Private Wealth Advisory
A Phoenix Capital Research Publication

# Back Into the Fire

© 2013 · Phoenix Capital Research, OmniSans Publish, LLC. All Rights Reserved. Protected by copyright laws of the United States and international treaties. This newsletter may only be used pursuant to the subscription agreement and any reproduction, copying, or redistribution (electronic or otherwise, including on the world wide web), in whole or in part, is strictly prohibited without the express written permission of OmniSans Publishing, LLC. · All Rights Reserved.

Disclaimer: The information contained on this newsletter is for marketing purposes only. Nothing contained in this newsletter is intended to be, nor shall it be construed as, investment advice by Phoenix Capital Research or any of its affiliates, nor is it to be relied upon in making any investment or other decision. Neither the information nor any opinion expressed on this newsletter constitutes and offer to buy or sell any security or instrument or participate in any particular trading strategy. The information in the newsletter is not a complete description of the securities, markets or developments discussed. Information and opinions regarding individual securities do not mean that a security is recommended or suitable for a particular investor. Prior to making any investment decision, you are advised to consult with your broker, investment advisor or other appropriate tax or financial professional to determine the suitability of any investment. Opinions and estimates expressed on this newsletter constitute Phoenix Capital Research's judgment as of the date appearing on the opinion or estimate and are subject to change without notice. This information may not reflect events occurring after the date or time of publication. Phoenix Capital Research is not obligated to continue to offer information or opinions regarding any security, instrument or service. Information has been obtained from sources considered reliable, but its accuracy and completeness are not guaranteed. Phoenix Capital Research and its officers, directors, employees, agents and/or affiliates may have executed, or may in the future execute, transactions in any of the securities or derivatives of any securities discussed on this newsletter. Past performance is not necessarily a guide to future performance and is no guarantee of future results. Securities products are not FDIC insured, are not guaranteed by any bank and involve investment risk, including possible loss of entire value. Phoenix Capital Research, OmniSans Publishing LLC and Graham Summers shall not be responsible or have any liability for investment decisions based upon, or the results obtained from, the information provided. Phoenix Capital Research is not responsible for the content of other newsletters to which this one may be linked and reserves the right to remove such links.

OmniSans Publishing LLC and the Phoenix Capital Research Logo are registered trademarks of Phoenix Capital Research. OmniSans Publishing LLC - PO BOX 6369, Charlottesville, VA 22906

## Back Into the Fire

The situation in the global economy continues to worsen.

China's credit-fueled bubble economy is falling to pieces before our very eyes.

Between 2008 and 2013, China's credit market increased from $9 trillion to an incredible $23 trillion.

To give this number some perspective, China's GDP is a little over $7 trillion. So China today has a credit market well north of 300% of its GDP.

There is simply no other way to view this than as a bubble. Indeed, we see all of the clear signs of a bubble in the real estate markets today with countless ghost cities, massive empty malls, and other excess capacity.

What's truly stunning to witness however, is the fact that in spite of all of this expansion in credit, China's GDP growth continues to fall.

Indeed, GDP is now trending downwards for the first time in a decade. China's Government has realized that this is a major problem for the country and so has announced that "GDP is no longer a measure of success."

This is an incredible admission from the Chinese Government as everyone on the planet knows China's GDP measure has been a work of fiction for decades. The fact that GDP growth is slowing in spite of all the manipulation of the metric is a major sign that

JULY 3, 2013

### SHORT-TERM ISSUES

- China's liquidity crisis approaches its "Lehman" moment.
- PIIGS debt back in duress with Portugal rates soaring.
- US stock market topping out

### INTERMEDIATE-TERM ISSUES

- European Crisis worsening.
- US economic data to worsen.
- An autumn market Crash?

### LONG-TERM ISSUES

- Central Banks to lose credibility.
- Scramble for quality collateral to accelerate.
- Debt defaults in the EU and Japan then finally the US.
- Global inflationary storm.

Phoenix
CAPITAL RESEARCH

things are sharply turning for the worse in the People's Republic.

Indeed, we get additional indications that China's economic data is dramatically overstated from other less massaged metrics.

China recently announced that it would be implementing a crackdown on fraudulent trade invoicing. It is not coincidence that right after this, China posted a truly horrible steel export results for the month of May: a mere 1% increase from the year before (hardly the stuff of which 8% GDP growth is made of).

Another metric is electricity usage, which increased by a mere **2.9**% in the first quarter of 2013.

