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The Coming Dollar Crisis

This is the scariest image in finance:

The above chart shows the dollar’s performance since the Fed announced its Quantitative Easing program in March. This chart tells us two things:

1) Americans just got 15% poorer on the world stage thanks to Ben Bernanke
2) A currency crisis is in the works (and perhaps already starting)

Regarding #1, when the financial crisis hit, the Fed realized it would need to keep interest rates low while it attempted to bail out the banks (80% of the $200+ trillion in derivatives sitting on commercial banks’ balance sheets are related to interest rates).

The problem with this is that it makes Treasuries very unattractive to foreign investors (China & Japan) who want a higher yield. Consequently, the Fed decided to pick up the slack by buying $300 billion worth of Treasuries: the now famous Quantitative Easing program.

As I noted in our issue last week, the Fed is now the largest buyer of US debt (it bought more debt than the next three largest buyers combined in 2Q09). China and Japan are no one's fools. And they're not going to fund a monetary policy that is both profligate and likely to erode the value of their dollar holdings.

Which brings us to item #2: the coming dollar crisis.

I am not a huge fan of technical analysis. But it is a useful tool for navigating a trader-heavy, liquidity driven, manipulated market such as today's. On that note, I want to point out that the dollar began forming a falling bullish wedge pattern starting in June (see above chart). This pattern entails an ever-tightening range of lower highs and lower lows and typically precedes major breakouts to the upside.

Except it didn't.

As you can see, the dollar broke DOWN out of this pattern in late September. It then rallied back up into the trading range before breaking down again.

This is BAD news. The next line of support (place where the dollar could bounce) is 76.

Below 76 the next line of support is 72. Now, the dollar has only fallen to this level ONCE in the last 30 years (Summer 2008, see the chart below). If we fall below that… we're in uncharted territory and a MAJOR dollar devaluation is in the works.

Perhaps it's already happening.

To review a point made earlier, the dollar has lost 15% of its value since March 2009. On an annualized basis we're talking about the dollar losing almost a third of its value in one year (30%). That is an ABSURD level of devaluation. And China, Japan, etc. have had enough. It is now clear that a flight from the dollar has begun: the Fed buys more US debt than the next three biggest buyers combined.

However, what most people don't realize is that even the FED ITSELF is shifting away from the dollar. Everyone knows that China and Japan hold massive foreign reserves (the dollar). But the US Federal Reserve does this too (we own euros, yen, etc.). And for some reason the amount of foreign reserve assets (non-dollar assets) on the Fed's balance sheet skyrocketed by 50% to $133 billion at the end of August.

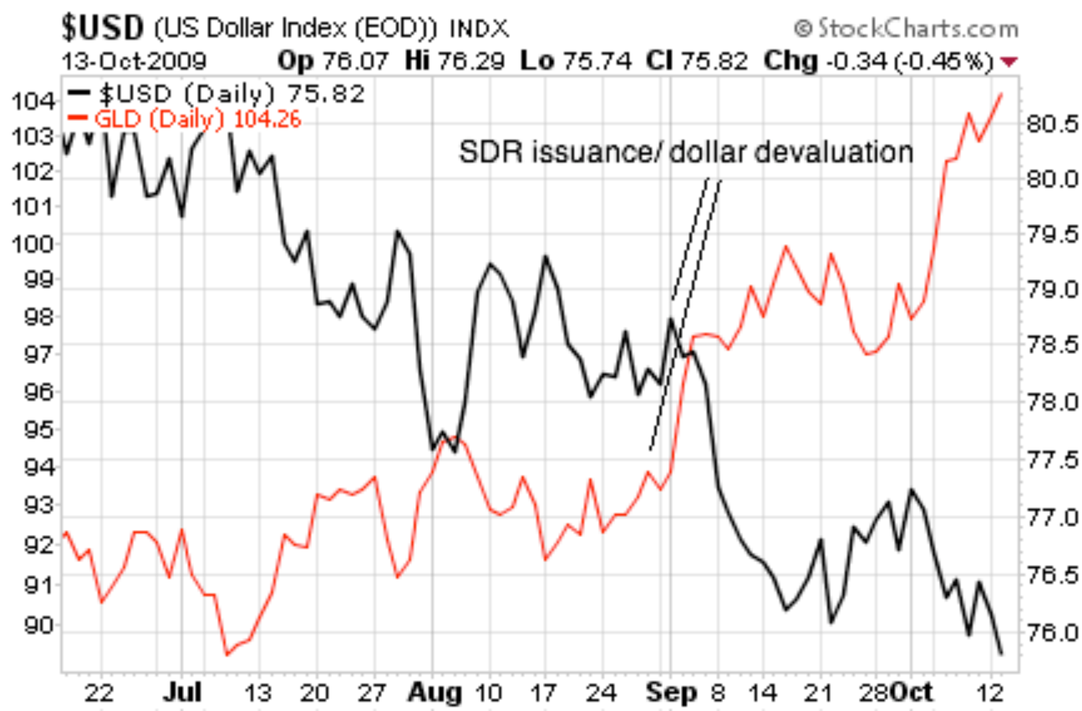
Now, $133 billion in foreign reserves is nothing compared to China and Japan's ~$3trillion. But a 50% increase in one week is an astounding rate of change.

