Book ONE

Why a Stock Market Crash, Monetary Deflation and Economic Depression Are Likely To Occur Soon

Part I

The Case for Crash and Depression

Uncomfortable woman in car: "I'm sitting on something!"
W.C. Fields: "I lost mine in the stock market."

—*International House* (1933)

Chapter 1:

A Myth Exposed

How many times over the past decade have you heard glowing reports about the "New Economy"? Hundreds, maybe thousands of times, right? Those of you who have been living on a desert island or who are reading this book fifty years from now can experience the same thing vicariously through Figure 1-1, which displays the accelerating frequency with which the global media have been referring to the "New Economy" year after year. It's been everywhere. Economists celebrate the broadening "service economy" and proclaim that economic growth in the new Information Age has been "unprecedented" in its vibrancy, resilience and scope. Rhetoric is cheap. Evidence is something else.

What would you say if you discovered that we have not had anything near a New Economy, that all that talk is a lie? This chapter is going to show you that the vaunted economic expansion of recent decades in the world's leading economic power, the United States — much less the rest of the world — is far less impressive than you are being led to believe.

First take a look at Figure 1-2, which depicts the U.S. stock market from its low in 1932 during the Great Depression all the way to the present. This graph delineates five phases — or "waves" — of rise and fall.

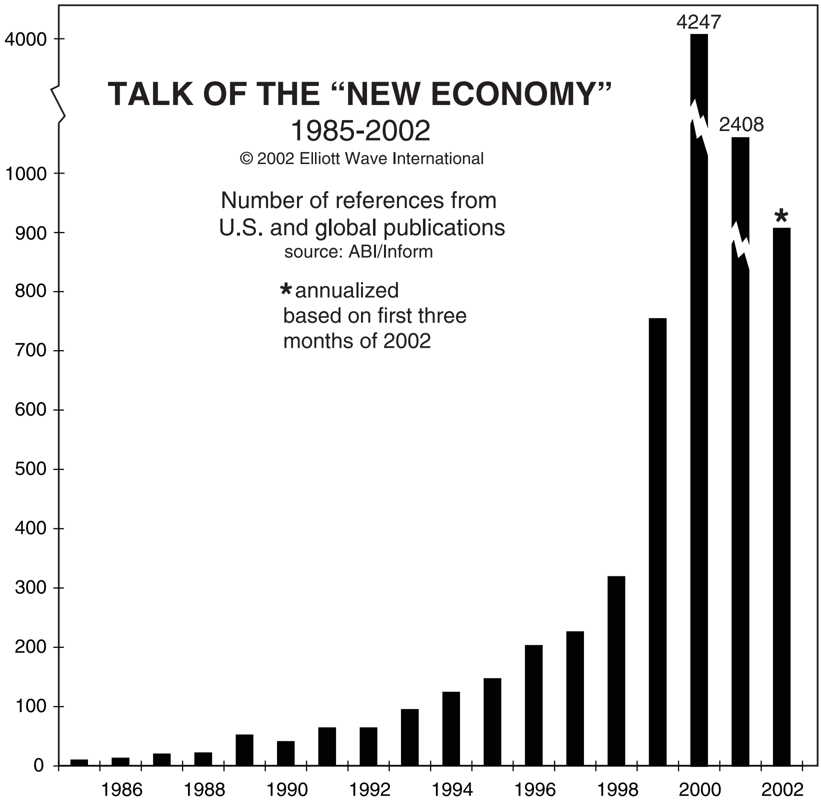


Figure 1-1

The notes on the chart summarize a shocking fact: The economic expansion during the latest phase, wave V, which lasted from 1974 to 2000, was demonstrably weaker than that during the preceding rising phase, wave III, which lasted from 1942 to 1966. Both periods sported a persistent bull market in stocks that lasted about a quarter century, so in that sense, they are quite similar. One noticeable difference is that the DJIA gained only 971 percent during wave III but a remarkable 1930 percent during wave V, twice the amount. This tremendous bull market in stocks in wave V is the great "boom" that people feel in their bones. Yet as you are about to see, the economic vigor

