

PIVOTAL EVENTS

THURSDAY, AUGUST 2, 2007

BOB HOYE

PUBLISHED BY INSTITUTIONAL ADVISORS

Signs from June:

Some quotations from June are worth repeating – perhaps for some they may be worth regretting.

“Freddie Mac says the subprime mess is contained.”

“Fund manager says, ‘The whole subprime mess has been basically looked over and is not taken as a big concern’.”

- Bloomberg, June 26

“Bernanke said [mortgage-backed securities] are a valuable market innovation and ‘sometimes there are bumps’ in the new-product road.”

- Market Watch , July 19

The first new era of financial innovation ran until the South Sea collapse of 1720. A dismayed, and possibly damaged observer complained:

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

“U.S. stocks retreat on subprime concerns; American Home plummets [On the day, down 90%].”

- Bloomberg, July 31

“The latest red flag: American Home Mortgage Investment – which doesn’t specialize in subprime lending – said it is suffering steep margin calls from its own lenders.”

- Wall Street Journal, August 1

Everyone knows that the Chairman *has* to say comforting words with the early signs of distress. There is no way of knowing his private thoughts, but as someone fully qualified in interventionist theories it is likely that he is sincere in his statements.

As for the above quotations from “Freddie” and the fund manager, they represent blatant cheerleading, with hopes of protecting their book.

It is important to discredit (scary connotation) the very popular notion that it was “liquidity” that was driving the markets and prosperity. Actually, as history so frequently shows, the mechanism works the other way – soaring prices stimulate leverage, which is a practical but impolite word for credit expansion. Then when collateral prices turn down it initiates the credit contraction.

As that occurs the powers of the margin clerk (or mortgage officer) overwhelm the powers of the central to inflate credit or, as real bankers used to say, “*create money out of thin air.*”

Stock Markets: Our theme since earlier in the year has been that the yield curve was usually helpful in determining a cyclical peak in the stock markets. Typically the ultimate thrust runs for some 12 to 16 months against an inverted yield curve.

Inversion began in February 2006, which counts out to somewhere close to the second quarter of this year, when a spectacular surge could conclude the bull market. The further refinement was that, while inversion could indicate inevitability of a top, it was when the curve reversed to steepening that – as we phrased it – the wheels begin to come off the most intense speculations.

Such reversal became apparent in late May, and accomplished by mid June.

Obviously the wheels have been coming off. A number of speculations, such as nickel plunged 41% from the May high and the subprime crisis resumed in mid May, which hit traditional corporate spreads in late June.

History’s point has been that a credit expansion will eventually culminate in reckless lending and borrowing. Speculation in price will eventually exhaust itself and the price decline will relentlessly force the credit contraction.

This began to be proved, once again, as the turn down in house prices prompted the subprime “mess” which is inducing liquidity concerns in other sectors.

Lacking a comprehensive appraisal of its own limitations, the world of policymaking is confident that financial problems can be contained.

Essentially policy making is reliant upon faulty logic and faulty research. The notion that the Fed can keep a recovery going by expanding credit is based upon the observation that business expansions are accompanied by credit expansions. This is correct, but the assumption that credit expansion will force a business expansion is not.

Indeed, in logic it is a glaring example of a primitive syllogism that assumes that because two things occur at the same time they are causally related. The old example is a rooster crowing *causes* the sun to rise.

Faulty research by most of the establishment fosters the notion that the Fed will lower interest rates and as an institutional analyst wrote last week, “*But let’s be clear – the Fed is likely to cut rates – and that should spark a stampede of new buying.*”

As popular as that thinking is, it is not supported by empirical evidence. Throughout the past 300 years, short-dated market rates of interest increase with a business boom and decline with the contraction. In so many words, so long as short rates are rising the party

is on, and this is good. Declining rates typically indicate that the part is over and this is bad.

Three-month treasury bills set their high in late February and, although modest, the decline has been associated with some rather bad stuff.

At the moment the stock market is oversold enough to prompt a sharp rally.

Sector Comment: With an onslaught of adverse stories the great complacency has been shaken but not shattered.

Representing banks and financial, the BKX tested the 121.16 February high at 118.45 in late May. Then changes in the yield curve and credit spreads in late June took the sector down. Our July 5 observation was that banks and financials were a “Widows and Orphans Sell”.

