Private Wealth Advisory

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The Next Wave of the Crisis

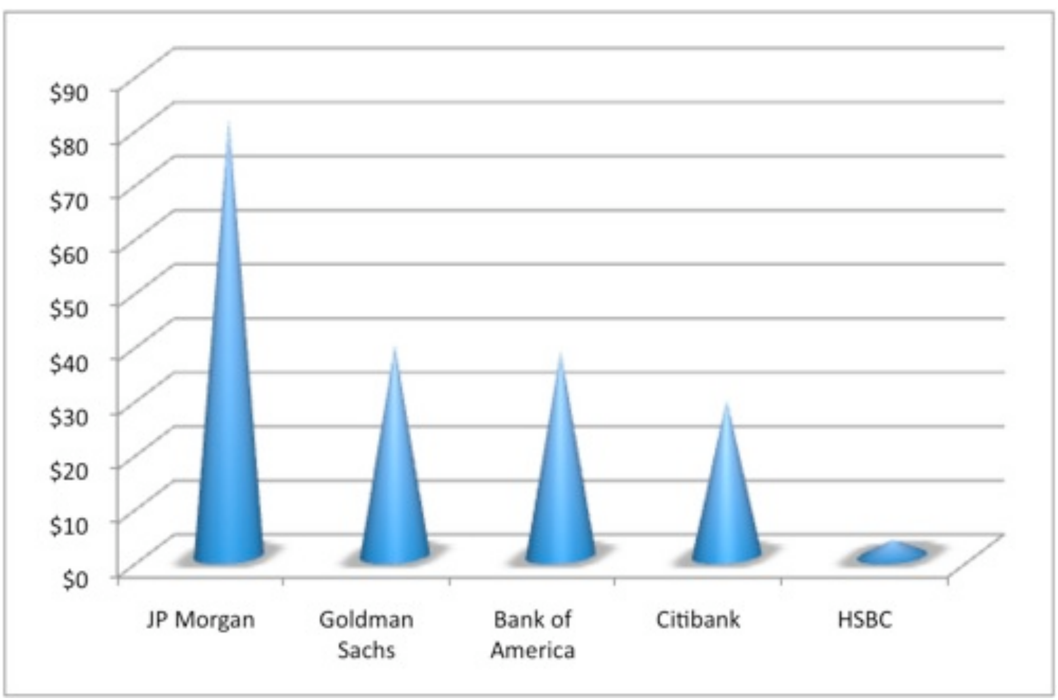
We may have gotten the "Sell" signal we've been waiting for.

As I wrote last week, I desperately want to go short this market. But because we've already tried to do so twice and were stopped out, I wanted to stay on the sidelines until we got a confirmed sell signal. When I wrote that issue, I stated that I wanted to see a weekly close on the S&P 500 below 1,000.

We have yet to receive that weekly close below 1,000. But we have seen a daily close below 1,000. And I am now willing to move ahead with our short selling because we've got the makings of a VERY serious situation developing in the financial markets.

In case you have not heard the news, China has announced that it will be instructing its state-owned enterprises to potentially default on their derivatives contracts. As I have written extensively in the past, the derivatives market is a massive time bomb just waiting to go off. China's latest move may be the match that lights the fuse.

All told, US Commercial banks own $**202 trillion in derivatives in notional value**. To put that number into perspective, it's roughly four times the global GDP. And 96% of this exposure sits on five banks' balance sheets. I've shown the below chart before, but it's worth re-visiting (chart is denominated in TRILLIONS).



Of course, not ALL of the $202 trillion these guys own is "at risk." As their name implies, derivatives are "derived" from underlying assets (homes, debt, etc). The actual "at risk" money can be far FAR smaller than the "notional" value of derivatives outstanding.

However, when you're talking about $200+ trillion, even a marginal amount of "at risk" money can mean ENORMOUS losses. Consider, if 1% of that $200 trillion were at risk, you're talking about $2 trillion in capital. Now, if even 10% of those bets go bad, you're talking about $200 billion in losses.

