

## **INSTITUTIONAL ADVISORS**

**March 23, 2005**

# **SPECULATIVE BLOWOUTS COMMODITIES NOW**

The action in commodities has become an irresistible bubble. This enjoys similar convictions to those fully expressed in the tech mania that blew out in 1Q 2000. It also shows remarkable comparisons with the huge boom in commodities that climaxed in 1980.

This seems to be ending and the following points, examples, and charts indicate that, once completed, a lengthy bear market for most commodities could follow.

## **LEVERAGE**

While Mr. Central Bank is always accommodative, Mr. Margin is only accommodative while price speculation is soaring. When prices fall, and they inevitably will, he becomes very disobliging.

The reason is that the job description of a margin clerk is vastly different than that of your basic central banker. The former's duty is to get the account in line and the latter's is to perform the role as a priest who has the power to infinitely reward the faithful and then needs to rationalize the flock's regular and cyclical disappointments.

## **STOCK MANIAS**

The bull market that blew out in 2000 was a classic "New Financial Era" with the nine-year duration to the inevitable climax. This is based upon our definition of duration, which runs from the peak of the last business cycle of the "old" era of inflation to the top of the bubble.

Using the NBER determinations, the business cycle peaked in July, 1990 and the stock market's peak was in March, 2000 – a 116-month duration.

For 1929, the key dates were January, 1920 and, as is so well known, September, 1929 for a duration of 116 months.

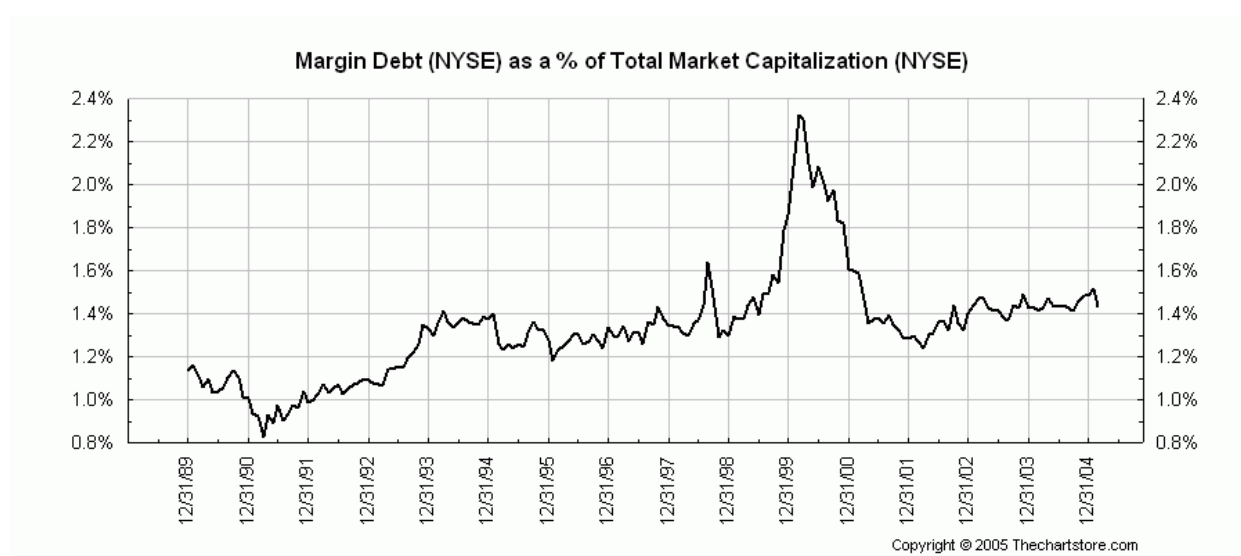
If one just uses the year of the last business cycle of the "old" era of inflation and the year the bubble concluded, the duration has been nine years. The first example ran from 1711 to 1720 (South Sea Bubble).

# STOCK MARKET MARGIN

The literature records that margin was aggressively employed in all six great financial bubbles. Indeed, one of the touts in the final stages of the 1929 mania was soaring broker loans. While everyone knew that this was leverage, it was then a bullish term equivalent to today's euphemism that leverage based upon soaring asset prices is "liquidity".

We don't have a chart of margin debt through the "Roaring Twenties", but chart maven, Ron Griess ( [www.thechartstore.com](http://www.thechartstore.com) ), has one back to 1943. The clip "*Margin Debt (NYSE) as a % Of Total Market Capitalization (NYSE)*" tells the story that the biggest employment of leverage ran from very low in 1990 to exceptionally high in 2000.