Last week’s edition observed that the index was getting somewhat oversold and at 103.5 momentum is at a level that can prompt a rebound for a few weeks. Who knows, but it could be associated with pundits talking about an imminent cut in Fed rates. This would be a correction in what could be the early stages of a cyclical bear market associated with a cyclical credit contraction.

In looking to the longer term, there is support at 95 but deteriorating fundamentals suggest that the last cyclical low of 60 for the BKX could eventually be reached.

Meanwhile over in the mining patch, the SPTMN almost made it to a parabolic move, but only made it to a technical up-thrust. The high was 955 set on July 14 and the low has been this week at 842. Although the daily RSI is not down to 30, which would be very oversold, it is at a level that has prompted rallies since the beginning of the year.

As we’ve been noting, a change of pattern in the mining stocks could foreshadow a change in the direction of base metal prices.

INTEREST RATES

The Long Bond made it to 110.25 yesterday. As noted last week, targets on both momentum and price have been accomplished.

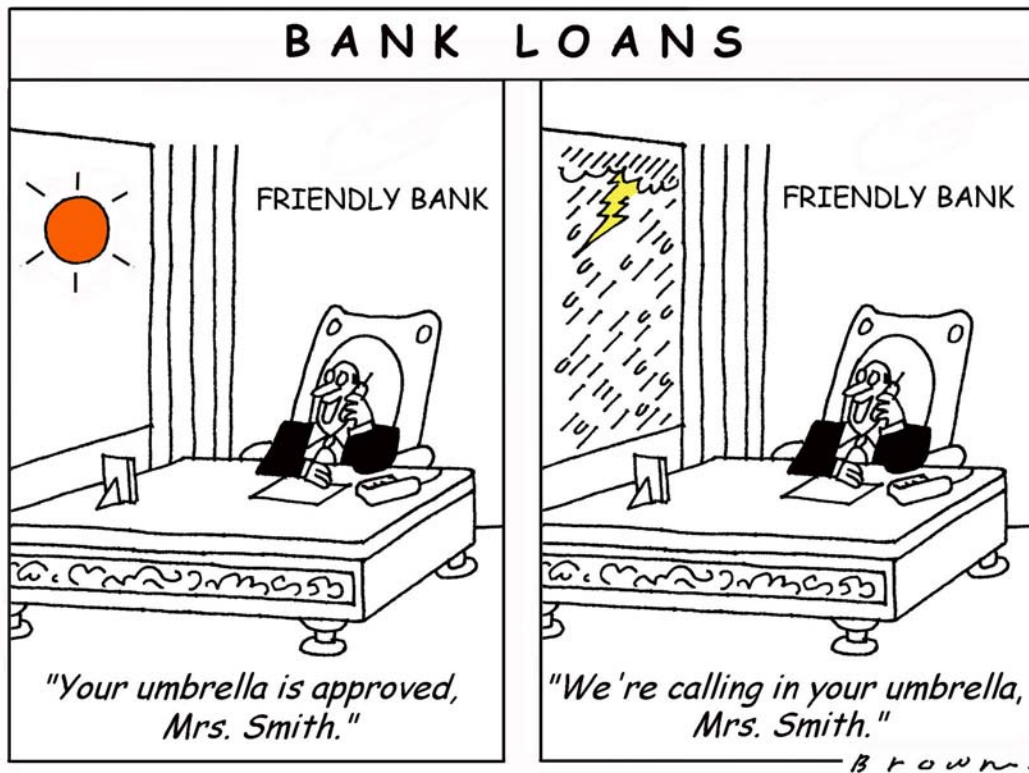
The extra $\frac{3}{4}$ of a point has been a bonus that traders should take off the table, but not yet short. Investors should sell the rally to take advantage of the next phase of steepening which should become evident by mid September.

The five-year maturities could outperform most investment alternatives.

Credit Spreads: The subprime disaster, as in any historical example, is radiating out from the initial, and supposedly isolated, crisis to encompass most sectors of the credit markets.

Tuesday’s collapse of American Home Mortgage illustrates a couple of points we’ve been emphasizing. The company wasn’t financing lower grade borrowers, they were specializing in Alt-A mortgages, which is a notch below an A or “prime” rating.

Then even the “A” rated mortgage bond prices turned down, and as Bloomberg reported, *“that is otherwise known as a margin call”*.



The rot that typically follows an over expansion of credit typically spreads from the initiating sector to supposedly high-grade sectors.

As this precedes eventually the avoidance of long-dated lower-grade stuff envelopes the high-grade market.

