Private Wealth Advisory

A Phoenix Capital Research Publication

The Cracking of a Corrupt Edifice

One of the primary focal points in ***Private Wealth Advisory*** is the corruption that has become endemic to the political and financial elites of the world. When we refer to corruption we are referring to insider deals, cronyism, lies and fraud. Since the Great Crisis began in 2008, these have become the four pillars of the financial system replacing the pillars of trust, transparency, truth and reality that are the true foundation of capitalism and wealth generation.

As we regularly note, corruption only works as long as the benefits of being "on the take" outweigh the consequences of getting caught. As soon as the consequences become real (namely someone gets in *major* trouble), then *everyone* starts to talk.

This process has now begun in Spain.

MADRID — Spain's governing Popular Party was drawn deeper into a web of corruption scandals this past week, after the Swiss authorities informed the Spanish judiciary that the ***party's former treasurer had amassed as much as 22 million euros, or $29 million, in Swiss bank accounts.***

The treasurer, Luis Bárcenas, resigned from his job in 2009, after being indicted in the early stages of an investigation, which is still ongoing, into a scheme of kickbacks and illegal payments allegedly involving other conservative party politicians…

Nonetheless, the revelations have brought a fast-growing list of corruption investigations, which have unspooled across Spain, to the doorstep of the conservative government of Prime Minister Mariano Rajoy, who has so far remained silent. ***About 300 Spanish politicians from across the party spectrum have been indicted or charged in corruption investigations since the start of the financial crisis. Few have been sentenced so far.***

http://www.nytimes.com/2013/01/19/world/europe/corruption-scandals-widen-in-spain.html?_r=0

The above story illustrates some key elements that all investors need to be aware of:

February 6, 2013

Short-Term Issues

- A loss of credibility for EU leaders.
- Corruption scandals in Spain, Greece, and Italy.
- Bond yields widening again in the EU.
- US stocks topping out.

Intermediate-Term Issues

- Inflation spreading globally.
- US GDP to worsen.
- European crisis to begin anew.
- Currency wars accelerating.

Long-Term Issues

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

1. EU politicians are so corrupt they make their US counterparts look clean by comparison.
2. Having been put off for years, investigations into corruption are now reaching the point at which the rich and powerful are actually at risk of serious consequences.

Note in the above story that former Spanish Treasurer Luis Bárcenas has been under investigation since *before* 2009. The fact that the real smoking gun (his hidden Swiss bank account containing over $29 million) is only just coming to light should give you an idea of how corrupt the system in Europe has become (there is no way on earth it would take four years to find this information).

That this information is coming out now also tells us that things are getting so bad in Spain that heads are going to start to role. As we stated earlier, corruption only works until the consequences outweigh the benefits of being "on the take." The above story tells us that we have finally reached that point in Spain. It's taken five years for this to happen (the Crisis begin in 2008). But the system has finally reached the inflection point at which key players will face real consequences for their corruption.

With that in mind we can expect more and more such cases to begin to emerge in Europe. The fallout from this will be major both for the political class and for the financial markets.

Indeed, later in the same story we find the following tidbit:

On Wednesday, amid another property investigation, ***the president of Madrid's regional government, Ignacio González, revealed that he and his wife purchased a penthouse last month in the holiday resort of Marbella for 770,000 euros, or more than $1 million.*** *Mr. González, who earns 4,800 euros a month,* ***about $6,380,*** *is denying any wrongdoing, as well as any link between his acquisition and the property investigation undertaken by a local judge.*

A regional President, earning less than $80K a year just bought a $1 million penthouse in a country where youth unemployment is above 50%, workers have gone over six months without being paid, and pharmacies are running out of medicine due to having not been paid some €500 million by the government.

The reason this is so important is because politics, not economics, drives everything in Europe. Please note that the entire EU banking system was pulled back from the brink of collapse last summer by Mario Draghi and other EU officials promising to do whatever it takes to end the crisis.

