

# Fullermoney

Global Strategy and Investment Trends by David Fuller

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Please note: This is a compilation of Comment of the Day for Subscribers, which appeared on the www.fullermoney.com website during the last week. Subscribers are encouraged to login at their convenience, to read the daily coverage and use the many other site facilities, including the Library of charts.

## Monday 6th October 2008

Tim Price: Armageddon outta here! - [There are some interesting observations and comparisons in this thoughtful letter](#), published by PFP Wealth Management. Here is a brief sample:

Something tells me we may hear more of the name of Steagall, for it was Henry Steagall who helped establish the Federal Deposit Insurance Corporation and it was Henry Steagall who, by means of the Glass-Steagall Act of 1933, helped prohibit bank holding companies from owning other financial companies including the sort of broker-dealers who have helped ignite the current bonfire. Those provisions were repealed in November 1999. They should never have been allowed to. Perhaps Goldman Sachs and Morgan Stanley will survive as newly converted bank holding companies. Whether they do or not, their future earnings prospects look frankly, for want of a better phrase, subprime.

Professor Shiller cites Benjamin Friedman and his 2005 book "The Moral Consequences of Economic Growth" which suggests that "when people see encouraging prospects for the future, they are better able to work together constructively, supporting democratic principles and political and social liberalization. When perceived prospects for growth falter, there are major setbacks.." In much of the world and particularly in Europe, the Great Depression of the 1930s led in turn to squalid outcomes like fascism, anti-Semitism, racism, nationalism - and ultimately a world war. But the US in the 1930s, by contrast, "stands out as an exception - in many respects the exception" to Friedman's theory. Now, in 2008, it would truly be a tragedy if the US were to join the rest of the world in a retreat to profitless fingerpointing and mudslinging before confidence in the financial infrastructure was shored up by government action.

My view - [Governments are usually reactive and therefore behind the curve of events in a crisis. Unfortunately, the west's credit freeze is no exception. The immediate challenge for governments is to reverse this record advance by the Ted-Spread](#), along with similar measures of the spread between short-term government securities and the rate commercial banks charge each other. I maintain these are the most important charts for investors to monitor right now. Only governments can end the credit squeeze and failure to do so will lead to deeper recessions, which is what tumbling stock markets are indicating.

Accelerating downtrends are an ending characteristic, as veteran subscribers know and as we have seen on so many other occasions. Provided the frenzy of government activity in the USA and now Europe succeeds in reversing the Ted-Spread's advance, my guess is that we will see an important medium-term bottom for stock markets this month, followed by an upside reversion to the mean, represented by 200-day moving averages, best viewed on weekly charts of stock market indices.

Martin Spring's On Target: How the Politicians are Selling Us Short - [This highly experienced and iconoclastic commentator has an interesting take on the credit crisis and other subjects. Here is the opening:](#)

I'm very glad I'm not a banker.

In the current environment of hysteria and muddle, everyone is blaming bankers for the credit crisis which threatens to plunge the world economy into another great depression.

But bankers only did, usually legally, what they were employed to do - make money for their companies.

They operated in an environment of abundant cheap credit provided by central banks, and within a framework designed by politicians and administered by regulators.

There was no secrecy about the huge rewards they received for their creative financial operations, and shareholders acquiesced in those rewards and the means used to earn them.

They catered to the demand from those eager to go deeper into debt to deliver immediate satisfaction, to finance greedy speculation, or to seek higher returns from investments whose risks they didn't understand.

What bankers did was foolish -- but they did so with the connivance or even active assistance of those in a position to stop their nonsense.

Now we are engulfed in the resulting mess. Central banks seem to be doing a reasonably competent job flooding the system with money to prevent its seizure, but governments are dithering or being panicked into often unwise reactions.

The Americans equivocate between stern rectitude (letting Lehman Brothers go bust) and buckling to pressure from foreign creditors (the Fannie/Freddie and AIG nationalizations).

The off/on Congressional rescue package is a dog's breakfast that focuses on using taxpayers' money to buy the dodgiest financial assets rather than addressing directly the problem of recapitalizing of the banking system.

It is a grossly wasteful exercise in political bribery, with the enabling act incorporating huge tax breaks for Alaskan fishermen, Puerto Rican rum producers and low-budget film makers. Anything to gain the votes of Congressmen under pressure from hostile voters.

Hostile, that is, to the idea of giving a finance minister who personally profited immensely from the credit bubble, hundreds of billions of taxpayer dollars to spend on what they see as a rescue for his friends. Especially as in recent months his policymaking has been unstable, unsure, even incompetent.

Interesting article from The New York Times (Sep 30, 1999) on easing credit requirements - [My thanks to colleague Marcus Love for this item, posted without further comment, except to say that the underscores are not my own. Here is the opening:](#)

In a move that could help increase home ownership rates among minorities and low-income consumers, the Fannie Mae Corporation is easing the credit requirements on loans that it will purchase from banks and other lenders.

The action, which will begin as a pilot program involving 24 banks in 15 markets -- including the New York metropolitan region -- will encourage those banks to extend home mortgages to individuals whose credit is generally not good enough to qualify for conventional loans. Fannie Mae officials say they hope to make it a nationwide program by next spring.

Fannie Mae, the nation's biggest underwriter of home mortgages, has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people and felt pressure from stock holders to maintain its phenomenal growth in profits.

Please note - [I leave for the USA tomorrow, where I will be participating in the 46th Annual Contrarian Opinion Forum, hosted by Fraser Management Associates. It should be lively and I look forward to seeing subscribers there. I will be back in the office on Monday 13th October.](#)

Additional Commentary by Eoin Treacy

Fed May See Lending to Companies, States as Next Crisis Fronts - [This article by Scott Lanman and John Brinsley for Bloomberg covers the increased likelihood that the Treasury will have to intervene directly in the commercial paper market to increase liquidity. Here is a section:](#)

Federal Reserve Chairman Ben S. Bernanke may find the next fronts of the financial crisis to be just as chilling as last month's downfall of Wall Street titans: its spread to corporate America and state and local governments.

Companies from Goodyear Tire & Rubber Co. and Duke Energy Corp. to Gannett Co. and Caterpillar Inc. are being forced to tap emergency credit lines

or pay more to borrow as investors flee even firms with few links to the subprime-mortgage debacle.

California Governor Arnold Schwarzenegger says his and other states may need emergency federal loans as funding dries up.

A cash crunch on Main Street would endanger companies' basic functions -- paying suppliers, making payrolls and rolling over debt. The widening of the crisis suggests that Bernanke and Treasury Secretary Henry Paulson may have further fires to put out even as the Treasury sets up the \$700 billion financial- industry rescue plan approved last week.

"The rest of the economy is clearly being affected right now by the tightness of credit," said Kurt Karl, chief U.S. economist at Swiss Reinsurance Co. in New York. "It's just gathering momentum in the wrong direction."

The market for commercial paper, which typically matures in 270 days or less and is used to help pay for expenses such as payroll and rent, shrank to a three-year low of \$1.6 trillion in the week to Oct. 1, Fed data show.

Gannett, the largest U.S. newspaper publisher, said Oct. 1 it drew on a revolving credit line to ensure it had funds to repay its commercial paper.

Duke, Caterpillar

Duke Energy, the owner of utilities in five U.S. states, last week tapped about \$1 billion from a \$3.2 billion credit agreement after concluding it may not be able to meet its plan for new financing. Caterpillar, the biggest maker of earthmoving equipment, had to pay the biggest premiums over Treasuries in at least three decades at a sale of five-year and 10-year notes.

"Credit is the lubricant that oils the engine of the economy" and if it dries up "then the engine seizes up," said Republican Representative Michael Conaway of Texas, who switched his vote last week to support the financial rescue. The inability of a major corporation to renew its short-term loans would have "a devastating impact on the economy."

Even as confidence grew that Congress would pass the bailout, banks hoarded cash, indicating the proposed purchases of devalued mortgage assets may not be able to stop the credit crunch from widening.

My view - [Banks' refusal to lend to each other is freezing liquidity in the commercial paper market and causing undue hardship for US corporations. It is the duty of the Federal government to ensure that markets continue to function so we can expect direct lending to corporations to begin if credit markets do not free up soon.](#)

Yen Unbeatable as Credit Seizure Kills Carry Trades - [This article by Ye Xie for Bloomberg covers the continued strength of the Yen against a host of other currencies. Here is a section from the opening:](#)

The same credit market collapse that drove Lehman Brothers Holdings Inc. into bankruptcy and sent bank borrowing costs in Europe to record highs is making the yen unbeatable.

Japan's currency was the best-performer in September and the only currency to appreciate against the dollar. Deutsche Bank AG, the biggest trader of foreign exchange, says the yen will rise 5 percent in coming months. New York-based Morgan Stanley is telling clients to buy the currency versus the euro and pound.