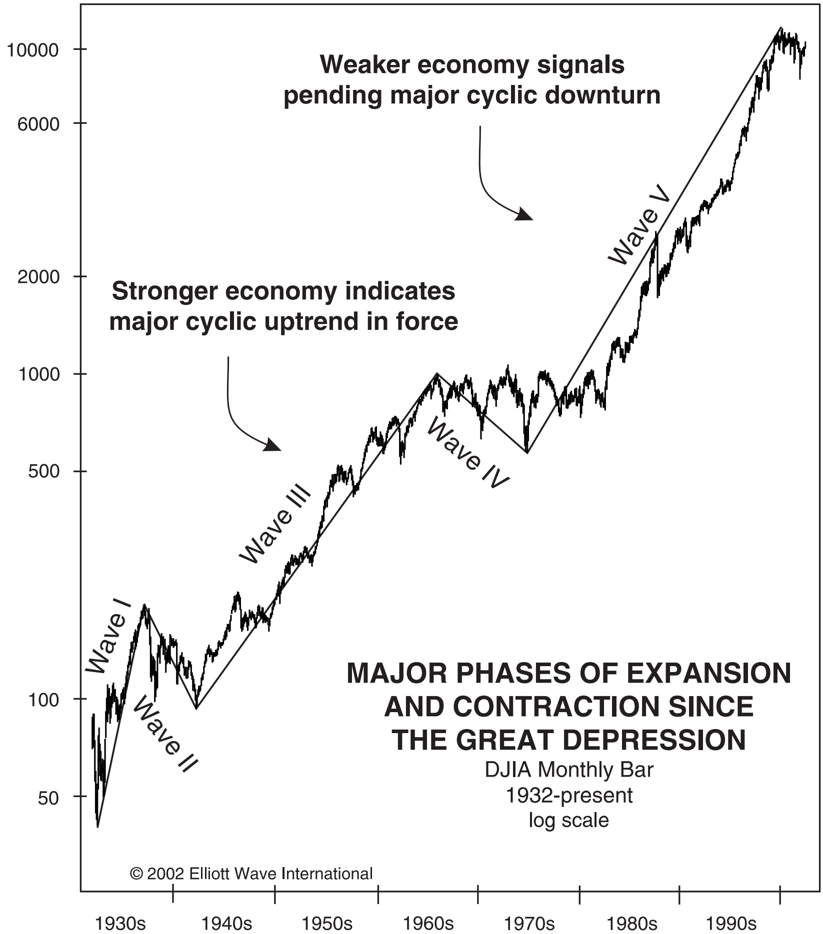


Figure 1-2

and financial health of wave V, the one that has received so much radiant press, failed to measure up to those of wave III by every meaningful comparison.

Please go through the following citations one by one. (Economists do not have all the data from the 1940s, so in some cases, our data for wave III begin later.) After you absorb this information, we will set to the task of finding out what it means.

Comparative Measures of Economic Health

(see Figure 1-3)

Gross Domestic Product

- In wave III, from 1942 to 1966, the average annual real GDP growth rate was **4.5** percent.
- In wave V, from 1975 through 1999, it was only **3.2** percent.

Industrial Production

- In wave III, the average annual gain in industrial production was **5.3** percent.
- In wave V, it was only **3.4** percent.

