PRIVATE WEALTH ADVISORY

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Two Markets and How to Play Them Pt 2

Short-Term Trends
-No QE 3, the Fed disappoints.
-End of the month performance gaming in full effect.
-The risk-on trade is intact… for now.

Intermediate Trends
-Greece to default within two months.
-The EU to break-up within six months.
-The US to enter a new recession within the next three months.
-Increased civil unrest and potential riots.

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

As I predicted the US Federal Reserve disappointed in a big way with its January 25 FOMC meeting. There was no announcement of QE 3. Instead the Fed promised to maintain its Zero Interest Rate policy (ZIRP) until 2014: an innocuous and mainly symbolic gesture.

In truth the Fed is now trapped. Because of political pressure, it cannot announce QE 3 or any other large monetary program without a Crisis first erupting.

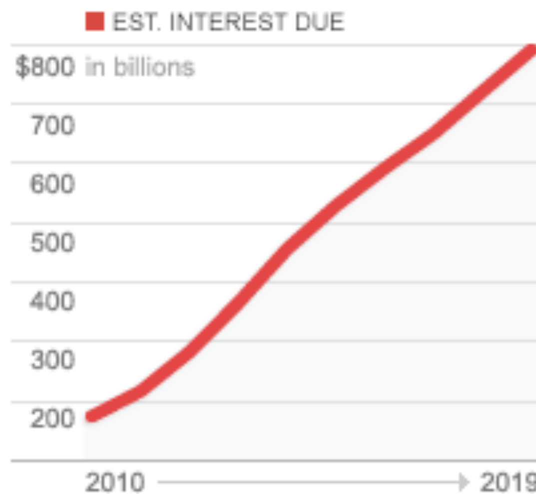
However, if the Fed were simply to announce that its view of the economy had worsened and *not* throw the markets a bone, then we could very well have seen a Crash in multiple asset classes as the entire financial system is trading primarily based on the notion that the Fed and other Central Banks can somehow manage to prop this house of cards up interminably.

As a result of this, we got more of the same with the Fed January FOMC: promises to act if needed, and a symbolic promise of future accommodation in the form of promising to extend ZIRP for years to come.

The reality is that the Fed is stuck in ZIRP and will never be able to leave it. In 2011, the US made $454 BILLION in interest payments. And that's with *interest rates at or near 0%.*

Things are only going to get worse. According to the Congressional Budget Office, the estimated interest that will be due on the US's debt load by 2015 will be $533 billion: an amount equal to 1/3 of all federal income taxes collected that year.

And of course, if interest rates rise in any fashion, the interest payment load will rise as well. This is part of the reason why the Fed cannot raise interest rates in the future… ever.



A second reason the Fed is trapped in ZIRP pertains to corporate leverage levels, which we detailed in Wednesday night's issue. Any rise in interest rates, particularly on the short-end of the curve, will mean that corporations will see a massive increase in interest payments due on the $7.3 trillion in debt they currently owe. That could put a serious dent in the "earnings" side of the P/E valuations sell side analysts are touting to claim stocks are cheap today.

Finally, we need to consider the over the counter derivatives market. Currently 82% of the $248 trillion in derivatives sitting on US commercial bank balance sheets are based on interest rates. If even 2% of these contracts are "at risk" and one quarter of those "at risk" contracts blow up, you've wiped out all equity at the five largest US banks.

Suffice to say, the Fed doesn't want interest rates to rise in any way shape or form. So the Fed is trapped at a ZIRP rate and will not be raising rates until the market forces it to do so.

This in turn means that inflation, which has already crept into the financial system as a result of QE 1 and QE2, will be gaining further traction in the months to come. As I've stated before, inflation and deflation are not mutually exclusive. And while

the Fed is focusing on stopping the dreaded debt deflation (a la 2008) hitting the financial system, it's let the inflation genie out of the bottle resulting in higher costs of living and civil unrest around the globe.

Inflation will also be growing due to a secondary mega-trend: that of finite resources vs. an exponentially growing population.

In 1800 there were roughly 800 million people on the planet. Today there is north of seven billion. And according to Mark McLoran of *Agro-Terra*, the Earth's population will be growing by 70-80 million people per year going forward.

