HS Dent Forecast - Special Update

October 30, 2006

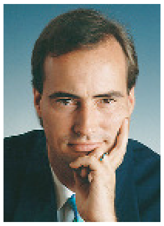
The Economic Guide for Effective Financial Decision Making

Feature Articles

Inside

Dow 15,000 by Early 2008 and 20,000 by Late 2009

Revisions to Our Forecast for the Last Great Bubble Boom in Light of the New Cold War-Like Geopolitical Environment



Introduction to HS Dent, Our Methodology, and Our History

From the late 1980s through the early 1990s, we were forecasting that the US economic boom that had started in the early 1980s would accelerate into the greatest boom in history and that the boom would continue into the end of the 2000s. Our forecast was based on a combination of the consumer spending of the massive Baby Boom generation and the productivity/technology gains of the information age. When we published *The Great Boom Ahead* in 1992 and forecast that the Dow would reach between 8,500 to 12,000, most people thought—despite compelling demographic logic—that there was no way that the economy could be that strong or that stocks could rise that high. In light of the crash of 1987, the first Gulf War, the 1990-1991 recession, the high levels of consumer debt and government deficits, and the memory of the early-1990s real estate bust, such bold predictions seemed absurd!

We stood virtually alone in forecasting the incredible boom and stock market bubble of the late 1990s, as well as predicting that the unprecedented federal deficit in 1992 would turn into a surplus between 1998 and 2000. We also forecast as early as 1988 that Japan would enter a long-term slowdown and bear market in the early 1990s, and that the slowdown would last into the early 2000s.

Despite aggressively optimistic calls in the past, we are not "perma-bulls" or "Pollyannas." From the beginning we have been forecasting a long-term slowdown in the US and Europe after this decade. More recently, as the tech and internet bubble reached a fevered pitch in 1999, we warned our newsletter readers that the market had gotten out of control and that a sharp technical correction was inevitable. We warned in our early 1999 book *The Roaring 2000s Investor* that stocks had gotten ahead of themselves, as measured by our technical analysis of the Dow Industrials, and that a sharp pullback was likely that would take the Dow back to its long-term channel trend line. We also warned readers at the same time that the Nasdaq was at serious risk of a crash and accurately predicted that it would top between February and April 2000. However, the bear market of 2000-2002 proved to be much deeper and more protracted than we originally thought.

In late 2000 and 2001, our technical indicators started to strongly suggest that we could fall back to the 1998 lows by late 2002. That caused us to revisit our research on technology bubbles to look for an explanation as to why. We found that it was typical to have a major crash and shake-out as new technologies approached 50% penetration on the S-Curve. That insight added a new dimension to our research along with many other new insights. Today, the market's reluctance to accelerate in line with very strong earnings has caused us to look more deeply into geopolitical cycles, which appear to be affecting valuations of stocks beyond basic economic and earnings trends.

It is important to understand that our research is new and represents a radical departure from past economic forecasting methods—hence, our research is always emerging and being refined to include more indicators for making it more accurate long term and short term.

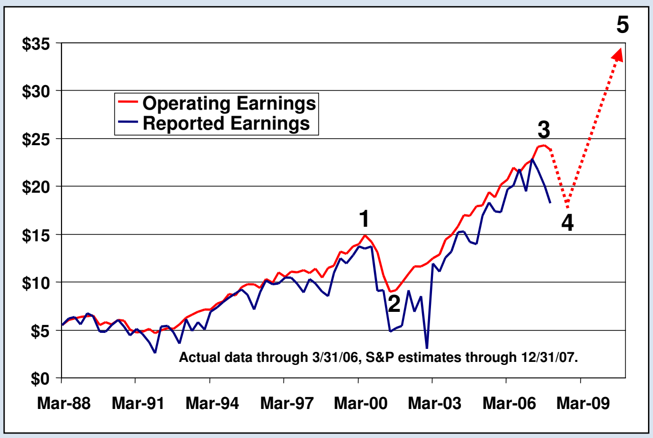
It's not like we found the Spending Wave in 1988 and then stopped there! In 1989 we found the powerful correlation with inflation and workforce growth, which explained another, very key, trend in economics. Then in the early 1990s we analyzed the Consumer Expenditures Survey in great detail to look at the different spending trends for the cradle-to-grave product and service cycles—and then did further research to clarify the real estate life cycle, as that is the largest industry and key to investment strategies as well. We have added cyclical indicators from the 4-year to 10-year to Decennial cycles and have continued to add technical indicators to refine our shorter-term forecasts with much greater accuracy in recent years. In fact, it was the divergence of the 2000–2002 stock crash from our earlier forecasts, as well as the depth of that crash, that caused us to greatly improve our technical indicators and our knowledge of technology bubble booms in the past through more research.

When we occasionally get significant divergences from our clear fundamental forecasts, then we ask: What are we missing? There are always new curve balls in economics, and that approach keeps driving greater insights and new indicators that only make our future forecasts more credible and accurate. The fact that this last bubble in stocks has taken a year longer to accelerate than we originally forecast has caused us to add a new long-term geopolitical cycle to refine our long-term forecasts—and that is the broader subject of this special report.

Today, the same economic expansion that began in the early 1980s with the Baby Boom spending cycle continues, although you might not know it from investor sentiment. Corporate earnings are at *all time highs*, yet investors seem to be unimpressed by those earnings, as stock P/E ratios are at lows not seen in nearly a decade. The good news is that this investor pessimism is quietly laying the foundations for another strong bull market in stocks! The bad news is that the factors that have contributed to the investor pessimism—such as wars, tensions in the Middle East, out-of-control government spending, and surging commodities—are likely to make the next boom less spectacular than we have been forecasting. This period is feeling more like the early to mid 1960s and early 1970s, wherein stocks kept advancing, but not as strongly as in the 1940s and early 1950s—as we find ourselves in a more threatening international environment, in a protracted war, and in a trend of creeping inflation and surging oil and commodity prices.

Make no mistake, we still think the next bubble has been emerging since July 2006 and that most stocks will soar to unprecedented highs—most likely to around 20,000 on the Dow by 2009—but geopolitical trends and tensions make our original forecast of 32,000 to 40,000, spelled out in the *Next Great Bubble Boom*, much less likely.

Why should investors pay attention to our views, given that equities have lagged our forecast recently? Because our forecasts for a continued and stronger boom after the early 2000s slowdown, based on demographic factors and technology trends, have continued to be extremely accurate. Despite the calamities of the post-September 11 world, consumer spending, productivity, and corporate earnings have been in a strong and solid uptrend since late 2001, and these economic drivers are even stronger now than they were at this stage of the boom in the 1990s. **Chart 1** shows the most critical trend for stocks, corporate earnings. We will discuss productivity and consumer spending trends later in this report.



Source: Standard & Poor's (www.spglobal.com) Chart 1

We forecast that strong demographic-based consumer spending would keep the economy booming and that this boom would be reflected in corporate earnings. Those earnings would, in turn, make stocks attractive to investors. The problem is that investors have found stocks *less* attractive in recent years, even as price/earnings multiples have *contracted* due to the stellar growth in profits—and that stock valuations are still very attractive vs. bond yields now that bond yields are lower than in late 2002. Why would investors shun equities with rising profits? The short answer is investor psychology and new geopolitical trends!

Even though the fundamentals suggest that there "should" be a stock bubble, as there is nowhere else for investment flows to go now that housing and commodities have slowed down (as we forecast in our newsletter), investors remain focused on bad news and the view that the markets could stall or fall "anytime." They are still in shock from the crash of 2000–2002. It seems irrational, but this is still the reality. As John Maynard Keynes once famously said, "the market can stay irrational longer than you can stay solvent." Through our continued research, we have found that market psychology is heavily influenced by long-term geopolitical trends, which run in cycles that will be discussed below. This negativity is what ultimately persuaded us to change the price targets on our long-term forecast while still predicting a continued very strong boom into late 2009 or so.

Since June-July 2006, our greatly refined technical indicators have been suggesting that a big move is coming between late 2006 and 2007 for stocks! That forecast was vindicated by the new highs on

the Dow in October 2006, which followed the new highs on other indices like the small and mid caps and the Dow Transports. So it is now clear—despite many bear market rally projections since 2000—that we are in a new bull market. So, the question now is, "How high will this market go and for how long?"

