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OUR ECONOMIC "PERFECT STORM"

By Otto Engelberth

I've been following the markets since 1972. That was when I went into the construction business. You may recall that this was around the time that Nixon implemented price controls in an attempt to slow down inflation. You may also recall that it was not effective because six years later, during the Carter years, we had double digit inflation and an economy plagued by stagflation.

Since my background was in engineering and the production side of construction, I didn't pay much attention to government economic policy. However, I soon recognized that the survival of my business venture would be tied to anticipating the consequences of government economic policy. So, over the last 40 years, I have been immersed in a crash course on real world economics.

My reason for writing this paper is that I wanted to do an analysis of the present economic situation for my own use. How did we get here, and how will it all play out? If you are like me, you are being bombarded with a broad range of conflicting investment advice. Some of it is based on where the investment herd is presently going, some on short term business cycles of the past, and some on the effects of long term cycles that could run in the hundreds of years.

I think you will agree that it is certainly a confusing time in our economy, with the housing debt crisis, federal budget deficits, long term unemployment, and the distortions in the markets caused by the interest rate manipulation by the Federal Reserve.

Rather than try to "read the current tea leaves," I thought it would be helpful to step back and discuss the long term trends that have produced our present economic situation which some economists have referred to as the "economic perfect storm." I like this expression because it implies that conditions exist which will create a very damaging storm. However, we can only guess as to the storm's intensity, when it will strike, where it will make landfall, and what destruction the storm will cause.

Before we go any further, I need to advise you that I am not an investment advisor; so keep in mind that the thoughts we will be discussing are meant to enhance the range of subjects about which you will be able to have a knowledgeable conversation with your friends. I am not giving investment advice!

Now that we've got that out of the way, let's take a look at the broad range of contributing factors that have come together to create our economic perfect storm. The factors that we will be looking at in some detail are:

- The digital revolution.
- The modern corporation.
- The banking casino.
- The global economy.
- The role of state sponsored violence.
- The impact of fiat currencies.
- Democracy's fatal flaw.
- The rate of population growth.
- The role played by national character.
- The impact of possible unanticipated "Black Swan" events.

And finally, I'll close out the paper by discussing some of the possible impacts that this economic perfect storm will have on our future.

The digital revolution is a real game-changer.

Never before, in recorded history, has there been a more game-changing capability than the digital revolution which has taken place over the past 50 years. A major impact of digital technology is in the generation and distribution of knowledge. And with the expansion and availability of knowledge has come the dramatic increase in innovation.

If you are over 40 years old, you have probably experienced some of the effects of the digital revolution. You may use an IPhone, IPad, and a personal computer. You communicate with other people via email, text messages, and a wireless phone. If you have a question, you do a Google search to find the answer. When you buy something at the store, you pay for it digitally with your credit or debit card. It's hard to believe that these devices did not exist 50 years ago.

Along the way, careers became obsolete, products became obsolete, and processes became obsolete. In their places, new industries, products, and careers have emerged. A byproduct of these changes is that they have dramatically reduced the demand for unskilled labor. This happened because of labor-force efficiencies, the application of robotics, and other equipment that effectively replaced low skilled labor in the work force.

In addition, digital information systems have rendered the military command and control organization model obsolete because it could not compete with the more effective team organizational structure. This change caused middle managers to be redundant because their role was to take orders, give orders, and to control information. This reactive skill has become obsolete because the team organization structure is characterized by equal access to information and a proactive mindset on the part of team members.

This digitally-driven change is still ongoing. Activities that have been late to change are those that are monopolies, highly regulated, require licensing, or are restrained from changing by organized labor. Significant parts of our economy that fall into this category are healthcare, public education, higher education, and government services like the U.S. Post Office. It is a good bet that the public’s demand for improved outcomes and cost efficiencies will drive change in these areas as well.

Eventually, paper and coin money will be phased out and all transactions will be digital. Gone will be cash registers in stores. Banking will change with the elimination of bank tellers and bank vaults. No longer will there be such a thing as a private transaction unless it is done using barter.

