PRIVATE WEALTH ADVISORY

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They're Slowly Awakening

Today, we are witnessing the investment world's slow awakening to the fact that the monetary actions taken by the world's Central Banks have not in fact solved the issues leading up to the 2008 Crisis.

In point of fact, the Central Banks' actions have exacerbated pre-existing problems (excessive leverage) while simultaneously creating *new* problems (inflation).

This slow awakening has taken much longer than I would have expected, but with tens of thousands of careers on the line (financial professionals) as well as tens of trillions of dollars in portfolios at risk, the vast majority of professional market participants were highly incentivized *not* to realize these issues.

However, at this point, it is becoming clear that not only are financial professionals slowly realizing that 2008 was actually "the warm up," but that Central Banks themselves are aware that they've:

1) Failed to solve the issues leading up to 2008.
2) Created other unforeseen problems.

Indeed, this process of realization first began in the US where we had signs as far back as April 2011 that the Federal Reserve was aware that QE (AKA monetization of US debt) was less "attractive" as a policy (read: not such a good idea).

The vast majority of the media and Wall Street analysts failed to recognize this, though Bernanke himself admitted it in public:

> Q. Since both housing and unemployment have not recovered sufficiently, why are you not instantly embarking on QE3? — Michael A. Kamperman, Waco, Tex.

Short-Term Trends
-Europe is on the brink again.
-Deflation is rearing its head.

Intermediate Trends
-Very very ugly charts indicating European collapse in May-June
-China economic deterioration to affect commodities and global GDP
-Downward revisions coming from BLS regarding employment and GDP

Long-Term Trends
- -Global debt implosion.
- -Markets to go to new lows either nominally or in terms of purchasing power depending on whether we get hyperinflation or severe defltation
- -Trade wars and very likely REAL warfare

> **Mr. Bernanke:** "Going forward, we'll have to continue to make judgments about whether additional steps are warranted, but as we do so, **we have to keep in mind that we do have a dual mandate, that we do have to worry about both the rate of growth but also the inflation rate…**
>
> "**The trade-offs are getting — are getting less attractive at this point**. Inflation has gotten higher. Inflation expectations are a bit higher. It's not clear that we can get substantial improvements in payrolls without some additional inflation risk. **And in my view, if we're going to have success in creating a long-run, sustainable recovery with lots of job growth, we've got to keep inflation under control**. So we've got to look at both of those — both parts of the mandate as we — as we choose policy"
>
> http://economix.blogs.nytimes.com/2011/04/28/how-bernanke-answered-your-questions/

This admission marked the beginning of a process through which the US Federal shifted its policies from those of aggressive monetization to those of verbal or symbolic intervention.

I addressed this at length in the last issue of ***Private Wealth Advisory***. But the main issue is that the Fed backed off from rampant monetization and began to simply issue verbal statements that it would ease if needed, thereby getting the same impact (boosting stock prices) without actually having to monetize debt/ print more money.

Indeed, the only monetary change the Fed has made in nearly a year was the launch of Operation Twist 2 in October 2011. However, even this policy was more about meeting immediate debt issuance needs in the US rather than printing money to prop up the market.

Operation Twist 2 was a policy through which the Fed would sell its short-term Treasury holdings and use the proceeds to buy longer-term Treasuries. The purpose of this policy was two fold:

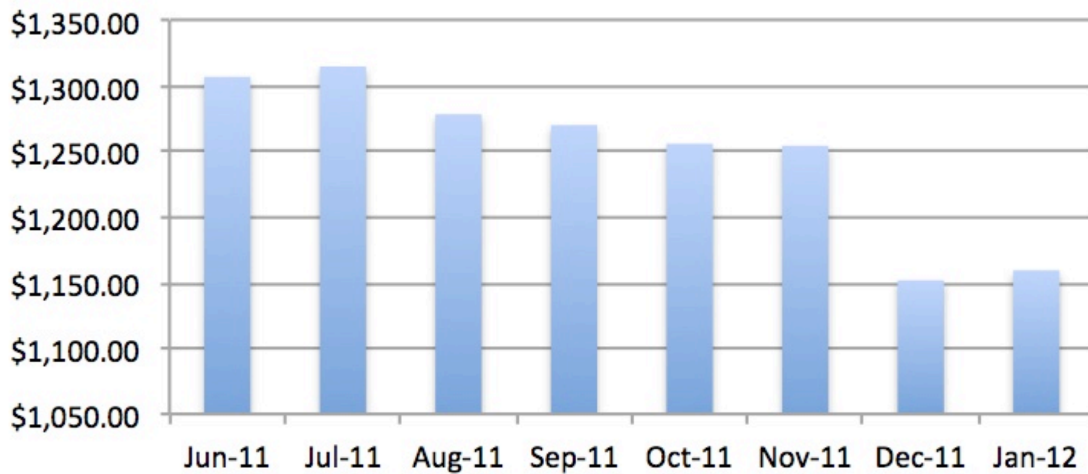
1) To make up for the lack of foreign demand in long-term Treasuries.
2) To provide capital to banks by permitting them to unload their long-term Treasury holdings in exchange for new cash.

