PIVOTAL EVENTS

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Signs Of The Times:

Last Year:

"Apartment Buildings Lose Their Immunity to Housing's Chill"

– Wall Street Journal, August 20, 2008

"U.S. Commercial real estate prices fell for a fourth straight month in June, bringing values to 11.8% below their October 2007 peak."

– Bloomberg, August 20, 2008

Note that commercial property prices peaked with the stock market, and began what is likely to be a lengthy bear market. And according to the NBER the recession began virtually with the stock market high. Usually the business cycle lags the cycle for share certificates by 8 to 12 months. Hitherto, the only time both have peaked together has been at the start of a Great Depression. Will it be different this time?

Martin Mayer, who has written a number of serious books on banking, was one of the speakers at last Spring's CMRE Dinner, and Bob enjoyed meeting him. His book *THE FED* was published in 2002. In it he observed ***"The truth is that liquidity is the only significant weapon in the central bank's arsenal, but it will not necessarily go where you want it to go."***

Anyone who has read financial history would make the same conclusion. For example, this was the condition during the post-1929 contraction when the attempts by the Fed to supply liquidity were summed up by Barron's in 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."

More than likely, the liquidity injections shored up impaired bank balance sheets and/or went into bonds on the "carry" against exceptionally low short-term rates.

The establishment, without Mayer's insight, still insists the Fed was "tight" in the early 1930s. The Fed was not tight but the contraction overwhelmed all artificial attempts to inject liquidity into the system. In so many words, accounts still alive avoided "losers" and some speculated in "winners" until there were no winners.

An interesting subset of this is Washington's "Cash for Clunkers" intervention. Folks are not buying "Detroit" cars, with value impaired by their monopolistic unions, but are buying US-made Japanese cars.

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This Year:

"Krugman Says World Avoided Second Great Depression"

– AP, August 10, 2009

Obviously, Krugman's Theory/History quotient is under-weighted the latter. Why, even senior economists in 1884 finally described the post-bubble contraction that began in 1873 as the "Great Depression". It is uncertain if they named it the "first", but since the collapse of the South Sea Bubble in 1720 there has been five such manias and their five consequent Great Depressions. The climax of the credit and stock mania in 2007 was the classic end to a great bubble – the Sixth. And, so far, this contraction is running close to the typical path to another Great Depression – the Sixth.

Naiveté is not just the privilege of Nobel Laureates. In the 1970s, Lester Thurow was the "Dean" of liberal economists and in 1978 boasted that intervention worked because it had prevented ***"all seven recessions since World War Two from turning into a Depression."*** Guess he didn't know that there were ten business cycles on the long expansion to 1929. Since the Depression bottom in 1946 there has been eleven business cycle peaks to 2007. Close enough, historically speaking.

Another Thurow clanger occurred when he celebrated the wonders of Soviet central planning just before Communism crashed. In 1989 he wrote ***"Can economic command significantly accelerate the growth process? The remarkable performance of the Soviet Union suggests that it can. Today the Soviet Union is a country whose economic achievements bear comparison with those of the United States."***

Clearly his thinking was that with fully authoritarian central planners – things were wonderful. Thurow was not alone then as all best-selling economics textbooks were on the same message.

The irony is that the US is now on the full-command experiment and it is a policy disaster that will not be fully grasped until the natural post-bubble disaster takes out the March lows in global stock markets.

"Both conventional and unconventional decisions made by this scholar [Bernanke] of the Great Depression prevented the Great Recession of 2008-2009 from turning into the Great Depression 2.0".

– Nouriel Roubini, OpEd, The New York Times, July 26, 2009

This writer would rather avoid discussion with liberal economists – especially when they become perplexed by the evidence that the Fed really tried to reflate during the early 1930s.

The next step is to ask them to explain the "errors" made by the senior central bank in not preventing the Great Depressions that followed the Great Manias of 1720, 1772, 1825 and 1873. This evidence that Great Depressions are methodical usually ends the discussion, as there is no solid rebuttal from theoreticians.

