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BARRON'S ARTICLE

- In the whirl of the holiday season, the December 20th edition of Barron's may have been missed.
- Sandy Ward's Question and Answer interview was titled in the index as "Trend Spotters" and it covered Institutional Advisors, with Ross Clark and Bob Hoye fielding the questions.
- The article follows.

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BARRON'S

A Rally for the Buck?

These forecasters expect a dollar comeback, but they also see a flight to safety -- including gold

By SANDRA WARD

An Interview With Bob Hoye and Ross Clark -- Clark's technical charts speak a thousand words. But if you still have trouble interpreting them, collaborator and senior strategist Hoye at Institutional Advisors, an independent market research and forecasting firm founded in 1980 and based in Vancouver, British Columbia, readily puts them into context with his lively daily and weekly commentary for institutional traders, hedge funds and chief investment officers.

The two focus on alerting investors to important market trends that present significant moneymaking opportunities, with special attention paid to interest-rate movements, the major stock-market indexes, base metals, gold and oil. Their calls tend to be uncannily correct, whether it's been predicting the stock- market bottom in October 2002, the seasonal rally in the stock market this summer or the new bull market in gold. That's why their forecast for a dollar rally is generating excitement and why their broad outlook for an eventual flight to safety seems so scary.

Barron's: *I'm interested in your notion that the world is long inflation and short the dollar.*

Hoye: That's where the main speculation has been. It is important to know that by inflation we don't mean the rate of change of the CPI [consumer-price index], but inflation in stocks and bonds, energy and industrial commodities.

Some think it's a sign of tightening that the Fed has increased the fed-funds rate four times. But the money supply is still growing. Speculation has become so intense that short rates have been going up because of the demand for speculative money. I doubt that the Fed would ever deliberately tighten, because they want to keep the party going.

Q: *So you're saying the Fed isn't in charge of our destiny?*

Hoye: It is all in the hands of the speculators. The market never accommodates the desires of the crowd, and we would include central bankers among the crowd.

Stuart McCall

Institutional Advisors' Hoye, left, and Clark: They say that if the dollar can hold its own in the next couple of weeks, a rally in the currency is in the offing.

Sentiment figures for the stock market, by many measures, show extreme bullishness. The Investor's Intelligence survey just popped up to a multiyear high. Sentiment as applied to the dollar index shows only 5% bullishness. Being long stocks, bonds or commodities is all a way of being short the dollar, so to speak, especially if you've borrowed to own it. If you borrow, you have got to pay it back, so therefore you are short the currency you need to pay it back in.

Clark: From a technical perspective, I look at the strength of trends. We do that on a daily, weekly and monthly basis. On a daily and monthly basis, the U.S. dollar index has declined at a pace that has reached an extreme, matching what we saw at each of the other interim bottoms since the index started trading in the mid-1980s.

Hoye: The last time the index was in this condition was this past January, before the dollar rallied to 92 from 84½.

Clark: Since 1985, we've had seven or eight such occurrences, and each one has produced either a consolidation within a declining trend or has created a very significant multimonth corrective rally.

Q: *Given the conditions, what do you expect this time?*

Hoye: We would like to have the dollar quietly stabilize -- that would be ideal -- and then later in January start to recover and end with some excitement with an intermediate move to around 90.

Clark: There are two ways in which the dollar can come off the bottom, historically, and they both start the same way. Typically, there is about a four-to-six-day recovery rally off a significant bottom. We've seen that. The relative-strength index got back to about 48 recently. Typically, in the first stages of a rally, the relative strength of the dollar will get to about 52, plus or minus about three points, so it's within that parameter. It is also back to the 20-day moving average, and this is the first thing you would expect to see at the turn.

In the next week to 10 days, you would expect to see more choppy action in the dollar after the recent directional move where the dollar recovered almost every day. The choppy phase should take us through the approach of Christmas. If it doesn't show a certain amount of strength, then it is probable it will work its way back down and reach a new interim low by the end of January. From there, we can stage a very significant rally.

Q: *What's the second path the dollar might take?*

Hoye: If the dollar can stay up in the next couple of weeks, it will suggest the turn is clearly in place and a significant bottom has been made. That will lead to a multimonth rally right off these levels. Otherwise, a rally might be delayed until we hit late January or early February before we are capable of it. I'd love the dollar to become an item that is no longer in the headlines and move back to page 3 or 4.

We are in the sixth great period of inflation in financial assets that started in the 1700s with the South Sea Bubble. As in the past, the real price of gold went down as the stock-market bubble blew out, then went up in the post-bubble contraction. Also, the senior currency became chronically and relentlessly strong, even after the bubble.

That's explained by the fact that the boom happened not only in the stock market, but also in debt instruments, as players in the world's financial capital were more than happy to lend money to emerging markets. The debt owed this time around is payable in dollars. The Fed may want to inflate credit, but if everybody is of a mood to pay down debt or avoid debt, then the Fed has a problem.

