

# **‘Tis only my Opinion!**

**Volume 27 - Number 1**

## **Outlook 2007**

### **Looking ahead at 2007**

The mid-term elections in the U.S. complicated the investment outlook going forward.

There are several areas that I believe the nation needs to address. In this Outlook 2007 issue, we will try to identify some of those needs and to suggest solutions which will probably not be politically correct.

Major topics covered in this Outlook 2007 center around the following areas:

- The political, military and religious differences existing in the Mideast and Africa could explode into a regional or larger confrontation.
- The consequences of withdrawal from Iraq and Afghanistan upon the credibility of the U.S.
- The demographic problems which the Western industrialized civilizations and Japan are facing due to falling birth rates.
- The decisions which are made based upon erroneous data provided by the Ministry of Truth. There is a significant disconnect between data provided by the government through the use of hedonic and seasonal adjustments with even data provided by other branches of the government to suggest that much of the data is manipulated for political and market impact.
- The direction of interest rates and the dollar's value in the United States and abroad when money supply continues to grow exponentially. The dollar's role as a reserve currency is being reduced and as it loses credibility, the ability of the U.S. to obtain foreign financing for its trade and federal deficits will become more costly.
- The inability to really understand what is going on in China both from a growth standpoint as well as the political and religious problems which continue to fester including the reconciliation with Taiwan
- The growing specter of asset expropriation throughout Russia, much of Latin and the Andes countries as well as Africa of asset expropriation and the lack of a legal system available to settle disputes.
- As the dollar weakens in value, the movement away from fiat assets by countries into hard assets could easily become a competitive devaluation process.

- The change in Congress with the Democratic party in control could lead to a stalemate in possible legislation and with the Presidential elections just two years ahead, the game of “gotch you” is front and center.
- If the House impeaches President Bush, the turmoil arising in the U.S. could become very divisive.

### The Large Economies

The following table shows a comparison of GDP for selected countries since 1990 from data contained in the 2006 Economic Report of the International Monetary Fund. While the largest percentage growth has occurred in China, Hong Kong and Taiwan economic group, the European Union and the USA remain still substantially greater economic engines.

<b>Comparison of GDP</b>								
in Billions of US dollars								
Year	USA	EU	China	Hong Kong	Taiwan	Total	India	Japan
1990	\$5,803	\$7,096	\$388	\$77	\$165	\$630	\$317	\$3,031
1991	\$5,996	\$7,532	\$406	\$88	\$184	\$678	\$281	\$3,454
1992	\$6,338	\$8,159	\$483	\$104	\$219	\$806	\$283	\$3,770
1993	\$6,657	\$7,419	\$613	\$120	\$231	\$964	\$276	\$4,337
1994	\$7,072	\$7,898	\$559	\$136	\$252	\$947	\$314	\$4,767
1995	\$7,398	\$9,077	\$728	\$144	\$274	\$1,146	\$357	\$5,274
1996	\$7,817	\$9,274	\$856	\$159	\$289	\$1,304	\$378	\$4,623
1997	\$8,304	\$8,733	\$953	\$176	\$300	\$1,429	\$411	\$4,237
1998	\$8,747	\$9,036	\$1,019	\$167	\$276	\$1,462	\$414	\$3,858
1999	\$9,268	\$9,037	\$1,083	\$163	\$299	\$1,545	\$442	\$4,363
2000	\$9,817	\$8,390	\$1,198	\$169	\$321	\$1,688	\$463	\$4,651
2001	\$10,128	\$8,476	\$1,325	\$167	\$292	\$1,784	\$474	\$4,090
2002	\$10,469	\$9,269	\$1,454	\$164	\$295	\$1,913	\$494	\$3,912
2003	\$10,961	\$11,273	\$1,641	\$158	\$300	\$2,099	\$575	\$4,237
2004	\$11,712	\$12,980	\$1,932	\$166	\$322	\$2,420	\$666	\$4,587
2005	\$12,456	\$13,503	\$2,234	\$178	\$346	\$2,758	\$772	\$4,567
2006	\$13,262	\$14,206	\$2,554	\$189	\$355	\$3,098	\$854	\$4,464
2007	\$13,928	\$15,183	\$2,871	\$201	\$375	\$3,447	\$933	\$4,599

Source: International Monetary Fund

### Looking at China

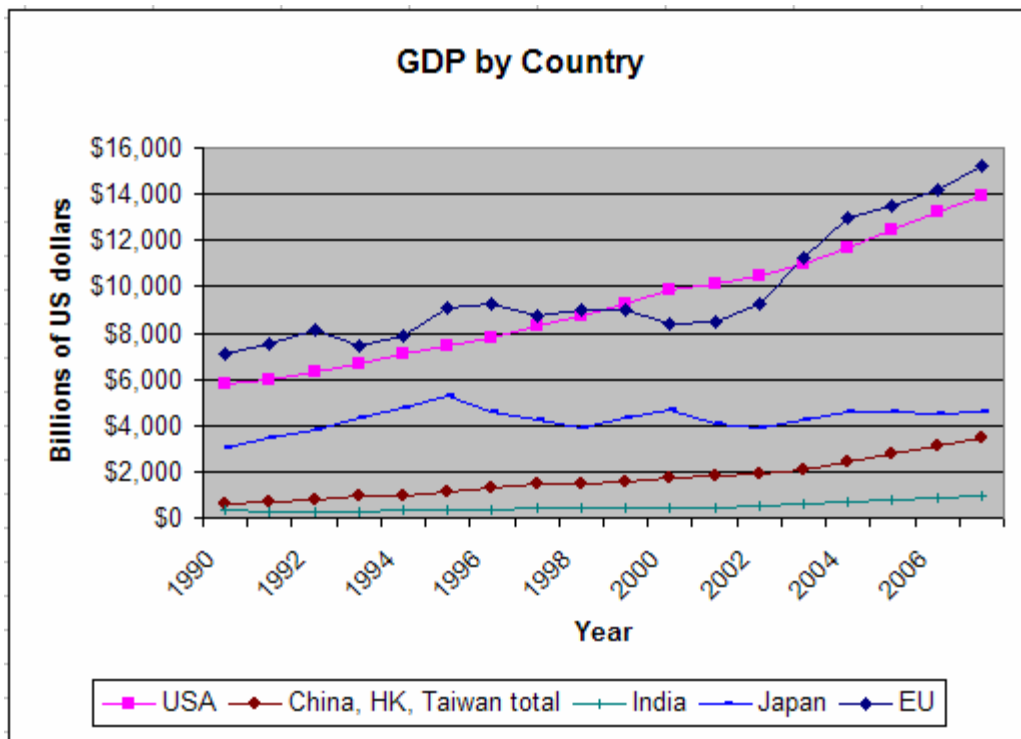
Moreover, the numbers for mainland China were revised upward in December 2006. The revised numbers are said to more accurately reflect the services sector which has been under-reported in the previous data.

**China's revised GDP growth  
 (% real change, year on year)**

	Revised	Original
1993	14.0	13.5
1994	13.1	12.6
1995	10.9	10.5
1996	10.0	9.6
1997	9.3	8.8
1998	7.8	7.8
1999	7.6	7.1
2000	8.4	8.0
2001	8.3	7.5
2002	9.1	8.3
2003	10.0	9.5
2004	10.1	9.5

Source: National Bureau of Statistics

The following graph shows the difference between these economic engines during the period without the effect of the December 2006 China revisions.



This data ignores the purchasing parity calculations. For example, if the Chinese currency was revalued to purchasing parity, the GDP for China in 2006 would be something in the area of \$10.6 Trillion rather than the \$2.9 Trillion shown.

When China is granted entry into the WTO, the value of its currency will float much higher. At the moment, the Chinese are using the low valuation of the renminbi to

increase their currency reserves and provide maximum employment for their economy. In November 2005, the population of China was 1.306 billion excluding those in Hong Kong, Macao, and Taiwan. Urban population stood at 561.6 million versus 744.7 million in the rural areas. Since the 1990 census, the rural population has declined from about 896 million. The 1990 census had a population of 1.143 billion.

In the population those with university education (junior college or above) were 67.64 million, those with high school education (including technical secondary school) were 150.83 million. 467.35 million had middle school education while 407.06 million had a primary school education. With a major movement of their population away from the rural to the urban areas, the Chinese have a major problem of adjustment to the workforce which if the renminbi were to rise to realistic levels could threaten both the economic and political situation within the country.

China's first National Population Development Strategy Research Report, released on January 11, suggested that the introduction of China's family planning policy prevented the birth of over 400 million people over the last 30 years.

