Private Wealth Advisory

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A System Without Trust

I want to start this issue by addressing the importance of trust.

As I've stated countless times throughout the last three years, the reason that the Great Crisis is not over is that we never addressed the fundamental issues that lead to it.

While the vast majority of analysis pertaining to the Crisis focus on the financial instruments involved, the reality is that this Crisis is ultimately all about trust being broken in the financial system.

Specifically:

1) The trust that banks and financial firms need in order to lend to one another.
2) The trust investors have in credit rating agencies accurately assessing risk.
3) The trust investors have in regulators monitoring the financial markets.
4) The trust investors have in banks and the banking system as a whole.

And so on.

Short-Term Trends
-Fed disappoints in November FOMC.
-Stocks likely putting in a top/ preparing for next move down.
-Greek referendum/ vote on bailout.

Intermediate Trends
-Greece to leave Euro.
-Other PIIGS to default/ potentially leave Euro.
-Germany to threaten to leave Euro.
-Dollar rallies, stocks and commodities correct.

Long-Term Trends
-Global debt implosion.
-Corporate, banking, and federal default.
-US household de-leveraging.

Without trust, the financial system cannot work. The regulators and Federal Reserve have done nothing to assuage these concerns. Instead they've shifted all trust onto their own shoulders: the defining bull argument for the market and economy is that "the Fed will save us", or "don't fight the Fed."

As powerful as it may be, the Fed is not the market. And since the Fed failed to restore trust in the system by forcing all bad debts to light, the financial world has grown increasingly volatile and broken as investors grow increasingly distrustful of the system and begin to pull their money from it: investors have pulled $266 billion from stock based mutual funds since January 2008.

Nowhere is the lack of trust more apparent than in the financial sector. Indeed, it was a lack of trust between banks (inter-bank lending) that caused the credit markets to jam up in 2008, which resulted in the Crash.

That lack of trust continues to this day. In the post-Lehman collapse, instead of forcing real derivative and credit risk out into the open, the Federal Reserve and regulators instead suspended accounting standards and allowed financial firms (and other corporate entities) to continue to lie about the true state of their balance sheets.

As a result of this, the financial sector remains rife with fraud and impossible to accurately value (how can you value a business that is lying about its balance sheet?).

Those times in which a company *was* forced to value its assets at market prices have always seen said values losing 80%+ value in short order: consider Washington Mutual, which sported a book value north of $70 billion right up until it was sold for… $2 billion.

This type of fraud is endemic in the system. Indeed, we got a taste of just how problematic a lack of transparency can be with MF Global's bankruptcy, in which a firm with $42 billion in assets lost over 80% of its value since August only to reveal in bankruptcy that it had *stolen* over $700 million worth of clients' money.

Report: MF Global Exec Admits to Using Client Money

MF Global, the futures brokerage that imploded this week after facing a run on the bank, **reportedly admitted to regulators it used client money in an apparent violation of government rules and Wall Street practices**.

According to The Associated Press, an unnamed executive from the New York-based firm that is led by former Goldman Sachs chief Jon Corzine **made the admission Monday morning after regulators discovered some $700 million went missing.**

http://www.foxbusiness.com/industries/2011/11/01/report-regulators-probe-missing-cash-at-mf-global/#ixzz1cU1reIJt

That MF Global engaged in fraud and stole clients' money is noteworthy. However, the far more important issue is: HOW did this company receive primary dealer status from the NY Fed this year?

The Primary Dealers are the banks that actively engage in day to day activities with the New York Fed regarding the Fed's monetary policies. Primary Dealers also participate in US Treasury auctions.

Put another way, Primary Dealers are the most elite, well-connected financial firms in the world. They have unequal access to both the Fed and the US Treasury Dept. In order for MF Global to have attained this status it must have passed through a review by:

1) The New York Fed
2) The SEC

This is not a quick nor superficial process. According to the NY Fed's own site:

> **Upon submission of a formal application, a prospective primary dealer can expect at least six months of formal consideration by the New York Fed**. That consideration may include, **among other things, on-site reviews of front, middle, and back office operations, review of compliance programs and discussions with compliance and credit risk management staff**, discussions with senior management about business plans, financial condition, and the ability to meet FRBNY's business needs, review of financial information, and consultation with primary supervisors and regulators.

