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COMMODITIES AND POLITICS

A huge change in both is possible.

Despite some dramatic reversals in the grains and continuing dislocations in the credit markets, commodity bulls remain confident that the action is only a few years into a bull market that could run for 18 years. The research behind this is quite simple – there was a bear market that lasted for as many years – and symmetry argues for an equivalent bull market

Last year, one of the most adamant of the bulls stated "***The current commodity bull run could last until 2014-2022, matching the bear market in the 1980s and 1990s.***".

This was carried in the Dow Jones wire and the guru was described as a "***commodity investment expert***". He went on to claim that commodities were "***the perfect anchor for portfolios as commodities move differently from other asset classes***".

Rationalization continued into last summer as a U.K. pension fund announced that it was going to double its exposure to commodities because it would ***"reduce the volatility of returns"***. At the end of March a hedge fund manager declared, ***"The world is going through the biggest industrial revolution it has ever seen. The demand for raw materials will be dramatic."***

Both the opinion about the duration of the projected bull market and the notion that commodities perform differently to other asset classes could be another example of the old saying in physics "***If you keep your data base short enough, it will fit your theory***". Regrettably, the world of policymaking is dependent upon just such a data base.

But before expanding on this, it is worth noting that throughout all, ***repeat*** all, of financial history, prosperity has been associated with rising commodity prices and hard times with declining commodity prices.

Also throughout history, a boom is more than an increase in business activity and consumption. On the financial side there is a rush to financial innovation that is usually corrected on the contraction, and on the social side there is the ambition to impose political innovation. In so many words, the left gets busy during a boom.

One recent and disastrous example of near-sighted financial research occurred in the early 1980s when Michael Milken and Prof. Edward Altman carefully selected a time interval when the junk bond default rate was about 1.5%. With the usual plunge in general interest rates that follows every commodity blow-off, this unusually low default rate was projected well into the future.

Then many discovered that weakening commodities were associated with deteriorating earnings power and deteriorating abilities to service debt. By later in the 1980s, with default rates soaring, junk had become just another four letter word.

The point to be made is that two apparently earnest researchers, Altman and Milken, became the messiahs of doubtful debt and, in the consequent calamity, the latter became the focus of yet another eruption of recriminatory regulation.

Unfortunately, Milken was charged with all kinds of offences and he plea-bargained to 6 of the lesser ones and served almost two years in the slammer. He also paid some $900 million in fines and settlement and was banned from the securities business for life.

At the time, the course of his persecution was widely followed. In real time, this writer's conclusion was that his only real offence was inadequate research and an impressive ability to wallpaper the world with doubtful securities.

Institutional chagrin was democratically allotted as far too many fund managers overlooked "***The Prudent Man Rule***". This was a 1934 judicial ruling intended to restore fiduciary responsibility to money management after the indiscretions of 1929.

Many proponents of the concept that commodities are an investment asset insist that the action is not correlated to other asset classes. However, through the 1990s junk bonds declined with commodities.

It was in late 2002 when commodities threw off a lengthy bear market and initiated the current bull market. Far from being an isolated phenomenon, it has been accompanied by a remarkable bull market in corporate bonds and stocks as well as in residential real estate.

While the latter has been faltering for over a year, the bull market in commodities has been accompanied by widespread prosperity – even to the point where hitherto borrowers with doubtful means to service debt, such as emerging countries, have had no problems funding most any state ambition.

According to Standard & Poors, the junk bond default rate plunged to 0.94% last year, which is a 24-year record low.

Beneath the gloss of modern accounting and reporting, we have been enjoying outstanding prosperity with generally rising prices. The Economist All-Items commodity index has soared from a cyclical low of 87 in late 2001 to a high of 272 recently. With the financial dismay of late 2002, panic selling of corporate debt took the high-yield sector to 13 percentage points over the yield for long treasuries. With the boom in financial assets, this important credit spread narrowed to less than 3 percentage points, which represented "good times" for borrowers and underwriters. While it may have been good times for indiscriminate lenders, given the nature of the credit cycle, it is usually the worst time to be buying risky securities. Despite the sub-prime disaster, there is still a regard for sovereign debt.

