Expected Events and Investment Strategy for 2006 and Beyond

Expected Events:

- A “dollar crisis” in 2006; our dollar is at extreme risk.
- An “emergency summit” with the G-7 or G-8 Trading Partners in 2006 to address the “dollar crisis”
- An agreement resulting from the “summit” that will unwittingly accelerate the destruction of the dollar and many other fiat currencies. i.e. they will all expand their “low interest rate” and “easy money” policies, which created the path of dollar destruction initially. The hope is that these actions will spur increased aggregate demand for capital goods as well as consumable goods and services. These policies in practice will create an extraordinary race for Central Banks to debase all major world currencies, and further attempt to exacerbate an already unwieldy U.S. credit expansion.
- Confidence in our U.S. government leadership will weaken significantly.
- A “geopolitical event” either contrived (invade Iran?) or a surprise (terrorist attack?) during 2006 that will serve as the anecdotal “newsworthy” and politically justified cause of the “dollar crisis” or the next recession (or entry into a depression).
- A major bank or hedge fund (e.g. LTCM in 1998) failure in 2006
- A bond market collapse in 2006-2010 of 25% or more
- A real estate market collapse in 2006-2010 of 20% or more
- A stock market “correction” of 30% in 2006, followed by a positive market response to the “emergency summit resolution”, followed by a collapse in 2008-2010 of 40% or more
- The U.S. dollar support scheme developed in the “summit” meeting will fail, and then a full-scale global depression will begin between 2008 and 2010 or sooner.

How Will 2006 Unfold?

I expect the equity markets will “muddle through” the balance of February, March, and early April staying within a trading range of + or – 5%. The end of April through mid-November will be an extremely high-risk period for the U.S. equity market. I expect the U.S. equity market to “correct” by 30% during the noted period, and experience one or two traditional “mini” summer rallies, and of course enjoy the traditional fourth-quarter rally in year two (2006) of the four-year Presidential cycle (see William Hester article below). I expect 2006 to end near the same level as the beginning or slightly lower. Following is an analysis that addresses the historical performance of U.S. equities during portions of the second and third years of the four-year Presidential cycle.

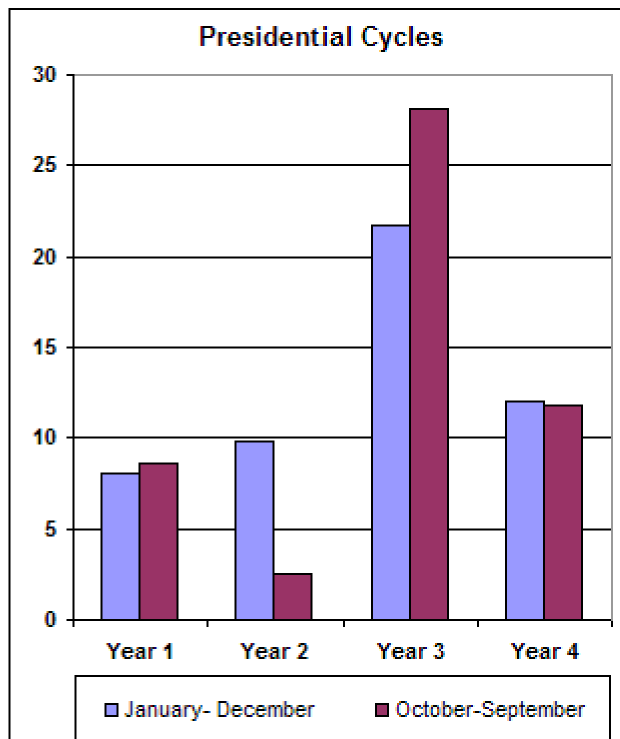
By William Hester [(1)], CFA with Hussman Funds; 30 December 2005…

“… If we split year two of the Presidential Cycle into two periods – the first nine months of the year compared with the final quarter - the patterns become apparent. **The average market performance during the period from January through September of each second year of the Presidential Cycle has been roughly flat since 1933.** The market has been down during these periods nearly as much as it's been up.

Things have usually been more interesting in the fourth quarter, where the average gain has been 8.7 percent. This is the highest average fourth-quarter return of any of the four years of the cycle, including the last quarter of year three and year four. **The fourth quarter of the second year is actually where many third-year rallies are born..."**

"…But the real standout has been the fourth quarter of year two, which has delivered results more like the typically strong first three quarters of year three. In fact, if we shift the Presidential Cycle one-quarter forward, third-year returns jump even higher. **The 12-month period beginning in October of the second year of the presidential term has enjoyed average total returns of more than 28 percent, on average. And since 1933, not a single third year 12-month period beginning in October has registered a loss (the worst return was a gain of 6.6 percent).**

In the chart below, the blue bar is the calendar year return at any point in the Presidential Cycle, while the red bar is the return as measured from October of the prior year through September of the year noted. **So for example, the poorest return has historically been from October of year 1 through September of year 2, a period that the market has just entered.**



Investment Strategies:

Precious Metals…
The safest storage of wealth is holding a precious metal in these times. However, few people do so with more than 10-15% of their investment portfolio. The primary issue with holding precious metal bullion or coins is that they don't earn anything... they just sit in storage. However, all fiat currencies will depreciate against them, so from that perspective, it's much better than cash... Visit the gold sites here http://www.austrianenginomics.com/id8.html for expert advice on what and how to buy.

