UPDATED EDITION

the Age of Deleveraging

Investment Strategies for a Decade of Slow Growth and Deflation

A. GARY SHILLING

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Updated Edition

A. Gary Shilling, PhD

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Foreword

When one thinks of the term "Renaissance Man" in conjunction with the world of investing, trading, and economics there are really very few names that come swiftly to mind. Wall Street is simply not known for its sense of art, or history, of philosophy, of literature, or of music. There are some from the past that come to mind of course, as great philanthropists to the arts, but they were philanthropists simply to buy a place in history rather than as a respecter of history and the arts. I have been fortunate, however, to have met a true Renaissance Man, and you are fortunate enough to be about to read one of his books. When I think of a Renaissance Man on Wall Street, I think instantly of my dear friend, Dr. A. Gary Shilling. Gary is a gentleman who can, with the best of them, launch into a discussion of Shakespeare's tragedies, and can instantly recognize the composer of a piece of classical music—and perhaps even name the conductor and the orchestra playing the piece in question. He understands the lessons of history through the ages and can discuss with alacrity and clarity the importance of the adjusted monetary base as reported by the Federal Reserve Bank of St. Louis or, just as readily, the implications of a revision to monthly durable goods orders. Gary is a true Renaissance Man, and he's taught me much.

I first became aware of Gary's economic forecasting abilities back in the early 1970s, when I was one of the young economists at Cotton, Inc. in Raleigh, North Carolina. My duties were to forecast cotton supply and demand statistics as well as generate a view on the economy that we could send to the cotton producers of America, who were our clients. Looking about for economic wisdom, I came upon Gary's work. He was White, Weld's Chief Economist, as I recall. He was the only economist on The Street at the time who was forecasting a severe recession. Everyone else was forecasting protracted economic growth. Gary was right. The recession of the early 1970s was the worst recession to that point in the post-World War II period. He earned my respect.

Gary was bearish again regarding the U.S. economy in the early 1980s when his peers on The Street remained steadfastly bullish. Applying simple logic and historical precedents to the situation, Gary's view was again proven right. Others, sadly, were proven wrong.

I followed Gary from afar for nearly a decade. Having chosen in the early 1980s to set up my own firm that would focus on writing a daily commentary on the global capital markets, I chose to "screw my courage to the sticking point," and called his office to request a meeting. To my great surprise and true delight, he said he'd be happy to meet with me. I remember to this day our meeting in a wonderful old building in lower Manhattan, where he graciously spent an hour or two talking about the markets, the economy, and his interest in Shakespeare, music, and history. From that point on, I've been an even greater fan of the man and his work.

Thereafter I read, with delight and great expectations, his books on topics such as inflation and economics as well as his monthly newsletter to clients around the world . . . never to be disappointed. In all his work, Gary's wisdom is more than merely evident; his writings are cogent, rational, and, far more often than not, they are utterly "spot on." Too, they are often witty.

Gary taught me the importance of technology shifts in matters few others could explain. For example, few today think about the Erie Canal, but in its time it was a huge shift for the better in the United States, opening up the western states to trade with the eastern seaboard in a manner previously unimagined. Gary's insights into why the wheat trade suddenly became an important part of the history of Buffalo, New York, which became perhaps the leading milling city in the then young United States, taught me why it was, through extension, important that Silicon Valley grew as it did in the 1970s, 1980s, and 1990s. He also taught me the importance of "good deflation" and "bad deflation." And of the benefits of rising production and falling prices of goods and services during the growth of agriculture in the nineteenth century, and how that could be extrapolated to technology today.

Gary taught me the importance of being an iconoclast in the world of economics, for it is he who sees with a different eye that survives the ebbs and flows of the investment world. He taught me the necessity of being away from The Street, where he and I could see with some sense of clarity what others might be seeing too closely and thus unclearly. He taught me the importance of keeping a long-term perspective, and the importance of having interests outside of Wall Street. So Gary has his bees . . . he's a well known beekeeper and gardener . . . he has his Shakespeare . . . he was once the Chairman of New Jersey Shakespeare Festival, a regional theater company . . . he has his music, and he putters around the house. And most importantly, he has his family. He's what, in the Midwest, we call "a good man." This is high praise.

