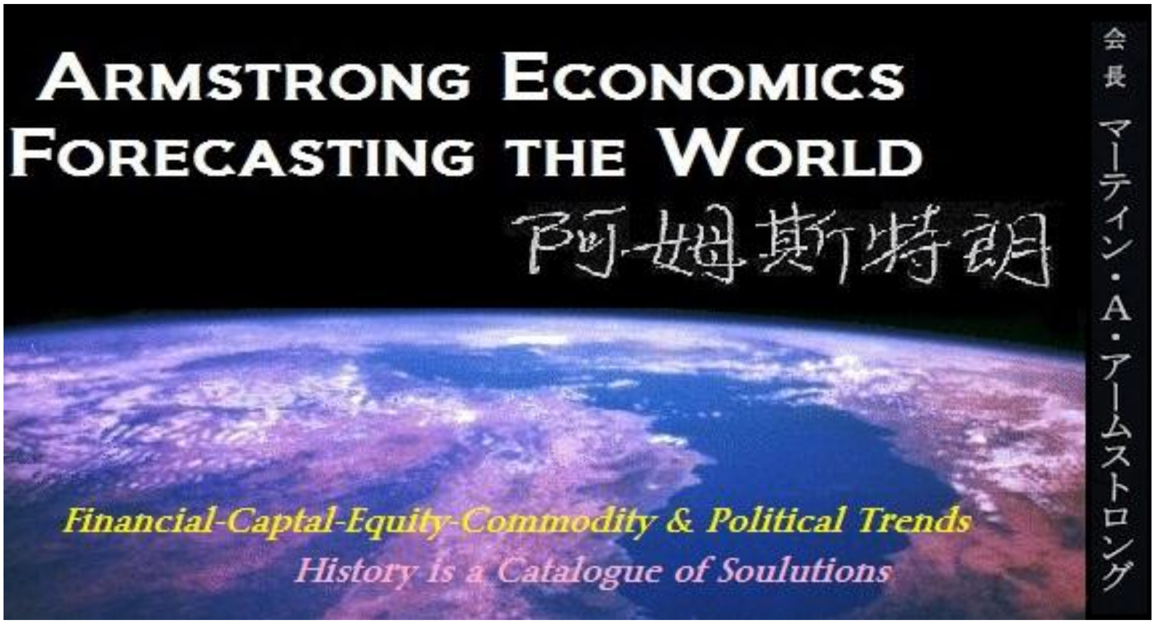
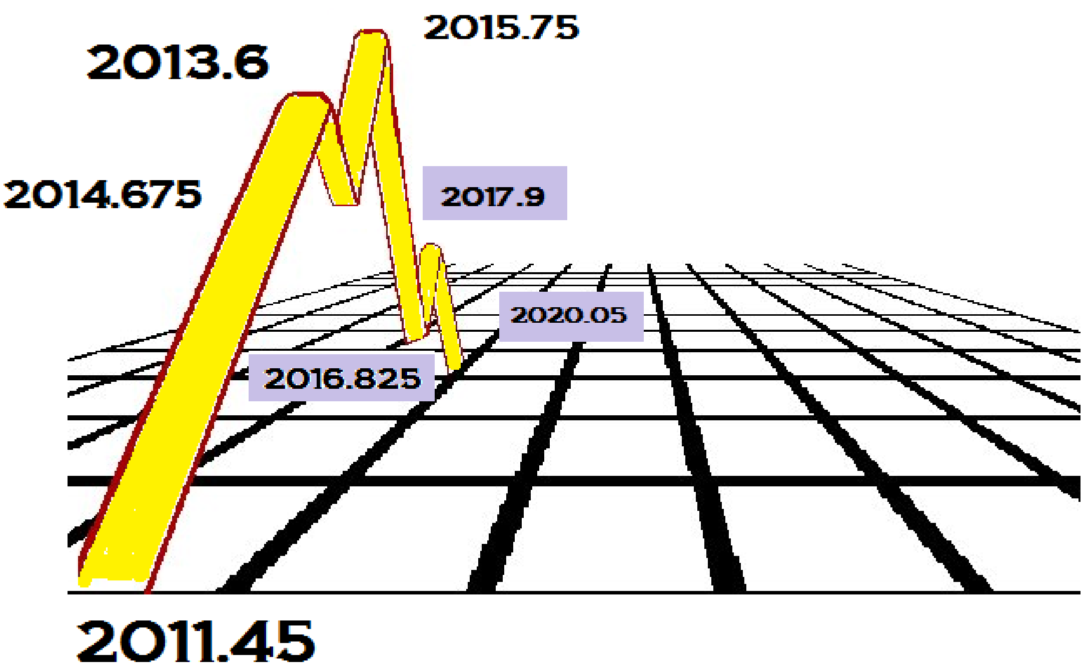


THE NEXT WAVE



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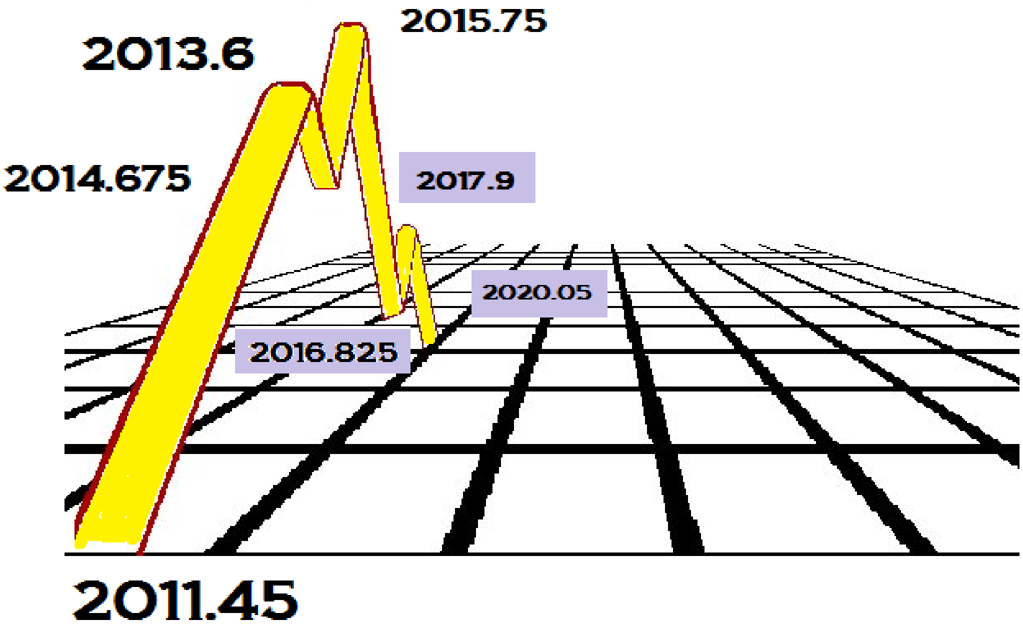
The Next Wave



April 21st, 2011

By: Martin A. Armstrong
former Chairman of Princeton Economics International, Ltd.

