

December 17, 2006 Review (sent 12/19)

Summary

The joy continues unabated on Wall Street. Not so much joy on Main Street. Who will be right? We will see won't we

Credit

- **Dec. 12, 2006** — - For many Americans, it's an annual tradition that goes hand-in-hand with eggnog and mistletoe -- millions of people will charge millions of dollars on their credit cards this holiday shopping season. Of course, it's easy to pull out the plastic in the weeks leading up to the holidays, but much more difficult when those bills come due in 2007. **More than 115 million Americans carry monthly credit card debt, with the average American debt around \$9,000, according to Cardweb.com.** And many of those paying off a high balance were surprised when the minimum monthly payment due rose during the past year. The Office of the Comptroller of the Currency, a bureau of the U.S. Treasury Department and a watchdog to protect consumers from abusive and deceptive credit card practices, cracked down with tougher guidelines on interest rates, marketing tactics, and account management practices. The higher rates will help consumers pay off their debt more quickly, but many budgets were squeezed by the new minimum payments. **For Those Who Finance Holiday Spending on Plastic, Some Helpful Reminders Will Prevent Debt From Getting Out of Hand Holiday Spenders Beware: Credit Card Hangover Coming**
<http://www.abcnews.go.com/Business/print?id=2719673>

Commercial Real Estate

Commodities

Currency

- Dec. 19 (Bloomberg) -- **Thailand, the country that set off the Asian financial crisis almost a decade ago, has again shocked investors with an abrupt change in its currency policy.** The results this time won't be nearly as dire. Unlike 1997, Thailand and other Asian nations are struggling to stem gains in their currencies, not losses. Their economies are also far healthier: Inflation has slowed, the region's trade balance has swung from a deficit to a surplus and its foreign-exchange reserves have ballooned. ``There are multiple differences between Thailand and the rest of Asia today and Thailand and Asia back in 1997," said Lawrence Goodman, a former U.S. Treasury official who's now managing director of global emerging market foreign exchange strategy for Bank of America Corp. in New York. Thailand is also unlikely to set a precedent this time. The central banks of the Philippines, Malaysia and Indonesia said they don't plan to follow suit. Thailand itself backtracked on part of its new 30 percent withholding requirement on foreign baht purchases after the main stock index slid 15 percent in reaction. ``The only way contagion may spread is if countries start it themselves by imposing similar controls," said Steve Barrow, chief currency strategist at Bear Stearns Cos. in London. ``It's unlikely they'll wish that on themselves." **Thailand**

triggered the Asian financial crisis in July 1997 after it abandoned its currency's peg to the dollar as foreign investors exited the nation. The economic turmoil spread throughout the region and eventually enveloped Brazil and Russia, which defaulted on \$40 billion of debt. **Thailand, 1997 Crisis Trigger, May Have Muted Impact This Time By Rich Miller and Simon Kennedy** [ok. So it's different this time. Wasn't the New Economy also "different this time?"]

<http://www.bloomberg.com/apps/news?pid=20601109&sid=aPmA5Pe7iS04&refer=exclusive>

- The trouble with waiting and seeing is that you can't only wait and see. You also have to do something. You can't stop breathing. You can't stop eating. And you can't stop investing. There is no such thing as suspended animation when it comes to your money; no such place as nowhere in the financial world. **Every minute of every day...for every asset class...you are either long or you are short. Either you own it, or you don't own it.** Of course, you can be leveraged or unleveraged too...but that is merely a measure of how bad the damage will be if you are wrong. If you don't own Google, for example, you will lose potential earnings if it goes up. And if it goes down, relative to the rest of the world - which includes Google holders - you will be ahead of the game. **You may say to yourself, 'Oh...I'm staying out...I'm in cash.' But that is merely an alternative investment position.** When you are in cash, you are short stocks...and long the dollar (generally). If stocks go down...your cash goes up, relative to the stocks. If stocks go up...your cash - measured in stocks - becomes less valuable. And what about the dollar itself? For most Americans, being 'in cash' means being in the cash printed up by the Bureau of Printing and Engraving and watched over by the central bank of Ben Bernanke. This year alone, that cash has gone down 10% against the cash of the European Central Bank. Against the 'cash' that comes out of the ground - gold - it has lost 20%. And in terms of consumer prices, cash is down too - about 3%, depending on whose estimate you believe. No, Dear Reader, there's no way to stay out of it. There's no refuge. There's no place where history stands still and prices stop moving. No matter where you are, you're in it whether you like it or not. **An American homeowner, for example, is long U.S. residential housing.** He may want to be long for reasons that have nothing to do with finances; he may simply like his house and have no intention of giving it up. He may have no mortgage on it...and no intention to sell. If it goes down, what does he care? **But a lot of people are long residential real estate, highly leveraged, and getting desperate.** Many are making bets they can't afford to lose. Imagine the poor lump who bought a house last year - with no money down and a backwards-walking mortgage. He couldn't quite afford the regular mortgage payments, so he took the 'pay option' plan. The difference between what he ought to pay and what he does pay is added to the principal. Well, at the end of 12 months, he has a bigger mortgage than he started with. And if his house went down in price, his mortgage may also be considerably more than the house is worth. This poor fellow has no business speculating on housing prices. He may never have intended to do so. He may have wanted nothing more than a decent roof over his head. But now his financial future hangs on what happens next year in the housing market. He has to 'wait and see,' too. But he must be sitting on the edge of his chair. He's long housing in a big way - he's staked an amount greater than his entire net worth on it. "Foreclosures up as borrowers fall behind," says a headline in USA Today. Almost one in 20 mortgages are in arrears, says the paper, led by Mississippi, Louisiana...and