In this bull market, which started in October 2002, large-cap stocks in the US have been the last to join the party and make new highs. Mid-cap stocks made new highs as early as 2004 and have advanced 131.6% since the bottom vs. 68.5% for the Dow. Small caps made new highs in late 2004 and have advanced 133.5%, while the Dow Transports also made new highs in late 2004 and have advanced 145.3%. The international picture has been even stronger. The emerging markets made new highs in 2004 and have advanced an incredible 228.6%. Asia ex-Japan also made new highs in 2004, and has advanced 157.9%. Even stodgy old Europe, with weaker demographic trends, has advanced 157.9%!

US large-cap and technology stocks are clearly due to catch up with the booms that have been experienced in other indices in the US and abroad!

Through the Increased Use of Technical and Cyclical Indicators, Our Analysis Has Been Much More Accurate Since the Bottom in October 2002

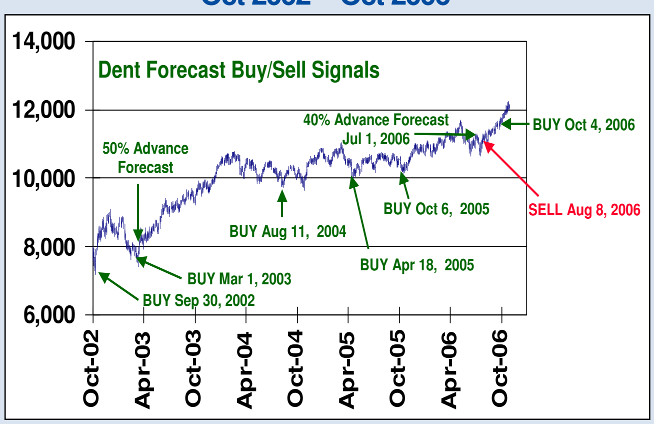
We have used technical analysis for years to interpret short-term market moves, where investor whims can lead to extreme zigs and zags that can last for weeks, months, or even a few years before market prices return to the long-term trend. By using long-term technical tools, such as channel lines and Elliot Waves, combined with short-term tools like option trader positions and sentiment surveys (and both within the context of our fundamental forecasts based on demographics), we have been able to successfully navigate the difficult investment environment of the last several years for the investors and advisors that followed our newsletter.

As mentioned above, our technical analysis warned of trouble as early as 1999. In *The Roaring 2000s Investor* we warned that the Dow Channel would hit its peak upper trend line by late 1999/early 2000 with a sharp correction to follow (page 26-27). We absolutely did not see the length and magnitude of the crash until late 2000/early 2001, when the technical indicators deteriorated. Subsequently we warned in our newsletter that the stock markets could go back to their 1998 lows, or as low as 1,100 on the Nasdaq by October 2002.

We gave the strongest buy signal in the history of the HS Dent Forecast newsletter (dating back to 1989) in early October 2002, estimating the 50% advance in the markets that occurred from late 2002 into 2003. We have given strong buy signals at every major bottom since that low in October 2002—March 2003, August 2004, April 2005, and more recently in October 2005 as shown in **Chart 2**—except one. The one we missed is the most recent, the bottom in July 2006.

We have a long-term policy of being more defensive between mid to late August and mid to late October into the mid-term elections on the 4-Year Presidential Cycle, as our long-term back testing results have shown this to be very positive for reducing risk and increasing returns. After the unusual and extremely bearish market activity of the 2006 summer, which saw numerous aborted rallies, we adopted a short-term defensive posture. At the time, we also saw unfavorable chart patterns and a strong bearish sentiment among the smartest option traders (who are rarely wrong near term). But our intermediate-term and long-term views remained steadfastly bullish due to the extreme oversold condition and undervaluation levels in stocks. That defensive posture was not productive, as occasionally happens with our cyclical indicators, as stocks rallied from their summer lows and the Dow hit a new all-time high. We reevaluated and repositioned to a bullish stance when the markets hit and held the new highs, just as we said we would, and we remain extremely bullish for US stocks into 2007 and beyond into 2009. We see a large advance ahead comparable to 2003, with a Dow of around 15,000 by late 2007 or early 2008, finally launching the long-awaited bubble (which started in July 2006).

The more important insight is that this boom is not over yet. It will be over when the Baby Boomers peak in their spending and the technology S-Curve cycles peak around late 2009.



Source: Yahoo Finance

Chart 2

At every stage of this boom, from the stock market peak in late 1987 and the minor recession into early 1991, to the stock market peak into early 2000 and the minor recession into mid 2001, economists have said "it's over and consumers can't sustain the boom with their high debt." Yet we continue to see extraordinary demographic and technology trends driving this unprecedented boom of economic growth higher, and it is not over yet!

It's Not That We Have Seen a Bubble Burst . . . But That We Are in a Bubble Boom!

We have seen a series of bubbles over the past several decades. These bubbles have rotated from inflation, real estate, oil, and gold in the late 1970s; to the first stock bubble from 1985 to 1987; to another minor real estate bubble in 1990; to a greater stock bubble into early 2000; to the greatest bubble in history for housing into 2005; and to a second oil and commodity bubble that appears to have finally peaked for now (but we will likely see $100 plus in oil prices by late 2009).

As we have reiterated for the past several years, this procession of bubbles will continue until the Baby Boom generation reaches its peak spending trends and the current technology revolution reaches 90% penetration of households, both of which should occur near the end of this decade (more on this below). Investors will naturally chase the next bubble, which should be marked by increasing economic growth and earnings into 2009 or so. The crash that follows will be similar to the long-term bear market in Japan from 1990 to 2003, and the

American Great Depression of the 1930s. So, as bullish as we have been in recent decades, our fundamental indicators suggest an extended slowdown in the US and most Western economies that will last from around late 2009 into 2022 or so. The areas of opportunity that will arise after the slowdown begins will show themselves between late 2012 and late 2014, in the form of many of the larger Asian economies and the health care sectors of the US economy, both of which benefit from growing demographics. So, it's not that there will be nowhere to invest long term, but that it will be best to be defensive between 2010 and 2014 until the larger world crash in stocks and real estate largely plays out. To weather the first years of the storm (2010-2012), investors should be in high-quality bonds and fixed income investments before reinvesting in the most opportune sectors after the markets have fallen from late 2012 to late 2014 forward.

Why We Changed Our Forecast

Divergences From Past Bubble Scenarios

In our last book, *The Next Great Bubble Boom*, we estimated that the current economic recovery would follow a 1920s-like bubble on an 80- to 81-year lag that would peak in late 2009 or 2010, based on our fundamental demographic and technology cycles. We have been following this scenario in the newsletter, noting how this economic and stock recovery closely paralleled the trends of both the 1990s and 1920s recoveries on an 11-year and 81-year lag, respectively. As the Dow came close to retesting its all-time high of 11,720 in April-May 2006, we were still close enough to those past bubble scenarios to continue forecasting these as the most likely scenarios.

Oil and commodities surged again into mid-2006, and tensions in the Middle East boiled over into a minor war between Israel and Lebanon. The larger picture continues to worsen. Now the West faces growing tensions with North Korea and Iran, and it wouldn't take much to reignite the war between Israel and Lebanon. There are also the continuing operations in Iraq and Afghanistan, which are looking more like the Vietnam War—there have been serious setbacks under the current strategy, but we can't just pull out either. Clearly, these regions of the world have become a tinderbox, ready to explode at any time. The 1920s and 1990s were not completely free of such tensions; it must be remembered that 1920s Europe was in shambles after the First World War, and the 1990s witnessed the beginnings of Osama bin Laden's Al Qaeda movement as well as the Balkans wars that ravaged southeastern Europe. Still, geopolitical events are more serious and pervasive in this decade and appear to be affecting the markets more than at any time since the mid 1960s and 1970s, in the midst of the growing Cold War.

We promised to reexamine our forecasts if we started to see divergences, and we have seen substantial divergences into mid 2006. As discussed above, the first and largest challenge to our forecast was the extreme level of the correction from 2000-2002. So we had to ask ourselves: What did we miss? Why such an extreme stock crash given very strong demographic trends and the S-Curve acceleration in technology?

