April 30, 2011

National Magazine covers signal the end of a trend
It never fails, that by the time a trend makes it to the cover of a National magazine, it’s fully played out, and the opposite trend is in force. So too last week, Barron’s cover featured a huge bull stomping the undersized bear you see below, just as the “third of the first” (iii^rd of the i^st) collapse is just about to get underway. This implies the Bear Market Rally is fully exhausted, and it’s the ferocious Grizzly, back from hibernation, which will impact our lives for at least the next several years.

Most Money Managers are “Steerish”
Again, Barron’s Big Money poll found 60% of money managers remain “bullish”, although a little closer look shows they’re really rather “Steerish”, “bulls without balls”. In aggregate, these Steers expect only a 5% market gain for all of 2011, and 2% for the first half of 2012 – hardly a bullish viewpoint. In reality he’s just “wishy-washy”; steers are easier herded than bulls. With such modest expectations, all it would take is a 10% drop to convert most to cowering sheep. Only 2% are “very bullish”, while the rest are fence sitters, numbering some 30%, while Bears at 10% are the overwhelming minority, with just 1% “very bearish”, as we are. What’s more, this herd expects the S&P to reach 1412 by December, and 1446 by mid 2012, up from 1337 last week. They project GDP growth slightly over 3% for the year, not too far off from the Fed’s revised projections, and foresee the S&P’s profits increasing to 15.5%.

Consistent with these modest expectations, only 39% of the Big Money managers think the market is undervalued. Only last fall, 53% saw plenty of bargains for the picking. Half now consider the market fairly valued and only 13% see it as overvalued – obviously they are being guided by Wall Street’s inflated earnings expectations, and clinging to the herd, rather than thinking independently.

**A 10% correction**

Yet a full two-thirds expect a 10% or more correction by year-end. The reason? About 25% expect a weaker economy, or a double-dip recession will be the cause, while 16% see the geopolitical turmoil as the primary source…still another 16% view the fall coming from disappointing corporate profits. When that 10% morphs into a 30% plummet, these neutered bulls will revert to cowering sheep.

All this timidity and two-thirds still expect equities to be the best-performing asset class in the next 6-12 months! A 12% smattering still favor precious metals as the top performer, and other commodities drew a 15% top billing. You have to wonder if anyone doing any thinking out there? Ironically, concerns about inflation drew only 1% of managers to anticipate bonds outperforming other asset classes; what’s more, 87% of
Big Money Investors are bearish on Treasuries! *Obviously this virtually guarantees that Treasuries will be big winners.*

Among equities, the US continues to be favored, with 45% of respondents making it their #1 pick, up from 27% last fall, while emerging markets excluding China, India and Brazil still came in second. Hopes that China will carry the world economy fell nearly in half to 7%, from 15% just six months ago.

**Overconfidence**

Why are investors so confident about companies’ earnings when their margins are at levels that at all other times have signaled a peak? Operating margins are at record levels, after brutal post-Lehman cost-cutting, yet by the looks of market activity one would think earnings will climb above the sky. Like many things, profit margins always revert to the mean – they snap back when they either get too high, but usually only after venturing to a low extreme.

But due to artificially cheap financing, courtesy of the Fed, just about any investment becomes profitable in the *short-run.* By the same token, when rates inevitably begin to climb, these marginal investments result in write-offs, bankruptcies and catastrophic losses. Commodity prices have been forced up by the same cheap financing, making mining and energy companies far more profitable, yet they result in shrinking profit margins for the rest of the global economy. One would think that this year’s scares from Portugal through Libya and Northern Japan would be enough to induce investor flight into safer assets, but not this time - again courtesy of the Fed. One can say, well Portugal doesn’t matter, but it’s not just Portugal. Right behind Portugal are Belgium, Spain, and a string of others, which endanger the Euro. The frugal Finns and Germans are already up in arms over having to foot the bill for their spendthrift neighbors, who have seen the Euro raise their living standards, and are unwilling to give up the “good life” of Zorba the Greek. These are all mere symptoms, just like fiscal stress in our American states and municipalities; the cause is the Bear Market, which requires a shift in gears, unlikely to be made until forced upon them. The Fed continues to induce investors to take risks by making returns on bonds and cash negligible – and investors
erroneously conclude that the only alternative is to take on more risk, when they should be either backing off, or heeding Wall Street's aphorism “sell in May and go away”.

