Stamper Capital & Investments, Inc.

"Focusing on Upside Potential with Downside Protection Since 1995."

CLARK STAMPER's
Deflation Watch
WEBLOG

Introduction - There are two types of inflation, **"fiat inflation**" which is from increasing the money money supply and **"credit inflation**" which is from increasing the availability of credit/debt throughout the financial system. Usually there is a mixture of money supply growth/contraction and credit growth/contraction. The inflation of the late 1970's, when gold hit $800 per ounce, was largely "fiat inflation." The recent inflation is largely a "credit bubble" or "credit inflation." Also, in the current inflation we believe that essentially any money supply growth, although also fairly large, has been mopped up by the increases in productivity, provided first by the personal computer revolution and next by the internet revolution and technology. Without increases in credit/debt nor increases in the money supply, we believe we would have already seen a substantial drop in the prices of goods and services due to the increase in productivity. We believe we did not see that substantial drop in prices (yet) because of the increase in credit/debt, i.e. "credit inflation." However, as we have detailed below, there have still been pockets of deflation and price drops and, **we believe, when "credit inflation" turns into a "credit contraction" or "credit bust," we will experience the overall deflation that was postponed. Unfortunately, a credit contraction most likely means prices of risky assets, which went sky high on the way up, will likely drop precipitously on the way down.**

Importantly, historically, fiat inflations have achieved "soft landings;" however, credit inflations are most likely to have "hard landings" because much of the credit/debt goes into default and usually takes years & years to work out. Remember Japan's credit inflation topped out in 1989/1990 and they are still suffering its effects 18 years later!

Accordingly, we think monitoring and considering the affects of deflation on asset values could save informed investors from future heartache; thus we started this Deflation Watch Weblog. Also, see our **Elements of Market Tops** and **Major Trend Change Indicators** weblogs, at http://www.risk-adjusted.com/Weblogs.html, and our **Annual Forecasts at** http://www.risk-adjusted.com/AnnualForecasts.html **,** for commentary and analysis more specific to those topics.

THE WATCH STARTS NOW
(June 18, 2004 - in reverse Chronological Order)

We ended this watch a few years ago and switched to our Anatomy of a Credit Contraction & Deflationary Downturn weblog, http://www.risk-adjusted.com/Weblogs.html, which we began **September 19, 2007. However, we wanted to include a short blurb on this article:** April 15, 2009, REUTERS,

"Consumer Prices Dip in March [2009], Post 1st Annual Drop Since '55;" "A key gauge of consumer prices fell unexpectedly in March and recorded its first annual drop since 1955, government data showed Wednesday, as slumping demand pushed down energy and food costs." The gauge is the closely watched Consumer Price Index.

August 22, 2007, WSJ.COM, **"Anxious Home Builders Pile on the Incentives;"** we would add "to get buyers to buy," We are using this article to confirm the decline in housing prices as we have correctly forecast throughout these pages. This article gives several examples of builders cutting prices of between 10% and 20% and/or offering incentives of the same relative size. **"...real-estate agents are going to new extremes to attract buyers, dangling lavish incentives and slashing prices."** Including:

Boca Raton, FL - offering to pay two years of property taxes and insurance
Richmond, VA - up to $100,000 off the cost of upgrades
Medford, OR - offering four months rent, and will still negotiate a lower price

"Across the country, the theme is the same: Homebuilders and home sellers are juicing their efforts to unload single-family homes. Among other things, they are offering buyers cash discounts of as much as 20%, throwing in a pool and agreeing to finish basements, garages and other spaces at a cost of several hundred thousand dollars..."

San Diego, CA - "...clients are scoring multiple concessions totaling as much as $80,000 [on houses in the $700,000 range]. Generally, that includes a price reduction, an agreement to pay closing costs or upgraded flooring or appliances -- or a combination of all three."

Dallas, TX - price reductions as much as 20% and free swimming pools.

A well known analysts says "This trend toward more-generous incentives is likely to intensify....citing a growing inventory of new homes, an oversupply of pre-owned homes on the market and a glut of homes that are a year or two old that investors bought as rental property that have never been lived in, and those investors are now trying to sell, too." **We at Stamper Capital find it ironic that back as far as 2004 people just rolled their eyes when we said there was no shortage of homes.**

Tallahassee, FL - "builders are offering incentives and price markdowns of as much as 15%..."

Bensalem, PA - "has knocked nearly $200,000 off the price of some already built million-dollar homes...and is offering an additional $20,000 reduction for buyers who buy inventory homes before Labor Day."

Website www.homebuilder.com apparently has "...the most comprehensive listings for new construction homes."

Of course, we find these price reductions and the incentives to buy a reflection of the deflation that is accelerating.

August 14, 2007, BLOOMBERG, **"Subprime-Infested Funds Drive Demand for [U.S.] Dollars;"** "The [U.S.] dollar is no longer the currency you love to hate. Now, it's the currency you can't live without." **"Last week's credit crunch has set off a worldwide RUSH for dollars as banks and fund managers scramble to pay back loans used to buy risky mortgage securities."** Well, this certainly is a Major Trend Change (that we have forecasted - see our **Major Trend Change Indicators weblog, http://www.risk-adjusted.com/Weblogs.html**) - however, we would have titled the article: **Huge U.S. Dollar Short Covering Rally to Ensue.**

We want to make a few points about what is going on:

1). A huge U.S. Dollar short covering seems to be in process as borrowers of U.S. Dollar denominated debt are rushing to pay it off.

2). To get the U.S. Dollars to pay off loans, U.S. dollars are going up in value.

3). With U.S. Dollars going up, almost everything else will be dropping in price - other currencies, industrial commodities, financial commodities, gold, stocks, real estate. - Deflation (ugh).

4). Loans being paid down is a "credit contraction."

5). The demand for U.S. capital is likely an upward force on U.S. interest rates. As reported below, worldwide, central banks infused a record amount of liquidity into market to bring back down short term interest rates, which had spiked up unexpectedly, related to this credit contraction.

Yes, the U.S. Dollar is a "safe-haven currency" but we believe this is more of a credit-contraction-and-U.S.-Dollar-denominated-debt short covering rally than a flight to the U.S. Dollar safe-haven currency rally. However, we expect this trend to last a number of months or even over a year and to be pretty much in parallel with deflation and a drop in the prices of risky assets.

August 10, 2007, BUSINESS WEEK (August 20 & 27 edition), **"Where Home Prices Drop, Malaise Follows;"** We are using this article to validate our previous forecast that the decline in the real estate market would "ripple." Talking about declines in home sales volumes, "state sales tax figures, a proxy for spending, are much weaker in the hardest-hit states." "A drop in sales of homebuilding materials and equipment is a factor. But Florida **retail sales figures show a BROAD PULLBACK, with falling auto and durable goods sales and a sharp slowdown in consumer nondurables such as clothing.** Its hard to explain this trend if you don't believe that the housing bust has any impact on spending...." We note that now most analysts are agreeing with us that the housing downturn is spreading to other sectors.

August 10, 2007, BLOOMBERG, "Countrywide, Washington Mutual Fall on Mortgage Slump;" We are using this article to confirm "deflation" in the prices of homes. **"We are experiencing home Price Depreciation almost like never before, with the**

exception of the Great Depression," said a CEO of a major home financier. Quite a statement from the top person at a major home lender.

August 10, 2007, CHRON.COM, **"Commodities Fall for Second Straight Day;"** "Commodities prices came under pressure on Friday as fears of a credit squeeze led to more selling on Wall Street and spread to the energy, industrial and agriculture markets. It was the second straight day that most commodities were pummeled by the overall uncertainty in financial markets. Many analysts continue to back a view [we do not] that strong global economic growth, particularly in China and other fast-growing nations, and strained supply of raw materials paint a bullish picture for commodities prices in the longer term. **BUT this week, investors have grown increasingly anxious that deteriorating credit conditions in the mortgage market, which sent stocks lower, could become viral and have reduced their exposure to risk."**

We have been somewhat dumbfounded that analysts could have been thinking that way. To us, when you have a credit contraction, financing dries up; and when financing dries up, prices that were financed with high levels of debt can no longer be maintained. **To us, it is pretty simple math: lower the amount of financing available from the current (or what was just current) record levels of debt and prices of just about everything are going to drop.** In addition, to us, it has been fairly easy to see a significant downturn on the horizon. How could analysts think commodity prices would be going up with the economy and thus demand dropping -add declining levels of financing (from record levels) and you have a recipe for precipitous drops in prices of end products - and their components (i.e. commodities) especially after the consumer has been gorging like crazy over the past several years, financing the majority of their purchases with declining savings (to below zero per year) and with hair raising levels of debt.

August 1, 2007, CBS MARKETWATCH, **"Gold Falls, Together with Global Stocks;" "Gold futures fell Wednesday, weighed down by a global rise in risk aversion** sparked by renewed credit market concerns that sent international stocks tumbling." **"Bullion has failed to benefit from safe haven trades** and has followed equities lower as worries about spreading credit problems prompt investors to flee from riskier assets..." Whoa!!! gold going down in reaction to risk-aversion. Gold bugs and inflationists wouldn't expect that. However, to us, **this (gold dropping along with stocks, other risky assets, and, in conjunction, with a "flight to safety") is more proof that what we are facing is deflation** - caused by record debt levels (that financed the stock and housing bubbles) contracting.

Please see our **Elements of Market Tops weblog, http://www.risk-adjusted.com/Weblogs.html, for a listing of articles signaling and confirming the onset of the credit contraction we have previously forecast.**

July 19, 2007, BLOOMBERG, **"Miami Condo Glut Pushes Florida's Economy to Brink of Recession;"** We will use this article to highlight that real estate has fallen previously by very large amount. What is interesting to us is that no one seemed to remember that until recently. **"In the 1970's, when condos were a new product, Florida developers built 500,000 units and prices fell 50%,"** a researcher in this article said. Continuing, "the difference is, back then they were two-story condo buildings that had $50,000 units; nowadays they are $700,000 units in 20-story buildings. Instead of building too much stuff that people could afford like we did then, this time we built too much stuff that people can't afford." Interestingly, speaking about the continued building after real estate has turned down, one real estate broker is quoted, "This is dumbfounding to me; it's a building boom in the middle of a housing bust." That is interesting. It is likely related to the fact that builder likely feel they will lose more money if they stop before completion and they are hoping for a positive turnaround.

July 10, 2007, BLOOMBERG, **"Sears, Home Depot Say Profit Will Fall on U.S. Housing Slump;"** That is a good headline - we are calling it **the "Big Ripple is Just Starting."** In the article an analysts says, "We're seeing the effects of the housing market ripple through the consumer segment." **"The biggest U.S. housing slump in 16 years has reduced spending on big-ticket items, causing appliance sales to decline." Home Depot said " [its] sales may decline for the first time ever."** Note that Sear's stock price dropped approximately 9.5% on the day. It is amazing to us that just a few months ago, most analysts were saying there would be no ripple due to the downturn in housing - have been warning about this for some time and believe this is only the beginning of the ripple's negative effects.

July 10, 2007, CNN/MONEY, **"Mortgage Resets: Record Bill Coming Due - Billions in Subprime ARMS will be subject to higher payments;"** Another article on the sub-prime adjustable rate mortgage Trigger that is essentially here. **"More than two million subprime adjustable rate mortgages (ARMs) are poised to reset at much higher rates in coming months, worsening an already suffering housing market." "In October alone more than $50 billion ARMs will reset." Analysts in the article estimate that a typical monthly payment will go up by about 39%.** As we forecast a couple of years ago, we believe this situation will most likely result in mortgage defaults and push the prices of houses downward (as the banks unload them) - not only that but those who continue to make the higher payments will have less money to spend on other goods and services, lessening their demand and likely resulting in dropping prices. Loan defaults will continue to the credit contraction that we documented recently started when credit standards were raised. We believe these multiple ripples will result in sales and revenues of less essential businesses and of luxury businesses dropping, causing defaults across the economy. At this point, you can probably see how the debt cycle that has been essentially expanding since 1980-1982 has now begun to contract and will do so in a similar self-reinforcing cycle (but in the opposite direction). All of this is thoroughly documented throughout this risk-adjusted website.

June 30, 2007, MONTEREY COUNTY HERALD, "Fed Sets Subprime Lending Limits;" **"Banking regulators Friday completed guidelines that call on lenders to strictly evaluate borrowers' ability to repay home loans."** Thus, to us, this article covers the continuing Credit Contraction. The guidance is "issued by the Federal Reserve and the other four federal agencies that regulate banks, thrifts, and credit unions..." **"The**

standards, which are voluntary and only apply to federally regulated lenders, calls for verification of borrower's incomes in most cases." Thus, no more No-Documentation ("liar") loans - definitely a contraction of credit availability, to us. In fact, "the chair of the Mortgage Bankers Association said the guidelines come with a downside - they will reduce the availability of credit for borrowers...." Agencies issuing the guidance are The Fed, FDIC, National Credit Union Administration, Treasury Department's Office of the Comptroller of the Currency and the Office of Thrift Supervision.

June 29, 2007 - **Stamper Capital Deflation Report - "The Ripple;"**

Based on the table below and recent news, it is fairly to see that the business cycle/credit crunch is in fact rippling as we forecast:

Adjustable Mortgages Resetting==>Housing==>Subprime loans ==>CDO's==>Hedge Funds==>Wallstreet (Blackstone, etc.)==>junk bonds (just starting to see the credit crunch)==>???

To us, about the only area that hasn't started down yet is regular common stocks.

June 29, 2007 - **Stamper Capital Deflation Report - "Deflation is Already Here - you just haven't read about it in the press yet;"**

	Top	Currently	Decline
Dow US Home Const.Index	5-05-06*@ $50.1	$31.3	-38%
Gold	5-11-06 @ $771	$643.50	-17%
Silver	5-11-06 @ $15	$12.16	-19%
CRB (commodity) Index	5-11-06 @ 365	313	-13.7%
Oil	8-07-06 @ $80.8	$70.7	-12.5%
U.S. Long Bond pric	12-04-06 @ 114.6	107.75	-5.9%
CDO, BBB- rated tranches	1-19-07 @ 96	55	-43%**
Dow Real Estate Index	2-07-07 @ 94.57	77.42	-18%
KBW Bank Index***	2-20-07 @ 121.06	105.80	-6.7%
Dow Utilities	5-21-07 @ 535.7	498.2	-7.0%
Dow Transports	6-01-07 @ 5,326	5,099	-4.3%

* Note: The I-shares Dow Jones U.S. Home Construction Index ("ITB") commenced 5-5-06 and went down right from the get go; however, **most home builder stocks peaked in mid 2005 and are down around 50%.**

** According to ABX, note, this is the mid-grade tranche; per other financial articles, "Toxic Waste" CDO (Collateralized Bond Obligation) tranches are down at 35 bid, an 85% drop. and high grade CDO tranches are down about 15%.

*** KBW Bank Index ("BKX") consists of the 24 largest money center banks & leading regional institutions (Citibank, JP Morgan Chase, etc.)

Also note, **"Homeowners with about $515 billion in adjustable-rate home loans will see their monthly mortgage bills rise this year [the remainder of 2007, we believe] as rates reset to higher levels, and another $680 billion worth of mortgages will reset next year [2008],** the Banc of America report said. Of those adjustable rate loans, more than 70% are subprime [per MONTEREY COUNTY HERALD, "Fed sets subprime lending limits," 6-30-07]." Per another source, the subprime default rate is running around 14%. Most of those defaults have been after resets. So we calculate $515 billion * 70% * 14% = **$50.5 billion is the expected monetary default over the next six months based on the current run rate - yikes.** The number for full year 2008 would be $680 billion * 70% * 14% = $66.6 billion. Of course, those are only rough projections based on the numbers we have been given, but they are eye-popping.

June 29, 2007, THE COSTCO CONNECTION, **"Getting a Leg Up on Troublesome ARMS;"** this is a great article for us because it wasn't written at all about deflation but we can use it to make a lot of good points.

Basically the article is about how to deal with an adjustable rate mortgage that is going to be resetting higher - **"an estimated $1.5 trillion" scheduled for reset over the next year** - however, all the advice that is given is deflationary - **cutting costs and consumption to absorb the cost of rising interest rate**s:

"Trim the cable to standard"
"Cut out the land line and rely on your cell phone"
"Ask your insurance agent about raising the deductible on your home and car"
"Consider selling" your property and "downsizing," "moving to another [cheaper] neighborhood, or even renting"
"Look at each expenditure and ask yourself, 'How can I reduce this cost?'"

We believe implementing any of those suggestions is reasonable and also deflationary.

June 26, 2007 - our own Stamper Capital mid-day "deflation watch report;" Today gold and silver are down rather precipitously (2% and 5.5%, respectively) and more importantly both have broken very long support lines indicating that deflation is very probably here. This price action and what is going on in real estate (and sub-primes and CDO's and automobiles) will likely result in deflation being here officially very soon. Also, the official price statistics have shown a remarkable drop in the rate of increase recently.

	top	today	Decline
Gold	5-11-06 @ $771	$643.50	17%
Silver	5-11-06 @ $15	$12.16	19%

Of course, to us it would make sense that deflation would arrive officially after the credit crunch (reported previously, see below) had started.

June 26, 2007 MARKETWATCH, **"Home Prices Fall at Fastest Rate in 16 years - S&P/Case-Shiller Index Shows Prices Down Annualized 2.7%;"** Well, the headline says most of it. This is "...the largest decline [in the index] since September 1991." The index started in 1987. Too bad the index does not go back to the 1960's. I would have been interesting to see what it reported for the top in 1974 and for the much larger top in 1979 down into 1985.

We want to point out that according to the article, "The Case-Shiller index is considered a superior gauge of home prices compared to the median sales-price data released by the Commerce Department or the National Association of Realtors, because it **tracks multiple sales on the same property and is therefore not influenced by a different mix of homes sold in a period."** We would add that it is probably less likely to be manipulated for political or other reasons. However, the Case-Shiller index is restricted to 20 cities.

This measurement of real estate prices is very interesting to us. Similar to this index, we have documented specific sales of multiple properties in Newport Beach which declined by over 60% from the 1979 top down to the real estate bottom in 1985 (two years after the stock market bottomed). Those drops were based on actual trades for specific houses in Newport Beach. When we see official statistics that show a little blip of a drop - we just laugh. The historical volatility of real estate has been dramatically more than we have ever seen reported; however, this Case-Shiller index may show the true reality. Of course that index is for the major cities. We have already reported articles on real estate in small cities citing price drops of over 20 percent in this current cycle.

May 23, 2007, MODESTO BEE, **"Car Sales Hit Brakes;" "First it was houses. Now its cars." "Motor vehicle sales fell a resounding 7.6% in the United States last month, and analysts said the troubled housing market was a chief culprit."** The article points out that "...the weak housing market is eating into vehicle sales in two important ways:"

"First, consumers who had been tapping their home equity to buy cars during the housing boom are less apt to do so when the real estate market is soft." "Second, building contractors are buying fewer pickups, vans and other vehicles..."

We think that reporting is accurate and, as we have pointed out previously, we believe the "ripple" will be very large. Here in The O.C. several of the largest sub-prime lenders have gone bankrupt (or are doing so) and have been laying off employees. We would expect that these employees will be making less at their new jobs.

Also, we do know that real estate sale volumes have dropped dramatically. We don't think it is a stretch to imagine that real estate agents are seeing their incomes drop since sales volume has dropped.

Finally, although touched upon in this article, the American consumer appears totally tapped out and with the recently raised lending/borrowing standards, it appears that consumption is being curbed, not just with automobiles but in other areas as well. We expect to be seeing lots of articles on this subject in the near future. We expect this lessening demand in conjunction with the credit crunch (documented previously) will likely result in falling prices, i.e. deflation.

May 2, 2007, BLOOMBERG, **"Rents Peak in Housing Glut;"** "The glut of U.S. properties for sales is about to hit the rental market. A record number of homeowners who can't sell condominiums and houses are competing for tenants with the country's biggest apartment owners....**Competition is already forcing the big apartment owners to offer concessions like two months free rent..." "Nationwide, 2.8% of houses for sale were unoccupied in the first quarter, the highest since the Census Department started collecting the data in 1956." "Unsold properties being turned into rental units are creating a shadow market that's driving up the vacancy rent and slowing the growth of rents."** The article points out that not only will rents likely continue to drop but the drop in rents will likely "derail a housing recovery next year." Its almost a situation where it feeds on itself. "If you get foreclosures of homes, they're going to be [more] homes for rent." More homes for rent will push rental prices down - lower rental prices will push prices down. Really just a reverse of the self-reinforcing cycles that created the bubble in the first place. Anyway, from a Deflation Watch Perspective, rents are apparently dropping and experts expect that lower rents will push prices of real estate lower.

April 29, 2007, NEW YORK POST, **"Holy Dow! Market's Rise Tied to Dollar's Dive;"** This is the only story in the major press that has pointed this out and we believe it is true. **"This week the Dow Jones Industrial Average hit 13,000 for the first time ever, and the U.S. dollar fell to new record lows against the Euro and the Pound."** "The wall of worry that Wall Street has been climbing is the same one the dollar has been descending." "In fact, the incredibly shrinking dollar is packing a powerful two-pronged boost for the Dow. Not only do the Dow 30 companies now derive a record 48 percent of their sales from overseas, the rest of the world is growing much faster than the U.S." We would point out the the dollar going down is essentially coincident with all the bubbles inflating since 2002, the real estate bubble, the stock bubble, the debt bubble, etc. The dollar is now at very important lows. We believe the Fed and the Treasury will have to decide if they want to try to keep the economy from heading into a deep recession (where it is headed currently) by lowering interest rates, and risk the dollar going further off a cliff and giving us inflation as foreign goods go up in price OR will they keep interest rates the same or possibly even raise them to coincide with the expected interest rate raise expected in the U.K. next week to protect the dollar but likely push our economy into the tank. It seems we are on a bit of a precipice right now. Its resolution will be very interesting and likely volatile. If they don't protect the U.S. dollar, they risk a possible reaction of foreign holder's dumping them; thus, we believe the U.S. Dollar will be protected even at the cost of a dramatic drop in the prices of risky assets and a recession or worse.

April 13, 2007, BUSINESS WEEK (April 23, 2007 edition), **"The Race to Build Really Cheap Cars;"** Recently, there have been more and more stories we could put on our Deflation Watch Weblog - really too many. However, this is the best story since:

The Subprime mortgage collapse began
The stock market had its 850 point mini crash
Lenders raised underwriting standards from 100% LTV to 95%

We think this article is a really good read. It covers many of the changes in the economy from inflation to deflation and from Bull to Bear. It also uses **language specific to deflationary psychology - language that we will highlight for you**.

"[Renault-Nissan and India's Tata Motors]...are leading a race to the bottom [of pricing] that could affect the business every bit as much as Henry Ford's Model T did a century ago." **"After years of making their mass-market cars more expensive, the world's automakers have ABRUPTLY SHIFTED into reverse."**

Nissan's CEO Ghosen's next challenge, "a future model that would sport a sticker price as low as $2,500 - **ABOUT 40% LESS than the least expensive subcompact currently on the [international] market."**

"Low cost cars are the single most important trend in the automotive industry today," says an executive of a major automotive consultant.

"Whatever the lowest sticker price turns out to be, the DISCOUNTING TREND WILL HIT CARS ACROSS THE BOARD, from minis to SUVs."
"That REALIZATION is NOW DAWNING on the industry's giants." "If the Japanese company's engineers do their job, the cost-saving strategies will be **deployed in everything** from Corollas to Lexus SUVs."

Innovation and technology cause/result in deflation - "The KEY is India's low-cost engineers and their prodigious ability to trim needless spending to the bone..." **"You have to cut costs on everything - seats, materials, components - the whole package."** "Combine Indian brainpower with Western innovation in design, materials, and processes, and **the potential exists for a QUANTUM LEAP IN COST-REDUCTION without major sacrifices in quality."** "The biggest breakthrough: Renault was able to eliminate expensive prototypes and the pricey tooling involved in building [new designs]." "Renault has figured out how to eliminate physical prototypes for all of its models." - thus, dramatically lowering its costs of development..

Competition for low cost cars is Widespread - **"So far this year, EVERY MAJOR CARMAKER HAS ANNOUNCED ITS OWN 21st CENTURY MODEL T PROJECT."** "Automakers will have to **live with a trend of lower-cost vehicles**. It is difficult but that's where the demand is." We would add that it is a NEW trend and that the trend is NOW - thus it is a major change in trend.

