Global Warning!
(Credit Spreads Widening)
THURSDAY, August 4, 2011

BOB HOYE

PUBLISHED BY INSTITUTIONAL ADVISORS

One of the confirmations of the start of a cyclical contraction is the change in the credit markets. Another one has been underway since April.

The process is methodical and often the results are startling enough such that central bankers lay the blame for the boom upon a "policy overshoot". Recently there has been a type of intellectual who specializes in intuiting what will happen when what policymakers does what, then this will happen. Speculative collapses also have been startling to this group and the surprise is described as a "Black Swan" event.

Where evidence exists a great financial mania will run some 12 to 16 months against an inverted yield curve, and then the contraction begins. As we counted it out in the first part of 2007--"June will be Month Sixteen".

The curve reversed in that fateful May, and credit spreads reversed to widening in June. Enough to prompt our observation "The greatest train wreck in the history of credit has started."

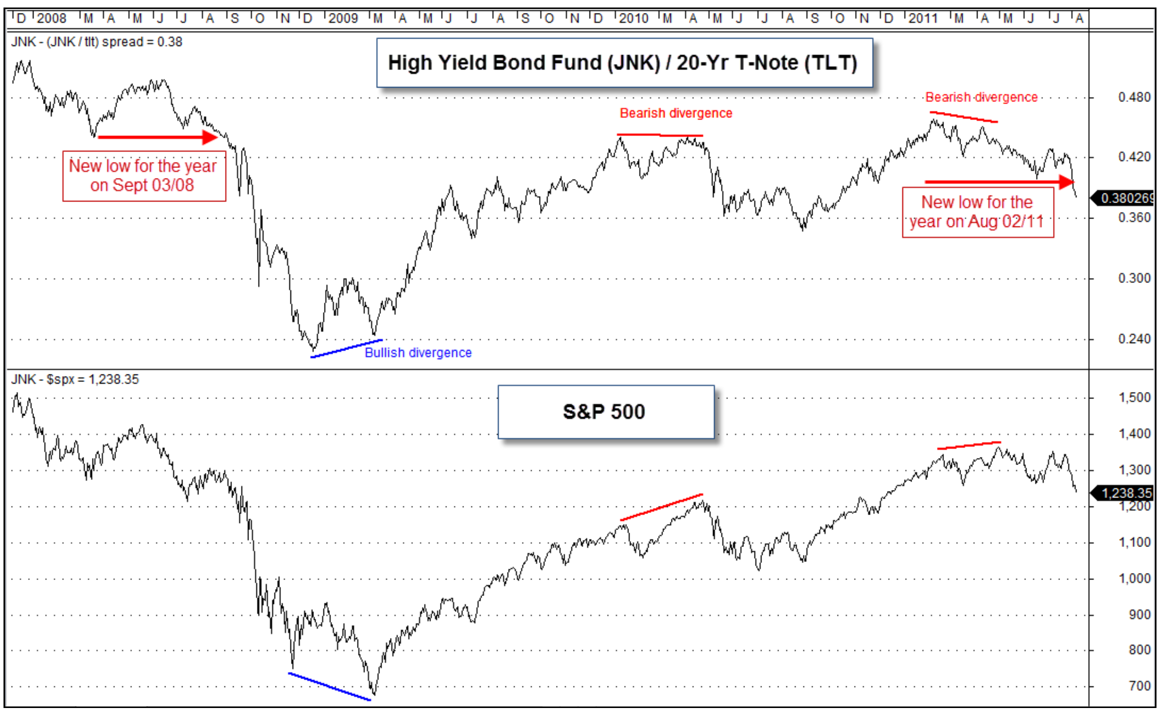
The credit collapse and bear market that began in 2007 were not Black Swans.

As the first business expansion out of the 2008 Crash comes to an end, the action in the yield curve has been too choppy to provide a signal.

Fortunately, corporate spreads have been running the pattern that signals trouble. It worked for us in 2007 and 2008. Is it working yet again?

The following chart shows the critical breakout in spread-widening on September 3rd, 2008. This time around the rise to new "wides" started on Tuesday, August 3rd. In 2007, the breakout occurred on June 25th.

The second chart has spreads inverted to show the link to the stock market.



