

# ***Windfall Gains in 2008:*** ***Esoteric Alternatives for Hedge Funds &*** ***High Net Worth Individuals***



December 2, 2007

## **JAPAN**

### **Nikkei:**

The peak at 18,000 was perfectly forecast and identified, as a top within a correction that was already over a year old. The Topix and the banking index made that more obvious (banks have corrected 50% from the 2003 advance), though the Nikkei's own pattern illustrated clearly for me that the move up was coincidental to the Dow's advance, thereby creating a false impression.

Namely, the Dow was in a primary advance up, while the Nikkei was in a counter-trend move up. The upshot was that a hard and fast spike lower in the Nikkei would be typical for such a pattern and that such a move would delude Western investors that a Japanese bear would be beginning, rather than ending. I have repeatedly written and forecast this, understanding that Westerners always get Japan wrong.

A second and larger upshot was and is that 2008 would usher in the official beginning of the mirror image of the 1990's, namely that the Dow will be making lower highs and lower lows, while the Nikkei will be making higher highs and higher lows. Since bottoming below 1.00 in 2003, the Nikkei's relative performance versus the Dow bottomed. The Nikkei and Dow have been moving in tandem, by and large, but the preceding has yet to occur, so...

... the dramatic sea change contemplated in the above paragraph is yet to officially begin and represents one of the most dramatic factors that I recommend fund managers and Advisors focus upon for 2008, and beyond.

The long-term weekly Nikkei chart below illustrates the perfection of this year's forecasts, which included a counter-trend peak at 18000, a collapse to 14,000 – 15,000 (already achieved!), where the index would complete its 18-month bear market, finding traditional support, trend-channel support, and, perhaps most importantly, the never-followed 200-week moving average. Take a look. It's all there, even allowing for a minor and meaningless new yearend low closer to 14,000 than what was achieved only days ago.

I have identified every secular and cyclical move in the Nikkei since 1988; this is not bravado. This is for readers to weigh the probabilities in considering the commentary and suggestions in the remainder of this section. Regarding the latter, for your study, your attention is drawn to page 5 and what follows the Shanghai section.

For now, note the following long-term and 1-year Nikkei charts, which illustrate the desired technical indicators, but also the Nikkei damage that will have required some time and base-building, as opposed to the mid-caps that have been dragged down by the Nikkei, but not by the same factors.

Specifically, the bad decline in the Nikkei created a negative climate for going out and making new Japanese (mid-cap) stock commitments before yearend, but the Nikkei has been smashed by foreigners who dominate the latter, while the mid-caps are not owned by them, and so their decline has been on low volume and only as a matter of yearend neglect that will have passed with yearend, and on the realization that the same and new cyclical Yen bull market that depresses the Nikkei also ignites the mid-caps!



## Domestic Stocks:

The following look at the mid-caps reflects a decline toward 3000, whereupon would be achieved an approximate decline of 45% of the index itself, as well as its advance off this decade's low. Its major support is also there. Index extremes tend to occur at yearend and this one looks like a dilly.



The 8-year chart above and the 1-year chart immediately below provide a look at the counter-trend market of value that hedge managers will be chasing in 2008, to escape the overcrowded-with-foreigners-Nikkei (25% of trade). Such overcrowding exposes the index to risk, when the Dow declines and non-Japan funds sell to raise cash, since they are not committed to that market by mandate.

(Commentary continues ahead of the chart, which gauges the relative performance of the mid-caps versus the large-caps.)



The following chart gauges the relative performance of the mid-caps versus the large-caps. Its bull market is 8 years old! It has corrected to support and the percent retracement levels that technicians love to see. It also created extremes at the very end of 2003, 2005, and now at yearend 2007, as you can see.

So, we know the following, so far: The Nikkei is peaking. The mid-caps are set to dramatically outperform the Nikkei, without the currency risk to which the multi-nationals are exposed. The Yen has clearly bottomed at last, as further impetus for the mid-caps and is key in fashioning any particular product, herein contemplated.

Regarding the *esoteric investment product for windfall gains in 2008 for hedge funds and sophisticated individuals*, I'll conclude this discussion at the end of the Shanghai section. For now, sufficed to say that the **SOLE** stock investment theme for 2008 - 2009 is the Japanese domestic mid-cap market. At the end of that section, you will be referred back to include the discussion on this page.



### Conclusion & strategy:

By yearend, use the 100% long Yen position in portfolios to invest in Japanese domestic mid-cap value stocks, along with any investment that includes a Japanese component that capitalizes on the fact that ALL Japanese indices will have bottomed by yearend, though larger caps will have required more time and base building. The end of the next section on Shanghai concludes with the special investment opportunity referenced in this report.

