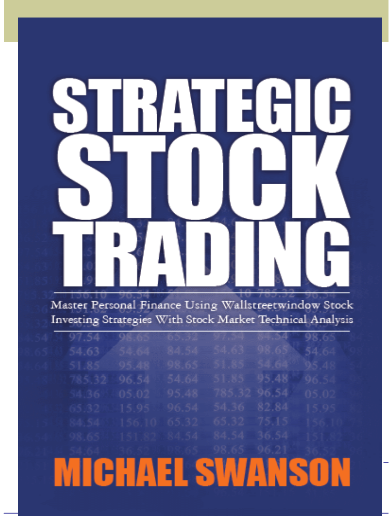
WallStreetWindow Monthly

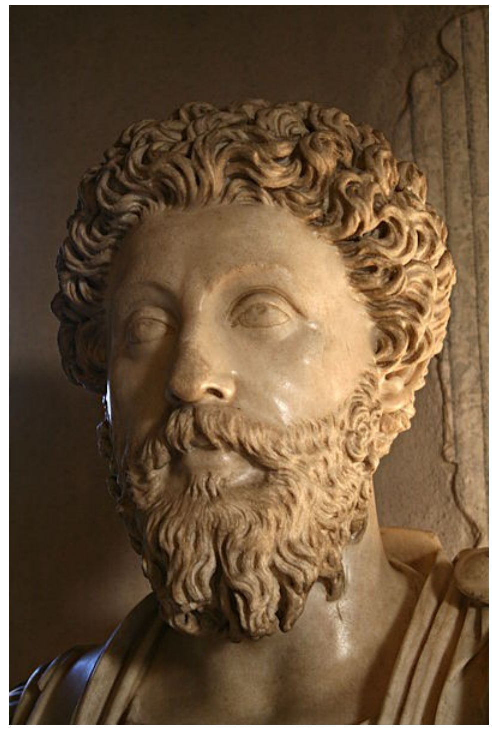
Stock Market Barometer

Quote of the month:

““I believe that America is exceptional,”- President Obama at the United Nations last Week explaining how the United States stands outside the limits of international law, economics, and history, because when his country goes to war it only does so because it is right.



We Reach the End of Our Era As Internal Fed Report Projects Government Bankruptcy By 2018 —Mike Swanson (10/01/13)



"Some things are hurrying to come into being, others are hurrying to be gone, and part of that which is being born is already extinguished. Flows and changes are constantly renewing the world, just as the ceaseless passage of time makes eternity ever young. In this river, then where there can be no foothold, what should anyone prize of all that races past him?" - Roman Emperor Marcus Aurelius, circa 170 AD.

I am 38 years old. I don't like talking about myself too much, but my age is important to what I have to talk about with you this month. I believe we approaching the end of an era and I'm pretty much a part of the last age group that was a part of it. What does this have to do with investing? Everything.

Both of my parents were born in the 1940's. I was born in 1975. I have more in common with them, than many people who are 25 or younger. The reason why is, because I'm really a part of the era my parents were born in. They were born at its beginning and we are now approaching its end.

People much younger than me really don't know what the era was about. They have no memory of the Cold War and really no memory of good economic times either. I started investing and doing business right at the end of the 1990's. The stock market peaked in 2000 and we have been in a secular bear market and increasingly bad economy ever since. If I had started out in the market and business a few years after I had I may not be here writing to you today.

