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THE PENDING BEAR MARKET FOR MANY CLASSES OF BONDS

"Junk Has Enjoyed The Mother Of All Rallies"

Perspective: At the moment, the best of all worlds exists for stocks, bonds, industrial commodities, and credit spreads. Since the 1991 contraction, the markets have seen considerable abuse of the credit and currency markets, otherwise celebrated as a "New Financial Era". As they occurred in the world's financial capital (now New York; previously London), they were followed by a long-lasting revulsion for debt and associated credit contraction.

An outstanding bull market for long-dated treasuries completed in June, 2003 with a speculative spike. This was mainly propelled by very earnest convictions that the Fed could "peg" long rates at 2 ½ %¹. At the time, we explained that this was founded upon some shoddy historical research and the intensity of the speculation was revealed by one of the six worst plunges for long governments in 300 years. We have now enjoyed the equivalent bubble in junk.

As the saying goes, *"Having exhausted themselves in the primary market, investors then shunned higher yields available in the secondary market."*

As represented by the bond future, the market has retraced 48% from last July's crash and is technically as vulnerable as it was at the top (the chart and discussion follows). A price decline could begin within a few weeks and is projected to run for about 3 months.

The consequent increase in long rates, which will likely be due to market forces rather than policy, could be significant and, for lower grade securities, eventually devastating. As the forces of post-speculative liquidity crises become acute, treasury bill rates could increase a little, but commercial paper rates could increase significantly.

Since the advent of central banking, and prior to our own example, there were five New Financial Eras and five consequent contractions that

¹ There is a practical way to get to 2 1/2 % and this is discussed below.

prevailed for up to 20 years. The usual business cycle of 3 to 4 years prevailed with stronger recessions until the process completed and then recoveries became stronger than the recessions.

It is worth noting that the basis of "modern" thinking that appropriate intervention can prevent or, get this, "remedy" a post-bubble contraction dates back to the prototypical "New Era" that collapsed with drastic repercussions in 1618. The contraction prompted intellectuals to prescribe yet more credit to cure a collapse from too much credit abuse.

This has been virtually replicated on every big crisis since. Veteran traders in the early 1600s scorned this as a naïve exercise of "*ydle braines*". The problems of the early 1930s prompted the same response by Keynes who, as Friedrich Hayek observed, was "*totally ignorant*" of financial history. (Keynes can be accused of many things, but never of plagiarism.)

It is tempting to consider that the Fed engineered the boom that began in October, 2001 but, more likely, without the aggressive buying of grand cars and median homes after 9/11 it wouldn't have happened. Instead, there would have been many articles about the Fed "pushing on a string".

As we may be approaching that melancholy condition soon, it is important to review the series of rampant speculations and burnouts that prompted someone to describe Alan Greenspan as a "serial bubble blower".

History suggests that he has not been causative, but only accommodative and that, for peculiar reasons, the market has enjoyed a bubble in lower grade bonds. This is uniquely vulnerable.

Peculiarity: In a world of serial bubbles, what's strange about one more? Every great speculation in stocks or commodities has been accompanied by soaring short-dated interest rates. This latest one has been accompanied by a remarkable decline in short rates.

From the high of 6.25% with the stock bubble in 2000, the bill rate plunged to 0.90%. Over the past few hundred years, this type of a decline has only occurred following the dramatic collapse of a New Financial Era. For example, following 1929 the bill rate plunged from 5% to 0.06%.

Indeed, this is one of the signatures of the post-bubble condition, as is the hostile official attack upon scapegoats by Eliot Spitzer. In the post-1929 example, the deflation of financial and tangible assets was so relentless that the prospect of leveraging up on falling short rates was an absolute impossibility. If one reads the newspapers of the day rather than after-the-event textbooks, it is clear that the Fed made a massive but

unsuccessful attempt to reflate the economy. Equally clear is that it didn't work.

This time around, the natural plunge in short rates has been factored into "zero-cost" financing for cars and an unprecedented rush of refinancing mortgages. This was for financial advantage of \$40 a month less in payments to massive leverage against renovations to "flipping" homes. As someone said, the average home had become an automatic teller machine.

While this has been an unusual speculation prompted by the typical post-bubble collapse in short rates, the really extraordinary event has been the combination of the cyclical recovery in the third year following a bubble and the awakening of China to the zests of consumerism as well as entrepreneurial drive. As with a similar condition in the 1970s – 1980s in Japan and in America in the late 1800s, the condition was subject to its own domestic speculative excess as well as the availability (or unavailability) of capital in the world's financial centre.

