PRIVATE WEALTH ADVISORY

AN OMNISANS RESEARCH PUBLICATION JULY 1, 2009

The New America

The last week, for all investment purposes, was a complete wash.

For the ordinary investor, the stock market must be completely baffling at times. Stocks look ready to collapse, fundamentals are worsening, the global economy is contracting for the first time in 50+ years, our country's central bank is now known to be run by a power-crazed crook who forced an illegal merger between two private companies (Merrill and Bank of America), and yet we still get monster rallies like last Thursday's.

The pundits and commentators came out of the woodwork that day proclaiming everything from "stocks are up on hopes of economic recovery," to "jobless claims will be less than expected," and more.

None of these interpretations were even close to accurate. The reality is that on Friday, the Russell 3000 (a common stock index like the S&P 500) underwent its annual rebalance adjusting: meaning it dropped some stocks and took other stocks on (275 for the latter group).

When a company is added to an index, it becomes available to institutional investors who are limited to only investing in indexed stocks. So it makes sense for the companies that were added to the Russell 3000 to rally substantially as new, big capital flows in.

But what's bizarre is that the market rallied THURSDAY the day BEFORE the Russell rebalancing. Someone (a lot of someone's) obviously had some kind of tip off about which companies would be added to the Russell and piled in. And they made a killing, pocketing easy double-digit gains from the flood of new institutional money that pumped these stocks higher.

For instance, Revlon, one of the companies to be added to the Russell actually bottomed on **Tuesday at $4.34 and rallied 11% before Friday even rolled around** (it has since rallied another 11%). Bear in mind, these moves came on NO news from the company. In fact, as recently as late May Revlon was on of the biggest percentage decliners for the NYSE.

Then, there was the late night rigging following the market's close. On Thursday night, over 12,000 futures contracts traded in two five-minute periods, ON NO NEWS WHAT-SO-EVER. Put another way, someone bet **over $1 billion that the market would rally on Friday.** Come Friday, we had bad employment numbers, neutral GDP numbers, and… **the Fed announcing it would be curtailing certain lending facilities** (positive sign for sure).

Connecting the dots, it is 100% clear that the Fed leaked this information to a few insiders all of whom made tens if not hundreds of millions of dollars betting the market would rally on the "official" release of the Fed's announcement at noon. This is insider trading and market manipulation at a truly offensive level. <u>But the SEC hasn't done ANYTHING about it.</u>

Indeed, the SEC has looked the other way on these sorts of matters for years now (late day rigging in the futures market is a virtual daily occurrence). Part of this is the SEC being complicit in helping the Fed bailout its buddies on Wall Street (the same folks the Fed is leaking information to). The other part is a lack of resources: the SEC has less people on staff than the Smithsonian Museum.

To return to my initial point, over the last week, the powers that be took their outright manipulation of the market to virtually unprecedented levels. Anyone who is actually performing valid analysis or investing based on fundamentals (that includes us) was tossed around like a canoe in a sea of oil tankers.

This is why last week was a total wash. The effects felt by our portfolio were complete and utter noise stemming from widespread market manipulation by institutional investors aided by a Federal Reserve that routinely leaks pertinent information to insiders ahead of its release.

So while several of our positions have fallen into the red, I am neither worried nor concerned. I've been through this kind of nonsensical volatility before and it does not concern me. Last year I went short financials in February. At that time I was laughed at for months until Fannie and Freddie collapsed in July at which point I doubled my money.

The same thing happened regarding the Crash. I was openly forecasting a full-blown Crash in equities back in April 2008. As a lone analyst forecasting this while EVERY Wall Street CEO proclaimed "the worst is over," I looked like a nutcase. Then October rolled around and I doubled my money again.

Bottomline: if you chase gains every day, hoping to stay ahead of the market, you WILL lose money. If you want to produce large gains and CRUSH the market, you need to focus on facts, not sentiment, stick with your thesis until it's proven false, and ignore everything else.