Michigan. And from California comes news that "Regional home prices grow at a sluggish pace...The median was up 1.7% last month from a year earlier, the smallest gain in nearly a decade." Meanwhile, more and more people seem to be long stocks. The Dow hit a new record high yesterday. Dow 36,000? Sure...why not?! But the Dow has done nothing compared to foreign markets. We were just in Bombay, where local stocks have gained an incredible 40% this year. North of the Himalayas, in Shanghai, stocks are up an unbelievable 95%. DR 12/15/06

<http://www1.youreletters.com/t/457622/1469639/23/0/>

Diversification

Derivatives

Housing

Housing Finance

- **December 14, 2006** - The number of people paying their mortgages late — or not paying them at all — picked up in recent months, a trend that is expected to continue well into next year. **The rise was sharpest among borrowers with troubled credit histories, and in particular, subprime borrowers who took out mortgages with interest rates that increase over the life of the loan.** The Mortgage Bankers Association said yesterday that a survey of more than 42 million mortgages found the rate of delinquencies rose to 4.7 percent from July through September, up from 4.4 percent in the second quarter, when the numbers were adjusted for seasonable variations. The rate had fallen for two consecutive quarters. Among subprime homeowners, designated as such because their questionable credit would otherwise disqualify them from obtaining a mortgage, delinquency rates were much higher. Subprime borrowers who had past-due payments rose to 12.6 percent, from 11.7 percent in the second quarter. **Subprime borrowers who took out adjustable-rate mortgages, which typically start at artificially low rates that increase over the life of the loan, were the most likely of all those surveyed to be in default. Among subprime adjustable mortgages, 13.2 percent were delinquent in the third quarter, compared with 12.2 percent in the second quarter.**

<http://www.nytimes.com/2006/12/14/business/14mortgage.html?ei=5090&en=844cac4096568702&ex=1323752400&partner=rssuserland&emc=rss&pagewanted=print>

Macro Economic

- Dec. 19 (Bloomberg) -- Prices paid to U.S. producers rose in November by the most since 1974, led by rebounds in the costs of energy and light trucks. Prices excluding food and energy increased more than forecast. The 2 percent gain in the producer price index was more than forecast and followed a 1.6 percent decrease in October, the Labor Department said today in Washington. Excluding food and energy, the so-called core rate rose 1.3 percent last month, the most since July 1980, after falling 0.9 percent. U.S. November Producer Prices Jump 2%; Core Up 1.3% (Update3) By Shobhana Chandra
- http://www.bloomberg.com/apps/news?pid=20601087&sid=aIR3U_y46QMw&refer=home

Retail

- Dec. 19 (Bloomberg) -- Circuit City Stores Inc., the second-biggest U.S. consumer-electronics retailer, reported its first loss in six quarters after it lowered prices for televisions and computers to match rivals' offers. The stock headed for its biggest drop in almost two years after the company cut its sales forecast. The net loss was \$16 million, or 9 cents a share in the third quarter through Nov. 30, compared with net income of \$10.1 million, or 6 cents, a year earlier. Sales rose to \$3.1 billion from \$2.9 billion, the Richmond, Virginia-based company said in a statement. Circuit City joined Best Buy Co. and Wal-Mart Stores Inc. in luring holiday shoppers in November with reduced prices on laptops and flat-panel TVs. Best Buy, the largest U.S. consumer-electronics retailer, last week reported profit that trailed analysts' estimates. "The pace of the decline in flat-panel television prices accelerated during the quarter as manufacturers and retailers competed aggressively for market share and prices fell to unanticipated levels," Chief Executive Officer Philip Schoonover said in a statement. **Circuit City Has Third-Quarter Loss; Shares Decline (Update1)** By Mark Clothier
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aXBiO44Rsoxw&refer=home>