The answer came by looking even deeper into history, to past technology S-Curve cycles and bubble scenarios and by digging up indices that were not widely available. It turns out that strong shake-outs and crashes are typical, occurring naturally in new growth industries as the new technologies approached the 50% market penetration level. At that point the many new growth companies had naturally over expanded, causing excess capacity just as the prices of their stocks were peaking. This led to falling product prices, which increased their affordablity. The excess capacity, and, hence, falling prices and falling earnings, caused the weak players in the industry to either fail or merge with a stronger rival, thus consolidating the industry and setting up the next stage in the S-Curve—the Maturity Boom. The surviving leaders now can bring the new technologies into even more mainstream affordability in the next boom that leads from 50% market penetration to the 90% mark. This was the case in the 1925-1929 bubble, which followed the 1915-1919 automotive bubble, after the surviving leaders brought the new technologies associated with the auto industry into even greater affordability and mass adoption. So, the first insight was that a second bubble follows the first one (after it collapses) right as investors think the greater boom is over.

In this recent recovery cycle, we saw that the economy and stocks were closely following the 1920s and 1990s cycles of sharp recoveries followed by a long trading range. After the quiet trading range of about two years, both cycles experienced a break up into the next bubble. Unfortunately, in our current recovery we started to increasingly diverge from these scenarios in 2006 as the trading range continued longer than in past cycles. This led us to consider what was different about the 2000s vs. the 1920s and the 1990s that could have a great enough impact to impede the markets in the face of such strong fundamental strength. The obvious answers, of course, are the commodity and oil bubbles, the rising geopolitical tensions since 9/11, and the ongoing troubles in Iraq. We concluded that this era is starting to follow the trend of the 1960s. The Cuban Missile Crisis hit in 1962, followed by the Kennedy assassination in 1963, the ramp up to the Vietnam War and its creeping inflation, and the broader Cold War between the US, the Soviet Union, and China. This era was followed by massive inflation in the late 1970s, caused by the peak entry into the workforce of the Baby Boomers.

In effect, we have an epic battle in the marketplace between the forces driving the markets higher—demographics, spending, technological innovation, and acceptance—and the forces that are holding us back—commodity prices, geopolitical tensions in the Middle East and North Korea, and the wars in Iraq and Afghanistan. We are now changing our forecasts and targets accordingly for the next bubble and for the timing of the next major downturn in light of these trends and events.

Our goal is simple, but bold: To offer a radical new approach to forecasting economic trends that will affect your life, your business, and your investments over the rest of your lifetime—and that is

something that mainstream economists do not offer or even think is possible. We are keenly aware that, even with our twenty-year history, this represents a new theory that needs to be constantly expanded and adapted. We continue to add new indicators to refine our radical new forecasting methods, which has improved our forecasting both long term and short term!

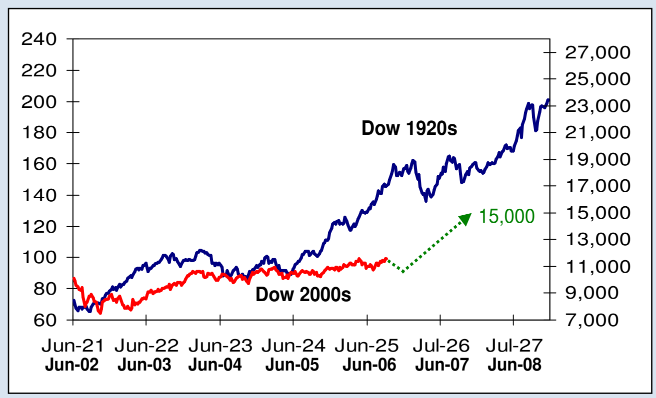
We do not "bury our head in the sand" and defend old forecasts when there is new or better evidence available. As the economist John Maynard Keynes once famously said, "When the facts change, I change my mind—what do you do, sir?" To stay relevant in this rapidly changing world, it is essential to continually refine forecasts. We started with fundamental demographic cycles and over time added technology and inflation cycles, other medium and short-term cycles, and technical analysis. Through it all, we have attempted to be neutral and objective, letting the models guide our decisions rather than vice versa. So, let's now look at the key divergences that lead us to change our forecasts for the bull market into 2009 or so.

Divergence of the Current Recovery From Previous Bubble Patterns

Chart 3a shows the 81-year lag on the Dow that was closely tracking the recovery and bubble cycle from the 1920s, which projected a Dow as high as 40,000 in 2010. As you can see, we were largely on track until oil and commodity prices surged again and Mid-East tensions escalated from May 2006 on. Hence, these trends did not suggest a change in our very bullish forecasts at that point. But given the trends recently, even if we get a stellar rally of 40% plus into 2007 as we expect, we will still not catch up to the bubble scenario pattern from the 1920s. So, something is different this time around. The difference does not lie in demographics, spending patterns, or technological innovation and adoption. All of these fundamental factors are as strong if not stronger than they were in previous periods, as we show in this report. Our conclusion is that the difference comes from the commodity/oil bubble and rising geopolitical tensions and terrorism (which did not occur in the 1920s or 1990s bubbles).

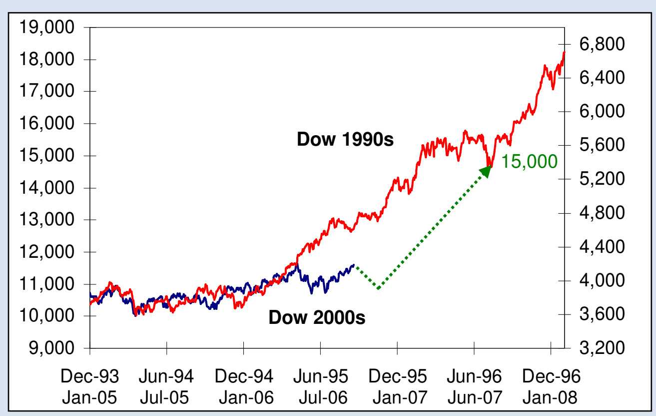
Chart 3b shows similar divergences of the current economic recovery from the 1990s recovery and bubble cycle on an 11-year lag. Here, there is not as much divergence, and we could come close to "catching up" if the Dow rallies to around 15,000 by late 2007 or early 2008. But there would still need to be a continued, very strong follow-through to catch up into 2008 into 2009. The 2000s could still follow the 1990s scenario on a 12-year lag if we get a 5-year bubble that continues into 2011 or early 2012. That would project a Dow of around 32,000, but

Dow Jones Industrials
1920s Recovery vs. 2000s Recovery



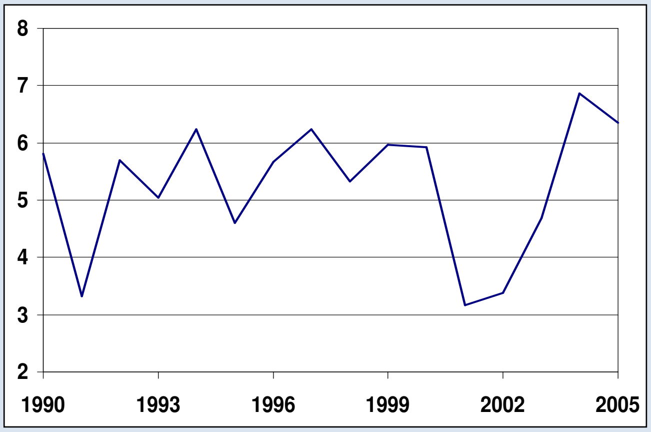
Source: Yahoo Finance
Chart 3a

Dow Jones Industrial Average
Dow 1990s vs. Dow 2000s



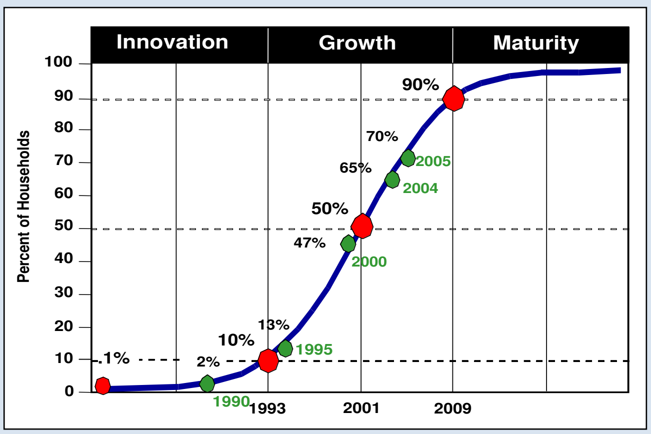
Source: Yahoo Finance
Chart 3b

Nominal GDP (Growth Rate)