### SHANGHAI

The daily 1-year chart of the Shanghai index (second chart below) illustrates a pattern supportive of an approaching double top for yearend, which would make it peculiarly reminiscent of 1989 in Japan, when the Nikkei peaked on the first full day of trading.

Markets – mostly equity markets, since fund managers hold greater sway there, as opposed to sovereigns who dominate currencies bonds and gold, for instance – tend to hit extremes right at yearend, with uncanny reliability.

As I had with Japan in 1989, I believe I'll have hit a perfect peak in this market. In 1988, I ignored Templeton who had turned negative on

Japan at 26,000. This time I ignored Greenspan's warning that the Shanghai market is in a bubble. In both cases, I know these gentlemen to have been right, but not at all as market timers. There, I fly by my own wits, particularly in order to derive the best possible strategy by which to profit in the greatest possible way, and with the idealized timing necessary to maximize leverage and further reduce risk.

So, while a double top in China would be consistent with a Dow in the higher 13,000's (see chart on page 8), I've learned not to correlate markets and merely look at each individually. That said, the following discussion of strategy for windfall gains in 2008 focuses on the discussion above and in the context of this section, as opposed to what follows later on in the section on the Dow.





### The opportunity:

If one were to simply buy a put option, or put warrant on the Shanghai index after the meteoric rise that it has enjoyed, premiums would be prohibitive. If one wanted a long-term call option or call warrant on the Nikkei, premiums would be prohibitive.

Using everything written above, including the commentary on page 5, there are ways of improving performance efficiency, by lowering volatility premiums (which govern option and warrant premiums) AND enhancing performance by fine tuning which of the Japanese components from which to choose.

Finally, the key is to structure a product that only pays for the out-performance of one index versus the other. For this, one pays a dramatically lesser premium, since the underwriter does not get involved in the business of making market forecasts, but, rather, merely responding to computer models that calculate the price of premiums, based on historical volatility. But not only does one only pay for out-performance, as opposed to an option on one index or another, but, properly structured, one can "cheat the bank" and actually obtain a double-whammy by betting against one insanely high item, and on a

deeply undervalued item, that further carries with it a volatility price reducing factor.

I can draw a simple conclusion that sums it up: The tailor made product achieves paying less for what one would actually be prepared to pay more. And therein lies the perfection of the engineering that delivers the structure for windfall gains, as lesser premiums are paid for what should actually be astronomical.

The basic details that I can and must mention here is that the product is a listed 2-year warrant, for which minimum investment is \$100,000. This achieves the classification by regulators of individuals as "sophisticated", from a legal standpoint (institutional investors so classified are already treated as exempt), while, as a result, making available a leveraged product that does not otherwise exist, on two markets at crucial junctures, and in one highly leveraged and efficient swoop.

### **NEW YORK**

The Citigroup news sparked a wild short covering rally this week for which the technical backdrop was primed, with tomorrow's rate announcement helping to ensure that traders lose their yearend short selling bravado.

The disappointment of Christmas sales will usher in a 1<sup>st</sup> quarter debacle, I believe, and there may be a surprising will to have this rally end in a manner as did the September – October rally of 1987, when the pattern was similar. Simply, smart money could get in front of the bad news and not wait for it to manifest, out of a healthy fear of everyone rushing for the exits at once. Hedge funds and family practices have greater mobility than do mutual funds.

And maybe Iranians won't be murdered until Christmas sales are a lesser concern, but maybe there are those who won't wait for that either, if they KNOW that it's going to happen.

\$100 Oil isn't good for consumer spending, which has an almost immediate effect on markets, but the propaganda on Wall Street now is that the low Dollar means that people will go the US from Europe to bail out the sales numbers. You gotta love those Europeans.

The surprise ½-point rate cut that led to a minor new high in the Dow Jones would need to be surpassed by a ¾-point cut Monday, to rationalize this rally and support the GUESS that such an action will

have indeed bailed out Christmas. After all, such a rally could be perception-based, based on a bit of surprising news.

Still, there are the smart guys who wonder what's left for an encore, who wonder how long a bad Dollar can save the day, before it ushers in a catastrophe as free sovereigns liberate themselves from the Dollar. The smart guys might wonder too whether the impeachment of mass murderers might not usher in the political instability necessary for sovereignties to try to wiggle free from oppression.

Yet another wild card is the factor that Alan Greenspan had more than once discussed, namely, the need to leave room to cut rates after markets get hit. Greenspan may have been a hypocritical scumbag, as I've called him in the past, but Bernanke will have been seen as an academic wimp, by the time this is over.

