

Bert Dohmen's Wellington Letter™

A Fundamental and Technical Analysis of the Economy and Investment Markets

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The Financial Crisis: only the 3rd Inning!

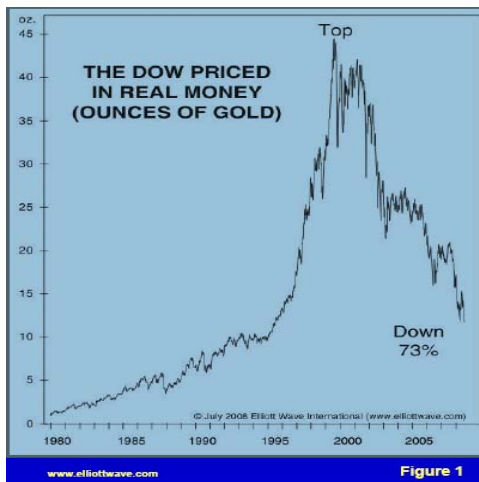
STOCK MARKET

A SUPER-CYCLE TOP

Since the year 2000 stock market top, we have said in these pages that it would be a long-term top that would stand for many years. Of course, some market indices have made new all-time highs since that time. Others, such as the NASDAQ, never even recovered half of the loss of the 2000-2003 bear market.

But the most important factor to realize is that if the dollar hadn't lost so much of its value, none of the major market indices would have made new highs the last 5 years.

One way to measure a real gain in the market is to compare it to gold. Gold is the best store of value. It's better than adjusting the market indices with inflation indices, because these are also manipulated by the government. The chart below is from our friends at Elliott Wave International. The DJI currently is down about 73% from that top in terms of gold, the best "store of value" for many centuries.



Yes, a continued decline in the value of our currency disguises the road to poverty. We are taxed on profits that really don't exist. A cynic might say that government has a great incentive in cheapening the currency, but then manipulating the inflation statistics to keep inflation numbers down, in order for the government not to have to boost payments to social security recipients, etc. Of course, I would never make such accusations.

In his *Economic Consequences of the Peace*, John Maynard Keynes wrote: "Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation governments can confiscate, secretly and unobserved, an important part of the wealth of their

citizens. By this method they not only confiscate, but they confiscate arbitrarily and, while the process impoverishes many, it enriches some. The sight of this arbitrary arrangement of riches strikes not only at security, but at confidence in the equity of distribution of wealth.

“Lenin was certainly right. There is no subtler, no surer means of overthrowing the existing order of society than debauching the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.”

THE NEAR TERM

After the market close on July 21, Apple released its latest results. They were excellent: Profits climbed 31% to \$1.07 billion for the last quarter. Total sales rose 38% to \$7.46 billion. It shipped nearly 2.5 million Macs during the quarter, up 41% from a year earlier, and iPod shipments grew 12% to over 11 million. What happened to the stock? In after-hour trading, the stock plunged to 156, down over \$9 per share. And this is after the stock had been declining for 7 days. When good news is greeted with a plunge, it's a sign of a bear market.

Merrill Lynch (MER) to take a huge write-down, selling \$11 billion of illiquid CDO's out of its portfolio to a hedge fund. Hundreds of billions of dollars of these things are still in the portfolios of financial firms as well as pension plans. But no one wants to dump them out of fear of having to price the remaining assets at that price, which would be market price. Merrill Lynch decided to take 22 cents on the dollar. But that's deceptive.

Merrill is financing 75% of the purchase price, non-recourse. This means that Merrill is only getting 5.5 cents on the dollar and has to take the CDO's back if the buyer defaults. As pointed out by Bloomberg News, "the financing is secured only by the assets being sold, meaning Merrill would absorb any losses on the CDOs beyond \$1.68 billion." The CEO of MER denies that.

So the real value of CDO's in the portfolios may only be worth 5.5 cents on the dollar, not 22 cents. That is now a problem for others. For example, Citigroup is carrying its huge portfolio of CDO's at 53 cents on the dollar. That's why many of the banks haven't been able to write more of them off: because the hit to their capital would cause them to violate capital requirements.

On another note, Citibank reported a 16% increase in delinquencies on credit card loans, to \$2.16 billion. Citigroup manages about \$202 billion of credit-card loans worldwide. Of these, about \$111 billion have been turned into securities and sold.

What started as a subprime loan problem is now a general credit market crisis, in my opinion the worst since the early 1930's. That one lasted 10 years. This one won't be any shorter.

THE COMING EARNINGS RECESSION

Falling Earnings Estimates for the S&P 500 for 2008

S&P Analysts estimates for
as reported earnings

Date	Earnings
March 2007	\$92
December 2007	\$84
February 2008	\$71.20
June 1, 2008	\$68.93
July 25, 2008	\$72.01

Our colleague, John Mauldin, who writes several exceptional investment publications, wrote in a recent issue of **Thoughts From The Frontline**, "Interestingly, they (S&P analysts) project lower earnings for 2009, down to \$67.66. At today's closing price of 1257, that projects to a lofty price to earnings (P/E) ratio of 18.55, well above long-term averages and well above trend for periods of poor or no growth. "...**there is no record in history of a bull market starting at a P/E of 18.**"

While the majority of economists are still debating whether a recession will occur, it's my view that the **economy is already declining at a 4-5% annual rate**. This is based on the government's intentional miscalculation of the rate of inflation, which is deducted from "nominal" GDP growth to give headline GDP. In other words, if the true rate of inflation, which according to some economists is now running at 12.6% using the model of 1980, then real GDP growth is already in the big, red numbers.

One highly respected economist from Merrill Lynch, David Rosenberg, wrote in a report on July 7: *"Though fiscal stimulus [rebate checks] will provide a lingering boost to 3Q we expect GDP to plummet 2.5% in 4Q and see a similar decline in 1Q. In all, we have shaved our 2009 GDP forecast to -0.5%, a full percentage point lower than where it was previously, while 2008 is broadly unchanged at 1.5%."*

His forecast is now for negative 2.5% GDP growth in Q4 of this year. But their 2009 growth estimate is for only a decline of 0.5%. They will have to revise that downward substantially as we get into 2009.

