



Lambs to the Slaughter

Innocent Investors Could Lose a Bundle

What To Do As These 7 Inflection Points Turn the Markets Upside Down

by Jack H. Barnes Jr., *Money Morning*

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An Inflection Point is when a major market trend reverses course completely.

Alarmingly, seven Inflection Points are about to hit the markets. Many of these will put innocent investors at risk.

The purpose of this report is to show you exactly what's coming... so you can protect your savings...

And make no mistake: Understanding how to play these trends can bring you tremendous returns.

For instance, in 2007 an Inflection Point hit just as the mortgage bubble caused the worse financial crisis since the Great Depression. Many "unaware" investors following the "herd" paid dearly. Yet a few saw the writing on the wall... reversed course... and made millions. Some, like hedge fund manager John Paulson, made billions – \$6 billion in one year, to be exact.

Another Inflection Point occurred in 2009. U.S. stocks had been in a near vertical decline. In the early part of that month, however, each of the three major U.S. stock indexes essentially "bounced" off their bear-market lows and launched into a bull market of historic proportions.

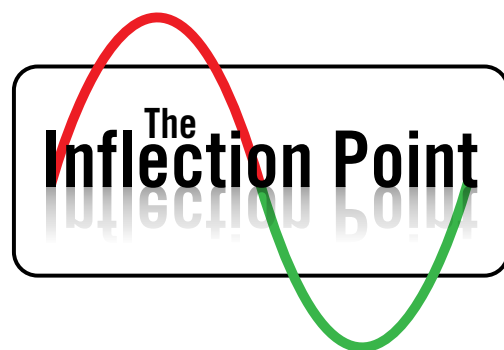
While the majority of investors were "out to pasture" piling their money in the safe bond market, those who saw the Inflection Point made a fortune.

That rebound was a textbook example of an Inflection Point. And the market has been on "autopilot" in an upward mode ever since.

But now it's the summer of 2011. And the bull market that's now fully two years old has surged nearly 100% off the bottom and is ripe for a major pullback. And there are several reasons why.

The U.S. stock market is definitely a market to watch. But it's only one of seven potential catalysts that are going to turn the world financial markets upside down – turning bullish sectors bearish and vice versa.

In the pages to follow, you'll find in-depth details on how these seven forces will lead to the market's imminent reversals. And you'll get actionable advice on exactly how to profit – and protect yourself from the worst kind of financial pain imaginable.



Those seven Inflection Point catalysts consist of:

- **Inflection Point No. 1: U.S. Stocks are Susceptible.**
- **Inflection Point No. 2: The U.S. Dollar is Ripe for a Rebound.**
- **Inflection Point No. 3: Adios to the Fed's Heavy Hand.**
- **Inflection Point No. 4: The Looming Bond Reversal.**
- **Inflection Point No. 5: The Coming Collapse of the Euro.**
- **Inflection Point No. 6: The Bill Gross Factor.**
- **Inflection Point No. 7: Why Japan Could Trip up the Global Economy.**

Inflection Point No. 1: U.S. Stocks are Susceptible

I see three potential catalysts for a stock-market reversal here. We could see sales fueled by:

- Profit-taking.
- Tax-planning.
- A deviation from recent trends or patterns.

Let's take a look at each of the three.

In terms of *profit-taking*, let's be honest: a lot of long-term capital gains have built up in the last two years. Any perception of a change in trend is going to start a harvest of those gains, which will strengthen the new (pullback) trend.

The market is also ripe for some early *tax-planning selling*. This includes both extremely profitable and extremely unprofitable blocks of stocks on the books at major shops. I expect some "algos" (algorithmic traders) are moving shares these days to balance tax considerations on profitable holdings.

This market has felt like a willing seller of size for some time now. This has been counterbalanced by "Buy" programs that push the market up on very little volume. The seller strikes anytime he feels there is a willing buyer. This market has been rising on light volume and dropping on large volume.

This is typically not a safe environment.

And I think that it's made us vulnerable to a *deviation from current trends or patterns*.

Indeed, this market has become so conditioned for one response – the proverbial "buy the dip" – that when it doesn't work (pay off) at some point in the future, the pain felt by the "buy-the-dip" (BTD) investors will be profound.

The market is a fickle beast and it climbs a "wall of worry" during a bull market. It also rolls over when the

THE BARNES FILE:

Name: Jack Barnes.

Title: Contributing Writer and weekly "Buy, Sell or Hold" feature columnist, **Money Morning**.

Overview: Barnes started his career at Franklin Templeton in 1997. He started out in the company's fund-information department - just as the Asian contagion infected the Asian tiger countries. Barnes launched his own shop, RIA, in 2003, just as the second Gulf War was breaking out. In 2006 he logged a one-year return of nearly 83%. His two audited hedge funds generated double-digit returns in 2008.

Barnes retired to the beach in the summer of 2009, and continues to write from there. He's now the author of the popular blog, "**Confessions of a Macro Contrarian**."

Accolades: In early 2006, after logging a one-year return of nearly 83%, **Forbes** named Barnes the top stock picker in its "Armchair Investors Who Beat the Pros" competition.

Source: Money Morning staff research

market participants tend to be the most bullish. In this case, the BTD investors have become conditioned to use these moments to load up on margin.

If you are a market maven – or a student of the cycles – you already know that major Inflection Points happen when they will hurt the largest number of market participants. The mass moves as a crowd, stampeding in an uncontrolled manner.

The commodity markets have been in a parabolic upward curve. This move has been driven by fundamentals in most cases, but with Washington providing the grease in the form of extreme amounts of liquidity.

So what is coming is nothing less than a commodity bull's worst nightmare.

The market is leaning completely one way, meaning that a wrenching reversal – much like the Great Commodities Pullback of 2008 – is overdue. We've already seen some of the early action, especially in silver. Oil, too, has stumbled a bit after a significant run-up, and more bloodletting is imminent.

U.S. Stocks and Your Investment Portfolio

Now is the time to remember the old adage: "Sell in May and go away." While the U.S. dollar looks ripe for a bounce, the U.S. stock markets look ready for a long, hot summer of volatility, frustration ... and pain.

You may want to dust off your old "inverse ETFs" that play the major U.S. stock-market indices in order to play the short-term trading opportunities.

While those leveraged ETFs are a lot of fun from a trading perspective, remember this: They are not investment vehicles – and, as such, should not be held for more than hours or days at a time. They are trading vehicles only. Never, ever write "naked options" on these investments. The margin requirements if you're wrong are not worth the perceived gains in additional leverage.

As the equity markets experience a long overdue pullback of 10%– or even more – remember this is predicated on a U.S. Federal Reserve decision not to launch a third round of "quantitative easing," which investors refer to as "QE3." If and/or when we see QE3, then we will "reverse" our market call again.

You see, if there is a QE3, the United States will be pumping funds into a world crisis. The equity markets will most likely experience a bounce up. However, if there is no QE3, you can expect the U.S. markets to experience a "headwind" as Japan becomes the carry-trade provider to world markets addicted to cheap funds and leverage.

UNDER ANY MARKET CONDITION, THIS STOCK IS A BREAKTHROUGH

As the Inflection Points hit, the market will get more difficult.

Your best bet? Find a small company on the verge of a major breakout... one that's launching a product with the potential to dominate a market.

The editors of *Money Morning*, have been following one tiny "smart drug" company for two years now...one that has enormous potential for investors. Just this week the *Journal of Clinical Oncology* updated the drug's FDA's trial results ... and they were spectacular. Of the 21 patients who received the new drug...16 saw their cancer completely wiped out. Shares of this company trade at under \$7 today, yet as it goes to its final trial, estimates show the price could run up to over \$100. Take a look. A full report on this opportunity is [right here](#).

Inflection Point No. 2: The U.S. Dollar is Ripe for a Rebound

For most of the past year, anything involving the U.S. dollar has been what traders like to refer to as a "one-way trade."

And with good reason: For much of the past year, the U.S. currency has traded in only one direction – down.

