

Notes From the Rabbit Hole ©



Peter Newell's illustration of Alice surrounded by the characters of Wonderland. (1890)

In Lewis Carroll's *Alice's Adventures in Wonderland*, Alice follows a mysterious white rabbit into a rabbit hole to enter 'Wonderland', an absurd and improbable world inhabited by many strange characters.

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Act of Desperation

The monetization of unserviceable debt has been in the Fed's toolbox all along. Academic wunderkind Ben Bernanke has used many conventional interest rate and liquidity tools, but with the recent announcement that the Fed will buy long-term US Treasury bonds, he is opening the door to the nuclear option. This tool actually resides not in the toolbox but in a separate room, locked in a titanium-nickel composite alloy vault accessible by a secret algorithm code. From the Fed's most recent monetary policy release on December 16:

"The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time."

This was of course, dictated by the t-bill market and is US Dollar non-supportive. But with Japan and the rest of the industrialized world falling right in line with this theme, it is truly going to be a race to the bottom for global currencies, not just the USD. I believe that people who focus grimly on the US Dollar are misallocating their energies. Given its heretofore status as 'world reserve currency' the Dollar is an important linchpin in the unraveling mess, but is by no means the only culprit in the global debt paper bubble now

unwinding. In fact, it could be argued that the primary fundamental underpinning of the Dollar is the enormous albeit misguided demand for US Treasuries as the deflationary backdrop begins to take root.

As I listen to media commentators dissect Fed policy, the auto bailouts, the bank bailouts and speculate on all manner of would-be welfare to come from the new US administration and its new New Deal, I cannot help but think about how the entire outmoded apparatus is trying to pretend this is normal or at least readily subject to standard analysis. What I am trying to say is that we are down the rabbit hole, in Wonderland. This is abnormal, asymmetrical and just plain off the charts. Standard methods of quantifying an insane financial system will work against the masses that fall for it – yet again.

The Fed is talking about buying up unproductive legacy (debt) to stave off economic devastation, and that may be the only option now. But the same talking heads – the ones that never saw this coming – expert in their dissection of what is wrong and how to fix it, do not look ahead. They do not see, nor evidently care about the big picture.



Pictured above is the iShares long term treasury bond fund, TLT. Under the current shroud of deflation, Mr. Bernanke infers that the Fed will buy up the long term debt of a chronic and hopeless inflator and of course that is the green light for the next mania, for the frightened herds to come piling in. It's deflation after all and in a deflation you own treasuries. Everyone knows that, especially now. "No matter that treasury bonds are over bought, at least we know we'll get our 'money' back one day" says the compliant herd.

I am not here to bash treasuries. As you may know I have kept all cash equivalent funds in treasury money markets, t-bills and short term treasuries for years. I have done so because it is the safest haven from domino defaults that I have viewed as likely for years. Just this week however, with the manic chart above in mind, I have begun to scale into its ultra-short cousin, TBT. We will call this a little hedge on the t-bills and short term treasuries I continue to hold.

But the story here is one of cattle being branded, tended and herded toward that big, ominous looking building over there with the strange and terrible noises emanating from it. Fighting the Fed is a dangerous game in the short term and this mania has got some heavy hitters as sponsors. But what I see here is an instant market created for long dated treasuries by Bernanke's jawbone and a disastrous economic backdrop that is going to get worse before it gets better.

Yes, buying long term treasuries is safe if you define safety as getting your money back with a little 'income' to boot. But in the big picture, it is the *value* of said money that is in question. As a nation, the US is committing to make whole \$Trillions upon \$Trillions in un-payable liabilities. This is being done by willing money into existence by various methods, with the treasury market front and center. The US is trading upon its rapidly disintegrating reputation. It's debt is non-productive and its market carries on as long as the masses are willing to suspend reality and maintain confidence in the system.

The herd buys long bonds and does what it is supposed to do. Better (for we who would prepare for a whopper of an inflation problem to come) they do this in compliance with convention than after being compelled by government (IRA filled with 30, 60 or 100 year bonds anyone?) in the name of national interest. There is no patsy like a subservient, pliable patsy. People who are *compelled* into certain actions may tend to get a bit revolutionary, and we cannot have that, now can we?

That is why we are here, looking not for riches and joy, but rather for relative protection from the fate that awaits the vast herds now once again being led by carrots they don't even understand.

US Dollar

The Dollar should be a good measure of the current system's ability to maintain itself. As you may know, I have been charting its course of late on the [blog](#) as it became wildly over bought in manic and compelling fashion and then swung to the opposite pole, reviled and cast aside by global mobs on the move.



