during these periods for someone who was simply holding the investment.

Procedure for a study can affect results. During the month of January 1980, gold soared, registered a major top and then dropped hard. This also happens to be the month a recession started. If we had used January 1 as the recession's start date, gold would have shown a gain for that recession. On the other hand, if we had used January 21 as a start date, it would have shown an even bigger loss, and the average gain for gold after transaction costs in Table 1 for all 11 recessions would have come out to about zero. The event itself tells us which date more properly expresses the relationship between gold and the economy. Gold soared over 700 percent during the final 3½ years of a 5-year expansion and peaked the very month that the recession started. Obviously the correct way to view these changes is that the turns in gold and the economy were concurrent: When the expansion ended, so did the rise in gold. It would be silly to claim victory for the bullish-recession theory because gold rose for the first three weeks of a six-month recession and lost value for the rest of it. Given the extreme drama of the final weeks of rise and reversal, our choice of start date can in this one case skew the results of the study, but our choice of the 15th seems to have pretty well captured the essence of things even at that dramatic juncture.

BEHAVIOR OF THREE KEY MARKETS DURING RECESSIONS

Table 1

GOLD								
Recession Start	Recession End	Length in Months	Start Value	End Value	Capital Gain/Loss	Income	Total Return	Total Return w/ 2008 Transaction Costs
(15th of month)	(15th of month)							
Feb 1945	Oct 1945	8	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
Nov 1948	Oct 1949	11	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
Jul 1953	May 1954	10	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
Aug 1957	Apr 1958	8	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
Apr 1960	Feb 1961	10	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
Dec 1969	Nov 1970	11	35.35	37.95	7.36%	0.00%	**7.36%**	**3.36%**
Nov 1973	Mar 1975	16	91.5	178.25	94.81%	0.00%	**94.81%**	**90.81%**
Jan 1980	Jul 1980	6	684	619.5	-9.43%	0.00%	**-9.43%**	**-13.43%**
Jul 1981	Nov 1982	16	412.25	403.25	-2.18%	0.00%	**-2.18%**	**-6.18%**
Jul 1990	Mar 1991	8	363.6	366	0.66%	0.00%	**0.66%**	**-3.34%**
Mar 2001	Nov 2001	8	260.9	275.6	5.63%	0.00%	**5.63%**	**1.63%**
	Average:	10.18182				**Average:**	**8.80%**	**4.80%**
© March 2008 Elliottwave International						**Median:**	**0.00%**	**-4.00%**

Table 2

DJIA								
		Length in Months	Start Value	End Value	Capital Gain/Loss	Income	Total Return	Total Return w/ 2008 Transaction Costs
(15th of month)	(15th of month)							
Feb 1945	Oct 1945	8	158.2	185.5	17.26%	2.55%	**19.80%**	**19.78%**
Nov 1948	Oct 1949	11	176	186.4	5.91%	5.86%	**11.77%**	**11.75%**
Jul 1953	May 1954	10	268.7	322.5	20.02%	4.22%	**24.24%**	**24.22%**
Aug 1957	Apr 1958	8	487.3	447.5	-8.17%	3.03%	**-5.13%**	**-5.15%**
Apr 1960	Feb 1961	10	630.1	648.8	2.97%	2.93%	**5.90%**	**5.88%**
Dec 1969	Nov 1970	11	784	759.7	-3.10%	3.85%	**0.75%**	**0.73%**
Nov 1973	Mar 1975	16	874.5	773.4	-11.56%	7.03%	**-4.53%**	**-4.55%**
Jan 1980	Jul 1980	6	868.6	901.5	3.79%	2.96%	**6.75%**	**6.73%**
Jul 1981	Nov 1982	16	954.1	1021.4	7.05%	8.20%	**15.25%**	**15.23%**
Jul 1990	Mar 1991	8	2980.2	2948.5	-1.06%	2.47%	**1.40%**	**1.38%**
Mar 2001	Nov 2001	8	10031.3	9872.4	-1.58%	1.21%	**-0.37%**	**-0.39%**
	Average:	10.18182				**Average:**	**6.89%**	**6.87%**
© March 2008 Elliottwave International						**Median:**	**5.90%**	**5.88%**

Table 3

T-NOTES								
		Length in Months	Start Value	End Value	Capital Gain/Loss	Income	Total Return	Total Return w/ 2008 Transaction Costs
(15th of month)	(15th of month)							
Feb 1945	Oct 1945	8	100	102.7167	2.72%	1.29%	**4.01%**	**3.87%**
Nov 1948	Oct 1949	11	100	103.8969	3.90%	1.98%	**5.88%**	**5.74%**
Jul 1953	May 1954	10	100	104.4658	4.47%	2.43%	**6.90%**	**6.76%**
Aug 1957	Apr 1958	8	100	110.036	10.04%	2.57%	**12.61%**	**12.47%**
Apr 1960	Feb 1961	10	100	103.8428	3.84%	3.54%	**7.38%**	**7.24%**
Dec 1969	Nov 1970	11	100	104.1723	4.17%	7.00%	**11.17%**	**11.03%**
Nov 1973	Mar 1975	16	100	95.45263	-4.55%	9.02%	**4.47%**	**4.33%**
Jan 1980	Jul 1980	6	100	102.879	2.88%	5.33%	**8.21%**	**8.07%**
Jul 1981	Nov 1982	16	100	119.0004	19.00%	18.76%	**37.76%**	**37.62%**
Jul 1990	Mar 1991	8	100	102.1924	2.19%	5.62%	**7.82%**	**7.68%**
Mar 2001	Nov 2001	8	100	100.1729	0.17%	3.19%	**3.36%**	**3.22%**
	Average:	10.18182				**Average:**	**9.96%**	**9.82%**
© March 2008 Elliottwave International						**Median:**	**7.38%**	**7.24%**

Gold against the Stock Market

Of course, it is one thing to say what gold did during recessions, but the more useful question is, "What did it do compared to other investments?" We have already noted that during recessions gold has done better on average since 1970 than previously, thanks to its behavior during a single recession. But how has gold done *compared to the stock market?* The answer is that since 1945 stock prices have held up during recessions as well as gold. Table 2 shows that the average total return in the Dow during recessions since World War II is nearly as good as that for gold. When modern transaction costs are taken into account for both markets, the Dow actually beats gold during recessions since 1945. The median for the Dow is much higher than that for gold, which means that the probability for a gain in the Dow during any particular recession is higher than that for a gain in gold; in other words, stock gains in recessions are more reliable.

Actual transaction costs used to be much higher for the stock market, and we could have figured the results on that basis, but doing so would counter the purpose of the present study, which is to determine the past as a guide to future investment decisions. We don't care to know how people investing on these dates would have done in the past but rather we care how we would likely do today, based on historical figures, if we were to own various investments during recessions. Therefore we use current transaction costs across the board under the assumption that stock-transaction costs are not likely to return to past levels. One might counter that the transaction costs for gold are overstated because in the modern world an investor can purchase gold through a futures contract, which has a lower commission. That is true, but a futures contract also loses value to offset the rate of interest, and given that the average recession in our study lasted over ten months and that the average interest rate was four percent, the holding cost of a futures contract, plus the commission, would be almost exactly equal to the conservative four-percent estimate we use for the cost of a two-way gold transaction. As markets become even more sophisticated and trading gold within a secure vault becomes a matter of clicking on a mouse, costs of transfer might fall dramatically. Regardless, both columns are there for your evaluation.

Even here, one cannot generalize that "the Dow beats gold in recessions." Table 2 does not include the two economic contractions of the 1930s, when stock prices got pummeled. Had we included them, stocks would have underperformed gold on a price basis but about matched it on an after-transaction-costs basis.

The Best Investment during Recessions

The most important question, however, is not whether the Dow beat gold or vice versa but whether making either investment would have been better than taking no risk at all. Table 3 shows that ten-year Treasury notes beat both gold and the Dow during recessions since 1945, *and they did so far more reliably*. T-notes provided a capital gain in ten of the 11 recessions, and of course they provided interest income during all of them. And the transaction costs are low. The average total return in T-notes per recession is a full ten percent, beating both stocks and gold. The average total return after transaction costs is 9.82 percent, beating the Dow's 6.87 percent and gold's 4.80 percent. If you compound these figures over 11 recessions, the difference is substantial. It is far greater when we include the major declines in stock prices during the economic contractions of the 1930s and figure in the transaction costs of buying and selling gold.

So if you want to make money *reliably and safely* during recessions and depressions, you should own bonds whose issuers will remain fully reliable debtors throughout the contraction. Of course, as *Conquer the Crash* makes abundantly clear, finding such bonds in this depression, which will be the deepest in 300 years, will not be easy. CTC forecast that in this depression most bonds will go down

and many will go to zero. This process has already begun. This time around, you have to follow the suggestions in that book to make your debt investment work.

O.K., Then, So What Is the Economy Usually Doing When Gold Goes Up?

If gold isn't going up when the economy is contracting, when is it going up? Table 4 answers the question: *All the huge gains in gold have come while the economy was expanding.* This is true of the three most dramatic gold gains of the past century:

(1) Congress changed the official price of gold from $20.67 to $35 per ounce in 1934, during an economic expansion. The gain against the dollar was 69 percent.

(2) The entire bull market from 1970 to 1980 occurred during an economic expansion, aside from $2.60 worth of gain in the 1970 recession and $87 worth of gain during the recession of 11/73 to 3/75. In other words, of the $815 per ounce that gold rose from 1970 to 1980, $725 worth of it came while the economy was expanding.

(3) The entire bull market from 2001 to the present occurred during an economic expansion, aside from the first eight months, when gold edged up $22. In other words, of the $748 per ounce that gold has risen since February 2001, $726 worth of it has come while the economy was expanding.

Even lesser rises in gold, such as the two big rallies during the 1980s, came during economic expansions. So the biggest gains in gold, by far, have occurred while the economy was in *expansion*, *not contraction*.

Why is such the case? Simple: During *expansions*, liquidity is available, and it has to go somewhere. Sometimes it goes into stocks, sometimes it goes into gold, and sometimes it goes into both. During times of extreme credit inflation, such as we have experienced over the past three decades, the moves in these markets during economic expansions are likewise extreme. When recession hits, liquidity dries up, and investors stop buying. During depressions, they sell assets with a vengeance.

Of course, we socionomists do not believe in the external causality of investment price movements. Recessions and expansions do not make investment prices move up and down. Fluctuations in social mood propel the economy, liquidity and movements in investment prices. So the only reason we bother with studies like this to de-bunk various commonly held views of financial causality. Now we know: The idea that gold reliably rises during recessions and depressions is wrong; in fact, like most such passionately accepted lore, it's backwards.

Even So, Is Gold Better Than Stocks During Expansions?

Here we return to our former question: Even though gold tends to rise during economic expansions, is it the right choice? Table 5 reveals that in fact the stock market has beaten the gold market during economic expansions. So even if an investor had bought strictly on the basis of divine knowledge of when economic expansions would occur, he would not have done well to have chosen gold. Stocks have done much better.

Of course, bonds tend to do relatively poorly during economic expansions, as Table 6 shows. The main reason is that interest rates tend to rise during expansions, which makes bond prices fall. There are exceptions to this guideline, but generally speaking, almost every investment outperforms bonds during economic expansions.

BEHAVIOR OF THREE KEY MARKETS DURING EXPANSIONS

Table 4

GOLD								
Expansion Start	Expansion End	Length in Months	Start Value	End Value	Capital Gain/Loss	Income	Total Return	Total Return w/ 2008 Transaction Costs
(15th of month)	(15th of month)							
Oct 1945	Nov 1948	37	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
Oct 1949	Jul 1953	45	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
May 1954	Aug 1957	39	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
Apr 1958	Apr 1960	24	35	35	0.00%	0.00%	**0.00%**	**-4.00%**
Feb 1961	Dec 1969	106	35	35.35	1.00%	0.00%	**1.00%**	**-3.00%**
Nov 1970	Nov 1973	36	37.95	91.5	141.11%	0.00%	**141.11%**	**137.11%**
Mar 1975	Jan 1980	58	178.25	684	283.73%	0.00%	**283.73%**	**279.73%**
Jul 1980	Jul 1981	12	619.5	412.25	-33.45%	0.00%	**-33.45%**	**-37.45%**
Nov 1982	Jul 1990	92	403.25	363.6	-9.83%	0.00%	**-9.83%**	**-13.83%**
Mar 1991	Mar 2001	120	366	260.9	-28.72%	0.00%	**-28.72%**	**-32.72%**
Nov 2001	est. Mar 2008	est. 76	275.6	996.5	261.57%	0.00%	**261.57%**	**257.57%**
	Average:	59				**Average:**	**55.95%**	**51.95%**
© March 2008 Elliottwave International						**Median:**	**0.00%**	**-4.00%**

Table 5

DJIA								
		Length in Months	Start Value	End Value	Capital Gain/Loss	Dividend Income	Total Return	Total Return w/ 2008 Transaction Costs
(15th of month)	(15th of month)							
Oct 1945	Nov 1948	37	185.5	176	-5.12%	10.93%	**5.80%**	**5.78%**
Oct 1949	Jul 1953	45	186.4	268.7	44.15%	13.27%	**57.42%**	**57.40%**
May 1954	Aug 1957	39	322.5	487.3	51.10%	11.52%	**62.62%**	**62.60%**
Apr 1958	Apr 1960	24	447.5	630.1	40.80%	7.09%	**47.89%**	**47.87%**
Feb 1961	Dec 1969	106	648.8	784	20.84%	31.26%	**52.10%**	**52.08%**
Nov 1970	Nov 1973	36	759.7	874.5	15.11%	10.63%	**25.74%**	**25.72%**
Mar 1975	Jan 1980	58	773.4	868.6	12.31%	17.13%	**29.44%**	**29.42%**
Jul 1980	Jul 1981	12	901.5	954.1	5.83%	3.54%	**9.37%**	**9.35%**
Nov 1982	Jul 1990	92	1021.4	2980.2	191.78%	27.13%	**218.91%**	**218.89%**
Mar 1991	Mar 2001	120	2948.5	10031.3	240.22%	35.41%	**275.63%**	**275.61%**
Nov 2001	est. Mar 2008	est. 76	9872.4	12146.4	23.03%	22.40%	**45.44%**	**45.42%**
	Average:	59				**Average:**	**75.49%**	**75.47%**
© March 2008 Elliottwave International						**Median:**	**47.89%**	**47.87%**

