PRIVATE WEALTH ADVISORY

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The Great Collapse Pt 2

Short-Term Trends
-Markets holding up into Fed Jackson Hole meeting on Friday
-Hedge fund liquidations (stocks, Gold, Silver)

Intermediate Trends
-No QE 3 coming: Fed's hands are tied.
-Major Euro move coming into September.
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Long-Term Trends
-US debt default
-China hard landing
-Civil unrest and Government shutdown in US

As an investor, it's critical to look at your arguments/ thinking patterns from an objective perspective. For that reason I sometimes like to argue with myself over my investment theses to see if there's something I'm missing.

So I spent the better part of last week trying to find an argument for why the market might hold up. I wanted to find a legitimate reason (ANY reason) that things would turn out well in the coming months.

These are the primary reasons I could come up with:

1) Emerging markets decoupling or the idea emerging markets can pull the world economy into growth.
2) The ECB and Germany solving Europe's problems resulting in the debt contagion ending.
3) The Fed announcing QE 3

Let's dissect these arguments one by one.

The emerging markets have indeed experienced economic growth and stock market gains far exceeding those of the US and other developed countries. The best example of this is Brazil, which has seen an inflow of fresh capital from investors and increased domestic growth courtesy of commodity prices rising (Brazil is the largest exporter of many commodities).

In simple terms, the fundamentals in Brazil were much better than those in the US in the post-2008 Crash period. As a result of this, the Brazilian market bottomed in November 2008 (compared to March 2009 for the S&P 500), and before it more than tripled vs. a 95% rally in the S&P 500.

Given this relative strength, many bulls believe that Brazil (and other emerging markets like it) have "decoupled" from the US economy, meaning that these emerging market economies are strong enough to stand on their own two legs and will hold up regardless of what happens in the US.

However, this whole belief came crashing down earlier this year when the Brazilian market first peaked before the S&P 500 and then lead to the downside: the Brazilian ETF is now 23% off its highs compared to 16% for the S&P 500.

Moreover, Brazil's growth forecasts have recently been lowered for three weeks in a row as inflation soars and the global economy slows. Indeed, even Brazilian economists have noted that the global economy slowing is impacting Brazil:

> *Forecasts for Brazil's economic growth are being driven lower by its tighter monetary policy and a slowing global economy, a central bank survey showed on Monday, signaling a steeper-than-expected slowdown is looming.*
>
> *The central bank survey found that forecasts for economic growth this year fell for a third week to a median 3.84 percent in the week ended Aug. 19.*

The situation holds true for China (the emerging market "darling") as well: the Chinese market is over 20% off its highs and Chinese GDP estimates are falling.

Indeed, it is quite telling that the S&P 500 has fallen far less than the BRIC markets: the S&P 500 is 16% off its highs, while Brazil is off 23%, Russia is off 22%, China is off 20%, and India is off 28%.

So right off the bat, the "emerging market decoupling" argument falls flat on its face. So scratch that as a reason that the global economy and financial markets will improve in the near future.

Now let's consider the belief that Germany and the ECB might solve Europe's debt problems.

For starters, this argument is absurd simply on a common-sense basis. Greece first asked for a bailout in June 2010. It's since asked for an extension on this bailout AND a second bailout… all within a 14-month period. The fact this has occurred in such a brief period of time should make it clear how impotent the ECB (and ultimately Germany) is at fixing the situation.

Indeed, Europe's debt contagion has now spread from Greece and Portugal to Spain and Italy: countries far too large for the ECB to bail out (by the way, the second Greek bailout hasn't even been finalized yet so that potential crisis is still on the table).

As I've noted in previous issues, any and all EU bailouts and interventions hinge on Germany, the largest, most solvent economy in the EU. No German support means no bailout, and no EU (in its current form).

As I've noted in previous issues, Germany has had enough of the bailout nonsense. The following stories confirm this:

Investor confidence sags in Germany as ZEW index falls to minus 37.6

German investor confidence fell sharply in August on fears about sagging growth in Europe's biggest economy, the region's government debt crisis and the possibility of another recession in the United States.

