# A Grand Unified Theory of Market Manipulation

a weekend supplement to

The Precision Report

August 2, 2009

***Background***

There is much speculation and anecdotal information regarding the rally that began March 6 2009, which have suggested the gains are the result of massive manipulation on the part of the Federal Reserve (FR) and the large institutions that dominate Treasury securities dealing, program trading and the derivatives markets. Traders have reported that traditional indicators and metrics used for market analysis stopped working for periods of time or altogether, and that correlations among markets have been erratic and quick to change. Record program trading by Goldman Sachs as reported by the NYSE, heightened focus on high frequency trading (HFT), outsized profits by the large and well-connected banks, along with unprecedented intervention by the FR in the markets only fuel the manipulation speculation.

If we had a big picture model (a Grand Unified Theory, or G.U.T.) that described the intentions, motivations and actions of the influential players, we could attempt to predict future market direction. A limiting factor is that the rules of the game have changed quickly, and what we believe is important to the major players now may not necessarily have been important twelve or even six months ago. Accordingly, while we will present as much supportive data as possible, our sample sizes will be small and we will rely on educated conjecture when necessary. As such, we would expect to be, at worst, self-referentially coherent and, at best, correct in our predictions for the coming weeks and months.

***The POMO Effect***

The theory for which we have the greatest supporting evidence of manipulation surrounds the fact that the Federal Reserve Bank of New York (FRNY) began conducting permanent open market operations (POMO) on March 25, 2009 and has conducted 42 to date. Thanks to Thanassis Stathopoulos and Billy O'Nair for alerting us to the POMO Effect discovery and the development of associated trading edges. These auctions are conducted from about 10:30 am to 11:00 am on pre-announced days. In such auctions, the FRNY permanently purchases Treasury securities from selected dealers, with the total purchase amount for a day ranging from about $1.5 B to $7.5 B. These days are highly correlated with strong paint-the-tape closes, with the theory being that the large institutions that receive the capital injections are able to leverage this money by 100 to 500 times and then use it to ramp equities.

To wit, the following charts are Time Profiles that we created to show the net point accumulation in the eMini S&P 500 (with other statistics) for each hour of a trading day that meets selected criteria (except that the last *hour* of the day is only 45 minutes). For an explanation of Large Player Effective Volume™, please see the creator's website at www.effectivevolume.eu.

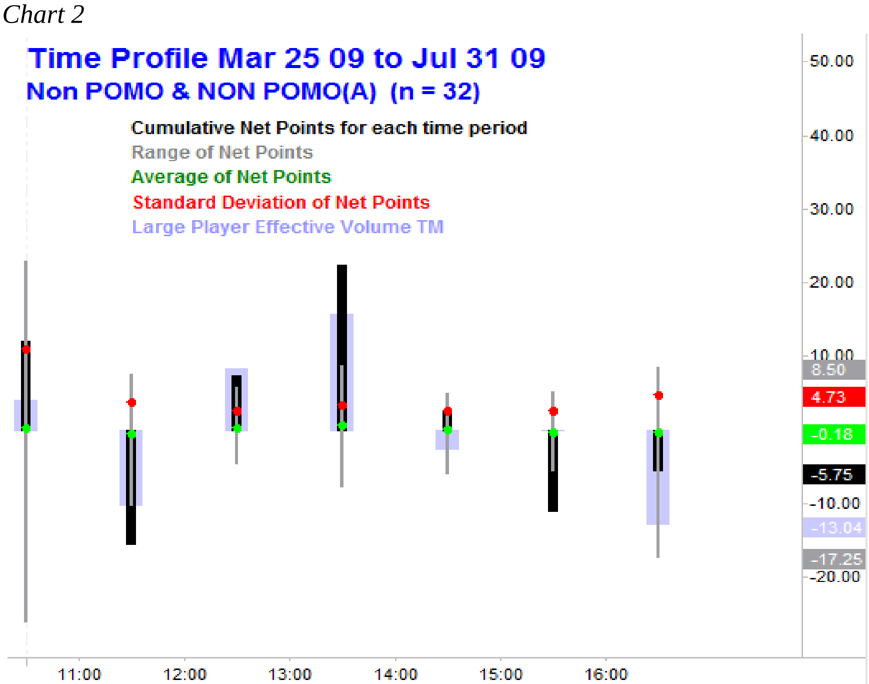
The first chart covers the rally from the date of the first POMO on March 25 2009 to present (through July 31 2009) and shows only those 42 days on which POMO were conducted.

