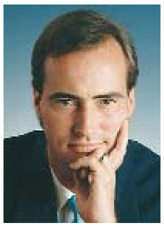
HS Dent Forecast

January 1, 2008

The Economic Guide for Effective Financial Decision Making

12 Steps to the Next Great Depression

(an excerpt from our January 2008 HS Dent Forecast monthly newsletter)



In November we released a short video to subscribers outlining how we expect this bubble boom to continue to play out and finally come to an end between late 2009 and late 2010. In fact, our next book in mid 2009 is likely to be called *The Great Crash of 2010*. The key message we have today is that this bubble boom has and will continue to unravel in a complex manner—in a number of steps and a series of bubbles that burst. Our strategy will not be as simple as getting out of most stocks in late 2009 and moving into high-quality bonds. Strong buying opportunities will occur in different stock and real estate sectors throughout the extended downturn from 2010 to 2021 through 2023. Here, we will look at 12 steps on the way to the next great depression—it was 10 in the video—we've already added a couple more. ***NOTE- We do not think that the current boom is over just yet, even though we are experiencing significant volatility in the equity markets. This is all part of the process as the economy and the equity markets work through this topping process.***

The first real bubble from the massive Baby Boom generation was actually the oil, commodity, and inflation bubble that peaked in 1980 after the highest sustained inflation rates in centuries. This trend correlated with the rising expenses and investments necessary to incorporate that massive generation into the workforce. Small-cap stocks peaked in out-performance in 1983 with the Baby Boom's Innovation Wave (22- to 23-year lag on births for workforce entry after college). We saw the first bubble in stocks in 1987, but the real bubble led by tech stocks occurred from 1995 to early 2000 as the S-Curve adoption rates took off. That crash worsened with the onset of a long-term adverse geopolitical cycle in 2001 that began with 9/11. Subsequently, investment dollars flowed out of stocks into real estate as the Baby Boomers were approaching their peak spending on housing, with that bubble peaking in July 2005. The aftermath of such explosive growth there lead to the subprime crisis, which may have caused financial stocks to peak long term in June 2007.

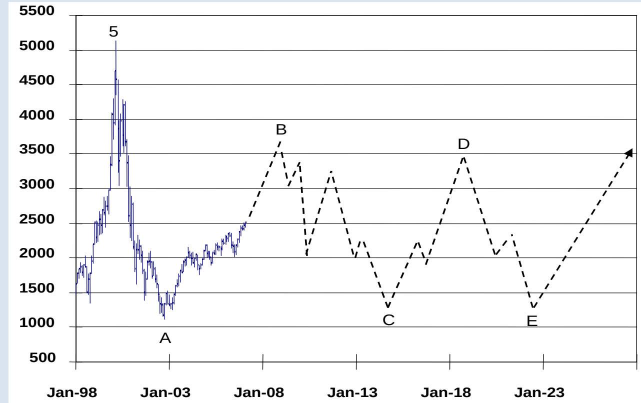
The next great bubble in stocks has sprouted in emerging markets and Asia. That bubble looks likely to peak next between late summer and fall 2008 (as will tech stocks and growth stocks in the US) as inflation resurges and the final bubble in commodity and oil stocks is the last to peak between late 2009 and early 2010—at the expense of most other sectors in the stock market. Once oil prices and inflation trends begin to curb the growth of stocks, we will see the long term slowing in technology and baby boom spending trends we have been forecasting for two decades. Hence, the great bubble boom finally ends around late 2009, and we will enter the next great depression from 2010 until around 2020/2024, when the Echo Boom generation drives rising spending and productivity trends again.

We have three major bubbles bursting in similar time frames: a stock bubble (now concentrated more in emerging markets), a real estate bubble, and a commodity bubble. The theme of this decade is that we see one bubble burst while the next rises until the whole bubble boom ends. The first bubble to peak long term was the tech bubble in early 2000; the last will be the commodity bubble around late 2009, with others peaking in between.

