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HIGHLIGHTS

I remain pessimistic for a definitive economic recovery in 2009 or 2010. My conclusions have been further confirmed by the long-term downward trend in the dollar, the widening deficit, national debt and the inevitable entitlement crisis. At the best of situations, inflation is sure to become a dominant force in the economy in the coming years.

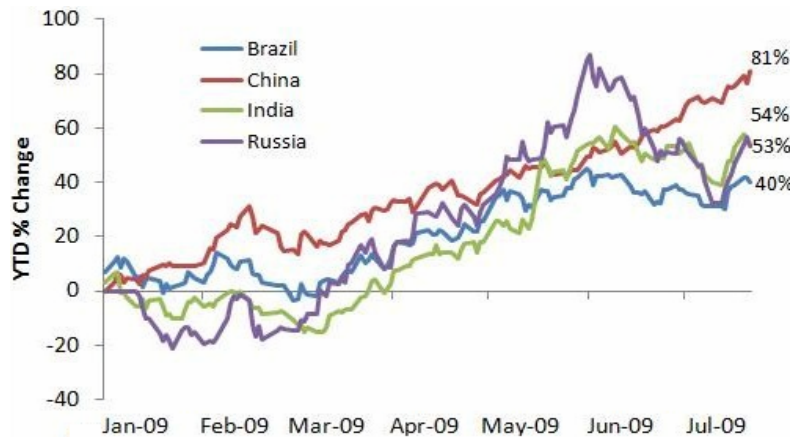
Of course, there will be a phantom recovery due to the trillions of dollars that have been pumped into the economy. But this will be a short-term event; an illusion. Savvy investors can do well by understanding the realities of this while being positioned to protect themselves from downside risk.

Most will be fooled, thinking a new bull market has arrived. Already, we are seeing the effects of a propaganda campaign designed to boost consumer confidence, with claims that a recovery is beginning.

Last month, I discussed my optimistic but cautious approach for China, India and Brazil. The fact is that these nations have expanding economies during the global recession, while practically every other nation has a shrinking economy. This is consistent with the forecasts made in America's Financial Apocalypse.

It appears as if a few of these emerging markets have bottomed. However, the emerging equities markets have rebounded by as much as 95% this year. Therefore, investors seeking to initiate new positions should proceed with patience and caution because a correction is likely.

On the other hand, the correction may not occur for another year or more while these markets continue to soar. The choice is yours and should be based on your skill level, risk tolerance, and other factors.



ECONOMICS: CONFIDENCE, GDP & PROPAGANDA

Last week, the Conference Board's Consumer Confidence reading came in at 46.6, down from 49.3 in June. This was a disappointing reading based on economists surveyed by Thomson Reuters who were expecting a reading of 49. This is the second consecutive month of declines. It is thought that a reading above 90 signals that the economy is healthy.

After a devastating Q4 '08 GDP reading of -5.9%, the economy weakened further in Q1 '09 at -6.4% GDP growth, representing the biggest quarterly drop since the recession of the 1970s. The latest GDP numbers (Q2) released on July 31 came in at -1%, beating the -1.5% estimates.

This marks 4 consecutive quarters of negative GDP growth, which is the first time this has happened since 1947. HOWEVER, we cannot forget that GDP is calculated much different today than decades ago. As just one example, decades ago, Washington economists did not have the luxury of hedonic pricing.

In fact, it's impossible to even make such comparisons simply based on the fact that GNP rather than GDP was used as the gauge of economic growth back in the 1940s.

July marked a notable month for the hacks, who came out in full force, from the Federal Reserve and President Obama, to the financial media and their hacks like Nouriel Roubini and other clowns all proclaiming a bottoming of the recession.

They've all teamed up in order to tip consumer confidence numbers towards optimism. Regardless how effective they are in this propaganda campaign, the fact is there will be no real recovery for many years. By some measures, there may never be a recovery.

Some are even claiming the recession is over. Don't forget these are the same clowns who denied a recession for 11 months. Remember, they did not even concede there was a recession until November 2008 and they admitted that it began in December 2007.

This is what you always get with these hacks—they're always late to report the damage and always early to the party. This serves a purpose—to minimize declines in consumer confidence.

Let's have a look at a typical hack job from the Associated Press.

"The recession looks to have largely bottomed in the spring," said Joel Naroff, president of Naroff Economic Advisors.

If you read the article, you would have noticed there was absolutely no balance; no counterpoints. This was intentional. It's propaganda meant to manipulate investor sentiment and consumer confidence.

I don't care what the numbers come out to, unless I'm the one doing the calculations I don't trust a thing coming from Washington or Wall Street.

But we cannot ignore the effect of this propaganda. Instead, we should exploit it while keeping the big picture in mind. This will help with the risk management process. Regardless, what all of this means is further positive momentum for the markets.

We cannot forget that none of the core problems have been resolved. Job quality continues to decline, median wage growth has not increased in over 10 years (adjusted for inflation), there are record foreclosures, fewer jobs now than 9 years ago, etc., etc.

Washington and the fed have simply played a shell game by shifting liabilities from the banks to the dollar. We have record low interest rates, and trillions passed to the banks. Now Washington is handing out billions to consumers to get them to buy cars.

Only a fool would think you can reverse economic devastation by printing more dollars. This is going to cause a severe drag on the economy and the dollar for a very long time. The key is to understand this when investing.

