

PIVOTAL EVENTS

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Signs Of The Times:

From Last Year:

"Demand Stays High For Junk-Rated Debt

– Wall Street Journal, January 13, 2007

"Private Equity Funds on a Buying Binge"

– Financial Post January 19, 2007

"Conservative Investors Line Up For Junk Bonds"

"Seeking Higher Yields, Funds That shun Risk Look Again; Appeal of Low Default Rate"

– Wall Street Journal, January 20, 2007

"Optimism Hits Heights At Davos"

"Bankers, investors and executives last week arrived at the Swiss resort giddy about profits and bonuses. After five days of hectoring by policymakers that they are too complacent, they left just as happy."

– Wall Street Journal, January 29, 2007

The second mention of problems in the sub-prime mortgage market was in a WSJ article on January 27, and our February 1 edition noted that the decline in the BBB bond from 98.20 at the end of November to 90.34 was a serious break.

That tranche has since plunged, by stages, to 14.58 (no typo). But it is still "ranked" as BBB, not even BBB-. This ranking is caught somewhere between a crock and a hard place.

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Showing sort of an opposite *déjà vu*, this year's conflag at Davos has been gloomy as George Soros described today's condition as the *"Worst market crisis in 60 years."*

Stock Markets: Our intermediate outlook theme included that in the early stages of a post-bubble contraction, that the month of November could conclude the capitulation of the initial bust. In our case, we noted that when this was running late the washout could complete in January (as following the 1825 Bubble).

This pattern also provided for stability in December and a plunge into January. This we have and to an excessive degree as determined by the ChartWorks proprietary model.

Using the Nasdaq Comp as a proxy, the plunge has registered a "Downside Capitulation" on the daily reading – the weekly rarely kicks in. The record has been consistent in determining the low on the initial phase of a bear, with an outstanding example occurring on April 17, 2000.

Lows of an interim nature generate the same reading and occurred, for example, on September 17, 18, and 21 of 2001. Another one occurred at the end of the Asian Crisis on November 13, 1997, and a "classic" on October 20 and 21, 1987.

Obviously, shorts should be covered and nimble traders could take a modest long position – on the general market. Investors will have another opportunity to sell.

There is another model Ross has been working on and it involves the employment chart.

The count on this one indicates an initial low for around January. The details will be outlined soon.

If it works, this could be the conclusion of a monumental step down, and as noted last week – typically the rebound could retrace some 40% to 50% of the loss. It seems unlikely that this would be any more than a relief rally in a lengthy bear market. Some might wonder if the August panic could be considered as the initial post-bubble plunge. This seems unlikely as it was too brief so we will rank it as a very important "heads up".

It is worth mentioning that this stock market failure, which is now an indelible event whose impact can't be erased, was not accompanied by a crisis in the money market. Another hit to money market desks similar to the August storm is pending – at some time.

Also, using the Nasdaq, it was another example of a 55-day crash.

Sector Comment: Banks and financials were under a lot of pressure over the last few days. The BKX plunged to 75, which compares to the high of 121 set in February last year and the sell-off low of 66 in April, 2003. The action is very oversold, and the turnaround from Tuesday's hit has been impressive and too far too soon. Nimble traders could take a brief long on the test of the low.

Both traders and investors should keep in mind our July conclusion that the credit markets are in the biggest train wreck in history. This is nowhere near concluding.

This also holds for base metal producers, which index (SPTMN) we have been looking for a trading buy in January. The high was 958 in October and the low was 598 on Tuesday and at a very oversold level. Usually this sector has a good seasonal high around March.

INTEREST RATES

The Long Bond: Back in June, the ChartWorks had a strong buy on the bond future at 105, and with a couple of tradable swings it made it to 122.81 yesterday. This is now very overbought and traders can play the short side. We have been aggressively positioned for steepening, and the next leg could feature rising long rates against little change in the bill rate.

Credit Spreads: Most of the widening has been seen in the junk spread as the stock market tanked. At 607 bps in October, the spread reached 1004 bps recently. On the move, the yield increased from 11% to 14.32%. As noted last week the cost of long-term money has been increasing, and it should be. It is worth adding that yield could be more of level than a rate at which issues are being floated.

This has also been accompanied by another crash in sub-prime mortgage bonds. On the same move the A sub-prime plunged from 65.16 to 28.89 on Tuesday.

Generally, spreads can also enjoy some brief relief.

The Dollar Index is at a neutral momentum reading. This suggests it could trade in modest range for some weeks. The street could conclude that "brilliant" policy has ended recent disquiet and the recession has been cancelled. In which case the DX could be firm, but who really knows during such wild conditions.

The Canadian Dollar is now oversold enough to prompt a rally. This would go along with a rebound in base metal prices.

Miscellaneous: The Baltic suffered a 43% plunge from the record high of 11,039 on November 13 to 6,246 on Tuesday. This almost retraces the speculative spike on the way up and shows the symmetry of such a spike. A relief rally is possible, but we have considered that the decline is cyclical.

The grains, obviously, have topped. Our January 4 edition noted that the GKX was becoming impetuous, and on January 10 we advised watching for the top and it was set at 418 last week. An exchange traded fund, DBA, is based upon agricultural products and reached 37.57 on Thursday, and recorded a very overbought.

