

CYCLICAL INVESTING PRÉCIS

David L. Smith, Editor

July 4, 2008

LAST ISSUE OF *CYCLICAL INVESTING*

As of the close on Thursday, July 3, 2008

DJIA: 11,288	S&P 500: 1,263	NASDAQ: 2,245	
DIA: 113.05	SPY: 126.31	QQQ: 44.63	
Treasury Yields	2-yr.: 2.54%	10-yr: 3.985%	30-yr.: 4.538%
¥en: 106.74	€uro: \$ 1.57/€	British Pound: \$1.983/£	
Gold: \$933/oz.	StreetTRACKS Gold (GLD): \$92.06	Oil (Nymex): \$145.29	
PWE: \$31.82	DXD: \$65.18	FXB: \$198.30	FXE: \$157.02

On July 4, 1984, exactly 24 years ago, I celebrated my own personal “Independence Day” and decided I would write a “contrarian chronicle of the times.” The vehicle for my ambition to become “the Samuel Pepys of my generation” was the *Cyclical Investing Quarterly Report* through which I would offer “Contrarian insight and cyclical economic and investment forecasts and strategies.” Over the years, to meet my subscribers’ demands for timely investment advice, I increased the frequency of my publications from 4 to 8, and later 12 times a year, plus the occasional *Bulletin*.

As the invasion of Iraq loomed in early 2003, as a “chronicler of the times” I felt obligated to expand my scope beyond economics and finance to encompass global social and geopolitical reportage and commentary. So I began writing *David L. Smith’s Cassandra Chronicles*, the first issue of which carried the dual title: “Why I Write” and “Why We Fight.”

Since then, I have continued to write and publish *Cyclical Investing* every month and, until recently, the *Cassandra Chronicles* once a quarter. However, for the past year the demands of *Cyclical Investing* during these changing and volatile times have crowded out my work on the *Chronicles*. Presently, the major longstanding *Cyclical Investing* themes - the Third Oil Shock and its stagflationary effects on the economy and stock market, the devaluation of the dollar, the massive U.S. trade deficits and corresponding rise of Asia and OPEC as dominant financial powers, the corrosive burden of excessive consumer and government debt, the Fed’s counterproductive tendency to pump too much new money into the banking system every time a recession looms, the stock market and housing bubbles, the technology revolution — once radically contrarian, have materialized to the point where most have become widely accepted as conventional wisdom. **Accordingly, given the constraints of available time, if I am to fulfill my goal of providing a contrarian chronicle of the times, I must discontinue writing *Cyclical Investing* and redirect my energies to the *Cassandra Chronicles*.**

For the past 24 years I have thrived on the challenges of analyzing, explaining and forecasting events in the U.S. and global economies, U.S. monetary and fiscal policy, the international scene, U.S. international trade and global oil markets. The ultimate challenge and test of my grasp on reality, however, has been to devise profitable

investment strategies for stocks, bonds, currencies, precious metals and energy, calculated to avoid loss and capture gains in these volatile and constantly changing markets. In my writing I have strived to meet the standards John Maynard Keynes used to describe his mentor, Alfred Marshall, whom he described as “The Master Economist”:

The master-economist must possess a rare combination of gifts. He must reach a high standard in several different directions and must combine talents not often found together. He must be mathematician, historian, statesman, philosopher - in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present in light of the past for the purposes of the future. No part of man's nature or his institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician.

In practice, my state of mind often more nearly approximated a cross between an *omnium-gatherum* and a soothsayer.

Nevertheless, in the process of meeting these challenges I learned a great deal about how the world works – in particular the interweaving of the economy, financial markets, government policy and current events. It is said that to truly understand a subject one must teach it. Those longstanding subscribers who patiently waded through my lengthy exegeses on subjects ranging from “liquidity traps” to “the contrarian mindset” essentially witnessed the process whereby I learned my subject matter by teaching it. For their forbearance, I am grateful and hope it was worth their time.

