Armstrong Economics:

The Coming Great Depression.

Why Government Is Powerless

It is frustrating to read so many comparisons of our current situation with 1929 while watching policy be set-in-motion to create spending on infrastructure. Everyone has their hand out looking for a bailout like a bunch of street burns pleading for money so they can get drunk or stay drunk. Almost nothing of what I have read is close to being accurate. The scary part is depressions are inevitably caused by politicians who may be paving the road with good intentions, but are relying upon analysis so biased, we do not stand a chance.

The stock market by no means predicts the economy. A stock market crash does <u>not</u> cause a <u>Depression</u>. The Crash of 1903 was properly titled – "The Rich Man's Panic." What has always distinguished a recession from a <u>Depression</u> is the stock market drop may signal a recession, but the collapse in debt signals a <u>Depression</u>. This <u>Depression</u> was set in motion by (1) excessive leverage by the banks once more, but (2) the lifting of usury laws back in 1980 to fight inflation that opened the door to the highest consumer interest rates in thousands of years and shifted

spending that created jobs into the banks as interest on things like credit cards. As a percent of GDP, household debt doubled since 1980 making the banks rich and now the clear and present danger to our economic survival. A greater proportion of spending by the consumer that use to go to savings and creating jobs, goes to interest and that has undermined the ability to avoid a major economic melt-down.

The crisis in banking has distinguished depression from recession. The very term "Black Friday" comes from the Panic of 1869 when the mob was dragging bankers out of their offices and hanging them in New York. They had to send in troops to stop the riot. A banking collapse destroys the <u>capital formation</u> of a nation and that is what creates the <u>Depression</u>. The stock market is not the problem despite the fact it is visible and measurable and may decline 40%, 60% or even 89% like in 1929-32. But the stock market decline is normally measured in months (30-37) whereas the economic decline is measured in years (23-26). Beware of schizophrenic analysis that is often mutually contradictory or often antagonistic in part or in quality for far too often people think they have to offer a reason for every daily movement.

Our fate will <u>not</u> be determined by the stock market performance. Neither can we stimulate the economy by increasing spending on

infrastructure any more than buying your wife a mink coat, will improve the grades of your child in school. We are facing a <u>Depression</u> that will last 23-26 years. The response of government is going to seal our fate because they cannot learn from the past and will make the same mistakes that every politician has made before them. Even if the Dow Industrials make new highs next week (impossible), the <u>Depression</u> is unstoppable with current models and tools.

Stocks & Consumers vs. Investment Banks

Let us set the record straight. The Stock Market is a mere reflection of the economy like looking at yourself in a mirror. It is <u>not</u> the economy and does <u>not</u> even provide a reliable forecasting tool of what is to come economically. We are headed into the debt tsunami that is of historical proportions unheard-of in history. There have been the big debt crisis incidents that have hobbled nations, toppled kings, and set in motion economic dark ages. It is so critical to understand the difference between the economy and the stock market, for unless you comprehend this basic and root distinction between the two, survival may be impossible.

To the left I have provided the Economic Confidence Model for the immediate decline. You will notice I did not call this the "stock market

model" nor a model for gold, oil, or commodities. I used the word "economic" with distinct and clear purpose. I have stressed it does not forecast the fate, of a particular market or even a particular economy. It is the global economic cycle some may call even a business cycle. Please note that what does line-up and peaks precisely with this model often even to the specific day that was calculated decades advance is the area of primary focus. Yet the US stock market reached a high precisely with this model and then rallied to a new high price 8.6 months later. In Japan, the NIKKEI 225 peaked precisely on February 26th, 2007. This is not a very good omen. But there was something profound that turned down with the February 27th, 2007 target - the S&P Case-Shiller index of housing prices in 20 cities. February 2007 was the peak for this cycle in the debt markets - not the US stock market.

The stock market always bottoms in advance of the economic low. In fact, we will see new highs in the now even in the middle of a Great Depression. At least the 1929 cycle was more of a bubble top in stocks than what we have in place currently in the US stock market. We still had the bubble top in the NASDAQ back in 2000, but this illustrates the point. There was a major explosive speculative boom. The bubble burst in 2000 and there was a moderate investment recession into 2002, but there was no appreciable economic

decline that was set in motion because of that crash. Currently, we have a major high in 2007, but it was not a bubble top because it was not the focus of speculation. The real concentration of capital that created the bubble top, took place in the debt markets. This is the origin of the economic depression - not stocks and not the displacement of farmers because of a 7 year drought created by the Dust Bowl that invoked the response of the Works Progress Administration (WPA) in 1935. Keep in mind the stock market bottomed in the mid summer of 1932 when unemployment was not excessive from a historical perspective. The 25% level of unemployment came after the major 1932 stock market low that was followed by both the banking crisis after the election of FDR and before his fateful inauguration. The Banking Crisis came about because of rumors that Roosevelt was going to confiscate gold. Herbert Hoover published his memoirs showing letters written to Roosevelt pleading with him to make a statement that the rumors were false. He did not.

