PIVOTAL EVENTS

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Consensus: The consensus has a problem. Monday's WSJ headlined "***Commodities Hold Key For Stocks***" and the story pointed out that forecasters who are looking for a good year for stocks in 2005 "***tend to be the ones who think commodity prices are under control***". The article said the contrast was "***The ones who are biting their nails are those who fear prices will surge again.***".

Actually, there are two problems. One is in the first sentence, which considers that for a "good" market, commodity prices have to be controlled. Who, pray tell, is going to "control" such prices? The Fed, the SEC, or Elliot Spitzer?

The other problem is the consensus that surging prices will be bad for the stock market.

Well, coming out of panic liquidation of stocks, corporate bonds, and industrial commodities in late 2002, these very same stocks, corporate bonds, and industrial commodities have rallied, if not flown, together.

Moreover, throughout most of recorded financial history, prosperity has been associated with rising prices and hard times with falling prices.

Steel prices more than doubled and insolvent Canadian producer, Algoma Steel, has soared from 1 in 2002 to a recent high of 30. Clearly, lower prices in 2002 would have bankrupted the company and the behaviour of the stock suggests not just some prosperity but considerable prosperity.

These versions of consensus just don't get it and would be well advised to review business history.

Character Of The Market: Since August, our theme has been that the speculative blowoffs set earlier in the year would be tested and would then fail.

Once the spike in lumber completed in late August, the conclusion was that, as with the examples set earlier in the year, the testing spikes would occur and fail sequentially. Lumber was followed by nickel on October 8, crude on October 18, and silver on December 1.

Over the last few weeks, we have been wondering about "Who's next?" and these have been stocks, bonds, and the Baltic Freight Rate.

With the Baltic plunging 13.6% (chart is attached), only stocks and bonds are left. How long can they remain isolated from the patterns of failing speculative spikes? The answer is in seasonal statistics.

Stock Market: In late July, we sent out an Institutional Advisors memo that concluded with "Party Time!" and the S&P bottomed at 1063 on August 12.

Lately we have been looking for the party to intensify and blow out near the turn-of-the-year. Last week, we reviewed the statistics and concluded that what was needed to make the phenomenon work was to have a rush of hot action going into the "window".

The dynamics for this is building upon exceptionally bullish sentiment figures.

Reflecting the latter, our December 2 edition noted that Ned Davis Research has put together an index of a number of sentiment readings. The resulting chart, called the "Top & Bottom Spotters Index", has been reliable and it gave a "sell" signal on November 26. This lead to the top has varied so we consider it as a valuable indicator on the character of the stock market and our work on timing will likely take us out with reasonable confidence when making the key call.

In the meantime, investors should continue to reduce exposure and aggressive selling could await the call.

Sector Comment: Base metal prices and the cyclical stock groups have been likely to rally into the "window" and then reverse to a bear market.

The long uptrend in our Bank Trading Guide from 122 in June, 2003 to 177 in December was impressive. Since then, it has suffered a rapid slump to 155 this week. This is the "alert".

While this is sufficient to end the uptrend, it is important, technically, for a rebound to test the high and then fail. There hasn't been this volatility in the Guide since it gave the huge "alert" and "sell" signal at the height of the mania for bank stocks in April, 1998.

The BKX topped in April at 91.3 and plunged 40% to 54.6 in October, 1998. A specific review is being prepared.

INTEREST RATES

The Long Bond continues to act well, but the rally, having started with the recent slide in base metal prices, is now running with a brief pop in crude oil, base metals, and silver – the usual party animals. So, for the moment, the bond is back on the carry trade – despite that the cost of the carry, as represented by treasury bill rates, has been going up.

Of course, yield curve flattening is indicating the continuing compulsion to borrow short and lend long.

In March, 2003, Warren Buffet observed "***The range of derivative contracts is limited only by the imagination of man or sometimes, so it seems, madmen***.".

In a recent Bloomberg column, Mark Gilbert wrote "***Buffet was right on* [this] *portrayal of a financial industry that's growing almost without limit. He was wrong, though, to question the savity of the architects who are building an edifice that's transforming the way investors play the fixed-income markets***.".