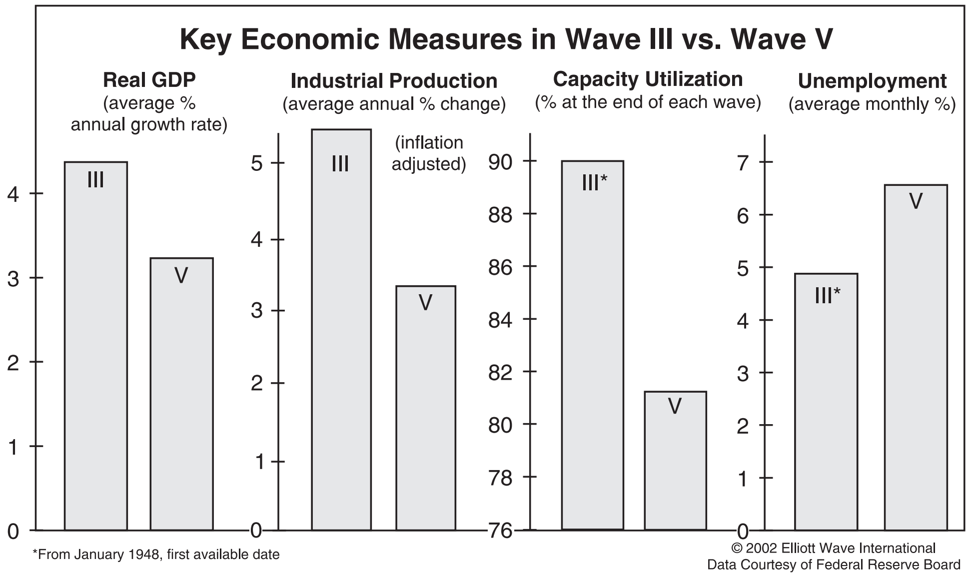


Figure 1-3

Combining GDP and industrial production figures, we may generalize from the reported data that the economic power of wave V was one-third less than that of wave III.

Capacity Utilization

Factories' capacity utilization depicts the energy of an economic expansion compared to the infrastructure's ability to handle it.

- In wave III from 1948 (when figures became available), capacity utilization rose 22 percent to **91.5** percent in June 1966 and stayed high through the late 1960s.

- In wave V, capacity utilization was net flat, peaking in January 1995 at **84.4** percent. U.S. plants were producing at only 82.7 percent of capacity at the ensuing peak in June 2000.

Unemployment Rate

This is an economic measure of *ill* health.

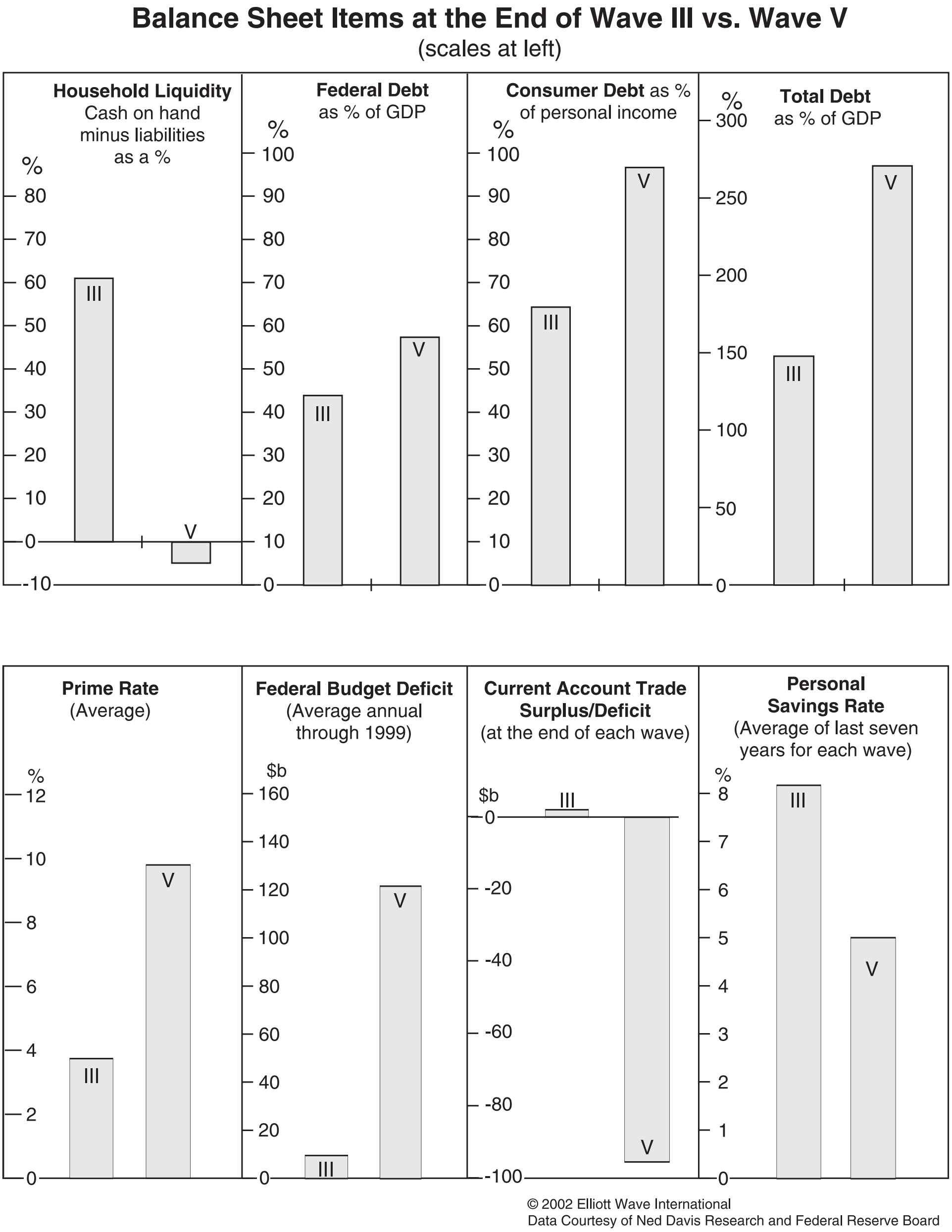
- In wave III from 1948 (when data became available), the monthly average of the unemployment rate was 4.9 percent.