*Chart 1*


The enormous 68.25 net points gained cumulatively in the S&P 500 in the final 45 minutes of trading (15:30 to 16:15 EDT) on POMO days is immediately obvious. As an aside, the dip into the 12:30 to 13:30 EDT hour is generally a tradable intraday low. There are also other tradable edges on which we update readers.

The FRNY also conducts POMO in Agency (Freddie/Fannie) securities with usually only a day's noticed as opposed to the one or two week's notice for Treasury POMOs. We call these Agency POMO days POMO(A). There is also a tape-painting effect on these days (not shown), but it is less pronounced. Following is a chart of those days on which *neither* POMO nor POMO(A) were conducted.

*Chart 2*

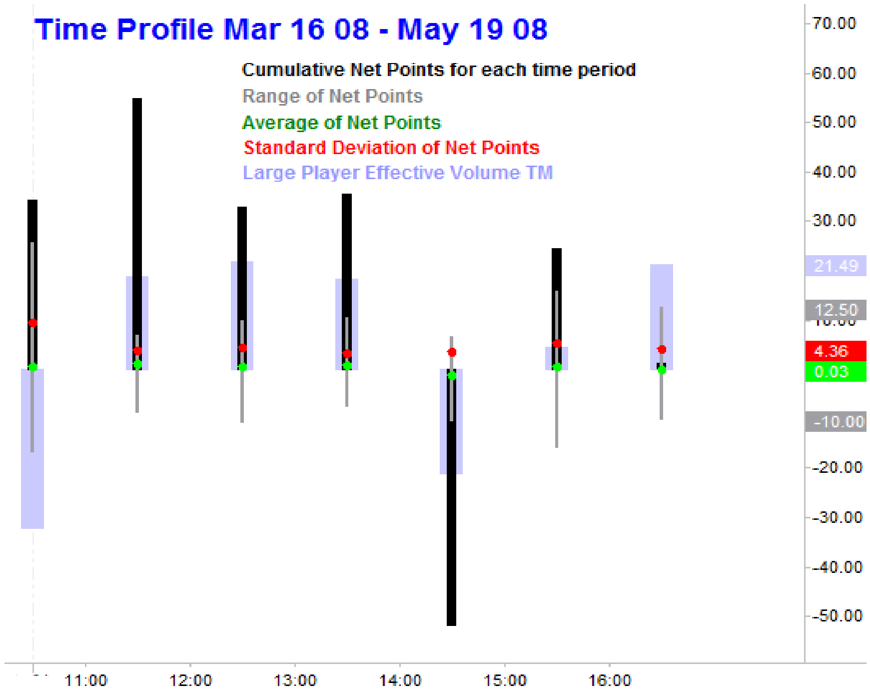


Note there is very little average edge in any given hour on the days in which the FRNY *doesn't* flood the large banks with liquidity.

Finally, here is a chart of all days in the March 16, 2008 to May 19, 2008 rally, which is the last comparable rally (in our opinion) in terms of length and strength.

*Char 3*




Note that most of the gains were made on average in the first half of the day with nearly no tape-painting.

From here forward, we must adopt a more conjecture and theory-oriented approach.

***Bernanke vs. the New York Fed***

It is easy to assume that the Federal Reserve headed by Bernanke and the regional FR banks (especially the Federal Reserve Bank of New York) operate with the same motivations, ambitions and desires. However, we hope to demonstrate here that their interests, though sometimes aligned, do not always converge and that, in fact, there may be an outright tug of war going on between Bernanke and the FRNY that is playing out in violent fashion in the equities and Treasury markets. It is important to note here that we identify Bernanke by name because his upcoming re-nomination bid (next January 2010) imparts political aspirations that transcend his title. There are also other major players involved that we don't mention (Larry Summers) because it is beyond the scope of this report.

