

May 31, 2005

CREDIT MARKETS

As with opportunities in equities, industrial commodities, or currencies, our objectives are to anticipate (when possible) major trend changes. Often this has been with enough advance for CIOs and portfolio managers to determine policy.

As the target time approaches, the ChartWorks, using reliable technical analysis, pinpoints the reversal and, once the change is starting, provides initial price targets.

The approach is impartial, with turns to the upside given equal emphasis as turns to the downside.

Our work is used by trading desks so the comments, obviously, are more frequent than this sector can accommodate. Instead, this page will review some key studies on the excesses that go with a world of remarkable financial volatility. In so many words, it places the convictions of the day in perspective.

- The first essay "Real Men Trade The Long Bond" is self-explanatory. It also notes that we have been long the long bond since June, 2004.

We didn't find the "conundrum" of short rates rising as long rates declined perplexing. The next change will be to falling short rates and increasing long rates, which may eventually be described as "Conundrum Two".

- The second essay reviewed all of the changes in administered rates through all five previous great financial booms as they occurred in the world's financial capital.

Prior to the Federal Reserve System, the senior central bank was the Bank of England.

When the central bank was permitted to change administered rates, policymakers lagged the critical changes in short-dated market rates of interest by many months.

The conventional wisdom, after the event, insists that the plunge in Fed funds from 6½% in 2000 to 1% in June, 2003 was deliberate, sort of an "emergency" move. The essay "Discount Rate Follies" was written in late 2001 and explains that such rapid plunges have only occurred with the initial collapse of a financial mania.

- Although equities get the most press, every great financial boom has included extreme action in credit spreads. This history has always been fascinating and "Sovereign Debt Follies" concisely says it all, or at least enough to foster scepticism.
- A similar review of the naturally recurring extremes in the yield curve will be posted.

INSTITUTIONAL ADVISORS

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REAL MEN TRADE THE LONG BOND

The U.S. Treasury intends to resume issuing long-dated treasuries. So far as managing the funded debt goes, this is a sound step. It will lock in some relatively low long rates. For market participants, this will provide a long bond with a low coupon, which offers the biggest trading swings on the inevitable changes in long interest rates.

It takes bold and experienced traders to take advantage of the opportunities offered in the long end.

In 1779, Samuel Johnson observed: "*Claret is the liquor for boys; port is for men; but he who aspires to be a hero must drink brandy.*"

These days, heroism is found in coloured martinis and the long bond. Some twenty years ago, there was an article along the lines of "*Real Men Trade Long Bonds*". We would still go along with this and note that the ten-year, like Chardonnay, is for boys.

Most of the fashion in the shorter maturities is due to Europe, which merits some review. Over the past 100 years, Europe's political and consequent financial instability made it a rare accomplishment to have a liquid money market, let alone a liquid market for long-dated issues. Perhaps when Europe abandons its dreadful and endless experiment in socialism (Moscow on the Maastrich), a liquid market for long maturities will develop.

This could take a couple of decades when eventually the trading of the 10-year will be relegated to those who have just reached the drinking age.

Of course, we all know that the biggest bang from the trading dollar is obtained from the lowest coupon with the longest maturity. In this regard, British Consols with a 3% coupon and perpetual term are ideal. We'll have to do some thinking about a perpetual "zero".

Canada used to have a 3% "Perp", but the "Federasts" repudiated their obligations by forced redemption. With a bureaucracy dedicated to lowering interest rates, having a 3% issue outstanding when the long yield was at 19% (1981) was just too embarrassing.

Throughout the history of long governments in the senior currency, the most violent swings have occurred with the culmination of the "old" era of inflation. For example, the 30-year went from 14.7% on May 5, 1981 to 12.6% on June 16, 1981. The next panic took it to 15.2% on October 26, 1981, from which the yield plunged to 12.8% on November 22, 1981. The eventual low was 4.24% on June 13, 2003.

Now that was a fabulous bull market, with the best investment and trading returns made in the long end. The lower the coupon – the better!

Since June of last year and in the face of consistent bearish advice from the establishment, we have been generally long as yields declined from 5.61% in mid-2004 and will remain generally long until the action blows out – probably with some fanfare from the establishment.