The Chinese expect that auto sales alone in 2007 will grow by 40%. Hence, the demand for oil will also increase resulting in increased demand for the world's supply of that commodity. The Chinese have been seeking to reinvest some of its trade surplus into asset rich countries and companies. In the past two years, they have acquired positions in copper, iron ore and oil sands to secure control over resources. China today is the largest producer of steel in the world.

In addition, the Chinese have decided to build using their engineering and steel resources a much larger blue-water navy for the first time in their history.

In the economic numbers shown above, we have grouped China, Hong Kong and Taiwan together to show the regional strength of the Chinese. While there is some friction between Taiwan and China, there is also a trend toward reconciliation and/or absorption which is accelerating. China covets the management skill which exists in the Taiwan manufacturing sector.

In recent years, the Chinese have convinced whole groups of Taiwanese workers to return to China by providing them with more pay and better living conditions than they enjoyed in Taiwan. One example is in the music industry where for years, the largest makers of brass instruments were Taiwanese. Today, most of those employees and their management cadre are living in Mainland China.

### **The Middle East and Africa**

Ever since the partitioning of the Ottoman empire and the subsequent UN mandate to carve out a Jewish state in 1948, the Asia Middle East area shown on this map has seen conflicts flare up between various religious factions whether they are Islamic or Jewish.

A major point of contention has been the imposition of the Jewish state and the unwillingness of most of its neighbors to recognize its existence. The failure of the Islamic nations to absorb the so-called Palestinian refugees unlike the Jewish refugees that were expelled from the Islamic countries and went to Israel has created a situation of despair in many of the refugee camps located in Lebanon, Gaza, and Jordan.

People without hope are easily convinced to participate in violence and become willing converts to radical positions including suicide bombers. The lack of education and economic opportunity provides the background that religious fanatics can exploit.



In recent years, the fundamentalist Muslim clerics have risen to power throughout much of the Middle East. Their doctrine is based upon a strict reading of the Koran and its exhortation to become the dominant religion in the world.

Top 10 largest Muslim populations		
#	Country	Muslims
1.	Indonesia	188,619,000
2.	Pakistan	144,788,000
3.	India	131,213,000
4.	Bangladesh	118,512,000
5.	Turkey	67,864,000
6.	Iran	67,610,000
7.	Egypt	64,647,000
8.	Nigeria	54,891,000
9.	Algeria	31,729,000
10.	Morocco	31,642,000

At the moment, the two leading Islamic faiths (Sunni and Shiite) continue to confront each other primarily in Iraq, but also in other regions of the area and throughout the Far East including Malaysia, the Philippines and throughout Central Africa.

As we stated in Outlook 2006, the war on terror has to be won. The United Nations have proved to be utterly useless in helping prevent the proliferation of nuclear weapons and the genocide of many in Somalia and other places in Africa. Of course, when you have an organization which votes by country and not by might or financial backing, what else can you expect? Even the Security Council no longer is effective at devising solutions to eliminate fighting between religious groups. With the growth of the Taliban and Al Quaida in the past ten years, the United Nations continues to stall any effective action.

### **An Effective Solution**

To effectively combat the terrorist threat, the financial backing and the training bases of the terrorists has to be neutralized. To accomplish this goal, the removal of certain governments in the Middle East such as Iran, Syria, Pakistan and Saudi Arabia which have aided and abetted the terrorists.

Further, the results of implied consent by “so-called” neutral parties towards the terrorists must also have consequences. Countries like France, Germany, Russia and China which have provided arms and safe havens must be confronted.

The Iraq Study Group’s paper wasted a lot of dollars and manpower to come up with a proposal which basically mirrored Chamberlain’s surrender to Hitler in 1938 although no responsible politician wants to admit that fact. But then what do you expect from a group of former politicians without significant military command experience?

President Bush has only one alternative ... to win the war on terror and forget about the problem of collateral damage. That means raising the troop level to a force able to accomplish the task. The rules of engagement presently in place prevent our troops from winning the war in both Iraq and Afghanistan much like the rules of engagement prevented the U.S. from winning in Vietnam.

### **War is hell**

**“War is hell”**, there is no other way of putting it. If you can not stomach the possible losses, you should never go to war. But once you have engaged, there is absolutely no substitute for winning and being the ones to write the history books.

### **The ramifications of not winning the war on terror**

Prior to the renaming of the Department of War, the U.S. never lost a war. However, with the renaming to the more politically-correct title, the U.S. has never won a war. Do you think there might be some connection there?

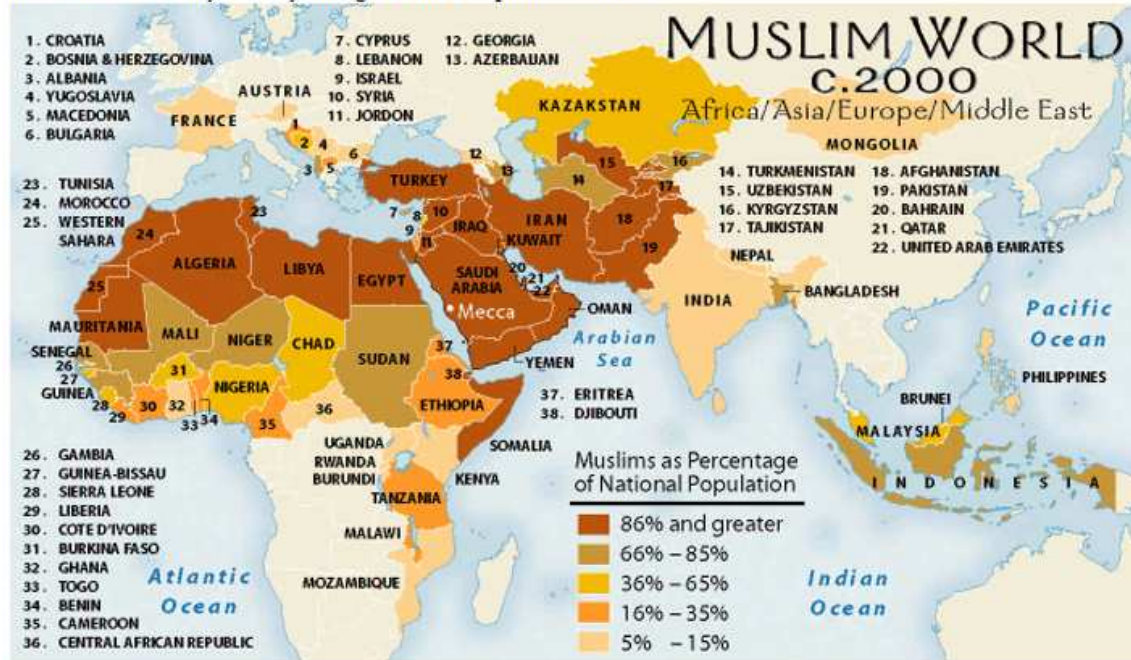
Failure to win in the absolute sense, the only possible outcome is the waste of a lot of good people and material in a cause which will have to be fought again and again.

### **The Muslim World**



**Muslim Countries of Africa/Asia/Middle East/South East Asia: Circa 2000**

Today there are nearly 65 states or countries with significant or majority populations who are Muslim. They include some of the largest nations in the world in terms of population, such as Indonesia, Nigeria, and Pakistan. Others are small countries like Qatar and Djibouti. Many are secular republics such as Indonesia, or monarchies such as Saudi Arabia, or so-called "Islamic states" such as Iran. Some are democracies, such as Malaysia. No majority Muslim state exists in Europe or the Americas. In almost all of those states where a majority of the population is Muslim, a belief in Islam serves as a common bonding among diverse inhabitants in politics and life. It is a source of faith and a significant foundation of social identity and community relations. Almost all of these Muslim states are also developing nations that have only recently emerged from European colonialism.

