Patient Capital.... Positioned for Profit

A PEEK AT THE WEEK THAT WAS - August 10, 2013

It's been a tough week at Club S&P.

Apparently a couple of Bartender Ben's bus boys got a little too close to the punch bowl and a few of the party goers thought they might try to take it away. The party crowd have been on edge ever since.

So this week, we'll pose the question...have the markets just become one big "Fed Watch". And in the process, we'll take a look at several graphs which may help to throw some light on the recent market jitters.

Of course, we couldn't resist one chart on the shiny stuff, which we think is particularly timely.

Finally, we'll take a look at our eye popping chart (actually a graph) of the week. We've written before about the sheer magnitude and associated danger related to the global derivative exposure of the major US banks. Well, it seems like the Germans love their derivatives too.

FED WATCH...ISN'T THERE ANYTHING ELSE ON TV?

When it comes to Club S&P, we wonder if anything really matters other than the punch bowl? The party crowd are so fixated on the amount of vodka being poured in, that nothing else seems to matter. All they do is keep a keen eye on Bartender Ben and his crew to make sure they are on the job. But most at the party know that Ben's shift is over at the end of the year. So they are increasingly worried about what the rest of his bar staff are up to. Could one or more of them try to take the punch bowl away?

This seems like an increasingly jittery party.

> From Yahoo Finance, Tuesday, August 6 - 9.00 AM
> **Markets await Fed speech for clues on stimulus**
> ***Stocks drift lower as investors await Fed speech for clues on future of stimulus program***
>
> From Yahoo Finance, Tuesday, August 6 - 12.50 PM
> **Wall Street drops after comments from Fed's Lockhart**

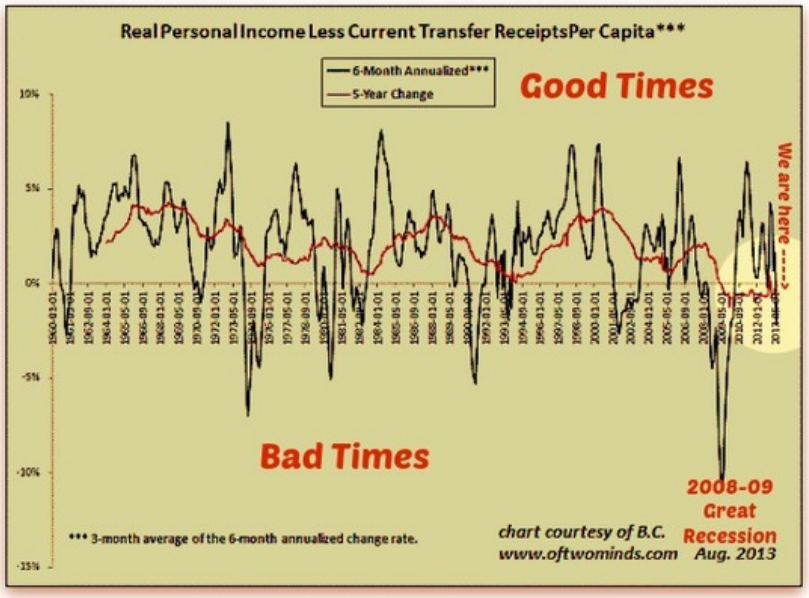
Of course, Ben is hoping that if he gets the party people boozed up enough on his patented, trademarked and oh so delicious "Wealth Effect", their buzz will make them sufficiently confident to start spending again...on things they probably don't need and actually can't afford. Once they start spending and consuming in earnest, he (or most likely his successor) can gently slide the punch bowl away and no one will notice. The party will just keep a'rockin'.

Here's the problem Ben. Whether they want to spend or not, the average good citizen has less money to do so in real terms now than he or she did before. And they know it.

As we'll see from the rather busy but signiciant chart below (courtesy of Hugh Charles Smith and his oftwominds.com blog), **the real personal income of individuals has been negative for the past five years**. This just makes sense. There are significantly more unemployed and underemployed than ever and as we've written before, the jobs that are being created are not of stellar quality and many are part time. Burger flipping baristas do not make a lot of moola.