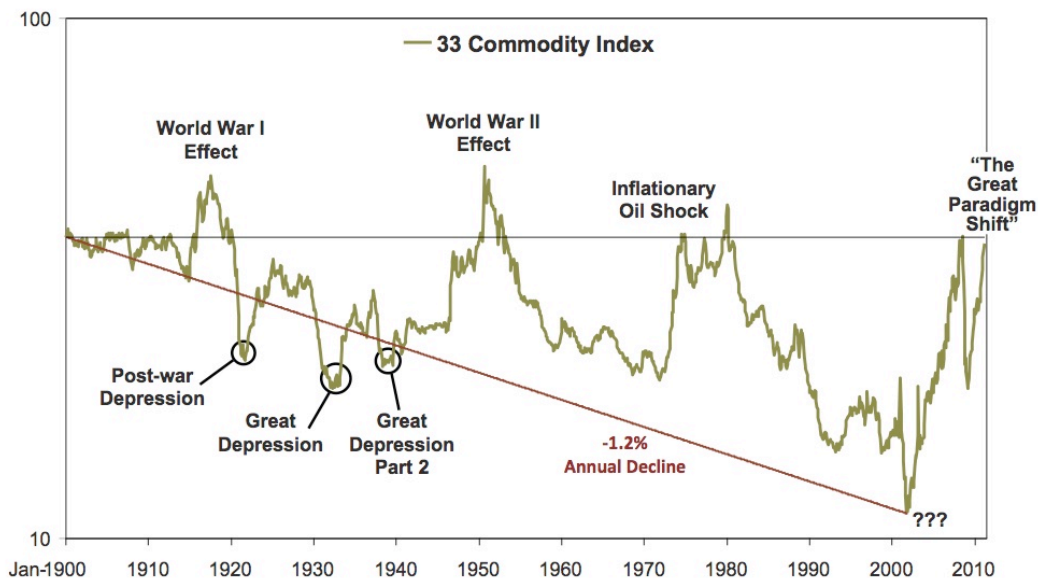
Against this backdrop of rapid growth, the supply of food is falling. Up until the 1960s, mankind dealt with increased food demand by increasing farmland. However, starting in the '60s we began trying to meet demand by increasing yield via fertilizers, irrigation, and better seed. It worked for a while (McLoran notes that between 1975 and 1986 yields for wheat and rice rose 32% and 51% respectively).

However, in the last two decades, these techniques have stopped producing increased yields due to their deleterious effects: you can't spray fertilizer and irrigate fields ad infinitum without damaging the land, which reduces yields. McLoran points out that from 1970 to 1990, global average aggregate yield grew by 2.2% a year. It has since declined to only 1.1% a year. And it's expected to fall even further this decade.

Thus, since the '60s we've added roughly three billion people to the planet. But we've actually seen a *decrease* in food output in terms of yield. And we're not discovering new farmland to compensate for this. Indeed, worldwide arable land per person has essentially halved from 0.42 hectares per person in 1961 to 0.23 hectares per person in 2002.

The result of this is that we are currently witnessing a tremendous shift in the natural resources space. As asset management firm GMO noted in a recent client letter, a 100-year trend in commodity prices began to shift in 2002.

GMO Commodity Index: The Great Paradigm Shift



Note: The GMO commodity index is an index comprised of the following 33 commodities, equally weighted at initiation: aluminum, coal, coconut oil, coffee, copper, corn, cotton, diammonium phosphate, flaxseed, gold, iron ore, jute, lard, lead, natural gas, nickel, oil, palladium, palm oil, pepper, platinum, plywood, rubber, silver, sorghum, soybeans, sugar, tin, tobacco, uranium, wheat, wool, zinc.

This chart and population demographics tell us in no uncertain terms that higher prices will be a reality going forward. Put another way, the days of cheap food and cheap resources is ending.

A secondary item that will impact prices going forward is the misallocation of natural resource revenues by political leaders in oil exporting nations. Rick Rule, one of the premiere natural resources investors in the world (between 1998 and 2006 he grew $15 into $460 million) shared this particular insight with me during a phone call discussing the oil and energy sector.

"Most people believe that most oil in the world is produced by the big oil companies, the Exxons, the Shells, the BPs, the Totals of the world," Rick began, "*That is not true. Most oil in the world is produced by national oil companies… companies owned by the state or government."*

I asked Rick what percentage of world oil production is controlled directly by governments. His answer: *"at least 70%."* Rick went on to explain that this creates a situation similar to the Peak Oil theory based not on lack of resources, but lack of competence on the part of political leaders.