The modern corporation.

I’ve included this section on the modern corporation because the digital revolution would not have happened without it. Unfortunately, the “Luddites” in our society, who believe that labor is at the center of economic activity, have painted the corporation as the villain that exploits labor.

So what does a corporation do that makes it so important in our present digital era of dramatic innovation? It is important because it is the vehicle for bringing to market new products and services that innovation has made possible. In simplistic terms, the corporation starts with an idea for a product or service that an individual or group believes that there is a market for. They then accumulate the money needed to bring the product to market by selling stock and bonds to people who believe in the idea and are willing to take a risk on it being successful. They then hire people and acquire the equipment needed to bring the product or service to market. If it is successful, the stockholders make money on their investment. If not, they lose the money they have invested.

The challenge for the corporation, in an era of innovation, is to not only stay competitive with other corporations with the same idea, but also to adjust their plans to incorporate the other innovations as they come along. If they don't, they will fall by the wayside as another company takes their place.

This process of creative destruction has facilitated the rapid change that is a part of the present economy we are presently experiencing.

The banking casino.

And finally, the digital revolution has changed the way that stock, bond, and commodity markets function. This change revolutionized markets because trades are now driven by decisions made by computer programs that execute trades instantaneously. This has resulted in markets being driven by competing computer programs which have the financial backing to execute massive trades to be held for very short periods of time. Given the size of these operations, they have made the markets subject to the "butterfly effect", meaning that a misstep by a computer program has the potential to crash the markets.

Added to this change is the introduction of new types of investments called derivatives. Some of these products are essentially private insurance products that are designed to share the risk of potential loss with the buyer of this product. Currently, the most well known of these is the credit default swap (CDS) that banks bought to share the risk they took in lending mortgage money to people who were a high credit risk.

When the housing market collapsed, the companies that sold these derivative insurance products did not have the resources to hold up their side of the bargain and this put them at risk of going bankrupt. The unfortunate part of this story is that many of these sellers were major banks that are part of the Federal Banking System. Guess who bailed them out. We did through our federal government. In other words, we bailed out the banking casino.

The global economy.

Before the fall of the Berlin Wall in 1989, the world had not known a truly global economy in which all nations could participate. This new global economy is characterized by the free flow of investment capital, goods, services, and information, world-wide.

Labor

As you might expect, globalism has not been uniform in its impact on the nations involved. In the case of the United States, it has been good for capital, okay for skilled workers and bad for unskilled workers. It has been bad for unskilled workers because they now have to compete with unskilled workers around the globe. They no longer could band together in a union and force their employers to pay them wages that were significantly higher than workers of equal skill in lesser-developed countries. On the other hand, unskilled workers in the underdeveloped countries benefited from getting higher pay than before they participated in the global market.

Investment Capital

In contrast to unskilled labor in the developed countries, globalization of trade presented vast new opportunities for investment capital. Rather than be constrained in its investment to the developed economies, it now could be invested almost anywhere in the world. This freedom for capital resulted in putting nations of the world in competition for capital to be invested with them.

From capital's perspective, the characteristics that it takes into consideration when choosing which country or state to invest in are:

- Is it governed by the rule of law?
- Does it have guaranteed property rights?
- Does it have an adequately trained and productive work force?
- Does it have reasonable labor laws?
- Does it have a competitive tax structure?
- Does it have an adequate transportation system to move goods and services?
- Does it have a functioning information technology infrastructure?
- Does it allow the free flow of capital across its borders?

Given these requirements, most of the countries that function in the global economy have adapted laws which accommodate the needs of investment capital.

The role of state-sponsored violence.

There is a truism that states, "In the absence of the rule of law, he who is most effective in projecting violence wins."

Global trade is put at risk when a group or nation chooses to ignore the rule of law on which the global economy is functioning, and chooses to get what they want through the projection of violence. This action is disruptive to global trade so it needs to be subdued with a force that is more effective in projecting violence than the disruptive force.

