Private Wealth Advisory

Investment Research That Converts

The "Free Lunch" Trade

The "Free Lunch" Trade

I'm publishing this month's longer issue of ***Private Wealth Advisory*** a week early.

The reason is that I intend to take next week off. As a result, we won't be publishing our usual weekly market update next Wednesday.

I *will* be monitoring the markets and providing updates if needed. However, given that the vast majority of Wall Street will be away from their desks next week, the action *should* be muted.

So I urge you to enjoy this time with family and friends. It's been a heck of a year, and 2017 is shaping up to be even *more* interesting.

Let's dive in.

The financial media, social media and investing public are obsessed with one item and one item only:

Dow 20,000.

All other items have become secondary to whether or not the DOW can hit this arbitrary level (Dow 20,000 is no more relevant than Dow 19,980).

This move is being driven by what I call "the Free Lunch" trade: that being the ongoing collapse of the Japanese Yen.

Anyone who believes that the Yen can fall as much and as quickly as it has without creating a crisis in the financial system is essentially believing that the markets are offering a "free lunch": a reward without cost or consequence.

December 21 2016

SHORT-TERM ISSUES

- Dow 20,000?
- A correction, possibly a crisis.
- China stages a sharp Yuan devaluation?
- Emerging Markets, US stocks, $USD to fall, bonds to rally.

INTERMEDIATE-TERM ISSUES

- Precious metals to begin their next major leg up.
- The Euro primed for a move to 121 as ECB ends QE.
- Emerging Markets ready for new bull market.

LONG-TERM ISSUES

- Excessive debt, bad demographics, and little if any deleveraging.
- Eventual market collapse of 50%+ in real terms.
- A scramble for high-end

Phoenix
CAPITAL RESEARCH

We've been in precisely this situation in 2000 and in 2007 when investors believed that the Tech bubble and Housing Bubble could somehow continue without consequence.

We all know how those situations turned out.

Now, some of you are likely asking, "*wait a minute, Graham, you were bullish on stocks and believed inflation was about to hit just a few weeks ago."*

Yes, that was a few weeks ago. What has happened in the last six weeks changed *EVERYTHING*.

Let me explain…

Think of the stock markets like a person's chest muscle group and upwards price action like doing a bench press.

When stocks go straight up for some time, it's like an athlete doing a number of reps on the bench press. No matter how strong the individual is, eventually he or she becomes fatigued and needs to "rack the bar" and give his or her muscles a rest before continuing with the work out.

A market rally in which stocks go almost straight up is similar in nature: at some point the market needs to consolidate or "rest" before continuing. From a technical standpoint, "resting" means shaking out some of the hot money and putting in a base before buyers move in again.

However, if investors continue to push stocks ever higher *despite* momentum waning, it's as if our hypothetical athlete continues to bench press the weight *despite* exhaustion.

At some point (and it's impossible to tell precisely when) the weight becomes too much and our athlete is at risk of being trapped under the bar or experiencing serious injury.

This is precisely what has happened in the markets in the last six weeks. Up until that point, we were in a kind of "risky place," but if the ongoing trend had taken a break or ceased (i.e. the Japanese Yen had stopped collapsing/ exporting a tidal wave of deflation Westwards) we likely would have been fine.

This has not been the case.

Instead the Yen has continued to collapse. If anything the collapse has accelerated. With this in mind, I believe there is a 100% chance stocks will soon drop *HARD.*

Whether it results in a full-scale Crash remains to be seen.

- If the Crisis comes in the form of a one off large devaluation in the Chinese Yuan, the answer is "yes"… stocks will crash and the system will face its first real test since the EU sovereign debt crisis of 2012. I put the odds of this at 30%.

- If, instead, the Crisis is the result of a mid-sized devaluation of the Yuan or some other non-major issue, the markets will likely dive 10% or so, put in a base, and then begin their next leg up. I put the odds of this at 70%.

Regardless of which outcome unfolds, I think stocks will be hit hard in the next three months.

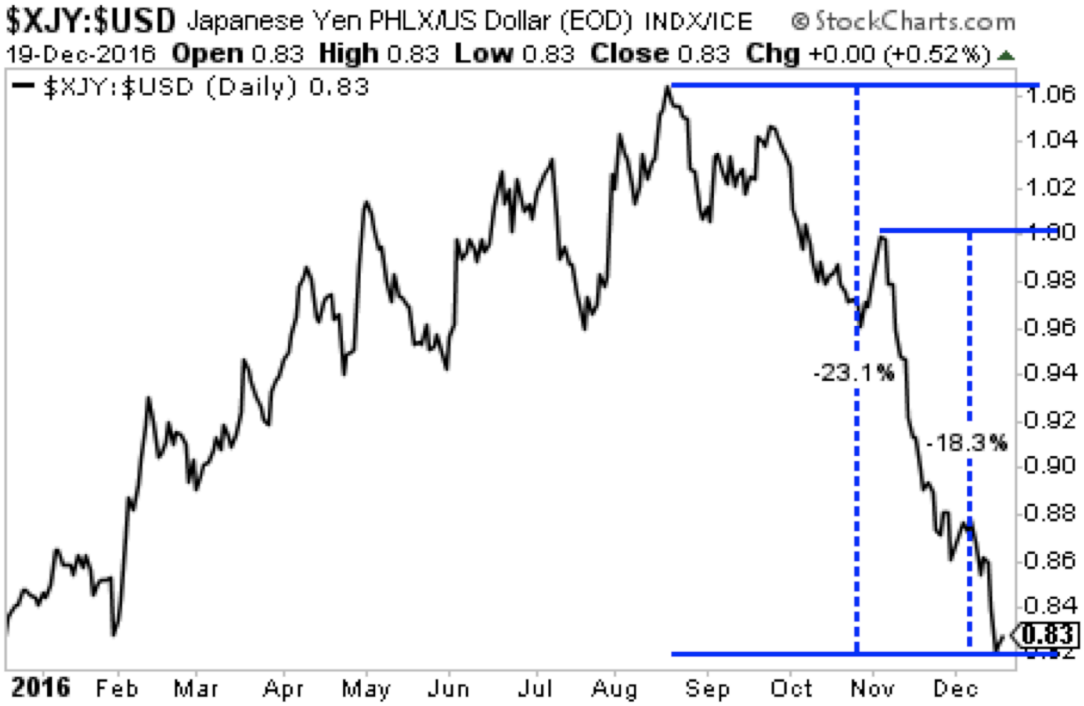
The driving forces behind this consists of three major items… all driven by the Bank of Japan's devaluation of the Yen and its secondary effects.

They are:

1) The $USD's rally post-November 8th.
2) The excessive market reaction to the Trump Presidential win.
3) The Fed's suggested hawkishness for 2017.

No matter what anyone else claims, the fact is that the $USD rally has been largely driven by the Bank of Japan's aggressive devaluing of the Yen. Indeed, virtually **everything** that has unfolded in the financial markets since August 2016 has been driven by the BoJ's Yen devaluation.

As the below chart shows, this process began back in August 2016. However, it accelerated dramatically in the aftermath of the November 8th 2016 US Presidential election: 18% of the total 23% drop occurred starting in early November.



The BoJ started this whole issue in August 2016 when it announced that going forward it would be targeting a 0% rate for Japan's 10-Year Government Bond.

<u>What few understand is that while this policy change *does* represent a move away from Quantitative Easing (the process of printing money to buy assets) it technically opens the door to unlimited money printing/ devaluation.</u>

The fact is that if you are "targeting" a particular rate for a particular bond, this means you can print as much of your currency as you like in order to maintain said rate.

This is precisely what the BoJ has done. Starting in August, the Yen was aggressively devalued. However, this process accelerated in November.