World Trend Change - **"To automaker's ASTONISHMENT, cheap cars are also proving to be just as popular in established markets as they are in the developing world...."** with Renault moving its low cost cars from sales in emerging markets to western Europe in 2005 with "...buyers [flooding] showrooms to et behind the wheel of the no-frills model." They are expecting low cost cars to hit the U.S. in 2008.

"THE SHIFT TO CUT-RATE WHEELS IS JARRING for an industry that has fixated for at least a DECADE on premium cars and their fat margins." The article here focuses on profits and margins...our focus at Stamper Capital, in terms of Deflation, is that **customer demand is driving this shift** and that demand is for smaller, bare bones, dramatically cheaper vehicles.

Thus, to us, you are seeing a dramatic shift towards deflation resulting from and as an effect of several forces:

Technology is allowing production of better products at lower costs.
Globalization is allowing for better products at lower costs.
Customers are demanding lower cost products.

We have already seen this trend in computer products and electronics, which have seen their prices drop dramatically even as the products have been given more and better features and performance. We believe that as deflation sets in, customers will be more demanding of lower cost products and will be willing to give up the extra features to pay less. As for our Deflation Watch, that information is our secondary research, re-interpretation of what this article is presenting. to us.

March 9, 2007, REUTERS, **"Countrywide Financial Ends No Down Payment Lending;"** "Countrywide Financial Corp. ("CFC"-NYSE), the largest U.S. mortgage lender, on Friday [March 9, 2007] told its brokers to stop offering borrowers the option of a no-money down home loan, according to a document obtained by Reuters. A similar BLOOMBERG article (on 3-9-07) points out that "...other lenders that have started requiring borrowers to put at least 5% down on homes include Washington Mutual Inc. and General Electric Co.'s WMC Finance Co. unit.

That is the news - Our analysis of this news is that this loan underwriting measure is the official beginning of the Credit Crunch and Credit Contraction. While we realize "at the time" it was easy for these companies to get caught up in the real estate bubble, probably a year from now (or even now) many people will be saying, **"what were they thinking?" making 100% loan to value loans**. It just goes to show how even the largest companies can get caught up in irrational business practices during certain cyclical times. Other related themes along these same lines are the "no-documentation loans" and "sub-prime lending." Years from now, people will think it unbelievable that such respected financial institutions at the time would make "no doc" loans or even "sub-prime loans."

As for our Deflation Watch, a substantial increase in lending standards such as this (going from 100% loan to value to a max of 95% L-T-V) means less loans will be made. This experience is by definition a credit contraction. Two other "flies in the ointment" of the real estate bubble are the $1 trillion of adjustable rate loans that are reseting in 2007 and by the end of 2008 and the admission of experts/authorities of the huge amount of underwriting (and outright fraud) to buyers that really did not qualify that happened as a result of the "no doc" and "sub-prime lending over the past few years.

This situation creates a One, Two KnockOut Punch for Real Estate:

1). **Punch One - lots of supply for sale on the market** as defaults step up and properties go back to the banks which then unload them on the market. Defaults from borrowers who can't make new payments when their adjustable rate mortgages reset; borrowers who purchased 100% L-T-V loans and can't make the payments; borrowers who didn't qualify in the first place, etc.

2). **Punch Two - Less Demand - Fewer buyers now** that the lending standards have been raised to 95% L-T-V and those who should not have qualified previously, definitely won't be qualifying in the future.

3). **Third Punch - Buyers who bought on Spec,** and this is a very large percentage of home ownership, will be flushed out. Thus, additional supply (and defaults).

As reported previously around 40% of the recovery since 2002 is widely attributed to the real estate industry. **Thus, we believe the collapse of the real estate bubble will create a huge negative ripple across the economy.** We believe collapsing prices of real estate will most likely morph into deflation in many other categories - certainly prices of other risky asset classes.

February 27, 2007, BLOOMBERG, "**U.S. Stocks Plummet** as China Triggers Global Rout;" (This article was posted after the market close on that day). Now you really don't get much out of the word "plummet" these days...over the past few years "plummet" might mean a drop of a hundred points in the Dow Jones Industrial Average. So to me, this headline **understates** what happened today (February 27, 2007). **Today, the markets had Huge drops as follows**:

Dow:	closed down 416 points or **down 3.3%**
S&P500	closed down 50.33 or **down 3.5%**
NASDAQ	closed down 96.66 or **down 3.9%**

"U.S. stocks plunged, wiping out about $600 billion of market value and erasing all of 2007's gains, after a sell-off in China spread and sparked **the biggest rout in four years.**" - that would be since the drop on the first trading day after Sept. 11, 2001.

O.K. so the reporting inside the article gives more of the magnitude of the decline and also its global nature but it is still downplaying the significance of the move. But here is another example, the next day's February 28, 2007 THE WALL STREET JOURNAL's Page One Headline on the story is, **"Market's Slide Spotlights Risks,"** which to us totally downplays its significance - to us this very large market drop may turn out to be a huge indicator of what is to come.

This reporting is reminding me of the news coverage of 1929 and the 1930's. During freshman year of college I had several hours between classes everyday so I decided to study the 1929 stock market peak and crash. The library had microfiche of THE NEW YORK TIMES. I began reading each paper from front to back starting at January 1, 1929. It took me about a month but I finally got to October 1929. As I recall, up to that point there had been essentially very few articles talking about the precarious state of the markets and none at all on the precarious state of the economy. **Even as the stock market was crashing back then, after each drop, the articles downplayed the drops and the politicians assured everyone that there was really no problem.** I was shocked that the media seemed to have completely missed the significance of what was happening. I continued to read each daily paper through mid-1933. **My conclusion at that time was that if you had been reading the paper in "real time" and had relied on its stories, you would have had no inkling of the financial debacle that was happening or was going to happen - it was like they totally missed it.**

It is almost surreal to see the lack of concern in today's headlines. We will see in the future how significant this turn in the markets really was - we believe this turn is going to turn out to be very significant.

December 19, 2006, THE ORANGE COUNTY REGISTER, **"Preview of Coming Subtractions - San Diego deals with retiree health care mess that looms for other jurisdictions;"** Its here - ugh. Well, what we have been forecasting (and it was not that much of a forecast as it is just math, it didn't add up right) is coming to pass. This article, which is in the Opinion Section, discusses the San Diego County Board of Supervisors recent decision "to eliminate the stipend for employees who retired after March 2002, when the county increased pensions by between 35% and 60%." The "stipend" is retiree health care benefits. Those who retired earlier have had their benefits frozen at the current level. Importantly, "**these changes will result in an estimated $1.2 billion savings for taxpayers over 20 years." In current dollars, "the unfunded liability will shrink from $640 million to less than $300 million and the annual obligation will be cut from about $70 million to less than $30 million."** To us, this is real deflation - although a lot of it was perception as we have explained numerous times - but, most importantly, **it is going to be painful for those whose expected benefits were just cut by, it looks like about 50%.** In his last paragraph, the author chimes in with what we have been saying with respect to the rest of California: **"In the near future, the state government, as well as cities, counties and school districts all across California, will be facing the same bleak alternatives San Diego County confronts. And it looks as if nobody is going to be very happy with the results."** We would add that this is not just a California problem - as we have documented numerous times, this problem is across the entire United States, unfortunately. Anyway, it appears deflation is arriving, unfortunately. Batten down the hatches.

November 27, 2006, BUSINESS WEEK (December 4th edition), "A **Shock to The System: States and cities are now discovering just how staggering their retiree health-care burdens are;"** This article is pretty much reporting what we forecasted a year or more ago. What is showing up now is the "shock" at how bad it is. The article points out that only a few municipalities have disclosed this newly required information so far; however, it does give a few examples. New York State "might have a liability of $250 billion." West Virginia "...has promised current and future retirees $8 billion in health care over the next 30 years, could see that figure balloon to $50 billion in 2040." And, **"West Virginia has NOTHING saved against that pledge..."** The article also points out that "...the new accounting rules don't require states [or municipalities] to fund the projected liability, just to disclose it." We pointed out previously that the bond rating agencies didn't consider these types of liabilities in their credit ratings since they couldn't get the information - now they will and it is already starting to take a toll. **The article points to Contra Costa County in California which was placed on "negative credit outlook" partly do to pressures from its $2.57 billion retiree health-care obligation.** Remember this required reporting of these liabilities is just starting to come out. **Nationwide some consultants are estimating a "30-year tab could total $600 billion to $1.3 trillion...."** Given the track-records of those involved, we expect those numbers will be surpassed. The key for us is that these "new liabilities" will have to be funded - money will have to be taken from somewhere else - services, taxes, fees, salaries, etc. and that, as we have said previously, "a pie that was just previously perceived to be very large and growing, will now be perceived as being smaller and shrinking, i.e. deflating" - ugh.

November 27, 2006, BUSINESS WEEK (December 4th edition), "Guess Who's Cutting Deals;" They are talking about in the automotive industry. **The answer is that BMW is actually cutting the largest deals on new cars right now. "According to Edmunds.com, givebacks cost BMW an average of $4,179 per car during October [2006], more than Chrysler's $4,136 a vehicle..."**

November 27, 2006, BUSINESS WEEK (December 4th edition), "The Housing Grinch Won't Steal Christmas;" I wouldn't bet against the grinch this year, myself. A couple of interesting deflation statistics: **The Consumer Price Index...."posted monthly declines of 0.5% in each month [September and October 2006], the largest two-month drop since 1948. The fourth-quarter CPI will actually be below the level for the previous quarter, a rare event in the past Half Century."**

November 27, 2006, BUSINESS WEEK (December 4th edition), "A Good Time to Ask Santa for a New House;" Probably not - probably far too early in the cycle as the down draft is just getting started but the article does contain some recent information. **"The median price of anew home in September fell by 9.7% from a year ago, the largest annual decline since 1970." "And it looks like prices in several markets will be heading even lower in coming months." "And, the stock of completed hew homes that remain unsold as of September [2006] grew by 46% from a year ago."** We do not buy that the housing market is anywhere near a bottom.

October 10, 2006, HERALDNET, "The Fed needs to act decisively on hedge funds;" We are going to skip most of the article as we have covered the possible problems with hedge funds several times on these pages. The important information in this article is that **"The San Diego County Employees Retirement Association pension fund,...had invested $175 million in Amaranth and has now lost about half of it or $85 million."** Of course, that makes the deficit in the previous article on San Diego a bit worse. We point out (as we have previously) that **many, even professionals do not seem to understand the difference between "investing" and "speculating." It will be interesting to see who else lost money out of the $6 billion in losses hedge fund, Amaranth, racked up in natural gas in less than two months.** We do believe that boards of directors of pension funds could suddenly see the light and all head for the exits at the same time - this is a very very large herd controlling a huge amount of risky assets. It has been reported numerous times that municipalities and pension funds and their investment managers have been pushed and pushed to ramp up returns to deliver increasing retirement benefits without raising taxes nor cutting services. In most cases like that, it is just a matter of time before the increased "risk that is taken" takes away a large part of the principal that was risked. We see this possibility as a real risk which would likely result in precipitously dropping prices of risky assets.

September 27, 2006, BLOOMBERG, **"Pennsylvania Pensions Face 'Crisis', Auditor Says;"** Another article on the continuing and most likely escalating public pension problems. This one is a bit more interesting because it is related to a new state that we have not covered previously. Also, **this plan was recently fully funded but is now in trouble.** "Pennsylvania's two largest public pension plans, which manage $85 billion combined, face a funding "crisis" because they are spending more than they are generating, state Auditor General Jack Wagner said." The School Employees' Retirement System and the Stat Employees' Retirement System together are underfunded by $11 billion. "Both plans were more than 100% funded in 2002 [we note that was near the bottom of the stock market drop - the bottom left of the right tilted W we have written much about on other pages]. By last year, the state workers fund was 93 percent funded and the teachers' retirement system was 85% funded. Each pension plan's total assets were lower at the end of 2005 than four years earlier because of investment losses and a 2001 law that increased pension benefits, Wagner [Auditor General] said." Then the article goes into a lot of finger pointing; however, on these pages the important points are how is it going to be resolved - lowered benefits, lowered services and/or increased taxes - and does this decrease in the economic pie result in less money to pay for things (either by taxpayers or pensioners) and ultimately result in dropping prices?

September 27, 2006, THE WALL STREET JOURNAL, **"San Diego and the SEC;"** Another bit of information the ongoing scandal and pension fund saga in San Diego. This writing was in the opinion area of the WSJ. The SEC is about to issue its final report....and then, the city has to deal with its situation. Currently, **"San Diego's pension fund is now underfunded by some $1.5 billion, or about 30%."** Thus, "the nightmare won't end there [with the SEC report] for San Diego taxpayers, who are left holding the bag for the misfeasance of the city council." The question is, the article points out, how is San Diego going to "balance" this mess - "Will the extravagant promises to city employees be honored without regard to their cost or the improprieties involved in making those promises?" **The city attorney, "a self-described liberal Democrat," Mr. Aguirre has "brought suit in federal court to have some of the benefits granted since 1996 rolled back on ground that they violated federal conflict-of-interest laws.**" "As Mr. Aguirre points out, current retirees are drawing 100 cents on the dollar from a pension fund that is only 60% funded." So, you can see why we believe there will be some "class warfare" between the taxpayers and the pensioners. It is interesting to us that the City Attorney fighting for the taxpayers is a "self-described liberal Democrat." You would expect most public pensioners are democrats; however, we believe this struggle will cut across political party lines as **both parties have large numbers of taxpayers**. As we have stated before we expect similar problems are going to surface across the country for states, counties, cities and other municipalities including police and fire pensions. To us, as either benefits get cut or taxes go up, and/or services are cut, the result will be that the economic pie will have shrunk, unfortunately. We believe that could be another cause of deflation.

September 25, 2006, STAMPER CAPITAL, **"Silicon Valley Outlet Store Sales Traffic Drives Off A Cliff?"** - A little "primary research" by Stamper Capital.

Last Friday afternoon, we went to the Gilroy Premium Outlets at the south end of the Silicon Valley in Northern California. It is a Huge complex with something like 140 outlet stores. Normally the parking lot is filled to the brim and so are the stores. I have been monitoring economic activity at that location since I moved to Monterey in 1995.

Eating - Normally this massive outlet center is packed - and so is the In-and-Out Burger located there. You typically had to wait several minutes and work fairly diligently to get a parking spot; then you had to wait in line for around 10 minutes to order; and then another 10 minutes or so to get your food; and then you can't find a place to sit down to eat it. The other day == no line and lots of open tables. Only one other time did I see it even close to that - back in the tech melt down of 2001.

Shopping - Usually you have to search and search through hundreds of parking spaces to park - the other day == almost Every Other Front Row space was vacant!!!!....the rest of the lot was pretty much empty!!!!! (less than 1/3rd full). They have four separate shopping areas - each with around 40 stores and their own huge parking lot == the amount of available parking spaces was the same in each section. I've never seen it close - not even anywhere close to that empty - almost never would you even think about getting a front row parking space without waiting 10 minutes or more. Even getting a parking space away from the front would often take a wait of a few minutes. The other day, the rest of each lot was around 3/4th's vacant.

During the Big Bull, the Nike store was usually the hottest place - on average around 300 or more customers in there clamoring for "outlet priced Nike stuff"....that store has about 12 registers - normally all with lines of customers - five or more deep - buying big-Swoosh merchandise. The other day == when I walked out at around 4 pm (a beautiful day) there was only one person making a purchase...and about 5 checkers sitting there twiddling their thumbs - it was eerie to me to see it so empty.

It was really quite unbelievable that this Silicon Valley outlet center was anywhere near that vacant == it was so different than the other 25 or so times I visited there over the last eleven years.

Does this drastic decline in sales traffic mean anything - we will see. It is a very narrow study of only one day in only one location. Maybe there was something else going on. Questioned clerks said it was a bit light. Maybe traffic down from the Silicon Valley had been blocked for some reason. Or, maybe, the bull market in retail sales is over - we will see.

August 11, 2006, BUSINESS WEEK (August 21/26th edition), **"Cheap Chic;"** "Fed Up with the high prices urban kids pay for sneakers marketed by their basketball heroes, New York Knicks point guard Stephon Marbury is launching the StarburyOne, a $14.98 sneaker he'll wear on the court." Wow! that is a huge change. Maybe we should put this on our **Major Trend Change Indicators weblog** page instead, http://www.risk-adjusted.com/Weblogs.html . The article points out this is 1/12 the price of Nike's $180 Air Jordan XX1. Of course, Michael Jordan is a bull market icon. I'm not familiar with Marbury's style of play but I would bet it is much more bruising and defensive as opposed to Jordan's bull-market finesse style. Obviously these are not the same pair of shoes, but they are still shoes- both basket ball shoes - both basket ball shoes promoted by basketball stars - NBA basketball stars and the new one is $14.98 and the old one is $ 180. This may not officially be deflation but it is definitely an indication of deflation, especially if the StarburyOne takes off.

August 7, 2006, PITTSBURG TRIBUNE-REVIEW, **"When market sentiment is cloudy, remember: The trend is your friend;"** This article presents lots of facts and figures that conflict and, thus, are used to demonstrate that it is difficult to tell exactly which way the economy is heading. The article's recommendation to stay with the current trend is made, so that you do not get left behind. However, the article (maybe cleverly) never tells the reader which way the current trend is heading. We suspect most would believe the current trend in equities is up. However, that is not the case. **Our May 17th, 2006 comments (see below for full comments on that date) have proved to be right on:**

"The real story is that the stock market and the commodity markets have had sharp reversals [from their early May 2006 market tops] and have almost certainly (to us) transitioned into major downtrends."

The trend since the May 2006 tops is clearly down, with lower lows and lower highs:

% Change from May 2006 Market top:	Dow Indust.	S&P 500	NAS DAQ	S&P SmallCap	Dow Transp
to recent bottom:	-8.2%	-8.1%	- 14.8%	-13.8%	-13.4%
to following rebound high:	-3.5%	-4.0%	- 12.2%	-11.0%	-13.4%

All lower lows and lower highs;tThus, pretty much all equity indices are in downtrends on an intermediate basis from their early May 2006 tops.

The long term trends of the Dow Industrials, the S&P 500, and the NASDAQ are also down - all having record peaks back in the year 2000. Until those tops are taken out (which we believe will be a long time from now) the long term trend in those indices is still down.

The small caps and the Dow Transports put in record highs in early May 2006. You can make the argument that their long term trends are still up; but, its clear from the chart above that their short term trends are downward. We believe their long term trends will turn out to be downward as they "catch up" with the bluer chips.

Many of the commodities, although definitely not all, have price graphs similar to the equity markets:

% Change from May 2006 Market top:	Gold	Silver	Aluminum	Natural Gas*
to recent bottom:	-22.2%	-34.7%	-21.3%	-47%
to following rebound high:	-15.9%	-17.3%	-17.6%	-29%

(*note: natural gas peak was early December 2005)

We believe if equity prices continue to drop and real estate accelerates its recent downward trend, and, if the commodity prices that are dropping are joined by the other commodities (oil, for example) that are still rising or trending sideways, it will turn out that May 2006 was pretty much the top in inflation and the beginning of deflation. Historically, such turns are not generally officially recognized or announced until many months after they have already occurred.

Accordingly, our message, is still, "Safety is the watchword for this decade."

June 8, 2006, BLOOMBERG, **"Intel Tells Customers It Will Cut Prices by 60%;"** "Customers of Intel Corp. said the world's biggest computer-chip maker plans to reduce prices on Pentium processors by as much as 60% to reclaim market share from Advanced Micro Devices Inc." **"...price cuts will start July 23 [2006]."** Definitely, a decline in prices.

May 29, 2006, AOL NEWS, **"Retiree Benefits Grow Into 'Monster';"** Definitely what we are calling a "reality recognition" article (see below and our **Major Trend Change Indicators weblog, http://www.risk-adjusted.com/Weblogs.html).** We have been covering the incredible pension problem for years yet this article is the most shocking and direct at exposing the problems faced. The analysis was conducted by USA Today which "compiled a list of all taxpayer liabilities - federal, state and local - to provide a fuller look at the nation's financial condition. The numbers are based on official government reports."

"Taxpayers owe more than a half-million dollars per household for financial promises made by government, mostly to cover the cost of retirement benefits for baby boomers, a USA Today analysis shows." **"Like an unpaid credit card bill, the balance grows every year - about $25,000 per household annually."**

Importantly, "...the obligations are valued in today's dollars."

"The cost of retirement programs will start to soar when baby boomers.....begin collecting Social Security in 2008 and Medicare in 2011." -- **Just 2 years away**, we add.

"American's government obligations are five times what people owe for mortgages, car loans, credit cards and other personal debt." To us, the only way being so indebted could have come into being is because the average citizen has no clue that it has happened to such an extent (it wouldn't have happened if everyone was solely responsible for themselves and/or their families). Unfortunately, as this reality becomes widely known, people will realize it is highly unlikely that these promises will be delivered as currently promised - it seems mathematically impossible. Basically, the benefits promised will be determined by what can be taken from taxpayers themselves - it seems it will all cancel out near zero - the perceived assets of retirement promises will be offset by funds required by the government to pay such promises (or the promises will be deflated). **The old excuse, "we owe it to ourselves" will finally take on the weight of its true meaning** - ugh.

Thus, it will likely be that everyone's reality will shift to recognizing that their economic pie has shrunk dramatically by the extent of these newly discovered liabilities!...ugh - very unfortunate and will almost certainly be reflected in the financial markets - sooner rather than later at this juncture. **In other words, we don't think these realizations will move risky asset prices up but most likely down. As people's wealth perceptions are deflated, so will likely be the prices of riskier assets.**

May 23, 2006, BLOOMBERG, **"Ford to Pay Highest-Ever Bond Yields to Conserve Cash;" "The world's third-largest automaker (Ford) is so enfeebled that it will wind up paying the highest interest rate -- and accept the lowest price -- on any Ford bond sold in the U.S. in the last century."**

We have spent a bit of commentary over the past few years on the perils General Motors is involved in and going through. Similarly to the steel industry and the airline industry, we believe in the "domino theory" for the automotive parts/service industry (which we have also commented on previously - think Delphi) and for the automotive manufacturing industry. Thus, we believe and stated years ago that we believe General Motors for a variety of reasons (chiefly due to very high levels of liabilities in the face of increasing competition) will go bankrupt or at least significantly restructure itself including cutting salaries and benefits. As G.M. begins to falter and go under, we believe the pressure on the next in line, Ford, will similarly cause it to falter and so on until only the manufacturers with the strongest true balance sheets (including retirement liabilities) remain. We have seen this "domino theory" work itself through the steel industry and the airline industry (although it hasn't taken down American Airlines yet, they have already cut salaries and benefits substantially). It is currently working its way through the automotive parts manufacturing industry and has a good start on the big automotive manufacturers.

This article highlights a lot of problems that Ford is having:

It is refinancing debt "with coupons as low as 4.95%" at over 10%.
  This will raise its interest expense by "about $90 million a year."
It has $57 billion in debt maturities over the next five years.
It is doing this exchange to "hold on to some of its $21.2 billion in cash.
It lost its "investment-grade credit rating a year ago.." (same time as G.M.)
It "now has $121 billion of junk-rated debt."
  Ford is rated Ba3/BB-
  Ford Credit is rated Ba2/BB-
"Ford's share of U.S. car sales fell to a record low of 15.9% in November [2006]."
Ford has announced (on 5-11-06) it plans to cut 30,000 jobs and close plants.

O.K. it sounds a lot like G.M.(or U.S. Air or United Air Lines) and it is due to similar reasons.

What prompted this article is that Ford is offering to exchange new higher coupon debt and some cash for older lower coupon debt that has short maturities. It is also offering unsecured debt for secured debt which is, in part, why the interest rate is higher. The thinking is that having less debt backed by real security will lower Ford's overall cost of borrowing versus the current structure of more secured borrowing in its Credit Division. It will also give Ford more flexibility if it gets further in trouble as it will have more security to use to borrow against later - thus, **we see this as a defensive maneuver by Ford, which we believe is a wise move considering their situation.**

As for **deflation implications**, we believe these layoffs and later likely reductions in benefits and/or cash compensation will ripple through the rest of the economy lowering the amounts people can pay for items and also putting pressure on others' salaries, thus, creating downward pricing on the economy overall.