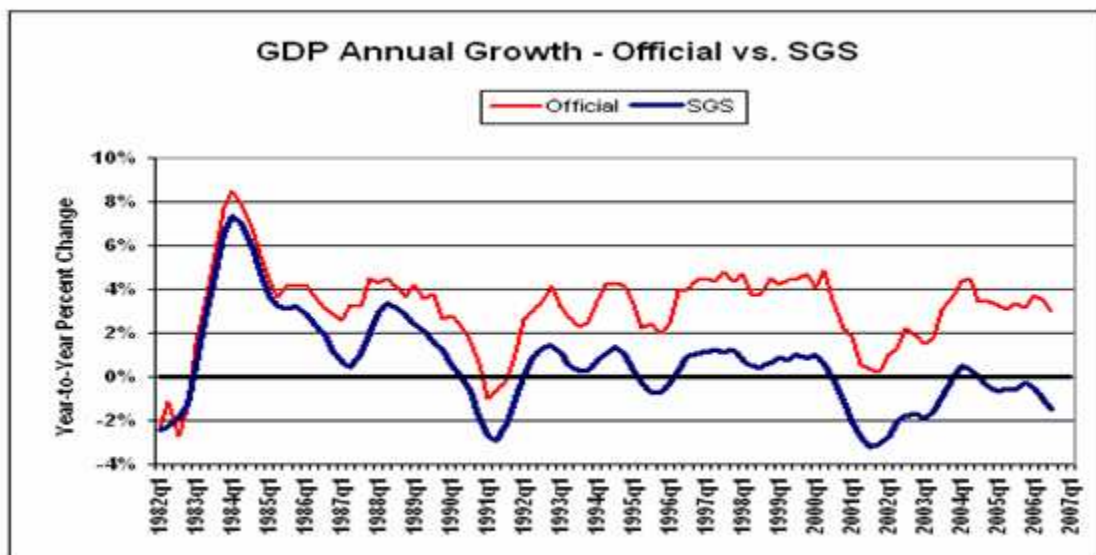


[http://www.theislamproject.org/education/Africa\\_Mideast\\_etc.html](http://www.theislamproject.org/education/Africa_Mideast_etc.html)



### Is the U.S. already in a recession?

John Williams of Shadow Government Statistics is convinced that the figures provided by the Ministry of Truth are somewhat tainted. The seasonal and hedonic adjustments that have been used to calculate many government statistics have become so pervasive that the Ministry of Truth data bears some significant differences from the real world. GDP growth shown here is running between 2 & 4% annually since 1984 whereas John Williams of Shadow Government Statistics calculates that the real growth is actually negative since 2001.

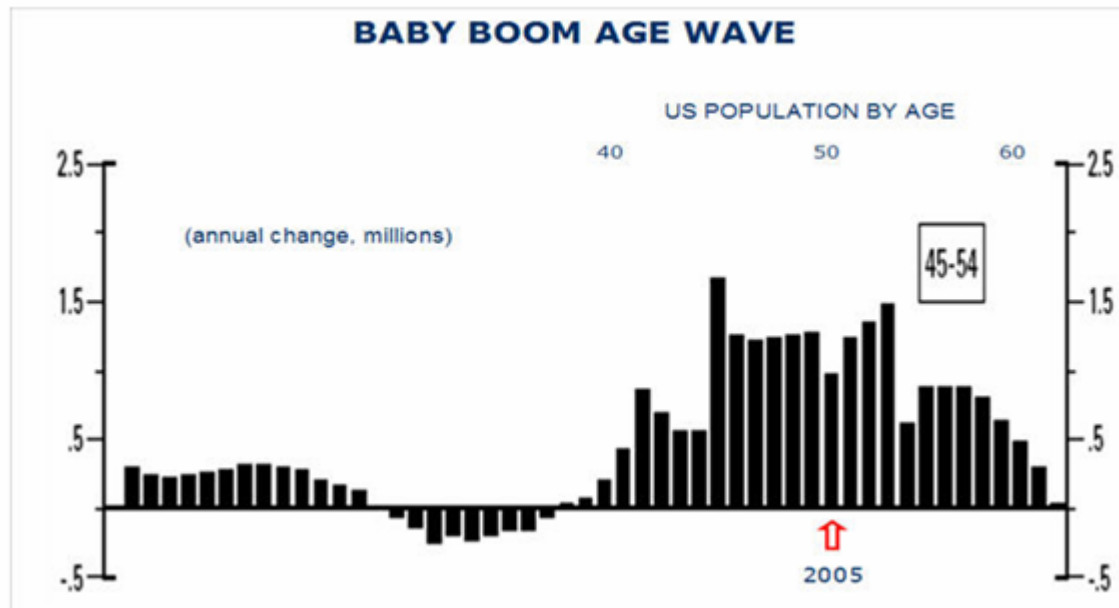


Courtesy of Shadow Government Statistics

For example, the GDP numbers for computers have a hedonic adjustment that supposedly accounts for the increased speed of the CPU and the actual sales shown by the computer manufacturers are adjusted higher to account for this increased speed. Hence, if one were to add the actual sales for all computers sold in the U.S. and compare it with the GDP numbers, the difference might astonish you.

### The Demographic Problem is getting worse.

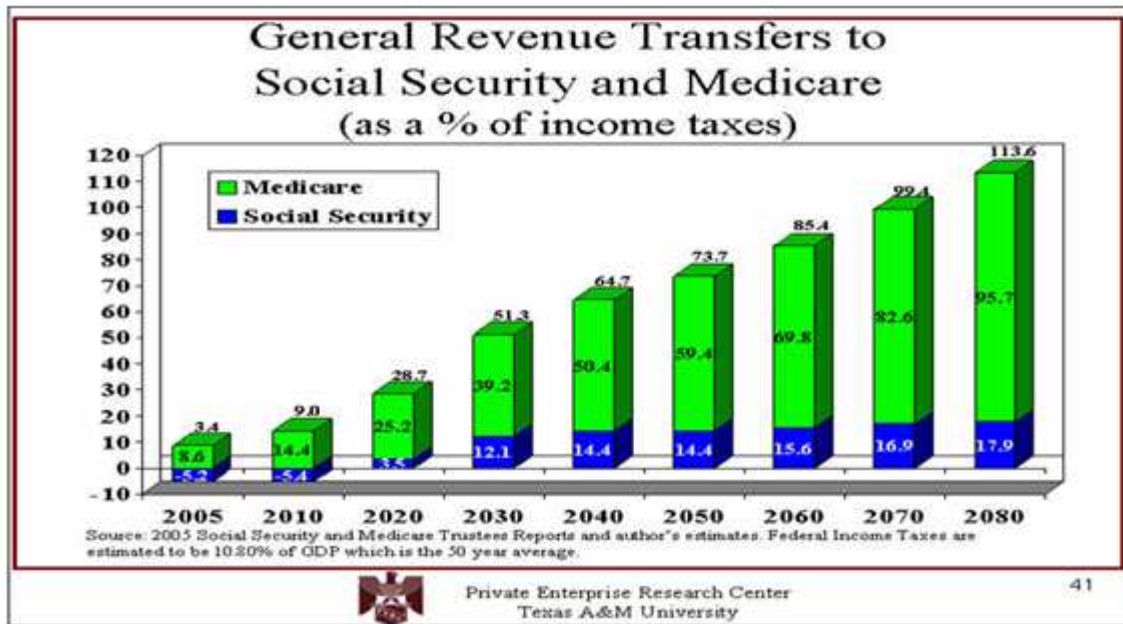
With the aging of most populations in the industrialized world, the problem of funding pensions, social security and other entitlement programs will strain most economies. These programs were often passed without any basis on a sound financial footing. In the U.S., the baby boomer wave is clearly moving towards retirement and holds the biggest voting block. Will this group be willing to sacrifice their living standards as this generation moves into retirement age?



The graph shows clearly that not only does this group have considerably more population within the baby boom age wave than the generations that will be called upon to support the Social Security and Medicare system that currently exists.

Congress has failed to address the possible bankruptcy of the Social Security and Medicare reform in previous tries. Moreover, the taxes which were placed in the Social Security system were spent by Congress, leaving the Trust Fund with nothing but U.S. Treasury notes. Clearly, the taxpayers will be required after about 2017 to start funding Social Security and Medicare payments.

The Private Enterprise Research Center at Texas A&M University has provided the following graph of current expected general revenue transfers to Social Security and Medicare in the future. This graph illustrates the amount of general revenue taxes required to meet the estimated needs of Social Security and Medicare based upon the current population mix and benefits promised. Clearly, the program must be revised.

