



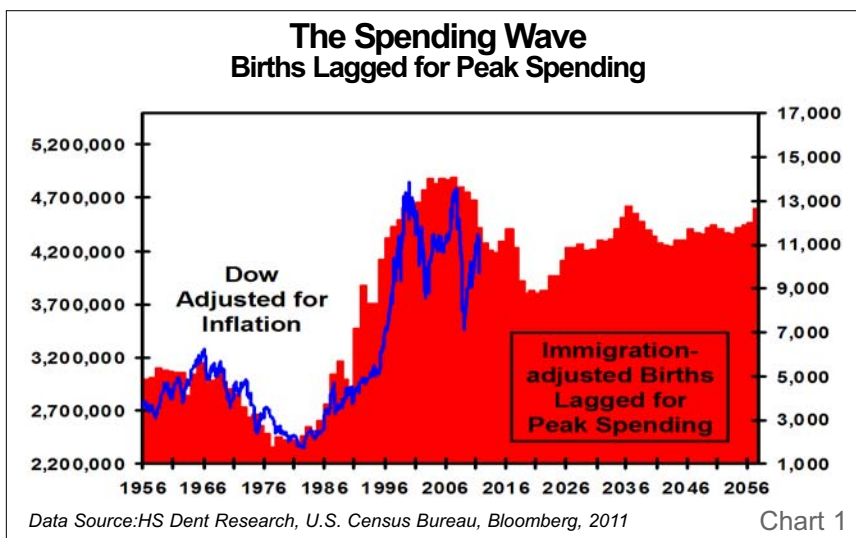
Deflation and a Deeper Downturn Are the Trends Ahead...Oh, That Means a Depression!

Why Massive Debt Deleveraging and Demographic Slowing Will Create a Rising US Dollar and Falling Stocks, Commodities, Gold, and Real Estate

By: Harry S. Dent, Jr., Author of *The Great Crash Ahead* (2011), *The Great Depression Ahead* (2008), *The Roaring 2000s* (1998), *The Great Boom Ahead* (1993), and Publisher of *The HS Dent Economic Forecast Newsletter*.

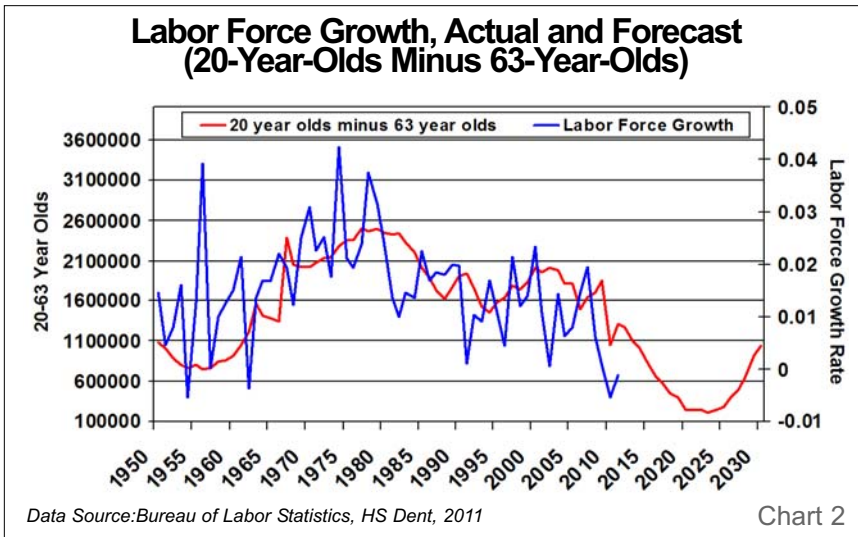
Economists did not see the great debt crisis of 2008-2009 coming. Warren Buffett says that the government has the right policies and we will come out of this sooner rather than later. He says he is investing in Bank of America. We see a deeper downturn ahead, with deflation of consumer prices, higher unemployment, bank failures, and a second, deeper crash in stocks, real estate, and commodities, especially gold and silver, which simply are the last great bubble after tech stocks, real estate, emerging market stocks, and oil and commodities. More importantly, economists say that longer-term economic trends cannot be predicted, as there are too many political and global variables over time.

We strongly contest the popular notion that long-term economic trends are not predictable. We say that longer-term economic trends are highly predictable using scientific and projectable trends in consumer (demographic) and technology (S-Curve) life cycles. It is the shorter-term cycles (which are becoming more volatile in this worldwide debt and real estate bubble) that are and always have been harder to predict. We predicted this deflationary downturn over 20 years ago. We predicted the long-term downturn in Japan in the late 1980s, when economists thought that the economy of Japan would surpass the US economy by 2010. We predicted the great boom of the 1990s and that the Dow would reach 10,000 between the late 1980s and early 1990s, when other economists saw a likely depression (as we finally face today). Way back in the early 1990s we also predicted the continued fall of inflation rates into the 1990s and 2000s and then *deflation* in prices into this decade of the 2010s.