May 19, 2006, BLOOMBERG, **"Commodities, Led by Metals, Have Biggest Weekly Drop Since 1980;" "Commodity prices had their biggest weekly drop in more than 25 years, led by metals and grains, on speculation that higher interest rates will erode the appeal of copper, gold and sliver as alternative investments."** Well, that is pretty much it but it for the metals but doesn't really explain why the grains also had 25 year record down weeks. However, our focus here will be on the fact that it looks like commodities overall have made a downward turn and if it continues it will most likely be deflationary.

May 17, 2006, BLOOMBERG, **"U.S. Stocks Drop on Inflation Concern;"** This is an interesting headline and does tell the predominant line of thinking right now (even if it turns out to be incorrect). However, we believe this logic is looking backwards into the rearview mirror of what the statistics will look like through the end of April when released, **while what has happened over the past week is the real story. The real story is that the stock market and the commodity markets have had sharp reversals and have almost certainly (to us) transitioned into major downtrends.** Thus, to us, stocks aren't dropping from inflation worries, they are dropping because we have entered deflation with prices of almost everything (especially riskier asset classes like junk bonds and real estate) dropping. To be more clear: previously you had some items rising in price like commodities, healthcare, and stocks and real estate. More recently real estate had been stalling. You also had some things going sideways; salaries are a good example of sideways over the past several years. And, you had lots of items dropping in price: computers, electronics, soft goods, clothing, shoes, etc.- think anything sold by Costco.. **Most important to this discussion, as of a week ago, commodities and stocks have switched to dropping sharply. Thus, Prices of Pretty Much Everything are Now Dropping ====>and we conclude: deflation has most likely arrived.** We will know for sure, after the fact, in a few months, but the turnaround and drop in prices of stocks and commodities is striking so far and will most likely be accompanied by falling prices of other, less liquid, investment categories such as junk bonds and real estate.

May 3, 2006, BLOOMBERG, **"Northwest Pilots Approve Contract with 24% Pay Cut;"** The headline says it all. Another example of some prices and incomes that are dropping even while others are rising. Our point is that we are not in an overall inflation like the 1970's and we believe the resolution of rising and falling prices (and incomes) will at first be an overall deflation for a couple of years.

May 2, 2006, THE WALL STREET JOURNAL, **"Car Industry Brings Back Incentives - To Counter High Fuel Prices, Rising Interest Rates, Dealers Offer As Much as $6,000 in rebates or Gas;"** The headline pretty much tells the story and makes our case. The point it makes for us is that unlike the inflation of the 1970's when the prices of everything were going up, currently, if the price of one category goes up, it must be offset by lowering prices in another area - thus, we are not in a situation of overall inflation.

May 2, 2006, LOS ANGELES TIMES, **"Price of Meat at Lowest in 3 Years;"** This headline also pretty much says it all. "On average....retail beef and pork prices are at three-year lows, and chicken prices are at the lowest in four years." The article then follows the effect of low prices - good for consumers bad for meat packers. The reason given for the decline in these prices is because the high protein diet craze has been fading. For us it is another example of some prices going down; thus, proving we are not in an overall inflation like the 1970's. Importantly, we expect the pull of prices upward and downward will most likely be resolved in an overall downward direction for a few years.

May 2, 2006: **"Parabolic Rise in Commodity Prices will Lead to Deflation as FED is Forced to Raise Interest Rates Further"** - That is our title - We have not seen an appropriate article on the commodities rally to leverage off of but we do want to make the following observations. **We believe the FED will have to continue to raise interest rates to stop/or reverse the very strong parabolic rise in hard money/metal commodities (silver, gold, copper, oil, etc.) and to revive the U.S. dollar from its recent accompanying decline.** In fact, we believe the past two years of interest rate raises by the FED have been much more related with keeping the dollar up than with preventing inflation (of which overall, there has really been little - real estate and healthcare rising offset by declines in prices of electronics, soft goods, clothing, auto's, incomes, etc.).

We believe the FED would rather not raise interest rates at this time since the housing market has already slowed down so much but it is essentially being forced to do so by those selling the U.S. dollar and purchasing the hard money commodities (U.S. dollar going down; hard money commodities going up). Unfortunately, another rise or two in interest rates by the FED (or the perception of more future interest rate raises) is highly likely push the housing and other credit sensitive markets into decline. **We believe an interest-rate shove that is strong enough to revive the U.S. dollar from its recent fall and to stop the parabolic commodity rally, on top of the record high debt levels and record lack of a cushion for this type of turbulence, is likely to send the prices of risky assets down sharply.** Then, those who have felt asset rich (principally due to higher real estate prices) will be feeling asset poor and will be restricting their economic activity - most likely resulting in **the resumption of the economic slowdown that began in 2001** (that was derailed, at least for a couple of years, by the massive interest rate cuts, tax cuts and fiscal stimulus). **Thus, although commodities have recently been rising in a parabolic fashion, we are still very concerned about coming deflation.**

April 16, 2006, PITTSBURG TRIBUNE-REVIEW, **"Coming to a city near you: Deficit pensions;"** Another "reality recognition" article - we believe we will be seeing more and more articles similar to this one as the major media turns from denying the bad news to highlighting it. This is a concise article on how municipal pensions got in the mess they are in and it does talk about eventually facing the music: **"Eventually, they've got to raise taxes, cut benefits or go bust under retirement burdens alone."** -- a pretty strong statement that we think will prove to be accurate, unfortunately. The writer believes **the problems are "...just a few years from landing on taxpayers."** We believe it will be sooner than that - as discussed in articles below, we believe the unfortunate reality will be staring everyone in the face by the end of 2006 because the results of the consultants studies will be completed by then so that the municipalities can begin putting it on their books in 2007 for the 3 year phase in under the new accounting rules for municipalities.

The article points out that while **Pittsburgh's deficit is $600 million, "the distress in some other cities dwarfs that" - that "San Diego has blundered $2 billion deep in**

pension deficit." "Illinois taxpayers are $38 billion in the pension red -- worst among the states."

The article highlights the opinions of a New York asset-liability expert who "blames it on bad accounting and reporting rules - legal but lax." **"He believes the underfunding is really big -- some 35 to 40% across the country."** He makes a brilliant analogy that explains how the municipalities got in such deep trouble: "**Las Vegas has built an empire on the principle that people play till they lose. In the late 1990's, equities (stocks) won big. Instead of taking their chips off the table, the pension funds kept betting. When the correction came, they lost everything they gained, and the had increased their liabilities because of the pension sweeteners."**

The article concludes, **"So a painful day in the city approaches. Inevitably."**

We believe this was one of the first of many "reality recognition" articles to come.

February 15, 2006, USA TODAY, **"Schools face 'death spiral'** - Districts must choose between students' needs, teachers' benefits" - (Note: this was part of a debate in the opinion section.) This article confirms much of what we have reported on over the past few years and gives another unfortunate example. **"Until last week, Los Angeles school officials thought their unfunded health care obligation for retirees was $5 billion. Then they scrubbed the numbers. The new estimate: $10 billion." Wow $10 billion in underfunding for a school district and that is only for health care benefits (not retirement benefits).** The discussion points out that "**new federal accounting rules** are forcing...." school districts to recognize the problem of allocating their future resources - **"ensuring that thousands of communities will receive the kind of news Los Angeles is getting."** The discussion goes into a lot of finger pointing and calls the contracts, "financial time bombs." **More importantly, "...health care benefits are [we add, just now] smacking against budgets." As we have mentioned previously, we think this "crowding out" or "forced allocation of resources" will result in deflation.** In this example, "Los Angeles sets aside $1,000 of its $5,500-per-student budget to cover health care costs for current and retired teachers. To cover the newly estimated $10 billion liability would require $2,087 per student." So, this is a very unfortunate situation and you can bet there is going to be a lot of difficulty in deciding what to do about the $1,087 per student per year shortfall. We do not think they will be able to simply raise taxes because most school district funding requires a taxpayer vote. Also, if they are able to raise taxes for the shortfall, that means those taxpayers will have less to spend elsewhere. Thus, some things will almost certainly be cut back - and we believe those cutbacks will likely result in deflation. The key reason it is going to be deflationary is because people in general thought they were wealthier than they really were and now that reality is hitting, there are going to be cut backs - ugh.

January 27, 2006, THE SLATE, MONEY BOX, **"Bye-Bye, Pension!"** Yes, we have covered the pension problems both municipal and corporate so many times over the years but this article highlights another wrinkle (Ok - I think we did cover this previously but this article is well done) - and that wrinkle relates definitely to deflation of compensation.

"Until recently, the cram-down [bankruptcy or negotiation] - the process in which a company walks away from pension and benefits promises - has generally been confined to failed companies like Delphi. Struggling companies frequently terminate their pension plans and push the liabilities onto the Pension Benefit Guarantee Corp. But **NOW perfectly healthy companies - solvent, profitable, thriving, industry-leading, blue chip companies - are moving unilaterally to slash the expected compensation of non-unionized employees by FREEZING pension plans."** That is the gist of it. The article names some very big names that have recently done just that, Froze their pension plan and are shifting it to or boosting their 401k plans.

Hewlett-Packard, last summer
Verison, December 2005
IBM, a few weeks ago
Alcoa, this month
Russell Corp (apparel), last week

Thus, in these situations, compensation is being reduced or deflated - ugh.

January 27, 2006, BLOOMGERG, **"What Growth? Economy Is Getting Worse, Americans Say;"** This "under-the-radar-screen" article makes several points about "reality recognition" - what is being realized by Americans. We think these points derived from the poll this article is based on are so important that we are also including this story on our **Elements of Market Tops** and **Major Trend Change Indicators weblogs, at http://www.risk-adjusted.com/Weblogs.html.** The article begins:

"The U.S. economy was robust by almost every measure last year,....[but]...Most Americans don't buy it."

What is amazing, according to the Bloomberg/LA Times poll, is that **despite the rosy economic statistics,** "**By a 59% to 37% margin, Americans disapprove of the way Bush is handling the economy**...and, **by 47% to 22%, the public says the country is worse off economically** since Bush became President." We aren't making a political point here - the results of this poll beg us to ask: **If everything is so great, how come the majority don't like the way things are being handled and think they are worse off?**

The article goes on to mention most of the problems (we have covered previously that) Americans are coming to realize. The key seems to us to be **"The failure of incomes to keep pace with the economy...."** and relatedly, **"Real GDP growth has been relatively healthy, but most Americans don't feel it."**

What is remarkable that we alluded to above is that **"Most economic indicators contrast sharply with opinions expressed in the poll."**

That was the "reality recognition" part, now comes the "deflation angle:" "**More than three-fourths of the [poll] respondents say they will need to reduce spending if energy costs continue to rise** [cutting across party lines and income groups]...**Even among those earning more than $100,000 [annually], as many people say they would cut back because of energy prices as say they wouldn't."** We would say this is definitely not "inflationary psychology;" maybe it is "disinflation psychology" and more likely it is "deflationary psychology." Maybe a better way to characterize it is that it is not "expansionary psychology" but **is "contractionary psychology."** Thus, notice that, rather than indicating they would take on more debt (maybe a new draw down on the ol'equity in the house), **they are going to Cut Back - this is 75% of those polled including 50% of those making $100k or more!**

"Cutting Back," to us, is the end of the Credit Expansion and the beginning of a Credit Contraction. We believe a credit contraction from the current, record high levels of debt, will most likely result in general deflation.

January 8, 2006 - Today we are going to cover several "reality recognition" briefly together - the titles pretty much speak for themselves and we have covered the subjects in detail previously; however, **it is the change in tone in the titles and the articles that merits their inclusion at this time on this blog:**

1-8-06 - THE LOS ANGELES TIMES, **"A Home Boom Busts** - Shanghai's hot housing market has fizzled after a run-up fed by speculators, threatening a significant part of China's economy;" Besides general statistics the article highlights the situations some individuals experienced - One persons thought they were in fat city for a couple of months since their property purchase in March 2005; however by "today, prices at the complex have fallen by a third..." The buyer admits that she got caught up in the frenzy but then says, "I was cheated" and is suing to get out of the "investment." **Brokers indicated that prices at another housing complex "...have plummeted by more than 50% since March [2005]."** Morgan Stanley's Chief Asia economist in Hong Kong indicated "Shanghai's housing slump is only going to worsen and imperil a significant part of the Chinese economy..." He also speculated that the current supply being built will "...remain empty for years." The article also lists many statistics during their up market that parallel the situation in the U.S. since 2002 and also changes that have been blamed for the implosion that are similar to measures that have been recently been taken in the U.S. Thus, we should beware, it can happen here - 50% down in just 10 months! - ugh.

1-8-06 - AOL MONEY & FINANCE, **"Pension Crisis Could Hit Balance Sheets;"** - This article is in respect to two possible crises in the Corporate pension sector: 1). Inadequate funding 2). The Accounting Change (we previously documented) "...that may make pension issues more painful for corporations..." by requiring ..." companies to add their net pension and retiree-healthcare costs to their balance sheets within the next year. "The first change..."will move pension and retiree-healthcare costs from footnotes to balance sheets, could be dramatic, increasing companies' leverage and changing computed returns, book value and shareholder equity ratios." Blah Blah Blah - the key here is that it is going onto the books, the shortfalls are going to be notable, benefits will almost certainly be cut and people will realize they are not as wealthy as they thought they were - unfortunately.

1-7-06 - THE LOS ANGELES TIMES, **"5 Indicted Over Pension Scheme;"** The pension scheme they are talking about is the situation in San Diego which we have reviewed in detail several times previously. The important addition is that "**The former and current San Diego city officials face federal fraud charges** in a plan that has left the city with a $2 billion deficit." The key to this addition is that because of this lawsuit it is an easy bet that boards of directors of almost all other public pension plans are going to make sure they have "cya'd" themselves and will most likely switch to very conservative and safe philosophies and implementation methodologies away from the previous possibly more questionable ones - thus, to us, spelling "contraction."

12-24-05 - THE NEW YORK TIMES, **"Take it From Japan: Bubbles Hurt;"** Again, we have covered this subject in detail several times before - what makes it notable is the blatant change of tone in the title and in the article. Starting around 14 years ago (shortly after pretty much everyone thought Japan was going to buy the world) "...Japan's property market collapsed." **"Now [2006], the land in Japan is worth less than half its 1991 peak."** "In Japan's six largest cities, **residential prices dropped 64 percent from 1991 to last year [2004]."** "Residential home prices in Tokyo rose 0.5% in the 12 months through July [2005], **THE FIRST GAIN IN 15 YEARS**, the [Japanese] government said in September [2005]."

So we again note that "reality recognition" that could very likely bring on widespread deflation and a credit contraction is very close.

January 6, 2006, BLOOMBERG NEWS, **"General Motors to cut Prices on 90% of U.S. Models;"** "General Motors, seeking to end six years of U.S. sales declines, will **cut prices on cars and trucks representing about 90% of its U.S. volume..."** Wow - ugh. Also, "... The program would expand an August [2005] move that reduced prices or added features on more than 50 models." Price cuts on 90% of G.M.'s volume - seems like deflation to us. Let's be careful here with high priced, risky assets - it is possible this news (and more) will usher in the "reality recognition" that we are actually in deflation and a credit contraction.

December 15, 2005, BLOOMBERG NEWS, **"U.S. Economy: Consumer Prices Fall by Most Since 1949;" "U.S. Consumer prices dropped by the most in more than a half a century last month [November 2005]..."** The 0.6 percent decline in consumer prices was the **largest since July 1949**...."due to a record drop in energy costs..." This drop is in line with the November 27, 2005 article, **"Now with Real Estate Prices Going Sideways or Drifting Lower and with Gasoline Prices Dropping Substantially, Almost All Prices are Dropping"** we authored since we could not find any articles pointing out the obvious (please see below).

December 11, 2005, THE NEW YORK TIMES, **"The Next Retirement Time Bomb;"** This is the **first article that we have seen in the "popular press"** on the retirement ***healthcare*** time bomb (-unbelievably, we have seen very few such articles in the financial press either). Importantly, this time bomb is for **healthcare benefits** not regular retirement benefits which has its own time bomb (which we have also detailed several times previously). This article has considerable detail into what is coming. We have reported most of it previously but there are a few new points and old points that are worth highlighting.

The overview is that **States, Counties, Cities and other Municipalities like School Districts have not put the liability of retirement healthcare benefits they promised on their books.** Yes, that is quite shocking all by itself. What is more shocking is that the **unaccounted for unfunded liabilities are likely to "be $1 trillion...."** as a national total - note this does not include the Federal government. A key **TRIGGER** to reacting to this far reaching revelation is that (as we previously reported) the Government Accounting Standards Board (GASB) is requiring these governmental bodies to **begin accounting for these unfunded liabilities beginning within two years** (depending upon each's fiscal year end- small municipalities get an extra two years to begin). The accounting for the unfunded liabilities will be **phased in over a three year period**. The article uses the specific story of one city's revelation that these liabilities haven't been accounted for (and now have to be) and are unfunded and the size of them, 2x the size of the cities annual operating budge. Faced with the deficit, the mayor is quoted, **"We can't pay for it....The city isn't going to function because it's just going to be in the health care business."** (That is what we said about GM - it isn't an automobile company any more, it is a retirement pension company.) While ..."under the new accounting law, local governments will still not have to set aside any money for those promises. But they will be required to lay out a theoretical framework for the funding of retiree health plans over the next 30 years and to disclose what they are doing about it. If they fail to put money behind their promises to retirees, they may feel the unforgiving discipline of the financial markets. Their credit ratings may go down making it harder and more expensive to sell bonds or otherwise borrow money." **Thus, essentially, the jig is up.** "Maryland, for example, now spends about $311 million annually on retiree health premiums. But when that state calculated the value of the retirement benefits it has promised to current employees, the total was $20.4 billion. And the yearly cost will jump to $1.9 billion under the new rule (that is a 6x jump), according to an analysis for the state by actuaries at Aon Consulting..." "Michigan says it has made unfunded promises that are now valued at $17 billion for teachers, part of a possible $30 billion total for all public [Michigan state] agency retirees."

Deflationary & Investment Impact: "Now that it is here, the general sense in the marketplace is that GASB 45 is going to lead to a **WATERSHED** in public-sector health benefits." We agree. "Indeed, the handful of states and cities that have already calculated their obligations to retirees have concluded they must also rein in the costs. Michigan, for example, with its possible $30 billion in largely unfunded health care promises, is already considering legislation that would **shift** a considerable amount of the cost for health insurance to the retiree..." Thus, similar to the opinions we stated below in regards to regular retirement benefits, it is unlikely that people are going to be receiving what they understood they were going to receive - that the "WEALTH PIE" HAS JUST SHRUNK, unfortunately. Actually, the perception of it shrinking hasn't occurred yet but it will be, even before these new accounting rules take effect in 2007. That is because **the information of the deficits is now starting to hit the popular press (see our articles on Orange County, below) and it will be coming up at municipal board meetings, and it is going to impact bond credit ratings which will impact the costs of borrowing for municipalities.** Not only will costs be shifted but, services to taxpayers will likely be cut, service charges raised, differential in pay and benefit scales between old and new employees will likely be implemented and at the extreme, benefits will be reduced. **The mayor of the city highlighted in the article, "most recently...reached out for what may prove to be the political third rail: he took issue with the idea that once a public employee has retired, his benefits can never be reduced. This idea, as applied to [retirement] pensions, is rooted in the constitutions of about 20 states, and unions argue that it also protects retire health care."** "If active workers must make concessions, he said, retired workers should make concessions, too." **Our point is that anyone who has "concessions" will be seeing their perceived "wealth pie" as being reduced. These reductions will likely ripple across the consumption and investment landscape, leaving less money to pay for salaries, debt service payments, services, consumption and assets.** We believe the result will be deflationary and will also be a major contributor of risky assets falling in price from their precipitously high current levels. Thus, to us, "Safety, continues to be the watch word for this decade."

December 7, 2005, BLOOMBERG, **"U.S. October Consumer Credit Falls as Auto Loans Drop;"** "Borrowing by U.S. consumers UNEXPECTEDLY fell in October [2005 by $ 7.2 billion] as plunging auto sales reduced demand for financing, a Federal Reserve report showed today. **This "RECORD" plunge in consumer credit** was "unexpected" = "Consumer credit had been expected to rise by $5 billion [in October 2005], according to the median forecast in a Bloomberg News survey of 33 economists....**Only two forecasters [out of 33] predicted a contraction." So the average expectation for October 2005 Consumer Credit was an increase of $7.2 billion and the number came in at a negative $ 5 billion.** Importantly, the decline is attributed to **a drop in the demand for financing new automobile purchases which dropped to a seven-year low. "Rising interest rates, higher minimum credit card payments and increased fuel prices also may have discouraged consumers from taking on more debt."** If you have been reading our comments over the past couple of years you will know that this pretty much matches our description of the beginning of a classic credit contraction. **Unfortunately, a continued credit contraction, which we think is highly likely, will be coincident to a decline in economic activity - a recession - and is a leading indicator of declining price levels in the future - hence, this occurrence is a major factor in our "Deflation Watch."** Thus, it seems like we are at the "tipping point" of the onset of outright deflation, ugh, unfortunately. For investors, the thing to watch out for is falling prices of riskier assets like equities, lower rated bonds, real estate, etc.

November 30, 2005, BLOOMBERG, **"Deflation Looms as China's Economy Cools Off;"** Wow, we haven't seen the actual word "deflation" in print in a while, even though lots of prices are actually dropping. In this article, they are talking about what is going on in China. Previously, we reported on the overcapacity over there and that their economy was cooling and now we are seeing others talk about it. The way the author of this article speaks, it is a foregone conclusion that China is going into deflation: "Chinese Officials seem to be pulling off an orderly **DEFLATING** of their nation's economic bubble." "The reason: **Overcapacity. China is still producing too much cement, aluminum, textiles and other goods. It is also constructing too many factories, buildings and resorts."**

This article highlights some important facts. Remember just a few months ago, China's economy was thought to be unstoppable - however, at that time, we highlighted that China's stock market had actually been dropping for some time and was most certainly forecasting a slowing economy. **Now, we learn ...."China ended five years of deflation in 2004 by stimulating investments in real estate, automobile manufacturing, power generation and elsewhere."** Anyway, we think it is important that **if China does have overcapacity (which they do) and if their prices start dropping (which they are) that their deflation will eventually work its way over to our shores.**

November 27, 2005, LOS ANGELES TIMES, **"Pension Gap to Force O.C. Budget Cuts;"** Well, here we are on a subject we have been highlighting for a few years. The key this time is that the **impact of these unbelievable pension programs is starting to actually hit in terms of dollars and cents (sense?) and jobs and services.** "Higher shortfall starts a search for as much as $84 million in savings in the next fiscal year." The reason: "so they can use the money (i.e. the savings) to shore up the pension fund." While these cuts are a very small proportion of the overall budget, it is just the beginning of a torrent. Importantly, "the proposed cuts are in response to an consultant's finding this year that the Orange County Employees' Retirement System was underfunded by $2.3 billion, about $1 billion more than previously realized." Shocking but most of this is a rehash except that **now things are actually starting to be impacted. We see it as a classic "CROWDING OUT" of government programs and services to finance these once-future pension obligations.** However, with respect to our Deflation Watch Weblog, the key is that **because of the pension-related budget crunch, people will be laid off and new hires will be hired at lower wages.** In fact, most government municipalities are trying to hire new employees with a different benefit package - importantly, a less-valuable-to-the-new-employee benefit package. Thus, because they simply don't have the money, what they can pay in the future (or NOW) will be dropping and thus, salaries and what they pay to contractors and for goods and services will almost certainly be dropping in price. It is really going to be shocking but will most likely be happening in a high percentage of governmental bodies.

