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Financial Intelligence Report

The Global Resource to Protect and Grow Your Wealth

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In This Issue

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(Please remember to use lowercase letters.)

'The Most Serious Financial Crisis Ever'

By Christopher Ruddy

Recent financial news seemingly confirms **Financial Intelligence Report**'s world view that the global economic situation will get worse before it gets better. You've seen some of the headlines.

The chief of the Bank of England recently said that this period is the worst economic crisis since the Great Depression of the 1930s, and perhaps in history. In early October, after injecting more than $100 billion into Britain's banking system to keep it solvent, Sir Mervyn King, the governor of the bank, said the move was in reaction to the current crisis: "This is the most serious financial crisis we've seen at least since the 1930s, if not ever. We're having to deal with very unusual circumstances and to act calmly and do the right thing. The right thing at present is to create some more money to inject into the economy."

I'm not so sure that frightful assessment accurately reflects what consumers and investors actually believe today. What does King know and see that makes his comments so ominous?

King may have been reading *The Economist* magazine when he chimed in. The respected publication's Oct. 1 cover showed a swirling black storm vortex with just two words in the center: "Be Afraid."

While the problems faced by Britain, Europe, and the U.S. economy are systemic and deeply rooted, I have little doubt the continuance of the recession is related to President Barack Obama's leadership. The United States remains the global engine of the world economy, especially of the Western economies. So far, Obama has failed to create a consensus-driven mandate of economic leadership.

In fact, he has taken steps that will make the recession deeper and longer. Take, for example, Obama's $1 trillion-plus national healthcare plan. In the middle of this recession, Obama decided to add 40 million uninsured to the health insurance rolls. Who pays for this extravagance? Well, you and I do. We pay for it with a slew of new taxes, fees, and cost increases to our private insurance.

Recently, I interviewed former President Bill Clinton in New York to discuss the current economic crisis. Clinton told me it would be folly to raise taxes or cut spending at this stage of the economic cycle. "I personally don't believe we ought to be raising taxes or cutting spending until we get this economy off the ground," he said. "If we cut government spending, which I normally would be very inclined to do when the deficit's this big, with interest rates already near zero, you can't get the benefits out of it."

But this is exactly what is set to happen beginning in 2013. Under the Obamacare law, individuals making more than $200,000 a year (and couples making more than $250,000) will see capital gains, dividends, and other taxes increase by about 25 percent to pay for the massive influx of uninsured. This will have a devastating effect on the economy.

And don't forget that in late 2012, Obama signed a law that extended the Bush tax cuts for two more years. When those sunset, income rates and other taxes will rise dramatically in 2013. Dividend tax rates will rise again to ordinary income levels — with an additional surcharge of 3.8 percent for Obamacare added on top of that.

There should be no wonder that Obama's actions have scared the bejesus out of businesses, investors, and consumers — many of whom seem frozen about engaging in significant economic activity until the 2012 election is decided.

If a sensible Republican is elected, we may see a period of positive economic growth, but it also may be followed by a period of serious inflation, even hyperinflation.

One of the best books I've read recently to explain the current situation we face is titled *The Ten Trillion Dollar Gamble: The Coming Deficit Debacle and How to Invest Now* by Russ Koesterich. Koesterich is iShares chief investment strategist and global head of investment strategy for BlackRock Scientific Active Equities. The current financial situation he paints is one difficult to argue with.

Even more unnerving is that he unmasks how current government projections about future improvements in the economy, budget, and deficit are rosy at best. Koesterich says that over the next 10 years, federal budget estimates are based on an optimistic view of the economy, with the government projecting growth over the next several years at a rate of 4 percent. (It has only been growing on average about 2 percent over the past decade.) Worse, these same projections account for no recession or economic downturns during this same period.

This is like me predicting that you will have beautiful weather all summer and no rain! It's an impossibility, and made even worse by the fact these projections are being banked on by the government.

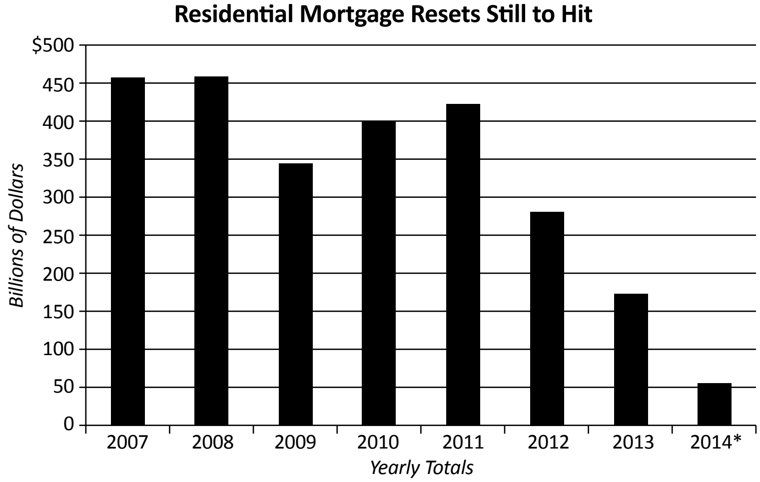
There are good reasons to see huge hiccups ahead and many "rainstorms." As Koesterich points out, the United States has $14 trillion worth of debt, which amounts to 90 percent of gross domestic product. He argues that because of this debt load, we will not see a repeat of the 1980s Reagan boom that followed the 1970s recessionary years. In 1985, long-term U.S. debt was only 45 percent of GDP, compared to 90 percent today. Also, in 1994, total U.S. nonfinancial debt was just $5 trillion. Today, it is a staggering $35 trillion.

Demographics are key to the puzzle: The average age today is 37 for Americans. Back in 1984, it was 30. This aging of the population is significant and will continue as the nation's largest demographic group in history — the 77 million baby boomers — all retire *en masse*. As FIR's Brain Trust has explained in the past several years, this fact is crucial to understanding the massive economic problems we will face over the next two decades.

To his credit, Koesterich tries to avoid hype and a "doom and gloom" feel. But it is clear he is worried about the dangers ahead and calls America's debt problem "an approaching train wreck." He makes a good argument that the U.S. financial condition is worse than Greece and some other Mediterranean countries that we've been collectively complaining about.

Koesterich writes: "When you compare the U.S. national debt (what we owe) to the U.S. government revenues, which will ultimately be used to repay those obligations, the United

Residential Mortgage Resets Still to Hit



Mortgage resets — the point in a mortgage, such as a five-year ARM loan, when the interest rate rises — have been significant in the last few years, and is a problem that threatens to fuel more foreclosure activity and keep the housing market depressed through at least 2013.

*thru September SOURCE: © Casey Research 2013

States looks far worse than just about any other developed country. Government debt is 165 percent of the revenue in Germany. It is 248 percent of the revenue in Ireland, one of the countries investors view as a significant risk. In Greece, the epicenter of the debt crisis, the debt is more than 300 percent of the revenue. In the United States, it is over 350 percent, more than double the ratio in Germany and even worse than Greece."

He also, like FIR, has been warning that in the long term, the U.S. economy faces "a very real possibility" of inflation, even hyperinflation.

Koesterich details several ways for investors to monitor the possibility of inflation. Of course, a primary way would be to watch financial money growth out of the Federal Reserve System. But that doesn't tell the whole story. The money supply has expanded dramatically, and we have not seen the same growth in inflation.

Koesterich says that key indicators of a possible inflation surge will be such things as job growth. If the economy suddenly resurges and job growth increases beyond recent averages, about a year later inflation will jump.

Another measure of inflation is factory utilization. Economists call this statistic "capacity utilization." Typically, American factories operate at 80 percent utilization. But during the recent recession, they dropped significantly below that and have been crawling back to about 75 percent. He argues that when utilization gets back to longtime averages of 80 percent, inflation may creep up a year or so after that, as well.

Koesterich predicts that the government will do what it typically does in these periods — increase taxes and cut spending. Government benefits will likely increase, adding to the load. The net effect will be a dramatic drag on the U.S. economy. Meanwhile, he thinks politicians will seek to "monetize" the debt, using inflated dollars to pay back fixed-debt costs.

For sure, he sees a "coming inflation shock," and he makes the argument that debtors will do better than investors during this period and that people who invest in fixed-income securities actually stand to lose a lot.

Protecting Against 'Inflation Shock'

Some of Koesterich's key approaches to investing:

• **Ladder income instruments.** He suggests using a method of laddering in which you don't lock all your funds into long-term fixed-income instruments, lest you get caught in an inflation wave and you see a devaluation of your money.

• **Invest globally.** Direct approximately two-thirds of your equity investments to countries other than the United States, Koesterich says. "And as an additional step, for the portion of your equity portfolio that remains in the United States, you'll want to favor companies and sectors that are focused on selling abroad rather than to U.S. consumers." FIR has been strongly advising investors to invest in blue chip stocks in solid economies. Like FIR, Koesterich likes Canada, Australia, Singapore, and other high-value small countries with well-developed economic structure and a better national balance sheet than those found in the U.S. or many European countries.

