PRIVATE WEALTH ADVISORY

AN OMNISANS RESEARCH PUBLICATION AUGUST 5, 2009

Changing Tactics

This week I'm cutting the economic editorial. Over the last month and a half, I've written nearly 100 pages detailing the economic and consumer trends that are currently shaping the investment landscape. If you're a recent subscriber I suggest starting with the June 24 2009 *Private Wealth Advisory* titled, *All That Rises Isn't Inflation* and reading my commentary throughout July.

As a brief recap, I've stated that America has entered a **New Normal** dominated by:

- Higher consumer savings
- Lower consumer spending
- Rising unemployment
- Lower corporate profits
- Increased Government spending/ transfer
- Reduced private sector growth
- Excess capacity
- Reduced production
- Excess bank reserves
- Reduced lending

This is, in a nutshell, a bleak economic picture. It is, however, reality. I know the media is now rife with folks predicting the end of the Recession. I even know "smart" analysts who are saying the same at independent research firms.

In terms of the REAL economic picture, these folks are completely misguided and wrong. The US is teetering on the brink of a full-scale economic collapse. Let me list a few items that don't spell recovery:

- 30 million Americans on food stamps
- 18% of incomes coming from an already broke government
- Seven million people will run out of unemployment insurance by Christmas (add their families and you have 13 million folks becoming destitute)
- Tax receipts are at their lowest levels since 1932
- 32 states have budget problems ($121 billion in total deficits) and the Federal Government is running a $2 trillion deficit
- Civil unrest growing: National Guard May Be Called to Alabama

- Industrial capacity for May ’09 was 68%: an ALL TIME low (roughly 1/3 of our plants and production facilities are doing nothing at all).
- Rail carload volume for 1H09 is down 19% from the already dropping level of 1H08.
- Even after laying off people and cutting costs, Quarter over Quarter Corporate Revenues and Profits fell 17% and 33% respectively in 2Q09.

Hard to get the word “recovery” out of the above. However, economics is a dark art, and in the hands of a deft accountant, you can dream up all kinds of nonsense, including a positive GDP… which we are likely to get in 3Q09.

However, with the Feds even openly acknowledging that their GDP findings are wrong (see the numerous revisions to the downside over the last year), this will be largely meaningless to anyone outside of the DC beltway.

On that note, the next time you see or hear anyone proclaiming that the recession is over, feel free to forward them the above list of data points and ask for their explanation as to how those items spell recovery.

You’re probably thinking, *“ok Graham, that all makes sense, so why is the stock market rallying?”*

Let’s attack that issue by looking at *who’s* participating in the rally…

Roughly 30% of US household wealth was destroyed by the collapse in housing and the 2008 Crash. Currently it stands at about $15 trillion, down % from $22 trillion at the 2007 peak. For simplicity’s sake, we’ll call this “assets.”

Now, consider that total US household debt stands at $13 trillion ($2.5 trillion in credit and $10.4 trillion in mortgage). As we noted in previous issues, consumers have only paid off about $50 billion in credit (about 2% of this).

Thus we have US household equity at about $2 trillion.

Because consumers can no longer use their homes as ATMs (the home equity line of credit era is over), if we’re going to track how much US household money has flowed into the stock market, we need to focus on money market funds: the proverbial “sidelines” of the stock market.

Well, since March 2009, only $400 billion has flowed out of money market funds. Even more interesting is the fact that individual investors are pouring more money into bonds and income plays rather than stocks: for July, only $4 billion flowed into stock mutual funds compared to $28 billion for bonds.

In spite of this lack of participation, the stock market has kicked off a $2.7 trillion rally since the March lows. With only $400 billion potentially coming from individual investors. we can deduce that US households have only contributed 14% or less of the market's gains.

Where did the other 86% ($2.3 trillion) come from?

See the Fed's Balance Sheet, *Factors Supplying Reserve Funds.* This is essentially the money the Fed has put into the system via various lending windows and liquidity swaps.

