

# PIVOTAL EVENTS

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BOB HOYE

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## Signs Of The Times:

" *Margin Loans Make a Comeback* "

" *Investors to Borrow Against Portfolios to Buy Cars and Homes*"

WSJ, April 20, 2006

" *Lenders Push Home-Equity Deals* "

" *With rates at 5-year high, banks seek to keep consumers borrowing.*"

WSJ, April 27, 2006

**Overview:** This is a huge blowoff and the speculative focus ranges from homes to base metals and energy concepts as well as the abilities of the Fed to keep depreciating the dollar.

Big speculative manias typically occur with the peak of a business and credit cycle.

When the ultimate speculative spike launches, it is difficult to pinpoint, in time and price, when the downside of the spike comes in.

One guide that has indicated the ending action has been the reversal in the yield curve from inverted to steepening. This trend, while still moderate, has extended this week.

This is indicating that the intensity to borrow short and lend long is diminishing, which is a significant change in the credit markets.

Over the past few weeks, credit spreads have been narrowing, so this sector is still a party rather than a warning.

However, one item that we thought would lead the spike has been giving a warning.

This involves a sequence of events. One was the proprietary "Upside Exhaustion" reading on silver, which anticipates an important top. This condition is a reading of dynamics and, as noted, can run for some weeks. Clearly, this has been the case and the incentive has been enhanced by the launch of the silver ETF (SLV).

Notably, the exhaustion condition is irrevocable and when the setback starts it will mark an important change in the markets.

The last time silver speculation reached this condition was in January, 1980 and it was associated with a spike in crude oil. Of interest in timing was that the gold/silver ratio, which declined with the mania and the reversal, anticipated the ultimate top by about three weeks or, more precisely, 10 to 15 trading days.

This is now a daunting prospect as this counts out to any time from today (Day 10) to Wednesday. This pattern of a rapid decline in the ratio with an irresistible play in gold and silver has been reliable back to the early 1970s.

On the bigger picture, the reversal in the gold/silver ratio to rising has been part of the peak of a business and credit cycle for centuries. Along with the obvious signs of excess in base metal and crude oil prices as well as changes in the yield curve, this strongly suggests that the speculative side of this business and credit expansion is about to fail.

Some volatility during the summer could provide confusion, but by late July deteriorating of credit markets should be more evident.

**Stock Market:** The market has been in a topping pattern since January. Within this, the Nasdaq 100 set its high on January 11 and is sliding after a failed test.

The DJIA and S&P are making new highs at a time when the best seasonal influence of the year maxes out and the weak period, typically from May until October, begins.

Making money on the long side against this seasonal is tough in most conditions, let alone from a cyclical peak. This alone is concerning, but the internals of the market continue to deteriorate. In this condition, it is prudent to avert one's eyes from the marvels of earnings and the wonders of central banking and take a hard look at the reality of the financial market.

Unlike earnings reports and central bankers, the market never lies.

**Sector Comment:** In April, leading miners such as PD and BHP set very high momentum readings that were last seen in March 2005 and March 2004.

Intermediate declines followed and, at best, a tradable decline is about to start or, worse, it could be the start of a cyclical contraction. More on this during the summer, but it is appropriate to lighten up, keeping in mind that the silver mania could end its spike any day now.

Over the past few weeks, the US bank index (BKX) shook off its lethargy since the first of the year and rallied to new highs for the move. From a low of 93 in October, the gain has been 21.5% to 113 (rounded) on Friday. (On the chart, there is an errant data post for Monday.)

In looking at the chart back to the boom high of 98 in 1998, the pattern is generally a tradable high in the first quarter with a key low in the Fall.

Our proprietary Bank Trading guide soared from 161 in January to 229 in mid-April. This is a big move and the action in the bank indexes seemed to lag until last week.

The reversal in the Guide was to 196 last Thursday and the test so far has been to 214 yesterday.