Over the years we've talked on the phone countless times, discussing the markets and viewing them with perspective. We've invested together, and we've sent clients to one another. We've had dinner; we've laughed; and all the while, I've learned far more from him than he's ever learned from me. In this new book, *The Age of Deleveraging*, Gary shares his newest ideas on the global economy, and I cannot recommend it strongly enough to anyone with even a tangential interest in how markets and economies work. I guarantee . . . and one is always warned never to guarantee anything in the markets . . . that you will come away from this book understanding how the United States and the global economy functions. You will be a better investor having read this book, and you will become enamored of this great gentleman.

To finish, let's not forget that despite his "Renaissance" visage, Gary has his feet in the modern world. After all, in years past he's entertained Keith Richards of the Rolling Stones and his family at his beach house on Fire Island. The tale of how this happened is another story for another time, but suffice it to say that when the world of the Rolling Stones and the world of Shakespeare can meet in the world of A. Gary Shilling, magic happens.

So, I wish you well in reading this excellent book and learning, as I have, what Gary offers. We are all the better . . . materially . . . for this.

Dennis Gartman
The Gartman Letter, L.C.
July 2010

Acknowledgments

This book is the result of literally decades of research and analysis, so many, many people have been involved over the years. Still, the actual writing of it took place from January through mid-April of 2010. The first months of the year are my "free time" for projects like this. From mid-April through October, my honeybees need lots of attention. So do my yard and gardens at our residence in Short Hills, New Jersey, and our beach house in Point O'Woods on Fire Island off the south coast of Long Island, New York. Then comes November and all the activities leading up to Thanksgiving and Christmas. So it's January 2 before I can catch my breath.

Assembling a book of this length and depth in three and a half months put a lot of strain on our organization, coming on top of an already hectic schedule. I'm delighted, however, that everyone worked long and hard, and with good cheer.

I'm especially indebted to our extremely able editor, Fred Rossi. In addition to the usual superb job he does in editing our monthly newsletter, *Insight*, and managing our growing distribution list, he typed and edited this book. I must confess that I broke into a museum and stole an ancient writing instrument called a pencil with which I wrote every word. But since I'm not completely antediluvian, it's a mechanical pencil. In any event, Fred did a magnificent job, as usual, in translating my chicken scratches on white lined pads into English—and did so in his usual calm, cheerful manner.

Colin Hatton, the senior man on our research team, also deserves my special thanks for much of the data, charts, and analysis in this book. Despite being only two years out of college, Colin has an excellent grasp of economic and financial data and a wonderful memory for the huge number of charts from which we selected the relatively few contained in this book. He also made a number of very helpful suggestions for the analyses that supported my arguments and forecasts. And Colin did it all with an unusual calmness and willingness to work long hours.

I also appreciate the work of Nestor Pura, a new research associate who nevertheless contributed to the analysis and charts. And I thank Jack Redmond, who took time from his investment advisory duties to unearth important financial data.

My most able assistant, Beth Grant, played an extremely critical role in keeping us all calm and focused on getting this book written on time and without the inefficiencies of personal blowups. How many times did Beth, in her extremely pleasant way, say, "Gary, how's the book coming?" I got the message loud and clear! Beth is the glue that keeps our firm together.

Finally, I thank my wife of almost 48 years, Peggy, for understanding the pressure I was under and for accepting the many evenings and weekends when I was not spending time with her, but bringing chapters of this book home from our offices and writing in the solitude of my den or on the dining room table. Even our female yellow Labrador retriever, Honey, seemed to understand the situation. Rather than bug me to go out and throw a tennis ball for her to retrieve, she lay down on the floor while I wrote, providing silent support and companionship.

Introduction

In 2007–2008, almost all investment categories suffered huge losses as the global financial crisis and worldwide recession unfolded. Stocks in almost every market worldwide; corporate, municipal, and junk bonds; commodities; residential and commercial real estate; foreign currencies; emerging market stocks and bonds; private equity; and most hedge funds bit the dust. Indeed, in 2008, the only winners were the traditional safe havens—Treasurys, the dollar, and gold.

