Private Wealth Advisory

A Phoenix Capital Research Publication May 18, 2011

Deflation Now, Then Hyperinflation

This portion of this week's *Private Wealth Advisory* newsletter is focused solely on the potential for another round of deflation hitting the markets.

We will pick up with the second part of our *How to Survive Hyperinflation* Report on Monday and continue with some investment ideas on how to profit from the inevitable hyperinflation that's coming in the future. We'll then be publishing parts 3-6 of the *How to Survive Hyperinflation* report over the next two weeks.

The reason I'm doing this is that right now, before hyperinflation explodes, it looks like we could see another round of deflation grip the markets. Indeed, I believe we could very well see this happen before the Fed unleashes QE 3, which would be the final nail in the US Dollar's coffin.

Having kicked off massive price increases in oil and agricultural commodities, the Fed cannot risk launching QE 3 right now without the public finally losing it. So I fully believe the Fed may in fact be willing to allow another round of deflation (collapse in asset prices) in order to pave the way for QE 3 (and even QE 4) down the road.

The reasons I believe this are the following…

First off, the US Dollar has bounced hard due to the following factors:

1) A bear raid on Silver and commodities in general
2) China's attempts to rein in inflation
3) Investors coming to realize QE3 will not be immediate

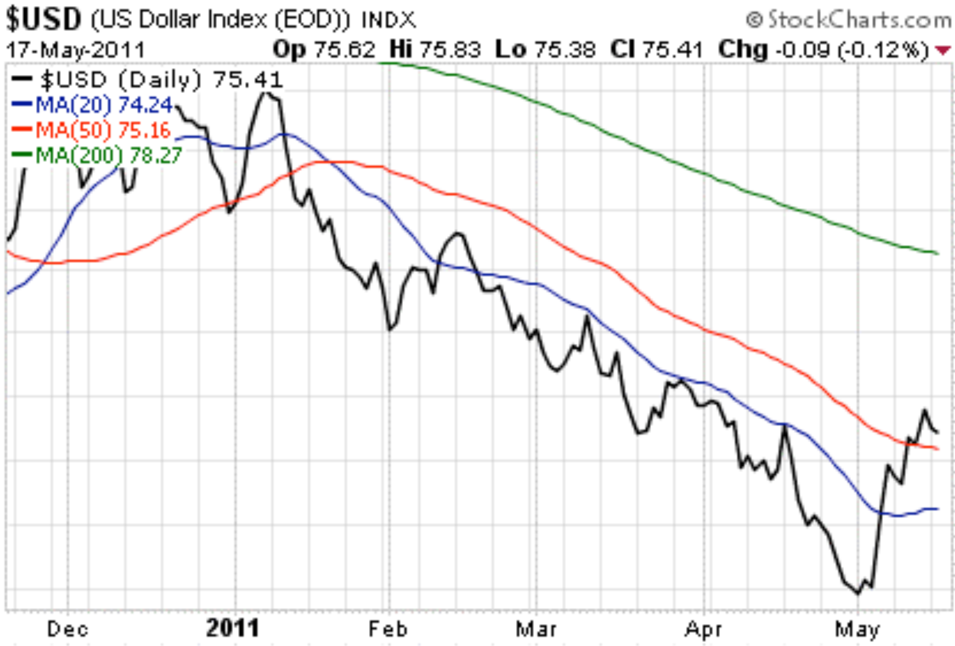
What happened over the last month for Silver was nothing short of a clear bear raid. True, Silver was overbought, having rallied more than 70% in the last six months. However, the primary driver of the Silver crash (it's fallen 30% in less than one month) was due to several brokerages raising margin requirements forcing many traders to liquidate.

With most if not all, trading programs based on correlations, as soon as Silver took a dive, oil was sold hard pulling the rest of the commodity space down:

This, combined with China's attempts to rein in inflation (raising reserve requirements at banks, etc) and the realization that Bailout Ben will not be providing more juice in the immediate future (more on this later) resulted in commodities taking a major hit.

With nearly every trader on the planet following a "if commodities fall, buy the US Dollar" mentality, this collapse in commodities resulted in the US Dollar rallying hard.

While ultimately doomed to hyperinflation, the US Dollar was overdue for some kind of a bounce, having fallen over 7% since the beginning of the year. However, the rally *has* seen some significant technical developments in that the US Dollar is now above both its 20- and 50-day moving averages (DMAs).



This situation needs to be watched closely. The US Dollar is currently one of the primary carry trade currencies (a currency investors borrow in due to its low interest rate) in the world. And with US Dollar sentiment at bearish extremes (traders are even more bearish today than they were when the US Dollar hit its all time low in April 2008), we could potentially see a serious snapback rally as the shorts cover.

