MONEY, MARKETS & MILESTONES

A PUBLICATION OF VERTUS CAPITAL ASSET MANAGEMENT
July 18th, 2011

Let the Rating Agencies Not Be Blamed for the Mistakes Politicians Have Made!

Inside The July Issue

"No snowflake in an avalanche ever feels responsible!" -Voltaire

"All propaganda has to be popular and has to accommodate itself to the comprehension of the least intelligent of those whom it seeks to reach." -Adolf Hitler

Executive Summary

Whenever things get really bad, the public has to find a scapegoat. The debt crisis of Europe has spread wide public conversation. In look for a scapegoat, the public – and politicians especially – turned their looks into rating agencies.

Accusing politicians and other pundits seem to forget that the purpose of rating agencies is not to make governments or tax payers smile, but give realistic analysis. Had rating agencies not reacted to the changing consensus in the EU, they would not be doing their job. Giving unrealistic ratings is not good for anybody on the long run.

Politicians should not play games with their voters and give promises that they do not have to participate in paying the bill. There are no cheap options available. Every option causes losses and someone gets the bill to pay. It is just that most politicians know this, but are afraid of telling their voters who happen to be angry already.

We would advise our readers to watch carefully if the S&P index experiences a false downside breakout from 1250 level, because that might very well be the bottom of this move. Should S&P go below 1200, it would definitely spark fear. In that case, there would be a lot or people telling that the bear market has begun. That would also be the trigger for QE3, which we believe is certain in any case.

.The investment environment stays difficult. However, we still see gold, silver and the miners' as attractive places to be in. CHF has performed very well. Those that implemented some of the ideas presented on the March Dollar Coaster Issue of this report should have done pretty well. The CHF looks quite over-extended and the EUR should enjoy a bounce at some point, even though the trend might very well be intact.

We contend that this correction is likely more complex than just a simple dip and run. We expect to see multiple rallies and declines, which will tire out a whole bunch of traders, before the bull market resumes. It would not surprise us to see the stock market experience a powerful bounce, when the US finally raises its debt ceiling.

Introduction

Whenever things get really bad, the public has to find a scapegoat. The debt crisis of Europe has spread wide public conversation. In look for a scapegoat, the public – and politicians especially – turned their looks into rating agencies.

The purpose of rating agencies is to evaluate risks of both governments and corporations. The better the rating, the lower the cost of acquired debt. When analyzing a government, rating agencies have to take into account a large amount of factors, including debt to GDP ratio, financial policies, political stability, expected growth rate, the government's ability to collect taxes, and so on.

European governments got good grades for years. The assumption behind favorable ratings was that countries involved in the EMU would not be let into default, because it would greatly jeopardize the credibility of the common currency. This was the practice of European countries until recently.

It was then that the rating agencies re-evaluated risks and downgraded Portugal and Italy into the junk bond category. Greece, of course, had suffered the same fate earlier already. Needless to say, this downgrading led to a rapid rise in bond yields. These countries will find it difficult to return to the financial markets for a long time, unlike ever planned in the EU.

In look for a scapegoat, politicians found the rating agencies. After all, it was their rating that was the reason behind rising debt yields. This is as logical as blaming the alcohol factory for producing liquors. Never mind the person who drank it. If there were no alcohol, there would be no drunks, would there? Without the downgrading of rating agencies, European crisis countries would serve their debts just fine. Right?

According to the critics, rating agencies cause nervousness in the markets now that it is especially dangerous and unnecessary. It is a ridiculous accusation. Behind the rating agencies' decisions there is an ever tightening requirement that the crisis countries creditors must bear their bitter share, that is to suffer losses. The highest officials have specifically spoken hard about it, especially Germany and France.

The question nobody really seems to be asking is how did they expect rating agencies to respond to such requirements? It is only natural that they downgrade the countries bonds now that the ever widening political consensus is aiming to reduce the creditors' receivables. The fact that bond yields have been so low is because investors expected their investment to be safe in bonds. If the value of their capital is in danger to go red, it goes without saying that bonds become extremely risky investments.