Now consider that, combined, the top five banks (JP Morgan, Goldman, BofA, Citi, and HSBC) have roughly $700 billion in equity.

And that's it only 1% of the derivatives outstanding are actually "at risk." Given the over-leveraged, stupid plays Wall Street made on mortgage-backed securities and credit default swaps (both investments that had SOME degree of oversight, even if it were paltry), as well as the fact that derivatives are COMPLETELY unregulated, I would argue it's quite possible that as much as 5% or even 10% of the derivatives outstanding could be "at risk."

In that case, we're talking about $10-$20 trillion in "at risk" capital. If even 10% of these bets go wrong, you've wiped out ALL the equity at all five banks AND THEN SOME.

As I mentioned just now (and before many times), the primary problem with derivatives is that they are COMPLETELY TOTALLY unregulated. NO ONE has any idea what's "at risk" or who owns what or who's betting against who.

But we may be about to find out.

Will China Go "Nuclear?"

I've detailed the ongoing conflict between China and the US regarding monetary policies on these pages before. The brief overview is that China owns $800+ billion (by some accounts $1.3 trillion or more) of our Treasuries (debt) and is not too happy about Ben Bernanke and other US monetary figures throwing trillions around in bailouts and emergency measures to counteract the financial crisis.

China has fired a couple of "warning" shots already, mainly in the form of various Chinese diplomats expressing concern and frustration with the US's monetary policies. They even flew China's Vice Premiere to an unscheduled talk with US monetary officials back in July.

No one knows what was said during the talks, but given that Ben Bernanke is extended Quantitative Easing to October and has shown little signs of reversing his current "anti-dollar" policies, it's pretty clear China didn't get what they wanted.

I’ve often wondered what China would do if push came to shove. Their decision to have their state-owned enterprises default or renege on their derivatives contracts may be the answer.

Let me explain.

As I’ve stated on these pages before, I view the “bailouts” as nothing more than an attempt to funnel taxpayer money to the large US banks so they can raise capital to avoid insolvency. It was essentially a “re-capitalization” effort using public funds. And it came at the expense of the dollar and Treasuries.

China, who owns more Treasuries and dollar-denominated assets than anyone, was obviously not too pleased about this. They’ve asked time and time again for the US to stop what it is doing. However, Geithner, Bernanke, et al, simply plowed ahead ignoring their requests (Geithner actually told a group of students in China that the math behind the US’s policies were solid which resulted in the students laughing at him).

China’s decision to default on its commodity derivatives is a very clever means of slapping the US Federal Reserve in the face without “going nuclear” by selling Treasuries outright.

Commodities account for the smallest portion of derivatives on US commercial bank balance sheets ($938 billion out of $200 trillion). A default here would trigger a chain reaction that could essentially wipe out the Fed’s attempts are re-capitalization (the US banks would suddenly be on the hook for billions in losses that they didn’t expect). It’s a **very serious** indirect way of China saying, “if you want to continue screwing around, we'll simply walk away from the table." But they're doing it in a select asset class that no one but Wall Street engages in (derivatives).

The primary issues now are:

- Whether China WILL actually begin defaulting (remember, so far it's just a threat).
- Whether or not China's decision would trigger a larger chain reaction in the derivatives markets.
- How the US will respond to China's threat.

I do not know the answer to these issues. No one does.

I DO know, however, that a derivative chain reaction throughout the financial system could cause a full-blown implosion like September-November 2008. We're talking about massive volatility (2%+ swing days) and a stock market collapse of 20-30% within a matter of weeks.

Remember, computers account for 70% of the market's volume. And they can simply walk away OR even worse, start driving the market lower as they adjust to trading in the new environment. These are not sensible, brain driven, investors who can make qualitative judgments. They are computers trading based on algorithms that track various metrics. If we get a black swan even (and China defaulting on derivatives would be one) these computers could go completely haywire and instigate a repeat of the '87 Crash.

