**It's the Economy, Stupid...! ; An "Austrian Enginomics" Perspective**

Few campaign slogans have been as effective at undermining and derailing an incumbent political machine's reelection bid as: "It's the economy, Stupid..!". Few slogans have been as effective at sealing the voter's belief in utter dependency upon a government to "manage" an economy and create jobs. Few slogans have been as politically divisive. Few slogans have been as damaging to our Republic... President George Bush Sr.'s popularity was sky high following the Iraqi-Kuwait war. Unfortunately for Mr. Bush, after a few ill-timed Fed interest rate hikes, a sputtering economy entering into the 1992 elections, and the debilitating slogan, George's popularity plunged along with his hopes to lengthen his presidential stay.

Few things have infuriated Republicans more than a Clinton presidency largely receiving credit for the positive impact of the Reagan tax cuts. Economists of any political persuasion know a rate cut in taxes takes time to become systemically integrated and effective in our massive "economic engine". Clearly, a tax cut for the lower end of the income spectrum will have an immediate marginal impact on spending and the consumption of goods and services. It is, however, the critical enhanced savings adjustments at the mid and high income end that take years to signal and encourage action by entrepreneurs and capitalists to shift the economic engine into a higher weight of capital investment (vs. consumption) that leads to greater productivity improvement and real growth. The "engine" did slowly respond through the balance of the Reagan administration, the Bush Sr. administration, and the first half of the Clinton Administration.

However, a little bit of a good thing can be carried to a destructive extreme. A stressed presidency in the second half of the Clinton administration along with an extraordinarily accommodative Fed enabled the most extreme equity bubble in the history of the Republic. Never before had key equity valuation indicators registered such extremes as we experienced in the late 90's. Never before had investor's levels of expectations for a future stream of wealth from the grossly inflated assets been so far above what was possible.

An equity semi-bust inevitably followed the unprecedented perceived economic success of the Clinton presidency during the next president's term. Not to be outdone… another common saying developed from yet another stressed presidency within George W's political machine responding to the semi-bust, namely: "Deficits don't matter". The Republican logic stemmed from the empirical evidence that the Regan tax cuts, which yielded higher deficits the first few years ultimately led to entrepreneurial spirit coming to full fruition later with growth finally trumping the nasty budget deficits during the Clinton second term. The fatal flaw in this logic is that the surpluses only happened during the noted historic massive bubble-building period yielding an artificial unsustainable surplus, NOT a permanent structural surplus condition by any stretch. The Republican thought was.... Hey, if the tax cut idea worked once (Reagan's), let's do it again...!

In all of the excitement, this most damaging undercurrent was building up under a society largely aloof. In all of this excitement there was no one minding the Central Bank "monetary store". With every foreign or domestic challenge, our Central Bank employed a very simple strategy.... suppress interest rates and flood the world with liquidity. Through the Mexican Peso crisis, the Asian financial crisis, the Russian default and LTC (Long Term Capital) crises, the anticipated Y2K crisis, the 9-1-2001 crisis, and finally the 2003 anti deflation crisis it was the same predictable response each time.... lower interest rates and flood liquidity. In concert with this banking windfall the financial world was aggressively leveraging this newfound profusion of capital through the most creative myriad of credit instruments ever. Any consumer with a pulse was being solicited to borrow and buy anything under the sun. "0%" interest, "optional" payments, negative equity, etc. solicitations were tempting us with every flip of the channel or trip to the mailbox.

Austrian economic theory recognizes extreme booms CAUSE extreme busts. In the aftermath of the greatest stock market bubble of all time we, of course, experienced the noted semi-bust. With all the power beholden the government and Fed, they coordinated the greatest combination tax cut and flood of liquidity in 2003 to stem a weakening economy and threatening deflation. This massive effort not only partially re-inflated the equity bubble, but it forged massive bond and real estate bubbles as well. We now are sitting upon the largest aggregate asset bubble (equities, bonds, and real estate) in the history of the Republic. The historic massive floods of liquidity during the past 10 years have largely channeled into the financial asset markets. and......It's getting worse by the week...! As long as real interest rates remain artificially suppressed and total Credit Market Debt is increasing at a faster rate than GDP, the bubble is expanding; not receding. Last year (2004) Total U.S. Credit Market Debt expanded $2.7 Trillion compared to a GDP increase of $759.2 Billion. We estimate the size of the aggregate bubble is now approx. $27 trillion….! (see graphs below).

