

CONSEQUENCES

Inflation or Deflation?

There appears to be a debate among those who understand the dangers that lie ahead whether the meltdown will occur by inflation or deflation. America already faces an inflationary environment fueled by record oil prices. Considering I expect oil to remain high, I'm betting on inflation to be the cause and/or the consequence of the fallout. If conditions get really bad, deflation could be a later stage sequela.

As discussed in Chapter Ten, the capital markets might blow up due to a failure in the MBS market. This could lead to defaults on trillions of dollars in loans, resulting in a deflationary environment. A severe blow to the MBS market would be one of the worst-case scenarios because it would lead to the loss of huge sums of money from pension funds, affecting nearly every American. Needless to say, the stock and bond markets would get hammered. Compensatory alterations in monetary and fiscal policy might later cause extreme inflation.

In contrast, the U.S. might continue its trend towards inflation merely due to continued high oil prices and weakness of the dollar. And only after some disaster such as a Fannie Mae blowup might deflation appear. The reality is that regardless of the magnitude of any economic correction, the next decade or two more will most certainly be characterized by extreme inflation. A severe catastrophe might usher in a deflationary period as an after-effect, but only after inflation has caused significant damage. Thus, the possibility of deflation will most likely be determined by the sequence of events, as well as the extent of the economic correction, while high inflation is a virtual certainty.

Much of the deflationary pressures present during the 2001 to 2004 period were largely due to an inventory buildup. This was one of the forces that triggered the expansion of credit by the Fed. Severe loosening of credit was required to soften the blow of the economic correction. President Bush's tax cuts were also initiated to combat deflation and stimulate consumer spending. However since 2001, the dollar has been in decline which would appear to counteract these deflationary effects. These actions have only served to delay the inevitable economic correction, which must now occur with more fervor.

What Can We Expect?

It's unlikely that America will escape a disaster similar to the socioeconomic meltdown witnessed during the Great Depression. Although it may look different, the overall

effects will be similar, with massive job losses or a wave of underemployment. The end result will be low income for millions, with further societal decay as an aftershock. Only after this devastation, will Washington gain the incentive to make needed policy changes. But these changes will require a long period of adjustment needed to reposition America for the changing world.

Market Performance

Independent of the two possibilities I've described, I have little doubt that the stock market will remain in a bearish period for the next several years. Of more significance, I do not feel America has experienced the kind of post-bubble correction necessary to restore economic balance and order. The longer it can delay a market correction, the lower it will recede.

Time is the best weapon for preventing a disastrous crash. However, it would not be shocking to see the Dow Jones Industrial Average (DJIA) fall to the 6500 level if a crash were to occur within the next 3 to 4 years, although this scenario appears to be unlikely. Most likely, the DJIA will stay in a trading range for several years, after which a correction might begin around 14,500 and head down to 10,500.

If a series of large market corrections does not occur within this time frame, America will most likely have escaped a post-bubble correction crash. However, there will continue to be tremendous market volatility which could result in a series of rallies followed by sell-offs, resulting in very little market appreciation over the period since 2001. *Note that the DJIA was about 2500 during 1991. Fifteen years later, and 450 percent appreciation (or about 14 percent annually) is still unreasonable.* If making money was only so easy.

What Correction?

In order to better understand my rationale, I have listed the major bull and bear market periods since 1900 in figure 16-1. Note that, although there have been several bull and bear markets, I have condensed them into *bear and bull market periods* for illustrative purposes. I have also labeled the two largest stock market bubbles in American history (1920s and 1990s).

I define a *bubble period* as the rapid acceleration of market appreciation during the final stages of a long bull market. The point I want to make is that all major bull market periods are followed by market correction periods that are characteristic of bear markets. However, corrections can either be one or more large market crashes or a long period of sideways market movements (i.e. typical bear markets). *Typically, when bubbles occur within bull markets, they are followed by some combination of crashes and a variable period of sideways trading.* This depends upon the severity of the crashes.

By 2012, at the best of scenarios (and assuming a depression has not occurred) I would expect the market (as measured by the DJIA) to have reached about 14,500. When you annualize the returns since the market highs of just over 12,000 made in 2000, this comes out to about 2 percent unadjusted for inflation. Yet, Wall Street will notify investors of only the most recent market gains to portray the illusion of a bull market.

