Addicted to Profits

Dave Skarica, Editor **Volume XI Issue IV March 2009**

Dear Subscriber,

“If stupidity got us into this mess, why can’t stupidity get us out of it.” Will Rogers.

Right now central banks and politicians around the world are just throwing money at the problems they helped to create. I do not see how building a high-speed monorail from Disney Land to Las Vegas is going to help solve credit bubble and housing crises but U.S. politicians are saying, “why not use economic calamity to start your own pet projects?”

Central banks around the world will continue to print money to fight the problem. If the problem gets bigger, they will print more. In the early thirties, the Fed took away liquidity. Everyone now is scared of repeating past mistakes; so they are over compensating by printing too much.

The G20 came up with all sorts of ideas, most of them bad, i.e. throwing money at emerging economies and coming down on tax havens in their desperate and greedy thirst for more tax revenue to pay for their projects.

I say that policy makers are applying the Will Rogers theory towards solving problems, “Stupidity got us into this mess, and why can’t stupidity get us out?”

The Trade for 2009 and Beyond

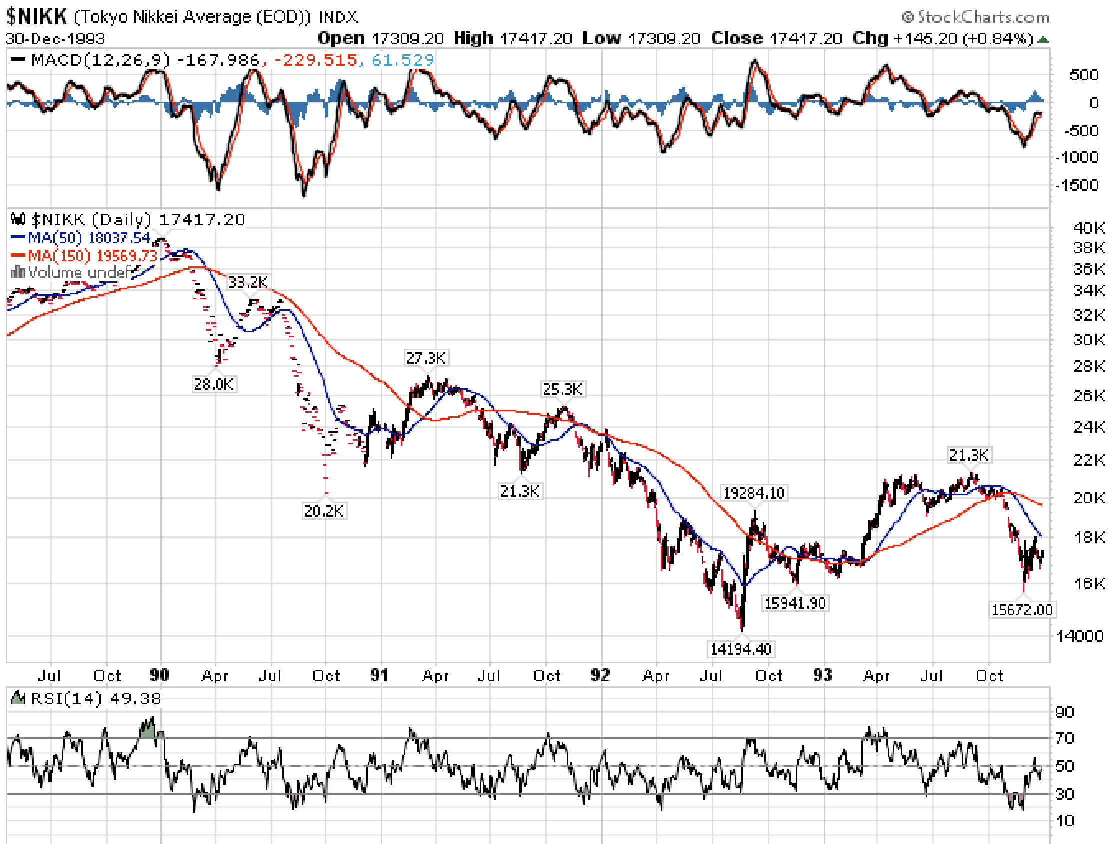
There is one trade I am rather certain of at the moment. There are only a few trades in your career where you feel almost totally confident, one of those “I can’t lose money here” type deals. I had one a few weeks ago in Tata motors. I loved that it traded at 50% of book at the bottom, or that it traded at a single digit P/E and paid 9% near the bottom. On top of that the Nano was about to be released. For those new readers unfamiliar with the Nano, the Nano is the 2000-dollar car Tata is bringing out for the Indian market. When I was buying Tata down near 3.50 per share, I just figured I could not lose. In the following month Tata has nearly doubled to 6.00 a share. I think it will pull back here, but this is one of the few trades you come across that seemed too good to be true.