Indeed, the chart *might* even be predicting this as the US Dollar has formed what could in fact be a bullish falling wedge pattern:

The primary line to watch here is the upper trendline which now sits at 76. If we break above this, we could see the US Dollar go to 80 in short order. However, this would only happen if we saw some kind of crisis in which the inflation trade reversed sharply (the last two major US Dollar rallies were induced by Crises).

There is no shortage of potential reasons for why this could happen. First off we have Europe, which continues to implode while also experiencing escalating inflation.

> **Annual consumer-price inflation in Germany, Europe's largest economy, was the highest in April since October 2008**, driven primarily by energy-price increases, the Federal Statistics Office, or Destatis, said Wednesday, confirming its preliminary figures published April 27.
>
> Consumer prices rose 0.2% on a monthly basis in April, and increased 2.4% annually, according to final calculations, Destatis said. The figures were unchanged from the preliminary data.
>
> **Annual consumer-price inflation in Germany was last as high in October 2008, while a higher figure of 2.9% was reached in September 2008.**
>
> http://online.wsj.com/article/SB10001424052748703864204576316392675493366.html

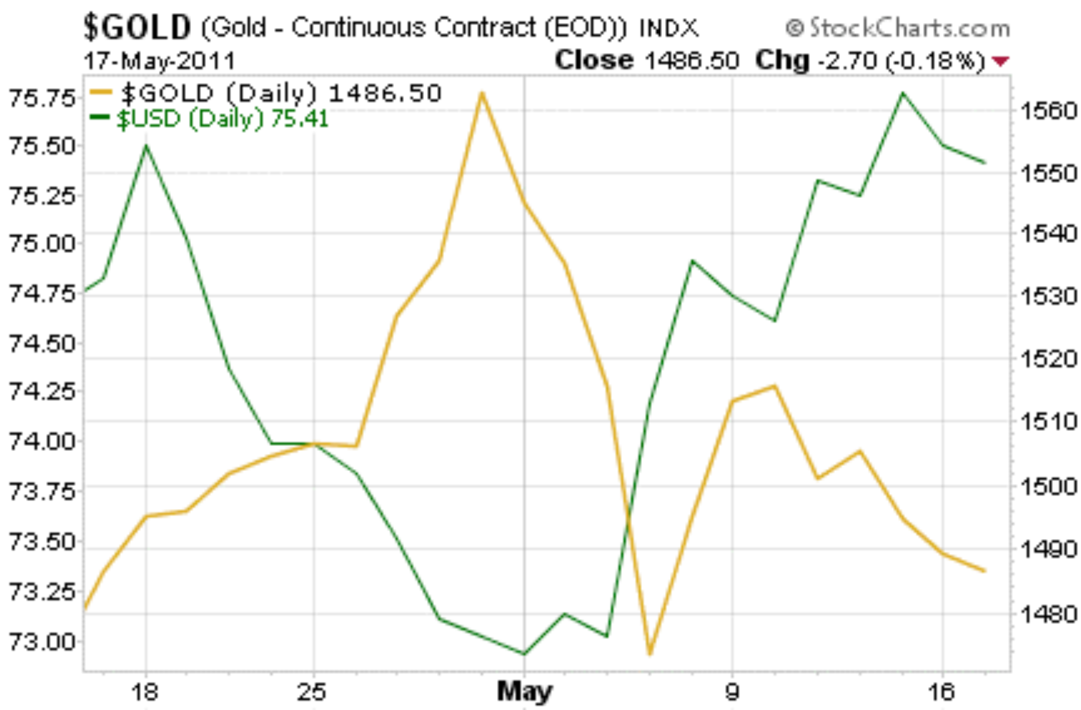
We also have China actively trying to control inflation (and failing). All told the PBOC has increased reserve requirements at its banks (in an attempt to stop lending) five times this year. Yet its inflationary measures continue to come in higher than expected. If China decides to get truly aggressive in its attempts to stop inflation, we could see a commodity crash which would also precipitate a US Dollar rally.

Finally, we have the US Federal Reserve deciding not to launch QE 3 and to let QE 2 reach completion. Since 2008, and especially since August 2010, the entire US financial system has been on life support from the Fed. For the Fed to remove its primary money prop at this time could potentially result in stocks crashing.

