Private Wealth Advisory

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The Fed's Hands Are Tied

Short-Term Trends

-Markets rallying into Obama's and Bernanke's speeches tomorrow

-Hype and hope for the September 21 FOMC meeting

-German court upholds Euro bailouts, Euro breaks trendline

Intermediate Trends

-No QE 3 coming: Fed's hands are tied.

-Return of deflation in late September/ early October

-Dollar rally/ Euro weakness

Long-Term Trends

-US debt default

-Bernanke legal problems/ crackdown on the Fed

-Civil unrest and Government shutdown in US

-End of the EU in current form

The financial markets are currently anticipating additional Fed activity, whether it be QE 3 or Operation Twist 2 (more on this in a moment) or some other move, at its FOMC meeting on September 21.

Let's address these issues one by one.

For starters, QE 3 is off the table unless we see a market collapse or a major bank go under. That's the truth, though the financial media refuses to accept it.

The reasons for this are both political and financial. From a political standpoint, the Fed particularly Ben Bernanke, has become politically toxic.

Indeed, Bernanke and his loose money policies are now virtually synonymous with current President Barrack Obama's spending and stimulus programs. Neither of these men or their policies are popular with the American people today. And it's clear that both will be campaign issues going forward into the 2012 Presidential election.

Indeed, we've already seen one round of spending conflicts between the GOP and the President. True, it was mainly smoke and mirrors. However, the fact that the topic of Government spending is now being debated at all indicates that the political environment has shifted from one in which the Government was seen as the savior of the economy (as it was from March 2009 to the end of 2010) to one in which Government spending and deficits are perceived as a problem/ campaign issue.

That is a massive shift in political perspective. Only two years ago the Federal Reserve and Obama were thought to have saved capitalism and the US economy. Today Obama's polls are at new lows and the Fed has been openly criticized by three of the Republican frontrunners for the 2012 Presidential election (Perry, Bachmann, and Paul).

This is hardly a climate in which the Fed can unveil QE 3 without some catastrophe striking first. On top of this, the Fed is also going to be facing increased political and likely even *legal* pressure from Wall Street in the near future.

First off, Goldman Sachs CEO Lloyd Blankfein has hired a criminal defense attorney… and not just any attorney, but Reid Weingarten. I'll let the following portion of a Bloomberg article speak for this man and his track record.

> Weingarten won the acquittal in May of Lauren Stevens, a former GlaxoSmithKline Plc (GSK) attorney accused of impeding a U.S. Food and Drug Administration investigation. He also represented Elizabeth Monrad, the former chief financial officer at General Reinsurance Corp. who was convicted in an accounting fraud scandal. She won a retrial earlier this month.
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> Weingarten previously represented former WorldCom CEO Bernard Ebbers, who was sentenced to 25 years in prison after he was convicted of an $11 billion fraud. He defended former Enron Chief Accounting Officer Richard Causey, who was sentenced to 5 1/2 years in prison.

If Blankfein is under investigation and hiring someone of Weingarten's caliber, a massive legal storm is about to begin on Wall Street. These lawsuits *will* involve the US Federal Reserve. And when push comes to shove, Blankfein (and other Wall Street executives who broke the law) will be blaming Bernanke and the Fed.

After all, the easiest defense is for Blankfein and his kind to simply say that they were pressured into defrauding investors and the public by Bernanke and the Fed when the financial system imploded in 2008.

Given that the Fed is run by spineless academics while Goldman Sachs and other Wall Street firms are run by those who make a career out of profiting at other's expense, who do you think will be going down when the legal dust settles?

Bernanke and the Fed.

The Fed already senses this and is moving to defend itself and shift the blame for the Financial Crisis to Wall Street. Consider that not long after Blankfein hired Weingarten, the Fed actually *sued* Goldman Sachs:

> The Federal Reserve announced an enforcement action against Goldman Sachs Group Inc., saying the company's mortgage-servicing unit had engaged in "a pattern of misconduct and negligence" in its handling of home-mortgage loans.

