

PIVOTAL EVENTS

THURSDAY, AUGUST 25, 2005

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PUBLISHED BY INSTITUTIONAL ADVISORS

Signs Of The Times:

"No End to China's Demand for Commodities" New Zealand Herald, August 24

"Hearing the IPOs 'Pop' Again?"

"A Dot-Com Quadruples on its First Day of Trading" WSJ, August 18

"Banks promote exotic mortgages, tiny apartments sell for outrageous prices, and regulators worry about loose lending standards.

The US in 2005? No, Japan in 1990." WSJ, August 17

*"ECONOMISTS BELIEVE THE COMING DECADE WILL BE A GOLDEN ERA
Many economists, and the Japanese government as well, say the classic
theory of business cycles no longer applies to Japan, which has minimized
instability factors and learned to drive slowly but steadily when necessary."*

Japan Times, December 26, 1989

As has been widely celebrated, there is a global boom in both financial and tangible assets.

When was the last one and the one before that?

Going way back in time, the big booms were only in tangible assets such as commodities and real estate. Of course, credit was employed and its condition invariably swung from "easy" to "unobtainable".

Then in the late 1600s with the invention of stocks and central banking, a new and tradable asset class began its history. A regular 20-year bull market in commodities blew out in a mania in 1711. Nine years later, the equivalent mania blew out in stocks and, showing great perspective, the final stages, in real time, were described as a bubble. The South Sea Bubble changed from euphoria in June of 1720 to doubt in September to calamity in November.

Players in 1720 did not need calculations of 4 standard deviations to identify the action as a bubble and, beyond that, would have laughed in derision if the head of the central bank claimed that a bubble couldn't be identified until it was over.

A key point for discussion now is that, while high-end residential property was bid up with the stock market, the action in commodities was a modest rally as compared to the commodity mania of nine years earlier.

With commodities first and stock bubbles 9 years later, subsequent paired asset inflations are dated as 1763 and 1772, 1816 and 1825, 1864 and 1873, 1920 and 1929, with the most recent pair occurring in 1991, which set the last business cycle high of the "old" era of inflation and 2000 clocking the stock market bubble.

As we like to observe, there is only one financial history and the paired asset inflations are the most outstanding events – along with the contraction troughs which set up the 20+ years of commodity bull markets. Secular bears for commodities ran for some 20 years and were concluded in 1743, 1792, 1844, and 1895.

For how long has there been 20-year bull markets for commodities followed by 20-year bear markets?

A reliable price index for England has been constructed back to 1260 AD. The pattern has been quite consistent and it is worth noting the typical nine years from the last high that ended the "old" era of inflation to the collapses in the credit markets that marked the beginning of the 20-year bear market for commodities.

It is worth looking at financial history subsequent to the global stock bubble that blew out in 1873 (U.S. not on a gold standard). The contraction lasted until 1895 and, while the usual 3 to 4 year business cycle prevailed, commodities were generally weak. The only real estate index we found for the times was Farm Land Values (England). Posted annually, this declined every year from 1873 until 1895.

Now how does the current mania for tangible and financial assets fit into the big picture?

On our go-around with the pattern, commodities (The Economist All Items Index) set its high of 161.9 in mid-1988 (chart page 8). The peak of the last business cycle of the "old" era of inflation was in March, 1991 and the stock bubble blew out 116 months later in March, 2000. The comparable dates on the previous pair of asset inflations were January, 1920, with that stock bubble climaxing 116 months later in September, 1929.

In the world's financial centre, this is a rare example of a huge speculation in stocks running with an equally huge speculation in commodities. But this is not too exceptional as the hottest stock sectors have been in resources – particularly in the energies.

That this has become so big seems due to the plunge in short interest rates from over 6% to less than 1%. The only other examples of such outstanding plunges

occurred following the 1873 and 1929 stock bubbles when it was associated with the initial and widespread contraction that lasted for 3 years.

Since early 2002, we have been noting that the usual post-bubble crash in interest rates, when combined with the compulsion to buy grand cars and median homes, created an extraordinary boom upon the usual business recovery that would start some 30 months after the stock bubble blew out.