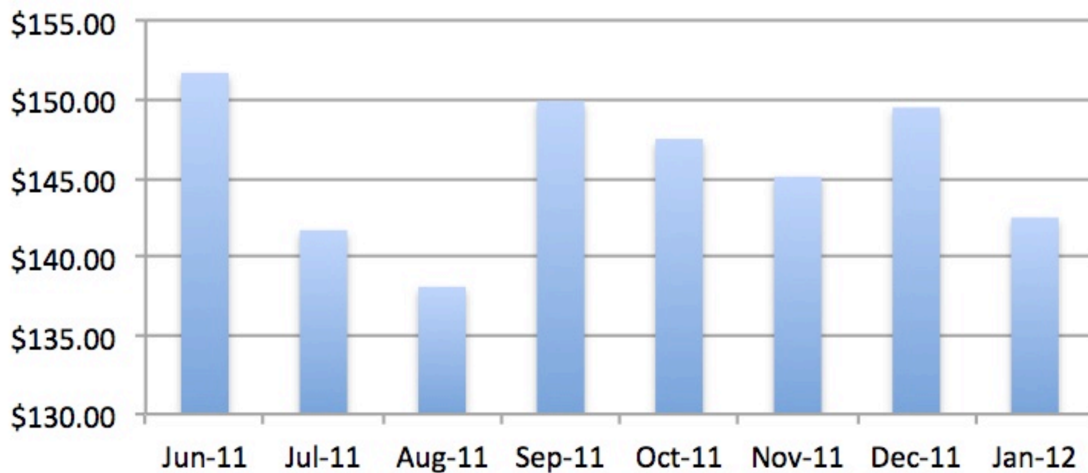
Regarding #1, the Fed is now obviously aware that the policies it has pursued in tandem with the Federal Government, namely maintaining low interest rates while running massive deficits and increasing the Federal Debt to the tune of $100-200 billion per month, have severely damaged the US Treasury market.

This is only common sense. By running Debt to GDP and Deficit to GDP ratios that are on par with the European PIIGS, the US has made it clear that those investors

who lend to it for the long-term (20+ years) are likely going to experience a haircut or bond restructuring much as Greece bondholders recently experienced.

As a result of this, foreigners have been dumping longer-term Treasuries. In particular, China and Russia have been lowering their exposure to US debt (see below).





The media and blogosphere have made a huge deal about this, implying that these moves indicate China and Russia will be dropping their holdings (and the US Dollar) completely. This analysis is naïve.

For starters, both China and Russia have substantial exposure to Europe from an economics standpoint. The EU taken as a whole is both China and Russia's single largest trade partners. So it makes sense that both countries have been diverting investments and funds away from Treasuries to the EU as they attempt to prop it up.

Secondly, I want to dispel the notion that China and Russia are the economic powerhouses everyone believes them to be. I will be addressing this further in later issues of ***Private Wealth Advisory*** but for now I simply wish to contend the idea that China and Russia are capable of dumping the US Dollar for trade purposes.

Rather than viewing these countries as superpowers, I would argue that they are in fact totalitarian regimes that are *barely* maintaining control over their respective populations. These are not free, vibrant economies based on small business growth and Democratic Capitalism; they are Centrally controlled economies in which a tremendous amount of the economy and wealth is concentrated in the hands of a very select few.

I realize this flies in the face of what 99% of analysts claim. I also realize that the US itself has begun to resemble such economies in some regards (wealth disparity for example). However, the fact remains that the US, while engaging in similar economic policies and witnessing a similar concentration of wealth, remains ultimately a free and open economy in which small business growth and true capitalism are possible.

Moreover, I believe that the US will differ dramatically from both China and Russia in terms of how it recovers from the coming global contraction. Even a cursory review of US history shows that this country has been in a continual state of collapse and renewal since its inception. And yet, it has grown from a loose band of colonies to the single most powerful economy in the world. *That* is the true power of capitalism in a free country.