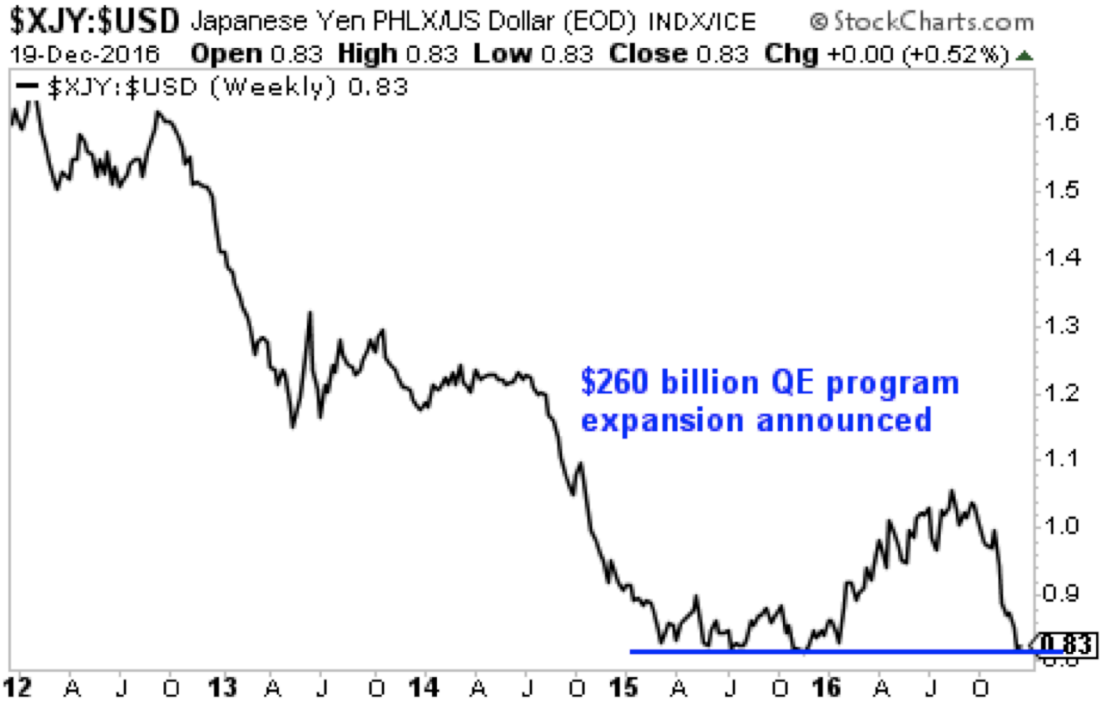
Why?

I believe the Bank of Japan is taking advantage of the brief window of time (November 8th to January 20th) during which the US Presidency is under transition. It's highly unlikely President Obama would try to stop this process. And President-elect Trump can't do anything about it (other than tweet) until January 20th 2017.

In short, we are experiencing what happens when you give a Central Banker a printing press

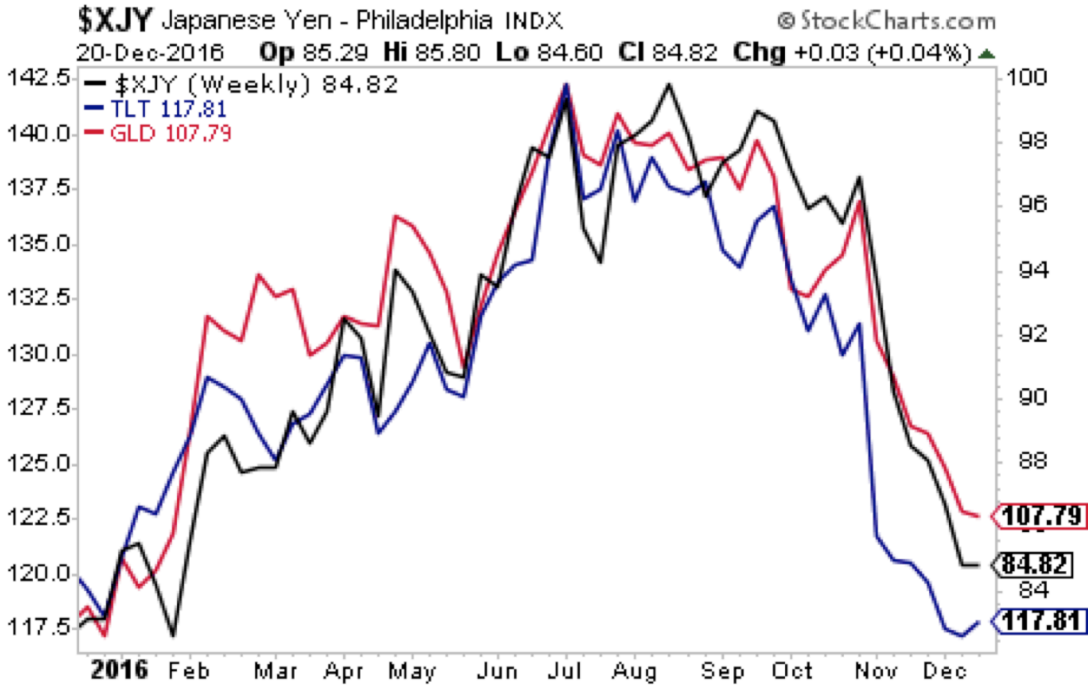
and a three-month window of time during which he or she can print money without consequence.

Indeed, the move in the Yen has been absolutely absurd, particularly since November. In a little over one month, the Yen erased an **entire six months' worth of appreciation.** Previously a move of this magnitude took six months and a $250+ BILLION expansion of a QE program.

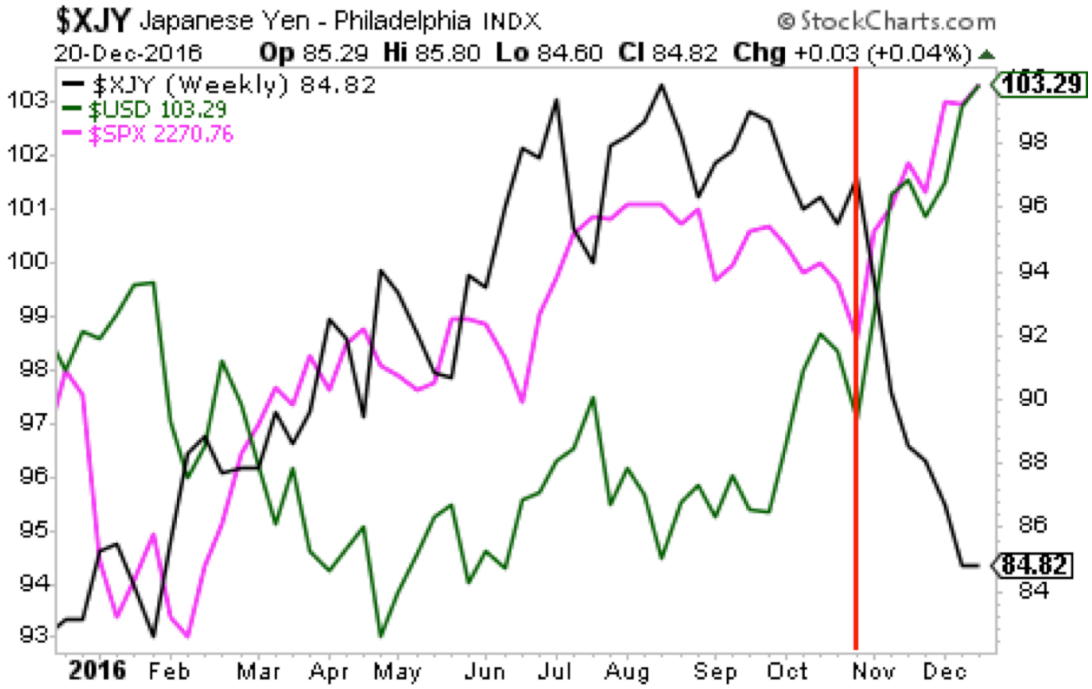


I want to be very clear here. The Yen is a funding currency for the financial markets. And this move in the Yen has had GLOBAL implications for ALL major asset classes.

The Yen devaluation has dragged down bonds (blue line) and precious metals (red line):



It has also ignited a move higher in the $USD (green line) and US stocks (pink line), particularly since late October.



Which brings us to the Trump Presidential win.

The market reaction to this event has been excessive to say the least. Trump won't take office until January 20th 2017. And he will likely not be able to engage in any of his proposed reforms until this time next year (it's possible he might be able to ram through a few bills via "reconciliation" in Congress, but the odds are likely that any major reforms will take a year).