November 27, 2005, BEAUFORT GAZETTE, **"Crowded stores see only modest spending;"** This was one of the more reasonable articles on "Black Friday" - the day after Thanksgiving when the Christmas shopping hype used to begin. According to several articles this day has morphed into the largest sales day of the year - previously that day was the last Saturday before Christmas. Also, because if the day's superior sales volume it is often thought to be the best gauge of the selling season. There were lots of other articles trying to paint this years Black Friday with an optimistic brush. However, when measured sales were finally published it turned out they slipped 0.9%. The small drop has been dismissed by those wearing rose colored glasses because this year the Christmas Season actually began before Halloween rather than after Thanksgiving. They have a point but that early start more probably is indicative of a fearful retail sector - some retailers trying to sell early, before the limited buying is spent. Some more realistic articles like the one we are piggy-backing off of right now point out that much of the sales and the traffic were accomplished with steep discounts. We would like to point out that this situation of giving deep discounts to reap large sales numbers likely has two downsides this go-around:

First, while the amount of sales for this year's Black Friday versus last years was only down 0.9%, with the deeper discounts, it is highly likely that profit (and cashflow) was down much more significantly.

Second, we only have to look at what has been going on in the auto industry to get a sense that it may just be that buyers will not make many purchases unless significant discounts are given; thus, the retail sector overall maybe be the new G.M.'s and Ford's - the bigger the discounts, the more the sales but at a loss - and, where discounting has become a part of the business.

Of course, customers delaying purchases unless discounts are given or in anticipation of lower prices in the future is "deflationary psychology."

November 27, 2005 - We have written our own story for this one since we haven't seen it anywhere (yet): **"Now with Real Estate Prices Going Sideways or Drifting Lower and with Gasoline Prices Dropping Substantially, Almost All Prices are Dropping;"** So based on the title of our story we ask, **"Doesn't this indicate we are actually in deflation?"** Also, we are seeing deep discounting (prices dropping) in the retail sector overall to try to springboard the Christmas selling season. **If continued discounting for Christmas is required to unload retail inventories, we think the case is pretty clear - deflation is probably here.** We do want to point out that technically falling prices are actually the symptom of deflation, while falling money stocks is the actual deflation. As we have reviewed several times previously, this time around it will almost certainly be a contraction in credit (debt balances) from their record high levels that will deflate the money stock. Based on what we have just stated, it will likely turn out that money stocks and debt and credit (opposite sides of the same coin) started contracting somewhat before prices started dropping or at least in tandem.

October 31, 2005, TIME, **"The Broken Promise," "Public Vs. Private: Where Pensions are Golden,"** (October 31st, 2005 edition - Cover: **"The Great Retirement Ripoff - Millions of Americans Who Think They Will Retire with Benefits are in for a Nasty Surprise...."**); Wow - this maybe the ultimate **"reality recognition article."** As we pointed out in early May in our Major Trend Change Indicators Weblog, suddenly, we are seeing more and more articles that catching up to the reality of what we have been pointing out - turning from being blindly optimistic to a recognition or an admission of the current much less attractive reality - this is one of those articles. What is striking to us is that this article:

is the "COVER STORY"
is in one of the widest circulation, NON-financial magazines (TIME)
is nine full pages
and it very closely follows what we have written over the past couple of years -
- meaning it is a fair presentation of the problem - which is really shocking

While the article reports on the incredible problems in private and public pensions, we will focus our attention on the public pensions. Amazingly, the article highlights the problems very graphically including "...that public-employee pension funds in the U.S. are SHORT $700 billion..." and that "As a result, many employees in the private sector will get hit with a double whammy: while their [private pensions] erode, increasingly they will be hit with cuts in government services and forced to pay higher taxes to cover the pensions of public employees..." Importantly, the article points out that these huge public pension shortfalls exist at the state, county, city and municipal levels across the country.

Also, it goes into the problems with health-care pensions: "And everywhere, the worst is yet to come: health-care obligations. A 2004 study by Workplace Economics, Inc. found ALL 50 state-government employees offered health-care benefits for retires under the age of 65. Many who work for state or local governments may retire in their 40s [!!!] and collect a pension as well as receive subsidized healthcare." Importantly, "Governmental entities pay the bills out of current revenue [!!!!!]" and the future costs are not well known and we believe probably not at all accounted for reasonably. Also very important, is that the article points out that in 2007 "new accounting rules go into effect requiring governments to itemize health-care spending and forecast costs for coming years. The change in bookkeeping will either set off a wave of tax increases, reductions in government services or both." Also, "Lest anyone think state and local retirement-plan sponsors may emulate those in corporate America and simply walk away from the promised health-care benefits, think again. More than once, courts have ruled that health benefits promised to government workers - unlike those promised to workers in private industry - must be honored." **Thus, if that does happen, you can imagine the increase in local property and sales taxes that will be enacted - and, to us, very importantly, the coincident impact on local real estate values - down, down, down.** However, as we have noted previously with respect to the situation in the city of San Diego (see previous articles), authorities and experts think that they will get the courts to reverse the promises by having them declared "fraudulent." We expect this strategy is likely to be a tact many municipalities and cities and counties and even states will likely take to bring some sanity to these obligations. Otherwise, upholding the impossible promises will result in fleeing taxpayers, plummeting property values and decades-long financial stagnation, similar to Japan over the past 15 years but probably even worse. Oh what a mess we have created with such blatant over-promising and woefully inadequate accounting. **As we have said before, such a situation has allowed people to think the economic PIE was dramatically larger than it was and now the reality of its small**

relative size is about to be upon us - especially when it is pointed out so well in TIME MAGAZINE.

October 20, 2005, BLOOMBERG, **"U.S. Economy: Leading Indicators Fall,** Manufacturing Improves;" **"U.S. leading economic indicators fell for a third month in September [2005]..."** This is an update of a subject we reviewed in detail revolving around two articles (below) on June 21 and June 22, 2005. We recapped that it used to be that when the Conference Board's leading index (LEI) falls three months in a row that it is forecasting a recession. Unfortunately, the indicator had historically forecast several recessions that never happened. However, we noted back in June 2005 that the index had also:

> "**.........just broken a very long term trend line**. In fact, **the longest support line that has been broken on the LEI's 20 year chart has just been broken!** The support line it just broke began in early 1995 so **it HAD held up for about nine and a half years!** The next longest breaks were the four years ending Late 1994 and the four years ending January 2000! **Thus, as a very long support line has been broken, we believe this break is most likely a very significant indication of a turn down in a very large cycle.** We will have to see."

So, that was more than just more than three months down. Then in the next story we reviewed the fact that the Conference Board decided to change the index so that **the way the interest rate differential is calculated and how it would effect the LEI.** The rationale, which we go over in more detail back in June 2005, was that the world had changed and the flattening yield curve was causing the index to drop and that they thought that effect was incorrect for forecasting the economy. Of course, almost everything you have read lately has pointed out how when the yield curve has inverted, nine times out of ten the economy goes into a recession. Never the less, they changed the calculation and got rid of the downturn in the LEI at that time. **So now we have three new months of downturn in the LEI despite the new way the index is calculated. Thus, in my book, this downturn should carry even more weight.**

October 11, 2005, BLOOMGERG.COM, **"Delphi Cheif Sees GM Bankruptcy Without Wage U-Turn;"** This article is an update to the Delphi/GM situation we reviewed a couple of weeks ago. At that time, we were standing pretty much alone saying that we expect a high likelihood of GM filing for bankruptcy. However, now that Delphi filed over the past weekend we are hearing some similar opinions. Importantly, GM may be liable for $10 billion in pension liabilities from Delphi, a 1999 GM spin-off, as a result of the Delphi bankruptcy. In this article, Steve Miller, the CEO of Delphi (GM's largest parts supplier that GM spun off in 1999) says **"[GM]..will have to file for bankruptcy if it can't wrest wage and benefit concessions from the United Auto Workers union during their next contract talks." "If GM comes out of 2007 with a labor agreement that looks like what today's agreement is, they are inevitably headed toward Chapter 11."** Importantly, Mr. Miller steered auto companies, steelmakers and airlines through bankruptcies over the past two decades. Mr. Miller sounds somewhat like us in making the new/current reality a very dramatic situation -

when he "outlined what he described as a Pivotal Point for U.S. industrial society - simply a Flash Point and a Test Case" - when describing Delphi's dilemma. He makes other key points that we have made over the past few years: **"Retirement costs were manageable when workers retired at age 65 and died five years later; they're debilitating to companies when workers retire at 50 and live 40 more years."** If you read what we have been reporting, you will see many parallels between this situation and others. Delphi's and GM's cases are very similar to United Airlines. On our Deflation Watch Weblog this situation is important because it points to wealth expectations which are being deflated by the "reality recognition" that what was promised was not saved for and cannot be delivered without coming from somewhere else - i.e. the Perceived PIE has just shrunk - ugh.

October 9, 2005, BLOOMGERG.COM, **"San Diego Pension Probes Underscore Tighter Scrutiny**, WSJ says;" Another wrinkle in the pension problem - "San Diego's $1.1 billion pension fund deficit has the city down in several **PROBES** that underscore how the tighter regulatory environment is extending well beyond the corporate world..." We covered this subject of increasingly tighter regulation and its effect on the economy in depth on our **Major Trend Change Indicators** weblog; however, we did not directly link it to pension problems like those of the city of San Diego or other municipalities. The original article in the WALL STREET JOURNAL points out that the City has been the subject of inquiries by several governmental oversight agencies. We want to point out that this trend will likely continue and will likely expose a whole host of problems, not only in San Diego, but in corporate and municipal pensions country wide, unfortunately. We believe the conclusion will be that most plans got away with over-promising by under accounting for the costs in what was the present; however, the future has arrived and the funds are in most cases likely going to be insufficient. Thus, we believe a large number of future pensioners are going to see their benefits slashed from what was originally promised, or the shortfall will have to be made up somewhere - higher taxes for example. **The bottom line is that people will be coming to the REALITY RECOGNITION that the PIE has shrunk** (or that it wasn't as large as they were led to believe). A very unfortunate position for all of us to be in but one that must be recognized and dealt over the next several years. Unfortunately, we believe the realization that the PIE is, in fact, smaller than was thought will turn out to be deflationary, as people will almost certainly adjust their spending, consumption, and saving rates according to the newly recognized reality.

September 30, 2005, THE BOND BUYER, **"San Diego Eyes Chapter 9 - Mayoral Candidates Call Bankruptcy an Option;"** This article updates the situation in San Diego related to the city's finances and its pension plans that we have reviewed several times previously. There is really nothing new - both the Republican and Democratic candidates for the special election for mayor have said that they consider strongly the option of putting the City into bankruptcy to fix its problems. Importantly, this article does point out that the City does qualify for bankruptcy - "Scott Ehrlich, a professor at California Western School of Law in San Diego, who teaches bankruptcy courses, believes the City does meet the insolvency criteria." His graphic language makes the shocking point: **"Can the city afford to pay those pension benefits and operate as a**

functioning municipality? If you look at those numbers, the answer is NO....There's no way that over any reasonable time period we can repay that retirement obligation and run the city." We believe those comments, unfortunately, will be quite accurate for most government (state, county, city, municipality) pension programs; we have documented several examples in these weblog pages. We believe the focus on San Diego's problems will bring "reality recognition" to the plight of numerous other programs - ugh who will be asking the same questions Mr. Ehrlich asks.

September 29, 2005, BLOOMBERG NEWS, **"Ford to Cut half of Suppliers, Extend Others' Pacts;"** "Ford Motor Co., struggling to stem north American losses and **reduce costs**, will eliminate more than half its auto-parts suppliers and sign long-term contracts with the rest." **The key to us with respect to DEFLATION is that Ford is doing this to "reduce costs;" and if Ford's costs are going to be cut, that means prices paid to suppliers are going to go down, which means lower prices paid to them - i.e. some deflation.** The other half of the story is the question: what will happen to the 50% of Ford's suppliers that are not getting new contracts? - unfortunately, **it would probably be a prudent bet that many of those not getting new contracts will be going out of business - which goes along with our forecast of a slowing economy, both domestic and globally.** The automotive supply business has already taken hits with several bankruptcies earlier this year. Currently, as mentioned in the article, Delphi (which was spun off from G.M. years ago) is seeking $6 billion in cash from G.M. to avoid going into bankruptcy. "Delphi Chief Executive Steve Miller has said he may seek bankruptcy for U.S. operations before October 17th unless GM provides aid and the unions accept wage and benefit cuts. Unfortunately, if GM does give them the money, it will likely get downgraded again by the rating agencies and hasten its own demise - if it doesn't Delphi will file as we expect. **Also, this time deadline (October 17th) goes along with the change in the bankruptcy laws that takes effect this October that we have highlighted a few times previously.** Also note that what is going on in the automotive industry is very similar to the **"domino effect"** we have been forecasting that first hit the steel industry and is now ravaging the airline industry, as we have documented numerous times previously on our website. Basically, companies that go bankrupt cut costs and then prices causing the next domino to file bankruptcy. Recently, Delta and Northwest Airlines filed bankruptcy to the **surprise of many institutional equity investors and hedge funds.** We expect investors (including professional institutional investors) will again be taken by surprise as the automotive industry suffers a similar fate to steel and airlines, including the likely restructuring and/or probable bankruptcy of both Ford and GM, in addition to numerous automotive suppliers, unfortunately. You can imagine if Ford and GM go bankrupt, there will be quite a ripple across the economy. For now, they both have a lot of cash (tens of billions) so even if they loose billions of dollars for 2005 and 2006, bankruptcy for them would not be likely until a couple of years out from now. We believe it will turn out in retrospect that they would have served their shareholders better if they had just shut the companies down (or sold them to other car manufacturers) and dividended the cash out to shareholders as opposed to try to keep the operating - of course, that would just bring the reality of their incredibly poor financial plight to a head more quickly as the pensioners would sue if any sizable dividend were made - as would Pension Benefit Guaranty Corp.).. Keeping them operating and trying to hold on until the up-cycle comes back will most likely use up their precious cash - what a terrible situation to be in - to us, **it just shows what immense problems can develop almost unnoticed when boat loads of debt are combined with miserable pension accounting which allows for dramatically under-funded/over-promised employee benefits.** We are seeing exactly the same thing playing out in the airline industry currently and we already saw it previously in the steel industry. Also, as we have documented numerous times previously, we believe it is highly likely that besides social security and Medicare we will see similar problems and resolutions in most municipal, state, county, city, teachers, etc. retirement programs - most have had insufficient accounting and funding. Unfortunately, we believe the "domino theory" will continue to hold until most debt (promises to pay) are liquidated. Finally, as we have documented **Major Trend Change Indicators** and **Elements of Market Tops** weblogs, http://www.risk-adjusted.com/Weblogs.html, we believe REALITY RECOGNITION has arrived - that means what has been hidden or refused to be perceived will have become so obvious that it can no longer be ignored, resulting in huge changes from the up-to-now-amazingly-complacent status quo - thus, we believe huge changes in the financial markets are once again upon us, similar, if not more dramatic, than what happened during the tech bust of 2000 through 2002. We are sorry to be so negative but as Greenspan essentially said last year, "you can't repeal the laws of mathematics."

August 20, 2005, THE NEW YORK TIMES, **"Falling costs of Big-Screen TV's to Keep Falling;"** We reported on these falling prices previously but it seems that the prices are falling even faster than most experts previously expected. **"the cost of big-screen televisions, which have been steadily dropping by about 25% a year, are now expected to fall even more sharply this autumn, according to industry analysts."** "A number of factors are causing that [prices to drop] faster than anyone expected. Manufacturers in China and Taiwan, the so-called Tier 3 makers that few consumers have ever heard of like Vestel, Changhong or Xoceco, are dropping heavily discounted L.C.D. TV's into general merchandise stores like Costco and Wal-Mart or at online discounters." Thus, as we have previously pointed out, **the firms riding the disinflation wave like Costco, Wal-Mart, Dell, Southwest Air, and Home Depot are continuing to do so. "Dell is applying to TV's the low-cost supply chain and direct-to-consumer sales model that struck such envy and dread in the personal computer industry.** While others were selling 42-inch plasma screens for $7,000, it blasted into the market with one for $3,500. It can do that because it does well on margins around 16 percent." Our additional comment it that of course, **it is very likely that the Dell business model can and will be used to bring down the prices of lots of other goods.** Back to TV's: The article talks about all the competition amidst new capacity coming on line that we reviewed in detail months ago. Gary Merson, editor of the HDTV Insider newsletter comments, "**Price is being led by capacity."** We definitely agree with that - **in fact, we believe that it will turn out that overcapacity has been created in lots of other areas besides big screen T.V.'s - think automobiles! - that is an obvious one since now it is pretty much after the fact - O.K. housing - this one will almost certainly be obvious a few years from now.** The typical problem with a business cycle, especially one exacerbated by excessive extension of credit, as we have commented on numerous times previously, is the misallocation of resources (as people feel wealthier than they are) and the resulting capacity of luxury products that turns out to be excessive, leading to falling prices when reality bites.

August 19, 2005, THE INDEPENDENT, **"The great mystery: Oil prices are soaring, so why is inflation low?"** This article is similar to the one we just reviewed; however, it is from a more worldwide perspective. Importantly, we believe the credit-expansion caused bubbles and accompanying symptoms (like the world wide pension problems we have been documenting) are a world-wide phenomenon this time around. "But if you acknowledge that oil prices have just about tripled over the past year, surely the oddity is that the rise in world inflation has not been even greater. To focus on Britain, the message of that left-hand graph which shows three different measures of inflation since 1992, is surely that since 1994 inflation has been broadly flat at about 2 per cent Think about that. Right through one-and-a-half cycles, from the ejection of sterling from the ERM, the gradual building of the 1990's boom, the dot.com bust, the recent housing price boom (sounds just like the U.S. doesn't it) - what has happened to inflation? The answer is not much." To us, a point well made. We explain our answer in the next review.

August 18, 2005, LOS ANGELES TIMES, **"Costly Gasoline: Inflation Foe? - Expensive energy can make it harder to boost prices on other goods.** Some say that should make the Fed more cautious in raising rates;" This article actually adds a bit of weight at least to the case for very limited inflation and some to the case for impending (or continuing) deflation. The article asks: "How can expensive energy limit inflation?" and gives the answer: **"It can make it harder to boost prices on other goods and services. With more of their budgets going to gasoline, consumers have less to spend on other stuff. And that means sellers must think twice before raising prices - on products as diverse as T-shirts at Wal-Mart Stores, inc. and computers at Dell Inc. -** even if higher energy bills are driving up their costs." O.K. that is a good answer and probably correct. The article also raises the important point that **"...[current] energy price increases don't have the same inflationary effect as two or three decades ago,** in part because the economy is relatively less dependent on energy, and, when adjusted for inflation, energy prices are lower than two decades ago."

However, we have explained the real goings-on of this "conundrum" a few times previously: If we had real inflation like the 1970's (especially the late 1970's), prices for everything would be going up. That real inflation was caused by increases in the money supply due to the Fed printing it - This type of inflation is called **"fiat inflation."** During fiat inflation the prices of everything rise. However, the recent expansion has not been driven so much by printing money but by excessive lending - called a **"credit expansion."** At first the prices of everything pretty much rise but no where near as much as during a fiat inflation because in the back of everyone's mind is that they will have to pay the debt they are taking on back - and during a credit inflation wages don't rise enough to bail out borrowers. As borrowers reach their practical debt limits (or go far past them as in the current credit bubble), borrowing slows and begins to subside - during this time period, the rise in price of one item like oil is offset by the decline in price of another, like clothing or computers or automobiles. **When credit starts to contract**

more rapidly, you will most likely see wholesale deflation - which we believe is coming up.

Back to the article: According to Nariman Behravesh, chief global economist at Global Insight, and economic consulting firm, the upshot is **"Unlike the past when oil had a huge inflationary impact, this time its inflationary impact is very small and it may have a somewhat DEFLATIONARY impact."** Wow, note that was him using the word "deflationary" not us (in this instance). The article goes on to give several of examples of prices that have been lowered (or not raised) as an impact of rising oil prices.

July, 11, 2005, THE WALL STREET JOURNAL, **"Japan's Burst Bubble in 1980's Real Estate May Not Echo in U.S."** Another "reality recognition article" - not until the last few weeks has the media been willing to admit to any real estate bubbles or the fact that real estate can go down and now we are getting a lot of articles like this one. "As U.S. home prices shoot to unprecedented highs in many regions, the notorious property bubble in Japan presents a scary scenario. Japanese land prices soared in the late 1980s....**Now, more than a decade later [try 14 years later], average Japanese land prices are still falling and banks are only just pulling out of a land-related bad-loans crisis."** To let you know, the article is more about the parallels than the differences between Japan back at the top in the late 1980's and the U.S. now - **my bet is that the editor tweaked the title because it is still to painful and risky for major media to fully report reality.** Some of the more useful information in this article is how the decline rippled through their entire economy which "only in the last two years has APPEARED to emerge from a series of recessions" - basically it has been one long, tough recession since 1990. Importantly, "Japan's boom and bust triggered a banking crisis...." Here is why we question whether the editor watered down the headline - and we quote, **"Still, even assuming U.S. authorities avoid Japan's mistakes, a decline in wealth from a house-price crash would hurt consumption. THE EFFECTS OF THAT COULD BE WORSE IN THE U.S. because consumption accounts for a greater part of the economy than in Japan."** <=== that is the real bottom line of this article, besides the fact that Japan had a bubble, the bubble burst and real estate and the economy (and its stock market, not talked about in this article) have been going down for over 14 years - and it is finally being report realistically (almost, except for the headline).

July 9, 2005, BLOOMBERG, "Debt of U.S. consumers declined $3 bill in May;" **"Borrowing by U.S. consumers UNEXPECTEDLY fell in May by the most since December 1990..."** To us, that information could be a big story - the beginning of a credit contraction. The highlights of this largely ignored story is 1). that the contraction happened "unexpectedly" and 2). that it was the largest one month decline "since December 1990" or over 14 years. A few stories down we had the largest one day fall in the CRB in 14 years. It could be a coincidence; however, from these totally record high debt levels and with so many possible overly inflated asset class bubbles, we think it is something that should be taken to heart.

July 5, 2005, BLOOMBERG, **"Ford Matches GM, Chrysler with Employee-Discount Plan;"** To that title, unfortunately, the immediate question that comes to mind to us is **"Downward price spiral?"** Basically, Ford is going to match GM's recent purchase incentive program that gives all buyers the same discount as employees. Apparently, DaimlerChrysler had already announced they had matched GM's program beginning July 6th. GM used the program to successfully increase its sales so much so that Chrysler and Ford have decided they have to match. To us, however, the key is that it means they are yet again lowering their prices in a desperate competition for sales.

June 28, 2005, BLOOMBERG, **"Commodities Fall the Most in 14 Years**, led by oil;" **"Commodity prices plunged by the most in 14 years, led by a drop in oil, soybeans, corn and hog futures." The CRB index of 19 commodities fell by 2.2% today, the biggest one day drop since January 17, 1991. Most recently, the index had peaked on March 16, 2005 and has dropped 5.8% since then including today's record one day drop.** Interesting to us and not pointed out in the article is that the Dow Jones Industrial Average and the S&P 500 indexes also peaked in March 2005. Such a rare, large drop in an index seems to us to be important to watch going forward, especially if it is one that is so closely related to the economy.

June 27, MARKETWATCH.COM, **"Global Megabubble? You decide - Real estate is only the tip of the worldwide iceberg; or is it?"** To us, this is the ultimate **"reality recognition" article** out of large number that have shown up recently (as a possible confirming indicator). As we pointed out in early May in our Major Trend Change Indicators Weblog, suddenly, we are seeing more and more articles that catching up to the reality of what we have been pointing out - turning from being blindly optimistic to a recognition or an admission of the current much less attractive reality - this is one of those articles. It is really amazing to us - this article pretty much encompasses all of the realities we have been pointing out over the past couple of years. Most importantly, it is the first article we have read in the mainstream media (well almost mainstream) that questions whether the bubble is worldwide - **"an extraordinary global megabubble and real estate is just one of its many components."** After he hedges himself on that statement, the reporter lists 20 bubbles that he wants readers to rank from 1, least likelihood of a bubble to 5, a definite bubble about to burst and he wants readers to respond to him - it is all done somewhat jokingly (to take the sting out of it - it is difficult reporting on reality). With each of the 20 bubbles comes "clues" to help the reader score each possible bubble. I would really like to copy his entire list and the clues, they are so well done; however, I'm only going to list a few of the most interesting ones::

"1. Real Estate bubble. Clues: Speculators driving prices. Lenders offer cheap money, short-term loans. Home-equity loans fund short-term spending. Fed chairman sees minimal froth."

