Private Wealth Advisory

An OmniSans Research Publication Dec 16, 2009

The Debt Spiral

Before delving into this week's stock market action, I wanted to take a moment to address the debt markets, particularly the US.

As you know Dubai was the first official debt default to occur, asking for a six month extension on $60 billion worth of its debt over Thanksgiving. The media is refusing to call this situation a debt default due to the fact that Dubai's oil-rich cousin (Dubai has little oil) stepped in making a $10 billion emergency loan. However, the fact remains that Dubai is flat broke. And this issue won't be resolved through anything other than additional emergency loans… or default.

Portugal, Italy, Ireland, Greece, and Spain (a group traders now refer to as PIIGS) are on deck with their own deficit/ debt issues: a situation that has been showing up in pronounced euro weakness in the last few weeks. However, even the PIIGS are not somehow unusual.

Indeed, the entire world has become over-saturated with debt. We all had debt problems BEFORE the Financial Crisis began. And the world's central bankers decided to address these problems by printing money and shifting private sector debt (most notably from large banks) onto sovereign balance sheets.

No one has done this better than the US.

Setting aside any kind of math or economic theory, let's simply look at what the US Federal Reserve has done from a basic, common sense standpoint. Wall Street banks were rendered insolvent by taking on too much debt that was backed by garbage assets/ investments (subprime mortgages, student loans, etc.). The reason these debts became a MAJOR problem for the banks was that no one wanted to buy them anymore. The reason no one wanted to buy them anymore was… SURPRISE: they were GARBAGE.

The Fed then decided it was a good idea for the US to buy these debts and put them on the US's balance sheet. I've repeatedly referred to the Fed as the "buyer of last resort." This was not a creative euphemism. The Fed *literally* was the ONLY financial entity willing to buy mortgage backed securities after 2007. Even the private investors who were called in to buy some of the junk via the Public-Private Investment Program wouldn't participate without the Treasury matching their capital AND FDIC backing.

Let's be blunt here: just how AWFUL is this stuff that NO ONE will buy it without the US Government matching their investment AND the FDIC insuring against losses?

The answer: really, REALLY bad. As in **worthless**.

So here we are today. The Fed has bought nearly $1.2 trillion worth of this junk. It's also leant out over $1 trillion to the banks. And that is simply the stuff we know about. I firmly believe a BIG reason the Fed doesn't want to be audited (despite 71% of Americans wanted it to be) is because any audit would show the Fed has committed far, FAR more money than is publicly known.

But all of this is beside the point. The point is that the Fed didn't fix ANYTHING. All it did was shift garbage that no one in their right mind wanted onto the US's balance sheet. And the reality is that most banks remain insolvent (we've covered this issue enough that I don't think it bear repeating).

Meanwhile, Obama and friends have decided to "spend" our way out of this economic mess. We've already got bills being developed for Stimulus Plan II. And this is coming at AFTER Stimulus/ Bailouts that exceed the entire spending of WWI, WWII, AND the New Deal combined.

Now, in order for the US to pull this kind of stuff off, it needs people to lend it money. The problem is that the rest of the world is not filled with complete utter morons.

Consequently, foreigners are no longer willing to lend us money for long periods of time. And this is coming at a time when the US needs to roll over TRILLIONS in current debt (we don't actually pay back the money we owe, we simply roll it over into new debt that foreigners were previously willing to buy… but not anymore).

Indeed, a story of MASSIVE importance was released yesterday though CNBC and friends didn't pick it up. That story was the Treasury International Capital Data for October: the numbers showing foreign interest in new debt issuance. The following is not a pretty sight:

> *Net foreign acquisition of long-term securities, taking into account adjustments, is* ***estimated to have been $8.3 billion*** (Graham's note: we've issued nearly $2 TRILLION in debt this year).
>
> *Foreign holdings of dollar-denominated short-term U.S. securities, including Treasury bills, and other custody liabilities* ***decreased $43.9 billion****. Foreign holdings of* ***Treasury bills decreased $38.3 billion****.*

In plain terms, the above data points illustrate that foreign governments are no longer willing to buy long-term US debt.

Thus, the US has entered a debt spiral: a situation in which more and more debt needs to be issued at the same time that demand for US debt is becoming shorter and shorter in duration: the above data PROVES that no one outside the US wants to buy 30-Year Treasuries.

All told, the US needs to roll over trillions in debt at the same time that it needs to issue an additional $150 billion in debt per month to finance its current deficit. Indeed, according to the Treasury, in the next 5 years the US will have 73 days in which it needs to roll over $20+ billion in debt and 46 days in which it needs to roll over $30+ billion. **Heck, we've got $130 billion in debt due within the next three months alone!**

Marketable Treasury Coupon Flows $ Billions

Date	Maturing Coupon Securities (Excluding SOMA holdings)	Coupon Payments	Total Outflows
November 15, 2009	38	21	60
November 30, 2009	21	4	25
December 15, 2009	15	1	16
December 31, 2009	23	4	27
January 15, 2010	26	6	32
January 31, 2010	25	4	29
February 15, 2010	48	27	75
February 28, 2010	26	5	31

At the same time, appetite for US debt is rapidly diminishing in duration. I've already noted that short-term Treasury yields went negative a few weeks ago. But now, we're finding Treasury auctions occurring in which the yield is 0.00%. That is not a typo: investors are buying short-term US debt when it is yielding NOTHING.

