Private Wealth Advisory

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Europe's Last Dance

The first item that needs to be addressed is the overnight coordinated move by the world central banks to make it easier to trade US Dollars.

> **Central Banks Take Joint Action to Ease Debt Crisis**
>
> The Federal Reserve moved Wednesday with other major central banks to buttress the financial system by increasing the availability of dollars outside the United States, reflecting growing concern about the fallout of the European debt crisis.
> Enlarge This Image
>
> **The banks announced that they would slash by roughly half the cost of an existing program under which banks in foreign countries can borrow dollars from their own central banks**, which in turn get those dollars from the Fed. The banks also said that loans will be available until February 2013, extending a previous endpoint of August 2012.
>
> "The purpose of these actions is to ease strains in financial markets and thereby mitigate the effects of such strains on the supply of credit to households and businesses and so help foster economic activity," the banks said in a statement.
>
> http://www.nytimes.com/2011/12/01/business/central-banks-move-together-to-ease-debt-crisis.html?_r=1

This move is being sold to the public as a means of providing credit to households and to businesses, but the reality is that it is a final attempt to prop up the financial system. Indeed, *Forbes* has already noted that the real reason for this move was that a large European bank almost went under last night:

Short-Term Trends
- -All EU options have failed.
- -The Fed had to step in to stop the system from collapsing.
- -Short-term pop in risk assets.

Intermediate Trends
- -Germany and/or France to leave the Euro and possibly the EU.
- -More PIIGS defaults.
- -Equities fall, Treasuries and US Dollar outperform.

Long-Term Trends
- -Global debt implosion.
- -China hard landing.
- -Corporate, banking, and federal defaults.
- -US household de-leveraging.
- -Energy prices higher.

Big European Bank Failure Averted: What Central Banks Did Not Tell Us

It appears that a big European bank got close to failure last night. European banks, especially French banks, rely heavily on funding in the wholesale money markets. It appears that a major bank was having difficulty funding its immediate liquidity needs.

The cavalry was called in and has come to the successful rescue.

The Federal Reserve, the Bank of England, European Central Bank, the Bank of Japan, the Swiss National Bank, and the Bank of Canada in a coordinated action moved to provide liquidity to the global financial system.

http://www.forbes.com/sites/greatspeculations/2011/11/30/big-european-bank-failure-averted-what-central-banks-did-not-tell-us/

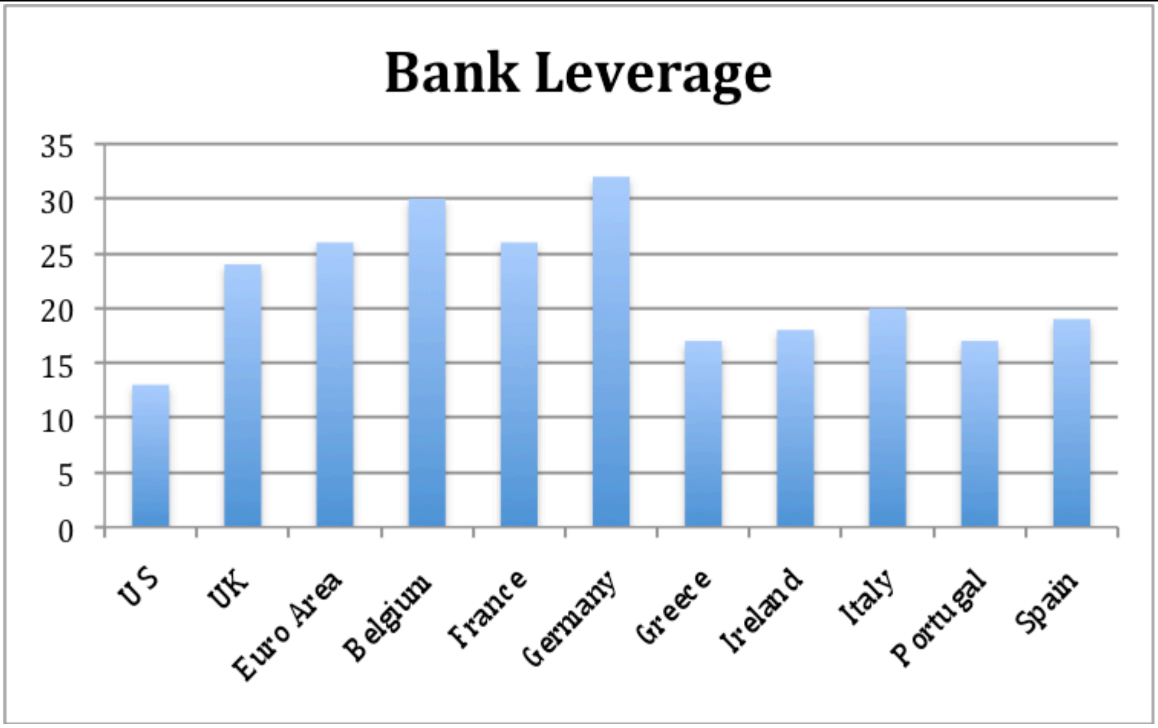
There are many implications to this, but the most important are:

1) Europe was/is on the verge of its Lehman moment.
2) The ECB/ Germany/ IMF/ EFSF bailout options have all failed.
3) The Central Banks are growing truly desperate to prop up the system.

As the above *Forbes* article makes clear, Europe was on the verge of its Lehman moment. I do not think that the coordinated Fed move has stopped this from happening… rather it's merely pushed back Europe's Crisis by a few weeks.

Remember, the situation in Europe is one of insolvency, NOT liquidity. Banks across Europe are leveraged at an average of 26 to 1. This means that they own 26 times more assets (read: *loans made to consumers, businesses, etc*) than they do equity.

At these leverage levels, if the assets fall even 4% in value, you've wiped out ALL equity, rendering the bank bankrupt.



Source: IMF data

The key item I want you to notice in the above chart is that French and German banks sport some of the largest leverage ratios of any banks in Europe. On that note, I believe it will prove to be *France*, not Italy that sees the first BIG bank failure. Indeed, we already see France moving to prepare for this:

> **The Agency for State Holdings (EPA), meanwhile, has been working for several days in a scheme that would allow the French to enter the capital of financial institutions.**
>
> But according to our sources, Paris is ready to act. If the level of European support-which must still be approved by some national parliaments, provides that the EFSF to recapitalize banks, the agency of state ownership (EPA), **meanwhile, has been working for several days in a diagram that would allow the French to enter the capital of financial institutions. "It's just in case ..." said a source familiar with the matter. Unlike what happened in 2008, which had pushed Bercy that all banks should call the financial office that had opened so that no-it-is stigmatized, only "two or three banks "This time would be affected by the device. "We're not in the same situation three years ago," says another source. And today, some are not willing to "pay" for others.**

A secondary implication of French and German banks' high levels of leverage is that it helps explain why Germany will be focusing more on domestic bank issues rather than supporting the Eurozone.

As I've noted in previous issues of ***Private Wealth Advisory***, Germany will look out for its national interests above everything else. This includes:

1) Not permitting the ECB to print money
2) Not permitting the issuance of Eurobonds

Germany will not tolerate price instability as it's already experienced the tail end of it (Weimar). Secondarily, the issuance of Eurobonds goes against the German Constitution, which neither the German courts nor the German people will tolerate.

The reason for this is Germany has its own problems. German banks have yet to be recapitalized and need at a minimum over 100 billion Euros in Capital. With that in mind, Germany will be focusing more and more on its domestic issues and not moving to backstop the EU.

I want to be clear… Angela Merkel will *verbally* state that Germany wants to remain part of the Euro, but German's actions (not putting up more funds for bailouts) speak louder than her words. Moreover, off the record, Merkel is known to have cried during meetings with EU leaders and threatened to have Germany leave the Euro if the ECB prints money.

Thus the European situation had reached its ultimate stalemate: neither Germany nor the ECB could step in to prop things up. When you consider that this is happening against the backdrop of market conditions that will not fund the leveraged EFSF (we've seen several admissions that the EFSF will not reach 1 trillion Euros and in fact will have little if any leverage: see article below) it's clear that Europe was out of options, which is why the Federal Reserve and other central banks staged their coordinated bailout this morning.

