PART I

FIRST THE BUBBLEQUAKE, NEXT THE AFTERSHOCK

CHAPTER 1

America's Bubble Economy

UNDERSTANDING HOW WE PREDICTED THE CURRENT BUBBLEQUAKE FOUR YEARS AGO IS KEY TO UNDERSTANDING WHY OUR LATEST PREDICTIONS ARE CORRECT

When our first book, *American's Bubble Economy,* came out in 2006 (the book proposal was actually submitted 18 months earlier), we were right and almost everyone else was wrong. We don't say this to brag. We say it because it's important for understanding why you should bother to pay attention to us now.

America's Bubble Economy (John Wiley & Sons), accurately predicted the popping of the housing bubble, the collapse of the private debt bubble, the fall of the stock market bubble, the decline of consumer spending, and the widespread pain all this was about to inflict on the rest of our vulnerable, multi-bubble economy. We also predicted the eventual bursting of the dollar bubble and the government debt bubble, which are still ahead. In 2006, these and our many other predictions were largely ignored. Two years later, it started coming true.

How did we see it coming? Certainly not by looking only at current conditions, which, at the time we wrote the first book, still looked pretty darn good. In fact, real estate prices were close to their record highs in 2006. With home values high and credit flowing, American consumers were still happily tapping into their home equity and credit cards to buy all manner of consumer products, from diapers to flat screen TVs, importing goods from around the world, boosting the economies of many nations. Businesses and banks appeared to be in good shape (very few banks were even close to failing), unemployment was relatively low, and Wall Street was still on an upward climb toward its record closing high (Dow 14,164) a year later on October 9, 2007.

With so much seemingly going so well back in 2006, how could we have been so sure that the housing bubble would pop, private credit would start drying up, the stock market would begin to fall, and the broader multi-bubble economy, here and around the globe, would begin a dramatic decline in 2008 and beyond? Our accurate predictions were not a matter of blind luck, nor were they merely a case of perpetual bearish thinking finally having its gloomy day. In 2006, we were able to correctly call the fall of the U.S. housing bubble and its many consequences because we were able to see a *fundamental underlying pattern* that others were—and still are—missing.

In this pattern, we saw bubbles. Lots of them. We saw six big economic bubbles linked together and holding one another up, all supporting a seemingly prosperous U.S. economy. And we also saw that each conjoined bubble was leaning heavily on the others, each poised to potentially pull the others down if any one of these economic bubbles were to someday pop.

In this pattern, we also saw the opposite of big airborne bubbles; we saw the evolving economic facts on the ground. As is always the case with bubbles, the facts on the ground did not justify the volume of the bubbles; therefore sooner or later, we knew they would have to burst. In a little while, we will tell you more about our six big economic bubbles (the first four have already begun to burst and the other two will shortly) and how we knew they were bubbles. For now the point is that economic bubbles, by nature, do not stay afloat forever. Sooner or later, economic reality, like gravity, eventually kicks in, and bubbles do fall. After they burst, they never are able to re-inflate and lift off again. In time, new bubbles may grow, but old popped bubbles generally do not take off again. When the party is over, it's over.

Most people, even most "experts," find it much easier to recognize a bubble (like the Internet bubble of the 1990s) *after* it pops. It is a lot harder to see a bubble *before* it bursts, and much harder still to see an *entire multiple-bubble economy* before it bursts. A single, not-yet-popped bubble can look a lot like real asset growth, and a collection of several not-yet-popped bubbles can look a whole lot like real economic prosperity.

We wrote *America's Bubble Economy* because, based on our unique analysis of the evolving economy, the facts on the ground did not match the bubbles in the sky. By that we mean high-flying asset growth that is not firmly pinned to some underlying real economic driver is not sustainable. For example, real estate prices are typically driven higher by a growing population (increasing demand) and the growing incomes of homebuyers (increasing ability to buy). When populations increase and incomes increase, home prices also increase. On the other hand, if you see home prices increasing, let's say, twice as fast as incomes, then that could mean something unusual is happening to the value of real estate. Why? Because home prices that high are not sustainable without a similar rise in the ability of buyers to keep paying those prices.

Asset bubbles are not always bad. On the way up, they can lift part or all of an economy and spur future economic growth. This certainly was the case with the housing bubble. On the way down, however, they can cause real problems. In fact, the bigger the bubble, the harder the fall.

Our first book identified several economic bubbles that were once part of a seemingly *virtuous upward spiral* that first lifted and supported the U.S. economy over many decades, and are now part of a *vicious downward spiral* that will inevitably harm the U.S. and world economies as these sagging, co-linked bubbles weigh heavily on each other and ultimately burst. These bubbles included: the real estate bubble, stock market bubble, discretionary spending bubble, dollar bubble, and government debt bubble. Despite how well the economy appeared to be doing in 2006, we predicted it would only be two or three years before America's multiple bubbles would begin to decline and eventually even burst.