"The fiscal history of Latin America … is replete with instances of governmental default. Borrowing and default follow each other with almost perfect regularity. When payment is resumed, the past is easily forgotten and a new borrowing orgy ensues. This process started at the beginning of this past century and has continued down to this present day. It has taught nothing." **Max Winkler, Foreign Bonds: An Autopsy**, Rowland Swain Co., Philadelphia 1933. There are often hazards attendant to making long term decisions on a short data base, and there is much to be gained by a scholarly stroll through financial history.

For example, the great financial booms started with the South Sea Bubble that blew out in 1720. England was under a bi-metallic standard, which inhibited direct devaluation but, with the party, the market, using an early instance of the "carry" trade, created enough credit for an extravaganza of speculation.

This included stocks of mature companies as well as a huge number of new flotations. With the boom, commodity prices rallied and real estate soared. In France, John Law was not constrained by convertibility and he had 9 presses printing currency as the "Mississippi Bubble" soared.

The prosperity was such that even servants of grand houses made enough to buy or hire coaches with liveried servants.

Then when the bubble collapsed of its own excesses, weaker prices brought hard times. Beyond that, it marked the end of a lengthy era of asset inflation.

There have been 5 eras of great asset inflations since then. Some better-known examples climaxed in 1825, 1873, and 1929.

One of the ironies in the history of finance became obvious in the 1960s. In the late 1940s, policymakers began buying long-dated treasury bonds out of the market - and get this – to prevent rates from rising above 3%. In the mid-1960s, this became an obsession and was promoted under the banner known as "***Operation Twist***". This was intended to prevent long rates from rising above the critical 6% level.

The irony, of course, is that the economically and politically correct policy ***drove*** the long rate to 15% - the highest recorded in the history of the senior currency going back to at least 1700. This is one of the most blatant errors.

This also launched an era of asset inflations that has driven stocks, corporate bonds, residential real estate, and industrial commodities to remarkable degrees of speculation.

After trading around 40 cents through most of the 1960s, N.Y. copper soared to $4.07 per pound.

While the chart history shows a number of cyclical bull and bear markets, a huge secular bull market has been underway.

Similarly, crude oil has enjoyed a secular bull market as well.

Just how secular can be determined by going back to crude's plateau at around $3.00 during the 1960s which, as noted above, saw the launch of the benighted policy to aggressively lower interest rates. Of course, this wasn't the advent of reckless policymaking – that formally began with the granting the Federal Reserve System the dangerous prerogative to depreciate currency.

The original promoters of the Fed used the euphemism of a "flexible" currency.

Initially, this really hooked up with the secular commodity bull market that began with the end of the "Great Depression" in 1895 (no typo) that ran from 1873, which was a peak of secular asset inflation, until 1895. As with previous examples, the subsequent long term expansion developed into an era of asset inflations that dramatically ended in 1929.

Naturally, the pitch with the Fed has been that it would sustain prosperity and prevent contractions with the "lender of last resort" ploy. This wrongly assumes that major contractions are caused by one important financial institution getting in trouble and bringing otherwise solvent lenders down. Reality records that at the end of an era of impetuous asset inflations, prices start down and bring down the speculative house of cards.

That these swings in finance and commodities occur regularly is recorded in the salient study by E.H. Phelps Brown and Sheila V. Hopkins entitled ***Seven Centuries of the Prices of Consumables***. This includes a reliable price index in England from 1264 to 1954, with the study published in 1956.

The basic secular pattern can, for convenience, be said to start from the bottom of a long contraction. The subsequent expansion culminates in an era of rampant asset inflation that is typically followed by a long or secular contraction. Typically, the period from peak to peak ranged from 50 to 60 years and the recording secular bull markets for commodities lasting for around 20 years, which ended with a speculative mania in asset prices that also included real estate – both commercial and residential.

The 700-year price index also shows an extraordinary run of prices through the 1500s. Through separate research, this writer has observed that a great accumulation of wealth prompts any government to go for control of the wealth and of politics through a relentless imposition of authoritarian rules, regulations, confiscatory taxation, and currency destruction.

The earliest example occurred as the prosperity of the Roman Empire inspired the politically ambitious to impose confiscatory taxation supplemented by chronic and eventually massive depreciation. Such abnormal state theft dislocated the reasonable workings of government and social and political distress was met with price and wage controls. By the end of the Third Century, the Roman Republic had become a tyrannical police state.

