

PIVOTAL EVENTS

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Signs Of The Times:

"Traders pile into oilsands frenzy."

"Junior's volume soars."

"The feverish excitement surrounding Alberta's oilsands stocks continues unabated, leading to comparisons with the dotcom boom of the late '90s."

FP, August 9

Stock Market: As the above quotations record, one of the driving components of the stock market is reaching a full-blown mania. There is little need to review the detailed reasons for the frenzy as they are very well known.

Our approach has been to look for the intermediate swings in the oil stocks. Usually this is against the seasonal swings in crude's price and this year has been exceptional. The ChartWorks nailed the 20% drop in the oils from the March high as well as that the probability of seasonal strength in crude from July into early October would suggest an intermediate rally for the stocks into the same window.

Within this, the ChartWorks is always alert to short-term "overboughts", of which there was one two weeks ago that has been overwhelmed by the power of the play. Along with the action in natural gas, this suggests that the recent seasonal considerations have had negligible effect.

Early in the year, we complained about the doggy action in natgas as we were looking for the rally into June. It came in and the natural high was 7.69, from which it has slipped to 6.98 at the end of June. Soaring to 9.25 within a period that is usually dull provides evidence from a different quarter that this truly is a mania. Of course, the critical question becomes "*How long?*".

As with most, if not all, mania blowouts, the excitement is accompanied by a business cycle which always includes a credit cycle. Both are maturing and, as noted a few weeks ago, the credit markets will likely provide the best reading on the pending transition.

In this regard, credit spreads narrowing continued into late July, from which there has been little change. Another critical measure will be the treasury curve reversing from flattening to steepening. This is not showing yet, but the UK curve reached inversion in early June (yield ratio 10-year to 3-month at

.87) and has now reversed trend (now at .97). The Bank of England got in line this week with a drop in administered rates, which applies the veneer of officialdom.

Based upon the consistent nature of tech-bubbles, our conclusions in January, 2000 were that the stock action would blow out and collapse, but that the rate of technical innovation would continue. On great speculations in resources, it is probable that the stocks would lead the peak in the price of the resource.

Typically, base metal mining stocks will lead changes in metal prices (up or down) and much the same holds for gold shares and gold. Clearly, as both the charts and some representative valedictory comments are saying (front page of this edition), the climax is on.

Considering all of this, it's not that many weeks until the really critical seasonal high for crude in early October.

Big Speculations: Tremendous speculative manias have always been accompanied by increasing short-dated market rates of interest. Often the completing phase of the action runs against some 18 months of rising interest rates.

We dragged this out in January, 2000 when almost every subsequent weekly edition noted that March, 2000 would be *Month 18*. It provided a remarkable forecast for the timing of that climax that took the Nasdaq to 5049 on March 10, 2000.

How does this mania compare? Short rates have been rising relentlessly since the key low for treasury bills of 0.86% in January, 2004. This count makes August *Month 19*. Within the timing accuracy of this one, it is time for a monumental reversal in the hot speculative games.

All of them!

Beyond the oil mania, these would include the biggest speculation in corporate bonds, residential real estate, as well as the hedge funds¹ phenomenon.

On the latter, a group of powerful Wall Street bankers have told the hedge funds to clean up the backlog of confused or unconfirmed transactions. Right up to the peak of the 1973 bull market, one of the signs of a speculative conclusion was when the process of doing the actual transactions in the back office clogged up.

On real estate, a August 4 study noted a sharp decline in U.S. housing affordability in the second quarter as compared with the previous quarter. The numbers were 132.3 in 2Q 2004, 133.2 in 1Q 2005, and 120.8 for the freshest quarterly report.

¹ This has been the biggest experiment in "fund of funds" since Bernie Cornfeld ramped the game out in the late 1960s. In his 1970 book *The Bernie Cornfeld Story*, author Bert Cantor observed "***Bernie Cornfeld and his IOS [fund] were mentioned with awe as a major factor in reversing the negative balance of payments position in the United States.***"

This study included a first-time buyers index, which indicates the ability of renters to qualify for a mortgage. This dropped to 70.1% in 2Q 2005 from 76.6% in the prior quarter. The high was 76.8% in 2Q 2004.

The index was created in 1980 and currently the median down payment is 3%, which compares with 10% in the inflation mania that blew out in 1980.

The survey included, without comparisons, that now 40% of new buyers are taking the plunge with no money down.

On commodities, the trend has been insistent for long enough to again make its way into modern portfolio theory. In an August 2 piece, the Financial Post reported "*Ideally, direct exposure to commodities, by as much as 5% to 10% of assets, will achieve meaningful portfolio diversification. Better still, commodities and commodity futures indexes have shown positive returns in periods of heavy equity market losses.*".

