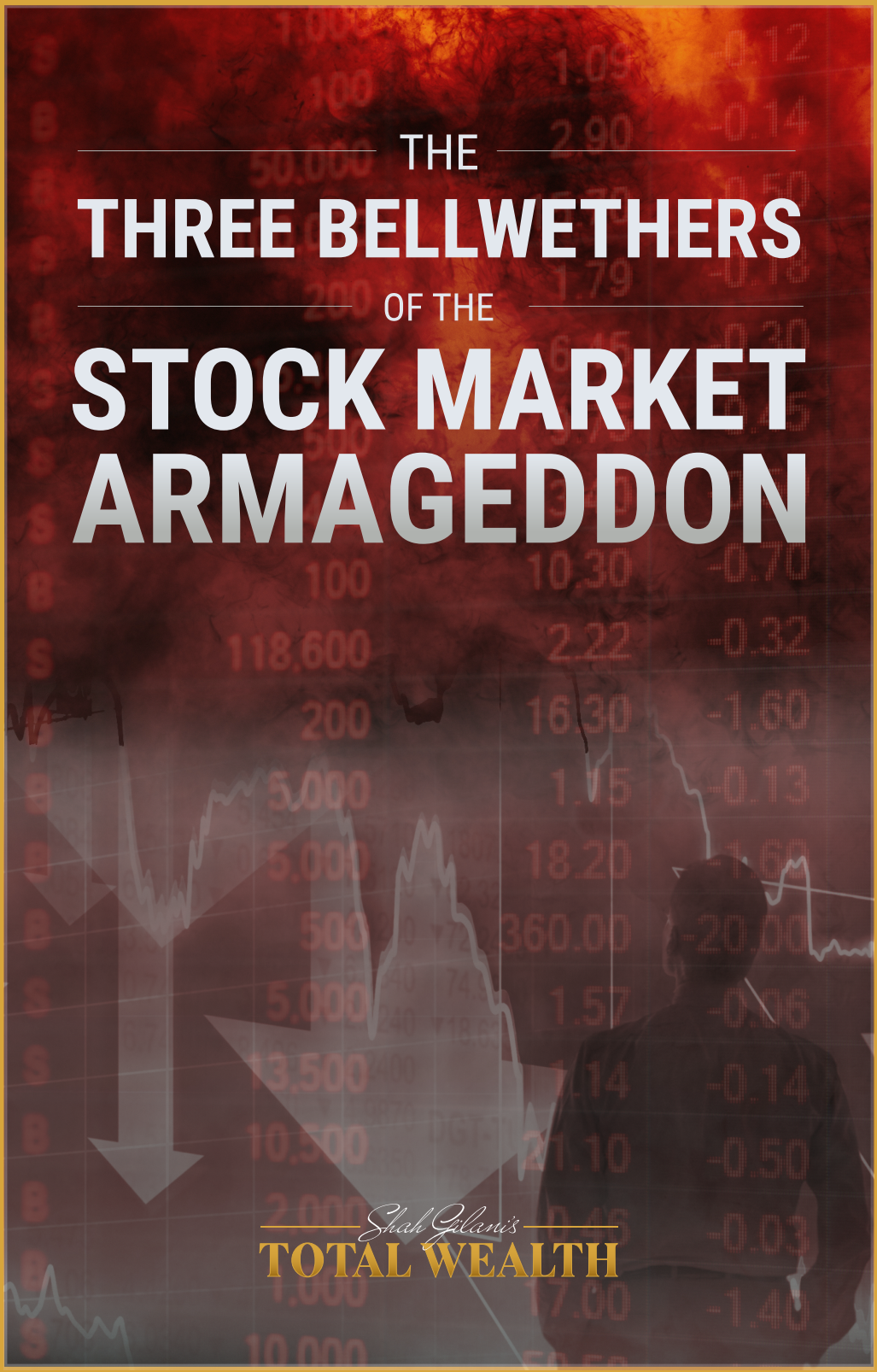
THE THREE BELLWETHERS OF THE STOCK MARKET ARMAGEDDON



Shah Gilani's
TOTAL WEALTH

The Three Bellwethers of the Stock Market Armageddon

It's a tale as old as time: *the four horsemen of the apocalypse*. It dates back to the Bible, the Book of Revelation, when the four evils of the world ride in on their horses, ready to take out humankind, maybe with a bang, maybe with a whimper.

The concept has been parodied countless times, but one thing remains the same – the warning signs. No bad event happens suddenly; there are always warning signs to tell you that something is coming, but most often, we don't see the signs until it's too late.

