MONEY, MARKETS & MILESTONES

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"Inflation is when you pay fifteen dollars for the ten-dollar haircut

you used to get for five dollars when you had hair."

– Sam Ewing

"We can't solve problems by using the same kind of

thinking as we used when we created them."

– Albert Einstein

"Nothing defines humans better than their willingness to do

irrational things in the pursuit of phenomenally unlikely payoffs.

This is the principle behind lotteries, dating, and religion."

– Scott Adams

"I'm spending a year dead for tax reasons."

– Douglas Adams

Introduction

We think it's fair to say that since 2007 we have witnessed economic destruction in epic proportions. Year 2009 was a complete disaster for the world economy. Just a couple of months ago many pundits were trumpeting that the world economy was heading for a recovery. Today their focus is on a possible double-dip recession.

We also think it's fair to ask if we ever had a meaningful recovery. Especially in the US, living standards are certainly lower than in 2007. Most jobs that are created are government jobs. It's not that government jobs are bad. It's just that they are terribly inefficient in creating value compared to private sector jobs. These newly employed government employees will no doubt vote for Mr. Obama in the next elections. After all, to be paid for doing nothing is always appealing.

To better see where we the economy is heading (and geopolitics as well, as they are deeply intertwined), it is once again meaningful to lean less towards economic and financial models and more on common sense. **In general, economics would greatly benefit from less mathematical models**

and more clear thinking. (Did they really think that real estate and commodity prices would keep on rising ad infinitum?) Before making any arguments as to whether zero interest rate policy is presently working or not, let us consider certain characteristics of V-shape and U-shape recoveries and then decide which one we are more likely have to have this time.

A typical V-shape recovery is swift and rigorous. The GDP takes some beating and after a couple of months comes back roaring again. The somewhat recent economic history since 1980s – for many people that is more than all the economic history they know! –has seen several examples of V-type recoveries. Typically, as interest rates are lowered capital expenditures perk up, firms hire more people and unemployment figures improve. People spend more as they have more money left after interest rate payments and taxes. The economy experiences a somewhat quick recovery. The fact that a central bank, such as the Federal Reserve, lowers interest rates has a great impact in a V-shaped recovery.

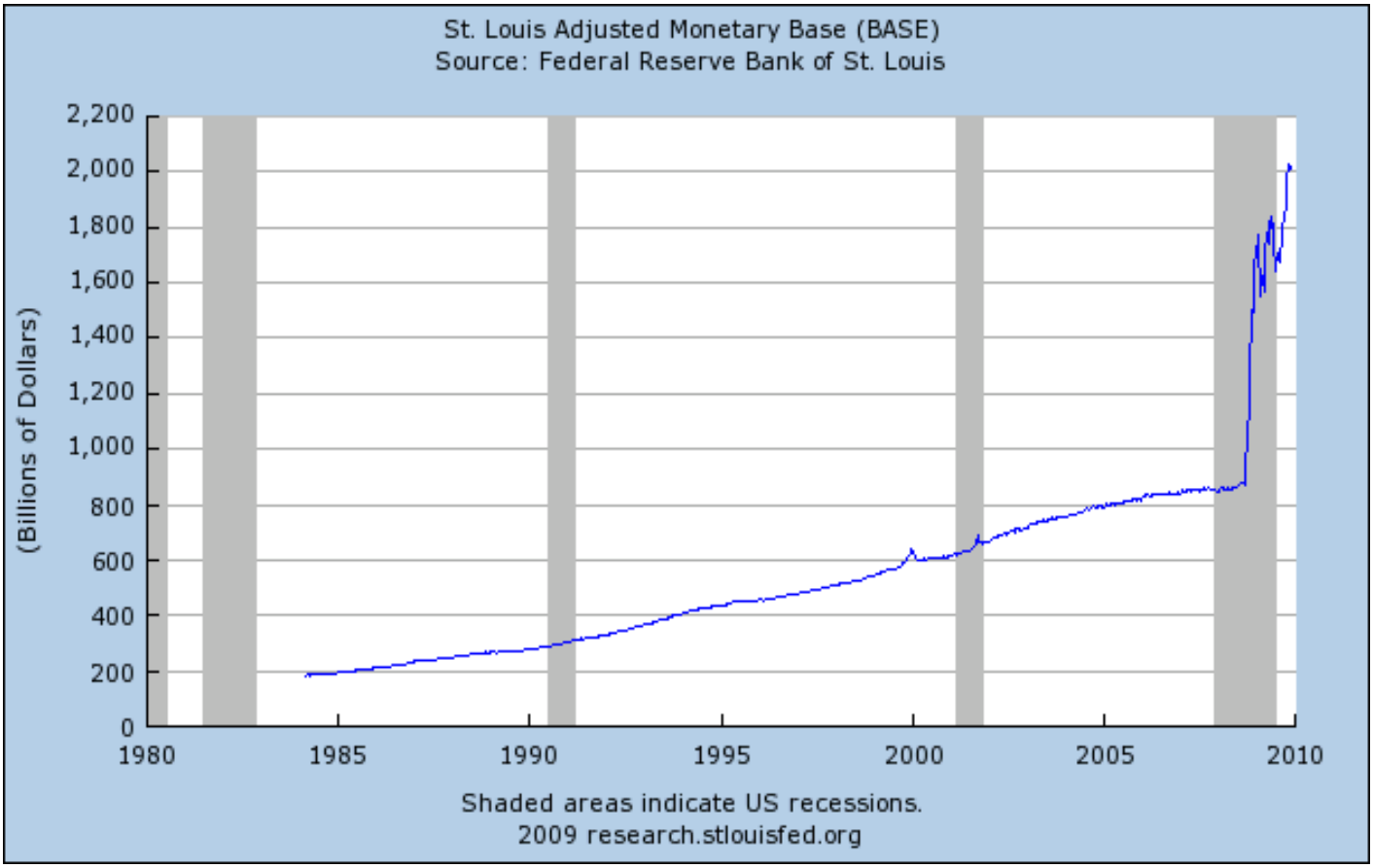
A typical U-shape recovery is different. It has its own characteristics. First, capital spending is very low. Currently, corporations are not short of capital. In fact, corporations have piles of cash, but they are sitting on it. We are now dealing with excessive supplies, which were driven by easy money and excessive credit growth. **We currently have excess supplies in just about every sector of the economy. They won't simply go away overnight even if the Fed keeps the Fed fund rate at zero**.

Second, people consume less goods and services. While the US consumer is now saving money (whereas in the recent years savings rate was negative – people spend more than they earned), it is noteworthy that their demand for goods and services is lagging behind from the boom years. This is because they are paying down their debt! Again, consumers will continue to pay down their colossal debt burdens despite the fact that Mr. Bernanke & Boys Co . keep the Fed fund rate at zero.

Thirdly, during a typical U-shaped recovery tightening lending standards often occur at some point. On June 30th 2004 the Fed began to slowly increase the Fed fund rate from 1% to 5.25% in August 17th 2007. However, what is really important is that no tightening in lending standards occurred! In fact, lending standards became more and more lax in the private sector until people with no money could get mortgages they could not afford. The system then became over-leveraged, not just the consumer but virtually every industry and every sector of the economy.

Finally, we should like to point out that asset markets can experience great volatility and even rise on a long U-shaped recovery. As we have discussed at length previously, the worse the economy becomes the more money is printed. **The fact that the economy is in shambles does not necessarily mean deflation.** Central bankers are keen money printers. All that newly-created liquidity will flow somewhere. What Mr. Bernanke – and Mr. Trichet at the European Central Bank as well although he will never admit that he too is a money-printing maniac – can decide is how much money is being printed. What they cannot decide is what that money is being spent on.

The problem in an over-leveraged and debt-addicted system is that as profitability and capital values decline, the ability to pay the interest on the existing debt and to rollover the existing debt upon maturity deteriorates badly. As a result, interest rate spreads blow out for any debt that isn't guaranteed by an AAA-rated government or at least by one that is perceived as such (notably the US). As interest rate spreads widen, the capital values of assets decline even more. Investors and lenders become more risk averse and are more concerned about repayment of capital than return on capital. A further tightening of lending standards inevitably follows.



It is important to understand that the current crisis did not unfold because of tightening in interest rates. This is a balance sheet recession, and it will take time to recover from it. Just as the consumer can recover from a job loss relatively quickly as he gets a new job, it will take longer time for him to recover from excessively large debt accumulation. This is because a lack of cash flow is easily covered again. A cancer in balance sheet takes longer to cure. It takes longer to pay down a mountain of debt than get a new job. In much the same way it takes a longer time for the economy to recover from a balance sheet recession than simply a temporary lack of demand for goods and services.

Presently, there is considerable excess capacity in the system, which creates over-supply. At the end of 2009 there was approximately 30% excess capacity in the economy. The demand side is hammered by the consumer that is paying down their debt, which they accumulated in the funny years. Even the governments are forced to reduce their spending as deficits have widened too far.

As a side note, we remember a relatively recent time when the US Government announced that deficits do not matter. **It makes us wonder why we have to pay taxes then.** Why not just borrow all the money? But this just shows how common sense escapes the academic who typically knows a lot more about monetary theory but too little about price signals in the real world.

So, considering that we have a weak demand and excess supply, our view is that the US economy will not recover meaningfully for quite some time. In addition, as we pointed out in the January 2010 issue of this report, there are very serious problems in the commercial real estate market. These problems could easily lead to a new contraction in the economy.

If the economy were to take a hammering again, the Federal Reserve is likely to shoot up their largest ever dose of fiscal stimulus. There are signs of this already as the Fed is weighing their options if the economy doesn't start to recover. In fact, Mr. Bernanke has recently finally blurted out that it is taking 5-6 years before the US economy recovers significantly. Some financial experts have pointed to the failure of Japan to reflate successfully in the 1990s as an example of government's inability to lift asset prices with monetary and fiscal measures. But had the

Japanese government sent each household a $5 million cheque you can be sure that prices in Japan would have risen – and the Japanese yen would have collapsed.

Suppose then that the US did what Mr. Bernanke has suggested, that the US would drop freshly printed US dollar bills from helicopters – say $1,000,000 trillion as a modest start. It is inconceivable that the prices of everything would not go through the roof and that the US dollar wouldn't collapse. Under this scenario, it is true that deficits would not matter anymore. There would also be no need to tax people, as a robust 1,000,000 % inflation rate would solve the problem. Now we understand perfectly well that there are many schools of economics that look at this problem with distinctively different views. Yours truly gives most respect to the Zimbabwean School of Economics which has obviously mentored Mr. Bernanke to master the science of currency destruction.

The upcoming fiscal deficits from pensions and medical care programs in the West cause us both worry and excitement. The US government, as all Western governments, has made promises is may not be able to keep. Just how big are those promises?

