The Grimm Reaper is Knocking

Dear Investor: June 3rd, 2009

Every relevant economic analysis begins with a long-term analysis, and then refines that to a more focused review of today's economy. A top down approach to economics is the only way to identify relevant trends. Although the media will have us think differently, 99% of the daily economic news is noise. We cannot accurately gauge the state of the economy by looking at the day's economic data. That data may change the direction of the stock market for a short while, but most of the economic data that we hear day in and day out makes no difference to the longer-term health of the economy. Eventually the Market gets back in line. I say this every day, and in large part, I do so to help investors make better decisions, but do not listen to the noise. That specifically means the economic news. It can be confusing.

Clearly, because I am an economist and a market strategist, this seems counterintuitive. However, by releasing our dependence on immediate economic news our eyes open to the longer-term trends in the economy. This is a more accurate gauge. Longer-term trends are much easier to identify than shorter-term trends. Because of that, longer-term trends are much more reliable, and they are always our starting point.

The longest longer-term analysis available is the Investment Rate. This is a proprietary analysis I developed in 2002. It dates back to 1900, and it is a demographic analysis. The economy is all about people. How much money do people have, how do they invest it, and how do they spend it. Nothing else matters. I should quantify that before I move forward. Nothing else matters to the longer-term trends in the economy. Clearly, short-term fluctuations may exist, but the longer-term health of our economy rests solely on the demographics of our country. Furthermore, because the United States is a dominant leader in the global economy, our population also affects the world economy.

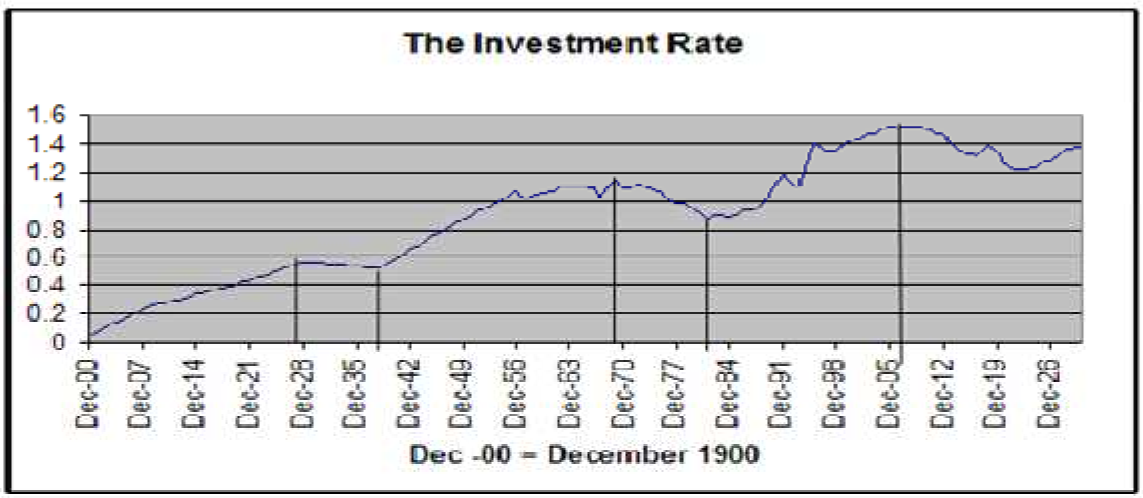
Specifically, the demand stemming from the United States affects the rest of the world. If demand increases domestically, the world economy flourishes. Conversely, if demand for investments contracts, the world economy experiences a recession. The Investment Rate measures that demand. However, it does so in more than just one way.

Demand can be broken down into two distinct categories. One is demand for goods and services. The second is demand for investments. When I developed the Investment Rate in 2002, I did so with the latter in mind. I wanted to measure the demand for investments within our population, and with careful analysis and evaluation using normalized lifetime investment patterns largely dependent on retirement planning, I came to a conclusion.

That conclusion provided me with a concrete understanding of normalized demand ratios for investments over long-term periods.

With that information in hand, I compared the trend of the Investment Rate to the stock market from 1900 to now. The result showed direct correlations. There are distinct up and down moves in the chart of the Investment Rate, which correlate directly to the major economic cycles experienced over time. The Great Depression and the Stagflation period of the 1970s are excellent examples, but so are the up trends in between. The Investment Rate was a leading indicator for both strength and weakness over time.