For the past 70 years, the United States has played that role; first with the Communist economic system which was hostile to capital, and later with the Islamic terrorists that were driven by an extreme Islamic system of Sharia Law.

In order to play this role, the U. S. has maintained a defense budget that was greater than the next 19 highest defense spenders combined. As we will discuss later, the U. S. may not be able to continue to play this role because they may no longer be able to afford to do so. The question needs to be asked; if we are not able to fill this role, who will do it and what will their values be?

Looking ahead, a major challenge will be how to effectively deal with a rogue nation that has deliverable nuclear, electromagnetic pulse, or biological weapons. Especially one who's value system includes being willing to use them because they are willing to die in order to achieve their goal.

Another future potentially disruptive weapon that nations will use is cyber warfare. This weapon will be able to destroy a nation's military capability, electrical power grids, financial systems, and communication networks, without using any type of explosives.
What makes this type of warfare challenging to defend against is that it is inexpensive. This makes it possible to be delivered by a nation, group, or an individual. At this point there are no "rules of engagement" for fighting this type of war so it will be interesting to see how it all plays out.

The impact of fiat currencies/capitalism on steroids.

Some have claimed that pure capitalism died about 100 years ago. In its place, capitalism became a hybrid by combining capital with central bank created credit. How did this happen? Why is it significant today?

First, you need to understand that in the era of pure capitalism, prior to 1914, value was represented by tangible assets such as real estate, commodities such as metals and agricultural products, and stock in a business, etc. It was an era where money's value was based primarily in the market value of metals such as gold, silver, nickel, and copper. It was an era where the aggregate value of assets stayed fairly constant. It was an era where lenders could only lend if they had something of real tangible value to lend.

That changed when nations set up central banks that could lend money that they could create out of thin air (fiat money). They initially did this because they needed to pay for the cost of fighting the First World War. The money they created was said to be backed by the full faith and credit of the issuing central bank instead of a tangible asset.

As time went on, the central banks made this money, which they created, available for borrowing by nongovernmental borrowers through the national banking system. This meant that credit availability was greatly expanded over what would have been available had the fiat money not been created. This dramatically increased investment capital's leverage because of easy credit. Easy credit made more money available for business investment which resulted in dynamic growth in business activity. And finally, this dynamic growth fueled the growth in economic activity that we have experienced over the past 100 years.

Eventually, this easy credit was made available to individuals, making it possible for them to borrow the money needed to buy homes, automobiles, toys (boats, etc.), and higher education. The demand for these products, made affordable by easy credit, contributed to the demand that fueled the unprecedented economic growth.

However, there is a price to be paid for the rapid increase in the supply of credit when a nation's central bank creates fiat paper money. The increase in the amount of money in circulation creates increased demand for products, and the increase in demand for products results in an increase in the price of products. Since it takes more money to buy a product, this means that there is a reduction in the value of money. Another word for this phenomenon is "inflation".

Over the past 100 years since the creation of the U. S. Federal Reserve Bank, the U. S. Dollar has lost 97% of its value. Put another way, what cost one dollar 100 years ago, now cost thirty-three dollars. The pace of inflation has accelerated to the point where today's dollar buys what ten cents did 50 years ago. Put this in context, if the present rate of inflation continues over the next 50 years, one gallon of gasoline will cost forty dollars.

There is no guarantee that the rate of inflation will remain constant. In the early 1920's in Germany, it got so bad that their money lost all of its value in 6 years. At the end of this cycle, prices went up every hour. People carried their paper money around in bushel baskets and wheelbarrows.

Another by-product of easy credit is that it results in a dramatic increase in the number and intensity of economic bubbles. Examples of these bubbles are:

- The 1929 stock market crash that was followed by 12 years of economic depression. A major contributing factor was the excess credit financed 90% of the stock purchase price.
- The 1980s Savings and Loan banking collapse that was caused by over-leveraged lending in the commercial real estate investment bubble.
- The 2007 housing collapse that resulted from excess credit made available to home owners.