Table 6

T-NOTES								
		Length in Months	Start Value	End Value	Capital Gain/Loss	Interest Income	Total Return	Total Return w/ 2008 Transaction Costs
(15th of month)	(15th of month)							
Oct 1945	Nov 1948	37	100	96.54861	**-3.45%**	**5.02%**	**1.56%**	**1.42%**
Oct 1949	Jul 1953	45	100	93.07405	**-6.93%**	**6.37%**	**-0.55%**	**-0.69%**
May 1954	Aug 1957	39	100	91.252	**-8.75%**	**7.73%**	**-1.02%**	**-1.16%**
Apr 1958	Apr 1960	24	100	89.18044	**-10.82%**	**5.28%**	**-5.53%**	**-5.67%**
Feb 1961	Dec 1969	106	100	95.73933	**-4.26%**	**33.12%**	**28.86%**	**28.72%**
Nov 1970	Nov 1973	36	100	101.3203	**1.32%**	**21.02%**	**22.34%**	**22.20%**
Mar 1975	Jan 1980	58	100	87.634	**-12.37%**	**36.21%**	**23.84%**	**23.70%**
Jul 1980	Jul 1981	12	100	80.43564	**-19.56%**	**10.17%**	**-9.40%**	**-9.54%**
Nov 1982	Jul 1990	92	100	104.5759	**4.58%**	**81.65%**	**86.23%**	**86.09%**
Mar 1991	Mar 2001	120	100	100.0213	**0.02%**	**80.97%**	**80.99%**	**80.85%**
Nov 2001	est. Mar 2008	est. 76	100	104.2168	**4.22%**	**30.11%**	**34.33%**	**34.19%**
	Average:	59				**Average:**	**23.79%**	**23.65%**
© March 2008 Elliottwave International						**Median:**	**22.34%**	**22.20%**

7 Why Buy and Hold Doesn't Work Now

From *Prechter's Perspective*
Published 1996 and 2004

Why Buy and Hold Doesn't Work Now

When the market is going up, everyone who buys stocks and holds them looks like a genius. But there are also times when a buy-and-hold strategy can also make investors look foolish — read why.

This interview with Bob Prechter in 1995 is reprinted from pages 149-155 of the book, *Prechter's Perspective*, first published in 1996 and revised in 2004.

What are some other characteristics of a major market bottom?

General despair. Investors completely give up. Sometimes you even begin to hear arguments as to why that market really has no reason to exist. For instance, in 1932, people said capitalism was dead, stocks were dead, and they'd never go up again. We had that situation in gold in 1971, when the government decontrolled it. Several economists came out and said that as soon as they took off the price controls at $35 an ounce, gold would drop to $6 an ounce because it had no industrial utility.

The market is an amazing beast. It even manages to do damage on the way up. Richard Russell has said that the "diabolical objective of bull markets is to advance as far as possible without any people getting in." The opposite is apparently true in bear markets.

Exactly. It's the old story. Bull markets climb a Wall of Worry. I made up a parallel maxim: bear markets slide down a Slope of Hope.

You anticipated this idea in the great bull market when it was just getting under way. You said, "Somehow the Dow has to get to 3600+ with almost nobody aboard."

All I really meant was that for the mechanism of the market to be satisfied, there must be reasons for people to disregard really important advice at the time it is most important that they actually take it. The psychology of 1984-1985 was exquisitely instructive in this regard. Advisors, newspapers and brokers *hated* the market. They were amazingly bearish. So the market went up with the fewest possible people participating. In fact, they were shorting and losing money as it rose. The history of markets shows that over 90% of investors cannot make money in the market. The few successful ones you occasionally hear about usually took the approach of long term buy-and-hold, without regard to trend, and they were lucky enough to be in a multi-year bull market.

But so-called typical investors just don't make money for long. They get interested in the markets at the top of every bull trend, and they get scared out at bottoms. The short term traders lose even faster. They're sending 2% or 3% of their accounts to the brokerage industry in commissions every week or so. How long can you survive that without a good rate of market success? Since people's hopes and fears are the engine of the market — their hopes make it go up and their fears make it go down — the result is that most people must lose money. It is their fears that make them sell near bottoms and their hopes that make them buy near tops.

Let's say you could dissect the average investor's stock portfolio over the course of a full cycle. What would it reveal?

More than 75 years ago, Don Guyon, the pseudonymous author of *One Way Pockets*, wanted to discover why his clients always lost money in a complete bull-bear cycle. It might be argued, he reasoned, that at worst, they should have broken even, since at the end, prices were back to where they were at the start. He found that the answer lay in the clients' temporal orientation to the market's future.

At the beginning of a bull market, he found all his clients were traders. At the top, they were all "investors." This is not only precisely the opposite of the correct orientation for making money, but also entirely natural for human beings and a key reason why the market repeatedly behaves as it does.

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Don Guyon

One Way Pockets

> When the bull market was in its infancy, each of the accounts showed purchases of industrial stocks at prices which a few months later appeared ridiculously cheap, yet advances of from one to three points brought these stocks back to the market. When Steel was in the 60s and Baldwin was nearly 100 points below the figure it finally reached, the accounts showed scores of completed transactions yielding profits of less than two points, liberally interspersed with losses. Then as a gradually higher level was established, these stocks were repurchased, usually at prices considerably higher than those at which they had previously been sold. At this stage, larger profits were the rule; three, five, seven and even 10 points were taken. [Later,] as one after another soared to unheard of heights, stocks were bought freely, and they were not for sale even when the purchaser had ten or fifteen points profit. What was fifteen points? Hadn't Bethlehem advanced over 500? The customer who three months ago had been eager to take a point profit on 100 shares of stock would not take ten points on 1000 shares of the same stock now that it had doubled in price. Just why the public should almost invariably do the wrong thing on Wall Street can be explained only on psychological grounds.

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Your contention is that we're experiencing a long term top of historic proportion. Is there evidence that the long term orientation is the predominant orientation today?

The Elliott Wave Theorist has gone to great lengths to show that the entrenched "focus on the long term" buzzphrase of recent years is of paramount importance in judging the psychological condition of today's market. Such exhortations are always made at market tops. "Buy and hold stocks regardless of anything you see, hear or read," the wisdom now goes. "Focus on the long term and hold your stocks" is what people said right after major peaks in 1930, 1946, 1969 and 1973, too. If a long term bull market ever "rings a bell" as it forms its top, this is it. Back in 1974, 1978, 1979 and 1982, you almost never heard that kind of commentary. The public certainly had no truck with it. Today, it's everywhere. People are writing books about how if you just buy stocks and hold them, you'll get rich. I think that's an excellent description of the past, but I don't think it's going to describe the next 10 years *at all*..

When will we know for certain that we have seen a market top?

For *certain?* When it's too late to act!

If you don't know until it's too late, should traders try to pick tops?

By all means, yes. Waiting for certainty means waiting long enough to miss it.

At what point in the Dow would a crash scenario become a possibility?

Any time it's open.

You know, if the most popular investment gurus of the day, Peter Lynch and Warren Buffett could hear our discussion, they would say, "It's nice to talk about declines, but nailing down when they are going to occur is almost impossible. So, individual investors should just buy the best stocks they can. If they diversify internationally, they can't get killed because they will have to spread the risk out all over the world. Forget about trying to forecast everything." What would your response be to that?

I have a lot of respect for those people because they have risen to the top of their field. However, their field is stock picking. They have been professionals during one of the most rewarding periods in history to be a stock picker. The trend, for the most part, during the past 40 or 50 years has been up. When that situation changes, so will the fortunes of the stock pickers.

But they have a point. Buying and holding works.

It *has* worked. That's different from saying it works or will work. It is also easy to say now. It was not easy to say in 1949, when almost no one followed that advice. So this supposed intellectual point is simply a description of the past. Has it "worked" for bonds since the mid-1940s? Has it "worked" for gold for the past twenty years? Buying always pays off as long as the relevant trend degree is up. When the trend is down, you could just as easily say that one should *sell short and hold*. If buy and hold is in, then market timing should be out, which it is today. It's more or less routine to hear about some new study that shows all the gains over the last 100 years came in less than 100 specific days, and investors should therefore be in the market every single day. In the second half of the 1970s, after the market had cycled for a decade, market timing was all the rage.

We certainly touched the opposite extreme in the recent mania as more than 92% of the respondents to the separate surveys said they were "in for the long haul." Even if stocks plunged, 75% said they would not sell. That conviction is the reason many analysts say the average investor is a "stabilizing force." They say it shows investors are far more market savvy than ever.

Today, to be "market savvy" means to be clueless about market fluctuations, valuation and history, and to buy and hold stocks without a second thought. The *truly* savvy people took such action in 1974, 1979 and 1982 — when *The Elliott Wave Theorist* said to "buy and hold" for the long term — *not* in 2000. In truth, these findings are a devastatingly bearish technical indicator. Taking these statistics at face value, however, analysts are concluding from the public's conviction that investors will continue to buy stocks no matter what and thus keep the market from falling. The only problem with this assessment is that people have minds, which they are inclined to change from time to time when dealing with investments.

Does this buy and hold attitude, in and of itself, mean that the top of the stock bull market is in?

These studies do not pinpoint the day of the top. However, they do provide critically, if not decisively, important information about the market's psychological state. The evidence EWT has been presenting is not merely of anecdotal interest. It is crucial to understanding that the state of the market is typical of the distributive phase that unfolds at the end of a long bull market. When investors are standing stock still (pun intended) mentally, they are in for trouble.

You've said technical analysis is up against "something of a brick wall" when it comes to gaining acceptance among fundamentalists but added that technical analysis has had its moments such as the 1970s and the 1930s-1940s, when it was widely in vogue. Did the bull market of the 1980s and 1990s help or hurt the cause?

In long term bull markets, no one really needs market timing because the market is always going up. This was true during the 1950s and 1960s, a period of market strength. And it has been mostly true since 1982. From 1966 to 1982, though, the market was very cyclic, so investors couldn't sleep like babies with a buy-and-hold blanket like they do today.

But timing is still the most important thing?

R.N. Elliott said quite properly in 1946, "In the matter of investment, timing is the most essential element. *What* to buy is important...but *when* to buy is more important." Regardless of today's bull market rhetoric, that is still true. Once you are satisfied that the trend is safe, you can then concentrate on stock selection. In fact, just to demonstrate that this is not a new viewpoint for *The Elliott Wave Theorist*, I will read this quote from over 12 years ago, in April 1983: "Large institutions will probably do best by avoiding a market timing strategy and concentrating on stock selection, remaining heavily invested until a full five Primary degree waves can be counted." That statement was possible only because of the luxury of having a perspective on the market from a timing standpoint. The gist was, "Now you can forget about timing for awhile." Now that timing is wholly forgotten, it is again absolutely crucial to success. The persistent rise, particularly over the past decade, has brought back into fashion the recurring belief that market timing is passé and useless, if not counterproductive: "All one needs is good stock selection. Just stay in good stocks, and you will make money and be safe." Well, we'll see.

So, who's right? Or is it just another timing play — a relative thing in which technicians are right at tops and fundamental buy and hold strategies are right at bottoms?

Technical analysis is the correct way to approach markets because it accommodates both bullish and bearish positions. "Buy and hold" is not ever right philosophically. It only appears so when the trend is up. The top technicians were bullish at the 1982 low. There are magazine articles to prove it. A very small handful of technicians are the only people bearish here at the top. The craft will only expand in influence as the years go by.

8 Looking Ahead in the Economic and Investment Cycle

From *The Elliott Wave Theorist*
December 2008

Looking Ahead in the Economic and Investment Cycle

One of Georgia's state legislators read Bob Prechter's book, *Conquer the Crash*, and invited Bob to speak to his committee to help them grasp the changes in the local, national, and global economies. What follows is the wide-ranging discussion and charts that Bob provided, which address issues every investor wants to know.

This transcript of Robert Prechter's remarks to Georgia legislators originally appeared in the December 2008 issue of *The Elliott Wave Theorist*, his monthly market analysis publication.

On December 10, 2008, Robert Prechter and ten other speakers addressed the Joint Economic Committee of the House and Senate of the State of Georgia. This is an edited transcript of his remarks.

Thanks very much to Senator Pearson and the committee for having me today. We have a lot of material to cover in a short period of time. I'm a man of fewer words than pictures. Pictures can tell more than words, so we are going to see a lot of pictures today.

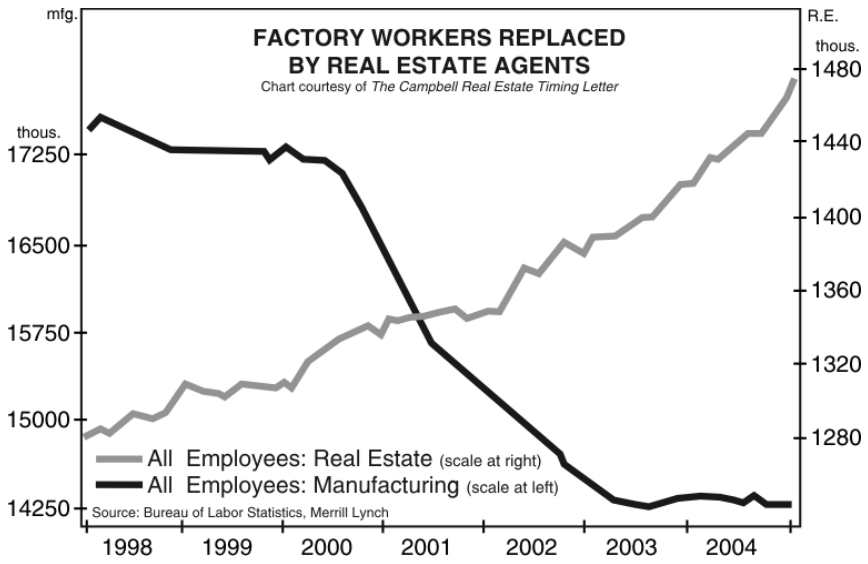
Anyone considering legislation would best have a good idea where we are in overall economic and investment cycle in order to make those decisions. Sometimes it is a short-term recession; other times, something bigger is going on. It's good to know, so that you can frame your policies accordingly.

