



THE WORLD ECONOMY (2008)



THE AGE OF SCARCITY

PART III

NO MORE BRICS IN THE WALL - THE FAT TAIL OF ARMAGEDDON.

- THE INDUSTRIAL ECONOMIES LEAD THE GLOBAL ECONOMY INTO RECESSION.

THE CASE FOR CAUTION - PART X

Volume 36 - No. 4

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"A falling camel attracts many knives" – Old Arab Proverb.

"The ultimate result of shielding men from the effects of folly is to fill the world with fools" – Herbert Spencer.

"The Fannie-Freddie bailout is one of the great political scandals of our age, all the more because it was so obviously coming for so long. Officials at the Federal Reserve warned about it for years, only to be ignored by both parties on Capitol Hill. The least we can do now is bury these undead monsters for all time".

Weekend at Henry's (Wall Street Journal – September 8th 2008.

"Today's bear market in financial assets is as nothing compared to the preceding crash in human judgement."

Jim Grant – Grant's Interest Rate Observer (Why No Outrage – Wall Street Journal July 19th 2008).

"Global financial markets continue to be fragile, and indicators of systemic risk remain elevated. Credit quality across many loan classes has begun to deteriorate with declining house prices and slowing economic growth. The policy trade-offs between inflation, growth, and financial stability are becoming increasingly difficult."

IMF Global Financial Stability Report – July 28th 2008.

"Like a Hollywood monster that is impervious to bullets, the credit crisis refuses to lie down and die. The authorities have bombarded it with interest-rate reductions, tax cuts, special liquidity schemes, and bank bail-outs, but still the creature lumbers forward, threatening new victims with every step."

The Economist – A Nightmare on Wall Street – August 30th 2008.

"We have a credit crunch the like of which we have not seen in generations. The economic difficulties the U.K. is facing are arguably the worst they have been in 60 years. It is going to be more profound and long-lasting than people thought."

Alistair Darling – U.K. Chancellor of the Exchequer – (The Guardian – August 30th 2008).

"Never did a ship founder with a captain and crew more ignorant of the reasons for its misfortune, or more impotent to do anything about it."

E.J.Hobsbawm – "Industry and Empire : An Economic History of Britain since 1750"

"The West is making a terrible mistake by mixing realpolitik with a battle of values. Drawing and defending moral lines is the first and most essential step in combating extremism, and there is no room for double standards. If the West is keeping track of its friends, it is time to take Mr. Putin off the list."

Gary Kasparov – (Wall Street Journal – December 2006).

"None of the democracies adequately prepared for war before it was unleashed on them in the 1940's. None was prepared for the terror assault of the 21st century. Even today there is little apparent recognition that we are under attack by a familiar sort of enemy, and great reluctance to act accordingly. This time ignorance cannot be claimed as an excuse. If we are defeated, it will be due to a failure of will, not lack of understanding." - Michael Ledeen – "Iran and the Problem of Evil" (Wall Street Journal – June 7th 2008.

CLIENT SUMMARY : -

No More BRICS in the Wall – When the Gods of the Market Tumbled (continued).

- Over the past three weeks it has become increasingly evident that we are in the worst global financial crisis since the Great Depression. The world economy is now de-leveraging across all asset classes, as what we called in our February report, *The Greatest Credit Destruction in History*, continues. Global equity, commodity, and property markets continue to decline as speculators and investors pay the price for years of excess. There are literally no more BRICS in the wall. The international system has entered the most dangerous period for global economic, financial, and geopolitical stability since the 1930's. All of the major industrial regions, North America, the Euro-zone, Japan, and the U.K, are on the verge of simultaneous economic recessions, as manufacturing production and trade have ground to a halt. Consumer discretionary spending has turned negative as real incomes decline in the context of rising inflation, and consumer confidence has hit 30-year lows in all regions.

- The emerging markets (EMs), forecast by some a year ago to have decoupled from the economies of the OECD, have lost one quarter of their value since last October, with the most rapidly growing and populous BRICs, China and India, down 60% and 30% respectively. Russia and Brazil have plunged 40% in recent weeks on falling commodity prices, capital outflows, and geopolitical concerns. World trade growth has slumped from 8% a year ago to zero in the three months through July according to the latest official data. International liquidity growth has contracted from 12% to 1.6% over the same period, while bank credit tightening and falling profits have cut global capital investment growth from 6.5% to 3%, as balance sheet problems and over \$500 bill. in write-offs of "toxic" sub-prime and other mortgage backed securities have slashed commercial and investment banks assets and profits. Global inflation has tripled from 2.2% to over 7%, including double-digit growth in many emerging markets.

- Meanwhile the global financial crisis, and the attendant destruction of trillions in bank capital and consumer net worth globally, continues to devastate international credit markets, with the Treasury's bailout of the financial zombies, Fannie Mae and Freddie Mac, the collapse of Lehman Brothers, and the takeover or restructuring into bank holding companies of the three remaining investment banks, being the latest developments in a sorry saga of regulatory incompetence and corruption. Despite the initial market euphoria which greeted the news of the federal "conservatorship", bankers, investors, traders and, dare we say it, even economists, are belatedly waking up to the fact that the world economy only narrowly avoided what the Italian finance minister described as a "meltdown of the global financial system", and that the recovery from the worst global credit crisis since the Great Depression could take years, not months. To those who see the plunge in world markets over the past year as a buying opportunity, based on purportedly low valuations, we would simply point out that we are still in the early stages of what is likely to be a multi-year period of weak economic growth and declining profits.

- In August 2007, in our report *Sowing the Seeds of the Next Recession*, we argued that the then developing period of FINANCIAL and credit turmoil and global de-leveraging, including severe declines in all of the major world equity markets, would lead into a second stage by the second half of 2008 marked by significant downturns in the REAL economies of the industrial nations, and a U.S. recession led by a sharp contraction in consumer spending. Second quarter real GDP growth has already turned negative in Japan (-0.7%), and the Euro-zone (-0.2%) including the "core" economies of Germany, France, and Italy, and is minimal in Canada and the U.K. (0.0%). In addition, U.S. third quarter data is already indicating a renewed consumer-led downturn and impending recession. The third stage, as outlined in our October 2007 report *The Coming Emerging Market Collapse*, would be a global recession involving the emerging market (EM) economies, with gross world product (GWP) growth falling under the 2.5% threshold by mid-2009, followed by an extended period of low economic growth and corporate profitability through 2010 and into 2011 (Tables 1-2).

- And while the debacle was initially created by the "geniuses" on Wall Street who devised the innovations in structured finance which will ultimately cost commercial and investment banks over

\$1.5 trillion in lost capital, and shrink global credit by at least \$15 trillion, the pain will disproportionately fall on U.S. consumers, homeowners, and small investors, who we estimate will see their household net worth plunge by almost 20% or \$12.5 trillion over the next three years. In the words of *The Economist*, "Like a Hollywood monster that is impervious to bullets, the credit crisis refuses to lie down and die. The authorities have bombarded it with interest-rate reductions, tax cuts, special liquidity schemes, and bank bail-outs, but still the creature lumbers forward, threatening new victims with every step".