Right now, we're seeing something called irrational exuberance, which means "investors" are buying and buying and buying, driving stocks higher on nothing but hot air. They're writing checks they can't cash by buying what's popular, backed by nothing, not a balance sheet, a market cap, or even an empty promise.

These stocks are rallying, being chased up by investors, and when they reach their peak... down they'll come, harder and faster than they did in the tech wreck of 2000.

But before that happens, you'll see the three bellwethers of the stock market Armageddon, a phenomenon not unlike those four horsemen – but you've got to pay attention.

Here's exactly what to watch out for, before you're caught in the landslide of the next massive market crash.

Bellwether #1: Bonds

Just because the master manipulators at the Federal Reserve say they're going to backstop U.S. bond markets, as well as debt on corporate balance sheets, doesn't mean they can.

It's true they're managing easily enough in the early rounds of the fight to save debt markets, corporations, and the economy, but they're going to have to do more, including the impossible, when their real opponent comes out swinging.

To its credit, the Federal Reserve's plan to save the stock market from imploding when it got hammered by the coronavirus was to backstop all bonds and everything related to debt and debt markets, where borrowing was coming to a dead stop as it did in the financial crisis of 2008.

Equity markets are initially always more important in a financial crisis than bond markets. That's because equities always fall faster than bonds, and when they crash, they drive news headlines, squash investor and consumer confidence, and more directly and immediately impact Americans' savings, retirement portfolios, pensions, and standards of living than falling bond prices do.

But if equity markets fall, bond markets won't be far behind. By backstopping debt markets, especially where corporations borrow directly, the Fed quickly becalmed equity markets and signaled an all-hands-on-deck "risk-on" riot.

As equities soared off their March lows, bond investors tepidly at first but with exponentially rising enthusiasm watching stocks skyrocket, flooded markets with buy orders to pick up depressed bond issues that not only were being backstopped by the Fed but were also being buttressed by buoyant equity markets.

Of course, there's a problem with all the backstopping debt markets have been getting. There's no meaningful risk premium being priced into new debt issuance and bonds in general, on account of investors believing the Fed's going to be there to pump up asset prices.

But there's a monumental difference between liquidity, which is what the Fed's been supplying, and solvency, which is the degree to which the current assets of a company exceed its current liabilities.

For example, if you owe $1 million and can't pay interest on what you owe because your assets, your means of producing income, have suddenly disappeared or are severely impaired, and the Fed offers you help with paying or deferring them, you'll take it and survive in the short term.

But if your income doesn't rebound, when the new short-term borrowing you owe gets tacked on to the rest of what you still owe, increasing your long-term liabilities, you're likely to become insolvent and default on your debt. The likelihood of default increases if your income declines or if interest rates start rising.

That's been happening in the corporate world for years.

So-called zombie companies that have managed to roll over debt as the Fed's consistently lowered rates while their revenues decline are now being joined by COVID-19-impacted companies, which are mostly surviving because Fed liquidity spigots slaked short-term liquidity needs.

With rates having been manipulated down to record lows and bond investors willing to take on any and all risk believing the Fed has them covered, there's not much room in the future for the rising

number of zombie companies to survive if they can't generate enough revenue to make their debt service or if rates rise and the cost of rolling over their debt finishes them off.

In the second quarter of 2020, the debt-to-EBITDA ratio (earnings before interest, taxes, depreciation, and amortization) for high-grade companies was 3.53, according to Bloomberg Barclays. That's the highest it's been since 1998, and it's 33% higher than the 20-year average of 2.65.

It's a lot worse for junk bonds. At the end of June 2020, the debt-to-EBITDA ratio for junk issuers was 5.42, up from 4.93 in March, and 4.44 at the end on 2019.

One egregious example is **Avis Budget Group Inc.** (**NasdaqGS:CAR**). While competitor **Hertz Global Holdings Inc.** (**NYSE:HTZ**) declared bankruptcy, CAR's debt-to-EBITDA ratio soared from 5X to 27X.

The average junk-rated company now has debt levels three times higher than what the Fed warned companies was excessive in 2013, and again in 2016. They've since dropped their warnings.

With corporate earnings across the board down by one-third in the second quarter, while companies piled on debt to maintain liquidity and stave off insolvency, leverage is rising rapidly.

Yet, bond issuance continues because it must for some firms and it's cheap to borrow.

U.S. corporate debt issuance is annualizing at a record rate of $2.15 trillion in 2020.

Low rates and investors' sense that the Fed's taking over default

risk by taking on credit risk will only encourage more issuance.

So far, it's all been good, because investors have done the bulk of the Fed's work for them, buying up new issues and secondary issues, elevating bond markets while tamping down yields with their speculative buying of everything from investment grade bonds to credit ETFs.