ECONOMICS: OIL

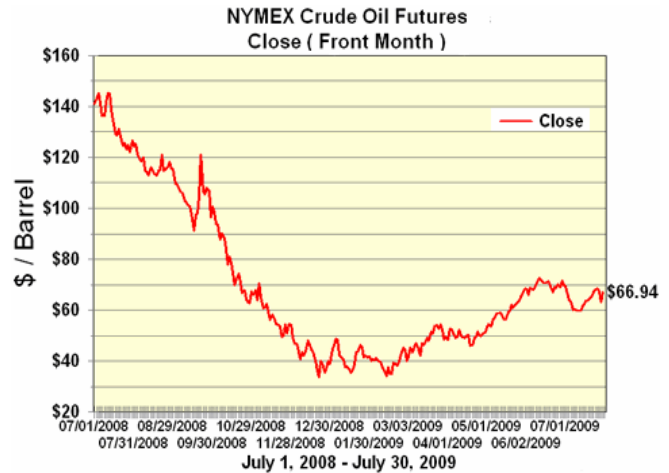
Since hitting the mid-70s last month, oil has sold off. As you will recall, I sent out a timely alert predicting the move from the low 60s to the mid-70s. But I also stated that oil was way ahead of itself.

Without the current propaganda of an economic recovery in sight, I would expect prices to continue their slide into the \$50s over the next few weeks.

The reasons for this are simple. As I have noted in the past, oil supplies have outpaced demand and inventories are quite high.

I've also noted that prices have been artificially buoyed by traders. However, now the CFTC is being investigated for price manipulation, traders might be more encouraged to allow supply-demand dynamics determine oil prices at least over the near-term.

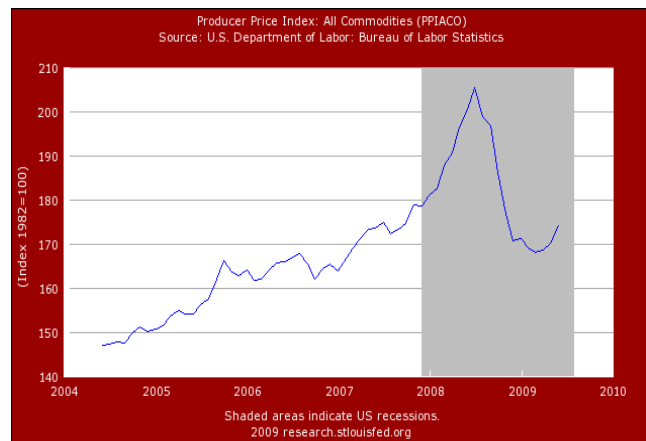
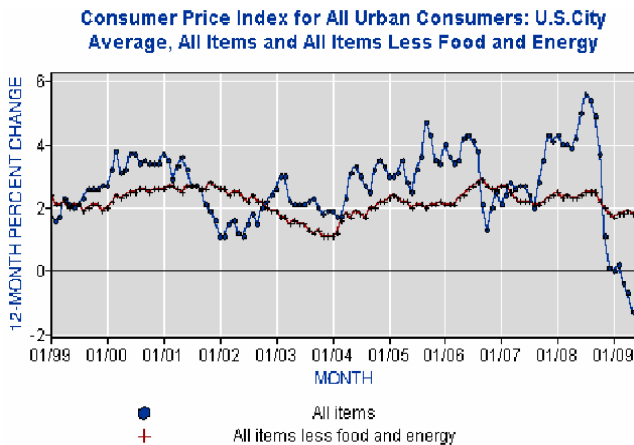
However, if the propaganda of an economic recovery is held up, this could send oil prices back up to retest the mid-70s. Still, even with signs of a recovery, oil is overpriced. Propaganda aside, I would price oil in the low 50s.



ECONOMICS: INFLATION

Washington continues to downplay inflation. In fact, officials still claim the U.S. is experiencing deflation. I do not have the time to tell you just how ridiculous these CPI measurements are (bottom left chart). Most likely, Washington is understating inflation in order to minimize the pressure for raising interest rates.

The chart to the right shows the producer price index, (PPI) which is similar to the consumer price index (CPI) for producers. That is, the PPI is a weighed basket of goods at prices sold to wholesalers or producers. This is often a good leading indicator of consumer inflation since producers often pass price increases or decreases onto consumers. In this case, the PPI provides a more accurate picture of inflation.



ECONOMICS: EMPLOYMENT

In the July issue, I provided a detailed look at the employment situation, so here I will be more brief, while summarizing the main points from July and expanding upon new data.

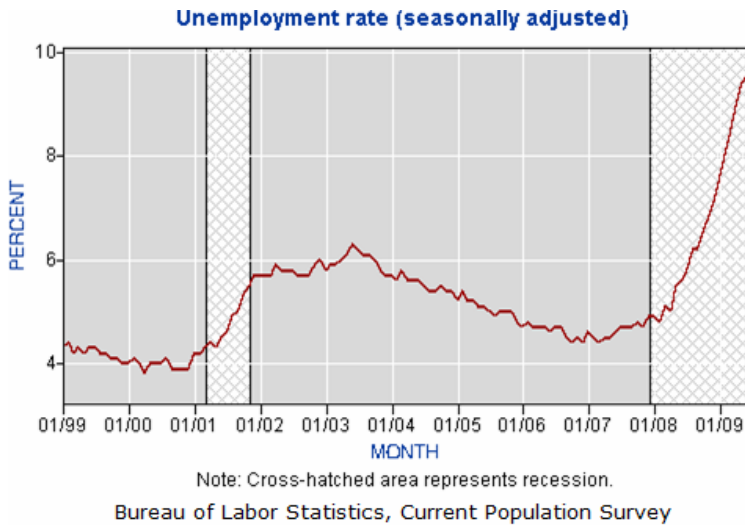
The official unemployment rate rose from 9.4% to 9.5% last month. However, as I have discussed many times, this number (known as the U-3) hides the real unemployment rate.

