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WEEKLY REPORT

September 25, 2011

Twisting In The Wind!

People in a hurry cannot think, cannot grow, nor can they decay. They are preserved in a state of perpetual puerility.

- Eric Hoffer

We began the week with such high hopes, some based on what the Fed would assuredly do to reenergize the economy one more time, and we ended on a sour note. The deception had to do with what the Fed did, but even more with what it said. Just a few words were enough to pull the rug out from under the market. What were the magic words? The Fed stated that they noted “substantial downside risk in the economic outlook” and all hell broke loose. Stocks, commodities, gold and foreign currencies started to fall hard around 3:20 pm EST on Wednesday and continued the decline throughout the day on Thursday. In fact the sell-off was a bit unusual in that we had back-to-back 90% plus down days followed by little or no interest in stocks on Friday. That tells us the urge to sell has not yet been exhausted.

On the surface operation twist might seem like it will inject liquidity into the economy but really it's a wash. You retire US $400 billion of short-term debt and you replace it with US $400 billion in long-term debt. In other words the Fed is now kicking the can down the road just like the Obama administration and Congress did back in August with the debt ceiling debate. One thing is certain though and that is such an operation will not create jobs and it will not lead to growth. In fact if the Fed isn't careful it might even cause some damage. How can that be? China is our largest creditor and they have options. As the Fed moves its portfolio to the long end of the curve, pushing down long-term interest rates, the relative appeal of short-term debt is increased. China might be tempted to do a "reverse twist" and move to the short end—muting the impact of the Fed's twist. In the end all the Fed will do is get China out of US debt faster than it otherwise would have. I believe this is exactly what will happen since we know that China is already a net seller of US debt and it has clearly stated that it wants out.

On the home front things continue to deteriorate as it was announced that the Democrats and Republicans in Congress can't agree on budget cuts needed to keep the government open for business after the 1st of October. Does any of this sound at all familiar? Then we have the President's jobs bill looking like it will die a quiet but painful death up on the hill. As if that's not enough it seems like the "super committee" has decided that it will not even discuss tax increases. Right now taxes are at +/- 14% of GDP and that is historically very low and there is evidence that shows the economy is at its best when taxes are around 18% of GDP. It goes to show that Washington is only good at one thing, spending, and even most of that is wasted. Who else could spend almost US $4 trillion and have nothing to show for it?