Step 1: The Tech Bubble Peaks

The bubble in Internet and tech stocks was a classic bubble that paralleled that of cars and electricity into the 1920s. As radical new technologies move mainstream on an S-Curve path, new growth industries explode and productivity rises beyond normal generational trends. Internet and cell phones hit a market penetration level of 10% of households between 1993 and 1994 and accelerated, reaching 40% market penetration between 1999 and 2000. This move from 10% to 40% market penetration is when the first tech bubble occurred in automotive stocks between 1914 and 1919, 80 years earlier on our New Economy Cycle. We have been forecasting a second bubble, similar to the bubble in equities in 1925 to 1929, between 2005 and 2009, as market penetration in many new technologies approaches 90%. But **Chart 1** shows that the Nasdaq likely peaked long term in March 2000, unlike the first tech peak in late 1919, which was followed by a greater peak in late 1929.

Nasdaq Composite
1998-2025



Source: Yahoo Finance Chart 1

This current bubble has been building momentum since mid 2006 but is unlikely to exceed the past highs. We are forecasting a continued bubble and burst scenario, but to lesser degrees as we move forward. The current bubble in the Nasdaq is likely to peak between 3,500 and 4,000—and then we are likely to see another bear market bubble rally between late 2014 and 2017 with another crash to follow. Why did we not see a second greater bubble in tech stocks as occurred in the Roaring 20s? That brings us to Step 2.

Step 2: The Adverse Geopolitical Cycle

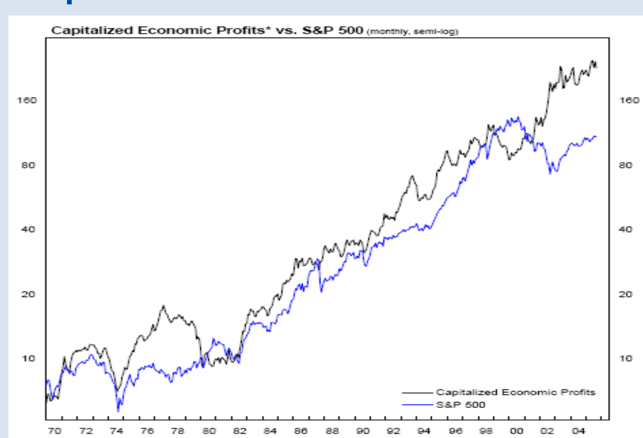
In 2000, the tech correction looked more like a normal setback. But in 2001, the bubble fully burst with a crescendo around the tragedy of 9/11. The stock market and tech sector simply haven't been the same since. Even after the strong recovery that we forecast between late 2002 and late 2003, the market has not followed the same bubble path that we saw from 1925 to 1929 or from 1995 to 1999 during the S-Curve progression. When we got strong divergences from these past bubble scenarios in mid 2006, we made the biggest change ever to our long-term forecasting models. We added a new Geopolitical Cycle (**Chart 2**) after restudying stock market history since the Industrial Revolution and modern era of the last 200 years.