Since that time, the economy has actually *worsened* in Europe. Unemployment has hit a new record and the vast majority of the EU has re-entered recessionary territory. Thus, it has been the credibility of various EU officials, *not* any fundamental improvement in things that has made the whole system work

Now that major corruption scandals are breaking out regarding key EU figures, it's going to be increasingly difficult for the EU political class to continue to convince the markets that the "everything is OK."

Indeed, this latest scandal has even snagged Spain's Prime Minister Rajoy.

A corruption scandal blew up in Spanish Prime Minister Mariano Rajoy's face over the past few days, sending the stock market down in a crash as bond yields surged dramatically…

"Never, and I repeat, never have I received, nor distributed black money," Rajoy said last Saturday, responding to accusations that he had formed part of a corruption ring that received money from a construction company in exchange for public contracts.

http://www.forbes.com/sites/afontevecchia/2013/02/04/spains-rajoy-accused-of-receiving-illegal-cash-payments-as-corruption-scandal-widens/

Long-time readers of ***Private Wealth Advisory*** will remember Spain's Rajoy well. He is the same individual who claimed Spain's banking system was in great shape right up until he demanded a €100 billion bailout from the EU in June 2012.

After procuring this bailout, Rajoy called it a "triumph," then announced that 2012 would be a "bad year" for Spain before hopping a plane to watch Spain's soccer team play Poland.

Since that time, Rajoy has been one of the most vocal EU politicians when it comes to claiming that the worst of the EU Crisis is "over." He has also fervently denied claims that Spain will need to seek a larger bailout from the ECB. It was Rajoy's credibility, along with his decision to raid Spain's social security to buy Spain's debt, that have resulted in Spain not already defaulting.

MADRID—Spain has been quietly tapping the country's richest piggy bank, the ***Social Security Reserve Fund, as a buyer of last resort for Spanish government bonds, raising questions about the fund's role as guarantor of future pension payouts.***

Now the scarcely noticed borrowing spree, carried out amid a prolonged economic crisis, is about to end, because there is little left to take. ***At least 90% of the €65 billion ($85.7 billion) fund has been invested in increasingly risky Spanish debt, according to official figures, and the government has begun withdrawing cash for emergency payments.***

http://online.wsj.com/article/SB10001424127887323374504578217384062120520.html

With that in mind, the fact that, Rajoy, a man who many thought could somehow *fix* Spain's problems, was actually being *paid* by construction companies during Spain's housing bubble has dealt a major blow to his credibility. What Spaniard in his or her right mind will listen to a Prime Minister who was on the dole for over €300,000 during the housing boom?

The corruption that allegedly involves Rajoy stretches even further back. Barcenas' notebooks ***show the current Prime Minister was paid €323,231 ($437,202) between 1997 and 2008 from a slush fund backed by construction companies;*** *Barcenas' notebooks show the fund having €6.69 million ($9 million) in assets. Rajoy denies ever having received tainted money, promising to upload his tax returns to La Monclona's homepage, the government's official website.*

http://www.forbes.com/sites/afontevecchia/2013/02/04/spains-rajoy-accused-of-receiving-illegal-cash-payments-as-corruption-scandal-widens/

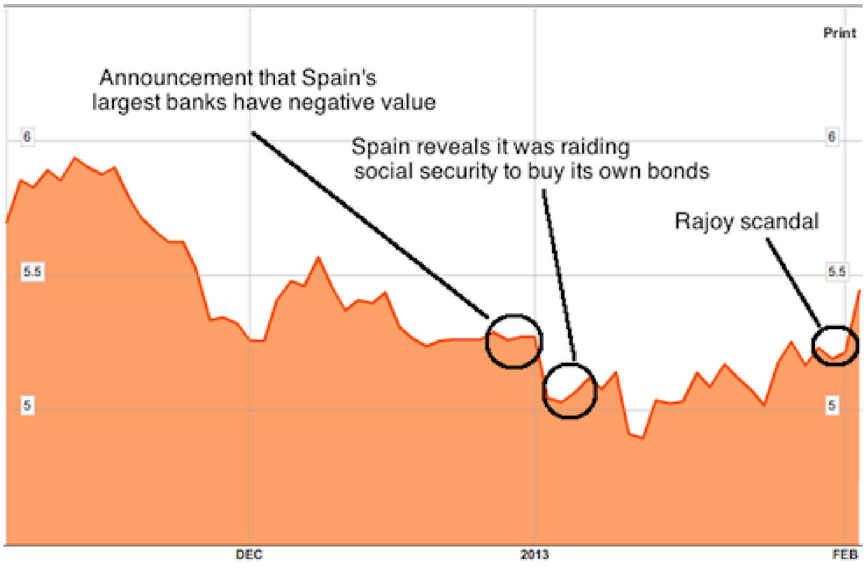
To put this number into perspective, Rajoy's official salary is just €78,000 per year. So the illegal payouts of €34,000 per year represent a raise of 43% (assuming there are no other illegal bribes or payouts which is very unlikely).