And yet, the financial media are abuzz with the idea that somehow GDP growth of 5% is going to hit in January. And investors are acting as if they believe this!

Let's run through Trump's proposals quickly.

1) **Tax Reform**: Trump wants to simplify the tax code, lower the corporate tax rate and offer multinationals the ability to repatriate their offshore cash with a one-time tax charge of 10%.

   Long-term, all of these moves are positive for the US economy. They will increase competitiveness and will allow large firms to put more money to work in the US.

   However, NONE of these items will have a *major* impact on the markets. Yes, a lower tax rate opens the door to greater corporate profits… but:

   a. As Tom Lee noted on CNBC, NO ONE gets excited about investing in a company because said company is going to be paying less in taxes.

   b. Any benefits from tax reform would take at a minimum six months and possibly a year to really begin trickling into corporate results.

   c. More importantly, most large corporations are already paying little if any taxes due to various gimmicks and loopholes. The Government Accountability Office found that in 2012 more than 43% of large corporations (those with $10 million in assets or more) paid **no corporate income tax**.

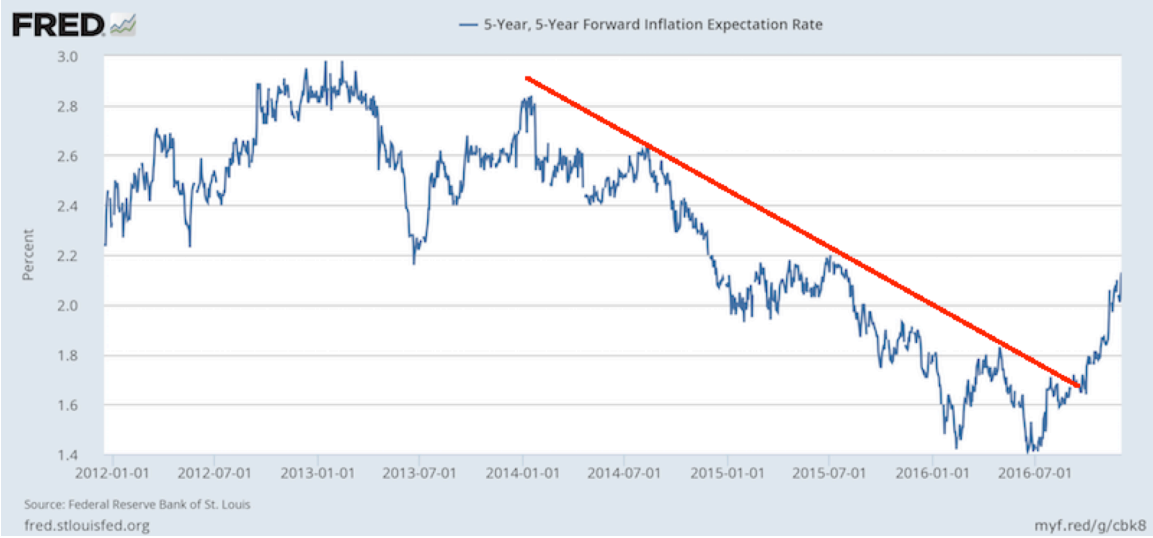
2) **Deregulation/Infrastructure Spending/ etc**.: None of these will likely be implemented until late 2017. A large-scale stimulus is a controversial measure that might not get through Congress. Even if it did, we already know such policies have minimal effect on GDP particularly late in an economic cycle (Bush's Stimulus act of 2008 and Obama's Stimulus of 2009).

<u>My point with all of the above is that any policies Trump implements will have minimal impact on stocks in the *short-term*. They CERTAINLY do not warrant the absolute mania we are currently experiencing in the stock market.</u>

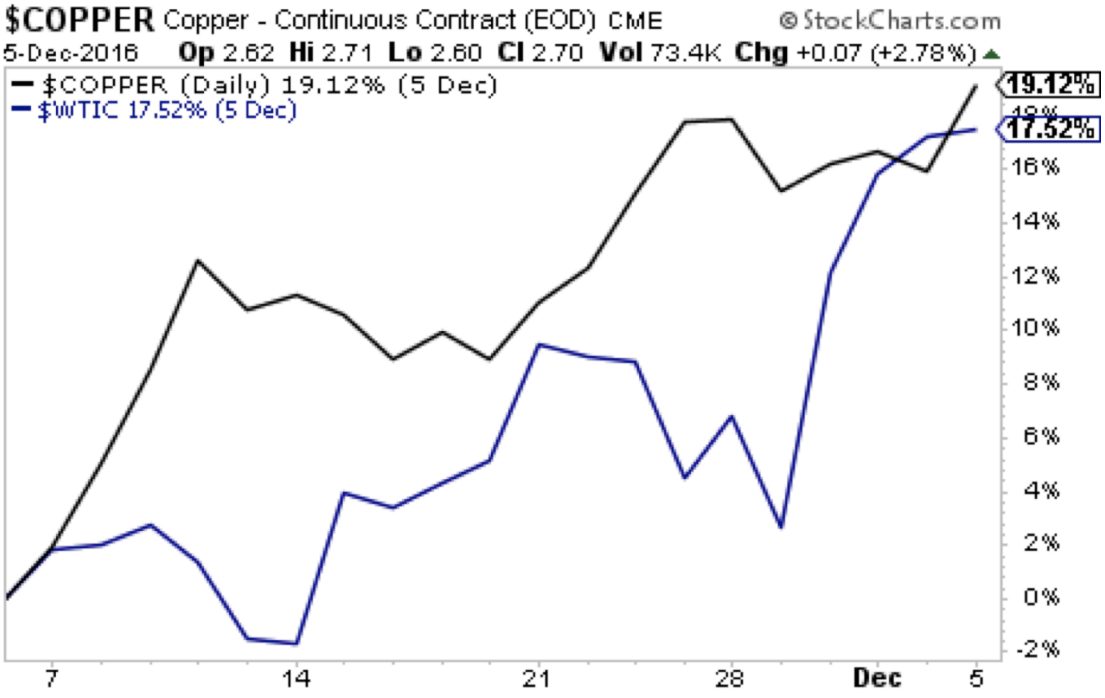
Simply put, stocks have gotten way ahead of themselves. This is particularly true for "economic growth" plays.

Consider the following…

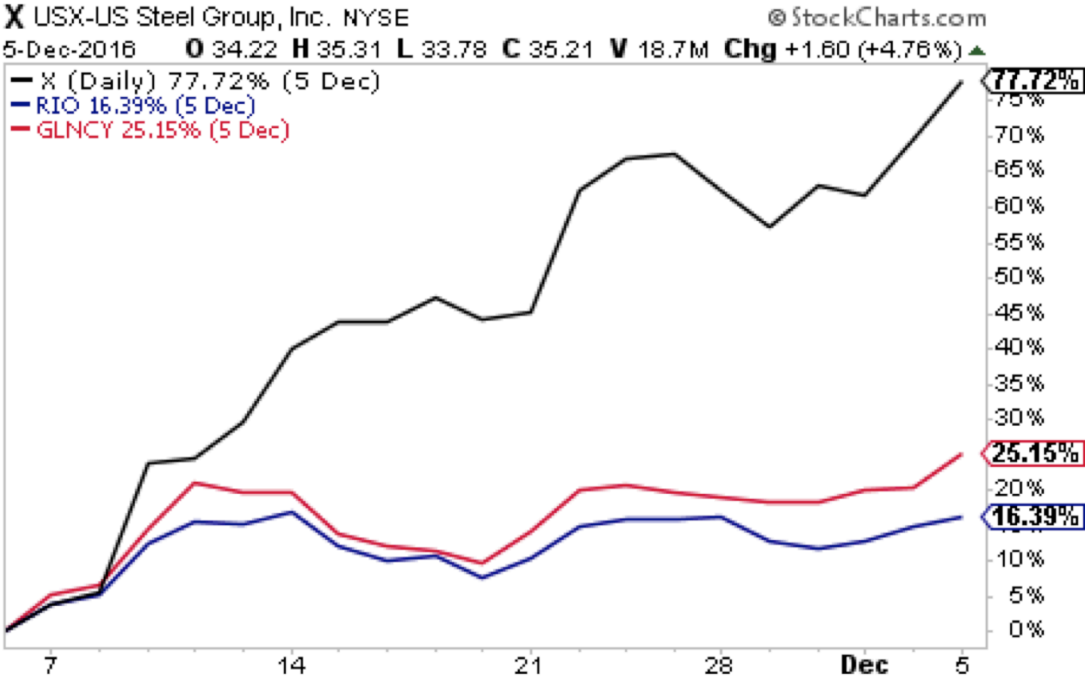
In the aftermath of the Trump Presidential win; inflation expectation soared higher, breaking out of a two-year downtrend…



Similarly, "economic growth" oriented commodities such as Copper and Oil soared…



…as did pro-growth commodity producers such as US Steel (X), Rio Tinto (RIO), and Glencore (GLNCY):



This is beyond bonkers. **We're talking about double digit price moves based on economic growth projections that we have no hope of achieving anytime in the next 12 months.**

Indeed, CNBC was actually talking about 5% GDP growth and the Dow hitting 40,000 yesterday!

