

# 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 20th October 2008

As Fuel Prices Fall, Will Push For Alternatives Lose Steam? - [This is an extremely interesting article](#) by Steven Mufson for the Washington Post. [Here is the opening:](#)

Just four months ago, a conference here on electric cars drew four times as many people as expected. District fire marshals ordered some of the crowd to leave, and the atmosphere was more like that of a rock concert than an energy conference. A brief film depicted an electric car owner driving off with a beautiful woman to the strains of "The Power of Love" while her original companion struggles to pay for gasoline. The audience cheered.

One discordant note in the series of enthusiastic speeches came from Bill Reinert, one of the Toyota Prius designers. He cautioned that designing and ramping up production of a new car takes five years.

"If oil goes down to \$60 or \$70 a barrel and gasoline gets back to \$2.50 a gallon, and that very possibly could happen," he said, "will that demand stay the same or will we shift back up?"

It didn't take five years to hit those numbers. One type of oil shock has given way to another. Even more swiftly than the price of oil rose, it has tumbled to the range that seemed far-fetched when Reinert spoke and oil was more than \$130 a barrel. Now that drop threatens a wide variety of game-changing plans to find alternatives to oil or ways to drastically reduce U.S. consumption.

"Declining oil prices can give us an artificial and temporary sense that reducing oil consumption and energy consumption is an issue we can put off," said Greg Kats, a managing director of Good Energies, a multibillion-dollar venture capital firm that invests in global clean energy.

The credit crisis is compounding that threat by making it more difficult to finance capital-intensive projects, whether they are new auto assembly lines or solar panels or wind turbines. General Motors has been touting the Chevy Volt as the first mass-marketed, plug-in hybrid vehicle. GM, which has been holding merger talks with Chrysler, believes the project will help justify federal financing. It hopes to deliver the car by the end of 2010.

Tesla Motors, a maker of a handful of pricey electric sports cars, had planned

to unveil a cheaper sedan next year. But on Thursday it delayed the new model because of trouble lining up financing. It also said it would close two offices and has replaced its chief executive.

The uncertain future of electric cars points to a sticky aspect of the global oil equation. The price of oil can change rapidly, but responses that would cut petroleum use take time. As oil prices climbed, major automakers including GM, Mitsubishi, Renault-Nissan and Toyota moved ahead with plans to produce plug-in vehicles. But the first of those cars won't be ready for a couple of years. What the price of oil will be then, and what consumers' appetite for plug-in cars will be then, is anybody's guess.

My view - The world has gained some welcome respite, albeit at the cost of recession for many countries, in terms of the long-term inevitability of Peak Oil, which Fullermoney defines mainly in terms of a rising cost of production.

I am certainly not saying that the latest oil price spike which peaked in July was the sole cause of our current economic problems - there is the terrifying matter of the West's financial crisis, but the cost of energy was a significant contributor. All previous spikes in the price of crude oil have resulted in global recession and the latest is no exception.

I maintain that the long-term trend of rising energy prices, albeit fluctuating as is the nature of markets, is a much more serious issue for the global economy than the West's irresponsible banking folly. The latter is extremely costly but temporary and unlikely to be repeated anytime soon. The world's heavy dependence on fossil fuels is on an unsustainable course, in terms of supply, cost and environmental considerations.

We now have another window of opportunity in which to reduce this dependence, while also further increasing the efficiency with which we use fossil fuels, including a steady reduction in the amount of pollution that their usage generates. These developments do not come free but the consequence of inaction would almost certainly be far more costly over the long term. Also, developmental costs are often rewarded with the new technologies and businesses which they help to create.

Squandering today's respite in energy costs would leave us in the position of frogs swimming contentedly in an initially cool pot, even as the heat is slowly increasing due to the flame below.

Email of the day (1) - On Friday's Audio:

"Good day David, I would like to compliment you on your Friday October 17th big picture audio. Your unemotional and calm comments have helped me see things more clearly and encouraged me to stay with my long term investment plan. Please keep up the good work.

"Thanks also for your comment on JII bonus subscription shares which I recently queried with you."

My comment - Thanks for the feedback. Calm is good if it facilitates the analytical process, but unhelpful if it is a sign of complacency, not unlike the unsuspecting frogs referred to above. Occasional complacency is part of the human, not to mention analytical condition, whether one is bullish or bearish. We all try to avoid it, but I am certainly not immune to the problem.

The question for the moment is, are we both being complacent in terms of what I said in my Friday Audio? Let's look at a little more evidence.

1. Better late than never, governments are increasingly moving to support their banking industries, while adjusting monetary policy to combat recession / deflation, rather than economic overheating (in some emerging markets) / inflation, as before.
2. The [Ted-Spread](#) has unequivocally peaked in my view. It is still 220 basis points above a healthy level but heading in the right direction.
3. Consequently, an "Armageddon" collapse of the financial system will be avoided, albeit at a cost yet unknown, and recession is a reality.
4. Commodity inflation is much reduced.

Therefore stock markets are left with the more familiar problem of corporate profit downgrades but equity prices have already gone a long way towards discounting this temporary problem. With monetary policy becoming more benign for shares, opportunities for investors in stock markets are now beginning to outweigh risks, but beware of further downgrades for corporate profits.

Blockbuster report on Asia Strategy - My thanks to a subscriber for this important [report](#) on Asia, produced by the research team at Citigroup. Here is a brief sample:

Asia ex-Japan is now at 1.3x P/BV. If we remained as bearish as we were at 3x, we'd be the fool - Asia-ex is down 57% from the peak; much bad news has been discounted by the equity market. Over the past 33 years, valuations have been higher than 1.3x for 90% of the time. Sure, we could retest the 1982 or 1998 lows of 0.9x, and much economic pain remains ahead of us. Yet given the correction in markets, we must temper our bearishness.

Earnings estimates remain way too high; expect plenty of downgrades - Earnings in Asia will grow 10% in the next 12 months, according to IBES estimates. In previous recessions, EPS growth has fallen 30-50%. The gap between expectations and likely reality is too wide. Not all is lost. At 1.3x P/BV and below, the market is pricing in a major retreat in EPS growth (-28% on average in the past). To date in this downcycle, 12-month forecasts have been cut for the past 2 months; historically, another 7 months have followed.

At the depth of past recessions, cashflow and dividend yield showed the highest returns - The temptation is to shift to marginal companies or small and

mid caps. Avoid this temptation. Stay focused on large caps, cashflow generators and dividend payers. Do not be tempted by the notion that buying forecast earnings growth is the road to riches. It is not. Indeed, it greatly underperforms cashflow and dividend yield. Asia-ex trailing yield is now 4%, a level it was last at in 1998 and 1990.

