GOLD & ENERGY ADVISOR

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"The Fed Takes Action! This is *Great* News for Gold and Energy!"

"Even as the dollar hits record lows against the Euro… even as oil soars up to $83, and gold shoots up into the $700s… the Fed lowers interest rates. Everybody knows this will kill the dollar. So why would they do such a thing?

"Because they don't have a choice. Here's what the mainstream media aren't telling you!"

James DiGeorgia, Editor

- **Why the stock market is gyrating up and down**
- **The subprime fiasco: not over 'til mid-2008**
- **How the Fed has changed the investing climate, and the best way to respond**

This summer has been a gut-churning ride in the markets.

Most financial commentators in the media are making soothing noises now. The disruptions are over… or so they tell us.

In reality, things are different. The underlying causes of this summer's chaos haven't been solved. In fact, they're going to get *worse* next spring.

In this issue, I'll discuss the real reasons for the recent disruptions. I'll also discuss why the Federal Reserve's recent actions are great news for the *GEA* portfolio!

First, let's look at exactly what's going on in the markets…

Another Bursting Bubble

You've probably heard that subprime mortgages are the underlying cause of today's market chaos. This is true, but they're only a symptom of the real problems.

First of all, subprime mortgages—loans to borrowers who can't qualify for more traditional mortgages—are obviously more risky than conventional loans. By some estimates, up to 20 percent of all current subprime loans will end in foreclosure.

Up until a few years ago, lenders were (correctly) reluctant to make these loans. Subprimes were only a small part of the loan market, and when they did occur, the borrowers were charged higher rates of interest to compensate for the additional risk.

A few decades ago, most lenders retained and serviced their own loans, and bore the risk of default. Therefore, they were very conservative in the loans they made.

Of course, that's no longer the case today. Most lenders sell their loans to investors, who then assume all the risk. As a result, until recently, subprimes were sold at a substantial discount to conventional loans—and rightly so.

THE GOLD AND ENERGY ADVISOR

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Today's problems began a few years ago, when some bright spark on Wall Street figured out how to "launder" loan quality. Loans can be rated anywhere from low-risk AAA notes all the way down to high-risk C mortgages. Obviously, AAA-rated debt is more desirable than a C-rated note, all else being equal.

Loans are usually pooled together, sliced and diced into different ratings, and then recombined. But here's the important part—somebody came up with a computer model that said these combinations, if they were diversified from different sources and structured in a certain way, had lower risks of default than a pool from a single source.

For example, using this model, a bunch of BBB rated loans could be recombined into a package with a rating of 75 percent AAA, and 12 percent AA. Only 4 percent of the package's capital structure would be rated BBB—even though *all* of the underlying loans were BBB.

Well, this was a tremendous opportunity for Wall Street's wizards. Suddenly, they could justify all sorts of shenanigans. Suddenly, huge pools of garbage-quality loans were being repackaged into investment-grade bundles.

Just imagine the money to be made if you could buy junk debt for cheap, quickly repackage it into "high grade" paper, and sell it for high-grade prices. That's the party that's been going on in Wall Street, and it's been a *very* wild party indeed...

Until the cops showed up!

The subprime game was so obscenely profitable that a huge credit bubble formed.

Lenders started making loans to anybody who could sign a contract. Adjustable-rate "teaser" loans were made to people who couldn't afford the higher interest rates that would kick in a few years after closing. Apparently, many of these borrowers didn't realize what would happen after those years had passed. The remaining borrowers were apparently hoping that their homes would rise high enough in value to bail them out. After a couple of years, they planned to sell their homes, or refinance into lower-rate loans, before the teaser rates evaporated.

Of course, you know what happened next. The housing market started to soften a couple of years ago, and real estate prices aren't shooting up any-more. In some places, they've fallen significantly instead. Now these subprime buyers have been getting new, higher interest rates that they can't afford—nor can they refinance, or even sell, their homes.

So they have been defaulting on their loans.

When a home buyer defaults, the investor who bought the loan takes the hit. The problem here is that lately, these investors didn't *expect* to get hit. They thought they were buying conservative investments. In many cases, the buyers of these loan packages were Asian or European institutions who bought AAA-rated paper—the highest possible grade. They didn't examine the paper's contents too closely, and why should they? After all, the paper was graded by Wall Street's most-trusted ratings agencies, right?

