
FLASH REPORT DIGEST

Week of April 13, 2009

MON, APR 13, 2009 3:57 PM - GOLDMAN AND THE INCREDIBLY SHRINKING MARKET LIQUIDITY

Good Afternoon,

Just reading a lot of research today on a very boring market day and it is amazing how the market moves in the last hour of trading and who is behind it.

In two words.....Goldman Sachs.

Goldman Sachs has been doing an enormous amount of institutional buying over the past few months and the majority of it has been done in the last hour of trade. This is why again today, we were down over 115 points at mid day and are now up on the day. The rally is like clockwork, starting exactly with an hour to go in the day and pushing right into the close and even pushing futures higher after the close to create a "gap" on the open the following morning.

The SEC is investigating market manipulations that result in stocks falling, but I guess it is not manipulation when it causes stocks to rise.

What we find incredible is the amount of volume Goldman is clearing on a daily basis.

Program trading purchases and sales for last week was 8% higher than the 52 week average, which on almost 4 billion shares, is a decent increase.

Principal trading (when a brokerage firm buys securities in the secondary market and then holding them to sell to some one else, hopefully at a higher price) is running 21% above it's 52 week average and agency trading (the buying and selling of stocks by an agent such as a broker on behalf of a client) is running 11% BELOW it's 52 week average. NYSE weekly volume is running about 9% below it's 52 week average.

Add all this up and it tells you that the public is not buying stocks. Volume as a whole, is down but the institutions such as Goldman Sachs are busy and appear to be the ones moving the market. Maybe more importantly, they are buying stocks NOT on behalf of their customers or clients but for their own internal trading operations.

And Goldman is the biggest firm playing this manipulative game and dominating all the volume numbers coming out of the NYSE. The NYSE publicly reported last week that Goldman traded \$1.4 billion shares for their own trading strategies vs. only 62 million for their customers. Their principal to agency plus customer facilitation ratio is a staggering 5 times which is off the scale compared to the other 14 firms on the list. Their ratios come in a less than 1 times.

This means that Goldman is still the trading king, trading much more than anyone and mostly for it's own principal benefit. It is bigger than anyone on the planet. And since Goldman is so close to the government, both past and present, it raises questions among traders, of the government using Goldman to carry out their wishes.

One comment we received from a former program trading desk manager is that the Goldman's number (over a billion shares principal) are unlike anything he has ever seen. He says the only way something this large could be explained in the past was a huge amount of index arbitrage or perhaps an unwinding or reestablishment of an entire book, but that is clearly not the case here. He is at a loss to explain the gap between principal activity vs agency volume.

The one important thing that strikes us here is that the liquidity of the market seems to be shrinking. There seems to be a very one sided trade here with one huge institutional house dominating the action and doing it on a principal basis and less and less customer agency buying.

It was brought up in an email to us, that the last time we were this lopsided on the liquidity front was January 2008 when the DOW was trading near 13,000. The problem we see lies in the dislocation away from historic

volume moving averages in the "slow" moderate public traders category, and the "fast" large liquidity providers. The public and mutual and pension fund participation is rapidly shrinking while the principal and "dark market" participation is exploding. **To us, this is not a positive market dynamic.**

In order to maintain market efficiency, the market liquidity "ecosystem" has to remain balanced meaning that retail and mutual and pension fund buyer liquidity needs to be balanced with the moderate and aggressive hedge fund buyers.

The top of the pyramid, the active traders like Goldman, enhance and make possible the liquidity for the public who form the foundation of the pyramid. In between, there are other layers made up of mutual and pension funds and other markets and Neutral Quant funds. Then a higher level is made up of the more aggressive public players and funds such as Citidel and Highbridge Capital.

Liquidity disruptions at any level usually lead to unexpected market aberrations such as wide spreads between bid and ask, the inability to unwind large positions and above average volatility. Think of last fall and that is what can happen as unbalancing occurs.