You should appreciate that *the stock market doesn't like uncertainty and it tends to overreact to large sudden events due to the ambiguity involved*. Uncertainty is and will remain a continuous corollary of America's fragile economy and vulnerable national security for the next two decades. Thus, a Dow 14,500 by 2012 is quite optimistic given the risks that lie ahead (summarized in table 16-1).

Market Valuation

Illustrated in figure 16-2 is perhaps the most common metric used to determine the fair value of the stock market (the S&P 500 Index in this case)—the price-to-earnings (PE) ratio. Basically, this method looks at the PE ratio of the S&P 500 Index and compares it to one of several selected historical averages. If the forward PE ratio is above the historical average, the market is considered overvalued; if below the average, it is considered undervalued.

The difficulty with any market valuation method lies in the fact that *the market can endure long periods of over- or undervaluation because investors are never in perfect agreement about the future of the economy*. As well, because investors have different investment horizons and different asset and risk exposures, one cannot readily use historical PE ratios as a market timing tool. However, market valuation techniques can serve as a general gauge to help model a risk management strategy.

Figure 16-3 shows the PE ratio versus the performance of the S&P 500 Index. The first thing to notice is that the PE ratio declined from a value of 35 in 1999 prior to the market collapse. As well, you should notice that the PE ratio actually peaked during the first half of 2002 at around 42, when corporate accounting scandals were being exposed. In contrast to the peak PE ratio made in 1999, the market in 2002 was actually in decline, yet the PE ratio continued to ascend. This was due to the almost sudden collapse of earnings reported by many companies during that period. That gives you an idea how bad analyst and company projections were.

Figure 16-3. Market Valuation Using the Price Earnings Ratio of the S&P 500 Index



Now focus on the period from 2004 to present. As the PE ratio gradually declined, the market index gradually increased in price. Normally, this is a good sign for a market in need of a downward correction and might prompt investors to think that the bear market period was officially over. However, *in no post-bubble period that I have studied has a bull market begun without a drop in the market PE ratio well below undersold levels.* In summary, what you see from this chart is a PE ratio that has remained at high or reasonable levels for a 10-year period. But *all bear market washouts have had PE ratios that reached the low teens or single digits.* Such an overreaction is necessary in order to attract a massive wave of investors who recognize huge discounts in the market. While a capitulation occurred in fall 2003, this only served to confirm a washout of the Internet bubble period and has not addressed America's longer-standing credit bubble.

As you can see from figures 16-1 and 16-2, the two greatest bull market periods began (1920 and 1987) only after the PE ratio went to single digits (any differences in looking at PE ratios from the S&P 500 Index from figure 16-2 and the performance of the DJIA from figure 16-1 are trivial). Based on this, *I would not expect the next bull market period to begin until the market PE ratio (of the S&P 500 Index) descends to 10 or lower.* Until then, the secular bear market will continue. Of course, when you combine this data with the economic woes I have detailed throughout this book, it should be quite clear that we are far off from the end of the current secular bear market.

INVESTMENT SOLUTIONS

In this chapter I'll highlight some of the better investment industries and sectors that, in my opinion will continue to perform well over the next several years, as well as during the devastating economic period I am anticipating. It's important to note that some of these sectors (metals and energy) are very volatile by nature. Therefore, market timing as well as management of investment positions is critical. As well, investors should note that some sectors (base metals) are most likely in the final stages of their bull run, while others such as energy and precious metals will last considerably longer in my opinion. I have divided this chapter into two parts based upon the type of trend-predicting involved. The first potentially lucrative investment category to be discussed is based on lifestyle trends. For this, I focus on demographics. The second category involves macroeconomics.

Lifestyle Trends

Baby Boomers

Spotting trends in consumer behavior is vital for identifying the most lucrative investments. And when accurate forecasting has been achieved, it can yield even greater profits. However, the ability to forecast trends in growing or emerging markets must be weighed against the investment horizon, objectives and risk tolerance of each investor. Otherwise, what might be a potentially great investment could turn out bad.