This reverts to Adam Smith's theory of supply and demand. The Investment Rate is a demand-side analysis, and it tells us when demand is increasing, and when it is decreasing over time. Because this is the longest longer-term economic indicator available, it also shows us longer-term trends that are irrefutable. Our population ebbs and flows, no one will argue with that. The age at which people start to invest money aggressively also ebbs and flows over time. I call this the Kee Age. Every year a different number of people reach the Kee Age. This change, measured over time, creates the chart of the Investment Rate.



The result is a directly correlated leading economic indicator. In fact, over time the stock market reacts to these normalized demand cycles, so it is also a leading stock market indicator. Therefore, in my opinion, the Investment Rate is the most accurate leading stock market and economic indicator ever developed.

In 2002, it told us that demand ratios within the United States would continue to increase until 2007, and that told us to buy the dip. In 2007, the Investment Rate told us that liquidity levels would peak, demand ratios would peak, and the market would begin the third major down period in US history. We knew this in 2002. The prior downtrends in the Investment Rate were the Great Depression and the Stagflation period of the 1970s. During those times, severe pressure weighed on the market and the economy. We have just experienced the first year of the third major down period in US history. By the end of this report, you will know just how long that will last.

Before I move ahead, I would like to go back to demand ratios. The categories I defined were demand for goods and services versus demand for investment. As our population shifts, and age groups are skewed based on birth rates, I have been able to measure the rate of change in the demand for investments over time. However, I can do the exact same thing for consumption. In fact, even though we have entered the third major down period in US history, and even though that warns us that significant economic weakness and market declines lie ahead, that does not reduce consumption patterns.

In fact, during major downtrends in the Investment Rate, consumption has still increased. Appropriately, the Investment Rate tells us that consumption levels will continue to increase even though the demand for investments will decline. This should bode well for those companies selling necessary goods and services to the consumer. However, it could also present problems when desired growth rates factor in.

My argument is that our economy grows based on investments, not on consumption. Most economists would agree with me. The more investment dollars in our economy, the more growth it will experience. During this downtrend in the Investment Rate, new investment dollars, which are the driving force of the economy, decline every single year. At the same time however, there are more net new consumers entering our economy every year too, and they are still buyers of basic goods and services.

Translated, consumption is not likely to wane significantly, but growth rates are likely to subside. This broad analysis does not take into account immediate conditions, but we will get to that later. Instead, it is offering us a normalized look at the broader picture.

The risks accompanied by these inversely related demand observations tie directly to inflation concerns. Normalized levels are the key to this analysis. The Investment Rate tells us where demand levels for investments should be on a normalized basis. In early 2007, normalized demand ratios were significantly below real demand ratios in our economy. Arguably, cheap money compelled investments into our economy that would not have otherwise been made. Then that changed. The result was a 180° turn in 2008. Demand ratios in our economy fell off a cliff. Not only did they come back to normalized demand ratios, as offered by the Investment Rate, but they fell significantly below those normalized demand ratios as well.

This prompted my Return to Parity Analysis in December of 2008. Real demand was significantly lower than it should have been. That caused an overshoot to the downside in both the economy and the stock market. Therefore, in December of 2008 my Return to Parity Analysis suggested that after the first quarter of 2009, economic conditions would improve and the stock market would rebound. We are seeing that happen right now.

However, my Return to Parity Analysis also offered another subtle point of fact. Although the economy would return to parity in 2009, according to my observations, it would only be returning to a downward sloping curve. The downtrend in the Investment Rate, which began in 2007, lasts for 16 years. This is substantially longer than the Great

Depression or Stagflation period. All though I expect the market and the economy to improve through the first quarter of 2010, the Investment Rate explains that the return to parity will eventually lead to a reversal lower again. My effort here is to convey that message and to be exact.

Many people were surprised when I offered my bullish forecast for 2009. But then, most people were surprised that I predicted a greater depression and 2007 as well. My analysis will always come before the expected economic or market conditions surface. We must always remain ahead of the curve; otherwise, we cannot act in advance and our efforts will be futile. My Return to Parity Analysis gave us advanced warning of the improved economic conditions that were likely to surface after the first quarter of 2009. This update explains in advance how this return to parity will pan out.