The ZEW institute said Tuesday that its index of investor confidence dropped to minus 37.6, down 22.5 points from the month before.

The institute said the drop was due to fears about a double-dip recession in the United States and uncertainty about the global economy, coupled with Germany's disappointing second-quarter growth of 0.1 percent reported last week.

Bundesbank questions legality of EU bail-outs

Germany's Bundesbank has issued a blistering critique of EU bail-out policies, warning that the eurozone is drifting towards a debt union without "democratic legitimacy" or treaty backing.

"The latest agreements mean that far-reaching extra risks will be shifted to those countries providing help and to their taxpayers, and entail a large step towards a pooling of risks from particular EMU states with unsound public finances," said the bank's August report.

It said an EU summit deal in late July threatens the principle that elected parliaments should control budgets. The Bundesbank said the scheme leaves creditor states with escalating "risks and burdens" yet no means of enforcing fiscal discipline to make this workable.

With the German economy slowing, the underlying tensions between the ECB and Germany are intensifying. And with Germany's next round of elections due in late September, the chances of Germany moving to backstop any additional bailouts are diminishing by the day.

Understand, I view any and all EU bailouts as failures. But the big question for the Euro's future is whether Germany will agree to kick the can down the road a little further. I do not believe it will. Which is why the Euro looks primed for a major move:

Having formed over six months, when this triangle pattern breaks, the move will be VIOLENT. The market has teased with the idea of breaking to the upside (courtesy of the ECB intervening in the bond and currency markets), but given the macro and fundamental backdrop, as well as the political backdrop in Germany, we're likely to see this pattern resolve to the downside with a target around 130.

When this happens the Eurozone will collapse as an aggressive move of this nature to the downside would make it clear that the ECB had completely lost control and that the EU in its current form was finished.

So scratch a German/ ECB bailout solution to the European debt problem as a reason for hope.

Let's now address the final bullish argument for stocks and the economy: that the Fed will announce QE 3 soon. I addressed this situation in this morning's *Gains Pains & Capital* writing:

> I've warned many times that QE 3 will not be coming any time soon and that stocks are on very VERY thin ice.
>
> With that in mind, I wanted to alert you to the following news story:
>
>> **Those looking for a clear and unambiguous green light for QE3 from Fed Chairman Ben Bernake's much anticipated speech in Jackson Hole on Friday could be disappointed.**

> There are three reasons that add up to Bernanke likely falling short of market expectations for an all-out endorsement of additional Fed [cnbc explains] action at the annual meeting of central bankers in Wyoming the way he telegraphed QE2 [cnbc explains] last year.
>
> **It's also rare for a Fed chairman, especially one this consensus-oriented, to get too far out front of his committee.** The August policy statement clearly showed a willingness of the committee to conduct additional asset purchases.

This article was written by Steve Liesman of CNBC. Liesman is known to have extremely close ties to the Fed. So for him to write this sort of story before the Fed's Jackson Hole meeting (Friday) is EXTREMELY significant.

Consider that the only reason the market is holding up is due to the bulls desperately hoping the Fed will unleash QE 3 this Friday. Now consider that Bank of America is close to collapsing at the very same time that the European debt contagion is threatening to take down the entire European banking system (Germany is increasingly unlikely to give the "greenlight" to more bailouts).

In this environment, for the Fed to NOT unleash QE3 on Friday could cause a full-scale market collapse. So it would make plenty of sense for the Fed to try and do some damage control ahead of time with a story like Liesman's.

Now, have a look at Gold's action this morning: the precious metal is down over 3% in just a few hours. Do you think perhaps some "well-connected" investors might know that Bernanke *isn't* going to unveil QE 3 tomorrow (the Fed has a precedent for leaking information to the "chosen" few).

If QE 3 were coming, Gold shouldn't correct. The same is true if BAC were going to be bailed out: Gold should keep rallying. But instead Gold is falling sharply.

The same goes for Brazil: THE commodity player and one of the emerging market darlings for the Bulls. Does this chart look like we're about to see QE 3 (which would send commodities through the roof)?