So, steel exports are increasing by 1% year over year. Electrical usage increased by just 2.9% in the first quarter of this year, and the Chinese Government has announced that the world should stop looking at its GDP numbers because they are not truly indicative of the economy there.

The Government is right in saying this, though not in the way it means. China's GDP is not indicative of its true GDP growth… it's sharply *overstating* it.

Take a look at the China ETF (FXI). We've had a false breakout to the upside and are now consolidating at support on the lower trendline.

Figure 1: The tell-tale False Breakout

Once we take out this lower line, we're going to 20 or so.

This is why we're shorting China with the **UltraShort China ETF (FXP).**

Indeed, it's now clear that the Chinese banking system is fast approaching a "Lehman" moment.

One of the biggest indications of this is the fact that the mainstream media has been trying to downplay the risks of the banking system over there.

This is the same crowd that missed the 2008 Crisis as well as the housing bust. Most of them do not have the first clue about China, its economy, or its banking structure. Indeed, the biggest evidence this crowd cites that all is OK in China is the fact that China's Central Bank stated that there was "reasonable" liquidity in the Chinese banking system.

I'll counter this statement with a statement from another banker, Jean-Claude Juncker, "When it becomes serious, you have to lie."

My question here: if the Chinese banking system is under control, why is the interbank lending rate currently higher than it was in 2008 when the whole system in China was imploding? (see Figure 2 below).

A final thought on this… if China's banking system is sound and without any problems, why did the Chinese Government just make it illegal for the local media to discuss the liquidity crunch?

Speaking of crumbling banking systems… in Europe, the grand façade that all is well is also falling to pieces.

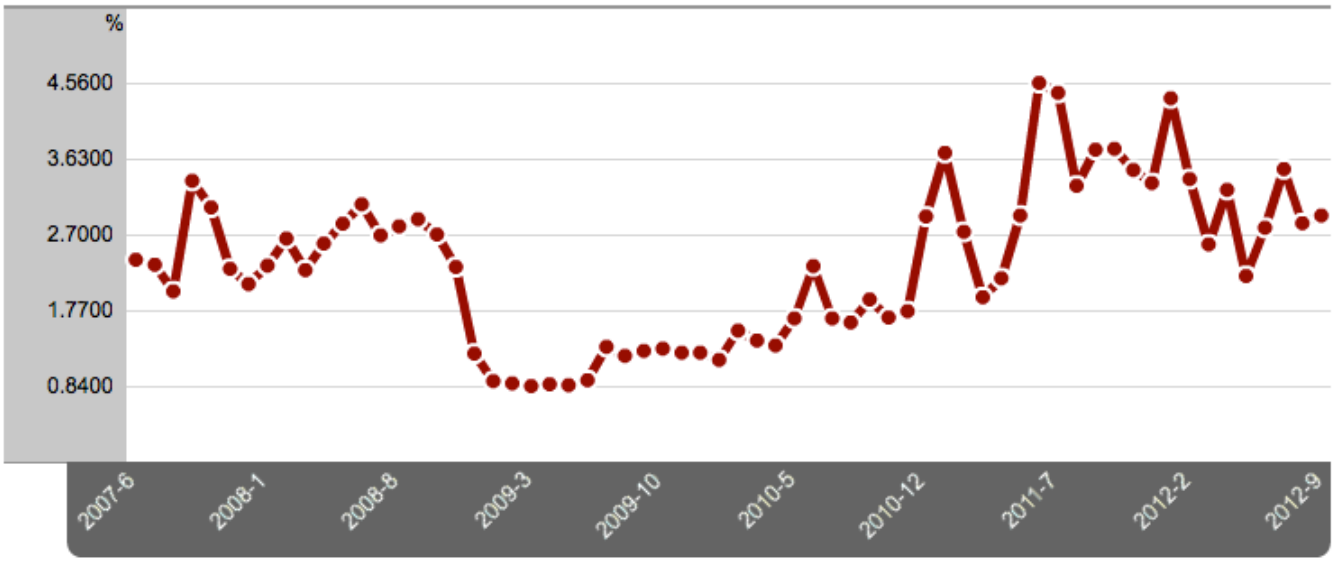


Figure 2: China interbank lending above 2008 levels

In Spain, the bad loan ratio at the country's troubled banks rose from 10.5% to 10.9% in April 2013. For perspective, the bad loan ratio in April 2012 when the entire Spanish banking system almost collapsed was just 8.7%.

