

BEST OFFENCE? GOOD DEFENCE



February 7, 2010

SUMMARY

SKGS has again identified the extremes in the equity markets, along with the intermediate/shorter-term inflection points in the currencies and precious metals.

Now, we reiterate the 4th-quarter view that there is a 75% - 80% probability that those extremes will have occurred for yearend, while the lesser probability contemplated a minor new high in February, after an initial January decline.

Indeed, January was the worst month since last February, after a good initial week (paraphrase: "...fading in the wrong direction in the first week.").

The theme is what to do now, given recent market action and in the context of the above-contemplated probabilities.

Hence the theme: Countertrend moves ought to be sold without any care for what happens thereafter, as we are well-positioned for the longer term. **Lost opportunity is not the same as lost capital.**

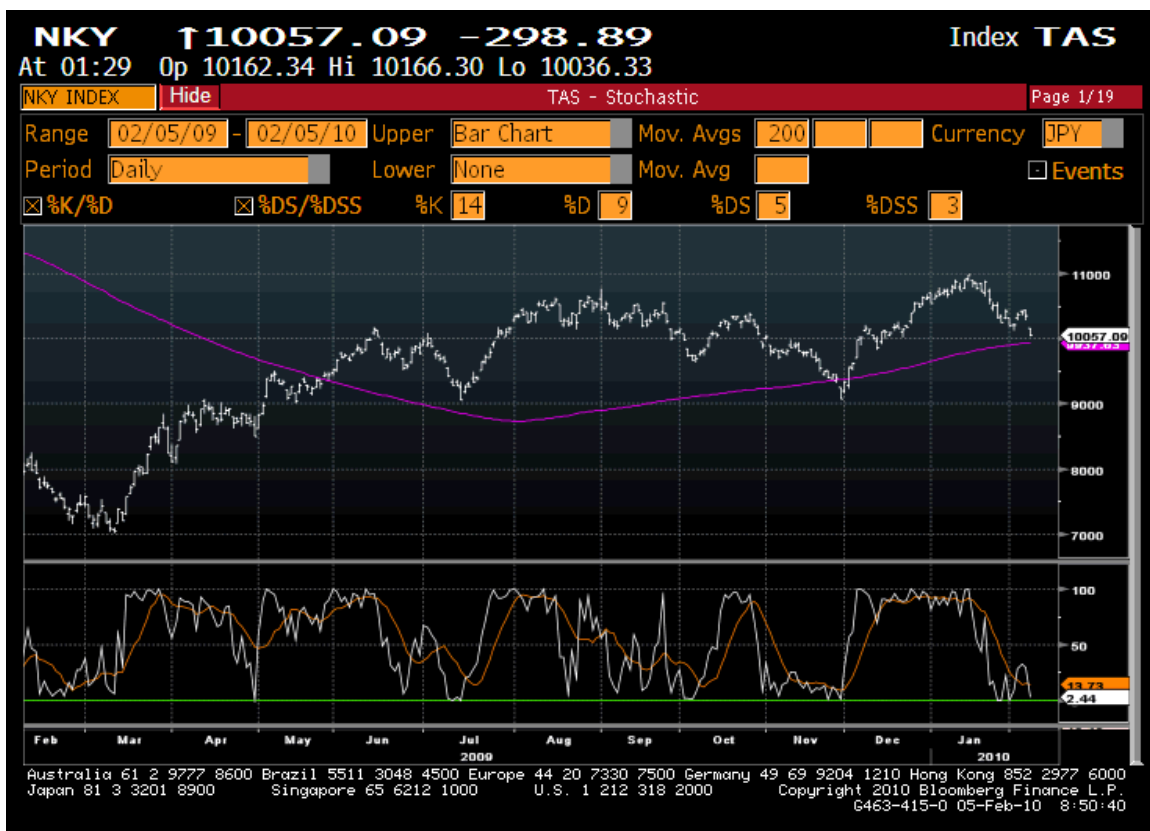
This best example of this attitude is found in my XAU commentary (see GOLD section), despite remaining bullish longer term on that index.

Due to last month's timely and extended reporting, commentary and technical coverage is kept to the abbreviated point, in this particular report.