Worth noting is that in each case narrowing with the financial party had ended and spreads had begun to widen which signals that speculators had become exhausted. In each of the recent cases, the "breakout" was associated with some news of distress.

Market attitudes were positive until June 14 when Bear Stearns announced a 10% decline in earnings. No big deal, but rather quickly uncertainty arrived. The on the 22nd, Bear announced that it would pledge $3.2 billion to shore up its "hedge" fund. That everyone was dangerously leveraged was revealed with the July 19th announcement the funds had "effectively no value". On that melancholy August 1st Bear Stearns reported that the two funds had filed for bankruptcy.

In 2008 Lehman was having considerable difficulty into July when in August a bailout was being put together by the Korean Development Bank. At the end of August it was discovered that this bank was in trouble itself.

As noted, the spread broke out on September 3rd.

Lately, the big headline has been about the US debt ceiling. The White House emphasized the threat of default in order to panic the markets. With this anything the Dems wanted would be passed. Remember "Don't waste a good crisis" of November 2008. It enabled one of the most idiotic intrusions into the markets in history.

But, the White House did not get the panic and it did not get to raise taxes.

Late July was expected to conclude a topping process for the S&P. Financial pressures have been expected to increase in September.

The US fiscal problem will continue to be too much government spending rather than too little revenue. And this will not be the catalyst on the pending liquidity crisis. The specific name can only be known when it's time comes.

Spreads broke to the widest of the year and the trend will likely continue to a crisis in the fall.

Other Indicators

One of the clear indicators of the end of the first business expansion out of the crash has been the top in copper. Often referred to as Dr. Copper--it set its high at 4.64 in February and the recent thrust was to 4.54. This is a failed test and the four-day decline amounts to 4.8 percent.

As the saying goes "gravity and bear markets suck". Base metals (GYX) have dropped 6 percent.

This is only four days of trading, which is not enough to declare a downtrend.

Within the context of our Momentum Peak Forecaster calling for the speculative surge to get overdone around April. Also noted was that when the Forecaster registered in an important commodity play as in 1973 and in 1980, the recession started virtually at the top of the commodities market.

This suggests this could be the start of a cyclical bear market for base metal prices.

This is supported by today's nice rise in the Dollar Index, which should continue.

Another indication of developing financial trouble is today's turn up in the gold/silver ratio. It is dramatic, but from the low close of 39.7 on July 18 the uptrend is brief.

It has been as high as 42.6 today and rising through 45 would set the trend.
This would confirm the pending arrival of a severe liquidity crisis.

The ratio has been a reliable indicator. Our July 24, 2008 edition concluded: "Rising through 54 would set the [ratio's] uptrend and this would provide additional confirmation of developing disorder."

It broke above 54 on August 6, 2008 and as the saying goes "The rest was history."

Gold Sector

The main conditioner for the silver market has been the blow-off in the silver/gold ratio in April. Silver usually outperforms gold during a bull market and the RSI provides a good indicator of the top.

This reached a little over 90 in April which was our "sell" on the sector.

In the third week of April we used the term "violent decline in silver" three times.

Ross has been accurate on the bottom and subsequent rallies, which were likely to run into August. It made it to this morning and the sector is now vulnerable. That includes gold, silver and their equities.

Silver's decline in price and relative to gold can be violent.

At times like this it is appropriate to review the characteristics of silver. The main ones are lustre, ductility and malleability.

The main characteristic of silver bugs has been gullibility--particularly when relying upon supply-demand research.

Silver cannot lose its characteristics, but silver bugs, as in 2008, could lose their lustre.

Conditions seem serious enough to write an in-depth study on profound market changes. Then we recalled the one we did in August 2008.

It is attached.

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

BOB HOYE

PUBLISHED BY INSTITUTIONAL ADVISORS

AUGUST 2008

WILL FED STIMULATION END THE CREDIT CONTRACTION?

