

PIVOTAL EVENTS

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Signs Of The Times:

" No doubt there's something new about the rise of commodity markets and prices."

" A new kind of commodity cycle is driving record base metal prices, with supply unlikely to catch demand soon." Rio Tinto Chairman, Paul Skinner, May 5

" One thing is for certain, [crude] prices will continue to rise ... traditional criteria of supply and demand don't apply."

Charles W. Duncan, Secretary of Energy, February 25, 1980

Overview: As we have been discussing, the blowoff of a great speculation is a violent clash of bullish emotions and the reality of implacable market forces.

The conflict now is as intense and violent as the 1Q 2000 example in tech stocks or the 1980 blowoff in crude oil, silver, gold and, to a lesser extent, copper.

The culture of the times then included the political left becoming overwrought, with Iran holding Americans hostage as Jimmy Carter, Neil Young, and the Ayatollahs were all singing "*Helpless, Helpless, Helpless*".

Commodity speculation suddenly collapsed and the trend of politics reversed from dominance by the hysterical left to the relief of political reform.

Then, confirming that what goes around comes around, commodities and the hysterical left are on a blowoff, Jimmy Carter is still trying for headlines, and (shudder) Neil Young has produced another album.

The break in commodities is significant and could lead to a business contraction and a refreshing shift in politics back to the quiet middle.

Stock Market: The lead to this stock market break has been the Nasdaq, particularly the QQQQ, which is the index of the big 100 listings.

As we have been noting, this sector also led during the downside of the massive top in 1Q 2000. Interestingly, the struggle between the bulls and gravity was choppy until late September when, with weakening economic numbers and earnings reports, the bear was widely recognized.

This time around, the Qs set the turn-of-the-year high on January 11 (the Dow did it in 2000) and the negative divergence has been indicating this week's swoon.

Importantly, this index has suffered a lot of damage with potentially widespread implications. The decline has taken out the uptrend line in place since last June, the 200 day moving average, and is making new lows for the year.

On the more fundamental side of the stock market, the housing sector (HGX) is also setting new lows for the year and is more advanced in this direction than the Qs. The high was 298 in July and, at 232, the action is threatening the October low.

Now that we are finally "*there*", the next question becomes "*What does it all mean?*"

As we have been discussing, great speculations tend to occur near a business cycle peak rather than at a trough. That's over the past few centuries, so the phenomenon has been reliable. Indeed, one of the warnings as to whether the boom has been in financial assets or tangible assets is the break in commodity prices.

We have this now and, combined with the yield curve reversing to steepening, the probability of a business and credit contraction is quite high.

Of course, as part of the impetus to bull prices up has been the conviction that the Fed can continue to depreciate the dollar. So, as part of the upside exhaustion, it would be appropriate to have the dollar index stabilize.

This has been in "oversold" territory since mid-April and a week with a higher high will initiate the "buy".

Typically, the peak in the stock market leads the peak in the business cycle by 10 to 12 months.

Sector Comment: As with previous "old fashioned" bull markets for the general stock market and industrial commodities, the mining sector is the last to top out.

This seems to be the case as the home builders sector topped out in August, the Nasdaq 100 in January, and the SPTMN index of mining stocks looks like it peaked on April 18.

This was close to the ominous reversal in the gold/silver ratio on April 19 and, importantly, mining stocks lead the high in metal prices, which was on May 12.

Our advice on the resource sector has been to lighten up. The break has been damaging to the markets and, considering the magnitude of the play, there will be a test of the highs.

This could bring promise of hope that the party will resume, but we would look at it as another opportunity to sell.

As of yesterday, our Bank Trading Guide has concluded its "sell" pattern. The volatility has been the most significant since 1998, which was followed by the LTCM collapse.

Typically, on important such signals, it leads the high in bank stocks by a few weeks. How this exactly works out is for the history books but, for us, it signals the time to begin selling bank stocks aggressively.

Also, as in 1998, it could be a signal on global bank stocks.

INTEREST RATES

The Long Bond has been likely to base as the frenzies in the hot games blew out.

This has been the case as the low in price for the future was 105.38 on Friday. This popped to 106.5 on Tuesday and the setback was to 105.31 yesterday¹.

We take this as a test of the low and the advice has been that nimble traders could take a brief long position.

Of interest is that the media explained yesterday's slump in stocks, which included industrial commodities, as due to "inflation worries".

A bit of a paradox there, but this view hit the bond market so the test with the wrong story provides the opportunity to buy the bond.

The Yield Curve: With the joy in the games last week, the curve (10s to 2s) flattened 21 bps on May 3 to 15 bps on Friday. Then today's bond rally moved it to 13 bps.

The overall trend to steepening foreshadowed the break in the hot games, which is appropriate but it will become more significant as short-dated treasuries begin to decline in yield. It would become even more significant when the decline in bill rates is accompanied by rising long rates.