What's the deal here?

In reality, the Trump rally has been driven by two things:

1) Desperate performance gaming by fund managers
2) Individual investors finally piling into stocks.

Regarding #1, the reality is that 2016 has been a horrific year for many fund managers. I don't say this to beat up on any of them. It's simply a fact. And many of them are now piling into momentum trades, specifically long US stocks, the $USD and Oil, while shorting Treasuries.

The goal here is to close out 4Q16 with the best possible returns. However, once 4Q16 ends and redemptions begin, this same group of investors will be forced to liquidate positions in 1Q17.

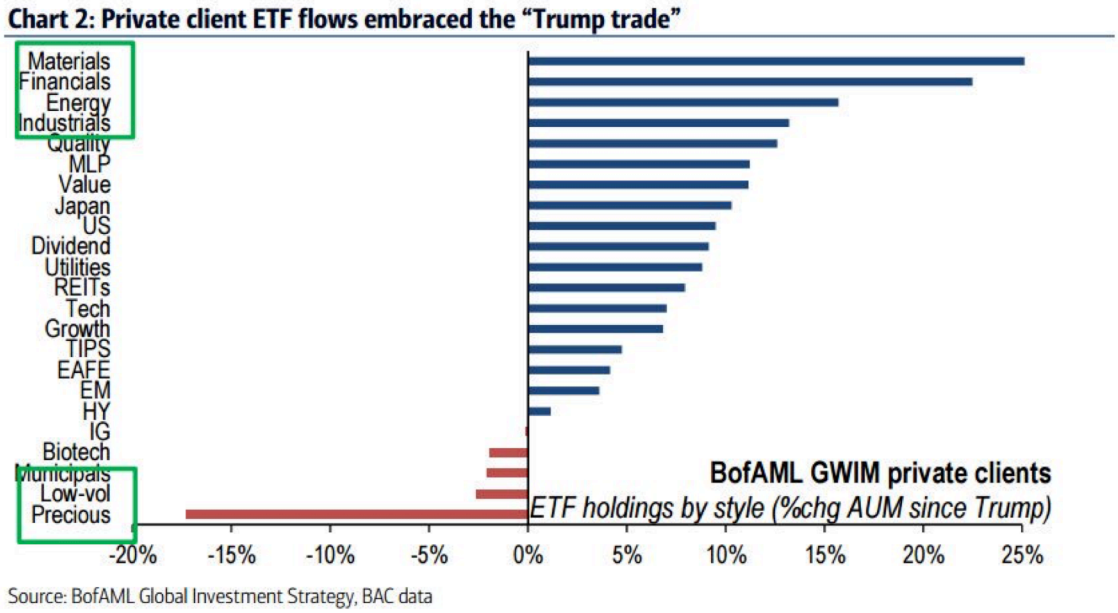
There's another group of investors piling into the "Trump growth story": individual investors.

The Trump win has accomplished something Central Banks have failed to do for seven years: pull in individual investors en masse.

According to TrimTabs, between November 8 and December 15, investors put $97 billion in US stock ETFs. Again, we're talking about nearly $100 BILLION in capital flowing into the stock market over the span of **five weeks.**

To give some perspective here, this same group of investors put just $61 billion in the same ETFs **during the entire year of 2015.**

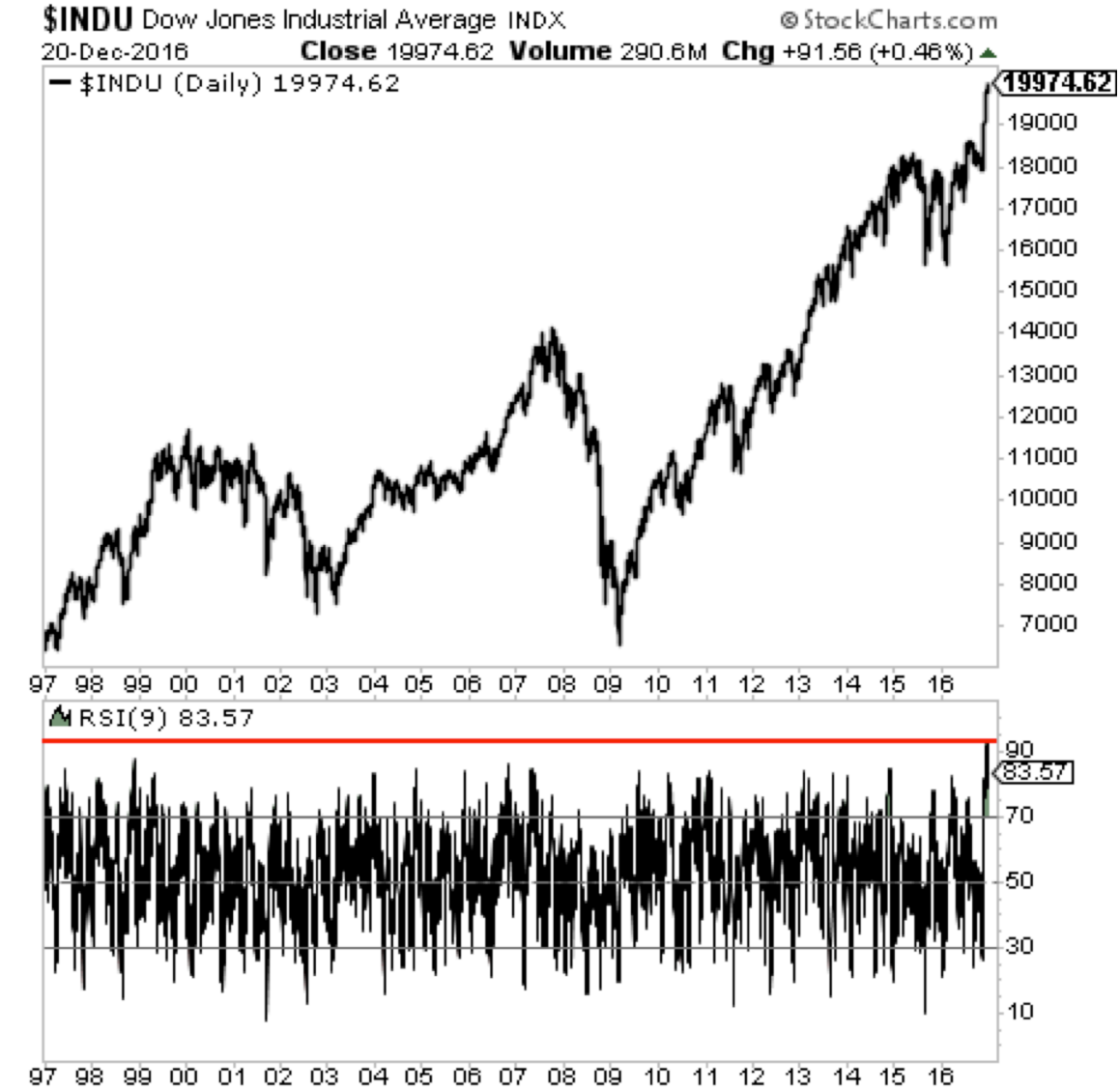
So we have fund managers and individual investors piling into momentum trades in stocks (particularly growth plays like Materials, Energy, and Industrials), the $USD, and Oil… while dumping precious metals… **all based on false growth assumptions and a massive Yen devaluation.**



These folks are hoping for a "free lunch." Wait until they see the tab.

