GOLD & ENERGY ADVISOR

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"The New Fed Chairman: A Disaster for the Dollar, But Great for the GEA Portfolio!"

"Greenspan's replacement has promised to 'maintain continuity with the policies established during the Greenspan years.'"

"That's great news for our portfolio—here's why!"

- **Bernanke's tenure at the Fed: what to expect**
- **Greenspan warns Congress of "serious economic disruption"**
- **Oil stocks: outlook and update**

President Bush has announced Benjamin S. Bernanke as Alan Greenspan's replacement. His confirmation is about to begin as I write this.

The Chairman of the Fed has been called the second most powerful man in America. What does Bernanke's appointment mean for our economy and our investments?

As the *Economist* recently noted:

"Current conditions for a handover are hardly ideal. America's economy has never looked so unbalanced, with a negative household savings rate, a housing bubble, a hefty budget deficit, a record current-account deficit, and rising inflation…

"Combine America's domestic and external financial deficits with a looming "Greenspan deficit" next year and markets could well push down the dollar and push up bond yields, thereby bursting the housing bubble...

"With inflationary pressures rising, the new Fed chairman will need to push short-term interest rates higher; there will be much less room to cut rates later, as Mr. Greenspan did after the stock market bubble burst in 2001…

"Would any sane person want this job?"

That's an excellent question. Although things look fairly calm on the surface, there are a number of different timebombs waiting to go off in our economy. Whoever is in charge of the Fed during the detonations will get blamed for the chaos.

So I've dedicated this issue to…

Did you make these five profitable trades this month? (See page 6!)

"Seven Reasons Why No Sane Person Would Want This Job." Reason One: Inflation is spiraling out of control.

The government's CPI (Consumer Price Index) is a complete sham. It excludes "non-core" costs like energy and food. (Apparently the government's hypothetical "consumer" doesn't need to eat or drive anywhere!) The true inflation number is much higher when these other costs are included.

Nevertheless, even these "massaged" numbers are showing swelling inflation. Over the last 12 months, the CPI is up 4.7 percent, and the PPI (Producer's Price Index) is up 6.7 percent. Import prices have jumped up 9.9 percent.

Despite efforts to whitewash our situation, government numbers show prices rising for a variety of common items in the past 12 months. Here are a few examples:

Consumer Item	Price difference
White bread	Up 6.8 percent
Electricity, per kwh	Up 7.1 percent
Flour	Up 7.2 percent
Ground beef	Up 12.1 percent
Ground roast coffee	Up 17.5 percent

And the overall trend is snowballing. Over the last three months, the CPI is up 9.4 percent, the PPI is up 14.8 percent, and import prices have leaped up by 20.5 percent (annualized numbers).

Reason Two: Employment is sagging

American jobs fell by 8,000 in September. October numbers were hardly better: up a mere 56,000. But that number includes 12,000 Boeing workers coming off their strike, and 33,000 construction jobs (many of which were created by the hurricanes).

The overall economy isn't creating any significant new employment. If this continues, it means we're heading for a recession.

Reason Three: Massive Debt Throughout the Entire Economy

The Federal Reserve tracks the "household debt-service ratio": the average percentage of household income that's eaten up by debt payments. It just hit an <u>all-time high</u> (13.55 percent). Then there's the "financial obligations ratio," which includes debt and other related expenses like automobile lease payments, rent, insurance, and property taxes. That number has hit a scary 18.36 percent.

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And this is when interest rates are still historically *low*. Once rates rise significantly, payments on adjustable-rate loans will soar. Consumers will be devastated, and we'll see a huge wave of bankruptcies.

Actually, that wave might already be starting. That's…

Reason Four: A Huge "Bankruptcy Bubble"

USA Today just ran an article entitled, "Size of Bankruptcy Bubble Surprises Banks." It said an "avalanche of petitions and the lines of debtors streaming out the courthouse doors" have overwhelmed bankruptcy courts. The bankruptcy laws were just changed, and many people wanted to file under the old rules. So in just 10 days in October, over 500,000 Americans filed.

That's about one-third of *all* filings in 2004. And tens of thousands of applications were still being processed weeks later, so we don't know the final figure.

