TECHNICAL SCOOP

Charts and commentary by David Chapman

September 22, 2011

26 Wellington Street East, Suite 900, Toronto, Ontario, M5E 1S2
phone (416) 604-0533 or (toll free) 1-866-269-7773, fax (416) 604-0557

david@davidchapman.com
dchapman@mgisecurities.com
www.davidchapman.com

THE 9/11 DECADE

When the airplanes struck the World Trade Center on September 11, 2001 (aka 9/11) the stock market had already been falling for over 18 months. The high tech/internet bubble of the 1990s had topped first with the Dow Jones Industrials (DJI) on January 14, 2000 followed by the NASDAQ on March 10 and the S&P 500 on March 24. By the close of September 10, 2001 the DJI was down 18 per cent, the NASDAQ had fallen an incredible 66 per cent and the S&P 500 was off 28 per cent from the highs of 2000. The markets re-opened on September 17, 2001 and after four more days of losses, the markets found a temporary rest on September 21. By that time the DJI was down 30 per cent, the S&P 500 was off 37 per cent and the NASDAQ 72 per cent from the highs of 2000. Fear gripped the markets just as it gripped the world on 9/11.

Two things happened on 9/11. The first was the tragedy that claimed upwards of 3,000 lives. The second was an event that spawned two wars that for the most part continue to this day, in Afghanistan and Iraq. The death toll from those wars for the US alone is estimated at over 6,000, plus another 1,700 contractor deaths. This far exceeds the death toll on 9/11. Over 30,000 have been wounded and over 700 journalists and academics have been killed. By some estimates, the wars have killed over 1.5 million combatants and civilians in Iraq and Afghanistan.

The cost of the wars to the US has by some estimates exceeded $4 trillion, with another $400 billion spent on Homeland Security. Canada has lost over 160 lives at a cost of $94 billion. The Afghanistan war has been taken by the US into Pakistan, and that continues to this day.

The event also spawned a massive security apparatus, particularly at airports, that continues to grow even today. Laws such as the Patriot Act in the US and the Canadian Anti-Terrorism Act allowed governments to work around other laws including, in Canada, taking some precedence over the Canadian Charter of Rights.

9/11 spawned the scandals and horrors at Abu Ghraib prison in Iraq, Guantanamo Bay in Cuba, and Bagram, the prison in Afghanistan. We learned that Blackwater was not a dark river but the name of a private security company used by the US in Iraq that became associated with the massacre of a number of Iraqi civilians.

Terms such as waterboarding and extraordinary rendition came into common use. The search for Al Qaeda operatives, the alleged masterminds behind 9/11, spread into other countries including Yemen and Somalia. Al Qaeda is a multinational, stateless army that today is estimated to have no more than 300 operatives, although at its peak it may have been as large as 10,000.

But those ten years haven’t been only about war, increased security and military scandals. The period has also seen a sharp increase in inequality. Middle-class wages continued to decline on an inflation-adjusted basis even as many at the top, particularly in the financial industry, garnered wealth far beyond most people’s dreams.

The Gini coefficient is a measure of inequality of distribution, with zero expressing absolute equality and 100 maximum inequality. Today the US’s Gini coefficient stands at 45 (CIA estimate 2007), which is as high as it was in 1929. This is similar to numerous Latin American and African countries today. Canada is at 32.1, a mid-range level on a par with numerous European countries. Nonetheless, inequality is growing in those countries as well.

Along with a growth in inequality, the past ten years has seen a rise in societal polarization, particularly at the political level. There has also been a sharp rise in xenophobia with the rise of extreme right-wing groups, particularly in Europe, that are usually directed at immigrant groups.

It has been a “decade of fear” which is also the title of book by *Toronto Star* reporter Michelle Sheppard (*Decade of Fear: Reporting from Terrorism’s Grey Zone*).

While the growing state security apparatus has been very visible, quite possibly one of the biggest disasters of the decade was of the financial kind – the financial collapse of 2007-09, triggered by the subprime crisis and the fall of Lehman Brothers.