- Despite these potentially huge future losses and write-downs, the commercial banks have since the beginning of 2007 only provisioned \$250 bill. or 25% of their capital according to FDIC data. In the U.K, where the housing market is experiencing its worst decline in over 30 years, the percentage is 20%. In contrast Japanese banks were forced to ultimately provision over 180% of their initial capital in the face of their property and equity market collapse in the 1990's, with the result that Japanese bank lending shrank contracted from 1994-2005 after rising by over 10% annually in the 1980's. The Federal Deposit Insurance Corporation (FDIC), which insures individual bank deposits up to \$100,000, increased the number of problem banks on its watch list from 90 with assets of \$26.3 bill. in 1Q 2008 to 117 with assets of \$78.3 bill. at the end of the second quarter. Analysts such as Gerard Cassidy of RBC Capital Markets forecast that 300 banks are likely to fail over the next three years. Others have forecast over 400 bank failures with total assets of over \$300 bill. Against these potential losses the FDIC had only \$45.2 bill. in its insurance fund at the end of 2Q, or 1% of total insured deposits of \$4.5 trillion. The FDIC will almost certainly have to borrow heavily from the Treasury to cover the expected tripling in bank failures. Overall the KBW Bank Index has plunged 50% from its 2007 highs and 30% this year. **De-leveraging the credit binge of the past six years is going to take a lot longer than the market apparently anticipates. Sell the rallies and look out below.**

- **As in the 1930's however, these drastic contractions in global output, trade, investment, credit, and liquidity, and the accompanying declines in world equity and property markets, is occurring at a time when the twin menaces of Islamo-fascism, and an expansionist and increasingly totalitarian Russia, are posing the greatest threat to international peace and global free markets in seventy years.** Over the past three years we have written a series of reports analyzing in detail the policies of the millenarian Ahmadinejad regime in Teheran, and its financing of terrorism in the Middle East and nuclear weapons development program. In addition in our series *The Re-Sovietization of Russia* we have warned of the expansionist ambitions of Vladimir Putin toward the former Soviet satellite states, and his utilization of Russia's energy resources to politically blackmail Western Europe. The Bush Administration, weakened by the unpopular war in Iraq, and with limited support from its European "allies", has been unable to respond aggressively to these challenges. In the face of Western impotence and diplomatic "appeasement" reminiscent of the late 1930's, this new "Axis of Evil", along with the Chavez and Assad regimes in Venezuela and Syria, have formed a strategic alliance aimed at undermining all neighbouring pro-Western or neutral governments, including Georgia, Lebanon, Iraq, and Colombia, and controlling the flow of energy resources from the Middle East/Caucasian strategic heartland.

- **This growing geopolitical threat to the Free World in a period of impending global recession is made doubly dangerous by the growing weakness and failure of leadership of the United States.** Militarily depleted by the wars on terrorism in Iraq and Afghanistan, economically sapped by the massive problems of its banking and financial system, declining consumer net worth, confidence, and employment, and an impending trillion dollar budget deficit, and possibly on the verge of electing an inexperienced political neophyte as its next President, America is perceived in Teheran and Moscow as a nation in decline, a "paper tiger." Twenty years ago in our series "*Is America in Decline?*" we took strong issue with Yale professor Paul Kennedy's conclusion in his book, widely accepted among the nation's liberal elites, that the United States, weighed down by the burden of "imperial overstretch" and the Cold War with the Soviet Union, was in irreversible decline, and predicted in contrast the imminent collapse of the centrally-planned economic system and the "Evil Empire." Today unfortunately Kennedy's predictions may belatedly be about to be realized, as a resurgent Russia rebuilds its military and economic strength, and plays from an increasingly strong hand in the geopolitical game, and Iran moves closer to the development of nuclear weapons and a confrontation with Israel.

- **Seventy years ago a critical factor behind the Western powers unwillingness to confront Hitler's expansionist ambitions, triggered purportedly by the need to remedy the injustices imposed on the German people by the Treaty of Versailles and obtain *Lebensraum* for the *Deutscher Volk*, was the Great Depression and the accompanying massive unemployment which had gripped Europe and the world economy in the 1930's.** Today the evidence is increasingly indicating that we are again entering a severe and potentially protracted global economic downturn. Consider the following data, reviewed in more detail in the pages of this report.

- Gross World Product (GWP) growth has slowed from a 5% rate in mid-2007 to an estimated 3.6% in 2Q 2008, with 3% growth projected for the second half of this year. All of the major industrial regions, North America, the Eurozone, and Japan, are heading into recession, with growth already negative in the latter two in the second quarter. Real GDP growth in North America (1.7%), Western Europe (1.4%), and Japan (0.9%) this year is projected to fall by an average of close to 1% point from 2007, and to decline a further 1% point in 2009 to average 0.5%. GWP growth is forecast to fall below the 2.5% recession threshold at 2.2% in 2009 and 1.8% in 2010 (Tables 3-4).

- Global industrial output growth continues to slow dramatically, falling from 4.4% in mid-2007 to 1.1% in 2Q 2008. In the OECD, which accounts for 73% of world production, output growth has plunged from 3.4% to -0.4% in this period, in conjunction with sharply declining new orders and exports, and is projected to decline by 0.6% this year before contracting by 2.4% in 2009. Industrial production growth in the developing economies was cut in half in the second quarter, falling to 4.5% yoy from 8.7% in 1Q. Global industrial production is forecast to contract by 0.7% in 2009 and 1.5% in 2010 (Tables 11-13)

- The J.P.Morgan global industrial and services output index contracted at close to the fastest rate since late 2001 in August at 49.7, with significant cutbacks in new orders at 48.3 and employment at 47.2, the sharpest decline since 9/11 and consistent with growth in global industrial production of less than 2%. The manufacturing index declined to its lowest level in five years at 48.6, with production falling to 48.5 and new orders slumping to 46.8. In the words of the survey, "*The downturn of global manufacturing became broader and deeper in August*". (Table 10).

- Global capital and residential investment are slowing dramatically, and we are forecasting a decline in business capex from 6.4% yoy growth in mid-2007 to an estimated 3% in 2Q, leading to outright contractions of 1% and 2.5% globally in 2009-10, and to a 2.5% decline in the industrial nations in 2009 as the world economy heads into recession. Globally, house price appreciation fell to 4.8% yoy in 2Q 2008 from 12.5% a year earlier, according to the Knight Frank Global House Price Index. In the U.S, housing prices are experiencing the greatest decline since the Great Depression, falling 17% yoy in June on the Case/Shiller index, U.K. house prices were down 10.5% yoy in August, and Spain, Ireland, Germany, Japan, and other industrial nations are experiencing accelerating home price declines (Tables 14, 49, 61).

