

Today's Notes:

1. The New Economic Paradigm for Washington

1. A NEW ECONOMIC PARADIGM

In what I think is a seminal, must read book, Bernice Cohen details the future of our economy and markets¹. She also lays out a rational investment strategy for today's investor. Regarding the dynamics of economics and markets following a credit crisis, Ms. Cohen quite accurately says,

*“Again the debt deflation takes a predictable form. The massive inflation of the boom is followed by the crisis of the crash and demands for cash become overwhelming. This triggers the liquidation a massive sell-off in financial and other assets to convert everything as quickly as possible into cash. **Every debt must be settled** (emphasis added).*

Loans will either be repaid and the borrower suffers, or the borrower will default and the lender bears the loss. In the scramble to repay debt property, commodities, precious metals, antiques, art objects, all will be sold, even at rock bottom prices ... marks the dawning of the new credit cycle and the turning point”

The first question I must ask is whether or not we have been through, or perhaps are still in, a credit crisis. No one can deny the febrile printing activities of 2008 and 2009 by the world's governments, the U.S. authorities in particular, to try to save the banks. Credit crisis it was (and still is) indeed! Vaunted industrial icons such as GM, AIG and Fannie and Freddie became wards of the government, aka taxpayer.

The credit miasma was touched off by President Bush's Treasury Chief, and Goldman alum, Hank Paulson who urgently felt the need in July 2008, more than two years ago, to guarantee Fannie and Freddie “paper” to its primary holder, China. At that time the guarantee was a measly \$200 billion. Within days the markets reacted and assets declined through March 2009. Just this past week Treasury Secretary Geithner held a conference to determine the fate of Fannie and Freddie who are respectively requesting about \$3 trillion more to stay the course as guarantors of the countries mortgage markets and homeowners.

This means that the trillions of dollars of housing assets, that Fannie and Freddie bonds back, are coming unglued and will likely decline more quickly than expected.

Just this AM the New York Times opined on the subject recommending government action. The article, “**Foreclosures Grind On**”² notes,

¹ Bernice Cohen, “The Edge of Chaos: Financial Booms, Bubbles, Crashes and Chaos”

² <http://www.nytimes.com/2010/08/20/opinion/20fri1.html?hp>

“The news on housing — where the financial crisis began — is also bad. And the government’s response to high foreclosure rates continues to fall far short of what is needed to help Americans hold on to their homes and to stabilize home prices”

But why does every American deserve to hold onto a home? Is home ownership guaranteed? Think about that.

RealtyTrac notes that in July, for the 17th month in a row, there were more than 300,000 foreclosure filings, including default notices, auction notices and bank repossessions. In July, 92,858 homes were repossessed. The necessary cycle of asset value destruction, proposed by Ms Cohen, is magnifying itself. RealtyTrac forecasts 1.9 million homes will be repossessed in 2010. More than 2 million homes were repossessed in 2009. The cycle of foreclosures and declining housing prices will continue through 2011 given the schedule of mortgage refinancing coming due.

The feedback effects of high unemployment, which is now 10.2 % if you add in the 1.2 million job seekers who recently left the labor market, impacts the ability of “homeowners” to make mortgage payments. So many of these “homeowners” are underwater (remaining mortgage principal greater than value of the home) that an increasing number simply walk away from their obligations. And so the waterfall of asset value destruction accelerates, just as Bernice Cohen predicts it must occur.

The New York Times suggests that Washington must come forward with an effective “antiforeclosure” program. To date the Feds have been ineffective at rewriting mortgage contracts. Because joblessness and falling home prices go hand-in-hand they reinforce and accelerate each other, the spiral is devilishly difficult to stop. This is one root of a deflationary spiral in which the economy contracts, prices fall and the money supply and its velocity shrink.

But Washington’s solons never seem to understand. The talk of repudiating mortgage contracts is anathema to any healthy economy and the capital markets that rely on contracts being fulfilled. Washington recently committed another \$4.1 billion for state-based efforts to help unemployed or underwater borrowers in 18 states that have been impacted by joblessness and falling house prices. About \$2 billion worth of projects have been approved and are expected to help 140,000 borrowers.

So, once again, the taxpayer pays or the additional debt must eventually be inflated away eventually by a declining dollar. Is it any wonder that gold continues to stay

around the \$1200 per ounce level? It is a very destructive process when governments can print money, run huge deficits and pile up monstrous debt to GDP ratios just to bail out debtors that should never have been allowed to borrow. The US deficit will balloon to \$1.3 trillion this year and the CBO suggests that it will be \$1 trillion next year. I think they are badly underestimated given the programs coming out of Washington. When will the world finally restrain Washington from debt financing?

Bernice Cohen is correct. The Austrians had it right all along. Keynesians and Monetarist fragilities are, at last, coming home to roost. No country can push its internal indebtedness (mortgage finance and housing is just one example) from the internal to the sovereign level. One example of a failed state in this regard is Greece. The US will ultimately fail at this as well. It is only a matter of time.

Cohen warns, *“Loans will either be repaid and the borrower suffers, or the borrower will default and the lender bears the loss”*

In this case it will be the taxpayer most likely that bears at least some of the loss. The current funding problems at Fannie and Freddie are emblematic of a Washington that misunderstands the causes, ultimate impacts and solutions to a real credit crisis. All debts must be settled! Lenders, borrowers or taxpayers must suffer. Obviously investors too will suffer.

The New York Times is wrong on this issue. There is no workable Keynesian or Monetarist solution that will not impact one or more of the players above. In other words, there is nothing the government can do in the present phase of this credit crisis to save everyone. The politics will have to take second seat. The current Congress can only blame the previous Administration for the “new normal” lifestyle that is surely coming. There is plenty of blame to go around on both sides of the aisle.

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Pundits talk of an economic recovery. There can be no real “turning point” till all debts are somehow made good. This is a process that no central government can manage.

But the golden constant provides an immutable store of value because of its rarity. It will work in a deflationary spiral even if its notional value declines because its purchasing power will remain. Evidence of this is the fact that the government is now beginning slowly to restrict the ability to buy the yellow metal. Be apprised.

Juneau has been wonderful. This has to be one of the upcoming gold capitals of the world. I will write further on what I've seen here next week. Have a great weekend.

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