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THE "YOU MAY NOT KNOW REPORT"

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Is the Future Economy Predictable? The "K-Wave" Says Yes

By Dennis Tubbergen

This month, in the "You May Not Know Report", I want to revisit a topic that I wrote about extensively in the book "New Retirement Rules".

I am doing so because I think the topic is even more relevant now than it was in 2011 when I first wrote about it after being introduced to the economic theory and subsequent to the introduction, doing extensive interviews and research on the subject.

The "K-Wave" is short for the Kondratieff Wave. (Pronounced Con-DRY-Tee-eff).

Mr. Kondratieff was a Russian economist who originally got his marching orders from Joseph Stalin, the iron-fisted ruler of Russia. Mr. Stalin hated the notion of capitalism and tasked Kondratieff to do economic research that would prove that capitalism and free markets were inferior to other economic systems.

Unfortunately for Mr. Kondratieff, after researching the topic, he found exactly the opposite. Mr. Kondratieff concluded that capitalistic societies work just fine but are subject to boom-and-bust cycles. He published his findings in his 1925 book titled, "The Major Economic Cycles".

My research on the topic has me concluding that these boom-and-bust cycles have historically been very manageable and get out of hand only when central bankers and politicians get involved and try to influence the cycle outcomes.

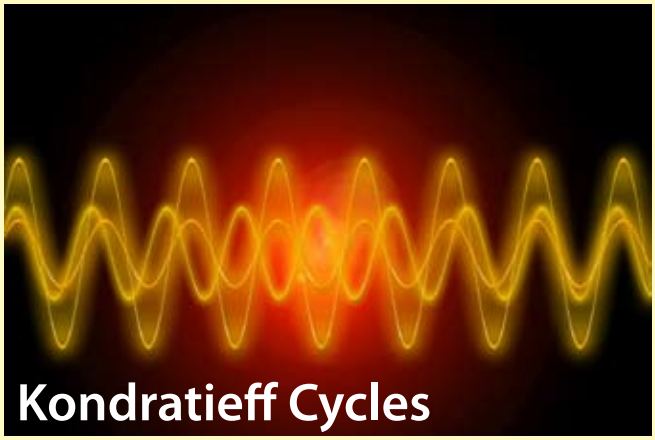
In this issue of the "You May Not Know Report", I'm going to give you some historical background on these cycles. You'll see that the boom-and-bust cycles have always existed but have gotten worse as central banks have assumed the role of issuing currency.

The "K-Wave" mentioned in the headline above, is the bust part of the cycle.

To finish the story of Kondratieff, as you might imagine, Stalin didn't appreciate the work of Kondratieff and made him pay. After his book was published, Kondratieff was relegated to a Siberian prison before dying at the hands of a firing squad in 1938.

Kondratieff's work lives on though. Many modern economists have built on the work of Kondratieff including Mr. Ian Gordon, a past guest on the RLA Radio program.

Let's dig in.



As noted above, many economists who have studied the work of Kondratieff have concluded, as Kondratieff did, that capitalist economies move in boom-and-bust cycles and that each of these predictable economic cycles can be broken down into four sub-cycles. As we will discuss, each of these four sub-cycles has existed four times in American history.

These sub-cycles can take anywhere from 15 to 30 years to complete, so in order to complete one full cycle of four sub-cycles, anywhere from 60 to 100 years can elapse, which is the approximate length of one human life. When the full cycle of four sub-cycles is complete, the cycle begins again.

For the purposes of this discussion, we'll label these sub-cycles of each economic cycle spring, summer, autumn, and winter. Kondratieff and many modern-day economists have tracked these economic seasons or sub-cycles, which have their roots in predictable human behavior, all the way back to the beginning of the Industrial Revolution in the mid to late 1700s.

Here is a brief description of each season and the characteristics of each one.

