

The Sentinel Financial Report

N O V E M B E R 2 0 1 0 E D I T I O N



WE HAVE A NEW NAME!

Beginning with this issue, this publication will have a new name. We adapted the name “The Sentinel Financial Report” to convey a better sense of what this publication offers. The term “Newsletter” has a different connotation than we would like. Newsletters are often targeted to smaller audiences that may have a specific association like a business firm, a charitable organization, a religious group or church, and even government agencies. We would like our message to encompass a broader audience.

The term “financial” implies money and credit. Money and credit are central to much of our discussion. Our economic structure is based on money and credit so the removal of “economic” from our publication’s title eliminated previous redundancy. Yes, there are also marketing reasons for changing our name. We simply felt that a more concise name that conveyed what we do best will help potential readers in selecting our publication to guide them in their wealth protection plan. We will also use the acronym “TSFR” when referring to this publication.

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FORECLOSURE - GATE

There has been so much discussion in the media lately about irregularities in the foreclosure process. Recently the chief judge of New York’s courts implemented a new rule to hold lawyers responsible for the documentation associated with foreclosures. As you might surmise, this problem had its genesis long before the foreclosure state arrived.

FORECLOSURE-GATE (CONTINUED)

As we have stated in these pages, the psychology of favorable credit practices that was an integral part of the positive social cycle led to highly irregular lending models. One of the main problems with the lending models was the vast market for mortgage-backed securities (MBS). The MBS market allowed large pools of mortgages to be aggregated and underwritten by large investment banks the likes of Goldman Sachs and others. The pool of MBS was then taken to ratings agencies like S&P, Fitch, and Moodys for their stamp of approval. The theory behind MBS was that a large pool of mortgages would assuage the risk of a few potentially bad apples in the pool.

The construction of these pools was problem #1. With a large mortgage pool the due diligence required to inspect the assets in the pool was significant. The sampling size of the assets was critically important. If the sampling size was small, the likelihood of misrepresenting the mortgage pool increased. There was a lot of pressure on the underwriters of these MBS to get the deals done quickly so checking all the assets was something that was not going to happen.

A recent story by a former MBS packager highlights some of the problems in the industry. According to this person, the largest pool sampling in which he ever participated was 30%. The perpetual fight was to keep reducing the size of the reviewed sample to keep the deals moving. The ratings agencies stood silently as long as the underwriting bank agreed with the deal. So rather than the ratings agencies dictating what the quality of the pool should be, they were spectators. Often times the pools would look very different than what was expected. The stated income levels of the borrower were not what was expected or there was missing documentation. No matter, the deal moved on anyway. The ratings agency would put their seal on it. The investment bank would underwrite the deal and send it out to hedge funds and pension funds.

So how is foreclosure-gate unraveling? Can you say "lawsuit"? None other than the New York Fed is launching an effort to force Bank of America (BoA) to repurchase \$47 billion worth of loans packaged into bonds by its Countrywide Financial unit. Some of these loan packages, like BoA's, require the seller to buy them back in the event loan quality falls below expectations. In a separate case, a Florida lawyer representing 3,000 homeowners in disputed foreclosures plans to expand his scope by meeting with other attorneys in order to potentially file a national class-action lawsuit against the major banks.

The implications of the legal challenges are numerous. Banks and other lenders will be saddled with mounting legal fees to fight these suits. If the banks are required to

buy back the less-than-stellar mortgage packages, it will hurt their balance sheet and dampen their ability to provide loans for potential homeowners. In the extreme case, it could mean bank failure. There is even the whole question about the pure legality of the foreclosure process. All of these events represent a contraction in potential credit issuance, which readers know is deflationary.

The seeds of foreclosure-gate were sown long ago. The delay in the foreclosure process will only exacerbate the credit problems already existing in the economy. Those facing foreclosure will still be required to face eviction. Even if somehow there is a stay in that process, prices will not recover enough for homeowners to want to remain in a depreciating asset for which they still owe large sums of money. There simply is no escape. Foreclosure and liquidation are ultimately required to bring market prices to a point where supply can meet demand. Foreclosure-gate merely delays that eventuality. Right now we are far from having real estate prices reflect any level of reality.