34-36 Yr. Geopolitical Cycle
Dow Industrials

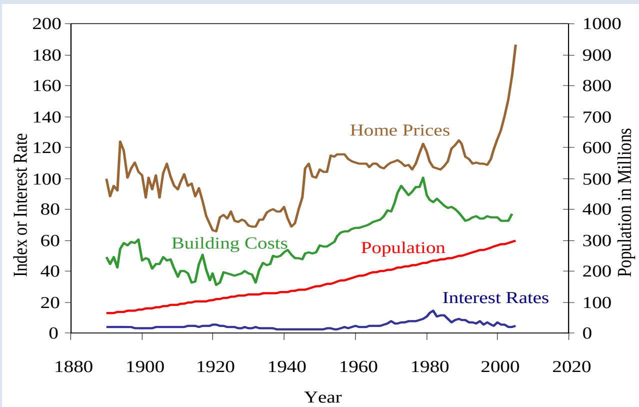
Source: HS Dent, Yahoo Finance Chart 2

The stock market tends to have a more favorable geopolitical environment creating higher valuations and growth rates for 16 to 18 years, and then the cycle turns more adverse for 16 to 18 years. It clearly seems that the last adverse cycle began in 2001, much like previous ones in 1965 (Vietnam, Cold War, and inflation) and 1930 (Great Depression and World War II). **Chart 3** shows how a model for the stock market that uses earnings trends adjusted for interest rates correlated closely with stock market performance from 1983 to 2000 but has diverged ever since. Stocks are about half of where they should be if the trends of the 1980s and 1990s had continued to follow the strong earnings of this decade. We were forecasting a Dow of 32,000 to 40,000 before we incorporated this model. Now we are forecasting a Dow of 16,000 to 20,000. This adverse Geopolitical Cycle should continue until around 2018 to 2019. Expect world events to get worse, not better, for over a decade to come.

Capitalized Economic Profits vs. S&P 500



Source: Steve Moore and Art Laffer Chart 3



Source: Robert J. Shiller, Irrational Exuberance, 2nd Edition, Princeton University Press, 2005.
Chart 4

Step 3: The Housing Bubble Peaks

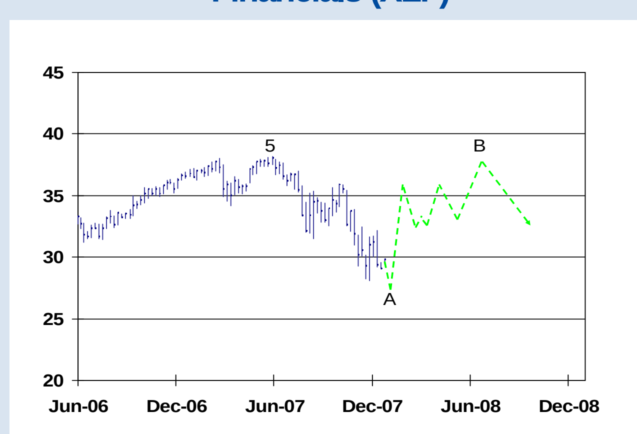
As soon as the stock market started failing, housing prices began to accelerate from 2000 to 2005, even with a minor recession. The money that had been flowing into the stock market simply was diverted rapidly into housing speculation, in which the trends remained strong, with the Baby Boomers in their peak housing spending years between the ages of 37 to 42. That boom continued until house prices reached their most overvalued levels in US and Western history in July 2005. We warned in *The Next Great Bubble Boom* and in our special report on *Demographic Trends in Real Estate* that the bubble would peak between 2004 and 2005 and that prices would go flat or fall slightly at first before crashing to an unexpected degree in the next decade when the economy finally slowed.

Chart 4 shows how much housing has gotten overvalued vs. inflation and long-term replacement costs, which is what drives housing prices long term (as opposed to what drives stock prices long term, which is economic growth). Similarly, housing prices are extremely overvalued vs. rents and incomes. Housing would have to fall 40% to 50% just to get back in line with fair value. Housing should see a peak in foreclosures by late next summer (see Chart 2 above) before we see a rebound in the economy and in housing demand. Rising inflationary pressures should cause interest rates to rise again between late 2008 and late 2009, slowing any recovery in housing until the economy weakens from 2010 on (due to demographic trends discussed ahead), which could cause a long slide in housing prices similar to what occurred Japan from 1991 to 2005 (down 60%-70%). The worst of the housing slide is likely to hit between early 2010 and early 2015.

Step 4: The Lending Bubble and Subprime Crisis—Financial Stocks Peak

The bursting of the housing bubble led to rising foreclosures and falling home prices, which was deadly for the bank and mortgage companies—especially the investment companies that bought packages of securitized loans. Throughout this boom, economists have been saying that consumers carry too much debt and that they can't continue to borrow and spend. But, just as we forecast based on the family spending cycle, consumers continued to borrow and spend—until 2007. Banks and financial institutions have finally realized that there is a limit to what households can borrow, especially when the largest collateral source by far, homes, are falling in price instead of almost constantly rising. Banks didn't see that much risk in lending with "zero down" and low short-term rates as long as housing kept appreciating. Now, many lower-end households are defaulting, and such foreclosures make the housing downtrend worse.

