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# BANK WEIGHTINGS

- Our proprietary Bank Trading Guide, which had been in a steady uptrend since June, 2003, steepened its climb in setting what turned out to be the high on December 1.
- The Guide's sudden plunge was noted in the December 9 edition of Pivotal Events when we increased our commitment to selling the banks and financials – globally – and advised more aggressive action when the Guide had technically completed the reversal.
- While we await this technical part of the signal to aggressively sell the sector, it is worth noting that credit spreads for high-yield (as well as junk) and some emerging debt have been widening since late December. This suggests a possible reversal from reckless to more sober lending policy. Given that such reversals typically reveal a lot of bad loans, we consider this as a fundamental reason to reduce exposure in the banks and financials generally.

## PHENOMENAL WEIGHTING GAMES

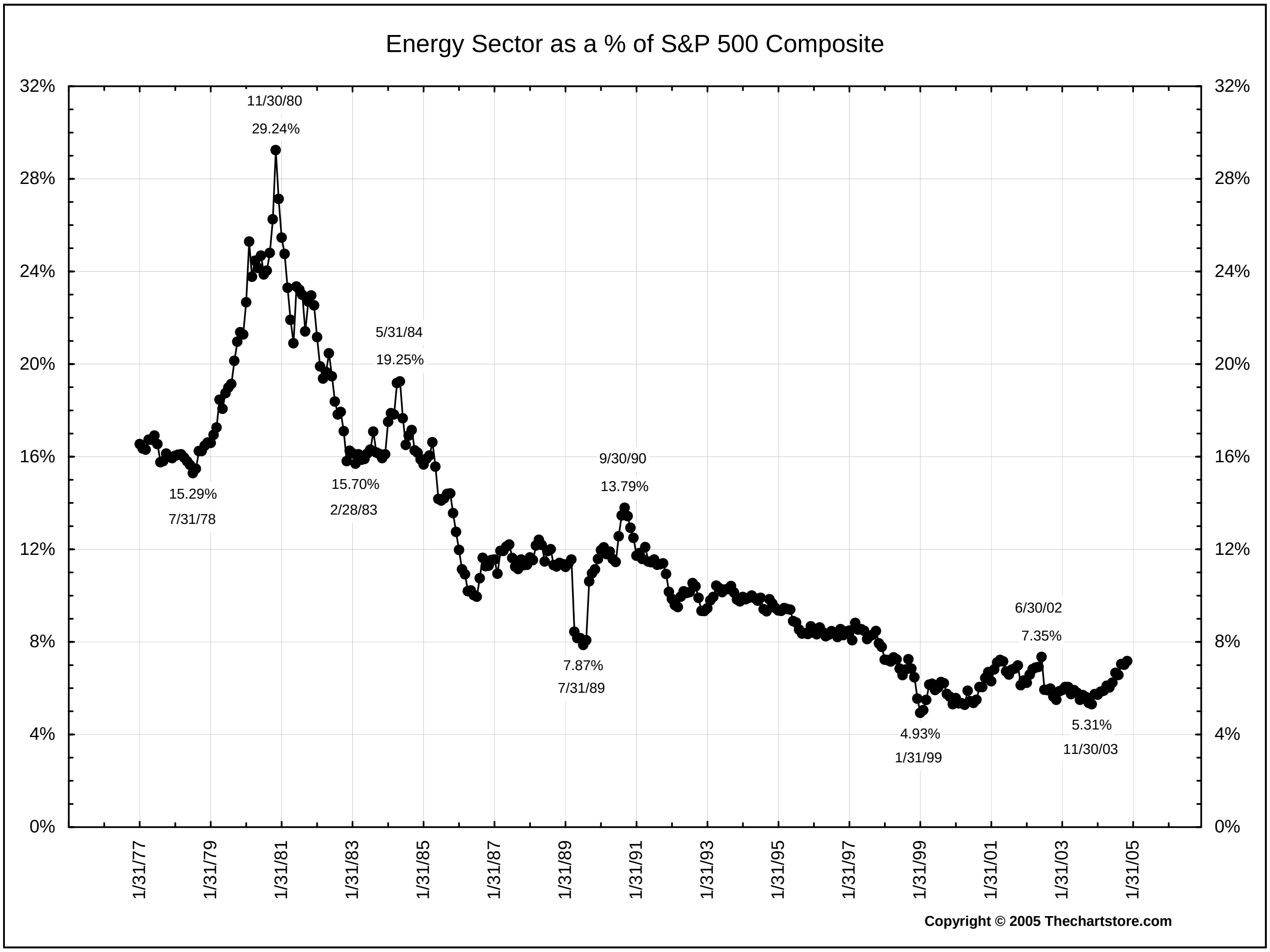
One of the measures of supreme confidence in a sector has been an extraordinary weighting relative to the rest of the stock market. Over the past 25 years, there have been 3 such examples of phenomenal weightings that formally recorded big market compulsions that inevitably became unsustainable.

