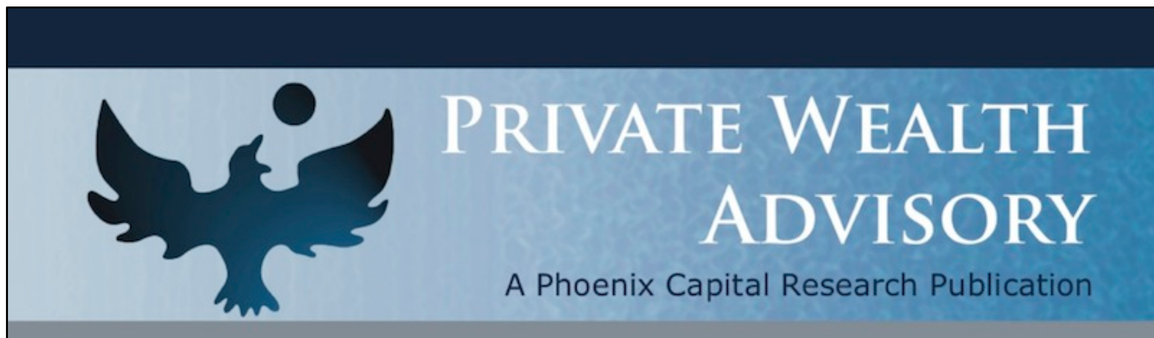


Weekly Market Update: 7-9-15

Dear Subscribers,

The markets are bouncing today because:

1) Traders are conditioned to hope and pray for Central Bank intervention.
2) Crises never unfold in a straight line
3) The Plunge Protection Team is out in full force

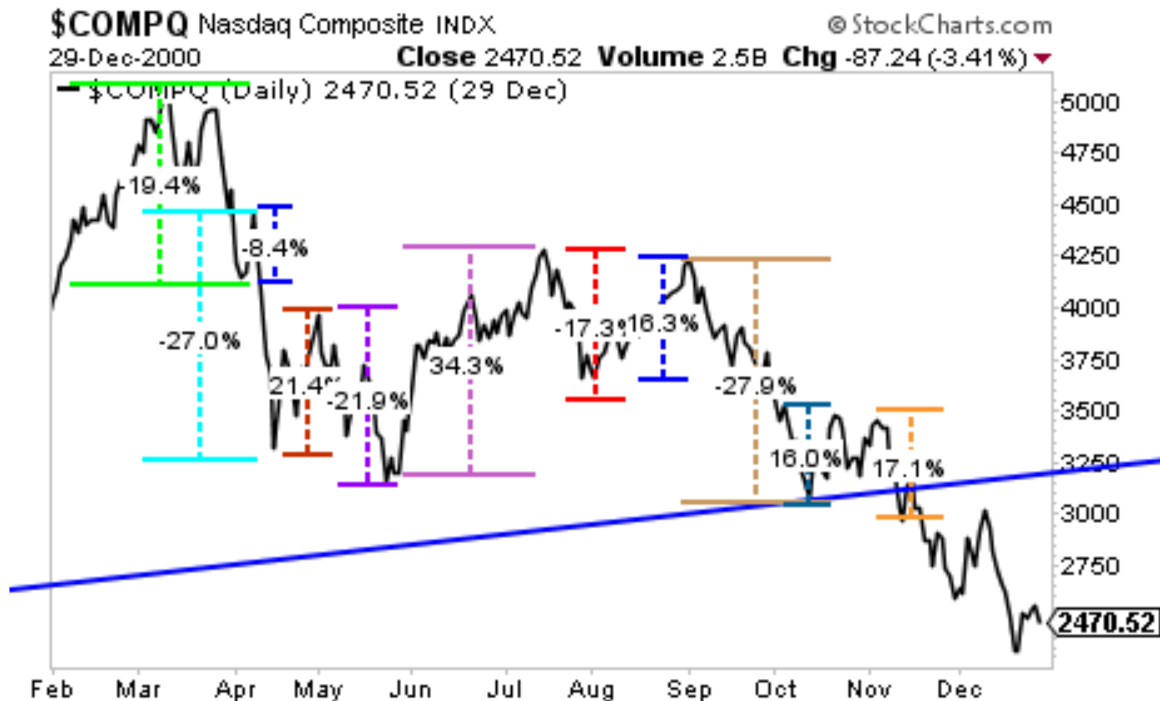
Regarding #1, while many in the media are acting as though the world is ending, the reality is that the damage to US stocks has been minimal due to the fact that traders are rabidly bullish and conditioned to believe that the Central banks will not let the markets crater. **Indeed, the S&P 500 is down LESS than 5% from its most recent high!**

Moreover, the VIX has barely registered a meaningful move upwards. We've not even moved above the former 2015 HIGH! Investors are EXTREMELY complacent!