In the early 1970s, Canada and the U.S. trod on freedom with an experiment in price and wage controls. In real time, it was interesting to watch and when the establishment began to see that it wasn't working, there was talk of putting "some teeth" into the punishment of those charged with economic crimes. This writer ironically wondered if the liberal establishment would do as they did in Rome and make such crimes a capital offence. As in the nasty Roman experiment, price and wage controls would not have worked to anyone's satisfaction.

The overall conclusion on the extraordinary Third Century was that the ambition of unlimited government was, well, unlimited. The greatest accumulation of wealth in history was insufficient to satisfy untempered ambition and consequent distortions collapsed the experiment after about 100 years. Authoritarian politics and chronic depreciation were insidious partners. The next extraordinary accumulation of wealth occurred in the 16th century with transport of massive amounts of gold and even greater amounts of silver from the Americas to Europe.

Spain was the super power and the largest portion of the treasure went to Spain and the greatest windfall in history was not enough. State ambition resorted to confiscatory taxation, loans, and currency depreciation. So undisciplined was the ambition that the Spanish government defaulted to its creditors three times during the 1500s.

Once again, the feature of a tyrannical century was a deadly combination of authoritarian politics assisted by deliberate and chronic inflation. As with the Roman example, it lasted for about 100 years.

Unlike the two previous examples, the accumulation of wealth this time around has been based upon an unprecedented increase in productivity rather than military conquest. In so many words, it was earned, and naturally it became envied.

The individual creation of wealth and its partner – limited government – ran until about 1895 when, with a secular business expansion, politics began to turn authoritarian.

Even a researcher well informed about the two previous tyrannical centuries would be unable at the depression trough in 1895 to expect that the Twentieth Century would produce a utopian ideology that murdered some 100 million individuals in the attempt to socially engineer the "perfect man".

However, once such a monstrous run of authoritarianism and its colleague, chronic depreciation, has prevailed for some 80 or 90 years with consumer prices increasing by a factor of 40, it would be time to look for a change. As with the Protestant Reformation, reform of the politics of brutality would be prompted by a popular revulsion about the failed promises of the cradle to the grave state.

Quite likely, this would occur with or following a speculative blow-off in commodities. The Economist All Items index shows a spectacular high in 1920 and, with the reversal, Soviet Russia went from communism to a form of socialism. Even the U.S. ended its nationalization of railroads.

Then in the 1960s the culture of interventionism became blatantly ambitious, inflation soared, and another phase of a great experiment in authoritarian government erupted. Essentially, the characteristics of a Tyrannical Century have been repeated, including the duration of some one hundred years. Then political and economic reform of the excesses started.

The overall description – The Protestant Reformation – merits brief clarification. The term covers the religious part of the greatest struggle for freedom since the corruption and collapse of the Roman Empire.

A first step is to look at the key word "Protestant" with the capital letter, which indicates the religious connotation. Just thinking of protestant and protest provides an accurate political connotation, which eventually reformed a murderous and powerful police state.

A Dissenter (which was also capitalized to indicate a Christian denomination) faced very real threats. Excommunication from the church, interview with the Inquisition, confiscation of all property for heresy and, without recantation – burning at the stake. Today those outside today's ambitions to save the health of the planet are called 'Deniers'.

However, an ethos that fostered thrift, business, and family eventually prevailed over a predatory bureaucracy that attacked all three in its claim to the commonwealth. On the secular side, superstitions employed by bureaucrats to enhance their power were also marginalized.

Convincing comments from wise men or women have always been expedient to policy utterances. The ancient Greeks, for example, used the "Oracle of Delphi". In the 16th Century the powers-that-be used astrology and continued the insidious practice of currency depreciation, as well as funding the something-for-nothing scheme of alchemy. It is interesting that the largest bank of the period regularly published a financial newsletter. Some editions in 1558 pointed out that mainly it was governments that funded alchemists.

As with interventionist economics over the past 100 years, alchemy would not have come to the forefront if it did not promise to transfer enormous power and wealth to the state.

The Protestant Reformation could more accurately be called the Great Reformation as it gradually ended the social, political, and economic excesses of the Second Tyrannical Century. Within this, serious research eventually turned astrology (which was used to support policy announcements) into the science of astronomy, and the physical side of alchemy became the science of chemistry.

Regrettably, the superstition of something-for-nothing is still ardently employed by the state in the form of interventionist economics. Indeed, this has been the main tool whereby the state and its bureaucracy has been so successful in its attempt to control, if not confiscate, the common wealth.