Wall Street will treat an academic harshly, because they're just not like that. They're looking to blame everything on him. Wall Street never assumes blame for its greed and havoc it causes. When things go bad, their touts will come front and centre, to describe what should have been done by the Fed, to deflect from their own greed and the equity price spiral that their insanity will have caused.

This week, a colleague was telling me about Wall Street's insurance products that strip savers of their annuities. It was an amazing and tragic example of yet another means by which they created a revenue-generating product that sparked consumer spending, while stripping consumers of savings. The tragic part is that it created investment banks (the modern day name for brokerage firms) that cheer for their clients to drop dead. You gotta love these guys.

**2008 Is going to be a whopper!**

#### **Technical:**

The weekly long-term chart immediately below illustrates a downtrend confirmed by its stochastic. Weekly stochastic are coincident and do not offer confirming divergences, as do such daily and monthly indicators.

The moving average shows support to be in the Dow 11,200 area, while the 1-year daily chart that follows it illustrates 200-day moving average resistance achieved. Still, it can be surpassed with a move to 13,600, but it would change nothing, in the context of the discussion above.



The following chart of the Nasdaq includes Friday's activity, unlike the Dow chart, which ends with Thursday's action. The Nasdaq can get up to 2720, or so, much as the Dow's resistance lies at 13,600, but Friday's "outside day" (day's highs and lows exceed those of the previous day) is potentially ominous as, in technical theory, such a day should mark a trend reversal (particularly if closing on the lows, which it did not do).

Hitting 2700 is dangerous enough. [Will they actually cut ¾ of a point?](#)



### VIX:

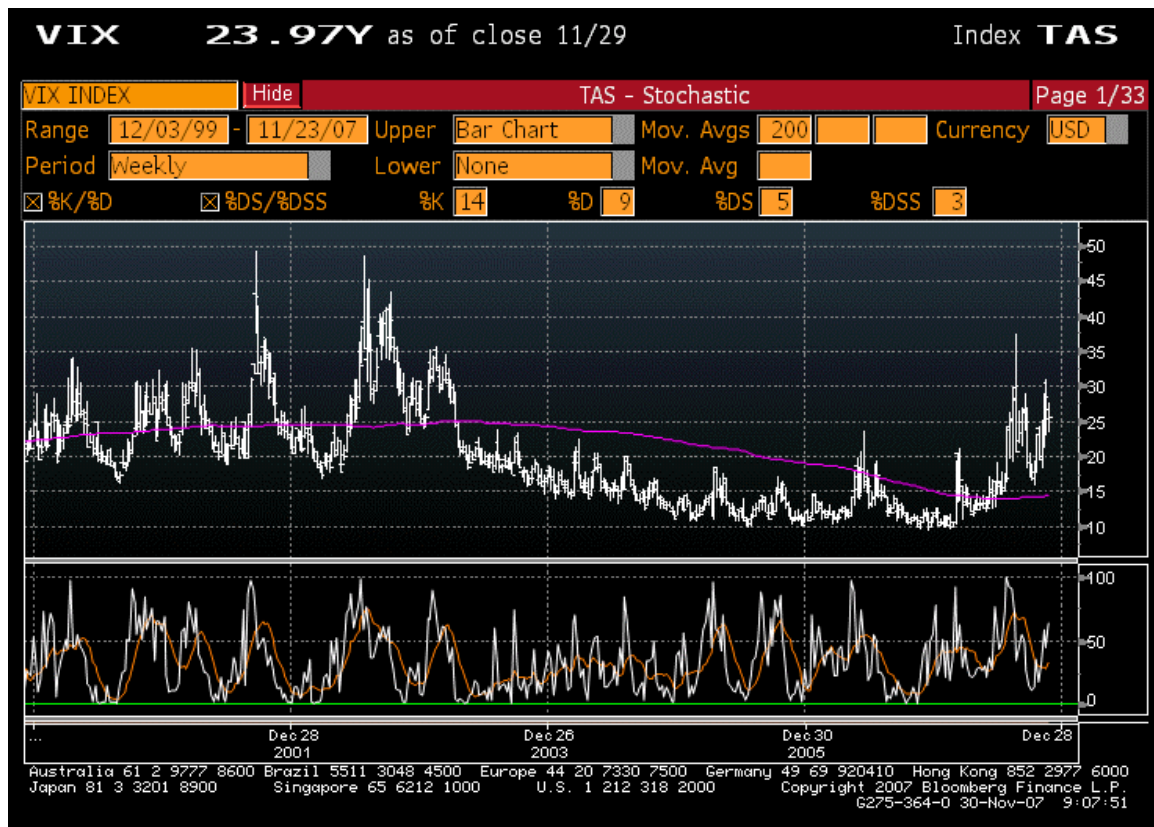
The long-term chart below illustrates the bowling pattern that reflects a tidal shift toward increased volatility, which is not going away anytime soon.

