

Apocalypse Later

The Daily Reckoning

London, England

Tuesday, January 04, 2005

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\*\*\* Unimaginable horrors...laughter is the best medicine...the roof is on fire...

\*\*\* The Great Mystery...the heavy burden that weighs on foreign investors shoulders...

\*\*\* Wondering when it will all fall apart...running low on luck...lending a helping hand...and more!

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More New Year's Guesses & Hunches

"What a remarkable world," we said to a colleague yesterday. No matter how extreme and provocative we try to be in our guesses about the future...they never seem to be provocative enough.

The subject of discussion had been the giant wave, which now seems to have washed away more than 150,000 lives. Tidal waves are much more likely to carry you off than terrorism, but what politician warned people to stay off the beach? Who imagined such a flood?

"The universe is not just stranger than you imagine," said a famous physicist, "it is stranger than you CAN imagine."

Scientists have been driven mad trying to understand the odd behavior of electrons, quarks and dark forces. Investors are not so much driven insane by the market as busted and broken by it. What keeps us going here at The Daily Reckoning is nothing more than a sense of humor; we know that things are odder than we can imagine, but we're determined to be amused by them.

What we find facetious today is the market's odd reaction to the dollar's fall. Every newspaper report tells us the dollar has further to fall. "Everything I see points to a stronger euro and a weaker dollar," says an analyst interviewed by the International Herald Tribune. And yet, there does not seem to be any rush by dollar asset holders (particularly U.S. bondholders) to get out of the crowded theatre. The building is clearly on fire. The roof is about to cave in. But the audience seems to want to see the end of the show anyway.

Why the bonds have not fallen is a mystery...a Great Mystery.

We proposed a solution yesterday. Today, we elaborate.

There must be some surprise coming. Americans now believe that the trillions in debts they owe to foreigners (and to themselves) will be calmly marked down by inflation and dollar devaluation. "It's our dollar," they tell the foreigners, "but it's your problem." But lenders do not sit still while their assets are marked down. They bolt for the exits. A panic out of the dollar would surprise nearly everyone - triggering immediate and unpleasant consequences for the whole world economy.

But people need dollars - almost desperately. That is why credit binges do not typically end in inflation. Debt loads are not usually lightened so easily. People need dollars to pay the interest on loans...and to pay back the principle. What usually happens at the end of a credit boom is that money becomes harder and harder to get. Debtors are stretched; they can no longer increase spending. Businesses have surplus capacity already; they cannot profitably add factories and workers. Capital spending slows down. Consumer spending slows too. Money becomes scarce.

So, here, we find another surprise...instead of seeing their debts eased by inflation and a dollar decline, Americans are likely to find the burden heavier than before. While the dollar might be worth less overseas... at home, it could be more precious than ever. Many may find it hard to pay their bills. Many credits - backed by people who are no longer good for the money - will become worthless. Others, such as U.S. Treasuries, will be sought after.

We have lived through the greatest credit expansion in history. On the other side of it lies a great credit contraction, about which nearly everything is unknown. When will it arrive? What form will it take? Who will be its victims? Its heroes? We don't know, but we vaguely expect it to be similar in many ways to what Japan has gone through for the last 15 years. Stocks and real estate have been pushed up not by honest toil and disciplined saving, but by reckless leverage. We read yesterday, that J.P. Morgan had set a new record for lending money - arranging more than \$2 trillion worth of loans last year...or more than 50% greater than the year before. The loans, we learned from press reports, were bought by mutual funds! Oh, what have we come to, we thought to ourselves; more and more money is lent to less and less creditworthy borrowers by more and more lenders who have less and less to lose if they go bad. Our guess is that they will go bad; in fact, we'd bet on it.

More news, from our team at The Rude Awakening:

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Eric Fry, reporting from Lower Manhattan...

"Despite America's frighteningly large trade deficit, Dan explains, 'certain industrial sectors of the American economy are already running a trade surplus. That's right, a surplus! If the dollar falls even more in 2005 (in the second half of the year, I'm forecasting), the industrial exporters will become even more competitive.'"

For the entire story, and for more market updates, see today's issue of

The Rude Awakening  
[http://dailyreckoning.com/body\\_headline.cfm?id=4386](http://dailyreckoning.com/body_headline.cfm?id=4386)

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Bill Bonner, back in London:

\*\*\* This from Dan Ferris:

"I keep about 100 stock quotes on my screen, plus a few of the big indexes and Treasury yields. If the prices move up, the number is green. If they move down, the number is red.

"Today there were times when the only green numbers were the Treasury yields...which, of course, move in the opposite direction of bond prices...so...everything I watch fell today.

"Everything.

"I have absolutely no feel for the market, so I ignore the issue of market risk. But on days like today, I can't help wondering for a moment...is this it? Is this the day it all falls apart?"