Spain was supposedly "saved" by a €100 billion bailout from the EU this time last year. The country today claims that its recession is "softening" which doesn't exactly jibe with its recent admission that it is considering requesting another year before it pays back the EU bailout funds.

We've seen this same process play out over the last three years with Greece where the country was saved time and again, only to request more bailout funds while extending the deadline for it paying back older loans.

The Spanish Ibex (Spain's stock market) certainly isn't buying the "all is well" view of things. It's taken out the trendline that has supported it since August 2012 (see Figure 3 below).

We're now retesting this broken trendline. If we cannot reclaim it, the next drop will be both sharp and significant (likely down to 7000 or so).

By the look of things, our patience shorting the Spain ETF (EWP) is about to pay off.

Indeed, Spain's ten-year bond has already peaked once and is now bouncing off former resistance indicating that higher rates are coming (see Figure 4 on the next page).

Figure 3: The "Spain is saved" rally is ending.

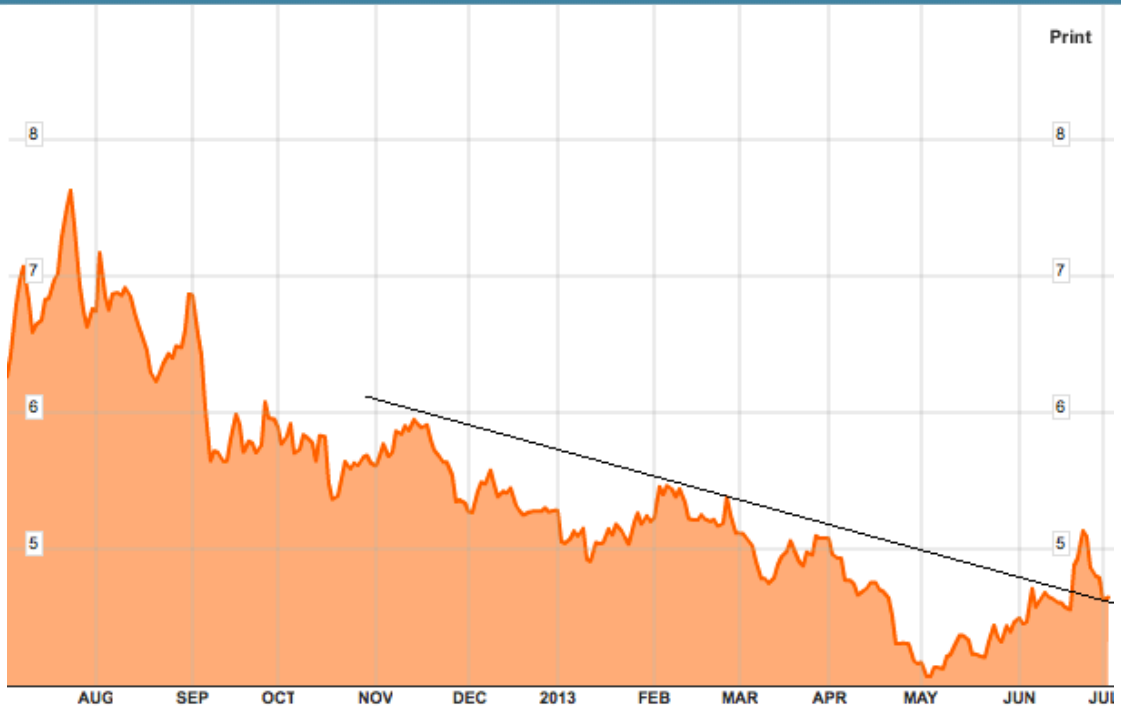


Figure 4: Spain's 10 year yields peaked and is now ready for its next leg up.

Figure 5: Portugal's 10-year yield breaks back above the dreaded 7% again.

This same mess is playing out in Portugal though that country is much closer to the brink with interest rates on its ten year bonds breaking above the dreaded 7% line (see Figure 4 on the above page).

Portugal has proven point blank that the various "solutions" proposed by EU politicians (namely austerity and tax hikes) are ineffective at dealing with the debt crisis.

The reason for this is that austerity cannot possibly work in a socialist environment (Portugal has been socialist since the mid-70s) as most of the "jobs" are based on Government spending. Cut Government spending and inevitably the economy falls and unemployment rises.

To whit, Portugal has been implementing austerity measures since it received a bailout from the EU in 2011. Not only has the country failed to meet the EU's deficit requirements (prompting the usual request for an extension) but Portugal has also experienced two straight years of recession (2013 is expected to be the third) and its unemployment has risen to a record 18%.

