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(For Policymakers)
WEEK ENDED FRIDAY, AUGUST 31, 2001

Near-Term Stock Market:

The expected decline into mid/August worked out and, as of this morning, the seasonal late August to early September pop is underway.

For traders, The ChartWorks notes that a rally has typically occurred from August 28-29 for 5 trading days.

We have outlined that, unlike last fall, banks and financials would not provide a safe haven during the heavy and widespread liquidation possible from late September until December. Their recent hard break (with cause) ensures this.

Near-Term Bond Future:

The main influence on the long bond has been the stock market and this was confirmed this week. The main setback to the rally would likely be with the turn-of-the-month pop in the stock market.

Perspective:

Conventional wisdom remains convinced that policymakers can turn the stock market and the economy around. This is a forced and expedient change from last summer when the consensus held that zooming prosperity was a result of policy and could be maintained.

Quite possibly, we were the first research organization to recognize the mechanism of a New Era and the characteristics of its dramatic climax. This work was essentially completed by 1980 and the briefest summary is provided in our Boom Indicators. These were formally assembled in 1995 with the hope that they would provide a means of identifying the climax of the mania.

As noted in the attached update, these have turned out to be a leading indicator and an asset allocation model with uniquely thorough methodology. Out of the LTCM calamity in August-September, 1998 the Indicators began to improve and were positive by early 1999.

This reached a reading of +12 (+14 is maximum) in the first week of 2000. That reversal is detailed in the update and the benefits of this long term (stately comes to mind) model have been outstanding, particularly when they have moved more negative during an expected stock rally.

This was the case during the expected rebound from late May to the first week of September, 2000. During this, the reading deteriorated from 0 to -3. This week, this dropped a notch to -10; the worst so far. The limit possible with the seven elements is -14.

Irony:

Earlier in the year, we reviewed the common stock theory of investing which was so thoroughly celebrated during the 1920s. Barron's provided a good record on the way up as well as its adamant defence on the way down.

In looking back on the study, it is also a way of "back-testing" theories on the course of the markets in a post-bubble contraction. The running record of main views from 1929 to 1932 is fascinating and adjudicated as follows:

METHOD GRADE

Street Sense (The "Trader" Column) B+

Technical Analysis (Charting) C+

Common Stock Theory F

Harvard Economic Society F

Barron's weekly format was thorough and provides continuity, in real time, on four different approaches to that contraction. Proponents of the Common Stock Theory and the Harvard economists eventually capitulated near the stock market bottom in 1932. The Trader did a creditable job through the bottoming process (Dow down 89%), which also merits a B+.

One of the most profound observations for today was Barron's conclusions on July 11, 1932:

"The Federal Reserve policy of cheapening credit through the purchase of government bonds has been unable to make a dent in the conservatism of borrower or bank lender, in short, every anti-deflationary effort has yet to provide positive results. The depression is sucking more and more bonds into its vortex."

Another Approach:

We are dealing with a typical year following the climax of another New Era. A rush of curve steepening in the first quarter was likely to totally reverse the previous inversion. A terrific rush of stock market enthusiasm was likely to peak (along with narrowing credit spreads) around May.

This, along with developments in industrial commodities, has also been similar to the action in the last two post-bubble years (1930 and 1874).

Now, the irony is that the senior commentators, bankers, and investment managers today are looking at a similar stream of financial events that faced their counterparts in the summer of 1930. Regrettably, they are making the same conclusions.

Prosperity Seen Not Far Ahead

Since our monetary and credit structure is not only sound but unusually strong, commercial credits are liquid, there is every prospect that the recovery which we have been expecting will not long be delayed.

- Harvard Economic Society, Barron's, September 8, 1930

Of course, Barron's was not totally filled with the comforts of conventional wisdom:
"Rising stock prices tend to instill an optimism over the business outlook that may prove to have no foundation."

This was made by The Trader in the same edition and was in line with his observations during the summer about weakening industrial commodity prices. For example, "The falling commodity price index has confounded the experts who months ago thought the turn was near." (Barron's, July 28, 1930)

Commodities:

We have been looking for a choppy recovery in crude oil prices until early October, which seems to be working out. Base metals were likely to stabilize through August and weaken in September. Our index declined 2.7% this week.

Indicating a broader trend, the CRB made a multi-year low at 197 (the symbol is CRY). Our August 8 special, "Global Warning", was mainly written from a point of view unfamiliar with the consequence of the climax of another New Era, but familiar with the business cycle, the yield curve, and commodity prices.

The latter two are on a path typical of a contraction and the recent crash in the Baltic Freight Rate confirms that this is global. The chart we used on August 8 posted the index at 1021. It took almost two years to recover from the base at 800 in early 1999 to 1762 last October; it has taken just 10 months to plunge to 939 this week. As we concluded the study: "This is severe!"

The Economy: GDP junkies were intensely focused on the second quarter report and were rewarded with a plus 0.2% gain rather than a minus. One economist observed, "Psychologically, I think this is a good thing."

This reminds us of owners who think up distinctive names for their race horses. Many claim that an exciting name is psychologically important to the horse.

Of course, the quarter ended on June 30 and, in today's volatility, this is ancient history. Since then, base metal prices have dropped 11% as the Baltic plunged 33%. From the expected high for the "good stuff" in May, the numbers are -18% and -37%.

Quarterly statistics seem to reinforce habitual complacency.

Bob Hoye
Editor & Chief Investment Strategist
www.InstitutionalAdvisors.com