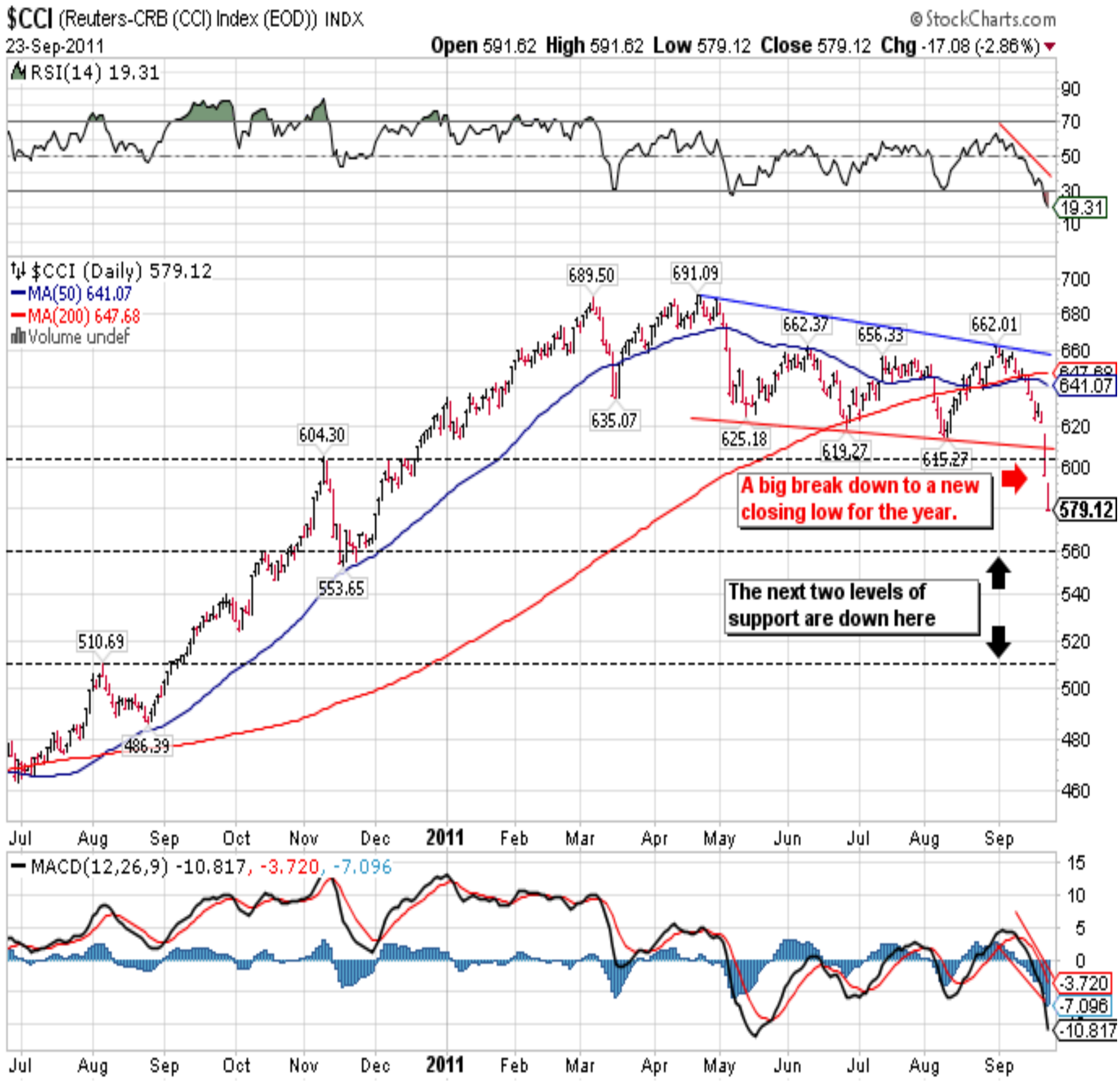
With respect to the Fed's "operation twist" we are seeing some unintended consequences, not the least of which is a big move higher in the US Dollar Index as you can see below:

This is bad news for the Fed because it makes all dollar denominated debt more expensive to service in real terms and it is bad news for the Chinese since their Yuan is pegged to the dollar. That means the price of Chinese goods goes up in real terms just when the world economy has stalled out. Talk about bad karma! As you can see this week's rally broke the US dollar out above a number of important resistance points and opens the way for a test of resistance from the old historical low at 80.16. Whether the dollar stops there or not is anybody's guess.

With respect to China the Shanghai Exchange topped out a full five months before the Dow as you can see below:

I believe the market was anticipating problems with respect to worldwide demand and maybe even the US dollar. Friday's close was a new closing low for this year and we aren't all that far away from a test of the 2010 low. The Shanghai Exchange is somewhat controlled by the government but there comes a time when you just have to let nature take its course, and we're about there.

The rising US dollar and the decline in worldwide demand for just about everything have put a serious hurt of the commodities market. This is evident in the following chart of the CRB Index:



Thursday and Friday saw *big declines* to new closing lows for the year, including a break below what should have been strong support at 1604.00! In particular copper, used in over 60% of the things that touch our daily life, cannot buy a friend. It has been the whipping boy for anyone with an urge to sell something short. Take a look:

You can see that copper has fallen off a cliff and this just a couple of weeks after numerous analysts were saying that it would be at new highs in October. Note that the 50-dma has now crossed under the 200-dma and that RSI, MACD and the histogram all register an extremely oversold condition. Like copper you have oil, the grains, cotton, coffee, sugar and lumber headed down the same road.