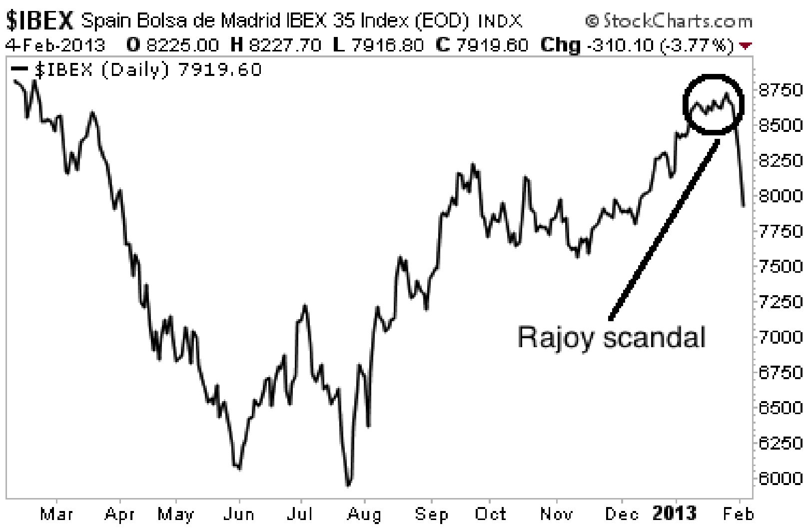
Even more concerning for Spain is the fact that Rajoy's defense of the allegations doesn't exactly inspire confidence:

"I repeat what I said Saturday: everything that has been said about me and my colleagues in the party is untrue, except for some things that have been published by some media outlets," *the 57-year-old prime minister said.*

The conservative leader did not clarify what things he believes are false, nor did he answer a Spanish reporter's question as to who he or his party plan on suing for alleging that many officials, *including himself, were given bonuses from a secret fund on top of their regular salaries.*

http://elpais.com/elpais/2013/02/04/inenglish/1359996476_669894.html





As we regularly note in ***Private Wealth Advisory,*** politics is everything in Europe. The Rajoy scandal is a prime example of this as its announcement resulted in yields on Spain's Ten Year bonds soaring (something that the announcement of Spain's banks having negative value nor the announcement that Spain had raided 90% of its social security fund to buy its own bonds could do).

The Rajoy scandal is also the first announcement to put a dent in the Spanish stock market's rally since August 2012.

From a technical analysis perspective, Spain has now officially broken out of its rising bearish wedge pattern. This pattern predicts the next major leg down will be to 7500 if not 7250.

We're already shorting Spain via the Spanish ETF (EWP). In light of the recent issues coming out of the country, we're adding a new trade by shorting Spanish bank **Santander (SAN).**

Santander is one of Spain's largest banks with 28% of its assets in Spain (another 28% is in the UK, which doesn't bode well for its future either). In the last two years, its non-performing loans have increased nearly 30%. And the technical picture indicates that we're ready for the next led down.

Action to Take: Short Santander (SAN).

Outside of Spain, corruption scandals have also erupted in Greece. There it was revealed that the very Greek political parties that were negotiated the Greek bailout had received over €200 million in loans from the Greek banks.