It’s the Debt Level Stupid

In 1907, the excessive debt was in the stock market. Call Money Rates (the level of interest paid to support broker loans) reached 125%. Even 1929 never came close to such levels. This also illustrates that the capital markets do not have enough money to invest equally on all levels in all

segments of a domestic economy or in particular nations. To create the boom-bust, it requires the concentration of capital. A bubble top is formed when the majority of those seeking to employ money to make money are focused in a particular market or even country. The 1907 Crash was a bubble top because capital invested on a highly concentrated basis in railroad stocks. The bubble top in Japan back in 1989 was caused by a concentration of both domestic and international capital that had made Japan the number one market in the World. It is this concentration of capital that creates the boom and bust cycle. If money was evenly disbursed like the socialistic & communistic philosophies argue, we would be back to the dark ages where there was no concentration of capital and no economy beyond the walls of the castle so to speak. That is why communism failed.

It is the overall level of debt that has reached a bubble top in almost every possible area. For example, in 1980, household debt was about 50% of GDP. Going into the February 2007 high, it reached about 100% of GDP. We must also realize that something profound took place back in 1980. Americans would on the first blush seem to be living it up, buying everything they can on credit and have piles of tangible assets to show for it. That is like looking at the statistics for carrots and arguing that they are lethal because every person

who has ever eaten a carrot is dead or in the process of a gradual slow death. This absurd example illustrates the bias that can produce the schizophrenic analysis.

There were, once upon a time, usury laws that generally held any interest rate greater than 10% was illegal. The Federal Reserve under Paul Volker believed that interest rates needed to be raised to insane levels to stop the runaway inflation, which was the first stone that hit the water sending the shock waves that we are having to pay for today. Once the usury laws were altered so the Fed could fight inflation, it set in motion the doubling of household debt, not to mention the national debt. At 8%, the principle is doubled through interest in less than 10 years. The national debt exploded from $1 to about $10 trillion in 25 years and household debt has doubled. Some states now consider usury to be 26%. Historically, these are the interest rates paid by the very worst of all debtors - the bankrupts. In fact, in China, the worst creditors historically paid at best 10%. What we have done is the lifting of usury to fight inflation back in 1980, has resulted in usury now being so high, a larger portion of income of the common worker is spent on interest, not buying goods & services that even create jobs. This is one primary reason why jobs have been leaving as well. The consumer needs the lowest possible price and labor wants the

highest wages, and to stay competitive, producers leave taking manufacturing jobs as well as service jobs. The extraordinary rise in interest rates that are historical highs since at least pre-Roman times, could not have been possible but for the lifting of usury laws back in 1980 to fight inflation. This amounted to setting a fire to try to stop a brush fire that failed. Consumers pay the highest rates in thousands of years that feed the banks at the expense of economic growth. Even the National Debt rose from $2. 1 to $8.5 trillion between 1 986 and 2006 with $6. 1 trillion being interest. We are funding the nation on a credit card and destroying the economy simultaneously.

This has been enhanced by the tremendous leverage and false position that were created in the derivative markets causing the banks to just implode. Indeed, this is the origin of the economic Depression we are facing. The $700 billion bailout might have worked if Paulson did what he said he would - buy the debt and take it out of the banks. Had the debt been segregated into a pool and managed independently by a hedge fund manager not an investment banker, we could have mitigated the problem. But that is now too late. The credit implosion is taking place on a wholesale basis around the world. The more the economy declines in housing prices, the greater the defaults, the greater the foreclosures,

and the lower the economy will move. We are now in a downward spiral that cannot be fixed by indirect schemes. As I said, you cannot get your kid's test scores up by purchasing a mink coat for your wife. Everyone will have their hand out begging for infrastructure money. But the theory of just spending money that will somehow make things better, it is like handing Mexico a trillion dollars and arguing that they will buy US goods that will somehow reverse the economy.

The leveraging of debt by the Investment Banks in particular has undermined the global economy. Where household debt has doubled since 1980, the professional financial service sector has seen a rise from 21% of GDP in 1980 to 116% by February 2007. Now consider the debt that they created with the mortgages is already down by 50% and falling, the bailouts will keep coming. To help correct the problem, the commercial banks will tighten credit to make their exposure less, and in fact, their solvency ratios will require it anyway. This we can expect to see not just in business, but housing and car loans that will contract the economy as well.