Our government has done everything in its power to stabilize our economy. Unfortunately, along the way somebody forgot the definition of capitalism. Prior to the bailouts, tarp, and the skyrocketing government debt levels that took place at the end of 2008 and the beginning of 2009, our economy already had major hurdles in front of it. These hurdles are not tied to the Investment Rate directly, though they have links. These hurdles are Social Security and Medicare. Government officials fail to incorporate these into the budget deficit when the budget deficit is calculated. That is an atrocity.

Without a doubt, Social Security and Medicare would stifle economic growth on their own. However, with the exponential recent increases in our debt levels, the impact of Social Security and Medicare will only compound and already ominous problem. The United States needs to take control of its debt, and then it needs to focus on Social Security and Medicare. Quite obviously, the money is not there to satisfy these obligations right now. This is a huge problem.

There are two possible solutions to satisfying the massive debt burdens. Combined, we are in debt up to six times GDP. No one wants to admit it, but the United States is bankrupt on paper. We have two choices. Either the government can slash spending across-the-board, or it can raise taxes on the US consumer. Clearly, a combination of the two is also possible. We cannot continue to borrow from Peter to pay Paul. The Chinese will not continue to buy our debt if they see that we cannot get a handle on our economy.

Unfortunately, this mess will be taking place during a downward trend in the Investment Rate, so we will not have economic growth to fall back on. Instead, there will be contraction. Taxes will go higher, government expenditures will probably decline, and the demand for the US dollar globally will decline too. This means, the demand for treasuries will also decline.

In December of 2008, when I issued my Return to Parity Analysis, I also referenced a trap that I expected to occur in US treasuries. It is happening already too. At that time, I issued recommendations to short US treasuries. I recommended two short ETFs: TBT and PST. The trap that I foresee is directly tied to a combination of the improved economic and market conditions defined by my Return to Parity Analysis, and the trap I expect to occur in US treasuries as the demand for zero rates of return subsides.

The cost of money is going up. Treasury yields will be increasing soon. When that happens, all of the funds invested in US treasuries will be stuck. In fact, those monies may already be stuck, because real rates are already increasing. That money moved to treasuries to find safety. However, because prices and yields are inversely related, when interest rates move higher, the value of the funds invested in those treasury bonds will move lower. With those risks, investors will not have the option of pulling their money out to invest in other places. This assumes they do not want to take a loss. The Chinese government and other foreign nations will be part of this pool.

Obligatory frameworks force many nations to buy dollars. Unfortunately, I expect that to change. The US dollar is likely to come under severe pressure in the years ahead. I expect the demand for dollars to decline, I expect foreign investors to be extremely cautious about investing in dollar denominated securities, and I expect the revolving debt cycle that our government has adopted to be much more difficult to satisfy. I do not believe it will be easy to borrow trillions of dollars anymore.

This is true not only because of the perceived economic weakness defined by the Investment Rate and its associated adverse impact on the position of the United States in our global economy, but it is also directly tied to the reduced overall demand ratios that the Investment Rate defines. When the Investment Rate begins to become obvious again, like it was in 2008, and less and less new money is available for investment in our economy for the next 16 years, the net demand for investments in treasury bonds will decline along with it. That is a bearish scenario for a Government dependent on increasing investments to satisfy debt levels. Another option is printing dollars, but that would be a measure of last resort, and would erode our economy even more.

Not only will the demand for stocks subside as the Investment Rate declines, but the demand for treasury bonds will decline as well. I expect that to be compounded by the negative perception foreign investors have about the United States as we raise taxes, cut spending, and try to tackle our debt. Our efforts, though necessary, will stifle all economic growth that might have otherwise occurred.

As a result, not only will the United States be faced with a naturally occurring economic cycle defined by the Investment Rate as the third major down period in US history continues, but the recent policy decisions of our government will also stifle any possibility at sustained recovery. With Social Security and Medicare lingering, this presents one of the worst economic forecasts imaginable.

However, at the same time, consumption levels will continue to increase. More consumers will enter the economy; they just will not have reached the Kee Age yet. Therefore, demand for goods and services are likely to increase even though the demand for investments will decline. Given the reduction in government spending and the increase in taxes that are inevitable, the ability of the consumer to pay for those goods and services is questionable longer term. This could be the face of the depression I foresee. However, the companies that provide the staples we use every day will likely have significant pricing power in the near term.