> The Fed's action on Thursday seeks changes in mortgage-servicing practices and unspecified monetary damages. It came as Goldman reached an agreement with New York state banking regulators over wrongful foreclosures, allowing it to complete the Sept. 1 sale of its Litton Loan Servicing unit to Ocwen Financial Corp.

The significance of this development cannot be overstated. Goldman Sachs used to be one of the Fed's favorite firms. Indeed, it could easily be argued that Goldman received the most preferential treatment from the Fed during the Financial Crisis.

Given just how close Goldman was to the Fed previously, the Fed/ Goldman relationship would only breakdown if an external threat meant that either group is going to be in MAJOR legal trouble (possible jail time). In light of Blankfein's recent moves as well as the Fed's lawsuit against Goldman, I fully believe that this is the case and that the relationship between the Fed and Wall Street will be deteriorating further in the coming months.

In a climate of increased legal pressure such as this, the bar for QE 3 is going to be much, much higher. It's one thing if the Fed and Goldman Sachs were simply making critical statements about one another in public. But lawsuits/ legal actions are a *totally* different matter. In plain terms things are now getting very serious behind the scenes. And Bernanke will not be able to simply do as he pleases without consequence.

For this reason, it will take another catastrophe for the Fed to implement QE 3. The days of the Fed implementing QE just for the sake of raising the stock market or affecting a "recovery" are over. It is clear now, even to those who have little financial understanding that Obama and Bernanke have essentially spent trillions of Dollars and accomplished next to nothing.

Worse still, we are discovering that much of this spending was in fact corrupt crony capitalist bailouts: Bloomberg recently revealed that Bernanke made over $1 trillion in "secret" loans to Wall Street during the Crisis.

For this story to be coming out now only adds to my view that the Fed, particularly Bernanke, will be increasingly in the hot seat going forward. Get the popcorn ready, things are going to be getting very interesting from a legal standpoint in the next 12 motnhs.

As a result of this, the Fed will be implementing large-scale moves ONLY in reaction to crises. Imagine the political impact it would have if the Fed were to unveil QE 3 in two weeks' time with Oil already at $90 a barrel and food prices skyrocketing.

Among other items launching QE 3 now would:

1) Destroy Obama's already faltering campaign (he backed Bernanke)
2) Generate massive public ill will towards the Fed and make it that much easier for Wall Street to roll over the lawsuits onto the Fed's shoulders.
3) Bring even more negative attention to Bernanke from GOP Presidential candidates (something Bernanke definitely doesn't want).

That's the political landscape for QE 3. Now let us consider the financial landscape.

While most commentators proclaim that QE is a completely new phenomenon, we have in fact seen a version of it in the form of the Fed's and Asia's (especially China's) purchases of US Treasuries/ currency pegs over the last decade or so.

Indeed, today, the Fed, China, and Japan collectively hold 61% of the $10 trillion of US debt held by "the public." When you add in the additional $4.6 trillion in US debt held by "intragovernmental holdings" (basically the Federal Government buying Treasuries by raiding Social Security and other pension funds) you find that Asia and the Feds have monetized $10.7 trillion of the US's total $14.6 debt (roughly 73%) over the last 20 years.

In this context, unveiling even more QE (the Fed buying US debt) is virtually pointless. Indeed, the Fed would have to unveil a QE plan of $2 TRILLION just to make its US debt ownership on par with the Federal Government's "intragovernmental holdings."

To put a $2 trillion QE program into perspective, that would be on par with the Fed unveiling a QE program equal to QE 1, 2 and some of QE lite combined in one single program.

Now, if QE 2 which was only $600 billion, blew the price of food and energy through the roof, how would a QE program of $2 trillion impact these items? Do you really think the Fed could unleash a QE program of that size without inciting full-scale unrest in the US, not to mention destroying the US Dollar.