The Spring Cycle

During spring, an economy experiences a gradual increase in business and employment. Consumer confidence gradually increases. Consumer prices begin a gradual increase compared to the levels seen during the previous cycle (the winter cycle). Stock prices rise and reach a peak at the end of the spring cycle, and credit gradually expands. At the beginning of the spring cycle, overall debt levels are low.

The Summer Cycle

During summer, an economy sees an increase in the currency supply, which leads to inflation. Gold prices reach a significant peak at the end of the summer period. Interest rates rise rapidly and peak at the end of the summer season. Stocks are under pressure and decline throughout the period, reaching a low at the end of the summer cycle.

The Autumn Cycle

During autumn, money is plentiful and gold prices fall, reaching a gold bear market low by the end of the autumn season. During autumn, there is a massive stock bull market and much speculation. Financial fraud is prevalent, and real estate prices rise significantly due to speculation. Debt levels are astronomical. Consumer confidence is at an all-time high due to high stock prices, high real estate prices, and plentiful jobs.

The Winter Cycle

During winter, an economy experiences a crippling credit crisis and money becomes scarce. Financial institutions are in trouble. There are unprecedented bankruptcies at the personal, corporate, and government levels. There is a credit crunch, and interest rates rise. There is an international monetary crisis. There are pension funding problems, and the price of gold and gold-related equities rise.

I believe we have been in the winter cycle for some time now. Going back to the financial crisis of a dozen years ago, there were many bankruptcies in both the private sector and in the public sector; evidence of debt levels that are unsustainable.

Instead, currency creation or quantitative easing, has simply temporarily masked the consequences of debt excesses which we will still have to deal with at some future point.

The reality is that since the financial crisis of about one decade ago debt levels have grown. Much of the economic growth that we've experienced hasn't been growth at all but rather debt fueled consumption.

Massive accumulation of debt last occurred worldwide during the autumn season of the1920s. Once the debt in the system reached its capacity, the trend of debt accumulation reversed and led to the economic winter season of the 1930s, which we all know as the Great Depression.

Given that debt levels are MUCH higher today when measured as a percentage of the economy, a similar outcome of banking failures and a collapse in asset prices is unavoidable in my view whenever the currency creation stops. (Currency creation WILL stop – it will be intentional and proactive or reactive as the populace looks for currency alternatives in earnest.)

It's a surprise to many when they learn that this autumn season debt accumulation cycle, followed by a winter cycle during which debt is purged from the system, has occurred three other times in US history. There are multiple other historical examples proving the existence of this cycle going all the way back to Greece in 486 BC.

Because this cycle of debt accumulation followed by deflationary debt purging repeats, the conditions that exist in today's economy are nothing new, nor should the ultimate outcome be surprising to anyone with knowledge of money and economic history.

The difference between the current winter economic cycle and past winter cycles is the present cycle finds debt at much higher levels than in prior cycles due to the extreme currency creation policies of the Federal Reserve.

Today's economic winter season had to occur because debt levels in the prior autumn season reached the system's capacity to handle debt. Due to the Fed's policies, we have yet to experience the fallout from debt being purged from the financial system but it's my firm conviction that we will.

History doesn't lie.

This is a predictable pattern that repeats itself over and over.

The first economic autumn cycle in US history occurred from 1821 to 1836. This autumn cycle was predictably followed by a winter cycle.

The second central bank of the US was chartered in 1817 when the country was dealing with massive debts accumulated during the War of 1812. The second central bank, like today's central bank, the Federal Reserve, printed currency. Then after the bank's charter was not renewed, state and regional banks were allowed to issue currency. This resulted in even more easy money and more widely available credit.

