



What's New?

December 1, 2009

KEYS TO THE BEGINNING OF A RECOVERY:

- 1. The Real Estate market must stabilize. If not reversing, at least not continuing to fall. *NEW HOUSING STARTS UP this past Spring and Summer because of seasonal factors but inventory still huge! The Nationwide COMMERCIAL COLLAPSE IS JUST BEGINNING!***
- 2. Unemployment must stabilize. If not reversing, at least not continuing to rise. Last report was lower! *IT'S ACTUALLY WORSE as a "%."* Back to near 11% - AND IT CONTINUES TO MOUNT @ OVER 250,000+ weekly.**
- 3. Corporate Earnings (profits) must stabilize. If not reversing, at least not continuing to fall. *SOME POSITIVE SIGNS but mainly in TECHNOLOGY.***
- 4. Banks must begin to make loans again (especially to small businesses and potential home owners...albeit under ancient premises of buyers being qualified and of all things, a down-payment! *Lots of "hoopla" from the mega banks, but it appears that there's no real progress. They're "hoarding" any cash they can get their hands on. And now here comes the Regional problems compounded by PRIME loan and Alt-A resets!***
- 5. The DOLLAR has to decline. *It's started for REAL!***
- 6. Auto sales must stabilize at some NEW level. *Maybe started!***
- 7. The consumer must get "back in the game of consumin'" *NO WAY!***

ANALYSIS OF THE ABOVE: No Real Hope YET! -12/1/2009

US Bankruptcy Is All but Certain!

This number is certainly beyond comprehension, it's one of those numbers that's so unbelievable you have to actually think about it for a while... Get this, within the next 12 months; the U.S. Treasury will have to refinance \$2 trillion in short-term debt. And that's not counting any additional deficit spending, which is estimated to be around \$1.5 trillion. Put the two numbers together. Then ask yourself, how in the world can the Treasury borrow \$3.5 trillion in only one year? That's an amount equal to nearly 30% of our entire GDP. And we're the world's biggest economy. Where will the money come from?

How did we end up with so much short-term debt? Like most entities that have far too much debt - whether subprime borrowers, GM, Fannie, or GE - the U.S. Treasury has tried to minimize its interest burden by borrowing for short durations and then "rolling over" the loans when they come due. As they say on Wall Street, "a rolling debt collects no moss." What they mean is, as long as you can extend the debt, you have no problem. Unfortunately, that leads folks to take on ever greater amounts of debt... at ever shorter durations... at ever lower interest rates. Sooner or later, the creditors wake up and ask themselves: What are the chances I will ever actually be repaid? And that's when the trouble starts. Interest rates go up dramatically. Funding costs soar. The party is over. Bankruptcy is next.

When governments go bankrupt it's called "a default." Currency speculators figured out how to accurately predict when a country would default. Two well-known economists - Alan Greenspan and Pablo Guidotti - published the secret formula in a 1999 academic paper. That's why the formula is called the Greenspan-Guidotti rule. The rule states: To avoid a default, countries should maintain hard currency reserves equal to at least 100% of their short-term foreign debt maturities. The world's largest money management firm, PIMCO, explains the rule this way: "The minimum benchmark of reserves equal to at least 100% of short-term external debt is known as the Greenspan-Guidotti rule. Greenspan-Guidotti is perhaps the single concept of reserve adequacy that has the most adherents and empirical support."

The principle behind the rule is simple. If you can't pay off all of your foreign debts in the next 12 months, you're a terrible credit risk. Speculators are going to target your bonds and your currency, making it impossible to refinance your debts. A default is assured.

So how does America rank on the Greenspan-Guidotti scale? It's a guaranteed default. The U.S. holds gold, oil, and foreign currency in reserve. The U.S. has 8,133.5 metric tonnes of gold (we are the world's largest holder). That's 16,267,000 pounds. At current dollar values, it's worth around \$300 billion. The U.S. strategic petroleum reserve shows a current total position of 725 million barrels. At current dollar prices, that's roughly \$58 billion worth of oil. And according to the IMF, the U.S. has \$136 billion in foreign currency reserves. So altogether... that's around \$500 billion of reserves. Our short-term foreign debts are far bigger.