Indeed, during the period in question the dollar was down 8.3% against the British pound, 11.65% against

European euro and 14.2% against the Japanese yen. During that stretch – a year-over-year basis, the biggest gains against the dollar were notched by the Australian dollar (20%) and the Swiss franc (26.7%).

This freefall by the greenback is part of the reason gold and silver soared to new records and commodity prices have zoomed during the past year (before their recent decline).

But here’s the thing: This nosedive by the dollar is ending – with a U-turn that’s going to send the U.S. currency into a zooming climb.

Traders refer to this abrupt reversal-of-fortune pattern as an Inflection Point.

And those traders recognize this about-face in the U.S. dollar for exactly what it is: A windfall profit opportunity for investors who understand just how to play it.

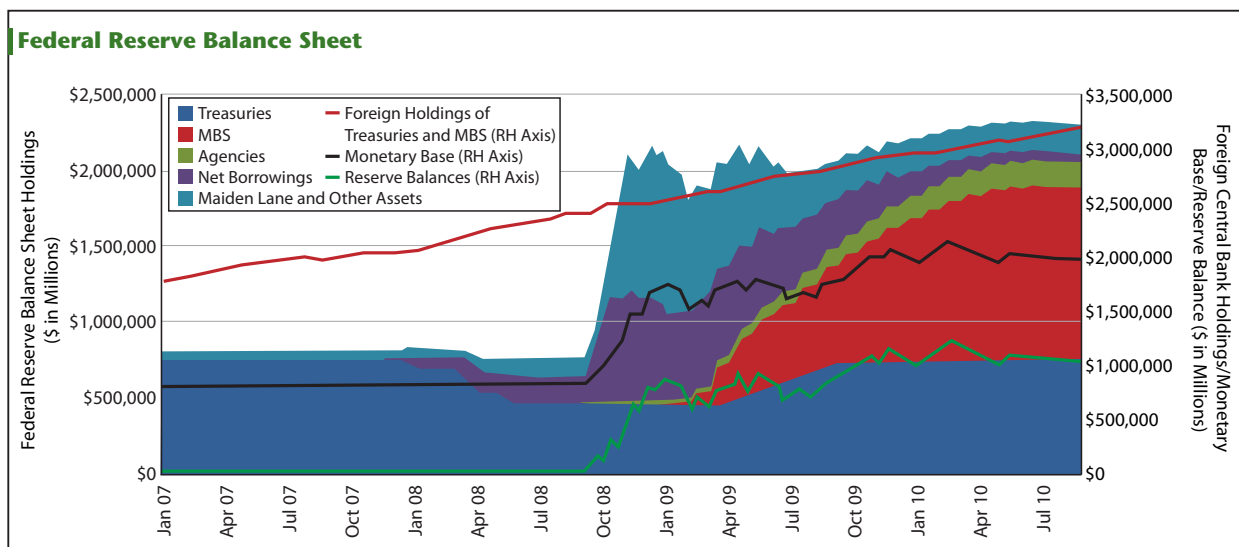
Anatomy of an Inflection Point

Since June, when it achieved its most recent peak, the U.S. dollar – as measured by the benchmark U.S. Dollar Index (DXY) – plunged more than 14%.

More recently, the greenback has rallied a bit. But there are much bigger gains to come – the kind of gains associated with a true financial-asset Inflection Point.

To understand the about-face we’re about to experience, it’s important to understand there were essentially five factors that tipped the greenback over into its nose-dive. Those factors included:

- **A Debt-Intent Central Bank:** A big part of the demise in the near-term value of the U.S. dollar was the continuation of a U.S. Federal Reserve monetary policy that caused the central bank’s balance sheet to balloon from \$850 billion in 2007 to a new all-time high of \$2.669 trillion in April of this year. Indeed, the Fed’s balance sheet grew by \$340 billion during the last year alone (see chart below).



- **A Debt-Addicted Federal Government:** Global interest in the dollar was further diminished by a U.S. federal debt load that soared from \$8.9 trillion on Aug.1, 2007 (when the first signs of distress *really* hit the financial markets) to \$14.298 trillion just 3.7 years later.
- **A New Market Rival:** Thanks to some market machinations by China’s government –which has caused that country’s yuan (renminbi) currency to rise slowly against the U.S. dollar while dropping against China’s other trading partners – the U.S. currency has grown progressively weaker. This has been driven by Chinese interventions in the so-called “FX” (foreign-exchange) markets on an almost-

daily basis.

- **A Global Leadership Vacuum From Washington:** It's a sad-but-true fact that the United States no longer commands the respect it once did on the world stage. And much of that is the fault of Washington, which has lost touch with what's important both here at home and abroad. This lack of respect has helped diminish the "reserve status" of the U.S. dollar, leading to a bit of a run on the American currency.
- **The 'Mortgage-Backed Securities' on the Fed's Balance Sheet Fueled the Real Dollar Collapse:** That real dollar collapse arrived as the implications of the Fed's monetization of MBS holdings hit home. In simple terms, people around the world have felt that America's central bank was debasing its own currency with the purchases of mortgage-backed securities (MBS) from U.S. banks that had been left holding the bag for some horrid trades. The Fed handed those bankers freshly minted U.S. Treasury bonds.

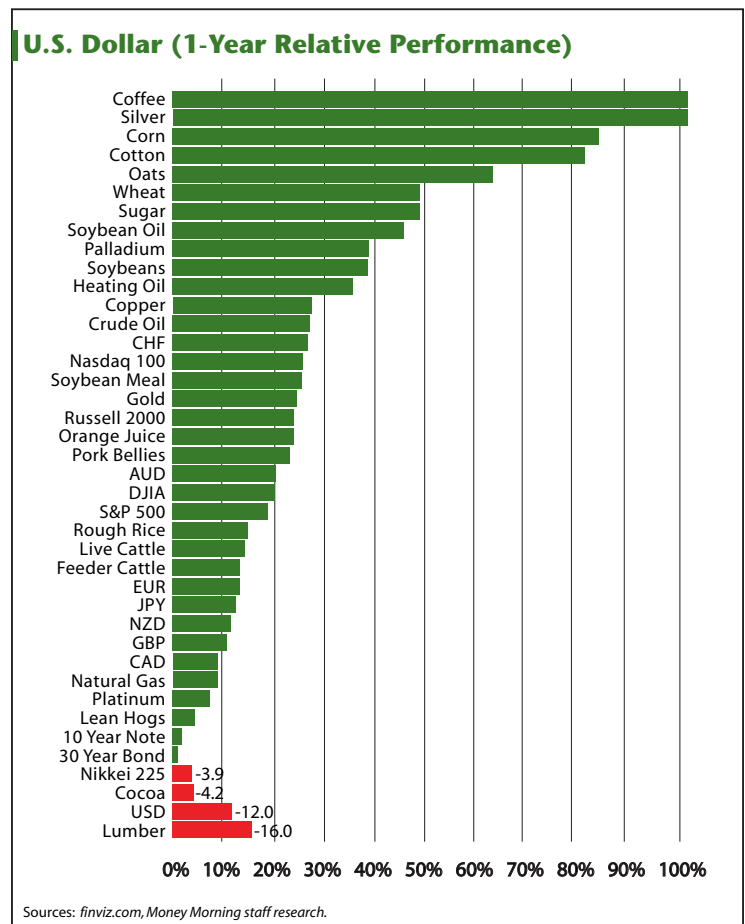
With each of these preceding five factors at work, it's little wonder that the United States was essentially debasing its own currency – leaving the leaders of other countries to watch as they scratched their heads in rueful disbelief.

In reality, Wall Street has been able to talk Washington into just about anything it needed – even though most of these schemes robbed Main Street consumers of their middle-class buying power. The obvious debasement of the American currency reached the point internationally that investors wanted to own anything *but* the U.S. dollar.

The accompanying graphic illustrates how investors have abandoned the dollar as they fled into other asset classes over the past year.

You only have to look at the results for a few seconds to see that the reserve status of the U.S. dollar was being abrogated. It didn't hit the lows it reached during the depths of the global financial crisis but it got darned close.

Now, however, the Inflection Point is upon us.



Time For a Trend Reversal?