> **Euro rescue fund doubts grow**
>
> The option of offering partial insurance on government bonds sold at auction by certain countries – the most likely candidates being Italy and Spain – is in the EFSF's new rules. Investors would be given a 20-30 per cent guarantee. That would allow the facility to use its current €250bn capacity to cover up to five times as many bonds, **although EFSF executives and ministers have conceded that it is unlikely to be able to guarantee much more than €500bn because of market volatility.**
>
> Investors' main concern, though, is whether the EFSF has enough money to do all that could be demanded of it. **After the recent bail-outs of Portugal, Ireland and Greece are factored in, only about €250bn would be left. Italy and Spain's bond markets are in a different league, with combined funding needs of about €1,000bn in the next three years alone.**

http://www.ft.com/intl/cms/s/0/0db408ba-1aab-11e1-ae14-00144feabdc0.html#axzz1fCzYc3yX

If you take home any single point about the above analysis it should be the following:

> **The US Fed was the last and <u>ONLY</u> option to prop up the European Banking System. This was an act of absolute desperation on the part of central banks.**

Regarding the coordinated bailout itself, the first item that comes to mind is the fact that this is just another temporary band-aid. The Fed did not provide new capital to help the banks; it just made it cheaper for foreign banks to borrow Dollars (take on more debt).

As I've noted countless times, you cannot solve a debt problem with more debt. Allowing European banks to borrow Dollars more cheaply may free up liquidity temporarily, but it does nothing to make European banks more solvent.

Moreover, it's not as though the intervention had a huge impact behind the scenes. Euro/US Dollar swaps are now trading back to where they were **just one week ago**. That's not exactly a home run for the Fed.

From a technical perspective, the bailout didn't do a whole lot for the Euro either. Indeed, today's move in the Euro has only brought us up against resistance:

We could see a potential move to 137.5 here, but in general the Euro chart does not breed confidence. Just look at the market action on a 1-minute basis:

If the market truly believed that this coordinated bailout would solve the Euro's problems, the Euro would have continued strong throughout the day. Instead, what we saw was a sharp move higher followed by pronounced weakness throughout the day.

Much of this is due to the fact that the market realizes just how desperate the bailout was (again, the Fed, which isn't even a part of the EU, was the one bailing out the system). Moreover, we had a similar bailout just two months ago in September. And that bailout did next to nothing to keep the markets afloat:

To recap, the situation in Europe is now truly desperate. It is clear that neither the EFSF, nor Germany, nor the ECB can maintain the system much longer. As a result of this, the US Federal Reserve had to step in to hold things up. But even this move will be short-lived (as the previous coordinated intervention and the current Euro chart show).

I've stated before that I fully believe Germany will be leaving the Euro. With that in mind, I want to draw your attention to recent comments from Germany's finance minister, Wolfgang Schauble.

> **Wolfgang Schauble admits euro bail-out fund won't halt crisis**
>
> Europe's "big bazooka" bail-out fund is not ready and won't stem the debt crisis that on Tuesday pounded Italy and the European Central Bank (ECB), admitted Wolfgang Schauble, Germany's finance minister.
>
> http://www.telegraph.co.uk/finance/financialcrisis/8924462/Wolfgang-Schauble-admits-euro-bail-out-fund-wont-halt-crisis.html

This is a pretty strong admission from the finance minister of the country that Europe looks to as a financial backstop. And the following is even more disconcerting for the future of the Euro:

Seeing in Crisis the Last Best Chance to Unite Europe

MR. SCHÄUBLE said the German government would propose treaty changes at the summit of European leaders in Brussels on Dec. 9 that would move Europe closer to the centralized fiscal government that the currency zone has lacked. The ultimate goal, Mr. Schäuble says, is a political union with a European president directly elected by the people.

"What we're now doing with the fiscal union, what I'm describing here, is a short-term step for the currency," Mr. Schäuble said. "In a larger context, naturally we need a political union."

Critics say the spending cuts German leaders have demanded from other countries are hurting growth across the Continent, in the process making debts only harder to repay. And his proposals to give the European Commission far-reaching powers to enforce budgetary discipline have been likened by skeptics in Britain to an invasive new "super state." Even some euro supporters fear that Mrs. Merkel and Mr. Schäuble are talking about long-term changes while panicked investors and practiced speculators are tearing the euro to pieces right now.

"There is a limited transition period where we have to manage the nervousness on the markets," Mr. Schäuble said. "If it is clear that by the end of 2012 or the middle of 2013 that we have all the ingredients for new, strengthened and **deepened political structures together, I think that will work."**

He sees the turmoil as not an obstacle but a necessity. "**We can only achieve a political union if we have a crisis,"** Mr. Schäuble said.

http://www.nytimes.com/2011/11/19/world/europe/for-wolfgang-schauble-seeing-opportunity-in-europes-crisis.html?_r=1&pagewanted=2

Note that Schauble repeatedly emphasizes the goal of a "political union," NOT a "fiscal union" or "monetary union." Indeed, his one reference to a "fiscal union" is in the "short-term," while stressing that in a "larger context" the EU needs a "*political* union."