"2. **Energy and oil bubble**. Clues: Crude hits another record. Political turmoil in oil-producing nations. Consumers buy gas-guzzlers at record pace. GM, Ford in trouble."

"5. **Corporate pensions underfunded**. Clues: Airlines, auto, other manufacturers heavily burdened, default to taxpayers."

"6. **Local government pension deficits**. Clues: A near $400 billion mess draining local taxpayer resources."

"10. **Medicare deficit**. Clues: Going broke faster than Social Security. Prescription drug benefit added an unfunded $8.1 trillion. Long-term estimates over $36.6 trillion."

"19. **New 'Mad Money' cable show**. Clues: Frantic, manic entertainment; 1990s irrational exuberance again." [note this is the new Jim Cramer show on CNBC]

June 27, 2005, BLOOMBERG, "International Paper Profit will be below Estimates;" IP, North America's biggest paper maker, said "second quarter profit fell more than estimated by analysts **because of falling demand for paper and boxes."** Important to us is that volumes of paper and boxes produced, sold and shipped are often a leading indicator of a downturn in the business cycle. **"The price of uncoated paper used in books fell 8.1%..."** from May 6th to June 27th 2005. **"Shipments for all U.S. box makers fell 1.2% in May [2005] and 2.7% in April [2005]** compared with the same months last year, according to Fibre Box Association, and industry trade group." While some of the price decline is likely due to shifting production overseas, volumes are still down and Fitch Ratings credit analyst, Dennis Ruggles says, "The industry is taking it on the chin in both," referring to paper and boxes. Thus, like the falling price in steel in the next article, the prices and volumes of paper and boxes is definitely something to keep tabs on regarding the direction of the business cycle and prices of other goods.

June 23, 2005, BLOOMBERG, **"Chinese Steelmakers May Cut Output on Losses, Falling Prices;"** Yep, you read that correctly, "Falling Prices" - even in China. Actually, "global prices have plunged as production from China surged 38% to a record 29.7 million metric tons last month from a year earlier." **"The U.S. price of benchmark steel sheet fell to $535 per ton in May [2005], down 29% from a peak of $756 in September [2004]**, according to Purchasingdata.com, a pricing service."

June 22, 2005, THE DALLAS MORNING NEWS, "Can We Handle the Truth?" More on the Index of Leading Indicators (also see next story). Apparently, according to this article (I have been unable to confirm it yet), **"...the Conference Board announced it will tweak the LEI's calculation to account for the new world we live in - where long-term interest rates fall in the face of short-term [rate] hikes."** What is going on here, you may be wondering? Well, since the LEI has been known to occasionally falsely forecast recessions and **because "this time it is different" in that long term interest rates have declined when short term interest rates were raised and because the differential in interest rates between shorter ones and longer ones ("a smaller gap is bad for the economy")** is currently the biggest negative of the 10 indicators in the index (only one is up - stock prices) and, most importantly, because the economists apparently don't believe their own indicator (the LEI) that has been flashing big problems ahead (see discussion below) for almost a year now, the economists, or at least certain members at **the Conference Board, have decided to change the way the interest rate differential is calculated and probably its impact on the LEI.** The reporter called the Conference Board to ask if the change would "substantially alter the recent trajectory of the index and erase the current impression of a predominantly negative trend?" To which the Board's Economist differed: "What we're going to produce is a more cyclically sensitive measure, but the changes certainly aren't going to turn a negative trend into a positive one. That's asking too much." We will see.

However, because of this new wrinkle, we decided to look at the LEI again (after doing so yesterday - see next story). While looking at a long term chart, we noticed something we missed yesterday - that **the LEI has just broken a very long term trend line**. In fact, **the longest support line that has been broken on the LEI's 20 year chart has just been broken!** The support line it just broke began in early 1995 so **it HAD held up for about nine and a half years!** The next longest breaks were the four years ending Late 1994 and the four years ending January 2000! **Thus, as a very long support line has been broken, we believe this break is most likely a very significant indication of a turn down in a very large cycle.** We will have to see.

June 21, 2005, LOS ANGELES TIMES, **"Leading Indicators Decline More Than Expected;"** "A closely watched gauge of future business activity **fell more than expected** in May, indicating slower growth may lie ahead this year...." the New York-based Conference Board said of its Composite Index of Leading Indicators. We note that the **index has now fallen consistently (with one flat month) from the end of November 2004 to the end of May 2005 or for five months straight**. It used to be that 3 consecutive drops was seen as an indicator of a recession on the horizon. However, over the past few years that forecasting ability has been diminished somewhat. But, we note also that other than two up months in October and November of last year, **the index has been falling consistently since April 2004 so for over a year now (13 months) and the trend is definitely downward**. A similar article in the June 21, 2005 WALL STREET JOURNAL, "Key Indicators Dropped in May; Sign of Slowdown," notes that "j**ust one of the 10 indicators that make up the leading index showed improvement in May,** and this was stock prices." The Board's Chief Economist also points out that "**this was not just a domestic phenomenon."** He noted that six of the eight countries for which the Conference Board monitors a leading economic index had either showed declines or slower growth. Thus, that this was a "surprise;" that the trend has been downward and is continuing downward, and that it is a worldwide phenomenon all support what we have been forecasting. Now that the indicators are lined up, next we will have to see what reality itself brings.

June 20, 2005, THE ORANGE COUNTY REGISTER, **"Small-business salaries slide;" "Salaries paid by small businesses declined for the 14th straight month**, according to SurePayroll's analysis of [its] payroll data for its 15,000 customers nationwide." SurePayroll is an online payroll service. Based on SurePayroll's figures, "nationally, **the average paycheck [for small business workers] declined 2.3% in May compared with a year ago....In 2004, the average check nationwide declined 4.8%."** The President of SurePayroll commented, "Most of the new businesses we talk to are not seeing as much new business as they'd like and are **facing pricing pressure** from rivals that are keeping profits down."

June, 20, 2005, THE DALLAS MORNING NEWS, **"Other Pensions are at risk;"** This article can be used to make some very interesting and important observations. In reference to what has been going on in the airline industry sector, Robert Crandall, former head of AMR, parent of American Airlines, is quoted saying "carriers still saddled with pensions would have to shed them to remain competitive." He is basically on board with the "domino effect" we have talked about several times before - that "the runway would have to be leveled after US Airways and United Airlines jettisoned their pensions onto the Pension Benefit Guaranty Corp." BUT, this article is about "other pensions" and poses the following question: **"Will such sectorwide moves give other industries ideas?"** It basically answers the question with: YES, "...if the Bush administration's proposed pension reforms are pushed through."

The new regulations are supposed to shore up deficient pension funds by requiring larger contributions and prohibition of new benefits if a pension fund is in a deficit. Thus, **the old regulations and accounting rules have resulted in funding levels and benefit promises that do not match.** This is the first article we have seen making this very important point (in such a graphic way) that the new rules will cause an uproar as companies are required to increase payments to their pension funds rather dramatically in order to get them back to reality. **Credit Suisse First Boston Accounting Analyst, David Zion, says, based on the new, more realistic regulations, "the airline, specialty retail, office electronics, road and rail, container and packaging, and metal and mining industries would see their required pension contributions TRIPLE in 2005 vs. their current estimated contributions."** For example:

> "Delta Air Lines funding requirement would jump to $1.2 billion from $340 million
> Xerox Corp.'s bill would rise to $386 million from $114 million
> Electronic Data Systems would have to fund $531 million up from $200 million
> 51 companies would go from zero expected contributions to $50 million or more."

Mr. Zion says, "The proposed changes will **materially affect many companies' cash** flows, if pushed through. Of course, that's a big if." And we point out that many companies and industries (like the Airline Industry) have been trying to get legislation to go the other way so that they can contribute less, not more, and make it up later (they hope, how did we get in this hole in the first place?). But, we think at some point it doesn't really matter, people are starting to realize that some companies were never putting enough away and, now that the cat is out of the bag, whether they make more contributions now or promise to make them later, investors and employees are going to **discount those promises** and actions more realistically than in the past. **Unfortunately, what that means is that everyone is starting to realize there was (and is) LESS PIE TO GO AROUND THAN THEY ORIGINALLY THOUGHT and they will have to restrict consumption and increase savings.** All the inadequate regulations and accounting did was to cause people to misallocate their resources based on faulty information. Unfortunately, correcting gross misallocations that have built up over the past sixty or so years will almost certainly result in an economic slowdown.

June 20, 2005 FORBES (July 4th edition), "Entrepreneurs - Cheapskates - **With fire-sale prices and insanely low costs, Steve & Barry's University Sportswear is the fastest-growing retailer you never heard of.**" These entrepreneurs use all sorts of methods (and the trend of disinflation to deflation) to sell all sorts of goods - "**T-shirts, varsity jackets, button-down shirts, sweatpants, jeans, work boots, sneakers, backpacks, down jackets and tank tops among them - for just under $10."** One of the management duo "insists there is no secret sauce except low costs." Well, that is not entirely true, the article spends considerable time detailing how these guys use all sorts of techniques to get around international tariffs. **Barry calls himself a "tariff engineer" and "has mastered the patchwork of international agreements that make up U.S. apparel trade law." What is interesting to us is that without these tariffs prices would be even lower and not just for Steve & Barry's but across the board.**

June 20, 2005, THE WALL STREET JOURNAL, **"Steel-Sector Middlemen Caught in Meltdown;"** This article isn't primarily about dropping prices but does contain some good information. Apparently, "the price of hot-rolled steel coil, a common product, has fallen for eight consecutive months to abut $500 a tone in June [2005] on the spot market, down from a peak of more than $750 a ton in September [2004]." - **thus, a drop of 33% from the spike top eight months ago**. The culprit has been "oversupply" after "service centers and their customers participated in a steel-buying frenzy last year, creating shortages and high prices." Since then, shares of steel companies have fallen around 50% because "their inventory values are falling." "...what they try to do is get rid of inventories before prices fall. They didn't get a chance to do that." "What's worse, with weaker demand for some steel products, service centers have a harder time getting rid of inventory even when they cut their prices to match market rates." Importantly, **"shipments from metals service centers from January [2005] to April totaled 18.6 million tons, down 4.7% from a year earlier...."** And, looking forward, "the service centers surveyed reported a 3.4 month **supply of steel inventory, 28% higher than a year earlier and 10.5% higher than in March [2005]."** Obviously, this is an isolated commodity but it is very possible and even **probable that other commodities such as oil will follow the same path.**

June 18, 2005, LOS ANGELES TIMES, "**O.C. Pension Shortfall Figure Soars - Supervisors are surprised when a new study puts the problem at $1 billion greater than previous estimates -** a recheck is ordered;" Another "surprise" - the Orange County (CA) Supervisors thought their pensions were underfunded by only $1 billion - now the estimate is 2x as large - $2 billion. The system has assets of $5.5 billion (which would put the liabilities at around $7.5 billion) and currently distributes funds to about 9,000 retired county employees. I**n 2000, the pension fund was considered fully funded**, "but based on the new figures it is **now only 69.1% funded** for long-term needs **for various reasons including increased benefits."** County Treasurer, John Moorlach said it is " 'a real concern' **that could require the county and the 15,000 employees covered to boost contributions** starting in July 2006." This situation and the Treasurer's statement makes our point concerning these pension deficits - the short falls will have to be made up and that will mean less money to be spent on other things - the result will most likely be a business contraction which will be compounded by record, inflexible debt levels could result in deflation. The article does point out that part of the reason for the increased shortfall is changed assumptions on growth of investments and also on growth of benefits. We believe it is an easy bet that many pension funds across the U.S.

and even internationally (as documented previously) have erred optimistically and that as cash goes out the door reality will hit hard - ugh.

June 14, 2005, BLOOMBERG, "Bank of Japan to Keep Rates at Zero, Cash Targets Unchanged, Survey Shows;" "The BOJ will this week probably hold interest rates at almost zero and **keep pumping cash into the world's second-largest economy to overcome more than seven years of deflation**, economists said." Wow, seven years of acknowledged deflation and still continuing! That pretty much says it all with respect to whether **deflation can happen in the present**. We will soon see if it can happen over here, unfortunately.

June 8, 2005, BUSINESS WEEK, **"Sink Hole! - How Public Pension Promises are Draining State and City Budgets;"** Wow - almost as we would have written it. As we pointed out in early May in our Major Trend Change Indicators Weblog, suddenly, we are seeing more and more articles that catching up to the reality of what we have been pointing out - turning from being blindly optimistic to a recognition or an admission of the current much less attractive reality - this is one of those articles. This is a huge article that pretty much encompasses everything we have been saying on the subject over the past few years so we are not going to rehash that much of it. Besides it being a very good summary of the problem, our interest is that it is glaringly pointing out the reality of problem - that is the important point - **the press is finally realizing or admitting the reality of these huge problems - next will be the public and then we will be at a recognition point** whereby the mass will act together - unfortunately, there are no easy solutions (as the article points out). First, they will try to raise taxes and cut services. Then, they will cut benefits to new employees but not those of old employees. Importantly, the article points out that "Most state constitutions guarantee pension promises, so once a benefit is on the books, It's permanent. There's no history of default, and may think even a municipal bankruptcy would not erase these debts." We will see; however, if these debts are not liquidated, those who don't will likely end up in a very extended quagmire similar to the 15 year recession/depression Japan has been in and that has not even ended yet! **The fact that Business Week is talking about Bankruptcy as a solution is remarkable to us, all by itself. We believe, that as everyone comes to a recognition point of the reality of the severity and scope of these types of problems, they will realize the prices of risky assets are grossly overvalued and the prices of risky assets will plummet.** Everyone will have to cut back their expenditure, which is going to be deflationary.

May 12, 2005, THE NEW YORK TIMES, **"Hedge Fund Rumors Rattle Markets;"** Uh Oh. Before we go into the article and recent events, lets review a little history on derivatives.

1.)My first experience with derivatives was in the middle 1980's when Savings and Loan's were being sold **"risk-controlled arbitrage"** programs where they would buy mortgaged backed securities and leverage them up by borrowing against them and using the proceeds to buy even more mortgaged backed securities. To "control the risk" they would then purchase futures contracts. Unfortunately, the "hedge ratio's" failed when

interest rates dropped more than expected in **early 1987** and prepayments sped up more than expected. This situation bankrupted quite a few S&L's.
2.) Fast forward to **1994** - that is when derivatives like **Inverse Floaters and I.O.'s and P.O.'s** blew up - this time mortgage prepayments slowed down more than expected as interest rates rose. This situation was the principal cause of the bankruptcy of Orange County, California.
3). Next to **1998** - the **"Russian Crisis"** hit in the middle of the year - at that time the yield spreads between junk bond yields and U.S. Treasury yields were at a record tightness (almost matched recently, in late 2004, but now widening out!). At that time, junk bonds got hammered (spreads widened out) and the "rocket scientists" at **Long Term Capital** found that their "sophisticated" models that had worked reasonably well on Treasuries and other high grade bonds levered up to the moon failed to take into account the lack of liquidity in the junk bond market which had been sent reeling.

Now, here we are with an amount of leverage, junk debt issuance, derivatives and hedge funds at record levels completely dwarfing levels at the beginning of the three prior meltdowns. Back to the article: **"Long-simmering worries about the growing influence of hedge funds erupted yesterday in a wave of nervous selling on world stock markets after talk that hedge funds had suffered large losses tied to the debt of General Motors. Shares of banks with connections to hedge funds fell sharply, even though the rumors could not be substantiated."** O.K., that is pretty much the gist of the article (and other similar articles). It is just a rumor at this point. The concern is that hedge funds were caught "mishedged" with large losses related to the price drop of GM bonds and surprise rise in the price of GM stock (from Kirk Kerkorian's surprise tender) and to downgrade of GM and Ford bonds and that, because of all the leverage and linkages, a "ripple" could cause problems across the board, especially at banks who could have exposure to such risks and to hedge funds. We will see if a problem has happened or will develop. If it does, it will most likely precipitate some sort of credit contraction which will be deflationary and will drive the prices of risky assets downward in price.

May 12, 2005, BLOOMBERG, **"Italy Enters Second Recession in Two Years;"** "Italy's economy, Europe's fourth-biggest, **UNEXPECTEDLY fell into recession** for the second time in two years as industrial production slumped and consumers failed to respond to 6 billion euros (7.7 billion in U.S. dollars) in tax cuts." This is more information about the worldwide global slowdown that we are concerned about - our view is that other countries around the world are somewhat ahead of the U.S. (**see below for similarities in Japan, England, Switzerland, Germany, etc. where "UNEXPECTEDLY" and "SURPRISED" seem to be the "key words"**). Back to Italy: "Gross domestic product shrank 0.5 percent in the first quarter, **the steepest drop in six years**, after a contraction of 0.4 percent in the previous three months..." We believe sooner or later financial mishaps related to "unexpected" events will most likely ripple over here to the United States. Unfortunately, financial mishaps in conjunction with record high levels of debt/credit and derivatives are highly likely to result in a credit contraction which would most likely be deflationary. Thus, we believe it very very prudent at this juncture to avoid riskier asset classes.

May, 10, 2005, BLOOMBERG, **"U.K. April Retail Sales [fall by most in 10 years];"** More on Britain's recent and worsening problems. Remember Britain is Europe's second largest economy. We believe the we are in a global topping process with most countries around the world being somewhat ahead of the U.S. (see numerous statistics and analysis, below, about what is happening around the globe). Back to this subject: **"U.K. retailers said sales fell last month by the most in at least a decade...the biggest decline since comparable figures began in 1995."** "Domestic demand is clearly slowing a lot quicker than was anticipated even a month ago." "The Confederation of British Industry said on May 3 its own gauge of retail sales in April [2005] recorded **the steepest drop since July 1992,** when Britain emerged from its last recession." "'Clothing demand worsened markedly in the month and footwear sales fell sharply across the board,' said the BRC, which represents 80 percent of the U.K. retailers..." **"Consumer spending, underpinned by rising home values, has so far fueled growth in the U.K." - hmmm, sounds a lot like the situation in the U.S. to us - unfortunately, we believe that our situation is not that far behind theirs.**

May 8, 2005, GUARDIAN, **"Personal Bankruptcy Hits Record - 28% annual rise pushes insolvencies to a fifth higher than 1990's peak;"** Ok, don't get too excited - this article is in reference to England; however, we believe we are in a worldwide global topping process with other countries in similar situations to the United States but somewhat further along the curve; thus, we still believe the information in this article is both startling and telling:

"The number of people going bankrupt reached record levels in the [2005] first quarter."

"...the recent rises in interest rates have led to a growing number of individual bankruptcies."

"The insolvency figures follow the publication last week of record numbers of mortgage repossessions."

"Personal bankruptcies are now more than a fifth higher that during their peak in the early 1990's, when the [British] economy was emerging from recession....Economists warn that there is worse to come."

"We estimate **households are paying the equivalent of 21% of disposable income on interest and debt repayments, the highest since 1990."**

"...in the early 1990's, **bankruptcies continued to rise for a full three years after debt servicing costs hit their peak..."**

"The rise in bankruptcies seems to support our analysis that **households' high level of indebtedness has made them more sensitive than in the past to small changes in in interest rates."**

"Economists were also concerned about the high level of bankruptcies, despite employment being at record levels Only a third of those declaring bankruptcy were unemployed, suggesting that even those with a regular income are running into difficulties."

Wow, those are some shocking quotes; importantly, we believe it is fairly easy to see that those same quotes and analysis could easily apply to the conditions in the United States even in the very near term future - unfortunately, we expect that this is most likely case - we will see.

April 25, 2005, BLOOMBERG.COM, **"Japan's Household Spending Falls; Economy Sheds Jobs;"** Here is an update (from our review last month - see below) on Japan. Unfortunately, "Japan's household spending fell for a second month in March and the economy lost jobs..." We are reviewing what is happening abroad because we believe we are in a global topping process with foreign countries a bit ahead of the curve as compared to the United States. This article has lots of very interesting and useful statistics about Japan, the world's second largest economy:

Spending by households...slid 1.1% from February
The Japanese economy shed 270,000 jobs
Industrial production dropped 2.3% in February and has declined for four of the past six months
Overtime hours at manufacturers have also fallen for four of six months
Consumer prices fell in March, marking the 7th year of deflation in Japan
"Women's, men's and children's clothing simply isn't selling."
Wages have risen in 3 of 4 months through February, after sliding on an annual basis for nine years.

Remember this is the world's second largest economy. Recently there have been negative surprises in Japan, Germany, Italy and Switzerland (see below). We will have to see if these worldwide economic problems spread to the U.S.

April, 24, 2005, THE NEWS TRIBUNE.COM, **"States try to fill $260 billion gap in public pensions;"** This is an update of the problem that State pension funds are having with respect to future and now almost current promises being grossly underfunded. **According to this article, the $260 billion in underfunding is with respect to 5.1 million retired teachers, judges, law enforcement and other public employees now relying on public pensions, with another 15 million workers expecting benefits when they retire.** We believe the similarity of this underfunding problem to what is going on with Social Security and Medicare, and with Corporate Pensions and City and County and Municipal pensions, is not a coincidence. In fact, we have discussed all of those problems in these web-pages. In addition, we have discussed similar problems in Italy, Spain, France, and Germany. **It seems to be a global phenomenon and maybe a result of human frailty - over promising what is just an accounting entry at the time for a benefit far out in the future - unfortunately, the future is arriving quickly.** This article contains many informative statistics:

45 of the 50 States have pension fund deficits
In 13 states, the unfunded liabilities exceed their annual revenue budgets
For half of the States, pension shortfalls top $3 billion each
West Virginia's oldest pension plan is the worst off, owing $3.50 in benefits for each dollar it has on hand

The equity rebound of 2003-2004 has helped a bit, according to Wilshire Associates, who found that the 64 plans it tracks had 83 cents on the dollar for every dollar owed for 2004, up from 77 cents on the dollar for 2003.

The article then goes over strategies States are reviewing to address these shortfalls:

Rhode Island's governor has proposed a minimum retirement age of 60 and would require state employees to work two years longer for a minimum of 30 years before they could receive pensions.

The Governor of Illinois' proposals include a later retirement age and shrinking annual cost-of-living adjustments.

New Mexico's Legislature passed a measure requiring increases in employer and employee contributions. However, the move is expected to raise $130 million in contributions over the next seven years, compared to a $2.4 billion pension deficit.

Oklahoma has $6 billion in pension liabilities and has earmarked a 5% portion of the states new lottery approved by votes in November which will raise an estimated $3.1 million.

You can see that so far, these proposals will make minimal dents in the deficits. **Over time the mathematics will force changes.** Unfortunately, the way we see it, either benefits will be reduced or costs of the participants will be raised - it is fairly simple mathematics. We believe either and both of the alternatives are deflationary, unfortunately. Another popular stopgap measure that has been used is to issue **Pension Deficit bonds** which merely push the problem into the future, giving the possibility that investment returns will be more than the cost of that funding with the incremental benefit bailing out the plan. However, as one person was quoted in the article, **"It's a little bit like using a credit card to pay your mortgage."** Another strategy is to change from defined benefit plans to 401k-style plans. However, we believe that will still be deflationary because those individuals will end up having to save more and spend less. **To us, the bottom line is that everyone thought they were going to get more than they most likely are going to get. That, in part, led them to overspend and over-consume. In the future, peoples' savings rates are likely to increase as much as their consumption decreases.**

April 11, 2005, BLOOMBERG.COM, "Singapore GDP Falls Annual 5.8%, More Than Expected;" "**Singapore's economy shrank at an annual 5.8% pace in the first quarter [of 2005], more than expected**, as makers of electronics and pharmaceuticals cut production." We are beginning to see a string of unexpected economic downturns - **see our review of the negative surprises recently in Germany, Italy, Japan, and Switzerland that we have outlined below** and note that these represent essentially the strongest economies of the world other than the United States and China. Continuing with Singapore, the decline in gross domestic product was "the first in almost two years." Again, we are reviewing what is happening abroad because we believe we are in a global topping process with foreign countries somewhat ahead of the curve as compared to the United States - time will tell.

April 7, 2005, THE WALL STREET JOURNAL, **"GM is Pushing Its U.S. Suppliers To Reduce Prices;"** The title pretty much says it. GM needs to reduce costs to compete and is pushing its suppliers to reduce their prices - sounds deflationary to us.

