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In Seeking Solutions to Every Problem, Governments Create Other Problems!

“By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens.... There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.”

J.M. Keynes

“Most success springs from an obstacle or failure. I became a cartoonist largely because I failed in my goal of becoming a successful executive.”

Scott Adams

“Nothing defines humans better than their willingness to do irrational things in the pursuit of phenomenally unlikely payoffs. This is the principle behind lotteries, dating, and religion.”

Scott Adams

INTRODUCTION

Some of my readers may have heard of Scott Adams. Mardy Grothe, whose books include *I Never Metaphor I Didn't Like*, *Viva la Repartee*, *Oxymoronica*, and *Never Let a Fool Kiss You or a Kiss Fool You* (you can subscribe to his refreshing weekly observations by sending an e-mail to drmardy-on@mail-list.com — highly recommended for anyone who is interested in life), wrote of Scott Adams, who was born in 1957:

After graduating from college in 1979, he worked for over a decade for two companies, Crocker National Bank and Pacific Bell Telephone (he got an MBA from Berkeley along the way). Fascinated by the misguided management methods of his bosses and the often bizarre nature of his co-workers, he began recording his observations and, after buying a book on how to become a cartoonist, drawing the cast of characters in cartoon

format. In 1989, while still working at Pac Bell, his “Dilbert” comic strip was picked up for syndication. By the end of the century, his satirical strip was appearing in more than 2,000 newspapers in over 80 countries, making him one of history’s most successful cartoonists.... In recent years, Adams has suffered from two debilitating neurological problems (focal dystonia and spasmodic dysphonia), but he has kept his sense of perspective and

sense of humor, recently writing in his blog: “Just because no one has ever gotten better from Spasmodic Dysphonia before doesn’t mean I can’t be the first.”

According to Grothe, “in the grand tradition of satire, Adams has turned his eye on the many fascinating absurdities of life (especially organizational life), and he has been able to use his gifts as a writer to express what he has learned”, including “there’s nothing more dangerous than a resourceful idiot” (politicians, economic policy makers, and voters, please note) and, as noted above, “nothing defines humans better than their willingness to do irrational things in the pursuit of phenomenally unlikely payoffs. This is the principle behind lotteries, dating, and religion” — and investments, I might add.

I have quoted Scott Adams for two reasons. He mentions that his success as a cartoonist sprang from his failure to become a successful executive. Judging from the quantity of e-mails I get from people who are looking for a job, and from the tone of e-mails I receive concerning incurred capital losses, I am sure that many of my readers feel they have also “failed”. But “failure” would seem to be a necessary condition for achieving success. As Charles Kettering once observed, “Failures, repeated failures, are finger posts on the road to achievement. One fails forward toward success.” And George Smith Patton noted, “Success is how you bounce when you hit bottom.”

The only problem I have with the notion of failure leading to success is that, from time to time, the failure may be so complete that it is almost impossible to bounce high enough to overcome the challenge. This is one reason why some societies and civilisations either never developed properly, or, after having reached a high level of prosperity and power, they eventually entered a secular decline and never bounced back in any meaningful way. Also, while as an investor it may be reassuring to say that “success is how you bounce when you hit bottom”, how can you

be sure that you have “hit bottom”? In the case of Japan, whose stock market peaked at 39,000 in 1989, it has taken 20 years for the market to hit what may or may not be its bottom! During those 20 years, investors were repeatedly confident that a final low had been reached, and important technical indicators such as the “Golden Cross” gave several buy signals during that period (see Figure 1). Furthermore, in both the corporate world and the stock markets, “success” means new price highs. But how many stocks and markets top out and never again visit their previous highs? Another issue I have with the notion of failure leading to success is, as Bertrand Russell observed, “stating the problem in a way that will allow a solution”. If the cause of the failure isn’t properly recognised and analysed, then success is unlikely to follow.

This is where I have the greatest problem with US economic policy makers. I don’t think they have ever recognised that the excessive, credit-driven expansion of the US economy was unsustainable in the long run and that, sooner or later, the current crisis was inevitable. But not only that!

Now that we all know that the monetary policies implemented after the Nasdaq bubble burst in 2000 led to the current crisis, US economic policy makers are attempting to restore economic growth through essentially the same policies; the difference, this time, being that gigantic fiscal deficits are also being created. And while it is likely that these policies will stabilise the economy at a lower level of output, they are unlikely to lead to sustainable, healthy growth. In fact, I would argue that the large fiscal deficits and easy monetary policies will make sustainable, healthy economic growth next to impossible. Probably the best medicine for revitalising the economy in the long term would be to slash government expenditures and cut taxes at the same time, which would allow the more dynamic private sector to expand at the expense of the largely unproductive government sector.

The point I am driving at is that failure can only lead to success if the failure doesn’t result in paralysis, but instead leads to a new way of thinking and to different actions than those that caused the failure. In this respect, “market wizard” Paul Tudor

Figure 1 Tokyo Nikkei Average (EOD) (\$NIKK), 1989–2009



Source: www.decisionpoint.com

Jones recently gave an excellent commencement address to the graduating class of the Buckley School, in Los Angeles, in which he talked about his failures in life. (They have been mostly minor, in my opinion.) He described his experience with a class of Bedford Stuyvesant sixth graders, which he adopted in 1986 with the promise that if they graduated from high school, he would pay for their college education. This first project didn't yield any meaningful educational results, and so in 2000 Paul Tudor Jones hired a great educator and the best teachers and started the Excellence Charter School in Bedford, which in 2008 ranked number one out of 543 public schools in New York City for reading and math proficiency for any third- and fourth-grade cohort. (Some 98% of the students were African-American boys.) In other words, Paul recognised the causes of the failure to achieve far better academic results in the case of the Bedford Stuyvesant sixth graders and implemented a

novel approach by hiring the best educators. Paul's entire speech is available at: www.scribd.com/doc/16588637/Paul-Tudor-Jones-Failure-Speech-June-2009 and is well worth a read.

In most societies, success is measured in terms of power, money, and fame, which are not true attributes of success. As George Washington Carver observed, "How far you go in life depends on your being tender with the young, compassionate with the aged, sympathetic with the striving, and tolerant of the weak and strong. Because someday in life you will have been all of these."

The second reason I quoted Scott Adams is because I agree with his view that "nothing defines humans better than their willingness to do irrational things in the pursuit of phenomenally unlikely payoffs". It is not only the majority of corporate leaders and government officials who are guilty of such irrational behaviour; investors also tend to buy the wrong assets at the wrong time,

either out of ignorance or because they don't consider the risks involved. Our regular readers will know how sceptical I am of the US government's economic policy, the prime objective of which is to boost consumption either by the private sector or — as is now increasingly the case — by the public sector, at the expense of policies that would encourage savings and capital formation (capital spending on plant and equipment, investments in education, and research and development). An astute reader of this letter, Bruce Himmelberg (bruce@cyberus.ca), a practising philosopher and independent investor who lives in Ottawa where, as he writes, "the cool northern tranquility is conducive to clear thinking", sent me some observations on this subject. Since he echoes exactly my sentiments about true "economic growth", "prosperity", and government's largely unproductive involvement in the economy I have decided to reprint his short exposé.

More and More Money — Less and Less Wealth

A philosopher's enquiry into our perplexing economics!

Bruce Himmelberg, bruce@cyberus.ca

It is odd that in modern times consumption is the greatest component of GDP — Gross Domestic Product, where the "product" is presumably that which results from production. No doubt it is a convenient measure of the sum total of all goods and services produced, but the fact that consumption [which in plain English is the antonym of production!] has come to outweigh production by a ratio of more than 2:1 should raise questions. How this contradiction has become commonly accepted in the Orwellian parlance of our times is the ultimate irony and when oil spills, hurricanes, and wars are "good" for the economy it calls for fresh thinking.

Let us examine production and consumption using money, the medium of exchange, as an indication of value. When value is increased or created, that is production, and when value is reduced or destroyed, that is consumption — or at least one could be forgiven for so thinking.

Let us go further and examine that ability which creates the value of the product: productivity. And let us presume that there is also its opposite: the "ability" to reduce or destroy value of that which has already been created — for which we might coin the antonym "consumptivity".

And we may also consider "counter-productivity" which is the

force which opposes productivity, the ability to thwart the creation of value. Thus true productivity should be counted as productivity less counter-productivity.

To put productivity into perspective, a few centuries ago most of our population were farmers. Indeed even today many corners if not swathes of the world are 90% agricultural — yet in the most advanced economies scarcely 1% are farmers. Even accounting for those who make the GPS tractors and petrochemical fertilisers which make this possible, it is still a phenomenal growth in productivity. It also begs the question "where have all the farmers gone" as they must have now migrated to more "evolved" forms of

employment to put their bread on the table. And if this degree of productivity, repeatedly replicating Adam Smith's pin factory, is parlayed into the other sectors of our economy, then we truly have a tsunami of productivity. If this is the case, then our real problem should actually be what to do with it all!

