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Orlando September 2008

Buffet "Yes there are weapons of mass destruction, weapons of mass financial destruction
The Economist magazine recently published an article "Do economist need brains."
Trial Lawyers believe their clients are innocent until proven broke
Newton I can accurately predict the movement of heavenly bodies but not the madness of crowds

Almost all major economies are now suffering from the dilemma of keeping interest rates lower to help growth vs. raising them to cool inflation

PARADIGM SHIFTS

End of Cheap Oil
End of Cheap Food
End of Easy credit
End of Dollar dominance
End of Easy water
End of De regulation
End of Anglo Majority
End of Suburbs
End of Blue Collar Middle Class
End of the American Golden Age

We get complacent between crises but then there is always another crisis
We always seem to have a crisis after we have forgotten the pain of the last one
The S&P is where it was 9 years ago a lost decade

We are suffering the effects of the collapse of the tinker bell financial market
Like tink this market could only exist as long as everyone agreed to believed in it

OVERVIEW

How bad is it and how long will it last
Most dangerous words in forecasting this time it is different.
A 1% decline in the US GDP impacts Asian economies by ½%
US 21% Share China 10.9% Japan 6.6% India 4.6% Germany 4.4% UK 3.3% Russia 3.2%
Brazil 3.1% The debate is no longer about a soft vs. a hard landing, but how hard will the hard landing be. And how long it will last. . The recession will be severe because the U.S. consumer - whose spending makes up 70% of our GDP - is shopped-out, saving-less, and debt-burdened.
Recession probably started in January. It is now obvious that the 2nd half will be weaker then the 1st half. This is a global event Europe has gone negative GDP and India and China will slow.
Global Manufacturing has declined to its lowest level since 2001, Japan UK and Europes manufacturing declined at sharpest rate sine 1998.

GLOBAL ECONOMY

When the US and the UK industrialized in the late 19th century they took 50 years to double their economy. Chinese did it in 9 years. In the past five years developing countries have grown an average of 7% while the developed averaged 2.3 The international monetary fund predicts that over the next five years they will grow at 6.8% while the developed will average 2.7% at that rate if you did trend line extrapolation (which never works) in 20 years they will account for 2/3rd of the global economy.

Economic power is shifting away from US, Europe, Japan Australia
 BRICS account for 40% of emerging world output
 82% of Worlds population
 75% of currency reserves
 53% of energy consumption
 50% of GDP
 43% of exports
 16% of Stock market capitalization

GLOBAL MIDDLE CLASS

The big story shaping the global economy is the emergence of a global middle class their incomes are growing geometrically not linearly. The US middle class is shrinking and the emerging market middle is growing - Emerging Markets, Emerging Middle Class, Emerging suburbs. While US Household are grappling with higher cost, rising unemployment, declining home values, stagnant wages and tighter credit standards.

In 2000, developing countries were home to 56% of the global middle class, but by 2030 that figure is expected to reach 93%. China and India alone will account for two-thirds of the expansion, with China contributing 52% of the increase and India 12%,

Last 5 years global economy has grown by 25%, the world has added a billion people to the middle class in the last 20 years. China says 20% of their population is now middle class or 250 million people

A growing middle class around the world is already increasing demand for meat, milk and other foods, thus increasing the prices of staple products. The middle class can afford more energy, precious metals and commodities per capita than the poor. In 2006, China added to its overall energy use as much as France consumes in one year

The middle class in poor countries is the fastest-growing segment of the world's population. While the total population of the planet will increase by about 1 billion people in the next 12 years, the ranks of the middle class will swell by as many as 1.8 billion. Of these new members of the middle class, 600 million will be in China. India's will be 10 times larger than it is today. 70 million people a year are joining the middle class, "as defined by those on incomes of between \$6,000 and \$30,000." The phenomenon may continue for the next 20 years, with this global middle accelerating to 90m a year by 2030. If this happens, an astonishing 2bn people will have joined the ranks of the middle class.

BEWARE OF PROTECTIONISM

Yet at the same time the US middleclass is under pressure. So far the US has exported about 1mm jobs by 2015 it will be 3.5 million, the real threat is not to jobs but to wages, real weekly wages for the average American worker has fallen by 4% since 2000. Food is 15% of the household budget; energy is 10% the worse the economy gets the more screams you get for protectionism, tariffs and less support for globalization

GLOBAL SHIFTS

Chinas Population is aging, Russia is shrinking, Western European native populations are declining and Islam is fastest growing population segment in Europe, The only reason the US population is not aging faster is in migration. By 2040 BRICS and Mexico will be among the ten

largest economies in the world. Interestingly in the mid 1850's China and India were then the world's largest economies

GLOBAL ECONOMIC TOUR

"If you're not planning to have more business outside the U.S. than in the U.S. market, then you're probably planning wrong,"

HOW GLOBAL ECONOMY REALLY WORKS

Foreign nations, primarily Asian takes our dollars and sends us cheap stuff, American consumers agree not to save very much and borrow again. The Asians agree to keep prices down and buy or debt to keep our interest rates down so we can afford to buy more cheap stuff so the Asian can hire more people to make more cheap stuff

CHINA

China is an island, although it is not surrounded by water. There are some areas that can be traversed, but to understand China we must begin by visualizing the It is surrounded mountains, jungles and wastelands that are difficult to traverse and enclose it. This outer shell both contains and protects China.