Q: *Are we close to a day of reckoning?*

Hoye: There was a series of speculative spikes earlier this year in commodities and other sectors -- first in nickel, then the Baltic freight rate, then grains, then silver.

All those faced a shakeout. Then the Nasdaq sold off. In late July, the market prepared for another rally where the market would test all the previous spikes or make sequential tops. The last to spike was silver, and the decline in silver recently has been particularly brutal. One traditional sign of liquidity disappearing is when silver plunges rapidly, relative to gold.

That is happening big-time. By the size of the drop in silver, somebody could be terribly offside, and it may take a while before we know who blew it. This is all reminiscent of other post-presidential-election periods. Of interest is the 1972 pattern in the Dow Jones Industrial Average and the S&P 500, which set one of the most important turn-of-the-year tops ever because what followed the high in the first part of January 1973 was the worst bear market since the 1930s.

Q: *Déjà vu all over again?*

Hoye: It looks similar.

Clark: If we take a look at the consolidation pattern we've been in since the early part of the year, there are probably two dozen examples in the last 100 years where we've come out in a very similar manner. A good percentage of those can be found around a post-election stretch, such as we have now. The move coming out of October was explosive, and the Dow, as we expected, reached 10,600 and the S&P hit 1194. That move didn't come on a single push. Such moves work their way up, but slowly lose momentum and consolidate and make marginally higher highs over a span of a few weeks to a month, which is what is going on right now. The momentum move is behind us. Now there should be less momentum on the upside. Support should be right around the 50-day moving average, which is 10,300 on the Dow. On the S&P, support is at 1160.

We have bounced off the 20-day moving average on both indexes recently, which is a perfect first test to have. Even if this rally has some legs and makes a new high, it will just be a marginally higher high because we still have to test support levels.

Q: *What role does oil play, since that was an important feature in 1973-74?*

Clark: Oil prices just happen to be coincident. When you look at individual items, you can analyze them but as you put them together in a basket, whether it be oil, the dollar or other assets, it is very difficult to recognize which one at a given time is the primary driving force. It is like people trying to rationalize budget deficits and currency moves, and it just isn't possible. At given times, they run in concert with one another; other times, they don't. It is similar to gold and the U.S. dollar: They run hand to hand about 25% of the time, but it is the 75% of the time that everybody is aware of.

Interview -- Part II

A Rally for the Buck? -- Part II

Q: *Does some of the momentum in the market you talk about correlate with what is known as the Santa Claus rally?*

Clark: Yes. I did some research with Dr. Bill Ziemba in the early 'Eighties on this, and we put together a small-cap- versus-large-cap trade, which has worked exceptionally well. The entry window is Dec. 15-17 and the exit should be by the 8th of January. You have to be careful about finding entry points for the Santa Claus rally and know your exits, just as you can't be a generalist about what happens in presidential-election years.

You have got to look for specific characteristics that should be present at certain turning points. So the last part of this week was where you would anticipate finding a good low entry point for small-caps. You look for an oversold condition in the market and then for that part of the market to show life once again. If you get that characteristic, then you have more confidence to go with the transaction.

DOLLAR BULL

The decline in the U.S. dollar index from its highs ("exhaustion alerts") has been extreme, signalling a bottom ("capitulation alerts") and positioning the greenback for a possible multimonth rally.

Source: New York Board of Trade and Institutional Advisors

If there isn't a hard break, it means that positions through year end would have to be of a smaller size than we would normally want. As we head into the seasonal turn at the end of the year, if we don't get a rally of significance, we have to read into that. That's what happened in Japan in January of 1990. Typically, January was the best month of the year in Japan, and yet in 1990, January didn't start on a positive note. That was the warning sign, and the market went into a slide from then on.

Historically, there are a couple of failures that occurred from December highs, and some of them are very similar to the makeup of the market right now. The U.S. market in January 1973 is a prime example, and it happens to have also been a climate where there were some very significant moves in commodities in the preceding two years. The statistics over many, many decades suggest that if there is a hot market going into the turn of the year, there is a good chance it is a very important top. And by any measure, sentiment figures on the stock market and sentiment figures on the lower grade bond market are about as extreme as you get. There is also an old market saw about bull markets having a "copper roof".

In the past 40 years, copper has set nine speculative highs, and seven of them topped out near the turn of the year. The high, so far, for copper was 149.4 on Oct. 11. It has come down to 135 or 134, but it might pop up again with the stock market.

Nonetheless, I think that also indicates a top.

Q: *Where is the opportunity, then?*

Hoye: In the government-bond market. In the three-to-five-year Treasuries. We're looking for a bond rally to continue for at least the next few weeks. But at some point, the general loss of liquidity in the financial markets could eventually pull down treasury bond prices. On the lower-grade side of the bond market, the loss of liquidity can be awfully quick.