JAPAN

The following 1-year Nikkei chart reflects a decline to a previously key resistance level (hence, present support) and the 200-day moving average (MA).

With the 14 and 9-period stochastic oversold as well (though absent any divergences), one can expect a bounce, before rejoining the global equity smash.



CHINA

The 1-year Shanghai chart which follows on the next page, reflects a break of the **rolling over** 200-day MA. Still, the presently positively divergent stochastic allows for a bounce, as part of a right shoulder and dangerously rolling over equity pattern.

From the December 6, 2009 SKGS report:

“...this index is points away from its top. The timing of the peak may be when the tracker indices come onto line with it, but that’s just an educated guess. Breaks of the moving averages could open up the gates to the downside. And what will Asian bourses do then?”

And from the January 10, 2010 letter:

“Indeed, this badly weakening index is just points from 3,500 and the end of wave c of c. Yes, it is THAT close to its demise.”



SKGS has warned that being short was of the essence, since any move up would fall under the “squiggle” category, and should therefore not weigh into any (dis)investment considerations.

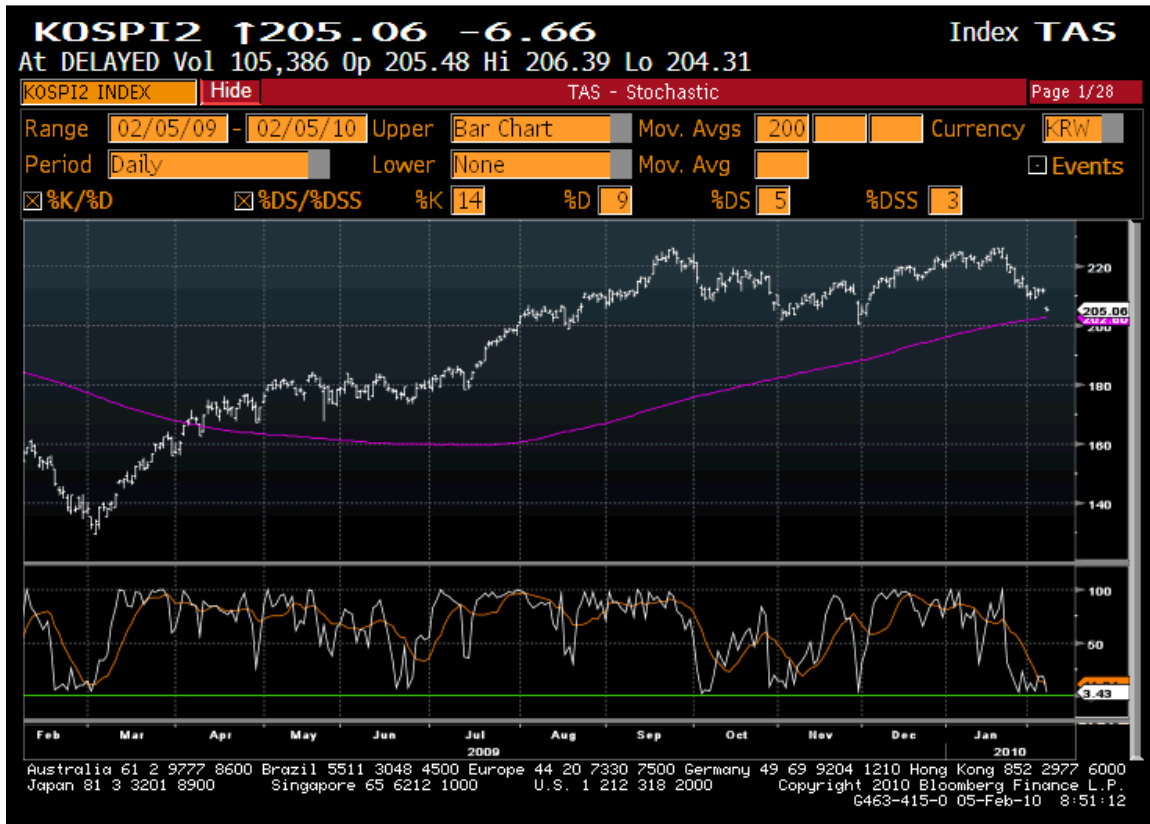
So, the 200-day MA has indeed been broken and no one should care about any 2-day bounce, if it even comes.