In a recent special report, we outlined 3 investment trends for 2009 and beyond. We picked two stocks (Marvel and Tata) and one trade (shorting the long bond), which we think, will do extremely well in the coming years.

However, the one no brainer I have now is shorting the US long bond. This trade looks good on so many levels:

(1) Stupidity – Politicians and the central bank really think that stupidity is going to get them out of this mess. They think, by nationalizing companies, restricting executive compensation, spending money on every pet project in sight, that they are going to somehow save the economy. This in the long run is a disaster. The government does not spend money efficiently. Japan went from debt as a percentage of GDP of 30% in 1990 to nearly 170% in 2009 and its stock market went down 80% over the same time frame.
(2) Supply and Demand – The U.S. is going to run a 1.75 trillion dollar deficit this year. It is going run up 9 trillion dollars in the next 10 years. That is a huge supply of debt that has to come on to the market. Markets trade on supply and demand; more supply means investors will ask for more return on their money to buy debt. This means higher rates in the future.
(3) Massive Printing of Money – We have quoted Milton Friedman's Money Mischief many times in these pages. One of Freidman's basic theses was that when governments print huge amounts of money it ends up in inflation 1-3 years down the line. He states that at first the money flows in safe investments such as bonds, pushing rates lower (this is what we saw last fall) and then the money filters throughout the economy and creates inflation. As government printing and spending is inefficient, it creates inflation rather than real economic growth. This looks like the case for 2010-2012.
(4) Price Action of This Bubble is Similar to Bubbles of the Past -- Markets that end in bubbles always trade in a similar trading pattern – (a) A market goes nowhere for a period of time and bottoms; (b) A good long steady bull market begins and trades for years with pullbacks and small bear markets along the way; (c) The bull market turns into a bubble and trades parabolic and tops out; (d) The bubble tops out and collapses.

The makeup and timeframe of the collapse is about the same as well. Most bubbles take about 2-3 years to burst and lose about 65 to 90% of their value in that time frame.