As 2004 nears its end, it is likely that most, if not all, of the speculative energies will have been seen to have been exhausted in the first half of the year.

Condition Of The Stock Market: As represented by the Nasdaq, the New York market is topping now. Reflecting the game in tangible assets, base metal prices will likely exhaust bullish speculators by late April.

Condition Of The Corporate Bond Market: Where the action in the stock and base metal markets has been led by the Naz and nickel, the corporate bond market has been propelled by the action in junk or by its euphemism, "high-yield".

This is another market that seems to be "topping". Based upon a long-running model, the technical "sell" was made on January 30. From the panic of October, 2002 when the spread had widened to 923 bps, over treasuries, narrowing became a mania into only 192 bps, over, on January 7. The next "low", at 194 bps on January 23, was technically important.

The junk game needs the global business boom to continue.

How Big Has The Game Been? One measure we reviewed in our January 23 Pivotal Events was the difference between the yield for junk bonds relative to the S&P operating earnings yield. This concluded that, at 185 bps, it was at record lows on a chart starting in 1985 and that all previous reversal lows were centred in December of the year. Two

cyclical lows were 6 years apart, reversed near the end of the year, and it was noted that the latest low was 6 years after the previous one. (The chart is attached.)

This model suggested the possibility of a cyclical excess and reversal near the turn of the year and this seems to be the case.

A few weeks ago, a high-yield fund manager pointed out that the market was overvalued by some 25% and at its "*gaudiest ever*". In the February 23 **Barron's**, Jennifer Ablan wrote that since the 2002 disaster junk "*has enjoyed the mother of all rallies*". For January, the average junk yield set a new low of 7.78% with an average price of 104. It's a good thing that the mania didn't continue; otherwise, veterans would be looking at the daunting prospect of junk trading at "cushion" prices.

Secular Bear Market: Financial history shows a regular pattern for long dated interest rates in the senior currency. Let's start with the seemingly endless increase in rates as the "old" era of rampant CPI inflation tops out. For example, this took U.S. treasuries up to 15% in 1981. Since 1720, this was the highest ever recorded, with the next highest secular high at 5.97% in 1797 (senior currency then was sterling).

Secular Bull Market: The table below details that the secular low has ranged from 3.0% in 1743 to 2.2% in 1896. This has been the basis of our conclusion in 1981 that long rates would eventually decline to 3 ½ % or, if policymakers' ambitions are tempered by sound money (a gold standard), 2 ½ % would be the target.

BUBBLE YEAR	1720		1772		1825		1873		1929		2000	
INTEREST RATE LOW		1743		1792		1844		1895		1946		??
YIELD %	5.0*	3.0	3.5*	3.3	4.0*	3.0	3.3*	2.2	4.8*	2.5	6.7*	??

* Yield in bubble year: UK to 1929; US in 2000

However, in all previous cases, there was a credit crisis severe enough to end the abuse of credit. The mechanism in each example was - the real cost of money soars thereby rationing credit to some and denying credit to many.

Real Long Interest Rates: The real cost of money is calculated by subtracting the rate of CPI inflation from the nominal rate of interest.

Real rates declined with every bubble and then, during the consequent contraction, they have soared. In the 1920s' bubble, the decline was from 9% to 4% in 1929. In our example, the decline was from 9% to 1.8% in 1 Qtr. 2001. This is one measure of the degree of official "accommodation" of rampant financial speculation and the low of around 2% is quite different from 4% in 1929.

The irony is that in 1966 Alan Greenspan criticized the Fed for being far too accommodative during the "Roaring Twenties".

The basic pattern was maintained through all five previous New Financial Eras and their *consequent* contractions as they occurred in the world's financial capital – originally London and now New York. It is worth noting that all examples ran nine years from the peak of the business cycle that marked the end of the "old" era of inflation to the blowout in the stock market². When the key dates are known to the month, it get remarkably precise. Our "new era" ran from July, 1990 to March, 2000, or 116 months. By the same measure, the previous one ran from January, 1920 to September, 1929, or 116 months.

In all cases, once the financial bubble was exhausted, real long rates typically increased by 12 percentage points which, again in all cases, was sufficient to change the world's attitude towards credit. The chart showing all the examples is attached.

Corporate Bonds 2002 to Date: By the end of the panic selling in October, 2002, both the stock and lower-grade bond markets had suffered their worst combined beat-up since the early 1930s. As discussed above, the rally for junk bonds since has been remarkable and, because it has been linked with the decline in short rates that only occurs during a post-bubble contraction, it is without precedent.

