The price of oil has been in the financial news as West Texas Intermediate Crude (WTC) pulled back from last Friday’s close of $113.10 to the $106 to $110 range. It is still above the critical level of $105 which is the upper limit of what American consumers can afford without significant collateral damage. Precipitating the drop, Jeffrey Currie, commodities strategist at Goldman Sachs, was reported to have closed his profitable long commodities trades early in the week “because he reckons the risk reward no longer favors a bullish stance.” He wrote, “‘not only are there now nascent signs of oil demand destruction in the United States...but also record speculative length in the oil market, elections in Nigeria and a potential cease-fire in Libya that has begun to offset some of the upside risk owing to contagion, leaving price risk more neutral at current levels.’” (Goldman jolts commodities market)

According to Javier Blas of the Financial Times, “Goldman is Wall Street’s largest commodities dealer by revenues and, although its analysts do not know the views of the trading desk, its opinions carry weight. Oil, for example, has corrected by about $4 a barrel since the note went out. Coincidence? Maybe.” (Time to take profits, says Goldman)

Zero Hedge was more skeptical: “To all who panicked following the programatic Goldman downgrade of Brent two days ago and dumped their holdings right into gaping maw of Goldman’s overeager prop desk...our condolences.” (WTI Recovers Over 60% Of Losses Since Goldman Downgrade) Taking a pragmatic position, Phil called shorting oil futures at $108.50 in pre-market trading “our little cash machine as they goose that sucker every night.” Oil then drops once the trading day begins.

In a classic retelling of the ancient “irresistible force meets immovable object” riddle, irresistible forces of rampant oil speculation, political and social instability in North Africa and the Middle East, and the Federal Reserve’s policy of quantitative easing (QE) are combining to support higher oil prices. Unfortunately, when the price gets high enough, it hits an immovable object called demand destruction every time.
Harris Interactive, conducting a survey for the American Institute of Certified Public Accountants, polled 1,005 people in March. It found that 60% of Americans have changed their behavior to adjust to rising oil prices. Among that 60%, 78% are traveling less, 58% are cutting back elsewhere, and 53% are consolidating trips. The survey also found that 48% of Americans have modified their behavior due to higher food prices. Many reported eating home more often, switching to generic or store brands, using coupons, and buying less expensive food items. (AICPA Survey: Rising Gas, Food Prices Blunt Gains From Economic Recovery)

The so-called “recovery” kicked off by Ben Bernanke’s QE policy appears to be stalling out. Initial unemployment claims for March jumped to 412,000, up 5.3% from February’s 391,000. At the same time, the inflation QE2 kicked off is gaining momentum. ShadowStats.com reported that U.S. inflation was running at an annual rate of 9.6% in February, when calculated using methodologies in place before 1980. (ShadowStats.com removes “gimmicked methodological changes” to more accurately reflect the common public experience.) Even official government statistics are showing substantial increases in core inflation. For example, the Bureau of Labor Statistics reported that the Producer Price Index jumped 5.8% year over year in March.

The Fukushima Daiichi nuclear power complex also dominated the news, starting with Monday’s announcement that Japan was expanding the evacuation zone around the facility. Later, the International Nuclear Events Scale rating was raised to a level 7 because “of the large quantity of radioactive substances that have been discharged from the plant’s damaged reactors.” On Friday, the head of the Atomic Energy Society of Japan, Takashi Sawada, admitted that two of the reactors (1 and 3) have partially melted down causing fuel to accumulate at the bottom of the containment vessels.

Japan’s economy continues to reel in the wake of the triple disaster, and estimates of damage are increasing. For example, Toyota Motor Sales USA warned dealers to prepare for shortages of new vehicles. “The havoc wreaked on the nation’s auto manufacturing and parts production is going to take longer to repair than most makers have insinuated.” (Japanese Makers Facing Protracted Recovery)

In last week’s newsletter, we wrote that we wanted the markets to show us if they could support our major breakout levels, and those levels mostly held up this week. Meanwhile, the Dollar traded in a channel between 74.6 and 72.5 all week. It’s critical support level of 76 failed to hold, and next week we’ll see if the 74 level provides support.
News that the International Monetary Fund (IMF) lowered its forecast for economic growth in the U.S. and Japan weighed on the markets as tech stocks sagged and energy stocks were hit. Oil dropped below $110 a barrel on rumors of a possible cease-fire in Libya.