Dallas Federal Reserve President Richard Fisher comments: **"According to our calculations at the Dallas Fed, unfunded debt of Social Security and Medicare combined has now reached $104 trillion — trillion with a 'T' — in discounted present value. And while much attention in recent years has been devoted to Social Security, the lion's share of the total entitlement shortfall (nearly $90 trillion) actually comes from Medicare [emphasis added]."**

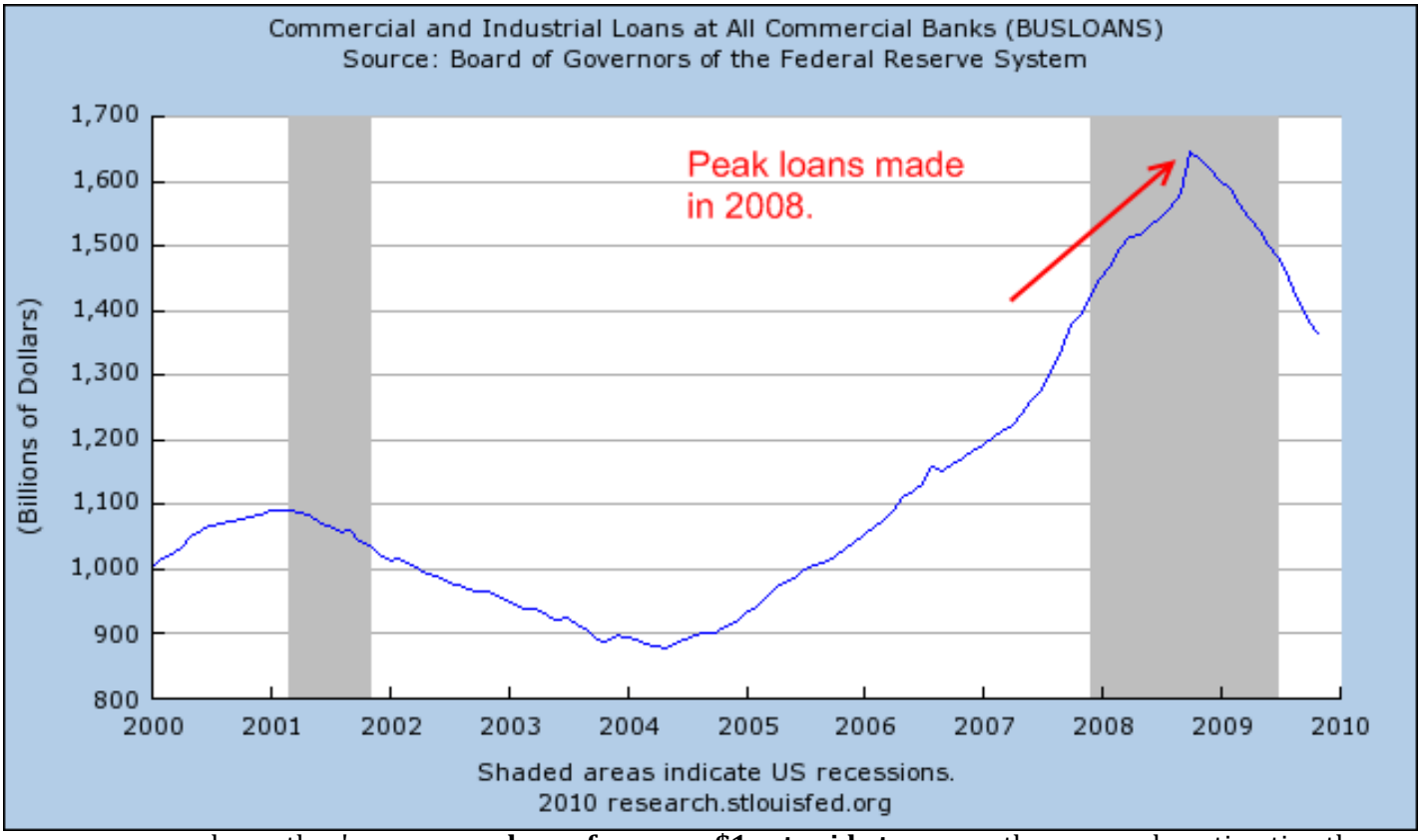
The US will have to come up with that $104 trillion somehow. There are three options: tax, borrow or print. **We think that as far as the eye can see, western central bankers will keep interest rates negative in real terms**. In other words, at some point they will be unable to resist the temptation to let inflation get out of hand. Of course, they can raise their key interest rates, but as long as they keep it below the level of inflation, they are in fact monetizing debt.

Collateral Damage

While the current crisis is largely – so far – about corporations and individuals, the next stop will be the governments. It is not inconceivable to say that the unfunded liabilities and ever widening deficits in the next 10-15 years will likely produce a total collapse of the system. It looks like the 2010s is not short of financial, economical and geopolitical problems. Now that the media – and thus the majority of people – are conveniently focused on the European debt crisis, let us consider something that is looming in the US. We have already talked about the commercial real estate market in the January issue of this report. It is not our intention to bore our readers with repetition, but this is such an important issue that we want to keep our readers updated.

Over the next five years, about $1.4 trillion in commercial real estate loans will reach the end of their terms and require new financing. What is striking is that nearly half are "underwater", meaning the borrower owes more than the property is worth. Commercial property values have fallen more than 40% nationally since their 2007 peak. Vacancy rates are up and rents are down, further driving down the value of those properties. A vacant property may be worth 50% of an occupied one. When the reckoning comes, everyone from banks to pension funds is vulnerable. When commercial properties fail, the result is a downward spiral in economic contraction. It will have an impact on job losses, deteriorating store fronts, office buildings and apartments, and the failure of the banks serving them. Dennis Lockhart, president of the Federal Reserve Bank of Atlanta, says that banks with the highest levels of exposure to commercial real estate loans account for almost 40 percent of all small business loans.

Commercial real estate loans typically have three- to five-year terms. Those loans are constantly being refinanced. The problem is that loans made at the height of the boom – 2005 to 2007 – were based on inflated values during a time of

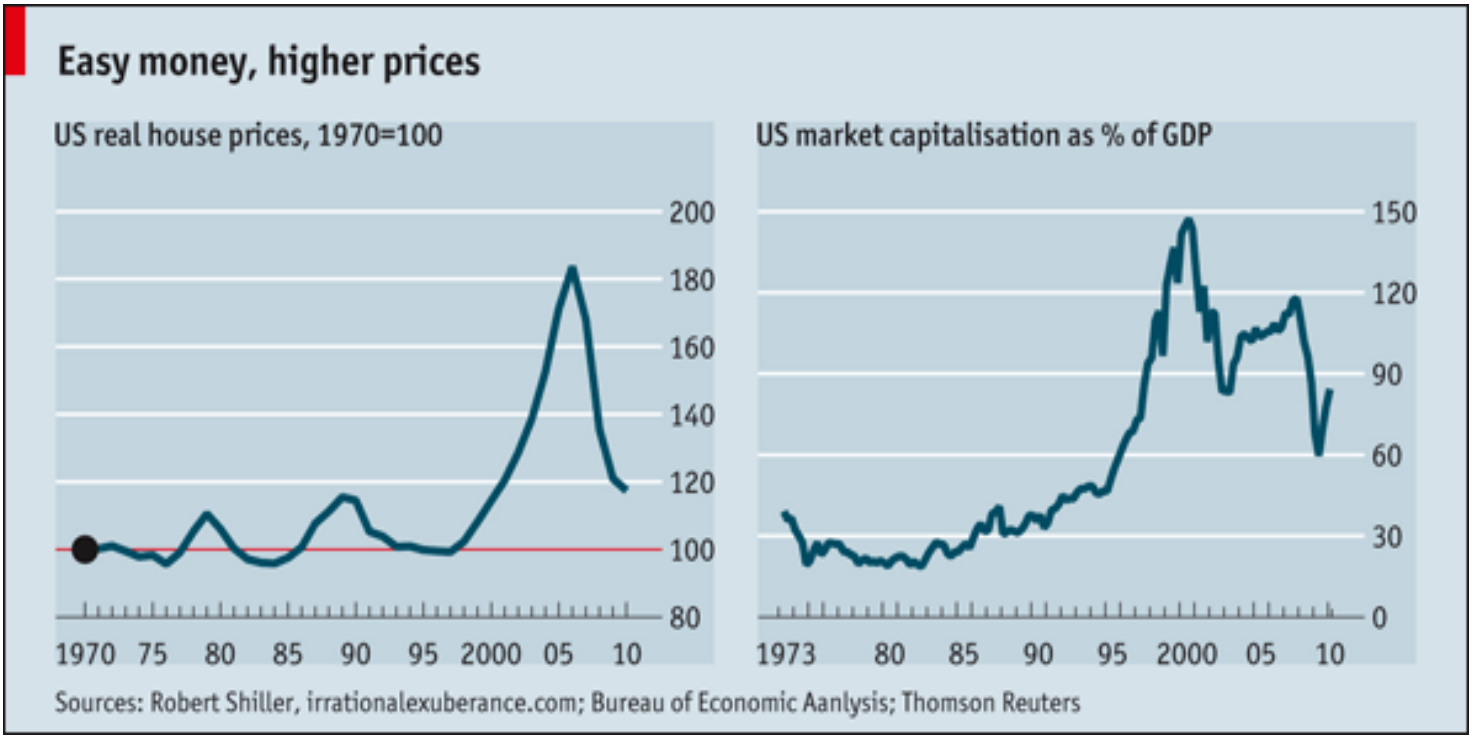


easy money, and now they're coming up on the end of their terms.

Some financial experts estimate that $770 billion or 53% of commercial mortgages maturing from 2010 to 2014 are underwater. More than 60% of mortgages maturing in 2012 and 2013 are underwater. Many of these loans are likely to default. We believe this will cause more small and medium-sized banks to collapse. The 20 biggest banks in the US, those with at least $100 billion in assets, have an average commercial property exposure equal to 79% of their total risk-based capital. For the nation's some 7,000 community banks, those with less than $10 billion in assets, the average commercial real estate exposure is 288% of risk-based capital**. So the average community bank has about $3 in commercial real estate loans for every $1 set aside to cover possible losses.**

These figures are enlightening, because they are certainly one of the reasons why banks are hoarding capital and not lending it out. In normal times, the money multiplier works. In other words, when a central bank offers money to commercial banks, the money goes into the economy and multiplies there through the fractional reserve system. But these are not normal times. The Fed is trying to figure out how they can make small banks lend money. They are already pressuring them. If they do not lend, which would be understandable to say the least considering the commercial real estate figures, Mr. Bernanke will likely keep money printers at full speed. As long as this continues, we are happy to own hard assets. While the deflationist camp has some sympathetic arguments, they are underestimating the central banker's ability to print money. Throughout history it has been a popular way to (try to) solve a nation's problems – and eventually face such intense domestic problems that the nation will go to war in order to shift their population's focus.

It should be clear that a conventional buy, hold and pray approach to investing is dead. Government interventions and Mr. Bernanke's money printing will cause – and has caused – rapidly inflating and deflating sectors. It will be a rather tricky environment. The Dow Jones Industrial Average has produced virtually no gains in 12 years. That is, if you invested in Dow Jones 12 years ago, you will have gained almost nothing. Meantime, inflation has been robust to say the least. The conventional approach to hold 70% of one's total assets in



stocks and 30% in government bonds is dead.

Naturally, everyone has to decide for themselves about their asset allocation. We are aware that each individual has different conditions in terms of cash flow, investment horizon, tax status and risk appetite. Assuming that preserving wealth is important, we would find it suitable to have 20-30% in equities, 20-30% in real estate, 20-30% in corporate bonds of different maturities, 20-30% in cash, and finally 10-20% in precious metals.

Money supply and asset prices have risen together since the early 1970s. This is when fiat money and floating exchange rates were introduced. The measure of global money, foreign exchange rates, has risen from under $1 trillion in the early 1970s to $7 trillion today. M3 rose from less than $1 trillion to $10 trillion by the time the Fed stopped publishing the numbers 2006. One has to wonder how far we have come after Bernanke took the money printer by the horns.

Every time we see Mr. Bernanke smile, we become a little scared. It makes us wonder how far he is willing to go to over-stimulate the economy (which will eventually happen – even the conventional academics will come to realize this later). When will he stop? The mere thought hasn't even begun to speculate about their merest possibility of crossing his mind. As far as the eye can see, he will monetize – and massively so.