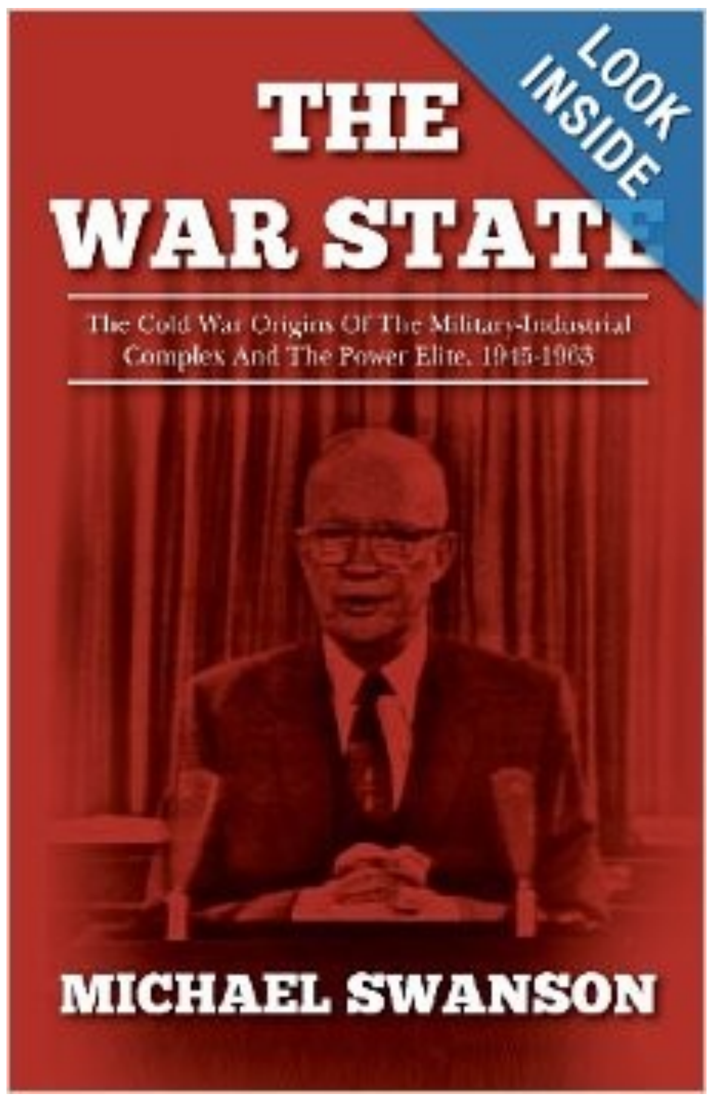
Looking back I can see that much of what I did fourteen years ago would be very difficult to start right now. People who graduate from high school or college now simply do not have the opportunities I had when I did. College is now three times what it cost when I went so the students who graduate are now saddled with enormous debt and there simply aren't the opportunities in the economy that there were fifteen years ago for them to get a good job or find a way to make nice money.

I look at people between the ages of 18 and 30 now as something like a defeated or lost generation. It's all the economy. Unemployment is sky high for younger people and many of them are simply dropping out of society. Some run to religion, others to drugs, and some just stay and live with their parents. People younger than them around age ten now will come of age at a great time of new opportunities, but right now we are witnessing the end of an era - and eras end with hardships.

When I'm talking of era's I'm thinking of 50 year plus trends in the economy, culture, and politics that begin with a great economic boom centered around new industries and end in total economic and financial turmoil. I'm looking at myself being born into an era that started after World War II, with the postwar economic boom and rise of the United States as a world superpower. The baby boomer generation were the people who grew up as teenagers when it started. The years after World War II saw the change in the physical landscape with the rise of the suburb, shopping mall, and highway system.

These eras often start with the rise of new sectors in the economy and new elites in politics and behind the scenes in power. So this era saw the rise of the military-industrial complex and corporate and national security elites tied to it inside and outside of government. That's what my new book titled The War State I released a few weeks ago is about. I don't know what they will call this era a hundred years from now. Perhaps the era of American global hegemony.

In the 1960's there were the watershed events of the Kennedy assassination and Vietnam War that followed. Perhaps the United States peaked as a world power sometime in that decade. The 1970's saw stagflation and seemingly inept political leadership as the political and economic debt fallout of the Vietnam War impacted everyone.



As the 1970's closed the dollar fell and Fed Chairman Paul Volker ramped up interest rates to stop inflation. The market dropped as a result but a new great secular bull market began after the bottom came in and the Reagan recovery years began. Bubbles formed though. The 1987 stock market crash. The S&L scandal came. The internet bubble appeared. The Fed would lower rates to prevent bear markets and fix each seemingly big "debt crisis" before it could become a contagion. The balance sheet of the Federal Reserve grew in size and the size of the US government debt grew.