And with the Fed already as unpopular as it is, Obama's polls falling to new lows on a weekly basis, and Bernanke well aware of the potential legal issues coming his way, **the odds of the Fed doing this in two weeks' time are next to none.**

Indeed, the Fed's balance sheet is already close to $3 trillion in size. How would commodities and the US Dollar respond to a Fed balance sheet of over $5 trillion? The Fed has already proved it has no means of draining the liquidity its put into the system in the last two years. What impact would an additional $2 trillion have?

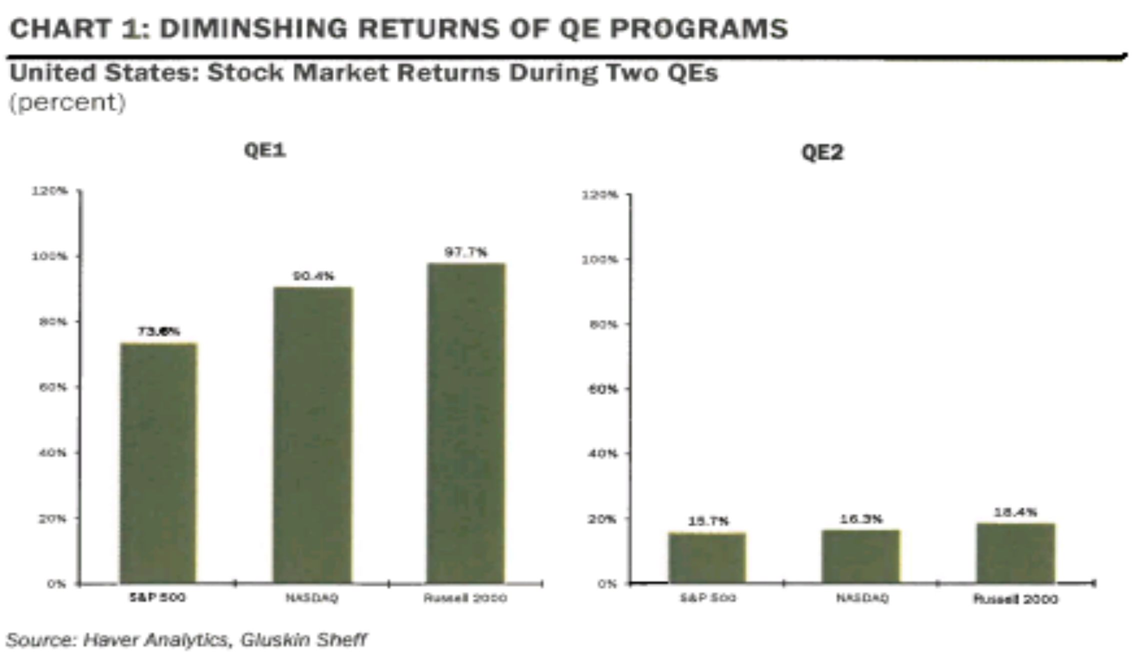
The short answer is that QE 3 of that size would kill the US Dollar, destroy the US economy, and result in Bernanke being forced to resign at the least and possibly the Fed being dissolved.

Do you think the Fed would do this? These guys are morons, but they're not so stupid as to take note of how the Greeks responded to financial ruin.

Another consideration is that each new Dollar of QE has created less "bang" for the marketplace. As I noted in our ***On the Verge of Another Crisis*** issue of ***Private Wealth Advisor*** **(**June 30 2011 **),** QE 2 *proved* that each new Fed stimulus program is less effective than the first. At that time I wrote:

> Consider that QE 1 provided $1.25 trillion in liquidity to the markets. From the date of its inception until its end, the S&P 500 roughly 540 points. Put another way, each $10 billion was worth 4.3 points on the S&P 500.
>
> In comparison, QE lite and QE 2 put roughly $900 billion into the market (roughly 75% of QE 1) creating a 251-point rally in the S&P 500. In this case, every $10 billion in additional capital was worth 2.7 points on the S&P 500.

