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By John Mauldin

Once again it's time for me to demonstrate the foolhardy part of my nature by putting to electronic pen my forecast for 2006. I spend more research time on this one letter than on any four or five combined, simply reading hundreds of pages of research, looking at mountains of data all in an effort to try and catch the gist of the markets. It is a daunting task, but one to which I actually look forward, as it challenges the mind like few other endeavors.

If I go into as much detail as I usually do on each topic, there is the potential for this e-letter to be much too long. Therefore I will try and take the larger picture, make specific and shorter predictions and save the details and the arguments for later issues. Let's begin by quickly reviewing how we did last year.

Each year as I do this forecast, I look for a theme. What will be the driving factor which will set the stage for the economy? In 2001 it was the coming recession; in 2002 it was a weak recovery and the beginning of the Muddle Through Economy; in 2003 it was Surprise and Transition. In 2004 it was the Silver Lining Economy and last year it was the See-Saw Economy. For masochists, you can go the archives at www.2000wave.com and read those forecasts.

This year, my theme is "On the Gripping Hand." Larry Niven & Jerry Pournelle wrote a masterful 1993 science fiction novel called "The Gripping Hand" which involved a species of aliens with three arms. They had a left and right hand along with their most powerful hand called the gripping hand. They also tended to find three ways to look at every situation: "On the one had, on the other hand and on the gripping hand." It was a species bred to be economists. We will look at a few such situations facing the economy today, and think about what forces have the world and US economy in their gripping hand.

As I re-read my last year's efforts, it was again not a bad year, but not perfect. I initially expected the dollar to get weaker against the euro, but by the end of March I reversed that as facts changed. I said the Fed would tighten to at least 4% and they did (this was a non-consensus view at the time). I also expected long rates to rise somewhat, which did not happen, and that was the one big miss. I suggested that stocks would be flat with the risks to the downside (again, out of the mainstream). I said gold and oil would be up. I predicted the economy would grow above trend and it has.

As I look at the coming year, I think it is likely I will not be as successful in my accuracy. There are a lot of potential variables which could cause any number of my predictions to be wrong. But chief of my concerns is Fed policy. When will they stop raising rates? In my mind, I see Ben Bernanke playing Clint Eastwood, doing the Dirty Harry role, looking into the face of the housing market and saying, "Do you feel lucky punk? Well, do you?" As we will see, this is the wild card upon which the economy will turn.

Let me note that this issue probably gets forwarded more than any other weekly letter I write. For new readers, you can join my 1,000,000 closest friends and get this free weekly letter sent directly to your email address by going to www.2000wave.com and simply entering your email address. Now, let's get into the forecast.

Bretton Woods 2 Keeps on Rolling Along

In 2005 the United States is projected to run a trade deficit of $806 billion, up from $668 billion in 2004. The International Monetary fund forecasts that the trade deficit will rise to $890 billion in 2006 and then to what can only be called a staggering $980 billion in 2007. How in the wide, wide world of global trading can one country run an almost $1 trillion dollar trade deficit? What is the rest of the world going to do with all those dollars?

Will central banks really want to buy almost $2 trillion more in US debt in just the next two years? They own approximately (and at least) $1.5 trillion today, accumulated over many years. Do they want to own all of our government debt? At the level of projected trade deficits, that could happen in just a few years. Is this really sustainable?

The simple answer is no, but the correct answer is that this situation can go on a lot longer than one would think. And all because of an odd arrangement many call Bretton Woods 2. I wrote about Bretton Woods 2 last February, but it is worth going over again briefly, as it is the lynchpin to our global economy.

Things Fall Apart; the Center Cannot Hold

"Things fall apart; the center cannot hold; mere anarchy is loosed upon the world, the blood-dimmed tide is loosed, and everywhere the ceremony of innocence is drowned." - William Butler Yeats

Yeats was not describing what has come to be called Bretton Woods 2, but it seems apropos to start with that quote. The first Bretton Woods system came about when representatives of most of the world's leading nations met at Bretton Woods, New Hampshire, in 1944 to create a new international monetary system. Because the US at the time accounted for over half of the world's manufacturing capacity and held most of the world's gold, the leaders decided to tie world currencies to the dollar, which, in turn, they agreed should be convertible into gold at $35 per ounce.