And that is just what happened. By the third quarter of 2008, home prices and sales had fallen significantly, mortgage defaults and home foreclosures were skyrocketing, commercial and investment banks were going under, unemployment was rising, and the stock market bubble had fallen from its peak of 14,164 in

October 2007 to under 7,000 (DJIA) not much more than a year later. We now offer you this second book in late 2009, as the rest of our conjoined economic bubbles are under tremendous downward pressure and about to fall.

Unlike at any other moment in our history, there is something *fundamentally different* going on this time. Even people who pay no attention to the stock market or the latest economic news say they can just feel it in their gut. Something is different. This is *not* merely a down market cycle, nor is it a typical recession. The difference is the *multi-bubble economy*. With so many linked bubbles now on the descent, the impact of their combined collapse will be far more dangerous than any downturn or recession we've experienced in the past. Unlike in a healthy economy, in this falling *multi-bubble* economy, the usual strategies for returning to our previous prosperity no longer apply. We have, in fact, entered new territory.

We call it a Bubblequake. As in an earthquake, our multi-bubble economy is starting to rumble and crack. Clearly, the real estate, credit, and stock market bubbles have already taken a serious fall, and the financial consequences for the broader U.S. and world economy have been terrible.

Next comes the *Aftershock*. Just when most people think the worst is behind us, we are about to experience the cascading fall of several, co-linked, bursting bubbles that will rock our nation's economy to its core and send deep and destructive financial shock waves around the globe. The Bubblequake fall of the housing, credit, consumer spending, and stock bubbles significantly weakened the world economy. But the coming Aftershock will be far more dangerous. A multi-bubble economy cannot be easily re-inflated. Rather than home prices stabilizing and the U.S. economy recovering in the next year or two, as many "experts" want you to believe, we see serious, groundbreaking new troubles ahead. In fact, the worst is yet to come.

That's the bad news. The good news is the worst is yet to come (with emphasis on the word *yet*). There is still time for individuals and businesses to cover their assets and even find ways to profit in the Bubblequake and Aftershock. But first you have to see it coming.

Prescient Quotes from Our First Book, *America's Bubble Economy*

Stock Market

> *Bottom line: Most stocks are overvalued and on their way down. Will there be some ups and downs? Of course. Is it worth taking a chance on it? We think not. As with real estate, although there may be some potential growth left in the stock market, the timing is very tricky and it's not worth taking the risk. In the short run, you are about as likely to lose as gain. And in the long run, all you will do is lose significantly when stock values begin to seriously plummet. Again, we will show you much better places to put your money.* (p. 139)

The Dow was at 12,100 when published in October 2006.

Real Estate

> *In the near term, the slow collapse of the Real Estate Bubble (in some markets it won't be so slow) will weigh heavily on the stock market. The loss of housing construction jobs, plus the factory and service jobs that support housing construction, will further slow the economy, putting more downward pressure on the stock market.* (p. 73)

Housing prices were at 205 according to Case-Shiller Top 20 Cities Index when published, and are now at 150; we're now losing construction jobs at a rate of 50,000 to 100,000 per month.

Private Credit

> *All adjustable rate loans, credit cards and adjustable or variable mortgages will become an absolute disaster when the bubbles burst. Interest rates will rise dramatically and so will your mortgage and other payments if you don't get out of these soon. Now is a great time to lock in your low long-term interest rates. Don't take a chance; get rid of your evil variable rate mortgage and other big debts now!* (p. 141)

Adjustable rate mortgages helped kick off the housing price collapse and are still one of the leading causes of mortgage default and foreclosure.

Stock Market

> *It is important to point out that all asset bubbles (such as the Stock Market Bubble and Dollar Bubble) will burst in two stages. The first stage will be the bursting of the recent over-valued price bubble. The second stage will be the additional fall in value due to the significant coming downturn in the economy.* (p. 10)

The Dow was at 12,100 when this was published in October 2006.

Collectibles

> *All collectibles crash in value. In fact, if possible, postpone any collectible purchase until after the bubble crash when everything is at bargain basement prices. Not only will they be far cheaper, but your selection becomes huge because so many people need to sell their collectibles to raise money.* (p. 173)

Sotheby's auction revenues fell over 70 percent from the first quarter of 2008 to the first quarter of 2009.

