Private Wealth Advisory

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The Math Does Not Lie

Thanks to everyone for their well wishes. I awoke this morning feeling much better and am now on my way to a speedy recovery.

Typically I start off each issue trying to discuss the underlying US economy in an entertaining way. With the situation as bleak as it is in the US today, there are any number of different angles to take when dissecting the situation.

However, this week I thought I'd simply lay out in plain numbers why the current US monetary system is totally and completely broken, why there is no way the US can service its current debts, and why this recession has neither ended nor improved dramatically.

Ok. The US economy is officially listed as $14 trillion. However, we know that this recession has dented it by at least 10%, so that puts the REAL US economy somewhere in the ballpark of $11 trillion.

Now, total public and private debt outstanding currently stands at $57 trillion. We've also got another $70 trillion in unfunded liabilities standing in the wings as a result of Social Security and Medicare. However, for simplicity's sake, we'll ignore this $70 trillion and focus on the debt we have to service right now.

With interest rates standing at 0.25%, the annual interest payments for our debt are around $142 billion which is roughly 1% of GDP.

US GDP	$11 trillion
Debt Outstanding	$57 trillion
Interest Rates	0.25%
Annual Payments Owed	**$142 billion**

So, what happens if interest rates go to 1%?

US GDP	$11 trillion
Debt Outstanding	$57 trillion
Interest Rates	1.0%
Annual Payments Owed	**$570 billion**

With interest rates at 1%, US debt payments jump to $570 billion, an amount equal to 5% of US GDP. At 2% interest rates we're up to $1.4 trillion (10% of GDP) and so on and so forth.

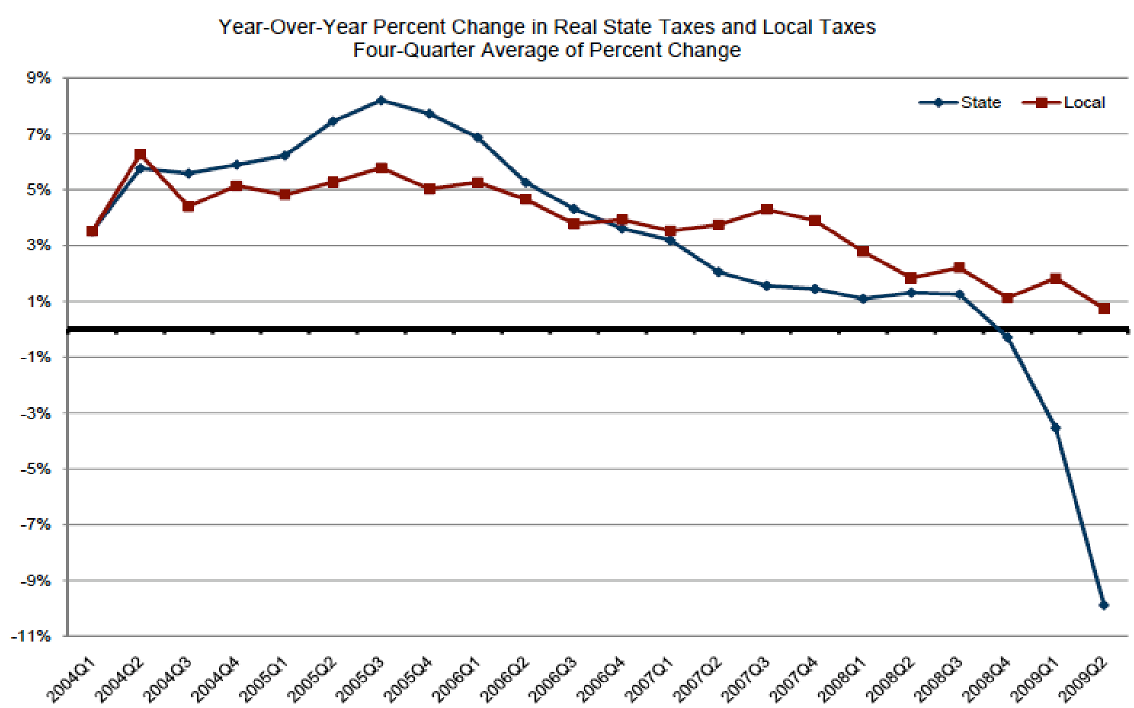
And that does NOT count return of principal, **those are merely the interest payments.**

Now, the US like most governments, funds payments via taxes. There's one small problem there though… tax receipts are plummeting (as unemployment soars) at the exact same time that the government is engaged in profligate spending. Since we've established that the Federal Government's statistics for virtually every economic metric (inflation, GDP, unemployment, etc) are nonsense, we'll stick with state information.