Using Potash (POT) as the proxy the Ag stocks have plunged real fast from 152 to 105.5. That's 31% in only 6 trading days and suggests the play in the products themselves is over. A bounce is in order, and this could provide the test of the high for this stock sector as well as for the grains.

While our advice to investors has been to lighten up as each sector became impetuous, more specific selling should be done in this sector on the rebound. The DBA, with options seems like an ideal vehicle for aggressive traders. A rebound is possible and it could be sold.

On the big picture, the agricultural prices have been the last commodity sector to do the spectacular zoom. And the test could define the top.

COMMENTS FOR ENERGY AND METAL PRODUCERS

Energy Prices: Crude oil has dropped 13 dollars from the famous 100 and traversed enough momentum points to prompt a tradable rally. The plunge took only 13 trading days and the rebound could run into March.

From the high of 1581 at the first of the year, oils stocks (XOI) plunged 23% to 1212 yesterday. This sector is also very oversold and nimble traders could get long for a brief rally.

Along with investors we sold the rally into November.

Natural gas is neutral on momentum and could continue trading in a range between 7 and 9.

Gas stocks (XNG) have dropped 17% in only 6 trading days and deserve a bounce.

Base Metal Prices: Our index set a low of 605 in mid December and rebounded to 678 on January 9, which we thought as too much. A test of the low was needed and the decline made it to 632 on Tuesday.

It is interesting that this occurred on the same day as many markets seemed to have capitulated. The rally has been likely to run until around March.

Gold Sector: Gold's nominal price came down to the 20 - day moving average, which was the target. This also tested the 859 level and the rise to new highs is technically sound.

In the meantime, the real price relative to our commodity index has continued its advance. The long bear was natural in the face of the financial mania and the low was 143 in May. The important thing was that its turnaround occurred with the historical reversal in the credit markets.

Just as there is a post-bubble cyclical contraction underway it is normal that it be associated with a cyclical bull market for gold's real price. It is the way financial history works.

Our gold/commodities index rallied from 143 to the 210 level in early December. It traded around this level until January 9 when the "discovery" of a liquidity problem in the stock markets lifted it to 219 on January 11. The quick correction to 214 set up the pop to 226, which compares to the high of 255 set in mid 2003 when the late boom launched.

Our advice since November has been to lighten up on the senior gold stocks and buy the smaller caps. This policy could be done more aggressively.

Gold/Silver Ratio: With relief in the financial markets, silver could outperform gold. Also there can be a seasonal low for the ratio in mid February.

	FRI	MON	TUES	WED	THUR NOON
JANUARY	17	18	22	23	24
BBB Spread	173	171	168	159	----
Treasury Curve	123	128	193	211	198
Base Metal Prices	653	646	632	641	649
Dollar Index	76.21	76.40	76.30	76.30	75.76
Gold	879.5	860.8	889.6	882.5	905
Gold/Commodities	216	217	225	226	----

Central Bank Follies

Policymaking and Panics: Until now, each swoon in the stock market was followed by not much more than "three-day wonders" – there were a few of the common one and a half day rallies – often seen within a severe decline.

This rebound could be of an intermediate nature. The selling climax occurred with a major policy effort to end the panic, which will soon be deemed to be successful. However the rebound is technical, which could also be called natural. Just how natural this is, as well as the response by policymakers is fascinating, and could be described as much more than panicedotal evidence.

History records many crashes or panics and many of them have occurred in the fall of the year. One of the big bubbles blew out in May of 1825 and the usual phase of heavy liquidation was delayed from the typical start in late September. The crash completed in January, 1826 when officials congratulated themselves in taking dramatic steps to end the panic.

As we outlined last summer, one of the blunders in policymaking has been to assume that once started, and unless somebody does something they will last forever. Also discussed was that once started a stock market crash typically ran for some 55 trading days when exhaustion prompted the rebound.

Using the Nasdaq Comp the high was set at the end of October at 2861 and the plunge from close to close ran for 55 trading days. To the interday low of 2203 the loss was 23%. During the week there has been considerable noise about stimulus and central bank rate cuts – all coordinated, of course.

The record is sufficiently reliable to suggest a rule. A crash will run for around 55 trading days, with the final stages severe enough to stimulate central bankers into headline-making action. Even without policy utterances the rebound would naturally occur. Sadly, officials making the heroic gestures are unaware of the equivalent gestures made by their counterparts during a number of previous examples.

One of the outstanding examples of the initial 55-day disaster occurred following the 1Q2000 tech blow off. That crash ran 52 trading days to the low and the rebound started on day 55. The 1987 crash ran 51 days to the low and after a quick test the rebound started on day 55. The notorious 1929 crash ran for 55 trading days. Even if this evidence was known to interventionist economists, it is doubtful that it would change the ardent belief that the 1929 crash was due to a policy blunder when the discount rate was increased from 5% to 6% in August. After all, central banking is a perfect system that only fails when somebody at the top makes an error. And that is an *ad hominem* argument so often employed by socialists when plans go wrong.

In most cases the 55-day crash was the initial distress that ended a financial mania. The 1987 panic was within the context of a bull market.

Considering the enormity of the credit problems, this crash can be described as the initial panic in a long post-bubble contraction. Policymakers are adding to their long record of futile gestures.

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