As of July 30, it stood at $2.01 trillion.

Ben Bernanke: the Nerd Destined for History's Biggest Wedgie

It's not hard to see what's going on here. The Fed lends out money to Wall Street banks. Wall Street banks then use the money to recapitalize their balance sheets and push the stock market higher, creating the illusion of "recovery" and "bull markets" in an effort to get US consumers to "buy in" or begin spending again: actions that would perpetuate the myth that the bull market is back and the economy is in recovery, thereby making the Fed look like a hero.

DO NOT FORGET that Ben Bernanke is an expert on the Great Depression. As such, he will do ANYTHING to make the market and economy NOT repeat that period in history. If this includes propping up the market by lending to banks that push stocks higher with high frequency trading programs (remember this accounts for 70% of market volume), why not?

The irony here is that Ben is in fact a tragic figure. He is the high school nerd who tried to get in with the "cool kids" (Wall Street) by bowing to their every demand and whim. What Ben doesn't realize is that Wall Street couldn't give a damn about him and are using the money to make massive trading profits and giving themselves massive bonuses.

The tragedy lies in the fact that Wall Street not only can, but WILL let the market Crash again, thereby repeating the Great Depression's market pattern to perfection and leaving Ben to go down in history as the guy who oversaw two mega-Crashes AND the devaluation of the dollar.

How do I know Wall Street will let the market Crash? Well, for starters the last few weeks have seen a number of large sales (transactions involving large blocks of stock).

We also saw the LARGEST options spread ever to hit the International Securities Exchange when someone sold 720,000 contracts on the S&P 500 ETF. In a nutshell, someone made a record bet than the S&P 500 would collapse sometime between August and December.

Indeed, there are 256,000 open "Put" contracts betting the S&P 500 ETF (SPY) hits December below 820. **There are another 140,000 contracts betting on 800, 116,000 contracts for 750, and 104,000 contracts for 600.**

Bottomline: some folks are betting BIG on the stock market collapsing before December… guess who that might be?

Now, about that market rally…

The Stage is Set for a Crash

As I've noted before, this whole rally was initially kicked off by the Federal Reserve pumping $80 billion into the financial system. Below are the weekly changes made to the Fed's balance sheet:

Date	**Fed Balance Sheet**
July 30 2009	-$38 billion
July 23 2009	-$33 billion
July 16 2009	***+$80 billion***
July 9 2009	-$12 billion
July 2 2009	-$19 billion
June 25 2009	-$46 billion
June 18 2009	+$20 billion
June 11 2009	-$25 billion
June 4 2009	-$2 billion

As you can see, the Fed's balance sheet contracted throughout most of June and July. Indeed, prior to pumping the $80 billion, the Fed had pulled out some $77 billion in the three weeks prior.

Now, there are three stages to bear market rallies. They are:

1) The immediate reversal from oversold conditions
2) The shorts get killed and push the market higher as they cover
3) Investors on the sidelines, see the market pulling away, and jump in

Stages #1 and #2 occurred between July 10 and the beginning of August. As I noted in last week's issue, Short Interest in the market (the amount of folks betting the market will fall) plunged an incredible 72%. Put another way, the number of shares "gone short" has dropped 72% in the last month. **This is without precedent**.

The final stage has probably already occurred (last week). The market hit 1,000, so traders no longer have a significant number to shoot for. Beginning of the month gaming has ended (stocks usually rally the first few days of the month). And volume is dropping even more.

Indeed, up days now show extremely weak volume while down days show heavier volume. In fact, just yesterday we saw a -.8 correlation between volume and price on financial stocks. This means that volume is now almost perfectly inversely correlated to share price. So if prices rise, volume drops and vice versa.

All of this, to me, indicates that the market has rallied on ever-worsening conditions. It's gone from being slight oversold (beginning of July) to unbelievably overbought.

How overbought?
The Relative Strength Index (RSI) is a measure of momentum for stocks. In a nutshell, it compares the upward or downward moves made by a particular stock from market close to market close.