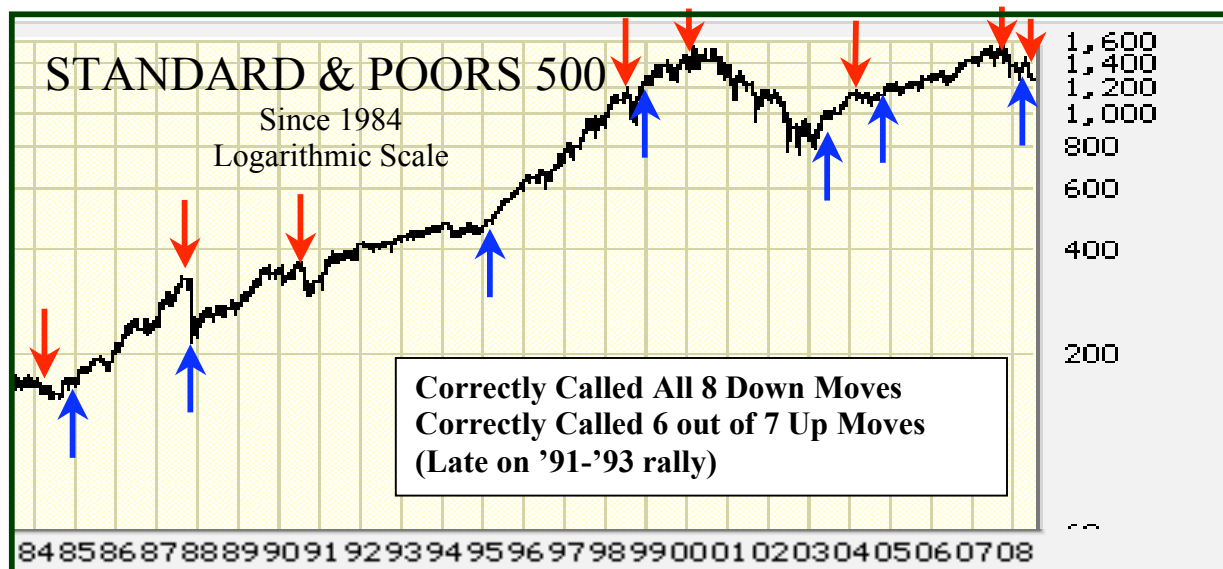
It has been my privilege and good fortune to enjoy the trust and confidence of thousands of subscribers over the years. I am deeply gratified by the many expressions of appreciation from subscribers whose financial wellbeing has been enhanced by my recommended investment strategies. For 24 years of interest and support, I thank you collectively.

I also want you to know that I did not arrive at the decision to cease publishing *Cyclical Investing* lightly. I am mindful of the reliance many subscribers have come to place on the investment strategies and asset allocations recommended in these pages – particularly in these troubled times. However, I trust that longstanding subscribers have absorbed the lessons I have striven to impart – notably a healthy skepticism about the conventional wisdom, heightened awareness of the aforementioned longstanding major *Cyclical Investing* themes, an understanding of economic cycles, their effect on the various investment markets, and the importance of preservation of capital as the first principle of successful investing. In due course, I will post my 24 years of back issues on the Internet for those of you who would like to brush up on these lessons.

The title of this document is *Cyclical Investing Précis*. Précis is an 18th century word derived from the French “precise” and defined as a “summing-up,” or “shortened version of a written text, containing the main points and omitting minor details.” This term seems to fit the bill admirably. So in that spirit, I would like to sum up the *Cyclical Investing* record of the past 24 years precisely, omitting minor details.