Over time, as the downtrend in the Investment Rate continues, I expect pricing power to subside. For now, the depressionary environment I am forecasting is not front and center. Instead, Wall Street sees a recovery, economic conditions are improving in line with the Return to Parity Analysis I provided at the end of 2008, and investors are becoming complacent all over again. Although demand ratios are returning to parity, and that makes us think that the Market is back in a growth phase, the return to parity is only a return to a declining curve.

With the fed funds rate at zero, however, money is cheap. New investment dollars are still hard to come by, but older money can be recycled to make this phase of our economic cycle appear to be something it is not. As that happens, and as companies realize that consumption levels still exist and are still relatively strong, companies will look for alternatives to natural growth in order to satisfy the demand of their shareholders and the market. This comes in the form of increased prices, and that means inflation. Our government seems to be asking for inflation, but if it comes, it will crush any hopes they may have had for recovery.

I expect inflation to be a major concern as 2009 ends. I expect increased prices for commodities and for the basic goods and services we use every day. Cost of living should increase across the board. When that happens, our government will need to combat inflation by increasing interest rates. I already believe that interest rates are too low and they will move higher anyway, but with inflation, interest rates may increase exponentially. If you thought higher taxes and reduced government expenditures would end the economic recovery, they are no match for higher interest rates intended to fight inflation.

In years past, I have remarked that the direction of the stock market and the changes in interest rates were directly correlated, not inversely correlated, when interest rates were adjusted based on the growth in our economy. I still believe that to be true. When the Federal Reserve adjusts interest rates based on economic conditions, the market moves in the same direction as those changes. For example, if the Federal Reserve increases interest rates because the economy is too strong, that tells us that the economy is doing well, and over time, especially over the last 10 years, during increasing interest rate cycles the market has done exceptionally well too. On the same note, when the Federal Reserve has lowered interest rates over the past 10 years, they have done so because the economy was weak, and during their easing cycle, the economy and the stock market remained under severe pressure until their policy decisions changed. They reacted to the economy, and were great indicators. Timing the market was easy if you bought and sold based on the changes that occurred in the direction of the fed funds rate.

However, these changes were all due to economic conditions, not inflation. Inflation shifts the landscape completely, and it creates the divergence we have all been accustomed to overtime. My observations of direct correlations between changes in interest rates and the stock market over the past 10 years prompted criticisms. However, my position is irrefutable. The criticism existed because many persons retained preconceived notions that the market reacts in the opposite direction of interest rates, not in the same direction, but that is only true when those changes are based on inflation. When interest rates are increasing to combat inflation instead of combating strong economic conditions, that traditional divergence is true. When it is based on the strength of the economy, the relationship is correlated.

In this specific situation, as inflation comes back into our economy in the latter part of 2009, and as interest rates increase from zero to a more rational level, I expect the exponential growth in interest rates, which will not be made to temper a strong economy, to result in severe market pressure. We should start to see exponential increases in interest rates by the first quarter of 2010.

From there, I expect inflation to be a wild card. Especially if taxes increase significantly, I am not confident that companies can sustain pricing power over longer periods. People will not have the money. Therefore, although I expect inflation in the near term and although I expect the Federal Reserve to combat inflation as it starts to escalate (they always react to economic news and rarely adopt proactive policies to get ahead of the curve), I do not foresee inflation as a major problem long-term unless it is commodities driven based on global demand. My presentation here assumes inflation based on corporate greed for the next few quarters; it is not based on long-term global demand. Global demand could add negative influence to this already detrimental economic situation. For now, I do not expect inflation to be long – lived, but I expect it to look serious as 2009 ends.

In the meantime, between now and the first quarter of 2010, I continue to expect improved economic conditions, slightly better corporate earnings, a healthier looking stock market, and a high degree of complacency. I expect Wall Street and corporate America to think everything is fine. I expect to see new investments, but I also expect those new investments to come from old money that pulled out in 2008. I do not expect new money to come into this market at a high rate.