Retirement

- How much of your retirement planning is based on wishful thinking? It's a question more people need to ask themselves as they approach later life. Developing a successful retirement plan is both an art and a science: sketching out how you wish to spend your time after leaving the office, and estimating what your income and expenses might be. But some answers -- about nest eggs, taxes and long-term care -- are harder to come by. And that's where people can end up deceiving themselves. "We're not exactly a nation of savers," says Rande Spiegelman, vice president-financial planning at the Schwab Center for Investment Research, a division of Charles Schwab Corp. **Thus, "we are in denial, to a certain extent, about retirement planning," Mr. Spiegelman says. "Maybe we need a reality check."** We asked financial planners, educators and economists across the country to share with us some of the most risky assumptions -- or outright lies -- that people are crafting as they approach retirement. The thinking usually goes something like this: "I might not be in the best shape when it comes to planning for later life, but that's OK because..." **The Retirement Lies We Tell Ourselves** By GLENN RUFFENACH Staff Reporter of THE WALL STREET JOURNAL December 11, 2006; Page R1
http://online.wsj.com/public/article_print/SB116544325824442699-0s0D8G0aHg50EEN_z6_rpnSNZx8_20061221.html
- See "the most important number in the world below"

Risk

- NEW YORK (CNNMoney.com) -- The merger machine's rolling full steam ahead, and private equity investors are playing a bigger role than ever before - a trend that's likely to carry into 2007. But some investors and merger experts are starting to worry that the slew of deal-making could come to a nasty end, especially if slower economic growth or a recession make it harder for companies to deal with the debt that's often involved in today's buyout deals. The merger boom's been fed by low interest rates, rising stock

prices, plenty of money in the debt markets and greater tolerance for risk among investors worldwide. It's still going like a house afire," said Colin Blaydon, director of the Center for Private Equity and Entrepreneurship at Dartmouth's Tuck School of Business. The risk, he and others said, is that a downturn in the economy could upset the applecart. "If the debt markets have a crisis of confidence and there is a real turndown of the economy we could see a dramatic pullback," Blaydon remarked. "We know there will be a pullback, we just don't know when that is going to happen." Private equity buyers in particular use borrowed funds to finance their deals, then usually overhaul the business and try to sell to another corporate buyer or investor group - or take it public. Often, investors use the assets of the target firm to secure the debt. After the buyout boom: The bust? A string of deals led by private equity firms will push buyouts to record levels this year. But if things turn sour, look out. **By Jessica Seid Dickler, CNNMoney.com staff writer** December 18 2006: 3:33 PM EST
http://money.cnn.com/2006/12/18/markets/private_equity_outlook/

Savings Rate

Tech

Wall Street

- The talk of Wall Street is the **immense bonus pool** to be shared by the fortunate employees of Goldman Sachs. But elsewhere in corporate America, employees are far more likely to find lumps of coal instead of bars of gold in their Christmas stockings this year. Earlier this week, the consulting firm Hewitt Associates **reported** that two-thirds of companies won't pay holiday bonuses this year, up from 59 percent in 2005. Of the 34 percent of firms that will dispense holiday largesse, "39 percent will award cash, 37 percent will provide retailer gift certificates, and 27 percent will give employees a gift of food (e.g., turkey or ham)." Meanwhile, 65 percent of companies have planned a holiday party, down from 74 percent in 2005. This trend isn't surprising. Of late, America's CEOs have acted like a bunch of Scrooges all year round. **As profits have soared to record levels, they've been unwilling to share the bounty with employees in the form of substantially higher wages, benefits, and bonuses. [Has the gulf between main street and wall street been wider????? AND/OR Will Amerquest take a turkey instead of my mortgage payment?????????] <http://www.slate.com/id/2155602/>**
- Charles H. Dow, who edited the Wall Street Journal a century ago, once observed "It is impossible to tell in advance the length of any primary movement, but the further it goes, the greater the reaction when it comes, hence the more certainty of being able to trade successfully on that reaction... The best way of reading the market is from the standpoint of values. To know values is to comprehend the meaning of movements in the market." Dow's successor at the Wall Street Journal was William P. Hamilton, and was also a brilliant observer of the market. Hamilton observed that bull markets generally occur in three phases. As **Richard Russell** summarizes: "Phase one is the rebound from the depressed conditions of the previous bear market. Here stocks return to known values. In the second and longest phase, shares advance in recognition of improving business and a rising economy. During the third phase they spurt skyward on the hopes and expectations of a continuing rosy future... The low-priced 'cats and dogs' historically make great

