PIVOTAL EVENTS

WEDNESDAY, NOVEMBER 19, 2008

BOB HOYE

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Signs Of The Times:

Last Year:

"Our economy is strong, there is no reason to panic."

– Wall Street Journal. September 10, 2007
Op-ed piece by Robert E. Lucas, 1995 Nobel Economics winner.

"The S&P will be up by 9.7% from Friday's close to 1600 at the end of this year [2007]***. This would be the steepest year-end rally in some time."***

– Bloomberg. November 19, 2007
Abbey Joseph Cohen, Goldman Sachs

"Multi-decade bull market for base metals due to China and India."

– Business News Network, November 27, 2007

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This Year:

"The nation's largest pension fund, known as Calpers, is paying dearly for its ill-fated decision to become one of the most aggressive real-estate investors."

– Wall Street Journal, November 13, 2008

"Panic Selling Resumes On TSX"

– Financial Post, November 13, 2008

"Down and Out in Beverly Hills. Rolexes, Picassos Hit Pawnshops."

"Clients need money for alimony, debt-relief, and even plastic surgery."

--Bloomberg, November 14, 2008

Remarks from the head of Beverly Loans Co., who added ***"We are the bank of last resort!"***

Well for the moment at least, or until the Fed gets enough cash to get into pawn broking.

* * * * *

Stock Markets: Well, last year we were looking for a significant slide into around January. This was based upon one of the great bubbles wherein the classic fall crash was delayed and then ran through into January.

Ross noticed that, typically, when the unemployment number turned bad near the end of a business cycle then the stock market would be down some 21 weeks later. The change occurred on September 17, 2007 and the eventual break ran into late January – close enough.

As with any expected change, it is daunting until it actually comes in. Something similar holds as we have been looking forward to this important test of the October lows likely to conclude around mid November. This is the week and conditions seem eligible for the start of a much-deserved rebound.

Once in a while the markets record some interesting numbers (using intra day extremes):

Bubble	October Panic	Rebound	November Test	Overall Decline
1929	-45%	+21.7%	-22%	-49%
2008	-48%	+19.6%	-22%	-51%

In 1929, the big hot stocks were in the DJIA, and this time around they are in the NASDAQ. We have been using the classic fall crash model, which is based upon the major post-bubble contractions. Typically, forced selling reached a maximum in late October, when the market briefly rebounded, and tested the lows around mid November.

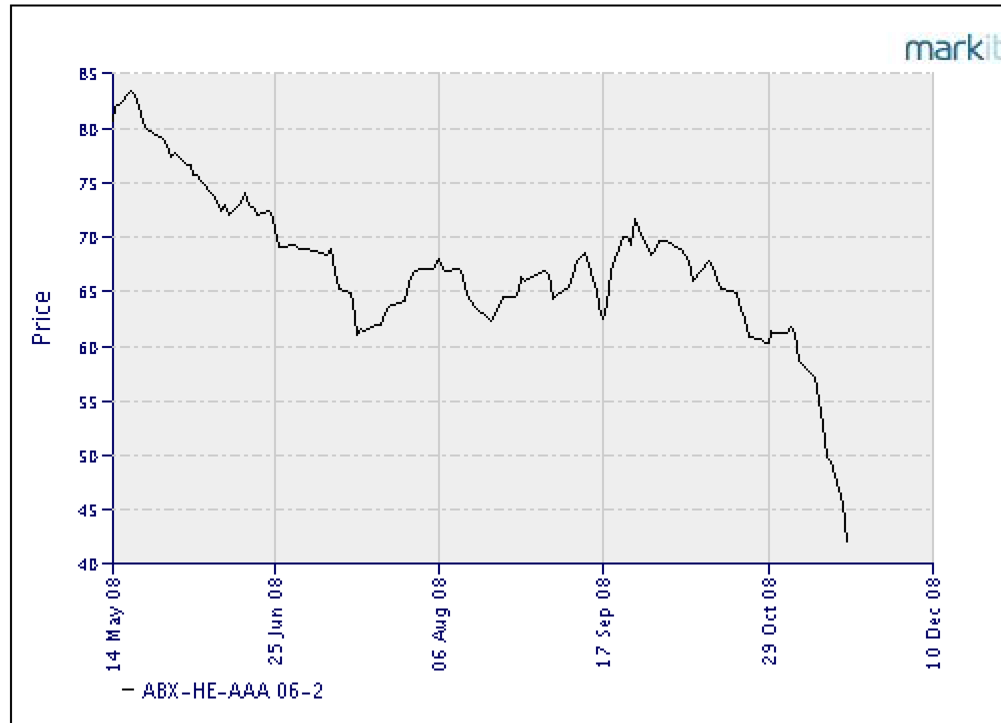
Occasionally there can be some interesting dates. In 1929 the panic low was on October 29, the bounce was to November 4, and the test was accomplished on November 13. This time around, the equivalent dates were October 28 and November 4.

