GOLD & ENERGY ADVISOR

Vol. VI, No. 2 $19 February 2009

"US Government Bailout Hits $9.7 Trillion!"

"That's enough to pay off over 90 percent of American home mortgages. It's $31,907 for every man, woman, and child in this country!

"This could be the biggest financial trainwreck in history. Here's the full story!"

James DiGeorgia, Editor

- **Seven Reasons Why the Bailout Won't Help**
- **"Fiscal Child Abuse"**
- **Four Possible Outcomes**

In last month's *GEA*, I pointed out that one trillion dollar bills would weigh over 1,100,000 tons. Yep, that's over one million *tons* of green paper.

But that's chump change compared to the tsunami of money flooding out of Washington nowadays.

The United States government has now spent or committed $9.7 trillion. (That's $1 trillion in stimulus packages, about $3 trillion in lending and spending, and $5.7 trillion in agreements to provide aid.)

That could pay for almost two-thirds of *everything* produced in America last year. It's 13 times the cost of Iraq and Afghanistan combined.

What are we getting for all that money? Nobody knows. Only $1.5 trillion in bailouts has actually been voted on by Congress. The rest came from unelected officials at the Fed, FDIC, and Treasury.

Even Congress is starting to wonder about our national finances. As Senator Byron Dorgan (D: North Dakota) bitterly complained, "We've seen money go out the back door of this government unlike any time in the history of our country. Nobody knows what went out of the Federal Reserve Board, to whom and for what purpose. How much from the FDIC? How much from TARP? When? Why?"

Why the Government is Panicking

It's easy to see why US officials are acting so desperate. For example, as you know, last year was the worst year for the stock market since 1931. National trade has also collapsed, with combined exports and imports plunging by 18 percent from July to November.

Gross domestic product also went down, tumbling by 3.8 percent last year. And that's actually too optimistic, because it includes a large (and rising) inventory of goods that were produced but not sold. If you subtract these from the analysis, the GDP looks even worse—down by 5.1 percent.

Meanwhile, business capital investment spending has fallen off a cliff. Orders for computers, machinery, and other such goods sank in December by 2.6 percent. That's the fifth month in a row it has fallen.

THE GOLD AND ENERGY ADVISOR

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The **GOLD & ENERGY ADVISOR** is published 12 times a year by The Silver & Gold Report, LLC, 925 South Federal Highway, Suite 500, Boca Raton, Florida 33432 (800-819-8693 or 561-750-2030). Subscription rates: Single issue, $19. One year (12 issues), $189. Two years (24 issues), $279.

According to the Labor Dept, almost 4.8 million Americans are receiving unemployment benefits. That's the most ever recorded. Over a half-million people filed new claims in just one week in January.

While all this is going on, banks are dying so fast that regulators can't even keep up. Of the 25 banks which folded last year, nine didn't face any enforcement action before they collapsed. The two biggest (Indy Mac and Washington Mutual) were only under enforcement actions for two or three days before going bye-bye. And in just the first 37 days of 2009, an additional nine banks have gone under.

The news stories get more frightening every day. That's why US officials are throwing trillions of dollars around like confetti.

But that's absolutely the worse thing they could do, especially when you consider…

Reason #1 Why the Bailout Won't Help: Bailouts Usually Don't Work

The World Bank has published an analysis of all the major banking crises of the last 50 years (titled "Managing the Real and Fiscal Costs of Banking Crises"). It found that when a systemic banking crisis occurs, government bailouts usually make the problem worse instead of better.

The authors noted, "Accommodating measures such as open-ended liquidity support, blanket deposit guarantees, regulatory forbearance, repeated recapitalizations and debtor bailouts appear to increase significantly the costs of banking crises. Did these accommodating policies achieve faster economic recovery? We failed to uncover evidence that they did. Indeed, they seem to have prolonged crises because recovery took longer."

Let's see… is the US providing open-ended liquidity support today? Yes. Deposit guarantees? Check.

Regulatory forbearance (not enforcing laws which would cause 'zombie' organizations to fold)? Check. Recapitalizations? Check. Debtor bailouts? Triple check.

It's like our officials are following a script or something. They're making the same mistakes that governments always do. The same mistakes that prolong the agony for everybody.

And they should have known better, because of…

Reason #2 Why the Bailout Won't Help: Nobody Asked the People Who Would Actually Pay For It

President Obama has promised us "trillion dollar deficits for years to come." But he didn't mention where those trillions of dollars will come from.