Let us give you two examples, of many we have, of trends that such mainstream economists would consider “magic” for predicting the future. The first is the longest term and the most simple. In the average family, heads of household enter the workforce in their early 20s and raise families, peaking on average in spending at age 46. If we move the Birth Index (adjusted for immigration) 46 years ahead as in **Chart 1**, we get an uncanny correlation with the growth of our economy and the stock market (adjusted for inflation). Birth rates for the massive Baby Boom generation surged from 1937 to 1961, and the economy boomed on an

almost exactly 46-year lag from 1983 through 2007. That is how, back as early as 1988, we predicted a peak in stocks and the economy, with an extended downturn setting in from 2008 to 2023. Even we did not expect that the economy would correlate that closely with demographics 20 years ago, and other cycles and short-term events can affect such predictions.

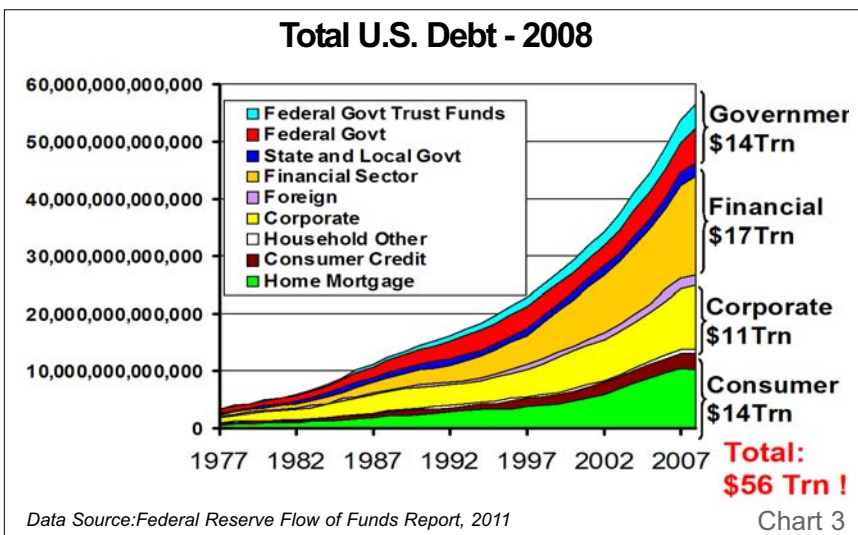


Inflation is another major factor on our economy, as are the values of stocks and bonds and commodities...and guess what? These trends are predictable as well. The biggest factor driving inflation is not monetary policy, but the natural dynamic between younger people and older people. Young people are inflationary, as they “produce nothing” and it “costs everything” for families to raise them, for the government to educate them, and for employers to incorporate them into the workforce at first. Workforce growth most correlates with inflation when younger people are entering the workforce more

aggressively, like into the 1970s at the top of the Baby Boom cycle. Look at **Chart 2**, which projects, two decades in advance, the number of people who enter the workforce at age 20 on average minus those who retire at age 63. This we can do with predictable demographic statistics two decades in advance! Like the stock market and the economy in Chart 1 that oscillates around that trend due to shorter-term political and economic trends, inflation rates follow this indicator amazingly well, despite cycles in oil prices and everything else! This indicator projects **deflation** in prices into around 2023 or so, as retirees increasingly dominate. Older people are deflationary as they wind down their assets and housing and spending.

With the predictable peak in the massive Baby Boom’s Spending Wave and the aging of our population, deflation is the trend, just like in Japan before us due to an earlier peak in the demographic trends there. Japan underwent a predictable downturn with stocks and real estate and crashed before us—a trend that economists totally ignored! We didn’t...we predicted that crash in the late 1980s! Twenty years ago, we also saw not only an extended downturn in the US economy from around 2008 to 2023, but a deflationary downturn or depression as well.

Now let’s look at the greatest cause of deflationary cycles throughout history: debt and asset bubbles. We have seen such deflation or depression cycles following every great bubble in history, as happened in 1835-1843, 1873-1877, and 1930-1942. When debt is allowed to grow much faster than the economy and low interest rates encourage speculation, as in 1820-1835, 1865-1872, 1920-1929, and, recently, 1994-2007, bubbles in



debt and assets surge. Then those bubbles burst and debt and asset deleveraging follow. There are no exceptions in modern history for hundreds of years back!

