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First Crack in the Wall

March 6, 2011

Not inspired by Pink Floyd, the title above is drawn from my mentor's sage words, to which I was often exposed in describing the initial break in trends that would portend the ominous beyond.

Here, I refer to the equity markets and their trends versus other asset classes and their related equities, whether precious metals or currency-related (cross-charts), so this month's report is written in and ought to be read in that context.

Separately, while the Bloomberg charts offer superior technical analysis, this month I use other and easier to look at graphs (the Bloomberg charts used in SKGS include 200-day moving averages and stochastic, but have a dark background).

NIKKEI

The index bottomed back in August, while having done so versus the Dow in November. More recently, the Nikkei has been making higher highs and higher lows versus the Dow, while following the latter, as opposed to leading it - for now. (Please see Nikkei and Dow charts that follow below.)

Having so noted, I must add to prior observations and forecasts regarding Japanese yearend market turning points:

I have studied Nikkei time cycles going back 30 years and have analyzed that turns in the index (up or down) occur around March 15, give or take a week or so (March 31 is the Japanese yearend, while the more influential calendar year influence stems from foreign window-dressing).

Therefore, given the context of my analyses concerning Nikkei-related global long/short out-performances, I suspect that the upside acceleration in out-performance is close at hand.

During the July - August period, I was "globally lonely" in forecasting a turn in Japanese performance versus the rest of the world. Now, however, I long for the days of tranquility in prescience.

Not only did one of the world's largest banks hop on board with my views in November, but so have many others since.

Two weeks ago, the news headlines were that the world was seeing a rush into Japanese securities as a hedge against investment in far more expensive financial assets. Curiously, the stock market was down that day.

However, the Yen was very strong, suggesting the basis for the talking heads' commentaries. My conclusion is that the only thing holding back the Nikkei's out-performance has been the Japanese yearend, which conclusion we are in the throes of viewing.

I have always believed that hedge funds and other large investors convert their currency into Yen before spending it on the Japanese equities for which they are earmarked (apart from other Japanese assets, such as bonds).

Though I do not do so here, it is worthwhile to analyze the Japanese **long bonds** and how they too may play a key role in global inter and intra-asset class long/short positions (one should not infer from this which part of the yield curve investors will flock toward).

In conclusion, this issue of SKGS replies to the question, "Okay, but when does all of this materialize for real?" Answer: imminently. As such, I have formulated the best combinations of strategies, with all of the affected asset classes in mind.

The **1-year daily Nikkei chart** follows at the top of page 3.

DOW

January 7, 2011
"So, history will have judged SKGS to have been early, but still quite accurate in the view that all of this has been a major countertrend rally akin to that one which was seen post-Crash into 1931."

And that is pretty much the only excerpt that I need to rehash.

All the way up, liquidity has driven financial assets in a most cynically phony manner. With each move upward there was/has been an attendant piece of economic news to misinterpret.

After all, what *talking head* is going to report, "The market opened up strongly today, driven by Fed manipulation and its printing press?"

I have remained consistent in this analysis and, this week, another example we may consider is the employment numbers. They were bad, not good. The growth was in the jobs that pay $11, not $25. Wages tell the tale, no?

Still, when financial aspects such as those contemplated 2 paragraphs above drive the market, a "reporter" needs a headline explanation. It is up to the investor to actually read the stuff of which these headlines are comprised.

Since my positions are short, I would like to give this over-extended (embellishment?) market the kiss of death by offering the short term bullish interpretation. (Richard Russell commented many years ago that the bears all of a sudden see a bullish reason to wait before shorting, right at the very peak.)

Immediately below, we can analyze a wave count that allows for a minor new high at 12,500 before falling apart.

Having so analyzed, allow me to add that the investor who would wait for that is simply one who does not know how to devise an appropriate combination of strategies, which allows for participation in what is likely a bull market that has seen its end.

This month as well, the VIX section contains most of the strategic message being transmitted herein.