In contrast to the US markets, some real carnage has occurred in China where something truly major is unfolding (more on this later). But in the US, I would argue that 99% of investors don't believe the markets are in serious trouble of any sort. Indeed, the Fed is even talking about potentially RAISING interest rates!

Regarding #2, Crises never unfold in a straight line. If this is THE top for the bull market started in 2009, NO ONE knows it yet. Indeed, it often takes months for investors to truly "get it" when it comes to bubbles bursting.

I've shown the below chart before, but it's worth repeating. The chart shows the NASDAQ's action when the Tech Bubble burst. During the first six months after the top came in, the market experienced **EIGHT price swings of 16% or greater**.



During this period, stocks went down 19%, up 8%, then down 27%, then up 21%, then down 22%, then up 34%, then down 17%, then up 16%, then down 28%, then up 16%, and finally down 17%. **Only at that point did stocks break their trendline for the bubble (the blue line) and it became obvious that the bubble had burst.**

Finally, I believe that the US markets are relatively complacent because of active intervention from the Plunge Protection Team.

It is not a coincidence that the market "broke" yesterday when Selling Pressure became high. There are many theories as to why the NYSE shut down yesterday (cyber attack, computer glitch, etc.), **but the reality is that it's highly likely that the system was simply closed to try and stop selling pressure.**

This game has been going on for sometime. While yesterday was a major example (the entire NYSE went down for four hours), the last three months have seen countless examples in which the markets "broke" briefly (during which time "someone" aggressively bought stock futures, forcing the markets higher) before reopening.

The below chart from Zerohedge shows this playing out clearly: whenever the markets began to sell off aggressively, they "broke" at which time stocks suddenly rallied for no reason at all.

We know that Central banks use the futures markets to manipulate stocks higher. It's not much of a leap of faith to assume that they'd also push the exchanges to close whenever selling pressure becomes significant.

However, the REAL takeaway to notice is that if the markets are so healthy and liquid… why do they break amid obvious Central Bank intervention anytime stocks fall 2% or more?

Put another way… just how fragile is the financial system that the Fed can't stomach even a 5% correction before it has to intervene?

The answer: VERY fragile… and increasingly at risk of a REAL crash.

Let's look at some charts…

The S&P 500 has taken out critical support of the 126-DMA. Over the last two years this has been THE line for the bull market. Indeed, the S&P 500 has only violated this line once before going all the way back to the beginning of 2013.