I am not saying that this WILL happen, but mention all of this to remind you of the investing environment we're in. Pull the plug on the computers and you've got panicked selling galore and a repeat of October 2008 if not 1987.

I'm preparing our portfolio for this eventuality this week (more on this in a minute) with a number of trades that should prove extremely profitable if the Crash I've been predicting for months comes to fruition.

However, we also need to consider the socio-economic implications of what could happen should China start defaulting on its derivative contracts with the US. If China chooses that route**, the US could choose to default on its debt to China**. **<u>At that point we would be in a full-scale economic war and potentially on our way to military conflict.</u>**

The fact that Japan's new leadership has also expressed displeasure with the US's monetary policy adds to the mix. This creates additional issues that I do not know the outcome of (Japan and China are our largest creditor nations).

I am not saying any of this to be "scary" or "doom and gloom." But things are coming to a head in a very REAL way on the global stage. And it is not looking good at all. This financial crisis is nowhere near over. If anything we're at the end of the beginning. Many,

many more banks will go under. We can and will see a lot more volatility in the bond and currency markets (a bear market in bonds would be a nightmare we haven't seen in 30 odd years). And stocks (already overbought and propped up via manipulation and accounting gimmicks) are primed to take a full-scale nosedive (more on this in a minute).

My Personal Message: BE PREPARED

In light of this, and on a more personal note, I am suggesting you prepare for the WORST if you are in the US. This means stockpiling food, and having enough cash on hand to survive an economic shutdown if it happens. We came close to such an event last fall (the story was not widely spread but banks in US and UK considered shutting down ATMs and having a holiday).

I can tell you that I personally have stockpiled food (3 months' worth) and am telling my family and friends to do the same. After all, what's the worst that could come from doing this? If I'm totally wrong and everything gets better, you simply eat the food just like you would anyway.

But if I am right, and things do get MESSY, then stockpiling now means you've got food on the table later. Again, we have the making of several black swan events that could push an already weak economy into SERIOUS trouble. Among them are:

- China defaulting on derivatives (triggering a chain reaction in the financial markets)
- China selling Treasuries (flight from the dollar and all paper money)
- Japan sell Treasuries (ditto)
- The $7 trillion commercial real estate market (as bad if not worse that the US residential market)
- Some other chain reaction event in the $1 QUADRILLION derivative market
- The H1N1 virus (a major flu pandemic would stop all economic growth in its tracks)
- A major bank failure (rumors of Wells Fargo or someone else are swirling)
- Some other item no one sees coming (e.g. Gmail shut down for an hour yesterday, imagine if the NYSE's servers did the same thing).

All of these could portend another crisis for the US economy and stock market. I put the likelihood that we are out of the Crisis and the Great Depression II (it is a DEPRESSION, not a RECESSION), at less than 5%. Even if we go the route Japan did in the '80s instead of a full-blown black swan induced meltdown, then we're talking about weak economic growth for a two decades with high unemployment, lower quality of life, and the stock market slowly losing 80% of its value.

How the Collapse Will Play Out If It Happens

As I mentioned at the beginning of this issue, we MAY have gotten the "Sell" signal I was looking for. Tuesday was a 90% down day, which means 90% of the stocks on the market fell. That's usually a sign of a VERY serious correction coming.

Moreover, the volume on Tuesday was the most we've seen since June before traders went on summer vacation. This tells us that the Big Boys are back in town and are essentially waiting to sell (up days have seen weaker and weaker volume in the last few weeks).

On top of this, we're entering September which historically has been the worst month for stock. In 63 of the last 108 years, stocks lost money in September. And then we've got October: the month of Crashes and the scariest month for stocks. And we're going into these months with 80% of investors bullish, low volume, a weakening economy, and several potential black swans on the horizon.

I think the likelihood of a full-blown Crash like last year is pretty high. Even if we don't get a Crash (and re-test of the March lows), stocks should retrench to 830 on the S&P 500, which is 17% correction.