As previously discussed, two decades ago when baby boomers were in their peak earning years, many new industries arose to serve their needs—housing, automotive, finance and consumer electronics to name a few. As this group enters retirement over the next two decades, they will no doubt have a smaller impact in many of the industries they helped build. In contrast, other industries will benefit from their changing needs, despite their greatly diminished buying power.

For instance, looking at current and future estimated birth rates, we should expect an overall decline in industries that obtain a significant percentage of revenues by serving infants and toddlers. However, the effects of an aging, low-income, less technologically savvy boomer generation on the consumer electronics industry should be minimal since this industry is able to control pricing and profit margins by supply and demand. As well, younger generations typically account for most of the demand growth of the latest high-tech electronic gadgets. Therefore, the effect of aging boomers should be minimal. Regardless,

with fewer Americans in the market for electronics, I expect more brick-and-mortar facilities to transition to an online business model. Those companies that are able to achieve this in an efficient manner will continue to benefit from a reduced cost structure despite lower revenue growth.

Healthcare

There are two industries I expect to clearly benefit from the aging boomer population. The first is healthcare. While I do not anticipate a system of true national healthcare anytime soon, I expect the trend of rapid healthcare cost growth to remain even if and when such a system is been created, since it would most likely be implemented gradually, and not without a fight by providers.

Many boomers will find it difficult to pay out-of-pocket healthcare expenses, regardless of their ability to qualify for Medicare and Medicaid. Without question, the majority of lifetime healthcare expenses occur over age 60. Treatment regimens for chronic end-stage disease management last longer and cost more. As well, these treatments create a dependency on pharmacological agents, medical devices, and longer, more expensive hospital stays.

What government or company pensions fail to pay for in medical expenses, elderly Americans needing healthcare services will. Boomers on their last leg will pay for critical care and any other goods and services they feel might prolong both the duration and quality of their lives. They will even use their credit cards if necessary. This trend is already present. In short, *the pharmaceutical industry will rebound from its current slump, delivering excellent earnings growth despite any economic meltdown.* This trend will continue as long as America allows big pharma to operate as a monopoly.

The two sectors within healthcare I expect to perform exceptionally well are home-nursing care and retirement community facilities. Statistical numbers from the Census Bureau alone provide estimations for this potentially huge market. While there are only a few publicly traded companies serving this lucrative market, I expect many more to spring up over the next few years. Alternatively, entrepreneurs should consider these businesses as viable candidates.

Finally, the most lucrative sector in healthcare that will be resistant to the effects of economic fallout is telemedicine/healthcare IT. This sector is expected to become enormous due to the government mandates for cost reduction in most segments of public healthcare. No doubt, these technologies will spill over into the private healthcare markets as well. The difficulty here lies in identifying the early winners.

Travel and Leisure

The second industry I feel will perform well is travel and tourism. It's no secret that aging Americans wish to travel and see more of the world before their permanent departure. Depending on where you live, you've probably seen tour buses filled with seniors. Even with most Americans expected to retire in poverty, I still believe that millions will take cruises. Consider that cruises can be very affordable for people on a tight budget when charters are provided. As well, with the high cost of oil, road trips and bus tours are becoming very expensive. While potentially lucrative, investment in the travel industry could be very risky

due to the vulnerability of terrorist attacks. Thus, it might experience difficulties during a depression. Still, this sector will be one to watch. Finally, gaming resorts in Las Vegas will continue their growth and popularity, and should be minimally affected by a weak economy. Never underestimate the power of addictive vices, especially when they've been glamorized by a "Hollywood" or "Disney" theme.

Industries Adversely Affected

On the other hand, I would expect the home improvement industry to face declining earnings growth due to the real estate shakeout over the next several years. In fact, the correction could extend throughout the next decade, as many boomers scale down to smaller homes, condos, or assisted living facilities. I'm not saying that Home Depot will shut down. Rather, I am predicting it won't have anywhere near the type of earnings growth seen during the '90s. The only chance for Home Depot and Lowes would be through business diversification. But management has yet to come up with any clear plans to provide such growth. Home Depot is facing several challenges.