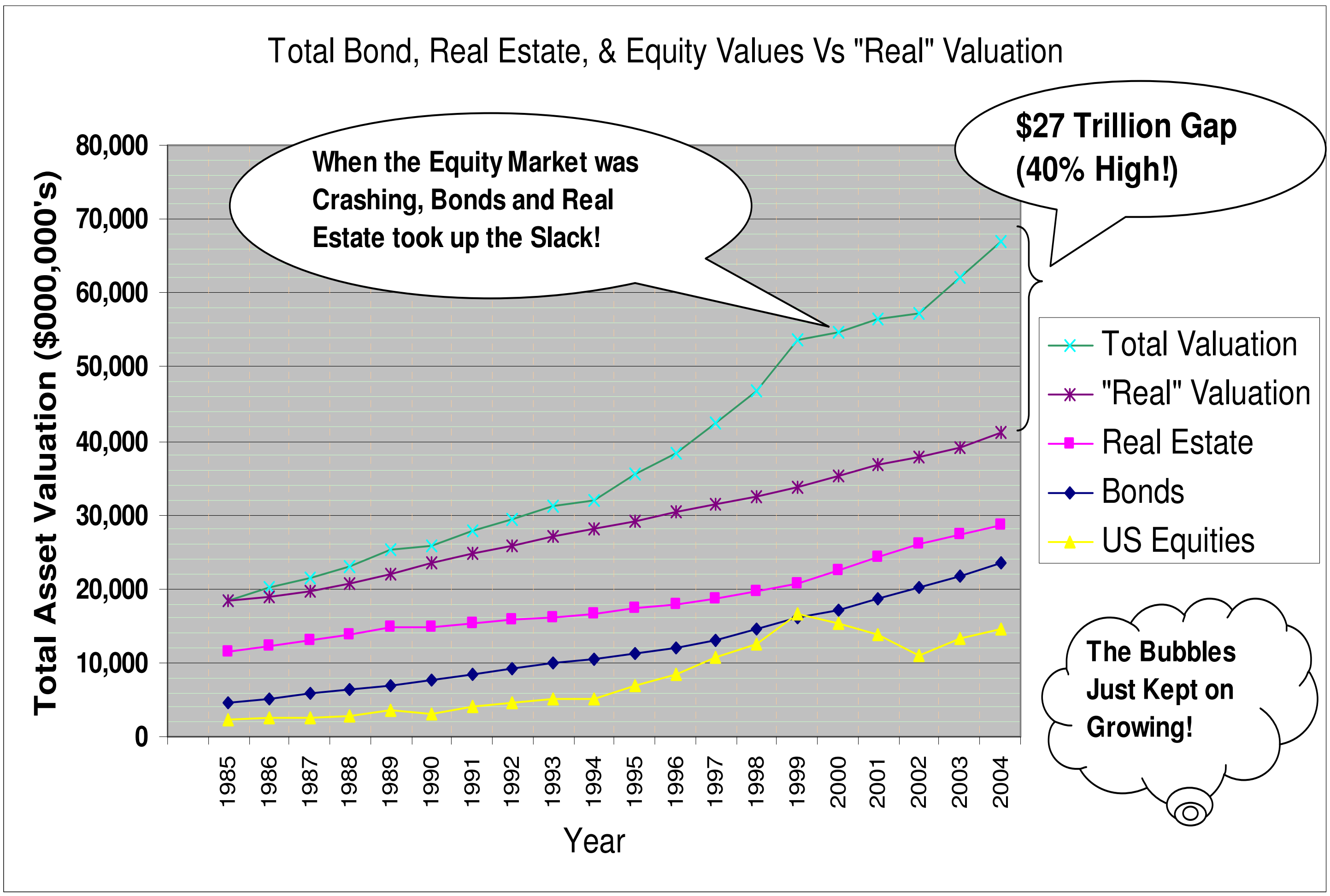
Equally as damaging as the massive asset bubble is the malinvestment or misallocation of resources. Once artificially low interest rates are systemically imbedded into the financial and entrepreneurial decision making processes, there is a massive shift of labor into industries that benefit from this artificial condition. Clearly, as the easy money policies reverse, the reversal of those resources will be very painful. They will be shed from these industries (e.g. housing, auto manufacturing, mortgage financing, etc.), and forced to return to some position within a "market justified" business. Unfortunately, the physical moves, transfers, training, and excitement associated with the new growth into these businesses will have gone for naught.