Remember, once you've bought (or gone short) an investment the only time its price truly matters is **<u>WHEN YOU SELL.</u>** What happens between your purchase and your sale is largely a matter of waiting and discipline. And judging from the market's recent action I don't think it'll be long before our waiting is richly rewarded. Indeed, there are several signs that bad news is coming for the market, and it's coming fast.

The New “Normal” For the US

Let’s take a look at the economic fundamentals for a moment.

The US has entered a new era. It is an era of increased thrift, lower consumption, lower employment, and lower corporate earnings. Americans are saving more (personal savings is at 6.9% a 15 year high), spending less, scrambling to find more work, and generally living more frugally.

Year over year, real wages and salaries are down 1.1% from a year. That’s the single largest drop in 50 years’ worth of data. Part of this drop is due to corporations scaling back production: the US workweek has been cut to a record low of 33 hours.

The other part is due to outright closure and bankruptcy: the *Financial Times* expects 62,000 US businesses to close shop this year. Indeed, Mass Lay-offs (lay-offs of 50 persons or more) have hit a record high. And the Center for Labour Market Studies at Northeastern University estimates that real unemployment now stands at 18.2%: higher than the posted rate at the end of the 1930s.

With this kind of downward pressure coming from employment, it is impossible for the US to experience any kind of significant economic recovery. Remember, 70% of the US economy comes from consumer spending.

Right now, consumers cannot spend, nor do they WANT to: the savings numbers are in fact an illusion because the government measures savings as income minus spending. The real fact is that consumers are paying off debt as fast as they can: $40+ billion in credit cards in the last four months alone.

The reason for this is obvious: banks are raising interest rates from 11% to 26%. Ditto for Option Adjustable Rate Mortgages, one million of which that are adjusting to higher rates this year.

No consumer spending means no uptick in US corporate profits. No uptick in US corporate profits means no business lending for banks: with industrial capacity at 69% (meaning we’re only using a little over two thirds of our industrial production capacity) it’d take a MAJOR recovery for businesses to be able to expand anyway.

Also, no uptick in corporate profits means more layoffs or workweek cuts... which in turn means even less consumer spending and more credit write-offs… which further limits banks’ abilities to recapitalize (as their loans continue to go bad).

This is nothing new… this trend has been playing out for a decade. According to *BusinessWeek*, between May 1999 and May 2009, private sector employment rose only 1.1% or **roughly 1.1 million jobs.** That’s what happens when you economy relies on bubbles. Jobs come and go with the bubble. But you don’t have any sustained growth.

In contrast, the government or public sector added more than double the jobs of the private sector: 2.4 million jobs since 1999. Similarly, government spending is the only source of wage growth in our current economy. Year-over-year government transfer (a measure of the government's allocating capital to society) is up 12%. Today, the federal government **contributes 18% of all personal income in the US via food stamps, unemployment insurance, welfare, etc.**

This is an all time high. And it shows clearly the degree to which the US economy and financial markets are operating on life support courtesy of Uncle Sam. Think about it… $1 in every $5 in personal income made in the US comes from the Government. And we're supposed to be considered a capitalist society?

This is the **New Normal** for the US. An economy marked by the following factors:

- Higher consumer savings
- Lower consumer spending
- Rising unemployment
- Lower corporate profits
- Increased Government spending/ transfer
- Reduced private sector growth
- Excess capacity
- Reduced production
- Excess bank reserves
- Reduced lending

None of these will change in any real way in the next 18 months to two years. And all of them bring me to my next major point…