$NIKK (Tokyo Nikkei Average (EOD)) INDX
©StockCharts.com
30-Dec-1993
Open 17309.20 High 17417.20 Low 17309.20 Close 17417.20 Chg +145.20 (+0.84%)
MACD(12,26,9) -167.986, -229.515, 61.529
500
0
-500
-1000
-1500
$NIKK (Daily) 17417.20
MA(50) 18037.54
MA(150) 19569.73
Volume undef
40K
38K
36K
34K
32K
30K
28K
26K
24K
22K
20K
18K
16K
14000
33.2K
28.0K
27.3K
20.2K
25.3K
21.3K
19284.10
15941.90
14194.40
21.3K
15672.00
Jul
Oct
90
Apr
Jul
Oct
91
Apr
Jul
Oct
92
Apr
Jul
Oct
93
Apr
Jul
Oct
RSI(14) 49.38
90
70
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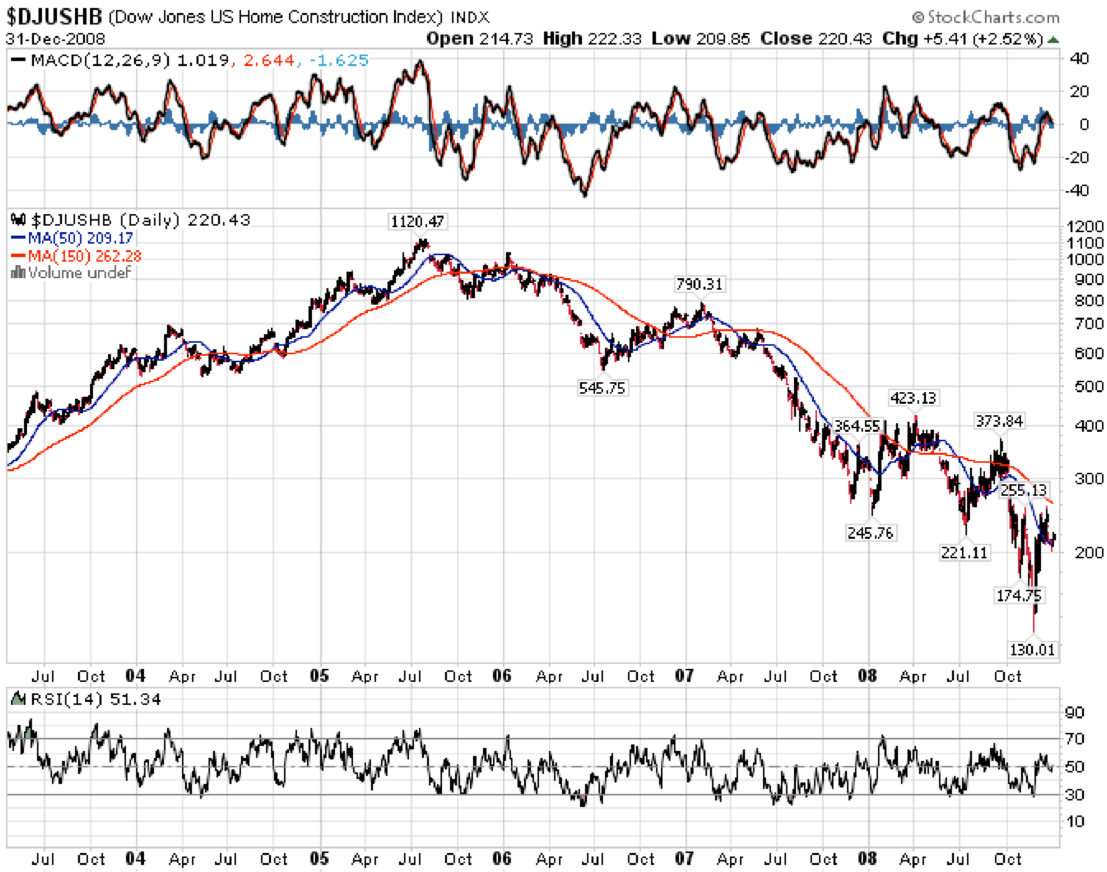
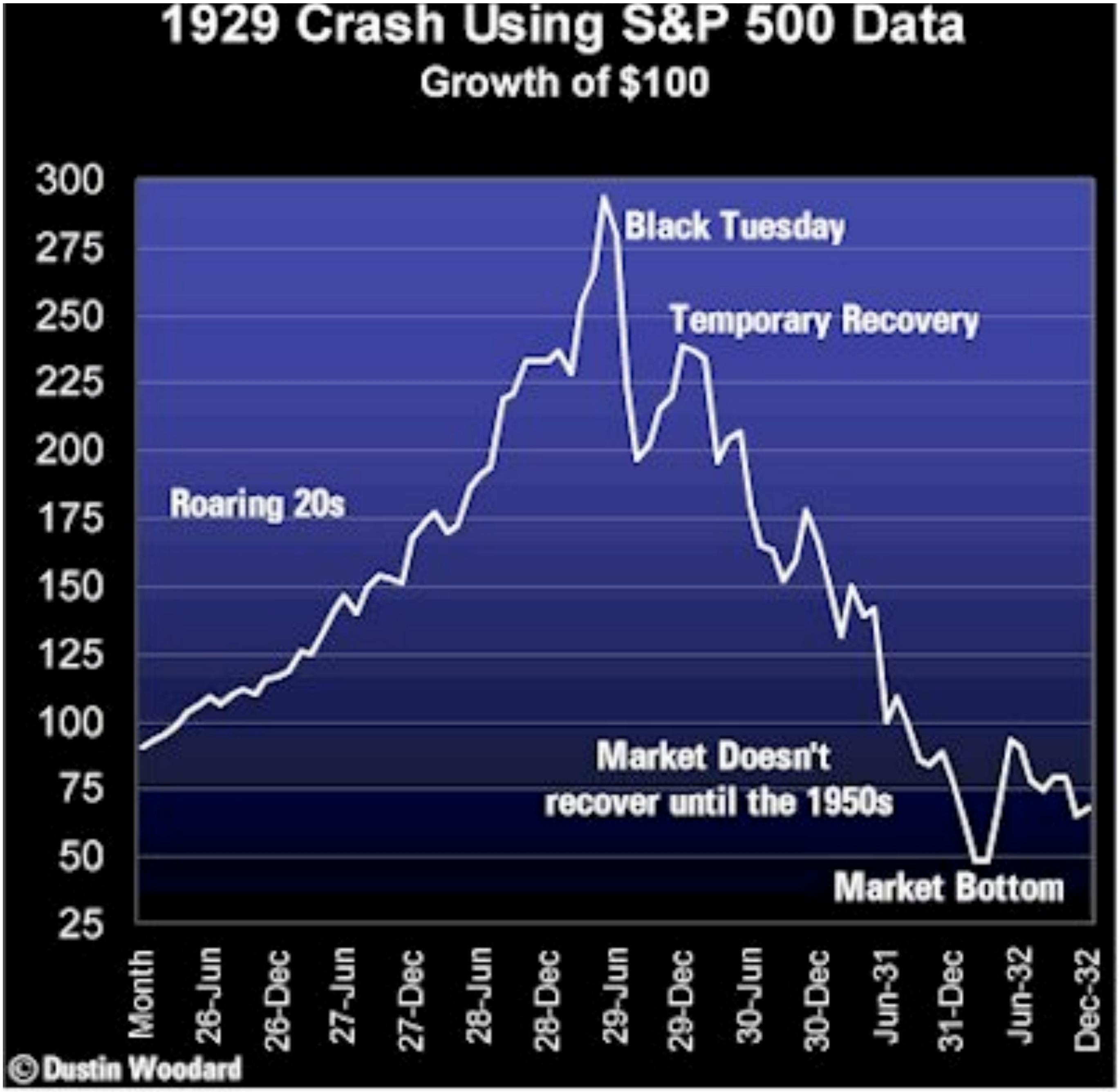