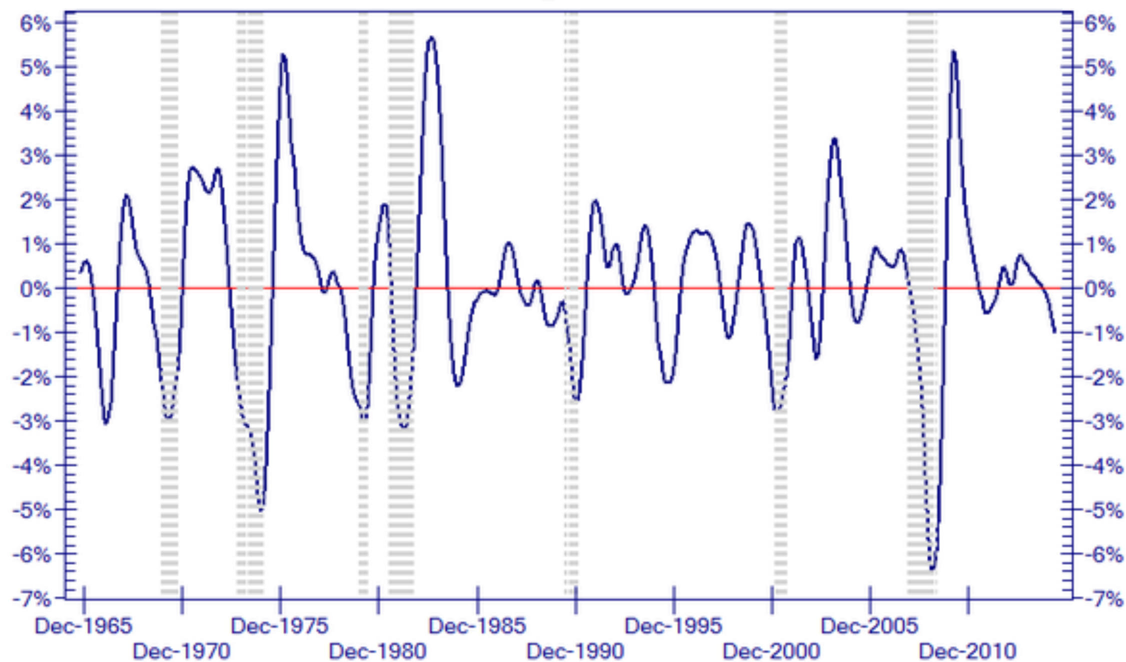
Having taken out this line, the S&P 500 has bounced off of the ULTIMATE line of support, the 250-DMA. Stocks are now between the 126-DMA and the 250-DMA. It's a tight trading range and whenever we finally break out of it, the move will be EXPLOSIVE.

It is impossible to know which way things will move. The fundamentals (a weakening global economy, a potential Grexit, the China stock market collapse, etc.) suggest the break should be DOWN. But stocks no longer trade based solely on fundamentals.

Indeed, the last time the market cratered like this (October 2014) we had a sharp bounce based on a **<u>non-voting</u>** member of the Fed (meaning his opinions have no impact on Fed monetary policy) suggesting that the Fed could hold off on ending the measly $5 billion that was left in its QE 3 program (an useless and irrelevant suggestion). **And yet, stocks roared over 10% higher in two weeks based on it**!

While I cannot predict accurately whether stocks will breakout to the upside or the downside of their trading range, I can tell you that the underlying US economy is weakening rapidly in the US.

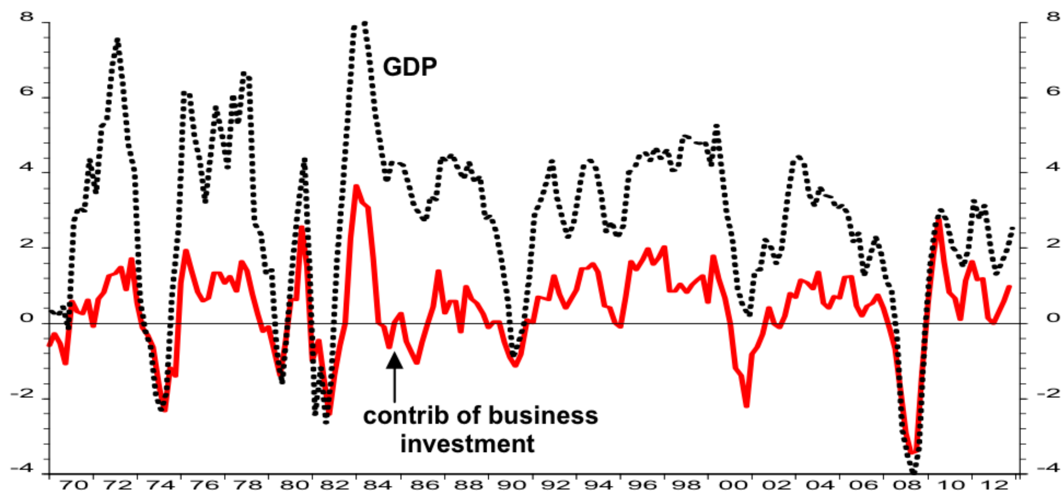
Indeed, the Leading Economic Indicator for the US is now at levels associated with recessions.



This is just the latest data point to suggest the US is back in recession. Indeed, we now know that excluding ObamaCare and weather related issues, GDP FELL 1.4% in 1Q15.