New jobs are not being created. This trend promises to make unemployment a persisting issue even after any phantom recovery has been declared.

Finally, the level of job creation is not even keeping up with current population growth, which requires 8.2 million jobs just to maintain pre-recession employment rates.

What does this mean? Severe and protracted economic stagnation at best.

The real story from this economic meltdown won't be the unemployment rate so much as the duration of high unemployment. Even if unemployment trails off in a few years, many Americans will have switched careers, most of them working for less than before, similar to what occurred after the dotcom collapse.



Washington will continue to hide the real data, using its bag of tricks, while the biggest area of job growth will be government jobs, similar to after the previous recession.

Rather than looking at unemployment rates, a better measure of employment is to look at the index of aggregate weekly hours.

This number more accurately reflects the employment picture since it provides information on lost jobs and employed workers whose hours have been reduced. As you might imagine, many workers have had their hours reduced.

U-3 Unemployment Data from Current Population Survey (seasonally adjusted)
Source: BLS

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1999	4.3	4.4	4.2	4.3	4.2	4.3	4.3	4.2	4.2	4.1	4.1	4.0
2000	4.0	4.1	4.0	3.8	4.0	4.0	4.0	4.1	3.9	3.9	3.9	3.9
2001	4.2	4.2	4.3	4.4	4.3	4.5	4.6	4.9	5.0	5.3	5.5	5.7
2002	5.7	5.7	5.7	5.9	5.8	5.8	5.8	5.7	5.7	5.7	5.9	6.0
2003	5.8	5.9	5.9	6.0	6.1	6.3	6.2	6.1	6.1	6.0	5.8	5.7
2004	5.7	5.6	5.8	5.6	5.6	5.6	5.5	5.4	5.4	5.5	5.4	5.4
2005	5.2	5.4	5.2	5.2	5.1	5.1	5.0	4.9	5.0	5.0	5.0	4.8
2006	4.7	4.8	4.7	4.7	4.7	4.6	4.7	4.7	4.5	4.4	4.5	4.4
2007	4.6	4.5	4.4	4.5	4.5	4.6	4.7	4.7	4.7	4.8	4.7	4.9
2008	4.9	4.8	5.1	5.0	5.5	5.6	5.8	6.2	6.2	6.6	6.8	7.2
2009	7.6	8.1	8.5	8.9	9.4	9.5						

Alternatively, we can look at the U-6 unemployment data for a better gauge of the employment situation.

U-6 is supposed to be the government's complete unemployment rate, counting marginally attached and discouraged workers. The previous reporting period (May data) came in at 16.4% unemployment (next page). Yet, you never hear about this number from the media.

ECONOMICS: EMPLOYMENT

The latest U-6 numbers reported for June show an increase to 16.5%. Still, this is not a completely accurate picture of the unemployment situation. My estimates put the total unemployment rate at around 22% (if all factors of gainful employment have been considered and misleading assumptions used by the government have been removed). That's 1 in 5 people in the U.S. who are without a real job.

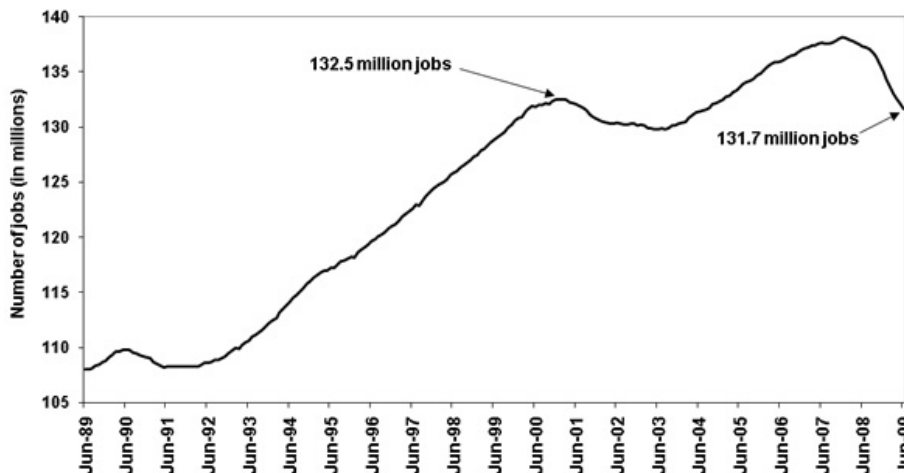
Of the 15 million Americans who are currently unemployed (by the government's conservative data), more than half have been unemployed for 15 weeks or longer. This is staggering. This percentage has jumped from the previous month as expected. Finally, as you can see from the last chart, there are fewer jobs now than nine years ago. You should not be too surprised, as this is what typically happens after a bubble pops.