We are approaching the end of this current 8.6 year wave come June 13th, 2011. What awaits us on the other side is a change in the overall trend. When we approached the same turning point in 1985.65, PEI took full pages advertisements and ran them on the back of the English magazine, the Economist for 3 of the 4 weeks that month. Therein we warned that there would be a change back to inflation and that the steep economic decline that followed the insane peak in interest rates during 1981 was over. Now as we approach this same period after a tumultuous 4.3 years down that saw the collapse of real estate, the demise of legendary firms such as Lehman Brothers and a score of bankruptcies that followed, if anything, these past 4.3 years have been anything but boring. Many people lost their retirement savings or had them seriously curtailed. The involvement of group trading witnessed a catastrophic economic contagion that swept the world taking many countries down with it such as Ireland and Iceland. But these things are nothing new. The banks had to be bailed out on the loans to South America, Russia, Long-Term Capital Management, S&L Crisis, and now the Mortgage backed debt derivatives. Looking at their track record post 1971, one wonders if they ever get it right and they clearly all flock together sniffing out the same scheme like dogs with wings or is it pigs with wings?

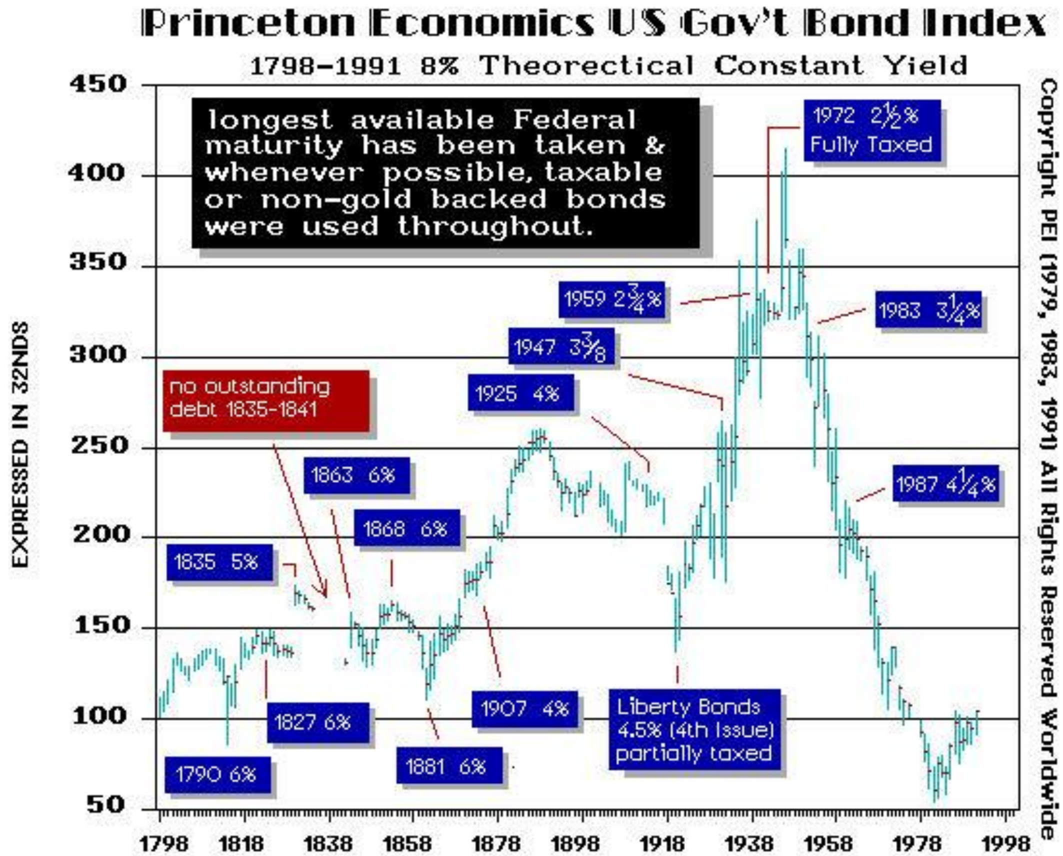
Our advertisement from the back page of the Economist in July 1985 was all about the coming change in trend. Curious, as today Standard & Poors issued a warning about the credit rating of the United States, there were difficult times back then as well. The dollar had risen so high the British Pound fell nearly to par and what would become the Euro fell to nearly 25 cents. The crisis was the trade deficit and the loss of jobs that government thought it could just manipulate the dollar and cure the problem.

The answer in government circles was to form the Group of 5 nations (G-5) known as the Plaza Accord for its location at the Plaza Hotel in NYC (Today G20). They decided that the five main countries would act as a group to coordinate intervention and force the US dollar down. They openly came out and announced publicly that they wanted to see the dollar fall by 40%.

1985 Plaza Accord
From left are Gerhard Stoltenberg of West Germany, Pierre Bérégovoy of France, James A. Baker III of the United States, Nigel Lawson of Britain and Noboru Takeshita of Japan

The interesting aspect of these turning points has been the uncanny inflection point for change that manifests itself both in the perception of the people as well as in the halls of government. There is no question today that governments worldwide are very concerned about the debt. This is the final showdown that we face in this next wave of Marxist-Socialism v Liaise Fair Economics. In other words, will the markets force change to prevent the end of the world, or will government just run off a cliff? There is a choice, but nobody seems to be paying attention.