Right Now, Inflation is an Opinion… Not a Fact

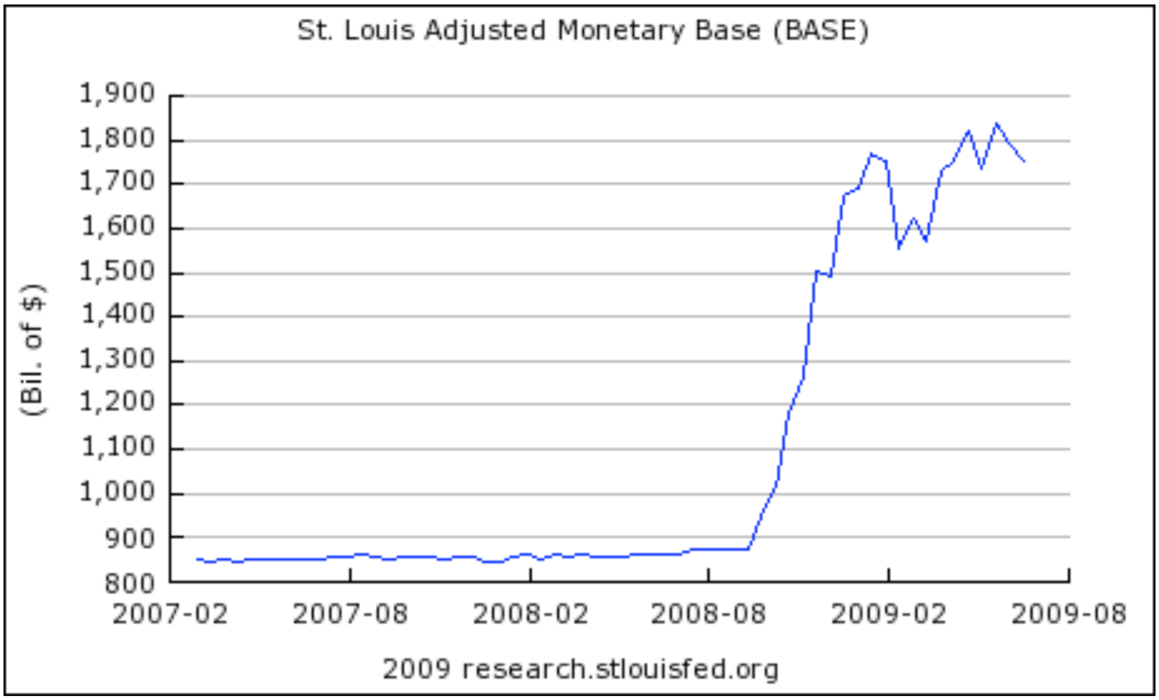
Last issue I began to re-assess the fears of inflation and hyper-inflation that have begun to grip the market. With oil rising above $70 and China grumbling about the dollar, everyone and their mother is warning about inflation right now. Heck, even Alan Greenspan has begun to warn about it (which alone should be a warning sign that it's not really an issue at the moment).

As a brief recap, last week I wrote that I believe inflation is a very serious *future* threat to the dollar. The key word in that sentence is "future"… as in years and possibly even a decade away.

My reasoning for this is as follows: most inflationists' analysis completely overlooks the fact that net worth and wealth based on assets continue to evaporate on a personal, financial, and federal level. Instead, they point to the Fed's money printing (the US monetary base) or the rise in commodity prices as evidence that inflation is already.

Both the money printing and the commodities arguments are fundamentally flawed as I will show you.