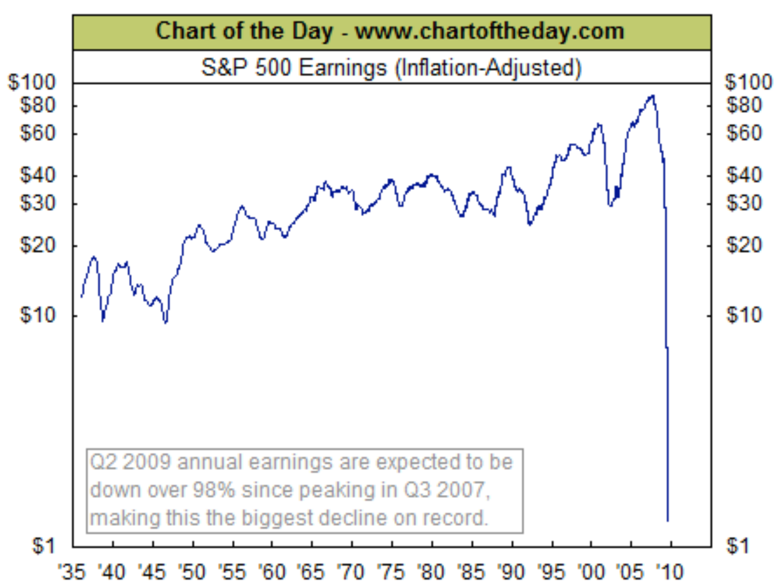
As a general rule of thumb, any time the RSI for an investment is over 70, it's very overbought. Whenever it's below 30, it's very oversold.

Today the RSI on the Nasdaq stands at 75.

According to a professional trader/ money manager friend of mine Ron Coby, the market has only been this overbought a few times in the last 10 years. Every time, the market staged a major correction in the following months:

Date	**RSI on Nasdaq**	**Subsequent Correction**
October 10 1997	76	-16%
July 20 1998	78	-33%
March 10 2000	75	-40%
October 11 2007	75	-21%
Today	**75**	**????**

There are a few other items to note as well. Insider selling is at its highest level since October 2007 (the all time peak in stocks). And corporate profits are evaporating.



To summate the current financial/ economic situation is:

1) Volume is contracting rapidly
2) Underlying fundamentals (economic and earnings wise) deteriorating
3) Trading dominated by High Frequency Trading Programs (HFTPs)
4) A total absence of real buyers in this market
5) Rising unemployment, drops in spending, and increases in savings
6) The Rise of the Mega-Welfare State in the US (18% of incomes coming from Uncle Sam)
7) The totally bogus belief that China will lead the world out of recession.

All of these items are fairly obvious, simple to understand, and correct. Seeing this, I positioned our portfolio to profit from a correction and change to risk aversion. This included:

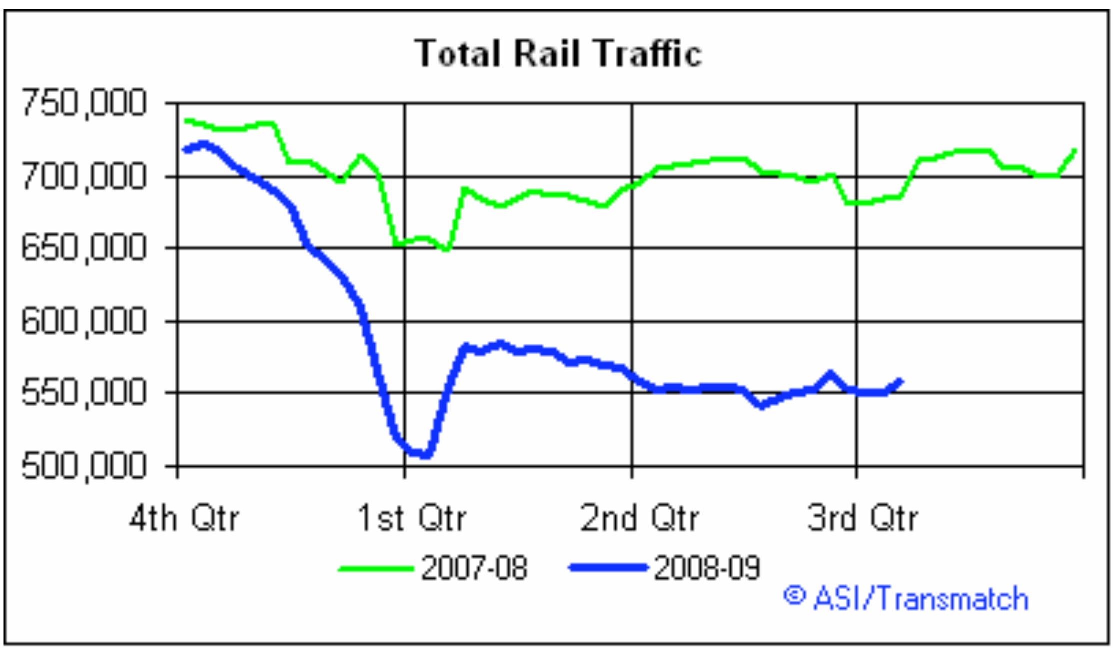
1) Went short "junk"= financials
2) Went long "flight to safety"= the dollar
3) Went short "economic growth"= commodities

However, I completely underestimated the Federal Reserve's desire to prop up the market at crucial moments as well as its willingness to damage the dollar, despite China getting extremely pissed off.

As I now know, I was WAY early on all of this. The stock market exploded higher in July, pushing our portfolio deep into the red. I watched as a "$0" like Host Hotels and Resorts rallied 35% to trade at 100 times trailing earnings: the kind of valuation last seen during the TECH BUBBLE. And this for a company that is no longer profitable (no $ in the last six months), watching revenues and earnings collapse, and paying off its current debt load by issuing more debt?!?!?

The same could be said for every position we hold.

Oil and other industrial commodities have rallied sharply in hopes of an economic recovery, in spite of the fact the world economy is contracting for the first time in 50 years, shipping has failed to move higher post-Stimulus, and rail car volume is down massively Year over Year.



These last two items are key measures of economic activity. The REAL economy involves shipping and moving things about. Without an uptick in the shipping and rail traffic, there is NO economic recovery. No economic recovery means commodities should be plummeting.

… And yet oil is at $71 a barrel and industrial metals have soared. As I mentioned earlier, the market is acting irrationally and we are getting out.

The Pain Threshold

I continue to believe that all of the above forecast a major crash in stocks in the coming weeks. However, I have completely and utterly hit my pain threshold with our current portfolio. This market rally is out of control and frankly I cannot stomach anymore losses.

Therefore I recommend the following:

Action to take: Cover our shorts on Host Hotels and Resorts (HST)

Action to take: Sell the UltraShort Financials ProShares (SKF)

Action to take: Sell the UltraShort Crude Oil ProShares (SCO)

Action to take: Sell the UltraShort Base Metals (SMN)

Action to take: Sell the Direxion 2.5X Dollar Bull

We were too early on these trades and we paid the price. Suffice to say the last month has been the most trying of my investment career. With Wall Street piling into financial stocks and REITs despite both industries being utter garbage, I am getting out of the way of this irrationality. It makes no sense and I want no part in it.

I apologize for the frustration of this last month. I really cannot believe what is going on in the S&P 500 right now. It is unlike any mania I have ever seen save for the Tech Bubble. When it rolls over (and it will in a month) we'll go short again.