Within our historical mind, this makes most classes of long-dated corporates extremely vulnerable. As we advised on the MACD technical "sell", investors should sell or avoid all lower grade issues. This would apply to emerging debt as well and the attached study (**Sovereign Debt Follies**) from 2001 covers the subject.

Timing: At the top of bull markets over the past 20 years, the MACD "sell" signal on the S&P has been closely tied to the credit cycle reversing to widening. This signal was registered and reported in our Pivotal Events edition of January 30. The advice was to begin selling most corporate issues and, with further technical deterioration in the stock market, the selling could be intensified.

² In the late 1920s and 1990s, one of the main touts that the boom would continue was that the Fed had been reformed and there was no inflation.

Corporate spreads narrowed until January 23 when "high-yield" declined to 688 bps, which was 194 bps over treasuries. With a good "test", the trend has reversed to widening and going through 260 bps would mark a very concerning breakout.

How Bad Will It Get? At the best for the junk market in January, one study determined that 85% of the high-yield market was trading at higher than par. Another calculated that the average price of the sector was at 104.

Is this excessive? If you are long in position and short of financial history, the returns are deservedly what they should be. However, if one has a perspective on financial history, the risks are extraordinary.

In 1970, Lester V. Chandler, in his "**America's Greatest Depression**", documented the structure of the bond market in the "good times" of 1928 when 89% of **all** corporates were trading at a price of 90 or better. In 1932, only 28% were. Within this, 53% were above par in 1928 and only 4% in 1932.

That was a dramatic reversal of fortune to a considerable number of bonds trading at distressed prices³. The key table from Chandler's study is attached.

A full trend change towards a disaster in the corporate and emerging debt markets could take a few more weeks and would be confirmed by a stronger dollar and a collapse of the speculation in industrial commodities.

This is the usual consequence of excessive enthusiasm in the credit markets, as is the first part of the warning a few months ago from the Comptroller of Currency in providing a warning on credit risk (a measure of the borrower being unable to service its debt).

What was unusual about the Comptroller's announcement was that it included a warning on term risk (which is an inconvenient discovery that even in treasuries you may not get your price back).

Treasury Market: This is competently covered in the February 24 ChartWorks, which is shown on the next page. Long treasury rates are about to take a noticeable rise.

³ A distressed bond is one that is rated at BBB – or higher, has a fixed coupon, and trading at a spread of 400 bps or more over treasuries. In price, that's 20 points or more below par.

ChartWorks

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BOND FUTURE A Profound Plunge Is Possible

Observations of rossclark@shaw.ca



- The match-up on the pattern is about as close as it gets. That also includes the RSI below each chart.
- Also, the match on time periods – for example, on the dotted boxes – is remarkably close.
- In which case, the top should be completed by early March.
- The subsequent price decline (and rising rates) could last for about three months.
- This and the possibility of widening credit spreads would severely dislocate the excesses of the "carry" against very low short-dated interest rates.
- The technical "sell" on junk bonds was made on January 30.

Unlike the plunge in treasuries in July, this decline could be limited to around 8 points, but for all except AAA corps it could be the start to a lengthy bear market.

Wrap: The third year (2003) after the collapse, a financial bubble was likely to be a good one and the setup was consumers becoming aggressive after 9/11. This was assisted by the typical post-bubble collapse in short rates which, in turn, has assisted a remarkable speculation in financial assets and the "good" year combined with the commercial and financial boom in China has created an equally remarkable zoom in industrial commodity prices.

We have argued that, as with any boom anywhere, it is vulnerable to domestic excess as well as to the availability of credit in the financial centres of London and New York.

As indicated by the topping action in the stock market and its equivalent in the reversal to widening junk spreads, the best is in the market and the trend to adversity has virtually started.

The final page of charts line up the coordinated speculation in the stock, junk bond, and commodities markets against the weakening dollar (which is shown inverted).

The handsome rally in long treasuries in the face of soaring commodities and a plunging dollar seems to be defying the usual fundamentals. However, the best explanation is that the long bond has become another asset class showing price inflation – not in the league of, say, nickel, but price inflation nonetheless.

This particular sequence of asset bubbles and their *consequent* collapses began with the Asian crisis in 1997. At the time, this was reported as being due to "currency turmoil". Actually, and more truthfully, Asian central banks lost the reserves of foreign exchange.