It was a bad day in Japan. Previously, on April 7, a 7.1 earthquake struck just offshore the Sendai region of Northeastern Japan. This was followed by a 6.6 earthquake on Monday in the Eastern Honshu region between Sendai and Tokyo. Japanese officials made two important announcements. First, the evacuation zone around the crippled power plant needed to be expanded due to accumulating radiation contamination. The Japanese government began encouraging people to leave areas beyond the prior 20km exclusion zone. Second, Japan’s Nuclear and Industrial Safety Agency declared that the situation at the Fukushima Daiichi nuclear reactor complex was a level-7 event on the international scale for nuclear disasters, putting it on par with the infamous 1986 Chernobyl disaster.

In Libya, there was a momentary glimmer of hope that a ceasefire might be worked out between rebels and the Gaddafi regime, as a peace delegation of five African heads of state met with Gaddafi and brokered terms for a ceasefire agreement. However, rebel leaders rejected the plan, saying that the increasingly bloody siege of Misrata by Gaddafi’s troops made talk of a ceasefire meaningless.

Monday morning, in the early am comments from my “Investing for Income” article, I added a suggestion to short silver futures as silver touched $42. Of course, we hit the oil futures shorts as oil crossed below the $112.50 and $111.50 lines. We rode those puppies all the way down to $110 - finally catching the wave we’ve been PATIENTLY waiting on for ages. For our non-futures players, my trade idea was the USO April $44 puts at $0.35. Those finished the day at $0.85, up 142% on the day with each $350 contract returning $850.” - Phil

“I explained why the economy could not withstand $4/gallon gas prices in Friday’s post. We had already been short oil and we doubled down on our short position on USO as oil hit $113 a barrel.

Besides the Libyan civil war’s continued effect on the price of oil, rampant oil speculation is artificially driving prices up. The harmful affect of speculation on oil prices, and on the average consumer, prompted Phil to write, “It’s a scam folks, it’s nothing but a huge scam and it’s destroying the US economy as well as the entire global economy. But no one complains because they are ‘only’ stealing about $1.50 per gallon from each person in the industrialized world.”
The market was sharply down Tuesday in reaction to Alcoa’s earnings and fears that high oil prices would diminish global demand. Goldman Sachs released a report calling for a substantial pullback in oil prices, as analyst David Greely pointed out that inventories and spare capacity are much higher now than in spring 2008, when prices were in a similar range. Net speculative positions in oil are also four times higher now. This was in addition to Goldman’s Jeffrey Currie’s comments about closing his profitable commodities trades.

Prices of new homes in Beijing dropped 26.7% month-over-month in March, and are down 10.9% year-over-year. This was the first annual drop since September 2009. Last weekend, Chinese Premier Wen Jiabao urged local governments to take responsibility for keeping housing supplies and prices stable. The premier has been urging stronger action in tackling rising property prices since the second half of last year. “Beijing’s property market is gradually moving back on track, as home prices are going down, non-local buyers are buying less. I think this could prove that the local government’s policies have played their intended role,” said Chen Zhi, deputy secretary-general of the local real estate association. (Beijing Home Prices Drop for First Time in 19 Months in March)

The Fed announced its new permanent open market operations (POMO) schedule. It intends to buy $97Bn worth of Treasuries over the next four weeks as it continues its QE2 policy.

This week’s INDU versus UUP (Dollar proxy) chart (above) shows the pattern “when the Dollar drops, the markets pop” breaking down. “This may be the end game for the Fed. We’ve been sensing it for weeks, becoming more bearish (and I was thinking last week, maybe too bearish). The last low volume push back to our market tops was looking less impressive - especially as it was predicated on an ever-weakening Dollar.” (Phil)

Charles Hugh Smith, writer of the blog “Of Two Minds” commented on the Fed’s difficult position. “The Fed can only choose the least-worst option now: either destroy the real economy by sinking the dollar below support and unleashing the Inflation Monster, or abandon the “risk trade” stock market rally.

“The Fed’s game plan - sink the U.S. dollar to goose corporate profits, re-inflate asset prices and create ‘modest inflation’ - is now the most dangerous game on Earth. As over-leveraged assets from real estate to stocks imploded in 2008 and early 2009, the Federal Reserve rushed to flood the global economy with zero-interest dollars. This did a number of things the Fed reckoned were necessary” [to create an illusion of recovery]... The goal was to enable the banks to recapitalize ‘painless’ on the backs of consumers and taxpayers. The other goal of the plan was to create some modest inflation by brute-force depreciation of the nation’s currency.” (The Fed’s Most Dangerous Game: Checkmate)
What, Me Worry Wednesday - Fitch Warns on China

Stocks rebounded on Wednesday, with the Nasdaq making the biggest gain for the day. Shares in Riverbed Technology (RVBD) climbed 12% after the networking-storage maker raised its first-quarter earnings forecast. In a statement, Riverbed Chief Executive Jerry Kennelly said, “Sales increased on an annual basis across all major geographies as spending on WAN optimization remains a priority.”