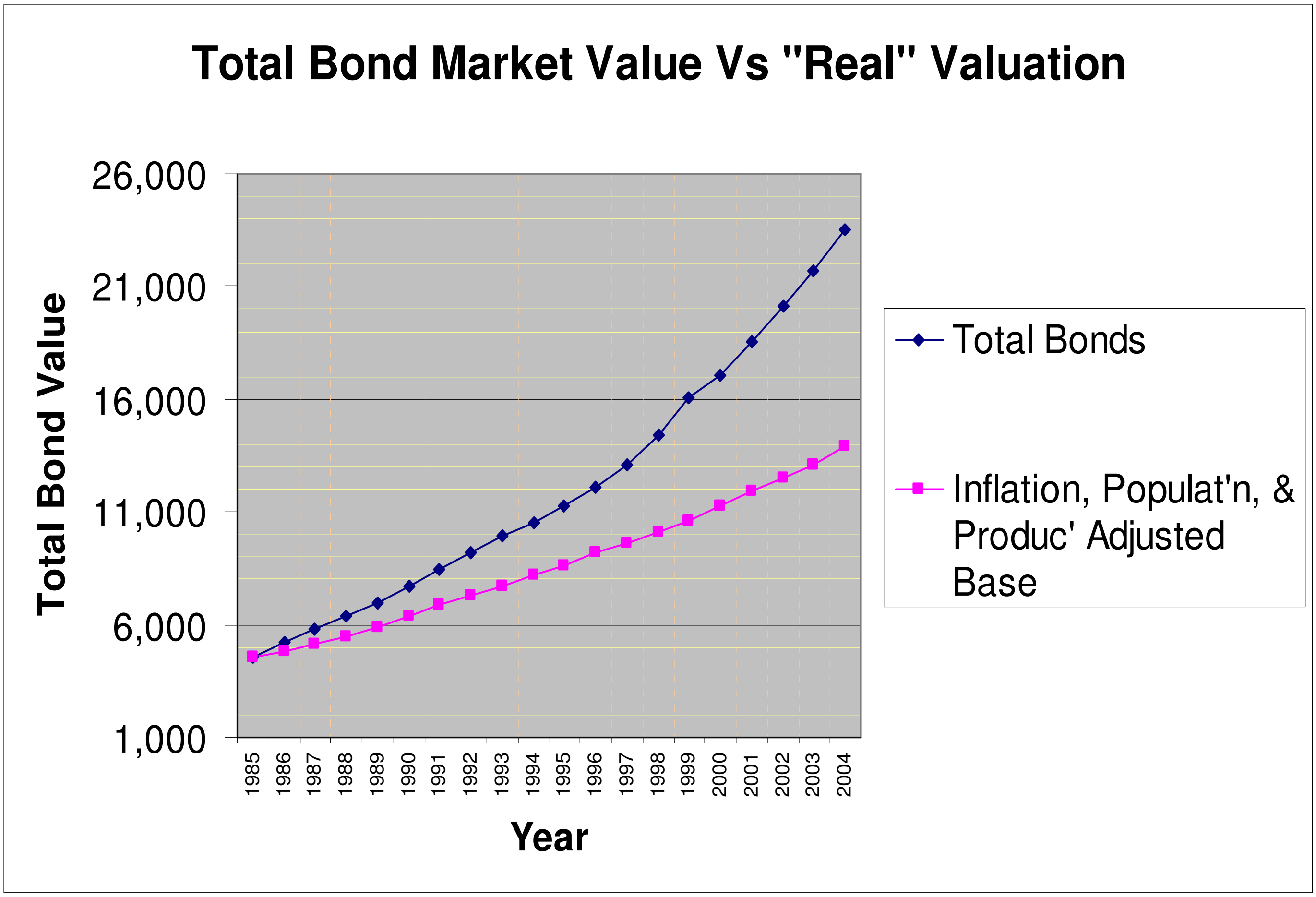
Yet another dimension to this sad tale is the historic "gutting of American manufacturing jobs"...! While experiencing widespread monetary instability throughout much of the non-U.S. industrialized world during the late 90's, the U.S. equity boom attracted hundreds of billions of foreign capital into the relatively stable US market, which poured into and exacerbated the equity Ponzi scheme bubble. This unbridled foreign "investment" momentum artificially strengthened the dollar and dollar based assets, thus making imported goods extremely inexpensive and U.S. exports very expensive. Of course, the outsourcing and massive shift of jobs to Asian countries was the result. We can thank the Clinton/Rubin “strong dollar” policies for that!