Markets are very oversold and redemptions are taking flows back to 2004 levels - We can identify 31 stocks that have traded all the way back to 1973; all 31 are now trading below their 200-day moving averages. This has happened only in such stressed periods as 97/98, 1987, 1982 and 1975. In terms of redemptions, all the inflows since late 2004 have left. The buy-in price for the 2004 inflows is 16% below current levels, inflows dated 03 are 28% below now.

My view - With its comparatively high growth and savings rates, Asia remains one of the world's more interesting regions for investors. Valuations are much more reasonable today but growth is still slowing. Therefore Citigroup is bound to be right concerning earnings downgrades.

Having received this report today, I have only skimmed through it so far but intend to study each section more fully. I think it provides a very useful fundamental background, which can also be assessed against price charts in months ahead. I intend to increase my investments in Asia but will proceed cautiously. Many of the declines look overstretched, which creates the potential for a technical rebound, but much of the bottoming out and base building process lies ahead.

Email of the day (2) - [On Advisors Sentiment](#):

"David - I hope you will take this question from an old subscriber in the cheerful spirit in which is intended. As I go back and think over this year's events, I remember that in the January/February timeframe you were suggesting that prices had gone too low, citing the extreme sentiment indicators. Those indicators (from Investors Intelligence?) had an admirable track record up to that point.

"Now, the acceleration to the downside we've just witnessed suggests a similarly oversold situation. Those of us who have attended the Chart Seminar understand that.

"I wonder though - could it be that under these extreme conditions the recent type 1 acceleration to the downside might be misleading as well? I ask because everywhere we turn we hear of veterans saying they've never witnessed anything like this in their lifetimes. In other words, could you be wrong? Could it be that this type of acceleration in times of extremely unusual, and global, stress is a feint?

"Thanks, as always, for your hard work on our behalf."

My comment - Thanks for a thoughtful email of general interest, and also for your considerable interest in Fullermoney over the decades.

In an ideal world one would say with astonishing prescience, this is the top and the bottom will be at a specific level on the following date. However there are no prophets on this basis - only good guessers and bad guessers, and no one has ever cornered the market in either category.

Fullermoney has identified periodic oversold conditions throughout the bear market to date. These coincided with trend acceleration and extremes of sentiment. Once scope for at least a short-term technical rally was identified, we have monitored progress, including the presence of resistance areas which have rebuffed each rally to date. We have also pointed out levels below which downtrends have been reaffirmed.

Recently, we have seen a further extreme of sentiment accompanied by downward trend acceleration. It has created another technical oversold condition. Consequently, we have been calling for at least a short-term rebound since last Monday and would not be surprised to see a medium-term bounce. Have we seen the bottom of the bear market? I do not know and none of us will really know until the next uptrend is well established. Meanwhile, the downtrends are still intact.

Have the odds increased that we are either at or close to sustainable lows? Yes, by definition of the additional declines that have occurred, plus the decisive changes in governments' financial and monetary policies seen recently and pending. However because of the extreme nature of the West's financial problems relative to what most of us have seen previously, it may be prudent to be cautious for a while longer.

In conclusion, there may be some additional downside risk in stock markets, or at least ranging base development time. Nevertheless, I suspect stock markets will be considerably higher in two or three year's time.

Additional Commentary by Eoin Treacy

Email of the day (1) - on acceleration and penultimate lows:

"I think it was last Wednesday when you were doing the audio. You suggested that with the great acceleration that we saw, that the current low might just be the penultimate low, with the market reaching a "marginal" new low before rising again.

"You suggested that we look at past charts that would demonstrate this. I do not know exactly where I should look for this. Is it possible for you to post some charts to give us some examples of this sort of low?"

"I am particularly interested in what "marginally lower" might be and if this is a marginally lower closing low or intra day low. I am also interested in what sort of time frame is common for this sort of ending."

My comment - Thank you for this interesting question and it is something we cover in detail at The Chart Seminar. The most important thing that has happened in stock markets lately is the massive downward acceleration which climaxed on Friday October 10th. That week saw many indices lose in excess of 20% of their value and most markets are now in the process of unwinding that extremely oversold condition. This acceleration occurred following a consistent downtrend which has been in motion for more than a year. As we teach at The Chart Seminar, acceleration is an ending signal of undetermined duration. The acceleration is the signal that we are entering the endgame but need not necessarily mark the absolute end of the move, although it often does. .

The bigger the acceleration the more important the signal it provides and when it occurs following a consistent trend, the likelihood is greater that we have reached an important low. However, it remains an open question as to whether the peak or nadir of the acceleration marks the absolute low for the move.

Acceleration is the easiest of the trend ending signals to identify but not every market that accelerates in one direction immediately reverses and accelerates in the other direction. Following the nadir of a downtrend which has accelerated, the size of the bounce is important because if it is particularly big, larger number of shorts will have been stopped out and they will be more inclined to reconsider their positions. However, if the instrument can only manage a weak rally and drifts back to test the lows, then it may break down once more.

On this [occasion](#), we have had a clear acceleration of an already well developed downtrend. It is possible that the acceleration low was the low for the entire move. However, market bottoms are often more volatile than market tops. This means that the end of the acceleration may mark the penultimate low. Generally in this type of environment, a market has exhausted much of the selling pressure in the downward acceleration and any further downward break does not initially have the weight of offers overhead to drive it lower for a significant period.

The [Dow](#) in 2001 and 2002 provides a number of examples of acceleration endings. From mid-May 2001 the Dow moved fell from 11305 to 8062 in September; following 9/11. The market rallied impressively from the lows and recouped the majority of the decline.

From mid-May 2002, the Dow fell from near 10,350 to 7350 in less than two months. On this occasion the short covering rally encountered resistance relatively quickly and fell back to post a marginal new low which was sustained for only a short time. In this case the acceleration was a clear indication that the selling pressure was being quickly exhausted but did not mark the absolute low for the entire move.

It might also be instructive to look at some examples of uptrends where the peak of the acceleration was the penultimate high rather than the absolute high the move. From late August to early November 2007 the Indian [Sensex](#) rallied from 14000 to 20000. The acceleration was clear but following a brief pullback the Index regrouped quickly and broke upwards again by late December. However, it was unable to sustain the gain and fell back significantly in mid January.

Sometimes, such as the [CRB](#) recently, an instrument can accelerate in both directions. However, more often a war between supply and demand is fought at important tops and bottoms. This often leads to volatile whipsaw trading activity. Acceleration, following an already persistent move, is a clear signal that we are entering an endgame and suggests one should be cautious in allowing the crowd to influence one's analysis.