Fitch ratings lowered its outlook on China’s AA-long-term local-currency rating from “stable” to “negative,” citing a “high likelihood of a significant deterioration” in the quality of bank assets over the next three years. A record jump in lending raised concerns that bad debt could overwhelm the banking sector, as Chinese banks extended $1.2Tn in new loans last year. These loans helped drive China’s economic rebound and also fueled a surge in property prices. According to Andrew Colquhoun, head of Fitch’s Asia-Pacific sovereign unit, “Fitch has documented a proliferation of off-balance sheet and other more or less informal channels through which credit is being extended to the economy. This gives rise to concerns that the effectiveness of monetary policy may be decreasing.” (China’s Record Bank Lending May Spur Fitch Ratings Downgrade)

After JP Morgan released its first quarter results, several analysts expressed concerns about the bank’s retail financial services which posted a loss of $208 million. This loss was driven by a $1.1Bn write-down in JP Morgan’s mortgage servicing rights business and reflected increased servicing costs. Sandler O’Neill’s analyst Jeff Harte wrote, “JPM’s decision to write down its MSRs [mortgage servicing rights] increases the probability that other banks, notably Bank of America (BAC) and Citigroup (C) ... will follow suit.”

Phil’s response: “Up on the FAS already! JPM was a BS reason to ramp up the Financials…” Details of the FAS trade are in the inset box below.

Inside Member’s Chat:

Phil wrote: “Good time to sell FAS Apr $31 calls at .55. That makes a full cover with 1/2 the $30s and 1/2 the $31s - tomorrow we roll if we have to.”

The FAS April $31 calls gained over 50% to .25 by the close of the markets on Wednesday.
The markets opened on a down note Thursday morning, but managed to recover during the day to close little changed from Wednesday. The House passed a bill funding the federal government for the rest of the fiscal year, and the Senate then passed the budget with a vote of 81-19 in favor.

As compared to this time a year ago, the markets have gained about 10% over the last 12 months. Meanwhile, the actual annual rate of inflation was 9.6% over the same period. We have been cautiously bullish during this time, based on the inflationary investment premise that stocks would go up as the Dollar lost value. Our cautious bullishness is not based on real improvement in the economy (as distinct from improvement in corporate earnings and devaluation of the U.S. Dollar.)

Initial unemployment claims jumped sharply in the week ending April 9, to a higher-than-expected total of 412,000, an increase of 27,000 from the previous week’s revised figure of 385,000. Tusca posed the question in Members Chat of whether the lousy unemployment numbers confirm the lack of real recovery, making Q3 inevitable. Phil suggested there would be “a stealth QE3 but not an overt one, and that will not give the markets more confidence (but it will cause inflation so a dip and then a recovery is still the theory).”

Michael Pento, Senior Economist at Euro Pacific Capital, described the dilemma that Bernanke is now facing as the end of its QE2 program approaches. “Surprise! Bernanke now has to make a difficult choice. Despite the Fed’s best laid plans, inflation is soaring but the housing and job markets are dead in the water. I have been warning from the start of Quantitative Counterfeiting that the economy, housing market and the unemployment would not significantly improve — however, inflation would become a significant problem.

“We don’t expect 1,300 to break unless/until the Dollar popped - and it hasn’t so far, so we need to look up now and the DIA $121 calls at .97 are a nice entry with a stop if the Dow can’t get back over 12,200 by 10:30 (and that becomes the stop) or out if we fail .75 or the S&P fails 1,300, of course. This is not a reversal - this is a bounce cover for longer-term bearish positions!” - Phil

The DIA $121 calls closed the day at $1.85 (up 90%)
The indexes we track traded up on Friday, although Google was down sharply, dropping more than 8% after missing earnings projections due to higher expenses. The week ended with our levels all unchanged from last week, with all five indexes we track over our Major Breakout levels, and the Nasdaq, NYSE and Russell 2000 all above our 100% lines.