In returning to the bigger picture, the next and typical phase of interest rate volatility can occur at the end of a great financial mania. On the short end, rates have recorded the most outstanding plunges. Following the 1873 bubble, the senior central bank's (Bank of England) discount rate plunged from 9% to 2 ½ %. Following the 1929 mania, treasury bill rates plunged from 5% to 0.06%. Following the 2000 extravaganza, the bill rate plunged from 6.42% in 2000 to 0.81% in mid-2003.

Other events should be emphasized. At some point, the investment establishment could conclude that conditions are again heading towards "deflation" and make the knee jerk that rates for long treasuries should decline. However, the track record shows that the most severe deflation of stocks, commodities, and wages occurred from mid-1931 to late 1931. With this, the long bond yield jumped from 3.13% to 4.28%, a substantial increase for those improperly positioned.

The shortest explanation for this was the collapse of liquidity in the corporate bond market as considerable amounts of debt became unserviceable.

Wrap: There is a considerable amount of money to be made in trading long treasuries and that will be enhanced by the new issuance of some low-coupons.

Wusses, of course, will be wearing bicycle helmets, sipping white wine, and stumbling around in the 10-year maturities.

Real men will be maxing out on the profits to be reaped in long bonds.

Over the past year, returns from the 10-year have been diminished by curve flattening as shorter rates increased. This is typical of a boom, but long rates declining was atypical enough to prompt Greenspan's "conundrum" query.

The reason why we remained long was that the establishment was short of duration and long treasuries were remote enough from rising short rates to become an asset play. Now, with softening commodities the bond rally has further to go and our colleague, Ross Clark, has refined the model that has provided some reliable entries and exits in this kind of financial volatility, and particularly as it is exacerbated in the long end. *"Exits are good."* We will advise.

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

INSTITUTIONAL ADVISORS

BOB HOYE

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DISCOUNT RATE FOLLIES

Through most of 2000, the notion that the bull market was a result of brilliant policy created widespread convictions that it could be sustained and this induced complacencies about risk in the face of reckless valuations. Even as prices plunged last fall, there was little doubt that the boom would soon be restored with masterfully timed cuts in the Fed's discount rate as well as judicious injections of credit.

Then, editorial pages that articulated the marvels of the boom were shocked by the reversal and then chagrined by the losses were equally articulate about finding a scapegoat. Regrettably, leading op-ed pieces in New York and Toronto on the first publishing day of 2001 stridently criticized the chairman of the Fed for the "error" of raising interest rates and "causing" the \$3.5 Trillion plunge in stock market capitalization. The attacks reveal over-reliance upon the dogma of intervention as no mention was made about the danger of leveraged speculation on the upside.

Financial manias have been the ultimate discriminator between research techniques that work and theories that don't. In any century, all it takes to launch a theory is some intellectual to suddenly become offended by the typical dearth of credit with the collapse of a great speculation. Of course, this requires an ego sufficient to broadcast a personal solution. Also essential is little or no experience in the markets and no knowledge of what their counterparts dreamt up in previous severe crises.

All such crises are virtually the same and stimulate the same superficial solutions. Statistically, these are tightly grouped in the immediate post-bubble distress and occur about twice each century. The personal remedies, as promoted by Keynes and his ilk in the 1930s, differ only in syntax with those of Middleton in 1622. (The critical boom collapsed in late 1618.) Anticipating that blowup, an experienced merchant observed that "the wisdom of the state" was listening to the "vaine promises of ydle brains".

Inevitably, runaway speculation has been followed by forced liquidation of suddenly unsupportable positions. The mechanics of this as well as the dramatic climaxes of all five previous New Eras is simply that the up causes the down. Moreover, market rates increase during the concluding mania and decline until the contraction runs its course. Regrettably, discount rates have always lagged the action.

The theories that some agency can benevolently manipulate interest rates or suddenly provide enough credit to stem a harsh contraction that typically follows extraordinary speculative manias have been around for more than 300 years. Their denial is history itself.

Through leverage of rising collateral values, credit expands whether the speculation is in tangible assets, as in the 1980s, or in financial assets, as during the 1990s. Moreover, when it's time for the latter, a financial boom will occur whether the senior central bank is under a sound money policy as England was in the 1772 or 1873 examples or when it was operating without constraint in accommodating speculators as in the notorious South Sea Bubble in 1720 or all the top central banks in the 1990s.