Commodities are just one of the markets deflating right now. Stocks are another as you can see in this chart of the Dow:

It was a difficult week for stocks as we saw the Dow give back 7% on

Wednesday and Thursday with back-to-back 90% plus down days. This is highly unusual and it was even more unusual that we saw a complete lack of interest in buying stocks on Friday as the Dow could only gain 37 points to close out the week at 10,771. You can also see that we completed an almost textbook head-and-shoulders formation with a close below the neckline. Finally the declines came on a large increase in volume as has become the custom over the last two years.

So where do we go from here? The Dow is not yet oversold and we need to look further at the Transportation Index for an answer:

Here we see a similar formation with one very big exception, the Transports managed to close below their August low on Thursday, and again on Friday in spite of a rally. That lower low is yet unconfirmed by the Dow. For the Dow to confirm it would have to close below its August 10th closing low of 10,719. It is worth remembering that the Transports lead the Dow, both up and down, and have been doing so for years.

With respect to the Dow I want you to look at the following chart and I will describe the scenario I see:

Here you see two very important series of Fibonacci numbers, one from the October 2007 all-time high down to the March 2009 low and another set from the March 2009 low to the April 2011 lower high. Notice that the 50% retracement from the all-time high down to the 2009 low is at 10,333 while the .381% resistance from the April 2011 lower high down to the 2009 low is at 10,444. The two together form a range, and I believe we are headed for a test of that range. I also believe that this range will be broken and that implies a test of the March 2009 low of 6,469. I do not know how many attempts it will take to break through this range of support but my guess is that is will break down on the first try. I say that because the indexes are not yet oversold. Finally, I expect to find a temporary bottom at the support from a 50% retracement from the April high down to the 2009 low coming in at 9,685. Then things will get interesting.

We continue to here on TV that stocks are cheap and those who don't buy right now will regret it, but stocks are not cheap. Companies are posting profits by cutting expenses and labor but this is self-defeating in the end. Unemployment rises and consumption declines so it follows that sales will decline as well. We are in that cycle now and it has spread beyond the US border and is affecting Europe, Latin America, the Middle East and China. It is producing unrest and it leads to unwillingness on the part of companies to invest. That is obvious right now as we see a record number of companies buying back their own stock. Many people think this is a good thing, but the opposite is true. The company is really saying that they have no good use for the money so they might as well give it back. Like everything else in today's world, it is an unproductive expenditure. Finally we see more and more companies disappointing on the earnings side and the gap will only increase. That's why stocks have a lot further to fall before they are truly cheap.

Aside from the deflation in commodities and stocks, we seem to be seeing deflation in the gold market as well. At least that is the way things look on the surface:

The first thing to take away from this chart is that in spite of the recent sell-off, both the primary and secondary trends remain intact. The next thing to note is that we have a convergence of not one but three trend lines coming in at 1,635.00 on the high side and running down to 1,610.00 on the low side. Finally, you can see that going back to early 2009, every time RSI on the weekly chart comes close to 50 we find ready buyers for gold and another leg up begins.

Now I want to take a closer look at more recent behavior. The market does not like to leave any unfinished business so on Friday it came all the way back down to fill a gap that was left over from early August at +/- 1,645.00. Also I've drawn in the same trend line that's on the first chart and you can see that price came right down to it and bounced. Finally we see that the histogram is in extremely oversold territory and the RSI is at a level that produced a big bounce the last time around. In short everybody is disappointed and has thrown in the towel. I've never received as many e-mails from clients swearing off gold as I did on Friday, everybody selling, so I bought at 1,640.00 because this is what a bottom looks like.