We all know the answer. There are only a few nations with enough money to spend trillions of dollars on Treasurys: China, Japan, and the Saudi royal family. But will they want to lend us those trillions?

A piece in the *Wall Street Journal* discussed this question.

> "They [the Chinese, Japanese, and Saudis] have to fund America's annual trillion-dollar deficits for the foreseeable future. These creditor nations, who already own trillions of dollars of US government debt, are the only entities capable of underwriting the spending that Mr. Obama envisions and that US citizens demand.
>
> "These nations, in other words, must never use the money to buy other assets or fund domestic spending initiatives for their own people. When the old Treasury bills mature, they can do nothing with the money except buy new ones. To do otherwise would implode the market for US Treasurys…
>
> "Our creditors must give up all hope of accessing the principal, and may be compensated only by the paltry 2%-3% yield our bonds currently deliver…
>
> "It seems inconceivable to President Obama… that our creditors may decline to sign on."

Or, even worse, that they are willing to sign on, but are unable to do so. That's…

Reason #3 Why the Bailout Won't Help: The 'Financial Balance of Terror' Has Collapsed

A few years ago, Larry Summers (who is now the head of President Obama's National Economic Council) described our relationship with China, Japan, and other countries as a "financial balance of terror."

Here's what he was talking about. The US government has been effectively bankrupt for years. Even before the current crisis, we were borrowing over $1.5 billion per day ($62,500,000 per hour) just to stay afloat. And that was on top of a $10.2 trillion national debt, which works out to $91,891 per household in this country.

This has been going on for many years. But every good loan officer knows you shouldn't throw good money after bad. So why did China, Japan, and other countries kept lending to us all this time?

Because of the balance of terror Summers was talking about. China owns some $682 billion in Treasurys. Japan has $577 billion. The UK has $360 billion. Other countries have about $1,471 billion, for a total of $3.09 trillion in Treasurys owned by other nations.

On average, the US was selling about $1.5 billion in new paper every day. If any major Treasury buyer stopped buying our debt—or worse, started selling it—the market would implode. Interest rates would shoot up. And the value of all existing Treasurys—like the $3.1 trillion owned by other nations—would plunge.

So the big Treasury owners were stuck. They had to keep financing Washington's borrow-and-spend binge, or else the value of their own holdings would collapse. Not only that, they wanted to keep exporting to the world's biggest import market (America).

So US officials were content to keep running up huge deficits, figuring that foreigners would be forced to keep funding them. Nobody expected that someday, foreigners would be *unable* to pay for it all.

The economic crisis has battered all the major economies in the world. The bottomless well of foreign lending is suddenly in danger of drying up.

Earlier this month, the normally tight-lipped Governor of the Bank of Japan said economic conditions were "very severe." On the Asian mainland, the *China Economic Review* wrote that "news will remain unflinchingly grim for several months." Over in the UK, unemployment is at an 11-year high, and Bank of England governor Mervyn King said they're in "the biggest banking crisis since World War I."

Plus, the United States isn't the only country trying to extract money from the debt markets. There's only so much money available to be lent out, and other nations will be borrowing too.

Russia has to renew $600 billion in debt this year. Latin American governments will be borrowing $250 billion. The Ukraine needs $30 billion. Hungary needs $15 billion. Other nations combined are about $100 billion more, for a total of roughly $1 trillion.

In this environment, the US plans to issue $2 trillion in new debt in 2009. America will be competing for a larger and larger portion of a rapidly shrinking debt pool.

So where will Congress get their trillions of dollars for their deficits and bailouts? They'll probably look to the American taxpayers. But that well is running dry too.

As a good illustration of this, there's…

Reason #4 Why the Bailout Won't Help: Our Deteriorating State Finances

Many state governments are in serious trouble. California is facing a $40 billion deficit. New York, a $12 billion deficit. Arizona, Florida, and Nevada each spend 20 percent more than their incomes. The list goes on and on.

Now the governors are squealing for help, and Congress is listening. The big stimulus package being passed into law has tens of billions of handouts for the states.

But again, that's exactly the wrong thing to do. Congress is punishing taxpayers in the frugal states, forcing them to pay for the gross mismanagement of other states' governments.

For example, California is whining about its budget problems. But where did these problems come from? California legislators have increased spending by 40 percent in just the last five years. Meanwhile, they've chased businesses out of the state with high taxes and draconian environmental regulations.

As for New York, it spends about $1,000 more per family each year than the average state does. If state officials would just reduce their spending to the national average, New York would have a $5 billion surplus.