Both official stimulus and the remarkable ability of the private sector to create credit against soaring asset prices plus the wildcard of velocity became widely celebrated as endless liquidity. As this generation has subsequently learned, the most preposterous stories can be ardently believed, but only so long as its stock price is rising. When the spell broke, the endless liquidity was discovered to be soaring debits in a margin account.

Another mistake was to claim that this credit or "liquidity" was driving stock prices up. Unfortunately, this was an extension of longstanding but unsupported notions that the state can expand credit and thereby stimulate business activity.

Yes, credit does expand during the good times. But over the centuries, financial adventurers have been successful in promoting the intuitive view that policy-inspired credit expansion will cause a business expansion. The first and telling test of this is that it has never passed a basic standard of logic. In this case, it ranks as a primitive syllogism, which attributes causality to two events that occur at the same time. Credit causes business activity and roosters cause sunrises both fall into the coincidence = causality blunder.

Poor interventionist logic and the lack of precedent of the senior central bank extending a New Era beyond its allotted time or preventing the consequent contraction provides little support for the concept of automatic stabilizers. Having been part of the tout that elevated valuations to unprecedented levels, on the way down they will likely be about as useless as a hard hat in a crowbar storm.

From the end of the old era of inflation to the end of the financial boom has ranged from 112 to 116 months. In the U.S., the example that blew out in 1873 did so at 115 months; that in 1929 lasted for 116; as did ours. Following the earlier example, the bear market lasted for 5 years as the discount rate declined from 9% to 2%. The next one lasted from 1929 to 1932 as the rate fell from 6% to 1 ½%.

In all cases, a long period of financial and economic contraction followed and one was exquisitely ironical. In England, the period from 1873 to 1895 was described as "The Great Depression" by leading economists until as late as 1939 when they discovered a more immediate one to theoretically solve.

As to the immediate success of discount rate cuts, the appropriate test is to review the behaviour of the discount rate and market rates of interest through the dramatic climax of each New Era.

In the 1720 and 1772 examples, usury laws prevented Bank rate from rising above 5% and market forces prevented it from falling. In the 1873, 1929, and 2000 examples, the discount rate increases during the boom followed short-dated market interest rates up. The lag was 3 to 5 months.

In the subsequent bear market and economic contraction, discount rate cuts lagged market rates by a similar interval and provided investors little intelligence in real time.

Fortunately, the course of market rates has had much to offer. Largely due to soaring demands for margin, these have typically increased for some 18 months until the mania completed. March, 2000 was the 18th month since rates reversed to rising in October, 1998.

This, with the New Era duration of some 116 months, suggests some remarkable forces at work, obviously with enough power and consistency not to be overlooked.

The mainstream's response to discount rates and post-bubble contractions is inconsistent. Bullish economists today celebrate the 300 basis point decline in 7 cuts as "aggressive". Yet the economyths hold that the equivalent 7 cuts in 1930, which amounted to 400 basis points, was woefully inadequate. Perhaps the knowledge that the equivalent 7 cuts following the 1873 bubble, amounting to fully 600 basis points, would have tempered decades of spurious *ad hominem* attacks upon the personnel at the Fed for being too tight following 1929 as well as being aggressive lately.

The July 11, 1932 Barron's made a fair observation on the attempt to inflate credit:

"The Federal Reserve policy of cheapening credit through the purchase of government bonds has been unable to make a dent in the conservatism of borrower or bank lender, in short, every anti-deflationary effort has yet to provide positive results. The depression is sucking more and more bonds into its vortex."

The literature provides no evidence of policymakers preventing a financial mania or its consequent contraction. This strongly suggests that central

banking's inability to manage the dramatic climax and collapse of each New Era is systemic rather than a policy failure.

Financial history, within itself, provides an impartial due diligence on the theories of intervention. It is astonishing that such a long data stream with consistent patterns has not been included in the interventionist models. This would require another essay, but an old saying in Physics probably provides the most elegant explanation: "If you keep your data base short enough, it will fit your theory."

Declining collateral values are the driving forces with a credit contraction and this is associated with a highly visible bear market and business slump, the first few years of which used to be called credit stringency and the term "vacuum" is just as accurate.