- In wave V, it was 6.6 percent.

Comparative Measures of Debt, Deficits and Liquidity

(see Figure 1-4)

To grasp the full measure of the underlying weakness of wave V's "fundamentals," one must look beyond economic figures to the corporate, household and government balance sheets that underlie those results.


Balance Sheet Items at the End of Wave III vs. Wave V
(scales at left)
Household Liquidity
Cash on hand minus liabilities as a %
%
80
70
60
50
40
30
20
10
0
-10
III
V
Federal Debt
as % of GDP
%
100
90
80
70
60
50
40
30
20
10
0
III
V
Consumer Debt as % of personal income
%
100
90
80
70
60
50
40
30
20
10
0
III
V
Total Debt
as % of GDP
%
300
250
200
150
100
50
0
III
V
Prime Rate
(Average)
%
12
10
8
6
4
2
0
III
V
Federal Budget Deficit
(Average annual through 1999)
$b
160
140
120
100
80
60
40
20
0
III
V
Current Account Trade Surplus/Deficit
(at the end of each wave)
$b
0
-20
-40
-60
-80
-100
III
V
Personal Savings Rate
(Average of last seven years for each wave)
%
8
7
6
5
4
3
2
1
0
III
V
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Data Courtesy of Ned Davis Research and Federal Reserve Board

Figure 1-4

Households' Liquid Assets

- At the end of wave III, households' liquid assets were **161** percent of liabilities.

- At the end of wave V, households' liquid assets were **93** percent of liabilities, meaning that they had *less cash on hand than they had liabilities*.

Federal Debt

- At the end of wave III, federal debt was **43.9** percent of GDP.

- At the end of wave V, it was **58.6** percent.

Consumer Debt

- At the end of wave III, consumer debt was **64** percent of annual disposable personal income.

- At the end of wave V, it was **97** percent.

Total Debt as a Percent of GDP

- During wave III, from 1949 to 1966, total credit market debt as a percentage of GDP slipped slightly from **151** percent to **148** percent.

- In wave V, it rose from **172** percent to **269** percent.

