

# HS Dent Forecast

The Economic Guide for Effective Financial Decision Making

February 10, 2012

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and inflation, then it would have been harder for the Fed to justify a QE3. However, it is probable that the Fed will meet the likely slowdown in the economy from the second quarter forward with stimulus to keep a market crash to a minimum. The stealth QE from Europe will bolster European stocks and economies for now. Thus, stocks are likely to rise near term, correct into mid-2012, and then rally higher into late 2012 before undergoing an even larger crash in 2013-2014 or so. Our view is that such a QE3 will likely have less impact due to the Baby Boomers moving out of their plateau into their decline phase in spending from 2012 forward.

The bigger picture continues to be a massive stimulus plan around the world, especially in the United States and in China, that is meant to fight an inevitable debt deleveraging and demographic slowing in the developed countries. Such QE policies do not lead to much lending and sustainable expansion as consumers and businesses are already heavily in debt, which is why we have seen only minor inflation. But the trillions of dollars that have been injected into the economy have led to rising stocks and commodity prices. Such monies are reinvested at higher yields by the banks, and investors have nowhere else to go, given record negative real returns in safe short-term or long-term government (formerly risk-free) bonds. These desperate stimulus plans will end only when the bond markets question their effectiveness and long-term interest rates start to rise, as already has happened in Southern Europe.

Stocks in the United States and Europe continue to edge upward even though Greece continues to look as if it will default, whether voluntarily or not. Stocks look likely to finally correct a bit in mid February, but look ultimately to continue up into mid March. The question now is whether this final stock bubble will continue off and on into late 2012 or so before bursting; that looks likely now. In this issue we look at a new, more likely scenario 1 that is much less bearish for 2012. In the feature article we also look at the massive long-term benefits of the very deflationary crisis that ultimately will ensue. The truth is that this crisis is our best shot at restoring the American Dream, in contrast to the short-term Band-Aids™ that both political parties are offering.

### Summary Recommendations:

1. Look for a short term buy signal (SPY) just ahead between 1,285 and 1,300 on the S&P 500.
2. If another substantial correction occurs in May or during the summer that holds near 1,050 on the S&P 500, then we are likely to recommend a broader buy signal in stocks into late 2012 or so.
3. We may recommend buying Treasury bonds from March or so forward as a hedge, but only shorter term, as yields may rise on a QE3 scenario, much as happened after the US government released QE1.
4. Gold is likely to ultimately make a run towards \$2,000, where we will give a final sell signal.

**The Fed Gets a Big Gift from Europe Making QE3 Very Likely: Markets Should Rally Ahead with a Mini-Crash Still Likely in the Second Quarter or so, but the Debt Crisis and Crash Could Come in 2013-2014**



**In Brief:** Two important events have happened that have changed our view on how this growing bubble and debt crisis will play out. Despite higher growth in the economy and persistent inflation near 4%, as we expected, bond yields on 10-year Treasury bonds have continued to fall. Investors have fled many European government bonds into the two last, large safety havens, the United States and Germany. In addition, the European Central Bank (ECB) finally figured out a way to do their own “stealth” QE, by lending \$640 billion at 1% interest to banks in Europe. Those banks will reinvest largely in government bonds at higher yields, which will push yields down and stimulate the stock markets in Europe—just as QE2 did in the US.

**This flight to US Treasuries gives the Fed full permission for a QE3 sooner rather than later, and at a stronger level. If Treasury bond rates had risen as we expected, in tandem with rising growth**

## What You Need To Know In This Issue

### Overview

The Fed has received a gift in the form of the European Crisis. A flight of capital out of the euro zone into the US dollar in search of a safe haven, along with the Fed's own buying of US Treasury bonds, has kept yields much lower than we anticipated during the brief run of higher inflation and rising GDP that we forecast. Typically such trends would call for higher interest rates as markets fear expansion leading to much higher inflation. This gift means that when GDP and inflation slow down – likely in the 2nd quarter – the Fed will have the opening it needs to implement QE3. Get ready. It's on the way. This once again pushes out, but in no way mitigates, the great crash we see on the horizon. It is still there. We have not fixed our issues.

### Individual Investors

We were early on the risk-off call. We have not solved our long-term issues, but the markets have taken a potential deal in Greece and a positive jobs number as all-clear signs. While this has led to a great rally at the start of the year, it does not mean we are out of the woods. We expect a short correction, followed by a spike higher, before a much larger downturn that should occur by the beginning of the summer. Short term traders can use a pullback to buy stocks for a quick rebound, but don't expect the rebound to last long. Long-term, the name of the game is still debt reduction to restore our economic health. We are not even close.

### Financial Professionals

Holiday sales were middle of the road, China is slowing, Europe is in recession, the US has jobs gains, but not enough, and corporate earnings are fading. Time to rally! No matter what the indicators say (mixed), the markets were on fire. Be patient. It is difficult to sit in a defensive posture while the markets move higher, but the economic issues we face have not been fixed. The risk is still of a significant downturn, not a huge upswing.

### Real Estate

Home prices fell again, as expected. There is a bank-foreclosure deal in the works, but do not expect it to revitalize the space. The state of New York has 100,000 mortgage foreclosures pending and no real plan for getting through them. This will be a long haul.

### Business Owners

Consumers used more credit in November and January, and auto sales moved higher. The markets appear to be continuing their bifurcation – up markets doing well, down markets suffering. As mentioned previously, continue to move your offerings upstream. Expect the economy to hold up throughout Q1, but expect the downturn that follows to last, as QE3 will take several months to have an effect.

# The Economy

## Continued Improving Trend but with Continued Mixed Signals and a Likely Slowing in the Second Quarter

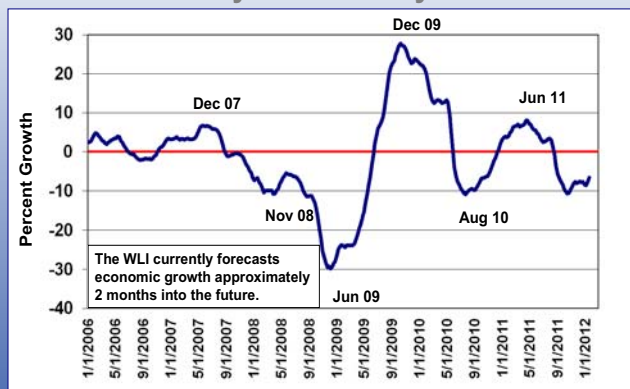
We continue to see mixed signals in our two main leading indicators and somewhat mixed signals in recent economic indicators like GDP and jobs. In general, the trend continues upward for now. We anticipated this rise, which has continued into the fourth quarter of 2011 and is likely to continue into at least the first quarter of 2012, given leading indicators. We expect the US economy to weaken, as a result of recession in Europe and other factors, starting sometime in the second quarter.

A big change has affected our forecasts and the likely scenarios ahead. The flight in risk-free capital has switched from much of Europe to Germany and to the United States. The Federal Reserve has gotten a gift at this time that has kept long-term Treasury bond rates even lower than the Fed's own QE policies would, especially given current 2% core inflation and 4% total inflation rates. Because the Fed now has more room and global permission to stimulate, we now think a QE3 will come sooner and will be larger than it would have been otherwise. Ben Bernanke also introduced a new tool from his trick bag: targeting the core inflation rate at 2%. Given that both the rate of money supply growth and inflation have flattened over the last several months, year-over-year changes in inflation should cause lower inflation rates from May forward. In the presence of lower inflation rates, the Fed is likely to give itself permission to buy more bonds or implement more QE before the US economy slows too much.

In addition, Europe finally figured a way to do QE without calling it that, in order to circumvent Germany's insistence on not inflating the economy. The ECB just lent \$640 billion to banks at a meager 1% interest rate—monies similar in relative size to QE2 in the United States. These banks will reinvest the funds largely in higher-yielding government bonds, which will push bond yields down. That move will have the same impact as when the Fed buys its own Treasury bonds, except that in the United States, the banks that sell their Treasury bonds to the Fed turn around and buy riskier assets, like stocks, commodities, and corporate bonds.

**Despite forced austerity in Europe, this new, \$640 billion European stimulus program gives more impetus to a stock rally there and, hence, here, as weakness or strength in European stock markets will spill over into the United States and vice-versa.**

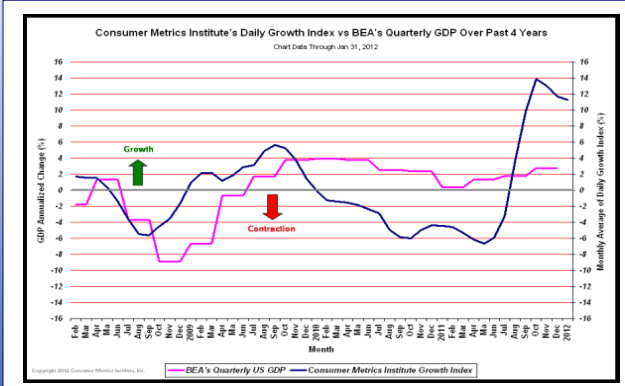
**Key Economic Indicator #1**  
ECRI Weekly Leading Index  
January 2006- January 2012



Data Source: Economic Cycle Research Institute, 2012 Chart 1

**A likely slowdown sometime in the second quarter of 2012 both could cause historically low 10-year US Treasury bond rates to fall to around 1.3% in the months ahead and could cause inflation to fall. If these things occur, the Fed will have further justification to move sooner and stronger on a QE3 policy, especially now that a large amount of funds is moving into US Treasury bonds. The stock meltdown we expect from the second quarter forward thus could be more limited, at say 20% or so (like past corrections), and stocks could rally strongly again into the presidential election. This situation, now our new, most likely scenario 1, includes a larger crash in 2013-2014 instead. Our now less likely scenario 2 includes a stronger crash this year, as we cover further in the Technical Analysis section.**

### Key Economic Indicator #2 Daily Growth Index February 2008-January 2012

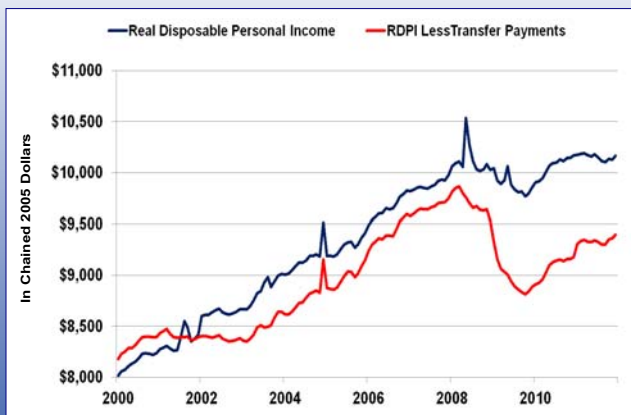


Data Source: Consumer Metrics, 2012

Chart 2

The Weekly Leading Index (WLI) in **Chart 1** has been pointing downward for months but has started to edge upward recently. Months ago, ECRI declared that a recession was coming, on the basis of this indicator and of their Long Leading Global Manufacturing Index. That declaration seems premature, as we expected. **Chart 2** shows the Daily Growth Index (DGI) from Consumer Metrics, which has been pointing upward, in direct opposition to the WLI. The DGI was the indicator that most warned that the fourth quarter and beyond would be stronger than expected. This indicator has proved right concerning the direction of the economy but has overstated the magnitude of the recovery, much as we expected from the inputs of the WLI. We have been combining these two indicators (which were much more accurate before the government implemented QE1 and QE2) to estimate economic growth. Now the DGI suggests that the surge has been slowing since late November and that the economy is likely to fall from around late March forward. However, the slowing of this indicator is not serious enough yet to predict a more substantial decline ahead. The WLI would need to fall again to confirm the predictions of a slowdown ahead, as the DGI is starting to hint at.