1-year daily Dow chart

Like so many indices, the S&P has an exchange-traded fund (ETF), which is known as the Spider. Its symbol is SPY and the reason that its graph is the same as the regular S&P is that it is simply 1/10 of the latter. So, why bother to publish the SPY instead?

The answer is that the existence of many such ETFs make the creation of long/short positions much easier for retail investors. So, to illustrate an example, I have included the SPY here, as well as the **gold ETF** (GLD) in the precious metals section below.

That ETF is also 1/10 of the regular underlying security (gold). Recently, the long\short {GLD - SPY} traded at 0 (zero), before rocketing almost 10 points.

There are different ETFs out there, thus allowing for different long/short combinations, according to the desired asset class(es) and index choices that allow for matching values, as much as possible (it is preferred to have the long and short sides be of similar values).

Of, course, there are different ways of creating such balance, particularly when including more than 2 **indices;** doing the former does NOT necessarily mean combining different **asset classes** on one of the sides of the market.

(By creating such balanced long\short positions involving relatively co-directional markets, the investor benefits greatly when enjoying portfolio margining, as the {GLD - SPY} position illustrated.)

1-year daily SPY chart

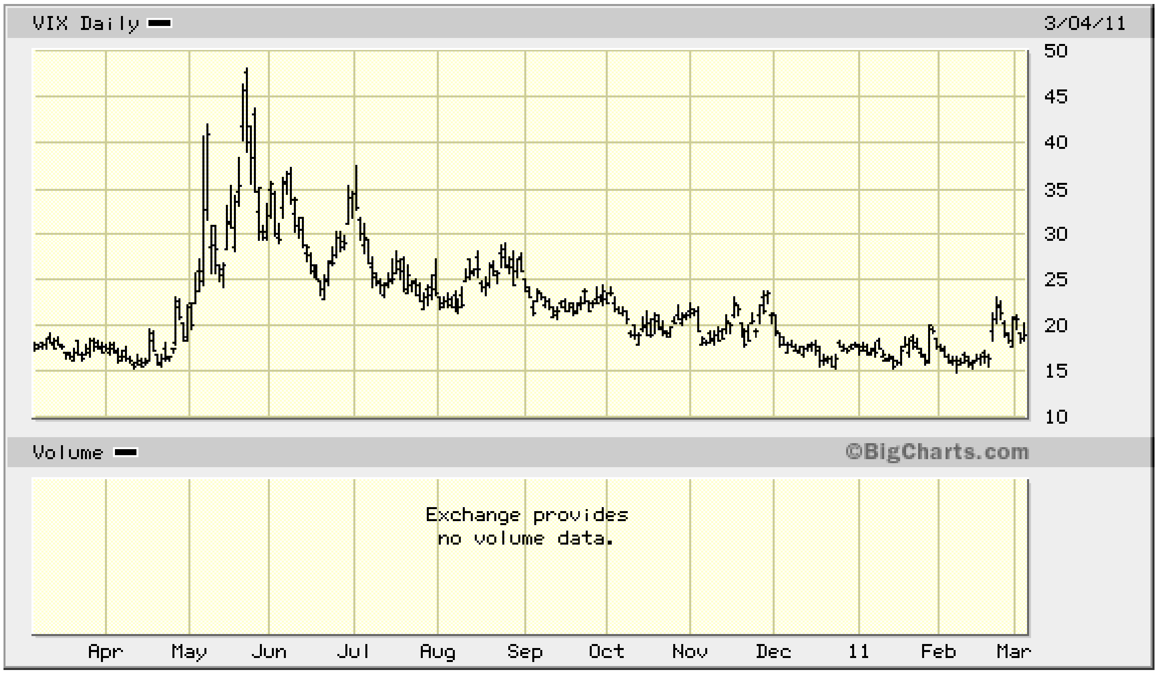
VIX

February 6, 2011:

"The technical conclusion is that there will be a spike to the 25 - 30 zone, which I believe corresponds to a spike in the Dow to the 10,000 level. Fast when it comes. By the end of April."

