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Meltdown 2008
the US and Global Economic Crisis

INTRODUCTION

Fifty years of deficit spending has culminated in a global economic crisis unseen since the Great Depression of the 1930s. What are the causes of the crisis, and how does one invest in order to survive what might prove to be severe economic dislocation and/or hyper monetary inflation?

HISTORY

President Lyndon Johnson's decision to implement the "great society" starting in the late 1960's was a noble idea. The Vietnam War, (1965-1974) however, caused federal spending to increase at a rapid rate. In the 1970's, a US foreign policy favoring Israel was disliked by the Arab oil producers and an oil embargo was implemented by the exporting countries. This caused domestic economic stress and the US economy went into a severe recession contributing to high unemployment, deficit spending and monetary inflation.

Stock prices declined in the 1974-1980 recession to a low S&P price earnings ratio of 6x, less than half the historic average. By 1979, a restrictive monetary policy under the new Federal Reserve chairman, Paul Volker, witnessed us short-term interest rates soar to a high of 21%, and long rates went to over 13%. The recession eventually bottomed in 1980, and interest rates started a 28 year decline.

The Reagan administration (1980-1988) attempted to implement a policy of economic stimulus and attempted to introduce the supply side economics of Dr. Art Laffer. Simply stated, this requires <u>reduced taxes and reduced spending</u> to stimulate economic growth. Taxes were reduced under Reagan, however, government spending increased. The economy grew rapidly for nearly a decade as unemployment declined and corporate and individual earnings grew, but the federal debt continued to grow as well. A speculative stock market bubble developed in 1987 and a significant correction occurred in October. The decline however, was temporary and the stock market ended slightly up for the year.

The end of the decade of the 1980's witnessed another economic decline and, by 1990, the economy was again in a recession. Under President George H. W. Bush (1988-1992) taxes were raised and the first gulf war was undertaken. The gulf war eventually stimulated economic growth, however, the recession was harsh and bush was defeated by president bill Clinton (1993-2000).

Under Clinton, the economic policies of bush remained mostly unchanged. However under fed chairman Alan Greenspan, interest rates were held artificially low, the money supply was significantly increased, and margin rates remained intentionally low. Some regulations were made more *lax*, especially in housing lending, and apparently, at times *ignored*. These policies stimulated the economy which grew rapidly and witnessed full employment. Advancing technology became a significant factor in increasing worker productivity.

The late 1990's witnessed congress and Clinton implement the start of sub-prime home lending to unqualified buyers. The impact of the legislation stimulated a housing boom and eventually, by 2007, a massive *housing bubble*. By December 1999, the stock market was in a "tech" bubble, valuations were at extreme levels not seen since 1929, and by March of 2000, the stock market and the economy started a 2 year decline.

Under the bush administration (2000-2008) the second Iraq war, the Afghanistan war, a massive trade imbalance and deficit spending continued to increase the *national debt*. Debt *increased* nearly a trillion dollars per year. *These actions were funded by massive increases in the money supply by the Federal Reserve.*

The elimination or disregard for regulations and established policies created an environment of excessive greed and massive debt increases. *Wealth disparity between the rich and poor, not seen since the 1890's "gilded age," reached excessive levels*. The fed, under Greenspan, continued the liberal monetary policy and maintained an *artificially low interest rate environment*. Unregulated capitalism became "capitalism rex" and started to devour the competition. *Massive financial liquidations and mergers resulted from this behavior.*

Wall Street, now even more unregulated, created "structured products" such *as CMOs, CDOs, bundled sub-prime paper, derivatives and massive leverage.* Rating agencies, hired by Wall Street, gave these "bundled products" AAA ratings. Junk we were to learn, although bundled, remained junk. This Wall Street *"junk virus"* was marketed to banks, corporations, sovereign nation portfolios, mutual funds, retirement plans, individuals and hedge funds.

UNWINDING:

The economic decline is composed of three phases: first, the corporate financial default phase which started in 2007. Second, the consumer credit default phase which is now underway. The third, and very dangerous, monetary inflation phase is yet to appear.

Phase 1: The stage was set for a massive economic and stock market correction. As "structured products" were liquidated, prices dropped and many leveraged investment banks, insurance companies, and banks went below ***net capital***. As redemptions continued from hedge funds and mutual funds many bundled products were found to be illiquid with no or low bids. As margin liquidations continued, other participants started to liquidate asset holdings including bonds, stocks, housing, commodities, consumer products and the like. Other asset prices started to decline, in some cases seeing massive percentage declines. As home prices decline, mortgage defaults increased, margin calls increased and the unwinding cycle continued.

Domestic and international portfolios including banks and country "sovereign funds" holding "bundled products" also were significantly impacted. The Wall Street "virus" infected the world financial markets

as well. Many banks were liquidated, merged, or sought out added capital to remain in business, as *net capital* requirements were violated. Major investment banks were converted to bank holding companies in order to survive.

Phase 2: The credit default phase starting with the housing defaults continues to grow. Unemployment has risen to over one million unemployed, and is rising. As companies cut back spending and layoffs rise, unemployment increases, credit contracts and credit default increases. Bankruptcies rise and government costs rise as income tax, sales tax, property tax and other tax revenues decline. Government social costs increase in this period, increasing the national debt even further. The *credit default phase* is now in motion.

Phase 3: Monetary inflation will now start to increase significantly. The government must print money to pay interest on the national debt, federal employee retirement, Medicare, and Medicade, military and defense spending, other entitlements, social security, and the like.

This is a very dangerous phase and most individuals have little knowledge on how to invest in this environment. A 12 percent rate of inflation causes the dollar to lose half of its purchasing power in 6 years.

The Weimar Republic in post World War I Germany is the best example of *high monetary inflation in a developed country*. The affluent and middle class Germans were educated, industrious, responsible, by the book citizens. Most were wiped out during this period of German history. How did the successful German investors survive?

CONCLUSION:

The successful investor must understand the lessons of history, recognize the new risks, and understand how to intelligently allocate capital in this altered economic environment. Not only must one be in the right sectors, but also own the right companies. Portfolios need to be re-structured in order to benefit in this post bubble period of the anticipated *weak dollar and high monetary inflation scenario***.**

The next decade will most likely experience economic volatility and sharp market price swings. *Investment disciplines that were successful in the past 50 years, for the most part, will unfortunately disappoint investors.* **Many portfolio managers will fail to understand the significant changes that have taken place in our economy. Just as they failed to see the recent market and economic down-turn, they will likely fail to see the next phase of the crisis.** *The rules have been altered and the Rubicon crossed.*

- Roger L. Johnson