<u>*High yields the biggest threat*</u>. We believe the largest problem facing Bernanke is high and rising long term interest rates. With record funding requirements by the Treasury, looming refinancing disasters in commercial real estate (CRE), massive upcoming defaults in prime, Alt-A and credit card, and waning enthusiasm for the US Dollar, he can ill afford the economic meltdown that a massive repatriation of US Treasuries and Dollars would have. Once long term yields reach a critical level (which we cannot know and would be difficult to even estimate), the FR becomes locked in a money printing cycle that will ultimately become hyperinflationary and result in the FR having to buy every US Bond, Note and Bill in order to prevent the economic Armageddon that comes with a panicked exodus from US debt and currency. Such a meltdown would be a 10 on a scale of 1 to 10 whereas last Fall was perhaps a 2 or 3, at best. As economist Robert Wenzel points out:

> And keep this in mind, we have never seen a collapse of a currency like the dollar. Even the hyperinflation during Germany's Weimar Period cannot serve as an example. Since the dollar is the reserve currency of most of the world, a panic out of the dollar means more dollars will return to the U.S. shores than any country has ever experienced.
>
> Other countries have had collapsed currencies, but never in the history of world of finance has so much currency been held outside a country of issue that could come flying back, almost on a moment's notice. If the panic out of the dollar starts, even if Bernanke stops printing money (unlikely), all the dollars flying back into the U.S. could cause a huge price inflation all on its own.

*Killing the stock market to lower long term yields*. If Bernanke's biggest threat is high long term yields, the easiest way to prevent or postpone a yield ramp is to kill the stock market and create a flight to safety situation that lowers long term yields. As the 30 Year yield started rapidly advancing in May of this year, we became increasingly vocal that this was a likely scenario. When it hit 4.83% on June 10 (and the 10 Year broke 4.00%), and we became aware that that M2 non-seasonally adjusted (M2 NSA) was on the decline as it had been the previous summer preceding the fall meltdown, we become open to the possibility of a large correction, perhaps to retest the 666 low in the S&P 500. Previously, we had been very bullish because of the inflationary money printing. Indeed, the S&P 500 corrected about 32% of its gains from its June 11 high and Treasuries had a sizable rally. On the break of the widely watched head and shoulders neckline in the S&P 500 in early July, we speculated there would be another failed rally that would finally reverse and take equities much lower. What happened, of course, was the monster rally that rose to new highs.

During this time, we revised our theory and became open to the possibility that there would not be an intentional market crash, but that Bernanke and the FRNY would engage in a dance that would see equities rise, then correct just as Treasuries were in danger of picking up downward momentum (and yields upwards momentum), then correct again just when it appeared that equities were in danger of crashing. In retrospect, this was the more logical choice because the FRNY, with the large member banks on its board, would not have permitted another major equities downturn if it could help it. Nor would the administration have permitted this, as it needs as much political capital as possible to achieve its massive reform agenda (including healthcare). Such political capital would evaporate in an instant with another major hit to 401(K)'s. Not to say that Bernanke prefers a falling stock market (which would hurt is chances of re-nomination), but it is the lesser of two evils. For those who wonder why Bernanke, an expert in depressions, is operating from the Japanese playbook that resulted in their *lost decade*, we submit that it is intentional and preferred to financial apocalypse.

As we have written often, this clash of the Titans, equity vs. bonds game, is a very dangerous one with much to go wrong. However, to date, it has worked. We have seen one short covering rally after another that has resulted in a materially higher stock market and long term yields under apparent control. We should also note here that we are intentionally painting a binary picture to emphasize probabilities when, in fact, there are many shades of gray. If the stock market crashed, it would severely jeopardize Bernanke's ability to be re-nominated as Fed Chairman. Similarly, the FRNY does not want economic Armageddon as a result of skyrocketing interest rates. In fact, the long term interests of Bernanke and FRNY are closely aligned, while the short term interests have Bernanke favoring Treasuries over equities, and the FRNY vice versa. Unfortunately, long term interests seldom carry great weight in politics.