Source: Bureau of Economic Analysis Chart 4

Mobile Phone S-Curve



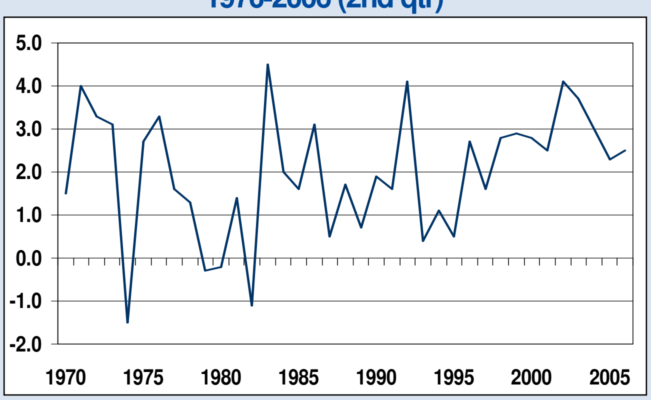
Source: Infotrends Chart 5

such an extended bubble is now much less likely given these headwinds and the fact that the technology S-Curve trends still look set to peak by late 2009 or so, as do the demographic trends around late 2009 or 2011 at the very latest.

The weaker performance in stocks in this recovery scenario is not from a lack of Baby Boomer spending. Businesses that cut back sharply from 2000 onward—after overexpanding so strongly in the late 1990s bubble boom—caused the very minor two-quarter recession into mid-2001. Baby Boomers continued to buy homes and consumer durable goods, causing the greatest housing bubble in US history as that bubble grew and finally peaked in 2005. The Federal Reserve has had to raise rates aggressively, 17 times in all since June 2004, to slow down the economy's initial recovery, which has actually been stronger than the initial recovery in the early to mid 1990s, as **Chart 4** shows.

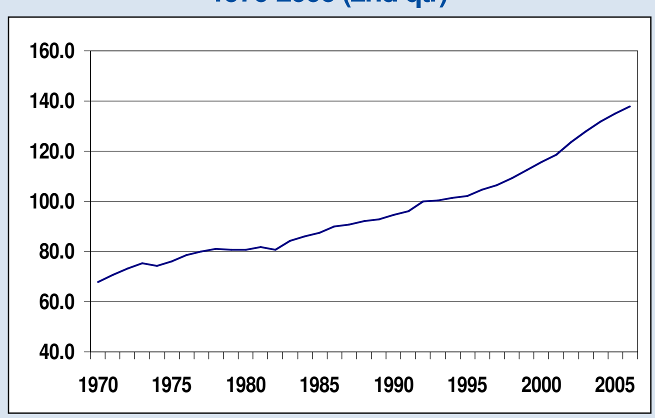
Likewise, the weak stock performance has not been caused by a slowing in technology progress and rapid adoption trends. All of our S-Curve patterns of growth and market penetration—from Internet to wireless to broadband and even digital cameras and high-definition TVs—have continued to advance on track, as **Chart 5** shows for cell phones and wireless technologies. Productivity rates in **Chart 6a** have remained very high vs. historical averages and look to go to new highs in the next few years, although the Fed's strong tightening cycle has worked against that a bit recently. Productivity trends started to accelerate again after 1994 (after slowing into the late 1970s), with the new Internet S-Curve trend behaving like autos from 1914 to 1928, as the broader Productivity Index shows in **Chart 6b.**

Productivity Growth Year-Over-Year % Change
1970-2006 (2nd qtr)



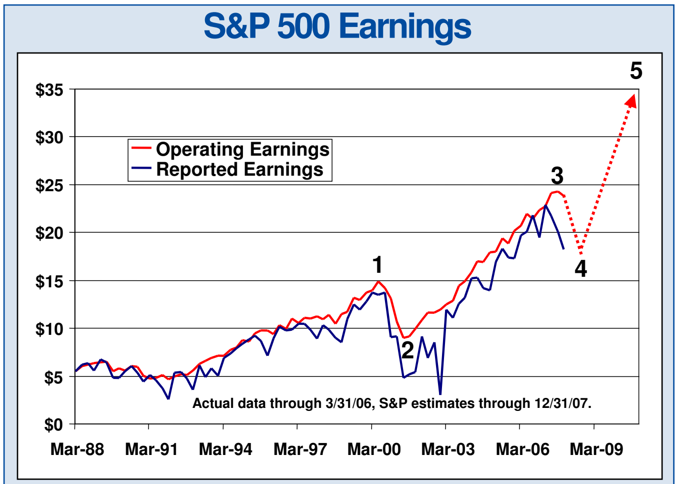
Source: Bureau of Labor Statistics Chart 6a

Productivity Growth Index
1970-2006 (2nd qtr)



Source: Bureau of Labor Statistics Chart 6b

Corporate earnings have, as a result, been the strongest trend in the economy, as we repeat in **Chart 7,** with even stronger performance thus far in this recovery and boom than in the 1990s. Corporate earnings are likely to subside a bit in the coming months, with a third wave peak recently before an even stronger fifth wave peak into 2009 or 2010 given the continued demographic and technology trends ahead. So, if earnings are so strong, why aren't stocks reacting as strongly on the bullish side as they did from 1995 onward?

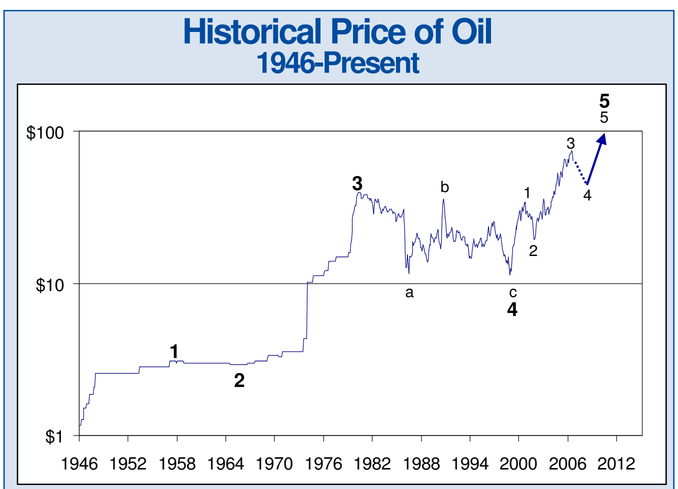


Source: Standard & Poor's (www.spglobal.com) Chart 7

What has changed is the geopolitical environment, including the commodity price bubble, since 9/11! The last time there was such a change was from 1962 into the 1970s, with the Cuban Missile Crisis and the Vietnam War within the broader and growing Cold War.

The commodity bubble is first being driven by very strong Asian demographic growth (in addition to the strong growth in the West) that includes commodity-intensive economies like China and India. But geopolitical tensions, especially in the Middle East, have added a premium of 10% to 20% to oil prices since 9/11. Hence, like in the 1970s, geopolitical tensions and commodity prices go hand in hand. We expected the oil and commodity bubble to peak initially in late 2005 and slow into 2006—but instead we saw new highs in July 2006. At present, oil and other commodity prices are finally weakening significantly.

Although there is the possibility of another brief spike over Mid-East tensions later in 2006, commodity prices have likely peaked for now and will correct well into 2007 with the slowing of the economy. We do expect a final bubble in oil and commodity prices between 2008 and 2009, which is likely to see oil at $100 plus. Why? The chart patterns **(Chart 8)** strongly suggest a fifth (and final) wave after the present correction. More importantly, many alternatives to oil and fossil fuels are emerging, as are major new discoveries in the Gulf of Mexico—but none of these will generate substantial benefits in the next 3 to 5 years. Hence, in a 5- to 20-year time frame we could see major alternatives emerge to relieve higher oil and energy prices. However, it will likely be the global slowdown after 2009, largely in Europe and North America, that will finally cause oil and commodity prices to peak and fall longer-term—likely back to $40, and perhaps lower by 2022 to 2024. If you think there is unrest in the Middle East now, imagine the prospects with crashing oil prices after 2009!