Here, in chronological order, are some of the more notable contrarian *Cyclical Investing* predictions around which profitable investment responses were fashioned:

- The 1986 oil price collapse and subsequent booming economy and financial markets, entry into the stock market recommended in early 1985.
- The 1987 stock market crash. Exit signal given October 16, 1987, 3 days before crash
- The rebounding economy and stock market after the crash. Re-entry signal October 31, 1987, eleven days after the crash.
- The 1990-91 Gulf War, oil-price spike, stock market slump and recession
- The sluggish stock market in 1994, duly avoided.
- The resumption of the bull market in 1995, duly participated in.
- The peak in the stock market in 2000. Exit signal given January 4, 2000, about 10 days before the all-time peak in the Dow at the time.
- The recession of 2001.
- The bull market in gold immediately following 9/11/01. Entry signal given at \$300/oz.
- The devaluation of the dollar beginning in 2002 and ensuing surge in exports, with recommendations to buy euros and British pounds thereafter.
- The Third Oil Shock beginning in 2003 and ensuing inflation with longstanding recommendations to own oil in effect to this day
- The economic and stock market rebound in 2003. Re-entry signals April-June 2003, beginning within a month of the 2003 bottom.
- The bear market beginning in October 2007 with profitable exit recommendations following promptly after the peak.
- The ‘Stagflation’ we are presently experiencing.



As previously noted, during the past 24 years, I predicted five important contrarian economic and financial themes, all of which have materialized in the fullness of time, finally to become accepted, in varying degrees, by the conventional wisdom. These include:

- **The central, dominant role of oil:** My first sentence in the initial, July 4, 1984 issue of *Cyclical Investing* was: “The economic outcome for the foreseeable future will be determined by the contest between the interests of oil and industrial capital over the price and availability of oil.” Thereafter, I dedicated a special section of each

newsletter to “The Petrocycle Update,” detailing the ebb and flow of that contest. Since then we have witnessed the collapse of oil prices in 1985-1986 followed by a decade and a half of unparalleled prosperity, two wars waged over oil and, since 2003, the Third Oil Shock, which I predicted in 1987, even to the point of writing an unpublished manuscript for a book by that title. Oil prices are now topping \$145 a barrel, sending the global economy and stock markets reeling from oil-driven inflation and “economic malaise” – stagflation – similar to (though, so far, not as bad as) that described by Jimmy Carter during the Second Oil Shock of the early 1980s. In April 2006 I distilled this subject into a *Cassandra Chronicle* “The Third Oil Shock: How to avoid loss and capture gains from the developing oil crisis,” subsequently updated. See: http://www.cyclical-investing.com/documents/cass_chronicles_april2008_the_third_oil_shock.pdf)

Given the apparent arrival of “Peak Oil,” the relentless growth in demand from the emerging economies of China and India and the constant threat of political disruptions of oil supply, we must assume an innate bias of upward pressure on oil prices with corresponding stagflation and depressing effects on stock prices. Recall that in real terms, adjusting for inflation, the interval during the first two oil shocks produced the worst stock market ever (even though in nominal terms stock prices appeared to move sideways).

This longstanding Petrocycle theme, once radically contrarian has been widely embraced as conventional wisdom, with a cottage industry springing up on the ‘net around “Peak Oil.” Consequently, as contrarians we must be alert for a turn, lest we fall prey to “Demon Extrapolation.” Accordingly, we must be alert to the possibility of an eventual downturn in oil prices resulting from oil demand reduced by either a global depression or significant development of alternative energy sources.

- **The devaluation of the dollar stemming from massive U.S. trade deficits and the corresponding rise of Asia and OPEC as dominant financial powers:** I started becoming alarmed about the expanding trade deficits in the late 1990’s but it wasn’t until shortly after the dollar began weakening in 2002 that I began recommending a significant defensive shift out of the dollar ambit into short-term sovereign debt denominated in euros and U.K. pounds. The devaluation of the dollar has proceeded virtually without interruption for over 6 years (except for 2005) and should continue for a while longer, given the persistence of U.S. mega-trade deficits (exacerbated by high oil prices) and the likelihood of a flight from the dollar by foreign creditors tired of sub-par returns on devaluing dollar-denominated bonds.

After 6 years of a declining dollar, this once-radical contrarian theme has also become widely accepted as conventional wisdom. Consequently, as contrarians we should be on the lookout for conditions that could reverse this longstanding trend. The two conditions likely to precipitate a turnaround in the dollar are 1) the closing or narrowing of the U.S. trade gap due to the stimulus to U.S. exports and the dampening of U.S. imports provided by a low-valued dollar and/or a collapse in oil prices as described above, and 2) the return of foreign capital to the dollar ambit (after a flight from the dollar to the euro), as foreign investors sweep up stock bargains in corporate America precipitated by an earlier exodus from the dollar. (This premise was summarized in the *Cassandra Chronicles* titled “The Asian Caper: Profit and peril from across the Pacific” and “The Prudent Gambler: How to avoid losses and capture gains when Asia takes home all the marbles.”)