The question on everyone's mind is, "Are we at a bottom? Are we getting close to a low in real estate prices and the industry in general? "

It will help to get a handle on how we got into this situation. Anytime you have engines of debt supporting an investment, you will ultimately create a bubble in that area. In past decades, the federal government has created many engines of debt aimed toward greasing the skids for people to buy real estate: Fannie Mae, Freddie Mac, Ginnie Mae, 12 Federal Home Loan Banks and the FDIC. The FDIC contributed in an interesting way. It has told depositors they don't have to worry about what their bankers are doing because they are covered with an implied guarantee by the U.S. government. An implied guarantee for an IOU makes the lender a lot less interested in looking carefully at what he is investing in.

Engines of Housing Debt

- **Fannie Mae**
- **Freddie Mac**
- **Ginnie Mae**
- **12 Federal Home Loan Banks**
- **FDIC**



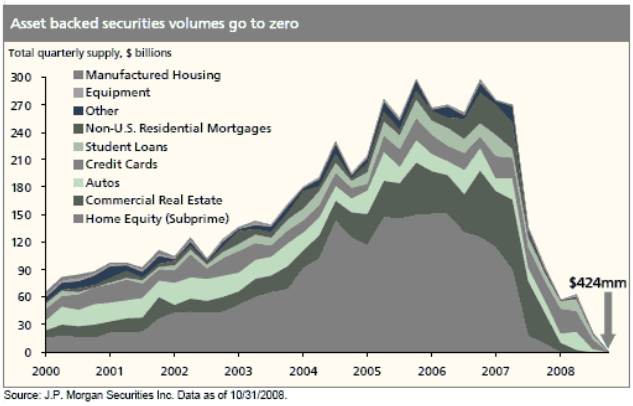
As a result of a lending bias towards the industry, we had an interesting divergence of trends. The declining line here is the number of people employed in United States manufacturing jobs, and the line rising toward the upper right is the number of people employed in the real estate business. Ultimately manufacturing supports everything. You can't have a declining manufacturing sector and a rising

consumer sector, at least not for long and particularly when it is fueled by debt, because it tends to lead to a glut. And of course that is the result we have today in housing.

One of the ways that a lot of this real estate debt was financed is very unusual historically, and that is through asset backed securities. They really came into their own in the decade of the 2000s up until 2007. A lot of people feel that such investment was normal, but it wasn't. For years and years, housing was built essentially to provide a home for people; in other words, it was a consumption item. But in the 2000s it turned into an investment item for people other than bankers. Wall Street packaged mortgage loans and began selling them as investments to people who didn't look very hard at what they were buying. And they didn't feel that they had to because, again, they felt that they were covered, at least with Fannie and Freddie mortgages, by implied guarantees from the federal government. What's happened though—and this graph is very important—is that the issuance of asset backed securities has fallen nearly to zero, not far from where it started. This method of financing is abnormal and something that comes along maybe once a century, when financiers get together and figure out a way to dress up and distribute IOUs in a certain investment area. So it is very unlikely that we will be returning to this type of financing anytime soon.

If you are in the real estate business, you don't have to feel alone. Here is a list of celebrated money managers who in the past year have suffered tremendous losses in the stock market portfolios that they manage. As you can see, the S&P500—when this was compiled—was down 41%, and two-thirds of these managers actually underperformed the S&P, all the way down to minus 60%. So, there is not only a real estate decline but also a stock market decline, and, as we will see in a couple of slides, we've also had a drop in commodities. It is very important that these markets are moving together. The last time that happened on such a scale was in the 1930s.

I'd like to try to answer a question: "Are we near a low in the stock decline?" Because in these times when stocks and real estate are declining together, they tend to bottom roughly together as well. So I want to take a minute and look at a valuation chart for the stock market.

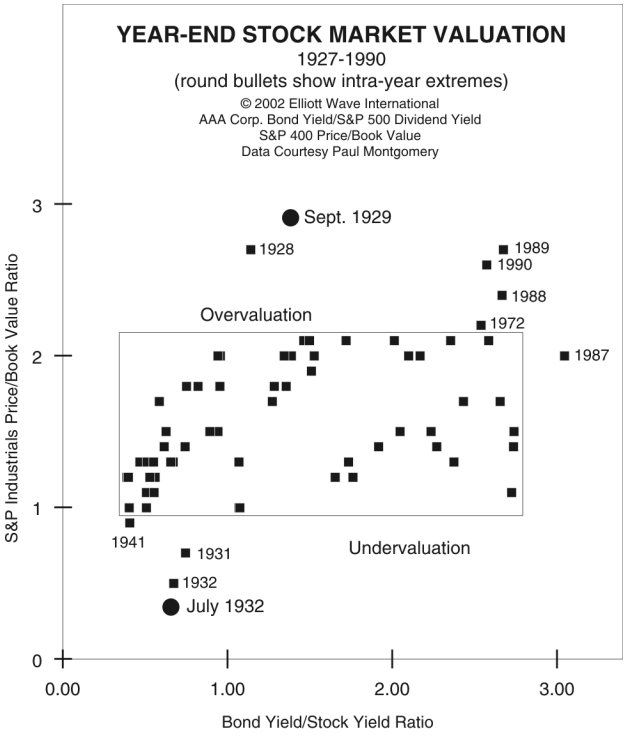


Celebrated Mutual Funds And Managers

As of November 17, 2008

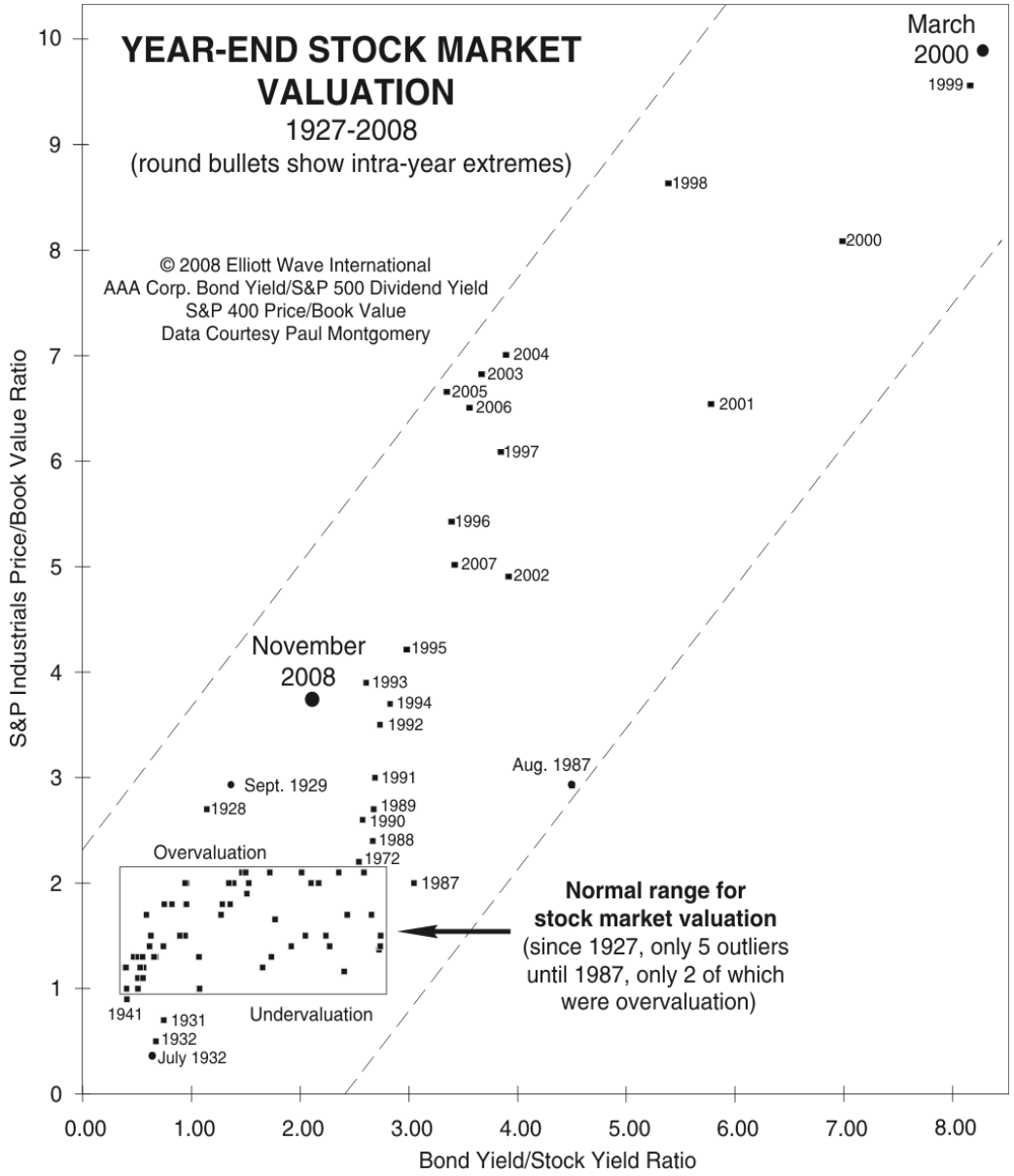
Sorted by 2008 YTD Returns

Fund	Manager	Ticker	2007	2008 YTD
Berkshire Hathaway	Warren Buffett	BRK/A	28.74%	-32.48%
Leuthold Core Investments	Steve Leuthold	LCORX	19.00%	-32.60%
The Pioneer Fund	John Carey	PIODX	4.70%	-37.42%
Fidelity Contrafund	William Danoff	FCNTX	19.80%	-40.24%
The Oakmark Fund	Bill Nygen	OAKMX	-3.64%	-40.28%
S&P 500			5.49%	-40.89%
Columbia Acorn Fund	Chuck McQuaid	LACAX	7.39%	-44.32%
Federated Kaufman Fund	Auriana/Utsch	KAUAX	21.40%	-44.83%
The Weitz Funds	Wally Weitz	WVALX	-10.35%	-47.05%
Dreman High Return Equity	David Dreman	KDHAX	-1.14%	-49.62%
Third Avenue Value Fund	Marty Whitman	TAVFX	5.76%	-49.63%
Baron's Partners Fund	Ron Baron	BPTRX	11.34%	-49.86%
CGM Focus Values	Ken Heebner	CGMFX	79.92%	-51.27%
Hancock Classic Value	Richard Pzena	PZFVX	-14.20%	-52.07%
Clipper Fund	Chris Davis	CFIMX	5.00%	-52.26%
Calamos Growth Fund	John Calamos	CVGRX	23.26%	-52.28%
Fidelity Magellen	Harry Lange	FMAGX	18.82%	-54.16%
The Airel Fund	John Rogers	ARGFX	-1.70%	-54.45%
Gabelli Equity Trust	Mario Gabelli	GAB	12.61%	-58.74%
Legg Mason Value Trust	Bill Miller	LMVTX	6.66%	-59.40%



What we have here on the “X” axis is the bond yield/stock yield ratio for the S&P 400 companies. Sounds fancy, but all it means is that the further you go out to the right, the less companies are paying in dividends compared to what they are paying on their IOUs—on their bonds. On the “Y” axis we have stock prices relative to book value. Book value is roughly equivalent to liquidation value, in other words, if you went and sold all the assets on the open market. When stocks get expensive, prices tend to rise relative to book value, and dividends tend to fall relative to the cost of borrowing. Why does that happen? At such times, people don’t really care about dividends because they think they are going to get rich on capital gains. So dividend payout falls, and stocks get more expensive.

The small square boxes indicate year-end figures. The large box is a general area that has contained values for the stock market for most of the years of the 20th century. We had a few outliers: 1928 and August 1987, which preceded crashes in the stock market. And of course stocks were really cheap in the early ’30s and again in 1941. If you are really astute, you have noticed something about this chart, which is that I’ve left off some of the data. It ends in 1990. What happened in the past two decades? Now I’m going to show you the same chart but with the data from the last two decades on it. The March 2000 reading we call Pluto. Real estate wasn’t so bad; I think it only got to about Neptune. But the stock market reached Pluto in March of 2000 in terms of the bond yield/stock yield ratio and the price multiple of the underlying values of companies. That’s going to take quite awhile to retrace.



I’ve also plotted the reading for November 2008. The market has made quite a trek back toward normal valuations, but if you look at these multiples in terms of book value, we are at 4 times. It has to go down to 2 times to get back into the box, and we are getting there on the bond yield/stock yield ratio which means that the dividend payout is rising somewhat to catch up with borrowing costs.

And because the S&P is down 45%, of course, the dividend payout as a percentage has gone up. But there is a problem there. If you're reading the newspapers, you know that companies have been cutting dividends. In fact, they've been cutting them at the fastest rate in half a century. So it is going to be difficult for values to get back to a normal valuation range. So the stock market has quite a bit lower to go in order to catch up with normal values, and this suggests that real estate may have the same sort of trend going on.

Most Dividends Cut Since 1950s
2008-11-26 15:18:42.310 GMT
By Lynn Thomasson and Eric Martin

Nov. 26 (Bloomberg)—Stock dividends are disappearing at the fastest rate in 50 years as the worsening recession forces U.S. companies to conserve cash.

Citigroup Inc., Genworth Financial Inc. and New York Times Co. are leading 91 companies listed on the biggest U.S. exchanges in reducing or suspending payouts to shareholders this month, the most since May 1958, when 113 companies slashed dividends, according to data compiled by Standard & Poor's. The reductions in November exceeded the 81 dividend cuts in October and 60 in September.

There is another area that has also been hit. A lot of advisors were recommending that people afraid of an economic decline should be investing in commodities. And commodities did fly. But in recent months the opposite has happened [Figure not shown, see October 2008 issue.] We've had plunges in the prices of many commodities: Platinum is down 67%, oil down 71%. I'm sure all of us buying gasoline recently have noticed that instead of paying $4 a gallon for regular we're paying $1.55. Silver is down 61%. The agricultural commodities are down as well. This is also a very rare event. When the stock market was weak in the 1970s, commodities were taking off. This time they are both weak together. How rare is that?