We have enclosed graphical examples, which illustrate this. Japanese stocks from 1990-1992, homebuilding stocks from 2005 to 2008, gold from 1980 to 1982, the NASDAQ from 2000 to 2002, Dow stocks from 1929 to 1932, all had the same pattern. They ran up huge, then collapsed 70 to 90% in 2 to 3 years.



1929 Crash Using S&P 500 Data
Growth of $100
300
275
250
225
200
175
150
125
100
75
50
25
Black Tuesday
Temporary Recovery
Roaring 20s
Market Doesn't
recover until the 1950s
Market Bottom
Month
26-Jun
26-Dec
27-Jun
27-Dec
28-Jun
28-Dec
29-Jun
29-Dec
30-Jun
30-Dec
Jun-31
31-Dec
Jun-32
Dec-32
© Dustin Woodard

So, if this indeed is a bubble, it means by 2011 to 2012 the TLT should be trading in the 30 to 50 range and if that is the case interest rates will again be pushing double digits as they did in the 1970s and early 1980s.

The Fed Buying Just Gives the Smart Money Time to Get Out

Some think the bond may rally because the Federal Reserve recently announced it would be purchasing $500 billion worth of bonds. However, we feel, that at best, this will keep the bond market flat before the bottom drops out. We must remember that Central banks are the dumb money.

We go back to the 1999 to 2002 period and the British central bank's selling of gold. Many thought that this was bearish for gold because a big central bank was dumping its gold. However, all it did was give savvy investors opportunities to get in cheap. They sat back, knowing that sales were coming. The central bank, being a government entity, was not concerned with making money on their sales. So they just sold their gold at dirt-cheap levels while smart investors gobbled up their gold. The average price that the British central bank sold their gold at came in at just under 300 dollars an ounce, which was virtually the low for gold.

In the past 7 years since these sales ended, gold has shot up nearly 3 times in value. The same will go for the bond. The Fed is just trying to manipulate rates lower. It will fail. Savvy investors will wait and sell their bonds to the Fed. This may hold up the bond market for a few months. But after all of this, the bottom will drop out. Yields will skyrocket, bonds will collapse in price.

We must remember the very fact that the Fed is even buying bonds is a sign of desperation. It is a sign that foreigners are slowing down their purchases and that the supply of bonds that is about to hit the market to fund huge U.S. deficits will NOT be met. This is very bearish.

How to Make Money from this Bubble

The way we would play this is by the TBT (Ultra short bond) and HTD (Ultra Short 30 year bond). The advantage to the HTD is that it trades in Canada so you are out of the US dollar. Both of these will INCREASE in value as the bond plummets. You can also short the TLT (the bond ETF) or purchase put options on the TLT.