Stock Market

> *Of course, the idea that the stock market at any time is risk free is completely false. Every market has downside risk. Back in the 1950s, 1960s, and 1970s that was understood. It's been a very long time since the experts have tried to tell us there is no risk in the stock market. Guess when it happened before? The last time market cheerleaders tried to get Americans to think of the stock market as risk-free was just before the big 1929 stock market crash that led to the Great Depression. Coincidence?*
>
> *A bloated overvalued market (Dow up tenfold in 20 years), now "stable" from mid 2000 to 2005 (also known as stagnant), plus cheerleaders telling us that there is no downside risk, all add up to one thing: a Stock Market Bubble on the edge.* (p. 110)

The Dow was at 12,100 when this was published in October 2006.

Because We Were Right, Now You Can Be Right, Too

Most people think the economy will get better soon. It won't. We can tell you what you want to hear, or we can help you enormously by showing you how to prepare and protect yourself while you still can, and find opportunities to profit during the dramatically changing times ahead. We may not give you news you like, but it will definitely be news you can do something about.

Now is not the time to look for someone to cheer you up. Now is the time to get it right because you won't care in three years if someone cheered you up today. What you will care about is that you made the right financial decisions. It matters more now than ever before that you get it right today. Please remember this important point as you go through the rest of the book: *It's only bad news for your personal economy if you don't do anything about it.*

Before we go on, we should take a moment to assure you that we are neither bulls nor bears. We are not gold bugs, stock boosters or detractors, currency pushers, or doom-and-gloom crusaders. We have no particular political ideology to endorse, and no dogmatic future to promote. We are simply intensely interested in patterns, big evolving changes over broad sweeps of time. And because we look for patterns, we are willing to see them—often where others do not.

At the time we wrote *America's Bubble Economy*, we saw, and continue to see, some patterns in the U.S. and world economies that others are missing. We see these patterns, in part because we are very good at analyzing the larger picture. In fact, co-author David Wiedemer has developed a fascinating new "Theory of Economic Evolution" (introduced briefly in Chapter 8) that helps explain and even predict large economic patterns that most people simply don't see.

But there's more to it than that. We can see things happening in the economy right now that many others do not because at this particular moment in history, it's very hard for most people—even most experts—to face what is actually going on. The U.S. economy has been such a strong and prosperous powerhouse for so long, it's difficult to imagine anything else. Our goal is not to convince you of anything you wouldn't conclude for yourself, if you had the right facts, based on objective science and logical analysis. Most people don't get the right facts because most financial analysis today is based on preconceived ideas about a hoped-for positive outcome. People want analysis that says the economy will improve in the future, not get worse. So they look for ways to create that analysis, drawing on outdated ideas like repeating "market cycles," to support their case. Such is human nature. We all naturally prefer a future that is better than the past, and luckily for many Americans, that is what we have enjoyed.

Not so this time.

Again, just to be clear, we are not intrinsically pessimistic, either by personality or by policy. We're just calling it as we see it. Wouldn't you really rather hear the truth?

At an April 2008 presentation about *America's Bubble Economy* to Hogan & Hartson, one of the nation's largest law firms, co-author Robert Wiedemer said he wished people would treat economists and financial analysts as doctors rather than people trying to cheer you up. What if you had pneumonia and all your doctor did was just slap you on the back and say, "Don't worry about it. Take two aspirin and you'll be fine in a couple days." Wouldn't you prefer the most honest diagnosis and best treatment possible? But when it comes to the health of the economy, most people only want good news. Even in the face of some very damning economic facts, people still want convincing analysis of why the economy is about to turn around and get better soon. The vast majority of financial analysts and economists are simply responding to the market. That's what people want and that's what they get.

Despite this universal desire for good news, and despite the fact that the housing and stock markets were both near their peaks in 2006, our first book did remarkably well. In fact, *America's Bubble Economy* has been discussed in articles in Barron's, Reuters, Bottom Line, and the Associated Press. The book was also selected as one of the 30 best business books of 2006 by Kiplinger's. Co-author Robert Wiedemer has been invited to speak before the New York Hedge Fund Roundtable, The World Bank, and on CNBC's popular morning show *Squawk Box.* So clearly there are people who are interested in unbiased financial analysis, even when that analysis says there are fundamental problems in the economy that won't be resolved easily or soon.

Yet even within this supportive audience, and among our most devoted fans, there is still a wish for optimism, a deep-down feeling that the future couldn't possibly be as bad as we say. We understand that. All we can offer is realism, based on facts and logical analysis. In the end, that is what's best for all of us.

Our original analysis showed us that the real estate bubble would be the first to burst, putting downward pressure on the stock market and discretionary spending bubbles, kicking off a major global recession. Now, in this book, we want to tell you more details about the next round of bubbles to fall while there's still time to protect your assets and position yourself to survive and thrive in this dangerous, yet potentially highly profitable new environment. Just like in the first book, our analysis is based on a reliable theory of economic evolution, backed up by cold, hard facts, and not random guesses.