The Shanghai index has not come into line with the outperforming tracker indices, and that’s so much the better for the bears anyway, from a profitability point of view. (It was solely a matter for market timing that I was checking for possible alignment.)

I have linked the Korean market (Kospi-200) to the Shanghai. It provides a much cheaper premium, while being a superlative Asian bear-play, which is caught between the Japanese and Chinese markets.

KOSPI-200

Here too we see the flattening MA, which is what precedes one that rolls over, obviously. An extremely short-lived right shoulder is all that one should expect from which to benefit, in putting on any as-yet un-established short positions.



The Kospi or Kospi-200 provides cheaper premiums (re: derivatives), though a less exciting short play, as compared to Shanghai or any of its tracker indices.

NEW YORK

At the beginning of last week, in two separate consultations, I cautioned that any bounce in the Dow would get stuck around 10,200 before reversing.

The logic, based on 27 years' experience was that 600 points was too shallow a decline to merit a greater bounce, unless the *bounce* was not a countertrend one but, rather, a rally which would finally complete the move up, to satisfy the alternate scenario of a slightly higher and final February high.

2-year Dow and S&P charts follow on this page.



The weaker S&P chart has dangled below 1100, while the Dow only briefly broke 10,000, giving foolish hedge fund managers a false sense of security heading into this week.

The December 6, 2009 report asked:

"Are the last trickles of the countertrend "1931" Dow rally completing right now?" The January 10 letter replied, **"Yes."**

Last month's (January 10) strategy section remained unchanged from the prior month:

"The Dow is rolling over and dangerously close to its tipping point NOW, in line with global market activity. 5000, give or take, awaits below, through 2011. This next cycle, which is commencing NOW will take the Dow to the 4000-6000 area."

VIX

We (I'm told it's poor form to write "I", hence the papal expression) nailed the recent low to the day, going long at 16.93 (the peak was perfectly targeted under and en route to 90, before we rode it down to just below 40; since then we took a 4-point loss, in going long too early).

Now, in firing up to 30, a bearish divergence has developed (see 2-year daily VIX chart on p. 7), which would suggest a pullback and, therefore, a corresponding bounce in the market.

I'm, not biting!

Once before – and only once – I allowed such a divergence to influence me in the short term, forgetting that this service is not about near term trading.

We're short the market, and long the VIX...and it's staying that way.

From the January 10, 2010 SKGS report:

"More calls are being bought than puts, as memories have faded of disasters past. This won't last long. Count on it. Bet on it."

Strategy

Revert to a 100% long position at Monday's open, with a close-only stop below 15.75."



PRECIOUS METALS (gold, XAU, silver)

From the January 27, 2010 report:

“Today’s action in gold suggests a greater likelihood of new short term lows.

“As evident in the 1-year daily gold chart (first of three 1-year graphs), wave-c would approximately equal wave-a (typical correction) around \$1,030, which would be closer to the pullback support that I had initially forecast, but which I then replaced with a target of \$1,080, after gold had crossed \$1,200 (thereby having traveled higher than initially anticipated).

“However, the action in the Philly Gold & Silver Index (XAU) suggests that the low it made today may have completed its correction and, since it leads gold, it fits that the metal is about to make its final short term bottom.”

A reversal in gold from these levels (and the proximate 200-day MA) would be perfectly consistent with the above commentary and that of the analyses that followed the forecasted breakout over \$1,000/once!

A 2-year daily gold chart follows immediately below:



From the December 6, 2009 report (strategy section):

“As from \$700 per ounce, gold has started its wave-3 advance toward \$3,500, in 2011. I look for a break above \$2,000 in 2010, however slightly. At EACH step of the way, there are bears and bearish arguments.”

GOLD/SILVER

From the January 27, 2010 interim report:

“After having identified the October 2009 low, as well as this January’s bottom to precision, the anticipated 2010 Wave-3 advance appears to already be well underway, with the breakout having occurred during this correction in the precious metals, despite the trade having been designed to be a low risk means by which to add to gold holdings.

