

PRIVATE WEALTH ADVISORY

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All That Rises, Isn't Inflation

We need to seriously re-assess the threat of inflation.

Anytime a particular point of view reaches mass hysteria, you HAVE to be willing to look at it from a different perspective. Today, inflationary fears are beginning to reach that point. The words "Weimar" and "Zimbabwe" are thrown around regularly. Hyperinflation is becoming a serious point of discussion even amongst people who rarely focus on financial markets.

Gold investment schemes (based on inflationary fears) are all over the radio and TV today. G. Gordon Liddy, a man who masterminded Nixon's break-in of the Watergate hotel, can be seen on television crumpling up dollar bills and telling investors to "buy gold."

When a crook of Liddy's caliber appears as a spokesperson warning you not to trust the government and to diversify away from the dollar... then you know things are beginning to get out of control. It would be one thing if only a small handful of professional investors were warning about this (as was the case with the housing collapse and financial crisis). But inflation concerns are now common amongst even non-investors.

Whenever everyone begins to think the same thing, you HAVE to question it, regardless of whether or not you personally believe it too. You never, and I repeat, NEVER make money by investing alongside the mob. So if the mob is screaming "inflation," you have to be willing to re-consider the facts. It's quite possible the mob is wrong (it usually is).

Please understand, I write this with the utmost humility. I myself have brayed about inflation in previous months. But this current inflation mania is beyond anything I could have predicted. For certain, all fiat currencies fail. And at some point inflation will take hold and the world's central banks will need to impose some kind of backing (most likely gold) to the world's reserve currency.

However, this may be several years down the road. It could potentially even be a decade down the road. No one really knows when it will happen. But one thing I DO know is that if I hear people talking about inflation in coffee shops (just as they were talking about Tech stocks in 1998 or housing prices in 2005) then it's quite possible they're wrong (at least in terms of the urgency of the matter).

So this week, we are going to re-examine the current economic data looking for REAL genuine signs that inflation is taking hold. I am going to attempt to leave all pre-conceived notions at the door and examine the facts from an objective standpoint. I hope you will do the same.

First off, I want to point out some striking similarities between this year's market action and the last. If you'll recall, 2008 was a year dominated by inflation fears (remember when oil hit \$150 and gold cleared \$1,000?). So it's worth considering how those fears played out in the financial markets especially when you see just how similar 2009 is to 2008 in terms of market moves.

Is This 2008 or 2009?

In 2008, commodities (as measured by the Rogers International Commodity index or RJI) bottomed in late January and then rallied 33% into the summer. Stocks followed suit a little over a month later, bottoming on March 10 and rallying 12% into May. They were lead by financials which had been the former biggest losers in the wake of the Bear Stearns collapse.

Thus the most salient items from the data in the first half of 2008 show us that:

- Commodities bottomed first and then outperformed stocks three fold.
- Stocks bottomed soon after and were lead by former losers (financials).
- Both stocks and commodities rallied into the summer (the former on views that the "worst is over," the latter on demand from China for the Olympics).
- Stocks peaked in May while Commodities peaked in July.
- Both stocks and commodities collapsed following their peaks.

So far in 2009, the exact same pattern has played out. Commodities (using RJI again) bottomed first on February 24. They then rallied 38% into the summer on demand from China (this time based on Stimulus Spending and diversifying away from the dollar).

Meanwhile, stocks (measured by the S&P 500) bottomed on March 6 (the same week as the bottom in 2008!!). Once again they were lead by financials. And once again they rallied into May before peaking. So far they're up 37% from trough to peak.

So once again, we see commodities bottoming first, stocks and commodities rallying into the summer, and strong upwards resistance meeting both asset classes beginning in May/June.

Indeed, the only notable difference between 2009 and 2008 from a financial markets' perspective is that so far in 2009, stocks and commodities have rallied roughly the same amount (37% vs. 38%) whereas in 2008 commodities were the big winners (33% vs. stocks' 12%).

These similarities are truly staggering. What's even more disturbing is the fact that investors piled into commodities in both years based on inflationary fears (remember when oil cleared \$150 in 2008 and was supposedly on its way to \$200?). So how did that play out?