Source: Dow Jones Energy Service Chart 8

And what is the prospect for geopolitical tensions? No one sees any credible solution to the Mid-East conflicts any time soon—if ever! But we see this from a slightly different point of view, incorporating the effects of a global economic slowdown in the next decade. It is possible we will see a full-scale backlash against globalization and modern technologies/lifestyles, a backlash that began with 9/11 and that will be at its worst in the downturn after 2009—but it will come to an end between 2020 and 2024. This backlash is coming from the most backward nations, which are still dominated by dictators that profit from keeping their countries isolated from the new trends in capitalism, technology, and democratic government—and many of whose people prefer to remain in their long-established, albeit backward, lifestyles and cultures.

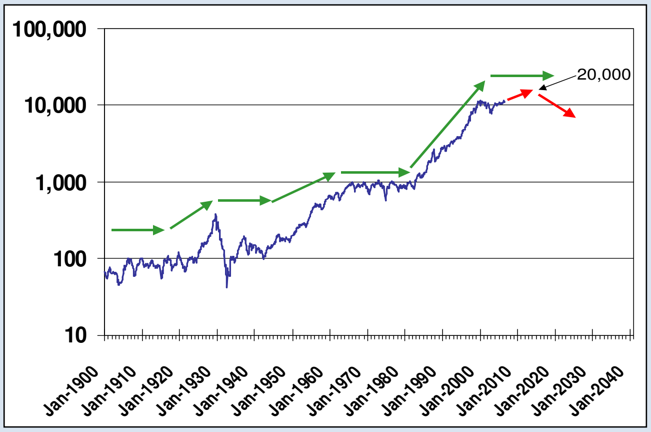
As the economy slows and unemployment rises around the world, tensions and dissatisfactions will rise dramatically as well—just as they did in the 1930s, which led to the rise of Hitler and World War II. In fact, the decline of oil and commodity prices after 2009 (which will hit the Middle East and emerging third world countries very hard) is likely to cause a level of unrest and anti-Western sentiment that will, paradoxically, finally drive these nations to modernize and to develop economies outside of oil and natural resources. These nations will continue to fight globalization and to see the economic decline as greater evidence of the evils of capitalism, modern technologies, and more liberal lifestyles. At first, the downturn will likely cause more protectionist policies in global trade and rising tensions, even with our trading partners in Europe and China.

Our view is that this backlash against globalization from the more backward and/or dictator- and terrorist-dominated nations will fail in the end—but they will cause a lot of disruptions between now and then that will exacerbate the downturn after 2009. Their desperate and extreme reactions, along with the economic impacts of the global downturn, ultimately will force the more successful established and emerging nations to adopt an effective mechanism for global security and greater global trade in order to pull out of the downturn and to combat terrorism, unrest, war, and broader issues like global warming—or a new global government in line with the globalization trend. This backlash is going against very strong fundamental trends in technology, culture, and economics that are moving exponentially into the future.

Hence, geopolitical tensions will most likely worsen after 2009 as the commodity and oil bubbles finally reach there long-term peaks and burst. This will be similar to the 1962-1982 period, when inflation first edged up amid increased geopolitical tensions. Note that stock valuations, measured by the P/E ratio, peaked in early 1962, well before the boom in stocks ended in late 1972. When the demographic downturn fully set in around 1973, inflation and commodity prices surged to extremes, while stocks fell and unemployment rose. This time, the price trends will be different: mild, creeping inflation from the continued commodity bubble (and Echo Boom generation workforce entry) will turn to deflation from 2010 to 2022 or 2023 as we move into the demographic downturn of our 80-year New Economy Cycle (and higher Baby Boom workforce exit and retirement vs. Echo Boom entry). Deflation is the worst environment for most assets, especially stocks and real estate! From 2010 onward, stocks and real estate will enter a major, long-term decline into around 2022 or so.

Adding a New 34- to 36-year Geopolitical Cycle to Our Demographic and Technology Cycles

36-Year Rise and Stall Cycle Dow Industrials



Source: Global Financial Data

Chart 9

That brings us to a new cycle that we have recently introduced into our work. **Chart 9** shows an historical cycle of stock advances and flattening/declines that occur every 34 to 36 years. Over the last century, the first such stock cycle peaked around 1892, the next around late 1929, the next around 1965, and the most recent around 2000-2001. Stocks tend to advance for around 16 to 18 years before facing headwinds and moving sideways or down for the next 16 to 18 years.

This cycle, especially when combined with our other fundamental cycles, explains many of the longer-term gyrations in the stock market. Unlike the fundamental cycles for demographics and technologies, this Geopolitical Cycle appears to be more psychological—which affects stock valuations rather than the underlying fundamentals such as earnings. In other words, this cycle does not drive the economy and markets, but it certainly does accelerate or counter them.

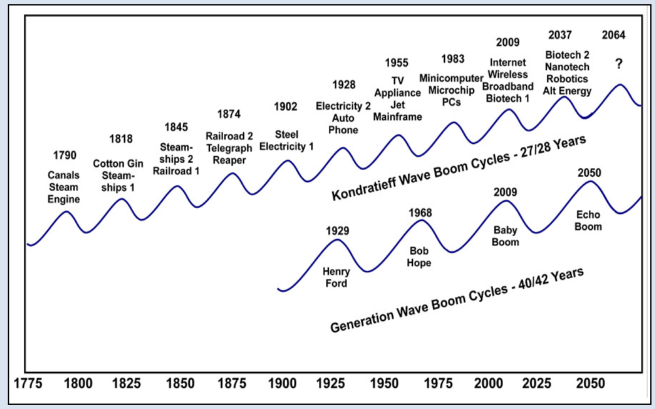
Taking a look at the last cycle, which peaked around 1962-1965, note that stocks continued to advance with rising demographic trends into 1968 (adjusted for inflation) and into 1972 (not adjusted for inflation) before falling. But the highest P/E ratios in stocks occurred in early 1962, just as the Cuban Missile Crisis set in (which was like the 9/11 of that era). P/E ratios continued to fall substantially into 1972 and then fell to very low levels into late 1982, when the inflation trends topped and the demographic trends finally bottomed. So, stocks continued to move upward with the more primary demographic trends, but with less strength after 1962 to 1965 due to the market's perception of geopolitical risks that muted investor optimism.

The cycle turned when the US finally started winning the Cold War in the 1980s, and by 1989 the Berlin Wall had fallen and democracy/capitalism had clearly won. It is also interesting to note that investor psychology improved right about the same time that Baby Boom spending began to accelerate in late 1982. The next cycle reached its peak in optimism as we entered the 2000s and the 9/11 attacks hit American soil.

For a deeper study of long-term cycles and how they interact with each other, review our 2006 Special Report: *Technology Cycles and the Demographic Supercharger.* This report looks at how the economy and markets have transitioned from the traditional 56 to 60-year Kondratieff Wave cycle in basic innovations, commodity prices, and inflation, to the new 80 to 84-year Generation Wave cycle in broader innovations, spending, productivity, and boom-and-bust cycles. The Generation Wave cycle is what we have been documenting over the last two decades, along with William Strauss and Neil Howe in their book, *Generations.*

The Kondratieff (K-wave) cycles were more dominant from the late 1700s into the early 1900s, until the rise in mass affluence from mass-production technologies caused a shift in power, leading to the dominance of the generational and demographic cycle (G-wave). Large numbers of everyday people began to have a greater impact on the economy through two major shifts: (1) spending and labor productivity cycles; and (2) skill-based services increasingly dominating over commodity and raw material inputs. **Chart 10** gives a very brief summary of how these basic technology boom-and-bust cycles (K-wave) have overlapped the growing generational boom-and-bust cycles over the last century, especially since the 1940s and the Bob Hope generation.