It is interesting to note how the value of US equities climbed relative to GDP and how the value of real house prices also jumped to unimagined levels. We are well aware that correlation does not prove causality. A skeptic could point out that the big moves did not occur until some 20 years later after the Bretton Woods system was abandoned. However, one has to remember that 1970s was a time of huge consumer inflation, which makes it extremely difficult for authorities to try to run the system. The 1980s allowed banks to take full advantage of the freedom created by fiat money. First, the financial sector was liberalized. Second, central banks showed after 1987 that they would step in to rescue the markets in times of trouble. Moral hazard, cheap money and insurance against ignorance provided a powerful combination.

According to David A. Rosenberg, who is the chief economist and strategist of Gluskin Sheff & Associates Inc., **the US turned 234 years old this year. Yet over half of the nation's money supply was created since Mr. Bernanke took over the flight controls four years ago.** We find this an incredible! What took 40 presidents to accumulate $1 trillion dollars in debt, the US managed to accumulate another $1 trillion in debt during just the past several months!

Remember, this situation is only going to get worse as Medicare and Social Security come on top of that. It may be tempting to blame Europe on the weak economy now. Yet, in terms of debt-to-GDP level, the US is in a much worse situation than for example Spain. That is, if you count in all the unfunded liabilities in the US.

Life After Debt

Perhaps our readers remember how both Chinese and American politicians stated that there was no risk that China would substantially shift their dollar reserves. Since late 2009, China has continually reduced its dollar holdings. In May alone, China let go of $32.5 billion worth of treasury bonds. What we find remarkable that a major creditor to the US does this at a time when America is at all time high on its debt. The question then becomes, who is left to buy US treasuries if China steps off? There is only one source, and that is the Federal Reserve. They will print, print and print. **We are convinced that the Fed will implement further massive quantitative easing. We expect it to happen within a couple of months from the release of this report.**

We have continuously underlined that excessive credit growth and artificially low interest rates create speculation and volatility in the markets. Savers become losers and debtors become winners. The name of the modern world is "Who owes whom". This is true both on an individual and a national level. This is why an investor cannot simply ignore credit, because it is one of the most powerful sources of leverage. Of course, leverage works both ways so today an investor needs to be very aware of how it works not only in his own portfolio but on a global scale.

The debt problem expresses itself on many layers. On a national level, 46 states in the US face budget shortfalls, which add up to $112 billion for the fiscal year. **In their March 2010 report for the Congress, the US Government Accountability Office concluded: "State fiscal positions will steadily erode and hurt the US economy through 2060."** That's right, 2060! That's not a typo.

Will states be able to meet their obligations? Are municipal bonds really risk free investments? We doubt.

They will of course try to balance their budgets by cutting back spending and raising taxes the same way Greece and Spain do. At some point, though, the people's ability to pay taxes runs out. It would not surprise us to see those states being bailed out. **As investors, we don't think that the municipal bond market is especially attractive on the long side, but the good news is, it could present very juicy shorting opportunities**!

As to China, there has been much discussion about its economy and whether it is heading to a crash. Presently, China is driving the world economy. Some experts warn about a bubble 1,000 the size of Dubai.

Now, to some extent there is credit bubble. Credit has been growing at an annual rate of 30%. Still, **it is important to understand that when you look at credit, you always have to look at where you start**. For example, if debt-to-GDP ratio is 100% the outcome is going to be very different than if it is 600% – as we have in the US, if we include Fannie Mae and Freddie Mac.

It is clear that China has excesses, malinvestments and over-supply in some industries. One thing is good to keep in mind, though. The biggest difference between China and the US how credit is being used. It is a completely different story if a country uses credit to make capital investments on R&D, infrastructure, and education. In China, they build roads, bridges, improve infrastructure and education. In the US, credit is used mostly on consumption. They buy hamburgers and SUVs on credit. **It should be clear that it is not only about credit growth but also about how the credit is used in the economy.**

However, we are not as optimistic as some investors. As with all bubbles, bears are usually too early to call it and bulls are usually too late to see it. **Our view is that a significant slowdown in the Chinese economy in the second half of the year is almost certain. A crash should not be ruled out either.** Such an event would

obviously have dire consequences for the global economy.

But why oh why might we want to be concerned about wealth preservation when we have honest central bankers at work in their Bubble Laboratories, trying to preserve the value of our currencies at any cost?

Fortunately the world is a safe place. There are no war-hungry nations in the Middle East or West, no provocative action in the Korean peninsula, and most importantly no money-printing central bankers. It is safe to put our money in the bank and earn a decent interest on it. There is no need for financial education, investment observations or buy-side free economists and investors providing Money, Market & Milestones Report to depress us.

Despite this, we will soon look at some juicy investment considerations.

Glowing Uranium

We are under the view that uranium prices appear to be bottoming, as China buys major supplies from **Cameco (CCJ: NYSE).** On June 24, China agreed to buy more than 10,000 tons of uranium oxide over 10 years from Cameco.

China is building up stockpiles for its long list of new reactors. According to the China Nuclear Energy Association, China plans to build at least 60 new reactors by 2020. Loading a new reactor requires about 400 tonnes of uranium to start. Take 60 reactors, times 400 tonnes

each. That's 24,000 tonnes of uranium (over 52 million pounds), which is about all of the world's current output for one year.

New nuclear plants represent a game-changing aspect for future uranium demand and pricing. Even though the reactors may not come on line for several years, the knowledge of hard future demand creates a solid floor for the uranium mining industry. Increased demand, just from China, could cause uranium prices to jump by about 32% next year, to about $55 per pound, according to RBC Capital Markets. And future speculative interest could drive prices to the $60-80 range, which is almost double the current price level.

Uranium prices have tumbled about 70% since peaking at $136 a pound in July 2007. The strong uranium market of 2006 and 2007 stimulated the development of new supply. But with current pricing in the $40 per pound range, the economics don't support new mines.

According to the World Nuclear Association, China's demand for uranium may rise to 20,000 tons a year by 2020. That translates into more than a third of the 50,500 tons mined globally last year. The thing is, all of the world's current uranium output currently has a market, supplying the existing global demand for nuclear power. Thus, we would not be surprised to see uranium in shortage by the second half of this decade. Looking ahead, there's just not enough new production in the planning stages. Going forward, we're watching as the new demand unfolds, to make uranium investments all that much more valuable.

Investment Considerations

It seems that most market participants have a bit of a short memory. To be precise, their memory span seems to be around 2-3 weeks. Two months ago, the possibility of a double-dip recession was not part of any mainstream economic conversation. Today hardly a day goes by without some financial expert predicting a double dip. Financial blogs are full of conversations and forecasts about when the markets take out the 2009 lows. An investor and a trader one has to have a sharp memory and a clear understanding of the markets.

For example, many people have already forgotten what happened on May 6th. The ones that remember it do not seem to understand what kind of a role it might play in today's markets. To illustrate this we have scanned all similar events from S&P-500 market history going back to year 1962. We have drawn a box in the daily charts. The high box is the top of the extreme bar or the bar that represents the next day (whichever is higher). The floor of the box is drawn on the low of the extreme bar of the day bar after whichever is lower.

As we can see, the box drawn on the charts has defined the trading range for the S&P index from several weeks to some months. The same thing repeats again. Every time the index has broken out of the box, it is drawn into it. It has gotten beaten back to the box until the final breakout happens. The similar pattern is intact right now. We have spent more than two months trading inside the box. The downside breakout attempt has been beaten back to the trading range just after testing the 500DEMA and 38% retracement level.

We are well aware that many of our readers have read the January issue of this report. However, we quote it because it's worth repeating: "As many of you know, bull markets typically proceed in three stages. During the first stage of run, prices recover from bear market's ridiculous lows. This is caused not by improved economic environment but the fact that prices have been hammered down to the cellar, no questions asked, and they bounce off like a football pushed under water and released. The second stage reflects the improvement in the real economy. Market movement is fueled by better earnings and brighter future outlooks. During the third stage of the bull market, prices rise due to rampant speculation and there is only so much room for real economy facts. That is the time when everyone is in and the party train is going on with full throttle. Presently, at least yours truly experiences some considerable difficulties figuring out the stage we are at in at the moment. However, the real question is what happens between the stages? Typically we can expect to enjoy some kind of a price break, which can really get nasty if you are not prepared for it. We could easily see corrections of 30-50% of the up-movement. Movements of that magnitude can offer very juicy opportunities to accumulate equity – or they can drive the joy out of life totally." It now strongly seems that we are in the no man's land between stage one and two. The economic data is very gloomy and the earnings announcements are dominated by worse than expected recovery. We have seen a typical bear market reaction during the past three months with aggressive rallies up to significant resistance areas – and sell offs. However, we would highlight how the bottoms are made. Economic and earnings news continue to be soft to say the least. However, the markets refuse to make any lower lows. At the same time, the bull-bear ratio falls around par or even negative, indicating that the bearish train is fully loaded!

Bullish divergences on the daily and also on the weekly charts show the lack of steam of the bear party. At this point shaggy markets have convinced most traders to throw the towel into the ring and leave the markets alone. It has been an inconvenient trip through dark market times. Now, it is also noteworthy that the NH-NL index has made its lows. Possible bullish divergence signals that water is flowing below the frozen surface. The bulls are getting stronger.


May 29, 1962
68.00
66.00
64.00
62.00
60.00
58.00
56.00
54.00
52.00
MAY
JUN
JUL
AUG
SEP
OCT
NOV
DEC
FEB
63
ALTML
2.0


January 8, 1986
250.00
245.00
235.00
230.00
225.00
220.00
215.00
210.00
205.00
FEB
MAR
APR
MAY
JUN
JUL
86
ALTML
5.0


September 11, 1986
275.00
270.00
265.00
260.00
255.00
250.00
245.00
240.00
235.00
230.00
JUL
AUG
SEP
OCT
NOV
DEC
87
ALTML
5.0


October 19, 1987
300.00
275.00
250.00
225.00
88
89
ALTML
25.0

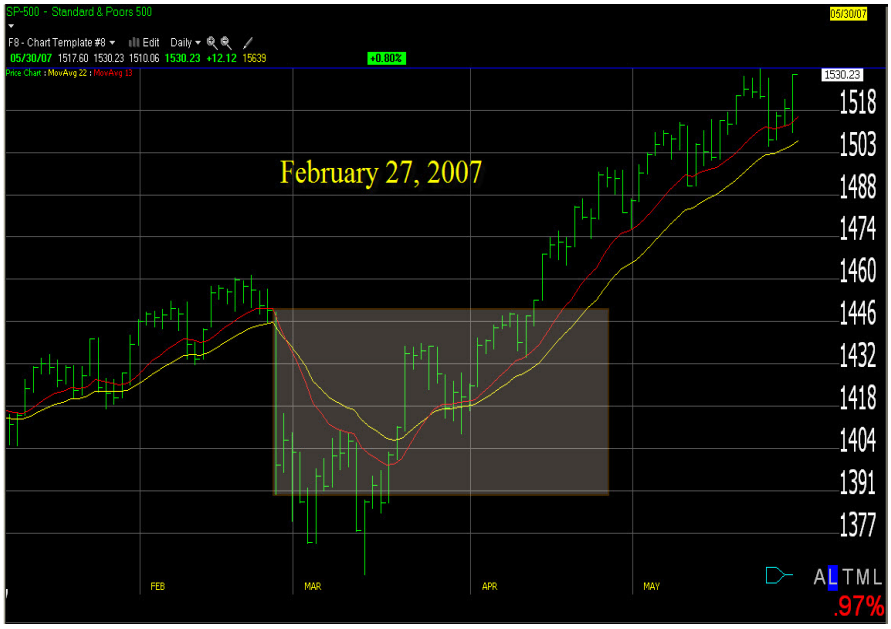

October 13, 1989
362.83
356.02
349.33
342.76
336.32
330.01
317.72
311.75
305.90
300.15
OCT
NOV
DEC
FEB
MAR
APR
MAY
JUN
JUL
AUG
SEP
90
91
ALTML
1.91%


March 8, 1996
676.16
671.26
666.39
656.76
652.00
647.27
642.58
637.92
633.29
628.70
FEB
MAR
APR
MAY
JUN
ALTML
.73%

By far we have seen the first stage of this correction. As we have already pointed out, this ride would not be a straight line walk but a series of strong rallies and vigorous declines. The recent decline draws a pretty shallow weekly New High-New Low numbers on the board. We are likely to see a lot deeper decline on the NH-NL index before the correction has done its work.