"*Much of the cash flow generated by these state owned companies is spent on government spending programs. Now, oil and gas are capitally intensive businesses. If you do not continually reinvest, you impair your ability to produce."*

"It is my opinion that this lack of reinvested capital will create a situation in which it is inevitable that in five years the world supply of export crude from several key

exporting countries will be greatly constrained of not stopped altogether. Those countries include Mexico, Venezuela, Peru, Ecuador, Indonesia and perhaps Iran."

According to the *International Energy Administration* worldwide demand for crude oil imports is growing at a rate of 1.5-1.6% a year. When you combine this growth in demand with a major cut to the tune of 20-25% of world oil exports you have makings of what Rick calls, *"a MAJOR price dislocation in energy prices."*

This is something I've yet to hear anywhere else, especially in the mainstream media. All talk of higher oil prices that I've seen focuses on speculation on Wall Street (true), the view that the world is running out of oil (false), or the view that situation in the Middle East will disrupt supplies (probably will be true). Nowhere is anyone talking about a cut in exports due to government misallocation of resources.

I asked Rick if his "price shock" forecast was a certain thing. He responded, *"There is one potential solution which may or may not work. The Gulf States, most notably Saudi Arabia, Kuwait, and Abu Dhabi, are aggressively reinvesting in building production capacity. The issue is whether or not they can expand capacity enough to shelter the shock of the decrease in exports coming from the other countries I listed before."*

So the one group that could stop a spike in oil prices is the Middle East?

"*Yes, paradoxically, the people who talk about supply issues in the US are concerned about the very nations that are our most reliable suppliers: the Persian Gulf countries. The Saudis are spectacularly reliable suppliers. They have invested tens of billions of dollars maintaining a surplus capacity of two million barrels per day specifically to level out price shocks. This suggests to me that American consumers have been massive beneficiaries of a region that they are being taught to dislike, namely the Middle East."*

These are key factors to keep in mind as political turmoil in the Middle East continues to accelerate (I note that Iran proposed a bill to cut off oil exports to Europe just yesterday morning).

If Rick's forecasts prove accurate, the impact on global prices will be tremendous. While oil's single largest use is transport (as a motor fuel), accounting for 52% of global oil demand, oil actually has a staggering number of uses aside from this.

Oil or oil derivatives are present in lipstick, Vaseline, solar panels, polyester (stain resistant clothes), chewing gum, crayons, Aspirin, pantyhose, sneakers, detergent, CDs, plastics of any kind, food additives, fertilizers, pesticides, candles, milk cartons, pen ink, and more.

In the US, no single one of these uses accounts for anywhere near as much demand as motor fuel (see the chart below). However, it is critical to understand that oil's entanglement with the world economy goes way beyond its transport uses.

Moreover, when you're talking about 7.14 BILLION barrels of oil used in the US per year, even a small slice of this, say Lubricants, which account for only 1% of demand, means you're talking about 71 MILLION barrels of oil.

Use	**% of US Demand**
Gasoline	46%
Diesel Fuel	18%
Jet Fuel (Kerosene)	8%
Propane/Propylene	6%
NGL & LRG2	5%
Still Gas	3%
Residual/Heavy Fuel Oil	3%
Petrochemical Feedstocks	3%
Heating Oil	3.30%
Petroleum Coke	2%
Asphalt and Road Oil	2%
Lubricants	1%
Miscellaneous Products	0.30%
Special Naphthas	0.20%
Aviation Gasoline	0.10%
Kerosene	0.10%

Indeed, oil has so many uses that it is not only a fuel driving economic growth; it is a significant chunk of GDP itself: according to the *International Energy Agency* each 1% in global GDP growth from 1980 onward was accompanied by a 0.3% increase in global oil demand.

So if oil prices spike in the coming five years due to oil exporting nations cutting back on exports, expect to see price increases in virtually every consumer product (especially food) explode higher.

Between these two factors (resources scarcity and the potential for a global drop in oil exports) as well as the global currency devaluation efforts maintained by the world's central banks (the Fed's ZIRP being one), long-term "buy and hold" investors will need to allocate a portion of their portfolios to investments that will maintain their purchasing power going forward.

The simplest way to do this will mean allocating capital to traditional inflation hedges such as Silver and Gold. If you do this, I strongly urge you to buy bullion, not paper-based ETF products. Bullion for both precious metals typically comes in either coin or bar form.

In terms of actual gold coins, there are three coins that comprise the bulk of the bullion market. They are Kruggerands, Canadian Maple Leafs, and American Gold Eagles. I've been told to avoid Maple Leafs by both a trader and a bullion dealer as they can easily be scratched which damages the gold and reduces the coin's value.