It is uncertain how long this correlation may last, but generally once the test is completed we have been expecting a tradable rally out to around March. This would likely carry most equity sectors with it.

INTEREST RATES

Credit Spreads: Lower-grade stuff continues under pressure. Since early October the so-called AAA sub-prime bond has plunged from 70 to 42, which is quite a whack. Even worse, in January the price was 84, which compares with 90 in the halcyon days of a year ago. The chart follows:

SUB-PRIME MORTGAGE BONDS



- This index is still called “AAA”.
- The crash into November is on schedule, and is reaching panic levels.

On the same move, traditional corporate junk yields have soared from 11% to 31.75%, or in price, plunged from 100 to 34.88. The spread has widened from 600 bps to 2759 bps.

Beyond messing up portfolios, the collapse represents another plunging asset class that will constrain the Fed's chronically bad habit of issuing credit on any excuse. We have never expected central bankers to voluntarily reform, but that a massive credit contraction would prevent them from continuing reckless behaviour.

It is difficult to estimate the drop in market cap on the bond side of the equation, but Ron Griess at www.thechartstore.com has estimated the collapse in global equities at $30 trillion and the chart follows.

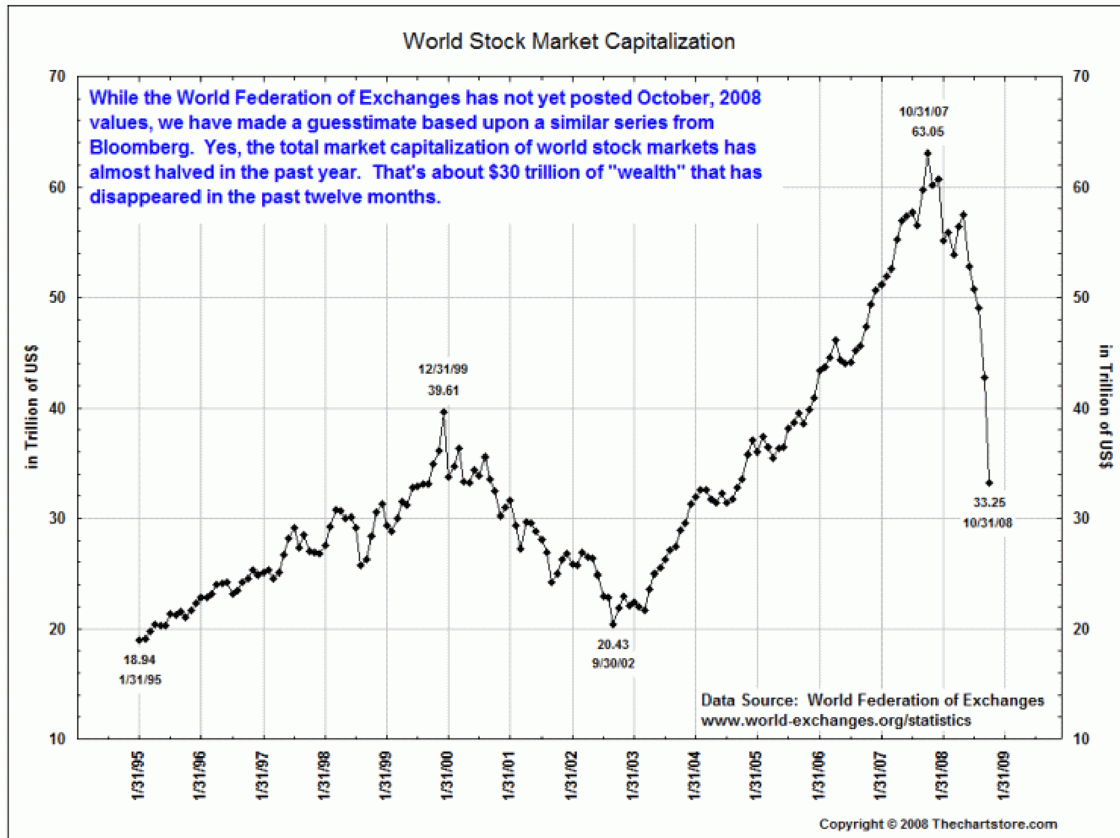


Chart above was featured in The Chart Store's (http://www.thechartstore.com) Weekly Chart Blog for the week ending November 7, 2008 and permission was obtained to reproduce it here.

- This is an outstanding proxy for stock market "wealth".
- The collapse of this "wealth" amounts to around $30 trillion.
- Valuation of privately-held companies would be marked down proportionately.

However, the last leg of the 2008 liquidity crisis has been expected to conclude in November and some relief into the spring has been possible. Investors have been avoiding spread products since last year and should continue to do so. Traders should begin to cover shorts and to build a modest long position in some Fannie, or Freddie bonds, or in Canada, some stuff with quasi-government protection. Monday's BondWorks will review some opportunities.

The Long Bond continued its rally as stock markets continued down. As noted last week, the future bounced off support at the 112 level and the high has been today's 121.81. This seems to be testing the high of 122.25 set on Black Friday, October 10.
This fits with the stock markets doing the mid November test of the October stock market panics. This should complete within the next few days and the bond can trade down to the 112 level. Considering the Downside Exhaustion reading on the CRB and the probability of copper's seasonal rally out to March, the long end is vulnerable to a multi-month price decline. In which case, the 104 level becomes a target.