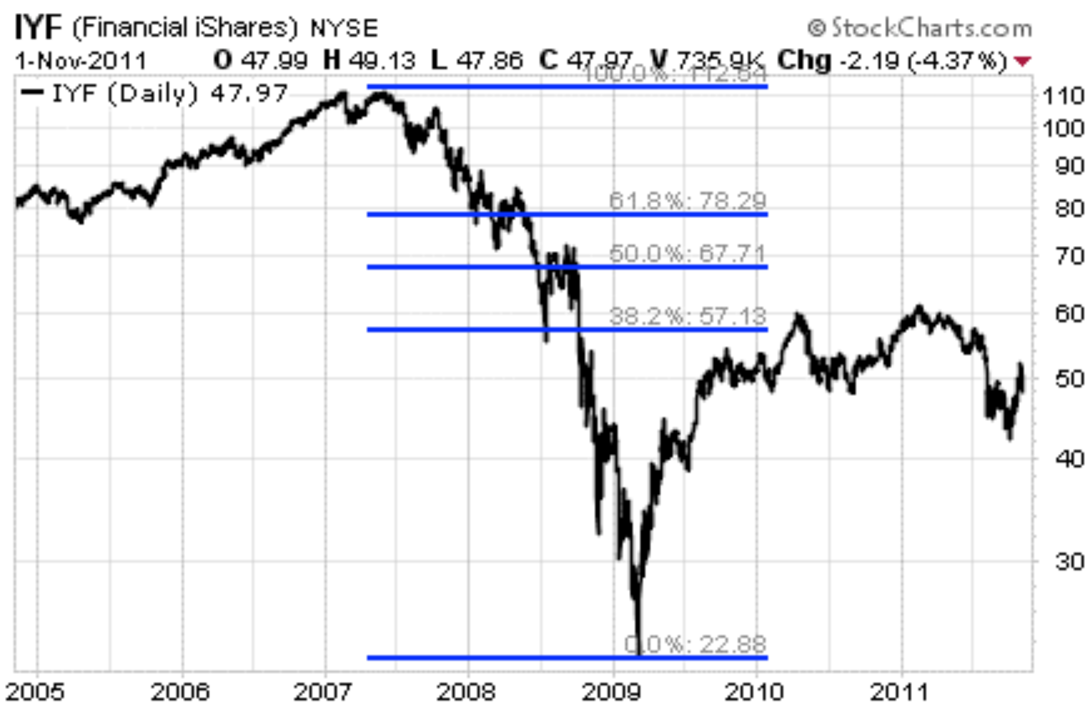
MF Global passed through all of these reviews to became a primary dealer in February 2011. **Today, a mere nine months later, the firm is in Chapter 11 and has admitted to stealing clients' funds to maintain liquidity.**

These developments reveal, beyond any doubt, that financial oversight in the US is virtually non-existent. This returns to my primary point: that trust has been lost in the system. And until it is restored, the system will remain broken.

A final note on this: the NY Fed is the single most powerful entity in charge of the Fed's daily operations. How can *any* investor believe that the Fed can manage the system and restore trust when the NY Fed granted MF Global primary dealer status a mere nine months before the latter went bankrupt?

If the NY Fed cannot accurately audit a financial firm's risks during a *six month review*, then there is NO WAY an ordinary investor can do so.

Collectively, the market knows this. No one will admit it in public, but you can see the total lack of trust in the financial industry via its share price which has barely retracted 38.2% of its collapse from the 2007 highs:



Typically, after a collapse like the one we saw in 2007-2008, you'd see a bounce that retraced 38% of the fall at a *minimum*. Indeed, a 50-61.8% retracement would be more sensible. This is just a basic trading expectation based on historic price movements and ratios.

Instead, the financial industry, which has receive the vast majority of bailout funds and interventions, has failed to maintain even a 38% retracement of its collapse. Put another way, despite record interventions and back room deals, the financial industry has failed to win investors' confidence or trust.

This one image alone makes it clear that the market as a whole does not trust the financial industry. Just compare the above chart to that of the materials sector and you'll see what I mean:

In this case, Materials have retraced ALL of their losses from the 2007-2008 collapse. In simple terms, investors trust companies that produce concrete more than they do banks.