Email of the day (2) - on TIPS:

"As always the commentaries provided by you and Eoin have been so important in endeavouring to understand so much of what has happened over the past year and the past 6 weeks in particular.

"The first question I receive at the end of each day from both my office staff and family members is 'what happened to the Ted Spread today???'.

"Quite mind boggling but equally quite fascinating and a time of greater education and understanding care of your 'knowledge is power' community.

" Hats off to you both.

"Looking at a more traditional investment strategy of bonds & equities although deflationary influences have quickly overtaken inflationary issues - fire & ice reversals - although inflation/interest rates are rapidly falling surely inflationary pressures will re-appear as global GDP starts to pick up in, say 2011 and beyond?

"Therefore on a theoretical basis would index linked government debt prove to be a better medium to longer term play compared to fixed interest government debt?

"Although falling inflation/interest rates should favour fixed interest holdings have these not already peaked due to their security safe haven status assuming that the fear factor will slowly diminish and markets take on board just how poor government finances now look following massive bail outs?

"Your usual wisdom will be appreciated as always."

My comment - Thank you for an inspiring email and I agree that the long-term implications of the various rescue packages is inflationary. To answer your family and colleagues first; the TED and OIS spreads fell further today as they continue to retrace the impressive moves from mid-August.

TIPS were selling at negative yields by mid-March, such was the panic about the inflationary pressures building in the global economy. However, since then, deflationary pressures have taken centre stage particularly since the bankruptcy of Lehman Brothers.

[10yr TIPS](#) yields bottomed in March and have since retraced their entire decline. The most recent part of the move has seen a stiff acceleration which has seen the instrument broke upwards to new recovery highs. The [spread](#) of Treasuries over TIPS hasn't been this tight since 1998 and even then did not spend much time at these levels.

TIPS are very oversold relative to Treasuries so a short-term rally seems quite likely. The possibility remains that they may post further lows if economies deteriorate further or we see another wave of bankruptcies. However, if their performance during the last inflation scare is anything to go; they should outperform Treasuries as new inflationary fears mount.

The iShares Lehman US [TIPS](#) Fund hit a low below 85 on an intraday basis but was unable to hold it and has since rallied well. A sustained move below 91 would not be needed to question scope for some further higher to lateral ranging.

Email of the day (3) - on the NYSE Advance / Decline Line:

"Is it possible to display the NYSE advance/decline line graph and display it on the same page with the DJI on a continuous basis. If so how do I do it and make it a favorite?"

My comment - Thank you for an interesting question. You can create the chart you want using the Charting Tool. First select the Dow and hit the Charting tab. Then click on 'Other Relative' tab which can be found in green below the Ratio dropdown. Use the embedded Search to find the Cumulative NYSE Advance Decline Line. Next select 'overlay' from the ratio dropdown menu. Next choose the Period and Sample you require. In the aquamarine bar at the top of the popup window click on Save. Give your Preset a name and hit OK. Next Apply at the Bottom of the popup window. Refresh the page.

This procedure will have save a Preset template to the list on your Chart options which can be accessed through the dropdown in the upper right hand portion of the page. Every time you wish to look at this overlay simply choose the Dow and select the Preset from the Chart menu. Here is a link to the [Help Pages](#).

I'm afraid this Preset cannot be added to your Favourites without applying the overlay to everything in there at the same time. With this in mind, I created the permanent [overlay](#) of the Dow and NYSE Cumulative Advance / Decline line and it can be found in the Spreads and Overlays section. To add it to your Favourites all your need do is click on the green cross next to the title.

Email of the day (4) - [on historical data](#):

"I subscribed to Fullermoney thanks to the highest recommendation from a very good friend. I am not disappointed, it is exactly the type of service I was looking for. My thanks to both David and Eoin for the great service.

"Your service provides good charts, but is it at all possible to get historical data? If not from Fullermoney, then your recommendation on a good, preferable free source would also help."

My comment - [Thank you for this relevant question](#). I'm afraid that our licence agreement with Bloomberg precludes us from reselling their data so we cannot provide you with back history. I don't know of another service that is not bound such regulations but subscribers might have some further insight.

Email of the day (5) - [on additions to the Chart Library](#):

"Good day gentlemen would you add the following two UK authorised funds to the chart library please:

Fidelity Funds Global [Telecommunications](#) A GBP shares (FITSC) - current price 0.15 Henderson Global [Technology](#) Acc Fund (TRGLTE) - current price 321.30.

"Thanks and regards"

[And](#)

"May I request you to kindly add the [Biotech](#) HOLDRS ETF, quoted on AMEX, to our chart library?"

[And](#)

"Good morning gentlemen (another request) would you please add the following UK authorised F.I. / Bond Funds to the chart library please (the last one is a Pension Fund):

"Invesco Perpetual [Monthly](#) Income Plus Inc (PPIPA) - last price 77.25 M&G [Corporate Bond](#) A Acc GBP (MGCBA) - last price 35.31 M&G European [High Yield](#) Bond A Inc GBP (MGIEH) - last price 28.43 M&G [Global Macro](#) Bond A Acc GBP (MGGMBA) - last price 67.10 Invesco [Sterling](#) Bond A (PPOISB) - last price 2.08 Scottish Equitable Indexed Linked [Pension](#) Fund - last price 464.38 (Bid) Thanks very much"

[And](#)

"KNM is a Malaysian stock that has been hammered recently due to foreign selling.

"The stock chart needs adjustment after a rights issue and stock split in July."

My comment - Thank you for all of these suggestions. All of these instruments have been added to the Chart Library.

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. The other searches through the rest of the Chart Library for indices, commodities, currencies bond prices and yields, ratios, spreads and overlays. You can also customise these charts and save any of them in your Favourites section. Check the Library's Help section for further details.

UK - continues to steady near 4000 and would need to sustain a move below 3500 to question scope for some additional upside.

Australia - finds support once more near 4000 and would need to sustain a move below that level to question scope for some further upside.

Brazilian Real per 1 US Dollar - The Dollar continues to retrace its advance and would need to sustain a move above R2.30 to question scope for further downside.

Last week's signups for the Free (Abbreviated) Comment of the Day - For the week of October 12th new signups, including subscribers and pre-subscribers, live in the following countries or regions: Australia, Canada, Hong Kong, India, Ireland, Japan, Malaysia, Russia, Sweden, the UK and the USA - 11 in total. In descending order, which topped the list in terms of the last week's new signups? It was the UK, India and Russia.