He continued: "...what we are then talking about is the strong possibility that profits end up being cut in half during this bear market – which would mean an ultimate low of around \$45 on operating earnings (in other words, we are only one-third of the way through the earnings turndown at a time when the consensus seems to be priced for the bottom being right about now!)."

Given his numbers, this bear market is still in the first half of the cycle. My view has been that we are in the 3rd inning, as in baseball.

On August 1, we got the newest numbers of expected earnings for the S&P 500 index. For next year, they revised earnings gains down to a little over 2% vs. over 8% just 30 days ago. We predict that within two months, those "gains" will be "adjusted" to losses. Lesson: don't believe any earnings forecasts from Wall Street!



Source: Bespoke Investment Group

The fact is that just about all economists, even the best ones, have been much too optimistic about the economy and corporate earnings. And that means that money managers and hedge funds are too heavily invested. Therefore, there is a lot of selling to be done.

WHAT TO DO

We have suggested buying some positions, over a period of weeks, in the ETF's which are designed to rise in price as the sector, or index, declines. They are the bear ETF's.

Here are the positions we recommended. They should do very well over the next three months.

PROFUNDS SHORT QQQ (PSQ)

PROFUNDS SHORT MID CAP 400 (MYY)

PROFUNDS ULTRA-SHORT CHINA XINHUA 25 (FXP) – this ETF is highly leveraged. Therefore, take only a small position.

We wrote: "Longer term oriented investors could hold those positions, **although they will suffer in a rally**. A plunge in oil will cause a relief rally in the financial sector. If you don't wish to have a potential rally go against you, we suggest closing out the above positions.

We also wrote: "We have not had any recommendations lately in the energy sector. However, if you have any, we would either use close protective stops, or **close them out**."

We also wrote: "Another point: if oil plunges, will other commodities be pulled down with it, such as the grains, or the precious metals? No one can know for sure, however, I believe that these other areas will see corrections. The precious metals have had a good run, and this would be a good excuse for them to take a breather."

As we know now, the above comments were right on target. The next three months belong to the bears. Commodity prices will plunge, and probably gold and silver will not do well either, although we like them for the long term.

NOTE: Specific recommendations with exact buy and sell advice are usually limited to our other services that are designed for that. These are SMARTE TRADER, FEARLESS FUND & INDEX TRADER and our PRIVATE PORTFOLIOS. Please go to our website, www.dohmencapital.com, for information.

CONFESSIONS FROM A HEDGE FUND MANAGER

This is part of an interview with Leon Cooperman of Omega Advisors, a leading hedge fund. Mr. Cooperman was a partner of Goldman Sachs and is a well-known personality on Wall Street.

Cooperman: We acknowledge that we were somewhat too optimistic about the year. And we basically pressed that optimism in March during the selloff when we largely took off all our hedges. We based that on an old tried-and-true – and tested – approach. We have found historically that when the S&P dropped 20%, which it did from its October peak to its March low, when the Fed and Congress were stimulating [the economy], when you are in an election year, when stocks are undervalued versus bonds and when stocks are somewhat cheaper versus their own history, you are supposed to buy.

What's surprised you, subsequent to March?

Cooperman: Oil getting to \$140 a barrel and the degree of weakness in housing was much more diverse, widespread and severe than anything we've seen. And the credit crunch turned out to be much more of a problem than we could have imagined. More of that problem migrated from Wall Street to Main Street than we allowed for.

Where does the market go from here?

Cooperman: The ingredients for a decent bottom are in place, but any significant upside is going to require help from two areas. No. 1, we have to see a bottoming in home prices. No. 2, we are going to have to see crude-oil prices recede. Frankly, we didn't forecast crude going to \$140 a barrel, so we aren't confident forecasting that crude is going to \$100. In fact, we have two energy experts, and neither believes crude is going much below \$120.

Einhorn: We have a market earnings estimate this year of \$90 and next year of anywhere from \$92 to \$100, and we'll refine that as the year unfolds. That's roughly 14 times this year's earnings, below the long-term average.

My Comment: This is traditional Wall Street thinking. Mr. Cooperman was totally wrong when he appeared last year on CNBC trying to calm investors during a sharp decline. They were wrong about the credit crunch subsiding, and now will be hugely wrong in their earnings forecasts for the market. But it's worthwhile to see what these people are doing...so you can do the opposite.

LEGG MASON RESCUES ITS MONEY MARKET FUNDS

(parts from Bloomberg)

Yes, money funds can get into trouble. Sometimes the sponsoring firm makes up the loss, sometimes they don't. Legg Mason did and injected \$2.15 billion into seven money funds to cover potential losses on debt issued by structured investment vehicles.

The company inherited the money-market funds in December 2005, when it traded its stock brokerage firm for Citigroup's fund operation.

Fetting (Legg Mason) said the company has reduced its exposure to SIVs in money funds to 2.2 percent of liquidity assets as of July 23, from 2.4 percent on June 30. During that time, assets in money funds have risen to \$189 billion from \$176 billion, he said.

"There are no new discoveries in our money funds," Fetting said in an interview today. "We continue to be confident that we will reduce our exposure even more in the next several months."

Money-market funds managed by Legg Mason bought debt from SIVs that held securities backed by mortgages.

The total of defaulting SIVs in the financial system so far is over \$31 billion. These are Structured Investment Vehicles, many started by banks in order to speculate without showing it on their financial statement. The legality of the SIV's will be tested in the courts.

Regarding housing, Bloomberg reports that "the number of vacant houses hit an all-time high in the second quarter as more properties were pushed into foreclosure. A total of 18.6 million U.S. houses, apartments and condominiums stood empty, more than at any time in history."

