PRIVATE WEALTH ADVISORY

AN OMNISANS RESEARCH PUBLICATION SEPT 9, 2009

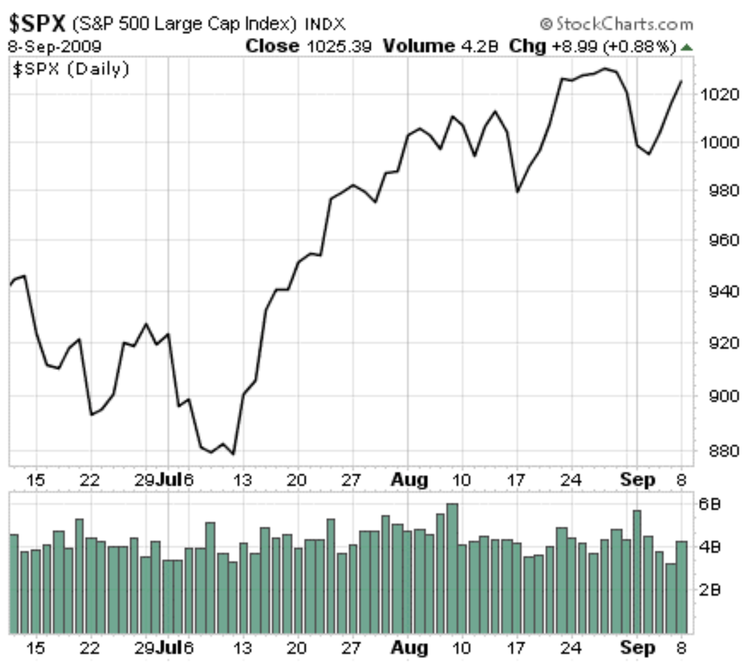
Here's the Rally, What's Next?

As I wrote in last week's issue, I expected a rally to occur before we saw the REAL meltdown in stocks. At the time I wrote:

> *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…*
>
> *...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.*

Well, we got the rally I forecast starting on Friday as traders gunned the S&P 500 higher on the lowest volume day we've seen since the week of the 4rth of July. Anyone telling you this rally has "signs of market strength" needs to have their head examined. This was nothing more than a handful of quant funds killing the shorts.

Also, remember that 30-40% of volume is in five stocks (Fannie, Freddie, CitiGroup, Bank of America, and the S&P 500 ETF). One can only imagine what the REAL volume would be without the high frequency computers passing shares of CitiGroup back and forth to collect a ¼ penny rebate on each transaction.



The question now is whether stocks put in a double top and then collapse… or will traders gun this rally even higher. I have stated repeatedly that I believe we shall see a mega-meltdown in stocks Fall. However, it's clear the quants and manipulators won't let this thing roll over without a fight.

If traders can push the market above its recent high (intraday 1,039 on the S&P 500) then we'll likely see a push to 1,100 or even 1,200. If that's the case we're going long to hedge our shorts (we opened 10% of our intended full positions in a number of shorts recently) and ride the final stage of this rally for a quick profit while we prepare for the coming collapse. Looking at the action today (S&P 500 challenging 1,030 again) it's possible this could happen.

However, it is equally possible that the August 28, 1,039 intraday highs were THE highs for this rally, and that stocks are in for a full-blown collapse within a matter of weeks. That is the reason I was willing to move early on our short positions: as I wrote last week, we were establishing 10% of our intended full short position in a number of trades. I acknowledged that we were likely early on these trades. Friday's and this week's rally confirm this suspicion.

So while it remains somewhat uncertain where stocks are headed in the near-term, to me it is clear where they are headed in the intermediate term (the next 1-3 months) and that is down, down, DOWN.

The Giant House of Cards That is Our Stock Market

To say that stocks are detached from economic realities would be the understatement of the year. Today, the S&P 500 is pricing in GDP growth of 4% and a 40-50% increase in earnings 2010. The odds of that occurring are less than 1 in 100 in my view.

