Private Wealth Advisory

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Something Worse Than 2008

Thank you to everyone for their concerns and well wishes.

The last month has been a very difficult one for me, health wise. I contracted a major internal infection about a week before the holidays. I don't know where I got it from, but I can say that I've never been that sick in my life.

As a result of this, I spent my entire holiday season either in bed or at various Emergency Rooms (four visits in two weeks). And it wasn't until last Thursday that I actually began to feel better.

The good news is that I am now well on my way to recovery and can get back to what I love to do: writing about and analyzing the markets.

Thank you for your patience and understanding during this difficult period. I would like to offer you an additional month to your subscription to make up for this down time.

On to the markets…

Short-Term Trends

-Deflation is the primary risk to portfolios.
-The EU in its current form will soon be broken up.
-The Fed cannot act until we see systemic risk or a major bank collapse.

Intermediate Trends

-More PIIGS defaults.
-Systemic deleveraging.
-Extreme volatility.

Long-Term Trends

-Global debt implosion.
-New alignment of politico-economic powers.
-Trade wars and very likely REAL warfare

The primary trends we've been tracking for the past few months remain intact. Most importantly, the deflationary forces of the European Debt Crisis continue to threaten systemic collapse.

The Euro Crisis is now in its second year (Greece first made headlines in early 2010), and there are no signs of things working out. Indeed, it's extremely telling that EU leaders haven't even solved a minor problem such as Greece, let alone the larger issues of Spain and Italy.

That's correct, despite one bailout, a good deal of debt write-downs, and the implementation of numerous austerity measures, Greece remains in Crisis Mode: there are only 37 billion Euros worth of funds left from its first bailout, and its second bailout is far from guaranteed as the below articles indicate.

France, Germany warn Greece to make debt deal

France and Germany, the European Union's key powers, insisted Monday that private creditors must take losses to help over-indebted Greece right its finances, but they also warned the Greek government that E.U. rescue funds will be held back unless it makes a deal soon with the increasingly nervous banks holding its debt.

The stern warning, after a meeting between French President Nicolas Sarkozy and German Chancellor Angela Merkel in Berlin, underlined the high stakes in faltering talks between the Greek leader, Prime Minister Lucas Papademos, and a coterie of banks and other financial institutions holding billions of dollars in Greek debt that the government acknowledges it cannot pay in whole.

Failure to reach a debt swap deal for Greece would most likely undo the rescue package concocted by E.U. governments late last year and dramatically undermine international confidence in the euro, the currency used by 17 of the 27 E.U. nations. If Greece or others among the 17 euro nations start to peel away, analysts have warned, the world economy could suffer a relapse and the entire E.U. project could be brought into doubt.

http://www.washingtonpost.com/world/france-germany-warn-greece-to-make-debt-deal/2012/01/09/gIQAl7UxlP_story.html

Merkel warns Greece on second bailout

German Chancellor Angela Merkel has warned Greece it will not be able to receive further aid unless it makes rapid progress on its second rescue package, including reaching agreement with private bondholders over a voluntary write-down on Greek debt, Reuters has reported.

Speaking at a joint news conference in Berlin with French President Nicolas Sarkozy, Merkel told reporters,"The second Greek aid package including this restructuring, must be in place quickly. Otherwise it won't be possible to pay out the next tranche for Greece."

The scheme aims to cut Greece's debt-to-GDP ratio from around 160 percent to 120 percent. However, last week European Central Bank (ECB) policymaker Athanasios Orphanides said the private sector deal should be scrapped, while on Saturday an adviser to Germany's finance minister said a 50 percent "haircut" was insufficient to tackle Greece's huge debt, Reuters reported.

http://www.globalpost.com/dispatch/news/business-tech/debt-crisis/120109/merkel-warns-greece-second-bailout

What's most striking here is that throughout 2011 there were countless headlines proclaiming that the Greece issue was resolved. I cannot count how many times the stock market rallied on these announcements. And yet, here we are in 2012 and Greece remains on the verge of collapse.

Indeed, when we dig into the political structures that surround the Greek debt crisis, the entire idea of a bailout becomes absurd.

Firstly, the question arises: just *who can* bailout Greece?

The first Greek bailout was funded by the IMF and EU member states as a kind of "one off" event. Having seen that effort fail, neither of these groups can pull off a second bailout without facing major repercussions.

First of all, the IMF is essentially a US-backed entity. With "bailout" fast becoming a four-letter word for the US populace, the likelihood of the public standing for more US-backed bailouts, especially of another country, is slim.

As for EU member states, at this point even the more stable ones (France and Germany) have got their own domestic issues to deal with (France is on the verge of losing its AAA rating while German courts and voters are moving to limit Germany's involvement in funding more bailouts). These factors greatly limit France and Germany's abilities to finance a second bailout.