It is this extraordinary productivity which has allowed us the luxury of becoming so statistically sloppy in our economics. Furthermore, our muddled policies have managed to so thoroughly squander our unprecedented cornucopia so as to make us believe that we are still living hand-to-mouth. To rediscover our "hidden" wealth we have simply to go back to basics in both the statistics with which we measure our wealth and also the policies with which we reinvest our wealth.

With regard to statistics, production and consumption should carry a "plus" or "minus" sign so that the "sum of all our economic activities" is not merely an agglomeration of anything that moves, but also takes into consideration that which we re-move through consumption, depreciation, or destruction. Furthermore, our statistics should more precisely reflect whether our efforts are useful, pleasantly useless, or actually counterproductive.

For example, if a doctor is required to hire more paper-pushers than nurses to argue with insurers who do not wish to pay and also to comply with metastatic regulations, this does not really make him a better doctor.

Yet the doctor's paper-pushers and the regulatory paper-pushers and the various insurers' paper-pushers are all merrily piled onto our supposedly growing GDP. Thus more money

certainly changes more hands, but there is little to show for it at the end of an ever more tiring day.

In contrast, let us consider the CERN Super-collider as an example of serendipitous productivity. There would be those who would argue that the billions spent pursuing such an abstraction is wasted. However that marvelous project gave the world the web as an early byproduct, and that too, gave it to the world for free! If we consider that the child of the internet, Google, is alone worth more than twice the cost of the CERN project, the debt has been amply repaid — and might even be said to be one of "our" best investments ever! And considering that such a return came from pure rather than applied research, we should be a little more far-sighted in funding the wealth of our future rather than throwing money at the mistakes of our past.

With respect to our policies, we could begin by rethinking our statistics so that we can tell the difference between creating and destroying wealth.

We should examine our regulations and laws to ensure that the lofty ideals to which they aspire are at least approached if not achieved — and that in the process they do not put us in the poorhouse. Perhaps most of all, we should understand the importance of reinvesting the fruits of our productivity in the very knowledge out of which productivity is invariably born.

Let us now try to reconnect the dots to paint a rather different picture. If we have come to think that we are poor it is not because we have a dearth of productivity — ironically man has never produced more or more efficiently. Our growing deficits are only because for

every productive step we take forward we take at least a regulatory and a legal step backwards. If the productivity of our farmers were applied to our regulators and our laws, then not only would there be more lawyers and lawmakers freed to go onto other useful pursuits, but surely we would get much better results from all our good intentions. Also, the resources freed by the growing burden of compliance could be plowed back into research where it could really do us some good!

Practically speaking [only in our wildest dreams, of course] if the US were to "retool" the 30% of the health care paper-pushers who are merely pushing against one another, not only could a good 5% of US GDP be reclaimed [that's over a trillion dollars a year!] the remaining health care workers would be much more effective and efficient — according to the health care workers themselves! Let us imagine repeating this principle throughout the economy and the deficits are quickly reversed. And if the honest efforts of those formerly working against one another are invested into research, education, and knowledge, we really start pulling ahead.

This has been a quick sketch beginning with a clean canvas to paint a much brighter picture of our future. It is hoped that the reader has followed the thread from the first simplification of our economic principles down to how to ameliorate our lives in some very practical ways. And it is definitely hoped that a clearer understanding will guide us to act in ways that will greatly benefit us all. No doubt there will be those who will protest that it cannot be that simple. To them let us put the question: "Does everything need to be so complicated?"

* * *

I think Bruce makes some excellent points, including about “rethinking our statistics so that we can tell the difference between creating and destroying wealth”. Since I have been travelling to different parts of the world regularly since the mid-1970s I can categorically assure my readers that in most emerging economies living standards have improved very substantially for the majority of the population. But I am not so sure that this is the case in the US (or in Western European countries) where, for most families (workers and the middle class), real incomes have hardly improved. Furthermore, if we look at the colossal US debt expansion as a percentage of GDP since 1980 (from 130% of GDP, to 370% currently) and at the US net balance of assets as a percentage of GDP (US assets outside the US relative to foreign assets in the US), a very disturbing trend is apparent (see Figure 2). Bruce also has a good point about the trade deficits: “for every productive step the US takes forward it takes at least a regulatory and a legal step backwards.” As a result of these backward steps, not only has production left the US, but also research and development is increasingly moving abroad. Finally, I fully agree with Bruce that if the US were to retool not only the 30% of the healthcare paper-pushers who are merely pushing against one another, but also the entire government apparatus, the remaining government employees would be much more effective and efficient and unproductive people would be forced into more productive occupations.

As I said above, the best policy under the current circumstances would be to cut government spending and taxes, which would of course sound like an economic death wish to the Keynesian-leaning Obama administration and to mainstream US economists. But because I am of the view that the US has lost out in its competitive position relative to the rest of the world over the last 30 years or so, I think that a new approach to economic and monetary policy would be most advisable (but is unlikely to occur under the present policy

makers). And since I am at it, I think that it might be a good idea to close the Federal Reserve and the Treasury Department and hand over their functions to Goldman Sachs. Since they seem to work closely together, and since Goldman Sachs would be far more productive and competent, such a consolidation could only be an improvement on the untransparent system that we have now. At least Goldman Sachs is run by a pragmatic and clever businessman (unlike the current economic policy makers, who have no real-life business experience). Also, Goldman Sachs provides an excellent training ground, is regularly audited, pays taxes, and gives generously to presidential candidates and charities!

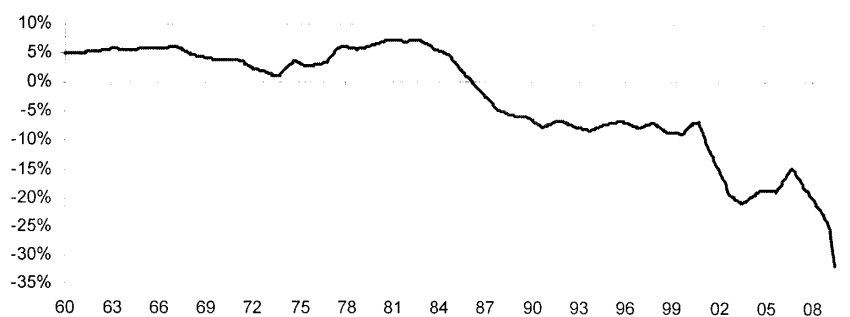
The debate about inflation/deflation continues, and asset markets are being buffeted by waves of inflation fears, which drive up commodity and stock prices and bond yields (such a wave has been in place since March), and waves of deflation angst, which drive down equity, commodity, and bond yields (such a wave was evident in 2008). What I find remarkable about the current environment is that, despite our finding ourselves in the worst economic downturn since the Second World War, a large number of prices are either not declining or are even continuing to rise.

The Williams Inference Business Intelligence Service (williamsinference.com), which recently commented that the tax system had evolved from a mess to a

nightmare, reported that “the number of pages in the CCH Standard Federal Tax Reporter, which records tax law regulations and related material, had soared to 70,320 from 26,300 in 1984.” As Bruce Himmelberg noted above: “Does everything need to be so complicated?” A flat tax would make much more sense, but that isn’t acceptable because half the IRS could be dismissed. Williams Inference adds that “our current tax problem is more than tax complexity. We are attacked by increased taxes from towns, states and federal government.... Our WIC probe, ‘Local Taxes’ was written in September 2005. In this probe, we stated that in North Kingston, Rhode Island, a retired dentist bought a two-bedroom home with a property tax of \$7,500. Four years later, in 2004, the same home had a property tax of \$17,000. Between December 2001 and December 2004 property tax collection surged by 25%, according to the U.S. Census Bureau statistics. Today, most past increases in personal property taxes remain, despite declining home values.”

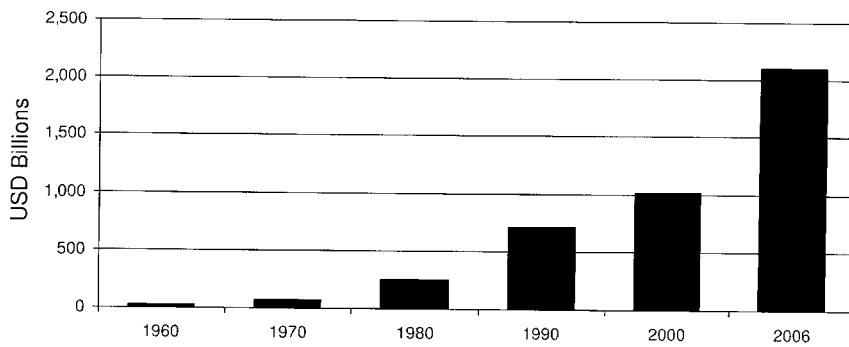
So, one sector of the economy (about 50% of GDP) where deflation is unlikely to occur is in payments to the government — this especially given the fiscal deficits and growing healthcare costs (see Figure 3). Healthcare costs are bound to go up because of the aging population. It costs 3.4 times more to care for a person aged 65+ than for an 18- to 44-year-old!