Doctor Roubini please meet Doctor Krugman, Doctor Thurow, Mother Nature and Mister Margin.

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STOCK MARKETS

The possibility of August as providing a second target for an important stock market high seems to be working out. This was based upon the typical five-month rebound from a classic fall crash. Also typically, the panic ended in November and the rebound made it to around May.

This time around, financial markets had to discount the discovery that the Democrat government was radically authoritarian. This panic ended in early March, giving the count to August. Also, Ross's detailed work on the "Presidential Model" called for an important high in early August. This was reviewed in the August 4 ChartWorks and updated on August 11. A sharp break would lead to choppy action, with a declining bias into September.

This seems to be working out, with a couple of warnings. One was the topping pattern on the high-yield bond (CYE). The concluding MACD came on Friday and was reported on Monday. On August 10, our "Potpourri of Problems" provided a warning on the excesses. The last line was a ***"Heads up for a change in credit markets"***.

Banks and financials are vulnerable to the change that is starting in the markets. The high-yield (CYE) bond has turned down, which will eventually trash the spread portion of the carry trade. Excessive leverage on the "carry" has also been employed in the curve, and this is becoming eligible for reversal. Earlier today, the ChartWorks provided a review of J.P. Morgan Chase.

In the meantime, our Bank Trading Guide, which had slumped to 135 on July 7 and to rather oversold, recovered to 157 last Thursday. The RSI reached 70, which was enough to reverse the move. The Bank Trading Guide is back to the “sell” mode, and it is time to start lightening up, and nimble traders could start to build a short position.

INTEREST RATES

The Long Bond found support at the 115 level – with that our target became around 120. The price is now in the 120s and has further to go.

Shorter maturities – ***“prices are fixed in quiet trade”*** describes the action.

The three-month bill has been at 0.18 percent since May 1. A way back then dealer commercial paper was 0.90 percent. After spending most of June at 0.45%, it's been at 0.35% since late July.

A year ago this week, it was at 2.75% and in the October hit it soared to 5.20%. One wonders about the remarkable decline. Has the credit quality of the underlying companies improved to that of pure gold? Doubt it, but it is likely representing the huge amount of "stimulus" sloshing around out there.

And as noted above, "stimulus" does not fix the losers, but chases short-term trading tactics, which gets this page into the nonsense of interventionist economics.

The market does not know that audacious economists have brilliant ideas about what the economy should be doing. It is the equivalent of giving a race horse an exciting name so that it will run faster. Man O'War did not know his name and it had no incentive, but his winnings became legendary. On the longer term the market will have its way.

Another point is that financial history does not know that it is supposed to be random, and continues to record great booms and great busts that show remarkable replication on each transition from good to bad. Even leading policymakers responses to the transitions have been the same. They take credit for the boom, find scapegoats on the bust, try stimulation, suffer a fit of recriminatory regulation and then turn to years of protectionism.

One of the great errors in intellectual history has been the notion of a national economy that can be manipulated by uniquely gifted policymakers. Over the past 300 years booms and busts have been shared by all advanced countries. The mania of 1720 afflicted France, Holland and England. As trade expanded so did the geographic influence of huge financial events.

Impractical mental speculation need not be limited to just intellectuals. One outstanding irony that argues against the notion of a national economy is that virtually all policymakers are interventionist economists with the same recipes. By establishment reckoning, the only way a national economy could exist would be through only one country being run by interventionists. Contrarily, their international presence argues for coordinated boom and busts. That's if they all succumb to the same recklessness.

There is even a pattern in the influence of central planners. During the latter years of a great boom, politics trends authoritarian – in every country. For example, in the full-command Soviet economy the experiment in Communism ran until the global boom in commodities blew out in 1920. With the contraction there was a global swing away from the command economy. The US privatized previously nationalized railroads and Russia turned from Communism to socialism. As represented by the fall of the Berlin Wall, a wave of political reform swept the world. Commodities recorded an important high in late 1988 and the wall came down in late 1989.