We are starting to see that this unbalancing is starting again and the NYSE figures support it. It seems that more and more large hedgers and quant funds are focused on trading among themselves and therefore liquidity is shrinking at each level down from the top of the pyramid. This is not a positive event.

When these imbalances occur, it always ends bad. As long as volume remains below average, the markets will not react in negative way.

But as the core of the capital markets gradually de-leverage to a point where maintaining a liquid and orderly market is impossible you will start to see volatility increase, large swings both up and down, massive spreads between bids and offers and the inability to clear some trades.

Our sources fear that the consequences could be worse than last fall.

Last fall, the volatility was historic and that was with the public still in the markets providing liquidity and orderly markets at each level. Even with the market falling and sellers dominating buyers as they did, liquidity was present as borne out by NYSE figures.

The next drop that occurs will happen with the public basically out of the market and the huge institutions mostly trading with each other. We have lost 3 or 4 of the necessary liquidity ecosystems and instead of 5 levels providing liquidity, we may have only one and that top level is dominated by one firm. We do not define a market where one firm trades with itself.

This is a real problem and one that is not discussed too often on CNBC. But it could be one of the reasons for the next coming down-leg in stocks. It won't be a headline maker on the evening news, but could be a top reason behind the next decline.

Sometimes, markets move because of pure internal liquidity issues. Sometimes they move because a floor trader mistakenly bought 1000 contracts of the S&P futures when they should have been selling. And sometimes it's because the simple mechanics of a market break down or one firm becomes so dominate over all others, that the true principals of a market fail to exist.

It's not always about banks and earnings and economic things. Sometimes it's just about liquidity.

We have advised over the past 2 years that the key to surviving this decline would be to stay solvent. To have cash available for opportunities. To use a guerrilla warfare strategy of trading, darting in and out and not overstaying your welcome.

We have a gnawing feeling in our stomach that there is something in front of us that is not good. There are starting to be too many bulls around and after reading this research today, it appears that this most current rally is not being built on any solid foundation. It appears to be a result of the "fast" money trading, buying on speculation and they fear of "missing out on the rally of the year." **It seems that a major cause of this rally is simply the big "fast" firms trading with each other and because of this, destroying the liquidity ecosystem at the lower "slower" levels which historically has proven to be a dangerous development.**

As one quant trader put it, " this market liquidity is shrinking at an incredible rate and he is wondering if this event could be the upcoming black swan of black swans."

Be very careful on the long side.....

MON, APR 13, 2009 4:42 PM - PDF ATTACHED.....HAPPY TAX DAY

Good Evening,

An interesting chart attached.

All of us must be ready to do some financial planning to help us steer through the coming tax increases we see ahead.

As we have shown before, the tax rates for the highest earners rose immediately after the Great Depression to 70 percent. The lowest wage earners were not spared either as their tax rates rose from zero to 10.6 percent.

Some historians say that raising taxes during this time put an abrupt halt to any meaningful economic recovery as they ushered in the 1937 recession and continued to dampen employment which up to World War II still hung in the 13 to 15 percent range.

As we have pointed out, it wasn't that long ago, less than 30 years that we still had a 72 percent top tax bracket in this country. We think we are headed back to that range before this crisis is over.

Receipts have a down year every now and then, but never expenditures.

What concerns us is the "angle" that both expenditures and receipts are now trending.

See Attached PDF

TUE, APR 14, 2009 5:30 PM - BLACK SWAN DEFINED

"But in my experience, I have never been in any accident...of any sort worth speaking about. I have seen but one vessel in distress in all my years at sea. I never saw a wreck and never have been wrecked nor was I ever in any predicament that threatened to end in disaster of any sort."

E.J Smith, 1907, Captain, RMS Titanic

We talk about Black Swan events all the time but I don't think we have ever defined it.

The general definition is a highly improbable event. It does have three characteristics as well that must be met to qualify as a Black Swan. The first is that the event is unpredictable. The second is it carries a massive impact and lastly is after it happens, we concoct an explanation that makes it appear less random and more predictable than it really was.