The major banks will take a cumulative estimated loss of over a billion dollars. That's bad enough.

But many analysts think this wave of filings is only the beginning. As I mentioned last month, delinquent credit-card accounts are now almost 5 percent of all open accounts, an all-time high. Many observers think October's filings were just the beginning of a wave of defaults. As one CreditSights analyst observed in the *USA Today* article, "The undertone of credit quality is worsening."

Reason Five: The Real Estate Bubble

In many parts of the country, real estate prices have gone beyond outrageous, all the way to surreal. But lenders are continuing to inflate the bubble anyway.

According to the *Wall Street Journal*, mortgage standards have been loosened. Lenders are now accepting borrowers with lower credit scores, and are increasing the debt loads borrowers are allowed to carry.

A unit of J.P. Morgan Chase & Co. now offers loans that don't require income verification. Wells Fargo allows interest-only mortgages on investment properties. Washington Mutual is offering home-equity loans on investment condominiums. Other lenders have allowed housing debt/income ratios to increase from 38 percent to 45 percent, and also allow 90 percent loan to value for investment properties.

Historically, second-home and investment loans are far riskier than loans on primary residences, since it's much easier for borrowers to default on properties they don't live in. Lenders are not only inflating the bubble further, they're also opening themselves up to huge risks by easing requirements on these properties.

Many borrowers are barely able to qualify for loans even with the looser standards. U.S. Bank says interest-only mortgages and incomplete-documentation loans are now 10 percent of their business. (Last year they were only 4 percent.) Borrowers usually don't take these loans unless they're unable to qualify for more conventional mortgages. So these borrowers are hanging on by their fingernails, and once rates go up, we're going to see a wave of foreclosures.

A few bankers admit they're flirting with catastrophe. A Washington Mutual executive said, "Risks are starting to increase with the very, very rapid price escalation we have seen." But bankers claim they're being forced to loosen their standards,

As I write this, oil executives are getting grilled in Congress for "unfair profits." It's the 1970s all over again.

We might even see the reinstatement of price controls and windfall profits taxes. Those were an utter disaster last time, and will be again if politicians are stupid enough to try them now.

The whole concept of "excessive profits" is offensive to a free-market thinker, but in this case it's even more ludicrous. Exxon Mobil's recent profit as a percentage of sales is 9.9 percent. ConocoPhillips is less, at 7.65 percent.

On the other hand, Microsoft is making a 32.3 percent profit on sales. Why isn't Bill Gates being dragged into Congress to testify about *his* "unfair" profits?

And what about all the other profitable companies in various industries? There are lots of companies making more than a 9.9 percent return on sales.

But there I go again: expecting our politicians to actually have brains…

Latest prices as GEA goes to press—November 14, 2005

Comex spot contract: silver $7.77, gold $468.55
Nymex spot platinum: $970.00, palladium $248.00
Nymex Light Sweet Crude Oil $57.81

Silver coins		Dealer will buy at this price	Dealer will sell at this price
100 1 oz. silver American Eagles		$850	$980
100 1 oz. common rounds		$777	$920
$1,000 face value US pre-1965 coin bag (circulated)		$4,950	$5,950
$1,000 face value US circulated silver dollar bag (VG or better)		$8,700	$9,400
US Morgan silver dollars	PCGS MS64	$38	$54
	PCGS MS65	$90	$150
	PCGS MS66	$280	$360
Platinum coins			
U.S. Platinum Eagle:	1 oz.	$970	$1,250
	1/2 oz.	$485	$625
	1/4 oz.	$240	$425
	1/10 oz.	$105	$150
Gold coins			
Australian Kangaroo		$460	$525
British sovereign (Kings)		$100	$150
(Elizabeths)		$100	$150
Canadian Maple Leaf		$460	$520
Credit Suisse 1 oz. gold bar		$460	$520
Mexican 50 peso Centenario		$540	$620
South African Krugerrand		$460	$510
US Gold Eagle:	1 oz.	$475	$540
	1/2 oz.	$220	$320
	1/4 oz.	$110	$170
	1/10 oz.	$49	$70
US $20 double eagle:			
Liberty	Raw MS60	$490	$580
	NGC MS63	$720	$875
	NGC MS64	$1,150	$1,750
	NGC MS65	$4,150	$5,250
Saint Gaudens	Raw MS60	$500	$600
	NGC MS63	$600	$750
	NGC MS64	$700	$850
	NGC MS65	$1,200	$1,350

Prices courtesy of Finest Known, Boca Raton, FL. (800) 806-3468.

to compete with other loan companies that have already done so.