No country in history has sustained such economic growth as China in the last 30 years, but eventually it cannot last. China has a basic growth philosophy, maintain job growth by expanding exports and support the exports by an artificially low currency. China is over heating and must raise interest rates and revalue Yuan. 60% of Chinese exports come from non Chinese owned factories.

China has placed itself in a position where it has to keep its customers happy. It struggles against this reality daily, but the fact is that the rest of the world is far less dependent on China's exports than China is dependent on the rest of the world

China's current account surplus growth is slowing 11% 2006, 9% 2008, 7% 2009. Chinese domestic demand has growth by 10%, retail sales jumped 23% and consumer contributed 2/3rds of Chinas GDP growth in 2008 up from 44% in 2007. Over the last year American exports grew by 23% vs. China 17%.

China is actually closing over 30,000 factories that make low end products; the government has said it no longer wants to be the world's junk factory. 20% of all foreign companies doing business in China are now moving all or part of their operations to other area outside of China

China and most Asian countries are now exporting more to Europe then to the US; China is now concentrating on expanding market share outside of the US. All countries are now dealing with many of the same trends: higher food and fuel, threat of protectionism, volatile exchange rates, aging population and housing

CHINA HAS SERIOUS PROBLEMS

They are having inflation up over 6.5% this year pork was up 70% poultry up 30% China is no longer the low cost labor market and is beginning to see labor cost inflation. There are other Asian countries with lower labor costs

Dire Demographics China the world's most rapidly aging population it is aging faster than any other country in history. The one child policy introduced in 1980 has had a dramatic effect

potentially preventing over 300 million births. By the mid 2020's the working age population will begin to decline. There will be more dependants and at the same time fewer workers to support them. In the next 30 years they will go from having 100 million people over 60 to 300 million, and they have no real pension or social security system in place. Another consequence of the China one child policy is the cultural preference for boys which has led to selective abortions and chillingly infanticide for girls. Currently China has over 118 boys under age five for every 100 girls.

Massive environmental issues. According to China's Deputy minister for the Environment, "The concern is that the economic miracle will end soon because the environment cannot keep pace. 16 of the 20 most polluted cities in the world are Chinese, 70% of their rivers and lakes are polluted, and 1/4 the population lacks clean drinking water and with global warming 40% of its water supply which is mountain melt could disappear due to global warming. Acid rain falls on 1/3 of the country

Authoritarian state run by a single party that limits free flow of information, stifles ingenuity and emphasizes group thinking vs. individual thinking and endemic corruption. They practice an oxymoron "Centrally planned free market economy."

CHINA IS A THREAT

Chinese Academy of Social Sciences, let it be known that Beijing had the power to set off a dollar collapse if it chooses to do so. They are getting so rich they are beginning to replace the US as every one's favorite rich friend

They have plans and can war on our satellites, information networks and internet. They are using their money to buy resources and political friend in Africa they have tripled military spending in the last ten years and already have the military equivalent of France and the UK combined this year china will boost military spending by another 20%.

DRAGON vs. ELEPHANT ECONOMICS

The World Bank estimates that 35% of Indians live on less than \$1 a day vs. 17% for China. China has an infant mortality rate of 30 per 1000 vs. 63 per 1000 for India and life expectancy in is 63 vs. 71 in China. In adult literacy it is 91% for China and 57% for India. At present 70% of Indians live in rural areas vs. 50% of Chinese.

China has more urban households because of the one child policy usually three people vs. five for India and therefore has more money to spend. China has a fairly broad middle class India has narrow more affluent elite. India with an average age of 26 is a younger country than China with an average age of 33. India's population growth rate is twice that of China's and is expected to over take China as the world's most populous country by 2035.

In 1990 China's share of world exports was 1.9% and 1.6% of imports, now it is 6.4% and 5.8%. Last year China over took Japan to become the world second largest trader behind the US and Germany and an overall economic size overtook Germany to become the world's third largest economy behind the US and Japan. Indian trade last year grew by 16% even so it is only 1% of global total. China's foreign exchange reserves are at over \$1 Trillion over 5 times that of India.

Despite India's technology prowess it has one of the lowest penetration rates of personal computers expected to grow by 37% over next 4 yrs that would mean an extra 80 million computers while china will add 178 million over the same times. China also has six times as many telephones. Due to power shortages 61% of Indian companies have their own generators

compared to 27% in China. In terms of labor productivity China has a big advantage due to better elementary education, though Chinese workers are 25% more expensive than Indian workers they are 50% more productive. However India is more efficient at using capital.

