

# PIVOTAL EVENTS

THURSDAY, MAY 31, 2007

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PUBLISHED BY INSTITUTIONAL ADVISORS

(PLEASE NOTE: DUE TO SPEAKING ENGAGEMENT  
THERE WILL BE NO PUBLICATION ON JUNE 7 AND 11)

## Signs Of The Times:

Democrat contender John Edwards is *“Getting \$50,000 to give a college speech on poverty; specifically noting that we live in two Americas, one rich, and one poor.”*

- Washington Times, May 23

*“Is this metal the next moly?”*

- Stockwatch.com , Eblast May 24

- Didn't open to learn what the mystery metal is.

*“Pedal to the metals”*

- Market Watch Video, May 29

- They were not raving about gold.

## SOME CURIOSITIES

*“Freak Snow and Ice Across Europe”*

- Daily Mail, May 29

*“Argentina Cold Wave Prompts Record Demand for Electricity”*

- Bloomberg, May 29

*“Freak Snow Storm Hits Nepal”*

- Drudge Report, May 30

**Stock Market:** Lately our theme has been that *“Rational Exuberance”* would conclude the bull market. Other than spoofing Greenspan's exclamation of December 1996, the term is meant to explore the rational nature of great financial events.

Buying stampedes and selling panics may seem irrational as extremes are belatedly realized. However, we've long observed the intense speculation is fungible with many

common features – no matter what time-series is the focus of animation. Similar behavior patterns seem to govern intense downsides or upside speculation.

The latter shows seasonal tendencies with, for example, base metal prices setting important lows in the fall and important highs in the spring. This is the case this year with copper being the best example.

The next and more important behavior pattern is that the biggest speculative bubbles, since the 1720 example, have concluded in the May-June time window. Our question – with stock market fundamentals so reasonable and with a competent Fed team, where are the excesses and risk?

Our proprietary model has been designed to impartially register the excesses seen in any time series.

In February the action in number of a number of global stock exchanges registered, on monthly determination, the “*Upside Exhaustion*” reading. These included most of Europe and Asia, with an important exception – China.

These have not been seen since the first half of 2000. It’s worth noting that this impartially measures the conditions only seen at the culmination of a big bull market. And as in many examples the exhaustion condition can register over a number of weeks.

Two weeks ago the Shanghai index (SSEC) kicked in the rare upside reading and it’s worth adding that this is an indelible condition that in all previous examples the excess has not gone away quietly. In so many words, the tattoo machine doesn’t have an eraser.

History has never provided an easy resolution to speculative excess. The bulls get to lose at the peaks and the bears lose at the bottoms. On the latter the model is also designed to register “*Downside Capitulations*” at extreme lows and the last such readings occurred in late September and into October 2002.

A cyclical bull market was likely to follow.

The other part of the question is the real abilities of policy makers to reduce risk. The literature provides no evidence of the senior central banks ever preventing a post-bubble contraction. This is why the culminating excess is so indelible.

What about the Fed’s “*emergency*” reduction of rates from 6% in 2000 to 1% at the end of 2002? The street considers the “*bold*” and famous 17 rate cuts as engineering the recovery. However, history shows that since the senior central bank has been materially able to change administered rates (since around 1850) the only massive plunges in such rates have occurred during the initial stages of a post-bubble contraction.

Following the 1929 extravaganza the key administered rate (Fed discount rate) plunged from 6% to less than 1%. The only other such plunge followed the financial mania that climaxed in 1873. During the initial phase of that contraction the Bank of England’s rediscount rate declined from 9% to 2%.

The popular notion that the Fed can time a rate cut to sustain a great boom seems to be based more upon wishful thinking than upon empirical evidence.

This is part of the evidence that lead to the conclusion that financial history, itself, is a due diligence on central banking.

On the nearer term this is regularly confirmed by the behavior of the yield curve. Even if one accepts that the Fed can materially change the course of short-dated interest rates, most understand that such manipulations have little material effect on long-dated interest rates.

In the course of a boom the yield curve usually inverts. As this dates back to before the advent of the overly-ambitious Fed one explanation could be that the demand for short-term funds by speculators simply raising short rates relative to long rates.

Typically the final stages of a bull market run some 12 to 16 months against the inverted curve before the hot action begins to falter. June is *Month 16*, and evidence is building for a change.

Of importance is that the yield curve is reversing to steepening which is usually close to when most speculations begin to fail.

However, as the saying goes, it is not over until it's over, and recently the short position has become rather large, which could be forced to cover. On top of this, from late May into next week is usually strong.

Perhaps this could provide the last extreme on the outstanding speculative market.

**Sector Comment:** Our game plan on depressed resource sectors last fall was to recognize the seasonal low and get long for the seasonal rally into late spring. We will address these sectors in our usual format below.