> Again, this is a major signal that QE 3 is not coming. Those who are hoping it will need to look at what the markets are telling us. Ignore stocks and pay attention to the credit markets: they're on DEFCON 1 RED ALERT.

In plain terms, the markets are telling us QE 3 isn't coming on Friday. This ties in with the current political atmosphere at the Fed, namely that:

1. Dissent is growing at the Fed
2. Bernanke and his loose money policies are now political hot buttons

As I've noted before, the three dissenting votes at the Fed's FOMC were an 18 year high for the Fed. At no point in the last 18 years have so many Fed leaders disagreed with the proposed monetary policies.

We also see Fed Presidents openly criticizing Bernanke and his loose money policies in public. Dallas Fed President Dick Fisher recently said the following:

> **My long-standing belief is that the Federal Reserve should never enact such asymmetric policies to protect stock market traders and investors. I believe my FOMC colleagues share this view.**

We also see Bernanke and his policies coming under political fire from Presidential Candidates Ron Paul, Rick Perry, and Michel Bachmann. All three of these candidates have seen their standing in the polls soar recently. In contrast, Bernanke's biggest defender, current President Obama, has seen his standings falling to new lows.

Add to this situation the following story:

> **Fed Chairman Ben S. Bernanke's unprecedented effort to keep the economy from plunging into depression included lending banks and other companies as much as $1.2 trillion of public money,** about the same amount U.S. homeowners currently owe on 6.5 million delinquent and foreclosed mortgages. **The largest borrower, Morgan Stanley (MS), got as much as $107.3 billion, while Citigroup took $99.5 billion and Bank of America $91.4 billion, according to a Bloomberg News compilation of data obtained through Freedom of Information Act requests, months of litigation and an act of Congress.**

… and you've got a political atmosphere that is fast becoming openly hostile to the Fed and the idea of more bailouts/ QE 3.

So, to recap… emerging markets are NOT decoupling from the US, Germany (the ultimate EU backstop) is not likely to continue funding more bailouts, and the Fed will not be able to enact QE 3 without a major bank collapsing or systemic collapse.

In other words, there is literally no reason to be bullish on stocks right now. Which is why we remain invested in our Crisis Trades (more on this later).

Indeed, I see two potential patterns emerging in the S&P 500. One is a triangle pattern:

So far the market has respected the upper descending trendline since the Collapse began in late July. By the look of things, we're ready for a drop to 1,150 in short order (more on this later).

The other pattern I see in the S&P 500 is a potential Head and Shoulders:

This is a messier pattern. And for it to be valid, the market would need to turn sharply lower soon For this reason, I favor the triangle pattern today. Indeed, this pattern is being confirmed by the emerging markets:

China:

And Brazil:

Brazil has the clearest pattern here. And by the look of things we're right on the cusp of breaking this pattern. This pattern needs to be watched closely as Brazil has been a market leader during the last few weeks: below chart shows Brazil's (black) performance vs. the S&P 500 (blue).

Now about the market rally that occurred this week.

Investment commentators are proffering countless explanations for why the market is moving the way it is. The simple answer is: hedge funds. During this recent market collapse, hedge funds were generally short stocks and long Gold. They are now unloading these positions (buying stocks and selling Gold) to prepare for the Fed's Jackson Hole meeting.

Indeed, I believe Gold is openly telling us that QE 3 is not coming. I know many commentators are claiming that Gold's recent drop in price was the result of margin hikes.

However, the CME hiked margins by 22% back on August 11 and Gold took off upwards again after dipping for only one day. In contrast, this time around Gold has fallen for three straight days already. And it's showing no signs of letting up. This didn't happen the last time margins were hiked.

No, it's not the margin hikes. Instead, there are three reasons for Gold's moves.

1) Gold was getting bubbly (definite)
2) John Paulson's abysmal track record for this year (definite)
3) The Fed leaked that no QE 3 is coming (possible)

Regarding #1, Gold was definitely getting bubbly. I know the Gold bugs will not want to hear this, but it's a fact. Anytime Gold stretches too far above its 350-day moving average, it has corrected sharply:

And even better indicator of just how overbought Gold had become is the 34-week Exponential Moving Average (EMA) which has been THE critical line for Gold throughout its bull market.