Q: *And the only other area you are positive about is gold?*

Hoye: Yes. Everybody was looking at gold in dollar terms as the dollar was crashing, but the price of gold until March was falling relative to commodities. Placer Dome, a big gold producer, reported a very disappointing quarter because their production outside of dollar terms wasn't making any money. Our gold-divided-by-commodity index improved from 183 in March to a high recently of 244. A nice gain, but what's important about it is the last time it came out of the doldrums and rallied was late September 2000, when it signaled there could be a contraction coming, and in November the yield curve reversed. One of the worst things that could happen now would be Treasury-bill rates starting to come down, which would steepen the curve.

The next step would be to have credit spreads between long Treasuries and high-yield bonds start to widen. There is none of that yet, but we are watching for it.

Q: *You talk about a loss of liquidity, but corporations appear to be very liquid and some say that's bullish for the market.*

Hoye: One of the things that really bothered policy makers in the 1930s is that corporations and individuals who had money wouldn't spend it.

Q: *How does China fit into your line of thinking?*

Hoye: There was a big commodity mania in 1864 in Europe and England and the United States. In the United States, it was particularly acute because of the Civil War. Nine years later, the financial bubble blew up. As late as 1940, senior economists were still describing the 1873-to-1895 contraction as "The Great Depression." At the time, the U.S. was enjoying tremendous immigration and also a lot of movement from one place to another within the United States. It was a very free economy. There was a change in iron and steel production, and railroads were being built like mad everywhere, but it was all within the context of a long contraction. An index of farmland values in England from the time went down annually from 1873 without relief until the depression bottomed in 1895.

The U.S. market was vulnerable to its own excesses, and it had some good booms and good busts during the period. It was also vulnerable to the availability of credit in the financial center, which was then London. Fast forward to China today. Our conclusion is it will be subject to its own speculative excesses, and it will also be subject to the availability of credit in the world financial capital. I think the availability of credit is about to change.

The China boom is probably over, and you are going to have some form of a recession there.

Q: *And just what will make credit less available?*

Hoye: The steepening of the curve will be the sign of a sudden flight to quality. That flight to quality necessarily ends speculative liquidity wherever it is.

In any financial disturbance, the sensible money goes straight to the most liquid items, which in the past has always been gold or short-term Treasury bills in the senior currency. I was absolutely startled earlier in the year to learn that other senior central banks and Japan were buying U.S. Treasuries as far out as 10 years, because that suggested they were speculating rather than positioning for reserves.

What can happen, for example, is that the Bank of Japan could start selling the longer Treasuries, but at the same time it might also be buying shorter-dated Treasuries. So the effect on the dollar would be negligible, but it sure as hell would steepen the yield curve.

Q: *How are you advising people to position themselves for this scenario?*

Hoye: We've been advising them to lighten up on lower-grade securities and sell some of the pricey better corporates and to go to shorter-term Treasuries. Big institutions have always got to own some equities, and they should be paring the industrial cyclicals where there have been some huge gains. They should trim their equity allocation to 50%, and if we get a sell signal in January, that could be cut further to 40%.

We've been emphasizing gold because we're probably in a multiyear-long bull market for gold. There is not much liquidity in gold shares, so the whole industry is going to have to grow as more and more investors come into it. Also, prior to 2000 there were five new financial eras, great financial booms, and in all five examples the real price of gold went down and gold stocks didn't perform well.

In all five examples, once the boom was over, a long bull market for gold started.

We can methodically identify an advancement group that is going to have a long horizon ahead of it, and it is our duty to advertise that.

Q: *But if the dollar isn't in such dire shape as you suggest, how can that be good for gold?*

Hoye: There's been a habit of thinking the last couple of decades that the only way that gold can go up is if the dollar goes down.

For a real bull market in gold you have to have gold going up in the senior currency. Why would it go up in the senior currency? Because of investment demand. That investment demand in the past has been anticipated by a steepening of the yield curve, as investors get out of longer-term Treasuries and into the shorter end. The two most liquid investments in a flight to quality are gold and the bill market in the senior currency.

Q: *Are you an advocate of owning gold stocks or gold bullion?*

Hoye: In gold, you will make more money out of the stocks than you will out of gold. Following the 1929 market crash, Homestake Mining made a low of 81/8 while the price of gold was fixed at $20.67.

In 1932, gold was still at $20.67 and Homestake Mining shares were up about 135%. That proved that you can have a bull market for gold shares with no change in the price of gold.

Q: *But hasn't the price of gold been doing well while the stocks have not?*

Clark: That was because it was part of a currency play.

Hoye: The price of gold wasn't going up in Canadian dollars or euros. To accept that gold can go up in senior currencies is difficult.

But again, you go back to any post-bubble period, and the real price of gold has gone up.

Q: *How significant is it that they've come out with gold exchange-traded funds?*

Hoye: It is an excellent tool for fund managers and for individuals, and it provides liquidity. If we go into a post-bubble contraction and you own gold ETFs, you gain purchasing power.

Q: *Thank you both.*