PIVOTAL EVENTS

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Signs Of The Times:

"Who Cares if the US gets a cold? America sneezed and the rest of the world went shopping."

- Financial Post, May 7

"Merrill and Morgan Spent Big Money on Subprime Lenders Just Before Slowdown"

- Wall Street Journal, May 19

ON THE SHANGHAI STOCK EXCHANGE

"Almost 100 million accounts open now – including 310,000 opened just this past Friday.

So far sellers haven't reported any problems, and the only jostling this year has been for places in line to open brokerage account, but by April trading in Shanghai was nearly twice as high as in January, and for the first four months of this year was seven times the level in the same period in 2006."

- Wall Street Journal, May 22

ON COMMODITIES

"Donald Coxe Convinced Base Metals Rally Just Getting Started."

- Financial Post, May 23

"Get out of the dollar and buy as many commodities as you can."

- Jimmy Rogers, Financial News, May 23

The theory and practice of policymaking over the past 100 years has been corrupt and in ascendency only because it transfers inordinate power and wealth to the state. That this is done through relentless currency depreciation is well known.

Our view remains that despite the unrelenting corruption, commodities and the dollar are subject to seasonal as well as cyclical forces. These seem to be culminating now with the world, so to speak, short the dollar and long 'investment' stories.

As this culminating action is similar to previous examples of outstanding speculation, we've called it ***"Rational Exuberance"*** and are alert to a rational denouement.

One reliable guide has been that typically the bull market part of a boom runs for some 12 to 16 months against an inverted yield curve (May is ***Month 15***). And then the wheels start to fall off. Typically this is associated with faltering commodity prices, and risk free attitudes in credit-spread markets.

Adding to the rational side is that often base metals set an important seasonal high in late spring and some of the biggest stock bubbles in history have exhausted themselves at around this time as well.

Last week our proprietary model registered a rare ***"Upside Exhaustion"*** reading on the Shanghai stock market.

Stock Market: Animated spirits were evident early in the week. This showed up in stocks, credit spreads, as well as in the big jump in base metal prices from Friday until Tuesday.

Junk spreads have come in to only 425 bps over treasuries. This is at new ***"narrows"*** for the move, and compares to 528 bps at the first of the year.

Along with this is the good news of rising short rates. The treasury bill which had declined to 4.73% last Wednesday and was becoming rather ominous has increased to 4.90%.

The revival of the good stuff timed with the announcement that China was placing some $3 Billion with The Blackstone Group – essentially a private equity fund, and just as essentially – the investment intends to increase returns from foreign exchange resources.

The last time the establishment sought higher returns from central bank reserves they sold gold right down to a significant low. They just had to join the crowd as gold always declines during a financial bubble.

The next policy mania occurred with the usual spread narrowing that goes with a financial bubble. In the mid 1990's this natural phenomenon was ignorantly attributed to the establishment of Euroland, whereby all spreads in Europe and elsewhere would narrow.

On that misunderstanding of market forces Long Term Capital Management committed the ultimate folly and failed. At the time, their model was so believable that a number of senior banks actually loaned the highly-leveraged hedge fund money. The Bank of Italy got totally carried away and took an equity interest.

LTCM was likely the biggest single failure in financial history.

The Chairman of the government agency said that China's main policy was to diversify beyond the usual positions in treasury notes into a ***"broad portfolio of small stakes in many companies"***.

This may be so, but one can't help recall that during the great Tokyo boom that blew out at the end of 1989 there was a mania to buy ***"trophy"*** hotels and golf courses.

This seems to be yet another avenue for establishment misadventure.

A reserve is a reserve – not something to be placed at risk for higher returns.

Wrap: The stock market is at the season of opportunity. In this case it is dynamically overdone in May which provides the exit for the usual decline into the fall.

Of course the epitome is the ***"Upside Exhaustion"*** registered last week on the Shanghai index (SSEC). This awesome warning registered on a number of stock exchanges in late February, but it has been missing in the SSEC until recently.

This is a measure of an outstanding bull market and the last cluster of these was registered in the first half of 2000.

This condition also fits onto the yield curve window whereby the final phase of a bull market is accompanied by an inverted yield curve. Typically the ending action in the stock market occurs as the curve reverses to steepening, and the curve has been trending towards reversal.

