Private Wealth Advisory

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Calling the Government's Bluff

The dollar is rallying largely due to verbal intervention that occurred over the weekend. I think this rally may last a week or so based on the dollar being over-sold. But leave it to the Feds to instigate it. A brief synopsis of their interventions is as follows:

- Friday (6/12/09) the *Wall Street Journal* ran an article saying that the US Federal Reserve wouldn't perform much more quantitative easing.
- Saturday, (6/13/09) Japan's Finance Minister Kaoru Yosano stated, *"our trust in U.S. treasuries is absolutely unshakable."*
- Friday-Sunday, (6/14/09) world leaders discuss exit strategies regarding their recent stimulus (indicating that things are improving)
- Monday, (6/15/09), Russia's Finance Minister commented the US dollar is in *"good shape."*

Now, the markets have never been efficient mechanisms for discounting future events. However, in today's world of highly leveraged quant trading (computer-based trading funds account for 33% of the volume on the NYSE), the *"trade now, think later"* mentality rules the markets.

With trigger happy traders pushing the market this way and that on a whim, verbal interventions can be highly effective means of propping up key sectors or currencies—consider homebuilder stocks' reactions to Alan Greenspan's comments (2006-2007) or financials' reactions to Ben Bernanke's statements (2007-2008).

And so, the recent statements from finance ministers (Japan and Russia) have kicked off a temporary (perhaps 1-2 week) halt to the inflation trade AKA go long commodities & long stocks while shorting Treasuries. We predicted this last week, closing out many of our inflation trade picks for double-digit gains. And we're going to be taking advantage of the trends' reversal too. However, before we get into this week's specific recommendation, I'd like to analyze just how ripe the stocks and commodities are for a correction.

Why Stocks and Commodities Are Overdue for a Correction

Ned Davis Research notes that typically when stocks bottom, you see a 10% rally in the P/E ratio of the market. In other words, if stocks are priced at a P/E of 10 at the market bottom, fundamentals dictate that it's healthy for the market to attain a P/E of 11 within three months. It's also healthy for the market to attain a P/E of 12 after six months.

However, during this current rally, the market's P/E jumped 40% (four times the norm) within the first three months. This has resulted in stocks being far too expensive, once again. If you go by expected 2009 bottom-line earnings, we're trading at a P/E of 33, hardly an attractive valuation.

Commodities have also gotten ahead of themselves. Hard assets have rallied 30%-100% since their March '09 bottom.

Much of this stemmed from China's record purchases of industrial commodities (copper, iron ore, etc.) in March and April— a move many commentators, myself included, have taken to mean that China is diversifying away from the dollar. As I mentioned before, we're in a "monkey see, monkey do" environment, and traders piled into commodities after China.

Commodities also got a boost form increased inflation hedging. Indeed, the "inflation trade" has become the most popular mantra for the investing herd, with investors loading up on gold, oil, and virtually every other inflation hedge you can name. This is most evident in two sectors: oil and gold.

Oil has more than doubled since its market bottom of $35 in March. Granted, the black gold was exceptionally oversold at its bottom. But investments don't double in three months from demand. Indeed, **worldwide oil demand fell 3.4 million barrels per day in 1Q09.** We're now back to pre-2007 levels in terms of worldwide oil demand. And yet, up until a few weeks ago, the black gold keeps rallying.

I think it’s highly likely that oil will continue to correct in the coming weeks, but there may still be some upside potential here. On Tuesday, Russian President Medvedev called for a new world reserve currency. This comment hit the dollar and pushed oil higher. Now, I realize it’s bizarre for Russia’s finance minister to say one thing and its President to say another (within 24 hours of one another, no less)… but Russia isn’t exactly a bastion of stable political leadership. And the world is currently undergoing a shift in power (more on this next week).

The Russia situation can be easily summated. With Industrial Output down 15% year over year and GDP expected to contract 6-8% this year, Russia needs oil prices to go up if it’s going to have any hope of a recovery. President Medvedev’s anti-dollar rhetoric is nothing more but a verbal intervention seeking to induce this.

He’s also got the faltering rally in Russian stocks to consider:

As is the case with oil, the Russians need Russian stocks higher in order to attract foreign capital and loosen up their credit markets. They’re willing to play ball to stop a full-scale currency crisis, but not much more. So expect more “pro-dollar/ anti-dollar” statements from there. But in the end, Russia is not China or Japan, and its statements won’t have the same impact on the Dollar.

To repeat, oil may trend higher from here. But the fundamentals don’t support it. So be wary of any moves to the upside.

The picture is somewhat different for gold. Unlike oil, gold has little or no industrial usage, so any rise in demand stems from investment (demand for gold as jewelry has fallen off a cliff due to the economic downturn).

In that light, it's staggering to see that global gold demand jumped 38% in the 1Q09. Three years ago, demand for gold as an investment only comprised 10% of global gold demand. Today it's over 30%. That's an unbelievable increase in investment demand.

From an anecdotal standpoint, I've begun hearing numerous "we'll pay cash for gold" radio advertisements. And just yesterday at the gym I saw G. Gordon Liddy on TV touting gold as king and the dollar as garbage (he actually crumpled a dollar bill up on camera).

I believe we may well be approaching the second leg of the gold bull market (the one in which full blown mania erupts). You can view my special report on Gold for more info on this: www.gainspainscapital.com/gold.pdf). However, in the short-term, I would not be surprised to see gold cool down a bit. The precious metal rose nearly $100 in May alone. I expect we'll see a temporary correction to $900 an ounce.

This brings us to the ultimate issue currently facing the financial markets:

The US dollar.