I mention all of this, because going forward trust is going to be absolutely critical in any and all investment theses. As the Great Debt implosion picks up steam, capital preservation will be key. The coming years will see fortunes made from those who are well positioned to profit from developments, much as the housing bust created some of the largest investment gains in history.

However, for the most part, capital preservation will be most key for investors. As debt deflation tears through the financial system, cash (whether it be a strong currency or real assets) will be king.

Those who emerge from this period with most of their wealth intact will find themselves much much wealthier by virtue of the fact that everyone else will be between 30-80% poorer, depending on their exposure to various underperforming/ defaulting assets.

With that in mind, I wanted to address the notion of trust relative to various investment assets.

For much of the 20th century, sovereign bonds, particularly US Treasuries were considered the least risky assets to own. The idea was that while corporations and other entities might default or go bust, the US , which is the largest economy in the world, will always be able to meet its debt obligations by virtue of its economic strength or, at a minimum, printing money to pay back its creditors.

However, when the Great Crisis first erupted with Round One in 2008, the Governments and Central Banks of the world chose two policies to combat debt deflation.

The first was to move private sector debts, particularly toxic mortgage backed assets and derivatives, onto the public or sovereign balance sheets. This was most common in developed countries such as the US, UK, etc.

The second policy that Central Banks and Sovereign Governments chose to enact was printing money/ providing capital injections into their respective economies in an attempt to promote economic growth.

Both of these policies put sovereign balance sheets at risk/ damaged their trustworthiness. The first policy didn't actually involve dealing with the debts via default or restructuring. Rather, the toxic debts and derivatives were merely moved from the private sector onto the public's balance sheet. At the same time, the second policy (monetary intervention) ballooned both public debt and fiscal deficits.

As a result of this, the "risk profile" for all asset classes has changed dramatically.

Let me give you an example.

Who do you trust more from an investment perspective: Exxon Mobil or the US?

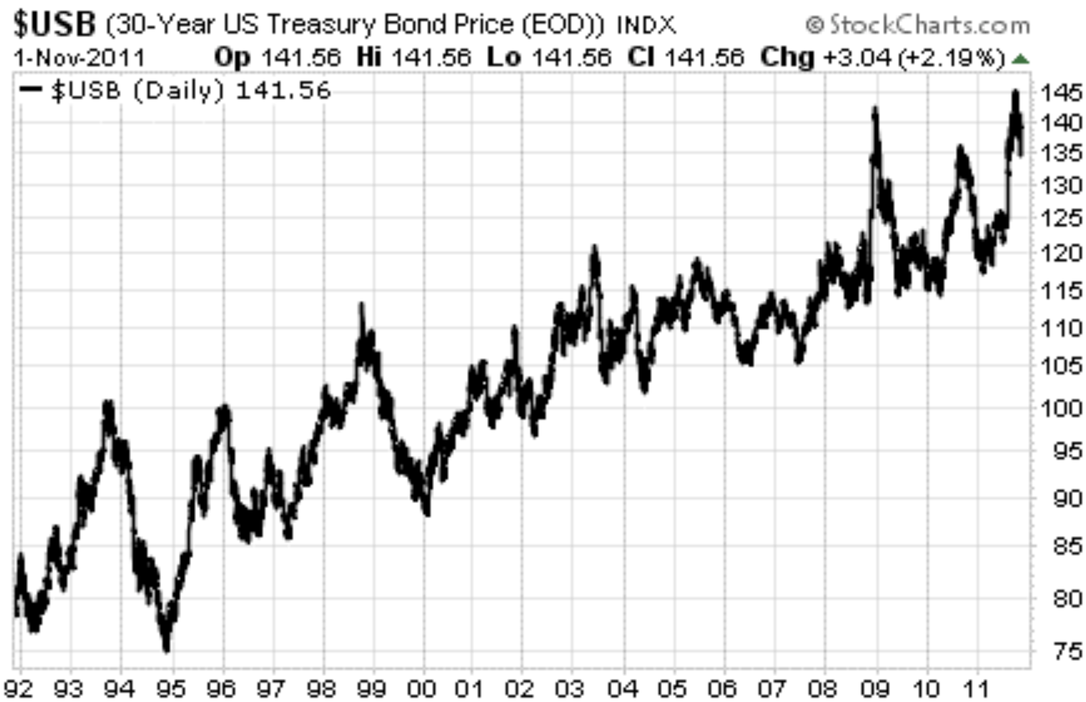
Historically, the common thought would have been the US. The US offered a better yield and was the largest, strongest economy in the world. Also, Treasuries are backed by the full faith and credit of the US Government, which has a printing press to insure you get your money back in one for or another.