New money is the driving force behind economic growth. We cannot expect the market to increase by churning money that is already invested. Instead, we need new investment dollars to move the market higher. The Investment Rate tells us that the amount of new investment dollars declines steadily for the next 16 years, so we cannot count n natural growth. This presents a landscape for weak economic conditions. It is a normal and natural occurrence, and there is nothing anyone can do to stop it from happening. All we can do is prepare for what is coming with prudent fiscal policies, and weather the storm.

Unfortunately, our government has blinders on. Instead of sound fiscal policies and adherence to capitalism, we have assumed more debt than we can handle, and our country is on the verge of bankruptcy. Taxes will be moving higher, that I am sure of. I expect Government expenditures to decline eventually, but it is hard to believe that will happen soon with Obama's recent decisions. In any case, our government has not taken steps to reduce the impact of this naturally occurring economic cycle, but it has made it worse.

That is the reason I am calling for a Greater Depression. I foresee the worst possible economic scenario imaginable. I expect naturally reduced levels of demand for investments, I expect significantly higher taxes, and I expect reduced government expenditures eventually. Over time, the consumer will find it hard to pay for basic goods and services as well. I also believe that the government will have serious difficulty borrowing money, I believe that the demand for the US dollar will subside considerably, and I believe that the perception that our global economy has about the United States will decline along with it.

For the next five years at least, I expect serious economic weakness. The market corrected in 2008, some people were hurt because of their bad investment decisions, but most people are still surviving and doing well. 2008 was a warning. The grim reaper is calling.

I am hesitant to put a downside level on the market at this early juncture. However, after the strength I expect going into the first quarter of 2010, I expect the resulting weakness to begin like Chinese water torture. I have already issued an upside target, and then down from there. Slowly, I expect our economy to flatten after the first quarter of 2010, I expect no growth for a short while, and then I expect corporate earnings to start to decline. When that happens, I expect an initial phase of denial to reverberate throughout Wall Street. However, after a couple quarters, I expect the weakness to be accepted and I expect the market to have already begun to decline again. This time, it will not look back. This will be the last opportunity to take action.

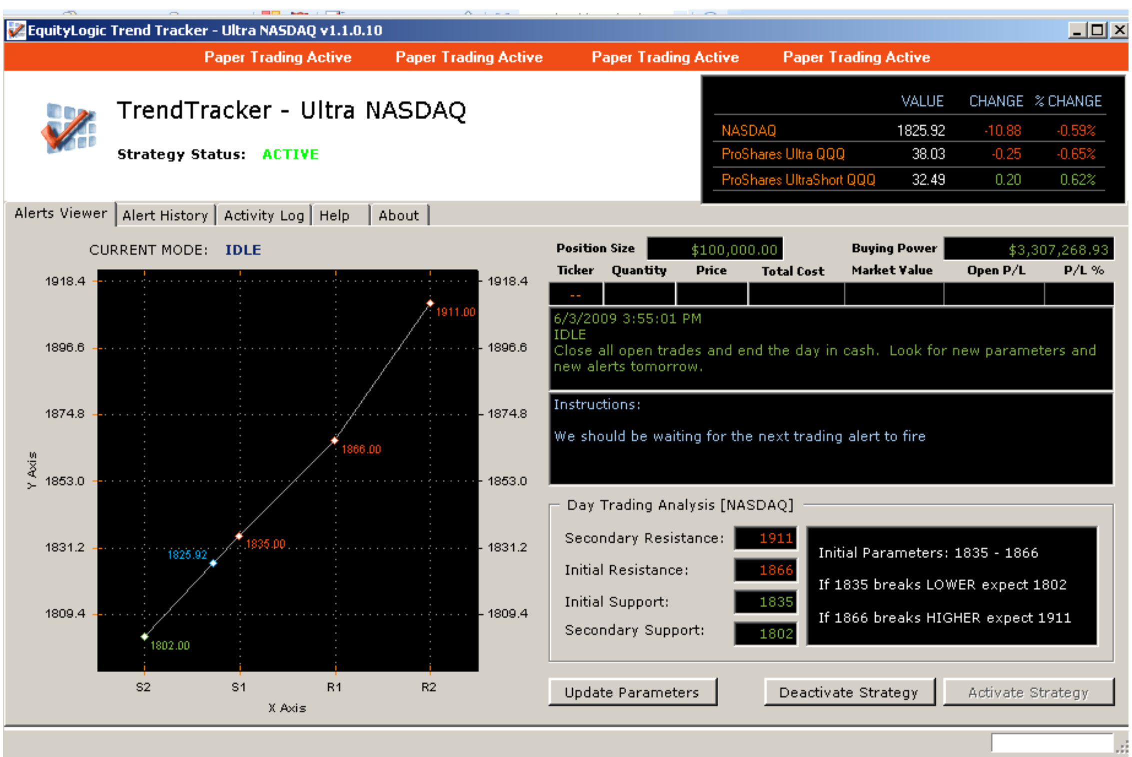
The declines I expect after the first quarter of 2010 will not be knee-jerk reactions to unexpected events like they were in 2008. Even though I supplied the Investment Rate to everybody many years ago, most people did not give it the time of day. Now they are starting to pay attention. The Investment Rate tells us that the current downward cycle lasts for the next 16 years. This is not a short-lived event. We cannot sit on our hands and expect everything to be fine. That is a mistake, because wealth ratios are at risk.