I think Europe will soon be on the brink of collapse. At the end of the day, any and all funding for Europe comes from Germany. The ECB can provide short term liquidity measures to keep the system afloat. But liquidity only goes so far when you're facing a solvency crisis.

Indeed, the key discussion for any and all of the various ECB bailout mechanisms (the ESM the EFSF and the OMT) all hinge on how much Germany will commit to their funding.

By way of example, consider that Spain and Italy, two countries that in of themselves are collapsing, are supposed to account for 30% of the ESM's capital!?!?

Without German funding, there are no bailouts. German Chancellor Angela Merkel is up for reelection in September. With that in mind, the likelihood of any more funding or bailouts coming from Germany in the near future is quite small.

This is why German banks are crumbling right alongside their PIIGS-based counterparts: see Deutsche Bank (DB) falling almost lockstep with Spanish toxic bank Santander (SAN) in Figure 6 on the next page.

Let me put all of Europe into perspective…

1) The entire European banking system is leveraged at 26-to-1 (Lehman Brothers was 30-to-1 when it collapsed).

2) The senior most assets that these banks own are EU-sovereign bonds (German, French, Spanish bonds and the like). So if any of these nations default, the banks implode. This is why the Greek bailouts have involved haircuts for a select number of entities (mainly hedge funds, NOT EU banks)

3) Backstopping this whole mess are the bankrupt nations themselves, who rely on the EU banks to buy their sovereign debts so they don't default.

Figure 6: German banks falling lockstep with the PIIGS

Figure 7: National Bank of Greece, from $7.50 to $25 and then back to $2.19

4) Above and beyond the EU sovereigns is the ECB which lies outright about the risks of the EU banking system and which doesn't account for assets or liabilities under anything resembling honest accounting standards.

Indeed, the ECB admits publicly that:

*"**Recognition of assets and liabilities***

*An asset or liability is only recognized in the Balance Sheet when it is probable that any associated future economic benefit will flow to or from the ECB, substantially all of the associated risks and rewards have been transferred to the ECB, and the cost or value of the asset or the amount of the obligation can be measured reliably."*

In laymen's terms, the ECB doesn't count something as an asset or liability unless:

1) All of the risks or rewards from the security have been transferred to the ECB.

2) The security can be measured accurately

There is a word for this kind of accounting: it's "make-believe." The EBC can literally decide if it wants to declare something an asset or a liability any which way it wants.

And this is the BANKING regulator's balance sheet we're talking about.

Anyone who wants to see how the European banking crisis will end needs to take a look at the National Bank of Greece (NBG in Figure 7 on the above page.)

As you can see, in the last year, the National Bank of Greece rallied from $17.50 to $32.50. It then collapsed to $7.50. It then exploded upwards to $25. And now it's crashed back down to $2.91.

This is what systemic failure looks like: white knuckle rallies on proclamations that "the crisis is over," followed by gut-wrenching crashes to unheard of lows.

Europe is finished. It has been for well over a year now. The monetary authorities and politicians pulled out all the stops staving off a systemic collapse last Spring. So whenever things get nasty this time around, there will literally be nothing they can do.

With that in mind, I'm keeping an eye on the EU financials ETF (see EUFN in Figure 8 on the next page).

As you can see, we've just taken out the trendline that has supported EU financials since August last year. We are now rallying to retest this line. If EUFN turns sharply downward now then the EU banking system is officially back in Crisis mode.

My point with all of the above is that:

1) China, which has been the single biggest driver of global GCP growth for the last five years is beginning to show signs of a credit bubble bursting. The mainstream media is trying to downplay the risks to this, but I believe China could prove the Black

Figure 8: The EU is saved rally is ending.

Swan that catches the financial system off guard.

2) The EU is rapidly descending back into Crisis mode. Considering that there is literally *no* extra capital lying around to prop the system up much longer, as soon as things really heat up over there we're heading for systemic failure.

In the US we continue to get confirmations of another recession with the ISM report posting the worst employment numbers since September 2009.

Similarly, the Chicago PMI collapsed from 58 to 51. This is the single largest decline in four years.

We get additional confirmation of economic difficulties from corporations with 87 companies in the S&P 500 putting out negative guidance. Coming on the heels of a report that corporate profits fell 7.9% in the first quarter of 2013, this does not bode well for the economy.