One impartial measure on whether credit has been tight or easy is the course of real long interest rates. These decline during the boom and then rise during the contraction. In our example, real rates have declined from 9% to less than 2%, suggesting that credit has been both ample and cheap. The decline to 1929 was from 9% to 4 ½%.

The level of nominal interest rates has little immediate influence upon raging speculators who are convinced that they can outperform the cost of margin. When the South Sea stock was still rising, such costs soared to 10% per month. In April, 1929, call money reached the high of 20% per year.

A significant low in real long interest rates was associated with the financial binge that concluded each New Era and then, in the subsequent credit vacuum, rates typically increased by 12 percentage points (that's 1.2×10^3 basis points) over the next 3 years. It's Mother Nature's way of ending the reckless abuse of credit and credulity, otherwise known as a New Era.

BOB HOYE, INSTITUTIONAL ADVISORS
EMAIL: bobhoye@institutionaladvisors.com
WEBSITE: www.institutionaladvisors.com

SOVEREIGN DEBT FOLLIES

" IT HAS TAUGHT US NOTHING "

Although the stock market attracts the most attention during a New Era, the financial mania includes a reckless reach for yield in lower grade securities. This inordinately narrows spreads and, in our example, LTCM's quest for the holy grail of "convergence" contributed heroically to this historical imperative. Every New Era has been followed by credit distress, insolvencies, and defaults; not to overlook recrimination. The initial contractions have been intense and completed in 3 years or more lengthy with a recovery in the third year.

1825: During the New Era that culminated so extravagantly in 1825, London was the financial centre and the City floated issues by Russia, Prussia, Spain, and a number of Latin American countries and cities.

For example, Peruvian 6s were done at 88 in 1822 for a yield to maturity of 6.95%; then again at 82 for a 7.50% yield in 1824, and at 78 (7.85%) in 1825. Then the market became illiquid and eventually collapsed with the usual post-New Era deflation. Some 70 U.K. banks stopped payment and Rothschild assisted in preventing the Bank of England's default.

1873: We have run the example of the Spanish failure recently. Not so much as a timing model, but to provide a probable sequence of events subsequent to the conclusion of a New Era.

The size of defaults, such as Argentina and Enron, have been increasing. Despite this, the attitude continues that nothing serious can go wrong as the greatest policymakers in history are on duty. Hubris prevails.

This was also editorialized by some leading newspapers during the New Era that climaxed in September, 1873. Fortunately, **The Economist**, in their April 27, 1872 edition, offered realistic rather than hopeful advice:

Avoid states which are constantly borrowing, which must therefore be paying off the interest on their old debt with the fresh loans.

- The Economist, April 27, 1872

The headlines of **The Economist** in 1873 tell the story:

- June 7: "The Approaching Spanish Repudiation"
- July 5: "[Spain] Making Arrangements for the Payment of Current Coupon"
- August 2: "Spanish Interest Will Not Be Paid"
- August 30: "Anarchy in Spain"

This compares with this year's [2001] headlines on Argentine debt. These followed stories as late as June about "Appetite for Credit Risk has Improved Considerably" on an expected "rebound in the economy before long".

- July 18, 2001: "Markets Laud Argentine Debt Accord – Calms Fears of Default"
- August 3, 2001: "Flurry of International Contacts to Prevent [Argentina] Default"
- December 14-20, 2001: "Angry Argentines Take Their Displeasure to the Streets"
"State of Siege"
"Looters Ravage Cities"

As part of our warning on the possible Argentine failure, the August 17, 2001 edition included the following ironical comment:

"The fiscal history of Latin America ... is replete with instances of governmental default. Borrowing and default follow each other with almost perfect regularity. When payment is resumed, the past is easily forgotten and a new borrowing orgy ensues. This process started at the beginning of this past century and has continued down to this present day. It has taught nothing."

- **Max Winkler, Foreign Bonds: An Autopsy**, Rowland Swain Co., Philadelphia 1933

It is worth stressing that such problems have been doubly exacerbated by having to service debt from an abused currency into a chronically strong reserve unit and typically following a period of speculative ebullience. Examples are readily available (except in textbooks) back to the travails of Henry VIII. His father (Henry VII 1485-1509) ran a sound balance sheet.

Financial pressures have been likely to ease in the first quarter [of 2002] and resume around mid/year.

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