Our Economic Condition
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After considerable research over the past six months, research that actually initiated itself about 2001 just after I lost $100,000 in the stock market, I have come to the conclusion that we are to expect extremely troubled economic times in the near future that can be expected to continue for several years; quite probably six or seven.

The economy we are facing, according to my research, will see market drops and depressed (deflated) prices reminiscent of the Great Depression.

My opinion was reached after examining several different perspectives that all result in the same basic effect; a substantial loss of purchasing power in the United States economy. It is well known that consumer spending drives America, accounting for over 65% of all spending and our economy. So what happens when the consumers stop, to the extent that they can or have to, spending? Factories produce fewer consumer goods. Fewer consumer goods are imported. Money is spent on “essentials”. Fewer cars are sold, fewer new clothes are sold, less warehouse space is needed because there are fewer goods to carry in the pipeline, and fewer people are employed at every level, perpetuating a downward cycle. Governments will have to reduce services and employees as their revenues decrease. The goods that remain to be sold will have such little demand that their prices must drop in order to have any sales at all. The economic nomenclature for this severe recessionary effect is “depression”.

Similarities to the Great Depression

The years before the Great Depression saw credit purchasing for the first time en masse, caused by sudden “easy” credit, resulting in massive over-borrowing. Another way of putting this is that there was an extremely rapid expansion of the money supply and a rush on credit. The late 20’s boom was largely due to the introduction of credit borrowing which fueled auto and real estate purchases. The populace over-borrowed and over-spent, depleting their savings in the process.

Today, America’s recent overly-liquid economy with extremely low interest rates has functioned to create an extremely rapid expansion of the money supply, causing a substantial rush on credit which we today have termed “sub-prime” borrowing. This has caused massive numbers of borrowers to over-borrow to purchase homes at inflated prices. They also borrowed against their home equity to fund consumer purchases in the belief that the real estate “value” (read “price”) was always going to go up and create instant value for them, which they deemed to be income and used it as such. In the over all economy, this created an artificial appearance of increasing credit demand and values of goods and services, including real estate. This phenomenon was commonly referred to as “using a home as an ATM machine”.

Then the real estate values stopped going up.

Together with this effect, credit was offered and consumed by people when they did or did not qualify for it, and at tricky terms; a three-year fixed artificially low rate followed by a substantial increase in interest rate and payment. The borrower, only able to afford the initial payment, ultimately defaulted. This happened en masse across the United States and has rippled upward through the economy. Those who had banked on and resold and invested in the paper essentially pretended that it had value in it, had little or none; some lost all value.

A major function of this phenomenon is similar to what happened just before the Great Depression in that America's savings have been depleted. America has not had such a low savings level as it does now since 1932.

Demographic Explanation

Demographic effects on consumer spending habits are best described by Harvard Economist, HS "Harry" Dent, Jr. Mr. Dent's research correlates the age of the 46 to 50-year-old heads of households in America with an accordant "Highest years of spending". As the cost of raising a family wanes, more money becomes available for luxury in consumer spending items. "This causes boom periods that last 26 to 29 years, followed by bust periods after the generation has peaked in its spending, that lasts 12 to 14 years" (Harry S. Dent Jr., The Roaring 2000's").

When the demographic quantity of 46 to 50-year-old people is overlaid with Dow Jones industrial average as adjusted for inflation, we see a very close correlation. Dent's work demonstrates the close relationship. Depression years saw a substantial drop in this 46 to 50-year-old age demographic. Dent believes that it was a sudden drop in consumer spending of his stated demographic component that caused panics and the markets to occur that exacerbated and accelerated, what was going to be a substantial recession, into the Great Depression. While it is clear that there were other aspects as well, it is easy to recognize and allow Dent's analysis.

When we look at the Immigration-Adjusted Birth Index and calculate the age of the 46 to 50-year-old heads of household in the current day, we see that a precipitous drop in this demographic is getting ready to occur. Specifically, it flattens in 2008 to 2010, drops precipitously until approximately 2014, rises a bit to 2020, and then drops precipitously again before bottoming out in approximately 2025. This analysis is entitled "The Spending Wave" by Dent and was copyrighted by his HS and Foundation in 1997.