One key problem for India is its bureaucracy in India it takes 89 days to secure a new business permit compared to 41 days in China and Insolvency resolution averages 10 years in India vs. 2 yrs in China

INDIA

India's population of approximately 1.13 billion people comprises approximately one-sixth of the world's population. India is expected to overtake China by 2030 Real GDP averaged 8.5% for the last 5 years growth is forecast to moderate from 9% in 2007/08 to 7.7% in 2008/09 and 7.1% in 2009/10. Industrial production grew at the slowest pace for more than six years; in May as spiraling prices prompted consumers to cut back spending.

The Indian economy employs 423 million people. The majority of this workforce—64 percent—labors in the agricultural sector. Of the remainder, 20 percent work in services and 16 percent in industry. Women make up 32 percent of the total labor force. The upper middle class comprises an estimated 40 million people. They have annual incomes of US \$600,000. The middle class comprises an estimated 150 million people, each with incomes of US \$20,000 per year each.

BRAZIL

8.6% core inflation, one of the best and toughest central banks raised rates to 11% to stop inflation, strong currency. The number of households with annual disposable incomes over US\$15,000 rose by 36.0% to 3.8 million, representing 7.4% of the total, from a 10-year low of 5.8% in 2002.

Population with approx 200m The number of households with annual disposable incomes over US \$10,000 rose by 31.6% to reach 7.1 million, representing 14.0% of the total, up from a 10-year low of 11.4% in 2002;

Car sales soared 28 percent last year.

16.04 births/1,000 population

6.22 deaths/1,000 population

Teenage market share in Japan was expected to shrink to 14 per cent of the market, with the over 60s making up almost 25 per cent. This is almost the inverse of the situation in Brazil.

Aggressive growing its outsourcing industry

RUSSIA

Russian economy has grown steadily since the crisis of 1998. In 2007 economic growth amounted to more than eight percent, Growth will remain robust this year, but risks have grown. Inflation remains a particular concern

GDP growth is forecast to come in at 7.7%, down modestly from 8.2% in 2007, as domestic demand cools and oil. Despite high oil prices, the Russian economic growth now shows signs of stagnation. Industrial output growth is shrinking together with investments, housing construction, and peoples' incomes

Russia also has problems. The worst is the government appears to rewrite contracts with impunity becoming a severe obstacle to foreign investment. According to recent polls other problems include: courts and police do not work properly," solve problems through bribery."

Poor environmental conditions.

The Russian middle class regards quality as its number one criteria for deciding which product to purchase. Russia's middle class is estimated to encompass 7-20 percent of the population they consider first, the price (higher is more trusted) second, the reputation of the brand name and third, the reputation of the store selling. An estimated 100% of households have televisions, 91% have mobile phones and 19% own four-wheel vehicles. Half the households experienced growing incomes in the past 12 months, of which one-third enjoyed a rise in excess of 20%. About 21% of households plan to buy vehicles

Growth still remains high however. In June, it amounted to 6.5%. Growth dropped significantly from May when it amounted to 7, 7 % Just recently the life expectancy of the Russian people has begun to decline. There are several factors at play in this problem. One of the most dramatic is the increase in violent crime in Russia. The other major factors can be tied to environmental pollution, alcohol and drug abuse. And 1.3 million Russians are living with HIV

Birth Rate: 9.95 births per 1000 persons

Death rate: 14.65 deaths per 1000 persons

Net migration rate: 1.03 migrant per 1000 population

What this means, is that the size of the working-age population "will fall by up to 1 million people annually." The current official projection by the Russian State Statistical Agency is some 101 million in 2050.

THE DOLLAR

Germany France Italy Sweden and Japan and UK may have all fallen into negative economic growth the weakness of the European economies is the real reason the dollar has been strengthening our economy is weakening but not as bad as the other major economies In addition on theoretical econometric model, the euro and the pound are already over valued to the dollar by 22% American trade deficit with Chinese are growing. FX Reserves ... \$1.333 trillion! We export 12% of GDP but import 17% of GDP

Raw Material Prices from 2002 to 2007

Aluminum 95%

Copper 350%

Gold 150%

Nickel 450%

Steel 117%

Oil 400%

OIL & ENERGY

Impact of energy prices simply can't be overstated. The commodities trade, US and foreign equities, debt and interest rates, everything is being driven by energy prices right now. Today spare capacity in the system is just 2% if the 86 million a day that we use. In 1991 it was 12%

According to the U.S. Geological Survey's latest estimates, 22 percent of the world's undiscovered technically recoverable resources are to be found in the Arctic.