• **Target key sectors.** Koesterich suggests focusing on stocks in such areas as energy, healthcare, and technology industries and going underweight in volatile sectors such as financial, utility, and consumer discretionary companies. Consumer discretionary companies are defined as those that sell "nonessential goods and services to consumers." Restaurants and department stores are examples of this.

• **Hedge with commodities.** Another area Koesterich sees as an important investment opportunity is commodities, which he calls an inflation hedge. He believes investors should start with at least 10 percent of their portfolios in a diversified series of assets involving commodities, including gold. He notes that "commodities tend to be most closely tied to inflation."

• **Diversify bonds globally.** He also advises that if you have a portfolio of bonds, include international bonds so that your values will not be hit as interest rates rise and bond values fall.

• **Realize that stock markets will fall.** It's important to note that as bond rates increase, the stock market typically falls. This will be a major effect of the coming inflation wave. Koesterich writes: "Historically, each 0.10 percentage point increase in long-term yields typically leads to an average 0.30 percentage point decrease in the S&P 500. Even when market conditions are favorable and corporate profits are rising, the direction of interest rates usually makes a difference."

On the Lookout for False Positives

Koesterich's advice seems sensible. Still, there are countervailing forces that may spur economic growth in the short term, creating an illusion of prosperity.

It is important to remember that without budgetary authorization, there are several ways Obama can help stimulate the economy to create the impression things are improving, and he seems to be using these tricks.

For example, lowering interest rates typically can help put cash into the economy. But short-term Federal Reserve rates have been zero or almost zero for years now.

Interestingly, in the past few months, demand for long-term, 10-year Treasurys has increased dramatically, causing 10-year rates to fall from about 3.36 percent in the beginning of 2011 to less than 2 percent — a drop of more than 30 percent.

Considering that the Federal Reserve did not continue its quantitative easing program, which ended in June, and such purchases amounted to one-third of all Treasury bill purchases, it remains a mystery to me who has stepped up to buy these Treasury notes and in such force as to lower rates to historic territory.

This rate decline may have a significant effect on the economy in two ways. First, mortgage rates have dropped to historic lows. For the week ending Oct. 6, mortgage rates fell to 3.96 for a 30-year mortgage and 3.28 for a 15-year mortgage. Such low rates will clearly help the ailing housing sector, key to any economic recovery.

But, importantly, the low rates allow current mortgage holders to refinance their mortgages on better terms. This is another way to juice the economy during the election year. With a cheaper mortgage, many homeowners may be able to spend several hundred dollars a month they previously didn't have available.

Another way Obama can help inject cash into the economy: If commodity prices fall, it'll free up enormous amounts of consumer cash. Energy prices are key to this driver. Obama will benefit by the fact that oil prices have dropped by about 20 percent in the past few months.

Americans depend heavily on their cars, which demand gasoline. Lower the price of gas and the consumers have more cash to spend. Lower oil prices act like a global tax cut.

Typically, American presidents cannot lower commodity prices. But political pressures can help lower oil prices. In the 1980s, President Ronald Reagan encouraged allies like Saudi Arabia to dramatically increase oil production. Oil prices fell and the U.S. economy boomed.

There is clear evidence that Obama has done the same thing. In June, *The Wall Street Journal* reported that Obama sent a "secret" delegation of U.S. officials to Saudi Arabia and followed up with a personal call to the Saudi king. Ostensibly, the Saudi meetings were to have Saudi Arabia accept the U.S. decision to sell oil from its strategic oil reserves. But the fact is, soon after the high-level meetings, the Saudis increased oil production by 1.5 million barrels a day to a 12-million-per-day output.

Earlier this year, the Oil Price Information Service found Americans on average spend more than $4,400 a year on gasoline. A drop in oil prices of 20 percent, as we have seen, frees up close to $1,000 for the same consumer to spend on other items. This could have an enormous, positive effect on the economy.

But in my opinion, Obama has to push to drop gasoline to $2 a gallon to have an effect that would dramatically improve his re-election prospects. Watch oil prices as a key barometer to short-term economic performance and the president's job approval ratings.

Long-Term Repercussions of Short-Term Policymaking

Finally, there is the issue of unintended consequences. The Arab Spring uprisings that the Obama administration not only has embraced, but also pushed for, may offer us serious blowback.

With Tunisia, Egypt, and Libya changing regimes, it is unclear who will take over. Nevertheless, the Obama administration has Syria in its gun sights. Syria is not reacting nicely to Obama's desire for regime change, and it is already warning of missile attacks on Israel if NATO attempts to influence events there.

I recall at the opening of the financial crisis, Gen. Alexander Haig, the former secretary of state and FIR adviser, told me his real worry was not about the economic repercussions from the crisis but the political ones. He remarked that the unfolding events could lead to a major war. No one can predict how and where such things will break out, but America's global economic weakness also has weakened our national security. It's the unintended consequences we need to watch for now. ■

Beware: The Inflationary 'Tipping Point' Ready to Hit the U.S.

By Robert Wiedemer

In the pages of FIR, we have written at length about our firm belief that critically high inflation is coming to the U.S. Many have doubted us, pointing to indicators such as the Consumer Price Index — still at a modest 3.8 percent — and wondering what all the fuss is about.

It's true that 3.8 is not the sort of number that would indicate high inflation is just around the corner. However, does that mean it won't come?

Absolutely not.

Fundamentally, when the government expands the money supply much faster than the growth in our GDP, we will get inflation.

And that's exactly what the government has done. As shown by the chart on Page 6, we have increased our money supply by over 200 percent since 2008, whereas our GDP has barely grown at all since that time.

But, in any inflationary scenario, there is always a lag between when the money supply is increased and when it manifests itself in inflation. The key question for investors and economists is, how long is that lag and what exactly will it look like? Specifically, what is the tipping point between relatively low inflation and high inflation?

The Two-Year Lag

In a normal economic situation, the typical "lag" factor between increases in the money supply and inflation is around two years. This lag factor is fairly well accepted in the economics community. In fact, in a paper coauthored by current Federal Reserve chair Ben Bernanke in 1999, a survey of economists concluded that the normal lag factor between money supply increases and inflation is 18 to 24 months.

However, there are a number of factors that can increase that lag. ***They don't prevent the onset of inflation, but they can postpone it.***

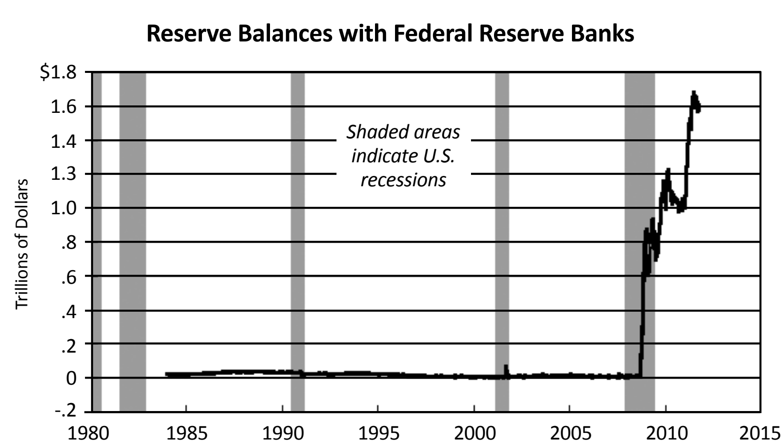
One such factor is banks holding a lot of the increase in the money supply in excess reserves. This is happening now. As we can see from the chart below, the amount of money held in excess reserves has skyrocketed.

These reserves are called "excess" because the Federal Reserve does not require banks to hold them to fund normal banking operations. (The requirement to hold funds exists because a bank can't be allowed to lend out all of its money, even though that would be more profitable, because it would be more vulnerable to a run.)

As borne out in the chart, in the past, banks have had no incentive to hold excess reserves because they damage their profits. Whether the economy was good or bad, banks simply didn't hold excess reserves.

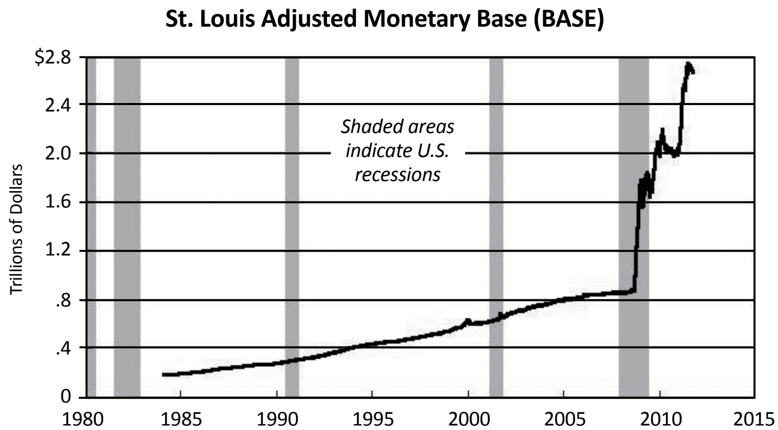
That suddenly changed in 2009. Why? Clearly, the Federal Reserve is putting pressure on the banks to hold excess reserves, now at historically unprecedented levels. In addition, it pays the banks 0.25 percent interest on their excess reserves, which encourages the action.