We expect this correction to last somewhere around October-November this year before the next stage begins. We would also like to stress that *all* forecasting is just a synonym for (sometimes) intelligent guessing. As Nassim Nicholas Taleb wrote in his book *The Black Swan*, financial analysts are not significantly better at forecasting corporate future than taxi drivers. We cannot argue with that. It is humorous how different analysis forecast very close to each other but as a group they remain far away from the reality. The estimation error is more significant than the estimation itself! This should be kept in mind at all times. It's difficult enough to see what will happen 6-12 months from now in a functional market – but with all the volatility created by government interventions, it becomes extremely hard.

Most financial news is just trying to explain and rationalize some very unpredictable events. Most events look clear and easy to explain in retrospect, but most of them are totally unpredictable. (For example, yours truly had

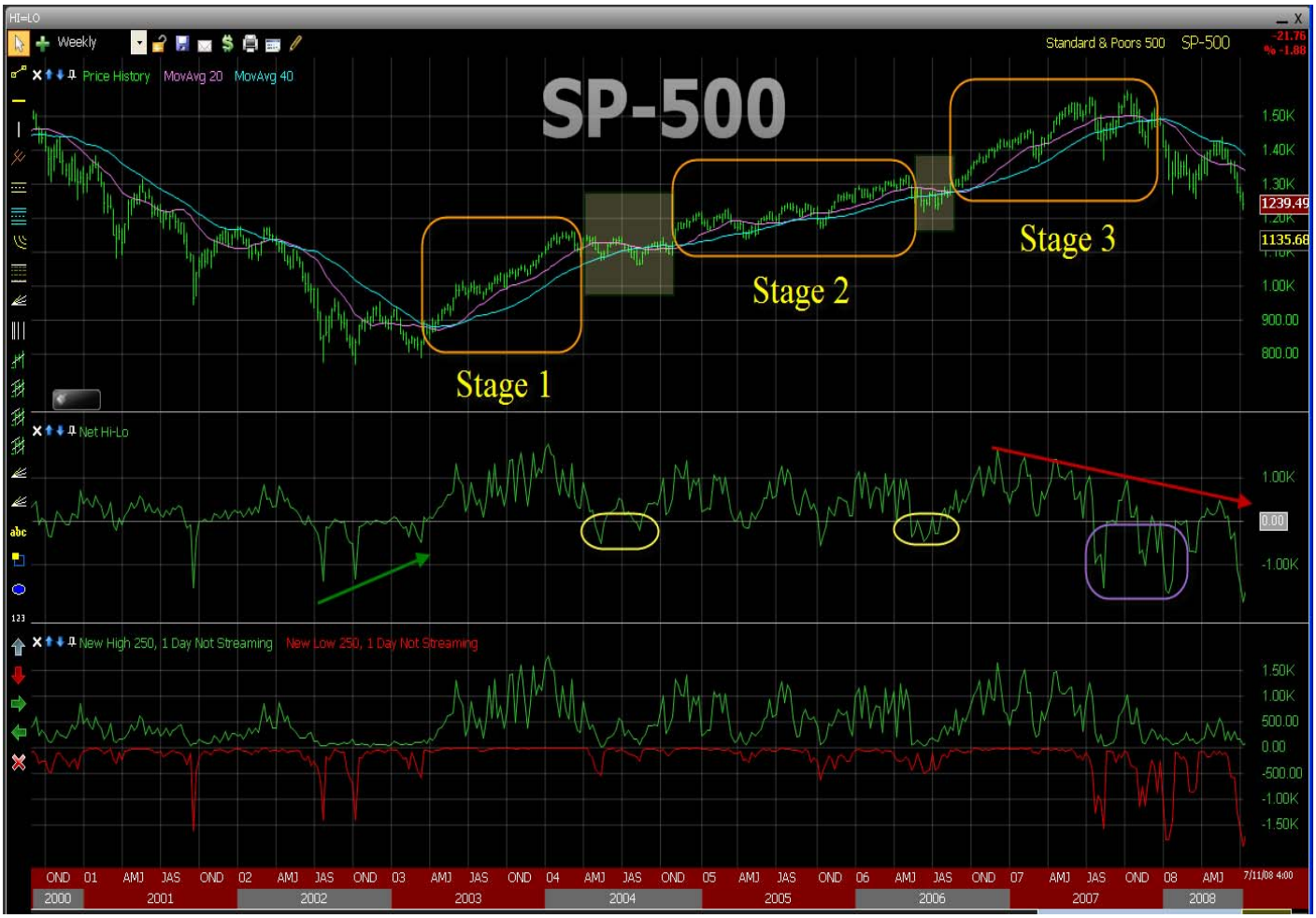


trumpeted the crash of the financial sector well in time. What took us by surprise – and still does – is how quick and violent the moves eventually became!) There are too many meaningful and totally random events that make the real world so complex that increasing parameters in the models do not increase the accuracy of the estimates. The irony is that just when everything looks safe and predictable, it stops being it. Take the BP oil rig blast. Did anyone see how it might affect the markets? Maybe. How many people made serious money on the move? Not many.

Structural changes of the market dynamics have pushed investors to ever more dynamic investment strategies. Spending a little time with the S&P 500 chart illustrates why this is so. The market has crossed below the 12+ year breakeven point, and this does not take into account any inflation (or dividends for that matter). It should be clear that the chart tells a horrifying story. The markets are like waves in the ocean. Big climbs have gotten even bigger and faster, followed by devastating declines. The past 12 years or so have led long-term stock investors to nowhere but troubles. It should be crystal clear at this stage that every investor needs a plan that includes exit criteria!

Now, there are some academic pundits that claim that market timing does not give any significant advantage to the investor compared to random buying and random buy and hold strategy. To the people that nod their heads enthusiastically to that, we have a couple of questions. Do you have fire insurance on your home? How about life insurance or car insurance? If the answer is yes, who would you not invest with a protective plan? We cannot stress enough the importance of the investment plan. The road will be rocky, but those with an open mind for new ideas are offered great investment opportunities.

We expect the recent lows at 1010 for the S&P 500 to hold at least for the intermediate term. However, we are very concerned that the next 4-6 months might give plenty of reasons for a worse view. Economic news and corporate earnings might very well be disappointing. For one thing, the concern about China's ability to stay on growth path is



The weekly NH-NL shows that the recent decline ended at a fairly shallow level. It is very probable that we are likely to see a deeper decline before this correction is over. Daily charts are yelling us that the new decline is comming. However, this back-and-forth is the normal course of a major correction within an overall bull market.

justified. If there is further US home price erosion, weak private sector employment data, and downward revision of corporate profit estimates for the latter part of 2010, it would not surprise us to see the S&P 500 fall below the recent support area. Remember, there are around millions of unsold homes in the shadow inventories not reported officially. This might spook the markets. However, as we have seen so many times, green shorts from Mr. Bernanke might float nominal market prices to absurd levels.

There are the people that believe that the S&P 500 will test the 2009 lows. Even some respected economists such as Shilling, Rosenberg and Roubini expect this. Where our angle differentiates with there is this. The US government's temptation to monetize debt is too high right now. We have discussed this in length in our previous reports.

It is fair to suspect that if the S&P 500 breaks below the 1000 yardstick, Mr. Bernanke is not the only gentleman to run money printers overtime. An investor needs to realize that most of the further stimulus does not necessarily flow to the stock markets, but odds are that at least some freshly created money will nominally support the stock markets. Mr. Bernanke's funny money probably continues to boost asset classes with a very limited supply. This would be favorable for precious metals and collectibles, rare art, and rare collectibles to name a few. Also, in some countries it would be favorable to real estate as well.

Corporate bonds don't look particularly expensive compared to equities. Even if the bond spreads have narrowed remarkably, the corporate sector looks relatively healthy in our eyes. We are far more interested being long on selected corporate bonds than government bonds right now.

It is in the nature of investment themes that there is not any lack of investment opportunities, but investors become frustrated by their own incapability to anticipate them. Many themes are difficult to

recognize on their early stages (an investor can be waiting in position on a certain market, but the wait may last much, much longer than he anticipates). The theme becomes obvious to most willing participants long after it has emerged. It is most visible when the train is full of passengers and none is left to the station. (Remember those NINJA-loans to property investors?) The undervaluation takes place in sector to which nobody is paying is attention. Thus the overvaluation and bubbles are found where all the eyeballs are staring.

When a major switch in an investment theme is about to happen, there is a strong disbelief among investors in the merits of the new theme. Moreover, it should be understood that even if the major investment theme is over, strong bear market rallies often occur. Such rallies are typically used for unloading positions, which leads the rallies to fail. Such rallies can be 30 to 50 point runs before they go sour.

In the January issue of this report we contended that US treasury bonds would be up to a bounce. We are happy to see that money indeed came out of the stock markets, trying to find the least dangerous place to hide in.

There are obviously two different camps, both of which are trying to find a safe place for their money. One group is putting their money into bonds. This is typical when the confidence on the economy is weak. When consumer confidence is high, people throw their money into the stock markets.

The second group is the disbelievers of the government actions. Enormous stimulus packages and quantitative easing (also known as gracious money printing) have raised the fear of future inflation. The lack of trust in fiat currency drives these people to buy precious metals to hedge against "the dark forces of life".

Presently, there is a hilarious race going on. Both of these camps are implementing their insurance strategy. Fearful savers are dunning the bond

All the investments made in the red zones are below water at the moment and the green areas are in the positive territory. It is very easy to see how difficult the buy and pray strategy has been during the past 12 years. During the same time period, active investor has done very well with a minor effort.

yields to ridiculous lows, creating an interesting shorting opportunity for contrarian traders. Gold is making record highs – and quite frankly, we are under the view that we have not seen anything yet.

We continue to believe that long-term treasury bond prices are closer to a secular high than bottom. In other words, treasury yields are closer to a bottom than the top. Even though some well known economists still continue to recommend US long-term treasuries as a great investment and a safe haven, our view is that the train is about to turn. We might see some additional bounce on bond prices. Our long-term view has not changed since our January 2010 issue. We suspect that the long wave of Kondratieff Cycle is up (remember, Kondratieff Cycle is a price cycle, not a business cycle). In addition, the lack of fiscal restraint and easy monetary policies will more likely lead to higher inflation and thus unsatisfying long-term government bond performance. For speculative investors, the high valuation of government bonds offers a possible short play opportunity. The most juicy opportunities are likely those that the majority has not recognized, and theme is not shining on its merits. Make no mistake; the next big bubble is forming on the bond markets!