The Great Depression is not the perfect model for today. It was a complete capital contraction. The stock market basis the now Dow Jones Industrials fell 89% between September 3rd, 1929 and July 1932. The contraction in debt was quite massive. Then too, the leverage in banks collapsed that

reduces the velocity of money and therefore the money supply. The banks were the first real widespread failures with 608 in 1930. Between February and August 1931, the commercial banks began to bleed profusely as bank deposits fell almost $3 billion or about 9% of all deposits. As 1932 began, the number of bank failures reached 1,860. The massive amount of bank failures in the thousands took place with the rumor of Roosevelt's intention to confiscate gold. Although he denied that was his policy the night of the elections, he remained silent refusing to discuss the issue until he was sworn in. on March 6, 1933 just 2 days after taking office, Roosevelt called a bank "holiday" closing the banks from which at least another 2,500 never reopened.

All of these events are contrasted by the collapse in national debts in Europe. Other than Herbert Hoover's memoirs, I have yet to read any analysis of the Great Depression attribute anything internationally other than the infamous US Smoot-Hawley Act setting in motion the age of protectionism in June 1930. It was the financial war between European nations attacking each other's bond markets openly shorting them that led to all of Europe defaulting on their debt. Even Britain went into a moratorium suspending debt payments. This is what put the pressure on capital flows sending waves of capital to the United States that to sane degree was kind of like

the capital flow to Japan into 1989. This put tremendous pressure upon the dollar driving it to new record highs that were misread by the politicians who did not understand capital flow. They responded with Smoot-Hawley misreading the entire set of facts. (see Greatest Bull Market In History) (Herbert Hoover's memoirs).

It is true that today we have Keynesian and Monetarist theories to manage the crisis. Sad to say, neither one will now work. Bernanke has responded in force dropping the federal funds rate from 5.25% to .25%. He has also opened the Fed Window and thrown out more than $1 trillion in 13 months. However, as admirable as this may be, he has no tool that will do the job. Milton Friedman was correct! The Great Depression was not caused by the decline in the stock market. The event was set in motion by the credit and banking crisis that resulted in a one-third contraction in the money supply.

Interest rates will do nothing. The flight to quality always takes place so what happens is a two-fold punch. (1) Interest rates collapse because capital seeks preservation not yield and will accept during such times virtually a zero rate of return, and (2) the flight to quality takes more available cash from the private sector because government debt truly does compete with the private sector. We are seeing this even now. Federal debt becomes the place to go so we see higher yields

in both state am municipal bonds because they are not quality and could default like any bank. This contracts the money supply. Opening the window and just throwing buckets of money into the system will never have any impact to reverse the trend.

Furthermore, we are now in a Floating-Exchange Rate system that has made the global economy far more complex than it was in 1929. We all know that China is one of the biggest holders of US government debt. With the contagion spreading to Russia, South America, and China aside from Europe, we see a steeper decline in the China stock market than we do in the United States because that is where capital had concentrated domestically. If China needs money to stimulate its own economy when exports appear to be collapsing by about 50%, then we can see that the Keynesian model is worthless. If the Fed tries to pump money into the system through buying bonds from the private sector, those bonds may be held by aliens who take the money back to their own economies. The Fed cannot be sure it is even capable of stimulating the purely domestic economy. Lower interest rates to virtually zero like Japan did during the 19905, then if capital finds a better place to invest, it can leave for a higher rate of interest as capital did from Japan to the United states, which is why their domestic economy was never stimulated by the' lower

interest rates. Leverage during the Great Depression was not even remotely close to what we have to face today. The credit-default swaps are alone worth about $60 trillion. This was a stupid product for it has so tangled the world there may be no way out. This product created the false illusion that you did not have to worry about the quality of the loan because it was insured. We have no way of covering this level of implosion. Add the unfunded entitlements and then the state and local debts who cannot print money to cover their shortfall s, and we are looking at a contraction of debt that is simply beyond all contemplation.

So What Now?

So now that we see it is not Wall Street, again, but the banks, perhaps we can separate the facts from the fantasy. We can now see that there are two separate and distinct forecasts to be made - (1) economy and (2) stock market. Economic Depressions have a duration unfortunately of generally 23 years with an outside potential of 26 years. The 1873 Panic led to a economic depression of really 23 years into 1896. There were bouts with high volatility and injection of major waves of inflation following the major silver discoveries. It was the age of the Silver Democrats who tried to create inflation by over-valuing silver relative to gold. This created a wave of European-American arbitrage where silver

flowed into the US exchanging it for gold, which then flowed back to Europe. By 1896, the US Treasury was broke.