Under the Bretton Woods system, central banks of countries other than the US were given the task of maintaining fixed exchange rates between their currencies and the dollar. They did this by intervening in foreign exchange markets. If a country's currency was too high relative to the dollar, its central bank would sell its currency in exchange for dollars, driving down the value of its currency. Conversely, if the value of a country's money was too low, the country would sell dollars and buy its own currency, thereby driving up the price.

The dollar became the world's reserve currency. Yet there were limits. Each country had to police its own reserves and currency or be forced to revalue. And the US was constrained because the dollar was fully convertible into gold. This changed in 1971 when Nixon closed the gold window.

Now we have what many are coming to call a Bretton Woods 2 system. That is where much of the world, but primarily the Asian countries, has more or less informally agreed to peg their currencies to the dollar. They do this in order to maintain their relative competitive ability to sell their products to the world and specifically to the US.

But this system is inherently more unstable than the first Bretton Woods. There is no gold conversion constraint upon the reserve currency. The US has few reasons to protect the value of the currency, and many reasons why they should want it to drop. And there is no formal agreement among the nations. Any nation at any time could begin to act unilaterally to change.

Bretton Woods Two is actually a Nash equilibrium. In game theory, the **Nash equilibrium** (named after John Nash) is a kind of optimal strategy for games involving two or more players, whereby the players reach an outcome to mutual advantage (or often as not mutual disadvantage). If there is a set of strategies for a game with the property that no player can benefit by changing his strategy while (if) the other players keep their strategies unchanged, then that set of strategies and the corresponding payoffs constitute a Nash equilibrium.

Foreign nations, but primarily Asian nations, take our electronic dollars and send us "stuff." On our side of the equilibrium, American consumers agree to not save very much and borrow against our rising housing values to hold up our end of the bargain. We have been very good at holding up our part of the bargain.

They agree to keep prices down. If they tried to get rid of their dollars, their currencies would rise in value against the dollar, and thus the cost of their stuff to us. This would make them less competitive against each other. So, to keep their factories going, they keep their currencies low in a competitive devaluation.

If there was one "Super-Asian" currency, there would be no incentive for them to do so. But as it stands, you have a dozen or more countries buying large amounts of US debt in a form of vendor financing. This happens when Asian company A sells us $10,000,000 of widgets. They need local currency to pay their bills, so they trade their

dollars into their central banks for local currency (either directly or indirectly through intermediaries). The central banks then manage the value of their respective currencies.

But now they have dollars, and need to do something with them. They could buy stocks or real estate or anything denominated in dollars, but central banks prefer US debt. This has also had the effect of holding down our interest rates on the long end of the yield curve. This in turn keeps mortgage rates low which helps power home values and cash-out refinancing.

Under Bretton Woods 1, Nixon could end the agreement by closing the gold window. Under Bretton Woods 2, foreign central banks have us in their gripping hand. For now, they have no incentive to change the rules, as it would hurt them to do so. Who would buy their widgets and keep their factories going and employment rising? But at some point, as a small but growing number of foreign central bankers have pointed out, the deal is going to have to change. You can have too much if a good thing, especially if you have to swallow a trillion of them a year.

What is so uncomfortable about this situation is that we will not know when the equilibrium equations will change until they have already changed. As Martin Barnes of Bank Credit Analyst puts it, "Of course, there is a limit to how high the US current account deficit can get. Unfortunately, we will only know that limit has been reached when markets start to riot. The dollar's strength argues against any near-term problem, but markets can be fickle, and we cannot rule out a marked reversal in sentiment toward the dollar. The crucial assumption is that Asian central banks would then step in quickly to restore calm to the markets."

It will take two things to happen for the trade deficit to reverse. First, the dollar will have to go down, and secondly, the US consumer will have to buy less and save more. We will look later at how likely it may be that those two events happen this year.

But in 2006, I think Bretton Woods 2 remains the global paradigm. I am still long-term bearish on the dollar, but do not think the dollar as measured against Asian currencies will see anything like a major correction this year. You will see small moves in the Chinese yuan as the Chinese government allows the yuan to rise just enough to placate US protectionists, and that may give some room for other nations to slowly shift as well. But the 30% or so correction in the trade weighted dollar that is needed to bring the current account into something closer to balance? I do not think it is in the cards this year.

The dollar has been strong for several reasons this year. The Fed has been raising rates, which is dollar bullish. The government had a one year deal which allowed companies to repatriate dollars held offshore. By the middle of last year, everyone and their brother were bearish on the dollar. If there is no one on the other side of the trade, then a correction is due, and we got it. For the record, I am still long-term bearish on the dollar, but as I note below, this correction could take a long time.

