Market Update: 2-18-15

I want to start this update by addressing the ongoing situation in Europe.

In simple terms, this situation revolves around just one issue: **whether or not Germany will permit Greece to restructure its debt.**

Greece has already had two bailouts. These bailouts were essentially loans made to Greece that would permit it to continue making debt payments on its pre-existing debt without a formal restructuring. Greek sovereign bonds *did* take a haircut in the second round of the bailouts, **but the only investors who were affected were private investors (not the EU banks or the ECB).**

The reason for this is because an "across the board" haircut (one that affected Greek bond holdings for EU banks or the ECB) would have triggered a derivatives crisis: **Greek bonds, along with German bunds and other EU nation sovereign bonds are the senior most collateral pledged against the large EU banks' derivatives trades.**

This is the one of the primary reasons why Germany and the rest of the EU are *against* a Greek debt restructuring today: because it would affect ALL Greek bonds, including the ones the ECB holds (the ECB is currently leveraged at over 250 to 1).

The other reason that the EU is against a Greek debt restructuring is because as soon as such a deal is approved, Spain, Italy, and ultimately France would be lining up to restructure their debt as well.

At this point, you're talking about over €3 trillion worth of sovereign bonds taking a hit, which would implode the entire EU banking system (a banking system that is leveraged at 26-to-1, **meaning that a 4% decline in assets would wipe out the banks' entire capital base).**

So on the one side you have Greece, that wants to restructure its debt. On the other side is the EU, especially Germany, that is completely against any debt restructuring and would like to simply implement another bailout.

The middle path would be just more "extend and pretend," meaning some kind of extension of bond repayments for Greece. Greece actually floated such an idea yesterday to the media:

> ***Greece may request an extension of its loan agreement for six months, according to a person familiar with the matter****, a step that could ease a standoff with creditors over the country's future financing.*
>
> ***Prime Minister Alexis Tsipras's government intends to make the request on Wednesday,*** *the person told reporters in Brussels, asking not to be named as the deliberations are private. Talks are continuing between Greece and its international creditors on the conditions that would be attached to the extension of the loan accord, the person said.*
>
> http://www.bloomberg.com/news/articles/2015-02-17/greece-said-poised-to-request-six-month-bailout-extension

The most likely outcome would be something along these lines, but the truth is, neither I nor anyone else knows how this will play out. It is clear that this round of negotiations is far more problematic than the previous bailout talks. But whether or not we'll get a Grexit is anyone's guess.

Speaking of which… **IF there *is* a Grexit, Europe will implement both border and capital controls. I can say this emphatically because these very ideas were floated back in March 2012 when the EU was last gripped by a debt crisis.**

At that time, then Prime Minister of France Nicolas Sarkozy openly called for the renegotiation of the Schengen Treaty: the treaty that established the 26-nation EU as a "borderless" entity in which individuals could move from one country to another with little difficulty and which also made trade among EU members easier. And a few months later, both France and Germany proposed the idea again.

> ***Germany and France's joint proposal to allow Schengen-zone countries to temporarily reintroduce border controls*** *as a means of last resort might sound harmless. But doing so would damage one of the strongest symbols of European unity and perhaps even contribute to the EU's demise…*
>
> ***According to the German daily Süddeutsche Zeitung, German Interior Minister Hans-Peter Friedrich and his French counterpart, Claude Guéant, have formulated a letter to their colleagues in which they call for governments to once again be allowed to control their borders as "an***

> ***ultima ratio" -- that is, measure of last resort -- "and for a limited period of time." They reportedly go on to recommend 30-days for the period.***
>
> http://www.spiegel.de/international/europe/german-and-french-proposal-for-border-controls-endangers-european-unity-a-828815.html

Here's another article floating the exact same policies in June 2012 when the EU Crisis was spinning out of control:

> **Exclusive: EU floats worst-case plans for Greek euro exit: sources**
>
> **European finance officials have discussed as a worst-case scenario limiting the size of withdrawals from ATM machines, imposing border checks and introducing capital controls in at least Greece should Athens decide to leave the euro…**
>
> **As well as limiting cash withdrawals and imposing capital controls, they have discussed the possibility of suspending the Schengen agreement, which allows for visa-free travel among 26 countries, including most of the European Union.**
>
> http://money.msn.com/business-news/article.aspx?feed=OBR&date=20120611&id=15208663

So should the EU Crisis again accelerate today (particularly if Greece leaves the Euro), these policies will most certainly be implemented. **For this reason, capital is already fleeing Europe and moving into the US.**

Most of it has gone into luxury real estate purchases (in cash) in New York and Las Angeles. However, the flow of capital has also helped the US stock market stay afloat despite the clear evidence that the US economy is once again weakening and heading towards a recession.

