Private Wealth Advisory

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The Last Hope… a Financial Fairy Tale

Years ago, in a land far, far away, called Normalville, people were reasonably happy with life.

Most of them had decent jobs, could afford keeping a decent roof over their heads, worked hard, saved a lot, and took the occasional vacation. Life was, in a word, decent for most folks. And they were happy to keep the money they worked for rather than handing it off to bankers or investment strategists.

However, one day a traveling magician named Alanus and his assistant Benito appeared in Normalville. No one had ever heard of either before because they were new to town and had never been involved in local commerce (or any commerce for that matter). However, it was rumored than Alanus and Benito could use their magic powers to make things levitate.

"This town is TOO boring," shouted Alanus. "Gather round and watch as my magic bubbles… RAISE YOUR SPIRITS!" With that he blew a bubble that enveloped a passing dog. The bubble immediately began to float off the ground with the dog within it.

The people were astounded. "How is this possible?" they asked. As soon as they heard this, Alanus and Benito knew they'd hit the jackpot. They quickly pulled out charts and graphs showing how bubbles could be applied to virtually anything, pulling it off the ground. Benito who was a bubble expert even quoted several scientific sounding studies by guys with fancy names detailing just how incredible life with more bubbles.

Throughout their demonstration, Alanus and Benito inflated bubbles around cars, trees, children, and more. However, it wasn't until they began inflating wallets and houses that people really went nuts.

"This is incredible!," they screamed. "With the miracles of bubbles, we can ALL have floating homes! Floating cars! Heck, even our money will be floating!!!"

Emboldened by the crowd's reaction to the first bubble, Alanus grew more and more confident in his bubbles. "I will inflate the entire world!" he cried and began pumping bubbles out furiously. Everyone was so excited about the inflationary effects of his bubbles that no one noticed the entire town of Normalville was no longer grounded on the earth: everyone and everything was inflated!

This continued for 20-odd years. As bubbles became more and more popular, traveling salesmen from various banks began going door-to-door selling bubbles to homeowners, pension funds, and other retirement plans. Soon selling bubbles was such a big business that every bank in Normalville was devoting 90% of its business to doing so.

Eventually, Normalville was so disconnected from the ground and so inflated that people no longer saved any money and homes were floating so high that first time buyers couldn't even get high enough to see inside the door. In fact, Normalville had become soooo inflated than even Alanus' most powerful bubbles were unable to push it any higher. It had reached a point of maximum inflation: a point at which adding more bubbles accomplished nothing.

And that's when it happened: Alanus' bubble spell broke.

You see, Alanus was actually borrowing the air he used in his bubbles from a guy named Asia. Asia was the biggest supplier of bubble mixture in the world. So Asia was only too happy to lend Alanus air because Asia knew that when it came time to buy bubble mixture, Alanus and ALL of Normalville would come a-knocking. To Asia, it seemed like a win-win.

Until the bubbles started popping.

At first it was only one or two… but soon bubbles were bursting by the dozen. Floating homes and cars were getting closer and closer to the ground by the day. Having completely forgotten about what life was like on the ground, the citizens of Normalville began to panic. "Oh my gosh! We're all falling! What are we going to do!?!?" they cried. "Let's go ask Alanus!"

But Alanus had quietly left town, leaving Benito in charge while everyone wasn't looking.

So the folks of Normalville went to Benito.

"Don't worry folks," said Benito, "everything is under control. Only a very small percentage of the homes and other assets are actually falling. In fact, I have numerous academic papers that prove it is impossible for homes to fall back to the ground."

"Well, that sounds pretty convincing," said the folks of Normalville. And they retreated to their homes. But as time passed the homes, cars, wallets, dogs and cats kept falling. People began to lose their faith in Benito. Benito sensed this so he called a special forum in the town center.