Also, it is important to point out that the money supply has increased by almost $2 trillion, whereas excess reserves are only $1.6 trillion, so a significant amount of that money has already slipped out. In fact, the amount that has been released is equivalent to almost 50 percent of our entire money supply in 2008. So, this is a factor that is postponing the onset of inflation but not preventing it.



Banks are hoarding cash, as the amount of money held in excess reserves has shot up dramatically of late. If and when this money starts leaking out, inflationary pressures will increase substantially.

SOURCE: 2011 research.stlouisfed.org



In a recipe for serious inflation, the U.S. has increased money supply by over 200 percent since 2008, whereas the nation's GDP has barely grown at all over that span.

SOURCE: 2011 research.stlouisfed.org

Inflation: A Monetary Phenomenon

Another factor to consider is a slow economy could dampen inflation. In a slow economy, it's hard to raise prices. That makes sense. However, massive increases in the money supply will overcome that, meaning it may cause a lag but it will not ultimately prevent inflation.

Think about it: Zimbabwe has a very slow economy, for instance, but a very high rate of inflation. In fact, the last time the U.S. economy had high inflation was when it had a very slow economy in the late 1970s and early 1980s. This was called stagflation. But, in reality, most inflation does occur in a stagflation scenario. That's because when the economy is heading down, governments lose tax revenues and at the same time often have rising expenses. Hence, they resort to the printing press to fund the money they need.

If the economy is slow and the government prints money, you will have inflation. But, if the economy is slow and the government does not print money, you will have deflation. Inflation is not controlled by the growth of the economy, but by the growth of the money supply. This is a key aspect of inflation. As Milton Friedman, the Nobel Prize-winning economist and monetary policy expert said, "Inflation is always and everywhere a monetary phenomenon."

De-leveraging is also talked about as a reason we won't get inflation. However, leverage is not what causes inflation — once again, increases in the money supply cause inflation. Did we get massive inflation when we up-leveraged over the past decade? No. Hence, we won't get massive deflation if we de-leverage. And, the actual amount of de-leveraging has not been that great so far. We are not up-leveraging like we used to, but we are not de-leveraging to that great an extent either. (For more information on inflation, please see Chapter 3 of my book, *Aftershock*, which provides a more detailed explanation of the workings of inflation and the many reasons people don't think it'll happen.)

Inflation on the Rise

In the great debate over inflation, it's important to point out that although we don't have high inflation yet, we do have much higher inflation. Inflation has increased dramatically over the past couple of years from an annualized CPI of 1 percent in late 2008 to an annualized rate of 3.8 percent today. Although that is not massive inflation (yet), that does represent a massive increase in inflation. And, that increase in inflation came during a slow economy — the Great Recession, as many people have called it.

Also, it is notable that the calculation of the CPI was changed under previous Fed Chairman Alan Greenspan to reduce its rate of growth. In fact, according to Shadow Stats, the CPI today, if calculated as it was by the Federal Reserve in 1990, would be 7.1 percent.

We all feel that higher rate of inflation in our pocketbook. Who isn't seeing the effects of inflation in their food, energy, healthcare, and education costs? However, the government, the financial markets and

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the financial press are driven by the CPI, not by the rate of inflation we feel in our pocketbooks. Hence, it is easier to argue that inflation is not a concern. A misleading calculation of inflation is another way of postponing the onset of inflation, but we all realize it can't prevent it. That's because in the long run, inflation will get high enough that even misleading statistics will show high inflation.

It's also worth noting that other countries that have resorted to using the printing press to boost their economies are seeing much higher inflation now. One of the biggest money printers, China, is the most notable example, with an official inflation rate of 6.5 percent, although the real inflation rate is much higher than that. Another big money printer, Britain, has also crossed the 5 percent inflation threshold.

The Key 'Tipping Points'

The first real tipping point is 5 percent to 8 percent. Less than 5 percent inflation can be almost completely ignored by the financial community. However, as it crosses 5 percent, inflation perceptions begin to change. A number of people in the investment community will begin to worry. It'll cause increasing unease in the financial markets, especially as it approaches 8 percent. Gold will begin to rise more steadily.

Most importantly, the Fed will have to be more careful about increasing the money supply just to support the stock market or boost the economy a little. It is likely that we will have crossed 5 percent inflation by the end of 2012.

However, at this level, many people will not be worried. Plenty will even contend that 5 percent inflation is a positive. Already, some are touting it as a way of dealing with our massive government debt.

Economic cheerleaders will have a relatively easy time of denying that inflation is a problem. Inflation will not affect interest rates too much at that stage, and the Federal Reserve can print money to keep interest rates low.

The bottom line is at this stage, only a minority will see a problem, but the fact that a minority of the investment community is starting to see a problem is a real tipping point.

The second real tipping point is 10 percent. At 10 percent, everything changes. The cheerleaders will no longer be able to deny that inflation is a problem. Conventional wisdom will reflect much greater fears over inflation. There may even be calls for wage and price controls. Fairly rapidly, the real estate, bond and stock markets will become destabilized. None of these markets anticipated any significant inflation, and they will be quite shocked that it is happening. A small-scale panic will begin.

Normally, the financial community would look to the Federal Reserve to bail them out of their increasing numbers of bad loans, falling stock market and collapsing bond markets. But, increasingly, the Fed will be seen as the problem, not the savior. The one financial problem the Fed can't solve by printing money is inflation.

The Fed currently would assume that it could pull the printed money out of the system at that point. They would also assume that the naturally rebounding economy and years of strong economic growth would allow them to pull the money out without hurting the economy.

But, this is where Fed leaders are making a fundamental mistake. They do not believe we have a bubble economy. Bernanke and his cohorts believe we are simply in a down cycle that we are guaranteed to pull out of.

The problem for the Fed is that we are indeed mired in a bubble economy. Not just one bubble, but multiple interacting bubbles (housing, consumer spending, private credit, and the stock market). When these bubbles pop, they don't automatically re-inflate. So, instead of providing stimulus to get us through a down cycle, the huge money printing operations of the Fed, which have helped support the massive borrowing operations of Congress, are simply keeping the bubbles pumped up. They are actually creating the biggest and worst bubbles of all — the government debt and dollar bubble.

10 Percent Is Only the Beginning

Because we are not simply in a down cycle, the Fed will find that there is no good time to pull money out of the system. It certainly won't be when the economy hits 5 percent inflation. And, it most definitely will not be when we hit 10 percent inflation. In fact, that's when the Fed will be forced to print *more* money.

Right now, money printing is discretionary. It is being used to boost the stock market and to prop up otherwise slow economic growth. But as the panic of 10 percent inflation starts to melt down the financial markets, the real money printing will kick in. Not because the Fed wants to, but because they have to.

At that point the Fed will have to print money to provide the liquidity necessary to keep the financial markets from freezing up. It will also need to print money to offset the steep drop in capital inflows from foreign investors due to the chaos in our financial markets. When that inflow becomes an outflow, the Fed will have to print even more greenbacks.

Unemployment will be rising very rapidly at that point. The Federal Reserve will be under enormous pressure to boost the economy with more printed money. But printing money in only the amounts of the QE1 and QE2 programs won't work anymore. They will need to print much more to have an impact on an economy where the unemployment rate will begin to approach 15 percent and higher.

Needless to say, the federal government's deficit will be expanding enormously, which will force the Fed to support massive borrowing with massive printing. Otherwise, the government won't be able to borrow the money it desperately needs to offset rapidly declining taxes and soaring social expenditures.

The other problem facing the economy when this happens is that inflation expectations will have changed dramatically. The lag factors discussed at the beginning of this article will be much less important. The lag between increases in the money supply and inflation will shrink dramatically. This will have the effect of accelerating inflation.

Once inflation starts, history shows that it is hard to control and tends to accelerate more rapidly over time. Hence, the real problem from inflation will come not just from what we are printing now, but from what we will be printing in the future.

Although this may sound very dramatic, it is a rather typical inflationary spiral that many countries have gone through in the last century. The big difference is that it is happening to the U.S., where it has never occurred before because we have never done what other countries have done. That's why financial markets have so much faith in us right now.

But, the United States has changed. We are now doing what other countries have done in the past and hence we will encounter similar problems without easy solutions.