Figure 2 US Net Balance of Assets as a Percentage of GDP, 1960–2009



Source: Bridgewater Associates

Figure 3 **US National Health Expenditures, 1960–2006**



Source: Sectoral Asset Management, Montreal

I read recently in the “Price Radar” section of a local newspaper in Switzerland, which would hardly have higher inflation than the US, that the price of vacuum cleaner bags had increased by 25%; flowers had gone up in price by 9%, Galak Snacks by Nestlé by 12%, and Calgonit Tabs by Reckitt Benkiser by 10%. (Most of these price increases occurred because of smaller packaging.)

My friend Faizal Kalla (azarkalla@gmail.com), who owns a wholesale business in South Africa, advised me recently that a leading newspaper had reported the following price increases compared to April 2008: rice +83%, cabbage +53%, tomatoes +49%, coffee +45%, tinned fish +45%, margarine +34%, polony +34%, tinned tuna +32%, meatballs in gravy +25%. And in Malaysia, the Commercial Vehicle Licensing Board has proposed a 30–50% increase in taxi and bus fares!

So, whereas it is true that some prices are declining (Nokia knockoff mobile phones made in China sell for about US\$60), the prices of most necessities, including electricity, water, food, transportation, insurance, and healthcare, are rising — and this in the worst economic contraction since the 1929–1932 Depression. (JP Morgan has just decided to increase some balance transfer fees on credit cards to 5%. I don’t find this surprising, since banks and other financial institutions need to cover their losses with higher fees.) I’ll leave it to the imagination of my readers to judge how ideal a recipe for sustainable growth is the

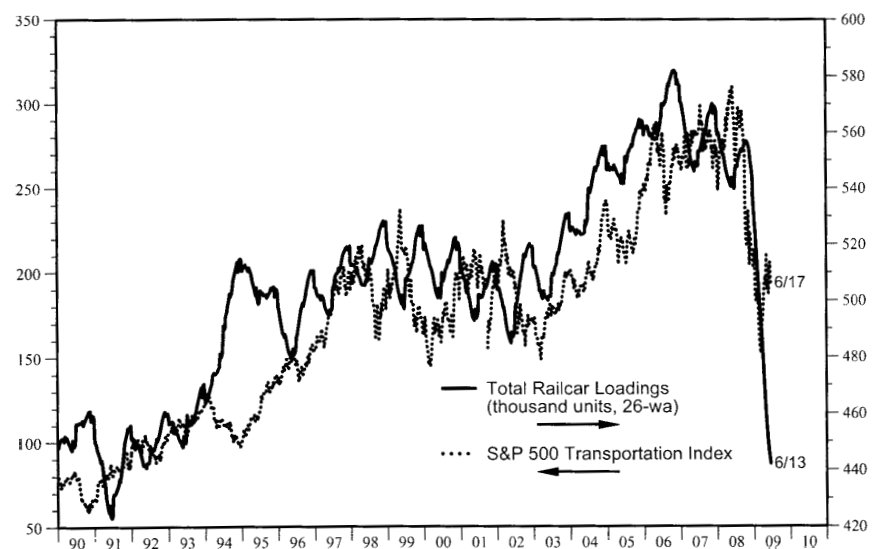
combination of rising prices of necessities and declining personal incomes....

INVESTMENT OBSERVATIONS

Occasionally, there are easy market calls. In 2000, it wasn’t difficult to see that the Nasdaq was a gigantic bubble. Nor was it difficult to identify the credit- and housing-related bubble of 2007. Similarly, at its March low, the US stock market was incredibly over-sold and a powerful rebound was at the time the most likely outcome. I have to admit that I don’t have any great convictions at present. I expect that the global economy will stabilise — and may

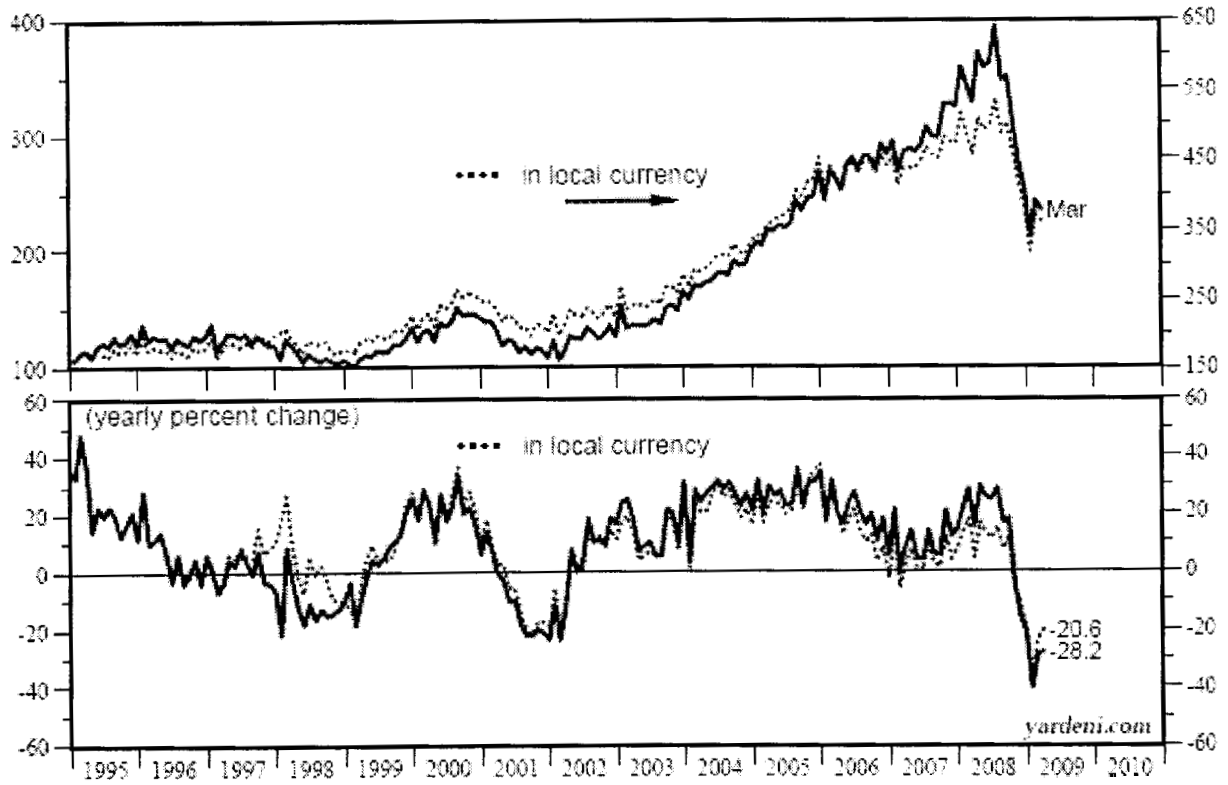
even recover — for a while, due to the ultra-expansionary monetary policies and fiscal stimuli packages being implemented everywhere in the world. Since US housing starts, car sales, and railcar loadings have completely imploded, a rebound within the next six months is very likely (see Figure 4). Similarly, it is probable that trade figures will improve somewhat. In the Asian economies, where exports have collapsed by between 30% and 45% year-on-year, some improvement should be expected (see Figure 5). Finally, a rebound in corporate profits is also the most likely outcome (see Figure 6). These are all relatively easy forecasts to make. More difficult is knowing what will follow a recovery in economic activity and to what extent the asset markets have already discounted a rebounding global economy. From its March low at 666 to its June high at 955, the S&P has already rebounded by 44%! Stock markets elsewhere in the world and selected commodity prices have rebounded even more. For instance, from its January low to its early June high, the Russian RTS Index soared 127%; and the Taiwan Index has risen by 80% since its late November 2008 low to a recent high (see Figures 7 and 8). (Note that the RTS