The Coming Collapse of The Super Bubble and the Dollar

Recently, we have talked a lot about bubbles. We have analyzed the housing bubble and the bond bubble. So it is now only appropriate that we talk about the "mother of all bubbles".

In his 2008 book, A New Paradigm for Financial Markets, George Soros talks about what he calls the "super bubble". Many may disagree with Soros' political and economic philosophies. But obviously, when it comes to trading and gauging psychology of markets, there is virtually no one better.

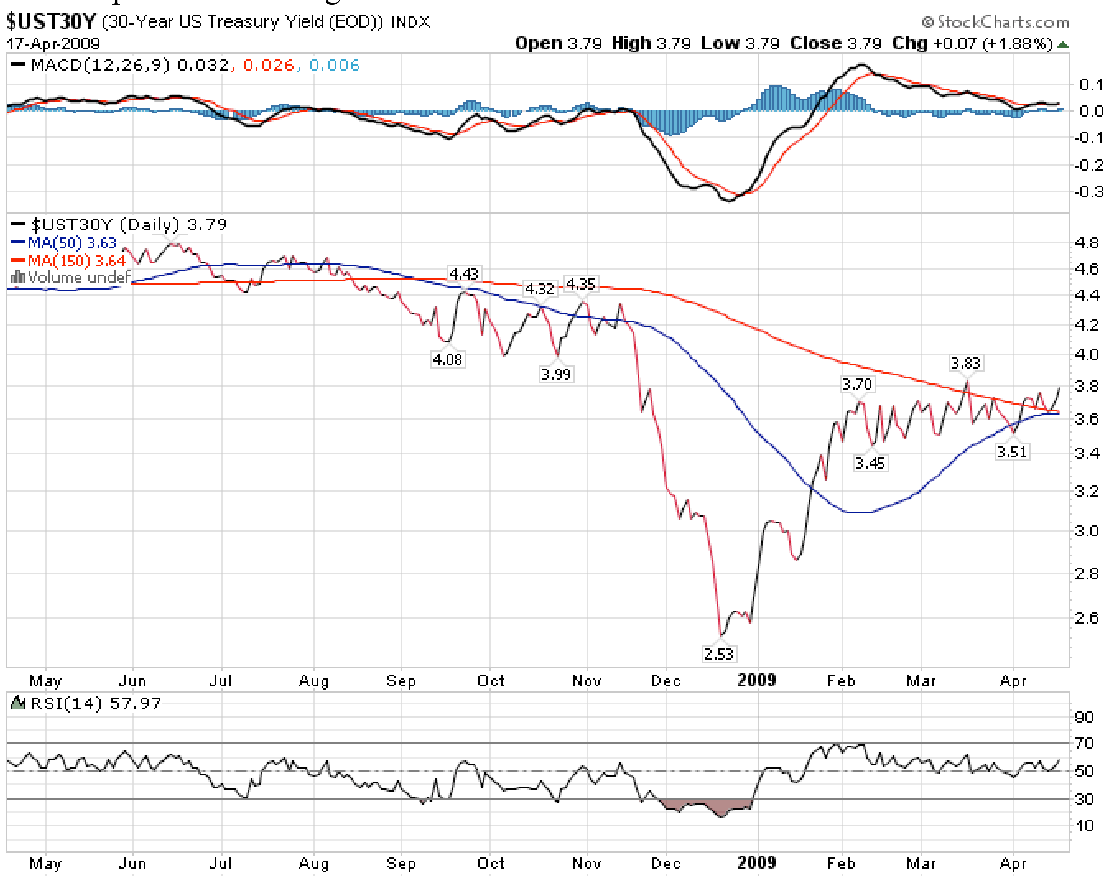
When Soros refers to the "super bubble", he explains that the United States has benefited from the fact that the US Dollar is the world's reserve currency and that money from all over the world has flowed into the U.S. This has in turn caused the US to not have to play by the same rules as other nations economically.

For example, if a country blew itself up economically and received bailout funds from the IMF, the IMF would set restrictions on that government's spending, deficits etc… However, the US was above and beyond these rules and was allowed to run excessive deficits and see excessive leverage and speculation in its financial markets. Also, it was allowed to create as much money as it wanted via the printing press.

Soros indicates that part of the financial collapse of the past year will end this "super bubble" and see a significant shift towards (more specifically China and India) the emerging economies of the world. There will be a shift of funds where the U.S. Dollar loses its' status as the reserve currency and the "safe" investment of choice. Flows of funds will be directed into Asia. If you go back and read our issue on Emerging Markets, you will see that we have come to the same conclusion.