Although much of what we predicted has come true, there is still much that we predicted in our first book that hasn't happened yet because most of the impact of the multi-bubble collapse is still to come. This is good news because it means you still have time to get prepared.

Didn't Other Bearish Analysts Get It Right, Too?

Not really. Back in 2006, there was a small group of more bearish financial analysts and economists who correctly predicted some slices of the problems we are seeing now. We say hats off to them for having the courage and insight to make what they felt were honest, if not popular, appraisals of the economy. It takes guts to yell "fire" when so few people believe you because they can't even smell the smoke.

However, there are times when smart people make the right predictions for the wrong reasons, or for incomplete reasons, and that makes them less likely to be right again in the future. In this case, there are some important differences between our way of thinking and the typical "bear" analysis, which we think you ought to know about. For one thing, a lot of bear analysis tends to be apocalyptic in tone and predictions, sometimes going so far as to call for drastic survivalist measures, such as growing your own food. Unlike these true Doom-and-Gloomers, we see nothing of the kind occurring.

Another important difference is that so much bear analysis seems to carry moralistic overtones, implying that, individually and collectively, we have somehow sinned by borrowing too much money and we will eventually have to pay a hefty price for our immoral ways. We certainly disagree that borrowing money is morally wrong. In fact, depending on the circumstances, borrowing money can be the best course of action for an individual, a business, or a government. Without the leveraging power of credit, it's very difficult to start business, go to medical school, build a bridge, or lift an economy. Borrowing is not intrinsically "wrong." Clearly, some debts are a lot smarter than others. For example, borrowing money to go to college for four years en route to a lucrative career is smart. Borrowing the same amount to spend four years at Disney World is not. (More on "smart" versus "dumb" debt in the next chapter.) For now, the point is that borrowing money, in and of itself, is not the biggest problem—*stupidity* is. Other bearish analysts who complain about too much borrowing tend to miss this vital distinction entirely.

The biggest difference between our predictions and the rest is that the other bearish analyses tend to ignore the bigger picture of our *multi-bubble economy*. Even the most realistic bearish thinkers fail to see all the bubbles in today's economy, and they certainly miss the critically important *interactions* between them. Instead, if they mention any bubbles at all, they often focus on one singular bubble—like the credit crunch, or the housing bubble, or the growing federal debt. They are right to point out that all is not well, but they generally don't connect the dots from their single complaint to the larger multi-bubble economy. More importantly, they don't see the crucial interactions between all these bubbles that are currently pulling our economy down.

Honestly, if all we had was a credit crunch or a fallen housing bubble, our economy could get past it fairly unscathed. Unfortunately, our multi-bubble problem is much bigger than any one of its parts. As we discuss in more detail in the next chapter, these bubbles worked together in a seemingly *virtuous upward spiral* to lift the economy up in the longest economic expansion in U.S. history, and together these linked bubbles will work in concert in a *vicious downward spiral* to bring the economy down.

Partly because of their single-bubble focus and partly because of the general market need to be more optimistic about the future, most bears predict an upturn in the economy coming shortly, perhaps as early as 2010. Grumpier bears say it could take as long as four or five years, but most see a turnaround ahead fairly soon.

Unfortunately, that's not the way it works in a multi-bubble economy. Even healthy economies don't naturally grow bigger and bigger without end. Multi-bubble economies certainly cannot stay afloat forever. There are real forces that push economies up and real forces that push economies down. These forces are not static, like repeating market cycles, but evolve over time. Based on our science-backed analysis of the evolving economy, which is neither bullish nor bearish, but simply realistic, the U.S. economy is in the middle of a long-term fundamental change. It is evolving, not merely cycling back and forth between expansion and contraction. Therefore, the multi-bubble economy will not automatically turn around and go back up again in the next few years. The idea that the economy is evolving, not merely expanding and contracting and expanding again, is a key difference between us and other bearish analysts, and it is certainly a huge difference between us and the bullish "experts."

We Said, They Said: Our Score Card

In Oct 2006, we said	Experts said	What actually happened from October 2006 to December 2008
Stocks will fall	Stocks will rise	Dow 12,100 went to 8600 NASDAQ 2350 went to 1575
Housing will fall	Housing will rebound	Case-Shiller Top 20 Cities Composite Index 205 went to 150
Commercial real estate will fall	Commercial real estate will rise rapidly	Dow Jones U.S. Real Estate Index 82 went to 37
Dollar will fall (euro will rise)	Dollar stable	Euro $1.29 went to $1.40
Gold will rise	Gold at peak	Spot Gold $600/ounce went to $880
Bear funds will rise	Bear funds will not rise	ProFunds Ultra Bear Fund (UPPIX) rose 9.13 percent annually for last 3 years (as of 12/31/08)
International bond funds safe	International bond funds not safe	T. Rowe Price International bond fund (RPIBX) had an average annual return of 4.28 percent for last three years, as of March 31, 2009
Foreign stocks will go down	Foreign stocks will rise	FTSE 100 (London) down 30 percent
Commodities will fall	Commodities will rise	Copper down almost 50 percent

For an update through 31 December 2009, please visit our web site; www.aftershockeconomy.com/scorecard.

