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Issue 24 - 2 July 2008



The header features a dark background with a golden, shimmering light effect. The word "Prosper!" is written in a large, white, serif font. To the right, in a smaller, yellow, sans-serif font, is the text "Dear Prudence, Won't You Open Up Your Eyes...". Below this, in a white, sans-serif font, is "Investment Insights from Louis Boulanger". On the left side, there is a small portrait of Louis Boulanger, a man with glasses and a beard. To the right of the portrait, his name "Louis Boulanger" is written in a bold, black, sans-serif font, followed by "CFA" in a smaller, yellow, sans-serif font. Below his name are his office and mobile phone numbers: "Office: +64 9 528 3586" and "Mobile: +64 275 665 095". To the right of the portrait and contact information is the logo for "louisboulanger now", where "louisboulanger" is in a bold, black, sans-serif font and "now" is in a smaller, yellow, sans-serif font. Below the logo is the tagline "Freethinking Investment Strategies" in a smaller, yellow, sans-serif font.

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Cruel Oil

"Most of the greatest evils that man has inflicted upon man have come through people feeling quite certain about something which, in fact, was false."

*- Bertrand Russell
(1872 – 1970)*

Philosopher, historian, logician, mathematician, advocate for social reform, and pacifist; he was awarded in 1950 the Nobel Prize in Literature, "in recognition of his varied and significant writings in which he champions humanitarian ideals and freedom of thought".

Since August 2007, the price of crude (and cruel!) oil has now doubled from under US\$70 per barrel to over US\$140 per barrel. This is of course a big problem for the global economy. Not only will it cause massive redistribution of resources from consumers to producers, but by making transportation and production that uses petroleum products as an input, it will slow economic growth and increase consumption prices. Hey, even Americans are now starting to find it expensive to fill up!



With oil prices doubling so fast it is not all that surprising to find Americans angry at the pump... gasoline prices are following suit, even there. Over the past four months, the average US price per gallon of unleaded has risen over one US dollar per gallon. When adjusted for inflation, gasoline prices are at record highs and 18% above their old inflation-adjusted peak of 1981 (see chart above).

Who's to blame? Well, it's certainly not 'speculators'! In my opinion, the US government and the US central bank, first and foremost, are to blame. Why? Oh, for a number of reasons, both economic and political. But the most important ones are the former's notorious disregard for deficits and the latter's blatant mismanagement of the world's reserve currency (in which crude oil happens to be priced).

As an aside, I'd argue that if the 'system' wants to blame the so-called speculators for the high oil and food prices, they should look at the biggest speculator of them all: Ben Bernanke! He speculated that this time it was different and that he did not need to increase interest rates to save the US dollar (or stop it from falling) and that all he had to do was jawbone his way out. Well, it did not work, is not working and will not work. He speculated on the US dollar and he lost!

A key factor that, in the short term, has contributed to the sharp increase in the price of oil is Ben Bernanke's US central bank (the Fed)'s inflationary monetary policies. In other words, that the oil price increased so much after the Fed started its aggressive interest rate cuts was not really a coincidence. Digging to find more oil or alternative sources of energy will not solve this short term effect, but may well provide a long term solution in due course. In the meantime, to provide short term relief, different solutions are needed.

This means, for example, that the Fed should stop its inflationary policies. Unfortunately, I don't think this is likely anytime soon. So I don't believe for a minute the possibility of a significant price decline in the near future, as many are suggesting. Nor should you believe that high oil prices are caused by speculators.

Hopefully, I've already provided enough expert commentary to convince you that 'blaming speculators (or, in effect, passive index investors)' is a lie, in the previous issue of *Prosper!* But, just in case, here's more...

How Commodity Markets Function

Starting with the basics, commodity markets can be divided into spot markets and futures markets. *Spot* markets are the markets for immediate delivery; *futures* markets are the markets for delivery at some future point in time, usually not more than a year or so in advance.

As futures contracts are constantly traded, it should be noted that someone who buys a commodity with a futures contract need not necessarily be the one that buys it at the expiration date. But this is not dissimilar to how someone who bought a commodity with a spot contract can sell the commodity to someone else.