For starters, the entire financial system and US economy are no completely reliant on profligate government spending. To date, the Federal Reserve claims to have pledged some $9 trillion in spending. God knows just how much money they've actually shuffled onto the big banks' balance sheets (there are far too many "off the balance sheet" lending windows for us to assess this), but Neil Barofsky (special inspector general for the bailouts) believes the bailouts could cost us $23 trillion total.

That is not a typo.

The banks have used this money to attempt to recapitalize their balance sheets. They've also been raising interest payments on credit cards and a slew of other moves in an attempt to grab any dollar they can from their customers. I personally have heard several stories of individuals with strong credit who had been customers of a particular bank for years suddenly seeing bizarre charges or fees on their accounts. This is just the banks' attempts to raise cash by any means possible.

Similarly, the large Wall Street banks have been taking advantage of bailout funds and feeble regulators (the SEC has failed miserably to do anything) to transform our stock market into a giant casino. As I noted in our July 22 issue *Crooks, Computers, and China* institutional traders collect ¼ penny rebates for every transaction they make on the market. Because of this, the NYSE and other indexes have become dominated by high frequency trading programs (HFTPs) that perform billions of transactions a day to cull that ¼ penny rebate.

All told, these programs account for 70%+ of market volume today. They also FRONT-RUN ordinary investors (you, me, pension funds, etc.) because they are given access to data feeds a few milliseconds ahead of everyone else. This allows them to get in front of your order, buy the shares you wanted, turn around and sell the shares to you for the same price, and collect a ½ penny profit (¼ penny for the purchase and ¼ penny for the sale).

This too, is an attempt to recapitalize the bank balance sheets. It's also the reason the stock market's action make NO SENSE what so ever. At one point the S&P 500 and the US dollar were trading at a perfect inverse correlation, meaning that should the dollar fall, stocks rally. Let me be blunt here, perfect correlations DO NOT exist in real world markets. They only can occur in highly manipulated markets that are dominated by program trading (on a side note, today the market is trading at a perfect inverse relationship to the yen/euro carry trade).

All of this could come to a crashing collapse at any point should regulators or anyone of political influence crack down on program trading. Warren Buffett and some other big names recently signed a petition to curb this practice. Buffett has a virtual direct line to the White House due to his massive support of Obama's campaign. And with public outrage growing, it's possible high program trading will come under fire soon.

Even if it doesn't there are any number of black swan events waiting to cripple stocks. Among them are:

- Crisis in commercial real estate (the $7 trillion debacle that is beginning to unfold… and big banks own LOADS of bad commercial debts)
- China's decision to default on derivative contracts (the $200+ TRILLION time bomb sitting on the banks' balance sheets)
- A serious H1N1 virus outbreak (this would destroy any optimism or economic recovery)
- Foreign banks flight from the dollar (signs of this are already beginning)
- The China Bubble bursting (China lead us up no the market and economic "recovery" myth. It's primed for a collapse in the next three months)
- Other items we cannot foresee (crisis can always come from left field).

In the end, stocks need some SERIOUS economic recovery to justify their current levels. And the US economy is an absolute disaster that is getting worse. At some point in the intermediate term (and I cannot be certain when) stocks will come back to reality. When they do, we should see a 20-30% collapse very quickly.

Uncle Sam: the Only One Hiring, Lending, or Buying

Meanwhile, the US Federal government has become the hirer, lender, and payer of last resort: a literal lifeline on what is without a doubt, the weakest US economy in 50+ years. Today, Uncle Sam supplies 18% of household incomes, is hiring at a pace far greater than the private sector, and is generating 90% of all new home loans.

Again, that last one is not a typo.