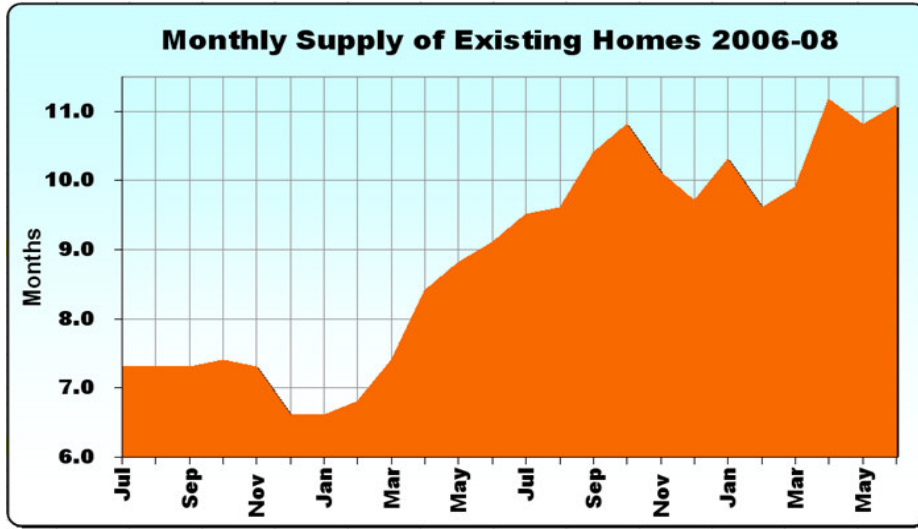


Chart courtesy of www.tradesystemguru.com

Here we can see that inventories of unsold homes continue to climb. And yet, homebuilders continue to add to the unsold homes. Apparently they feel that they just have to do something with the land they hold.

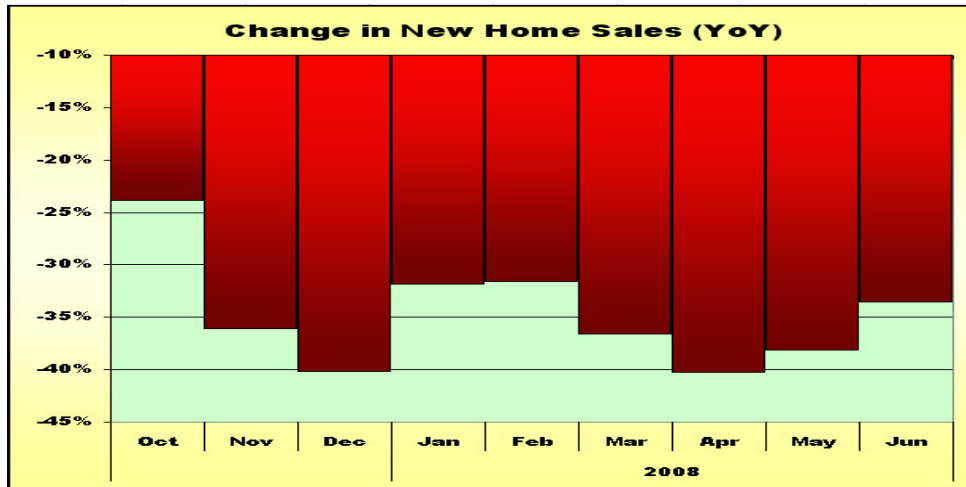


Chart courtesy of www.tradesystemguru.com

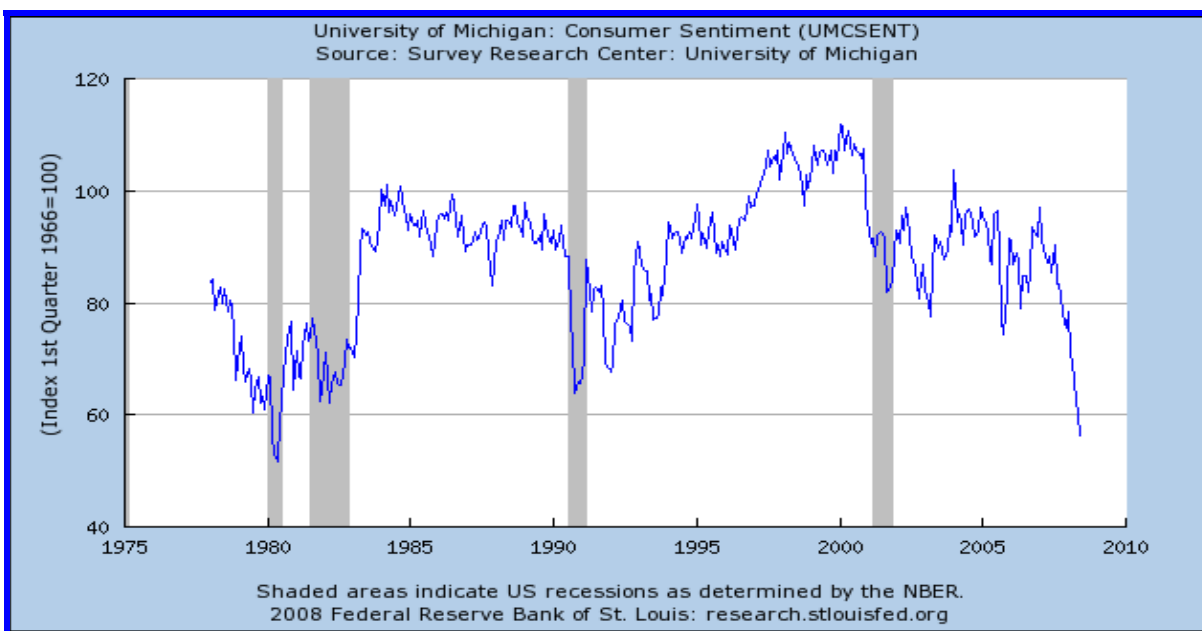
While inventories continue to build, there is no sign of sales having a rebound. One of the problems is that mortgage rates continue to rise and lenders are very tough in granting new mortgages.

Remember when, in early 2007, economists said housing would recover in late 2007? Then in mid-2007, they said the recovery would start in the first half of 2008. Now they tell us it will be next year. Do you want my forecast? There will be a bounce in 2010. It may last one year or so. And then its downward again to new price lows.

One thing is defaults on mortgages, which are soaring, but the other part just surfacing is defaults on Home Equity Loans (HELOC). And the collateral for these, after the payment of the first mortgage, is non-existent in many cases.

Banks have about \$700 billion of home-equity loans – in which a bank lends money to a homeowner against the equity in his house. Usually these homes also have first mortgages. If a homeowner defaults on the HELOC, the lenders usually can't collect on a defaulted home-equity loan by seizing a house. The mortgage lenders have first claim, and the HELOC is not a mortgage. If we assume that possibly 25% of these loans will eventually default, you have \$175 billion to be written off. But the actual defaults may be 50% or more. That's going to be a problem.

