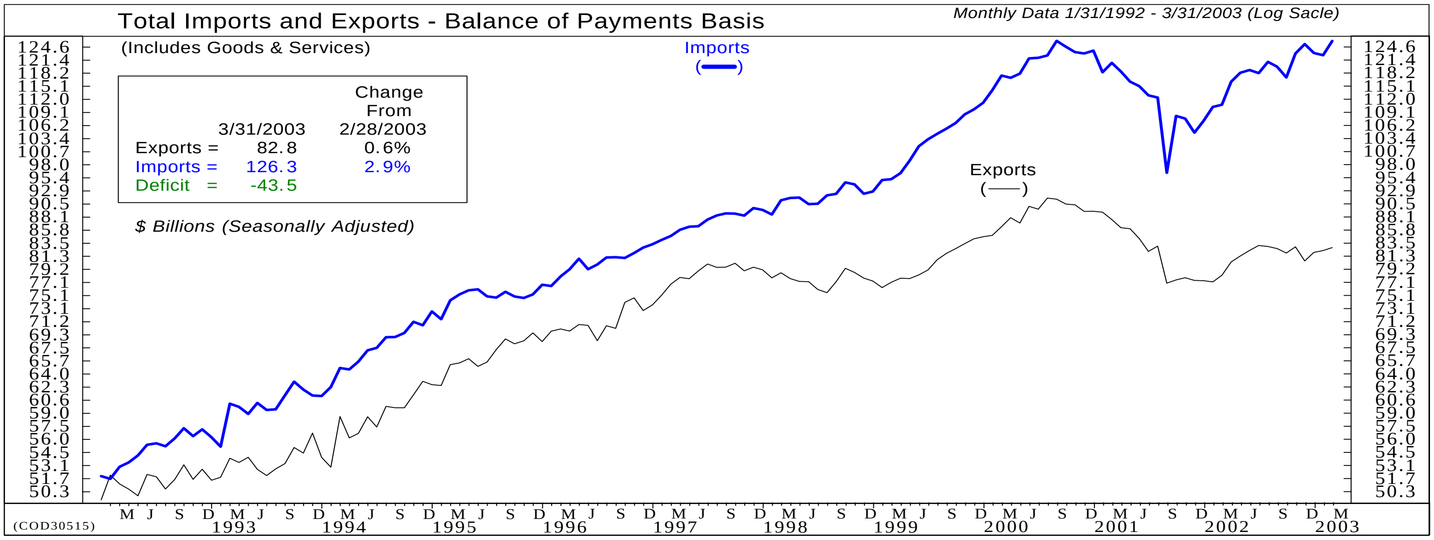
WHAT'S GOING ON -- MY "TWO-CENTS" WORTH OPINIONS

Question -- I don't get it. How can "deflation hedge" bonds be going up at the same time as inflation hedge gold? How can stocks, which anticipate an economic recovery, go up while bonds go up (bonds surging indicate a "double dip") and the dollar plunges (predicting a weak economy)? Nothing makes sense. How do you explain it?

Answer -- There is a sweet spot early in an economic recovery when the economy is running well below potential, when stocks rise anticipating a better economy, and bonds rise responding to a better inflation picture, so that is easy for me to explain. The dollar is probably going down simply because it was **way** too high and U.S. goods **exports** (despite supposedly "miracle" productivity gains) **have not really grown since 1997**. (See chart below) Gold is probably responding to the weak dollar and to the fact it has been in a 20-year secular bear market and is a hedge against shaky paper currencies worldwide.



But my real point is that we like to analyze each market separately. If you study enough market history you can find plenty of cases where stocks and bonds ran together or where they went directly opposite. You can find plenty of cases when stocks and gold went up together and even more cases where they went opposite to each other.

So the "reasoned" discrepancies don't bother me. I actually like moves that "don't appear to make sense." I like "climbing a wall of worry or falling a slope of hope." It tells me the crowd has probably not yet figured out the reason, and thus, there is a lot more potential than a move everybody understands.

But let me go at this from another direction because I am going to speculate on something that could profoundly affect all our financial lives. From here on in is my "two-cents" worth opinion. Let me return to the painful post-bubble aftermaths. There are the bears that proclaim history will surely repeat, and the bulls that claim history is unreliable because the Fed, after 1929, made huge policy mistakes as did the Bank of Japan after 1989. The bulls claim we will not make these same mistakes, and the Fed will "let growth rip." I have two problems with the bulls' arguments. (1) It could be that crowd psychology and human nature are bigger than the Fed. Polls show Americans say they want to borrow less and save more. This is what Bernanke and other Fed officials are worried about. If consumers and business do that, the Fed will continue to fail as it did during the first 11 interest rate cuts. Number 12 is still in question. (2) The other problem I have with the bulls' argument is that I feel the so-called policy mistakes were not caused by stupidity, but **mandated by the currency markets**. In other words, the initial decline in a currency from its bubble-related peak is clearly helpful in righting a sinking economy. Central banks like it and probably even quietly help it along. But at some point the weak currency causes foreigners to flee the currency, and even people in the country involved seek havens overseas. At this point the currency slide changes from a good to a **very big bad**. The central banks cannot sit by under a currency collapse and, therefore to push up the currency, they must take policies that **directly hurt the economy**. In our ***Markets in Motion*** book we noted in 1931, "*Run on U.S. dollar forces Fed to raise interest rates*"…"*European currency system collapses in summer*"…"*England devalues sterling 50% and introduces tariffs*." I personally think it the height of smug arrogance to sit here in 2003 and say the Fed was stupid in 1931. Nobody in the Fed wanted to raise rates; I can promise you! But they **had no choice**.

So right now we are in that sweet spot where the economy continues to muddle upward, where bonds can rally as inflation comes down, and where the falling currency boosts earnings and helps us anticipate a pickup in exports. It may not feel great to the laid-off workers, but the financial markets can be **very happy**. I think the dollar is the key to this happy situation continuing. It needs to continue to slide but slowly and very carefully. If foreigners get alarmed and start dumping U.S. investments and foreign governments start trade and tariff type wars to defend their own currencies, the situation could turn from good to bad overnight. I hope the bulls are right and we can stay in this happy spot, but if we ever get a run on the dollar, all bullish bets are off. --Ned