It's not that we will collapse as a nation. In fact, I think we will come through this much stronger and better than before. That's also not too different from other countries. Think of Germany or Brazil, which have gone through inflationary spirals and come out of them even stronger. We will too. But, our sterling reputation for financial management will have been damaged. Our financial markets will also change dramatically. And we will have learned an important lesson. It won't be fun; lots of people will be financially hurt and be very angry.

But, inflation tends to hurt those most who prepare for it the least. There are many ways to protect against inflation, as we have discussed many times in FIR and will continue to in the future. Just remember, the most important step in shielding yourself against inflation is recognizing that it can happen. To that end, we will continue to keep vigilant watch for those critical tipping points, and keep you apprised of what to do next. ■

Special Report: Does Japan Offer Opportunities for Profitable Investment?

By David Skarica

Nippon — the country most know as Japan — literally translates to "the sun's origin." Indeed, Japan has been long known as the "Land of the Rising Sun."

But over the past few decades, there is sentiment that the sun has been setting on the once-great nation. Some think it has already set.

Japan has indeed been mired in a 20-year economic rut after a real estate bubble burst there in the late 1980s, leading to the so-called "Lost Decade" of 1991 to 2000 that has, in fact, continued onward to present day. And then in March, the country was decimated by a magnitude 9.0 earthquake, which generated a devastating tsunami and caused a nuclear meltdown at the Fukushima Daiichi plant.

Because Japan has struggled for such a long time, people tend to forget its incredible past — how it recovered from World War II, gradually growing into a historically unrivaled economic miracle. In a tale of Japan's future prospects, it is essential to look back at the country's boom, bust, and how it came to where it is today.

After the War

Japan was devastated after World War II, in no small part because of the nuclear bombing of Hiroshima and Nagasaki, a horrific event soon followed by an end to wartime hostilities.

However, on top of that, the country possessed an old feudal-type system, in which a handful of owners and the government controlled most of the farmland. That was about to change.

Between 1947 and 1949, about 5,800,000 acres (38 percent of Japan's cultivated land) were purchased from the landlords under the government's reform program and resold at extremely low prices (after inflation) to the farmers who worked them.

By 1950, 3 million peasants had acquired land, dismantling a power structure that the landlords had long dominated. At long last, after years of servitude, Japanese people had property rights and a way to create wealth through land ownership.

This new prosperity created opportunities for families to send their children to top-tier schools, which in turn transformed Japan into an educated, progressive society.

Japan began industrializing itself in the 1950s and '60s. The country initially became a producer of lower-end goods — much like China today, Japan was viewed as making junky, cheap products and was not taken seriously. However, by the late '60s, Japanese cars and higher-end electronic goods began to roll out around the world.

The '70s, which saw stagflation in the Western world, was a period of prosperity in Japan. My mentor, investing legend John Templeton, made one of his first great long-term investments by investing in Japan in the early '60s and then selling out in the early '80s. The Nikkei Index soared from about 1,000 to more than 8,000 during that time.

In the 1980s, many financial pundits thought that Japan's fortunes would continue to accelerate and expand, and that it would even eventually overtake the U.S. economy. After all, the argument went, Japan possessed superior export products, along with a soaring stock and real estate market.

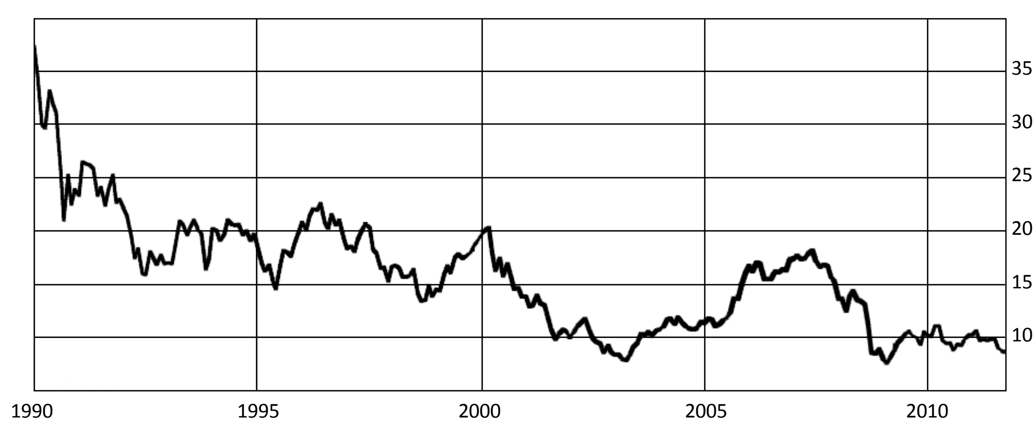
Unreal Estate

What the world didn't see at that point was the dangerous fact that Japanese prosperity was built on a shaky foundation of loose credit and a hyperinflated property market.

In the '80s, the Nikkei rose from about 6,000 to an all-time high on Dec. 29, 1989, of 38,957.44. But unlike the boom of the '60s and '70s, this expansion was not real — it was an unsustainable bubble. At the top of the market, it was estimated that blocks of real estate in Tokyo were worth as much as the state of California, a ridiculous state of affairs.

When the market did implode, the nation's leaders did not let the market cleanse itself. Leaders instead enacted policies to keep its failing banks afloat, allowing them to earn the apt moniker "zombie banks" because essentially they were dead (their economic net worth was less than

Nikkei 1990 – 2011



The all-time high of Japan's Nikkei Index was 38,957.44, a top reached on Dec. 29, 1989. From that point, the economic fall and stagnation of this world power has been well chronicled. Japan's "Lost Decade" has in fact stretched well beyond 10 years, and is still ongoing today, with the Nikkei's sub-10,000 levels just one of many visible symptoms.

SOURCE: 2011 Yahoo! Inc.

zero) but for the government propping them up. The government printed money, created public-works projects, and spent money they did not have, ballooning the debt.

Japanese demographics also were shifting for the worse, economically speaking. An aging population with strict immigration laws combined to stifle growth of the working-age class.

At this point, you may be expecting me to draw the parallels between Japan's experience over the past three decades and the plight of America and Europe today. It all sounds familiar, after all — the real estate bubble, the zombie banks, the skyrocketing government debt burden, et al.

Truly, there are interesting comparisons to be made. But that is nothing more than a history lesson, and a limited one at that, as the crises of Japan in the '90s and the United States of today diverge in important respects that make each a unique paradigm.

What's more important to those of us seeking out returns in a world in which high yields are hard to come by for the individual investor is this: Is Japan a viable investing opportunity?

The Case for Nippon

About 22 years after the Nikkei peak — as of this writing, it stands at about 8,600 — there are signs the economy has finally been cleansed of the excesses that led to the Lost Decades.

Legitimate concerns are often expressed about Japan's government debt, which stands at more than 180 percent of its gross domestic product. That's unsustainable and an unnecessary weight on the economy as a whole, to be sure.

What is not as well-publicized, however, is Japan's low levels of private debt, and it's a telling statistic indeed.

Private debt, as a percentage GDP, peaked in 1997 at more than 250 percent. It's now only 113 percent. This level is the lowest in the postwar period. (By the way, for comparison's sake, the U.S. private debt figure is more than 250 percent.)

What do those statistics tell us? The Japanese have deleveraged.

In addition, as mentioned, the Japanese stock market has gone nowhere for 20 years. Looking at long-term trends and data reveals that stock markets tend to trade in mega-bull and mega-bear market cycles that last 15 to 20 years.

Based on that, Japan should be nearing the end of its bear market cycle.

In addition, Japan is still a top-tier exporter. Despite the fact that the yen has risen more than 400 percent against the dollar over the past 40 years — in 1970 it took 400 yen to buy the dollar, while it now only takes 80 — Japan still exports twice as much to the United States as the United States does to Japan.

We all see Honda, Mitsubishi, and Toyota cars on the roads. Sony and Panasonic are ever-present brands among electronics technology. In addition, the banks are among the strongest in the world. They have nearly 20 years of deleveraging behind them to rebuild their balance sheets. Think about it: You haven't heard anything about Japanese banks during the financial crisis.

Reeling In the Yen

However, despite still making high-end products and cleansing the banking system, Japan is still in a rut, with the Nikkei languishing nearly 80 percent below its 1989 high.

Why is this? And how can it be changed? I think the answers lie in two main areas, the yen and the country's demographics situation getting a much-needed boost:

1. The Japanese yen is very high and is hurting exports. It makes items like Sony televisions and Toyota cars expensive. Japan has not been as aggressive in devaluing the yen as the United States has been in savaging the dollar.