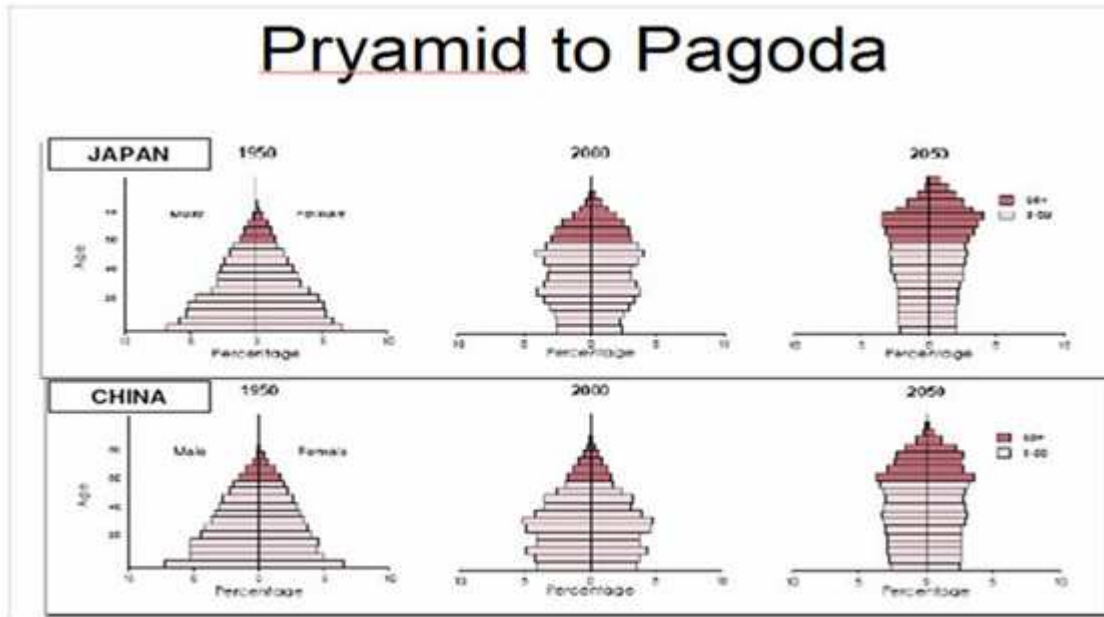


There are only about three solutions to the problem. First, the age at which a person can begin to draw from the system can be increased from the current 65 level to something higher, perhaps, 70 or even 75. Second, benefits could be frozen or reduced based upon a needs test. Finally, taxes could be raised either by raising the amount subject to tax, or by increasing the tax rate.

There maybe a fourth solution and that is for people in the U.S. to increase the size of their families. Perhaps, income taxes could be increased substantially on those people without children. For each child, income taxes could be lowered significantly. Follow the money, someone often said.

In the demographic area, it is clear that the problem in the U.S. is getting acute in two ways. First, we are barely replacing the population through births. Second, while our population is now above the 300 million mark, a substantial portion of the recent increase has occurred through out-of-wedlock births and immigration.

The demographic problem is facing most industrialized countries and China. The following graph portrays the situation over the next 50 years for China and Japan. While Japan is not replacing its population, China is also showing the results of the one-child policy. By 2050, both countries will have major problems supporting the elderly.



Courtesy of Mulvihill Asset Management

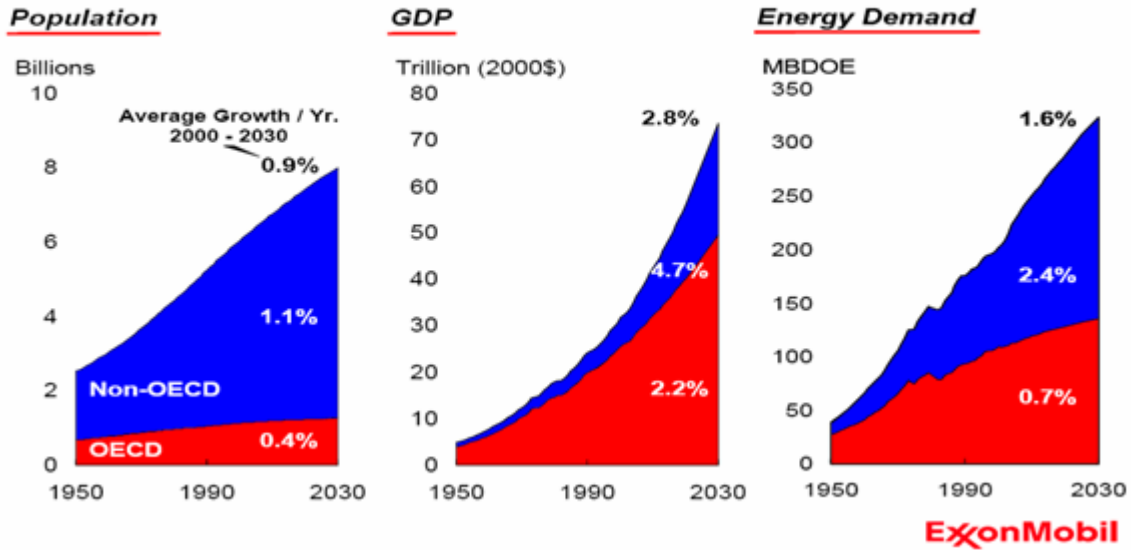
### The China Problem

For the past two decades, the growth of the Chinese economy has been significantly higher than that of the U.S. Of course, it is also

### Global Economics and Energy

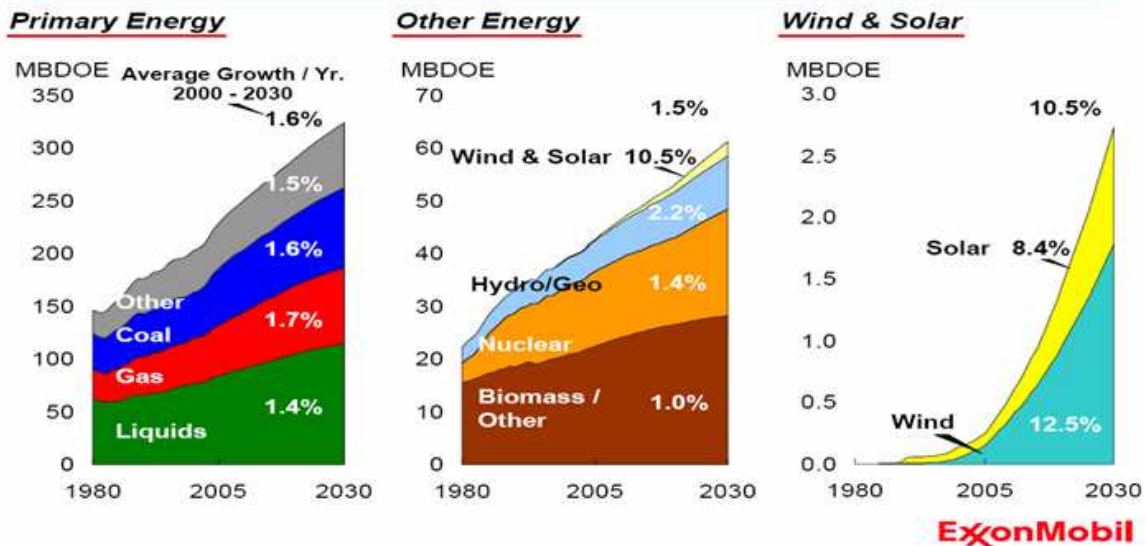
Most of the world's population growth during the next 25 years will occur in the non-developed world. Likewise, GDP growth will not. However, energy demand will increase at a faster rate in the non-OECD countries according to the 2007 Energy Outlook from ExxonMobil.

## Global Economics and Energy



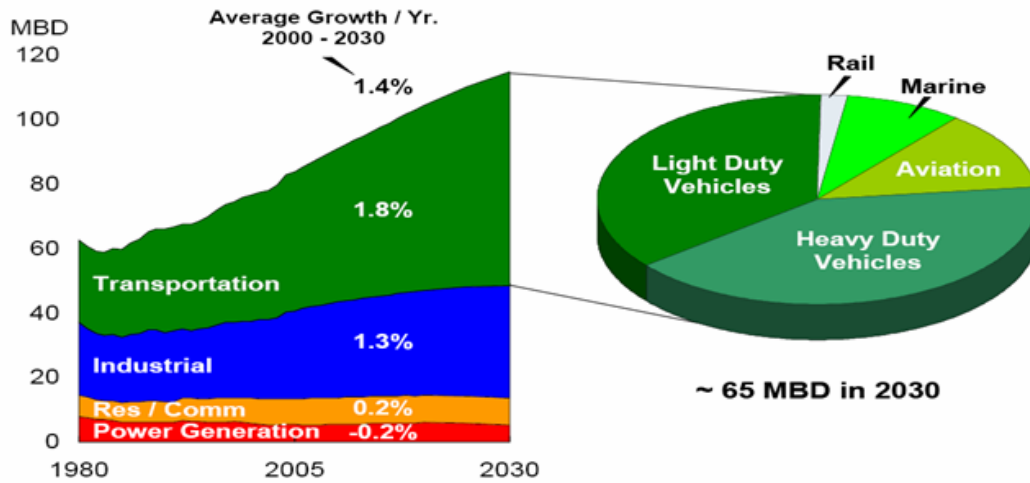
The ExxonMobil report also suggests that the prime energy source in the next 25 years will remain liquid distillates, natural gas and coal. While other energy sources such as biomass, nuclear, hydro/geo, and wind and solar sources will increase the primary energy sources will still dominate.