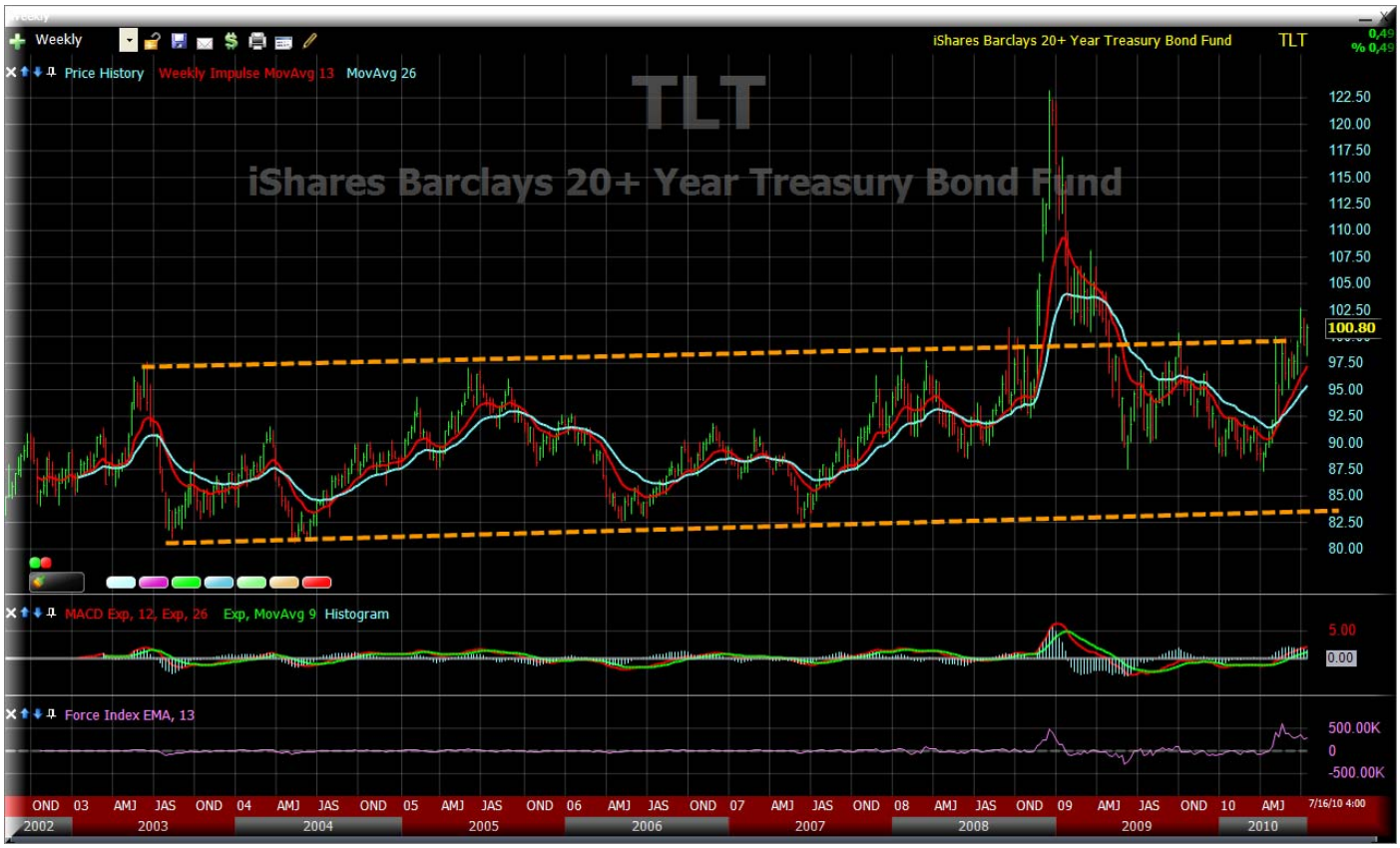
Gold has very strong seasonal changes in its price. The period between June and August are known to be sideways or downward biased. Historically, the strongest month has been September. We still see this yellow metal heading to $1,500-$1,600 range some day. However, we wouldn't be surprised to see nasty sell-offs before this happens.

We are aware of the danger that some of our readers might very well get bored with the upcoming charts but bare with us. It will definitely be worth the time and effort. The purpose is to show the bad shape the markets are in. Note that the nominal values might very well blast up even if the real recovery doesn't take place until 2016 or 2023.

First we will go through some industry sectors and after that some easy-to-follow index ETFs to get a picture of the overall global stock markets.

As you easily see, most of the sectors and country ETFs are currently running similar patterns.. We think that this signals more important message that just that the bull market has paused. **The key observation is that diversification across the industry sectors and countries will not give you any good protection against the bear markets**. **Asset markets are today more synchronized than ever before**. It is all about active portfolio management and trend following. As we have argued earlier, markets are becoming more selective. It really pays off to do one's homework and pick the right sectors and stocks. As always, there are plenty of healthy opportunities out there, even though they are not obvious to most investors.

We continue to accumulate physical god and a bit troublesome physical silver from the pullbacks. We like to point out that gold and silver miners might offer absolutely fantastic investment opportunities. Agricultural plays have just recently rallied a lot from the extremely oversold conditions as our active followers very well know. We had great plays there. However, it is more important than ever to bulletproof your portfolio against the most unexpected events – such as financial Armageddon. One has to remember the Black Swans, the tail-risks that evidently exist in the system! There are a lot of relatively affordable ways to protect your portfolio. Of course you have to pay for it, but it is a cheap price to pay if all hell breaks out. The most appropriate time to buy protection is always when the volatility is low and everything looks smooth and sexy. Then again, a high-volatility environment offers great possibilities for deep in the money covered call plays, shorting puts and writing covered calls (OTM).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iShares Barclays 20+ Year Treasury Bond Fund
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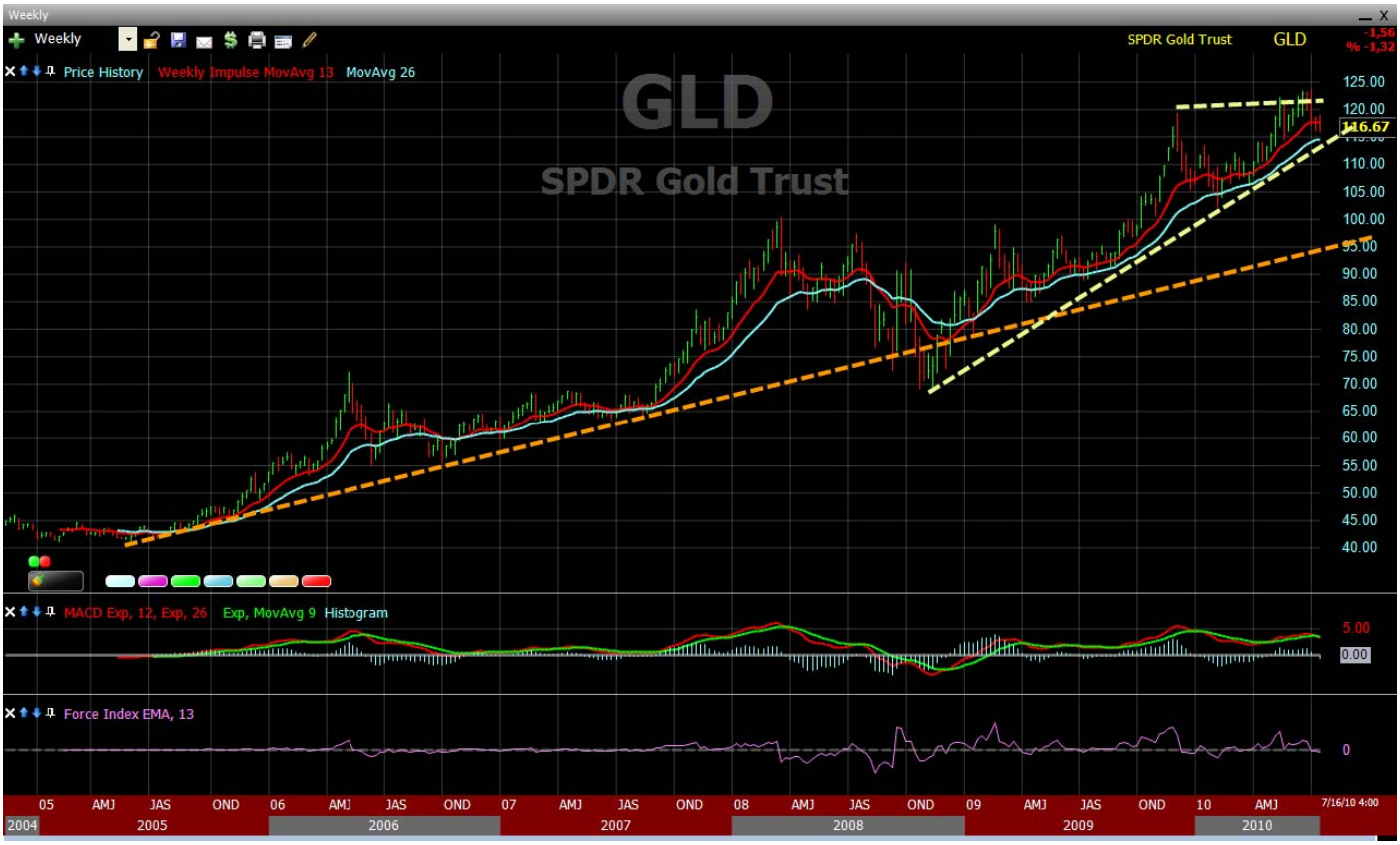
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Histogram
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2004
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2009
2010


DJ US Steel Index
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MovAvg 26
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Simple, MovAvg 4
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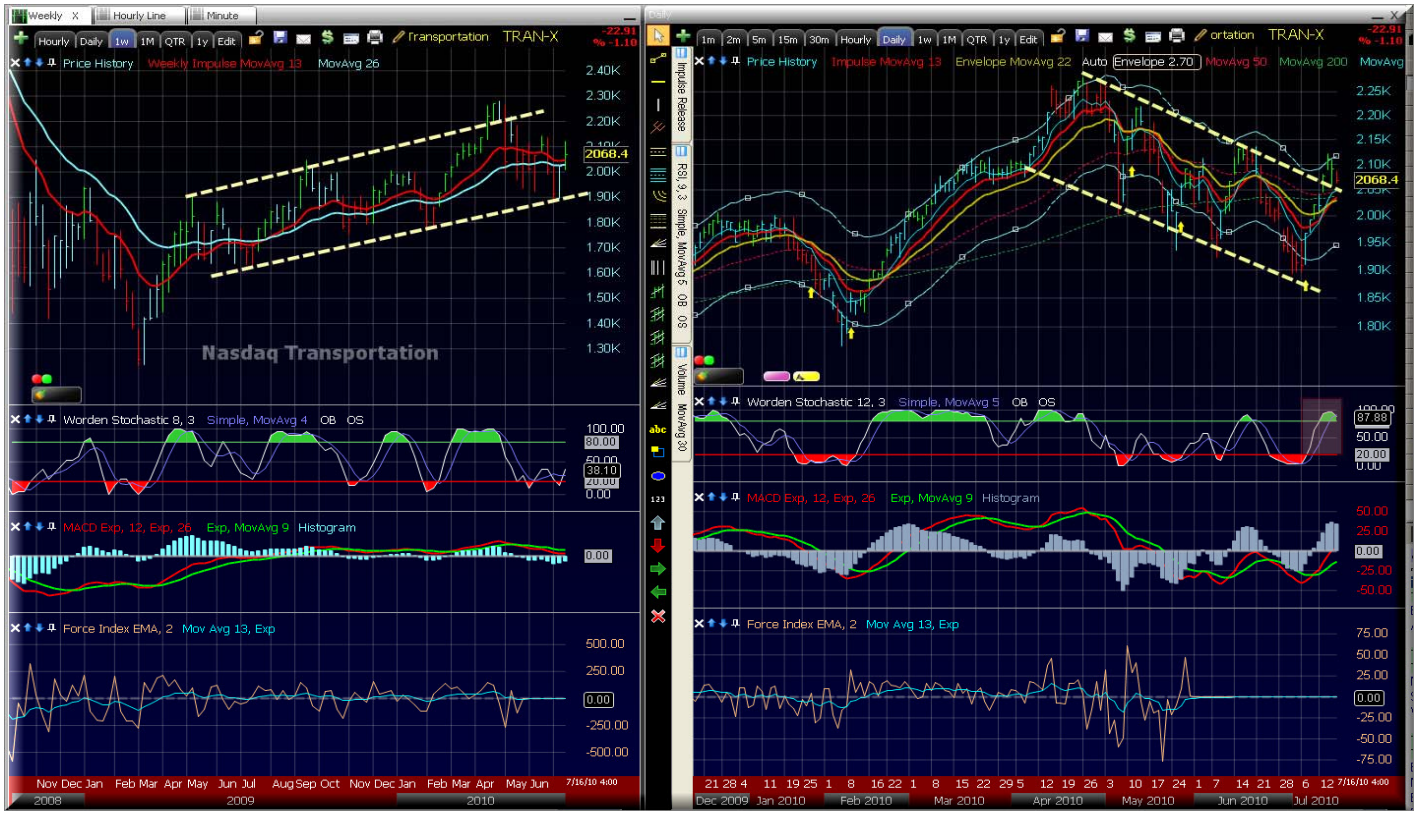
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MovAvg 200