However, I recently watched an interview with Soros on Bloomberg in which he basically stated that most bubbles have now burst. However, "most" does not equal "all"; there is one more bubble to be burst which is an extension of Soros' theories regarding the "super bubble".

The last bubble is the bubble in long-term U.S. treasuries. I believe that this is the last bubble component of the larger "super bubble". Acting out of fear and panic, investors flew to the Long Bond late last year. It was the ultimate last folly of this "super bubble". Consider the foolishness of this so-called "flight to safety" with the background of the economics prevailing during this panic. Investors rushed to buy into the very debt of the nation which caused the financial crises and which was on the verge of spending trillions of dollars and indebting itself even more with historically unprecedented and massive deficits. Basically, investors who were feeling the heat rushed into the burning building as a safe haven – this just showed you how far the "super bubble" had gone.



We feel that when the bond bubble bursts, it will be the final pinprick that will burst the "super bubble". That will mark a significant shift where funds will no longer be invested into the U.S. They will move into other assets; those assets will probably be mixed in their make up. Emerging markets, gold, commodities etc… However, what there will be is less buying of the U.S. dollar.

Many think that the dollar and bond market are gong to collapse as the Chinese and others dump. We don't think so. We think that the bubble will burst, as the world cannot meet America's insatiable demand for debt. We have heard a lot about the U.S. consumer cutting back and starting to save again. However, as the U.S. consumer has gone from a negative savings rate to a 4% rate and even assuming that the savings rate is headed back to the late seventies level of 12%, the government has picked up the slack. Most of George Bush's deficits were in the 2% of GDP range, and this year that is skyrocketing to an unbelievable 13% of GDP. The government is taking on the debt for the consumer.

At some point the U.S. is going to have to bite the bullet as the "super bubble" collapses and both the government and consumer must cut back.

The collapse of the "super bubble" will probably lead to a big decline in the U.S. dollar. If you look at the U.S. Dollar's 2001 top of 120 on the US dollar index as the top, we probably think this bust will take the dollar 50 to 70% from its high, which means the U.S. dollar index will fall from its current level of 85 to the 40 to 60 range. This would be in line with what happened to the British Pound when it ceased to become the world's reserve currency.

Why You Must Think Out of the Box

Another one of Soros' themes is to examine out of the box themes or events that are out of the ordinary and then take advantage of them. We have heard talk of deflation and past busts in real estate and financial assets such 1929 and Japan in the nineties; analysts often think and say that this bust will be the same.

However, we think what takes this out of the box or different from past crises is that we will see this crisis ending America's reign as the super power of the world. Whenever, this has happened in the past, as occurred in Rome, Spain, England, the result has always been inflationary, with the super power debasing their currency and inflating their debt away.

Also, we also wonder why can't both aspects of inflation and deflation occur? For example, why can't most financial assets remain depressed but the prices of real things, commodities, gold etc… increase in price? For example, in the Bahamas, where I reside, I have noticed rents on many upscale condos on the oceanfront have dropped 20-30 or even 40%. However, day to day expenses such as gas, food etc. have not dropped near that much in the past few years and it is my impression that food prices have remained high.

It is hard for me to envision high-end real estate either on rents or prices reaching the heights of 2006 anytime soon. Therefore, we could see a mixture of inflation and deflation where real assets increase in price and financial and real estate assets decrease in price.

One thing that really frustrates us is hearing false myths such as the myth that there can be no inflation because of the slowdown in the global economy. The global economy boomed from 1982 to 2000, yet commodity prices FELL during that period. The global economy struggled from 1970 to 1980 but commodity prices BOOMED. Economic activity really doesn't have a whole lot to do with it; monetary policies, the performance of the U.S. dollar, long-term cycles play more of a role.

We must also remember there are very little similarities to the 1920s and today. The U.S. was a huge creditor then; now they are the biggest debtor in the history of mankind. Back then the U.S. was on a gold standard; now they are on a pure fiat currency. Back then we saw commodity prices peak in 1920 and fall during the entire 1920's boom (another example that economic activity does not create inflation) then accelerate to the downside after the 1929 crash into 1932.