### Disposable Income, With and Without Government Transfers, 2000-2011

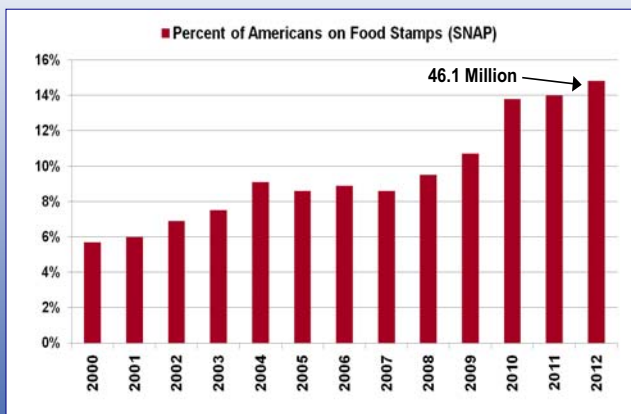


Data Source: Bloomberg, 2012

Chart 3

To put the recovery in a clearer perspective we show personal disposable income for consumers with and without government transfers in **Chart 3**. In both measures we have only retraced about half of the decline in disposable income. But when you take out government transfers, consumer disposable income would be about \$800 billion lower: this represents about 5% of GDP! This is another way of demonstrating that the recovery is not sustainable without continued and unprecedented high levels of government stimulus—not counting QE1 and QE2, which did not create direct transfers to consumers, but did push up stock prices, making those who have higher incomes (the top 1% control about 20% of spending and 40% of wealth) feel more affluent.

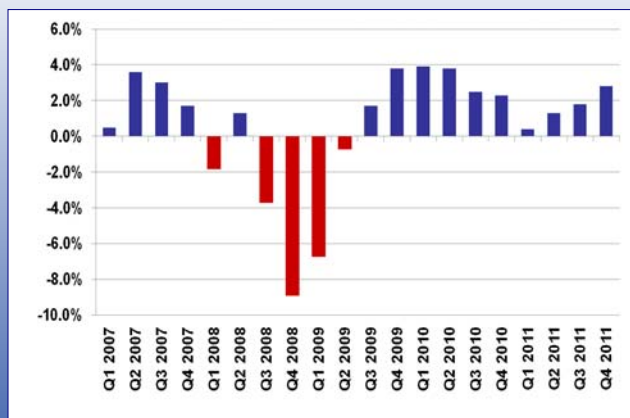
### Food Stamps 2000-2012



Data Source: Office of Management and Budget, 2012 Chart 4

What we do have is unprecedented levels of transfers such as food stamps, as shown in **Chart 4**. 67 million people now rely on some federal program according to the Heritage Foundation. In 2010 for the first time ever, average spending on dependants programs (up 23% in 2 years) exceeded US per capital disposable income!

GDP growth in **Chart 5** came in at 2.8%, near our estimates of 3.0% in the fourth quarter. However, most of the gains came from inventory building by businesses,

U.S. GDP Growth, Quarterly  
2007-2011

Data Source: Bureau of Economic Analysis, 2012

Chart 5

which accounted for just over 1.9% growth, not from consumer consumption, which only accounted for just over 0.8% growth. These variables go back and forth and we could see stronger consumer buying ahead and falling inventories. However, the GDP report made the economic recovery look weaker than we and others expected. The bigger picture from our view is that if you look at GDP growth vs. QE1 and QE2, it seems that such stimulus hits the most on a 3- to 4-quarter lag and then tails off in the year after that. The QE1 gains hit from September 2008 into March 2009, and the economy was at its strongest between the fourth quarter of 2009 and the first quarter of 2010. The effect of QE1 stimulus waned in the summer of 2010 and fell away even more in the first quarter of 2011. The QE2 stimulus was implemented from November 2010 into June 2011; that caused GDP to rise in the fourth

quarter of 2011. Increases in GDP are likely to continue into the first and possibly the second quarters of 2012. After that time, the effects of QE2 should wear off and the economy should slow again. We assume that each successive QE stimulus plan will be less effective and that the effects will wear off sooner, given that Baby Boomers will continue to age and to have higher savings and lower spending rates.

There are two big questions here: “When is a significant slowdown likely to set in given that other headwinds are probable ahead?” and “When do stocks pick up such a slowing in the economy?”. We expect more of an economic slowdown in the second quarter, but we don’t yet have definitive signs from our leading indicators that such a slowdown is imminent. A significant economic slowdown does not look likely until at least after March. At present, stocks are likely to keep edging upward, with a near-term minor correction from February into at least mid March or so, as the economy is not likely to show signs of weakness before then. The debt restructuring and bailout of Greece will hit a wall in late March; that is the most likely time for stocks to start to react and go sideways to downward again.

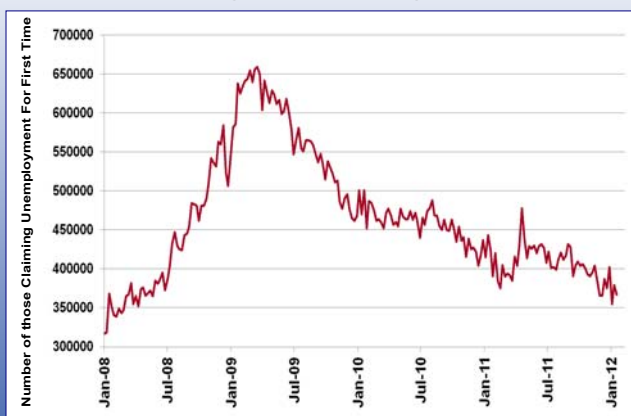
**Here are the 6 reasons that we expect could cause the economy to slow again between the second and third quarters:**

- 1. Europe clearly is moving into a widening and deepening recession that will hit the exports of other countries and have repercussions for the US financial system. Greece will hit its major deadline for refinancing debt in late March, which could cause a crisis.**
- 2. The possibility of a short-term conflict or war precipitated by Iran is rising, which could spike oil prices for months ahead.**
- 3. Home prices continue to edge downward, despite an improving economy and record-low mortgage rates. Banks may stop withholding foreclosures from the market, which could cause the downward spiral in home prices to accelerate.**
- 4. The Fed largely has paused in aggressive implementation of QE since June 2011, and the effects of QE2 should wear off in the 2nd quarter of 2012 or so.**
- 5. Baby Boomers naturally are likely to increase their savings and spend less as the last of their kids get out of college, on average by May 2012.**
- 6. The government offering of 100% deductions for capital expenditures expires at the end of**

**2011, so business capital spending is likely to slow in 2012 as some future expenditures were shifted into late 2011.**

However, if the US economy and inflation rates slow, we would expect the Fed to respond with a strong QE3 stimulus sooner rather than later, possibly by May. Stocks could turn around quickly, but the economy is likely to lag for months unless there is more direct fiscal stimulus—and you can't rule that out in an election year.

**Initial Jobless Claims  
January 2008- January 2012**



Data Source: U.S. Labor Department, St. Louis Federal Reserve, 2012

Chart 6

On Friday, February 3, the US Department of Labor released a surprisingly strong jobs report for January, showing an additional 243,000 new jobs. This good news was at odds with the lower consumer growth of the fourth-quarter GDP. Also surprising was the ADP household report that came out days earlier, which estimated growth of only 125,000 jobs in the private sector. The ADP National Employment report usually comes in higher, not lower, than the government report. The difference in these two reports shows how inaccurate government estimates can be and why there are often major revisions later. This is also why you have to look at these reports over time and not overstress one report. However, the fact that initial jobless claims continue to be well below 400,000 (**Chart 6**) confirms that the jobs picture is remaining more favorable. At least for now we expect to see close to 150,000 to 200,000 jobs created per month just ahead.

**Key Economic Indicator #3  
American Workforce, 2007- Jan. 2012**



Data Source: Bureau of Labor Statistics, 2012

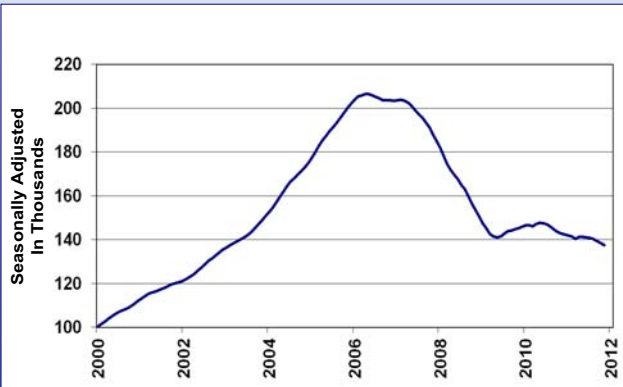
Chart 7

**Overall the economy continued to look better in the fourth quarter of 2011, and this trend is likely to last at least through the first quarter of 2012.**

In the past we have used unemployment rates at the U3 official level and at the U6 underemployment level as a key gauge of employment. However, from this month forward we are switching this third key economic indicator and will instead look at the actual size of the workforce (see **Chart 7**). This chart shows only very minor rebounds in the total workforce, following a major decline of 10.4 million (7%) since early 2008 and does not count the fact that many of the new jobs are at lower wage rates or salaries. We have added about 4.2 million jobs back into the workforce since late 2009 from the stimulus, but that is only 40% of the

jobs lost. The total workforce is still 6.2 million or 4% lower than at the peak. Also, many people now have either left the workforce voluntarily (such as second-income earners whose kids are now out of school) and even more people have given up looking for a job, given record rates of longer-term unemployment. Higher apparent job creation would be expected to reduce the unemployment rate, as it did from 8.6% to 8.3% in January. However, if job creation continues to improve, more of the underemployed and “given-up” types will re-enter the job market. Thus, paradoxically, the unemployment rate could go back up again, as the CBO (Congressional Budget Office) predicts for 2012, despite recent gains in job creation. Additionally, past unemployment rates have grossly underestimated the true unemployment situation!

#### Key Economic Indicator #4 Case-Shiller 20-City Home Price Index 2000-2011



Data Source: Standard & Poor's Case-Shiller US 20-City Home Price Index, 2012

Chart 8

**If the size of our total workforce continues to fall, flatten, or at best mildly bounce, then we are not making much progress on this front. The jobs situation is critical to maintaining home prices to any significant extent.**

The greatest insult and challenge to the Fed's massive stimulus program is the continued mild slide in home prices, shown in **Chart 8**. This slide persists despite the lowest mortgage rates in history and recent improvements in job creation, which clearly should be a plus for home sales and prices. However, as we have pointed out repeatedly, an endless backlog of foreclosures will continue to weigh down home prices for years to come. At the present rate of foreclosure sales, **Chart 9**, it would take 4 years to work off the present backlog of 4.2 million homes, one half of which are already in the foreclosure process and the other half of which are headed for foreclosure because the owners are seriously delinquent in their mortgage payments. We are looking for signs of rising foreclosure sales as banks realize that continued sinking home prices in such an improved economy and mortgage rate environment make holding back foreclosures a losing game. We have not seen those signs yet, as foreclosure sales are still flat to trending slightly upward.

#### Key Economic Indicator #5 Foreclosure Starts & Sales 1995-2011

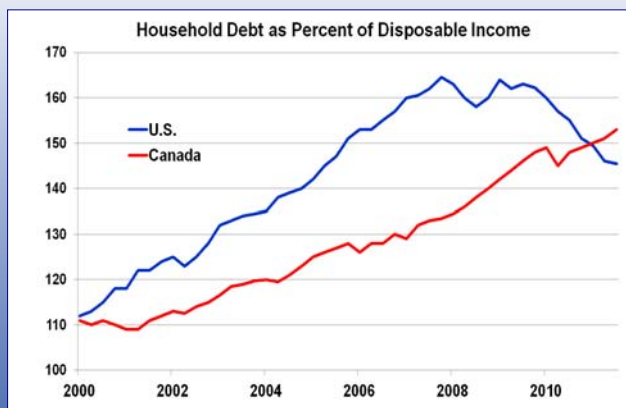


Data Source: Information provided by LPS Applied Analytics, 2011

Chart 9

The good news in Chart 9 is that new foreclosures have dropped sharply with the improvement in the economy. President Obama is pushing a new plan of forcing Fannie Mae and Freddie Mac to refinance mortgages (at 125% of home value) at today's ultra-low mortgage rates. That should stem a good deal of future delinquencies and may even keep some of the 2 million serious delinquencies from turning into foreclosures. However, the present backlog of foreclosures is so massive that such a plan will not in the near term help to stop the slide in home prices. And note that, as usual, the government does not require banks actually to write down loans to market value, as that would result in losses and insolvency in many cases. So, although this new plan is a step in the right direction, given that refinancing lowers monthly payments, the government and banks are still in denial about writing down underwater loans that are presently or eventually will be in default.