Once the bubble bursts, how quickly could everything implode? A lot faster than we'd like to think. We can look to the United Kingdom for a preview.

Lots of people in the UK took out low-rate adjustable loans in 2003. This year, the initial period was over, and the rates were adjusted. Now the borrowers are defaulting *en masse*. A recent report described a whopping 66 percent rise in repossession orders. (London alone had an 81 percent jump.) Real estate bubbles can pop very quickly.

The Fed has been jacking up short-term interest rates, but long-term rates haven't moved much. Once long-term rates rise, there's going to be a bloodbath in U.S. real estate.

Reason Six: Massive Trade and Current-Account Deficits

As I write this, the Commerce Department has just released its September figures. Our monthly trade deficit is up to $66.1 billion. We're on track for a yearly figure of $706.4 billion, an astronomical figure that would shatter previous records.

Some analysts are making soothing noises, attributing this number to the high cost of oil. Yes, some of the deficit *is* due to oil (which has come down a bit since September). But so what? We were hitting deficits of almost $60 billion per month even *before* the hurricanes made oil spike upwards. That's $60 billion bleeding out of our country every month into the accounts of foreigners. And much of the deficit isn't from oil anyway. For example, China alone accounted for $20.1 billion of our deficit (also a new record), and we don't buy any oil from them.

Even Greenspan is finally trying to sound the alarm, in his own way.

He told Congress, "Federal spending on health and retirement programs…risk placing the budget on an unsustainable trajectory. Unless the situation is reversed, at some point these budget trends will cause **serious economic disruption**."

For a man noted for his incomprehensible mumbly-mouth statements, this is the equivalent of jumping up and down and screaming.

Reason Seven: "Drunken Sailor" Government Spending

Many voters are outraged at the current administration's spending, and with good reason.

Both houses of Congress, and the Presidency, are controlled by the party that claims to champion limited spending. Whatever your politics, that claim has now been shown to be a complete lie.

Our supposedly "conservative" President has never vetoed a spending bill. According to the Citizens Against Government Waste, the fiscal 2005 appropriations bills included no less than 13,997 pork projects (an increase of 31 percent over last year's total of 10,656).

And the current administration signed them all into law.

Let's look at some of the more outrageous examples. There's an island in Alaska (Gravina Island) with a population of less than 50. Occasionally, someone from the neighboring metropolis of Ketchikan (pop. 8,000) needs to get there, and they do so by taking a 7-minute ride on the ferry. (Ferry tickets are $6 for a car, $4 for a pedestrian.) But our politicians decided this ferry isn't good enough for this overwhelming amount of traffic.

So in its infinite wisdom, Congress has decided (with the President's approval) that you must help to pay for a new bridge to Gravina. It will be almost as long as the Golden Gate bridge, and higher than the Brooklyn Bridge. The cost: $315 million, which is $23,649 per local resident. (We could buy each resident a lifetime supply of ferry tickets, say 1,000 of them at $6 each, and still save $235 million!)

But that's not the only new bridge Alaska "needs." You'll also pay your share of $231 million for a causeway connecting Anchorage and Port MacKenzie. By the way, this thriving "port" has exactly one resident, and consists of a "500 foot bulkhead" in the midst of 8,000 acres of swamps (with a few spots of dry ground here and there).

In just one transportation bill, Alaskan Rep. Don Young stole $941 million of our tax dollars for these "bridges to nowhere" and other useless projects. (Compare this to a 2005 report by the Institute of Transportation Engineers, which said a similar amount of money could improve *every* traffic light in the country, reducing congestion by up to 40 percent.)