Firstly, the market is *severely* overbought.

The Dow, which everyone is focusing on as they push for a final move to 20,000, is currently more overbought based on its daily RSI than at **<u>any other period in the last 20 years (including the 2000 and 2007 peaks).</u>**



<u>So we have a severely overbought market in which everyone has gone "all in" on stocks.</u>

Based on this alone you could expect a correction or sorts… which is why I put the odds of a 10% stock market drop at 70%.

However, as I mentioned before I think we might be setting up for something worse.

There is no such thing as a "free lunch" in finance. And the BoJ isn't going to get away with a 23% devaluation of the Yen without causing some major distress in the system. You simply cannot export this much deflation into the system without something breaking.

That "something" looks to be China's financial system.

As I noted previously, ever drop in the Yen has pushed the $USD higher. This in turn is forcing the Chinese Yuan higher, which is forcing China to burn through its foreign reserves (read: sell Treasuries) to defend the Yuan.

The situation is worsening almost daily. China's bond market broke temporarily last week:

> ***Chinese bond yields soared and authorities halted trading in some futures contracts for the first time on Thursday,*** *as a global bond-market selloff worsened a day after the Federal Reserve signaled a quicker pace of interest-rate increases next year.*
>
> *The Chinese 10-year government bond yield, which rises when prices fall, hit a 16-month high of 3.4%,* ***extending selling that began in late November and accelerated this week amid slowing growth, outflows of capital and concerns over asset bubbles.***
>
> *http://www.wsj.com/articles/china-halts-trading-in-key-bond-as-panicky-investors-sell-securities-1481803121*

Indeed, things are now serious enough that China's Central Bank is forced to issue emergency loans to financial firms.

> ***China's central bank extended hundreds of billions of yuan in emergency loans to financial firms on Friday*** *and ordered some of the country's biggest lenders to extend credit as well,* ***as it moved to ease a liquidity crunch and continuing debt selloff.***
>
> ***The moves marked a second day in which the People's Bank of China pumped money into the financial system and markets, after the U.S. Federal Reserve signaled it might quicken the pace of its rate*** *increases. That in turn spooked Chinese investors who were already worried about government attempts to let the air out of a highly leveraged and overheated bond market by tightening credit.*
>
> http://www.wsj.com/articles/china-central-bank-extends-emergency-loans-to-financial-firms-1481894137

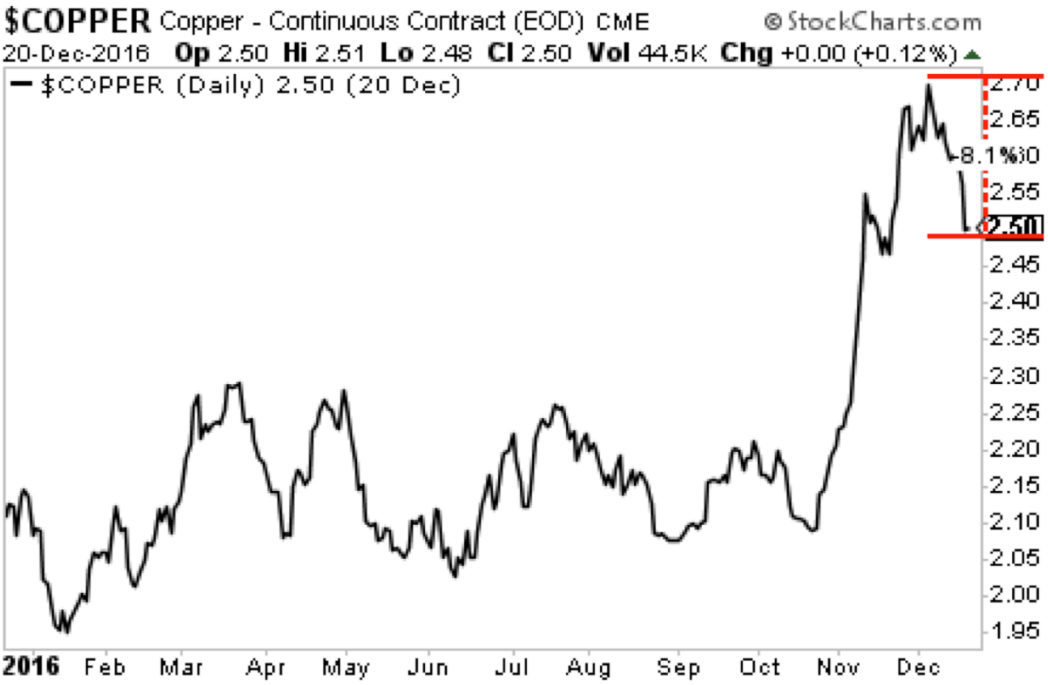
These are VERY serious issues. It is only a matter of time (days, perhaps weeks) before China is forced to act.

That act will likely feature an aggressive Yuan devaluation, similar to the ones that triggered the August 2015 and January 2016 market meltdowns… and possibly bigger.

Indeed, this devaluation appears to *already* be underway, though the vast majority of US investors have yet to realize it as they chow down on the "Dow going to the moon Free Lunch"

Those of us who have kept our wits about us during this US stock mania are already seeing deflation creeping back into the markets.

Consider the following… Copper has dropped 8% from its recent peak.



Mining giant BHP Billiton (BHP) is down 11% from its recent high.

Copper producer Freeport McMoRan (FCX) is down 17%.

Steel producer Arcelor Mittal (MT) is down 16%.

These are significant downturns for *very* economically sensitive businesses. They are telling us that "deflation is back."

We get additional signs from the Yield Curve (Short-Term Treasuries vs. Long-Term Treasuries), which has flattened considerably in the month.

This was the context going into last week's Federal Reserve meeting…

In this context alone, the Fed's decision to hike rates by 0.25% was a bad idea. But the Fed *also* announced that it expects to raise rates **another three times in 2017!**

Inflation expectations have since erased HALF of the "Trump wins" spike

If the Bank of Japan had created a potential deflation bomb, the Fed and its forecasts have lit the fuse.

In light of this, we're making some changes to our portfolio.

Those changes consist of:

1) Reducing our Long Exposure to stocks.
2) Increasing our exposure to Bonds
3) Adding a number of shorts.

Regarding #1, we're closing out a number of our Emerging Market plays.

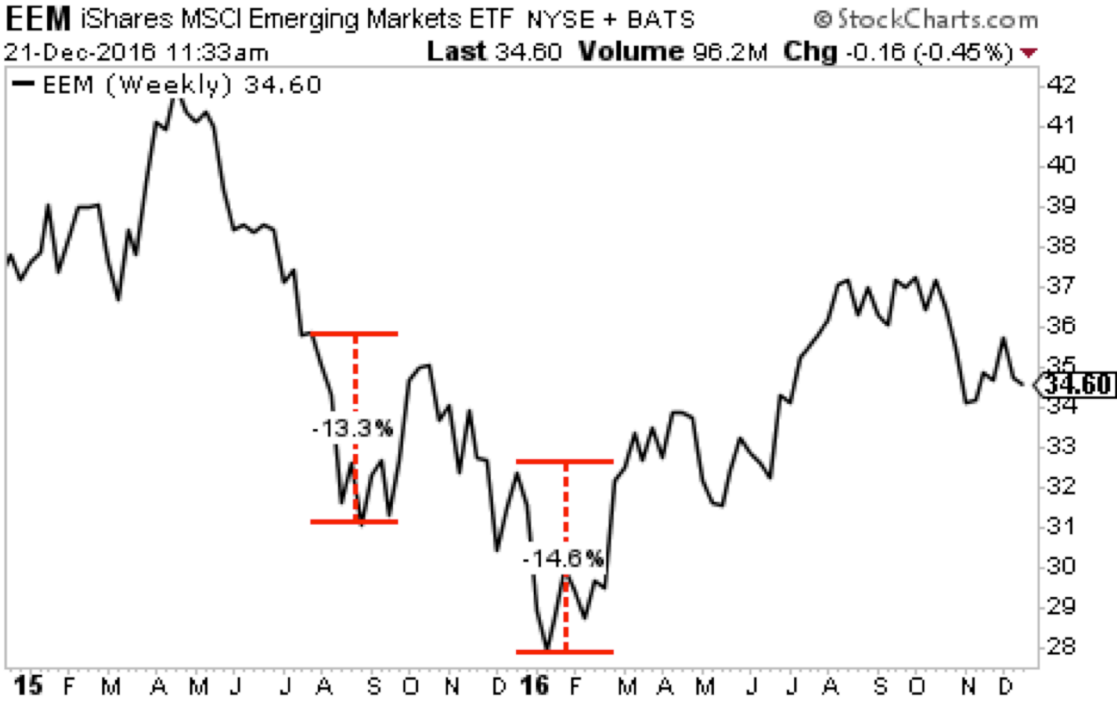
The first one is the China ETF (ASHR).