What Did the "Experts" Say?

We enjoyed an article in the January 12, 2009 issue of *BusinessWeek* magazine so much that we thought we'd include some of it for you here. What follows are observations and predictions about the economy in 2008 by well-known and highly trained financial professionals, writers, investors and economists. It is interesting to note that, in the course of our research for this book, we keep a file of predictions and observations that well-known analysts, investors and economists make. In reviewing the file for this section of the book, we noticed that it is very hard to find *anyone* who will predict economic movements beyond a year. Hence, it limits just how wrong they can be. It also makes it very hard to compare our long-term predictions that were made in October 2006 with anyone else since so few people in 2006 made predictions for 2008 or 2009. That we can show the accuracy of our predictions against much easier short-term predictions that other people make shows the power of our financial and economic analyses in understanding our economy. For most investors, long-term predictions are really the most important because most investors are investing for the long term, whether it be for capital appreciation, capital preservation, or for retirement. Financial analysis has to be accurate long-term to really be valuable.

Stock Market

"A very powerful and durable rally is in the works. But it may need another couple of days to lift off. Hold the fort and keep the faith!" A quote from Richard Band, editor, *Profitable Investing Letter*, Mar. 27, 2008.

What Actually Happened: At the time of Band's comment, the Dow Jones industrial average was at 12,300. By December, 2008 it was at 8,500.

AIG

AIG "could have huge gains in the second quarter." A quote from Bijan Moazami, distinguished analyst, Friedman, Billings, Ramsey, May 9, 2008.

What Actually Happened: AIG lost $5 billion in the second quarter 2008 and $25 billion in the next. It was taken over in September by the U.S. government, which will spend or lend $150 billion to keep it going.

Mortgages

"I think this is a case where Freddie Mac and Fannie Mae are fundamentally sound. They're not in danger of going under. . . . I think they are in good shape going forward." From Barney Frank (D-Mass.), House Financial Services Committee chairman, July 14, 2008.

What Actually Happened: Within two months of Rep. Frank's comments, the government forced the mortgage giants into conservatorships and pledged to invest up to $100 billion in each.

GDP Growth

"I'm not an economist but I do believe that we're growing." President George W. Bush, in a July 15, 2008 press conference.

What Actually Happened: Gross domestic product shrank at a 0.5 percent annual rate in the July-September quarter. On December 1, the National Bureau of Economic Research declared that a recession had begun in December 2007.

Banks

"I think Bob Steel's the one guy I trust to turn this bank around, which is why I've told you on weakness to buy Wachovia." Jim Cramer, CNBC commentator, March 11, 2008.

What Actually Happened: Within two weeks of Cramer's comment, Wachovia came within hours of failure as depositors fled. Steel eventually agreed to a takeover by Wells Fargo. Wachovia shares lost half their value from September 15 to December 29.

Homes

"Existing-Home Sales to Trend Up in 2008" from the headline of a National Association of Realtors press release, December 9, 2007.

What Actually Happened: NAR said November 2008 sales were running at an annual rate of 4.5 million—down 11 percent from a year earlier—in the worst housing slump since the Depression.

Oil

"I think you'll see [oil prices at] $150 a barrel by the end of the year" a quote from T. Boone Pickens, one of the wealthiest and most respected oilmen today, on June 20, 2008.

What Actually Happened: Oil was then around $135 a barrel. By late December it was below $40.

Banks

"I expect there will be some failures. . . . I don't anticipate any serious problems of that sort among the large internationally active banks that make up a very substantial part of our banking system." Ben Bernanke, Federal Reserve chairman, Feb. 28, 2008.

What Actually Happened: In September 2008, Washington Mutual became the largest financial institution in U.S. history to fail. Citigroup needed an even bigger rescue in November.

Madoff

"In today's regulatory environment, it's virtually impossible to violate rules." Famous last words from Bernard Madoff, money manager, Oct. 20, 2007.

What Actually Happened: About a year later, Madoff—who once headed the NASDAQ Stock Market—told investigators he had cost his investors $50 billion in an alleged Ponzi scheme.

More Wrong Predictions

Following is another collection of predictions made about 2008 that was published in *New York* magazine. Again, these are all professional financial analysts that represent the opinions of many, many others, even if they are not quoted directly.

Stock Market

"Question: What do you call it when an $8 billion asset write-down translates into a $30 billion loss in market cap? Answer: an overreaction . . . . Smart investors should buy [Merrill Lynch] stock before everyone else comes to their senses." From Jon Birger in *Fortune's Investors Guide 2008*.