This is equal to approximately 13% of the world's undiscovered oil and 30% of the undiscovered natural gas. There is yet more offshore oil and gas off the coasts of the US that is not being utilized. And that is assuming current technological methods. You have to know technology is going to improve recovery rates. There are debates about energy policy, as to whether we should

go to solar, wind, or bio-fuels, drill for more oil and gas, build 45 nuclear plants, etc. check a box that says all of the above

Oil could go back to \$100 in the near term, in the long term (3-5 years) it could easily go to \$200 and \$6 a gallon if we do not do something now and maybe even if we do. Boone Pickens is right; we are sending \$700 billion out of the US each year for oil. Over ten years it could be over \$7 trillion. It is the largest transfer of wealth in history. It is unsustainable. It will be a serious drag on the dollar, which will make things even worse.

PEAK OIL VS PEAK PRODUCTION

In 1988 23 Billion Barrels of oil were found and used now it is 31 Billion used and 8 billion found. World oil output peaked in 2005. Peak oil Refers to the point which oil production peaks and begins the final depletion of world reserves, which may be as early as 2015. Its not that we lack as much oil, as we lack the capacity to produce more oil. Peak production refers to the oil infrastructure that is currently in place has maximum capacity of 100 Million Barrels which will be hit by 2010. Yes we have more oil but physically cannot pump and move more than that. Even an immediate and massive investment in infrastructure today would not increase peak production for 5-7 years.

ALTERNATIVE ENERGY

Transformation from being a crop farmer to an energy farmer. The old formula was sell corn and soy, some wheat and get some farm subsidy. Now it is higher crop process, dividends from ethanol plant payments wind turbines and income from selling co2 sequestering

This national transition will not occur without a widespread conversion of rural farm economy with its abundance of wind, sunlight and energy rich crops, On long term wind power could grow from 1% of us power supply to 20% it is the worlds fastest growing energy technology, the best places for wind farms are far removed from major population centers and are windy the Dakotas are perfect, and ethanol bio-diesel could grow from 4% of current supply to 20%. Geo thermal solar and which only produce 3% of our needs nuclear another 10%. Even if we do everything in another ten years we sill still be spending \$350 Billion a year on oil imports.

CREDIT CRISIS

CONSUMER TAPPED OUT?

Personal Debt 60 years in the making

The consumers 25 year shopping spree is over

Consumer debt is up 27% over last 5 years

Retiree debt went from 29% to 40%

College borrowing cost rose by 194% but tuition rose by 66%

US Government Interest expense on federal debt up 20% over last year

US Government debt has swollen to 9.5 Trillion or 65% of GDP

Add unfunded liabilities, Social Security, Medicare debt is \$53 trillion of \$175,000 per person

AMERICAN MIDDLE CLASS

The American consumer is scared

Credit crunch closing new loans

Falling housing prices

Bank failures are more common

Decline of us auto industry

Rising food and oil prices

Fear of loosing your job

Spiraling health care costs and reduced insurance

Even with stagnant real incomes, we can always live a little better every year by borrowing. Most Americans feel like they missed the boom. From 2002 to 2007 average incomes on the top 1% rose by 11%, the rest of us it grew by 1%. According to the IRS, the wealthiest 1% has 21% of all income that is the highest level since 1920. The bottom 50% has 13% of all income. The top 1% is above \$364,657, the median income in the US is \$30,881. How do you keep your standard of living growing when real income is not, credit cards! And when the subprime crisis hit that is exactly what happened. Credit card debt has increased by 8% in just the last 6 months.

Despite all the economic problems besetting the United States, the American economy is still larger than the next three economies combined (Japan, Germany and China).

CREDIT CARDS

We still have massive amount of consumer debt average family is now 123% of income there are over 1.7 Billion Credit cards an average of 7 for everyone over 15. Delinquency rates on cards are spiking in the exact same areas that have the biggest residential real estate problems. Most worrisome investors in credit cards are demanding higher yields to compensate for greater default risk. Defaults on credit cards are rising. 8.6% of all credit cards loans were 60 days past. At least \$500 billion at Fannie/Freddie to get them back on their feet again.

Consumers are more likely to load up on higher interest rate credit card debt now that home equity loans are drying up. Paradoxically the worse a person's house situation the greater likelihood they will repay credit cards as this is the last source of credit they have. We could see the largest pullback in consumer spending in decades as much as \$250 Billion, reduced access to credit combined with falling real estate values.

BANKING

It seems that with each passing month the estimates for losses in the international banking system keep rising. This time last summer the largest estimates were around \$400 billion, give or take a few months. By the end of the year it was in the neighborhood of twice that. Then last quarter we saw estimates approaching \$1 trillion. The number now is \$1.6 trillion,

We have seen some \$500 billion in bank write-offs so far in this credit crisis. Most of the write-offs have been mortgage-related and housing has not yet bottomed. We have not seen the write-offs that will come as consumers start defaulting on credit cards, auto loans, and other consumer debt. Neither have we seen the losses that will come from commercial real estate or corporate loan as the recession progresses.