Accusing politicians and other pundits seem to forget that the purpose of rating agencies is not to make governments or tax payers smile, but give realistic analysis. Had rating agencies not reacted to the changing consensus in the EU, they would not be doing their job. Giving unrealistic ratings is not good for anybody on the long run.

We are well aware that our readers think that rating agencies have fallen to that trap before. We fully agree and we are not anyhow here to make a case for rating agencies. Before the global financial crisis hit, they gave all too optimistic ratings for various debtors, which itself can be seen as one of the triggers of the crisis. What the European countries are asking, though, is them to repeat their previous mistakes in order to help European crisis countries serve their debts.

Sometimes it is even hard to criticize the US government for their actions. After all, what sane man would not delay his death?

Politicians should not play games with their voters and give promises that they do not have to participate in paying the bill. There are no cheap options available. Every option causes losses and someone gets the bill to pay. It is just that most politicians know this, but are afraid of telling their voters who happen to be angry already.

It would not surprise us to see European crisis countries default in their debts and give room for populist extreme right-wing politicians all over Europe. Currency crises have sown the seeds of disaster in history so many times that this factor cannot be overlooked.

Every now and then rises the obvious public question, who is to blame. We find it amusing that every time a society experiences a transformation (big or small), the public has to turn it into a spectacle by blaming somebody.

Although we feel for the little person, one thing is seldom mentioned.

In a democracy, the voters should accept some responsibility for the parties that are in control. It is easy to say that "I didn't vote them!" but that would be lazy person's thinking. The fact is that people share common responsibility for their politicians and therefore for the decisions that they make.

In an avalanche, no snowflake ever feels responsible. When the Nazis came to power in post WWI Germany, people had given the Nazi Party their support. What came about was unexpected at the time, but it was not resisted at first even when the consequences were becoming clearer every day—except for the demise, but that is part of the public spectacle pattern.

Why are we comparing the Nazi Germany to the present day? There are two reasons.

First, to remind that voters and common people share a responsibility and power that cannot be underestimated. Just look in the Middle East, even though they do not enjoy a free democracy. It can still cause significant political unrest and even governments collapsing.

Second, to highlight certain historical patterns that have evolved relatively quickly.

Both of your authors travel the world. Although we both live primarily in Helsinki, we do spend increasingly more time in other cities around the globe. New home towns can be found in various corners of the world. One such place in Europe for one of us is Lugano, for the other it is Berlin.

Especially in Berlin it is distasteful to see the extreme leftist counter the extreme right wing with violence, not much different from what was seen in Germany in the early 1930s. Politicians and their families get mugged, hundreds of cars are set in flames and extremely xenophobic atmosphere raises its head in certain parts of the city.

In general, wherever in Europe we go, we hear from our friends and we witness with our eyes that the political environment is changing. Left and right wings are gathering strength again. Both want to get rid of the European structures but for very different reasons.

In Greece, youth unemployment is at record 40 %. Just consider what happens when the country goes into a deep recession to pay its bills (as Finland did in the early 1990s with success but with not as high unemployment rate). What worries us is that as more European countries experience distrust in the European political structures—the south for the reason that they are forced into recession and paying their bills—and the affluent north for ending up paying for the irresponsible south. This gives ground for populism, which itself is not that dangerous. What is worrying though are the unintended side products that populist parties bring to the society.

In Finland, there hardly goes by a day that the populist right wing True Finns, as they call themselves, do not get public attention with openly racistic comments.

Of course, the population of Finland is so small that it is nothing to be worried about. What is, though, is that it may serve as a leading indicator to rising racism and even fascism in Europe. Should the Euro collapse and lead Europe to depression, it would be easy for populist parties to collect the long hanging fruit. Angry people want change. Typically, they do not know what they want to move towards, but they know what they want to move away from. Therefore, all that is needed for a cause is large opposition against something. Solutions need not be presented yet since—as mentioned—it is always the same. Getting rid of the scapegoat, that is.

One could say that we are overly pessimistic about the future. But we assure you, we are not. One of us is travelling through Siberia and the far ends of Mongolia just to see the world in his own eyes for both learning and enjoyment. To reach the odd cities of Siberia voluntarily by train should be a big sign of basic optimism in life!