The Black Swan is an outlier as it lies on the outside of regular expectations. Nothing that has happened in the past can convince you that the event is even a remote possibility. The combination of low predictability and large impact makes Black Swan events a great puzzle.

The puzzle in Black Swan events is that you need to change your thinking and logic. Black Swan logic makes what you don't know far more important than what you do know. This is important to comprehend especially when you consider that most Black Swans can be caused and made worse by the very fact that they are unexpected.

Think of the 9-11 attacks. If the risk had been known, then many different things would have happened. Jet fighters may have been on patrol over New York, bolted and bulletproof cockpit doors would have been installed and the attack would never have occurred. But because it was totally unexpected, it happened.

It is a strange phenomenon to see events happen that were never supposed to happen. What kind of defense do we have against these events. How can you stop an unexpected, highly improbable event?

Our fault as humans is that we act as if we can predict historical events, or even worse, we can change the course of history. Economists make 10 year predictions all the time and investors believe them. Few are ever accurate.

How many financial plans written 5 years ago have met projections forecasted then? How many spent thousands of dollars on these plans and spent countless hours putting together the information? And why are they not worth the paper they were written on? Because of one missed, but major projection in the probability models used to generate the future returns. Instead of the market averaging an historical 7% rate of return over that period, it came in at a minus 3.46%. This Black Swan event was inconceivable five years ago. One wrong assumed rate of return wrecked an entire retirement plan.

A lesson we take out of Black Swans is that the world is an illusion. Everyone thinks they know what is going on in the world and the fact is that the world is far more complicated and random than anyone realizes. And by thinking they know exactly what is happening backed by facts and data, they feel they can predict the future.

History is full of stories of refugees fleeing their homeland thinking they would shortly return. During the Russian revolution with suitcases half packed, they streamed into Berlin thinking they would return in a few months when in reality, they would never return. Cuban refugees fleeing Castro in the late 50's leaving pets at home and windows open thinking they would be in Miami for a few weeks, and have never been back.

And investors, holding on to their mutual funds and never selling thinking that the market would come back in a few months and make new highs.

Things are never predictable and history does not crawl, it jumps. Things can happen very quickly and take everyone by surprise. History is full of examples of things happening fast and without warning. The Black Swan event is almost always caused by humans looking backwards and bathing in self delusion about the future. And it happens fast and without warning. Out of the blue giving people and investors little time to react and virtually no time to prepare.

The key to dealing with Black Swan events is to realize that they can and will happen and therefore to protect yourself as best you can. Ask your current portfolio manager what their definition of risk is. Ask them if you are prepared for a highly improbable event. We have always stressed to have cash and lots of it at this point in time. Solvency is the key and is one way to guard against a market Black Swan.

We are always looking at the extreme possibilities in everything we do. A couple of days ago, we wrote about a possible Black Swan on the upside, thinking that everyone was way too bearish and what if this economy was in much better shape than everyone thinks. What are the possible market ramifications if that happens. **Crowds don't believe Black Swans are possible. Therefore you can prepare by being a "lone wolf".**

After reading the book "The Black Swan" our one major view is that most people say and listen to what they want to hear and not what is reality. Over the last year or two, we have tried to stay in the reality of the moment. We have been very negative because things are negative. We wish they were not, but the reality is they are.

The Black Swan should be required reading for all of our clients and friends. It will give you tremendous insight into the workings of the world, the human mind and the markets.

Nassim Taleb writes in the book that one of the most influential books he read as a young man was William Shirer's Berlin Diary: The Journal of a Foreign Correspondent, 1934-1941. Shirer's book was a diary of what happened in Berlin during Hitler's rise to power. Taleb likes this book because it presents the reader with a clear view of what was happening at the moment, not after. The words were written without knowing the outcome. And it was interesting how different Shirer's conclusions were versus what really happened.

This is the same thing we need to realize today when you read about the current financial crisis and listen to the "experts" tell you what you should do now. Realize that 10 years from now, historians will look back with the advantage of knowing the outcome. And also realize that what is written about today and the recommendations being made today will have far different outcomes and unintended results than anyone can imagine.