[For more from Mr. Ferris, see his special report:

Extreme Value  
<http://www.agora-inc.com/reports/EVI/WEVIE813/home.cfm>

\*\*\* More guesses from The Daily Reckoning cosmology:

The bear market that began in January of 2000 is still the dominant force in the stock market. While stocks rose very slightly in dollar terms in 2004, when looked at through the lens of the euro or gold - they fell. In real money, stocks have gone down every year since the bear market began. They will go down again in 2005...perhaps very sharply.

The dollar is in a bear market too. But predicting the fall of the dollar is too easy and too obvious. The great surprise will be that the dollar either goes down much further, faster than expected...or not as much as expected. In the former case, all Hell breaks loose all at once. In the latter - which we expect - the doors of Hell are pried open very slowly; the dollar falls against gold and oil, more than against foreign currencies. A soft, slow, slump takes hold in the U.S. economy...forcing consumers to stop spending so much, putting the U.S. in recession, and thereby easing pressure on the dollar itself.

The consumer will probably near the end of his spending spree in 2005. He is running out of time, out of money, and out of luck.

It will be a time of deflation, not inflation. Prices for most assets will fall in real terms...even if they go up in dollars. Consumer prices may fall too.

The major bull market in gold that began in 1998 will continue.

If these things do not happen as we predict, we will deny we ever said them. More tomorrow. [Ed. Note: Feel like the only one concerned about the dollar's long, slow slide? You're not alone...in fact; you're in quite good company. The esteemed Dr. Richebächer's new special report shows you how to protect yourself (and even profit!) from the falling dollar. See here:

7-Year Slide

<http://www.agora-inc.com/reports/RCH/WRCHEC09>

\*\*\* "Why are you coming to the United Kingdom? What will you do there? How long will you stay? Do you earn money in Britain?"

Coming into London, we were harassed by the border guards for the first time.

So much of what goes on in the world is humbug, fraud or poppycock. That is true of almost all border controls. What difference could it possibly make to anyone why we wanted to enter the U.K. or how long we stayed? Would the world be a happier place one way or the other?

\*\*\* Last week, we showed you how you could help the tsunami victims by donating to the International Red Cross. Here's another option:

A friend of ours does volunteer work for a remarkable, private relief organization called Knightsbridge. Another friend, John Mauldin, sends this update:

"Sir Ed Artis of Knightsbridge is heading up a massive relief effort to Sri Lanka. He has found \$5.5 million of medicine and supplies, enough to fill a 747, and will be going to Sri Lanka, along with Dr. James Laws and other volunteers, to personally see that the supplies get to where it is needed most. Of course, he maxed his credit cards out at \$108,000 to get the medicine, trusting that friends and donors will be found to help with the bill.

I don't have to tell you how urgent the need is. You see it on your TV every day. Ed and the team are forming up and leaving as you are reading this letter.

Knightsbridge is an all-volunteer NGO (non-governmental organization) that has brought aid to some of the most dangerous and roughest spots in the world. These are the really, really good (if somewhat crazy) good guys. They have been featured on National Geographic and papers worldwide. When you donate to them, 100% of your money goes to the field. There are no salaries, "overhead expenses" or fund-raising costs.

I know that there are some very wealthy readers of this letter. For \$130,000 plus your on ground expenses, you and your friends can outfit your own mission. Knightsbridge can show you where to get the discount medicine, help arrange shipping and diplomatic contact to get them in country and will either meet the plane or be on it with you. Now that's an adventure to tell the grandkids about, and you will save the lives of 1,000's of someone else's grandkids and grandparents.

Every penny is needed. You can help. You can learn more about Knightsbridge by going to [www.kbi.org](http://www.kbi.org) and send a tax-deductible check (it is still 2004, at least in your checkbook, is it not?):

Knightsbridge International  
PO Box 4394  
West Hills, CA  
91308-4394

Thanks from the bottom of my heart.

[Editor's Note: For another way to contribute to the tsunami relief effort, see our site:

A Wave of Solidarity  
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The Daily Reckoning PRESENTS: Although economic growth isn't looking so good for Japan and Euroland, forecasts for the United States remain upbeat. The Good Doctor explores...

APOCALYPSE LATER  
by Kurt Richeächer

Despite all the worried talk about the sliding dollar, both the financial markets and economic forecasters are taking it in stride. Conspicuously, nobody speaks of a dollar crisis at present or in the future. High-riding expectations of a strong year-end rally in the stock markets have been somewhat disappointed. Yet there have been two pleasant major surprises. One is the sharp fall of oil prices, and the other is the resilience of the U.S. bond market, defying not only the dollar's weakness, but also the four rate hikes by the Federal Reserve.

It appears to be a common view that economic growth in the eurozone and Japan is badly faltering again, with both countries flirting with new recessions. In contrast, the forecasts for the U.S. economy remain rather upbeat, hailing the plunges in oil prices and the dollar.

We stick to our diametrically opposite view that the U.S. economy is prone to sharply slower growth. It is the profligate consumer who has kept the economy afloat since 2000. What kept the consumer afloat is also no secret. It was mainly two events: First, inordinate tax cuts; and second, exploding ultra-cheap borrowing facilities, made available through the Fed's creative bubble strategy and implemented by ultra-low short-term interest rates.