Money managers and mutual funds need to understand this. Everyone must adopt proactive strategies, or significant declines will wipe out major pools of investments all over again. I consider this a last chance opportunity to become proactive. I pounded the table in 2007 and told everyone to sell everything. I pounded the table in 2008 and I told everyone to adopt proactive strategies. Then in 2009, I automated our strategies so anyone can take advantage of them. Now, no one has an excuse. If you do not have the time, use the automated strategies. If you do not make the time, you will remain at risk. Money managers, mutual funds, and investment advisors, are paid to have your money invested, not to manage your risk. The fees they receive are for managing money, not for allocating it to cash.

We are responsible for risk management. No one else will do it for us. I expect the market to increase until about the first quarter of 2010. I expect everyone to be happy again too, but in line with the old-school premise, we will sell when everybody else is buying. If you are sitting on a $10 million managed account that was worth $4 million in March, and now you feel complacent to sit on that money and let it work for you over time because everything looks better, think again. The Investment Rate lays the groundwork for a weak economic environment. The best-case scenario would be Stagflation. However, our government has made so many mistakes that reconciling their mistakes will prevent any hopes for economic stabilization, much less recovery.

I was mocked as the Grim Reaper by Erin Burnet on CNBC in 2007 for outlining this same scenario. If you need to do it, call me the Grim Reaper again. However, I always look at the cup half full. We must always look at the cup half full. With advanced knowledge, like the information I am giving you here, we can position ourselves to take advantage of the moves, up or down, and protect our money when the market begins to decline. We can make money when the market falls as well as when it increases. If we adopt a proactive approach to the market, we can manage our risk and realize opportunities regardless of market direction and without sacrificing time or lifestyle. With the automated systems I have introduced, we can do this without lifting a finger. There should be no more excuses.

This is Trend tracker:



Prior to my conclusion, I want to address the other side of the coin. What if I am wrong? What if the market, even though it has followed the trend of the Investment Rate since

1900, stops following the trend of the Investment Rate? What if the government finds some way of paying off the debt without raising taxes, and they cut taxes instead? What if Social Security and Medicare are no longer burdens because health-care reform reduces the cost of health care so much that Social Security and Medicare are a fraction of what they otherwise would have been? Really, what I am asking is, what if the market goes up instead of down as I have forecast.

The beauty of my recommendation is that, if I am wrong, if the market increases instead of declines, we will still be managing our risk, we will still be realizing opportunities, we will still be able to do it without sacrificing time or lifestyle, and we will still be able to use the automated strategies if we want to. These systems work regardless of market direction, so if I am wrong, these systems will still allow us to participate with the upside. These present normal investors with competitive advantages over large financial institutions. We can manage risk better than they ever could. My strategies have exploited that. Use them to your benefit. They will work even if I am wrong.

However, I am not wrong. The market has entered the third major down period in US history. 2008 was a warning. There was an overshoot to the downside in 2008, and the recovery that we are witnessing now is merely a recovery to a downward sloping curve. After that recovery comes full circle, the declines will continue, economic growth will be stifled, the economy will come under severe pressure, and real wealth ratios will be wiped out all over again. My analysis is quite clear. If you have not already adopted a proactive strategy, learn how to do so, prepare to sell all of your longer-term investments, and get ready for the worst possible scenario imaginable. I will tell all of my members when I think it is time. For now, I am anticipating Q1 2010.