“For those with such access, the best risk/reward scenario was with a time/price call spread, though a futures trade was most fortuitous, given the tight stop that the trade provided at prevailing prices, within the context of the low margin requirement.”



As we see from the 1-year gold/silver ratio chart immediately above, and in the context of the referenced SKGS commentary at the bottom of page 8, while the best entry point for the option strategy (referenced, but details not provided) was at the October low, the forecasted Wave-3 eruption's commencement has provided a quick (approximate) **16%** profit just since the identified January low (see p. 8), for traders of futures or like product, discounting **ANY** leverage!

XAU

To reiterate, the GDX is a listed and optionable closed-end fund which mirrors the XAU (Philly Gold and Silver Index). Similarly, there is new product out there which mirrors the XAU to a great extent.

However, before analyzing in too much detail, consistent with the theme of this report, I must advise caution and being prepared to suffer lost opportunity.

I have discussed often of the behavior of gold stocks which collapsed in 1929, along with all financial assets, and how that same phenomenon recurred in 1931 when the Crash resumed, before breaking from its association with the Dow, reversing and skyrocketing thereafter, even as the Dow plummeted to its ultimate lows.

Therefore, I am VERY sensitive to the XAU's mirroring the equity markets during this recent decline...and in a leveraged manner, at that.

Therefore: an XAU bounce to 165-170, and we're out. A decline to 120-130 is possible, once the Dow cracks to 8000 soon, and I wouldn't want to suffer through it. At that point, the gold stocks would divorce themselves from the broader indices (a la 1931) and skyrocket.

If, on the other hand, the XAU's intermediate term uptrend is unbroken, my indicators and cross-charts will reflect that to me and we'll hop back in at advantaged prices. In the same way, we have enjoyed quality entry points, which have thereby allowed us no-harm-done exit points....like this one.

The 2-year XAU chart immediately below also reflects a break of the 200-day MA, and a strong reversal Friday, though it is hard to see from the 2-year chart.

The same can be said of the gold chart, which reversed strongly. Therefore, and in each case, you may see the prices at the top of each Bloomberg chart, to note the respective intraday lows.



Simply, the gold and XAU charts each reversed 20 and 10 points, respectively.

YEN, DOLLAR

From the urgent November 20, 2009 interim report, entitled, "USD:"

"The bottom line is that it's really about other currencies taking a break from their bull markets."

"STRATEGY

On the basis of all of the above, the broad-stroke target range for an intermediate term rally is 85 – 95, in 2010."

Immediately below is a 2-year chart of the US Dollar index. Since identifying the low, the rally has already carried the Dollar up to 80, well on its way to the forecasted 85 - 95 range.