One bubble, that has not yet burst, is the sovereign debt bubble. This a bubble that occurs when a nation or state borrows more money than they can ever hope to pay off the principle plus interest costs. We will discuss this in greater detail in the next section.

Oh, before we go on; we hear a lot about going back to the gold or silver standard for our currency. You need to understand that while this move would correct the currency inflation problem, it would dramatically reduce the availability of easy credit that is a characteristic of our present fait money central banking system. This means that we would not experience the credit-driven demand that is a characteristic of our present economy.

Democracy's fatal flaw.

Most of the nations participating in the global economy have some form of democracy that is characterized by the citizens selecting their leaders via elections. This trend started with the industrial revolution 200 years ago and has been sustained into the global economy, because free self-governing people tend to be more creative and productive than those that are not free.

The challenge that democracies face is that voters will tend to vote for governments that will, in effect, buy their vote by giving them something in return. Since democracies' leaders are not personally liable for the promises that they make, they assume that the government will always be able to collect taxes for and borrow the remaining funds needed to make good on their promises.

Over time, democracies turn into "Robin Hoods", in that they tend to take from the rich and give to the rest of the people. They are careful not to take from the middle class, who represent the fat part of the bell curve of voters, because they need their votes in order to stay in office.

Eventually, human nature being what it is, political leaders promise more than the tax structure will support. When that happens, the government goes into the market and borrows the money to make up the shortfall. Borrowing money to make up for tax revenue shortfalls works for a while. But eventually, as the government gets deeper and deeper in debt, the lenders get concerned about the borrowing government's ability to pay back the money that they have borrowed plus interest.

When this happens, the lenders charge higher rates of interest to reflect the greater risk that they are taking. These increased rates of interest not only effect the new money the government borrows, but also the rates that they will have to pay when they roll over their old debt.

Usually, all debt either gets paid off or written off. However, in the case of a nation that issues their own fiat currency, they have one more option. They can create money out of thin air and use it to pay off their debt. As we discussed in the previous section, an advantage in doing this is that the money they are using to pay off their debt is usually worth less than the money that they barrowed.

The rate of population growth.

It took thousands of years for the earth's total living population to reach one billion people in the year 1811. By 1927 it had grown to two billion, and now, 86 years later, it is around seven billion people. Experts tell us that 40% of the people who have ever lived are alive today.

There are several contributing factors to the rapid expansion of the world's population. Among them are; availability of food, elimination of childhood diseases, and the improvement in health care.

Over the past 60 years, life expectancy in the developed nations has gone from 65 to around 80 years. With this change has come a new dynamic in government involvement in providing a safety-net of healthcare and support for basic living costs of their aging populations. The pace of this change was unanticipated at the time that these programs were put into place. In many cases the projected cost of these programs is putting a strain on government budgets, thus diverting funds from those needed for the continued growth of their economies.

Since most of the world's population growth has occurred in Asia, the mid-east, and Africa, areas of the world that do not produce enough food to support their populations. Therefore, they are highly dependent on the continuation of the free flow of goods that is a characteristic of our global economy. In addition, they need to be able to earn enough to afford to buy food from other parts of the world. For these populations, the margin of error is fairly slim. Any interruption in the flow of imported food will bring about starvation and a major disruption of social order.

As you probably are aware, the supply of food is not the only thing that is impacted by the increase in population. The supply of oil used to power autos, airplanes, trains, heat homes, generate electricity, and produce agricultural fertilizer is also under strain.

The role played by a nation's character.

In my counseling of young people considering marriage, I always advise them to make sure that they have the same values. I give them this advice because there will come a time in their marriage relationship that there will be a crisis that requires a values-driven solution. If their values are different, it will be difficult for their relationship to survive the crisis.