At the end of 2004, the Financial Services Sector accomplished a 23% weighting relative to the S&P 500. This compares with the 7.5% recorded in late 1990 as the Fed had to suddenly bail out Citigroup and Chase as they became insolvent following their aggressive lending in real estate and energy.

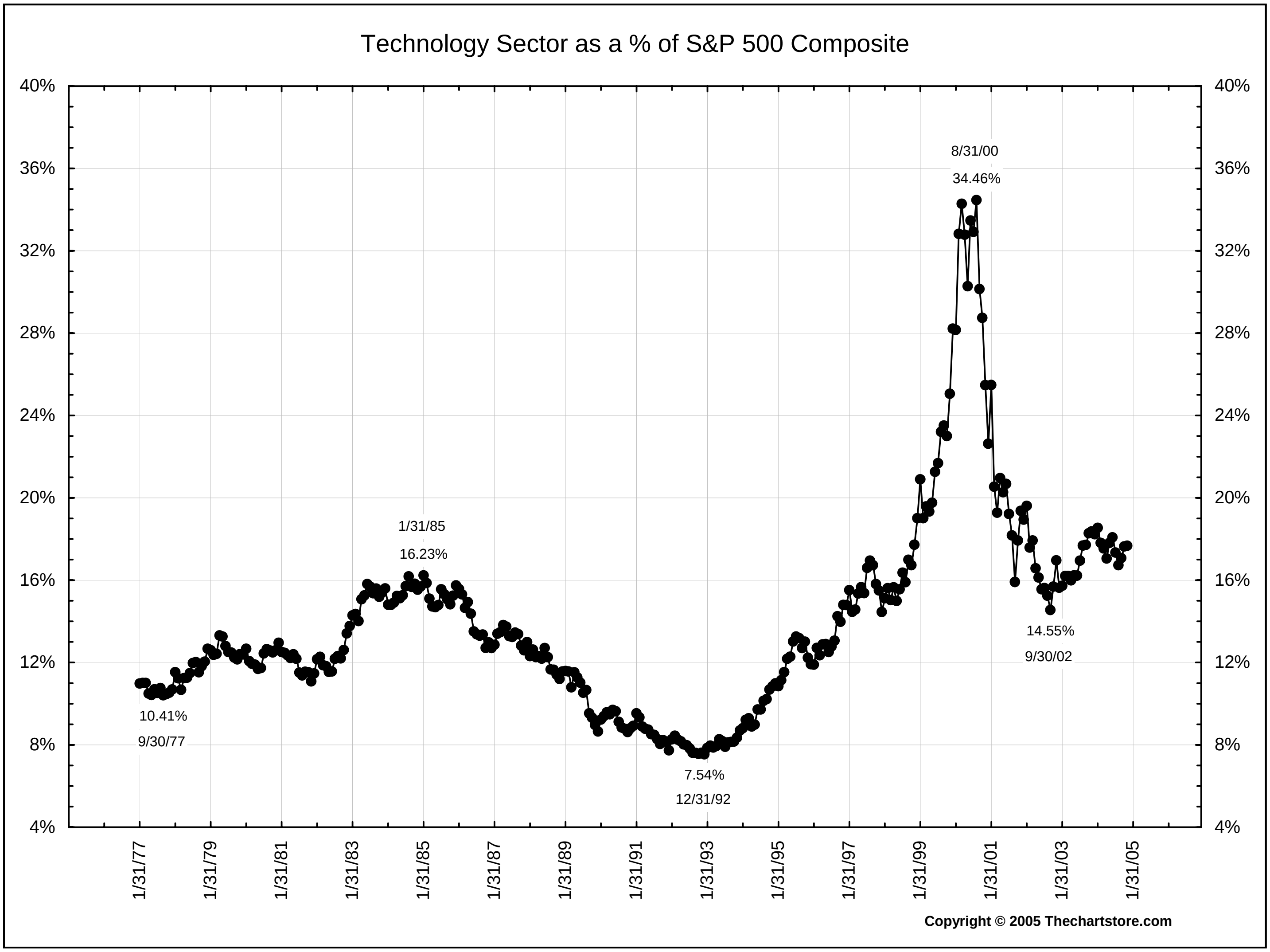
Banks are the most recent example and could be vulnerable to the typical post-euphoria loss of esteem so it is worth noting that the two previous examples were followed by a long period of dismay and, eventually, neglect.