After seven years of providing the cheapest source of funds for investors buying higher-yielding New Zealand dollars, Australian dollars and Brazil reals, the yen is appreciating as \$587 billion of subprime mortgage-related losses force banks to restrict credit. It strengthened 4.4 percent on a trade-weighted basis in September, according to the Bank of Japan's effective exchange rate, the most since August 2007, when the seizure in capital markets began.

“We are in a multi-year trend reversal,” said Paresh Upadhyaya, a senior vice president at Putnam Investment LLC in Boston who helps manage \$50 billion in currency assets. “We are going to see a global central bank easing cycle. The yen is the place to be in this environment of economic slowdown and heightened volatility.”

This year will be the first since 2002 that the economies of the U.S., euro-region and Japan all expand less than 2 percent, according to data compiled by Bloomberg. The BOJ's effective exchange rate rose 5 percent from April through September of that year, the best six-month performance since the end of 1999.

#### 'Counter-Cyclical Currency'

Strategists are turning more bullish, forecasting the yen will end the year at 107 to the dollar, compared with an expectation of 109.15 on Sept. 12, according to the median of 40 estimates compiled by Bloomberg.

The currency rose to 103.88 per dollar as of 12:46 p.m. in Tokyo from 105.32 late in New York on Oct. 3. Japan's currency also climbed 3.3 percent to 67.56 per New Zealand dollar and gained 4.3 percent to 78.10 against the Australian dollar. It advanced to 50.7812 versus the Brazilian real from 51.5240. “The yen is a counter-cyclical currency,” said Richard Benson, who oversees \$14 billion of currency funds at Millennium Asset Management in London. “When the global economy looks bad, the yen should do well.”

#### 211 Percent Return

The currency lost 60 percent against the Australian and New Zealand dollars in the seven years ended June 30, and depreciated 24 percent versus the real and 20 percent to the British pound. The main cause was the so-called carry trade, where investors took out loans in Japan to take advantage of the lowest benchmark interest rates among the Group of 10 industrialized nations. They then sold the yen and invested the proceeds in high-yielding assets outside the country.

Investors who used the strategy to buy the New Zealand and Australian dollars, euro and pound, would have generated a return of 211 percent on average in the past seven years, according to data compiled by Bloomberg. The trades would have lost 13 percent this year.

The collapse of Lehman, the government takeovers of Fannie Mae, Freddie Mac, American International Group Inc. and Washington Mutual Inc. and the forced sales of Merrill Lynch & Co. and Wachovia Corp. reduced confidence in the world's financial system.

**My view** - The Yen Carry Trade depended on two things, low Japanese rates and a weak currency. Japanese rates haven't changed but bets are increasing that interest rate differentials with other currencies will contract over the coming months. We have already seen some countries cutting rates and it is only a matter of time before more of the G7 follow suit. This makes it likely to be less profitable to bet against the Yen.

The carry trade was, in some respects, self-perpetuating because it facilitated the process by which investors were short the currency. As new trades were opened, even greater quantities of Yen were shorted. Now that the appetite for risk has turned negative and liquidity is unavailable, carry-trade funded positions are being closed contributing to the process of global deleveraging.

The Yen has been one of the main beneficiaries and has broken consistent sever-year downtrends against the [Euro](#), [British Pound](#), [Swiss Franc](#), [Swedish Krona](#), [Canadian Dollar](#), [Australian Dollar](#), [New Zealand Dollar](#) and [Brazilian Real](#). All of these charts indicate that the Yen has undergone a fundamental shift of direction. All have now crossed their long-term moving averages, sustained the moves and a number have found support at the moving average and rallied successfully from it. They would now need to sustain moves below their moving averages to offset scope for additional Yen upside.

Against the [Singapore Dollar](#) and the [Chinese Yuan](#), the Yen has found support and would need to sustain a move below the August lows to question scope for a successful upside break.

The Yen continues to rally strongly against the [Indian Rupee](#) and this is one of the only currencies it has reached significant new highs against. It is currently looking overextended relative to the moving average but a downward dynamic would be needed to question momentum beyond a brief pause.

The Yen is also outperforming against the [Russian Ruble](#) and [South Korean Won](#). These are accelerating moves and the Yen is becoming quite overextended following three months on the upside. However, a downward dynamic would also be needed here to check momentum beyond a brief pause.

The Yen found support against the [US Dollar](#) in mid-August and continues to rally. A sustained move below 0.9 would be needed to question scope for further upside.

Email of the day (1) - on Japan from a Tokyo based market maker:

"Look at an infantryman's eyes and you can tell how much war he has seen." Time was a 5% haircut on the Nikkei would have made traders levitate above the bed and projectile vomit, now you can't even see their expressions change: what's another few hundred points on an equity index when the KRW/JPY cross is realizing mid-30's vol and the top weighted 225 stock is nearly untradeably illiquid (see attached)? Few of the usual stress markers were present aside from early Asia-time SPX selling and despite the magnitude of the slide intramarket technicals were calm as the NT ratio was trapped in a civil 0.8% range, no mean feat with the TPX closing in triple digits for the first time since '03 (if you were trapped in a cave during the Koizumi era you can start buying). What if the House had voted Nay???"

My comment - Thanks to John Clappier for his ever interesting and often humorous missive on the Japanese market. The Nikkei and Yen spot price have been strongly correlated since 2004. This remains the case, so with the currency appreciating against a wide basket of currencies, the Nikkei remains under pressure. The deleveraging process may cause this correlation to break down but there is not evidence of such a change yet.

The Nikkei broke below 12,000 in mid-September and despite a brief rally, failed to push back up into the overhead range. It has since reaffirmed its downtrend and is looking increasingly overextended. However, an upward dynamic is needed to check momentum beyond a brief pause.

Email of the day (2) - on the gold/XAU ratio:

"According to John Hussman: ".when the Gold/XAU ratio has been greater than 5.0 and the ISM Purchasing Managers Index has been less than 50 (indicating a contracting U.S. manufacturing sector), gold shares have appreciated at an average annualized rate of 125.6%. In contrast, when the Gold/XAU ratio has been less than 3.0 and the Purchasing Managers Index has been greater than 50, precious metals shares have plunged at an average annualized rate of -49.9%."

"The previous all-time high for the Gold/XAU ratio since its start in 1984 was about 6.35 in the summer of 2001. It is now over 7 and the PMI is at 43.5, so Dr. Hussman's study would suggest it is an excellent time to buy miner shares aggressively. However, the ratio breaking to a new all-time high gives me pause to consider whether I should be more cautious.

"I'd be curious to know your thoughts."

My comment - Thank you for this interesting question and I agree that gold shares are historically cheap relative to the yellow metal. (Also see Comment of the Day on Friday) However, I also share your reticence because the ratio has now expanded to a previously unheard of peak. The process of global

deleveraging may be affecting many previously reliable ratio signals, so watching the action of the constituent instruments is probably more useful.

A sustained move above 150 on the [Philadelphia Gold & Silver](#) Index would be a more conclusive signal that mining equities are finding support. In the short-term, finding support at current levels would help to offset immediate potential for further downside.

World Equity Index Valuations Tables - Here is the monthly [list](#) of 100 global indices ranked in descending order by dividend yield and then in ascending order by P/E.

P/E ratios have fallen considerably and dividend yields risen as the credit crisis knocks prices for stocks on a global basis. The trend may slow or reverse as corporate profits contract and dividends are cut. This would seem an inevitable result of the current crisis and acts as a useful backdrop to the above table. Here are some charts that demonstrate how much P/Es and Dividend Yields have moved: S&P 500 ([PE](#), [DY](#)), Dow Jones Industrials, ([PE](#), [DY](#)), Germany DAX ([PE](#), [DY](#)), UK FTSE-100 ([PE](#), [DY](#)), Switzerland SMI ([PE](#), [DY](#)), Australia ([PE](#), [DY](#)), Canada ([PE](#), [DY](#)), Ireland ([PE](#), [DY](#)), New Zealand ([PE](#), [DY](#)), India ([PE](#), [DY](#)), China ([PE](#), [DY](#)), South Africa ([PE](#), [DY](#)), Brazil ([PE](#), [DY](#)) and Russia ([PE](#), [DY](#)).

Many of these charts are getting increasingly overextended but this is not enough of a signal on its own to suggest that a stock market lows are being reached. Upward dynamics on the above stock markets which are sustained beyond a few days are needed to offset current scope for further downside.

(Please note: All data quoted above originates in Bloomberg. We realise that some of the data displayed is inaccurate for some indices, particularly where ADRs are included. However, I have endeavoured to remove those indices which were problematic. We continue to publish these tables because the data is generally accurate and going forward we will continue to weed-out the less reliable data sets as subscribers highlight them for us. I have also deleted the FTSE AIM Index from the list because it does not seem to have very reliable figures.)

Email of the day (3) - on Frontline and Cameco:

"Would you be a buyer or seller of Cameco and frontline stocks?"