For all intensive purposes, there is no such thing as a "private sector economy" in the US anymore (save the small businesses left to their own devices). Private sectors job losses have wiped out all the "job growth" of the last 10 years. Mass layoffs (firing of 50 or more people at a time) has hit a record high. The average workweek is at a RECORD low: 33 hours per week. Like I said, the private sector is virtually dead in the water. And it's only getting worse.

In contrast, the Federal Government has its fingers in the automobile, banking, mortgage lending, defense, and other industries. It's now gunning for healthcare and god knows what else. We're now running trillion-dollar deficits spending money we don't have to the dismay of our creditors (China and Japan).

And what have we got to show for all this government intervention?

Unemployment continues to rise (REAL unemployment around 16%). In REAL terms, one million people fell off the "employment" grid in July. More than 35 million Americans are relying on food stamps (some of these folks are borderline destitute, many others are simply trying to make ends meet after being forced to work part-time: see the average work week comment above).

Housing prices continue to fall: 14 million US homes are underwater, meaning the mortgage loan is now greater than the market value of the house (Deutsche Bank expects 40% of US homes will be underwater by 2011). Defaults on loans are in the double digits. Even the prime real estate market is showing serious signs of distress.

Banks continue to hide trillions in bad loans on their balance sheets. No one has stepped up and begun regulating derivatives (there are $200+ trillion notional value on US commercial bank balance sheets alone).

But, wait a minute… isn't all that government money supposed to have FIXED these issues: employment, housing, insolvent banks, etc.?

Let me blunt, the bailouts and stimulus have been an abject failure. They have not addressed the core issues plaguing our economy (jobs, incomes) NOR have they addressed those plaguing our financial system (insolvent banks, corruption, fraud). We've essentially thrown trillions of dollars around and solved NOTHING.

Why?

Because the US government has been prescribing the same junk (excessive debt, funny money) that created this mess in the first place as a solution. And we've hit a point of debt saturation.

We've Already Used Up the Growth They're Trying to Create Now

In 1966, $1 of new debt created $0.90 of GDP growth. As credit usage (consumer, mortgage, and the like) accelerated in the '70s, '80s, and '90s, we "pulled forward" future growth into the present. Put another way, by spending money we didn't really have, we created the illusion of REAL massive demand, which pushed prices and the US economy higher rapidly.

This is the power of credit: it allows you to put your current economic "growth" on steroids. A guy with a $50,000 limit on his AMEX can buy a much more expensive car than a guy who has to rely purely on savings (the actual money he has in the bank right now).

This is why prices exploded higher in the last 40 years. Most commentators claim it was inflation. That's a crock. Yes, the dollar has lost 80% of its value since 1971. But in 1971 college tuition cost $2,400 for an undergraduate degree, the median home value was $23,000, and a new car cost $1,600 or so. Today college tuition is around $100K+, US homes cost $180K, and a new car (decent) costs $15K+.

Put another way, the cost of "things" has soared exponentially higher than the dollar has fallen. This is due to excessive credit. When everyone is buying things they can't really afford, demand soars, which pushes prices higher. Indeed, one could easily argue that the period 1971-2007 was the largest period of inflation in history (remember inflation is CREDIT and MONEY growth, not merely currency devaluation).

This process of issuing more debt (credit) to achieve growth came to a screeching halt in the late '90s/ early '00s when the Tech Crash occurred (it was largely fueled by easy money courtesy of Alan Greenspan). However, old (dumb) habits die-hard and the Feds went all out trying to get the US debt machine back on track. Greenspan cut interest rates effectively to 0% and we had a "jobless recovery" fueled largely by the one of the largest speculative frenzies in history (large both in terms of caliber and in terms of the asset class investors were speculating on) HOUSING.

Buying and selling stocks does not require a lot of money. Buying and selling houses DOES. The period of 2000-2007 represented the pinnacle in the government's funny money policies: people were able to buy the largest single asset available to man (a home) for $0 money down.