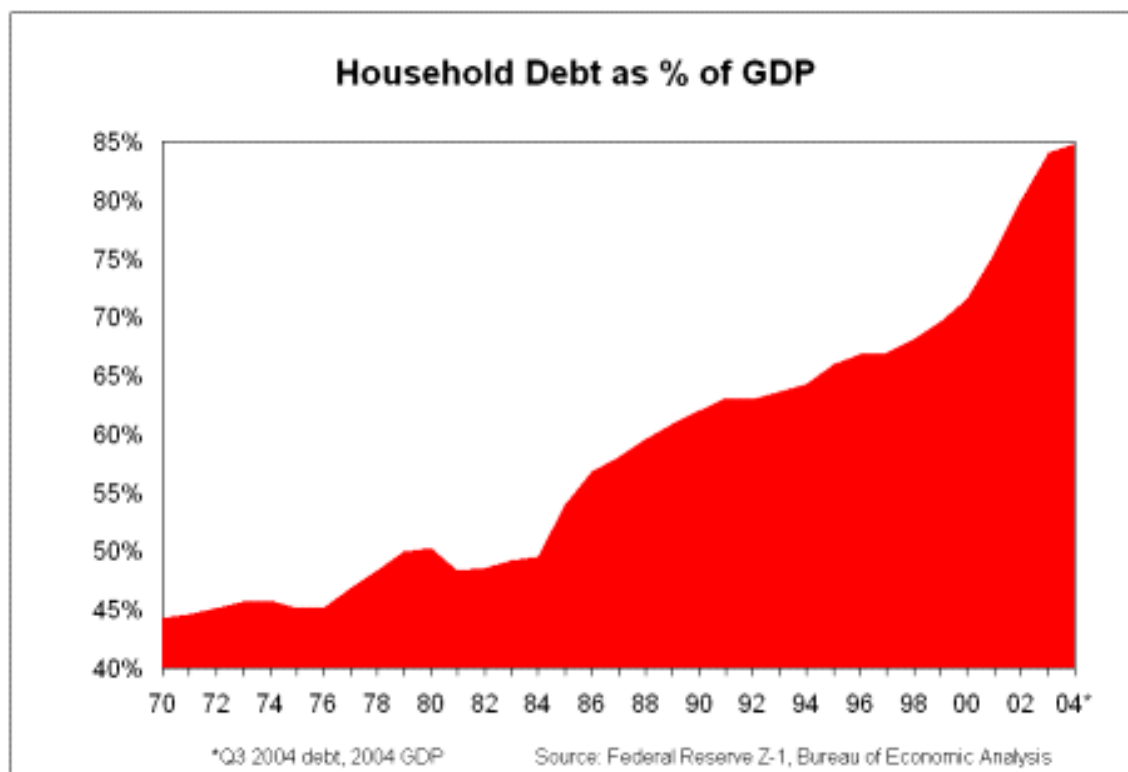
As the chart below shows, the collapse was steep and painful. For the Nasdaq, the leverage was greater, but the chart is not available.



## LATEST MANIA

The latest mania encompasses both tangible and financial assets. The former includes commodities and the China boom, as well as in residential real estate.

This has run the savings rate down to zero and one way of comprehending the risk is to review the chart of household debt below.