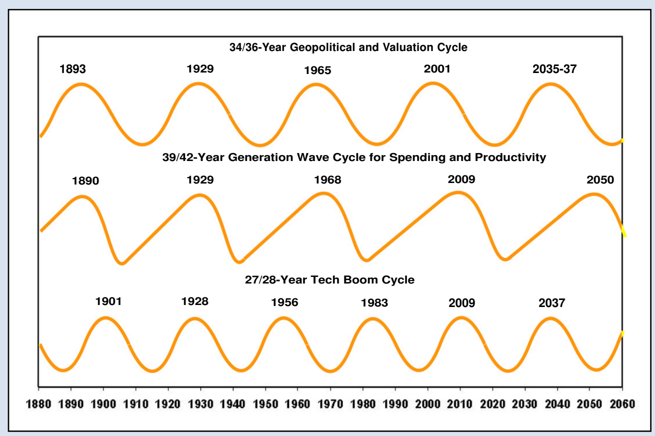
Kondratieff and Generation Boom Cycles
1775 - 2050



Source: HS Dent Chart 10

These two cycles converged in a broader top around 1929 and diverged a bit into the broader Generation Wave top around 1968—making that top less dramatic than the famous 1929 Crash and the ensuing Depression. But now both of these cycles will be converging again around late 2009, potentially setting the stage for another seismic shift in the economy and markets.

3 Macro Cycles



Source: HS Dent Chart 11

Chart 11 examines how these three long-term macro cycles have correlated over the last century. Remember that the G-wave cycle is increasing in dominance relative to the K-wave cycle because commodities and basic innovation cycles are less critical than broader G-wave cycles (which are based on people) in innovation and productivity. The 34 to 36-year Geopolitical Cycle seems to be consistent, influencing less than the G-wave and more than the K-wave in modern times. The Geopolitical Cycle peaked between 2000 and 2001 and points sideways to down into around 2018 or so. The G-wave cycle points up into 2009 (and possibly a bit later) and then turns down into around 2022 or so. The K-wave cycle is up into around 2009 or so and then turns down into around 2023 or so.

These three cycles all point down from 2010 into 2018. The last time all three of these cycles were down was 1930 to 1942, and that was the worst time for the economy since the great 1840s depression, which was preceded by a stock bubble and valuation peak in 1835 on this same approximate Geopolitical Cycle.

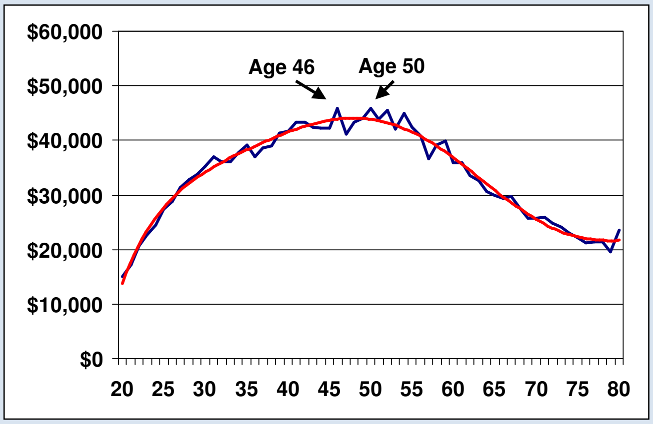
The Geopolitical Cycle can be followed back as far as the 1800s, although market and economic data were harder to measure back then, and the impacts of the Generation Wave were clearly less important. This Geopolitical Cycle seems to vary between 32 and 37 years, and the K-wave cycle tends to vary between 27 and 30 years. The G-wave cycle tends to vary between 39 and 42 years. So, it is obvious that all of these cycles have an impact and they all have some minor variations, likely depending on the impacts of other cycles and more seemingly random shorter impacts like 9/11.

Refining the Forecast for the Peak and Downturn

As we get into the late stages of this boom, we will refine our forecasts for when the fundamental trends are likely to peak by monitoring the basic indicators. **Chart 12** shows the peak in spending with 2000 data from the Consumer Expenditure Survey, and it shows a plateau between 46 and 50, or 48 on average. A 48-year birth lag for our Spending Wave would put the peak around the end of 2009. But if economic conditions were very favorable otherwise, the boom could extend toward the outer end of the plateau at age 50, which would put the top at late 2011 or so.

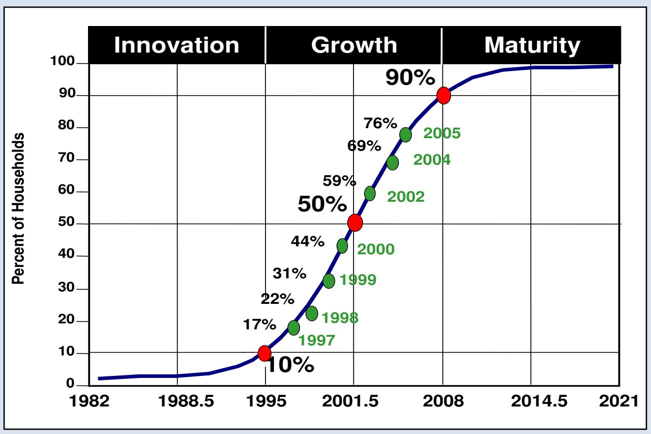
Charts 13 to 15 are updates to the S-Curve trends in key new technologies, adding to **Chart 5**. In **Chart 5** for cellular phones, the projection looks to hit 90% market penetration in mid to late 2009 vs. late 2008 previously. **Chart 13** shows that Internet market penetration is now more likely to peak sometime in 2008 rather than 2007. Broadband (**Chart 14)** still looks to be on track with our original estimate for hitting 90% market penetration in 2009. Wireless Internet (**Chart 15)** looks to peak around 2013, and other consumer items like digital cameras look to peak around 2015 and HDTV televisions around 2009 to 2010. The key point here is that the consumer technologies that have underpinned the current consumption and productivity boom will largely hit 90% and slow down between late 2008 and late 2009. Hence, we have returned to the forecasts of the timing of this boom as originally outlined in *The Next Great Bubble Boom*, which projects the peak of the boom around late 2009, give or take a year. Given the broader geopolitical headwinds of this new cycle, it is less plausible that the bubble would extend much beyond the peaking fundamental trends (although the housing bubble did from late 2003 to mid-2005).

Household Spending By Age



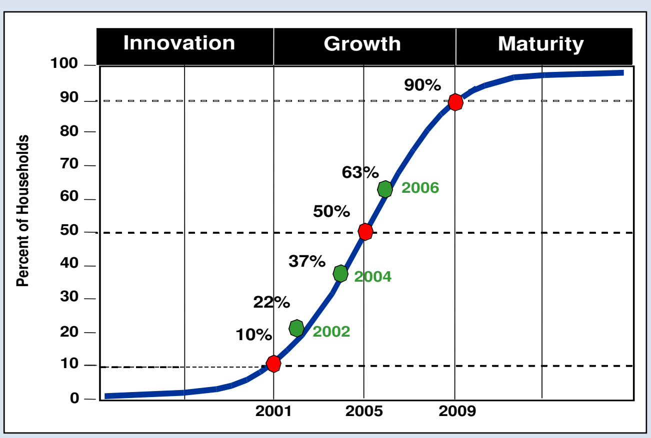
Source: Bureau of Labor Statistics Chart 12

Internet S-Curve



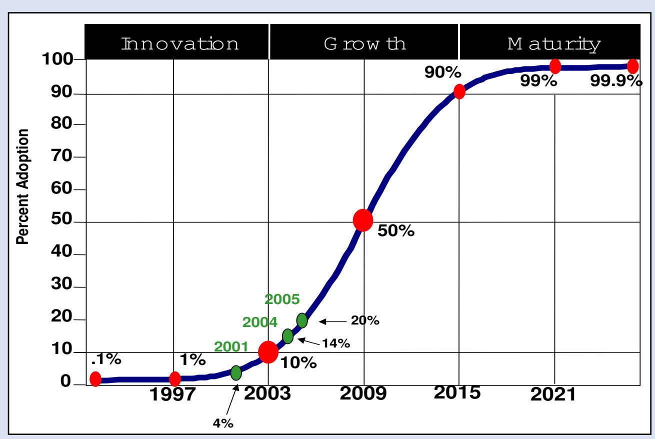
Source: Internet World Stats Chart 13

Broadband S-Curve



Source: Pew Internet Chart 14

Wireless Internet S-Curve



Source: ZDNet Chart 15

The most likely scenario now is that the next bubble that started in July 2006 will last for three years, peaking around late 2009. The basic targets for now are the Dow around 20,000, and 4,300 to 5,000 for the Nasdaq. If we saw a 3-year bubble as strong as late 1984 to late 1987, then the Dow could reach as high as 27,000, but that is less likely.