I am sure that when the German people voted for Hitler and the Nazi party in the March of 1932, they never envisioned in their wildest imagination what would happen to them, their families and their country over the

next 15 years. And I am sure that investors never imagined the economic ruin that has occurred today when 10 years ago, the people managing that economy, Alan Greenspan, Robert Rubin and Larry Summers, were being praised and appeared on the cover of Time Magazine called the "saviors of the free markets".

There are more Black Swans out there. Don't focus on things you already know, but more importantly focus on what you don't. Start to think about the "impossible" whether it be good or bad. Simplify your thinking moving more toward generalities and away from specifics. And don't listen to the "experts".

As Taleb says, if a blindfolded school bus driver crashes his bus, don't give him another one to drive.

WED, APR 15, 2009 10:59 AM – FREIGHT RATES AND INFLATION

Good Morning,

The Baltic Dry Freight Index (BDI) has increased 75% since the FED announced quantitative easing in December 2008. But in the last month, it has declined 33% at the same time most global stock markets were rebounding and the FED started executing it's quantitative easing programs instead of just talking about them.

The BDI is a favorite index of anyone who trades commodities so we look at it which some suspect. China can move this index single-handily and the combination of the deliberate undervaluation of the Yuan and the huge economic stimulus measures being undertaken there, should continue to push the BDI higher in coming months.

We think this increase in the BDI should benefit commodity linked ETFs and indexes as they will be the direct beneficiaries of the wall of money being thrown at the markets by the government.

Just look at the industrial commodities performance recently. Copper and lead are both up over 40% while gold is up only 5%. Other industrial commodity prices including the leading JOC index (Journal of Commerce) have all moved dramatically higher. An external observer would have to conclude that something very powerful is underway in material prices.

The JOC index leads Producer Prices (PPI) by about 9 months. In looking at the stabilization in the JOC and now the rise over the last couple of months leads us to believe we will see a stable to rising PPI by late summer.

The world's central banks are printing money like crazy while the world's governments have rediscovered the political joys of deficit spending. This is now being done on a "biblical scale".

Currency traders always pointed out in the past that they had more money than did the central banks but that is not the case anymore. The future course of markets is going to be determined by their ability to accommodate the huge amount of money being thrown at them. How they handle these sums will determine inflation's impact.

We think they will handle it very badly. We think eventually, the longer term price we will pay for these short sighted political stop gaps, will be fierce.

It is imperative that inflation dangers be recognized NOW and strategies formulated before this Black Swan event occurs.

WED, APR 15, 2009 1:58 PM - THE STOCK MARKET IS LOOKING FORWARD AND LIKES WHAT IT SEES

Good Afternoon,

The FED just released the Beige Book, which is it's update on the current economic conditions in America. It breaks the country into 12 regions and each FED governor then reports on what is happening in their particular district.

Today's numbers were awful as expected with not much positive outlook. They did report that 5 out of the 12 regions were starting to show some signs of improvement but overall, it was as bad as expected.

The stock market rallied on the report. And this is a key point.

We have all heard that markets are forward looking creatures and the stock market in particular looks out 6 months into the future. Whether you agree with this theory or not, lets use it as a "given" here.

The market is now discounting the current "bad" news about earnings and economic reports and if indeed they are looking out 6 months, are sending a signal that things are looking up for the economy.

Fed Chairman Bernanke has stated recently that he believes the economy will bottom out this year and we will see start to see visible recovery as we head into 2010. And with recent action by the market, it seems to agree with him.

If you look at this in a simple manner, the market has made it's choice. It is telling us with every negative economic report it shrugs off that the future looks brighter. With every negative earnings report it fades, it is saying that the company will be better off in 6 months.

It has made a conclusion about the future. And that conclusion is the economy will be better in 6 months and stocks will be higher.

