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New York Times bestselling author Bill Bonner

THE END OF AUSTRALIA

The Real Story Behind Australia's Coming Economic Collapse and What You Can do to Survive It

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FOREWORD BY BILL BONNER

PORT PHILLIP
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For Linda, Alexandra, Emma and Grace.

Thank you from the bottom of my heart for all your love and unwavering support. You have all enriched my life in so many ways.

Love from a very appreciative husband and dad.

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Foreword

A few weeks ago, I was in Greece. I was there on the day the world was supposed to end. Greece has been living beyond its means for years. It was supposed to stop on 12 July. The Greeks had voted not to accept Germany's terms. The credit was supposed to run out on 12 July. So, I went to see what the end of the world looked like.

As it turned out, they worked out a last minute deal, proving that Greeks can kick the can further and longer than you can stay in Athens waiting for the debt bubble to blow up.

But just because you have to wait a long time for big events to occur doesn't mean that they won't occur. That which has to happen sooner or later will happen sometime. And the longer you wait for it, usually, the more important the event finally is.

In this book, my friend and colleague, Vern Gowdie, is warning about something that hasn't happened yet…and which many readers think never will happen. Or they think it is such a remote threat that it is not worth worrying about.

This is not a threat that is limited to, or even principally focussed on, Australia. It is worldwide. It has been developing for more than half a century. It now hovers over everything — our economies, our governments, our retirement and health systems — like a giant battleship from space.

But almost no one wants to say anything about it!

That's why this book is so important. Vern is pointing up. 'Watch out,' he's saying. He is one of the few who dare to notice and dare to say anything.

Why? Why aren't the authorities warning you?

The Keynesian model used by central financial planners over the last half century calls for tight policies when the economy is hot…and loose policies when it is cool. This is supposed to smooth out the boom/bust cycle.

But what we've gotten is not counter-cyclical policies, but just a boatload of easy money. The feds were quick to cut rates and slow to raise them. In the US, for example, rates were either flat or falling 80% of the time since 1986.

And fiscal policy — the US federal government budget — has always been stimulative. The feds are supposed to run surpluses in the fat years and deficits in the lean years. But there hasn't been a dime of real surplus since the mid-70s. Nothing but deficits.

This was not a good model. It was only occasionally counter-cyclical. Usually, it was pro-cyclical — making the booms and busts worse, not smoothing them out.

And now, thanks largely to all that stimulus delivered to the financial sector — but not to the real economy — there's a huge gap between what the economy actually produces in real wealth…and the wealth that people think they have as measured by stock, bond and real estate prices.

And the financial press reinforces the illusion. Look at the narrative of the crisis of 2008–2009, for example. It goes like this: the country suffered a financial crisis because of deregulation and greed. It is now recovering, thanks to the decisive action by the authorities. Ben Bernanke, Janet Yellen, and Mario Draghi are the heroes. The big banks are the villains. Dramatic tension is provided by occasional kangaroo courts that hit the bankers with big fines, and arguments over how fast the economy is recovering…and when the Fed will raise rates.

Good luck to you if you believe any of that. It is all nonsense. Nonsense on stilts. Nonsense on steroids. Nonsense with broadband.

But in the financial press and the mainstream press you will hear nothing different. Nor will political leaders give you a hint that there might be something wrong. Because if you admit that today's sales, profits and asset prices are tricked up by excess credit, you also have to admit that the whole system is vulnerable to a disastrous correction, like 2008, but worse.

That is the sort of financial crisis that no one wants to think about…especially the people who are responsible for it. So you will hear nothing about it from the *New York Times*. Nor the *Wall Street Journal*. Nor from Congress or president Obama. Nor Janet Yellen. Nor Jamie Dimon. Nor Paul Krugman. Nor the banks.

As far as I know, Vern and a small group of independent analysts — people who are not dependent on Wall Street or the government or, more importantly, on unlimited credit and ultra-low rates — are the only ones who are able to warn you. They are the only ones — apart from a few lonely academics and brave, and rather poor, hedge fund managers — with a logical and practical theory about why a depression is coming and why it could be a good thing.

But let's not call it a depression. Depressions have gotten so much bad press. Let's call it a 'reboot'. You know, if you use a computer, that it tends to accumulate trash…viruses…bad commands…confusion. Over time, it slows down, or even comes to a halt.

What do you do? Increase the power? Put on more software? More apps? More big files? No, you reboot it. You start afresh.

Well, sometimes, you have to do that to an economy too. And if you don't do it, it happens naturally…but often savagely. Vern explains why. And he also tells you what you need to do to protect yourself from it.

Bill Bonner
New York Times bestselling author

Introduction

As a sixth generation Australian who loves our country passionately, I can tell you writing this book has not been easy.

The natural Aussie predisposition is to adopt the 'glass half full' outlook on life.

This is best typified by the 'she'll be right mate' refrain to any obstacle or hardship placed in our way.

As one of five children growing up in suburban Brisbane in the 1960s and 70s, an attitude of 'she'll be right' was crucial to coping with the rough and tumble of life.

Especially the backyard sporting contests with my brothers.

Broken arm from football…she'll be right.

Hit in the ribs by a fast rising cricket ball…she'll be right.

A cut requiring stitches…she'll be right.

Ours was a typical middle class family. Dad worked and Mum stayed at home looking after the needs of the family.

We played in the yard or over at a neighbour's place, or explored the bush down the road.

With the exception of borrowing to buy the family home, my parents (children of The Great Depression) either saved or used lay-bys to buy bigger ticket items. Credit for consumption was not in my parents DNA.

Life was simpler. Kids entertained themselves. People generally lived within their means. Government was less intrusive. People tended to be more responsible for their actions. Teachers applied discipline with the endorsement of the parents…*'you obviously deserved it son'*.

The Australia I see today is one far removed from my childhood.

As a society we do not live within our means. Personal debt levels are amongst the highest in the world. Government intrudes into 'every nook and cranny' of our lives. People want to blame someone, anyone for the state of their lives — so long as it's not themselves. Personal responsibility is a rare commodity. Suffer an injury and it's no longer 'she'll be right,' but, 'who can we sue?'

With that said, I have travelled enough to know that Australia is still one of the greatest nations in the world to live, work, and raise a family in. And it's a country I'm proud to call home.

For that reason, putting into words the hardship I think Australia is going to face in the coming years has been more emotional than I expected it to be.

Australia is a wonderful nation filled with great people. However, we've allowed ourselves to be seduced by the powerful 'buy today, pay tomorrow' propaganda machine.

For decades we've lived beyond our means, courtesy of a financial system offering all sorts of credit facilities — home loans, credit cards, payday lending, 48-month interest free financing, and so on.

Year after year, debt levels have increased while savings dwindled. It's been one hell of an indulgent party — McMansions, new cars, holidays, furniture packages, the latest electronics, white goods, luxury goods, the trendiest fashions and plenty of expensive dinners out.

And even as the party ended for many nations around the world after 2008, Australia kept dancing. Thanks to China, a mining boom and a supposed 'miracle economy', there was no need to stop.

We purchased things we didn't need, with money we didn't have, to impress people we didn't know. Weekend garage sales bear testimony to the amount of excess 'stuff' that clutters our lives.

But all good things come to an end.

Unfortunately, no country on earth can remain permanently recession-proof

What I will demonstrate in this book is that the global debt crisis is coming to Australia's shores.

And debt crises <u>never</u> have good endings…

Believe me, I don't make this prediction lightly. And I have no interest in trying to scare you.

I'm simply following my research to its logical conclusion.

The global debt pile our lifestyles and retirement aspirations sit atop is the largest ever accumulated in history. Globally, hundreds of trillions (yes, <u>trillions</u>) of dollars have been created to finance our 'cake and eat it too' world.

The financial sector has grown obscenely rich on the ability to lend more and more dollars under a fractional banking system. And yes, the more they give out, the more interest income they receive, and the bigger the bankers' bonuses. The remuneration structure rewards greater issuance of debt, not prudence.

Governments issue IOUs (bonds) like confetti to finance budget deficits. These deficits are the direct result of over-promising in politically popular programs, like generous welfare and healthcare arrangements. Taxes are raised to cover the short-fall, and within a few years budgets are once again in the red. Politicians simply cannot help themselves…they spend excessively to buy votes.

Witness what has happen in Australia since 2007. Eight years ago, Australia's Federal Government was debt free. But true to form, our politicians have once again plunged us into the red. As at August 2015, Federal government debt had reached $379 billion. By 2020, it's forecast to be $550 billion.

Has anyone given serious thought to how debt, measured in the hundreds of trillions of dollars, can ever be repaid?

There is simply not enough currency in circulation to even come close to covering the principal and interest payments on this mountain of private, corporate and public debt.

Based on the simple concept that if something cannot continue, then it won't, it's reasonable to assume something has got to give.

When it does, there will be a high price to pay…very high.

You may think the title of this book, *The End of Australia*, is hyperbolic.

But I chose that title because I sincerely believe that, in an alarmingly short time, the way of life we Australians have become accustomed to will end.

In these pages I will show you why, and what this means for you.

You can challenge every single one of my facts, and you'll find that I'm right about each allegation I make. And then you can decide for yourself.

Will you act now to protect yourself and your family from the enormous correction — which I call The Long Bust — that I see coming for this country? I hope so. That's why I wrote this book.

I'm going to walk you through exactly what I am doing personally, and what I am advising my friends and readers to do as well. I can't promise you'll emerge from Australia's Long Bust completely unharmed. But I can just about guarantee you'll be a lot better off than people who don't read this book, or who ignore its warnings.

What is Australia's Long Bust?

Officially, the term Long Boom tends to apply to the post-Second World War period, right up to the 1970s. A rising tide of factors — increased global trade, a population boom, a developed world explosion in consumer demand for automobiles, white goods and televisions — lifted all boats.

While Australia lived off the sheep's back during the post Second World War long boom, our real golden economic period was from 1991 to the present. This has been our Long Boom. And, as I will demonstrate in this book, Long Booms tend to end in equally Long Busts.

As The *Australian's* editor-in-chief, Chris Mitchell, said in July 2015, Australia's 24 years of recession-free growth has created '*a community expectation that growth will continue and prosperity will go on rising*'.

As I will demonstrate in these pages, that expectation could be fatal.

It's one that's going to result in bankruptcies, property foreclosures, high levels of unemployment, shattered retirement dreams, family breakdowns and worse.

But, until very recently, the China-driven mining boom has sheltered Australians from a simple fact…

Australia is part of the wider world. And the wider world is one that now functions with an increasing level of dependency on mountains of easy credit. Without credit, the wheels of commerce seize up.

We saw the havoc this caused in many countries when the global debt super-cycle started to crack up in 2008. Now, finally, the same havoc is heading Australia's way.

Put in its simplest form: we are entering a world where people make purchases based more on savings and less on credit. And this is going to be highly disruptive. Think of it in these terms:

Credit is a high calorie sugary fix and savings are a vegan diet

The girth of the global economy has expanded decade after decade on a high calorie intake of credit. The level of sugar build up in the system has rendered the global economy sluggish and extremely unhealthy.

Going 'cold turkey' to a vegan diet will be a massive (but essential) shock to the system. The withdrawal symptoms are going to be far more painful than people are prepared for.

Unfortunately the economy has to suffer this 'dietary' extreme before we can return to a more balanced, stable and sustainable economy.

There's no doubt the 'she'll be right mate' attitude has served Australians well when the chips were down. Most Aussies have a quiet confidence in our ability to overcome and capitalise on whatever challenges are put to us as individuals or a nation.

However, with what I believe awaits the country within the next decade, Australia and Australians will need much more than the Aussie spirit to survive.

The prospect of our 'lucky country' entering a prolonged period of extreme hardship — or Long Bust — gives me no joy. However, the facts are what they are.

No amount of wishing it could be different will change the facts…imbalances, unfortunately, must be corrected.

An attitude of 'she'll be right' may assist in providing us with a coping mechanism…putting on a brave face amidst a world of turmoil.

But behind closed doors, the brave face will give way to the inner demons of:

- Is my job safe?
- How will we cope on one wage?
- Will I ever find employment again?
- Will we be able to keep our house?
- Why did we borrow to buy that second property?
- How much more will my superannuation lose?
- Are we going to be able to keep the business open?
- Can we afford to keep the children in private education?
- Will there be a job for me after uni?
- Will we be able to retire?
- What if the government cuts back on the age pension?

These are questions framed by fear…the fear of losing lifestyle, assets, employment, business and entitlements.

The coming collapse of the global debt super cycle…and the ensuing Long Bust here in Australia…means everything we've grown used to as being normal is going to be challenged. Hence the title of this book: *The End of Australia*.

Without context, trying to make sense of the magnitude of this pending upheaval will be difficult to comprehend.

This book has been written in the spirit of 'forewarned is forearmed'.

- How we've arrived at this point
- Why Australia is defenceless against 'GFC MkII'
- What you can expect when the debt cycle collapses
- How best to protect your finances from the coming Long Bust
- The ways you can capitalise on the opportunities that will arise from this adversity

As I say, the prospect of a Long Bust or Even Greater Depression gives me no joy.

All Australians are bound to be adversely impacted by the effects of a contracting economy. Very few will escape the suffering caused by this economic contraction.

The after effects won't be pretty. However, the prospect of a more rational and sustainable society emerging on the other side gives me great hope for my children and future generations.

A society that is less obsessed with keeping up with the Joneses might just create a healthier, less stressful and more compassionate world.

Perhaps in a world that is more affordable and less focussed on 'things' it may mean children can be nurtured at home by parents who are happy and financially able to put their career on hold.

After all, solid family values make an invaluable contribution to the fabric of society. The monetary value of a well-balanced family with a strong moral compass and work ethic is impossible to calculate…it really is priceless.

While the near term is going to be extremely challenging and upsetting, in the longer term I am confident a stronger, wiser and more prudent Australia will emerge.

The aim of this book is to help guide you through the troubling times ahead, so that you and your loved ones not only survive, but are in a position to prosper from the next financial crisis.

Vern Gowdie,
Gold Coast, August 2015

PART ONE

How we Arrived at 'The End of Australia'

Since 1950, Australia, together with all other developed countries, has enjoyed a period of economic growth that is without parallel in history…growth we have come to expect as our birthright.

In 1950 Australia's GDP was around $50 billion. Today it exceeds $1.5 trillion.

That's a fairly impressive 30-fold increase in economic activity.

But where did this phenomenal growth come from?

Population growth has been a factor in the GDP increase. Since 1950 Australia's population has grown from eight million to 24 million (an annual growth rate of 1.7%). A trebling in the consumer base has most definitely meant more dollars circulating in the system.

However, the major driver behind the exponential GDP growth (here and in other major economies) has been our willingness to take on debt.

Since 1950, Australian private debt levels have risen from 20% of GDP to today's level of around 160%…an 800% increase.

If we convert these percentages into dollars, you start to appreciate the enormity of what the financial sector has created since 1950.

Year	GDP in $ terms	Debt/GDP ratio	Debt in $ terms
1950	$ 50 billion	20%	$ 10 billion
2014	$1,500 billion	160%	$2,400 billion

In dollar terms debt levels have grown an eye-watering 24,000%.

If you want evidence of the debt dependency in our system, look no further than the obsessive media coverage leading up to every Reserve Bank of Australia (RBA) meeting.

- Will the RBA cut or raise rates…or leave them alone?
- The press canvasses the nation's leading economists on whether the RBA is going to give a thumbs up or down on rates.
- Will households be given some relief in their budget?
- Retailers and property industry spokespersons express hope the RBA cuts to stimulate their areas of self-interest.

Any relief on the $2.4 trillion vice that's crushing economic activity is greeted with fanfare normally associated with a Rio carnival.

But not all sections of the community are 'fist pumping' each successive 0.25% rate cut. That rare and forgotten breed called savers suffer in silence. In this world where everyone deserves a prize, whether they've earned it or not, the savers dare not speak out on the injustice of having their income continually eroded.

Since August 2008 (the month prior to the Lehman Brothers collapse) Australia's official cash rate has fallen from 7.25%

to 2.0%. For savers this represents a 70% reduction in their earning capacity over seven years. What other sector of the community would suffer this sort of income erosion in silence?

Savers have been sacrificed to appease the debt gods. The system is so heavily dependent on debt for growth that there is a bias towards encouraging more debt. This is why the media focusses on the ‘woe is me’ plight of borrowers. This is why we are experiencing the lowest interest rates in history.

However, everything has its boundaries — even interest rates. And we are fast reaching the point where it doesn’t matter how cheap money is if you no longer want to go into debt. This may be because you fear for your job security, are approaching retirement, or simply have no desire to add more to your existing debt burden.

Whatever the reason, if the majority of Australians start shunning debt, the ‘growth’ model will be exposed for what it is…a fraud.

But the end of rampant debt accumulation is in sight…

What do I mean by that? And what does it mean for you?

Back to the math on our $2.4 trillion debt pile. Remember, in 1950 Australia’s total debt was $10 billion. Today it’s 24,000% higher.

Granted a 1950 dollar had a different buying power to a dollar today. However Australia has not experienced a cumulative inflation rate of 24,000% over the past 65 years. Our debt levels have grown disproportionately to our economic growth (albeit that this growth was a by-product of increasing debt levels).

If households and businesses had opted to maintain a conservative 20% debt to GDP ratio over the past 65 years, there's no question inflation and GDP growth figures would have been much lower.

Over the next 65 years Australia's population is predicted to roughly double to 50 million people. Trying to identify trends 65 years into the future is a big call…anything can happen.

However for the purpose of this exercise let's say the population does double over the next 65 years (this is two-thirds the population growth rate of 1950 to 2015).

If the Australian economy is to maintain past economic growth levels into the future then we need a 160-fold increase (two thirds of the 240-fold increase of the past 65 years) in current debt dollars to achieve this target.

Now that's a big number — $2.4 trillion x 160 = $384 trillion.

Is it possible that in 2080 Australia will have a debt burden of $384 trillion? Maybe. But unlikely. It would mean per-capita debt of $7.7 million. That's $7.7 million dollars owed by every man, woman and child. As stated earlier, if something cannot continue, then it won't.

What's more likely is a credit contraction. Or put another way, a debt collapse.

Debt crises correct excesses in the system. They force society to adopt more conservative and prudent attitudes towards debt accumulation.

My view is we're going to slip right back to a much lower debt to GDP figure. And I'm not just saying that. History shows it. That's been the case in the past when our system became bloated with debt.

And while the past does not always repeat itself identically, it does tend to rhyme.

Australia has experienced two previous credit bubbles — 1880 to 1892 and 1925 to 1932. From 1880 to 1892 the debt to GDP ratio rose from 40% to 110%.And from 1925 to 1932 the debt to GDP ratio rose from 40% to 80%.

When each of these bubbles burst, it took 20 to 30 years to expunge sufficient debt from the system to enable the Australian economy to once again make meaningful progress.

One other thing. Note that the previous credit bubbles were relatively short in duration (12 and seven years respectively). The current credit bubble has been building since 1950…a 65 year build-up.

The current bubble started from a much lower level (20% of GDP) but has far exceeded the heights reached in the previous bubbles. This has been made possible by central banks actively reducing interest rates to increase the capacity within the system to support higher levels of debt.

Based on the theory of equal and opposite force, the bursting of the current bubble is going to be much more brutal both in duration and the extent of losses. We face a very Long and severe Bust indeed. So how will this play out?

The pattern with the previous credit crises was that most of the losses occurred in the early stages of the correction period. Therefore we should expect the greatest shocks early in the next financial crisis. Eventually debt to GDP levels fell back to 40% in 1925 and 20% in 1950. Which means tremors will still ripple through the economy long after the initial shocks.

Using these ranges as a guide on today's GDP dollars, it means current debt levels would fall to between $480 billion to $960 billion…up to nearly $2,000 billion lower than the debt that exists today.

That would be a credit contraction of up to 83%.

I acknowledge these are simple numbers, and statistics can be twisted and manipulated to say what you want.