This time around we saw commodity prices boom and actually peak AFTER the stock market did; commodities rose until July 2008 and then falling sharply during the deleveraging in 2008. We must warn you in the coming months there will be a lot of talk of deflation. The time period right now – spring to summer of 2009 – is the most favorable for year-to-year comparisons for inflation. We are at that point in the year where commodities went up like gangbusters at this time in 2008. From now to

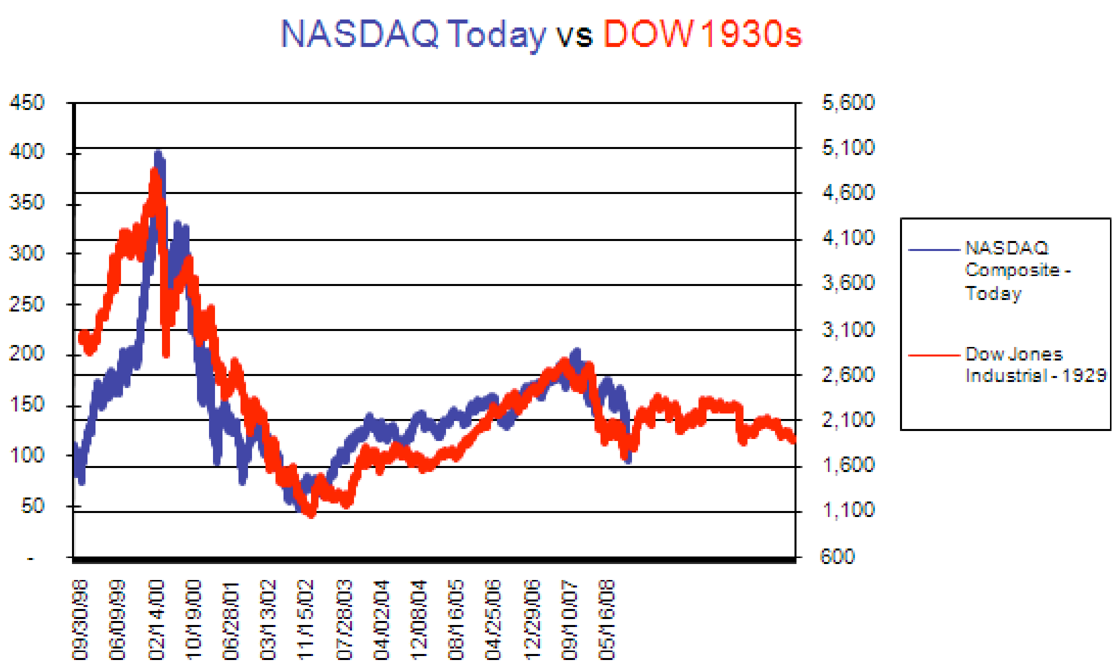
September, all of the comparisons on energy prices year over year are with oil prices at over 100 dollars a barrel. The only reason we seem to have deflation is because we are seeing year over year comparisons with last year's hyper inflated prices.

This is why we must look at different scenarios, not just act like past busts will trade exactly as they do today.

How We See Things Playing Out

There seems to be a consensus that the economy will bottom out in the second half of this year or 2010, and then rebound and the economy will then rebound for a few years into 2012.

