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LETTER 1407

**June 28, 2006**

**June 9, DJIA 10891.92; PTI 5685; A-D Ratio +28.07**
**June 16, DJIA 11014.55; PTI 5678; A-D Ratio +27.23**
**June 23, DJIA 10989.09; PTI 5669; A-D Ratio +27.04**
**S&P Yield: 1.96% S&P p/e: 17.14**
**Gold 50-Day MA: 644.50**

**THE FED** — The papers are full of articles regarding what the Fed might do or not do with short rates. But how is it that nobody ever questions the very worth or non-worth of the Federal Reserve itself. The Fed has never been audited. It's legitimacy, it's worth, is NEVER questioned — the Fed appears immune to questions. One problem is that nobody understands what a monstrous fraud the Fed is.

When the US government needs money, it doesn't just issue United States Federal Notes (dollars), which it certainly could do. In other words, incredibly, the US government does not issue its own money. Instead, the government issues bonds, thereby loading itself with ever increasing interest-bearing debt. Here's how this disgrace works —

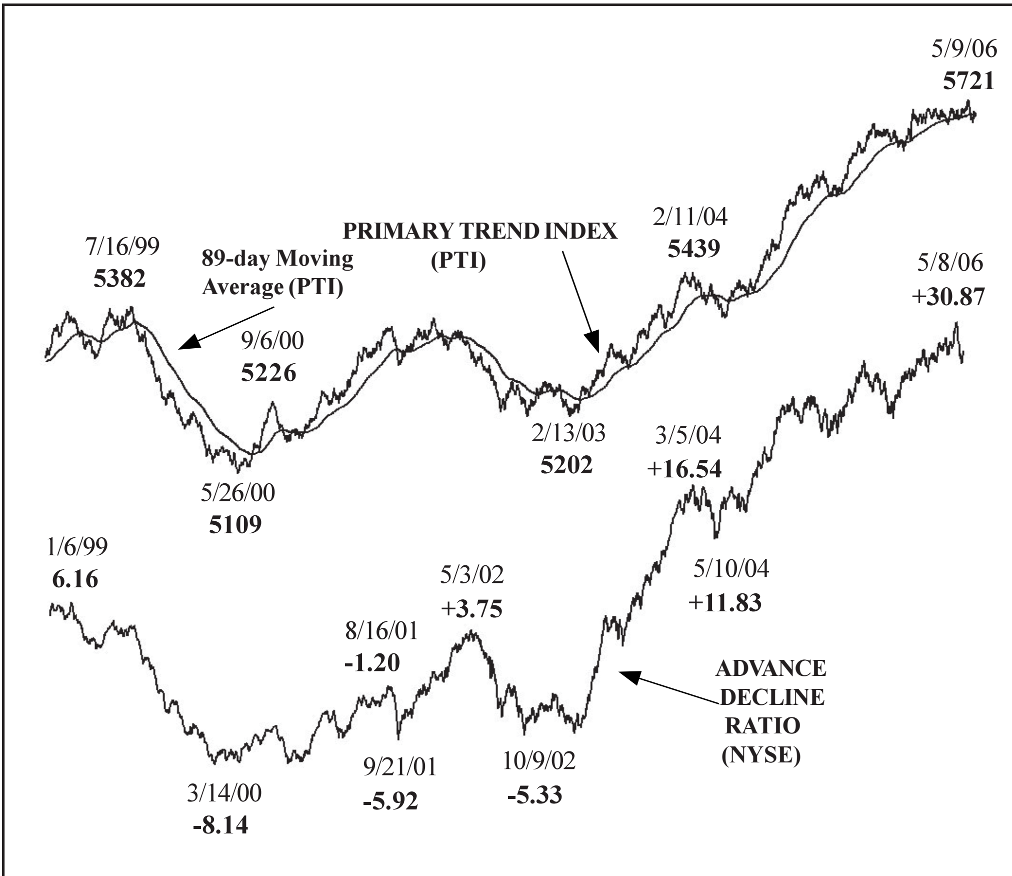
The US government issues a billion dollars of interest-bearing US government bonds. It takes the bonds to the Federal Reserve — the Fed accepts the bonds and places one billion dollars in a checking account. The government then writes checks to the total of a billion dollars against the checking account — a billion dollars that has been created "out of thin air."

Meanwhile, the debts of the US grow and grow. And the government pays interest on the bonds. Yet that isn't enough for the US government. It taxes its citizens, taking away a percentage of their passive and active earnings. And as if that isn't enough, it robs its citizens via inflation, so that as their living costs rise, simultaneously their savings are whittled away.

The Fed has been in existence for 93 years. In those 93 years the Federal Reserve Notes that the Fed issues have lost 98% of their purchasing power. To cover up this monumental scam, we hear the Fed blather and bluster about how worried they are about the current inflation rate. The current inflation rate is the cover-up; what kills us is the systematic year-after-year loss of purchasing power of those billions of fiat Federal Reserve Notes.