However, there's no escaping some basic facts:

1. Our willingness to go deeper into debt was a major contributor to economic growth over the last 50 years.
2. To maintain past growth trends requires continued credit expansion.
3. History shows that all previous periods of excessive credit expansion have been followed by an extended period of credit contraction.

Using these facts, we can formulate three probable scenarios on what awaits us in the coming years.

Scenario #1

DEBT LEVELS CONTINUE to increase at the same rate as in recent decades. PROBABILITY: 5%

It's possible. The fact that bothers me with this scenario is the effect of more and more debt compounding year after year eventually adds up to a very big number. Unless incomes rise dramatically (which is unlikely in a highly competitive globalised world) there is no way Australian households will have the capacity to repay debt levels much above where they are today, let alone a debt pile measured in the hundreds of trillions of dollars. Also history places the odds firmly against a continued indefinite extrapolation of this trend. I'd rate this probability at 5% or lower.

But if it does increase, that doesn't mean you can just ignore everything I've written in this book. Rather, you can take everything I've written about the consequences of the Long Bust and magnify it two, three, four times or more.

As this debt boom goes on it doesn't get further away from disaster, it gets closer.

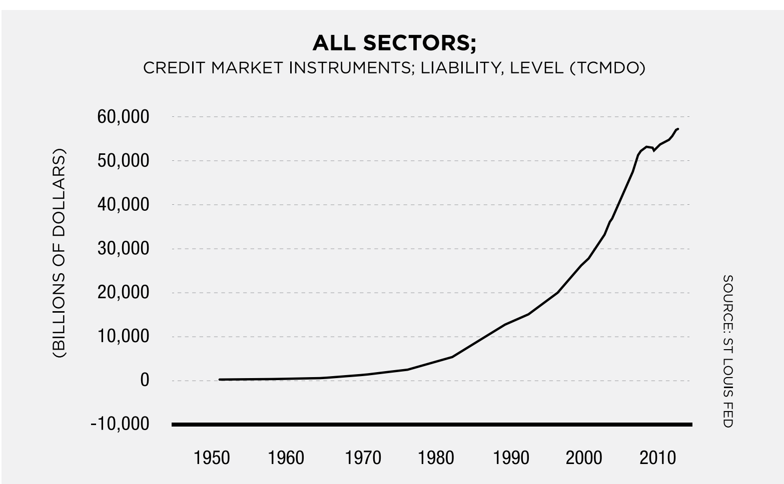
Scenario #2

DEBT LEVELS STAGNATE as households consolidate their balance sheets and boomers retire. PROBABILITY: 15%

To some degree this is what's happened since 2008. The uptake of private credit has slowed and forced public (government) debt levels to rise to fill the void.

The following chart from the US Federal Reserve Economic Data (FRED) shows how US debt levels (private and public) have gone from virtually zero in 1950 to nearly US$60 trillion.

The point to note in this graph is the slight downward movement in the top right hand corner — this little blip caused the GFC. The resumption of the upward trajectory has largely been due to the US government's willingness to go deeper into debt to keep the whole global economic growth show going.



Look at this chart carefully.

This has been the ‘secret’ to Western prosperity over the past 65 years. Debt, debt and more debt has financed a lifestyle we could not have possibly afforded from our own honest efforts of production and savings. The world, including Australia, is living a lie.

The very minor dip in 2008 shows just how fragile and vulnerable the global economy and financial system have become due to a complete and chronic dependence on debt.

Stagnation, or even modest withdrawal of private sector debt, is creating havoc with government budgets. Lower consumption equates to lower tax revenues from mining royalties, GST, income tax, company tax, fuel excises and so on.

Budget black holes are being filled with more public debt. In some cases like Japan, Europe and the US this debt has been directly or indirectly financed by newly minted money. In other cases, governments (like Australia) have raised capital from the bond market.

There’s a school of thought that believes governments can print *ad infinitum* and never have to worry about seeking investor funding for their deficits ever again.

The Japanese government has certainly adopted this strategy. Can Japan do it forever? Possibly, but they’re venturing into territory no country has ever entered before.

While everyone has a theory on how this experiment will pan out, history and common sense suggests that printing money to fill the void between stagnating tax revenues and rising expenditure is not prudent financial management. A bad strategy is a bad strategy.

Japan is an ongoing experiment in how far the credibility of fiat (paper) money can be stretched.

However, when we look at the bond market in its entirety, it’s useful to remember all of these debts are interconnected. The bond market is where companies, state and local governments, and national governments of varying credit risks go to raise capital in various amounts.

With a modest downturn placing a squeeze on revenues, some of the more highly leveraged borrowers are likely to default. This will spark a domino effect as investors panic about who will be next.

The bottom line is this:

The prospect of Western governments printing money indefinitely to finance increasing budget deficits (due to burgeoning welfare and healthcare expenditure) defies logic. Surely one or more of these heavily indebted sovereign borrowers will one day find out that no one will lend them any more money. What will they do then?

In my opinion, the probability of governments printing indefinitely and markets not having an adverse reaction to stagnating or falling levels of household debt is less than 15%.

Scenario #3

Credit expansion followed by CREDIT CONTRACTION. PROBABILITY: 80%

Balance is the natural order of our world.

Night and Day. Right and Left. Yin and yang. Male and female. What goes up must come down.

Prior to 1980, global GDP and debt levels grew roughly in tandem. After 1980 the global debt genie was well and truly released from the bottle.

The combination of financial deregulation, taming inflation, innovative debt products, globalisation (flooding the world with cheap foreign goods) AND (it's a big AND) the materialistic desires of baby boomer consumers fuelled a 20-fold increase in global debt …while GDP only grew seven-fold.

Can this parabolic trend continue? Obviously those controlling the money supply and their financial sector mates think so… otherwise they would cease their 'stimulus' efforts.

Total world debt (according to the latest McKinsey study) stands at US$200 trillion (AU$277 trillion). This scary number is the *official* debt level.

Add in the various unknown and unofficial shadow banking activities, plus the Western world's unfunded social security commitments, and the *real* debt tally is probably upwards of US$500 trillion (AU$694 trillion) — resulting in a global debt to GDP ratio of over 700%.

Never before in the history of money has there been debt accumulation of this magnitude. Hence the reason behind the longest period of the lowest interest rates in economic history.

In 1971, Nixon's abolition of the gold standard paved the way for the expansion of credit, money supply and entitlement commitments that are without historical precedence. Can this trend continue? History says — in flashing neon lights — NO.

For the following reasons, common sense also dictates the same:

- Boomers are moving from their credit fuelled consumption days to savings dependent retirement. They are opting for cruise ships over container ships.

- The ability to accumulate so much debt was aided and abetted by the compression of interest rates (the cost of money) from 20% to 2% in Australia. Rates have moved even lower in the Northern Hemisphere, where some central banks now have negative interest rates. The capacity for debt to get much cheaper is very limited.

- Future debt accumulation is likely to be by governments to fund snowballing welfare and healthcare costs. This is unproductive debt — there is no return on the capital invested.
- On the opposite side of this debt is a lender who wants to be repaid interest and principle. There's not enough physical money in the world to make this equation possible.

Based on history and the universal law of 'for every action there is an equal and opposite reaction' the probability of a significant credit contraction, by my math and reasoning, is 80%.

Reaching this tipping point has been a long time coming

The future direction of the Australian economy is something no one has experienced before.

In addition to dealing with the vast quantities of debt and entitlements embedded in the system, the rapid advancement of automation threatens to disrupt employment in many sectors.

Navigating our way through what is shaping up to be as defining a period in economic history as The Great Depression is the challenge I've attempted to address in this book.

What will the coming Long Bust look like?

What will it mean for Australia?

What happens to the money you have invested in property and stocks, in bank accounts, in bonds and in precious metals? We explore these issues in the coming pages.

But there's no sugarcoating it. If the research I'm about to unwrap for you is correct, the Long Bust could destroy the savings of

Australia's middle and upper class. I know that sounds stark. But believe me, it's happened before. And it will happen again.

Imagine the 2008 crisis TIMES 50.

Imagine a period where there is virtually nowhere safe to put your money...and few ways to get it there even if there was. That's why, if I'm right, you need to take precautions NOW. At some point, and history bears witness to this, it will simply be too late. You and all the wealth you have will be stuck. Helpless. At the mercy of events WAY beyond your control.

We got a *very small* taste of what this might feel like in 2008 and 2009.

You may or may not remember the pressure the Australian banking system was under in 2008.

According to The *Australian* on 21 June 2010:

> '[Australian] *Households pulled about $5.5bn out of their banks in the 10 weeks between US financial house Lehman Brothers going broke* [September 2008] - *the onset of the global financial crisis - and the beginning of December* [2008].'

The demand by panicked depositors for physical cash put a strain on the RBA's cash reserves:

> '*...the Reserve Bank's strategic reserve holdings of $50 and $100 notes started to run low and the call went out to the printer for more. The Reserve Bank ordered another $4.6bn in $100s and another $6bn in $50s.*'

In addition to depositors wanting to hold their cash close to their chest, overseas investors wanted their cash back as well:

> '*Balance of payments figures show that in the immediate aftermath of the crash, Australian banks were called on to repay $50bn in short-term debt to international investors who refused to roll over their exposures.*'

When people lose confidence, everyone wants cash…more specifically they want their cash.

In 2008/09, central banks and governments were able to restore calm and quell the panic. Offering $1 million deposit guarantees. Printing money. Reducing interest rates.

When the next crisis hits these emergency confidence restoring options won't be available. Rates are now at rock-bottom, deposit guarantees are already in place and, ironically, when the next crisis hits we'll know that printing money did not save the world after all.

Then what happens?

The events of 2008/09 were a great example of how massive, complex and far-away monetary events can adversely impact Australian investors. Even if, economically, we got off comparatively lightly.

Yet with all the talk of 'the Australian Economic Miracle avoiding a recession', it's easy to forget that Aussie stock investors and retirement savers were hit hard during the Global Financial Crisis. Since its October 2007 high, the ASX 200 has lost 18% of its value. By comparison the US S&P 500 index is up 40%, and the UK's FTSE 100 is at breakeven.

Aussie stocks have suffered more than any other major index from the subprime bust. And that's despite a domestic commodities boom that has raged until recently.

Now imagine what's going to happen when the exponentially larger global debt bubble bursts.

And when there is no mining boom to shield the Australian economy.

The truth is, when the Long Bust is upon us, there is nothing you or I (or anyone, for that matter) can do to stop it. But that's not the point.

There is something you can do with your money. You can analyse the situation and try to prepare for what comes next. So let's get started.

PART TWO
This is the End

What will a Long Bust look like in Australia?

I don't know for certain. No one does. But we can look back at when the last Long Boom ended in the mid-1970s for an indication.

That event was small potatoes compared to what's likely around the corner today.

But even so, it *wasn't pretty*...

Aussie house prices crashed, unemployment doubled, riots, industrial disputes, inflation up 16% — *and all that was in 1974!*

Australian profits imploded; government spending ballooned 46% in a single year; we plunged into current account deficit and never ever got back into surplus.

Just a year before the economy had been sailing along nicely at 6% annual growth!

Maybe you were there and you remember.

Ordinary Aussies were shell-shocked with how quickly it all happened. The 'she'll be right, mate' attitude Aussies had enjoyed for the previous decade disappeared.

It's about to happen again…only this time it will be far worse.

Some predictions are so unpalatable many people just refuse to entertain the possibility. Too much would have to change. Too much wealth would be destroyed. Too many retirements delayed.

But if you're old enough to remember 1974 — the 'year the economy went bung' — then you may have already drawn some unsettling parallels with what's going on right now.

To understand what's to come, you need to understand why I called this book *The End of Australia*. More specifically, you need to understand three things in particular that are ending. And why these three endings spell the beginning of Australia's Long Bust…

ENDING #1

The End of the Global Credit Boom

US$200,000,000,000,000…and counting.

According to the 2015 McKinsey Report titled 'Debt and (not much) Deleveraging', this 15-digit figure is the amount of *official* outstanding debt in the system.

McKinsey stated that since 2008, global debt levels have increased US$57 trillion. An average of US$9 Trillion each year.

This equates to US$1 billion for every hour of every day being added to the debt pile.

Tick, tick, tick. That's the sound of the clock attached to the debt time bomb.

Where did all this extra money come from?

In 2008 the global money supply (dollars, euros, yen, pounds, renminbi) in the system was US$60 trillion.

According to research released by Trading Economics in February 2015 '*the total money supply for the entire planet now stands at about $US78.8 trillion*'.

That's an increase of US$18.8 trillion.

Central bankers have (out of thin air) increased money supply by 30% over the past seven years

With the magic of the fractional lending process, that additional US$18.8 trillion in funny money has been turned into an additional US$57 trillion of real debt.

When you add unfunded liabilities (future welfare and healthcare costs promised to an ageing developed world population) the real global debt level is estimated to be a whisker shy of US$500 trillion.

Even the US$78.8 trillion in paper money floating around the world is nowhere enough to satisfy this level of liability.

Einstein told us that compound interest on savings paves the road to wealth creation.

If Einstein were alive today, I'm sure he would say the compounding effect of the interest costs on hundreds of trillions of dollars in debt is an equally assured path to wealth destruction.

The debt numbers are now so big, the compound effect invites Zimbabwean comparisons.

Do we merrily march to the US$1,000 trillion ($1,000,000,000,000,000) level and beyond? (That's a quadrillion dollars, if you'd prefer a 'simpler' number.)

Will the debt stack be higher or lower in the next McKinsey report in 2021?

Or, do we succumb to the golden rule of, 'If something can't continue then it won't'?

Global Debt Compound Annual Growth Rate		
	2000–7	2007–14
Total	**7.3%**	**5.3%**
Household	8.5%	2.8%
Corporate	5.7%	5.9%
Government	5.8%	9.3%
Financial	9.4%	2.9%

The debt addicted economic growth model is flawed for all to see. Households recognised this fact after the GFC. Whereas government blindly pursued a policy of increased indebtedness. It must end at some point. But until then, consider the following tables.

The first table is a list of the 'debt to GDP' levels for 47 countries. The Western world dominates the top half of the table…our so-called 'prosperity' has been nothing more than a debt binge.

The collective debt obligations each country has amassed have driven the 'economic growth' over the past 30 years. This table is the legacy of that manic drive for growth.

As the level of debt has risen, the cost of that debt has fallen. Short term interest rates in the Northern Hemisphere are well below 1% and in some cases into negative territory.

This is the sad and sorry place our policymakers have taken us with their rhetoric of 'targeted sustainable growth in demand and inflation'.

Country	Debt to GDP
Japan	400%
Ireland	390%
Singapore	382%
Portugal	358%
Belgium	327%
Netherlands	325%
Greece	317%
Spain	313%
Denmark	302%
Sweden	290%
France	280%
Italy	259%
United Kingdom	252%
Norway	244%
Finland	238%
United States	233%
South Korea	231%
Austria	225%
Hungary	225%
Malaysia	222%
Canada	221%
China	217%
Australia	213%
Germany	188%

Country	Debt to GDP
Thailand	187%
Israel	178%
Slovakia	151%
Vietnam	140%
Chile	136%
Morocco	136%
Poland	134%
South Africa	133%
Brazil	128%
Czech Republic	128%
India	120%
Philippines	116%
Egypt	106%
Romania	104%
Turkey	104%
Indonesia	88%
Colombia	78%
Mexico	73%
Russia	65%
Peru	62%
Saudi Arabia	59%
Nigeria	46%
Argentina	33%

There is nothing sustainable about debt levels growing to the sky.

The following table, prepared with data from the IMF, is a projection of current debt levels to 2025 and 2040.

The projections assume there will be no policy changes from future governments to rein in spending.

Country	Debt to GDP 2025	Debt to GDP 2040
Japan	620%	1277%
Ireland	605%	1245%
Singapore	600%	1247%
Portugal	544%	1105%
Belgium	510%	1056%
Netherlands	514%	1073%
Greece	488%	1001%
Spain	476%	966%
Denmark	483%	1020%
Sweden	444%	905%
France	428%	874%
Italy	396%	808%
United Kingdom	381%	769%
Norway	378%	779%
Finland	371%	769%
United States	361%	744%
South Korea	370%	780%
Austria	353%	735%
Hungary	347%	710%
Malaysia	351%	733%
Canada	338%	690%

Country	Debt to GDP 2025	Debt to GDP 2040
China	341%	709%
Australia	322%	650%
Germany	284%	573%
Thailand	294%	611%
Israel	283%	594%
Slovakia	233%	477%
Vietnam	226%	466%
Chile	208%	424%
Morocco	218%	459%
Poland	205%	418%
South Africa	211%	444%
Brazil	195%	395%
Czech Republic	197%	404%
India	188%	392%
Philippines	177%	362%
Egypt	169%	354%
Romania	158%	321%
Turkey	166%	351%
Indonesia	139%	291%
Colombia	122%	257%
Mexico	111%	225%
Russia	103%	215%
Peru	96%	196%
Saudi Arabia	90%	184%
Nigeria	74%	155%
Argentina	51%	107%

These tables demonstrate the stupidity of the perpetual debt machine that was commissioned in the early 1970s to drive economic growth. The debt pile just keeps getting bigger.

The endgame for this debt super cycle is fast approaching…

At some point one or more of these 47 nations is going to default. That is an absolute guarantee.

In 2008 the world buckled under a debt weight that is far less than today.

There is no way each country in this list can support rising debt levels without massive tax increases. Discussions are already underway in Australia to raise the GST from 10% to 15% to cover the projected increased shortfalls in healthcare costs. Instead of tackling the thorny issue of spending restraint (reducing welfare and healthcare costs) governments the world over are going to do all they can to grab every tax dollar.

But rising taxes are counterproductive. People simply stop working, and a cash society blossoms.

So here's what we know with a fair amount of certainty about the coming decade:

- Without bold policy initiatives to curb spending (welfare, healthcare and warfare) and increased revenues from higher taxes and/or user pay systems, debt levels are going to continue to rise.
- Debt, like obesity, can only expand the girth so far before it becomes fatal. The odds are that at least one or more of the nations in the tables above are going to default, and this has the potential to set off a contagion effect in the bond market.

- The number of Baby Boomers above age 65 is going to significantly increase — transitioning from tax payers to tax receivers.
- Major scientific advancements in the treatment and prevention of diseases means longer lives, which means a greater long-term burden on healthcare and welfare.
- Automated work systems will not only threaten but actually take employment away from the workforce that is meant to support the ageing boomers. Perhaps governments will introduce a 'robot tax' to offset the loss of income tax revenue!

These very deep and powerful trends are going to have far reaching implications.

The solution to the debt crisis will be market led. The Great Credit Contraction is a market force the policymakers have been powerless to stop.

The gathering momentum of The Great Credit Contraction means the debt infused economic model of the past 65 years is functioning on 'borrowed' time.

Demographics and debt have collided. The Baby Boomer consumers of yesterday are the retirees of today. The world enjoyed a period of credit expansion without peer. The Baby Boomers prospered from this period of excess — higher incomes, higher house prices, higher share values.

The Great Credit Contraction started in 2008 and is proving to be far more powerful than central bankers had ever imagined.

For seven years they've tried (and Lord knows they've tried) to prevent the deflationary forces of credit contraction.

What has all the Fed's money printing achieved? A level of inflation that's barely hovering in the positive.

The Fed is committed at all costs to avoiding deflation. But it's proving much harder and costlier than they thought it would be.

Former US Federal Reserve chairman Dr Ben Bernanke famously talked about dropping money from a helicopter if it were required to stop deflation. It's embedded in the Fed's DNA to create inflation.

Other central bankers the world over are following suit.

To prop up this global Ponzi scheme, the policymakers have created more debt.

On balance, there is enough confidence out there at present — the number of bulls versus bears is indicative of this — but what's missing is the Baby Boomer consumer's appetite for debt.

Confidence — or more precisely, overconfidence — is what landed us in this predicament.