Another 100 banks could fail, in the next six months, Banks have laid off 7% of their employees it may be 25% before this is over. But in the meantime, the trend toward lower lending is likely to continue a huge headwind for an economy that is already struggling. Banks cut back lending by 10% in the last 3 months, issuance of mortgage back securities is down 87% and junk bonds by 63%. In the last 12 months there has been \$2 trillion of mortgage downgrades. Part of the problem was the incestuous relationship between banks and credit rating agencies during real estate bubble the same as the relationship between mortgage brokers and appraisers.

Banks and investment institutions worldwide may need another \$500 billion in capital infusions. But where they are going to get it is the problem. As banks incur losses, they either have to find new capital or reduce their lending in order to maintain their capital ratios, or some combination of both. And what we are seeing is that lending is starting to actually decrease.

Credit spreads the cost has gone from 70 bps to 390 bps! That is over a 500% move - a big hit to margins and profitability.

DEAD MEN WALKING

Regions Bank
 Washington Mutual
 Wachovia
 Fannie Mae
 Freddie Mac
 Ford
 GMAC

LIMPING MEN WALKING

These that may be 'too big to fail', have enough quality assets to sell, a franchise that is worth something to an acquirer or could just be broken up into pieces.

Citi
 Merrill Lynch
 Morgan Stanley
 Suntrust
 Legg Mason
 Capital One
 AIG
 MetLife
 Prudential

FEDS SOLUTION

Play for time and pray it works its way out. The Federal Reserve Board has recreated itself as the all purpose guarantor of the US financial system they have become very innovative but they are stretched thin. The credit crunch flowing from America's subprime woes is causing a global increase in market interest rate spreads and a global tightening of bank lending standards. This is hardly surprising: almost half of all U.S. asset-backed subprime mortgage securities were distributed abroad. Out of a US economy with a \$56 trillion net worth it fell by \$3 Trillion in the first Quarter

In 1980, every major bank in the US was technically bankrupt. When the Latin American countries started to default, as they all had large amounts of Latin American bonds in their portfolios, at a size far larger than their capitalization. If the Fed had made the banks mark their portfolios to market, it would have been a disaster of biblical proportions. There would have been no American banks left standing. The US economy would have gone into a deep depression.

Instead, with a wink and nod, they let them keep the bad bonds on their books at face value, which they all did. Then in the latter part of the decade they began one by one to write off the bad loans, but only when they had enough capital to do so. It took six years (or more) of profits and capital raising to get to where they could deal with the problems without imploding themselves and the economy the same time.

The Fed and central banks around the world are allowing banks to buy time to work through their problems. There really is no other option. That extra \$1.1 trillion that they will have to be written off. This is going to be an ongoing process that will take several years at a minimum. Just like in 1980, the regulators are going to allow banks to write down their losses as they can

The problem is leverage, in the shadow banking system it has been as high as 100 to 1. The authorities are slowly losing control. All they can do is crisis manage. There are no good solutions, only expedient ones. Once the double bubbles in housing valuation and housing debt burst a little over a year ago, everybody, and in particular, every levered financial institution - banks and shadow banks alike - decided individually that it was time to de-lever their balance sheets. At the collective level, however, it has given us the paradox of deleveraging: when everyone is dumping bad loans on the market they exacerbate the problem creating even more write off.

\$25 TRILLION LOST

The 20 Trillion dollars in home values shrink by 25%. Taking \$5 trillion out of the economy. The stock market declines have taken \$3 Trillion dollars out of the economy. In banking for every dollar of equity you have you can loan ten dollars, if you loose \$1.6 Trillion in equity you have lost \$16 Trillion in lending power. The Fed and whatever administration comes in will do the same as the current group, which is to buy time so that the wounds can heal

HOUSING

The natural level of demographic demand for housing in this country is annual demand of 1.45 million units. From 2003 until 2007, builders added on average nearly 2 million residential units per year, or 30% more, than the natural demand could absorb. Home ownership in the last 5 years went from 63% to 69%. Housing market is so bad a developer in San Diego is offering a buy one get one free program.

There is currently an excess supply of 3.5 million homes. It's going to take some time to work through those excess homes - for the prices to drop enough that people can go in and buy them or rent them. 21 million households are below water on their mortgages. Any borrower who is upside down will be more likely to pay their credit cards and auto loans first and not the mortgage. We are probably talking 2011 before we finally work through this housing crisis and get back to a normal market where housing contributes significantly to GDP growth. Value of housing will bottom out with a 30% decline wiping out \$6 Trillion in household wealth. Remember real estate is still local of the 80 largest markets 23 actually are now stable or have gone up. The good news is that we're probably more than half way through the real estate correction. The bad news is that we've likely still got at least another 15% down on home prices to go before we reach bottom

COMMERCIAL REAL ESTATE

It is frequently said that no one rings a bell at the top a bull market but Sam Zell did in commercial real estate. Over the last 7 years the value of commercial real Estate has tripled while the stockmarket has gone up 8%, 16 out the 20 largest markets had double digit returns last year, the vacancy rate was 12.4% the lowest in 6 years in commercial real estate how do you make money if Cap rate is below lending rate. There are now beginning to see major cracks in Commercial real estate further exacerbating banking problems