U-6 Unemployment Data from Current Population Survey (seasonally adjusted) Source: BLS

Duration of Unemployed for 15 Weeks or Longer (seasonally adjusted) Source: BLS

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1999	7.7	7.7	7.6	7.6	7.4	7.5	7.5	7.3	7.4	7.2	7.1	7.1	1999	25.1	25.6	25.2	24.2	25.9	27.4	25.5	25.0	24.6	24.7	24.1	24.4
2000	7.1	7.2	7.1	6.9	7.1	7.0	7.0	7.1	7.0	6.8	7.1	6.9	2000	24.3	22.3	22.3	22.5	22.8	22.3	23.7	23.9	23.0	24.1	23.4	23.6
2001	7.3	7.4	7.3	7.4	7.5	7.9	7.8	8.1	8.7	9.3	9.4	9.6	2001	23.0	24.4	24.3	23.2	24.0	24.1	25.5	26.5	27.3	27.0	29.1	29.5
2002	9.5	9.5	9.4	9.7	9.5	9.5	9.6	9.6	9.6	9.6	9.7	9.8	2002	31.3	31.9	32.5	32.9	35.3	36.0	35.6	34.6	35.9	36.6	36.0	37.6
2003	10.0	10.2	10.0	10.2	10.1	10.3	10.3	10.1	10.4	10.2	10.0	9.8	2003	36.8	36.9	36.9	38.0	37.1	38.6	40.5	39.6	38.9	39.4	39.8	40.2
2004	9.9	9.7	10.0	9.6	9.6	9.5	9.5	9.4	9.4	9.7	9.4	9.2	2004	40.0	40.0	39.5	36.4	37.8	38.2	35.9	35.3	36.6	37.7	37.3	36.8
2005	9.3	9.3	9.2	9.0	8.9	9.0	8.8	8.9	9.0	8.7	8.7	8.5	2005	36.5	36.2	36.8	34.9	34.9	32.5	33.2	34.6	33.5	33.4	32.9	33.5
2006	8.4	8.5	8.2	8.1	8.2	8.4	8.5	8.4	8.0	8.2	8.0	7.9	2006	32.1	35.1	33.5	32.8	32.8	31.0	32.2	32.1	32.5	30.8	31.7	31.0
2007	8.3	8.1	8.0	8.2	8.3	8.3	8.3	8.5	8.4	8.5	8.4	8.7	2007	30.2	31.4	33.4	32.9	32.6	33.1	33.6	32.8	32.8	32.0	33.2	33.1
2008	9.0	9.0	9.1	9.2	9.8	10.1	10.4	10.9	11.2	12.0	12.6	13.5	2008	33.0	32.1	31.4	34.6	32.9	34.1	35.6	36.0	38.1	40.0	38.3	40.4
2009	13.9	14.8	15.6	15.8	16.4	16.5							2009	39.2	41.7	43.5	45.9	48.0	51.9						

Fewer jobs now than nine years ago



THE FED'S BALANCE SHEET

Factors Affecting Reserve Balances of Depository Institutions and
Condition Statement of Federal Reserve Banks

July 30, 2009

1. Factors Affecting Reserve Balances of Depository Institutions
Millions of dollars

Reserve Bank credit, related items, and reserve balances of depository institutions at Federal Reserve Banks	Averages of daily figures			
	Week ended Jul 29, 2009	Change from week ended Jul 22, 2009	Week ended Jul 30, 2008	Wednesday Jul 29, 2009
Reserve Bank credit	2,010,048	- 611	+1,115,620	1,985,907
Securities held outright (1)	1,343,891	+ 17,940	+ 864,717	1,344,561
U.S. Treasury securities	695,818	+ 8,842	+ 216,144	695,758
Bills (2)	18,423	0	- 3,317	18,423
Notes and bonds, nominal (2)	627,146	+ 8,571	+ 214,754	627,575
Notes and bonds, inflation-indexed (2)	44,438	+ 215	+ 5,267	44,438
Inflation compensation (3)	5,811	+ 56	- 560	5,323
Federal agency debt securities (2)	104,066	+ 1,945	+ 104,066	105,915
Mortgage-backed securities (4)	544,507	+ 7,153	+ 544,507	542,888
Repurchase agreements (5)	0	0	- 113,714	0
Term auction credit	287,629	- 5	+ 87,629	287,621
Other loans	108,591	- 2,109	+ 90,887	109,888
Primary credit	33,803	+ 55	+ 16,351	36,270
Secondary credit	105	+ 74	+ 16	0
Seasonal credit	88	- 1	- 13	94
Primary dealer and other broker-dealer credit (6)	0	0	- 3	0
Asset-Backed Commercial Paper Money Market				
Mutual Fund Liquidity Facility	1,073	- 2,487	+ 1,073	806
Credit extended to American International Group, Inc., net (7)	43,054	- 78	+ 43,054	42,196
Term Asset-Backed Securities Loan Facility	30,408	+ 328	+ 30,408	30,422
Other credit extensions	0	0	0	0
Net portfolio holdings of Commercial Paper Funding Facility LLC (8)	94,414	- 16,087	+ 94,414	67,200
Net portfolio holdings of LLCs funded through the Money Market Investor Funding Facility (9)	0	0	0	0
Net portfolio holdings of Maiden Lane LLC (10)	26,029	+ 40	- 3,036	26,870
Net portfolio holdings of Maiden Lane II LLC (11)	19,672	- 83	+ 19,672	19,144
Net portfolio holdings of Maiden Lane III LLC (12)	19,166	+ 349	+ 19,166	21,137
Float	-1,778	+ 280	- 457	-2,372
Central bank liquidity swaps (13)	87,738	- 2,126	+ 25,738	87,738
Other Federal Reserve assets (14)	78,756	+ 1,191	+ 34,604	78,420
Gold stock	11,041	0	0	11,041
Special drawing rights certificate account	2,200	0	0	2,200
Treasury currency outstanding (15)	42,487	+ 14	+ 3,811	42,487
Total factors supplying reserve funds	2,065,776	- 597	+1,119,431	2,041,035

Note: Components may not sum to totals because of rounding. Footnotes appear at the end of the table.

