COMMODITIES ESSENTIAL
The resource for what matters
BLACKSWAN

Main Article, p2thru5

It's starting to get interesting, I think. Bottom line: watch volatility for clues ...
It is mostly agreed that QE1 and QE2 did little, if anything, to bolster the real economy. The Fed even acknowledged that they very much relied on the wealth effect of rising stock markets to support the habits of consumers and businesses. **But some analysts have predicted QE3 could actually work** for the real economy by shoring up sentiment of businesses and consumers.

That certainly might help. The difference between this time and previous periods of monetary accommodation is the open-endedness. If the Fed effectively closes the open-endedness of QE3, they risk shooting themselves in the foot by undermining their support measures before they finally might work as hoped.

It's been said only a major market meltdown will bring about needed action on the fiscal front. After all, that's what happened in 2008 to necessitate stimulus measures. Might the Federal Reserve "inadvertently" create the conditions for a market meltdown as they flirt with increased transparency? It may be a round-about way to get lawmakers to perpetuate the status quo and delay the inevitable yet again.

So ...

Trade Essentials, p5

No new recommendations or adjustments at this time.

Positioning, p5

Stopped out of **DTO**, **ZSL** and **BOM** with profits. Still short **CORN**.

21 November 2012
******

It's starting to get interesting, I think. Bottom line: watch volatility for clues.

The Fiscal cliff is coming, but it will be avoided, unless it is not.

Frankly, I can't predict with any certainty the outcome of the deliberations over the coming tax cut expirations and spending cuts. I'm inclined to think lawmakers will do what they do best – kick the can.

Policymakers have set the precedent, and it seems like a compromise to merely postpone the day of reckoning is the likeliest scenario.

What makes it most interesting is the renewed gridlock in Washington DC – Congress remains divided and Mr. Obama has been re-elected. The House Republicans, the Senate Democrats or the President can throw a wrench into the negotiations. But who has the most leverage?

One might think, considering the brash nature of President Obama and his administration, Democrats would be able to use their current momentum to force Republicans to come their way.

But Republicans, bitter after the election results, may be determined and better positioned to pull Democrats their way – they may have more leverage than meets the eye. With a second term secured, the President now looks to his legacy. If he is concerned about his post-office appeal he'll be very cautious not to completely alienate the country by risking a disastrous economic event should no agreement be reached. He's playing prevent defense at this point.

Enter Federal Reserve Chairman Ben Bernanke ...

He's on record with new comments that urge lawmakers to reach an agreement.

"The realization of all of the automatic tax increases and spending cuts that make up the fiscal cliff, absent offsetting changes, would pose a substantial threat to the recovery."

"Indeed, by the reckoning of the Congressional Budget Office and that of many outside observers, a fiscal shock of that size would send the economy toppling back into recession."

He's made news with similar comments throughout the year. Indeed, several Federal Reserve members have come out saying the Federal Reserve can't do much more to support the economy and that Congress must become proactive.

Mr. Bernanke must know that almost half the country doesn't want to swallow more public sector involvement. And he must know that the nuances of monetary policy fly under the radar to a much greater degree than those of fiscal policy. And therein lies a new problem ...

Transparency is harder after the fact

When Barack Obama ran for President in 2008, he promised to bring an unprecedented level of transparency. Sadly, everyone assumed that meant more transparency, not less.

Obviously the administration found it tough to follow-through on its promise. It is doubtful transparency will improve at all in a second Obama term.

The Federal Reserve, however, appears intent on improving its own transparency.

Yes, increased Fed transparency has been a recurring theme in the last few years. Bernanke's now regular post-FOMC press conferences are among the efforts taken to disclose the workings of the central bank.

Now we're getting calls for more transparency. And the calls are becoming quite specific – to set quantitative conditions on the latest quantitative easing operation.

When QE3 was announced the FOMC left it open ended. In others words, they'll keep buying MBS and twisting the duration of bond purchases each month until they see sufficient economic momentum. The definition of "sufficient economic momentum" was also left open ended, or qualitative, with unemployment the preferred and non-specific gauge of recovery.

Since the announcement of QE3 in September, I've been warning of the potential for the market to front-run the Fed, anticipating the end-date for this open-ended easing. **That would likely mean a sell-off in the markets that erases much of the QE-led uptrend.** A notable improvement in unemployment and payrolls could do it. Consecutive trend-level growth in quarterly GDP could too. Even a series of improved manufacturing and consumption data could trigger this investor anticipation of a QE3 stopping point.

Naturally, then, the Fed wouldn't want to hasten market expectations and undermine the potential effectiveness of its latest policy actions. But that's exactly what they're now talking about doing. They're talking about outlining a concrete unemployment level, or inflation rates, or a calendar date at which point they'd consider abandoning their current easing. They insist such quantitative thresholds would not be absolute, but that may not matter to markets players trying to predict Fed behavior.

Thwarting the Fed's own efforts to promote the need for fiscal action?

It is mostly agreed that QE1 and QE2 did little, if anything, to bolster the real economy. The Fed even acknowledged that they very much relied on the wealth effect of rising stock markets to support the habits of consumers and businesses. **But some analysts have predicted QE3 could actually work** for the real economy by shoring up sentiment of businesses and consumers.