I hate losses, but there is a good chance we see a Crash here if China devalues the Yuan aggressively. The last two times China was forced to take aggressive measures to stop deflation, ASHR fell 26%+.

Let's get out of this play for now. We're down less than 5% so the loss is minimal. We can always revisit this down the road.

Action to Take: Sell the China ETF (ASHR).

We're also closing out the Emerging Markets ETF (EEM) for the same reason:



Again, I hate losses, but I'd rather they be very small (we're currently down 2% on EEM) than large.

Action to Take: Sell the Emerging Markets ETF (EEM).

We're also closing out our Emerging Markets Small-cap ETF (DGS). We're down 3% here.

Action to Take: Sell the Emerging Markets Small-cap ETF (DGS).

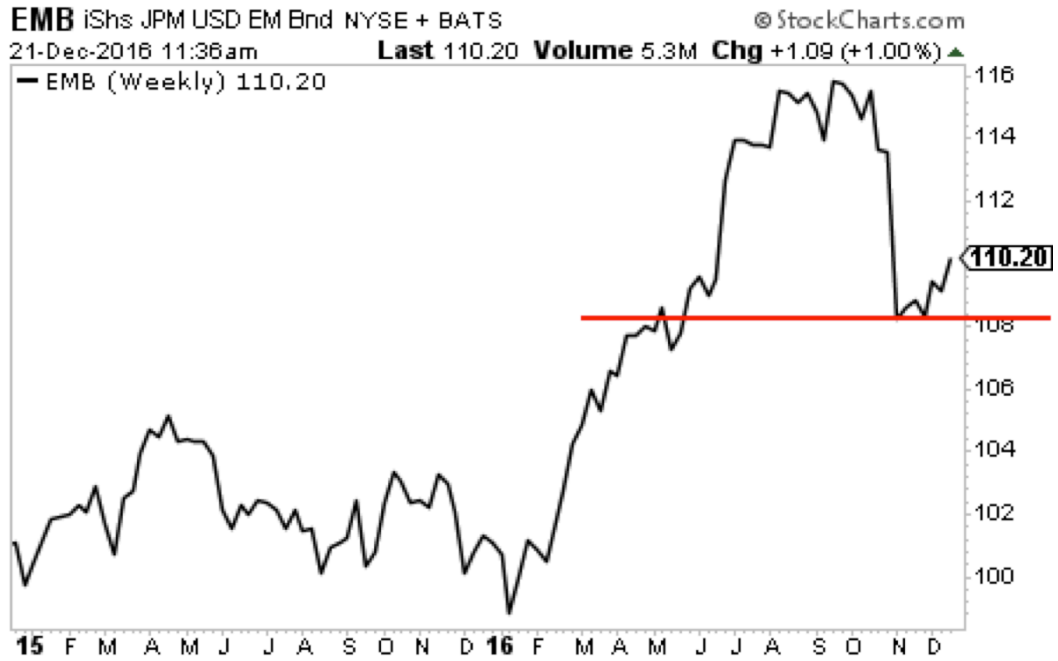
We will be revisiting all of these positions once the inevitable correction ends.

The flip side of this is that as deflation sweeps through the Western financial system, bonds should bottom and begin their next leg up.

We are beginning to see signs of this. The long Treasury bond ETF (TLT) looks as though it has finally found support. It should rip higher in the coming weeks.

Action to Take: Buy the Long US Treasuries ETF (TLT) if you have not already done so.

Indeed, Emerging Markets Bonds (EMB) look to have already bottomed and are beginning their next leg up.



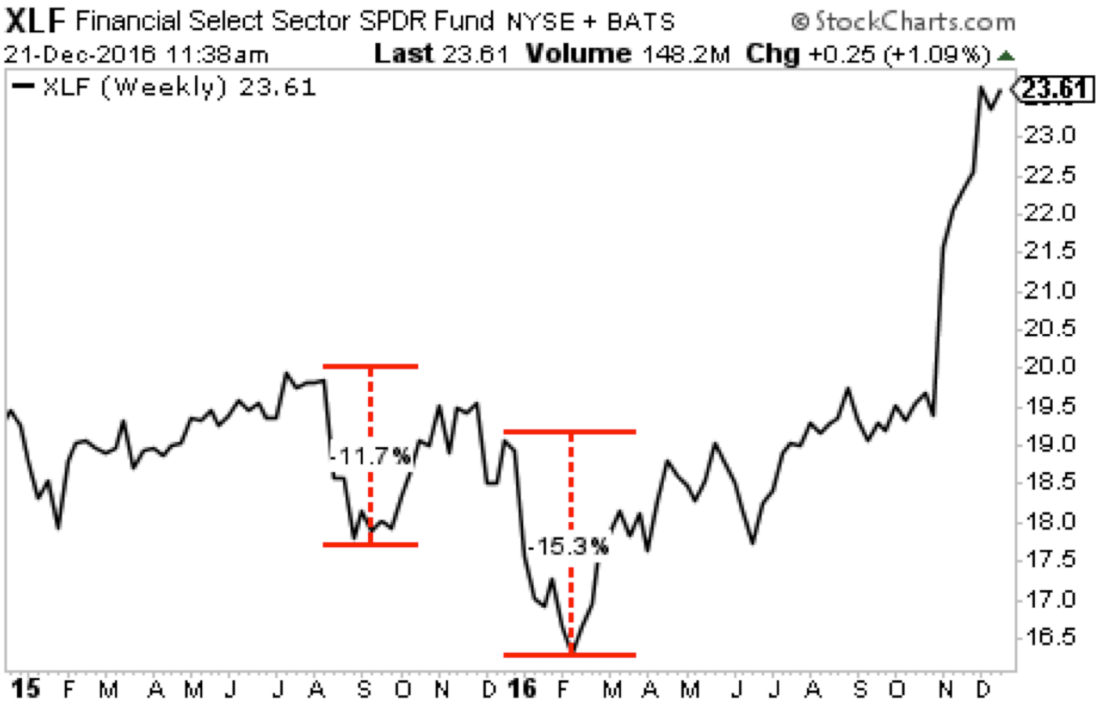
Action to Take: Buy the Emerging Market Bond ETF (EMB) if you have not already done so.

Finally, we are going to increase our exposure to shorting the market.