T H E E C O N O M Y

There seems to be a quietly building momentum to the idea that the worst of the economic doldrums is behind us regardless of some of the troubling numbers in areas like unemployment. If for some reason this feeling is incorrect, then the Wizards at the Federal Reserve stand ready with more quantitative easing (QE). QE is a deliberate policy by the Fed to purchase bonds from institutions who ostensibly are creating more credit for use by businesses and consumers. In September, the stock market came alive when the Fed admitted that they were fully prepared to engage in another round of QE to support the economic recovery.

A forgotten point to the latest QE was the initial QE effort during the onset of the financial crisis in 2008. We will call this initial effort QE1. QE1 resulted in Fed purchases of \$1.43 trillion in assets and an increase of \$1.03 trillion in excess reserves. What does this mean? Excess reserves are bank reserves in excess of requirements set by the Fed. Banking laws dictate that banks have to have specific amounts of cash or other liquid assets on reserve with the Fed or in the bank's own vaults. These reserves are the backstop for demand deposits (checking accounts) and time deposits (CDs) held by banks. When a bank holds excess reserves, they are not using that money productively in loans so they are not earning any interest. The Economic Stabilization Act, passed during the onset of the crisis in the fall of 2008, allowed the Fed to pay interest on not just excess reserves but reserves themselves. For banking, this was a great deal. They did not have to worry about loaning money to potentially risky borrowers since the Fed was paying them a worry-free interest rate. Figure I shows the large spike in excess reserves occurring in 2008.

THE ECONOMY (CONTINUED)

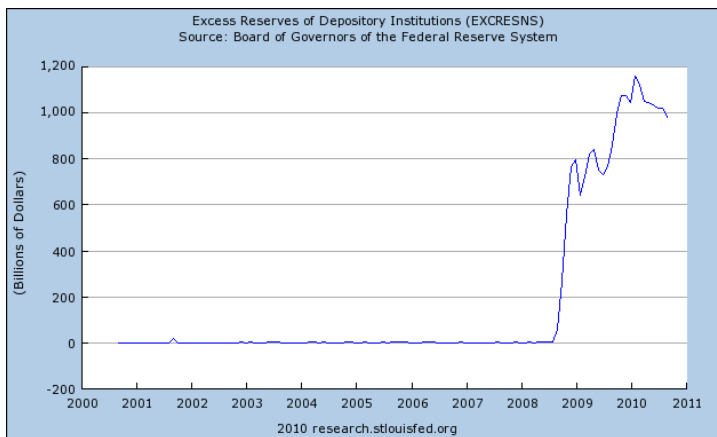


Figure I (Excess Reserves at Fed)

Prior to the fall of 2008 it made little sense for banks to hold excess reserves. After the Economic Stabilization Act, it made little sense for banks to lend. Figure II shows what happened to outstanding bank credit in the same period. From peak to trough bank credit fell nearly \$700 billion before recovering to a fall of \$300 billion. That is a bunch of money being taken out of the economy. For an economic system relying on continual credit creation, this is lethal. This is another unintended consequence of government action.

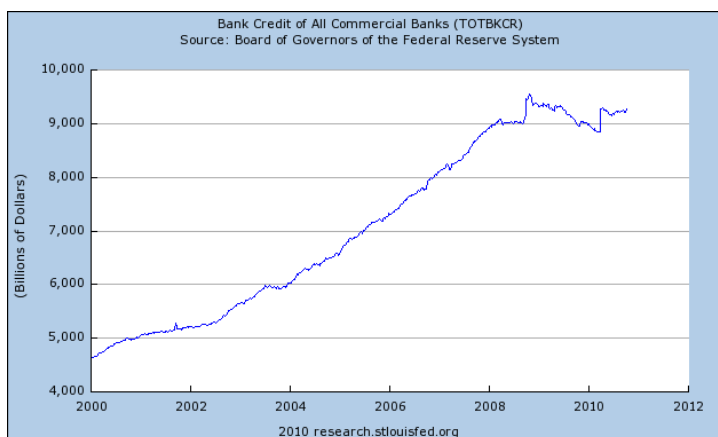


Figure II (Total Bank Credit)

If QE1 worked so well, why do we need another round (QE2)? Despite unprecedented Fed action to facilitate the creation of more than \$2 trillion in credit, overall credit *declined* for the first time in 63 years. The supposed wizardry of the Fed will be severely tested if and when it occurs. Deflation is a powerful force that our credit system created and now will be unable to stop.

