PIVOTAL EVENTS

THURSDAY, SEPTEMBER 23, 2004

BOB HOYE

PUBLISHED BY INSTITUTIONAL ADVISORS

"***Too much prosperity makes men greedy and desires are never controlled sufficiently to stop at the point of attainment.***" – Seneca (4 BC-AD 65)

Preface: Occasionally we mention that the investment world is much larger than the focus upon equities would suggest. In particular, during and following a "new" financial era, the play in stocks is very dependent upon the action in the credit markets. Unfortunately, the equity culture becomes overly enthused about all the good news being generated by corporate and economic results as well as being far too reliant upon the abilities of senior central bankers.

The problem with this limited view is that at important stock market bottoms, earnings and the economy typically decline for some months after the trough in the stock market. Often, as the consensus waits for the good numbers, the stock market is enjoying the initial rally of a new bull market.

Going the other way, the stock market leads by a number of months the orthodox measures of earnings, economy, and policymaker boasting.

Watching the wrong but conventional items can be hazardous and this is why we have done a lot of work on commodity prices and credit conditions, which have often anticipated disappointment in equity land.

This week's edition will start with the financial sector but, before this, it is worth noting that the stock market, commodities, and credit spreads seem to be setting a big test of highs set earlier in the year.

INTEREST RATES

Credit Spreads: This sector was likely to participate in the August revival of the "good stuff". The action has been vigorous enough to generate this week's glowing storylines: "***Junk Bonds Gain Luster as Investors Seek Yield***". This became a little zesty this week with the observation "***There is still tremendous demand out there that has not been met***."

The latter relates to the fact that a growing number of corporations are building cash rather than borrowing to expand plant and equipment; therefore, a lower supply of junk. On the former, the compulsion to reach for yield at the top of a business cycle usually suggests untimely confidence.

At times such as this year, it can be a winner. For example, since early 1998 the DJIA has gained 3%, 10-year treasuries are up 7.5%, with emerging debt making a big one at +22%. According to a September 12 **WSJ** review by Merrill Lynch, "***Emerging-Market Bonds Handle Rate Increases***".

This continued on Tuesday's increase, but the enthusiastic headlines and the technical aspects of the big test of previous highs suggests picking up the pace of selling risk.

The high-yield spread set what is most likely a cyclical low at 194 bps, over treasuries, at the end of January. This then widened to 295 bps in May, from which it came in to 235 bps on September 15. With a couple of zig-zags, it has widened to 247 bps yesterday. A tested reversal to widening over the next few weeks seems likely and we would take this as a warning of a developing liquidity problem.

The Yield Curve: This action is fascinating. Typically, as a business boom matures the yield curve flattens or even inverts as short rates rise relative to longs. This we have but, also typically, this is accomplished as both short and long rates ***increase***.

On this one, it has been different. The bill yield has increased from 0.98% in May to 1.71% this week as the 30-year has decreased 77 beeps to 4.78%. By this measure, the curve has flattened from 457 bps to 308 bps.

With this, the more widely followed (30-yr. to 2-yr.) segment has flattened from 302 bps to 232 bps yesterday. On the move, the 10-year yield has declined from 4.85% to 3.98%.

The point to be made is the one we hammered in the first half of 2000. When the curve inverts, a recession follows and, in many examples, all it took was the curve approaching inversion. The instruction from the past is that the key is not so much whether inversion occurs, but when the reversal to steepening happens it signals the end of the party.

It seems that the best explanation that the curve has not inverted is because "the world"[1] has been buying longer dated treasuries. This segment has been one of the party animals.

---

[1] This week, the shorts joined the party.

In the summer of 2000, Wall Street pundits were very distressed about the increase in Fed funds from 5 ½ % to 6%. Our advice then was that rising rates indicated that the party was still on. The worry should be about bill rates reversing to a decline.

On the big picture, it is usually sound to ignore changes in the Fed rate and its associated comments and watch for the reversal in the curve.

The change to steepening and spread widening will signal a pending liquidity crisis.

The Bond Future: In a year that has featured a series of speculative spikes, it is likely that the uptrend in long government prices would conclude with some excitement. This seems to be happening with some big players on the wrong side.

"***A broad swath of participants seriously misjudged the market's ability to rally in the face of Fed tightening***." - **WSJ**, September 23, 2004

Well, the Fed is again getting in line with the trend in short-dated market rates of interest. The term "Fed tightening" may not be accurate. Yes, the administered rate was increased, but that the Fed is voluntarily tightening is doubtful.

Traders can ride the rally for another week. Levente will advise.

Stock Market: The ChartWorks has been looking for both a momentum and price high in the September 8 to 14 window and the momentum objective has been accomplished. Indeed, in a thrilling, if not standing ovation, acclamation of Greenspan's words on Tuesday, "they" knocked the dollar down and ramped up all the carry-trade games.

Last week, we noted that if the S&P rallied above 1130 then the high side of the target, which was 1143, could be reached. On the very positive action on Tuesday, the S&P closed at 1129, which compares with 1128 on September 14 and 1158 earlier in the year. Yesterday's drop is a warning.

