

PIVOTAL EVENTS

THURSDAY, JANUARY 31, 2008

BOB HOYE

PUBLISHED BY INSTITUTIONAL ADVISORS

Signs Of The Times:

This Year:

The blaming of a \$7 billion hit to SoGen on one trader seems to be taking our old observation that *"The bigger the trading loss-the more unauthorized the trade"* to hitherto unimaginable levels.

The full story is not out yet. However, considering the enormity of widespread losses, dire exclamations would be natural, but have been subdued, or perhaps we missed some. Or maybe, the lack is indicating that the worst will be discovered over the next hill.

Last Year:

"Credit Woes Chip at Banks"

"Even as the big banks crank out double-digit earnings gains, weakening in credit quality is showing up."

– Wall Street Journal, January 18, 2007

"Conservative Investors Line Up For Junk Bonds"

"The junk-bond market is undergoing a sort of gentrification, appealing to more conservative investors, who like many in the current low-yield environment, are starved for higher returns."

– Wall Street Journal, January 20, 2007

The old "reaching for the extra 1/8th in yield" is always and inevitably a killer. Well, the best that can be said for the exposure is that they were onside for a few months as the yield and spreads went the consensus way until May when the yield had declined from 9.75% to 9.25%. With this the spread narrowed to a record 4.18%.

Now the yield is 14.32%, which represents a plunge from 106 to 71, or 35 points. Not nice, and there is a lot further to go as eventually many bonds will be quoted in parts per million (ppm), rather than as percentage of par. And the spread has now reached 10 percentage points over treasuries.

Stock Markets: We have had the month of January as a possible low for the initial phase of forced liquidation of suddenly insupportable positions in the stock markets. This was global and dislocated most sectors.

Using the Nasdaq, the "crash" ran for the typical 55 trading days to Wednesday, January 22. With this accomplished, the rebound could run into March and retrace some 40% to 50% of the loss. It is worth emphasizing that the break followed mounting problems in the credit markets, which change is first in the order in ending a boom and starting a cyclical contraction. The irony is that the next step on the way is the break in the stock market, which is inevitably followed by the economy rolling over.

Earnings usually turn with commodities, and those who "study" the economy to determine the course of the stock market are working with a self-imposed and costly handicap.

While there could be unsettling news items, the general market could recover to a tradable high in the next 6 to 8 weeks.

INTEREST RATES

The Long Bond soared up to 122.81 a week ago Wednesday, and last Thursday's advice was that traders could start playing the short side. We were looking at the very overbought condition, the flight to safety nonsense, as well as the likelihood of a stock market rebound.

Steepening also seemed to reach a crisis with the stock market on January 23, and has come back a little. We would stay with the steepeners for some time. This, along with spread widening is on a cyclical trend to great dislocations.

Credit Spreads could be in a narrow trading range until the rebound in confidence has had its way. Junk spreads could enjoy some relief as well.

The Dollar Index: Last week, the DX was showing neutral momentum and we thought a trading range would prevail for some weeks.

The Canadian Dollar has been expected to firm with the rebound in the stock and base metal markets. So far it has recovered from 97 to 101.2 and has further to go. Somewhere in the 102s with an RSI at 69 could cap the move.

Miscellaneous: The Baltic Fright (no typo) Rate continues to plunge. The high of 11,038 on November 13 set a double top with the high of 11,033 on October 29. We didn't have the data to do the technicals on this one, but the Shanghai market (FXI) had registered a rare "Upside Exhaustion" and we concluded that it would apply to the BDIY as well.

Support could soon be found at the sell-off low of 5,258 in June. This, along with other revivals could prompt a brief rebound. It is worth noting that the final surge ran for five months, which only took two and a half months to undo, which is typical of a speculative spike.

Over in the grains, which commodity group is still garnering accolades from the bulls, the action is looking topy. The GKX (Goldman's Ag index) is still very overbought on the

weekly and is in neutral on the daily. This seems bound to follow the serious breaks as seen in crude, or the severe decline in base metals.