> **"We have lost control."**
>
> *Alan Greenspan, describing the American deficit to the French Finance Minister*

And this bill is only one among thousands of pork-barrel projects the government is funding. Here are a few examples:

- $2,300,000 for "animal waste management" in Bowling Green, Kentucky. (Can't they shovel their *own* manure?)
- $100,000 for the Trees Forever Program in Iowa, which teaches people about "the type of injuries trees can sustain during the winter from heavy loads of ice and snow."
- $250,000 for "asparagus technology and production," including language asking the USDA to buy more asparagus.
- $6,285,000 for "wood utilization research."
- $100,000 for the Go-Girl-Go Program in New Hampshire, which among other things teaches girls how to skip rope.
- $1,000,000 to install radios in the police cars in Southaven, Mississippi. (National taxpayers have to pay for this?)
- $5,791,000 for the East-West Center in Hawaii, which has important exhibitions like "Monkeys: Myth, Magic, and Mischief in the Arts of Asia," and nationally significant performances like "Huun Huur Tu: Throat Singers of Tuva."

And there are many more examples like this—thousands of them. So it's little surprise that our national debt is soaring…

Last month, U.S. Government debt exceeded $8 trillion for the first time!

As the new Chairman of the Fed, government spending would be beyond Bernanke's formal responsibilities. But the Chairman has tremendous power and influence: he could easily use his public position to shame the government into more responsible finances, at least partially anyway. Greenspan hasn't, but Bernanke could.

Even the politicians themselves know this. That's why Sen. Charles Schumer (D-NY) told Mr. Bernanke that the next Fed chairman should be "a cheerleader or jawboner to prevent our deficit from getting any worse."

New Recommendations and Portfolio Update

I've issued well over a dozen e-mail Updates since our last monthly issue.

These are a major part of your *GEA* membership. If you haven't signed up to receive them, here's how to do it: Go to the *GEA* site at www.goldandenergyadvisor.com. Click on "Member Login" on the left, then click on "Update Account Information." Enter your member information, and you'll then be able to enter or update your e-mail address.

As you'll see in a moment, sometimes we enter a position and then take profits in a matter of weeks, even days. If you're not receiving the Updates, you're missing these opportunities.

As the market establishes a new trading range, we will be buying on pullbacks and hedging on rallies. One of the hedges that we have increased is writing calls on our positions. This strategy lowers the cost of our positions, lowers the volatility of our portfolio and enhances our returns. Here are the recommendations I've issued recently:

Positions Opened and Closed

- EnCana: We sold puts at $3.50, then bought them back at $2.85 two weeks later. For every contract you sold, you made $65.
- Cabot Oil & Gas: We sold puts at $2.60, then bought them back at $1.00 after 13 days. For every contract you sold, you made $160.
- XTO Energy: We sold puts at $2.80, then bought them back at $.45 after 13 days. For every contract you sold, you made $235.
- XLE: We bought puts on the XLE at $2.55, and sold 6 days later at $2.90. Our profit: 13.72%

Open Positions Now Closed

- EOG Resources calls (EOGJM): We bought back our calls at a wash.
- Murphy Oil calls (MURAG): We sold at $11.50. Our profit: 15% in 20 days

Newly Opened Positions

We reduced our cost basis in a number of stocks by hedging. If you own the following stocks, here are the hedges we recommended:

- Anadarko Petroleum: sell the December 95 calls (APCLS) for $2.80
- XLE: sell the December 50 calls (XBTLX) for $1.70.
- Cimarex Energy: sell the December 40 calls

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I thought this was a fascinating revelation. Here's a U.S. Senator—one of the people that write and vote on government spending bills—essentially admitting that he, and all of his colleagues, are completely helpless to stop their wild spending binge. Instead, he's reduced to pleading for help from someone whose job, at least technically, has nothing to do with government spending.

Unfortunately, Mr. Bernanke replied that "at the Fed he would not comment on non-monetary matters."

That's why many observers are noting that…

Bernanke is the Wrong Man for the Job

As the *Economist* points out, "Four years ago, Ben Bernanke was a professor of economics at Princeton whose policymaking experience consisted of a stint on the local school board. On February 1st, barring any unforeseen hiccups in his Senate confirmation, he will become the most powerful central banker in the world, replacing Alan Greenspan as chairman of the Federal Reserve Board."