I'm sure this might come as a shock to many as I am often thought to be "doom and gloom," based on the fact that I foresee a large-scale Crisis and economic contraction coming in the future. However, I believe the US will recover much more quickly from this Crisis that either China or Russia due to the fact that the US's economy is unbelievably dynamic, based on innovation and entrepreneurialism.

In contrast, the wealth and capital accumulated in China and Russia have largely been the result of back-room deals in which a small minority were granted access to formerly state-controlled assets and entities at bargain basement prizes in return for political alliance with the controlling parties. Very few businesses in these countries started out as small entrepreneurial efforts that then grew into empires. They are not capitalist, at least not in the sense that the US has been from day one.

Having said that, I do not believe that China or Russia are in any position to dump the US dollar, at least not in the near-term. The US Dollar *may* one day no longer be the reserve currency of the world. But that day is years and possibly decades out. And the notion that China or Russia could just dump the Dollar and move around the US in terms of trade is unbelievably naïve and greatly underestimates the importance of the US to the global economy.

In this context, I do not believe China and Russia's recent dumping of Treasuries to indicate that these countries are moving away from the US. Rather I view them as both countries diverting cash away from the US and into Europe in an attempt to prop the EU up.

I also view these moves to indicate that both China and Russia are in fact facing problems at home that require their attention. Reports out of both countries show political instability increasing amidst mass protests. Both countries will be diverting cash towards dealing with these issues through various stimulus schemes, bribes, bailouts, etc.

In short: I do not believe that China or Russia are in fact dumping Treasuries or the US Dollar because they believe the US is doomed. Rather I believe these moves to indicate both countries are facing larger, more pressing issues that require their capital at the moment.

Back to Operation Twist 2 and the Fed.

Because of a lack of foreign interest in long-term Treasuries, the Fed decided to step in to pick up the slack. As a result of this, the US Federal Reserve has accounted for 91% of all new debt issuance in the 20+years bracket. Put another way, the US Federal Reserve is now effectively the long-end of the US debt market.

Operations Twist 2 has also allowed US commercial banks to unload their long-term Treasury holdings in exchange for new capital: something most of the Primary Dealers are in dire need of. This in turn helps to explain why the US stock market has advanced despite the fact that retail investors have been pulling out of the market in droves.

Put another way, the markets have been ramped higher by more juice from the Fed (and corporate buybacks). However, the fact remains that this juice has come from the Fed reallocating its current portfolio holdings, NOT printing more money outright to monetize US debt via QE.

So while the media and 99% of analysts believe the Fed is and can continue to act aggressively to prop up the markets, the fact is that the Fed has been reining in its monetary stimulus over the last nine months, largely relying on verbal intervention from Fed Presidents to push stocks higher.

We at Phoenix Capital Research have known this for some time. But the general public and financial media are only just starting to realize that the Fed, in some ways, is at the end of its rope in terms of monetary intervention. This has become increasingly clear in the Fed FOMC statements.

Consider the latest FOMC statement released yesterday…

> ## Fed Signals No Need for More Easing Unless Growth Falters
>
> **The Federal Reserve is holding off on increasing monetary accommodation unless the U.S. economic expansion falters or prices rise at a rate slower than its 2 percent target.**
>
> "A couple of members indicated that the initiation of additional stimulus could become necessary if the economy lost momentum or if inflation seemed likely to remain below" 2 percent, according to minutes of their March 13 meeting released today in Washington. That contrasts with the assessment at the FOMC's January meeting in which some Fed officials saw current conditions warranting additional action "before long."
>
> http://www.bloomberg.com/news/2012-04-03/fomc-saw-no-need-of-new-easing-unless-growth-slips-minutes-show.html

Ignore the verbal obfuscation here. The Fed *knows* that inflation is higher than 2%. It also *knows* that US growth is faltering. The above announcement is the Fed essentially admitting its hands are tied regarding more easing due to:

- Gas being at $4 and food prices not far from record highs.
- This being an election year and the Fed now politically toxic.
- Growing public outrage over the Fed's actions (secret loans, etc.) in the past.

Again, we are in a process of slow awakening to the fact that the Fed has not solved the problems that caused 2008. Instead, the Fed has exacerbated these problems (excess leverage) and created new problems in the process (inflation).