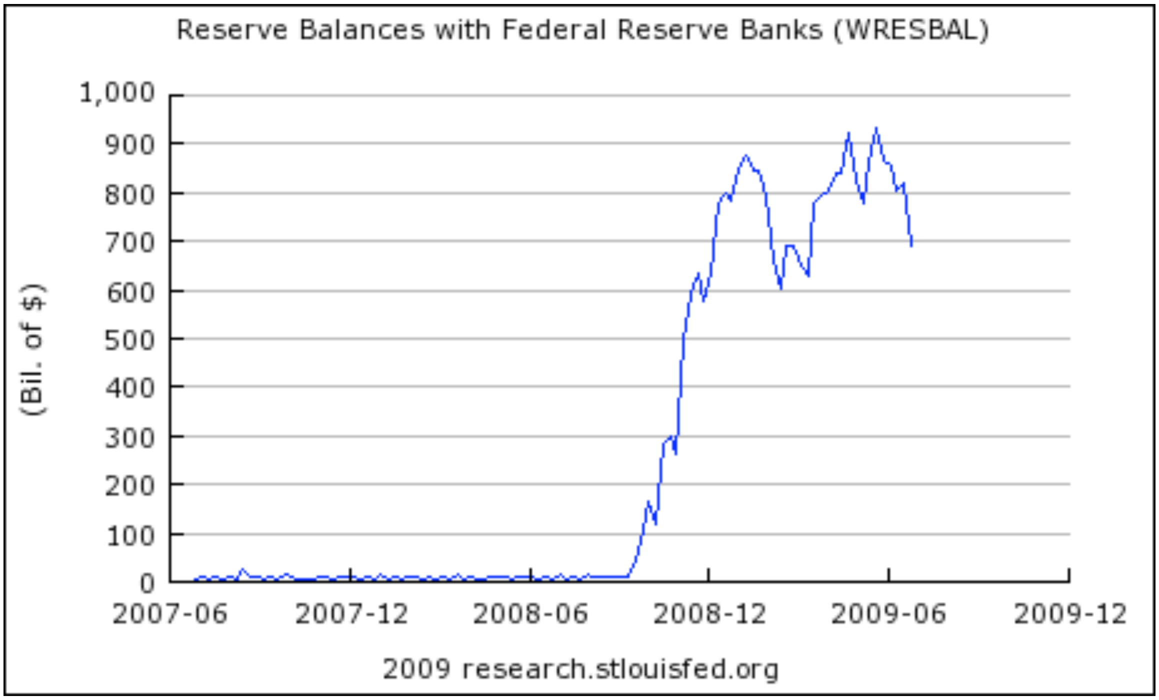
The US monetary base *does* measure the Fed's money printing. As you can see, the Fed has pumped some $900 billion into the financial system (this doesn't count the $13 trillion in off balance sheet arrangements that have occurred).



However, the US Monetary Base *does NOT* show where the Fed's money is going. For inflation to hit, the Fed's money printing HAS to enter the actual economy. After all, if the Fed gives all of us $1 million, but we all just bury it in our backyards, has the actual money supply changed?

NOPE.

This is precisely what's happening in the US financial system today, although banks are burying the Fed's loans on their balance sheets instead of their backyards. See for yourself:



The Reserve Balances with Federal Reserve Banks shows the amount of money banks are keeping in EXCESS OF required reserves. As you can see, banks are hoarding most of the Fed's money. This is because the banks DO NOT want to lend: the 21 largest recipients of government money actually saw a 7% drop in their loan books in April 2009.

Without bank lending, the Fed's money printing cannot enter the financial system and inflation cannot take hold. This raises the question then: WHY aren't banks lending? For us to truly understand this, we need to assess how we measure "wealth" in today's economy.

Let's say we have a random investor, Joe America. Joe worked hard his whole life, is now in his 50s, and thinking about retirement. Joe owns a $350,000 house, has $200,000 invested in the stock market, and $15,000 in cash in his bank account (Joe is a fairly prudent guy).

If you follow the inflationists' method of analysis in assessing Joe's wealth, you would argue that Joe's net worth is only $15,000 (the money he can throw around). However, for those of us living in reality, Joe's net worth is actually $565,000. And most (53%) of it is tied up in his home… which is losing value. The same goes for his stock holdings.