"Folks, the problem with all of this is that we weren't using enough air with our bubbles. So I am going to go all out pumping as much air back into Normalville's bubbles. And you know what? I don't care if Asia won't lend me any more air. If you'll all be kind enough to lend me some of each of your children and grandchildren's air, I'll have more than enough to re-inflate Normalville!" Benito then began showing off a bunch of fancy charts and graphs that looked very impressive explaining how his new strategy would work.

The townsfolk were a little concerned about lending their children's air… but Benito sounded so clever and convincing that they went along with his plan. So Benito went hog-wild blowing bubbles. He was literally hyperventilating 24/7 'til he was red in the face. Within one year he'd pumping nine trillion ounce of air into Normalville's deflating bubbles… but they kept on deflating. So Benito pumped even more air into Normalville, but to no effect… he simply could NOT re-inflate Normalville.

At this point the people of Normalville were getting desperate. So they turned to the town's mayor, Obama. Obama was perhaps the most eloquent speaker in the town. And since everyone had lost faith in what Benito had to say, Obama was their last hope.

"Folks, I know a lot of your are concerned about what is happening in Normalville," said Obama, carefully addressing the crowd as though he were speaking to each and every one of them. "But we've got a secret weapon to stop this deflation. That secret weapon is the power of political might. As your mayor, your elected leader, and the leader of the greatest town on the planet, I have been imbued with a force of will that is beyond comprehension.

"People of Normalville, I tell you this," he continued, "If I stand in front of the deflating bubbles and use my political might to say 'stop deflating at once,' the power of political might shall stop the deflation instantly. You see, politics are more powerful than things like gravity… or economic realities. There is literally NO force on earth greater than political might."

"We don't want more bubbles," cried the people of Normalville, "we want you to lock up Alanus, Benito, and all the other guys who were telling us to buy bubbles!"

But Obama was not flustered in the slightest. "People of Normalville, you do not understand. Putting those responsible for this mess in jail will not solve anything. Bubbles are a good thing. And we need to create more of them. Watch now as I use the force of my political might to stop this crisis and create the greatest bubble of all time, the bubble of government!!!"

Without saying another word, Obama walked out in front of a field of deflating bubbles. Poised like the last hope he was, he breathed deep filling his lungs with all the air he could. And then he cried out, "I am mayor of Normalville!! You will stop deflating at once and return to a state of full inflation! Normalville is not returning to normal! It is going to stay inflated forever!!!"

The bubbles stopped for a few minutes and lifted a few inches, ever so gently. The people of Normalville collectively held their breath…

And then the bubbles began deflating again.

$11 Trillion Spent… And For What?

I originally was going to launch into an extremely heated tirade for the lead of this issue. To be blunt, I am pissed off big time with the way things are going in the US. But since negativity rarely helps anything I thought I'd try to dress up the economic disaster that is the US in a children's story so it wouldn't be so depressing.

Having done that, let's look at the facts.

To date, the US government (I include the Federal Reserve) has spent some $11 trillion+ trying to re-inflate the US economy and stock market, They have failed miserably. Consider:

- 27 states in the US now have unemployment rates above 8.5%
- 60% of Americans don't have enough money saved to retire
- 2,690 employers performed mass layoffs (firing of 50 or more employees at once) in August (up from 533 in July)
- REAL incomes continue to collapse: at an annualized rate of 5% for the three weeks of August 28-September 23
- REAL weekly unemployment claims have topped 500,000 since January
- US bank loans have been falling at an annual pace of almost 14% since the early summer
- Shipments in capital goods fell 1.9% in August, similarly, rail shipments which slowed their rate of decline the last few months, have begun to accelerate downward again
- Industrial production has dropped 11%
- Fannie Mae's August data shows a surge in delinquencies from $4.2 billion to $70 billion.

