

Yearend Risk Management & The Components of 2011 Long/Short Shifts



September 5, 2010

JAPAN

Hedge fund managers, please take special note of the excerpt immediately below.

Asset Allocation section, August 22, 2010:

"The lag times between the reversals in the different asset classes and sectors suggest very careful short and short-intermediate term analysis, in maximizing best prices, whether this relates to currency, bonds, equities, long/short positions, or derivatives relating to any of these.

"However, this is true only to the extent that one wishes to try for best or better prices, since it is such prices that determine one's leverage.

"Everything gets trickier, the greater the precision that one aims for."

The 10-year weekly and 1-year daily Nikkei charts follow, respectively (the 10-year is from BigCharts for clear viewing).

Regarding the 10-year Topix Small Index, which chart follows the 2 Nikkei graphs, that picture illustrates the clear neckline support zone at the 800 – 850

area. This intermediate term support correlates well to the 9000 level on the Nikkei, for the short- to-medium term.

Bottom Line:

Either as outperformance or as absolute returns, as the case may be: Up for Japanese equities, down for Yen and long term bonds.

As I have been saying, bonds will be sold to some extent for the purchase of stocks, due to the wish to earn compensatory returns for the simultaneous deflation in other asset values.



The upshot is that a 21-year (3 x 7, for numerology lovers) secular or long term bear market is ending at the end of this calendar year, as Japan takes its turn with fiscal stimulus and, more, even the probability of **Yen Monetization**.

In 1989, SEVERAL indicators had turned decidedly bearish for what lay beyond yearend, for those prepared to read the handwriting on the wall.

I repeatedly warned that the final quarter's upward **momentum** was merely the result of investment capital that **had already been earmarked** for the market. However, the funds then turned against the very market that window dressing had compelled them to be allied to until just days before.

Commentary continues after the above-referenced charts.



Today, there is the effect of window dressing again, but now going the other way. The market is preparing to turn versus other markets, as cross-charts (long/short) bottom about 3 months ahead of the component indices, as I have written so often over these recent years.

Therefore, the next 3 weeks are critical for timing, but: for long term players, particularly those using premium, a week early is usually better than a day late, due the volatility that typically ensues from extreme levels, as such is the nature of "extreme."

I advise Japan watchers to note the Yen commentary contained in the July 4, 2010 report, including commentary published hence.

KOREA

While other Asian indices represent superb long term potential – certainly as outperformance plays – the Korean market is one that struggles to clear previous peaks, by anything more than a few points and, again, just enough to touch its overhead up-trending resistance trend-line.

The Kospi-200 trend has also trended with the Dow over this past cycle, and here too it is worth noting that cross-charts bottom about 3 about months ahead of the turns in the component long/short indices.

I have written in the past that Korea may be so off-cycle with other markets over the longer term, that 2008 may have been the final decline in a secular bull market, as opposed to its first decline in a new secular bear market, harmonious with other markets.

The 1-year daily chart follows on the next page.

Please scroll down to page 5.



DOW JONES

August 1, 2010:

"Still, as I did not foresee the most recent rally from 10,000, I *might* revisit the best global strategy, upon the market's return to that level; I expect that pullback very soon."

As illustrated by the 1-year chart on the next page, the above report was indeed followed by the minimum downside forecast of 10,000, from which the index sprung back.

Considering the discussion of fiscal stimulus, particularly as it is a subject that spreads Christmas gaiety (until Thanksgiving, if that far, given the consumer confidence readings), I must indeed revisit the above contemplated consideration of risk management. To wit:

In lightening short term bullish commitment, by way of the change in the VIX strategy (next section), as well as the management of long term Dow puts:

Nearer term puts can be double-sold against the long-dated Dow put position, which could be augmented by the credit created by the double sale. This increases the size of the long position, without adding capital.

If the short side expires months from now, if appropriate, the new position could have time extended in like manner, also at no expense. Particulars relate to each individual case.

These strategies are designed to take seasonality into partial account, as well as the loss of some time, even if for long term positions.

In considering the very worst-case scenario for bears, the limit would be Dow 11,000, at which the market would become a 200% short!

Never forget:

It is an old axiom that identifying the timing of peaks is nowhere as relatively simple as identifying a low, as peaks can take much longer to form than bottoms.

Never forget either that the longer the topping process, the more viscous the decline, in terms of volatility.

I call it, "catching down." As an example, I forecast the Dow at 8000, perhaps 7000, by mid-April. If the decline were to only begin in December, then the volatility would simply be much greater.

Simply, the decline would trap everyone with speed, shock and awe: "volatility".

The 10-year weekly and 1-year daily Dow charts follow on the next page, respectively.

Please scroll down to page 7.



VIX

July 4, SKGS 2010 letter:

"The June 20, 2010 report advised going long at the next day's open. Thus, we nailed another VIX low, this time at 22.87."

When the June and August lows are connected, there appears to be a pennant from which volatility could break out; the downtrend line of the pennant derives from the May, July and August tops.

Still, given the theme of this report, and within its context, considering further that the present VIX trade was purchased at it lows, in order to reduce net short exposure to the market for strategic reasons, liquidate the VIX trade in the morning.

The 1-year daily VIX chart:



PRECIOUS METALS

The August 22, 2010 report, including the August 1, 2010 letter to which it was postscript, made the point that a critical gold bottom had again been identified, and was ultimately preparing to accelerate to \$1,500.

The long term chart illustrates the unfolding long term acceleration, while the daily 1-year graph includes a stochastic reading that is dangerously negative for bullish traders. The weekly chart also includes a divergence, but not as important.

Against the backdrop of a flattening moving average, the stochastic divergence is a triple divergence, and this is most ominous, but, again, only for short term traders whom I again remind to not be fooled by **upward trending corrections**.

The 10 and 1-year gold charts follow hereunder:





XAU

August 22, 2010:

"As opposed to gold, any break to lower lows in this index would not necessarily be accompanied by similar action in gold.

"This relates to the phenomena of upward corrections in gold, which continues to be caused by Eastern accumulation, coupled with the equity markets' effect on the precious metals index (XAU)."

I add nothing to the August 22, 2010 report at this time.

DOLLAR/YEN

August 1, 2010 SKGS report:

"We are getting ever closer to a revision in our asset allocation model..."

August 22, 2010 SKGS:

“Meanwhile, a bullish reverse shoulder-head-shoulder pattern is plainly in place. A break above 90 will send the bears running for cover...covering their short positions!”

“Thereafter and further coupled with the comments in the JAPAN section, as forewarned, please note that **I hereby officially recommend taking massive profits (presently under 82) in what I had called the “best fiat currency in the world for capital appreciation.”**”

When looking at the weekly and daily stochastics of the Japanese Yen, we are treated to a classic view of a long term turning point in the underlying market.

Therefore, there is no change in the analysis from the previous letter, as my Yen view is reconfirmed. This means than any US fiscal stimulus in the US will be outdone in Japan. (Please see Nikkei comments above.)

Either way, the Dollar low I identified in the 4th-quarter has now been followed by the identification of its peak versus the Yen.





ASSET ALLOCATION

The SKGS asset allocation model remains (and will for a while):

50% gold, with 25% Swiss Franc, and 25% US Dollar.

Sid Klein

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