Signs of American Economic Decline

So much attention was paid to growing the economy through the service sector that we forgot about manufacturing. Readers know that wealth is a material item produced by human effort having exchange value. Factories produce wealth. If we have fewer factories then we are less wealthy by our definition.

- Since 2001, the U.S. lost more than 42,000 factories!
- Median household income declined 3% from 2008 to 2009—the second yearly decline in a row.
- The U.S. ranks as the 9th most prosperous country (a fall of 5 positions since last year) but is ranked third worst in poverty among advanced nations.
- How many televisions do you think are made in the United States? According to Princeton economist Alan Blinder, the U.S. produces a total of ZERO TVs.

S O C I A L C Y C L E M O D E L

This publication will be released just prior to the mid-term elections of 2010. Incumbents will be fighting for their lives. Since the beginning of this publication's existence we have spent time discussing how the social cycle will turn, and really has turned, from happy to angry. The target of this anger will initially be government but eventually it will extend into other areas of society as well. Part of this anger's manifestation can be seen with the emergence of the Tea Party. When the Tea Party emerged on the scene, some political analysts surmised these were simply disgruntled Republican voters who wanted the party in power out of office. The reality is something quite different. If you consider how the Tea Party got started, the spontaneous combustion of anger erupted into massive gatherings in April of 2009 without any formal political organization. The age of the internet and ubiquitous communication allowed this party to rise. Yet, to call it an organized political party is quite premature but that is not the important point. This is simply a potential voting bloc that wants their voices heard. More Americans are categorizing themselves as Independent voters, not Republican, not Democrat and not Tea Party. In fact, many of these independents reject the Tea Party. This is anger on many levels.

Another facet of the changing political landscape is the emergence of more women as candidates for office. This is not surprising since women now are in more positions of leadership in the corporate world. Additionally, women are awarded the majority of college degrees. It would be difficult to argue that the most visible personality in the Republican party right now is Sarah Palin, a Tea Party favorite.

The anger vented at Congress is also something to behold. Despite a very active Congress passing landmark legislation reminiscent of the 1960s, voters hold them in very low regard. Perhaps it is *because* of the legislation they passed is the reason voters are so angry. Much of this legislation, like healthcare, was very controversial. It is a very difficult sell to pass a radical overhaul of healthcare while the economy is in the doldrums. For many, healthcare legislation becomes a more expensive proposition during a time when incomes are dropping and the public overall feels poorer. We wonder what will happen when Congress has to propose deep spending cuts in order to achieve some level of budget rectitude? Will we see protests like in France where young rioters were offended by raising the retirement age two years? Be prepared for similar belt tightening here in the U.S. and similar protests.

As investors we need to recognize that it will be a rocky political landscape for several years. Such political instability will mean the emergence of new ideas and even more candidates representing different philosophies. It also opens the door for demagoguery. Demagoguery can often times lead to draconian efforts by government to control the economy. We will be watchful.

STOCK MARKET

Optimism is running high in several markets with the stock market being a prime recipient. Some prominent investment advisors have come out recently extolling the virtues of stock investing. Some of these advisors see double-digit growth in the stock market in 2011. Will this really happen?

Last issue we spent time outlining two readily identifiable head and shoulder (H&S) patterns. The first pattern (Figure I) shows a multiyear H&S pattern extending to the beginning of this millennium. The left shoulder of this pattern is in 2000, the head occurred in 2007, and the right shoulder was made in April of this year. This pattern remains intact though prices are approaching the right shoulder level. We also outlined a near-term H&S pattern with a right shoulder occurring in August of this year.

This pattern was actually quite complex with the right shoulder actually having two peaks and in essence making a triple top with a head pattern between all of it (Figure II). This near-term pattern was violated with recent price action approaching the Head level.