1. Factors Affecting Reserve Balances of Depository Institutions (continued)

Reserve Bank credit, related items, and reserve balances of depository institutions at Federal Reserve Banks	Averages of daily figures			
	Week ended Jul 29, 2009	Change from week ended Jul 22, 2009	Week ended Jul 30, 2008	Wednesday Jul 29, 2009
Currency in circulation (15)	908,661	- 83	+ 78,102	910,869
Reverse repurchase agreements (16)	66,206	- 1,599	+ 22,670	66,010
Foreign official and international accounts	66,206	- 1,599	+ 22,670	66,010
Dealers	0	0	0	0
Treasury cash holdings	332	- 15	+ 19	302
Deposits with F.R. Banks, other than reserve balances	268,912	- 11,724	+ 256,142	265,601
U.S. Treasury, general account	61,406	- 11,782	+ 56,312	57,825
U.S. Treasury, supplementary financing account	199,936	0	+ 199,936	199,936
Foreign official	2,032	+ 296	+ 1,931	2,178
Service-related	5,152	- 12	- 2,101	5,152
Required clearing balances	5,152	0	- 2,101	5,152
Adjustments to compensate for float	0	- 12	0	0
Other	386	- 226	+ 64	511
Other liabilities and capital (17)	57,045	+ 434	+ 13,166	56,293
Total factors, other than reserve balances, absorbing reserve funds	1,301,156	- 12,988	+ 370,099	1,299,075
Reserve balances with Federal Reserve Banks	764,620	+ 12,391	+ 749,332	741,959

<http://www.federalreserve.gov/releases/h41/Current/>

REAL ESTATE SIGNS OF BOTTOMING?

Based on some of the superficial data I have seen, it appears that real estate is showing signs of bottoming. This is what many so-called experts (i.e. real estate and Wall Street hacks) have been saying now for well over a year. However, when you look at the big picture, things look a bit different.

As mentioned in the last issue (as I have for over a year now), the big foreclosure avalanche begins in 2010 and will last through 2011, as most of the ARM and Alt-A loans reset during that period. This serves as a fairly good indicator of where interest rates are headed. You shouldn't expect short-term rates to move appreciably higher until at least the Spring of 2010.

Thoughts of a bottom in real estate would boost consumer confidence, which would create more buyers. This would boost housing prices, which would further boost consumer confidence. Combined, this would boost the stock market—it's a chain reaction within an endless loop. This explains why Washington and Wall Street are trying to generate a recovery picture.

Understand that when people speak of a "bottoming" in real estate, they usually don't specify their definition. For some, bottoming means a pick up in housing starts, for others it means increase sales. To me, it means real estate prices. As such, I stand by my original forecast made three years ago for a median real

estate price decline of 35% (upper end). If that turns out to be exact, we are nearly there.

It is very likely that we will see further signs of a real estate bottom over the next few months. However, if real estate is beginning to bottom, the process will take many months, perhaps a year. Thereafter, it will be a slow climb up.

You should also be aware of the fact that with most Americans in the red for their homes, it's not only difficult to refinance, but it's also virtually impossible for most who might be out of work to relocate.

You can't sell your house if you owe more than its worth unless you have the cash to pay the bank the difference. I would not suspect there are many unemployed homeowners who have the cash to pay off a mortgage deficit.

Fannie Mae is now offering refis at 125% of value as another desperate attempt to rescue the living dead who are being gouged by crooked banks that issued what I feel should be banned—ARMS and option-ARMS.

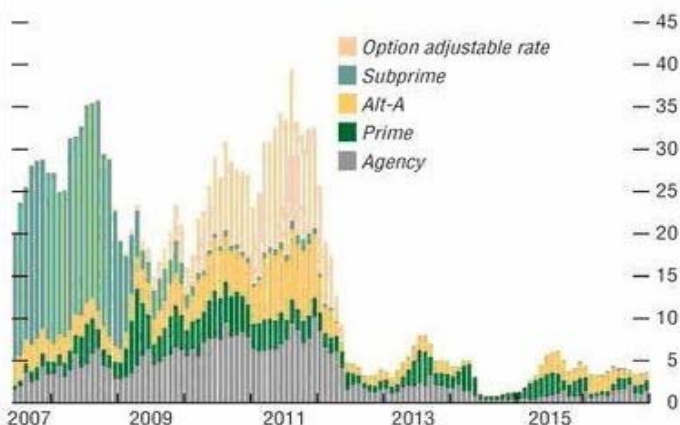
Does that mean you should consider real estate as an investment? Consider that it will probably take at least 10 years for median home prices to get back to the 2006 peak.

If you do invest in real estate, do NOT use more than a reasonable amount of leverage. And make sure you have sufficient cash to cover your holding costs—property taxes, HOA dues, insurance, mortgage payments—for at least two years. I would focus on rental units. But keep in mind that there is still a huge number of empty rental units and single-family homes.

Real estate is one of the few investments that does well during inflation. And high inflation is coming in a few years. The problem is that things might be different this time due to the huge inventory of vacant rental units and single-family homes (11 to 13 million units) as well as the manipulation of interest rates by the Fed.

I would advise those interested in real estate as an investment to read **Cashing in on the Real Estate Bubble**. Institutional real estate investors should contact our offices

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

WHAT WENT WRONG?

America's real economy was transformed by decades of unfair trade policies that destroyed millions of U.S. jobs. As an attempt to mask the reality, economists and politicians proclaimed the "Information Age" as the engine of the "New Economy," promising higher living standards for all.

Rather than higher living standards for all, the "New Economy" has brought higher living standards to much of the developing world, corporate executives and wealthy shareholders of U.S. corporations.

Meanwhile, working-class Americans have been left out of the picture. In fact, because there is a finite amount of wealth to divide, it's clear that America's wealthy elite and much of the developing world have seen their living standards increase at the expense of working-class Americans.