The continuing European debt crisis was in the news again. Moody’s downgraded Ireland’s foreign and local government bond ratings by two notches to Baa3 from Baa1. Key reasons for the downgrade were an expected decline in the Irish government’s financial strength combined with the country’s weaker economic growth prospects, and the uncertainty created by the solvency test required by the European Stabilization Mechanism (ESM) for the provision of future liquidity support.

German Minister of Finance Wolfgang Schaeuble declared in an interview with Die Welt newspaper that additional steps would need to be taken to deal with Greece’s debt burden if an upcoming analysis in June shows it to be unsustainable. This comment was the first acknowledgement from a German official that Greece may need to restructure its debt. Grecian 10-year bond yields climbed to a new euro-era high of over 13%, and yields on 2-year bonds are now over 18% as the markets become increasingly convinced that some kind of restructuring is inevitable. (Fears grow over Greek debt default despite bail-out)

“...It’s all about inflation, of course, and don’t say we didn’t warn you about that one! We grew more bearish up at those 100% lines we’ve been watching, and now the question really is ‘how bad was it?’ Inflation is, after all, our long-term BULLISH premise. We don’t think corporations are performing better. They are simply benefiting from a weak dollar, a loose labor market, cheap money and a lack of competition (because weaker companies are going bankrupt). To say this indicates a strong economy is like saying the last few surviving Bald Eagles benefit from having their pick of the best nests now that the rest are dead...” - Phil
Round two of the Federal Reserve’s current program of quantitative easing (QE2) is scheduled to end on June 30. There is considerable debate about whether QE will end as planned or whether there will be a continuation of the policy in one form or another. Wall Street Journal reporter Jon Hilsenrath quoted Bernanke explaining: “a $600 billion program of Treasury bond purchases known as quantitative easing looks likely to run its course as planned in June. This will effectively mean the Fed is moving to a neutral stance of no longer easing while not beginning to tighten policy.”

In other words, (effectively) zero percent interest rates will continue indefinitely. James Grant, founder and editor of Grant’s Interest Rate Observer, had some eloquent words for Bernanke’s multi-trillion dollar experiment with the economy, and with lives: “The Fed is unconscionably complacent about the consequences of what it is doing, and let us not blink at what it is doing: it has imposed the lowest money market interest rates anyone remembers, it has expanded its balance sheet into something grotesque all in the space of a couple of years. These are monetary events that have never before been seen, and indeed, never before imagined... The Fed’s policies are certainly great for one class of society: the speculative classes... We have socialized risk, we have privatized gains, much to the relief of Greenwich, CT where our zillionaires live, and the unconscionable and indefensible fallout of this is that savers get zero on their savings balances, and the speculative classes get to borrow in wholesale markets at zero and get to make their zillions all over again... The Chairman is whistling by the graveyard in this manner of 2% inflation rate being harmless.” (Jim Grant On Inflation: “There Will Be A Lot Of It Suddenly” Because Our Interest Rate Structure Is “Beyond Strange”)

While the Fed is currently downplaying inflation by claiming it is only 2%, real inflation is running at nearly 10%, as measured by ShadowStats.com. The tidal wave of liquidity unleashed by QE has, by design, devalued the Dollar. It has caused predictable problems such as severe price inflation around the world. Inflation in food prices has lead to multiple outbreaks of mass protests in North Africa and the Middle East - two governments have been overthrown (Tunisia and Egypt), a civil war has erupted in Libya, and Saudi forces have been called in to suppress protesters in Bahrain. Widespread turmoil has hindered oil production in the region. As a result, oil, a critical commodity that was already heading higher due to inflationary pressures and rampant speculation, has been pushed it even higher.

As the American consumer copes with rising food prices, rising energy costs, stagnant wages, high unemployment, and declining real estate values, the premise of a “consumer led” recovery is difficult to fathom. High gasoline prices alone are costing U.S. consumers...
$360 million more a day compared to prices a year ago, according to petroleum industry analyst Bob van der Valk. Bob also expects the price of West Texas Intermediate Crude to drop sharply over the next few weeks, and points to the fact that inventories at the Cushing, Oklahoma hub are at all time highs, something we have been noting for months.