#### Canada and U.S. Consumer Debt vs. Disposable Income, 2000-2011



Data Source: Federal Reserve, Statistics Canada, 2012

Chart 10

Our subscribers in Canada should note that consumer debt as a percentage of disposable income (in **Chart 10**) has now risen a bit higher than in the United States. We make the same argument now in Canada as we did in Australia in September and October. Canada did not have

### Key Economic Indicator #6 Money Supply Measures - M3, 2003-2011



Data Source: St. Louis Fed, Shadow Stats SGS, 2012 Chart 11

the subprime crisis that the United States did in 2008 and had only minor setbacks in home prices. However, Canadian consumers have continued to extend their debt, and home prices have crept back up, often to slight new highs. Home prices in countries in this situation, like Australia, New Zealand, Canada, and the United Kingdom, will fall dramatically in the years ahead, as they will be falling from much higher levels than in the United States, even though the US is likely to undergo a deeper correction overall.

**Everyone and every country need to see this credit and real estate bubble as a worldwide phenomenon. See it like a popcorn popper, with the bubble peaking and bursting in different countries at different times.**

### 10-Year Treasury Bond Channel 1989-2015



Data Source: Yahoo Finance, 2012

Chart 12

The broadest measure of the money supply (M3, **Chart 11**) has been trending more sideways, near 4% growth over the last several months and has just started to edge upward. The sideways movement for much of 2011 suggests that year-over-year inflation will slow down. However, if M3 starts to trend upward again, that will be a warning of future inflationary pressures that could curb the capacity for Fed stimulus and further stimulus beyond any QE3 ahead.

**Implementation of a QE3 program, which is likely ahead, may cause the bond markets to react as they did to QE1, with yields on the 10-year Treasury bond rising from 2% to 4% very quickly (**Chart 12**) in reaction to worries about inflation. Such a move could seem more desperate than did QE2, given the present European slowdown.**

A move from possible lows near 1.3% to potential highs near 3.8% could mark the beginning of the end for further QE policies and could offset the benefits of a QE3. The question is, how soon do we test the bottom of the T-bond channel and then see rates rising again?

**Such a QE3 is very likely to create less of a rise in economic growth as Baby Boomers move out of their plateau phase into their decline phase in spending from 2012 forward. QE3 is likely to represent “3 strikes you’re out” for the Fed.**

A scary meltdown and rising government deficits negatively affected the bond markets in late 2008 and early 2009; hence, the sudden rise in rates. The markets were reacting to potential inflation, budget deficits, and the credit quality of US bonds. Hence, rates rose 2 percentage points despite the fact that the Fed aggressively bought bonds to push down yields. The QE2 reaction was the opposite. The economy was not in a banking crisis. The effects of QE1 simply were wearing off and the bond markets saw little inflation or crisis. Thus, the bond buying from QE2 worked more like it should have: Treasury bond rates moved down, not up. Market reaction will be a major issue if the Fed issues a QE3 after a slowdown ahead. If the bond markets start punishing the US as a result of a QE3, then the Fed may lose the option of further stimulus, as has happened with Southern European countries. We could see 10-year Treasury bond rates go from as low as 1.3% at the

bottom of the channel back toward the top of the channel, to as high as 3.8%, in a short period of time. That increase would make it harder for the Fed to keep stimulating. If we break above the top of this channel to 4% plus, then the bond markets will start considering the US to be more like Italy—which would be a death knell for further stimulus and would help to induce a major stock crash. In the scenario of a rapid response to a slowdown with a strong QE3, the economy could instead go into a deeper meltdown from sometime in 2013 forward instead of in mid-2012, as we will cover in the Technical Analysis section ahead.

## Feature

### **The Massive Long-Term Benefits of a Deflationary Crisis: Greater Efficiency, Competitiveness, Innovation, Lower Debt, and Lower Costs of Living . . . That Is How To Restore the American Dream!**

Our government is doing everything possible—TARP, massive loan guarantees, QE1, QE2, and very likely QE3 ahead—to stave off an inevitable debt crisis that will solve most of the problems that responsible citizens are concerned about: record levels of debt, ever-rising healthcare and education costs, rising oil prices, growing inequalities in incomes and wealth, runaway entitlement costs, and a loss of competitiveness for the United States around the world. Germany, on the other hand, insists on an austerity program in Europe that will lead them deeper into an already evolving recession, while secretly hedging with a stealth QE policy by the ECB. We think that austerity is the better policy, as it always comes in the Winter season of the economy, only once in a lifetime. Austerity is likely to create massive long-term benefits for many decades to come, like the great US and global expansion after the Great Depression and World War II. It is “the pause that refreshes.” You only get to a new, expansive Spring season by going through Winter!

We must stop denying that we have become addicted to debt and stimulus. Government budget and trade deficits have continued since 1970 and seem endless. Private debt has grown at 2.65 times economic growth since the boom that started in 1983 in the United States. Keynesian economics suggests that governments should run deficits in down periods (like the 1970s) to offset declines in the private economy, but only after running surpluses in good times. The problem is that we got addicted to debt and to stimulus. We started borrowing in the down times, but then kept borrowing at all levels in the boom that followed. We are like a drug addict, adding more debt to keep the “high” going. The policies of the US government will look unbelievably irresponsible decades from now. So, let’s get off of this debt addiction now. How? Through debt “detox,” or deleveraging!

**Our recommendation to investors, families, businesses, and most of all to politicians is simply to understand and to cooperate with this inevitable Winter season, rather than to fight it. A Winter season (such as 1930-1942) is the most challenging of the four economic seasons, but it also historically has been the most productive and opportune, especially for those who understand it. History proves this, as winter clears the decks for spring and for a new, expansive economic cycle, playing on the mass innovations of the Fall bubble season, like 1914-1929 and 1994-2008.**

None of the current presidential candidates have a clue about what actually caused this economic crisis and as to why there are no “magic” solutions near term. Democrats such as President Obama and leading economists like Paul Krugman recommend adding more debt and stimulus to counter the debt crisis. Even Obama’s latest plan to restructure more mortgages at lower interest rates does not restructure mortgages to fair market value. The plan simply protects the banks from writing down bad loans and does not allow the loans to fail. However, even a 10-year-old could understand that adding debt to a debt crisis cannot be the

right solution. We are only kicking the can down the road and making the debt crisis worse. Each stimulus plan seems to work somewhat for about a year and then the economy falls back to near-zero growth again. The effects of QE1 faded in mid 2010 to early 2011 and the effects of QE2 are due to fade by mid-year 2012. What does that tell you? Our economy is dead, due to massive debt and the aging of the Baby Boomers, the largest generation in history. The Boomers are now in a saving cycle and will retire in mass eventually. This group will not increase its spending willingly, regardless of the stimulus offered, and their needs in retirement will weigh down the US economy for decades if we don't restructure government entitlements as corporations have had to do.

**Why not restructure the massive \$42 trillion in private debt back down to pre-bubble levels of \$20 trillion? That debt more than doubled between 2000 and 2008 and dwarfs Federal debt, at \$15 trillion! Restructuring would eliminate \$22 trillion in debt, free up cash flow for consumers and businesses, and save something like \$1.5 trillion a year in interest and principal for years and decades to come. Why not do this rather than trying to stimulate consumers to spend and to borrow when they are already too much in debt and as demographic trends are naturally slowing ahead? This situation is true to different degrees for all aging, developed nations, which collectively still control 65% of world GDP and even more of the wealth.**

Republicans like presidential candidates Mitt Romney and Newt Gingrich, recommend cutting individual and corporate taxes to stimulate investment in new capacity and jobs. However, something like \$2 trillion in cash sits on the balance sheets of US businesses and the businesses still are not spending. US businesses are facing the lowest corporate borrowing rates in history and still are not borrowing very much. Businesses expanded too much during the great boom into 2007. They are too much in debt and don't see a sustainable recovery in consumer demand beyond the short-term stimulus plans—and where they see demand is overseas, not in the United States. Why would corporations invest just because they had lower tax rates on their profits? Consumers also are facing record debt levels, at 100% of GDP, twice that at the top of the 1929 bubble peak. These consumers are not buying houses, even given record low mortgage rates and the greatest stimulus plan in history. Why? The Baby Boom generation has peaked in its 25-year spending wave from 1983 to 2007 (a 46-year lag on births for the peak in spending at age 46 on average) and will be saving more, spending less, and paying down debt for years to come. These are predictable demographics that any household can understand! The next generation will not create higher spending and borrowing trends until the early 2020s forward.

Europe is facing greater austerity now that the bond markets have raised the interest rates for borrowing of the Southern European nations, which have endless deficits and face slow economic growth. Why? Even greater slowing in demographic trends and high public and private debt! The focus in Europe is more on high public debt, but private debt is higher and more extreme in countries like the U.K., Ireland, Portugal, and France. The European countries with high private debt will face a slowdown ahead, perhaps more than will Greece or Italy, which have less private vs. public debt. Also, Germany's export engine will die when Europe falls into a recession ahead. Then the very weak demographic trends of Germany will begin to take a further toll on the German economy. If this happens, then the export engine of China will sputter. China faces the greatest overexpansion worldwide, due to government capital spending at 50% plus of its economy, as well as the most extreme real estate bubble of all, which is set to burst.

European countries do not have the monetary printing press that the United States does, with the exception of the European Central Bank (ECB), which finally set forth a \$640-billion stealth QE policy, and more is likely to come. Germany has the greatest say in the actions of the ECB and has not allowed a bailout of Southern Europe without austerity measures. Germany would rather have short-term pain than long-term insolvency! We agree with that. So what are the best policies? We must restructure the largest private debt and real estate bubble in history, along the lines of the American innovation of Chapter 11 bankruptcy—and restructure the unprecedented level of government entitlements in line with expanding life expectancies to include later

retirement and means-tested and cost-effective benefits. The United States cannot afford for everyone to have 25-plus years of retirement pay and unlimited healthcare benefits—it is that simple! Such benefits are not plausible given aging societies worldwide and a slowing world economy.

**The United States alone has \$66 trillion in unfunded obligations for healthcare and retirement benefits, and that number is rising. All developed countries are aging and have exponentially rising entitlement obligations. When you add up our private, government, and unfunded entitlements, our debt totals over \$120 trillion, or 8 times GDP!**

When a company is in trouble, the creditors tend to attack and force a fire sale of the company's assets. They are like vultures descending on a corpse. Chapter 11 laws created a new environment, wherein the courts would protect a struggling company for a period of time to allow them (1) to sell off assets at a more reasonable price, (2) to cut costs, and (3) to renegotiate debt with creditors. The idea is that you can go to creditors and say, "If you will take a 50% cut in your debt we can pay that out of this restructuring, but if you force us into Chapter 7 liquidation of our assets, you are only likely to get, say 10%." If the creditors agree at some point, it is a win-win for everyone and the company re-emerges into growth again with lower debts and expenses! Most developed countries are heading toward bankruptcy, and this realistic and practical solution that addresses the root causes of unprecedented debt and aging demographics is the type of stimulus and restructuring that we need in the developed countries. We do not need more fiscal Band-Aids™ and short-term stimulus, which will fade again and again, leaving us with more debt and more "bubbly" markets that will crash again.