- The late bubble has been the greatest on record and is the accumulated consequence of 95 years of Fed stimulation.
- Every experiment in currency depreciation ends with great market and political volatility.
- Keynes thought that he had invented a way to end credit contractions. But, because he was ignorant of market history he didn't know that almost every century has an example of some intellectual having a personal revelation about avoiding or prematurely ending a post-bubble contraction. An early example occurred with the post-1618 bust, when in 1622 Missleden prescribed adding credit to a credit contraction.
- The forever-esteemed editor of The Economist, Walter Bagehot, wrote in 1873: ***"A panic in a word, is a species of neuralgia, and according to the rules of science you must not starve it. The holders of the cash reserve must be ready...to advance it most freely for the liabilities of others."***

  No problems, if the right thing is done at the right time. As noted below, the subsequent period was described as "The Great Depression" and it ran from 1873 to 1895.

  Actually, such sound advice had been implied by the Bank of England in a report following the big problem in 1825: ***"We lent by every possible means and in modes we have never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on Exchequer bills of exchange to an immense amount, in short, by every possible means...seeing the dreadful state in which the public were, we rendered every assistance."***

  The subsequent general contraction endured from the climax of the bubble in

1825 until the mid 1840s.

- At the height of the 1929 mania the Fed with its “elastic” currency was celebrated, as the old system was condemned. The following is by John Moody:

  “The old breeder of financial panics, the National Banking Law, which had been a menace to American progress for two decades, has now been replaced by a modern, scientific reserve system which embodied an elastic currency and an orderly control of the money market.”

  In so many words, “nothing could go wrong”.

- Similar confidence in the old system prevailed as the 1873 bubble came under the usual credit changes that signal a top. A leading New York paper, the Herald, editorialized:

  “True, some great event may prick the commercial bubble of the hour, and create convulsions; but while the Secretary of the Treasury plays the role of banker for the entire United States it is difficult to conceive of any condition of circumstances which he cannot control. Power has been centralized in him to an extent not enjoyed by the Governor of the Bank of England. He can issue the paper representatives of gold, and count it as much as the yellow metal itself. [He has] a greater influence than is possessed by all the banking institutions of New York.”

  In so many words, “nothing could go wrong”.

  Ironically, the editorial contained some totems that are still deemed to have great power. Even today, for some the terms "centralized", "banker for the U. S." and "influence" provide considerable assurance. On the initial panic into late September, the Herald editors extolled abiding confidence in the Treasury System with ***"A crisis in our financial dealings has been met and passed without loss of confidence... Here are growth, understanding, [and] increased knowledge."***

  As it had done on previous crises, the Treasury added liquidity and appeared to have avoided disaster. Under similar pressures, today's Fed and Treasury have injected liquidity and on the technical rebound into May such orthodoxy was celebrated: ***"The policy response to financial asset deflation was not only extremely fast, but extremely well coordinated. US policymakers deserve the Nobel Prize."***

  Back to all the confidences and issuance of liquidity in the early panics of the post-1873 contraction. The usual business cycle prevailed, but the recessions were stronger than the expansions. By 1884 leading economists began calling the prolonged contraction as the "The Great Depression". Although it ended in 1895, it was still being analysed as such until as late as 1939.

  In order to preserve the notion about an infallible Federal Reserve System, it has been expedient to lay the blame on the Fed keeping too tight a policy during the post-1929 contraction. A couple of notes suggest otherwise:

- A Fed memorandum following the 1929 crash explained ***"The drain upon bank reserves was met in the classic way with a policy of free lending"***.

  By free they meant liberal and this was exemplified by George Harrison, who was head of the New York Fed. As with today, the NY branch was huge compared to the whole Reserve System and Harrison, in discounting freely, exceeded his authority by a factor of six. This was conventional theory and practice and as with a number of examples did not prematurely end a post-bubble contraction.

- It seems that part of the tout at the top of the mania includes a celebration of whatever central banking or treasury system that happens to be in place. Naturally, with the recrimination and revulsion that goes with any post-bubble contraction the prevailing system will be criticized.

  The first stage will likely be an *ad hominem* attack on the personalities running the Fed. Bernanke will be worked over for not providing the exact interest rate change that would have prevented the contraction. The rate change of the perfect amount made with perfect timing only exists in the imagination of interventionist economists.

  Eventually, the contraction could become severe enough to prompt rigorous scrutiny. This would involve examining the history of central banking – not for policy errors, but for systemic inadequacy.