US hourly wages fell at their fastest pace since 1947. Real disposable income is falling at rates last seen right after Lehman failed in the third quarter of 2008.

And on and on.

However, out of all of the data coming out,

nothing looks as poorly as the collapse in housing industry.

Housing is ultimately about mortgages (few, if any, people can buy homes in cash). So a collapse in mortgage applications usually signals a collapse in housing.

With that in mind, mortgage applications have fallen in seven of the last eight weeks falling 29%. In fact just last week we just posted the single largest drop in mortgage applications since *June 2009*.

Mark Hanson is a great housing commentator I follow. He recently noted that three large private mortgage bankers he follows just announced mass layoffs of 25-50% of their operations staff.

With that in mind, homebuilders are looking ripe for a collapse. The most obvious candidate is DR Horton (see DHI in Figure 9 below).
DHI has a market cap of $6.7 billion and over $3.2 billion in debt. It is the debt load that is fast outpacing profits.

Indeed, homebuilding debt for the company was just $1.6 billion in March 2012. Today a mere year later, it's over $3 billion.

Over the same time period, operating profits only increased 4% from $175 million to $182 million.

Figure 9: DR Horton ready for a drop

And as you can see, DHI's chart is ripe for a drop to $12.

Let's ride this one down.

**Action to Take: Short DR Horton (DHI).**

I realize many of you would like me to have a few long positions for this week, but the problem is that there are very few good long opportunities in the markets right now.

The economy is contracting, corporate profits are falling, Central banks are losing their grip on the markets… none of these bodes well for a bull market.

Against this backdrop there are few opportunities for big profits to the longside. One of the few is Cotton which we were obviously early on, but which is starting to show signs of life (see Figure 10 below).

Another sector that really interests me is Gold miners.

This has been one of the hardest hit sectors in the last year. Most if not all of them are extremely oversold. And when you consider the price performance of miners relative to that of Gold, the collapse is incredible (see Figure 11 on the next page).

While we have yet to hit a bottom here, many mines are priced at ridiculously cheap levels. Obviously we were very early in buying some of them, but the fact of the matter remains that this is one of the better long plays out there.

Figure 10: Cotton is preparing for a breakout to the upside

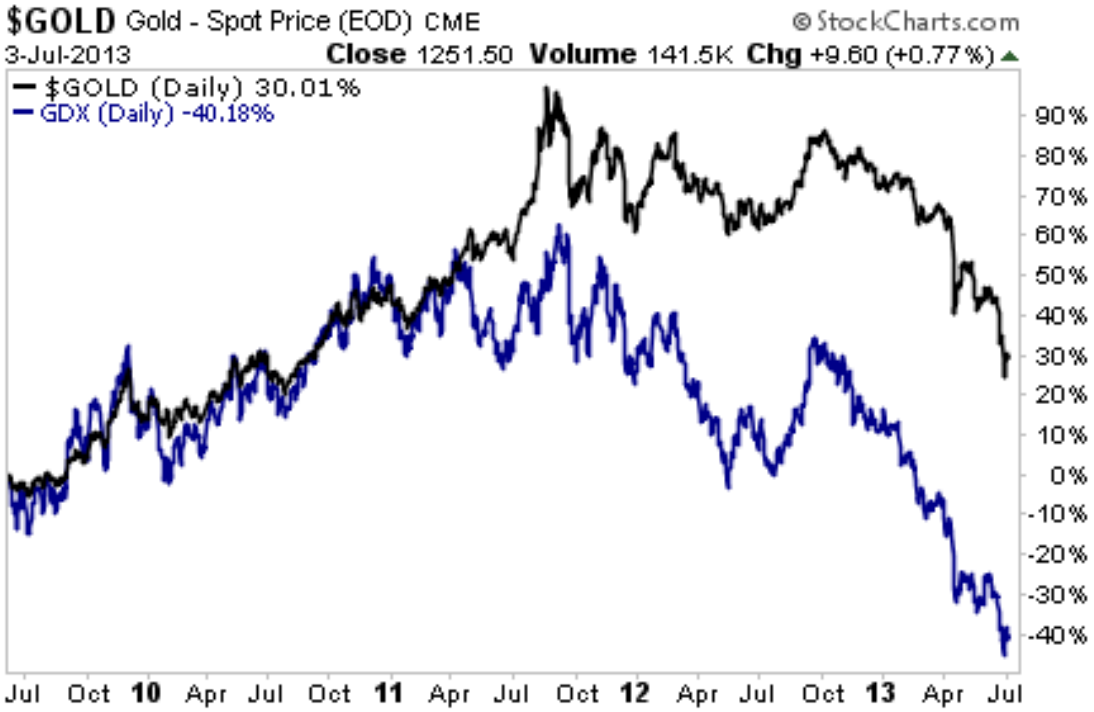


Figure 11: Gold miners implode

The industry is absolutely hated. All we need is a significant bounce in Gold prices and miners will absolutely explode higher.