Just as there is always both a buyer and a seller in a spot contract, there is always a buyer and a seller in a futures contract. Usually though, the buyer is referred to as having a *long* position while the seller is referred to as having a *short* position, but that is basically just semantics. People with long positions are in effect buyers while people with short position are in effect sellers.

What you should also realize is that most commodity speculators invest in *futures* while what matters for the price of crude oil actually used in the economy is primarily what happens in the spot market. It's also important to note that commodity speculators can take both *long* positions and *short* positions. This implies that commodity speculators may not, in fact, be contributing to higher prices.

Indeed, if speculators as a group have equally large long and short positions then they will have no effect on futures prices, and if they as a group have

larger short positions than long positions then their speculations will in fact lower futures prices.

That's not all... and this is really important for you to understand in my view... even if speculators as a group have a net long position, the speculators that pushed up the *futures* price in the first place will, once the futures contract approaches expiration date, face two choices:

Choice number one is to sell the contract or sell the underlying commodity to some consumer once the contract expires.

Choice number two is to put the commodity in some physical inventory and keep it there.

If the speculators choose the first alternative, then this will push down the price back to the level where it would have been in the absence of the original purchase. In this case, speculation will thus have no effect on the *spot* price. If, on the other hand, the second alternative is chosen, then speculation will indeed contribute to higher prices, at least temporarily.

But, while that second option is a possible theoretical scenario, it does not mean that it is applicable to the current situation. In fact, so-called 'index-speculators' (like me and my clients, I guess, since we've been passively investing in commodity indices for the last three years now) are actually true investors of the first kind above; just like anyone investing passively in an equity index fund or a bond index fund.

The difference is that, now, commodities are also beginning to be considered by more and more investors as a legitimate asset class to diversify their overall portfolio risk and protect their wealth from inflation. There is simply too much money chasing too few assets and tangible assets are now being increasingly preferred to financial assets.

China's Car Frenzy

When I was in Shanghai, I simply could not believe the number of cars I saw on the road. Last time I was there before that (in 2001), there were not many cars on the roads and there were few highways; not anymore! I was in awe to see such great highways (the road from the new airport to the city is the best there is in any city, with more flowers, plants and trees all along the pleasant one hour journey than even in Singapore...

So I was particularly happy to see the following dispatch from Casey Research last week, as it helped me understand the sheer scale of change that's taken place there since 2001:

"Record oil prices have failed to temper the enthusiasm of Chinese auto buyers. In 2006, 6.2 million cars were sold in China, enough for the Middle Kingdom to surpass Japan for #2 in total vehicle sales (the United States still sells twice as many). In the first five months of 2008, Chinese auto sales show no signs of decelerating, up 17.4% from the same period last year.

The rise in Chinese auto sales has been so dramatic that projections by

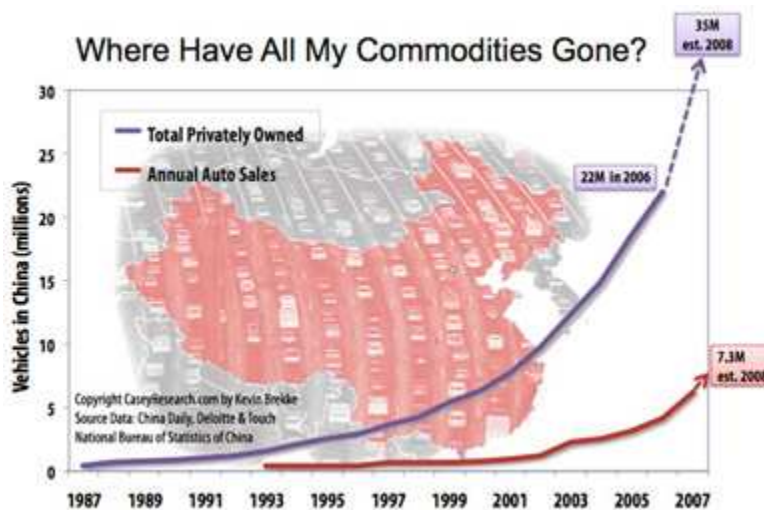
China's government for auto sales in 2020 were already exceeded by 2005.