As a result of financial stress for the consumer, naturally confidence is waning. This chart shows the U. of Michigan Consumer Sentiment survey. Important: note the shaded vertical areas. These are recessions. Now note the recent plunge, which is more severe than seen during recession. Yet there is "no recession." Can you imagine Ph.D. economists still debating whether this is a recession? They should ask for a refund of their college tuitions. I predict that next year, when NBER finally declares the official start of the recession, it will be late 2007.



And now we get to the ultimate confidence destroyer, UNEMPLOYMENT! The latest report shows that the unemployment rate rose to 5.7%, from 5.5% the prior month. In April it stood at 5%. At this clip, it should be at around 6.5% at year end. No job, less income, less spending. And soon the artificial, one-time boost from the tax "rebate" program will be gone. Will there be another, wasteful Stimulus II?

The best stimulus is a permanent tax cut. But they don't understand that in Washington. After all, over 80% of the people in Congress are lawyers.

IS THERE A LIMIT TO GOVERNMENTAL BAILOUTS?

Government's exposure to the credit markets increased by an unprecedented \$1.46 trillion last year, according to economist Steve Liesman of CNBC. That's an incredible amount in such a short time. And there is more to come.

On July 30, the Fed extended several of its loan facilities, in which it swaps valuable U.S. Treasury securities it holds for almost worthless mortgage paper with banks and Wall Street firms, until January of next year. The Fed also increased its swap line with foreign central banks. All these extensions were accompanied with a statement that current fragile conditions in the financial markets warrant these moves.

The Fed reportedly takes a 20% "haircut" on the mortgage paper it receives. That means it values them at 80% of face value. But as we saw with the Merrill Lynch sale of \$11 billion of CDO's, their "haircut" was at minimum 78%, and probably 94.5%. They received 5.5% of the face value, with MER financing 75% of the sale for the buyer. That falls almost into the worthless category.

The Fed seems to be holding around \$400 billion of these now. When the "extension" expires in January, will the Fed really ask for the U. S. Treasuries back and give the banks their illiquid CDO's etc. back, putting the banks' existence into question? Or will there be more extensions, year after year? It will obviously be the latter.

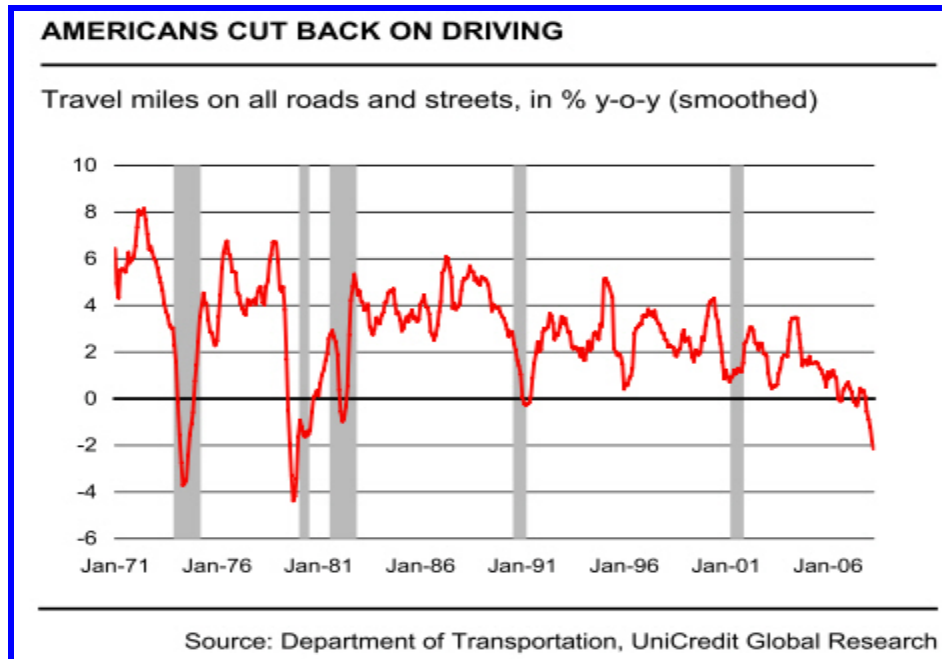
Note the timing for the new expirations: after the election. The SEC also extended its 30-day period for the new short sale rules on a number of financial stocks.

OIL: A TOP!

For the last quarter of this year, some forecasts are for S&P 500 earnings to be up 100%. That's quite a bit too optimistic for our taste. Consider: In the last quarter, earnings for this index would have been down almost 25% if you exclude energy stocks. Now that oil seems to have made a top, the earnings contribution from that sector will diminish. That should upset those fantastic earnings projections.

What will be the effect of a plunge in oil prices? Let's think about it.

We are witnessing energy demand destruction worldwide because of the high prices. Here is a chart, courtesy of tradesystemgurus.com, showing the plunge in miles of driving in the U.S. over the past two years. What's really important is the big plunge in consumption during recessions (grey vertical bars). If our forecast of this becoming the longest U.S. recession since the 1930's is correct, then the decline in driving will become remarkable. That should mean lower oil prices.



Barron's reported that gasoline usage in the U.S. "has fallen for 13 consecutive weeks, right into the height of the summer vacation driving season, and demand is down 2.2% year to date. That will continue. And places as far away as Italy and Taiwan show energy use drops of 4%-6%. Even China is showing a slowdown in the growth of energy demand."

A report released on July 27 by the Transportation Department shows that over the past seven months, Americans have reduced their driving by more than 40 billion miles. Because of high gasoline prices, they drove 3.7% fewer miles in May than they did a year earlier, the report says, more than double the 1.8% drop-off seen in April.

Why is this important? An unprecedented cutback in driving is slashing the funds available to rebuild the nation's aging highway system and expand mass-transit options, underscoring the economic impact of high gasoline prices. The resulting financial strain is touching off a political battle over government priorities in a new era of expensive oil. While Wall Street analysts are now pushing the "infrastructure stocks," the buyers are likely to be very disappointed. The governments just won't have the money to put into infrastructure.

Demand destruction, combined with the new alternative energies coming to market, and hopefully successful efforts in Congress to defeat the saboteurs who refuse to permit exploration of the vast oil resources of the U.S., is a combination for lower oil prices, at least over the next several years. That's the minority view.