Other than that, we do not trust the politicians to get it right. In addition, the central bankers have already shown their capability to mess things. As a friend of us said, to not own gold is to trust the central bankers.

That we cannot do.

As to the people, we hope they can accept more responsibility for the long-term consequences of their collective behavior.

As to politicians, we hope that they stop playing games and admit that they have made a mistake. The people will find out sooner or later.

Both he people and the politicians, to quote Seneca, must know that night falls fast and “death lies near at hand”.

Markets

Since the previous issue of this report, we have been dealing with ever deepening macro scale problems on both sides of the Atlantic. Fears over European debt problems as well as the uncertainty related to the US debt ceiling have offered fuel for volatility. The US economy has signaled weaker-than-expected recovery while the labor market has continued to stay weak. As to Europe, the Spanish property market is even worse than previously expected. To make matters worse, Australian property markets and weakening consumer spending have made the market soup all the more spicy.

At the same time, companies have reported strong earnings across the board. The flow of earnings continue to be strong. The big question is, what kind of guidance companies announce. In summary, uncertainty is high for a good reason.

However, the pullback bottoms occur always, when it is darkest outside. Right now the political game makes the markets swing. It is not our place in this world to trade based on political battles. The good news is that the uncertainty of the debt ceiling is likely to go down to the wire. It is highly unlikely that U.S. will default on their debt (for now!). Make no mistake, this does not change our long-term view of worsening U.S. debt problems. There is no doubt that US will default, but the question is how and when. The most intelligent guess we can make is to expect them to print colossal amounts of money and let inflation do its job.

This is of course one kind of default, although not quite the text book version of it—yet.

Let us have a look at the charts and see what they tell us. The weekly S&P chart spit on our faces and yelled STOP. There is a possibility that a head and shoulders formation is taking place now that S&P has traded above the middle line of the up channel for an extended period of time. Should the H&S pattern play out full, we might see S&P trading around 1150 points. That would, by the way, accidentally also be the 61.8 % retracement level from the lows of July 2010. That would also be slightly below the trend line. This scenario looks almost too juicy to be true. All of these key levels are at the same area. It is almost too obvious, and we know that Mr. Market is not at all an obvious creature. Only time will tell if the 1250 support level will hold and if S&P will break out to new highs. However, that would seem unlikely without the financials participating in the move.

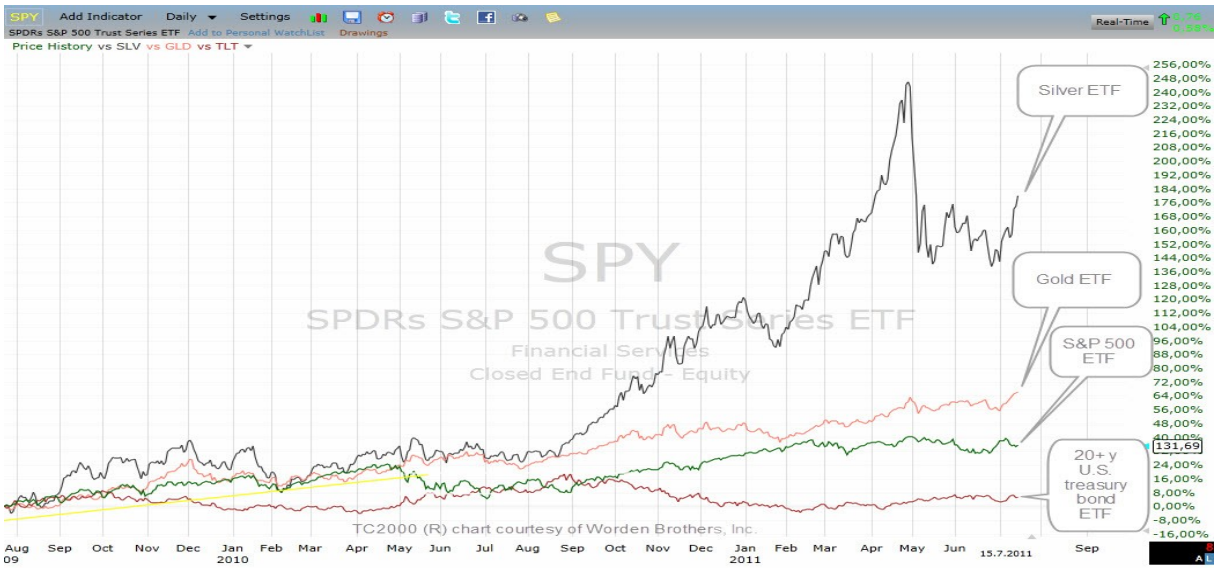
We would advise our readers to watch carefully if we get a false downside breakout from 1250 level, because that might very well be the bottom of this move. Should S&P go below 1200, it would definitely spark fear. In that case, there would be a lot or people telling that the bear market has begun. That would also be the trigger for QE3, which we believe is certain in any case.