Well, the 2008 commodity rally ended with a massive correction in which commodities across the board fell 50% in a matter of months. Investors who bought the “inflation trade” then got completely obliterated as the dollar rallied and commodities collapsed.

This is why I am nervous about the inflation mania today. Looking at the similarities between this year’s action and the action from 2008, I cannot help but wonder if commodities are going to experience a similar correction again. Right now everyone is worried about inflation... but are those worries truly valid or justified by data? Could we possibly be heading for another large correction in commodities?

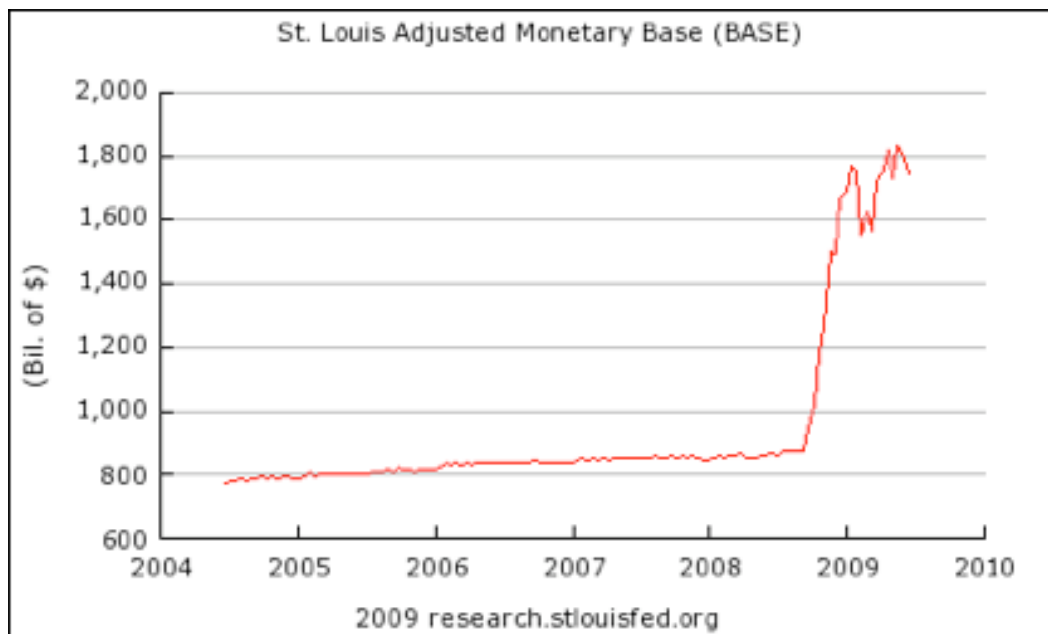
As I write, oil has already shown signs of a top, falling four days in a row from a recent high of \$72 to 67. Gold and other commodities have been showing signs of weakness as well (despite the fact inflation mania is rising).

Because of this, we are going to investigate the central arguments of the inflationists to see if they hold water. Investing is all about making money in the markets, not arguing opinions. If the facts dictate that inflation is not a genuine concern today, we are going to position our portfolio accordingly (one can only imagine the money to be made shorting oil for instance, if we get a replay of last year’s commodity correction).

And personally, I’d much rather make money than argue.

The Inflationists’ Manifesto

The primary belief driving the inflation trade is the idea that the Fed’s money printing will damage the dollar irrevocably. The below chart showing the US monetary base is often cited by inflationists (myself included) as evidence for this.



As you can see, the Fed has more than doubled the US monetary base in the last year, pumping some \$900 billion into the financial system. Inflationists are also quick to point out that the monetary base doesn't account for the \$13 trillion the Fed (and Treasury) have put into the system via various lending windows and off balance sheet arrangements. These lending/ printing efforts are seen as further evidence that the US is heading for massive inflation in the near future.

Aside from the current money printing, there are also looming deficit and liabilities issues to be dealt with. All told the US has \$11+ trillion in debt on its balance sheet. When you throw in future Medicare and Social Security expenses, our future liabilities explode to \$65 trillion. Inflationists believe that the Fed will have to inflate these debts away, because the public would not stand for a default or rolling back of these programs. This last point is quite arguable however, since the hyperinflation used to inflate these debts away wouldn't exactly thrill voters either.