If my rules are followed, this dire analysis will not impact you at all. In fact, the noise we hear every day will no longer concern you. However, my approach is outside of the box, and hard for some people to accept. Traditional doctrine tells you to buy and hold. Mine does the opposite. Instead, I recommend that investors stay in cash most of the time. My Strategies pinpoint opportunities, they do not expose us to risk. If you can accept the weakness that lies ahead, if you have adopted a proactive approach to the Market, and if you have chosen an execution method similar to those I offer on my website, you will eventually find the Comfort Zone too. Until you do, remember…

The Grimm Reaper is knocking.

Good Trading.

Sincerely,

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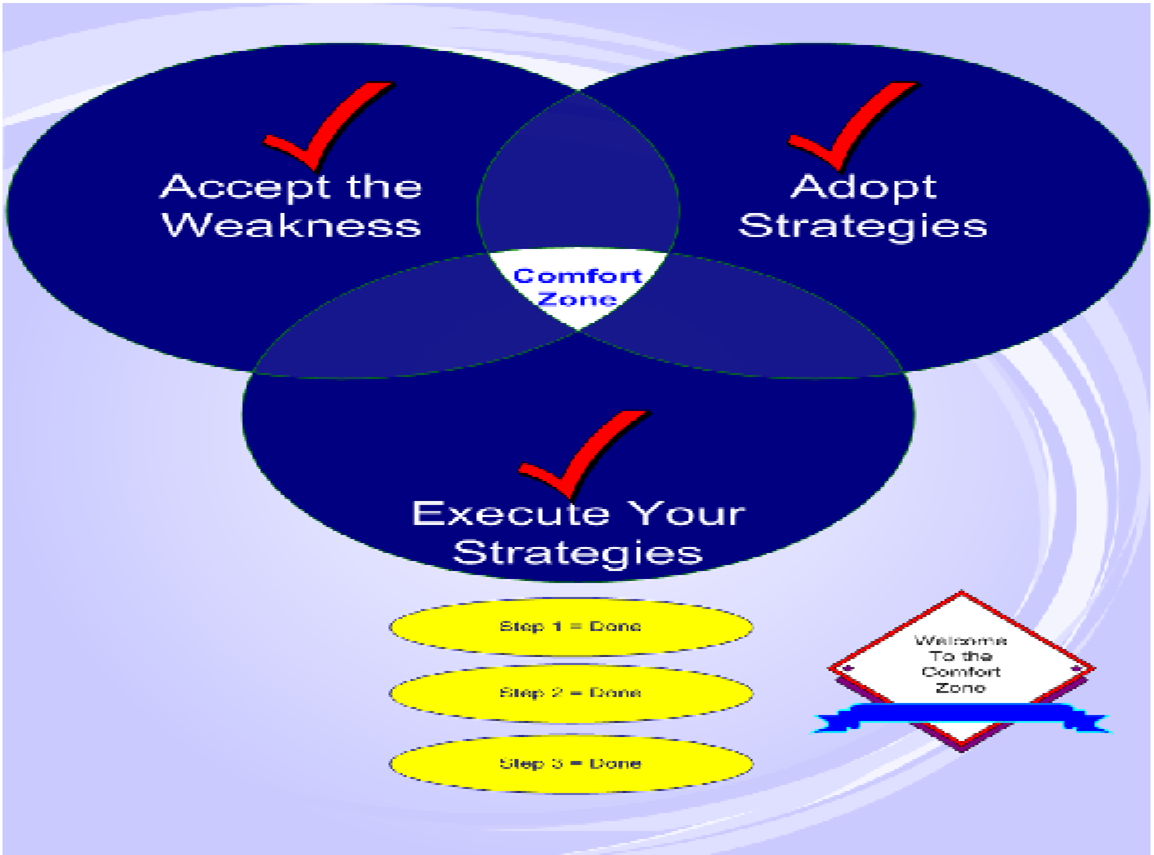
Accept the Weakness
Adopt Strategies
Comfort Zone
Execute Your Strategies
Step 1 = Done
Step 2 = Done
Step 3 = Done
Welcome To the Comfort Zone