For Immediate Release
December 15, 2009

CONTACT: Office of Financing
202-504-3550

TREASURY AUCTION RESULTS

Term and Type of Security	28-Day Bill
CUSIP Number	912795R86
High Rate[1]	0.000%
Allotted at High	56.12%
Price	100.000000
Investment Rate[2]	0.000%
Median Rate[3]	0.000%
Low Rate[4]	0.000%
Issue Date	December 17, 2009
Maturity Date	January 14, 2010

Again, we are in a debt spiral. Investors are piling into short-term Treasuries hoping to have some kind of security for periods up to three years or so. But the long-term end of the bond market is collapsing due to lack of demand: no one believes the US will be able to continue its current debt orgy and so is unwilling to lock up their money with Uncle

Sam for 30 years. In fact, as the above data showed, foreigners are now SELLING our debt.

This is most evident in the action in the long-term bond market which has been taking a shellacking in the last two months. The below chart shows the iShares T-bond 20+year ETF. It's basically a proxy for long-term Treasuries (those maturing in 20 years or more).

As you can see, long-term bonds have been plunging in the last two months. The drop accelerated in December with bonds falling nearly 10% in a few weeks. Indeed, from a technical perspective, long-term bonds have broken their upward trading range:

This is BAD news for US debt: a drop in Bond Prices means higher yields which means more money going towards interest payments, which means BYE! BYE! any hope of economic recovered.

I believe that 2010 will be the year that the bond market gets UGLY. Indeed, the pattern we are seeing in long-term US bonds today mirrors other similar patterns that occurred following peaks in other investment classes.

Here's the 30-year Treasury chart:

Here's Nasdaq chart from '00:

Here’s the Nikkei from the ‘80s:

In a nutshell, US Treasuries are forming the classic “bubble” pattern: a massive spike followed by a collapse, followed by a bounce, and then the REAL fireworks:

It’s still a little early, but we’re getting awfully close to seeing an official BUY on our UltraShort Treasuries ETF (TBT). If the 30-year Treasury breaks below 112, then it’s time to buy. Looking at the above chart, I’d say we’ll get our signal sometime in 1Q09.

Which brings us to stocks.

Like last week, there is very little report on stocks. We DID have a break above the trading range (1,080 to 1,110 on the S&P 500), but it occurred on a triple options week: options for December, the quarter and the year are all due this week. In plain terms, this week more than any other week of the year was likely to see a spike in prices as traders pushed the market higher to close their options at a gain. Since then, the S&P 500 has fallen right back into its trading range:

This is literally a **market limbo**. No one in the West believes in this rally (a fact made clear by China's stock market typically trading more volume per day than the US, Tokyo, and London combined). However, no one wants to sell the farm just yet with year-end just around the corner and Bailout Ben steering the Fed.

The reality is that barring any catalysts, we are likely going to end the year with the US stock market still in this trading range. Indeed, today's action was typical: the futures spiked higher pushing stocks to open higher, then the Fed's FOMC minutes revealed nothing of note so stocks tanked back into their multi-month trading range. In fact, the Dow actually ended up DOWN for the day.

It's like a broken record playing the same pattern over and over.

Indeed, everywhere I look I see signs of a major top being formed. Let's look at some of the big market leaders for this rally.

First up: IBM (IBM)

As you can see, IBM is right back to its 2008 highs. The trendline on this stock is absolutely extraordinary both in terms of its spike AND the potential losses it portends. Indeed, not only is this current trajectory unsustainable… but once IBM breaks below it… LOOK OUT BELOW. This is high on my list for shorts in 2010.

How about Amazon (AMZN)?

Higher than it was during the 2007 ALL TIME high. Amazon will be one heck of a short next year (it's currently trading at a P/E of 75!?!?)

The same could be said for GAP (GPS) which seems to believe that we're somehow NOT in a recession:

I simply cannot believe this company is trading higher now than it was in 2007. In 2007, GAP produced roughly $16 billion in sales. Since then revenues have fallen by about $1.5 billion (10%). The company hasn't seen an increase in same store sales in years. And yet, GPS is priced like it's 2006/ 2007 all over again: a P/E of 15 and P/CF of 9. Granted these aren't bubble valuations… but we ARE in the WORST recession in 80+ years.

Perhaps that's why Gap insiders are unloading shares by the $ millions?