So the system allows this semi-private banking system to create money out of absolutely nothing (all of it a loan to our government) and charge interest on this debt forever. Thus, the Fed collects interest on the government's own money. It's a system that is beyond belief, but one that runs the life blood of the nation — the life blood of a nation is its money. A communique sent from the Rothschild investment house in England to its associates in New York noted, "The few who understand the system. . . will either be so interested in its profits or so dependent on its favors that there will be no opposition from that class, while on the other hand, the great body of people, mentally incapable of comprehending . . will bear its burdens without complaint."

**DEBT** — The US is up to its eyebrows in debt — but the debt I'm thinking about is consumer debt. "Lots of debt and no savings" is the picture of the US consumer. Well no, optimists tell us that consumers' savings are in the increased value of their homes or their condos. But housing prices, like the price of almost every other asset class, are set at the margin. And




at the margin, there's a ton of badly financed homes and condos that are due to have their variable-rate mortgages reset.

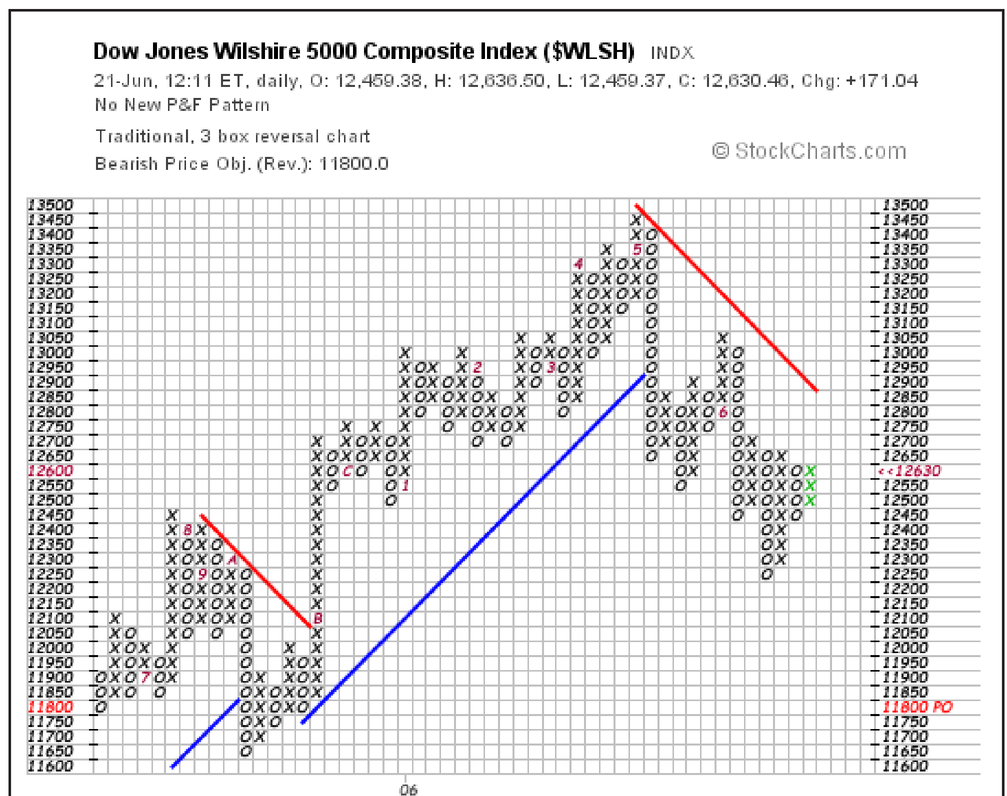
The new resets on mortgages are going to shock a lot of home buyers who were convinced that owning a home was the one-day road to riches. In fact, the "wealth through housing" was so thoroughly accepted by US consumers that an amazing 40% of all home and condo purchases last year were second homes. In other words, the buyers didn't need these beauties to actually live in, most were simply bought on speculation. Heck, if you owned one home and its price was rising, why not own two homes, maybe even three.

Below we see the "bad boy" of the situation. This is a daily chart of the bellwether 10-year T-note, around which most mortgage rates are figured. The trouble with this picture is that the trend of the 10-year note is bearish. Today the yield on the 10-year T-note is 5.15%. If the note breaks to a new low, the yield is going to rise to a new high for the year. And that will put the squeeze on all debt, including, of course, a lot of the mortgage debt held by US home owners.