What Actually Happened: Merrill's shares plummeted 77 percent and it had to be rescued by Bank of America through a deal brokered by the U.S. Treasury.

Housing

"There are [financial firms] that have been tainted by this huge credit problem . . . . Fannie Mae and Freddie Mac have been pummeled. Our stress-test analysis indicates those stocks are at bargain basement prices." Sarah Ketterer, a leading expert on housing, and CEO of Causeway Capital Management, quoted in *Fortune's Investors Guide 2008*.

What Actually Happened: Shares of Fannie and Freddie have lost 90 percent of their value and the federal government placed these two lenders under "conservatorship" in September 2009.

Stock Market

"Garzarelli is advising investors to buy some of the most beaten-down stocks, including those of giant financial institutions such as Lehman Brothers, Bear Stearns, and Merrill Lynch. What would cause her to turn bearish? Not much. 'Our indicators are extremely bullish.'" Quote from Elaine Garzarelli, president of Garzarelli Capital and one of the most outstanding analysts on Wall Street, in *Business Week's Investment Outlook 2008*.

What Actually Happened: None of these firms still exist. Lehman went bankrupt. J P Morgan and Chase bought Bear Stearns in a fire sale. Merrill was sold to Bank of America.

General Electric

"CEO Jeffrey Immelt has been leading a successful makeover at General Electric, though you wouldn't know it from GE's flaccid stock price. Our bet is that in a stormy market investors will gravitate toward the ultimate blue chip." Jon Birger, senior writer, in *Fortune's Investors Guide 2008.*

What Actually Happened: GE's stock price fell 55 percent and it lost its triple-A credit rating.

Banks

"A lot of people think Bank of America will cut its dividend, but I don't think there's a chance in the world. I think they'll raise it this year; they have raised it a little in each of the past 20 to 25 years. My target price for the stock is $55." A quote from Archie MacAllaster, chairman of MacAllaster Pitfield MacKay in *Barron's 2008 Roundtable.*

What Actually Happened: Bank of America saw its stock drop below $10 and cut its dividend by 50 percent.

Goldman Sachs

"Goldman Sachs makes more money than every other brokerage firm in New York combined and finishes the year at $300 a share. Not a prediction—an inevitability." A quote from James J. Cramer in his "Future of Business" column in *New York* Magazine.

What Actually Happened: Goldman Sachs' share price fell to $78 in December 2008. The firm also announced a $2.2 billion quarterly loss, its first since going public.

Despite the hit to its stock (which has almost doubled by July 2009) Goldman has by far the best management and skills on the Street and will have a consistently better performance than any other major firm.

Predictions from Ben Bernanke and Henry Paulson—We Trust These Officials With Our Economy

Federal Reserve Chairman Ben Bernanke and former Treasury Secretary Henry Paulson unfortunately make an incredible team for wrong forecasts. With the performance below, you have to wonder why they are given so much credibility.

March 28th, 2007—Ben Bernanke: "At this juncture . . . the impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained."

March 30, 2007—Dow Jones @ 12,354.

April 20th, 2007—Paulson: "I don't see (subprime mortgage market troubles) imposing a serious problem. I think it's going to be largely contained." "All the signs I look at" show "the housing market is at or near the bottom."

July 12th, 2007—Paulson: "This is far and away the strongest global economy I've seen in my business lifetime."

August 1st, 2007—Paulson: "I see the underlying economy as being very healthy."

October 15th, 2007—Bernanke: "It is not the responsibility of the Federal Reserve—nor would it be appropriate—to protect lenders and investors from the consequences of their financial decisions."

February 28th, 2008—Paulson: "I'm seeing a series of ideas suggested involving major government intervention in the housing market, and these things are usually presented or sold as a way of helping homeowners stay in their homes. Then when you look at them more carefully what they really amount to is a bailout for financial institutions or Wall Street."

May 7, 2008—Paulson: "The worst is likely to be behind us."

June 9th, 2008—Bernanke: "Despite a recent spike in the nation's unemployment rate, the danger that the economy has fallen into a 'substantial downturn' appears to have waned."

July 16th, 2008—Bernanke: "[Freddie and Fannie] . . . will make it through the storm." "[are] . . . in no danger of failing.", ". . . adequately capitalized."

July 31, 2008—Dow Jones @ 11,378

August 10th, 2008—Paulson: "We have no plans to insert money into either of those two institutions" (Fannie Mae and Freddie Mac).

September 8th, 2008—Fannie and Freddie nationalized. The taxpayer is on the hook for an estimated $1–1.5. Over $5 trillion is added to the nation's balance sheet.