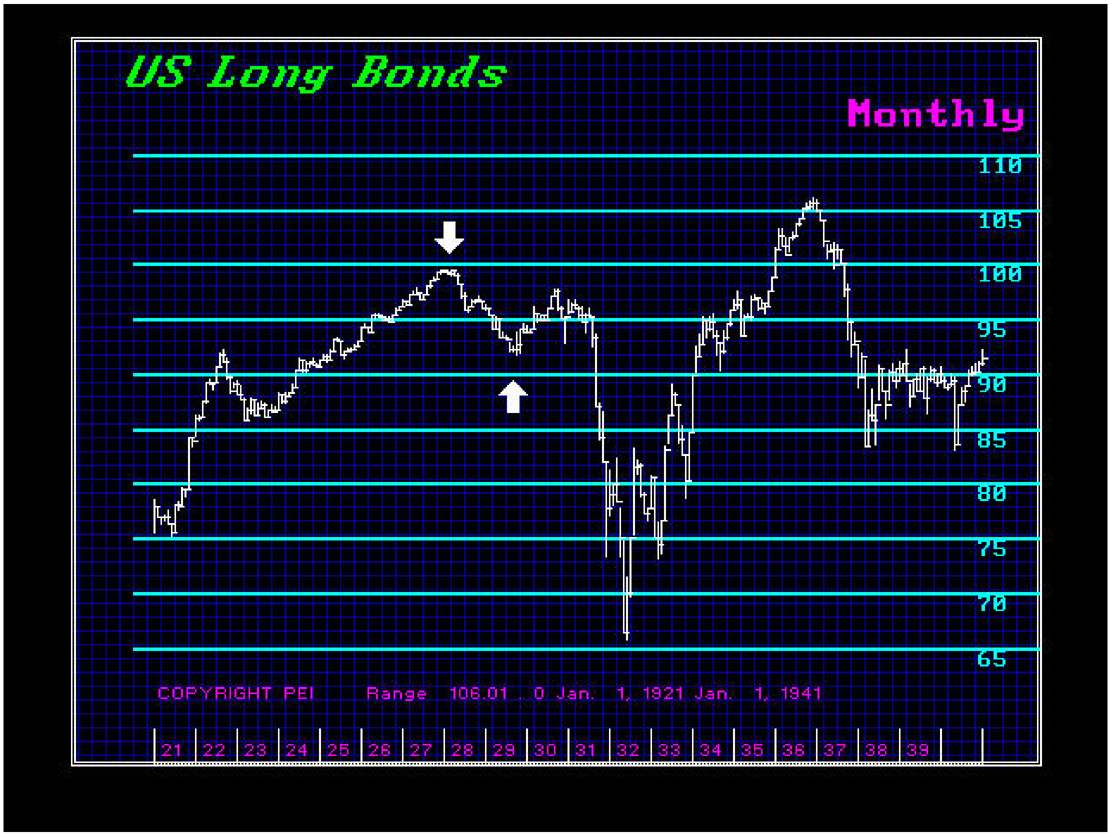
What is stunning, however, is the fact that Standard & Poors has even dared to issue a warning. Of course they are using the budget fight to scare the politicians. But everyone knows, there is no way they will ever downgrade US debt. Let us face the facts! If you always borrowed to pay off your old debt and just rolled it perpetually increasing your loans because of interest, then nobody would give you a credit rating worth anything and you might go to jail.



Above is a perpetual chart of US government bonds we use to publish. This is based upon a view of price rather than yield. We can see that just after OPEC began in the early 1970s, investing in US debt has been anything but a good long-term investment. But the cold hard face of reality, warns that no country's debt has offered a mirror image. Indeed, what prompted Standard and Poors to signal a danger to the credit rating of the United States was based upon IMF data showing the US deficit reached 10.6% of GDP. The US Congressional Budget Office puts that at 8.9%. Just as the Chinese Credit Rating Agency downgraded US debt and it was ignored saying "oh that's China," well the major credit rating agencies are American. Do you really think they would dare to downgrade US debt and live to talk about it?

Everyone was always looking at Britain warning they would be the next to default. The British deficit is 10.4% according to IMF data just behind the USA 10.6%. Even France is at 7%, Canada at 5.5%, Australia is 4.6% and Germany comes in at 3.3%. But these are ALL deficits as a percent of GDP and means there is no balanced budget and debt is continuing to escalate.

There is nobody with a balanced budget and nobody who is reducing the national debts. This means that the debt bubble is just going to grow larger and larger. There is no intent to actually balance the budget no less reduce its national debt. Thus, the problem is percolating as we enter this new 8.6 year wave. By the time we reach the end, well we should see the most interesting times separating a fool and his money.

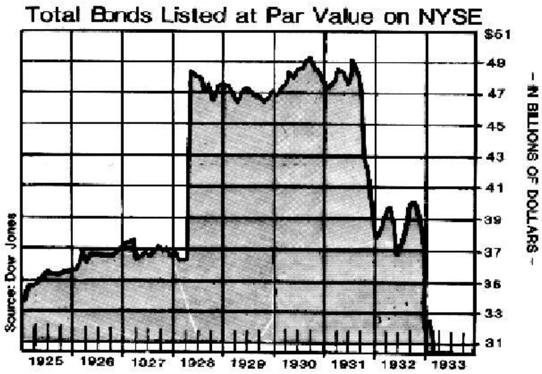


Sell the RUMOR – Buy the News

Here is a chart of the US Long Bonds covering the Great Depression and Postwar period. Notice that the bonds collapsed on fears in 1931 that everyone else defaulted on their national debts except France so it became widely anticipated the US would do the same. Clearly the Federal Government did not default. Nevertheless, as you can see, ANTICIPATION of a POSSIBLE risk of default wiped out the bond market purely upon expectations that did not materialize. And this was a period when the government was not in trouble and had chronic BALANCED budget surpluses. That is what prompted John Maynard Keynes to argue in times when DEMAND collapsed, government should take up the slack by deficit spending to stimulate that DEMAND.

There is always a dramatic difference between reality and possible reality. Something need not actually even materialize for you to suffer the effects. During the Great Depression, state and local municipals did get in serious trouble. The City of Detroit suspended payments on its debt, but resumed in 1963. So there were practical defaults that took place in the muni market.

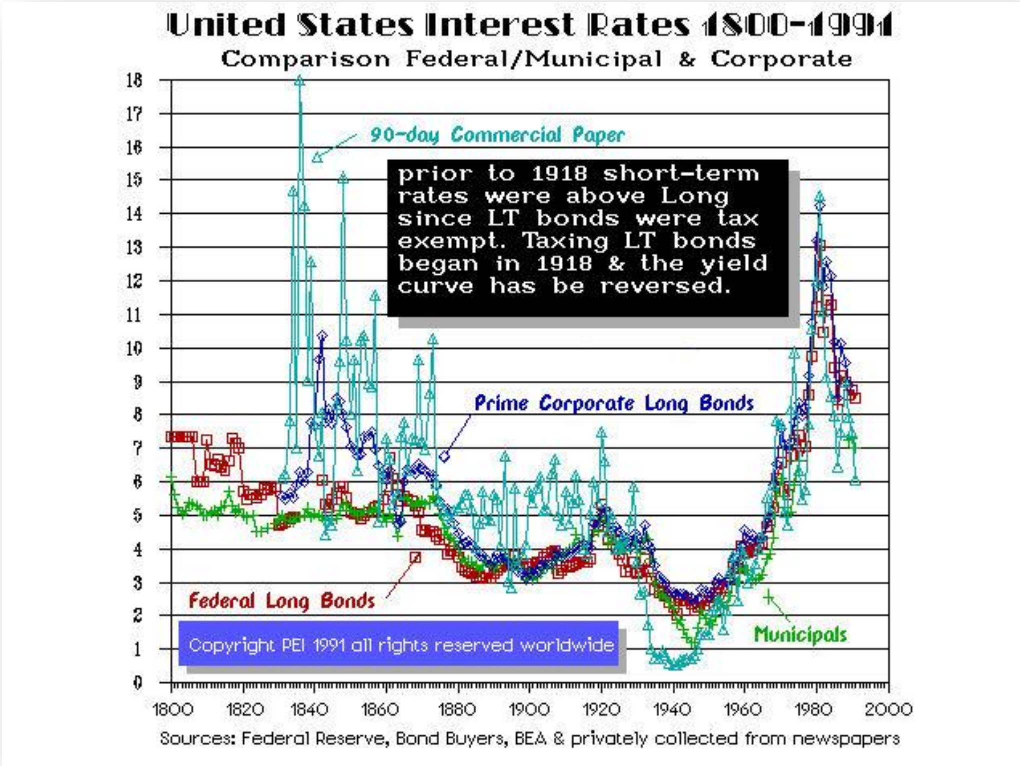
As I have written before, it is ALWAYS the perception of risk that matters. The sky need not actually fall. It only has to appear as if it will collapse and that is enough to wipe your family out for generations. Indeed, the massive sovereign defaults of the 1931 Crisis left a group of little old ladies who always protested lending money to foreign governments into the 1970s. These were the children whose families suffered from the bond defaults.