However, as I've mentioned earlier we DID NOT get the official "sell" signal I was looking for: a weekly close below 1,000 on the S&P 500. In light of this (and the fact stocks didn't sell off today), I am not issuing a full-blown "go short with everything you've got" recommendation.

You see, the way corrections and sell-offs usually occur is that you get an initial rapid drop, a brief bounce, and THEN the REAL descent begins. This is how 2008 played out.

As you can see, in September 2008 stocks slid for the first two weeks then staged a bounce (September 17-20). After the bounce the REAL sell-off began, with stocks entering a virtual free-fall into October. Indeed, it is HOW stocks perform after the bounce that decides whether you're in for a collapse or a consolidation period.

In light of this, I believe the correction of the last few sessions to be the initial drop. So we could very well see a brief rally this week or next. After that it will be time to go short with a vengeance.

At the same time, if stocks do start a free-fall without a bounce, I want to be on board to capture the gains. We're already doing this with our China Short (FXP) and Gold (GLD) and Gold Miners (GDX) all of which are up.

So here is how we will play what's to come.

Three Trades to Prepare Us for the Coming Collapse

This week I am going to recommend three trades. For the sake of our official track record today's closing prices will be the "buy" prices. **But I strongly urge you NOT to establish your full position in them today.** Instead, simply take a nibble or two (maybe 10% of your intended position).

For instance, if you're looking to ultimately put $1,000 to work per position, I suggest only buying $100 of these three trades today. I then suggest averaging in to your full position over the coming weeks as we wait to see whether we get a bounce or not. I will send out updates telling you when to increase your positions. I will also be addressing this in the coming issues of *Private Wealth Advisory*.

So again, DO NOT rush out and pile into these trades. Establish a small position now and then wait for confirmation that the REAL sell-off is here. DO NOT ESTABLISH YOUR FULL POSITION TODAY.

Remember, this market is nothing if not heavily manipulated. The powers that be could step in to crush the shorts again, kicking off another brief rally. It's clear that the market is becoming unhinged. But when you're playing cards with an 800lb gorilla (the Fed and Treasury) you can have the winning hand and STILL get beaten up.

Ok, on to the trades.

Trade #1: SHORT the Big Banks

The big banks have the largest derivative exposure (as well as the most junk on their balance sheets). If China chooses to default on their derivatives contracts (or another round of deflationary crisis hits), these guys will suffer the most.

Rather than picking an individual bank to short, I want to short the entire sector. The easiest way to do this is to **SHORT the SPDR KBH Bank ETF (KBE).**

The SPDR KBH Bank ETF (KBE) is an ETF of the big banks and financial companies. Its holdings are as follows:

Bank of America	10.38%
Bank of NY Mellon	5.57%
Capital 1	4.35%
CitiGroup	4.56%
JP Morgan	8.57%
M&T Bank	4.15%
PNC Bank	5.35%
State Street	5.26%
US Bancorp	7.28%
Wells Fargo	9.94%

As you can see, KBE owns all of the big boys. Shorting it is essentially shorting the "too big to fail" crowd (what I prefer to call the "big failures" crowd).

Financials have lead the market during the upside rally. They will do so on the downside as well. Wherever the next wave of the financial crisis comes from (commercial real estate, derivatives, etc) the large banks will fall hardest. As you can see, KBH (blue) has already begun to break down compared to the S&P 500 (red). **Most notably, KBE actually FELL 2.4% today, while the market only fell 0.30%.**

Action to take: SHORT the SPDR KBH Bank ETF (KBE).