Figure 4 **S&P 500 Transportation Index vs. Railcar Loadings, 1990–2009**



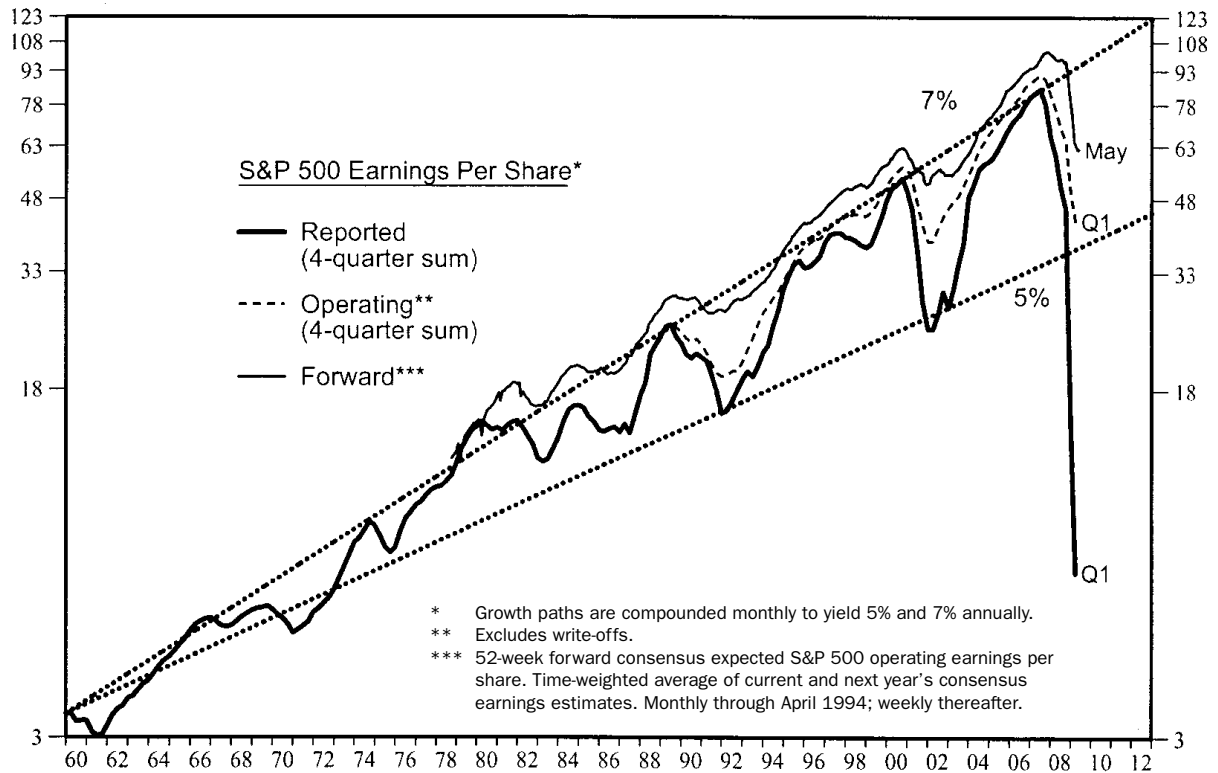
Source: Ed Yardeni, www.yardeni.com

Figure 5 **Singapore Merchandise Exports (billions of US dollars, saar), 1995–2009**



Source: Ed Yardeni, www.yardeni.com

Figure 6 **S&P 500 Earnings per Share (ratio scale, dollars), 1960–2009**



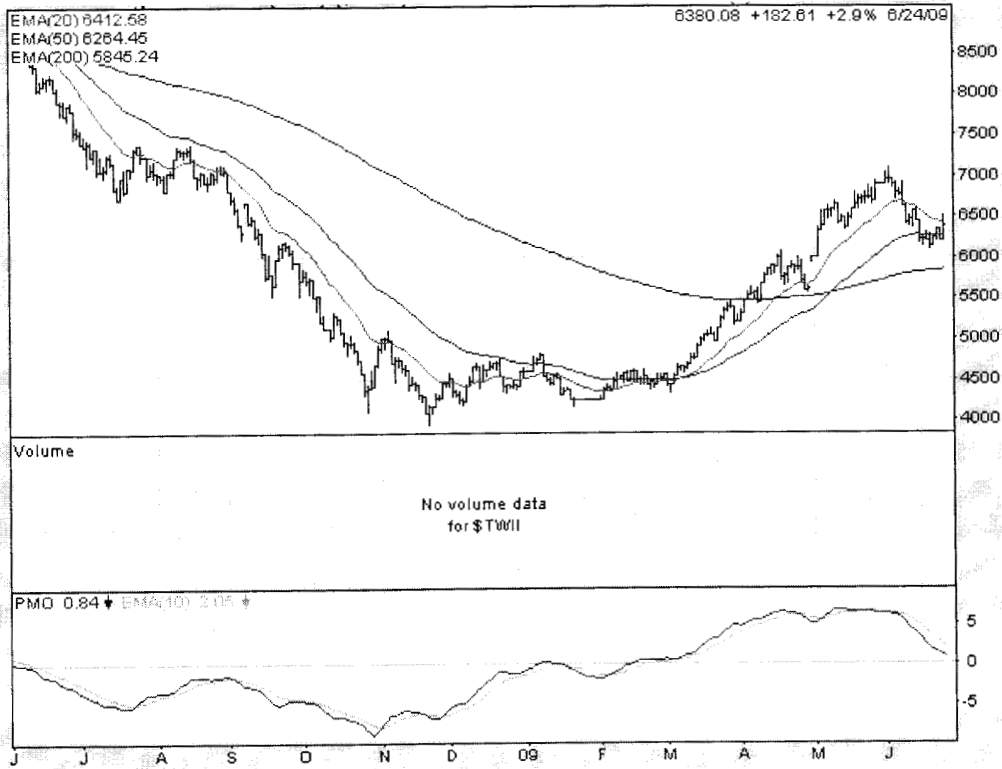
Source: Ed Yardeni, www.yardeni.com

Figure 7 **Russian Trading System (RTS) Index (EOD) (\$RTSI), 2008–2009**



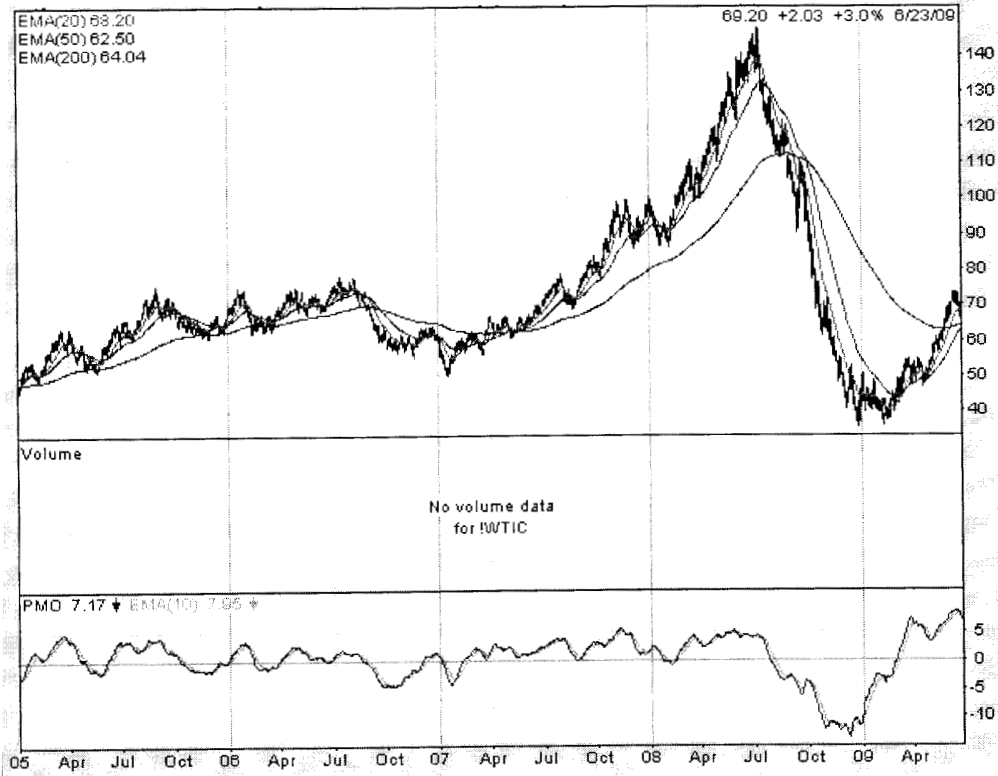
Source: www.decisionpoint.com

Figure 8 **Taiwan Weighted Index (EOD) (\$TWII), 2008–2009**



Source: www.decisionpoint.com

Figure 9 **Light Sweet Crude Oil (Continuous Contract) (WTIC), 2005–2009**



Source: www.decisionpoint.com

Figure 10 **Copper Futures – COMEX (EOD) (\$COPPER), 2005–2009**



Source: www.decisionpoint.com

and Taiwan indices have already corrected from their early June highs by 20% and 10%, respectively.) Commodities have had similar spectacular rebounds from their lows. Crude oil and copper prices have increased 126% and 96%, respectively, from their late December lows to recent highs (see Figures 9 and 10).

