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KONDRATIEV'S Final Lesson

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Kondratiev's Final Lesson

This Murdered Soviet Economist's Groundbreaking Research Could Mean Investment Breakthroughs. Understanding His Theory Is Essential To:

- Understanding where opportunities for investors are happening within the rapid economic changes currently underway
- Correctly judging what is a market trend and what is a short-term fluke
- Correctly judging when to click “buy” and when to leave an idea in the dust
- Correctly judging what companies, industries and innovations are likely to make you money
- Understanding whether you are hedging against disaster while opportunities are passing you by or playing it safe and smart...

In short, understanding Kondratiev's little-known theory can help you position your assets to maximize future gains even in an environment that confuses and frustrates most investors.

A Soviet scientist who was murdered in prison over 70 years ago had inadvertently found the key to understanding what is happening with the U.S. economy and the long-term implications for the next several years.

His insight may have cost him his life.

Nikolai Dimitrievich Kondratiev was born in Kostroma, Russia, on March 4, 1892. The son of peasants, he joined the Socialist-Revolutionary Party and became an agricultural economist and statistician.

After the Bolshevik Revolution, Kondratiev pursued academic research. He sealed his own fate in 1922 when he published his first writing on long cycles *The World Economy and Its Conjunctures During and After the War*. Kondratiev argued that one of the most closely held beliefs of the Marxists who controlled the Soviet Union — that capitalism would suffer imminent collapse due to its inherent contradictions — was false.

Instead, he posited that capitalist economies were characterized by successions of expansion and contraction... growth and decline... euphoria and fear.

Kondratiev advocated a market-led industrialization that emphasized agricultural exports. The “mixed” economy prevailed in the Soviet Union until the rise of Joseph Stalin in the mid-1920s. Stalin favored

total state control of the economy and ended any semblance of free enterprise, leaving Kondratiev's influence to quickly wane. He was removed from his position at the Institute of Conjuncture in 1928, arrested in July 1930 and sentenced to eight years in prison on fake charges.

Kondratiev continued his economic research in prison, despite harsh conditions and declining health. In his last letter to his family, he noted he was working on five more books on economics.

This was apparently too much for the rulers. Kondratiev finished his sentence in September 1938 and was promptly retried and executed.

The Kondratiev “Waves”

The intuitive nature of his “wave” theory demonstrates a fact most of us already know: Nothing lasts forever.

The greenback is still the world's reserve currency. That is, until it isn't anymore.

No matter how many digits are magically “printed,” we can't have all “up” and no “down.” That's not how markets work. As our founders Addison Wiggin and Bill Bonner noted in their book *Financial Reckoning Day*:

[Free markets go] from crisis to crisis... from creative boom to creative destruction. From fully functioning, liquid markets to markets as frozen solid as the polar ice cap in the days before global warming... But now, in step the central banks. The boom is fine, they say, but we'll put a stop to those nasty busts.

The idea isn't new. There are indisputable movements in the market. We're talking about big trends up and down. Central bankers can delay those trends, but they can't stop them.

How is it we can have an impending currency crisis and have new paradigm-shifting technological breakthroughs at the same time?

Kondratiev wrote about economic cycles that would take place every 50 years or so. After his death, Joseph Schumpeter labeled his idea “Kondratiev waves,” or K waves, for short. They are broken up into “seasons.”

Spring is the start of a boom: People start out weary of the market, only to be egged on by something like cheap credit. That's when summer hits. As businesses start to boom, people become more confident and start to enter the market. Inflation starts to creep in. Real estate, stocks, gold and other commodity prices get pumped up.

Then in autumn, debt begins to balloon and stock

continue...

prices start to peak. People realize the state of affairs is unsustainable. All of the market's supply and debt cause inflation to slow, setting the stage for winter. That's when the bust sets in. Then all of the debt and oversupply is defaulted on and liquidated.

After the system is flushed, the cycle starts all over again.