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 21st October 2008**

Tim Price: Diamonds amidst rubble - This is a superb letter from one of our most witty and original contributors. It is published by PFP Wealth Management and here is the opening paragraph:

It comes to something when you make a habit of watching the opening Normandy landings sequence of 'Saving Private Ryan' just to relax. Where conventional fund management theory is hugely deficient is in its almost complete absence of reference to the emotional impact of huge volatility, let alone both mark to market and realised losses. As Mike Tyson once said,

everyone has a plan until they're punched in the mouth. Though to be fair, behavioural economics addresses the cognitive and emotional factors that affect investment decisions. And there's a book on my bookshelf with the title 'Judgment under uncertainty: heuristics and biases'. But you can tell it probably wasn't written by Woody Allen.

My comment - Don't miss Tim Price's comments on 'the great hedge fund unwind' and also his thoughts on valuations.

Email of the day (1) - On USA's corporate earnings:

' "We are into the endgame" according to David Fuller. Perhaps, but, S & P earnings estimates (yes, always behind the curve) for 2009 are now under \$49.

"Depending on what multiple you'd like to apply it seems to me that we are NOT likely at the ultimate bottom yet. Tradable rally perhaps, but just apply a mid-recession generous multiple of 15 leads to the S&P 500 being at 750 more than 20% below today's value.

"Let's not even think of the unthinkable bear market bottom if these earnings estimates prove to be yet again to optimistic or the multiple compression takes us to an even lower P/E.

"Your thoughts would be appreciated."

My comment - You highlight what is now my main concern - overly optimistic earnings estimates. However that is a relief relative to what was until very recently my considerably greater concern - the growing risk of very serious policy errors by governments and their central banks (CBs) in delaying a coordinated and effective response to what is certainly the West's most serious financial crisis that I have seen.

Now that the CBs have launched their motley armada into a wide Rubicon, in what I said on Friday may feel more like the Dunkirk evacuation to embattled investors, I assume that an even more serious collapse of our financial system has been averted.

Meanwhile, there are many strands to the earnings outlook. Earnings are not Fullermoney's specialty, fortunately. In truth, we could theoretically employ an army of analysts, all beavering away at corporate earnings estimates, without solving the stock market conundrum.

The reality is that earnings are too often negotiable. In other words, companies can and do use all manner of accounting ruses, including off balance sheet items, to show us only what they want us to see. It can require a forensic accountant to make sense of what a company reports, and try doing that for all the S&P 500 companies, let alone the many thousands of shares listed in our Chart Library.

Even if historic earnings are accurately forecast on any basis other than company guidance, this does not tell us what future earnings will be. Also, if we guessed that correctly, the data would often be less important to market performance than sentiment and liquidity.

For these reasons Eoin and I stick to price charts for most of our guidance. However we remain interested in what fundamental specialists say about earnings, thus many of the reports posted on Fullermoney. We can also see the trend of GDP and reported corporate earnings, and it remains downwards.

In general terms, one does not need to be a forensic accountant to see that the financial crisis and inflation crisis have hit GDP growth hard. However most of that inflation came from commodity prices which have fallen on average by 50% or more. This will lower costs for many companies. As the freeze on credit subsidies, lower interest rates will also help with costs.

Nevertheless it may be a long road back to sustained profit growth for the S&P 500 Index companies, which were cited as a concern in the email above. Maxed out consumers are not in a position to spend at former levels. US exporters, which kept the economy just above water last year and until recently, have been hit by slower global growth and the appreciating US dollar.

For these reasons, in addition to the downtrends evident among most stock market indices, and with clear evidence of base formation development yet to emerge, I am in no hurry to invest my cash position in stock markets, despite forecasting a technical rebound following the climactic low on 10th October. Provided the recent lows continue to hold, I would not be surprised to see a rally into the New Year.

The adventurer in me wants to buy and that impulse may be right for at least a trade. However, in my cash account I am receiving a surprising 8.03% for my latest monthly rollover in New Zealand dollars. This feels comfortable, although the [GBP/NZD](#) exchange rate is still not in my favour, but it has improved recently. Therefore, I will not deploy any of this cash in stock markets just yet, even though I watch them with great interest, reasonably confident that we have seen by far the worst of this bear market.

China's Slowdown - My thanks to a reader for this [good summary](#) of China's outlook, prepared by Shane Oliver of AMP Capital Investors. Here is a brief sample:

While China is slowing significantly, it is unlikely to experience a hard landing. Given China's potential growth rate of around 8% to 10% and its need to find jobs for roughly ten million rural workers each year, a hard landing would mean growth of around 5%.

The Chinese banking system appears solid compared to those in the developed world. Loan to valuation ratios have been falling, there are limited linkages to global banks, there is no dependence on foreign capital, there is

no confidence crisis and credit availability has only been an issue to the extent that the government has restricted it.

The Chinese corporate sector is in good shape. Leverage has been falling and the level of retained earnings is high, as is the return on equity. The equity market only accounts for 15% of corporate financing.

Consumer spending is likely to remain robust. Despite the 70% slump in Chinese shares and falling house prices, consumer spending has actually accelerated recently. Chinese consumers have very high saving rates, are not very geared and only 5% of Chinese households have a significant share exposure. On top of this, the authorities have been trying to boost consumer spending via a range of policies including social security reforms, labour reforms and assistance for rural workers.

My view - I agree with most of Shane Oliver's report, which expands on Fullermoney's comments regarding China in recent months, although I suspect that demand for industrial commodities will not lag when GDP growth picks up once again.

Unlike earlier cycles, China's rapid economic growth and infrastructure demand in many other emerging markets caused demand for industrial metals to rise steadily as global GDP growth picked up in 2003, as you can see from these 10-year charts of [aluminium](#), [copper](#), [lead](#), [nickel](#), [tin](#) and [zinc](#).

Metal prices really took off as they became collectors' items for hedge funds and trackers. Similarly, disinvestment by these vehicles, plus some short selling, has played a big role in the retreat towards former bases by several of these metals. Mining capacity has increased but as industrial demand picks up once again, possibly in the second half of 2009 and almost certainly in 2010, it will not be in the miners' interests to flood the market with supply. The big firms know how to nurture an uptrend when demand is firm, and can afford to do so.