"***The most sophisticated financial engineering is in credit derivatives – obligations tied to corporate debt values and credit worthiness.***".

The article almost glowed about the advantages of being long telecommunications bonds, while "***buying a credit-default swap – a form of insurance against default – that will gain value as the credit worthiness of your disliked company deteriorates***.".

An "architect" of such structured credit trading reported that to mid-2004 volume had amounted to some $1 trillion and that this would double by year-end and double again next year.

Then the article got into some of the complicated details, but never lost enthusiasm for the ability to hedge both credit and term risk.

Those totally innocent of market experience would conclude that the perfect hedge is at hand but, as only too few know, the perfect hedge is found only in a Japanese garden. Beyond that, the other term that makes us nervous is "financial engineering" which, in its original translation, was called "Zaitech".

This concept was wildly employed in Tokyo until December, 1989, which was the top of the Japanese mania for both tangible and financial assets.

A long period of discouragement followed and much of the blame was assigned to "financial engineering".

On our own shores, the term "portfolio insurance" remains daunting for anyone with a recollection of the 1987 stock market crash. That "tool" for equity portfolios turned what would have been an intermediate correction into a crash.

To get back to reality, the long bond yield has also been working on a "test" of the low yields set earlier in the year. The "spike-downs" fit into the table as follows:

	NICKEL	SILVER	BALTIC	30-YEAR YIELD	HIGH-YIELD
FIRST SPIKE	8.05 {JAN.6)	8.50 (APR.2)	5681 (FEB.8)	4.66% (MAR.22)	6.88% (JAN.23)
EXTREME	5.46 (SEP.9)	5.51 (MAY 11)	2022 (JUN.22)	5.55% (MAY 13)	8.45% (MAY 14)
SECOND SPIKE	7.52 (OCT.8)	8.19 (DEC.1)	6208 (DEC.6)	4.71% (NOW)	6.65% (NOW)
RECENT LOW	5.75	6.49	5551	??	??

Obviously, the second sequence of failing spikes is critically underway with only stocks and bonds yet to complete their part of the pattern.

Levente has been consistently long the bond based upon the character of the market, which has shown consistent bearish opinion and under-positioned accounts. This writer's view has been that raging speculation in commodities would end and the drop in, for example, base metal prices would prompt a bond rally. The other view was the tendency of the bond to rally with the hot games, which has been the case, but those rallies didn't amount to much.

Within this has been the view that the bond price could rush up to test the spike of early in the year.

It is a relief to see all the above prospects coming into play in conjunction with the possible turn-of-the-year top in stock and base metal markets.

In reviewing the charts back to 1922, there are no equivalent statistical tops for the bond market.

However, there is one pattern that stands out. A multi-year bull market for bonds topped in January, 1973. Ross has been using the last half of 1972 as a "model" for the stock market and it is intriguing that, as on the S&P, the match is showing up in interest rates as well.

1972 COMPARISONS 2004

	STOCK MARKET	BOND PRICE	TREASURY BILL RATES
1972	Multi-year bull Topped Jan.3/73	Multi-year bull topped Dec./72	Reversed in February, 1972 Increased from 3% to 5% in Dec.
2004	Multi-year bull Top ???	Multi-year bull Top ???	Reversed in January, 2004 Increased from 0.88% to 1.22% now

Bond Conclusions: We are finally getting some zest into the action and it is compelling that, like the other games, it is developing a very big test of the high price made in March.

The yield comparisons for the 30-year are 4.66% in March and 4.71% now. For the high-yield, the numbers are 6.88% in January and 6.65% now.

Because of their tendency to suddenly lose liquidity, we have been selling lower grade issues, which should now be reduced to minimal or nil.

Last week's advice was to begin shortening term in better grade bonds.

When the "sell" comes on treasuries, we will advise.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: A blast of well below seasonal cold has prompted a sharp rally for heating oil, which popped the crude price by 8.4% from the low of 40.71 on Friday.

We are still looking for the market to reverse to an intermediate uptrend from January to March. This could be the initial stage from which a big test of the low would be needed to make the call.