Figure I (Quarterly DJIA 1997-2010)



Figure II (Weekly DJIA 7/2009—8/2010)

We know the market is complacent for a variety of reasons. Recently the National Bureau of Economic Research (NBER) ruled the recession officially ended in June of 2009. It took this organization more than a year after the recession's official end to actually declare it dead. Why so long? Even President Obama declared the possibility of a second depression officially null and void. A standard measure of market complacency, the VIX or volatility indicator has been traveling downward. After reaching an intermediate high in late May, this indicator recently fell under 20. This was the lowest reading since the stock market high in April of this year. While we are still not to the levels experienced in October of 2007, the market is definitely getting comfortable with itself. We do not expect to reach the levels of 2007 since that was a MAJOR top in the stock market, a multigenerational top which will not be exceeded for some time. We expect the next meaningful stock market top to be the beginning of the next wave down in stocks marking the end of the bear market rally that began in March of 2009. Since the top will not be as significant as the 2007 top, we don't expect the VIX to get to levels seen in October 2007. VIX levels this low are indicative of a stock market near a top and not a bottom.



Figure III Weekly DJIA

Figure III is a chart of the Dow illustrating the entire bear market rally from March 2009. While it appeared that a defined Head & Shoulders pattern was forming, recent price action has negated this view. The price action is taking the market to the April 2010 high. The April high is another important price level since it is very close to a 0.618 retracement (11,284) from the March 2009 low. We discussed the significance of the 0.618 level in a previous issue detailing the golden proportion. The April high sits at 11,308 while the most recent high fell at 11,266. The April high, will serve as a powerful price level repellent. This does not mean the Dow needs to stop at this level.

The combination of this approaching price level, the VIX mentioned earlier, the persistent bullishness in the market as

expressed in the figures like the Daily Sentiment Index (DSI) near 90%, and other measures we have chronicled in these pages (low dividend yield, high P/E ratio), makes a top in this market more likely every day.

BONDS

Sometimes the lessons of previous bubbles are easily forgotten. Remember all the discussion about toxic assets based on risky home loans? One would think after the carnage in the housing market that these instruments would have fallen out of favor. Think again. Private issues backed by Alt-A mortgages and adjustable rate loans are regaining favor with investors seeking double the yield of corporate bonds and triple the yield of U.S. Treasuries. These instruments also carry greater risk since they are not guaranteed by a U.S. Government Sponsored Agency (GSE) like Fannie Mae or Freddie Mac. Why would investors pile into these things again? This is simply part of the cyclical process that occurs with investors and markets. Even after the first shock is felt, there are rationalizations made despite the underlying conditions remaining the same or worsening.

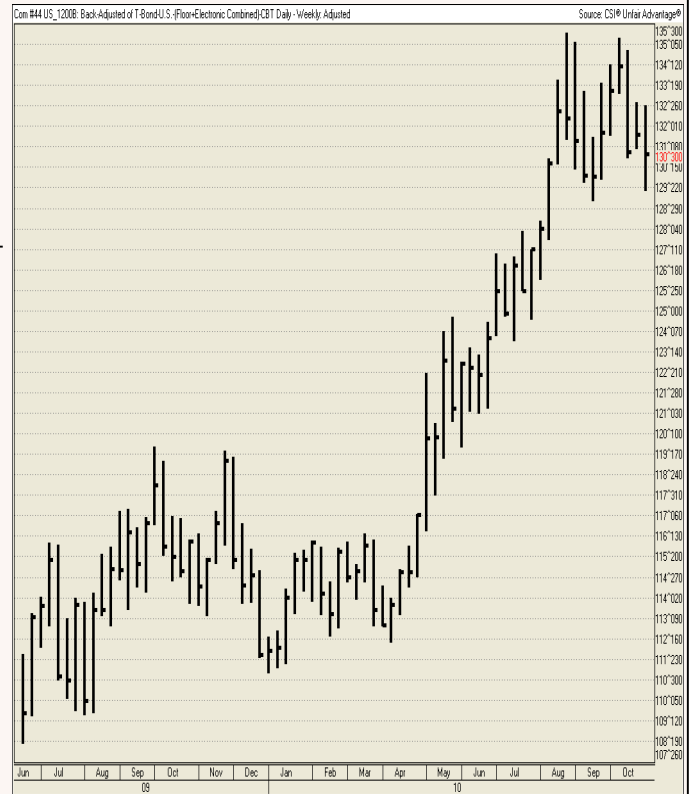


Figure IV (Weekly U.S. Treasury Bonds)