All Australians — individuals, businesses, the government — were so confident tomorrow would be bigger and better than today.

And for a time it was. Every Australian played the game to varying degrees.

These are the dynamics of The Great Credit Contraction and the coming Long Bust. It's not lack of confidence; it's a lack of desire by the Boomers to go into debt.

Boomers have moved on. I know because I'm one of them. My desire for debt is zero. My desire for consumption is modest. My mates and family members echo this sentiment. They have their eyes firmly fixed on retirement. They are looking at all savings measures, including increasing super contributions and paying down any remaining debts, to boost their nest eggs.

Unless my circle of family and friends is unique, it's a fair bet this mentality is widespread amongst most boomers, here and overseas. The data certainly seems to indicate that this is the case.

To summarise: the tipping point is arriving…when the will and desire of tens of millions of Boomers will be far stronger than the increasingly desperate policy fixes of the central bankers.

Hastening the credit collapse

Gloom and doom accompany a credit bust.

Where once it was easy to get credit, it will slow to a trickle. Ironically, only those who do not need credit will be able to access credit.

Uncertain of how to make sense of what is happening, people will soon lose confidence.

Imagine the social mood when people go to the ATM and the maximum amount of cash they can withdraw is $100. The people of Cyprus and Greece have already experienced this.

Banks may impose lower credit card limits to minimise the possibility of writing off too many bad debts. This will act to further reduce the amount of credit in the system, hastening the credit collapse.

With far too many people living paycheque to paycheque, there is a very serious risk of social unrest.

With restricted access to cash and reduced credit, individuals start prioritising their outlays — for example, food takes precedence over rent.

This in turn means landlords with negatively geared properties find themselves under pressure to make their mortgage payments.

And even those landlords without encumbrances who rely on rental income to fund their living expenses will then be forced to prioritise their expenditures.

And so it flows on through the economy.

The much touted 'bulletproof' Australian banking sector, with its balance sheet so heavily exposed to residential property, suddenly looks vulnerable.

As credit shrinks, the impact will be felt in all sectors of the economy. It will have far reaching consequences…some known and others that are unknown and completely unexpected.

Most people will struggle to comprehend what is happening in this new world order of credit contraction.

Everything that happens will be the exact opposite of what they have experienced throughout their lives.

Decades of growth have created a mindset of prosperity.

Real estate values rise. Wages increase. Share markets go up. Superannuation balances generally increase. Employment opportunities abound.

It's also created a mindset of entitlement and government dependency.

We have become conditioned to believe this is how things are meant to function. Wrong. This is how a world dependent on debt functions.

A world suffering from debt withdrawal operates in a counter fashion. What used to go up, now goes down. What once expanded now contracts. Cash, not debt, is king.

Understanding this counterintuitive reaction is critical to surviving and eventually prospering from *The End of Australia* and the beginning of The Long Bust.

ENDING #2

The End of Australia 'The Lucky Country'

'*Never spend your money before you have it.*'

– Thomas Jefferson

Australia's renown as the 'Lucky Country' comes from a book that's now 51 years old.

But few people remember that the title of *The Lucky Country*, by Donald Horne, was meant to be ironic. It's actually a rather dire indictment of Australian society in the 1960s.

'*A bucket of cold saltwater emptied onto the belly of a dreaming sunbather*,' is how the BBC reported one critic describing it at the time.

But, over the years, people have come to use the term in its literal sense.

This drove Horne mad. He later moaned, '*I have had to sit through the most appalling rubbish as successive generations misapplied this phrase*.'

However, when you apply the term to the last few decades, 'lucky country' really seems like an apt description.

We are blessed with an abundance of resources — mineral and agricultural — all captured within a coastline that's the envy of the world.

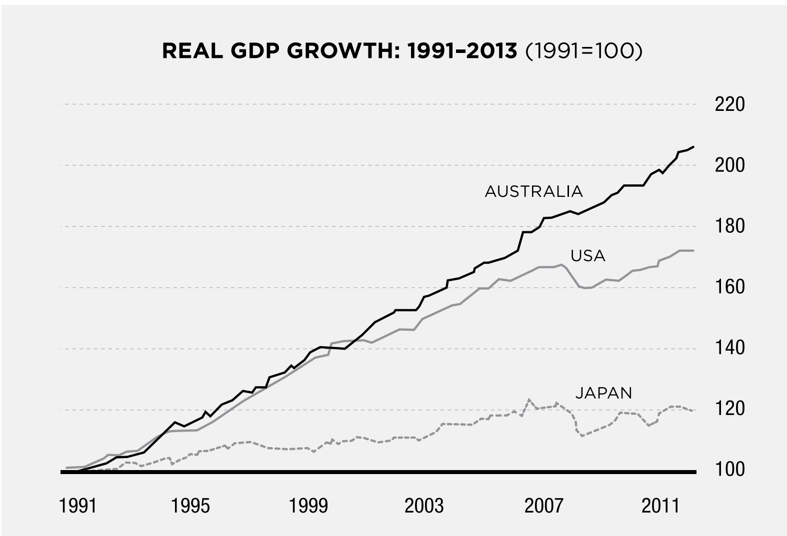
Last year investment bank Credit Suisse named Australians as the richest people on Earth. Our median adult wealth sits at over $258,000.

We are the second best country in the world to be born into, according to the Economist Intelligence Unit, second only to Switzerland.

Multiple Australian cities sit in the top 10 places to live in the world.

Throw in the fact that the Australian economy has been recession-free for the past 25 years and the 'lucky' tag seems well deserved.

The following chart shows just how well off Australians have been since 1991 compared to our Japanese and American counterparts.



The onward and upward trajectory of the Australian economy means hardly anyone under the age of 50 has truly experienced a recession.

Complacency breeds contempt. Famed economist Hyman Minsky stated, '*Stability creates instability*.'

The prevailing wisdom is 'what has been, will continue to be'. Extrapolating the past into the future is the most common cause of investor disappointment. The world is a dynamic place. Nothing stays static…unless you belong to an ancient tribe.

Japan's blind pursuit of growth, with money they had no hope of ever repaying, gave the Australian economy a welcome injection of capital in the 1980s.

When Japan hit the wall in 1990 Australia experienced a brief flat spot. By comparison Japan has never really recovered.

Fortunately, around the same time as Japan's economy hit the skids, China decided to accelerate its ambitious growth plans.

This was the birth of the Australian mining boom.

Australia has prospered enormously from the past 20 years of growth in the Middle Kingdom. It created an embarrassment of riches. At the height of the boom it felt like nearly every other person was being lured to the mines for a six-figure income.

What amounted to a doubling and even trebling of income meant houses, cars, jet skis and holidays were on the shopping list. Money was flowing through the veins of the Australian economy.

Governments couldn't believe their good fortune. Tax revenues flooded in and promises poured out. Baby bonuses, generous means testing, tax free super pensions, disability schemes, green schemes…they couldn't make the barrels quick enough or big enough to pack all the political pork into.

And what does the 'lucky' country have to show for this prolonged period of prosperity? $379 billion in public debt, with a budget covered in red ink and a long list of unfunded entitlements.

In addition to this list of wasteful shame, Australia also has the dubious honour of having one of the world's most indebted private sectors.

Well done Australia, we have managed to squander the Chinese lotto win. Peed up against a wall of indulgence.

Australia's debt story

An over-indebted public sector is the reason the slump in the iron ore price is causing angst for state and federal governments. Extrapolating past ore prices into the future has resulted in treasury officials seriously miscalculating expected revenue. Revenue that was meant to service the cost of debt.

The signs were there for Treasury's financial wizards to see. But as my mother used to say, '*There are none so blind as those that do not want to see*.'

The McKinsey Report identified that China quadrupled its debt levels from $7 trillion to $28 trillion between 2008 and 2014.

Surely the bean counters didn't think China could maintain this level of stimulus (created out of thin air) indefinitely? Judging by the 'budget black hole' headlines, obviously they did.

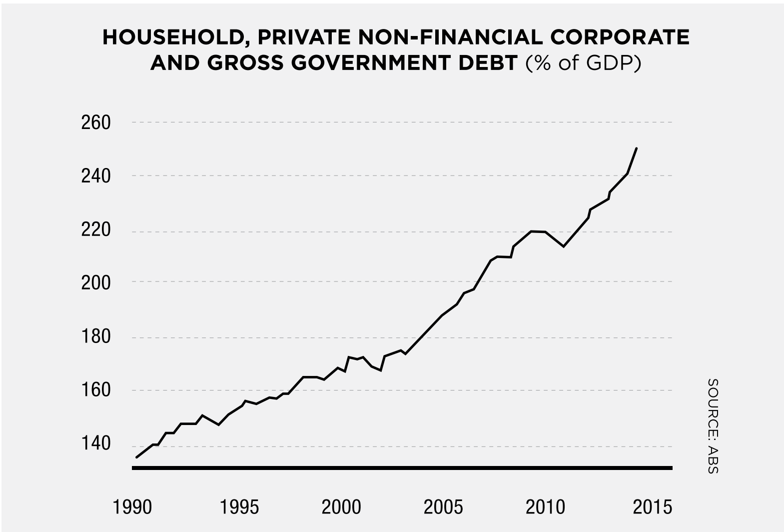
Supposedly smart, well educated people genuinely believed this Ponzi scheme could continue unchecked. Why? Because it is all the modern world has known…

Anyone studying economics is indoctrinated to believe government stimulus is the panacea to stimulate a slowing economy.

The following chart shows the level of total (private, corporate and public) debt in Australia. Australia's willingness to embrace debt is the 'miracle' behind the stellar growth over the past 25 years. The injection of all this additional credit into the system has obviously been reflected in the official measurement of our economic activity — GDP growth.

According to the chart, debt to GDP has doubled over the past 25 years. In simple terms, this equates to 4% per annum… almost identical to the official GDP growth rate over this period. Common sense tells you that if we had maintained a constant debt to GDP ratio over the past 25 years, then GDP growth would have been much lower.

When economists talk about returning to 'trend growth', it would require Australians to keep borrowing more and more each year to achieve the trend growth rate. It's unrealistic to expect this chart to continue its upward trend indefinitely.

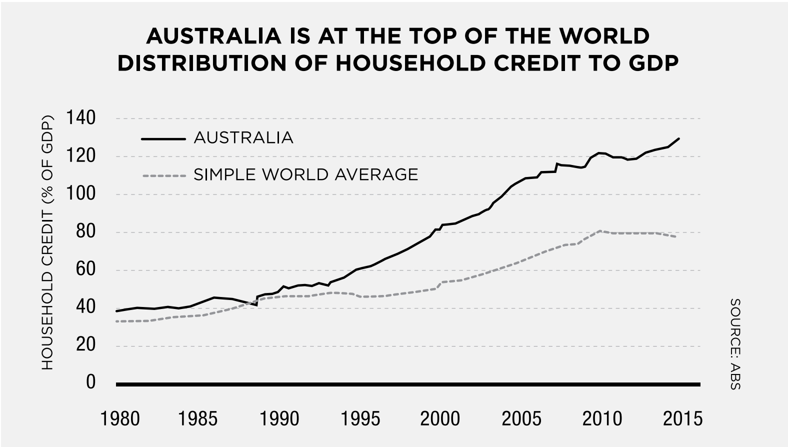


If Treasury projections are predicated on returning to trend growth, then government budgets will continue to over-promise and under-deliver.

In breaking down the total debt numbers, the following chart shows that the Australian household credit to GDP, at 130%, represents over half of our nation's debt load.

Note that Australia's movement away from the world average began after 1990 — the year of the last Australian recession. As the recession became but a distant memory, each passing year Australian households put more and more red ink on their balance sheet. This chart could easily substitute as an indicator of rising complacency levels.

Australian households are among the most indebted in the world. This makes Australia extremely vulnerable to a global deflationary slowdown. Something the 'lucky country' is ill-prepared to handle.



Failure to recognise our vulnerability to excess debt in 2008 has lulled Australians into a false sense of security.

But it's only a matter of time before the Australian economy finally falls into a debt-induced recession.

Australia's good fortune is about to run out

Few people realise that Australia in 2008/09 only avoided a recession because of a federal government spend-a-thon (school halls, pink batts, etc.) and a global money printing spree without peer. Dumbed down by the assurances of policy makers telling us 'normal transmission will resume shortly,' Australian households have gone further into debt.

With every reduction in the official interest rate, the Treasurer begs Australians to do their patriotic duty and go <u>even further</u> into debt.

When the next and far more powerful GFC hits, Australia's debt laden and fragile economy won't escape the consequences.

When that happens credit (bond) markets will go into a frenzy.

Everyone trapped in the collapsing bond market will be trying to exit at the same time. But like a packed hall with only a single exit, few will make it out in time. Nervous and panicked bond markets will impact share and property markets.

Wall Street has the potential to easily fall 50% within a short space of time, and my guess is it will overshoot and fall much further. Revisiting the 2009 low means falling 65–70% from the current level on the Dow Jones Index.

With restricted credit and cash, battered share markets, and forced selling in property markets, *what will this feel like?*

Without China acting as a white knight to create another mining boom, unemployment levels will rise significantly. This happened across the board in the Northern Hemisphere in 2008 and 2009.

Rising unemployment and stagnating wages creates a newfound level of financial conservatism in society. This is exactly what government doesn't want or need. Why?

- Rising unemployment = higher welfare outlays
- Falling asset values = increased age pension outlays under the assets test
- A society under stress = increased healthcare outlays
- Stagnating wages = lower tax revenues
- Restrained spending = a lower GST take and lower corporate tax revenues

Without meaningful expenditure reform, such as cutting back welfare, healthcare and education outlays, government has two options to meet its budget shortfall — issue more debt and/or raise taxes.

However, accessing more debt, in a risk-averse world, may not come cheap. The bond market may demand a higher premium (interest rate) to finance the new debt. This will put more pressure on budgets.

This creates a Catch 22 situation — without the ability to finance the deficit, the government can't pay the interest on existing debt. This causes the bond market to become even more nervous at the prospect of a default and demand an even higher risk premium.

This creates a vicious feedback loop. This may not happen in Australia but it's a fair bet it'll happen somewhere…and the ripple effect of higher bond rates will be felt in Australia.

But why shouldn't it happen in Australia? What makes Australia so different or special compared to any other debt-laden country? Nothing.

But remember, when a financial crisis hits, there aren't just financial consequences. There are social consequences too. Do you not think the riots in Ferguson, Missouri and in Baltimore, Maryland had some connection to years of rising debt and rising welfare dependency?

Here in Australia, with rising unemployment the social mood is likely to become xenophobic (as is happening in France) — with immigration intakes reduced to appease the crowd. The much hoped for population growth (to maintain economic growth) suddenly disappears. Property values fall, creating another set of problems for Australia's burgeoning debt.

According to the latest APRA report, there is approximately $2 trillion in superannuation. 85% of this is invested in market related assets, and only 15% in cash and term deposits.

Let's say markets — property, share and bond — suffer a collective fall of 30%. This wipes out over $500 billion in retirement savings!

Can you imagine what a 30% deletion of your total assets in as little as a year might feel like? Australians may not have to imagine much longer…

A loss of this magnitude might make a few people re-think their retirement plans. Especially when you consider it'll be mostly people over 50, with the larger fund balances, who'll feel it the most.

Perhaps, on a subconscious level, this is one reason why many of my fellow Boomers are opting to stay in the workforce. Thus denying the younger generation the opportunity to access a less restrictive employment market.

Youth unemployment will increase. And disenfranchised youth tend to do one or more of a few things — become depressed, participate in street marches, turn to crime or head overseas.

And make no mistake: the Middle Kingdom won't save us. Its years of phenomenal growth appear to be coming to an end.

No conversation on Australia's future would be complete without a look at China. China is what Japan was 30 years ago — a disaster waiting to happen.

Yes, I know. China is different.

There's a bigger population base for domestic consumption, lower trade barriers and a communist government.

However, there is also no new way to go broke — it's always because of too much debt.

Japan was the miracle economy of the 1980s due to credit expansion on steroids.

Private sector debt more than trebled from 300,000 billion yen in 1980 to 1,000,000 billion yen in 1990.

The miracle was in fact a mirage.

This is an extract from the McKinsey Report on 'Debt and (not much) Deleveraging':

> *'China's debt has quadrupled since 2007. Fueled by real estate and shadow banking, China's total debt has nearly quadrupled, rising to $28 trillion by mid-2014, from $7 trillion in 2007. At 282 percent of GDP, China's debt as a share of GDP, while manageable, is larger than that of the United States or Germany.*
>
> *'Three developments are potentially worrisome: half of all loans are linked, directly or indirectly, to China's overheated real-estate market; unregulated shadow banking accounts for nearly half of new lending; and the debt of many local governments is probably unsustainable.*
>
> *'However, MGI calculates that China's government has the capacity to bail out the financial sector should a property-related debt crisis develop. The challenge will be to contain future debt increases and reduce the risks of such a crisis, without putting the brakes on economic growth.'*

China has gone one further than Japan — it's quadrupled its debt since 2007 — driving the iron ore price to a high of US$160 in 2013. Since then it has all been downhill. Again, the miracle is a mirage.

Yet the Australian mining sector failed to see, or did not want to see, the mirage. Fortescue Metals is $9 billion in debt and went so far as to suggest a cartel be formed to keep the price of iron ore above its production costs.

A number of small miners have hit the wall and mining contract firms are pleading for more time from their bankers.

In my simple world one assumes these captains of industry have some smarts and know the dynamics in their industries. However, time and again those closest to the action seem blind to the obvious.

How on God's earth could anyone possibly think China could maintain debt growth of that magnitude indefinitely? Why didn't the Boards apply a little caution and take a slightly more conservative approach? But boom or bust seems to be the name of the resource game.

Even if you believe long term in a sustainable China miracle — assuming they can rebalance to a domestic consumption economic model — surely it would be wise to expect the growth path to at least plateau for a while rather than to continually rise.

China is now subject to downward revisions on its projected economic growth.

Deutsche Bank is forecasting some stronger headwinds in the coming months, with projected growth possibly below 6%. With what is happening around the world — due to The Great Credit Contraction — the Deutsche Bank prediction is hardly rocket science and is probably optimistic.

There is even more evidence to support the idea of a slowing Chinese economy. Transportation costs and movements are one measure of the health of an economy. For instance, the Baltic Dry Index (the price of moving raw materials by sea), is used as a reasonable indicator of global trade.

A country's rail freight data also provides a glimpse of what is happening domestically. And China's rail freight has been heading in one direction — down.

In 2014, Chinese authorities adjusted (tightened) policy settings. Obviously, this had a big impact on the economy. Year on year rail freight shipments plunged more than 15%.

Chinese officials are in a difficult position. Do they start another lending spree and risk a much larger full blown financial catastrophe? Or do they restrict lending and risk a financial catastrophe anyway?

The asset bubble in Chinese housing needs a continuous supply of debt to keep it going. Without a sufficient level of new lending, the housing market will start to fall.

A significant amount of China's middle and upper class wealth is tied up in property. While official lending conditions restricted debt funded purchases of multiple properties, the shadow banking system didn't operate under these controls until 2014.

Estimates are that mortgage funds and other non-bank lenders account for about US$4.5 trillion in loans. That's around one-fifth of the size of the official banking sector.

There have already been defaults in China's shadow banking sector that have unnerved officials. Hence the new rules, introduced in 2014, designed to tame and contain this riskier style of lending. To appreciate the risks posed by the Chinese shadow bank sector, think of the shonky mortgage funds in Australia on steroids.

The slowdown in the property market means attention has turned to the Chinese share market, the Shanghai Composite Index.

Investors rushed to open new share trading accounts.

The fact they have little or no experience in share investing is of little consequence.

A headline in March 2015 in the *Australian* noted that 'China's new stock trading accounts hit 8-year high'.

The market was on a parabolic trajectory, and every Chinese and his dog wanted a piece of the action.

When the *Australian* article was written, the Shanghai Composite index had gained 65% in a nine-month period.