Greek prosecutors have ordered the two main ruling parties to testify in an ***investigation into more than 200 million euros in loans they received from banks, officials said on Friday.***

The investigation - which is examining whether the loans are legal and whether any wrongdoing was involved - *could embarrass the fragile conservative-led government, which relies on aid from the European Union and the International Monetary Fund.*

Last year a Reuters report revealed the conservative New Democracy and the Socialist PASOK parties were close to being overwhelmed by debts of more than 200 million euros as they face a slump in state funding because of falling public support.

http://www.reuters.com/article/2013/02/01/us-greece-parties-idUSBRE91010O20130201

Here again, we find that politicians were "on the take" via questionable if not illegal funds. The fact that this story is coming out now does not bode well for Greece, which is barely holding together as a country.

The consequences of this discovery will not be positive for the Greek political class:

Greece's finance minister was sent a bullet and a death threat from a group protesting home foreclosures, *police officials said on Monday, in the latest incident to raise fears of growing political violence.*

The package was sent by a little-known group called "Cretan Revolution", ***which warned the minister against any efforts to seize homes and evict homeowners, police sources said. The group sent similar letters to tax offices in Crete last week.***

http://news.yahoo.com/greek-finance-minister-sent-bullet-mail-165717734.html

Italy is also facing a major scandal implicating key political figures including the biggest player for European financial system, ECB President Mario Draghi:

Back in mid-January, Bloomberg's Elisa Martinuzzi and Nicholas Dunbar reported that Deutsche

Bank helped Italy's third-largest bank, Monte Paschi, cover up a 367 million euro loss at the end of 2008 with a shady derivative deal. *That swap helped the bank look better than it really was just before taxpayers bailed it out—echoes of Goldman Sachs's deal to hide Greece's national debt.*

The Italian papers followed Bloomberg's scoop days later with news that Nomura had structured a derivative for Monte Paschi along similar lines. The Italian central bank then disclosed Monte Paschi executives had concealed documents on the trades from them. Reuters reported that JPMorgan also did a sketchy derivative for the bank.

But the scandal only continued to grow. ***So far, the bank may have lost a billion dollars on the deals, and it turns out that the Bank of Italy knew about the allegedly fraudulent deals back in 2010, when Mario Draghi was its chief. Draghi is now head of the European Central Bank, and has been critical in tamping down the euro crisis in the last several months.***

Now, the scandal threatens to change the course of Italian national elections being held later this month, giving a leg up to Silvio Berlusconi…

http://www.cjr.org/the_audit/bloomberg_unearths_an_italian.php

The key item in the above story is Mario Draghi's involvement. As head of the European Central Bank, Draghi is arguably the most powerful man in Europe. Indeed, it was his promise to provide unlimited bond buying that stopped the systemic implosion of Europe last summer.

In this sense, the entire EU has been held together by Draghi's credibility as head of the ECB. The fact that we now have a major scandal indicating that he was not only aware of fraudulent deals in 2010, but gave them a free pass will have *major* repercussions for the future of the Euro, the EU, and the EU banking system.

We hope by now that you see why we have remained bearish on Europe when 99% of analysts believe the Crisis is over. The only thing that has the EU together has been the credibility of politicians who we are now discovering are all either corrupt, inept or both.

To use a metaphor, if Europe were a single house, it would be rotten to its core with termites and mold. It should have been condemned years ago, but the one thing that has kept it "on the market" was the fact that its owners were all very powerful, connected individual. We are now finding out that the owners not only knew that the home should have been condemned but were in fact getting rich via insider deals while those who lived in the house were in grave danger.

As we stated at the beginning of this issue, corruption only works as long as the benefits of being "on the take" outweigh the consequences of getting caught. As soon as the consequences become real (in that someone gets in major trouble), then *everyone* starts to talk.

The above stories about Greece, Spain, Italy reveal that we have entered the stage at which people have begun to talk about Europe's corruption.