My comment - Thank you for this interesting question. In the interest of full disclosure, I bought [Frontline](#) for my daughter, Fiona, on [July 21st](#). It was outperforming at the time and I like the 26.6% yield. It has since fallen back into the three-year range but is looking overextended. However, a break of the progression of lower highs would now be needed to question scope for some additional downside.

For my views on [Cameco](#), please see Comment of the day on [October 2nd](#).

Email of the day (4) - on selections for the Chart Seminar's, custom chartbook:

"Please can you add:

[SG Japan Core Alpha Ret Acc](#) to the Chart Library, as I want to ask for it to be used as the basis of my discussions at the Chart Seminar in November."

My comment - Thank you for this suggestion and it can now be found in the Chart Library. It will also be added to the custom chartbook for the November 13th&14th London seminar.

For subscribers and pre-subscribers who have not previously attended [The Chart Seminar](#); every delegate can nominate two instruments they want included in the custom chartbook. Delegates provide all of the working examples during the course of the seminar, and we ensure that we cover all of the instruments suggested by delegates.

Today's interesting charts - The Chart Library contains a large number of ratios and indicators relevant to measuring the extent of the credit crisis. For example, the Outstanding Amount of Commercial Paper continues to decline, suggesting increasing tightness in that market.

Gold - continues to find [support](#) above the mid-September low near \$750. It would need to sustain a move below that level to question potential for some additional higher to lateral ranging.

Corn - extending the medium-term [downtrend](#) and an upward dynamic is needed to check momentum beyond a brief pause.

Germany - continues to extend the medium-term [downtrend](#) and is becoming increasingly overextended relative to the moving average. However, an upward dynamic is needed to check momentum beyond a brief pause.

Last week's signups for the Free (Abbreviated) Comment of the Day - For the week of September 28th new signups, including subscribers and pre-subscribers, live in the following countries or regions: Australia, Canada, Denmark, Hong Kong, India, Ireland, Netherlands, Singapore, South Africa, Spain, the UK and the USA - 12 in total. In descending order, which topped the list in terms of the last week's new signups? It was India, the USA and the UK.

Thousands of people around the world receive Fullermoney's Free (Abbreviated) Comment of the Day, and their numbers steadily increase. Why do so many sign up? It is primarily due to word of mouth or word of press mention, from people who like Fullermoney's global perspective and our Empowerment Through Knowledge theme. Incidentally, on receiving our free daily email, you will not be contacted or solicited with advertisements and

other marketing material. No one else will have access to your email address. We respect your privacy.

**Tuesday 7th October 2008**

Commentary by Eoin Treacy

Global recession: What does it mean? - Thanks to colleague Jackson Wong for this interesting [report](#) by Larry Hatheway and Kenneth Liew for UBS covering the potential for a global recession. Here is a section:

The detailed regional breakdown of our new global GDP forecast is shown in the preceding table. The new features include a deeper and longer recession forecast for the US and UK than we previously anticipated. For the first time, we also forecast a (mild) recession in the Eurozone. Japan is now expected to register growth of 0.7% in 2009, down from 1.2%. The Japanese economy is already estimated to have shrunk in Q2 2008 and we believe another small contraction will be recorded in Q3.

The good news is that within the developing economy bloc most of the major economies should avoid recession next year by posting positive growth rates, albeit much weaker than what they averaged over the past 4-5 years. Our forecast for China, for example, has been lowered to 8.0% in 2009 from a previous estimate of 8.8%. For smaller emerging economies that either have a big exposure to the developed economies via trade linkages, and/or a big exposure to financial markets, the downside risks have become more pronounced.

The obvious fundamental challenge stemming from our more downbeat assessment of economic activity is, of course, to earnings and cash flows. The concerns are presumably all the greater because, thus far, earnings weakness outside of financials has not been that great. Indeed, the chart below-which comes courtesy of our global equity strategy team-suggests that earnings could readily fall another 15-20% if 'all' that happens is an earnings compression on par with previous recessions.

Of course, this is not an ordinary recession. It is more widespread in the industrialized complex, and more consumer-driven in the US, than past downturns. At the same time, however, earnings in some sectors-such as energy, mining, basic materials or industrials-may be more resilient than in the past, given relatively subdued capital investment in this cycle, at least relative to the growth of earnings.

Perhaps the most important determinant of the investment call, however, will be what multiple investors are willing to assign to an even lower base of earnings. On a trailing P/E basis, for example, the S&P500 now trades on a multiple of about 13 times. If earnings were to fall 15-20%, the multiple would be around 15 times. In a 'normal' world that is a fair valuation and one that could even allow for some expansion. In an uncertain environment-such as the one still unfolding-it probably can not and may even be demanding.

My view - Price / Earnings ratios have contracted considerably over the last year. (Also see Comment of the Day [yesterday](#) for a large number of charts on this subject.) In all likelihood P/Es will rise as earnings expectations are pegged back, but this does not negate the fact that equities are considerably cheaper now than they were a year ago. What lower earnings are more likely to affect is the pace of recovery once the market bottoms. Following an initial sharp rally, equities are likely to need significant time to generate support in a base building pattern.

Fed to Purchase U.S. Commercial Paper to Ease Crunch - [This article by Craig Torres for Bloomberg covers today's activity by the Fed in the Commercial Paper markets. Here it is in full:](#)

The Federal Reserve will create a special fund to purchase U.S. commercial paper after the credit crunch threatened to cut off a key source of funding for corporations.

The Treasury will make a deposit with the Fed's New York district bank to help set up the new fund. The central bank will also lend to the program at policy makers' target rate for overnight loans between banks. The Fed Board invoked emergency powers to set up the unit, the central bank said in a statement released in Washington.

Today's action follows a slide in the commercial-paper market to a three-year low of \$1.6 trillion last week as investors fled even companies with few links to the subprime mortgage crisis. Companies from newspaper firm Gannett Co. to electricity producer Southern Co. have been forced to tap credit lines or forego raising debt because of the market's disruption.

The Fed's efforts are aimed at "stemming the bank-run-like panic," said Mark Gertler, a New York University economist and research co-author with Bernanke. "The immediate threat to the real economy is that large corporations are having difficulty obtaining funds via the commercial paper market."

Fed officials in a conference call with reporters didn't say how much commercial paper, which hundreds of companies use to finance payrolls and meet other cash needs, it plans to purchase. The central bank's special purpose vehicle will be big enough to backstop the entire market, one official said on condition of anonymity.

#### Size of Sales

Issuers will be able to sell commercial paper to the Fed up to the average amount they had outstanding in August, an official said.

Policy makers began considering buying commercial paper several weeks ago as the market began to seize up, with borrowers increasingly only able to raise funds on a short timeframe, even just overnight, officials said. The Fed's unit will buy three-month commercial paper, which should help issuers extend the maturity of their borrowing, an official said.

Fed officials anticipate that yields will come down significantly as a result of their initiative.

Yields on top-rated overnight U.S. commercial paper dropped 0.74 percentage point today to 2.94 percent, according to data compiled by Bloomberg. Borrowing for seven days increased 1.25 percentage points to 4 percent.

#### Treasury Deposit

The Treasury's deposit with the Fed's special purpose vehicle will be substantial, officials said. The funds won't come from the \$700 billion rescue plan authorized by Congress last week.

Stocks initially climbed and Treasuries sank after the Fed's announcement, while shares later turned lower. The Standard & Poor's 500 Stock Index was down 0.1 percent at 1,055.38 at 10:23 a.m. in New York. Yields on benchmark 10-year notes climbed to 3.51 percent from 3.45 percent late yesterday.

Today's announcement came hours before Fed Chairman Ben S. Bernanke speaks on the economic outlook at 1:15 p.m. in Washington. He and Treasury Secretary Henry Paulson held discussions yesterday as stock markets slid and money market rates climbed as the crisis deepened.

The Fed's new unit will buy three-month dollar-denominated commercial paper at a spread over the three-month overnight- indexed swap rate, which is a measure of traders' expectations for the Fed's benchmark rate.

Fed officials on the conference call indicated that they would like the facility to be a backstop, which would suggest the special vehicle's rate would be set at a slight penalty to normal market rates. They declined to answer a specific question as to whether the rate would be set above current rates, or below, which would constitute a subsidy for borrowers.

#### Fed to Consult

The Federal Reserve will consult with market participants regarding appropriate spreads that are consistent with the facility serving as a funding backstop under more normal market conditions," the Fed said.

Commercial paper purchased by the vehicle must be rated at least A1/P1/F1, the Fed said. Issuers will pay the unit an upfront fee based on the commercial paper initially sold to the vehicle. The vehicle will cease buying commercial paper on April 30, 2009, unless the Board of Governors agrees to extend it.

The Fed will cap the amount of commercial paper each company may sell to the central bank.

The Fed yesterday said it will double its cash auctions to banks to as much as \$900 billion, and telegraphed today's announcement by saying it was looking for other ways to alleviate liquidity strains.