I remember the energy crisis that ended in the early 1980's: oil was at \$35, and the popular projection was for it to go to \$64. But we got important sell signals on our technical indicators on all the oil company stocks, right at the top. Thus, we said that an important top had been made. We were right! The bulls were wrong.

The next downside target is \$108. Then the \$100 area, and finally \$85, which should be seen next year. So, \$85 is a reasonable target when the world's economies go into recessions. Eventually, we may see lower prices.

In addition to demand destruction, the U.S. Geological Survey reported that in the U.S. Arctic there are probably 90 billion barrels of oil. The naysayers immediately answered that it would take 10-20 years to get into production, and that it's only a few years of world demand. Presumably, therefore, it's not worth using this huge store of oil. But it is three times greater than the oil reserves of Saudi Arabia. And history shows that once you start developing the original find, you start discovering much more in the same area.

The Pelosi/Reid mentality prevents Americans from tapping what may be the largest stores of energy in the world. Can you imagine, these two individuals even prohibited a vote by Congress on an energy bill! What arrogance. Isn't part of the democratic process that the majority decides, instead of two individuals who have goals totally at odds with the good of our country?

Had we drilled in the ANWR when President Clinton signed a bill prohibiting the drilling there, we would be using that oil now. That was over 12 years ago.

If mankind had always taken the attitude that any new project would take too long to bring results, we would all still be living in caves, rubbing sticks to make fire. And that's where these naysayers belong.

A GLOBAL RECESSION IS AHEAD

While economists spend their time debating whether the U.S. is in a recession, the U.S. and other economies around the world are weakening and on their way to long-term recessions.

How can I say this? Well, it's simple: credit makes the world go around. Tens of trillions of dollars of credit were created during the 5 years of global boom. And now that credit creation has come to a screeching halt. It's that simple.

Individuals took \$900 billion of equity out of their homes last year through refinancing, using the money for various things. That refinancing is now down about 90%. Therefore, the consumer has no choice but to retrench.

At the same time, financial institutions don't want to create more credit because they are loaded up with so much bad paper already. They are desperately searching for money to raise their capital base. But it appears that the former sources of capital, to a large extent the Sovereign Wealth Funds of foreign countries, are becoming reluctant.

Bridgewater Associates' recent estimate of losses from mortgage-related securities in the financial institutions is \$1.6 trillion. If you look at the leverage ratios of these firms, they seem to average around

25 to 1. That means each dollar of capital supports \$25 of assets. If \$1.6 trillion has gone up in smoke, than we multiply that times 25, and get a reduction in lending capacity of \$40 trillion.

The world's economic product (similar to a country's GDP) is around \$55 trillion. So we can see that the reduction in lending capacity is 80% of what the world produces each year. However, we also have to consider how many institutions, banks or financial firms, have severely cut their lending voluntarily just to be more cautious.

And then we have Wall Street's incredible money machine, which pooled loans of all types and resold them via certificates, coming to a screeching halt. In fact, that was one of the largest contributors to worldwide liquidity creation. European banks also participated in such techniques. This involved trillions of dollars.

The result is that money will be very tough to borrow over the next many years. The bad stuff has to be liquidated first before new credit can be created. And when money creation flips from creating tens of trillions of dollars to liquidating similar amounts, you have a drastic change in liquidity. And that can only result in a serious, long-term recession, globally.

People ask me, why haven't we seen the U.S. economy plunge into a deep recession? There are several reasons:

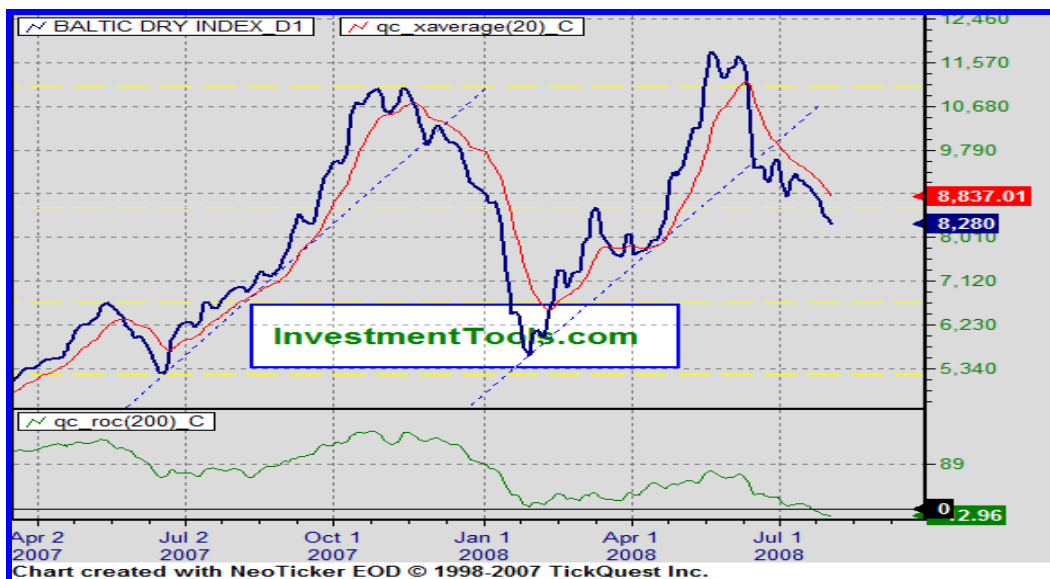
1. The recession is being hidden by the government intentionally depressing the official inflation numbers. We are already in a meaningful recession. I have discussed this many times in past issues. GDP is calculated by taking the numbers for goods and services, and then deducting the rate of inflation. But actual inflation, as calculated in 1980, is now at 12.6%. Deduct this from the 5% nominal GDP growth, and we get negative 6-7% GDP.