We look at this action and obviously do not agree with it. We have presented enough evidence through the last couple of months to come to the conclusion that we are still early in the game. We have looked at past bear market time frames and patterns and none point to a bottom here in stocks. As a matter of fact, we have stated we are probably only in the 5th inning.

And now we have another worry and that is the market's expectations have shifted rather dramatically in a very short period of time. This quick shift in sentiment is usually a sign that the market has to retest the lows once again.

Major bear markets usually end with a whimper, not with a bang. When I first stated in the business in 1981, the interest in stocks was zero. I held a mutual fund seminar and one person showed up. There was no interest whatsoever in the stock market simply because people had lost so much money in the 1970's and early 80's. Inflation was the front page story and locking in high yields was the investment choice.

The market today is looking out and is hopeful of a turn.

We think that turn is still a lot farther off than the market. Analysts are discounting a GM bankruptcy (we think the unforeseen events stemming from this event can be a huge negative), they are discounting the problems in the commercial real estate market (today the journal is writing about how to play the take-over game) and they are discounting the increased rate of foreclosures and credit-card defaults (Sam Zell says the housing market has bottomed...of note he said the same thing last October).

We think if any one of these "shockers" hit the market, the mood will quickly turn which could lead to the most intense sell-off of the year. We think this discounting of bad news is just another phase in this market wave pattern. B waves are corrective waves.

B waves are always fooler waves. Their personality is one of hope and turnaround within an ongoing bear market. And the hope and promise do influence prices for a short period of time. That is what is occurring now. Eventually the B wave will top and as we have warned before, C waves are third waves and they are the most destructive of the wave cycle. This is what we are preparing you for.

So while we can see this rally extending, we do not buy into the Bernanke economic turn in the fall. We still think there are many unforeseen, improbable events out there that will test the nerves and the theories of the bulls.

FRI, APR 17, 2009 4:28 PM - JIM GRANT'S "KITCHEN SINK"

The government's response to the credit crisis is by far the largest ever government intervention to support the government. Jim Grant, the excellent writer from Grant's Interest Rate Observer calls it the "kitchen sink" approach to ending the credit crisis. Here are the details:

PEAK	TROUGH	LENGTH(Mos)	GDP CHG	STIMULUS AS % OF GDP
Aug -29	Mar-33	44	-27 %	8.3%
May-37	Jun-38	13	-3.4 %	2.2%
Nov-48	Oct-49	11	-1.7%	3.3%
Jul-53	May-54	10	-2.7%	-1.4%
Aug-57	Apr-58	8	-3.2%	3.2%
Apr-60	Feb-61	10	-1.0%	1.7%
Dec-69	Nov-70	11	-0.2%	2.7%
Nov-73	Mar-75	16	-3.1%	4.0%
Jan-80	Jul-80	6	-2.2%	1.5%
Jul-81	Nov-82	16	-2.6%	3.8%
Jul-90	Mar-91	8	-1.3%	2.8%
Mar-01	Nov-01	8	-0.2%	7.2%
AVERAGE		14	-4.05	3.27%
SUM		na	na	39.3%
DEC 07	????	15	-1.8%	29.9%

The current downturn (last row starting with Dec-07) shows that real GDP has fallen just 1.8% and has lasted 15 months. This is 1/15th (7%) the size of the decline of the Great Depression when real GDP fell 27%.

During the Great Depression, the combined amount of fiscal and monetary stimulus was 8.3% of GDP. Currently, **the combined amount of fiscal and monetary stimulus is 29.9%** of GDP, almost as much as the last 13 recessions combined.

Currently, the federal response to this downturn is orders of magnitude larger than anything ever seen before. It is on average almost 10 times the typical government response in past recessions and almost 4 times the amount used during the Great Depression.

This right here, this one fact is the tipping point for us in forecasting a tidal wave....a Big Wave ...of future inflation.

We have been away from the Voodoo Shack the last couple of days and heard a lot of experts telling us that the public is moving out of money market funds and into bonds right now. As a matter of fact, high yield bond funds

have had their biggest inflows of capital since 2003 as investors tire of low money market interest rates and want a higher yield.