As well, I feel that there will be a selective decline in many financial companies. While all will not be affected, those that will be hit particularly hard will have large exposure in mortgages (especially sub-prime), derivatives, and those that have grown earnings primarily through acquisitions, such as Bank of America and Citigroup. Derivatives exposure is a particularly critical risk to watch out for. Beginning in about 10 to 15 years, I anticipate a wave of divestitures of many of these mega-banks.

Future Healthcare

During the '80s and '90s, the pharmaceutical industry enjoyed the best growth of any industry, but times are changing. A recent wave of drug recalls and lawsuits with Phen-Phen, Vioxx, and many others, as well as whistle-blowers at the FDA and even within the drug companies have caused a mounting force of protest among many healthcare providers and recipients. Already, the demand for nutritional supplements and alternative medical products is huge. I expect these markets to continue their growth, as more Americans realize that one of the reasons for the escalating costs of healthcare is due to their love affair with prescription drugs and medical devices which often cause more harm than good.

Pharmaceuticals and Biotechnology

Certainly, the biopharma industry will recover from its recent downturn. And while it will continue to face more competition from alternative therapies, this industry will still be one to invest in. But there are some short-term issues to contend with. A record amount of patent-protected drug revenues will lose protection beginning in 2007. Over the next year, the value of sales revenues disappearing each year due to patent expiration is expected to surpass \$23 billion worldwide, the largest decline ever. Previously, the largest decline attributable to patent expiration was \$9 billion in 2001. Along with the recent controversy surrounding the FDA process and its ties with the drug industry, the wave of drug liability lawsuits has stimulated a growing shift towards nutritional and other alternative therapies that will continue to present challenges for the drug makers. But this should only be a short-term effect.

Problem #1: Patent Expiration

With rare exception, the generic drug makers are typically poor investment choices because they are in the drug commodities business, and therefore use a price leadership advantage. Price leadership is nowhere near as strong as the price control strategy utilized by the big drug makers. The best reason for investing in drug companies is to take advantage of their monopoly status. Generics merely manufacture drugs whose patents have expired. As well, there can be intense competition from rival generics and parent drug companies, due to billions spent annually to build brand recognition. Below I've mentioned some key patent expiration data.

Pfizer: By 2007, Pfizer's patent on the antidepressant Zoloft will expire, opening the door for generics. In 2005, Zoloft had \$2.7 billion in U.S. sales. It's probable that Zoloft will face huge liabilities from future lawsuits due to adverse effects. Overall, Pfizer faces the loss of almost a third of its total revenue during the next three years from the expiration of patents on Zoloft and other drugs, including Norvasc. Pfizer has already announced cutbacks even deeper than Merck and is fighting off competitors from its anti-cholesterol blockbuster Lipitor, an \$11 billion drug whose patents start expiring in 2009. Look to pick this one up after a sell-off.

Merck: Amongst many of its other problems, Merck is already suffering declining revenues for Zocor. In June 2006, the generic manufacturers rolled out lower-cost versions of the drug and this is expected to ultimately diminish annual Zocor revenues by \$2 billion (revenues were \$3.6 billion in 2005). As well, in 2005 Merck's Fosamax patent extension was denied. And of course Merck lost all future revenues for Vioxx, which brought in over \$1.5 billion in sales in the year prior to its removal. Within the next 5 to 6 years, Merck will face a revenue reduction of up to 60 percent due to patent expiration and the loss of Vioxx. And with a very limited pipeline of new drug candidates, its ability to replace a large part of these revenues is unlikely over the next 8 years. Finally, it still must deal with a potentially large financial liability due to Vioxx lawsuits, which will continue for several years. Look to pick this one up after it gets hammered again.

Bristol-Myers Squibb: In 2007, Bristol-Meyers will lose patent-protection on its cholesterol drug Pravachol, which brought in \$1.4 billion in the 2005. Overall, patent expirations threaten about 31 percent of Bristol-Myers Squibb's total earnings by 2008. But this company has deeper issues within management that will cause it to linger for the next several years. I would stay away from BMY.

Wyeth: By 2007, Wyeth will lose patent-protection for its top-selling drug Effexor, an antidepressant which topped \$2.3 billion in sales in 2005. Overall, by 2008, Wyeth faces a loss of approximately 29 percent of sales due to patent expirations. Of course, the company still has a long way to go before paying out over \$22 billion in damage awards from previous drug recalls. Similar to Bristol-Meyers, Wyeth is another with too many skeletons in its closet. I would stay away.