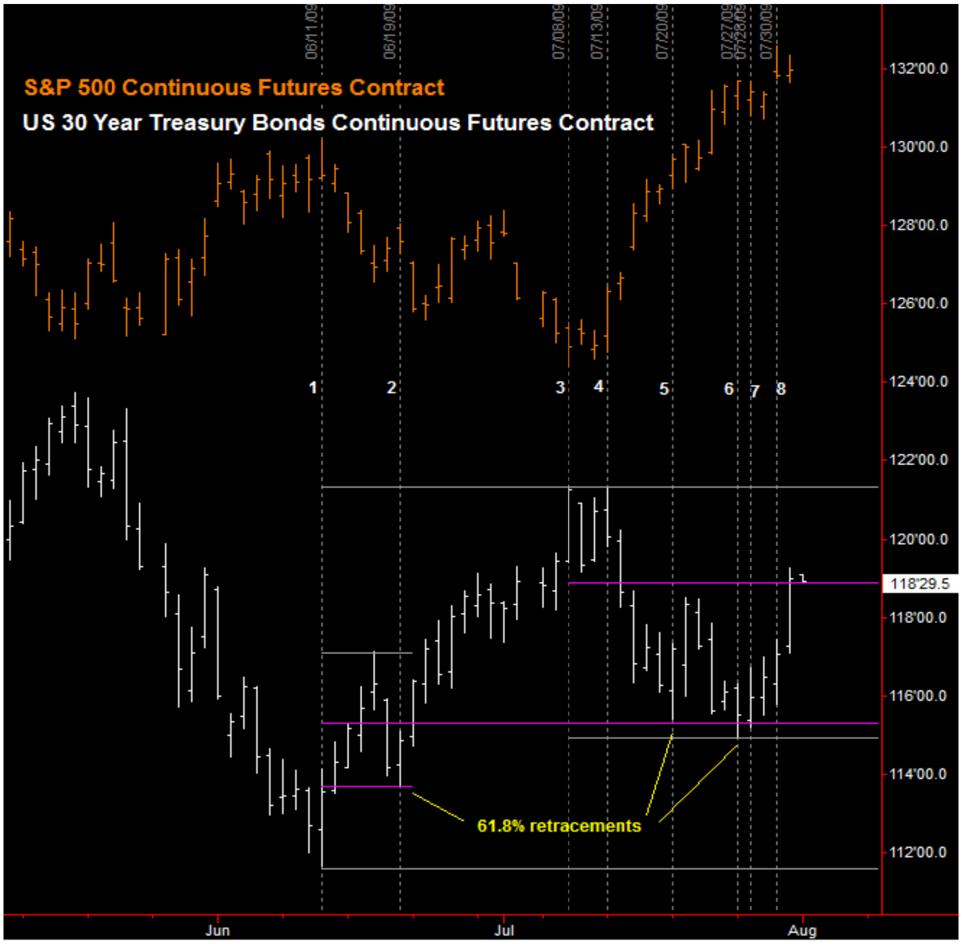
*How to ramp Treasuries*. So far, we have discussed POMO as the preferred means of equities ramping. Likely, there are many other things at play, but POMO is the most obvious. On the flip side, we need to discuss what goes on in the Treasuries side that allows them to gain (and yields abate). To test the theory of whether POMO money was simply being diverted from equities into Treasuries by the large banks, we created Time Profiles (not shown) of POMO vs. non POMO days during the June Treasuries rallies, and found there was not a noticeable edge that would suggest as much. Also, there is no reason to assume that large financial institutions would willingly participate in a stock market decline when their short term interests are so heavily weighted in favor of rising stock markets. Instead, we believe (1) that the Treasury auctions, beginning in June have been rigged to demonstrate heavy interest in long term US Treasuries, and (2) money supply volatility (as measured by the 13 week % change in M2 NSA) has been whipsawed from a historic high to a near-historic low, with the intent by Bernanke of cooling equity rallies (and encouraging Treasuries recovery). We wrote a detailed analysis of this latter phenomenon last week and summarize it after the next paragraph.