Why speculate in credit ETFs? Because the Fed's promised to buy the likes of **iShares iBoxx $ Investment Grade Corporate Bond ETF** (**NYSEArca:LQD**) and **SPDR Bloomberg Barclays High Yield Bond ETF** (**NYSEArca:JNK**), and yeah, it's a junk bond ETF.

If corporate revenues don't rebound as advertised or if interest rates start rising, the Fed and bond investors are in big trouble.

If revenues don't trend higher or backslide, corporate borrowers are going to feel the pain of their leverage and debt service.

More importantly, interest rates could rise.

Of course, the Fed's not going to raise rates, even if inflation measures flare, Chairman Powell recently said so in his speech from the virtual Jackson Hole central bankers' conclave.

That doesn't mean bond investors won't hedge their holdings by shorting bond derivatives, or start paring portfolios, or stop buying new issues if they don't perceive there's enough rising rate premium in them.

That's how rates could start rising.

It wouldn't take much for even a small backup in rates to panic investors into taking profits and selling to cut potential losses, since

bond investors are always leveraged to increase their returns.

It could just work.

But if not, we'll see it in how **iShares 20+ Year Treasury Bond ETF** (**NYSEArca:TLT**), LQD, and JNK trade – these are your three best bond bellwethers.

What to Do Next

Note: The dark green horizontal lines are support and resistance lines.

iShares 20+ Year Treasury Bond ETF (NYSEArca:TLT)

The middle support on TLT is at $160. If TLT can't hold that support level, start paring your stock positions and short TLT. If TLT breaks below its lower support at $153, you're going to be glad you shorted it and took profits on your stocks.

iShares iBoxx $ Investment Grade Corporate Bond ETF (NYSEArca:LQD)

On LQD, support comes in at $134.50. If LQD can't hold that level, short it and start taking profits on your stock positions – you'll be glad you did if LQD breaks below its lower support at $131.

SPDR Bloomberg Barclays High Yield Bond ETF (NYSEArca:JNK)

Support on JNK, the junk bond ETF, is at $101. JNK's trading a lot higher and looks like it can break out of resistance at $106.30 and go higher. That's because of all the speculators in high-yield bonds and because the Fed's buying shares of JNK. But if JNK backtracks and heads down to test its support, it's a sure sign the Fed's losing control of rates, and you'd better take your profits everywhere – in your stock positions and any bond positions you have.

Bellwether #2: The "Big Five" That Control a Quarter of the Broader Market

I am, of course, talking about what I call the "FAAMG" stocks – **Facebook.com Inc.** (**NasdaqGS:FB**), **Apple Inc.** (**NasdaqGS:AAPL**), **Amazon.com Inc.** (**NasdaqGS:AMZN**), **Microsoft Inc.** (**NasdaqGS:MSFT**), and Google's parent company, **Alphabet Inc.** (**NasdaqGS:GOOG**). These five stocks account for 25% of the valuation of the entire S&P 500.

That's *five out of 500* stocks.

That means as the price of those five stocks goes up, their equity capitalization (price per share times number of shares outstanding) goes up, and their impact on the much broader indices and ETFs they're in goes up significantly.

Any movement in any of them impacts the S&P 500, which is the most watched, followed, traded, and important stock market measure in the world.

For starters, the Dow Jones Industrial Average, which, as of Monday night, was less than 4% from its all-time highs. It then rose a stunning 54.11% off its March 23, 2020, lows as of the end of August and is now only 0.03% away from being positive year to date.

The S&P 500 rose 56.78% off its March lows and, at of the end of August, is up 8.4% in 2020.

And the Nasdaq Composite, which shot up 70.47% from its March lows, is up 31.23% this year.

All the indices owe their gains to the "FAAMG" stocks (and one more stock, but we'll get to that in the third bellwether).

FB powered 99.51% higher off its March 18, 2020, lows and is up 42.8% year to date as of August 31, 2020.

AAPL jumped 130% off its March 23, 2020, lows and is up 75.77% as of August 31, 2020.

AMZN leapt 105.8% off its March 12, 2020, lows and is up 86.78% year to date.

MSFT shot up 65.85% off its March lows and is up 43% year to date, as of the end of August.

GOOG ran up 54.66% off its March 23, 2020, lows and is up 22.22% year to date.

That's what I call irrational exuberance.

Again, just because there's a lot of hot air blowing these stocks up doesn't mean they can't get blown up a lot more.

Enjoy them inflating, but don't sell them. Just use trailing stops to protect your gains as they get pumped up.

And keep these "levels" in mind, meaning mark them on your graphs and on your brokerage statements. Because if these stocks break down through the proprietary levels I've calculated below (which are close to technical levels traders are going to

be watching), that will be the ringing sound of for whom the bellwether tolls, and you don't want it to be you.