Chart 3 shows the acceleration of debt in the United States, especially since 2000, when the real estate speculation bubble followed the tech stock bubble of the 1990s, with even lower interest rates from the Fed, easier loans for consumers through Fannie Mae and Freddie Mac, and Wall Street financing of subprime loans and more. The debt in this country is not primarily the growing, \$14 trillion plus of

the US government, it is the \$42 trillion in private debt that more than doubled between 2000 and 2008! The biggest part of that debt was something that never occurred before: financial institutions borrowed to lend against mortgages and other assets. Normally banks lend against cash deposits—but not in this last, even greater bubble cycle! Banks lent and then passed the loans to Fannie Mae, Freddie Mac, and Wall Street, and that freed up their reserves (or restrictions) to lend even more and at lower rates, supported by the Fed. Why worry about the risk of default when real estate prices only go up? We will not go into the endless “teaser rates,” no-doc loans, incentives like no principle or interest for the first 5 years, and so on. But suffice it to say: this was the greatest and most irresponsible credit and lending cycle in history!

This was madness in the banking and financial sectors. Financial sector debt soared to \$17 trillion and consumer debt to \$14 trillion by 2008, both more than the entire federal, state, and local government debt combined at that point. This is the greatest debt and real estate bubble in all of modern history, and it will have to deflate—slowly or quickly—in the years ahead. And the destruction of such unprecedented debt destroys dollars created in the bubble boom, which means fewer dollars and which creates deflation in prices, not inflation. To repeat: there are simply fewer dollars to chase consumer goods as the economy slows, and that means *DEFLATION!*

There is another dimension that is even more sinister. Like all of the companies and municipalities that promised increasingly liberal retirement and healthcare benefits in the great boom from 1983 to 2007, with endless earnings ahead and high returns on investments projected for their pension funds, the US government and all other governments in the developed world promised even more liberal entitlements for all! Unfunded entitlements for Social Security and Medicare/Medicaid are best projected at around \$66 trillion—and about 80% of that is in health care. When we combine that with the total government and private debt, at \$56 trillion in Chart 3, we get as much as \$122 trillion in long-term US debt, or over 8 times our GDP. Such total debt was only 2 times our GDP in 1929, before the debt deleveraging cycle of the 1930s depression.

It is the natural and inevitable deleveraging of \$42 trillion in private debt, which dwarfs the US government debt, that will create deflation in prices ahead, as more dollars are destroyed in the private sector than are created through stimulus and deficits in the government sector. We actually debased the US dollar in the boom, and we will restore its value in the debt deleveraging depression in the coming years and decade ahead, as we did in the 1930s—but only when the Fed’s endless stimulus fails and this natural process is allowed to happen.

It is that \$66 trillion and rising in unfunded entitlement debt at the federal level that will continue to sink our economy and the up-and-coming, young Echo Boom generation in the decades ahead. That is the longer-term crisis that we have to address. The shorter-term, more imminent crisis is the deleveraging of the \$42 trillion in private debt, which mushroomed suddenly from \$20 trillion to \$42 trillion between 2000 and 2008, and the real estate prices, which more than doubled from 2000 to 2006! That is what, along with 92 million Baby Boomers moving from spending and borrowing to saving and retiring, will tank our economy and banking system, at the worst between 2012 and 2014, and broader into 2020-2023.

Let’s conclude this short special report with a look at the very thing that “debt crisis” authors, from Peter Schiff in *Crash Proof 2.0* to David and Robert Wiedemer and Cindy Spitzer in *Aftershock* to Mark Steyn in *After America*, have warned would collapse in this great crisis ahead: the US dollar! We should note here that we agree with them almost 100% on the extent of the debt crisis and if anything see a greater debt bubble. But **we disagree 100% on how to invest to protect yourself and to prosper.** The US Dollar Index in **Chart 4** (compared with our trading partners’ currencies) has fallen sharply since 1985, just after our great boom started. In fact, it has already fallen 58% since its peak in 1985.



The point here is that we debased the US dollar in the bubble boom from 1983 to 2007 by allowing debt (which creates dollars out of thin air in the banking system) to grow at 2.65 times the rate of economic growth for two and a half decades! Creating more dollars than economic growth makes dollars less valuable. When we destroy such debt and dollars in the downturn and debt deleveraging cycle ahead, dollars will become more scarce and, hence, more valuable again.