I believe the same is true for nations. Their value systems will determine how their citizens will respond when there is a breakdown in the functioning of their government as a result of the coming economic perfect storm.

How this coming event will affect you will have a lot to do with the values of the society that you are living among. In my view, there are essentially three types of value systems; those that are based on a religious system; those that are based around a tribal structure; and those that are based on a secular view of life.

The four primary influential religious systems that are functioning today are Christianity, Islam, Hindu, and Confucius. Each of these religions advocates a system of laws or values that transcend government. So we could expect that society would fall back on those laws and values in the event that their government becomes dysfunctional.

The modern versions of the tribal structure value systems are communism, socialism and tribalism. A common characteristic of these societies is that the ownership of most of the assets of the group is held in common and that the yields on those assets are distributed among members of the tribe. As we have seen in the case of Russia and communist Eastern Europe, those societies remained fairly orderly during a time of the breakdown of government. I believe this was the case because they had no current history of private property.

I believe that the value system that holds the most personal risk in the event of their government's breakdown is a society that is based on secular values. Why is this? It's because it is a society that is based on the values that are portrayed in most current Hollywood movies, a society that is made up of narcissistic individuals. In the event of the collapse of government, each individual will be a law unto themselves. Anarchy will prevail. For an example of what this looks like, examine what life is like in some of the ghetto areas of our large cities.

The impact of unanticipated "Black Swan" events.

Of course, no examination of an economic perfect storm would be complete without considering the impact of an unanticipated event. Just a few days ago we had a meteor, which flew toward the earth; explode over a town in Russia. In 2011, there was a major earthquake off the coast of Japan that caused a destructive tsunami that destroyed coastal cities and shut down a nuclear power plant. And in 2004, an earthquake resulted in a tsunami that flooded the coastal cities of Indonesia and India resulting in massive destruction and the loss of life for 220,000 people.

These are events that are not caused by mankind. What about a nuclear attack? After all, there are as many as eight nations on the Asian continent alone who can deliver these weapons now, as well as one (and soon possibly two) in the Middle East, two in Europe, one in Africa, and one in our hemisphere (United States), who also have these weapons.

It is my view that the U. S. is probably the most likely to be a target because we have historically provided an umbrella of nuclear protection for the western nations. In the mind of the attacker, if the U. S. went away, the rest of the western world would be susceptible to nuclear extortion.

Another example of a possible unanticipated man-made event is a major disruption in the free flow of goods by shipping. This could happen by shutting off the flow of oil from the Middle East oil producers by closing the Straits of Hormuz. Another would be the closing of the Panama Canal which is now run by China. And finally, there could be an open sea disruption of shipping movement by the use of force.

How will these factors impact the economic future of the U. S.?

The Making of the "Great Recession"

In 2008, the U. S. economy experienced the bursting of a massive residential housing bubble. This was followed closely by a collapse of the stock market and the collapse of our major banks. These events were broadly felt by the average person, because they not only lost significant value in their primary real estate investment, their home, but also lost around fifty percent of the value in their stock portfolio.

The housing bubble was brought about by our federal government. The government brought about a dramatic increase in demand for housing by making credit available to people who would not have been able to afford to have a 20% down payment and couldn't meet the income requirement that was typically required by banks. This increase in demand for houses drove up the price of homes much faster than would otherwise have been.

To make matters more risky for lenders and home owners, homeowners were able to use the increased equity in their home as collateral for additional borrowing. On top of this, many home owners, feeling well off, used their credit cards to borrow additional money. Many people carried $50,000 to $100,000 unpaid balances on their cards.

When the bubble burst and home prices fell dramatically, many homeowners owed more money on their homes than they were worth so they stopped making payments on their mortgage debt. Banks foreclosed on these loans, taking possession of property that was now worth much less than the mortgage they held, so they took a loss.

But it didn't stop there because the banks had hedged their risk by selling part of their loan to other banks and investors. In addition, they bought portfolio insurance (better known as derivatives) that would pay them if their loan became nonperforming. When the bubble burst, this house of cards collapsed, bringing down the banks as well as those who sold them the insurance.