But how suitable is Bernanke for this position?

With a profligate government, record trade and current-account deficits, soaring inflation, and other problems, we need a Chairman like Paul Volcker was. Someone who's unafraid to do whatever it takes to fix our national problems. You might remember his policies were painful, but he rescued the American economy from the brink of runaway inflation.

Instead, we're getting a Chairman who says our massive imbalances aren't the result of overspending. Instead, they're from a "global saving glut." (Apparently foreigners are too conservative with their money: they insist on actually *saving* part of what they earn, instead of blowing it all on the latest American consumer goods.)

We're getting a Chairman whom the *Economist* describes as "nonchalant about the scale and cause of America's external imbalances."

We're getting a Chairman who has "little appetite for trying to burst stock-market or real-estate bubbles," according to the *Wall Street Journal*. (Indeed, you can blame Bernanke for part of the stock bubble and crash in 2000-2001. Back in 1999, he had co-authored an influential paper arguing that the Fed should do nothing about asset bubbles.)

Perhaps worst of all, we're getting a Chairman who says, "My first priority will be to maintain continuity with the policies and policy strategies established during the Greenspan years."

Let's see…a continuation of Greenspan's policies. What does that mean?

First of all, it would mean he won't make a peep as our national debt grows even more monstrous. When Greenspan became Chairman in 1987, our national debt stood at $2.35 trillion. In the 18 years since then, "Easy Al" has stood by while it exploded up to $8 trillion. Indeed, his Fed even injected huge amounts of liquidity into our economy at various times.

Again, although he didn't vote on the spending bills that created this debt, he certainly didn't use his position to prevent it. Actually, the opposite is true: when the rest of the world refuses to lend our government the money for its pork projects, the Fed steps in and "monetizes the debt" (i.e., creates the money out of thin air and lends it to the government) instead.

Which is a good segue to another of Easy Al's legacies: the massive amount of dollar inflation. The M3 money supply stood at $3.6 trillion when Greenspan took over the Fed. It's now approaching $10.5 trillion. So the money supply has almost *tripled* during his tenure.

Again, the Fed itself has created a lot of these dollars with its "magic checkbook." (The one that creates the money for each check as it's written, with no limit on the amount, ever. Wouldn't *you* like to have a checkbook like this?) Each time the Fed buys another government bond, the money supply balloons by that amount.

Of course, more dollars popping into existence means there are more dollars chasing existing goods and services. That's the textbook definition of inflation.

And that's why inflation, even as measured by the "massaged" CPI figures, totals 75 percent since Greenspan took office. According to the Bureau of Labor and Statistics, you'd need $1.75 today to buy the same item costing $1.00 in 1987.

Can we expect lower inflation in the Bernanke era? Not a chance.

In fact, Bernanke is notoriously soft on inflation, thanks to a now-infamous speech he gave in 2002 to the National Economists Club. He said:

"Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the

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(XECLH) for $2.05.

- Apache Corp.: sell the November 65 calls (APAKM) for $1.45.
- Talisman Energy: sell the December 50 calls (TLMLJ) for $1.80.
- Pioneer Natural Resources: sell the November 50 calls (PXDKJ) for $2.30.
- Encore Acquisition: sell the December 40 calls (EACLH) for $2.10.
- Noble Energy: sell the December 40 calls (symbol NBLLH) for $2.20.
- EOG: sell the December 75 calls (EOGLO) for $2.00.

Positions That We Modified

- Devon Energy (DVN): We bought back our existing October 50 calls (DVNJJ), and sold the January 55 calls (DVNAK). We paid about $2 net to give us more time and $5 more upside on the stock.
- Conocophillips (COP). We bought back our November 70 calls (COPKN) and sold December 65 calls (COPLM). Our net was $3.60.

Oil Stock Outlook

Thanks to high prices, oil demand has slowed down. This has brought energy prices down a bit.

The conservative perspective on the market is that we've probably seen the peak of oil prices for a while. We're reaching the end of an economic growth cycle, and I expect demand will be suppressed for 12-18 months. After that, we'll enter the next growth cycle, and oil stands a good chance of reaching $100.