David Rosenberg of Gluskin Sheff recently published the below chart showing the difference in market gains as a result of QE 1 and QE 2 (without QE lite):



So in financial terms, QE 3 is not likely to have a large impact on the market. The reason is that the entire US GDP miracle has been induced by some form of QE whether it be the Fed, China or Japan buying US debt or the US raiding pension funds to buy Treasuries over the last 20 years.

Combine these facts with the inflationary pressures created by QE 2 as well as the current political climate which is increasingly anti-Fed, and it's clear the Fed will not be able to unveil QE 3 without some kind of catastrophe hitting first. **Put another way, the Fed will be acting purely reactively, not proactively going forward.**

Another rumor spreading through the financial community is that the Fed will launch some variation of Operation Twist: a program the Fed first launched in 1961 to raise short-term rates and lower long-term rates.

This idea is being falsely presented. Operation Twist was NOT aimed at flattening the yield curve. That was the effect it had, but that was NOT what it was about.

Instead, Operation Twist was *aimed* at raising short-term interest rates. Do you think the Fed wants to do this now? Didn't they just announce that they'll be maintaining ZIRP through 2013?

Make no mistake, the Fed most certainly does NOT want to raise short-term rates. So to even talk about Operation Twist today is off-base.

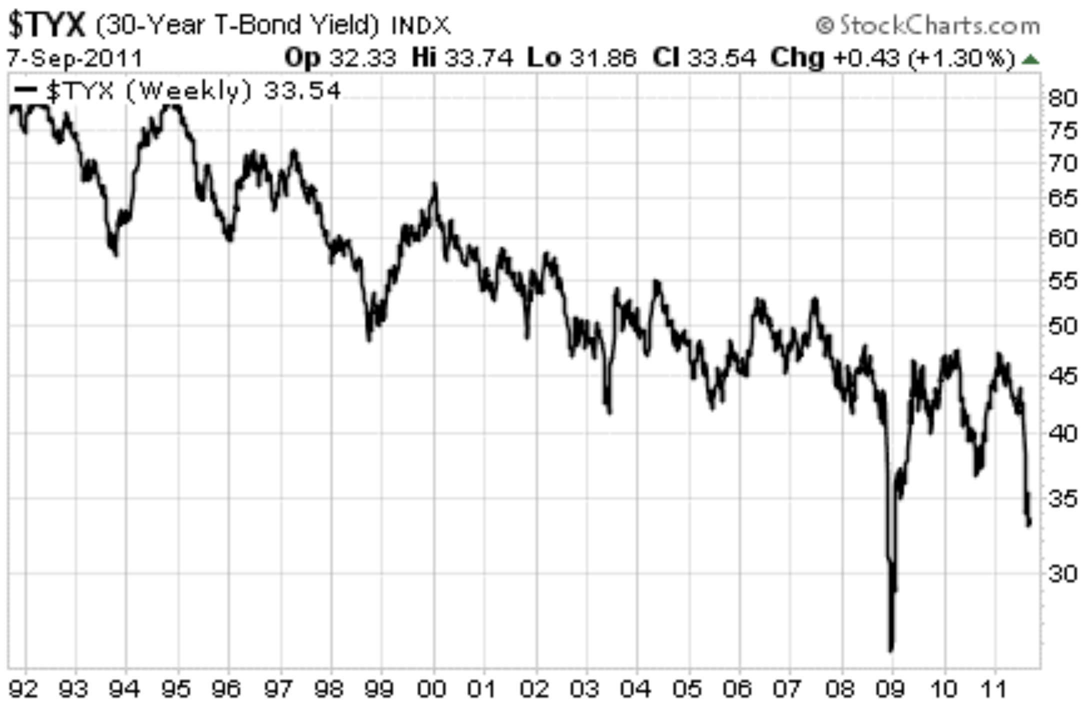
As for lowering long-term interest rates… the yields on the 10-year and 30-year Treasuries are at or close to all-time lows. How exactly could the Fed lower them more? Here's a weekly chart of the 10-year. How exactly would the Fed lower this rate more? What's the point?