DJ Wilshire 5000 Composite
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MovAvg 26
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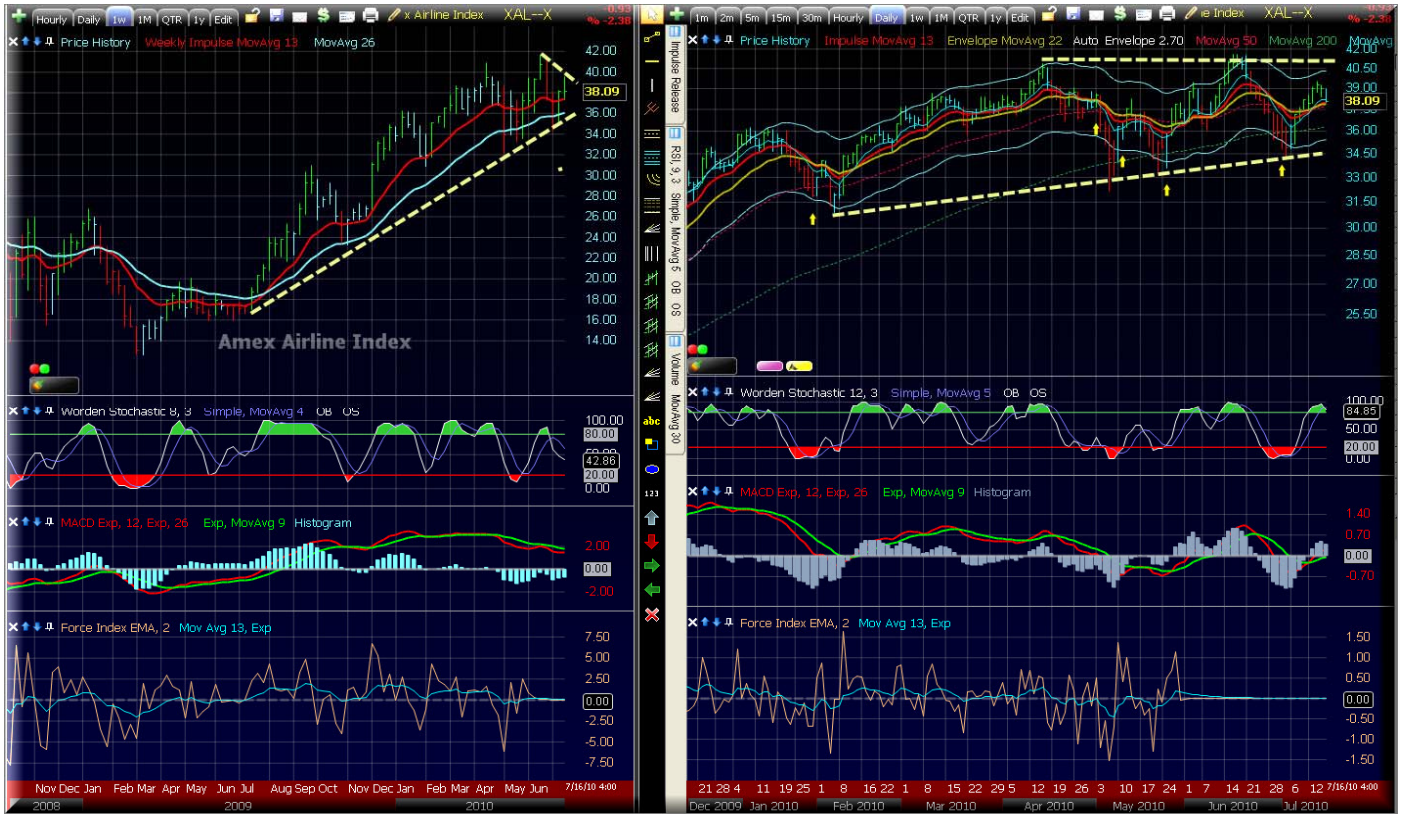
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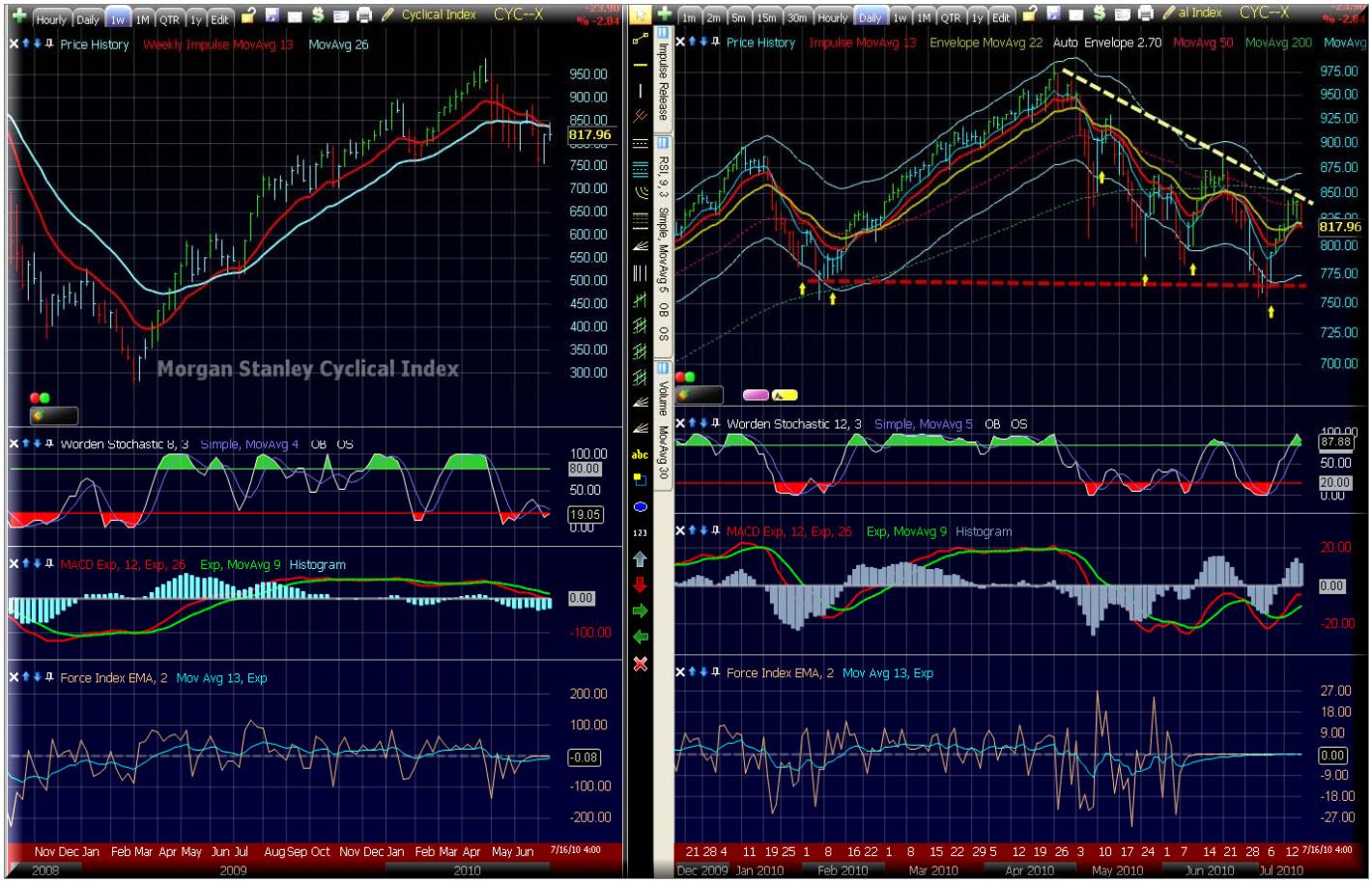
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Auto Envelope 2.70
MovAvg 50
MovAvg 200
Worden Stochastic 12, 3
Simple, MovAvg 5


Weekly
Hourly Line
Minute
3. Retail Index
Price History
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MovAvg 26
Dow Jones U.S. Retail Index
Worden Stochastic 8, 3
Simple, MovAvg 4
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Exp, MovAvg 9
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Mov Avg 13, Exp
Impulse MovAvg 13
Envelope MovAvg 22
Auto Envelope 2.70
MovAvg 50
MovAvg 200
Worden Stochastic 12, 3
Simple, MovAvg 5