We have also been looking for a seasonal low in natural gas in late December, from which a rally could run into June.

Base Metal Prices: We have been expecting that the final rally of the cyclical bull market for copper and the stock market would be set either side of the year-end.

The statistics for both is that turn-of-the-year peaks have been frequent for both and all that is needed is some impetuous buying into the "window".

The link to the rest of the metals has been the tendency for nickel to set important highs and lows with the Nasdaq. One critical high for both was on March 10, 2000.

Gold: The low of 433 was close to our downside target of 430 and some rebound is underway. This seems to be mainly with the rebounds in crude oil and base metals.

There has been no change in the favourable trends in credit spreads and the treasury curve. Reverses in these would signal the beginning of a lengthy increase in investment demand.

In dollar terms, gold has likely to work off its "overbought" with a choppy correction through January. After that, enough of the hitherto lively speculations could be sufficiently changed in trend to increase the investment demand for gold.

In real terms, our gold/commodities index has now set a nine-month uptrend from a multi-year low of 183 in March to 244 on December 3. The importance is that the key to the discovery of the liquidity problem in October, 2000 was the recovery in gold relative to commodities in late September. This, with steepening of the yield curve, said "game over" to the stock market and "go ahead" to gold shares.

With the next 5 weeks, the treasury curve could reverse to steepening, which would be the next signal on the developing liquidity crisis. How can one be sure of this possibility? It is straightforward – they are the consequence of leverage against hot speculations, which always runs to excess and inevitably fails.

Dollar Index: The downside action registered the first set of capitulation readings since the low of 84.5 in January. This is likely to be followed by a recovery to 90. After the initial reversal, we have thought that the action would turn dull and then early in the New Year begin a more steady rise.

Over the past few years, the Fed has been blatantly honest in its policy of dollar depreciation. With its purchasing power diminished by some 93% since the 1930s, some veteran observers are convinced that the intention is to go for the final 7 percentage points and that will be a disaster. No.

We'll use the 1922 to 1923 Weimar inflation as the example when the monetary authority took the exchange rate from 4 marks to the dollar to 4 trillion marks to the dollar.

That was virtually to zero, but the feature was that the speculative party was on with the stock market and gold, for example, outperforming the rate of depreciation. This continued until it ended and this has been our main point – there is no problem and plenty of fun while the depreciation is on.

Then, once it's over, the troubles of massive deflation follow and we have considered that the way to anticipate this reversal is not when the dollar reaches 4 trillion to the mark (as some project), but when the prices of the objects of speculation run out of power and technically fail.

This may be at hand as the hot games have been sequentially running out of power at their speculative spikes of earlier in the year.

Now, how does this compare with the popular notion that all that is needed is a "carefully managed depreciation" of the dollar?

To believe this is to believe the "Goldilocks" story that the brilliantly managed bubble of the late 1990s could continue beyond its allotted duration of 9 years.

Silver: The December 2 Pivotal Events concluded that silver would be next on the sequence of failures and that a plunge relative to gold would be a warning on the longevity of the boom.

With the boom, the gold/silver ratio declined from 82 in June, 2003 to 56.6 on December 1. Since then, it has increased to 64.9 in only 9 trading days. This was a fast move as it took 2 ½ months to come in from 64.9.

Beyond this, we can't over-emphasize silver's role in anticipating hugely important reversals in the prevailing mania.

Going into the height of the precious metal and energy mania that blew out on January 21, 1980 (silver at $50), the gold/silver ratio reversed from declining at a multi-decade low of 14.83 on January 3, 1980. The lead was a little over two weeks.

Moving forward, the ratio declined during the final phase of the 1972 bull market for stocks. The decline was from 42 to 31.5 – on December 26, which was only one week before the NYSE top on January 3, 1973. In nominal terms, this was followed by the worst bear market since the 1930s and it ended in late 1974. In deflated terms, the DJIA lost 68% from 1973 to 1982.

Overall Conclusion: Just as at significant market bottoms, a number of apparently unrelated forces irresistibly come together to indicate a cyclical top.