The message here is very, very clear: Germany is interested in the EU as a political entity, NOT the Euro as a currency. With that in mind, consider the following story which received almost NO attention from the media:

-German Chancellor Angela Merkel's conservatives on Monday passed a resolution at a party convention urging the government to establish rules in

Europe that would allow a country to voluntarily leave the euro zone without giving up membership in the European Union.

The resolution reads:

"Should a member [of the euro zone] be unable or unwilling to permanently obey the rules connected to the common currency he will be able to voluntarily--according to the rules of the Lisbon Treaty for leaving the European Union**--leave the euro zone without leaving the European Union**. He would receive the same status as those member states that do not have the euro."

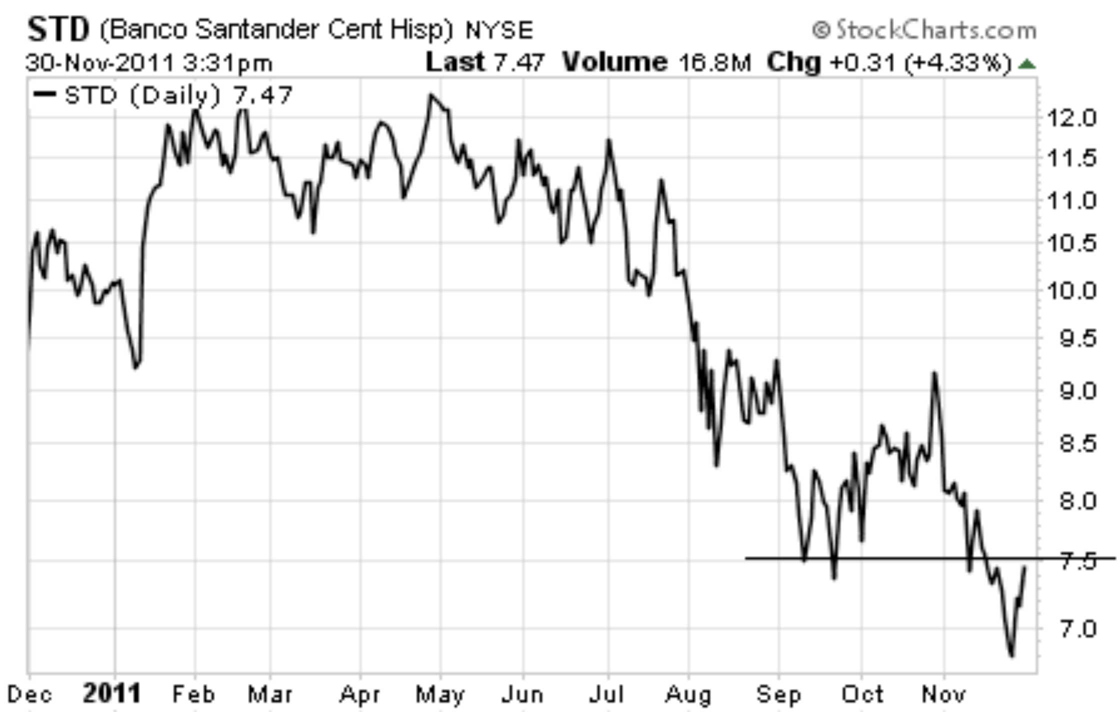
http://online.wsj.com/article/BT-CO-20111114-712771.html

I fully believe that Germany is laying the groundwork for it to leave the Euro while still remaining a member of the EU. The alternative to this would be for Germany to demand other nations give up their fiscal sovereignty and make Germany a kind of monetary authority in exchange for additional bailouts. However, the likelihood of this option being presented is next to ZERO as ALL of Europe remembers WWII and the threat of German rule.

So I expect Germany to duck out of the Euro in the near future. It may happen in the next few weeks or it may happen in early 2012. But considering that the Federal Reserve had to step in to save the European banking system today I believe it will be sooner rather than later.

With that in mind, I would look to short Deutsche Bank (DB) as soon as it’s rejected at resistance at $40 per share:

Our other European bank shorts of choice are also approaching the point at which I would re-open our shorts:



To recap, I believe that the European banking system is on the verge of a Lehman moment/ systemic collapse. I also believe that the Euro in its current form will be broken up in the near future.

