PIVOTAL EVENTS

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Signs Of The Times:

" ***After Subprime: Lax Lending Lurks Elsewhere***" **WSJ, February 20**

The article reviewed some research by UBS that notes that the downturn in the sub-prime mortgage market was "***marked by an unexpectedly large number of early defaults***", by which borrowers stop paying shortly after getting their mortgages.

The article continues with the increasing frequency of "***soft fraud***" whereby "***someone takes a mortgage, buys a home, avoids payments and lives rent-free until the marshals come***".

The day earlier, Reuters carried a review by Barclays Capital. This polled 250 institutions on their views on commodities. Positions on commodities or, as it was phrased, "***assets under management in commodity products***" could reach $120-$150 billion by end-2008.

Of those polled about this, 52% said that investment would reach this level, while 36% indicated it would exceed $150 billion.

To our way of thinking, this seems that some 86% of institutional money managers are very bullish on commodities with, expressed in a different way, a majority of planning to reach an allocation of 10% commodities.

Last June, HSCBC noted that institution commodity exposure would be about US $100 billion by the end of 2006, which compared to $10 billion at the end of 2003.

The high for the benchmark index – the CRB – was 366 on May 11, and the cyclical low was 182 in October, 2002.

At the end of 2003 when institutions held some $10 billion, the index had increased to 240. The point to be made is that when commodities were at their last cyclical low, the position was less than $10 billion. And closer to the cyclical peak (possibly last May), institutions own over $100 billion and are intending to own over $150 billion. "***Come on in, it feels good – all the lemmings are doing it !***".

Although the action must be disappointing since the halcyon days of June, especially with the occasional expensive rollover, the tout is still on. This reminds of the establishment's chronic bear raid on gold. This continued well after the real price began a cyclical bull market in November, 2000.

It seems to take a long time for the establishment to become disenchanted with the last investment fashion. This long-term pattern shows up in our study of life insurance companies since the 1860s.

This was sent out in June and can be reviewed through the following link: http://www.institutionaladvisors.com/pdf/060616-ACTUARIALLY-DRIVEN_INVESTORS.pdf

At the top of bond markets, they tend to be fully positioned in high-grade bonds; near the peak of a boom, they tend to be long hard assets, stocks, and low-grade bonds.

Then, typically, when strong convictions are fully employed, a long period of chagrin follows. We have not noticed any rationalizations that the institutional direct entry into commodities will reduce the big swings hitherto inherent to commodities.

Applied to equities, this reasoning prevailed from around 1966 to 1969 when institutions were distinctively taking larger positions in stocks.

The tout was that the research capabilities of the institutions would caution against over-commitment at cyclical peaks. This, in turn, would provide the ability to buy going into cyclical bottoms.

Now this all sounded quite practical, but along came the special reasons about "***this time it's different*** ". One was championed by the towering influence of Paul Samuelson who had, in the mid-1960s, declared that through very wise manipulations the business cycle had been eliminated.

"***No more recessions***" was the tout from interventionist economists and Wall Street strategists extrapolated the new venture into equities by institutions into a ***"shortage of equities"***!

This prevailed through to the end of the 1960s while the DJIA, deflated by the CPI, set its high in 1966, from which it plunged 75% to a dismal low in 1982.

Obviously, this was accompanied by the usual recriminations when a fashionable asset goes bad.

This time around on the new institutional infatuation, the "new" policy theory has been "Helicopter Ben" and the theory that the business cycle has been eliminated is summed up in one word – China.

This provides, once again, that there is no risk of a reversal of fortune – that's despite mounting carnage in housing and sub-prime mortgages.

The investment policy history of financial institutions suggests that the next big event will be a lengthy disgorgement of commodities within a climate of boardroom chagrin.

Stock Market: The high-powered zoom started in November and has continued. That's been the nature of this market – it runs to a time target and continues.

What's more, in some cases the action has reached what Ross is calling "***the Eiffel Tower***" pattern with a parabolic blowoff steepening to almost vertical.

Information on the tower itself includes that it is 324 meters high and the latest innovation is ***"twinkling lights"***, which is very popular.

Needless to say, but the stock market could be described as twinkling as well, and is definitely popular. Indeed, the ChartWorks proprietary model, which registered "Downside Capitulation" in late September, 2002, has registered the opposite "Upside Exhaustion" on a monthly basis on a number of stock exchanges around the world. On these, all that has been needed to prompt the "sell" is an appropriate loss of momentum.

We will advise and update the list on this opportunity.

In the meantime, the same upsides were registered on Goldman Sachs (GS), which has yet to lose momentum, but this week the outstanding example of the tower Brookfield Properties (BPO) took a hit and is now a "sell". The action needs to test the high and this would provide the opportunity.

This week, and as with BPO, a couple of agricultural stocks have accomplished the monthly upside exhaustion. Industry leader, Potash Corp. (POT) has reached the lofty condition on the monthly reading and Agrium Inc. (AGU) has registered on the daily, weekly, and monthly bases – as BPO did.

This is interesting as Goldman's index of agricultural products has been working on a big top with negative momentum divergence. The latest rally to 280 is likely testing the high of 277 set in early December.

As with other resource sectors, the stocks could roll over and lead the decline in the products.

We have been thinking that our Bank Trading Guide could improve until around now. From 200 in late January, it reached 214 on Tuesday. This is the test of the 220 high set in December.

With this, the BKX has rallied to new highs at 121.

There is a significant progression of events in the financials. Since our "sell" on the sector last summer, Accredited Lenders (LEND) has recorded a relentless decline from 60 to last week's low of 22.90.

Another high profile sub-primer, New Century (NEW), declined from 45 to 30 a little over a week ago. Since then, it has plunged to 16.15.