April, 2, 2005, BLOOMBERG, "Japan's Bonds Rise for Fourth Week on **Signs of Slowing Economy;"** The information in this article is the kind we like to use. It is written to highlight the fall in interest rates in Japan that it says is because of the weakening economy - however, we are going to use the information on Japan's economy directly. We include articles on other nations such as Japan, the world's second largest economy, because we believe we are in a global topping process where what is going on in the United States is lagging the rest of the world. Statistics in the article are: "The central bank's Tankan index on **business confidence UNEXPECTEDLY fell** to the lowest in a year yesterday." **"Industrial production fell 2.1% in February**; the biggest drop in a year...**The Unemployment rate rose to 4.7%** and **spending by households declined 4.1%** in February from the previous month, other government reports showed..." We will see if these types of surprises start appearing in the United States shortly.

April, 3, 2005, BALTIMORESUN.COM, **"Car buyers wait for better deals - Dealers watch sales skid as public accustomed to zero-percent rates and other discounts balks at the prospect of paying anything close to full price;"** This article summarizes many points we have made over the past couple of years with respect to deflation and deflationary psychology (although it doesn't label it as such). The first few sentences get right at the issue: "**Bargain-conscious shoppers snubbed their noses at Wal-Mart Stores, Inc. when it tried to back away from its low-price promise.....Department stores also had to rethink their strategy when sales lagged as consumers waited for better deals. Now, the car industry is feeling the pains of a consumer public that has gotten so used to discount shopping that it often won't buy at regular price."** The rest of the article covers it in more detail with some select information. "Nationwide, sales of new cars and trucks dropped 2% in February after a 1% drop in January [2005]." "There is a concern that people are waiting for the next deal." "Many customers won't buy unless there is an incentive attached." "It is likely they will have too many models sitting on dealers' lots, and the only way to improve them is with higher incentives..." Thus, **the psychology of deflation whereby buyers postpone purchasing in anticipation of prices dropping in fairly well documented in this article.**

April, 1, 2005, GUARDIAN, **"No 'feel good' factor as house prices suffer worst fall in 10 years;"** This article is about the real estate market in Britain. We are including information and analysis on what is going on abroad because we believe we are in a global topping process with most other countries' experience somewhat ahead of what is happening here in the United States. This quote pretty much sums up the article: "Britain's biggest building society reported the sharpest fall in house prices for 10 years." "....seasonally adjusted prices tumbling by 0.6% last month [so March 2005]." While that drop doesn't really seem that large given the prices increases over the past couple of years, it is the largest one month drop since 1995 and we believe it understates the move (compared to a price rise) because people generally hold back transacting when prices are dropping. Also, it could be an indication of increase in the speed of prices dropping. **Only time will tell if that is an acceleration of a downward trend in Britain and if it is an accurate indication of what to expect here in the U.S.**

March 30, 2005, THE BEAUFORT GAZETTE, **"Many Buyers 'upside down' on Car Loans;"** This article provides interesting information we can use to make a few relevant points. Basically, **"more than a quarter of buyers [of new cars] are upside down when they come in and the average is nearly $3,800 [underwater]..."** Thus, these car owners owe considerably more on their auto loan than the car it finances is worth. The article points out that this situation is caused: 1). because "prices of new cars and trucks have been held down as manufacturers **offer incentives and rebates to lure purchasers**" (we believe this is an indicator of deflation all by itself - but we have reviewed that several times previously, 2). "As new car prices flatten so do resale [i.e. used car] values" (ditto), 3). **"Buyers, meanwhile, are choosing increasingly longer-term loans, sometimes extended over 84 months [that is seven years!!] , to reduce payments"** (more gas on the fire). Ok, an additional point we would like to make is that **without the low cost financing, including subsidized rates and extended loan terms, many people would not be able to purchase autos at even the current prices, and prices would have to fall - i.e. deflation. Thus, as interest rates rise prices of debt financed assets should, unfortunately for the sellers, drop**. Also, more and more auto owners being "upside down" or "underwater," means fewer and fewer can sell their old car and purchase a new one. A final quote: "In the late 1970s and early 1980s, most loans were for 36 months.....Now, the average term is about 58 months [almost five years], and some lenders go as long as 72 months or 84 months [7 years!]."

March 27, 2005, NEW YORK POST, "**Greenspan's Wake-Up Call Rings Bell**;" This article makes several good points, many of which have been made recently elsewhere, but this article puts it together concisely. Talking about Greenspan's recent concern about inflation and the need to raise interest rates, the reporter says, "But there is more, I suspect to Wall Street's sudden interest rate phobia. **It's the realization that even a 2.75% federal funds rate is starting to hurt an economy that is leveraged to the hilt and addicted to cheap money**." Wow - sounds like a lot of what I have been writing here over the past few years. "For a vision of Wall Street's worst nightmare, look no farther than GM (We have been calling it the 'perfect storm')." **She points out that GM has had to scrap its zero percent financing program "even as its auto sales were in a near free-fall."** Also, that GM has been "zapped by higher gasoline prices and soaring healthcare costs (i.e. pensions)..." and that those and "higher interest rates are squeezing the company from all sides." **She highlights an astounding fact that GM, with $300 billion in debt, is the only company with more IOUs outstanding than Fannie Mae.** Continuing, she points out that a large number of major companies do not make much money on their products but, like GM, make their money on the financing - thus, "GM is now a bank that just happens to sell autos - a huge finance company on wheels." **"In fact, 30% of all U.S. corporate profits now come from finance, up from 19% in**

1994, the last time Greenspan embarked on an aggressive rate-rising campaign." Wow!!! Thus, she reasons, **this is why the economy is susceptible to rising rates even at such low levels.** However, she concludes by talking about the "irony [that] would not be lost on many if the man who succeeded Paul Volcker as Fed Chairman left that position with inflationary pressures smoldering once again - Thus, **we believe the conclusion doesn't really jive with the excellent analysis. To us, we believe that this all comes together as rising rates applied on record debt levels causing the economy to tumble badly and for deflation to raise its ugly head, not inflation.**

March 27, 2005, SAN DIEGO UNION TRIBUNE (Associated Press), "Inflation is coming, **but is the economy strong enough**?" (by Michael J. Martinez) This article asks several questions (including the title) that are phrased in interesting ways. First, the article sets the stage by highlighting, "**trading in federal funds futures suggest that investors are betting that central bankers may follow [the rate increase of the other day] with a half point hike in either May or June [2005]**." Thus, the futures market is saying there will be another 50 basis point rise in short term interest rates. Then, an interesting question the reporter asks is, "Will consumers be able to handle higher prices now that **parts** of corporate America **appear** to **finally** be **gaining pricing power**?" Certain words in this question are very interesting - PARTS, APPEAR, FINALLY. The question implies that there has been no pricing power **until now** - that **only parts** of the economy are now getting pricing power, and that they are **finally getting it**. Thus, we believe this particular reporter must be much smarter and more knowledgeable than the average bear (no pun intended) and **he basically implies that there hasn't been any inflation and that there might appear to be some in some parts of the economy finally**. Then his next question ties to the first to make the same implication that his title makes is: "And will companies be able to continue expanding as the cost of raising capital rises?" In other words, will rising interest rates choke off any recovery and any rising prices. The manner in which he phrases his words leads us to believe he is one of the few who believe the economy is really already in the tank and that inflation worries "appear" (to use his word) to be unfounded. The rest of the article talks about data to come out in the next couple of weeks which should affect the outcomes.

March 24, 2005, REUTERS, "**If G.M. cut to Junk, Merrill [Lynch] sees Asset Sales;**" "The huge debt of General Motors Corp. and its finance arm will likely slide to junk status this year, forcing asset sales and a cut in GM's dividends, Merrill Lynch said on Thursday." "The downgrade of a combined $200 billion in unsecured debt to junk territory would be unprecedented in capital markets, and investors should expect a bumpy ride, Merrill said in a report." We believe that is somewhat of a understatement. The report goes on "we find little reason to believe this erosion of [G.M.'s] fundamentals is reversible." S&P has warned that the Company's ratings could be cut to junk at any time. The article keeps going. We want to make a few points. One is that the pension problems of G.M. (and numerous other companies), that we have documented several times over the years, are now starting to take their toll as **what was previously only accounting entries has be come "cash out the door."** As we have mentioned several times previously, **this is very similar to what happened in the steel industry and is happening in the airline industry.** Importantly, **G.M. "now has about 2.4 retirees for**

every active employee in North America, making pensions and retiree health care an 'immense burden', Merrill said." Given that handicap it is a miracle that they can compete at all. Second, the amount of G.M. debt that will most certainly be downgraded ($200 billion) will flood the below-investment-grade (junk) bond market. **Thus, not only will G.M.'s cost of borrowing go up, the situation of increasing demand for junk financing will push up the cost of borrowing for all lower quality (risky) borrowers.** Thus, credit quality spreads (the difference in yield between the cost for high quality borrowers and junk borrowers) will widen out. (**We do not think the increase in those interest costs can be pushed along to consumers, considering consumers are already loaded to the gills with newly purchased assets and the accompanying record high debt that has financed those purchases**.) Unfortunately, for G.M. and other weak borrowers, this credit quality yield spread widening can be somewhat of a spiral - becoming a lower quality borrower increases the cost of borrowing which lowers their quality more which raises the cost of borrowing. Thus, the Merrill Lynch analyst points out that "yields on GMAC bonds are already so high that issuing unsecured debt is likely to be prohibitively expensive." If they run out of assets to borrow against, "GMAC could meet funding needs through mid-2006 with cash or assets sales...." You can see that the future is bleak unless the demand for autos steps up for some reason. However, **we believe this is another example of the change from credit expansion to credit contraction which will, unfortunately, wreak havoc and is resulting in deflation.**

March 24, 2005, INTERNATIONAL HERALD TRIBUNE, **"Italy Facing Economic Slowdown;"** To us, another possible domino in the direction of a worldwide recession (See articles below on Switzerland, Germany and Japan which all had "unexpected" negative growth recently). "Domenico Siniscalo, [Italy's] Finance Minister, cut his forecast for Europe's fourth-largest economy to 1.5% from 2.1% after the government said Thursday **the [Italian] economy shrank more than previously forecast in the fourth quarter [of 2004]." Thus, similar to Switzerland, Germany and Japan, Italy's economy got weaker UNEXPECTEDLY.** "The downward quarterly revision of Italy's fourth-quarter gross domestic product, to a **contraction** of 0.4% from 0.3%, was led by a sharp decline in Italian exports." An economist quoted in the article gave a more precise possible explanation: **"Italian companies have aggressively relocated production to low-labour-cost countries, and especially to some Eastern European countries, in an attempt to regain price competitiveness**....By now, this seems to be a large enough phenomenon to have a significant impact on GDP." **Thus, if his explanation is correct, it sounds like they are trying to deal with declining prices by lowering costs by moving production to lower cost countries - that sure sounds like deflation to us and it likely to be hitting all the developed nations including the U.S.**

March 14, 2005, THE CHRISTIAN SCIENCE MONITOR, **"Why Commodities Make Sense NOW;"** Ok, I emphasized the "Now" in the title. That title, especially with the "now" is amazing to me. **"Now"- after a huge move has already taken place -** talk about coming to the table very late (this article being published with this title is probably going to prove to be a near-pin-point indicator of the top in commodity prices). A move that we believe is unsustainable, as we have documented throughout this and other of our web-pages. Here is our short version: Commodities are up on the fear or the anticipation of inflation - there currently is not any inflation, overall. Retail demand is dismal and getting worse (look at the discounts on the terrific new automobiles - the discounts are huge because they can't sell these marvelous cars). Inventories are at record levels (on average) and are still building. Now with the new Bankruptcy Bill and for numerous other reasons (many of which we have documented), credit is going to contract (although many of those are symptom to us, not the cause) and people are at record debt levels so if they can't borrow, they can't buy. **The bottom line is that we believe that when manufactures realize that the huge consumption binge is over, they will not be purchasing many commodities on the anticipation of inflation - actually, the opposite, they will be cutting back orders even as commodity prices are plummeting.** Again, we think the timing of this article given its incredible title will prove to be very prescient in predicting the top in commodity prices.

March 11, 2005, AOL NEWS, **"Senate Approves Bankruptcy Overhaul - Bill Makes it Harder to Shed Bad Debts;"** Based on that title, it is easy for us to stretch to an expectation that this new law will result in less borrowing - which is the opposite of an expansion. **It almost certainly means less people will borrow to spend - causing prices to drop - a classic credit contraction.** Also, as we explained below, **it marks a change in psychology from the bull market "no problem" attitude to now pressing concern that more and more bankruptcies are going to happen.** This change in cycle could be a kind of self-fulfilling prophecy or spiral - with the new direction keying off the change in psychology.

March 10, 2005, BUSINESS WEEK (March 21st edition), **"States Have Pension Woes, Too;"** Ugh - more on pension deficits. "As of December 31, [2004,] Wilshire [Associates] says the **109 state pension plans it tracks were $375.6 billion underfunded with 94% of them in the red. By contrast, the 331 companies in the S&P 500 that offer traditional defined-benefit pensions owed $123 billion** more to current employees and retirees than their plans had in assets. The largest state gap is with the State of Illinois, which as a $35 billion gap and owes another $2.1 billion to meet minimum 2005 funding requirements. Not mentioned in the article is that many of these government-sponsored pension plans have been issuing municipal bonds to fund their current year funding shortfalls, thus, pushing their problems out in the future at possibly even higher costs. I guess the point here (and I have not seen it in print before) is that the State Government-sponsored pension plan problems are much larger than those of large corporations. We believe this problem is long term deflationary because it is, unfortunately, most likely that future benefits will have to be downsized or deflated (as we have documented several times is already happening in several foreign countries), resulting in a feeling of a loss of wealth which will reduce consumption and likely be contractionary.

March 8, 2005, SMART MONEY.COM, "Where Are the Small-Business Jobs?" **"Hiring and raises among small businesses have stalled during the first two months of 2005,** says,...SurePayroll, a Skokie, ILL.-based firm that keeps payroll records for about 15,000 small businesses around the country." Importantly, "The lackluster results come after **a 4.8% reduction in compensation in 2004** - despite a 4.4% increase in hiring, according to SurePayroll." **"SurePayroll predicts a 3% decline in average paycheck size among small businesses in 2005."** Thus, this topic of this article and declining wages, unfortunately, plays along with current and future reductions in prices of goods and services that we are forecasting and documenting..

March 7, 2005, REUTERS, **"'Don't You Raise Those Prices' U.S. Consumers Say;"** This sentence give you the idea, "**Businesses' lack of pricing power** has kept inflation under wraps in America despite robust 4.4 percent growth last year." Importantly, **"subdued [retail] prices are also squeezing [company] profits..."** because while they are paying more for raw materials and oil, they have **an "inability to pass on the hit to American Consumers."** The article goes on to point out that many companies are dealing with their inability to pass along higher commodity costs by being more efficient including reducing jobs. That is where the article stops. We would like to add that if more and more employees are laid off to cut costs that could cause consumers to be able to pay less and less - thus, **the spiral of credit creation turns into a spiral of credit contraction** - that is the risk. If that happens, sooner or later (and maybe very soon) demand for commodities will drop (and so will their prices) as manufacturers realize they aren't going to be able to sell their products at higher price levels (think Ford and GM or the airlines).

March 6, 2005, MSNBC.COM, **"Credit Card Penalties, Fees Bury Debtors;"** This article is related to the coming Bankruptcy bill that will likely pass. But first, it covers what it calls the "cycle of debt" whereby "penalty fees and sharply higher interest rates after a payment is late - compound the problems of many financially strapped consumers, sometimes making it impossible to them to dig their way out of debt and pushing them into bankruptcy." And the article gives several examples. Unfortunately for the borrower, the penalty fees and penalty interest rates make those are often so large borrowers often cannot catch up and their debt balance grows to higher and higher levels. Even if a person makes their minimum monthly payments, they will find themselves - **lets see, how did that old song go, "one day older and deeper in debt - I owe my soul to the company store."** Of course, we agree that these people almost certainly shouldn't be borrowing. However, at the same time, these credit card companies probably shouldn't lend to these borrowers. But now they are going to change the rules of the game - in mid stream. The new bill may prevent excessive fees from being charged but it is also most likely going to make it more difficult to file for bankruptcy and to require many of those going bankrupt to continue to make payments if they are able to. The reason we are including this article is because **it shows a change in psychology** - creditors are now more afraid they are going to be paid back by fewer and fewer borrowers. **We say that during the bull market few, including lenders, were concerned about people borrowing above their means or filing for bankruptcy - now it has become a major concern. We believe that change in this psychology and the likely consequences are deflationary.**

March 4, 2005, THE INTERNATIONAL HERALD TRIBUNE, **"Swiss Economy Stumbles in Quarter;"** To us, another possible domino in the direction of a worldwide recession. (See articles on Germany and Japan below). "**Switzerland's economy**

contracted in the fourth quarter for the first time in nearly two years as high oil prices and a tepid economic recovery in the 12-nation euro zone damped demand for Swiss exports, the government said Thursday." Importantly, Switzerland's economy has been "long viewed as one of the world's most stable..." "...the latest drop signaled that Europe's economic weakness was beginning to spill over to Switzerland, which relies on European Union nations to buy two-thirds of the goods it sells overseas." **"The fragility of the economic recovery in the euro zone is the major risk to Swiss economic growth."** We believe **that could be the case with the U.S. economy also. Similarly to Germany and Japan (see articles below), "Nobody expected a minus sign in front of the fourth-quarter number" - it was another "surprise."**

March 1, 2005, FINANCIAL TIMES.COM, **"German Unemployment at its highest since 1930s;"** and, THE INDPENDENT, "What Happened to the German Economy?" These are two interesting articles. We have included what is happening abroad because we believe we are in a global topping process including global deflation. The first article points out "German **unemployment shot up to 5.2% last month, its highest level in 73 years, dragging Europe's largest economy deeper into its most serious political crises** in months." Further, it comments, "The country's stubbornly weak economic growth, the failure of companies to hire and invest despite healthy profits and competitiveness gains, and consumers' reluctance to spend has left economists perplexed." - sounds like the U.S. The second article goes more deeply into causes. First, **it reminds us that Germany and Japan were the world's economic powerhouses of the 1980's.** Then, it talks about several of the problems we are experiencing in the U.S. but in regards to how they are negatively affecting Germany - high non-wage labor costs acting as a tax on jobs, recent increases in capital mobility resulting in investment by German companies outside of Germany, outsourcing effects (positive and negative) and export success, etc. Importantly, the article mentioned that **"in the final quarter of 2004, the German economy unexpectedly contracted." - this is huge to us because the same surprise just happened in Japan - see our next article. Our opinion is that it could be that the world is just a few months away from slipping into a global deflationary recession.**

February 15, 2004, BLOOMBERG.COM, **"Japan Falls Into Recession as 4th-Qtr GDP Shrinks:"** The first sentence gives the gist of this recent surprise: "**Japan's gross domestic product UNEXPECTEDLY shrank** in the three months ended Dec. 31, [2004], **throwing the world's second-largest economy into a recession."** The largest recent negative seems to be a drop in consumer spending. The article also makes several somewhat shocking points about Japan's situation over the long run:

Japan's economy shrank at an annual 0.5% pace in the 4th quarter of 2004
Japan's economy shrank in the two previous quarters, just-revised figures show
Japan has endured **"...more than six years of falling prices"**
Wages in Japan have "...fallen for 43 of the past 46 months"
Japan's full-time labor force has "...contracted for the seventh straight year"

Wow, those are some shocking figures. Remember that back in the late 1980's it looked like Japan was going to buy up the entire world. **What happened to Japan shows just how quickly and dramatically fortunes can change and how long it can take to work misallocations of resources out of a financial/monetary system - especially if high debt financing levels have been incurred.**

February 7, 2005, THE WALL STREET JOURNAL, **"Sluggish Sales of SUV's Prompt Financing Deals:"** Here we go again - just like in 2004. "The Big Three auto makers are firing up a new round of financing deals on sport-utility vehicles after sluggish January sales left dealers with unusually high inventories." We point out that the industry was already at record inventory levels late last year. Anyway, the new financing alternatives for the 2005 models is shaping up very similarly to that for the 2004 models - 0% interest for 60 months! - however, we point out that 0% financing is worth more now than last year because short and intermediate interest rates are higher (so the discount is worth more). The article gives us some ammunition pointing to **what we call the psychology of deflation** - "Detroit's problem is that consumers have come to expect big discounts on most domestic brand models, Bob Schnorbus, chief economist at J.D. Power & Associates, said, **consumers now expect incentives to grow each year."**

January 31, 2005 BUSINESS WEEK (February 7, 2005 edition), **"Signs that Inflation is Losing its Fangs;"** Wow - Now it appears that everyone else is going to admit to disinflation. That is what this article is about. The article makes several points as to why disinflation (or even deflation) is likely now saying, "…the inflation process in the U.S. has changed dramatically in the last decade." Of course, you know we agree and have been documenting it ourselves for years. Major points include: "intense global competition continues to limit pricing power even amid a weaker dollar and rising production costs;" "the technology-fueled speedup in the long-term growth rate of productivity means the labor-input cost of producing a unit of output now grows more slowly at any given rate of growth in wages and benefits (in other words, compensation growth will continue to stagnate);" and "the information revolution is having one other, often overlooked (not by SCI) effect: It has empowered buyers by giving them more knowledge of products and markets, taking away some of the pricing edge that sellers used to hold." Of course, we have covered all of them previously. The importance of this article to us is that the major financial media are finally coming out of the denial of disinflation. A couple of gems of statistical data from the article are: "prices of core consumer goods actually fell 2.5% in 2003, **something that hadn't happened since the great depression.** A bounce back was inevitable in 2004, but, even so, core goods inflation in 2004 rallied to just 0.6%."

A point that the article doesn't make is that if the U.S. dollar were to rebound as we expect it will, that will cause the prices of imported goods to drop even faster! And we believe the U.S. dollar rebound began in late 2004 and will chop upward for most of 2005. So that scenario plays right into the change from disinflation to deflation just as the major financial press is willing to admit to disinflation. We are comfortable with these scenarios since we are typically a bit too early in anticipating cyclic changes – however, **it is usually better to be early rather than late.**

January 13, 2005, BUSINESS WEEK ONLINE, "Apple's Down-market Gamble - **By Launching a much Cheaper Mac and iPod, Steve Jobs is appealing to hordes of price-conscious consumers**. The risk: Cannibalization;" The article's title pretty much tells it. To us, we are thinking that Steve Jobs and Apple are joining the disinflation/deflation wave that Southwest Air, Home Depot, Wal-mart, Cost Co. and Dell Computer have been riding. Highlights of the article are the $499 price for the new Mac Mini and lots of discussion about cannibalization of its higher priced lines by these new cheaper versions. We believe they are being smart to offer lower priced products because the prices of their competitors are dropping monthly - just take a look at any advertisement from Fry's or Office Depot or Office Max, etc. - prices are dropping every month.

January 10, 2005, THE NEW YORK TIMES, "Cheap Seats Provide View of Troubles at Exchange;" "**On January 5th [2005], a seat on the [New York Stock Exchange] sold for $1 million, Down 63% from its peak in 1999 and the lowest sale price since 1995.**" That sentence pretty much sums up the drop in prices of stock exchange seats. Now, the article goes into other reasons for the price drop than deflation - chiefly the uncertainty about the future of the exchange's floor model. However, the prices of seats seem to go up and down with the stock market and this could be an indicator of a resumed down trend.

January 9th, 2005 - Sometimes we do our own "primary" research. I haven't seen a story on this, so here it goes. Our title: "**The Christmas Selling Season May Not Have Been A Total Disaster (on a Top Line Revenue Basis) - But Merchants Seem to Have As Much Inventory Now as They Did Before Christmas - Look For More Markdowns Ahead**;" I have been shopping for a couple of non-Christmas, non-seasonal items over the past few days. I was shocked to see the level of After-Christmas inventories at Robinson's May, May Department Stores (in a different mall) and J.C. Penny's (in yet another different mall). It reminds me of the Christmas of 1989. I'm sure most do not remember that time nearly as vividly as I do - especially with respect to investing and the retail sector in particular. Now that was just before the recession of 1991. Even more strongly than this selling season, most stores were saying that their same store sales were up. I was especially interested because I had been the Junk Bond analyst in charge of the retail sector. Also, I had just moved to Connecticut and was checking out the scene on the East Coast in detail. Anyway, I had noted and can still see in my mind the level of inventory in the Macy's at the Stamford Mall - you could barely walk through the isles a couple of weeks before Christmas of 1989. Then, they put everything on sale a week or so before Christmas. A couple of weeks later, Macy's announced Same store sales for that Christmas selling season had been positive. No one seemed to focus on margins. At the time, I said, sure they made their top line sales numbers (actually that was pretty unbelievable considering the inventory I had seen) but their margins must have been horrendous since everything was marked down 30% or more. Sure enough that was the case and later that year (1991) Macy's and many other retailers fell into bankruptcy or restructuring.

