PIVOTAL EVENTS

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Signs Of The Times:

"***Europe Catches Deal Fever***"
"***Value of M&A Activity in 2005 is Likely to Exceed $1 Trillion***"
"***Racing to Levels Close to the Frenzied Bubble-Years of 1999-2000***"

FP, September 30

"***August Frenzy Powers Market for New Issues***" **WSJ, October 3**

"***The appetite of institutional investors for commodities as an asset class is here to stay.***" **Barclays Capital, as reported by Reuters on October 12**

"***The irony is that the New York establishment in 1989 competently described the action in Tokyo as a "bubble", but seems unable to make the same diagnosis now. As with previous examples, participants find them too prosperous for circumspection. As Lord Acton might have said, bull markets tend to corrupt and great bull markets corrupt absolutely.***"

Institutional Advisors, April, 2000

Overview: Essentially, there are two main classes of speculator. There are individuals who voluntarily choose to speculate and policymakers who seem compelled to tout highly speculative theories and practices. Regrettably, the latter never strays too far from using currency depreciation as a poultice for any real or perceived problem.

This prerogative conveys immense powers to a committee and that is the power to depreciate currency. The danger is that this is coercive in that, in order to protect itself, the public is forced to speculate almost all of the time. Currently, the focus is on residential real estate and the conviction that one can make a fortune just by living in a house is not an exchange of service or goods for economic advancement.

However, since the inception of a central bank of issue (Bank of England, 1694), the record shows that the power to exaggerate voluntary speculation is not continuous but subject to violent dislocations.

Also, that while the senior central bank can exaggerate market speculation – the public solely chooses the asset of speculation.

For example, through the 1970s the usual definitions of money (M_1, M_2, etc.) soared as speculation in tangible assets soared. Actually, this was "galloping"

CPI inflation and it traumatized the investment community. In real terms, the bear market for stocks and bonds that ended in 1982 was a disaster and the street was convinced that it would continue.

By 1980, our research was essentially completed and, when presented to institutions, the main conclusion (in the first part of 1982) was that "***no matter how much the Fed prints, stocks will outperform commodities*** ".

This was controversial to the world of orthodox economics, but the feature of previous "New Financial Eras" was soaring money supply against soaring prices for financial assets.

Beyond that this worked out so spectacularly was that there was no change in the definitions of money (M_1, M_2, etc.), but that the speculation had shifted to stocks and bonds.

This is worth stressing. The Fed was doing its usual bit to force monetary expansion but, in so many words, the "***same old – same old*** " didn't ramp up commodities.

Its culmination in 1Q 2000 completed the sixth "New Financial Era" since the South Sea Bubble climaxed in 1720. As we have noted since late 2002, the initial post-bubble bears typically ran for some 30 months and were followed by a cyclical bull market.

This is now completing and the next big point in this essay is that the public chooses which asset class to speculate in and takes it to a climax, which often occurs close to the 18th month of rising short-dated market rates of interest. As we have been noting, August was ***Month 19*** and the key stock indexes set important highs on August 2.

That looked after the most probable point of timing as the other critical aspects of an "old-fashioned" peak for the business side of the equation.

As we have been reviewing them, these include industrial commodities topping out, credit spreads widening, and the yield curve reversing to steepening. Of these, only the curve has yet to indicate "topping" action. This will be reviewed in the usual order.

Stock Market: Earlier in the summer, we were looking for the action to top out in early September. Then the speculative surge into August 2, which was close to the 18 months of rising rates rule modified the topping target to a window from August 1 to early September.

As it turned out, the key indexes set the highs on August 2, slumped, and did the test in early September – close enough.

The August 4 edition used the term "Geriatric Bull Market" to indicate that it was becoming very old. The line was added to a cartoon by David Brown, which can be viewed in our website under "Humour".

Given the age of the bull, late September could have done it in, but institutional window dressing held it together until the end of the quarter. Obviously, the market has been seriously breaking down since, leaving fund managers to ponder the wisdom about substituting short-term gain for long-term pain.

The July 26 edition of ChartWorks outlined that the Russell 2000 (small caps) was setting up a top similar to the one for the Nasdaq in 1973. This included the percentage gains of the big rallies on the way up as well as the characteristics of the topping action. This is working out.

Back in the gloom of May, the ChartWorks called for the market to turn around and rally into September. To add some colour, we included " ***However, whatever the summer brings, there are three things that guide the smart set. Never mix ginger ale with your scotch, never wear white shoes after Labour Day and, for this year, don't be overly long equities after Labour Day.*** ".

Again referring to Ross Clark's July 26 study, the eventual bottom is projected to October, 2006 (no typo – 2006). For those with a shorter-term horizon, the intermediate low could be accomplished in November. This would fit the typical seasonal pattern of late-summer euphoria followed by the sudden discovery of evaporating liquidity.

The initial selloff will likely include most sectors, It is not certain if the summer excesses have set up a bout of heavy liquidation or a stair-step decline. In either case, the first step could pause at 10150 on the DJIA.

INTEREST RATES

The Long Bond continues its price decline. The future has slumped to 112 ½ as the yield increased to 4.69%.

There are two aspects of this failure. One is that long treasuries were bid up as an asset class from June, 2004 to June, 2005. Although it sounds weird, the end of this means one less asset class that the Fed can inflate credit against.

With the resumption of widening corporate spreads, this takes a huge asset class out of the play. Longer-dated treasuries amount to $10 trillion and adding on corporates and the mortgage-backed stuff amounts to around $30 trillion.