On banks and financials, our Bank Trading Guide reached a high of 214 on February 26, which was the day before the first China hit.

The BKX set its high at 121 on February 20 and that week's slump anticipated the China correction that hit so many markets. Technically the bank index became overbought and the initial slide took it down to 109, which was rather oversold.

The rebound took it to 118.4 on May 18 and it's now hanging around 117.

In the meantime our Bank Trading Guide declined to 195 on May 4 from which it has been flat at 200. Declining through 195 would indicate a "sell" on most of the financial sector. The last big "sell" on this sector was last summer and it took out the subprime sector.

The subprime mortgage bond we've been following collapsed from 100 last August to 73 on February 27. The rebound has brought it to 84.6 last Thursday, which was the high for the move. It has declined to 81.66.

We are watching this for the change because it would again signal deterioration in the subprime sector. A breakdown in the Bank Trading Guide would be a negative for banking overall.

## INTEREST RATES

**The Long Bond** made a 2-point rally of support at 110.

Our policy has been that investors should use each rally to get defensive in the 4 to 5-year maturities, pending the reversal in the curve to steepening.

Traders have been flat.

**The Treasury Curve:** After reaching maximum inversion in late February the curve is making the change to steepening.

This is being accomplished with short rates declining as long rates increase which typically has happened just prior to the advent of previous contractions.

For historical reasons we prefer to use the whole curve from bonds to bills. This reached -54 bps on February 27 from which there has been an insistent move to 29 bps today.

This is looking like the reversal to steepening in the fall of 2000. The distinction is that that reversal occurred in the season that can be very weak for stock markets.

This one is occurring in the season when major highs can be set. We are taking the curve reversal as a warning.

On the investment side trading desks can play the steepening side for quite some time.

**Credit Spreads** have been acting well. Junk continues to narrow. From 530 bps, over treasuries in January, junk has come in to only 423 bps this week. This is record stuff.

Needless to say, but the action has been very exuberant in providing little discount for risk.

As noted last week, May can also set the best for spreads on a seasonal basis.

**The Dollar Index** seems to be more rational than exuberant. However, it has been likely to decline as commodities rallied out of their problem in January.

The DX became sufficiently oversold at 81.25 in late April to prompt a rally. So far the high has been 82.6 on Monday.

The daily momentum things suggest a brief pause is possible. This could be associated with one last blast in the stock market.

However, there is more up in the dollar yet. We've been looking for an intermediate rally.

**The Canadian Dollar** had little problem with the old high of 91.42 set a year ago, which was our target. The high has been today's 93.67 and with a couple of days of gapping up at the opening the action is getting compulsive.

Tuesday's high of 93.35 was accomplished with two openings where the action gapped up, which looks like unusually severe short squeezing.

The political scene is blah so the drive seems to be from overall exuberance.

On the weekly momentum, it is the most overbought since November 2004, and the action is vulnerable to a correction.

On the longer term 100 has been likely with evidence of political reform in Ottawa.

Regrettably this is not showing now.

## COMMENTS FOR METAL AND ENERGY PRODUCERS

**Energy Prices:** Crude was expected to reach a seasonal high in late March and the high for the July contract was 68+ in early April

A descending series of highs and lows has brought the price down to 63.25. Usually the low is in late June – early July and last week we thought the trend through this low would be moderate.

We've been long the oil sector since the fall and from the low for the XOI of 1018 in October the rally has carried to 1373 for this week.

Our advice has been to take some money off the table as the index is the most overbought since September 2005 and seems vulnerable to a brief correction. Typically in the petroleum sector the product leads the significant turns in the stock indexes. In mining the stocks lead turns in the metals.

Natgas didn't rally as strongly as we expected on seasonal strength usually seen in April. On the other hand without that strength it has had little reason to decline.

On the stocks, we've been long since the fall. The seasonal low for the XNG was 390 in October and our target for the rally out of the January setback was higher than the December of 476.

So far the high is 521 set on May 20, making a 34% gain on essentially a seasonal move. The action is somewhat overbought and traders can take some money off the table.

The correction could be modest with a much bigger rally for natgas possible in the last half of the year.

**Base Metal Prices:** What a party! Takeovers, mergers and strikes by the workforce.

That's in the headlines, but underneath the action in metals is vulnerable to the yield curve. We recently ran the chart of the curve against copper and the pattern is inversion and than a bear market.

As with the stock market the transition relates to when the curve reverses to steepening, which is the case recently.

In the April 11 ChartWorks Ross used 4 different technical tools that indicated that the upside action was very overdone. Also it was at the conclusion of a "*Sequential Sell*" pattern, which we liked because it was the end of a "*Sequential Buy*" that got us in.

The high was 380 (Comex) on April 4 and it looks like the top is in. The recent low has been 316 and taking out 310 would confirm the downtrend.