With that in mind, the most pressing risk to the financial markets in the near-term is a deflationary Crash. In this environment, I would expect:

1) The US Dollar to rally and the Euro to fall
2) Stocks and other risk assets (especially emerging markets) to fall sharply with US indexes outperforming Emerging Markets
3) Gold and Silver to correct due to liquidations/ deleveraging

Regarding #1, a little acknowledged fact is that the US Dollar *just* eked out a new high before correcting:

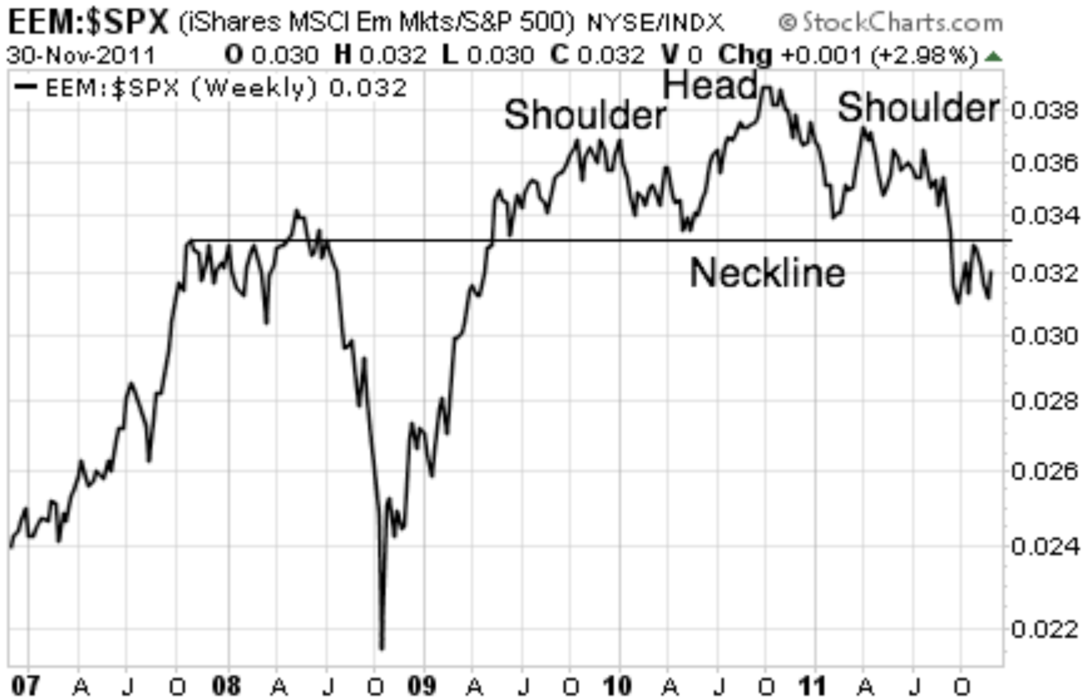
This is technically bullish and predicts greater gains fro the greenback.

Regarding #2, depending on how strong the momentum gets, I believe the S&P 500 *could* rally to possibly 1,250 or at most its 200-DMA at 1,275. However, after that I expect we'll see a sharp reversal and/or market Crash.

I also expect emerging markets to underperform US indexes going forward. One chart I use to view how these two assets perform relative to one another is to price the Emerging Markets ETF (EEM) via the S&P 500. When this chart rallies, Emerging Markets outperform the S&P 500. When this chart falls, the S&P 500 outperforms Emerging Markets.

As you can see, since August, the S&P 500 has outperformed Emerging Markets with the exception of a few brief periods. I expect this trend to continue with US markets holding up better than their Emerging Market counterparts.

Indeed, the long-term chart of EEM relative to the S&P 500 shows that the love affair with Emerging Markets may indeed be ending:



As you can see, we've broken below MAJOR support here and have since failed to reclaim this line (indicating that former support is now resistance). This is a VERY bearish chart which indicates that we are very likely entering a prolonged period in which Emerging Markets will underperform US indexes dramatically.

Finally, when the next round of major deflation hits, I expect both Gold and Silver to take a hit. With that in mind, Gold has formed a clear triangle pattern and is testing resistance at $1,750. Unless we can break above this line with conviction, Gold is liable to stage a sharp sell off, possibly to even $1,450.