This volatility has not been seen since 1998 when we did the big "sell" on banks. The signal was so strong that we called it a "*widows and orphans*" short and, by way of example, Citigroup plunged 155% from 29.58 in July to 11.59 in October. The BKX dropped 41% from 92.2 to 54.6.

This was with the LTCM collapse that was anticipated by the widening of credit spreads that began that fateful May. LTCM was highly leveraged for narrowing spreads and was financed (in part) by the senior central banks.

As with then, it is of course impossible to determine ahead of time the name of the big failures upon a major change in the markets but, given the degree of speculation and its pending exhaustion, there will be some big ones.

As Chess master Savielly Grigorievitch Tartakower observed: "*The mistakes are all waiting to be made.*". We would say that the mistakes have been made but, as yet, not revealed.

Clearly, the pending "sell" signal from the Bank Trading Guide will be important and will be advised.

## INTEREST RATES

**The Long Bond:** On the near term, the seasonal influence on price decline could run into next week.

Of interest is that this could coincide with the probable end to the silver and base metal mania possible in the time window from today until mid-next-week.

Very nimble traders could consider a brief long position, but our policy since August has been to sell the rallies for the defensive 4 to 5 year maturities.

**Yield Curve:** As we have been noting, the main influence on rising rates is the demand for speculative credit and this can continue in the hiatus as different participating sectors run out of momentum.

Treasury bill rates turning down will not release another leg of speculation, but will signal the end of speculation.

Bummer, dude!

So far, the reversal to steepening has been moderate as it has been due to long rates increasing faster than short rates. This will become serious when shorts begin to decline as long rates continue to increase.

**Credit Spreads** continue to narrow, but in the last couple of days there has been a little widening in some emerging debt issues.

However, despite the bliss, or perhaps because of it, the risk in lower grade stuff is becoming immense.

Continue to reduce exposure to lower grade bonds.

**Dollar Index:** The dollar is tied to the speculation in commodities which, in base metals, has continued for some weeks longer than we originally thought.

However, these are trading with silver and, as we have been noting, this could conclude about three weeks after the reversal on the gold/silver ratio. That was on April 20 and the actual lead has been from 10 to 15 trading days.

This works out to anytime from today into early next week.

The US\$ is in the most oversold condition since December, 2004 and is very eligible for an intermediate rally.

The catalyst would be a distinctive break in silver.

**The Canadian Dollar** has been rallying on commodities and narrowing of US credit spreads as well as modest steps towards replacing historical corruption with sound government.

Yesterday's federal budget suggests that business, military, and all taxpayers are no longer the enemy of government.

Works for us, but the advance could flatten and then, on disappointment in spreads and commodities, the correction could be to around 87.

## **COMMENTS FOR METAL AND ENERGY PRODUCERS**

**Energy Prices:** Our momentum and price targets for crude oil have been met and we look for the seasonal decline into late June – early July.

The April 20 edition noted that natgas had reached the 8.25 to 8.50 targets and the question was "*Are we there yet?*" and the answer was "*Yes*".

The high for natgas was 8.50 (8.19 close) on April 19, which was also the day the gold/silver ratio set its low.

The decline in natgas can accompany that for crude down to late July.

**Base Metal Prices:** In the oil and gas sector, our question two weeks ago was "*Are we there yet?*" and the response was "*Yes*". The same holds for silver and the other base metals now.

Our base metals index (less nickel) soared to 670 on April 26. This is up 42% from the last low of 472 on March 8. On the same move, the index (including nickel) gained 40% from 1130 to 1584.

Obviously, this extended beyond copper's usual seasonal high in late March, but as distinguished experts tell us "**this time it is *really* different**".

Indeed, it is different as metal prices have exceeded the best of any cyclical bull market (on data back to the early 1900s). Extraordinary valuations were also accomplished with the stock mania to 1Q 2000 but, as we observed then, in dynamics and timing the action was similar to any high-tech stock bubble since the first one – the South Sea bubble of 1720.