- The negative impact of sharply higher interest and labor costs on the availability of financing and on corporate profits and capital investment, have significantly impacted the anticipated global "infrastructure boom". Infrastructural spending growth, estimated at 10% in 2007, is projected to slow to 3% this year and show no growth or decline in 2009 according to a new Morgan Stanley study. Project cancellations, due largely to soaring costs and lack of financing, are running at four times their historical average.

- Slowing global output is being accompanied by sharply rising prices, with the global CPI almost quadrupling from 2.2% in mid-2007 to 7.7% in 2Q 2008, driven by soaring energy and food prices, with increases of 7.0% and 4.6% forecast in 2008-09. Headline inflation in the industrial economies has tripled from 1.4% to 4.1% in the past year, and is at double-digit levels in the Middle East, South Asia, and Africa (Tables 15-18).

- World trade volume growth has also been slowing significantly over the past 18 months, declining from 9.3% in 2006 to 7.2% in 2007 and to a minimal annual rate of 0.9% including a 0.6%

contraction in global imports in 2Q2008, and has shown no growth in the three months through July according to the latest data from the Netherlands Bureau for Economic Policy Analysis, which monitors world trade data for the EU and the World Bank. We estimate that world trade growth will be cut in half to 3.6% this year, and decline to 2.5% in 2009 and to 1.5% in 2010 (Table 30).

- The Baltic Dry Index, which measures dry bulk shipping rates and is a good leading index for global production and trade, and has been called "*the best economic indicator you've never heard of*", rose almost thirteen-fold between late 2001 and 2007. However since October 2007, when it neared an all-time high of 11,180, it has formed a double-top and has plunged 62% since a May peak of 11,700 to 4,500 currently (Table 31).

- According to our proprietary Cass Research Liquidity Index (CRLI), which has been an accurate leading indicator of trends in global output since 1973, real global liquidity has plummeted from 12.1% yoy growth in 2Q 2007 to 1.2% in the last quarter. Over the next three years global liquidity growth is forecast to slow to 0.2% in 2009, and a 4% contraction in 2010. Such levels of liquidity growth have always coincided with global recessions. The combined impact of zero to negative real liquidity growth, a decline of close to \$14 trillion in U.S. household net worth, and an estimated \$1.5 trillion in losses by the world's banks and investment institutions, will constitute what we termed in our February report, "*The Greatest Credit Destruction in History*", as an estimated \$15 trillion in global lending capacity is eliminated (Table 20).

- With profits, trade, and capital inflows declining significantly, the MSCI Emerging Markets index has fallen almost 30% since last October when we recommended the under-weighting of virtually all individual EMs in our report "*The Coming Emerging Market Collapse and U.S. Recession*." Far from decoupling, as forecast by EM pundits Marks Mobius and Faber, who at that time were forecasting large gains in China (to over 8000) and India, these two markets have plunged by 60% and 40% respectively to below 2000 and 13000 respectively at their lows (Table 165).

- In the **United States**, although second quarter U.S. real GDP growth of 2.8% exceeded market expectations, increasing 2.5% points from the 0.3% average growth of the prior two quarters, it was due entirely to an \$80 bill. improvement in net exports, which contributed 2.9% points to the total. In contrast to the contribution from foreign demand, gross domestic purchases declined by 0.1% in 2Q despite the rebate stimulus, and have declined at a 2.5% annual rate over the past three quarters (Tables 32-33).

- Current data is suggesting that the economy will weaken through the remainder of 2008 on a quarterly basis, and we are forecasting growth of 1.6% in 2008, with minimal growth of 0.4% in 3Q and negative growth of -0.5% in 4Q marking the start of recession. For 2009 we project a further slowdown to -0.4% growth on an annual basis, with recession continuing through the first half of the year, as business capital spending, and exports contract by 5%-6%, and declining consumer discretionary spending and further cutbacks in inventories add to the economic downturn.

- Despite a \$596 bill. increase in disposable personal income in May from the Economic Stimulus Plan, consumers spent less than 16% of the extra disposable income, or less than one half of the projected amount, with the rest going into savings as forecast in our July report, while confidence has plunged to 30-year lows. July data on consumer spending and personal incomes showed contractions in both areas, with consumer spending projected to decline by 1.3% in the third quarter, the first negative quarter in over two decades. August retail sales declined at a 3.6% annual rate and were up only 1.6% yoy (Tables 34-36).

- The devastation in consumer balance sheets in the first half of 2008 was by far the most severe since records were inaugurated in 1945, with household net worth plummeting at an annual rate of \$4.2 trillion to \$56 trillion, confirming our view that we are entering perhaps the most severe recession since WWII. Household real estate holdings, based on the OFHEO valuations, declined by a relatively modest \$550 bill. to \$19.43 trillion, but consumer financial assets plunged by \$1.56 trillion to \$44.34 trillion, while home equity fell to a record low of 45.2% of consumer real estate. **We are now forecasting a cumulative \$12.5 trillion plunge in total household net worth by the end of 2010, with consumer spending falling by \$300 bill. in nominal terms, the first decline since the Great Depression (Tables 38-39A).**

- Both the household and payroll surveys are showing significant job losses this year. The historically lagging Payroll Survey shows employment fell by 387,000 in the six months through July. The picture was even worse on the more timely and accurate Household Survey, which showed a 1.15 mill. rise in unemployment in the latest three months to 5.7%, a massive 4.6 mill. annual rate. We expect unemployment to exceed 7% by the end of 2009 (Tables 41- 42).

- The housing market remains at the epicenter of the domestic and global credit crisis. Home prices are in free-fall, with an estimated worst-case 30% correction from peak to trough through mid-2009 increasingly possible, as prices fell at a 25% annualized rate in the three months through May and 17% yoy through June according to the S&P/Case-Shiller index. A 30% decline would exceed the previous record 26% decline in the five years through 1933 in the Great Depression (Table 61).

- Existing home sales are down over 2 mill. units since 2005 at 4.91 mill. units in August, prices have fallen a record 9.5% yoy and 24% in the West, while inventories remain excessive at 10.4 months sales or 4.26 mill. units, double the 2004 level. New home sales fell 34.5% yoy and 67% from the July 2005 peak of 1.4 mill. to 460,000 in August, while inventories rose to 10.9 months sales. Housing starts plunged a further 6.2% to 895,000 units in July, the lowest level since March 1991, and are now down 33.1% yoy and 61% from their January 2006 peak of 2.29 mill. units (Tables 50-52).

- Foreclosure filings affected 739,714 households in the second quarter, and rose to a 3.26 mill. annual rate in July, up 121% yoy, and compared to 1.3 mill. filings in 2007. Bank repossessions (REO's) tripled to 222,400 in 2Q representing 30% of total filings and pushing the total inventory of bank REOs to almost 800,000 or 17% of the existing inventory of homes for sale. Nationwide some 20%, or 10 mill, of all homeowners with mortgages are now in negative equity on their houses, while 4.3% of all homeowners and 20% of sub-prime borrowers were delinquent on their mortgages in 2Q. These numbers are projected to double if house prices fall a further 15%.