Given the losses that the average person took on their home and investment portfolio, they circled the wagons economically and stopped spending unless it was absolutely necessary and focused on paying off their loans. The prices for most products began to drop. The market for new automobiles collapsed and two of the three U.S. automakers went through a government-controlled bankruptcy.

In order to stay solvent, businesses began laying off people. Unemployment, when measured by the method used 50 years ago, jumped to more than 16% of those wanting to work. Wages began to drop in the private sector. With this reduced private sector income, it followed that the revenue that government collected from taxes also dropped.

This economic collapse was at least as bad as the 1929 collapse that resulted in 12 years of deflationary depression that followed. However, so far, government action this time has given us a different result. The government stabilized the banking sector by lending them the money that they needed to survive the losses that they suffered. In addition, the government aggressively funded the public safety net of food stamps, unemployment insurance, and social security disability compensation. This aggressive action stabilized prices and stopped the deterioration of our economy.

So Where Are We Now?

It is now 2013, more than four years removed from the collapse of the housing bubble. Prices have been fairly stable, unemployment has not improved much, and interest rates are at historic lows. Banks are now flush with cash, the stock market is now making new highs, the inventory of foreclosed houses is being worked off, and auto sales have recovered.

In order to get to where we are, the federal government has had to borrow over 40 cents of every dollar it spends. To do this it borrowed an additional five trillion dollars, pushing its total U.S. sovereign debt level to over 17 trillion dollars. This level of debt will be unsustainable when normal interest rates return. To put this amount in perspective, if the government paid the usual three and a half percent interest on this debt, we would be spending more on interest alone than we presently spend on defense.

Looking ahead, it even gets worse; the federal government has unfunded liabilities for Medicare and Social Security of more than 50 trillion dollars that will come due over the next 20 years. To meet this obligation will require a doubling of our present federal budget, resulting in an ever increasing budget deficit and expanding sovereign debt.

In order to keep interest rates low, the Federal Reserve Bank is now buying 70% of all new debt that the government is issuing by creating the money to do so out of thin air. To date, it now owns 15% of the 17 trillion dollars that the government now owes.

What Does the Future Look Like?

That’s the question that is on many people’s minds. That’s why I wrote this paper; I assumed that when I got to this point I would have it all figured out. The reason that the answer is slow in coming is that we have never been here before. There are several variables that come into play:

- Is the present government stimulus enough to keep the economy from falling back into a deflationary depression?
- Will the U.S. Federal Reserve's present rate of creating money result in future price inflation? If so, how much, and when?
- Will the federal government encourage inflation as a way to pay off its debt and give the illusion of meeting its commitment to provide Social Security and Medicare for the baby boom seniors?
- Are the federal government's economic statistics accurate, or are they biased by the way they calculate inflation? If so, what are the implications for the investor? See www.shadowstats.com
- Will a flat median income since 1995 provide enough consumer demand stimulus to get the economy moving again?
- How will the efforts of the world's 40 central banks to lower their currencies' value impact the U. S. export competitiveness?
- What will be the impact on the value of the U. S. dollar if it loses its reserve currency status? And if it loses this reserve status, what currency will replace it and when will this happen?
- At what point will fiat currencies lose their credibility as a store house of value.
- What will be the impact when currency goes totally digital rather than paper bills and coins? Will there be a non sovereign currency?
- What impact will the excessive sovereign debt levels of the world's democracies have on their political stability?
- How will possible Black Swan events impact the U. S. economy?
    - Interruption of the global supply of food.
    - Interruption of the global supply of oil.
    - War between Israel and its neighbors.
    - Will North Korea make war with South Korea and the U. S.?

Now you know why there is so much confusion among investors as to where they should invest their money. Of course various asset classes will run up in price when they become the focus of the investment herd. However, for me, I want to know how the various asset classes will perform over the next five years.