## Global Energy Demand by Fuel



As China and India modernize, the growth of auto production and demand for fuel for those vehicles is growing at a substantial rate. In 2007, auto sales in China are expected to increase 40%. The following graph illustrates where global liquid demand is expected to increase by 2030.

## Global Liquids Demand by Sector

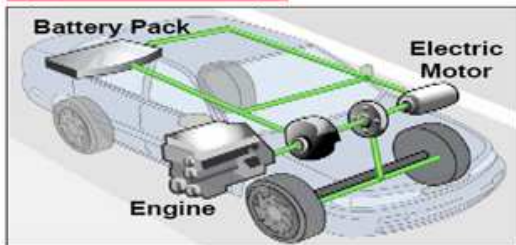


**ExxonMobil**

As transportation demand for global liquids is the fastest growing sector, many environmentalists and government programs are trying to develop high efficiency vehicles. The following graph illustrates the expected growth in the U.S. of high efficiency vehicles in the next 25 years.

## Penetration of High Efficiency Technology

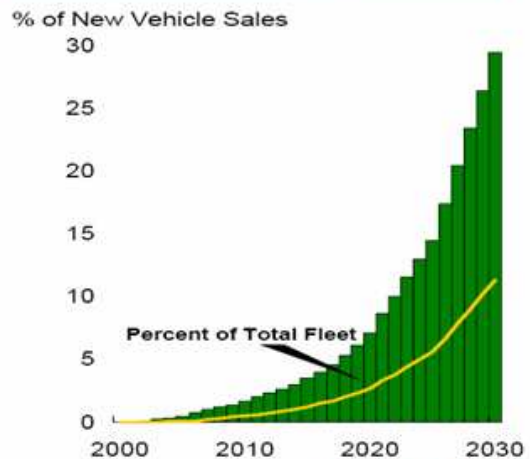
### Hybrid Vehicle Design



### Homogenous Charge Compression Ignition



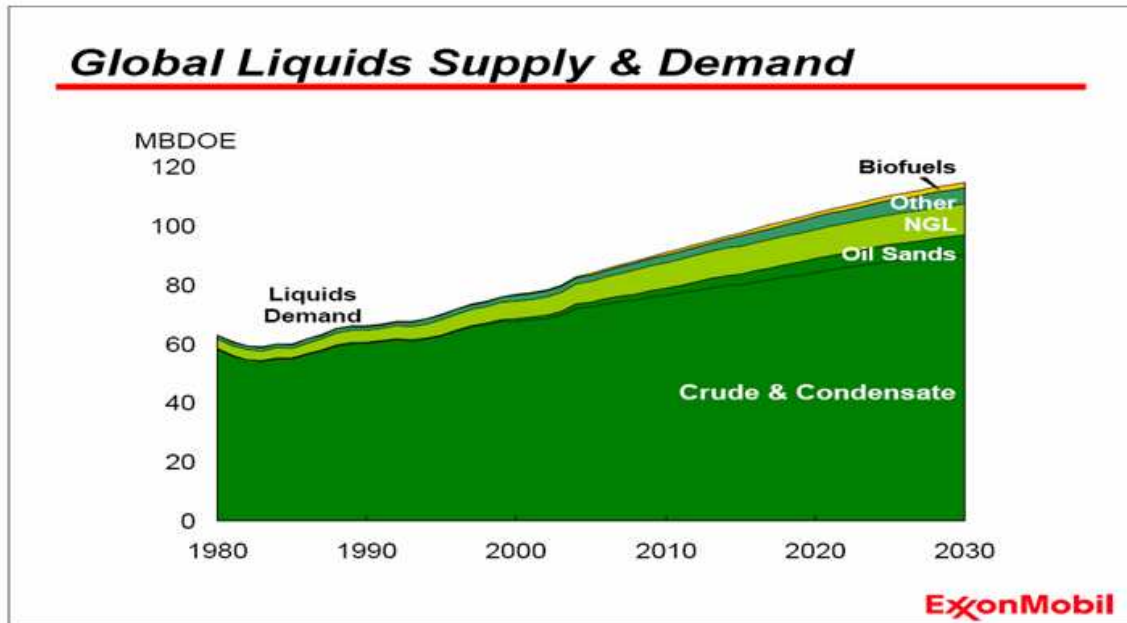
### U.S. Advanced ICE / Hybrid Penetration



**ExxonMobil**

However, until battery packs become less expensive and more efficient or we find a technology that permits solar energy to be an effective source, the internal combustion and/or diesel engines will remain the primary source of power for vehicles.

Hence we will have to largely rely upon global liquids to meet our energy requirements. Of course, by immediately beginning to build nuclear plants in the U.S., the demand for natural gas and oil could be reduced substantially. However, it is probably safe to say that no politician has the intestinal fortitude to advocate such a program. Hence, we are stuck with the fact that crude will dominate energy production in the next 25 years.

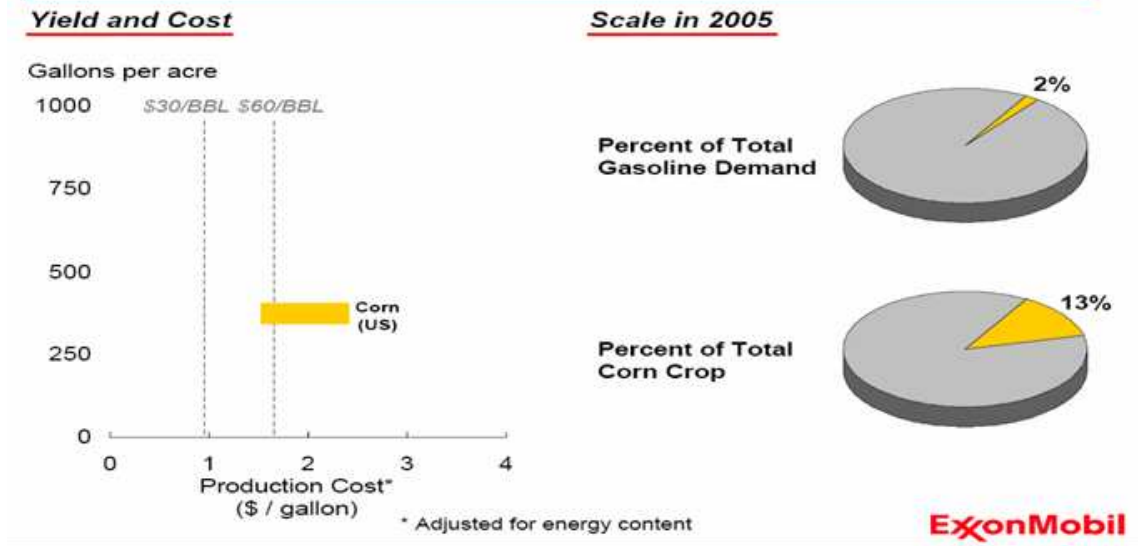


The real question is whether that demand can be met. With the Iran's (the 2<sup>nd</sup> largest producer of crude) production falling 10% per year, and the North Sea also dropping, exploration will be critical to finding the necessary reserves to meet demand.

There are some alternatives which might become viable depending upon the cost of crude. Ethanol made from either corn, waste products or sugar cane might provide some relief. In the case of corn, the real tradeoff is from food value versus fuel value. Most estimates of ethanol costs using corn fail to include the future value of the mass by-product as a livestock feed source.