Prime Rate

- In wave III, the prime rate of interest, the cost of money for the highest quality corporate borrowers, averaged **3.74** percent.

- In wave V, it averaged 9.66 percent, nearly three times as high.

Federal Budget Deficit

- In wave III, federal budget deficits were not sustained. The only consecutive years of deficits were in the war years of 1942-1946. The average annual federal deficit was less than **$9** billion.

- In wave V, the annual federal deficit averaged **$127** billion, which is far greater even when adjusted for inflation.

Current Account Trade Figures

- At the end of wave III, the U.S. showed a net Current Account trade *surplus* of **$1.3** billion.

- At the end of wave V, the Current Account showed a record *deficit* of **$96.2** billion.

Personal Savings Rate

- In wave III, the personal savings rate followed a fairly flat trend, bottoming at **6.5** percent of disposable personal income in February 1969.

- In wave V, the personal savings rate dropped persistently, falling to a record low of **0.5** percent in March 2000.

U.S. Balance Sheet (not shown)

- At the end of wave III, the U.S. was a net **creditor**.

- At the end of wave V, the U.S. was a net **debtor**, owing a record $2 trillion more to foreigners than it is owed.

These figures, dramatic as they are, do not reveal the full extent of wave V's inferior relative performance because both the government's economic reports and corporate accounting methods changed during wave V in such a way as to overstate wave V's economic vigor. If we adjusted for those cosmetic alterations, most of these figures would reveal an even greater dichotomy between the two periods. If we begin wave V's figures in 1982 to put the expansion in the best possible light, they change little and in a few cases are worse. If the Dow were to manage a new high in coming months, we would have to add the weak economic and financial figures of the past two years to wave V's average performance, which would drag it down even more. So you see, *it has not been a New Economy after all* but rather a comparatively lackluster one.

Economic Deterioration During the Final Decade of Wave V

The economic expansion waned not only on a long-term basis but also on a near-term basis, within wave V. While real GDP stayed fairly steady throughout the bull market, some measures showed a subtle but persistent slowdown in economic vibrancy. For example, average annual corporate profit growth fell from **10.8** percent in the first 15 years of the bull market to **8.8** percent in the 1990s, a decline of about **20** percent. From the stock market's low in September/October 1998 through the third quarter of 2000 (the peak of economic performance for that period), profit growth averaged only **4.6** percent, revealing further slowing as wave V crested.

Portent of Reversal?

Collectively, these statistics reveal that the economic advance in the United States has been slowing *at multiple degrees of scale*, a trend that is still manifest today. A continuation of this trend will mean that the expansion that resumed in October 2001 will be the briefest and weakest yet.

The persistent deceleration in the U.S. economy is vitally important because, in my opinion, it portends a major reversal from economic expansion to economic contraction. Chapter 5 will expand upon the reasons for this conclusion. As we are about to see, though, we need not rely on hypothesis alone. The 20th century provides two great precursors to the current situation.

The U.S. in the 1920s

If you recall your economic history, you know that a phrase in vogue in the 1920s was that the economy had entered a "New Era." Economists of the day, as President Hoover ruefully recalled in his memoirs, gushed over the wonderful economy, just as they are doing today. Were the Roaring 'Twenties truly a New Era, or was such talk a spate of hype spurred by the good feelings associated with a soaring stock market?

According to data from Professor Mark Siegler of Williams College (MA), from 1872 through 1880, the annual inflation-adjusted Gross National Product of the United States rose from $98 billion to $172 billion, a **68** percent gain. From 1898 to 1906, real GNP rose from $228.8 billion to $403.7 billion, a 56 percent gain. In contrast, from 1921 through 1929, during the Roaring 'Twenties, GNP in the supposed "New Era" rose from $554.8 billion to $822.2 billion, only a **48** percent gain. This latter performance was particularly poor given that the stock market enjoyed a greater percentage rise from 1921 to 1929 than it had done in any equivalent time in U.S. history.