The Panic of 1873 marked the collapse of J. Cook & Co, the huge investment bank that was the 19th Century version of Goldman Sachs. They went bust because of excessive leverage in railroad stocks. It matters not what the instrument may be, it is always the leverage, which set the tone for a economic depression that lasted into 1896 where JP Morgan became famous for leading a bailout of the us Treasury organizing a loan of gold bullion. The stock market rallied and made new highs with plenty of panics between 1873 and 1896. The point is, The Panic of 1893 was quite a horrible one. The point is, the stock market is not a reflection of the economy. It often trades up in anticipation of better times, and trades down on those same perceptions of bad times. In both cases, new highs or lows unfold even contrary to economic trends.

We will see new highs in the now long before we see the final low in the economy. The ideal lows on a timing basis for the stock market will be as soon as April 2009 or by June of 2009. The more pronounced lows would be due on a timing basis between December 2009 and April 2010. The most extreme target would seem to be August 2010. The shorter the resolution to the stock market low, the sooner we will start to see much higher

volatility.

The low for the Dow would be indicated by reaching the 3,500-4,000 area. A 2008 closing below 12,000 in the cash now Jones Industrials will signal that the bear market is underway into at least 2009 if not 2010. A year-end closing for 2008 below the 9,700-9,800 level, will signal higher volatility as well. The real critical level for the closing of 2008 will be the 7,200 area generally. A year-end closing beneath this general level will signal that we could see the sharp decline to test the extremes support at 3,600-4,000 by as early as April 19th, 2009 going into May /June 2009. If we were to drop so quickly into those targets, this would be most likely the major low with a significant rally into at least April 16th, 2010.

The less volatile outcome would be a prolonged decline into the December 2009 target to about April 16th, 2010. A low at that late date would tend to project out for a high as early as June 2011 or into late 2012. Nevertheless, volatility appears to be very high. Those who were at the 1985 Economic conference in Princeton, may want to review those video tapes. The volatility we were looking at 20-30 years into the future is now. As 3 of the 5 major investment bankers failed, Merrill, Lehman and Bear, the liquidity has evaporated so the swings are going to be much more dramatic.

The major support is 3,600 on the now Industrials.

During '09, the support area appears to be 6,600, 5,000, and 4,000-3,600. Clearly, resistance is shaping up at 9,700-9,800. It would take a monthly close back above the 12,400 level to signal new highs are likely. If we saw a complete collapse into a low by April 2009 or June 2009 reaching the 4,000 general area, this would be the major low with most likely a hyper-inflationary spiral developing thereafter. In that case, the now Jones Industrials could be back at even new highs as early as mid 2011 or going into late 2012.

Gold has decoupled from oil as it should and has been rising on an ounce-to-barrel ratio. Here, the pivot area for 2009 seems to be the $730-$760 area with the key support being still at the $525-$540 zone. The major high intraday was on March 17th, 2008. A weekly closing below $800 warns of consolidation. Only a monthly closing below the $535 area would signal a major high is in place. The more critical support appears to be at about $680 - $705. A weekly closing beneath this area will also warn of a potential consolidation. A major high is possible as early as 2010-2011 with the potential for an exponential rally into 2015 if there is any kind of a low going into 2011.45. The key to watch will be crude Oil. The collapse of Investment Banks has removed the speculation that exaggerated the trend. A year-end close below $40 for 2008 would signal a major high and serious economic decline ahead.

There Are No Tools Left! The Emperor Has No Clothes

It is hard to explain to someone who believe he has power, that he really has nothing of any significance. This becomes the story of the Emperor Has No Clothes. No one will tell him, and if you do, it may be off-with-your-head. This is akin to the man behind the curtain in the Wizard of OZ trying to keep up the whole illusion. After all, why do we vote for people unless we believe that will somehow change our lives?

<u>Interest Rates</u>

When an economy is rising and the stock market is exploding, interest rates always rise because the demand for money is rising because people believe that they can make a profit. Government pretend to be raising interest rates to stop inflation, but they do not create a trend contrary to the free markets. What happened in 1980 was merely that the government over-shoots the differential between expectations and the rate of interest. If you believe the stock market will double, you will pay 20% interest. A rising interest rate does not create a bear market. Only when the rate of interest exceeds expectations of potential profit offering almost a fixed secured return, will capital leave the speculative market and run to the bond market. In a bear market, interest rates always decline because of the flight to quality.