The Curve: There are two salient features of previous post-bubble contractions that can be applied to current conditions. The curve will steepen as the real flight to quality will be to treasury bills, and away from the long bond.

The other is relentless widening of credit spreads.

Both have started, with the curve flattening recently which we take as a correction on the trend that started in late February.

The Dollar Index was likely to make it to about 81.25 on the initial rebound out of the extremely oversold condition at 80.03.

So far it has recovered to 80.93 and on the near-term neither overbought or oversold.

However, the stock market has become oversold enough to rally and this could be associated with a pause in the dollar rebound.

A test of the low was part of ChartWorks' recent analysis of the dollar.

The Canadian Dollar slumped from 96.68 to 93.52 as the wheels came off some of the hot games. Near-term momentum is neutral and the price is at support.

The C\$ can test the high and will likely roll over as liquidity problems again become concerning after mid-September.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: From the exceptional low of 51 in January the rally has been better than the one to 79.86 in the equivalent period last year. Also it has been without the unseemly emotional excesses about hurricanes and all. Instead it has been a fairly steady rise with modest corrections off the overbought short-term highs.

The seasonal component of the rally has been likely to run into late September – early October. The old high can be reached and the action then will tell the story about how much further it can run.

One tedious feature could happen as new highs will likely knee-jerk revival of “Peak Oil” superstitions.

On the oil-patch stocks, the July 19 edition noted that the XOI was getting overbought enough for a pause in the action.

The high was 1522 and the correction has been to 1340. Last week's view was that some stability would set the market up for a rally into late September.

Stocks sold off somewhat more than expected, underperforming the action in crude. Perhaps oil stocks are becoming vulnerable to the spreading loss of liquidity.

On the weeklies and dailies the XOI is almost oversold enough to rally.

Natgas has been expected to set a significant low in July and the low was 5.86 on July 24. This was accompanied by enough oversold on the daily to prompt a rally. So far the high was been 6.47 and a test of the low would be a healthy step towards setting up an outstanding rally to late in the year.

Last week when the XNG was at 488 we thought gas stocks could go a little lower on momentum and price. Also noted was that support would be at 475. So far the low has been 480 and in responding to the product rally the XNG has recovered to 497.

Both gas and gas stocks could settle a little and should be bought.

Base Metal Prices: The July 19 advice was that metals could advance for 6 to 8 weeks. Our index (less nickel) then was 775 and the rally has been to 825 on July 24 when the hit to the financial side of the stock market took the index down to 771 on Monday.

However, the stock rally should take metals up into September.

It should be understood that the liquidity problem that started in the subprime will eventually constrain the availability of funds needed to play the takeover mania in mining

stocks. As noted, mining stocks typically lead base metal prices at cyclical lows and highs.

In which case the rebound to test the SPTMN high of 955 will be interesting, and our next call depends upon whether it falters or continues to fly.

Golds: Since the high of 401 in May 2006 investors have had indifferent performance with the HUI spending much of this year in the 300 to 372 range.

Goldbugs have had their formula going for them – that is to say that commodities have been strong and the dollar has been weak, but it has not translated into a soaring market for gold shares. On the junior exploration sector it has been zero to very negative action.

And as we belabor the point, on a business expansion commodities will outperform gold. So using the goldbugs' theory itself, one should be long commodities and base metal stocks rather than the gold sector. This shows up in the charts. Since May 2006, gold has gone from 730 to 663. With this the HUI has declined from 401 to 339.

On the same move our base metal index has gone from 1548 to a high of 3200 in May this year. It is now at 2182.

As noted above, the action in base metal miners (SPTMN) has been outstanding. On the move we've been discussing this index has soared from 547 in May 2006 to a high of 955 in June.

The reason why the gold sector has been underperforming is straight forward – gold and gold shares always underperform during a business boom. Fortunately the action is close to blessing the golds as they typically outperform alternative assets during a post-bubble contraction. For example, Homestake had a low of 8.13 in the 1929 crash and could have been bought at 9 during 1H 1930. It soared 122% to 20 at the end of 1933 – with no change in the 20.67 price of gold.

As the nominal price of gold was being rigged up by Roosevelt to 35 Homestake made it to 68, and was paying 4.50 per share dividend.

Those with the curiosity needed to thrive in the world of investments would wonder what was going on and what was associated with such outstanding performance.

Quite simply, gold's real price began to increase in the fall of 1929 with the collapse of the highly speculative boom. The previous great boom in stocks and commodities blew out in Europe and London in May of 1873, and in New York in early September. Gold's real price turned up in November of 1873 for a lengthy recovery.