Problem #2: Lawsuits and Diminished American Confidence

Drug liability lawsuits have never been larger and more widespread as they are today. Virtually every attorney wants in on the action. And due to major safety issues with many of the me-too drugs, you should expect the wave of lawsuits and drug recalls to continue. This heightened attention has caused more Americans to question its drug-centric healthcare system, leading many to seek alternative therapies and nutritional products. As well, it has partly been responsible for the early growth and success of the organic food industry; another growth area to consider.

One of the key variables to look out for when analyzing the effects of contingent liabilities of drug litigation cases is where the trials are held. For Enron, holding the trials in Houston was certainly a disadvantage because the scandal cost many local residents so much. However, *for Merck, having trials in New Jersey has proved to be a major advantage due to the support from the local communities. This could be the edge it needs.*

Problem #3: Healthcare is Expensive and Poorly Accessible

Solution #1: Drug Price Controls

I do not see drug price controls happening anytime soon in America. Therefore, as long as Washington allows big pharma to control prices, they will continue to produce strong earnings. And with the recent launch of Medicare Part D, I anticipate a nice boost to current lingering sales, as well as massive fraud which will help earnings of many drug companies.

In conclusion, look for a modest earnings decline in pharmaceutical industry over the next couple of years, as these companies struggle with pipeline issues and litigations. I expect significant downsizing to occur as a way to cut costs, followed by revitalization in a few years. Even after this brief period, investors should not expect the kind of blockbuster earnings growth witnessed in the '90s due to more effective and safer therapeutic options. Yet, the pharmaceutical industry will never go away and will continue to earn robust profits. It just won't represent the most profitable industry as in the past. Therefore, investors can no longer blindly invest in drug companies and do well. Selectivity will be the key to excellent investment returns from this industry. Investors should focus on the big names such as Pfizer, Merck, and Eli Lilly. Relative valuation should be a key consideration.

Finally, I expect biotechnology to overtake big pharma as a better risk-reward investment. Note that biotech stocks tend to be more volatile due to the uncertainty of earnings. And while the larger, more established names provide less volatility, they also have less upside. It's difficult to determine the potential upside of the entire industry since a merger spree with pharmaceutical companies could change the outcome. Investors should focus on the blue-chip biotechs like Amgen and Genentech.

Investing in newer sectors such as stem cells can be dangerous since most of these companies do not have sales revenues. And the political environment currently does not favor an absolute advantage for U.S.-based stem cell companies. However, there is a good chance that this will change after President Bush leaves office. These companies will continue to provide excellent short-term trading (experienced traders only) returns, sparked by announcements of federal funding or changes in the political landscape.

Solution #2: New Alternatives

Nutritional Supplements Market

This industry is multi-tiered. On the one hand, we've already witnessed rapid growth of the nutritional supplements industry. And while there is more room for growth, these companies are probably not good candidates for conversion into publicly-traded companies due to their emphasis on commodity-based products and high marketing expenses. What these companies have done is increase the availability and awareness of nutritional supplements. And this has created a huge retail market for these products. However, until the FDA begins to regulate nutritional supplements it will be very difficult for this industry to create product distinction and proprietary protection through patents. Therefore, they will remain as commodities, subject to the effects of price wars; never a good situation for profitability.

So where are the potential areas of investment? *Investors should keep on eye out for nutritional/organic franchise restaurant chains which may grow large enough to go public.* This might represent an excellent opportunity to replace your other restaurant stocks. In addition, *organic and specialty grocery stores chains will continue their surging growth.* Already, in just five years, Whole Foods has experienced phenomenal growth and there is much more on the way. This company is well-positioned to utilize America's changing perceptions on health and nutrition.

Over time government programs such as Medicaid and Medicare will begin using more nontraditional therapies and advanced technologies as a way to curb massive cost increases due to an aging population. The only problem is that it is difficult to find any one company that will benefit from these changes since most nutritional therapies are not patentable (the use of advanced technologies in healthcare will be discussed later under Solutions #3). As a result, the current nutritional supplements-based companies should be considered as retail businesses; a nice area for entrepreneurs to get into. Notable exceptions are some of the newer energy-boosting beverage companies and others that sell items such as protein bars, etc. While some of these companies are already public, I would be very cautious because they have not yet demonstrated an ability to extend their business lines and create consistently strong earnings growth. In order to produce staying power, they will have to diversify into newer products.