So, we can see that whereas equities and commodities have rebounded strongly, the global economy is yet to recover meaningfully. How meaningful and sustainable the recovery will be should then determine if equities and commodities continue to increase in price. I have explained in the past that fiscal deficits and easy money lead to high economic and financial volatility. Therefore, I am not ruling out the possibility that economic statistics such as car sales, home sales, and export volumes could actually surprise on the upside for a while. However, I am more sceptical about the sustainability of the coming economic recovery. Somehow, I very

much doubt that railcar loadings and Asian exports will recover to their 2006 or 2008 peaks any time soon (see Figures 4 and 5)!

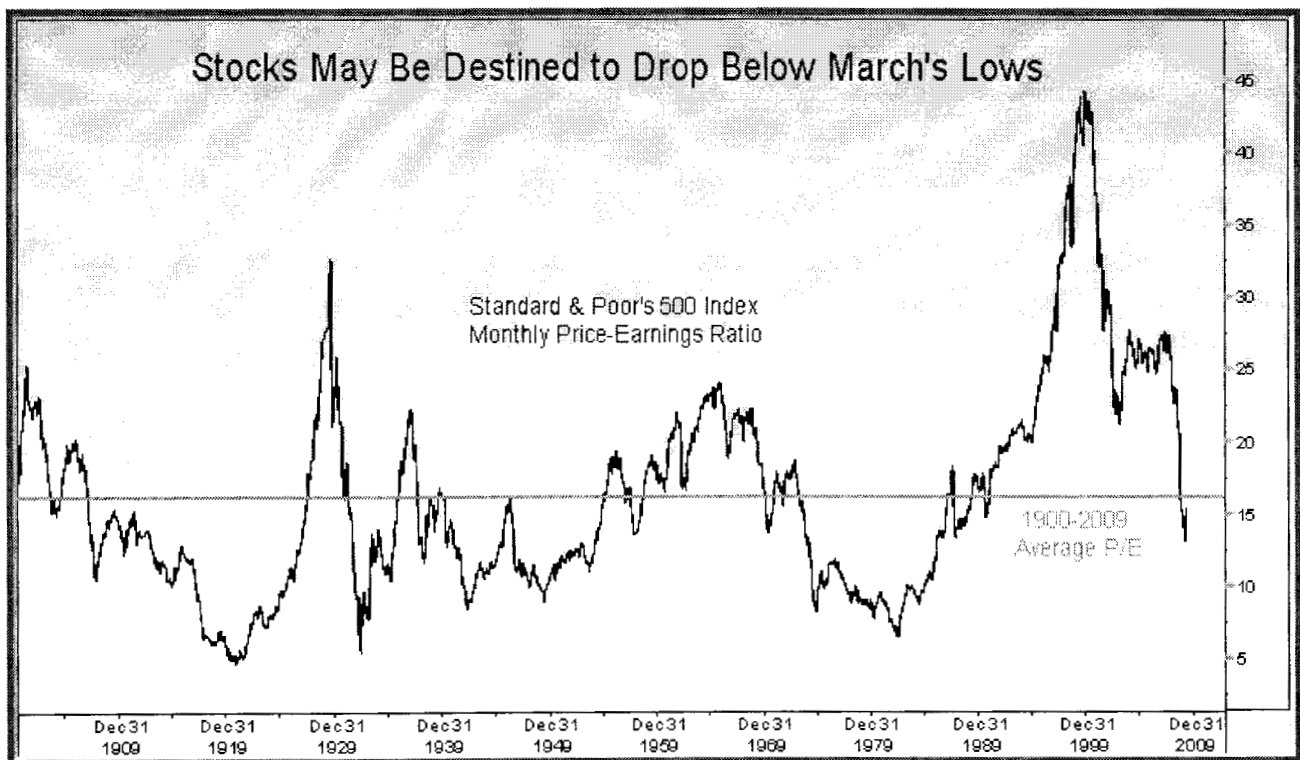
At the same time, a profit recovery is likely. But even if S&P earnings recover to between US\$50 and US\$60, the S&P 500 at around 900 isn't particularly inexpensive (see Figures 6 and 11). In fact, some credible analysts and strategists are predicting new lows for the S&P 500 and for US government bond yields, and a collapse in commodity prices based on their deflationary outlook.

I have great sympathy for this view, but I would like to add two observations. First, it may be a few years before new lows are reached. The Japanese Nikkei Index bottomed out for the first time at 15,000 in 1992. The Index then made a marginal new low in 1998 and a more meaningful low in 2003, before reaching its final low at less than 7,000 in October 2008 (see Figure 1). So, with all the various government stimulus packages, and with the Fed's expansionary monetary policies, the

stock market could trade in a range for some years before reaching a final low.

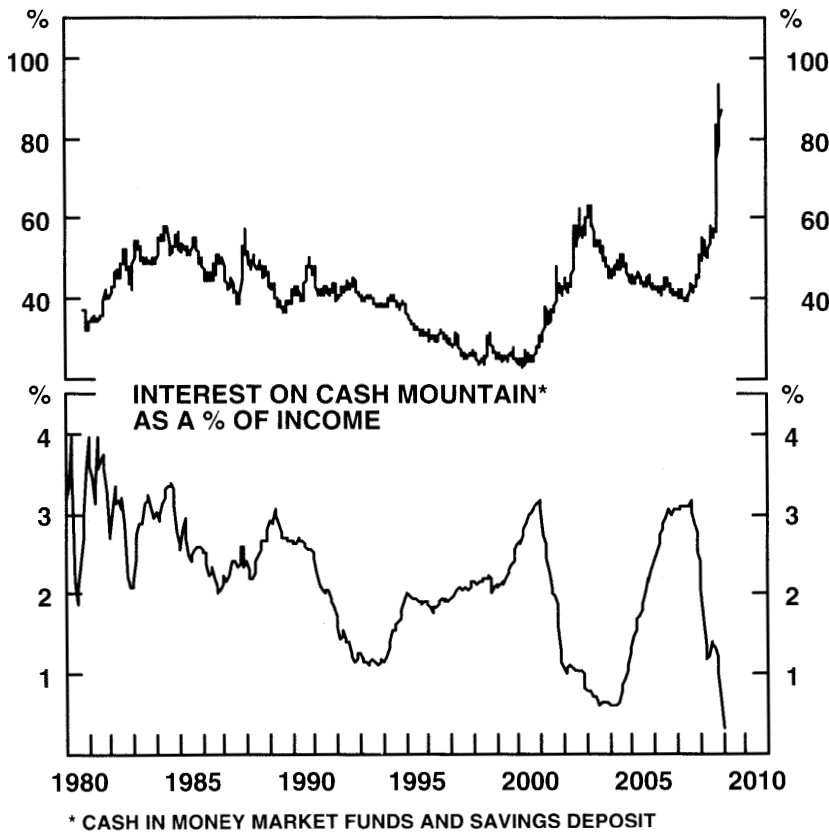
Another possibility that I am leaning towards is that if the S&P 500 once again approaches or declines below 800, the Fed will increase its money-printing activity and implement additional fiscal measures. Don't forget that the S&P 500 will only decline below 800 if economic conditions continue to deteriorate. This will then give the "greatest Fed chairman" and "greatest Treasury secretary" ever (in my humble opinion, two great natural disasters to hit the US at the same time) the opportunity to further intervene in the economy with fiscal and monetary measures that should support the asset markets. In fact, it is obvious that the thinking behind the Fed is to make holding cash as unattractive as possible (with zero interest rates, this has to some extent been successful) and to channel savings into equities, real estate, and consumption. And since cash positions are large, and since most investors missed the March to June

Figure 11 **Bearish Views, 1909–2009**



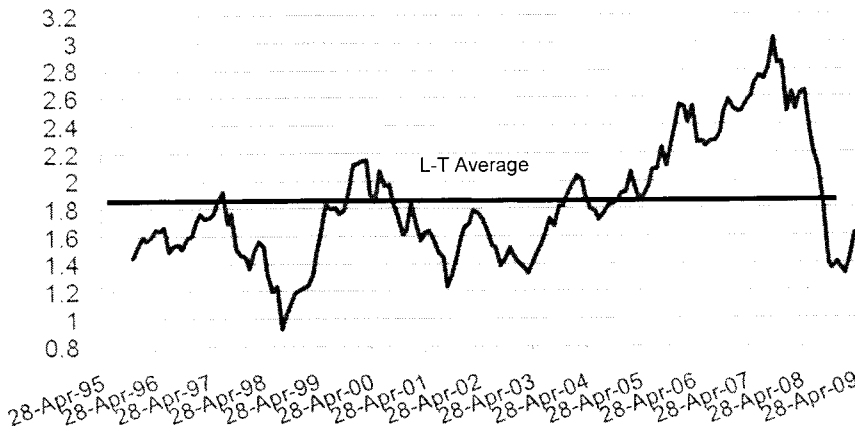
Source: Robert Shiller and Bloomberg

Figure 12 **Cash as a Percentage of Wilshire 5000, 1980–2009**



Source: *The Bank Credit Analyst*

Figure 13 **Emerging Economies' Price to Book Ratio, 1995–2009**



Source: *Silkstone Capital Management LLP*

In sum, I believe that the stock and most commodity markets became over-bought in early June. At the same time, insider sales have recently accelerated as well as the issuance of equities, which increases the supply at a time when the buyers' demand is still subdued. So, the likely course is a correction, but new lows are (in my opinion) unlikely for now. Whether the June high for the S&P 500 at 956 can be exceeded this year will depend on numerous factors, including the economy, geopolitical events, the swine flu, and how deep the correction that began in mid-June will prove to be.