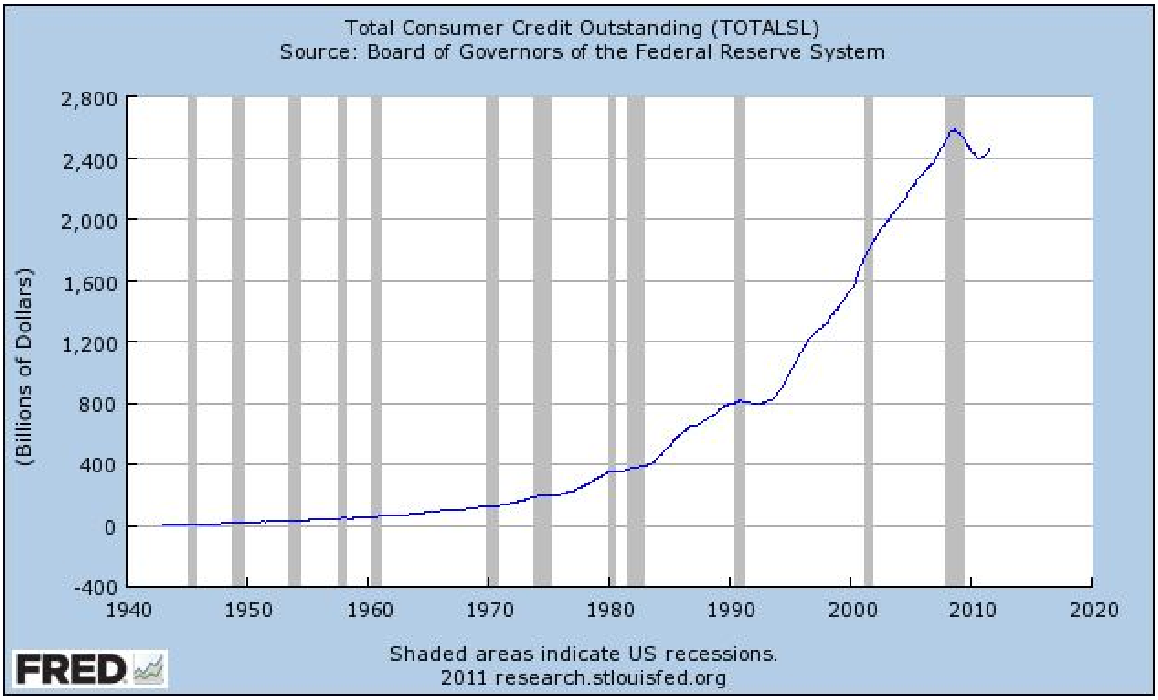
To listen to many commentators at the time, one would have thought it was the end of the world. The DJI fell 55 per cent from its peak in October 2007 to its nadir in March 2009. In the history of the DJI since 1900, only the Great Depression crash from 1929 to 1932 of 89 per cent was worse. It was indeed a crash of historic proportions.

Yet the fact that it happened should not have been a surprise – any more than the events of 9/11 should have been surprise, according to the 9/11 Commission. In the *New York Times* bestseller *This Time is Different: Eight Centuries of Financial Folly*, Carmen Reinhart and Kenneth Rogoff state that “no matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experience from other countries and from history”.

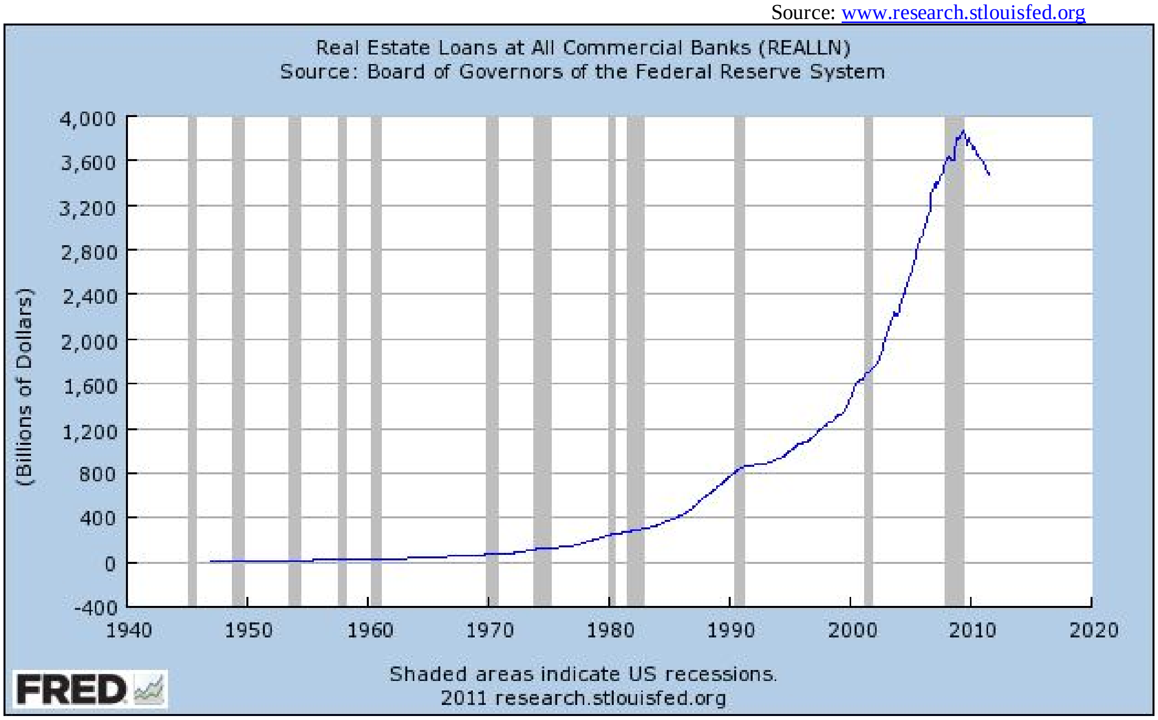
Following the events of 9/11 President George W. Bush, in an effort to restore confidence in the airline industry, told the American people to “Get down to Disney World in Florida”. He did not tell them to go shopping, although he did ask for “your continued participation and confidence in the American economy.” Mr. Bush saved shopping for 2007 when, confronted with the possibility of a recession, he did urge people to “go shopping more”.