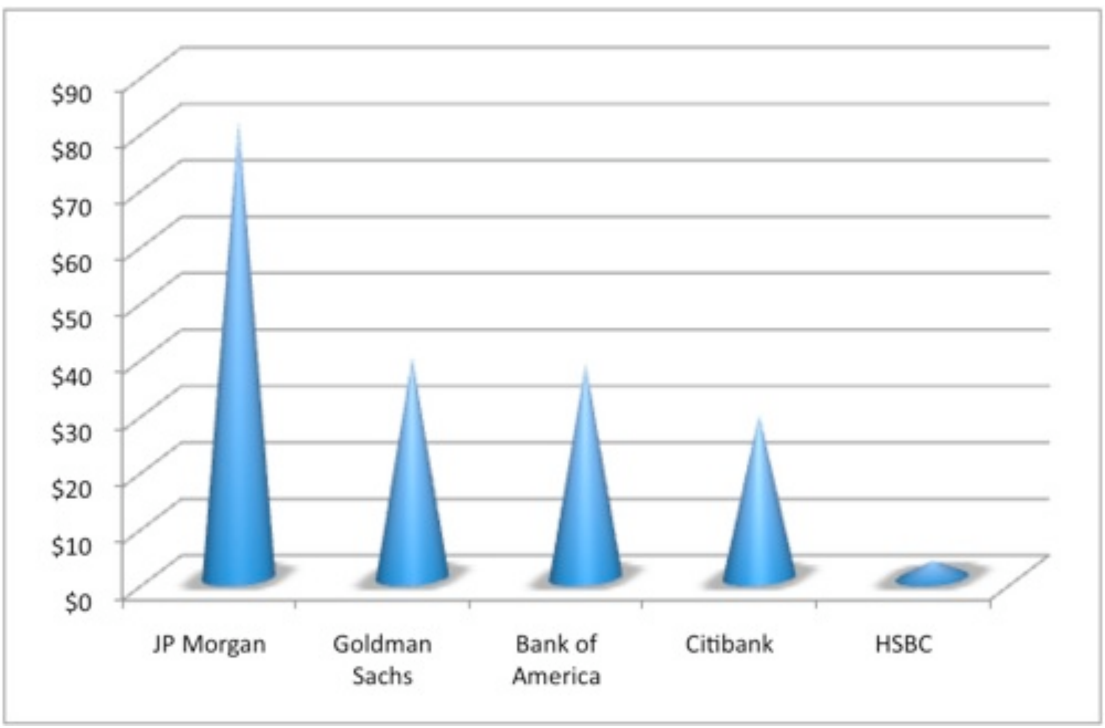
Indeed, last year's collapse in housing and stocks wiped out $11 trillion in household net worth in the US. That's roughly 18% of total US household wealth at that time. Put another way, <u>Joe America just lost nearly 1/5th of his wealth in a single year.</u> And it continues to plunge: home prices fell another 0.6% in June, which represents another $100 billion in wealth gone.

Now, let's apply the "Joe" metaphor to the entire financial system. Total private sector debt stands at $49 trillion. Almost all of this is based on rapidly depreciating assets (homes, cars, etc.). That is a HUGE amount of downward pressure on wealth in the US. And it shows the degree to which the Fed's money printing simply cannot create inflation: $49 trillion losing value cannot be re-inflated with $13 trillion in additional loans.

This trend is playing out for banks on an even larger scale. Few commentators care to mention that the total notional value of derivatives in the financial system **is over $1.0 QUADRILLION (that's 1,000 TRILLIONS).**

US Commercial banks own an unbelievable $202 trillion in derivatives. The top five of them hold 96% of this. Look at the names below, then consider who has taken the MOST bailout money from the Feds, and you begin to see what is really happening in the US.

BTW, the chart is in TRILLIONS of dollars:



As you can see, Goldman Sachs alone has $39 trillion in derivatives outstanding. That's an amount equal to **more than three times total US GDP**. Amazing, but nothing compared to JP Morgan, which has a whopping $80 TRILLION in derivatives on its balance sheet.

Now, as their name implies, derivatives are "derived" from underlying assets (homes, debt, etc). And the assets these derivatives are based on are currently losing value. Indeed, they "officially" lost over $1 billion in value during the last two quarters. I say “officially” because derivatives are not regulated in any way, shape, or form, so the banks can essentially value these securities at whatever level they please (we all know how well that accounting model played out in the housing bubble).