CORPORATE EARNINGS

Recessions do ugly things to corporate bottom lines. They savage earnings, and that is what ultimately drives the stock market lower. For you to be bullish today, you have to believe that the recession is over and that earnings are going to rise, not fall

Year to date domestic earnings have declined by \$125 Billion, but overseas earnings increased By \$100 billion corporate America now derives 35% of earnings from overseas, but most of

those earnings come from big multinationals. Real trend is American corporate capital spending is being directed overseas to foreign operations not domestic, translation profits are coming home but the jobs and capital investment is going overseas

A 15% drop from where we are today would not be out of historical character. It would be a merely average bear market in an average recession. But it is worse than that. This is a very uneven picture

S&P 500 Earning decline by	- 20%
Financials by	-80%
Consumer Discretionary by	- 56%
Telecom by	-3%
Energy up	18%
Technology up	16%
Consumer Staples	13%
Healthcare	8%
Industrial	6%
Utilities	5%

FORECAST

I think we are likely to stay in recession for perhaps the rest of the year and well into 2009 before we start a very slow recovery. Earnings are going to continue to come under pressure, and earnings are what drive the stock market over the long term. We could see total S&P 500 earnings drop below \$60. You do the math. Even with a 16 multiple, that does not yield a pretty picture. Out of all the asset classes, stocks, cash, bonds, commodities, the only one to have a negative inflation-adjusted return over the past 10 years is the S&P 500

We are in the middle of a long term sideways market just like 72- 80. I think we are going to at least test the recent lows and then possibly watch the market go lower as the market gets disappointed in the earnings from the third quarter, and re-test those lows again. We are in for an extended period of Muddle Thru, while we wait for the housing market to find a bottom and the credit crisis to abate.

Over the next 20 years the US economy will grow at roughly a rate of 3 percent compounded, in real terms. But I believe that we have some headwinds for the next year or two. So I think the real bottom of this economic cycle will be later this year, during the fourth quarter and possibly into the first quarter of next year. But it will take two years, to get back to long-term trend growth. Era of low inflation is over

Recessions by definition mean that we're going to be seeing rising unemployment. We're already up past 5.5 percent. We'll probably see 6 percent and maybe higher. 2009 does not promise to be much better. We look for savings to rise, as consumers adjust to the tighter credit environment by building their savings rate up to 2-3/4% by the end of 2009.

WHEN WILL IT END

We now have a viscous circle banks have less lending ability the consumers get less credit which means less spending which means deeper recession, which means lower home values which means more bank lending losses.

- 1) Need to see the savings rate go to eight percent, not such a bad thing as 60% of middle class retirees will outlive their financial assets if they try to maintain their current standard of living
- 2) Housing supply below eight months inventory, we now have 121 months inventory and condo is 19 month inventory
- 3) Interest coverage ratio has to come down to 10.5%. The average household is spending 14.5% of its budget on interest and principal repayments. It's at a near-record high, there are only two ways to eliminate debt. You either walk away from it, or you pay it down. That means that the savings rate is going to be forced higher. This, again, is going to be very, very disinflationary. It means frugality is going to set in. We're going to be living in smaller houses, driving smaller cars and living more frugally

Interest rate cuts (2.25%) by the fed started over a year ago that should start to be kicking in, but despite cuts the yield spread has been widening and mortgage rates are now 1% higher than a year ago

AUTOMOBILE INDUSTRY - SURVIVAL

The slow motion death of the American automobile industry is almost too painful to watch. The flood of bad news coming out of Detroit has literally swelled into a tsunami, and there is no end in sight.

Standard & Poor's did another number on the industry. In three separate reports, it downgraded General Motors Corp, GMAC, Ford Motor Co, Ford Motor Credit Co., Chrysler and DaimlerChrysler Financial Services Americas. The stated rationale for these downgrades (S&P could have chosen a dozen reasons) was basically concern over shrinking cash flows and liquidity at all three companies and their finance arms.

In 1995 Ford had 20% of US market now it is 10%. Ford motor lost \$8.7 Billion loss last quarter and has a \$9 Billion underfunded pension liability

The dramatic reduction in the availability of auto financing will be another nail in the coffin of the American automobile industry (at some point the coffin will have so many nails in it that it won't need any wood). Leases account for roughly 26 percent of annual auto sales. Just as subprime mortgage financing led many consumers into homes that they couldn't afford, low-cost auto leases allowed many people to lease cars to which they otherwise wouldn't have had access. Leases also led many consumers to replace their vehicles in a much shorter period of time than they ordinarily would have done, leading to higher auto sales. Automobile manufacturing and financing is a significant component of the American economy, and we are watching it being deconstructed piece-by-piece before our very eyes