This graph shows the orgy of sovereign debt where foreign bonds were listed on the New York Stock Exchange. Just as we went through the mortgage backed securities crisis, the banks back then were selling foreign government bonds to the public in small denominations. It was the sovereign bond bubble that burst that time and it was the public that took it on the chin. But that had the side-effect of causing them to withdraw funds from the banks and we ended up with massive bank failures.

Bonds from South America, Europe, Russia and China all defaulted to the point you can usually find them for sale framed up from antique shops. This was a massive capital formation destruction that created the Great Depression more than any other element.

With each financial crisis there is always one element that attracts capital causing it to concentrate as that particular investment becomes popular. Each time caution is thrown to the wind. Just as the mortgage debt crisis took place with people talking themselves into the notion that some mortgages will default, but by pooling them together, the risk declines and the pool rises to the AAA status even though the component mortgages are B rated at best. Then they sliced and diced them according to risk. Back then, the sales pitch was similar in that these were sovereign nations. Well some at least look pretty when framed up. We use to have a bunch lining the hallways at our office to remind us what happens to the debt of nations. Just as they pitched the Russian bonds in 1998, the same was done in the '20s. History repeats because mankind is just too stupid to learn from past mistakes.

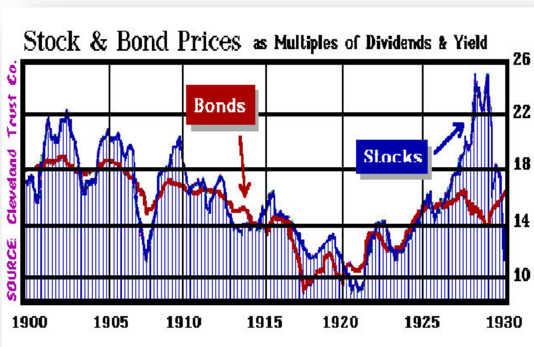


Here you will see the yields overlaid of the four primary general debt categories. We have the municipal and federal debt interest rates along with 90-day Commercial Paper and Prime Corporate Long Bonds. Note that the municipals were lower yields than federal in 1800 because the confidence back then was more in the state and local levels distrusting the new federal government. By the 1830s, you will see the introduction of corporate debt. There was the spike high with the Panic of 1837 and spikes with the Panic of 1857 running into 1873. This Panic of 1873 shifted the Financial Capital of the United States from Philadelphia to New York City. Now notice as the Great Depression manifested, the aftermath of the sovereign debt crisis brought with it a shift to corporate paper being viewed as safer. The 90-day commercial paper fell to the lowest rates of the group. Post World War II, the rates tended to converge with oscillation still evident.

As we move deeper into this sovereign debt crisis during the Next Wave, we will see the relationships evolve between these groups once again. That means we will see corporate paper become the preferred safe harbor for capital compared to municipal, state, and federal paper. The relationships all change.

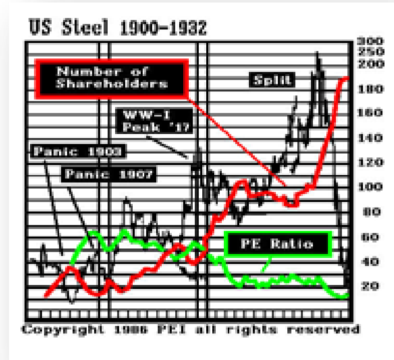
What this chart clearly demonstrates is that NOTHING lasts forever. Everything around us is simply in a constant state of flux so that there is ABSOLUTELY NO RELEATIONSHIP that is permanent throughout history. This is the driving force behind what I refer to as CAPITAL CONCENTRATION. No matter what you look at, each sector and market gets its 15 minutes of fame.

The variables are extraordinarily complex. There are so many that exist that it's impossible to keep track of so many without a massive computing effort. It is just not so easy to break it down to a single cause and effect. Once a trend is set in motion, what we are looking at is a bunch of markets and indicators flipping so that the forecast for the long-term actually becomes easier than tomorrow. You can't turn a battleship around like a speedboat. That is what the long-term becomes easier to see because it cannot change direction on a dime.



He I have provided a chart covering 1900 to 1930 overlaying bond and stock prices as multiples of their respective yields. Notice that there was a surge in stock prices going into 1929 that created this huge spike attracting capital like a bug light. This is another trend that will emerge during this Next Wave when the public begins to figure out that stocks are the alternative to more risky bonds.