moves in this third phase...” **As another follower of Dow, Robert Rhea, once wrote: “the final stage is sometimes recognizable because people then buy stocks simply because they go up, and because other people are buying them.”** With the S&P 500 currently trading at nearly 18 times fresh record earnings, on record profit margins, it seems clear that the current bull market is well into its third phase. To anyone who examines more than one or two decades of market history, even a multiple of 18 is very rich by historical measures, and can't be reconciled simply by reference to interest rates or inflation. On closer inspection, of course, valuations are even more hostile. Over the past three years, profit margins have widened to record levels, which has detached P/E ratios from other fundamental measures – such as price/revenue, price/dividend, and price/book ratios. The S&P 500 is currently about double its historical norms on those metrics. That isn't a forecast that stocks have to eliminate that valuation gap, but it certainly does suggest that stocks are priced to deliver unsatisfactory long-term returns from these prices. It bears repeating that if profit margins were at normal levels – even on the basis of profit margins that prevailed *during the 1990's* (indeed, anytime prior to the past 3 years) – the price/earnings ratio of the S&P 500 would currently be nearly 25. **Unless investors want to speculate on the notion of a “permanently high plateau” in profit margins, the stock market is strenuously overvalued at present.** Neither current earnings nor “forward” earnings should be considered – in themselves – as anything close to robust or reliable metrics of value here. *Phase Three: The Speculative Blowoff*

John P. Hussman, Ph.D. <http://www.hussmanfunds.com/wmc/wmc061211.htm>

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[Article of the week:](#)

Ageing bull

Dec 7th 2006 | NEW YORK
From The Economist print edition

With few places left to turn, investors have pinned their hopes on the stockmarket

ROCKY is returning to American cinemas this Christmas. And the financial markets increasingly resemble Sylvester Stallone's ageing pugilist: they may get knocked about a bit, but they always seem to bounce back.

In recent weeks disappointing economic data have pointed to the possibility of an American recession in 2007. The dollar has weakened sharply, raising the spectre of the complete collapse that bears have been predicting for years. And on December 4th Pfizer, the

pharmaceuticals giant, saw its share price plunge after yet another drug failed the testing process (see [article](#)).

But the stockmarket has rolled with the punches. And other asset classes have been similarly buoyant. The spreads (extra yields) on corporate bonds and emerging-market debt are low by historical standards; commercial-property valuations in America and Britain are high.

The general explanation for this bullishness is that the world is flush with liquidity. But liquidity is one of those catchall phrases that is not as good as it sounds—a bit like saying “there are more buyers than sellers”, which is itself a cliché of dubious merit (for every buyer who makes a trade, there must be a seller).

What does appear to be clear is that investors are happy to take on risk and eager to buy any asset that offers a higher yield than government bonds. And even those investors who do worry about the American recovery, or about political risks in the Middle East, have to think twice before they sell. The corporate sector is still increasing profits and churning out cash in the form of dividends and share buy-backs. Every Monday seems to bring news of a mega-merger; on December 4th, it was the combination of Bank of New York and Mellon Financial (see [article](#)). Potential bid targets from the private-equity sector get larger and larger (the latest tittle-tattle is about Home Depot, worth over \$100 billion if you throw in debt). Why sell your shares if someone might be willing to buy them tomorrow at a 20% premium?

As for the dollar, the reason to worry would be if a falling currency prompted foreign investors to demand higher yields on American Treasury bonds to compensate them for the risk. That might really push America into recession. But it is not happening so far; yields have been falling.

All this adds up to what Jim Cramer, the hyperactive pundit of American financial television, describes as “one of the best markets I’ve ever seen.” Bulls are talking about double-digit stockmarket returns in 2007, thanks to a combination of stockmarket rerating (higher price-earnings multiple) and growing profits.

So what might spoil the party? One problem, as the producers of the Rocky series know only too well, is that sequels are subject to the laws of diminishing returns. Once bond spreads and property yields are low, there is no longer much scope for further capital gains.

That is why investors' hopes are pinned on the stockmarket in 2007; share valuations are only at historically average levels. But company profits are at a 40-year high as a share of American GDP. If profits were about to revert to the mean, share multiples should fall below average.

The bulls do not think that will happen soon. But whereas one more year of above-average profits growth is possible, three or four more are hard to imagine.

Clearly, the use of borrowed money to enhance returns (often referred to as the “carry trade”) means that the markets are vulnerable to a change in sentiment. When the trend changes, as it did in May, there will be a mad rush for the exits. As Bill Gross of Pimco, a bond giant, writes: “I have a strong sense that the ability to lever any or all asset returns via increasing leverage is reaching a climax.”

