

Are The Levees Starting to Break?

Doug Wakefield with Ben Hill

“I have often stopped to ponder our human condition – specifically, our uncanny ability to dismiss the seriousness of an event beforehand and to lament our lack of preparation after it has happened. How many New Orleans residents stated, in some form or fashion, that they never expected the storm to break the levees? But, it’s easy to see the rationale behind their unresponsiveness. They had been through countless storms since the levees were first established and nothing that dire had ever happened.”

– September 2006, *The Investor’s Mind: Too Costly to Bear*

By late 2003, I knew that we were living in a historic time. With this in mind, I began to write to warn investors about the enormous risks in the financial markets and to record my observations, so that future generations could more fully comprehend this mania as they look back on this period. Since that time, and the release in January 2006 of our research paper on short selling, *Riders on the Storm: Short Selling in Contrary Winds*, I have certainly had plenty of material to write about. However, up until July 2007, it appeared as though understanding numbers, people, and events, outside of the day-to-day noise of upward moving price trends, was a complete waste of time. The markets were climbing, and thus my comments appeared to have little value.

Even today, many investment and trading publications continue to talk as though real world events – like Wall Street banks receiving billions from sovereign wealth funds to cover similar losses of investments backed by thousands of mortgages and credit cards – tell us nothing about the next major trend in worldwide capital markets. Yet, as we ponder what has transpired over the last several years, ask yourself, “Are most of the things unfolding today really that unpredictable? Could we really not see that unlimited amounts of debt and dollars would eventually create enough stress to have *real world* consequences?” Now, some reading this article might be thinking, “Hey, we’re about out of the woods,” and you certainly have a right to your opinion, but do you really believe we can fix our current dilemma by papering over all of our problems with *more* short-term debt?

Prices Move Fast

The difference between most retail investors and advisors versus professional traders is that since traders realize they can destroy or make their careers in short periods of time, many of them respect, and watch for, rare events. In our November 2007 article, *A Gallery of Crowd Behavior*, we noted the price levels of various assets that had hit multi-year extremes in either bullish or bearish sentiment. Since that article, the following price changes have taken place:

Symbol	Index	11/02/07	01/15/08	% Gain/Loss
\$NDX	Nasdaq 100 Index	2213.86	1894.09	-14.44%
\$BKX	Philadelphia Bank Index	96.54	80.71	-16.40%
\$XBD	AmEx Broker/Dealer Index	219.95	187.23	-14.88%
\$HSI	Hong Kong Hang Seng	30468	25837.00	-15.20%
\$GOLD	Gold - Continuous	808.5	903.40	11.74%
\$USD	US Dollar Index	76.26	75.61	-0.85%
MER	Merrill Lynch	57.28	53.60	-6.42%
CFC	Countrywide Financial	13.46	5.87	-56.39%
C	Citigroup	37.73	26.93	-28.62%

While my forecast – based primarily on the speed of ascending and descending trends, Elliott Wave patterns, and crowd sentiment extremes revealed in bullish and bearish sentiment – was largely accurate, I was wrong on gold.

If you've read some of my articles over the last few years, you may've already been convinced that prices could move lower. So, the next question is, "Did your investment strategies and managers profit from these changes, or have your losses been mounting since the credit contraction began last summer?" If you *are* losing money, then you need to reread the opening statement to this article and prepare now.

Fear and Greed are Measurable in Markets

Some professional traders use bullish and bearish sentiment numbers, which are based on the number of long versus short contracts in particular investment markets, and volatility measures to assess the markets.

For example, when I made my gold forecast in November, gold and silver showed daily sentiment readings of 94 and 96, respectively. With so many people on the long side of this trade, it seemed a foolhardy entry point. And, with current daily sentiment readings on gold and silver at 94, I continue to stand aside.

In February of 2007, I spoke with Mike Arnold, of [Pairnomics](#). With his experience as a floor trader on the Chicago Exchange – a job only a few individuals in the world of money have ever held – I thought his opinion would be beneficial to our subscribers. One of the first things Mike spoke about was that the volatility index, or the VIX, had hit a 17 year low.



In June of 2006, when the equity and commodity markets were hit, the VIX surged, at point A, and then began to decline as these markets started their ascent again. At point B, we see that the VIX hit its 17 year low in December of 2006.

Then, in May of 2007, the banking index started moving down, and the VIX rose. Even with the Fed's rate cuts from August through December of 2007, at point C, the VIX has not returned to its May to July level. With the hammering that equity markets have taken around the globe since 2008 opened, it seems many investors' attitudes have changed from complacency and greed to fear, which is what the VIX was designed to measure.