But in response to massive government bailouts of financial institutions here and abroad and huge worldwide fiscal stimuli, those many depressed investments revived vigorously, starting in early 2009. So most investors believe that 2008 was simply a bad dream from which they've now awoken. We're returning to the world they knew and loved, with free-spending consumers supporting rapid economic growth, fueled by ample credit and backstopped by governments. After all, they reason, the recent experience proves not only that major financial institutions are too big to be allowed by governments to fail, but that the same is true for underwater homeowners. Monetary and fiscal largesse is so extensive, they believe, that economic overheating and serious inflation are the next major problems.

But the optimists don't seem to realize that the good life and rapid growth that started in the early 1980s was fueled by massive financial leveraging and excessive debt, first in the global financial sector, starting in the 1970s, and later among U.S. consumers. That leverage propelled the dot-com stock bubble in the late 1990s and then the housing bubble. But now those two sectors are being forced to delever and, in the process, are transferring their debts to governments and central banks.

This deleveraging will probably take a decade or more—and that's the good news. The ground to cover is so great that if it were traversed in a year or two, major economies would experience depressions worse than in the 1930s. This deleveraging and other forces will result in slow economic growth and probably deflation for many years. And as Japan has shown, these are difficult conditions to offset with monetary and fiscal policies.

The insidious reality is that this deleveraging doesn't occur in a straight line, but in a series of seemingly isolated events. After each, the feeling is that it's over, all may be well, but then follows the next crisis. When the subprime residential mortgage market collapsed in 2007, most thought it was a small, isolated sector. But then it spread to Wall Street with the implosion of two big Bear Stearns subprime-laden hedge funds in June of that year. Most hoped the Fed actions that summer had ended the crisis, but as the financial woes spread, Merrill Lynch suffered a shotgun wedding, major banks like Citigroup and Bank of America were on government life support, and Lehman went bankrupt in September 2008.

Then the third phase struck as U.S. consumers stopped buying in the fall of 2008 and the fourth, the global recession, coincided. The optimists hoped the $787 billion fiscal stimulus package in the United States and similar fiscal bailouts abroad would take care of all those problems, but were surprised by the eurozone crisis in late 2009 and early 2010. Nevertheless, that's just the fifth step in global deleveraging. The combination of the Teutonic north and the Club Med south under the common euro currency only worked with strong global growth driven by the debt explosion, but now that's over.

As I discuss in this book, further traumas on this deleveraging side of the long cycle lie ahead. They may include a crisis in U.S. commercial real estate that could exceed the one in housing, a collapse of what

I believe is a Chinese house of cards, and a slow-motion train wreck in Japan.

I hope this book convinces you that the deleveraging process has years to go and that economic and financial markets have not returned to business as usual, at least not to the world of rapid growth supported by oversized and growing debt. If you agree with me, you'll appreciate the investment strategies that I see as appropriate for a decade of slow growth and deflation. In Chapter 11, I cover 12 investment sectors to sell or avoid, and in Chapter 12, I discuss 10 you should consider buying.

During the past fascinating decade, I played three roles. First, I was an eyewitness to history, watching speculation survive the Internet bubble collapse in the early 2000s due to massive monetary and fiscal stimuli, and then the spread to commodities, foreign currencies, emerging market stocks and bonds, hedge funds and private equity, and especially housing. I saw the housing and financial bubbles expand and then explode. I watched the fears of financial meltdown spur gigantic monetary and fiscal bailouts. I experienced the witch hunts that followed, the inevitable result of widespread losses and high unemployment.

Second, I've been a participant in this drama, not only chronicling it in our monthly *Insight* newsletter, but also continually warning of the impending collapses in the housing and financial bubbles. And I was involved through a very profitable year in 2008 for the portfolios we manage when all 13 of our investment strategies worked—most gratifying, in contrast to those who never acknowledged that those bubbles existed, much less could burst.

Third, I've participated as a forecaster in successfully foreseeing the expansion and then collapse of the housing and financial bubbles. More recently, my forecasts have focused on the continuing deleveraging that the bursting of those two bubbles commenced, and the resulting investment strategies for the next decade.