The Fed lowered interest rates in response to the bursting internet bubble in 2000 and created another mess. They made a real estate bubble. Then 9/11 came and all of the bad trends just mushroomed.

Useless wars were the answer and a wild escalation in government debt came as their result. George Bush increased government spending more than any other President before him to fund the new wars in the

Middle East. Then when Obama came in, he incredibly increased the debt at a faster rate than Bush did.

So now the size of the debt to GDP for the United States is reaching the crisis 100% mark. Congressional budget office estimates are that if the budget deficit is not reduced - by cutting government spending - than by 2030 there will be some sort of government debt crisis.

It is such an event that will mark the end of the era and it is quickly approaching - much faster than the CBOE estimates. Such a crisis would represent the failure of the American debt driven economy centered around the military-industrial complex that truly came into being in the 1950's and Wall Street. The next era will be marked by some other new economic industry and elite that will create a more productive economy than the one we have now. I don't know what it will be like, just that it will be different. New elites always form when new economic blocs come into being - and tend to displace elites that were once dynamic parts of the economy, but have now become inefficient. It's all a repeating cycle of history and every era ends in a time of troubles.

The era before ours was different than the one we were born into and take for granted with no question just as we think nothing of the oxygen we breath. Few of us realize that before World War II the United States had a very small government and no military-industrial complex. Hardly anyone paid any taxes.

When did that era before ours begin? Probably after the Civil War. It started with the rise of the "robber barons" and the great industrialists in steel, oil, banking, and railroads. Mark Twain called it the "Gilded Age" It brought the rise of the Morgans and the Rockefellers. And yes they messed up too. In 1914 they created a Federal Reserve whose policies brought the creation of financial bubbles in the 1920's that when they popped led to the Great Depression. The era ended and so did the type of political power yielded by the Morgan and Rockefeller dynasty. If President John Kennedy and Ronald Reagan were the two great Presidents of our era than it was Woodrow Wilson and Ulysses Grant that typified the era of the "Gilded Age."

In 1929 the Morgan interests had an agent on the board of directors of every single one of the top thirty corporations in the United States. A decade later almost all of them were gone. Congress investigated and smeared the Morgan family with a series of Congressional investigations in the 1930's. The power elite of that era lost their place and by the 1940's new interests sprouted in the American economy and political system tied to war, automobiles, airplanes, and the defense industry that came to dominate it by the end of the 1950's. That's what my new book is really about. Read it if you haven't already.

And before this earlier robber baron "Gilded Age" era you probably have the era after the American Revolution until the Civil War. That was an era that ended with war and the collapse of the dollar as the Federal government created "greenbacks" to pay for it. The plantation elites of the southern states were liquidated. The great two Presidents were George Washington and Andrew Jackson. Abraham Lincoln was the key figure that bridged the old founding fathers era and the new "Gilded Age" to come in the country's worst time of troubles in its history.

Eras end in financial turmoil and the replacement of one elite with another. The old elites fail. Instead of being dynamic leaders of the future they fail to adapt to a changing world and run systems now inefficient in the economy. They become millstones that drag everyone down with them. And in government instead of great political leaders you get what look like dangling puppets.

The way the people lived before the Civil War was much different than the way we live today. The culture of the time was vastly different. And the way people lived during the "Giilded Age" era was different than what we grew up in too. And so tomorrow will be different. I cannot imagine how it will be. Every end of an age is like a dream that is dying while a new one is coming into birth.

I'm 38 years old. So I was born into this era and there is nothing I can do about that. So were you. My parents were born when it began and I am witnessing it come to a close. And I was lucky to not have been born just a few years later than I was or I would have been a part of the lost and defeated generation who grew up just as the economy went sour, closing a lot of opportunities with it.

It could be that a hundred years from now historians will look at this past month of September, 2013 as a key turning point in our era. Two events that could prove to be watershed moments occurred.