James Turk of the excellent FGMR report, calls attention to an interesting website for this. John Williams, who publishes Shadow Government Statistics, (www.shadowstats.com), writes: *"Inflation Explosion Likely to Continue... Adjusted to pre-Clinton (1990) methodology, annual CPI growth rose to roughly 8.3% from 7.5% in May, while the SGS-Alternate Consumer Inflation Measure, which reverses gimmicked changes to official CPI reporting methodologies back to 1980, rose to a 27-year high of roughly 12.6% in June, up from 11.8% in May."*

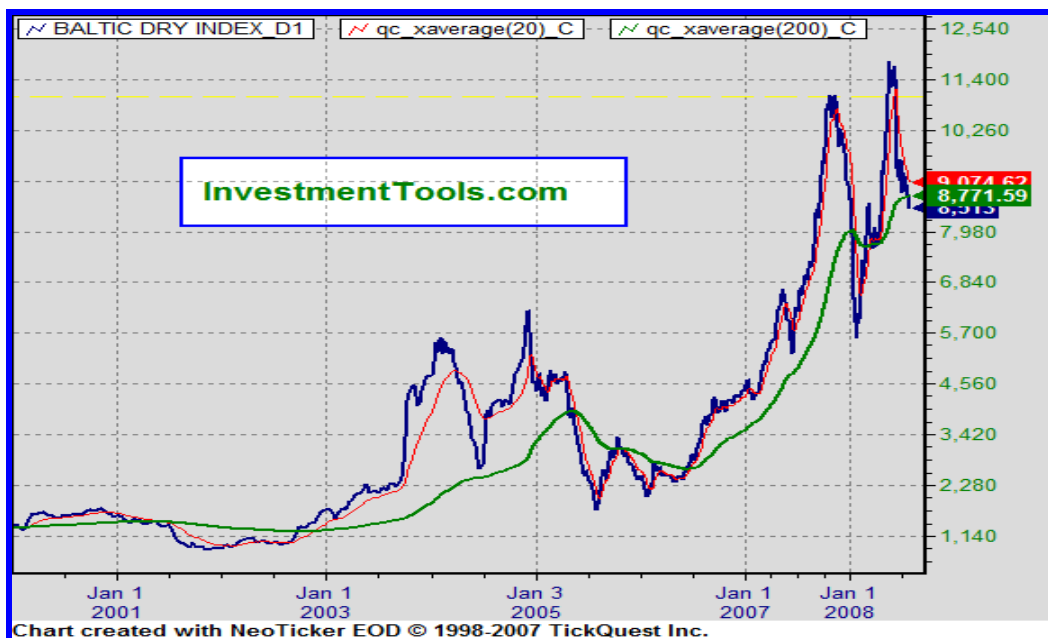
2. U.S. firms have outsourced a lot of manufacturing to firms abroad. In other words, large U.S. firms have become "platform" companies, which do research, design, and then market. Ex.: Nike. But they don't manufacture very much. These foreign outsourcing firms now have the burden of having factories and tens of thousands of employees. When sales decline, the U.S. firms just reduce orders. The outsourcing firm has the problem of firing employees and idling the factories. In other words, we have pushed many of the problems of a recession to the less-developed countries. That's why we think that the emerging stock markets will have a much more severe plunge over the next several years.

3. Individuals had substantial monetary reserves from the refinancing boom. I wrote over one year ago that these reserves might last a year or so, and then the consumer would see his assets depleted. The home ATM machine is closed. Corporations will follow the same path. They had large cash reserves going into the recession, but as it becomes more difficult to get loans or sell commercial paper, the cash hoards get depleted in a recession as profits turn to losses. This is a lagging factor, and may take another year to fully emerge.

Are we getting any clues of a global slowdown? Well, in Europe there is already a serious real estate recession in countries like Britain and Spain. But there is a sensitive indicator we like to use: the index of shipping costs. When world trade slows, shipping rates decline. We have shown this chart before. It's the **Baltic Dry Index**, which does not include oil tankers. Note the false upside breakout in May and then the strong plunge thereafter. We know from the investment markets that "false breakouts" are usually followed by serious declines. This one should be no exception.



And here is the longer-term chart, which clearly shows a long-term double top. (*next page...*)



This chart goes back to the year 2000. Note that the dry shipping rates had a 10 time increase in 6 years. That's unsustainable. A 50% decline in rates would get us back to the rates of early this year. An eventual decline back to the 2001 rates is entirely possible. But that would suggest a serious global recession.

THE PAIN OF BEING TOO EARLY

Last year when the large hedge funds and foreign **Sovereign Wealth Funds (SWF)** were buying multi-billion dollar portfolios of mortgage-related paper from troubled financial firms, or investing in troubled banks, we wrote that they were much too early and that their investments would accrue billions of dollars of losses. Well, now they have these multi-billion dollar losses. A subscription to the WELLINGTON LETTER could have saved them this pain.

Mutual fund managers have also been taught the lesson of not trying to catch a falling knife. Here are some of the results of those large funds that wanted to be contrarians, buying the financial stocks early this year.

Legg Mason Value Trust ([LMVIX](#)) lost 41% year over year. Its manager had a great track record of beating the S&P for 15 years. We wrote about him early this year when he was buying Countrywide and other financial firms which we considered basket cases.

Fidelity's Growth and Income fund ([FGRIX](#)) is down 31% for the year according to Morningstar. Same problem.

The nearly \$3 billion Oakmark Select ([OAKLX](#)) fund has fallen 31% since July 2007.

John Hancock Classic Value ([PZFBVX](#)) fund is paying the price for falling into a value trap, a term money managers use to describe stocks that look compellingly cheap but actually have big problems. The nearly \$4 billion fund is down about 41% in the last year.

Putnam Investors ([PINVX](#)) has dropped 29% in the past year.

These are all so-called "value funds." The managers buy stocks which are considered cheap on the basis of the common financial ratios. I believe that the value theory of stock investing has gone the way of the "buggy whip." Nowadays, cheap stocks are cheap for a reason, not because they haven't been discovered. In the days before computers, you could really find overlooked bargains. Today, everyone is able to do scans on thousands of stocks, finding "cheap" ones. What new stocks can you possibly discover that way when hundred of thousands of people can now do these scans?

MARKET RELATIONSHIPS

If you want to be an active investor, you have to consider inter-market relationships. These can give you great advance clues as to what will happen in related markets in response to events in another market. These relationships change from time to time. But here are some relationships you may wish to consider at this time. Note that these are relationships in EXPECTATIONS, but which may not actually produce the expected changes except for shorter term moves in the price of the related investments. And, most important, these relationships change all the time. For example, a decline in the price of oil may initially have the beneficial effects described below. However, if the price goes very low, say below \$75 per bbl., then the concern turns into fear of a serious recession and all the positive effects turn into negatives.