Email of the day (2) - [On the possibility of a depression](#):

"Hi David, I think it is fair to say that nearly everyone got this market wrong and it has been a disaster for the average retiree's self managed super fund, if one didn't panic initially and sell up everything early in the decline. Apparently Warren Buffett is down 15 billion and the rest of us an equivalent amount in our own portfolios. The dilemma is what one does now. The solution seems to me to hinge on one very important question. Are we now in for a world recession or a world depression? Opinion seems to be divided on this issue. By nature, I would describe myself as an optimistic realist but then, I am still holding BHP in my super fund! I have to take responsibility for my own financial decisions and I quite clearly got that wrong. If we are in for a world depression then I will cash up and sit tight. Would you be prepared to give us the benefit of your wealth of experience in the markets and give us your opinion on the likely outcome of this global financial meltdown?"

My comment - It has been tough, and frightening. Downturns of this sort tend to be expensive for all of us, one way or another.

In answer to your question, if you have not yet read Tim Price's latest letter above, I commend it to you. He is no permabull cheerleader; he mentions miners in this issue and also quotes John Hussman.

Some smart subscribers in the USA feel that the country really is sliding into a depression. I think it is certainly a tough recession and lengthy period of underperformance for the USA, but depositors are not seeing their savings wiped out by bank failures and there are social welfare nets that did not exist in the '30s.

More importantly for you, living in Australia, is regional strength due to your economy's trade with Asia. Australia's boom is over for a while but I see no reason why your economy should not flourish in the next upturn, which I suspect will be led by Asia. [BHP](#) has been subject to forced selling during this deleveraging period, as have many other quality shares. Consequently the next 2 to 4 years are easier to predict for this stock than the next 24 hours. However it represents outstanding value at today's prices and I would much rather be a buyer than a seller.

Email of the day (3) - On a subscriber's game plan:

"David...I'm a USA subscriber. Here's my game plan...I got lucky and sold POT RTP BHP close to the top. Because of a global recession (perhaps a deep one with a seasoning of deflation) I think Fuller \$ themes ( Gold, commodities, emerging mkts ) are on hold for the medium term. I'm scaling into the SPY ETF and also scaling into High Yield US debt where the spreads are huge. At present. those are the only two investments that make sense to me.

"Your thoughts?"

My comment - Well done on your share sales near the top. Check the daily Audios for my summary and outlook comments.

Most stock markets and commodities are very oversold following capitulation selling, including forced deleveraging, plus short selling. The same can be said for corporate bonds. Consequently, they may rebound around the same time, which could be soon.

Email of the day (4) - On Gaussian models suddenly not working:

"The failure of the 2 Bear Stearns hedge funds in August 2007 was the heralding of what I have long described as when things go discontinuous and happen in power curve fashion ultimately popularized by Taleb's black swans. There is nothing to prevent back to back once in ten thousand year events. Virtually all of the models being used were Gaussian, beautiful but fatally

flawed with the assumptions of reversions to means and probabilities! The world isn't linear. History is a series of insanities. The truth is the opposite of Santayana's notion as belief history repeats ultimately dooms those who believe it does! History is singular and stochastic. The failure of the Bear funds was as seminal of an event as was Nixon closing the gold window that in large part gave rise to the credit bubble. The failure of the Bear funds showed the world that everything that was perceived as "value" could no longer be assumed. The emperor was naked and events have spun out of control since as increasingly larger doses of credit backing assets started going in reverse. Everything authorities are trying to do is to attack a liquidity problem when the issue is insolvency. As always, we must keep open minds as no one knows!"

My comment - I enjoyed this, particularly: "History is a series of insanities." Our recent market experiences have reminded us that 'the impossible' can happen and occasionally does. Lest it all seems too terrifying, the method by which every one of us might have avoided serious problems is accessible to all and comparatively simple.

Many of the market collapses occurred following dramatic over extensions relative to their mean, represented by a long-term moving average such as 200-day (40-week), which I maintain is best viewed on weekly or even monthly price charts. Moreover, where multiyear uptrends ended in less dramatic fashion, prices not only broke beneath those MAs, but also stayed below them, with the MA eventually turning downwards before most of the serious damage occurred. Bear Stearns is no longer in the Library but here are a few samples:

[Lehman Brothers](#) - note the third upside failure near \$80 and downturn by the MA in July 2007. [UBS](#) - very similar to Lehman in its topping process, as was the case with most other bank shares. [Crude oil](#) - a very different pattern but note the excessive upside overextension, finally halted by a huge downward dynamic on the first week off the high. Many other commodity uptrends ended in a similar fashion.

Subscribers can use this criteria to check nearly 18,000 instruments in the Chart Library. And guess what - the next multiyear uptrends will commence with similar characteristics, shown in reverse, although the patterns may take longer to form due to fewer participants at market lows.

The human challenge is to avoid rationalising or ignoring the evidence when multiyear trends - up or down - eventually roll over. We have all done it, even when we know better, particularly when inconvenient signals do not suit our expectations or book. We do not have to repeat this mistake in future.

Please note - Comment of the Day and the Audio will be completed around 5:30pm (BST) tomorrow.

Ted-Spread - Here is the latest [update](#) - still falling which is good news.

Additional Commentary by Eoin Treacy

Russian oil company report - [Thanks to a subscriber for this interesting report by Alexander Korneev and Ildar Khaziez for Citigroup covering Russian oil companies. Here is a section:](#)

Below US\$90/bbl Brent price, Russian oils should start cutting capex - Our analysis shows that Russian oil companies would have to tap into the debt market in order to sustain upstream capex developments below a US\$90/bbl long-term Brent price. We believe only government intervention via oil MET rate cuts would be able to sustain upstream capex targets and subsequently prevent oil output decline in the country. Our analysis presented in Russian Oils: Plenty of room for further MET rate cuts, 7 September 08, shows that the 2009-11 forecasted budget surplus should allow the government to lower MET starting as early as 2009.

\$70/bbl Brent price is critical - At \$70/bbl we estimate operating cash flow of Russian oil companies would not cover the necessary capex to develop new reserves, making the oil business economically unviable. Our DCF values for most Russian oil names falls to zero at this price level. Even the Russian government would likely not be able to support the sector via lower taxes as 2010-11 budgets are balanced at cUS\$70/bbl oil price.

US\$86/bbl long-term Brent price is currently priced in - Russian oil companies are highly sensitive to oil price due to: 1) ongoing shift to green field from brown field, and 2) high tax burden. As such, we estimate that the current market prices of Russian oil companies are pricing in around an US\$86/bbl long-term Brent price. We believe Surgutneftegaz with its US\$11bn (or \$19bn including long-term investments) cash position is the least sensitive to the oil price fluctuations.