*Record Treasury auction participation*. As to (1), above, we do not believe it was a coincidence that the June 2009 auctions in the 2, 5 and 7 Year (all for record amounts) went off spectacularly, with high bid to cover ratios and high non-primary dealer interest. 30 Year bonds were able to push through resistance on this strength after having retraced to the critical 61.8% level from the prior high (which was the first leg up in the 30 Year since its drubbing temporarily ended on June 11). We will get to the importance of technical levels in the 30 year later. We do not know the exact means of how these particular auctions could go so well while prior months' (for lesser amounts) had not. All we can measure is the effect, which is all too perfect for us to believe it was an accident.

*The M2 Volatility Factor*. As we wrote last week, M2 NSA has a seasonality that typically peaks in the third week of April, then declines into the third week of July. We found a strong correlation between the degree of whipsaw of M2 (M2 Volatility) and the likelihood of a large stock market correction or crash into the third week of October, with corresponding high volatility during such time. Historically, the FR does not have much ability to directly influence M2, with its effects typically confined to the monetary base (M0). However, the Fed has now historic *emergency* powers, including the congressionally approved ability to pay interest rates on excess reserves, and we believe the record M2 Volatility is an intentional act by Bernanke. Exactly how and the speed with which effects can be induced by Bernanke on M2 are unknown to us (another point for future exploration). Another possible side effect of a shrinking supply of Dollars (in the form of M2) is that, with excess money sidelined or otherwise tied up, it is easier to steer money from equities to Treasuries and, correspondingly to have a tight leash on yields. Unfortunately, with record M2 Volatility comes a greatly increased risk of a stock market crash, that even record POMO operations and other innovative FRNY machinations may not be able to avert.

***Charting the rebound in Treasuries with the 30 Year Bond***

The 30 Year bond continuous futures contract has been behaving technically the best in our opinion (as opposed to the 10 Year Note or other ETF based proxies), and we will use it to demonstrate the sequence of events in its recovery. Also shown is the S&P 500 continuous futures contract.




1. June 11 2009—the low is (to date) in for the 30 Year and the high is in for the S&P 500. Both post strong reversal candles. At this point, the 30 year had the critical 5% yield target in sights (high of 4.82% intraday). Equities had had a nice run and could afford a correction.
2. June 19 2009—the last Friday before the dreaded record Treasury auction week ahead, the 30 Year retraced to critical 61.8% support from the high posted two days prior, but closed strong enough to abate fears of a gap down on Monday. That following week, the 30 Year would post new highs for the month into Thursday's 7 Year auction and equities also had a higher week lead by a huge rally on June 25 for no apparent reason (which was, though a POMO day).
3. July 8 2009–As equities resumed their downward direction in the following weeks, the 30 Year eventually posted its high on this date, which was also the low for the S&P 500 that broke the neckline of the head and shoulders pattern. This would be *the* July low for the S&P.
4. July 13 2009–The rally in the S&P really began with the strong short covering rally on this date, lead by the record earnings announcement by Goldman. Further outsized gains were made two days later on the JP Morgan earnings that allowed the S&P to clear most of the difficult mid-range resistance.
5. July 20 2009–With the S&P 500 within a hair of punching through to new highs, the 30 year had retreated again to its 61.8% resistance intraday, but very successful 3 and 6 month auctions allowed for a strong close.
6. July 27 2009–One week later, on the start of another record auction week, the 30 Year actually pierces the 61.8% support line intraday and closes dangerously low, but just above it. The 3 Month, 6 Month and 20 Year TIPS auctions had strong demand and saved a likely return of the 30 Year to contract lows as the S&P continued to make new highs. The continuous futures contract for Gold (not shown) precisely hits its 61.8%

resistance.  A break to the upside, would warn of an inflationary retest of the 1,000 level and would be a disaster for Treasuries.