My view - Today's action helped to pull the [TED](#) spread back from its all time highs. The short-term progression of higher lows remains in place and it needs to take those out to suggest a sustainable high has been reached. However, the impact of this action on the Commercial Paper market is potentially very important and should help to get liquidity moving once more.

Over the last few weeks, economies in Europe have felt some very real consequences of the credit crisis. Potential for a concerted effort with the USA to stimulate markets and preserve the global financial system are increasing. This could be manifested in simultaneous rate cuts by the Fed, ECB and Bank of England.

European central bankers have been slow to recognize that inflationary pressures have receded and deflation is now much more of a threat. Once they change tack, they could act aggressively to get in front of the curve. How successful intervention in the money markets is, will be likely to have a bearing on the extent of any rate cuts in the UK and Eurozone.

Email of the day (1) - on the LIBOR-OIS spread:

"Is it possible to get the LIBOR-OIS spread chart added to the chart library?"

"This (as I'm sure you're aware) measures the spread between US dollar-denominated 3M and overnight credit in the interbank market, is an indicator of liquidity tightening and risk aversion. The spread has blown out massively over the past few days, and is the talk of the market.

"This will look something like the below panel of the Bloomberg [chart](#) below (preferably inverted to show a spike) - is this something you can create?"

My comment - Thank you highlighting this highly relevant spread.. You will find it in the Spreads & Overlays section of the Chart Library. You can also find it using 'overnight index swap' or 'OIS' as search parameters in the Chart Library's dedicated search.

The [spread](#) has widened to unheard of proportions over the last month and while it fell slightly today, a downward dynamic is needed to check momentum beyond a brief pause.

Email of the day (2) - on how to find the TED spread in the Chart Library:

"Please, where in the chart library is the TED Spread chart located."

My comment - The Ted Spread is located four from the top on the middle column of the Spread & Overlays section of the Chart Library. You will also see a number of other important spreads in the same section. It is also possible to find it using the Chart Library's dedicated search with 'Ted' as your keyword. It will be the first item on the list.

Email of the day (3) - on the RBA cutting interest rates:

"The longer central banks and governments procrastinate the higher the solution cost to all. The global collective of central banks and governments obviously need to pick up the pace a little!

"Thankfully the Irish Government acted quickly guaranteeing bank deposit. The Reserve Bank of Australia has acted decisively today lowering cash rates by 100 basis points to 6.0 per cent. See:"

My comment - Thank you for this forthright opinion and the [link](#) to the [RBA's](#) statement. The [ASX 200](#) broke below the September lows this morning but rallied on the rate cut news to close above 4600. It would now need to sustain a move below 4500 to question scope for some additional upside. However a sustained move above 5250 is needed to suggest potential for anything more than a technical rally at this point. The [ASX200 Financials](#) Index found support near 4500 this morning and rallied well. It continues to range around this level and needs to sustain a move above 5000 to suggest scope for additional upside and above 5500 to complete the emerging base.

Email of the day (4) - on platinum:

"Is that a small key day reversal in platinum today?"

My comment - Thank you for this interesting question. The short answer is no. For an upside key day reversal, the instrument must move to a new low for the move and then close above the high of the previous day. You are correct in pointing out that platinum made a new low but it did not close above the high of the previous day, so this is not a key day reversal.

The key to the key, so to speak, is the size. A key day reversal's power is in its dramatic impact on investor psychology. It should be clear to anyone looking at the instrument that something important has changed. This is not yet the case with platinum. It remains in a consistent downtrend and would need to sustain a move above [\\$1200](#) to question the integrity of the medium-term move.

Email of the day (5) - on using the US Dollar as a hedge against a weak Pound:

"In view of the continued strength of the us\$, might not the us\$ be an effective hedge against a weakening £s, at least in the near term?"

"Continued appreciation to you both for being able to provide most valuable guidance and support to those who otherwise might have foundered by now."

My comment - Thank you for your kind words and interesting question. One of the points we stress at The Chart Seminar is that there is no market which will

not eventually provide consistent rhythmic uptrends. The persistence of any trend will then depend on the secular theme supporting it. The [Pound](#) appreciated against the Dollar from early 2002 before peaking near \$2.10 late last year. The impressive Dollar rally from the end of July broke the Pound's uptrend and it looks like it has further to go in the near-term. A sustained move above [\\$1.85](#) would be needed to question this hypothesis.

As long as global deleveraging continues, the odds are in favour of continued rallies for the Dollar and Yen against a host of other currencies. However, leaving aside the unwinding of carry trades, I find it difficult to propose a convincing bullish argument for either of these currencies. So to answer your question, they might provide at least a partial hedge against the current environment but one would be well advised to prepare for a quick reversal when deleveraging has run its course, whenever that may be.

Today's interesting charts - The Chart Library has two Search Engines. One searches the more than 17,000 equities, funds and ETFs in the International Equity Library and the other searches through the rest of the Chart Library for indices, commodities, currencies, bond prices and yields, ratios, spreads and overlays.

Dow Jones Industrials - remains in a consistent [downtrend](#), although looking quite overextended relative to the its 200-day moving average. An upward dynamic is needed to check momentum beyond a brief pause.

Norway - continues to post new lows in this accelerating [downtrend](#). An upward dynamic would also be needed here to check momentum beyond a brief pause.

Oman - was the best performing Middle Eastern stock market before hitting a ceiling near [12,000](#) and remains in a consistent downtrend. An upward dynamic is needed to suggest the Index is finding a floor.

Email of the day (6) - questions on the Chart Library:

"I have 2 questions:

"How do I de-list a chart from my Favourites section?

"Is it possible to save a chart to Favourites direct from the commentary in the comment of the day?"

My comment - Thank you for these interesting questions. To delist an instrument from your Favourites. Hold the mouse over the entry. A red 'x' will appear click on the red 'x'. A box will appear asking you if you are sure you want to remove the item, click yes if you are sure. You can also find the instrument on the menus and click on the red 'x' next to it. This will automatically remove the instrument from your Favourites.

As for your second question; it is not currently possible but I will add this interesting suggestion to our development list. ]

Email of the day (7) - a humorous take on the banking crisis from a Japanese perspective:

"Japanese Banking Crisis:

"Following the problems in the sub-prime lending market in America and the run on HBOS in the UK, uncertainty has now hit Japan.

"In the last 7 hours Origami Bank has folded, Sumo Bank has gone belly up and Bonsai Bank announced plans to cut some of its branches.

"Yesterday, it was announced that Karaoke Bank is up for sale and will likely go for a song, while today shares in Kamikaze Bank were suspended after they nose-dived.

"Samurai Bank is soldiering on following sharp cutbacks, Ninja Bank is reported to have taken a hit, but they remain in the black.

"Furthermore, 500 staff at Karate Bank got the chop and analysts report that there is something fishy going on at Sushi Bank where it is feared that staff may get a raw deal."

My comment - Thank you for the burst of levity in such a tense environment.

Please note - David is participating in the 46th Annual Contrarian Opinion Forum, hosted by Fraser Management Associates. He will be back in the office on Monday 13th October.

### **Wednesday 8th October 2008**

Commentary by Eoin Treacy

Fed, ECB, Central Banks Cut Rates in Coordinated Move - [This article by Scott Lanman for Bloomberg](#) covers the simultaneous rate cut by a number of central banks this morning. Here it is a section:

The Federal Reserve, European Central Bank and four other central banks lowered interest rates in an unprecedented coordinated effort to ease the economic effects of the worst financial crisis since the Great Depression.

The Fed, ECB, Bank of England, Bank of Canada and Sweden's Riksbank each cut their benchmark rates by half a percentage point. The Bank of Japan, which didn't participate in the move, said it supported the action. Switzerland also took part. Separately, China's central bank lowered its key one-year lending rate by 0.27 percentage point.

Today's decision follows a global meltdown that sent U.S. stock indexes heading for their biggest annual decline since 1937; Japan's benchmark today had the worst drop in two decades. Policy makers are also aiming to unfreeze credit markets after the premium on the three-month London interbank offered rate over the Fed's main rate doubled in two weeks to a record.

“Central banks of the world have finally woken up to the gravity of the current situation,” Charles Diebel, head of European rates strategy at Nomura International Plc in London, wrote in a note. “It is potentially not the last we will see of central bank activity particularly in Europe as the macro situation is still weakening dramatically.”

### Rate Levels

The Fed reduced its benchmark rate to 1.5 percent. The ECB's main rate is now 3.75 percent; Canada's fell to 2.5 percent; the U.K.'s rate dropped to 4.5 percent; and Sweden's rate declined to 4.25 percent. China cut interest rates for the second time in three weeks, reducing the main rate to 6.93 percent.

“The recent intensification of the financial crisis has augmented the downside risks to growth and thus has diminished further the upside risks to price stability,” according to a joint statement by the central banks. “Some easing of global monetary conditions is therefore warranted.”