After Western fund managers pounded into Asian stock exchanges (until 1997) with limited liquidity, the next sure thing was that European central planners were going to "converge" the yields in vastly different countries. Beyond being huge, the collapse of LTCM was embarrassing. A number of central banks were lending money directly to LTCM and, as if this wasn't bad enough, the Bank of Italy had had an equity position in the "sure thing".

The next example was, of course, the stock bubble in 2000.

Another example of "sure thing it is" erupted in May-June, 2003 when the establishment convinced itself that it would be a snap to "peg" long

treasuries at 2 ½ % when it was rushing down to 4.17%. The crash was for the record books.

The latest eruption of adamant convictions has driven junk and soon-to-be-junk to where the risk isn't worth the reward as it seems now. As the action has been at measurable excess and a little past the crest of the credit cycle, it would be appropriate to avoid all lower grade bonds.

Indicative of a pending credit contraction is that the various measures of money supply M₃ and MZ, etc. have been shrinking since last August (the blip up in January seems to be due to a change in method).

Should the contraction continue (and this will be confirmed by weakening base metal prices), it could become difficult for many companies to service debt. During any recession, over-issuance of low grade debt becomes a problem, but the point of every post-bubble contraction is to ultimately end chronically reckless abuse of the credit markets.

With the "third good year", we seem to be following the long initial contraction that followed the 1873 bubble. As the speculative strains became worrisome in the summer of 1873, the leading New York newspaper editorialized: *"True, some great event may prick the commercial bubble, and create convulsions; but while the Secretary of the Treasury [U.S. was at that time between central banks] plays the role of the banker for the entire United States, it is difficult to conceive of any condition or circumstances which he cannot control. Power has been centralized in him to an extent not enjoyed by the Governor of the Bank of England. He can issue the paper representative of gold to the amount of scores of millions."*

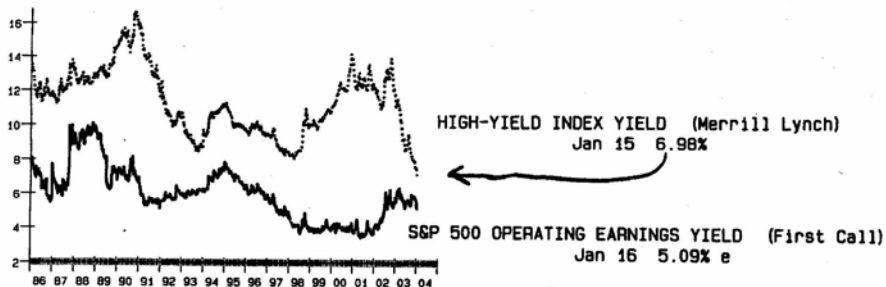
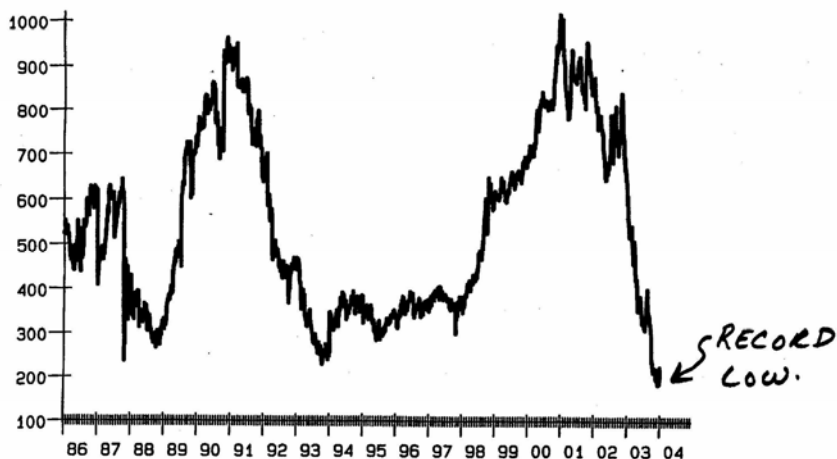
No matter how long it takes, eventually the observations could be similar but not quite as drastic as those made by **Barron's** in 1932: *"Every anti-deflationary effort by the Federal Reserve has yet to provide positive results. The depression is sucking more and more bonds into its vortex."*

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JUNK NO LONGER CHEAP RELATIVE TO STOCKS

Relative to the S&P 500 operating earnings yield, junk yields are now low. Jim Moltz has pointed out that one implication of declining junk yields is that investors have been more willing to take risks, which, along with relatively attractive earnings yields, may help support stocks.