## The Twelve Benefits of a Deflationary Crisis

Our research has revealed an 80-year economic cycle with four seasons: Spring, Summer, Fall, and Winter. We will not elaborate fully on that here, but we are transitioning from the Fall "bubble boom season" to the Winter consolidation and "bubble burst season." The Spring and Fall are seasons of booms and low inflation and are the best periods economically. However, the Summer season (with high inflation, like the 1970s) and the Winter season (with deflation and depression, like the 1930s) make the greatest impacts, as they provoke accelerated innovation and efficiency to drive the next boom seasons to follow. The Winter season is about consolidating the massive innovations of the fall bubble boom (with new technologies moving mainstream with easy credit and capital access) down to the companies that got it right. These companies must become even more efficient to survive as their competitors go under. This hardening and consolidation will give the winners greater scale and market share and will allow them to bring products and services at a lower cost to consumers in the future. The asset bubbles, from stocks to real estate to commodities, will deflate and the cost of living will go down longer term. Real estate costs and mortgages will come down, as will health care and education costs. That is a good thing!

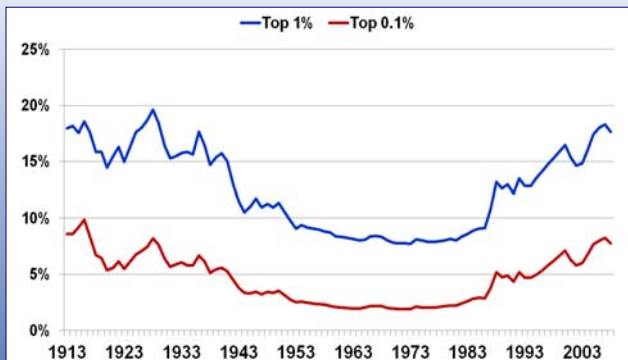
**Here are the long-term pay-offs, the 12 benefits that will come from a deflationary crisis:**

1. Housing prices, the greatest single cost of living, will come down, as will interest rates to finance homes. This cost reduction will lead to a higher standard of living for the next generation to come along, in this case, the Echo Baby Boomers, our kids! Escalating healthcare and education costs also rapidly will come down to reality.
2. Commercial real estate costs will fall even further, lowering costs for businesses, including those related to education and health care and governmental entities, which are real-estate intensive.
3. Massive amounts of private debt, in this case \$42 trillion in the United States, will be restructured to near pre-bubble levels, at \$20 trillion. Debt restructuring will lower principal and interest costs by as much as \$1.5 trillion per year for decades ahead. That is the ultimate stimulus plan.

4. The survival-of-the-fittest struggle in businesses will shift market share to the strongest businesses to give them greater scale and lower costs, which will be passed on to consumers for decades ahead—as happened with GM and GE from the 1930s forward.
5. Long-term entitlements will be restructured to reflect the reality of longer lifespan and workers will stay in the workforce at least 10 years longer. Thus, consumers will earn, save, and spend more over their lifetimes, bolstering aging economies in the developed world. The peak in spending will still occur among consumers in their late 40s in age as their kids leave the nest, but the slowdown to follow will not be as extreme and the next boom will be stronger.
6. Commodity prices, from food to energy to materials like copper, will fall, which will help to lower the cost of living, especially in emerging countries that consume more commodities. Commodity exporters will be hurt more at first, but there will be an even greater commodity boom to follow, from 2023 to 2039, for them to benefit.
7. Dictatorships will fall in emerging countries, which will put such countries on an economic path toward democracy and economic development. This is already happening and will continue, although it may take a decade plus for these struggles to show fruition. Developed countries will see a second democratic revolution as well, like during the 1780s in America.
8. Developed countries will realize as their demographic trends continue to slow and their savings and wealth build naturally with aging that they will most benefit from investing in infrastructure and cleaner energies in the emerging world, which will accelerate development of these countries and lower global pollution—a win/win situation.
9. Natural restrictions on trade and immigration in the crisis will cause more nations to realize that free global trade and immigration are for the best. Thus, globalization will accelerate and specialization of labor and trade will expand.
10. Developed countries will realize that they cannot compete in commodities and low-cost labor industries. These countries will be forced to move more rapidly into “customized goods and services” through network organizations that operate from the bottom up, not the top down. This trend will create a new, mass affluence in the developed world that will pass down over time into the emerging world.
11. During the Fall bubble boom, most of the benefits went to the “1%” (top income earners), who were the innovators and financiers. In this crisis and beyond, the 1% will lose wealth and income as their innovations move mainstream to benefit the everyday worker, as from 1942 to 1972. The middle class will be restored at a higher level and will see greater gains in income and wealth than will the top 1% for decades! See Chart 13 ahead.
12. New, long-term innovations in technologies will emerge, including things like nanotechnologies that make goods out of thin air; robotics that take over everyday functions, high and low; biotechnologies that replace and re-grow organs, etc.; cleaner, more affordable energies; and things we can’t yet envision. We could live to be 120 years old or older! That would greatly extend our demographic cycles of learning/innovating, earning/spending, and changing society in our older, power years of wealth and influence.

One of the largest shifts ahead for decades to come will be the restoration of the middle class as we show historically in **Chart 13**. The top 1% of income earners controlled almost 20% of income in 1929 but only 8%

### Top 1% and .1% of Income Shares in U.S., 1913-2008



Data Source: Alvarado, Facundo, Anthony B. Atkinson, Thomas Piketty and Emmanuel Saez, *The World Top Incomes Database*, <http://g-mond.parisschoolofeconomics.eu/topincomes>, 1/31/2012

Chart 13

of income by 1976. Their share of income rose back to 18% in 2007. The top 0.1% of income earners controlled in 1929 at their peak 10% of income; their share fell to 2% in 1976 and then rose again to 8% in 2007. Although the rich remained rich, the massive decline from 1929 to 1976 represented a big loss in economic dominance for the top 1% and the biggest rise for the middle class in history. In the Fall season income and wealth (as high as 40% to 47%) shift to the top 1%. In the Winter season, the assets that bubbled deflate, many of the companies owned by the top earners fail, and the government raises taxes the most on those with the highest incomes. The cost of living comes down and new technologies become more mainstream and accessible, which helps the everyday household more than it does the top 1%.

**We predict that incomes and wealth will rise faster for the average household than for the top 1% for at least 3 decades or more, restoring the middle class, as happened from the 1930s forward. Financial institutions should recognize this monumental shift and start chasing smaller investment, insurance, and financial accounts instead of focusing just on the top 1%+ of earners.**

We are crystal clear in our belief that all four seasons of our economy have clear challenges and long-term benefits. All four seasons exist for a reason and occur in all human, technological, and natural cycles, both long term and short term. The key is to understand such cycles—to take out your coats and snow skis and store your bathing suits and water skis in the winter season—and to prepare for, take advantage of, and benefit from this most severe and most opportune season. The businesses of the future and a new, more-affluent middle class will re-emerge in the coming decades to generate productivity and higher standards of living even in aging countries that are facing inevitable demographic slowdowns and/or slower growth in the future.

## Technical Analysis

### A New, Likely Scenario with a Mini-Crash in 2012 from March or May Forward, Another Strong Rally, and a Greater Crash in 2013-2014

We've been looking for a top between early January and mid March, and the market has continued to edge upward with very little correction. This rise, again, is an unhealthy sign. However, it is the nature of a market in which the Fed throws trillions of dollars into banks, which will push most "risk" markets higher, as these dollars are put into new, money-chasing investments. Also, market returns on safer assets like Treasury bonds disappear and investors are forced into riskier assets, such as stocks. There are conflicting signs around a top in early 2012, which makes us suspect that a top could come later in 2012, after another 20%+ correction in the months ahead.

### NYSE Advance / Decline Line 2007-2012

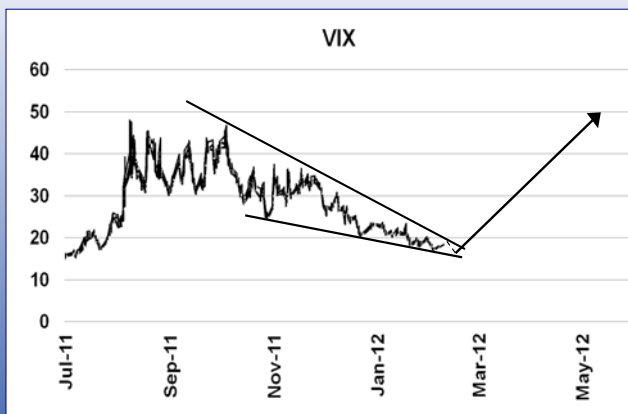


Data Source: Bloomberg, 2012

Chart 14

We mentioned previously that Lowry's measures of buying power and selling pressure are showing the classic divergences on the rally since October 2 that would suggest that this is a substantial or major top, much like October 2007. However, another key indicator, the advance/decline line in **Chart 14**, does not suggest a major top here. The advance/decline line measures the breadth of a rally. Are most issues participating, or are they only a minority of larger, leading stocks? When the markets reach new highs and the advance/decline does not, that is a sign of a top. Lowry's comments that the last time such a signal failed was in the late 1970s. From our demographic view that was a time when small-cap stocks would have done very well; we show a correlation with small-cap outperformance on a 22-year lag on the Birth Index for peak innovation. That same 22-year lag will end in another peak in small-cap outperformance in 2012. So maybe this indicator is skewed here and is not as meaningful. However, it can't be ignored.

### VIX (CBOE Volatility Indicator) July 2011- June 2012



Data Source: Bloomberg, 2012

Chart 15

Another great indicator at major tops and bottoms is the VIX (CBOE Volatility Indicator) in **Chart 15**. In fact, the VIX was the key to the best buy signal we ever gave in early October 2002. Volatility hits extreme levels near major bottoms and very low levels near major tops. Back in 2002 the extreme levels were in the 45 to 50 range for a bottom. During the crash in 2008, the VIX spiked to almost 90, which heralded the new Winter season. Hence, we will be looking for levels of 90 to 100 to determine when the next major crash may bottom. Minor corrections near 20% now tend to be at levels of 45 to 50. On the other hand, near tops in recent years the VIX has tended to fall to around 14 to 15. We saw those levels in early October 2011 at the bottom at 14, and near there a few times since. The VIX has been falling with the rally since October 2 in a contracting wedge, which indicates the likelihood of a major reversal upward in the coming weeks. The market has fallen to as low as 16 recently and is not likely to fall to lower than 14 or 15. Thus, a substantial top and correction should be ahead—but not necessarily a major crash or a top of the magnitude of 2000 or 2007. However, it strongly suggests that a 15% to 20% correction is coming, as we saw in mid 2010 and mid 2011.

### S&P 500 Fibonacci Time Lines 1995-2012



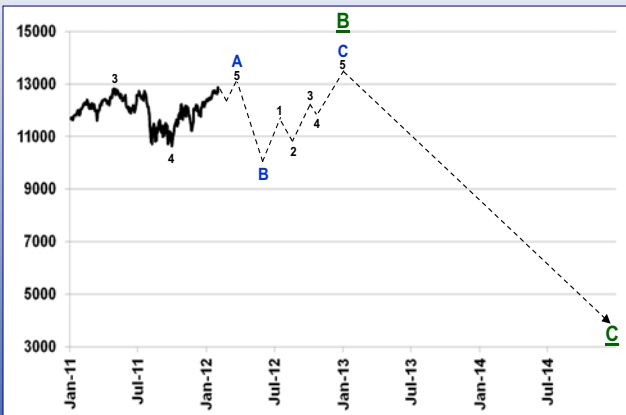
Data Source: Yahoo Finance, 2012

Chart 16

**The very low VIX or volatility readings suggest that a substantial correction is likely in the coming months.**

If we look at some simple Fibonacci patterns in **Chart 16**, there are two likely times for a major top in the third and

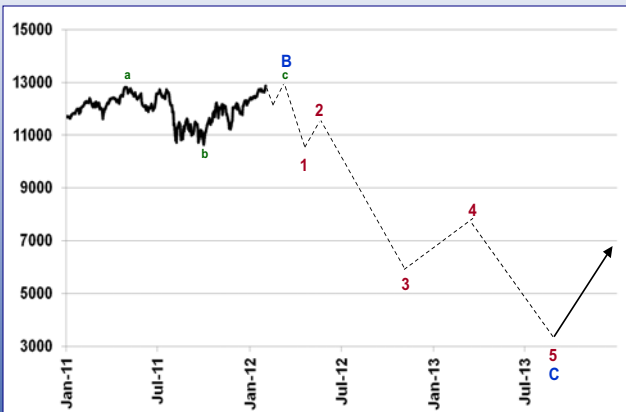
**Likely Crash Scenario 1, Dow  
2011-2014**