Take a good look at this chart. We know it's not easy to read but it tracks real personal

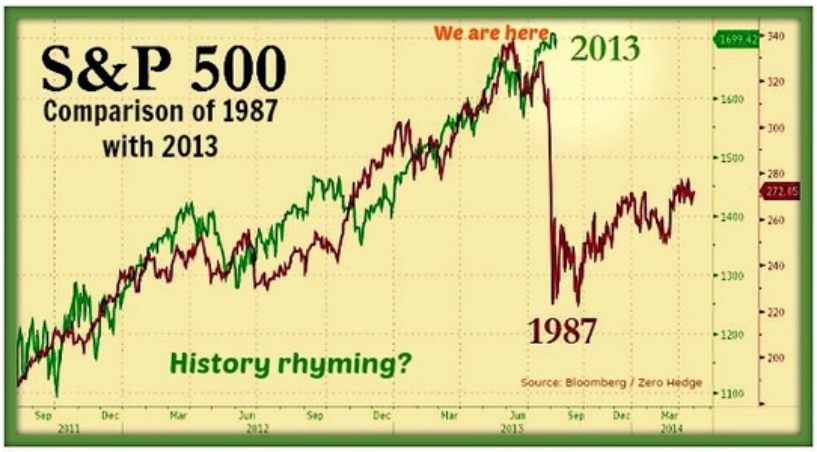
income from 1960 to the present. It excludes government transfer payments such as Social Security, welfare, etc. and is adjusted for loss of purchasing power...in orther words...inflation. As such, it's a pretty good representation of Jane and John Citizen's real ability to spend. Note also, how every time the real income level drops below zero on this chart, it has coincided with a recessionary period. Again, this just makes sense because Jane and John have less money to spend directly into the economy or to support expanded borrowing.



So Ben, your zero interest rate policy (ZIRP) has starved savers in recent years and virtually forced everyone into Mr. Market's party. The smarties who got in early are edging out. Mom and pop, who just can't stand getting no return on their money, are lining up at the front door. Their real personal income is lower than it has been and they are desperate for yield. The lights are dimmed inside the intoxicating atmosphere of Club S&P so they can't necessarily see the danger signs. But they are there.

Let's take a look at just a few, shall we?

Firstly, let's dive into our "History Rhymes" file and go back to 1987, a year that started out with such promise but ended in sadness for many. If you compare the nominal performance of 1987's Club S&P with Ben's boozy club of today, there is an eerie resemblance. Of course, old timers will remember that in 1987, interest rates were far different than they are today and the Fed was far less cheery, but it does give us reason for pause.



Which takes us to our next chart, showing the current market volatility...or should we say, lack thereof. When the volatility index (the VIX) is low, everyone is exuberant. When the volatility is high, fear is predominant.

From Investopedia:

The VIX is a contrarian indicator that not only helps investors look for tops, bottoms and lulls in the trend but allows them to get an idea of large market players' sentiment. This is not only helpful when preparing for trend changes but also when investors are

determining which option hedging strategy is best for their portfolio.

From Wikinvest.com:

The index, commonly known by its ticker VIX, is also known as the "fear index" because a high VIX represents uncertainty about future prices. The index is calculated using the price of near-term options on S&P 500 index. Because the value of an option is closely linked to the expected volatility of its underlying security, options prices can be a useful indicator of investors' expectations of volatility.