Indeed, the whole psychology of a second Greek bailout is ridiculous: the first one failed to accomplish anything and even the proposed second one would only lower Greece's Debt to GDP ratio to the still bankrupt level of 120%!!!

Small wonder then that EU political leaders talk a lot about finding a solution, but have yet to actually pony up any actual funds. EU leaders know they can't stage a REAL monetary intervention, so they're trying to intervene verbally.

This is most clear in Germany, which has explicitly stated that it will contribute more funds to Greece if the latter country meets certain budgetary requirements… requirements that Greece couldn't possibly meet even under the best of circumstances.

And therein lies the primary problem with the EU experiment: **you cannot marry countries monetarily without compromising issues of political sovereignty.**

In plain terms, Germany is not willing to offer additional aid if Greece is not willing to submit to German fiscal demands (German voters and courts simply will not tolerate any alternative to this).

However, the mere notion of submitting to German demands is unpalatable to Greece and most EU members. Remember, virtually every political policy implemented in Europe in the post-WWII era was aimed at limiting Germany's power and influence.

It's not as though Greek politicians could submit to Germany's demands even if they wanted to: any move by Greek leaders to renege on promised entitlement payments to the Greek population will result in widespread riots and civil unrest. Several Greek politicians have already been attacked for promoting such policies.

Finally, we have to consider that even if a second Greek bailout *were* to be implemented, it would *still* feature Greece staging an even larger default, which would cause the bond market to implode as investors dumped all PIIGS debt en masse.

This is literally a doomed if you do and doomed if you don't scenario. And truthfully there is no way it can be resolved without some kind of Crisis. And remember, we're only talking about *Greece* here: these same issues pertain to both Spain and Italy only on a much larger scale (Italy is the third largest bond market in the world).

On some level, EU leaders are aware that the game us up, which is why they continue to play for time by scheduling conference after conference without actually committing to any concrete policies. However, every day that a solution isn't reached brings the EU that much closer to systemic collapse.

Case in point, France is on the verge of losing its AAA status.

> **French Debt Costs Rise at Bond Sale as AAA Decision Looms**
>
> "There's still the threat of a downgrade hanging over France and until we get that situation cleared up you can't signal the all-clear," said Eric Wand, a fixed-income strategist at Lloyds Bank Corporate Markets in London.
>
> France has the biggest debt burden of the six top-rated euro nations, at 85 percent of gross domestic product. **Its 10- year yield spread to German debt widened to a 21-year high of 204 basis points on Nov. 17 amid concern Europe will struggle to contain the region's debt crisis**. Today, it reached 151 basis points, or 1.51 percentage points, the most since Nov. 25. It was at 149 basis points at 5:39 p.m. Paris time compared with a premium of 47 basis points for AAA rated Finland and 39 basis points for the Netherlands.
>
> http://www.bloomberg.com/news/2012-01-04/france-takes-market-pulse-with-bond-offering-as-aaa-rating-decision-looms.html

The fact that debt contagion has now spread to even France should make it clear just how dire the situation has become in the EU. Remember, France is considered to be one of the two strongest members of the EU (after Germany).

Indeed, the bond markets are already anticipating a Crisis worse than 2008. For one thing, the spread between French debt and German debt is at a 21 year high, indicating that France is no longer perceived as a safe haven.

Another indication that all is not well comes from US Treasuries which are also discounting something even worse than a 2008-type event in the near future.

And finally, German bond yields have just gone negative for the first time EVER:

Germany sells treasury bills at a negative yield for first time

An auction of German government short-term bonds produced a negative yield for the first time ever, providing stark evidence that an increasingly nervous European financial community is opting for security and liquidity over any semblance of returns.

Germany's issue of €3.9-billion ($5.1-billion) of six-month treasury bills on Monday resulted in an average yield of minus 0.0122 per cent. German officials confirmed it was the first time the country had ever sold government debt securities at a negative yield – a rare circumstance in which buyers actually pay for the privilege of lending money to the debt issuer…

Negative yields have begun to pop up with growing frequency as Europe's sovereign-debt woes linger. **High-quality government issuers such as Switzerland, Denmark and the Netherlands have all sold bonds at negative yields recently, and German short-term bills have traded in negative territory on the open market for the past several weeks.**

http://www.theglobeandmail.com/globe-investor/german-sells-treasury-bills-at-a-negative-yield-for-first-time/article2296689/

If you'll recall, US Treasury yields went negative during the 2008 Crash. The fact that a similar process is unfolding in Europe now should make it clear just how close the EU is to a breakdown. It is essentially a warning that the smart money is preparing for another round of sharp deflation.