According to the *Rockefeller Institute*, state taxes fell 16% in the second quarter vs. the year before. This was the third consecutive quarter of tax revenue drops. More importantly, **this is THE BIGGEST QUARTERLY DROP GOING BACK 50+ YEARS.**

I've long stated that this recession is not like most recessions. Here's definitive proof: tax receipts (a REAL measure of income and jobs) are down the most in 50+ years. Every other recession in the last five decades is barely a blip compared to this one.

Figure 1. State Taxes Are Faring Worse Than Local Taxes



Sources: U.S. Census Bureau (tax revenue) and Bureau of Economic Analysis (GDP price index).
Notes: (1) 4-quarter average of percent change in real tax revenue; (2) No adjustments for legislative changes.

California is the most glaring example, but we now have 48 states facing deficits ranging from 15% (Arizona) to 0.6% (Florida). In nominal terms we're talking about $15 billion in deficits. This doesn't sound like much (amazingly we've gotten to the point that $1 billion doesn't even sound like a lot of money). The only problem is that this $15 billion in deficits is **ONLY for the first three months of fiscal year 2010 (it began July 1).**

We're actually on pace to see $178 billion in state deficits: an amount equal to 26% of total state budgets. **When you add in 2011, you're looking at $350 billion in deficits for the two years.** And that's assuming unemployment and other economic issues don't worsen from here (and they are worsening).

Put another way, the primary form of revenue to fund our debts (taxes) is plummeting. And this is occurring at a time in which our Federal government is running the biggest deficits on record AND funneling trillions into insolvent banks courtesy of a balloon crazed Fed Chairman.

Indeed, our Government has decided to attempt to combat ALL debt issues by… creating MORE debt. A grade-schooler will tell you this is insane. However, for argument's sake, we'll pretend we're insane for a moment and play with the math. The only problem is…

It doesn't add up either.

Roughly **$140 billion** of Obama's $800 billion Recovery Bill goes towards helping states meet their deficits over a 2.5 year period. The only problem is that states are facing roughly **$350 billion in deficits**: **an amount equal to more than twice Obama's bailouts.**

Thus, even IF Obama DOUBLED the bailout efforts, US states would STILL be underwater. In very simple terms, the ENTIRE US GOVERNMENT (state and federal) is bankrupt.

We have literally no means of paying back the debts we owe. And the bailouts are only increasing those debts. Indeed, if we removed the printing presses (our ability to print money) the entire house of cards that is the US economy would come crashing down: remember from earlier issues that the Fed is now THE largest buyer of US debt, even larger than the next three largest buyers.

None of the above math is complicated or hard to understand. And yet our Government refuses to deal with it. I can't pretend to know what they're thinking. But I would guess that they're hoping to run the printing presses until the economy works things out and some technological innovation or organic growth starts creating jobs again. In metaphoric terms, they're hoping to use band-aids until the wound heals. The only problem is that the wound is a fatal one **(again we WILL NOT be able to pay back the debts we owe).**

The other issue is that the bailouts are killing our currency:

I wrote last issue that the dollar was at a critical stage in its breakdown. At that time I wrote:

> *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 MAJOR dollar devaluation is in the works.*

Well, we broke below 76. We're now working our way to 72. This is a MAJOR problem in that China and Japan are now heavily invested in an asset (the dollar) which yields 3-4% (30 year note) but is losing 30% of its value on an annualized basis (we're down more than 15% for the year). Small wonder that Asian countries have virtually stopped investing in our debt: again, the Fed is THE largest buyer.

Clearly the bond market is going to want higher yields from US Treasuries. This means that at some point, the US bond market should implode (bonds have to fall for yields to rise).