That the Fed will boost the Funds rate to 5.25% at the end of June appears to be "in the bag." The housing industry isn't exactly thrilled about that. And now the talk is of another boost in August. Well, maybe, we're not really certain about August, but it seems that new Fed chief Bernanke is out to show the populace that he's not "Easy Al." Mr. Bernanke wants to come on as "No-nonsense Bennie," and he's sorry, really, really sorry that he ever mentioned those damn helicopters. Hey, people, forget about "Helicopter Ben," and get used to "Brutal Bennie." Well, all I can say is that it's shaping up to be a "fun year."

The big home builders gave us the early hint that all was not well in housing. Most of the home-building stocks look and act about the same so let's check out a typical home-builder, giant KB Homes. The stock has already collapsed as have the other home-builders. Now these stocks are oversold, and they should be ready for some kind of upward correction. What I want to see is how much of a correction these stocks can put together. If they are essentially weak, the correction will be unimpressive. If the home building situation is better than we think, then they'll build a strong bottom and the stocks will move substantially to the upside. Let's watch 'em. After all, it costs us nothing to watch.

I love the big picture, and the big picture in the stock market is the Wilshire 5000, an index that covers almost all the stocks on the NYSE, the Nasdaq and the Amex. The only thing bigger than the Wilshire is the Dow-Jones World Stock Index, but for now let's stay with the stocks of the good ol' US of A. This P&F chart shows that the Wilshire gave its first signal of trouble when it turned down and filled the 0 box at a price of 13100 in May. Down went the 0 column to the 12650 box. Next, a further drop to 12550, and then a rally to 13050. Well, to make a long story a bit shorter, the latest move is a column of 0s down to the 12450 box. And the question now is will the Wilshire rally to fill the 12750 box or will it decline to 12200 and reconfirm the downtrend.




I like this chart because it is so clear, so decisive and so important. After all, the trend of nearly 6,000 stocks (that's what the Wilshire actually traces) is pretty darn important. In fact, I'd say that if the Wilshire declines to hit the 12200 box, we're on our way to a rotten economy, probably a recession. That's what the Wilshire is weighing right now. Let's watch the Wilshire the way a hawk watches a rabbit. You know, they say a hawk can spot a rabbit from half a mile up in the sky. That's the way I watch some of these charts!

I want to talk about one major change in the world economic picture. It's the decision by Chinese authorities to clamp down on the inflation that

has been running rampant in China. Said deputy central banker We Xialoing, "We will remove the firewood from under the cauldron so that banks do not have the money to spend." In a special operation on June 13th, the Chinese central bank absorbed 100 billion yuan ($12.5 billion) from the banking system.

Then on June 16th the People's Bank of China lifted bank reserve requirements by a half-percent to 8.0% effective July 5. Said the central bank, "Money supply and credit growth is too fast. And also the trade surplus is widening. The increase in bank requirements to 0.5% is aimed at curbing this rapid growth. This increase would help drain 150 billion yuan from the market." The Chinese central bank wasn't fooling around, and its moves have put pressure on commodities across the entire world.

One place I've been watching is Dr. Copper. Copper is used in large quantities everywhere for almost everything. Copper is a great international economic barometer. Which is why economists watch the action of copper so closely. Recently, copper has been on a tear, rising to record high prices. But the chart above shows the recent top-out for copper. However, copper is still holding far above its 200-day MA, and the histograms are beginning to contract towards zero. Actually, copper looks a lot like gold. Remember, the central banks want to press hard — er, but NOT too hard.

**RUSSELL MUSINGS:** Investing is one tough business. Consider this — Dr. John Hussman notes that "the S&P 500 has underperformed the lowly 3-month Treasury bill for what is now more than 8 years, earning average annual total returns of just 3.2% since early 1998." Hussman adds, "Sometimes there is simply no point to retaining an exposure to market fluctuations at all. When valuations are rich, internet rates are rising, and internal market action displays wide divergences. . . there has been no benefit historically in maintaining even a speculative exposure to market risk."

Yeah, it's a tough business. I often think back to the time in the '80s when I bought 10 shares of Berkshire Hathaway for 250 dollars a share. Basically, I bought the shares because I wanted to read Buffett's comments in his annual reports. I never, in my wildest dreams, thought that those shares would some day sell for $94,000 a share. Had I known, of course, I would have put every cent I owned into Berkshire shares. But honestly, who knew.

The same story could be written about Starbucks, Microsoft, Whole Foods, and any number of stocks in today's market. But who knows what little-known company today will some day be a colossus? A few years back it seemed that Amazon and Ebay and Yahoo would be fabulous future winners. Great, load up on these growth babies. And, of course, they did grow — but look at what happened to their stocks.

If you examine the portfolios of those people who have made multi-millions in investing, you'll find that most of these people have been smart enough or lucky enough to load up early on one or two great companies. Ah, to find those great companies is difficult. But that's not enough. You have to load up on a winning stock if you want to be a true winner. And how many investors have been able to do that? Or how many investors have the money, the knowledge, the luck, the conviction and the courage to do that?