Today, the issue is far more murky. Take a look at the following numbers:

	Exxon Mobil	**The US of A**
Debt to Market Cap/ GDP	37%	100%
Earnings/ Receipts to Market Cap/ GDP	8%	15%
Cash on Hand	$7.8 billion	$73 billion
Credit Rating	AAA	AA+
Two year annual yield	4.8%	0.31%

From a balance sheet perspective, Exxon is more attractive with less debt and a higher yield. It also has a higher credit rating and a history of *increasing* its payout to investors (the company has raised its dividend every year for 26 years).

In contrast, lending money to the US means receiving next to nothing in yield (0.31%). It also means you're even more likely to see your investment lose money as Treasuries are in a bubble that will end as all bubbles do:



Other issues to consider are that the US is currently running a deficit of $1.5 trillion, sports a Debt to GDP ratio of 100% (300+% when we consider unfunded liabilities). And shows no indication of reining in these policies.

Thus, even by a quick back of the envelope analysis, we find ourselves in an environment in which a single corporation such as Exxon is actually more trustworthy (from an investment perspective) than the US Government.

This represents a complete reversal from the mentality that dominated investing for most of the last 80+ years. During that time, stocks were widely held to be riskier assets while Government bonds were considered safe: investment advisors would urge younger investors to invest heavily in stocks for "growth" while older investors who were closer to retirement were urged to invest in bonds, particularly Government bonds for "income".

This is why the Greek default is so important for the financial world: if a sovereign nation's bonds can lose 50% in value in a single day, the entire "risk spectrum" among asset classes has changed dramatically.

Indeed, I believe that in the coming weeks we will see other PIIGS countries line up for defaults. We are already seeing hints of this:

> **Portugal, Spain urge G20 members to help ease crisis**
>
> Spain and Portugal said on Saturday the euro zone's debt crisis is a global problem, calling on the United States and other G20 powers to help contain the fallout.
>
> Spanish Prime Minister Jose Luis Rodriguez Zapatero urged the G20 countries least affected by the crisis to provide "urgent stimulus plans" to shield the global economy.
>
> Europe's debt crisis looks set to dominate the summit of Group of 20 leading economies in France from Nov. 3-4.
>
> http://www.reuters.com/article/2011/10/29/eurozone-g20-portugal-idUSN1E79S03020111029
>
> **Merkel: Must prevent others from seeking hair cuts**
>
> Chancellor Angela Merkel said on Friday it was important to prevent others from seeking debt reductions after European Union leaders struck a deal with private banks to accept a nominal 50 percent cut on their Greek government debt holdings.
>
> http://www.reuters.com/article/2011/10/28/us-eurozone-germany-merkel-idUSTRE79R3NL20111028

Now that a precedent has been set for debt defaults, other nations will soon follow Greece into debt restructuring. This is where things will begin to get *really* interesting for the EU.

While Greece is already presenting serious problems for the European Union, it is Italy that will prove to ultimately break the Euro's back.

Italy's GDP is $2.05 trillion, making it the third largest economy in the EU and the EU's biggest financial headache. It has the second worst Debt to GDP ratio in Europe (behind Greece) and the third largest bond market in the world (behind Japan and the US).

In plain terms, Italy is a HUGE problem for the financial system. And it's only going to be getting worse. Indeed, Italy's reality is already far worse than most realize today.

When you throw in unfunded liabilities, Italy's REAL Debt to GDP ratio is north of 360%. In order for Italy to meet ALL future liabilities, it would need to have an amount equal to nearly 10% of its GDP sitting in a bank collecting interest *FOREVER.*

Suffice to say, Italy doesn't have that cash. And based on its debt maturation cycle I expect we'll see an Italian default within the next six months. Indeed, no matter what happens with Greece, Italy will make sure that the EU in its current form no longer exists within the next year.