We see further signs of this in the Euro's chart, which is just downright ugly:

As you can see, we have the makings of a Head and Shoulders top that is within the confines of a multi-year downward trading channel. Having just taken out the neckline here, the Euro will eventually break below its May 2010 lows.

We recently closed out our UltraShort Euro ETF (EUO) for a 9% gain, as the Euro looks ready for a brief bounce here. We'll revisit this position soon when the next leg down begins. I believe we'll see the Euro below its May 2010 lows before the end of the year.

As the Euro deteriorates, we will see continued strength in the US Dollar. Indeed, the greenback has just taken out major resistance and is now primed for a move to the mid-80s.

I want to be plain here: I ultimately view the US Dollar as a doomed currency. Indeed, the US is currently running Debt to GDP ratios and Deficit to GDP ratios that are on par with some of the PIIGS countries.

However, until the Euro mess is sorted out, the US Dollar will be winner of the paper currency wars by default (neither the Yen not the Yuan are in better shape). As the defaults begin to spread globally, investors will flock to those currencies where they are most likely to get their money back. This will bring them to the US: we can always print money to pay investors back… compared to Europe where it's highly likely that the Euro won't even exist in its current form.

Because of the highly correlated nature of the financial system, Dollar strength will be met with weakness in the commodities sector.

With that in mind, I want to alert you to the fact that Gold has taken out its long-term trendline. It is now rising to test this level. If Gold *cannot* reclaim this line then it is going to $1,500 in short order (another hint of future deflation).

For this reason, we continue to have out UltraShort Gold ETF (GLL) open.

Meanwhile, the US stock market continues to become more and more detached from reality. While Europe's Crisis approaches critical mass, the S&P 500 has rallied based on hopes of more QE from the Fed.

This is only possible because of the extremely light volume. Stocks traded roughly nine billion shares on the second trading session of 2012. This marks a 36% decrease from trading volume for the second day of 2011 (nearly 14 billion shares).

Put another way, stocks are levitating on lower and lower volume. Indeed, volume on Monday of this week was the *lowest* volume of the year so far, even lower than that of last week.

A large part of this is due to investors fleeing the market, leaving traders to play their games on thinner and thinner volume: investors pulled $140 billion from stock-based mutual funds in 2011.

However, the fact remains that any time volume *does* pick up, the market collapses:

With that in mind, I urge everyone to be cautious regarding the recent rally in stocks. Aside from the fact that it is occurring on weaker and weaker volume, the political environment in the US simply will not tolerate more QE from the Fed.

There are two primary reasons for this:

1) The US continues to fudge its economic data to make the economy look stronger than it is… which negates the need for more QE
2) The Fed is growing increasingly politically toxic and will find itself limited in its future actions.

Regarding #1, US economic data points have become truly outrageous. Consider the latest jobs data, which proclaimed that the US actually added 200,000 jobs in December 2011.

On the surface this sounds great… until you realize that when you remove all the accounting gimmicks used to craft this number, the US actually LOST 219,000 jobs in December.

That’s correct, the jobs gains were all about seasonal adjustments and other accounting gimmicks, NOT real new jobs.

Another gimmick US bean counters use to massage their data involves dropping people from the “unemployed” list if they haven’t look for a job in the last month.

The following is taken directly from the BLS’s report:

> **About 2.5 million persons were marginally attached to the labor force** in December, little different from a year earlier. (The data are not seasonally adjusted.) These individuals were not in the labor force, wanted and were available for work, and had looked for a job sometime in the prior 12 months. **They were not counted as unemployed because they had not searched for work in the 4 weeks preceding the survey.**

Thus, US bean counters find themselves in a bind. They want to make the US economy and employment situation look as good as possible. However, by doing this, they’re making it less and less likely for the US Federal Reserve to launch any new policies:

> **QE not likely now, given data: Fed’s Bullard**
>
> More bond purchases, otherwise known as quantitative easing, are not likely at least in the short term because the economy seems on more solid ground, St. Louis Federal Reserve Bank President James Bullard said Saturday.
>
> “I don’t think it [QE] is **very likely right now because the tone of the data has been very strong right now,**” Bullard told reporters after a speech at the American Economic Association meeting.
>
> “We already have an easy policy, and the economy is improving, and so we can probably wait and see for now,” Bullard said.
>
> http://www.marketwatch.com/story/qe-not-likely-now-given-data-feds-bullard-2012-01-07?siteid=rss&rss=1

Aside from this, the Fed continues to be on the defensive as we head into the November elections. I’ve mentioned before how Gingrich, Bachmann and Perry have all criticized Bernanke and the Fed. Now even GOP front-runner, Mitt Romney, is sharpening his attitude towards Bernanke.