But somehow his statements were construed to mean that America should get out there and shop. Spurred on by record low interest rates, the White House encouraging consumers to buy, and the financial institutions providing easy credit, people shopped. What erupted was an unprecedented boom in housing and consumer goods. From 2001 to its peak in 2007 consumer credit almost doubled and mortgage debt grew by 80 per cent. Today both are below their peaks. Not unlike many other financial crises in the past, the one-word reason for the collapse is clear: debt.

The two charts below show this huge growth in consumer debt and mortgages in the US. The picture would be generally the same here in Canada and Europe. It got underway in the 1990s but it really exploded, going almost straight up, during the most recent decade. Whether the current downtrend will stay in force is difficult to say, but there is little on the horizon to suggest that it will start growing again. Without debt growth, the economy can at best grow only sporadically, if at all.



Source: www.research.stlouisfed.org



Source: www.research.stlouisfed.org

The debt accumulation didn't stop with the consumer. Business debt grew by 60 per cent, state and local government debt by 90 per cent, and Federal government debt by over 180 per cent. But even as the debt levels grew, the economy only grew in an anaemic manner. From 2001 to the peak in 2007 the economy only grew by 17 per cent, suggesting that it took at least $6 of new debt to buy $1 of GDP. (Note: all percentages calculated from the Z1 Flow of Funds Accounts of the United States – Federal Reserve Board).

And that was just the US. The same thing to varying degrees was taking place all around the world. An unprecedented global debt binge all fuelled by huge injections of liquidity and low borrowing rates.

The trouble with a debt binge is that it artificially inflates everything, whether it be housing or stock prices, usually far beyond what is sustainable or what it is even worth. During the boom everything feels good, financial institutions are making lots of money and the standard of living appears to be rising. But when the boom ends as it always does, it can end badly, leaving the economy and everyone in it with a huge hangover. Thousands lose their jobs and, as was seen when the subprime mortgage crisis erupted, thousands lost their homes.

That condition remains today. In the US it is estimated that homeowners have lost $7 trillion in equity since the 2005 peak of the housing market. Since then, US housing prices have fallen 31.6 per cent on average, according to Case-Shiller. In some places the declines have been over 70 per cent. Housing prices today are still falling. These weak conditions are expected to remain well into the coming decade. One in five homes in the US is worth less than the mortgage. It is estimated that 2011 could see a further one million foreclosures, with more to come in 2012.

The same story was played out around the world, particularly in Europe. The housing market collapsed in Spain, Portugal, Italy, Britain and Ireland. Iceland was brought down by its banking system that was invested globally in the securities and other financial vehicles used to finance the huge boom of the 2000s.

The housing collapse in turn caused a banking collapse. The financial institutions had created an array of financial instruments to fuel the housing boom, many of them with derivatives attached. The credit and financial engineering boom also set off a merger and takeover boom that also collapsed with the housing market. Thousands of banks and other lending institutions have gone under. The US Treasury and Fed and the European central banks and governments came to the rescue of the huge banking conglomerates as they were considered "too big to fail".