In terms of the US market, the head and shoulders pattern I noted last week has been invalidated. Instead, it now looks to me like we're in an upward- trending channel that is part of a larger megaphone pattern.

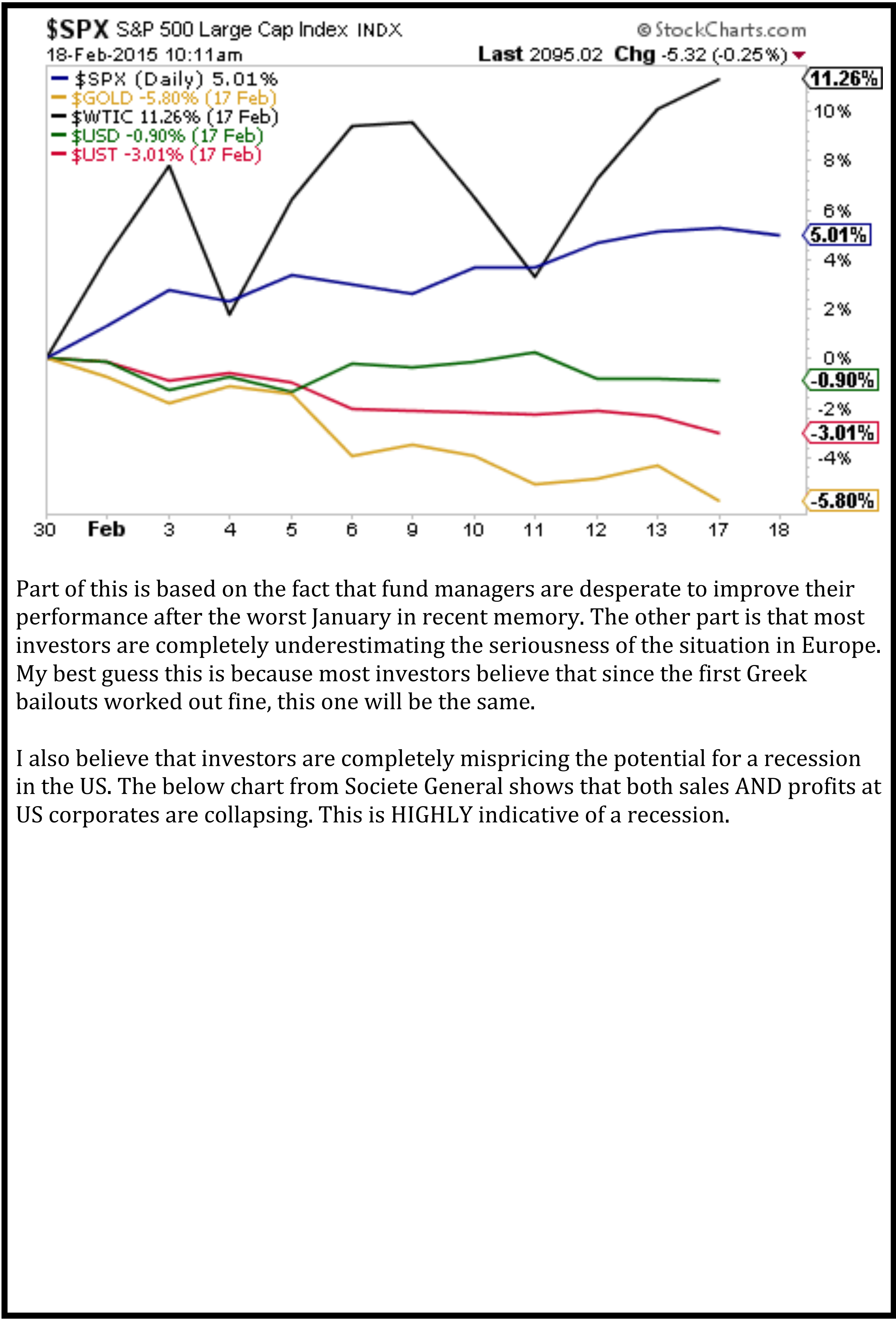
The pattern suggests we could get a blow off top to a little over 2,100. But if and when we take out the lower trendline (green) we're falling to sub-1800 in a very short period.