Figure IV is a chart of weekly prices for U.S. Treasury Bond futures. This market formed an important bottom in June 2009 and meandered aimlessly for several months before exploding to the upside in April of this year. Even though the stock market has made a strong bear market rally, there was enough carnage in 2008 that some investors went scurrying for the perceived safety of long-term U.S. debt. Prices approached the recent August high before retreating. The makings of a double top pattern is at hand. Treasury yields are so low that there is little upside potential. Of course, this stampede into U.S. Treasuries is curious given the increasingly perilous financial condition of the U.S. Government. Investors of all stripes have forgotten about the return of their principal.

But its not just U.S. Treasuries that have experienced a bullish run. Junk debt issuance is rising at a rate that is even greater than heady days of the credit bubble in 2005. Why all the optimism? Was this not the same sector that got killed in 2008? The chase for higher yields is making investors forget about safety once again. I hear conversations among people that lament how low yields are with dividends or bank products. The DSI for bonds is above 90% meaning that upside potential is also limited in this respect. We expect interest rate spreads between U.S. Treasuries and junk debt to continue to widen even as the prices of both fall.

U . S . D O L L A R

As high as optimism is for U.S. stocks and bonds, it is equally pessimistic for the U.S. Dollar. I saw an article in Yahoo Finance this week that all but proclaimed the death of the greenback and what investors needed to do to deal with this situation. Sentiment is scraping the bottom with less than a 10% bullish reading. We have been saying for some time that news regarding the U.S. Dollar's death is quite premature. One thing analysts seem to forget is that there is no legitimate money in circulation—all are fiat-based creations of governments and central banks. To declare one currency somehow "better" than another is to ignore the fundamentals of fiat money. That said, there was a bunch of dollar-created debt which must be paid at some point. Even if much of it goes into default, there will still be a need for cash.

Demand for cash and demand for credit are inversely related. When credit contracts, that type of "money" which circulated in the economy no longer can chase the goods and services it once did. The substitute for this credit is cash. But the ratio of credit in existence to actual cash is so large, it makes the cash remaining in the economy that much more valuable. Figure IV is a weekly representation of the U.S. Dollar Index. There are two important support points below current price levels. Prices could go lower but with bullish sentiment so low, there is little fuel for prices to carry further to the downside. Rest assured, the greenback is not dead and will not be so for some time.

P R E C I O U S M E T A L S

Gold's run since the beginning of August has been quite strong with prices appreciating 20% into mid-October. Gold's rise is has been in direct opposition to the U.S. Dollar's fall—yes there is a relationship here. With the pronouncement of the dollar's imminent death, investors have flocked to gold as the ultimate inflation hedge. Since we do not forecast inflation in our near future, we suggest the rush into gold is more of a speculative run than a rational position based on what gold truly represents. The recent large price gap down that remains unfilled after the October high, makes us uncomfortable declaring the top is in. Silver made a new high on 10/29 though market sentiment is extremely high (95% bulls) leading us to anticipate a price retracement soon.



Figure IV (Weekly U.S. Dollar Index)

TRENDS

	Weekly Trend	Monthly Trend
Stocks	Medium bullish	Medium bullish
Bonds	Mild bearish	Mild bullish
Short-term Deposits	Mild bullish	Mild bearish
US Dollar	Mild bullish	Mild bearish
TED Spread	Steady (16)	Steady (16)

There are two important trends in place that bear strong commentary. First, the Short-term Deposits figure, which we measure with the 3-month Eurodollar futures closed on Friday, October 29th at historical highs with a price of 99.675. To review, a Eurodollar is a U.S. dollar deposit in a financial institution outside the United States. Given the nature of a dollar deposit outside of the U.S., the interest rate on such a deposit is usually higher than a similar U.S. bank deposit. The U.S. bank has more protection surrounding the safety of the deposit. As such, investors will demand a premium for a Eurodollar deposit. A figure of 99.70 implies a very low interest rate. There is simply very little upside to Eurodollars.

