

PIVOTAL EVENTS

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Signs Of The Times:

“BHP says credit crunch will not affect metal prices.”

- August 21

Hank Paulson and Ben Bernanke to Senate Banking Committee:

“Fed will use all tools available” to stem crisis.

- August 21

“US [home] foreclosure filings rose 9 percent from June to July, and surged 93 percent over the same period last year.”

- August 21 AP

As someone wiser than us wondered *“How does an injection of administered liquidity help a company that is already insolvent or bankrupt?”*

Then there is the hope that GSEs such as the discredited Fannie and Freddie are going to restore market confidence.

And then there is the quip from a financial market veteran *“The sudden absence of liquidity seems to be accompanied by an equally sudden loss of veracity.”*

“Traders who would formerly have taken the precaution of reducing their commitments just in case a reaction should set in, now feel confident that they can ride out any storm which may develop. But more particularly, the repeated demonstrations which the market has given of its ability to ‘come back’ with renewed strength after a reaction has engendered a spirit of indifference to all the old time warnings. As to whether this attitude may not sometime itself become a danger-signal Wall Street is not agreed.”

- New York Times, September 1, 1929

Stock Market: Our theme since April has been that bull markets typically conclude with rational exuberance. Rational in the sense that typically the concluding stage runs some 12 to 16 months against an inverted yield curve. Inversion began in February 2006, which counts out to a peak of speculation by around June.

Within this is the very critical observation that it is when the curve reverses to steepening that the most blatant speculations begin to fail.

The curve reversed in May and the salient events have been the resumption of the subprime problem and its disregard of the “containment” theory. We thought that the

contagion would eventually encompass all credit spreads and that it would be a cyclical change.

This seems to be the case and the other immediate fallout with the reversal in the yield curve was the 54% crash in the price of nickel. Base metals are also likely working on a cyclical change.

The other point is that while the senior stock indexes were not enjoying the exuberance seen with the peak in 1Q 2000 the intense speculation was in financial innovation and the housing sector. The latter's record decline in the median price at some 11 consecutive months triggered the problem.

While the establishment, including the Fed, was going on about "liquidity" pushing the stock market the fall in house prices confirmed our view that as with any previous great boom today's mania needed rising prices and the credit markets would not be able to handle falling prices.

The next rational step was that the initial hit to the most reckless action in the credit markets would not be "contained" and would afflict most, if not all aspects of credit.

This has worked its way from the discovery of illiquidity in the subprime to the discovery of a serious loss of liquidity in the traditional corporate bond market. Junk took a more than 20-point price hit.

A credit expansion will eventually become irresistible to the point where "everyone" is fully exposed to the hazard of falling prices. Then going the other way, when weakening prices reveal the loss of phoney liquidity, it eventually impacts all aspects of credit. The next hit on the schedule will be to long-dated treasuries and that will be another downer for the stock market.

The bond market will be reviewed below, but it is important to look for the next threat in this kind of market. Well, it isn't going to come from earnings, valuations, or the economy.

At the moment pundits are touting these comforts as well as the abilities of the Fed to juice the stock market with an injection of money it has borrowed or created out of thin air, as well as the next cut in administered rates.

We have argued that once the curve reverses to steepening central bank attempts to push the boom are typically denied by further yield curve steepening. Full post-bubble steepening includes short-dated market rates declining as long-dated treasuries increase.

On the initial panic the bill yield declined from 4.94% on July 12 to the exceptional low of 2.45% on August 20. With this the 30-year went from 5.23% to 4.98% on the 20th. The yield has since declined to 4.85% on the flight to safety story. This, as explained below, is just plain wrong and today's slump to 3.62% could be anticipating more of the bad stuff.

The next phase of steepening will have two negatives on the stock market – declining short rates and rising long rates.

Technical Discussion: Following the July highs the senior indexes have been stair-stepping down, with a couple of sharp declines and weak rallies. This has been

accompanied by diminishing trading volume and deteriorating A/Ds, which is not healthy.