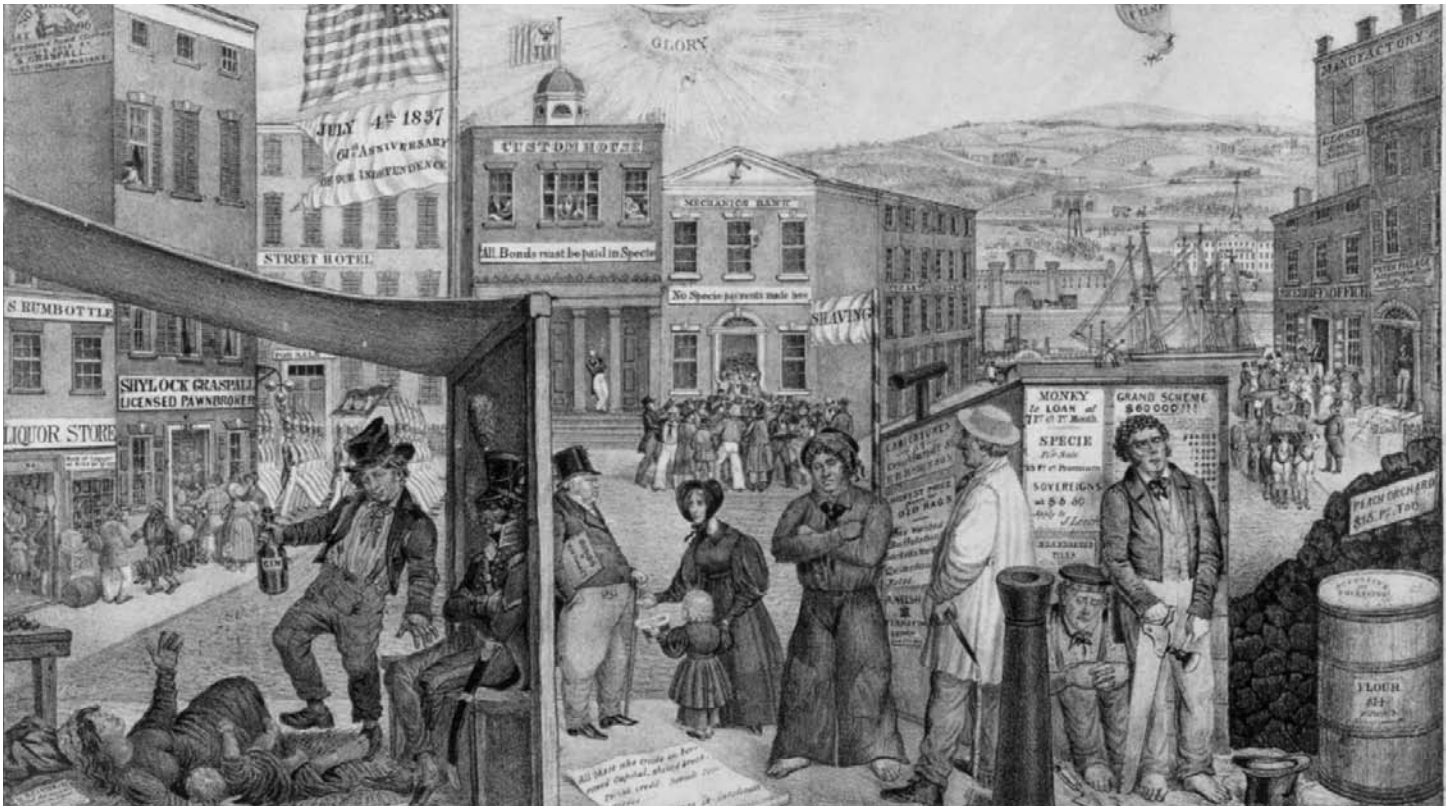
Without widely available easy credit, the system cannot reach its capacity for debt, and asset price bubbles cannot form.

In the economic autumn season of the 1830s, as a result of this easy credit, a real estate bub-

ble formed and subsequently burst. Speculators abounded. It was a typical autumn season asset bubble fueled by easy credit.