David Skarica is a sought-after speaker for investment seminars and conferences throughout the United States and Canada and an expert on the gold and commodities markets. At 18, Skarica became one of the youngest people on record to pass the Canadian Securities course. At 19, he became a financial adviser and today authors the newsletter Gold Stock Adviser for Newsmax. In November 2010 Skarica's book, *The Great Super Cycle: Profit from the Coming Inflation Tidal Wave and Dollar Devaluation*, was released. It delves into the ramifications of the world's debt bubble and how investors can protect themselves and profit.

However, I expect that the yen is near topping. With the government having such deep debt problems, at some point, that debt dynamic will negatively affect the yen and this will, in turn, help Japanese exporters.

2. As I stated earlier, Japan is an aging country. The median age in Japan is nearly 45. By comparison, India, an up-and-coming economic powerhouse, has a median age of 25. Japan must open up its immigration policies.

However, I think Japan is about to "luck out" in this department in one respect. As the rest of Asia becomes more affluent, Japan will export to these nations. Therefore, the more favorable demographics across Asia may essentially act as Japan's young consumers.

Trading Japan

Although it's important to note that the FIR Brain Trust is not officially moving to add any of the following positions to the FIR Portfolio, as an individual investor, if Japan is intriguing to you, I would recommend playing it in three ways:

• **Japanese Exporters:** Japanese exporting companies are very cheap. This group includes top-tier export-orientated companies like Honda (HMC), Toyota (TM), and on the consumer electronics side, Panasonic (PC) and Sony (SNE).

Panasonic and Sony trade at price-to-book ratios of 0.60. Panasonic possesses a price-to-earnings growth ratio of 0.51 (anything less than 1.0 is considered undervalued). Honda and Toyota trade at less than half of sales. With the continued economic growth of Asia and with the coming devaluation of the yen, you will see the sales of these companies skyrocket.

• **Japanese Small Caps:** Small caps are even cheaper in Japan than in North America. They have been ignored because of a stagnant market and economy. Many small caps trade at single digit P/E's despite recent solid growth. The Japanese Smaller Capitalization Fund trades at a shockingly minimal P/E of 5. It also yields more than 1 percent. I recommend this as a great, inexpensive way to play the Japan market.

• **Japanese Banks:** Looking back 15 to 20 years ago, Japanese banks were where American banks are today. But Japanese banks have now had 15 years in which to rebuild their balance sheets. They have become solid companies with ample cash reserves and offer high dividends.

For instance, Mitsubishi Financial Group (MTU) trades at a P/E of 5 and yields more than 2 percent on the dividend side. Mizuho Financial (MFG) yields more than 9 percent.

In addition, the demand for construction rebuilding from the recent earthquake damage should help these banks; they'll get a lot of legitimate loan requests in order to rebuild devastated areas.

A Rising or Setting Sun?

Japan was once heralded as the next superpower. Then the country tumbled into an economic malaise because of the bursting of a huge credit bubble. Exacerbating the economic problems was the government's unwillingness to let the post-bubble mess cleanse itself.

Put it all together and Japan slipped into years of zero growth and economic underperformance. (Disturbing for Americans, all this sounds a little too familiar in present day.)

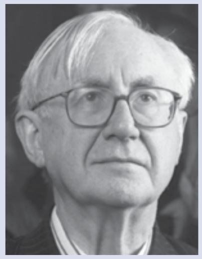
What Japan still possesses, however, is a hardworking populace and some of the most respected and well-run companies in the world. I expect that the combination of (1) construction rebuilding because of the devastating earthquake and tsunami, (2) a devaluation of the yen, and (3) the continued long-term boom in Asia will stimulate demand for goods produced by Japanese companies.

Finally, after 20 years of running to stand still, Japanese equities are dirt cheap. There has been a huge valuation contraction.

In addition, no one is bullish on Japan. Being the ultimate contrarian, I love to see such negative sentiment toward a country or investment class because that usually marks the bottom.

Take note, though, that an investment in Japan is not a short-term play; the positive developments that buoy asset prices could take years to unfold. It reminds me a lot of U.S. equities in the early '80s or gold in the late '90s. These were assets that had done nothing for a long time, but after years of bottoming, both of these investments shot up.

You want to buy stocks at the point of maximum pessimism, as Templeton famously advised. Japan looks like it has finally arrived at that point, indicating that investors could be well-served to add Japanese equities to their portfolio to profit in the coming years. ■



Sovereign Value by Lord William Rees-Mogg

Fear's Afoot, but the End of the European Union Is Not Upon Us

Next year will be an election year in the United States. According to folk wisdom, that will mean that the U.S. economy will be given lots of artificial stimulants to make the electorate think that the Obama administration is overcoming the difficulties of the U.S. economy.

The rest of the world hopes to benefit from the U.S. economic expansion, and there may be a sufficient recovery to encourage trade on global basis, if not to win the election for Obama.

There are, however, weaknesses in this forecast, of which the European economies' poor performance is the most serious. One difficulty is that Germany, as a major world economic power, unfortunately is in a position of being the credit base of the eurozone. Far from rising to that challenge, Germany has so far rejected it.

A German court ruling has created a serious obstacle to the issuance of eurobonds.

All the evidence of recent elections has been discouraging for the Christian Democrats; their popularity has waned because the electorate is not willing to pay the price of bailing out weaker eurozone countries. German voters do indeed have a reasonable case. It was a mistake to abandon the magnificently authoritative Deutsche Mark of the post-war years and replace it with the weaker euro. The DMark's advantage over the euro was obvious even when the decision to launch the euro was made: It depended on the creditworthiness of one major national economy. The euro depends on several different European economies, including many with a long record of economic problems like Greece, Ireland, Portugal, Spain and now Italy; most of them had to devalue repeatedly in the post-war period.

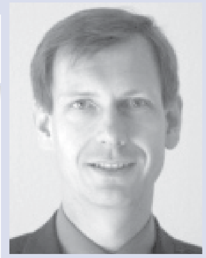
There was, nevertheless, good reason for thinking that Germany would come to the aid of eurozone economies in the euro system in danger of default. The euro itself is part of Germany's European policy; without German support, the euro wouldn't exist. Self-interest might have persuaded the Germans that it'd be cheaper to bail out a single small European economy than to risk losing the whole euro system. Most commentators have thought that Germany would come to agree on a permanent support system for weak eurozone economies.

Two factors have blocked that. The first was the German electorate's resentment at having to bail out poorly managed eurozone countries. The second was a decision of the German Constitutional Court which could make it unconstitutional for the German government to enter into any arrangement which imposes a permanent liability on Germany. This has been interpreted as being a prohibition on the issue of eurobonds, which had seemed to be the natural way to back up the weaker European countries. There is still some doubt about the precise definition of the court's judgment, but it has certainly created a serious obstacle.

As for a general failure of the euro, my own view is that it'll probably not happen. The eurozone may well lose Greece, and might also lose Portugal or Ireland, but the European governments and central banks would fight very hard to avoid the general crisis that would result from a larger economic power withdrawing.

The big five of Europe are Germany, France, Italy, Britain (which has never joined the euro), and Spain. Looking at possible euro withdrawals among those, Italy is the only one with any plausibility. None of them is as vulnerable as Greece. Europe is in bad trouble, but this is not the end of the European Union. ■

Lord William Rees-Mogg is the coauthor of the best-selling financial books *The Great Reckoning* and *Blood in the Streets*. He is the former editor of *The Times of London* and an adviser to some of the wealthiest investors in the world.



Forex Insight by Axel Merk

Fed's 'Operation Twist' Clears The Way for More Money Printing

The U.S. Federal Reserve System's "Operation Twist" may have been officially announced Sept. 21, but looking at the Fed's balance-sheet holdings, it doesn't take an economist to see that the Fed had already been "twisting" its holdings of Treasury securities. Operation Twist really is nothing new, but an extension and expansion of policies in place since 2008.

Indeed, Fed Chairman Ben Bernanke has a playbook, hiding in plain sight. In the 2002 speech that earned him the nickname "Helicopter Ben," Bernanke laid out his plan when faced with the threat of deflation. Whereas his predecessor Paul Volcker took years to convince the markets that the Fed was serious about fighting inflation, Bernanke appears to be relentless in trying to convince the markets that deflation is not going to happen in his backyard. But why not simply print more money as the economy has slowed — in other words, engage in "QE3"?

It looks like Bernanke at least wants to maintain the appearance of keeping long-term inflation expectations low. Earlier this year, he complained a few times that the risk-reward ratio of another round of easing is not all that clear. He looks to make it clearer by first crushing the short end of the yield curve by committing to low interest rates until mid-2013, then lowering long-term interest rates by selling the Fed's short-term securities and reinvesting the proceeds in long-term securities.

Add to that overall gloomy economic data, and conditions may be ripe for inflation expectations — as priced into the bond price differential — to drop.

Sure enough, that is exactly what has been playing out. Inflation expectations over a nine-year period, beginning one year from today, show recent communication and action by the Fed may have contributed to an environment closer to what Bernanke would like to see. With inflation expectations low, Bernanke is back in familiar territory, able to print more money.