That certainly might help. The difference between this time and previous periods of monetary accommodation is the open-endedness. If the Fed effectively closes the open-endedness of QE3, they risk shooting themselves in the foot by undermining their support measures before they finally might work as hoped.

It's been said only a major market meltdown will bring about needed action on the fiscal front. After all, that's what happened in 2008 to necessitate stimulus measures. Might the Federal Reserve "inadvertently" create the conditions for a market meltdown as they flirt with increased transparency?

It may be a round-about way to get lawmakers to perpetuate the status quo and delay the inevitable yet again.

Barring any real action from the Fed on transparency, I believe the market will take the fiscal cliff deadline in stride. It appears the downside correction in risk appetite has run its course and markets can run higher. Commodities will likely underperform stocks since the global economy will not undergo significant growth spurts in the near future.

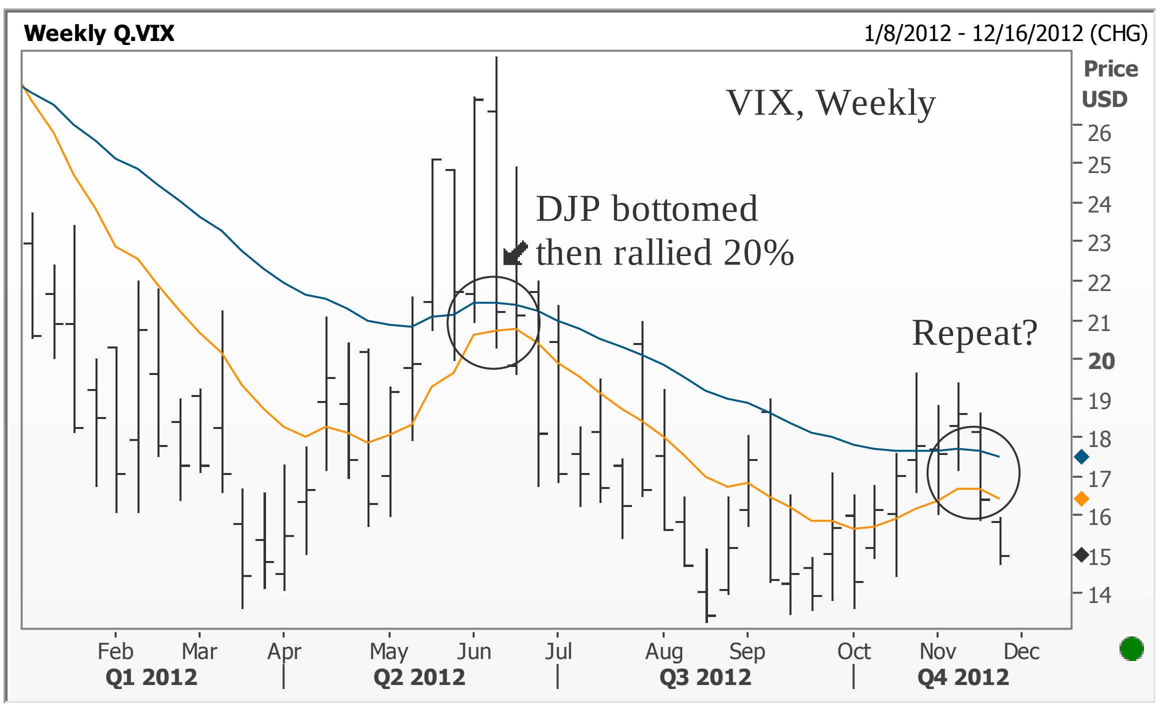
The big risk to this strategy is for the Fed to undermine its own efforts. I think markets would be quick to express their disapproval.

Watch these three letters: V-I-X

The VIX volatility index has come to reflect the sentiment of traders. Periods of high and rising volatility have corresponded with periods of risk aversion; and vice versa with periods of risk appetite.

The Brogan Group sent us a piece of technical analysis a couple weeks ago that highlighted an indicator on the VIX which might help predict the direction of volatility at key inflection points. The indicator is a basic cross in two moving averages they identified as being important.

I've been watching this chart (recreated below) and see action with these moving averages similar to earlier this year. At that time risk appetite recovered and sent markets rallying. Might we see a repeat?



A commodity index ETF – **iPath DJ-UBS Commodity Index (DJP)** – rallied about 20% back when the VIX gave us a head-fake in June ... nearly identical to what it's doing right now. This adds validation to my current bias expecting a rally through year-end. It may make sense to add shares of **DJP** ... and other commodity specific exposure ... very soon.

Looking at the alternative scenario, if the Fed-induced risk I described above does materialize and begin to pressure markets lower, its impact and staying power will likely be confirmed once we see a cross in the moving averages on the above chart of the VIX, suggesting greater volatility and investor unease to come.

With that said, sit tight for now and have a joyful Thanksgiving.

Trade Essentials.

No new recommendations or adjustments at this time.

Positioning

Position	Date	Ticker	Direction	Entry	Stop	Last	Target	Return	Notes
Teucrium Corn Fund	11/2/2012	CORN	Short	47.7	**48.57**	47.1	TBD	1.26%	Hold.

Click on the hyperlink to view the audio/visual chart analysis. **Bold** denotes change.

BLACKSWAN

JR Crooks www.blackswantrading.com