On November 21, 2007, we warned that the financial sector (XLF) was threatening to break below the last major upward peak, which could cause both a short-term panic in stocks and mark the long-term top in financials as June 2007. The financials are recovering and will continue to recover after the correction into November 2007, but chances are that they will not reach new highs in mid to late 2008 as will most international and US sectors. The financials (**Chart 5**), along with the Dow



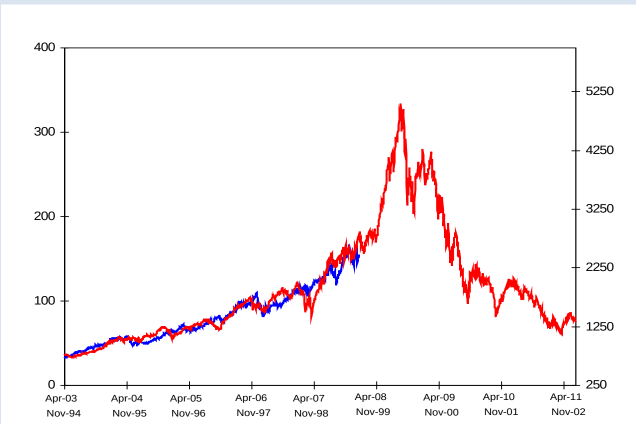
Source: Yahoo Finance
Chart 5

Transports (which also may have peaked already), will be sensitive to the rising inflation trends we are projecting for late 2008 to late 2009. Hence, they are likely to continue downward to sideways in 2009. This likely peak in financials long term represents the most recent step toward the next great depression. The economy will not be as hot as it was in the late 1990s or mid 2000s now that banks are tightening credit standards significantly.

Step 5: Emerging Markets Bubble

The greatest bubble to emerge since the housing bubble peaked has been the emerging markets and Asia. Many countries are quickly following the capitalistic and development models of the West but have stronger demographic trends and are benefiting from the rising bubble in commodity and oil prices, which we will discuss ahead. This sector has replaced the tech bubble of the 1990s, and this is where the next great bubble has been occurring. **Chart 6** shows how the emerging markets sector, which we track by watching the ETF symbol EEM, closely parallels the Nasdaq and tech bubble of the late 1990s. In past issues, we have shown similar trends and correlations for stock markets in China, India, Brazil, and Russia. If these stocks continue to follow this trajectory, they are likely to peak from their own momentum between summer and fall 2008. Hence, this will be the next major stock bubble to peak.

Emerging Markets 2000s vs Nasdaq 1990s

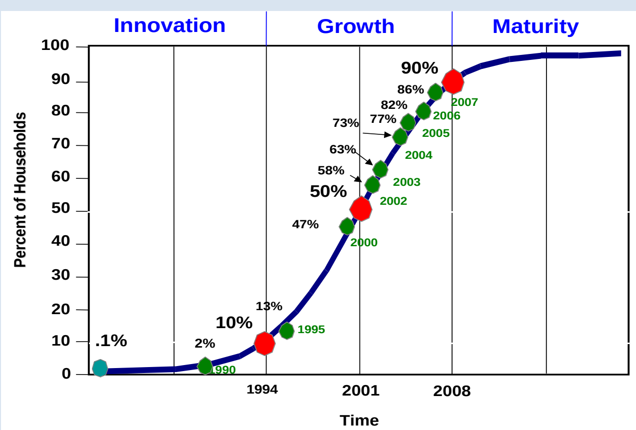


Source: Yahoo Finance Chart 6

Recall that the tech bubble did not peak because the economy slowed but because of its own extreme overvaluation. We did not see a minor recession until 2001. Hence, these markets will not peak because of a slowing in demographic or economic trends. Sky-high valuations clashing with rising inflation and commodity prices trends will burst this next bubble. Like the Nasdaq in 2000, these markets are likely to have a mini crash and then look as if they are coming back in 2009. The greater crash then is likely to follow into 2010, when the worldwide economy starts to slow and the commodity bubble bursts as well.

