

PIVOTAL EVENTS

THURSDAY, DECEMBER 9, 2004

BOB HOYE

PUBLISHED BY INSTITUTIONAL ADVISORS

Signs Of The Times:

" US Dollar's Fall a No-Brainer"

" This realization is as close to a slam-dunk as we have in the world of finance." - Bill Gross, Pimco, as quoted in FP, Dec. 2

[The editor is convinced that Gross was speaking hyperbolically rather than ironically.]

" Veteran Comex traders say there is a gold rush these days, fueled by hedge funds and big institutions." - WSJ, Dec. 2

" Commodity funds hold their appeal." - WSJ, Dec. 3

" Get used to disappointment." - The Princess Bride (1987)

Character Of The Markets: Normally we start with the stock market, but it is only one element in a speculative blowoff. As with the example in 1Q 2000, the orthodoxy of tracking management, earnings, and Fed utterances may be inadequate to anticipate rapid changes in market forces. The Fed and corporate management will lag the change.

The universal link to the formation of high-flyers has been the sinking dollar. We won't claim that the decline is causing the speculation. This will be discussed below, but at this stage of this piece it is appropriate to consider the action as a package and, in recalling the sequential spikes in the first part of the year, we have been alert to the second set of spikes and the possibility of another sequential failure.

The link is the dollar and, as we have been noting, "*the world is long inflation and short the dollar*". Of course, by inflation we don't mean the rate of change of the CPI but its use in the proper sense. This means an inordinate expansion of credit (which is glaring) against soaring asset prices (which is, for the moment, celebrated).

So, by "long inflation" we mean the street is dangerously committed to continued inflation in stocks, bonds, and commodities. Two weeks ago, this page quoted the best Wall Street economist in the 1920s' mania with his April, 1929 comment that "*We have a condition of inflation which*

manifests itself in rising prices ...". Benjamin Anderson concluded with a warning about "over-confidence and excessive speculation".

The point worth stressing is that soaring asset prices foster credit expansion through leverage and then the inevitable decline in prices forces the credit contraction. On this phase, the agent is not the Fed but is the margin clerk or, more widespread, the loan officer at a bank or mortgage lender.

Of course, the compulsion to borrow has always been matched by the compulsion to lend and this part of the financial equation is fulfilled by the equivalent compulsion to borrow short and lend long.

This shows up as a flattening yield curve and the demise of the mania has typically been signaled by a reversal to steepening (not yet) and to credit spread widening (ditto).

However, we have had a bounce in the dollar and it has definitely been *linked* to some deflation in copper, nickel, and silver. It is appropriate that the link to the party seems to be working on the pending transition to the contraction.

Stock Market: Yesterday's ChartWorks #3 outlined the parameters of this decline, which was essentially the same as noted in last Thursday's Pivotal Events. Using the S&P, the initial pullback would be to 1176 (1177 was the low yesterday). The next target is the 50-day ema, which is rising. So the key level of support could be around 1160.

Then the rally into early January will likely cap the cyclical bull market that arose out of the panic that ended the last bear market in October, 2002.

Portfolio Strategy: With stocks, bonds, and commodities close to the peak of a cyclical bull market, it is necessary to be appropriately positioned for a significant change.

- Credit spreads will likely reverse to widening early in 2005 so we would continue selling lower grade issues and begin shortening term in better quality corporates.
- The other feature of the contraction likely to be noticeable in the first quarter will be the start of a long trend of curve steepening. On this treasury rally, we would shorten term down to the 3 to 4 year maturities.
- The stock market will likely initiate a cyclical bear, in which case a significant unweighting in most equity sectors is suggested.
- Gold and gold shares are the main contra-cyclical components of the financial spectrum. All accounts should build overweighted positions on phases of weakness into February. The ChartWorks of October 24 provided the "Ranking System" on a variety of gold stocks.

Sector Comment: Two weeks ago, this sector observed that base metal prices were working on a cyclical peak.

Last week's was "*We would lighten up on mining stocks and other "old" cyclicals. Producers should be selling [metals] forward aggressively*".

Base metals and silver could recover with the stock market rally expected to run from mid-December until around January 12, which would provide additional selling opportunity.