Jan Hatzius is Goldman Sachs’ chief US economist, and is responsible for setting the firm’s US economic and interest rate outlook. Friday afternoon, Zero Hedge reported that Mr. Hatzius issued a major downgrade in his forecast for the “real GDP” for 2011, revising it down to 1.75% (annualized), from 2.5% previously (and from 3.5% not too long ago). He is very concerned about the downside risk to household real disposable income. In his view, the best chance for improvement in the forecasts is either “a substantial acceleration in the labor market and/or a large drop in gasoline prices.” (Jan Hatzius Friday Night Bomb: “We Are Downgrading Our Real GDP Growth Estimate”)

With all the talk about real inflation rates, the impact of inflation on food and energy prices, and its resulting problems, popular opinion begins to embrace the inflationary premise and soon people begin talking openly about the possibility of not only inflation, but even hyperinflation. However, not everyone shares this opinion. Charles Hugh Smith, of the blog “Of Two Minds,” takes an opposing view of the future:

“What the true believers of hyperinflation and the destruction of the dollar cannot accept is that debt is an asset to the owner of that debt. In focusing solely on the advantages of inflation to borrowers, they ignore the critical fact that inflation quickly destroys the value of the asset that debt represents to the owner. And debt is a primary asset to pension funds, insurance companies, banks, and indeed the entire financial sector.

“So in claiming high inflation is guaranteed, adherents are claiming that the entire financial sector will accept being wiped out, just so Mr. and Mrs. Taxpayer won’t have to pay interest on the ballooning government debt.

“That’s exactly backward: the entire point is for Mr. and Mrs. Taxpayer to pay high yields on Treasury debt, owned by the Financial sector’s Oligarchs. The Con is to strip-mine the public coffers, then impose higher rates and “austerity,” buy the debt with the cash plundered from the public, and then sit back and enjoy risk-free returns as taxes are raised on the remaining tax donkeys. Inexpensive Bread and Circuses (SNAP food stamps and the political theater of the two parties staging a partisan “fight to the death”) will keep the peasantry entertained and complicit...

“In effect, it’s a Third World/colonial scam on a gigantic scale: plunder the public treasury, then buy the debt which was borrowed and transferred to your pockets. You are buying the country with money you borrowed from its taxpayers. No despot could do better.” (Here’s the Setup for the Con of the Decade)

This week’s trade idea comes courtesy of Pharmboy: “Cerus (CERS) was an original pick a few months ago, and has fallen back into a sweet spot for another buying opportunity. The company makes the Intercept system which is designed to inactivate blood-borne pathogens in donated blood components intended for transfusions. Cerus markets the INTERCEPT system for platelets and plasma primarily in Europe, the Russian Federation, and the Middle East. The company is also developing INTERCEPT Blood System for red blood cells which is designed to inactivate blood-borne pathogens in donated red blood cells for transfusion. At $2.79, the stock is relatively inexpensive. Insiders were buying last month between $2.59 and $2.70, and it is my belief that the stock has significant upside potential.”
### Next Week’s Economic Calendar

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<th>Monday 18</th>
<th>Tuesday 19</th>
<th>Wednesday 20</th>
<th>Thursday 21</th>
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<tr>
<td>10:00 AM: Housing Market Index</td>
<td>7:45 AM: ISCS-Goldman Store Sales</td>
<td>7:00 AM: MBA Purchase Applications</td>
<td>8:30 AM: Jobless Claims</td>
<td>Good Friday - All Markets Closed</td>
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<td>11:00 AM: 4-Week Bill Announcement</td>
<td>8:30 AM: Housing Starts</td>
<td>10:00 AM: Existing Home Sales</td>
<td>10:00 AM: Philadelphia Fed Survey</td>
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<td>11:30 AM: 3-Month Bill Auction</td>
<td>8:55 AM: Redbook</td>
<td>10:30 AM: EIA Petroleum Status Report</td>
<td>10:00 AM: FHFA House Price Index</td>
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<tr>
<td>11:30 AM: 6-Month Bill Auction</td>
<td>11:30 AM: 4-Week Bill Auction</td>
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<td>10:00 AM: Leading Indicators</td>
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<td>10:30 AM: EIA Natural Gas Report</td>
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<td>11:00 AM: 3-Month and 6-Month Bill Announcements</td>
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<td>11:00 AM: 2-Year, 5-Year and 7-Year Note Announcements</td>
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<td>4:30 PM: Fed Balance Sheet and Money Supply</td>
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<td><strong>POMO DAY ($1.5Bn - $2.5Bn)</strong></td>
<td><strong>POMO DAY ($5Bn - $7Bn)</strong></td>
<td><strong>POMO DAY ($1Bn - $2Bn)</strong> (TIPS Purchase)</td>
<td><strong>NO POMO TODAY</strong></td>
<td><strong>NO POMO TODAY</strong></td>
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