Step 6: Tech S-Curve Trends Hit 90% Market Penetration

Mobile Phone S-Curve



Source: Forrester, Census Bureau Chart 7

Just around the time that emerging markets are peaking, most of the key technology S-Curve trends we have been tracking will have hit 90% market penetration of households in the US—from Internet to wireless and cell phones to broadband. The growth in these leading sectors will slow from double-digit rates to modest single-digit rates at best, which will cause earnings forecasts and price/earnings ratios to start falling. **Chart 7** shows the chart for wireless and cell phone market penetration, which has most closely paralleled the auto S-Curve 80 years back, from 1914 to 1928. Penetration should hit 90% by the end of 2008. Hence, many leading growth stocks will slow in the US and Europe after 2008.

Step 7: Inflation Resurges From Late 2008 into Late 2009

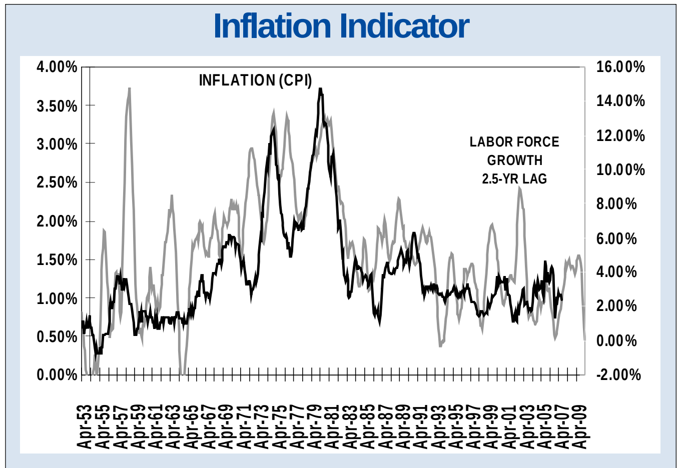


Chart 8

Alan Greenspan warned a few months ago that inflation was likely to return to 4% to 5% in the coming years. That level of inflation is exactly what our best inflation model shows based on workforce growth on a 2.5-year lag (**Chart 8**). Hence, this model gives us a more accurate forecast of inflation trends 2 to 3 years ahead. Inflation has fallen in line with this model since 1980, as the Baby Boom workforce entry has slowed and their productivity has risen. Since 1998, Echo Boom entry has started to push inflation trends upward only modestly due to minor Baby Boom retirement to offset thus far—and peak Echo Boom entry will be in the years ahead. Baby Boomers will start to retire more rapidly starting in 2010 and cause deflationary trends, as we will discuss ahead.

The slowdown in the economy that the Weekly Leading Index (Chart 1) forecasts should keep inflation and commodity trends at bay until late 2008. However, the recovery that is likely by then will reignite the inflation trends that are already built into the economy from Echo Boom workforce entry. A resurgence in inflation to 4% or higher will raise 10-year Treasury Bond yields significantly, toward 6% to 7% and will cause the Fed to start raising the Fed funds rate again. Both of these trends will create headwinds for stocks just as the economy starts to improve and earnings get stronger again. Hence, we continue to think that most stock indices in the US will peak long term by late 2008—except the commodity-oriented sectors. The Fed then will hit its next great dilemma: it will be fighting inflation just before we hit the first great deflationary period since the 1930s!