When there is a risk of a .banking crisis as well, then the flight to quality shows that capital is willing to accept virtually zero in return for the privilege to park itself is a secure manner to preserve the future.

In both cases, the government may accelerate the trend, but by no means can they create the trend or alter the trend. Lowering interest rates to zero right now will not reverse the economic decline. People will look out the window and until they feel confident again, they will not come out from behind the castle walls. Japan lowered interest rates to virtually zero for nearly a decade. All it did was fuel the carry trade whereby yen was borrowed at 0.1 % and invested in dollars at 5-8%. There was little opportunity to invest domestically in Japan and the stock market languished in a broad consolidation with flurries the upside every-now-and-again.

Monetary Theory

The Fed has already put into the system about $1 trillion in 13 months. The real problem is they are buying back US government debt injecting cash into the system. But if those bonds are sold to the Fed by foreign holders, there can be no injection of cash into the domestic economy. This amounts to the monetization of our debt in any event. Clearly, buying bonds from the market is not a guaranteed increase in domestic money supply

especially when the velocity of money is itself collapsing. Borrowing heavily all these years and depending on foreign investors to buy that debt, altered the course of economics. Of course there has always been the foreign investor, but there has not been the floating exchange rate system. The rise and fall of the dollar itself can now either attract foreign capital with an advance or repel capital with its decline. Like we needed another new variable.

Infrastructure Spending

There really is nothing left in the tool bag that can help even to mitigate the coming Economic Depression. The unemployment rate at the end of 1930 was only about 8.9% - similar to the 1975 recession. Things were very slow back then. Even housing was not moving and people took whatever offers came their way. It was the Dust Bowl that began in 1934 that sent the unemployment rising after the 1932 low in the stock market. About 40% of the work force was agrarian. Hence, Congress could not pass a law to make it rain. The real devastation was that this presented a huge portion of the work force that had to be retrained into skilled labor. It was the Great Depression that finally by force of necessity, created an industrial work force that may have taken another 200 years to unfold by gradual transformation.

The WPA was formed in 1935, 3 years after the low in the stock market (1932). It had a slow and marginal success. At best, if we attribute all improvement to this one program, very unlikely, unemployment was only reduced by about 20%.

1935 20.3%

1936 16.9%

1937 14.3%

1938 19.0%

1939 17.2%

1940 14.6%

Even if we attribute everything to the WPA, all the way into 1940, the most the unemployment declines was by 30%. However, at the end of World War II, we see an Unemployment rate of 1.9% by 1945. Any ideas that we can spend trillions on infrastructure and make it all better, forget it.

Turning to infrastructure in the middle of a debt crisis makes no sense. The idea of just spending money will somehow stimulate the economy, will not work. This is like trying to fight in the desert of Iraq using the same tactics as in Vietnam. There has to be sane connection to what we are doing. Just because FDR instituted the WPA when we had a huge displacement issue in the work force, almost 6 years after the crash began,

makes no sense at all for our current problems. As I said, this is like buying your wife a mink coat to somehow influence your kid to get their grades up. The connection is tenuous at best and nonexistent in all reality.

Summary

Unless we attack the debt structure directly, there is no point in counting upon any government to help mitigate the problem and more-likely-than-not, our very future may be recast in so many ways, the level of frustration will rise, and that leads to war because war distracts the people from hanging their own politicians. The oldest trick in the book is to blame the guy next-door down. Unless we are honestly prepared to truly 1) reorganize the structure of government, 2) reorganize the entire debt structure both private and public, 3) regulate leverage, 4) restore usury laws that will free up personal income, and 5) look at just eliminating the federal income tax in combination with 6) establishing a new national heathcare system that will restructure all pension plans public and private, there is not much hope for the future from government. Our definition of money (M1) does not include bonds so we can fool ourselves by issuing $10 trillion in bonds is different than printing the cash. It is still money. Taxes are needed in a gold standard where money cannot be created. Stop competing with the states, control the budget as a percent of GDP,

increase the money supply to that degree, and stop the taxing when money is created by leverage and velocity anyway. This will restore jobs and inject huge confidence as in 1964 when the payroll tax was cut permanently. One-offs never work. People save the rebates for a rainy day. We need real honest reform since the states will go broke and seek handouts as well. So, it is time to get real. It is time we restructure the entire system including the banks which always cause the problem. We don't need excessive regulation of things that did not create the problem when the real culprits always escape.

You may send comments directly to Martin Armstrong at ArmstrongEconomics@GMail.com.

January 09, 2009 in Martin Armstrong | Perma

Martin Armstrong: The Coming Great Depression

Armstrong Economics The Coming Great Depression Why Government Is Powerless