Rather than higher living standards for all, this proclamation of a "New Economy" has provided a smoke screen for more permissive free trade policies that continue to destroy working-class America, while enriching corporations and workers from developing nations. It's been socialism for corporations and developing nations at the expense of working-class Americans.

Not by coincidence, the current bailouts advocated by Washington bear a striking resemblance to their own policies of economic extortion through the mechanisms of free trade.

As a replacement for jobs that produce real goods, America's "New Economy" is now characterized by a service economy based on scavenging wealth from the huge Ponzi scheme designed by Washington.

America's "Old Economy" created good jobs during a period when U.S. imports were in high demand.

As a result, America became the world's largest creditor because it served as the global leader of manufactured goods; real products needed and demanded by the world – the best automo-

biles, consumer appliances, textiles, and basic materials. Foreigners sent money into America. This helped create a strong middle class that fueled economic growth.

During the "Old Economy" Americans had a healthy savings rate, a one-income household was the norm, healthcare and higher education were affordable, there were no credit cards, there was no need for cheap labor from illegal aliens, and America was a net exporter of crude oil.

Towards the final stages of America's "Old Economy" Asia began modernizing its own manufacturing industries. Rather than automotive plants and consumer electronics, much of Asia's manufacturing efforts were focused on providing goods for its own consumers so as to decrease dependence on imports. At first, they weren't so good at it.

But once free trade became the status quo, it enabled Asia to enter the market place with unfair advantages while using illegal trade practices.

Furthermore, as more American firms sent manufacturing plants overseas, Asia became the recipient of the unintended but inevitable transfer of intellectual property from the United States.

This enabled Asian companies to gain access to critical manufacturing and design secrets. Even Japan has benefited from U.S. intellectual property as the result of free trade. In many cases, huge companies have been sold off to foreign competitors because they simply cannot compete on U.S. soil due to unfair trade.

In return, U.S. corporations have increased their profits while providing cheap goods to U.S. consumers who buy more than they can afford using credit. But as we know, all Ponzi schemes eventually come to a harsh end. At some point you need a real job to buy goods. Now we are seeing this Ponzi scheme unravel. Unfortunately, it still has a long way to go.

CHINA

Retail sales in China continue to post 14-15% monthly and year over year growth, with consumers spending focused on food, clothes, autos and home décor.

If the U.S. economy remains weak, China should get a boost from U.S. consumers via the U.S. stimulus plans. I would say there will be at least three such plans. If the U.S. mounts some kind of recovery, even temporary, China will do even better.

As I have been saying for quite a while now, the developing world will mount a rapid recovery from the global economic meltdown, while the U.S. lingers. This is precisely what is going on, with Asia leading the pack.

According to the WTO, in 2008 exports from developing nations soared to a record 38% of all global trade. Germany edged out China to remain the world's leading exporter of merchandise (\$1.47T vs \$1.43T). However, based on continued weakness in the Euro economy, China is expected to blow past Germany to assume the number one position by year's end.

Export trade is a critical variable for investors to watch because so much of China's economy relies on exports. You might recall that the Chinese stock markets collapsed to their lows late in 2008. This period coincided with a collapse in trade to the U.S. with net trade rising only by 1% for the year, even with an increase of 14% in Q3. This helped the market form a bottom.

According to data from the WTO, in 2008 the U.S. led the world in merchandise imports with \$2.17 T (for a 13% share of the world market). I find it ironic that the current budget deficit is about the same.

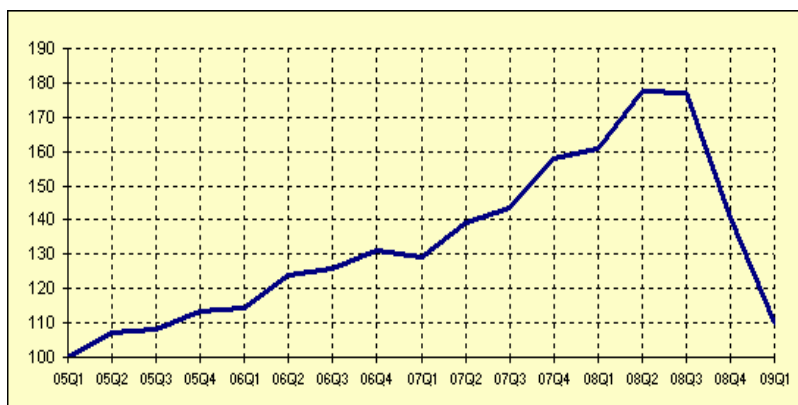
Although I predicted China's rapidly growing auto market to surpass the U.S. in AFA, I did not expect it to happen so soon. After a meltdown of the Big 3, it's official. For Q1 of 2009, China blew past U.S. sales of 2.2 M autos with 2.7 M of its own. This is only the beginning of much more to come.

While auto sales are expected to decline globally by 8% in 2009, sales in China are expected to rise by an eye-popping 17%. And you had better believe foreign automakers are looking to China to rescue them. In April alone, auto sales skyrocketed by 37.4% compared to a year ago, with over 834,000 units sold.

But you shouldn't expect GM or Ford to benefit much. With more than 100 domestic automakers in China, foreign automakers haven't yet adjusted downward to the optimal price point of most Chinese consumers.

Still, there are plenty of Chinese millionaires ready to scoop up luxury vehicles. In fact, top-end brands like Mercedes, BMW, Jaguar and yes, even Ferrari are more likely to capture a much larger chunk of the Chinese market because they face very little competition from domestic auto makers.