The result has been yet another deplorable experiment in authoritarian government and concomitant confiscation of wealth.

Communism has been the most vicious form of the experiment. In eschewing state murder, it would just rank as pernicious. Interestingly, a definition that links all experiments in social engineering can be borrowed from real science.

The modern physicist, Murray Gell-Mann, provided a definition of a totalitarian system as "***that which isn't prohibited, is compulsory***", which elegantly describes the ambition common to the promotion "causes" from Pravda to The New York Times.

The latest phase of the boom has been accompanied by soaring commodities and political ambitions – in all countries and all political parties. In so many words, the left is ascendant in both America and Russia.

The boom in 1920 was accompanied by authoritarian revolutions, but when commodities crashed in 1920-1921 the political change was towards the middle. Even the Soviets turned from pure communism to a corrupt socialism.

The next major high in commodities peaked in 1988 and the fall of the Berlin Wall in November 1989 symbolized the popular demand for reform of a corrupt political culture. That swept most of the world.

The return of power to the left began as this expansion arose out of the tech-bubble collapse in 2002. The subsequent boom for commodities and the left has been remarkable, with the latter featured as the cover story (*"Is America Turning Left"*) in the August 17, 2007 edition of The Economist. Amongst commodities, the action has also generated headlines as well as the most extraordinary gains in a century. Copper's real price (deflated by the PPI), for example, gained 428% which compares to the best previous at 174% to the March 1956 peak. For lead the gain was to 654%, which significantly beat the best at 287% to the cyclical peak in March 1990. To its recent high, crude's gain is 749%, which compares with the best of 464% to the 1980 peak.

These, along with similarly extraordinary gains for nickel and wheat and their collapses suggest that ambitious estimates of 18-year bull markets for base metals have been largely discounted. Remarkably violent changes in the credit markets are signaling the end of the boom in stocks, corporate bonds, a myriad of derivatives and most commodities.

The key to this is that the final stage of a boom typically runs for 12 – 16 months against an inverted curve. This time around, June, 2007 was the sixteenth month and it is worth emphasizing – when the curve reverses to steepening it marks the period when the wheels begin to fall off the most blatant speculations.

The curve accomplished just such a reversal by that fateful June and the rest, as the saying goes, "is history".

The widely-followed Economist All-Items commodity index has soared to 272 recently. Of course it will take time to determine if this was the cyclical peak. But, there is little doubt that recent changes in the yield curve as well as convulsions in credit spread markets are indicative of a massive credit contraction that in the past have been accompanied by a severe decline in most prices.

This has serious implications for stocks, bonds, derivatives and commodities. All asset classes have been bid up aggressively and the recipe is straightforward. If enough assets fall in price it will eventually limit, if not deny, the compulsion of the Fed to depreciate the dollar.

Since the early 1900s interventionist economists have preached that the best thing to keep a recovery going is to artificially inflate credit, which depreciates the currency. Also preached is that in the case of a contraction (ironically, these are always due to exogenous events) the best policy is to artificially inflate credit, which depreciates the dollar.

Stripping out euphemisms and putting it as simply as possible, the "best" policy in any circumstance has been dollar depreciation. Evident for decades it was amplified in April, 2007 by the chief market strategist at Bank of America: ***"It's the best of all worlds. Global growth is strong and the dollar is weak."*** It follows, then, that the worst thing that could happen would be an outbreak of sound money.

How could this happen?

The world is fully informed of the bad habits of the Fed and the world is short dollars against the hot "stories" of the day. The frenzy in energy prices could be the last page of this chapter.

Any trader knows that hazards go with universal convictions. History statistically knows that great bubbles have been followed by equally great contractions. The first era of great asset inflations culminated in the South Sea bubble of 1720. Today's generation of investors and speculators have been participating in the sixth great era of financial innovation and asset inflation.

Each previous one has been followed by a credit contraction (this one has started) and a significant decline in business activity, and illiquid markets for most stocks, bonds and commodities. Only in retrospect does the reversal in fortune seem to happen all at once. In real time it is a progression of reversals beginning with the credit markets.

Beyond "everyone being short the dollar" there is a more direct analysis of how the senior currency eventually became firm against most currencies, and most commodities, for most of the time. During the remarkable credit expansion most of the debt created is underwritten in the financial centre. Now it's New York – it used to be London, back in the 1500s it was Antwerp.