Here is a chart outlining the cycles and the cycles within cycles that constitute the wave:

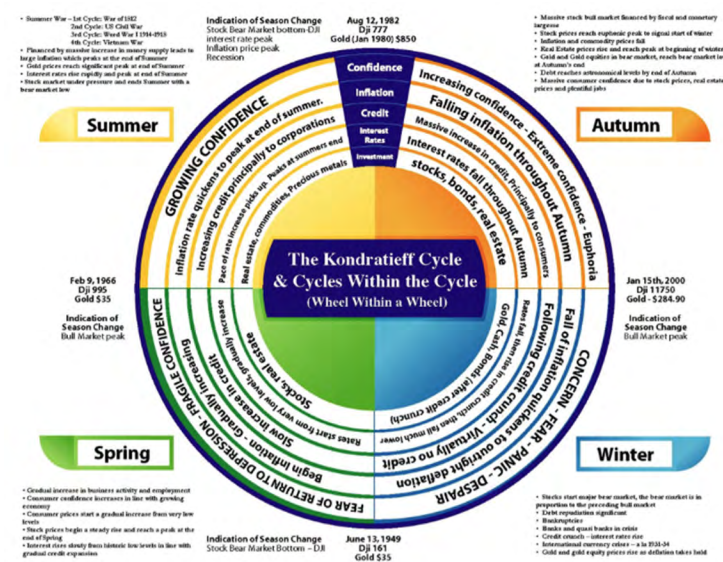


Chart Courtesy of North Coast Investment Research

Where Are We Now?

Theories vary widely among both market analysts and academics as to the expected impact of this most recent “winter” phase. Many believe Western debt has come to a head thanks to cheap credit that was enabled at the expense of the currencies we use. When a full-blown winter hits, the old currencies are expected to be purged and something new to emerge.

As *Currency Wars* author James Rickards predicts, that could be a new paper money configuration, a type of gold standard or complete chaos. Suffice it to say that holding some of the yellow metal during this “winter season” would be prudent.

Something interesting seems to be taking place... the most recent cycle, beginning around 1950, seems to be a bit longer. The stock market collapse of 2000 seems to be the end of the autumn phase of the 1990s, when overconfidence, credit binging and a sense of invincibility permeated stock markets. Winter then began. **What is not clear is how long this winter will last.** See nearby chart.

Christopher M. Quigley, the Irish author, investment adviser and founder of Wealthbuilder.ie is predicting a depression for the next seven years...

Long K cycles have nearly a thousand years of supporting evidence. If we accept the fact that most winters in K cycles last 20 years (as outlined in the chart above), this would indi-

cate that we are about halfway through the Kondratieff winter that commenced in the year 2000. **Thus, in all probability, we will be moving from a “recession” to a “depression” phase in the cycle about the year 2013, and it should last until approximately 2017–2020.**

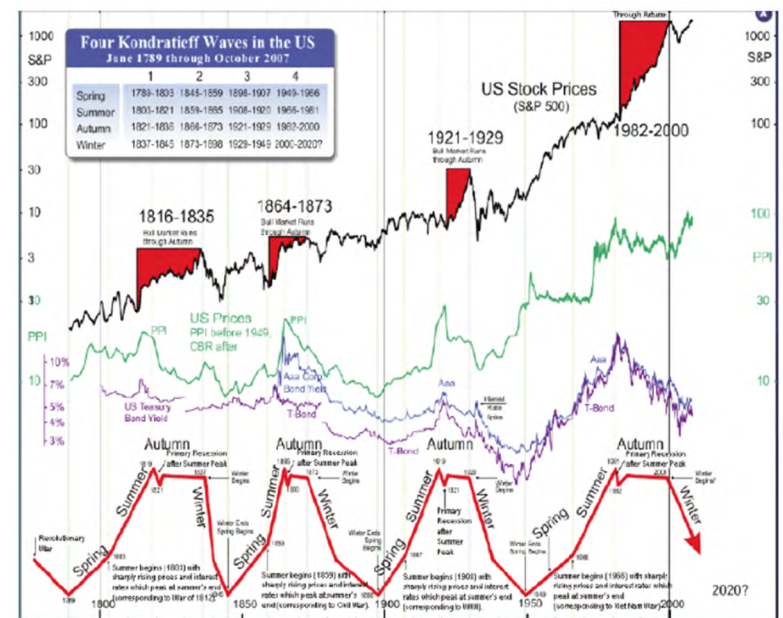


Chart courtesy of sovereignspeculator.com

Quigley believes that the winter phase may be stretching out longer than it should because economists have misdiagnosed the problem. “World bankers, if they were properly versed in their craft, would realize that Kondratieff’s heroism has given them the understanding they require to correctly comprehend and deal with the crisis,” Quigley claims. **“However, instead of seeing ‘it’ as an acceptable development based on the natural result of technological stagnation, they have panicked and misdiagnosed it as a credit/monetary problem.** Thus, the epiphany of truth will only finally dawn when the both the Fed and the ECB go bust, and as every financial dog on Wall Street knows, this is not a matter of ‘if,’ but ‘when.’”