The daily chart of the Volatility Index beneath it also reflects that upward trend, and clearly indicates how the 200-day moving average has become defining support. Not only does this tip off traders as to when the market is within a day or two of turning down, it also shows when the timing is ripe for entering into the put options, which represent our sole investment in New York.

Short selling is a major involvement and with everything else working so well longer term, across our asset allocation spectrum, who needs

the grief, particularly since the Dow puts will single handedly provide the returns sought, even while only representing a tiny portion of one's wealth, with size depending on the individual.

The long-term chart of the VIX immediately below suggests that it can go a lot higher and thereby support the notion that markets may yet head a lot lower by yearend, while the one-year chart reflects support at 20, which I don't think will be attained, given my views regarding market resistance levels. Such a decline would be consistent with a triple top in the Dow and a rate cute of  $\frac{3}{4}$  of a point, though that's just a scenario, of course.



Please scroll down to page 14.



### Conclusion and strategy:

A move toward 13,600 would be (is) a good opportunity to short the Dow, because 14,000 is not worth waiting for, if **the downside next year is 8800**. The concerted effort to save another Christmas is providing a glorious opportunity to short 2008, which even the powers-that-be have surrendered to the bears, on a fundamental basis. The Dow in 2008 has an appointment with 8800, and even the first quarter may well get the job done. I've learned this over the last 25 years: When the Street realizes that something is going to happen, they just make it happen and don't wait for others to sell ahead of them. Remember, the Fed has already forecast a weaker 2008. **HEAR THE BELL!!!** It's ringing so loud, it's drowning out the fat lady.

### PRECIOUS METALS & DOLLAR (YEN):

#### Technical (gold):

The previous report warned of a possible eruption to \$1000 by yearend, since the forecasts made at the beginning of the year have been unfolding and thereby heading in that direction.

The song remains the same. While potential short term is to \$750, it means nothing and the long-term risk is to the upside. As written for 6 years, this is a secular bull with only one direction. The first phase, I forecast, was to \$500. Then, it would be critical to stop playing with it but stay long as a matter of permanent currency allocation, as the metal would advance against all major currencies. And it has.

The 3<sup>rd</sup> phase, I've explained (but not harped on), would be and is one of acceleration, and acceleration to the upside means the point at which silver takes on dominant importance in the currency complex. **Yes, that's right. I now consider silver a currency and will now treat it as such.**

Beware the yearend opportunities, as extremes are achieved in equity, currency, and metals markets, as fund managers are guided by business considerations, as opposed to purely market factors and considerations.





### Technical (silver):

Readers were advised to go 200% long on a spike toward \$11.00, which was perfectly achieved. Last month's report warned that a decline to \$14.00 should be used to accumulate by those new readers who are not yet long, notwithstanding potential to \$13.50 and \$13.25.

I stated clearly that **this move alone in one's holdings would create the year's desired portfolio returns**, all else notwithstanding. Frankly, for 6 years, it has been as easy as taking candy from a cavity-ridden Western central banker.

Since the beginning of 2002, I do not believe that anyone in the world has enjoyed this track record of success with gold and silver and, now, the asset allocation is being modified to include silver. Heretofore, I advised including 10% silver at the expense of a 50% gold allocation, which would be reduced to 40%, but only at the discretion of the investor. However, the official asset allocation for all wealth now changes to reflect the turn in silver's fortunes versus gold itself (see "asset allocation", at report's conclusion).



## YEN:

After the Yen's initial 11% blast to the downside, there was a correction toward 118 that had tested the faithless. After warning to be unmoved by such a bounce, by recognizing it as such, the Yen resumed its new and only 5-month old bull market and it has now completed a near term low 13% from its bottom.

Our major currency asset allocation has been the best in the world on a risk and volatility adjusted basis for years, by combining the Swiss Franc, the Yen, Euro (until one point, this decade), gold and silver, in the way that I have.

I have been very clear this year that the Yen is where the big currency gains lie ahead now for global investors and that this is in keeping with a brand new cycle for domestic Japanese stocks powering upward in the face of global equity declines, much as what occurred at the beginning of this decade. In 2004, the Yen peaked and then the domestic equities did the same.

The lag between the currency and domestic non-multi-national equity turning points was the same in 2004 as it is now, as will be evident very soon, with 2008 upon us (see JAPAN above).





## Asset Allocation:

- 45% gold
- 5% silver
- 25% Yen
- 25% Swiss Franc

From the September report: **"This is a wonderful time to own the Yen, gold...and silver!"**

Good fortune to all,

Sid Klein

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