The decline into last Thursday had a whiff of panic to it and the rebound accomplished a 60% retracement.

The next few weeks will be interesting and the market is telling us to sell the rallies.

INTEREST RATES

The Long Bond has been rallying for the wrong reason, and that has been the flight to safety pitch.

As history shows, a fully engaged credit contraction will include a revulsion for longer-dated corporates that eventually encompasses the long bond. In the credit markets, an ebbing tide lowers all boats in the harbour.

Technically the latest price rally made it to new highs for the move, which at a little over 112 on Wednesday compared to the rally to 112 in early May. Also the daily momentum things are almost at the level that has ended rallies.

Seasonality, as Levente noted in Monday's BondWorks, can be negative from the latter part of August until late in the year.

The latest pop is part of the volatility that goes with the discovery of illiquidity. Investors can continue to sell the rally and traders can wait a bit before making another attempt to play the short side.

Credit Spreads: As noted last week the spread department has been steady with little change. Even the revulsion in the subprime improved a little from 41.42 on August 16 to 43.39 on August 23. However, it has since declined to 42.39.

On traditional corporates the BBB spread, which had widened to 139 bps last Thursday, has narrowed to 131 bps. This compares to only 104 bps in the halcyon days of May. That was record "narrows".

Regrettably the spell of "no-risk" has been severely interrupted and the next hit could really initiate the ancient concept that each investor should always monitor risk, rather than assume that bundling enough academics into a committee will eliminate market risk.

Our advice in the spring to avoid or eliminate lower-grade credits was based upon the seasonal turn to widening that can happen in May.

The Dollar Index: Two editions ago we noted that the DX was overbought and that the decline would serve to provide a floor to liquidity pressures.

The low close was 80.66 yesterday and so long as it stays low it will help the financial markets which are hooked on the drug of depreciation.

It needs to spend a week or so at this level, or a little lower to stage another rally.

The Canadian Dollar declined with the liquidity crisis and is attempting to stabilize.

However, it did reach an impressive overbought at 96.78 in July and is still vulnerable to its two main negatives – weakening commodities and widening US corporate spreads.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy Prices: Crude oil has had an impressive swing from overbought in July to oversold. This was noted last week as was the chart support at the 68 level.

Both momentum and support seemed to work as the low was 68.63 and the resumption of the rise to a seasonal high in late September – early October seems to be underway.

The oversold on oil stocks (XOI) was also noted as was that support could be found at the rising 200 day MA. This roughly worked out and the rebound needs to get above 1325 to become constructive.

On both oil and the XOI we have been planning to exit the trade on the forthcoming seasonal high.

On the longer term, it looks like the action will be an important test of the XOI high at 1522 in July. However, it is important to compare the XOI to the product.

Crude reached 78.77 in July, which could be a huge test of the 79.86 peak reached in July 2006. At that high the XOI soared to 1232 (repeat 1232).

Retrospectively, the high of 1522 in July was suggesting that a large number of stock investors were positioned in the play. It's appropriate to keep this in mind as we begin to lighten up.

In looking back to the July 18 edition, we concluded that the XOI was overbought and that the action could stall out for a while.

On the natgas, the selloff down to 5.86 through July was appropriate. However, the rebound to 7.34 was impetuous and unsupported by *the* hurricane.

This is also a period of weakness and inventories are unusually high, so instead of dull but slightly higher prices they hit new lows at the 5.50 level. This could prevail for a few weeks yet as the weekly RSI comes down a little more.

Similarly gas stocks (XNG) are approaching an oversold as well. Ross is working on an update that we hope will be timed well for the next advance. Also in looking at the financial storm it would take some extraordinary circumstances to drive the price to 12.

Base Metal Prices: Propelled by lead our index (less nickel) rallied to 826 on July 23 then in the midst of the initial liquidity squeeze declined 16% to 693. A rebound to test the high has been expected to run into September, and so far it has made it to 737.

However, Goldman's Industrial Metal Price index (GYX) should be updated. This reached 536 in early May, sold off to 460 and rebounded to 506 in mid July. The next low was 413 on August 16, and the oversold reached 40 which is the lowest since the bull market really launched in 2003.