Also, in a correction, I would be more inclined to increase the exposure to emerging economies' stock markets, which in an economic recovery should continue to outperform the US. Valuations still seem to be reasonable (see Figure 13).

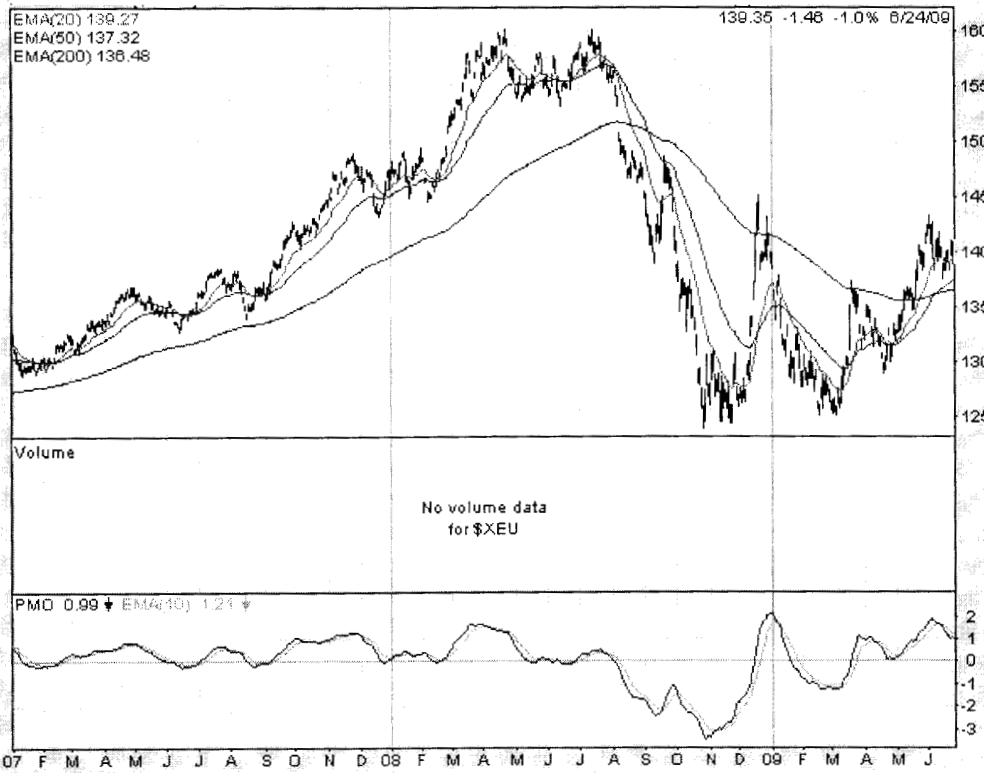
The US dollar hit a peak of 1.2457 against the Euro on March 3, 2009 amidst extremely negative sentiment for the Euro. (Please note that the S&P 500 bottomed out on March 6 at 666.) The Euro then recovered and reached a peak at 1.4338 on June 3 amidst extremely negative sentiment for the US dollar (see Figure 14). The S&P 500 then topped out on June 11 at 956. I am noting this because, as I have explained in earlier reports, a strong dollar means tightening liquidity, which is bad for asset markets, including commodities. And whereas I am negative about the US dollar in the long run, I think that for the near future the US dollar could rally against the Euro, the Swiss Franc, and commodity-related currencies such as the Canadian and Australian dollar (see Figure 15).

Our regular readers should know that I am very negative about US long-term government bonds from a longer-term perspective because I expect inflationary pressures to mount in the years ahead. However, after the 10-Year Treasury Note yield moved up from a low of 2.038% on December 18, 2008 (in my opinion, a milestone low in the long interest cycle) to a high of 4.014% on June 11, 2009 (please note that the

2009 rally, stock markets and commodities could — following a correction — exceed the early June highs even without (or with just a muted) economic recovery (see Figure 12). As can be seen from the figure, cash as a percentage of the Wilshire 5000 is at its highest level in

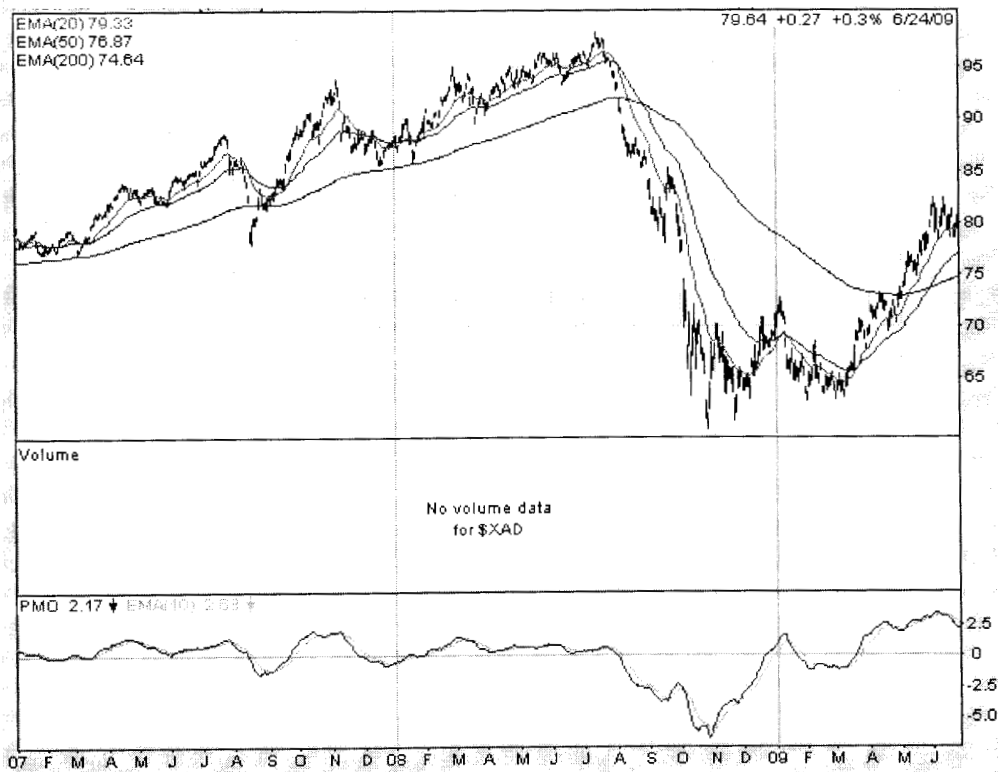
30 years (or likely even more). In the meantime, as just mentioned, the interest rates on cash are close to zero, which lowers incomes — see the bottom of Figure 12 — and is painful for conservative investors who kept their money in cash and refused to speculate.

Figure 14 Euro Index (\$XEU), 2007–2009



Source: www.decisionpoint.com

Figure 15 Australian Dollar (\$XAD), 2007–2009



Source: www.decisionpoint.com

Figure 16 **10 Year Treasury Note Yield (\$TNX), 2007–2009**



Source: www.decisionpoint.com

yield peaked out the same day as the S&P 500), a downward correction in yields (bond market rally) is likely (see Figure 16). As mentioned above, asset markets are buffeted by recurring waves of inflationary and deflationary expectations and I am afraid we might now run again into a bout of deflationary fears. But, unlike the deflationists, I don't expect new interest rate lows in this cycle.

The interesting part about all this is how the various asset classes relate to each other. Equities and commodities seem to move up at the same time (driven by rising inflationary and growth expectations), while bonds and the US dollar move down (the pattern since March 2009). But, when deflationary expectations increase,

the US dollar and bonds strengthen while commodities and stocks decline (the pattern of 2008).