**Fed’s distortions**

Why are bond yields so low, when at any other time worries about sovereign risk would have pushed them far higher? True, Uncle Sam has tax-raising powers and for the time being is unlikely to allow a technical default. Yet, most investors expect a pseudo-US default to be camouflaged by inflation. However investors are not counting on a dramatically shrinking economy, nor on 25-30% unemployment. Both individuals and enterprises have limits to how much tax they are willing and able to pay, before they “vote with their feet” by relocating to a lower tax locality, resulting in lower, rather than higher tax rolls. Judging by the Fed’s actions, it still fears a Japanese-style deflation much more than inflation. Yet sharply higher commodity prices do not appear to have affected Treasuries. This time, rather than manipulated by the Fed, lower rates will be the result of “flight to safety”, the result of cascading global equity markets.

In short, all the Market's contradictions stem from the Fed’s distortions. Yet expectations of an end to QE2 have already had a major effect on markets, as traditional big Treasury investors, such as PIMCO’s Bill Gross of, have sold off their entire Treasury holdings, and gone short in anticipation of a price collapse. We too have sold, and bought inverse bonds temporarily, as we await the trough to go long again.

**The probability of the improbable - Black Swans, alias “Noah events”**

The VIX, Wall Street's “fear gauge” is near multi-year lows following last week’s post-US debt warning rally. But the CBOE’s Skew index suggests apathy is building. The Skew examines out-of-the-money S&P 500 options to measure investor’s perception of tail risk, recently dubbed the “Black Swan index”. According to the CBOE the SKEW has moved within a range of 100-150 with an average of 115. A value near 100 indicates complacency and a low perception of risk. As the Skew rises, the chances of shock increase. With the SKEW near 130, the trend over the past few years is noticeably higher. As Mandelbrot clearly showed the probability of the highly improbable is far greater than virtually anyone cares to acknowledge.
Once again, investors are being coerced back into stocks, and/or reluctant to reduce exposure before making up previous losses. Not realizing that those losses are like “spilled milk” or “water under the bridge”, and not worth a second thought. Regardless of previous losses, if investors can manage to hold on to what they have left, deflation will make it proportionately and comparatively larger through increased purchasing power. Relative to others suffering catastrophic losses, those who prosper from a Market collapse or just manage to hold on to what they have, will gain tremendous purchasing power relative to everyone else. When everyone else is broke, the dollar will buy nearly as much as it did 70 years ago.

**False hopes of higher wages**
While the Conference Board’s index of Consumer Confidence increased to 65.4 in April, up from a revised 63.8 in March, as more Americans said they expected their income to rise in the near future. Unfortunately given current supply & demand dynamics, a soaring unemployment rate acts to keep wages in check, so “hopes” of higher incomes have no basis in reality. At the same time, the Richmond Fed reported weaker manufacturing activity, and according to the Case-Shiller home price index, US home prices fell 3.3% in February from the previous year.
Inflation revisited
While monetary stimulus otherwise called “printing money”, is feared to result in future inflation, so long as credit creation remains subdued this is highly unlikely. It takes the two together to cause inflation. Just like a growth in housing credit resulted in rapidly escalating demand for housing, and abnormally high housing inflation. These days, consumers and enterprises are paying down their highest-cost capital, as the prospects for higher returns bear much risk and small potential rewards. Rather than inflation, what we now have is an anemic dollar, soon to Spike and collapse in an inverted “V”. Although most credit growth is currently coming from emerging markets, the primary stimulus still came from our Fed. Induced by the profit-motive, capital was merely exported to the higher-return emerging markets.

Emerging Market Inflation

Emerging Markets have experienced both credit and money supply growth. Monetary growth particularly in the BRICs, is in the range of 15-30% over the trailing twelve months. Loose credit in turn has boosted demand excessively by those who have “done without” for so long. As we might expect, over-stimulated demand naturally leads to inflation. Yet monetary tightening, coupled with their currencies’ increased purchasing power, act to cap commodity prices.