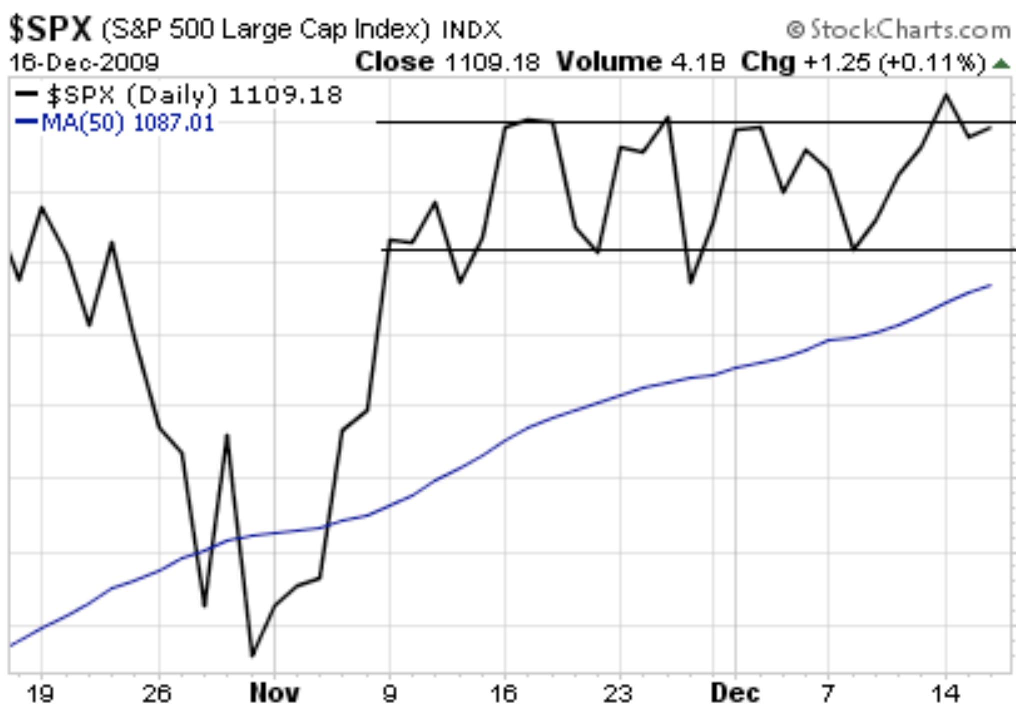
All in all, nothing has changed. It's annoying, frustrating, and downright difficult to stomach… but that's exactly how tops are. Remember the unstoppable 2007 rally? We had nearly 90 straight up days. Ditto for the Tech bubble: the mania continued longer than anyone thought possible.

We're in the exact same boat today.

Indeed, with Time naming Ben Bernanke "Man of the Year" we are in an absolute mania stage. Think about it: 71% of Americans want the Fed audited. Only 21% of them approve of Bernanke. And yet… he's man of the year. Extraordinary.

Regardless, from the BIG PICTURE point of view, stocks have broken their uptrend and have essentially done nothing for nearly two months.

Meanwhile the 50-DMA inches closer and closer to the market. Any break below this level will kick off a massive collapse as the momentum traders' trading models trigger "sell!"



I truly wish I had more to tell you, but there simply isn't anything new to say. Stocks are in limbo. The Dollar has put in a bottom and continues to show signs of strength. Commodities related to economic growth are flagging. Inflation hedges (gold) have begun to correct. It's essentially the same thing we've seen for a month now. If you're not a day trader (or insider) then this market hasn't offered a cent in potential profits since November 9. Indeed, our portfolio has been essentially unchanged for the last three weeks.

Thus, we must sit on our hands and wait. As I said earlier, it's likely the market will coast into the end of this year. However, once 2010 starts, LOOK OUT. We have already seen multiple signs that a Crash is coming (see our December 2, 2009 issue). And I also want to note that stocks have fallen dramatically in nine out of the last ten years during the first six weeks of the year.

Again, tops of THE most annoying time to be an investor. And we are at nothing, if not a top. Indeed, this "bounce" stage of the Crash has done NOTHING for stocks. As I've noted many times, all Crashes follow a pattern:

1) The initial decline
2) The bounce
3) The REAL fireworks

We've seen #1, we're now in #2, and it looks like #3 will come in the New Year.

I'm watching the markets closely. Barring any catalyst the year will likely end with the markets coasting. However, once 2010 starts, the nightmare begins. Stocks AND bonds are now showing serious signs of duress. And these ripples will soon become a tsunami.

Should anything change in the next week, I'll issue an update. Otherwise you'll hear from me in next week's Private Wealth Advisory. Until then…

Good Investing!

Graham Summers

OPEN POSITIONS					
Company	**Symbol**	**Buy Date**	**Buy/Short Price**	**Current Price**	**Gain/ Loss**
Ultrashort Russell 2000	TWM	11/2/09	$31.74	$26.44	-17%
Ultrashort Nasdaq	QID	11/2/09	$24.13	$20.40	-15%
Ultrashort Semiconductors	SSG	11/2/09	$26.00	$19.94	-23%
SHORT SAKS	SKS	11/11/09	$6.30	$6.64	-5%
UltraShort Financials	SKF	12/9/09	$25.23	$24.85	-2%

ON DECK PORTFOLIO: TRADES THAT NEED OFFICIAL "SELL" SIGNALS		
Company	**Symbol**	**What We Will Do**
UltraShort China	FXP	Buy
UltraShort Long-Term Bonds	TBT	Buy
Russian ETF	TRF	Go Short
UltraShort Emerging Mkts	EEV	Buy