Timing, however, is notoriously difficult. Bears can point to low share volatility, as measured by the Chicago Board Options Exchange's VIX gauge, as a sign of investor complacency. But it may merely be that investors have seen no need to incur the costs of insuring their portfolios against loss.

The markets will thus need some sort of shove to push them off today's course. Higher unemployment would be one possibility: it might turn the housing-market correction into a rout. If the nuclear dispute with Iran were to escalate so that, say, the straits of Hormuz were blocked and crude jumped to \$100 a barrel, investor confidence would take a hit.

But predicting such events is more in the realms of astrology than financial punditry. Sceptical fund managers have been forced into a position of being "fully invested and scared as hell." The knockout blow will undoubtedly come (probably in the credit markets). But just like the Rocky franchise, bull runs on financial markets have a habit of going on much longer than most people expect.

http://www.economist.com/finance/PrinterFriendly.cfm?story_id=8382415

HERB GREENBERG

Is it brains or a bull market?

Investors shouldn't lose sight that there are two sides to each trade

By *Herb Greenberg, MarketWatch*

Last Update: 10:53 AM ET Dec 15, 2006

SAN DIEGO (MarketWatch) -- To repeat what I said on Kudlow & Co. Thursday night: "It's said you should never argue with a crazy person. I'll add that you should never argue about a crazy market."

And that pretty much describes where we are - in a market that hangs by the thread of oil until it decides the risk of rising oil prices is irrelevant; in a market that hangs by the thread of the latest economic indicator, until it decides that indicator is irrelevant; in a market that one week is enthusiastic about the Fed's likelihood of cutting interest rates and the next week enthusiastic when it looks like a cut is less likely.

This is a market, as I've written previously, that lacks conviction and will fall in a vacuum on the whiff of something unexpected - like aging Karl Wallenda, the most famous of all high-wire walkers, falling to his death from a skywalk in Puerto Rico when the wind shifted in a direction he hadn't expected.

Is the economy growing or is the economy slowing? YRC Worldwide

a trucker that should have its fingers on the pulse of the economy, says the latter.) Doesn't really matter because, as of today, the market sees both as good.

Not to worry: All that really matters is "global liquidity," a catch-all to explain the inexplicable.

"Unnatural," is the way market strategist Jeff Saut of Raymond James explains this market in his latest missive.

"Markets typically go up, correct by 25%, and then re-rally if they are going to trade higher," he writes. "This, ladies and gentlemen, has not been the case recently as the averages have 'unnaturally' vaulted higher without so much as ANY correction."

He further marvels at how the SEC caved in to a New York Stock Exchange petition in mid-October to reduce margin requirements "for an already over-margined hedge fund community. And that 'mysterious surprise' gave the major market indices another leg up (read: re-rally)...Why in the world would one introduce more leverage into an already over-leveraged hedge fund community is a mystery to us!" (And to us!)

What about the value of the market relative to earnings? Everybody says it's cheap. Everybody, that is, but John Hussman, of Hussman Funds, who in his weekly commentary writes that at 18-times earnings the market is into its "third phase" -- the phase, he notes, that Richard Russell of Dow Theory Letters says occurs when stocks "spurt skyward on the hopes and expectations of a continuing rosy future ... The low-priced 'cats and dogs' historically make great moves in this third phase."

Adds Hussman: "To anyone who examines more than one or two decades of market history, even a multiple of 18 is very rich by historical measures, and can't be reconciled simply by reference to interest rates or inflation. On closer inspection, of course, valuations are even more hostile. Over the past three years, profit margins

have widened to record levels, which have detached P/E ratios from other fundamental measures - such as price/revenue, price/dividend and price/book ratios. The S&P 500 is currently about double its historical norms on those metrics. That isn't a forecast that stocks have to eliminate that valuation gap, but it certainly does suggest that stocks are priced to deliver unsatisfactorily long-term returns from these prices." There's no shortage of pundits who would disagree, of course. But that, dear readers, is what makes markets - inverted yields, consumer credit, shaky subprime-mortgages, the weak dollar, uncertain housing, financial leverage and complacency, be damned. Minyanville's Todd Harrison put it best in a column here the other day when he wrote, "For every risk, there is an offsetting reward. And those betting on a year-end ramp would be wise to remember that this is a two-way street." Amen, bro'. ■

Herb Greenberg is senior columnist for MarketWatch and contributor to CNBC television based in San Diego. He does not own stocks (except for shares of his employer), and he does not sell individual stocks short or invest in hedge funds.

<http://www.marketwatch.com/news/story/story.aspx?guid=794CC3CBDB1D4C57A2C8FE7326154352&siteid=mktw&dist=nbc&print=true&dist=printTop>

THE MOST IMPORTANT NUMBER IN THE WORLD
by David Galland

78 million.