Given that the entire edifice of the EU banking system has been held together by verbal interventions from EU leaders (in economic terms things have gotten worse in the EU as most of its is now back in recession and unemployment just hit a new record high), we can now say that the next round of the EU Crisis is fast approaching.

As a brief recap of just *what* Europe's banking system *really* looks like…

The EU banking system is approximately €46 trillion in size: over THREE times that of the US. It's over three times the EU's total GDP and over NINE times the EU's total annual tax revenue.

To make matters worse, this entire mess is leveraged at 26 to 1. At this level, <u>even a 4% drop in asset prices erases all equity.</u> European financial institutions have debts exceeding 100% of the EU's total GDP.

This is the *real* picture of Europe's banking system. The fact that this entire mess is being held together by little more than corrupt politicians' verbal interventions should be enough to give any sane investor pause.

With that in mind, EU financials are going to be in trouble again in the very near future. So let's short the entire EU's financial sector using the Euro Finance ETF (EUFN):

As you can see in the chart below, EUFN has just broken out of a smaller rising bearish wedge in the context of a larger wedge that goes back to May 2012. We should see a quick drop to $20 if not $18 in short order:

Action to Take: Short the European Financial ETF (EUFN)

Those EU leaders who have yet to be implicated in scandals are not faring much better than their more corrupt counterparts. In France, socialist Prime Minister Francois Hollande, has proven yet again that socialism doesn't work by chasing after the wealthy and trying to grow France's public sector… when the public sector already accounts for 56% of French employment.

France was already suffering from a lack of competitiveness. Now that wealthy businesspeople are fleeing the country (meaning investment will dry up), the economy has begun to positively *implode*.

The first sign of this came actually came from Germany. As we noted a few months ago, Germany had prepared a working group to examine the impact of an economic collapse in *France*.

German Finance Minister Wolfgang Schaeuble has asked a panel of advisers to look into reform proposals for France, concerned that weakness in the euro zone's second largest economy could come back to haunt Germany and the broader currency bloc.

Two officials, speaking on condition of anonymity, told Reuters this week that Schaeuble asked the council of economic advisers to the German government, ***known as the "wise men", to consider drafting a report on what France should do…***

"The biggest problem at the moment in the euro zone is no longer Greece, Spain or Italy, instead it is France, because it has not undertaken anything in order to truly re-establish its competitiveness, and is even heading in the opposite direction," *Feld said on Wednesday.*

"France needs labour market reforms, it is the country among euro zone countries that works the least each year, so how do you expect any results from that? Things won't work unless more efforts are made."

http://uk.reuters.com/article/2012/11/09/uk-germany-france-economy-idUKBRE8A80MN20121109

This German concern has proven to be well founded, as the recent spate of French economic data has been truly horrific.

Auto sales for 2012 fell 13% from those of 2011. Sales of existing homes outside of Paris fell 20%

year over year for the third quarter of 2012. New home sales fell 25%. Even the high-end real estate markets are collapsing with sales for apartments in Paris that cost over €2 million collapsing an incredible 42% in 2012.

Since the EU Crisis began in 2008, France and Germany have been the two key countries backstopping the implosion. The fact that France is now facing an economic implosion does not bode well for the future of the Euro or the EU.

The other sovereign backdrop for the EU, Germany, is also experiencing an economic slowdown.

The German economy was hit hard by the euro zone crisis in the final quarter of last year, shrinking more than at any point in nearly three years as traditionally strong exports and investment slowed, *the Statistics Office said on Tuesday…*

Gross domestic product shrank by 0.5 percent in the final three months of 2012, the ***worst quarterly performance since Germany fell into a recession during the global financial crisis in 2008/2009 and only the second contraction since it ended.***