Your 401K…
Global market crashes, which will be in our future for the next four-plus years, tend to bring ALL Equities down (domestic, international, large, mid, and small cap, utilities, energy, etc, etc...), so cash (money markets) is probably the best short term option in a 401K during the unfavorable market season (May thru Oct.) when most crashes occur. Generally, you might stay in your “diversified investments” during the favorable season (November through April), then “go away in May” safely to cash. If your 401K has a gold or precious metal fund option, it may suffer the least damage, and may rise quickly while everything else keeps dropping. However, gold is extremely overbought at this point in time, so an entry into any precious metal fund should again be guided by expert advice. Precious metals are a very small market, thus if any significant contingent of investors pursue bullion delivery or stocks of the mining companies due to a loss of confidence in our fiat currency, they have the potential to escalate dramatically in value.

Your IRA…
This can be much the same as the 401K strategies above. However, an option for you IRA is to RISK betting against the market during the "unfavorable" season (May thru Oct) this year. There are many "short" funds that invest in shorts and puts. Some are designed to go up 1% if the market declines 1% and some are designed more aggressively @ 2% up for every 1% down in the market (e.g. Rydex... RYVNX based upon the Nasdaq 100). These types of funds are risky and pay little if any dividends, but can "hedge" other positions.

As Time Progresses Through 2006 and Beyond…
The investment debate of this century will be centered around predicting **inflation vs deflation....!** Most economists agree that inflation is imminent in order to diffuse the unprecedented and unsustainable U.S. debt buildup at all levels. Creditors holding this debt domestically and internationally will lose. The question is how much and when.

However, we will experience a sequence of conditions that I believe will include both deflation and inflation! If the bubbles (stock, bond, and real estate) are near my estimate of $28 trillion in magnitude and they crash to "neutral" in say 2 years, that decline in “real” valuation is over a $1 trillion a month. To combat that asset devaluation, the Feds would have to “pull all stops” to pump that much liquidity into the system so quickly. They effectively need to counter the devaluation “punch” with an inflation “punch” the same size (attempting to keep your house and equity investments at the same dollar valuation level; albeit in debased dollars). Considering the week following 9-11 the Feds increased M-3 approx. $190 Billion in the banking system, which pales in comparison to the $1 trillion per month devaluation “gorilla”. Problems would multiply, as the bond market would sense imminent inflation and rapidly sell-off. Further, our foreign investors

would sense the concerted effort to debase our currency, and would unmercifully dump the dollar. Keep in mind we haven't gone out of our way to befriend many of our key trading partners lately. The rapid inflation increase would then force interest rates to the moon.

I expect the $1 trillion per month devaluation “gorilla” to easily overwhelm the Fed’s inflation efforts for 1 to 3 years. In that case the aggregate stock, bond, and real estate valuation will decline by 20-30% AND the new valuations will be in 10-20% “cheaper” dollars. Once that period passes, then the hyperinflation phase would have a launching pad to take off similar to countless desperate countries in world history. Note: The **C**onsumer **P**rice **I**ndex (the government’s inflation measurement index) will not change significantly until the hyperinflation phase begins.

If the economic crash first descends into a deflationary condition, then the dollar will be in high demand relative to "real wealth" goods and services. I.e. fewer dollars to buy the same stuff. So... holding cash during this phase is OK...

If the crash transitions rapidly into a hyperinflationary condition, then we will follow the same path of the Weimar Republic (Germany pre WW-2), Argentina a few years ago, and many others. In that case holding cash is a big loser...

In any event, it will seem like a slow motion train wreck. So, don’t panic…!

Conclusion:

As the American consumer chokes on debt and slows spending, there will likely be a short- to mid-term deflationary impact on finished goods and services and even commodities (except precious metals, which have been suppressed by a coordinated central bank effort for 20 years) domestically this year. Then, as the consumer spending contraction becomes more severe, our Fed along with all other key trading partners (based upon the “emergency summit”) will pull all stops to "save the dollar" and stoke the global economy. That means foreign central banks will be pressured to continue buying our debt (or lose our implied military protection; e.g. Japan), and rapidly debase their currencies faster than we debase ours. Keep in mind the Feds will believe they must debase our currency rapidly to avoid sinking into a deflationary depression (been there...done that in the 1930’s...).

At some point our trading partner citizen investors will ask what their respective governments are doing. They will attempt to rapidly dump their dollar-based investments and pressure their governments to stop supporting the US "sink hole". At that point we're well into the beginning of the depression.

Longer term, as this mess unfolds, if you stay "liquid" with your investments, then you can move into inflation protected investments (commodities, energy companies, real estate (post devaluation), etc.), or deflation protected investments (cash, necessities like medical, food, energy, water, utilities, etc.).

Good luck!

By Russell Randall; 2-14-2006

References:

1) by William Hester, CFA with Hussman Funds; 30 December 2005. See: http://www.suite101.com/print_message.cfm/investing/98070/1152899