This may be perplexing to the establishment, whose record of confusion in 2004 as short rates increased with long rates going down was described as a "*Conundrum*".

"*Conundrum II*" could start by mid-year.

The Dollar Index has been oversold and attempting to base. Our advice has been to buy when a weekly high has been accomplished. For our

¹ Bond prices will be recorded in decimals rather than in 32nds.

economist readers, this means a week with a higher high than the week before.

The rally could carry to 92.

The Canadian Dollar will likely consolidate its gains as commodities weaken.

For some time now (well, ever since David Dodge was appointed Governor of the Bank of Canada), we have thought that the stature of central bankers in North America could be vastly improved if David Dodge took elocution lessons.

Now there is something with real substance on the horizon.

The Canadian dollar could rise to trade at par with the US\$ and the Bank of Canada, in pegging the exchange rate, becomes a currency board.

Just think of it – no central bank and no central bank governor.

For those opposed to state theft through currency depreciation, this would be a "*halleluiah*" day.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: We have been looking for a tradable decline in the oil patch (includes the natural gas sector) into late June – early July and then a choppy rally until early October.

Base Metal Prices: A lot of red is showing on the quotation screens. Yesterday was nasty, with declines ranging from – 1.9% for the Dow, - 3% for the goldbugs index, - 3.8% for the silver ETF, and – 4.25% for Comex copper.

As it turned out, our work on the gold/silver ratio provided the timing on the reversal to about as good as it gets.

We started discussing this in March and the sequence went from our proprietary "Upside Exhaustion" reading on silver. The next step was to watch for the reversal in the ratio to rising.

At the two big peaks in gold and silver in 1980 and 1974, gold outperformed silver on the last phase of the move. This was also the case on a number of other highs.

This time around, the ratio reversed on April 19 and, as was pointed out, the high for both gold and silver would likely be set 3 weeks later – on Wednesday, May 10.

The highs for both were set on May 11, which is close enough.

We were confident on this and noted that quite likely the high for base metals and the stock market would soon follow.

The foundation for this was not intuition, but that often the end of great speculations are associated with the beginnings of a contraction and silver falling relative to gold is a key indicator.

This is how it tables (ratio reversal on April 19).

	WED. APRIL 19	THURS. MAY 11	RECENT LOW
Ratio	43.6	48.5	52.7 [High is bad]
Gold	632.6	719.8	683.6
Silver	1449.9	1484.6	1324.6
Copper	2.97	3.98 (May 12)	3.70
Nickel	8.26	10.07 (May 12)	9.27
Zinc.	1.45	1.81	1.56
S&P	1310	1326 (May 9)	1267
London	6090	6106 (May 9)	5675
Frankfurt	5994	6141 (May 9)	5653

Clearly, the reversal in the gold/silver ratio in April anticipated the end of the speculative spike in the hot items, which included the euphoria in the stock market.

Although in early stages, this is confirming the adage that every bull market has a copper roof.

With this, we continue to look for guidance from the ratio, which is at 53.3 this morning. This is becoming a rather fast move, which makes its warning all the more strident.

Golds: Following the high for silver and gold likely to be set last week, a correction for both into mid-June was possible – with silver falling relative to gold.

The financial markets are in the transition from boom to contraction, which will inevitably increase the investment demand for gold and reduce the industrial demand for silver. Speculative demand for the latter seems to be diminishing already.

One point to be stressed is that gold's zoom to 720 was propelled by the wrong reasons. These, of course, are the goldbugs' favourites – plunging dollar and soaring commodities. And it's worth reminding ourselves – goldbugs at full excitement are dangerous to the gold market.

The advice has been to lighten up on the big cap golds in order to accumulate the exploration sector.

With silver likely to underperform gold, silver stocks should generally underperform the golds.

The appropriate recipe for gold's success in a post-boom contraction is falling industrial commodities (just started), stock markets (ditto), and a steepening treasury curve (modest start).

The main thing now is that further extension of last week's big reversals seems highly probable and this will take out eternally naïve goldbugs. This phase could complete by mid-June when evidence of contraction could begin to increase the investment demand.

This will show up in our gold/commodities index which, as we have been noting, has been in a general decline since early January. This indicates that mining costs were adverse through the first quarter.

Starting at the high of 241 in January, gold's real price declined to 221 on April 25. The recovery has been to 233 and the low needs a test in order to set the uptrend. This could be established in June.

We would then look for a lengthy advance in the real price, which will drive a cyclical bull market for gold shares against a cyclical bear market for business and the general stock market.

	FRI	MON	TUES	WED	THUR NOON
MAY	12	15	16	17	18
High-Yield Spread	278	283	289	291	—
Treasury Curve	15	17	16	19	13
Base Metal Prices	775	713	725	745	712
Dollar Index	83.9	84.5	84.7	84.8	84.7
Gold	710.3	683.6	691.5	690.5	682
Gold/Commodities	229	233	236	233	—

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