Dow Jones U.S. Automobiles Index
Price History
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MovAvg 26
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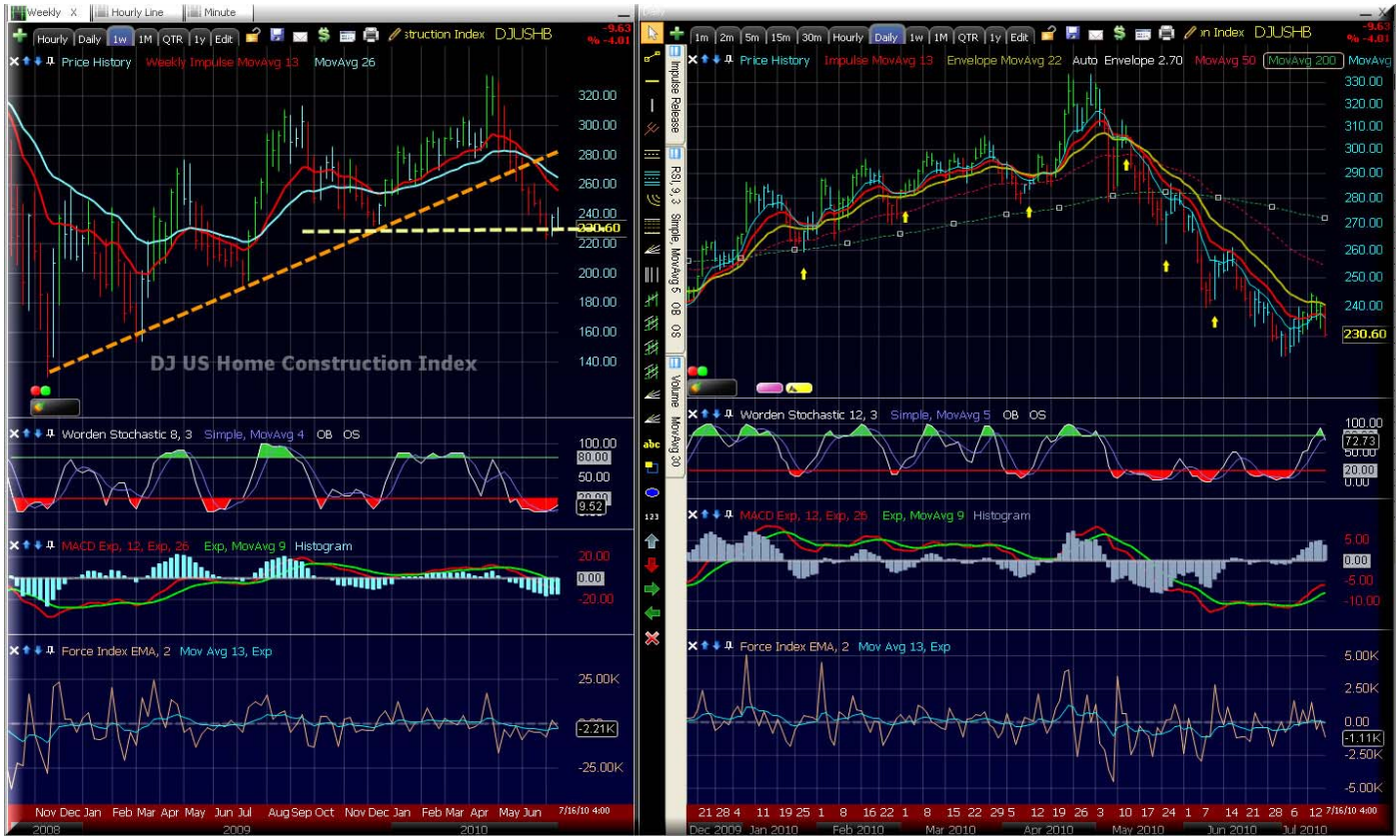
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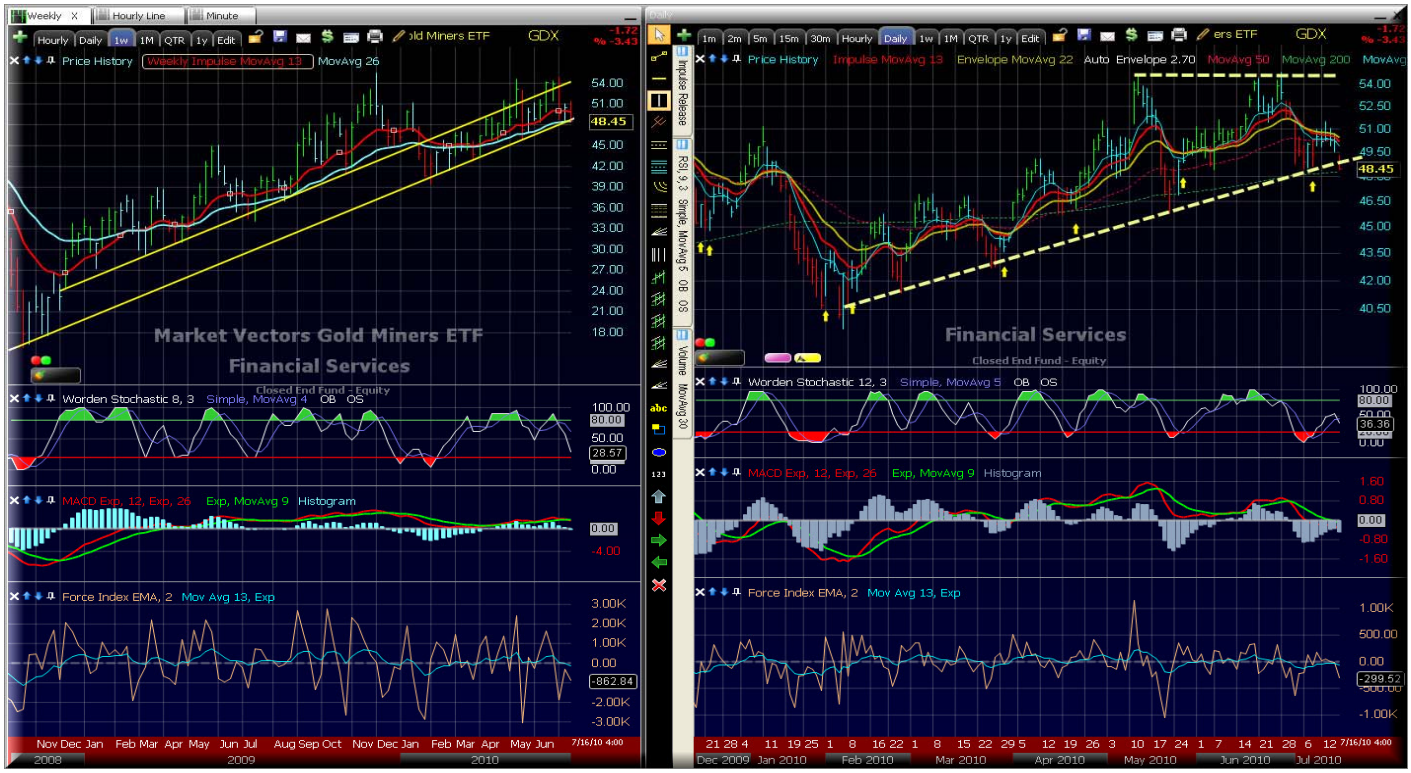
Market Vectors Gold Miners ETF
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MACD Exp, 12, Exp, 26 Exp, MovAvg 9 Histogram
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MovAvg 200
Worden Stochastic 12, 3 Simple, MovAvg 5 OB OS


SPDR Gold Trust
Financial Services
Closed End Fund - Equity
GLD
Price History
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MACD Exp, 12, Exp, 26 Exp, MovAvg 9 Histogram
Force Index EMA, 2 Mov Avg 13, Exp
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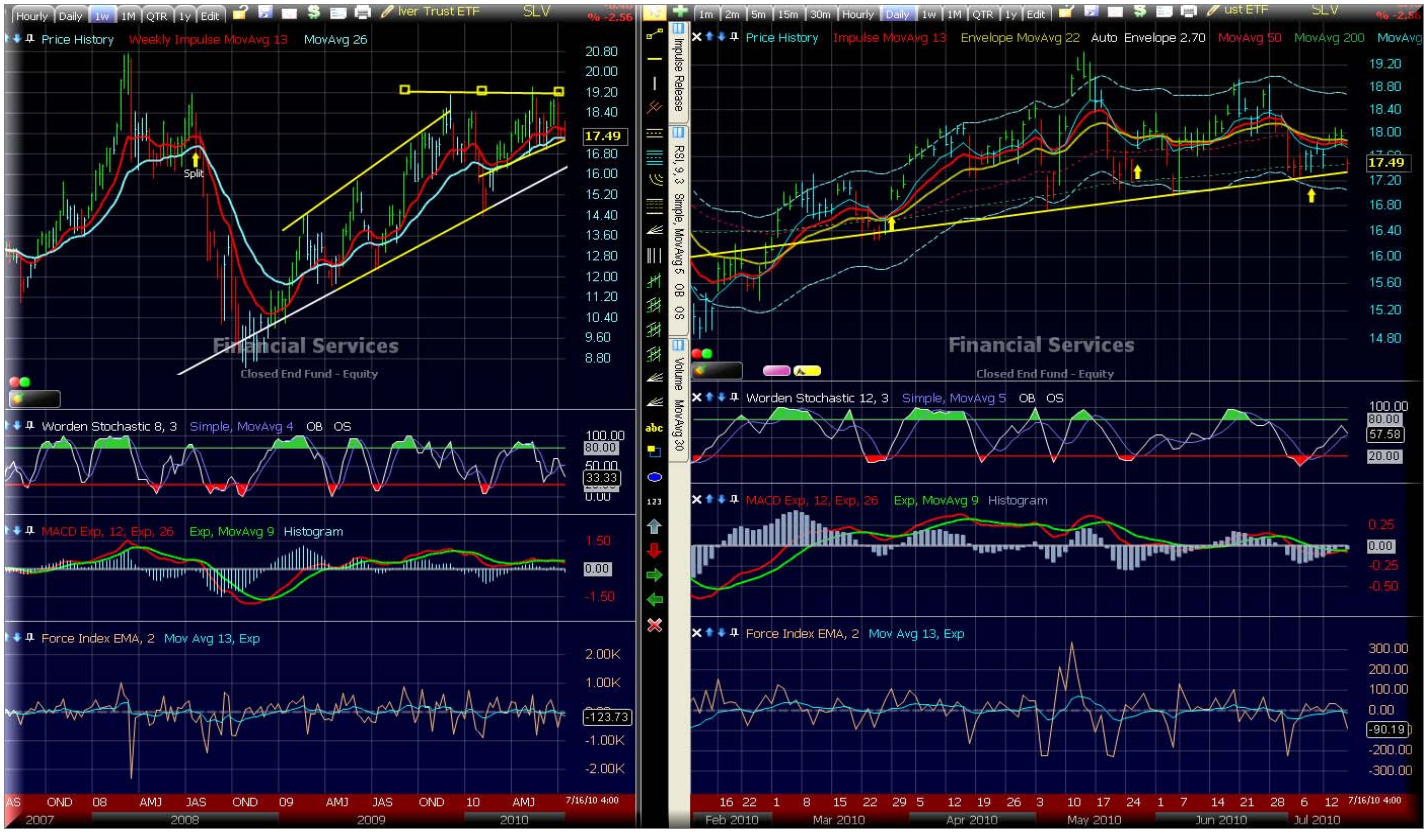
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Simple, MovAvg 5


FXE
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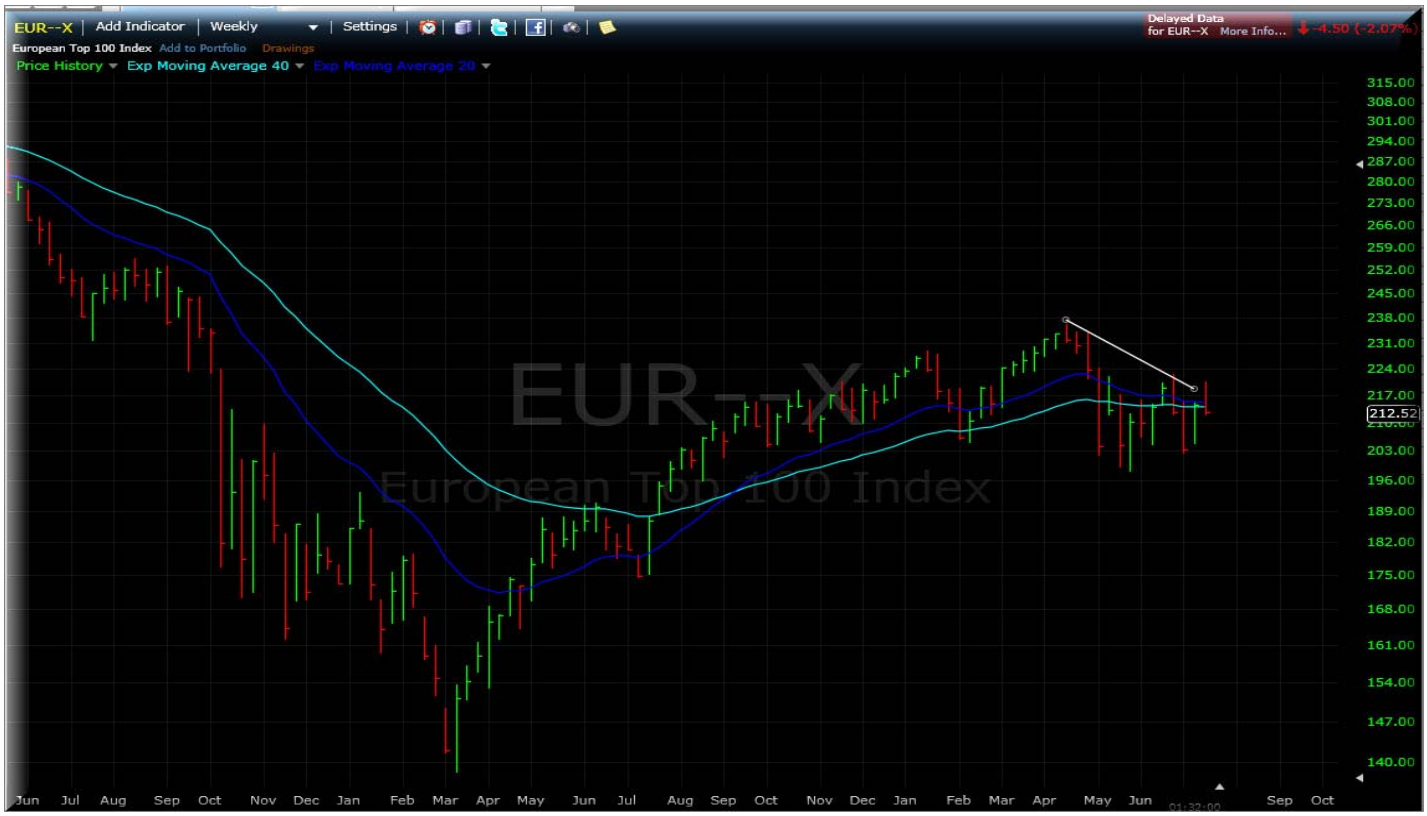
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European Top 100 Index
Add to Portfolio
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Exp Moving Average 20
Delayed Data for EUR--X
More Info...
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EUR--X
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301.00
294.00
287.00
280.00
273.00
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259.00
252.00
245.00
238.00
231.00
224.00
217.00
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203.00
196.00
189.00
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168.00
161.00
154.00
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140.00
Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Sep Oct


