

# PIVOTAL EVENTS

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## Signs Of The Times:

*“It’s the best of all worlds, global growth is strong and the dollar is weak.”*

- Wall Street Journal April 27  
Chief Market Strategist at Bank of America

However, there are some observers who are becoming concerned. A piece in WSJ.com on April 30 provided an outstanding review of over-employed leverage, or as it is euphemistically called – liquidity.

**Hedge-fund manager John Paulson made \$1 billion using a complex financial instrument to pump up a bet that the subprime mortgage market would crater. The parent company of retail giant Sears made \$74 million using a similar device to boost its wager that a basket of stocks would rise in value.**

**Both were playing with leverage – the magical power that allows investors to make big investments without putting big money on the table. These days, they have lots of company. Thanks to advances in financial engineering, investors have never had so many different ways to make commitments that exceed their bankrolls. And never before has leverage wormed its way into so many nooks of the financial world.**

**We’re living on planet leverage, and regulators and market gurus are growing nervous.**

**How did this happen? For starters, hedge funds and leveraged-buyout funds have proliferated. They’re pioneers in boosting returns using borrowed money, the most traditional form of leverage. Also, investment banks are pumping out newfangled leveraging tools such as derivatives, complex securities that allow hedge funds and other investors to add leverage without borrowing money.**

The kicker, of course takes us one step beyond the liquidity euphemism into the surreal with the convenience of being able to *“add leverage without borrowing money”*.

Recently, Warren Buffett has warned that widespread use of derivatives is endangering the financial system and observed *“It’s easy to put on leverage, but not as easy to take it off.”*

On April 4 the Financial Post had an article that included *“the rapid evolution of products”* and that *“The new strategies include collateralized loan obligations, currencies and credit-default swaps.”*

In returning to the WSJ.com article which also noted that dealers offer “*derivatives in dizzying variety. The values of some are tied to single stocks, others to baskets of stocks or market indexes, still others to bonds, oil, or even the weather.*”

And exemplifying another piece of financial jargon Buffett is quoted again, “*total-return swaps make a mockery of margin requirements.*”

The important thing to be noted is that this is not the first time that financial innovation has inspired new instruments, and when it arrives – chagrin.

The earliest huge mania that was complete with all the miracles of financial innovation was the South Sea Bubble of 1720. Bitter disappointment followed and was nicely recorded for posterity:

*“the English Nation run a madding after new inventions, whims, and projects [promotions], that impoverish, fiddle them out of their money, by the strange, unheard-of engines of discount, transfers, tallies, debentures, shares, projects, and the devil and all figures and hard names.”*

That bubble peaked in May to June of that fateful year. The market drifted with weak rallies during the summer and crashed in the fall. The South Sea Company, which was the big-cap wonder, crashed from a high of 1000 to only 120 in only six months.

**Stock Market:** We’ve been on the “*Rational Exuberance*” theme which considers that if exuberance occurs at about the right time it’s rational. It’s worth adding a little more to the concept in noting that the powerful rally has been accompanied by strong commodities. This is also rational as it is typical of a great boom.

Also part of the formula is highly confident projections by highly-placed commentators, one of which we’ve featured on our front page. Another aspect of a great top is the more conservative side of the street commenting on very reckless lending habits. This seems to be starting what could be a good crop of them now.

So far, these paragraphs have been anecdotal and it’s worth turning to the numbers side.

The action has become measurably overdone as noted, in February a number of global stock exchanges have registered the “*Upside Exhaustion*” on the monthly reading. For example, EAFE (EFA is the exchange traded fund) began registering in late February, which was accompanied by the weekly as well.

The index corrected from 77 to 70 with the China hit and since soared to 80 and is still generating the excessive condition. It should be added that these readings haven’t been registered since the remarkable cluster of them that occurred in the first half of 2000.

We, of course, are alert to the loss of momentum that will indicate the “sell”.

Seasonal rallies for crude oil and base metals were expected to stabilize and then rally the markets after the China hit. This has been the case and crude observed its seasonality when it reached 68 in early April. This weakness could run into July and contrary to conventional wisdom weak crude is not good for the stock market.

Other support has come from strong base metal prices which, like the stock market, is action that is getting stretched to the limit.

On the oil and gas stocks, we've been lightening up. The XOJ has rallied from 1018 to this week's 1315. Natgas stocks (XNG) have rallied from 390 in October to 505 in early May.

We've been in both on a seasonal play since October – November for a rally into March – April and our policy is to continue lightening up.

On almost the same seasonality we've been long the mineralized rock patch and the index of mining stocks (SPTMN) has rallied from 543 in the November dip to this week's high of 805. This is now into the weekly overbought for the first time since last April – May. That high on May 11 last year was anticipated by the dramatic reversal in the gold/silver ratio on April 19.

On this boom the action in the ratio hasn't been dramatic enough to repeat the success of last year's collapse. We've been looking to other indicators.

One really big one is that the conclusion of a cyclical bull market in stocks and commodities typically runs for some 12 to 16 months before the bad things start to happen.

This is *Month 15* which suggests that a cyclical peak is at hand and seems to be rationally fitting this model rather well as the markets are getting exuberant in the correct cyclical time window.

On this indicator it's speculative demand for short-dated credit that drives short rates higher than long rates and inversion eventually throttles the flow of speculative credit.

The next aspect is seasonality and it's appropriate to have the resource sector as well as the general markets up for a late spring peak. The old saying "*Sell in May and go away*" is not policy-induced, so to study, say, the Fed's utterances on administered rates, should be considered irrational.

In a few examples such as at the conclusion of the great booms of 1929 and 1873 the move out of inversion and into steepening occurred as the stock market started its serious slide.