Global policy makers are reducing rates as economies weaken around the world. The International Monetary Fund said the global economy is heading for a recession in 2009 and increased its estimate of losses from the financial crisis to \$1.4 trillion.

The Fed's Open Market Committee, which voted unanimously for the move, said in its statement that “incoming economic data suggest that the pace of economic activity has slowed markedly in recent months. Moreover, the intensification of financial-market turmoil is likely to exert additional restraint on spending.”

My view - The concerted move by central banks to support markets is a clear indication that they are now focusing on fostering growth and combating deflation. The acceptance that the current environment does not pose an inflationary risk, rather the opposite, is an important milestone in how monetary authorities are willing to deal with the crisis.

The move by the ECB in particular is to be highlighted since they were the only major central bank to raise rates this year. Their prolonged contention that inflation was the problem rather than deflation is now problematic for them because their rate cut smacks of desperation. Equity markets across Europe met the rate cuts with scorn, implying that the ECB has to do much more to combat the deepening banking crisis across the continent.

News today, that the Bank of England will inject [£50billion](#) into the UK's banks is to be welcomed if it succeeds in heading off further nationalizations. However, such moves also appear to be needed in a host of other countries

and the question remains where the money is going to come from if the ECB has no mandate to provide it.

However, in conjunction with the TARP, intervention in the commercial paper market, direct infusions of liquidity into the banking sector, as well as other measures; today's simultaneous rate cuts are a highly significant move. The implication is now obvious that central banks are willing to do whatever is necessary to kick start the credit markets.

Importantly, the [Ted Spread](#) and [OIS spread](#) both rallied today, with the later hitting a new high. These remain the two most important indicators of the credit market's liquidity and are a significant headwind to any potential stock market rally. Further measures need to be put in place to help restore confidence to an extent that these spreads decline. The [VIX Index](#) also hit a new high today and also needs to decline significantly before an important low is confirmed.

Investors Intelligence Advisors Sentiment indicator - Thanks to colleague Tarquin Coe from Investors Intelligence for these three charts of the S&P500 immediately following historic lows in the Advisors Sentiment indicator.

In [1978](#) when the indicator had a reading of -40.2 on November 24th. The indicator's low did not coincide with the low for the Index, but the S&P failed to fall very much beyond this oversold level.

In late-January [1982](#) the reading was -34 at its nadir and while the S&P didn't hit its low for a few months, it also failed to fall significantly from the indicator's bottom.

In [1990](#) the reading was -27.8 on September 14th. On this occasion the Index hit a low within a few weeks.

[Right now](#) the indicator is at -27.7, a level not seen in 18-years. That does not mean it cannot go lower but it suggests that sentiment is getting increasingly bearish and we are being set up for a significant rally.

Eoin's personal portfolio: Dow Jones Industrials Average long opened and subsequently stopped out at a loss - On seeing the rate cut news this morning I opened a long in the December [Dow Jones Industrials](#) contract at 9632. Although the Index advanced soon afterward, it subsequently gave up its entire advance and more. I was stopped out at 9442. I reduced my trading considerably over the last few months, in an attempt to preserve capital and intend to wait for a more conclusive signal before opening further trades. While the markets were unable to sustain today's move, I believe we are getting increasingly close to an important medium-term low.

Email of the day (1) - on volatility:

"In the last few days the Dow has gyrated in excess of 5% daily. This is something usually associated with emerging markets. Is the money moving out of Equity funds at such a rapid rate or have the volumes been lower and the indices suffering as there are no buyers to stem the tide."

My comment - Thank you for this interesting email. These charts of the [Dow](#) and [S&P](#) indicate that while volume has been higher than average recently, it has not reached the highs seen in mid-September.

In a falling market, buyers are very tentative and become increasingly less likely to buy as the instrument accelerates lower. "They are hunkered down in their foxhole and won't come out until the shooting stops" as we say at The Chart Seminar. The sellers are panicking out of positions and those short are triumphant and probably pyramiding their trades. However, we will come to a time when those who wanted to sell have sold and shorts are overleveraged. At this point it only takes a small amount of demand to force some of the shorts to close positions which forces more to be closed and a powerful rally can ensue.

Many markets are accelerating lower and the first upward dynamic will put at least near-term floors under them. Assuming the gains made following such a move are sustained, we anticipate a short-covering rally which could see indices advance back to test their 200-day moving averages over the coming months.

Email of the day (2) - on velocity of money:

"Despite the money thrown at markets in recent weeks, there seems to be little positive effect, but rather a negative effect. Could the equation 'money times velocity' be the real culprit, in which 'velocity' of money is the problem more than 'money'? I wonder how many more tanker loads of new money will be created before velocity picks up, and how much that priming fuels future inflation."

My comment - Thank you for this interesting point. Velocity of Money figures are only issued once a quarter, but I would expect the figure to be lower when next published. This chart of [M2 Velocity](#) was relatively steady up to the end of June. [Multiplying](#) this figure by the M2 gives us an almost straight line from bottom left to top right.

The money entering the market over the last year has made up for the slowing velocity of cash in the system. This volume of new money would in turn become sharply inflationary over the medium-term if it is not removed once velocity picks up again.

Email of the day (3) - on chart pattern similarities and relative performance:

"Let me add my appreciation for the calm and considered way with which you have both approached this current crisis. Hopefully we will retain enough

capital to look back laugh about the crisis of 2008 and savour the gains made from the next bull run.

"As a long term investor my question arises from tentatively using the charting facility to compare pairs of investments in a single chart. This is a wonderful tool. I am struck with the surprisingly close correlation between different investments. For example I have been looking at FTSE100, Dow Jones Ind, Templeton Emerging Markets, Black Rock Gold & General, JPMF Japanese Smaller Companies, CF Eclectica. I know that "a rising tide lifts all boats" (and vice versa) but over any recent 3-6 month period these seem to follow each other fairly closely. I wonder if I am missing something? Can you offer any insights? If this is the case then long term investment selection would seem to be less important than the "tide" that rises and falls."

My comment - Thank you for an inspiring and thoughtful email. Your contrarian optimism is admirable in the current environment. You are absolutely correct to point out that many instruments have been moving in relatively similar patterns not only over the last few months but over the last 5 years. We have gone through a period of synchronised global economic expansion where almost everything was in an uptrend and one uptrend looks much the same as another in that type of environment.

Here is the [overlay](#) of the Dow Jones and the Templeton Emerging Markets Investment Trust (TEM) over the last year and [5-years](#). However, the relative performance is something entirely different. [TEM](#) has advanced hundreds of percent over the last 5-years while the Dow has been relatively stagnant. This [chart](#) shows the extent to which the Dow has fallen relative to TEM.

You are correct that a rising tide lifts all boats but not all markets advance equally. Getting the secular call correct is the most important factor in picking investments for the long-term. Yes, when liquidity contracts they will all fall together, but those markets with a sound fundamental supporting theme outperform when liquidity expands once again.

Email of the day (4) - on The Chart Seminar and the relative cost of goods and services:

"Some charts here I think you may appreciate particularly the first one of gearing and cash balances for Asian corporates .....

"P.S. Not sure of Eoin's direct email but would like to thank him for most recent Chart Seminar. At least one timing success this year was travelling overseas on \$AUD in May/June with the seminar as my motivation. Interestingly (accommodation in London & Paris excepted) at that exchange rate I didn't find the experience that expensive relative to Australia. I could buy quality fresh seafood in Cornwall and French markets very much cheaper than I could at home.

"Perceptions take time to change and flying with JAL and doing a Tokyo stopover there were still comments about Japan being expensive. That time

has gone with Japanese deflation for a substantial time and I could indulge a quality, genuine Japanese restaurant experience in Asakura (Tokyo) cheaper than home in Cairns (Australia), Sydney, Paris or London.

"Many in Australia have still not adjusted (particularly the tourism industry) to the reality that Australia is no longer a cheap country relative to the rest of the developed world ..... although perhaps recent exchange rate trends will yet restore that perception? I always remember only a handful of years ago the UK cricket loving 'barmy army' consoling themselves for the hammering they were taking on the field by chanting on the SCG Hill "we've got 3 Aussie dollars to the pound".

"Isn't change and volatility fascinating?"

My comment - Thank you for this insightful email. I'm delighted you enjoyed The Chart Seminar and your observations as to international prices are enlightening. Incidentally, for those thinking of attending The Chart Seminar in November, places are filling up quickly. Thanks also for the interesting report posted below.

Cash hoarding in Asia - [This report](#) by the Asian Microstrategy team at Macquarie Bank treats of how less leveraged Asian companies with surplus cash are performing relative to their more leveraged competitors. Here is a section:

Asia's corporate balance sheets are still robust, driven by buoyant economies, lower interest rates and lower capex spend over the past few years. We are now in a period where rising risk aversion overwhelms all other considerations and cost of debt is rising.