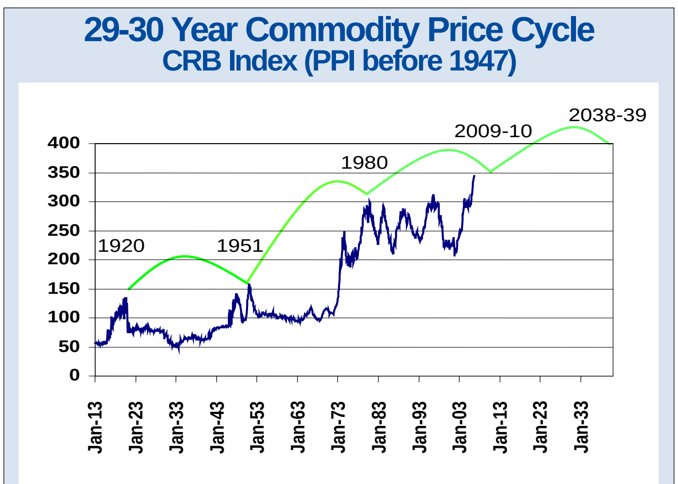


Chart 9

Step 8: The Oil and Commodity Bubble Peaks

Adding to inflation trends will be the continuation of the oil and commodity bubble that has also returned since the late 1990s, after a long hiatus from the last peak in 1980. Since late 2006, we have been predicting that oil prices would go well over $100 by the end of this decade, along with new peaks in precious and industrial metals. But we also reviewed the last two centuries thoroughly for commodity price trends and uncovered a new 29- to 30-year Commodity Price Cycle that derives from the old Kondratieff Wave model that seemed to fail so miserably in the 1990s (when it was calling for the next Great Depression). The model did not fail so much as become overridden by the massive demographic and generational trends of this and the last century. However, commodity prices still follow a regular cycle, as **Chart 9** shows.

The last Commodity Cycle peak was in 1980. The next Commodity Cycle peak is due between late 2009 and early 2010. Our Elliott Wave projections for oil prices also suggest that one more wave upward is ahead, which will peak around that time frame. Hence, the last bubble to peak in this great bubble boom will be oil and commodity prices, around late 2009 or early 2010 at the latest. Along with rising inflationary pressures, such a final bubble is likely to keep most US and global stock indices from reaching new highs in 2009, as interest rates rise and central banks tighten monetary policies. The commodity and oil bubble will be the last primarily because the long spending spree of the massive Baby Boom generation will finally start to slow long term and deflation will set in as they start to retire. A decade-long cycle will also peak here as well and point downward into the first half of the next decade.

Step 9: The Decennial Cycle Peaks, Around Late 2009

One of the most consistent long-term cycles is the Decennial Cycle in **Chart 10**. Corporations tend to plan on ten-year cycles and thus over-expand toward the end of each decade; then they must consolidate in the early years of the next decade. Stocks and the economy tend to make almost all of their long-term gains in the second half of most decades and tend to see their worst corrections in the first few years of each new decade. The last cycle bottomed on cue in late 2002, and now we are due for a peak around late 2009, right in line with the commodity and oil bubble cycle. That means the next all-out crash is not likely until after late 2009—similar to the early 1920s, 1930s, 1940s, 1960s, 1980s, and 2000s. The next strong bear market rally is due from late 2014 onward, which probably will be the best time to reinvest in international and health care sectors.

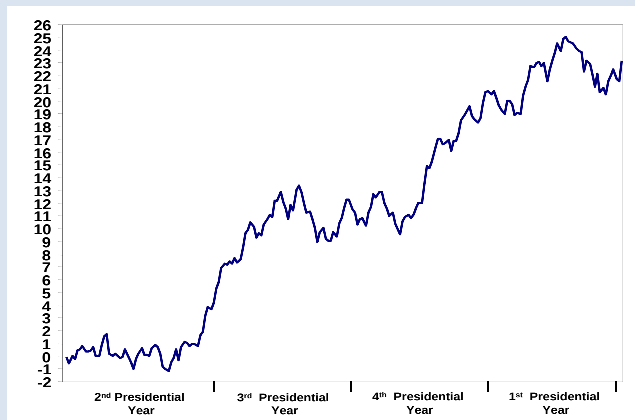
Decennial Pattern Since 1900
Dow Industrials - Average 10-Year Decennial Pattern
Weekly Data 1/6/1900-12/31/1999