So according to Dent, a major indicative if not correlative function of consumer spending in the United States of America is about to come to a screeching halt.

What are baby boomers doing today? Believing that there will not be a Social Security system to pay them, they are saving at a more rapid rate for their retirement, having a further negative effect on consumer spending. Unfortunately, there functionally is only one way to fund the void in Social Security and that is with higher federal taxes. This of course will have a further deleterious effect on consumer spending.

We know some things now that we didn't know at the Great Depression. Here are some other things that are likely to occur, as they have been occurring on a very regular basis for the last 80 years. These factors may very well serve to exacerbate those sited herein.

1. The first two years of every decade are almost always down years in the economy and is so demonstrated in the Dow Jones Industrial Average.

2. The first two years of a Presidential Cycle are almost always flat to down in terms of economic activity as the new administration gets accustomed to running the country.

Technological innovation/contribution-to-productivity cycles have a definite effect on economic productivity. Generally referred to as "S-Curves", they relate to consumption and maturity of technological functions, in terms of percent of households that acquire ownership of a given major technology and the resultant increases in economic productivity and growth.

3. The S-Curve in automobiles began in 1900 and rose gradually to 1914, accelerated rapidly to 1928 when approximately 90% of <u>urban</u> households owned a car. This was termed the "Henry Ford era" and had an astounding effect on economic growth of the United States. This curve flattened until 1942. Today we have mobile phones, broadband, internet, digital cameras, and digital recorders of all kinds. Virtually all of these recent technologies will have reached their 90% maturity level, in terms of percent of households that own them, by 2009. Again quoting Harry Dent, "... Once the power of these tools has been fully utilized, the productivity growth slows down. And when the productivity growth slows down, so does income growth and with it your standard of living".

4. We all recognize the value of technological innovation in the American economy. With the slowdown soon to be replaced by new growth technologies and technological innovation in the information age, which will take time to engage, we can expect the economy to slow as well.

<u>Oil.</u>

America has been reliant on oil without competition in the world until now. With the industrialization of China and its incredible thirst for oil, America now has to compete on the world market for oil supplies. That means we are going to have to pay as much for oil as they have been paying in Europe for decades. This is going to take purchasing power out of the economy that people are accustomed to spending for other purposes. People will of necessity buy fuel for their automobile instead of buying new clothes, for example. Many will get stuck with older cars that are not fuel-efficient because they will not be able to afford a new car, creating a rather vicious cycle. Until America gets used to its new fuel prices, consumers are going to struggle. Until a new technology accelerates to the point where it can make a difference in fossil fuel consumption in the United States, (even though electricity is coming on fast it will take years to integrate into the United States automobile economy) we are going to be stuck with the inefficiencies that the new high fuel prices will exact on our economy and on the individual budgets of most citizens. Simple gasoline for automobiles is not the only effect. Increasing fuel costs will keep materials and delivery costs high. Fuel costs are responsible for an almost 8% increase in food costs across the board in the last two months alone

Middle-America Home Purchase/Financing.

My observation in the real estate industry is that a substantial number of consumers took out low interest, but variable rate loans, to buy substantially more house than they would have otherwise been able to afford. Many of them refinance their homes much in the same way as the first time homebuyers did. (We refinanced our house four times in two years). Personally my wife and I did not borrow more money (as we certainly could have and were urged by our lender to do) with our goal simply being lower payments. Many others used home equity to fund trips abroad, new cars, and other consumer expenditures. Today, if one of the two earners in a household has a pay cut or a layoff or a job loss about the same time that the rate rolls to a new rate, there will be an additional consumer spending negative effect and result of family economic trauma. And the over-borrowing over-buying was not limited to the lower income category. The bloom of "McMansions" across the country is evidence of this, with a similar result of massive loss of value, with foreclosure often the result. While the savings of this higher income group may not have been depleted, certainly the erosion of real estate value has had a significant adverse effect on them, often creating negative equity.

Other Financing.

And many did the same thing with commercial properties. "We" took the attractive short-term adjustable interest rates and increased our loans, reinvesting additional borrowings in more real estate, also leveraged. Loss of a tenant or slow-paying tenants will of course cause pressure on savings and causes some properties to go into foreclosure. This in turn causes pressure on banks and causes them to make fewer loans available, crippling the effect throughout the economy. I believe the banks are going to own a lot more real estate than they want to, and that some will fail.