**The Result?**

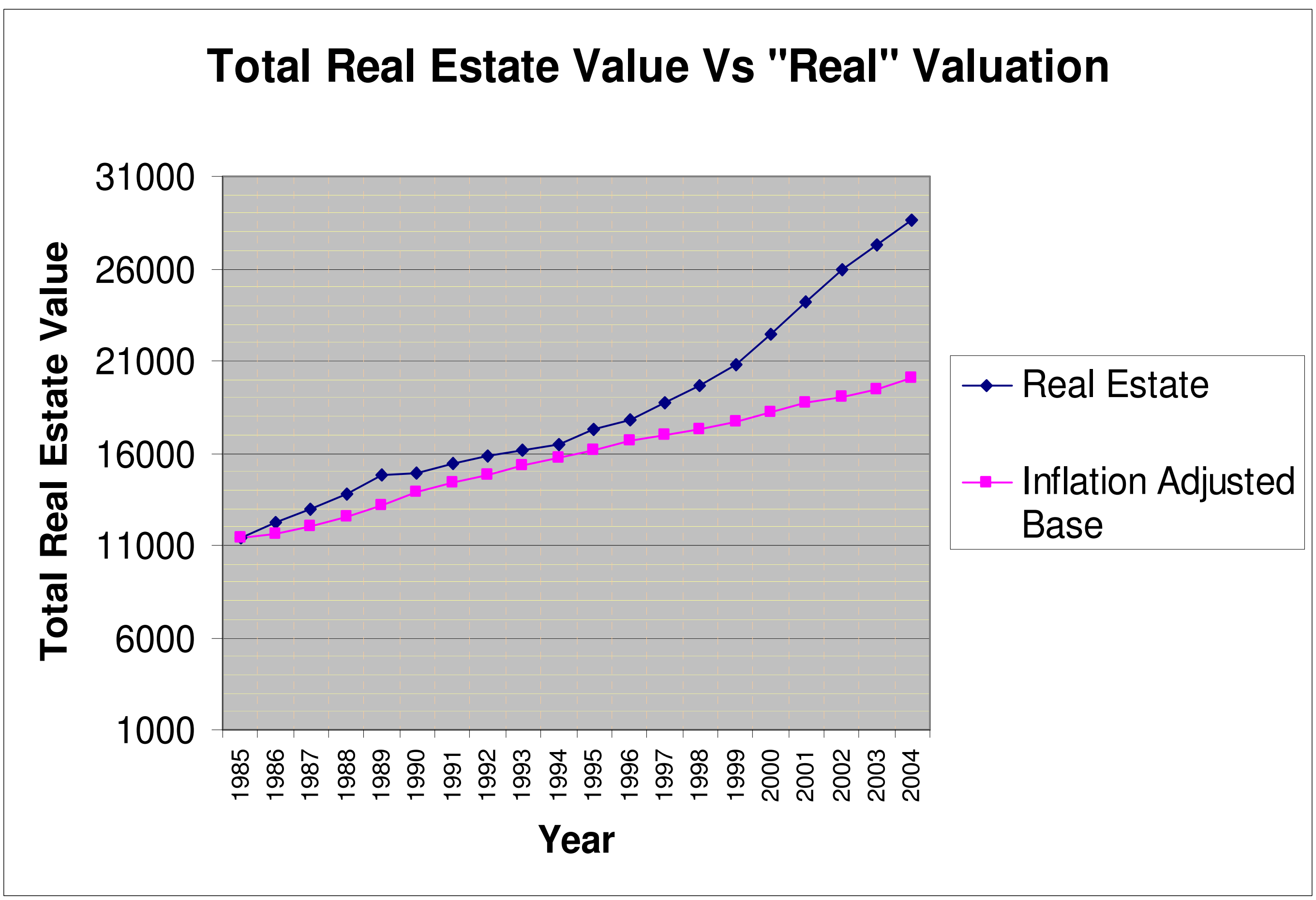
The aggregate asset bubble and resource misallocation will correct abruptly. Bubble formations are extremely popular and politically irresistible, but the market discovery of the wealth illusion and correction are always relatively speedy and very painful. When will the real bust that the Austrian logic implies happen? Simple...! There will be a point in time when a critical mass of Boomers (U.S., Asian, and European) begins to retire in the 2008-2010 timeframe. When this happens we will begin to actually task the bubble. i.e. attempt to cash in on the inflated assets. The real U.S. economic engine output will become "disrobed" for what it is. We will learn that a reduced work force relative to those not working (higher dependency ratio), combined with the need to stop consuming more than we produce at an unprecedented rate (the trade deficit), combined with the need to start paying back the foreigners who have so generously funded our consumption binge for the past 15 years, will be an impossible hurdle to overcome. Something must give. The real return capability of our capital assets will become painfully apparent. The days of the financial asset mirage will then end.

Thus, the new slogan framer might say.... It's NOT the economy, it's government monetary intervention, stupid!...