This book describes all three of these roles. I hope you find it enlightening, provocative, instructive, and at times amusing. It would probably have been more convincing had you read it in early 2009 in the depths of the recession and financial crisis, but it may be more useful today.

A. Gary Shilling
May 2010

Introduction to Paperback Edition

Since I finished writing this book in May 2010, events to an amazing degree have confirmed its analysis and forecasts. Consequently, most of my investment recommendations back then have done very well and still make sense.

Greek Bailouts

The €110 billion bailout of Greece in the spring of 2010 was supposed to give that country time to get its economic house in order, drastically slash government spending and deficits, and return to the public markets for sovereign debt financing. Nevertheless, I wrote that "the likelihood that Greece will shape up and fly right is slim," and it has been. The probable decline in real Greek gross domestic product (GDP) of 5 percent this year, the inability to sell substantial government assets, and the resulting budget deficit that's more likely to hit 9 percent of GDP than the government's target of 7.6 percent in 2011 forced the second Greek bailout plan in July 2011.

That plan, however, is in jeopardy because Germany, Finland, and other solvent northern eurozone lands are reluctant to keep bailing out the weak countries in order to keep the eurozone intact. Greece, Ireland, and Portugal, the countries aided so far, account for only 6 percent of eurozone GDP. Nevertheless, the sovereign debt crisis has infected Spain (10 percent of eurozone GDP) and Italy (16 percent), requiring European Central Bank (ECB) support for their bonds, and contagion threatens France (21 percent).

The latest government leader discussions center on fiscal policy integration in the eurozone to match the monetary union under one currency, the euro, and one central bank, the ECB. But, as I wrote in Chapter 12, the critical differences and mutual distrust between, say, Greece and Germany make this highly unlikely. Also, the proposed euro bonds to replace individual eurozone sovereign issues are problematic since the profligate Club Med southern countries would place an ever-growing debt burden on the Teutonic North's credit rating. With the financial mess in Europe and declining consumer and business confidence, a eurozone-wide recession is increasingly likely.

Chinese Hard Landing

The hard landing I forecast for China, with annual economic growth dropping from double digits back to recessionary 5 percent to 6 percent levels, has also become more probable since May 2010. The Chinese government is determined to curb the property bubble and inflation that resulted from the massive 2009 stimulus program—equivalent to 12 percent of GDP—enacted in response to the global recession that disrupted China's export-driven economy. By August 2011, consumer prices had risen 6.2 percent from a year earlier, and food prices, crucial to the many living at subsistence levels, were up 13.4 percent.

China's crude economic policy tools point to a hard landing. So does the reality that the U.S. Federal Reserve, with all its sophisticated techniques, effected only one soft landing in 12 tries in the post–World War II era, with the other 11 resulting in recessions.

I also forecast in this book that a hard landing in China will knock the foundation out from under the global commodity bubble since commodity bulls believed that China, aided by other developing countries, will soak up the world's industrial and agricultural commodity supplies indefinitely. In fact, the prices of copper, a key industrial commodity, and sugar in the agricultural arena commenced their massive declines in February 2011.

I also wrote in this book that the decoupling theory, which maintains that China can grow independently of U.S. consumer demand for its exports, was disproven by the 2007–2009 global recession, and that the theory's revival in 2010 would be equally debunked. China and most developing lands still depend directly and indirectly on U.S.-bound exports for growth.

Japanese Train Wreck

Chapter 12 describes Japan as a slow-motion train wreck since its ability to finance the huge government debt internally and still have capital left over to export will succumb to ongoing U.S. consumer retrenchment and, therefore, weakening demand for Japanese exports. Then it will need to import capital and pay global interest rates, ending the government's ability to finance its net debt-to-GDP ratio of 117 percent at 1 percent for 10-year bonds.

I didn't forecast the March 2011 earthquake and tsunami in Japan, of course, but they probably speeded up the train wreck. Exports were curtailed by supply chain disruptions, some of which may linger. Meanwhile, the national disaster-linked surge in imports will be longer lasting in the form of building materials for reconstruction and more energy imports to replace shut-down reactors.