They are also telling us that investors are shunning risk and now feel that the worst is over and are looking to riskier assets with the potential of more return.

We are completely puzzled by this view, puzzled by the complacency that we see all around us when it comes to this inflation threat and mucho puzzled on how anyone would want to own 3.6% 30 year Treasury Bonds...including the Chinese and other foreign investors...when this kind of storm is in the distance.

Let's look at some facts here about the recession so far. This is a garden-variety recession when it comes to GDP numbers as well as duration. Where it becomes extraordinary is within the global credit markets. And what is also extraordinary is the government's response to this recession. And, the government is not done yet adding to these numbers. The deficit will get larger.

Last week, we talked about the next Black Swan event being that the economy may not be as weak as everyone thinks and in fact, all of this stimulus will end up to be the absolute worst thing for the economy and consumers. We talked about the government pouring gasoline on a fire when they thought it was water.

Almost nobody on Wall Street has stopped to take the measure of the mind numbing figures above and asked if they were and are necessary. It is a perfect Black Swan event.

Everyone assumed that things economic, were sliding off the cliff. Just as everyone assumed that housing prices could never fall more than 7%. **Everyone assumed that the banks needed \$750 billion to survive, just as they assumed they would not be effected by sub-prime debt.**

The same people making all of the wrong assumptions, were demanding we accept the new ones. If a blindfolded school bus driver crashed the bus, don't give him a new one to drive!

We ask a simple question. Could it be that all of these policies are not helping the economy but instead hindering it?

The singular fact of this recession so far is that the government has thrown 29 percent of GDP, both monetary and fiscally at this recession and it dwarfs whatever has been done before it.

We saw what the historic credit crisis did to the markets. We saw historic drops, historic volatility, historic low interest rates, historic deficits, historic stimulus packages, historic elections, historic bail-outs and historic bankruptcies.

What do you think awaits us on the other side of this historic spending?

Wall Street seems to think all will be well. The FED, including Chairman Bernanke testified that they would be able to contain inflation on as the economy recovers. **This is the same Chairman Bernanke who testified in 2007 that the sub-prime crisis could end up costly the economy about \$300 million dollars. Then he went to \$500 million and in early 2008 he admitted things were worse than he thought and the bill could reach \$200 billion.** Now he says they will be able to contain inflation and not to worry. He also said in that same speech that they will be able to adjust interest rates on the upside IF inflation becomes a problem.

In December of 2007, the FED's assets floated to \$870 billion dollars. Not quite a year and a half later, it is \$2 trillion plus. There has been nothing like it.

The Black Swan economic event is that this government has once again miscalculated to such a degree that the coming economic boom could be huge but accompanied by the boom will be nasty inflation and historically high interest rates.

The government miscalculation will produce historic results just as dire and dramatic on the back-side of this crisis as what was seen on the front side. The only difference is that the front side decline was stocks, the backside will be bonds.

We also want to point out that we think people are missing the real news of last weeks inflation reports. While everyone was sure there would be no inflation, and there really wasn't, the more important thing was there was no deflation. Where is this massive deflation everyone is talking about.

The investing world is starting to believe, just as it did on the front side of this crisis, that there would be no consequences to the housing bubble and mortgage meltdown. That while it would be a hindrance, all would be fine. A "steady as she goes" attitude.

Today, we see the same attitude taking shape. They are now believing that we are on the way out of this thing with no real consequences to fear from government actions. We get a sense that investors feel they can apply the same metrics, the same models that they used before and get the same results.

We say that the historic nature of the bubble leading to the crash on the front side, is a precursor to what will happen on the backside. The historic spending measure taken today, will have just as a dramatic impact on various markets on the backside. Historic measures usually produce historic consequences.

We are very, very bearish on Treasury bonds. We think the upside is very slight and the downside immense. Central banks are printing money as they never have before and people are so complacent about it as if that is the norm. We think they will soon realize it is not.