Suffice to say, “real” notional losses from derivatives are far, far higher. The IMF claims it will be north of $2.7 trillion. But even that seems far too low. With $202 trillion in derivatives on US commercial banks’ balance sheets, the IMF is essentially stating that only 1.3% ($2.7/ $202= 1.3%) of these will end up as losses.

I ask you, is there an asset in the history of the planet (let alone one that is totally unregulated or experiencing ANY kind of oversight) in which only 1.3% is of poor quality? Consider that credit card defaults now stand at 10%. Heck, even 2.4% of PRIME mortgages are in default (and both of those debt markets are actually audited!)

To return to “Joe America,” if Joe America is seeing a large evaporation in his net worth due to a decline in asset prices, then American Banks are seeing an even larger, far more rapid evaporation occurring to THEIR net worth AKA their balance sheets.

In this light, the Fed’s $13 trillion in off balance sheet lending should be seen as nothing more than an attempt to help banks recapitalize without public stating that the banks are insolvent: banks are using the Fed’s money to pay of debt, raise equity (by issuing shares which dilute current shareholders’ positions), and lower their leverage.

It’s also clear that the Fed’s efforts, as dramatic as they have been, are totally inadequate in dealing with the amount of wealth that is evaporating. $13 trillion comes to less than 10% of the notional value of the derivatives on commercial US bank’s balance sheets So suffice to say inflation isn’t just around the corner from a money printing perspective.

Bottomline: in order for inflation to hit, employment needs to rise and banks need to start lending. This WILL happen eventually (my estimate is 2011 or 2012). And it very likely will put the US right back into a recession again.

So from an employment perspective, inflation is not a possibility right now. It remains a huge future threat (indeed it will probably push us back into a recession when this recession ends and banks start lending again), but right now, we are in a wage and asset price-based deflationary environment.

But what about commodities?

Many commentators have made a big deal about the sharp rise in industrial commodities, particularly oil clearing $70. They take theses moves to mean inflation is already here.

They’re wrong.

For starters, a rally in commodities does not signal inflation. Inflation occurs when a currency is debased and loses value. And the US dollar is stronger today than it was before the financial crisis truly erupted with Bear Stearns' collapse (Feb. 2008).

Instead, commodities are rallying for two reasons:

1) China Stockpiling
2) Financial Speculation (especially from China)

Once commodities bottomed out in February, China began stockpiling with a vengeance: copper imports hit a 329,000 tons in February, only to be eclipsed by a new record of 375,000 tons in March. The Chinese also began acquiring commodities via acquisitions of public and private firms:

- Feb.10, 2009: China buys Oz Minerals, the world's second largest zinc miner for $1.7 billion
- Feb. 12, 2009: China buys $20 billion worth of Rio Tinto, one of the three largest iron ore producers, giving it the potential to raise its stake to 19%.
- Feb. 24. 2009: China buys 16% of Fortescue Metals an Australian iron ore company.
- April 1, 2009 China buys $46 million worth of Terramin Australia's lead and zinc supplies in Algeria.
- April 15, 2009: China buy 51% of Ontario's Liberty Mines: a nickel producer.

With investor sentiment at multi-year lows, the news that “China is buying,” sparked a sharp rally in commodities and numerous claims that the Chinese economy was back on track. In a matter of months, oil nearly doubled, copper rose 60%, zinc rose 40%, etc.

Let me be blunt: China is THE commodity story in the markets. The world economy is in a recession. Deflation is occurring in both the US and Japan: the two largest world economies. China is an export economy that relies on the US to continue its growth. Anyone claiming China can prop itself up with Stimulus or internal consumer spending is off their rocker due to the fact that:

1) Chinese banks have NOT marked down their debt yet
2) China’s unemployment rate is nearing a 30-year high (bear in mind this doesn’t count laborers or non-urban workers).
3) China is already experiencing civil unrest due to economic issues
4) Chinese real estate is in a bubble and prepared to collapse (in some cases literally as the recent collapse of an apartment building reveals).