Millions of tons of copper, nickel, aluminium have gone into China's car frenzy, boosting the commodity prices of every raw material involved. But the most pressing consequence of China's great leap into the culture of happy motoring is its impact on crude oil demand.

Assuming that the 7.3 million new car owners in 2008 each drive 5,000 miles a year, and they achieve 40 miles per gallon, the result would be an additional 45.6 million barrels of crude demand, equivalent to 125,000 bbl/day. In other words, new Chinese drivers will devour 25-30% of the recently promised Saudi production increase in a single year.

To those predicting an imminent decline in world oil demand, we say: don't bet on it."

I couldn't agree more. Not convinced? They say a picture is worth a thousand words. So please take a good long look at the chart below that was produced and released by Casey Research along with that recent dispatch:



The Time to Act Is Now

If you have not yet taken into account the out of control inflation that's upon us once again (last time was in the 1970s), you should adjust your investment portfolio NOW – your economic survival may depend on it. If you rely on others, such as trustees, for such investment decisions to be made on your behalf (for example, if you are a member of a superannuation scheme), then make sure they have already taken or are now finally taking inflation seriously. Your plan to retire may depend on it.

The most important trend for any investor to correctly anticipate is inflation. Get that right, and you get just about everything right. In an inflationary environment, cash, bonds and most stocks rapidly lose value; commodities, gold and other tangible assets gain value. In a strong deflationary environment, stocks, commodities and risky bonds are reliable losers. Cash and safe bonds are sure winners.

There's no way to escape the importance of being right about this one. If inflationary, then assets that would thrive in a deflationary environment get hammered. If deflationary, then assets that would benefit from inflation get strangled. You'll find much more on what inflation is and is not further below.

In the meantime, [here's the link](#) to an interview with Frank Holmes, CEO of US Global Investors, on Bloomberg News. Frank tells it as he sees it on the prospects for gold and commodities more generally. I think you'll find it refreshingly different from what you are more likely to hear. It's about 10 minutes long and he does go into a few mining stocks too, should that be of any interest to you.

"Facts do not cease to exist because they are ignored."

*- Aldous Huxley
(1894 - 1963)*

English writer, intellectual, humanist and pacifist; best known for his Brave New World

Inflation is only going to get worse, before it gets better. Prepare yourself for whatever the big central banks throw at us by their mismanagement of national currencies: protect yourself and own bullion (gold, silver and platinum)!

Please note that all past issues of *Prosper!* are available [Here](#) for your convenience.

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Inflation, Money Demand and Velocity

"I have said many, many times that inflation is a sinister beast that, if un-caged, devours savings, erodes consumers' purchasing power, decimates returns on capital, undermines the reliability of financial accounting, distracts the attention of corporate management, undercuts employment growth and real wages, and debases the currency."

*- Doug Casey, Chairman, Casey Research, LLC (www.caseyresearch.com)
American free market economist, best-selling financial author, and international investor and entrepreneur; his 1979 book [Crisis Investing](#) became the largest selling financial book in history*

Inflation appears on the edge of getting truly out of control, almost everywhere, because governments are madly printing 'money' to keep the world's financial house of cards from collapsing!

The global fiat currency regime is in for some serious pressure in the months ahead. While I could not possibly know with any certainty of course the fate of any currency over the next month, quarter or year, it now seems obvious to me

at least that at some stage (and the sooner, the better) our global monetary regime will need to be reformed; one backed by gold has to be a strong contender.

I wrote in some detail about inflation back in October 2006 ('What Inflation Truly Is and Why It's Back with a Vengeance!') in Issue 3 of *Prosper!* In this Issue, I will attempt to explain why I believe the long term trend for the US economy and that of the EU – and possibly, as a result, the global economy – will continue to be inflationary, with only brief intermissions of monetary inflation from time to time.

What's Inflation Again?