The article concluded with "*Given the rising clamour for exposure to this 'asset class of the decade' driven by the China story, portfolio insurance has never looked this compelling.*"

Commodities are portfolio insurance?

On the stock market, the July 21 edition of ChartWorks noted the similarity of the 1973 topping action of the pre-Nasdaq OTC market (small caps of the day) with the Russell 2000 now. Originally, we thought that the 1973-type of "upthrust" conclusion could be accomplished by the second week of September.

Considering this is *Month 19* of soaring speculation against rising short rates, it is possible that new highs for the Russell within the August through mid-September window could be the ultimate one.

Wrap: The usual format of this week's Pivotal Events has been changed to emphasize that the speculation includes stocks, corporate bonds, and industrial commodities. More specifically, the small caps have been replicating their action going into the 1973 top. The *consequent* bear was the worst since the 1930s.

Stock Market Technical Item: The ChartWorks has an update on uraniums that will soon be sent out. In the meantime, Robert Brown (rbbrown@shaw.ca) points out that one sentiment reading has suddenly become interesting.

The difference between percent bulls and bears is at 39.8%, which is well above the "normal" of 10%. Prior to the slump into April, it reached 40%. At the end of April, it was a bullish 13.1%.

INTEREST RATES

Credit Spreads: The high-yield, which widened from only 183 bps early in the year to 403 bps on May 17, narrowed to 303 bps on July 27. We took this as part of the "good stuff" that would arise out of the April slump and run into June.

This spread traded out to 307 bps and then back to 303 bps last Friday. Now it's at 309 bps. No big deal but not without interest, especially when a reversal to widening is possible.

The Long Bond: Some price decline has been possible as the hot action in the orthodox items extended. Around 114 was the targeted support. So far, the intra-day low has been 113²⁴ on August 9.

Traders could initiate a modest long position for a brief test of the 119 highs. Equity traders could position the TLT.

Dollar Index: After hitting 90.5 against our target of 90-92, a correction has been possible into September.

The move to 87 has been rather quick and some stability in the 86s seems likely.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: Some of the stocks have ripped through some technical bands that have turned away of number of speculations in any number of items.

This is turning the action into a parabolic blowoff last seen in the techs in 1Q 2002.

As with then, not all stocks or sectors within the energy play will top at the same time.

Base Metal Prices took off when "they threw the switch" on July 1. After reaching 357 in March, our index (without nickel) sold off to 319 in May. A test of the high was expected in June and 351 was accomplished in mid-June.

The next decline was to 325 on July 1. So far, the high has been 354 on August 5, which is a much better test of the March high.

The action to the conclusion of the bull market in base metals will likely be similar to that for the stock market. That is to say, it could be accomplished by mid-September.

Gold: Based upon soaring crude prices and the weakening dollar, there has been some excitement in the gold patch. However, gold's price recovery relates to the wrong reasons and as yet does not have the financial footing so essential for another sustainable post-bubble bull market.

The gold community has been painfully learning that unless gold's real price goes up, a plain-vanilla rally in dollar terms doesn't guarantee operating prosperity.

Indeed, when gold's real price goes down, operating a gold mine can be costly. Placer's quarterly loss attests to this. Our gold/commodities index reflects the real price and it has suffered a cyclical decline from 255 in mid-2003 to 185 on June 1.

Perhaps the most obvious link is to crude oil, which roughly represents energy and blasting costs. In June 2003, the gold/crude ratio was 11.7 and only a few months ago it reached 7.2, which was something like a 15-year low.

As of yesterday, it was at 6.72, which makes energy very expensive relative to gold. Going the other way, to get the big perspective for investors, gold is exceptionally cheap relative to crude.

It's interesting that gold shares are showing some signs of strength as the key stock indexes (DJIA, S&P, Nasdaq, and Russell) are showing their initial signs of weakness. Because there are signs of goldbug excitement that could be ephemeral, it is worth reviewing the appropriate changes to indicate a cyclical bull market for golds.

From a multi-year low of 55.3 on June 1, the gold/silver ratio has increased to 62. Beyond being a plus for gold, this is a minus for the boom items. The high-yield spread has increased from 303 bps to 309 bps. A small plus, as it is not yet a trend reversal. The treasury curve (from bonds to bills) has steepened slightly from 103 bps to 108 bps. While this is a plus, it is not yet a trend change.

Going the other way, the dollar index has been weakening. Some stability would be a plus for gold in a post-boom contraction.

Buy the dips.

	FRI	MON	TUES	WED	THUR NOON
AUGUST	5	8	9	10	11
High-Yield Spread	303	308	309	307	—
Treasury Curve	107	106	105	108	105
Base Metal Prices	1012	1010	1000	1018	1023
Dollar Index	88	87.9	87.9	87.6	87.1
Gold	437.4	434.3	433.8	436.1	443.5
S&P	1226		1231	1229	1230

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