All that is needed is that a majority of the debt contracted is in U.S. dollars, which has been the case. In order to service the obligation, debtor countries will have to sell their raw materials, manufactured products, as well as other currencies to obtain dollars.

History relentlessly records the problems of a weak borrower in a weak currency trying to service debt into a firming senior currency. Many of Thomas Gresham's letters to Elizabeth's government from the financial centre in Antwerp dealt with that problem in a crisis.

The reason historical examples are provided is to illustrate that in the markets there is nothing new. Mercantilism, which argues for authoritarian intervention, prevailed in the 16th century as well as over most of the past century. Each generation that gets caught up in a financial mania believes that its financial innovations are really new and doubts are dispelled by convictions that "this time it is different".

Since May a year ago, global credit markets have made changes that in the past have been followed by a cyclical credit contraction. Inevitably, this has been followed by a bear market for stocks, corporate bonds and most commodities. It is worth adding that there is no record of the senior central bank ever preventing the contraction that follows the culmination of a great financial mania. Even today's discovery of a sudden loss of liquidity seems to prompt statements similar to previous examples.

In February 1560 Gresham wrote that there was ***"a great scarsity of monny upon the burse"*** and that this had, ***"clean alteryd the credit of the Queene's Majesty and all of the nacione"***. In the initial panic last August, The Wall Street Journal reported ***"Debt isn't merely expensive, it is scarcely available at any price."***

There is little practical reason to look for reasons to explain that this time it is going to be different. That's despite a political culture that claims to be able to make everything different from an assumed "Random Walk" economy. Last July this writer observed that the biggest train wreck in the history of credit markets was underway. The rapid decay through August caught senior central bankers flat-footed. Their utterances had been concerns about keeping interest rates high to "fight" the chronic price inflation their policies induce.

The real problem is another bout of post-bubble credit contraction, not credit inflation, or even price inflation. It is appropriate to quickly review the fatal flaws of interventionist economics.

The first is that economic history is not a random walk. History is periodic and not event driven. On data since the late 13th century there are regularly recurring periods of long expansions followed by long contractions. The latter typically show bull markets for commodities that run for some 20 years, but they arose from an equivalently long phase of contraction.

The bear market for commodities ran from the high in 1980 to the dismal low in 2001. In the face of consistent, if not chronic, credit expansion and after 1985 a generally weak dollar, this was frustrating for commodity bulls. But as pointed out in real time, credit can be inflated against financial assets as well as against tangible assets, and the public decides where it is going to speculate.

Up until 1980 it was in tangible assets, and from 1982 until 2000 it was in financial assets. As this writer observed in early 1982, ***"no matter how much the Fed prints, stocks will outperform commodities"***. Since 1700, that transition had worked on five similar patterns.

Then, after the tech-bubble crash there has been a remarkable boom in both financial and tangible assets that has some similarities to the bubble in both that blew out in September 1873. As the typical strains developed the leading New York newspaper editorialized that Secretary of the Treasury Richardson had powers to inject liquidity beyond those of the governor of the Bank of England, whose issuing ability was constrained by a gold standard. Nothing could go wrong because the U.S. had a fiat currency.

The subsequent general contraction was so severe that by 1884 leading economists in England described it as "The Great Depression". Although it ended in 1895, economists were still analyzing it, without irony, as "The Great Depression" until as late as 1939.

There is instruction from that contraction in the senior economy. America recorded a huge population growth as well as the beginnings of the shift from rural to urban life. Industry, railroads (include street railways), and roads were expanding and the period could be described as similar to the changes going on in China. It was a remarkable transformation to an agricultural and industrial giant.

According to W.W. Rostow, in 1840 the U.S. had 5% of the world's industrial production. By the 1880s this had jumped to 29%. America, including Canada, was vulnerable to the availability of credit from domestic as well as international markets.

This could be the case this time around and in reviewing the specific struggle between policymakers and financial history it can be concluded that financial history itself is a "due

diligence" on every credit innovation devised by the street and every theory to "manage" the economy as contrived by academics.

It is important to understand that credit is just not simply something that comes out of a Federal Open Market Committee, but has been described as money of the mind, or by the cliché ***"credit is suspicion asleep"***.