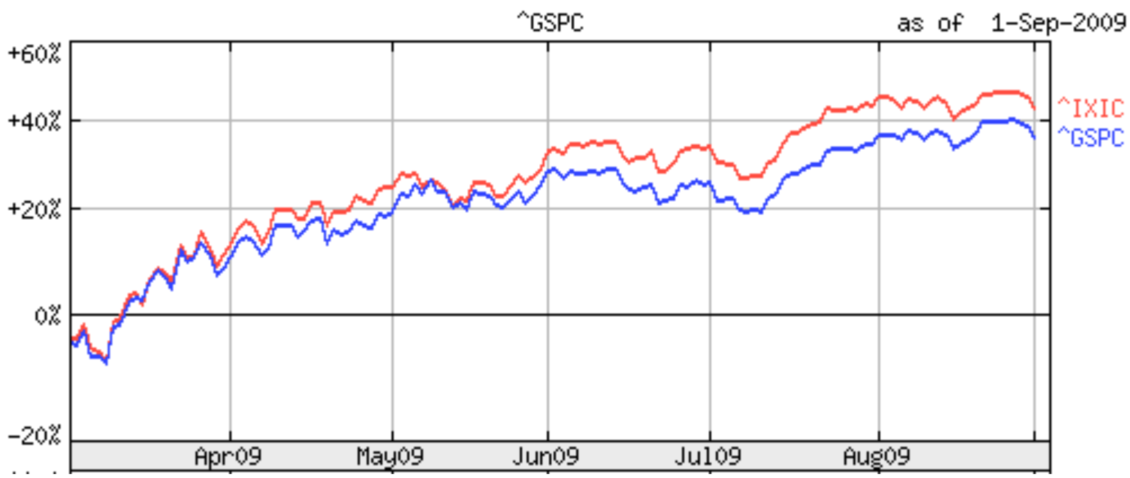
REMEMBER: we are SHORTING this investment, NOT buying it. If you're not familiar with shorting talk to your broker. ALSO, remember NOT to establish all of

your position today. Buy only 10% or so of your intended full position. We'll average in as the sell-off intensifies.

Trade #2: SHORT Tech Stocks

I've talked about going short Tech stocks before. The whole investment community views tech as a kind of safe haven, largely because they have the smallest exposure to derivatives/ other toxic waste and because they have a lot of exposure to international markets.

Because of this, the NASDAQ (red) has outperformed the market in general (S&P 500= blue) throughout the rally by about 5-10%.



Let's be blunt here. Tech is not a safe haven. When it comes time to cut costs, consumers (international and domestic) will go without iPods and computers before they stop buying food or alcohol. Dell and Intel only posted "better than expected" profits by cutting costs to the bone and selling their products at massive discounts.

Meanwhile, the NASDAQ is showing serious signs of a breakdown: most notably a continued rally on a lower Relative Strength Index (RSI) reading.

If you're unfamiliar with the metric, the Relative Strength Index is a great way to measure the internals of the market. It reflects how overbought or oversold the market currently is compared to history, both recent and past. Typically an RSI around 75 means a market is overbought, while an RSI of 30 means the market is oversold.

A lower RSI on a rally is a very ominous sign for the market. It essentially means that the market is rallying on weaker and weaker strength. This is what happened for most US indexes in the autumn of 2007. And it's precisely what is happening with the NASDAQ today.

As you can see, the NASDAQ RSI hit an overbought level of 75 in early August. The RSI has since collapsed to 50 while the NASDAQ pushed onwards. This is a SERIOUS sign of weak internals.

We're shorting the NASDAQ by **BUYING The UltraShort NASDAQ ETF (QID).**

QID returns 2X the inverse of the NASDAQ. So if the NASDAQ falls 5%, QID rallies 10%. If the NASDAQ falls 10%, QID rallies 20%. It's a great means of playing the coming collapse in Tech stocks.

Action to take: Buy the UltraShort NASDAQ ETF (QID).

