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DAILY REPORT **(03/11/09)** ***More Government!***

Everybody is calling for more supervision so we don't repeat past mistakes. That translates into more government bureaucracy and it's the same mantra we heard in 1907 and again in 1930, and it's the mantra that brought about the existence of the Federal Reserve. The Federal Reserve was supposed to eliminate the extreme peaks and valleys that occurred every so many years. They would do that by injecting liquidity during difficult times and retiring liquidity during the good times. Over the last twenty years they were great at the former and complete failures at the latter. It should be mentioned that these liquidity injections ended up being debt injections, since the Fed has no real assets, and that also led to the problems we face today. In response to the current financial disaster we have established committees and ordered studies which are both a big business in their own right. In the end bureaucracy is all about money; getting money out of your hands and into the hands of the politicians. What's good for you is tertiary at best.

I maintain that in order to solve today's problems you must go in the other direction, i.e., less government. A lot less government! I believe

you could cut government in half, and that includes the armed forces, and you won't miss a beat. Start with the IRS, which employees close to two million people. Introduce a flat rate consumption tax of 12% and you could eliminate 9/10^{th's} of all the employees. If you want to consume, you automatically pay the tax. If you don't want to pay the tax, you simply do not consume. Aside from the savings, you eliminate a government agency that has become judge, jury, and executioner, something that was never intended by the Constitution. Mention the IRS and you often invoke the same fears that the word Gestapo produced seventy years ago. I have read enough of Jefferson, Franklin, and Paine to know that was not the intention of our founding fathers.

Then we have this idea of "too big to fail". Empires have fallen so why can't US companies and banks fail? Then there is this vagueness with respect to who lives and who dies. Everybody is willing to let GM and Ford go into Chapter 11, but why not AIG and Citigroup? I think the answer is twofold: first, it is upper class versus blue collar and blue collar does not have the might, and secondly, no one in power wants a close examination of what went on in Citigroup or AIG. Bankruptcy would require such an examination. Secrecy is a requirement and that's why Bernanke refuses to say how taxpayer money is being spent. I guess it goes without saying that I would eliminate the Federal Reserve and put the US on a gold standard as a second step, and I would allow the AIG's of the world to fold up their tent and go home. Other efficient banks would come along and replace them as they have throughout history.

Finally, I would eliminate lobbies and limit campaign contributions to some modest amount like US \$1,000 per family. There is no way that electing a president should be a "billion dollar business". They treat the whole process like the NFL playoffs and the countdown to the Superbowl, but it's not about trophies and money. It's about trying to find the right man for the job. For decades the US has elected everything but the right man. And assuming you can find him, and he gets elected, he must be required to balance the budget. Better yet a surplus must be accumulated for those rainy days that always come around. If you get one dollar in, you spend ninety cents and stick a dime under the mattress. All of this may sound foreign to you, but it is basically how the

United States was run from 1830 to 1913, and it was that philosophy that allowed it to become a world power as well as the world's largest creditor nation.

Now it's time to get down off of my soap box and talk about the markets. Due to the constant meddling in financial markets by both the Fed and Department of Treasury, we have accumulated distortions that bring along unintended consequences. A good analogy is to pull a loose thread in a sweater and the whole thing unravels almost by its own accord. That's where we are today; a cold winter's day outside and all we have is a pile of thread. One of our threads leads us right to the bond



Market. We know that the Federal Reserve has lowered interest rates close to zero in an effort to prop up the economy, and yet the bonds topped out more than three months ago and have been on the decline. That means the bond market is driving rates up and there could be two reasons for that:

- Investors see increased risk in holding US debt and therefore demand a higher rate to compensate for that risk, or
- Foreigners see an avalanche of new debt coming and are unloading the paper in their portfolios.

Some people think the higher rates are in anticipation of a coming increase in inflation but I disagree. For one thing, gold would not be trading down US \$100 from its recent high if that were the case. There is no doubt in my mind that we've been deflating, and higher rates only serve to make a difficult situation impossible.

	SUPPORT	RESISTANCE
30-YEAR BOND	124.27	125.15
	123.24	126.13
	121.30	127.06

Finally, we have the stock market which is staging a nice rally as I type on news that Citibank is making money. That statement was vague and didn't say how, but we are supposed to believe they are making money. They can't price their assets due to illiquid markets, but they are making money. They'll need more money from the government in a month or two, but they are making money. Do I sound cynical? The Dow is up 300 points at 6,847 as of 1:08 pm ET and I might want to remind you that we've seen these rallies before and they usually fizzle out in a day or two. Until someone gives me proof to the contrary, this time will be no different. Without a doubt the stock market is oversold, but that does

	SUPPORT	RESISTANCE
<i>DOW</i>	6,715	6,913
	6,654	7,151
	6,623	7,288

not mean that we can sustain a rally. This market has been oversold and continues to decline indicating that we will not see a bottom, and a substantial rally, until there is an exhaustion. To date that has not occurred. The fabrication of “good news” will not sustain a rally either.

Finally, I would like to close with a word or two on gold. Earlier today the April gold fell as low as 892.50 intraday and is currently trading at 898.00. As I have mentioned before, the April gold has strong support at 886.50 and should hold due to the fact that the rally from the October 2008 low to the recent 1,007.70 high was quite strong. A strong



rally is often accompanied by weak reactions; a weak reaction being a 25% or 38.1% retracement and the latter takes us to 886.50 highlighted by the red/green horizontal line on the chart. That support level also corresponds nicely to the bottom band (red line) of the up sloping trend line.

	SUPPORT	RESISTANCE
<i>GOLD</i>	886.50	912.40
	869.90	930.20
	848.70	949.80

In the interest of fairness I have talked at length about what I think will be gold's strong move to the upside, and now I would like to talk about what happens if I am wrong. If gold breaks more than marginally below the 886.50 support level that indicates we'll test the 50% support at 848.70, but more than that it indicates that deflationary pressures are on the rise. In my opinion that would be a very bad omen with respect to the coming weeks and months. We tend to forget that deflation feeds on itself until the whole thing implodes. I've gone through that in Latin countries and it invariably ends up in the same. A faltering gold price would mean that we are closer to an implosion than I thought, the 5,890 support in the Dow probably will not hold, and the rally I am looking for in stocks will not materialize. Couple that with a stronger dollar, rising interest rates, and a comatose banking system, and you can imagine the end result. Watch gold closely because it is at a critical stage.

Dow Theory Analysis SAC
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