Slow Growth So Far

The basic argument in this book is that the global economy is in the Age of Deleveraging. I point to nine forces that are likely to limit U.S. economic growth to a slow 2 percent annually for many years to come. As I finished writing it, however, many believed that massive monetary and fiscal stimuli had rekindled the economy and returned it to earlier salad days. The 2008 collapse in the economy, stocks, commodities, and foreign currencies was just a bad dream from which we'd awaken, they were assured.

Stocks in the United States and elsewhere were on a tear that commenced in March 2009 and lasted until July 2011 before nose-diving. Rallies in other investments that were killed in 2008 were also robust. In mid-2010, the U.S. new home ownership tax credits convinced many investors that house prices were bottoming, so they eagerly bought foreclosed property for quick flips at higher prices. In August, Fed Chairman Bernanke signaled another round of quantitative easing, which sent stocks and commodities skyward, even before the formal announcement in November.

Nevertheless, the economy has not returned to robust growth. Real GDP grew at a mere 0.4 percent annual rate in the first quarter of 2011 and an anemic 1.3 percent rate in the second quarter. Growth at those slow rates or lower is in prospect in coming quarters, with a recession likely in 2011 as sentiment of U.S. consumers and small businesses falls, as real household incomes decline and high unemployment persists, as business frets over the uncertainty of government regulation and future sales, as housing remains mired and prices retreat due to excess inventories and weak demand, and as state and local governments cut costs and jobs as they confront ongoing deficits and underfunded public employee pensions. Abroad, the European financial crisis is poised to spread globally and recession threatens, while the economic growth engine in Asia sputters.

No Magic Bullets

Equally important to the investment climate is the realization that earlier massive monetary and fiscal stimuli, while probably having some positive effects on the U.S. economy, did not return it to robust health and that policy makers have no magic bullets left to fire. The net effect of quantitative easing phase 2 (QE2) was to add $600 billion to excess bank reserves at the Fed, which now total $1.5 trillion, while banks are too scared to lend and creditworthy businesses and consumers don't want to borrow. That quantitative easing did temporarily propel stocks and commodities, but didn't aid lower-tier homeowners through lower mortgage rates, and actually harmed financially stressed Americans the Fed hoped to help due to higher grocery and gasoline costs.

Fiscal stimuli in 2009–2010 in the form of personal tax cuts, unemployment benefits, aid to state and local governments, and so on are expiring in a still-weak economy after pushing federal budget deficits to $1.3 trillion annually. Despite the gigantic size of the fiscal stimuli, they have offset less than half the private-sector deleveraging. Since early 2006, U.S. government borrowing has risen from 3 percent of GDP to 8 percent, a 5-percentage-point jump. But in the same time, private-sector borrowing dropped from 16 percent of GDP to zero, a 16-percentage-point decline. Nevertheless, this deep government red ink spawned a backlash that forced Congress and the administration to enact huge deficit cuts—$2.4 trillion over the next decade—in the midst of a faltering economy.

Nine Growth Retarders

To date, then, economic performance is confirming my forecast of slow growth that will persist for about a decade due to the nine causes I cover in this book (see Table 6.4 on page 182).

1. Consumers are shifting from the 25-year borrowing-and-spending binge that drove their saving rate from 12 percent to near zero to a saving spree, with the saving rate now back to 4.5 percent, and are also paying down debt. As I predicted, the high volatility of equities in the past decade has made individual investors no longer trust their equity portfolios to substitute for saving from current income. Few participated in the 2009–2011 near-doubling in stock prices as they dumped stock mutual funds in favor of bonds.

   Declining house prices since I completed this book have further depleted home equity and the ability of homeowners to use it to fund spending. The postwar babies are increasingly aware of their underfunded retirement funds and need to spend less, save more, and work longer in order to enjoy comfortable retirements. And persistent high unemployment encourages those with jobs to save for contingencies.