In terms of silver, the easiest way to get it is via pre-1965 coins (often termed "junk" silver). The bullion dealer I spoke to prices them at 50 cents over spot. However, you can also get silver one-ounce rounds (coin-like medallions) and 10-ounce bars, both of which can be bought at 95 cents over spot. You can buy Silver Eagles coins at $2.50 over spot, though the premium higher.

I cannot tell you which dealer to go with, but look for someone who's been dealing for years (not a newbie). You should ALWAYS ask for references from the dealer (former clients you can talk to about their purchases/ experiences).

Some warning signs to avoid are dealers who try to store your bullion. NEVER, I repeat, NEVER store your bullion with someone else. ALWAYS store it yourself. Also, be sure to talk to the dealer for some time and ask him or her numerous questions about the industry, the coins, etc. (feel free to test him or her on the information I've provided you with e.g. the three most liquid Gold coins, etc.). If they can answer everything you ask in a knowledgeable fashion, their references check out, and you verify everything they say with a 3rd party, you should be OK.

Personally I have placed orders with Camino Coins in California. They've been dealing bullion for over 50 years and I've been very happy with their services. I receive NO compensation in any form for mentioning them here. They're just dealers from whom I have personally bought and trust.

Camino Coins
1301 Broadway
Burlingame, CA 94010
Phone: 800-348-8001 or 650-348-3000
Fax: 650-401-5530

On a side note regarding Gold's current technical picture in regard to our Gold Short, I wish to point out that Gold has yet to reclaim its long-term upwards trendline, which is why we have not yet closed out UltraShort Gold ETF (GLL). Should Gold reclaim this line and hold it, we'll be forced to close this position at a loss.

Outside of bullion, long-term investors need to have some exposure to equities that are able to pass on rising costs to consumers (at least in part). I'm talking about well-defined brands that offer goods and services which consumers are willing to pay more for as prices increase due to increase operational costs and commodities prices.

This inevitably leads to defensive non-cyclical industries: tobacco, beverages, medicine, energy, etc. It also means having some exposure to the mining sector (I'll be devoting a large portion of our next issue to several great mining plays).

In the meantime, I'll detail a handful of non-mining "strong brand" companies that have pricing power here. Amongst the large-cap space, the following are worth consideration.

Company	Symbol	Industry	Price to Cash Flow	Dividend Yield
Kraft Foods	KFT	Food	16	3%
Nestle	NSRGY	Food	18	3.6%
Coke	KO	Beverage	17	2.7%
McDonalds	MCD	Fast Food	14	2.8%
Exxon Mobil	XOM	Oil	7	2.1%
Clorox	CLX	Cleaning	13	3.4%

		Supplies		
Colgate-Palmolive	CL	Oral Health	14	2.%

Smaller companies I would consider are

Company	Symbol	Industry	Price to Cash Flow	Dividend Yield
Smith and Wesson	SWHC	Guns	10	N/A
Sturm, Ruger & Company	RGR	Guns	14	1.44%
WD 40	WDFC	Lubricant	19	2.68%
Hormel	HRL	Spam	16	2.01%

I am not suggesting going out and buying any of these companies right now. The reason is that the market is sharply overstretched and susceptible to a sharp correction at any point.

Moreover, many of these companies are priced at valuations that are simply too rich for me. If they were at Price to Cash flow multiples below 12 then I'd be more likely to make them official buys.

I'll be monitoring all of these companies and adding to these lists going forward. Whenever it's time to buy one of them, I'll send out an alert.

The primary message I want you to take away from this portion of this issue is that inflation is real and present already in the system. Going forward every investor will need to allocate a portion of his or her portfolio towards those investments that can preserve their purchasing power.

Now on to Europe and the pressing issue of debt deflation.

The markets have rallied sharply over the last two weeks on hopes of additional QE from the Fed. The Fed disappointed in a big way with its January 25 FOMC meeting. This leaves end of the month performance gaming and start of the month buying as the last remaining trader games to prop the market up.

I wish to stress that a large reason this market move has been possible is because trading volume is terrifyingly light. As *CNNMone*y noted:

> During the first 10 trading days of 2012, roughly 6.8 billion shares a day changed hands in the United States, down from 8 billion in 2011 and 8.3 billion in 2010, according to the New York Stock Exchange.