If we have a Crash then Gold will fall sharply like every other risk asset. However, I do not expect it to fall as dramatically as it did in 2008. The reason for this is that the fundamentals for Gold are better today than they were in 2008 as investors in general are less trusting of paper currencies.

Indeed, even Central Banks have become net buyers of Gold in the last two years. So if we see a systemic collapse, I would expect Gold to fall primarily as hedge funds are forced to liquidate positions to meet redemptions. However, the precious metal should hold up well relative to other asset classes.

In the case of Silver, if the market Crashes I think we could see the precious metal fall to $20 per ounce.

If this happens, I would view both precious metals (Gold and Silver) as major buys. While defaults are deflationary in nature and will initially force Gold and Silver lower due to liquidations, investors will be looking for new safe havens away from paper currencies and sovereign bonds. That search will lead them to the precious metals space.

On that note, I want to address the mining space. While Gold and Silver have been off to the races for much of the last two years, the mining complex has essentially gone sideways.

The primary reason for this is that mining is an extremely capital intensive business. In a deleveraging cycle such as the one we are in today, bank lending falls resulting in businesses such as mining companies having difficulty getting access to capital and credit to begin/ expand production.

Europe Bank Woes Felt Around Globe

A pullback in lending by European banks is beginning to be felt by companies in Africa, Australia and Latin America, making borrowing harder and more expensive, and putting pressure on slowing economies.

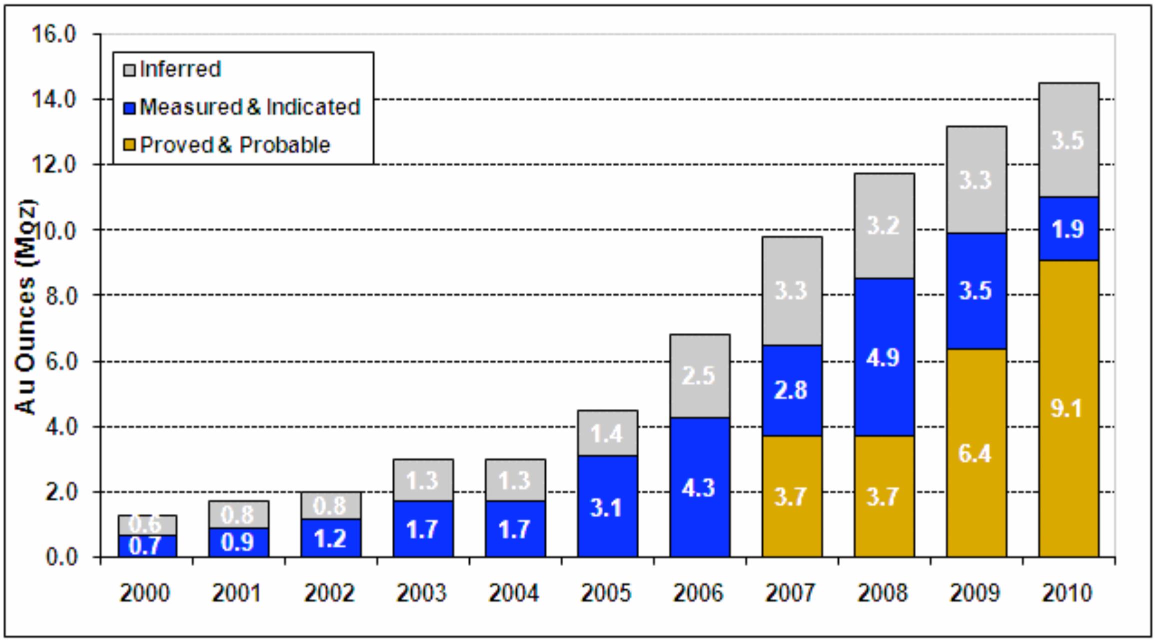
European banks in recent years dramatically boosted lending to emerging markets and were among the biggest cross-border lenders in these countries. Their retreat has tightened credit in industries—from aircraft to media to mining— squeezing economies already feeling the effects of reduced demand from the developed world for their exports.

http://online.wsj.com/article/SB10001424052970203710704577051823227742042.html

In an environment such as this, buying the mining complex as a whole makes little sense. However, smaller players with strong management teams and high quality assets will be major takeover targets as larger cash rich producers look to boost their reserves and production.

A classic example of the kind of takeover target to look at is Centamin Mining (CEE.TO), our Egyptian Mining company.