That figure is the key to steering your portfolio successfully past the reefs of today's brewing monetary crisis. And, if you play things right, it's the key to making a lot of money for yourself over the next decade.

78 million is the number of baby boomers who are in or approaching retirement. That's the biggest demographic bulge in U.S. history, fully 26% of the population.

And many of those 78 million are in a jam. As they approach retirement, they are still carrying historic levels of debt and, on average, have woefully inadequate net worth -- and much of that based on shaky housing prices.

In fact, 25% of the retiring boomers - nearly 20,000,000 in all - are facing retirement with a net worth of less than \$50,000. You don't need to be an accountant to see that, with today's degraded currency and longer life expectancies, they won't get very far on so little.

This is a real tragedy in the making. After all, what could be sadder than millions of people striving for a lifetime to reach the American dream and then discovering that the "golden years" are just a fantasy, their wealth having been sucked away by decades of inflation and taxes so that politicians and bureaucrats could squander it to grease the skids for their own political success.

In 1930, the total share of the U.S. economy directly controlled by or dependent on government was about 11%, leaving the balance of 89% firmly in the hands of private enterprise.

Today, by the late Milton Friedman's calculations, the government's share of the U.S. economy - including the time and resources required to comply with all the regulations - has ballooned to over 50%, reducing the wealth-creating machinery of free enterprise to an auxiliary engine for government.

No wonder so many people live paycheck to paycheck.

U.S. government debt now tops \$9 trillion, before taking into account its unfunded obligations for Social Security and Medicare - debts that the retiring boomers will soon have their hands out to collect.

After adding in Social Security, Medicare and all the government's other pay-later obligations, the current debt actually comes in at over \$60 trillion - an amount so large, not one person in a million has a real sense of it. So let's try to put that number into perspective.

A trillion is 1000 X 1000 X 1000 X 1000, or a million millions. In his first address to Congress, President Reagan, himself a big spender, accurately pointed out that a stack of \$1,000 bills four inches high makes you a millionaire, and that a trillion dollars would be a stack 67 miles high!

The U.S. government owes 60 of those sky-piercing stacks of \$1,000 bills.

It's a lot of money. And it's not just any kind of money. Amazingly, this unbacked currency of a bankrupt government is still the reserve currency of virtually every nation in the world today. But not, we think, for much longer.

To service its debt and keep the game going, the U.S. government must sell on the order of \$2.5 billion per day in new Treasury bills, much of it to foreigners already sitting on something like \$6 trillion of U.S. paper.

Absent the foreign buyers of U.S. Treasury securities, the whole scam begins to unravel. And once it begins to unravel in earnest, with wealthy foreigners and then governments rushing to switch out of dollars, the speed and steepness of the monetary collapse will be breathtaking.

While millions of boomers will be lucky to scrape by for a year or two of hard living in a trailer park, their meager assets won't carry them through the 20 or 30 years of retirement that medical science now promises. For that, they'll have to rely on scraps from Washington. And if they have nothing else, every one of them has a mailbox that's just right for receiving government checks.

In fact, according to the Fed, a majority of retired Americans already rely on Social Security for 80% or more of their income.

And that makes Social Security and Medicare politically untouchable, no matter how badly the programs trap the U.S. economy.

Recognizing that the United States has little capacity to rein in its profligate spending and has neither the intent nor the ability to actually pay off its \$60 trillion debt in money worth anywhere near what it's worth today, foreigners are increasingly leery about accumulating more greenbacks.

On November 9, for instance, Reuters reported that, "The bond and foreign-exchange markets were struggling to come to grips with comments from China's central bank governor Zhou Xiaochuan, who said his country had a clear plan to diversify its \$1 trillion in foreign-exchange reserves and is considering various options to do so."

Normally, the more skeptical foreign investors become, the higher interest rates must go to entice them to continue raising their hands at Treasury auctions... and to keep them from dumping their existing holdings.

But even that route, at least for now, is closed. That's due to the critical role of housing in today's economy and in the financial statements of so many millions of American homeowners. Simply, higher interest rates would devastate the already weak housing market and bring ruin to a heavily indebted populace, especially cash-strapped boomers, and further ratchet up the cost of government borrowing. In other words, raising rates is not an option.

So what are nervous bureaucrats to do?

The answer is to depreciate the currency - and as quietly as possible. That allows the government to meet its obligations, but with ever more worthless dollars. It's their only way to buy time.

In fact, Fed Chairman Ben Bernanke virtually gave the game book away in a speech in Frankfurt on November 10.

"It would be fair to say that monetary and credit aggregates have not played a central role in the formulation of U.S. monetary policy."