The reality of a "one-way" trade opportunity – which underscores the sharpness of an Inflection Point – is that they persist until they don't. I think of this as the "inflection moment," the point at which investors realize that they've ridden the trade as far as they can, meaning it's time to cash out and book their profits.

This is usually represented by a giant shift in investor sentiment. In the case of the U.S. dollar, it was the monetization of our national debt – to fund the deficit spending of the last two administrations – that destroyed the trust in the U.S. dollar. This single action, once boiled down, has carved off the U.S. dollar's buying power.

But now – with the dollar at a potential Inflection Point – should the Fed shift away from its currency-debasing policy, this could well prove to be the market bottom. That means the greenback will build on the early rebound move we've already seen. Markets bottom when selling pressure abates.

At some point, the net selling pressure will abate as sellers run out of ammo, and the market switches to net buying pressure. It doesn't matter if it is FX, commodities, stocks or bonds. At the margin, trading is where real price discovery happens.

You can see the different signs showing up in different places, if you know where to look.

Five Inflection-Point Signals for the Dollar

During my time as a hedge-fund manager, I discovered five indicators that, taken together, provide a pretty reliable signal that a dollar reversal – an Inflection Point – is at hand.

When viewed individually, these indicators aren't that significant. But when they all shift at once, it's a pretty powerful hint that a new trend is afoot – and that windfall-profit opportunities are there for the taking.

To anticipate a reversal in the current decline of the dollar, you should:

- **Follow the U.S. Dollar Index (DXY)**: Despite its travails, the greenback remains the world's most-reliable reserve currency, which also makes it one of the very best indicators of raw market sentiment. If the index (as a proxy for the actual currency) establishes a bottom, you can bet change is afoot.
- **Watch Commodity Exchange Margin Requirements**: As volatility increases, something we normally see in advance of an Inflection Point, exchanges will rein in risk by increasing margin requirements. As we've seen with silver – a commodity that stumbled after margin increases in recent weeks – these shifts in the regulations can have quite an impact on speculation and on prices – dampening both.
- **Follow the (Big) Money**: Pacific Investment Management Co. LLC's Bill Gross is the largest bond-fund manager in the world. Gross' buying or selling can get a market moving in a new direction quite easily. So when he opted to dump all his U.S. Treasury bonds recently, investors took note.
- **Never Forget the Fed**: When the U.S. Federal Reserve needs to change its direction, it will send out a plethora of independent Federal Reserve presidents, or governors, to reshape market expectations.
- **Watch Dollar-Denominated Assets**: The capital markets can be boiled down into a couple of major asset classes, which will trade either with – or against – one another. The U.S. dollar is the single-best example of this. Commodities are priced in dollars.

So let's look at each of these five in a bit more detail:

- **The Dollar Index**: When the dollar *does* start to strengthen, it will unfold over a period of months, giving you plenty of time to make your move. Commodities will be directly affected: As the dollar increases in value, the cost to purchase them should start to shrink. If you are an investor with a long-term outlook, a lot of damage can be done to your portfolio while you wait for the next commodity-bull-market-move to return.
- **Commodity Margin Requirements**: The Chicago Mercantile Exchange (Nasdaq: CME) changed margin rates on silver futures 10 times in the last six months or so. In early November, the CME Group's Comex Division permitted a leverage level ratio of 28-to-1 on futures contracts already held. Most recently, after five margin increases in silver in the last two weeks, the CME is now offering leverage of about 8-to-1. In my field, this is called "leverage compression," and it was likely one of the primary reasons that silver topped the way that it did – "spiking" up, and then down.
- **Big Money Moves**: PIMCO's Gross is in a unique position. He manages the world's largest bond fund, which has morphed into the world's largest mutual fund. The so-called "King of Bonds," as he was known during the "Great Bond Rally of 1983-2010," is now out of U.S. Treasuries. This is

a “screaming Buy” alert to anyone who pays attention to the “big picture” in terms of top-down investing. In fact, at the end of April, the **PIMCO Total Return A Fund** (MUTF: PTTAX), was 4% short on U.S. Treasuries via swaps in that “world’s largest bond mutual fund,” according to *Reuters*. This extreme change in sentiment is a tacit illustration of his expectations for the direction of the U.S. Treasury yield curve over the near-term to medium-term time horizon. Historically, Gross has been great at calling Inflection Points in the market. The only way his trade will make sense is if the U.S. Federal Reserve makes a surprise quarter-point increase in the benchmark Federal Funds rate – which would set the stage for a long-term series of rate increases in the future. While a 25-basis-point-hike is insignificant in the big picture, it is a major change in sentiment and one that would have serious implications for the future structure of the U.S. bond market.

- **Never Forget the Fed:** When the central bank decides to change its stance, markets will move. While hawks on the policymaking Federal Open Market Committee (FOMC) have started to sound off about a stronger U.S. dollar, this group lacks the votes, which has kept the market from fearing their comments. If and/or when the sentiment within the FOMC changes to favor an increase in rates (or even a “bias” in that direction), then all market biases will change. If you want an example, the best to review is one from 1994 when the market endured a steady state of small, incremental increases. Stock prices were challenged, and bond values were hammered.
- **Watch Dollar-Denominated Assets:** If the dollar is in a downward-trading pattern, there is little reason to fear that your long commodity positions will be hurt. If the U.S. dollar changes direction, you can expect that the longer-term commodity-price trends will experience a change, too. That may not happen overnight. But “at the margin” all commodities are a “short” U.S. dollar trade, meaning they represent a bet against a rising dollar. In other words, if I am leveraged long gold, I am realistically making a leveraged short U.S. dollar trade.

The Dollar and Your Investment Portfolio

Now that we know what to look for, it’s time to talk about how to profit – at least in a general sense. But for you to understand what we’ll be talking about, you need an overview of the kinds of profit plays we’ll be looking for and talking about.

When the U.S. dollar bottoms, you can expect to see commodities pull back in price. You can expect to see margins expand in businesses that consume high levels of raw commodities. International shipping companies should see their profit margins improve.

Investors, companies and governments around the world use U.S. dollars as their “reverse” currency. When the dollar changes direction, it affects the economy of the whole world. In the near future, having reached this Inflection Point, the dollar will change its bias direction. And when it does so every investment or investment strategy that used to work in the global financial markets no longer will.

Now is the time to prepare your portfolio for the coming change in bias – the Inflection Point. You’ll be glad you did.

Inflection Point No. 3: Adios to the Fed’s Heavy Hand

In my opinion, the U.S. economy has been aggressively and actively managed by the heavy hand of the U.S. Federal Reserve since the summer of 2007. During this era, we have seen the benchmark Fed Funds rate get slashed from a starting point of 5.25% all the way down to a “range” of 0.00% to 0.25% – a historic low where it’s remained for more than a year.

We have seen the Federal Reserve purchase the Maiden Lane assets from The Bear Stearns Cos. For an encore, the

central bank returned and did much the same thing with **American International Group Inc.** (NYSE: AIG) – twice.

The Fed also started a series of special liquidity facilities, including one with that exact name. These facilities, like the Term Auction Facility, Primary Dealer Credit Facility, and the Term Securities Lending Facilities, to name a few, were intended to enhance liquidity in the overall financial system.

We have seen the Federal Reserve roll out Quantitative Easing 1.0 (the buying of mortgage-backed securities, or MBS), Quantitative Easing “Lite” (the MBS roll-off and replacement with U.S. Treasury bonds), and Quantitative Easing 2.0 (direct “permanent open market operations,” or POMO, to support U.S. Treasury prices as needed anywhere in the curve).

The result is that the Federal Reserve has generated credits on its own balance sheet which have been used to buy up U.S. assets at no “actual” cost to the central bank. As noted earlier in this report, the Fed’s balance sheet has more than doubled in size during this short time frame, while the central bank has injected liquidity into its member banks.

As I detailed in the preceding section, the U.S. dollar has experienced significant pain during this process, dropping against other fiat currencies, *and* against most commodities. Very recently, the market has been expecting some kind of comment on the continuation of Quantitative Easing, which insiders and pundits refer to as Q.E. 3.0 (the mainstream media simply calls it “QE3”).