The culprit?

A 500% increase in SDRs: the "global" currency issued by the IMF. The blog *ZeroHedge* caught this story first and pointed out that SDRs are the IMF's means of maintaining a "super reserve" currency for the world. SDRs are defined as: *a basket of currencies, today consisting of the euro, Japanese yen, pound sterling, and U.S. dollar.*

Now, one has to wonder why the US Federal Reserve decided to suddenly buy $40 billion worth of SDRs overnight. The answer is that the IMF decided to massively increase the amount of SDRs outstanding from SDR 21 billion to SDR 204 billion in late August. This came as part of a G20 decision made in April 2009 to stabilize the global financial system. **Interestingly, of the countries involved in buying SDRs, the US bought the most SDR 30 billion, compared to Japan (SDR 11 billion), and China (SDR 6 billion).**

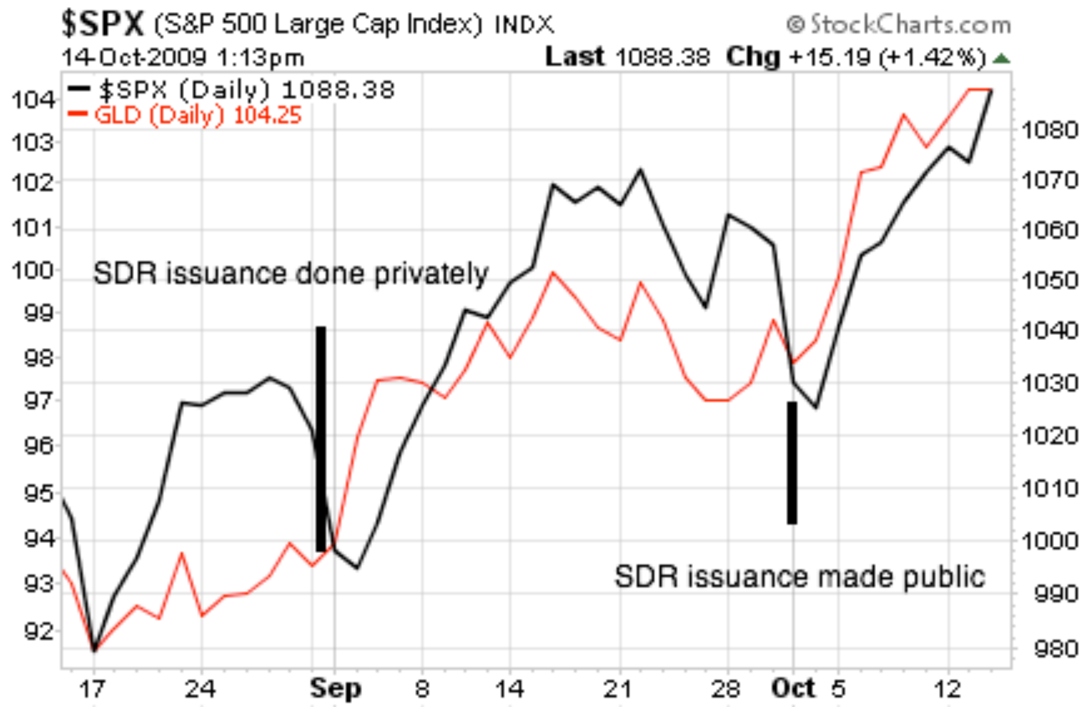
I realize this is getting a bit technical. **But in simple terms this means that the US Fed intentionally participated in a world reserve currency scheme that devalued the dollar.** Looking back at the dollar's chart you can see that this kicked off the dollar's latest nosedive (the one that took it down below its trading range):