This all came to a screeching halt in 2007 when we hit a point of debt saturation: meaning that the level of debt creation was now unsustainable because most money was already going towards debt repayments. By that point it took $5 of new debt to create $1 of new GDP growth. The US private sector was more in debt than at any other point in history ($52 trillion). Consumer debt was $2.5+ trillion: an amount equal to 20% of GDP at the time.

This is why pumping the system with more debt WILL NOT work. It will only create another bubble (likely in gold as people lose faith in the dollar). Even a 10 year old knows that you cannot solve a debt problem by issuing more debt. However, because our government and the Fed are dominated by academics who have:

1) Never run a real business and so have no clue about actual real world economics
2) Have never dealt with real confrontations other than cowardly students who need to get a good grade and so cannot actually call "BS"
3) DID NOT see the crisis coming

The government is, essentially, prescribing the same medicine that got our economy sick in the first place. And it will not work. Review the last few pages of this issue and ask yourself "why, if they're spending trillions, have things not improved for housing, jobs, etc?" You know now the answer. Things CANNOT improve via the issuing of more debt.

Consumers know this and are doing the only sensible thing: cutting back on spending and saving more money (although most of the alleged "savings" numbers are really just debt payments). Year over Year (YoY) changes in consumer credit are at record drops for the post-WWII era. July consumer credit fell $21 billion, a new record after the record $15 billion drop in June.

We've been doing this for some time. Credit card debt switched to negative as far back as end of 2007. The absolute peak for consumer credit came in July 2008 (not the beginning of 2009 as most commentators claim). Since that time, US households have paid off some $110 billion in debt…

And we've still got $2.45 trillion to go.

Remember, the US consumer accounts for 70% of our GDP and 16% of WORLD GDP. A major consumer credit contraction like this has ENORMOUS economic implications. I don't why the following is so difficult for the powers that be to understand:

Mass unemployment + increased savings/ credit contraction = NO recovery

Again, consumers are doing the only sensible thing (paying off debt) while our government continues to spend like a drunken sailor propping up businesses who should have failed (banks and autos). This will end very, VERY badly. And it will CRUSH stocks within the next 1-3 months.

Why the Market Will Crash Again

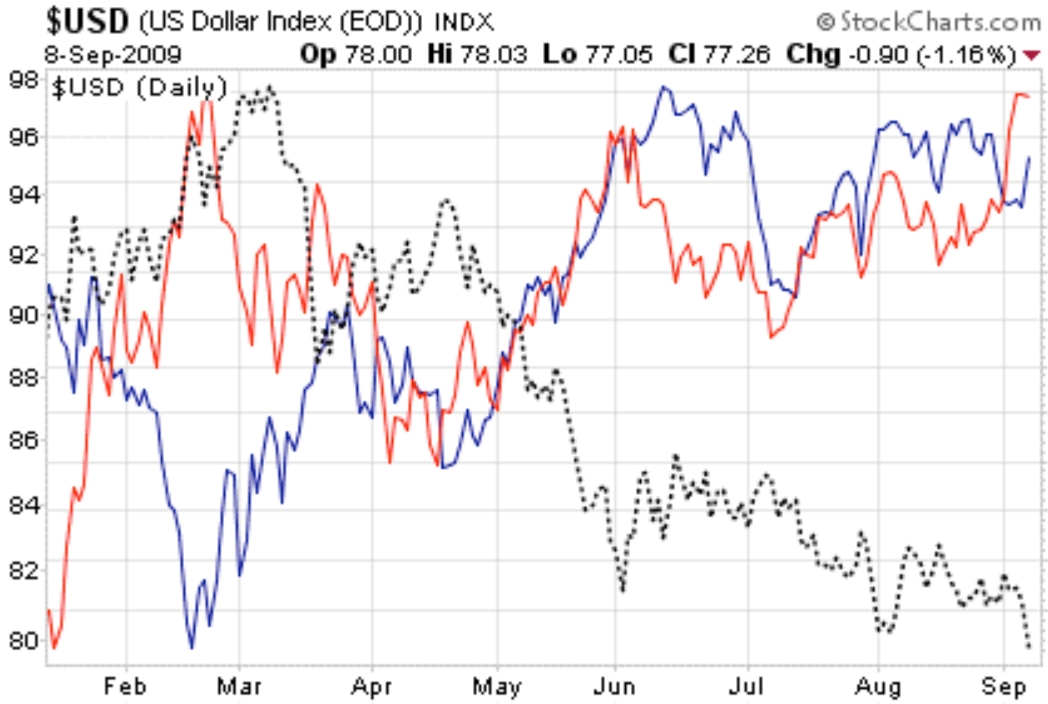
Looking at today's market I see a market that has/ is:

1) Rallied beyond anything remotely resembling economic realities
2) Dominated by program traders and algorithms that have no qualitative insights
3) Extremely low volume on up days and heavy volume on down days
4) Highly manipulated via clear end of the day ramps and carefully timed futures purchases
5) Highly overvalued (P/E= 100!!!)
6) Ignoring several enormous catastrophes lurking beneath the surface (commercial real estate, derivatives, dollar collapse)

None of these items bode well for stocks. This has been a liquidity-funded rally that traded based on technical details (cross-overs and moving averages) NOT anything resembling fundamentals or economic realities.

Indeed, since March '09 the market has largely rallied as a result of dollar debasement (the Fed pumping the system, pushing stocks higher and the dollar lower). As I mentioned before, at one point the market (S&P 500 or solid line) was trading at a perfect inverse correlation to the dollar (dotted line) as you can see in the chart below.

This, of course, has resulted in a slew of money flowing into oil (blue line) and gold (red line) as the dollar (dotted line) falls. After all, oil and gold are the most popular inflation hedges. And the market views everything the Fed is doing as pro-inflation.



However, Bernanke's policies can only work IF there are folks lined up to buy Treasuries/ US Debt. Put another way, you can only devalue your currency (and fund massive deficits and stimulus) as long as there are folks willing to lend you money to do it.

The Feds have been issuing a record number of Treasuries this year ($1+ trillion needs to be sold this year). At the beginning of the year, there were signs that foreign interest for Treasuries was waning (China and others creditors aren't too keen on Bernanke's anti-dollar policies). Because of this, Bernanke announced his Quantitative Easing program in which the Fed would buy Treasuries itself.