Given that the stock market is facing stronger headwinds than in the 1920s or the 1990s, and given that this bubble is starting later, this represents a substantial reduction in our original long-term targets of 32,000 to 40,000 for the Dow and 10,000 to 14,000 for the Nasdaq—but still very attractive returns in the next three years!

This new forecast also means that we are likely three years away from the next major stock crash and secular bear market, and as little as four years from the beginning of a major decline in home prices and real estate after the recent slowdown that we forecast.

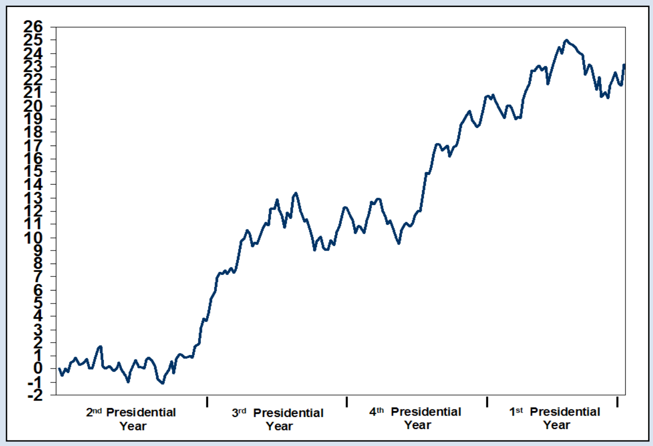
Technical Indicators Confusing But Still Critical

Now that we have outlined the longer-term fundamental forecast, let's take a look at some of the shorter-term indicators. Clearly, not only is the fundamental outlook extremely strong into 2007 and 2009 due to demographic and technology trends, but also the short- and medium-terms look quite encouraging as well.

The most consistent cycle is the 4-Year "Presidential Cycle." Thus far, 2006 has been a typical flat-to-mild correction year, as is typical in the second year of the 4-Year Cycle. We initially expected this year to be stronger, given that the bubble was due to kick in by early 2006 (according to past cycles) and that the broader Decennial Cycle was well behind schedule. If you look at **Chart 16**, the second year into the mid-term elections is shown first on the left side. It tends to start up, correct a bit into May or so, rally to a new high in the late summer, and correct again into October or so before rallying into year-end and finishing slightly up for the year (on average 3.3%).

As we have noted from research by Don Hays, when presidents have second terms the market does much better in the latter part of the second year and ends up with strong gains—an average of 18.5% (as is more likely this year). Regardless, the most important thing to remember about this cycle is that the strongest rallies come between the low, typically mid to late in the second year, and the high, typically late in the third year or early in the fourth year. **Chart 17** shows, in every such cycle back to the beginning of this boom, how consistently strong these rallies

4-Year Presidential Cycle



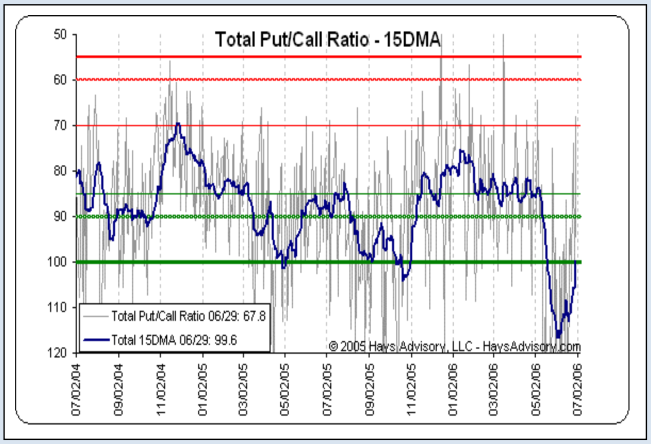
Source: Ned Davis Research, www.ndr.com — Chart 16

3rd Year Rallies in 4-Year Presidential Cycle Since 1983

1982-1983	68.57%
1986-1987	65.50%
1990-1991	41.17%
1994-1995	41.64%
1998-1999	58.38%
2002-2003	43.15%
Average	53.07%

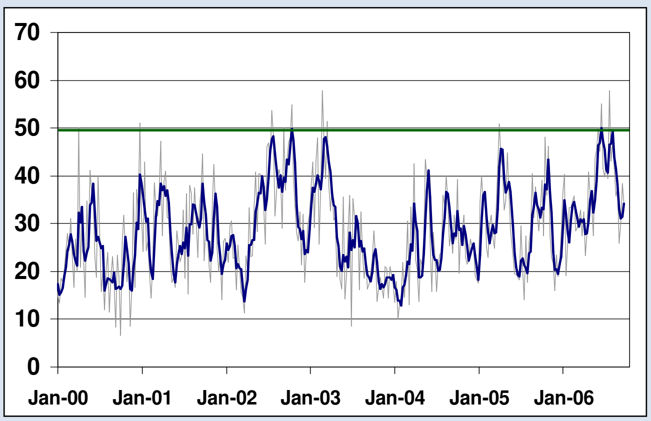
Source: HS Dent — Chart 17

Total Put/Call Ratio



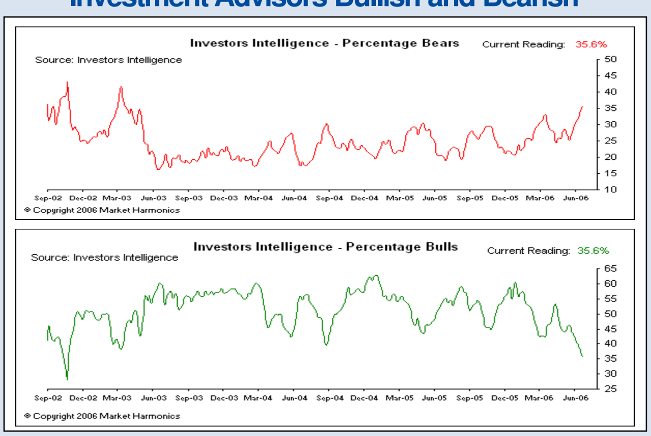
Source: Hays Advisory Chart 18

AAII Bearish Sentiment
3-Week Average



Source: Hays Chart 19

Investors Intelligence
Investment Advisors Bullish and Bearish

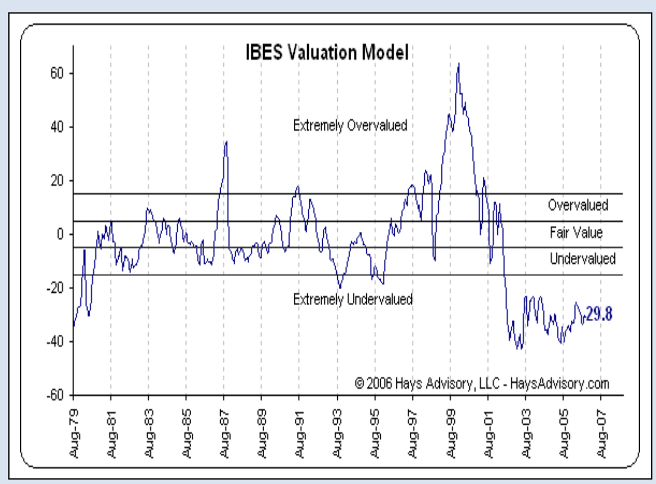


Source: Investors Intelligence / Market Harmonics Chart 20

have been. They have averaged 53% with a range of 41% to 69%! This strong cycle was a major reason for our forecast of a 50% rise in stocks from late 2002 into late 2003, and conditions obviously look ripe again on this cycle.

The sharp correction in US stocks that took place for most of the late spring and summer of 2006 saw extremes in many technical/psychological indicators, and we covered several of these in recent newsletters. The most critical ones will be reviewed here. **Chart 18** shows the indicator with the most extreme reading. In July of 2006 the total put/call ratio measuring the "dumb traders" has gotten more bearish than it was at any point in two decades—off the chart! This is a very good sign, as these everyday traders tend to be wrong at key turning points in the market. Bearish "dumb traders" usually mean that a strong rally is to follow.