At that time, I publicly forecast in my weekly newsletter that China's soaring market wouldn't continue in the same direction much longer. But I did have this caveat, ‘*when the herd rushes in strange things can happen…for a little while at least*’.

What had escaped the average Chinese investor’s notice, is that markets do not operate in isolation. The ‘wealth effect’ also operates in China.

Chinese property ownership is one of the highest in the world. Falling property values (the reverse wealth effect) impact on domestic consumption.

Reduced consumption leads to lower corporate earnings.

Lower corporate earnings — you guessed it — mean lower share prices.

Investors rush into the share market because the property market is no longer the hot game in town. But they fail to realise the fortunes of the former are very much tied to the latter.

And if you’ve followed the news recently, you’ll have noticed that some people are now rushing out again…

Since March 2015 the Chinese share market has been on one hell of a ride. My prediction that the soaring Chinese market couldn’t last much longer, turned out to be accurate.

The Chinese share market continued on in the same parabolic direction for a further three months after my warning… rising from 3372 points in March to over 5000 points in June 2015.

The time-honoured saying for the fate of overheated markets is ‘they rise by the escalator and fall by the elevator’. That means it generally takes longer for stocks to rise than it takes for them to fall.

But not China. They went one better.

The Chinese share market rose by the elevator and then fell out of a window.

In the space of three weeks the Shanghai Composite plunged 30%. It wiped out trillions of dollars of value.

In this world of centrally controlled market values, this was not meant to happen. Caught by the suddenness of this wealth destruction, investors naturally panicked.

Cash became king.

And according to an article in *Bloomberg*:

> *'"People are selling everything in sight to get their hands on cash," Liu Xu, a trader at private asset-management company Guoyun Investment Co. in Beijing, said by phone. "Some need to cover their margin calls in the stock market, while others are gripped by fear that the Chinese economy will be affected by this crisis."'*

Chinese share investors were selling everything and anything — pig food, sugar, eggs, etc. — to get their hands on cold hard cash. This is what happens in a market rout…everyone wants cash and will sell at whatever price they can get.

Over-geared Chinese share investors are learning a very important lesson about liquidity in a falling market.

But don't think this is just about China. I'm not telling you about China so we can point, laugh, and say it could never happen here. I'm telling you about China because it's a warning sign for what <u>will</u> happen here.

During Australia's Long Bust, Australians will have to learn this lesson too…

The Chinese authorities are also learning a very important lesson about markets…they can only control them so much.

In an effort to stem the losses, the government issued a directive to government controlled institutions, pension funds, state owned corporations and any other entity that knows what's good for them, to BUY BUY BUY!

Then officials moved to suspend 70% of the stocks from trading.

But that wasn't all.

They instructed the securities regulator to ban all shareholders with stakes of more than 5% in a company from selling shares over the next six months, and for good measure they threatened to investigate '*malicious short selling*' and prosecute anyone found guilty of these '*illegal*' market activities.

What else?

They issued orders to the media to only print and televise good news on the market…you know that 'buy the dip' type propaganda that works so well in Western markets.

For a government to interfere in a market so heavy-handedly tells you something about the interventionist world we are living in. People have become reliant on government fixing everything in their lives.

At the time of writing, the selling in the Chinese share market had abated.

But at what cost?

According to the 18 July 2015 edition of the *Financial Times*:

> *'The huge scale of Chinese government intervention to staunch a stock market sell-off has been revealed by reports showing the country's biggest state owned banks have provided the equivalent of $200bn to help prop up equities.'*

America set the precedent. China is replicating it…

The precedent for market meddling was set by the US Federal Reserve as far back as 1987. What started out with then Fed Chairman Greenspan dropping interest rates to support markets, has grown into a fully-fledged dependency program of money printing (Quantitative Easing — QE) and record low interest rates.

The Chinese are just following suit.

The printing presses have created a world of artificial value and wealth. China's actions are just one more example of the depths policymakers will plumb in order to maintain the illusion they can right every wrong.

However, with over 30 million new share trading accounts opened in China in the last six months (and over 200 million trading accounts in total), there's a fair bet not all these 'gamblers' have the nerve to hold shares for the long term. While Chinese officials have bought a temporary truce, the sheer number of potential sellers means we are only one or two more panics away from another market rout.

Officially sanctioned policies with the sole purpose of creating the wealth effect of rising share and property values, have a limited shelf life. In the long term, manipulation can never replace market pricing.

Whether it's China, Europe, Japan, UK, US, Canada or Australia, everyone is in this struggle together.

Some countries are further down the debt path than others. Some are wrestling with how to keep paying ever increasing entitlement promises with shrinking revenues. All are trying desperately to spark a resurgence in credit fuelled consumption. All are committed to stimulus programs to encourage investors to keep asset prices afloat.

So much is dependent upon the wealth effect appearing to be real rather than what it is...illusionary.

China, due to its sheer weight in numbers, has an undoubted economic strength. But that strength has been significantly enhanced in recent years by increased debt. Excessively rising debt will always have repercussions. When that involves a quadrupling in debt levels in six years, it's a fair bet the ramifications will be huge…and very damaging.

The headwinds we face

In this chapter we've delved into what's happening on the ground level, here in Australia and in China. Hopefully this book's title, *The End of Australia*, now seems a little less hyperbolic. Certain conditions for prosperity — that the vast majority of Australians took for granted — are indeed ending.

We'll look at some specific ways you can protect yourself, and survive the transition, later on in this book.

But we must not forget we are just one cog in a much bigger machine. A machine that is now breaking up.

The Great Credit Contraction is a function of two dynamics — debt and demographics.

A huge amount of debt and an ageing population means the future is not going to be the past.

And if you're thinking about extrapolating the past into the future, here's a list of some of the headwinds the global economy faces.

Due to globalisation, these headwinds will impact every nation in some way, shape or form.

- **An abundance of labour:** Developing nations such as India, China and other emerging markets are providing a plentiful supply of cheap labour. In this interconnected globalised world, this labour can be accessed easily from all corners of the world. Hence, the demise of the manufacturing industry in Australia.

- **An absence of employment opportunities:** Jobs are not nearly as plentiful. With a global economy that's actually shrinking, and the slow but steady uptake of robotics, the jobs market is becoming tighter.
- **Downward pressure on wages:** An increased demand for employment in a world with a softening supply of jobs means wages are going to come under pressure. Stagnating wages in the Western world make it difficult for a consumption led recovery, and difficult for governments to honour entitlement promises.
- **Our happy reliance on debt must come to an end:** The Western world has had it too good for too long — lifestyles financed with borrowed money. A decade or two ago Baby Boomers thought nothing of taking on more debt. Today it's all about debt reduction and increased savings.
- **The Boomer demographic time bomb underpinning it all:** The Western world is experiencing an annual exodus of workers. This demographic phenomenon casts a huge shadow over the global economy. The post 1980 surge in debt and asset markets shows the financial firepower that was unleashed by Boomers who wanted everything immediately. The reverse holds true. When Boomers opt to or are forced to live within their means, there will also be a definitive turning point downwards.
- **Student debts mean the younger generation are hitting the workforce with a significant burden:** Boomers left university debt free and walked into a

world with an abundance of employment opportunities. The younger generation is entering an uncertain employment market, encumbered with major debts. It's unlikely they'll be in any position to take on further debts until they're able to repay part of their student loans.

- **Reluctance to marry and have children:** Birth rates in the Western world are falling. Household formation numbers are falling. Due to cost of living pressures and an uncertain employment market, tomorrow's families (on average) will be much smaller in size and number.
- **Private sector deleveraging on a huge scale:** The love affair with debt is over. Globally, households are focussed on debt reduction and not debt accumulation. The air is escaping out of the bubble.
- **Deep shock as the housing bubbles finally burst:** Anyone involved in the property market will go to great lengths to tell you that the Sydney and Melbourne property markets are not in a bubble. We'll see. But Australia's property sector is not the only one at sky high levels. China, Canada and the UK are all displaying signs of an overheated real estate sector. The implosion of the US subprime loans showed that property markets are not a one way bet. A substantial fall in property values will create a great deal of social upheaval and uncertainty. In a nutshell, houses are expensive, they aren't cheap. Expensive assets are vulnerable to corrections.
- **Horror as the Chinese economy has its day of reckoning:** Massive credit expansion, way too much spent on building infrastructure that has no foreseeable productive use, and local governments that are

dependent on the property boom continuing to fund their administrations. As mentioned above, China is a mirage, not a miracle. Eventually the malinvestment of trillions of dollars will shake the Chinese economy and the rest of the world to its core.

- **Further implosion of Europe:** The balance sheets of European banks are loaded with sovereign bonds from technically insolvent countries. One or more sovereign defaults could expose the fragility of the European banking system. If suddenly the bond markets decide the paper from any of the PIIGS is worthless, then Europe's major banks will be in big trouble.
- **Japan finally hitting its economic wall:** Japan in the 1980s was the miracle economy. Today, the only miracle is that it still hasn't defaulted on its mountain of public debt. Abenomics (named for the prime minister of Japan, Shinzo Abe) is the last hurrah for Japan. With an outright target of doubling the Japanese money supply, the Bank of Japan is effectively the sole buyer of all government debt. It's even resorted to buying shares in an act of desperation to boost asset prices. Japan is showing the lengths governments are prepared to go to in order to keep the illusion alive. Sometime in the next five years Japan is at short odds to face the full consequences of its actions.
- **Retirement crisis that our super and pension systems cannot possibly contain:** According to Centrelink, 77% of people aged over 65 receive either a full or part age pension. The same statistic applies to pretty much all Western economies — the vast majority of retirees need some form of government support. This tells us people don't have sufficient retirement savings to fund their living

expenses. Especially in a low interest rate world. This trend is not about to reverse anytime soon. With more people retiring and living longer, governments will be placed under enormous strain. This is vastly different to the world that existed 30 years ago. Boomer workers provided governments with a steady supply of tax revenues to fund a much smaller number of age pensioners.

These are some of the major headwinds the world will have to face in the coming years and decades.

The world is innovative, and will continue to advance. However, at some stage it has to deal with the debt, demographic, and entitlement legacy built up over more than 30 years.

This will be a particularly difficult chapter in the history of the Australian economy. It may take many, many years (similar to the post-Great Depression period) to resolve these issues.

The next 30 years won't be the same as the last 30 years. The starting point is completely different.

Whenever anyone tells you we can continue to have it all, they obviously assume:

- The debt piles will continue to rise ever higher
- Governments will continue to fund welfare (age pensions, healthcare and the many entitlement payments) without change
- Asset prices, including property and shares, are a one way street with the occasional pullback and pause

This is nothing more than extrapolating the past into the future, without applying any critical judgement to the situation as it is today.

ENDING #3

The End of Rising Share Prices

'In the long term share markets always go up.' Sound familiar?

If something is repeated often enough and for long enough, then it becomes accepted as truth.

The investment industry has marketed this message so well that it's rarely challenged.

Every long term chart on the share market (with the exception of Japan) shows a wiggly line ascending from the bottom left to the top right. Case closed?

Not so fast.

Very few people actually study those 'wiggles' to understand the history lesson that lies within.

'Long term' means different things to different people.

Statistically, in the long term your favourite sporting team should win a premiership. The question is, will you be alive to see it? Maybe. Maybe not.

In my opinion, long term is relative to your time horizon. If you are 60 years old, the share market making new highs in 30 years' time is of little value to you.

The more accurate portrayal of the share market's wealth creation capacity is:

'In the very long term share markets always go up, but this rise may not necessarily be in your investment lifetime.'

The All Ordinaries Index has been a stellar performer since 1983. In this 32-year period the Aussie market has risen from 500 points to around 6000 points…a twelve-fold increase.

But what about the next 32 years…will the All Ords repeat the past 32 years and go to 72,000 points, for another 12-fold increase?

Perhaps a look at history may give us an insight.

The following chart shows that the All Ordinaries managed 'only' a four-fold increase (from 130 points to 500 points) over the 25-year period from 1958 to 1983.

Compared with 1982 to 2015, this was a much more subdued rate of return.

Why?

In 1968, the Australian share market ran headlong into a global secular bear market. From 1968 to 1983 (15 years) the All Ords went nowhere…zigging and zagging in a sideways pattern.

Very few people realise the All Ords had this extended breather before its stellar run of the past 32 years.

ALL ORDINARIES INDEX: JANUARY 1958 TO JUNE 1996

Is the market due for another breather?

To answer this question requires a look at the dynamics and influences of long term market trends.

Everyone has heard of bull and bear markets. Put the word 'secular' in front of them and more often than not people will give you a quizzical look…even those in the investment industry.

Secular markets are not very well understood. Secular markets are long periods (up to 20 years) when the market's overall direction is either up, down or sideways.

Let me give you some examples.

From 1902 to 1920 the US market lost 1% in value over an 18 year period. During this 18 year secular bear market there were the shorter term bull (advancing) and bear (declining) markets we are familiar with.

However, the additions and subtractions from these annual movements culminated in a market that returned minus 1% over the entire 18 years…so much for 'buy and hold'.

The period from 1920 to 1929 was a different story altogether for investors. The pluses far outweighed the minuses, leading to a 240% gain over the nine-year period. This was most definitely a secular bull market.

The secular pattern of long term advancement followed by extended periods of retracement is clearly evident when you view the markets with a wide angle lens.

Unfortunately most investors stand way too close to the action to appreciate these larger trends.

The other trend to consider when looking at secular bull and bear markets is the price to earnings (PE) ratio. Specifically, I look at the Shiller P/E Ratio.

The Shiller P/E (also known as CAPE 10), as described by website *Guru Focus* as:

> *'Prof. Robert Shiller of Yale University invented the Schiller P/E to measure the market's valuation. The Schiller P/E is a more reasonable market valuation indicator than the P/E ratio because it eliminates fluctuation of the ratio caused by the variation of profit margins during business cycles.'*

Professor Shiller uses the past 10 years of earnings (adjusted for inflation) of the S&P 500 to reduce the peaks and troughs in the earnings data. This methodology is not perfect, however for patient long term investors it provides us with a trend on valuations.

During the 1902 to 1920 secular bear market, the market started with a P/E of 25x in 1902, and finishes in 1920 at 5x.

Then, during the secular bull market of 1920 to 1929, the P/E started at 5x and finished at 25x.

The pattern of P/E contraction and expansion is again evident when viewed with perspective.

The P/E (Price/Earning) ratio is the multiple investors are willing to pay for company earnings.

For example, company X can earn $1 billion, but what is company X worth? In 1920, an investor might look at those earnings and determine company X is valued at $5 billion (based on a P/E of 5x). However, nine years later, investors might look at these same earnings and decide the company is worth $25 billion — a 500% gain, without a dollar increase in earnings.

In reality the P/E ratio is like a barometer for social mood:

- Pessimism = low P/E (The Great Depression)
- Calm = average P/E
- Exuberance = high P/E (the peak of the dotcom boom)

Secular markets are periods when society is either building up to a high or coming down from one. Changes in social mood and attitude don't happen overnight. Hence the reason why secular markets take a decade or two to fully express themselves.

The important take-away from the history of secular markets is:

- Secular bear markets start with a HIGH P/E and finish with a LOW P/E.
- Secular bull markets start with a LOW P/E and finish with a HIGH P/E.

This rhythmic pattern has played out repeatedly over the course of the past 115 years.

Unless it's different this time, this pattern will happen again.

This is why the greatest bear trap in market history is waiting to spring shut.

The END of rising share prices is what awaits

Contrary to what you may think, the US share market has been in a secular bear market since 2000.

The CAPE (Cyclically Adjusted P/E) 10 smooths out earnings over a 10 year period. And with a current reading of 26.3x it tells us we are a long way from the current secular bear market ending. That's assuming the pattern of high to low P/E is to be repeated.

The determined efforts of the world's central banks to keep the wealth effect in play since 2000 have delayed the market's natural cleansing process, for now.

The CAPE 10 is only one of the tried and true valuation metrics flashing a warning sign.

But no matter which valuation tool you use, the US market is moving deeper into overvalued territory…similar to the period prior to The Great Depression and dotcom bubble.

Low interest rates and a cheap supply of funding to investment banks have pushed the US market to this extremely unhealthy level.

But with the All Ords being fairly valued by analysts, why does it matter to us if the US market is overvalued?

The old saying that, 'If the US sneezes, we catch a cold,' holds true. If the US share market falls 50% in value, there is no way the Australian market can avoid a major slump.

So whatever happens in the US — good or bad — Australia will feel the effects.

Based on the proven concept of reversion to the mean, the US market is poised to suffer a fall of at least 50%, and possibly as much as 80%.

You've read that right. The US market could fall between 50–80%. Don't take my word for it, though.

Jeremy Grantham is one of the smartest minds in the investment business.

Jeremy Grantham's intellect and integrity have earned him the utmost respect as an investment professional. When Grantham talks, astute investors listen. His 40 plus year track record speaks for itself.

His Boston based firm, GMO (formerly known as Grantham Mayo Van Otterloo), has one of the most impressive records in identifying bubbles and long range forecasting for various asset classes. That GMO can do this consistently is a credit to their mathematical and analytical skills.

In his first quarter 2014 newsletter to investors, Jeremy

Grantham suggested the US bull market would not end for maybe a year or two, and not before the S&P 500 had risen to 2250 points. After that '*the stock market will revert to its trend value, around half of its peak or worse, depending on what new ammunition the Fed can dig up.*'

When Grantham made this observation, the S&P 500 was around 1850 points. I recall thinking at the time, 'It doesn't seem possible that this market has another 400 points in it.' I should have known better than to doubt Grantham's judgement.

If Grantham's prediction of 2250 proves reasonably accurate, then there's around 7% upside left before it begins its downward journey to '*around half its peak or worse*'.

Should this occur, nearly all the gains of the past six years will be lost. A fall of this magnitude will unquestionably impact the Australian share market.

Again using the balance of probability, if you are a share investor, do you hang in there for another possible 5% to 10% upside that comes with the risk of a 50% to 80% downside? OR do you start exiting near the top and guarantee yourself no downside?

Of course, it's possible Grantham is wrong. The trajectory of the market could continue upwards indefinitely, with only minor corrections. In all seriousness, this would be a brave call.

Younger investors (under 40) could recover from a hit of 50% to 80%. In general, they have two things on their side — time, and lower portfolio values.

Whereas if you're over 50, and especially if you're eligible to commence an account based pension, you have some serious decisions to make on how much of your capital to expose to an asset class that appears to have more risk than reward.

Superannuation is the savings and accumulation vehicle of choice for most Australians. The tax regime of 15% tax on earnings in the accumulation phase and 0% tax in the pension phase is too attractive to ignore.

Assuming most people over 50 have a reasonable amount of retirement capital invested in superannuation, it's also then fair to assume that most will convert this accumulated capital into an account based pension (formerly known as an allocated pension).

Financial planners *love* account based pensions. Why? What better way to promote a product than to tell a client, 'You won't pay any tax if you invest in this.'

The tax advantages are true, but nothing is ever one dimensional in the investing world.

Let me show you what would have happened if you'd retired in June 2007 (when share markets were still going strong) and invested in the industry preferred diversified choice of the 'balanced fund'.

You place your trust in a responsible planner. They recognise the market's looking a bit toppy in 2007. To offset the prospect of any downturn in the market, they follow the theory — as set out in the textbooks — on how to construct a prudent, account based pension portfolio.

The textbook says to place four years' worth of drawdowns in cash and the balance in 'growth' assets. This way you can draw off the cash balance while the 'growth' assets are quarantined for at least four years. In theory, this is sufficient time for the growth assets to recover from any market setbacks.

Here's our example based on $500,000 to invest and a $25,000 per annum drawdown. For the purpose of the exercise, I've used performance data supplied by SuperRatings.