The second quarter GDP data shows that the economy is supposedly back on track, growing at a 2.2% growth rate, but none of the hard economic indicators I follow confirm this, **which suggests that the GDP growth rate is being "massaged" higher for political purposes.**

Remember, recessions are caused by a substantial drop in business investment. Indeed, as the below chart from Societe General shows, whenever business investment drops below 0% in Year-Over-Year growth, GDP collapses soon after.



The logic here is simple… businesses create jobs. When business investment grows (we're talking about organic expansion and hiring, NOT buying another company and laying off staff to improve sales), the business is expanding and people are being hired. When business investment *drops* the economy soon follows suit.

With that in mind, all of the following data points suggest the US is already in a recession:

1) Corporate profits falling for the first time since 2008.
2) Factory Orders declining for six straight months.
3) Industrial production falling for five straight months.
4) Labor productivity has fallen for two straight quarters.

With profits falling, business will spend less. The sharp drop in factory orders and industrial production confirms this. Stocks have yet to figure it out… but they will.

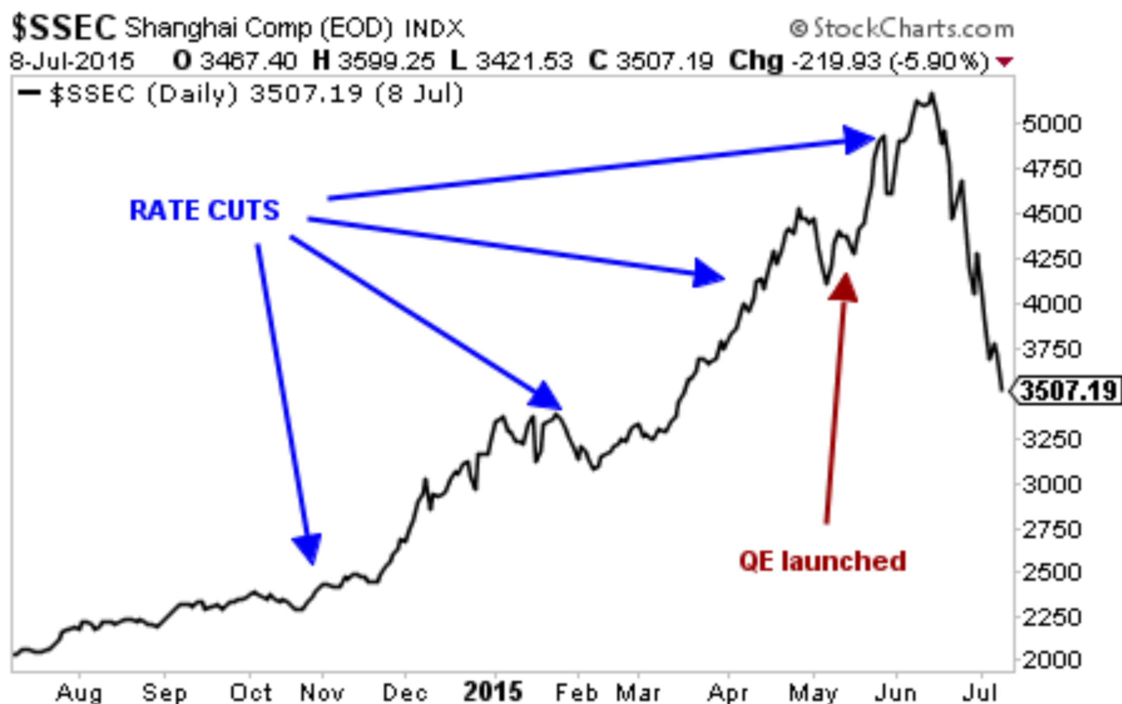
However, even this development pales in comparison to what is happening in China today. Indeed, China has just signaled a tectonic shift in the financial landscape.

Historically, stock bubbles have burst due or collapse due to Central bank *tightening*.

China's bubble is bursting while the Central Bank is ***LOOSENING*** monetary policy aggressively. Indeed, in the last two months China has:

1) **Issued two surprise interest rate cuts (four total since November 2014)**
2) **Launched its own version of QE.**
3) Loosened regulations on margin trading
4) Banned short-selling on many stocks
5) Threatening to arrest those who "cause" financial stability (meaning anyone).
6) Made it illegal for large investors to sell stocks
7) Issued a number of small bailouts of brokerages and financial firms.
8) Halted trading on 1400 Chinese stocks.

Despite this, the China stock market has imploded.