Also contributing to the upside action was that, ideally, commodities and house prices would have been firmer with that bubble. But the Asian Crisis that began in July, 1997 effectively took Asia out of the play and the collapse of LTCM in August-September, 1998 further quelled a more vigorous but still moderate rally possible with the 2000 boom.

This then deferred a lot of commodity speculation into the next business cycle – which seems to be peaking. The conditions for this will be elaborated in our usual format below. But before going there, we'll note this week's significant plunge in Indonesia's currency, stock market, and credit markets. As with the start of the Asian Crisis in July, 1997, conventional financial reporting described it as "currency" turmoil" and that it would be limited to just the Thai baht.

The same reporters told the same story as the crisis spread from one country to the next. Actually, the crisis was more than "currency turmoil", it was each central bank running out of reserves as each domestic speculation collapsed.

Great Speculation typically soar against rising interest rates and climax at or near the 18th month of rising rates.

We used this successfully beginning in January, 2000 that March, 2000 would be *Month 18*.

Ominously, the speculation became intense going into August, which we have observed is *Month 19*.

While many participants soar with the party, not all peak at the same time. Last week, we noted the sequence of speculative spikes in commodities beginning on May 1 for lumber, May 12 for nickel, June 1 for silver, and June 24 for the grains.

This leaves the hot action in copper and the petroleums.

Two weeks ago, we outlined that the action in the stocks would likely top out before the action in the underlying resource did.

On the metals, PD set a high of 115 on August 15, which compares with the cyclical low of 22.90 on October 10, 2002. The action for Rio Tinto (RTP) is similar.

On the energies, Canadian Natural Gas (CNQ) has been outstanding in running from 8.97 in November, 2001 to 59.96 on August 8. On this sector, the most

likely target for a significant high for crude has been the seasonal in early October. Last week, we noted that the gain in the real price to the 1980 peak was a factor of 6. Using that number this time around, a similar gain works out to around 75. At 68 this week, this does not seem all that far away.

The 1873 bubble enjoyed outstanding action in the resource stocks. Crude oil was barely a commercial product so, as the saying went, "*Coal Was King*". Assisted by Jevon's tout about "*The Coal Question*" (think Peak Coal), coal producers reached 50.6 in August 1873, from which the first bear market took them down to 23.1 in February, 1879.

After a rebound to 44.8 in 1881, the coal index fell to 12.7 in May, 1885. The low at the contraction trough was 12.5 in 1897.

Enjoying a bigger party, the mining and smelting index soared from 99 in January, 1871 (there was the Franco-Russian War and the world was going to run out of copper) to 447 in late 1872. From a high of 419 in 1873, the mining index declined to 24 (*no typo*) in 1884. The low with the depression bottom was 25 in 1897.

The point to be emphasized is that the paired asset inflations of the 1860s and early 1870s featured major studies of crucial shortages of coal and copper. As Jevon's wrote, the condition almost merited conversion "*This is a question of almost religious importance which needs the separate study and determination of every intelligent person.*".

On the financials, our proprietary Bank Trading Guide gave a huge "alert" in December. While this signaled the high for the BKK of 104.4, it wasn't followed by the definitive "sell" signal. This came in on August 15 and was reported in the August 18 edition of Pivotal Events as the key "technical sell" signal. The BKK has slipped from a pop up to 99.6 on August 15 to 98. The rebound high was 101.9 on July 15.

Prompted by a government political ploy about "mergers", the Canadian bank index set its high at 174 on August 1, from which it has slipped to ***.

It's worth noting that the Guide is based upon a treatment of spreads and has been effective on global banks and financials.

INTEREST RATES

Credit Spreads: some of the countries in Morgan's emerging debt index are oil producers and the MSD has rallied from 9 in April to 10.30 on Monday. This ETF share provides a good way for equity desks to trade changes in interest rates.

The rally was no big deal, but it is testing the 10.50 high of early March, from which the plunge to 8.90 only took 2 weeks. The Indonesian loss of liquidity

could be the start of something big – experienced traders could start to short MSD.

The benchmark high-yield is attempting to resume the widening trend that started earlier in the year. From 183 bps, over treasuries, then it widened to 403 bps in mid May. Then the "good times" took it in to 301 bps on August 2.