(See: <http://www.cyclical-investing.com/documents/CassChroniclesJan2006AsianCaper.pdf>)
<http://www.cyclical-investing.com/documents/THE%20PRUDENT%20GAMBLER%20Report%20ar3.pdf>)

- **The depressing effect on the economy of excessive consumer and government debt:** This theme has long been a red flag of mine, beginning so long ago that I began to feel like “the boy who cried wolf” as years went by and the predicted credit crunch failed to materialize. (One of my problems is that I tend to see events coming long before they happen.) Eager foreign lenders, flush with dollars derived from trade surpluses with the U.S., extended the credit spree by recycling their dollars back into U.S. credit markets. In so doing they pumped up U.S. stock market and housing bubbles thereby encouraging American households to keep borrowing and spending long past the limits of prudence. I stuck to my guns, however, comforting myself with the thought that eventually the wolf showed up, catching the boy’s denigrators by surprise. It took the collapse of the housing bubble to squeeze households to the point where many homeowners were forced to default or, if lucky, merely trim back spending. The financial system and the economy are now paying the price for excessive credit extended to mortgage- and credit-card-abusers.

This theme, like the others, was radically contrarian when I first began articulating it, but, having materialized, now has found its way into the conventional wisdom’s canon. Given the extent of credit abuse by middle- to low-income households, now squeezed by rising unemployment, flat real incomes and rising cost of living, there is doubtlessly more financial distress to come before excessive credit is wrung out of the system through defaults and restricted lending. So I find myself in that uncomfortable phase when I am in agreement with the consensus. However, being Demon Extrapolators, the consensus will doubtlessly cling to this scenario long after massive defaults and the eventual rescue of corporate America by foreign investors turns the sagging American economy around. Watch for it.

In the meantime, there is the other side of America’s borrowing spree – the U.S. government’s accumulation of over \$5 trillion of debt owed to the public (don’t get sucked into that \$9 trillion number which includes about \$4 trillion the government owes itself). This debt simply represents future tax increases to be levied on future generations by “conservative” ideologues that believe tax cuts are the answer to every problem. The debt poses two problems: 1) It limits the government’s ability to revive the economy with fiscal stimulus and 2) It sets up intergenerational conflict when younger generations are eventually presented with the bill for government services the older generations weren’t willing to pay for.

This is a theme the conventional wisdom has yet to accept, since it would force policymakers and pundits alike to face up to their financial obligations and raise taxes to cover the current costs of government. The problem is likely to become acute, and therefore, undeniable, when foreigners stop underwriting the federal deficits, and/or angry younger generations acquire the political muscle to “recover taxes not paid” by taxing the wealth of older generations. Stay tuned.

- **The counterproductive tendency of the Fed to pump too much money into the banking system every time a recession looms.** I leveled this criticism at Alan Greenspan long before it became popular to diss the former Fed chairman. The