Then with the global boom that launched in 1996 the world has gone to the left, with the US, for example, on the most aggressive push against its natural freedom to intrusive government in its history. With this, Russia has been returning to its native authoritarian habits.

However, as the post-bubble contraction continues all of the interventionist potions will be seen to fail and political power will begin to return to the individual. As with the contraction, political reform will be universal.

The latest global "sure thing" in the markets has been the "carry" against the curve and spreads – this is close to reversing.

Currencies: After reaching a dismal sentiment of only 3 percent bulls, which must have been global, the DX recovered from 77.4 to 79.5 and is consolidating. Considering the size of the crude rally on hurricane concerns the latest slip in the dollar has been modest.

Technically, it is poised for an intermediate rally that will be eventually supported by the fundamentals of the next liquidity crisis.

Other currencies, including the Canadian, will trend weaker.

COMMENTS FOR ENERGY AND METAL PRODUCERS

Energy Prices: Crude oil is again testing the 73.90 high in June. The recent break to 66 was a "heads up" on the sector, but within possible choppy action into September. Reasons for the recent pop include the Middle East and a hurricane. Serious weakness into late in the year would likely follow September.

On the stocks, we got in on the crash and the low on the XOI was 744. We essentially got out in our targeted time window in May. That high was 992, with the action reaching 1027 in early June. The subsequent low was 843 in early July when the move was generous enough to cover shorts.

So far the high has been 987 early in the month. We look for a shorting opportunity later in September.

Base Metal Prices: As measured by Goldman's metal index (GYX), the rally to last week achieved the most overbought in three years. Buying of metals has been one hedge against the dollar and became the popular thing do.

The key high was 528 set in March 2008 and the crash low was 190. The rebound to a 50 percent retracement is 357. Last week's high of 354 seems close enough. With a pending liquidity problem miners should be selling more aggressively. In a few years time, metal inventories could be so huge as to rival the Great Wall of China as being the only man-made item that can be seen from outer space.

As noted last week, mining stocks (SPTMN) have been outstanding performers. This also reached one of the highest RSIs in a couple of years. It reached 825 last week, which compares to last year's high of 895.

This is a way beyond the rebound in metals and it is doubtful that metals will catch up to the stock action. Investors should lean into the wind and continue lightening up. Traders should await a shorting opportunity.

Gold Sector: With the dollar likely to stabilize, gold's nominal price could correct and this seems to be working out.

The last good rally took the HUI and a number of small caps up to early June. Our advice was to take profits on both and to eventually accumulate smaller caps on weakness likely to occur in another phase of the credit crisis in the fall.

The HUI made it to 404 and has traded between 303 in early July to 380 earlier in this month. Now it is at 350.

In the meantime, our Gold/Commodities Index, which was likely to decline on the rebound in orthodox markets, seems to be stabilizing. The high with the crash was 519 in February and the low has been 308 on August 13, which was the high day for the senior stock indexes, as well as for a number of other stock exchanges. The best for speculation in corporate bonds was set the day before, so there is the possibility of an important change.

This seems to be suggested by the action in the gold/silver ratio, which set its recent low close at 63.5 – also on August 13. So far, yesterday's 68.2 shows a good turn, but needs the confirmation of a test. Getting above 70 would set the next leg up, and we always keep in mind that rapid plunges in silver relative to gold is a warning on financial disaster. Thus our advice to build a short position in the big silver stocks or ETFs.

> ***"It*** [the State] ***has taken on a vast mass of new duties and responsibilities; it has spread out its powers until they penetrate to every act of the citizen, however secret; it has begun to throw around its operations the high dignity and impeccability of a State religion; its agents become a separate and superior caste, with authority to bind and loose, and their thumbs in every pot. But it still remains, as it was in the beginning, the common enemy of all well-disposed, industrious and decent men. "***
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> – Henry L. Mencken, 1926
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> In a 1909 editorial opposing income tax, *The New York Times* wrote, ***"When men get into the habit of helping themselves to the property of others, they cannot easily be cured of it."***

- Mencken would not have changed his principles.
- Obviously, the NYT has been corrupted.

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