Retail Investors or Sovereign Wealth Funds

Whether we're advisors with hundreds of millions under management or investors with a few million in our portfolios, when it comes to overall size in the financial markets or [Sovereign Wealth Funds](#) (SWFs), we are specks.

Wikipedia defines a SWF as "a fund owned by a state composed of financial assets such as stocks, bonds, property or other financial instruments. Most of the savings of SWFs originate in accumulated foreign currency reserves." Wikipedia also notes that SWFs have, "become increasingly popular as the spending power of global officialdom rockets upwards." So basically, on their way to competitive currency devaluations, some countries decided to buy other assets with their huge and growing supplies of fiat.

Month - 2007	Direction	Amount - Billions
July	Inflow	10.7
August	Outflow	12
September	Inflow	7.5

October	Inflow	11.2
November	Outflow	10.8
5 months	Net	6.6

And, the last few months have shown that the American retail investor, as reflected by the numbers above from the [Investment Company Institute](#), reveal that the sum total of all investors into or out of stock mutual funds are no match for Sovereign Wealth Funds. Compare the numbers above with those below, and you see why little investors are losing any amount of influence they once had.

Company	Sovereign Wealth Fund	Amount - Billions	Date
Morgan Stanley	China Investment Corp	5	December 19, 2007
Merrill Lynch	Kuwait Inv. Auth., Mizuho Corp. Bk., Korean Inv. Corp., Govt. of Singapore Inv. Corp. (Temasek), Davis Selected Adv. (US)	12.8	December 24, 2007 & January 15, 2008
Citicorp	Govt. of Singapore Inv. Corp (Temasek), Kuwaiti Inv. Auth, Prince Alweed bin Talal (Saudi Arabia), Sandy Weill (former CEO of Citicorp)	20	November 27, 2007 & January 15, 2008

As you can see, the total net inflow from all investors into US stock mutual funds from July through November 2007 was only \$6.6 billion, while in less than 2 months a handful of big investors placed a total of \$37.8 billion in three global, financial powerhouses. To help us grapple with these numbers, we note that from 2000 to 2007, February of 2000 saw the highest net inflows, at \$53 billion, and July 2002 saw the highest net outflows, at \$52 billion. And I think we all still remember what was happening in early 2000 versus the summer of 2002.

Think, Act, Think Some More

Most investors think they are paying for advice about the future, but select investments based mostly on past returns. And, most managers and advisors get caught up in pleasing their investors.

As market volatility picks up, the world's capital market begin to look less like investing and more like a casino. If you want to survive the markets ahead, I strongly encourage you to seek those sources that have a keen grasp of history, math, and crowd and individual psychology. Then, make sure that they have experience trading the short side of markets and can give you very well thought out plans about how they are going to deal with the *real* world that is unfolding *in front* of us.

In closing, we include the following statement, made in the [UK Telegraph](#) just days before the opening of 2008, regarding the shrinking number of new issues being placed in the low and high grade corporate bond markets in Europe.

“Glance at the more or less healthy stock markets in New York, London, and Frankfurt, and you might never know that this debate is raging. Hopes that Middle Eastern and Asian wealth funds will plug every hole lifts spirits.

Glance at the debt markets and you hear a different tale. Not a single junk bond has been issued in Europe since August. Every attempt failed.

Europe's corporate bond issuance fell 66pc in the third quarter to \$396bn (BIS data). Emerging market bonds plummeted 75pc.

‘The kind of upheaval observed in the international money markets over the past few months has never been witnessed in history,’ says Thomas Jordan, a Swiss central bank governor.”

2008 is likely to be a historic year. We best get out our thinking hats and ask those we are depending on for our long-term financial success a lot of questions. Since July 2007, the market environment has changed. As the credit contraction intensifies and market prices continue to adjust to the downside, investors and advisors will have to move from an investing to a trading mentality. Since most investors and advisors have little to no experience with that mindset, they should seek the most liquid place to avoid the destruction of their investment portfolios and find trading professionals who have years of experience through various market cycles.

If you're interested in what various experts, from a variety of disciplines, have to say about finance, you should consider becoming a part of The Investor's Mind and benefiting from the research and views of some of the most experienced individuals in the world of money. To get a feel for the educational material we've presented to our readers since January of 2006, [click here](#). We continue to gain recognition for our 154-page industry paper on short selling, [Riders on the Storm: Short Selling in Contrary Winds](#), which can be obtained with a [subscription](#) to The Investor's Mind. To learn more about our mission, as well as our educational and advisory services, visit our [website](#).

Doug Wakefield,
President
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