Private Wealth Advisory

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Portfolio Review

I'm going to be blunt, the market today is perhaps the most delusional I've ever seen. The second Greek bailout is in fact not done by any stretch, though the vast majority of investors are ignoring this fact, as well as the facts that both Spain and Italy are facing similar debt issues and are far too large to be bailed out.

The reality is that Europe as a whole is facing a banking Crisis that will result in systemic failure at some point. That is a fact. The leverage levels over there make the US's in 2008 look like a joke. Even German banks are facing the loss of tens if not hundreds of billions of Euros in losses based on their Greek exposure alone (nevermind the rest of the PIIGS).

The only thing propping this system up is the ECB which has essentially expanded its balance sheet (*read: handed out money via bond purchases and swaps)* by over 800 billion Euros since June 2011. To put this number into perspective, this is the equivalent to over $1 trillion… in just eight months.

The latest schemes the ECB is engaging in are its Long-Term Refinancing Operations or LTROs. The first one was for 489 billion Euros and took place December 21. The second is scheduled to be unveiled this week on February 28.

The simplest explanation of how the LTRO works is as follows: any European bank can borrow money from the ECB for up to three years if it puts up what the ECB determines to be "eligible collateral" (securities that are A-rated or higher).

The European bank then uses this money however it sees fit, but must pay interest on it (a measly 1%). Again, this is essentially free money, and the collateral being put up in exchange for it may be officially rated A or higher… but anyone with a working brain knows most of it is very likely totally toxic garbage assets (hence the phrase "cash for trash" which is being used in regards to the program).

Over 523 banks participated in the first LTRO. *Barclay's* believes that 193 billion Euros' worth of it was used as actual new money handed out to the banks while 296 billion Euros' worth of it was used to roll over maturing loans at the European banks.

What the banks are doing with this cash remains to be seen. We do know that European banks had parked some 412 billion Euros with the ECB at the end of 2011.

But it's also pretty clear that quite a few banks used the money as a carry trade, essentially borrowing from the the ECB at 1% and then buying Spanish or Italian bonds which pay 6+% and pocketing the spread.

This made the various sovereign bond auctions look better as demand seemed to increase. This in turn lowered interest rates across several PIIGS nations, especially Italy and Spain which made them appear "safer" as though the Crisis was over.

On the flip side of the deal, the European banks that bought these sovereign bonds could book profits on their newly acquired assets because the bond prices were rising (yields were falling).

This also helps explain the Euro's rally over the last few months, as banks "bought" Euros from the ECB. Of course, it also helps that there were a near record number of Euro shorts to be shredded (as the Euro rallied the shorts covered which meant they had to buy Euros).

So, on the surface, the LTRO scheme appears relatively clever… in the short-term: everyone involved in the scheme (the European Banks, EU countries, particularly those whose bonds were under fire, and even the Euro currency itself) temporarily look better while the credit markets become less jammed.

As far as stocks go, this is why the market has exploded higher since December: LTRO was unleashed on December 21 and LTRO 2 will be released this week on February 28. So the banks and financial system had a jolt of new capital and the hopes of even *more* capital coming soon.

The whole thing is a bit like the rally we saw between QE lite and QE 2 which occurred in 2010: investors are buying into the notion that a Central Bank can work its way through a massive credit crisis without unleashing any unintended consequences.