This article excerpt explains (emphasis added):

> *In 1837, however, the young nation endured its most serious depression yet.*
>
> *This panic was made worse by a number of factors: large debts incurred by states due to over-expansion of canals and the construction of railroads; an unfavorable balance of trade as imports exceeded exports, resulting in a loss of specie (gold and silver -- as opposed to paper currency); and several crop failures in 1835 and 1837. The major cause of the panic, however, was the economic impact of land speculation. It was a period of speculative mania.*
>
> ***After the demise of the Bank of the United States, state and wildcat banks grew rapidly during the 1830s. Funds were more easily available, and investors borrowed money at an incredible pace.*** *Not only the small Western farmer, but merchants, manufacturers and traders also borrowed heavily.* ***The business community, rather than paying off their debts and refinancing new ventures, anticipated greater returns if they invested their borrowed money in speculative enterprises -- investments that, they hoped, would greatly increase in value while they held them. Leading the list of speculative ventures were investments in the vast amounts of readily available cheap land.***
>
> *Land offices throughout the country reported record sales as speculators invested for quick returns. Between 1834 and 1836, sales totaled 37 million acres.* ***By 1836, sales were ten times greater than they were in 1830****. "Land office business" was the order of the day. In an effort to curb this speculative fever, President Jackson issued the Specie Circular. This order mandated all land offices to accept only gold and silver, rather than "rag" money, in payment for public lands. Since state banks did not have adequate specie backing, land sales dropped. Numerous speculators defaulted on*



their payments, because little gold and silver were available.

***The speculative mania continued to spread, despite the Federal Government's attempts to halt it**, or at least to curb the speculative holding of large tracts of land. Speculators, armed with ample cash, hired shrewd agents to keep them apprised of the best lands -- and land bargains -- available. Large speculators also used a slew of unethical and illegal methods to gain the upper hand in their quest for land.*

Public land, although the most important facet of speculation, was by no means the only kind of land sold. Urban real estate was also caught up in this mania as values increased. A Hartford speculator related making 75% annually on an investment of $1,000 in Michigan, where the boom was in high gear. Not only the Midwest witnessed wild speculation. Valuation of real property increased in New York over 50% in five years. And even Maine timber lands tripled in price in just a few years.

Asset price bubbles are common in an economic autumn season. The economic autumn season from 1821 to 1836 was followed by the winter season depression of 1837 to 1845, during which debt was purged from the system.

When debt-fueled asset bubbles burst, banks which have debt as assets, go bust. During the economic winter season beginning in 1837, out of the 850 banks in existence in the US at the time, 350 banks failed completely and another 62 experienced a partial failure. This brings us back to an eternal economic truth: If there is too much debt to be paid, it will not be paid. That's why economic winter seasons exist.

The next autumn season in US history began in 1866. Price bubbles in assets formed, and easy credit was again the cause.

In 1863 and 1864, National Banking Acts were passed into law. Until these acts were passed, only state banks existed, with the Federal Government having no control over them. The National Banking Acts created nationally chartered banks. These nationally chartered banks had gold, silver, and government debt as assets. Each national bank could issue its own currency but was limited in the amount of currency it could print. Each national bank could only print currency to the extent it owned government debt to back the currency.

It was this change in the backing of currency that allowed the country to finance the Civil War. By changing the currency rules from requiring gold to back the paper currency to allowing government debt to back the paper currency, more currency could be created.

After the war, easy credit was readily available as a result of currency printing. Like other times when there was abundant easy credit, asset price bubbles formed. The following summary explains (emphasis added):

The era of high prices and business activity which had followed the war yielded its legitimate effect in an abnormal growth of the spirit of speculation. The inevitable consequence followed. In 1873 came a financial crash that carried ruin far and wide throughout the country. ***It began on October 1, in the disastrous failure of the banking firm of Jay Cooke & Co., of Philadelphia, the financiers of the Northern Pacific Railroad. Failure after failure succeeded, panic spread through the whole community, and the country was thrown into a condition resembling that of 1837, but more disastrous from the fact that much greater wealth was affected.*** *Years passed before business regained its normal proportions.* ***A process of contraction***

***set in**, and it was not till 1878 that the timidity of capital was fully overcome, and business once more began to thrive.*