2. Financial deleveraging is proceeding and reversing the trend that financed much of the global growth in recent years. U.S. banks have been forced out of profitable but risky activities like off-balance-sheet vehicles, derivatives, and proprietary trading by losses, bank management fear, and government regulation. They're back to core spread lending, which is being squeezed by the flattening yield curve as banks also contend with losses on troubled mortgages they originated and sold earlier to investors. Also, the Fed's "Operation Twist," which involves selling shorter-term Treasurys while buying long-term issues further flattens the yield curve. European banks face severe losses on questionable sovereign bonds as well as dollar funding problems as U.S. money market and other fearful lenders retreat. This curtails their lending to U.S. and other dollar-based customers.
3. Increased government regulation and involvement in major economies is not only stifling innovation and reducing efficiency but also creating so much uncertainty that businesses refrain from hiring and investing. The detailed regulations to implement the 2010 Dodd-Frank U.S. financial regulation law are largely yet to be established and, therefore, uncertain. Also creating unanswered questions are the legal status and implications of the 2010 health care law that expands insurance coverage to 32 million Americans. Political gridlock in Washington also slows economic growth due to uncertainty over future laws and the implementation of past and future regulations.
4. Declining commodity prices are just beginning to curb spending in commodity-producing countries. Some Middle East oil producers are cutting government spending in response to the fall in crude oil prices. Commodity-exporting emerging economies such as Brazil earlier were plagued by huge capital inflows and surging currencies because of their high interest rates compared with near-zero developed lands. More recently, the swoon in commodity prices and stocks universally is reversing the process. Their currencies are retreating as foreign investors head for the exits and local-currency bonds are dumped.
5. Developed countries are moving toward fiscal restraint. As mentioned earlier, in mid-2011 Washington enacted a plan to reduce

the 10-year federal budget deficit by $2.4 trillion. The eurozone financial crisis is forcing Greece and other troubled countries to slash their deficits—actions that are deepening their ongoing recession. In 2010 the United Kingdom embarked on an experiment to drop government spending and employment not only to reduce future deficits but also in the hope that lower government involvement in the economy will energize the private sector to more than make up for the cuts. So far, the net effect has been a weaker economy. That forced the Bank of England to increase its quantitative easing massively.

6. Protectionism has grown in the past year and a half and threatens global growth. China continues to battle the United States and Europe over favoritism for Chinese firms in selling to government enterprises. Brazil has initiated a "Buy Brazil" policy to favor local producers that are being pummeled by the strong real.
7. The U.S. housing market keeps slipping under the weight of 2.0 to 2.5 million in excess inventories over and above normal working levels. Those surplus units will take five or six years to absorb in a climate of heavy foreclosures, stringent mortgage lending terms, high unemployment, and the realization that, for the first time since the 1930s, house prices can and do fall, eliminating the bedrock of home-buying zeal. Excess inventories, the mortal enemy of prices, are pushing house prices down toward the 20 percent further fall that I predict.

   Since I finished writing this book in May 2010, investors, forecasters, and Washington politicians are joining me in realizing that until the housing market is cleared, the resumption of meaningful U.S. economic growth is highly unlikely. Even then, the likely flattening of house prices and memories of past declines and horrendous losses are likely to keep residential construction from returning to its earlier substantial role in promoting economic growth. Home ownership is no longer desirable for many.
8. Goods and services deflation is not yet established and thereby curtailing spending as buyers anticipate lower prices. But as commodity prices drop, the early 2011 fears of inflation have faded and I foresee the media chatter shifting to deflation before long. Worldwide excess supply, globalization, competition from many developing

countries that depend on exports to the United States for growth, and falling U.S. real incomes and wages seem destined to initiate widespread chronic deflation of 2 percent to 3 percent per year.

Already, five of the seven types of deflation I explore in this book are in place. Financial assets led by stocks, tangible assets (notably residential real estate), industrial and agricultural commodities, real U.S. incomes, and almost all foreign currencies against the dollar are deflating.

9. State and local governments have contracted considerably since I finished this book in May 2010. From the early 1970s until recently, state and local government spending accounted for a steady 12 percent of GDP, only second in size to consumer spending at 70 percent. Since April 2010, state and local payrolls have fallen by 420,000 employees, or 2.1 percent, with many more cuts in prospect. And these job losses have a bigger-than-average negative impact on consumer spending since state and local employees are paid 44 percent more on average than private-sector workers. As noted earlier, municipal budgets remain stressed due to weak tax collections and the expiration of federal aid. Pension fund underfunding is being enhanced by the realization that projected investment returns are too high and the assumed current value of future benefits is too low.