1. **OIL:** Declining oil price > lower inflation pressures > lower commodity prices including metals, etc. > expectations for greater consumer spending > higher stock prices for retail, restaurants, and consumer discretionary stocks > rising dollar. However, a longer-term decline reverses all of these benefits.
2. **DOLLAR:** Rising dollar > lower Euro > lower gold & silver > less liquidity creation > lower emerging market stocks > eventually bearish for U.S. stocks as the economies of emerging countries implode.
3. **TRADE DEFICIT:** As the U.S. economy slows, the trade deficit will decline > the dollar rises > commodity prices decline > lower inflation expectations > lower long-term interest rates > but finally a severe recession.

The above relationships work most of the time, but as you can see, what was initially a positive effect eventually turns negative. As an active investor, you must catch the inflection points.

LOOK WHO SHARES OUR VIEW

Bill Gross, founder of PIMCO, the largest bond management firm in the world, wrote this recently:

An asset deflation in turn becomes a debt deflation, as subprimes, alt-As, and finally prime mortgages surrender to the seemingly inevitable tide. PIMCO estimates a total of 5 trillion dollars of mortgage loans are in risky asset categories and that nearly 1 trillion dollars of cumulative losses will finally mark the gravestone of this housing bubble. The problem with writing off 1 trillion dollars from the finance industry's cumulative balance sheet is that if not matched by capital raising, it necessitates a sale of assets, a reduction in lending or both that in turn begins to affect economic growth, creating what Mohamed El-Erian fears as a "negative feedback loop."

As you know, we believe the eventual losses will be much larger than \$1 trillion. I believe it will be three or four times that. Never before in history has the banking system encountered such losses.

Ted Forstman of the buyout firm, Forstman Little, told *The Wall Street Journal*:

"We are in a credit crisis the likes of which I've never seen in my lifetime. The credit problems in this country are considerably worse than people have said or know. I didn't even know subprime mortgages existed, and I was worried about the credit crisis."

Larry Summers, former Treasury Secretary, said: *"It is quite possible that we are now at the most dangerous moment since the American financial crisis began last August."*

Summers recommends a governmentally financed infrastructure rebuilding program, including job training. You see, we are now getting to the job programs of the Great Depression. Of course, his idea hasn't been implemented, but it will be by late next year as the unemployment rate soars. And it won't work, just as it didn't during the Great Depression, or during Japan's 17-year struggle to get out of economic misery.

Eli Broad, the billionaire founder of KB Home who works mostly as a philanthropic investor now, says **the U.S. economy is in its worst straits in more than 60 years**. "This is worse than any recession we've had since World War II," Broad, 75, told Bloomberg News. He calls this the "worst period" of his adult life for the economy and says recovery for the housing market lies "several years" away.

Still, he's not looking for a 1930s-style depression, thanks to the country's safety nets.

Well, finally some of the smartest entrepreneurs are adopting the views we have held since April of 2007. Better late than never. Although still in the minority, we appear to be in good company.

ARE THE INMATES RUNNING THE ASYLUM?

There seems to be a scramble in Washington to stop "speculation" in the futures markets. Everyone wants their name on a bill to accomplish the task of reducing commodity prices. Senator Lieberman seems to have started all this with his bill. I am very disappointed in him. But that's what you get with professional politicians who don't know much about the real world. They should all be forced to go out and get a real job to see how the economy really functions.

At the start of the late June hearings on the subject, Lieberman said: *"Since we initiated this inquiry nearly 2 months ago, a lot has happened. The Commodity Futures Trading Commission (CFTC) has announced at least four new initiatives to address speculative activity. Last week, the chief executive of the New York Stock Exchange indicated that investments by large institutions, particularly pension funds, were completely altering the supply and demand for commodities.*

*"Our colleagues here in Congress have introduced at least **eight bills** on this subject, most of them focusing on market transparency but some going further by seeking to bring foreign or over-the-counter markets under [US] federal regulation," he continued.*

Read this again. They even want to regulate foreign markets. That's the height of arrogance.

Sen. Byron L. Dorgan (D-ND) introduced another bill that would compel the CFTC to differentiate between hedge and other commodity trades, increase margin requirements to 25% for non-hedge trades, revoke or modify "all prior actions that prevent the CFTC from protecting legitimate hedge trades and **discouraging speculative trades,**" and convene an international group of regulators to protect petroleum futures markets from "excessive speculation and worldwide forum shopping."

Note the phrase about "speculative trades." Who do they think takes the trades of the companies that want to hedge their business exposure? It's the speculators. Could someone send these people a copy of a book on Commodities 101?

Is it too much for us taxpayers to expect our legislators to inform themselves before they pass legislation which could damage our markets forever?

There is also a move underway to re-impose the "uptick rule" for short selling. Without that rule, which was eliminated last year, you can sell short without waiting for the last price to "tick up." This makes it easier to sell short, which, according to regulators, is not desirable for stocks.

I ask, If we want to keep short selling from driving stocks down, wouldn't it be justified to have a "downtick" rule for buying? In other words, you could only buy if the last trade ticked down. That would make it difficult to manipulate stock prices upward. Or are they saying that it's ok when speculators drive stocks up, but not when they drive them down?

Of course, a "downtick" for buying stocks will never come up because the masses want stocks to go up.

But when it comes to oil or commodity prices, regulators want them to go down and want to fix the market rules to accomplish this. And that will happen, but not because of government, but natural forces.

The danger for the next ten years: manipulation of the rules by Washington to prevent smart investors from profiting in an adverse environment. It's not the speculators who cause price trends, but monetary policy. Speculators only take advantage of the environment presented to them.

Frankly, I have never understood the difference between a speculator and a so-called investor. Doesn't an investor buy stocks in expectations that he can sell them at a higher price? Isn't that speculation? The

only difference is that the successful speculator is usually much smarter than the lazy, long-term investor because when he discovers that the Fed or other central banks have put the financial system in danger, he will sell short the vulnerable sectors in order to profit. The so-called investor will sit with his stocks, taking the "long-term hold" approach, and see his stocks decline 80-90%.