Initially these came off a momentum high with our "sell" on the sector and have plunged with widening of spreads for sub-prime mortgages.

As reviewed last week, the key spread in the sub-prime structured finance stuff (ABX HE BRB index) was at 100 at the end of October, 98.2 at the end of November, and 95.25 at the end of December. The announcement by HSBC noted that their position in this sector deteriorated from good to concerning in only two months. The spread index declined on the two key months of November and December from 100 to 95.25, or 4.75%.

Bad enough, but in the almost two months since, the index has slumped 21% from 95.25 to 75.19. Clearly, this is becoming toxic, not just to HSBC's balance sheet, but to any lender ***who has been reckless***.

To our unfashionable minds, it is likely anyone who has bought anything close to BBB, let alone worse than BBB is vulnerable but, as the WSJ reported on January 4, "***Junk has never been so fashionable.***".

This regard has maintained as non-mortgage but nevertheless BBB corporate bonds have continued to narrow relative to treasuries.

At 543 bps, over treasuries, in early January these have impressively narrowed to 450 bps this week.

This reminds of 1997 when the "Asian Crisis" was heading to New York and made that October the worst month for the corporate market in a decade. As the juggernaut was rolling its way to Wall Street, Lehman's head honcho for international bonds was reported by the WSJ as not being able to understand why a problem in Indonesian bonds would affect Venezuelans.

Hey, it's all one credit market and, at a cyclical turn, troubles in one sector or region will inevitably afflict complacency elsewhere.

BBB sub-prime stuff has suffered serious widening while BBB corps have been narrowing. Technically and practically speaking, the negative divergence is enormous. Also technically, we await the next "sell" from our Bank Trading Guide and, in the meantime, large holders can do some lightening up.

Advice in sports-car racing **–** ***to increase performance, add lightness***.

INTEREST RATES

The Long Bond: Last week, we noted that the action would likely be choppy to down until commodities rolled over. This would include mainly base metals and agriculturals.

Credit Spreads have been discussed above.

The Yield Curve remains inverted with the 10s to 2s hanging around **–** 13 bps.

Typically, inversion can run some 12 to 16 months before the wheels come off the speculative games.

March will be ***Month 13***.

The Dollar Index has been steady this week at 84.2.

This has been likely to trade between 85 and 83.5 with the lows associated with surges in commodities.

The latter could run its course in March when the dollar could trend higher against a loss of speculative abilities in ramping the hot games.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: On the rally possible into March, we have been hoping that the bulls would not do their panic buying until then. So far, so good. The high has been 60.80 on February 13, there was a brief consolidation, and now it's at 61.

Close to 65 has been our price target in March.

The index of oil stocks (XOI) is consolidating after the rally to 1165. At 1163, the November high of 1242 seems possible.

Gas stocks (XNG) have also been consolidating recent gains. At 459, the seasonal target has been December's high of 476 – a little higher seems possible.

Natgas can run to a later seasonal high.

Base Metal Prices: On the mini panic exacerbated by stories about a smallish hedge fund, our index (less nickel) declined to 570 on February 8.

The seasonal rally has taken it up to 636 today, and 675 has been possible on this rebound.

This week also recorded new highs for lead, nickel, and tin. The latter seems to be assisted by the governments of tin-producing countries.

This is becoming the most remarkable action since the Tin Council (think cartel) blew their market all to hell in 1985. The damage to the London Metal Exchange was impressive and it greatly reduced OPEC's image as well.

Once again, we look to www.thechartstore.com for the big picture chart. Ron Griess does not have the daily, but the monthly high was 13,084 in June, 1985. This compares with 14,045 today. This, in turn, compares with the cyclical low of 3,595 set in July, 2001.

In real terms, as deflated by the CPI, four big cyclical bull markets performed as tabled.

TIN (DEFLATED BY CPI)

START		PEAK		GAIN	DURATION
4,346	September, 2001	14,045	February, 2007?	223%	66 Months
16,898	July, 1971	49,594	October, 1978	193%	87 Months
5,564	April, 1932	21,286	March, 1937	283%	59 Months
5,564	August, 1921	17,812	March, 1927	220%	67 Months

These are the numbers for the big cyclical bull markets on a data base beginning in 1913. The example that ran through World War II and the Korean War was not included, but the gain was 224% from 1938 to 1951.

Clearly, gains in the order of 220% have been the most common, with 193% and 283% being the exceptions.

The other driver seems to be duration, with 59 to 67 months being the limiting range.

The 1978 example at 87 months is exceptional and the 13-year run to 1951 occurred under unusual conditions.

It seems that tin's bull market is accomplishing a gain and duration that has ended previous big cyclical bull markets.

Considering the seasonality of March and metal prices, as well as the almost 13 months of yield curve inversion, the tin market is vulnerable to a massive reversal.

Golds: The underperformance of gold stocks has been suggesting a correction in the sector as the gold price, itself, has been likely to continue its rise.

This has worked out and the action in the bullion price is approaching the time target that the ChartWorks calls the "Pi Cycle". This has been suggesting that next week would set an important high and be followed by an interim correction for the sector.

For stocks, it could amount to 12% or somewhat more. For gold – perhaps around 5%.

This "Pi" turning point could also influence the pending end for the rebound in the battered base metals, as well as the pending top for those making new highs.

The culmination of this leg of speculation could be signaled by an increase in the gold/silver ratio.

	THUR	FRI	TUES	WED	THUR NOON
FEBRUARY	**15**	**16**	**20**	**21**	**22**
Junk Spread	460	456	457	450	—
Treasury Curve	- 12	- 14	- 13	- 15	- 12
Base Metal Prices	633	628	617	610	636
Dollar Index	84.1	84	84.2	84.2	84.3
Gold	667.3	668.8	657.1	680.2	679
Gold/Commodities	173	172	167	172	—

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