In other words, the total amount of money in the system - what we "print" -- is whatever the government finds convenient from one day to the next. That's a politic way of admitting that the U.S. government is planning to paper over all its many obligations and accelerate a trend that has been in motion since the creation of the Federal Reserve in 1913.

Make no mistake, it's a desperate strategy, but at this point it's the only option for a government whose decades of reckless spending have led the economy into a box canyon, the floor of which is covered in quicksand. There is no way out. The best they can hope for is to stall the inevitable for as long as they can. "Not on my watch" is the phrase of the day.

In this age of instant communication, the government can't hide the truth - at least not for long. So, no matter that they have stopped publishing M-3 money supply numbers, recognition that we are between a rock and a hard place is spreading.

Reckoning day is not far off. And when it comes, it will rush in faster and more brutally than almost anyone expects. The world's financial picture will be redrawn from scratch, and a painful unwinding of the economic dislocations built up by decades of political pandering will begin.

While no one can say with certainty how the disaster will play out, there is one truth you can take to the bank. Throughout all of human history, gold has always held its value as a monetary instrument. That sort of shockproof durability cannot be claimed by any paper currency, certainly not by the dollar, which has lost 95% of its value since abandoning the gold standard in 1971. With the dollar untethered from gold, the worth of the \$20 bill in your pocket is headed for its intrinsic value... as a recyclable.

In the weeks, months and years just ahead, gold, silver and other tangible assets are again going to become much more than financial obscurities tucked away on the commodities page. They're about to become front-page news.

When that happens, the prices of the metals - and of the high-quality gold and silver shares we follow on behalf of subscribers to our International Speculator -- are heading for the moon.

Hopefully, enough of the 78 million baby boomers will catch on to the underlying realities of their situation early enough to take advantage. For many, it may be their last chance at enjoying dignified golden years - instead of laboring through their eighth decade under the Golden Arches.

Regards,

David Galland
for The Daily Reckoning

Editor's Note: David Galland is Managing Director of Casey Research, LLC., publishers of Doug Casey's International Speculator, a monthly newsletter focused on identifying high quality natural resource stocks with the potential for a double or better over the next 12 months. A 3-month risk-free trial to the letter is available for interested investors. Click here for all the details:

International Speculator
<http://www.caseyresearch.com/crpmkt/crpSolo.php?id=30&ppref=DRK031ED1206A>

MONETARY ANARCHY
by Dr. Kurt Richebächer

The encouragement of mere consumption is no benefit to commerce because the difficulty lies in supplying the means, not in stimulating the desire for consumption; and production alone furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption.

- Jean-Baptiste Say, A Treatise on Political Economy, 1803

From discussing politics back to discussing economics. Just as before, though, it remains a dialogue among the deaf. The great majority of economists has its eyes stubbornly focused on apparently positive features for the U.S. economy, like the sharp fall in the oil price, abundantly available liquidity, tame inflation, low and falling interest rates and strong profits.

A minority of economists, in contrast, keeps just as stubbornly stressing that the economy's famous gross imbalances and structural distortions and the associated debt explosion are inexorably undermining economic growth. In this view, the ongoing housing downturn will finally abort U.S. growth and drive the economy into recession, with major adverse spillover effects on consumer borrowing and spending.

Generally, however, optimism distinctly prevails about the U.S. economy. It is not the old buoyant optimism. Yet it is optimism in the sense that some true malaise, like a crash in the asset markets and a recession, let alone a deep and prolonged recession, are absolutely out of the question. Thanks to its superior dynamism and flexibility, the U.S. economy has time and again bounced back smartly from periodic downshifts, and so it will again.

Let us start with the hard facts. For six, seven and more months, U.S.

economic data are overwhelmingly surprising on the downside, and moreover, the surprises have been going from bad to worse. Real GDP has successively fallen from 5.6% in the first quarter of 2006 to 2.5% in the second and 1.6% in the third.

That's bad enough, but what rescued the latter quarter from total disaster was a rather quixotic statistical event. While auto firms slashed their output, it soared in the real GDP account, owing to sharp price cuts on gas guzzlers. In this way, falling vehicle output contributed fully 0.72 percentage points to third-quarter real GDP growth, after subtracting 0.31 percentage points. The price index for gross domestic purchases increased 2% in the third quarter, compared with an increase of 4% in the prior quarter.

It is an old wisdom that the scale of the boom excesses essentially determines the severity of the following process of economic and financial readjustment. It has been comfortingly argued that the U.S. housing boom of the last few years has been less fierce than prior booms, which all ended without steep price declines.