U.S. Federal Reserve Chairman Ben S. Bernanke seemed to hint at QE3 during his historic press conference in late April. However, the much-ballyhooed QE3 has not yet been defined and, if the U.S. economy continues to grow, may not be needed at all.

If that’s the case, then it appears the end of this “liquidity cycle” could finally be arriving.

The Federal Reserve has a unique structure, with regional presidents. Since the Fed allows each of these regional presidents a chance on the podium, it gives us a chance to hear more than one voice on a topic when it concerns the state of the economy. This sometimes creates a bit of a “choral” effect.

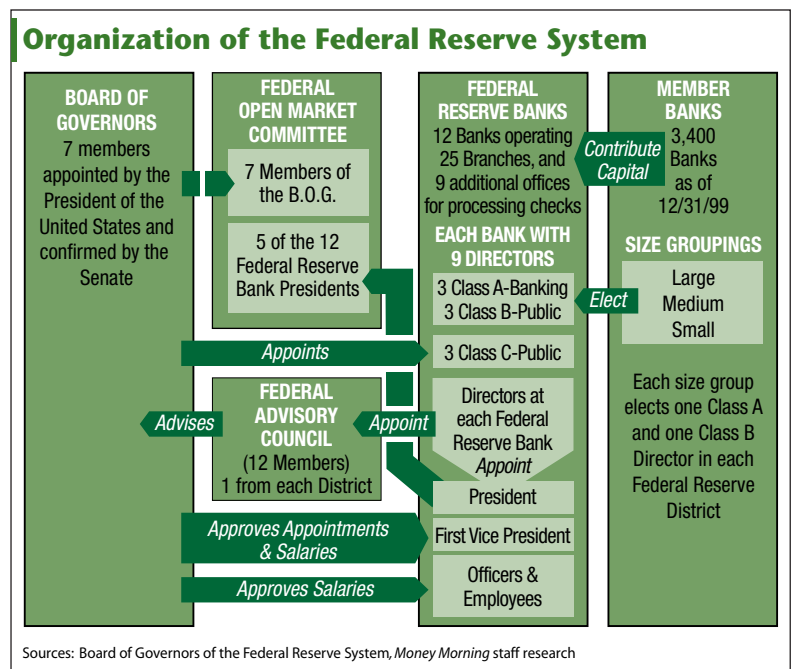


Ben S. Bernanke

Lately, the historically outnumbered hawks on the central bank’s board of governors have been waiting for a change in the rolls of voting members. That change has taken place, and with it a fresh concern over actions already taken has started to arise from voting members.

The first of these comments that caught my eye was from the Philadelphia Federal Bank President Charles I. Plosser, who said he wanted to see the Fed abandon its “dual mandate” (growth balance with controlled inflation) to embrace an inflation-only focus.

During an appearance at a Shadow Open Market Committee event in New York in late March, Plosser said headline inflation – not “core inflation,” which excludes volatile food and energy components – is really the only inflation that “matters.”



“What matters? Headline inflation,” Plosser said during a question-and-answer session that came after he gave a speech at the event. “That’s all that matters at the end of the day – what consumers pay.”

Were the entire Fed to adopt this viewpoint, make no mistake: There would be significant ramifications.

This is especially interesting to consider in the context of the future actions of this Fed once we reach the stage when we need to unwind the Quantitative Easing initiatives already in play.

The news flow on that late-March Friday was fascinating, with a burst of Federal Reserve presidents making public comments on the same topic. It was very obvious that this has been under discussion for some time and that a new round of “jawboning” was getting started. In a matter of hours, I counted no less than five comments from the Federal Reserve and its new club of hawks. The silence from the rest of the chorus was, shall we say, interesting!

“Following through on that to the tune of \$600 billion, like we’ve said, I think is appropriate,” Chicago Fed President Charles L. Evans told reporters at the regional bank’s headquarters. “I personally don’t see as many needs for a further amount, as I probably thought last fall.”

It appears the makeup of the votes within the Fed is changing. This could have serious implications in the coming months should the U.S. economy slow, meaning the lack of liquidity would be of significant concern once again.

Minneapolis Fed President Narayana Kocherlakota told reporters in Marseilles that the U.S. economy would need to worsen “materially” for the bank to consider further bond-buying.

Evans’ comments – in concert with those of Atlanta Fed President Dennis Lockhart, who on that same Friday said that “it’s a high bar” for the Fed to do more – suggest the debate at the Fed has moved away from a consideration of further easing.

The bottom line for us here is that it certainly appears that QE1, QE-lite and QE2 will be drawing to a close by the middle of this summer, if only for a few months, while those in power attempt to see whether the U.S. financial system is capable of standing on its own – without liquidity injections from the Fed.

“The economy is looking pretty good,” St. Louis Fed President James Bullard told reporters in Marseille, France, back on March 26, according to a Bloomberg News report. “It is still reasonable to review QE2 in the coming meetings, especially this April meeting, and see if we want to decide to finish the program or to stop a little bit short.”

I honestly expected the events in Japan would have “green-lighted” the start of QE3. But it now appears that the shift in the votes, along with massive stimulus expected to be generated in Japan, has slowed the need. It appears Japan will be providing the world with liquidity as it rebuilds its infrastructure.

When you consider that the International Monetary Fund (IMF) is going to need to help bail out the European banking and sovereign-debt markets again, it becomes even more plausible that the U.S. central bank is getting ready to firm up the value of the U.S. dollar.

The Fed and Your Investment Portfolio

If all this occurs, then – as we noted earlier – the dollar will no longer be a “one-way trade.” In fact, with all these Fed-related developments taken *in toto*, when it comes to the greenback, investors may soon be able to write the epitaph for the “Bernanke Put.”

I expect we could see interest rates increase in 2011, and potentially also the beginning of the end of the Fed’s heavy hand. In fact, you could argue it’s already long overdue.

If this occurs, the markets will act confused for a time, as major shifts in global-investing strategies take shape.

After all, the *last* thing anyone expects at this time is a *strong* U.S. dollar.

But if this does occur, commodities may have a headwind in the near term; commodities are largely priced in U.S. dollars around the world – and an attempt by the United States to raise the value of the greenback will create tough going for commodity bulls ... at least for a time.

Inflection Point No. 4: The Looming Bond Reversal

The U.S. Federal Reserve only officially sets one rate, which is the “discount rate” at which a bank in trouble can borrow from the U.S. central bank. As the Fed itself states:

“The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank’s lending facility--the discount window. The Federal Reserve Banks offer three discount window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate. All discount window loans are fully secured.”

The Federal Reserve also explicitly targets the rate for the benchmark Federal Funds that banks charge each other for overnight loans, for money on deposit at the U.S. central bank.

“ ... Changes in the federal funds rate triggers a chain of events that affect other short-term interest rates, foreign exchange rates, long-term interest rates, the amount of money and credit, and, ultimately, a range of economic variables, including employment, output, and prices of goods and services.”

What Your Father Never Told You About Fed Policymaking

These rates are set/targeted by the policymaking Federal Open Market Committee (FOMC), which meets about every six weeks. These two rates, both at the extreme short end of the lending curve, are the baseline for what money should cost in the domestic economy.

The FOMC is a blend of monetary-system stakeholders. This provides it with a pool of political appointees and a rotating roll of regional presidents.

“The Federal Open Market Committee (FOMC) consists of twelve members--the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis.”

The combined group of monetary leaders meets eight times a year and set policy. The policy is communicated to the world via a tightly massaged and scripted press release that the world’s money managers scavenge to see what individual words have changed. (In times past, money managers only had that press release – and the tendency to “overreach,” or to see what wasn’t there at all, was commonplace. Now, with Chairman Bernanke having held the first press conference on the day of a policymaking meeting in addition to the press release, those same money managers have [YouTube](#) videos of the chairman’s comments to watch over and over again to their hearts’ content – and then read too much into.)