In the current environment of volatility and uncertainty, we feel companies with cash holdings will exhibit defensive characteristics. Microstrategy's free-to-invest Cashflow Analyser shows that the region's cash generating ability continues to be strong (free-to-invest cashflow of US\$175bn in 2009). This should quell concerns regarding availability of cash to support future growth.

Rising cost of debt is a cause of concern for highly geared companies. The total debt-to-equity ratio of our Asia ex-Japan coverage universe (ex financials) has been falling in the past few years, but analysts now expect a slight increase in 2008. Cost of debt has turned around since last year following the credit crisis and analysts now expect this to be higher by over 110bp in 2009 compared to their forecasts a year ago.

This would be a cause for concern in the short term for companies with high levels of debt. However, we expect interest cover (EBIT divided by net interest expense) for the region to continue improving in future.

My view - The credit crisis has been indiscriminating in attacking share prices across sectors and countries. As global deleveraging continues, even companies with sound balance sheets are being sold to fill holes left by

unprofitable positions in investors' trading accounts. However, when this crisis eventually ends, and investors look around to begin making the decision as to what to purchase, high growth Asian economies will be one of the first ports of call. In an environment where there is less appetite for risk, companies with cash in hand, solid balance sheets and sound business plans will be recognised as the best opportunities.

Email of the day (5) - on Atlantis China Fortune Fund:

"Further to the email from a subscriber last week, asking why this Fund was doing so badly even allowing for the fall in the China markets, you will now be aware that Atlantis have "suspended" redemptions and dealing in the Fund and also the calculation of NAVs. It is my belief that the fund manager has gone overboard on IPOs of questionable quality and this is at least partly the cause of the collapse (see my email to you of last week). Since I understand that this Fund is a core holding in David's portfolio, and no doubt in that of many subscribers, I would welcome a comment from you."

My comment - Thanks you for your thoughtful email on the reason for the suspension of NAV calculations and redemptions. Here is a [link](#) to the statement issued by Atlantis yesterday. It is not heavy on details so I called James Alexander, Atlantis' market director, this afternoon. I left a message on his voicemail asking for further details and have had no reply yet. This is an unfortunate situation and I agree that the manager's decision to invest in hard to value, private companies has left her in a bind as redemptions mount. It remains to be seen how long this hiatus will last but it is not confidence inspiring to put it mildly.

Today's interesting charts - Credit spreads occupy an important niche in monitoring the global liquidity situation and a myriad of them can found in the Chart Library.

Nikkei 225 - accelerating [lower](#) in what appears to be climactic action. However, an upward dynamic is needed to check momentum beyond a brief pause.

S&P Banks - the ban on shorting of US Financials runs out tonight. At present the Index is [testing](#) the late September lows and an upward dynamic is needed to question potential for some additional downside.

Copper - remains in a [consistent](#), though increasing overextended downtrend. However, an upward dynamic is needed to question scope for some additional downside.

DJ Europe Stoxx Banks - breaks [down](#) the three-month range and needs to rally smartly back above 250 to question scope for further downside.

US 10yr Swap Spreads - used as another indicator of risk in the banking sector, [swap spreads](#) broke down today and would need to sustain a move above 60 to question for further downside.

Please note - David is participating in the 46th Annual Contrarian Opinion Forum, hosted by Fraser Management Associates. He will be back in the office on Monday 13th October.

## Thursday 9th October 2008

Commentary by Eoin Treacy

U.S. Stocks Drop, Erasing Early Gains, as Banks Slump on Libor - [This article](#) by Lynn Thomasson for Bloomberg covers the continued illiquidity in the credit markets. Here is a section:

U.S. stocks slid for a seventh day, the longest losing streak for the Standard & Poor's 500 Index since 1996, as higher lending rates sent a gauge of financial shares to an almost 12-year low.

SLM Corp., the education lender known as Sallie Mae, lost as much as 47 percent and Prudential Financial Inc., the second- biggest U.S. life insurer, tumbled 39 percent as the benchmark three-month Libor rate climbed to the highest level of the year. Chevron Corp. slumped 5 percent, sending the S&P 500 Energy Index to a two-year low, as oil slid below \$87 a barrel on concern the global economy is heading into a recession.

The S&P 500 fell 12.18 points, or 1.2 percent, to 972.76 at 11:17 a.m. in New York. The Dow Jones Industrial Average slid 93.66, or 1 percent, to 9,164.44. The Nasdaq Composite Index increased 0.4 percent to 1,746.46. Almost two stocks fell for each that rose on the New York Stock Exchange.

``Everyone's watching the Libor, looking for credit market to thaw and it's not there yet," said Alec Young, a New York- based equity strategist at Standard & Poor's. ``Until you get some convincing thawing in the credit markets, the threat of a global recession and a global profits recession remains and it's going to be difficult for stocks to build momentum."

U.S. stocks fell yesterday after Treasury Secretary Henry Paulson said more banks may collapse and unprecedented global interest-rate cuts failed to convince investors the economy will avoid a recession. Paulson signaled the government may invest in banks as the next step in trying to resolve the deepening credit crisis.

My view - The ban on short selling of financial companies expired last night and today saw some significant moves for a number of shares. The [S&P500 Banks](#) Index continues to move lower and looks set to test the July lows. An upward dynamic would be needed to question scope for further downside. The [S&P500 Diversified Financials](#) Index broke below its September and July

lows yesterday and while it remains in the general proximity of those levels, an upward dynamic is needed to question potential for some additional downside. The [S&P500 Regional Banks](#) Index has been the best relative performer in the sector but is also falling back. It broke below the early October lows today and an upward dynamic is needed to put at least a short-term floor under the market.

Shorting of these shares has resumed despite the multiple measures now in place to support them. One of the reasons banks remain a prime target for short-sellers is the shortage of liquidity in the money markets. The [TED](#) spread and [OIS](#) spreads posted new highs today and as we have been reiterating for more than a week, stock markets are unlikely to sustain an important rally until these spreads contract.

Email of the day (1) - on the ratio of Gold to gold shares:

"Listening to your audio today and, if I didn't misunderstand you, you mentioned your view that gold would not breach the 1000 previous high in the short term and, being a present outperformer, once the markets experience a relief rally it would arbitrage with previous underperformers. My question is about Miners. I read Mr. Hussmann's opinion that Miners were at historical lows regarding its ratio against gold. What could be their behaviour if markets rally and gold underperform? Will they be seen as stocks or as gold derivatives? Thank you for your thoughts and your superb coaching."

My comment - Thank you your complimentary email and I'm glad you are enjoying the service. I've been monitoring the Gold/Philadelphia Gold & Silver Index quite closed over the last week. (See Comment of the Day on October [6th](#) and [3rd](#).)

The [ratio](#) peaked on the 7th with gold at more than 8.5 times the price of the Philadelphia Gold & Silver Index. The same is true of Gold relative to the Amex [Goldbugs](#) Index, topping out at 3.5 times. Yesterday's downward reactions put at least a near-term cap on the advance and they need to sustain moves to new highs to question scope for further downside.

Gold shares are extremely overextended relative to the price of the metal and their 200-day moving averages. There is significant scope for this divergence to be closed over the coming months. As long as the price of gold remains relatively steady and global credit conditions ease, gold shares should reacquire the mantle of a derivative on the metal. The [Philadelphia Gold & Silver](#) Index is very overextended relative to its moving average and rallied well from the psychological 100 level. It would now need to sustain a move below that level to question scope for some additional upside. Trading has been remarkably volatile on the way down and the Index needs to sustain a move above 150 to break the progression of lower rally highs. The [Amex Goldbugs](#) Index has a very similar pattern. It rallied well from the 250 level yesterday and needs to sustain a move above 350 to break its progression of lower rally highs.

[Gold](#) has been a fantastic relative performer throughout the most recent part of this crisis. Its safe haven status, disillusionment with the financial sector, distrust for fiat currencies, scarcity of physical gold and lower interest rates have all helped to support the price. However, even with all of these bullish factors and despite a whopping upward dynamic from near \$750; gold has at best held its own.

The 200-day [moving average](#) provided support from mid-2001 to early August. Significant technical damage has been done and requires time to repair. Gold has rallied well to test \$900 and the moving average but the going gets tougher from here. I maintain that the environment is weighted to further volatility and a sustained move below \$820 would be needed to question scope for some additional higher to lateral ranging.

Which was the best performing S&P sector over the last 5 days? - The S&P Gold Index topped the [rankings](#) over the last 5 days but another heavily sold index was the second best performer.

The S&P Fertilizers & Agricultural Chemicals Index has been one of the worst performers over the last month but a number of important stocks found support over the last week. Upward dynamics for [Monsanto](#), Potash Corp and [Agrium](#) have helped to put at least a short-term floor under these oversold markets and a sustained move to new lows would be needed to question scope for some further upside.

Email of the day (2) - on BHP Billiton and Rio Tinto:

"I wonder if you would mind commenting on the BHP/RIO situation as they comprise two of your, and probably many subscribers, major holdings.