"The bottom line is that this "1932-rally" has extended dangerously in terms of time, thereby threatening financial institutions, which services are threateningly tied to margin calls or their equivalents, depending on the investment or institution type."

1-year VIX chart



While providing an excellent way of playing the stock market to the short side, the counter-trending VIX offers a look at what could threaten institutions, as described at the top of the page.

However, beyond using the VIX only as an indicator (which has represented SKGS's limited use of that index) - save for a handful of occasions when trades were recommended, the net of which resulted in sizeable-to-explosive gains - **the VIX does indeed offer strategic possibilities that are actually superior to those provided by shorting the equity indices.**

Going long the VIX makes for a good combination of strategies since, when liquidating, it bottoms ahead of the stock market. And, on the buy-side, the VIX tends to bottom ahead of the equity market peak, as well.

However, there are even more intriguing factors:

The VIX offers products that are strategically easy to trade. I do not refer here to the extreme market liquidity. Rather, I refer to the fact that options on the VIX are based on the cash VIX, which chart we see above; the premiums are huge!

Is that bad? NO. Simple retail thinking is that large premiums make profit more difficult but, in the case of the VIX, the positions with which the options are being traded in conjunction are futures that are priced on a curve, whereby the size of the futures' relative premiums diminishes over time (the premiums increase at a lower rate each month at a certain point)!

So, this makes call writing very fortuitous in reducing capital risk exposure, while, for the diagonal spreads (below), such pricing assists in creating improved risk/reward scenarios.

It is true that something similar can be said of the equity index puts, except that the steepness of the respective futures' curves doesn't even compare, since the equity index futures' premiums are largely determined by interest rates. Not so with the wild VIX.

Now, please hold that thought while considering the following:

As reflected by the VIX, the more the market falls, the more the equity market option premiums increase. For this reason, equity index put buyers enjoy a positively leveraged double-whammy as the market falls.

In looking at diagonal VIX call spreads on the shorter end of the curve, the economic opportunities on the VIX are superior to the diagonal put spreads that I see on the Dow, for instance.

Huge premiums on the VIX options make all of this possible with ever-increasing benefit, the farther out in time the long side of the diagonal spread goes. This is due to the nature of the above-mentioned curve of the futures premiums.

All taken together, the best combination of strategies includes both shorter and longer term diagonal call spreads. The shorter dated strategy does not squander much profit with a quick and sizeable move down in the stock market, since the longer-dated strategy uses slightly higher strike prices.

In such a scenario, the latter benefits much more than any lost opportunity in the shorter term strategy which uses lower strike prices.

So, the combination of combinations (diagonal spreads) creates a win-win scenario, unless the stock market were to spike up to and maintains new highs (unlikely). But, guess what!?

The unusual VIX option premiums provide plenty of premium-selling or replacement opportunities, once the short side of the shorter term diagonal call spread would expire. But here is another "Guess what!?"

These call premiums offer exponential profit opportunities, as opposed to the geometric ones that come with equity index puts.

As I reminded above, the latter enjoy a double-whammy as the stock market falls, since option premiums (the VIX) are increasing and perhaps even flying. Using more plain English, that double-whammy equates to geometrically increasing gains.

In the case of the VIX, however, the rate of increase itself increases, spelling exponentially appreciating profits.

Simply, the VIX calls go up at an increasing rate the more the stock market falls, since the latter creates the VIX's appreciation. The appreciation of the calls on the VIX becomes hairy, the more the VIX rallies, however.

The volatility of the calls increases as the VIX goes up (while the VIX rallies as the market falls).

I reiterate certain points here to underscore the superior profit opportunities that exist, and in the context of superior strategic possibilities, which are also due to the ridiculous VIX option premiums, all as described above.