In so many words the public can believe the most preposterous things so long as the price is going up. This included the tout that the boom in stocks, bonds and commodities was "liquidity" driven. History shows that such asset inflations are driven by price which is used by the crowd to leverage up. Then, upon speculative exhaustion, the price decline shifts power from those who create credit to the margin clerks. It is, and has been, that simple and the margin clerk has a vastly different job description – which is to get the accounts in line. It seems the function of policymaking has been to get the accounts over extended.

Mentioned above is the important blunder of the policymaking culture, the fraudulent claim that financial history has been and will continue to be random.

Another blunder is an egregious error in logic, and that is the primitive syllogism that because two things occur at the same time they are causally related. Yes, credit does expand with a boom, but it does not cause the boom. This is the old saw about roosters crowing causing the sun to rise.

The only reason why interventionist economics has had such a long run is because it transfers wealth and power to the state. And that it has, and in seeking to label the phenomenon, the old and notorious Vancouver Stock Exchange had the classic definition of a promotion: ***In the beginning the promoter has the vision and the public has the money. At the end of the promotion the promoter has the money and the public has the vision.***

In the early 1900s all levels of government were taking less than 10% of GDP. Recently in too many countries the take is at or approaching 50% of GDP, and too many in Wall Street have the "vision" about what central planners can accomplish.

The latter have a huge professional and personal commitment to keep the boom, or to use the jargon, "the recovery", going. The most obvious is to maintain prosperity; the not-so-obvious is to prove interventionist theories. The two main tactical tools have been the compulsion to apply yet more credit when the initial loss of liquidity is the result of an unsupportable amount of credit against soaring price trends that suddenly fail.

The next policy prescription is to lower administered rates. The theory is that this will keep the recovery going.

The answer to this notion doesn't require any formal logic, just empirical evidence. Short-dated market rates of interest, such as treasury bills, increase with a boom and decline with the contraction. Despite sub-prime turmoil the good times prevailed until last July when the treasury bill rate was at 5%. With the March panic this was as low as 0.65%.

Following the change in England's Bank Act in the 1840s the Bank of England was no longer constrained by usury laws and was able to at least keep up with changes in money market rates. And the record is that at the troughs of a contraction, typically, the senior central bank follows the rise in market rates of interest by a few months. It is worth adding that such an increase indicates the beginning of the recovery in prosperity.

Then at the peaks of great booms, such as in 1873 and 1929, central bank rates were a few months behind the decline in market rates of interest.

The next point is that the bigger the boom the more drastic the decline in short-dated interest rates.

For example, following the 1873 mania in financial and tangible assets the key Bank of England rate declined from 9% to 2.5%. Following the 1929 infatuation the Fed's discount rate declined from 6% to less than 1%, and following the tech-mania in 2000 Fed funds declined from 6% to less than 1%.

The big point is that most of the plunge in administered rates took place in the initial and severe phase of a post-bubble bear market. From a high of 5.18% in February, 2007 three-month bills plunged to 3.80% before the Fed made the first cut.

Those with curiosity might wonder where the notion came from that lowering interest rates would prolong a boom?

Strange that policymaking is so removed from reality but it has been this way for a long time. There was a pattern of events that ended the previous century of experiment in central planning with deliberate and prolonged currency depreciation.

A long boom in commodity prices completed in 1609 and subsequent unemployment pressures prompted a significant experiment in policy. Britain's government was envious of the prosperity of Amsterdam, which was the commercial and financial capital of the world, and decided to replicate its cloth-finishing abilities in England. The huge expense and collapse almost bankrupted the Crown.

Beginning in 1618, the contraction was severe and even higher numbers of unemployed was amply recorded in complaints and suggestions to Parliament.

In 1621 Misselden wrote: ***"As it is the scarcity that maketh the high rates of interest, so the plenty of money will make the rates low."*** (This was the theory behind 'Operation Twist' of the 1960s.)

This of course, has been repeated by many intellectuals, who seem to get offended by the sudden discovery of "hard times". And have to impose a personally revealed remedy.

Keynes, of course, was essentially lucid until he took a bath in the 1929 crash and invented the "liquidity preference", which along with other personal ideas has fostered a period of remarkable financial innovation and volatility. The street, all on its own can create impressive speculations But, the imposition of highly speculative theories over so many decades has exaggerated the hitherto natural limits of speculation. All with the tout that central planners can make things better, or in a classic non sequitur – if things turn bad only they can make it less bad.