Most likely, many of these companies will become buyout candidates for beverage names such as Coca-Cola, Pepsi, Anheuser-Bush, Altria, and several others. These blue chips might see this new wave of nutritional products as a way to address declining growth. *Combined with their strong branding power and ubiquitous distribution channels, it is entirely possible that such acquisitions could lead to an enormous market due to their unique ability to alter consumer ideas and buying attitudes.*

When Coca-Cola began experiencing a decline in earnings growth, company executives recognized the huge and growing bottled water market and came out with their own brand, Dasani. This move leveraged Coca-Cola's great brand name and extensive distribution channels, resulting in a large market share in a short time period. After all, Dasani is only filtered water yet costs \$1.50 per 16 ounce bottle. Look for other blue chip beverage makers to enter the high margin nutritional supplements market.

Solution #3: Cost-Effective Alternatives

Telemedicine

Telemedicine has been defined as the “Use of electronic signals to transfer medical data from one site to another via the Internet, intranets, PCs, satellites, or videoconferencing telephone equipment in order to improve access to health care” (Telemedicine Information Exchange, 1997). Telemedicine provides access to medical specialists and healthcare services unavailable to many individuals, and does so in a timely and cost-effective manner. As well, it allows expenses to be reduced using advanced wireless and digital technologies so providers can monitor, diagnose and treat patients located in different geographical regions.

Tremendous time can be saved by the organized storage and fast retrieval of data and the integration of claims forms and medical records. This will cut costs and minimize errors, allowing physicians to spend more time preventing and treating disease, rather than looking for data and doing paperwork. Virtually every discipline of medicine has found benefits in telemedicine, from teleradiology to telepsychiatry. The first mainstream impact of telemedicine will reach two areas of healthcare delivery:

- **Home-health** and community Medicaid patients. Home healthcare is the fastest growing healthcare delivery sector in America. Demographics dictate this trend will continue its explosive growth over the next few decades. Otoscope and stethoscope attachments can be connected to a home computer or wireless device and monitored elsewhere. Blood pressure and ECG readings can be taken as well.
- **Point-of-Care testing** will improve dramatically. Web-enabled and wireless patient-monitoring solutions include diagnostics and treatment over the Internet enabled by secure archive data centers that can be accessed via standard web browsers or wireless devices. This has applications for monitoring and treating virtually every chronic disease. Already, there are several private companies providing home-health and POC services.

As discussed previously, Medicare and Medicaid are in a huge mess, with insurmountable liabilities and annual decreases in coverage due to lack of adequate funding. Washington cannot possibly fund this \$40 trillion public healthcare liability and is betting on telemedicine to cut costs. *Already, Washington has mandated that by 2014, at least 10 percent of all healthcare delivery in America should be through telemedicine.* Based upon the estimates for healthcare expenditures by 2014, that means the market for telemedicine will be over \$300 billion within eight years.

Right now the only publicly traded companies investing in telemedicine do not have enough at stake to show a major earnings benefit. But already, many large companies such as IBM, Intel, Siemens, GE, Motorola and several others are investing in telemedicine and bioinformatics. The best way to capture investment opportunities in this space is to keep an eye out for the development of this market and look for IPOs.

Healthcare IT

Of all high-tech industries in America, healthcare IT is by far the most antiquated, least organized, and the most prone to error. Ironically, due to the enormous volume of critical data, the healthcare industry should have the most advanced and secure IT systems. The lack of efficient IT systems in hospitals costs billions of dollars and thousands of lives each year. It has been estimated that over \$25 billion is lost annually in reimbursements due to coding errors, non-inclusion of procedures and other administrative errors. As well, thousands of patients die annually in hospitals due to errors that could have been prevented with proper data management systems.