We did a study that went back 300 years to find those times when both the stock market and commodities were falling together [Figure not shown, see November 2008 issue.] What we have on the top graph is a chart of stock prices in real terms—divided by the PPI. In other words, how much can you buy with your stock shares in terms of goods and services? It's based on U.S. prices going back to 1796 and English stock prices prior to that. The middle graph is the price of commodities. The bottom graph, which we call our Positive Correlation Index, shows times when stocks and commodities were moving in the same direction, which is rather rare. We were interested in those times when they were both falling together and falling a lot, as they are now. It turns out that the only two comparable times on the entire graph are 1929-32 and 1720-22. We all know about the early 1930s; that was when the stock market had its biggest drop in U.S. history, and commodities were falling as well. Maybe fewer of us know what happened in 1720. That was the South Sea Bubble in England, a tremendous stock boom fueled by credit, just as we've had in the past couple of decades. When a powerful credit boom finally ends, you tend to get declines in the stock market, commodities and real estate together. It's a very rare thing, and it's a big deal.

That's what we are dealing with here: not just another little recession. Every other week, I open the Atlanta Journal Constitution and there's somebody writing an article about how this is a garden-variety recession. I don't think that is true, and I don't think it will be over by the first quarter next year. We can see historically that this is something important.

9 Be One of the Few the Government Hasn't Fooled

From *The Elliott Wave Theorist*
August 2008

Be One of the Few the Government Hasn't Fooled

It's easy to be lulled into the sense that the U.S. government or the Federal Reserve can fix the economy's problems. But here's the information you need to keep you from being fooled.

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SOME MYTHS AND REALITIES IN THE WORLD OF POLITICIZED FINANCE

Markets have followed our outlook so far in 2008. Stocks are in a bear market. Many foreign stock markets, which some managers touted in favor of the U.S., are losing value twice as fast as U.S. stocks. Real estate is down as much as 25 percent, depending on the region. After peaking above $1000/oz., gold is back below $800. Silver has declined by 40 percent in just five months, following EWT's call for a top at the March high. Commodities, which many bears have favored, are falling. We have recommended none of these markets. The dollar index has risen nine percent since March and is up on the year. We continue to believe that, by the end of this bear market, money—whatever of it survives—will be king. With stocks and commodities falling and the credit markets contracting, it seems that deflation may have finally taken hold. But until all stock averages (including the Transports and small-cap averages) fall below their March lows, we cannot be sure of it.

Economic fallout is also occurring as expected. The bear market has put the economy under pressure. The total equity/debt ratio for American homes is the lowest ever recorded. Real estate sales are drying up, and the national foreclosure rate is the highest since the Great Depression. The unemployment rate is rising. Job losses this year have reached half a million. Fannie Mae and Freddie Mac cut their dividends by 50 percent and 80 percent, respectively. General Motors suspended its dividend for the first time since 1922. On 7/30, USA Today reported on its "survey of 54 economists at corporations, universities and trade associations"; when asked if the economy is in recession, half of the economists said no, and among them 81 percent said that there would be no recession over the next 12 months. Until this sentiment changes, plenty of economic contraction lies ahead.

As the slow-motion disaster of wave **c** unfolds, investors are holding onto all the optimism they can, heartened each time the government announces some new plan to "help" the real estate market, the mortgage market, the economy, etc. It might be useful to discuss some of the misconceptions that permeate the news coverage of financially related political events. One hardly knows where to begin. Let's examine a few of them.

Who are the "homeowners"?

Everywhere you turn, news articles are discussing how Congress, the President and the Fed are taking action to "help homeowners." People's understanding of this statement is 100 percent wrong. The homeowners in question are *not* the residents of the houses. The homeowners are *banks*. Unlike some states, Georgia made its law very specific on this point. Our local paper recently explained that, by recognizing the reality of ownership, "Georgia employs primarily a nonjudicial foreclosure" and therefore "has one of the fastest procedures in the country." Specifically, "The *property owner* gives the *mortgage holder* a 'security deed' or a 'deed to secure debt'. Technically, until the debt is paid, in full, *the mortgage holder owns the property* and allows the borrower to possess it." (GT, 8/6) In states where the mortgage holder is deemed the property owner, the title is merely a legal technicality. The day he stops making mortgage payments, he no longer owns the property; the bank does. After foreclosure, many of those whom politicians and the media call homeowners will simply go from paying interest to a bank to

paying rent to a landlord. For those with little or no equity, it's not that big a deal. The real devastation is happening in banks' portfolios, and banks, not home-dwellers, are the ones whom the government is trying to rescue, at others' expense.

One might be tempted to charge therefore that Congress makes its laws for the *purpose* of helping banks. This idea, too, is incorrect. Helping banks is merely a side effect. The reason that Congress creates privileges for bankers is to benefit *politicians*. They make laws in response to campaign contributions from lending institutions, real-estate organizations and builders' associations. They also garner votes from mortgage holders and, miraculously, from voters who think that their "representatives" are being "compassionate."

"Who Will Benefit From The Housing Act?"

This question is an actual headline from a national daily paper. The real answer is: mortgage lending corporations, developers, real estate agents, speculators and politicians. The government is also pledging tax money to providers of "financial counseling" and grants for speculators who want to "buy and renovate foreclosed housing"; in other words, it will hand tax money to charlatans and unfunded wheeler-dealers. But a far better headline would have been, "Whom Will the Housing Act Hurt?" The answer to that question is: (1) *prudent* people, i.e. savers, earners, renters and people who have waited to buy a house at a reasonable price; and (2) *innocent* people, i.e. taxpayers.

Government action (unless it is aimed at destruction) always causes the opposite of its stated effect. If taxpayers ultimately have to shoulder the burden for all the bad mortgage debt, those who are on the edge of being able to make their mortgage payments will be forced over the edge, causing more missed mortgage payments and more foreclosures.

There is never any need for a law granting privilege except when the goal is to reward the undeserving and to punish the innocent. If the goal were otherwise, there would be no need for a statutory law, because the natural laws of economics, when unencumbered, serve to reward the deserving and punish the imprudent and the guilty. Populists loudly challenge this idea, but they are wrong.

Aren't those people foolish who took out mortgages on houses they could not afford or borrowed off their home values as if prices could never go down?

Of course they are. But there is a far less obvious question: Which people are ten times more foolish? The biggest idiots in the mortgage fiasco are the *creditors*, the ones who blindly threw gobs of their money at the furious creators and packagers of housing-based IOUs. Ultimately, the creditors who believed the rating services (*Conquer the Crash* said don't do it), who believed they were insured (*Conquer the Crash* said they weren't), who thought that borrowing short-term to lend long at 30-to-1 leverage was like printing money for free (axiom: there is no such thing as a free lunch) are the ones who blindly financed the whole debacle. Fevered speculators who sent their money to hedge funds that loaded up on mortgages deserve to lose their stake. Managers of pension plans and insurance companies who think that IOUs are money deserve to have reality slap them awake. Bankers who got greedy and kept mortgages on their books instead of blowing them out to other oblivious creditors deserve to take losses. But government fights justice at every turn, so it remains to be seen whom it will ultimately force to shoulder these losses.

Shouldn't we feel sorry for some people caught up in this mess?

By all means, many people involved deserve great sympathy. Aged widows trying to live in their homes on the savings their husbands left them are being thrown out onto the street because they can't pay soaring property taxes due to inflated home values. They are innocent victims. It is very sad to hear

of people who have paid on their mortgage for years but lost a home through job losses in a weakening economy. They thought they were making an "investment," but the bank, not the mortgage payer, has first dibs on the equity. Many bank depositors will lose their savings, and their only crime will have been to believe the government's deposit guarantee. The tendency to believe authority figures seems to be regulated at the pre-conscious level, so one can hardly blame them for being ignorant. Taxpayers stuck with the government's bills deserve sympathy, too, because they are the innocent targets of extortion, and their only crime is to be productive.

Didn't Congress create the Federal Housing Authority, Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Banks for the purpose of helping the public buy homes?

You're kidding, right? What happened is that clever businessmen schemed with members of Congress to create privileged lending institutions *so they could get rich off the public's labor*. In return, members of Congress got big campaign contributions from the privileged corporations and, as a bonus, even more votes. The public's welfare had nothing to do with it.

Who celebrated when Congress passed the latest housing bill? Answer: "The California Mortgage Bankers Association applauded Congress for permanently increasing the size of loans Fannie Mae and Freddie Mac can buy…." (USA, 7/28) The legislation exists to "protect the nation's two largest mortgage companies…." (NYT, 7/24) Who took out full-page ads to encourage Congress to "enact housing stimulus legislation now"? Answer: the National Association of Home Builders. Who celebrated when the administration "unveiled a new set of best [sic] practices designed to encourage banks to issue a debt instrument known as a covered bond"? Answer: "[Treasury Secretary] Paulson was joined at the news conference by officials from the Federal Reserve [and] the Federal Deposit Insurance Corporation…. Officials from banking giants Bank of America Corp., Citigroup Inc., JPMorgan Chase & Co. and Wells Fargo & Co. issued a joint statement saying, 'We look forward to being leading issuers'" (AP, 7/29) of covered bonds. And voters still believe that Congress is there to help the needy.

Shouldn't we blame business? Firms such as Countrywide went crazy making loans.

They did work overtime to feed the beast. But who is the beast? Fannie and Freddie "own or guarantee about half of the nation's $12 trillion in mortgages." (Atlanta Journal Constitution, 7/12) Other government agencies—Ginnie Mae (the Government National Mortgage Association) and the Federal Home Loan Banks—own or insure another $3 trillion worth. Together these government-created entities own or insure 75 percent of all U.S. mortgages! And the Federal Reserve System, which Congress created, allows commercial banks to create way more mortgages than they would if they had to use real money. And the tax code, through the mortgage deduction, forces taxpayers to subsidize mortgages. So the federal government is *the* prime instigator and facilitator of American citizens' mortgage indebtedness. Businesses simply lunged for the carrots that the government dangled in front of them.

Debt is a lousy way to buy houses. The Amish just build each others' homes, and then each one *owns* his house. A free market would operate much the same way, as homes would be traded for other services through money. But thanks to the federal government's debt-based money system and the government-created mortgage corporations, not to mention taxes, the only thing most people can buy homes with is IOUs.

As with all government programs, credit-stimulating legislation hurts its supposed beneficiaries. Instead of helping people *own* homes, which is what a free market would do, the government institutions lead people to *borrow money*. This makes money manipulators rich, but it ultimately spells disaster for would-be homeowners, who end up in debt and devastated. Every government program eventually creates the opposite of its stated goal. Here again, more people will become homeless as a

result of the government's lending schemes than would have absent them. Even people who scrimped for 30 years to pay off their mortgages ultimately paid twice for the house what it was worth and now face steep tax assessments on inflated property values. How is any of this good?

Are Fannie and Freddie too important to let fail?

A national newspaper says in an editorial, "These companies are simply too important, not just to housing but to the entire economy, to be left to founder." (USA, 7/15) First of all, the opposite is true: These companies are in fact too toxic to housing and the entire economy to allow them to continue operating. They are the *problem*, not the solution. Second, they have already failed. According to independent accountants using market prices, Fannie Mae and Freddie Mac are insolvent. If companies somehow had reached such a state in a free market, creditors would already be divvying up their loan portfolios, and we would no longer have to put up with these debt peddlers. But Congressmen want to keep the cash flowing into their re-election campaigns, so they are pledging to prop up their favored entities with taxpayer cash. They claim it will take only $24b. Do you believe that? Did you believe it when they said the Iraq War, now on its way to a trillion dollar tab, would cost only a few billion dollars?

Will expanding the FHA's debt load "help shrink losses"?

This question derives from another actual headline, this one claiming that the Federal Housing Administration and other such agencies, by taking on more debt, "could help shrink losses." But the government can't shrink losses! It can only *transfer* them. It can take value from savers, earners and producers through taxes and inflation and turn it over to favored groups. That's all it does and all it can do. But in the process, government takes a substantial portion of the money, so any such program does not just transfer losses but also *adds to them*. Merrill Lynch just demonstrated that its packaged mortgages—and therefore the packaged mortgages of all other holders—are worth somewhere between 5 cents and 22 cents on the face-value dollar. This is the market price, which is the actual price, the real price, the *price*. Therefore, any time a government agency takes on such mortgages at face value, it is forcing taxpayers to assume losses on 78 to 95 percent of that money. The losses may not be realized yet, but they are there just the same.

Did the $168 billion fiscal stimulus package passed by Congress help the economy?

Taking money from savers and investors to give to spenders, or taking it from one group of spenders to give to another, *hurts* the economy. People who earn their money tend to invest and spend it wisely. People who get a check undeserved tend to spend it less wisely. Smart spending is better for the economy than stupid spending. The argument that the government is only "giving" money back to the "taxpayers" from whom they took it is incorrect. Net-net, it is taking money from prudent people and giving it to imprudent people. If this were not the case, there would be no reason to do it. The scheme hurts some parts of the economy—the ones that prudent people would have supported—and helps others—the ones that did not deserve the money.

Can't state laws help the situation?

Oh, you mean such as the New York State law shifting the liability from buyers, appraisers and mortgage writers who perpetrate frauds onto the careless investors who buy their paper? No, all that laws shifting fraud liability will do is change investor behavior, in this case *decreasing* the number of mortgages sold, thereby contributing to deflation. This excerpt (NYT 8/13) explains how such laws make behavior change:

> Freddie Mac said Tuesday that it would stop buying subprime loans issued in New York State as a new law takes effect that holds investors accountable for mortgage fraud. Freddie will not buy loans dated on or after Sept. 1 that meet the state's subprime definition, the government-

> chartered company said in a lender bulletin on its Web site. Gov. David A. Paterson of New York signed new foreclosure and lending laws last week that tighten legal protections for borrowers. The legislation holds mortgage buyers like Freddie liable in ways that "we have no way of monitoring and preventing," Brad German, a company spokesman, said. A spokeswoman for Governor Paterson, Erin Duggan, had no immediate comment.

You bet the governor's office has "no comment." The state legislature probably had no clue that its law—designed to encourage campaign donations from real estate groups—would have this obvious side effect.

Can't the Fed just keep on making loans to banks ad infinitum?