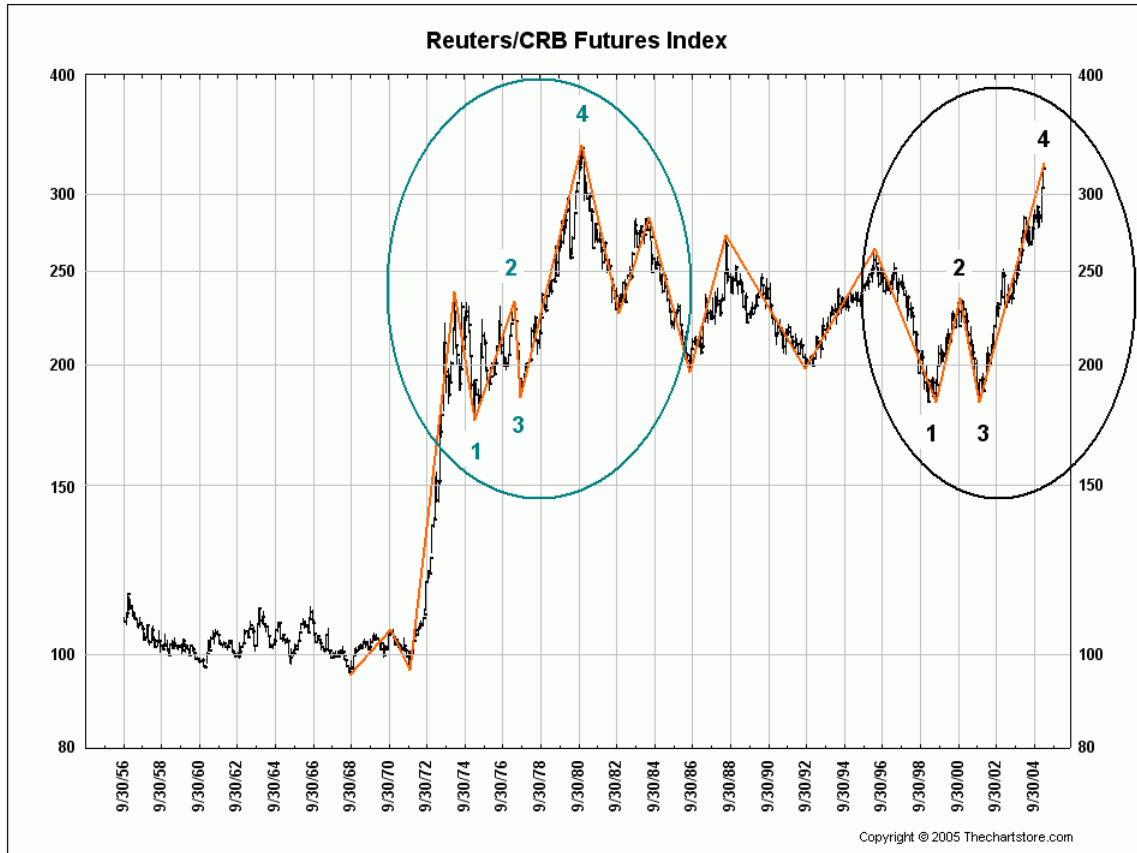


Any ambitious employment of leverage will have a sorry outcome. The most immediate indication of the pending turn to adversity is the reversal in credit spreads as shown by this week's breakout in the high-yield, over treasuries, and the failure of the MSD chart (i stock for emerging debt). Confirming this is that the BKM (U.S. bank stock index) is failing.

This covers the financial side of the waning boom and it is critical to review the mania in commodities. The convictions for the long term seem to be as strong as those for tech stocks in 2000, or commodities in the late 1970s.

The point to be made is the replication of the basic pattern on the last huge speculation in the CRB commodities index as well as the comparison on the percentage changes on the swings. This shows up visually on the following log chart.

# COMMODITIES



## ACTUAL COMPARISONS

	LOW	FIRST HIGH	INTERIM LOW	BLOWOFF HIGH
<b>THIS PATTERN</b>	182.6	234.4	182.8	323.3
	July 13/99	Dec. 20/00	Oct. 24/01	March 16/05
<b>EARLIER PATTERN</b>	175.1	232.7	184.7	337.6
	March 3/75	April 18/77	Aug. 29/77	Nov. 22/80

As our research into market history was mainly completed by around 1980 (it will never be fully completed), the correlation on some recurring patterns was, in some cases, impressive. An outstanding one was the typical increase in gold's purchasing power by a factor of 1.7 times during the long post-bubble contractions. No matter what the monetary or trade policies of the senior economic country or how many wars there were, the deflated price of gold enjoyed a similar increase during the post-bubble deflations.

The above chart and table on the CRB shows another set of fascinating comparison. Just note how close the numbers are on each of the equivalent turning points. Two have 4% differences and, on the other two, it is less than 1%.

Clearly, market forces are trying to tell us something.

Whatever it is – the chart includes timing as the count on the run to the height of the mania in November, 1980, of 69 months. The bull market that started in late 1999 ran 68 months to this March.

This comparison is impressive and becomes even more so when counted in days:

PATTERN	DURATION	PERCENT GAIN FINAL LEG
JULY 13, 1999 to MARCH 16, 2005	2,089 DAYS	25.3%
MARCH 3, 1975 to NOVEMBER 20, 1980	2,073 DAYS	28.6%

**Great Convictions:** Over the last 150 years, energy concerns seem to provoke particularly reckless forecasts:

*"One thing is for certain, [crude] prices will continue to rise ... traditional criteria of supply and demand don't apply."* - Charles W. Duncan, Secretary of Energy – Feb. 25, 1980

In the midst of the great boom in commodities that blew out in the 1860s, Stanley Jevons published what a bio described as *"an alarmist treatise on the imminent exhaustion of energy supplies"*.

He was a British economist and the book, which was published in 1865, was titled *"The Coal Question: An Inquiry Concerning the Progress of the Nation, and the Probable Exhaustion of our Coal-Mines"*.

In it he states *"This is a question of almost religious importance which needs the separate study and determination of every intelligent person."*

The book included some excerpts published by Edward Hull in the January, 1864 edition of the Journal of Science.

*"If we had reason to expect that the increase of future years was to progress at the same ratio [consumption doubling every 20 years], we might tremble for the result; for that would be nothing less than the utter exhaustion of our coal-fields, with its concomitant influence upon our population, our commerce, and prosperity."*

**Conclusions:** Certain types of great speculations replicate themselves. With adequate data on the stock market back to the late 1600s, there have been 6 "New Financial Eras" – each with a duration of 9 years or, with more precise data, 116 months.

The action for the CRB commodities index formed a distinctive pattern on the big and raging bull market that culminated in 1980. With remarkable fidelity in both gain and duration, this basic pattern has been replicated – including all the emotional aspects of the mania that concluded the 1980 speculation. In this regard, the steeper the climb, the longer the horizon of the forecast.

The latest bull market in commodities seems to be burning out right now. This will be confirmed by, for example, further widening of credit spreads as well as by sudden plunges in silver relative to gold.

Investors and traders should get prepared for a cyclical bear market in commodities.

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