Data Source: Yahoo Finance, 2012

Chart 17

**Likely Crash Scenario 2, Dow  
2011-2013**



Data Source: Yahoo Finance, 2012

Chart 18

**S&P 500 Megaphone Pattern  
1995-2012**



Data Source: Yahoo Finance, 2012

Chart 19

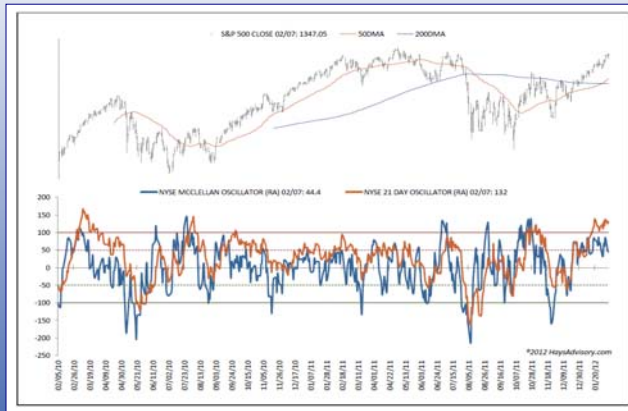
final bubble that we are forecasting—which seems to be expanding with more and more stimulus. The past two bubbles occurred in 5-year runs, 1995-1999 and late 2002 to late 2007. A 3-year or 0.618 ratio would be best set to peak around March 2012. If this rally were to extend to 5 years, it would top in March 2014, which is beyond what we see as likely, given deteriorating demographic trends. The second Fibonacci pattern shows that the time between the early 2000 and late 2007 bubble tops was near 8 years. A 5-year or 0.618 ratio would call for a top in late 2012, say between September and November.

Given the major fall in bond yields from the flight to quality from Europe, despite rising GDP and rising inflation, we now think that a strong QE3 is coming sooner rather than later; that sets up a new, preferred scenario 1 (**Chart 17**). In this case we assume that a minor top will be made in March 2012 at our upper targets of around 1,377, which would represent a new high over 1,370 on May 2, 2011, and would make the rally from March 2009 a possible 5-wave rally, or an A wave up. This would be followed by a B-wave correction into late May or the summer down to 1,050 to 1,100 (20% to 25%). With a strong QE3, stocks would rally to slight new highs again, to say, 1,400+ into late 2012, in line with the Fibonacci pattern for a major top there. Thus, investors still should be out of stocks, especially by around mid March, and especially as scenario 2, discussed ahead, predicts a much bigger crash.

If we see an acceleration of the downturn in Europe, accelerated dumping of foreclosures by financial institutions in the US, and/or a war with Iran and spiking oil prices, the Fed could lose control of the economy in 2012 (scenario 2, **Chart 18**). In that case, a QE3 could be too late to make enough difference. We envisioned this scenario in past issues, but it looks less likely now. In this case, March 2012 or so ends up being the major bubble top. The markets would get a minor wave downward at first, a major crash into the summer or early fall, a more minor bounce into late 2012, and then a more orderly downturn and low sometime around mid 2013 or later, a lot earlier than in scenario 1.

**How strong a crash, especially between March and the summer, will tend to indicate whether scenario 1 or scenario 2 will dominate. Our present analysis favors scenario 1, with a mini-crash in 2012 and a major crash in 2013-2014.**

### McClellan and 21-Day Oscillators, NYSE (2/2010-1-2012)



Data Source: Hays Advisory, 2012

Chart 20

How big a rally will follow could depend on how long the US, China, and Europe can continue to stimulate, as trends have shifted more toward stimulus in Europe, the US, and even China. The most bullish and greatest bubble scenario would be higher highs on most major indices in an expanding wedge or “megaphone” pattern that would be the most bearish into 2013 and beyond. We show this pattern in **Chart 19** for the S&P 500, which could have prices as high as 1,600 (Dow near 16,000) by late 2012 or so. We covered this megaphone pattern in past issues for the Dow Transports and the Russell 2000. For the present scenario the pattern is even more exaggerated, with targets as high as 6,300 plus for the Dow Transports and 1,000 or so for the Russell 2000 (small caps).

### Crude Oil 2008-2013

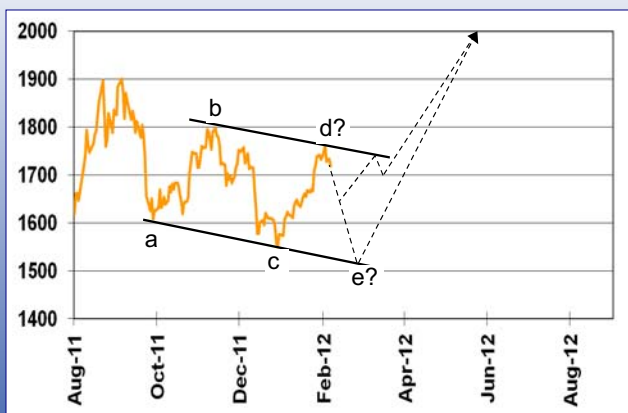


Data Source: St. Louis Federal Reserve, 2011

Chart 21

Near term the stock markets have become more overbought than any time in five years. The best oscillators in **Chart 20** show a divergence between the McClellan oscillator (blue line) that peaks first and the 21-Day oscillator that confirms and peaks later. The 21-Day oscillator has now greatly surpassed the levels of the McClellan, which suggests that this market is extremely overbought near term. A short term correction is likely in mid February back to 1,285 - 1,300 on the S&P 500. Then a final rally is likely to 1,377 or so into around mid March.

### Gold Aug. 2011 – June 2012



Data Source: Bloomberg, 2012

Chart 22

A major variable as to which scenario plays out best could be oil prices. **Chart 21** shows a giant triangle pattern that suggests that oil is about to break strongly up or down in the next few months. If oil breaks above this triangle (at \$107 currently and declining ahead), then oil prices could spike to \$120 +. That situation is most likely in the case of a war with Iran or severe disruptions in other parts of the Middle East. The longer such a conflict continues and the higher oil goes, the more the situation would favor scenario 2, with a bigger crash in 2012. If oil breaks below this triangle (currently around \$80 and rising) it would be due to a resolution of the Iran conflict, and likely due to slowing global demand. Thus, stocks would decline as well at first. The more oil falls, the larger the stock correction is likely to be. Hence, either breakout, if strong, could suggest a substantial correction for stocks ahead.

We have been holding off on a final sell signal for gold and silver; both were oversold in late December and looked like they would rally. Gold has rallied to over \$1,760, as we show in **Chart 22**. Now it looks like gold needs a correction. If the correction can hold between 1,620 and 1,660, then gold is likely to push above the declining top trend line. If so, then the high-end target could reach near

\$2,000 in the months ahead. Recall from our last issue that gold and silver rally in anticipation of a financial crisis, but fall when the crisis sets in, with debt deleveraging and deflation. Also recall that gold and silver tend to run with the “risk-on” trade with stocks and commodities but often peak a few months later as they react positively in the early stages of a crisis. Hence, if stocks peak near term around mid March as we expect, then gold and silver could peak as late as May. Conversely, if gold continues to correct in an extended a-b-c-d-e pattern in the channel drawn in Chart 22, then it could lead to a rally toward \$2,000. If gold were to break below this channel, i.e., below \$1,500, then we will give a long-term sell signal.

**Summary Recommendations:**

1. We may issue a very-short-term buy signal for stocks (SPY) if there is a modest correction to between 1,285 and 1,300 on the S&P 500 into around the third week of February. Any short-term investors still holding SH (short S&P 500) should sell if there is a correction to 1,300 or lower.
2. We are likely to issue a second major sell signal for stocks and a short signal (SH) for aggressive investors and traders around mid March.
3. Look for a major break upward or downward in oil in the next month or two. That could affect our assessment of whether scenario 1 or 2 above is more likely.
4. Look for a possible final sell signal in gold and silver sometime between March and May, likely closer to May.
5. Look for 10-year and 30-year Treasury bond yields to fall (and bond prices to rise) from around March into the summer. Buying TLT is a way to play this trend.
6. The US dollar has had a setback and should rise again if stocks start to correct from mid March forward. UUP continues to be a way to play that trend.

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## The Fixed Income Confiscation Game

### Feature Articles

#### 8 Demographics in the News: Japan, Africa, and Beyond By: Charles Sizemore, CFA



Interest rates aren't what they used to be. There was a time way back in history, say 2007, when fixed income investors arguably were compensated fairly for lending their money to borrowers. This is no longer the case. Instead, anyone buying high-quality fixed income is literally giving money away, unless the investor is either shrewdly buying mispriced securities or with luck buying bonds that are enjoying capital appreciation. This is the case all along the

yield curve, from short-term bills to long-term bonds, with the possible exception of 25- and 30-year securities.

This great transfer of wealth from savers to borrowers has a cause or, more specifically, has a director, and his name is Ben Bernanke, the Chairman of the Federal Reserve (the Fed). The actions taken by that entity and the course laid out for the years ahead are designed specifically to fleece savers and enrich borrowers, all in the name of exorcising deflation from the business cycle. This process is occurring just as the members of the largest generation in the US economy, the Baby Boomers, are trying to build up savings for retirement. Those already in retirement watch in desperation as their CDs and other fixed income investments roll over into new issues that pay almost no interest. The message from the Fed has been, "You don't matter. The goal of our policies is a constant rise in asset prices at any cost." Welcome to the great confiscation game. Fixed income investors are paying the cost. Why? Because they have the wealth. The Fed is taking money from savers because, as Willie Sutton famously said about why he robbed banks, "That's where the money is."

### Why They Do What They Do

When the Great Recession took hold in late 2007 the US economy was moving toward disaster. During 2008 and 2009 the economy suffered gut-wrenching declines in spending, investment, asset prices, unemployment—almost nothing was spared. Through it all there was a call for the government to do something, and it did. The resulting fiscal programs (which come from the elected officials in the White House and the halls of Congress) included the bailouts in 2008 and the stimulus in 2009, along with various other programs, such as extensions of the current low tax rates and reductions in Social Security taxes (payroll tax cut). While these programs are big, they are typically one-time issues that must be voted on and that involve much handwringing and gnashing of teeth. At least the voting public gets to feel like they have some say in the outcome via their elected officials. The same cannot be said for the other programs, which were implemented to heal what ailed the US economy; those programs fall under monetary policy and are the dominion of the Fed. Congress confirms appointments to the Fed. However, the voting body of the Fed, the Federal Reserve Open Market Committee (FOMC), has the authority to implement anything it wants with no oversight.

Because of the lack of oversight, there is great concern over what goals the Fed will pursue. The stated purposes of the Fed by law are moderate, long-term interest rates, moderate prices, and full employment. These goals sound reasonable enough. After all, who would not want such things? The problem arises when clearly stated, simple-sounding goals run headlong into the messy reality of life.

In broad terms, the goal of the Fed is to tame the business cycle: to keep everyone employed, to avoid runaway inflation, and to keep interest rates low. By working toward these goals the Fed assumes the role of ultimate master over the flow of wealth within the economy, typically by adjusting interest rates. When Ben Bernanke talked in the early 2000s about dropping dollars from helicopters as a way of fighting deflation, he was not being literal. He was making the point that he would adopt policies that make capital, in the form of credit, much easier to obtain. Low interest rates are a common way of pursuing this goal. The problem is, the plan is not working.

The clearest example of the ineffectiveness of this policy is the housing market. Interest rates, which inform mortgage rates, are thought to be the ultimate tool for causing the number of home purchases to move higher or lower. As interest rates rise, mortgages become more expensive, so home buying slows down. When interest rates fall home buying is supposed to rebound. Currently, 30-year-fixed home mortgage rates are at all-time lows, just under 4%, and yet the number of home purchases continues to bounce at extremely low levels. Over

2 million new homes per year were being built in the mid 2000s, whereas now the rate hovers around 500,000. The national price level for existing homes fell dramatically in 2007-2009, rebounded modestly for a few months, and then started moving downward again. The obvious point is that lower interest rates alone did not and cannot cure what ails the housing market.