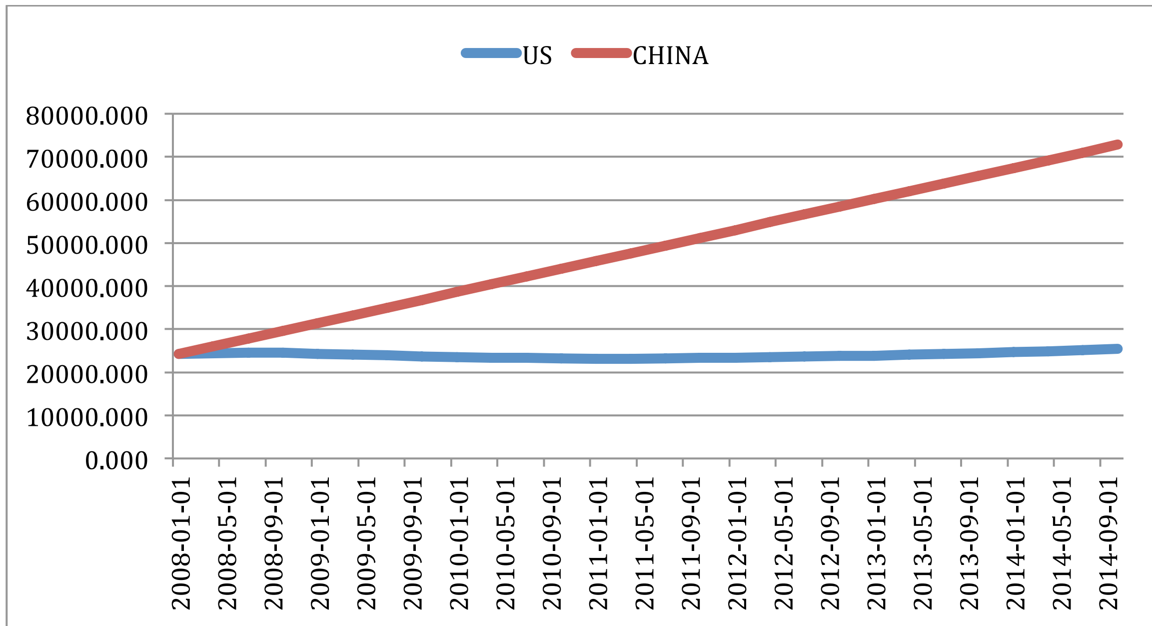


This has NEVER happened before: the stock market STILL crashed despite a Central Bank cutting rates and implementing QE.

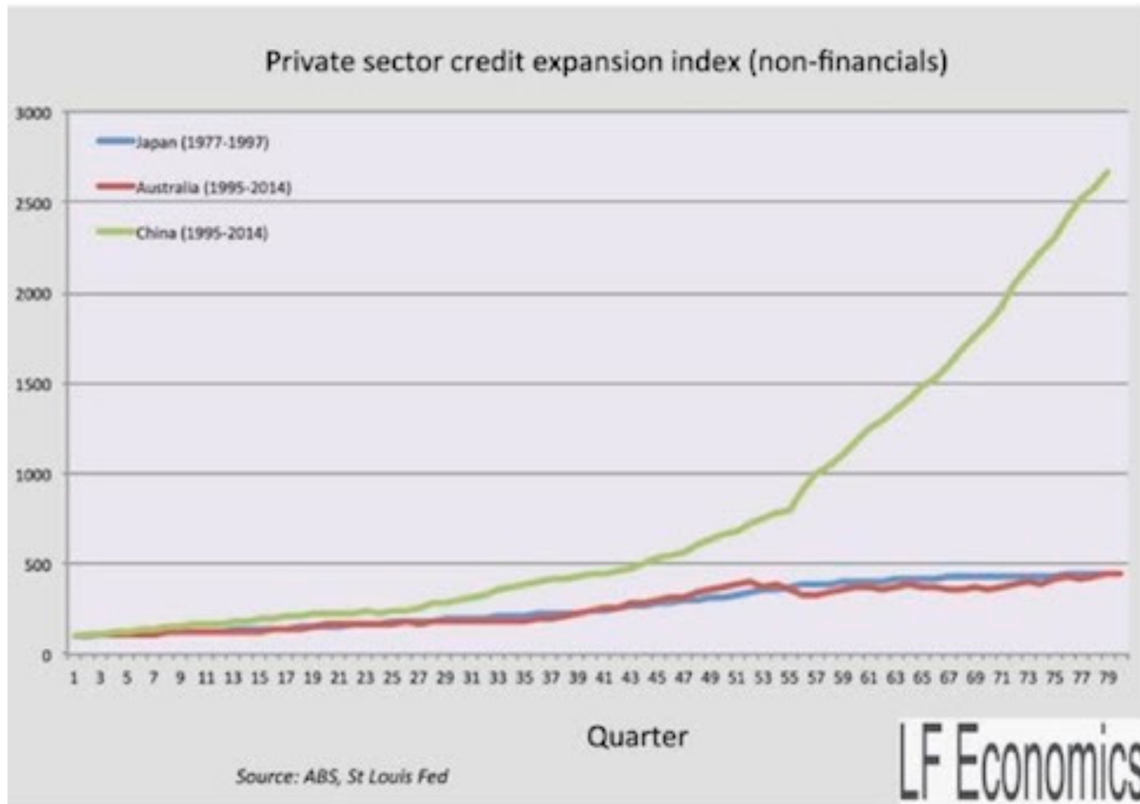
I cannot overemphasize the significance of this, especially considering that China has lead all monetary policy for the world post-2008.