Over and over again this summer, investors have thought they owned conservative investments, only to discover…

They actually owned a big, steaming pile of you-know-what instead.

They thought they were buying blue chips. Instead, they got cow chips.

Here's why this has hit the markets so hard. Many of the loan buyers were hedge funds—investment pools limited to wealthy investors. These people demand exorbitant returns on their money. So, to satisfy their clients, hedge fund managers have to make exorbitant profits.

As it turns out, subprime loans pay pretty well, when compared to other forms of debt. For example, while a Treasury bond might get you only 5 percent, a subprime loan might get you 8 percent. Thus, these have been popular among hedge funds, especially since the loans were graded as investment quality.

Of course, a typical hedge fund investor scoffs at an 8 percent return. He expects double-digit returns, at least. So the managers have used leverage any way they could—lots and lots of it.

For example, one popular form has been the yen carry trade. Thanks to Japan's ongoing economic woes, you can borrow yen at only 1 percent or so. Obviously, this presents a great opportunity—you can borrow yen at 1 percent, and invest it at a higher rate. Later, you pay back your loan plus the 1 percent, and keep the difference.

So let's say a hedge fund manager has $10 million to invest. If he buys subprime loans directly, he might make 'only' 8 percent. And his investors would flee his fund faster than a Senator from an ethics investigation.

However, if he borrows another $20 million in yen, and then buys a full $30 million in loans, he makes $2.2 million (net after the interest on the loan). So, thanks to the yen carry, he's pumped up his returns from 8 percent to 22 percent. Now his fund has investors beating down his door to get in.

Again, this all works great… until the subprime loans start to default. Suddenly, everybody wakes up and realizes that even "investment grade" paper can be contaminated with these loans. Suddenly, the price of debt paper plunges.

In the last few weeks, we've seen subprime paper get devastated. BBB-rated bundles have fallen by 60 percent. A-rated is down by 50 percent, and AA by 25. Even AAA fell by 10 percent.

Now the leverage that worked in the hedge funds' favor starts to work against them. In the example above, the manager doesn't own only $10 million of these loans. He owns $30 million instead. Let's say he had bought the most "conservative" paper available, AAA. Suddenly, he's lost 10 percent of $30 million, or $3 million—a full 30 percent of his fund's capital.

If he had been a little more ambitious and bought AA paper instead for a higher return, he's now lost $7.5 million—*three-fourths* of his fund's capital.

That's why the Dow and other indices plunged this summer. The hedge funds got absolutely pounded, and had to sell other assets (stocks, bonds, etc) to raise capital.

So that's what's been going on. Now let's look at…

Why this will continue for at least another year.

The trigger for this whole fiasco was a wave of defaults in subprime loans.

Everybody seems to think this wave is over. But it's actually just beginning.

The mortgage industry tracks loan resets: the time when a loan converts from its initially low teaser rate to its full, market-driven rate. When the reset happens, a borrower's payment usually shoots way up. (You've probably seen stories in the

Latest prices as GEA goes to press—September 24, 2007

Comex spot contract: silver $13.41, gold $732
Nymex spot platinum: $1,331, palladium $338
Nymex Light Sweet Crude Oil $82.00

Silver coins			Dealer will buy at this price	Dealer will sell at this price
100 1 oz. silver American Eagles			$1,375	$1,450
100 1 oz. common rounds			$1,340	$1,440
$1,000 face value US pre-1965 coin bag (circulated)			$8,700	$9,700
$1,000 face value US circulated silver dollar bag (VG or better)			$10,900	$11,700
US Morgan silver dollars	PCGS	MS64	$46	$54
	PCGS	MS65	$120	$140
	PCGS	MS66	$240	$260
Platinum coins				
U.S. Platinum Eagle:		1 oz.	$1,340	$1,400
		1/2 oz.	$670	$700
		1/4 oz.	$335	$350
		1/10 oz.	$138	$148
Gold coins				
US Gold Eagle:		1 oz.	$745	$775
		1/2 oz.	$373	$385
		1/4 oz.	$187	$200
		1/10 oz.	$75	$85
US $20 double eagle:				
Liberty	Raw	MS60	$760	$825
	NGC	MS63	$860	$925
	NGC	MS64	$1,400	$1,500
	NGC	MS65	$3,700	$4,200
Saint Gaudens	Raw	MS60	$740	$790
	NGC	MS63	$860	$925
	NGC	MS64	$900	$975
	NGC	MS65	$1,300	$1,400

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media about people losing their homes after their payments soared by hundreds of dollars a month.)