7. July 28 2009–Gold reverses to the downside sharply overnight and the EuroYen forex cross (not shown) posts an equally large reversal to the downside, indicating an aversion to risk (supportive of Treasuries as a safe haven).  We believed at the time that these markets had been manipulated to intentionally send a signal that the Treasury auctions would be successful overall this week and that upside action in equities was limited.  Equities would make higher gains on Thursday after Wednesday's poor 5 Year auction, but Treasuries were short term spared, even after the poor results of the 2 Year auction on the day prior date (which we wrote at the time we thought was a head fake).  What surprised us was the worse showing at the 5 year the following day.
8. July 30 2009–Demand had been spared for Thursday's 7 Year auction, which saved the entire week and allowed for the next day's (Friday) huge (nearly 2 big points) gain in the 30 Year that broke through prior swing high resistance.  At this point, the Bernanke has averted disaster and has a week before facing another round of Treasury auctions (the 3, 10 and 30 Year) and an FOMC meeting.

***Signals from Leading Markets***

As we suggested in (7) above, leading markets, such as gold and the EuroYen can be manipulated at key points to generate signals that savvy market participants can read.  We find it no coincidence that the FRNY has large holdings of gold and exactly two currencies, the Euro and the Yen.  These markets turn or break through important support and resistance levels all the time; however, looking to whether Treasuries or equities are in jeopardy at a particular moment can give clues as to whether an actual signal is being given as opposed to normal market movements.

***Putting it All Together – the Weeks Ahead***

The stakes could not be higher for the week of August 10 to August 14 2009.  What is troubling is that, as we mentioned in (8) above, demand had to be saved for July's 7 Year auction as opposed to the prior month where all the auctions fared well.  We don't doubt that Bernanke will pull out all the stops to ensure a decent showing of demand in the 10 and 30 years on August 12 and 13, especially in light of the August 12 FOMC meeting (and his assumed desire to be reappointed after next January).  However, we are not so sure he will be entirely successful.  If, as we suspect, the results have the potential to disappoint, the 30 Year will need to have advanced further (ideally to a safe level above the July high) to absorb the disappointing auction news without leading to a prolonged selloff in Treasuries.  With the 30 Year having closed just over its 61.8% resistance Friday, it is in a bullish stance to do just this, though it is a bit overbought.  While equities and Treasuries can both advance or decline in semi-lock-step temporarily, even for as long as a week, a move that strong in Treasuries through resistance requires a hit to equities, and we would expect a moderate to strong down move into next Monday (August 9) if Treasuries were able to end up pushing through the early July highs.

If, on the other hand, Bernanke has locked in excellent support for the 10 and 30 Year auctions, then Treasuries merely need to tread water and not violate the 61.8% retracement of last week's range (currently 116'18).  In this case, we would see only a minor decline or a continued nominal upward push in equities.  There are other variations on this theme, but the logic and methodology should be clear by now.  And, while it is a bit early to favor one side or the other, we are currently leaning toward a nervous Bernanke and the need to ramp Treasuries at the expense of equities into August 9.  Equities have had more than a nice run and can suffer a bit of a correction.  Key will be watching the close on Wednesday.  A failed POMO paint the tape close could signal that an equities correction of at least a few weeks has gotten underway.

***Conclusion***

Nothing would please Bernanke and the FRNY more than to see both low long term yields and higher highs in equities for perpetuity.  However, the juggling act required to ramp both equities and Treasuries is unprecedented in both consequence and complication.  In the end, we have low expectations of success.  Hopefully, with this framework, we will be able to better navigate the markets and steer clear of the next major crisis, should it arise.  As always, we will be monitoring markets within the framework of these ideas in real time and will report findings to our readers, beginning with our analysis of overnight action this morning.