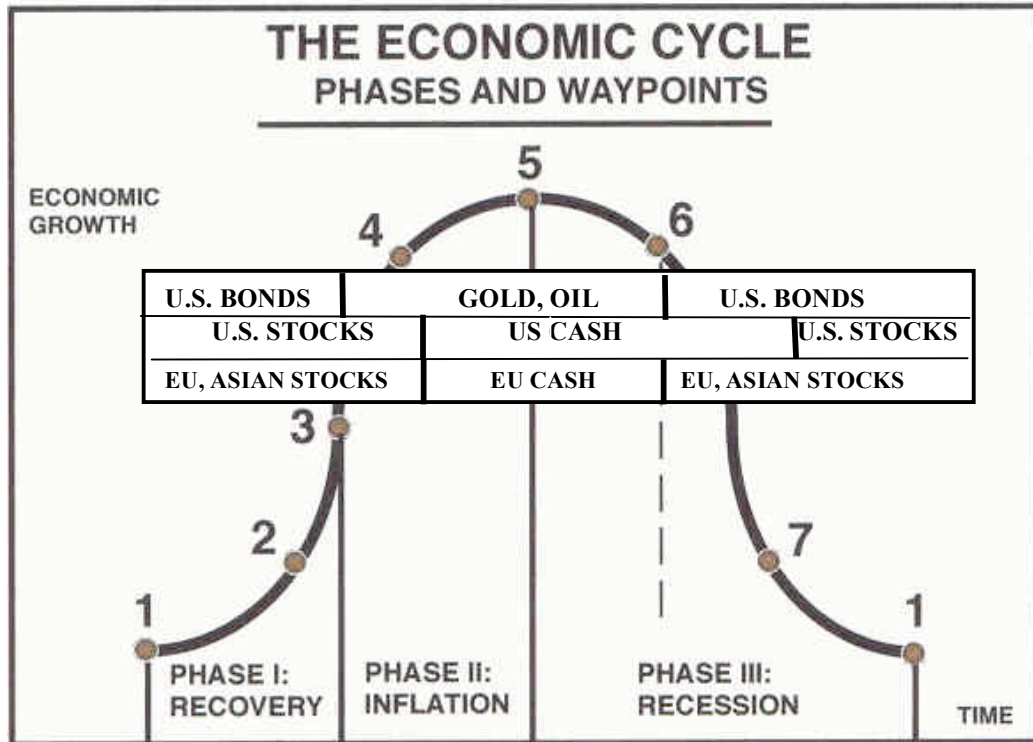
conventional wisdom has awakened to the fact that the Fed's expansion of the money supply contributed to our present woes by pumping up the stock market and housing bubbles, generating excessive household debt (in conjunction with foreign lenders) and fueling inflation. However, conventional wisdom does not yet see that the Fed's interventionist policies in support of "perpetual prosperity" (attempting to prevent or minimize every looming recession) simply trades off a series of manageable, market-driven recessions for one big depression by fueling an unhealthy accumulation of consumer debt. (I will do a *Cassandra Chronicle* on this subject.)

- **The Megacycle wrought by technology.** A Megacycle, is a transformation of the human enterprise on the scale of the Hunter-Gatherer Revolution 100,000 years ago, the Agricultural Revolution 10,000 years ago, the Industrial Revolution just over 200 years ago and the Petro-Industrial Revolution about 90 years ago. In each case, major changes in technology and energy produce a near-total transformation of how humankind earn a living, where they live, how they get around, how they communicate and what constitutes assets or wealth. The good news is that over time such transformations vastly increase human material wellbeing. The bad news is that since the Industrial Revolution, after a period of euphoric innovation and growth, such transformations are invariably punctuated by a second phase of severe economic and financial turmoil and war before arriving at a condition of relatively stable prosperity and rising stock prices. The electronic technology revolution produced the first phase of euphoric growth of the current Megacycle in the late 1980s and especially in the 1990s. Unlike the previous Megacycles, however, the present technological transformation has not been preceded or accompanied by a corresponding transformation in energy. We are still mired in the Petro-Industrial age with oil as our prime mover. Consequently, the economic and geopolitical frictions associated with the replacement of oil by the next dominant form of energy, has, since the First Oil Shock in 1973, heightened the economic, financial and political turmoil usually associated with the second phase of a Megacycle. This has been particularly true in the first decade of the new millennium. The implications of the troubling second phase of the present Megacycle are only dimly understood by the conventional wisdom.