And those are merely the data points I can quickly recall from recent releases. Elsewhere in the world (remember the Stimulus efforts were global) things aren't any better. The *Telegraph* recently noted that, *"China's exports were down 23pc in August; Japan's were down 36pc; industrial production has dropped by 23pc in Japan, 18pc in Italy, 17pc in Germany, 13pc in France and Russia…"*

When you consider just how little "bang for your buck" we got out of the unbelievable amount of Stimulus spent… you have to wonder what the heck the point of it was. Remember, the bailouts were sold to us as a massive effort to help Joe America keep his job, his house, and his ability to spend.

The reality is that the bailouts have accomplished none of these intended goals. There are two reasons for this:

1) Much of the bailout funds were never intended to help anyone but the banks
2) You cannot hold off economic realities indefinitely.

Regarding #1, it's clear now that Hank Paulson was engaged in:

- insider trading (it's fairly obvious he leaked information about bailouts/ interest rate cuts to Wall Street before the public announcements)
- embezzlement (he admitted to a reporter that he intended to give the bailout money to banks NOT buy toxic assets 10 days before testifying to Congress)
- fraud & perjury (he lied to the US and Congress about the real intentions of the bailout)

Regarding #2, no matter how you spin it, political grandstanding, bailouts, and emergency lending are powerless against the mega-deleveraging taking place in the world. Obama and Ben Bernanke can appear on TV or speak at the G20 and claim that we've pulled the economy back from the brink, but saying this doesn't mean it's true. All they've done is reignite a bubble in stocks (more on this in a moment).

It's truly a shame. Obama and pals were gifted a golden opportunity to reform the US economy. However, they chose to do everything from a "top down" perspective, hoping that government intervention and profligate spending would trickle down to the rest of the economy. This of course, ignores the real issues facing the US: the need for a REAL increase in jobs, incomes, and standards of living.

There are numerous solutions that would have been better than the chosen bailouts. Just off the top of my head, I think the following would have done a lot more to fix the crony capitalism as well as the financial system:

Solutions to fixing the crony capitalism situation:

1) Sending bankers who committed fraud, embezzlement, etc. to jail (by the dozens if not hundreds)
2) Revoking the charters of banks that were proven to break the law (Goldman Sachs, etc)
3) Abolishing the US Fed after publicly firing Ben Bernanke and raking Greenspan over the coals
4) Immediate subpoenas on Bernanke, Paulson, and all the others we now know broke the law during the Crisis
5) Dismantling, or better yet, letting the "too big to fail" banks go under.
6) Ending bonuses and putting salary caps on any banks receiving public money
7) Auditing the balance sheets of any bank receiving public funds
8) Revoking the charters of any bank receiving public funds that refuses to go along with #'s 5 and 6
9) Making all unregulated derivatives illegal
10) Dramatically increasing the capital requirements for banks operating in the US
11) Banning political contributions from ALL corporations

12) Instituting a system of checks and balances for former bankers who take government positions

Solutions to the US economy:

1) Some kind of income tax rebate (giving back income taxes from last year)
2) Massive tax cuts/ a tax system overhaul (adoption of sales and spending tax and abolishment of income tax and real estate tax)
3) Stimulating the small business segment of the economy (which accounts for 70% of the businesses in the US)
4) A massive cut of military spending combined with dramatic increased spending on education, technology, and engineering: fostering the next wave of entrepreneurs/ inventors who will alter the economic landscape
5) Some kind of mortgage refinancing for homeowners who are underwater

Heck, even if the government didn't spend a dime to bail out the US economy, they should at least hold those who created this mess responsible and send them to jail. We have loads of evidence that bankers and the like KNEW they were selling garbage or rating junk as AAA. That way headlines like "Goldman Sachs to pay out record bonuses" wouldn't incite public outrage (and coming civil unrest).