These, as far as I've seen, are the central arguments for coming inflation. Drawing from these ideas, inflationists believe that the dollar will soon roll over pushing commodities (especially gold) through the roof.

The strange thing is that they haven't.

This is Inflation?

In July 2008, when the dollar index bottomed at 72, the Fed had committed less than \$500 billion in bailout funds/ intervention (mainly to Bear Stearns). Since then, the Fed has:

- Spent \$400 billion on Fannie/ Freddie (Sept '08).
- Taken over insurance company AIG (Sept '08) for \$85 billion.
- Doled out \$25 billion for the auto makers (Sept '08)
- Kicked off the \$700 billion Troubled Assets Relief Program (TARP) (Oct '08)
- Backstopped \$540 billion in money market funds (Oct '08)
- Backed up to \$280 billion of Citigroup's liabilities (Oct '08).
- Given \$40 billion more to AIG (Nov '08)
- Backed up \$140 billion of Bank of America's liabilities (Jan '09)
- Spent another \$787 billion in the Stimulus Plan (Jan '09)
- Announced plans to buy \$500 billion worth of mortgages (Jan '09)
- Announced plans to buy \$300 billion of Treasuries (Mar '09)
- Announced plans to buy another \$750 billion worth of mortgages (Mar '09)

This is a staggering, and I mean STAGGERING amount of money being thrown around. And yet, the dollar today is actually a full 11% HIGHER than it was in July 2008. **In fact, it's trading higher than it was BEFORE Bear Stearns went under!!!**

\$USD (US Dollar Index (EOD)) INDX

© StockCharts.com

23-Jun-2009

Op 80.87 Hi 80.94 Lo 79.70 Cl 79.84 Chg -0.94 (-1.16%) ▼

\$USD (Daily)



Meanwhile, commodities across the board (even gold) have failed to re-test their 2008 highs:

1 Year Copper Spot



1 Year Zinc Spot



OIL (iPath S&P GSCI Crude Oil Total Return ETN) NYSE © StockCharts.com
23-Jun-2009 **O** 24.13 **H** 24.85 **L** 23.82 **C** 24.65 **V** 2.0M **Chg** +0.79 (+3.31%) ▲



GLD (streetTRACKS Gold Trust Shares) NYSE

© StockCharts.com

23-Jun-2009 O 90.66 H 91.03 L 89.95 C 90.92 V 12.1M Chg +0.38 (+0.42%) ▲

GLD (Daily)



This is beyond bizarre. The world is currently operating under a fiat currency discipline: meaning no major currency is backed by anything of real value. Under this discipline, the Fed (and central banks around the world) are pumping TRILLIONS into the world's financial system... and yet commodities and other traditional inflation hedges have FAILED to best their July 2008 highs (a time when Central Banks had yet to commit substantial funds to battling the crisis).

They've also failed to best their July 2008 highs despite the fact that EVERYONE (even the coffee shop crowd) is worried about inflation.

To be blunt, either the market has lost any ability to discount the future what-so-ever, or the inflation story is not actually as simple as inflationists have claimed (money printing=inflation). I'm inclined to believe the latter, as indeed, nothing is ever quite what it seems or as simple as people make out.

Indeed, the dollar chart and commodity charts paint a very different picture from the common opinion that "the Fed is printing dollars ad infinitum and inflation is exploding higher." Clearly, the market is trying to tell us something different. What is it?

The Point of Debt Saturation

For starters, we need to address the most common misconception pertaining to the Fed: that of "money printing." The Federal Reserve doesn't actually "create" money. It issues debt and lends money out (like any bank), **but it doesn't just give money away.**

Where does this money go?

Onto US banks' balance sheets. And it only translates into inflation if the money flows into the US monetary supply (the actual money in circulation, as opposed to the money base which is a measure of money left in banks' vaults and reserves).