This begs the question. Is this degree of oversold indicating an outstanding buying opportunity or is it suggesting a change of pattern?

During the bear market that set its low at 123 in late 2003 the oversolds on each stair step down were at or below 30.

One answer is in a recent statement by Chilean copper producer, Antofagasta, *“Despite uncertainties in the United States, demand remains.”*

On the other hand, the credit markets are well into the transition to a cyclical credit contraction that is global and this will soon be followed by a global business contraction and a cyclical bear market for base metal prices.

The latter will be confirmed as our metals index declines below 693 and for the GYX the breakdown level is 413. Numbers now are 728 and 441.

Editions through May reviewed that we were long base metals and mining stocks on the fall lows *“with the intention of capturing most of the seasonal move into spring”*.

The extraordinary cyclical gains in the leading metals were noted as far beyond the best in a century and within this copper had accomplished a “sequential sell” pattern. This seemed appropriate as the opposite, the preceding “sequential buy”, assisted getting long.

The timing of the inversion was running for 12 – 16 months (May was *Month 15*) and the *“end of speculation usually occurs fairly close to the reversal to steepening”*.

The GYX set its high of 536 on May 7, and our May 17 edition advised that *“Traders and investors could sell more aggressively”*.

Propelled by merger mania, mining stocks (SPTMN) soared to 951 on July 12, which has been concerning as usually mining stocks peak before metals. Maybe this time *was* different.

Nevertheless, the SPTMN slumped 25% from 951 to 710 in one month. This along with increasing credit stringency seems to have quelled the mania.

The usual seasonal decline into October – November could be severe for mining stocks as well as metals.

Golds: Gold’s nominal price has been steady as it outperforms many commodities, which is constructive for the sector.

Also constructive is the change in the credit markets, which is dramatic and anticipating an equivalently dramatic increase in investment demand for gold.

However, as we’ve been noting through most of the first half of the year, the tout about commodities up forever and the dollar down for about the same time prompted gold bugs to project the sector would perform at least as well as the base metal sector was.

As we’ve explained, the popular view about gold is not supported by history and that whenever gold bugs get excited for inappropriate reasons it is usually dangerous to gold and gold stocks.

This has been realized over the past month and pressures upon the latter could continue for a month or so.

In the meantime, this time around the mania to innovate financial instruments has been without precedent, but notwithstanding the complexities and fantastic terms, it has simply

been the greatest credit expansion in history and this has given the illusion of liquidity. Call it a sudden loss of liquidity, or a policy error by a “rookie” central banker, the nub is that credit is now contracting and with it overall liquidity is disappearing.

And since the early 1700s this is how it works. Through a bubble, that always ends with a buying climax, credit expands and in the post-bubble demise credit contracts. This has happened whether the important currencies have been on a gold standard or a fiat currency.

On each loss of liquidity in the popular instruments of credit Mother Nature has reliquified the global banking system by increasing gold’s real price, which spurs production increases.

Typically gold’s real price declines with the boom and increases for 2 to 3 years following the collapse of the bubble.

At some point, perhaps in October, continuing increases in the real price will pull gold shares up.

	FRI	MON	TUES	WED	THUR NOON
AUGUST	24	27	28	29	30
Junk Spread	674	675	676	680	----
Treasury Curve	67	38	68	89	121
Base Metal Prices	730	----	737	726	728
Dollar Index	80.66	80.86	81.00	80.66	80.73
Gold	668	666.8	664.4	666.3	665
Gold/Commodities	190	----	187	187	----

“The heaviest losses appear to have fallen on private speculators, and more especially on that class which may be described as provincial. Being quite ready to swallow all the promises of success published in newspaper advertisements, or in a prospectus of some new-born company, and enjoying no opportunity of personal intercourse with the better experienced commercial class in order to secure reliable information, these people may console themselves with their ‘manifest destiny’ to become victimised to the advantage of professional highway gamblers.”

- The Economist June 21, 1873

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