More money printing is just a matter of time and what the Fed sees as a viable reason for it. One of the most potent is the falling of S&P. The question is, of course, would it help the stock market make new highs? The problem with money-printing, as we have previously pointed out, is that you can never be sure where that money flows.

Having trade plans is always important, but right now it is more important than ever. We strongly advise our readers to be selective and to not over leverage. There is a good chance that the world does not end and life goes on even though everything is pointing to a dead end. So far, the US stock market action is normal bull market action before the next leg up.

Gold has continued its volatile dance higher. The move has been orderly fashioned. GLD has traded within the lower half of the up channel almost the whole year 2011 and has now broke out to new highs. GLD has also moved to the upper pane of the channel, which indicates that the market is heating up. Gold's little brother silver is a lot more volatile creature. 50 percent retracements are typical for silver. We just tasted one of those juicy drops. You really can taste the panic during those moves! It is useful to step back and have a look at the longer term charts during these big trend

Silver formed a flag on the weekly chart, increasing the fear of some additional downside move. However, against all expectations, SLV broke out of the pattern, moving decisively higher. TLT is a 20+ year U.S. Treasury bond ETF. It shows us very well how the freshly printed money has inflated different asset classes one after another, sucking more and more people into the bubbles—just before it bursts. TLT has formed a pattern that might end up being a huge head and shoulders formation. If (and when) the reality kicks in, U.S. treasury yields should start reflecting the real credit risk and TLT should drop like a stone. Bear flag looks increasingly more possible and a downside breakout would complete the



H&S pattern. A bond selloff would swing the treasury yields to remarkably higher level than they are today. However, problems in Europe might keep the U.S. bonds from dropping. It is like comparing dog crap to elephant poo. Both are excrements, but the market has to choose, which one is relatively more attractive.

A quick look at the relative performance of SLV, GLD, SPY and TLT shows that the bond holders have already been really big losers even though the real waste has not even hit the fan yet.

USO represents relatively well the oil market mood. The weekly chart shows no pretty picture. Dropping energy prices indicate rapidly slowing economy. Do we have a bear flag or is USO just bouncing of the support?

Shanghai Index has gone nowhere since August 2009. It hit the wall on a 61.8 percent recovery level. The index has traded inside a down trending channel since the 2010 highs and doesn't make us jump around in excitement.

A brief look at the EUR / CHF chart tells pretty much the whole story. Enormous uncertainty and the lack of trust in real solutions keep money flowing out of EUR as well as USD and into CHF. We are not happy to see markets suffering like they have done during the last months. The investment environment stays difficult. However, we still see gold, silver and the miners' as attractive places to be in. CHF has performed very well. Those that implemented some of the ideas presented on the March Dollar Coaster Issue of this report should have done pretty well. The CHF looks quite over-extended and the EUR should enjoy a bounce at some point, even though the trend might very well be intact.

We contend that this correction is likely more complex than just a simple dip and run. We expect to see multiple rallies and declines, which will tire out a whole bunch of traders, before the bull market resumes. It would not surprise us to see the stock market experience a powerful bounce, when the US finally raises its debt ceiling.

Author & Publisher Subscriptions & Enquiries
JAAKKO SAVOLAINEN **Email: mmm@theMMMreport.com**
MATIAS SAVOLAINEN **Website: www.theMMMreport.com**

Reader Comments: comment@theMMMreport.com