- Lending practices in the commercial property market have been as reckless as those in the residential sector, with some 8000 regional and local banks even more exposed to losses on construction loans, which make up 65%-70% of their assets, than the major city banks. RBC Capital Markets are forecasting that close to 200 regional banks could fail in the next couple of years due to construction loan losses alone, the highest bank failure rate since the early 1990's S&L crisis. A record net 80% of reporting banks have tightened lending standards for commercial real estate loans in the latest FRB Loan Officers July survey (Table 67).

- Capital spending grew by only 2.2% in 2Q following a modest 2.4% gain in the first quarter, as equipment outlays contracted by 3.3%. Capex forecasts are being reduced, as business capital equipment expenditures have grown by only 2% in total since the first quarter of 2006, while declining industrial production and capacity utilization, and plunging IT equipment orders, down 27% in July, suggest continued weakness in business spending in the second half of 2008 and a more significant downturn in 2009 (Table 70).

- Domestic profits (after IVA), comprising over 75% of total NIPA profits, peaked in 2Q 2007 at \$1557 bill. and have plunged 22% to \$1223 bill. over the past year. Profits from the non-financial sector have fallen by \$225 bill. or 21% in this period. Profits from the financial sector, which currently account for 36% of S&P domestic profits, have fallen by a similar amount from their 2Q 2007 peak as a result of growing consumer and housing sector related credit problems, with profits falling \$110 bill. to \$383 bill (Table 73).

- Since the mid-1960's, the share of foreign profits has quintupled from 5% to a record 26.2% in 4Q 2007, rising by \$115 bill. or 43%. However in every U.S. recession since 1970 global earnings have fallen on average 30% from their highs. Overseas profits have had an almost perfect correlation with global industrial production growth, which has already slowed from 7.5% last year to 4% currently and a projected 2.6% in 2009. Over the next two years, as industrial production growth declines sharply, as world trade growth slows from the current 5.7% to 1.5%, as the global economy enters recession, and as the dollar rises by close to 10% on a trade-weighted basis, we are forecasting a one-third decline in overseas profits from \$400 bill. to \$280 bill. Overall we estimate that NIPA profits will decline by \$270 bill. or 16.5% from peak to trough, with S&P operating earnings falling to close to \$70 by 2010, suggesting a potential decline to 1100 on the 500 index (Table 72).

- Industrial production growth has ground to a halt since July 2007, plunging by 1.1% in August and 1.5% yoy, and is expected to decline by close to 4% over the next two years, including a 0.5%

contraction in 2008 and a 3% decline in 2009. Capacity utilization also fell to a four-year low of 78.7% in August, and is projected to decline by 5% over the next two years to 76.5, well below its 35-year average, further reducing the need for new investment in structures (Tables 78-81).

- Headline inflation rose to close to a 17-year high of 5.4% yoy in August, despite a 0.1% decline in the latest month as energy prices fell by 3.1%. Core inflation, excluding food and energy, rose at a 3.4% annual rate in the latest quarter, and 2.5% yoy. At the producer level (PPI) prices declined 0.9% in August but rose 9.6% yoy at the finished goods level, the second fastest rate in 27 years, while intermediate goods prices rose 16.7% yoy and crude goods prices rose by 38.1% despite an almost 20% decline in energy prices in August. Import prices soared at a 32% annual rate over the past five months, and were up 21.6% yoy in the year through July. Although falling energy and commodity prices will continue to slow the rate of inflation over the remainder of this year and in 2009, we have raised our annual inflation forecast to 5% in 2008 (Tables 89-91).

- With the economy slumping the prospect of "stagflation" must be taken seriously. There is ample historical precedent for the combination of rising inflation and falling economic growth, notably in the 1970's. The principal factors which have kept U.S. inflation subdued in recent years, namely globalization and high levels of productivity, are now having a diminishing impact on holding down price increases. Manufacturing productivity has slowed from a 5% rate between 2002-05 to 2.2% in 2006-07, while productivity in the non-financial corporate sector, which the Fed uses as a key inflation indicator, slowed to a much weaker 1% over the past eighteen months. We project further below-trend gains in non-farm productivity of 2% in 2008 and 1.6% in 2009, putting additional pressure on unit labor costs, a key determinant of core inflation, which are forecast to rise by 2.1% annually (Tables 92-94).

- The worst global credit crisis since the Great Depression is now a year old but there is no end in sight, despite the Treasury's \$700 bill. mortgage bailout (TAPP) plan to avert a global market meltdown. This September feels a lot like the Fall of 1929, when panic gripped Wall Street before spreading to Main Street. Regulators, bankers, and investors are still flying blind with no clear idea of the remaining risks and ultimate losses. An enormous \$520 bill. has already been written off on sub-prime loans by the lenders, but this is less than half of the potential \$1.3 trillion in losses projected by the IMF and one quarter of the \$2 trillion in ultimate losses which we now anticipate (Tables 23, 95A).

- The Federal Deposit Insurance Corporation (FDIC), which insures individual bank deposits up to \$100,000, increased the number of problem banks on its watch list from 90 with assets of \$26.3 bill. in 1Q 2008 to 117 with assets of \$78.3 bill. at the end of the second quarter. Analysts estimate that 300 banks are likely to fail over the next three years, with total deposits of close to \$300 bill. Against these potential losses the FDIC had only \$45.2 bill. in its insurance fund at the end of 2Q, or 1% of total insured deposits of \$4.5 trillion. Next on the agenda for massive write-offs are the \$1.1 trillion market in home equity loans, of which \$700 bill. are held by commercial banks, and the \$2.5 trillion in credit card debt.

- At the end of 2007, Wall Street had \$3 in capital for every \$100 in assets, a 33:1 ratio. Now Bear Stearns and Lehman Brothers are bankrupt, Merrill Lynch has been acquired by the Bank of America, and the two remaining large investment banks, Goldman Sachs and Morgan Stanley, have converted to bank holding companies. **Wall Street, as we have known it for decades, has ceased to exist, destroyed by its own incompetence and greed.**

- While private sector financial institutions, banks, brokerage houses, hedge funds, and mortgage lenders are aggressively de-leveraging, the public sector lenders, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are increasing their leverage, creating enormous potential risks to U.S. taxpayers. These Government Sponsored Enterprises (GSEs), now under federal "conservatorship", have combined balance sheets assets (loans) of \$1.7 trillion resting on only \$70 bill. of equity, a 24:1 ratio. In 2007, of the \$1.9 trillion in mortgage-backed securities (MBS) issued the GSE's accounted for \$1.2 trillion or 63%. Credit-default swaps (CDS), which caused American International Group (AIG), the world's largest insurer, to seek a government bailout, now cover \$62 trillion in debt, up from \$144 bill. 10 years ago.