Consumer Effects.

Here are some examples that are already evident in our economy and drops in purchases of goods and services.

We will see a drop in purchases of:

- Furniture (fewer houses to furnish)
- Cotton goods/clothing/soft goods (clothing comes after fuel and house payments)
- Restaurant meals
- Hair cuts/Styling (longer between appointments)
- Restaurant purchase type (more credit purchases and in cash now, "delaying the pain" taking more purchasing power to pay the interest on the credit card); lowered tips
- Higher priced wines (people will still drink wine but will buy less expensive ones)

These effects will cause lower tax revenues in municipalities and cause them to cut back on employees and municipal services. While there are a lot of government jobs that will be immune from cutbacks such as police, teachers, firemen, etc., they will be more vulnerable than they think.

<u>Conclusion.</u>

Our current economy is clearly being adversely affected by the same fundamental functions that predated the Great Depression. It is clear to me that a similar recovery process and time must take place**. Individual savings has been depleted** and needs rebuilding. Defaults are occurring and prices are falling, causing a return to "real" value of real estate assets and then probably below what we believe to be a historic basis of value. Indeed the rapid run-up of artificially induced real estate prices from 2005 to 2007, approximately 20% in some cases each year, was artificial and must come back down. I refer to the overpriced nature of housing as being in a "Plateau flow", having to work through its own aftermath of momentum. Last year's single-family residential lot prices generated prices and products that are no longer attainable. I predict that we will see within the next three to four years, a full 25% drop in real estate prices in many cases 40%. Here's another view. Residential real estate is 6.28% of GDP. If it goes down in value 50%, the national effect is a major reflect recession, reflecting a 3% drop in GDP.

We now have and can expect a greater **major reduction in purchasing power**; the result of an excessive expansion of the money supply combined with artificially-induced financing. This is confirmed on "The Street", and there is little, if any, hope for near-term recovery. "Fed" temporary fixes will be just that but can have no real long-term functions to restore personal savings to the economy and therefore the prosperity that drives consumer spending. A downward spiral in employment, wages, and consumer demand will cause values of almost everything to decline in an economic depression (deflation). Any national or international incident will exacerbate the effect.

Any one of these above-stated observations, or "cause/effect functions" would have a deleterious effect on the economy. Combined, **the result will be profound**. Certainly there are sections of the economy that will be nominally affected. While many are guessing at what those will be and while many believe for some reason that "their" sector is immune to recession, it remains to be seen what sectors will escape with nominal adverse effect. It will be interesting to see what happens with the gambling industry, for instance.

Higher prices are a logical certainty. This will not be limited to federal income taxes.

Fundamentally, this is a scenario for the consumer to hoard cash and have little or no debt. A reasonable alternative strategy to having little debt, it is said, is to have a lot of debt, because a lender is less likely to foreclose on a property with a nominal equity margin than it is one with a substantial equity margin. I'll go with that.

2008 will be a great time to get out of stocks and into cash, because as stocks go down in any relation to what they did in the Great Depression, we'll be looking at the Dow Jones industrial average of about 2000. Some believe that as low interest rates come to an end in late 2008 to 2009 that the interest rate on US treasuries will rise, causing a reasonable as tragedy to go to the safe investment A strong bonds. I do not know enough about this but it seems to make sense to me.

One should pick their banks carefully and allocate assets among more than one bank.

Here's the really good part. For those with cash and the ability to sustain several bad years of little or no income **there are going to be some great real estate buys out there.** One needs to be careful to not use' 05-'07 prices to benchmark one's bargain.

One last point: there is no presence in the current media of any observation that says the economy is *not* in trouble and most observe that it's going to get worse. We have not had this predominance of thought in recent history.

Respectfully submitted,

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Please feel free to send criticism/counterpoint comments to:
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PS – while this downward economy has already begun, there may be a slight relaxation of the downward trend demonstrated in mid-2008, both quarters two and three. The National Association of Realtors recently predicted a rebound for this term. I believe this will be a misleading bubble. The fact that it is a Presidential Year alone is cause for the logic that the current administration will stimulate the economy to the extent possible during this time.