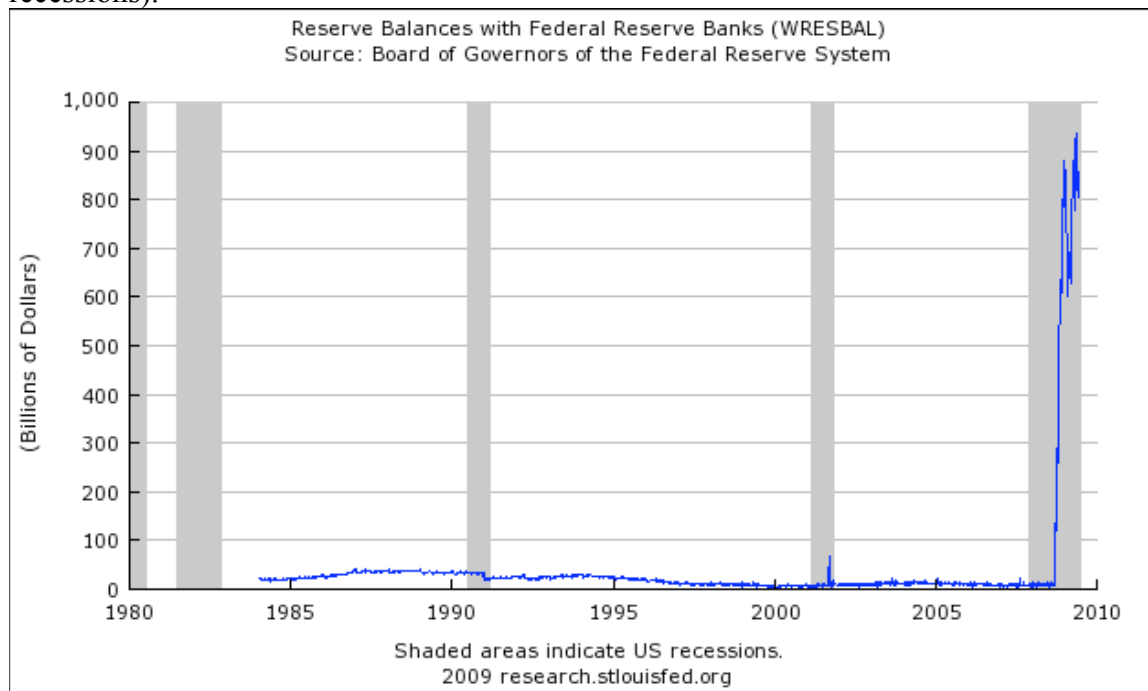
And it isn't.

US banks are not lending this money out. It is NOT entering the US money supply. Why? Because the banking system is essentially insolvent, or would be if it marked the assets on bank balance sheets anywhere near the price said assets would fetch on the market. Banks have too many debts or liabilities and need to raise capital. They are doing this in three ways:

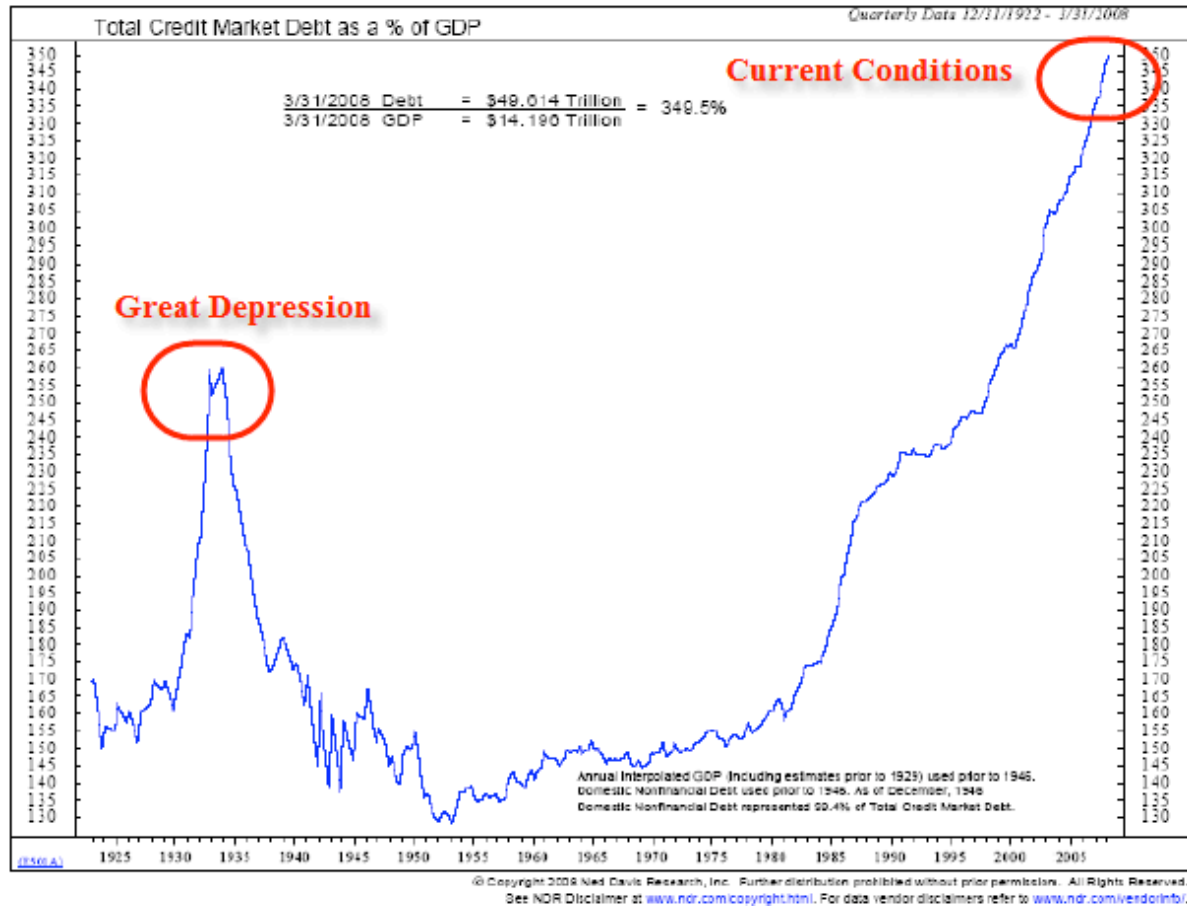
- issuing more shares
- dumping liabilities on the Federal Reserve's balance sheet
- hoarding the Fed's low interest loans.

This analysis is often left out of most inflationists' forecasts: the money the Fed is lending out **isn't getting into the economy.** Why? Because banks are hoarding it.

The below chart shows reserve balances with Federal Reserve banks. In simple terms, this shows how much money is sitting on banks' balance sheets in excess of what they're required to maintain. If you're wondering where the \$900 billion that the Fed has been printing is ending up, look no further (BTW, the gray bars on the chart indicate recessions).



This situation is not going to change any time soon. The easy money and loose credit standards maintained by Alan Greenspan for 20+ years allowed banks, consumers, and companies to take on a truly staggering amount of debt. All told, total private debt is currently 350% of GDP or \$49 trillion. To put this number into perspective, it's far, FAR greater than the percentage of credit debt relative to GDP that put the US into the Great Depression.



Already insolvent, banks have absolutely no incentive to increase their lending. They need to raise capital (hoard cash) and lower liabilities. So giving out money to consumers or businesses (especially during a recession when earnings are falling due to the slowdown in consumer spending and the rise in unemployment) is the LAST thing they want to do. This is most obvious in the fact that credit card mailings are at their lowest levels since 2000. Indeed, credit card mailings for the first three quarters of 2009 were HALF of those mailed in the last three months of 2008.

Anyway, it's not like consumers or businesses WANT to take on more debt. In fact, they're doing the same thing as the banks: trying to pay off debts and raise capital. For consumers this has translated into two trends:

- Increasing savings
- Paying off debt

According to the *Bureau of Economic Analysis*, personal saving as a percentage of disposable personal income was 5.7% in April, up from 4.5% percent in March. Remember, this stood at 0% only four years ago.

Consumers are also cutting back on spending instead choosing to pay off debts in record amounts. All told, Americans have paid off \$40 BILLION in credit card debt since February. Those who cannot pay off debts are simply choosing to default: credit card defaults at Citigroup, Wells Fargo, and American Express are all at 10%, meaning it's very likely that **\$1 out of every \$10 in credit card debt will NEVER be paid back.**

There's another reason banks aren't lending, that being that lending standards have risen dramatically. With unemployment rising, consumers still in debt up to their eyeballs (despite paying some of it off), and household net worth plunging (\$11 trillion lost in 2008 alone) the banks' number of potential loan applicants has shrunken dramatically.