This time in 2004/2005, well, **it is worse off to start with - same store sales for many retailers were down despite very large mark downs**. I haven't seen an article talking about the margins, but it is an easy bet that they are down due to the mark downs. **But this time it is different because the retailers are still loaded with inventory that they did not sell** - it was really unbelievable walking through those stores over the last couple of days - it seemed like it must have been before Christmas! So when the dust settles we are expecting: **sales flat to down**, **margins down**, and **a huge mal-investment inventory hangover** that must be cured, probably at even larger discounts.

December 26, 2004, THE NEW YORK TIMES, "From Aw-Shucks to Cutthroat: Southwest's Ascent:" Although the article does not present it in these terms, basically, **to us, Southwest Airlines is "the Wal-Mart" of the airline industry**. That is the gist of the article. The article points out how Southwest is gobbling up competitors turf and operations, etc and it explains pretty much how and why. One key driver is that most of its competitors are loaded to the gills with debt. Southwest has $2 billion in cash and only $1.9 billion in debts which compares incredibly well to Delta which has $1.45 billion in cash and a whopping $20 billion in debt. It also points out the [equity]-market capitalization of Southwest at $12 billion is 5x greater than any of its competitors. These and numerous other reasons including the lack of material legacy pension plans have enabled Southwest to take advantage of the recent opportunities presented to it by the state of the economy and rising oil prices, and most importantly, those that it has created by lowering its prices in service areas that it is invading. We have discussed some of this before; however, **we neglected to include Southwest on our list of disinflation/deflation plays where it certainly belongs along with Home Depot, Dell Computer, Wal-mart, and Cost-co**. Again, we do not believe these companies are causing the weak pricing/disinflation/deflation phenomenon but that they are riding that wave to their advantage.

December 20, 2004, DALLASNEWS.COM, "Fed's Fear May Be Inflated:" This article by Danielle DiMartino reviews Merrill Lynch Chief Economist, David Rosenberg's recent remarks in a letter to clients in regards to the economy and actions by the Federal Reserve. Key points are:

Merrill's measurement of the "augmented" **unemployment rate "remains above 8.5%, close to its recession high**."

"...year-over-year productivity growth stands at 3% - double the normal for a recovery that's just turned 3 years old."

"**Year-on-year unit labor costs are still south of 1%,** no the 4+ percent you'd expect to see at this stage."

"The latest urge to merge has resulted in massive layoff announcements, which could slow labor cost growth even more in the year to come."

"**Every measure of core inflation is running below 2%**."

He is looking for economic growth to "come in somewhere around 3% for all of 2005, a half-percent below economists' consensus estimate" and that "...the offshoot of economic growth below 3.5% is that excess capacity, especially as it pertains in the labor market, will linger in 2005." The article's author chimes in, "The slowdown Merrill (and everyone else, for that matter) is predicting necessarily **implies a slowing in jobs growth**." Also, the key for our website page, "if, as Mr. Rosenberg predicts, all of these factors converge, **core inflation should fall next year not rise**." **Thus, it sounds like Mr. Rosenberg is expecting disinflation!** Also, he is amazed "at the [bond] market's assumption that the Federal Reserve will raise rates three more times by the middle of 2005." Apparently he is amazed because he thinks the economy is too weak for that. We agree; however, we believe the Fed is really raising rates to protect the dollar and that an unfortunate consequence will be that this managed rate rise is happening in a very weak economy and could cause it to stagnate further and also cause disinflation or even deflation, especially of prices of riskier assets.

December 7, 2004 - THE ORANGE COUNTY REGISTER, "**Slower Retail Sales Spur Bigger Discounts**:" Ugh, these articles and my analysis is getting a bit depressing. Anyway, this article contains more bad news about Same-Store-Sales for retailers for November 2004:

Old Navy - down 5%
Gap - down 4%
Gymboree - down 10%
Ann Taylor - down 16.3%
Pier 1 Imports - down 9.1%
Bombay - down 13%

Pretty depressing, but, unbelievably (but typical), investors have not figured out that these retailers will not be ordering as much in the future and it will ripple and affect essentially all investments.

The article has good pointers on where the best Christmas selling bargains are to be found. Analysts quoted in the article are NOW expecting more and more discounts to be offered before Christmas. To us, these lower prices translate into deflation of retail prices which could very likely ripple throughout the economy..

December 3, 2004 - THE NEW YORK TIMES, "Early In Season, Wal-Mart Changes Sales Strategy:" Because of its poor performance in November, especially the day after Thanksgiving and the following Saturday, Wal-Mart " is quickly changing some selling strategies, executives said yesterday. **Starting today, it is marking down two dozen of its most popular toys and electronics.."** For example:

	Was	Now	Percent Price Drop
Elmos	$26.78	$ 16.88	37% drop in price
Portable DVD Players	179.87	149.87	17% drop in price
Black & Decker Jar Opener	34.88	28.42	19% drop in price

Wal-Mart will also begin "an **unusual advertising blitz** this morning. Wal-Mart which does not usually advertise in newspapers - preferring the monthly color circular - will run full-page ads in 15 major markets and 35 secondary markets....Next week, Wal-Mart will introduce seven 15-second television spots." Thus, to us, Wal-Mart's actions tell a tale almost of panic.

The article also points out that "while retailers reported that the day after Thanksgiving was strong, the rest of the weekend, for many, did not live up to expectations. Thus, like we said below, **for this Christmas season, for most people, we are thinking "if it isn't marked down, it isn't going to sell." Wal-Mart's actions could be a leading indicator of this situation.**

December 2, 2004 - Three Articles from BLOOMBERG NEWS: "The May Department Stores Reports Sales for November;" "Limited Brands Reports November 2004 Sales;" "Federated's November Same-Store Sales Down 1.4%:" After Wal-Mart posted poor November results (see below), many analysts indicated that the problem of weak Christmas sales would be restricted to the low end. However, the results in these articles are huge cautionary signals to that line of thinking. May, which operates Lord & Taylor, Famous-Barr, Filene's, Foley's, Hecht's, Kaufmann's, LS Ayres, Meier & Frank, Strawbridge's, Robinsons-May, the Jones Store and Marshall Fields, had a same-store sales **decrease of 7.7%**. Limited Brands, which operates Victoria's Secrets, Bath & Body Works, Express, Express Men's, Lerner New York, Limited Stores, White Barn Candle Co. and Henri Bendel, had a comparable-stores sales **decrease of 5%**. Federated Department Stores, which operates Bloomingdales, The Bon Marche, Burdines, Goldsmith's, Lazarus, Macy's, Rich's, and Stern's, had a same store sales **drop of 1.4%**. **Importantly, most of these lines are not at the low end.** Also, declines in same-store sales can be from declining prices or declining volumes or both. So, while declining same-store sales are not necessarily an indication of deflation, we place a high probability that that will prove to be the case most likely across the board (possibly not including the very high end). **What with the dismal retail performance that has already been reported, record low savings rates, record high debt levels, declining consumer confidence and a 5th month in a row decline in the Index of Leading Indicators along with possibly consumption-SATURATED consumers (givers and receivers), for this Christmas season, for most people, we are thinking "if it isn't marked down, it isn't going to sell."**

November 30, 2004, THE WALL STREET JOURNAL, "**Wal-mart Loses Discount Edge in Sluggish Holiday Sales**:" This article reviews Wal-Mart's poor November 2005 top line performance. "The Company now forecasts a negligible 0.7% year-over-year increase in same-store sales for November, down markedly from the previous forecast of 2% to 4%." The Company acknowledged "that a strategic shift to boost profits by ratcheting back discounts has backfired, camping sales during the crucial Thanksgiving holiday period..." A few points we would like to maker are: 1). Most importantly, we are of the opinion that if the prices aren't slashed, no sales are going to be made this Christmas at least at the low end, 2). Maybe Wal-Mart was not trying to ride the disinflation/deflation wave that we have been talking about - maybe they were just trying to get market share and happened to luck out with that strategy - **now, when they try to increase the bottom line (by not keeping prices low), they get clobbered!!!!**, 3). Many analysts discounted Wal-Mart's poor performance in November and still feel we are going to have a strong Christmas season - we are very cautious about strong prospects this Christmas season.

November 29, 2004, THE NEW YORK TIMES, "**A Glut of Thin TVs May Soon Lead to Lower Prices**:" This article reviews this year's (and Christmas selling season's) hot ticket - Big, Flat Screen T.V. sets - both Liquid Crystal (LCD) and Plasma. Important to our Deflation Watch is that "According to several manufacturers and analysts, **the prices for LCD flat-panel TV's will drop in the new year, falling by as much as 30% by the end of 2005**. The prices of plasma flat-panel TVs are also expected to fall significantly." Actually, later in the article a Vice President of Sears throws out figures that compute to **an expected drop in prices of plasma TVs of between 57% to 68%!!!**

November 27, 2004, BUSINESS WEEK (December 6th Edition), "**The China Price**:" We found this article to be very compelling and comprehensive on the subject of "a massive shift in economic power [that] is under way [from the U.S. to China]." With respect to deflation, **the key of the article is that when a U.S. supplier is asked to meet "THE CHINA PRICE," that means a price that is "30% to 50% less than what you can possibly make something for in the United States. In the worst cases, it means below your cost of materials**." Thus, the option of dropping a manufactures price by that huge amount or face the prospect of not getting the order (as the purchasers looks to China) is a huge contributor to the disinflation and deflation that we are seeing in almost all manufactured goods. "Nearly every manufacturer is vulnerable -- from furniture to networking gear." Importantly, the article makes the case that this situation is for low tech manufacturing on up and, now, including high tech manufacturing, and is not going to go away. A key is that China has been building a HUGE MANUFACTURING INFRASTRUTURE that encompasses pretty much anything a manufacturer could ever need. One of the keys to the low costs is a huge pool of Chinese labor at roughly 1/5 to 1/10 the cost of labor in the U.S. But it is not just the labor intensive industries where they have the huge cost advantage. The SCALE of their new manufacturing facilities dwarfs anything in history and contributes to keeping costs low (and, eventually to overcapacity and saturation of demand). In addition, the CLOSE PROXIMITY of manufacturing plants supplying required units of production also gives them another competitive cost and time advantage. Not only that, but most of their manufacturing capacity is NEW - half the age of competitive nations. The article also details how many U.S. firms are, even at this moment, shifting more and more STATE-OF-THE-ART manufacturing projects to China with many HUGE PLANTS to come on line in 2005 and 2006. Thus, if this article is accurate, and we believe it is, the huge number and variety of products from China is going to continue to proliferate, and combined with the SATURATION of demand we see in the United States, is most likely going to smash prices in the U.S. to even lower levels over the next couple of years. **The best example the article cites is the drop in bedroom furniture with prices "plunging 30% (in the U.S.)" as 59 U.S. plants employing 15,500 workers have closed since January 2001 and Chinese imports have rocketed 221% to equal half of the U.S. furniture market**. A very important key to the success of China is that they have dramatically more flexibility than we have in the U.S. While the United States has become more and more institutionalized and regulated, China has been lowering tariffs, government subsidies and regulations. Thus, to us, the best analogy is that China is becoming the United States of the early 1900's and the U.S. is becoming the Europeans/British of the early 1900's. Unless the U.S. returns to the politics of our founding fathers and quickly moves back to self-responsibility including no special favors for anyone and as little government as possible, we think China is going to clean our clock, unfortunately. The article also covers the trade deficit and the fact that we are purchasing/consuming goods from China which is letting us purchase with our U.S. dollars which they are holding onto. Thus, we consume and China manufactures as long as China accepts and keeps our dollars - once China quits keeping our U.S. Dollars (i.e. sells/dumps them), the U.S. dollar is going to get clocked and we will get less for our money. It is for this reason, that we believe (as we have said several times over the years) that eventually, the FED will have to protect the U.S. Dollar to keep other nations from dumping it, our highest-margin export. Thus, we have covered a few topics here (and will add a few possible conclusions): 1) deflation - the drop in prices domestically of anything (and everything) manufactured in China and sold in the U.S. will continue and probably step up, 2) the FED will likely have to raise rates to protect the U.S. dollar from being dumped by China and other countries, 3) because China has dramatic labor, incentives, flexibility, scale, and proximity advantages which translate into a 30% to 50% cost advantage (versus the U.S.), manufacturing capacity and jobs will most likely continue to shift out of the U.S. and to China; thus, contributing to deflation of compensation in the U.S., 4) Saturation of demand and record domestic debt levels in the U.S. could combine with China's dramatic overproduction of goods to most likely result in Supply overwhelming Demand causing in a step up in the deflation of prices of manufactured goods in the U.S., 5) eventually (a couple of years from now), there will most likely be a trade war of sorts with all kinds of tariffs and exchange controls (note that we believe such regulation and accompanying legislation almost always takes place at the end of the trend when such forces are already being taken care of by natural market forces). We highly recommend that interested investors read the original article.

November 26, 2004, THE WALL STREET JOURNAL, "Postal Service to Seek Rate Increase:" Ha! That doesn't sound like deflation - however, upon closer reading the article actually makes a few important and useful points about deflation. First, this possible rate rise of 11% from 37 cents to 41 cents would not take effect until 2006. Second, first-class stamps have already increased by 12% since early 2001; however, we want use this example to point out (as we have several times previously) that prices of services that the government is heavily involved in have been rising (for example: postage, healthcare, education, etc.) while prices of almost everything else have been dropping (shoes, clothes, electronics, computers, cars - you get far more for the same dollars - groceries, see numerous examples below, etc.). Now the somewhat shocking main point - "**The unusually hefty size of the expected new rate increase stems partly from the demise of proposed legislation that would have allowed the post office to take advantage of about $3 billion a year in PENSION-FUND savings resulting from a change in how it contributes to a federal retirement fund. The bill also would have freed the Postal Service from future PENSION PAYMENTS to certain postal workers who served in the military**. There you have it - only with a government entity can you raise your prices because your costs are out of control - compare this to what is happening in the airline sector which has similar problems but does not have a monopoly (see numerous articles, below) - private market competitors usually have to handle this problem by cutting costs. In fact, a Postal Service Senior Vice President of government relations said, "....the needed price increase likely will be in the double digits if the post office has to keep contributing to the pensions of veterans and can't tap the pension-fund savings." Thus, just like many other industries, corporations, states, counties, cities and municipalities, the Post Office has a cost problem related to their promised pension fund benefits. Normally, just because costs are going up doesn't mean you can just raise prices. If they do raise their prices, most likely less mail will be sent using their services; thus, their total revenues could actually fall. Their real solution is most likely to cut costs.

November 22, 2004, USA Today, Two articles: "**Airlines May Set Passenger Record**" and "**Business Airfares, Down 11% Might Be Lowest Ever:**" The interplay of information of these articles is really interesting - First, we have the airline industry "**poised in 2004 to set a record for the most passengers carried**." Second, we have **the cost for fares at "the lowest [level] in five years of quarterly tracking" - 11% lower than 2003 and 16% lower than "the recent peak year of 2001**, according to a report to be released this week by American Express unit eClipse Advisors. Obviously, we are using this data to make the point that these prices are falling, but **it is very interesting that prices have been falling while volume has been increasing!!!!** I do not think that many people have seen that before. It just goes to show you that the "rules of economics" do not work all the time and that **human action (what is actually taking place) is the real deal.**

November 21, 2004, LOS ANGELES TIMES, "**Wal-Mart Effect Moves into the Grocery Aisle**:" This article is about the apparent price "effect" of Wal-Mart moving into the grocery business. In the article, a consumer from Palm Desert California comments that "he had concluded that **throughout [his] area, grocery prices have fallen about 10% since the [Wal-Mart] Supercenter opened its doors**." The article contains a price comparison for twenty items at several grocery stores versus the Wal-Mart Supercenter:

Albertsons - Wal-Mart was 24% less
Ralphs - Wal-Mart was 16% less
Vons - Wal-Mart was 20% less
State Bros.- Wal-Mart was 14% less

Yes, when Wal-Mart moves in, prices drop. But that is not the main point - **our point is that Wal-Mart is and has been riding the Disinflation-Deflation wave of prices dropping - it is not causing prices to drop all by itself**. Other companies riding the disinflation/deflation wave that we have talked about over the years are Costco, Dell Computer, and Home Depot.

November 18, 2004 FINANCIAL TIMES, "**Japan's Economic Recovery seen as an Illusion**:" The first sentence pretty much sums it up: "Part of Japan's recovery has been a statistical illusion, according to the government, which on Thursday announced **a change to gross domestic product calculations that indicated the economy had not grown**

for the past six months." Following on that: "....the revised GDP numbers indicated that the upturn was never as strong as originally thought." "...the cabinet office....said, the economy stagnated in April-June [2004] and shrank in July-September [2004]." In a monthly report the Bank of Japan said, "Japan's economy continue4s to recover as a whole, although the increase in exports and production seems to be coming to a pause." **One point we would like to make is that it is very difficult to measure things like GDP**. Another point we would like to make is that Japan's GDP (and "recovery") are weaker than previously thought and Japan's economy seems to be faltering yet again. We think these are important points that could possibly carry over to the United States.

November 7, 2004, BLOOMBERG, - two articles on interrelated subjects: "**Dollar May Drop to Record Low** as Bush Seen Increasing Deficits," and, "**Gold May Top 15-year High as Dollar's Value Falls**:" We want to make a few points on these subjects - the dollar at a record low and gold at a 15 year high. First, gold is most likely to take out its 15 year high; however, as our previous analyses on Silver and Copper have pointed out, both Silver and Copper have recently had major plummets of 33% and 13% (in four days), respectively, most likely indicating that their trends are now downward. Thus, unless they catch back up to Gold in terms of taking out those previous tops, the divergence between those three precious metals indicates that the price of Gold should roll over shortly and all three should begin a deflationary drop. We believe that timing will most likely coincide with a rebound in the U.S. Dollar which has dropped to record lows against the Euro. We believe that in order to protect our most precious export, the U.S. Dollar, Greenspan will continue to raise interest rates. We note that our Fed interest rate raises have been lagging most other countries, which is probably a primary reason that the dollar has taken such a beating. **Thus, we expect Greenspan to raise Fed short rates faster than previous consensus, that those raises will revive the falling dollar and that as the U.S. dollar goes up, Gold will likely join Silver and Copper by falling in price. Stay Tuned.**

November 6, 2004, THE LOS ANGELES TIMES - three articles all on one page, all on one industry: "**Northwest Pilots OK 15% Cut in Their Pay**," "**Delta Tells Where it Plans to Cut Jobs**," and, "**United Airlines Union Vows to Battle Bid for Concessions**:" We keep coming back to the airline sector because what is happening there is possibly an appropriate metaphor for the U.S. economy overall in the future. United Airlines, which as already achieved labor savings by securing $2.5 billion in annual compensation reductions previously, is now seeking..."an additional $725 million in labor cuts and to eliminate traditional pensions" which in conjunction with other cuts will save the Company another $2 billion in annual costs. At Northwest, **89% of the pilots voted in favor of the 15% annual compensation cut**. Delta's "7,000 pilots are **voting on a proposed agreement, reached by union leaders last week, that would cut their salaries by one-third to keep Delta out of bankruptcy**." Thus, compensation in this industry continues to be deflated. **Importantly, we believe those lower levels of compensation, and the accompanying layoffs, will ripple through the rest of the economy.**

October 31, 2004, ST. LOUIS POST DISPATCH, "Companies can call the shots on **Office Space**:" This article's first sentence gives the gist of what we are concerned about: "**The area's office market remains stuck in a rut that has kept vacancy rates at about twice the lowest level of the late 1990s**." As we have discussed several times on our website, the fact that the commercial real estate market has continued to be weak in terms of high vacancy rates, soft rental rates, and stagnant market prices, as opposed to residential real estate which has appreciated, told us (and continues to tell us) that real estate is not really in a bull market (as difficult as that is to believe) - that it is a bubble and the prices of residential real estate will most likely drop hard someday (we pointed out previously that we believe most residential real estate markets topped out in May/June/July 2004). The article points out that the commercial real estate vacancy rate is 16.4% in St. Louis and 25% in Dallas. We point out that the high continuing commercial real estate vacancy rates is an indication of the weakness of "the recovery."

October 26, 2004 - Here is a timely subject on which we were able to find no major media articles - Here is our headline: **Copper just dropped by 13% in price in just 4 days!** - Wow and no major news coverage. The price topped out around $148 per ounce on October 11th 2004 and dropped to just over $125 an ounce four days later on October 14th 2004. Importantly, the use and price of copper is a fairly reliable leading indicator of future economic growth an activity.

October 19, 2004 - We just added some new articles: October 11, 2004 THE DALLAS MORNING NEWS, "**Is the Debt Tide Turning**" and October 19, 2004 INDEPENDENT NEWS, "**House Price Falls 'Steepest for Nine Years'**" on our Elements of Market Tops page http://www.risk-adjusted.com/Weblogs.html, and October 18, 2004 THE WALL STREET JOURNAL, "**Insurers Reel from Spitzer's Strike**" on our Major Trend Change Indications page, http://www.risk-adjusted.com/Weblogs.html, that review current factors contributing to deflation. Follow those links to read about the change from credit expansion to credit contraction, the change from everything goes bull market psychology to much more scrutinizing bear market psychology and the topping of the real estate market.

October 3, 2004, AOL.COM, "The Looming National Benefit Crisis:" The subject matter of this article should be on the front page of all newspapers and have top billing on the television news shows (but it isn't and doesn't). You've probably heard bits and pieces over the years but, in this format, it is truly shocking. Also, until now it was just accounting, now it is cash out the door:

$473,456 per household - that is the amount of government debt, including present value amounts of social security promises, healthcare promises, and all other government debt (on balance sheet and off balance sheet) that each household is on the hook for Today! (in today's present value dollars).

$53 trillion - that is the same $473,456 dollars each household is on the hook for today multiplied by the number of households - thus, the aggregate number. It is 9x the $9.5

trillion individuals owe on their mortgages, car loans, credit cards, and other personal debt. (Thus, each household also owes $84,454 in personal debt.)

Here is how the numbers break down (remember these numbers are the present values right now - they will grow and grow into the future):

$ 12.7 trillion for Social Security
$ 30.0 trillion for Medicare
$ 10.3 trillion in on balance sheet government debt

The article says what we have said several times previously - "**that the Greatest Generation and baby boomers have promised themselves retirement benefits so generous - and have contributed so little to financing them - that even the most prosperous economy in history cannot pay the bill**." Thus, it appears that everyone wants (and thinks they deserve) dramatically more benefits than they have paid for - here are more numbers/estimates from a different source based on the "median couple":

$283,500 - present value of what the median couple would receive in joint **Medicare Benefits** (as promised) if they retired right now.
$ 43,300 - present value of what the median couple will have paid into Medicare if they retired right now.
$240,200 - Yup, that means they are reaping a present value $240,200 benefit!!!!!!!!!! (more than they put into the system!) - no wonder there is a huge deficit!!!!!.

$326,000 - present value of what the median couple would receive in joint **Social Security Benefits** (as promised) if they were to retire right now.
$198,000 - present value of what the median couple has paid into the Social Security System if they were to retire right now.
$128,000 - deficit to taxpayers and windfall to median couple.

IT GETS WORSE - the money that was paid into those systems ----- uugghhh --- has been spent (on things like welfare, defense, etc.) - it is an accounting entry (off balance sheet, of course) - an I.O.U. that must be paid by other taxpayers!!!!

Thus, taxpayers will have to come up with the full $609,500 (present value) to fund the median couple that retires right now. Worse than that, BENEFITS PROMISED TO FUTURE GENERATIONS ARE EVEN LARGER!!!!!! - The present value of the debt of the the next generation median couple (the age of the current median couple's children), based on current promises is $884,000 VALUED NOW!....thus, it is 45% larger in present day dollars (not because of inflation of money (remember this is "present value") but **because of inflation of promises**!!!! to the next generation). Obviously, these promises and outlays don't come close to adding up.