Together, the two have unquestionably contained the fallout from the bursting stock market bubble. They also had respectable effects in terms of U.S. real GDP growth during the second half of 2003 and the first half of 2004. Yet the most important aim of all the monetary and fiscal stimulus - to set in motion a self-sustaining economic recovery - has been flatly missed.

A "self-sustaining" U.S. economic recovery urgently needs accelerating employment and income growth. Just the opposite is happening. During the six months up to last November, real disposable personal income grew just 1%, or 2% annualized. This is down from 3% in the first half of 2004 and 4.8% in the second half of 2003. Taxes and higher inflation rates are taking their toll. Debt-financed spending went to new records. During the third quarter, private households increased their spending by \$139.4 billion, while their earnings increased only \$81.6 billion.

Employment and income growth are the key fundamentals of household finance. According to the reports of the Bureau of Labor Statistics (BLS), they have significantly improved in 2004. But no less than two-thirds of these gains owe their creation to the ominous "net birth/death" computer model of the BLS, designed to estimate employment growth by new business formations.

All that is needed to activate this job creation is a unilateral decision by the BLS that the U.S. economy is in a recovery. Implicitly, the Bureau of Economic Analysis translates these computer-generated additions to employment into corresponding additions to wages and salaries. Considering the persistent, unusual weakness in employment, as documented by the actual surveys, it requires a lot of heroism to assume an employment boom from new business formations.

For November, the BLS reported 112,000 new jobs, as against an expected 200,000. As bad as the report appeared, the reality was even worse. No less than 54,000 of the new jobs had come from the net birth/death computer model, compared to 30,000 jobs in November last year.

In the third quarter of 2004, consumer spending accounted for 89.2% of real GDP. It is the familiar ruinous growth pattern. A viable economic recovery would require a strong contribution through sharply higher business investment and hiring. Both remain missing, although the recovery is entering its fourth year.

Euroland's Secret Success Story:

"The United States is richer and grows faster than euroland because productivity levels are higher and productivity growth stronger - right? Actually, no. Euroland's inferior GDP performance is attributable to a slower- growing labor force that works shorter hours.

"Euroland's underlying economic performance is better than many commentators portray. Over the past decade, GDP per head has risen virtually at the same rate in euroland as the United States; euroland productivity growth (output per hour) and the rise in the employment rates were slightly faster than in the United States; and to maintain the same growth in GDP per head, U.S. workers have had to work much longer hours than their euroland counterparts."

This subtitle and the above two paragraphs are not ours. They are the introductory remarks to a study about the eurozone economy, written by Kevin Daly and published by Goldman Sachs in January 2004.

Gloomy reports about the eurozone economy always abound. To quote a leading article that appeared in The Financial Times under the headline Two Broken Motors: "The latest economic data leave the eurozone and Japan looking more than ever like two enfeebled old men unable to progress at more than a stagger."

With utter amazement, at the same time, we keep reading that the U.S. expansion remains firmly on track, particularly with sharply improving jobs data. Third-quarter real GDP growth was revised upward to 4% at annual rate, compared with an annualized growth rate of 1.2% for the eurozone. Since the end of 2000, America's output, as measured by real GDP, has grown more than twice as fast as the euro areas.

Quoting the London Economist: "Euro-pessimists see this as further evidence that arthritic economies are being held back by lazy workers and by governments unwilling or unable to carry out reforms. In contrast, America's more robust recovery, it is often said, reflects its amazing flexibility."

Our view, in contrast, is that the U.S. economy's recovery since 2001 peaked in the first quarter of 2004. This assumption is primarily based on four observations: First, it is the overwhelming message of recent economic data and early indicators; second, the power of egregious fiscal and monetary stimulus has been spent; third, continuous rate hikes by the Fed will prick both the carry trade and the housing bubbles; and fourth, the U.S. economic recovery is of a flatly unsustainable pattern.

To prevent a more painful fallout from the bursting equity bubble in 2000-01, Fed Chairman Alan Greenspan systematically blew three intertwined new credit bubbles: the carry trade bubble in bonds, house price inflation and the mortgage refinancing bubble.

It was the policy of a desperado who did not care at all about adverse consequences in the longer run. In actual fact, the very imbalances that provoked the preceding recession have grossly worsened under the impact of the new asset and credit bubbles.

Regards,

Dr. Kurt Richebacher  
for The Daily Reckoning

Editor's Note: Former Fed Chairman Paul Volcker once said: "Sometimes I think that the job of central bankers is to prove Kurt Richebächer wrong." A regular contributor to The Wall Street Journal, Strategic Investment and several other respected financial publications, Dr. Richebächer's insightful analysis stems from the Austrian School of economics. France's Le Figaro magazine has done a feature story on him as "the man who predicted the Asian crisis."

This essay was adapted from an article from the January edition of:

The Richebächer Letter