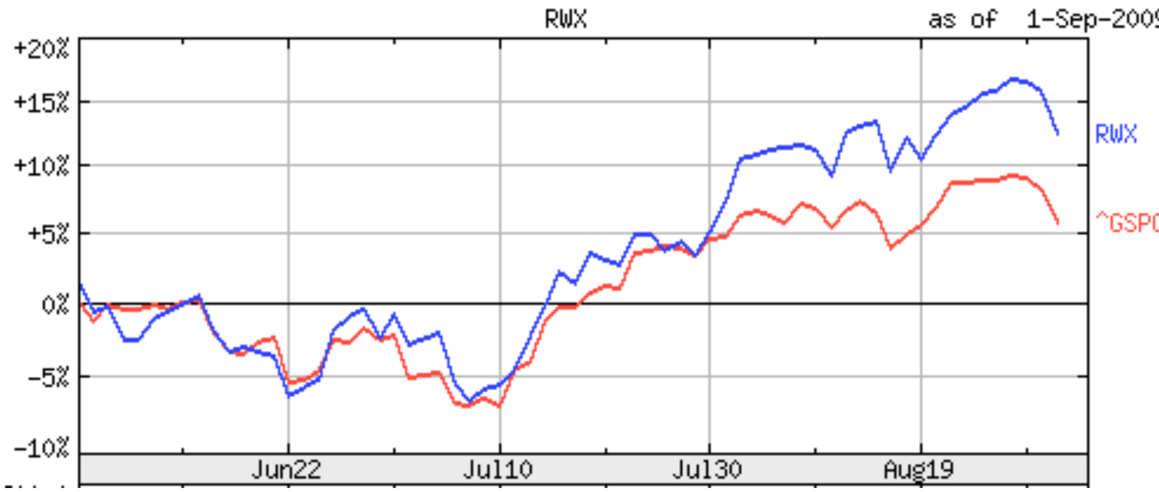
REMEMBER DO NOT establish all of your position today. Buy only 10% or so of your intended full position. We'll average in as the sell-off intensifies.

Trade #3: SHORT Real Estate

Real estate stocks, like financials, are in serious trouble.

The real estate sector (blue) has rallied and outperformed the general market (S&P 500=red) dramatically since this latest rally began in early July. They've done this despite worsening fundamentals (the good housing news was largely the result of seasonal adjustments and accounting gimmicks. REAL new home sales for are down 31% year to date).

And just like financials, real estate will lead on the way down.



The fundamentals here are actually quite simple:

No jobs + no bank lending = no home sales.

Banks DON'T want to lend because they're using bailout money to improve their balance sheets. Consumer don't want to borrow because they're already highly in debt.

And yet real estate stocks have rallied 25% since the July 10.

This has the making of a terrific short. And we're playing it by **BUYING the UltraShort Real Estate ETF (SRS).**

SRS returns 2X the inverse of the real estate ETF. So if real estate stocks fall 5%, SRS rallies 10%. If real estate stocks fall 10%, SRS rallies 20%. It's a great means of playing the coming collapse in real estate stocks.

One can only imagine what will happen to homebuilders and real estate companies when the next wave of the crisis hits: they'll go down, down, DOWN.

We'll profit when they do.

Action to take: BUY the UltraShort Real Estate ETF (SRS).

REMEMBER DO NOT establish all of your position today. Buy only 10% or so of your intended full position. We'll average in as the sell-off intensifies.

Conclusion

In conclusion, these three trades will all profit beautifully from the next wave of the financial crisis. The market is giving very serious signs that its latest rally is ending. We may see a brief bounce, which is why I suggest only establishing 10% of your full intended position in our three new trades today.

However, once the bounce ends, stocks should begin rolling over in earnest. With our two largest creditors (China and Japan) beginning to make serious moves things could get UGLY very fast. We're already positioned to profit from this with our China Short (FXP), Gold (GLD), and Gold Miner's (GDX). Our three newest positions will perform do wonderfully too.

Good Investing!

Graham Summers

OPEN POSITIONS					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Gold ETF	GLD	8/25/09	$94.75	**$96.19**	**2%**
Gold Miner's ETF	GDX	8/5/09	$40.93	**$42.48**	**4%**
UltraShort China	FXP	8/11/09	$9.98	**$11.19**	**12%**
SHORT the Bank ETF	KBE	9/2/09	$21.60	**SELL SHORT!**	
UltraShort NASDAQ	QID	9/2/09	$26.83	**BUY!**	
UltraShort Real Estate	SRS	9/2/09	$13.10	**BUY!**	