Speaking of which…

Shipping Didn't Get the "Recovery" Memo

As I noted in previous issues, 2009, for the most part, has followed 2008's patterns to perfection. This includes:

- Commodities bottoming before stocks (Feb vs. March)
- A strong spring rally in commodities based on China stock-piling
- A strong stock rally on beliefs the "worst" was over
- The Baltic Dry Index collapsing in June
- Commodities beginning to correct in July
- Stocks beginning to correct in August

As you can see, in June of 2008, the Baltic Dry Index (dotted) began to unravel. Stocks (solid line) followed suit. However, the latter group (stocks) reversed in the first two weeks of July when Fannie/ Freddie were nationalized and the SEC banned short-selling of certain financial firms. The Baltic, on the other hand, continued to plunge. Stocks then staged a chopping August, before rolling over into the nightmare that was September-November.

The SAME EXACT PATTERN IS PLAYING OUT IN 2009.

As you can see, the Baltic peaked in June and then started to collapse. And just like last year, stocks followed in step briefly before staging a massive short-covering rally. In fact, stocks are even more divorced from reality today than they were in 2008.

The above graphs don't do a good job of indicating the respective plunges largely because the 2008 graph has all of August in it, whereas 2009's does not.

So consider the following:

- **June 1-August 5, 2008: Baltic collapses 28%**
- **June 1-August 5, 2009: Baltic collapses 25%**

- **July 15- August 5, 2009: S&P 500 rallies 5%**
- **July 10- August 5, 2009: S&P 500 rallies 14%**

As you can see, the 2008/ 2009 collapses in the Baltic Dry Index were virtually identical. However, this year (2009) stocks have rallied an ENORMOUS rally compared to that of 2008 (14% vs. 5%).

This tells me one of two things:

1) This rally was indeed largely the product of MASSIVE short covering
2) Stocks are even more disconnected from reality today than in 2008.

I strongly believe in #1. The fact that brokerage firms are trying to outlaw inverse ETFs, just shows you how much of a short squeeze this rally has been. In simple terms, brokerages are trying to stop individual investors from going short the market. Doing this didn't stop the market from collapsing in 2008. It won't this year either.

Indeed, considering the MASSIVE stimulus we've seen from around the world (even China got in on the action), it's VERY telling that the Baltic has collapsed virtually lock-step with its 2008 performance: a time of very little Stimulus.

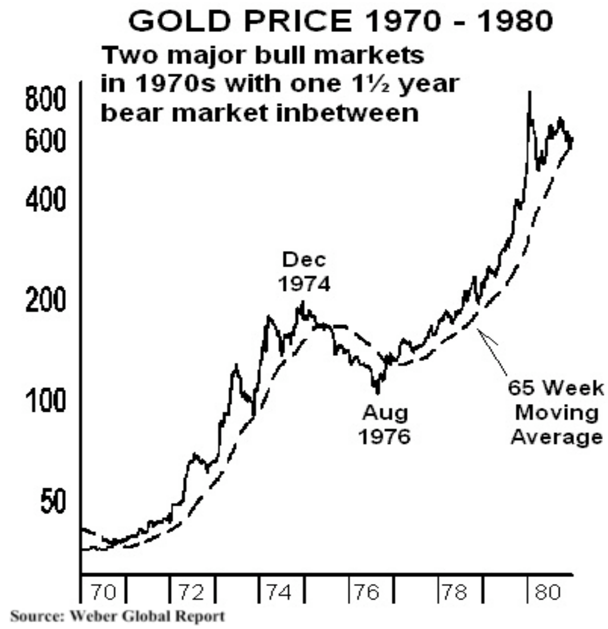
In light of this, I believe stocks are on very, VERY shaky ground right now. As I mentioned before, the only time stocks have been this overbought in the last 20 years, the market has absolutely collapsed in the subsequent months.

I believe and continue to stand by my thesis that stocks are on borrowed time. The S&P 500 began to come unraveled this morning, before JP Morgan stepped in and bought 1,500 futures ($150 million worth) pushing the S&P 500 back up to 1,000.