Quarterly World Exports Merchandise Developments, 2005-2009



World exports in the first quarter of 2009 decreased by 22 per cent Q-o-Q, 31 per cent Y-o-Y. But this hasn't seemed to affect China much. Any drop off in exports has been countered by strong consumer spending in China.

CHINA

So where is all of this spending coming from?

First, as predicted in AFA, the Chinese government has passed many favorable subsidies, tax breaks and other stimuli to encourage consumers to spend more as a way to buoy the economy through the global meltdown.

Make no mistake, with over \$2 trillion in government reserves, China is the only nation in the world in the position to do this.

But it's even more important to understand some things about Chinese consumers. Unlike U.S. consumers who generally tend to have fairly equal spending (expected for their period through the human life cycle), the situation is much different in China.

To be clear, China's robust spending is coming primarily from consumers under age 35. China has approximately 250,000 affluent consumers, as determined by having assets in excess of \$1 million (China Market Research Group).

According to a study by McKinsey, 80% of "wealthy" consumers (as defined by household income of about \$37,000) are under age 45, compared to 30% in the U.S. and 19% in Japan. Most of the remaining 20% of affluent Chinese consumers are over 65.

Why do we see these bizarre demographic trends? First, you need to understand that most Chinese live with their parents until they are married. Therefore, they have fewer expenses and higher disposable incomes.

Second, Chinese between the ages of 45 and 60 are known as the "lost generation" due to the effects of the Cultural Revolution in the 1960s and 1970s which caused this generation to miss out on wealth generation.

Finally, it appears as if younger Chinese consumers have more rapidly accepted the economic reforms and early doctrines of capitalism. This has created a new generation of Chinese who are more independent and who feel the excitement of

a less hindered economic system. As a result, they spend much of what they make.

All of this spending aside, it should be noted that China's historically strong savings rate is not by accident. Compared to Americans, Chinese citizens do not have anywhere near the type of safety net as U.S. citizens.

While Medicare, Medicaid, and Social Security might have some issues, they're still a vital part of America's safety net.

So what's the bottom line? Combined with the stimulus plan, Chinese consumers have the savings to help pull their economy through the global recession, but only for so long.

Regardless how well China is doing, it still depends on U.S. consumers. Savings by Chinese consumers can only go so far. But this relationship is likely to change in the future.

On the other hand, at some point, China will need to refurbish its savings in order to prepare for what I expect to be a very difficult period of adjustment in perhaps 10 to 15 years. Until then, China is likely to continue its tremendous growth.

As well, China must maintain a certain level of employment in order to prevent social unrest. Many economists feel that China needs an annual GDP of 8% in order to maintain current employment levels. I cannot say whether this is a valid assumption or not.

Whatever the number is, keep in mind that employment in China is still largely tied to the U.S. economy. So if the U.S. stagnates, this could create problems in China. With only a modest recovery in America, China should maintain adequate employment.

The risk to Chinese investments would be the highest under a scenario that brings a severe and prolonged global recession or depression. In this case, soaring unemployment could cause severe social unrest in China. In all other scenarios, China looks to bode well.

WHAT ABOUT THE FINANCIALS?

Many investors are wondering if it's now time to buy financial stocks. I recall many thinking they were a great buy month after month over the past two years. Meanwhile, I was recommending short positions since October 2007. So I wanted to print an article I published a year ago to remind readers about my views on the financials.

"I've read and heard countless investors who have been thinking the banks were a "good deal" since the first big market sell-off in January 2008. Since then many are down another 50%, some more.

Every month I see new investors looking to pick up a "bargain" in the financials without realizing the only bargains have been short positions.

Most investors have been programmed by the financial media to always buy stocks when they go down because 'in the long-term they are a great value.'

Well I don't know about you, but long-term to me means at least twenty years. And anyone who considers long-term any shorter than that needs to consider these sobering facts:

- ◆ *Since making its highs in March 2008, the Nasdaq is still down by over 55%; that's going on 8 years folks. In the best of scenarios I cannot see those highs being tested for at least another 8 years.*
- ◆ *Since making its highs in 1990, the Nikkei is still more than 65% down. Next year will mark 20 years since the Nikkei approached 40,000.*
- ◆ *Finally, since making its highs in 1999, the Dow is now by about 3% after 9 years. Most likely the Dow will go considerably lower.*

Those are things to consider when buying stocks in general. But when we are talking about the biggest banking crisis ever, things look much worse.

The financials continue to write down assets and take losses. And they still have no idea how large the total losses will be.

Finally, they continue to sell off assets and raise capital using debt and more so by issuing new equity.

Now, what do you think is going to happen to say, Citigroup (C) once it realizes all its losses? Next, consider how much future earnings will suffer after selling off a good chunk of assets. For most financial firms, assets represent a large portion of their ability to generate revenues.

Finally, consider what the shareholder dilution will do to per share earnings. Yet, Citigroup is in much better shape than most of the other banks. Before it's all said and done you should expect to see most of the financials trading in the teens, some the single digits.

As for Goldman Sachs (GS), I'm betting it will break down well below \$100 before it's all said and done.

As far as the financials are concerned, when you take huge losses, you can recover as long as you have strong assets to deliver earnings. But when you are selling off a good portion of these assets your ability to deliver earnings will be diluted. These dilutions are even more severe after you have issued more shares.

Let's see now, diluting shareholders + selling off revenue-generating assets + more debt = a slow earnings recovery.

'Bottom-fishing' as they call it isn't an activity amateur investors need to be involved with. Some bottom-fishers have already been fooled many times in the past six months. And if they have any cash remaining, they are likely to be fooled again.

But if you do plan to take a stab at a bottom, you need to stay away from distressed securities; in this case, distressed industries such as the financials, autos, airlines, and soon to be retailers.