So, assuming there is a recovery in bond prices (lower yields) and a rebound in the US dollar, then equities and commodities (and commodity-related currencies) should correct their recent steep advance.

Numerous readers have shown considerable interest in agricultural investments. It is difficult to find good investment vehicles for agricultural plays with the exception of fertiliser, farm equipment, and farm-owning companies such as Cresud (CRESY) and Boswell (BWEL). Like most other commodities' ETFs, agricultural ETFs have relatively high fees. Ned Schmidt publishes regular comments

on precious metals and agricultural commodities, and his reports can be obtained from http://home.att.net/~nwschmidt/Order_AgriValue.html.

Marc Schober is the editor for *Farmland Forecast* and an associate with Colvin & Co. LLC. Farmland Forecast (<http://farmlandforecast.colvin-co.com/>) is an educational blog on the investment opportunities in agriculture, and it has provided the comment below. Marc regularly publishes outlooks on farmland, agriculture news, and updates on agriculture-related companies. Colvin & Co. LLC (www.colvin-co.com) is an agriculture-focused investment manager, focusing primarily on investing in farmland. Colvin is currently in the process of raising money for its first investment fund.

Why Invest in Farmland?

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Everyone has to eat in order to survive. The production of almost all food can be traced back to farmland around the world in some way. Demand is growing for farmland as the world's population and global needs for food are growing. What many don't realize is that the supply of farmland is not changing, thus creating a severe imbalance in the supply and demand of farmland.

An investment in farmland over the long term will provide a steady stream of income and capital gains due to the increasing global demand for agricultural commodities, driven by the rising world population, rapid growth in emerging markets, and continued demand for ethanol and bio-fuels. Demand for agricultural commodities is outpacing supply, which positions farmland for long-term appreciation.

We believe that now is an excellent time to invest in farmland due to the compelling fundamentals of agriculture, the inflation hedge farmland provides, the bottoming of land prices, and the stable return profile.

World and emerging market population growth

According to the USDA, world population growth is expected to increase at 1.1% per year through 2018. The United Nations estimates that the world's population will increase from roughly 6.6 billion people to 9 billion people in the year 2050. As the global population increases, demand for food will increase proportionally. This will also cause the supply of agricultural land to diminish due to development, thus increasing the value of existing farmland.

Rapid population and economic growth, primarily in India and China, will increase food demand and U.S. exports. **China is one of the largest importers of grain as the country**

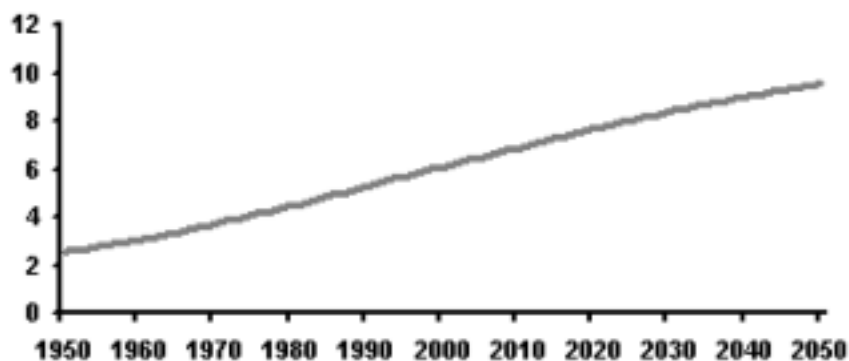
has roughly 20% of the world's population although only 7% of global arable land. China was a major exporter of grain but increasing incomes and the development of a middle class have changed consumers' diets, moving away from carbohydrates towards proteins. The continued transfer to protein will significantly increase the demand for grains as one pound of meat requires roughly 10 to 15 pounds of grain.

The increasing global demand for grains needed to feed the growing world population and its changing dietary habits will continue to increase U.S. agricultural exports. Looking forward, the USDA baseline projections show a continuing

upward trend with total U.S. agricultural exports reaching \$113.0 billion in 2017 from \$82.2 billion in 2007.

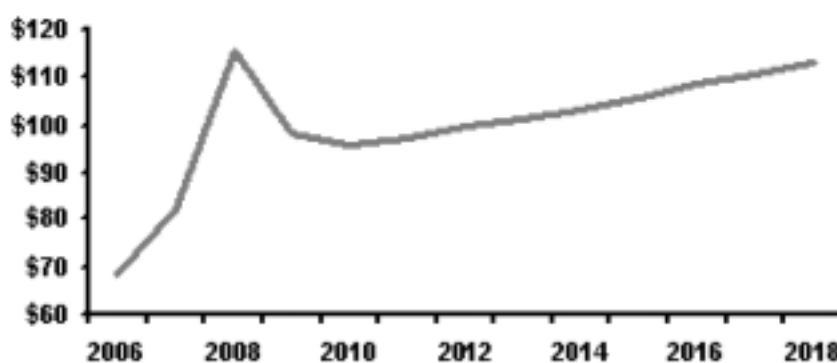
A recent advertising campaign from Monsanto highlighted the importance of sustainable farming and food production. The campaign highlighted the fact that **agricultural output will likely need to double by 2050 to meet the growing global demand.** Monsanto also noted that in seven of the last eight years, the global consumption of grain has outpaced total production. To meet future demand, Monsanto is predicting that we will need to produce more food in the next 50 years than what was produced during

Figure 1 World Population (billions), 1950–2050



Source: U.S. Census Bureau, International Data Base

Figure 2 Total U.S. Agricultural Exports (\$ billions), 2006–2018



Source: USDA Long-term Projections, February 2009

the previous 10,000, putting more and more pressure on future farmers and the land they use to produce food.

The fight for “food security”

In order for developing countries to meet their growing demand for grains, many countries have begun to reconsider their future “food security” by acquiring foreign farmland. Countries such as **China, South Korea, and the United Arab Emirates, have purchased farmland to support their growing need for grains** in areas such as Africa, Australia, and Eastern Europe. The nations are sending expatriate farmers to foreign countries to farm the land and export the grain directly back to their respective homelands, thus ensuring a consistent supply of grains.

Increasing use of ethanol and bio-fuels

Concerns regarding climate change and fossil-fuel dependency have led to a significant focus on renewable fuels, such as ethanol, as a replacement for high polluting carbon-based fuel sources. Ethanol is primarily manufactured from crops such as corn, wheat, and sugar cane. According to the USDA, ethanol production in the U.S. has increased from less than 3 billion gallons in 2003 to over 6 billion gallons in 2007 and is estimated to exceed 12 billion gallons in 2020. The Renewable Fuel Standard from the 2007 Energy Act calls for total renewable fuel to reach 36 billion gallons by 2022. The USDA estimates that more than **33% of the U.S. corn production will be used to produce ethanol by 2010.**

President Barack Obama is expected to continue to be supportive of alternative energy sources. In April, the Environmental Protection Agency proposed raising ethanol limits in gasoline. The agency said it is seeking to raise the limits of ethanol blends in gasoline from 10% to 15%. The increase has largely been driven by a petition initiated by the

trade group Growth Energy, which cited a Department of Energy study that found raising blends to 20% would result in no significant drivability issues.

Declining ending stocks to usage ratio

Increasing U.S. exports and ethanol use have caused consumption to increase faster than production. Ending corn stocks to usage ratio (current inventories as a percentage of annual consumption) has declined over the last four years from roughly 20% in 2004 to 9% in 2008.

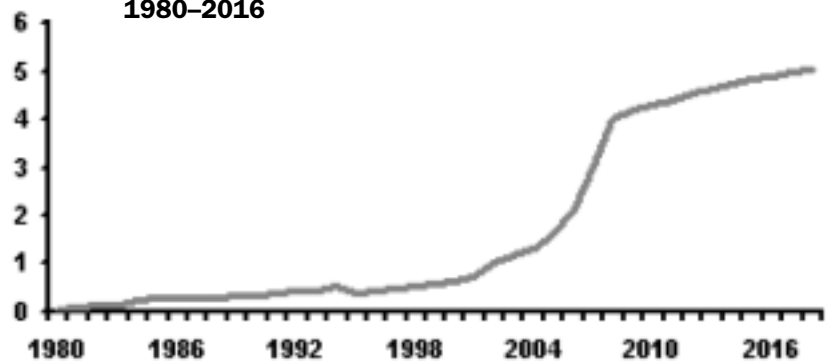
In the USDA's May update of the World Agricultural Supply and Demand Estimates (WASDE) report, ending stocks for 2009/10 are projected to be down 28% to 1.1 billion bushels, as corn use is expected to exceed production by 470 million bushels. A difficult

harvest season, or any unexpected demand for grains, could put a significant strain on global grain supplies, which are currently at record lows. **U.S. corn stocks have declined to a 33-day supply, meaning that if corn production was halted, the U.S. would run out of corn in a little over a month.**