This week's trading action has been interesting. Base metals ended a sharp rally with New York copper doing an outside reversal to the downside on Tuesday. On Wednesday nickel plunged 6.5% on increased inventories in Shanghai.

Outside reversals don't necessarily end a trend but they can indicate a possible change in speculative abilities. In this regard, yesterday clocked an outside reversal to the downside for the DJIA. As this edition is being finished it is working on another one. It is rare to have two back to back.

Also indicating excess is that the weekly ***"Sequential Sell"*** pattern has developed in the DJIA chart. It's worth adding that this pattern ended the copper rally. This pattern is not 100% reliable but considering today's conditions it should be respected.

On the really big picture, the great bubbles such as completed in 1720, 1772, and 1825 blew out in the May-June window. In the 1873 and 1929 examples London and European bourses fit the pattern while New York accomplished a surge with a diminished number of participating stocks into early September.

Sector Comment: We've been long the resource sector since October – November with an eye for the seasonal rally into late spring. We've been there for the past few weeks and have advised lightening up.

INTEREST RATES

The Long Bond was likely to rally a couple of points off the low of 110. It made it to 112 and change in early May. Our position has not been to trade it but to use any rally for investors to become defensive.

The decline in the bond price seems tied to stock market exuberance, but our concerns for the long end were based upon the overall loss of liquidity that always follows a bubble.

Our strategy has been to be positioned in the 4 to 5-year maturities pending the cyclical reversal to a steepening yield curve.

The Yield Curve reached maximum inversion just before the first China hit that began on February 27.

Because of the longer history available and more dramatic moves we prefer to monitor the whole curve from bonds to bills.

This has changed from -54 bps in February to + 13 bps yesterday. There has been no change like this since 4Q 2000.

It is worth emphasizing that while an excess of time and effort is expanded discussing Fed policy it is market forces that determine the yield curve. During a boom the curve heads towards inversion and the reversal to steepening is part of the turn to contraction.

The mechanism seems straightforward. During the party the demand for short-term funds by speculators drives short rates up faster than long rates.

There are two reasons for watching the curve. One is to make money on the reversal; the other is to recognize that the turn to steepening indicates diminishing demand by speculators.

This is likely a cyclical turn and traders can play the steepening side for quite some time.

Credit Spreads: One could say that risk no longer exists. Obligations made on every bond, note, or (shudder) derivative will be met. To doubt this truth is to doubt the ***'truth'*** about capitalism and the good life causing global warming.

There is ample reason to doubt both, but this page will stay with credit markets.

Junk has narrowed from 530 bps in January to 425 bps which is a new ***"low"*** for the move. Considering the strength in stocks and base metals it is not surprising that exuberance is showing up in the sector as well.

However, the spread market is eligible to change and there can be seasonal forces to recognize in this sector. We used this in May 1998 to forecast that spreads would widen ***"to dislocating conditions in August-September"***.

It is that seasonal widening that took out LTCM, and if it happens this year the change could have some interesting results.

The Dollar Index found stability and has recovered a little. At the low of 81.25 in late April it became oversold enough to prompt an intermediate rally.

The weekly RSI got down to 30 and has recovered to 39. Some pause is possible at around 50, but to conclude an intermediate rally the RSI could get to 70.

The worst thing that could happen to the markets, policymakers, as well as to corruption, would be a firming dollar.

The Canadian Dollar soared through the old high of 91.42 set a year ago in May.

That was with an important high for crude oil and base metal prices as well as for the stock market, not to overlook the good times in credit spreads.

Similar conditions are evident now and the Canadian dollar is at 73 on the RSI, which compares to the 70 reached a year ago.

Last week we thought the rally would stall at last year's price and RSI but the rally has continued.

Last year the C$ traded almost to the day with the action in base metals and this could be the case now.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: There seems to be some cross-currents at work. Crude oil set its seasonal high nicely at 68 in early April. The seasonal high for natgas is usually 6 to 8 weeks later and we thought it would support the sector.

Natgas made it to 8.40 last Friday. We've had a target of around 9, but it should have been accomplished some weeks earlier such that the sector would have a good correction into early July.

