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BANKS AND FINANCIALS " ALERT "

The December 2 edition of Pivotal Events noted that the steady uptrend in our Bank Trading Guide had taken on some upside volatility and, as in 1998, this could be the precursor to a reversal.

This is particularly important because the complete reversal will provide a "sell" signal. Using the U.S. as the example, in August banks and financials have accomplished a 22.91% weighting on the S&P 500 index. We have called this the *phenomenal* weighting, only achieved or bettered by the techs in 2000 and the energy sector in 1980.

Obviously, any sign of reversal would be of widespread importance.

From a low of 122 in June, 2003, our Guide soared to 177 on December 1. The uptrend then suffered a considerable setback to 154, which is sufficient to offer an "alert" to a trend reversal.

For the technical "sell" signal, all that is needed is the rebound, in its test of the high, to roll over and then fail. That provides the "sell" and the last really big one was registered on April 2, 1998.

The high for the BKX was 91.3 on April 13, 1998 and the subsequent low was 54.6 on October 6, 1998, for a plunge of 40%. Of course, the main event with this crash was the absolute collapse of the huge LTCM hedge fund, which was on the wrong side of a dramatic widening of credit spreads. (On this, our model expected spreads to reverse to widening in May (✓) and become severe by October.)

At the time, we published our main report at the first of each month so, once the signal had been registered and as the downtrend in the Guide was extending, this writer persuaded Bill Hanley, at the Financial Post, that we were very convinced that a major decline was imminent.

Showing considerable nerve, his April 28 "Market Eye" column included a phrase we thought would provide the appropriate emphasis.

Bob Hoye ... , is nothing if not cheeky. Last week he told us that many banks stocks the world over looked like "widows' and orphans' short sells".

Understandably, this upset the establishment and Bill immediately received some nasty comments from those in high, as well as modest, walks of life. Hanley eventually responded on August 10 with:

The markets do have an unlimited capacity to surprise. We are reminded that some readers were moved to phone in and castigate us when we reported April 28 that Bob Hoye ... was ...noting that bank stocks the world over looked like "widows' and orphans' short sells".

At the close on Friday, the TSE's financial services subindex was off 20% from its April high.

Now Hoye is wondering if the "widows and orphans" are laughing all the way to the bank.

The Bank Trading Guide was developed early in 1997 and its first "sell" signal was followed by a 15% drop in banks. In back-testing, we noticed that while it tended to lead at important highs it was coincidental at important bottoms. This was the case at the low in October, 1998.

The important thing now is the increase in volatility and the developing reversal in the Guide. This could be confirmed by the end of the week and, as with previous big examples, banks and financials could remain firm for a few weeks after the technical "sell".

Are banks now another "widows and orphans" short? While the "alert" seems strong, it is too early to say, but we will advise.

Strategy: Over the past few months, our advice has been to lighten up on this sector – mainly because of the extraordinary weighting relative to the S&P as well as to the extraordinary narrowing of credit spreads. This combination of institutional complacency and overall disregard for credit risk suggests that this sector is vulnerable, perhaps even dangerous.

Investors can pick up the pace of selling and, upon the technical "sell" signal, become aggressive.

Controversy: The 1998 call on the banks was controversial and while the link can never be known – that August the Ontario Securities Commission (OSC) requested the research.

Naturally, we complied and, in following it up to ensure that it had been received, the agent handling the file was friendly. When asked if there was anything offensive in the research, he answered no. When asked why the research was requested, he just chuckled.

That was the first inquiry from the OSC and we have had none since.

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