Other states have similarly self-inflicted wounds. For example, Arizona, Florida, and Nevada have each bloated their budgets by more than 50 percent faster than the average state.

According to the Census Bureau, overall state and local spending has almost doubled in the last decade. States also roughly doubled their debt, adding $1.09 trillion. During that time, the population grew only 5 percent.

Without any bailouts, this mess would be self-correcting. Unlike the federal government, state governments can't run perpetual deficits. The states that have fouled up their finances would normally be forced to clean up their acts quickly. They would cut unnecessary spending, and start competing heavily for investment and businesses to move into the state. As businesses and capital flowed in, jobs would be created. Tax revenues would go up. Prosperity would increase.

But a bailout has the opposite effect. It encourages state governments to spend recklessly—after all, someone else will pay for it. Instead of managing their finances wisely, state officials start ballooning their budgets so they can take their turn at the national trough. Instead of trying to make their policies more efficient, they hire lobbyists instead. Why do anything to restrain yourself, when Washington will shower you with money when you overspend?

This is just one example of a broader principle. And that is…

Portfolio Update

In Update #640, we issued hedge instructions for subscribers who own Encore Acquisition (symbol EAC), Pioneer Natural Resources (PXD), and the Energy Exploration and Production ETF (XOP).

On EAC, we sold the Feb. $30 calls (EACBF). On PXD, we sold the Feb. $17.50 calls (PXDBW). On XOP, we sold the Feb. $32 calls (XOABF).

In Update #643, we recommended a position on Occidental Petroleum (OXY) for both portfolios. We sold short the March $50 put (OXYOJ).

In Update #647, we recommended Apache Corp. (APA), Canadian Natural Resources (CNQ), and Anadarko Petroleum (APC).

For both portfolios, we recommended selling short the APA March $60 put (APAOL) and the CNQ March $30 put (CCDOF). For the GEA 2 portfolio, we recommended selling short the APC March $35 put (APCOG).

Reason #5 Why the Bailout Won't Help: It Rewards Incompetence and Creates Perverse Economic Incentives

American capitalism has produced the wealthiest society in history. But bailouts are fundamentally opposed to the most beneficial forces in capitalism.

Capitalism rewards productivity. Bailouts reward political influence.

Capitalism creates opportunities for profit, spurring entrepreneurs to hire people to take advantage of opportunity. Bailouts reward lobbying.

Capitalism favors small, nimble entrepreneurs—people who can think creatively and invent new innovative ways to create wealth. Bailouts favor large, entrenched organizations with lots of money to hire lobbyists.

Capitalism enables radical new ideas and inventions that can benefit society for generations: advances in medicine, energy efficiency, and the like. Bailouts have minimal effect on long-term economic behavior: if the recipient is uncertain about the future, he will probably not spend a short-term windfall.

I could go on, but you get the point. Government bailouts and handouts work directly against the economic forces that bring prosperity.

But you might be wondering what this has to do with our current situation. Isn't a big stimulus necessary in today's crisis?

It depends on how you define "stimulus." And that definition is the basis of…

Reason #6 Why the Bailout Won't Help: There's Little Real Economic Stimulus

By the time you read this, the big "stimulus package" will probably have become law. As I write this, the final details are uncertain. But there's enough information to understand how much of a disaster this package is.

Americans are being promised an immediate economic stimulus. But there's little real stimulus in this bill. And whatever economic effect does occur will not happen immediately.

If you can suppress your gag reflex long enough, I invite you to read the House bill (H.R. 1) that was passed. Yep, all 680 pages of it. It's not the final version that will become law, but it's close enough for our purposes.

You'll see that despite Congressional claims, very little of the $800 billion will be spent this year. According to the Congressional Budget Office, only 21 percent of the funds will be disbursed in fiscal 2009. In fact, there's a lot of language that <u>forbids</u> spending a lot of the money until 2010, 2011, and beyond.

So this $800 billion monstrosity, that President Obama says is so urgent and must be passed immediately, will actually have very little effect this year.

Nor will it stimulate the economy much. The *Wall Street Journal* waded through the bill, and added up the 'stimulating' parts (tax cuts, infrastructure repair and construction) along with the non-stimulating parts (handouts, pork barrel spending, palm-greasing, etc.)

According to their analysis, only 12 cents on the dollar could actually be considered a stimulus. The other $720 billion or so was just a blowout spending bill.