Sector Comment: Base metal prices were expected to recover with the stock market into September. Our index, including nickel, has rallied 15% since September 9. This is the kind of action needed to conclude the move at about the right time.

With this, the "old" cyclicals, such as the mining index, has recovered to 237 which compares with the 241 high earlier in the year.

SOX plunged from 555 early in the year to 352 on September 8. In less than two weeks, it bounced 13% to 404, but this amounts to only a 26%

retracement of the loss. It could go a little further but, as most of the games are testing earlier highs from which failure is probable, the SOX could soon resume its downtrend.

Banks and financials have been hit with some news this week. A downgrade for Citi and something rotten for Fannie ended the rally. The BKX set inter-day highs at 100.2 on September 7 and 100 on Friday, which compares with 103 in March. Today it's at 97.

As we noted in the September 9 edition, the banks seemed to be running out of momentum as the Bank Trading Guide had generated a "sell" signal. When this one works, the lead to the high has been around three weeks and the advice of two weeks ago was that "***selling should now become more aggressive***".

The way things look now is that a reversal to widening of corporate spreads would add to our selling convictions. This would likely precede the eventual reversal in the curve to steepening.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: Obviously, the upside target of around 46 for crude oil by early October has been exceeded. The hurricanes have been exceptional, but it still seems quite likely that the first week of October will set the stage for a reversal to an intermediate downtrend.

The 46.25 target was based upon a .618 Fibonacci retracement so it looks as though the high will be a big test of the 49.40 set on August 20.

The storms also rallied natural gas out of its slumber, as it rallied from 4.57 on September 10 to 5.63. We have been looking for 4.10 by late in the year.

Dollar Index: Almost "on cue" with the maestro's brilliant increase in the Fed rate, the dollar index dropped a full handle from 89 to 88. Since then, it has stabilized at 88.3 and our forecast remains with a slow recovery to 91 to 93.

The Canadian Dollar continues to recover with commodities and favourable action in U.S. corporate spreads. We are now looking for some topping action.

Base Metal Prices have continued the advance and, at 304, our index (less nickel) seems to be testing what was thought to be solid resistance at 300.

In only two weeks, our index (with nickel) has soared 15% to 958, which compares to the high of 1015 in July and 1068 in January. Nickel's jump in the same two weeks has been outstanding and likely to be unsustainable.

It seems that this is all part of a volatile culmination of the cyclical recovery out of 4Q 2002. In the first half of this year, the feature was a series of speculative spikes that began with nickel in January and included silver in April. After a period of consolidation, at times severe, the impacted games have recovered to again speculative conditions that seem to be major "tests" of earlier spikes.

Gold continues to act well and, like other items, is close to old highs. However, the distinction is that, while we expect gold to continue in a choppy fashion to 460, the hot games in stocks, bonds, and commodities will decline. That's in dollar terms as well as relative to gold.

Of interest is that, with this week's commodity rally, our gold/commodities index has slipped to 210.

GOLD / COMMODITIES

CYCLICAL			RECENT		
HIGH	255	JUNE/03	HIGH	220	SEPT.10/04
LOW	183	MARCH/04	LOW	210	SEPT.22/04

The next key step will be commodities becoming exhausted and renewing their decline relative to gold. By this measure, it set a tested uptrend of 20% to the 220 high on September 10. Support is at 208 and the breakout level is at 230.

Silver has been expected to recover to 6.85 – 7.00 and this could be accomplished with crude's seasonal high in early October.

Once again, any sudden slump in silver relative to gold will signal that the liquidity problems that always follow a financial binge are one step closer.

Gold Shares: This is the one industry that predictably does very well during the typical post-bubble contraction. Gold's real price (relative to commodities) suffered a cyclical correction from 255 in May, 2003 to the low of 183 in March, 2004.

There will be more of these, but in the meantime the increase to 220 is, as in late September 2000, beginning to anticipate a cyclical contraction in the economy and general stock market.

We consider that this is ***Year 4*** in a 20-year bull market for gold shares. The advice is to buy aggressively on weakness.

MISCELLANEOUS

About a month ago, a trivial item crossed our desk. Wonder Bread invented and has been selling sliced bread since 1930. This really reinforced that the exclamation "***the greatest thing since sliced bread***" needs updating.

The manufacturer of Wonder Bread as well as Twinkies, Interstate Bakeries, declared bankruptcy yesterday and that formally makes the old saying very stale.

Trying very hard to avoid the obvious puns, this reveals a desperate need for a new exclamatory cliché. Readers are invited to make suggestions for a new "***the greatest thing since . . . !***".

	FRI	**MON**	**TUES**	**WED**	**THUR** NOON
SEPTEMBER	**17**	**20**	**21**	**22**	**23**
Swap Spread	43.5	42	41.75	40.75	40.75
High-Yield Spread	237	240	242	247	-
Treasury Curve	322	317	313	308	308
Base Metal Prices	879	876	910	944	958
Gold	405.8	405.3	408.3	407.2	410.8
S&P	1129	1122	1129	1014	1110

BOB HOYE, INSTITUTIONAL ADVISORS
E-MAIL bobhoye@institutionaladvisors.com
WEBSITE: www.institutionaladvisors.com