Finally, for those who want to play the currency market, I think being long the yen against the euro is the way to go.

The Bernanke Fed's First Challenge

Where was the hint of inflation that was in the air last year? As I wrote last quarter, I think the inflation cycle peaked and we are now going to see a period of lower inflation. Core inflation is low in most countries around the world. The reigning paradigm in the world is still deflation.

The duel mandates for the US Fed are to hold down inflation and to promote full employment. The economy is still creating jobs, albeit slowly, and inflation is slowing. However, it seems that the Fed is going to raise rates at least twice more - once at the end of January at Greenspan's last meeting and then on March 28 when Bernanke is chairman.

Let's review Greenspan's major speech of last year at Jackson Hole. I wrote about this last August, but it is so critical that I think we should review it. Here are a few key paragraphs from that speech.

"The structure of our economy will doubtless change in the years ahead. In particular, our analysis of economic developments almost surely will need to deal in greater detail with balance sheet considerations than was the case in the earlier decades of the postwar period. The determination of global economic activity in recent years has been influenced importantly by capital gains on various types of assets, and the liabilities that finance them. **Our forecasts and hence policy are becoming increasingly driven by asset price changes.**"

Read that last sentence again. I had been writing for months that I thought the Fed was targeting asset prices, and specifically home prices. They are worried about a housing bubble creating problems in the economy.

The Fed Is Targeting the Price of Your House

Greenspan says above they are targeting asset prices. Can it be any clearer? You think they are worried about a stock market bubble? Commodity or gold prices? What other asset price is driving Fed policy? I think they perceive the greatest risk to be a continued housing bubble, and they are going to move to do what they can to let the air out of the bubble. Continuing:

"The steep rise in the ratio of household net worth to disposable income in the mid-1990s, after a half-century of stability, is a case in point. Although the ratio fell with the collapse of equity prices in 2000, it has rebounded noticeably over the past couple of years, reflecting the rise in the prices of equities and houses. Whether the currently elevated level of the wealth-to-income ratio will be sustained in the longer run remains to be seen. But arguably, the growing stability of the world economy over the past decade

may have encouraged investors to accept increasingly lower levels of compensation for risk. They are exhibiting a seeming willingness to project stability and commit over an ever more extended time horizon.

"The lowered risk premiums--the apparent consequence of a long period of economic stability--coupled with greater productivity growth have propelled asset prices higher. The rising prices of stocks, bonds and, more recently, of homes, have engendered a large increase in the market value of claims which, when converted to cash, are a source of purchasing power. Financial intermediaries, of course, routinely convert capital gains in stocks, bonds, and homes into cash for businesses and households to facilitate purchase transactions. The conversions have been markedly facilitated by the financial innovation that has greatly reduced the cost of such transactions.

"Thus, this vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk. **Such an increase in market value is too often viewed by market participants as structural and permanent.** To some extent, those higher values may be reflecting the increased flexibility and resilience of our economy. **But what they perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums."**

Again re-read the last paragraph, especially the last three sentences (emphasis mine). Greenspan is clearly saying that you should reduce your risk in your investments and business. He is saying that you should not project the current trend into the future. There is more risk than most investors are assuming. He is warning, in as clear as possible terms, that housing prices could easily go down. And in fact, he is all but saying that he intends to help them do just that, or at the least stop rising.

He and the rest of the Federal Reserve board are intent on raising rates until the housing market cries uncle. We have had several speeches in the past few months by Fed governors making that clear. This seems to me like a mindset that suggests the Fed is going to do what they have historically done in the past. They raise rates until the economy slows down or the yield curve inverts, or both!

But at the end of this month the "he" in that paragraph becomes Ben Bernanke. Does he agree? I think we should assume he does.

One of two things is going to happen. Either the housing market is going to slow down in terms of price increases, thus signaling the Fed it is time to call a halt to this cycle of rate increases or the Fed is going to keep raising rates until the housing market slows down.

Ben Bernanke has your home value in his gripping hand. He is called Gentle Ben. We may find out just how gentle he is.

The inventory of homes for sale is rising. Housing prices are starting to soften in a number of markets. Fannie Mae says home sales will be down 6% to 8% in 2006.

The third Fed meeting of the year is scheduled for May 10. In a somewhat ironic twist, if the economy is still roaring along, the Fed could (and I think would!) find justification for raising rates again, thus making it all the more likely there will be a slowdown later on, and a bigger one than we would think today.