- The Federal Reserve Board itself, and the New York Fed, are already leveraged to the hilt with garbage collateral that no one else wants. Even before the Bear Stearns bailout and guarantees to J.P.Morgan, the FRB had \$881 bill. in assets resting on a mere \$38 bill. in capital, while the NY Fed had \$312 bill. in assets supported by less than \$10 bill. in capital. Since the beginning of the credit crisis in July 2007, the FRB's holdings of U.S. Treasuries has been cut in half from \$780 bill. to \$370 bill.

- America has now entered an extended period of soaring government deficits. Ten months through the 2008 fiscal year, the federal government deficit has risen to \$371 bill, \$213 bill, higher than the shortfall recorded in the same period in fiscal 2007, as adjusted expenditures rose by 8.4% compared with a 0.8% revenue decline. Corporate tax revenues declined 14.4%, confirming our forecast of a near double-digit decline in NIPA profits in 2008, while individual income tax payments fell by 1.6%. At the state level, with tax revenues plunging, a \$50 bill. state and local budget surplus under the Bush Administration is projected to become a \$40 bill. deficit in fiscal 2009. If all of Obama's tax proposals are implemented, the U.S. deficit could rise to over \$1 trillion (Table 97).

- Net exports contributed 3% points to real GDP in the second quarter, more than offsetting the weakness in housing and inventory liquidation. On a national accounts basis the net export deficit, which peaked at \$638 bill. in the fourth quarter of 2005, declined by \$85 bill. to \$378 bill. in the second quarter, the lowest level since 2000. In the second half we expect the net export deficit to fall at half the pace of 2Q however or by \$38 bill. to \$340 bill, as world trade growth and import demand from our major trading partners in Europe (26% of U.S. exports), Canada (21%), Mexico (11%), and Japan and China (5%) slows sharply, and dollar appreciation is reflected in nominal export data (Table 102).

- With the growing evidence of sharp downturns in the Eurozone, Japanese, British, and Canadian economies, and increasing uncertainties about the stability of the international financial system, foreigners demand for U.S. securities appears to have rebounded in recent months, with net foreign purchases of U.S. long-term securities accelerating to an \$800 bill. annual rate over the past three months, more than enough to cover the current account deficit, compared to \$446 bill. in the year through June. The dollar has now completed its six-year correction on a trade-weighted basis and we expect the current account deficit to return to a sustainable level at 4% of GDP in 2009 or \$635 bill. on a 5.6% decline in exports and a 2% drop in imports, and we expect continued appreciation in the dollar against the euro, and sterling, with six-month targets of 1.30, and 1.60 respectively (Table 113).

- Second quarter **Euro-zone** economic growth fell by 0.2%, the worst quarterly performance since the common currency's launch in 1999. With the German economy contracting by 0.5%, France and Italy by 0.3%, and the U.K. facing its worst economic conditions in 60 years, it is clear that the European economy has entered a sharp and potentially protracted downturn in the face of declining consumption by over-leveraged consumers, shrinking investment and export growth, and financial market turbulence. With order backlogs at record lows and inventories at record highs, business sentiment has weakened significantly in all major countries, with the German IFO index falling in August to a 3-year low and expectations plummeting to their lowest level since 2002. We have again lowered our Euro-zone real GDP forecast for 2008 to 1.4% compared to 2.2% in 2007, and are projecting a further slowdown to 0.7% in 2009, well below the current *Economist* consensus forecast of 1.2%, led by sharp declines in capital spending and exports. We would remain underweight all European markets (Tables 114-127, Pages 77-79).

- In **Japan**, 2Q real GDP contracted at a revised 2.8% annual rate, the largest decline in seven years, confirming that the economy is sliding rapidly into recession. Year-on-year growth slowed to 1% as a downturn in business capital spending, corporate profits, and exports, has joined continued weakness in consumer demand. Real consumer spending, accounting for 60% of GDP, fell at a 2% annual rate, while real business capital spending declined by a downwardly revised 6.5%, real exports by 10%, and residential investment by 13%. Consumer prices rose by 2.3% yoy in July, the fastest rate in 11 years, and wholesale prices were up 7.1% yoy, a 27-year high. A consensus of 21 private-sector economists slashed their forecast for fiscal 2008 growth from 1.5% in June to 0.7%, with

forecasts for fiscal 2009 averaging 1.3% compared to our own forecast of 0.3% (Tables 128-155, Pages 79-85).

- The outlook for **China's** economy continues to deteriorate. The stock market bubble has collapsed, and excess liquidity and food shortages have driven producer price inflation to double-digit levels. The wealth effect of plunging stock prices cut real urban income growth to 6% in 1H from 12.2% in 2007, the smallest increase since 1997. Corporate profit growth have been slashed by almost two thirds in 1H 2008 by rising wages and commodity and energy input prices, and could fall to close to zero in 2009, while shortages of power and skilled labor threaten to constrain future growth. We expect China's economic growth to slow from 11.9% in 2007 to 9.4% in 2008, led by declining investment and export growth, with the economy slowing further to 7.7% or lower in 2009 and beyond as all of the major industrial economies fall into recession. The risk of a hard landing is rising (Tables 156-174, Pages 85-94).

- Excess capacity, rising inventories, and sharp increases in raw material and labor costs, are increasingly impacting Chinese corporate profits and the continuing stock market downturn. The 60% plunge in the stock market over the past ten months, including a 34% decline in 1Q, the worst quarterly decline in the bourse's history, and the consequent reversal of stock market profits on corporate income statements, could see overall Chinese corporate profits plunge by two thirds this year. Last October we forecast a minimum 50% decline in Chinese shares from the then 6000 level. This has already been substantially exceeded, with the Shanghai Composite index (SSEC) falling to 1800 in recent weeks. Individual and corporate speculators are now dumping shares with a vengeance in the face of a slowing economy and slumping profits. We have revised our downside target to 1500 in 2009.

- **While most market strategists pay only lip-service, if at all, in their forecasts to geopolitical factors, beyond the potential disruption of oil supplies, we believe that they are an increasingly important element in assessing the global economic and market outlook, and have incorporated them in our research for the past thirty years. Currently there are three major sources of geopolitical risk – Iran's nuclear weapons program and Israel's response, the growing political instability in, and "Talibanization" of, a nuclear-armed Pakistan, and Putin's increasingly aggressive strategy to restore Russia to its former borders, while controlling the flow of energy to the West and building an alliance with Iran.**

- In **Russia**, in pursuit of his strategic goals Putin has in recent months unleashed a cyber-war against tiny Estonia, formerly a Soviet republic, threatened the Czech Republic and Poland with nuclear targeting if they host U.S. antimissile hardware on their soil, and exploited small price disputes to stop gas deliveries and thus show Ukraine, Belarus and former Warsaw Pact members who runs the "Common House of Europe." Georgia, the object of Putin's latest trumped-up intervention, and the "last of the independents," is a critical conduit for oil and gas that goes around Russia into the Black Sea and (with a planned gas pipeline) via Turkey into the Mediterranean. If Moscow gains control over Georgia, it is "good night, and good luck" to Europe. All of its gas and oil bought in Eurasia (minus the Middle East) will pass through Russian hands in one way or the other. These are the flash points of the 21st century's Great Game, and the issue is: who will gain control over the Caspian Basin, the richest depository of strategic resources next to the Middle East (Pages 9-16).