HIGH-YIELD INDEX YIELD (Merrill Lynch) minus
S&P 500 OPERATING EARNINGS YIELD (First Call)
Jan 15 185 BP



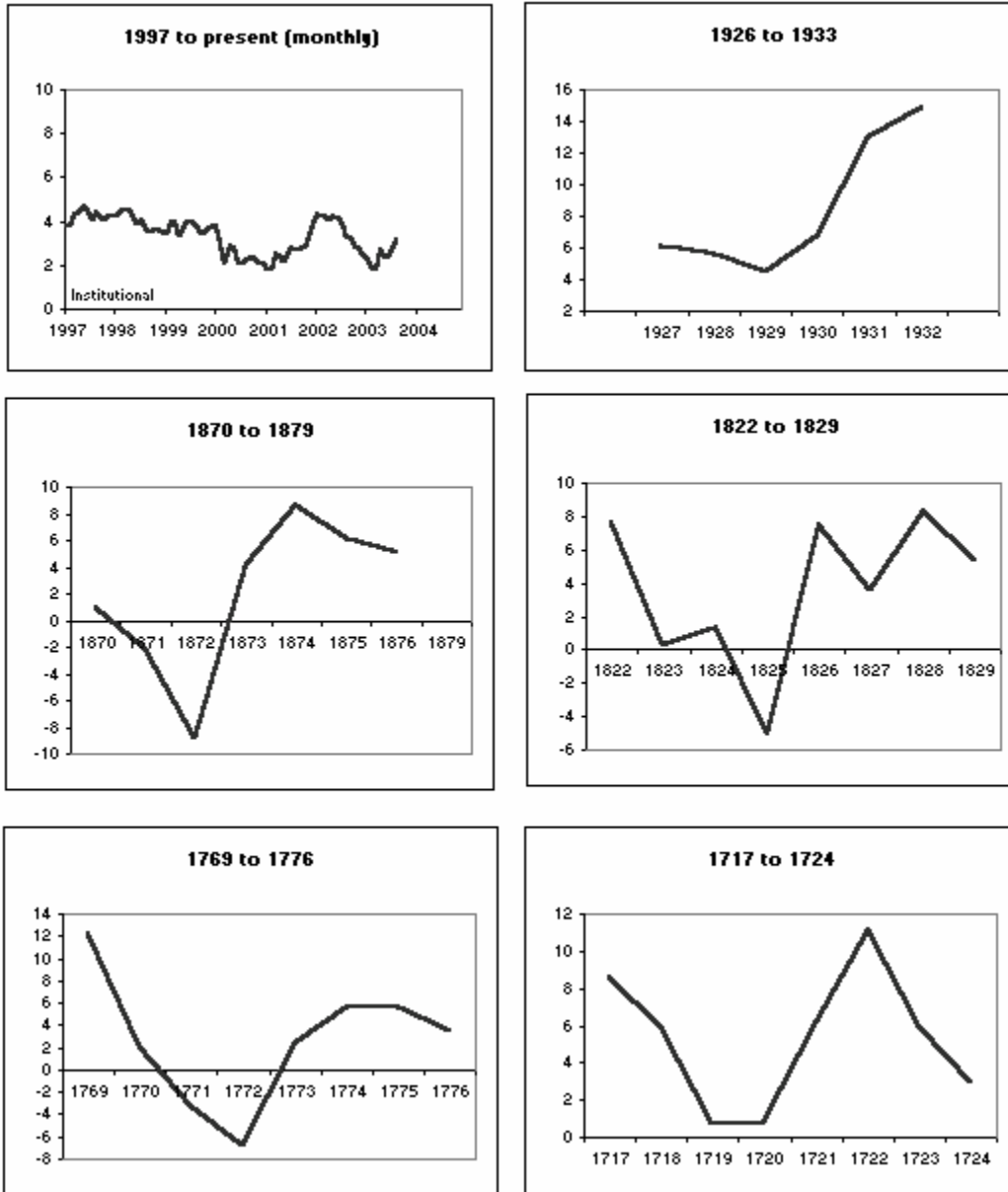
1/21

SOURCE: ISI

The Real Cost of Money During the Dramatic Climax of all New Eras

Annual Average Long Term Government Minus Annual Rate of Inflation

% Interest



The typical increase has been 12 percentage points – this is now our target.