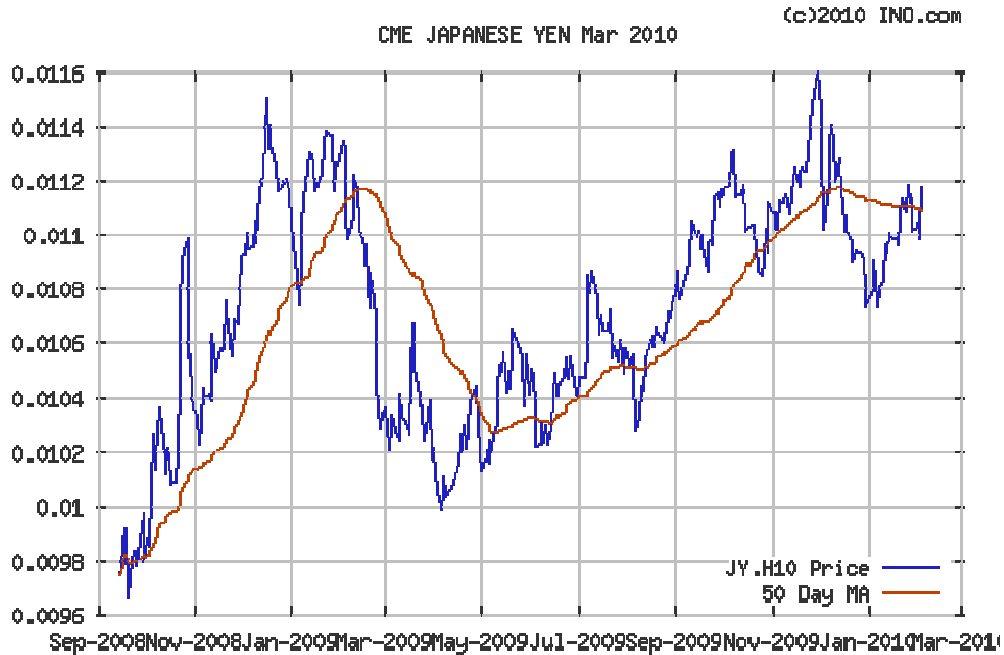


However, it appears that the rally may have carried far enough for now. In Elliott terms, this would suggest the completion of wave-a of a 3-leg correction, to be followed by a b-wave decline therefore, preceding wave-c, to complete 2010's countertrend move in the Dollar.

The resistance and neckline at 80 should be sufficiently formidable to provide the here-contemplated pullback, which would be consistent with the gold rally discussed in the gold section.

This view further explains my reluctance to sit through what could happen with the XAU through a Dow decline to 8000 (en route toward 5000 in this newly commenced bear cycle).

See page 13 for Yen commentary.



The 1st chart on page 12 is of the Yen/Dollar (since September 2008), while the 2nd one is the USD/Yen chart, dating back to January 2008. Different traders have different preferences. (Ordinarily, we look at the Dollar/Yen Bloomberg charts.)

When the Yen reversed from 124 USD/Yen, it followed my having turned bullish on the Yen (at 117), stating that it was by far the best major fiat currency in the world for capital appreciation. This was proved correct.

Looking at the second chart on the previous page, we see the Yen as having reversed to the upside, after the 200-day MA was hit on that USD/Yen graph. We also see that the Yen was up in January, even as the USD advanced.

When SKGS turned nervously bullish on the Dollar for the intermediate term, I forecasted a rally in the Dollar **against** the Yen to the 95 – 105 zone, at the same time as I had made my new Dollar forecast, including the forecasted target area mentioned in the beginning of this section on page 11.

At the 4th-quarter USD/Yen peak, SKGS reported that the Yen advance had gone far enough in the short term, much as I am making such a case regarding the Dollar (Dollar index, DXY) at this time.

Hedge fund managers should be wary of making strategic commitments that are too short-sighted, by over-focusing on the turns that we are seeing now, in ANY of the markets covered in this report today.

Simply, some turns are corrections within corrections, though such is not the case where the equities are concerned. In the end, the biggest consideration by far is that of asset allocation. Since turning "bullish" on the Dollar, my asset allocation remains unchanged.

ASSET ALLOCATION

From the November 20, 2009 interim report:

"ASSET ALLOCATION

"On the strength of the preceding, my asset allocation model is today altered to 50% gold (unchanged), with the Swiss Franc, Yen and USD now sharing the other 50% equally. (Previously, the DXY portion was evenly split, between the Swiss Franc and Yen.)"

"I suspect that this will remain SKGS' asset allocation model through a good part of 2010."

CONCLUSION

From the January 10, 2010 report:

“The fun has begun. Believe it....before sweating that 2010 will bring with it old nightmares. Stay the course.”

What I add today is that investors need not fear lost opportunity, **no more than they should not have waited for the ideally confirmed peak in the equity markets.**

Just as we have seen what an error that that was for those who made it, it is now foolhardy to not sidestep intermediate term losses in the XAU, which would allow for the establishment of great and leveraged opportunities, if the XAU were to indeed decline to new intermediate term lows after this bounce completes.

This theme is similar where the currencies are concerned, with the risk being lost opportunity. And with this massive secular bear market having resumed, why take the risk of being greedy?

The biggest returns, as I so often remind, **are ALMOST ALWAYS the safest returns**, and, for the knowledgeable, a massive secular bear market provides safe and massive return opportunities.

There will have been incredible gains in our markets, including in those precious metals themes, which I am NOT abandoning.

Therefore, the best offence will have proven to be a good defense.

Sid Klein

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