Our Head & Shoulders topping pattern played out like a charm as weakening momentum indicators finally came into force. This shows the kind of non-committed support that was built into the Dollar's run since July. Again, people who are compelled into something do not tend to be committed in any heartfelt way. The Dollar's holders over the last four months were compelled by redemption, margin and the fear of losing everything. Thus, when the break came, it came in the form of a collapse. Mania, it never ends well.

One sign that the global bear market is not over and that peoples' confidence in the system remains intact is the way casino patrons piled out of the USD and into the euro driving both to extremes. The Dollar became manic over sold in a very short time and now we are on the retrace. The 84-85 zone looks like a no-brainer short if it gets that

high. The reaction could top out sooner however as the price gets closer to the now rapidly declining EMA 20. In the extreme, I expect the SMA 50 to act as strong resistance.

Of course, given the global casino's 'Uncle Buck against the world' orientation, I would expect my lone bullish stance, the gold stocks, to finish up their correction at whatever time the Dollar decides to top out. Again, the same forces that drove USD higher drove the gold miner fundamentals higher as well. This is another looking glass into the idea that the global casino remains active; they are still going by cartoon analysis that says a strong Dollar has to be bad for *all* aspects of the 'resource' trade. This despite the hard evidence for all to see in our gold-oil, gold-GYX, gold-silver and gold-IRX charts. Importantly, we can now add gold-TNX (10 year rates) and gold-TYX (30 year rates) to the gold-human hopes for prosperity ratios.

Well, with all this talk of gold stocks, why don't we just transition to this sector next...

Gold Stocks



The HUI is acting so normally it makes me wonder. The 250 area presents what should be strong support. The recent break above channel was nice because it fueled the MACD above the important zero level but the index became a bit too excited as the Dollar tanked and the histogram on the MACD flashed a slight bearish divergence.

I had noted that 300 could provide some resistance and so it has. Although the index is in a posture of trying to hold the break above the channel, I am going by the idea that a magnet known as 250 will try to pull it south. There is lower potential back to the SMA 50 but that is getting ahead of our selves. The HUI is bullish and 250 is solid until such time that it fails. The next bullish target remains the 350 area or around the SMA 200. There will always be hard corrections in this sector, but the big picture continues to look good by my data points.

Stock Market



The S&P 500 maintains the bottoming stance we have been following but the bulls are sure not getting an easy ride up off the would-be bottom. The mini inverted H&S

remains in play until such time as the neckline (blue line), which just happens to reside in a support zone, is violated. The 'wedgie' look of the rise is a minor concern, but the market leaders, the gold stocks, looked wedgie earlier in their rise as well.

If support in the 850 area is lost this market swings from guardedly hopeful to high risk.

Wrap Up

Commodities, correlated positively to the economy as they are, remain very weak although many sport bullish divergence in momentum from price. Oil, NatGas and industrial metals have been destroyed and unlike the counter-cyclical gold stocks, have yet to firmly establish a bottom in most cases. This syncs up well with the struggles of the broad stock market, which is of course also positively correlated.

LIBOR1 and **LIBOR3** have utterly tanked to .47 and 1.50 respectively. **TED** has declined to 1.51. Insofar as these indicators reliably forecast the 'velocity of money' that so many obsess over, they are saying that money is gaining velocity into the system. So too will inflation *effects* one day.

Go to the St. Louis Fed website <http://research.stlouisfed.org/publications/usfd/> and you will see that the graphs for **MZM** and **M2** are now joining **Monetary Base** in 'hockey stick' territory. We are inflating folks, and it is being done with the big guns. Failure is not an option.

Portfolio Notes *(Portfolio notes edited for NFTRH sample editions)*

I continue to do what comes naturally for me; tweaking, risk managing and doing some trading. The capital preservation portfolio is back to 'baseline' and currently holds 73% cash and t-bill / short term treasury equivalents (with initial XXX hedge). Core gold stocks are XX, XXX, XXX, XXX, XXX, XXX and XXX. I would like to add back XXX on a decline to the mid 5's. XXX, my favorite silver stock is also held.

The speculation portfolio took profits on XXXX once again as well as the NOBS feature from NFTRH11, Dynasty Minerals. 80-90% in a week will almost always trigger the trader in me, regardless of fundamentals. Featured gold stocks in this portfolio are XX, XXX, XXX, XXX, XXX, XXX along with silver stocks XXX and XXX. Again, I look to add XXX back to this portfolio in the mid 5's and XXX at around 15. Portfolio cash level is 34%.

As a side note, some readers may have noticed strange activity in some smaller gold stocks at yesterday's close. XXX and XXX (I added to this one) come to mind. This was evidently due to some index funds liquidating upon the close due to S&P/TSX rebalancing <http://www.newswire.ca/en/releases/archive/December2008/12/c9488.html>. I would expect the effects of this to even out on Monday.