- Putin's re-transformation of Russia into a one party fascist dictatorship, and his enforcement of state control over the economy and the media, has been but a prelude to the even more dangerous re-Sovietization of Russian foreign policy. Declaring that *exclusive zones of influence are a thing of the past*, Putin has signed trade and arms deals with anti-American governments such as Iran and Venezuela, which are clear strategic threats to the United States. In returning to the politics of the Cold War it is clear than an era of apparent cooperation with the West is over, and that the Kremlin's foreign policy objectives now pose a growing threat to both stability in the Middle East and in Europe. Growing evidence of military, nuclear, and dual use technology supplies to Islamo-fascists in Iran, Iraq, Syria, Lebanon, and Palestine is indicative of a return to the Soviet world-view of the Cold War years.

- While attention has focused on the implications of Russia's actions in Georgia, for Ukraine, the Baltic States and Europe generally, there is also a direct strategic threat to U.S. efforts in Iraq and Afghanistan. The drama now unfolding in the Caucasus casts Moscow's shadow across all of Central Asia and down into the Middle East. Between Russia and Iran, in the lower Caucasus, sits a small wedge of independent soil, namely Azerbaijan and Georgia combined. Through those two countries runs the immensely important 1000 mile long Baku-Tbilisi-Ceyhan (BTC) pipeline, which delivers precious oil circuitously from Baku, Azerbaijan to Ceyhan, Turkey and out to the world. Besides their own pipeline, Georgia and Azerbaijan offer a fragile strategic conduit between the West and the "stans" of Central Asia, including Afghanistan, an area that the Soviets once controlled in toto. An isolated Central Asia means an isolated Afghanistan. Instability, or outright Russian intervention in the "stans" could further destabilize an Afghanistan already under the control of regional warlords in the north and west, and under attack from the Taliban and Al-Qaeda in the east and south.

- Russia is also collaborating with Iran on its nuclear missile program. With its military now based in South Ossetia, Russian troops are less than 300 miles from the Iranian border. The Russians are acting as go-betweens with North Korea as part of a multi-million pound deal they negotiated between Teheran and Pyongyang in 2003 which has enabled Teheran to receive regular clandestine shipments of top-secret missile technology, believed to be channeled through Russia. Western intelligence officials believe that the technology has enabled Iran to complete development of an intermediate-range ballistic missile (IRBM) with a range of 2,200 miles, designed to carry a 1.2-ton payload, sufficient for a nuclear device, allowing the Iranian missile to reach targets far into Europe - including Rome, Berlin, and much of France. North Korea has also developed a three-stage ICBM, the Taepo Dong 2, that could reach America's west coast, based on the submarine-launched Soviet SSN6. Russian specialists have also been sent to Iran to help development of its Shahab 5 missile project, which the Iranians hope to have operational by the end of the decade. Finally, delivery of Russia's advanced S-300 anti-aircraft systems (also known as the SA-20), which can track 100 targets simultaneously with a range of 75 miles, before the end of the year, directly or through Belarus, has been described by weapons experts as a "game changer", vastly increasing Iran's ability to intercept an Israeli attack.

- By undermining diplomatic efforts to contain Iran, and assisting in the building of Iran's nuclear facilities such as the Bushehr reactor and its long-range missiles, by signing a \$3 bill. deal with Venezuela's Chavez to provide arms and fighter planes which will be used to suppress internal opposition to his authoritarian and violently anti-U.S. regime and supply terrorist guerillas in Colombia, by its overt and covert support for Hezbollah and Hamas which it has refused to place on its recently released list of international terrorist groups, by allowing Iranian banks to continue to conduct business, and the opening of ten new North Korean bank accounts in Moscow to circumvent financial sanctions against a rogue nuclear regime, by its subversive activities against democratic governments in the Ukraine and Georgia, and by its increasing use of its oil and gas resources to manipulate and threaten the cut off of energy supplies to Europe, the Putin administration has demonstrated that it poses an increasing threat to international stability.

- Russia's economy remains massively vulnerable to the withdrawal of foreign capital however. Since the invasion of Georgia over \$40 bill. in foreign capital has left the economy, and \$700 bill. has been wiped from the capitalization of the RTS index, which plunged almost 60% since May from 2500 to below 1100 before regulators stopped trading. The ruble has registered its biggest monthly decline against the U.S. dollar in more than nine years. The amount of debt raised by Russian companies in August fell 87% from July levels, while the issuance of new equity has ground to a halt, as a mere \$3 million was raised in August compared to \$933 million in July. Falling oil prices have also added to Russia's economic problems.

- Given the rapid deterioration in U.S./Russian relations and the growing risk of both U.S. restrictions on trade and investment in Russia, and the increasing potential for expropriation of western assets, we reiterate our view, first stated in our December 2006 report, that further equity and direct investment in an increasingly fascist Russia is both counter-productive and inappropriate, and we would continue to significantly reduce any existing holdings.

- In **Pakistan**, the resignation of Nawaz Sharif's Pakistan Muslim League (N) from the governing

coalition in late August, and the outlawing of the Taliban umbrella group, Tehrik-e-Taliban, by Asif Ali Zardari's ruling Pakistan Peoples's Party (PPP) has further increased the prospect of instability and sectarian strife in a predominantly Sunni country whose support is crucial to America's war on terror. Zardari's, Benazir Bhutto's widower and a Shia, relations with the military were soured in July when his government tried to put Pakistan's military spy agency, the Inter Services Intelligence (ISI), under the home ministry rather than the military. Zardari's intensification of the anti-terrorism effort in the frontier provinces of the NWFP and FATA has been welcomed by the U.S. and NATO, which have pushed Pakistan to do more to prevent militants attacking their troops in Afghanistan from across the border. However 71% of Pakistanis in a recent poll opposing cooperation with the U.S. in counter-terrorism, and 51% opposing fighting the Taliban. Zardari and the PPP will have a hard time gaining popular support for their policies from both the public and the military (Pages 32-36, Maps 9-10).