This is also the time at which gold began to erupt higher, kicking off its recent rally. **Ironically, at the exact time that this intentional dollar devaluation was happening, the Fed was allegedly preparing for the end of its Quantitative Easing program: there is currently only $6 billion of the original $300 billion left to spend. This is also around the time that discussions of "exit strategies" began to circulate around the world.**

This "do one thing, say another" strategy is the primary policy for the Fed. The problem is that the Fed is also clearly notifying various market participants (Wall Street) of its actions weeks before the public finds out. **For instance, the SDR issuance/ dollar devaluation announcement was only made public SEPTMEBER 29, a FULL MONTH after the act.**

Obviously SOMEONE knew what was going on:



Those “in the know” caught a quick 7-8% rally in stocks. The general public then kicked off the second wave of gains in early October when the SDR announcement went public. This put stocks solidly back into the bearish rising wedge we’ve been tracking.

Thus, we did not get our "official" sell signal. It's maddening, frustrating, and downright annoying… but there you have it.

So where do stocks go now?

A close-up of the S&P 500 forecasts that there is additional room to run here. Indeed, with the Dow briefly touching 10,000 today and the S&P 500 closing in on 1,000 the stage is set for additional gains: we will now likely see the Dow test 10,300 and the S&P 500 go to 1,300 before stocks collapse.

In light of this, we are closing out our speculative shorts:

Action to take: Sell the UltraShort China ETF (FXP)

Action to take: Cover your Bank ETF (KBE) SHORT

Action to take: Sell the UltraShort NASDAQ ETF (QID)

To say that I am frustrated with this development would be a **huge understatement**. But I cannot abide further losses in these positions, even though we have taken speculative, small stakes in them.

It rarely pays to fight the trend. And the market's current trend is decidedly up (the latest corrections we've seen have been both minor AND relatively weak). Put another way, selling, in general, has become quite light on a day-to-day basis in the last week. This means there are plenty of buyers pushing this market higher (today's action in particular shows this). My guess is that many of the mutual funds who have been sitting on the sidelines are finally capitulating and buying stocks… pushing the market higher.

We shall be revisiting all of the above investments (FXP, QID, Short KBE) at some point in the future when stocks finally collapse. In light of this, I am adding them to our "On Deck" portfolio of positions we plan to purchase when the market finally begins to tank.

However, in the short term, I am not interested in fighting the trend any longer. The game is rigged against us as I noted in last week's issue (and the SDR portion of this issue above). And since the powers that be want to push stocks higher, that's the trend we shall ride for now.