The plan proposed by the Washington to modernize America's healthcare IT infrastructure is called the Health Insurance Portability and Accountability Act (HIPAA). HIPAA is the first step towards efficiently run healthcare. It will revolutionize healthcare delivery, helping to

Macroeconomic Trends: Metals

Metals have been of immense value to civilizations since prehistoric times due to their utility, beauty and durability. We've come a long way since the use of metals for knives and forks, yet we still use them. But this isn't the reason to get excited about metals. The point is that, despite the advancement and use of modern synthetic materials, metals are as valuable to us today as they were in ancient times. And for many of their uses, we have found no substitute.

Regarding the investment appeal of metals, investors should note the current status of the economic cycle, which is causing commodities to rise. However, the base metals should be approached with caution because the commodities bubble has already had an impressive run since 2001. Most likely this bubble will run out of steam when China's economy corrects, which I expect to occur by 2010. In contrast, there are other factors that will continue to lead to the appreciation of precious metals for a longer period—*continued weak dollar, higher interest rates, and declining support for the dollar. These trends will most likely lead to record prices for precious metals over the coming decade.*

Base Metals

Unlike gold, the other precious (the non-commodity metals) and base metals (commodity metals) are consumed for industrial means. Due to the tremendous growth of China and India, demand for base metals is outstripping supply. These populous nations must have an ever increasing supply of base metals for infrastructure expansion, as well as for raw materials for finished goods. There simply hasn't been enough nonferrous metal supply to meet the demands of the Chinese industrial machine.

As previously mentioned, I do not expect the base metals to continue their bull run beyond the next 4 years. In contrast, the precious metals bull market should continue for at least the next 7 years. And when a depression hits America, this could send the price of gold

and silver to astronomical highs. Such a catastrophe could lead to price levels that exceed historical marks adjusted for inflation, or over \$2200 per ounce for gold (based on 2006 dollars) within the next two decades.

Gold Rush

The main problem with investing in gold and other precious metals is that they tend to perform poorly relative to the overall stock market over long periods. However, during a post-bubble correction period, (which can last from 12 to 15 years) gold can provide tremendous gains, although investors will be subject to extreme price volatility.

Unlike gold, stock prices and company valuations are intangible. And during periods of extreme uncertainty or panic, investors opt for more tangible expressions of wealth like gold and silver. Because so many investors rush to buy precious metals, supplies become limited, often leading to magnificent price appreciation. Therefore, if one believes that the stock market is still largely overvalued relative to the economic realities masked by Washington, both now and in the future, you should expect gold to continue its bull run from this consequence alone.

As the dollar has been weak, foreign central banks have been seeking to hedge against further declines by increasing their gold deposits. But the effects on supply have been further accentuated by signs of supply shortages in critical gold-mining hot spots. Even production in the rich mines of South Africa appears to be maturing, after an 80-year record-low output in 2005 amidst soaring prices. Finally, worldwide gold production in 2004 experienced its largest decline in over 39 years, pointing to significant supply issues. The other possibility to consider is whether producers withheld inventories from the market due to further anticipated price increases. *Regardless of any potential inventory manipulation, worldwide demand for gold is rising from investors and central banks wishing to mitigate the effects of a weak dollar.*

Gold and Inflation?

Gold has been shown to provide a great hedge against deflationary conditions. And in many cases, it has also performed well during inflation. But to say that gold will always provide a hedge during inflationary periods would probably be unfounded. The most recent evidence of gold's demand during a deflationary environment occurred during the last recession, when the gold bull market commenced. In 2001, at a price of around \$230, gold has surged to over \$700 in five years.

This leads us to the inverse correlation between gold and stock market performance. Statistical analysis shows that over the past thirty years, *the correlation between gold and the Dow Jones Industrial Average actually declined during the worst-performing 30 months of this index, thereby serving as a hedge against the most severe market declines.* The inverse relationship between gold prices and stock market performance might be explained by the investor-neglect of gold during strong bull market periods, causing severe undervaluation of this precious metal. Likewise, *the retreat of investors from an overvalued stock market during a post-bubble correction could cause the rush into gold as a safer, more attractively valued asset class.*

Gold ETFs

Gold exchange-traded funds (ETFs) make investing in gold more convenient, less expensive, and less risky for smaller investors. Unlike other ETFs, gold (and silver) ETFs actually buy gold (and silver) bullion and store it in a central bank. Therefore, investors in precious metal ETFs actually own a stake in the metal as opposed to owning shares in the mining companies. In 2005, two new ETFs were launched that track gold—iShares Comex Gold Trust (IAU) and StreetTracks Gold Shares (GLD).