And that deserves a discussion of its own…

Reason #7 Why the Bailout Won't Help: Political Fear-Mongering and Massive, Wasteful, Disgusting Pork-Barrel Politics

Washington's attitude toward the crisis was inadvertently summarized by White House Chief of Staff Rahm Emanuel recently. Here's what he said:

"You never want a serious crisis to go to waste…. [It] provides the opportunity to do things you couldn't do before."

That explains recent events, doesn't it? Politicians don't view the crisis as a problem to be solved. No, it's an opportunity to sucker the American people.

House Democrats said H.R. 1 contained vital, emergency measures to rescue the economy. How does $13 billion for special-education programs rescue the economy? Or $2 billion to the Head Start program? Or the massive bloating of the Department of Education's budget overall (up to $66 billion, more than the entire Department's budget a few years ago)?

Obviously, the powerful educational lobby got a pretty good payoff from its campaign donations.

But there are other lobbies too. For example, environmentalists got a windfall. $18.5 billion for "energy efficiency and renewable energy"… $2.4 billion for carbon-capture research… $2 billion for national parks and fish hatcheries… $1.4 billion for climate research…$2 billion for a low-emission power plant in Illinois… $200 million for "stream gages" and volcano monitoring systems… $650 million for "national forest maintenance"… and on it goes.

Other pet causes got showered with money. Amtrak has lost money for the last 40 years, but got almost $1 billion anyway. Congress is giving a whopping $2 billion for a "national coordinator for health information technology." Another $4 billion will be spent on local law enforcement—something the beneficiary communities are supposed to provide for themselves.

The pork goes on and on. How will it rescue the economy to spend $500 million on obesity and smoking-cessation programs? Or to give $50 million to the National Endowment for the Arts? Or to spend $335 million for preventing sexually-transmitted diseases?

And we won't even discuss the hundreds of millions that Nancy Pelosi was going to spend on birth control, but was forced to take out of the final bill. (She defended the spending by saying, "We have to deal with the consequences of the downturn in our economy." Huh?)

So far, though, this is all penny-ante stuff. The real blowout in the bill is the $252 billion or so in direct money giveaways. This includes Medicaid, unemployment benefits, food stamps, income tax credits, and so on.

The bill includes some $87 billion for Medicaid alone. It drastically expands eligibility, allowing millions of new people to qualify for benefits. As Karl Rove commented, "What American will be hired by a small business, factory, retail shop, hotel, restaurant, or service company because of this spending? The answer is very few."

Plus, there's a massive expansion of the State Children's Health Insurance Program. According to the Congressional Budget Office, this will double the program's size, and an estimated 2.4 million people will drop their private coverage to switch to the public program. As for other federal health programs in the bill (mostly the Medicaid and COBRA provisions), the CBO estimates an additional 10 million people will move onto the public dime.

Under the excuse of an economic stimulus, this bill is a massive government takeover of large sections of the economy.

Are there any good elements to the bill? Well, President Obama claims it will create three million new jobs. Doing the math, that means we're paying $267,000 per job. The free market would have created many more jobs, at a fraction of the cost.

I think Senator Tom Coburn of Oklahoma summarized this bill the best. He said, "[T]he bill represents one of the most egregious acts of generational theft in our nation's history, with taxpayer money going to special-interest earmarks, an ill-conceived bailout to states, and permanent spending increases that expand government's reach in areas like health care and education."

Dick Armey had a good summary too…

He said the stimulus package is "fiscal child abuse that heaps massive debts on future generations."

If it seems that I'm criticizing Democrats in this issue, I'm not. (Not exclusively, anyway.) Republicans are no better.

During the first George W. Bush Administration, the Republicans controlled both White House and Congress. And what did we get? The biggest expansion of the federal budget in history (up by $345 billion).

The only other four-year period that comes close is Bush's second term, which added $287 billion. Economist Veronique de Rugy also points out that Bush expanded "economically significant regulations" by 70 percent, costing the economy more than $100 million per year.

No, both parties are equally complicit in this disaster. The American taxpayer has been sold out to a long list of lobbyists, special interest groups, and pet pork projects.

But enough about the stimulus by itself. Let's look at the bigger picture.

Right or wrong, there are trillions of dollars about to start sloshing around in our economy. How will this affect your investments?

The future is always uncertain, but we can anticipate four possible outcomes of current events.

Possible Outcome #1: Deflationary Depression

Under this scenario, the markets (along with most other assets) make weak attempts at recovery. Nevertheless, they fall further over time. A black gloom descends over investors and consumers. Cash becomes king.