> **Mitt Romney says he wouldn't keep Bernanke**
>
> Republican presidential hopeful Mitt Romney said on Wednesday that if he were elected president, he would not keep Ben Bernanke as chairman of the Federal Reserve.

> "I'd be looking for somebody new," Romney said in response to a question at the Republican debate held at the Ronald Reagan presidential library. "I think Ben Bernanke has overinflated the amount of currency he has created."
>
> He also said the Fed's quantitative easing program had not worked. The Federal Reserve has used two rounds of "quantitative easing " -- increasing the money supply by buying up securities to help boost the economy.
>
> http://www.reuters.com/article/2011/09/08/us-usa-campaign-bernanke-idUSTRE7870ND20110908

Again the Fed is now on the defensive, having its cronies at the *Wall Street Journal* write "humanizing" articles about Bernanke. Another tactic has been to open the Fed up to the public for questioning via townhall meetings.

This is an extraordinary development. As you'll recall from 2009-2011, the Fed pretty much did whatever it wanted without fear of consequence. This included Bernanke lying to Congress about monetizing the debt and the Fed refusing to release data on just who it bailed out during the Crisis.

Now consider that the Fed is openly whining to Congress about how unfairly it's being treated by the media. We also see Bernanke trying to draw attention away from the Fed's earlier monetary failures.

> **Fed Study Says Greater Mortgage-Agency Losses May Aid U.S. Housing Revival**
>
> A report from Federal Reserve Chairman Ben S. Bernanke called the weakness in the housing market a "significant barrier" to U.S. economic health and said Fannie Mae (FNMA) and Freddie Mac might have to bear greater losses to stoke a broader recovery.
>
> The study, delivered today to leaders of the Senate Banking and House Financial Services committees, noted "tension" between aiding the economy and minimizing losses of the failed government-sponsored enterprises, which depend on taxpayer aid for survival.
>
> http://www.bloomberg.com/news/2012-01-04/bernanke-sends-congress-fed-study-of-options-to-lift-housing.html

From 2009-2011, the Fed claimed that QE was the best tool to fight the housing crash. Time and again, Bernanke argued that QE would benefit housing prices. Yet here he is changing tactics entirely… and making no mention of QE what-so-ever.

I urge all of you to keep this in mind as we approach the January 25 Fed FOMC meeting. Stocks are levitating on hype and hope that the Fed will deliver more juice on that day. But neither the political environment, nor the economic data (as massaged as it is) warrants it.

This is why I believe the stock market is vulnerable to another round of deflation. All the signs are there:

1) Treasuries are at all time highs.
2) German bonds yields are negative for the first time.
3) Commodities are all screaming deflation.
4) Gold has broken its long-term trendline.
5) The Dollar's chart looks very bullish.
6) Debt contagion has spread to France.
7) Political pressure will limit the Fed's monetary policies/ limit the amount of juice the Fed provides.

Against this backdrop, the only reason deflation has not erupted in the stock market again is due to misguided hope for more QE from the Fed. So stocks may hold up for the next week or so as traders wait on the Fed January 25 FOMC.

However, given the weak volume in the markets and the severe deterioration of the banking system in Europe, the market could literally collapse any day now. At any point some horrifying announcement could come out of Europe and drag the whole market down again.

So for now, the best policy is to watch and wait. I'm watching the markets closely and will issue updates and trade alerts as needed. But as of today, the market looks set up for a sharp collapse in the coming weeks. As soon as it's time to invest accordingly, you'll receive an email from me.

Until then…

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	$1,642.00	47%
Silver bullion	N/A	3/17/10	$17.50	$29.96	71%
Centamin Mining	CEE.TO	5/25/11	$2.01	$1.38	-31%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$22.72	4%
Rydex Strengthening Dollar 2x Strategy	RYSDX	12/14/11	$14.39	$14.51	1%
UltraShort China	FXP	11/2/11	$32.64	$27.12	-17%
UltraShort Materials	SMN	11/2/11	$20.23	$16.29	-19%
Deutsche Bank*	DB	12/14/11	$35.33	$35.88	-2%
Santander*	STD	12/14/11	$7.11	$7.14	0%
HSBC*	HBC	12/14/11	$37.07	$38.55	-4%
Barclays*	BCS	12/14/11	$10.65	$11.79	-10%
UltraShort Gold	GLL	12/14/11	$19.76	$19.69	0%

*** Opened 12/14/11 at 11:13AM**

RECENTLY CLOSED POSITIONS

Company	Symbol	Buy Date	Buy Price	Current Price	Gain/ Loss
Ultrashort Silver*	ZSL	12/14/11	$15.57	$17.60	13%
UltraShort Euro*	EUO	9/21/11	$19.13	$20.80	9%

*Sold December 28 after the market's close
**Sold January 5 2012 at 11:32AM