On the all-important banks and financials, last week we noted that our Proprietary Bank Trading Guide had extended its uptrend with a sharp rally, which seemed to be bringing in the volatility necessary for a reversal. Considering the huge 21% weighting on the S&P and the lengthy uptrend, it is critical to be alert to change.

The big rally for the Guide started at 122 in June, 2003 and the high was 177 on December 1. It declined a little to 173, from which it quickly slumped to 158. This is a big move – enough to reverse the long uptrend and we read it as a "sell" signal. Technical confirmation will come with the rebound to test the high and then failure.

Phenomenal weighting of 23%+ of the S&P has been accomplished by the banks and financials. This compares to the extraordinary weightings achieved by the techs in 2000 and the oil sector in 1980.

With all of this in mind, we have been lightening up on banks and the advice now is to become aggressive on the rally possible from mid-December to mid-January.

Every bull market climbs a wall of worry and then in a rush of confidence leaps over – only to find Murphy waiting.

INTEREST RATES

The Long Bond has been frustrating. On one hand, it has been a modest player with all of the hot speculations. But it couldn't accomplish sufficient energy for a top.

We have been long and last week we were looking for a "pop" as the street finally noticed that commodities were weakening. Where plunging energy prices had little influence, the slide in base metal prices did the trick.

The last high in yields was 5.05% for the bond and 4.40% for the 10-year. That was on December 2, which compares with our base metal price index rallying to 978 on November 30 – two days earlier. This is accompanied by weakening retail sales with particularly weak car sales. Rosenberg, at ML, notes that dealer inventories are growing at a "two-standard deviation rate".

It's a relief to see the rally and the next obvious target would be the previous lows at 4.75% and 3.97%.

There could be some choppiness getting there.

On the very long term, our theme remains that weakening industrial commodities will signal diminishing pricing power. This will result in a bear market in earnings and the always dreadful inability to service debt.

A growing revulsion for lower grade issues (oops – almost used the term securities) could begin in the first quarter. Eventually this could become serious enough to, stage by stage, pull down the price of most classes of bonds.

For treasuries, the near term is positive but the long term is not pretty.

Credit Spreads: The table of "spikes" places the action in spreads in perspective and it is updated:

	NICKEL	SILVER	HIGH-YIELD SPREAD (bps)
INITIAL SPIKE	8.05 (JAN.6)	8.50 (APR.2)	194 (JAN.23)
TESTING SPIKE	7.52 (OCT.8)	8.19 (DEC.1)	194 (NOV.29)
THIS WEEK	5.75	6.49	203

First of all, it is essential to note that after the October, 2002 calamity the high-yield spread narrowed from 923 bps to only 194 bps. This is a huge move and, despite extremely bullish sentiment, the action in the spreads could be spiking by running out of momentum at the previous excess.

As with spikes earlier in the year, the failures have been sequential. This set began with lumber on August 23, nickel on October 8, and crude oil on October 18. Last week, we ran the sequence and observed that silver and credit spreads were still unscathed.

Silver has been hit, which leaves spreads and the stock market the next vulnerable games.

Dollar Index: After a series of "capitulation" days, one of the requirements for the "buy" is an uptick in momentum. As of Wednesday, we have this. The last such signal occurred in January at 84.5 and the recovery was to 92.

What we would like to see now is stability, followed by a quiet recovery with some excitement eventually driving the dollar index to 90.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: Crude's 25% plunge from 55.65 on October 18 to 41.46 on Tuesday was fairly dramatic and seems to be running out of momentum. However, we are still looking for new lows in January, which would end the decline.

Once the bottom has been accomplished, we will be looking for an intermediate recovery into March.

We have been expecting an important low for natural gas around late December, from which a rally could run until June.

Base Metal Prices: Over the past 100+ years, base metals have enjoyed outstanding bull moves that typically lasted for around two years. From its cyclical low of 467 in October, 2002, our base metal index gained 130% to its high of 1081 on October 8.

Within this, and over the past 40 years, copper has set 9 speculative highs and 7 topped out near the turn-of-the-year. So far, copper's multi-year high has been 1.49 (LME) on October 11 and, with another leg up in the stock market, copper, which has declined to 134.6, could rebound to test the high.