Strong farm income

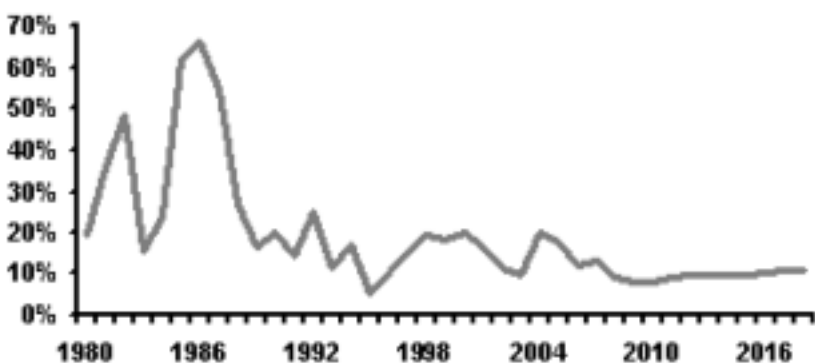
The increasing population, growth in emerging markets, changing dietary habits, and increases in ethanol production will result in higher commodity prices and an increase in farm income over the long term. The USDA expects farm income to remain strong through 2018 due to sustained bio-fuel demand and rising global food demand, partially offset by lower government payments and rising farm production expenses.

Figure 3 **U.S. Corn: Use for Ethanol Production (billion bushels), 1980–2016**



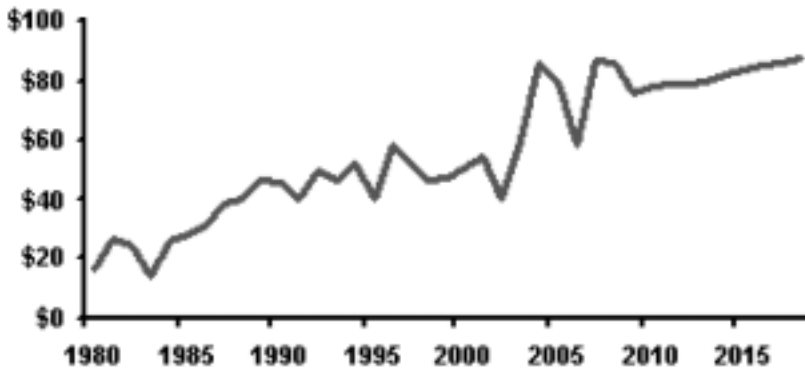
Source: ERS/USDA Long-term Projections, February 2009

Figure 4 **U.S. Corn Stocks/Usage Ratio, 1980–2016**



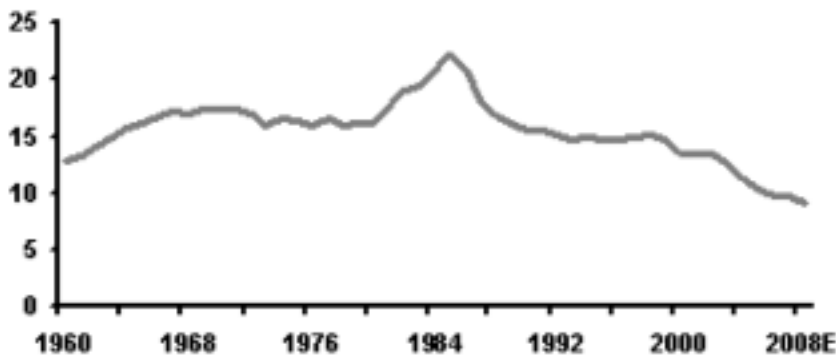
Source: ERS/USDA Long-term Projections, February 2009

Figure 5 **U.S. Net Farm Income (\$ billions), 1980–2015**



Source: USDA Long-term Projections, February 2009

Figure 6 **Farm Sector Debt to Assets Ratio, 1960–2008**



Source: Economic Research Service/USDA

Opportunity for wind development

A bonus to owning farmland is that it provides additional opportunities to generate income or capital gains through wind development, oil and gas leases, the sale or lease of water rights, and recreational use.

South Dakota farmland owners are in an excellent position to capitalize on wind energy. According to Dakota Wind Energy, South Dakota has the wind potential to meet 50% of the U.S. electricity demand. Presently, South Dakota ranks fourth in the nation in wind power. Factors that make developing wind energy difficult are that South Dakota does not have the transmission infrastructure to transport energy to populated areas (although projects are being considered) or the policies that are favorable to renewable energy.

Landowners may have the opportunity to lease farmland for wind development that does not interfere with farming operations. **The land owner is compensated through an annual payment per wind turbine that is estimated to be between \$2,000 and \$5,000** according to the South Dakota Energy Infrastructure Authority. One turbine can be placed on roughly 60 acres. Wind development could provide substantial income opportunities to farmland owners in the near future.

President Obama's stimulus package is providing incentives for wind energy by providing grants to renewable energy developers for 30% of the facility cost. Renewable energy developers must apply by September 20, 2011 to qualify for the 30% grants, which should drive a land grab by developers over the next two years.

Inflation hedge

The drastic increase in the last few months of the U.S. national debt and the 24/7 operation of the printing presses increasing the U.S. money supply will put significant long-term

Low farm sector debt levels

Strong agricultural fundamentals and minimal use of debt have allowed the U.S. farm sector to maintain conservative balance sheets. Current debt to assets ratios are at 40-year lows. According to Iowa State University, **72% of the land in Iowa has no money borrowed against it.** The minimal amount of leverage on farmers' balance sheets will limit the potential downside.

Aging population will provide a good buying opportunity

The aging farming population in the U.S. will create a window of opportunity to purchase farmland in large quantities. Typically, farmland is held for long periods of time and is

not available for sale until the owner passes away. The USDA estimates that over one-third of all farmland owners have less than 15 years of remaining life expectancy.

Government farm commodity programs provide a safety net

Farm commodity programs help stabilize and support farmers' incomes by shifting some of the risk to the federal government. Federal assistance exists for roughly two dozen farm commodities and the payments are comprised of direct payments, counter-cyclical payments, and marketing assistance loans. Farm commodity programs, combined with crop insurance, help stabilize farmers' incomes and thus reduce the risk of owning farmland.

pressures on inflation and the U.S. dollar.

Historically, **farmland pricing has maintained a high correlation to inflation, oftentimes outperforming during high inflationary periods.**

Agricultural land also affords investors the chance to diversify away from stocks and bonds, as farmland is not highly correlated with these more volatile asset classes.

The commodity bull market is also likely going to be reenergized given rising prices. As commodity prices continue to climb, supported not only by an inflationary environment, but broader global demand, the land supporting those commodities will further appreciate. A simple comparison of commodity prices in the inflation era of the 1970s demonstrates the high levels grain prices can reach in a high inflation environment.

Gold is the asset typically relied on during high inflation periods, which is evident by the fact that prices recently surpassed \$1,000 per troy ounce. Farmland is a lot like gold, acting like a hedge against inflation. But farmland offers something that gold does not; intermittent cash flows. Farmland not

only offers protection from inflation, it also pays you to own it.

Bottom in land prices

The recent dislocations in the capital markets have provided a once-in-a-lifetime opportunity to invest in farmland. The recent burst of the housing bubble has depressed most financial and real estate assets, including farmland.

We believe that **farmland prices have exhibited a bottom in prices in the first quarter of 2009.** Regional Federal Reserve surveys have displayed slight increases or flat prices in the first quarter following declines in 2008. The Chicago Fed said farmland prices increased 2%, the Minneapolis Fed said nonirrigated land increased 1% and irrigated increased 3%, and the Kansas City Fed noted that nonirrigated land increased 1.4% and irrigated land was unchanged.

The Rural Mainstreet Economy Index, a survey of community bank presidents in a 10-state area from Creighton University, displayed that farmland prices increased the last two of the last three months after hitting a bottom in March.

Historical performance

Farmland, through current income and capital appreciation, has provided consistent positive returns. In the last 100 years, farmland has displayed only three brief periods of negative returns (1930s, 1980s, and 2008).

Over the last six years, farmland as measured by the NCREIF Farmland Index has significantly outperformed stocks and bonds. Despite farmland's strong performance, **bull markets in commodities over the last century have lasted an average of 17 years.** The current supply-and-demand imbalance will continue to drive farmland values higher.

Farmland provides an opportunity to invest in an asset class that is not directly correlated to stocks and bonds and has significantly less volatility. Farmland also provides a margin of safety to investors, as stock prices can go to zero, but farmland will always have some value.

Read more about farmland and agriculture at: Farmland Forecast (<http://farmlandforecast.colvin-co.com/>)

THE GLOOM, BOOM & DOOM REPORT

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