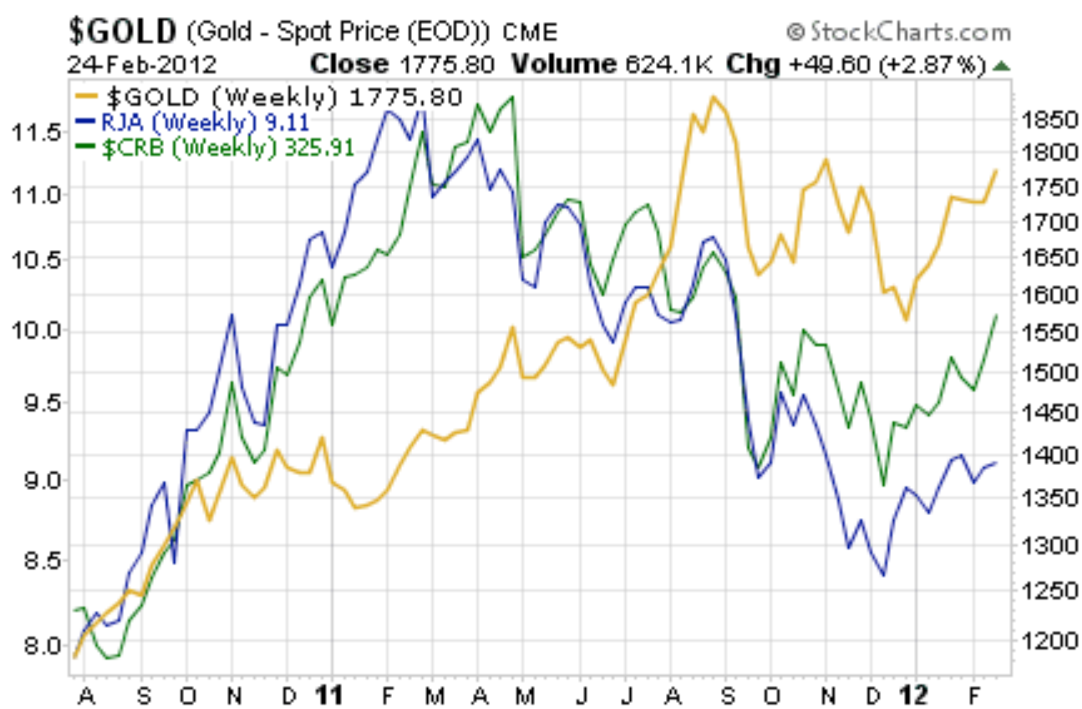
However, just as QE lite and QE2 created *many* unintended consequences (among them rampant inflation, worldwide riots, toppled Governments, slowed economic growth due to increased costs of living, and the Fed becoming politically toxic to the point that it's a primary political issue for the 2012 Presidential race), I believe the LTRO scheme will have some equally negative unintended consequences.

The only difference will be that the LTRO schemes are literally the only thing stopping widespread defaults and the breaking up of the EU and Euro.

Here are just a handful of the various potential unintended consequences I see for the ECB's LTRO functions:

Unintended Consequence #1: Inflation Soars Again

As the below chart shows, Gold (yellow), Agricultural commodities (blue), and commodities in general (green) caught a bid as soon as the new LTRO was announced.



The same is true for Copper, Silver, and virtually every other inflation hedge. This situation needs to be watched closely this week. The first leg of this move is now ending and we're coming up against resistance. If the second LTRO proves to be larger than expected and we take out resistance, then it'll be time to establish some inflationary trades (I've already got three lined up).

Gold:

Agricultural Commodities (RJA):

The commodities index:

The consequences of this move alone could be severe. China, Euope's largest trade partner is beginning to show an uptick in inflationary pressures:

> **China's inflation rebounds in January, renewing pressure to control living costs**
>
> China's inflation rebounded in January as food prices soared, renewing pressure on Beijing to control surging living costs as it tries to boost slowing growth in the world's second-largest economy amid warnings of a global downturn.
>
> Consumer prices rose by an unexpectedly strong 4.5 percent over a year earlier, up from December's 4.1 percent, data showed Thursday. **Food prices jumped 10.5 percent, accelerating from the previous month's 9.1 percent.**
>
> http://www.washingtonpost.com/business/economy/chinas-inflation-rebounds-in-january-renewing-pressure-to-control-living-costs/2012/02/08/gIQA5kM7zQ_story.html

Will China be pleased about the ECB's actions? I doubt it. In China, inflation is a much bigger problem than unemployment as the former tends to result in widespread civil unrest and riots.