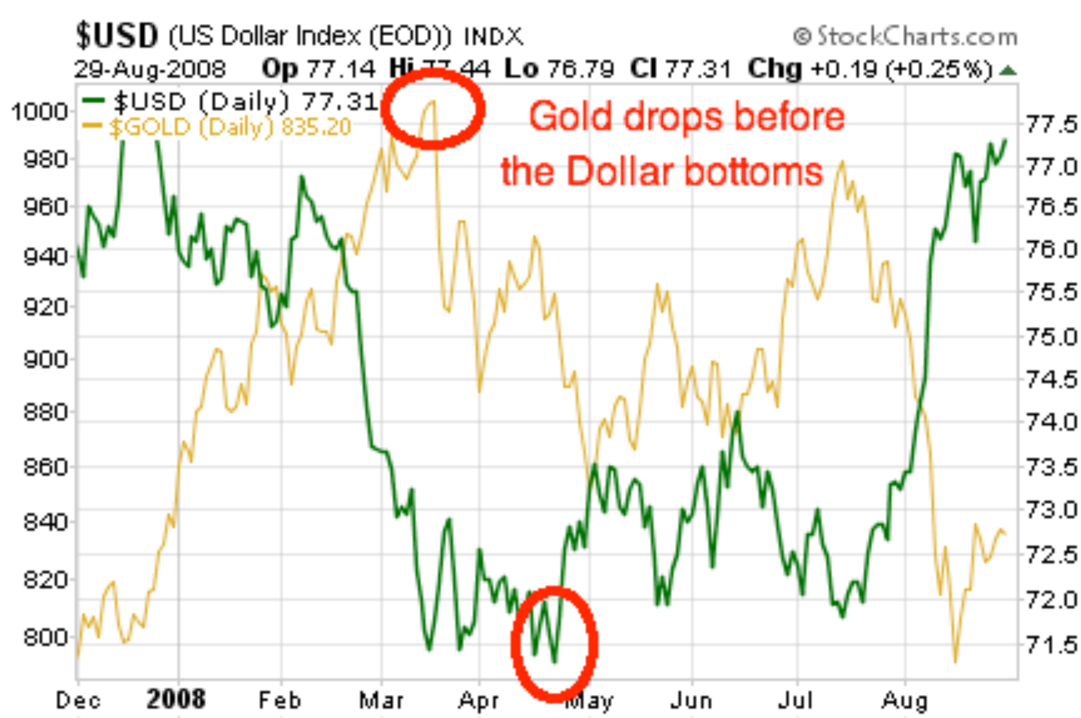
IF this were to occur (so far stocks are holding up well) we would likely see a US Dollar rally as investors fled stocks and commodities for the perceived “safety” of the US Dollar.

In some ways this would solve most of the Fed’s problems as it would lower inflation (commodity prices) and pave the way for more QE (a stock collapse would likely be used as evidence that QE is necessary to keeping the system together).

From a technical standpoint, one indicator I am watching for signs of a deflation collapse/ rally in the US Dollar is Gold. As the below chart shows, Gold had already collapsed 5% before the US Dollar began to rally.



Gold staged similar sharp corrections before each of the last two major US Dollar rallies. Here's 2008:



And here's 2009:

This is why I moved us out of our Inflation Trades last month: because the odds of deflation hitting the markets again had become much, much higher.

I cannot say with absolute certainty that we will see deflation hit in a big way right this moment. But the odds of another round hitting the markets is much higher than it was last month. And given the slew of negative news we're getting from around the world, stocks are more than overdue for a serious correction of sorts, which would also be US Dollar positive.

To reiterate my primary points here:

1) Dollar bearishness is at extremes
2) It's clear the "powers that be" want to take down precious metals
3) The Fed has indicated it will be cutting the juice in the near-term
4) The financial world remains extremely problematic

All of these point towards a potential US Dollar rally in the short-term. Again, I want to stress that I believe the US Dollar is absolutely doomed and will experience hyperinflation in the future. But we *could* be on the verge of a short-covering rally in the greenback induced by any number of crises.

The primary charts to watch to determine this are the bullish falling wedge pattern I showed before:

Again, we need to watch the upper descending trendline closely. IF the Dollar breaks above this line, then we could be going to 80 or even 82-84 in short order (largely based on short-covering).

The second chart to watch is the following depicting the US Dollar relative to its 50-DMA:

As you can see, the US Dollar has *just* broken above its 50-DMA. While this could be a false breakout similar to the one we saw in November 2010, we need to watch this situation closely as a break above the 50-DMA has occurred before every major US Dollar rally of the last three years:

So, IF the US Dollar launches a sustained break above its 50-DMA now, we could potentially be at the beginning of a significant US Dollar rally.