In the credit markets the end of the cyclical bear market in gold's real price was associated with the reversal in the yield curve from inverted to steepening and with the reversal in credit quality spreads from narrowing to widening as regard for risk went from complacency to calamity.

The gold sector underperformed as our Gold/Commodities index (G/C), which represents the real price, went from a high of 241 in May 2006 to 143 in late May. The high of 255 in June, 2003 was set as the business boom really launched.

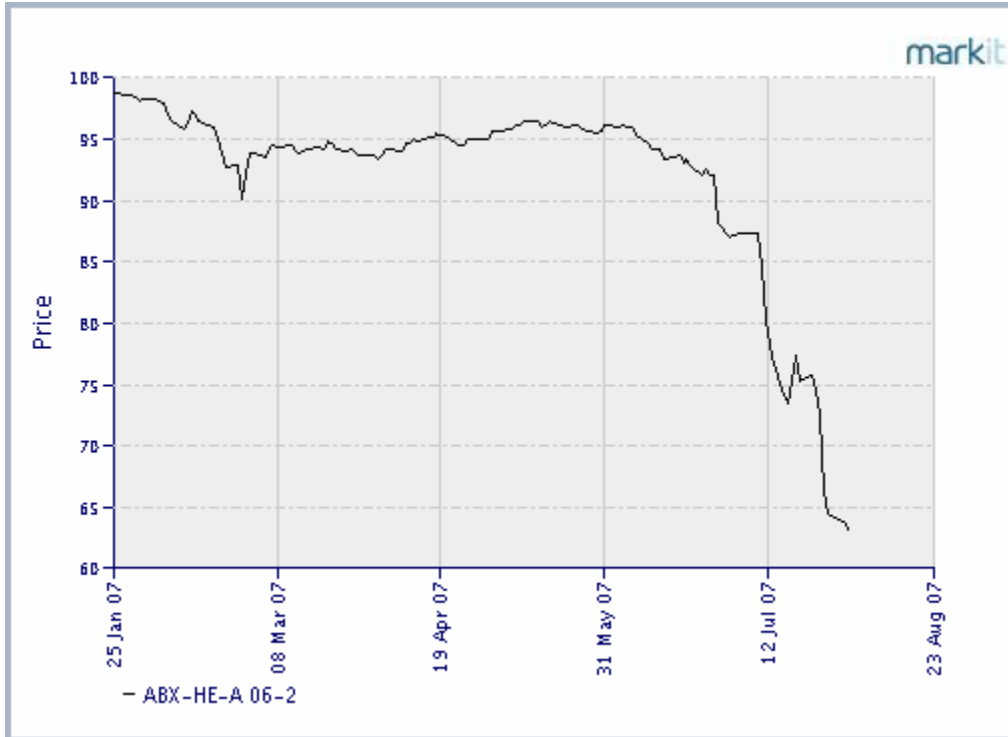
So far the high has been 178 and conforming to credit market history – the improvement in gold’s real price has been associated with the reversal to a steepening treasury curve and widening credit spreads.

Late May of this year saw the curve make it through to steepening, the rebound in subprime mortgage bonds ended and started their second crash, and traditional corporate bonds reversed to a significant widening.

This is the historical recipe for a real and lengthy bull market for the gold sector. However, after September liquidity concerns could become greater and more encompassing. This would be accomplished by falling stocks, commodities and corporate bond prices as well as a steady to firming dollar.

Going into this could shake the goldbugs out of gold and gold stocks, which will provide an ideal buying opportunity, accompanied by the right condition for the big bull market for golds.

SUBPRIME MORTGAGE 'A' RATED BOND



- Lower-grade stuff such as the BBB completed its first crash at the end of February.
- Liquidity concerns turned the “A” rated bond down in early May.
- Traditional corporate bonds were considered safe until mid June.

	FRI	MON	TUES	WED	THUR NOON
JULY/AUGUST	27	30	31	1	2
Junk Spread	674	670	----	----	----
Treasury Curve	9	13	4	5	4
Base Metal Prices	776	771	798	780	797
Dollar Index	81.03	80.70	80.81	80.82	80.80
Gold	660.9	664.1	666.9	664	663.7
Gold/Commodities	176	178	174	177	----

B HOYE, INSTITUTIONAL ADVISORS
E-MAIL bobhoye@institutionaladvisors.com
WEBSITE: www.institutionaladvisors.com