First the President of the United States sought to start a new war in the Middle East and was rebuked by the rest of the world and the American people. The wars simply do not seem to work and the people have had enough of them. No one bought the story the President was peddling for this war he wanted. A new war made no sense to a war weary people and a world skeptical of what a new war would bring as all of the previous ones have just brought more disorder in the world.

Secondly, the Federal Reserve failed to reduce its quantitative easing money printing program despite Fed officials saying for weeks on end that it probably would do so. If there is one single reality that underpins our era and the global supremacy of the United States it is the fact that the US dollar is the global exchange currency of the world.

You see our era also started with the creation of the Bretton Woods monetary system that made the US dollar convertible for other currencies and gold in the international markets. Nixon took the dollar off the gold standard in the 1970's, but after some years of currency instability the dollar continued to retain its status as the world's great reserve currency.

That enabled the US government to rack up enormous debts with seemingly no consequences. Foreigners had no problem financing the federal government's budget deficit. However, if one day the US debts grow so large that people lose confidence in the dollar then we'll see the dollar decline in value, inflation will grow, and interest rates will eventually spike - in what would be the final event to bring the end of the secular bear market that begin in 2000. It would be the end of our era and a new one will begin to emerge out of the turmoil.

In short our era will end when the United States government goes through a government debt crisis like we saw in Europe last year or in Argentina from 1999 to 2002. The bad news is that will mean another big drop in the living standards of the average American who suffers from the inflation bomb. The good news is that such a crisis will likely spell the end of the current secular bear market that started in 2000 and bring a bottom to the economic malaise the country is trapped in. It will pave the way for a true economic boom that those aged around ten years old now will be coming to age at the start of.

Right now there are not enough buyers in the United States and the rest of the world to buy all of the bonds that are being issued by the US Treasury to finance the federal budget deficit every month. So the Federal Reserve is using QE money printing to bridge the gap and buy additional mortgage securities on top. They need interest rates to stay low to continue to do this or else the financing costs for government debt will go up. They would then need to increase QE or else interest rates would skyrocket and create a vicious spiral that would lead to the United States federal government going bankrupt.

The financial media is treating last month's FOMC decision to not reduce its QE money printing operation - that is the Fed's funding of the federal government's deficit - as if it is just a normal run of the mill decision. They are saying that the economy isn't growing as fast as they expected and they are just reacting to the data. But in the statement they released with the decision they explained that the main reason they didn't reduce QE was because bonds dropped and interest rates went up. The very first paragraph of the statement reads:

"Some indicators of labor market conditions have shown further improvement in recent months, but the unemployment rate remains elevated. Household spending and business fixed investment advanced, and the housing sector has been strengthening, but mortgage rates have risen further and fiscal policy is restraining economic growth."

Now I have come into my possession a shocking internal Federal Reserve report that says that the Federal Reserve is on path to go bankrupt by 2018. It says the CBOE projections aren't real and the real crisis is going to hit much sooner than anyone realizes. Its implications are for QE to not only continue forever, but to likely be increased within the next year.

This report is very important for you, because internal Fed reports often set the agenda for future monetary policy. They can tell you what people inside the Federal Reserve are thinking. To give you an idea of what this can mean for you back in August of 2007 Frederick Mishkin, who had been appointed to the Federal Reserve Board of Governors by Ben Bernanke - the two have been close friends for decades, wrote a report for the Fed that laid out what would happen to the economy if real estate prices in the United States were to drop and what the Federal Reserve should do if it starts to happen.

The paper called for a rapid reduction in interests rates to near zero. The report predicted everything that was to come. I got a hold of it in September, 2007, and after I read it I realized that the US economy and stock market were in big trouble. With this knowledge I actually bet against the stock market in 2008 and made a gain of over 35% in my main account as the stock market crashed and almost everyone else lost tons of money in the market.

It was one of the most important papers I read about in my life and I shared it with all of the people I could as soon as I read it. If you want you can read it here:

http://www.federalreserve.gov/pubs/feds/2007/200740/200740pap.pdf

Now Mishkin and a team of economists presented another paper back in February for the Fed titled "Crunch Time: Fiscal Crises and the Role of Monetary Policy," in which they predict another financial crisis in a few years - this time to be centered around a government funding debt crisis.