The NASDAQ Composite hit its high over 5000 in the year 2000. Many of those Internet and tech stocks have disappeared. Remember the high-flyer Commerce One? It went from around \$3 to \$998. I sold most of my shares between 980-996. I should have sold them all. The company no longer exists today.

The NASDAQ Composite, after a big rally since 2003, is still down more than 50%, at 2300. Who is better off, the speculator who got out and sold short, or the long-term investor?

Long-term investing won't work for the next nine years. That puts us into the year 2017.

THE FED: A DILEMMA?

We always hear that the Fed is "between a rock and a hard place." Should we sympathize with the Fed's predicament, or is it self-made?

As readers know, one of the problems at the Fed is that there are too many economics professors on the FOMC (Federal Reserve Open Market Committee). They have no real-life experience, and don't seem to have any sense of financial history. One dilemma often described is that the Fed is faced with a deteriorating economy, which would require stimulus, while inflation is rising, which in their thinking requires higher interest rates, i.e., more expensive money.

I am not an economist, but have a degree in chemistry, and I have never understood how raising the cost of money can produce lower prices. I have asked Ph.D. economists about this and never received a clear answer. The only way to get such a cause and effect is by raising interest rates so high, that it becomes prohibitive to borrow. And then the economy tumbles into a deep recession. Fed chairman Paul Volcker did this in 1980. Millions of people lost their jobs, millions of business went bankrupt, and thousands of people committed suicide because of financial stress.

If the marketplace, instead of the Fed, were allowed to set interest rates, then rates would reflect economic conditions. The market can do that better than a small group of professors. In fact, the Fed is very much like the communistic system of the former Soviet Union, which had the job of allocating resources, deciding how many shoes or cars were to be made, what color they should be, and what sizes. In a democracy, the customer makes those choices.

The biggest credit bubble in the history of mankind was produced from 2003-2007 by the Greenspan Fed and the shadow banking system. Interest rates were kept lower than market forces would have allowed. After factoring out actual inflation, borrowed money was free. This caused huge misallocations of resources, financial and otherwise. The large private equity firms and hedge funds borrowed as much

as they could. With that money they would buy assets which would produce a much higher return than the cost of money, which had been set by the Fed. It was a "no-brainer" for these financial engineers.

Now that bubble has burst. Nothing grows to the sky. Reality has returned. You can't reinflate a burst bubble, but in Washington they are trying. This will lead to more gigantic distortions.

Inflation was a natural consequence of the credit bubble. But these forces go into the "pipeline" and take about a year to be noticeable. That's what we are seeing now. The deflationary forces put into the pipeline also take about a year to emerge. We will see that next year, just when the Fed may start fighting inflation with higher interest rates. If these professors had any sense of history, they would know that inflation numbers usually peak near the end of a recession. That may be shocking to many, but inflation actually rises during most recessions because of the delay effect discussed.

On July 22, a member of the FOMC, Charles Plosser, said: *"Inflation is already too high and inconsistent with our goal of – and responsibility to ensure – price stability."*

He has voted against the latest interest rate cuts by the Fed and would prefer to have the Fed raise rates soon. He is the President of the Philly Fed, and a former economics professor at the U. of Rochester.

In my view, if the Fed follows his advice, we will be in for some very bad times. Whereas the Fed kept interest rates too low before 2006, to raise them now would be a disaster, as many banks are teetering on the edge. Greenspan rescued the banking system in 1990 by pushing short-term interest rates down. Long-term rates stayed high, which allowed banks to borrow cheaply and invest it in higher yielding government bonds. Those profits were very important for the banks.

GAMBLING IN MACAU

Starting August 1, China will limit the travel by Chinese citizens to Macau, the only Chinese region where gambling is legal. In May, China cut the number of visits by its people to Macau to **once per month. From now on, it will only be once every two months.** That may cut substantially into the revenues of the casinos. As a result, the stocks of the big casino owners have plunged.

Furthermore, Chinese can only stay there for seven days. They want to cut the gambling growth. This is definitely a blow to the U.S. casino firms that have invested hundreds of millions of dollars. It's the peril that goes with the potential of higher reward in a country with a new rule of law, and where new regulations are issued without warning.

Yes, Westerners often forget that China is a communist country. You can be put out of business overnight.

CHINA: IS THE NEXT PLUNGE NEAR?

Top Chinese securities regulators have made it clear to the securities firms that they don't want a market plunge ahead or during the Olympics. They want "stability."

The chairman of the China Securities Regulatory Commission (CSRC), Shang Fulin, said that, "Preparations should be made to deal with any emergency and prevent trading from being harmed by rumors or hackers' attacks."

The bottom line is that Chinese officials are becoming concerned about the stock market. It's down over 50% from last year, and there doesn't seem to be a bottom at this time. Once the U.S. recession gets noticed, Chinese stocks will weaken even more.

Apparently, the market will be kept relatively "stable" during the Olympics. But after this event, WATCH OUT.

Wishing you successful investing,

Bert Dohmen

LATE NEWS: Fed Meeting

The Fed (FOMC) decided to leave the Fed Funds rate at 2%.

Here is what they said:

They noted that financial markets remained ``under considerable stress."

``Labor markets have softened further. Tight credit conditions, the ongoing housing contraction, and elevated energy prices are likely to weigh on economic growth."

``Although downside risks to growth remain, the upside risks to inflation are also of significant concern to the committee."

``Inflation has been high, spurred by the earlier increases in the prices of energy and some other commodities," the Fed said. ``The committee expects inflation to moderate later this year and next year, but the inflation outlook remains highly uncertain."

There was one dissenting voice, once again Dallas Fed President Richard Fisher. He preferred an increase.

My Comments: The Fed wouldn't dare raise interest rates, now or next year. The real recession will be felt next year. In regard to inflation, we have seen consumer good inflation, but at the same time have very strong asset deflation. The latter is much more important, and more destructive. We never hear them differentiating. We can only hope that someone at the Fed knows the difference.

Then they make the statement that inflation will moderate, but that "the inflation outlook remains uncertain." If it's uncertain, how do they know it will moderate?

Bert Dohmen's
Wellington Letter™

The stock market rallied strongly today, even BEFORE the meeting. But nothing has changed. The same problems remain. Therefore, we have to consider this the summer rally. A good target for the S&P 500 is the 1320 area, as we have stated previously. The index was in the 1277 area today.

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