This seems to be the case now as it will inevitably change the course of stocks, spreads, the curve, and industrial commodities – all to adversity.

	FRI	**MON**	**TUES**	**WED**	**THUR NOON**
DECEMBER	**10**	**13**	**14**	**15**	**16**
High-Yield Spread	201	201	204	-	-
Treasury Curve	258	258	256	251	260
Base Metal Prices	891	890	901	911	931
Dollar Index	82.6	82.2	82.2	81.6	82.2
Gold	433.9	438.9	435.9	440.8	438.8
S&P	1188	1199	1203	1206	1206

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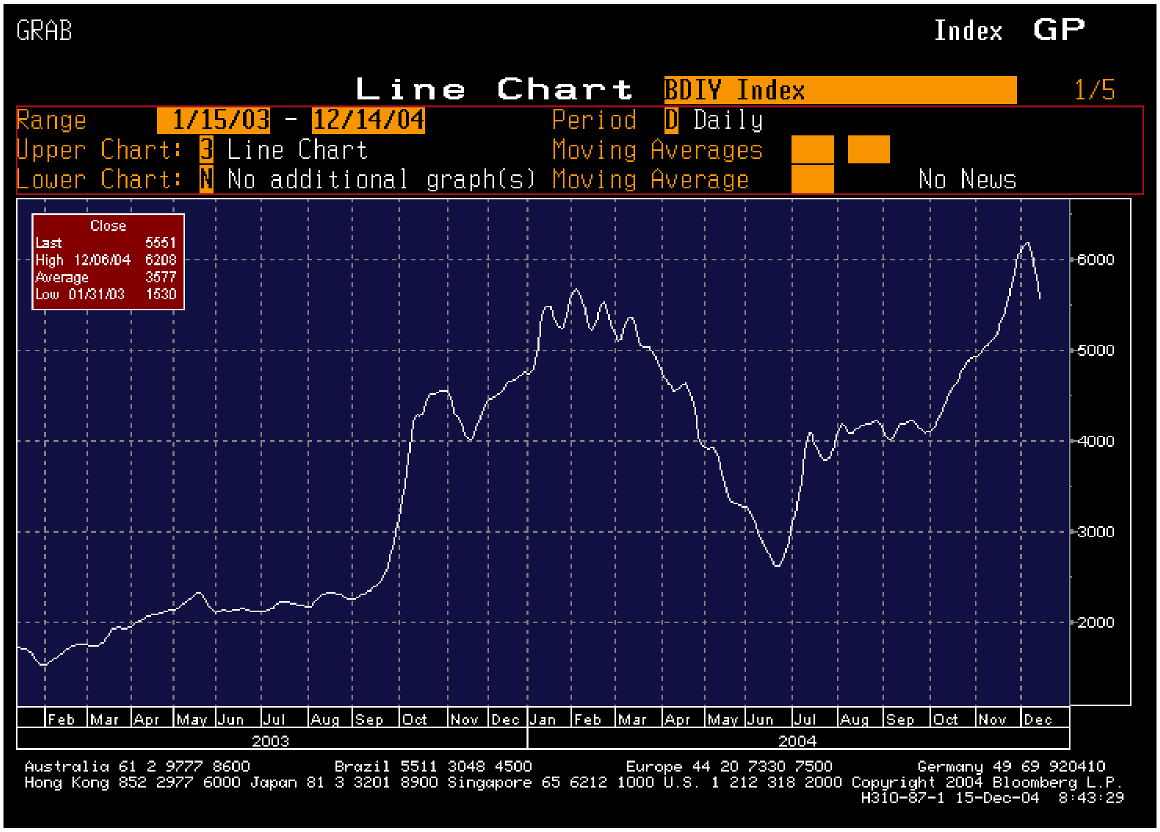
BALTIC: TEST OF EARLIER SPIKE ACCOMPLISHED AND FAILING



- **February 8 High: 5681**
- **June 22 Low: 2022**
- **December 6 High: 6208**
- **Now: 5363**
- **Down 13.6% in only 7 days is fast.**