Besides rescuing the conglomerates, the monetary authorities lowered interest rates to virtually zero and threw yet more liquidity into the financial system through a mechanism called quantitative easing (QE). QE is another term for printing money. This is akin to pouring more gasoline on a fire. It doesn't put out the fire, it just makes it larger. Since the solution to the first crisis was more debt, and usually government debt, it is now a sovereign debt collapse that is at the heart of another growing crisis, one that is again threatening the existence of the banking conglomerates that were bailed out only three years ago.

Sovereign debt collapse and banking crises are not new. The past few centuries are rife with examples of sovereign debt and banking collapses. It has touched most every country in the world at one time and hit every continent.

Europe saw numerous external debt defaults from 1300 to 1800. Spain and France did it several times and even England defaulted a few times. In 1345 Edward III overburdened with debts to finance his wars defaulted bringing down the Florentine banks that were the most powerful and largest banks at the time. Banking crises and collapses were not uncommon during the period.

There is very little difference with today's potential default of Greece or Italy and the resulting banking crisis that is unfolding, and earlier periods of sovereign debt defaults and the resulting banking crisis. Spain defaulted 14 times from 1300 through to 1900. There is no record of Spain defaulting since that time. France defaulted nine times in the same period. Could the current crisis bring about the first Spanish debt default since 1882?

At the heart of all of these periods of collapse and crisis are long-term cycles. Long-term cycles are not the easiest to explain. Many doubt their existence. Yet there is evidence that periods of sovereign debt collapses and banking collapses occur with some regularity.

The longest cycles that are followed are the 72-year and 90-year cycles of sovereign and banking collapses and economic depression. The long-term Kondratieff cycle now appears to be falling into a similar pattern. Evidence of the Kondratieff cycle used to suggest a cycle of 55 to 60 years. Since 1929 the Kondratieff cycles of spring, summer, autumn and winter appear to be unfolding in periods of roughly 18 years. Four times 18 equals 72 years.

Note: the terms spring, summer, autumn and winter have been applied to the Kondratieff four seasons. Spring is associated with beneficial inflationary expansion; summer with inflationary expansion, a commodities boom and bust and a steep recession; autumn with a mild deflationary expansion, usually associated with falling commodity prices and culminating in a stock market bubble. The Kondratieff winter is a deflationary collapse, severe recession and economic depression and is associated with debt collapse (individuals, sovereign countries and banks) from the excesses built up in the Kondratieff autumn.

The Kondratieff seasons appear to be unfolding over a period of roughly 18 years (range could be 15 to 21 years). The last Kondratieff winter 1929-49 was 20 years; the Kondratieff spring lasted from 1949 to 1966, or 17 years; the summer went from 1966 to 1982, or 18 years; and the autumn lasted from 1982 to 2000, again 18 years. The current Kondratieff winter got under way with the collapse of the internet/dot.com bubble and the market top in 2000. Note that even in the Kondratieff spring, summer and fall can have periods of recession's even nasty one. During the current Kondratieff cycle spring saw severe recessions in 1953-1954, 1957-1958 and 1960-1961; summer had the recessions of 1969-1970, 1973-1975 and 1980-1982; autumn had the severe recession of 1990-1992 plus the stock market crash of October 1987.

If the Kondratieff winter lasts 18 years, this period is not expected to make its final bottom until at least 2012, or even out as late as 2022. The final bottom could be a higher bottom than any stock market low recorded earlier; however, there is no law that says new lows could be seen as well. Some have suggested that in the Kondratieff winter a stock market collapse of 80-90 per cent is not unusual. The collapse of 2007-2009 was only 55 per cent. The stock market as well usually goes through a long period of making no new highs, although on a nominal basis the market may see new highs as was the case in 2007. On an inflation-adjusted basis the markets did not make new highs.

The Kondratieff winters in American history have been the period of the Great Depression and WW2, 1929-1949 a period characterized by the collapse of thousands of banks and sovereign defaults that included besides Germany and Japan numerous other European and Latin American countries; the period known as the Long Depression (more like a series of severe recessions/depressions, interrupted by a railroad boom in the 1880s) that lasted from 1873 to

1896 and as well saw the collapse of thousands of banks and sovereign debt defaults including numerous Latin American countries and a few European countries (Spain, Russia, Portugal and Greece); and the depression of 1837 to 1845 that followed a long period of US expansion in population and land speculation that saw a huge build-up in inflationary pressures and granting of credit. It all collapsed in a panic in 1837 when banks refused to accept paper currencies, accepting only gold and silver specie. That depression saw over 600 banks fail and unemployment soar. There was a similar collapse in Europe at the time and the period was punctuated by sovereign debt defaults including Greece, Portugal, and Russia. Is today any different?