Unintended Consequence #2: The ECB Blows Itself Up

This may sound outlandish, but we need to consider that as a result of its moves, over a quarter of the ECB's balance sheet (700 billion Euros) is now comprised of PIIGS debt.

This is why the ECB recently moved to swap its 50 Billion Euros worth of Greek debt for new debt that would not take a hit during Greece's debt restructuring. But what about Italy and Spain and the other PIIGS? Will the market *really* swallow the ECB swapping all of its exposure to these countries' sovereign bonds as well?

No chance.

So if we see a sovereign default in Europe, the ECB itself could get taken under (how the ECB would cover its losses it unknown). And if the ECB posts losses on its PIIGS positons it will have *enormous* implications for the global financial system as it will represent the first time during this Financial Crisis that a Central Bank took a hit.

In addition to this, LTRO 1 has already expanded the ECB's balance sheet to over 2.73 trillion Euros (roughly $3.65 trillion). If LTRO 2 is equal in size or larger, the ECB's balance sheet will be over 3 trillion Euros ($4.2 trillion), making it larger than even *Germany's GDP*. And if LTRO 2 is one trillion Euros as some analysts are calling for, things will get "interesting" very quickly.

Remember, when the Fed expanded its balance sheet aggressively, inflation exploded higher. What happens in Europe when the ECB does the same? Germany has already experienced Weimar and won't tolerate a rise in inflation. They've made this more than clear during EU meetings and have even gone so far as to create legislation that would permit them to leave the Euro but remain a part of the EU should they need to.

On a final note, the ECB is now leveraged at 30 to 1 (Lehman Brothers levels).

Conclusion

These are just two of the potential unintended consequences of the ECB's LTRO schemes. And the facts remain that things are quickly coming to a head regarding the Greek issue and the EU as a whole.

Today, the German courts are voting on whether or not to go along with the Second Greek Bailout. Even Angela Merkel has admitted to MPs that there is no guarantee the Second Greek Bailout will work.

On top of this, the G20 meeting over the weekend saw G20 leaders placing the responsibility for saving Europe squarely on Germany's shoulders. In plain terms, the G20 said it would not provide more aid via the IMF or other means until Germany has done more to "firewall" Europe via the ESM mega-bailout fund.

German's finance minister has already said there is no way Germany will put up more funds for the ESM. And one can only imagine the political fallout an increase in Germany's commitment to the ESM would have on German voters when the vast majority of them are against the Second Greek Bailout.

How all of this will play out remains to be seen. But I remain convinced our portfolio is well positioned for what's coming. Germany *will not* bailout all of Europe. It couldn't even if it wanted to. So the EU *will* be breaking up. The question is whether it's in the next week with the launch of the second LTRO or if it happens in March before the Second Greek Bailout goes out.

Regardless, I am monitoring the market closely and will post updates as needed. Deflation remains the primary risk due to Europe's situation. Until something changes, we're focusing primarily for that risk.

Best Regards,

Graham Summers

OPEN POSITIONS

Inflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Gold bullion	N/A	3/17/10	$1,120	$1,775.00	58%
Silver bullion	N/A	3/17/10	$17.50	$35.38	102%
Centamin Mining	CEE.TO	5/25/11	$2.01	$1.44	-28%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$21.92	1%
Rydex Strengthening Dollar	RYSDX	12/14/11	$14.39	$13.32	-7%
UltraShort Euro	EUO	9/21/11	$19.41	$18.93	-4%
UltraShort China	FXP	11/2/11	$27.93*	$23.00	-18%
UltraShort Materials	SMN	11/2/11	$17.48*	$14.52	-17%
Deutsche Bank	DB	12/14/11	$39.89**	$45.89	-13%
Santander	STD	12/14/11	$7.63 **	$8.30	-8%
HSBC	HBC	12/14/11	$39.83**	$43.53	-8%
Barclays	BCS	12/14/11	$12.37**	$15.31	-19%
UltraShort Gold	GLL	12/14/11	$19.76	$15.00	-24%

* Average price of 11/2/11 and 1/27/12
** Average price of 12/14/11 and 1/27/12