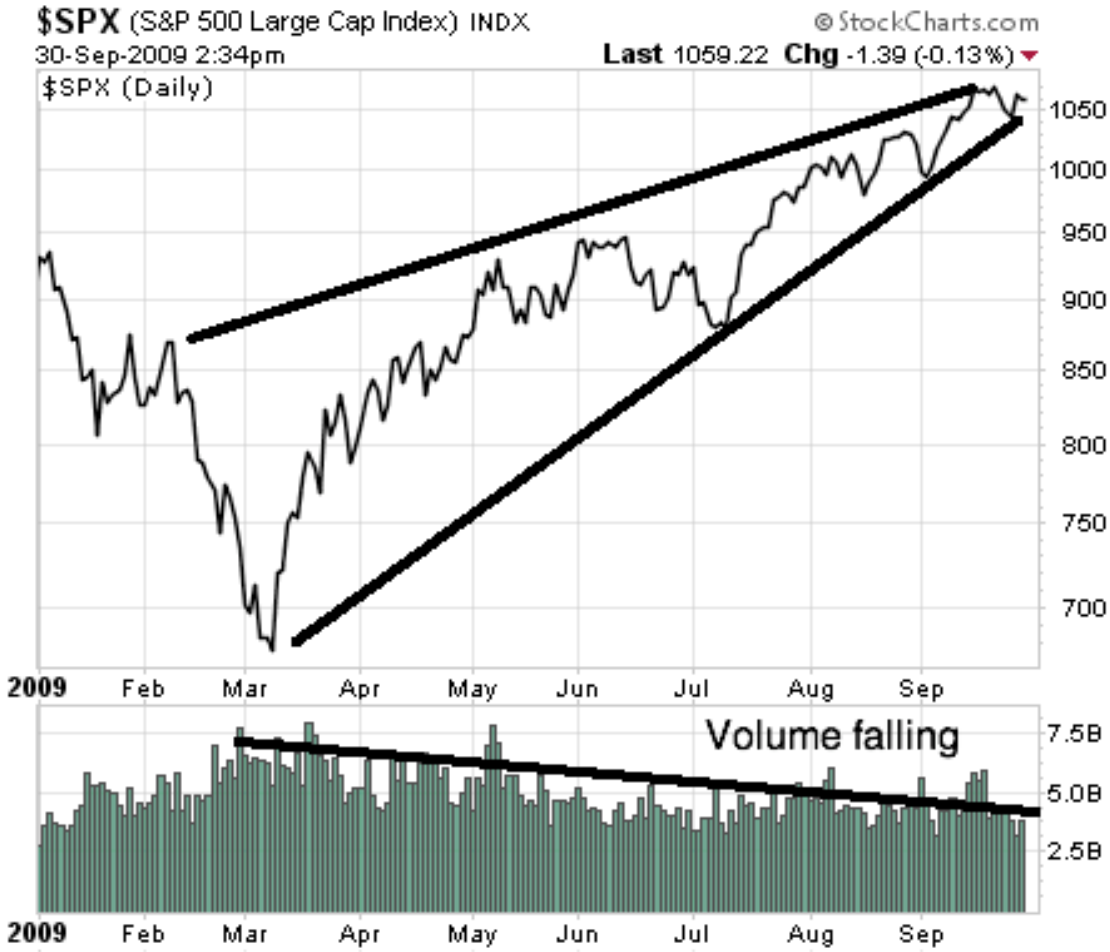
Alas, the solutions proffered were the direct result of our system. The reality of what's happened is actually very simple: either Obama, Bernanke, and the other political authorities do not understand economic realities OR they choose to ignore them because short-term fixes are better for currying votes… and because being honest would mean political suicide (one can only imagine the results if Obama publicly stated the banks were insolvent, the US was in a depression, and that it's highly likely we will be facing failed Treasury auctions in the near future).

In the end, all they've accomplished is staving off one Crisis (stocks collapse) by creating another (Treasury default? Derivatives implosion? Flight from the dollar? Etc). In the meantime, the one thing they did accomplish— a MEGA stock market rally— is showing serious signs of breaking down.

We're Soooooooo Close!!!