My view - Assuming that the estimates above are correct; if oil prices remain around current levels, let alone goes lower, investment in increased supply will be severely impacted. When prices for any commodity decline, producers are forced to extract their resource from the cheapest available source which is usually the best one they have. When prices rise they generally invest heavily in more expensive to produce reserves in order to ensure future continuity of supply. We are not going to run out of oil for a very long time, but the whole peak oil argument is centred on the rising cost of production. As old, cheap to produce fields are exhausted and more expensive to produce fields are brought on line, the average cost of production increases.

[Brent](#) crude remains in a consistent, although overextended downtrend and needs an upward dynamic to check momentum beyond a brief pause. As prices fall, more and more unconventional production will become uneconomical and will lead to supply being withdrawn, quite apart from what OPEC decide to do. This should help to put a floor under markets at some point, but there is no evidence of it yet.

The [Russian](#) stock market had another failed upside break in mid-May and broke the progression of higher lows in early August. It has since accelerated lower and while it is becoming increasingly overextended relative to the moving average, an upward dynamic is needed to check momentum beyond a brief pause.

Email of the day (1) - on industrial metals:

"I have attached a report by an Australian broker with Southern Cross Securities from the Eureka Report and draw your attention to the following extract. Could you please comment on these observations?

"I am hearing from my overseas sources that the climax in the recent commodity meltdown, particularly for industrial metals last week, was due to a new form of contagion from the deleveraging process. My contacts confirm that the sell-off on Friday occurred as commodity traders moved their private bilateral contracts on to commodity exchanges and clearing houses in an attempt to reduce their counterparty risk in the deepening financial crisis.

The transfer of these opaque over-the-counter deals to physical metal exchanges has resulted in massive volatility and a significant increase in volume. Martin Abbott, chief executive at the London Metal Exchange, confirmed that as traders tried to reduce their risk positions, the exchange's turnover has soared by over 45% in September compared with a year ago. As a result, the exchange has extended its forward-dated futures contracts in copper and aluminium to 10 years from five previously, in an attempt to capture more over-the-counter business.....

However, considering the extent of the deleveraging process, I guess it is not surprising to hear that a significant amount of over-the-counter trades have been operating in commodity markets. As a result, it appears the current meltdown in base metals in particular, is a clear reflection of the unwinding of counterparty risk as traders crystallise financial positions on to physical markets.

Consequently, a significant amount of the increase in new metal delivered into London Metal Exchange warehouses from the unwinding of complex over-the-counter long commodity trades by hedge funds is showing up as an increase in the exchange's official base metal inventories. I believe investors are confusing the negative impact of this process with the perception of a cataclysmic slowdown in Chinese commodity demand."

My comment - Thank you for this informative segment which, in another section, argues the bullish case for industrial metals. This is an unloved sector at present and all six metals are under pressure, though in varying stages of their corrections. The credit crisis is resulting in finance being withdrawn from a number of marginal projects. This means that projected increases in global output are unlikely to be realised in the short term. The slowdown in global GDP growth is also dampening demand for many resources which put further

pressure on the supply side. This type of activity is leading to supply being withdrawn from the market. Over time, this will help to support prices.

It is certainly possible that traders are moving their over-the-counter (OTC) contracts onto exchanges as concerns about counterparty risk persist. However, the only commodities where inventories have risen to any extent are [aluminium](#) and [nickel](#). Inventory increases for the other industrial metals: [copper](#), [zinc](#), [tin](#) and [lead](#) are far less remarkable.

Higher [aluminium](#) inventories might be a cause for some concern for those bullish of the metal. It remains in a consistent medium-term downtrend and would need to sustain a move above \$2300 to break the progression of lower rally highs and offset scope for further downside.

[Nickel](#) has fallen back to test the top of the long-term base near \$10,000. The decline looks increasingly overextended but we have yet to see evidence that it has bottomed.

Email of the day (2) - on the South African rand against the British Pound:

"Looking forward to a holiday in Cape Town and seeing the weakening of the Rand to Sterling which I assume is directly related to falls in the price of metals has the weakness peaked or is the anticipation that we could yet see higher highs as the deleveraging within commodity positions continue?"

My comment - Thank you for an interesting question. I went on my first visit to South Africa in [2001](#) when the Rand was trading at about the same level as today relative to the Pound. It was one of the best holiday's I've had, with world class diving and safaris as well as wonderful food, wine and excellent company. I'm sure you'll have a great time. It's also the right time of year to see Southern Right whales from the shore of Walker Bay near Hermanus. I would highly recommend taking a look for anyone interested in sea life.

The slowing of commodity demand may have something to do with the Rand's comparative value, but probably just as important is the South African governance situation. The possibility that a new party could be formed by disgruntled members of the ANC is one concern. Uncertainties surrounding the new prime minister are also a cause of disquiet among holders of Rand investments.

The [Pound](#) has been appreciating against the Rand since mid 2006. It consolidated its early gains between late 2006 and early 2008, when it broke upwards once more. It surged upwards on the 15th and hit a short-term peak near [R18.75](#) on the 16th. The Pound has since pulled back and found support near R17. It would need to sustain a move below this level to question scope for some additional higher to lateral ranging.

Email of the day (3) - on how to get data for financial instruments:

"This [site](#) will be of use to the Collective."

My comment - [Thank you for alerting us to this site, contributed in the spirit of Empowerment Through Knowledge.](#)

Can One Man's Actions Take \$6 Billion In Value Out Of A Minor Metal Market In A Month? - [Thanks for a subscriber for this interesting article by Jack Lifton for the ResourceInvestor.com covering a potential reason for the sharp fall in platinum and rhodium prices. Here is a section:](#)

Now we come to our present situation and story. It's now two years later and the successor to the man who sold the rhodium when he shouldn't have it is said now decided not to repeat that mistake. So he came up with a new blunder. He decided to stockpile not six-months worth of rhodium as the formerly great corporation had been doing but 18 months worth, and he proceeded to do just that. This meant that the formerly great company wound up holding or controlling by the end of the spring 2008, some 10% of the global rhodium supply. On June 15, 2008 this inventory had a nominal value of nearly \$1 billion dollars. The top financial managers of the great corporation announced that they had made a huge amount of money in futures trading even though the formerly great corporation had its worst overall quarter ever in early 2008. Perhaps the top managers even believed that since the rhodium (and platinum) inventory was now priced at all time highs for both metals they actually had 'made money.' The problem was that they needed liquidity, so it is said they instructed the hapless PGM buyer to correct his inventory to the previous standard of six months physical. He then actually went to the RSA to see if agreements could be cashed out, or unwound, or sold to another buyer with profits for both the producer and the formerly great company, or changed. The producers wouldn't do anything but stick to the original terms.