Historically, we've always used the curve from bonds to bills as the best representative. This reached maximum inversion at -54 bps on February 27 from which it has come in to only -1 bps yesterday. This is now indicating danger.

## INTEREST RATES

**The Long Bond** has recovered a couple of points from its support at 110 (the low was 110.25), as commodities have weakened a little. The low bond price was on April 13 which was also the high day for the CRB at 318.

Obviously the long end is not moving with the short end, and this is likely a cyclical turn, in which case the 4 to 5 year maturities is the best place to be on the curve.

**Credit Spreads** have been relatively unchanged on the week. However, the latest go at narrowing took the BBB to 102 bps in late April. With that the high-yield narrowed to 253 bps and junk to 447 bps.

Now that's the traditional corporate stuff and there has been modest widening since.

On the innovative subprime mortgage sector the bond we've been using as the proxy has recovered from its disastrous plunge to 73 on February 27 to 84.15 on Tuesday. Amounting to a 41% retrace this is becoming a little too ambitious.

Quite likely deterioration in the subprime sector will be accompanied by deterioration in the traditional corporate market.

On the collapse of the former, spread traders and yield hogs found complacency in the traditional market and as it prevails the more vulnerable it becomes.

**The Dollar Index** came down to 81.25 and at 30 in the weekly RSI and this was as oversold as it was at the low in May last year, and almost as oversold as at the low of 80.39 at the end of 2004.

We had thought that the dollar would weaken as stocks and commodities rallied out of their January problems.

It has spent some 3 weeks in forming a base and could rally with any significant deterioration in credit spreads, the stock markets as well as commodity prices. As this edition is finished this seems to be on.

**The Canadian Dollar** is the most overbought since the high of 91.42 set in June last year. That's on the weekly and daily readings.

Although we like the longer term outlook, short-term the C\$ seems eligible for an intermediate correction.

Initial support could be found at 87.5 level and more durable support could be found at 85.

## COMMENTS FOR METAL AND ENERGY PRODUCERS

**Energy Prices:** Crude met our targets in late March and the decline could run into late June – early July. Of course, this could be interrupted by hysteria about the Middle East but once the seasonal low is in the rally could run until October.

Natgas has yet to set a seasonal high.

### **Base Metal Prices:**

*“Huge funds target exotic metals, looking for unexploited, unsaturated markets.”*

*“Exotic metals such as cobalt, vanadium and molybdenum may be the next targets for investors.”*

- Reuters April 27

To employ a concept used in the first quote, the base metal story seems to be reaching saturation. As the huge mania in gold and silver blew out in 1980 it left a virtual industry of promotion looking for something – anything – to promote. The tout become *“strategic metals”*.

We will review the periodic table for the difference between exotic and strategic metals, and in the meantime there is the story about the \$100 Billion merger with Rio Tinto (RTP) and BHP. This has even greater luster than the Alcan deal, and seems difficult to top.

This places these stocks well into the weekly overbought condition. In the past these levels have concluded rallies. The index of base metal mining stocks (SPTMN) is about 70 on the weekly RSI which is usually sufficient to end a rally.

Anyone who has done some white water paddling knows that turning a canoe or kayak into the eddy behind an obstruction is very difficult and when successfully done – very rewarding.

The problem is that while the main current is downstream the water behind the obstruction is going upstream – often vigorously. So, on going through the transition opposing currents are forcefully attempting to roll the boat over.

The rules for success are “*Momentum, Lean and Angle*”.

The metal markets are in a powerful current that is getting close to reversing, in which case, some questions could be reviewed:

- Is the market up when it should be?
- Is there anyone who doesn't have a firm conviction on the fundamentals?
- Are there signs of excessive speculation?

The answers seem straight forward and the factors suggesting a reversal include excessive momentum, seasonal forces, as well as the final stages of a boom again, now, at 15 months of yield curve inversion.

**Golds:** This sector seems to be buffeted by conflicting currents.

On one side is gold bug excitement about soaring commodities, and the other – the real side – is that said commodities are still outperforming gold. This has brought our gold/commodities index to a new low of 151. This was at 255 in mid 2003, when this cyclical boom got launched.

But in gold's long history this is how it works. In a boom the real price goes down and in the inevitable contraction the real price goes up.

Fortunately there is a pattern in the credit markets that anticipate or confirm a cyclical bull market for gold. Credit spreads remain in dangerous complacency, but the one with usually more direct influence, the U.S. yield curve, is making the turn to steepening.

Widening of credit spreads usually indicate increasing investment demand for the liquidity of gold.

The gold sector could suffer a choppy to down price action due to gold bugs bewildered by weakening commodities and conservative investors responding to storm signals from the credit markets.

Continue to accumulate on weakness.

	<b>FRI</b>	<b>MON</b>	<b>TUES</b>	<b>WED</b>	<b>THUR</b> NOON
<b>MAY</b>	<b>4</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
<b>Junk Spread</b>	456	458	456	450	----
<b>Treasury Curve</b>	- 3	- 4	- 4	- 6	- 5
<b>Base Metal Prices</b>	780	----	780	783	771
<b>Dollar Index</b>	81.8	81.7	81.9	82	82.2
<b>Gold</b>	687.7	688	685.1	680.3	673
<b>Gold/Commodities</b>	152	151	151	150	----

**Whenever you save five shillings, you put a man out of work for a day.**

- **John Maynard Keynes, 1933**

**Professors . . . prefer their own theories to truth: the reason is that their theories are private property, but the truth is common stock.**

- **C.C. Colton, 1820**

**When professors become central bankers, the old “publish or perish” becomes “print or perish”.**

- **Editor, May 2007**

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