Last year (2011) by all counts was a year of low volume. And thus far we're seeing volume down over 15% from those levels. With volume at these levels, and trading programs accounting for anywhere between 60-80% of trading volume, you have a market that is extremely easy to move with very little actual capital.

A secondary reason the market is rallying is that investors believe that Europe is somehow close to finding a real solution to the ongoing Debt Crisis.

This couldn't be farther from the truth. Indeed, it is now clear that Europe is weeks, if not days, from a full break down in negotiations. Indeed, Germany has finally played its hand regarding this entire mess.

Consider that in the last two weeks the IMF has not only sought more funds to deal with the European Crisis, but has also warned that Europe is facing a meltdown if swift action is not taken.

Germany's response to these statements was the following:

Berlin resists pressure to give Greece more

Germany, the biggest and richest country in the euro zone, has provided the bulk of the funds for the bailouts of Ireland, Portugal and Greece. **Now it is firmly rejecting calls to come up with yet more funds for Greece to compensate for any shortfalls in a debt relief deal with private creditors.**

On Friday Foreign Minister Guido Westerwelle defended Berlin's tough stance. The Greeks, he insisted, should show that they are willing to implement reforms before getting more money.

"We Germans do not expect from anyone in Europe more than what we are asking from our own citizens. We cannot explain to taxpayers in Germany that they have to do things that others do not want to do while at the same time asking for their money," Westerwelle said in Brussels.

He pointed out that Germany had already come up over 200 billion euros ($262 billion) for the bailout funds. "It makes no sense" he said, to give more money to Greece, "if we don't know whether the reforms which have been agreed upon will be really implemented." He argued that coming up with more money just lessened the pressure to reform.

http://www.globalpost.com/dispatch/news/regions/europe/germany/120127/berlin-resists-pressure-give-greece-more

Diplomatically, this is about as close as Germany can come to telling the IMF to "stuff it." Germany knows the IMF doesn't have the funds and won't be getting them (the IMF is primarily a US-backed entity and the US won't stand for a US-backed European bailout).

Indeed, just a few days after Germany said "nein" to more Greece bailouts, it then threw the following suggestion out:

German proposal seeks EU commissioner with sweeping powers to directly control Greece's budget

Germany is proposing that debt-ridden **Greece temporarily cede sovereignty over tax and spending decisions to a powerful eurozone budget commissioner** before it can secure further bailouts, an official in Berlin said Saturday.

The idea was quickly rejected by the European Union's executive body and the government in Athens, with the EU Commission in Brussels insisting that "executive tasks must remain the full responsibility of the Greek government, which is accountable before its citizens and its institutions."

http://www.washingtonpost.com/business/markets/german-proposal-seeks-eu-commissioner-with-sweeping-powers-to-directly-control-greeces-budget/2012/01/28/gIQAxHWgXQ_story.html

In plain terms, push has now to come shove in Europe. Germany permitted the ECB to implicitly monetize various EU sovereign nations' debts during 2011 because Germany hadn't yet taken the steps to prepare for a collapse of the EU.

It now has. In the last six months, Germany has:

1) Passed legislation permitting it to leave the Euro without leaving the EU.
2) Passed legislation permitting it to nationalize German banks during times of Crisis.
3) Demanded that German banks in general raise capital.

In plain terms, Germany is now prepared to walk if it has to. And it's made its demands very clear: **if you want German funds, you will need to give up fiscal sovereignty.**

It's also made it clear that it will tolerate neither the issuance of Eurobonds OR direct and open monetization by the ECB.

In other words, Germany has said "it's our way or the highway." True, this borders on an act of financial warfare, but in the end, Germany has never truly been interested in a monetary union so much as a political union.

Germany will not suffer inflation (they've seen how monetization works out, e.g. Weimar), nor internal discord (in November 78% of Germans thought the Euro would survive… by December 60% of them though the Euro was a "bad idea".)

Put another way, Germany is going to look after its own domestic interests. And if some EU member wants German funds, it's going to have to give up its fiscal sovereignty and essentially become a vassal state for Germany. End of story.

With that in mind, I believe the next round of the Euro Crisis is now at our doorstep. Indeed, this latest short-covering rally in the Euro (Euro shorts were at a record) looks ready to end and reverse:

With that in mind, we're re-opening our **UltrShort Euro ETF (EUO)** position.

Action to Take: Buy the UltrShort Euro ETF (EUO).

It also looks to be time to add to our Euro Bank short positions.