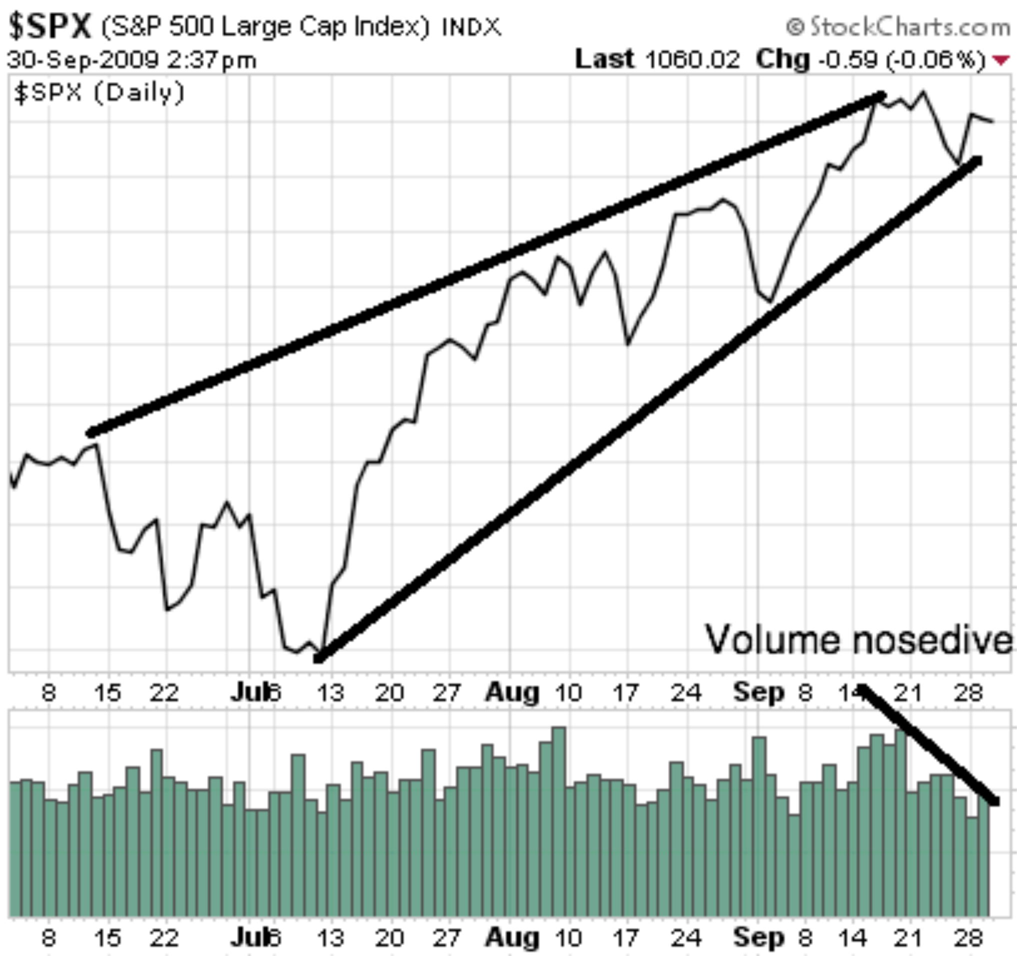
I've shown the below chart several times before. It depicts the S&P 500's performance since its March 2009 bottom. As you can see, the market has been carving out a near perfect rising bearish wedge: a rally in which the trading range becomes tighter and tighter the higher the market rallies.

This is a classic topping pattern in the sense that it typically precedes a large move to the downside. All you need is for the market to break below the pattern to the downside. And as you can see, we're sooo close to seeing this breakdown. When you consider that this pattern is completing on rapidly dwindling volume, you have the makings of a VERY serious collapse.



It’s also interesting to note that a near identical pattern has formed from the July lows (when the latest leg up of this current rally began). Looking from this perspective, it appears the market has some additional upside to it before the pattern is broken.