The Fed has $912b. worth of assets. A year ago, most of its assets were Treasury bonds. In the past year, it has swapped more than half of its formerly pristine portfolio for mortgages and other bank debt. Yesterday it began another "auction" of loans that will total $75b. over the next two weeks. Clamoring for the first one-third of that credit amount, 64 banks sought a total of $55b. In other words, each one of these starving banks needs nearly a billion dollars of short term loans to keep operating! Before August ends, the Fed's ratio of Treasury holdings will fall below 50 percent for the first time ever. This will mean that the Federal Reserve is no longer a *federal* reserve. I would guess that its machinations will soon begin to engender heated discussions about what the Fed's greenbacks, now backed mostly by consumer debt, are really worth. Soon the Fed will be down to its last $400b. worth of Treasuries. They blew the first $500b. in a year. How long will it take the Fed to blow the rest? A few months? Then what?

Can the Fed loosen its rules for banks even further to support more credit inflation?

Maybe, but that's the opposite of what it is doing: "The Federal Reserve approved *tough mortgage lending rules* designed to prevent a repeat of recent excesses that led to the most serious housing downturn since the Great Depression." (USA, 7/15) Despite all of Bernanke's talk about dropping money from helicopters, he is bowing to social sentiment and acting to restrict bank lending with one hand while trying to shore up the weakest banks with the other. If the new rules mattered, they would be deflationary. But they are irrelevant, because bankers have already been pulling in their horns since the mortgage market imploded in 2007. It is typical for authorities to "act" months after a problem has already ended, and these new rules simply express a change that has already occurred. But they are harmful in a small way: As one banker complained, they cause banks to waste money on understanding, disseminating and following the new rules as well as keeping a paper trail to prove they are complying.

I thought the Fed was created to "help manage the economy."

After a secret meeting on Jekyll Island (GA), Congress and a handful of bankers created the Federal Reserve System for two purposes. The first one was to allow the government to counterfeit money, thereby letting it steal value from savers through inflation. The second was to allow bankers to make profits through debt creation, also at the expense of savers. Any other claim is a smokescreen.

So shouldn't we blame the Fed for the country's financial problems?

That's like blaming the collapse of your house on the biggest termite. The Fed is only one of the monsters that Congress has created. In the financial realm, others include Fannie Mae, Freddie Mac, Ginnie Mae, Sallie Mae, the FDIC, the FHA, the FHLBs and the income tax. But there are also a hundred other havoc-wreaking agencies of the federal government. Congress is to blame for ruining

America. The Fed is only one of the mechanisms it created along the way. It's a big one, and it's fine to campaign against it, but to blame it for everything is to give its creator a free pass.

This is an important distinction, because many people seem to think that abolishing the Fed will cure America's money woes. They seem to think that once the Fed is abolished, Congress will behave responsibly. One website even calls for abolishing the Fed in favor of giving money-printing power directly to the federal government! Abolishing the Fed is a worthy goal, but Congress will work tirelessly to create one disastrous institution after another, because that's what campaign donors pay for.

Will mortgage-backed securities…

Hold it right there. Packaged mortgages are not securities; they are *insecurities*.

O.K., will mortgage-backed insecurities remain a vital part of the debt market?

No. They are a manifestation of peak optimism at Grand Supercycle degree, an event that comes along no more often than once every two centuries. They will *go away*.

But won't the scheme to issue "covered" bonds revitalize the mortgage markets?

The administration has backed this initiative, telling the public that it will make more credit available for mortgages. The New York Times explains covered bonds:

> Unlike a mortgage security, the home loans that back a covered bond stay on the issuing bank's balance sheet. If loans default, banks replace them, making the bonds less risky to investors but more so to the banks. In July, four big banks—Bank of America, Citigroup, JPMorgan Chase and Wells Fargo—said they would issue covered bonds.

Does this scheme reduce risk? No, it merely transfers risk from creditors to banks. But wait. Banks are already in credit trouble, and this arrangement exposes them to even more risk. Creditors rely on the integrity of the mortgage payer, but depositors rely on the integrity of the bank. Under the covered-bond arrangement, there is just as much risk as before, but it has been socialized to become the depositors' risk. New question: Would you want to be a depositor in a bank that issues covered bonds? If not, you had better read that list of banks again.

Why are banks willing to take on this new risk?

Banks think depositors will put up with anything, and so far they have been right. Depositors are stunningly docile, thanks to the government's "sticker insurance," the supposed guarantee from the Federal Deposit Insurance Corporation. The FDIC is yet another government institution designed to facilitate the expansion of debt, in this case by making depositors think that lending their savings to banks is riskless, thereby allowing banks to lend with impunity. Perhaps in the smoke-filled back rooms, bankers are betting that they can issue covered bonds, ride out the recession without going under and get healthy again during the next upswing. But the economy is diving into a depression, so such hopes are misguided. Even so, bankers probably figure that if they issue a huge amount of covered bonds, they could rush to Congress in a depression and whine that it is not fat-cat creditors whose money is at stake now but the savings of their hapless depositors. If Congress were to agree to use government money to bail out the depositors, then the socialization of bad debt would be complete, and innocent savers and taxpayers would pay for the bad decisions of creditors and depositors. So, from the bank's point of view, what's not to like about covered bonds? But covered bonds are not performing well in Europe right now, because psychology has shifted into "wave C" mode. So my guess is that this scheme—new in the U.S.—will fizzle and fail.

Who cares if a bank goes under? Won't the FDIC protect depositors?

The FDIC is not funded well enough to bail out even a handful of the biggest banks in America. It has enough money to pay depositors of about three big banks. After that, it's broke. But here is the real irony: The FDIC, as history will ultimately demonstrate, *causes* banks to fail. The FDIC creates destruction three ways. First, its very existence encourages banks to take lending risks that they would never otherwise contemplate, while it simultaneously removes depositors' incentives to keep their bankers prudent. This double influence produces an unsound banking system. We have reached that point today. Second, the FDIC imposes costly rules on banks. In July, it "implemented a new rule…requiring the 159 [largest] banks to keep records that will give quick access to customer information." As the American Bankers Association puts it, the new rule "will impose a lot of burden on a lot of banks for no reason." (AJC, 7/19) Third, the FDIC gets its money in the form of "premiums" from—guess whom?—healthy banks! So as weak banks go under, the FDIC can wring more money from still-solvent banks. If it begins calling in money during a systemic credit implosion, marginal banks will go under, requiring more money for the FDIC, which will have to take more money from banks, breaking more marginal banks, etc. The FDIC could continue this behavior until all banks are bust, but it will more likely give up and renege. Remember, every government program ultimately brings about the opposite of the stated goal, and the FDIC is no exception.

Would you please provide me with a list of banks you think might go under?

Sorry, it's de facto illegal to provide you with that information. Many states, including New York and Georgia, have laws forbidding "verbal or written statements that incorrectly 'cast suspicion upon [a bank's] ability to meet its deposits'." (Atlanta Journal Constitution, 7/19) The banking lobby got legislatures to make these laws. The laws appear to suppress only false statements. But they stifle free speech on the subject, because some banks have sued people who speak out. They take the position that a *false* statement can *cause* a failure. If that logic is true, how does one decide the truth or falsity of the statement subsequent to a failure? So much for the First Amendment. People can write all sorts of horrible things about McDonald's and Wal-Mart, but you can't bad-mouth a bank.

It is my position that any bank that is so compromised by bad loans or over-lending that it cannot withstand a false negative comment in the press *deserves the negative comment*. In other words, there is no such thing as a false negative comment that breaks a bank. But the legal system (it's not a justice system) does not go by my logic, so in order to protect ourselves and still serve you, *Conquer the Crash* restricted itself to listing what a reliable rating service showed to be the *safest* banks in each state at that time. (Things change, so keep checking the ratings for your bank.) It also recommended avoiding the U.S. banking system altogether, a better alternative being to own—directly or through a fund—U.S. Treasury debt and the debt of better fiscally managed governments such as New Zealand, Singapore and Switzerland. For readers of *Conquer the Crash*, we have updated the short list of money market funds that appeared to invest exclusively in U.S. Treasury debt. Surprisingly, from our original

2 LARGEST TREASURY-ONLY MONEY MARKET FUNDS
WITH NO TRANSACTION CHARGES OR LIMITS
Source: Weiss Ratings, Inc.

Fund Name	Toll-Free No.	Expense Ratio	Risk Rating	Custodial Bank	Web Address
American Century Capital Presv Fund I	(800) 345-2021	0.48%	Low Risk	None	www.americancentury.com
Dreyfus 100% US Treasury MMF	(800) 782-6620	0.65%	A+ (thestreet.com)	New York Mellon	www.dreyfus.com

list, only three funds confirm that they hold no mortgages, mortgage "securities," corporate debt, municipal bonds or anything aside from Treasuries. Unfortunately, one of them is owned by JP Morgan, and since we have a choice it seems prudent to pick a fund that is independent of a bank. Here are the two funds remaining that fulfill all our requirements:

"Politicians are so stupid."

This is another belief that is totally wrong. How many times have we all read a letter to the editor from someone who calls government actions "stupid"? They say government-created lending institutions were a "dumb" idea; FEMA's waste of half a trillion dollars after hurricane Katrina was due to "ineptitude"; the war in Iraq is "idiotic"; the state-controlled educators are "incompetent"; the military is "mismanaged"; the subsidy of ethanol is "a colossal failure"; the Fed is "foolishly" inflating; the welfare system "doesn't work"; the immigration department "can't do its job"; the war on drugs is a "failure"; and so on. All of this is completely wrong. Over the past 40 years, members of the House of Representatives have enjoyed an average *re-election rate* of 94 percent! In the last five elections, they have enjoyed a re-election rate of 97 percent! What is stupid about that? Obviously, politicians are not wasting a dollar or mismanaging anything. Government is designed to *serve the people in it*, and for that purpose it works *great*. The public gets fleeced, cheated, punished and crushed, but that's just a side effect. The favor-trading process, in which special interests fund campaign coffers in exchange for pet legislation, is a form of unnatural selection that weeds out those who are unwilling or incapable of predictable, reliable and discreet power brokerage, which is a rare, delicate skill. People who can rob their fellow citizens blind, throw their money down rat holes, plague them with endless rules and punishments and simultaneously get their victims to confer upon them society's highest level of respect are in some intuitive way geniuses. Members of Congress may be short-sighted, dishonest, corrupt, pragmatic, hypocritical, immoral or amoral, but they are not stupid. They know exactly how to influence voters, hand out tax money and manipulate the political system to enhance their personal, social and financial status while making it look as if they are upstanding citizens trying their gol-darndest to provide services. And the public buys it. So which group is stupid?

But Congress's popularity is way down. Are people wising up?

Because of the trend toward a negative social mood attending the bear market, the popularity rating of Congress has fallen to the lowest level ever recorded: 14 percent. (One is tempted to ask what's wrong with those people making up the 14 percent, but that is approximately the percentage of employees who work for federal, state and local governments.) But even with record low approval ratings for both Congress and the President, citizens are gearing up to go to the polls in November so they can line up to vote in the same old rascals and a few new ones, all the while thinking and hoping—for the 50th straight election—that they might actually effect "change"! Politicians are not stupid! The voters are.

It seems unfair to lump all Congressmen together as being dishonest. Some of them seem sincere.

Every Congressman takes an oath to uphold the Constitution, and every one of them—with Ron Paul an arguable exception—breaks his promise every month of his tenure. The other branches of government are complicit. Presidents push Congressmen to violate the Constitution, and the Supreme Court lets them get away with it. The fact that some members of Congress appear to be "sincere" or "well meaning" in their beliefs about how to *subvert* the Constitution is irrelevant. Taking an oath you have no intention of keeping or breaking an oath with impunity after you take it is dishonest behavior, whatever your convictions.

You say politicians are smart, but I have been disappointed many times by government workers.

Sure, government *hires* a lot of incompetent people, because that is one privilege of a system run by force. Competent people, or at least people who properly price their labor, don't need force; they can get jobs from employers acting voluntarily. One need not make a case for the difference other than to say, "Read the papers." People were "shocked" this week to read of an African-American woman whose decision to call 911 led to an hour of bumbling and then the unfortunate lady's death. Here is an excerpt from an article that appeared on the front page of the AJC yesterday:

> The director of Fulton County's 911 center has been removed after an operator's mishandling of a call left a dying woman without help for more than 25 minutes [other reports say an hour]. Alfred "Rocky" Moore will still head the county's Emergency Management Agency, but a deputy will take over management of the emergency communications center that receives 911 calls from the public. The announcement came Tuesday as personnel files were released for Gina Conteh, the 911 operator who was fired last week after her mistakes handling an emergency call resulted in a woman's death. Conteh's personnel file made available to the media on Tuesday -- more than 2,100 pages of documents spanning her 17-year career in the 911 center -- revealed numerous reprimands and suspensions. Her infractions since 2002 include other mishandled calls, confrontations with co-workers and emergency responders, making lunch while emergency calls were coming in and sleeping on the job -- in one instance, she slept so deeply she tumbled out of her chair and onto the floor. Between 2002 and 2007, Conteh was suspended at least seven times for disciplinary problems and given several written warnings for mistakes, according to her files.

The government kept an incompetent operator on the job for *17 years* despite the fact that her incompetence was a matter of *life and death* for the public. The government did not fire the supervisor who let it happen; it just transferred him to another position. You will be happy to know that the agency has pledged to conduct an "analysis" of the situation, at taxpayer expense. Only government can survive employing people like this and then charge people more when it screws up, because only government can force people to pay for its activities.

This is not to say that all government workers fit this mold; many are hard-working and highly competent. It is a shame, however, that they have reduced their potential in life by volunteering to work in a flawed system.

If governments always act to protect themselves, then it seems that municipal bonds should be safe. Won't states, counties and cities just raise taxes to cover their interest payments?

Of course, they will raise taxes. But parasitic behavior works only as long as the host can support it. In Georgia, cities and counties are jacking up tax rates, most notably on property: "Business owners in Fulton County are being socked by huge increases from a countrywide commercial revaluation with a 44 percent median increase…. Atlanta officials say the average increase in Buckhead was double the countrywide median." (AJC, 6/1) In other words, that area's taxes have risen nearly 100 percent virtually overnight. Will these tax increases satisfy government's voracious appetite for taxpayer cash? Not a chance. Four months ago, just one state agency, the Georgia Department of Transportation, reported that it was $1 *billion* in the hole relative to "projects it has promised in the near future." (AJC, 4/10) But that's nothing; read this report, from CBS (7/30): "New York Governor David Paterson says the New York state budget deficit has gone up *$1.4 billion in the last 90 days*." Project *that* rate out for a few years.