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**CORPORATE BONDS IN ALL INDUSTRIES
CLASSIFIED BY THEIR PRICES AS PERCENTAGES OF PAR VALUE
1928 AND 1932**

PRICE CLASSES AS % OF PAR	1928		1932	
	OUTSTANDING ISSUES	PAR AMOUNT OUTSTANDING	OUTSTANDING ISSUES	PAR AMOUNT OUTSTANDING
UNDER 20	1.0	0.4	5.4	3.6
20 – 39	0.3	0.1	12.9	9.3
40 – 49	0.4	0.2	8.1	7.8
50 – 59	0.7	0.3	7.9	7.3
60 – 69	2.8	1.3	9.7	11.0
70 – 79	3.2	3.3	12.5	17.0
80 – 89	6.9	5.7	15.4	19.0
90 – 99	31.6	30.5	24.0	19.1
100 – 109	49.3	51.1	4.0	5.8
110 – 119	2.4	6.4	•	0.1
129 & OVER	1.4	0.7	•	-
TOTAL	100.0	100.0	100.0	100.0

• LESS THAN 0.1

SOURCE: AMERICA'S GREATEST DEPRESSION – LESTER V. CHANDLER (1970)

- In 1928, 89% of issues were trading at 90 or better. In 1932, only 28% were.
- The definition of "distressed" is trading at yields of 10 percentage points above treasuries.
- In the early 1980s, Altman and Milken selected a period of low defaults and claimed it was "normal" at 1.4%. Milken's incredible salesmanship "papered" the Street with junk. The default rate has increased from 3 ¼% early in 2000 to eventually 10%. More recently, it's around 5%.

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SOVEREIGN DEBT FOLLIES

" IT HAS TAUGHT US NOTHING "

December, 2001

Although the stock market attracts the most attention during a New Era, the financial mania includes a reckless reach for yield in lower grade securities. This inordinately narrows spreads and, in our example, LTCM's quest for the holy grail of "convergence" contributed heroically to this historical imperative. Every New Era has been followed by credit distress, insolvencies, and defaults; not to overlook official recrimination. The initial contractions have been intense and completed in 3 years or, more lengthy, with a recovery in the third year.

1825: During the New Era that culminated so extravagantly in 1825, London was the financial centre and the City floated issues by Russia, Prussia, Spain, and a number of Latin American countries and cities.

For example, Peruvian 6s were done at 88 in 1822 for a yield to maturity of 6.95%; then again at 82 for a 7.50% yield in 1824, and at 78 (7.85%) in 1825. Then the market became illiquid and eventually collapsed with the usual post-New Era deflation. Some 70 U.K. banks stopped payment and Rothschild assisted in preventing the Bank of England's default.

1873: We have run the example of the Spanish failure recently. Not so much as a timing model, but to provide a probable sequence of events subsequent to the conclusion of a New Era.

The size of defaults, such as Argentina and Enron, have been increasing. Despite this, the attitude continues that nothing serious can go wrong as the greatest policymakers in history are on duty. Hubris prevails.

This was also editorialized by some leading newspapers during the New Era that climaxed in September, 1873. Fortunately, **The Economist**, in their April 27, 1872 edition, offered realistic rather than hopeful advice:

Avoid states which are constantly borrowing, which must therefore be paying off the interest on their old debt with the fresh loans.

- The Economist, April 27, 1872

The headlines of **The Economist** in 1873 tell the story:

- June 7: "The Approaching Spanish Repudiation"
- July 5: "[Spain] Making Arrangements for the Payment of Current Coupon"
- August 2: "Spanish Interest Will Not Be Paid"
- August 30: "Anarchy in Spain"

This compares with this year's [2001] headlines on Argentine debt. These followed stories as late as June about "Appetite for Credit Risk has Improved Considerably" on an expected "rebound in the economy before long".

- July 18, 2001: "Markets Laud Argentine Debt Accord – Calms Fears of Default"
- August 3, 2001: "Flurry of International Contacts to Prevent [Argentina] Default"
- December 14-20, 2001: "Angry Argentines Take Their Displeasure to the Streets"
"State of Siege"
"Looters Ravage Cities"

As part of our warning on the possible Argentine failure, the August 17, 2001 edition included the following ironical comment:

"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

It is worth stressing that such problems have been doubly exacerbated by having to service debt from an abused currency into a chronically strong reserve unit and typically following a period of speculative ebullience. Examples are readily available (except in textbooks) back to the travails of Henry VIII. His father (Henry VII 1485-1509) ran a sound balance sheet.

Financial pressures have been likely to ease in the first quarter [of 2002] and resume around mid/year.

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