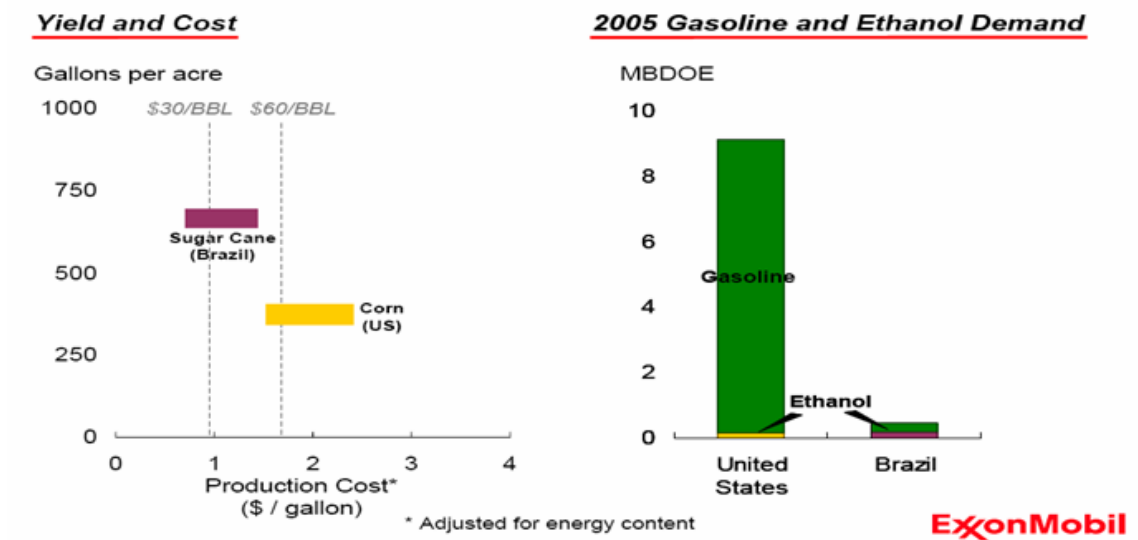
In the U.S., ethanol is probably a viable alternative if oil is over \$60 per barrel unless it is subsidized. The current growth of ethanol plants suggests that about 25% of the expected corn crop in 2007 will be utilized by ethanol plants. The following chart from ExxonMobil illustrates the current situation.

## U.S. Corn Ethanol



Brazil has been producing ethanol from sugar cane for about 30 years using technology originally developed in Germany during WWII. A three-decade-long alternative energy campaign has outfitted Brazilian filling stations with fuel pumps that offer pure ethanol, a blend of gasoline and 20% ethanol called gasohol, or even natural gas. In 2006, Brazil will achieve energy independence — a goal the United States has been chasing without success since the energy crises of the 1970s. Sugar cane is a viable alternative to gasoline at about \$30/barrel for oil.

## Brazil Sugar Cane Ethanol



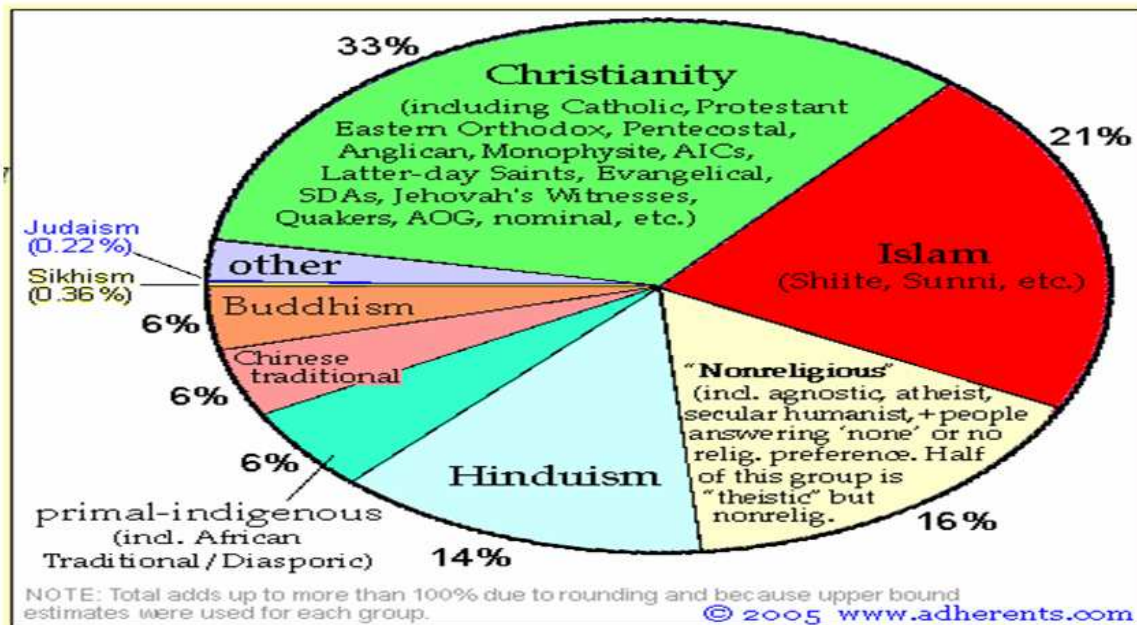
As more vehicles are sold throughout the world, the demand for not only crude oil but also other fuels will increase. With the major oil-producing countries in the undeveloped



world, it is important to understand that control of those resources will be a major source of contention in the years to come.

### **Demographics, Global Economics and Religious Differences are on a Collision Course!**

The following chart illustrates the world population that purports to one religious faith. The fastest growing population is not Christianity which is generally suffering from a declining birth rate. The fastest growing faith is Islam by birth data.



As the non-developed countries strive for more economic power, the growth of radical Islam will find more adherents among those individuals living well below the world standard-of-living.

### **Immigration policy adds to the problem.**

In France, Holland and the Balkans, the increasing hostility of the mainly immigrant Islamic population towards their hosts is causing those nations to rethink their immigration policies.

Rethinking immigration policy without doing something to accelerate the birth rate of the non-immigrant population will not provide a long-term solution for much of the Euro common market countries.

In the U.S., we already have population centers where Islamic immigrants have become the majority and in many cases, neighborhoods have deteriorated. Not only in Michigan is the problem growing. In Rochester, Minnesota, the situation is becoming acute. Minnesota's welfare benefits and the easy standards required to qualify for those benefits has attracted a significant Moslem population.

The newly-elected Democratic Congress is likely to offer an amnesty program for some 12 million illegal immigrants. Congress is also on the verge of passing a bill that will grant any illegal immigrant social security benefits after working only 18 months. The cost is expected to further reduce the time before the Social Security trust funds become depleted.

According to a recent U.S. Treasury report on FY 2006, "Despite this short-term progress, funding for current Social Security and Medicare participants will come up \$44 trillion short in the next 75 years at net present value, according to the report. Without fundamental reform, **the cost of these programs is projected to triple as a percentage of the U.S. economy by the year 2080.**"

### **Where's the Money coming from for the Benefits?**

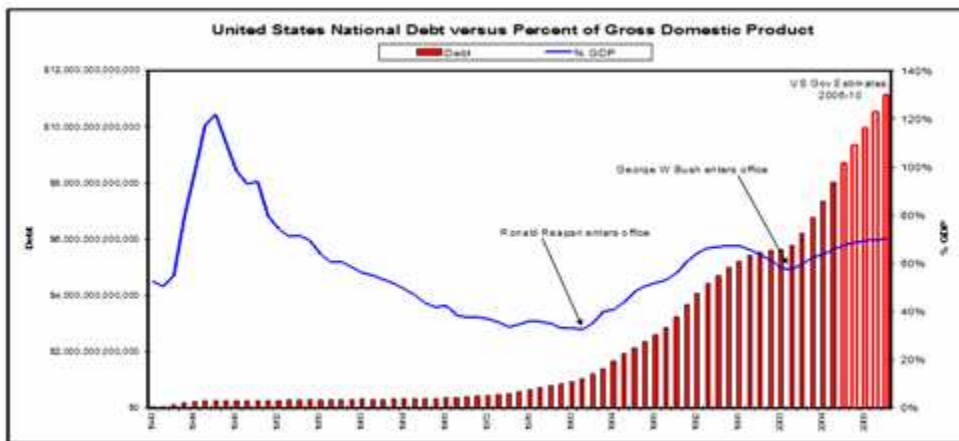
While the Republican Congress during the past 12 years paid lip-service to the idea of limited government, both governmental spending and the national debt increased at the fastest rate in history. In 1994 when the Republican became the majority party in Congress, then federal debt stood at \$4.5 trillion. In 2007, the federal deficit had almost doubled during that time increasing to \$8.7 trillion on January 3, 2007 to \$8.7 trillion.

The following chart shows the growth of the national debt since 1938 with the various Presidents' terms marked by vertical lines. There is no question that the steepest upward increases in debt took place after President Reagan was elected.



<http://www.cedarcomm.com/~stevelm1/usdebt.htm>

The debt to GDP ratio had been dropping from the end of World War II as shown in the following chart. When Reagan entered office, the ratio stood at 33.3%. Current government estimates indicate that the debt to GDP ratio will be in excess of 69% when the current President Bush leaves office in 2008.



<http://www.cedarcomm.com/~stevelm1/usdebt.htm>

While these numbers may seem difficult to believe, the real problem lies not in the federal budget and debt numbers but the demands of the unfunded liabilities which are not widely understood by most voters.