Well, these are extracts from what I wrote in October 2006 and are as relevant and true today as then:

"Inflation occurs when governments print money or borrow from a central bank in order to pay their bills. Politicians often blame inflation on such scapegoats as greedy businesses, powerful labour unions, big oil companies, or foreigners. But this is a ruse – a diversionary tactic. Persistent inflation has a single source: rapid growth in the supply of money."

"The key to price stability is straightforward: control the growth of the money supply. Each country's monetary authority, typically a central bank directed by politically appointed officials, needs to be held accountable."

"Money can only maintain its buying power when an increase in the money supply is matched by an equivalent increase of the supply of real goods and services. Central banks often set interest rates at artificially low levels supposedly to stimulate growth. These low interest rates cause demand for loans to increase excessively and the money supply to expand at a faster rate than the real economy. This results in fast growing amounts of money chasing slowly growing quantities of goods causing prices to increase, i.e. inflation."

There; that's all you need to know. People (including economists!) get confused about inflation, I think, simply because the word 'inflation' itself is misused a lot and, all too often, the context in which inflation is being commented on is not made explicit or clear enough.

For instance, is it *monetary* activity or *price* activity that we're talking about? The first is the cause and the second is the effect of inflation. Just like wet streets are caused by rain and not the other way around, price increases are the effect of inflation and not the other way around.

In other words, it's not that there is inflation because prices are increasing; instead, prices increase because there is inflation in the first place. And that inflation is the monetary inflation caused by excessive growth in the money *supply* by central banks.

What Causes Price Changes?

Supply and demand does. In economics, supply and demand describes market relations between prospective sellers and buyers of a good. The supply and

demand model determines price and quantity of that good sold in a market. This model is fundamental in economics and is used as a foundation for many economic models and theories. It predicts that in a competitive market, price will function to equalize the quantity demanded by consumers and the quantity supplied by producers, resulting in an economic equilibrium of price and quantity.

So, what then can we say about how this supply and demand model applies to money? Money is different; it's not a good as such but a means of exchange. Nevertheless, with reason, we can see that the same common sense can apply to the price of money as such. As a currency depreciates (because there is too much of it in the system or people start losing faith in the ability of the issuer to pay its debts or other reasons), the price of things expressed in that currency go up.

So, what causes prices to *increase*? It's an increase in the money supply and credit, by central and commercial banks, beyond what is required to maintain price stability. There; simple, eh? OK, that covers money *supply*. Well, what about money *demand*? Aha! Now, there's an interesting subject... Let's take a closer look at it.

Money Demand and Velocity

You won't find much at all written or, more importantly, that is being written these days about what money *demand*, as opposed to money *supply*, actually is. After all, any other commodity's price (oh, oh, I'm implying here that money is a commodity; well, actually, **real** money is... but not fiat money or currencies or what is generally considered today to be 'money') is determined by supply and demand. So, normally, both supply and demand are reported and closely analysed and monitored. But no, not money demand! Hummm... Gee, I wonder why?

In fact, you'll probably find even less to read about what the *velocity* of money is... The what? Velocity; it's another important economic concept associated with understanding how money works or how the demand for any given currency affects prices expressed in that currency. So, let's get right into it then!

One of the many sources of research that I subscribe to, in order to develop my own ('freethinking') view of how the world is going, is a monthly newsletter called *Early Warning Report (EWR)*, by Richard Maybury in the US. It is mostly geostrategic, although he also occasionally goes into economics. His opinions are at times pretty extreme, to say the least. But I consider his way of seeing things interesting and it is one of the many pieces I have available to use, or not, from time to time, in developing my own changing mosaic view of the world. Maybury's website is www.chaostan.com, should you be interested.

The latest issue of EWR had much to do about money demand and velocity. But this was not the first time he wrote about this complex topic. In fact, he even wrote a number of short essays that treat the subject in as simple terms as possible: 'The Money Mystery', 'Whatever Happened to Penny Candy?' etc. You can find those books on Amazon quite easily, if you're interested.

I have Maybury's permission to make copies of his latest EWR and pass them along to you, dear readers, should you be interested. That's how critical he

thinks one's understanding of this subject is for one's financial survival in these turbulent and uncertain times. So much of what follows is actually his way of thinking about this stuff, but I found it to be a useful tool and maybe you will too.