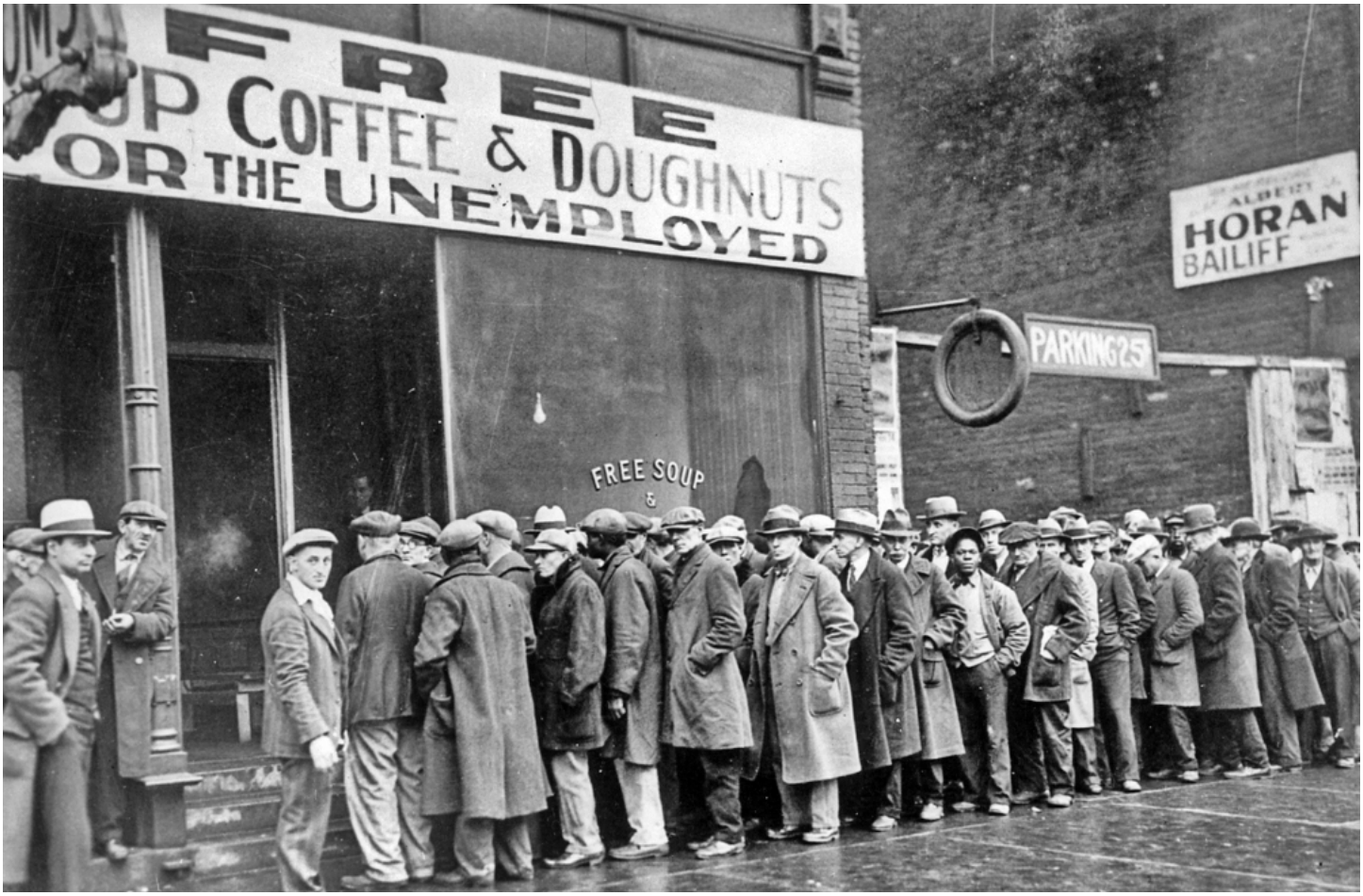
*Industry and trade had flourished beyond precedent during the first years after the war. The high protective tariff contributed its share to the general rush of enterprise. In 1873 railroad mileage had doubled itself since 1860, and this was a prolific cause of rash speculation. While business was expanding the currency was contracting. Paper money had depreciated, and the conditions foreboded a crash. The Jay Cooke firm stood at the head of the great banking concerns. This house had handled most of the government loans during the war, and as already stated, were financing the doubtful Northern Pacific scheme. When this firm broke, strong institutions tottered and thousands of people in every rank of life were stricken with absolute ruin or sufferings that were none the less poignant for being outside the category of direct financial failures. The blow was felt for years in impaired credit, pressure for payment of dues, the lowering of securities and general dread of even safe enterprises. United States bonds fell from five to ten percent. **Savings were exhausted, and many banks went under. Labor felt the cruel stroke for long after in the shutting down of factories and the half-time employment.** The country was in a state of alarm and disgust at the bitter consequences of questionable acts in Congress, by the Administration, and in the realm of finance, and its indignant resolve to change things for the better was expressed in the heated contest which replaced the Grant administration with that of President Hayes, in 1876.*