With a lot of this leveraged at less than 2% margin, conditions seem eligible once again to turn the Keynesian "multiplier" into the "divider".

Credit Spreads: With the summer party, the high-yield spread narrowed from 403 bps (over treasuries) to 303 bps on August 5.

Widening since has been a caution with the resumption of the trend accomplished by going through 320 bps on September 21. Going through 340 bps would extend the trend and that was accomplished with Tuesday's 344 bps. Yesterday's number was 347 bps.

This is important as it is the key step on the way to a disorderly market possible for late in the year.

The Dollar Index slipped from 90.1 on October 3 to 88.7 on October 6 and has popped to 90.4 today. The original forecast was that this could correct down to 85 – 86 in September. The low was 86.3 in early September and the index has been either side of 90 since October 3.

The September 15 edition renewed our research that concludes that after a bubble era finally concludes the senior currency becomes chronically firm against most currencies and most commodities most of the time.

Worth noting is that interest rates are soaring and to us this could be part of the transition from boom to bust. Within this, the treasury curve (10s to 2s), which had flattened to 16 bps on October 5, has steepened to 24 bps.

This can't be called a reversal yet, but the move has been associated with the dollar index recovering from 88.7 to 90.4.

A test on the dollar and the curve would be needed to confirm a reversal in the curve and the resumption of the dollar uptrend.

The Canadian Dollar has been supported by speculation in industrial commodities and credit spreads.

These seem to be working on an intermediate move to adversity that will turn the Canadian unit down. (This was written yesterday and we are staying with it.)

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: The September 29 edition wondered if the Katrina buying panic had pre-empted the key high for crude expected in late September – early October.

The high was 70.85 on August 30, from which the first break was to 63.11 on September 11. The rebound to 67 on September 21 seems to be a test of the panic high as well as the best it could do on the seasonal high.

Following the latter, an intermediate decline was possible. So far, the low has been 61.36 on October 7, which is a lower low.

However, markets being what they are – each day takes us further away from the seasonal high zone and the ability to bull the market diminishes. With copper getting in line with the weaker base metals, the "commodities forever" crowd will find themselves on the wrong side of the market for a while.

Natural gas has been likely to rally in to a strong seasonal high after October 18 – perhaps in November.

Base Metal Prices: We have been looking for base metal prices to set a cyclical top and this would most likely be led by a high in the mining stocks.

A representative index set a high of 351.3 on September 19 and our metals index (less nickel) rallied up to 386 on Wednesday. Within this, copper did a 7-day rally to a record high at 1.87 (LME) on Wednesday, from which it slumped over 4 cents in yesterday's New York session. Today it has lost a further 3 cents.

With the main move, zinc rallied to 67.5 and aluminum to 88.1 (compares to 92 with the March high).

For perspective, we'll update the table of big moves for copper in real terms.

COPPER
(Deflated By PPI)

LOW	HIGH	GAIN	DURATION
November/2001 72.7	October/2005 186	156%	47 Months
October/1984 90.6	December/1988 240.8	166%	39 Months
March/1958 115.9	May/1970 253.4	119%	140 Months
June/1949 91.7	March/1956 249.7	172%	81 Months
December/1932 69.1	March/1937 173.5	151%	63 Months
January/1924 110.5	April/1929 225.1	104%	63 Months

We ran this in the September 29 edition and the extension of the rally pushed the gain out to 156%. This compares with the two best at 166% to December, 1988 and 172% to March, 1937.

As that edition concluded, "***the outcome will be interesting*** ".

Golds: This sector ended a cyclical bear market in May and set a cyclical bull market which could run for a couple of years.

By far the most important part is that the real price (gold/commodities) bottomed in June at 185 and gained 25% to 231 on Tuesday. This relates to the profitability of gold mining and the change to a solid uptrend is anticipating that the exploration sector will become an outstanding asset class – think small tech stocks in 1994.

The October 3 edition of an Institutional Advisors memo noted that the COT model gave a "sell" on gold and concluded that a brief decline would correct the excesses of the goldbugs buying for the wrong reasons.

In Tuesday's edition of ChartWorks, Ross points out that the downside on the correction would be around 460, but the main theme is that, technically, gold is poised for a significant extension to the move that started in May. After this correction, the next target would be around 542.

Overall, gold is high but preparing to extend the bull market. Going the other way, the big stock market is becoming oversold. Keep in mind that sometimes this does not prompt a rally but becomes a failure point.

The correction has included the real price as our gold/commodities index slipped to 226 yesterday. Support should be found at 216 and, as in late 2000, it could take a few weeks for the gold stocks to shrug off weakening commodities and begin the next leg up – based mainly on an improving real price. Also, as with late 2000 – early 2001, fluctuations in the dollar index and the nominal price of gold will have a lesser influence.

Some have asked why this page uses its own commodity index. Regrettably, most indexes consider gold as a commodity and include it as a component. In a world where gold's real price declines with a boom and rises with the ***consequent*** contraction, gold is still acting like money and should not be included in a commodity index.

Beyond that, it simply distorts the results when dividing gold by a commodity index that includes gold.

This dip in gold stocks may not last too long and it should be bought.

	FRI	**MON**	**TUES**	**WED**	**THUR** NOON
OCTOBER	**7**	**10**	**11**	**12**	**13**
High-Yield Spread	341	—	344	347	—
Treasury Curve	18	—	17	21	24
Base Metal Prices	977	971	954	963	947
Dollar Index	89.1	89.5	89.9	89.7	90.4
Gold	474.7	475.1	477.1	473.9	469.2
Gold/Commodities	228	231	231	226	—

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