We may already be nearing the end of the last technological stagnation, as Quigley calls it. The next phase now dawning will be a “boom” in technological development that will radically revolutionize the economy.

Jim Richter of *The Richter Report* noted in 2007 that the winter cycle that began in 2000 led to the Federal Reserve’s perpetual “easing” program, which he likewise blames for a worse winter than otherwise should have occurred:

I believe that the actions of the Fed, especially under Greenspan, caused a delay and distortion in the Kondratieff cycle, but did not eliminate it. The winter began in 2000. However, when the stock markets collapsed in 2000, the Fed lowered interest rates and triggered a real estate bubble, which has now finally collapsed. All of this was built on reckless debt creation. Now we are seeing the

results as big banks such Merrill, Citi, Bear Stearns and numerous others are having to write off staggeringly huge losses. The Fed has no alternative but to try to inflate us out of this mess by creating unlimited amounts of money through the creation of new debt. The problem is that during a Kondratiev winter, banks become afraid to lend, and borrowers become afraid to borrow!

David Knox, considered to be one of the top experts on the Kondratiev cycle, said in 2010 that he believed **the winter phase began with the crash of 2000 and had bottomed out in 2009.** Adding to that, Richter likewise noted, that massive interventions in financial markets by central banks may have prolonged the winter phase unnecessarily:

When the current K winter ends, investors will face significant psychological challenges. Just as in 1949 and 1982, many people will have been so badly burned by the stock markets that they will shudder at the thought of ever owning stocks again. Given what has happened to real estate investors during the past decade, I suspect that the same will be true in that sector as well.

Many social scientists also consider Kondratiev waves a very important component of the modern world-system dynamics. Andrey Korotayev and Sergey Tsirel studied the K wave phenomena for their academic paper on the topic for University of California, Irvine a few years back. They note “the presence of K waves in price dynamics... has found a very wide empirical support.” The authors continue:

Long waves of economic growth possess a very strong claim to major significance in the social processes of the world system. Long waves of technological change, roughly 40–60 years in duration, help shape many important processes... They have become increasingly influential over the past thousand years. K waves have become especially critical to an understanding of economic growth, wars and systemic leadership...

But they also appear to be important to other processes, such as domestic political change, culture and generational change. This list may not exhaust the significance of Kondratieff waves, but it should help establish an argument for the importance of long waves to the world's set of social processes.

Korotayev and Tsirel note that K waves “appear to be detected for the GDP dynamics of the West.” They conclude that their research “suggests rather optimistically that the current world economic crisis might mark not the beginning of the downswing phase of the fifth Kondratieff wave, but a temporary

depression between two peaks of the upswing... the next peak might even exceed the previous one but only postpone the downswing... **the new upswing will start in 2011–12 and will reach its maximum in 2018–2020.”**

Spring May Be Upon Us

The spring cycle is described as a period of dramatic technological innovation that begins the cycle anew after the failure of winter. The last Kondratiev spring occurred in the postwar period, from the late 1940s to the mid-1960s, a period characterized by the explosion in new consumer technologies and enthusiasm for innovation.

This last “spring” cycle saw the invention of the VCR, barcode, power steering, pacemaker, answering machine, polio vaccine, laser and many other amazing things that revolutionized our lives.

With the rapid technological developments happening all around us today, the evidence seems strong that the Kondratiev “spring” is upon us. This spring is poised to bring us even more incredible inventions in the next few years than occurred in the last few decades.

The developments are happening almost faster than we can keep track of: new digital currencies, rapidly evolving 3-D printing, advances in encrypted communication, escrow, medical developments, online sales and many others are democratizing information and entrepreneurship and empowering individuals to take greater control of their own lives.

Understanding K waves can help investors spot big trends for long-term investments. Knowing what assets to buy and what to steer clear of can mean the difference between big gains and crushing losses.

The idea is simple: *Innovation — only innovation — accelerates wealth.*

If there's a way we'll grow ourselves out of the current situation, this is how we'll do it. It is, in fact, how we're doing it, even if most people don't realize yet that it's happening.

We'll keep you updated on the trends you should know about — both large and small — that may come our way. Not everyone will be ready for the seismic changes that will assuredly shake up markets. Many jobs will be lost... others will be created. Those who are ready to accept this reality and profit from it stand to live extremely well for these next 10 years and beyond.

Best,



Peter Coyne
For *The Daily Reckoning*