Fortunately for the Fed, the European Central Bank has picked up the intervention slack since the Fed began pulling back in mid-2011. Indeed, between July 2011 and today, the ECB has expanded its balance sheet by an incredible $1+ trillion: more than the Fed's QE 2 and QE lite combined (and in just a nine month period).

The two largest interventions were the ECB's LTRO 1 and LTRO 2, which saw the ECB handing out $645 billion and $712 billion to 523 and 800 banks respectively.

As a result of this, the ECB's balance sheet exploded to nearly $4 trillion in size, larger than the GDPs of Germany, France, or the UK.

Country	GDP
European Union	**$16 trillion**
United States of America	$14.5 trillion
China	$5.8 trillion
Japan	$5.4 trillion
European Central Bank	**$3.8 trillion**
Germany	$3.2 trillion
US Federal Reserve	**$2.8 trillion**
France	$2.5 trillion
United Kingdom	$2.2 trillion

This rapid and extreme expansion of the ECB's balance sheet (again it was greater than QE lite and QE2 combined… in nine months) indicates the *severity* of the banking crisis in Europe. You don't rush this much money out the door this fast unless you're facing something very, very bad.

This rapid expansion has also resulted in the ECB obtaining a similar political toxicity to that of the US Federal Reserve. Indeed, those European banks that participated in the LTRO schemes have found their Credit Default Swaps exploding relative to their non-LTRO participating counterparts.

The reason for this is obvious: any bank that participated in either LTRO implicitly announced that it was in dire need of capital. As a result of this the markets have stigmatized those banks that participated in the schemes, thereby:

1) Diminishing the impact of the ECB's moves.
2) Indicating that the ECB is now politically toxic in that those EU financial institutions that rely on it for help are punished by the markets.

There is an additional, political angle to the ECB's moves that we must consider.

As I've noted in previous issues of ***Private Wealth Advisory*** there is a growing tension between the ECB, the central bank backstop for Europe, and Germany, the de facto sovereign EU backstop.

In brief, the ECB has wanted to monetize and bailout needy EU members aggressively while the inflation-phobic Germany has wanted to impose fiscal constraints as well as austerity measures (essentially fiscal sovereignty) on needy EU members in exchange for bailout funds.

The reason for this difference in attitudes is political in nature: Germany has already experienced the consequence of rampant monetization (Weimar). Moreover, Germany, sees this as an opportunity to further extend its reach and political clout in Europe. So it's used every chance it can to advance a German-lead "political union" (German Finance Minister Wolfgang Schauble's own choice of words).

In light of this, Germany has been willing to stomach the ECB's moves because it does not want:

1) To be seen as the cause of a Euro breakup
2) To kick off a banking collapse via #1

However, things have recently taken a sharp turn for the worse in ECB/ German relations. The reason? The ECB first swapped out its Greek debt exposure for bonds that would not take a haircut on the second Greek bailout… then announced that *any* of the losses on its PIIGS portfolio (over a quarter of its $3.8 billion balance sheet) would be rolled back onto national Central Bank shoulders (aka Germany's Bundesbank).

Germany was none too pleased about this, and has taken steps to rein in the ECB's policies:

Germany launches strategy to counter ECB largesse

The plans have major implications for monetary union, dashing hopes in Southern Europe that Germany might accept a few years of mini-boom at home to help lift the whole system off the reefs.

Andreas Dombret, a key board member of the Bundesbank, **said the body would be given powers to check "excessive credit growth" and impose "maximum leverage ratios" to nip economic overheating in the bud.**

The Bundesbank will be able to impose "counter-cyclical capital buffers" on lenders, and use "macro-prudential haircuts" in the securities markets. It is understood that the menu of new tools will include limits on the loan-to-value on mortgages along the lines of those used in Hong Kong and other Asian states.

The new framework - introduced by German government in a draft law this week - is partly inspired by the Bank of England's new system but it also has a German twist…

German house prices rose 5.6pc last year after a decade of stagnation. Officials in Frankfurt are watching the property data closely, fearing that Germany may succumb to the sort of housing bubble that engulfed the Club Med bloc in the early years of EMU.

"The Bundesbank does not want to be blamed for making the same mistakes as central banks in Ireland and Spain where they did not address asset bubbles early enough," said Bernhard Speyer from Deutsche Bank.

The German authorities are in effect preparing a form of quasi-monetary tightening to offset ECB largesse…

"If the eurozone is to adjust, southern countries must be able to run trade surpluses, and that means somebody else must run deficits," said Dr Speyer.