A reason why the Fed first needed to set the stage is because the Federal Open Market Committee has a couple of outspoken hawks not afraid to voice their dissent. (Incidentally, only one hawk will remain in 2012, probably standing little chance against a flight of doves.)

While the markets have been disappointed, when push comes to shove, Bernanke has stuck to his playbook. He has paved the way for QE3.

I've argued that investors may want to actively manage their U.S. dollar risk. You indeed may want to position your portfolio to take the risk into account that Bernanke will do exactly what he has said. ■

Recent communications issued (and actions taken) by the Federal Reserve may have contributed to an environment closer to where Bernanke would like to see — lowered expectations of inflation to pave the way for more quantitative easing.

SOURCES: Bloomberg (Data), © 2011 Merk Investments, LLC

Global Investor by Hans Parisis

Will Stock-Market Optimism Give Way to Grim Economic Realities?

Despite a moment of "desperate optimism" in the markets as we go to press with this issue of **Financial Intelligence Report**, to me, the eurozone member countries are still far from getting their act together in a serious, honestly united, transparent, doable, trustworthy and therefore sustainable way.

Until that happens, if it happens at all, the eurozone solvency and liquidity crisis will continue to damage the rest of the financial world and remain a menace to global growth that could at any moment push the United States — as well as most of the economically important economies — into recession once again. Investors should keep in mind that there simply isn't a quick solution to this crisis.

"The crisis is systemic and must be tackled decisively," Trichet warns.

The cause is simple: With hindsight, we must admit the euro project started on the wrong foot by aspiring for quantity, not quality, and worst of all, neither respected nor applied its own created "Maastricht Treaty" rules.

On Oct. 11 in Brussels, Jean-Claude Trichet, speaking as chair of the European Systemic Risk Board, said the world faces a crisis of sovereign risk. "Over the past three weeks, the situation has continued to be very demanding," Trichet said. "The crisis is systemic and must be tackled decisively . . . we are the epicenter, but it's a challenge for all sovereign signatures."

In this context, it's enlightening to look at the latest composite leading indicators, released by the Organization for Economic Co-operation and Development, which to point to a further slowdown in economic activity in most OECD countries and major nonmember economies. The CLI for the OECD area fell 0.5 point in August, the fifth consecutive monthly decline.

The CLI for the United States was down to 102.2 from 102.8, Germany dropped to 101.9 from 102.9, the United Kingdom fell to 100.4 from 100.9, and Russia was down to 103.0 from 103.4. They all point more strongly to a slowdown than in the month before, but were still above 100, indicating that economic activity remains above its long-term trend.

For all other major economies, except Japan (which has remained at 104 since May), the CLIs are below 100, pointing strongly to a slowdown in economic activity below the long-term trend. (Brazil dropped to 95 from 96.6, India was at 95.7 from 96.5, and Italy fell to 99.6 from 100.3, to name a few.) The CLIs for the major five countries of Asia were down to 100.2 from 100.4.

Finally, it's also worth noting the comments of Oman's central bank president, Hamood Sangour al-Zadjali, about U.S. Treasurys on Oct. 10 at the World Economic Forum's Summit on the Global Agenda 2011 in Abu Dhabi. He said Oman will keep investing in U.S. Treasurys and the central bank also has instructed local banks not to expose themselves to "toxic" European debt. "We are still keeping our investment in U.S. Treasurys," Sangour al-Zadjali said, "because no one else is pulling out their investments."

Looking at the entire landscape of the global economy, I can't find indications of a general economical expansion somewhere on the horizon. On the contrary, we are teetering on the brink of a global contraction and continue moving in that wrong direction. I also expect credit downgrades in Europe to continue. In this light, it's my opinion that investors can't err by taking this environment into account when considering new investments. The time for taking risks is still not upon us. ■

Economist Hans Parisis spent three decades in the European banking industry. He's now based in Panama City, Panama, where he runs a global investment consulting business.

In Brief

Former Reagan Adviser: Real Shock to U.S. Confidence Still to Come

Former Reagan adviser and Clinton-era Fed official Lawrence Lindsey believes the real shock to American consumer confidence could still be ahead, a dire warning for the economy if proven true.

Recent U.S. spending data show that we seem to be unfazed by the discussions in Washington about the state of federal debt, Lindsey writes in *The Weekly Standard*.

While personal incomes have been steadily falling, so has the household savings rate, Lindsey points out.

"The data suggest that households have responded to their troubles so far by digging deeper into savings to maintain their spending levels," Lindsey writes. "This would actually be a good sign if household incomes were not still dropping. But an economy cannot sustain itself with ever-dropping saving rates in the face of dropping incomes."

Declining income will in time result in a higher, not lower, savings rate and potentially a "real shock to confidence," Lindsey contends. "It will be another reminder that confidence follows cash flow, not the other way around."

CEOs might be ahead of consumers in terms of what's coming next. The latest report from The Conference Board on chief executive confidence stands at 42, down sharply from 55 in the second quarter. The board notes that a result below 50 reflects a negative outlook.

"CEO confidence has declined substantially in the last two quarters and is now at its lowest level in over two years," Conference Board Consumer Research Center Director Lynn Franco said in a statement. "Clearly, this prolonged period of slow growth is taking a toll on confidence, and expectations are that these lackluster conditions will persist through early 2012."

Economist: U.S. Entering Modern-Day Depression

The U.S. economy is sliding into the depths of a depression, or at least a modern-day version of one, says David Rosenberg, senior economist and strategist at Gluskin Sheff in Toronto.

Officially, the United States has brushed off the recession — defined as two consecutive quarters of economic contraction — but remains sluggish and immune to policy responses.

Yet with unemployment rates hovering at 9 percent or higher and one crisis after another threatening to shatter a fragile economy, the economy is clearly experiencing something worse than a typical recession, which often sees a strong bounce back upon conclusion.

"Here we are today, with a severe recession (2007-09) followed by the weakest recovery on record and now on the precipice of another economic downturn," Rosenberg writes in an analysis, CNBC reports. "This is a modern-day depression, not entirely dissimilar to Japan's post-bubble experience of the past two decades."

The government has rolled out $800 billion in stimulus measures, while the central bank has slashed interest rates and bought trillions of dollars in assets from banks to pump money into the financial system.

Recovery, meanwhile, has been anything but acceptable to policymakers. "Simply put, an economic depression occurs only once it becomes painfully obvious that the markets and the economy are failing to respond to repeated bouts of policy stimulus," Rosenberg explains.

The word depression can conjure up images of the soup lines and grim, dusty faces in the 1930s, although CEOs say seeing scenarios that dire on a mass basis is not likely. "Recovery is under way, but it's a long, slow recovery, slower than we'd like," says General Electric CEO Jeff Immelt, as reported by Reuters.

FedEx founder Fred Smith agrees: Things are bad, but the country's not falling off a cliff. "We don't see a contraction; we don't see a recession," Smith says. "It's steady-as-you-go, slow growth."

Pimco's Gross: Job Gains Won't Stoke Growth

The United States added 103,000 net new jobs in September, which exceeded expectations but isn't nearly enough to fuel more meaningful economic growth, says Bill Gross, founder of Pimco, the world's largest bond fund.

The economy needs to add 200,000 to 250,000 new jobs per month for a while if the United States is to return to pre-recession levels of activity, Gross tells Bloomberg. "This report screams 'decent'; it doesn't scream 'pretty good,'" Gross says.

Don't look to Republican or Democratic leadership for meaningful policy, either.

"I don't think Barack Obama has been very good for the economy, and I don't think Mitt Romney would be, either; neither camp recognized the problem in terms of job creation," Gross says. "We need to, yes, to have currency revaluations, which the Republicans are opposing. We need in some cases penalties, tariffs where applicable. We need a buy-American, produce-America type of policy in order to create jobs."

Many analysts had been expecting the U.S. to add 60,000 jobs in September, which would have been an improvement from the zero jobs added in August. However, the unemployment rate remained at 9.1 percent, well above pre-recession levels.

"The September performance is more of a dead cat bounce than real progress," Peter Morici, economist at the University of Maryland, said to CNBC. "Jobs creation will remain inadequate to keep unemployment from falling in the months ahead, especially considering the mass layoffs recently announced in banking and pharmaceuticals that will be effected in the months ahead."

Schiff: U.S. Dollar Is a Disaster, So Look to Buy Gold

The continuing buildup of U.S. government debt will devalue the dollar, and the best alternative is gold, says Peter Schiff, CEO of Euro Pacific Capital.

That was a contrarian view when Schiff said it in early October, given the euro's 8 percent decline against the dollar to that point since Aug. 29 and gold's 14 percent drop since Aug. 22. But Schiff told Yahoo, "The best thing to have is gold. Gold is real money. Everything else is merely a substitute."