The cyclical change in the credit markets will eventually force a cyclical bear in agricultural prices. In addition to playing the Ag stocks, there is the ETF. We mentioned the DBA last week, and its high was 37.57 two weeks ago. The decline was to 34.25 and the rebound made it to 37.31 on Tuesday.

It is uncertain if the general revival will take this further, but there is the possibility of a rotation out of grains and into some beat up sectors.

Taking out 34.25 would set a downtrend.

COMMENTS FOR ENERGY AND METAL PRODUCERS

Energy Prices: Crude took the slump, and last week nimble traders were advised to get long for a rally into March. From the low of 85.40 on January 22 the gain has been to 92.71. So far, so good.

Natural gas was likely to trade between 7 and 9, while the stocks (XNG) could recover for a few weeks.

Gold Sector: Technically gold's nominal price has been acting well. The correction down to the 20-day moving average at around the third week in January, was expected to be followed by continuation to beyond 905. The correction low was 868 on January 22 and the rally made it to 942 yesterday.

Needless to say, but gold has been gathering more widespread popularity – even wistfulness amongst those following orthodox theories about portfolio management. So, where do we go from here?

One aspect is that it is yet another rotation into the latest fashionable game. This may be so, but our view has been is that some of the move is due to increased investment demand with the onset of the credit contraction. This shows up in the real price of gold, which reached a cyclical low in May at 143. This, of course, is when the credit markets reversed and our gold/commodities index has rallied to 230 this week.

However, in the past week the senior gold indexes have not kept pace with the bullion move, suggesting that the sector could have a brief rest.

As noted last week, the gold/silver ratio could continue its decline into mid February. This would be due to the spiritual revival after the storm as well as due to the possibility of the seasonal whereby silver outperforms gold.

Some fund managers and analysts are preparing a select list of smaller-cap gold stocks for us and we will publish it when it is timely. In the meantime, there are some gold funds that can be bought for their existing positions in small caps.

OCM Gold Fund (OCMGX)

Apogee Gold Fund LLC (accredited investors only)

Sprott Gold and Precious Metals Fund

Tocqueville Gold Fund (TDLDX)

Next week we will update our historical report on the gold sector, and the opportunities over the very long term.

	FRI	MON	TUES	WED	THUR NOON
JANUARY	25	28	29	30	31
BBB Spread	172	172	170	172	----
Treasury Curve	202	202	203	207	235
Base Metal Prices	663	641	669	673	678
Dollar Index	75.93	75.55	75.55	75.09	75.33
Gold	910.5	927.6	925.1	920.6	927
Gold/Commodities	223	230	225	224	----

Much is being said about Bernanke's "Helicopter Money", and some have concluded that the Fed, in its desperation to prove that interventionist theories always work, will depreciate the dollar to zero. Of course, great financial distortions can only occur when intellectuals focus upon the markets and the blunders can be monumental.

For example, during the notorious German inflation of the early 1920s leading economists found compelling reasons to keep it going. That really was a printing press inflation and, given the technology of the day, it could have been called "Autogyro Money". No matter what it is called it destroyed Germany's economy and political culture. But on the way, leading economists found reasons to keep the rip-off going, that in today's light seem nonsensical.

“In proportion to the need, less money circulates in Germany now than before the war.”

– Prof. Julius Wolfe, Summer 1922

“However enormous may be the apparent rise in the circulation in 1922, actually the real figures show a decline.”

– Prof. Karl Eister, 1923

A couple of generations of gold bugs have been claiming that the Fed would ultimately accomplish such an inflation. Our point has always been that in the early 1920s Germany had no bond market to destroy, and that the U S bond market and its "Vigilantes" would prevent the actual printing of paper currency. And now a credit contraction is underway that will likely forcefully prevent the Fed from further massive depreciation by any means.

B HOYE, INSTITUTIONAL ADVISORS
E-MAIL bobhoye@institutionaladvisors.com
WEBSITE: www.institutionaladvisors.com