What to Do Next

If FB backtracks to $278, take some profits; if it backtracks to $258, take some more. If FB heads quickly towards $225, you'd better hope it stays there, otherwise it's time to take your profits and see how low it can go before you buy back in.

If AAPL backtracks to $118, take some profits; if it backtracks to $99, take some more. If AAPL heads quickly towards $88, there's a good chance it will test support at $82. You'd better hope it stays there, otherwise it's time to take your profits and see how low it can go before you buy back in.

If AMZN backtracks to $3,245, take some profits; if it backtracks to $3,085, take some more. If AMZN heads quickly towards $2,886, you'd better hope it stays there, because if it can't, it's time to take your profits and see how low it can go before you buy back in.

If MSFT backtracks to $217, take some profits; if it backtracks to $200, take some more. If MSFT heads quickly towards $187, you'd better hope it stays there, otherwise it's time to take your profits and see how low it can go before you buy back in.

If GOOG backtracks to $1,543, take some profits; if it backtracks to $1,462, take some more. If GOOG heads quickly towards $1,398, you'd better hope it stays there, otherwise it's time to take your profits and see how low it can go before you buy back in.

As bellwethers, you want to be watching each of these stocks and their support levels. One or two breaking down will likely let you know there's trouble ahead.

If they all start breaking down at the same time, just take all your profits off the table, and get ready to run.

Bellwether #3: Tesla

Okay, you're a **Tesla Inc.** (**NasdaqGS:TSLA**) fan, I get it. Me too. I love their cars, especially the S models.

But falling in love with the stock and believing TSLA's more than what it is at this juncture, which is a car company, not the Amazon of all things electric and a transportation technology platform, though Ringmaster Elon Musk would have us believe in his magic, is just wishful thinking.

TSLA's got problems, accounting problems in my opinion, and I'm not alone thinking that.

In a July 23, 2020, piece at ZeroHedge by "Toulour" titled, *Gordon Johnson: Tesla "Engaged In Accounting Games" To Make Their Q2 Profit*, Toulour begins the piece by saying, "Gordon Johnson of GLJ Research put out a note after Tesla's earnings telling us what we already know for the most part: Tesla's growth story is an illusion and the company was only able to turn a profit when it reported yesterday due to the sale of regulatory credits and other financial engineering."

It looks like TSLA sold, or accounted for sales, of $428 million in "regulatory credits" in Q2, which helped it register a $16 million GAAP net profit. Three GAAP profits in a row now and TSLA's being considered for membership in the vaunted S&P 500. I'll come back to that, for sure.

What are regulatory credits? Funny you should ask…

They are programs like California's **Zero Emissions Vehicle (ZEV) program** which mandates automakers sell a certain number of electric vehicles relative to total sales to receive credits. Ten other states in the U.S. have adopted similar measures. If an automaker ends the year without sufficient credits, they're fined – that is, unless they buy them from a company exactly like TSLA.

According to *Car & Driver* magazine, "Similar measures have been put in place in the European Union, where rules mandate average emissions from new vehicles. In order to avoid what could have amounted to over $2.1 billion in fines according to analysts, **Fiat Chrysler paid Tesla** hundreds of millions of dollars so their vehicles are counted in the same fleet and therefore FCA's emissions are averaged with those of Tesla."

TSLA's been racking up revenues by selling credits for years, which a lot of investors don't understand, or they think it proves how smart TSLA is.

TSLA, make that Elon Musk, understands how to play the credits game.

In 2006, Musk backed his cousins, brothers Peter and Lyndon Rive, founding and building SolarCity, a solar panel company whose existence was predicated on "credits," as in government credits for alternative power, state credits for the same, and power grid credits for selling utilities unused solar electricity – credits, not revenues. TSLA bought struggling, dare I say failing, SolarCity in a $2.6 billion "merger" in 2016. Both cousins are long gone, and the credits are too.

So forgive me if I'm skeptical about TSLA's accounting, its reliance on credits, the irrational exuberance over its future, and its stock price.

What to Do Next

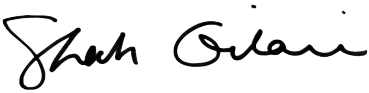
If TSLA backtracks to $400, take some profits; if it backtracks to $320, take a lot more off the table.

If TSLA heads quickly towards $273, you'd better hope it stays there, otherwise it's time to take your profits and see how low it can go before you buy back in.

In closing, the markets won't end, but the stock market rallies might, and there will always be a way to make money. We'll find the best paths to the fastest wealth-building opportunities, mitigate the risk, and double down on the profits when we can.

That's the ***Total Wealth*** way.

Sincerely,



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