In examining the long cycles of 72 and 90 years, one needs a starting point. The best one to use is the stock market bottom seen during the Great Depression 1932. 72 years later was 2004. There were stock market lows in 2002 and 2009 (70 and 77 years respectively). Both are within acceptable range for the 72-year cycle low. Since there was a low followed by a secondary low, the most acceptable nadir for the current 72-year cycle was probably 2009 (Raymond A. Merriman – MMA Cycles www.mmacycles.com). If one uses 2009 as the nadir of the current 72-year cycle, counting back 72 years from the financial panic of 2007-09, one obtains some interesting results:

- 1937 – a financial panic triggered by attempts to balance the budget following five years of recovery from the depths of the Great Depression in 1932-33. The financial panic and subsequent recession/depression is considered a sub-set of the Great Depression. The highs of 1937 were not seen again until 1945. As noted above the period was characterized by the collapse of thousands of banks and sovereign debt defaults.

- 1865 – The American Civil War ended in April 1865 and the US quickly entered an economic recession that lasted until 1867. There followed the financial panic of 1873 that in turn triggered a depression and banking collapse. The seeds of the 1873 panic and collapse were sown by the war. The ensuing depression also saw bank collapses and sovereign debt defaults.

- 1793 – 1792 saw a panic get underway in stocks and goods. It was the first year of trading for the NYSE. The panic was caused by speculation against stock held by the Bank of New York. A bank run got under way and stocks fell 25 per cent in two weeks. The banks were bailed out (sound familiar?) by the Secretary of the Treasury. Following intervention, things returned to normal. But the period also numerous banking collapses and sovereign debt defaults. Following a century of wars the strain was too much. France defaulted in 1788, Austria in 1796.

- 1721 – Both the South Sea Bubble and the Mississippi land bubble culminated in 1720, causing bank runs and collapses. The effects lingered for years. The bursting of these two bubbles alone triggered a banking collapse. France had defaulted earlier in 1715.

- 1649 – This one is interesting as 1649 was the culmination of the English civil war, and the year in which Charles I, the King of England, was deposed and executed. In 1648 France defaulted as a result of its costs during the 30 years war. Following the execution of Charles I, a period of instability and economic depression was ushered in under Oliver Cromwell before he too was overthrown in 1660.

- 1577 – This one is interesting as well. France was experiencing considerable inflation in the 16th century which greatly impacted the rural peasant class, although landowners and the merchants grew rich. Sharply declining purchasing power for the peasants and a decline in

> manufacturing led to a monetary crisis. In 1577 France abandoned the *livre* as its money of account, replaced it with the *ecu* and banned most foreign currencies. France had also during this period been involved in numerous civil wars and other military adventures which had severely strained the treasury. There were religious wars and crop failures and epidemics. All of this caused banking failures. At the time the dominant banks were Italian. In 1568 there were 75 Italian banking houses in Lyon. By 1597 only 21 remained. It should be noted that both France and Spain defaulted near this period, Spain in 1557 and France in 1558.

One could go back further and find further evidence of financial collapses. The next 72 years back from 1577 was 1501. This was the age of Columbus, and Columbus was getting ready for his fourth voyage. However, things were already turning against him and the financial strain was beginning to show in the Court of Spain, as instead of finding gold and silver Columbus was only finding spices. Many became discontented. His fourth voyage was a disaster as they ran into a hurricane. While Columbus's ships survived, the governor's ships, laden with gold and financed by Italian banks, was lost. Columbus died in 1506.

The 90-year cycle is a secondary cycle associated with the 72-year cycle. Its range is roughly 80 to 90 years. Note that it too falls on the 18-year cycle as well. The next 90-year cycle trough is not expected until out to 2022 although its range is 2012 to 2022.