"I notice BHP on the Australian market made a very powerful key day reversal on the daily chart on 7 October following the RBA's 1% interest rate cut.

"However, considering the general state of the market and sentiment, plus the performance of the rest of the sector, I suspect there will not be any positive follow through. I believe you have often pointed out that key reversals, like all other indicators, are not infallible. The subsequent action in BHP on the 8th was very subdued and towards the bottom end of the scale of the previous day's key so there is at least a delay in further gains, if not a failure of the key. On the other hand, BHP is showing a lot of relative strength, especially compared to RIO, but is probably unlikely to do anything dramatic on the upside until the entire Australian market enters a probably short term reaction to the downtrend.

"In regard to BHP and RIO, BHP's current price of around 30 means RIO should be somewhere near 102 based on the takeover offer of 3.4 BHP shares for each RIO share. However, RIO is languishing at 81. It would seem the market is not rating the chances of a successful takeover very highly at present.

"I'd be interested in your comments as your guidance, as always, is greatly appreciated."

My comment - Thank you for your interesting observations. I'm sure David will have more to say when he returns, but I will attempt to answer your questions in the interim. This [article](#) from Mineweb today quotes the Chinese Premier saying they anticipate demand to remain strong for Australian commodities. Over the long-term the secular bull story remains intact for these shares. However, at present they are suffering from expectations for a global recession next year and fears that the Chinese economy will slow more than forecast. We have to weigh these arguments and put them in perspective relative to the extremely bearish sentiment currently gripping markets.

The Chinese economy is not immune to the economies of its clients moving into recession. However, it has a range of tools and oodles of cash-in-hand to help support the economy if necessary. Other Asian economies which may have been priced out of the market when commodity prices were high are now a potential source of commodity demand.

[Rio Tinto](#), listed in the UK, is more divergent from its moving average now than at any time in the last 5-years. The fall from 5000p to 2500p has been unrelenting but the share is now looking very overextended. An upward dynamic would help to put at least a short-term floor under the market and an ensuing sharp rebound looks likely. Listed in [Australia](#), the share has also fallen aggressively over the last month but not to the same extent as in the UK. An upward dynamic is also needed here to provide support and suggest that demand is returning.

[BHP Billiton](#) broke below the January and August 2007 lows this week. It is also more divergent from its moving average than at any time in the last 5 years. The share remains extremely oversold and an upward dynamic, as with Rio Tinto above, is likely to spark a short-covering rally. In [Australia](#), the share has fared slightly better, but also broke below the January and August 2007 lows this week. You are correct to point out that follow-through on a key reversal is important to how powerful the signal is. On this occasion, it succeeded in halting the decline in the short-term, but the share needs to do more to pressure the shorts and suggest demand is returning in force.

Following any rally for BHP Billiton and Rio Tinto, which should help to clear their oversold conditions, it will take time for them to build support and a period of consolidation is likely.

This [ratio](#) of BHP Billiton to Rio Tinto shows the massive rerating of Rio following the takeover offer and the diminution of that premium since. Even though the Australian authorities gave it their go ahead last week, Rio is reluctant to be taken over at that price and the deal is now looking unlikely without their acquiescence. The wild card is the credit crunch. Both of these shares have healthy balance sheets, however, if Rio were to have trouble raising cash for infrastructure or development then they may become more amenable to an offer.

Email of the day (3) - on finding value:

"While chaos reins supreme in the markets I thought this was interesting. John Hussman for the first time since 2000 eased up on his bear view regarding USA equity valuations! Great [article](#)."

My comment - Thanks for this enlightened article by John Hussman. I agree with him, that the competition to come out with the most bearish forecast coupled with markets accelerating lower is a recipe for at least a bear market rally and potentially more. Investors who are willing to commit cash to the markets in the coming weeks and months should do well over the next number of years; short-term volatility excepted.

John Hussman's [strategy](#) performed well in 2003 when sentiment was bearish and stocks were recovering. This was because he has the fortitude to wait for stocks to become cheap before making purchases. This conservative strategy is being hailed in today's market where his fund is a relative, if not absolute, outperformer. However we should also be aware that this strategy precluded investors from taking part in the bullish phase which lasted from 2004 to 2007.

Email of the day (4) - on Barron's Confidence Index:

"Have you ever seen a chart on the Barron's Confidence Index?"

My comment - Thank you for this suggestion, but this is the first time I come across it. I found this definition on [investopedia.com](#):

A confidence indicator calculated by dividing the average yield on high-grade bonds by the average yield on intermediate-grade bonds. The discrepancy between the yields is indicative of investor confidence.

A rising ratio indicates investors are demanding a lower premium in yield for increased risk and so are showing confidence in the economy.

The theory is that if investors are optimistic they are more likely to invest in the more speculative grade of bonds, driving yields downwards and the confidence index upwards. The opposite is true if investors are pessimistic.

I'm not sure what their definition of intermediate grade bonds is but as a proxy I created this ratio of 10yr Treasuries divided by a composite Index of 10yr US\$ [BBB](#) bonds. The ratio has accelerated lower from its highs near 0.80 in the middle of last year. It continues to post new lows and an upward dynamic is needed to question scope for some additional downside.

Email of the day (5) - on Baltic Dry Freight rates:

"According to BBC news tonight the Dry Freight Index has halved in last few weeks. Explanation given is that Chinese imports have dried up, and could

foretell a major slowdown in that country. Any thoughts please as Far East looked likely to miss most of the coming recession, but now???"

My comment - The [Baltic Dry Index](#) is too open to manipulation by the parties involved in leasing and purchasing shipping contracts to be a reliable indicator of future economy activity. In my view its value is limited to an indication of shipping prices and little more. The Index is extremely oversold and the first upward dynamic is likely to spark at least a short covering rally. (Also see Comment of the Day on [October 1st.](#))

Email of the day (7) - on Russian indices:

"I noticed some large variance between action on the Russia RTS index and the MICEX index today-could we please have the MICEX added to the library."

My comment - Thank you for this suggestion. I added the [Micex](#) and [Micex 10](#) indices to the Chart Library today. They are both denominated in Rubles while the [RTS\\$](#) and [CRTX](#) are both denominated in US Dollars. Other than that I don't see a great difference.

Email of the day (8) - on charts of P/E ratios and dividend yields:

"Would it be possible to permanently add those great PE and dividend yield charts that you produced on Monday to the library? And do you have ones for the Topix and Nikkei?"

"Your endeavours are very much appreciated, especially during these stressful times."

My comment - Thank you for your kind words, I'm afraid it is not currently possible to reproduce charts for P/Es and dividend yields in the Chart Library because we do not get this data in our feed from Bloomberg.

Today's interesting charts - a number of precious metals are looking undervalued relative to gold and the Chart Library contains a number of relevant ratios.

Platinum / Gold Ratio - Platinum's [premium](#) to gold has collapsed over the last 5-months and is looking remarkably overstretched. In fact platinum hasn't been at parity relative to gold since 1994. An upward dynamic would likely initiate at least a partial reversal of this trend.

Brazilian Real per 1 US Dollar - the US Dollar hit an accelerated [high](#) against the Real yesterday and is now retracing the advance. A sustained move above BR2.4 would be needed to question scope for some further Dollar weakness.

Spain - [extending](#) the break below 10,500 and an upward dynamic is needed to check momentum beyond a brief pause.

Please note - [David will be back in the office on Monday 13th October.](#)

## **Friday 10th October 2008**

Commentary by Eoin Treacy

G-7 'Against the Wall,' Weighs Loan-Guarantee Plan - [This article](#) by Simon Kennedy for Bloomberg covers a number of options currently being discussed to restore the interbank lending market. Here is a section from the opening:

Finance ministers and central bankers from the Group of Seven nations meet today facing a breakdown in investor confidence in their ability to end the credit freeze endangering the global economy.

Threatened by the worst economic outlook in a quarter century, officials arrived in Washington still without the broad-based strategy that investors were seeking, raising the risk of further turmoil if their remedies disappoint. Among the options: a proposal by U.K. Chancellor Alistair Darling for nations to guarantee lending between banks, a suggestion that U.S. Treasury Secretary Henry Paulson hasn't ruled out.

Unprecedented interest-rate cuts and bank bailouts failed to quell panic in markets, putting the officials under pressure to pull even more policy levers. The MSCI World Index of stocks is recording its worst week in more than three decades and credit markets remained frozen.

"Global policy makers have their backs against the wall -- they have nowhere to run, nowhere to hide," said Marco Annunziata, chief economist at Unicredit MIB in London. "Do not underestimate how hard they are going to fight back now."

The officials from the U.S., Japan, Germany, U.K., France, Canada and Italy are gathering for the first time since the financial crisis intensified last month and spread more virulently beyond U.S. borders.