Currencies: The key to recent action in the Dollar Index has been the Upside Exhaustion registered in the third week of October, which set up a period of correction. The opposite, Downside Capitulation, was registered on the Euro and the Canadian. The Euro/Yen reached an overbought.

Subsequent moves have been tied to phases of heavy liquidation of stocks, corporate bonds, and commodities. This process is close to concluding and the correction for the DX could become a trend that would run into the first quarter.

COMMENTS FOR ENERGY AND METAL PRODUCERS

Energy: There are two things going on. One is that we have been expecting crude oil and natural gas prices to decline into late December. Other aspects are the Downside Exhaustion on the CRB, and the pending correction in the Dollar Index.

Along with the possibility of a general rally in the stock markets into the first quarter, last week's advice was to begin to get long energy stocks.

The low for the XOI was 765 on October 27 and the rebound made it to 1000 on November 4. So far the low has been 815 and today's low has been 880. The sector could continue to be accumulated in the 850 to 900 range.

Something similar holds for the gas stocks, with accumulation continuing in the 370 to 400 range.

Base Metal Prices: Last week's advice was that metal traders should cover shorts and begin to get long. Our index (less nickel) set its panic low at 354 on October 24 and bounced to 418 on October 30. So far the decline with the November test has been to 351 yesterday, and today it is at 354.

Mining stocks continue under severe pressure. The index, SPTMN, set a panic low at 290 on October 27 and bounced to 398. The test of the low expected around now has been a plunge to 210.

This is now registering a Downside Capitulation on the weekly, which means that the mining sector is being trashed in a measurable fashion. The last registration was at the conclusion of the bear that ran from March 1997 to the end of August 1998. The decline amounted to 60% and the reversal occurred within a week of the signal.

With the post-1873 bear market mining stocks had declined by 66% on the equivalent move. That chart, which was discussed recently, is based upon monthly data.

From the high of 955 in July 2007 the SPTMN has plunged 78% and the sector is down when it should be. That is on the forecast of a 1929 type of decline into November, as well as on the target of a seasonal low around now.

Deep pockets can continue to accumulate; smaller pockets can wait for some positive technicals before committing. The usual seasonal high is around March.