"**One way to do that is to allow higher inflation in Germany but I don't see any willingness in the German government to tolerate that, or to accept a current account deficit.**

http://www.telegraph.co.uk/finance/financialcrisis/9174661/Germany-launches-strategy-to-counter-ECB-largesse.html

The ECB recognizes a warning shot when it sees one. Indeed, ECB President Mario Draghi knows that if inflation rises in Germany, the latter will take very serious actions, including potentially threatening to walk out of the Euro:

Draghi Says Inflation Risks Prevail as Economy Stabilizes

European Central Bank President Mario Draghi said policy makers are prepared to act against inflation threats if needed, while assuring investors that the ECB doesn't plan to withdraw emergency stimulus any time soon.

"All the necessary tools are available to address upside risks to price stability in a firm and timely manner," Draghi told reporters in Frankfurt after the ECB held its benchmark rate at a record low of 1 percent today. At the same time, it's premature to talk about the ECB's exit strategy, Draghi said, adding that the economic outlook is subject to downside risks and inflation will remain contained in the medium term.

The ECB is balancing the threat of inflation in Germany, Europe's largest economy, against the need to fight the sovereign debt crisis. **While nations from Greece to Spain are battling recessions and record unemployment,**

workers in Germany are winning some of the biggest pay increases in 20 years.

[ECB President Mario Draghi] **declined to comment on recent wage settlements in Germany, where 2 million public service workers are set for a 6.3 percent raise over two years, according to the Ver.di union. It would be the biggest increase negotiated by the union since 1992**. IG Metall, Europe's biggest labor union with about 3.6 million workers, is demanding 6.5 percent more pay.

http://www.bloomberg.com/news/2012-04-04/draghi-says-inflation-risks-prevail-as-economy-stabilizes.html

And so the ECB, like the Fed, has found its hands tied: if it continues to monetize aggressively, inflation will surge and Germany will either leave the Euro or at the very least make life very, very difficult for the ECB and those EU members asking for bailouts.

Against this backdrop, it's quite clear that the EU's banking system remains under extreme duress. Case in point, European financials have in fact wiped out all of the gains produced by LTRO 2 in just one month's time:

So… if the ECB *doesn't* continue to supply the juice, the European banking system could easily topple. And all of this is happening a time when REAL problems (namely Spain and Italy) are coming to the forefront.

Last issue I showed some horrifying charts of Spain's and Italy's stock markets. Well, things have gotten much worse even quicker than I anticipated:

As you can see, the Spanish Ibex has *just* broken *THE* trendline of the last 15 years. This is HUGE. If the Ibex does not reclaim this line quickly and with conviction, then we're going to see a REAL bear market starting in Europe.

For the sake of US-based investors who cannot short the Ibex, here's the Spain ETF (EWP). The chart is not as clean as the Ibex itself, but you get a similar picture:

Just looking at this chart, I would anticipate a break below the trendline followed by a re-test of it from below. If the re-test *fails* I would suggest shorting EWP as the downside target for the collapse would be at least 20 if not 15.

So we're in watch and wait mode here. If the breakdown I'm worried about *does* hit, we're in for a very dark time in the financial markets. Spain already sports unemployment north of 20%. And it *just* started its first serious austerity measures last week. The Ibex is already telling us what this means for the Spanish economy: COLLAPSE.

We're getting other serious warnings of collapse from Italy, which is now well on its way towards confirming the massive Head and Shoulders pattern I warned about last issue:

The close-up here shows that once we take out $12.50 is when things are in *real* danger:

Even safe haven Switzerland has also been rejected at resistance as I forecast and looks to be on its way to confirming the Head & Shoulders I noted there.

The same goes for France: a sharp rejection at resistance followed by a nose-dive towards the neckline:

Even the German DAX is looking downright bearish:

My point is this: Europe, particularly Spain, is in trouble again. And the ECB has already backed itself into a corner politically by acting so aggressively in the last nine months.

Think about that for a moment. The ECB spent over $1 trillion in just nine months and Europe is once again on the brink. And this is happening at a time when:

1) France, Greece, and Ireland are all fast approaching elections/ referendums that could go against the ECB's moves and Germany's austerity measures
2) Germany has just fired a *major* warning shot against more monetization from the ECB
3) The ECB's balance sheet is now bloated with PIIGS debt rendering its own solvency questionable

In simple terms, Europe is a disaster just waiting to happen. I thought we'd see things get ugly in May-June, but by the look of things it might come even sooner than that.