So, trading any fund is dumb, while the strategic possibilities are superior using the futures and options, since they enhance leverage while reducing risk!

GOLD

February 6, 2011

"Separately (sort of), gold speculation is at a 5-year high, while the overwhelming physical demand is concurrently suggesting a low coming into place."

January 7, 2011
"Those who simply note the extent of gold's advance and relate it too closely to the moves in the broader indices will be fooled once the correction in equity prices commences in earnest. (We are getting ever-closer to that de-coupling!)

"The point of total decoupling, which I have long since forecast, will leave investors behind, especially those who will be waiting for the completion of the correction in the general stock market to be fully invested in gold and silver equities."

What has happened over the past month? A rally that approached 8%! This jives with the excerpts above, which contemplated a shorter term low, along with restraining longer term indicators. (The aspect of "restraint" is reflected by the XAU which has not done so well in the context of the broad market.)

It is **VERY** noteworthy that the XAU has been counter-trending versus the broad market on near term bases (day-to-day). This is a change. So, we have seen the warning shot across, as per the January 7, 2011 excerpt above.

December 6, 2010
"Among the arguments was that corrections are so powerful that they are disguised by actually moving higher during those corrections, as eager long term buyers (such as Easterners) absorb whatever gold that silly Westerners are dumb enough to let go."

"2011 belongs to the mega-bulls, and readers will still more clearly appreciate why I have advised investors to maintain 50% of all liquid wealth in this one true currency."

Anyway, we will see if gold meaninglessly pulls back $100 from top to bottom.

Its meaning would only be in the context of the long/short opportunities referenced earlier in this report, and with respect to which the **1-year GLD**

chart above is published. As discussed in the **DOW** section, this ETF is 1/10 the price of regular cash gold.

This year's reports have said it all, and their study is timely!

SILVER

I have often noted the similarity between the patterns of silver and the XAU (Philly Gold & Silver Index), and the following two charts reflect the dynamic outperformance of silver. In fact, as is evident above, the metal has way outperformed the XAU.

We are only 33% long the XAU, albeit from the 165 zone. So, given the parabolic curve above, the desired pullbacks will be used to hit the XAU....which has started to show me clear counter-trending versus the broad indices.

This fact will help hone the next strategy, while investors try to determine the best risk/reward investments at a time when the stock market falling.

Welcome to 1931!

1-year silver chart

XAU

December 6, 2010

"Structuring long/short investments, still, I am happy to say that we have not missed the bottom of those structures that are and will be designed to benefit from the precious metal equities' out-performances.

"This is why I have maintained that the best time for that will be after a sharp stock market decline drags down the XAU, before the latter breaks away and reverses, as co-directionality comes unglued. Just like 1931."

My XAU commentary appears in the preceding gold and silver sections. The chart immediately below reflects this index's poor relative performance of late, both versus the broad equity indices, as well as silver which it has tended to emulate.

1-year XAU chart

YEN

The **1-year daily Yen chart** on the next page includes Thursday's sharp move, **right off of the downtrend channel.** This chart is of the FXY, which is a Yen ETF that is not traded on a futures exchange.

As opposed to Bloomberg charts which express the Yen versus the Dollar in reverse, here, a chart decline reflects a drop in the currency (a Bloomberg chart would illustrate a corresponding bull move, as the Dollar increases versus the Yen).

In any event, I have again used a graph from BigCharts, both to reflect a clearer image, while, more importantly, illustrating the more numerous strategic possibilities of which one may avail oneself, by being aware of the different products at one's disposal.

The Yen message is found in the Nikkei section above. (As far as targets go, the Yen chart below should easily see 116 by summer.)

December 6, 2010

"For 21 years, the exact opposite has been taking place. The US printed money, while the Japanese did not. Now, it is the Japanese who will 'create money.'"

ASSET ALLOCATION

The breakdown remains:

50% gold
25% Swiss Franc
25% US Dollar

Sid Klein

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