The argument perpetuated in the financial media is that Operation Twist 2 (the nickname being tossed around) would lower yields on the 10 year to help mortgage refinancings.

Well, the 10-year interest rate is already at its lowest levels in 20 years, **and refinancing applications are DOWN 35% from last year's levels.**

Obviously low interest rates ARE NOT helping the refinancing market. So the idea that the Fed would lower 10-year rates even more(despite rates being at record lows) to help refinancing (when the refinancing market has already collapse) is absurd.

As for the Fed lowering the long end of the yield curve, here's a weekly chart of the yield on the 30-year Treasury:



As you can see, yields have only been lower one time in the last 20 years: during the depths of the 2008/ 2009 Collapse. And the Fed would lower rates from today's levels to… ??? And because???

Folks, Operation Twist is not coming. I know Bill Gross and a number of other prominent figures have suggested it. But they are wrong. The Fed *may* try to flatten the yield curve (though it would be pointless), or it may decide to extend the maturities of its holdings, **but both of those moves are very different from Operation Twist**.

So to conclude, I do not believe QE 3 or Operation Twist 2 will be unveiled in two week's time. Instead, I believe that the Fed will engage in more verbal intervention (trotting out various officials to promote more easing) without actually taking action. This policy is already in place as the below quote shows:

Mr. Evans, who stirred markets with similar comments earlier in the day on CNBC, said he felt the Fed needed to make an even stronger commitment to keep interest rates low. He worries the public has tended to be too quick to assume the Fed will raise interest rates whenever the economy perks up a little and says that view is undermining the recovery.

If the Fed can affect the very items it wants (stock prices rising and the yield curve flattening) just by talking… why would it bother inciting political outrage, potential legal trouble, and civil unrest by instituting any major new programs?

The answer is simple: it won't. The Fed is going to talk up the markets but do nothing of note in its September FOMC meeting. Those who claim otherwise are wrong and letting their portfolio positioning dictate their thoughts.

With that in mind, we need to consider that we could very easily see a return of deflation in the near future. Indeed, the S&P 500 has formed a clear bearish flag pattern. For those of you unfamiliar with these patterns, they consist of a sharp collapse followed by sideways/upward action on light column which is then followed by a *second* sharp drop to new lows.

Here's the bearish flag formation in the S&P 500 today:

We *may* see additional moves to the upside here, possibly to even 1,225… but after that we're going to new lows. **The downside target for this pattern is in the ballpark of 1,000 or so.**

An excellent place to make additional shorts is anywhere between 1,200 and 1,225. We've already added to our Crisis Trades in anticipation of the next leg down. For those of you wanting to add more or establish new shorts, the S&P 500 has bands of resistance between 1,200 and 1,210:

We also have long-term MAJOR resistance at 1,217-1,225:

This is why we recently added to our Crisis Trade positions to average in better prices. Indeed, I fully expect we could see stocks reverse sharply and plunge to new lows (even 1,000 on the S&P 500) within the next week or two. The markets are currently hanging on to hype and hope about the potential for more easing at the Fed's September 21 meeting. But as I wrote earlier in this issue, it VERY unlikely we will see more easing of any significance.

In terms of gauging when the next leg down will begin, the primary indicator will be the US Dollar. As noted in our last issue, the greenback has formed a massive bullish wedge pattern. By the look of things we've just broken it:

Once the US Dollar take 76 out, we'll be working our way up to the mid-80s. This will be accompanied by stocks entering a free-fall:

Keep an eye on this situation. Once we get the bullish breakout here, stocks are on their way down in a BIG way.