Based upon Bureau of Budget numbers, the federal deficit for FY 2006 fell to \$248 billion from \$318.6 billion in FY 2005. Of course, the federal deficit grew by \$44 billion the day after FY 2006 closed. Using GAAP accounting, the same Bureau of Budget recently indicated that the true deficit for FY 2006 was over \$4.2 trillion.

billions of dollars	2002	2003	2004	2005	2006
<b>Liabilities Net of Assets (balance sheet)</b>	\$ (6,820)	\$ (7,094)	\$ (7,710)	\$ (8,467)	\$ (8,916)
	The balance sheet presents a 'snapshot' of an entity's current financial position (net of assets and liabilities as of the end of the current fiscal year).				
<b>Social Insurance Responsibilities, Net (closed group -- off-balance sheet)</b>	\$ (24,219)	\$ (26,858)	\$ (37,279)	\$ (40,038)	\$ (44,147)
	The Statement of Social Insurance presents the present value of estimated future revenues and expenditures under current law.				
<b>Combined Net Liabilities (current) and Social Insurance Responsibilities (future)</b>	\$ (31,039)	\$ (33,952)	\$ (44,989)	\$ (48,505)	\$ (53,063)

<http://www.fms.treas.gov/fr/06frusg/06frusg.pdf>

Moreover, if one adds the stated debt to the future social insurance responsibilities (net) shown in the above table, GAPP accounting would indicated a short-fall of \$61 trillion.

Of course, although GAPP accounting requires an audit to be performed, it is useful to understand the following problems with the *2006 Financial Report of the United States Government*. The following disclaimer is certainly enough to suggest that even \$61 trillion might be understated.

For each of the past ten years, GAO has issued a disclaimer of opinion on the consolidated financial statements. A 'disclaimer' means that sufficient information was not available for the auditors to determine whether the information was reliable. Material weaknesses in internal control and other scope limitations resulted in conditions that prevented GAO from forming and expressing an opinion on the Government's consolidated financial statements for the fiscal years ended September 30, 2006 and 2005. However, **eighteen of the 24 most significant Federal agencies earned unqualified opinions on their FY 2006 financial statement audits.**

Unqualified			Qualified	Disclaimer
USDA	Treasury	SBA	Energy <sup>1</sup>	Defense
Commerce	VA	SSA	Transportation	DHS <sup>2</sup>
Education	USAID	Ex/Im Bank	Smithsonian <sup>3</sup>	State
HHS	EPA	FCC		NASA
HUD	GSA	PBGC		
Interior	NSF	RRB		
Justice	NRC	SEC		
Labor	OPM	USPS		

<sup>1</sup> Balance Sheet Audit Only

<sup>2</sup> Balance Sheet and Custodial Statement Audit Only

<sup>3</sup> GFRS Audit Only

<http://www.fms.treas.gov/fr/06frusg/06frusg.pdf>

The fallacy of the reported numbers is just too ludicrous. The Ministry of Truth continues to hoodwink the populace! Does anyone have any idea of the true facts after reading the *2006 Financial Report of the United States Government* and discovering that **six of the 24 most significant agencies including those with the largest budgets were unable to receive an unqualified opinion.**

### Unfunded Liabilities

By failing to recognize in a public way, the tremendous costs facing the U.S., the Ministry of Truth enables Congress to continue to vote spending programs that appease the public and get votes.

The sad fact is that the costs of the Social Security and Medicare/Drug program have ballooned since originally enacted. The costs of government pensions at both the federal, state and local levels are off-budget. Unless the benefits are reduced, many governmental entities will either have to increase taxes or declare bankruptcy.

During the past 50 years, the highway infrastructure and governmental facilities have not been replaced. The Interstate Highway System is almost 70,000 km and accounts for 30% of the National Highway System (NHS). The original request by President Eisenhower was for \$175 million to construction an interstate highway system. Two years later, the expanded Federal-Aid Highway Act authorized a budget of \$25 billion, of which the federal share was to be 90%.

The final estimate to build the Interstate Highway System, according to John Fischer at the Congressional Research Service writing in *21st Century Highways*, was \$128.9 billion. ***About 98 percent of all roads in NHS have been built. The 256,000 kilometers (km) of NHS include only 4 percent of the nation's roads, but they carry more than 40 percent of all highway traffic, 75 percent of heavy truck traffic, and 90 percent of tourist traffic.***

The IHS is deteriorating and a large portion needs to be replaced or rebuilt in the next few years. Fifty years after its birth, the 46,876-mile network is imperiled by crumbling concrete, decaying steel, insufficient lanes and overstuffed traffic – and federal and state gas tax receipts can't keep up with the cost of the needed improvements.

The cause of the roadway plight is easy enough to explain. Millions of more cars and far heavier freight-hauling trucks are pounding away at the aging system than engineers anticipated. The IHS is the most visible of the National Highway system. In addition, there are four other components of the NHS.

There are 21 congressionally designated high-priority corridors as identified in ISTEA. These corridors total 7,200 km.

The third component is the non-interstate portion of the Strategic Highway Corridor Network, or STRAHNET, identified by the Department of Defense in cooperation with DOT. It totals about 25,000 km. These corridors and the interstate highways are critical strategic links.

The fourth component is major Strategic Highway Corridor Network connectors. They consist of more than 3,000 km of roads linking major military installations and other defense-related facilities to the STRAHNET corridors.

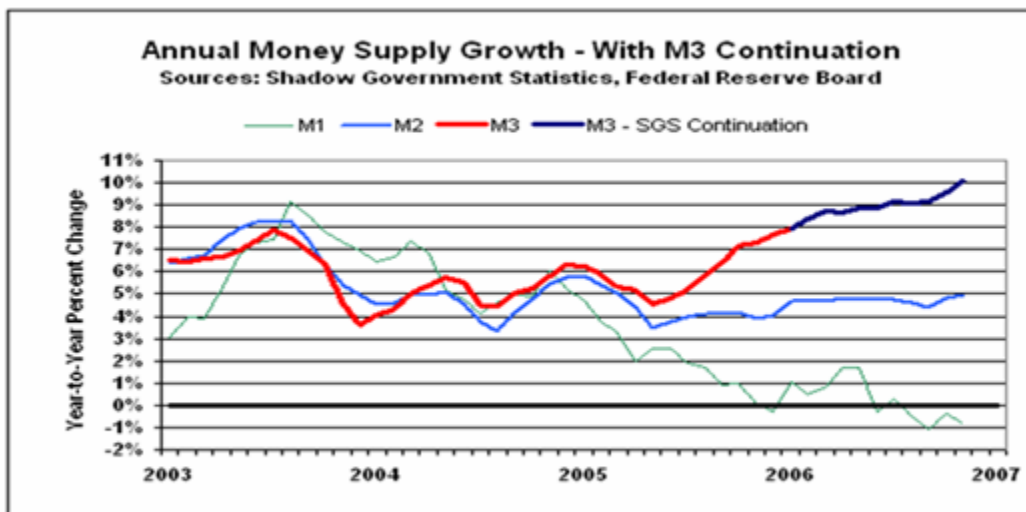
Collectively, these four components, all specifically required by ISTEA, account for about 112,000 km or roughly 43 percent of the system.

The fifth component is the rest of the system - about 148,000 km of important arterial highways that serve interstate and interregional travel and that provide connections to major ports, airports, public transportation facilities, and other inter-modal facilities.

Unfortunately, the cost to rebuild the NHS infrastructure is above \$50 trillion at today's prices according to one estimate.

### **Liquidity and Fiat Money**

Although the Federal Reserve stated that the reason for eliminating the M3 report was due to its cost, a few analysts have doubts. Moreover, those analysts have undertaken to reconstruct the M3 report.



Courtesy of Shadow Government Statistics

Both John Williams at Shadow Government Statistics and others including [www.nowandfutures.com/key\\_stats.html](http://www.nowandfutures.com/key_stats.html) are calculating M3 and their results are surprisingly close.

It is no wonder that the Ministry of Truth does not want the public to see the true M3 explosion in the money supply which will eventually reduce the value of their money by creating inflation. As the broadest measure of domestic liquidity, M3 is a key leading indicator and driving factor of both economic activity and inflation.

In October 2005, seasonally-adjusted M2 was \$6.6 trillion, while M3 was \$10.1 trillion. It is incredible that the Fed would even suggest that the shifts in and growth of the \$3.5 trillion in non-M2 assets had no meaning.