In the next 14 months alone, Italy needs to roll over an amount of debt equal to over 30% of its GDP ($615 billion). When you add in NEW debt issuance to meet Italy's deficit, the number balloons up to 40% of GDP or $820 billion.

The problem with this is that investors are quickly waking up to the fact that Italy is BROKE. With a GDP growth rate of 1.3% and an aging population, Italy's economy is in shambles.

In this environment, appetite for Italian bonds is collapsing, resulting in higher interest rates on Italian bonds, making Italy's debt payments even larger (each new percentage point in interest rates means $4.1 billion more in funding costs for Italy in 2012).

> **Italy at heart of crisis as borrowing costs climb**
>
> Italy's borrowing costs jumped to record levels Friday, underlining its vulnerability at the heart of the euro zone debt crisis and skepticism about whether the struggling government of Prime Minister Silvio Berlusconi can deliver vital reforms.
>
> **The 6.06 percent yield paid at an auction of 10-year bonds was the highest since the launch of the euro**, and not far from the level reached before the European Central Bank intervened in August to cap Rome's borrowing costs by buying Italian debt.
>
> www.reuters.com/article/2011/10/28/us-italy-berlusconiidUSTRE79R0ZV20111028

Indeed, by many accounts, the only reason Italy hasn't already staged a *failed* bond auction is because the ECB has been aggressively intervening and buying Italian bonds.

In plain terms, if it were up to the market alone, Italy *would have already defaulted*. And yet… Italy is somehow going to find investors to buy up $800+ billion worth of its debt?

So Italy will be defaulting. And it will be defaulting sooner rather than later. The question all investors must ask themselves is: what happens *when* Italy defaults?

Global exposure to Italian debt is north of $860 billion. This is over THREE TIMES the exposure banks have to Greece… and we've already seen the impact *that* situation has had on the markets.

Regarding exposure to Italian bonds, European banks comprise 90% or $782 billion. As Bank of America Merrill Lynch notes, foreign bank claims on Italy are higher than for any of the other PIIGS countries.

The significance of this cannot be overstated. Indeed, it was $3.2 billion in Italian bond exposure that took down MF Global:

Source:Zerohedge

Italian bond exposure has also hammered both BNP Paribas:

... and Barclays:

This is the REAL systemic risk today. And it's the number one reason why we've opened our Crisis Trades again. The Italian ten-year note just cleared 6.2% earlier this week. Once it clears 8% it's GAME OVER for Italy.

I'm watching this situation closely and will issue updates as needed. For now, I will say that the Financial System is in danger of systemic risk, NOT from Greece, but from Italy. And this situation could come unraveled any day now.

Thank you for reading.

Best Regards,

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	$1,733.00	55%
Silver bullion	N/A	3/17/10	$17.50	$33.89	94%
Centamin Mining	CEE.TO	5/25/11	$2.01	$1.76	-12%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$21.75	0%
UltraShort Euro	EUO	9/21/11	$19.13	$18.18	-5%
Bank of America (short)*	BAC	11/2/11	$6.48	$6.72	-4%
Citigroup (short)*	C	11/2/11	$29.19	$29.83	-2%
Goldman Sachs (short)*	GS	11/2/11	$106.64	$106.13	0%
JP Morgan (short)	JPM	11/2/11	$32.65	$33.64	-3%
Deutsche Bank (short)*	DB	11/2/11	$37.45	$39.10	-4%
Santander (short)*	STD	11/2/11	$7.91	$8.07	-2%
HSBC (short)*	HBC	11/2/11	$42.03	$43.32	-3%
UltraShort China*	FXP	11/2/11	$32.64	$28.35	-13%
UltraShort Emerging Markets*	EEV	11/2/11	$34.78	$32.08	-8%
UltraShort Brazil*	BZQ	11/2/11	$19.04	$17.59	-8%
UltraShort Materials*	SMN	11/2/11	$20.23	$18.55	-8%
UltraShort Real Estate*	SRS	11/2/11	$40.09	$39.53	-1%
UltraShort Financials*	SKF	11/2/11	$65.13	$62.85	-4%

* opened November 1 2011 at 9:41AM