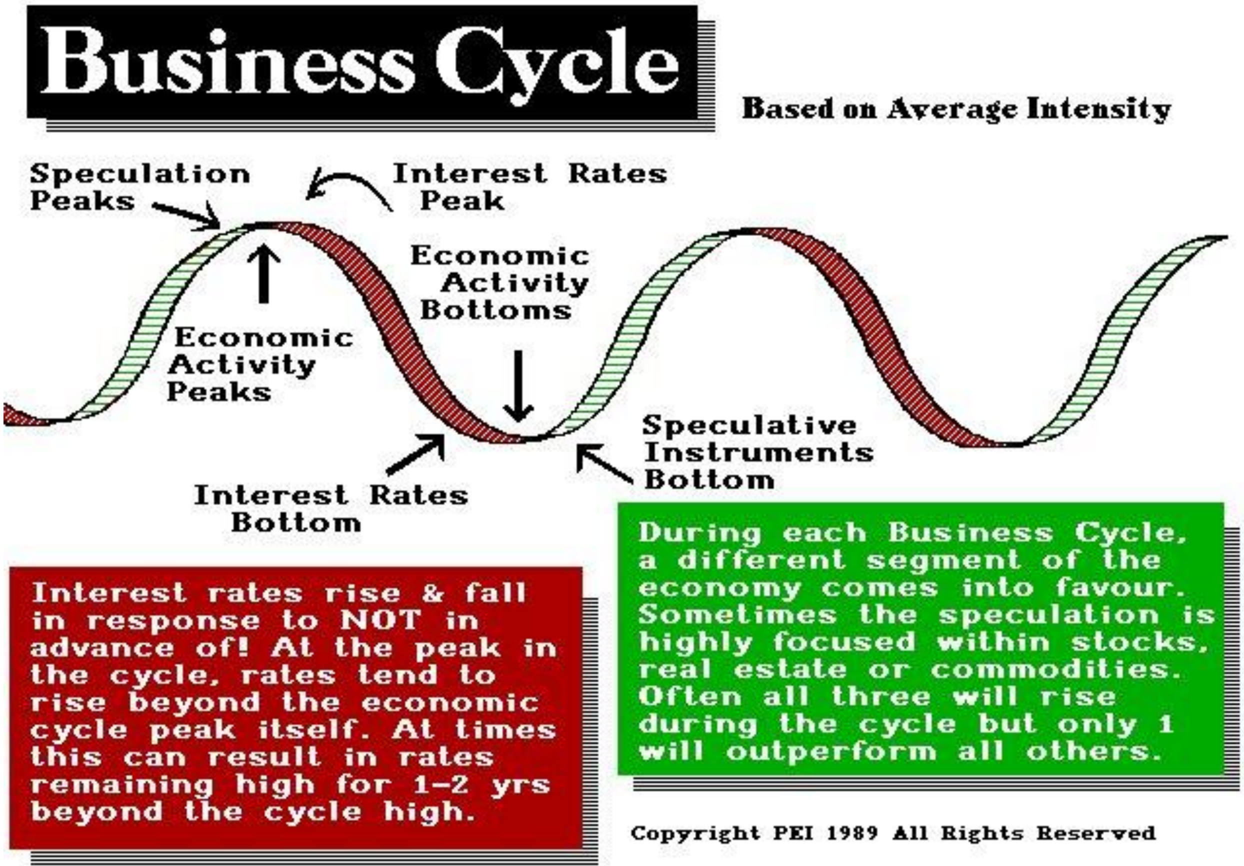
Looking closely at this chart reveals the spike swings over time. The sharp drop for the Panics of 1903 and 1907 are illustrated nicely, with the final low going into 1921 after the Panic of 1919. Once again, no relationship is ever stagnant. Everything fluctuates.



Additionally, here is a chart of US Steel a leading stock during the Roaring '20s. Notice the ever rising red line reflecting the number of shareholders. This rises and the PE Ratio declines into the major high. Once more, this shows key trends that need to also be watched to distinguish big bull markets and shifts in domestic capital concentration.

Perhaps you are now getting a sense of what our model was tracking; EVERYTHING that ever moved. The economy is a vast complex and dynamically adaptive self-referral network interlinked on a global scale most have yet to fathom. If it moved, we grabbed it, threw it into the microwave to see what it would taste like. This was done on a massive global scale. We are far beyond RSI, moving averages, and stochastics here. Once you begin to see the dynamic structure, understanding how it unfolds is truly an enlightening experience.

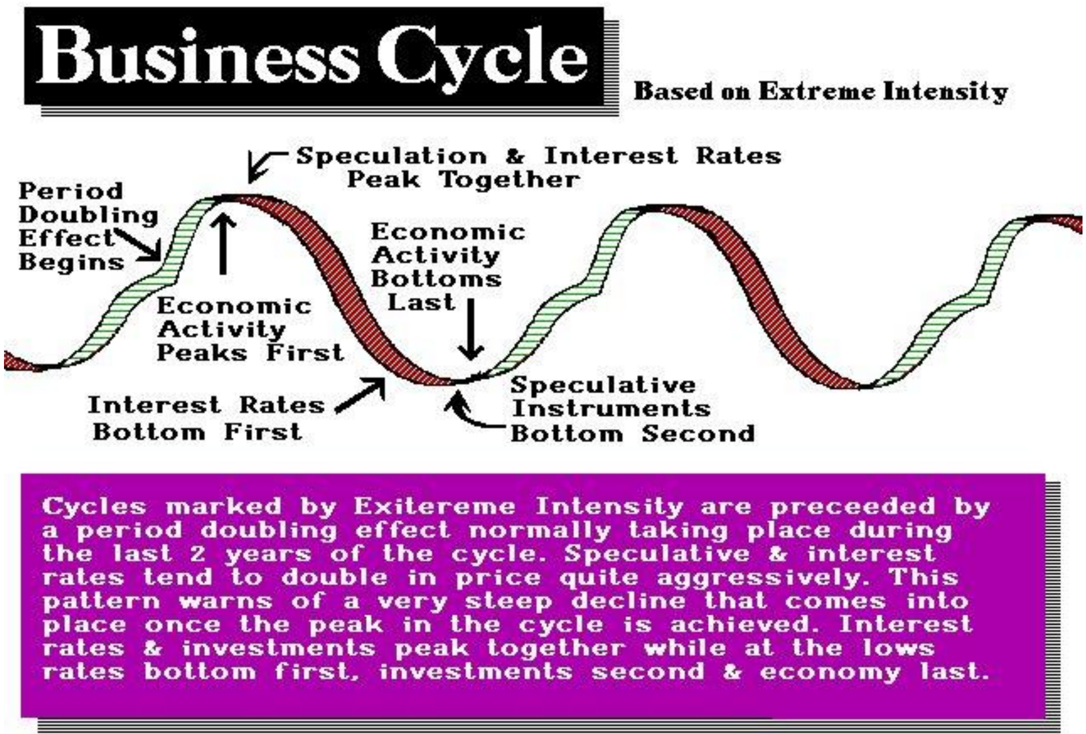
In reality, there are correlations between many individual trends that are spectacular. You begin to see how groups really react and the trend unfolds before your eyes so you can see the future manifest in such a manner that there is no other solution. The future becomes verifiable as interrelated links confirm each other.



So we are approaching the nadir on the Economic Confidence Model. There is really no one Behind the Curtain who does not realize it's a cycle. You probably can find an obscure book at the ***Foundation For the Study of Cycles*** by Paul A. Volcker, former Chairman of the Federal Reserve, entitled ***Rediscovering the Business Cycle*** published in 1978. So those who want to pretend cycle theory is somewhere out in left field, are either on a disinformation campaign or are really uninformed. The **Bureau of Economic Analysis** (BEA) seasonally adjusts data and that means they are smoothing the data to try to remove the spike highs and lows of the cycle.