The same is true of other areas, like unemployment. Part of the Fed's goal was to use low interest rates to spur borrowing for uses other than home loans, like auto loans, corporate loans for business expansion, and general credit for consumers. The theory was, and is, that lower costs of capital make purchases easier to afford, therefore lower interest rates spur spending. Of course, it isn't working like the Fed wants. Consumer credit, which rebounded ever so slightly in the last couple of months, has been in a long decline since 2008. Auto loans are rising as auto sales are bouncing up from very low levels. Student loans are the one area that is showing robust growth; unfortunately this area is not one the Fed likes to highlight. Are those young people who are now leaving college with tens if not hundreds of thousands of dollars worth of debt going to get jobs that make those loans affordable? Good question.

No, the Fed has not tamed the business cycle, and it cannot. The other factors that drive activities like consumption, the extension of credit and the assumption of debt, and general business activity are far beyond the scope of what the Fed can control. Also weighing in are demographic trends, which we have covered in depth elsewhere, the psychology of markets (manias and times of pessimism), and now the interconnectedness of global goods markets, labor markets, and capital markets. To think that the Fed can override all of these factors is something of an act of hubris, but they will try, because it's the job.

Even though the Fed cannot override or suspend the business cycle (as has been proven by every downturn in the business cycle that has occurred since the Fed's inception in 1913), their policies can and do have effects. One effect is a drop in the cost of capital, which has been the focus so far. However, the equal and opposite effect is a drop in the return on capital. Many are feeling the pain of that drop in returns, but as yet those suffering have found no voice. Baby Boomers fed up with earning 3% on their long-term fixed income and senior citizens angry at rolling over their CDs only to find that the next 1-year CD rate is anywhere from 0.10% (Bank of America, per Bankrate.com) to 0.70% (Everbank, per Bankrate.com) have yet to rise up against the system. Using 0.50% as a rough middle ground, for every \$100,000 a person invests he will receive \$500 per *year*. At that rate, investing seems almost not worth doing, and that is exactly what the Fed wants you to think.

While the Fed is interested in making rates cheaper for those predisposed to borrow, part of the goal is to make "rational actors" change their choices when deciding between saving and spending. In the eyes of the Fed and many who deal in economic policy, money in the bank is simply a store of value that can be used at any time. If the rate of payment on that capital is high enough, then not only will money remain in the bank, but also more money will flow to the bank, thereby slowing down the economy. If capital (in savings, a CD, money market, etc.) is earning a very low rate in the bank, then a rational actor would determine that he is better served by spending the money than by continuing to save it. Of course, this completely ignores huge factors, like why the person saves the money in the first place.

If the funds are in the bank because the investor wants to save up for a TV, then perhaps a lower cost of credit coupled with low interest on the savings will bring that purchase forward. However, if the goal of the savings is to prepare for or provide for retirement, then a lower rate of interest is not going to bring the spending forward, it is simply going to make the goal that much harder to achieve. But as the Fed has pointed out in the past, that is simply the cost of trying to balance out the economy.

The Fed has been flummoxed by the length and depth of the recent economic downturn. In response, they have taken interest rate manipulations to the extreme. Now, not only are savers receiving much less than previously, but they also have to *pay* the borrowers. Savers are not charged to put their money into CDs or money market accounts, at least not yet. Instead, the Fed does it by forcing interest rates lower than the rate of inflation, which means those who invest in high-quality short-term fixed income assets actually lose money by saving it. This is exactly the Fed's plan. They want the pain to be very great so that savers will be motivated to spend.

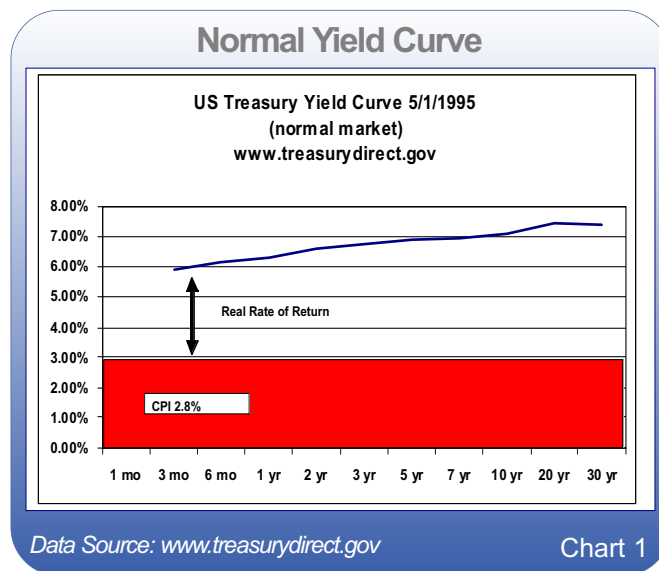
A few examples will illustrate the point.

In a “goldilocks” economy, one that is not suffering from rising costs (inflation) and is not on the verge of or in a recession, the Fed is content to keep the very-short-term interest rate (the Fed Fund rate, which is the rate at which banks borrow from each other, set by the Fed) at some nominal level that reflects both a real rate of return and the current rate of inflation. These numbers change with the economy over time, but the basic idea does not. In general, investors should earn a “real rate of return,” meaning a true payment for allowing someone else to use their funds for a specified period of time, be it one day, one year, or 30 years. This is different from the rate of inflation, or the general decline in the value of money over time.

If an investor buys a 1-year CD, then he is allowing the bank to use his funds for a year. The investor would expect to be paid not only for the use of his funds (the real rate of return), but also for the rate of decline in the value of his funds (the current rate of inflation). Together, these components make up the nominal interest rate.

$$\text{Nominal Interest Rate (i)} = \text{Real Rate of Return (r)} + \text{Rate of Inflation (I)}$$

A normally functioning interest-rate environment would produce a yield curve that looks like the one in **Chart 1**, which is the yield curve, or interest rate on various US Treasury bills and bonds from very short maturities to very long maturities.

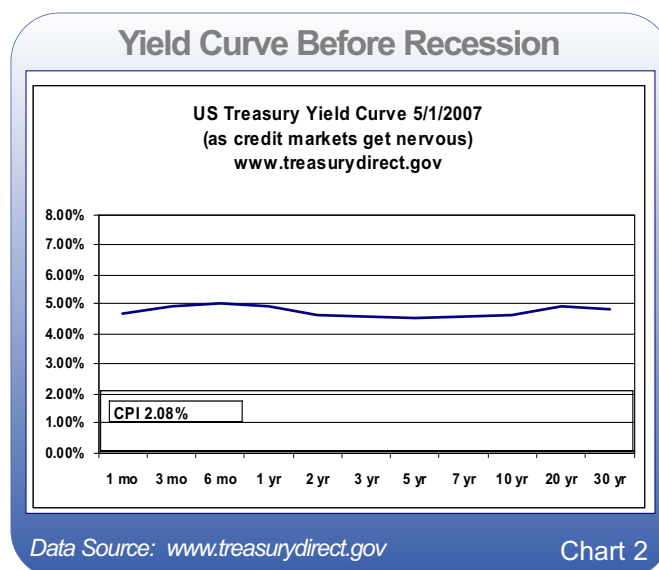


The rate of inflation, noted in red, was 2.8% in 1995. With 1-year short-term interest rates around 6.1%, then the real rate of return was 6.1% to 2.8%, or 3.3%.

$$(i) 6.1\% = (r) 3.3\% + (I) 2.8\%$$

At the time, the cost of simply borrowing money was 3.3%. The inflation cost was 2.8% for one year and rose gradually further out on the yield curve. If a borrower wanted a 30-year loan, then she would pay 3.3% as the true cost of borrowing and an additional 3.8% to compensate for potential inflation over the life of the loan.

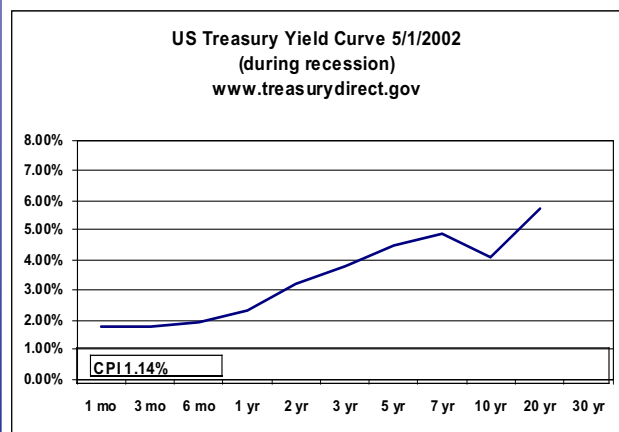
Of course, it is unusual to have a perfectly functioning, all-is-well economy and bond market. In the typical economy, perceived to be at risk of inflation, the Fed raises short-term interest rates, thereby making the cost of borrowing higher. This change on the short end of the yield curve pushes up rates, which is better for savers.



The long end of the curve is almost always where buyers and sellers of bonds have the most control over interest rates. If bond buyers think the economy is growing and inflation is a risk, then they will demand higher interest rates. The reverse is also true; if participants in the bond market believe a recession is coming, then buyers will take lower rates, believing that inflation is coming down. They want to grab yield while they can. When the economy is seen as being on the cusp of entering a recession, the yield curve will flatten out, much as shown in **Chart 2**.

Notice that the yields on bonds from 2 years to 20 years are actually a bit less than the yield on 6-month notes. This is a reflection of the Fed setting the Fed Fund rate at roughly 4.5% (implying a real rate of return of 2.42%), and bond market participants estimating that inflation will fall in the months and years to come.

### Yield Curve During Recession



Data Source: [www.treasurydirect.gov](http://www.treasurydirect.gov)

Chart 3

It is common to hear investment professionals say, “Listen to the bond markets.” This is a reference to analyzing the shape of the yield curve. If the interest rates on long maturities are higher than the rates on short maturities, then the curve is positive, which implies that economic growth is expected in the years ahead. If the curve is flat or inverted, meaning short maturities have higher yields than long maturities, then the bond community is telegraphing that they see trouble ahead.

A problem arises when the Fed makes dramatic changes to interest rates. Typically when the economy goes into recession the Fed will lower short-term rates in the hopes of spurring home buying, general consumption, and greater investment on the part of businesses. This also has the effect of changing the shape of the yield curve. If the curve was flat (bond participants saw trouble ahead so the rates on long maturities fell) and then the Fed lowered

short-term rates, then the curve is once again positive. **Chart 3** shows the yield curve during the recession in 2002.

This curve does not include 30-year bonds, because for a few years in the 2000s the US government did not issue 30-year bonds. Hence, there was no interest rate for that maturity, but the premise of a recessionary yield curve is easy to see. The Fed lowered interest rates dramatically in response to the recession that was underway and to 9/11. Fed Funds were set to 1.75%, whereas inflation was down at 1.14%. This implies a real rate of return of only 0.61%, which is very low indeed. To get a higher rate of return, investors would have to move further out on the yield curve.

Once the recession was over, the yield curve would again reflect growth, with higher rates on the short end as the Fed moved the rate of Fed Funds back to a normal level, around 4% or so, and bond market participants found equilibrium somewhere around 6% or so. If inflation was around 2%, it would imply a 2% real rate of return, plus the premium for inflation.