EWG
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Price History
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EWG
iShares MSCI Germany Index Fund ETF
Financial Services
Closed End Fund - Equity
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37.50
36.00
34.50
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31.50
30.00
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24.00
22.50
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18.00
16.50
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01:41:54


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25.00
Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Sep Oct
01:42:25


EWZ
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Exp Moving Average 20
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EWZ
iShares MSCI Brazil Index Fund ETF
Financial Services
Closed End Fund - Equity
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115.00
110.00
105.00
100.00
95.00
90.00
85.00
80.00
75.00
70.00
64.53
60.00
55.00
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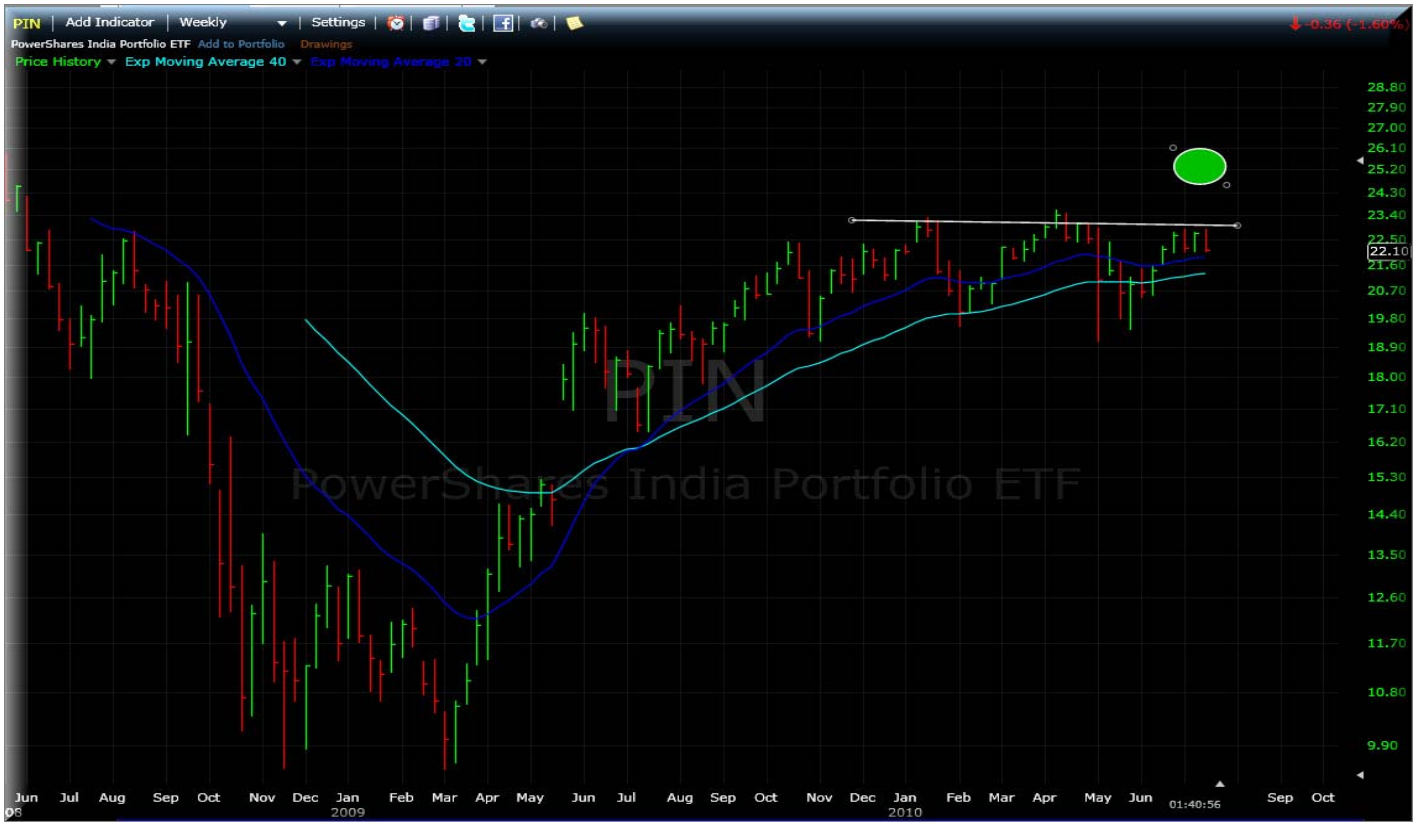
PIN
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Exp Moving Average 20
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PowerShares India Portfolio ETF
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2009
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01:40:56


FXI
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Settings
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Financial Services
Closed End Fund - Equity
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2009
2010
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EWA
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Add to Portfolio
Drawings
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Exp Moving Average 40
Exp Moving Average 20
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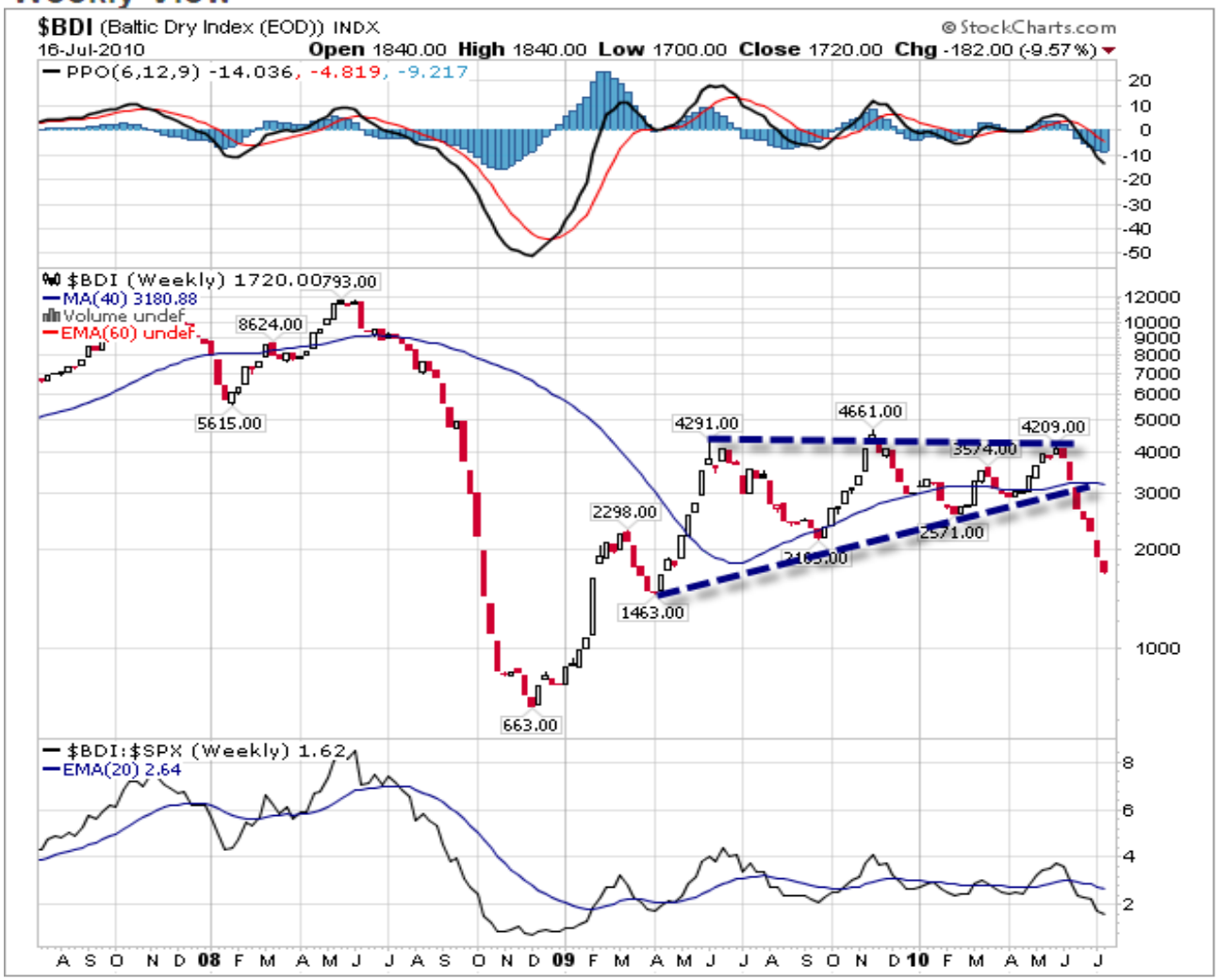
Financial Services
Closed End Fund - Equity
Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Sep Oct

Weekly View


$BDI (Baltic Dry Index (EOD)) INDX
© StockCharts.com
16-Jul-2010 Open 1840.00 High 1840.00 Low 1700.00 Close 1720.00 Chg -182.00 (-9.57%)
PPO(6,12,9) -14.036, -4.819, -9.217
$BDI (Weekly) 1720.00793.00
MA(40) 3180.88
Volume undef.
EMA(60) undef.
8624.00
5615.00
4291.00
4661.00
4209.00
3574.00
2298.00
2571.00
2165.00
1463.00
663.00
$BDI:$SPX (Weekly) 1.62
EMA(20) 2.64
A S O N D 08 F M A M J J A S O N D 09 F M A M J J A S O N D 10 F M A M J J

To summarize, the statement we made in January about the market probably getting into a corrective stage has occurred. This correction is likely to last several months. So far this correction has lasted fewer than three months. We have argued that that this correction is most likely to be more complex than a simple dip and run. We have seen and will see multiple rallies and declines, tiring out a lot of traders before the bull market resumes. The early July bottom marked the end of the first decline of this correction. The rally of the oversold conditions fueled by a bullish divergence on the MACD lines is a typical relief rally during the bear market phase.

It is probably best to sell at the rallies when they hit the strong resistance areas such as the 50 day moving average. The plot of the weekly New High New Low index shows that the recent July decline ended at a fairly shallow level. We are likely to see a deeper decline before this correction ends.

We would like to point out that this report is not conducive to precision timing. These reports are published to show you how to interpret some of the key market themes and to be aware of the economics hidden from the main stream media headlines.

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MATIAS SAVOLAINEN

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