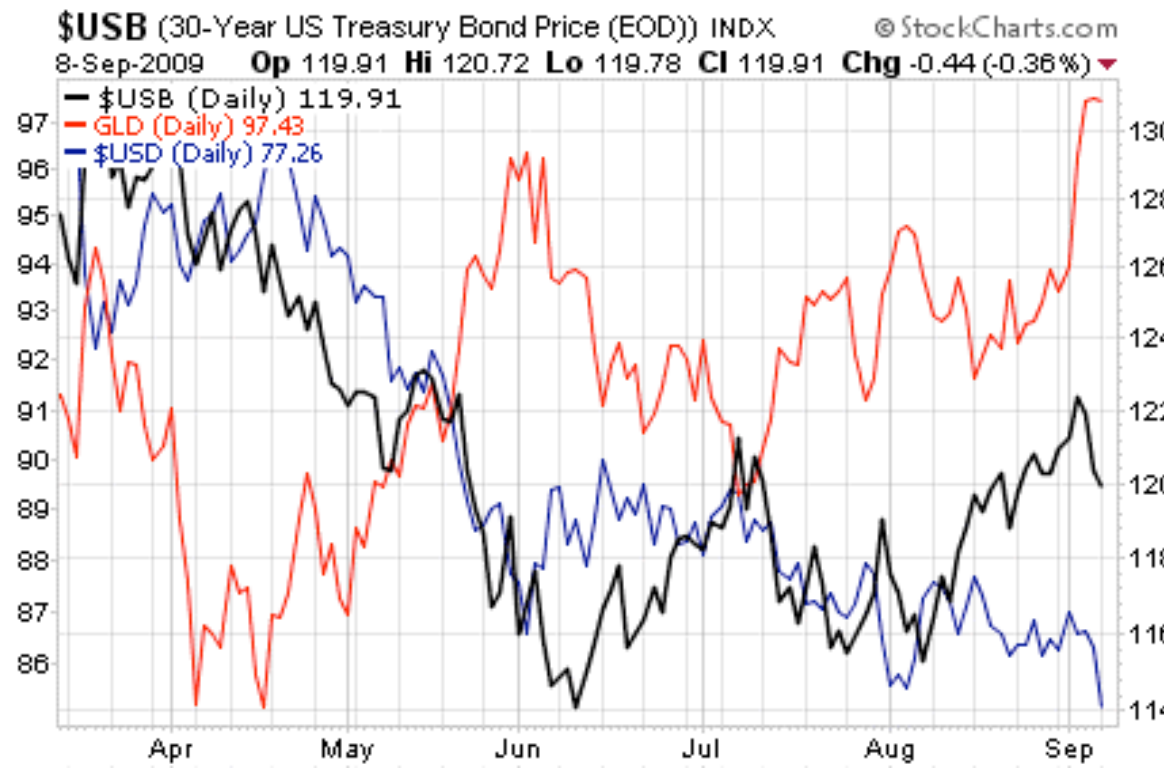
Then, the Feds altered their measures for buying bids at Treasury auctions. In simple terms, the Feds changed how they categorize who is buying what when Treasuries are auctioned off.

There are likely several reasons they did this, but the most obvious is that they are trying to hide the fact that REAL foreign interest is tanking. Indeed, the Feds have been caught buying back Treasuries that they previously claimed they sold to actual buyers (in this setup, the buyer buys the Treasury at the auction, sits on it for a week or two, and then sells it to the Fed).

Put another way, it is becoming increasingly clear that REAL buyers for US debt are diminishing rapidly. You can also see this in the gold market, where the precious metal has exploded higher on the flight from paper money.

Now, if BOTH gold and Treasuries were rallying things would be ok for the Fed because it meant that their policies of Quantitative Easing and bailouts were still acceptable to the market (folks were still willing to lend the US money, even while others were buying gold: the historic inflation hedge).

BUT… if gold RALLIES and Treasuries DROP… this means we might have REAL flight from paper money underway. Put another way, the BIG BOYS (foreign banks and institutional investors) would be sending a message to the US: **we don't trust you, your policies, OR your currency.**



The above chart shows a SERIOUS storm brewing. Gold (red line) is erupting higher. The dollar (blue) is rolling over. That's nothing new… but then we have Treasuries (black) beginning to come unhinged: the 30-YR Treasury was rejected strongly at 122, a point of key resistance.

If 30-YR Treasuries continue the collapse they started at the beginning of the month then we're in for a REAL inflationary storm a la the early '70s. The dollar and Treasuries remain above the former lows (71 on the dollar index and 107 on 30-yr Treasuries), but that will not last much longer if Bernanke doesn't alter his stance.

I guarantee you Ben Bernanke knows about the above chart. This alleged expert on the Great Depression has bet the farm that his policies would work under the view that no matter how crazy he got with the bailouts, there would still be folks willing to lend to the

US. The bond market is beginning to disprove him. So he now has a choice: sacrifice stocks or sacrifice bonds.

He’s going to have to sacrifice stocks.

Since 2007, stocks have largely been a liquidity game. The Fed pumps the system, stocks rally. The Fed drains the system, stocks fall. The Fed drained $100 billion at the end of September last year… three days later the market began its collapse in earnest.

The same thing happened in June of this year. The Fed contracted its balance sheet and drained some liquidity and stocks began rolling over. The Fed then juiced the system the week earnings started and kicked off this latest rally.