According to the U.S. Treasury, \$2 trillion worth of debt will mature in the next 12 months. So looking only at short-term debt, we know the Treasury will have to finance at least \$2 trillion worth of maturing debt in the next 12 months. That might not cause a crisis if we were still funding our national debt internally. But since 1985, we've been a net debtor to the world. Today, foreigners own 44% of all our debts, which means we owe foreign creditors at least \$880 billion in the next 12 months - an amount far larger than our reserves.

Keep in mind, this only covers our existing debts. The Office of Management and Budget is predicting a \$1.5 trillion budget deficit over the next year. That puts our total funding requirements on the order of \$3.5 trillion over the next 12 months.

So... where will the money come from? Total domestic savings in the U.S. are only around \$600 billion annually. Even if we all put every penny of our savings into U.S. Treasury debt, we're still going to come up nearly \$3 trillion short. That's an annual funding requirement equal to roughly 40% of GDP. Where is the money going to come from? From our foreign creditors? Not according to Greenspan-Guidotti. And not according to the Indian or the Russian central bank, which have stopped buying Treasury bills and begun to buy enormous amounts of gold. The Indians bought 200 metric tonnes this month. Sources in Russia say the central bank there will double its gold reserves.

So where will the money come from? The printing press. The Federal Reserve has already monetized nearly \$2 trillion worth of Treasury debt and mortgage debt. This weakens the value of the dollar and devalues our existing Treasury bonds. Sooner or later, our creditors will face a stark choice: Hold our bonds and continue to see the value diminish slowly, or try to escape to gold and see the value of their U.S. bonds plummet.

One thing they're not going to do is buy more of our debt. Which central banks will abandon the dollar next? Brazil, Korea, and Chile. These are the three largest central banks that own the least amount of gold. None own even 1% of their total reserves in gold. Surfers and trend followers love to ride the wave – unless the wave is a tsunami; then they must get off before it crashes. When a heavily indebted country holds interest rates at zero and refuses to defend its currency, a currency carry trade results. Carry trades build like a tsunami and end in disaster.

Speculators borrow and short the weak currency (in this case the dollar) and put the proceeds into interest bearing notes of a strong currency (New Zealand and Australia dollars, Brazil's Real, etc.).

As the weak currency continues to decline, huge profits are made, leverage is employed and more speculators and investors join the party. The carry trade builds to huge proportions; US dollars are shorted and sold with the proceeds used to buy commodities, stocks, real estate, etc.

Picture a game of musical chairs, where you keep adding people but not chairs. When the music finally stops, the scramble for a chair is ferocious. A carry trade ends when the weak currency begins to rally. Huge profits can turn into huge losses overnight. It is a mad scramble to liquidate assets and repay dollars before you get crushed.

We saw in 2008 what happens when investors want to sell assets at the same time; everything goes down. Below are the reasons we believe a dollar carry trade has formed and, like a tsunami, is about to crash ashore and reverse, leaving devastation in its wake:

- 1. Everyone is short the dollar. A recent survey showed 98% of investors have lost confidence in the dollar.*
- 2. World stock and commodity markets are beginning to trade tic for tic inverse to the dollar.*
- 3. Recently, 3-month Treasury bills went to 0% interest and 12-month Treasury bills to 0.26% interest. Some institutions are already seeking higher ground.*
- 4. Brazil has introduced a 2% financial transaction tax on foreign investments in Brazilian stocks and fixed income securities. Brazil does not want the Real to appreciate further. President Lula de Silva appears to understand the implications when a carry trade reverses.*

Both Liu Minkang, chairman of the China Banking Regulatory Commission, and Donald Tsang, the chief economist of Hong Kong, have recently stated that the Federal Reserves policy of keeping interest rates near zero is creating a massive amount of dollar speculation in the form of a carry trade.

We certainly agree, as they remind the world of the Asian financial crisis of 1997 brought about by the Yen carry trade. Most of the damage in 1997 was limited to Asia, but that will not be the case with the US dollar carry trade. Remember the Asian Contagion?

No one knows for sure if a dollar carry trade has formed, how big it is, or when it will reverse. By our calculation, a 4% rally in the dollar (to 78 on the dollar index) should touch off a short, swift collapse in world stock and commodity markets.

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We continue to receive more and more inquiries about our Down-side Risk Management disciplines along with our group of recommended money managers. We appreciate your "referrals." It's the main way we continue to build our business.

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