This article laid out the numbers of the situation in a startling way. Obviously, something has to be done - either promises cut in half, taxes doubled, etc. **Our point, in this section of our website, is that whatever is done to try to remedy this situation will**

almost certainly be deflationary (or it could be solved by runaway inflation, which we think is much less likely).

According to the article, these estimates were calculated from official government numbers by "USA TODAY and are similar to ones by government watchdogs agencies such as the Congressional Budget Office and the Government Accountability Office and respected think tanks such as the conservative American Enterprise Institute, the liberal Brookings Institution and the non-partisan Urban institute.

September 27, 2004 BLOOMBERG, "Fannie Mae to Correct Accounting and **Boost Capital**:" More on Fannie Mae - see our Elements of Market Tops link, http://www.risk-adjusted.com/Weblogs.html, for our Fannie Mae review relating to the real estate cycle. The key of this particular article is that because Fannie Mae had cooked the books previously it turns out that they are somewhat undercapitalized; therefore, Fannie Mae has agreed to increase its capital to a level 30% above the required minimum. Based on figures from the article, its minimum capital requirement is $31.4 billion and it currently exceeds it by $4.7 billion or by 15%. Thus, to exceed it by 30% we estimate that it needs to raise capital by another $4.7 approximately. Or, more easily and likely, they could lower the amount of their loans outstanding. $4.7 billion of capital divided by 2% (which we estimate is their minimum capital percentage) would be roughly equivalent to loans of $235 billion. **Thus, according to our back of the envelope calculations, the company could make $235 billion in fewer loans or it could raise $4.7 billion in capital (which would be tougher to do) or it could do a combination of the two**. We believe that either of these actions is essentially a "**credit contraction" that is deflationary - it will make the cost to finance a house go up, which will make the price people are willing to pay for that house drop**. Rates up, prices drop - just like bonds.

September 9, 2004 LOS ANGELES TIMES, "Safeway Sees Gains in Labor Pact": The article reports that Safeway Stores ("SWY"-NYSE), the large grocery store chain with over 200,000 employees, is going to have substantial cost savings as a result of the deal ratified by the Company and its unions earlier this year. **The deal will "lower Safeway's wage and benefit costs by as much as $4 per hour for food clerks by then end of the three year contract."** Safeway's Chief Executive points out that the savings should "lower the pay gap by one-third between it and non-union rivals such as Wal-Mart Stores..." Thus, he is saying that it will level the playing field somewhat. Also, he helps us make one point we have made several times before - that firms like Wal-Mart and Cost Co are riding the wave of deflation. **Our main point, with respect to this article, is that the compensation reduction, which, to us, is a sign of the times, is deflationary, unfortunately.**

September 9, 2004 THE ORANGE COUNTY REGISTER, "Pension Tsunami, Part II - County Retiree Medical Liability Tops $1 Billion": This article is from the Opinion Section. The article makes several good points about the questionable timing of the revelation of the $1.3 billion deficit in the county retiree medical benefits plan. However, we are not going to cover local politics as shocking as they are. The point is that after a recent vote, the County's retirement pension obligations were raised by instantly by around $300 million. That $300 million liability increase is on top of a retirement pension deficit of over $1billion. Then, the medical benefits were increased and its deficit revealed. **Let's be clear here - there are two deficits:1) retirement benefits & 2) retirement medical benefits - The County recently dramatically increased the deficits for both pension categories (which already had huge deficits)**. Thus, including previous 1994 bankruptcy debt (yup, that was Orange County, CA) the total liability is now "hitting $3 billion." The article then recommends interested readers and taxpayers to look to THE NEW YORK TIMES article on San Diego's problems (that we previously reviewed in the following paragraph on this page) "for a preview of the coming disaster." Of course, this problem is more of the huge pension over-promising that we have been writing about for a few years. What is shocking and what the article points out is that supervisors would continue to heap more retirement benefits on systems that already have such large deficits [& we would add will almost certainly not be paid out in full]. Personally, we were monitoring this exact fiscal irresponsibility in Northern California/Santa Cruz when we were living up there - we believe the problem is rampant throughout the municipal systems. The article also makes the point that sooner or later someone is going to have to make up the shortfall. **Our point is that the future has essentially arrived - before it was just accounting, now it is cash - most likely promised benefits will not be delivered as recipients are expecting - thus, they will be deflated. As for investing, credit quality is probably not nearly as strong as currently perceived.**

September 6, 2004 THE NEW YORK TIMES, "Sunny San Diego Finds Itself Being Viewed as a Kind of Enron-by-the-Sea": There are some really shocking quotes in this article about the financial situation of the City of San Diego, its pension problems and the underfunding problems of "hundreds of other public and private pension systems..." **It seems that San Diego "had for years been shortchanging its public pension fund, leading to an unfunded liability of more than $1.15 billion....[and] that the city owes nearly $1 billion more in health care benefits to retires and [does] not have the money.**" That according to a trustee of those retirement programs. Importantly, as a result of this and other financial mismanagement, "reputable analysts have begun talking openly about the possibility that the city will have to declare bankruptcy, as Orange County did a decade ago." One analyst suggested that **"the best solution might be reorganization under Chapter 9 of the federal bankruptcy law to allow the city to rescind pension benefits."** You read that right - "RESCIND PENSION BENEFITS." But the key quote is from Mr. Kern, the San Diego Mayor's Chief of Staff, who, first denies the city is near bankruptcy, but says, **"Hundreds of other public and private pension systems were suffering problems similar to San Diego's because of...."** If you have read some of our material, you would know that we concur with most of what is being said here. Actually, it goes along with what Mr. Greenspan says in articles we reviewed a couple of paragraphs down this page. **The point this article makes for us is that, just like many corporations (think steel companies, airlines and automobile manufactures, etc.) and many foreign governments, the problem of grossly under funded pension problems is also rampant in state, city and municipal systems**. The benefits have been over-promised, under accounted for, and under funded and, as

Greenspan indicated in my slight misquote: 'you guys aren't going to be able to repeal the laws of mathematics," the actual benefits that will be received almost certainly are going to be much lower than people currently believe they will be - these systems just do not have the money - it was never properly put aside and there is a considerable shortfall in most plans. Thus, benefits and expectations of benefits will be **deflated** and we think that deflation is beginning now.

August 31, 2004 THE MOSCOW TIMES.COM, "Money Supply Shrinks after Bank Crisis": We have included this article because we believe this **deflation is a worldwide phenomenon**. The facts in this article, while extreme compared to the situation in the United States, demonstrate **out how quickly inflation and deflation and growth and contraction of the money supply can occur in a highly leveraged, fractional reserve style banking system**. "The nation's (Russia's) M2 money supply shrank in July [2004] for the first time in 17 months," even as the central bank is trying "...to meet its 10% inflation target." M2 declined by 1.4% during the month. The article said, "July's decline was mainly due to nervousness over the banking sector after a mini-crisis earlier this year spurred many depositors to close their accounts and swap their rubles for hard currency." One commentator said, "It looks like we could have a combination of two factors -- the reduction of deposits and an outflow from the ruble to the dollar." Of course, in this instance, the flow is to the U.S. dollar. Argentina has been experiencing similar problems as we outlined previously.

August 30, 2004 AOL BUSINESS NEWS, "**Greenspan Says Social Security, Medicare Must be Cut**": We analyze this subject in more detail under the Major Trend Change Indicators link, http://www.risk-adjusted.com/Weblogs.html . Basically, Greenspan warns that benefits of entitlement programs (Social Security and Medicare) cannot be delivered at volumes that have been promised and to save the system steps must be taken now. He talks about cutting back promised benefits, increasing taxes and extending the ages at which benefits can be taken along with emphasizing that people need to take matters into their own hands and save more to have more for retirement. We agree with all of this. **Unfortunately, Greenspan's basic message is: expectations need to be deflated - Our point here is that ever one of those solutions is deflationary** - more savings, means less consumption - less benefits means less consumption, etc..

August 27, 2004 BUSINESS WEEK (September 6th edition), "Germany: Welfare Reform Won't Cut It": This is another article we have included because **we view the current "deflation" as a worldwide phenomenon**. This article points out that a new German law **drops long term unemployment benefits by 27%!!!** from $1,097 a month to $801 a month. According to the article, the law change, which takes full effect in 2006 was enacted "to give Germany's 4 million unemployed a greater incentive to get off the dole." Of course, we point out that that reduction is deflationary. The article points out that "Germany's wage levels [are] so high that many positions are now priced out of the market - forcing companies to transfer production to Poland, India, or China" - sounds kind of like here in the United States. **We point out that high wage levels would not be such a problem if we were in inflation as opposed to deflation.** It is our opinion that most countries are experiencing similar problems of rising unemployment due to deflation, and the accompanying distress and pain of accepting lower wage rates (especially in light of the huge debt levels whose payments are fixed unless discharged in bankruptcy) - a very tough situation.

August 20, 2004 THE WALL STREET JOURNAL, "Court Upholds Brazil **Pension Tax**": We have included this article and our analysis because we believe this current "deflation" is a worldwide phenomenon. "A [new] Brazilian court ruling to allow taxation of retired state workers' benefits gave a boost to the government's efforts to implement restructuring measures seen as taboo a few years ago." Wednesday, "the Supreme Court ruled that taxing the benefits of state pensioners was constitutional, settling an issue that has been debated for nearly a decade.." We have three points here: 1) this ruling only passed (after a decade) because the situation is so dire and the psychology is that they now need to tax the pension payments - rulings like this don't happen at the first sight of problems; 2). pension problems like this are a worldwide phenomena (as we have detailed below and previously in our annual forecasts); 3). The net result to the pensioners is that their retirement benefits (after tax) have been deflated (unfortunately).

August 19, 2004, BLOOMBERG, "Google's Auction Loosens Wall Street's Grip on High-Priced IPOs": To us, this article totally has it right, but it has only half of the story. "Google,'s share sale has put Wall Street on notice: The old way of doing business may be ending." The article points out that managing IPOs is "among Wall Street's most lucrative assignments, often pay[ing] fees 10 times greater than underwriting investment-grade corporate bonds." Back to Google's IPO - "The initial public offering's 28 underwriters...**received half their usual fees** because they weren't needed to find buyers" - Google executives used the internet to find the buyers. Deflation caused by the internet and technology is a theme we have covered several times over the years. **The point we would like to add to this article is that you just saw a 50% deflation in the fees paid to an underwriting syndicate** - and, accordingly to the experts in the story, that is the future - to us, that deflation is the real story.

August 8, 2004, THE NEW YORK TIMES, "Companies find they can't buy love with bargains." And we quote, "**Companies are offering the best bargains in history**. It has **never been cheaper** to fly from Dallas to Los Angeles, to make a phone call from Boston to Brussels or to buy a computer or a DVD player." That is from THE NEW YORK TIMES. The article is not really about deflation, it is about the fact that it is more and more difficult to impress customers despite offering them more and more value. The article's main topic is interesting especially to business manger types (like ourselves) but we especially like it because THE NEW YORK TIMES just made the case that we are in actually in deflation (unfortunately).

August 6, 2004, CHICAGO TRIBUNE, "**Incentives no longer excite car buyers**:" The first sentence of the article sums it up well, "Zero percent financing has lost its potency and consumers aren't hurrying to car dealerships to grab $5,000 rebates, either." But the next sentence is even more important to us, **"Hence, they often wait for better deals or scour dealerships for a lower price."** This is huge in that it demonstrates that the **psychology of inflation - buying now before prices rise - has given way to the**

psychology of deflation - wait because the prices will probably be lower in the future. In fact, the article quotes a buyer, "I'm **waiting** to see what the deals will be for August...I know their sales are down 21% this year, so they have a lot of unsold stock." In that sentence is another point that is very important - **automobile companies are carrying record inventories despite record discounts....and, the new 2005's are coming out; thus, we question, what do you think will happen in late August and in September?**

August 3, 2004, THE JAPAN TIMES, "**Land Prices Down for 12th Year**": Yes you read that correctly; land prices are down 12 straight years in a row!; however, it is land prices in Japan that the article is talking about. **Still it is a sobering fact - I have included this article to highlight that real estate can actually go down and it can go down over a long period of time**. I believe this is the best recent example of that occurance. "The average price of land along select major thoroughfares was down this year for the 12th straight year, the National Tax Agency said..." For year ending 12-31-03 this index of land in Japan was down 5%, slightly less than the previous year's 6.2% decline. Tax authorities in Japan "use the so-called roadside land price to assess inheritance, gift and land taxes..." The article points out that land prices in some big city locations have risen lately but "the most expensive prices in five prefectural capitals...fell more than 20%." **The point is that real estate doesn't only go up, and it can go down and down and down over a long period of time.** Most people should remember that it seemed like the Japanese were going to be able to buy the entire world when their economy was peaking in the late 1980's - sounds kind of familiar to the United States in the roaring 1990's.

July 30, 2004. While there have been lots of interesting articles recently, we could not find one to leverage off of on this topic so we wrote our own with the title: "**Is The Entire World Declining?**" Below we have put, in tabular form, the recent tops in several asset classes that we have been following - **"Percent Decline" is from the Recent Top-Date to today:**

Asset/Index Name	Recent Top Date	Percent **Decline**	Comment
Dow Industrials	02/11/04	-5.7%	
NASDAQ	01/26/04	-12.3%	
S&P 500	02/11/04	- 4.8%	
Gold	04/01/04	-8.8%	
Silver	04/06/04	-20.4%	
CRB	04/08/04	- 4.9%	
Crude Light Oil			still in parabolic rise
U.S. Treasury 30 yr	03/16/04	-11.1%	yield is up 58 basis points
Hang Seng (China)	02/18/04	-12.1%	
Indice Bolsa (Argenina)	01/20/04	-22.2%	currency failure
Mumbai Sensex (India)	01/14/04	-16.5%	bank runs and failure

Russian Traded Index 04/12/04 -34.1% bank runs and failures

Remember those declines are all down from recent tops. **I could have included many more, but their graphs look pretty much the same - a top between December 2003 and April of 2004 and a drop of 4.5% or more - all in definite downtrends with lower lows and lower highs**. I included stock indices for those countries that have recently been having the most obvious financial problems but almost all equity indices are down from tops earlier this year; for instance, Japan's Nikkei topped on April 26, 2004 and is down 6.89%. The best example for Europe is the Dow Jones Euro Stoxx 50, a capitalization-weighted index of 50 European blue-chip stocks - the Stoxx peaked 3/08/04 and has dropped 8.08% to today. The only asset classes that are still rising are real estate and oil but we think these two are experiencing (or have just experienced) classic "blow off" tops (see the Elements of Markets Tops section of our website). **If everything is declining in price, then we are definitely in deflation which is why I wrote this analysis.**

July 15, 2004 BUSINESS WEEK (July 19th edition), "The Benefits Trap - Old-line companies have **pledged a trillion dollars to retirees**. Now they're struggling to compete with the new rivals, and **many can't pay the bill**." The Cover of Business Week pretty much sums it up - unfortunately, retirement benefits are deflating. The article by Nanette Byrnes is well written and very comprehensive on a topic that we have reviewed for a couple of years now. She gives a fairly representative example of a retiree from U.S. Airways who was expecting a six figure annual retirement but will get $28,585 (about 75% less!). She points out that "the companies of the S&P 500-stock index continue to run an aggregate pension deficit of $149 billion, according to David Bianco, an accounting analyst at UBS....If conditions don't change, Bianco figures the S&P 500 companies will end the year $192 billion in the whole." We point out that this negative growth is in a "recovery" year. Another important point the article makes and we have made previously is that companies are now shifting the retirement and health care burden to the employees (without increasing other forms of compensation) - thus, to us, this is a **clear deflation of compensation**.

July 14, 2004, BLOOMBERG, "Argentine Creditors seek to Build Opposition to Offer": This article discusses the Argentine government's offer to restructure $100 billion of its defaulted government debt at **25 cents on the dollar**. If this isn't deflation, we don't know what is. Unfortunately, the financial system in Argentina is a mess and has been experiencing a severe credit contraction including bank runs, capital flight out of the country. The defaulted bonds are trading at around **30 cents on the dollar**, so the market believes that they will get more than the 25 cents currently offered. Another point we would like to make with respect to the Major Trend Change Indicators we have been highlighting is that the IMF denied a bailout of Argentina - to us, this is a major trend change away from "too big to fail."

uly 13, 2004, THE WALL STREET JOURNAL, "Major Round of **Airfare Cuts** Gets Under Way": This story, published in the Personal Journal section is all about how you personally can benefit from the lower prices that were just announced by Southwest

Airlines and matched by all the other major carriers. Most of the articles relating to this topic are about personal transportation or the impact on the prices of stocks and bonds of the carriers. However, **the story that is overlooked is that this is an example of deflation** - prices of transportation are continuing to drop - even with oil prices up! and even in a "recovery."

July 7, 2004, CONSUMER REPORTS (August 2004 edition), "**Countertops - High Design At Lower Prices**": We quote from the article, "**Falling prices for granite and other tony materials** mean that you can now get a custom-look countertop for about what you'd pay for solid surfacing..." "Falling prices" - that pretty much sums it up. Of course, we think most would agree that anything that you purchase at Home Depot is dramatically less in price than the price you paid elsewhere ten years ago - and the quality is much better - thus, to us, clear deflation. In fact, we would say this deflation in terms of lower prices and improved quality goes for many, many items. Automobiles for example, the $15,000 car you purchase today is dramatically improved in quality and reliability over a $15,000 car five years ago, for example.

July 2, 2004, BUSINESS WEEK (July 12th, edition), "When Quotas End, Who Gets The Goodies?": This article is about the cessatation of decades-old quotas on apparel imports on January 1, 2005. Rather than being about deflation, the article's main discussion is summed up in this question from the article: "**Wholesale apparel prices will plunge, but retailers may not pass on a lot of savings**?" The article spends a lot of time saying that the consumer will not get much of the benefit, but finally admits "...**retail apparel prices have fallen at a 2.1% annual rate over the past five years**..." and quotes an economist's expectation that "...**retail prices will drop abut 4% a year [each year] for the next five years**." The key reason is because the end of the quotas will let retailers consolidate their off-shore retail production. Previously, companies could only buy a limited amount from each country (i.e. the quota). For example, J.C. Penny plans to consolidate from 51 countries to the cheapest 23 countries it currently produces in.. Our point is that we have already been seeing dramatic deflation in the prices of retail goods and this change in law should make that deflation continue.

June 30, 2004, TIME, "Sour Notes of Summer": This article starts off, "Owing to **dismal ticket sales,** organizers have called off the alternative-rock festival Lollapalooza (Morrissey), before it even began." **Other tours that have been cancelled** are Madonna, Marc Anthony, Jessica Simpson, Christina Aguilera and Britney Spears. The article points out that all the cancellations (except Britney) are having lackluster sales - explanations range "from overexposed talent to high ticket prices." We want to point out that dramatically declining CD sales and prices (from $18 down to $12) were a good indicator of the decline from the early 2000 market top even though at that time they were attributed to CD burning/copying. **Thus, this current weakness in the concert circuit, for which there is no "copying excuse," gives us another reasonable indication that the economy is not doing that well**. It may be that to get these concerts going again, they will have to cut ticket prices - i.e. deflation.

June 23, 2004 BLOOMBERG, "**AT&T Cuts Revenue Forecast Citing 'Pricing Pressure,' Regulatory Changes**": I don't think there is anyone who would argue that costs to talk long distance haven't dropped dramatically over the past few years and AT&T is telling us that it is going to continue to drop. Today, AT&T announced "that it is revising its 2004 full-year outlook, **citing ongoing pricing pressure**, recent changes in Federal Communications Commission policies and new product initiatives." "...**recent escalation in competitive pricing pressure** is expected to negatively impact AT&T's Business division in the near-term." Also related to deflation, the Company says that it will combat declines in the "top line" (i.e. revenues) by ..."aggressively lowering costs." In our book, lowering costs is also deflationary.

June 22, 2004 FORBES (July 5th edition), "Get Out the Handkerchiefs - **Microsoft employees are outraged over a stingier stock plan and other reduced perks**. Get used to it.": We would call this deflation of compensation. Microsoft has "nixed its once-sacred stock option grants...altered its stock-purchase program to reduce the employee discount from 15% to 10%...also now workers make co-payments on some brand-name drugs." Another good point we would like to make upon reading this article is that lots of **employees are now having to pay more directly for their healthcare** (think Safeway and other supermarket chains) - this is not inflation but deflation - as it is really a cut in compensation (that reduces funds for other activities).

June 18, 2004 BUSINESS WEEK (June 28th edition), "Jean Therapy, $23 a pop, **Levi's line of discount denims is making inroads**. But is it enough to stop a long slide?": This article discusses the plight of Levi's and how they are now selling their Levi Signature line in Wal Mart and Target for "...only $21 to $23 a pair. That is <u>as little as half the price</u> of the familiar 505 and 501 pants that art part of Levi's core Red Tab line." Another, fact just as important with respect to "deflation" is that Wal Mart "...already sells a house brand called Faded Glory, for about $16 a pair." The article also talks about the risk that Levi's will cannibalize sales of its higher priced product; however, we would like to highlight that if it doesn't other lower cost competitors will (a problem with widespread deflation). While on that topic, we note that we have, in the past, read several articles where people are angry at Wal Mart for lowering prices and salaries and want legislators to do something about this. **It is our contention that the drop in prices and salaries is bigger than Wal Mart - that Wal Mart is just riding the disinflation/deflation wave** (see our January 2004 forecast, where we point out that most of the best equity performers (Wal Mart, Home Depot, Dell Computer, Costco, etc.) have been disinflation plays).

June 18, 2004 BUSINESS WEEK (June 28th edition), "Delta: The Fog Thickens": More on declining costs and prices relating to travel. Quote, "...the Atlanta airline is facing **more competition from low-cost carriers**." Our take (not discussed in the article) is that basically all the old line carriers will eventually succumb to the pricing of the new discount carriers. The old carriers have substantially higher cost structures (including higher salaries and benefits) that really cannot compete with their new, unencumbered competitors. Thus, to us, "the general deflation" is causing these prices to go down and make many old line companies uncompetitive with regards to costs and prices.

June 18, 2004 THE WALL STREET JOURNAL, **"Its Sales in the Rough, Callaway Resorts to Hacking Prices":** This article was written about the fortunes of Callaway and its stock price. However, it contains some valuable information about Deflation/Inflation - and we quote, "'Irrational' discounting in the past six months has created a tough retail environment for drivers, says Callaway Chief Executive, Ron Drapeau. He says that **competitors' drivers that sold for $399 six months ago are now being discounted to $199 or even $99**."

June 18th, 2004 THE WALL STREET JOURNAL, **"US Airways Cuts Washington Fares as Rival Emerges"**: ...."today [US Airways] will roll out cheaper fares with fewer restrictions on 22 routes, including 15 served nonstop from Reagan National Airport."

June 17th, 2004 BLOOMBERG, "United Airlines Denied $1.6 Bln U.S. Loan Guarantee": The gist of all the articles related to this subject is that after all the substantial labor concessions (i.e. salary and benefit reductions) already agreed to (i.e. prior deflation), their costs are going to have to be reduced even more (i.e. deflated even more) And, we quote, "...which may force the world's second-largest carrier to seek other financing or **more cost reductions**."

June 17th, 2004 BLOOMBERG, "Snow Says that **No U.S. Company is 'Too Big to Fail'**": Our view is that the subject of this article, also related to United Airlines, could mark a huge change in the government bail-out cycle that started with Chrysler, and the accompanying attitude that the government would not let large businesses (or governments - think Argentina) fail. This article quotes U.S. Treasury Secretary, John Snow, "**But I don't think we can ever take the view that businesses are too big to fail. To take that view is to set in motion all sorts of very unwelcome behavioral incentives.**" Thus, apparently, the bail-out party may have topped out - which, to us, is most likely very deflationary.

(page initiated June 18, 2004)

Returns - Figures quoted are total returns calculated for the share class and time periods shown. Performance includes the reinvestment of income dividends and capital gains distributions. Performance does not reflect the deduction of taxes that a shareholder would pay on a fund distribution or the redemption of fund shares. Please go to Morningstar's and/or Lipper's websites for more information.

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