There are press releases with zero changes in them, or rather none that are noticeable. In others, rarely, there is an Inflection Point. These inflection-point press releases establish new central bank policies, which typically will be in place for a year or more.

A change in stance is a rare moment in the markets, and one that can make or break a money manager’s career. These are the important meetings, and the wording of the new press release can drive markets around the world.

The bond market is considered to be “slow money,” in that it does not tend to change direction as a trend

very often. The last time there was a major change in direction by the Fed was in the summer of 2007. That's when the central bank started a series of emergency cuts in the two afore-mentioned rates – ostensibly to help banks with funding issues to deal with the fallout of the subprime mortgage crisis and its market aftermath.

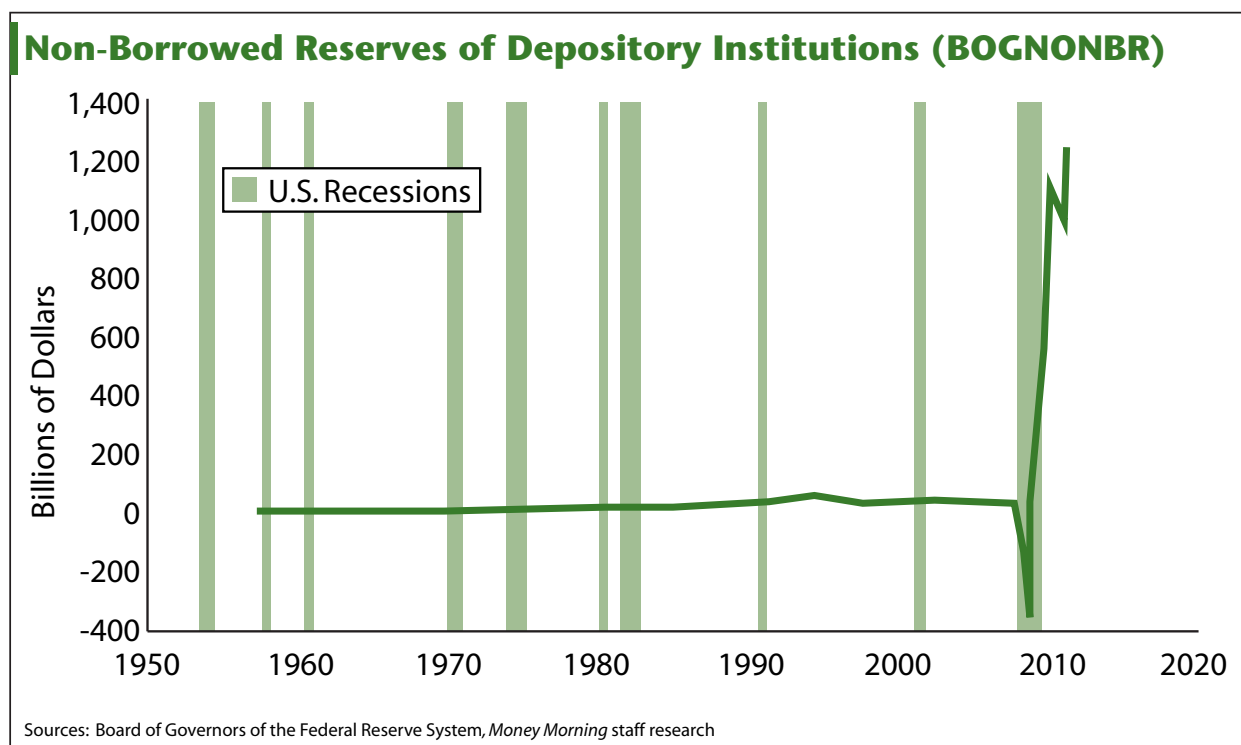
The Federal Reserve made the first Fed Funds rate cut in September 2007, and by December 2008 had slashed that benchmark from 5.25% all the way down to the afore-mentioned range of 0.00% to 0.25%.

The Fed Funds rate has remained at that level ever since.

The central bank started cutting the discount rate back in August 2007 and continued the decreases throughout 2008. A single increase in early 2010 left the primary discount rate at 0.75%, where it has remained ever since.

Together, this has helped Fed-member banks to raise cash cheaply to cover their funding issues.

But the banks have left these funds on deposit at the Federal Reserve. This has caused a scenario in which no one is loaning money to anyone. In monetary theory, we have a Fed that is pushing on a string, trying to get the economy to grow.



The graphic displayed just above is significant. According to the St. Louis Fed, “by definition, non-borrowed reserves are equal to total reserves minus borrowed reserves. Borrowed reserves are equal to the sum of credit extended through the Federal Reserve’s regular discount-window programs and credit extended through certain central bank liquidity facilities.

Total borrowings from the Federal Reserve are presented in table 1a of the release. Over much of 2008, in order to maintain a level of total reserves consistent with the Federal Open Market Committee’s objective for the Federal Funds rate, increases in borrowed reserves were offset through a nearly commensurate decrease in non-borrowed reserves, which was accomplished through a reduction in the Federal Reserve’s holdings of securities and other assets. The negative level of non-borrowed reserves was an arithmetic result of the fact that borrowings from the Federal Reserve liquidity facilities were larger than total reserves.”

Are the Bond Market’s Biggest Players Playing Musical Chairs?

Lately, very large players in the bond market have been selling into the QE2 primary-open-market-operation

events – thus lowering their bond exposure. Two of the largest are the most obvious.

During a recent four-month stretch, China was a net seller of U.S. Treasuries, according to the U.S. government's Treasury International Capital (TIC) reporting system. At roughly the same time came the news that PIMCO's Gross had achieved a net-short exposure to U.S. Treasuries.

This leads a market observer to wonder who will be buying U.S. Treasuries when neither the largest international holder, nor the world's largest mutual fund, is in the market. The answer is that PIMCO's Gross will, by law, have to start to reverse his position. This makes him a major future buyer of U.S. Treasuries.

But the obvious question is: Just when?

The Fed, which has grown its balance sheet to more than \$2.6 trillion from less than \$900 billion in 2008, has become the largest buyer and holder of U.S. Treasuries.

The Fed also held about \$1.3 trillion in mortgage-backed securities (MBS) purchased during the initial Quantitative Easing foray that the central bank is holding to maturity. These were purchased from large investors, such as the afore-mentioned **PIMCO Total Return A Fund** (MUTF: PTTAX), which made an obvious bet on the MBS buying before it was announced.

These MBS contracts, pretty much abandoned by Wall Street traders, were sold to the Fed. This transfer of ownership moved the future losses to the central bank balance sheet.

This means that as people refinance or sell a home, the odds are that a good chunk of the proceeds are sent to the Federal Reserve as partial payment for the originating MBS holdings.

This “run off,” as it is called, is pouring billions of dollars per month in fresh capital – in the form of cash – directly onto the Federal Reserve's balance sheet. The Fed, via its “QE-lite” program, is reinvesting this cash into U.S. Treasuries.

This program is ongoing and will not be affected by the ending of the QE2 program. So, while the market discusses the end of QE2 and the start of QE3 at some point in the future, QE-lite goes on. And that is generating the need for regular purchases of U.S. Treasuries from the open market.

Bonds and Your Investment Portfolio

While the Fed has made it clear that it wants to keep rates low for an extended period, it will not be the 800-pound gorilla in the U.S. Treasury bond market it has been during the QE2 period. This means that the long end of the U.S. Treasury market should start to move up in yield. This shift will be driven by a price drop in these very same bonds.

This is the trade that PIMCO's Bill Gross is playing. He is supposed to have purchased puts on the U.S. Treasury long end. If so, he is betting on an oversized increase in the long end of the U.S. Treasury yield. This is a very logical outcome to out-of-control spending because of the ever-increasing rollover needs of current debt.

The move at the long end of the bond market – even if it happens quickly – will be telegraphed by the actions taken at PIMCO. As the world's largest bond manager, this firm helped set the gold standard for bond exposure. When it starts to unwind its short position, the market will know it and telegraph the event. Bonds are referred to as the “smart money” for a very good reason: In the end, they have a business model built around patience.