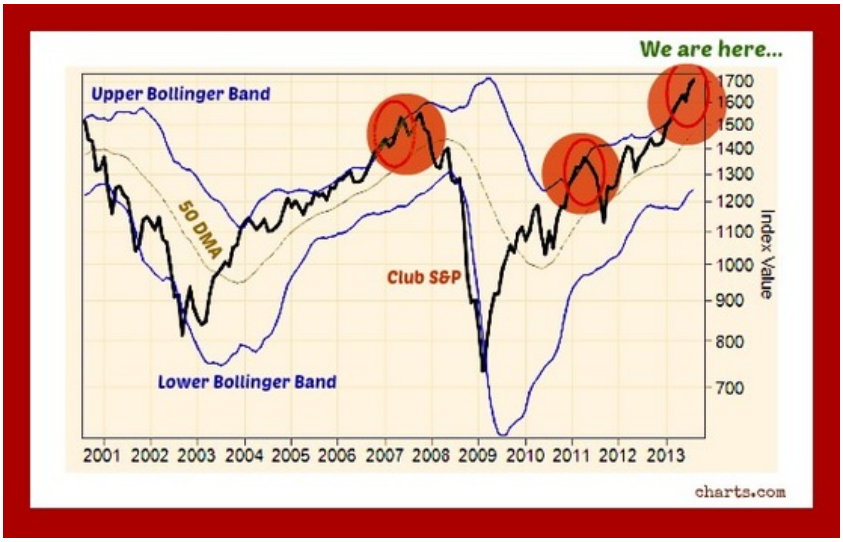
The chart below shows the VIX for the past 12 months. Right now, Mr. Market is dancing a jig and mom and pop are loving it. No reason to worry. Bartender Ben has our back.

Finally, let's take a look at a particular technical indicator called "Bollinger Bands", which, fortunately or unfortunately for Club S&P, have no relationship to champagne.

Once again, from Investopedia:

A band plotted two standard deviations away from a simple moving average, developed by famous technical trader John Bollinger. Because standard deviation is a measure of volatility, Bollinger Bands® adjust themselves to the market conditions. ***The closer the prices move to the upper band, the more overbought the market,*** *and the closer the prices move to the lower band, the more oversold the market.*

Notice below how each time the S&P bumped up or through the upper Bollinger Band (the red dots) it followed with a sell off. Of course, the most dramatic was in 2008 but here we are in 2013 where, at the end of July, the S&P had actually closed above the upper Bollinger Band. This is an unusual occurrence, to say the least. It might make sense to take heed. The smart money is.



IF IT'S SUCH A GOOD TIME FOR THE SMART MONEY TO SELL, WHY WOULD WE BUY?

To us, Ben and his bankers don't really look like party folks and so we don't have as much confidence as others that his gang really know how to keep a party going without the virtually

unlimited booze. The so called smart money knows that too.

As we saw last week, while the retail investors are lining up at the front door of Ben's Club S&P, the institutional investors are easing out the back exits. The same is apparently happening in the private equity and mega fund space.

From Bloomberg, August 2:

Fortress to Blackstone Say Now Is Time to Sell on Surge

Private-equity managers from Fortress Investment Group LLC (FIG) to Blackstone Group LP (BX), which ***made billions by buying low and selling high****, say now is the time to exit investments as stocks rally and interest rates start to rise.* **[buying low and selling high...what a quaint idea?]**

*"****This is a better time for selling our existing investments than making new investments****," (Fortress Fund's Pete) Briger said on the call. "There's been more uncertainty that's been fed into the markets."* **[and we know just who we can package them up and sell them to...he he...]**

Their comments echoed remarks from Apollo (APO) Global Management LLC Chief Executive Officer Leon Black to Blackstone President Tony James, who said last month ***the environment is ripe for selling*** *because credit markets are still hot and equities strong.* **[yep, just like mom and pop like it...]**

*"It's almost biblical: there is a time to reap and there's a time to sow," Apollo's Black said at a conference in April. "****We think it's a fabulous environment to be selling****. We're selling everything that's not nailed down in our portfolio."* **[And mom and pop are buying...what's not to like? And we are doing God's work, after all!]**

As usual, the snide bracketed comments are ours.

To read the full article, click here.