Source: Ned Davis Research, www.ndr.com Chart 10

Step 10: 4-Year Presidential Cycle Turns Down, Late 2009 to Late 2010

The most consistent short-term cycle is the 4-Year Cycle (**Chart 11**). It tends to peak well into the first year of the President's term and has its worst corrections into the mid term elections in the year to follow. Every major correction in the last 5 decades outside of 1987 has bottomed in this second year of a Presidential Cycle, typically between the summer and late fall. This cycle also peaks along with the Decennial Cycle by late 2009, which suggests that the greatest probability for a strong crash will be between late 2009 and late 2010; hence, our forecast for "The Great Crash of 2010." For most markets, that crash is likely to start in late 2008, but the real panic probably will follow between late 2009 and late 2010. The rise in short-term and long-term interest rates and the commodity bubble all play into these two cycles peaking around late 2009 almost perfectly. The next time for a likely follow-through crash and market bottom will be into late 2014 on the next cycle. Hence, late 2010 and late 2014 should bring some great medium-term buying opportunities in the best sectors of stocks, although we may be in a general bear market well into the early 2020s due to the Baby Boom spending mega trend that has been driving this boom since the early 1980s.

Four Year Presidential Cycle

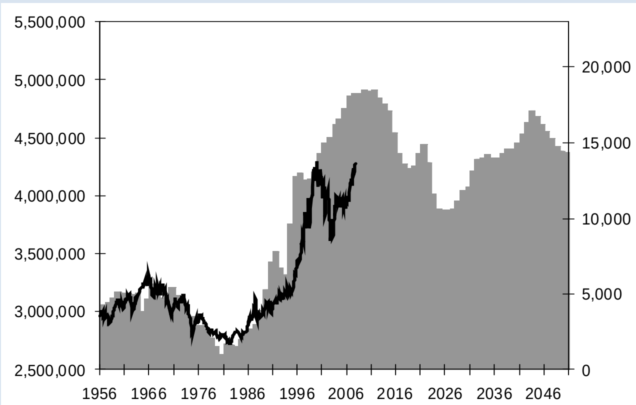


Source: Ned Davis Research, www.ndr.com Chart 11

Step 11: Baby Boom Spending Wave Peaks and Slows Long Term

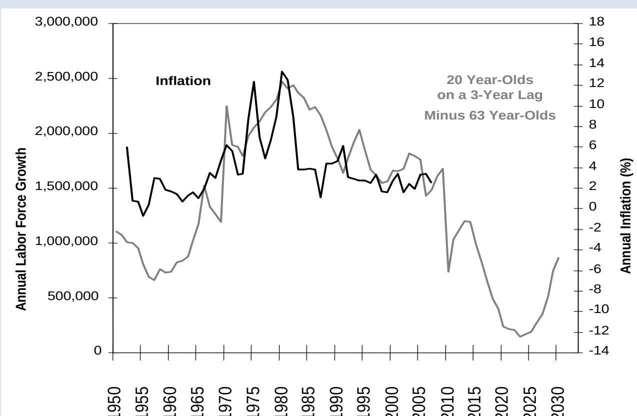
Our central premise since the late 1980s has been that the most fundamental trends driving our economy are the spending and productivity trends predictable as new generations age. Since we invented the Spending Wave (**Chart 12)** in 1988, we have been predicting that this boom would finally end around the end of this decade. However, the bursting of the emerging markets bubble and then the commodity bubble will not be