China launched the single largest stimulus relative to GDP to combat the 2008 slowdown (25% of GDP). It also more than tripled its credit market in the post-2008 era.

It's well known that the Fed pumped its brains out putting credit into the US financial system. However, China's credit growth post-2008 has been so aggressive that it makes the US credit expansion looks like a FLAT LINE!



Moreover, China's credit bubble is larger than ANYTHING ever seen in history. The Japanese bubble of the '70s and '80s was so massive that the land beneath the Japanese Imperial Palace was valued greater than the entire State of California. China's current bubble (the green bubble) makes that bubble (the blue line) look like nothing.



So what happens in China is of MASSIVE import to the rest of the world, because China has lead the way in terms of response to the 2008 crisis, as well as credit expansion, and the building of asset bubbles.

So for China's bubble to burst DESPITE its Central Bank loosening monetary policy is a MASSIVE warning **that we may in fact have reached the point at which QE and rate cuts WON'T prop the markets anymore.**

Remember, China's stock market has lead the US's stock market during the last ten years. Indeed, China crashed in 2007… a full two quarters before the US markets began to collapse.

So the China collapse is a MASSIVE warning to US investors that trouble is approaching. **This is particularly true for anyone who is buying US stocks today based on hope of more Fed QE down the road.** China DID launch more QE and the market STILL crashed.

H/T Bill King

Finally, a number of you have written to us asking how to deploy capital in this current market.

The first thing I want to emphasize is that you should NEVER invest based on what is happening in the markets right now. You should invest based on what is LIKELY to happen in the future.

Starting in January of this year, I believed that we were entering a period in which the following would happen:

1) The US Dollar would continue to strengthen
2) Emerging markets would collapse
3) Industrial commodities would collapse.
4) China would eventually collapse