On July 31, GMAC released its second quarter 2008 results, a loss of \$2.5 billion (that would have been much worse without \$1.55 billion of lease support payments that GM is obligated to make to GMAC under risk-sharing and support agreements dating from 2006.) GM reported that it has \$30 billion in North American leases, including \$12 billion in SUVs and \$6 billion in other trucks. If current trends hold, GMAC is looking at further multibillion write downs. Backing out these so-called one-time charges left GM with a \$6.6 billion quarterly loss, which was still 450 percent larger than analysts projected

Global sales plunged by 18 percent during the quarter, with U.S. sales fading by 16 percent through June. July trends continue to point sharply downward, and the effective elimination of leasing by GMAC can only further reduce sales, how is GM going to survive as a going concern

If we're lucky, the U.S. auto market will post no more than a 10 percent decline this year. From the peaks we saw early in the decade, the numbers will drop to barely 15 million, according to the latest forecasts, and some pessimists still think we could plunge down to the 14 million range.

The latest news out of Detroit makes it abundantly clear that the endgame for the Big Three is going to be massive bankruptcy restructurings.

Chinese love big cars it is a sign of prestige, the number of SUVs sold in China rose 45% last year, and there are only about 15 million private cars in land of a billion people. Chinese are buying to the American Lifestyle big houses big cars. Big suburbs. There are now more Buicks sold in China than the US. Some estimate the Chinese market will demand 9.3m new cars, in 2010. Others suggest an overestimation of 1.5m vehicles. That's half of Germany's annual sales.

The trouble with the automotive business in China is that all of the big companies want to sell a million cars there and think their sales can grow at 30% to 40% per year. The market leaders, GM (GM) and VW, are likely to find that the number of rivals with a presence in the market is getting larger as time passes. According to the report, sales in South America and Eastern Europe grew by 24% in year-over-year results, outpacing China's 17% yearly gain.

Complicating matters, the Chinese market is also the world's most competitive. Virtually every Western, Japanese, and Korean nameplate is pushing to expand its presence there, as are the best of the domestic Chinese brands, like Cherry and Brilliance. That's been driving down prices spectacularly, in some recent periods by as much as 25 percent a year. So it seems increasingly difficult for carmakers to count on China to make up the dollars they're losing in the U.S. and other struggling Western markets China is actually preparing to invade other markets like US Europe and a real focus on Africa

Russian car sales have soared by 40% in the first half of 2008, totaling 1.45 million automobiles, making it the second largest European market behind Germany, where 1.63 million cars were sold. Car sales in Russia grew by 34% last year to 2.3 million units. . Russia is becoming Europe's top car market. Spending on autos increased 64 percent to a record \$33.8 billion,

Brazil's car production has expanded by 23 per cent so far this year and Brazil is the seventh largest auto maker in 2007, surpassing Canada and Spain, and is primed to overtake France and South Korea in 2008. May become the world's fifth or sixth biggest car market. Some customers in Brazil have to wait up to three months to get a car; Eighty per cent of vehicles sold in Brazil are flex fuel models that run on ethanol, manufactured locally from sugar cane. Brazil's car market is the largest in South America, accounting for 60% of the region's volumes. For passenger car and heavy commercial vehicle sales the upturn was approaching 30.0%. New-vehicle sales have soared this year on the back of improved consumer confidence, tax cuts, better credit terms, falling inflation and economic stability.

Indian government hopes auto sales jump from last year's \$34 billion to \$145 billion in 2016. If they do, the domestic auto industry could represent about 10% of India's gross domestic product Companies like FORD and TOYOTA cannot afford to miss the China opportunity. But, as local car companies are not going to permanently leave the market to outsiders, and nothing goes up at 40% forever.

VISION 2020 - LOOKING FURTHER OUT

In the next 21 years we will see double the technological change that we saw in the entire 20th century. At that pace, we will see almost four times the rate of change within 25 years

Between 1900 and 2000 the world's population quadrupled. Now 40% of the world's population lives in countries with a negative fertility rate. The world's current population about 6.5 Billion is expected to peak about 2050 and then begin declining. Japan is another worst case example with its population dropping from 110 Million to 90 Million by 2025 and then 40% of its population will be over 65

THE END OF CHEAP FOOD

Riots over food shortages and prices have broken out in over 35 Countries

Including Russia, Egypt, Argentina, Pakistan, Nigeria, Ukraine

In 2006 the top 5 oil producing countries supplied 43% of the worlds supply

In 2006 the top 5 corn producing countries produced 77% of worlds corn supply

73% of world rice supply

66% of wheat

62% of beef

Consequently a disruption in any one of these key countries can create massive problems

Wheat was \$400 a ton double the 25 year average, Earlier this year corn was \$175 a ton but is still 50% above its average for 2006 The food price index is up by 1/3rd in the last year, these record prices are happening not due to scarcity but abundance. This year the cereal crop will be 1.66 billion tones the largest on record and 5% more then last year

From 2004 to 2007 global corn production increased by 51 million tons at the same time biofuel use of corn used 50 million bushels but at the same time global consumption of corn increased by 33 million ton