Certainly, there are different possibilities of measurement. For us, the most important, and also easiest, measure of excess is the associated credit expansion. The use of credit in the wake of this housing bubble has been simply bizarre, outpacing all past experiences by far. Over decades until 2000, outstanding total mortgages accumulated to \$4.8 trillion. In the second quarter of 2006, they amounted to \$9.3 trillion. Mortgage growth over the last five years was almost equivalent to its growth over the prior five decades.

The second highly important point to see is that this housing boom was the first one in the United States to impact the economy at a vastly broader scale than just the building activity. As private households, using the rising house prices as collateral for mortgage equity withdrawals, stampeded as never before into debt to finance additionally other kinds of spending, the whole economy developed into an outright bubble economy. New single-family homes and multifamily homes rose in 2005 from a trough of fewer than 1.5 million units in recession year 2001 to a postwar high of 2.2 million units. Over the same period, the constant quality price index for new homes rose 30%, and the purchase-only price index of existing homes published by the Office of Federal Housing Enterprise Oversight (OFHEO) rose by 50%.

Boosting the net worth and the borrowing facilities of private households, this drove consumer spending to persistent considerable excess over income growth. In correlation, personal saving plummeted into negative territory, unprecedented for an industrialized economy.

It was a boom that plainly went to extraordinary excess in various ways. As a rule, this suggests a very severe aftermath of painful corrections. The first effects of the housing bust have definitely been bigger and more abrupt than most experts had expected. Yet hopes are riding high for a benign adjustment. To quote Federal Reserve Vice Chairman Donald L. Kohn from a recent speech: "The economy will grow at a moderate pace for a while, somewhat below the rate of increase of its potential, and then growth will begin to strengthen."

Among his comforting arguments were first, the overbuilding in 2004 and 2005 was small enough to be worked off over coming quarters; second, this situation stands in sharp contrast to some past downturns in the housing

markets that followed actions by the Federal Reserve to tighten credit conditions; third, as the inventory overhang in residential building and automobiles are worked off, economic growth should pick up again.

Mr. Kohn does not even mention that through the cash-out refinancing boom, this housing bubble had unprecedented spillover effects on the economy as a whole. In 2005, private households raised \$1,080 billion through mortgages. Of this amount, they only spent \$95.1 billion on higher residential building. Spending on goods and services rose altogether by \$539.9 billion, against an increase in disposable income by \$354.5 billion. In other words, about one-third of the increase in consumer spending depended on mortgage borrowing.

Actually, it strikes us how promptly the change in the housing market has impacted mortgage borrowing. It peaked in the third quarter of 2005 at \$1,225.9 billion at annual rate. Falling steadily, it was down to \$819.6 billion in the second quarter of 2006. This sharp decline was, however, to a small part offset by higher consumer credit.

Mr. Kohn stresses that monetary conditions remain quite supportive of borrowing and spending. Clearly, interest rates are so low that they exert zero restraint on borrowing. But more importantly, falling house prices no longer remain supportive for such borrowing. Remarkably, the sharp decline in new mortgage borrowing since the third quarter of last year has occurred even though house prices were still rising, albeit at sharply slowing rates. As the price climate is sure to deteriorate for some time to come, it seems a reasonable assumption that this initial sharp slowdown in mortgage borrowing has some way to go yet.

While this suggests further sharp falls in house prices, this may well take some time to materialize, because the housing market is notoriously sluggish in its reactions. In contrast to financial markets, its initial response to a change in the market situation is not in price, but on how long unsold homes stay on the market until the prices are lowered to realize desired sales. Sellers tend to resist downward price adjustments as long as they can. Instead, the market becomes illiquid. For sure, lenders will notice and adjust their lending conditions.

Mr. Kohn also takes comfort from the fact that the present housing downturn, in sharp contrast to past ones, is not caused by credit tightening. As he rightly stresses, "The Federal Reserve has returned short-term interest rates only to more normal levels and long-term rates are unusually low relative to those short-term rates." We think, though, that he is drawing a totally false conclusion. All downturns caused by tight money were followed by vigorous recoveries. A downturn happening despite low interest rates and loose money seems to us the most worrying kind.

Regards,

Dr. Kurt Richebächer
for The Daily Reckoning

Editor's Note: Dr. Richebacher has found the best investments to protect your portfolio, no matter what lies ahead for us in 2007. See his full report here:

Wealth Insurance
<http://www1.youreletters.com/t/456360/1469639/792691/1033/>

Dr. Kurt Richebacher is the editor of The Richebacher Letter. Former Fed Chairman Paul Volcker once said: "Sometimes I think that the job of central bankers is to prove Kurt Richebächer wrong." A regular contributor to The Wall Street Journal, Strategic Investment and several other respected financial publications, Dr. Richebächer's insightful analysis stems from the Austrian School of economics. France's Le Figaro magazine has done a feature story on him as "the man who predicted the Asian crisis."