However, I want to draw your attention to the absolute collapse in volume in the last few weeks. This tells us that we do indeed have the makings of a Crash here. This chart is literally screaming “no one is participating in this rally any longer” (remember 70%+ of volume is high frequency programs trading blocks of shares back and forth, NOT real buyers like you and me).



Remember, technical analysis is an art, not a science. And depending on how you slice a chart, the projections may differ. This is why I am comparing the rising bearish wedges from both the March and the July lows.

However, the fact that both charts depict a near identical pattern (with the only difference being in terms of WHEN the breakdown occurs) lends greater weight to my belief that when the formation does breakdown, the move will be severe. Throw in the accelerated drop in volume and you've got a VERY, VERY ugly breakdown coming within the next month or so (I've said numerous times the Crash will be between September and December).

Kiss the "New Bull Market" Theory Good-bye

I've also been tracking the S&P 500 in relation to its 88-weekly moving average: THE definitive metric for what establishes a bull vs. bear market. As I said in the last two issues, if the S&P 500 breaks ABOVE the 88-weekly moving average and stays there, then YES, we're in a new bull market. However, if it's turned away and falls below the 88-weekly moving average… THEN LOOK OUT BELOW.

As you can see, the S&P 500 was rejected at the 88-weekly moving average. If you're having trouble seeing this, the below chart shows the recent action more clearly.

It is now literally "do or die" time for the stock market. Either stocks consolidate here and then push above the 88-weekly moving average OR they "kiss" the line one more time and then roll over and collapse.

As I've stated time and again, I fully expect the collapse to occur this fall. As the above charts show, it will be sooner rather than later. However, the bearish rising wedge patterns starting in both March 2009 and July 2009 both leave room for a little more potential upside. This is why we are keeping all of our current positions small (I've recommended establishing only 10% of your full-intended short position, e.g. $100 out of an intended $1,000 position).

This is also why I have not written to tell you "sell the farm" just yet. Time and again, the market has been manipulated higher on weaker and weaker volume courtesy of the Fed's loose monetary policy. It's never a good idea to bet heavily against the Fed. And our current Fed Chairman, Ben Bernanke, is a bubble-blower extraordinaire (seriously, he's managed to create yet another mini-bubble in stocks during the worst financial crisis in 80+ years). So I don't want us stepping out in front of this bubble-making machine with much capital.

However, blowing bubbles is not an economic policy. It is a road to ruin. And we are now headed there at an accelerated pace. With that in mind, we are launching an "On Deck" portfolio this week.

The "On Deck" portfolio is exactly what it sounds like: trades we shall make as soon as the market breaks down from its Bearish Rising Wedge pattern. DO NOT invest in these trades just yet. Just keep them in the back of your mind (on deck) for when we get the official "Sell" signal.

Two Trades For the "On Deck" Portfolio

Trade #1: Short the Russell 2000 (IWM)

This one is short and sweet. Firstly there is a myth that microcaps outperform large caps. This is a myth. Dividends account for 70% of all stock gains over time. If you want sustained ever-growing dividends, you have to go to large-caps since microcaps rarely if ever pay out dividends.

Despite this fact, virtually everyone believes microcaps or penny stocks offer the greatest gains. This too is false. More than half of the companies on the Russell 2000 have NEVER turned a profit. Most of them should not have gone public in the first place.

In simple terms, the Russell 2000 is garbage. They are the worst of the worst quality stocks, outside of financial stocks which we are already shorting via the KBE banks index. And yet, microcaps (blue line) have outperformed the broader market (S&P 500: red line) by a wide margin.

During market reversals, the former leaders to the upside often lead to the downside. This tells us that when the Crash comes (next 1-2 months), junk stocks will collapse the most as there is a flight to quality/ safety (blue chips, Treasuries, the dollar).