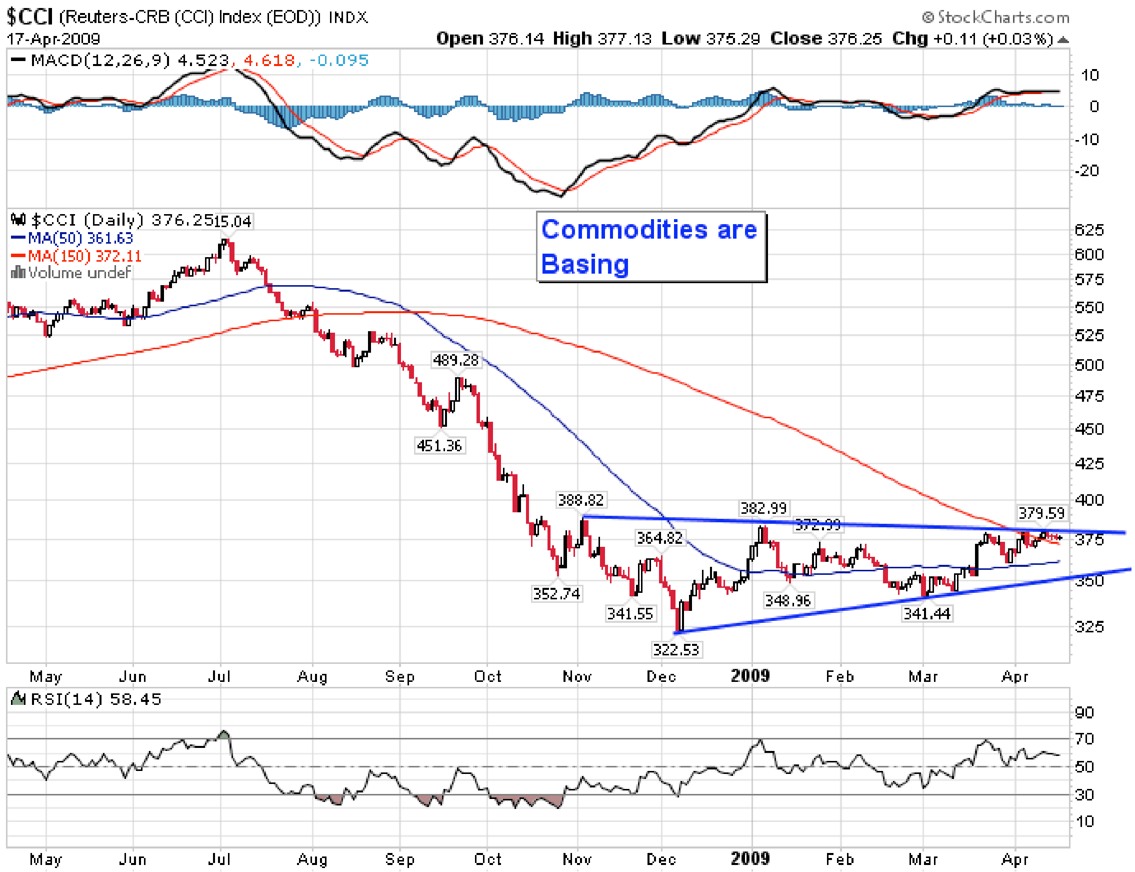
However, this is where we also differ from the mainstream using our "out of the box" thinking. We think that in the 2010 to 2012 time frame we will see a huge upside explosion of inflation and a huge upward move in interest rates.



We have again enclosed our chart of the Dow in the 1930s and the NASDAQ of the 2000s, both of which have charted each other in a mirror type fashion in the past years. Both peaked, then endured 2-3 bursting of the bubbles which took the NASDAQ down 80% and the Dow down nearly 90% over 2 ½ year periods. Then both had 5-year bull markets, which took the DOW up 300% from its lows and the NASDAQ up nearly 200%. Then both endured a 1-year bear market that took both down about 50%. If we continue to follow this trend, this would mean that in March we began a 60% rally in the NASDAQ, which should last 7 to 15 months. This fits with our theory that rates and inflation will come back not right away but later sometime in 2010 to 2011.

What will happen at first is that rates will begin to go up on the long end of the bond. Commentators will say that this is not negative. It is a sign that the economy is rebounding and there is demand in the economy and interest rates are reflecting this. This will be the positive spin of a negative event - just like when housing prices started to decline in 2007 and commentators said it was a small pullback from a hot market. Then the interest rate increases will get out of control and this will again stall economic activity. We will then start another major bear market in bonds, which could take us into a downward trend in bonds for years. The last bear market in bonds lasted from the early sixties until 1981 or nearly 20 years. The bull market in bonds lasted from 1981 to 2008 or 27 years. Therefore, we expect that December 2008 was the start of a major 15 to 20 year bear market in the bond market.


$NATGAS (Natural Gas - Continuous Contract NYMEX (EOD)) INDX
© StockCharts.com
17-Apr-2009
Open 3.71 High 3.92 Low 3.67 Close 3.86 Chg +0.26 (+7.31%)
MACD(12,26,9) -0.119, -0.136, 0.017
$NATGAS (Daily) 3.869
MA(50) 4.05
MA(150) 5.59
Volume undef
Very close to bottoming...
8.59
7.59
7.02
6.51
6.24
5.28
4.75
3.74
3.50
RSI(14) 49.92
May Jun Jul Aug Sep Oct Nov Dec 2009 Feb Mar Apr



Conclusion

What we see is some sort of false uptick in 2009. Government spending and all the measures being taken might bring a slowdown in economic decline and a slight rebound in the economy. However, we feel this will bring a false security that the worst is over when really the inflationary phase of the recession and the bursting of the bond and "super bubbles" are just beginning.