Below is the median annual return for balanced funds over the past seven financial years:

- 2007/2008 financial year: negative 6.4% (loss)
- 2008/2009 financial year: negative 12.7% (loss)
- 2009/2010 financial year: 9.8% (gain)
- 2010/2011 financial year: 8.7% (gain)
- 2011/2012 financial year: 0.4% (gain)
- 2012/2013 financial year: 14.7% (gain)
- 2013/2014 financial year: 12.7% (gain)

The table below shows the outcome if we apply the above performance figures to our $500,000 investment — $100,000 in cash (four-year buffer) and $400,000 in balanced fund — and assume a drawdown of $25,000 per annum (not indexed) for living expenses.

(Note the $100,000 cash buffer plus interest earned exhausts the cash buffer after 4.5 years. Therefore, halfway through year five we need to draw on the balanced fund to pay our retiree their income.)

Year	Start Amount of Balanced Fund	Performance	Balance	Less Annual Drawdown	End of year balance of Balanced Fund
07/08	$400,000	Minus 6.4%	$374,400	Nil	$374,400
09/10	$374,400	Minus 12.7%	$326,850	Nil	$326,850
09/10	$326,850	Plus 9.8%	$358,880	Nil	$358,880
10/11	$358,880	Plus 8.7%	$390,100	Nil	$390,100
11/12	$390,100	Plus 0.4%	$391,660	$12,500	$379,160
12/13	$379,160	Plus 14.7%	$434,900	$25,000	$409,900
13/14	$409,900	Plus 12.7%	$461,960	$25,000	$436,960

After seven years our starting $500,000 is now worth $436,960 (the cash buffer expired in early 2012).

The account balance would be much lower if the drawdown had been indexed (which happens in reality). In addition, if a planner was involved, there would also be establishment and ongoing fees deducted from the account balance. What we see above is a 'best case' scenario.

The fact is if your account based pension gets hit early by negative returns, it's unlikely you'll ever recover your starting position.

As you can see, the impact of two negative years has not been offset by five positive years. And in the context of negative returns, minus 6.4% and minus 12.7% are not all that catastrophic.

Imagine the damage to portfolios if the US market tanks between 50% and 80% and stays there for years.

With superannuation being the home of most Australian retirement capital, the potential for significant losses becomes apparent when you consider $1.7 trillion (85%) of the $2 trillion superannuation pool is invested in market related assets.

As mentioned previously, if the property, shares and bonds markets suffer a collective fall of 30%, this wipes out over $500 billion in retirement savings!

Retirees living from their account based pensions are suddenly squeezed hard on both sides — capital and income.

Cost of living pressures mean they'll need to continue to withdraw the same dollar amount from a smaller pool of capital. The forced erosion of capital is likely to lead to a heightened level of household austerity.

Fewer dollars going around in the system delivers the government lower tax revenues. Precisely when more retirees — thanks to lower portfolio values — will be eligible for an increase in age pension entitlements under the assets test.

The almost universal underpinning of our economic growth on debt and the wealth effect is actually sowing the seeds of our demise.

So…

That's the BAD news…

Three interconnected 'end-themes' are going to make things very, very difficult for many Australians in the years to come.

- End of the debt super-cycle
- End of Australia as the 'lucky country'
- End of rising share markets

On a broader level…

One era in economic history is about to end, and another is about to begin.

If I've learnt anything during my years as a student of the markets, it's this: you can lose more than just a bit of money if you ignore reality; you can lose *everything*.

The reality is that Australia is on the precipice of one of the longest and most painful busts in its history.

The kind of secular correction that only happens once or maybe twice a century. It will likely begin to play out and ruin millions of people's retirements by the end of this decade.

The good news is this…

Once you grasp this, there are ways you can protect yourself — and even make some serious wealth building moves coming out the other side.

But only if you accept that the world is in the midst of a great crisis…and that Australia will not be protected this time.

Only if you accept that you need to change your thinking about how you live and invest.

And you don't have a lot of time to make that change.

For the rest of this book we'll focus on practical things you can do to survive Australia's Long Bust.

PART THREE

How to Prepare for (and then Profit from) Australia's Long Bust

The Long Bust Investment Philosophy

I'm often asked the question, 'If everything is so bleak — for the world and for Australia in particular — what should I actually do with my money if I agree with your outlook?'

Well, the good news is **there is a wealth preservation plan for an Australian 'Long Bust' scenario**. And it's easy to implement.

You don't need to be a millionaire to benefit from it. And the best part is that it offers you a lifeboat of financial sureness at the exact time large forces are moving the world, changing history, and making a lot of people a lot poorer.

This global 'system of systems' is about to face its biggest test in more than 80 years.

For reasons I have outlined, Australia won't miss this like it did the GFC.

So how do you survive, and what should you be doing?

'Winning by not losing' best describes my investment philosophy for *The End of Australia* and the beginning of The Long Bust.

It’s actually a philosophy I’ve held for most of my professional career. It just so happens we are now entering a prolonged period where it’s going to come into its own.

Winning by not losing doesn’t mean avoiding risk and volatility — they are a constant when you invest.

What it does mean is increasing your chances of being rewarded for the risk you take during these times of great uncertainty.

Unfortunately, the average investor believes risk equals reward. The investment industry tells you repeatedly that high risk equals high return. Wrong. High risk can also mean total capital destruction.

Just because you jump into a high risk investment and are prepared to wait a few years for the big payday, does not mean there is any certainty that payday will ever arrive.

My preferred strategy is one of low risk/high return. Put another way — buy low and sell high. Now that may sound overly simplistic. But think about it…

The more of your capital you lose, the bigger the returns you need to recover your starting capital.

At what point in the investment cycle is there the greatest risk? That’s easy. It’s the latter stages of a bullish and over-optimistic market. The more feverish the buying activity, the greater the odds of overpaying.

That’s the stage we’re at right now.

Yet time and time again the alluring and seductive power of a booming market attracts wide-eyed investors. More lambs to the slaughter.

The following table shows why you need to avoid the impulse of overpaying for an asset. An asset that falls 80% in value requires a corresponding gain of 400% to recover your original capital.

Loss to Portfolio	Gain required to cover loss
5%	5.3%
10%	11.1%
15%	17.6%
20%	25.0%
25%	33.3%
30%	42.9%
35%	53.8%
40%	66.7%
45%	81.8%
50%	100.0%
55%	122.0%
60%	150.0%
65%	186.0%
70%	233.0%
75%	300.0%
80%	400.0%
85%	567.0%
90%	900.0%

This is the 'buy in haste and repent in leisure' experience so many investors have been through.

Buffett's description of risk is the permanent loss of capital.

For mere mortals with significantly less money, losing half of your capital would constitute an unacceptable risk.

We are at an absolutely critical time in investment markets…

The level of central bank intervention is without precedent. They have pushed interest rates to record lows, and provided abundant capital to push share prices ever higher.

Have central bankers really been able to repeal the traditional market price discovery processes? Or are we in a period of suspended animation…awaiting a thud back to earth?

The choice is simple — man versus market.

This battle of wills has raged for centuries — Tulip Mania, the Mississippi bubble, the South Sea bubble, the Panic of 1907, the Roaring Twenties, DotCom mania, the US housing bubble.

The bouts between man and market can sometimes be decided in the first few rounds; others last a little longer. But the winner each and every time by knockout is the market.

The market's impressive track record is chronicled in Professors Reinhart and Rogoff's book *This Time is Different: Eight Centuries of Financial Folly*.

In 800 years of man versus market, the outcome is always the same. The market wins each time.

With this background knowledge, do you bet your retirement capital on the perennial loser (central bank manipulation) or the undisputed champion?

The US share market, the one that influences all other markets, is at a record high. Did it get there under its own steam, drawing on the strength of the underlying economy?

No.

It's only because of zero interest rates and newly printed dollars.

Unless history decides to completely rewrite itself, this market will meet the same fate as all other debt crises and market manipulations.

When this market collapses it will earn a place in the history books, for all the wrong reasons.

We have never seen this level of intervention on a global scale before. Every major economy is involved in rigging markets in an attempt to boost economic growth. But the strategy has been an abject failure.

The history books might draw parallels with The Great Depression. My guess is it's shaping up to be even worse. The only 'science' behind this gut feeling is that the higher it goes, the harder it falls.

After nearly 30 years in the investment business I've learnt to keep things simple.

This fundamental belief is what's guided me in the develop-ment of an investment philosophy to achieve long term investment success.

And it's a belief that should stand you in great stead during the Long Bust I see coming…

'Life is really simple, but we insist on making it complicated.'

Confucius

Confucius must have had the investment industry in mind when he offered this pearl of wisdom.

Creating wealth is simple if you follow the rules.

The financial world is awash with complexity — hedge funds, derivatives, options, CDOs, CFDs, structured investments, and so on.

Too often with financial matters, the tendency is to make it complicated. Why? Because complicated gives off an aura of being smart and connected. Financial institutions are clever at building products and stories that appeal to the inner gambler and egotist. Sadly, a good portion of these products also ends up in the hands of the naïve.

In my experience, the long term beneficiaries of these complex structures have predominantly been the promoters. Sometimes the savvy or extremely lucky investor has a win, but they tend to be a very small minority.

For these reasons the strategy behind my macroeconomic and investment service, *The Gowdie Letter* is built on some fairly simple and straightforward philosophies. These beliefs are the result of nearly three decades of seeing what works and what doesn't over the long term.

13 timeless wealth rules that are about to become more important than ever

At the outset I'm prepared to accept there are exceptions to each of the following philosophies. However, far too many people think they are the exception. And I sincerely believe that adhering to these guidelines will be more crucial than ever as we enter a Long Bust…

- **To create and preserve lasting wealth, you must spend less than you earn.** This was the basic rule in *The Richest Man in Babylon* by George Samuel Clason. This rule applies to individuals, companies and governments. Living within a budget is a discipline that will stand you in good stead when tough times inevitably come.
- **Only invest in things you understand.** There is enough risk in 'vanilla' investments without adding extra layers of unquantifiable risk. When presented with an investment opportunity, I evaluate the merits of the offer based on Einstein's wisdom: '*If you can't explain it to a six-year old, you don't understand it yourself.*'
- **What goes up must come down.** Simple. A bust always follows every boom. It has always been true. It always will be true.
- **The pendulum of valuations swings from undervalued to overvalued.** Social mood — ranging from pessimism to optimism — drives the valuation process. Buy low and sell high.
- **The taxman is not your biggest enemy.** The taxman tells you upfront the percentage of income and capital gain he intends to take from you. The markets and their promoters give you no such guar-

antee. They can take all your capital without you ever making one cent of income or gain. I am no fan of the taxman and encourage you to do everything you can to legitimately reduce your tax contribution. However, investments promising to minimise tax — agri-schemes, negative gearing, depreciation allowances, etc. — should be subject to a very high level of scrutiny before you proceed.

- **Avoid capital destroying losses.** If markets fall 50%, you must achieve a 100% return to recover your original starting position. Few people understand this simple fact, and it can cost them dearly.
- **Patience is absolutely essential to long term wealth creation.** Lasting, long term wealth is not about chasing the hot return. It is about identifying trends and either participating in or avoiding those trends. If these trends take a long time to play out, so be it. Markets move at their own pace, irrespective of your wants or needs.
- **Avoid excessive debt.** The old saying is, 'There is no new way to go broke — it is always too much debt.' The investment industry has coined the phrases 'good debt' and 'bad debt'. In theory margin lending is 'good debt' — ask investors in Storm Financial how good that debt turned out to be. They would have been better off running up a $30,000 credit card (bad) debt and at least having a great time of it. 'Good debt' to buy an overpriced asset is a bad debt. Borrow cautiously and within your means.
- **What you want and what you get are two different things.** Investors may want a certain rate of return to achieve a particular goal, however achieving that rate of return with a degree of safety may

not be on offer. For example, you may want an 8% return on your capital, but interest rates are only 3% — be very careful trying to chase that extra 5%, it could come with a hefty capital loss. Therefore you have to adjust your expectations rather than chase return.

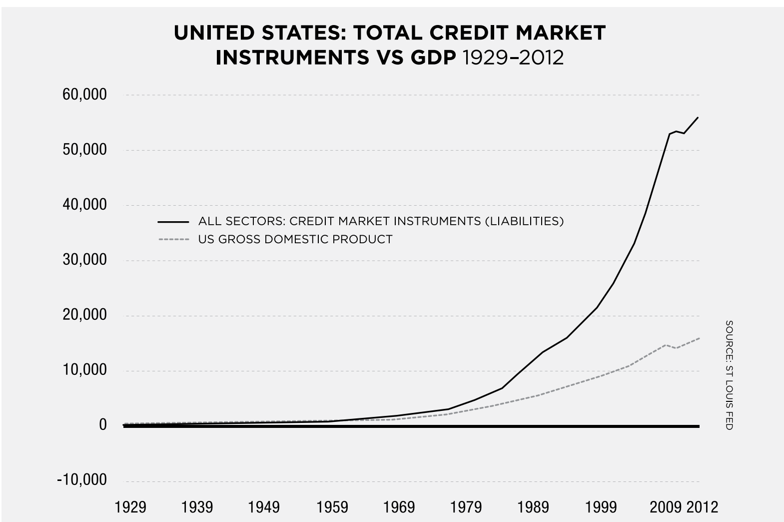
- **If it sounds too good to be true then it usually is.** If whatever is offered to you does not pass the 'sniff' test, then walk away. It was Donald Trump who said, '*Experience taught me a few things. One is to listen to your gut, no matter how good something sounds on paper. The second is that you're generally better off sticking with what you know. And the third is that sometimes your best investments are the ones you don't make.*'
- **Risk does not always equal reward.** Too often investors mistakenly believe that risk equals reward. In other words, the higher the risk, the higher the reward. When in fact the higher the risk can mean the greater the loss. Even low risk can result in a big loss — just ask the depositors in Cypriot banks. Evaluating risk is critical to investment success.
- **Past performance is a very poor guide to future performance.** The world is dynamic. The events that created the past performance are not necessarily going to be replicated in the future. Yet time and again the greatest inflow of money into an investment sector happens when the positive trend is reaching its use by date.
- **Governments giveth and governments taketh away.** Treat any entitlement from government as a bonus rather than a right.

A practical application of the Long Bust philosophy

The following chart serves a number of purposes.

First, it clearly explains how we arrived at the economic funk we find ourselves in today. Second, it gives us a guide as to how difficult generating future economic growth is going to be. Third, it allows us to see the consequences of breaking the simple rules.

It compares America's growing debt with its Gross Domestic Product…



As you can see the two lines start to separate around 1980. This is the time the first wave of Baby Boomers started to infiltrate the management ranks of banks and investment institutions… and also after the US had a decade of becoming accustomed to the 'freedom' of unfettered fiat money.

Debt in all its shapes and sizes (the upper line) has grown exponentially since the 1980s. In turn, the injection of this debt into the US economy has lifted their GDP (lower line).

Note that the debt to GDP ratio is 4:1 (US$60 trillion versus US$15 trillion). This corresponds with the studies that show the greater the level of debt in the system, the more debt that's required to generate $1 of GDP.

According to *The Economic Times*, '*Debt-driven consumption became the tool of generating growth. But this requires ever increasing levels of debt. By 2008, $4-5 of debt was required to create $1 of (US) growth. China now needs $6-8 of credit to generate $1 of growth, rising from $1-2 of credit for every $1 of growth a decade ago*.'

By extension, to achieve the Fed's GDP growth objective of 3% (US$450 billion) a further US$2.25 trillion in debt has to be added to the existing debt levels. Can you see where this is going? If this trajectory continues it will take $10 of debt to produce $1 of GDP — this is the situation Japan now finds itself in.

The central banks' necessity to grow debt, together with the tens of trillions of dollars of unfunded commitments (pensions, healthcare, etc.) is why the current Western financial model is in deep trouble.

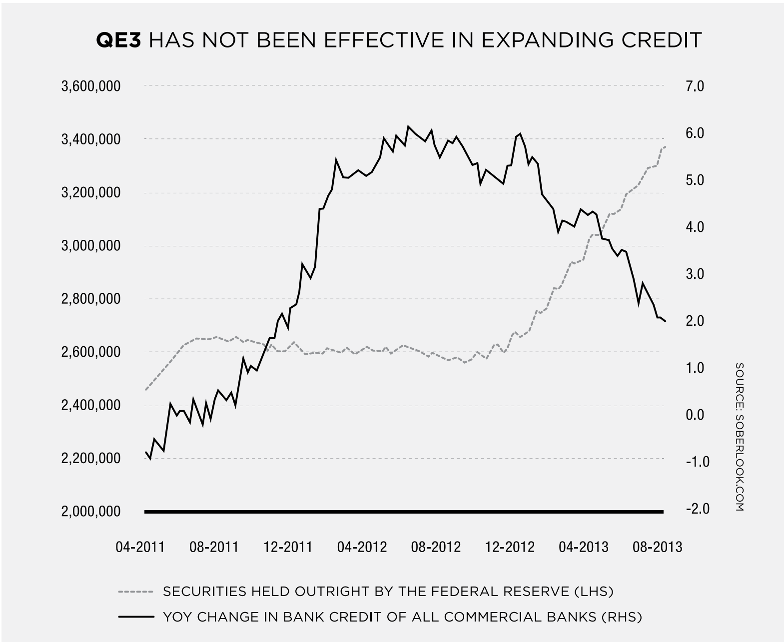
The question is <u>when</u> will it happen?

And here we return to one of my core investment philosophies for survival in the coming years. Patience is absolutely essential to long term wealth creation. You identify the trend, and need to be prepared to wait for it to play out.

Reaching this untenable situation of ever increasing debts has meant breaking two simple rules:

- To create lasting wealth you must spend less than you earn.
- Avoid excessive debt.

The next chart tells us why the US Fed is finding it increasingly hard to increase borrowing levels. The Fed's stimulus efforts have not resulted in increased private sector borrowing. Private sector credit growth continues to contract.



The dotted line (referenced to LHS) represents the increase in the Federal Reserve's balance sheet through QE. The black line (referenced to RHS) is the annual percentage change in bank credit.

The Fed was hoping that by making more cheap money available, households would take the bait and resume the credit fuelled consumption binge of yesteryear. To paraphrase, 'you can take the consumer to a well of cheap money, but you can't make them borrow it'.

The consumer of yesteryear (the Baby Boomer) is in a different phase of their life. Little wonder treasury officials in all Western economies continue to revise their growth forecasts downwards. Without the economic driver of credit addicted Baby Boomer consumers, the economy is giving us a truer reflection of itself.

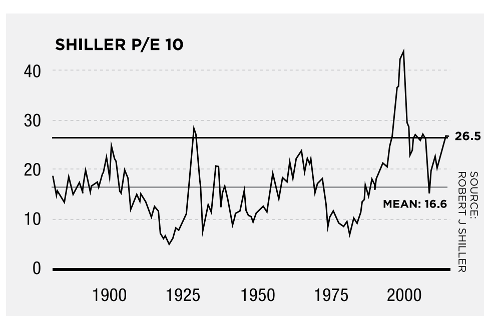
With the Boomer mindset switching from consumption to retirement, the growth picture of the future will be vastly different to the past. This change has enormous implications for government revenues and how they meet their budget commitments — the interest cost on public debt (even more onerous when interest rates rise), social security, healthcare, defence and so on.

The rules the Fed have ignored are that past performance is a very poor guide to future performance and what goes up must come down.

The great hope was that the emerging markets (China, India, South America) would make up for the lack of Western growth. However, the period for these economies to transition from a heavy reliance on infrastructure building and exports to domestic consumption is taking far longer and proving more painful then was forecast.

The emerging markets are all dealing with their own debt issues, so there is little prospect of an emerging market consumer-led boom helping to boost the global economy anytime soon. The next chart shows you why investors are going to learn the lessons from these rules:

- Valuations swing from undervalued to overvalued.
- Avoid capital destroying losses.
- Risk does not always equal reward.



Over the course of the past 130 years, the P/E ratio of the US market has wandered above and below the long term average of 16.6x.

With hindsight, the peaks and troughs are readily identified with various times in history — The Roaring 20s; The Great Depression; The 1970s Oil Crises; The Tech Boom.