Thus we see the gaping hole in tradition inflationist claims that money printing = dollar debasement and rampant inflation. The Fed is loaning out money as fast as it can... but banks aren't letting that cash get into circulation. And consumers don't want more debt anyway.

These are all facts, not opinions. And they go a long way towards explaining why the dollar is actually stronger now than it was before Bear Stearns AND why commodities are not soaring past their former highs.

Instead, what we are witnessing is a slow motion deleveraging and recapitalization of the world financial system. Banks are trying to put off marking their assets to market so they can continue to perpetuate the illusion that they are solvent while raising capital. Consumers are paying off personal debts or defaulting (something the banks cannot afford to do). Thus the trillions of dollars the Feds are pumping into the banks are not entering circulation, thus inflation has not taken hold.

These are the major trends going forward. With \$350 trillion in private sector debt, it's going to be years before the Fed's money printing efforts get into the system in a truly inflationary way. So while inflation is a real concern going forward, investors are waaaaaaay too early on the trade.

Thus, I think it's highly likely we shall see a serious correction in commodity prices AND stocks in the near future. We've already shorted stocks for a quick 12% gain with the UltraShort Russell 2000 ProShares (TWM). But I think we'll have an even better shorting opportunity in the next week:

\$SPX (S&P 500 Large Cap Index) INDX

24 Jun-2009 12:25pm

© StockCharts.com

Last 906.50 Chg +11.40 (+1.27%) ▲

\$SPX (Daily)



As you can see, stocks have not quite made up their mind which way to turn. The S&P 500 just staged a bullish crossover (when the 50-DMA crosses above the 200-DMA) which is typically an extremely bullish sign. But instead of rallying further, stocks have fallen 5% in the June. On top of this, the S&P 500 has failed several times to break above the crucial 950-level, which indicates stocks are extremely tired.

Had the collapse at the beginning of this week continued (with the S&P 500 failing to rebound) I would say it's time to go short now. However, right this minute stocks are on hold as they try to analyze the results from the Fed's FOMC meeting and the recent economic data for signs of what is to come (truth be told, nothing has changed, but traders are on the sidelines).

So for now we're on the sidelines. This rally might have one last jump to it... but soon we'll see a full blown collapse, especially if the S&P 500 closes below the critical 880 level. When that happens I'll send out an update announcing that it's time to go short and detailing which shorts to take (it will likely be an inverse ETF related to one of the indexes).

So don't go short just yet. The Fed has painted itself into a corner trying to support bonds, the dollar, AND stocks all at the same time. However, in the grand scheme of things, the dollar and bonds are key because the higher interest rates that would emerge should they tank would DESTROY any hope of economic recovery. So, of the three, stocks will most likely be sacrificed in the near future.

Especially emerging markets stocks...

The BRIC countries (Brazil, Russia, India, & China) have completely trounced the US indexes in the spring rally. The S&P 500 has rallied 37%. But Russia, Brazil and the like have all doubled since their March lows.

Of the lot, Russia is the most susceptible to a major collapse. Russia has the weakest economy from a structural standpoint, based largely on oil and nothing else. Indeed, Russian GDP is expected to contract 7% this year (that's up from the expected 4.5% contraction originally forecast March).

Russian industrial production is down 16% year over year in April. It fell 8% between March and April of this year alone. Unemployment is forecast to hit 13% and poverty levels are expected to clear 17% of the population. At the same time, Russia is receiving a massive margin call in the form of \$200 billion in debt payments that are due this year alone (at a time when consumer spending in that market has disappeared).

However, it wasn't until this week that Russian stocks really began to breakdown.



As you can see, the **Templeton Russia Fund (TRF)** has recently violated its 50-DMA with little trouble. It's the first of the BRIC countries to do so. Aside from worsening economic fundamentals TRF now has the added stress of needing to clear its 50-DMA to fully reassert its uptrend (no small feat given how worried traders are about the Russian economy AND oil prices).

This has the makings of a terrific trade: worsening fundamentals AND a weak chart. I think TRF will very likely rise to test its 50-DMA before rolling over to a new low and a possible test of the 200-DMA. We're going short today to profit when it does.