Another development that caught my attention is Gold's failure to break out of its wedge pattern. By the look of things, we're likely going back down to $1150 here.

If this doesn't hold we could go to sub-$1000. Gold is currently at THE trendline for the move that began back in 2005. If we take this trendline out, we'll fall back to the long-term bull market trendline which is currently around $850.

I would view ANY break to or below $1000 as a MASSIVE buying opportunity.

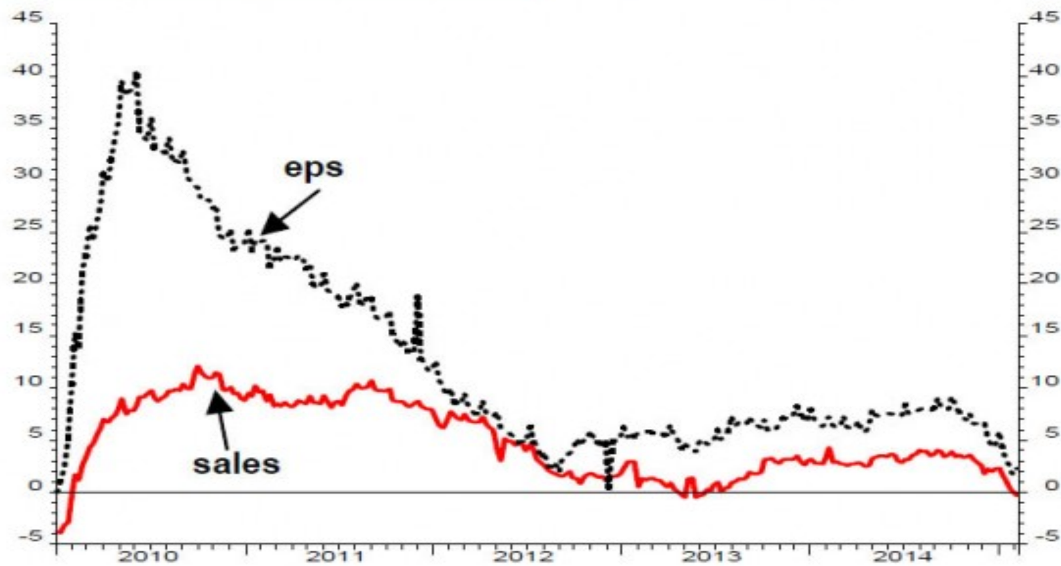
Gold's weakness is part of a generalized shift into "risk" assets that began in February. Since the start of that month, stocks (blue) and Oil (black) have soared, and the US Dollar (green) has flat-lined, while safe-havens like Gold (yellow) and Treasuries (red) have tumbled:



Part of this is based on the fact that fund managers are desperate to improve their performance after the worst January in recent memory. The other part is that most investors are completely underestimating the seriousness of the situation in Europe. My best guess this is because most investors believe that since the first Greek bailouts worked out fine, this one will be the same.

I also believe that investors are completely mispricing the potential for a recession in the US. The below chart from Societe General shows that both sales AND profits at US corporates are collapsing. This is HIGHLY indicative of a recession.

US S&P profits and sales have stalled out (yoy%)



Source: Datastream

If this trend continues, then the markets will correct VERY sharply sometime in the first half of 2015. For now, the markets are pricing economic perfection. This won't last much longer. Today, stocks are stretched a full 35% above their 200-weekly moving average. The market as a whole is more stretched than it was during the 2007 peak and quickly approaching the levels seen during the Tech Bubble (the single largest stock bubble in 100 years):

$SPX S&P 500 Large Cap Index INDX ©StockCharts.com
18-Feb-2015 10:22am **Last** 2093.32 **Volume** 2.1B **Chg** -3.67 (-0.18%)

This is obviously unsustainable. We are more than overdue for a sizable correction at least to 1,800.

I'm watching the markets closely and will issue updates as needed. Otherwise, you'll next hear from me in our longer monthly issue next week.

Until then…

Best Regards

Graham Summers
Chief Market Strategist
Phoenix Capital Research

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