The first occurred during the secular bear market that ended in 1982. Within a DJIA decline in deflated terms of 68% from 1969 to 1982, the energy play became compulsive and topped out in January, 1980 along with the frenzy in gold and silver.

Plotted at month-ends, the following chart shows the build in the energy mania from 15% in 1979 to 29% in 1980.

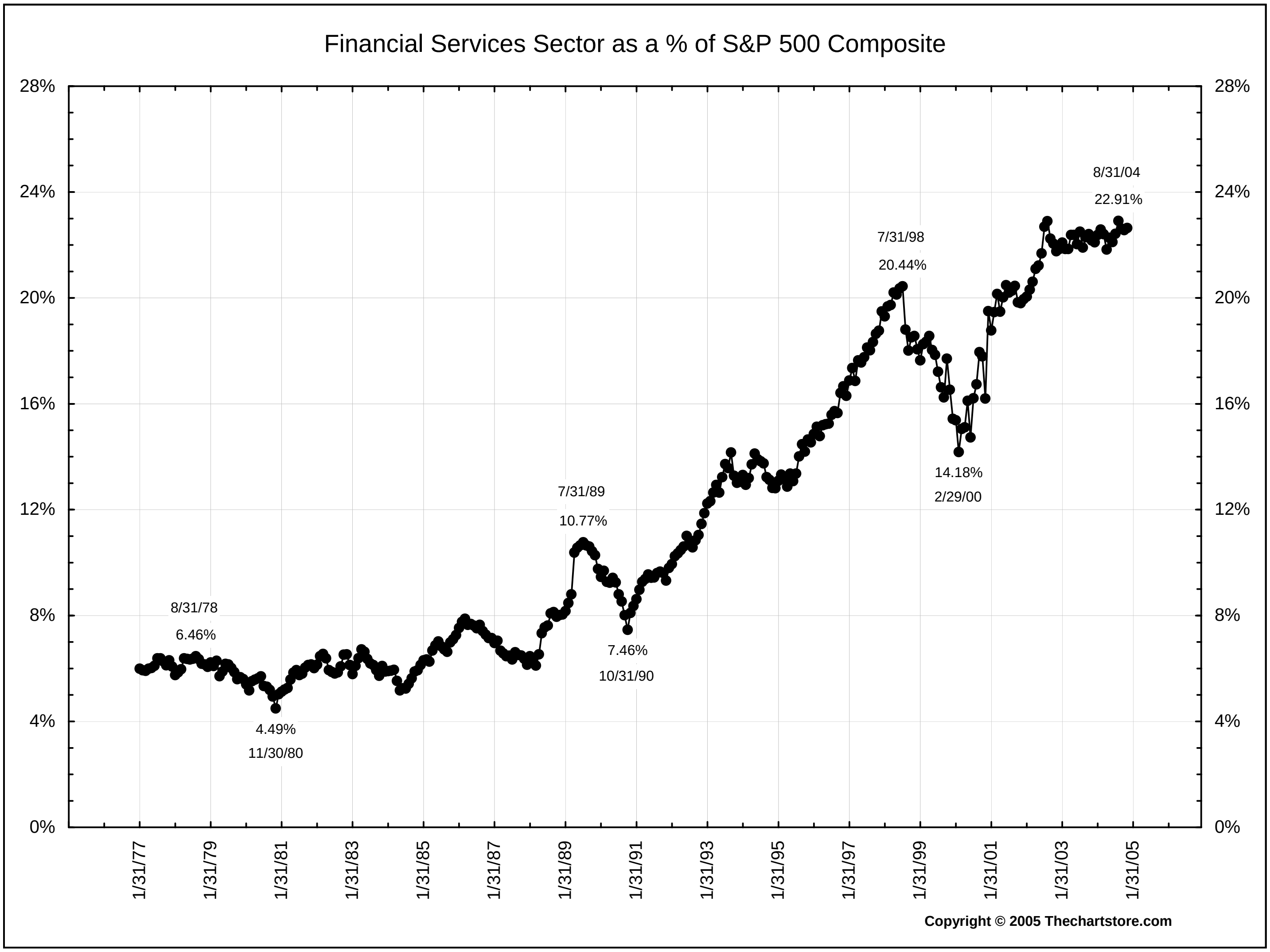


The next rush to a phenomenal weighting was accomplished in the techs as they went from 7.5% at the end of 1992 to 34% in March, 2000. The special feature was that this occurred at the climax of a new financial era as previously exampled by the South Sea bubble of 1720 or the 1929 financial bubble.