Selecting a currency to invest in now amounts to choosing the lesser of evils, he says. "But if you're going to be in a currency," Schiff says, "there are a lot of fiat currencies out there that I think are a lot less flawed than the dollar. The dollar has been the Titanic." Even the euro looks better, he says.

That's because Europe is now facing up to its fiscal crisis, while the U.S. just keeps on building up debt, led by the Federal Reserve, he says. "People are writing obituaries for the euro. It's premature," Schiff says. His favorite currencies are the Australian dollar, the Canadian dollar, the Swiss franc, the Norwegian krone, and the Singapore dollar.

Many experts say Europe will have to do more to solve its debt crisis before the euro rebounds. "We just need to know that there's a bold policy response that European policymakers are willing to take to avert a meltdown," Mark McCormick, a currency strategist at Brown Brothers Harriman, told Bloomberg.

Bogle: Investor Speculation Has Turned 'Ridiculous'

Stock speculation has reached a "ridiculous point," making it harder for traditional investors to gauge value, says Jack Bogle, founder of the Vanguard funds and a value investing legend.

"The most actively traded stock today, every day, is the SPDR, the Standard and Poor's 500 exchanged traded fund," Bogle tells Morningstar in an interview. "And it turns over at about 10,000 percent a year. Ten thousand percent a year, and I think 25 percent is a high turnover!"

A well-run financial system should direct capital toward the best moneymaking endeavors, Bogle explains. Investors use the market to allocate capital to the productive sector that needs capital.

What's happening now, however, is more about shifting money back and forth among the same players than finding and rewarding the better companies, Bogle says.

"In a typical year, our financial system has directed $200 billion a year into new public offerings and additional offerings of company stock," he explains. "We trade $40 trillion worth of stocks a year. That's 200 times as much speculation as investment."

The trouble with speculation, Bogle points out, is that nobody wins but Wall Street.

"All this trading back and forth, by definition, doesn't enrich the investor, because if I buy, you sell and vice versa, but what it does is enrich the croupier in the middle, which we call Wall Street, which has a bunch of very angry people sitting on its doorstep as we speak," he says, referring to the "Occupy Wall Street" and similar worldwide protests. ■

Portfolio Review

Building Our Defensive Front Against Inflation

In September, our two portfolio positions in gold bullion — specifically the SPDR Gold Trust ETF (GLD), purchased at two different times and prices — sold as they hit our sell stop price, making us a tidy profit.

However, it left an important part of the FIR Portfolio, the section we refer to as our "Inflation Hedge," with only two remaining holdings, iPath DJ-UBS Livestock (COW) — which you should note we have changed to a "hold" from a buy — and Freeport-McMoRan Copper & Gold (FCX). That situation may leave investors wondering, with our continued concerns about rising inflation outlined in depth in this and previous issues of FIR: Is our portfolio properly positioned?

The truth is that we are dedicated value investors, and thus buy when bargains are afoot and sell when a price gets too far ahead of itself.

In that regard, gold seemed to get ahead of itself as it bolted past $1,900 per ounce, an all-time nominal record. After the market knocked it from that perch, we protected our gains on the way down.

By the time the price of gold reached its peak in August, the metal was up more than 50 percent in only 12 months. John Maynard Keynes was an economist who got many things wrong, but he was correct when he pointed out that trees don't grow to the sky. Good investments are a lot like trees, in that they grow in spurts, resting in between before shooting higher again.

A price advance of 50 percent or more in a year is usually associated with a market that offers more risk than reward, which is the exact opposite of the characteristics we want in our investments. As gold moved higher, as you recall we tightened our stop price to allow participation in the upside but to automatically lock in profits if and when a decline came.

That's an important tactic to use when an investment starts stretching toward the sky, as Keynes would say.

For now, we think that the price of gold may move sideways for a time, or perhaps even decline, before moving higher. We sold to protect the sizable profits we had in those positions and because we want to be armed with cash, ready for the future, since there certainly will be investment opportunities with more potential rewards.

Seeking the Protective 'Moat'

Meanwhile, while we await the next opportune time to enter a gold position at a value price, we certainly believe that the entirety of the FIR Portfolio is positioned to hedge against inflation.

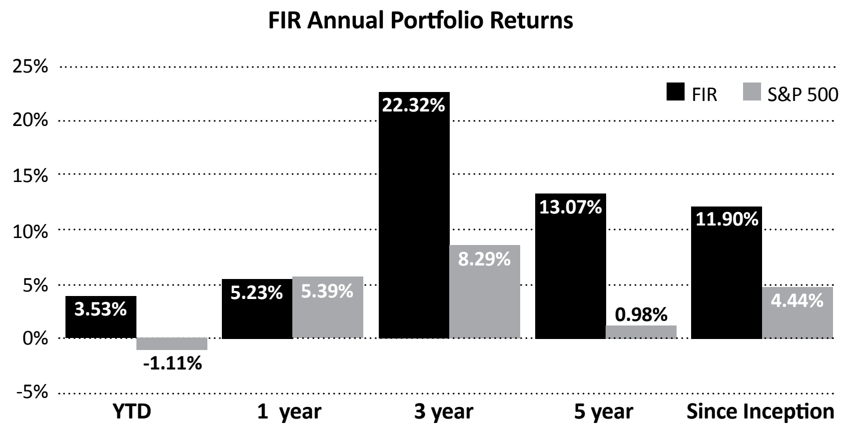
For instance, we are holding the bulk of the model portfolio in large-cap stocks with strong brands and good businesses, such as Johnson & Johnson, Pfizer, GlaxoSmithKline, and our newest addition, Danone. They are the kind of stocks that Warren Buffett would target, and because of their global reach, they offer us some critical protection against inflation.

Many of the companies have what Buffett calls a "moat" around their business. The moat provides an identifiable competitive business advantage and helps keep competitors from undermining the long-term profit potential.

For example, Danone and Johnson & Johnson have powerful brand-name products that are, in reality, moats. Two other holdings, Pfizer and GlaxoSmithKline, have strong reputations and key pharma patents that help them weather economic storms. Telstra has a large installed customer base and an infrastructure that would cost billions of dollars to duplicate. And the San Juan Basin Royalty Trust operates over a large area with proven reserves and financial strength.

These examples highlight that we believe our stocks enjoy strong potential for the future based on their business models and they all sell at what we consider to be a reasonable valuation level.

We will stick to the time-tested value approach in selecting investments and apply it to all our positions.



The stocks in our model portfolio are down 0.32 percent since our last portfolio review. The stock market, which we represent with the S&P 500 index, showed a gain of 1.89 percent over that same time. Both of these figures are on a total return basis which includes the impact of dividends. Since the beginning of 2011, the portfolio has outperformed the market — the model portfolio gained 3.53 percent over that time while the S&P 500 has had a loss of 1.11 percent.

For those wondering about gold, we believe it most likely will reappear at some future time in our model portfolio. We will be buyers of gold when it offers a low-risk entry point and appears ready to move higher. For now, there are other investment hedges that seem to offer more value.

Open Positions

Freeport-McMoRan Copper & Gold (FCX) fell sharply over the past month. The company is facing strikes in Indonesia and Peru, while the prices of copper and gold are falling, compounding the negatives weighing on the stock.

We're still a believer, however. At this point, FCX is more of a value than it has been in years. The stock has a price-to-earnings ratio near 5 and offers a dividend yield of more than 3 percent. Analysts expect the stock to earn almost $6 a share in 2012.

The dividend is offering a significant margin of safety, and even if analysts are off by as much 50 percent, FCX is trading well below the market P/E and is a good buy.

In other news we have been tracking, SABMiller made an acquisition offer that was acceptable to the board of directors of our Global Growth and Income holding, **Foster's Group (FBRWY.PK)**. That stock is now trading with the takeover priced in.

Foster's shareholders will receive two cash payments related to this deal. One will be from SABMiller to buy their shares, and the other will be considered a return of capital from Foster's. The return of capital has a possible tax benefit for investors, and we will continue to hold Foster's to maximize the after-tax gain for investors in the model portfolio.

In other news, on Sept. 26, India-based **Dr. Reddy's Laboratories (RDY)** called off a previously announced $34.9 billion deal that would have expanded the company into the markets of Russia and the Commonwealth of Independent States.

It had been poised to acquire the drug prescription portfolio of JB Chemicals & Pharmaceuticals in Russia, which would have included 20 branded drugs. No reasoning was given by either company, other than it was mutually called off "in the overall business interest of both parties."

In any case, effects on Dr. Reddy shares were minimal, and in other respects, good news continued to flow out of the pharmaceutical company, including its anticipated launch of the generic version of Novartis AG's dementia drug Exelon in the United States.

On the merger-and-acquisition front, **BHP Billiton (BHP)** ended up making one of the top five largest merger deals in the third quarter of 2011, buying Houston-based Petrohawk Energy in August for $12.1 billion, or $38.75 a share, representing a 65 percent premium over the stock price.