Centamin owns 100% of the Sukari mine in Egypt. This resource has 9 million ounces of proven reserves and nearly 6 million ounces of measured and inferred reserves. The company is actively moving to tap these additional resources.



More than being an asset play, Centamin also has operations that are already producing income. The company began production in 1Q10 producing over 200,000 ounces in 2010. It just produced over 50,000 ounces of Gold in 3Q11 for an operating profit of $43 million.

Bear in mind, these results come on the tail end of full-scale riots and a regime change in Egypt. Put another way, the Egyptian Government literally collapsed and Centamin managed to continue operating with few hiccups.

Indeed, Centamin is on track to produce 200,000-210,000 ounce at a cost of $550 per ounce in 2011. And the company hopes to boost production to 500,000 ounces per year in the future.

Centamin has $201 million in cash on hard and no debt. With a market cap of $1.8 billion, Centamin is literally trading for nine times cash. It also has a P/E of 13. This is a *mining* company, with a P/E of 13.

The reason for the cheapness is Egypt's political turmoil and the recent death of Centamin's CEO. The first issue is well known. There is little information being publicized on the latter issue. I am working to find out more about what happened and will publish my findings in the next issue of ***Private Wealth Advisory***.

While the impact of these issues have been significant from a market sentiment perspective, from a fundamental perspective, they've proven to be of minor import to Centamin's business. The facts remain that Centamin sits atop a top quality asset and has proven capable of producing strong results even during periods of major political upheaval.

For that reason, we continue to hold this company in our portfolio. From a technical perspective, I would look to have us add to our position if Centamin can stage a significant move above $1.52 and hold it.

For now, Centamin is a hold. I'll issue an alert when it's time to buy.

I'm also looking around for other smaller mining plays that are prime takeover targets. If we get a market Crash we could find some very, very good plays trading at discounts even to their cash levels (this happened in 2008). Talk about easy money.

To conclude this week's issue: Europe is on its last dance. I fully expect the impact of this latest intervention to last a week or two at most. After that, we should see the market turn down in a big way. And should things heat up in Europe again (highly likely), the downturn could come even sooner.

I'm watching the markets closely and will issue alerts as needed. As always thank you for reading.

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	$1,748.00	56%
Silver bullion	N/A	3/17/10	$17.50	$32.73	87%
Centamin Mining	CEE.TO	5/25/11	$2.01	$1.68	-16%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$22.06	1%
UltraShort Euro	EUO	9/21/11	$19.13	$18.92	-1%
UltraShort China*	FXP	11/2/11	$32.64	$28.83	-12%
UltraShort Emerging Markets*	EEV	11/2/11	$34.78	$32.21	-7%
UltraShort Materials*	SMN	11/2/11	$20.23	$17.70	-13%

* opened November 1 2011 at 9:41AM

RECENTLY CLOSED POSITIONS

Company	Symbol	Buy Date	Buy Price	Sell Price	Gain
JP Morgan (short)*	JPM	11/2/11	$32.65	$30.84	6%
Deutsche Bank (short)*	DB	11/2/11	$37.45	$34.90	7%
Santander (short)**	STD	11/2/11	$7.91	$7.32	8%
UltraShort Emerging Markets** (half of position)	EEV	11/2/11	$34.78	$38.12	10%
UltraShort Real Estate** (half of position)	SRS	11/2/11	$40.09	$44.03	10%
UltraShort Financials** (half of position)	SKF	11/2/11	$65.13	$71.41	10%
UltraShort Emerging Markets*** (half of remaining position)	EEV	11/2/11	$34.78	$39.50	14%
UltraShort Brazil*** (half of remaining position)	BZQ	11/2/11	$19.04	$21.37	12%
UltraShort Real Estate*** (half of remaining position)	SRS	11/2/11	$40.09	$46.04	15%
UltraShort Financials*** (half of remaining position)	SKF	11/2/11	$65.13	$75.23	16%
UltraShort Brazil **** (all of remaining position)	BZQ	11/2/11	$19.04	$22.40	18%
UltraShort Real Estate+ (all of remaining position)	SRS	11/2/11	$40.09	$44.45	11%
UltraShort Financials+ (all of remaining position)	SKF	11/2/11	$65.13	$71.47	10%

* Sold 11/17/11 at 12:42 PM
** Sold 11/21/11 at 10:43AM
*** Sold 11/23/11 at 11:11AM
**** Sold 11/25/11 at 11:55 AM
+ Sold 11/29/11 at 11:04AM