Overall both crude and natgas are weathering the seasonal set back rather well.

Some weakness through June is possible and both gas and oil stocks could then be accumulated on weakness.

After early July the sector could be strong through to October.

Base Metal Prices: We've been documenting that some base metals have been clocking the biggest cyclical gains in the past 100 years.

Copper was detailed last week and the gain to last May was 428%, which compared to the previous best at 174% to March 1956.

Tin was reviewed on April 26 and the gain to April, which still holds the high, was 223%, which compares to the best at 198% to March, 1927.

NICKEL
ONE BIG ONE AND TWO OTHERS
(ADJUSTD BY PPI)

START	PEAK	GAIN	SUBSEQUENT LOW	YEAR
5,757 Oct. 2001	54,054 May 2007	839%	? ?	? ?
5,348 Nov. 1982	38,664 March 1988	623%	5,146	1998
5,518 Jan. 1924	17,216 Nov. 1933	212%	4,104	1949

In late 1999 we interviewed 3 different actuarial firms about the methodology behind their advice that pension funds should hold a 60% weighting in equities. It was surprising that otherwise very methodical actuaries had no formal method behind that recommendation. It was a consensus derived out of thin air and it did not serve their clients well in the debacle that followed 1Q 2000.

Similarly, the consensus about commodities seems to be based upon rather thin methodology. After 1980 commodities suffered an 18-year bear market, therefore there should be an 18-year bull market.

Our research covers all of the great asset inflations and contractions in history. There is a reliable price history in England calculated back to 1280 AD. Typically bull markets for commodities run for some 20 years. Of more than passing importance they have always started out of a long contraction bottom. They have never come out of a period of great asset inflations as we've seen over the past couple of decades.

The part we have been focused on over the past couple of months is the yield curve and it is now indicating a pending contraction. Over the past month we have noted the seasonal nature of cyclical peaks and have documented that in some metals the percentage gains, when adjusted by the PPI, are the greatest in the past 100 years.

The story about commodities soaring for many years seems to be in the market – fully – and conditions are eligible for a cyclical bear market.

Golds: This sector has been underperforming as orthodox investments have been soaring. Yes this is tautological, but it is the case until this hot action in stocks, commodities and low-grade bonds blows itself out.

One measure of this is the DJIA/Gold chart, which reached a low of 15.90 and an exceptional oversold last May. This has recovered to 20.56. This level represents overhead resistance and is also recording the most overbought condition since 2000. Although moderate, something similar holds for DJIA/XAU.

Another comparison that is difficult to chart is that the returns from junk bonds has been outstanding over the past year.

However, the best indicator for the sector is gold's real price which for 300 years has set a significant low at the peak of great asset inflations.

Gold's nominal price can be deflated by a consumer, wholesale, or producer index. We prefer to use our own commodity index, which is well-weighted in base metals, because it can be calculated daily.

The attached chart shows an exceptional low and the importance of the real price is that it represents profitability for mining operations. If the real price is going down, the nominal price is not keeping up with rising costs.

Going the other way, a rising real price indicates improving profitability.

Of interest is that the Coppock technical indicator is replicating the pattern that started the cyclical bull market for gold's real price at the end of the 2000 boom.