If this happens, I will be recommending the following trades:

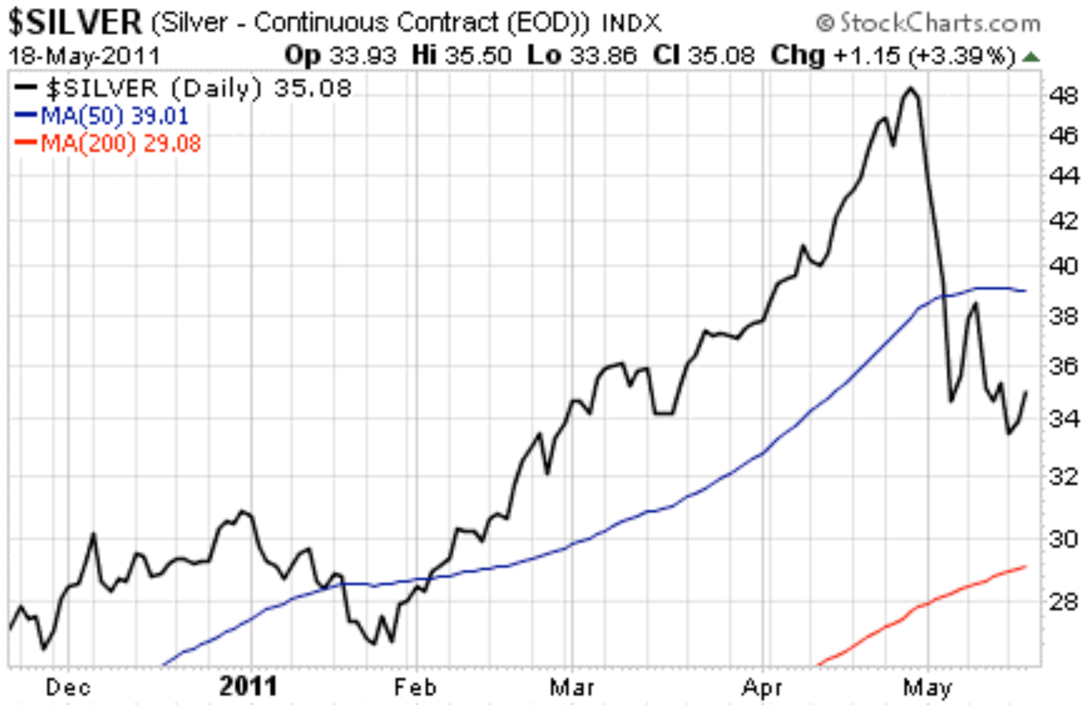
1) US Dollar Bullish ETF (UUP)
2) UltraShort Silver ETF (ZSL)
3) UltraShort Material ETF (IYM)

The first position, the US Dollar Bullish ETF (UUP) is simply a play on the US Dollar. It has no leverage, but simply tracks the US Dollar's performance.

Alternatively, you could simply move more of you portfolio to cash and see an increase in purchasing power that way. I'm using the **US Dollar Bullish ETF (UUP)** for the purpose of tracking our gains from staying in cash when and if we enter another round of deflation.

The second investment, the **UltraShort Silver ETF (ZSL)** returns 2X the inverse performance of Silver. So if Silver falls 5%, ZSL returns 10%. If Silver falls 10%, ZSL returns 20%.

If deflation really gets going, we could see Silver go to $30 if not $27.50 in short order. Indeed, the only thing stopping me from recommending ZSL right now is I want to see how Silver handles the $34-46 range.