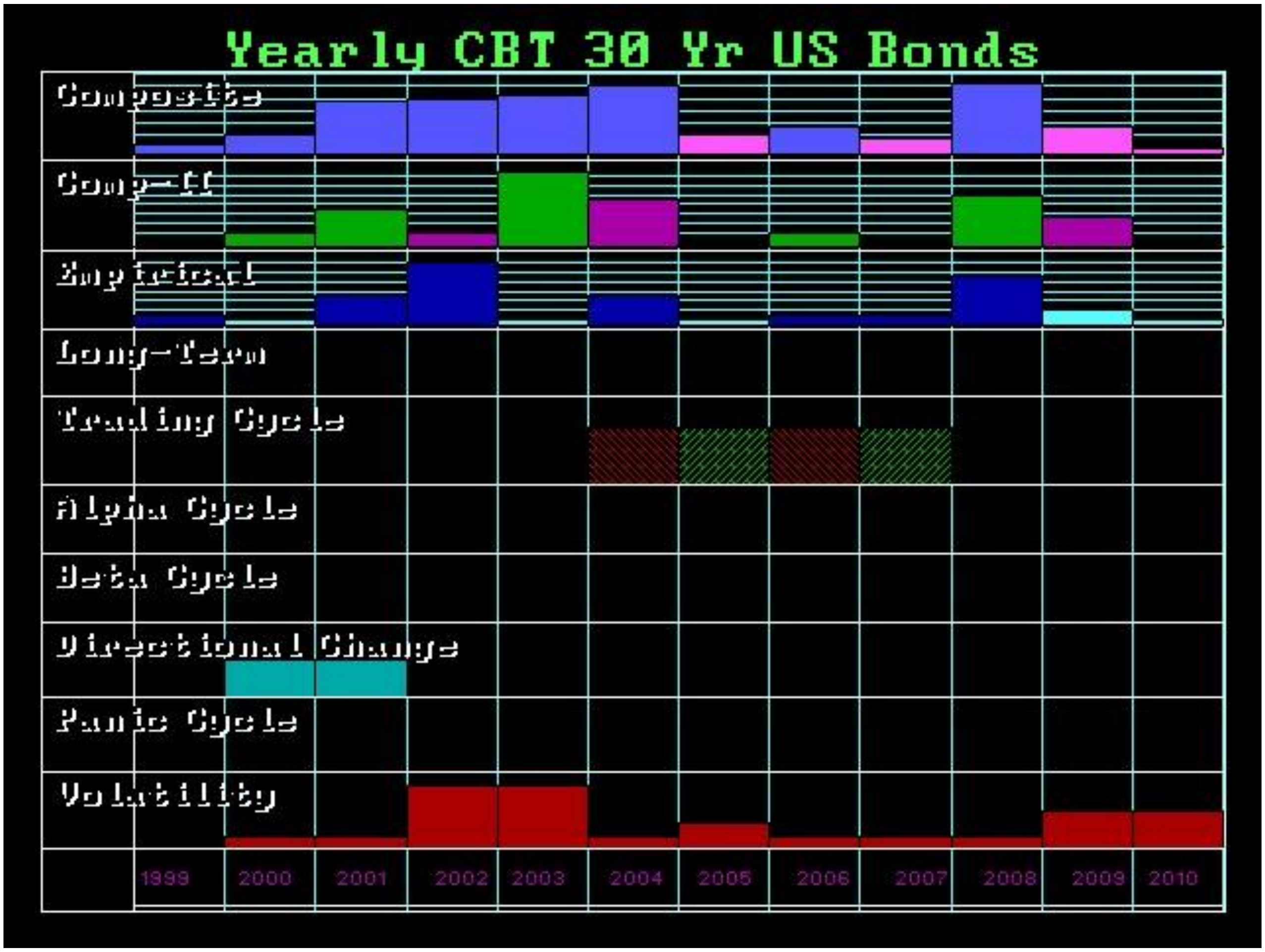
Understanding that we face a very important change in trend on June 13th, 2011 (2011.45) is vital to our future. There is no chance in hell that everyone would ever follow one cycle. I personally believe it is a growing process. In our younger years, we take our losses and perhaps buy the high. After such a fiasco, we learn our lesson and become more cautious. A good trader values his losses more than his wins. This might sound stupid, but wins are a celebration, rarely time for reflection. A loss contains VALUE. You paid for it dearly. Learn why you made your decision and strive to implement that new costly knowledge. In this wave, we give meaning to that phase – ***Ah to be young again; but with what I know today!***

So what we have to comprehend is that as illustrated just above, there are normal business cycle patterns that are distinct with clear traits,

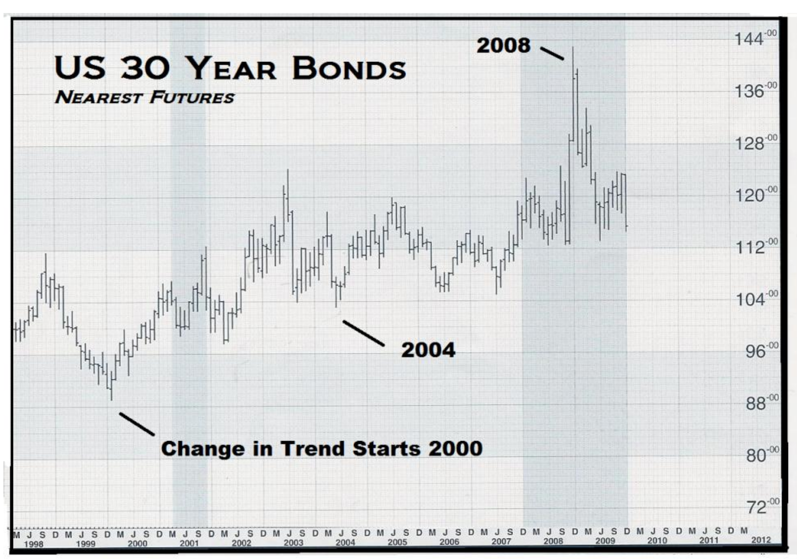


and then there is the rogue tsunami wave. This is the wave that creates the Bubble Tops and reflects deep capital concentration. This is the wave formation that brings the house down. This is the wave that hit in 1929, and in Tokyo in 1989. It is the spike wave that is a PHASE TRANSITION whereby there is a price doubling in the last stage. We even saw this in gold and silver going into 1980. Gold rallied from $103 to $400 between 1976 and 1979. Then in the last few moments, gold blasted from the $400 level in December 1979 peaking at $875 on January 21st, 1980. We saw a similar pattern doubling in price in the Nikkei 225 in Tokyo.