A slowing economy—which is not yet even in recession!—is bringing politicians' decades of accrued obligations face to face with reality. (The same thing is happening with many corporations that promised exorbitant union benefits, essentially because of governments' union-favoring laws.) The debts and promises of states, counties and cities are so huge that no level of taxation can cover them. Jacking up taxes kills incentives and causes marginal businesses to close their doors, so higher taxes may offer a short-run solution, but they will cause more long-run devastation. A depression will assure shrinking tax revenues, and voter backlash will probably stall or reverse many tax increases before the depression reaches bottom. Governments never cut spending before crises hit. As predicted in *Conquer the Crash*, many municipalities are going to default on their bonds, and nothing can prevent it.

But public pensions are already funded. So even if a depression occurs, won't they keep most retired government workers afloat?

Most books on trading tell you not to "double down." Yet look what a report from Bloomberg (8/14) says is going on now:

> Public pension funds in the U.S. are increasing bets on high-risk hedge funds and real estate in an attempt to fill deficits in retirement plans and make up for their worst performance in six years. New York Comptroller Thomas DiNapoli is asking lawmakers to increase a cap limiting the amount of so-called alternative investments in the state's Common Retirement Fund, the third- biggest U.S. public pension at $153.9 billion. South Carolina's retirement system adopted a plan in February to invest as much as 45 percent of its $29 billion in hedge funds, private equity, real estate and other alternatives, from nothing 18 months ago. The Austin-based Teacher Retirement System of Texas, which manages $106 billion, said in May it will increase investments in alternatives to 30 percent from 11 percent over the next several years. New Jersey expects to increase its alternative investments to 18 percent of its holdings from 11.5 percent, said William Clark, director of New Jersey's Division of Investment, which oversees the statewide pension fund. The California Public Employees' Retirement System, the largest U.S. public pension plan…approved an expansion into commodities in the past year, while increasing its target for private equity investment to 10 percent from 6 percent last December.
>
> The need to maintain returns comes as 29 states are facing at least $48 billion in budget shortfalls for the 2009 fiscal year that for most began July 1, according to the Washington- based Center on Budget and Policy Priorities, a nonprofit group.
>
> Massachusetts Pension Reserves Investment Trust lost $80 million in the last two years when Greenwich, Connecticut-based Amaranth Advisors LLC closed in September 2006 and Sowood Capital Management LP of Boston imploded in July 2007, according to reports last year. New Jersey's fund lost about $15 million when Amaranth collapsed. `"It doesn't come risk-free,'" said Susan Mangiero, president of Pension Governance LLC, a research firm based in Trumbull, Connecticut. "You could end up having a worse performance…."

We at Elliott Wave International are confident that this foray into shaky debt and higher leverage will devastate public pension funds, especially those that try feverishly to make up for losses.

But a new bull market would save the system. Isn't the SEC helping to spur a bull market by banning "naked" short selling?

On July 21, the SEC made it illegal—for three weeks and only for 19 stocks under substantial selling pressure—for speculators to sell short shares of stock that they had yet to borrow. This move

was billed as an **"**emergency order by Wall Street regulators to combat 'bear raids'…. The SEC crackdown," said one money manager, "essentially took much of the gunpowder away from the bears." (USA 7/21) This is nonsense. Bears don't need gunpowder. They are frolicking on a Slip'n'Slide. As the article points out, shares of Fannie and Freddie nearly doubled on the news, but even then their shares were still down 81 percent and 86 percent, respectively, from their highs. If would-be short sellers wanted a rally to sell on, the SEC gave it to them.

Short sellers, "naked" or covered, still need to buy back the stock they are short, so naked short selling does not force stock prices down any more than it will force them up later. Bullish buyers can always make naked short sellers cover if they have the inclination and the money. It's just that, in a bear market, they don't.

What if something happens in the political realm to change the trend?

On the contrary, events on the political front are right in line with our socionomic expectations. As social mood has trended further toward the negative, social conflict has been rapidly increasing. This week, Russia attacked Georgia, and President Bush delivered yet another stunningly belligerent statement to a foreign government, this time to Russia: "The United States [government]…*insists* that the sovereignty and territorial integrity of Georgia be respected." (AP 8/14) This statement continues a string of Bush administration ultimatums and threats previously delivered to Iraq, Iran, Afghanistan, Pakistan, Syria, Libya, Turkey, Ukraine, North Korea, Venezuela and China. Yesterday the administration upped the ante by pledging anti-missile technology to Poland, incensing the Russians further. Not since 1940, in the last Supercycle bear market, has a U.S. administration been so hell-bent on going to war. Of course, a great number of U.S. citizens are vehemently of the same mind, which is why Bush's popularity rating soared to 91 percent when he ordered the invasion of Iraq. This mood is exactly what socionomics predicts for bear markets. Putin is in the same chest-puffing league as Bush, not to mention potential successor McCain, who has demanded—despite his utter lack of authority—that Russia "unconditionally cease its military operations and withdraw all forces" from Georgia. He added, "In the 21st century, nations don't invade other nations," forgetting that the U.S. government invaded Iraq, fostering death and havoc in the Middle East for five years.

If Obama gets elected, he is not likely to avoid confrontation, either, because McCain has tagged him as weak, so he will strive to prove otherwise. Today's politicians, at *our* peril, ignore the Founding Fathers' admonition to avoid foreign entanglements. So, whatever your proclivities, get ready for far more war risk *in your personal life.* Also look for signs of labor-management conflict during the next administration. Obama has pledged to back a bill cynically named the "Employee Free Choice Act," which manipulates unionization proceedings in order to push unions on companies, even where the workers don't want them. According to AP (7/3), Obama's solution to social problems is "repeated calls for American sacrifice." So the attitudes of both major parties' presidential candidates are right in line with what wave **c** has in mind.

Quotes of the Month

The Economist said wisely in its July 31 edition,

> Macroeconomic cycles matter more than politicians will admit.

But you can't admit what you don't know, and politicians—at least in bulk—do not understand waves and cycles of social mood. Alan Greenspan, on the other hand, and despite his behavior as Fed chairman, seems to know something about them. Here is a recent statement from an article by Greenspan published in the Financial Times (8/4):

> The cause of our economic despair, however, is human nature's propensity to sway from fear to euphoria and back, a condition that no economic paradigm has proved capable of suppressing without severe hardship. Regulation, the alleged effective solution to today's crisis, has never been able to eliminate history's crises.

Sounds like *Socionomics*.

> He also said, "This crisis is…a once or twice a century event."

Sounds like *Conquer the Crash*. Except that what's happening now is just a mild preview; the real crisis lies ahead.

10 The Bear Market and Depression: How Close to the Bottom?

From *The Elliott Wave Theorist*
January 2009

The Bear Market and Depression: How Close to the Bottom?

Hardly anyone could foresee the wrenching changes the U.S. economy is going through in the late 2000s. But *Conquer the Crash* outlined many of them, and this discussion looks ahead again.

This report originally appeared in the January 2009 issue of *The Elliott Wave Theorist*, Robert Prechter's monthlty market analysis publication.

As we have long argued, because the current bear market is of one larger degree than that of 1929-1932, the depression it creates will be deeper, which in turn means that the unemployment rate will exceed that of 1933. The peak rate in 1933 was 25 percent. Therefore, unemployment in the U.S. should rise to about 33 percent at the trough of this depression. Fitting this expectation, U.S. job losses in the fourth quarter were greater than at any time since 1945, when World War II ended and defense factories shut down to re-tool. Even after this plunge, however, the "official" unemployment rate is just 7 percent. But the true unemployment rate, as it would have been measured before the era of government support payments and statistics fudging such as omitting the number of people who give up looking for work, is currently 17 percent. This figure is courtesy of John Williams' Shadow Government Statistics at http://www.shadowstats.com. So we're halfway there.

Here is an excerpt from *Conquer the Crash*: "When the bust occurs, governments won't have the money required to service truly needy people in unfortunate circumstances." It's starting to happen: Agencies administering state governments' "unemployment benefits" are swamped and running out of money. In a depression, taking funds from healthy companies to pay people out of work is a scheme that cannot endure. Serious suffering will occur when reality strikes and governments are forced to rescind their promises to the unemployed and stop paying them.

Oh, and the Dow lost more value in 2008 than in any year since 1931.

Would you believe that *despite* all this news, the primary mood in society is still one of *optimism?* Read on.

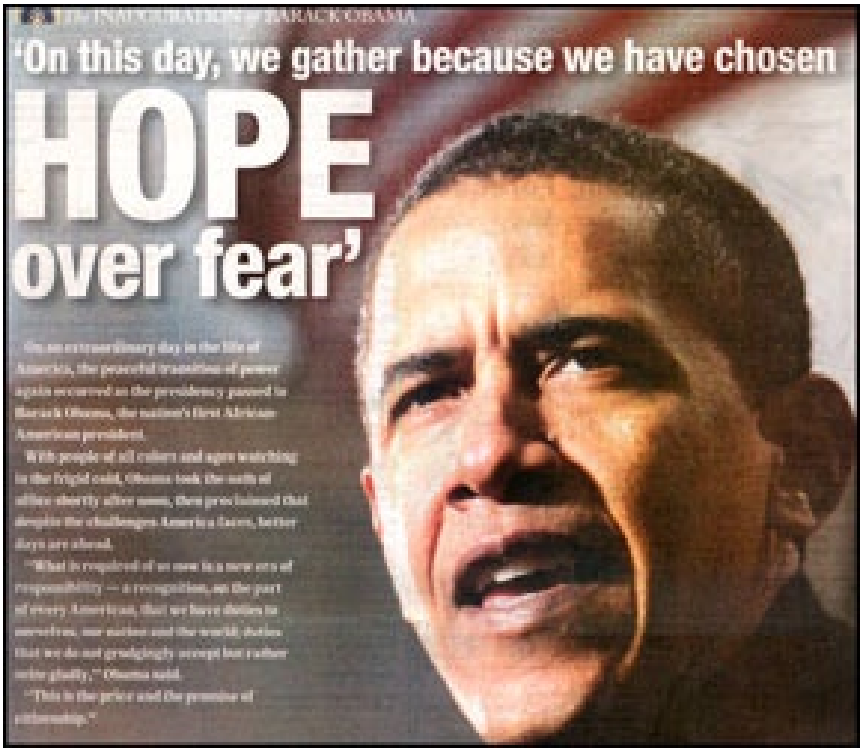
The Stock Market

The stock market is an animal of terrible beauty. Watching it work is like glimpsing an owl swoop down and grasp a mouse in its claws or watching a shark hone in on its prey. Its motions are efficient, and its dead eyes convey no emotion.

For a dozen years, from 1995 to 2007, a vicious bear, disguised as a siren, whistled and sang to its future victims, drawing them into its den. It is still whistling and singing, but only when it has the time to breathe between bites of feasting.

The December 2008 issue discussed one of the faux siren's sweetest-sounding songs: the hope—expressed throughout the media in stunning excess—that the market had bottomed and that President-elect Obama would save the economy. Economists were so bullish in December that two polls asking them to make predictions for 2009 registered *not one bear*; the average prediction for the Dow was for a double-digit gain of 17 percent. Positive mood among short-term investors became so extreme that the put/call ratio last month fell to levels it had not seen since December 2007, when the Dow was only 3 percent from its all-time high and just before it swooned 2000 points in six weeks and 46 percent in less than a year. Back in April 2008, a New York Times/CBS News poll showed that only 39 percent of

Americans believed that "things" would be better in five years. Early this month, the same poll shows that 61 percent of them believe it. This Fibonacci switch (from .382 to .618) is another manifestation of the change toward optimism reflected in the sideways trend of stock prices from October 10 to January 6. This re-blossoming of optimism peaked just in time for the market to have its largest early-January decline on record. Even so, the positive sentiment has hardly abated. A headline from the U.K.'s Daily Mail (1/17) reads, "Obama can save us, says America as polls show new wave of optimism." USA Today (1/22) announces: "Country's optimism swells as Obama takes oath." The article cites the very latest poll: "By nearly 6-1, those surveyed Tuesday in a USA Today/Gallup poll say Obama's inauguration has made them feel more hopeful about the next four years." Other articles have graduated to calling him a "savior." In Obama's first speech as President, he made a statement that is 100 percent accurate: "We have chosen hope over fear." Perversely, which is to say characteristically, the market kept its victims disoriented by sliding right through the Presidential inauguration. Whenever complacency reigns, the claws close and the shark bites.



Some people contact us and say, "People are more bearish than I have ever seen them. This has to be a bottom." The first half of this statement may well be true for many market observers. If one has been in the market for less than 14 years, one has never seen people this bearish. But market sentiment over those years was a historical anomaly. The annual dividend payout from stocks reached its lowest level ever: less than half the previous record. The P/E ratio reached its highest level ever: double the previous record. The price-to-book value ratio went into the stratosphere, as did the ratio between corporate bond yields and the same corporations' stock dividend yields. During nine and a half of those years, from October 1998 to March 2008, optimism dominated so consistently that bulls outnumbered bears among advisors (per the Investors Intelligence polls) for 481 out of 490 weeks. Investors got so used to this period of euphoria and financial excess that they have taken it as the norm.

With that period as a benchmark, the moderate slippage in optimism since 2007 does appear as a severe change. But observe a subtle irony: When commentators agree that investors are too bearish, they say so *to justify being bullish*. Thus, as part of the crowd, they are still seeking rationalizations for their continued *optimism*, and one of their best excuses is that everyone else is bearish. This would be reasoning, not rationalization, if it were true.

But is the net reduction in optimism since 2000/2007 in fact enough to indicate a market bottom? For the rest of this issue, we will update the key indicators from *Conquer the Crash* that so powerfully signaled a historic top in the making. When we are finished, you will know whether or not the market is at bottom.

Figure 1 updates our picture of Supercycle and Grand Supercycle-degree periods of prosperity and depression. The top formed in the past decade is the biggest since 1720, yet, as you can see, the decline so far is small compared to the three that preceded it. There is a lot more room to go on the downside.