<u>I WANT TO STRESS THAT YOU SHOULD KEEP THESE POSITIONS RELATIVELY SMALL. THESE ARE MEANT TO BE MARKET HEDGES FOR US UNTIL THE MARKET BOTTOMS, *NOT* CORE POSITIONS.</u>

Having said that…

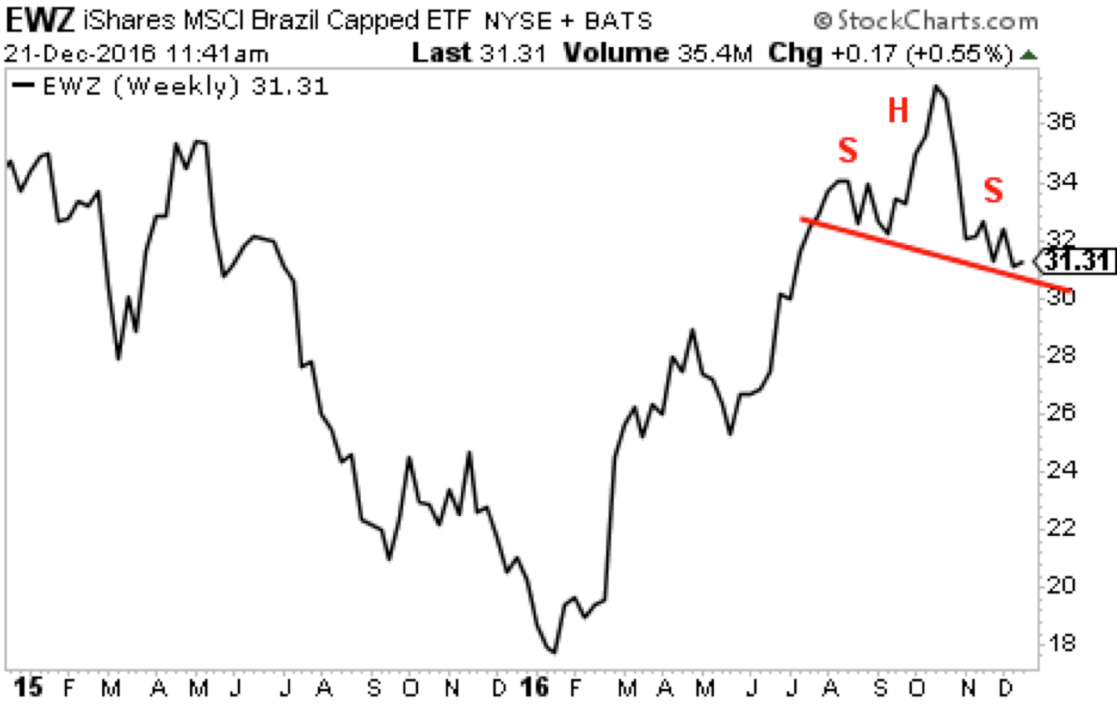
Financials have skyrocketed based on the notion that rates will be rising. As bonds bottom, this sector is in for a very rude surprise. During the last two drawdowns, XLF fell 11% and 15% respectively in a matter of days. This time around I expect we'll see a 20% drop.



Action to Take: Short the Financials ETF (XLF)

Another area of the market that will drop sharply is commodity-centric Brazil (EWZ).

EWZ is sporting a slanted Head and Shoulders pattern. We could easily see $28 if not $26 here when the markets turn.



Action to Take: Short the Brazil ETF (EWZ)

Finally, I want to address precious metals.

Gold and Silver are simply proxies for the Yen/$USD currency pair. You can see this clearly in the below chart. Gold (blue line) and Silver (red line) track this currency pair almost tick for tick.

This is going to reverse and reverse HARD when the $USD rolls over. The $USD is already failing to break to new highs in the week after the Fed proposed its 2017 rate hike forecast.

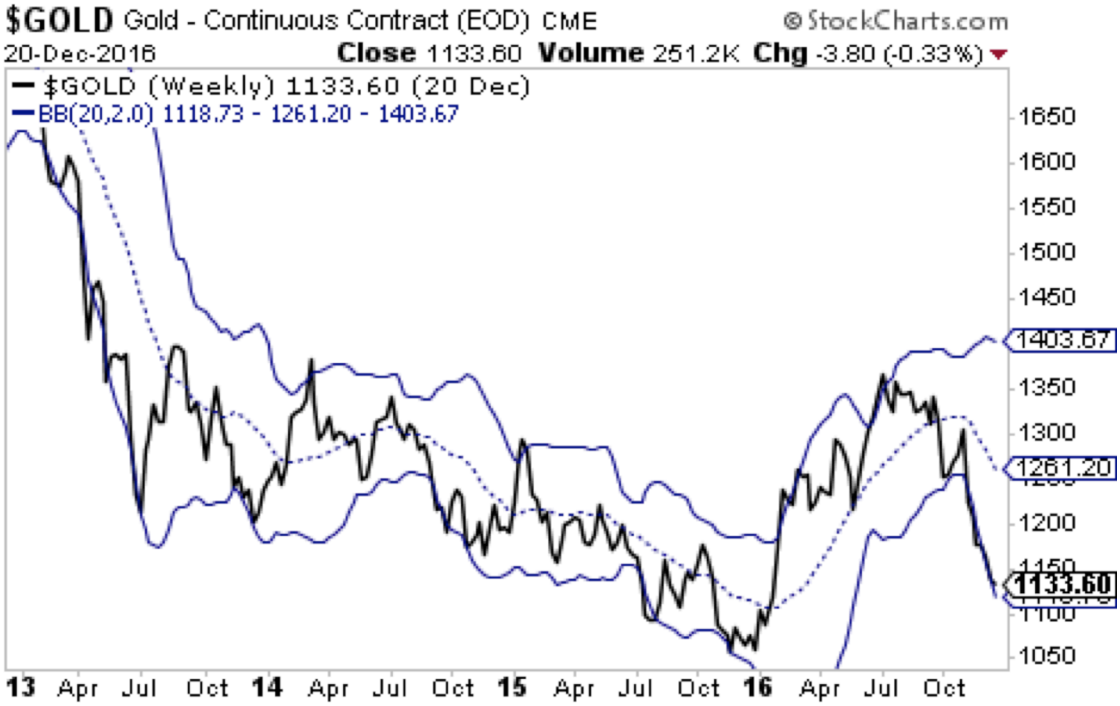
I believe that the Fed is going to be FORCED to walk back its rate hike proposals just as it did in early 2016.

The Fed hiked rates in December 2015 and proposed four rate hikes for 2016. Roughly one week later, the $USD peaked as China began aggressively devaluing the Yuan. The $USD then began its descent as the Fed was forced to walk-back its rate hike forecast.

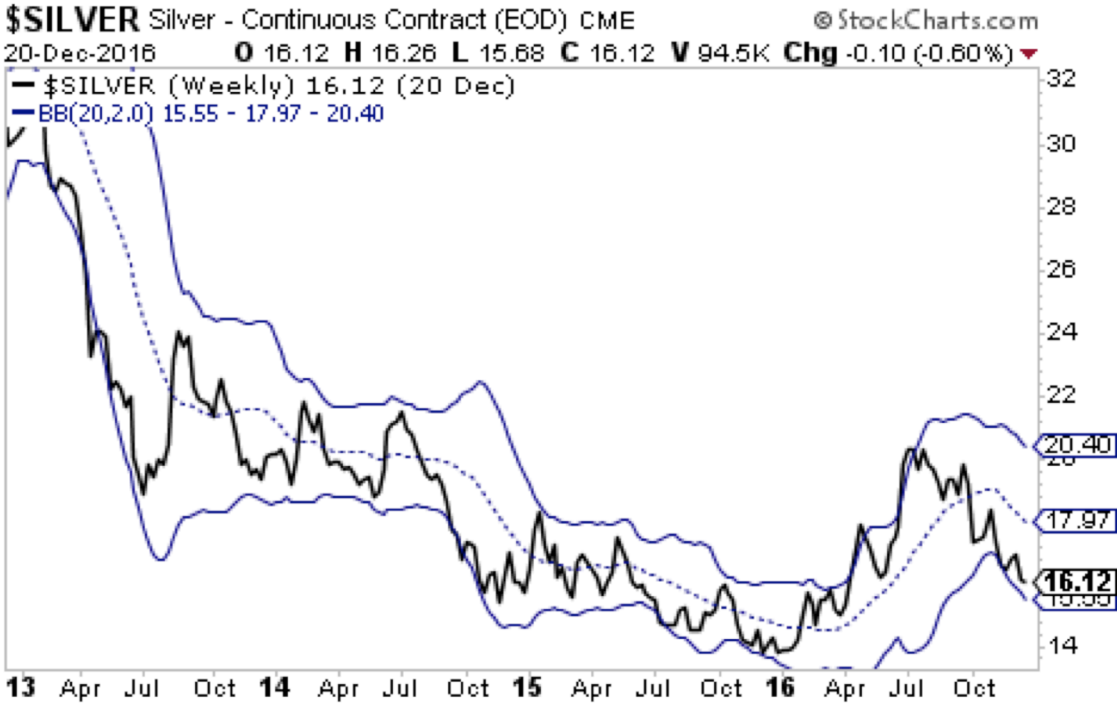
This time around the $USD is even MORE sharply overbought.