The deal gives BHP a foothold in the growing U.S. shale gas exploration market, and it comes on the heels of a deal to acquire a set of shale gas assets from Chesapeake Energy for $4.8 billion a few months earlier.

Admittedly, BHP Billiton had a terrible third quarter as far as stock price is concerned, sliding from an adjusted close of $93.34 on June 30 to a close of $66.44 on Sept. 30, leaving it at a P/E ratio of about 8.

Despite this setback, we believe this stock will find its footing and we have continued to give it a "buy" rating. If you have the patience to wait for a rebound over the longer term, the recent dip has given new investors an excellent entry point.

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November 2011 Portfolio

This chart reflects the positions we currently hold. (Our full list of bought and sold stocks is available online — see page 20 for details.) Over the past eight years, our portfolio has outperformed the S&P 500 by 244 percent, including dividends. Realize that many of our biggest winners fell in value soon after we recommended them, but over the longer term rallied to the inherent values we initially recognized. If you're following our FIR Portfolio, it's important to monitor this space monthly for our latest recommendations.

New Recommendations

No new recommendation this month.

Global Blue-Chips: Large-Cap Multinational Stocks

Ticker	Recommendation	Entry Date	Entry Price	Current Price	Total Return	Buy/Sell or Hold	Buy at or Under	Sell Stop Price
PFE	Pfizer	1-Aug-05	26.46	18.97	-5.29%	Hold	—	
GSK	GlaxoSmithKline (ADR)	15-Mar-07	54.21	43.40	-1.16%	Hold	—	
JNJ	Johnson & Johnson	12-Jan-09	57.80	64.42	21.92%	Hold	—	
BHP	BHP Billiton	15-Dec-10	89.13	76.06	-12.69%	Buy	100.75	
DANOY.PK	Danone	1-Sep-11	13.57	13.08	-3.61%	Buy	13.60	

Global Growth and Income Stocks

Ticker	Recommendation	Entry Date	Entry Price	Current Price	Total Return	Buy/Sell or Hold	Buy at or Under	Sell Stop Price
DBU	WisdomTree International Utilities Fund	15-Oct-07	33.38	18.56	-32.75%	Buy	22.25	
FPNIX	FPA New Income Fund	21-Jan-10	10.98	10.72	-0.65%	Buy	10.79	
BMO	Bank of Montreal	20-May-10	54.88	57.91	9.10%	Hold	—	
FBRWY.PK	Foster's Group	15-Dec-10	5.43	5.39	4.46%	Hold	—	
TD	Toronto-Dominion Bank	15-Dec-10	72.27	73.08	4.95%	Buy	85.00	
TLSYY.PK	Telstra	21-Jan-11	13.83	16.12	29.90%	Hold	—	
SJT	San Juan Basin Royalty Trust	24-May-11	23.78	23.95	2.92%	Buy	25.00	

Inflation Hedge: Gold and Commodities

Ticker	Recommendation	Entry Date	Entry Price	Current Price	Total Return	Buy/Sell or Hold	Buy at or Under	Sell Stop Price
COW	iPath DJ-UBS Livestock TR Sub-Idx ETN	29-Jul-10	29.63	31.66	6.85%	Hold	—	
FCX	Freeport-McMoRan Copper & Gold	16-Sep-10	40.87	35.38	-11.53%	Buy	54.50	

Emerging Markets: Stable Growth Plays

Ticker	Recommendation	Entry Date	Entry Price	Current Price	Total Return	Buy/Sell or Hold	Buy at or Under	Sell Stop Price
RDY	Dr. Reddy's Laboratories (ADR)	15-May-06	33.55	30.95	-6.38%	Buy	37.25	
EMF	Templeton Emerging Markets Fund	16-Sep-10	20.40	18.44	-9.03%	Buy	24.00	

Aggressive Contrarian Plays

Ticker	Recommendation	Entry Date	Entry Price	Current Price	Total Return	Buy/Sell or Hold	Buy at or Under	Sell Stop Price
TBT	UltraShort 20+ Year Treasury ProShares	21-Jan-10	47.92	21.07	-55.42%	Hold	—	
PFIUX	Pimco Unconstrained Bond Fund	21-Jan-10	10.88	10.87	1.78%	Buy	10.95	

As of close October 18. The "total return" percentage in the chart includes not only the change in price but also splits, dividends and distributions

Continued from page 18

Closed Positions

Since the last update, we have had no stop prices hit, so our portfolio holdings remain the same. We are also leaving intact our current sell-stops, and not adding any this month, although we will continue to monitor all positions.

New Positions

We have decided not to recommend any new stock positions this month.

In finding few tempting bargains in the market, even after the steep third-quarter decline, we're in good company. Buffett recently announced that he'll be buying back shares of Berkshire Hathaway, an admission on his part that he can't find enough large-cap value stocks to buy with his significant cash reserves.

Buffett faces a unique problem: His cash holdings keep growing, and even though he has been holding nearly $50 billion in cash, Berkshire continues generating cash from its operations. Buffett is in the position of having to do something, and faced with a lack of bargains, he is buying his own stock at full value.

He announced that he will buy back shares at a price as high as 10 percent over book value.

As for the FIR Portfolio, we'd rather buy stocks that are below their value, and we're confident that there will be opportunities in the months ahead. ■

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For a complete historical record of the FIR Portfolio's holdings and performance, visit FinancialIntelligenceReport.com and click on "FIR Historic Results Table" under "Special Reports."

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52 Million Americans Have a Thyroid Deficiency and Don't Know it!

And it's linked to heart disease, stroke, cancer, diabetes — **59 diseases** in all!

ALERT: 40 to 70 percent of Americans have a thyroid hormone deficiency called "hypothyroidism" and do not know it!

Dr. David Brownstein, M.D.

And, according to Newsmax medical expert Dr. David Brownstein, what's even more shocking is that their doctors don't know it, because the standard thyroid test is wildly inaccurate.

If left untreated, **this thyroid deficiency** can play a major contributing role in 59 separate diseases — some that are just troubling, others that can ruin your life, and a few that **can actually kill you.**

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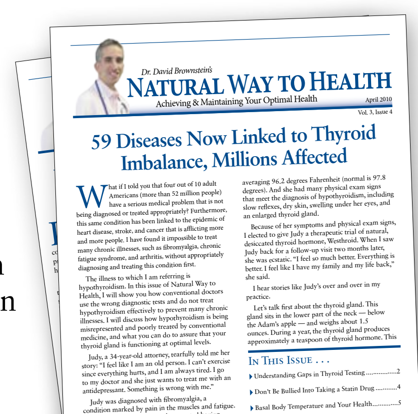

Dr. David Brownstein's
NATURAL WAY TO HEALTH
Achieving & Maintaining Your Optimal Health
April 2010
Vol. 3, Issue 4

59 Diseases Now Linked to Thyroid Imbalance, Millions Affected

What if I told you that four out of 10 adult Americans (more than 52 million people) have a serious medical problem that is not being diagnosed or treated appropriately? Furthermore, this same condition has been linked to the epidemic of heart disease, stroke, and cancer that is afflicting more and more people. I have found it impossible to treat many chronic illnesses, such as fibromyalgia, chronic fatigue syndrome, and arthritis, without appropriately diagnosing and treating this condition first.

The illness to which I am referring is hypothyroidism. In this issue of Natural Way to Health, I will show you how conventional doctors use the wrong diagnostic tests and do not treat hypothyroidism effectively to prevent many chronic illnesses. I will discuss how hypothyroidism is being misrepresented and poorly treated by conventional medicine, and what you can do to assure that your thyroid gland is functioning at optimal levels.

Judy, a 34-year-old attorney, tearfully told me her story: "I feel like I am an old person. I can't exercise since everything hurts, and I am always tired. I go to my doctor and she just wants to treat me with an antidepressant. Something is wrong with me."

Judy was diagnosed with fibromyalgia, a condition marked by pain in the muscles and fatigue. When I took Judy's history, she reported having

averaging 96.2 degrees Fahrenheit (normal is 97.8 degrees). And she had many physical exam signs that meet the diagnosis of hypothyroidism, including slow reflexes, dry skin, swelling under her eyes, and an enlarged thyroid gland.

Because of her symptoms and physical exam signs, I elected to give Judy a therapeutic trial of natural, desiccated thyroid hormone, Westhroid. When I saw Judy back for a follow-up visit two months later, she was ecstatic. "I feel so much better. Everything is better. I feel like I have my family and my life back," she said.

I hear stories like Judy's over and over in my practice.

Let's talk first about the thyroid gland. This gland sits in the lower part of the neck — below the Adam's apple — and weighs about 1.5 ounces. During a year, the thyroid gland produces approximately a teaspoon of thyroid hormone. This

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