I expect oil stock earnings to be good into the first quarter of 2006, although not quite as good as we're seeing right now. After that, for the remainder of 2006, I'm anticipating stocks will trend sideways. Short-term trading will play a larger role in our portfolio.

Having said that, there's always the chance of nasty surprises. A plunge in the dollar could send oil soaring, as would a number of other events. There are lots of political "wild cards" in the world right now, waiting to be played. And many of them could easily trigger violent reactions in energy prices.

So we'll stand ready to take advantage of whatever opportunities arise!

number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

He spoke approvingly of Franklin Roosevelt's 40 percent devaluation of the dollar in 1933-34. (The fact that Roosevelt stole the gold of American citizens to do it, and the unconstitutionality of the whole incident, doesn't seem to bother Bernanke.)

He also spoke approvingly of economist Milton Friedman's "helicopter drop" idea: stimulating consumer spending by flying over the landscape and throwing bucketfuls of money out the window.

Ever since that speech, Bernanke has been known as "Helicopter Ben." (Which I suppose is better than being known as Mister "Devaluing the Dollar By 40 Percent In One Year Is A Good Policy Tool.")

This is the man appointed to control inflation and our money supply once Greenspan leaves? We're in serious trouble.

As famed analyst James Grant wrote in the *New York Times*, "In the Greenspan era, the United States became an immense net debtor. A prudent American central banker, it might seem, would therefore be at pains to spare these overseas accumulators of greenbacks any unnecessary anxiety about inflation damaging the shelf life of their money. Not Mr. Bernanke. In that 2002 speech, he said that because the currency is intrinsically worthless, the government can (and in certain circumstances should) print up as much of it as it wants. And it should not be stymied in the work of restoring the rate of inflation to a decent minimum even if interest rates fell to zero."

Nope, No Sane Person Would Want This Job

Returning to our earlier theme: even if Bernanke was the right one for the job (which he's not), no sane person would want it anyway.

The next Fed Chairman will not be treated kindly by history. He'll be blamed for the economic shipwreck that's coming. As *USA Today* noted in its article, "New chairman faces gathering storm":

"He will have the misfortune of taking over just as a fiscal storm largely beyond his control is gathering strength…When the nation's leaders are intent on spending beyond the government's means, handing out ill-advised tax cuts without matching spending cuts and ignoring the looming demographic challenges that threaten Social Security and health care, it's hard to see what the monetary policymakers at the Fed can do to avert an economic train wreck…

"The fiscal challenges facing the nation are so acute, and the resolve of politicians to address them so weak, that Bernanke would do well to amplify concerns that Greenspan has begun to cite…The federal government is edging perilously close to a debt crisis…All told, the U.S. economy accounts for about $25 trillion of red ink when governments, companies, and individuals are totaled. That's triple the debt of 18 years ago when Greenspan took office."

Or, as the *Economist* delicately put it: "The new boss of America's Federal Reserve will need a lot of luck."

Bernanke: Doom for the Dollar, Great for Gold

I've been pounding the table about gold in these pages, and for good reason. It's almost doubled in the past few years, and is still undervalued when considering the economic problems ahead.

Unlike many, I'm not a knee-jerk "goldbug." There are times to invest in gold, and times to disinvest.

If we had received a new Chairman in the mold of Paul Volcker, I was prepared to re-think gold's prospects in the coming years. A Chairman who clamped down on dollar inflation would be bad news for gold. (You might remember how hard gold fell under Volcker's drastic anti-inflation measures.)

But that's not the case now. In fact, the opposite is true. "Helicopter Ben" seems prepared to inflate the dollar fast and hard, whenever he thinks it's appropriate. In his speech, he recommended the Fed act "preemptively and aggressively" when fighting economic trouble, taking action even *before* the potential problems actually appeared.

This is bad news for dollar bulls, but great news for gold. It also means support for continual high energy prices over the long term.

In short, Bernanke's appointment fits right in with our investment objectives in the *Gold & Energy Advisor*. Our portfolio's long-term outlook has never looked brighter. Stay tuned!