During the autumn season of 1866, mortgages were easy to get. Large banks were more than glad to make loans to developers. Half-built buildings were accepted as collateral for many of these mortgages because almost anyone could get credit. A housing bubble formed.

But there was another bubble as well. Railroad construction had been financed mainly by large banks like the Jay Cooke firm mentioned above. Complicated bonds that many investors didn't understand were used to finance the railroad construction. Eventually, this rapid construction became unsustainable. Railroad companies and large banks failed. The stock market crashed, and a deflationary period followed. During the economic winter season starting in 1873, banks and railroads failed. With just a few variations, it was 1837 all over again.

The predictable pattern is clear.

Easy money precedes easy credit, which precedes asset price bubbles, which precedes a



financial crisis. The financial crisis occurs when debt levels reach the system's capacity to handle the debt. Deflation follows as debt is purged from the system.

This pattern repeated itself yet again in the 1920s. The newly formed Federal Reserve, the nation's third central bank, was founded in 1913. After the central bank was founded, the backing of the US dollar by gold was reduced to 40% of its prior level, allowing for an expansion of the currency supply.

This massive expansion of the currency supply led to private sector debt expanding to unsustainable levels during the economic autumn season of the 1920s before reaching the system's debt capacity. The debt accumulation trend then reversed and transformed itself into the debt purging, deflationary period of the 1930s, the last economic winter season, which we all refer to as the Great Depression.

Like the two autumn seasons before, the economic autumn season of the 1920s saw prosperity seemingly everywhere. But as most of the planet was feeling happy and prosperous, debt was slowly increasing to dangerous, unsustainable levels.

Bubbles in the real estate market and the stock market formed before ultimately bursting. The Harvard Business School described the bubbles of the 1920s like this (emphasis added):

> *The famous stock market bubble of 1925–1929 has been closely analyzed.* ***Less well known, and far less well documented, is the nationwide real estate bubble that began around 1921 and deflated around 1926****. Real estate was the first asset-price bubble of the 1920s with the later stock market bubble and the Great Depression that followed. Limited data*

on 1920s home prices and foreclosures means that many questions remain unanswered. Historical trade publications like the weekly New York Real Estate Record and Builder's Guide, of which Baker Library holds a sixty-year run, allow researchers to fill in the blanks. The implications of early findings may challenge conventional wisdom about the factors that caused and prolonged the Great Depression.

