

Today's Notes:

1. WILL CHINA RENEGE
2. DISCOVERY INVESTING TUTORIAL- VIDEO
3. THE PRINCETON CLUB SEMINAR

1. CHINA AND ITS OIL FUTURES

There are two significant events that have recently transpired. Spurred by rumors of speculation in the oil markets Washington (Gary Gensler's CFTC) is reviewing its futures market regulatory stance. New CFTC Chief Gary Gensler promises an increase in regulation. Because Mr. Gensler is a Goldman Alum, we think any serious re-regulation is unlikely. We have always been fans of the options (not the futures market) here at DisocveryInvesting.com. Cash settlement in the futures market leaves us cold – just as it did during the massive equity market decline of October 1987. Will we ever learn?

How many OTC derivative and futures-induced bubbles must burst before we properly design our derivative contracts (position limits, margin requirements, no cash settlement, etc.) and regulate naked shorting – which is nothing more than stealing from honest shareholders. Birch Mountain is the most painful example of naked shorting, in my opinion.

And in academe, teaching CAPM, Value at Risk, Black/ Scholes and Binomial option pricing as the major risk discounting vehicles on which base risk analysis and valuation of the markets is naïve. In reality it has become mark-to-model in all markets. Assuming the world is **Normally** distributed (Gaussian) in its risk profile is a simplifying yet failed assumption. Mathematics as the driving force is out. Perhaps Pimco's Bill Gross is correct there is a **New Normal** – fat tails and Black Swans anyone?

We do not agree with all the talk in New York and Washington, especially from the naive meanderings of the Obama capital market people, on the evils of speculation. Simply design a fair and transparent listed options contract and then establish the framework to run the options markets properly. Because we can print cash, according to the Federal Reserve's Bernanke, unbridled cash settlement of futures is a no, no. Never mind, the big players have been lifted from the muck and mire by the "too big to fail" label and the egregious violation of **Moral Hazard**. Really what does risk taking mean anymore to any large institution? Perhaps this is China's concern.

A fair, listed and transparent derivative market cannot be beyond the reach of today's capital and futures market thinkers. Goldman Sachs and JPM could take the lead here. Citizens, investors and legislators need to become self-educated and must demand no less.

The second issue of importance is China's recent threat (See China Economic Review September 2, 2009) to walk away from some of its futures contracts in the oil market. More important is the rumor that China has made the long side of the gold and silver futures market for the likes of Bear Stearns, JP Morgan, HSBC and other shorts. Should China walk away from its gold and

silver positions all hell will break loose. Ted Butler, the most well known and prescient silver analyst, in the world, has recently written on the potential of this.

Twenty two years ago (early October 1987), I presented at the Citigroup Asian Country Head seminar run by Harvard University in Singapore. At that time I forecast the great market collapse of 1987 reasoning that the equity futures market would be undone by the futures market. I reasoned that portfolio insurance (another can't-fail futures product of Wall Street) would crash the market. Following that I spent a good deal of time in the next decade in Asia. In 1995 I was invited to present my analysis of China's nascent T-Bond Futures market. I presented to the CSRC (the equivalent of the US SEC) in both Beijing and Shanghai. It was a wonderful experience. Most of the terminology did not exist in the Chinese language at the time (simultaneous translation). In any event, after I finished and described the effects of the 1987 equity market demise they abruptly shut the futures market down. It reopened only a few years ago. This AM I sent this email to my good friend Chris Tibbs who had invited me on behalf of CitiGroup and China to speak.

“Chris,

We said all these things (position limits, margin, cash settlement, etc.) about the futures market in 1995 while in China. The case study of the 1987 portfolio insurance debacle should have been enough. What we did not mention then were fast trading strategies, unlisted derivatives and the morality of the other side. I am amazed that China is threatening to walk away from some of its oil futures positions. They would not do this if they did not know much more than they are reporting. Sure, they lost money on their oil futures but they made a contract. Based on our experiences I assume no one twisted their arms to buy.

What do they know about their losses that have them angry enough to threaten so publicly to walk on futures contracts? The particular issue here is the hundreds of millions of dollars that Chinese SOE's lost on their oil futures positions.

The next issue of interest may be the gold and silver futures markets - JPM and HSBC (up to four firms according to Ted Butler via his excellent analysis of the COT) recently established the largest commercial short position ever - on silver. China has encouraged its citizens to buy silver in up to 5 kilogram bars - which could make Revett and Quatterra much more valuable. But with commercial silver shorts at record high levels would China also walk from its silver and gold futures contracts? What might happen?

Would new CFTC Chief Gary Gensler (a Goldman Sachs alum) re-regulate and modify the oil futures market / contracts and not the gold and silver futures market? Unlikely.

I think Ted Butler has it right on - this AM we have gold over \$1000 - let's see what happens by 11 AM on the COMEX.

I emphasize this because I remember so well your comments, Chris, that when Chinese authorities act they act very quickly - as per our futures market presentations to the CSRC in 1995 in Shanghai and Beijing and the subsequent shut down of their futures market for years. Personal experiences!

Perhaps China would actually like to see gold and silver prices fall so dollars could be swapped more economically for the precious metals. Interesting times - the shoe may most definitely be on the other foot now. Maybe it is simply a message from China as there have been so many lately.

http://www.chinaeconomicreview.com/dailybriefing/2009_09_02/SASAC_clarifies_statement_on_derivatives_contracts.html

It will be a most interesting time for gold and silver investors as we move forward. Please be sure to have a core discovery position in gold and silver.

2. DISCOVERY INVESTING TUTORIAL

Finally I have completed a University style lecture on Discovery Investing. I would be most interested in feedback that you may have, good, bad or indifferent as long as it is constructive. This is an introductory seminar. I plan to present several more which will be more detailed and focus on specific topics; the 10 point grid, the 8 point discovery process and risk analysis. We will also present three case studies (both winners and losers) to help in the teaching of the technique. The video is about 30 minutes in duration so I do not think it will be a waste of time. I am available to present these topics at any live conferences that you may be attending.

http://rs6.net/tn.jsp?et=1102684391176&s=2721&e=001n6svihhR4KlwANefvx9dxDGZg_Mc135idJZ7LWl67LCKVXwsCeHdywY2WGaa02ylz-IUjCytPyH0leQ_V4aV0tXOjs-CkOmWU14RsPSOOjDuaOIWkEz8X4bvXur1BWz45UVGq4BdxuC9RjNknguBbfdZEEapLFcvrzVZK931LCBuTZA7AiYMUmaQQW8NfDxxJl2TmpXf4kKmP3fXTyM9v_I9DTp7_w0nEwGF8Whcsew=

3. PRINCETON CLUB SEMINAR SEPTEMBER 10TH 4:30 PM

PLEASE JOIN US !!!

QUATERRA RESOURCES

Dr. Michael Berry will open with a discussion “Where Are We Headed in the Economy?” followed by Dr. Thomas Patton, CEO, Quaterra Resources “The Bright Future of Quaterra.”

Quaterra’s silver exposure in Mexico is one critical aspect of his discussion

***Thursday, September 10, 2009
4:30 PM to 6:30 PM***

Cocktails 4:30 PM

Presentation promptly at 5:15 PM

**Princeton Club
15 West 43rd St.
New York, NY**

RSVP to info@discoveryinvesting.com

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