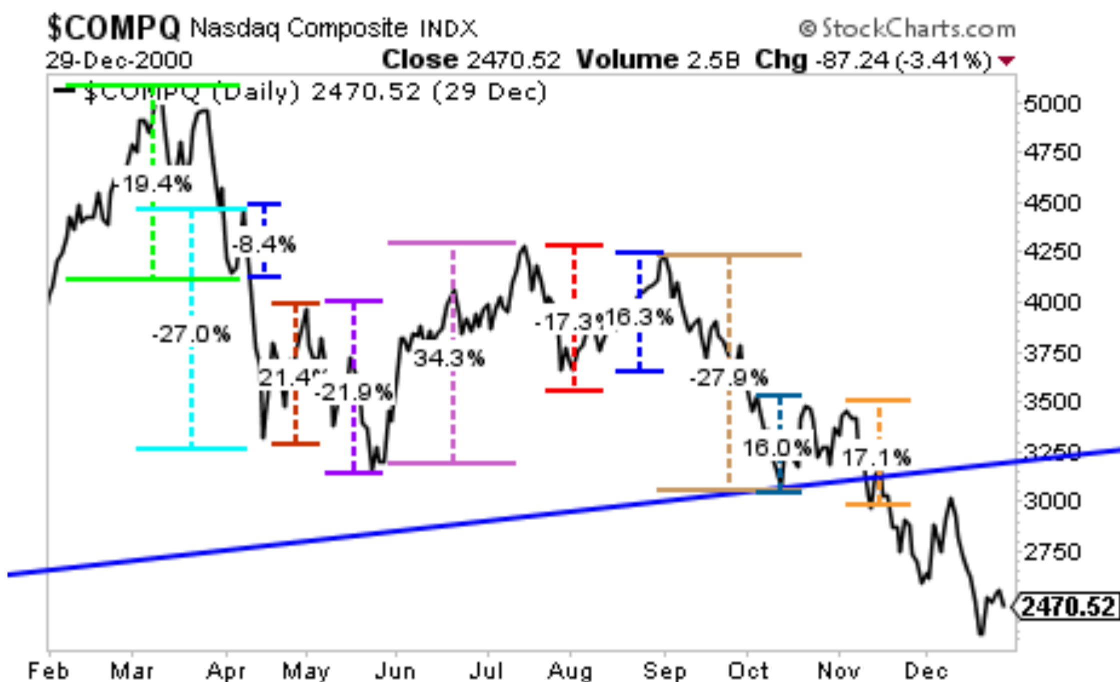
I had us position our portfolios accordingly. All of these trends have recently proved correct. And so we have taken profits in them.

POSITION	SYMBOL	BUY DATE	BUY PRICE	SELL DATE	SELL PRICE	GAIN/ LOSS
UltraShort Oil ETF	SCO	5/27/15	$61.08	7/6/15	$70.30	**15%**
UltraShort Gold	GLL	2/25/15	$95.49	7/7/15	$101.75	**7%**
Copper (SHORT)	JJC	3/10/15	$31.35	7/7/15	$28.78	**8%**
UltraShort Brazil ETF	BZQ	5/27/15	$85.70	7/7/15	$92.02	**7%**
Industrial Metals	UBM	3/25/15	$15.24	7/7/15	$13.56	**11%**
UltraShort China	FXP	3/10/15	$36.45*	7/8/15	$41.93	**15%**

*Average of prices: $42.71 bought on 3/10/15 and $30.18 bought 6/17/15

Put simply, the first wave of the Deleveraging Cycle that I anticipated has hit and we've taken some money off the table. We are now taking a breather before determining the next set of investments to make.

Remember, no market goes straight up or down. As the chart of the Tech Bubble bursting that I showed you earlier illustrated, when a bear market begins there are a LOT of legs down.



In terms of where to invest now, I believe we remain in the context of a large multi-year bull market in the US Dollar.

This will involve the US Dollar strengthening, while "risk" weakens, particularly in Emerging Market Currencies and Emerging Market Stocks.

It will also feature pronounced weakness in the commodities markets, particularly industrial commodities associated with Emerging Market economic growth.

Eventually the carnage will spill over into US stock market. Precisely when this will happen, I do not know. I DO KNOW however is that when things really heat up, Central Banks will unleash another round of QE.

At that point, how things will proceed is uncertain. If the QE programs are massive enough, we could enter an inflationary collapse in which precious metals and inflation hedges soar. However, it's also possible that the QE programs would fail to induce another wave of reflation (as is the case in China today) and the system would continue to collapse/ deflate.

In the simplest of terms, my BIG PICTURE view is Deflation Now, possible Inflation Later. However, predicting what's going to happen too far down the road is a dangerous proposition. We've had great success so far by focusing on what the next few months will bring and going no further in terms of our forecasts.

Right this moment, we are in a "risk on" bounce. We've take some money off the table and are watching to see how strong the bounce is and how long it lasts.

Once we have a better sense of what is happening, I'll begin to recommend new positions for you to profit from it. But for now, I like the US Dollar. After all, it's hard not to like an investment that outperforms stocks with much less risk. Don't let the CNBC crowd know, but the greenback has outperformed stocks this entire year so far!

This concludes this market update. I'm watching the markets closely and will issue alerts as needed. Once I have a better idea of what the next move is for the markets, we'll start to make some new investments.

Best Regards

Graham Summers
Chief Market Strategist
Phoenix Capital Research

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