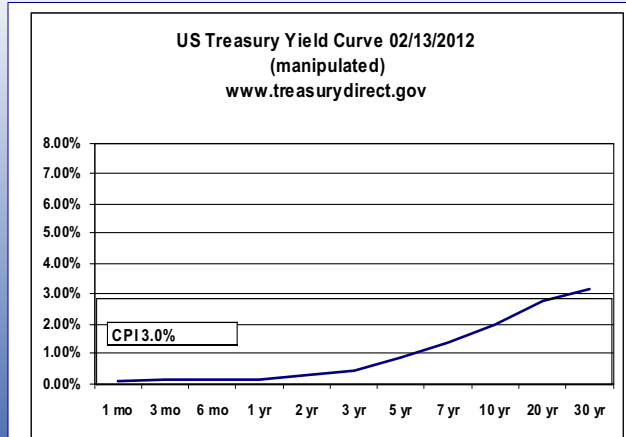
### Interest Rates Today

After suffering through the worst economic downturn since the 1930s, the US economy has officially been out of recession since the summer of 2009 and in expansion mode for 2½ years. Thus, a common assumption would be that the Federal Reserve, after moving short-term interest rates lower during the downturn, would move Fed Fund rates back up to a normal level of around 4%. Of course, that is not the case. In a continuing effort to meet its list of impossible mandates—low interest rates, moderate prices, full employment—the Fed continues to keep short-term rates not just low, but at zero. One-month, 3-month, and 6-month T-bills often trade at 0.001% to 0.005% or even sometimes trade negative. However, the Fed has not been content simply to keep short-term rates low for years.

In August 2010 the Fed announced its intentions to start buying US Treasuries all along the yield curve, which had the desired effect of driving down interest rates. This action did not spur consumer spending in any meaningful way, nor did it cause the housing market to rebound. However, it certainly caused the rates of return earned by savers to drop. When this action failed, the Fed implemented Operation Twist, which calls for the Fed to sell its short-dated US Treasury bills and to buy long-dated Treasury bonds. The goal is to push interest rates even lower in hopes of stimulating the housing market and general economic activity. It is still not working, but that does not mean that the actions of the Fed have had no effect. Look at the current yield curve in **Chart 4**.

What immediately should stand out is not only that there is no real rate of return, but also that interest rates are lower than the rate of inflation! This is the case along the entire yield curve out to the 30-year bond, at which point the interest rate and the inflation rate are basically even.

## Yield Curve Manipulated



Data Source: [www.treasurydirect.gov](http://www.treasurydirect.gov)

Chart 4

For savers, those who buy bonds, which would be the fiscally responsible portion of our economy, the equation is clear.

On 1-year bonds:

$$(i) 0.15\% = (r) -2.85\% + (I) 3.00\%$$

For the year that the investor holds this bond, she earns 0.15% interest, but the value of her money drops by 3.00%, thereby netting the investor a loss of 2.85%. Now consider the flip side, the borrower. The debtor receives the loan, and then pays it back in one year with interest. Since the value of the dollars used to pay back the loan has fallen by 3%, the debtor is ahead by 2.85%. Arguably the price of whatever the debtor purchased went up by 2.85% (gasoline, food, etc.). This all means that the lender (the investor that bought the bond) gave the borrower the use of the money for a year, received back his principal

and 0.15% interest, but now his principal will only be 97% of what it would have purchased before due to inflation. There should be no question, no argument, no misunderstanding about this interest rate environment: the Federal Reserve is specifically manipulating the bond market in order to transfer wealth and purchasing power from those that have money to lend (savers) to those that are willing to borrow (debtors).

### Who Would Take This Deal?

With negative real returns, the only reason investors are buying short-dated high-quality bonds is for safety. There cannot be another answer, as the bonds clearly confiscate wealth over time. Purchasing a 2-year US Treasury bond at 0.29% interest while inflation is running at 2.0%-3.0% guarantees a loss, but at least the buyer can be assured that the United States will send back the dollars at maturity. It is this basic point—that the US can use various means to always pay its bills—that has allowed the US to issue bonds at historic low interest rates, thereby dragging down interest rates for all high-quality fixed income assets.

This scenario of chasing high-quality fixed income not for investment return but instead simply for the security that the funds will be returned is a statement on the fragility of economies and currencies around the world. These are not markets driven by individual investors who are doing their best to save for retirement, these markets are driven by multi-billion-dollar sovereign wealth funds, insurance companies, pension funds, and others who have the unenviable task of finding investments that fit their long-term liabilities and investment parameters.

Unfortunately, while the returns in the high-quality fixed income markets are being driven to all-time lows, the small investors who rely on these markets for safety and income are watching their investment portfolios suffer. Consider retirees who allocate 40% of their portfolios to fixed income, specifically US government bonds. While their older bonds have appreciated in value as interest rates have fallen, this premium is captured only if they sell their bonds before maturity. Monies being invested today, such as interest payments and maturing bonds, are earning substantially less than the rate of inflation, causing the overall fixed income portfolio to decline in value once inflation is taken into account. Falling income means less to spend on food, gasoline, medicine, etc.

Economic theory tells these retirees that they should withdraw their funds, as the return is so low as to be negative, and instead spend the money. Then what would the retirees do in the future? The only recourse these investors have is to take more risk to earn higher returns. That's not much of a choice; it is instead a "free choice" made with a gun to one's head.

### The Size of the Scam

The numbers look sort of small when comparing interest rates: should the 1-year US Treasury note be the current rate of 0.15%, or closer to 4.0%, which would give investors a real rate of return (1.2%) plus recoup their loss of purchasing power due to inflation (2.8%)? However, when these interest rate changes are put into

the context of the size of the fixed income markets, the numbers become very large and very meaningful.

Currently the 1-year US Treasury has a negative real return of -2.65% (the nominal interest rate minus the inflation rate, or 0.15% to 2.8%). Keep in mind that in years past, as seen in Chart 1, the real rate of return has been closer to 2%. In order for that to happen, 1-year interest rates would have to be 4.65% higher than they are today, which would represent the rate of inflation (2.8%), plus the real return (2.8%), minus the rate of interest today (0.15%). Instead of shooting for the stars and earning a real return of 2%, let's use a modest real rate of return of 1%. Even there, the 1-year US Treasury bond yield would have to be 3.65% higher than it is today. This means that investors are currently giving away 3.65% on all of the newly issued fixed income. How big is that market? Assuming that this situation of manipulated rates has been in place since the third quarter of 2010, here are the US bond issuances since Q3 2010 according to the Securities Industry and Financial Markets Association (SIFMA):

2010 Q3	1,671,200,000,000
2010 Q4	1,966,700,000,000
2011 Q1	1,548,500,000,000
2011 Q2	1,253,000,000,000
2011 Q3	1,221,800,000,000
2011 Q4	1,338,500,000,000
Total	8,999,700,000,000

Loss of 3.65% annual interest: -328,400,000,000

This is not the only loss. With short-term rates held to zero, those who hold money in savings accounts and short-term time deposits are also losing. Estimating that these savers should at least earn a little less than the rate of inflation, the loss on these funds is arguably 2.00% per year (less than the 2.8% inflation rate of 2011). The average size of this market over the past 1½ years according to the Federal Reserve's H.6 report is:

Savings deposits	5,432,100,000,000
Small-time deposits	897,700,000,000
Total	6,329,800,000,000

Loss of 2.00% annual interest: 126,600,000,000

Together, these numbers equal almost one half of one trillion dollars lost annually because the Federal Reserve is artificially holding down interest rates in all maturities, in an attempt to change the natural ebb and flow of the economy. To ensure that asset prices do not fall in order to guarantee that the business cycle can only go up or sideways with very little downside even after large bubbles in asset classes like housing and waves of speculative debt, the Federal Reserve is specifically moving wealth from responsible savers to those who are willing to borrow.

### Investors Are Losers, But There Is a Winner

For those wondering if there is any good news at all in this, rest assured that there is! Of course, whether the news is really good depends on your point of view. The estimate above concerning the loss of income on bond issuance (3.65%) also represents a cost that borrowers do not have to pay. Who is the biggest borrower of them all? The US government, of course. Over the last six quarters the US Treasury has issued roughly \$2.7 trillion in debt. At a savings of 3.65%, that equates to a cool \$100 billion per year the US government is *not* paying to borrowers that it otherwise would be.

In short, there is a tremendous transfer of wealth going on that can be traced back to the Federal Reserve and its quest to control the business cycle. There are winners and losers. Those who have saved and put away money for the future are seeing their wealth drained away, and those who borrow to spend are getting a benefit

just short of “free money.” With almost all maturities of US Treasury bonds yielding less than inflation, how can it be anything but a gift?

### **The Loser Side Effect: Private Pensions**

While the interest paid (or not paid) on US Treasury bonds and other fixed income has a direct affect on those who own the bonds, a weird side effect also occurs. Different contractual instruments such as Adjustable Rate Mortgages (ARMs) and other payment schedules have rates tied to certain US Treasury bond yields. One very large group tied to US Treasury yields is private pension plans. Companies that sponsor these plans are required to use the yields on US Treasuries to determine how much money must be set aside each year in order to meet their long-term pension obligations for current and future retirees. A simple illustration of how this is done is by determining the average length of the pension obligations (say 20 years in the future) and then using the corresponding US Treasury rate (currently 2.78%) to figure out how much money should be in the pension fund today to meet the obligations. The problem is that as interest rates go down, the amount of money that must be in the account goes up.

In the weird world of pension fund accounting, companies annually must calculate how much money should be in their pensions in order to meet future obligations. These calculations take into account the current amount held, the future contributions expected from workers and the company, and the anticipated future returns. It is this last part that has teeth, and unfortunately it changes every year.

Because pensions use the US Treasury yield that matches their average future liability (20 years, for example, as shown above) in their calculations, the outcome of their calculations changes as interest rates change. If interest rates are falling, then the calculation will forecast lower earnings and require more money to be contributed by companies to make up the shortfall. If interest rates are rising, then the opposite is true. The pension calculations would forecast more earnings on investments and require lower company contributions. Since interest rates are constantly changing, pensions use moving averages to smooth out the volatility. However, the last several years have been something of a one-way train, with interest rates now at historic lows and the Federal Reserve making clear that they anticipate holding rates low in the future. Thus, expect private companies that sponsor pensions to show shortfalls and to be required to take money out of earnings to shore up their pensions.

### **What Is an Investor To Do?**

The first thing an investor should do is to recognize the risk of buying bonds in this market. Take long-term Treasuries as an example. If a 30-year bond moves from a 3.00% yield to a 2.50% yield, then the price of the bond moves from \$1000 to \$1,100. That's only a 10% gain but it requires the bond yield to fall by 0.50%. Is it possible? Of course. Is it likely? Who knows? More to the point, while waiting for capital to appreciate as a result of falling rates, investors are only earning 3%. That's a lousy return for a 30-year investment.

This same calculation is true of most other traditional fixed income investments, such as high-quality corporate bonds. The last two years have been good to investors because rates have fallen dramatically, but what opportunity exists in the months and years ahead? For those that require yield, it is better to look elsewhere.

Many investors are using dividend stocks to shore up their portfolios with some income and a better opportunity for upside risk. An area that is often overlooked is that of energy trusts. While we do not analyze this area or make recommendations in it, we do recognize that many of these trusts pay between 4% and 8% interest, which is very attractive in today's interest rate environment. Insurance contracts, rental property, and less-well-known parts of the bond world such as Build America bonds are all worth considering.

The point is that the Federal Reserve has made a very clear, long-range decision to punish savers while rewarding borrowers, all for the purpose of disrupting the normal business cycle and holding down costs for the US government. This has created a dilemma for investors who rely on interest income to meet their financial goals, because there is an extreme, artificial disparity between what investors should be paid (real rate of return plus the rate of inflation) and the current level of interest rates. The only way to solve the

dilemma is either to move away from traditional investment-related instruments such as US Treasury bonds and corporate bonds or to have the Federal Reserve stop intervening in the bond markets. It's not much of a guess as to which one will happen.