So far no American mainstream reporter has done a story about the report. CNBC has not informed its viewers about it. They didn't share with their audience the 2007 report and they aren't telling their audience about this one neither. Nor has the Wall Street Journal or any other American newspaper. Journalists in the United States are asleep and TV news is just propaganda. I can't find a single story about it anywhere.

But it has been a hot topic of discussion inside the Federal Reserve all year and will prove to be one of the most important things I have read when it comes to investing and have to share with you. At the end of February a panel convened at the Fed "U.S. Monetary Policy Forum" in Chicago to talk just about the report. Mishkin presented a revised version of the report this August at the annual Jackson Hole Fed gathering.

You can read the report in its entirety right here:

http://research.chicagobooth.edu/igm/usmpf/download2.aspx

It's a begins with an abstract summary of what is to come in the rest of its 94 pages. The summary contains these lines:

"We analyze the recent experience of advanced economies using both econometric methods and case studies and conclude that countries with debt above 80% of GDP and persistent current-account deficits are vulnerable to a rapid fiscal deterioration as a result of these tipping-point dynamics. Such feedback is left out of current long-term U.S. budget projections and could make it much more difficult for the U.S. to maintain a sustainable budget course. A potential fiscal crunch also puts fundamental limits on what monetary policy is able to achieve. In simulations of the Federal Reserve's balance sheet, we find that under our baseline assumptions, in 2017-18 the Fed will be running sizable income losses on its portfolio net of operating and other expenses and therefore for a time will be unable to make remittances to the U.S. Treasury. Under alternative scenarios that allow for an emergence of fiscal concerns, the Fed's net losses would be more substantial."

The study goes on to look at the history of financial government debt crisis in countries all over the world and finds that when the ratio of government debt to GDP passes the 80% mark eventually some sort of crisis hits. These crisis can hit suddenly when the costs to finance government deficits increases exponentially due to a rise in interest rates. Then governments can no longer manage their debts and must default or print them away. This isn't really new stuff. A great book came out a few years ago titled This Time Is Different by a group of economists who studied all of this using historic economic data from countries all over the world and broke down the various ways these debt blows ups tend to play out. This "Crunch Time" report uses this book as a source. It's worth reading too.

Now according to a Congressional Budget Office release of September 17, 2003, the current US government debt to GDP is 73% and they expect it to rise to 100% by 2030 if nothing is done to cut government spending and control the budget deficit. However its gross debt to GDP is over 100% and the CBOE has also recently projected the government debt to GDP to go above 100% next year. It has a habit of changing its projections.

Nonetheless twenty-five years from now and sometime around 2030 has been the mainstream target for seeing a future of debt trouble. In the last chapter of my War State book I cite a Peter Peterson article in Foreign Affairs were he uses these CBOE figures and targets the same time period around 2030 as our window of trouble.

However, once you get to page 47 of the Mishkin "Crunch Time" report you get to the scary stuff. If you flip to it and read it for yourself you'll see that the CBOE figures people are using in these projections are based on the faulty assumption that interest rates will stay at their current historically low near zero levels forever. If rates go up than the costs of funding the government debt will suddenly rise exponentially - the government debt to GDP would then skyrocket well above the 100% crisis level overnight. Investors all over the world would demand a higher rate of interest to fund the country's national debt, the dollar would decline, and another economic crisis worse than the one of 2008 would hit as the cost for the federal government and Federal Reserve to finance the debt escalates.

As this "Crunch Time" report states:

"In 2012, debt service was quite low (less than 1.4% of GDP) because interest rates were so low. Roughly one-quarter of the Treasury debt outstanding is in the bill sector (meaning an original maturity of 1 year or less) and borrowing costs at the short end of the yield curve have been close to zero for the past several years. Even longer-term notes and bonds issued by the Treasury in recent years have had a very low coupon. But, if the U.S. continues to pile on more debt and if we assume – as CBO (2013) does – a normalization of interest rates over the course of coming years (to roughly 4.0% for 3-month T-bills and 5.2% for 10-year notes), then debt service costs will eventually skyrocket."