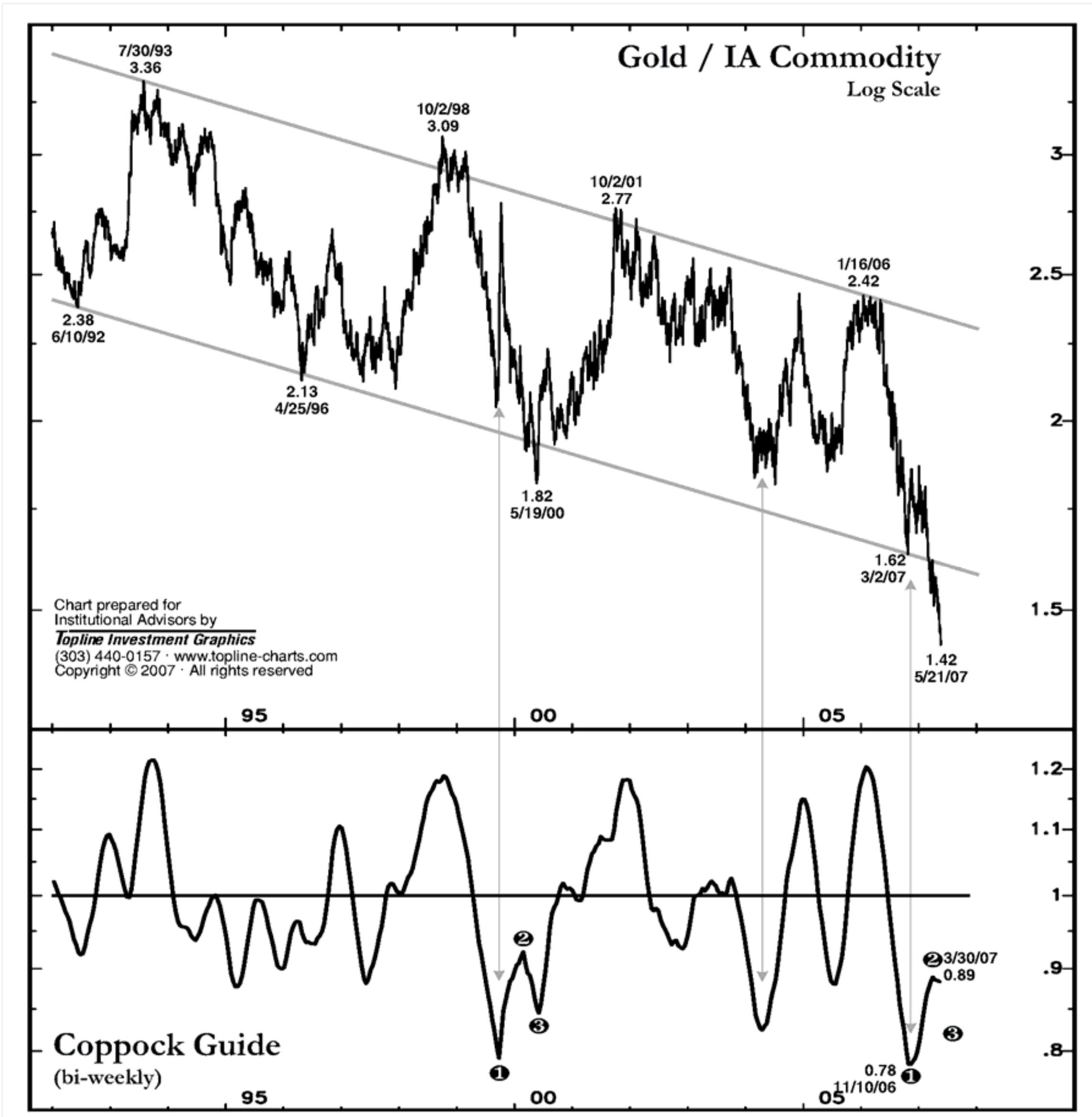
It is worth emphasizing that as the real price came out of the final low set in late 2000 the HUI advanced as well. That was against a flat trading range for gold at the 268 to 272 level.

The irony is that the HUI and the old TSE gold index were up some 50% before gold broke above 272 in May, 2001.

It seems probable that the rally in the real price, when it comes, could be associated with a stealth bull market for gold stocks in the face of indifferent action in gold's nominal price or in the direction of the dollar index.

The real price could reverse in the next 4 or 5 weeks, which is the basis of our advice to accumulate the sector on weakness.

GOLD'S REAL PRICE



- Over the past 300 years gold's real price set a significant low as a great boom concludes.
- The last such cyclical low was in 2000.
- Note the similar pattern on the Coppock Guide.

	FRI	MON	TUES	WED	THUR NOON
MAY	**18**	**21**	**22**	**23**	**24**
Junk Spread	434	436	428	425	----
Treasury Curve	- 2	- 2	- 1	- 2	+ 1
Base Metal Prices	710	727	743	715	725
Dollar Index	82.2	82.3	82.4	82.3	82.4
Gold	661	662.9	659.1	661.9	653
Gold/Commodities	147	143	144	150	----

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