- The new government has also inherited a sharply weakening economy. Real GDP growth is estimated to fall to 4% or below in the current fiscal year through June 2009 after averaging 7% over the past four years, inflation has quadrupled to 24.3% yoy in July, and the current account deficit has doubled to \$12 bill. Net foreign investment plunged 40% in the last fiscal year, interest rates are in double-digits, and foreign exchange reserves are falling. Imports of expensive oil have cut Pakistan's foreign-exchange reserves by more than 35% since last October, widened the country's trade deficit and put pressure on its currency, the rupee, which has touched record lows against the dollar in recent weeks. Pakistan recently raised prices of fuel products for the sixth time in five months, by as much as 17%. Runaway food prices, energy shortages and a plunging stock market have hit Pakistanis hard and left the government scrambling to defuse public anger. Chronic power outages, which have come during Pakistan's sizzling summer months, have disrupted businesses and helped sour the political mood. The main Karachi Stock Exchange index fell for 15 straight sessions in August, and is down 30% since April, triggering a window-smashing rampage at the exchange by anguished investors.

- The Talibanization of Pakistan is now spreading from the frontier provinces of the NWFP and Baluchistan to the interior cities. Events in Islamabad in 2007 proved that the Taliban are not satisfied with remaining confined to the tribal belt. Peshawar adjacent to the Khyber Agency is under siege and government officials report that the Taliban is close to taking control of the city, the HQ of Pakistan's 11th Corps and the site of a U.S. consulate. Businesses are abandoning the city, as 90% of their supplies are undeliverable for security reasons. The government's control over three of Pakistan's four provinces remains tenuous at best. The western province of Baluchistan which comprises half of the country's land mass is in the grip of an insurgency, law and order has broken down in Sindh. Kashmir is a disputed battleground with India, and the so-called Federally Administered Tribal Areas (FATA) of Waziristan and the North-West Frontier Province (NWFP) have been effectively ceded to the Taliban Pashtuns and Al-Qaeda respectively, with the governments attempts to reach negotiated accommodations with the militants ending in failure and renewed violence.

- U.S. and NATO frustration with the former Pakistani coalition government's unwillingness to confront the Taliban in the NWFP and FATA had reached a critical point, and the U.S. has responded by intensifying military operations into Pakistani territory and increased use of air and artillery strikes including Predator drones. The latest assault in South Waziristan on September 3rd, involving U.S. special operations troops and the Afghan military, was the fourth cross-border attack since Aug. 20 and the 10th confirmed attack this year. Only ten such strikes were recorded in 2006 and 2007 combined. Pakistan has warned of violations of its sovereignty and threatened retaliation against U.S. forces. There can be little doubt, as detailed in a June RAND study, that the Taliban enjoys the support of the ISI and the Frontier Corps, and is conducting cross-border operations from a safe haven against NATO and Afghan forces with the full connivance of the ISI. Given the deterioration in relations with both the U.S. and the Karzai government in Kabul, and the growing threat posed by the Taliban to Pakistan's increasingly unstable civilian government, there is a growing possibility that the U.S./NATO/and Afghanistan will choose to launch their own major cross-border offensive to destroy the Taliban support bases and sanctuaries in the NWFP and FATA in the coming months.

- The danger is that should this occur, and the Pakistan government respond militarily to the invasion of their sovereign territory, as their senior generals have threatened, America could find itself embroiled in a major confrontation, at a time when its military is already stretched to breaking point. A NATO force of 60,000 in Afghanistan could find itself facing a

650,000 strong army, by far the largest in the Muslim world, backed by a further 300,000 paramilitaries, a modern air-force courtesy of the United States, nuclear missiles, and a resurgent Taliban. In recent weeks Pakistan has been testing the Hatf-VIII air-launched cruise missile, reverse engineered from the American Tomahawk cruise missiles recovered in Afghanistan, which the army claims can carry a nuclear warhead and has "special stealth capabilities." Although Zardari and the PPP have pledged closer cooperation with the U.S. in dealing with the terrorists in the NWFP and FATA, their control of the Pakistani military, and in particular the ISI, remains tenuous, and could create the pretext for a new military coup by Islamic hardliners within the Army, increasing the risk of a confrontation with the strongest nuclear-armed military power in the Muslim world.

- In **Afghanistan**, the Taliban insurgency has been reinvigorated not only by the growing political instability in Pakistan but also by a significant build-up of sophisticated weapons and IED's provided by Iran along the traditional smuggling routes through Herat and Faraj to the main Taliban bases in Helmand and Uruzgan provinces. Attacks on U.S. troops in these provinces were up 20%-30% in June/July from a year earlier, and U.S./NATO casualties will be the highest since the 2001 invasion. Despite the recent expansion in NATO troop levels to 60,000 U.S. and allied forces, and a further 8,000 troops involved in counter-terrorism operations in most of Afghanistan's 34 provinces, the overall security situation continues to deteriorate. The corruption and weakness of the Karzai government in Kabul and of regional officials, inadequate levels of foreign aid for economic and infrastructural development, and rising civilian casualties, have all served to undermine popular support for the central government.

- Afghanistan is at risk of becoming a lawless narco-state, where drug dealing warlords and terrorists will determine who holds power. Rising crime, in particular the kidnapping of businessmen for ransom, and official corruption are leading to capital flight and a reversal of investment trends. Outside of Kabul where construction is booming, and to a lesser extent Kandahar, the country is plagued by massive unemployment, shortages of electricity where availability is lower than seven years ago, and a collapsed infrastructure. Frustration and cynicism are mounting, and the weak and unpopular Karzai government appears incapable of taking the strong action necessary to contain the growing power of the warlords such as Dostum, curb official corruption linked to the narcotics trade, and limit the Taliban resurgence in the south. With AQI and the Mahdi Army militias crushed in Iraq, and two-thirds of the country's provinces under the control of the 600,000 strong Iraq Security Forces (ISF), both U.S. presidential candidates have endorsed transferring U.S. forces to Afghanistan. It is to be hoped that the new "Surge" will be sufficient to roll back the Taliban insurgency (Pages 36-38).

- **Iran's** nuclear weapons program, now under the sole control of the IRGC, is approaching critical mass, and the window of opportunity for disarming strikes against the key facilities is beginning to close. Iran now has 4000 operational centrifuges, compared to less than 200 two years ago, with plans to build 54,000 to enrich uranium. Iran's controversial nuclear enrichment programme at Natanz, which Tehran insists is designed to produce fuel for nuclear power, runs on P1 centrifuges. But Iranian nuclear scientists recently conducted successful tests on a prototype P2 centrifuge at Natanz, which can enrich uranium to weapons grade two to three times faster than conventional P1 centrifuges. The potentially imminent development of a nuclear warhead becomes even more critical as evidence accumulates that Iran is close to production on its Shahab-4 series missile with a range of up to 3000 kilometers (almost 2000 miles) capable of reaching targets in Europe and anywhere in the Middle East (Pages 18-21).

- Iran has also been conducting test launchings from naval vessels in the Persian Gulf to determine if its Shahab-3 ballistic missiles, capable of carrying a nuclear warhead, can be detonated by a remote-control device while still in high-altitude flight, to destroy America's technical infrastructure, using electromagnetic pulse (EMP) weapons, even one of which could knock out America's critical electrical and technological infrastructure, effectively sending the continental U.S. back to the 19th century with a recovery time of months or years. A recent Iranian military journal article entitled "*Electronics to Determine Fate of Future Wars*" discussed the potential launch of an EMP attack on the United States. Detonated at a height of 60 to 500 kilometers above the continental U.S., one nuclear warhead could cripple the country, knocking out electrical power and circuit boards, paralyzing U.S. domestic communications, and therewith much of the economy, for months if not years.