Each of these major events had an impact on society's prevailing psychology — ranging from euphoria to despondency. Naturally, these moods reflect what we are prepared to pay for certain assets.

These mood swings are captured by the historical low of 4.8x during the 1921 Depression, and the historical high of 44.2x, reached at the height of dotcom mania.

Depending upon the prevailing mood, over the past 135 years $1 million of earnings has been valued between $4.8 million and $44.2 million. So you can see the valuation (social mood) pendulum does indeed swing a long way in either direction.

Currently the Shiller P/E sits on 26.9x. This is 63% higher than the historical average.

Based on previous (and rare) periods when the P/E has been at this extended level, the Implied Future (next eight years) annual return is minus 0.3%. A classic case of a market representing very high risk and very low return.

Even if the market simply reverted to its average of 16.6x, it constitutes a fall of 40% from current levels. But as the chart shows, markets never stop at the average.

Therefore, the potential reduction in capital value is likely to be significantly more than a simple mean reversion exercise.

Granted, before the market falls, it could indeed go higher. But as long term value investors, why risk making a few extra percent when the potential downside is at least 40% or more?

That would be a very poor risk/reward calculation

History shows us that the value equation of low risk/high return in the share market comes when the Shiller P/E is registering 10x or under.

These rules are not rocket science. Yet cycle after cycle, investors make the same mistakes.

The GFC did not happen by chance. It was the result of the masses being financially illiterate. Households, businesses and governments (all operated by human beings and all influenced to varying degrees by the emotions of greed and fear) either forgot or ignored the basics of a balanced budget. Collectively the developed world lived beyond its means. The GFC was the reaction to that action.

Simple budgeting — at all levels of society — could have avoided the debt mess the world is in today. But this isn't how the world works.

As mentioned at the outset, the history books have numerous examples of fortune followed by misfortune.

People ignore the basics. Reality is temporarily suspended. But, eventually, reality sets in and the market comes crashing back to earth. That's the sad and sorry cycle that repeats itself time and time again.

It was Eleanor Roosevelt who said, '*Learn from the mistakes of others. You can't live long enough to make them all yourself.*'

Learning the lessons of the past is far less painful than making the mistakes yourself.

Knowing the basics can influence the quality of your investment decisions. Live by and understand these simple rules and you'll be better off than most.

- Live within your means
- Borrow conservatively
- Always have a contingency (rainy day) fund
- Booms are always, always, always followed by busts
- Greed and fear drive markets at the extremes
- If it's too good to be true — then assume it is
- Get rich quick schemes are code for 'Get poor even quicker'
- If you don't understand the investment, DO NOT invest
- If you are promised a rate of return higher than that offered by a reputable bank, then there is always the risk of losing some or all of your capital

The whole point of having simple rules is to minimise the possibility of making mistakes.

In the investing world, mistakes can be extremely costly… retirements foregone, fortunes lost.

Avoiding these life changing mistakes is a constant challenge. Markets — share, property, interest rate and precious metals — are all dynamic and interact with each other to produce negative and positive outcomes.

Understanding these dynamics and the impact they can have on your financial position is a process of continuing education…the pursuit of truth.

What if the Bust doesn't happen next week, or next month, or even next year?

Again, we come back to patience. Remaining patient when others around you are achieving returns significantly in excess of the cash rate isn't easy. The world we live in today has made patience unfashionable…a relic of a bygone era.

And yes, there are times when fortune does favour the brave, but there are also times when a fool and their money are soon parted.

In my view, only a fool would think global markets could rise indefinitely on a sea of printed money and the distortion of zero to negative interest rates. Or that the long, recession-free boom Australia has experienced can go on forever.

The US share market is overvalued to an extreme level. It's only a matter of time before it crashes. We just don't know exactly when it will happen.

That's what makes it foolhardy to risk large stakes for potentially small returns. Having said that, I know from experience that when good gains are on offer in the market being a spectator can be extremely frustrating.

The hardest part of my former life as a financial planner was managing client expectations. Investors invariably wanted a higher return with minimal or even no downside — a 'having your cake and eating it too' strategy. Taking profits and paying taxes on realised gains during a booming market challenged most clients' thinking. It was counterintuitive to the way most investors are wired.

The 'Financial Planner philosophy' will only bring pain in The Long Bust

If I was in practice today, recommending clients hold 100% in cash would be commercial suicide. The majority of clients would take their business elsewhere. Wanting another planner to advise them to do something, anything, to justify the fees they are paying.

Whether that something or anything is genuinely the best advice in the longer run is a moot point. When you are frustrated with missing out on what your neighbour/friend/work mate/family member has been making while you're in cash, anything is better than sitting still.

The desire to do something is why the financial planning industry invariably finds itself the subject of public ridicule.

Planners feel the real or imagined pressure to achieve a rate of return in excess of what people could generate themselves. Therefore, they take risks. However, the full extent of those risks only become apparent when falling markets place strategies and products under pressure.

Nearly 30 years in this business has provided me with my share of 'being wise after the event' moments. It's the knowledge gained from these experiences that motivates me to share my thoughts with you…in the sincere hope that I'll help improve your knowledge before the event.

In due course markets will present patient investors with an opportunity to buy at discounted levels. When that time comes, I expect investors to be somewhat fearful to leave the safety of cash.

Markets will be in turmoil. Financial pain will be etched on peoples' faces. The social mood will be very sombre.

Transferring from a risk free world of cash to a world that is perceived to be full of risk in the financial markets will be counterintuitive. Common sense tells us markets that have crashed are far less risky than markets that are booming. Yet the herd thinks differently.

This is why my investment approach places so much emphasis on understanding value. Recognising that most people only know price, not value, is a distinct edge in the wealth transfer business.

This is why having simple to follow rules will enable you to remain calm while others are panicking.

Winning by not losing. Easy to say. Hard to do.

The Long Bust Portfolio

> '*Health authorities warn people to stay indoors as dust storm hits Sydney and NSW*'

news.com.au 23 September 2009

> '*Stay indoors! Emergency services warn residents to brace for more wild weather after strong winds buffet NSW and Victoria*'

dailymail.co.uk 28 June 2014

> '*Surviving Cyclones: Preparation and Safety Procedures: Remain indoors (with your pets). Stay tuned to your local radio/TV for further information*'

bom.gov.au

When natural disasters hit, all official warnings advise residents, for their own safety, to stay indoors.

This is basic common sense. Stay out of harm's way. Minimise the risk to life and limb.

What if, on the cusp of a natural disaster hitting, a State Premier advised people to go about their everyday business? In fact, they advised you to go swimming, play cricket, kick a footy, take the kids to school and generally ignore the imminent danger? No worries. She'll be right mate.

We can be fairly sure this would be their last irresponsible utterance. There is no difference between this hypothetical irresponsibility and the advice issued by the financial sector to continue investing into an overvalued share market. Ignoring valuation warnings that show the forces within the market are building into the financial equivalent of a Category 5 cyclone. A market that is threatening to unleash a fury that is certain to leave financial devastation in its wake.

Historical valuation measures provide a useful guide as to the extent of the fury within the market. The greater the market increases in price (moving further away from fair value), the more the fury intensifies. This is the way nature and markets function. First the pressure builds, then it's released.

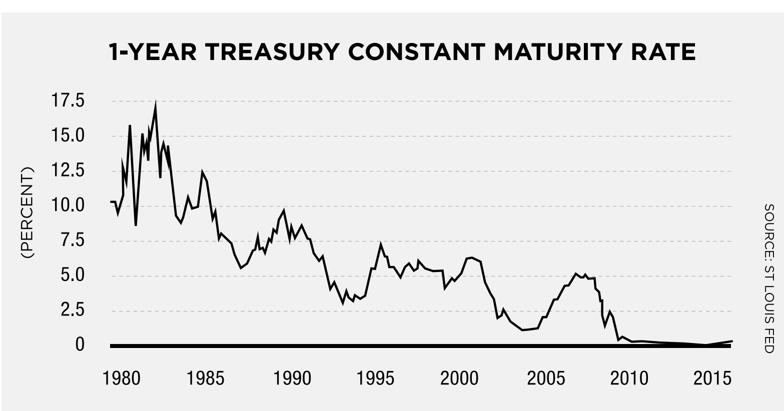
The stay indoors equivalent in financial markets is being invested in cash. Money in the bank. Sure, staying indoors is boring, but it beats the alternative — the risk of financial ruin.

Sometimes in the wealth creation process, you have to adopt a safety first approach. Otherwise you risk destroying your wealth.

When disaster has passed, the cashed up investor can take advantage of the bargains on offer.

This strategy is directly from the Warren Buffett playbook, '*Be fearful when others are greedy and greedy when others are fearful.*'

Right now the prevailing mood among most investors is a mixture of greed and the need for income (due to interest rate suppression). This is the financial warning that makes me fearful.



For 35 years the US one year interest rate has been trending downwards — with the occasional period of temporary reversal.

This chart is a perfect example of complacency breeding contempt, and stability leading to instability.

There are very few investors and money managers who have ever experienced anything but falling interest rates — providing cheaper and cheaper access to borrowed funds and forcing investors to leave the security of cash to chase higher income returning assets.

With a tailwind of falling interest rates for 35 years, it's little wonder share and property assets have appreciated up to 20-fold in value. Investors swapped savings for debt to finance purchases of 'growth' assets.

A multi-decade period of asset appreciation conditions society into believing this is how markets function. Very few people ever delve into why the trend occurred or the sustainability of the trend.

We know how the trend happened, but where to from here with interest rates?

Obviously there's not the scope to replicate the interest rate reductions of the past 35 years.

At best, rates can bounce along the bottom and at worst, rates start to rise.

Either of these scenarios spells the end of the era of cheap money getting cheaper. Without more and more cheap debt to fuel economic and asset price growth, it is game over.

A 35-year trend leads to complacency — what has been, will continue to be. Complacency (together with ultra low interest rates) is what makes investors pay prices for assets that are well above much longer term averages.

Everything eventually reverts to the mean.

The warning signs of an impending financial disaster are all there — Sydney property prices, historical highs on the Dow Jones and S&P 500, 10-year government bond rates yielding under 1% per annum, and outright market manipulation by policymakers.

The pressure within the system is intensifying. Something is going to crack, and when it does it will be devastating.

When debt defaults start to multiply in number, we'll see interest rates start to move higher as investors demand to be compensated for the increased risk of default.

Higher rates will lead to more debt defaults as borrowers buckle under from the increase in debt servicing costs (especially in a world of stagnating personal incomes and corporate earnings). A negative feedback loop, feeding on itself. The polar opposite of the positive feedback loop created by an environment of falling interest rates. The yin and yang of life.

So…what is my portfolio allocation to cope with the coming financial storm?

And how should you adjust that portfolio when the storm starts to subside?

I warn you now. There's nothing complex, clever or 'sexy' about the model portfolios that I have devised for the periods before and after the Long Bust.

But the truth is, in times like these, it's people who break away from time honoured rules who tend to lose the most.

In designing a portfolio for the current conditions, the priority is on protecting capital. The post-crash model portfolio is designed to take advantage of discounted assets that are going to be on offer.

The design of the pre- and post-crash portfolios has been based on these probable scenarios:

1. The forces of The Great Credit Contraction, which will involve debt repayment or default, will exert a deflationary influence on the global economy. During this phase 'Cash is King'.

2. Policy makers are attempting to fill the void created by the withdrawal of the private sector with increased deficit spending financed by money printing. When the market collapses, central bankers (rather than acknowledge their mistakes) are likely to adopt a Japanese-style stimulus plan — double the money supply in a very short space of time.

   There are longer term inflationary implications from the world's central bankers adding significantly to the global money supply.

3. In the next two to three years, as the global economy weakens, Australian cash rates will continue to fall into the sub-2% range.

4. Global share markets are currently being supported by artificial means — zero interest rates and money printing programs. If share markets follow previous secular bear markets, valuations are destined to fall significantly, representing a better buying opportunity for cashed up investors.

5. Unlimited and indefinite money printing has a high probability of unleashing inflationary forces later this decade. The rate of money flow in the economy may well gain speed as people realise the buying power of their cash is being eroded and scramble to buy things.

6. Higher inflation erodes the buying power of cash. At some point investors will need to switch funds from

> the safety of cash to the inflation protection offered by hard assets — property, shares in quality businesses and precious metals. This transfer needs to be in place before the herd awakens to the inflationary forces embedded in the economy.

So, with all that in mind, this is the Model Portfolio I will be gradually moving towards while the Long Bust is in progress…

The Vern Gowdie Long Bust Model Portfolio

The Model Portfolio is simple, transparent and extremely low cost.

Asset Class	Preferred Allocation %	Reason for inclusion
Cash/ Fixed Interest	20%	Security and liquidity
Listed Property Trust	20%	Income and inflation protection
Australian Shares	20%	Tax effective income and capital gain (inflation protection)
Emerging and Frontier Markets	20%	Capital growth (inflation protection) from developing economies unencumbered with debt and welfare and healthcare commitments
Precious metals	20%	Inflation hedge against excessive money printing

The Model is based on a *beta* approach to investing.

What is *beta* investing?

Beta investing is for passive investors wanting to track the index of the asset class they're invested in.

Whereas *alpha* investing is for the active investor. This is the investor who tries to outperform the market by attempting to invest in more winners than losers. The majority of fund managers are *alpha* investors.

Plenty of studies show that over 80% of active managers actually fail to achieve their stated objective of consistently outperforming the relevant index.

Active (alpha) management is not cheap. Active fund managers can charge up to 2.0% per annum. Not only do you under-perform the index, you pay handsomely to do so. This, in my opinion, is dumb investing.

If the majority can't beat the index, then why not simply invest in the index?

Simple and transparent.

Also index funds, due to their passive nature, are low cost… some as low as 0.15% per annum.

When the time is appropriate to begin allocating capital into the various asset classes in the Model Portfolio, it will be via low cost Exchange Traded Index Funds (ETFs).

But…in the meantime, this is my Pre-Bust Model Portfolio. The one I recommend you adopt now. In my opinion, this is the best asset allocation model to adopt while you are still waiting for the tipping point to occur.

The Vern Gowdie Pre-Bust Model Portfolio

Asset Class	Preferred Allocation %	Reason for current allocation
Cash/ Fixed Interest	100%	Security, liquidity and current rates still offer a fair return of 2.5% to 3%.
Listed Property Trust	0%	This sector is still working through its debt issues. Also any share market downturn will impact unit prices negatively and represent a better buying opportunity.
Australian Shares	0%	Do not believe markets are standing on their own two feet. Too much central bank intervention and anticipate a fall of 50+% in next 2-3 years.
Emerging and Frontier Markets	0%	While these markets offer solid long-term gains they will be adversely affected by any major downturn in western world markets.
Precious metals	0%	Watching this sector closely for a staged buy in. Independent research indicates further sell off in precious metals may materialise in the event of a major economic upheaval e.g. GFC Mark 2.

As you can see, you really can't get any simpler than that.

And it's certainly not a portfolio model many financial advisors would recommend to you. **But history dictates that it's absolutely the safest asset allocation model to adopt right now.**

That said, a frequently asked question with having 100% in an asset class is, aren't you putting all your eggs in one basket?

Yes, you are. However, when the next GFC hits, cash is likely to be the safest and most in-demand asset around.

During the 2008/09 GFC every asset class except cash suffered losses…even gold.

When investors scramble for liquidity, everything is up for sale (as we've seen in the recent Chinese share market rout).

The next crisis — most probably caused by one or more sovereign defaults — will result in another massive rush for liquidity. There are two reasons for this.

First, investors will want cash in order to buy US Treasuries for their perceived safe haven status. And second, a large percentage of world debt is in US dollars. Investors desperate to access US dollars to repay dollar denominated debt will be forced to sell anything of value.

Gold — the traditional safe haven in times of turmoil — will be caught up in the panic for liquidity. Gold is a highly tradeable asset, and in the frenzy for cash it will be on the auction block along with quality shares and property.

When it comes to quality shares the bluest of blue chips in the Australian market are Commonwealth Bank of Australia, BHP Billiton, National Australia Bank, Australia & New Zealand Banking Group, and Westpac Banking Corporation.

These five companies constitute approximately 40% of the Australian share market.

Add Telstra, Wesfarmers and CSL to the list and these eight companies make up almost 50% of the Australian share market.

The other 50% of the All Ords index is influenced by the price movement of 492 companies.

When the share prices of the top eight companies move up, down or sideways, they exert a major influence over the direction of the All Ordinaries Index.

When the next crisis hits, two major negative interlocking forces will drive the share prices of the bluest of blue chip shares much lower than most expect.

Remember, the Australian market is pretty much in lockstep with the US market. If the Dow Jones and S&P 500 indices fall 50%, the Australian market will closely mirror the US lead.

In the rush by panicked investors to cash up, the highly liquid shares are the most readily saleable. Try selling your specky mining stock in a market meltdown? No chance. The big blue chips are dumped in the rush to raise cash…driving the index lower.

Cash is king in times of panic

When it comes to cash, there are two questions people frequently ask me. How safe is cash in the bank? And, in a low interest rate environment, where is the best place to invest my cash?

The answer to the first question hinges on the government honouring its promise to guarantee deposits up to $250,000 (per taxable entity) with Approved Deposit Institutions (ADIs). Assuming the government stands behind the guarantee, then cash in the bank (up to $250,000) is safe. Hopefully, it will also be accessible.

Based on this assumption, there is no viable Plan B. Money under the mattress doesn't quite cut it.

People are also concerned that after GFC MkII (the next crash), there may not be any cash, that Fiat money will disappear. I don't believe that's a major concern. Without cash, who'll have money to buy any assets? How would you value anything? What good is a $500k share portfolio or home, if you can't sell the assets in return for cash?

If cash is required, the RBA can simply print the physical bank notes — which is what the RBA did during the GFC banking crisis.

Where should you put your cash to obtain the best rate while you're waiting for the Long Bust to properly kick off?

There are two websites I use to gain an insight into what's on offer in the marketplace. They are Canstar and Infochoice:

http://www.canstar.com.au/savings-accounts/

http://www.infochoice.com.au/banking/

Both sites are easy to navigate. There are a variety of savings account comparisons on each site.

But do note that these sites have sponsored products. Various institutions pay to place their accounts at the top of the comparison tables — like Google ads.

Accept this sponsorship arrangement for what it is, and use the comparison tables to assist in identifying which accounts may suit your requirements.

Be mindful with the 'bonus saver' accounts. Each offering has fine print on the conditions relating to how you qualify for the bonus payment.

Watch out for this little-known deposit trap!

The government's deposit guarantee is for $250k in total with an institution and its subsidiaries.

For example St George Bank, Bank SA and RAMS are owned by Westpac.

Therefore, if you had $800k and deposited $200k into Westpac and each of its three subsidiaries, you'd be in for a nasty shock if or when the worst happens. In this example, thinking you had diversified your risk, you would find that only $250k of the $800k is covered by the government's deposit guarantee per institution. Imagine learning that the hard way.

Other examples of this little trap are NAB, which owns UBank, and CBA, which owns BankWest.

Make sure you know which parent institution is covered by the guarantee, so you don't unwittingly place more than the

$250k with any one institution.

Also note that not all online high interest cash accounts accept monies from Self-Managed Superannuation Funds (SMSF).

The benefit in looking through both sites is you'll be able to ascertain which are the better online accounts in terms of rates paid, bonus rate conditions and ease of use for your needs.

If you're looking for term deposits, both sites provide comparisons on these too.

The links are:

http://www.canstar.com.au/term-deposits/

http://www.infochoice.com.au/term-deposits.aspx

The value I find in the term deposit comparison tables is the ability to then shop these rates around. It tends to make institutions sharpen their pencils a little more.

Make sure you do this before depositing money in smaller institutions

Before depositing your funds in any of the lesser known institutions, check that they or their parent institution is on the Approved Deposit Institution list. Here's the link to the official government site that lists all the Approved Deposit Institutions covered by the deposit guarantee:

*http://www.apra.gov.au/adi/pages/adilist.aspx*_

Investing with a lesser known institution — credit union, building society or small bank — does not affect the deposit guarantee. Provided the institution or its parent is on the list, your deposit up to $250,000 <u>per taxable entity</u> is guaranteed.