Moving up a level, we see the broadest measure of everyday investors in **Chart 19**, the AAII survey. A very steep increase (drop on the chart) in bearishness has gotten into the extreme and clear buy zone, nearly as bearish as in late 2002 and early 2003 at the extreme bottom of the markets. At the next level, we see financial advisors and the Investors Intelligence Survey in **Chart 20**. This indicator used to be more effective years ago before it was so closely followed, but it still has some predictive value. Importantly, in July 2006 this indicator was at its most extreme readings since the major bottom in late 2002 and early 2003. The investor sentiment indicators help explain why stock P/E levels have remained low despite stellar earnings, but they also clearly forecast a major move up in the years ahead! And, finally, **Chart 21** shows the best long-term measure of stock valuation by comparing the yield on the 10-year Treasury to the



Source: Hays Advisory Chart 21

earnings yield on the S&P 500. This indicator says that stocks are still undervalued by 30%. It would take a rally to around 15,000 just to get the Dow back to fair value! With these very bullish sentiment indicators and our very bullish fundamental indicators, let's now look at the likely scenarios ahead for the stock market.

Scenarios for the Last Bubble

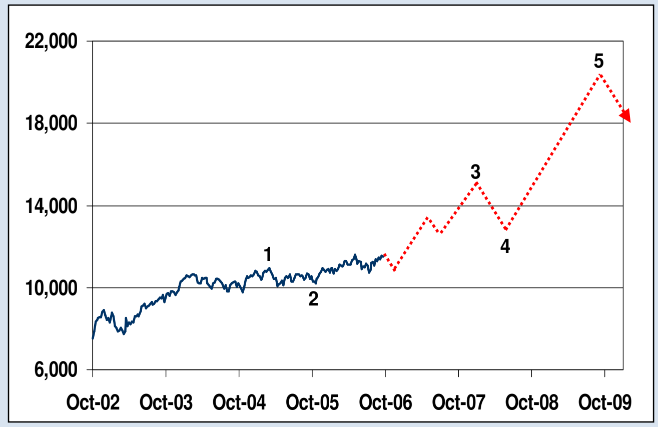
Chart 22 shows the most likely scenario: a Dow of 18,000 to 22,000 by late 2009. This scenario would likely see a strong advance into late 2007/early 2008 to around 15,000 for a third wave up in the rally from late 2002 (with its first wave peak in May 2005), and then a final fifth wave up that would peak between 18,000 and 22,000 around late 2009.

Chart 23 shows an update of our Dow Channel. Given this new less favorable geopolitical cycle, but with continued storng demographic and earnings trends, we are simply now targeting the middle trend line (fair value) rather than the upper band for the peak in the markets. That would now project a peak just over 20,000 in late 2009. If we do see more of an extreme bubble, then the target could be as high as 32,000 by late 2009.

Chart 24 shows the most likely scenario for the Nasdaq, which would entail a B-wave that comes close to retesting the highs of early 2000 between 4,300 and 5,050. As occurred in the late 1920s, the tech stocks started peaking in late 1928, one year ahead of the broader Dow in late 1929. This could occur again, especially if the oil and commodity stocks take center stage and lead again as they did into 2005 and 2006. Hence, the Nasdaq peak could come between late 2008 or early 2009 and late 2009. If the peak comes more in late 2009, then it could be a bit higher, towards the highs of 5,050.

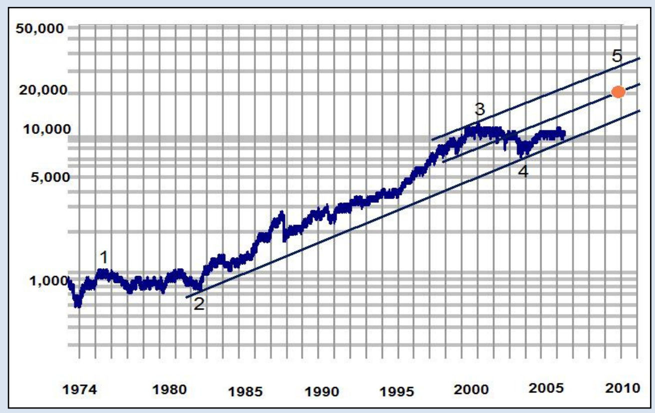
In this scenario, a very sharp crash would likely occur into 2010 on our 4-year, 10-year, and Decennial Cycles, followed by a series of crashes that continue into at least late 2012 and likely late 2014. This would represent a strong A-wave crash. A bear market rally would follow between around 2015 and 2017 or possibly into 2018; with a second C-wave correction afterwards. This would put the final bottom between late 2018 at the earliest and more likely around late 2022.

Revised Dow Forecast



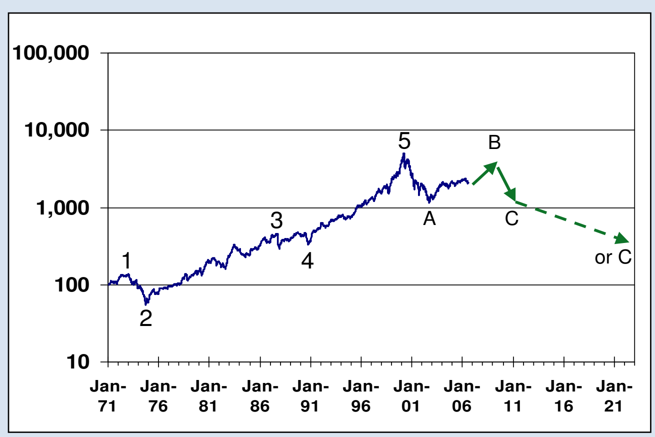
Source: Yahoo Finance
Chart 22

Dow Channel
1974-2010



Source: Yahoo Finance
Chart 23

Revised Nasdaq Forecast



Source: Yahoo Finance
Chart 24

It is still possible that this next bubble could gain strong momentum and, after a first strong setback in 2010, get either more extreme into late 2009 or extend into 2011 or early 2012. But given the more adverse geopolitical environment and likely continued rising commodity prices after a break into 2007, we think the scenario that we have outlined above is the most likely and that this stock market bubble will end by 2009—probably earlier than that in the technology and small-cap growth stocks. We will be working over the coming years on refining our forecasts for the top and next crash scenario for our newsletter subscribers and for our next book, which is likely to come out between late 2008 and late 2009.

At this point our strategy is to get our investors very defensive by late 2009 and possibly by late 2008 or early 2009 in the tech and small-cap growth stocks. After this, we will look to reinvest short term in late 2010 if stocks get very oversold and global trends still look somewhat favorable into late 2011 or early 2012. Then, we would get very defensive again from early to mid-2012 into late 2014. The worst of the next great downturn will likely occur for stocks between 2010 and 2014, and for the economy and real estate by early to mid-2015 or so.

To Summarize the Risks and Investment Strategies Ahead

Taking all of the fundamentals and cycles into account, the most dangerous times for the stock market will likely be, in order: (1) late 2009 to late 2010; (2) mid-2012 to mid to late 2014; (3) late 2017 into late 2018; and (4) late 2019 into mid to late 2022. Real estate is likely to lag the stock market by a year or so; hence, home prices are likely to start weakening seriously from late 2010 onward, especially from late 2012 into early 2015 when unemployment levels and bank failures are likely to be the highest (like early 1932 to 1934 in the Great Depression). But, as in Japan from 1991 into 2005, housing prices are likely to weaken more consistently over a long period of time—whereas stocks will tend to crash more dramatically between 2010 and 2014 and between 2018 and 2022. High-quality fixed income is the place to be from late 2009 onwards, with a possible final buy opportunity for stocks between late 2010 and early 2012 and opportunities to buy into continued strong demographic areas from health care in the US to Asian economies from mid to late 2014 onward.

Between now and late 2009 we continue to recommend that investors buy on minor corrections and to focus in the large-cap growth sectors of technology, financial services, health care, Asia, and emerging markets. Commodities should become more attractive again by late 2007 to mid 2008. Small-cap and mid-cap growth should also be attractive sectors for this last bubble, but the valuations are more attractive now in large-cap growth stocks.