The index of mining stocks has had an outstanding run from 498 in October to 808 on May 22. On the weekly, this is the most overbought it's been since May a year ago and some correction is possible.

This is another of our seasonal plays in positioning in the fall for profits to be harvested in late spring. The index is up 62% and we would continue to lighten up.

This week lead has extended its highs to 2,348. As deflated by the PPI the price is up 357% since the cyclical low of 513 in October 2002, which is working on the biggest

gain in a hundred years. The previous record gain was 287% on the run from 1985 to 1990.

This, along with nickel's fabulous gain of 839%, compared with the next best at 623% (1982 to 1988) unambiguously states that this is the biggest base metal mania in over a hundred years.

As someone said a while ago, the Fed has become a serial bubble blower and this ability now includes base metal prices. The tech bubble that concluded in 1Q 2000 was measurably the biggest in history.

The resolution of this spike in metal prices will be spectacular.

**LEAD  
(ADJUSTED FOR PPI)  
SIX BIGGEST RALLIES**

<b>START</b>	<b>PEAK</b>	<b>GAIN</b>	<b>SUBSEQUENT LOW</b>	<b>YEAR</b>
513 Oct 2002	2,348 May 2007	357 %	? ?	? ?
507 March 1985	1,966 March 1990	287 %	507	1993
939 Dec 1975	3,249 June 1979	277 %	556	1985
739 Sept 1962	2,290 Feb 1965	210 %	939	1971
517 July 1932	1,964 Mar 1937	280 %	812	1938
616 Feb 1921	1,988 Dec 1924	223 %	517	1932

**Miscellaneous:** The widely-followed CRB index is showing a weakening pattern. The high was 366 set in the heady days of May 2006, from which the rebound made it to 323 in December. The next rally made it to 316.

These have been set with negative momentum divergences. Taking out 307 would roll the chart over. Taking out 301 would set the down trend.

The Baltic Freight Index (BDIY) can be an important indicator of significant lows or highs. As with other items related to the China phenomenon it has been on a roll.

From 2000 in January 2006 the BDIY chugged up to 4,647 in January 2007, took a correction to 4,219 (along with the problems in crude and base metals), and then the zoom launched.

In 2 ½ months it soared 59% to 6,688 on May 15. The spectacular rally from 1,000 in mid 2001 to over 2,000 in mid 2003 signaled the launch of this international boom.

The decline of 10% to 6,023 in only 10 consecutive trading days seems the most distinctive break in 2 years. The index is volatile but this slump with the changing yield curve is interesting.

**Golds:** Tuesday's ChartWorks thoroughly updated gold's nominal price, which has been buffeted lately.

The problem, as our work on the real price has been pointing out, is that goldbug buying on the usual knee jerks brought about by soaring commodities and a plunging dollar. The frustration is that in a boom, typically gold underperforms commodities. The hazard is when commodities weaken and the dollar firms. Brief setbacks to the goldbug formula have set the lid on the recent rallies.

The curious may wonder how the market gets out of this impasse.

The irony is that in real terms (we use our gold/commodity index (G/C)) gold sets a significant low as a great boom concludes.

In mid 2003 there were a few developments that indicated a boom. One was the launch of the Baltic BDIY, and another was the change in the yield curve towards inversion. Also part of the play was the change in the gold/silver ratio to declining, which has been associated with the long decline in our G/C index.

This has declined from 255 to 143 on May 16 and on May 21. It has recovered a little to 147.

Our case is that gold's real price is setting a significant low as the boom is maturing. The gold/silver ratio had a key low of 46.7 in late February and the yield curve is turning to steepening.

These changes usually anticipate a significant increase in the investment demand for gold, which is associated with a proportionate increase on the real price.

Over the past few weeks the advice on this page has been to accumulate the sector on weakness. The May 18 ChartWorks had a shopping list of oversold resource stocks.

	<b>THUR</b>	<b>FRI</b>	<b>TUES</b>	<b>WED</b>	<b>THUR NOON</b>
<b>MAY</b>	<b>24</b>	<b>25</b>	<b>29</b>	<b>30</b>	<b>31</b>
<b>Junk Spread</b>	426	426	423	424	----
<b>Treasury Curve</b>	11	14	21	18	29
<b>Base Metal Prices</b>	725	710	720	720	735
<b>Dollar Index</b>	82.4	82.4	82.3	82.4	82.3
<b>Gold</b>	653	655.1	657.1	653.1	658
<b>Gold/Commodities</b>	147	146	149	147	----

- Typically at the close of a boom the yield curve reverses to steepening.
- The dynamics are more visible through the whole of the curve from bonds to bills.
- The table has been changed from showing the 10s to 2s to the whole curve.
- It is moving this week.

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