### **Emergency Meeting**

The International Monetary Fund, which activated an emergency-financing mechanism to aid countries that run into trouble, and the Financial Stability Forum held emergency talks yesterday with officials from 27 nations to discuss responses to the turbulence. Paulson helped lead the meeting.

G-7 officials are scheduled to release a joint statement at about 6 p.m. in Washington.

"This is an opportunity to make sure that they're all on the same track," said former Federal Reserve Chairman Paul Volcker. He urged that "all of them now admit or all of them own up to the fact their own banks are going to need

support," in an interview with PBS Television's Charlie Rose show.

Reflecting the seriousness of the crisis, President George W. Bush will meet with the G-7 in an echo of predecessor Bill Clinton's gathering with the group during a 1998 financial crisis. Officials from the broader Group of 20 will convene for a special meeting tomorrow.

My view - Central banks and governments are finally coming to the realisation that this is a global crisis and requires a global solution. The simultaneous rate cuts announced this week were a signal that this is now starting to happen. However, investors have lost faith in the ability of the authorities to deal with this problem. It is going to take further concerted efforts to revive confidence and a commitment to tackling the central themes of this crisis, i.e. rising foreclosures and the drying up of liquidity in the money markets.

The focus of the current panic is that banks are unwilling to lend to one another because they don't trust their counterparties or because they need the cash themselves. If government agencies take shares in their respective banking sectors, thus adding capital, the question will remain outstanding as to whether it is enough. If however, governments guarantee loans made between banks, it will almost certainly get the market moving once more. This approach runs the risk that suspect institutions will survive when they would normally have gone bust. However, given the extreme nature of this crisis, this question of moral hazard is going to be put off for another time.

The best indicators of liquidity remain the [TED](#) spread and the [OIS](#) spread. Both made new highs today and remain in accelerating uptrends. The [VIX](#) also hit another new high today and further indicates that fear is the overriding emotion gripping investors right now. Stock markets are unlikely to find an important low until these spreads begin to contract. It is to be hoped that today's G7 meeting presents a powerful statement concerning greater cooperation between governments to stem the decline in confidence.

How overextended are the Dow S&P 500 relative to their 200-day moving averages? - Thanks to a subscriber for these highly relevant indicators, contributed in the spirit of Empowerment Through Knowledge, which plot the [Dow Jones](#) and [S&P's](#) divergence relative to their 200-day moving averages.

Moving averages are a trend smoothing device that lag by definition. However, since a long-term moving average such as the 200-day is a mean level for any market, we are most interested when an instrument diverges from its mean for any significant length of time. These indicators provide useful barometers of how oversold both the Dow Jones and S&P500 have become.

The S&P has never been so overextended relative to its 200-day moving average. Previous occasions when it got close in [1973](#), [1987](#), and [2002](#), all marked significant lows for the market. We have no evidence yet, that the S&P has found support but the more overextended it becomes, the sharper the covering rally is likely to be when the tide of sentiment begins to turn.

The Dow Jones has only been more overextended relative to its moving average in [1938](#) and during the collapse of markets from [1929](#) to 1932. However, on every occasion, once the indicator bottoms, it has been a reliable signal that the market is close to an important low. I will post these indicators on a weekly basis until a recognizable bottom is completed.

Email of the day (1) - [on the bearish case and safe havens](#):

"Just my observations: It feels like a slow-motion crash. Volume isn't spiking as prices decline. All financial media are looking for the 'capitulation' spike down and it isn't happening. There is just a steady drift lower and its beginning can be traced to last year. There are daily moves by government finance arms, and after each one the market continues to slide. Today's talk is for the US FDIC to insure unlimited bank deposits. Money velocity must be plunging (there are no up-to-date figures published). Banks are being propped up and bought, the US Fed is lending directly to business, and it appears we are headed towards commercial and financial socialism. What a switch -- from unregulated 'free' markets to socialized finance! Everyone's asset values are plunging, and later we will witness an inflation that erases most of the residual value. Sorry to evoke such gloom but these conditions require a survival mentality rather than a search for the chimera of an entry point into these markets."

My comment - [Thank you for your frank assessment which encapsulates the reasons the market has fallen so consistently over the last weeks. Measures currently in place to stem the deterioration of the financial system are not working yet, but they cannot be viewed as unilateral moves. All of these measures will have a cumulative effect and central bankers are intent on continuing to implement new policies until they get the result they want.](#)

[Looking at these weekly charts of the Dow, S&P, Nasdaq, UK FTSE-100, German DAX, Spanish IBEX, Hang Seng, Nikkei-225 and Australian ASX 200, I've never seen such climactic activity as is occurring right now. Anyone still looking for capitulation selling is obviously not looking in the right place. If I were short, I would now be nervous and lowering stops as these trends go parabolic. Markets cannot fall at this rate indefinitely. Therefore, the farther they fall, the closer we are to the next medium-term low. These indices have plenty of potential to post impressive rebounds which would unwind their current extremely oversold conditions.](#)

[Please see the following item concerning safe havens.](#)

[Yen Set for Biggest Gains in 10 Years as Carry Trade Evaporates - This article by Daniel Kruger and Kim-Mai Cutler for Bloomberg covers the continued strength of the Yen as carry trades are unwound. Here is a section:](#)

[The yen headed for its biggest weekly gain in a decade against the dollar as the global stock- market rout prompted investors to sell higher-yielding assets and pay back low-cost loans in Japan.](#)

Japan's currency was poised to rise the most versus the 15- nation euro in any week since its debut in 1999 as the worst week ever for the Standard & Poor's 500 Index discouraged carry trades. President George W. Bush said the U.S. is working with global partners to solve the financial crisis as Group of Seven finance ministers and central bankers met in Washington.

“Investors are concerned it could get worse,” said Jens Nordvig, a currency strategist at Goldman Sachs Group Inc. in New York. “Clearly a lot of investors have only one goal, to preserve capital.”

The yen traded at 99.75 per dollar at 11:07 a.m. in New York, compared with 99.82 yesterday, after reaching 97.92, the strongest level since March 19. Japan's currency advanced 0.8 percent to 134.73 per euro, from 135.83. It touched 132.83, the strongest level since July 2005. The euro fell 0.7 percent to \$1.3508, from \$1.3604.

The U.S. currency has dropped 5.2 percent against the yen this week, the most since Oct. 9, 1998, when it plunged 14 percent as investors shed risk and abandoned yen carry trades in the wake of the collapse of hedge fund Long-Term Capital Management LP.

Coordinated interest-rate reductions by central banks in the U.S., Europe and Asia in the past two days failed to revive lending among banks, putting stocks on course for their worst week in 30 years. The cost of borrowing in dollars in London for three months rose to 4.82 percent today, the highest since December, the British Bankers' Association said.

My view - The yen, the dollar and gold have all benefitted from their safe haven status during the most recent iteration of the credit crisis. Their strength can be attributed to slightly different reasons such as unwinding of Yen carry trades, a shortage of Dollars internationally and distrust of fiat currencies, respectively. However they all share the risk that when credit markets free-up and risk appetite recovers somewhat, they may become more risky investments.

The [Yen](#) has been the strongest currency in the world of late and improved by more than 10% against the Dollar over the last 6 weeks. The greenback needs to sustain a move above ¥102 to question potential for some additional downside.

Measured by the [Dollar Index](#), the greenback remains in a relatively consistent uptrend and would need to sustain a move below 76 to question scope for further upside.

[Gold](#) has been a comparative outperformer compared to other commodities and most stock markets. It rallied well from \$750 and is currently ranging in the region of the 200-day moving average. However, today's key day reversal from the upper side of the range probably caps the short-term advance. Even so, the prognosis remains for further ranging as long as it sustains the move above \$825.

Today's interesting charts - The Charting tool allows you to save Preset templates so they can be applied to any instrument at a later date with a minimum of hassle.

Oil - extends the medium-term [downtrend](#) and would need to sustain a move back above \$90 to question potential for some further weakness.

Ireland - falls to another new [low](#) but has not experienced the same degree of acceleration as other European markets, probably because it had already fallen so much. However, an upward dynamic is needed to check momentum beyond a brief pause.

Brazil - remains in an accelerating [downtrend](#) and an upward dynamic is needed to check momentum beyond a brief pause.

Email of the day (2) - on additions to the Chart Library:

"Congratulations on a superb service at this difficult time. Could you please include the following eurobonds in the chart library?"

0 % [New South Wales](#) Treasury 23.11.2020 (currency: A\$)  
4 % [Austria](#) 24.3 2011 (currency: C\$)"

My comment - Thank you for your kind words and I'm delighted you're enjoying the service. Both of these bonds have now been added to the Chart Library. .

Email of the day (3) - on additions to the Chart Library:

"Could you please add FRESNILLO [[FRES](#)] (silver miner) to the charts - thank you?"

My comment - Thanks for the suggestion. You will find this share in the International Equity Library.

Please note - David is away and will return on Monday.

Quote of the week - on when to buy:

"Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell."  
-Sir John Templeton, 1994

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