The Chinese government took a page out of the US’s playbook and has tried to stimulate its economy back on track despite the fact that their largest customer (the US) is experiencing a Depression AND a seismic shift in consumer behavior. With 30 years of economic growth under their belts, Chinese officials are going to do everything they can to keep the “China story” alive. But they cannot without US and European consumers buying.

Thus, the Chinese stockpiling of commodities has been perhaps the biggest “head-fake” in history. And it will end very, very badly in the commodities markets. In fact it already is…

Australia’s *Sydney Morning Herald* noted yesterday that that several Beijing officials and advisers have announced an end to "strategic" stockpiling and massive iron ore contracts likely to expire today. *"We don't anticipate that the country will continue to build its reserves," said Yu Dongming, the head of the metallurgical department of the National Development and Reform Commission.*

Take China away and the commodities markets will collapse. I’m talking about a 20-30% drop across the board. Well, China has stopped stockpiling… so it’s only a matter of time.

If all of this sounds strangely familiar, it’s not your imagination. The commodity story for 2009 has mirrored last year’s to perfection: a 1Q bottom, China starts stockpiling, commodities rally, China stops stockpiling in July… and commodities collapse in July/August.

And we’re heading for the exact same pattern this year.

The other reason commodities have rallied has to do with financial speculation. Last year oil rallied from $70 a barrel to $140 while demand FELL and supplies ROSE. Indeed, today oil speculation via the oil ETFs account for 50% of all oil futures trading. And rampant lending from Chinese banks has fueled a speculative boom in commodities in general.

Chinese banks (which have yet to write down the bad debt on their books) have lent out more than $1 trillion since December 2008. Much of this money has flowed into the financial markets, particularly commodities as manufacturers used ETFs and other plays to hedge their future costs. This will have disastrous consequence for the world economy: producers already seeing a drop in sales are now facing rising costs.

Stockpiling and speculation can prop a market up for some time, but eventually both give way to economic fundamentals. Remember in 2008 when oil cleared $100 and was allegedly on its way to $200? Remember when political instability in the Middle East and Russia allegedly resulted in commodity prices erupting high? Remember when "inflation" was going to push commodities and gold through the roof?

Instead we got the mother of all sucker punches: a 50-80% collapse in commodities across the board. This time around (2009) the collapse will not be as dramatic, but I expect we will see a major correction in commodities some time in the next 3-4 weeks. By major I mean oil falling back to $50 while the industrial metals plunge 20-30%.

There will be some truly fantastic shorting opportunities in the near future, but it's still too early. So for now, simply put oil and the industrials on your radar.

To recap, the most essential trends in the financial markets today are:

1) The market is currently experiencing a historic rig in which key insiders are fleecing the public, propping up stocks to kill the shorts, and front-running major news releases by the Fed
2) Unemployment continues to be the MAJOR issue for the US. We are now officially a Welfare State. And no one has addressed this or come up with any viable solution.
3) The overall economic theme in the US is deflation now, inflation later (the latter is null and void until banks start lending)
4) A new, permanent shift in US consumer trends is underway. The age of consumerism is over, the age of frugality is in.
5) Stocks and commodities are both poised for a major collapse. Stocks will roll over in the next 1-2 weeks, commodities in the next 3-4.

Our portfolio is positioned perfectly for all of these events. I would actually like to open some additional shorts in both equities and commodities, but given the nature of the market rigging going on, I think it's a little early. So this week we're not establishing any new positions. However, very shortly we'll have some spectacular opportunities. And our current portfolio is well suited for this market, despite the temporary losses we've incurred due to outright manipulation by Wall Street and the Fed.

Portfolio Review

Gold (GLD) is the ultimate currency. It performs well during both inflation and deflation. And it's also the only real catastrophe insurance. According to historic trends, gold should begin its next leg up (the one producing the most gains) in Sept/Oct of this year. So we're holding on for now.