Where We Have Been Wrong

There is one area in which we have been wrong before and we will likely be wrong again. Timing exactly when each bubble will pop in the Bubblequake and Aftershock is nearly impossible to accurately predict. Timing is always tricky when making any forecast but if you know what to look for, the *overall trends* of each phase are predictable, even if the exact moments when specific triggers that will activate them are not. That's why, throughout this book, we give general time ranges for our ideas about future events, and we attempt to link these to other signs and events, rather than trying to predict specific dates.

Recognizing the overall trend is absolutely essential. If you know winter is coming, you can prepare yourself without knowing exactly when the first snowflake will fall. On the other hand, if you are expecting summer, that first winter storm is really going to snow you.

An old stock market saying is "the trend is your friend." We say "the trend is your best way to defend" against the dangers of trying to time the Bubblequake and Aftershock. If you know the general trend, your asset protection and investment timing will, on average, be fine (see Chapters 5–7). Even if the trend seems to go against you for a while, if you follow a fundamental trend that you know may take years to play out, you will do fine. This type of fundamental, long-term trend thinking is key for success during each stage of the Bubblequake.

Within an overall trend, there will be moments, or trigger points, when dramatic shifts occur. For example, in the fall of 2008, the stock market dropped more than 20 percent of its value within a few weeks of Lehman Brothers going bankrupt. Predicting the occurrence or the timing of that kind of specific event is essentially impossible. What we did predict with complete accuracy was the overall trend of an over-valued stock market bubble poised for a fall.

Specific trigger points are so hard to predict because their activation usually involves a high psychological component, and try as we might, the timing of human psychology is not especially predictable. For example, if you objectively analyzed the Internet stock bubble prior to its fall, you'd know that it was bound to pop at some point, but you'd be hard pressed to know when and what would kick it off. Even today, well *after* the fact, it is still hard to figure out exactly what triggered the pop of the dot-com bubble in March 2000. Was it the collapse of Microstrategy's stock price due to the restatement of earnings forced on it by Price Waterhouse Coopers in March? That's a good guess, but not necessarily correct. Other people have their own guesses, but in talking to many investment bankers and venture capitalists, we have found no unified agreement on what the actual trigger point was, even though they are experts in this area and this was a major economic event that affected each of them quite personally. All we know with certainty is that we had a bubble in Internet-related stock prices, and in March 2000 investor psychology dramatically changed.

When thinking about how bubbles in general tend to burst, it's interesting to note that during the fall of the Internet bubble, NASDAQ didn't just collapse and go straight down. Over the course of nine months, it fell and recovered, at one point rising not too far from its peak, before its eventual final fall. Even right in the middle of the dot-com crash, most people didn't see it. In fact, the mantra among investors at the time was that we were simply moving away from a business-to-consumer model toward a business-to-business model, and then to an infrastructure play. The infrastructure play begat the rise of the fiber–optic companies in the summer of 2000, most notably JDS Uniphase, before it, too, collapsed. Ultimately, NASDAQ would rise and fall again many times until it had fallen 75 percent from its all-time high of nearly 4700 in early 2000 until finally hitting its low point of 1170 in September 2002.

The moral of the story is that it's hard to predict specific triggers before they happen. Even *after* the fact, it can be hard to understand the timing of specific events. Why did investors change their psychology in March 2000 instead of in August 1999? After March 2000, why did people think that infrastructure was the next big thing? Did they just want to keep the old Internet boom alive or were they really sold on infrastructure? Most investor decision-making turned out to be based on psychology, not real analysis of the underlying trends. Eventually, all the stocks in the infrastructure play collapsed. Even wishful thinking can't grow a bubble forever.

So when people challenge us to tell them exactly when each phase of the Aftershock will begin, we don't take the bait. All we can say with certainty is that the transitions from each phase to the next will involve triggering events, the timing of which will be as hard to predict as the popping of the Internet bubble.

We do know that trends can take years to assert themselves fully, and along the way, long-term trends can be temporarily delayed, even briefly reversed, by a short-term trend. For example, the long-term trend of a falling stock market bubble was temporarily delayed by the short-term trend of the rise of the private equity company buyout bubble. With easy credit at very low interest rates, private equity and hedge funds raised enormous amounts of money and went on a company buying spree the likes of which we've never seen. Total merger and acquisition transaction values went from $441 billion in 2002 to $1.4 trillion in 2006 and $1.3 trillion in 2007, according to Mergerstat. This, plus generally good investor psychology, drove stock prices higher, helping to boom the Dow above 14,000 in 2007. Of course, it also made the stock market bubble much bigger, and therefore, much more vulnerable to the credit crunch, caused by the fall of the housing bubble and the private debt bubble (see Chapter 2).