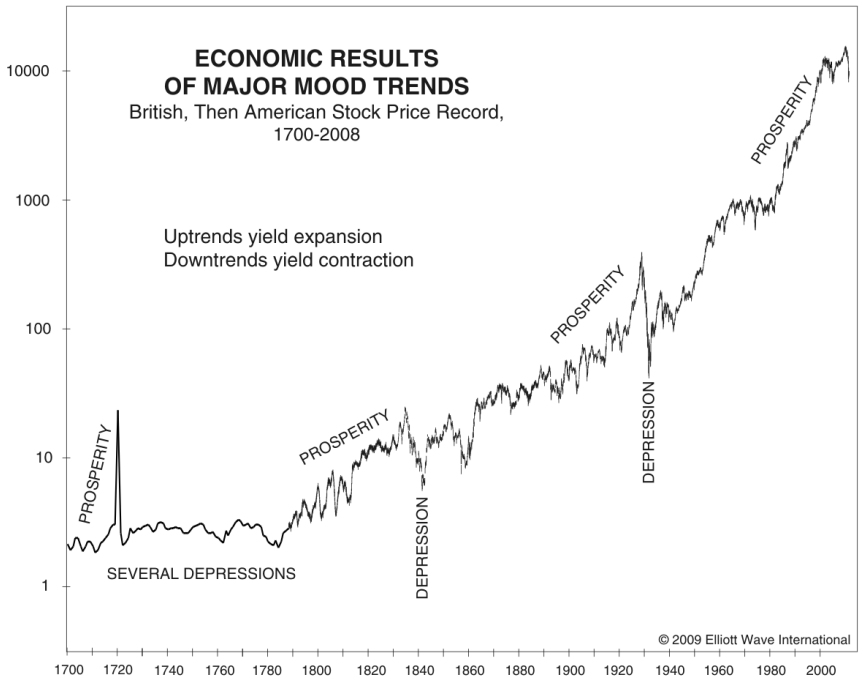


Figure 1

Figure 2 updates the Dow's dividend yield. Over the past nine years, it has improved nicely, from 1.3 percent to 3.7 percent, near its level at previous market *tops*. If companies' dividends were to stay the same, a 50 percent drop in stock prices from here would bring the Dow's yield back into the area where it was at the stock market bottoms of 1942, 1949, 1974 and 1982. But of course, dividends will not stay the same. Companies are cutting dividends and will cut more as the depression deepens. So, the falling stock market is chasing an elusive quarry in the form of an attractive dividend yield. This is a downward spiral that will not end until prices get ahead of dividend cuts and the Dow's dividend yield goes above that of 1932, which was 17 percent (or until dividends fall so close to zero that the yield is meaningless).

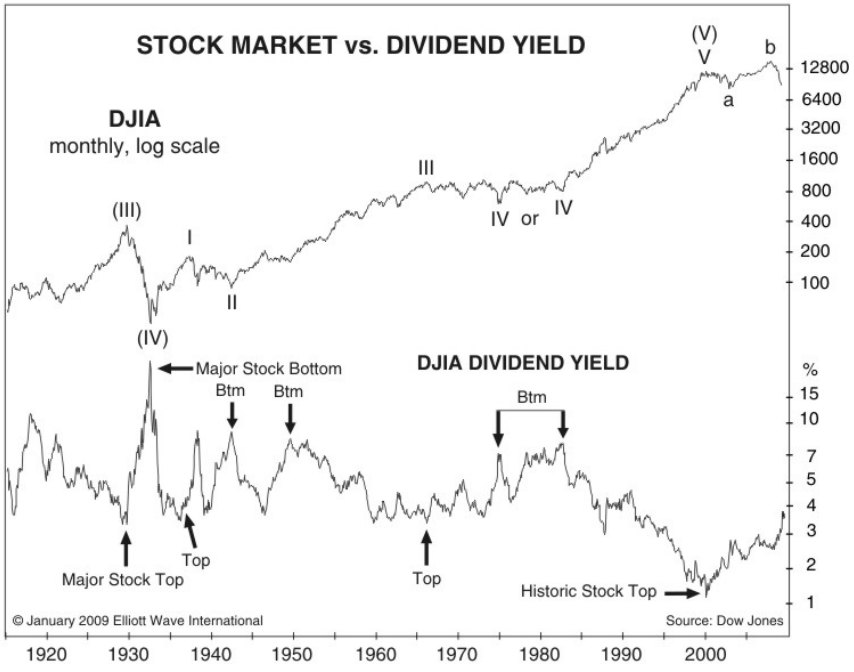


Figure 2

Figure 3 shows that the Price/Book ratio and the bond/stock yield ratio for S&P companies have moved a long way back toward what for 50 years was the normal range. All prices need do is drop by another 2/3, and both of these ratios will be at bear-market bottom levels. But they will have to drop a lot more to exceed the valuations of 1932, which should happen in this Supercycle-degree bear market.

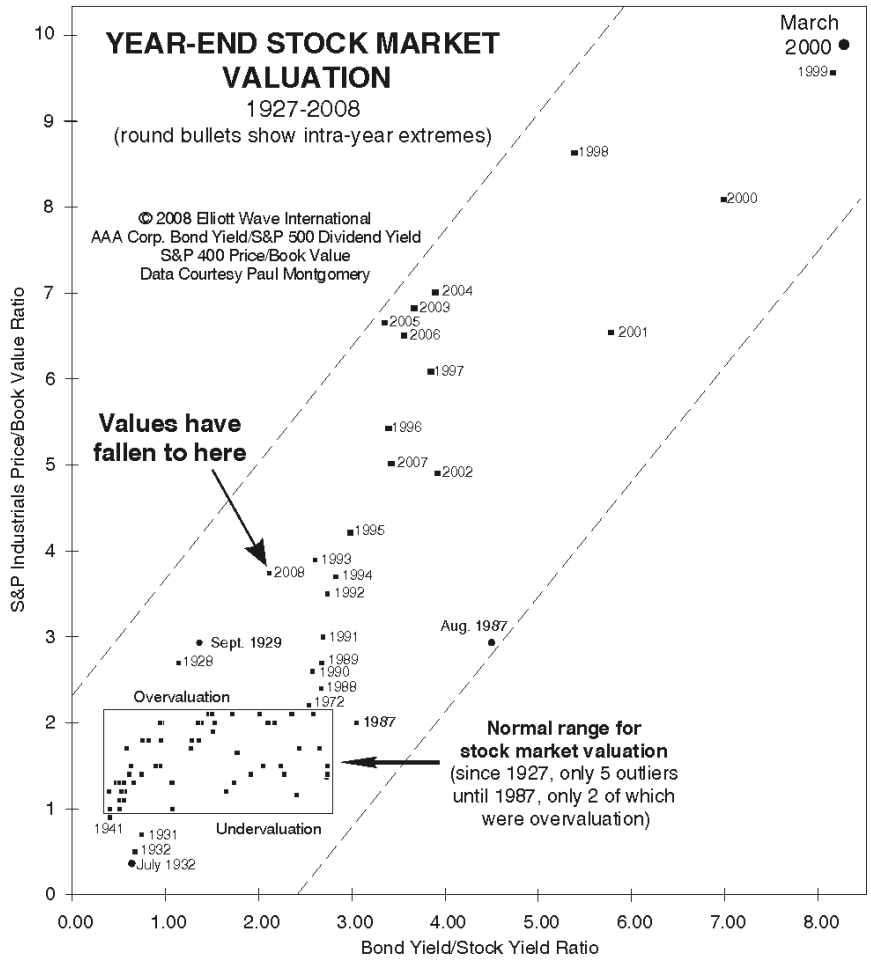


Figure 3

Figure 4 shows that the P/E ratio has also improved a lot, from 48 to 22. As with the indicators in Figure 3, if the Dow were to drop by another 2/3, the P/E ratio would return to bear market levels. But wait; that is only if E doesn't fall, which is not a likely scenario in a depression. In March 2007, analysts at Standard and Poor's were estimating $92 in earnings per share for the S&P 500 in 2008. As of the first week of January 2009, with figures still to come in, their estimate for 2008 is down to $48. So a falling P is chasing a falling E. This is the same situation that exists with the dividend yield.

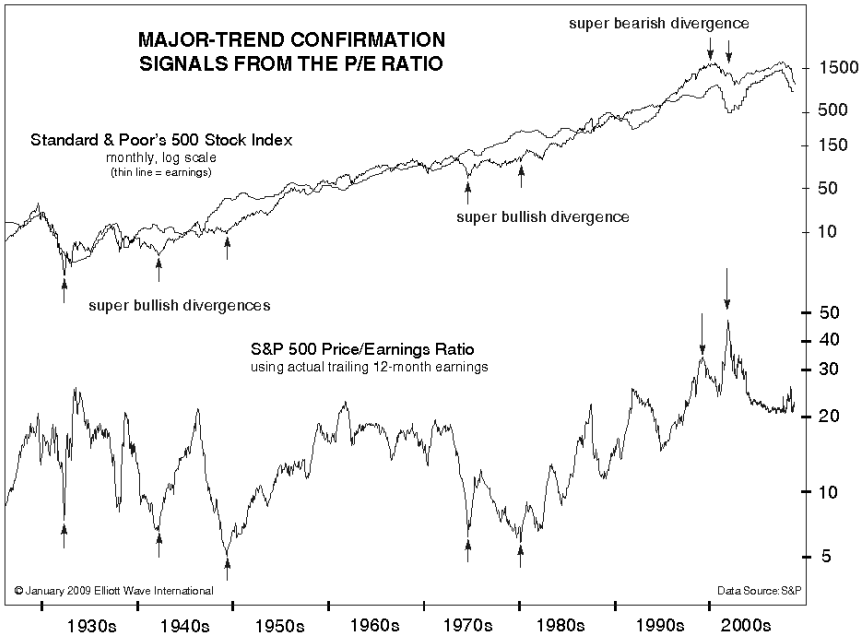


Figure 4

Figure 5 updates the cash/assets ratio among stock mutual funds. From an all-time low in 2007 of 3.4 percent, this ratio has climbed to about 5 percent. It's a start. At buying opportunities over the past 30 years, this ratio has been in double digits. Some people have responded, "Well, today it is different because mutual funds *have* to be invested." But this answer simply relates to the extent of the previous mania. Can you imagine someone having said any such thing in 1974 or 1982? What's more, it's not true. The WSJ reports, "Of the 50 best-performing U.S. stock funds that reported cash holdings last year, the average portion in cash was 22.9%." Surprise: Cash has been a good thing. (But with average investment levels at 77 percent, you can bet that these "best-performing" funds still lost a lot of money.) When a few funds have cash, they are simply smarter than their cohorts. When they *all* have cash, it's a signal. As recently as 1994, the average mutual fund had nearly 14 percent cash in its coffers, waiting for lower prices that never came. Today the managers and their customers are all presuming—or at least hoping for—higher prices ahead. But higher prices are not likely to materialize until managers' shared presumption melts away and they become worried enough to raise cash in the aggregate. A triple from here to 15 percent would be a bullish sign.

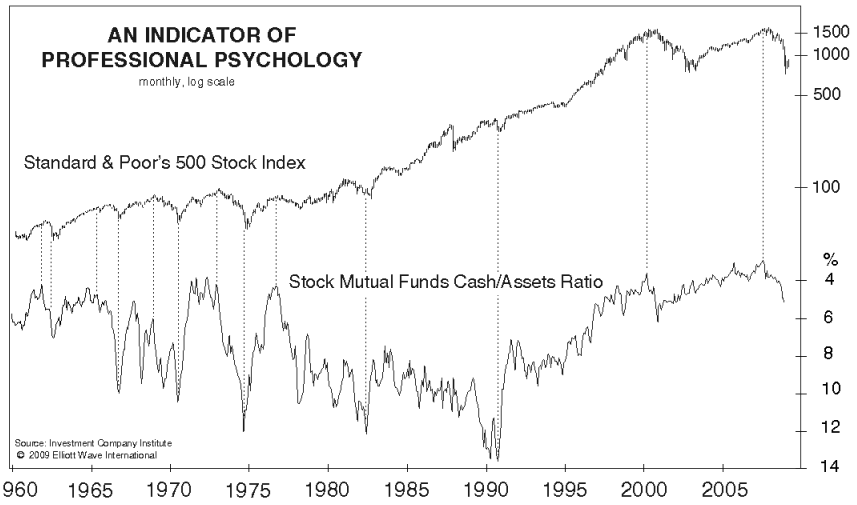


Figure 5

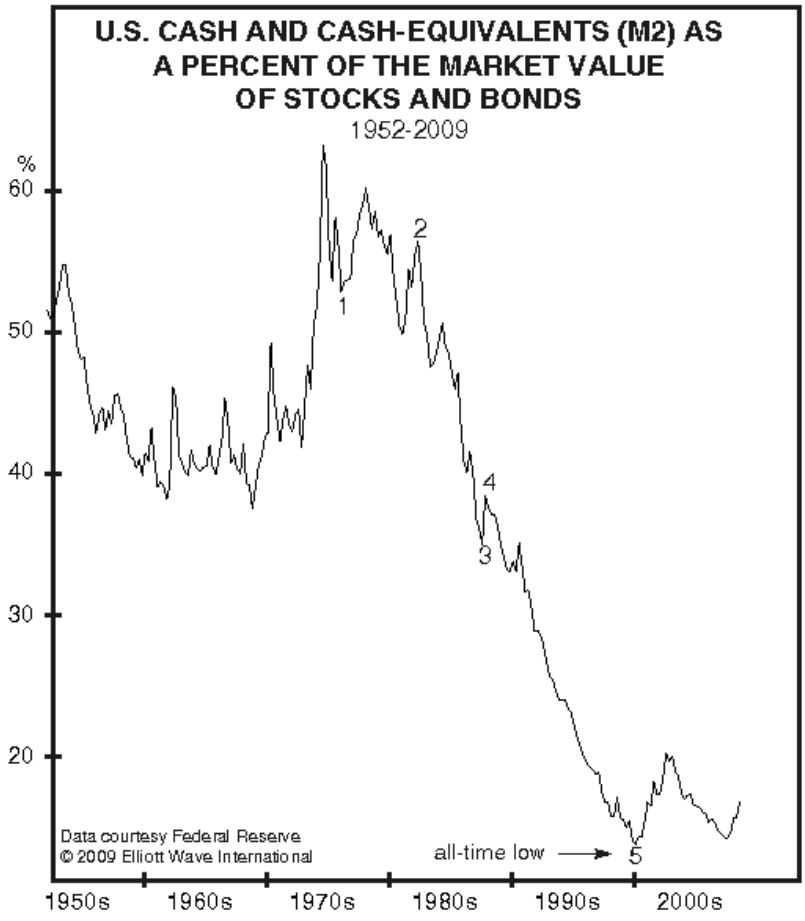


Figure 6

Figure 6 shows that cash as a percent of the market value of all stocks and bonds hasn't budged. Stock values have fallen, but the Fed and the Treasury keep creating new credit, and all the old credit is still on the books. So the pile of cash is still small relative to the nominal (as opposed to realistic) values in the stock and bond markets.