Once in a while you or I will have a brainstorm and be able to envision some extraordinary event that will send some stock or group to the moon. For instance, I think the dollar is heading for major trouble. I believe many nations who are envious of the US and who distrust the debt-logged future of the US willl attack the dollar. In fact, I believe a subtle attack on the reserve status of the dollar is now underway (and I'll be writing a lot more about this).

So what is the ultimate anti-dollar? It's gold. OK, you should own gold. But how much can you own? Let's face it, gold is really a rich man's game. It's a rich man's game because gold pays no interest or dividend. Therefore, for the average person it's a sacrifice to take a large position in gold. The average investor is not going to get rich on his gold, even if gold goes to 5000 dollars an ounce.

For the rich man it's a different story. He has $25 million — and he puts 2 or 3 or 5 million dollars in gold. He can afford to do without the interest on $5 million, he has another $20 million that is invested. So if gold goes through the roof in the year 2010, it's the rich man who makes the big killing in gold. As for the average American, if he's well-informed and lucky, he owns 37 American Eagles and five Krugerrands.

You want to read a great piece? No, I'll rephrase that — please read this great piece. Turn to the Hussman Fund site and bring up Dr. John Hussman's latest essay in which he explains why the fair value of the S&P is around 800 or maybe even lower. What 800? Well, damn it, the S&P is selling today at 1260. If the S&P was to decline to Hussman's 800 fair value, it would lose 36% of its current value.

Right, and that's the danger with being invested in today's market. Stocks are expensive, they're not paying much in the way of dividends, and the odds are against us if we're holding stocks for the "long run." Do you remember Warren Buffett's thesis that "In the short run stocks are a voting machine, but in the long run stocks are a weighing machine." What Buffett means is that in the nearer term stocks go where people think they should go based on emotions, the current fads, etc. But over the long run stocks go towards values. Over the long term, fundamentals guide the market, not emotions, and not the conventional wisdom of the week or month.

Markets need leadership. Back in the 90s it was techs that led. The whole tech frenzy drove the market higher. And, of course, the Internet was an integral part of the tech concept. Since the 2002 lows, the market leadership has varied from housing, to energy to financials plus a lot of hype about small-cap stocks. Most of these groups have already topped out.

Above we see a chart of the **Banking Index.** What we see here is a modified type of head-and-shoulders top, and then a break below the support line. The bank stocks appear to be the last of the market leaders, but now they too have hit the brick wall. With banking gone, where are the leaders? I can't find any. Over recent weeks, we've seen the market jump all over the place with a series of 90% up-days and down-days along with a number of 80% days. The action reminds me of my two standard poodles. They'll be fast asleep for three or four hours. Then there'll be a loud noise, and in a flash the two poodles are up and rushing around the house barking wildly as they try to find the cause of the noise. Three minutes later they're both on the living room floor snoring away.

The chart to the left is the VIX or volatility Index, which is based on the action of S&P futures. This chart covers the last three years. The VIX has been declining throughout those three years, along with periodic pops of volatility. But suddenly this months volatility went wild — and a few days ago the VIX shot up to 24. Why? What happened? Darned if I know. Oh, maybe the stock market got nervous at the idea of another interest rate boost — or was it Iran, or North Korea or Iraq? Who knows why the thought of one more interest rate increase could set the market swooning? It's like the noise that drove my poodles crazy.

What I'm getting at is that I believe we're seeing a lot of meaningless moves in the market at this point. The Dow up 140 points, the Dow down 100 points, the Transports up 135 points, the S&P down 15 points. I just think its a bit of market hysteria with prices going nowhere in a hurry. We're just going to have to wait until a clear trend appears. Let me put it this way — traders love volatility, the hedge funds love volatility. I don't like volatile markets — too often they represent a lot of action but the action usually signifies nothing.

I saw the movie, "Syriana," last night, and it's a sort of a horror movie about the politics of oil. But forget about the movie, here's a weekly chart of oil. The oil stocks have been correcting, but you don't see much in the way of correction in the price of oil. Despite all the hoopla, oil today continues to sell above 70 dollars a barrel, and my suspicion is that there are three reasons why oil could sell higher.

One reason is extreme competition among nations to tie up oil reserves, and I'm talking about the entrance of the new-comers such as China, India, and various Asian nations. The second reason is that I believe an "accident" or two lies ahead. To my mind, the whole oil infrastructure is a sitting duck waiting for some Islam fundamentalist to blow up a vital structure. In fact, I'm surprised that it hasn't happened already. The third reason is nationalization, the current trend of nations to take over their own natural resources, one of which, of course, is oil. In the meantime, oil sits well above its 40-week moving average and above the 70 dollar level, which most experts told us would not hold.

**Next Mailing: July 19, 2006**