Remember the very old one that "*every bull market has a copper roof*".

Copper has been in a cyclical bull market for 26 months and this is December.

Turn-Of-The-Year Statistics: Some big speculations have blown out close to the end of the year. The last one occurred with the DJIA at 11,723 on January 14, 2000. Another one for the stock market was on January 3, 1973 and both were followed by the worst bear markets¹ since the 1930s. In real terms, the DJIA plunged by 68% from 1973 to 1982.

Other stellar examples include the Nikkei at 39,300 on December 31, 1989 and silver at \$50 on January 21, 1980. This week, the numbers are 10,777 and 6.49 respectively.

Going further back, from 1893 to 1982, of the 13 significant stock bear markets 7 started from excesses achieved near year-end.

On the optimistic side, 3 out of 4 modest bear markets started in the same time window.

Of course, what is required to make the phenomenon work is to have a cyclical bull market soar to speculative excess going into the statistical window.

¹ Using the example of "Governors General", perhaps "bears market" would be more grammatical.

Gold: The upside target was around 450 and the high close was 456 last Friday. Then, in the style of The Economist in the 1870s, "this week a profound change came over the markets". For gold, it was a 3.3% drop from NY close on Tuesday to 437 on Wednesday. In London, it got down to 433 before stabilizing.

Once the high was in, the correction target became 430 and the question is – has the correction been accomplished?

A one-day whack does not a correction make, particularly as it is likely to have been against a recovery in the dollar index until around February. Perhaps the action will be choppy for a few weeks against a choppy dollar.

However, our target for the dollar index is now around 90 by February and that could set the last low for gold in a choppy period.

Gold's Real Price: Relative to commodities, gold's uptrend has extended. From a cyclical low of 183 in March, our gold/commodities index has set a solid uptrend to last week's high at 244.

The importance is that, to have a real bull market for gold shares, it is necessary that the price is advancing over costs – which improves operating margins. During all five previous new financial eras, the price of gold went down and then typically recovered for a couple of decades.

As part of the topping process that ended the 2000 bubble, our gold/commodities index reversed to rising in September. Then the following reversals in the treasury curve and widening spreads identified that the contraction was becoming undeniable.

Gold/Silver Ratio: The most important part of the profound change is that silver is plunging relative to gold, bringing the gold/silver ratio up from the low of 56.6 on December 1 to 66 this morning.

As concluded last week, "*At conditions of great excitement, often a sudden plunge in silver relative to gold is the herald of a reversal in fortune. That melancholy event is at hand.*".

Obviously, the change in the ratio this week has been huge and is signaling an overall liquidity crisis.

December 2 brought news of a \$500 million failure of China Aviation Oil Singapore. The company, under the slogan of "Leveraging China, Going Global", earlier in the year shorted jet fuel and, when hugely offside, doubled the position.

Obviously, this can be called a derivative trade and its failure is significant.

The Austrian School of economists did the definitive work on the credit cycle. Ludwig von Mises is the leading name and, in reasoning from first

principles, he concluded that for a boom to turn into a contraction it did not require bankers to begin calling loans – all that was required was that they become a little concerned and stop making them.

Quite simply, a derivative is a highly leveraged loan and the failure of China Aviation may induce some caution in the extension of derivatives. One of the components of the LTCM disaster in 1998 was being aggressively short gold. Perhaps someone was aggressively long silver through derivatives.

Well, the mathematical term for the rate of change is derivative and we are particularly interested in the second derivative failure and what follows.

	FRI	MON	TUES	WED	THUR NOON
DECEMBER	3	6	7	8	9
High-Yield Spread	202	203	200	201	-
Treasury Curve	269	267	265	255	256
Base Metal Prices	914	912	925	893	884
Dollar Index	80.9	81.2	81.2	81.9	82.3
Gold	456	454.2	452	437.2	435.7
S&P	1191	1190	1177	1183	1181

Too much prosperity makes men greedy and desires are never controlled sufficiently to stop at the point of attainment.

- Seneca (4 BC – AD 65)

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