Gold Sector: Our view since July as been that gold shares could decline on financial dislocations into October-November. Also in reviewing gold's behaviour during previous post-bubble busts gold's price tended to decline. In 1873 the quote for the gold premium declined from 118 in August to 106 in November when that crash ended. In the 1929 crash Homestake declined 31% from 11.75 in August to 8.13 in November.

This time around, the HUI plunged 65% from 479 in August to this week's 168.

At about the right time for an important low, gold shares have been trashed in the liquidity crisis. In the two days it takes to write this publication this crisis has turned from bad to worse, but it is similar to the pressures in November that concluded the same action in 1929, 1873, 1772, and 1720.

We are staying with our story and this week's pressure should clear within a few days.

In which case following every post-bubble crash gold mining eventually became the premier industry and gold stocks became the premier performer.

Our advice since late October has been to cover shorts in silver stocks and begin to get long the gold sector.

Last week we noted that the gold/silver ratio could indicate the end of this crisis. The high close was 84.3 on October 20. As that crisis eased the ratio came down to 70.9 on November 5, when with this one it has increased to 79.8 – a lower high.

From extremely overbought in October the ratio can decline for some time. The next turn down in the ratio would signal or confirm the rebound out of this phase of the financial disaster.

	THUR	FRI	MON	TUES	WED NOON
NOVEMBER	**13**	**14**	**17**	**18**	**19**
BBB Spread	558	582	608	613	----
Treasury Curve	316	301	300	299	285
Base Metal Prices	358	370	354	351	354
Dollar Index	86.7	86.7	86.8	87.2	87.7
Gold	704.9	742.4	741.9	732.6	734.2
Gold/Commodities	317	326	337	334	----

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POLICYMAKING ON THE BOOZE

The launch of the party that eventually overwhelmed traditional banking can be said to have started somewhere between the incredible opening chords of Chuck Berry's ***"Roll Over Beethoven"*** and Keith Richard's distinctive riffs in the Stone's ***"Satisfaction"***. It wasn't just the culture of music that changed, but most everything including the hard-earned culture of prudent banking. That's in commercial as well as central banking.

An early reference to booze and central banking appeared in 1927 when faltering spirits with the collapsing Florida real estate bubble needed reviving. Ben Strong, then the head of the New York Fed, told a visiting French central banker that he was going to give the markets a ***"coup de whiskey"***. It did not help Florida and as with the stimulation of this summer the lolly went to the hot games – not to crippled speculations.

The next reference to booze appeared with the extraordinary change in banking during the 1960s.

Recently graduated economists claimed that the promises of interventionist theories could be realized on earth and in our times. Veterans in the financial business at the time considered price inflation as diabolically damaging and only happened in lesser countries in Europe, or South America. Such monetary corruption could not happen in Canada or the US. Period.

Then in the mid 1960s consumer price inflation and market rates of interest began to increase as too many politicians were beguiled by promises of "full employment". A more cautious central banker would try to temper such ambitions with a line about "trying to get a quart of wine out of a pint bottle". Over a few generations of aggressive central bank accommodation, the term quart became passé as measure or as a warning. Intervention eventually displaced sound banking, and untempered ambition provided an endless stream of financial innovation.

In looking at the numbers to describe, for example, the derivatives outstanding the old description of infinity comes to mind – the biggest number you can think of plus one. And it is particularly useful now in considering the leverage employed in the creation of synthetic securities or synthetic positions.

Just how did centuries of sound commercial and central banking get so strung out?

The cocktail culture that arose early in the 1900s had a lot to do with it. Within this was the certain belief that a bartender could combine some ingredients with alcohol that would provide a "kick" over the same amount of alcohol consumed in a "shooter" or genteelly sipped. This reputation was enjoyed by individual bartenders with, obvious, sales abilities as well as other skills to suspend disbelief. The original promoters of the Fed suspended old doubts with the claim that an infallible Fed with the elixir of a "flexible" currency would prevent contractions.