Action to take: Short the Templeton Russia Fund (TRF).

I've checked with most discount online brokers. They all told me that they can short TRF for you.

I expect we'll see a quick double digit gain here within a few weeks. Russia's economy is bad and only getting worse. It's gotten to the point that the Russian President publicly trashes the dollar in hopes of pushing oil higher and kicking off a recovery in Russian stocks. When a political figure begins committing verbal interventions to prop his financial market up, you know that market is primed for a fall.

Portfolio Update

Given my current bearishness regarding commodities, we're closing out our Rogers Agriculture Index (RJA). From a fundamental perspective, agriculture is one of the few sectors I'm quite bullish on in the long-term. However, in the near-term this sector (like all commodities except gold) is primed for a correction. RJA's chart has begun showing serious signs of weakness too.



As you can see, RJA has broken below both its 200-DMA and its 50-DMA. I had great hopes for this position given that it had recently staged a bullish crossover (when the 50-DMA crosses above the 200-DMA) which is an extremely bullish move. However, this latest correction has erased my bullishness entirely.

I believe RJA and the entire agriculture sector will soar much, much higher in the coming months. But in the near-term, I wouldn't be surprised to see RJA correct to \$7.00, an additional 5% drop. I make it a point to always minimize losses by exiting a position as soon as its chart turns against me in a serious way. RJA has done this. So we're closing it

now. And while I hate locking in a 4% loss, I'd much rather do that than see greater losses or worse, be stuck in a losing position for months waiting for a rebound.

Action to take: Sell the Rogers Agriculture Index (RJA).

As for gold, I'm holding on for now. Gold is unique amongst investments in that it performs well during both inflationary AND deflationary eras. I've actually written just published an article explaining this facet in depth on our FREE daily e-letter, *Gains, Pains, & Capital*. If you haven't already read it you can do so by going to: http://www.gainspaincapital.com/index.php?option=com_content&view=article&id=79:gold-doesnt-care-if-its-in-flaion-or-de-flaion

Indeed, out of all the commodities, gold has been the most resilient during the recent pullback. This is equally impressive when you consider that the precious metal is currently performing well during its weakest season of the year (March through August). Finally, should stocks collapse (a distinct possibility), gold will perform extremely well from safe-haven buying.

So I'm holding on for now.

As for the dollar, I'm actually quite bullish right now (as I hope my explanation of the current financial crisis indicates). From a technical standpoint, the currency has recently staged a series of higher lows. It even rallied today despite the a lackluster Fed statement.



Understand, I am in no way shape or form bullish on the dollar in the long-term. But this recent sell-off is overdone (as is the rally in commodities and stocks). And the Fed HAS to prop the dollar up if it doesn't want the increasingly disillusioned Chinese to start selling.

Thus, I expect the next few weeks will be dominated by a sell off in stocks and commodities and a rally in the dollar. We're positioned beautifully to profit from this last item with the Dollar Bull 2.5X Fund (DXDBX) which returns 2.5X the return of the dollar index.

We're also positioned to profit from the coming collapse in stocks thanks to our UltraShort Financials ProShares (SKF). Financials lead the rally on the way up, they will lead on the way down too. SKF returns 2X the inverse of Financials. So if Financials fall 5%, SKF returns 10%. Financials fall 10%, SKF returns 20%. We're already up % here, with plenty more gains to come.

I'll be watching our portfolio closely over the next week. If anything comes up, I'll send out an update immediately. However, if nothing changes you'll hear from me next Wednesday in our next issue of *Private Wealth Advisory*. 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	\$91.47	2%	
Rogers Agri ETN	RJA	5/6/09	\$7.62	\$7.33 SELL	-4% SELL	
UltraShort Financials	SKF	6/3/09	\$42.18	\$44.19	5%	
Dollar Bull 2.5X Fund	DXDBX	6/17/09	\$31.76	\$30.76	-2%	
Templeton Russia Fund (SHORT)	TRF	6/24/09	\$16.52	NEW	SELL SHORT	
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%
UltraShort Russell 2000	TWM	6/10/09	\$40.55	At Close 6/22/09	\$43.45	12%
Portfolio Average					12%	
S&P 500					-3%	