In the 1920s, Florida was the site of a real estate bubble fueled by easy credit *and advertisers promoting a lifestyle of sunshine and leisure.* ***Contemporary accounts describe a collective madness that consumed Florida investors; city lots in Miami were bought and sold as many as 10 times in a single day.*** *The received wisdom holds that a 1926 hurricane pricked the bubble, but house price indices and construction data suggests that the boom and bust was in fact a nationwide phenomenon whose causes and consequences remain unclear.*

The housing price downturn in 1926 led to a rise in the foreclosure rate. Foreclosures were the cause of considerable hardship in the 1920s, but public attention focused on the plight of family farms, not residential real estate. ***Heavily mortgaged during World War I, in expectation of continued high prices, many family farms were overwhelmed by the postwar collapse of the agricultural commodities market. Yet foreclosures of residential properties also increased in 1926, rising steadily through the stock market bubble and peaking in 1933.***

Once again, the pattern is clear. The prosperity of the economic autumn season, driven by increasing debt levels fueled by easy credit, gives way to an economic winter season characterized by high unemployment, bank failures, and asset price bubbles bursting.

It is my belief that we are now in another winter season.

Central bankers are frantically trying to prop up markets and asset prices, but history teaches us they will ultimately fail. And, when one compares the 1920's and the 1930's to where we are presently, the conclusions one has to draw are very sobering. I wrote about this in a "Portfolio Watch" weekly newsletter not long ago.

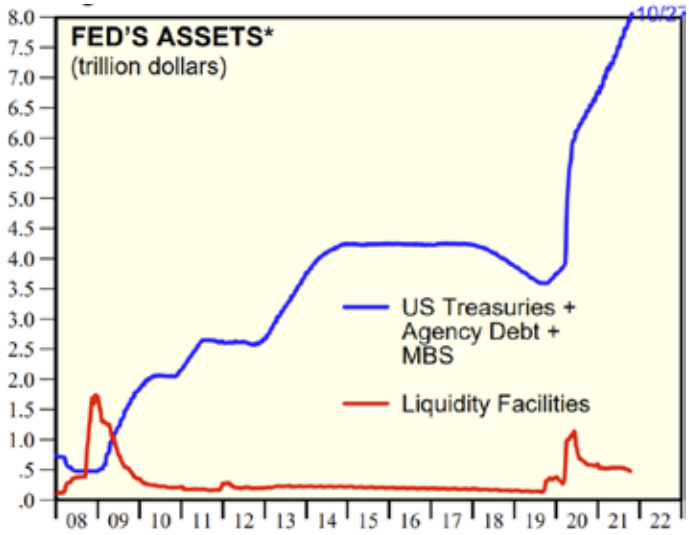
> *The events of the 1920's led to the depression of the 1930's. An article written by Richard Timberlake for the Foundation for Economic Education in 1999 (Source: https://fee.org/articles/money-in-the-1920s-and-1930s/) explains (emphasis added):*
>
> *Other observers, for example, many Austrian economists, believe that all the trouble started with a central bank "inflation" in the 1920s. This "inflation" had to be invented because it is a necessary element in the Austrian theory of the business cycle, which seems to describe most Austrian economic disequilibria. Austrian "inflation" is not limited to price level increases, no matter how "prices" are estimated. Rather, it is any unnatural increase in the stock of money "not consisting in, i.e., not covered by, an increase in gold."*
>
> *Once the Austrian "inflation" is going, it provokes over-investment and maladjustment in various sectors of the economy.* ***To correct the inflation-generated disequilibrium requires a wringing-out of the miscalculated investments. This purging became the enduring business calamity of the 1930s.***
>
> *The late Murray Rothbard was the chief proponent of this argument. Rothbard's problem is manifest in his book America's Great Depression. After endowing the useful word "inflation"*

with a new and unacceptable meaning, Rothbard "discovered" ***that the Federal Reserve had indeed provoked an inflation in the 1921–1929 period****. The money supply he examined for the period included not only hand-to-hand currency and all deposits in commercial banks adjusted for inter-bank holdings—the conventional M2 money stock—but also savings and loan share capital and life insurance net policy reserves. Consequently, where the M2 money stock increased 46 percent over the period, or at an annual rate of about 4 percent,* ***the Rothbard-expanded "money stock" increased by 62 percent, or about 7 percent per year.***

Money stock increasing at 7% per year resulted in inflation in the 1920's followed by a painful deflationary period in the 1930's.