Then wondrous capabilities of intoxicating powers were assigned to suddenly fashionable drinks. One of the earliest was the "French 75" named after the artillery piece used in World War I. The drink was made from champagne and gin or cognac and was considered as special. Either way, the concoction like the 75 mm howitzer was celebrated as "deadly, or "lethal". Harry Craddock in The Savoy Cocktail Book claimed it "Hits with remarkable precision."

A long line if similarly celebrated cocktails followed and were named "Singapore Sling", or "Harvey Wallbanger" as well as any number of corruptions of the basic Martini. At one time this gem was referred to as "Electric Waters" and if you had enough of them the saying went that you had reached the point of invisibility. The reasoning was that you would only be doing such stupid things if you were invisible.

The link to central banking goes beyond the old saying that when the Fed is the bartender everyone drinks until they fall down. Seriously, the mechanism is the belief that the genius of the Fed is such that it can precisely time the exact change in interest rates to "keep the recovery going". Oddly, this finds widespread support with chief investment officers or portfolio managers who consider "timing" of the markets as quite impossible.

At times of soaring price inflation, policymakers became invisible by blaming "inflationary expectations" as the cause of rising prices. The other aspect is that it was Keynes who dreamed up interventionist recipes that have become a lethal financial cocktail dispensed by so many central bankers since. Like the deadly French 75, the myth doesn't stand the test of reason, or practice.

A dictionary of science describes alcohol as the "colorless, fermented or distilled liquid that is intoxicating". The chemical symbol is C2H5OH and no matter what potable beverage it comes in it won't change the intoxicating part of booze in any way at all. Whether it is stirred or shaken makes no difference – the same measure of alcohol will create the same measure of buzz no matter how it is delivered, or for that matter, the same amount of hangover.

In this writer's experience, perhaps the most intoxicating time for interventionists did not occur, for example, when Paul Volker single handedly "ended inflation" in 1981. It occurred in the mid 1960s when interventionist economists, who by this time were populating so many financial institutions as well as much of industry, really believed that wise (always) manipulations by the Fed had ended the business cycle. The academic "could" had become accomplishment.

The main tool has been appropriately timed and counseled credit stimulations, which in due course becomes dollar depreciation. Although faulty, the reasoning is straight forward. Historically, credit has always expanded with a business expansion. The problem is the general conclusions about causal relations. Interventionist theory and practice rests upon the notion that a credit expansion causes a business expansion. The trouble is that this is another example of a primitive syllogism that because two events occur at the same time they are causally related. The classic on this clanger is the old one about a rooster's crowing causes the sun to rise. Sadly, when stripped of a lot of jargon the basic tool of intervention has been founded upon a simple, but common blunder in logic.

Another general error is found in the concept that financial history is a "random walk". Any quick review of market history definitely refutes this, but the idea of a homogenous world is essential to the boast that it can be arbitrarily altered.

The next notion that seems to have been invented out of thin air is the idea of the "lender of last resort". This considers that if one bank through imprudent lending becomes insolvent and if the private sector is unable to bail it out the Fed will. This considers that financial history is episodic – an offshoot of the random walk theory, and the problem that regularly occurs is that so many banks get overextended at the same time. Then when the boom becomes exhausted, as they inevitably do, many insolvencies and defaults are discovered at virtually the same time. Lately, the Fed has been on a bender of last resort.

When it comes to finance, there are a couple of ways of looking at history. One is through economics, which essentially seems to be a history of ideas. Another is to review the history of financial markets, which need not include a lot of arbitrary ideas. Indeed, implacable market forces provide a long due diligence on every theory or idea that dreamers can come up with, and that includes many in the world of policy.

Based upon private initiative financial markets can become extremely speculative on their own, without the intervention of central planners. This began to change in the early part of the 1900s as theories of reducing risk began to corrupt the native caution of sound banking.