### **Inflation/Deflation or Stagflation**

The Federal Reserve continues to focus on inflation as about the only way out of the current economic malaise. By continuing to inflate the money supply, thus, providing liquidity to the markets, the hope is that the dollar will not fall out of bed and that the current foreign debt holdings and off-shore currency reserves won't be dumped.

According to Michael Pento in his December 2006 article "Economy and Dollar Balancing Act" (<http://www.safehaven.com/showarticle.cfm?id=6462>):

The Fed's mandate is to maintain dollar stability. However, they may have to decide in 2007 whether to rescue a falling currency by hiking rates or to lower rates in order to stave off a recession. Which posture they take will have major ramifications for the bond, stock market and the economy.

The Fed must appease foreign holders and prospective buyers of our treasuries by offering higher relative yields.

It is my contention that the Fed will attempt to keep the Fed Funds rate at 5.25% and talk about the dangers of a falling dollar and inflation. Concurrently, while ostensible appearing to be an inflation hawk, they will monetize newly issued treasury debt and flood the economy with new money. If successful, they may delay the dollar's ultimate fate and bolster the faltering economy.

During 2007, the Fed hopes to generate a "soft landing" in the economy and that the housing downturn abates. The Fed does not want to give up the inflation fight fearing deflation much more.

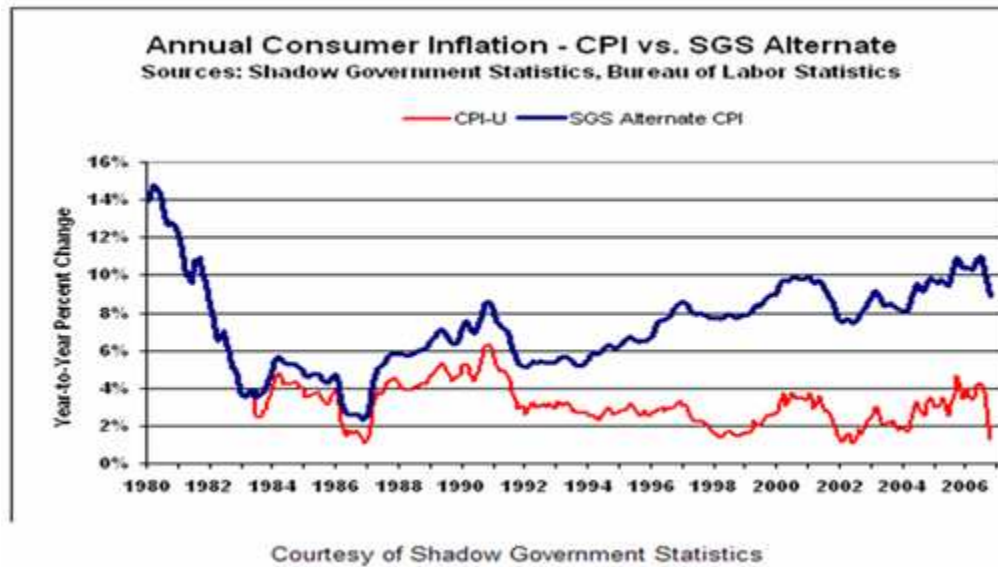
And then, we can look at the future costs for Homeland Security. Of course, no one can anticipate such costs nor the costs associated with replacing a city like New York or Los Angeles if a dirty bomb is exploded there.

Use any number you want for these costs, and clearly the unfunded liabilities are multiples of the U.S. GDP.

### **The Consumer Price Index**

The CPI has been changed 14 times since July 1996. In various publications, the consumer price index has seven different numbers based upon the Ministry of Truth's calculations. Hedonic and seasonal adjustments have some uses but over the past several years their continued use has only served to confuse the public. In most of my own work, we try to rely upon raw, non-seasonally adjusted data.

The following chart from Shadow Government Statistics shows the relationship between the government series and their own calculations of the CPI. Clearly, there is a significant difference in the two calculations.



The changes in the CPI have reduced by about 50% the average social security check over the past 20 years.

### **The Investment Outlook for 2007**

With the Democratic Party narrowly retaking control of Congress, any outlook for the coming year must look at the political landscape. I have therefore developed three possible scenarios that might happen in 2007.

The best scenario which I give about a 15% chance to contains the following elements:

- Congress & White House get along
- FED engineers “soft landing”
- Dollar does not weaken further
- Ten year Interest rates above 4.25%
- Trade & Federal Deficits decline further
- Middle East simmers but does not boil
- China & Japan don’t reduce US \$ holdings
- Commodity prices remain relatively stable to lower
- Stagflation does not appear
- Housing slowly improves w/ values down < 10%
- No terror attack on U.S. soil

Under the best scenario, the economy and markets may remain in a slightly downward trending range during the first half of 2007 and could rally towards new high ground in the 2<sup>nd</sup> half of the year.



The most likely scenario which I give about a 60% chance contains the following elements:

- Congress & White House stalemate
- 1st half weak, 2nd half about even
- Dollar continues slide down toward 70
- Ten year interest rate heads above 5%
- Trade deficit falls but Federal deficit higher
- Commodity prices increase < 10%
- Israel/Iran problem flares up
- Foreign US \$ holdings reduced slowly not dumped
- Housing stabilizes in 2nd half 2007 after <15%
- No terror attack on U.S. soil

Under the most likely scenarios, the economy and markets would move lower and undergo a correction of between 25 and 30% before recovering late in the year.

The pessimistic scenario is estimated to have about a 25% chance of occurring contains the following elements.

- President Bush impeached
- Recession becomes obvious
- Dollar slides below 60
- Ten year Treasury above 6.5%
- Both trade & Federal deficit balloon
- Commodity prices increase > 10%
- Limited nuclear/WMD war in Middle East
- Foreign dumping of US \$ holdings
- Housing bubble bursts w/value down > 30%
- Terrorist attack on U.S. soil

Under this scenario, the markets would initially slide downward until the impact of the scenario could be evaluated. The best place to hold assets in this scenario would be in hard assets and off-shore.

### **Negative Sectors to Watch**

Irrespective of which scenario is played out, there are some sectors which do not excite me with their positive prospects. These sectors are:

- Housing
  - Sub Prime Lenders
  - Housing Stocks
  - Furnishings

- Finance
  - Derivative exposure
  - Competitive devaluation
  - Lending spreads
  - Bond funds
- Mutual Funds
- Latin America/South America ETF's
- Mining is South African area
- Firms dependent upon Medicare

### **Sectors that have a Positive Bias**

- International
  - ETF's
  - Asset-based companies w/o political risk
- Technology
  - Medical devices
  - Geriatrics
  - Entertainment

### **Sectors that might be interesting**

- Transportation
  - Airlines
  - Railroads
  - Trucking
- GAZPROM
- MOAT companies for long-run

### **The Moat Theory**

Warren Buffet is credited with first advocating the "Moat Theory." Buffett looks for companies that have a "moat" that shields them from competition and allows them to earn high rates of return. The moat is something that creates high barriers to entry for would-be competition.

Examples of these companies include Coca-Cola, Proctor & Gamble, Union Pacific, etc. A strong brand name is one requirement of a moat company.

### **Wealth Management**

For many investors, their trading style and portfolios are dependent upon their occupation and age. Unless inherited, large wealth generally comes through the development of an entrepreneurial company either as a founder or key employee. Once achieved, a diversification of that wealth becomes important.

'Tis only my Opinion! Volume 27 – Number 1  
Outlook 2007 by Fred Richards - December 30, 2006

In many large holdings, the concept of having a few core positions or core holdings is common-place. Often these core positions contain elements of the original source of wealth, i.e, the Ford Foundation or the Carnegie Foundation.

A portion of the wealth is then placed in a stock trading portfolio where portfolio managers attempt to increase the funds.

Further diversification occurs as money is moved into real estate, collectibles and/or intangible assets.

With many wealthy individuals, the key to successful investing is to remember that the corpus can be passed on either to the heirs and/or a foundation but you can't take it with you.

### **Conclusion**

The key to a successful investment strategy in 2007 appears to be one of understanding both macro and micro trends. Each scenario discussed above will create different trading and investment opportunities. It is vital that investors monitor interest rate trends both within and outside the U.S., the movement of the U.S. dollar versus other currencies, and those market internals which might provide an early insight into the market's future trend.

Most of all, investors should not be afraid to be in or out of the equity and bond markets. Sometimes, sitting on the sidelines is the most profitable trade.

Remember, we all make mistakes. The key is to keep them small.

Finally, I admonish you to remember again in 2007, our motto:

KISS +SF! (Keep It Safe, Simple and Stay Focused!)

Fred Richards

December 30, 2006