Instead of the intention of moderating animated spirits (a Keynesian term) the belief that policymakers could reduce risk removed traditional banking concerns about risk. In other words, there have been few adults in policymaking. The credit markets need a legion of 'deniers", rather than of "cheerleaders".

A tragic naiveté has been revealed by the rapid change in convictions from a "liquidity" driven market to Fed concerns about inflation within a rapid and relentless credit deflation. Eventually this prompted a sudden and unscheduled change in an administered interest rate, which was soon criticized as a "rookie" mistake by the new Chairman.

The point to be made is that the final stage of the boom can be described as "rational exuberance", whereby the conclusion of this financial mania has much in common with previous examples. Typically the markets soar for some 12 to 16 months against an inverted yield curve.

Inversion began in February 2006, making the possible peak somewhere in the February to June period of 2007. Within this, the critical influence is that when the curve reverses to steepening the most blatant speculations begin to fail. Through that fateful May, the curve did reverse to steepening and the rest is history, with the discovery of suddenly unsupportable positions in the credit markets.

As the curve has been reliable in so many instances in indicating a loss of speculative abilities it is worth detailing. Policymakers may be able to artificially lower short rates, but cannot push the curve, so this analysis nets out Fed influences.

For centuries the curve inverts during a boom as speculative demand for short-term funds increases those rates faster than the increase in long rates. It is speculative impetuosity against a slower moving traditional investment culture, but the change in the curve seems to provide a sophisticated reading on the turn to reducing demand for speculative play money.

It has done it once again, and in conjunction with the long decline in the median house price illustrates that natural market forces provide the turn from credit expansion to credit contraction. Also the link from falling house prices to contraction refutes the illogical notion that liquidity was driving prices. This is now being noticed more generally as falling commodities will likely be the next problem for hedge funds, then for their bankers.

Lead, nickel and zinc collapsed by more than 60% since October. This month, the action in crude oil became impetuous enough to register the highest technical readings since Iraq invaded Kuwait in 1990. By the monthly measure, it is almost at the reading generated at the monumental high in 1980. But failure in energy prices should not be taken as a happy sign that inflation is over. This would be the start of the next asset class to fail and inappropriately positioned investors, as with sub-prime mortgage bonds, will be forced to liquidate. This will have widespread repercussions, especially to policymakers that have again attempted to impose virtually unlimited ambition, and personal revelations, upon the always implacable tides in the market place.

The karma of the markets is beginning to overwhelm the dogma of interventionist economics. In the long run this can be a good thing. Essentially the end of the two previous authoritarian centuries occurred as the public compared policymaking promises to results. Then in a moment of opportunity, when prices stopped going up, faced down intrusive government. The public lost the complacency of submission as the governing classes became unnerved and lost the will to impose authority. This phenomenon was reviewed in 1975 by Barbara Bell on dynastic collapses in ancient Egypt.

This was the mechanism that led to the fall of the Berlin Wall in late 1989, that symbolized a wave of political reform that changed the politics in most countries. Essentially this was against state-run or state-sanctioned monopolies.

Declining propensity to believe preposterous stories could uncover the public's common sense as it turns its attention to the unholy trinity – central bankers, bureaucrats and politicians. At the top, the practice of artificially manipulating interest rates and currency has been a dangerous prerogative granted to the Fed when it was formed in the early 1900s. This was more recently joined by the artifice of pricing securities, or derivatives, by mathematical models. The full

corruption of traditional finance occurred as the brokers devised math models so that the credit rating agencies could rate the phenomenon of artificial securities, as exampled by the appetite and then revulsion for sub-prime mortgage bonds.

Politically, and as usual, the latest boom in commodities has been accompanied by an increasingly active left to the point of earning the distinction of the front cover of the August 17, 2007 issue of The Economist magazine. Students of the market might recall cover stories in 1982 proclaiming *"**The Death of Equities**"*.

However, the rapid and methodical change in the credit markets is strongly indicating the end of this cyclical boom in financial markets as well as in the political markets. The latter would end this phase of the political counter-reformation.

If the resumption of main reformation is anything like the Great Reformation of the 1600s every political and cultural institution will be examined for practicality and purpose. Some will be abandoned and some will be revised.

As with the collapse of the Berlin Wall, there will be another popular attempt to end or modify monopolies that only the state permits. In the Western world the most dangerous prerogative has been the monopoly of a nationalized currency.