- Next week will mark five full years since Iran's covert nuclear weapons program came to light, and nothing has changed in that time. Iran has demonstrated the ability to enrich uranium; it has installed and tested 4,000 centrifuges; it has advanced the construction of its heavy water plant at Khondab; it has tested missiles with sufficient range to hit Israel; it has taken delivery of advanced Russian SA-15b anti-aircraft missiles; it is in the process of purchasing even more advanced Russian SA-20 missiles; and it has not deviated an inch from its basic position of never yielding their "right" to a full nuclear program. Meanwhile, the UN does the only thing it knows how to do: dole out more sanctions—and hope for a different result. Iran has no intention of stopping its pursuit of nuclear weapons, no matter how many UN sanctions are levied against it. Time is running out.

- **Israel** however may not be willing to wait for diplomatic negotiations by what Condoleezza Rice has ludicrously called "*a successful multilateral coalition*" to end Iran's endless filibuster while it moves ever closer to nuclear weapons. Nobody in Tel Aviv, or in the White House, realistically believes that diplomacy, or the impotent U.N's sanctions, can stop Iran's development of nuclear weapons. The Israelis know that given the size of their country one nuclear bomb could destroy it. But to destroy Iran's nuclear program Israel would not only need to hit a dozen nuclear sites and scores of anti-aircraft batteries, but to prevent a devastating retaliation, they would have to knock out possibly hundreds of long-range missiles that can carry chemical warheads. Recent exercises over the Eastern Mediterranean, involving more than 100 fighters, helicopters to rescue downed pilots, and refueling tankers, which flew 900 miles, the distance from Israel to Natanz, were preparation to do just that. Israelis across the political spectrum, believe the risk incurred by inaction is far greater.

- Dealing with Iran has become a key issue in Israel's Kadima party primary on September 17th. However unlike the attack on North Korea's reactor in Syria a year ago, the Bush Administration has reportedly refused to give Israel the green light for an attack on Iran's key nuclear installations, the underground uranium centrifuge enrichment and heavy water production facility at Natanz, the heavy water production plant at Arak, and the nuclear research center at Isfahan, preferring covert action. Kadima's choice of Tzipi Livni, formerly Israel's foreign minister, to succeed Ehud Olmert, over the contender with the most hawkish stance, Transportation Minister Shaul Mofaz, who has made repeated statements about potential military strikes against Iran's nuclear program, makes the prospect of a Likud government led by the even more hawkish Benjamin Netanyahu more likely. **There is little question that Israel is prepared to attack the key Iranian nuclear installations, with or without American approval, if it believes there are no remaining alternatives to Iran acquiring nuclear weapons (Pages 21-22).**

- The critical question is what would be the Iranian response to air-strikes against Iran's nuclear and military facilities by the Israelis. Although a full-scale Iranian military retaliation is possible, although highly unlikely given its far inferior conventional forces, especially with the significant US force presence in Iraq, Afghanistan, and the Gulf, the commander of the IRGC, General Mohammad Ali Jaafari, has specifically said that Iran will "impose control" of the Straits of Hormuz and the Persian Gulf. It is also possible that Iran could use its ballistic missiles to strike US or allied targets throughout the Persian Gulf region, including the Saudi oil-fields, and in fact other Iranian officials have explicitly promised to do just that. In addition Iran would almost certainly use its Lebanese terrorist proxy Hezbollah, to launch renewed missile attacks on Israel in the event of Israeli air-strikes. Ahmadinejad and his Islamo-fascist regime, have also in the past made it clear that they will respond through widespread terrorist attacks and suicide bombings in the West, utilizing their "sleeper-cells" of *Shaheed* or martyrs (Pages 23-24).

- The United States could also suffer a repeat of 9/11 (see Appendix) from Al-Qaeda and Hezbollah sleeper-cell terrorists. U.S. authorities have no doubt there are terrorist sleeper cells in our midst. In 2002 the FBI concluded in an internal review that somewhere between 50 and 100 Hamas and Hezbollah operatives had infiltrated into America. The FBI believed these operatives "were in America working on fund-raising and logistics, and they had received terrorist and military training from Lebanon and other countries in the Middle East, giving Hamas and Hezbollah the capability of launching terrorist strikes." In 2004 the FBI reported that al-Qaeda sleeper cells were believed to be operating in 40 states, awaiting orders and funding for new attacks on U.S. soil.

- A terrorist attack using a RED (radiation-explosive device or "dirty bomb") would produce chaos

and fear, while a coordinated attack, where a group of terrorists carried out simultaneous or near-simultaneous dirty-bomb explosions within once city such as New York, could effectively shut down that city, Having five car bombs explode on any given day in New York City would bring the town to a sudden halt, kill hundreds of people, contaminate parts of the city for months if not years, and cause massive fear that other attacks could be scheduled to follow either in New York City again or in any other major U.S. metropolis: Cleveland, Detroit, Boston, Chicago, Los Angeles or San Francisco.

- It is seven years today since the horrors of 9/11, and the potential for a new terrorist attack on the U.S. homeland remains high. There are huge quantities of fissile nuclear material available all over the world, frequently without adequate inventory control or protection safeguards in place. What has emerged as an even more serious threat, especially with the millennial regime in Iran going nuclear, is what is known as the improvised nuclear device (IND). The IND has become the preferred choice of serious terrorists. Manhattan Project physicist Luis Alvarez affirms that making such a bomb is not complicated. **In the Appendix, "The Next 9/11", we outline what could happen should terrorists detonate an IND in Manhattan. The results would be devastating, not only for New York, but for the whole of the United States, and the global economic, political, and military implications catastrophic. Given current geopolitical trends, it may be only a matter of time before such a catastrophe occurs.**

Roger Cass

September 25th 2008.

GLOBAL PORTFOLIO STRATEGY – EQUITIES.

Overweight

Canada (12500)

Market Weight

United States (11100/1210),Australia (5000),Mexico (25600), Taiwan (6100), Korea (1500).

Underweight

Japan (12000), Germany (6200), U.K. (5200), Spain (1240), France (4200), Italy (21000), China (2300), India (13600), Thailand (650), Brazil (52000), Argentina (1700), South Africa (25000), Russia (1300), Hungary (19000), Poland (38000), Israel (800), Egypt (2400), Saudi Arabia (7500).

GLOBAL PORTFOLIO STRATEGY – CURRENCIES

Long – U.S. Dollar (1.55 SDR – 1.40 end-2009), RMB (6.85 – 6.40),

Short – Euro (1.45 – 1.30), Pound (1.85 – 1.60), Rand (7.80 – 8.70), Real (1.85 – 2.00).

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