Anytime you see politicians or finance ministers touting the value of a currency, you know the currency is in big trouble. Over the weekend we saw not one but multiple political leaders touting the dollar. We've even sent both Hillary Clinton AND Tim

Geithner to China to promote the dollar's alleged strength—Clinton was met with suspicion, Geithner with outright derision (students openly laughed at him during his presentation).

However, everyone ALREADY knows the dollar is horribly flawed. Investors have been buying "anti-dollar" investments in record numbers for months now. And they've overdone it as usual— again, oil has doubled in three months and gold commercials are playing on the radio and TV.

This tells me two things:

1) The inflation trade has come too far too fast.
2) The dollar is set for a significant bounce.

The second item has already begun.

From a technical standpoint, the dollar could very well rally to test its 50-day moving average (DMA). I have been expecting this, which is why we closed out several of our inflation positions (TBT, BDD, GDX) during the last two weeks.

Indeed, I think the dollar has room to rally from here. Granted, from a long-term perspective, the dollar is done. But nothing ever goes straight up or straight down. And the dollar has just come off a three-month correction that shaved 10% of its value—historically, a correction of this magnitude typically takes 6-9 months, NOT 3 months.

In simple terms: we have the makings of a nice bounce here. And we're going to ride it with **Direxion Funds Dollar Bull 2.5 Fund (DXDBX).**

DXDBX returns 2.5X the return of the US dollar index. So if the dollar rallies 2%, DXDBX returns 5%. If the dollar rallies 5%, DXDBX returns 12.5%. It's a simple, but effective means of playing the dollar's bounce and picking up a quick double-digit return in the process.

To reiterate the central theme of this issue, commodities and stocks have exploded higher during the last three months as the dollar plunged. These trends are now reversing (temporarily). And I believe we will see a brief 1-2 week correction in the commodities markets, a possible collapse in stocks (which we'll ride with the UltraShort Russell 2000 ProShares (TWM)), and <u>a bounce in the dollar.</u>

In fact, given the just how popular the anti-dollar trade has become, any bounce could potentially be dramatic. DXDBX gives us the profit from this. And I expect we'll see gains of 10-15% within the next nine trading sessions.

Action to take: Buy the Direxion Funds Dollar Bull 2.5 Fund (DXDBX).

Elsewhere in the *Private Wealth Advisory* portfolio, we're holding onto our gold and agriculture positions (GLD and RJA, respectively). Gold, while overbought, is the best means of catastrophe insurance. And I believe the US markets could well have another crisis (this one instigated by either commercial real estate the dollar, or both). I want gold in our portfolio in case this happens.

As for the **Rogers Agriculture ETN (RJA),** agriculture remains one of the few sectors in which we see rising demand, falling supply, and falling production. Indeed, the world is headed for a very serious food shortage within the next 2-3 years if world leaders don't address this issue soon. The below charts are from Mark McLornan, of Agro-Terra.

Figure 1 **Wheat: Stocks-to-Use vs Real Prices, 1970–2009**

Figure 2 **Corn: Stocks-to-Use vs Real Prices, 1970–2009**

Source: USDA; Datastream

As you can see, wheat and corn stocks-to-use are all at or near 30 year lows. And this is occurring at a time in which we're adding 70-80 million new people to the planet per year.

Bottomline: Agriculture is one of the few sectors in which fundamentals are improving dramatically every day. So we're holding on for now.

UltraShort Financials ProShares (SKF): when a bubble bursts, it takes decades before the sector that experienced the bubble returns to its former levels. Financials' Bubble burst in 2007. And the sector has recently staged a classic dead cat bounce: an enormous jump based largely on short-covering NOT fundamental improvements in the sector.

I think we'll see a re-test of 35, possibly even the March low of 25, on the Financials ETF. We're using the **UltraShort Financials ProShares (SKF)** to ride it out. SKF returns two times the inverse of the Financials ETF. If Financials fall 5%, SKF returns 10%. If Financials fall 10%, SKF returns 20%. We're currently up 6% on this position, with a heck of a lot more to come.

UltraShort Russell 2000 Proshares (TWM): as I've explained in this issue and the last three, stocks are primed for a correction of at least 10%. Microcaps (the Russell 2000) led stocks during the rally; I think they'll lead them during the correction too. TWM returns two times the inverse of the Russell 2000. If the Russell 2000 falls 5%, TWM returns 10%. If the Russell 2000 falls 10%, TWM returns 20%.

Stocks began to roll over on Monday. We're currently up 7% on this position and just getting started.

I'll be watching our portfolio closely in the coming days. If anything develops I'll send out an update. However, if nothing new comes up, you'll hear from me next Wednesday with our next issue published after the market's close. Until then…

Good Investing!

Graham Summers

OPEN POSITIONS

Company	Symbol	Buy Date	Buy Price	Current Price	Gain/ Loss
Gold ETF	GLD	5/6/09	$89.54	$92.31	3%
Rogers Agri ETN	RJA	5/6/09	$7.62	$7.52	-1%
UltraShort Financials	SKF	6/3/09	$42.18	$44.87	6%
UltraShort Russell 2000	TWM	6/10/09	$40.55	$43.30	7%
Dollar Bull 2.5X Fund	DXDBX	6/17/09	$31.76	NEW	BUY

CLOSED POSITIONS

Company	Symbol	Buy Date	Buy Price	Sell Date	Sell Price	Gain/Loss
UltraShort 20+ Yr Treasuries	TBT	5/6/09	$50.11	At Open 6/12/09	$57.13	14%
Gold Miner's ETF	GDX	5/6/09	$36.86	At Open 6/3/09	$43.74	19%
Powershares DB Base Metals	BDD	5/27/09	$7.11	At Open 6/12/09	$9.62	35%
				Portfolio Average	**12%**	
				S&P 500	**-2%**	