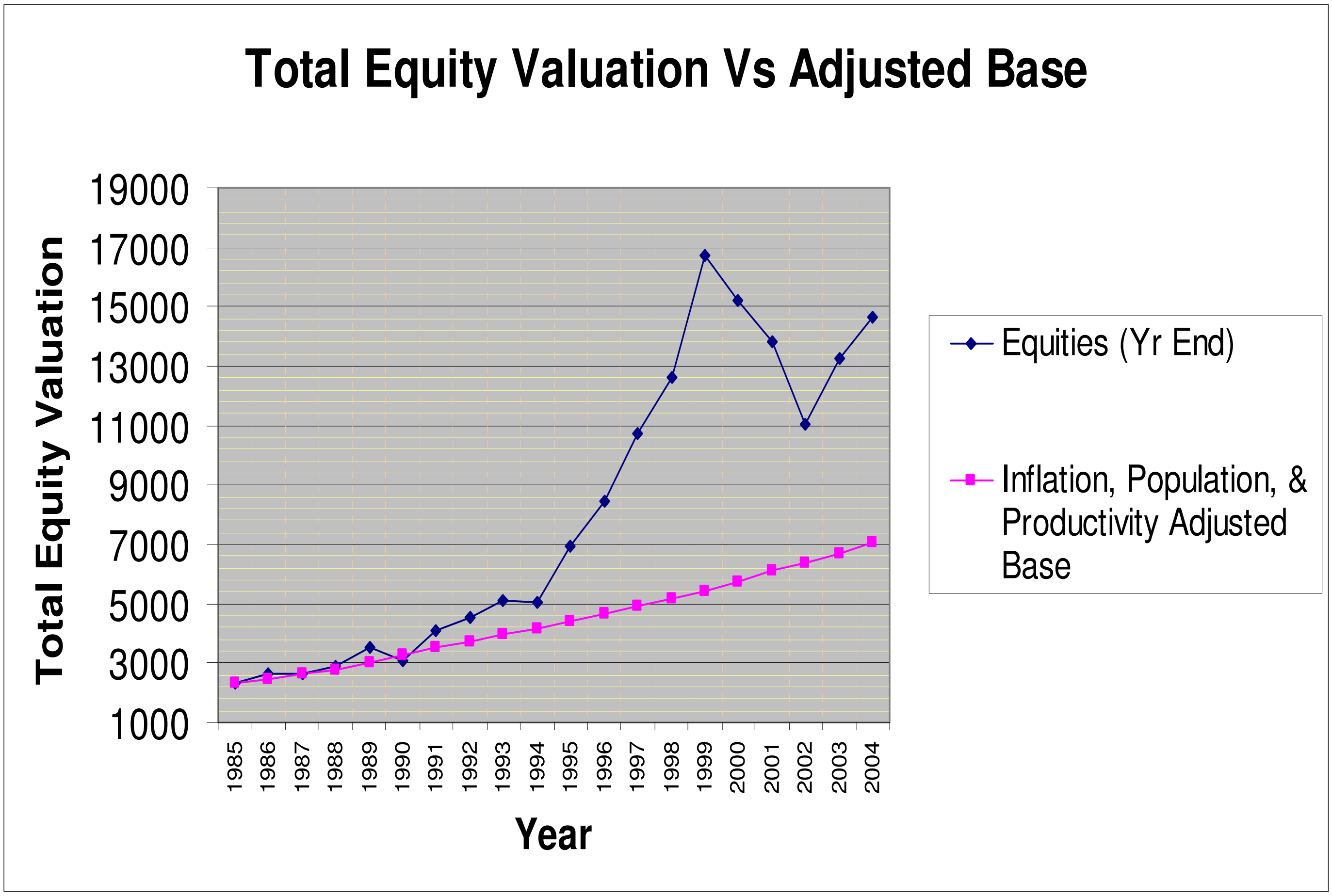




Total Bond Market Value Vs "Real" Valuation
26,000
21,000
16,000
11,000
6,000
1,000
Total Bond Value
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
Year
Total Bonds
Inflation, Populat'n, & Produc' Adjusted Base

Total Real Estate Value Vs "Real" Valuation
31000
26000
21000
16000
11000
6000
1000
Total Real Estate Value
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
Year
Real Estate
Inflation Adjusted Base


Total Equity Valuation Vs Adjusted Base
Total Equity Valuation
19000
17000
15000
13000
11000
9000
7000
5000
3000
1000
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
Year
Equities (Yr End)
Inflation, Population, & Productivity Adjusted Base

End