The most recent example of an extraordinary weighting has been achieved by the banks. Quite fittingly, the low of 4.5% was set at the same time as the mania in the energy sector blew out.

For this study, we will focus on the action from the low of 7.5% in late 1990 to 23% at the end of December. This has occurred within the context of two cyclical bull markets and is all the more remarkable for maintaining the high weighting on the latest one for many months.



It is worth focusing on the pattern leading to the important high in 1998. The weighting increased 7 points from 13% over 3 ½ years to 20% in July, 1998. Recall that for that year our Bank Trading Guide signaled a "sell" in April (highs for the TSE and BKX banks were set that month) and that our model on credit spreads expected spreads to begin widening in May to "dislocating conditions in July-August". The huge hedge-fund LTCM was dislocated into bankruptcy and the BKX plunged 40%. To review that call, please click the following link:

http://www.institutionaladvisors.com/pdf/050104%20BANKS%20AND%20FINANCIALS.pdf

On the latest move, which started at 14% at the end of 2000, the increase has been to 23% - that's 9 points in 5 years.

This has been a rather big event and vulnerable to a change of esteem.

## TOTALLY OUTRAGEOUS WEIGHTINGS

Canada does not provide a sober example in this department. During the energy mania that climaxed in 1980, institutions just had to own Dome Petroleum (remember "Smilin' Jack Gallagher"?) – even when they were discussing the exceptional market capitalization and soaring debt burden.

Dome Pete's weighting relative to the TSE 300 rose from 1% in 1978 to 6% in 1980 – and then it plunged to less than 1% in 1984.

Although outrageous at the time, this was modest compared to Nortel Networks' record with the financial bubble that blew out 2000. This mania started at 2.1% in 1994, reached 6.5% in 1Q 1999, only to get completely insane with the 26.7% weighting accomplished in 2000.

Nortel's weighting collapsed to 0.48% in October, 2002.

## TIMING AND CONFIDENCE

Obviously, this is a key question that can best be answered through tested methods. One is our Bank Trading Guide, which is building the most distinctive technical "sell" since 1998. To conclude this, the Guide has to break down.

Another consideration is that credit spreads since year-end have been widening. This potential reversal requires a "test" to technically confirm the change. For example, the US corporate high-yield narrowed to 183 bps, over treasuries, on December 29 and in only 8 trading days widened to 224 bps. The test would retrace part of the gain and then move to new highs.

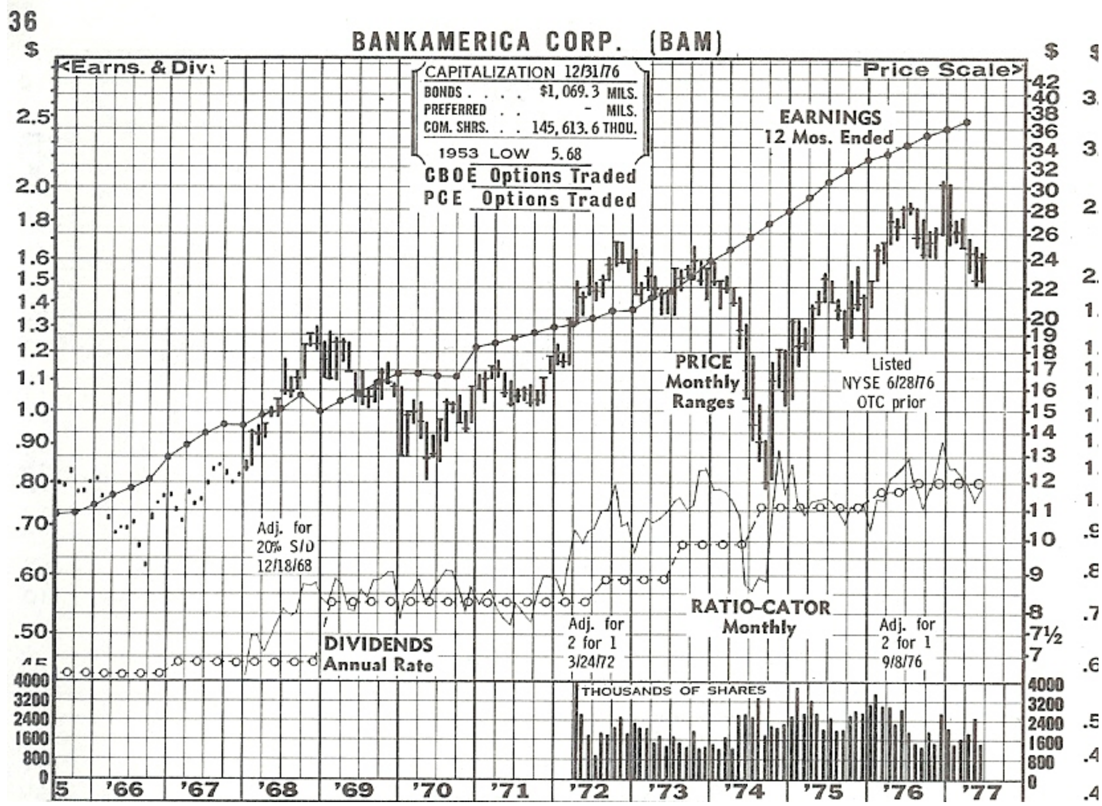
Full reversals for both the Guide and credit spreads could be completed within 6 to 8 weeks.