That is the major and very significant difference between what we recommend that investors do in the debt crisis and crash ahead vs. the tiny minority of very astute authors and economists who are not in denial about this great debt crisis ahead. We see deflation, not inflation, due to massive private debt deleveraging beyond inevitable rises in federal US debt. Even states and local municipalities will have to cut costs and pare down debt to survive, and those actions are deflationary as well. Deflation means that you need entirely different investment and business strategies, strategies that we do not have time to cover fully here.

For investors who think that gold and silver will save you in this debt crisis ahead, you need to understand that gold and silver go up during the *anticipation* phase of a debt crisis, because those in the markets think that government printing of money will lead to inflation. In the current debt crisis, as deleveraging actually set in, in late 2008 to early 2009, gold went down 32% and the US dollar went up 23%! And, as has not occurred since the deflationary crisis of the 1930s, almost all investments went down: US stocks, international stocks, real estate, commodities, oil, gold, etc.

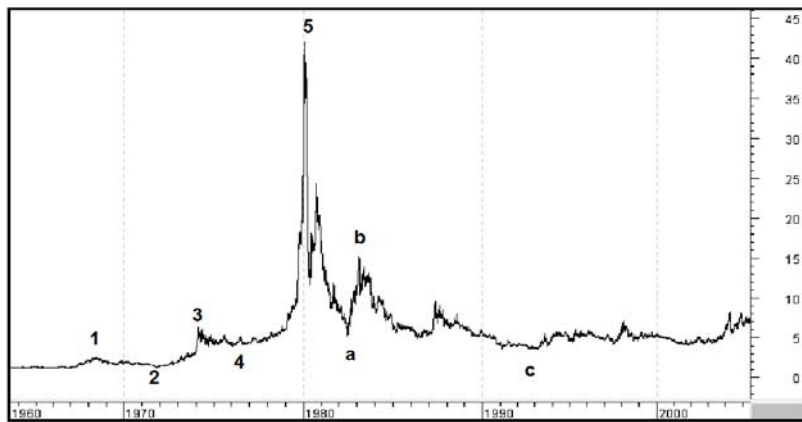
The US dollar was the best safe haven in the actual financial meltdown in 2008 and early 2009—not gold or silver or commodities or real estate!

In *The Great Depression Ahead* (2008), we not only predicted a downturn and a strong stimulus to follow that would create a rebound in the economy and stocks that would ultimately fail, we predicted that precious metals would be the final bubble before everything burst into a greater depression and debt deleveraging cycle. We also admit that we thought that the slowdown and stimulus failure would occur by late 2010, but it was deferred by \$2.3 trillion in direct injections of printed money, beyond our expectations at the time. Now we see a next, deeper economic slowdown and crash in markets across the board again, like in 2008 but deeper, which will occur between mid-2011 and late 2014 and most likely will be at its worst between early 2012 and mid-2013.

If you think that you are “getting safe” by buying gold or silver—as they are the only real currencies and values—think again! **Chart 5** shows the last time silver bubbled and followed a bubble cycle very similar to recent years. From the late 1970s into early 1980, silver went from \$5 to \$50 and then crashed within two years back to \$5, a 90% loss from the top. Silver bubbled up to \$50 recently and may reapproach that high. Gold is still heading toward as high as \$2,000 near term before crashing in the years ahead.

We say that gold and silver are inflation hedges, not deflation hedges. Silver could fall from the \$50 seen recently to as low as \$6 to \$10 in the years ahead. Gold could fall from \$1,900-\$2,000 to a wider range of \$250-\$750. Oil could fall from a high such as \$147 in 2008 to as low as \$10-\$40. We advise

Silver 1965 - 2002



Data Source: www.chartsrus.com

Chart 5

being in safe assets like very-short-term US Treasuries and T-bills, and, better, the US Dollar Index, to preserve your capital—and even more so if you are overseas, to benefit from the likely rise in the US dollar vs. your currency in the years ahead. We think that the greatest risks among all assets to fall in the next 2 to 3 years during “The Great Crash Ahead” could be in silver and gold!

To summarize: The crash of 2008-2009 and the one ahead between 2012 and 2014 are unique in that during the deflationary periods of deleveraging that follow great credit bubbles, virtually all

investments and assets crash. Hence, there is nowhere to hide. The number one goal is preserving your assets and waiting for the bubble to burst before reinvesting in “the sale of a lifetime” on financial assets.

We have much more to tell in other special reports like this one, in our free webinar “Understanding the Economy” at <http://www.hsdent.com/presents>, and in our new book, *The Great Crash Ahead*, which you can order through Amazon at <http://www.hsdent.com/book> or Barnes and Noble at <http://www.hsdent.com/bookbn>.

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