These are patterns that are typical and universal. They are incredibly important to understand for they are the difference between emotional forecasts and real forecasting. If you do not have the experience, it is hard to see things rationally in times of such extreme price movements. At a seminar in Tokyo a private individual bribed hotel staff to get into our institutional conference. He later made his way up afterwards and told me how he got in and was desperate to ask me advice. He was in his 60s and had bought the Nikkei on the day of the high in 1989. He then told me he had NEVER invested in stocks his entire life. I was now captivated. I asked him why he bought on that day. He told me brokers had called him every year for the past 7 years telling him every January they market rallied around 5%. He said he watched their predictions every year pan out. So he gave in and invested about $50 million. The Nikkei fell about 40% and he still had the position because he kept waiting for it go back up to get out at a break-even. Those spike highs on this PHASE TRANSITIONS represent such highs because everyone who EVER thought about buying, has bought. There are no buyers left. Scare that herd, and you have a stampede that is unprecedented.



When we look back at the last forecast array generated by the computer, the top line is the composite of all the various models ran by the computer. The main turning points were 2000, 2004, and 2008 when generated back in 1998. As we can see from the chart provided, these main targets were very critical. The 202 high came in nicely on the Empirical Model and then the next strongest target back then appeared out 10 years forward in 2008. I have been asked; How can a computer project so far in advance? To answer that question, long-term trends are set in motion and become self-fulfilling for they are also self-referral. You simply cannot change the long-term consequences of accumulative actions over decades. We all know you cannot live forever on a credit card and never make payments or work. Governments are the same.

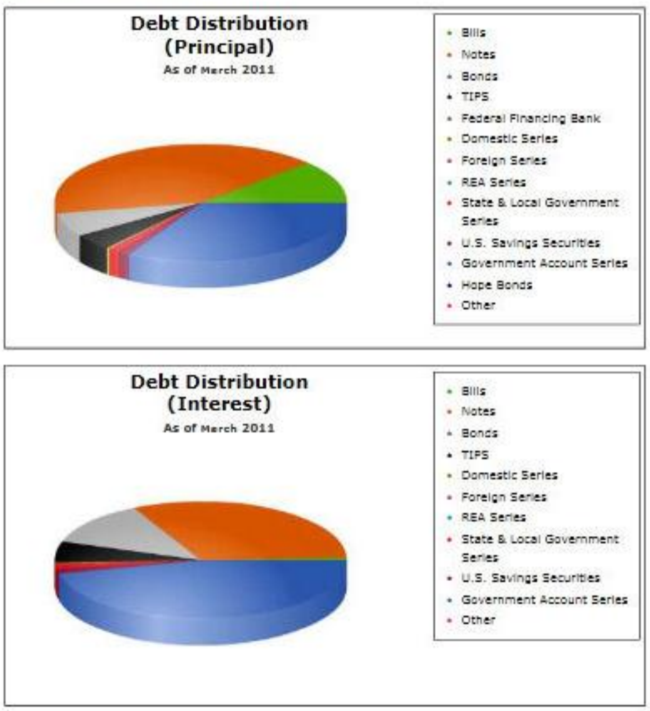


THE CONSEQUENCES OF QE-2

No matter what people think, there are always two sides to every coin. The consequences of QE2 may indeed prove to be the same as those that have manifested from the Japanese government intervention that created: **The *LOST QUARTER CENTURY***. While it may sound good to intervene and try to support the economy in periods of sharp decline, this type of action also has its negative side. What happened in Japan was outrageous. Indeed, the road to hell is paved with good intentions. This is what happens when the government believes (1) it has the power and (2) the obligation to intervene without any understanding of the consequences of its own actions.

Once a government intervenes, they are trying to manipulate the economy and markets. That **CANNOT** be done on a long-term basis. In Japan, the economy got worse because foolish corporations held on to their portfolios believing that the markets would not continue lower because of the government intervention. Had they simply liquidated their positions, the decline and fall would have been much shorter in duration just as the Great Depression. As illustrated above, there was no intervention directly. There was manipulation of interest rates being lowered to try to stimulate demand and senate investigations that led to the creation of the SEC. But there was no **DIRECT** intervention as took place in Japan, Long-Term Capital Management (1998), or with TARP, and QE2. Direct Intervention appears to prolong the economic upheaval, not shortening it at all.

Debt Distribution



For the Debt Distribution (Interest) graph, the interest expense is cumulative per fiscal year, which includes the months of October through September. In December and June, non-marketable interest will increase due to semiannual interest payments for Special Issue securities that occur at the end of these months.

Security Type

The debt is made up of a variety of security types. Check the rest of our website for a more complete description of each type of security.

In other words, when capital realizes it is on its own, it deals with the consequences and moves on. Losses would have been taken swiftly and that beings about a faster conclusion to the outcome. I disagree with Alexander Hamilton that a National Debt is the price of Liberty, and I think this will be shown in the Next Wave.

DIRECT intervention has a nasty side-effect that does not appear on the warning label. As long as capital BELIEVES government is there to protect it, there is a tendency to jump in the back-seat and let them drive. Loses are held and that actually prolongs the economic decline.

QE2 side-effect is the impact it has had upon the real capital investment profile. Those who are in the KNOW, realize that QE2 has to come to an end. The fear of inflation rising as a byproduct of QE2 is widespread. Thus, there are two primary concerns that arise:

(1) Will the makes decline (particularly real estate) when QE2 ends for there is real doubt as to whether or not the actual bottom has ever been reached.

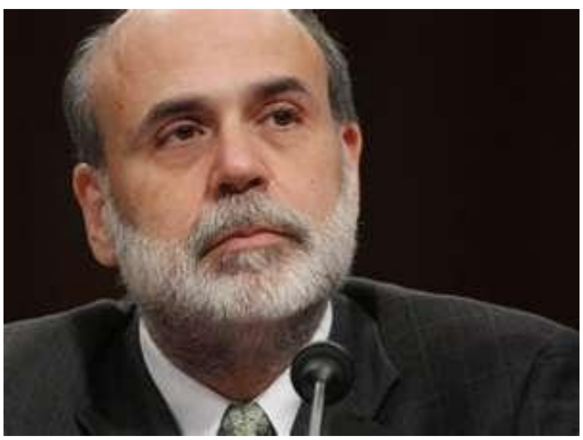
(2) What happens to the bond market when QE2 ends? If the Fed no longer supports the debt market and we return to having to rely upon the private markets to take up the debt, then we are once again betting on the fact that there will be buyers indefinitely into the future.