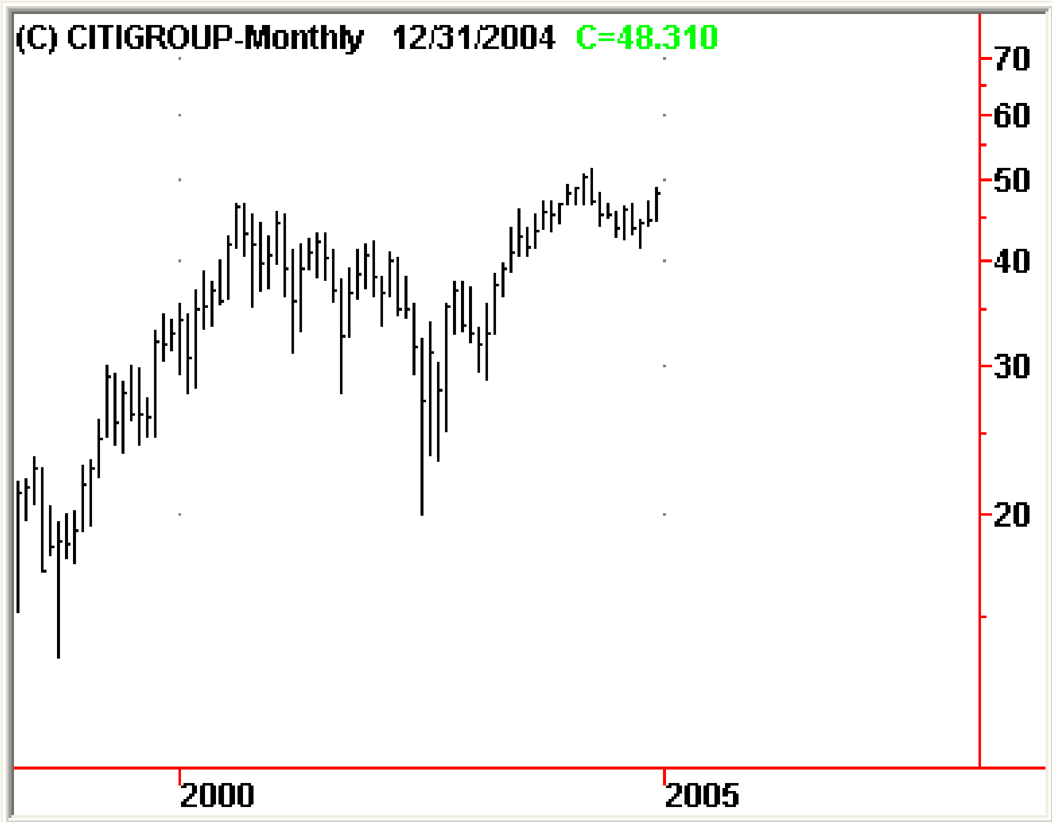
The sharp breaks in the other hot games, such as the stock market and base metal prices, are quite likely integrated with the sudden widening of spreads. While this increases our confidence in the pending bear market for global bank stocks, it is prudent to look to another approach.

A few weeks ago, the ChartWorks noticed that Citigroup's chart was showing some striking similarities to the pattern described by Bank of America's stock peak at the beginning of the formidable January, 1973 – late 1974 bear market.

Citigroup is completing an upside move similar to that seen in BankAmerica in 1973. A failure to hold $47.30 would be considered a breakdown.


Another Comparison of the Big Picture



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# CANADIAN BANK AND FINANCIAL WEIGHTINGS


- The last big "sell" signal was in April, 1998.
- Note the subsequent decline.
- Typically, the Bank Trading Guide is coincidental at bottoms.
- At 34%, this sector is in la-la-land.


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