I want to be blunt here. In no way, shape, or form do I believe we have begun a new bull market. Indeed, if you account for the dollar's decline, those who have invested in stocks have lost 25% of their REAL purchasing power in the last ten years regardless of where stocks have traded. <u>Put another way, 10,000 in today's Dow is really the equivalent of a Dow at 7,500 ten years ago.</u>

New bull markets do not occur on manipulation, fraud, and accounting gimmicks. New bull markets come from earnings growth, sales growth, and increased profitability. As I wrote in Monday's essay for *Gains, Pains, & Capital,* the US market is currently trading at its most expensive levels of all time:

…According to David Rosenberg of Gluskin Shef (and former Chief Economist of Merrill Lynch), no US market has ever been this expensive in history. The Tech Bubble, which by all accounts was an extraordinarily overpriced market traded around a P/E of 40 during its peak…

…[Rosenberg] points out that typically when the US economy shifts from contraction to expansion (as some claim it is now) the stock market is usually price at a P/Operating Earnings of 15 (roughly half its current levels). He also notes that there reason the P/OE is as high as 15 at these times is because earnings are extremely low due to economic hardships destorying profitability.

Indeed, with the exception of 2001, stocks have never been so rich after any recession in the last 55 years. Put another way, today's S&P 500 is more expensive that at any point in the last half century when compared to the underlying economic conditions.

http://www.gainspainscapital.com/index.php?option=com_content&view=article&id=152&Itemid=1

However, the market, as richly priced as it is, has sent a clear message that it will be heading higher as the dollar continues to weaken. I don't agree with it but I am going to profit from it.

On that note, we’re opening a speculative long position: **the S&P 500 SPDR (SPY).**

SPY tracks the performance of the S&P 500. It’s a simple means of profiting from the continued dollar devaluation/ market madness. To be blunt, the market likely only has another 3-5% in gains before things come unwound completely. But those are gains I’m happy to pocket while we wait for the trade of a lifetime when we go short as the next wave down in stocks begins.

Action to take: Buy the S&P 500 SPDR (SPY).

Keep this position small. It is purely speculative as a means of profiting from the market’s continued upward momentum. Again, DO NOT put much money to work here. The REAL time to invest will be when stocks roll over.

I am now convinced more than ever that stocks are primed for a full-blown Crash. We are back to October 2007 all over again in terms of sentiment (bulls vs. bears), insider trading (selling vs. buying ratios), corporate debt issuance (sell it while the getting’s good) and other metrics. **<u>This will end horrifically… but today’s action indicates it may take time before the “end” hits.</u>**

In the meantime, we’ve got our inflation hedges (gold, gold miners, agriculture commodities) in place. All of them are up in the last week. And the Utilities ETF (XLU) and the S&P 500 SPDR (SPY), give us exposure to any continued upside in stocks.

This has been a frustrating period for me as all signs point to a major collapse coming. However, every single time stocks are perched to come undone someone steps in with an intervention/ dollar devaluation. There are now rumors swirling of a Stimulus II bill in the works. I never thought I would see this degree of insanity in the marketplace but this is the particular song the Government is playing, so our best bet is to dance to it while keeping our eyes on the exit for when the music stops.

Judging from the data and technicals, that should come sometime in November.

Good Investing!

Graham Summers

OPEN POSITIONS					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
UltraShort China	FXP	8/11/09	$9.98	**$8.22 (SOLD)**	**-18%**
SHORT the Bank ETF	KBE	9/2/09	$21.60	**$23.40 (SOLD)**	**-11%**
UltraShort NASDAQ	QID	9/2/09	$26.83	**$21.92 (SOLD)**	**-18%**
Utilities ETF	XLU	9/16/09	$30.05	**$29.38**	**-2%**
Powershares Agriculture ETF	DBA	9/16/09	$25.45	**$26.05**	**2%**
Gold ETF	GLD	10/7/09	$102.36	**$104.18**	**2%**
Gold Miner's ETF	GDX	10/7/09	$47.90	**$49.13**	**3%**
S&P 500 SPDR	SPY	10/14/09	$109.31	**NEW**	**BUY!**

On Deck Portfolio: For When the Crash Begins		
Company	**Symbol**	**What We Will Do**
Russell 2000	IWM	Go Short
Saks	SKS	Go Short
UltraShort China	FXP	Buy
UltraShort NASDAQ	QID	Buy
Bank ETF	KBE	Go Short