Thanks to the credit bubble, lenders originated huge numbers of adjustable rate loans in the last couple of years. We're now in the middle of the time when these "bubble loans" are resetting.

But it turns out that these resets are far from over. In fact, there are a lot more coming than what we've seen so far.

Here are the expected resets for 2007-2008:

Month	Resets (in billions)
2007: January	$22
February	$25
March	$35
April	$37
May	$36
June	$42
July	$43
August	$52
September	$58
October	$55
November	$52
December	$58
2008: January	$80
February	$88
March	$110
April	$92
May	$76
June	$75
July	$50
August	$35
September	$26
October	$20
November	$15
December	$17

Source: John Mauldin, SafeHaven.com

Through last month, we've seen $292 billion in resets so far in 2007. There's another $223 billion due in just the last four months of the year.

Next year, it gets even worse. The first six months of 2008 alone will have more resets than *all* of 2007 combined.

That's why I said this problem will continue into next summer. Actually, that's a conservative outlook—it will take longer than that to work itself out. Borrowers don't usually default immediately when a loan resets—they usually try to struggle along and make the new payments for a few months before giving up.

By this point, you might think this won't affect you. If you weren't in the markets when they went down, you might be feeling insulated from all this.

Well, you're not. None of us are. Before I explain why, let's look at…

How the housing market has propped up the entire US economy

Consumer spending accounts for about 70 percent of the US economy. And what has driven consumer spending for the last several years? Real estate—especially residential housing.

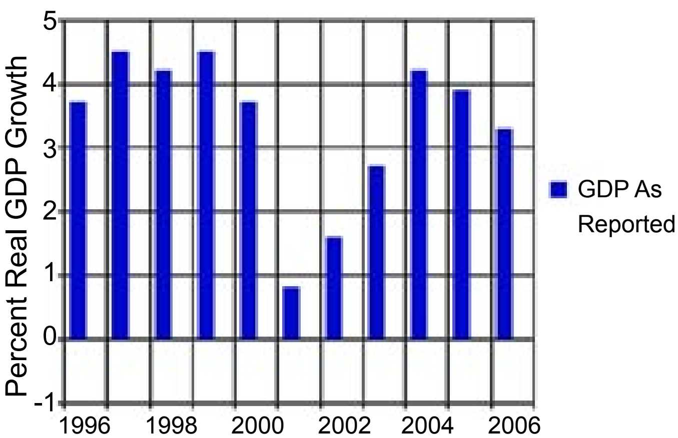
First of all, let's recognize that the US housing market is being dealt a huge blow. By some estimates, about half of those mortgage resets will result in foreclosure. After all, most of the borrowers will be unable to roll them over into new loans. They won't have enough equity for conventional loans. (In fact, many have *negative* equity right now—they owe more than their homes are worth.) And they won't be able to get another subprime loan, since the subprime aftermarket has seized up hard.

So there's a big wave of foreclosures coming, which will depress real estate prices nationally. In fact, there will probably be several big waves. As each one occurs, it will batter housing prices, which will sink more homeowners underwater on their loans, which will encourage more foreclosures.

Not every region will be hit, of course. But overall, the US market will be hammered for the next couple of years.