From the look of it, this is just around the corner:

The above chart shows the performance of the iShares Treasury Bond ETF for bonds with terms longer than 20 years. **It's basically the ETF used to track long-term bond performance.**

Historically, Treasuries are where money runs to hide when the rest of the financial world is in trouble (see Oct-Nov '08). They've been falling since March 2009 due to an increased appetite for risk and Ben Bernanke's anti-dollar policy. However, since June, they've begun moving in a well-defined trading pattern (a close up is below):

As I've pointed out before, demand for Treasuries is plummeting as international faith in the US government and financial system begins to deteriorate. International investors WANT a higher yield. However, any rise in interest rates would completely DECIMATE the US economy (as I've shown in the first 2 pages of this issue).

Thus we are at a point of MAJOR historical significance. It is literally a question of WHICH Crisis is next:

Crisis	**What Happens**	**Implications**
Stock Crisis Pt 2	Stocks collapse, Treasuries rally, US economy implodes	China et al are still willing to buy US Debt as long as it gives higher yields
Currency Crisis	Stocks rally, Treasuries Collapse, flight from dollar intensifies/ massive inflation hits US	China and friends call "BS" on Bernanke's policies and kick the dollar to the curb
World Crisis	Stocks AND Bonds collapse, US enters Greater Depression, money flees the country,	End of US as super power, global economic collapse, trade wars, etc

I, and the rest of the financial world for that matter, do not know which of these will unfold. However, it looks as though we may be heading for Option #3 since no one but the Fed is buying Treasuries in any large amount. Thus the stage is set for the dollar to collapse, which will make Treasury Yields skyrocket, which will destroy the US economy and force the US stock market to implode.

How will we know when this has begun? When the following trends breakdown:

US BONDS: Sell Below 95

Short Treasuries with TBT

When bonds collapse, I recommend buying the **UltraShort 20+ Year Treasury ProShares (TBT).** TBT returns 2X the inverse of the iShares Treasury Long Term Bond ETF I mentioned before. So if long-term bonds fall 5%, TBT returns 10%. If long-term bonds fall 10%, TBT returns 20%.

<u>We're waiting for bonds to break below 95 (the current trend line) to buy TBT. DO NOT BUY THIS POSITION NOW. We need to wait and see if the trend is broken.</u>

The Treasury is issuing an astounding $180 billion in debt next week, $116 billion of which is new debt.

- $29 Billion in 91 Day Bills, October 26
- $30 Billion in 182 Day Bills, October 26
- $7 Billion in 4.5 Year TIPS, October 26
- $44 Billion in 2 Year Notes, October 27
- $41 Billion in 5 Year Notes, October 28
- $31 Billion in 7 Year Notes, October 29

Now the US only has $150 billion left before it hits its debt ceiling $12.1 trillion). And Quantitative Easing is about to end (meaning we're about to see what the bond market REALLY thinks of US debt without Fed interference). Given that bonds are already trending lower, I believe we're about to see some REAL fireworks in the bond market. **<u>Put another way, I believe we'll get a "BUY" signal on TBT within 10 days.</u>**

Sit tight for now. Let's see what the market thinks of next week's auctions.

Action to take: add the UltraShort 20+ Year Treasury ProShares (TBT) to the "ON DECK" portfolio with an expected entry point sometime in the next two weeks.

Now for stocks…

STOCKS: Almost at the End of the Pattern

I've shown the above rising bearish wedge several times. I now want to draw your attention to a close-up of the last three months' action:

As you can see, stocks have begun forming an expanding wedge pattern WITHIN the bearish rising wedge we've been tracking. This is PRECISELY what you would expect for a MAJOR top (increased volatility) and it only further adds to the evidence that another Crash is on the way. It also gives us a definite target for our SELL signal: **whenever stocks finally break below this expanding pattern (currently the lower end of the range is 1,045 on the S&P 500).**

The issue with stocks is whether this rally gives up now, rolls over and breaks below the trend line… or if there will be some greater push to the upside. The below chart gives us some clues as to what may happen next:

The technical resistance lines for the S&P 500 are 1,000 (we've broken), 1,100 (we've tested) and 1,200 (we're not there yet). I've also laid out the Fibonacci retracements based on the S&P 500's collapse in March (see the red lines).