To put this in simple terms if the interest rate on the 10-year treasury bond were to go to over 5.2% than the cost to finance the deficit will explode.

The report states:

"The CBO's baseline estimates (and similar projections produced by the White House Office of Management and Budget) assume that long-term interest rates rise gradually to reach a level of 5.2% in 2018 and then re-main constant at that level despite a continued escalation in the amount of public debt outstanding. The theoretical analysis and historical experience reviewed in Sections 2 and 3 suggest that this assumption could lead to a significant understatement of the potential deterioration in the budget picture because yields are assumed to hold steady at normalized levels as debt continues to accumulate."

The implications of all of this mean that the Federal Reserve cannot allow the interest rate on the 10-year treasury to rise beyond 5.2%. To prevent that it would have to increase its so called "quantitative easing" bond buying program and purchase more bonds. The report calls this policy "fiscal dominance" and a way to manage the mushrooming debt "through inflation."

The report explains, "to see how this would play out in practice, we need to recognize that fiscal dominance puts a central bank between a rock and a hard place. If the central bank does not monetize the debt, then interest rates on the government debt will rise sharply, causing the economy to contract. Indeed, without monetization, fiscal dominance may result in the government defaulting on its debt, which would lead to a severe financial disruption, producing an even more severe economic contraction. Hence, the central bank will in effect have little choice and will be forced to purchase the government debt and monetize it, eventually leading to a surge in inflation."

All of this means that it has now become virtually impossible for the Federal Reserve to reduce its QE money printing operation and in the future it will be forced to actually INCREASE it in order to provide enough additional buying pressure in the bond market to keep interest rates from increasingly over 5.2%. That would mean inflationary pressures and a falling dollar and a new crisis by 2018.

It is such a crisis that I believe will mark the final chapter of the era US global supremacy that began after World War II and was backed by the fact that the US dollar is the reserve currency of the world, which has enabled the federal government to essentially run gigantic deficits to fund its military-industrial complex and various social programs. It will also bring the last and final inning of the secular bear market ball game that began in March of 2000. It would mean one final bear market at the end that will mark the bottom of the whole financial and economic mess the country has been in for over thirteen years now.

It will be a time of financial turmoil for most people. Inflation will explode. Stocks will go up for awhile more, but crash in the end. Money can be made in the right investments in such an environment, but few will make the adjustments necessary ahead of time. We must navigate all of this together and we will witness some wild moves in markets all over the world in the next few years. However, the simplest way to profit and/or hedge against all of this is to own some gold and silver in your portfolio. Own more investments in markets outside of the United States instead of the typical mutual funds and ETF's that most Americans own that are merely tied to the action in the S&P 500 and the DOW.

Most Americans fear the rest of the world. And many come to hate what they fear so they are unable to invest in anything else than the standard US stock market centric model taught to them on CNBC and in the financial media. They're afraid to own foreign stocks. But there is no reason for you to be to be scared. There are some who will make money in all of this.

But you won't figure things out watching CNBC. CNBC talking heads did not warn anyone to watch out for the 2008 stock market crash. Instead their "economist" Steve Liesman said the Fed was handling things and everything would turn out fine. Jim Cramer will not tell you what is coming and neither will the "Fast Money" crew on that network. Nor will playing on Facebook and watching "reality television" help you either. You have to look out for yourself. Yes this is not time to be lazy like everyone else or to bury your head in the sand like an ostrich.

The first step of action is to educate yourself to what is going on and then plan. I recommend that you read the Mishkin "Crunch Time" report for yourself:

http://research.chicagobooth.edu/igm/usmpf/download2.aspx

I also suggest that you buy my investment book Strategic Stock Trading to learn some basics of investing and my history book the War State in order to understand how the country got to where it is. If you know the past it's easier to understand what is happening today and where things are going.

I just released the War State book this past month and it is already getting some great reviews on Amazon. Go there to check them out. One person titled their review "possibly the most important book of the year." You can just go to Amazon.com and type The War State in the search bar to see the reviews for yourself, buy the book, and see why this person said that. To get the book click here.