Similarly to today, the economy of that time failed to keep pace with the advance in stock prices and under-performed the prior expansion. The aftermath was the Great Depression.

The Japanese Experience and Its Implications

If you are over 20 years old, you surely remember the "Japanese Miracle" of the 1980s. The country's products were the best in the world. Its corporate managers lectured and wrote books on how they did it, and the world's CEOs flocked to emulate their style. The Japanese Nikkei stock average soared, and foreign investors poured into the "sure thing." Was the Japanese economy truly miraculous, or once again were economists ignoring economic statistics and simply expressing the good feelings associated with its stampeding stock market?

Figure 1-5 shows real GDP growth in Japan from 1955 to the present. Notice that Japan's growth from 1955 through 1973 was extremely powerful, averaging **9.4** percent per year. But its economic growth from 1975 through 1989 averaged only

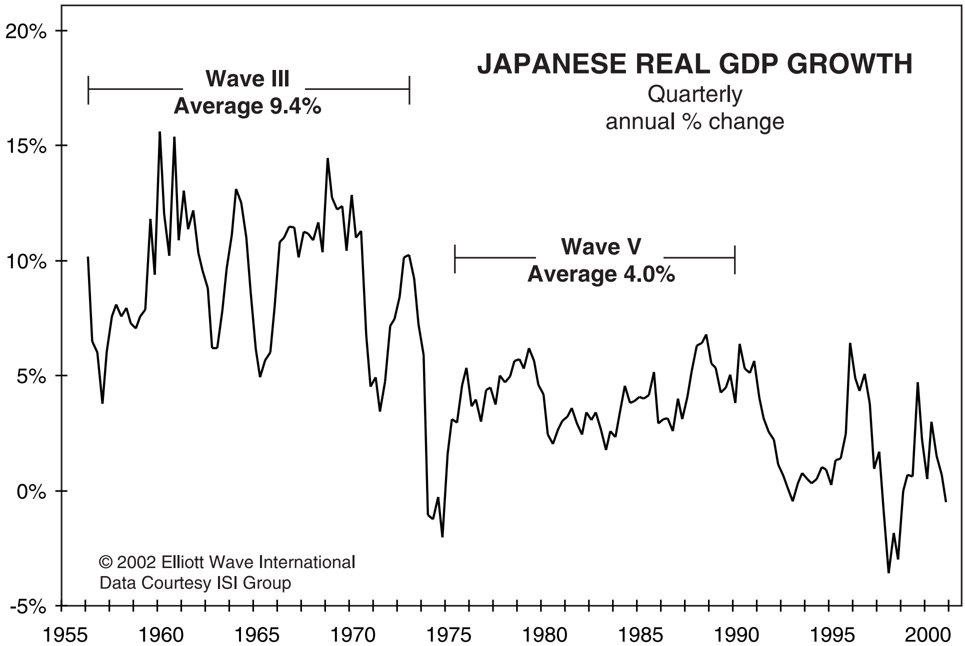

Figure 1-5

4.0 percent per year. This relatively poor economic performance coincided with a record-breaking stock market boom. Just as in the U.S. in the 1920s, the economy in Japan's celebrated years failed to keep pace with the advance in its Nikkei stock index and under-performed the prior expansion. This double dichotomy signaled an approaching reversal of multi-decade importance in both stock prices and the economy. Since the top of its own "wave V," the Nikkei stock index has plunged 70 percent, the economy has had three recessions in a dozen years, and the banking system has become deeply stressed. As we will see in Chapter 8, this downtrend isn't over yet.

A Naked Emperor

The "New Era" of the 1920s ended in a bust. The "Japanese Miracle" of the 1980s ended in a bust. Is that what will happen to today's "New Economy"? We have already gotten a hint of the answer. The next seven chapters will provide a definitive reply to that question.

When historians return to this time, I suspect that they will discover the slow but persistent regression in both U.S. and worldwide growth over the decades in the latter half of the twentieth century and wonder why so few recognized it as a signal of the coming change.