It widened to 318 on August 12, from which we thought a test was needed to reverse the trend to widening. So far, it has come in to 313 bps last week and yesterday.

Rising through 320 bps will set the trend and through 340 bps will extend it.

Serious reduction of exposure should be done now as the spread patch could become illiquid beginning in September.

The Long Bond was expected to find support at 114 (the low was 113²⁴ on August 9). A test of the high of 119 has been possible and we have been long the trade. So far, it has made 117.

However, conditions in lower grade corporates and emerging stuff could become severe enough to pull down the price of long treasuries.

Our advice to investors has been to use the rallies to get defensive. Around the 4 to 5 year could be the ideal maturity for when the curve reverses to steepening. This could be accomplished as short rates decline (*not yet*) as long rates increase (*ditto*).

Dollar Index: Once our target of 90-92 had been achieved (90.5 on July 5), a correction into September has been possible.

However, within this some firming off the 86 level was possible and this took the index up to 88.6 last Friday.

Now, as anyone who has ever read anything about interventionist theories and practices know, the best of all worlds is ensured through currency depreciation. Going with this is the counterpoise that the worst possible condition would be a strengthening dollar in the face of determined efforts by the central bank to maintain the depreciation.

In the past, the unthinkable has happened because too much debt was compulsively leveraged against soaring asset prices.

Some practical instruction on this is possible in October. One part of the path could be the dollar index slipping down to test the 86 and then rallying – possibly to new highs.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: Our approach has been to catch the swings in the stocks for traders. For investors, the high for the year would likely occur close to the seasonal high for crude in early October.

From early in the year, this has been building a magnificent mania for crude oil, natgas, and the oil patch shares. The latter took a tradable hit in March-April, from which the party became parabolic into early August.

The sensationally overbought condition is being corrected and the question becomes – *will the rebound extend the parabola or just test the highs?*

At this stage of spiking action, it is impossible to make the call. In the meantime, one steady buyer of crude is out of the market. The U.S. stockpile of crude was expected to be completed and full in August and this has been announced.

That's an important change, but it is also important to understand that no amount of that stockpile will be sold to ease an hysterical market.

Base Metal Prices have continued to party with our index (without nickel), setting new highs at 362 on Tuesday. This has been carried by copper making new highs with striking miners.

Early in the year, we outlined that a cyclical peak could be set with a high in March followed by a test in June. Our index (without nickel) rallied to 1099 in March and to 1128 in June. It is now at 1038.

Gold: The key point is that the gold stocks (NEM, HUI, XAU) sold off with the energies into mid-May. That placed the senior golds in the bear market for the real price and exploration stocks. This began in mid-2003 (real price) and for both the big and junior stocks at the end of 2003.

It is our case that this had been a cyclical bear market for the gold sector against the cyclical boom in stocks, bonds, and commodities. On the next contraction, golds will enjoy a cyclical bull market.

However, as we have been noting, as they have been rallying with energies and base metals this has been for the wrong reasons. This has been within the boom context of narrowing credit spreads and the flattening trend of the yield curve.

In the meantime, the action is mindful of conditions going into September, 2000. Stock market complacency was suddenly lost and our gold/commodities index (real price) bottomed in October along with the HUI. Both made good gains into February, 2001 when gold was stuck around 267-270 and the dollar index was steady.

This time around, golds can sell off with the end of intense speculation in stocks and commodities. With this, which could become visible later in

September, gold's real price would start to increase. Ideally, this would be accompanied by the usual signs of financial distress – widening credit spreads and steepening treasury curve.

All three turning would indicate increasing investment demand for gold.

We wouldn't chase any gold rallies, but would buy any selloff with a liquidity crisis possible in October.

	FRI	MON	TUES	WED	THUR NOON
AUGUST	19	22	23	24	25
High-Yield Spread	315	314	314	313	—
Treasury Curve	20	21	19	18	16
Base Metal Prices	1035	1055	1046	1045	1038
Dollar Index	88.6	88.1	88	87.9	87.6
Gold	436.8	437.9	439	436.9	437.5
Gold/Commodities	195	193	195	193	—

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THE ECONOMIST COMMODITY INDEX