So what would you think would be the worst thing one could do in this situation? You are right. It would be to try and sell a large amount of rhodium into a declining market. The hapless, unsophisticated, unskilled-in-PGM-trading manager, it is said, offered 30,000-60,000 ounces of his 90,000 ounce rhodium inventory to the market. So he not only corrected the slight global market deficit, but also sent the market into instant surplus. The market collapsed; and the manager was transferred to another country and another job. Rather than having a rhodium inventory marked to market at \$1 billion the formerly great company now has a remaining inventory it is said worth at market a maximum of \$240 million. We are waiting for the announcement of the nearly \$700 million loss, but I don't think we will see it anytime soon. Perhaps it really never happened.

By the way I heard that the same situation occurred with the formerly great company's platinum inventory, but that inventory only lost a third of its value in the exact same time period for the same

This is a cautionary tale for small investors. If you think that someone has worked out a way for the little guy to make a play in a rare thinly traded minor metal such as rhodium please keep in mind that there is a credible story that a

Fortune 500 end user of rhodium crashed and burned. This by convincing itself that trading one commodity is just like trading another so that any member of the finance staff is up to the job managed to lose as much as a billion dollars of the shareholder's money because he and his management were way over their heads. An analogous situation actually is well known to have occurred in 2001-2 when panicked and inexperienced buyers at Ford and Toyota convinced by sophisticated advisors from a New York-based financial institution that palladium was going to go to \$3,000 an ounce entered into take-or-pay agreements for several years forward that obligated them to pay \$500-700 an ounce for palladium that never again went over \$300 an ounce during the lives of their agreements. Those deals cost Ford and Toyota each over \$1 billion in write downs.

My view - I don't know if it is true that one company botched its hedging and inventory management to such an extent that they prompted the decline seen to date. However, what the charts tell us is that there has been an extreme oversupply or lack of demand since mid-July in the [platinum](#), [palladium](#) and [rhodium](#) markets. To date platinum, palladium and rhodium has fallen 61%, 70% and 80% respectively.

All of these downtrends remain consistent but are overextended relative to their moving averages and are coming back towards areas of potential support. However, they need break the progressions of lower highs to damage the integrity of the downtrends and question scope for further downside.

Today's interesting charts - The wide number of currency crosses in the Chart Library will be of use to anyone attempting to monitor the Dollar's appreciation over the medium term.

Swiss Franc per 1 US Dollar - The Dollar broke [upwards](#) to a new recovery high today and would need to sustain a move below Chf1.13 to question scope for further upside.

Topix 2nd section - firming following the downward [acceleration](#) and would need to sustain a move below 1800 to question scope for some additional higher to lateral ranging.

Copper - testing the psychological [\\$2](#) level but would need to sustain a move above \$2.50 to question potential for a reasserting of the downtrend.

Chile - [bouncing](#) impressively from the October 10th lows and would need to sustain a move below 11,500 to question scope for further upside.

### **Wednesday 22nd October 2008**

Erwin Grandinger: Europe post-Lehman Brothers Holdings Inc.: The Price to Pay is the Renaissance of the Leviathan - [Veteran subscribers will remember Dr Grandinger's articulate and informative reports for their political insights.](#)

Published by EPM Financial Services Group, here is the opening from his latest [analysis](#):

Western European democracies will pay a high price for the 2008 credit market implosion. In fact the way they operate - politically and economically - will fundamentally change. We can already conclude this, despite the fact that the outlook remains extremely fuzzy. Even in the hectic of crashing markets everybody understands that an era has come to an end. Since 1989 Europe has been living in an asymmetric world. The political and economic central-planning systems of the Warsaw Pact member countries imploded, leaving the Western World as the sole survivor and the role model. In 1989, when the Berlin Wall came down, the United States of America had the moral and economic upper hand - and lost it. So much about cycles: cycles hit everything and everybody. There is no escape, whether it takes decades or centuries (think the Roman Empire). The Iraq war, Guantanamo, Wall Street failures and US government/Congress-supported easy credit / easy money policies (e.g. Fannie, Freddie & the Fed) will haunt the next US president and possibly generations thereafter - and the rest of the world. For decades Europe has been sitting on a mountain of government debt and abysmal demographic developments. Now, to stem the crisis, it is creating even more debt to service the existing debt and to prevent systemic collapse. In future this Ponzi scheme will take place on an even larger scale than the present credit market implosion. The European's 'roll-over-debt-scheme' will also come to an end at some point unless two factors can be put to work: demographic change and / or inflation. If not, currency reform will follow, as usual. Europe's Maastricht-induced Growth and Stability Pact was designed to keep the 'roll-over-debt-scheme' working, but not to eliminate the core of the problem: unsustainable government debt in combination with Europe's ageing demography.

Modern superpowers cannot be destroyed by military forces outside of the system (except random, unintended destruction). The Soviet Union experienced this simple logic. It imploded owing to its rotten finances and its systemic inability to allow for 'trial and error', as Nassim Nicholas Taleb so correctly points out. Government central-planning tries to completely remove 'randomness', something that is simply not possible given the nature of human beings. 'Capitalism', in all variations, is about trial and error, about greed and fear, about victory and defeat. It is therefore particularly suited to human nature. The Western European states always allowed room for excesses on the upside and tacitly used human greed as a driving force. The latter belongs to mankind like night and day to mother earth. When the (German) stock market rose fourfold from 2003-2007 not one politician complained about exuberance. Everybody took it for granted, humility was disregarded in favour of stepping up to claim responsibility and wisdom. Western European societies and political systems are scarcely able to adjust to the opposite (i.e. excesses on the downside) since failure is not an accepted part of their cultures (unlike the US/UK). The collective memory of the 1920s and 1970s is very distant. When the excess is on the upside, everybody wins, nobody complains: the Wall Streets of this world, the citizens, the politicians, the finance ministers and the welfare state protagonists. But the pendulum always (!) swings both ways - the unknown factor is time. And now the time has

come. This is the reversal to the mean. This time it is not the 200-day moving average but the 'real world', with which many bankers are probably not too well acquainted.