And the Russell 200 is nothing if not junk. And like the S&P 500 it's forming a fantastic rising bearish wedge that forecasts a major collapse.

If the Russell 2000 breaks below the lower trend line and fails to re-enter it's former trading range, then it's time to sell. But as the above chart indicates, there could be additional room to the upside here. So DO NOT GO SHORT YET.

Instead, we're adding this trade to our "On Deck" portfolio. When it comes time to sell the farm, I'll send out an update alerting you.

Trade #2: Short Saks (SKS)

Let's do a brief overview of the facts. The boom in consumer spending is over. With unemployment at 16%+, mass layoffs hitting records, and 35+ million Americans on food stamps, people are not going to be rushing off to buy expensive jeans and blazers.

Nowhere is this more apparent that Saks (SKS). SKS sells luxury clothing, jewelry and shoes. As you can imagine, this is a rough business to be in right now: SKS's first quarter same store sales dropped an incredible 27%. They fell another 15% in the second quarter. The company has not been profitable in a year. And insiders are selling shares in droves.

And yet, SKS shares have been on a tear.

As you can see, SKS shares are up more than 300% since their March lows. This is truly astounding when you consider that SKS's sales are falling off a cliff and that the company operates in one of the hardest hit sectors: luxury retail clothing. Below that it's $4.50. And if stocks truly fall apart, we could SKS shares as lone as $3.50.

However, it’s still too early to go short here. As long as SKS shares remain above the 21-day moving average the trend is up. That’s fine by me. I’d love to see SKS at $7.50 when we go short, giving us even more potential downside as this stocks returns to earth.

Conclusion

I’ve got several other trades lined up for when the market takes a dive. I’ll detail them in next week’s issue. As I mentioned before we are now literally just a few weeks from seeing some real fireworks. Stocks are barely clinging on from a technical perspective. As soon as we get an official “sell” signal, we’re going all in shorting this rally. As I mentioned last issue, I would count any of the following as official “sell” signals.

1) Stocks break below their Bearish rising wedge pattern
2) The S&P 500 is rejected at the 88-weekly moving average and **moves sharply down**
3) The S&P 500 breaks below 1,000 and then 980 in a meaningful way

We’re getting very, very close to #1. We’ve gotten half of the qualifications for #2 (a rejection but not the sharp move lower). It’s truly just a matter of weeks (perhaps even days), before we get our signal, go “all in” and collect a fortune as the market comes crashing down (I expect stocks will drop 20-40% across the board).

I continue to monitor the market as well as the economic announcements closely for signs of a breakdown. Remember, technical analysis is an art, not a science. There are any number of potential catastrophes awaiting stocks (a derivative implosion, debt default, failed Treasury auction, etc) that could supersede the technical analysis I’ve outlined here.

Rest assured, you’ll hear from me as soon as we get an official “sell” signal OR if some unforeseen crisis hits. In the meantime, I suggest focusing on something other than the stock market. Stocks have been completely detached from reality for months now. And there’s really no sense driving yourself nuts trying to make sense of it. I’m monitoring everything very closely and will update you as soon as things unravel. Until then, turn off CNBC, ignore the garbage that passes for the financial media, and spend some time doing the things you love.

Good Investing!

Graham Summers

OPEN POSITIONS					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
UltraShort China	FXP	8/11/09	$9.98	**$9.17**	**-9%**
SHORT the Bank ETF	KBE	9/2/09	$21.60	**$23.59**	**-8%**
UltraShort NASDAQ	QID	9/2/09	$26.83	**$22.86**	**-15%**
Utilities ETF	XLU	9/16/09	$30.05	**$29.36**	**-2%**
Powershares Agriculture ETF	DBA	9/16/09	$25.45	**$24.64**	**-3%**

On Deck Portfolio		
Company	**Symbol**	**What We Will Do**
Russell 2000	**IWM**	**Go Short**
Saks	**SKS**	**Go Short**