We've already profited beautifully from this with our French bank shorts and by shorting the European Financials ETF (EUFN). We'll likely revisit these positions shortly depending on how things play out.

I'm watching the markets closely and will issue alerts as needed. We may in fact be opening our Crisis Trades in the next two weeks if the breakdown accelerates. I'm also searching around for other undervalued asset plays similar to Centamin Mining (CEE.TO).

We're now down 50% on Centamin. I realize a 50% paper loss is hard to stomach, but the value of this company and its resources have not changed in any way. We're in a situation in which we can either let volatility hurt us or help us. We're going to opt for the latter by adding to our Centamin position once it bottoms out, thereby averaging in a better buy price (much as we did for several of our European bank shorts which are not moving towards the black).

Indeed, we closed out Santander (STD) today for a 6% gain. By carefully adding to our position and waiting, this paper loss turned into a gain. We'll do the same with Centamin as well as our current paper losses.

On a final note, I want to stress that while the coming collapse will produce a lot of pain for a lot of people, it will *also* create some extraordinary buying opportunities in many high quality asset plays. Years from now, as population demographics and scarcity of resources make commodity and natural resource prices skyrocket, people will marvel at the bargain basement prices many junior producers traded at during the fall-out.

Indeed, during the 2008 Crash, many gold *producers* were trading *below* their cash levels (you got the gold, mines, machinery, etc for free). I expect we'll see a similar situation in the coming collapse. And I fully intend to have us profit from it.

This concludes this week's issue of ***Private Wealth Advisory***.

As always, I, and the rest of us at Phoenix Capital Research, thank you for your business.

Best Regards,

Graham Summers

Investment Watchlist: Trades we've yet to open.

UltraShort Emerging Markets ETF	EEV
UltraShort Brazil ETF	BZQ
UltraShort Russell 2000	TWM
UltraShort Nasdaq	QQQ
UltraShort Real Estate	SRS
UltraShort Financial	SKF
Apple (short)	AAPL
National Bank of Greece (short)	NBG

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	$1,621.00	45%
Silver bullion	N/A	3/17/10	$17.50	$31.36	79%
Centamin Mining	CEE.TO	5/25/11	$2.01	$0.99	-50%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$22.13	2%
Rydex Strengthening Dollar 2x Strategy	RYSDX	12/14/11	$14.39	$13.72	-5%
UltraShort Euro	EUO	9/21/11	$19.13	$19.55	-1%
UltraShort China*	FXP	11/2/11	$32.64	$26.09	-7%
UltraShort Materials*	SMN	11/2/11	$20.23	$15.33	-12%
Deutsche Bank (short)*	DB	12/14/11	$35.33	$46.36	-14%
HSBC (short)*	HBC	12/14/11	$37.07	$44.35	-10%
Barclays (short)*	BCS	12/14/11	$10.65	$14.06	-12%
UltraShort Gold ETF	GLL	12/14/11	$19.76	$17.79	-10%

*** Opened 12/14/11 at 11:13AM, averaged in second prices on 1/27/12**

RECENTLY CLOSED POSITIONS

Company	Symbol	Buy Date	Buy Price	Sell Price	Gain/ Loss
MSCI Euro Financial Fund (SHORT)*	EUFN	3/21/12	$18.37	**$17.48**	**5%**
BNP Paribas (SHORT)*	BNPQY.PK	3/21/12	$24.99	**$23.70**	**5%**
Societe General (Short)*	SCGLY.PK	3/21/12	$6.34	**$5.83**	**9%**
Credit Agricole (Short)*	CRARY.PK	3/21/12	$3.27	**$3.08**	**6%**
Societe General (Short)**	SCGLY.PK	3/21/12	$6.34	**$5.64**	**12%**
Credit Agricole (Short)**	CRARY.PK	3/21/12	$3.27	**$2.97**	**10%**
MSCI Euro Financial Fund (Short)***	EUFN	3/21/12	$18.37	**$17.34**	**6%**
BNP Paribas (SHORT)***	BNPQY.PK	3/21/12	$24.99	**$22.78**	**10%**
Santander +	STD	12/14/11	$7.63	**$7.21**	**6%**

* Sold half on 3/29/12 (10:50AM)
** Sold remaining positions on 4/2/12 (11:11AM)
*** Sold remaining position on 4/3/12 (3:39PM)
+ Buy price is the average of an initial buy of $7.11 on 12/14/11 and a double down of $8.15 on 1/27/12. This position was also sold on 4/4/12 (10:01AM)