Again, in this wild market it is prudent to seek the guidance of history and, as we have been noting, this blowout could be tied to the pattern that ended outstanding speculations in silver relative to gold.

As detailed below, this pattern is working out and it leads to a general collapse in speculative abilities. That's for the street's ability to promote "stories" and the Fed's abilities to bull the markets and depreciate the dollar.

Investors should be selling base metal mining stocks and producers should be selling base metals forward.

**Wrap:** We have been careful to point out that whether the asset class has been stocks, corporate bonds, commodities, or real estate, it is all one big financial market.

Within this, the link to all the last innings on all the games is the yield curve. This indicates the willingness of the markets to create credit hypothecated against rising prices. The change in the curve to steepening is market-inspired and has rather little to do with central bank policy. They, and we are sure many central bankers also know, are merely along for the ride, which means that equity investors should not be distracted by stories about earnings or theories that the Fed can always deliver the "good stuff".

Clearly, as represented by the New York financial markets, the world's financial centre is at the "top of the ninth", to use a baseball term.

Given the storms building on distance horizons, the game could be called on account of rain.

Of course, the distant horizon represents the action in smaller outlying bourses.

Since Roman times, the end of great speculations have often started in the outlying exchanges.

In this regard, since January we have been watching the action in the Dubai stock exchange with unusual interest. The DFIML index soared to 1267 on November 9, from which it plunged to 960 in only five weeks.

The rebound was to 1100 in early January, from which it plunged to 600 in mid-March.

The rebound made it to 720 in early April and this week the key 600 level was taken out decisively at today's 550.

This is not an isolated event nor is it likely to remain isolated. To make some comparisons, the first selling wave in 2000 took the Nasdaq down 41%. For the Dow in 1929, the number was 47% and for the Dubai it was 52%.

In the real world, the Baltic Freight Index (BDIY) often leads turns in the stock market and, in this instance, the index has been in slow decline since mid-March. Last week, it took out key support and has continued down this week.

Nothing dramatic, but at 2364 it's not too far away from major support at 2100. This is worth watching.

A speculative peak is a convergence of powerful forces that inevitably fails to the downside. Current developments are tracking just such a path.

**Golds:** Continue to sell the big ones in order to buy the smaller caps in perhaps 4 or 5 weeks.

The speculation in silver relative to gold has likely maxed with the gold/silver ratio at 43.6 on April 19. Then, using the typical pattern at the end of a number of such examples, the end of the play occurred 10 to 15 trading days later as gold generally outperformed silver.

This has been the case this time around and today is **Day 10** on this pattern.

The long the silver ETF (SLV) and short the big producers initiated on Friday has been a good trade so far. This spread could be kept on for some weeks yet. Those with more aggression in mind could sell the SLV on the next bounce.

All of our research suggests that the best for silver and silver stocks is in and this sector could considerably underperform the gold sector.

Of course, gold and gold shares need to correct recent excesses, but it should be modest.

	<b>THUR</b>	<b>FRI</b>	<b>MON</b>	<b>TUES</b>	<b>WED NOON</b>
<b>APRIL / MAY</b>	<b>27</b>	<b>28</b>	<b>1</b>	<b>2</b>	<b>3</b>
<b>High-Yield Spread</b>	290	290	286	—	—
<b>Treasury Curve</b>	18	19	20	21	24
<b>Base Metal Prices</b>	653	657	—	668	653
<b>Dollar Index</b>	86.5	86.1	86.3	85.6	85.8
<b>Gold</b>	636.3	651.8	657.5	667.9	667.8
<b>Gold/Commodities</b>	227	234	—	—	—

**BOB HOYE, INSTITUTIONAL ADVISORS**  
**E-MAIL** [bobhoye@institutionaladvisors.com](mailto:bobhoye@institutionaladvisors.com)  
**WEBSITE:** [www.institutionaladvisors.com](http://www.institutionaladvisors.com)