Folks, this market could go up and up because, as that best friend of central bankers the world over, Lord Keynes, observed many decades ago...***"The market can stay irrational longer than you can stay solvent".***

But if ever there was a time to be both rational and solvent, we suggest it is now.

In summary, we will leave it to the great John Hussman (of Hussman Funds' fame) to say it better than we ever could:

The U.S. equity market is now in the third, mature, late-stage, overvalued, overbought, overbullish, Fed-enabled equity bubble in just over a decade. Like the 2000-2002 plunge of 50%, and the 2007-2009 plunge of 55%, ***the current episode is likely to end tragically****. This expectation is not a statement about whether the market will or will not register a marginal new high over the next few weeks or months. It is not predicated on the question of whether or when the Fed will or will not taper its program of quantitative easing. It is predicated instead on the fact that* ***the deepest market losses in history have always emerged from an identical set of conditions*** *(also evident at the pre-crash peaks of 1929, 1972, and 1987) –* ***namely, an extreme syndrome of overvalued, overbought, overbullish conditions****, generally in the context of rising long-term interest rates.*

To read his full and very good commentary, click here.

A GOLDEN SEASON

We just had to throw in one chart on the shiny stuff, if only because it's so timely...and we thought you might like to see it.

More than most commodities, gold has a certain seasonality to it. The northern summer is typically not a good seasonal time for gold. But that tends to change as we move into the fall. You might ask why?

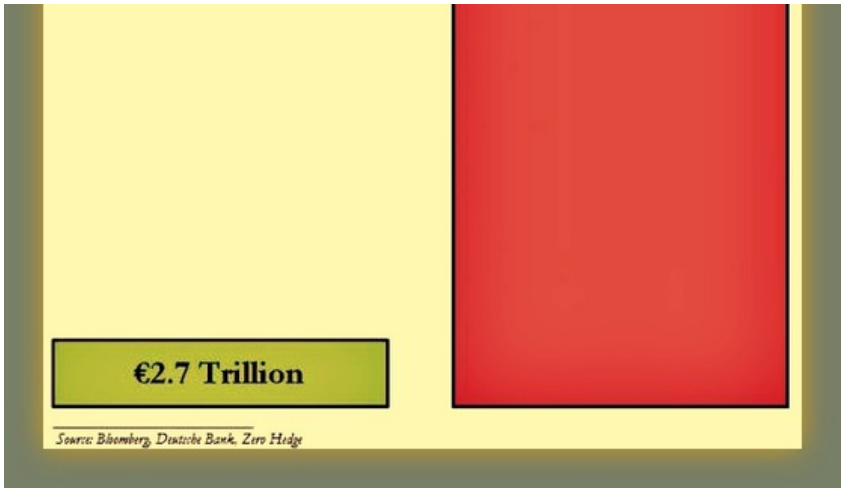
A lot of it has to do with the gold buying season in Asia and India. Gold is the wedding gift of choice in the Sub Continent and the wedding season follows the festival season. So from August till May, there is a lot of demand for gold in India. Of course, the genius Indian bankers recently doubled the import tariff (to 8%) on the shiny stuff but the smugglers and black marketeers have stepped in to help fill the void. The Indians will have their gold, one way or the other. Will this year be different? We think not.

GRAPH OF THE WEEK - DERIVATIVES GONE WILD?

We tend to worry a lot about derivatives and what can possibly go wrong with greedy bankers, unlimited liquidity, massive leverage and an almost rabid willingness to take risks with other people's money. How much is too much? As usual we have no idea but when we look at the derivatives exposure of our friends at Deutsche Bank, we have to wonder. Apparently, they now have more wagers out than even Jamie's crew over at JPMorgan. Now that's quite an achievement.

Observe the stark difference between DB's derivative exposure and the German GDP.

As industrious as the Germans tend to be, we wonder if they ever make enough cars, sauerkraut and sausages to cover the outlandish bets of their favorite bank.



Til next week...

"Ignorance is the curse of God. Knowledge is the wing wherewith we fly to Heaven."
William Shakespeare

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