The parlous fourth quarter pushed overall growth for the year down to 0.7 percent, a sharp slowdown from the 3.0 percent registered in 2011 *and a post-reunification record of 4.2 percent in 2010. The 2012 figure was a tad below a Reuters consensus forecast for growth of 0.8 percent.*

http://www.reuters.com/article/2013/01/15/us-germany-gdp-idUSBRE90E09Q20130115

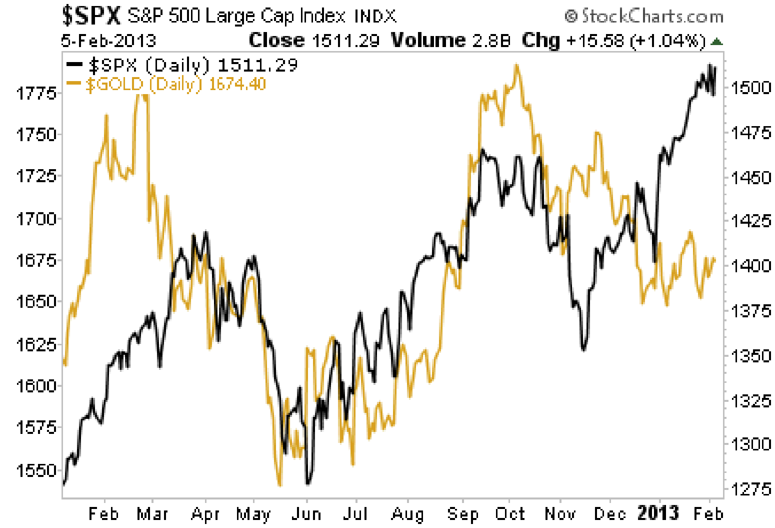
Thus, we find that Europe's primary political market props (EU leaders including ECB head Mario Draghi) are coming unraveled at the precise time that EU banks are showing warning signs *and* the most important EU economies are heading sharply south.

2013 is going to be a very *interesting* year for Europe.

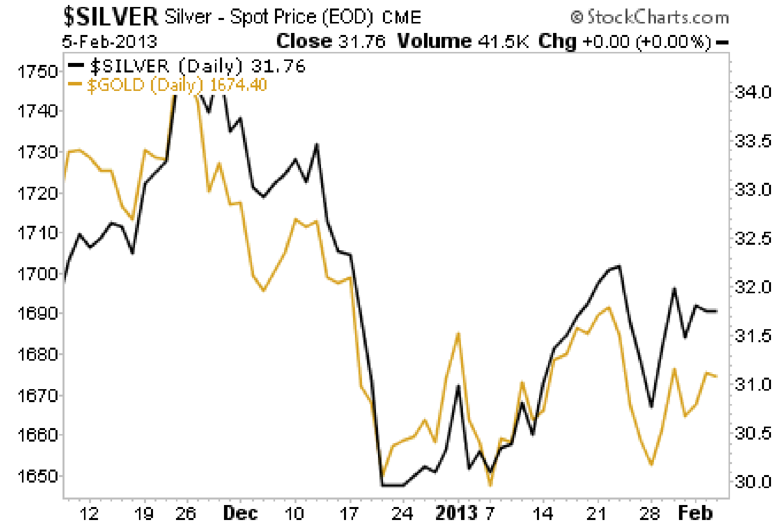
Across the pond in the US, the divergence between the S&P 500 and the Russell 2000 continues to indicate that a top is forming (see chart below).

While it is too early to tell how this will play out, the fact the Russell 2000 is underperforming the S&P 500 indicates this latest rally is quite long in tooth. My gut feeling is that we'll eek out a new all-time high in stocks in the form of a blow off top. But given the headwinds facing the markets, I expect that before the first half of 2013 ends we'll see a very sharp and severe correction in US stocks.