WHAT ABOUT THE FINANCIALS?

You'll also need to contend with the high possibility that things are going lower. And the trip back up is going to be slow and nerve-racking.

In conclusion, with rare exception, I do not envision any point in time when I will buy the financials hoping for a long-term recovery.

In the best of scenarios, the only way they will be able to mount a reasonable earnings rebound will be through share buybacks or reverse splits. But that is unlikely to happen anytime soon if ever.

Consider that Citigroup still has not realized the need to eliminate its dividend completely. It would rather sell off revenue-generating assets to raise cash like the one announced today in order to appease nervous shareholders.

But with 5.25 billion shares outstanding and an annual dividend of \$1.28, this \$7 billion (\$4 billion post-tax) asset sale only allows them to continue dividend payments for one year.

In contrast, they have lost a powerful retail presence in France, and all of the future earnings it would have brought. These banks need to wake up and start managing their business in crisis mode rather than the irresponsible mindset that got them where they are today.

So if you think the banks will be a great buy when they do bottom, you should reconsider. Your money can be invested elsewhere with much lower risk and higher returns. And while inflation is sure to eat away at any cash, at least you don't risk losing it all."

Now let's have a look what has happened since that July 11, 2008 article was published.



As you know, many other banks have had a similar fate as those mentioned. But is it finally a good time to buy the banks?

In my opinion, no. They simply aren't worth the risk. Not for me anyway. I can find much better risk-reward opportunities.

Amateur investors frequently buy stocks that are buried in risk because they do not understand how to measure risk.



I personally have never bought nor recommended buying financial firms for any of my clients because I have always felt the financials hide much of their risk.

That said, there are some financials that appear to be in recovery mode, namely the dedicated credit card companies like American Express, MasterCard, Visa and Capital One. But still, I would touch them even though they could do well.

PROFITING FROM MEDIA SPIN

Some of you realize the farce behind the financial media. Many more of you realize the ridiculous nature of Wall Street research. But still, you make certain to stay tuned in; most likely for all the wrong reasons.

In this article, I'm going to illustrate a clear example of why you can't and shouldn't EVER pay attention to the financial media or Wall Street - unless you're a day trader.

On Monday, July 13th, the stock market was sparked by a televised interview from a former Wall Street analyst, Meredith Whitney, who upgraded Goldman Sachs, while offering further encouragement for the banks, expected to report in the following days.

As you might imagine, CNBC was all over the interview. And although I don't watch that trash, I'm

willing to bet they made Whitney's upbeat outlook the focus of the day. From there, the story branched throughout the closely connected financial media networks.

The bottom line was that this segment served as the spotlight of the day, causing the market to rebound from a somewhat dangerous level, not seen in several weeks. I made reference to this interview when I ran across the headline.

http://www.avaresearch.com/article_details-303.html

Meanwhile, a company update from Dell Computers took place the next day. The tone from this presentation signaled further trouble ahead based on what Dell interpreted to be as a weak demand for PCs. This caused the stock to take a beating of nearly 10% despite the near 200-point gain in the Dow on Tuesday July 14th.



One might have expected Intel to sell off in response to Dell's news, but that didn't happen.

Investors wanted to wait until Intel reported at the end of the bell. It was a good bet for those expecting good things from Intel, as they blew away estimates.

But it was the institutions that traded the stock up by more than 7% on July 15th.

Does anyone really believe Intel's earnings are indicative of signs of an approaching economic recovery, or as Intel put it, things not being that bad?

Apparently, most investors disagree. The next day, after facing a sell-off of nearly 10%, Dell rallied in support of Intel's blockbuster earnings report. So how was it possible for the picture to turn 180 degrees in one day?

It's called spin.

SECURITIES UPDATE

In the Mid-July Update I sent to subscribers (Profiting from Media Spin), I illustrated what I felt was a nice lesson on how to use media spin to make a relatively low-risk short-term trade. I followed up with a brief mention of AMD's earnings pointing to this report.

However, one thing I failed to mention (due to lack of time) in this report was how to determine that Dell was undervalued.

Relative valuation is perhaps one of the most difficult skills to master and cannot be easily explained. It takes years of experience. Those who have The Wall Street Investment Bible might note that I discuss valuation methods extensively.

Regardless, those who have been subscribers since June will recall that Dell was one of the securities I mentioned to buy on valuation with a market correction. This implied Dell would fall along with the market.

So you say "But Dell fell while the market rose." Yes, indeed it did. However, I also mentioned in the special report that in my opinion, this price decline was an overreaction which implied a short-term undervaluation. You should remember this in the future.

Here, I will go over some of the securities I mentioned in previous issues and see where we are and whether I have changed my position.

Note that due to the tremendous number of topics covered in each newsletter, I cannot promise nor do I intend to follow each security on a monthly basis. This should not matter for the most part since every investor will have a different situation. Therefore, what I like may not apply to you.

DOW

From the June issue, you will recall I recommended picking up DOW in the mid-teens and below. I reiterated this in the July issue. In fact, DOW has been my number one pick for several months and I have mentioned it numerous times online.

As you can see from the chart, DOW was just under \$18 when I made the call in June. The call I made was to buy it below \$15. Thereafter, it rallied a bit with the market then sold off over the next 6 weeks, hitting a low of around \$14.22 on July 10th. This was the time to buy. As of July 23rd, DOW is just over \$21.50.

Of course, even before the newsletter began, I had been recommending DOW for several months when it was \$10-\$12. Hopefully you picked it up then. If you did not, the only way I can see it falling is if the market falls.

I feel it is still undervalued for a long-term perspective.