Very Nebulous Subjects...

Velocity and money demand are very nebulous subjects. There is little reliable data to shed light on them. What you are about to read is not science, but educated and experienced guesswork. One has to be intuitive when trying to understand, let alone explain, velocity and money demand...

During times when velocity is stable, you can pretty much ignore it and so, you don't really need to understand it. But when it becomes erratic, as I think it now has, a deeper understanding is helpful. So, what is velocity? Velocity is the speed at which money changes hands. It is a measure of demand for money. For the sake of simplicity, let us assume here that there is only one currency in existence, the US dollar, and that it actually is money.

When people are reluctant to *spend* their dollars, demand for the dollar is up and the speed with which money changes hands is reduced: money demand up, velocity down. On the other hand, when people are more willing to spend, money demand is down and the money changes hands more quickly: money demand down, velocity up.

When we spend, the money is in circulation, helping to drive prices up. If we don't spend, it's as if the money was taken out of circulation and hidden (or *hoarded*, if you prefer). Money that's circulating more slowly is creating less demand for goods and services and less pressure to drive prices up. Clearly, a dollar that participates in no transactions has no effect on prices. One that participates in twice as many transactions as some other dollar has twice the effect on prices.

Are you with me so far? OK, good; let's continue then...

The Three Stages of Inflation

Inflation typically goes through three stages, according to Maybury. In the first stage, **prices do not rise as fast as the money supply**, because people don't know what's happening. Some delay their spending in the hope that prices will fall back. In effect, they take some money out of circulation as the government or central bank is pumping it in.

In the second stage, many people have caught on and are spending their money quickly. **Prices now rise faster than the money supply** because each unit of the money is changing hands faster. Many people want to get rid of dollars quickly and are willing to accept less for them.

In the third stage, the 'runaway', **the whole population is in a panic to get rid of the dollars** as soon as they get their hands on them. The money then declines to its real or intrinsic value, which is the value of scrap paper...

In other words, in Stage 1 the currency is not losing its value very fast because people still trust it. In Stage 2, the currency is in trouble. In the last half of Stage

2, it's circling the drain... And in stage three, well, it goes down the drain!

Let's recap, shall we? Velocity is the speed at which money changes hands; it's a measure of the *demand* for money. We know velocity exists because we know demand for money exists. I want money, you want it, and so does everybody else. But although money *supply* is a big public issue, money demand and velocity seem not to be. Why? Good question.

Velocity is (and, it seems, must remain) a mysterious thing... But Maybury observes that if the following two conditions exist at any point in time, it seems reasonably certain money demand, on average, is falling and velocity is rising:

1. Prices are rising faster than the money supply is; and
2. Many people are expressing a fear of holding onto their money.

OK, let's put all that in the context of today's monetary conditions now. Are you ready? Let's go!

All Together Now

During the 1970s inflation, the global velocity of the US dollar was unhinged by US President Richard Nixon's economic bungling in 1971 (when he severed the only remaining link of the global monetary system with gold), it then probably peaked in 1979 when there was a global panic to dump US dollars (which was mostly reported in the media then as an oil crisis; but it was, in fact, a US dollar crisis) and it stayed erratic until the early 1990s.

It is becoming erratic again. Most Americans, it seems, are just now catching on to what has long been widely understood outside the US. Fears of a long recession are now greater in the US than in the rest of the world and so, the US is probably still in Stage 1 whilst the rest of the world seems to already be in the first half of Stage 2 (referring to the above three stages of inflation outlined by Maybury).

We already know that, since the Global War on Terror (it sounds so much better than WWII...) began, the US dollar price of most if not all raw materials or commodities (and a great many other things we consume) has risen dramatically. Now, people who are close to the commodities/currencies markets are reporting that some governments and super wealthy individuals are actually trying to get out of their US dollar holdings. Demand for US dollars down; velocity (and prices, in US dollars) up.