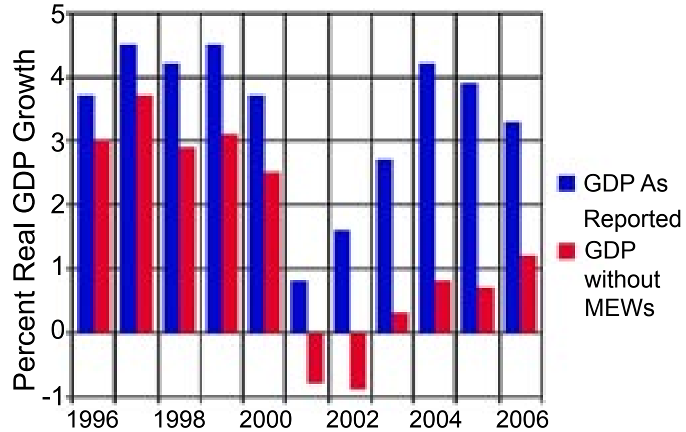
Obviously, flat or falling prices mean less home equity. In turn, this means fewer home equity loans. And this is very bad news, because home equity loans have been *the* driving force behind consumer spending.

Look at this chart of recent GDP (Gross Domestic Product):



According to most reports, our GDP is robust. Therefore, our economy is healthy.

But is it really? Let's take a look at the GDP, but without the effect of mortgage equity withdrawals:



Source for charts: Calculated Risk (calculatedrisk.blogspot.com)

MEWs (mortgage equity withdrawals) represent money withdrawn from home equity and spent into the economy.

Without this spending, real GDP looks awful. In fact, without MEWs our economy would have been officially in recession for two of the last seven years, and barely gasping along for the remaining five.

Of course, the government is well aware of our economy's dependence on MEWs. In fact, the MEW information comes from an economist you've probably heard of before. His name is Alan Greenspan.

Along with Fed economist James Kennedy, Greenspan has studied the MEW situation closely since leaving his position with the Fed. Together, the two have published several research papers on the subject.

This is one of several reasons why I believe…

The government will do everything possible to prop up the housing market!

If the housing market goes down, the US economy goes down with it.

We know it, and the government knows it. And the government will do anything possible to prevent this—especially because there's a Presidential election next year.

When the most powerful office in the world is up for grabs, the group in power will do anything and everything to keep that power. An economic meltdown in 2008 would be disastrous for the Republicans. So they'll do everything they can to prevent it.

Therefore, I expect to see Fannie Mae and Freddie Mac loosen their standards. I also expect to see banks working with borrowers to avoid defaults. (Some of this is happening already.) Various forms of legislation are also possible. Basically, anything the government can do to help the housing market, it will do.

However, the government's actions will be inadequate. The real "juice" to the economy can come from only one source: the Federal Reserve.

All by itself, the Fed has the power to create or destroy liquidity. All by itself, the Fed can lubricate the markets, or make them seize up.

The only question is whether or not the Fed is willing to do it or not. And that's why it's so interesting that…

Fed officials have promised to "aggressively" support the housing market!

For example, the *Financial Times* reported a recent speech by Fed governor Frederic Mishkin, who "**argued for a rapid and aggressive monetary policy response** to any fall in house prices." (The bold text is in the original.)

Also, the Federal Reserve's website talks about the impact of falling housing prices, and warns:

"Exceptionally unfavorable conditions in the housing sector have the potential to create instability in the financial system—instability that could magnify problems for the overall economy…

"Because fluctuations in house prices affect the economy, we have seen that managing the economy well requires that the monetary policy authorities respond to changes in house prices. The issue of how central banks might respond to house price movements is therefore *not* whether they respond at all but whether they respond *over and above the response called for in terms of objectives to stabilize inflation and employment*." [emphasis added]

The document concludes with the recommendation that the Fed lowers the federal funds rate "more aggressively and substantially faster" than it historically has.

This isn't just talk, either. Just in the last month or so, we've seen the Fed do the following:

- **Massive injections of liquidity.** On August 9 and 10 alone, the Fed injected $62 billion dollars into the US financial system. Huge sums of money were created out of thin air and dumped into our economy.
- **Openly propping up the markets**. On Friday August 10, the Fed bought $38 billion of bonds. This is a large amount, but not too unusual… except that these bonds weren't US Treasuries. They were mortgage-backed bonds *only*. Yes, the Fed is now *openly intervening* to support prices of certain assets.

Portfolio Update

In Update #388, we took profits on our position in our Oil Futures ETF (symbol USO). We made a 15.68% profit in about 3 1/2 months.