But right now, things seem to be slowing down on their own. Wal-Mart just reported its smallest December sales gain in five years. Auto sales for the Big Three were all off in December. But the key is mortgage re-finance applications are down significantly. And that brings us to my next prediction.

A Mid-Cycle Slowdown

Depending on which set of statistics you want to use, mortgage refinancing has been responsible for at least 2-3% of GDP growth for the last few years. Take that component out and growth would have been quite dismal. Cash-out mortgage refinancing has been possible because hone values have been rising at an extraordinary rate for the last five years.

While I am not suggesting that all mortgage refinancing is going to stop, I think it is clear it is going to seriously slow down if home values stop rising and especially if home values start to fall.

The portion of GDP growth from mortgage refinancing is going to drop. By how much? No one knows, but it could easily be cut in half or more. We have seen mortgage applications for refinancing decrease by about 25% or so already.

Further, in many parts of the country, homes have been bought as investments. When prices stop rising, those homes are going to go onto the market, as the carrying cost of an interest only loan is painful. These “investors” are going to just want to stop the pain. That is going to exacerbate the housing price slowdown.

Will the housing market crash? I do not think so today (well, maybe in a few markets that are simply crazy). Overall, we are just going to see home prices go flat for what will likely be several years in a reversion to the mean. We have two references for what happens after a period of significant home prices increases in England and Australia. Neither of those two housing bubbles popped. The market just went flat in those countries, and that is the more likely scenario here.

But “flat” is all that is needed to slow down cash-out refinancing. So, that is one headwind the economy faces.

This scenario also suggests that new home construction will slow. That means job growth will slow down as well. Today's job number of 108,000 has to be viewed as disappointing, even if it is tempered by an increase of 71,000 for the two previous months.

We have seen mid-cycle slowdowns in the US in the last two economic cycles, both in the 80's and 90's. It now seems we will see yet another replay of that trend this decade as well.

If the Fed does not do what it has often done in the past and raise rates until we get a full and serious yield curve inversion and the follow-on recession, I think we will get a "mere" reduction in growth into the 2-2.5% area.

The consensus of economists is clearly bullish. But then listening to consensus economists is not very useful. Louis Gave brings this note to me:

"In any case, econometric models, like all mean-reversion techniques, are notoriously poor at spotting turning-points and detecting trend changes. In fact, according to a 2002 IMF study, out of 74 identified episodes of recession in different countries, only four had been correctly predicted by econometric forecasts published just three months prior the recession year – and in two-thirds of cases, consensus economists had failed to 'forecast' the recession even four months *after* it had started."

The Return of Muddle Through

I define what I call a "Muddle Through Economy" as an economy that grows below trend. Note that I used the word growth. I think we are in a Muddle Through Decade. Growth so far this decade has been 2.6%, which is below the trend of 3.6% since 1950. I think we will be lucky to end the decade with a 2.6% number, as I expect at least one more recession this decade. I think the following decade could be very strong.

By the end of this year, I think we will see growth slow into Muddle Through territory. Clearly, a slowdown will not be good for the US stock market. Last year I said the market would be flat with risk to the downside. This year I think the market actually ends the year down, and by at least 10% or more during the year.

That is clearly not consensus. The big majority of those polled by Business Week are anywhere from mildly bullish to wildly so. Elaine Garzarelli thinks the Dow will top 14,000. What is she smoking? It reminds me of the George Carlin line in some forgettable movie listening to someone tell a very improbable wild story about spies and doomsday drugs. "Wow," he said, "the 60's were sure good to you." 14,000 would put the P/E ratio back to 1999 territory. And with Ford and GM in the Dow? Come on.

This market correction is going to put more pressure on the retirement plans of the baby boomers. The market has been essentially flat since 1998. On March 31, 1999 the

S&P 500 was at 1286. Today the market closed at 1285. That is almost seven years of going nowhere for index investors.

But that is what happens in secular bear market cycles. The market goes nowhere for long periods of time waiting for valuations to reverse and then go below trend. When housing values begin to stop rising and stock markets disappoint, the aging boomer is going to look at his retirement funds and start to really worry. He is going to have to do something that heretofore he has resisted. He is going to have to save more.

By the end of the year, consumer spending is going to slow down as the "wealth effect" from both housing and stocks becomes negative. Enough to put us into recession? I don't think so, at least not this year. But it will slow the economy down. Thus, I think it is quite possible that Bernanke actually starts to lower rates before the end of the year. Yes, I see the irony.