Inflection Point No. 5: The Coming Collapse of the Euro

The Eurozone project has seen better days, which is why the future of the euro isn't a bright one.

In fact, as all the latest speculation about Greece either abandoning the euro currency – or being booted out of the Eurozone outright – is demonstrating, “the market” is about to apply a level of pressure well beyond

what the Eurozone and European Union (EU) were designed to handle.

The number of sovereign states in the EU that are facing difficulty selling new debt, or even a rollover of current debt, is growing.

The Eurozone and the EU are both in trouble. Clearly, the structure that exists today is flawed and will not withstand the rigors and pressures headed directly its way.

The ability to kick the can down the road is about to end, and with it some hard decisions will need to be made by the political and wealthy elite.

Let's take a closer look.

Warning Signs About the Future of the Euro

Just a moment ago, I mentioned that “the market” is ready to expose the flaws in the euro mechanism. The truth is that this is already happening. The risk-adjusted interest rates demanded by the market is now significantly higher than what the market would charge a major AAA-rated corporation for money that it borrowed via a bond issue.

As recently as a few months ago, we reached a point where the credit-default-swap (CDS) pricing on Western European states is higher than that for Eastern European states.

In case you are wondering, this is a first.

Simply put, bond-risk managers want to be paid a higher rate of return to insure Western Europe than Eastern Europe. This is a significant and statistically important point. The Eastern European states are only partially absorbed into the European Union. Of all the participating members, it's this group of Eastern states that could leave the EU the easiest and the quickest.

This could help determine the future of the euro. Indeed, if you look at the big picture, the individual European states will need to consider a return to independent sovereign rule in the extreme – or at the very least a return to separate national currencies, thereby ending the Eurozone and euro currency experiments.

The number of governments that have experienced a change since this economic crisis started is growing.

That list includes all of the island nations of Europe – Iceland, Great Britain and even Ireland. (Just yesterday (Tuesday), in fact,

The Euro's Uncertain Future

The escalating debt crisis in Greece has increased already-existing concerns about whether the Eurozone will survive “as is” for even another year or two – without a successful rescue plan for some of its debt-laden members.

The European Union (EU) to which Greece belongs teamed up with the International Monetary Fund (IMF) last year to bail out the troubled Mediterranean nation with a loan of \$163 billion (110 billion euros). But Greece's deepening debt woes prompted Standard & Poor's to cut that country's debt rating to B from BB-, and the ratings agency warned that additional downgrades were possible. The 27 EU member states now fear that a default by Greece could set off a financial contagion that will spread throughout the region. Among the most concerned are the 17 Eurozone member states, shown below, that use the European euro as their currency.

Eurozone Members (2011)			
State	Adopted	Population (*)	Nominal GDP (**)
Austria	Jan. 1, 1999	8.36	\$0.39
Belgium	Jan. 1, 1999	10.74	\$0.47
Cyprus	Jan. 1, 2008	0.80	\$0.02
Estonia	Jan. 1, 2011	1.34	\$0.02
Finland	Jan. 1, 1999	5.33	\$0.24
France	Jan. 1, 1999	64.11	\$2.65
Germany	Jan. 1, 1999	82.06	\$3.33
Greece	Jan. 1, 2001	11.26	\$0.33
Ireland	Jan. 1, 1999	4.52	\$0.23
Italy	Jan. 1, 1999	60.09	\$2.11
Luxembourg	Jan. 1, 1999	0.49	\$0.05
Malta	Jan. 1, 2008	0.41	\$0.007
Netherlands	Jan. 1, 1999	16.48	\$0.79
Portugal	Jan. 1, 1999	10.63	\$0.23
Slovakia	Jan. 1, 2009	5.41	\$0.09
Slovenia	Jan. 1, 2007	2.05	\$0.05
Spain	Jan. 1, 1999	47.02	\$1.46
Eurozone		329.94	\$12.48

(*) In millions of people.

(**) In trillions of USD; as of 2009, according to the World Bank.

Sources: Wikipedia, Money Morning staff research

Ireland underscored the challenges it faces and stunned observers by disclosing a plan that will have it raiding *private* pension accounts in order to finance the spending on its job-growth strategy.)

Even in the heart of continental Europe, the number of nations experiencing wrenching change is steadily growing. Belgium has not had a government in almost a year. And Portugal's austerity challenges are so large in scope that not even Socrates could save it – Prime Minister Jose Socrates, that is. He resigned and is being replaced.

In France, President Nicolas Sarkozy, the most visible leader of the French government, is experiencing career-low approval ratings. His party has committed a series of political gaffes, leaving it weakened and distracted in domestic politics. The current Sarkozy government is focused on G20 political events, trying to generate a positive spin on something. President Sarkozy is not expected to survive the next political round of national elections.

The European (Dis)Union – The Dissolution of the EU

In Germany, the heart of industrialized Europe, we're seeing a series of changes in the makeup of the state-level governments. The current national government of German Chancellor Angela Merkel is expected to fall, with a new coalition of parties forming a government to replace her central conservative government.

Going forward – no matter who is in charge – you can expect to see a German government that's more willing than ever to make "tough calls." For instance, as a direct result of the nuclear-power plant disaster in Japan, Germany will experience ever-increasing pressure to turn off all 17 of its own nuclear plants – a move that will prove very costly for consumers.

In the months and years to come, you can expect to see Germany start to focus more on what is best for Germany – to the exclusion of what is best for Europe – even though that self-interest will come at the expense of the rest of Europe.

Germany is going to be far less likely to agree to additional bailouts for other European countries. In fact, the era of unlimited access to Germany's hefty balance sheet is just about over.

The implications for the EU's overleveraged "PIIG" nations (Portugal, Ireland, Italy and Greece) – which no doubt believed they would always have access to Germany's deep pockets – have yet to be fully determined. But to modify an old Wall Street adage – "Bulls make money, bears make money, PIIGS get slaughtered" – when Europe must do without Germany's deep pockets, investors can expect casualties.

So while the idea of unity in Europe may have merit, and the future of a unified Europe is still open to discussion, the cold reality is that the EU, as it currently exists, is on life support. And in its current state, the union and the currency won't even make it to the end of 2012 – at least not in my opinion.

One major problem I see is that the European Central Bank (ECB), which handles the monetary policy for the 17 Eurozone member states, is not properly capitalized to handle the demands being made upon it.

The ECB is tasked with providing independent monetary actions in an environment of extremely intense political and economic negotiations between historically sovereign states. Needless to say, the most sensitive topic is how much each of the more-affluent member states will provide in the way of financial support to weaker sister states (a key reason that Germany is going to become so much more protective of its national balance sheet).

The Irish Connection and the Future of the Euro

Since its beginnings last summer, the European debt crisis has been a major cause for concern, with global investors worrying that it might cause a double-dip downturn in world economies and financial markets.

But as I told some of *Money Morning's* top editors and writers during one of our regularly scheduled "private briefings" several weeks ago, the drawn-out nature of this affair has helped diminish its impact. At that same time, however, I told the editors about a particular set of circumstances that could serve as *the* catalyst needed to transform the European debt crisis into a full-fledged conflagration – an inferno intense enough to bring about the dissolution of the euro-currency structure.

The catalyst I identified was Ireland.

And Ireland will play a key role in determining the future of the euro.

In the midst of the growing sovereign debt crisis last year, Ireland was forced to seek a bailout because of an economy that shrank 15% from where it was in 2007. Needless to say, debt, too, was a problem: Government borrowings – about 25% of gross domestic product (GDP) at the end of 2007 – are projected to peak at 116% of GDP in 2014.

"I think we can deal with it," new Irish Prime Minister Enda Kenny said during a meeting of the Council on Foreign Relations in New York last week. "The scale of the challenge is enormous but so is the opportunity."

The new government was brought into power to renegotiate the deal that the last government agreed to with the ECB and International Monetary Fund (IMF). This agreement is both technically in effect and technically not fully agreed upon. In other words, it's in kind of a "limbo" status, leaving the Irish government room to demand renegotiations.

Prime Minister Kenny is seeking a reduction on the average 5.8% interest rate his country is paying on that aid.