Public Debt of the U.S., 1870-2009

Source: Bureau of Public Debt, U.S. Dept. of the Treasury; World Almanac research

Fiscal year	Debt (bil)	Debt per cap. (dollars)	Interest paid (bil)	% of federal outlays
1870	$2.4	$61.06	—	—
1880	2.0	41.60	—	—
1890	1.1	17.80	—	—
1900	1.2	16.60	—	—
1910	1.1	12.41	—	—
1920	24.2	228	—	—
1930	16.1	131	—	—
1940	43.0	325	$1.0	10.5%
1950	256.1	1,688	5.7	13.4
1960	284.1	1,572	9.2	10.0
1970	370.1	1,814	19.3	9.9
1977	698.8	3,170	41.9	10.2
1978	771.5	3,463	48.7	10.6
1979	826.5	3,669	59.8	11.9
1980	907.7	3,985	74.9	12.7
1981	997.9	4,338	95.6	14.1
1982	1,142.0	4,913	117.4	15.7
1983	1,377.2	5,870	128.8	15.9
1984	1,572.3	6,640	153.8	18.1
1986	2,125.3	8,774	190.2	19.2
1987	2,350.3	9,615	195.4	19.5
1988	2,602.3	10,534	214.1	20.1
1989	$2,857.4	$11,545	$240.9	21.0%
1990	3,233.3	13,000	264.8	21.1
1991	3,665.3	14,436	285.5	21.6
1992	4,064.6	15,846	292.3	21.2
1993	4,411.5	17,105	292.5	20.8
1994	4,692.8	18,025	296.3	20.3
1996	5,224.8	19,805	344.0	22.0
1997	5,413.1	20,026	355.8	22.2
1998	5,526.2	20,443	363.8	22.0
1999	5,656.3	20,746	353.5	20.7
2000	5,674.2	20,106[1]	362.0	20.2
2001	5,807.5	20,361[1]	359.5	19.3
2002	6,228.2	21,616[1]	332.5	16.5
2003	6,783.2	23,326[1]	318.1	14.7
2004	7,379.1	25,130[1]	321.6	14.0
2005	7,932.7	26,754[1]	352.4	14.3
2006	8,507.0	28,414[1]	405.9	15.3
2007	9,007.7	29,804[1]	430.0	15.4[1]
2008	10,025.0	33,237[1]	451.2	16.2[1]
2009	11,956.6	38,850[1]	383.4	26.0[2]

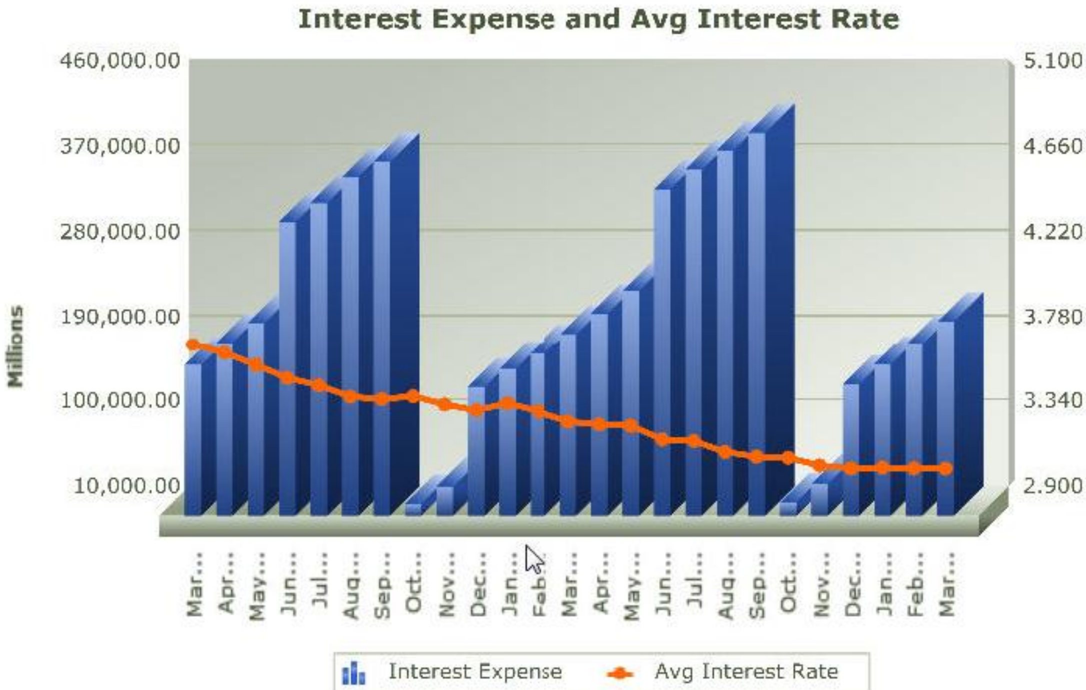
Note: As of end of fiscal year. Through 1976, the fiscal year ended June 30. From 1977 on, the fiscal year ends Sept. 30. (1) Estimated. (2) Based on 2009 federal outlays estimate.



Ben Shalom Bernanke, Fed Chairman

The primary unknown factors that **REAL CAPITAL** is concerned about ***BEHIND THE CURTAIN*** remain focused on the effects of QE2. For example, once QE2 ENDS, will the markets make new lows or is the worst truly past? What will happen if interest rates rise when QE2 ends? Will real estate resume the decline as was the case in Japan? What happens with the rolling debt going forward? If interest rates begin to rise AFTER QE2, will the National Debt then resume its rise as interest expenditure increase as a percent of total national debt? This would mean that all the efforts to reduce spending will be minimalized by the rise in interest expenditure. All the hype now will be just noise.

There have been some mind-bending shifts in the debt that bought us time and have contributed to pushing the real crisis off until 2016-2020. One of the primary factors that caused the National Debt to explore was the raising of interest rates into 1981 to affect inflation. The Fed's theory on that score is brain-dead. By raising interest rates to reduce demand makes sense ONLY IF the government is not the largest borrower. They reduced private demand, but accelerated the rise in the National Debt that transformed short-term inflation into a systemic inflation rate.



The statistics on the US National Debt show that the decline in interest rates has had a profound effect on buying more time. The lowering of interest rates to virtually zero, and the flight to quality that drove government short-term rates negative, allowed for reducing the debt as a percent of total accumulated interest expenditure. This has been largely overlooked. Money that would have gone to interest went to TARP. Nevertheless, this has purchased more time before the Sovereign Debt Crisis manifests, but it did not cure the problem since the interest expenditures now concern a largest debt historically. The upturn in rates rate will be devastatingly inflationary accelerating the debt even faster.

Additionally, the next aspect has been the percent of total debt attributed to the accumulative interest payments, which stood at 84.6% in 2007 and fell to 65.4%. This reflects the vast surge in the deficit to **DIRECT** intervention within the economy that has been unprecedented, and the lowering of the interest rates themselves. Thus, the surge in the debt was NOT caused by interest expenditure, but by stimulation.

As we enter the Next Wave, these are just a few of the new factors that will be driving the forces ahead in the global economy. We must come to grips with these dynamic forces if we expect to understand the potential advances for the stock markets, corporate debt, and things like gold. There will be a lag in these shifting forces that will lead to confusion while the perpetual optimists will proclaim victory and argue once again for the demise of gold and the return to normalcy.

The big breakout in GOLD still does not appear to be now. The PHASE TRANSITION to exceptionally high prices will be in the NEXT WAVE, not the conclusion to this wave. We still face the readjustment in the economy and it will take some time yet for the DEBT crisis to explode.