It therefore seems likely, as Maybury suggests in his latest EWR letter that the Stage 2 pressure that already exists outside the US will gradually force itself inside the US, as more and more foreigners refuse to accept US dollars as payment. What will the US hegemonic power do then? Scary...

Be Wealthy; Stay Out of US Dollars

That's right; the single most important thing to realise right now, if you want to cope with the rising velocity of the US dollar, is that having a lot of it (what was once considered 'as good as gold' and is now increasingly considered to no

longer be 'real' money) isn't the same thing as being wealthy. Money itself is not wealth. Money is just the tool we use to measure and trade wealth. Wealth is real stuff.

"The best investments in 2008," Jim Rogers said in Shanghai earlier this week, "are commodities and natural resources. Agricultural prices have much higher to go over the next decade. We have a shortage of everything, including seeds." Rogers, speaking at a conference in Nanjing, provided a myriad of forecasts, including: "Crude oil prices are not high enough to stop people from consuming more energy... the bull market will not go to an end until supply and demand come to a balance."



*Photographer: Charles Pertwee/Bloomberg News
Source: www.bloomberg.com*

Stay out of the dollar "at all costs," he added! That man has been right since 2000. I suspect he still is. Why? He's proven himself many times as a guru with the Quantum Fund in the 1970s, when he worked with George Soros. Now, he stands alone and does not represent anyone or anyone else's beliefs but himself and his own. He's a true freethinker; I like that, a lot. I look forward to being in Vancouver later this month to hear him speak at another conference and, hopefully, even get to meet him. Go Jim!

The Fed keeps inflating so strongly (just this year, to date, it doled out over US\$1 Trillion into the system with the new Term Auction Facility and Term Securities Lending Facility it created for commercial banks and financial institutions to borrow US dollars or Treasury notes on advantageous terms, so they can have the capital they need to remain solvent without having to go to market!), that it is now fast losing credibility.

Only a replay of what Paul Volcker (one of Ben Bernanke's predecessors as Fed Chairman) pulled in 1979-1980 can save the Fed and the US dollar now. But don't count on it; it won't happen any time soon... After all, there's a presidential election in the US this year... So US interest rates will probably remain excessively low (in fact, below the inflation rate, making them negative real rates!) until the end of the year and the price of things priced or traded in US dollars (like oil) will continue to go up in the meantime.

Fiat Money v Real Wealth

In summary, this is what is most important for you to keep in mind as we sail through this financial storm: the difference between money and wealth. Remember that by 'money' here (in this Issue), I mean what is generally considered to be money, i.e. fiat currencies like the US dollar (or any other currency on the planet, for that matter).

I don't mean **real** money, like gold and silver bullion. That actually **is** wealth and a real store of value. The Fed's excess US dollars will chase anything that is 'hot', meaning anything for which *demand* is far greater than its *supply*. In the 1920s and the 1990s, it was shares; after 9-11, it became housing. Now, it's oil and food; next, it'll be precious metals (gold, silver and platinum bullion).

It's not 'money' that makes life better; it's wealth. You don't want to have a lot of 'money'; you want wealth. In Stage 1 of an inflation, to have 'money' and to be wealthy are the same thing. In Stages 2 and 3, according to Maybury, having a lot of 'money' is sure to lead to *less* wealth. Central banks have simply created too much 'money' out of thin air, as they continued to serve the greedy needs of governments and banks.

And what do governments and banks actually do with all that 'money' exactly? Well, they trade it for real wealth; for valuable goods and services. Be a wise investor and **do the same!**

"Inflation can be pursued only so long as the public still does not believe it will continue. Once the people generally realize that the inflation will be continued on and on and that the value of the monetary unit will decline more and more, then the fate of the money is sealed. Only the belief, that the inflation will come to a stop, maintains the value of the notes."

*- Ludwig von Mises
(1881 – 1973)
Austrian Economist, philosopher and a major influence on the modern
libertarian movement*

Your freethinking investment strategist, acknowledging Richard Maybury's significant contribution to the contents of this Issue and encouraging you to buy at least one of his books or visit his web site: www.chaostan.com

Louis Boulanger, CFA
Louis Boulanger Now Ltd.

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