In order to make this determination, I am inclined to make the following assumptions:

1. The U.S. government will direct the Federal Reserve Bank to create whatever amount of money it takes to prevent deflation from happening. They will do this because the alternative would be catastrophic for the government, given all of their unfunded mandates, loan guarantees, and the fact that lowering voter's dollar incomes would be politically unpopular.
2. The policy outlined above will eventually result in moderate to high inflation. If for no other reason than to maintain our global trade competitiveness with all of the other nations whose central banks are deflating their currency's value. Add to this risk, the possibility that the U.S. dollar could experience a move to hyper inflation once it is no longer the world's reserve currency.
3. Our economy will remain flat for the next ten years because of the reduced consumption of resources by the ageing baby boomer population. This, along with the fact that global competition will result in the continuance of the wage stagnation that we have experienced for the last 15 years, thus limiting consumer demand.
4. The U.S. state and federal governments will become much more aggressive in confiscating their citizen's assets through tax policy and limiting the movement of assets out of the country. The shift to a totally digital currency will help them facilitate this policy.
5. Democracies, including ours, will experience more social unrest because their central banks continue to print money that will benefit those who have access to it while poor people who don't have access will suffer from higher prices.

Given this scenario, how will the various Asset Classes Perform?

Most financial advisors encourage their clients to balance their investment portfolios between stocks, bonds and cash. Others encourage adding commodities such as gold and silver as an insurance policy against the collapse in the dollar's value. The theory behind this approach is to spread your risk by not over-committing to one asset type. Let's see how these various asset types will fare in the probable high inflation future that I've laid out.

<u>Cash</u>

Inflation, by definition, describes an ever increasing reduction in the U.S. dollar's value. So when holding cash during times of artificially low interest rate, as we are now, it is virtually impossible to earn enough after paying tax on interest income to not lose money while holding cash. So holding more cash than you need to cover current living expenses, long term, would not be a good investment.

Bonds

Since bonds are essentially cash in another form, they are impacted, as cash is, during times of inflation. While the rate of interest income on bonds may be greater than holding your cash in a bank savings account, bonds can carry much more risk in two ways. One risk is that the entity issuing the bond may default on paying the bond holder interest income during the life of the bond and also may not be able to pay off the bond when it matures. Examples of this problem were experienced by General Motors bond's holders in 2008.

The second risk for bond holders occurs when market interest rates rise after they buy their bond. If they want to sell the bond before it matures, the bond's sale price will be reduced to reflect the increase in market interest rates. So holding bonds during a period of rising interest rates would not be a good investment.

Stocks

Unlike cash and bond investment, a stock's value is based on the anticipated earning capacity of the company which issued the stock. Its price at any point in time reflects the current value of the currency that it is priced in. What this means is that, during times of inflation, the dollars that you use to purchase the stock will be more valuable than the dollars that you get when you sell it.

For example, if you bought a stock for $10 in 1965, you would have to sell it for $100 today just to break even. But the story does not end there. The government would say that you made a $90 profit on your investment on which they expect you to pay a 20% tax. While this example is simplistic in that it does not take into consideration possible dividend payments, it does show how inflation effects stock investment.

Of course, there are other factors that impact a stock's value. One primary factor is the psychology of the investment herd. When the stock market indicators start to move higher, investors move into the market to get a piece of the action and their entry into the market increases demand and prices continue to move higher. Over time, this process leads to a bubble that bursts and the market collapses as everyone tries to get out of the market at the same time.

Another factor that influences market volatility is the total value of a particular market verses that of other investment opportunities. A Google search reveals the total value of each of the major investment categories. The global bond market is around 80 trillion dollars, the global stock market is around 50 trillion dollars, and the total value of gold that has been mined is between 8 and 10 trillion dollars. In the case of gold, the actual value of the gold that is available to be bought in the open market is only a fraction of the stated amount because the rest is held by government central banks to maintain their credibility and is not usually available to potential buyers. Given this information, you can understand why the gold market is much more volatile that the stock and bond markets.