Spot gold has good support at 1,645 from a 61.8% retracement form the 1,923 high back down to the 1,478 low. Furthermore gold is thirteen days off of that *intraday high* so we stand a good chance of having seen a bottom on Friday. Good resistance is at 1,701 and a move and two consecutive closes above it would tell me that we've seen the bottom and we're on our way back up. What's the down side risk? We are 23 days down from the *all-time closing high* of 1,900.40 on August 22nd so it is possible to see a decline for another 7 days to as low as the 200-dma at 1,522.00. So far gold has corrected 292.00 or 15.2% using intraday numbers. If I use closing numbers gold has corrected 238.00 or 12.5% and neither one is anything out of the ordinary and hardly justifies the calls to an end of the bull market that resonate through the media. I will repeat here what I've been saying for months. Gold has not topped and will continue to march to new highs until January at the very least. We all love it when it goes up but reactions occur and they need to be seen for what they are, i.e. buying opportunities! I bought on Friday and if we fall to the 200-dma I will simply buy again.

Silver is the beautiful young woman that's kept in an ivory tower by a rich old man and we saw evidence of that this week with a 15% decline in one day. You can only worship from afar. We see things in the silver market, and with gold to a lesser degree, that we simply don't see in any other market. I'm referring to manipulation of course and it will continue and that's fine as long as we see it for what it is.

With that said I've called it a name but I haven't resolved anything. Silver is the most difficult market and it's the only market I use stop/losses in (gold on rare occasions). Now let's look at a five-year chart and see if we can pick up the pieces:

Like gold silver's primary trend as well as the secondary trend (shown here with an upward sloping red line) remain intact. Note that silver came almost all the way down to the support from the 50%

retracement from the April high back down to the October 2008 low. That support stands at 29.11 and Friday's low was 29.84. From there it bounced to close at 31.08 and good resistance is all the way up at 34.00.

Without a doubt damage has been done but silver is extremely oversold and I think it found its bottom. Gold on the other hand has suffered minor damage. Two weeks ago gold had an extremely bullish Point & Figure price target of 2,190.00. This last week the chart changed and gold hosted a bearish price target of 1,690.00, and that has been met. Gold is on the verge of being extremely oversold and silver is beyond extreme. At points like these no one wants them and no one is willing to step up to the plate and buy, but it is precisely at times like this that you buy. I have been at this point a half dozen times or more over the last eleven years and I have never been disappointed by the outcome. Gold is not going to decline over the October-December period with India reaching the height of its buying season and the Chinese economy under considerable strain. They can raise the margin requirements for gold and silver all the up to "cash", and they probably will, but it will not derail the train. Given the reaction we've seen, gold is now good to go all the way up to 2,450.00. The only question is will it start from here or a worst-case scenario of 100.00 lower. I suspect it will start from here and if Friday's low holds through this coming week, then you can assume that the low is in fact in. Either way gold is a buy.

CONCLUSION

With each passing week volatility is increasing and not just in the stock market. The copper and silver longs had a truly religious experience this week as buyers simply folded up their tent and went home. With respect to the stock market we can see that the Volatility Index increased by 25% this week and left a big unfilled gap in its wake:

The trading range in the Dow is 200 to 400 points a day and puts a strain on anyone who try's to trade on margin. You are often both right and wrong on the same day, and you go home poorer for the experience.

News is driving the market like never before and the next headline is like a quick fix. Anything from the Fed is treated like manna from above and yet no one seems to catch on that the Fed is powerless to do anything else. Congress and the administration can't get together about anything and the EU members are following in their footsteps. All in all they'll all fiddle while the world economy burns. That's a realization that hasn't sunk into the heads of those who live on Main Street just yet, but it will. Once it does the elevator will only move in one direction, down! We're almost there. Each time the Dow is down 400 to 600 points at 2 pm you can just see it the faces of the analysts on TV. Will this be the time that it doesn't hold? They also know its coming but they must serve their Master and avoid the real questions. Soon they wouldn't have any other alternative but to turn and face reality.

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