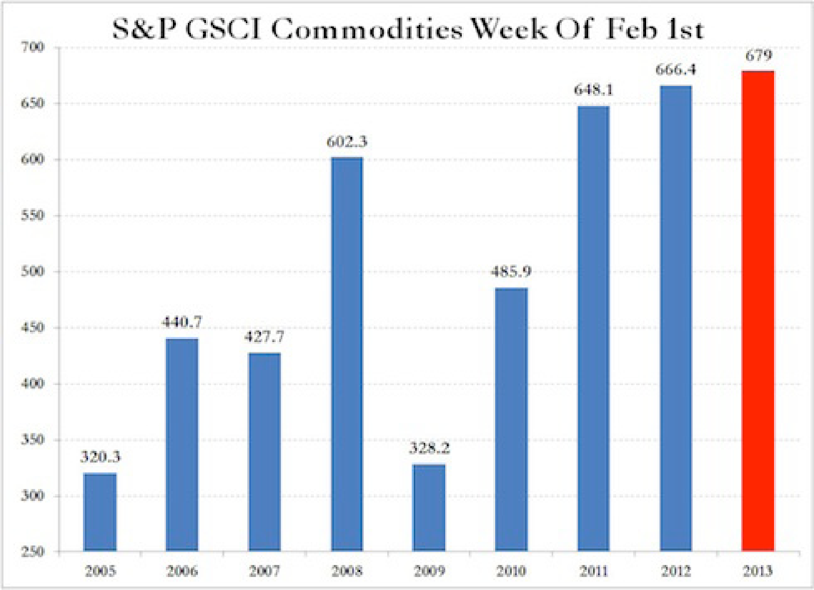
Gold, which also leads stocks, is diverging sharply from the S&P 500.



Another item to be aware of is Silver's outperformance of Gold. Historically Silver has done this whenever inflationary concerns spread throughout the system. It's happening again now.



Speaking of inflation, as Zerohedge recently noted, commodities have *never* been more expensive at this time of year than they are now.



This tells us point blank that the next wave of inflation has take hold in the financial system. With that in mind, we need to consider which investments perform best in this environment.

To help you do this, we've are just putting the finishing touches on a new Special Report titled ***The Inflation Secrets Your Broker Won't Tell You About.*** We will be selling it to the general public for $79, but you as ***Private Wealth Advisory*** subscribers will all get free copies.

We'll likely have this report to you early next week. But we guarantee that it will be quite an eye opener as we are debunking several of the biggest myths about inflation that the investment community has spread to individual investors.

This concludes this week's issue of ***Private Wealth Advisory.*** By the look of things, Europe is ready to enter the next round of its Crisis. The US will perform better than Europe during this period but we'll likely see a sharp correction here as well. Now is the time to be preparing for this. Missing out on a few percentage points in gains is no big deal compared to the risks that are coming out of Europe today.

We suggest getting defensive by focusing on safe havens and lightening up on those investments that are based on hopes for greater growth and success in Europe.

Best Regards,

Phoenix Capital Research

OPEN POSITIONS

Inflation Portfolio*

Company	Symbol	Buy Date	Buy Price	Current Price	Gain/ Loss
Gold		3/17/10	$1,120	$1,673.00	49%
Silver		3/17/10	$17.50	$31.81	82%
Rogers Agircultural	RJA	8/17/12	$9.80	$9.32	-5%
Soybeans ETF	SOYB	12/17/12	$25.18	$25.27	0%

Deflation Portfolio*

Company	Symbol	Buy Date	Buy Price	Current Price	Gain/ Loss
Ultra Bullish Dollar ETF	UUP	5/23/11 (10:35AM)	$21.79	$21.70	0%
Rydex U2X Dollar strategy	RYSDX		$14.39	$13.16	-9%
UltraShort Euro ETF	EUO	6/25/12	$21.45	$17.90	-17%
Russia ETF (SHORT)	TRF	6/25/12	$13.21	$15.76	-14%
Italy ETF (SHORT)	EWI	10/1/12	$12.33	$13.67	-11%
France ETF (SHORT)	EWQ	10/1/12	$21.39	$24.17	-13%
Spain ETF (SHORT)	EWP	11/14/12	26.93	$30.41	-13%
UltraShort Russell 2000	TWM	12/21/12	$25.70	$21.95	-15%
UltraShort Materials	SMN	12/21/12	$55.40	$50.10	-10%
UltraShort Emerging Markets	EEV	12/21/12	$22.58	$21.44	-5%
UltraShort Brazil	BZQ	12/21/12	$66.63	$62.78	-6%

*Prices as of market's close on 2/5/13.