UltraShort Financials ProShares (SKF) Admittedly we were early on this one. The Financials ETF (of which SKF performs 2X the inverse performance) has begun a squeeze between its 21-DMA and its 55-DMA. These kinds of patterns typically precede major breakouts (or breakdowns) as the pressure builds with the stock trading in a tighter and tighter range.

To me, it seems highly likely that the breakout move for Financials will be to the downside. The Financials ETF has failed to best its early May high and in fact has staged a series of lower highs and lower lows in June. It's also been rejected two times on the upside by the 21-DMA. Given the worsening fundamentals for financials (we're cleared 40 busted banks this year alone) I think we're poised to see a tremendous drop in the Financials ETF.

Again, we were early, but I am still extremely confident of this trade. Hang in there for now. A big move is brewing. And both fundamentals and technicals indicate it should go our way. When this happens, **SKF**, will erupt higher.

Dollar Bull 2.5X Fund (DXDBX): Despite all the mania about inflation and hyperinflation, the dollar has managed to remain a full 10% above its May 2008 lows. It has also remained well above its recent June 2009. These are both very strong signs despite the fact everyone (including Alan Greenspan) is so worried about the dollar collapsing. Indeed, does the below indicate an imminent collapse?

I think the dollar has entered a range bound trading pattern and will remain in this for the next several weeks. Once commodities roll over as the China story ends we should see a strong spike similar to the one occurring in July 2008. Personally, I think we'll see the dollar index rally to at least 84 if not 86. We'll pocket double digit gains when it does.

So sit right for now. The commodities rally is showing serious signs of weakness. It's only a matter of time before this final obstacle to a dollar rally occurs.

Short Sell of the Templeton Russia Fund (TRF): Russia's economic picture continues to worsen. The Russian economy is contracting for the first time in ten years with an expected drop of 7.9% in GDP this year alone. The World Bank has issued a report claiming Russia will not return to pre-Crisis levels until 2012.

The Russia story is based on oil, plain and simple. And the Russian stock market is essentially oil with leverage. Russia needs oil higher for it to recover in any real way. And Russian politicians are not above verbal intervention, trashing the dollar in hopes of pushing black gold's price higher.

However, remove the rise in oil prices and you've got a recipe for a Russian collapse (see the chart below):

The dark line is the oil ETF, the light line is the Templeton Russia Fund (TRF). As you can see, TRF mirrors oil perfectly. The only difference is that it's risen far FAR higher in the recent rally. Push oil down to say $50, and TRF should collapse 30%+.

I've outlined why I think oil and other commodities are ripe for a major correction already in this issue. We've established out position. Now it's just a matter of waiting. This year's historic market rig will not last forever (just as it failed last year). And shorting TRF gives us a fantastic opportunity to profit from the coming collapse in Russian equities. So just sit tight for now.

I want to thank you again for subscribing to *Private Wealth Advisory*. These are truly bizarre times… times of outright market manipulation, fleecing of individual investors, abandonment of fundamental analysis, and historic rigging in the financial markets. But ultimately, no rig lasts forever, no matter how much money you throw at it. This time around will be no different.

Again, I forecast a serious correction in stocks within two weeks and a serious correction in commodities within four. We're prepared for both eventualities. And despite the recent dip in our open positions, our portfolio remains up 8% for the year, outperforming the S&P 500 by a full 9%.

Good Investing,

Graham Summers

OPEN POSITIONS					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Gold ETF	GLD	5/6/09	$89.54	$92.35	3%
UltraShort Financials	SKF	6/3/09	$42.18	$41.89	-1%
Dollar Bull 2.5X Fund	DXDBX	6/17/09	$31.76	$31.03	-1%
Templeton Russia Fund (SHORT)	TRF	6/24/09	$16.39	$17.22	-5%

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	Close 6/22/09	$45.45	12%
Rogers Agri ETN	RJA	5/6/09	$7.62	At Open 6/25/09	$7.33	-4%
				Portfolio Average	**8%**	
				S&P 500	**-1%**	