Markdowns

The recent and prospective slow economic growth and the still-huge size of excess debts continue to persuade me that we are in The Age of Deleveraging. The financial sector globally and U.S. households, the two sectors that built up massive leverage in the past three or four decades by huge outside financing, have worked down only 10 percent or so of those excesses on their way back to previous norms. The deleveraging that remains will take many years to complete. And the decline will likely be punctuated by further traumas such as another 20 percent decline in U.S. house prices, a hard landing in China, major disruptions and restructuring in the eurozone, and frequent and severe recessions.

Even the most Pollyanna of optimists are realizing, since I finished this book 17 months ago, that the good life and rapid growth of the 1980s, 1990s, and early 2000s—funded by massive financial leverage—won't return any time soon. It's become clear to all that deleveraging involves not only increased saving and debt repayment but also the price markdown of many assets, including houses, many forms of commercial real estate, mortgages, stocks here and abroad, commodities, some foreign currencies versus the dollar, and junk securities.

Investment Strategies

Given the high degree to which events have confirmed the predictions I made in this book, completed in May 2010, it's no wonder that most of the investment strategies I advocated have worked well since then and continue to appear attractive.

This book discussed 12 investment areas to sell or avoid, starting with *big-ticket consumer purchases.* These are postponable, largely discretionary items, such as autos, appliances, airline travel, cruise lines, destination resorts, casinos, ski resorts, and so on. When times are tough, these expenditures suffer, as witnessed by the heavy hotel vacancies and low casino activity in Las Vegas and Indian casinos. As consumers cut out the frills, gambling casinos have suffered. In 2010, U.S. commercial casinos employed 34,564 people, 30,000 fewer than in 2006 before the Great Recession started. At the other end of the spectrum, Procter & Gamble, which has always emphasized premium household products at premium prices, in September 2011 appealed to frugal shoppers and those forced down from middle- to lower-class status by launching a new dish soap, Gain, at a low price—the first such strategy change in 38 years. "Forever frugal" consumers has become the watchword of producers and retailers of consumer products.

Meanwhile, Wal-Mart has revived its layaway plan due to consumer requests. Consumers who want to avoid using credit cards can have merchandise set aside, make periodic payments, and then pick up the items, usually Christmas gifts, after the last payment is made in December—debt free.

From the beginning of 2011 through September, a representative group of these stocks fell 38 percent compared to the 8 percent drop in the Standard & Poor's (S&P) 500, demonstrating their weakness relative to the total equity market.

I also disfavor *credit card and other consumer lenders.* Since the fourth quarter of 2008, U.S. consumers have reduced their credit card debt by 21 percent as they delever, and this trend is likely to continue. So far in 2011, some of these companies' stocks have actually risen, however.

Conventional homebuilders and related companies, I predicted, would be in the doghouse for years as house prices fall, foreclosures mount, and distressed houses are dumped on the market at prices that undercut newly constructed homes. That's clearly been true so far, with one homebuilder exchange-traded fund (ETF) down 23 percent from the end of 2010 through September 2011 versus the S&P 500's 8 percent drop.

With goods and services deflation yet to be established, the related weakness in *antiques, art, and other tangibles* lies ahead. But *banks and similar financial institutions,* another on my sell or avoid list, are obviously under pressure. As noted earlier, their profitable but noncore activities are being eliminated, bank loans and leases have been declining, lending interest spreads are being compressed, and banks are under pressure to make good on troubled loans they sold earlier to investors, including Fannie Mae and Freddie Mac. This is reflected in bank ETFs, with one falling 26 percent and another down by 25 percent compared with the 8 percent S&P 500 decline in the first nine months of 2011.

The zeal for yield in the low-interest-rate environment of the past several years pushed the prices of *junk bonds* up and the yields down close to record lows. Money was so available for low-rated issues that it took real skill to default, and default rates dropped to less than 1 percent, levels not seen since 2007, just before the Great Recession pushed them up to 13 percent.

Starting in early 2011, however, the spread between junk bond yields and 20-year Treasurys has jumped from 3.6 percentage points to 6.5 percentage points in September. In part, this reflects the decline in Treasury yields, but also higher junk bond yields, as investors anticipate tough economic times and leaping defaults for low-rated securities. I continue to believe these securities should be sold or avoided.