This concludes this week's issue of ***Private Wealth Advisory***. Barring any new developments you'll next hear from me on Wednesday July 17. Until then…

Best Regards,

Graham Summers
Chief Market Strategist
**Phoenix Capital Research**

# OPEN POSITIONS

## LONG PORTFOLIO *

| POSITION | SYMBOL | BUY DATE | BUY PRICE | CURRENT/ SELL PRICE | GAIN/ LOSS |
|---|---|---|---|---|---|
| Gold | | 3/17/10 | $1,120 | $1,251.00 | 12% |
| Silver | | 3/17/10 | $17.50 | $19.72 | 13% |
| Rogers Agircultural | RJA | 8/17/12 | $9.80 | $8.36 | -15% |
| Soybeans ETF | SOYB | 12/17/12 | $25.18 | $23.65 | -6% |
| Asanko Gold | AKG | 4/25/13 | $2.66 | $2.13 | -20% |
| Richmont Mines | RIC | 4/25/13 | $2.06 | $1.45 | -30% |
| Vista Gold | VGZ | 4/25/13 | $1.65 | $0.98 | -41% |
| Exeter Resources | XRA | 4/25/13 | $0.93 | $0.74 | -20% |
| Uranium ETF | URA | 5/28/13 | $18.14 | $16.82 | -7% |
| Cotton ETF | BAL | 6/11/13 | $56.36 | $54.55 | -3% |

*** Prices as of market's close 07/3/13**

## SHORT PORTFOLIO *

| POSITION | SYMBOL | BUY DATE | BUY PRICE | CURRENT/ SELL PRICE | GAIN/ LOSS |
|---|---|---|---|---|---|
| Ultra Bullish Dollar ETF | UUP | 5/23/11 | $21.79 | $22.57 | 4% |
| Rydex U2X Dollar strategy | RYSDX | 12/14/11 | $14.39 | $14.33 | 0% |
| UltraShort Euro ETF | EUO | 6/25/12 | $21.45 | $19.40 | -10% |
| France ETF (SHORT) | EWQ | 10/1/12 | $21.39 | $23.20 | -8% |
| Spain ETF (SHORT) | EWP | 11/14/12 | 26.93 | $27.89 | -4% |
| UltraShort Russell 2000 | TWM | 12/21/12 | $25.70 | $17.41 | -32% |
| UltraShort Materials | SMN | 12/21/12 | $55.40 | $52.68 | -5% |
| Healthcare ETF (SHORT) | IYH | 5/1/13 | $98.57 | $100.33 | -2% |
| Retail ETF (SHORT) | XRT | 5/1/13 | $72.52 | $77.59 | -7% |
| Australian Dollar ETF (SHORT) | FXA | 5/28/13 | $96.57 | $90.84 | 6% |
| China Real Estate ETF (SHORT) | TAO | 6/11/13 | $20.11 | $20.01 | 0% |
| UltraShort China | FXP | 6/20/13 | $25.60 | $24.84 | -3% |
| Cemex (SHORT) | CX | 6/20/13 | $10.03 | $10.36 | -3% |
| DR Horton (SHORT) | DHI | 7/3/13 | $20.96 | NEW | SHORT! |

*** Prices as of market's close 07/3/13**

## RECENTLY CLOSED POSITIONS

| POSITION | SYMBOL | BUY DATE | BUY PRICE | SELL DATE | SELL PRICE | GAIN/ LOSS |
|---|---|---|---|---|---|---|
| UltraShort Brazil ETF | BZQ | 6/11/13 | $84.50 | 6/19/13 | $91.35 | 8% |
| Timber ETF (SHORT) | CUT | 4/3/13 | $22.46 | 6/24/13 | $20.86 | 7% |
| Biotech ETF (SHORT) | BBH | 5/1/13 | $69.07 | 6/24/13 | $65.01 | 6% |
| Russia ETF (SHORT) | TRF | 6/25/12 | $13.89 | 6/25/13 | $13.23 | 5% |