In much the same way that Iceland had banks that were larger than its entire domestic economy, the Irish banks had grown their own balance sheets beyond the size of the nation they represented. As a result of this leveraging up process, the tab for bailing out the banking sector could swell to \$101 billion – or \$21,610 for each of Ireland's 4.5 million citizens.

In other words, in a country with a nominal gross domestic product (GDP) of about \$230 billion, this banking mess has left "the people" on the hook for debts well beyond anything that they could hope to pay back.

Little wonder that Ireland's new government appears so willing to rob the private pension funds of its citizenry.

In briefing *Money Morning's* editors, I said that if Ireland's leaders proved themselves willing and able to indebt the country's future generations – to force those generations to cover bad loans made by what had been the country's "private-sector" banking business – I could see the European debt crisis intensifying in a way most observers just weren't seeing.

Those banks are now being nationalized, and the risks absorbed by the balance of the people.

Making matters worse is the reality that renegotiating the bailout package may be easier said than done.

Germany's Merkel is now in a position where she can't afford to appear to be bailing out any of the EU's PIIG-member states. At the same time, it seems that Kenny's new Irish government has staked its future on providing a reduction in the costs of the bailout.

The bottom line: Neither the Germans nor the Irish appear to have an acceptable compromise to present to the home crowds.

On top of all this, looming quickly is the big sovereign-debt rollover for Italy and Spain, which combined owe about \$400 billion. It is a sum that "the market" is not likely going to want to provide on terms either government will find acceptable.

This leaves the already-broke ECB, and its new "bad-bank" twin, the European Stabilizing Fund (ESF),

along with the IMF, to ride to the rescue. The rescue will not be piecemeal, but will, in fact, be a major package for most of the liquidity-starved states.

The cost will most likely come in the form of giving up individual sovereign rights while protecting the banking system from itself.

And if this all can't be ironed out, then the future of the euro will be very, very clear. And so will the currency's epitaph.

The Euro and Your Investment Portfolio

As the incremental funding needs for the Eurozone/European Union countries become more and more noticeable, the response will be to dilute and print its way out of the worsening mess with a series of emergency-funding events. The IMF and the European Union have a major crisis coming.

You will want to watch the Swiss and a Euro FX currency cross for a flood of money fleeing Europe for safer harbors. The ECB is undercapitalized and will be relying on funding being provided by U.S. proxy sources.

Given the serious structural pain I'm forecasting for the euro currency, the action to take is clear. When it becomes obvious that the Eurozone/EU may not continue with its current membership ranks, investors will fear for the currency's future, and the euro will fall.

I would suggest looking to buy "near-the-money" puts for January 2012 on the **CurrencyShares Euro Trust ETF** (NYSE: FXE). These puts should appreciate nicely if and/or when the European euro reacts to the prospect of a breaking of the economic union, which is on the table now.

Inflection Point No. 6: The Bill Gross Factor

As we've noted several times in this report, Bill Gross is one of the largest money managers in the world. He is the portfolio manager of **PIMCO Total Return A Fund** (MUTF: PTTAX) at Pacific Investment Management Co. LLC. This fund has grown into the largest mutual fund in the world today. It is known as the largest bond fund in the world, but with its size and mandate, it is now the largest mutual fund in any market it enters.

This massive size isn't without side effects – both good and bad. Here are a couple of obvious ways the fund affects the markets in which it invests.

The first is that it causes its own slippage, which is a bad thing. What this means is that it is so large to start with, that any real positions it takes will cause that market to rise or fall on its own, making each additional purchase more expensive.

This causes the fund to be its own worst enemy, as it pushes around the very markets in which it wants exposure. This cuts down on the net return the fund can generate, as it pushes prices up when buying and pushes prices down when selling.

The next significant issue of a fund this size is that any major position the fund takes instantly becomes known to professional investors. This allows people like me to see these potentially major Inflection Points.

We can see the capital move in the markets in real time, via pressure in specific markets. Once the filings are updated each month – or each quarter, depending on the sources used – you can find out exactly who made that major move.

This guessing game is played out every day, as money managers try to guess what the "big money" is doing in the market (we explained this "big-money" factor in the U.S. dollar section of this report).

When a major trade is announced, the market dissects what it means to future supply or demand in a market.

I say all of this to establish a foundation for an explanation of a major trade that has been announced to the world by the largest mutual fund manager in the world. It is a massive bet, against his specialty. Bill Gross, the acknowledged “Bond King,” has sold all of his U.S. Treasuries, and via the usage of swaps, appears to be net short U.S. Treasuries. (According to a recent *Reuters* report, the **PIMCO Total Return A Fund** (MUTF: PTTAX) was 4% short on U.S. Treasuries via swaps in that “world’s largest bond mutual fund.”

This is significant because his benchmark is 40% long U.S. Treasuries. This has him potentially up to 50% short his return baseline requirements. He cannot maintain this position for any length of time and stay compliant to his SEC-required mutual fund rules. Therefore, it is a significant indication of his expectations of the near-term direction of U.S. Treasury rates.

The only reason he would position the world’s largest fund in this direction is if he expected an event that would cause U.S. Treasury rates to rise in the near-term. The most obvious way this could happen is if the Federal Reserve announced an early end to QE2, and/or unveiled a surprise increase in the benchmark Fed Funds rate at June’s policymaking FOMC meeting.

If that happens, Gross will look like a genius again. He’ll generate a great trade as he sold high, and will be ready to reverse his net short position into a panic dumping of U.S. Treasuries as investors adjust to a new Federal Reserve stance.

As we noted earlier, if the U.S. central bank *does* change its monetary stance, it would be the first time it did so since the summer of 2007, when the financial crisis started to take shape. At that point the fallout was expected to stay contained within the subprime part of the market.

The Federal Reserve has to change course at some point, and if you read the tea leaves it looks like it could happen sooner rather than later. It appears to me that Bill Gross has already moved in anticipation of this event.

The Bill Gross Factor and Your Investment Portfolio

You’ll want to read the “bonds” section, which this basically augments (Gross will be one of the key drivers behind the predictions that I’ve made for that asset class).

PIMCO’s Gross has set himself up to become the most-famous – or most-infamous – money manager of our lifetime. After founding a small business that grew into the world’s largest bond-management firm, he has positioned his firm in a public relations battle with the U.S. government.

He has become the very “bond vigilante” that his peers were when he started his firm. This has led him to adopt a stance that is contrary to the very essence of U.S. monetary and fiscal policies and evolved into a growing short on the U.S. Treasury bonds that make up 40% of his bogey (benchmark).

In the new future, Gross will either be proven right, or be proven wrong.

However it plays out from a timing standpoint, I doubt anyone is arguing with him about his big-picture view of the U.S. government balance sheet. If Gross is correct, there is a major “event” coming soon to the bond markets. When this happens, it will be interesting to see how he deploys his cash. You see, Gross has amassed a horde of cash that is now reported to be worth about \$80 billion (you heard me correctly).

When that cash horde is put to work, you will definitely want to surf it. It will move markets.

Inflection Point No. 7: Why Japan Could Trip Up the Recovery

In our ongoing search for possible Inflection Point catalysts – financial stimulants that could help turn global markets upside down – the Japanese economy has to be a prime candidate.

In the last part of the 1980s, Japan was *the* world power – so much so that investors on the U.S. trading

floors of New York each day watched the Tokyo markets with a mixture of awe and fear. An oft-cited investing aphorism of the day explained this very clearly by holding that “when Tokyo sneezes, Wall Street catches a cold.”

Not long after, the Japanese miracle ended, the stock-and-real-estate markets crashed, and that Asian country fell into a funk known as the “Lost Decade” – a misnomer, since the economic malaise that’s lasted virtually ever since is actually more than 20 years long.

If we fast-forward to the present day, Japan has been economically leapfrogged by both the United States and China, and is no longer the global-economy trendsetter that it once was.

But as we inventory Inflection Point catalyst candidates, we’ve discovered one interesting fact: In the present day, and in its present state, Japan has regained the ability to help give the rest of the world a very bad cold.