Here is why that is interesting.

The chart on this page illustrates the Fed's assets. It's important to remember that the Fed



creates currency to buy these assets. As you can see from the chart, the Fed has more than doubled the money it's created in less than 2 years.

By comparison, the 7% increase in the money supply from 1921 to 1929 is very mild yet the painful deflationary period of the 1930's followed.

That's not good news moving ahead.

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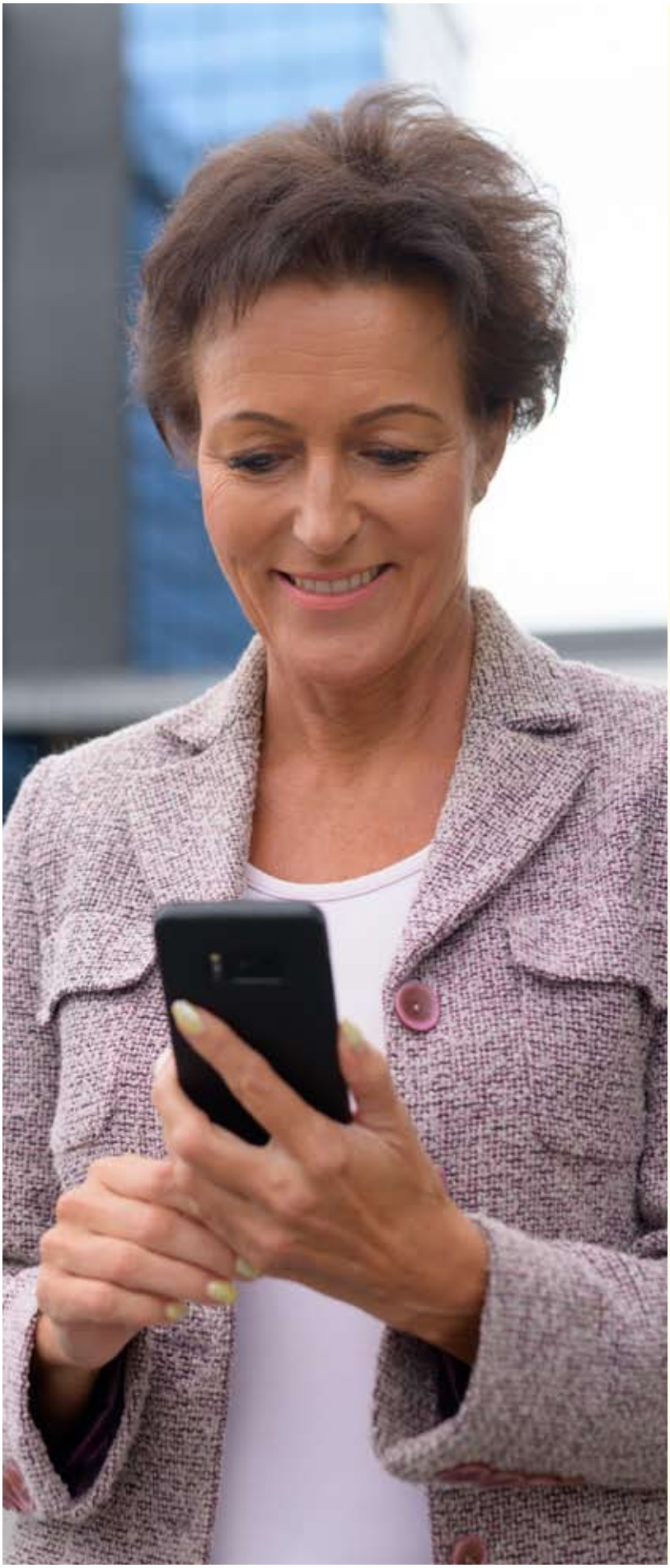

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