A taxable entity means individuals, companies, or an SMSF.

For example, if Bill and Mary Smith had Smith Pty Ltd and Smith Super Fund, they could invest their cash as follows:

Bill Smith $250k
Mary Smith $250k
Smith Pty Ltd $250k
Smith Super Fund $250k

Bill and Mary's entire $1 million could be invested with a single institution and be covered because it is spread between taxable entities.

In summary, there is no single best definitive cash account or term deposit.

Interest rates can and do change, depending on an institution's need for cash.

The websites listed provide you with an opportunity to narrow your selection down to a chosen few. Then you can go to each site to determine which one feels right for you.

If we have done this cash protection right, and the government honours its guarantee, your cash will be safe.

But what about your money in superannuation? Is it guaranteed?

Well that depends on whether you are invested in a public offer fund or a self-managed superannuation fund (SMSF).

Self-Managed or Managed?

If you are one of the millions of Australians with the majority of their retirement capital invested in superannuation, you may be thinking, how can I cash up and protect myself from the next financial crisis?

Superannuation is divided into two camps — managed (public offer funds) and self-managed.

Self-managed superannuation funds with cash held in Approved Deposit Institutions are covered by the government guarantee (up to $250,000 per institution).

The cash options within public offer funds are not guaranteed.

With the growing exodus from public offer funds to self-managed funds, it's worth exploring the pros and cons of the two superannuation alternatives.

In the interests of simplicity, it's important to remember the intent behind superannuation. The Sole Purpose Test defines that for us:

> '*The sole purpose test requires that all regulated super funds including SMSFs are established and maintained for the sole purpose of providing benefits to members upon their retirement, or to a member's beneficiaries in the event of their death.*'

In other words, the investment process behind superannuation must be solely focussed on providing retirement benefits to its members — not participating in some personal indulgences on the road to retirement.

The investment industry has campaigned long and hard on the basis people can't be trusted to manage their own funds. Granted there have been cases of flagrant abuse by members. But in fairness there have also been some atrociously managed professional funds.

The world will always have its 'bad eggs', and no amount of legislation can outlaw corrupt and stupid behaviour.

The $64 question is whether self-managed is for you or not.

Depending on whom you talk to, you are likely to receive conflicting answers.

These are the criteria I would use to assess whether an SMSF is warranted for a client:

- Do you have sufficient funds and/or annual contribution levels to warrant establishing an SMSF?

There are differing views on how much is enough to start a SMSF. Online accounting and audit services — such as those offered by esuper.com.au ($799 per annum) and superannuationwarehouse.com.au ($468 per annum) — make establishing a SMSF more attractive for those with lower balances. For investors with a combined balance of $100,000, this equates to an annual cost of between 0.5% and 0.8% per annum. Which is quite reasonable.

Obviously the higher the fund balance, the lower the fee becomes as a percentage of assets in the fund. This is what makes SMSFs so attractive for those with larger balances and/or with the capacity to make significant contributions.

Please note that I'm not recommending either of the above online admin services. I'm simply mentioning the economical cost of their service to highlight the point of what amount of money is required to justify establishing an SMSF.

Here's a link to compare the various SMSF providers and their fees (establishment and ongoing):

http://www.thesmsfreview.com.au/comparison-table-smsf.html

If you have an amount under $100,000, you should ask yourself these questions. Can you make maximum contributions to reach the level necessary to make the annual accounting and administration fees a reasonable proposition?

- Do you have an interest in controlling and managing your own funds?
- Do you have a long term investing mentality, or are you more about making a quick buck?

- Have your previous investment attempts been successful or not? If you have a poor track record in investing, then perhaps an SMSF is not for you. Because if all else fails, having an industry or retail fund to fall back on isn't a bad thing.
- Do you have life and disability insurance cover in your existing super fund that requires replacement?
- Do you like keeping good records? Compliance is a major consideration in a SMSF.

Assuming you're comfortable with your answers to the above, then you can move forward and delve a little deeper into the SMSF world.

The pros and cons of SMSFs

As mentioned above, superannuation is the government's preferred savings vehicle. The tax system is skewed towards encouraging people to contribute, accumulate and eventually draw an income from superannuation.

In return for the tax concessions, the government requests (via legislation) you do the right thing with the funds. The intent should be to invest your retirement funds in a manner consistent with promoting the long term growth of your capital.

Taking control of your superannuation with an SMSF may be considered your right but, as always, rights are accompanied by responsibilities.

The major benefit with an SMSF are the lower fees and the greater flexibility.

If you have a large super fund balance, the costs can be extremely economical. For example the annual cost to administer an average simple SMSF can range from $468 to $2,000. For a fund with $100,000 the fee equates to 0.5–2% per annum (a touch too expensive at the higher fee level). However for a fund with $1 million, it's a mere 0.05–0.2%. This is an extremely low cost for a super fund.

You also get to control where your funds are invested — for the most part anyway. Conservative investors can access higher paying term deposits and higher risk taking investors can access individual shares, property or precious metal investments.

The ability to tailor your investment approach to your view of the world, rather than accept an off-the-shelf balanced fund, is a major attraction of SMSFs.

The major negative of an SMSF is compliance.

Freedom comes with responsibility. The ATO places a higher level of scrutiny on the accountability of SMSFs. A few bad apples have abused the investment flexibility, such as buying assets for personal use and accessing their retirement funds too early. Therefore, it's essential you maintain good records on the movement of funds within your SMSF. Contravention of the superannuation legislation can lead to heavy penalties. These include:

- The trustee or trustees can be suspended or removed and an acting trustee appointed
- The assets of the fund can be frozen
- The fund can be declared non-complying for the relevant year(s) of income. This means losing the tax concessional treatment of contributions and income
- The trustee or trustees can be prosecuted under the Civil Penalty provisions of Part 21 of the Superannuation Industry (Supervision) Act 1993 (SISA)

Believe me, the ATO is the last cage you want to rattle. Good record keeping, a considered investment approach and access to qualified professional advice should keep you on the straight and narrow.

Should you hold individual shares and investment property in your super or concentrate on a certain asset class?

The type of investments you hold within superannuation will depend on a number of factors:

- Your experience in investing
- Your risk tolerance
- Whether you are retired and seek a steady income or accumulating funds and can afford to invest with the potential for greater capital gain
- Where we are in the investment cycle — for example having an overweight share exposure at the peak of the market in 2007 was not a great strategy

You know by this point in this book where I believe we are in the cycle right now. Even if you only plan on holding cash in your super fund, an SMSF can still work for you. You'll have control over your cash, you'll know where and how your money is invested, and you will be covered by the government deposit guarantee.

The more active you are with your investment strategy — such as trading shares — the greater your administration fees. Accountants charge by the hour and the more transactions you do, the more they'll charge.

If you do well out of the individual share trading, then offsetting the additional accounting costs shouldn't be an issue. If on the other hand you invest in a series of 'dogs' you'll pay dearly to account for your losses.

Our post-crash model portfolio is based on a simple *beta* approach to investing, meaning a preference to invest in index funds rather than individual shares. This passive approach ensures lower administration and investment transaction costs.

It appears the 'fors' far outweigh the 'againsts' when it comes to SMSF

Investors are voting with their feet and establishing SMSFs in record numbers.

Over the past two decades, through a combination of compulsory superannuation contributions and the occasional window when much higher contributions have been allowed, the amount of money accumulated in superannuation has grown to $2 trillion.

Little wonder everybody wants to get a slice of this ever growing stash of cash…

- Investment managers
- Industry funds
- Retail funds
- Asset allocation consultants
- Administration services
- Actuaries
- Financial planners
- Government
- Vested interest groups e.g. infrastructure projects
- And finally, the members themselves

When you look at this list of hangers on, you can see why members (in their droves) have been migrating to SMSFs.

The following factors pretty much sum up why they've taken matters into their own hands:

- Percentage based fees discriminate against those with higher fund balances — members with higher balances are subsidising the costs for members with minimal balances
- Periods of poor performance (especially post-GFC) from professionally managed super funds
- A desire to create certainty from an uncertain environment
- Control over the investment process

No one (even with the best of intentions) will look after your money with the same level of care and attention as you

Most in the investment industry don't consider a portfolio invested entirely in cash as a viable strategy.

Even though all valuation metrics are pointing to a capital destroying rout being on the horizon, the investment industry just can't accept the idea of a safe cash portfolio.

And when the market does collapse, the industry, true to form, will trot out all the usual excuses that no one saw it coming.

The pre- and post-crash portfolio models are ideal for an SMSF.

All you need is a bank account (or bank accounts if you have more than $250,000 in your fund) and an account with an online share broker to transact the purchases of the ETF index funds. Simple and low cost.

Let's now skip a little further ahead…

Things can't stay on the same trajectory forever. For reasons outlined in previous chapters, something has to give.

While we are waiting, the best place to be is in cash.

Sure the return on capital is low, but it's not about return <u>on</u> capital. The reason for cash is to be in a position where you'll have a return <u>of</u> capital…all 100 cents in the dollar.

And then…at some stage during the coming bust…it will be time to move out of your 100% cash allocation and into the other asset classes in our Model Portfolio. Some of which will provide great buying opportunities at distressed prices.

The final chapter of *The End of Australia* will look at how to do that.

What to do when it all comes crashing down

At the time of writing the S&P 500 index has been in a holding pattern for several months. It's the longest stretch since 2013 that the market hasn't made a fresh high.

That said, its run over the last few years has been a sight to behold. New market high after new market high.

In Australia it is a slightly different story. Daylight remains between the current level of the All Ords and the record high the Aussie market set in November 2007.

The presence of a few trillion freshly minted dollars, the major driver behind the US market's stellar performance, tends to create that level of distortion in market values. Also, higher Australian interest rates have not forced investors to chase yield to the same extent as investors in the US and Europe.

In the grand scheme of markets, the world cares little about whether our market is going to eventually break through the psychologically important 6000 point barrier or not.

All eyes are on the US.

The US share market could possibly be having a pause before launching itself even further into overvalued territory. Expensive markets can become even more expensive…the dotcom era proved this.

The US share market has now entered the seventh straight year of its post-GFC bull run. This is an extraordinary run… yet another infamous precedent from this market for the history books.

Rational analysis — using historical performance and valuation data — tells us the US market is living on borrowed time. But markets are not always logical. They have a way of surprising people — on the upside and downside.

You cannot discount the US market marching higher than current levels. Drawing in more investors is a distinct possibility.

In December 1996, then Fed Chairman Alan Greenspan made this famous statement (emphasis is mine):

> *'But how do we know when irrational exuberance has unduly escalated asset values…'*

This comment was made in relation to the dotcom valuations at the time. Markets continued to be *irrationally exuberant* for another three years.

After which the NASDAQ then proceeded to lose nearly 80% of its value in a little over two years.

Given the extended record run of the current market, it would be highly unlikely it would continue for another three years. But who knows?

However another 10% upside is probable. All this does is take the market to a much higher point from which its dramatic fall will happen…a NASDAQ-type experience awaits.

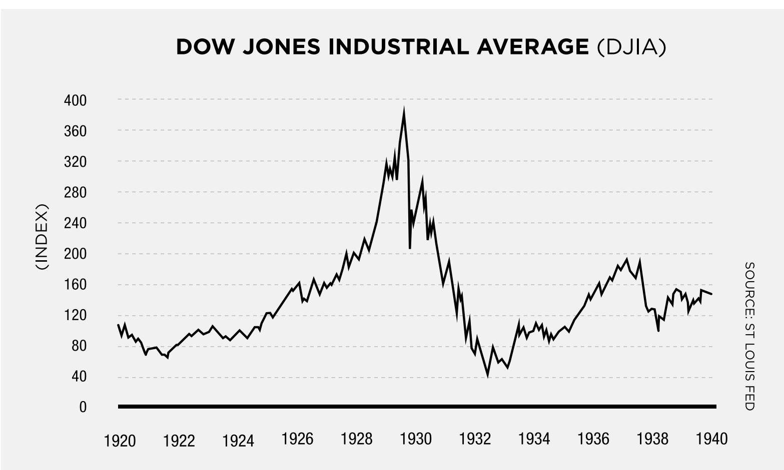
In due course we can expect another record to be set by this market — the greatest collapse since The Great Depression.

With the US market possibly staying afloat for a little while longer, this buys us some time to consider our options for what to do when it all comes crashing down.

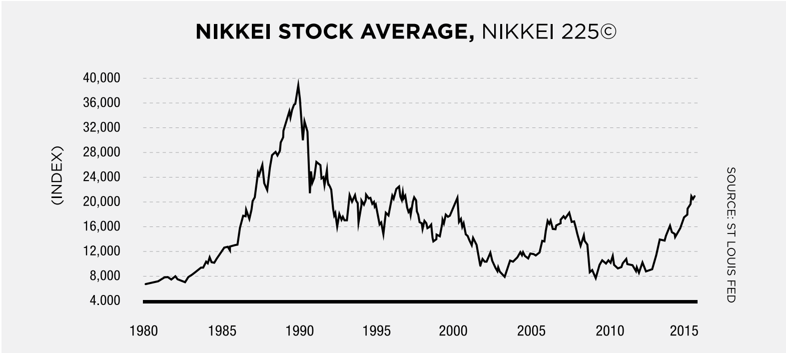
Market corrections are rarely the same. The speed, size, volume and intensity can vary. But in an attempt to provide some insight into what the future may hold, the best place to start is with history.

The two greatest market meltdowns in history — the US share market during The Great Depression and Japan post-1990 — each reached the same destination, but in different timeframes.

The Dow Jones Index fell 87% over a three year period.



Whereas the Japanese market 'snaked and laddered' its way to a loss of 80% over a nearly 20-year period.



A number of US valuation metrics — Shiller PE10, Tobin Q ratio, Market Cap to GDP — show the current market is on par with the conditions that existed prior to The Great Depression.

While the period prior to The Great Depression — The Roaring 20s — was a time of exuberance, it paled into comparison with the *irrational exuberance* of the dotcom boom. The valuation metrics at the peak of the dotcom boom in 2000 occupy a special place in the share market's Hall of Fame — the most exuberant period of unbridled enthusiasm in the 135-year history of the US share market.

This precedent of *irrational exuberance* is what analysts use to support the bullish argument for the current market to soar much higher before it falls.

That's possible. But either way you look at it, the market is in rarefied air and a fall back to earth is all but assured.

It's just a matter of when…

If you're a share investor, how do you want to stage your fall back to earth?

Long, slow and bumpy like Japan, or short and sharp like the US?

From a purely selfish perspective, we want a 1929 type fall. I'd like it to be all over in the space of three years.

That way we can start deploying our 100% cash position into distressed assets more quickly.

The two US market corrections since 2000 have been relatively short-lived. They were over within 18 months to two years. Each correction took around 50% off the market values of the S&P 500 and Dow Jones index.

The next correction could be very different from these recent experiences.

The two previous corrections were rather short-lived courtesy of Fed intervention. In 2000, it was lower interest rates that revived the market. In 2009 it was a combination of much lower interest rates, plus the huge money printing programs.

These Fed programs helped turn the market around and propel it to its current height.

Whether the Fed has enough firepower to counteract the next market downturn is a topic of much discussion.

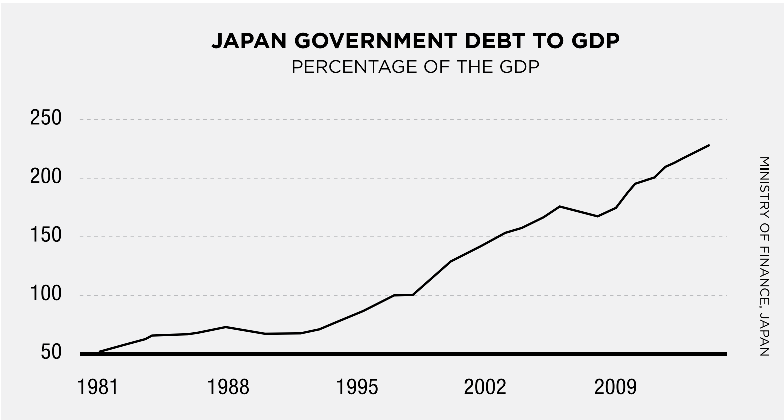
But negative interest rates won't cut it.

Print even more money? Been there done that. There's only so many times this trick can work. But that doesn't mean they won't do it again…on an even bigger scale.

The punters aren't stupid. They have an acute sense of when something doesn't feel right. The harder the Fed tries, the more likely the market will do the opposite of what is expected.

Here's my guess on the possible look and feel of the next serious, history making market downturn. While I don't know for sure what the collapse will look like (remember, no two corrections are the same), I'm fairly certain it won't be like Japan. Why?

The Japanese government had minimal public debt in 1990 and its 10-year bond rate was around 7%.



These two dynamics provided plenty of scope for successive Japanese governments to subject share investors to financial pain.

It was one stimulus plan after another. Each promised to be the great hope for the markets, a way to boost the economy. As the debt schemes mounted up, interest rates fell.

The constant stimulus combined with a falling bond rate denied Japanese investors the short sharp fall they deserved.

Underneath it all the Japanese economy was adjusting to a private sector that had lost its appetite for debt. The weakness in private sector spending and an ageing population were eventually reflected in much lower share values.

The starting point for an impending correction couldn't be more different. Public debt levels are much, much higher and interest rates are already at multi-century lows.

The US government doesn't have the capacity to implement ill-fated stimulus plan after ill-fated stimulus plan over a 20 year period.

So if we discount the possibility of a long drawn out Japanese style correction, then what will happen? Again, I can't know for certain, but my research and analysis means I've got a pretty good idea.

Based on math and history, the US market could suffer a fall in excess of 75%.

The correction could happen in two or three phases.

Up front you may see a 50% hit straight off the bat…happening over a year or two.

Given that this is similar to previous corrections, then it's almost assured we'll see a 'buy the dip' mentality kick in. After all, who doesn't want a two-for-one bargain?

The surge of dollars to 'buy the dip' creates a temporary market recovery, making up some lost ground. At this stage the talking heads are all blathering about a recovery.

But my guess is this will be a suckers' rally.

While the share market is putting on a show out front, behind the scenes the economy is coming to grips with writing off or renegotiating great swathes of debt.

US Federal Reserve Chair Dr Janet Yellen isn't going to sit idly by as her life's work in academia is exposed as a fraud. She and the Fed will do everything they can, looking for a way to reverse the market's collapse.

But the weaker economic activity eventually (like in Japan) works its way into much softer corporate revenue numbers. Apply a single figure P/E ratio to the weaker earnings and hey presto, the market continues to fall.

It may well take a few years for the market to eventually come to rest and resume a genuine recovery. Of course this is all guesswork, to some degree. But I haven't just made this up.

It's based on years of research and analysis, studying the markets and how they move in boom and bust conditions.

So all we can do is react to the situation as it unfolds. Now to the million dollar question…

How will you know when markets are offering an equation of more return with less risk?

We use historical valuation metrics as a way to recognise potential dangers and opportunities.

Here's an example of the table of valuation metrics I use to determine where we are in terms of value. The positive deviation from the mean average indicates an overvalued market.

When the deviations go into negative territory, then we start to become interested in deploying our cash into the Model Portfolio asset allocation.

Measurement	Current Level	Historical Mean	Deviation from Mean
S&P 500 P/E	20.93x	15.55x	+34.6%
Shiller P/E 10 ratio	26.3x	16.60x	+58.4%
S&P 500 Dividend Yield	2.01%	4.4%	+54.3%
Price/Sales ratio	1.80	1.40	+28.6%
Price/Book ratio	2.85	2.75	+3.6%
Market cap/GDP ratio	128.9	69.5	+85.5%
Tobin Q ratio	1.09	0.64	+70.3%
US Corporate Profits After Tax/ GDP	10.0%	6.0%	+66.7%

As you can see from the table, the P/E on the US market is 34.6% above the historical mean average. Using the Shiller P/E 10 ratio, the market is 58.4% above the historical mean.