Elsewhere in the markets, Treasuries have been exploding higher on investors front-running the Fed based on expectations of more easing. We're due for a correction here, likely to 135 or so:

We’ll play for this with a small speculative position in the **UltraShort Long-Term Treasuries ETF (TBT)** **<u>tomorrow after Bernanke’s speech is finished</u>.**

TBT returns 2X the inverse of long-term Treasuries. So if long-term Treasuries fall 5%, TBT returns 10% and so on.

DON’T GO BUYING this investment just yet. We’re likely to see a final pop in long-term Treasuries going into Bernanke’s speech tomorrow (1:30PM). After that, I expect we’ll see a quick correction. That’s when it will be time to buy TBT.

I’ll send out an alert when it’s time to buy TBT tomorrow.

Elsewhere in the markets, the Euro rallied hard today on news that German courts have upheld the Euro bailouts. The European currency was oversold and due for a bounce has it hit up on support. However, the facts remain that the Euro has broken a critical bullish trendline and we will be making our way to new lows:

Ultimately we’ll be going to test the May 2010 lows of 118. Once we take out 140 we’re going there in short order.

We'll be adding to our UltraShort Euro positions when this bounce ends. I'm looking to have us do this anywhere between 141 and 142:

I'll send out an alert when it's time to add to our UltraShort Euro (EUO) position.

Another new position to watch is the Spanish Bank Santander (STD) which has formed a clear bearish flag formation:

I think we might see a rally to $8.50. Once that happens, we'll go short as the above pattern forecasts a move to $5.50 in short order.

Again, I'll send out an alert when it's time to go short here.

To recap, the markets are sending us clear signals that the Crisis which began in early August is about to enter a second leg down. However, over the next week or so, we could see stocks hold up in anticipation of some major new monetary program from the Fed. As I've shown in clear details earlier in this issue, the Fed will NOT be introducing any new major policies until the markets Crash or a major Bank goes under.

Put another way, the markets are going to be in for a very rude surprise at the Fed's September FOMC meeting. I fully expect stocks will be at new lows by early October.

We're positioned to profit from this with our Crisis Trades. If you want, feel free to add to these positions over the next week. If you've yet to take positions in these Trades, you can do so now if you like. But be aware that stocks will likely hold up for the remainder of this week and possibly into the next.

To review the investment ideas in this issue:

- Stocks have formed a bearish flag pattern that forecasts new lows (1,000 on the S&P 500).
- The Euro has broken a key trendline and will be falling to test its May 2010 low (118) once it's finished its current dead cat bounce.
- Treasuries are due for a sharp correction after Bernanke's speech tomorrow.
- The US Dollar looks to be on the verge of a MAJOR breakout to the upside over the coming weeks/ months.
- European banks will be falling to new lows over the next month.

I've arranged our portfolio to profit from all of these developments. **I'll be sending out alerts on the UltraShort Euro ETF (EUO), UltraShort Long-Term Treasury ETF (TBT), and shorting Santander (STD) when it's time to do so. So be on the lookout for alerts from me over the next week.**

This concludes this week's issue of ***Private Wealth Advisory***. Until next time,

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	$1,819.00	62%
Silver bullion	N/A	3/17/10	$17.50	$41.56	137%
IamGold	IAG	5/25/11	$20.95	$22.07	5%
Centamin Mining	CEE.TO	5/25/11	$2.01	$1.79	-11%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$21.43	-2%
UltraShort Euro	EUO	7/28/11	$17.32	$17.47	1%

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	$31.78	-8%
UltraShort Emerging Mkts	EEV	8/9/11	$40.30	$33.42	-10%
UltraShort Brazil	BZQ	8/9/11	$23.40	$17.78	-14%
UltraShort Russell 2000	TWM	8/9/11	$62.75	$49.92	-13%
UltraShort Real Estate	SRS	8/9/11	$19.50	$14.41	-17%
UltraShort Financials	SKF	8/9/11	$88.73	$73.31	-11%

RECENTLY SOLD POSITIONS

SOLD 9/2/11 at 11:57AM					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
UltraShort Gold	GLL	8/24/11	$16.58	$14.83	-10%