My forecast to avoid *flailing companies* with below-average revenue growth, high fixed labor and other costs, and big debts is also unfolding in the current stock bear market and should continue to be valid in the slow growth, deflationary, and globally competitive world I foresee. Ditto for *old-tech capital equipment producers* in an atmosphere of worldwide excess capacity and the resulting low demand for more of it.

Commercial real estate is also the victim of excess capacity, especially office buildings and retail space as high unemployment and weak consumer spending reign and Internet shopping continues to explode at the expense of bricks-and-mortar stores. There are exceptions, however, that we continue to favor. Rental apartments will continue to benefit from the single-family housing bust, as discussed later. Medical office buildings should be in high demand as a result of the growing use of medical services and the shift of medical providers from small practices to hospital employment. And self-storage facilities will continue to thrive as people downsize from McMansions to smaller single-family houses and apartments and store their excess treasures. In 2011 through July, commercial real estate prices overall fell 1 percent.

Commodity prices were still rising in May 2010 when I finished this book, but peaked in early 2011, as noted earlier. From the peak in February, copper prices were down 32 percent as of the end of September, measuring anticipated declines in global manufacturing since copper is used in almost every factory-produced good. The Thomson Reuters/Jefferies CRB (TRJ/CRB) index of all commodities declined 20 percent from its late April top. I expect these declines to continue, especially if the hard landing in China I'm forecasting materializes and removes the foundation from the bullish commodity structure, as noted earlier.

Developing country stocks and bonds remain unattractive, in my view. As noted earlier, kingpin China seems destined for a hard landing as officials there combat the undesired effects of their massive 2009 stimulus program—the property bubble and high consumer inflation. In addition, almost all developing economies are driven by exports, most of which have been purchased directly or indirectly by U.S. consumers.

Now, however, American households are retrenching to the detriment of emerging country exports. When I finished this book in May 2010, both emerging country bond and stock prices were leaping. Recently, those bond prices have fallen as domestic and foreign invetsors retreat. As with U.S. junk bonds, investors are beginning to worry about slower growth and recessions in Asia and Latin America, and rising risks or even defaults on emerging country bonds.

Emerging market *stocks* were also zooming in 2010, but investors more recently have begun to worry about slower growth, including a hard landing in China. Since early May 2011, those equities on average are down 27 percent, but still expensive, in my view. They would need to fall 48 percent from here to return to the low level of late October 2008.

Since I finished this book in May 2010, the earthquake and tsunami speeded up what I had described as a slow-motion train wreck in Japan, as discussed earlier. Despite Japan's rebuilding efforts, its basic flaws remain, including its heavy dependence on exports for economic growth and to allow internal financing of its huge government debts. Consequently, with the global economic slowdown under way, the Nikkei 225 dropped 14.9 percent in the first nine months of 2011.

Buy Strategies

The buy recommendations listed in this book are headed by my 30-year favorite and proven winner, *Treasury bonds.* In 2011 through September, they have performed magnificently, with 30-year Treasury bonds rising 28.5 percent in price with 2.9 percent in yield, for a total return of 32.8 percent, compared with the 8 percent total return loss on the S&P 500. One well-known bond manager sold off all his Treasurys early in 2011 and then sold more short. He said back then that owners of government bonds were like frogs slowly being boiled alive and oblivious to the risks of owning Treasurys. As they say, the rest is history. I have a toy frog on my desk, and I've been known to croak occasionally—and the water temperature has been just fine.

The 30-year Treasury prices may continue to rise and the yield fall from 2.9 percent at the end of September back to the 2.5 percent reached in late 2008 in the aftermath of the near meltdown on Wall Street and demise of Lehman Brothers. That would push up the price of 30-year coupon Treasurys by 8 percent, and 13 percent for 30-year zero-coupon bonds. As noted earlier, deflation fears may soon dominate as global economic growth slows and worldwide recession looms large, all to the benefit of Treasury bonds.

In the United States, financial and economic uncertainty as well as the unattractive alternatives of falling stock and bond prices and pitifully