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MARKETS HAVE HAD A COUP de WHISKEY

Signs Of The Times:

"There are risks that an abrupt fall in the dollar could either be triggered by, or itself trigger, a loss of confidence in dollar assets."

– Head of IMF, AFP, October 22

Seems to be something inconsistent with this. Most now know that a good portion in the rise in asset prices such as stocks, corporate bonds, and commodities relates to dollar depreciation. So then, how do falling asset prices in US terms square with a plunging dollar? If it is going to plunge further then asset prices would be marked up in dollar terms. Even in the horrendous German inflation in the early 1920s the stock market outperformed the rate of inflation. What are they smoking over at the IMF?

But hey--not to worry:

"The Federal Reserve will continue to monitor developments in the financial markets and act as needed to support the effective functioning of these markets and to foster sustainable market growth and price stability."

– Fed Governor Randall Kroszner, AP, October 22

And more reasons to remain complacent:

"US bank shares are so cheap – and dividends so high – that some of the biggest investors now say the combination is 'unbeatable'."

– Bloomberg, October 30

"Citigroup retreats on dividend concern."

– Bloomberg, November 1

Stock Markets: Dollar depreciation continues to increase the price of the stock market and crude oil. However, the latter is at a seasonal high and has had the initial hit. A significant decline is now likely, which makes the stock market vulnerable.

Technically, participants are no longer bulling the whole market, but have been focusing on some outstanding leaders leaving behind the rest of the flock. In so many words market breadth has been lagging, which is symptomatic of a topping market.

This week there was confidence in orthodox fundamentals such as GDP for the past quarter as well as in this week's waving of the FMOC magic wand. Unfortunately,

subprime bonds having been plunging and we have been noting that the sequence of events would follow the pattern seen in the summer.

The slump in the BBB would lead the A, and this would lead the collapse in the AAA, which would signal widening of traditional corporate spreads and the turn down in the stock market.

This seems to be moving along, as the BBB took out the August low in late September. The A did it on October 18, and the AAA failed this week. With this, traditional corporate spreads have widened a little since October 18. Also with the move the yield curve has steepened a little. Tuesday's memo "Credit Is Three-Dimensional" included charts of the stock market and subprime.

Today the next crisis seems to have started.

Sector Comment: Action in the banks (BKX) flirted with a breakdown at 100, but did not close below the critical level. Our Bank Trading Guide declined to 177 on October 24 and recovered to 182 on Monday. With this the BKX recovered from 100 to 104, also on Monday. Today it's down 4.7% to 98.6.

The subprime action, either up or down, is a proxy for the monumental mess in the precarious world of synthetic dealings, otherwise known as CDOs or more generally as derivatives. The recent decline was particularly acute in the AAA sector. With an AAA rated bond trading at 87 one has to doubt that this is still a rating, or is just an arbitrary designation representing moral relativism?

Technically, the failure point on the BKX remains at 100 and for our Guide at 177. Continue to lighten up.

Over in base metal mining, the SPTMN continues to work on the test of the big high with equivalent momentum set at 955 in July. The downdraft was to 668 in the turmoil of August and the test made it to 958 in mid-October with the next attempt making it to 943 – both with diminishing momentum.

Taking out 860 will start the downtrend.

Wrap: This week the street's focus has been on past history. At cyclical peaks the economy lags the stock market by some 10 to 12 months, and at the completion of a bubble, changes in administered rates by the senior central bank typically lag changes in short-dated market rates of interest by a number of months.

Changes in the curve and spreads are little influenced by policymakers and since May have been suggesting a cyclical reversal in the credit markets. Recent plunges in subprime bonds have significantly moved this possibility along.

INTEREST RATES

The Long Bond has stalled out with diminished momentum at 114, which compares to the high of 114.25 of early September. Right now we don't see much reason to rally further or to take a dramatic plunge. At some point, resumption of distress in the subprime will unsettle the corporate market such that revulsion for most bonds will eventually encompass long treasuries.

In the meantime the October 17 Financial Times made some interesting points:

"A decade ago, when Asia was facing a financial crisis, American bankers and government officials regularly traveled to the region delivering homilies about the best way to exit a banking mess. After all - or so the lectures went - America had suffered bank crises, such as the Savings and Loan debacle of the late 1980s. This experience had shown that the best route to recovery was to establish realistic prices for distressed assets, by conducting fire sales if necessary, and then write the losses off. However, it seems that some US financiers seem to need to take a hefty swig of the medicine they used to wave at Asia."

Well, that problem is not just in America, but global financiers and central bankers combined to juice the markets, prompting impressive short covering.

It reminds of 1927 when faltering spirits with the collapsing Florida real estate bubble needed reviving. Ben Strong, then head of the New York Fed, told a French central banker that he was going to give the markets a "*coup de whiskey*". The rally was terrific but as it turned out, yet another story in the house of cards. It might just as well have been called a "coup de bourse", and it was celebrated as a "coup d'eclat", prompting a "coup de chapeau". For realists it was eventually seen as a failure ("coup de manque") as was all the preceding nonsense about managing "price stability". As for us, we would have been content with a "coup de beer".

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