And it can do so by infecting the new heavyweight champ of Southeast Asia.

I’m talking, of course, about China.

The Japanese Economy: On a Collision Course... With China

Of all the impacts that the March 11 earthquake, tsunami and resultant nuclear-plant disaster in Japan will end up having, the most surprising – and long-lasting – may be the way it changes that country’s relationship with its next-door neighbor to the west.

It’s probably the worst time possible. But the fact is that the Japan economy is on a collision course with its China counterpart. And the aftermath of that collision could contribute to the major market reversals that we’ve been discussing in this *Money Morning* series, “The Inflection Point.”

The fact that Japan’s government is attempting a major rebuild of the Japanese economy – at the same time that China is continuing its massive build-out program – will have both nations bidding on (read that to mean “competing” for) the same raw materials that each nation needs in order to grow whole cities from scratch.

The two nations, with a long history of invading each other, will find themselves sharing the same dirty air. The smokestacks of China will continue spewing out pollutants, which will now mix with the airborne radioactive fallout contributed by Japan.

The ways in which these unfortunate realities could sour the relationship between these two Asian heavyweights in the months to come are almost too numerous to list here. Suffice it to say that this already stressed relationship will be under an increasing amount of pressure during the rest of this year, and well into 2012.

And one place that this skirmish can be watched is in the global currency markets.

Does China Have a Yen for Japan’s Currency?

The currency market has always been an arena in which each national central bank carries out the collective will of its people.

In China’s case, this monetary policy has included a *de facto* peg to the U.S. dollar. So while the exchange rate may change incrementally between the Chinese yuan and the U.S. dollar, the changes are not significant enough to make the two currencies distinguishable from each other in the world markets.

This has meant that, while the United States has devalued the dollar, and its buying power against other fiat currencies, China has essentially also simultaneously devalued the yuan.

And that's not the end of it: This devaluation process has also meant that China's yuan has been devalued compared to its neighboring currency – the Japanese yen.

The escalation in the yen has put Japan at an export disadvantage to China. This has only been exacerbated by the end of the so-called “yen carry trade.” The great unwinding, which ran through pretty much every trading “stop” in the currency markets, forced the major Western central banks to step into the markets “as one” to restore order – and calm.

These market interventions – as well as Japan having poured more than \$700 billion worth of yen into the local markets in order to stabilize them since the earthquake – have temporarily capped this spike in the value of the yen. The hope is that this respite – or reprieve – will buy Japan some time so that its economy will again start to function in the aftermath of the March 11 disaster.

This puts Japan in a situation where the country must weaken the “perceived value” of the yen in the marketplace. To put this in context, Toyota Motor Corp. (NYSE: TM) the world's largest producer of cars in 2010, is now talking about pulling out of Japan if the yen continues to climb.

As a result, it is my expectation that Japan will have to continue to conduct a series of extremely large “unsterilized” currency events.

(When I talk about “unsterilized currency events,” think of Zimbabwe and how it used to print currency with zero assets or debt behind it. Japan is the most indebted developed nation in the world. And with the triple-whammy of earthquake, tsunami and nuclear meltdown having acted as a right, left and uppercut combination of punches, Japan cannot now afford to pay for this in any other way. So, as traders say, it will print yen “in size.” The Bank of Japan (BOJ), if it wants to break the trend of a strengthening yen in the marketplace, will have to “out-print” the United States in a fiat-currency printing war.)

But any attempt by Japan to weaken its currency could turn into a punching match with China – which isn't exactly known for allowing other nations to achieve a perceived advantage in mercantilism.

Thus, if China continues to act according to form, it will need to step into the currency markets and buy up most, or even nearly all, of the yen that Japan will be printing. This would be an attempt to strengthen the yen, blunting any currency advantage that the Japanese economy might have achieved. I don't believe that even China can soak up the level of currency printing that Japan needs to happen.

In the current environment, however, this won't be a slam-dunk play for China: In the aftermath of the disaster, in its hour of need, the world's major central banks have been rallying around Japan and taking steps to weaken the yen.

This is the first time since the historic 1985 Plaza Accord, or the 1987 Louvre Accord, that the major central banks have united in the global currency markets in order to weaken a specific country's currency.

That these major nations are working in concert again speaks volumes about the perceived gravity of this current situation involving the Japanese economy. The interventions of March 2011 by the central banks are not yet fully understood by the market. I believe, in hindsight, they will be a major chapter in the banking structure of tomorrow.

A Look Ahead

If we cast our eyes forward – in an attempt to see what may still develop – we can see that Japan faces some major potential issues involving China and some of its other neighbors.

For instance, Japan has always had an energy shortfall, but with the loss of a key nuclear plant, and

growing anti-nuclear sentiment, that shortfall is worse than ever. Here at *Money Morning*, we've discussed some of the potential solutions to Japan's energy shortfall – including projected increases in liquefied natural gas (LNG) imports – but have done so acknowledging that they're only “partial” solutions.

Some of the potential points of friction include:

- **Energy Scuffles:** Japan needs to boost energy importation by a large amount in the aftermath of the March 11 catastrophe. It needs to boost LNG imports and construct cross-country natural-gas-powered plants to replace its lost nuclear-power capacity. But the Eastern China Sea natural-gas field – of which both claim a piece – remains a point of serious contention.
- **The “Rare-Earth Wars”:** Rare-earth metals are central elements of many technologies, meaning that advanced economies such as Japan and the United States have a great need for these raw materials. But China now controls as much as 97% of global-rare-earths production – and is restricting exports. In its current weakened state, Japan needs these more than ever, meaning this will certainly exacerbate the friction the two nations are already experiencing.
- **A Knee-Buckling Debt Load:** Critics rant about America's government debt burden, but Japan – at 225% – has the highest level of public debt as a percentage of gross domestic product (GDP) of any major economy in the world. This could limit Japan's maneuverability as it tries to rebuild, and any kind of a credit scare could have ripple effects throughout Asia.
- **The Aftermath of the Powerplant Disaster:** Japan's nuclear accident will be a costly one – on many levels. First and foremost, the contamination will last for years – and won't be limited to Japan proper. The air and waters of the region have been contaminated, and the damage won't really be known for years. As already stated, it will force Japan to seek alternatives, which will raise prices in a way that can't help but prove costly to China. And the accident has opened the door to virulent protests over – and heightened worldwide scrutiny of – nuclear energy, an energy source that China absolutely must rely upon.

Japan's economy has been hurt much more than most realize by the earthquake, tsunami and all that came after. Now, as a nation, Japan will be looking for something to rally around. The Japanese people are known for their stoic nature. They are also known for being unwavering when they decide to take a course of action. How they respond to the pressures that are mounting on the Japanese economy will be interesting to watch.

Equally interesting will be the effects that Japan's tragedy, and its aftermath, have on China, a key to global growth. If the ripple effects of Japan's problems cause China to stumble, then the Japanese economy could end up being a true Inflection Point catalyst.

The Japanese Economy and Your Investment Portfolio

The coming gross-domestic-product (GDP) crunch that is hitting Japan is not yet factored into the markets. That country's electricity shortfall will become increasingly noticeable in the coming months.

The Tokyo Electric Power Co., the operator of the ruined nuclear powerplant, is in dire straits. This means that the Japanese government will have to shoulder the immense long-term costs of the Fukushima radiation crisis. Japan is going to start printing yen, as the traders say, “in size.” Going forward, you want to track the **CurrencyShares Japanese Yen Trust** (NYSE: FXY).

When the yen starts to drop in value, we want to be ready to ride its decay. As the U.S. dollar increases in value, Japan will be trying to devalue the yen to parity with U.S. cents, if possible.

Watch for a parity trade to break out in terms of the Japanese yen for the Chinese yuan. You may ask why we are talking about U.S. dollars when this is a Japan-versus-China trade. The reason is that China is still maintaining a *de facto* peg to the U.S. dollar, loosening it incrementally over time.

This means that, from a correlation-trade point of view, yuan are dollars when talking about trading partners. A change in yen-versus-yuan will include U.S. dollars as a synthetic marker. 🌱

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