As the above chart shows, Gold has NEVER been this overstretched from its 34-week EMA. So we could potentially see a move down to even $1550-$1600 here.

A second reason for Gold's collapse is John Paulson, whose massive hedge fund has its largest position in Gold, specifically the Gold ETF (GLD). Paulson made huge bets on the US economy improving. He's now getting taking to the cleaners as his positions in bank stocks (BAC and C) get crushed. He also recently lost over$500 million on a Chinese company that proved to be a fraud.

As a result of this, Paulson is one of the worst performing hedge fund managers in the world right now. Consequently, he is being hit with redemptions from investors, which undoubtedly is resulting in him unloading some of his GLD position.

A final *possible* reason for Gold's decline is that the Fed has already leaked that there won't be a QE 3 announcement on Friday. The Fed certainly has a history of leaking information to its favorite firms (JP Morgan and Goldman Sachs). And as I noted in a recent update, it's VERY possible the Fed actively *bought* the market through Goldman Sachs after its FOMC meeting earlier this month.

So it's not beyond reason that the Fed has already leaked that QE 3 isn't coming on Friday. Remember, the Fed wants to keep stocks up. So it would want to mitigate damage control (Steve Liesman's piece).

Since Gold has rallied the most going into this week, it would be hit hardest if the markets realized QE 3 wasn't coming. Looking at the action today and earlier this week, I think this might easily prove to be true.

For these three reasons, I had us short Gold today with the **UltraShort Gold ETF (GLL):** to capitalize on what will likely be a short, but violent correction in the precious metal.

Understand, long-term I am EXTREMELY bullish on Gold. But the precious metal has moved too far too fast. So if you've not already bought GLL, feel free to do so now.

Action to Take: Buy the UltraShort Gold ETF (GLL).

If the Fed *doesn't* announce any new loose money measures, the US Dollar might finally catch the rally I've been forecasting for the last few months. Indeed, the US Dollar chart reveals a MASSIVE wedge formation that is literally on the verge of breaking:

The pattern is even clearer on the US Dollar's weekly chart:

This pattern, when it breaks, would forecast a SHARP US Dollar move to 81 if not 82 in short order. This would be accompanied by an *absolute massacre* for stocks and the precious metals.

The credit markets appear to be warning us that this indeed will prove to be the case. Based on credit spreads, Europe is in a full-fledged liquidity crisis and the US banking system is teetering on the brink of collapse as well.

Remember, the credit markets predicted the 2008 Crisis perfectly. And stocks are ALWAYS the last to "get it."

For that reason, we remain invested in our Crisis Trades: because the system is telling us that something very, VERY bad is occurring behind the scenes. The potential for a full-scale 2008 Crisis is higher than at any point in the last three years (even higher than the risk of September 2008).

I am watching the markets and will issue updates as needed. But for now we are well positioned for what is likely coming down the pike. For certain we'll know everything within the next 48 hours (I'll have an update after the Fed's Jackson Hole meeting ends).

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	$1,754.00	57%
Silver bullion	N/A	3/17/10	$17.50	$39.80	127%
IamGold	IAG	5/25/11	$20.95	$19.72	-6%
Centamin Mining	CEE.TO	5/25/11	$2.01	$1.72	-14%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$21.25	-2%
UltraShort Euro	EUO	7/28/11	$17.32	17.35	0%
UltraShort Gold (NEW)	**GLL**	**8/24/11**	**$16.58 (11:41AM)**	**$16.95**	**3%**

Crisis Portfolio (Bought on August 9th at 3PM					
Investment	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
UltraShort China	FXP	8/9/11	$36.58	$33.76	-8%
UltraShort Emerging Mkts	EEV	8/9/11	$40.30	$36.76	-9%
UltraShort Brazil	BZQ	8/9/11	$23.40	$19.95	-15%
UltraShort Russell 2000	TWM	8/9/11	$62.75	$53.59	-15%
UltraShort Real Estate	SRS	8/9/11	$19.50	$15.53	-20%
UltraShort Financials	SKF	8/9/11	$88.73	$77.29	-13%