If one counts back from the nadir of the Great Depression in 1932 one comes to 1842, which was during the depression of 1837 to 1845 noted earlier. 90 years earlier than that was 1752. This period preceded the seven years war which many consider to be the first global war as it was fought on two continents – Europe and North America – and involved numerous European countries. When it was over it changed the world in a significant way. The strains of all the wars over the past century caused considerable financial stress. France, unable to properly finance its North American colonies, lost New France. Britain, stressed by the costs of its wars, overtaxed its colonies, leading directly to the American Revolution. France overburdened with the costs of all of its wars defaulted in 1770.

Most studies of the 72-year and 90-year cycles of stock market crashes and sovereign and banking defaults usually only look at the last few such as the Great Depression, the Long Depression, the banking depression of the 1830s and 1840s, and the depression that gripped the world following the end of the seven years war and the American revolution. Going back further does provide some evidence of banking and sovereign collapses, but the history is sketchier.

What does appear to be consistent is that war, speculation, debt and financial chicanery (usually present in all periods of speculation) resulted in sovereign, banking and individual debt collapses.

This time has been no different. The tools to prevent a collapse are running out. More QE and more printing of money while maintaining interest rates near zero is no longer working. Japan tried that and it has been through a 20 year nightmare that still appears to have no end. The system needs to be cleansed before a new cycle can get underway.

But the process takes years and the 9/11 decade was probably only the beginning. This coming decade may be even more stressful as bankruptcy and war continue to dominate the headlines. History seems to suggest that the long-term down cycles are in full force and the worst may be yet to come.

David Chapman is a director of Bullion Management Group Inc. the
Manager of the BMG BullionFund and the BMG Gold BullionFund www.bmgbullion.com

General Disclosures

The information and opinions contained in this report were prepared by MGI Securities. MGI Securities is owned by Jovian Capital Corporation ('Jovian') and its employees. Jovian is a TSX Exchange listed company and as such, MGI Securities is an affiliate of Jovian. The opinions, estimates and projections contained in this report are those of MGI Securities as of the date of this report and are subject to change without notice. MGI Securities endeavours to ensure that the contents have been compiled or derived from sources that we believe to be reliable and contain information and opinions that are accurate and complete. However, MGI Securities makes no representations or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to MGI Securities that is not reflected in this report. This report is not to be construed as an offer or solicitation to buy or sell any security. The reader should not rely solely on this report in evaluating whether or not to buy or sell securities of the subject company.

Definitions

"Technical Strategist" means any partner, director, officer, employee or agent of MGI Securities who is held out to the public as a strategist or whose responsibilities to MGI Securities include the preparation of any written technical market report for distribution to clients or prospective clients of MGI Securities which does not include a recommendation with respect to a security.

"Technical Market Report" means any written or electronic communication that MGI Securities has distributed or will distribute to its clients or the general public, which contains an strategist's comments concerning current market technical indicators.

Conflicts of Interest

The technical strategist and or associates who prepared this report are compensated based upon (among other factors) the overall profitability of MGI Securities, which may include the profitability of investment banking and related services. In the normal course of its business, MGI Securities may provide financial advisory services for issuers. MGI Securities will include any further issuer related disclosures as needed.

The Author of this report is an outside director of Bullion Management Group, the manager of the BMG Bullion Fund. Also, the author may from time to time, be long and or short positions in the companies named within this technical market report.

Technical Strategists Certification

Each MGI Securities technical strategist whose name appears on the front page of this technical market report hereby certifies that (i) the opinions expressed in the technical market report accurately reflect the technical strategist's personal views about the marketplace and are the subject of this report and all strategies mentioned in this report that are covered by such technical strategist and (ii) no part of the technical strategist's compensation was, is, or will be directly or indirectly, related to the specific views expressed by such technical strategies in this report.

Technical Strategists Trading

MGI Securities permits technical strategists to own and trade in the securities and or the derivatives of the sectors discussed herein.

Dissemination of Reports

MGI Securities uses its best efforts to disseminate its technical market reports to all clients who are entitled to receive the firm's technical market reports, contemporaneously on a timely and effective basis in electronic form, via fax or mail. Selected technical market reports may also be posted on the MGI Securities website and davidchapman.com.

For Canadian Residents: This report has been approved by MGI Securities which accepts responsibility for this report and its dissemination in Canada. Canadian clients wishing to effect transactions should do so through a qualified salesperson of MGI Securities in their particular jurisdiction where their IA is licensed.

For US Residents: This report is not intended for distribution in the United States.

Regulatory

MGI SECURIITES is a member of the Canadian Investor Protection Fund ('CIPF') and the Investment Industry Regulatory Organization of Canada ('IIROC').