This is the worst-case scenario. Fortunately, it was never very probable, and a $9.7 trillion bailout makes it only a remote possibility. It seems safe to ignore this scenario.

Possible Outcome #2: The Goldilocks Recovery

This is what politicians and Fed officials are hoping to achieve. This outcome is their goal.

Under this scenario, the bailouts and massive spending bills finally jolt the economy out of its doldrums. Investors cautiously re-enter the markets.

Then, as the economy reinflates, the Fed carefully drains out all the extra liquidity it's been flooding into the system. Stability is restored.

This scenario would require an amazing balancing act by the Fed. And frankly, they've never been able to manage the economy this precisely before. So I think it would be naive to expect them to have this ability now. Along with deflation, this scenario is also very improbable.

Possible Outcome #3: A Runaway Hyperinflation

Under this scenario, the $9.7 trillion bailout pushes our currency over the edge of the cliff. Inflation ignites as the trillion-plus dollars created in the last few months flood out of the banking system and roar through the economy.

The dollar goes into freefall. Dollar-priced assets like equities soar. Gold does even better, leaping up to $2000, $3000, maybe even $5,000 per ounce.

I give this scenario about a 30 percent chance right now. On the one hand, the government is running the printing presses at full speed. On the other hand, American consumers are (finally) starting to save their money and cut back on spending.

Even though the money supply has inflated dramatically, money velocity (the speed at which it circulates) has fallen sharply. This has a deflationary effect.

If we're lucky, this will be enough to prevent hyperinflation while the Fed is unwinding all its emergency loans, backstops, and bailouts. We'll have to wait and see.

Possible Outcome #4: An Inflationary Recovery

Under this scenario, the free-market's natural resilience takes over. Despite the massive pork and general stupidity of the stimulus package, the markets recover anyway—uncertainly at first, then with growing confidence. As investors move back in, equities move up sharply.

Meanwhile, the government's over-stimulus takes its toll on the dollar. Inflation surges up to levels that will be uncomfortable, but not uncontrollable. Gold surges up as well, although not as strongly as during a hyperinflation.

I think this is the most likely scenario right now. Clearly, the government and Fed are creating too much liquidity, and they won't be able to drain it all back out once the recovery begins. Not all at once, anyway.

That's why I recommend you should...

Keep Your Powder Dry

Whether we get medium inflation or outright hyperinflation, don't give up on equities. Before the markets seized up, our *GEA* investment approach made handsome returns year after year. Once investors return to the markets, we can resume making great profits again.

Even now, when stocks are down 8 percent for the year, our original *GEA* portfolio is barely down at all (by less than 1 percent). And our *GEA 2* portfolio is <u>up</u> by 2 percent.

I think we'll be in an excellent position once the markets turn around.

And there's one more factor to consider. Thanks to the crash in equities...

There's a ton of cash sitting on the sidelines.

Today, lots of people have been scared out of stocks. Investors and institutions have an estimated $8.85 trillion in cash, bank deposits, and money market funds. (That's a huge number—about 74 percent of the market value of US companies.)

Once our economy recovers, and that cash starts to move back into equities, I expect the market's strength to be renewed. In fact, I expect its strength will surprise most investors. And we'll be ready to start racking up gains again.

An Important New Recommendation

In the past, I've recommended that 10-15 percent of your portfolio should be in gold. I'm now raising that recommendation to 20-25 percent.

This is an unusual recommendation, no doubt. But we live in very unusual times.

I sincerely hope our markets and economy recover quickly, and everything goes back to normal soon. I love watching our *GEA* portfolio climb. I love knowing that I've made my readers as much as 49.86 percent in just one year.

But as I said, there's a very real threat of hyperinflation right now. And gold is the best 'wealth insurance' you can have in times like this.

Today, the eight top gold ETFs combined are valued at about $36 billion. That's only one percent of the savings in money markets alone.

What would happen if, despite the Fed's best efforts, inflation kicks in hard? What would happen if even a small percentage of the $8.85 trillion in investor cash moves into gold—where the entire fund market is only $36 billion? Gold's price would go to the moon.

That move might not happen. But then again, it might. And if it does, you'll want to have 25 percent of your portfolio in gold ahead of time.

The free-market system is the most powerful economic force discovered by man. It's also amazingly resilient. And our economy will recover eventually, in spite of the stupidity and counter-productive pork coming from our 'leaders' in Washington.

So I'm looking forward to making big profits in energy stocks again. But we must also be prepared for potential problems with the dollar. Make sure your 'insurance' is in place!