Deutsche Bank (DB)

Here we've resistance as well as a giant triangle pattern in place. Moreover, we've got resistance at the 200-DMA:

Action to Take: Add to your Deutsche Bank (DB) short position.

The same goes for the Spanish bank **Santander (STD)** which is coming up against major resistance.

Action to Take: Add to Your Santander (STD) Short.

HSBC (HBC) has a similarly bearish chart. HBC shares are coming up against resistance as well as the 200-DMA.

Action to Take: Add to Your HSBC (HBC) Short.

The same goes for Barclay's (BCS).

We've just poked above the 200-DMA, but we've got major resistance at $15.

Action to Take: Add to Your Barclays (BCS) Short.

For our track record, going forward I will be taking the average of these new prices and our original buy prices. By averaging in like this we're positioned to maximize our gains when the Euro Crisis begins anew.

Now let's look at our Crisis Trades.

China's ETF (FXI) is *extremely* overbought and coming up against resistance.

I'd also suggest adding to our China short.

Action to Take: Add to Your UltraShort China ETF (FXP).

The same goes for the Materials ETF:

I'd suggest adding to this Crisis Trade as well:

Action to Take: Add to Your UltraShort Materials ETF (SMN).

Again, for our track record, I will be taking the average of these new prices and our original buy prices. By averaging in like this we're positioned to maximize our gains when the market correction begins anew.

In closing I want to stress something.

The single most difficult part of investing is the discipline of waiting to be right. As many of you will recall, our winning streak during the second half of 2011 took quite a bit of discipline as many times our positions were in the red for weeks before those trades worked out.

Having said that, I realize it is difficult to be sitting on large paper losses as we are today. The reason we've had to wait so long is because in Europe, politics is everything. What I mean by this is that the influence politicians have over the media and the pace of economic developments is extraordinary.

Consider the US debt ceiling/ credit downgrade situation that occurred in the US last summer. That entire process, including all the back and forth bickering between political parties and threats of a downgrade took only six weeks in total.

Now consider that the Greek bailout/ debt crisis has now been going on for over **two years… and it STILL hasn't been resolved.**

The geopolitical and financial picture in Europe has been clear since at least 2010 if not earlier. However, EU political leaders have been playing for time by staging press conference after press conference and leaking various rumors to the media in an attempt to draw out the length of the crisis, thereby minimizing its impact.

On that note, I wish to point out that the news out of Europe has been uncommonly quiet over the last eight weeks (aside from the weekly Sarkozy-Merkel meetings which are an exercise in playing for time). I believe this is because behind the scenes, policymakers have been putting the pieces in place to prepare for the next round of the Euro Crisis/ the break-up of the Euro zone.

Based on the fact that Germany has now *explicitly* refused additional bailouts funds without Greece giving up fiscal sovereignty, I think the "quiet before the storm" period has finally ended and we are now heading straight into the next round of the Euro Crisis.

With that in mind, I believe that the European Banking Crisis and its accompanying debt deflation will begin anew within the next two weeks. This is why we've averaged in on our Deflation and Crisis trades: to secure better buy prices for when the next leg down in the market's correction begins.

In closing I wish to thank all of you for your patience during the writing of this letter. I am still not back to 100% in terms of health but am recovering speedily. Going forward all ***Private Wealth Advisory*** issues and alerts will be published on time. I make it a point to hit deadlines, but in truth the last six weeks has been the most challenging of my life from a health perspective.

As always, 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	$1,737.00	55%
Silver bullion	N/A	3/17/10	$17.50	$33.96	94%
Centamin Mining	CEE.TO	5/25/11	$2.01	$1.52	-24%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$21.99	1%
Rydex Strengthening Dollar 2x Strategy	RYSDX	12/14/11	$14.39	$13.87	-4%
UltraShort Euro	EUO	9/21/11	$19.41	**NEW**	**BUY!**
UltraShort China**	FXP	11/2/11	$32.64	$23.22	-29%
UltraShort Materials**	SMN	11/2/11	$20.23	$14.73	-27%
Deutsche Bank**	DB	12/14/11	$35.33	$44.44	-20%
Santander**	STD	12/14/11	$7.11	$8.15	-13%
HSBC**	HBC	12/14/11	$37.07	$42.59	-13%
Barclays**	BCS	12/14/11	$10.65	$14.09	-24%
UltraShort Gold	GLL	12/14/11	$19.76	$15.74	-20%

**** Add to your position.**