In a word, the game is almost up. With Wall Street now the only thing standing in the way of a full-scale collapse, it's only a matter of time before we see the Crash of 2009 commence. We'll go short before it happens. However, in the meantime, we're closing all of our shorts and going long gold and gold mining stocks. I don't wan to risk anymore losses if this insane rally has more legs.

Gold is Ready to Make a Major Move

During the last bull market in gold, the precious metal rose 2,329% from a low of $35 in 1970 to a high of $850 in 1980. <u>However, during that time, there was a period of 18 months in which gold fell nearly 50%</u> (see the chart below).



As you can see, from mid-1971 to December 1974, gold rose 471%. It then fell 50%, from December ’74 to August ’76. After that, it began its next leg up, exploding 750% higher from August ’76 to January 1980.

Now, in the first wave of its current bull market (2001 to March 2008), gold rose over 300% from $250 to a little over $1,000. It then staged a retracement of 30% falling to $700. So if we were to go by the historic pattern of the gold market in the ‘70s, gold should experience upwards resistance for 19 months after its first peak today.

Gold’s recent peak was $1,014 in March ’08. If this current gold bull market parallels the last one, then gold should renew its upward momentum in a very serious way starting in September-October 2009. And this next leg up should be a major one (the biggest gains came during the *second* rally in gold’s bull market in the ‘70s).

So I’m recommending we buy gold and the gold miner’s ETF to collect these profits while we wait for the stock market to roll over.

Action to take: Buy the Gold ETF (GLD)

Action to take: Buy Gold Miner’s ETF (GDX)

Conclusion

This last month has been positively miserable for anyone performing fundamental analysis (that includes us). Time and time again stocks have exploded upwards on worsening fundamentals and economic conditions. It doesn't pay to fight the trend and so we're leaving our shorts and putting our money to work in gold and gold miners: two sectors that will perform well as the dollar continues to fall while stocks and commodities rally.

Thank you again for your interest in *International Wealth Advisory*. I am available via email at pwa@gainspainscapital.com if you have any pressing concerns. Please remember however that I am not permitted to give any personal investment advice on a one-on-one basis.

Good Investing!

Graham Summers

OPEN POSITIONS					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Gold ETF	GLD	8/25/09	$94.75	**NEW**	**BUY!**
Gold Miner's ETF	GDX	8/5/09	$40.93	**NEW**	**BUY!**

CLOSED POSITIONS						
Company	**Symbol**	**Buy Date**	**Buy Price**	**Sell Date**	**Sell Price**	**Gain/Loss**
Dollar Bull 2.5X Fund	DXDBX	6/17/09	$31.76	Close 8/5/09	$28.29	-9%
Host Hotels (SHORT)	HST	8/8/09	$7.30	Close 8/5/09	$10.34	-42%
UltraShort Financials	SKF	At Open 7/22/09	$40.54	Close 8/5/09	$29.39	-28%
UltraShort Crude Oil	SCO	7/29/09	$20.70	Close 8/5/09	$15.63	-24%
UltraShort Basic Materials	SMN	7/29/09	$15.73	Close 8/5/09	$12.96	-18%
UltraShort 20+ Yr Treasuries	TBT	5/6/09	$50.11	At Open 6/12/09	$57.13	14%
Gold Miner's ETF	GDX	5/6/09	$36.86	At Open 6/3/09	$43.74	19%
Powershares DB Base Metals	BDD	5/27/09	$7.11	At Open 6/12/09	$9.62	35%
UltraShort Russell 2000	TWM	6/10/09	$40.55	Close 6/22/09	$45.45	12%
Rogers Agri ETN	RJA	5/6/09	$7.62	At Open 6/25/09	$7.33	-4%
UltraShort Financials	SKF	6/3/09	$42.18	At Open 7/9/09	$46.18	9%
Templeton Russia(SHORT)	TRF	6/24/09	$16.39	At Open 7/9/09	$15.17	7%
Gold ETF	GLD	5/6/09	$89.54	At Open 7/9/09	$89.63	0%
				Portfolio Average	**-2%**	
				S&P 500	**8%**	