The TED Spread is also near historic lows once again. This spread is difference between LIBOR (an interbank interest rate) and U.S. Treasury Bills. The spread is an indicator of the perceived credit risk in the market since Treasury Bills are considered to be virtually risk-free while LIBOR reflects the risk in lending to commercial banks. The historic low figures with the TED spread show a great complacency in the interest rate market. During the days of the financial crisis in 2008, this spread reached 465. Despite everything that has occurred in the credit markets, there is no fear. The sentiment expressed by the TED spread and the Eurodollar figure reflect very easy credit conditions at the short-term spectrum of interest rates.

Stocks remain in a very strong trend to the upside. As we mentioned in the section on stocks, we are close to an important price level from which they could very easily turn down. This is also another very complacent market as indicated by the VIX measure. Since our proprietary trend measures show a very bullish posture, we cannot declare this move over yet.

Bonds are in the early stages of a move down. Our weekly trend indicator just changed to a mild bearish position, which is the first step necessary to envision a change in this market. We will watch the market lows of mid-September for further confirmation. A violation of these price levels would confirm the trend change for us. Our forecast on long-term bonds remains the same—expect lower prices and do not own these products.

The U.S. Dollar is not dead. Our weekly trend indicator changed to bullish which frankly surprised us. That is the nature of proprietary indicators. These indicators help us eliminate whatever bias even we have as analysts. With bullish sentiment almost gone for the greenback, we suspect our indicator will be proven correct.

I N V E S T O R A C T I O N

There are no changes to the investment distribution matrix. We continue to advocate safety. Nothing that has occurred economically leads us to any conclusion that there is a light at the end of the tunnel. Fire specialists advocate checking the smoke detectors in your living unit on a periodic basis. We would like to suggest the same thing with respect to your bank. Banking can no longer be a passive activity. In previous issues, we mentioned how important it is to monitor the health of your bank on a regular basis (quarterly to semiannually). If you are skilled enough to look at raw banking data, do so or engage the services of a group like Veribanc.

Investor	Cash/Bank Prods	Short-Term Obligations	Precious Metals	Inverse Investments
Type A	30%	40%	10%	20%
Type B	30%	50%	10%	10%
Type C	40%	50%	10%	0%

S U M M A R Y

Foreclosure-gate is nothing more than a characteristic of the collapse and aftermath of a speculative bubble. As we outlined in this publication last year, the collapse and aftermath of any bubble features the discovery of massive fraud, recrimination of guilty parties and the government stepping in to restore confidence. We saw this with the numerous Ponzi schemes uncovered by the FBI and we will now see it with mortgage contracts. The end result will be even more public anger and distrust. This anger and distrust is part of our social cycle model that will culminate in less credit and the accompanying deflationary conditions.

The Fed has been active in the credit markets buying up U.S. Treasury debt and is considering another round of intervention which we dubbed QE2 (quantitative easing 2). We question the rationale for this action if the first round, QE1, worked so well. When QE2 proves ineffective, the public will realize the Fed does not provide economic salvation.

The mid-term elections in the U.S. are this week and the anti-incumbent sentiment is expected to come front and center. We will see if newly elected leaders have the political will to face the American public and tell them severe austerity measures are needed.

We are excited to announce the publication of an upcoming book entitled *E\$caping Oz*, which provides a comprehensive view of how we got in the financial crisis and what steps we need to take to deal with its aftermath. The book is written for individual wealth protection but it also provides a framework for having discussions required on a national level especially with respect to electing future leaders. We hope to release this book for circulation within the next month.



**N O V E M B E R 2 0 1 0
E D I T I O N**

Jim Mosquera publishes The Sentinel Financial Report and is responsible for its content..

Membership plans:

Web site - free content

Monthly newsletter - paid content

Your economic and investment guardian

The Sentinel Financial Report is published monthly. Our goal is to help you find your way in the often muddy waters of investment and economics. We give readers specific reasons for investment action, rather than simply telling you what to do. The explanation is given with historical context and contemporary examples. Such an approach applies reasoning to investment action rather than the herding instinct typical to most investors. Herding is not wrong, it is just human instinct. That human instinct unfortunately can lead you right off the investment cliff.

We hope the ideas presented will be large and you will never think about investments or the economy the same way again.