If you're not familiar with Fibonacci retracements, they act on the belief that the stock market (like many elements in the natural, economic, and artistic worlds) follows the famed Fibonacci sequence. However, when it comes to the stock market, the idea is that the market typically collapses or rallies a % that falls in line with this sequence (for example 38.2%, 50%, 61.8%).

As you can see in the above chart, for today's rally started in March 2009, the 50% retracement on the S&P 500 is at 1,121. The 61.8% retracement is 1,228. As silly as this may sound on the surface, these levels could prove to be decisive turning points (you'd be amazed how many times the market has rolled over or rallied to test a Fibonacci retracement). I would posit we will see the ULTIMATE SELL come at the 61.8% retracement level (1,228 on the S&P 500).

Regarding stocks, we're already got a number of positions "ON DECK" for when the collapse begins. However, I realize many of you want more than just inverse ETFs and the like. Now that I am recovered, I am going to spend the next week finding some new trades for us.

Truly, there are no shortage of overpriced garbage companies out there. And there are quite a few EXTREMELY undervalued minerals and natural resource companies out there too. I will be looking into both sectors and others extensively this week. I'm also looking into some international firms: foreign markets have rallied to truly ridiculous levels given the underlying economic realities. I believe they are ripe for shorting as well.

In conclusion, I want to reiterate the key point of this issue: that the US is bankrupt as a country and will either enter a period of massive dollar devaluation OR default on its debts. It is no longer a question of "if," it is a question of "when."

Stocks and bonds have been pushed higher thanks to the Fed's loose money policy (I guarantee MOST of the money propping this market up came from bailout recipients). But this is now ending (the Fed's QE program ran out yesterday). It is now a mere matter of weeks before the market liquidity dries up and the CRASH I've been forecasting comes true.

The point I want to make here is that you make the MOST money investing when the market turns. Our "ON DECK" portfolio is lined up so that even a minor correction of 10-15% could send out portfolio shooting dramatically higher once we shift all of those positions to official BUYS or SELLs.

BUT DON'T DO THIS JUST YET. WAIT FOR MY SIGNAL.

I know the last few months have been frustrating for many of you. They've been that way for me too. In fact, it's been almost a perfect repeat of 2008. All through that year I warned of a collapse. Starting in April 2008 I wrote repeatedly that a full blown Crash was coming. I was mocked and laughed at. And I lost some money going short early. Then October-November 2008 came and many of the shorts I'd recommended doubled in less than 6 weeks.

I fully expect a similar scenario this year. It's only a matter of time. The Fed is literally out of ammo in terms of interest rates. And the QE program is officially finished. **We're about to get a taste of what an un-pumped market looks like.**

My gut feeling is that it won't be pretty. In the meantime, we've got exposure to several inflation hedges (DBA, GLD, GDX) as well as a few speculative longs to profit from any last minute push to the upside (the expanding wedge in the S&P 500 forecasts a push to 1,200 or so).

HOWEVER, I continue to recommend you keep MOST of your money OUT of the market. DO NOT INVEST HEAVILY NOW AS IT MAKES NO SENSE WHAT-SO-EVER. All of our current positions should be viewed as speculative. You SHOULD NOT put a LOT of your portfolio into ANY of them.

Keep your powder dry. The big collapse is coming (probably in early November). You'll want ammo ready to gun the market when it finally hits.

On a personal note, I want to thank those of you who offered condolences for my being sick. I was deeply moved by many of your emails. I truly cherish writing these newsletters to you. I hope you enjoy reading them as much as I enjoy writing them.

Good Investing!

Graham Summers

OPEN POSITIONS					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Utilities ETF	XLU	9/16/09	$30.05	**$29.93**	**0%**
Powershares Agriculture ETF	DBA	9/16/09	$25.45	**$26.05**	**5%**
Gold ETF	GLD	10/7/09	$102.36	**$104.18**	**2%**
Gold Miner's ETF	GDX	10/7/09	$47.90	**$47.13**	**-2%**
S&P 500 SPDR	SPY	10/14/09	$109.31	**$109.47**	**0%**

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
UltraShort Long-Term Bonds	TBT	Buy