How do we know if my prediction of a slowdown will turn into a recession? We will watch the yield curve. Typically it will give us a 9-12 month warning. Stay tuned.

We are already running long, so let's cut to the chase on the rest of the items. A slowdown will mean that long bond rates will be lower at the end of the year than they are today. The bear market in bonds is over, says bond king Bill Gross, and I agree. This will also serve to lower mortgage rates and is one of the reasons I think we could avoid an outright recession. A little stimulus here, and little stimulus there.

I should note that Gary Shilling makes a strong case for the housing bubble to burst, with prices dropping 20% and a major recession as a result. I will use that part of his last letter as an Outside the Box in coming weeks. For new readers, I send a second letter on Monday nights to all subscribers of my regular letter called Outside the Box which is the work of another analyst which I think is interesting and important, and most of the time it is non-consensus and thus Outside the Box thinking.

I am still bullish on gold, although I think we should see a correction to the recent powerful run-up. Gold is now rising not just against the dollar but against all currencies. It is not rising due to supposed inflation worries. If that were true, bond yields would also be rising. It is part demand from Asia and the Middle East, part momentum and investment driven and partly as a way to protect oneself from paper currencies. But it all adds up to a bull market in gold. It will be interesting to see if it becomes a bubble, although that is a long way off.

I am still bullish on energy. Demand is going to increase so much over the next ten years that prices are going to be pushed to new highs. Plus, I get very nervous that so much of our world supply of oil is in places like Nigeria, Venezuela and the Middle East which could see serious supply disruption due to local politics. An oil spike caused by a disruption in supply (as opposed to demand driven) could have a very negative impact on my mid-cycle slowdown prediction.

The global economy should do well, in spite of a US slowdown. Japan is starting to show signs of life. I do not expect China to have a hard landing as some predict. In fact, I am still quite positive about China and think growth is going to be quite good. There are a lot of positive things happening in China, and I am going to write about them in the coming weeks.

Let me give you one reason. Those "communists" understand something that our politicians don't. Last year, they simply did away with all rural taxes. In 2006, the threshold for income taxes has been doubled. Imagine, tax cuts designed to produce growth. Caveat: If Congress does not extend the dividend tax cut, watch the market get killed. It will be ugly.

Given my view, I am not all that excited about long only commodity funds. I think copper could be in for a serious correction this year. Funds which can benefit from volatility will have the potential to do well in this environment.

Toronto, New York and London

I will be in Toronto November 18-19 speaking at a private conference, but my friends and partners at Pro-Hedge will be setting up a speaking event one evening. If you are interested in coming, just drop me a note and I will get you details. I will be speaking at the "Hedge Fund Incubation and Seeding Conference" on January 30-31 in New York put on by Financial Research Associates. You can get more info at www.frallc.com. It is a subject I am quite interested in. I will be in London the week of 12-15th of February working with my London partners, Absolute Return Partners.

If you are an accredited investor (net worth of $1,000,000 or more), I might suggest you go to www.accreditedinvestor.ws. In conjunction with partners in the US (Altegris Investments) and around the world, we research and offer a variety of private offerings, commodity funds and hedge funds. (In this regard, I am president of and a registered representative of Millennium Wave Securities, LLC., member NASD. Be sure and read the risk disclosures below on the web site about hedge funds and private offerings.)

And speaking of Altegris Investments, I will be at their office in La Jolla next week for our annual planning meeting. I am looking forward to some new and exciting things we will be able to announce soon.

This is going to be a very busy year for me. I have committed to write another book called The Millennium Wave which is due in the fall. I have been thinking about this topic for 6 years. We will be starting a new service which will recommend money managers to regular investors (no net worth requirements) in February. I am quite excited about that. There are managers who understand the concepts of absolute returns about which I write so often, and I look forward to introducing them to you. We will be adding partner firms in various parts of the world to be able to serve more of my international readers. Those announcements will come soon!

We are having perfect weather in Texas. It is unseasonably warm for winter. We had a very mild summer as well. If our weather were really like this every year, California housing prices would plummet as everyone there would come here to get houses for 25% of what they are in California. There is no housing bubble in Texas.

It's time to hit the send button. Enjoy your week and year. Here's to a year where our bodies weigh less and our investment portfolios weigh more!

Your always excited at the beginning of a year analyst,

John Mauldin

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