The main advantage of precious metal ETFs are that they protect investors from company-specific and political risks, which can be very high, especially when companies are mining in unpredictable and politically volatile nations such as South America and Africa. Therefore, the risks are reduced to those affecting trading prices of the metal (i.e. the macroeconomic risks). In contrast, because many of the smaller mining companies use leverage, they can multiply their earnings during a gold bull market. But this can also work against them when gold prices correct.

Gold ETFs have grown so rapidly over the past year that they now hold over 424.7 tonnes of bullion. Since ETFs actually purchase and store gold, this will help deplete reserves, causing an increase in price. When compared to mutual funds, ETFs:

- Are more tax-efficient
- Have lower costs
- Can be hedged with options
- Have no penalties for liquidation

Other Precious Metals

Even more impressive than gold has been the appreciation of silver, platinum, and palladium over the past three years. Similar to gold prices, while these precious metals are certain to correct, they're likely to make new highs over the next several of years. But corrections in the precious metals can be brisk and devastating, so position management will be critical.

Silver

Similar to gold, investment demand for silver has been minimal over the past several years but has recently picked up due to concerns with the U.S. dollar. But unlike gold, silver is consumed for consumer goods. Demand for silver stems from three main areas; industrial/decorative, photography and jewellery, and silverware. Together, these three categories represent more than 95 percent of annual silver consumption. In 2003, 351 million ounces of silver were used for industrial applications, 200 million ounces for the photographic sector, and 266 million ounces were consumed in the jewellery and silverware markets.

Silver's high demand for industrial applications is due to its unique physical, mechanical, and chemical properties—strength, malleability and ductility, electrical and thermal conductivity, sensitivity to and high reflectance of light, and its ability to endure extreme temperature ranges. In many cases, no substitute materials can mimic silver's physical and chemical characteristics.

The chart below shows the historical price chart of silver since it began trading on an organized exchange. For the most part, silver prices remained constant for more than 150 years, failing to keep up with inflation. By around 1980, the price of silver soared to over \$22 per ounce. Over the next several years, I expect this record to be surpassed and it could easily cross the \$25 mark without a depression. A depression could cause silver to soar over the \$50 mark. As the next chart shows, silver has already surpassed a critical technical analysis resistance level which favors its continued uptrend.

Up is the Only Direction for Silver

Silver has been experiencing a huge depletion of inventories over the past decade. Since 1991 alone, the above ground silver supply has declined from about 1.4 billion to over 600 million ounces. Note also that Warren Buffett purchased 130 ounces of silver in 1998. It's unknown whether he still holds this amount. If so, he would have control over 20 percent of the world silver market. I have read reports that indicate he has since sold his stake. If so, that would imply an even more bullish indicator, since a tremendous price appreciation has occurred despite the release of such a large supply.

Annually, silver deficits are around 50 to 100 million ounces. And because reserves are at very low levels, we could see skyrocketing silver prices well beyond the \$20 per ounce level by 2012. Now that one silver ETF has entered the market, this will further strain supplies since the precious metal ETFs buy the metals, thereby removing them from the market.

Regardless of the future economic environment, silver is destined to continue its rise along with gold. *Under strong economic conditions, silver's use in industry will no doubt propel its price to new highs. In contrast, under a weak economic scenario, silver prices would soar even more due to decreases in base metal use and therefore mining.*

Platinum

Platinum plays a critical role in the high-technology industry. For instance, it is used to convert hydrogen and oxygen to heat, water and electricity. However, it has hundreds of other critical industrial uses. Since 2002, platinum is already up by over 250 percent. And while it will most likely continue its bull run, current levels appear to be quite high. Therefore, I would tend to stay away from this metal until it corrects downward by a large amount. In contrast, while other precious metals have also experienced similar surges, on a historical basis they're still quite attractive in price. Once again, *investors opting to invest in the precious metals should only buy after large corrections and trim positions after large rallies.*