I’ve got a couple of key measures of liquidity I watch. One of them is showing potential for a serious liquidity drain $73 billion on September 23. I’m also seeing that the growth in the broad money supply (M2) has begun to slow.

In light of this, I believe Bernanke may already be slowing the money pump in an effort to defend bonds. He can’t raise interest rates because the vast majority of the $200 trillion in derivatives sitting on banks’ balance sheets are interest rate related… but he can curb the expansion of the Fed balance sheet and drain liquidity from the system: both of which are Treasury positive and stock negative.

Remember, the Fed CANNOT publicly announce that it is pulling the plug on stocks otherwise we’ll see stampede (this may happen regardless). So instead, the Fed has to quietly begin removing the market props. I believe it is already doing this and it’s merely a matter of time before stocks enter a very SERIOUS correction (potentially a full-blown CRASH).

We’ve already established minor positions in a number of shorts in anticipation of this. But it’s still early to go short with a vengeance. The market literally closed today just below its recent top. If the S&P 500 doesn’t clear it’s intra-day high of 1,039, it’s likely a double top has formed and the sell off will be forthcoming.

Again, it’s too early to place a large bet on a market decline. We’ve gotten the rally I expected. Now it’s time to see how stock play out. But keep you eyes on the end of September when the Fed’s liquidity drain could begin in earnest.

In conclusion, I believe the US economy to be in absolute shambles. I believe the bailouts and Stimulus have failed miserably to address the key issues plaguing our financial system and economy. I believe stocks are in a mini-bubble, completely divorced from reality. This mini-bubble was perpetuated by trading algorithms run by the big banks which have been using Bailout funds to attempt to recapitalize their insolvent balance sheets.

Finally, I believe Ben Bernanke's high wire act of propping up stocks by devaluing the dollar is coming to a head. The Treasury market is showing signs of duress. Bernanke will have to choose who "gets it," stocks or bonds. I think his "behind the scenes" moves of late (de-acceleration of money supply and potential liquidity drains) indicates that it will be stocks.

With that in mind, we've opened a number of short positions, putting 10% of our intended full positions to work. We are currently down on these trades due to our being early (a possibility I fully laid out last issue). We are now in the "waiting" period to see how the market rally plays out. REAL collapses occur in three stages: a brief correction, a brief rally, and then the REAL collapse. We've seen the first two stages of this pattern already. It's now a question of whether stocks break above their recent highs or roll over.

We'll know everything in a matter of weeks (before the end of September). So hang on for now. If a Crash comes, we're already positioned to make enormous gains. But if stocks rally a bit more and then collapse, we've only got a small portion of our capital at risk.

Again, now is the time to wait and see what happens. We need to let the market dictate our next move. But the odds are high we'll see a spirited decline in the next few weeks and possible even another full blown Crash in October.

I'm watching the market closely and will issue updates in real time as needed.

Good Investing!

Graham Summers

Portfolio Update

I have nothing to add on our current positions. The only new development is that gold has broken out as we forecast in early August. Having rallied to the critical point of $1,000 in a matter of weeks, gold is due for a cooling off or consolidation period. I expect we'll see far greater gains from both the Gold ETF (GLD) and the Gold Miner's ETF (GDX). For now we're up 2% and 8% respectively.

Hold tight here. The next leg up in gold's bull market is just beginning.

OPEN POSITIONS					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Gold ETF	GLD	8/25/09	$94.75	**$97.08**	**2%**
Gold Miner's ETF	GDX	8/5/09	$40.93	**$44.12**	**8%**
UltraShort China	FXP	8/11/09	$9.98	**$9.31**	**-7%**
SHORT the Bank ETF	KBE	9/2/09	$21.60	**$22.79**	**-5%**
UltraShort NASDAQ	QID	9/2/09	$26.83	**$24.45**	**-9%**
UltraShort Real Estate	SRS	9/2/09	$13.10	**$11.04**	**-16%**