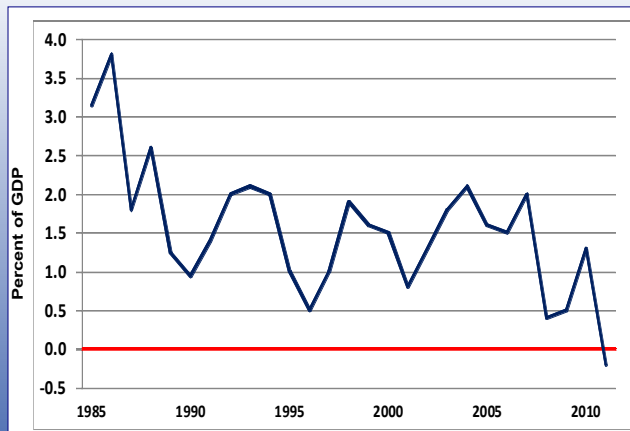
## Demographics in the News: Japan, Africa, and Beyond



**By: Charles Sizemore, HS Dent Research Analyst and Editor of the Sizemore Investment Letter**

Last month, *The Economist* ran a headline I never expected to see: "After Half a Century of Trade Surpluses, Japan is now in Deficit" (see "Seeing Red," January 14, 2012, <http://www.economist.com/node/21542794> and **Chart 5**).

Japan Trade Balance, 1985-2011



Data Source: Bloomberg, 2012

Chart 5

For the first time since 1963, in 2011 Japan's imports exceeded its exports. For Japan, the country that practically invented the "Asian model" of export-led growth, this marks a stunning reversal, and one that might last for a while. As written in *The Economist*,

There are powerful structural reasons to expect Japan's current account to move towards deficit. A nation's current-account balance reflects the gap between domestic saving (by households, firms and the government) and investment. Historically, the Japanese were keen savers, with national saving greater than investment. But a rapidly ageing population saves less because people draw down their assets when they retire. The more retired folk there are relative to workers, the lower the saving rate.

The relationship between the savings rate and the current account balance can be a little difficult to grasp, but it works like this: When a country has a high savings rate

and spends less than it produces, the "excess" production gets sent overseas as exports. When a country consumes more than it produces (i.e., has a trade deficit) the difference has to be made up by a drop in the savings rate. An economics professor might chide me for oversimplifying, but this is how the relationship works in a nutshell. Big-exporting countries tend to have high savings rates. Per *The Economist*,

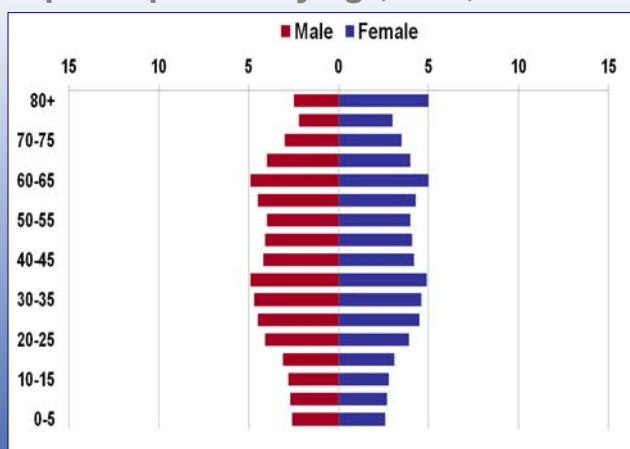
Japan's household-saving rate has fallen from 14% of disposable income in the early 1990s to only 2% in the past couple of years. The government's budget deficit (10% of GDP in 2011) also counts as negative saving. The current account has remained in surplus because shrinking household saving

has been offset by a surge in corporate saving. Since 1990 Japanese firms have swung from being big borrowers to big savers as they sought to repay debts. As the population continues to age, households' saving rate is likely to turn negative.

## Why Do Japan's Trade Balance and Savings Rates Matter?

Today it is China that inspires protectionist sentiment in the United States and Europe, but not all that long ago it was Japan. In the 1980s "Japan, Inc." was the unstoppable juggernaut that rolled over less-efficient American and European competitors. Bookstores (yes, people still read books made of paper that they bought in physical stores back then) were full of titles instructing readers in the art of thinking Japanese. Japan was primed to take over the world, not by brute military strength but with its newfound economic power. And then it all slipped away.

Japan Population by Age, 2010, in Millions



Data Source: United Nations Population Division, 2012

Chart 6

Long-time HS Dent readers no doubt will have read ad nauseum our writings about the Japanese asset bubble of the 1980s and its subsequent burst and deflation throughout the 1990s to the present. We continue to bring it up because this topic has never been more relevant. As Mark Twain so eloquently put it, history never quite repeats itself, but it does tend to rhyme. And Japan's slow-motion depression of the 1990s, 2000s, and now 2010s is the best example we have found to illustrate what we expect in the United States as the Baby Boomers exit their peak spending years and prepare for retirement.

Japan is now in its third decade of recessionary conditions, for all intents and purposes a permanent recession. For this the country's demographics are to blame. Japan is slowly growing into an island nursing home (see **Chart 6**).

Japan has roughly the same number of people over the age of 80 as it does teenagers. As demographic research proves (and common sense would tell you) people spend a lot less money in their 80s than they do in their 30s, 40s, or 50s. This is why Japan's domestic economy has been so persistently weak in recent decades. The older the country gets, the less it consumes. Yet perversely, the older Japan gets, the less it saves as well. You see, while people in developed countries tend to hit their peak spending year around the age of 50, they still continue to earn the highest salaries of their working careers for another decade. This is in preparation for retirement, of course. But once retired, we begin to spend down our assets or at the very least stop adding to them.

This is where it starts to get sticky for Japan. The only things keeping the Japanese economy from becoming completely unglued were...you guessed it, the high exports and high savings rate. According to *The Economist*, net exports accounted for fully one half of Japan's GDP growth over the past decade. For Japan, with its shrinking domestic market, no net exports means no growth.

And that's not the worst of it. Japan has sovereign debts that make the Eurozone's mammoth debts look like chump change. Japan's debts are approximately 220% of GDP, fully 100% higher than those of Italy. Italy! As I quoted above, Japan's government budget deficit for 2011 was an almost unfathomable 10% of GDP.

All of this borrowing is made possible by Japan's low interest rates (the 10-year Japanese government bond yields barely one percent), and Japan is able to borrow at such absurdly low rates only because it has large pool of domestic savings to tap into. Or at least it did.

What happens when Japan's savings rate falls into deeply negative territory and the country has to go to the international bond markets for the first time? Do you remember how the markets revolted against Greece, Italy, and Spain last year? Imagine *that* on steroids.

When Japan is forced to turn to the international bond markets for funding, its yields will soar, making debt service impossible. According to *The Economist*, a mere one percent rise in yields would cause its interest burden to double.

The yen, which has been a strong currency since the onset of the 2008 crisis, will plummet in value, and inflation—something that has been conspicuously absent in Japan in recent decades—will come roaring back with a vengeance. To put it bluntly, everything that investors feared might happen in Europe last year will happen in Japan but on a bigger and more devastating scale. There is no happy ending here. Japan is a ticking time bomb.

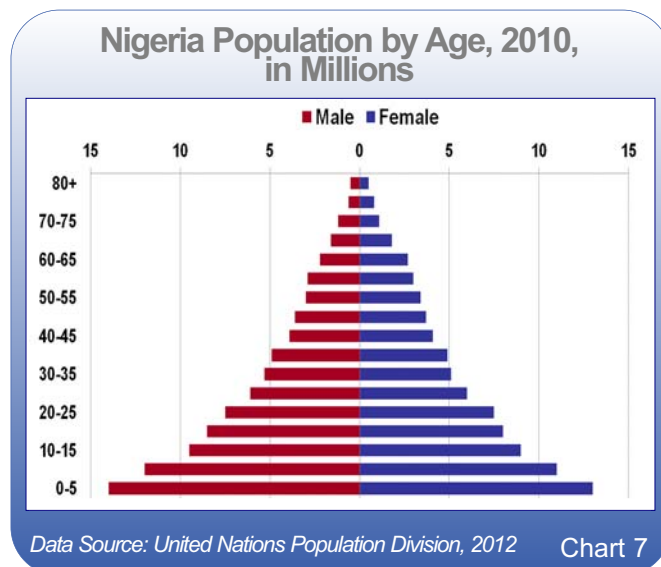
## Falling Births in Africa

Moving on, in a separate article from December, *The Economist* published a good article on African demographics entitled “Miracle or Malthus” (see the December 17, 2011, issue, <http://www.economist.com/node/21541834>).

Malthus was, of course, the economist and demographer in 18<sup>th</sup> century Britain who famously wrote that “The power of population is indefinitely greater than the power in the earth to produce subsistence for man.”

Malthus predicted mass starvation for the world’s poor, a sentiment that was echoed two centuries later by Paul Ehrlich in *The Population Bomb*. Overpopulation was the risk that mankind faced, and it was the responsibility of the world’s policymaking elite to do whatever it took to prevent it.

At HS Dent, we could be considered “Anti-Malthusians.” The risk that we focus on is that of under population in the developed world, or more accurately the economic consequences of aging societies. However, I have to say that when I think of Africa I sometimes cannot help but think that Messrs. Malthus and Ehrlich had a point.



Consider **Chart 7**, which covers Nigeria’s population and gives a very different picture than Chart 6. In the popular mindset, the entire continent is teeming with malnourished children whose families lack the funds to pay for food and basic necessities.

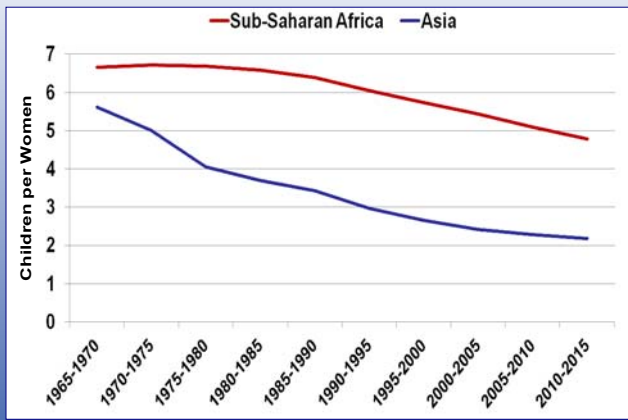
While there is certainly an element of truth to this stereotype, African demographics are changing and the story is far more complex. As written in *The Economist*,

African demography is unique. It is the only continent that will double in size, reaching 2 billion people by 2045 at current rates. Some countries, such as Liberia and Niger, are growing faster still, doubling in size in less than 20 years—a stunning increase that is causing forecasts of Malthusian disaster for countries that cannot feed themselves.

Yet Africa is also showing signs of embarking on the same transition towards smaller families that has occurred everywhere else. In North Africa families of two are the norm. Even if you exclude that region, the sub-Saharan part includes areas of relatively low fertility such as southern Africa, where families of three prevail. Big cities, such as Zambia’s Lusaka and Congo’s Kinshasa, have fertility rates below four; the rate in Ethiopia’s Addis Ababa is probably just two. Evidence of lower fertility is raising hopes that Africa can reap a “demographic dividend”, the economic benefit countries get when the share of the working-age population rises relative to children and old people.

Overall, the trend is unmistakably one of falling fertility (see **Chart 8**).

### Total Fertility Rates, Sub-Saharan Africa vs. Asia, 1965-2015



Data Source: United Nations Population Division, 2012

Chart 8

Even while Africa continues to have some of the highest birthrates in the world, fertility is in decline, even if it is declining at a slower rate. Many demographers attribute the change in family size preference to the availability of birth control and an increase in average age at marriage for women. While these factors clearly matter, we tend to put a greater emphasis on economic considerations.

Urbanization and industrialization tend to go hand in hand with falling fertility. In a simple agrarian economy, children are economic assets. They provide labor and a “retirement plan” for the parents. But children, no matter how much you may love them, quickly become economic liabilities in a modern economy. It takes 18 years (or perhaps 25+ years these days) to raise them before they earn an income to speak of. Also, time spent raising kids is time taken away from building a career—meaning that kids present both hard costs and harder-to-quantify opportunity costs.

Africa’s birthrates will fall to Western levels when the continent reaches a tipping point in urbanization and industrialization. This may happen sooner than a lot of people think.

Asia and Latin America are running out of cheap labor. Already, it is common to see factories leave China for cheaper markets in Vietnam and elsewhere in Southeast Asia. However, as incomes rise in these smaller markets, they too will quickly become expensive.

This leaves Africa. It may be well into the 2020s before most economists notice, but the next big investment boom will be in Africa. When it happens, just remember that you heard it here first.