In Update #390, we issued instructions for subscribers who own the Jan. $30 calls on Plains Exp. & Prod. Co. (PXPAF). We lowered our costs by legging into a spread. We sold the Nov. $45 calls (PXPKI) for $1.40.

In Update #392, we issued instructions for subscribers who sold short the Anadarko Petroleum September $50 Put (APCUJ). We bought back the put, making $155 profit for each contract.

In Update #393, we issued instructions for subscribers who sold short the S & P Oil and Gas Exploration and Production ETF Sept. $43 Puts (XOPUQ). We bought back the put, making $90 profit on each contract.

In Update #395, we issued instructions for subscribers who own Pioneer Natural Resources (PXD). We sold October $45 calls (PXDJI) for $1.50. This reduced our cost basis in the stock.

In Update #397, we issued instructions for subscribers who have September $75 calls on ConocoPhillips (COPIO) and September $70 calls on Devon Energy (DVNIN). We rolled up the COPIO calls to the November $75 calls (COPKO). We also rolled up the DVNIN calls to the October $70 calls (DVNJN). These actions reduced our cost bases in both stocks.

In Update #398, we issued instructions for subscribers who have September $35 calls on Cimarex Energy (XECIG), and September $25 calls on Encore Acquisition (EACIE). We rolled up the XECIG calls to the October $35 calls (XECJG). We also rolled up the EACIE calls to the December $25 calls (EACLE). These actions reduced our cost bases in both stocks.

- **Violating safe banking practices**. On August 20, the Fed allowed Citigroup and Bank of America to lend up to $25 billion each to their brokerage affiliates. By regulation, federally-insured banks like Citibank and BofA were restricted in their ability to fund brokerages—they were limited to just 10 percent of their capital. But not any more. For example, $25 billion represents about **30 percent** of Citibank's capital. *Fortune* magazine said this was exemption from regulations was "disturbing," and explained: "One of the central tenets of banking regulation is that banks with federally insured deposits should never be over-exposed to brokerage subsidiaries; indeed, for decades financial institutions were legally required to keep the two units completely separate." (As an example of why this is necessary, think back to Barings Bank, which was destroyed in 1996 by the actions of a single trader.) Nevertheless, the Fed is now willing to breach even this wall of safety to accomplish its goals.

There are other examples of recent Fed intervention besides these. Obviously, the Fed *is* acting to prop up the markets, and will continue to do so.

So What Does This Mean?

Back in March, Fed Chairman Ben Bernanke made this comment to Congress:

"At this juncture, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained."

This statement seems laughable now. And the Fed has been also stung by recent accusations like this one from Morgan Stanley's Stephen Roach:

"For the second time in seven years, the bursting of a major-asset bubble has inflicted great damage on world financial markets. In both cases—the equity bubble in 2000 and the credit bubble in 2007—central banks were asleep at the switch…. Central banks have failed to provide a stable underpinning to world financial markets and to an increasingly asset-dependent economy."

Now Bernanke and his fellow Fed officials are gritting their teeth. They've determined that from now on, they will act decisively, "aggressively," and even *preemptively* to prop up the economy. (Their recent rate cut was done to "forestall" problems. They're no longer reacting to events—now they're trying to drive them.)

Also, the Fed has said specifically that it should, and *will*, act to protect housing prices. Apparently, they share the fears of Alan Greenspan himself, who warned back in March: "If [housing] prices go down, we will have problems—problems in the sense of spillover to other areas." Fed officials believe these problems must be prevented <u>at all costs</u>.

So what does this mean? It means the Fed will do whatever it takes to support the housing market…

Even if the dollar gets torpedoed!

Lower interest rates make the dollar less attractive to investors. It also increases the numbers of dollars in circulation (since loans increase, and banks can create money to fund these loans). Inflation swells as a result.

The upshot is that lower rates make the dollar's value fall. This is why the Fed would normally be raising rates right now, not lowering them.

Think about our current situation:

- The dollar just set a *new record low* against the Euro.
- Oil is at all-time highs.
- Gold is in the mid-$700s.

The dollar is *weaker than it's ever been in history*. It needs a spike *upwards* in rates, not a half-point cut. But a cut is what it got.