While an individual stock's price is influenced by the issuing company's performance, the psychology of the market herd also influences price. One aspect that influences the investment herd is the actions of all of the side bets that are being made in the form of derivatives. Experts estimate that the value of all of all of these side bets exceed 1,000 trillion dollars. Most of these bets are highly leveraged, meaning that players can get wiped out when prices move against their position (remember MF Global?). Since many of these side bets require the purchase of a stock or commodity if the market moves beyond a certain price, this process adds additional market volatility.

So, how do all of these factors impact the risk associated with investing in today's stock market? I thought you would never ask.

Today's stock indexes, the Dow Industrial and the S&P 500, have broken through their all time highs that were last reached before the market crashed in 2008. This, so called, bull market is now in its fifth year and is, I believe, getting into a high-risk phase, but is still being driven by the additional new money entering the market; some from the European Common Market that is in recession and concern about the soundness of some of the members banks; some from the present very low yield bond market and some from the group of investors who were burnt when the market collapsed in 2008 who are just getting back in. And finally, additional demand is created by the new money borrowed by those who bought stock on 50% margin, which, by the way, is now near an all time record high.

Given the fact that we've had little or no real growth in our economy over the past five years and our economy is being kept afloat by government deficit spending, the optimism that is driving the stock market may turn out to be an illusion. When investors realize this, they will exit the market, and the indexes could experience a typical 50% retrenchment from its gains since the 2008 lows.

Precious Metals

The two metals that usually are considered in this class of investment are gold and silver. They can be bought as coins that have been in circulation as money, or as coins that have been minted as investment coins, or in blocks called bullion. Bullion can also be bought through Exchange Traded Funds (ETF) that have the same characteristics as a gold or silver backed paper currency.

The knock on owning metals is that they don't earn interest or dividends. In fact, in the case of bullion, you may pay a fee to have it securely stored. Another negative is that the transaction fee when purchasing precious metals is higher that when buying stocks or bonds. And finally, the profit from buying and selling precious metals is taxed as regular income rather than the lower capital gains rate. A way to get around this tax disadvantage is to invest in precious metals mining stocks, whose gains are taxed as capital gains, rather than the metals themselves.

So with these disadvantages, why would you want to own precious metals? First of all, while the dollar has lost 90% of its value over the last 50 years, gold's value measured in dollars has gone from $35 per oz. to $1,600 per oz. over the past 40 years. This means that gold's real value has increased 450% in 40 years.

Gold has the additional advantage in that it can be stored anywhere in the world. It is marketable anywhere in the world. And in coin form, it could easily be used in bartering if currencies went digital under the control of some government. It is easily transported. Ten pounds of it would be worth $256,000.

<u>Real Estate</u>
When investing in real estate, we normally think of several different possibilities. Among them are residential, commercial, and agricultural properties. While real estate is a good store house of value, it has limitations. It can't be moved so it is at the mercy of local government's regulation and tax policy. Its value is dependent on the local economy's impact on demand for its use. It needs to be maintained and managed. Another risk factor is that it usually has to support a mortgage payment that can go up in cost when refinancing during periods of high inflation. And finally, real estate has the disadvantage of not being easy to sell.

Summary

I suppose you are wondering what I'm going to do now that I've gone through this economic analysis. I've decided not to discuss that with you because you my take it as advise on what you should do in your financial circumstance. That would be wrong because your situation is probably different from mine and so what works for me may not work for you. I encourage you to seek out a qualified financial advisor to help you develop a plan, taking into consideration all of the factors that I've discussed in this paper.

Hopefully you have found this analysis to be helpful. I've had fun writing it, although at times it was a little depressing. I guess reality can be messy.

If you have any comments or suggestions, please email them to me at Otto.Engelberth@gmail.com. This article will also be posted under the EZINE section of my web site www.IsThereACreator.com