The Spending Wave
Births Lagged for Peak in Family Spending



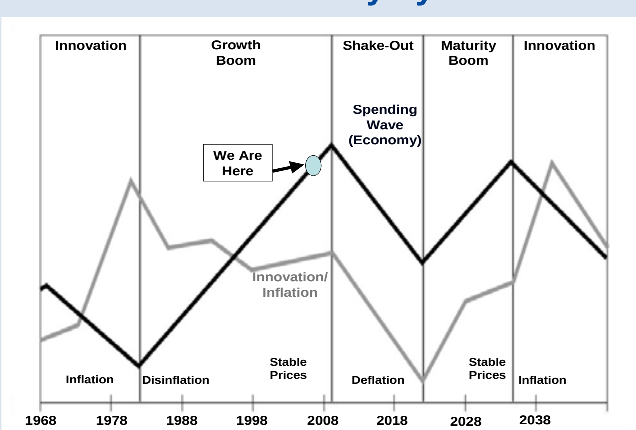
Source: HS Dent — Chart 12

Inflation Forecast



Source: U.S. Census Bureau and U.S. Bureau of Labor and Statistics — Chart 13

New Economy Cycle



Source: HS Dent — Chart 14

caused by this trend at first. This is a long, slow trend that peaks and declines more gradually. As we start to recover from "The Great Crash of 2010," these trends increasingly will work against the economy and the earnings of companies. From around 2010 to around 2023, we have been predicting that we would see the next Great Depression and extended downturn, much as the Japanese saw (and as we predicted that in the late 1980s) from 1990 to 2003. Hence, The Great Crash of 2010 will not be just another bubble that bursts with new ones to follow. Instead, it will lead us into the next Great Depression and the deflation of the entire bubble boom that started somewhere between 1975 and 1983 (according to different measures). The Echo Boomers, with their own productivity and spending, will not lead us out of that extended downturn until somewhere between 2020 and 2024. The worst of this next depression is very likely to occur between 2010 and early 2015 on the Decennial Cycle and in the early years of the great bubble bust.

Step 12: Inflation Rapidly Shifts into Deflation

The first surprise for economists and the Fed will be the sudden resurgence of inflation by mid to late 2008 just when they thought it was licked. The biggest surprise of all will be when that inflation resurgence suddenly shifts into a deflationary cycle, starting in early 2010 or so. The long term slowing of Baby Boom spending, the much greater banking crisis that will follow as housing weakens further, and the bursting of the 29- to 30-year Commodity Cycle clearly suggest such a trend, but it will be the aging of the Baby Boomers and their progressive retirements at higher rates starting around 2010 that will make deflation an inevitable and persistent trend!

Taking the same correlation of workforce growth and inflation in Chart 20 shown previously, we can now in **Chart 13** roughly forecast such trends out two decades by projecting when new workers will enter the workforce (20-year lag) and when retiring workers will exit (63-year lag). As discussed above, the Echo Boom generation started to enter the workforce in rising numbers in the late 1990s, but this generation is slightly smaller than the Baby Boom generation, which started its first stages of retirement around 2000. This has kept the rise in inflation to modest levels. Even though the Echo Boom generation will continue to enter the workforce into around 2010 - 2011, Baby Boomers will start to retire more rapidly from 2010 into 2024. This strongly suggests deflation in that time period. Remember, this is not just falling inflation rates, but real deflation. The commodity bubble bust and the long-term slowing of the economy will again play into this trend strongly.

In addition to all of this, an even broader cycle strongly suggests deflation in the coming decade: our 80-Year New Economy Cycle (**Chart 14**). With every other 40-year-generation, radical new technological and social trends emerge in an Inflationary/Innovation period. That is followed by a Growth Boom that sees bubbles in the new technologies and trends. That bubble boom is followed by a Shake-out/Deflationary stage that wrings out the excesses and lowers prices in a survival-of-the-fittest drama that makes the strongest companies and institutions stronger. The next generation then reaps the benefits of those efficiencies in the Maturity Boom that follows and the technology revolution from the previous generation fully extends its benefits to the everyday worker, much like the post World War II boom.

As these three bubbles burst—stocks, real estate and commodities—the banking system will have to write off major loans, which will contract the money supply exponentially and cause the both deflation and the next great depression. The worst of it is likely to come in the first few years and during the ebb of the Decennial Cycle between 2010 and early 2015—especially for stocks between late 2009 and late 2010. The key thing to understand is that during a period like this, all assets deflate except high-quality bonds and cash.