The Fed is trapped. Right now it has to make a choice: either support the dollar and hurt the housing market, or *vice versa*. For all the reasons we've discussed in this issue, it has to support the housing market.

Which means…

The dollar is going down.

There are three possibilities ahead of us. In its actions, the Fed will undercompensate, overcompensate, or keep the game going as it was before. Let's look at each one.

Undercompensation. The Fed might not do enough to prop up the markets, and we would see deflation and a recession. I don't think this will happen. We're already seeing Bernanke's determination to "forestall" problems instead of waiting until they happen. And don't forget, "Helicopter Ben" has said the government could use the printing press to print its way out of any deflation.

So I think it's much more likely that we'll see…

Overcompensation. The Fed might ease too much. This means inflation would shoot up.

Or it will be "just right." Ideally, the Fed would like to stimulate the economy just enough to offset the housing market's woes. If they managed this, it would mean a continuation of the economic conditions we've seen over the last few years.

So which will it be?

My prediction for the future

As I said, I'm not worried about the Fed under-easing the economy. I think we'll see either over-compensation, or a continuation of the status quo.

If the Fed overcompensates, we'll see the dollar sinking even faster than it has the last couple of years. Oil and gold will be *great* investments!

Even if they somehow manage to continue the status quo, I expect gold and energy will still be great investments. Don't forget, gold has almost doubled, and oil has *more* than doubled, just since *GEA*'s inception in the spring of 2004.

Even if we only got a repeat of the last 30 months, we'd still see $120 oil and $1,176 gold!

Whether fast or slow, I think bigger inflation is coming. Even if the Fed restrains itself, the world's other central banks might not. (We saw this in August, when the European Central Bank injected a staggering 155.85 billion Euros—$191 billion—into the markets in just *two days*.)

And of course, when currencies are inflating…

Gold will shine!

There's an aspect to this summer's problems that few have mentioned. All over the world, investors are (finally) waking up to an ugly fact—the entire Western financial structure is based on IOUs. This is blatant for bonds and other form of debt, of course, but it's true for other assets as well.

Derivatives and other forms of leverage have spread through the markets like a cancer. Now, a problem in even a tiny part of the market can trigger a wave of cascading cross-defaults, until entire markets implode into piles of smoking rubble.

There's only one asset class immune to counterparty default: gold. When you own it, it's *yours*. It doesn't matter what happens in the markets, or how much screaming and teeth-gnashing is going on in New York, London, or Tokyo. The yellow metal still has the same weight and beauty as it sits quietly in your palm.

The market disruptions we saw this summer are a clear warning to us all. We have storms approaching the real estate market, a Fed that's promising to inflate "aggressively" to counteract them, and an election-year government that will be eager to inflate the dollar into oblivion just to stay in power.

Gold just smashed through the $700 barrier. Its $800 record in 1980 is now within reach. In fact, I'd be surprised if it didn't go a *lot* higher in the next 12-18 months. Buy gold now!

Can Congress Fix It?

Some commentators say our housing situation isn't really that bad.

For example, they say the subprime loan resets and foreclosures can be fixed with legislation. However, if Washington tries to pass laws allowing defaulting homeowners to keep their homes, this will *hurt* the housing market, not help it.

For the most part, mortgages are private contracts between a borrower and a lender. And most mortgages today are bundled and sold soon after closing.

If the government steps in and tries to invalidate foreclosure provisions, it will affect thousands of existing loans. Governmental interference in pre-negotiated private agreements would set a *very* dangerous precedent, in all areas of civil law.

More to the point, the mortgage market would seize up hard. What investor in his right mind would buy loans any more? Foreclosure, or the threat of it, is the only thing that keeps default rates low on mortgages. If the government takes away that option, default rates would skyrocket.

Mortgages would become unsecured debt. And investors would demand unsecured-debt rates.

Imagine paying credit-card interest rates on a home mortgage. That's what could happen if the government interferes too much in the housing market. Obviously, if mortgages were that expensive, housing prices would plummet.

That's why I believe that actions by the Fed are the most effective option to keep the housing market going. I hope Congress isn't stupid enough to try to do it themselves.