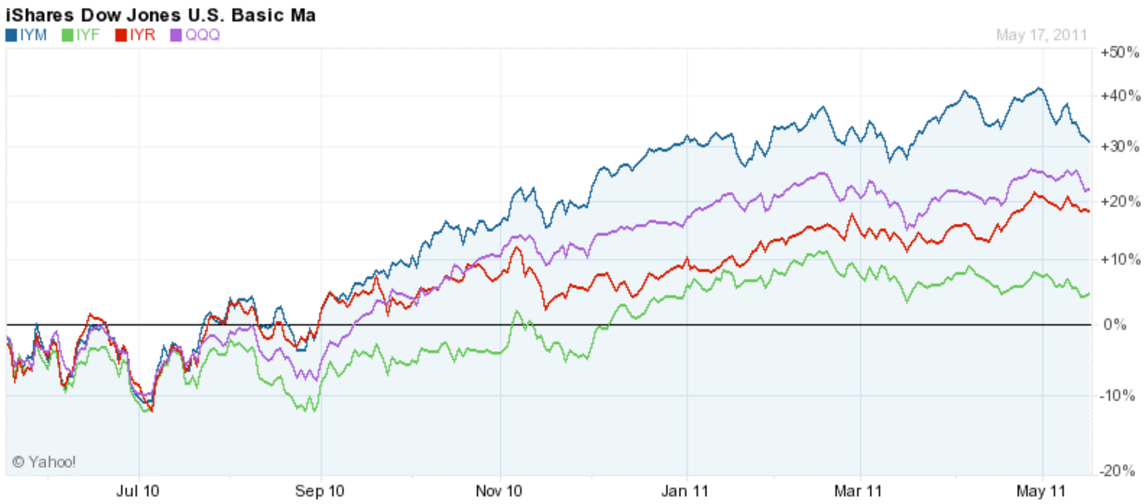


As you can see, Silver just reclaimed support $34. But it faces resistance at $36. I want to see what happens at these levels. If Silver rolls over from here and breaks below $34, we'll be buying ZSL.

A final investment I am interested in is the **UltraShort Materials ETF (SMN).**

SMN returns 2X the inverse performance of the Materials sector. So if Materials falls 5%, SMN returns 10%. If Materials falls 10%, SMN returns 20%.

The Materials sector (blue line below) is essentially a play on commodities. As such it's the top-performing sector of the last year outperforming real estate (red), financials (green), and tech stocks (purple):



However, the technical picture for the materials sector right now is downright UGLY. For one thing, the sector has just staged a double top at its all-time high:

It's also *just* take out the trendline that has supported it since the 2009 lows:

Add to this a definitive break below the 50-DMA and you've got the recipe for a drop to 75 if not 72.5 in short order.

The only thing stopping me from recommending SMN now is that I think we'll first see a re-test of the 50-DMA at 80. If we test that level and fail to reclaim it, I'll be recommending SMN.

To conclude this issue, I remain certain inflation and hyperinflation are in the US's future. However, as I've stated in previous issues this year, the inflation trade has become extremely lopsided. This combined with the Fed's unwillingness to launch QE 3 right now could very well lead to another round of deflation.

As I've said several times in this issue, the Fed would very much like for this to happen as it would permit additional QE efforts without pushing commodities into the stratosphere.

With that in mind, my current forecast is as follows: we will likely see a deflationary June and July. This will feature some US Dollar strength (not much) but pronounced weakness in commodities and stocks.

Once the collapse has been significant enough, the Fed will likely launch QE 3 and it will be bigger than QE 2. At that point the US Dollar will collapse to new all-time lows and commodities, particularly precious metals, will EXPLODE higher.

So this issue is focusing on how to play deflation as it is the most significant risk at this time. Commodities and stocks are rallying this week on options expiration but will very likely roll over and collapse next week. I'm looking to have us short Silver and the Materials sector while going long the US Dollar when this happens.

Once this round of deflation becomes severe enough, the Fed will announce a massive QE 3 program, possibly to the tune of $1+ trillion. When that happens, the inflation trade will come roaring back with the US Dollar collapsing to new lows as Silver and Gold and other inflation hedges hit lift off.

When that happens, we'll be prepared with the inflation hedges I will be detailing over the next two weeks. We'll also very likely revisit some of our older inflation hedges as they will be much more attractive at that time.

On a final note, we are not selling our Gold and Silver bullion holdings as they are long-term holdings, NOT trades. Both precious metals remain in long-term markets so we're not selling now.

This concludes this week's issue. Until Monday…

Good Investing!

Graham Summers

OPEN POSITIONS

Inflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Gold bullion	N/A	3/17/10	$1,120	$1,496.00	34%
Silver bullion	N/A	3/17/10	$17.50	$35.05	100%

Deflation Watchlist (waiting to buy)	
Company	**Symbol**
US Dollar Bulls ETF	UUP
UltraShort Silver ETF	ZSL
UltraShort Materials ETF	SMN

RECENTLY SOLD POSITIONS

Company	Symbol	Buy Date	Buy Price	Current Price	Gain/ Loss
Vista Gold	VGZ	12/15/10	$2.55	$2.92	15%
Novus Energy	NVS.V	12/15/10	$1.01	$1.03	2%
Centamin Mining	CEE.TO	2/23/11	$1.95	$1.97	1%
Anderson Energy	AXL.TO	2/23/11	$1.19	$1.04	-13%
Bullish Oil ETF	UCO	4/7/11	$60.85	$48.04	-21%
Conoco Phillips	COP	4/7/11	$80.40	$71.88	-11%
Pretium Resources	PVG.TO	4/7/11	$10.00	$8.50	-15%