In 1930, the venerable financial journalist, Alexander Dana Noyes in reviewing the collapse of speculation that started in 1929 observed, "[The speculative 1901 bull market assumed] ***that we were living in a new era; that the old rules and principles and precedent of finance were obsolete; that things could safely be done today which had been dangerous or impossible in the past. The illusion seized on the public mind in 1901 quite as firmly as it did in 1929. It differed only in the fact that there were no college professors in 1901 who preached the popular illusion as their new political economy.***" (emphasis added)

Under the impetus of ambitious economists this essentially has gone on with little in the way of intellectual or practical correction. Anything nasty such as the contraction of the 1930s was not compared with so many previous examples, but was explained with an *ad homonem* argument. By intent with a "flexible" currency, the design of the Federal Reserve System is considered infallible. It is not the first institution to be granted such powers and likely it won't be the last, but it failed on its first major test following 1929. This was the fifth example of a post-bubble contraction, but apologists since the 1930s have laid all the blame on those who were running it then.

This view maintains through to the current chairman who made his career as an expert on the post-1929 contraction, but in orthodox interventionist terms. Those at the Fed made policy mistakes. It is doubtful that Bernanke made a comparison to the four great eras of asset inflations that preceded 1929 and their consequent contractions.

This limited research falls into the old saying in physics that "If you keep your data base short enough, it will fit your theory."

Applied almost without limit, a spirit of financial innovation has animated much of academe, Wall Street and government. In a remarkable way, policymakers have become as speculative as the wildest private speculators in history.

The process started with the Fed and, as described by the original promoters, its "flexible" currency. The experiment in artificial money and artificial interest rates has had a basically uncriticized run of almost 95 years. (Appropriate arguments from the Austrian School haven't been covered by the financial media.) Over this time the purchasing power of the dollar has declined by 95.3 per cent. It is not an accident due to rising prices, which is the usual tautological explanation; it is a result of arbitrary issuance without a care for self governance.

In engineering terms, this is described as a positive feedback mechanism, that in the real world runs faster and faster until it blows up.

Before getting into this as it might apply to today's precarious credit markets, it is worth reviewing the full extent of financial innovation as conducted by the private sector, as well as the link to policymaking.

The general description for innovation has been derivatives, which creation began some twenty plus years ago and amounts outstanding have been growing exponentially. Until the discovery of the sub-prime problem earlier in 2007 continued growth of derivatives was a given. Now there are serious misgivings about the stability of financial innovation.

Sub-prime mortgage bonds are a subset of derivatives, with the advantage of a readily accessible price record. Through 2006 and into the first half of 2007 the street was convinced that Fed-created "liquidity" was driving asset prices up. Actually, as with any speculative market soaring prices are accompanied by leverage and for some reason this expansion of "IOUs" was taken as liquidity when it was just the opposite. This has been forcefully instructed as the decline in residential house prices made mortgage lending precarious.

Essentially, sub-prime mortgage bonds have been bundles of synthetic securities that in order to be placed with financial institutions needed to have a price and the underwriters created mathematical models to provide such a price, without the benefit of a market.

Another essential needed by institutions has been a credit rating for the derived securities. Rating agencies were accustomed to analyzing a company's earnings reports and balance sheets when providing a credit rating, but sub-prime bonds being synthetic had none of these numbers. So the underwriters created math models to provide credit ratings.

The result has been huge amounts of artificial securities, priced artificially, with the institutional comforts of artificial credit ratings. This has been a run of financial innovation which success has never been doubted. Under the general term of derivatives, there has been a 25-year run of concept and practice without correction until the problems were discovered in the sub-prime sector. So far, discoveries of disaster have been modest compared to the full exposure.

On the fundamental side, this has been accompanied by the usual changes in the yield curve and spreads seen at the beginning of previous credit contractions. This suggests problems in the sub-prime are nowhere near being over and that the troubles will afflict most aspects of the credit markets. It is worth emphasizing that while the Fed can briefly push short rates it has no influence on the yield curve or credit spreads. Nada.

As briefly as possible this covers private-sector financial innovation.

Then there is the financial innovation on the coercive side of the equation as the Fed has been arbitrarily experimenting with artificial money and artificial interest rates with no corrections in basic theory or function for 95 years. At least three generations of financial adventurers in policy have displaced long standing traditions of probity and accountability.

A real engineer would describe this as an unusually long spell of positive feedback and in a safe place would be fascinated in watching it run to self-destruction.

An historian of the markets would observe that using a number of always compelling concoctions that implied the elimination of risk the Fed has been bartender to the world.

As Frank Sinatra sang it, ***"The party's over, it's time to call it a day"***.