Without exception, a flattening yield curve heralds recession. As you well know, our US yield curve remains steep, meaning higher interest rates for longer maturities, only because it has been distorted by the Fed, just as it began to flatten. However in emerging markets, yield curves are flattening as monetary tightening takes hold. Like late cycle economies, emerging market inflation is climbing, along with monetary tightening, flattening yield curves and overly optimistic earnings forecasts. 45% of EM companies reported negative earnings surprises during the last reporting period. Regardless of emerging markets’ central banks, commodity inflation will subside, given the commodities cycle is rapidly coming to an end.
Expectations of 3% GDP growth are foolhardy

With the US economy growing only at an annualized rate of just 1.8% in the 1stQ, the Fed continues attempts to “pull the wool over our eyes”, with illusionary GDP growth projections. Although down from 3.4-3.9%, the Fed’s current GDP estimates of 3.1-3.3% are for the highly gullible. It’s starting to dawn on people that this “recovery” is not as "strong" as previously imagined. This can only be followed by disillusionment concurrent with an avalanche in stocks. They blame it on higher oil prices, lower defense spending, weather-related weakness in the construction industry, and a slew of other excuses, yet the cause remains the Bear Market. The mirage continues as slower growth is chalked up as a temporary phenomenon, when in fact it’s a toned-down preview of the long-term economic contraction just ahead.

Unemployment

Instead of the 4-5% that the economy typically rebounds at this stage of recovery, at the current growth rate, the misleading 8.8% unemployment rate can only continue to deteriorate. The only way U-2 unemployment numbers can improve, is if even more people totally give up hope of finding gainful employment. That’s why U-6, which includes those who are under-employed or working part-time out of necessity, is far more realistic, though still highly understated.

Record low interest rates accompany sky-rocketing Treasuries

Although interest rates are going to remain low for a while longer, it’s not for the reason Mr. Bernanke expects. While Bernanke claims to want a strong dollar, “in principle”, in practice he’s largely responsible for its rapid deterioration. Although his actions are totally contradictory to a strong greenback, regardless he’s very likely to get his wish very soon – for all the wrong reasons! As capital flight from an equity market panic moves into supposedly safe-haven T-bonds, interest rates will tumble and the dollar surge. But don’t expect the start of a long-term phenomenon either, it’ll be just a
momentary “head fake” only to suddenly reverse into a major collapse, just as investors begin to feel “safe” once again.

The dollar ended March at the lowest level since it began to trade freely in 1973. Bernanke has lost credibility, now when he attempts to shore up the dollar, an accelerated decline occurs instead. The dollar remains the world’s reserve currency based on its powerful reputation and aura of safety, yet the Dollar’s global perception is highly inconsistent with economic “reality”. If we look at gold for example, it’s up 8% in terms of dollars this year, but in Euros, gold is down 2.5%!

Just like stocks do well when currencies drop, so too, when stocks tumble, currencies tend to outperform, this is especially true of the dollar. With the S&P at nearly the level it was in 2001, while European equities are down 35%. This does not imply that US companies have more efficient managers, but rather that the dollar has fallen more than a third against the Euro.

The Charts
As you see above the *a-b-(a), a-b-(b) Supercycle Transition* is complete, from here we drop in a move ten times the magnitude of anything we’ve seen since the last *Supercycle* move from 1982-2000.
As you see above, wave ii is complete and an a-b transition has given the false indication of a continuing rally, yet these are corrective waves moving in 3’s rather than 5’s. Below is the hourly magnification showing the maximum 3 extensions are now over.
Likewise in the SPXU a transition up is likely complete, signaling the collapse could very well begin on Monday.
In the weekly VIX below, unless I'm mistaken, the 3rd *Diag II* means there must be a spike next in volatility consistent with a collapse in the market. A jump to 40, where the uppermost *Diag >* begins in March 2009, is our first target. Eventually the VIX must exceed the high of 90 shown for the 2008 plunge in equities.

The hourly VIX, new since the debut of VIX ETFs shows a detailed complex transition which is likely also includes a “degree of trend” hike.
At the same time the catapult in the dollar has an extremely elongated tail, which like a fulcrum serves to launch it like a projectile.
The long EEM chart shows a bit more advancement than the S&P with a likely plunge to a minimum of 40.5 to where the Diag > begins. In its hourly inverse EDZ, there have been two Diag IIs to indicate a long trajectory up could begin at any moment. The dashed green lines mark the likely resistance points.
In inverse Financials this marks the third *Diag II* and no more are possible, therefore a Spike can only come next.
DRV, inverse Real Estate, is highly oversold and has completed two *Diag IIs* so far. From here a Spike is most likely.
TMV inverse bonds are on a terminal trajectory, indicated by the *Diag >*, just as we expect. Below is the big picture bonds, showing the drop we expect to the red dashed line where we go long again. As in stocks the *Supercycle transition* means a relatively giant move ahead.
Best regards,

Eduardo Mirhayes

*Exceptional Bear*

“Opportunistically timed investments that maximize wealth”