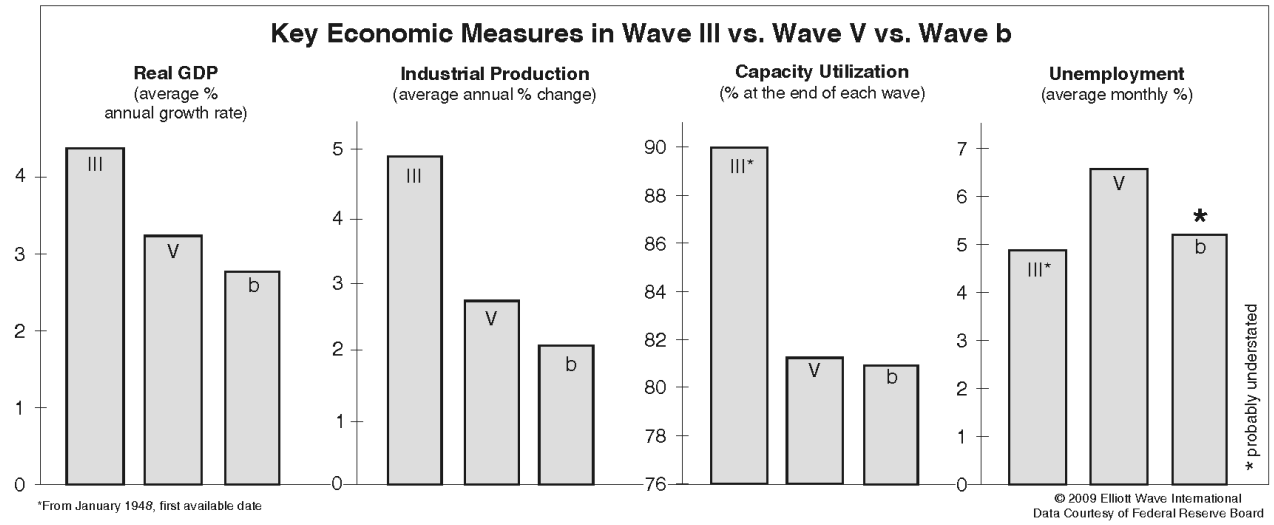


Figure 7

Finally, Figures 7 and 8 are brand new and update the progression of upward waves as they relate to the economic activity they engendered. *Conquer the Crash* showed that wave V from 1975 through 1999 was weaker than wave III from 1943 through 1965, and now we can show that wave b from 2003 through 2007 was weaker than wave V, in every respect. (See Figure 2 for a visual depiction of these waves.)

To summarize all these indicators, the bear market is still navigating its Slope of Hope. By our lights, the bear-market wave structure is as yet unfinished, and these indicators say that our interpretation of the pattern is still probably correct.

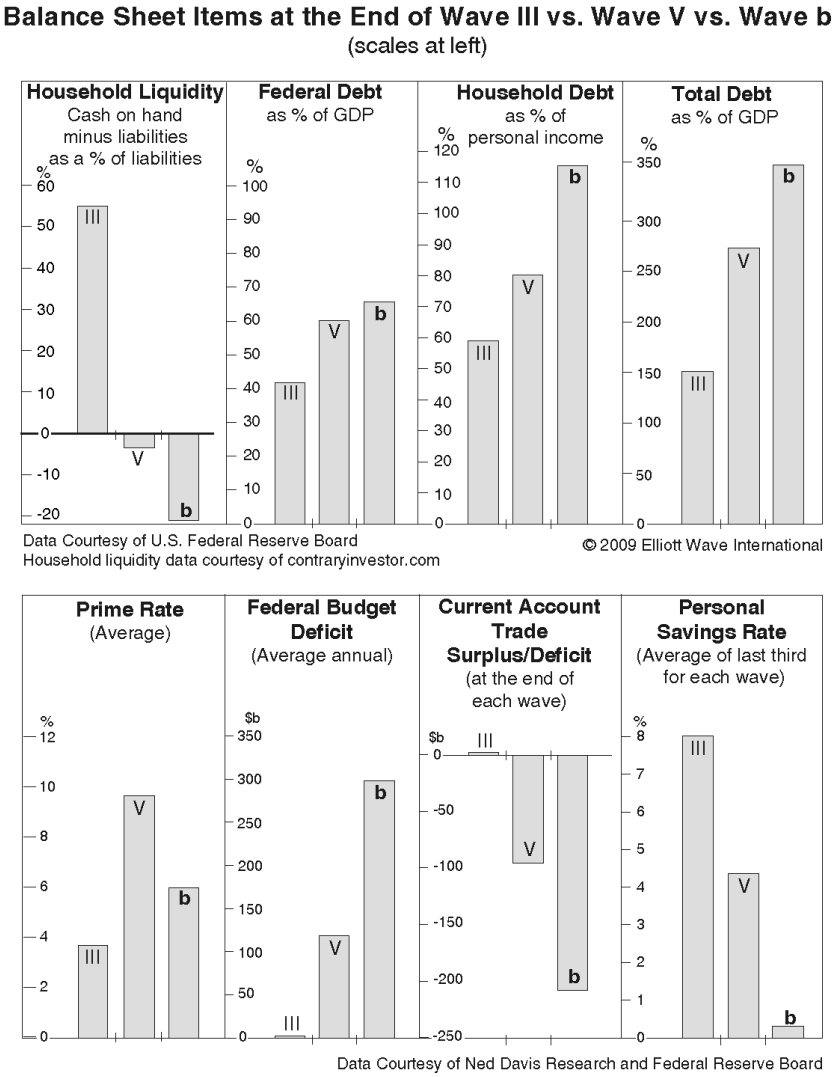


Figure 8

11 How Gold, Silver and T-Bonds Will Behave in a Bear Market

From *The Elliott Wave Theorist*
February 2009

How Gold, Silver and T-Bonds Will Behave in a Bear Market

Still think that there's a reverse relationship between gold and T-bonds? Time to question your assumptions.

This report originally appeared in the February 2009 issue of *The Elliott Wave Theorist*, Robert Prechter's monthly market analysis publication.

Gold, Silver and T-bonds

This section will offer a novel viewpoint. Can you imagine a scenario under which precious metal and Treasury bond prices would fall together? Most people would think such an event would be impossible. After all, as we showed in our study of March 2008, bonds do well during deflationary recessions, and gold goes up during inflationary booms. Shouldn't they be contra-cyclical?

Look at Figure 3 and realize that gold and T-bonds have been going *up* together for an entire decade. This is completely normal behavior according to our liquidity theory of market movement at the end of credit bubbles and their aftermath, as proposed in *Conquer the Crash* back in 2002. If gold and T-bonds can go up together for ten years, they certainly can go down together as well.

One possible reason for a decline in both markets is if the stock market finds a bottom for Primary wave ① here in the first quarter and embarks on a big rally for wave ②. Investors would quickly forget about safety and start chasing stocks and other investments again. Given current data, this is the most likely scenario.

Another scenario is likely to occur later, but since it could happen now, let's review it. *Conquer the Crash* said that bonds which are AAA at the start of the depression *and stay that way until the end* will be the best investments. As explained then, the problem is that I could not identify which bonds, *if any*, would be consistently that highly rated. The Financial Times reports that 60 U.S. companies had AAA ratings in 1980, and now only six do, and two of those are about to lose that rating. Even U.S. Treasuries

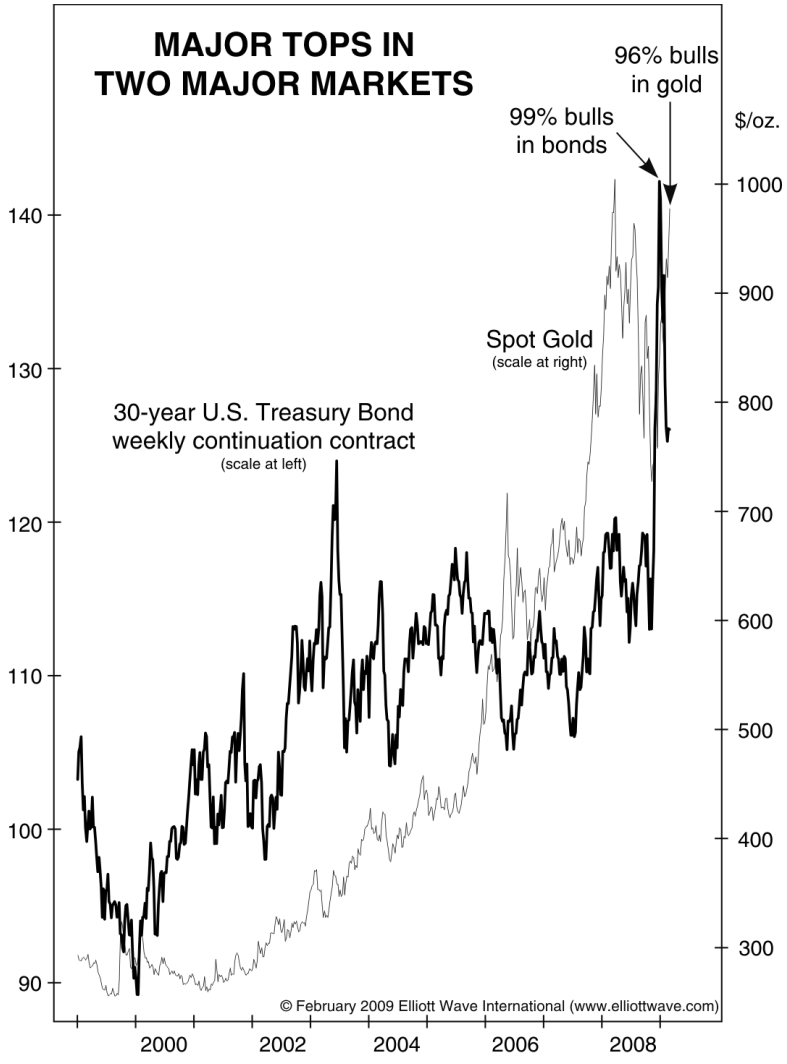


Figure 3

cannot hold up forever, particularly given the drunken-sailor approach to fiscal management that Congress has practiced over the past century and which has accelerated madly in the past eight years and even more outrageously since last September. The latest "bailout" program is yet another trillion dollars down the tubes, all borrowed. At some point, Uncle Sam's credit rating will begin to slip.

According to the price of credit-default swaps on U.S. Treasury debt, it is already slipping. When the monopoly issuing agent of dollar-denominated debt—the Federal government—begins to lose credibility as a debtor, the U.S.'s great experiment in fiat money will end. Read it here first: The U.S. government is the *borrower* of last resort. When it can't borrow any more, the game will be up, because the government's T-bonds are the basis of our "monetary" "system."

What will happen when creditors begin to smell default wafting on the wind from the intellectual, moral and political swamp of Washington, D.C.? *They will demand more interest*. At first, it might not be much: 4 percent, 6 percent. But as the depression spreads, spending accelerates, deficits climb and tax receipts fall, the rate that creditors demand might soar to 10, 20, 40 or even 80 percent. In 1998, annual bond yields in Russia reached over 200 percent before the government finally threw in the towel and defaulted. Now, barely a decade later, some of its banks are in the same trouble. Bloomberg (2/11) reports, "Yields on bonds due next year from Moscow-based Transcapitalbank and JSC AIKB Tatfondbank in the Russian republic of Tatarstan are trading at yields above 80 percent, up from 12 percent in August." Prices of outstanding bonds, of course, collapse when yields surge. Concern about this very eventuality in the U.S. is why I have consistently recommended Treasury *bills*. If rates go up, we will continue to earn more and more interest.

The U.S. government is the only U.S. institution that can keep promising a higher and higher interest rate and still have many people confident that it will pay. In a crisis, rising interest rates for Treasury debt could serve as a "black hole" for money. As rates rise, many people will sell other investments to lend at these "attractive" rates. In such a situation, T-bonds would be the primary engine of falling prices, as they suck value from other investments. If this scenario unfolds, it will be the lunatic center of the credit crisis.

So, this is another way that gold and bond prices can go down at the same time. As T-bond yields go up, prices fall, and if investors rush to sell other assets to receive high yields, other investment prices will fall.

This is hardly a guaranteed scenario. Maybe the government will begin spending less than it takes in, thereby shoring up its credit rating. Maybe the rush to own real money will keep gold rising. But unless Congress, the Treasury and the Fed change their behavior, rising interest rates for T-bonds seem inevitable.

Some people might be confused. Don't rising rates mean inflation? Not always. We saw last year how the exception works. Asset-backed paper representing sub-prime mortgages went to *infinite* yield as prices went to zero. The rise was not due to inflation but to deflation. As explained in CTC, interest rates go two ways during deflation: *down* on pristine debt, and *up* on everything else, due to fear of default.

So far, Treasury debt has gone down in yield, in fact to zero on the short end of the curve. That's because the world still perceives Uncle Sam as a triple-A-rated debtor. But with the Treasury and Congress on a spending spree that would make the "Shopaholic" character blush, fear of Treasury default seems inevitable. Even if the Fed agreed to print all the money the government needed to pay its interest, creditors would recognize the move as a scheme to cheat them, and the rate they demand would rise even faster, choking off any threatened inflation.

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