The confluence of these five themes has created the conditions for a "Perfect Storm" economically. The resulting economic contraction is likely to be longer and deeper than the conventional wisdom expects. Therefore, my overriding advice to subscribers is to:

1. **Preserve capital.** "Above all, don't lose money." Be wary of the stock and bond markets and the dollar as long as present dangerous trends persist in the economy. (Stocks and bonds are presently below lines-in-the-sand set forth in my last (May 16, 2008) *Quarterly Report*, and, therefore should be avoided. Stay liquid, particularly in the euro ambit, and British pound, and to a lesser extent in short-term U.S. government debt instruments. Ride the horse in the direction it's going, particularly in the currency, gold and energy markets. But have some technical indicators – trendline, slow stochastic, moving average, momentum indicator, Bollinger band or combinations thereof -- in your back pocket that signals a change of trend, and heed them.
2. **Maintain a contrarian mindset.** Be skeptical of the conventional wisdom and always on the lookout for turns in the road, particularly when the consensus agrees that the road will be straight "for the foreseeable future." (See my article titled "The Contrarian Mindset, Key to Investment Success" at <http://www.cyclical-investing.com/documents/The%20Contrarian%20Mindset%20Report%20698.pdf>)

3. **Be cyclically aware and responsive.** This means a) monitoring the progress of the economic cycle, using the 3-phase, 7-waypoint cyclical model I developed and have been using in my *Cyclical Investing* newsletters for the past 24 years, and b) allocating assets profitably in relation to the current state of the economic cycle, owning those assets supported by economic forces at the time, and avoiding those likely to be depressed by them. Here's where an online review of past issues of *Cyclical Investing* may come in handy – at least until such time as I re-issue my course on “How Investments Respond to Economic Cycles,” time permitting.



Finally, let me invite you, if you haven't already, to subscribe to the *Cassandra Chronicles* -- “a study of the past, in light of the present for purposes of the future” to borrow John Maynard Keynes' phrase. The *Chronicles* represent the logical extension of *Cyclical Investing* as a “contrarian chronicle of the times.” In the *Chronicles*, not only do I offer occasional analysis, commentary and forecasts encompassing the global economy and financial markets (though not detailed and time-sensitive investment strategies), but I also address the fascinating realms of government policy, geopolitics, military developments, political philosophy, religion and the grand sweep of history. These global issues are of vital interest to those of us concerned about the fate of humanity. By introducing new contrarian themes and solutions (with the hope that some day they will become the conventional wisdom) I hope to contribute, in some small way, to a favorable outcome, mindful of the following verse from William Wordsworth:

Enough, if something from our hands have power
To live, and act, and serve the future hour.

In this spirit, I invite you to “serve the future hour” by subscribing to the *Cassandra Chronicles*.

Chronicle subscribers will be eligible to download the following past issues:

“Why We Fight: The real reasons Messrs. Bush and Cheney invaded Iraq” (April, 2003)

“The Trifecta that Wasn’t — A contrarian view of monetary policy, tax cuts and a devaluing dollar (June 2003)

“Eye on the Prize / The Perfect Storm: Possible scenarios in the Middle East” (November, 2003)

“The Clash of Civilizations: Christianity vs. Islam Redux” (April, 2004)

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“Prohibition’s Hangover: The Income Tax -- Why a Graduated National Sales Tax is Better” (March, 2005)

“God, Government and Mammon – The Reformation Redux: Church and State in America” (June, 2005)

“Point and Counterpoint – Letters to the Editor” (December 2005 and September 2006)

“The Asian Caper — Profit and peril from across the Pacific.” and companion “The Prudent Gambler: How to capture gains and avoid losses when Asia takes home all the marbles.” (January 2006)

“Iraq: Vietnam Deja Vu” (March 2007)

“The Third Oil Shock — How to avoid loss and capture gains from the developing oil crisis” (Originally published April 2006, updated June 2008)

I will, from time to time, update these topics and introduce new ones. I am close to finishing a fascinating *Chronicle* titled “The Egyptian Solution” in which we learn how the ancient Egyptians of the Pyramid-building Age developed “God’s answer of peace.”

In either case, simply print the subscription form at the end of this Précis, fill in the blanks and 1) scan and e-mail it back to me as an attachment 2) FAX it to (214) 447-9249 or 3) mail it to 5161 San Felipe St., Suite 320. Houston, TX 77056.

Again, I thank you for your ongoing interest and support, and as always, invite questions, comments and suggestions.

Kind regards,



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