In another example, the potential full negative impact of the collapse in home prices on the economy and stock market in 2008 was blunted by the short-term trend of lenders making much riskier loans in 2006. Historically, July 2005 was when home prices stopped going up in many places or slowed their growth dramatically. They weren't falling, but they weren't rising rapidly anymore, thus setting the stage for the sub-prime and adjustable-rate mortgage collapse. Lenders' willingness to participate in riskier home loans in 2006 and early 2007 to some extent, slowed the fall of the housing bubble and delayed its impact on the economy and the stock market for a while. In our first book, we couldn't give the exact timing of the housing bubble fall because it was hard for us to predict just how crazy lenders would get. We did know they could not keep it up forever, and in fact, they didn't. Lenders pulled back on their risky loans very dramatically in 2007, triggering an even bigger collapse in real estate prices.

Thus, our 2006 prediction of the long-term trend of falling housing and stock market prices began to emerge with a vengeance by the end of 2007 and early 2008, firmly establishing the start of the Bubblequake. And, if it were not for emergency measures by the Federal Reserve to lower interest rates in the spring of

2008, which were almost unprecedented, the stock market would have fallen much further. *But the dramatic government intervention only served to temporarily blunt (not stop) the effects of the underlying fundamental trend, which is why the falling housing, private debt, and stock market bubbles are still on their way down.* In time, these trends will also include a major Aftershock that few others are anticipating: the bursting of the dollar and government debt bubbles. When will that happen? All we can say with any reasonable degree of confidence is that the full force of the Aftershock will likely begin in the next one to three years.

Love us or hate us—the fact is we got it right before, while others got it wrong. And unfortunately, we will be right again, for the very same reasons. As Paul Farrell, senior columnist for Dow Jones *MarketWatch*, said about our first book in February 2008, "*America's Bubble Economy*'s prediction, though ignored, was accurate."

Leave 'em Laughing

After reading some of the quotes from senior financial analysts and financial leaders you may be laughing or crying. But, to be sure you start the book with a little humor in an otherwise difficult situation, we thought we would close out the first chapter of the book with the following bit of humor. We were e-mailed this by one of our supporters. It's not ours, but we honestly don't know who to give credit to. So, if someone knows who wrote this, e-mail or call us and we'll post it on our web site.

You Know It's a Bad Economy When . . .

1. Your bank returns your check marked as "insufficient funds" and you have to call them and ask if they meant you or them.
2. The most highly-paid job is now jury service.
3. People in Beverly Hills fire their nannies and are learning their children's names.
4. McDonalds is selling the quarter- ouncer.
5. Obama met with small businesses—GE, Chrysler, Citigroup, and GM—to discuss the stimulus package.
6. Hot Wheels and Matchbox cars are now trading at higher prices than GM's stock.
7. You got a predeclined credit card in the mail.
8. Your "reality check" bounced.

9. The stock market indexes have been renamed: the Dow is now the "Down-Jones" and the S&P is the "Substandard & Very Poor".
10. Webster's is keeping its dictionary length constant by adding words that are commonly used, such as Twitter, tweet, and Facebook, and dropping those no longer needed, such as retirement, pensions, and Social Security. The continuing evolution of the experts' predictions is covered in our subscription newsletter at www.aftershockeconomy.com/newsletter.

He Said What?!

In an appearance on CNBC's "Squawk Box" in February 2008, co-author Bob Wiedemer offered what must have seemed like a whacky investment idea: *Start shorting housing stocks*. The analysts on the program cringed at what they considered yesterday's news—perhaps good advice the year before, but clearly no longer valid. Bob stood his ground. Based not on a lucky guess or some morbid wish for a crash, but based on the science-backed analysis of our first book, Bob knew the full collapse of the housing bubble (and therefore the construction industry) still lay ahead.

By now, we all know he was very right. Homebuilders' stocks fell by almost 50 percent over the next year, according to the Dow Jones U.S. Home Construction Index, which fell from 20 in February 2008 to 10 in December 2008. It would have been a tidy profit for any investor, especially if you were wise enough to use LEAPs (Long-Term Equity Anticipation Securities, which are publicly traded options contracts with expiration dates longer than one year)—one of our many investment suggestions. If you have an underlying theory that predicts overall trends, based on cold, hard facts, you don't have to run with the pack. Without trying to precisely "time the market," if you know the overall trend, you can stay out in front of the curve.

In fact, while the cameras were still rolling and the experts were still telling him he was dead wrong, Bob knew that eventually *all* the major publicly traded homebuilders would not just decline, they would eventually go bankrupt. Naturally, he didn't dare say such a thing. (You don't get invited back on these shows if you are too pessimistic about stocks.) But, on that particular prediction, we know Bob will be quite right again. Without an underlying theory of economic evolution to base one's investment ideas on, even the "experts" don't realize just how fundamental the coming changes will be.