Driven by the new wealth of India and China stoking demand for meat and the growth of the overall world population demand for bread and tortillas. In 1985 the average Chinese ate 44lbs of meat now its over 100lbs of meat, Farmers now feeding 250 more tones of grain to animals then they did 20 years ago

The rampant demand for ethanol the US is the worlds largest grain exporter but it now uses more for ethanol then for export due to the demand for corn, farmers planted more and planted less of wheat and soybeans this year the use will harvest 335 million tones of corn of which 85 million will be used for ethanol. Overall stockpiles of all cereals will decline by about 53 million tons. American ethanol production accounts for half the worlds unmet need for grains. The same amount of grain one person needs in year is the same to supply an SUV in a year

Food prices in 2005 was slightly lower then 1974 which means in inflation adjusted food prices fell by 75% over the last 30 years. In 1960 food accounted for 25% of a families spending now it is 12%. Net farm income will be 50% more then it averaged for the last ten years 2.5 billion people are involved in food production that includes 75% of the worlds poorest. The net impact food prices have increase global inflation for 6% to 8%. If food prices rise by 30% it will reduce the standard of living in rich countries by 3% but 20% in poor ones. The expansion of ethanol and other bio fuels will reduce calorie intake in Africa by 6% and 3% in Asia. Global warming could cut world agricultural output 16% by 2020

GLOBAL WARMING

Everyone now seems to agree we are having some type of global warming, the argument Are the solutions to expensive to be worthwhile? When the President of Shell Oil gives a speech and says 90% of world leaders believe that greenhouse gasses are impacting climate change, the debate over the science is over.

Butterflies are moving from southern Europe to Finland, ski lift operators are asking to move their leases to higher elevations; polar bears are losing weight and declining in numbers. Power planners in the Northwest which gets three quarters of its electricity from hydro electric are now making contingency plans. But the ultimate proof may be from the hard nosed pragmatists of the major reinsurance companies like Swiss and Munich re where the impact of global climate change are the fastest growing part of their research and actuarial assumptions. No wonder insurance premiums and deductibles have tripled in some coastal areas. Allstate insurance has already run scenarios of the impact of a CAT 3 hurricane hitting New York City Harbor and driving a 15ft wall of water up Broadway and Wall Street.

Hard to asses future costs, Drought in Africa, floods in Europe Hurricanes in US rising sea levels, of course the solutions is the rising cost of fossil fuels and the declining price of alternative fuels, with a concentrated effort at the cost of 1% of global GDP could stabilize the situation by 2050. If we do nothing could be 6 degrees warmer by the year 2100, to do nothing would be our greatest failure. Of course it is not all bad more people die from cold weather then from heat waves and some areas like Canada and northern Europe will become more desirable.

The real issue as these problems manifest themselves, the third world is industrializing and the new middle class will demand even more accelerating the damage. In effect the developed countries are telling the developed they must stop polluting because the developing countries have already done the damage.

SOVERIEGN FUNDS

The rise of sovereign investment are a threat, these are not companies these, are foreign governments buying our assets with cheap dollars. They have approx \$2.5 trillion compared to \$1.5 trillion in hedge funds. UAE \$ 1 trillion, Singapore \$400 billion, Saudi \$600 billion, China \$500 billion, Norway \$300 billion. Korea \$100 billion. Not to mention that national pension systems of several countries.

DECLINISM

For the last 20 years we have had an economic golden age, steady growth, low inflation, rising incomes, improved standard of living with only two minor recessions and the stockmarket has gone from DJIA 2,000 to 14,000. But now the world economy has reached a decisive point. In the past decade we have weathered-Asian Financial Crisis, Russia's debt default, dot com bust, global terrorism, Iraq war and now housing bust. Also household debt as percentage of disposable income has gone from 75% to 128% in the US and from 80% to 155% in the UK- much of Europe is the same.

So is America in the twilight years of economic power destined to fade in the 21st Century? Before you say yes, ask yourself a question, in 25 years what country would you like to live in? The mistake we make is not in over stating our problems but in under estimating the problems of our rivals. As a global military power our spending on defense is equal to the next 15 countries

combined. The GDP of the US in 2007 is \$13.2 Trillion, China is \$2.6 Trillion. US consumer spending is 4 times that of China and India combined.

China's population is starting to shrink. Germany is aging so fast that by 2020 they will have one worker for each pensioner, Russia has a lower birth rate along with a lower life expectancy and net population is declining by 700,000 a year.

America is responsible for ¼ of global manufacturing, the same as it was 40 years ago. In last 50 years manufacturing has shrunk from 35% of the US workforce to 12%. Today China is responsible for 1/10 of global manufacturing. 30 years ago American Manufacturing produced \$1.3 trillion with 20 million workers today we produce \$4.5 trillion with 14 million workers. America is blessed with a durable constitution, cultural diversity, abundant resources and an open society. Above all American believe improvements can always be made and have an unwavering sense of optimism