<u>I believe the $USD will be at 94 before June 2017.</u>

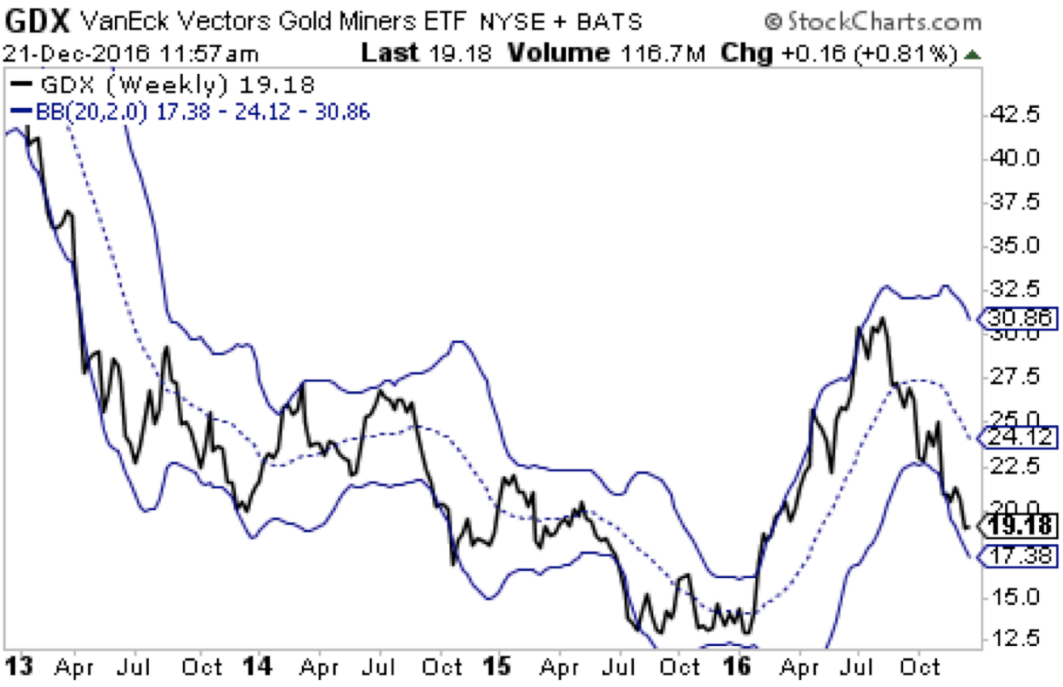
This will trigger the next MASSIVE leg up for precious metals with Gold going to $1400…



And silver going to $20.



Gold Miners will be going to 30.



And Silver miners will be heading to the low 50s.

This concludes this month's issue of ***Private Wealth Advisory***.

The Bank of Japan has unleashed a wave of deflation. Economically sensitive commodities and their producers are already "smelling" this. It's only a matter of time before the markets react as a whole, collapsing the $USD and US stocks and igniting a sharp rally in bonds and precious metals.

There is a small chance (10%) that everything holds together through year-end based on desperation and performance gaming… but once we close the books on 2016, the first three months of 2017 are going to be BRUTAL.

I'm altering our asset allocation based on this. Our new asset allocation is as follows.

Asset Class	Percentage of Portfolio
Stocks	15%
Bonds	40%
Precious Metals/Miners	20%
Cash (EURO)	20%
Special Situations/ Hedges/ Shorts	5%

Barring any new developments you'll next hear from me Wednesday January 4rth in our usual weekly market update. Thank you for your business in 2016. Here's to a great 2017!

Best Regards,

Graham Summers
Chief Market Strategist
Phoenix Capital Research

OPEN POSITIONS

STOCKS PORTFOLIO

POSITION	SYMBOL	BUY DATE	BUY PRICE	CURRENT PRICE	GAIN/ LOSS
Exxon	XOM	9/24/14	$95.82	$90.50	1%
RPX Corp	RPXC	8/5/15	$15.48	$11.15	-28%
Ambev	ABEV	11/25/16	$4.96	$4.87	-2%
Cemex	CX	11/25/16	$8.07	$8.03	0%
Enterprise Products Partners	EPD	11/31/16	$25.93	$26.90	4%
Peru ETF	EPU	12/7/16	$33.23	$32.34	-3%

BONDS PORTFOLIO

POSITION	SYMBOL	BUY DATE	BUY PRICE	CURRENT PRICE	GAIN/ LOSS
Nuveen Muni. Fund	NVG	1/2/14	$13.12	$14.08	28%
Emerging Market Bonds	EMB	11/21/16	$109.82	$110.22	1%
Long US Treasuries	TLT	11/21/16	$121.05	$118.24	-2%

Prices as of market's close on 12/21/16 at 1:15PM
Price include dividends

PRECIOUS METALS/ MINERS PORTFOLIO

POSITION	SYMBOL	BUY DATE	BUY PRICE	CURRENT PRICE	GAIN/ LOSS
Gold		3/17/10	$1,120	$1,133.00	1%
Silver*		3/17/10	$16.23	$16.00	-1%
Uranium ETF	URA	6/8/16	$15.49	$13.74	-11%
Gold Miners ETF	GDX	10/5/16	$22.83	$19.16	-16%
Gold Mining Juniors ETF	GDXJ	10/5/16	$37.52	$28.33	-24%
Silver Wheaton	SLW	10/5/16	$22.59	$17.53	-22%
Silver Standard Resources	SSRI	10/5/16	$10.30	$8.08	-22%
Barrick Gold	ABX	10/5/16	$15.54	$14.14	-9%
New Gold	NGD	10/5/16	$3.88	$3.19	-18%

SPECIAL SITUATIONS/HEDGES/SHORTS PORTFOLIO

POSITION	SYMBOL	BUY DATE	BUY PRICE	CURRENT PRICE	GAIN/ LOSS
France ETF (SHORT)	EWQ	9/16/16	$23.38	$24.32	-4%
Italy ETF (SHORT)	EWI	9/16/16	$21.56	$23.94	-11%
American Eagle Outfitters (SHORT)	AEO	5/26/16	$15.36	$16.10	-5%
Russell 2000 ETF	IWM	12/14/16	$135.37	$137.60	-2%
Financials ETF	XLF	12/21/16	$23.61	NEW	SHORT
Brazil	EWZ	12/21/16	$31.25	NEW	SHORT

Prices as of market's close on 12/21/16 at 1:15PM
Price include dividends
***Average price of $17.50 and $14.97**

CASH/ CURRENCIES PORTFOLIO

POSITION	SYMBOL	BUY DATE	BUY PRICE	CURRENT PRICE	GAIN/ LOSS
Euro Trust	FXE	10/5/16	$108.80	$101.28	**-7%**

Prices as of market's close on 12/21/16 at 1:15PM
Price include dividends

RECENTLY CLOSED POSITIONS

POSITION	SYMBOL	BUY DATE	BUY PRICE	SELL DATE	SELL PRICE	GAIN/ LOSS
Gerdau	GGB	11/7/16	$3.36	11/22/16	$4.18	**24%**
Copper Miners ETF	COPX	11/7/16	$17.90	11/22/16	$21.10	**18%**
Conoco-Phillips	COP	11/2/16	$43.46	11/25/16	$45.38	**4%**
Schlumberger	SLB	11/2/16	$77.93	11/25/16	$80.96	**4%**
Chevron	CVX	11/2/16	$105.53	11/25/16	$110.76	**6%**
Apache	APA	11/2/16	$58.46	11/25/16	$62.86	**8%**
Natural Gas Trust	UNG	10/5/16	$8.71	12/7/16	$9.32	**7%**
Santander (SHORT)	SAN	2/3/16	$4.13	12/7/16	$5.04	**-22%**
Barclays (SHORT)	BCS	7/5/16	$7.92	12/7/16	$11.90	**-50%**
China ETF	ASHR	11/7/16	$24.80	12/21/06	$23.88	**-4%**
Emerging Markets ETF	EEM	11/25/16	$35.25	12/21/06	$34.53	**-2%**
Emerging Markets Small Cap ETF	DGS	12/7/16	$40.00	12/21/06	$38.87	**-3%**