These are warning signs that no one should ignore.

Of course, there's a widespread belief in the omnipotence of the Fed. After seven years of market recovery, this attitude is understandable.

But trust in the Fed is dangerously misplaced. They aren't omnipotent. They just think they are. They don't have the ability to manipulate the market according to their whim forever. They just think they do.

The only prudent thing to do as the pieces of the deflationary puzzle seem to be falling into place, is to sit and wait in the safety of cash. As dull as that may be.

Yet, the lower interest rates go, the more restless investors and savers become staying in cash.

And with the RBA's most recent cut in interest rates, there are more and more 'cash is trash' articles appearing in the Australian financial press. Each one trying to provide a 'conservative' yet high yielding alternative to cash.

After nearly 30 years in the investment business I can tell you categorically that once you step out of the bank and accept an investment 'opportunity' paying a higher rate of return, you've taken on capital risk…no ifs, buts or maybes.

When the financial system is shaken to its core, the faults in the so-called conservative high yielding investments will become all too evident. I've been there and done that, and I'm not going there again.

The plan is to stay in cash and watch the valuation metrics…

When the valuation metrics are all headed below the mean, then you can get excited about gradually committing your capital to our 'Model 5x20 Portfolio'.

That means dividing your capital among five asset classes, giving you a 20% asset allocation in each.

But remember, markets do not fall in a straight line. Markets, more often than not, zig and zag to their final resting place.

That's why I suggest that you gradually move to the Model 5x20 Portfolio, when we believe the time is right.

The final resting place of a market undergoing a severe correction — like The Great Depression or Japan — is only known with the benefit of hindsight.

Various valuation metrics can provide an indication of when a market is in undervalued territory, but that doesn't mean a cheap market cannot become even cheaper. That's the opposite of what we are experiencing today and witnessed in the dotcom boom — when an expensive market became even more expensive.

To demonstrate a probable strategy to convert our cash into discounted assets, I've used the indicator Warren Buffett described as '*probably the best single measure of where valuations stand at any given moment*.'

That is, corporate equities (the value of the US share market) relative to GDP.

As at August 2015, the 'Buffett Indicator' recorded the US share market at 129% of GDP. This means the value of the US share market is 29% larger then the entire US economy.

To place this over-valuation into context, the 65-year mean average for the 'Buffett Indicator' is 69%. The average makes sense…as it is ridiculous to think financial markets can be more valuable than the economy.

For the record Australia's current market cap to GDP is around 80%.

The lowest reading for the 'Buffett Indicator' in the US is 32%. This was recorded at the end of the 1968–1982 secular bear market.

When the coming crisis hits, the market cap to GDP ratio could well test its 1982 lows or perhaps go even lower. Not knowing in advance just how far a market in panic mode can fall means we have to approach the allocation of our capital cautiously.

In looking at the numbers — reversion to the 'Buffett Indicator' mean would necessitate a fall of around 50% in value. Hitting the 1982 low requires a sizeable correction of 75%.

Market corrections, such as in 1987, 2000 and 2007, have been in the order of 50%. When a market halves in value, we've been conditioned to think this is the worst of it, and that it's time to buy.

But what if the 50% correction isn't the full extent of the crash? What if the market falls much further…as it did during The Great Depression?

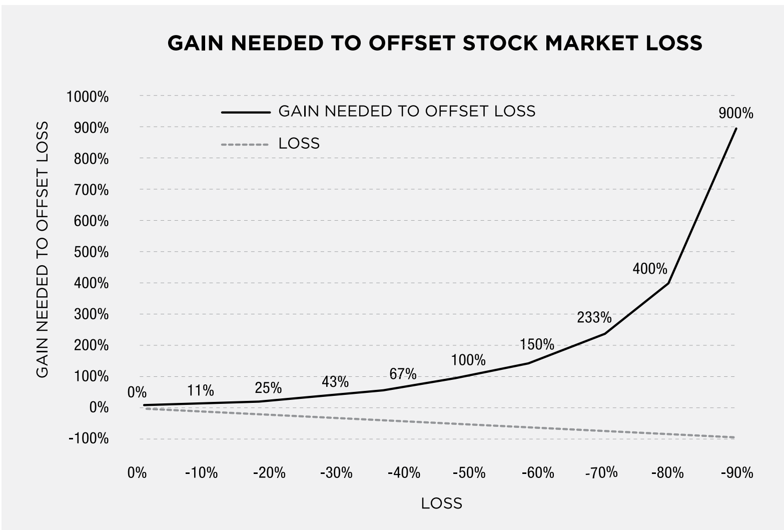
If math isn't your strong point, it may seem difficult to comprehend that buying into a market after it has fallen 50%, exposes your capital to a 50% loss if the market does indeed stage a 75% correction.

Still coming to grip with all the percentages? Let me explain in simple numbers.

Say the market peak was 1000 points and it falls 50% to 500 points. Based on your assumption the correction is going to be the same as the past three, you decide to buy in.

To everyone's surprise the market continues to fall to 250 points (75% below its peak). In this scenario, your buy in at 500 points has halved in value.

The following chart is a reminder of the gains you need to recover from any losses. From a 50% loss…you need a 100% gain.



The challenge when GFC MkII hits is to remain calm and not to be suckered into a market just because it looks cheap relative to previous downturns.

The prudent approach is to ease your way into the market with a strategy known as 'Dollar Cost Averaging'.

Let's assume the valuation metrics are starting to switch from overvalued to undervalued.

This will be taken as a signal that we are now interested in the prospect of transitioning our cash into the Model 5x20 Portfolio.

For the purpose of this example let's assume you have a portfolio of $120,000 — this equates to $24,000 for each of the five asset classes in the Model Portfolio.

The dollar cost average strategy for each investment (outside of cash) would be to allocate $2,000 per month to be invested over a 12 month period.

The beauty of this strategy is that it's not set in stone — you can stop, start, increase, decrease, lengthen or shorten the buy in period. The gradual approach provides you with options.

Only time will tell when the absolute best time to buy in would have been…without a crystal ball we have to feel our way in on a gradual basis.

The trick is to buy in somewhere near the bottom…minimising the amount required for any capital recovery.

The other option is to try to 'time' the market and pick the bottom with an all-in investment into a particular asset class. This may work, but the odds are against any investor doing this successfully.

The risk with an all-in investment in a highly fragile market is that the market may not have stopped falling.

Gradually exposing your risk-free capital to risk assets in times of severe market upheaval is the only prudent way to capitalise on assets that are being heavily discounted by investors at their wits end.

To summarise, here are several things we can assume with high degree of certainty:

- Based on the time honoured mathematical principle of reversion to the mean, there is a sizeable market correction in our future.
- The extent of the correction is unknown. But my research and analysis suggest that, based on previous

severe market downturns, it could be between 50–80%.

- The timeframe for the correction is unknown too. But again, my analysis suggests that on the balance of probabilities, it will be within the next five years. But, it could well happen before then. There's no telling what the central banks could do to postpone the inevitable collapse. We also have no idea about the extent of the initial shock and subsequent aftershocks that cause the market to reach for lower lows. A market in outright panic is likely to react irrationally.
- Historical valuation metrics are the only reliable guides we have on whether markets offer value or not. The valuation picture these metrics provide is never crystal clear…the picture is always slightly out of focus. Only hindsight gives you the perfect picture.

I'll repeat again: given the hazy nature of market values, the most prudent way to invest capital into a fearful market is on a gradual basis.

The plan is to work slowly, but meaningfully, in our endeavour to create long term wealth.

The aim is to ultimately transition our cash holdings into the Model Portfolio asset allocation.

As a reminder, the asset classes are:

- Cash and fixed interest
- Australian shares
- Australian listed property
- Emerging markets
- Gold

The asset classes may all fall together in a perfectly synchronised pattern, enabling us to buy into each asset class on a gradual basis at the same time.

Possible, but a low probability.

Alternatively, Australian shares and listed property may fall much harder than, say, gold. Therefore the cash allocated for investing in gold remains in the bank, while we deploy funds into shares and property.

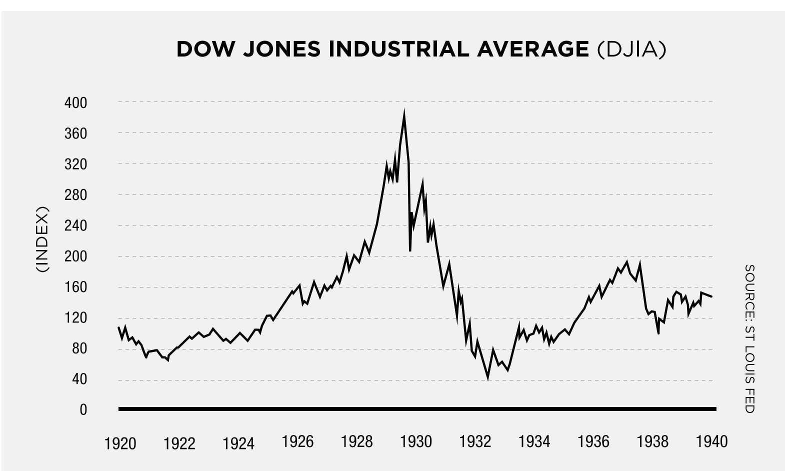
Until the event actually happens there is no hard and fast way to approach the transition from cash to the Model Portfolio.

The criteria will be:

1. The asset must be trading below its long term mean average.
2. The investment of capital must be on a gradual basis.

To emphasise why we need to move slowly when committing cash funds to a risk asset in times of market upheaval, below is the chart of the Dow Jones Index including 1928 to 1933.

In my opinion the next crisis is more likely to resemble The Great Depression. Therefore, this chart may give us an inkling of what the market has in store for us.



From its peak in 1929 of 380 points the Dow fell around 40% in value to 230 points in late 1929.

Based on the severity of this fall, many investors would have been tempted to buy-the-dip with an all-in investment.

For the next six months to mid-1930 that decision looked like a winner, with the market rising 30% in value.

However, underneath it all, the economy was experiencing a massive change. Social mood had turned negative. People had lost confidence. A credit contraction was changing the dynamics in the economy.

Eventually the market reflected the economic reality and proceeded to lose more than 80% of its value over the next 18 months. It's for this reason we must allocate funds on a progressive basis.

Even though the market bottomed out in late 1931, the market spent all of 1932 bouncing around the bottom.

In times of major market upheaval it's impossible to predict how fearful investors will become. A market falling for a sustained period of time can play havoc with investors' heads. Second guessing whether more falls are coming and translating this into how these losses impact on your life can make once rational people act in the most irrational of ways.

The truth is, the next crisis will be like no other we have ever experienced. Yes we have The Great Depression and Japan as reference points, but neither of these had the potential intensity of this coming crisis.

Global debt levels are beyond comparison with any other debt crisis in history. And no debt crisis in history has ever resolved itself without causing financial hardship.

Never before has so much been promised to so many. And you can be sure of one thing — when governments cannot honour their social contracts in welfare and healthcare, social unrest will further erode confidence.

Since the GFC there have been isolated depressions in Greece and Iceland as each of these countries faced the fallout of their debt overindulgences…believing lifestyles can be financed on the never never.

The next crisis will be a global unwinding of a period of excess without peer.

A period that is destined to earn a special place in the history books.

When this credit boom bursts it will be life changing.

People will lose fortunes. Dreams will be shattered. And those astute enough to read the signs in advance will have the chance to make a fortune.

When the next crisis hits, it will be *The End of Australia* as we have become conditioned to know it.

In the long run, that will not be a bad thing.

Our over-reliance on debt has created enormous imbalances in the financial system and our lives.

Restoring balance will be both painful and necessary if we are to once again earn the right to call ourselves 'The Lucky Country'.

Epilogue

Making dire and what appear to be apocalyptic predictions on the future of Australia contrasts with my normal optimistic disposition.

However, after a decade of research and analysis, the reality is what it is.

There's no point trying to gloss over the overwhelming evidence that we are in the midst of the greatest debt crisis in history by saying 'she'll be right mate'.

Of course, this would be a far more comforting message, but one that would be highly irresponsible.

Government, institutional economists, real estate agents, share brokers and financial planners are not going to tell you anything other than 'she'll be right'. Why?

For two reasons.

Firstly, I think the majority have absolutely no idea how we have arrived at this point of no return.

They think going deeper and deeper into debt is normal. After all this is the way it has been for all their adult lives. They point to the world's recovery since 2008 and genuinely think central bankers have figured out how to save the world with printed dollars. Why worry? The Fed has our backs. In simple terms, they are clueless.

Secondly, and I think far more immoral, are the minority that realise the system is a giant Ponzi scheme but have no intention of revealing the economic fraud and endangering their capacity to milk this sham for all its worth. The insiders have their parachute strategy in place and will have taken the necessary precautions to protect their wealth while the masses (as usual) suffer the horrific financial consequences.

The Australia of my childhood is a world away from the Australia I see today. We have embraced the great Australian dream of property ownership (plus a few more rental properties thrown in for good measure) irrespective of the level of indebtedness this 'dream' requires. More credit is used to furnish the 'dream' with the latest mod cons, pool and landscaped yard. Gone are the backyard 'test matches' and rugby league 'grand finals'.

The bank managers of yesteryear were prudent and not afraid to say 'no' to those they considered less than credit worthy.

Since the 1980s the banking industry has prospered more than any other sector of the economy. The simple formula for the banks' success has been fractional banking — the ability to charge interest on money that does not exist.

The more money central banks conjure up out of thin air, the more profit banks make.

The proliferation of 'funny money' has been a game changer for the banking industry.

That's why the big four banks occupy the top five places in the All Ordinaries Index.

The once honourable profession of banking has been reduced to an industry of 'product floggers'.

The bank managers of old who failed to adapt to this new aggressive approach of meeting sales targets, were shown the door. This new age banking model may be highly profitable, but it has also made the financial system highly vulnerable.

When the next crisis hits and banks buckle, questions are going to be asked as to how we let this sector become so dominant. Sorry, but this will be too little, too late. The bank execs who oversaw this flawed business model have taken their bonuses and run.

With three adult children of my own, I often reflect on the difference in my starting position at their age. Housing was far more affordable based on a multiple of household income, there was an abundance of employment opportunities, and we didn't have student loans. By comparison, life seemed a little easier.

Ironically I feel the coming collapse will, in the fullness of time, be seen as a positive for the younger generation…the ones who are not overly indebted with loans for overpriced houses.

Hitting the reset button on the global economy may, in the longer run, produce a couple of obvious positives.

Property becomes more affordable. And a culture of prudence and respect for money is restored to society (much like my parents had from their experiences during The Great Depression and the Second World War).

The continued accumulation of debt over many decades has influenced government entitlement policy, financial markets, economic growth and our attitude toward money. Nearly every aspect of our lives has in some way been directly or indirectly impacted by a multi-decade long credit-fuelled consumption binge.

For example, would we have so many factories in China pouring out tonnes of pollutants if we in the western world had acted with restraint in our purchasing habits? Probably not. Indirectly, climate change is a result of our love affair with debt.

To combat climate change, governments are all now thinking of implementing various (costly) carbon reduction schemes. Perhaps when the next crisis hits, these schemes won't be necessary, as a good number of the factories will cease to operate.

The views I have expressed in this book have been ones I have held for a number years.

The risk with publicly stating your views well in advance of a potential crisis is you invite calls of the boy who cried wolf.

The more time that passes and nothing happens, the louder the calls become.

The one thing I have learnt over the years is that you cannot time markets. Vested interests, powerful media messages and momentum can delay the inevitable outcome for much longer than you might think possible. This is when patience is required.

Sir Isaac Newton, to his great cost, learnt this lesson in 1720. Newton invested in the South Sea Company in early 1720 and sold out several months later for a handsome profit. Rather than take his profit and wait for the South Sea bubble to burst, he could not resist the lure of a market that continued to rise. Impatience got the better of him. A few months later he bought back in — at three times his original buy-in price — and the rest as the say 'is history'. The bubble burst and Newton lost his life savings of 20,000 pounds (about $3 million in today's dollars).

With plenty of time to think about his losses, Newton mused, '*I can calculate the movement of the stars, but not the madness of men.*'

The GFC was warning us of the madness of continued debt accumulation. The central bankers drowned out this message with printed dollars and suppressed interest rates.

The madness continued…the world is US$60 trillion further in debt than it was in 2008.

Once again the market will call time on this madness. Next time the message will be so loud and so clear central bankers will be rendered impotent to stop the market from doing what it should have done in 2008.

Yes, I have been early on my forecasts. So be it. The Fed has paid an extremely high price to buy seven years of 'calm'. I did not anticipate this level of intervention…it has been, like a lot of things since 2008, without precedent.

Investing in cash is the equivalent of Noah's Ark. When the markets wash away all in front of them, your Ark of cash will float above the flood that rages below. But you must build your ark <u>before</u> it rains.

They mocked Noah, but he had the last laugh. Take the time now to get your house in order. Follow some simple rules.

If you have debt, make a determined effort to pay it down more quickly than you otherwise would have.

Do your budget, and learn to live within your income.

If you have investments and/or superannuation, move at least some, if not all, into cash. Take profits voluntarily now rather than be forced to realise losses later.

Above all, be patient. These things can and do take a long time to play out.

Finally, I hope this book has been of assistance to you in formulating your strategy to not only survive but eventually prosper from *The End of Australia*.

As dire as the current situation is, I believe the end will pave the way for a new beginning. An Australia that's not addicted to debt. A nation where our children and grandchildren no longer have to bear the burden of our overindulgences.

About the Author

Vern Gowdie has been involved in financial planning since 1986.

In 1999, *Personal Investor* magazine ranked Vern as one of Australia's Top 50 financial planners. His previous firm, Gowdie Financial Planning was recognized in 2004, 2005, 2006 and 2007, by *Independent Financial Adviser (IFA)* magazine as one of the top five financial planning firms in Australia.

Vern's weekly 'Big Picture' column was published in regional newspapers from 2005 to 2013. Vern has been a commentator on financial matters for Prime Radio talkback. His contrarian views often place him at odds with the financial planning profession.

Since 2013, Vern has been the editor of the investment advisory, *Gowdie Family Wealth*. He is also a weekly contributor to *The Daily Reckoning* and *Money Morning*.

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'An outstanding insight into the problems facing Australia's economy. Written in plain English, it's a must-read for anyone who wants to understand what the future holds for Australia.'

Kris Sayce,
Money Morning Australia

'In this book Vern Gowdie is warning about something that hasn't happened yet…and which many Australians think never will happen. Or they think it is such a remote threat that it is not worth worrying about.

As far as I know, Vern and a small group of independent analysts — people who are not dependent on Wall Street or the government or, more importantly, on unlimited credit and ultra-low rates — are the only ones who are able to warn you.'

New York Times bestselling
author Bill Bonner

Chances are you already sense the 'Lucky Country's' luck wearing thin...

With the slowdown in China, stagnating wages, high household debt and weak job growth, recession is increasingly likely for Australia.

What most Australians DON'T realise is how serious and deep it will be…how much it will change things…how long it will last…and what measures you need to take now to look after yourself and your family.

The End of Australia, first and foremost, is a wakeup call. Vern Gowdie coldly and meticulously proves that the global debt crisis is finally coming to Australia's shores. And debt crises tend not to have good endings…

But *The End of Australia* is also a survival manual.

As Gowdie shows in vivid detail, Australia's 'Long Bust' will be life-changing. People will lose fortunes. Dreams will be shattered. But, for those astute enough to read the signs in advance, there will also be chances to make a fortune.

This book outlines the steps necessary to protect yourself and your family from Australia's 'reversion to the mean'. Because the fact is, this crisis is now inevitable. But you still have a small amount of time to get ready, while the means of saving yourself remain cheap, easy, and legal.

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