In Sep09 Germany will hold its next federal election. All political parties that aim to enter the German Bundestag lower house, with the one exception of the Free Democrats FDP, are now Big Government parties. There is only one grand theme: the German governments (state and Länder) should and must control everything - every sphere of life, especially every banker and every manager, every business, every welfare program, every bank account, every PC activity and every education program. Simply everything. The 'liberal' model, in the European not US sense, is dead. 'Liberal' here means laissez-faire within reason but laissez-faire is now associated with evil. In Europe, certainly in Germany, neo-liberalism and neo-conservatism are dead for the time being. It is as simple as that. Although, certainly in Germany, someone will eventually step up to fill the developing void on the political right, similar to the role played by the late Jörg Haider in Austria in the last 25 years. His right-leaning BZÖ and the competing FPÖ, also right-leaning, achieved over 30% in the Sep08 Austrian federal election, effectively killing off the apparently 'conservative' ÖVP that had become 'social-democratic' over the years. We think the Austrians are simply ahead of the cycle compared to Germany.

My view - In democracies, the electorate is usually more passionate about voting against a particular party or candidate, than for the most likely alternative. Financial and economic crises intensify this tendency, usually to remove the incumbent power.

Erwin Grandinger forecasts a shift to the left in Germany. The same tide of sentiment should also strongly favour the Democrat Party and Senator Obama in the US election on 4th November, although at times some of the polls have indicated a surprisingly close race. Similarly, the UK's recession should produce a Conservative victory in 2010, despite Prime Minister Brown's relief bounce following his latest bank rescue programme.

Email of the day - On the scramble for \$ liquidity:

"\$ is more of a credit/solvency issue as there is a scramble for \$ liquidity to pay off increasingly burdensome \$ debts. The nightmare scenario is stronger \$ and Yen with falling gold, commodities and equities! I'm thinking the template is US 1873 rather than 1929. 85 now exceeded and 95 on \$ index are both consistent with a long run \$ debacle. That said, there is too much \$ bullishness and Euro bearishness and bearishness in many commodities as we head into a key turn time!

"The post election equity rally should start between 1st Oct and the first few days of Nov."

My comment - I think your credit / solvency point has certainly become a factor as the US Dollar Index's rally ([monthly](#), [weekly](#) & [daily](#)) has persisted. Interestingly, I maintain that this move started with intervention in July, was

then fuelled with short covering including the unwinding of US\$ carry trade positions, caught a second wind from momentum buying plus deleveraging in commodity trades, followed by EM buying to cover US\$ borrowings. It will be important to identify the end of this surge. Tomorrow, I will update my previous review the US\$'s trends against a number of currencies.

I also feel that it would be unusual, even in the current circumstances, not to see a US election bounce for stock markets.

The 1873, comparison is interesting, although I am not sure what it proves other than financial excesses and panics repeat. Here is a section from the NYT [article](#) by Professor Scott Reynolds Nelson, *New York and the Panic of 1873*, dealing with the resolution:

With the credit markets frozen, at one point the overnight lending rate shot to a quarter of a percentage point, Professor Nelson said, which annualized is about 148 percent. The top national banks of New York formed a Clearing House Committee [pdf], pooling their cash and collateral into a common fund and issuing loan certificates against it that would operate like cash. This became the basis for the reconstruction of the credit markets.

Eventually, on Wall Street, the panic "had run its course, like a great fire that burned itself out" [pdf]. But it took about 40 days [pdf]. During the full course of the crisis, 73 members of the stock exchange and 5,000 mercantile companies [pdf] failed.

Even though the Wall Street panic was over, the commercial crisis across the country was just beginning because of the lingering credit crunch. Even two months later in Richmond, Va., just before Election Day, the effects of the economic crash were quite visible with shuttered tobacco companies, all-but-closed flour mills and a retail slowdown.

A number of railroads defaulted in the payment of the interest on their bonds (and railroad construction dropped from 7,000 miles in 1873 to 1,700 in 1875) [pdf]. Businesses with good credit curtailed their purchases, while those with bad credit had no buying power. The closing of cotton and iron mills and other manufacturers threw hordes of laborers into unemployment, many of them former Civil War soldiers. They became transients, and the words "tramp" and "bum" became commonplace American terms. Relief rolls grew rapidly in major cities, with 25 percent unemployment in New York City alone.

The panic was not without political consequences. The collapse of farm prices set the scene for an agrarian insurgency. Disenchanted farmers who believed that the government's mismanaged currency policy was determined by Eastern bankers and industrialists eventually formed the short-lived Populist Party, which called for a graduated income tax, pensions and nationalizing transportation and communication.

This recession hit industrial workers particularly bad. A bitter antagonism emerged between workers and the leaders of banking and manufacturing, which led to labor unrest that continued through the following decades,

resulting in some of the most violent strikes in American history. In January 1874, police violently broke up a demonstration by thousands of unemployed workers in New York's Tompkins Square Park, which was the largest demonstration in the city's history.

The financial crisis led Congress to pass a bill in 1874 that would allow for more printing of currency to spur inflation and reduce the real value of debts. In a surprise move that was viewed by many as the most important event of his administration to that point, President Grant vetoed the bill.

In early 1875, Congress passed a bill, known as the Specie Resumption Act, which would back United States currency with gold. By pegging the dollar against hard currency, the act helped curb inflation, tame speculation and produce a stable dollar. It turned the Republican Party toward a stance of conservative fiscal policies.

The American and world economy did recover - slowly, but it took more than four years of depression. A 1911 New York Times magazine article assessed the panic, observing in a perhaps overly lyrical way:

*However, as the sun always shines after rain, so conditions began to improve in 1877, and by 1878 there was a better feeling throughout the nation.*

*Confidence returned slowly, but it did return, and the tide of prosperity rose steadily until its inspiration had penetrated every city and hamlet in the country. The fertile lands of the West and South brought forth bountiful harvests, and ocean commerce expanded under the stimulus of good crops. The excess of American exports was only one of the features of this golden period in our affairs, which broke all records.*

*Stocks began their rise in spring of 1878, and in 1879, men of means awoke suddenly to the fact that railroads were of value as investments after all, and a marvelous buying of securities sprang up, which electrified the financial world and led to a boom in prices."*

My comment - Typically, optimism increases with the election of a new US President, but I do not think the country is electing a President Grant clone, in terms of monetary and fiscal policy.

Additional Commentary by Eoin Treacy

Global Emerging Markets Strategy - Thanks to a subscriber for this even-handed and well illustrated [report](#) by Jonathan Garner, Michael Wang and Vinicius P. Silva for Morgan Stanley covering the prospects for emerging markets. Here is a section:

1. Earnings based equity valuations hit all time lows on 10th October (7.8x trailing P/E and 1,100 bps equity risk premium). However, P/Book multiple (1.3x) is still some 25% above the Sep 98 trough.

2. MSCI EM on 10th October was 3.4 SDs oversold to the 200 day m.a. This was the most oversold market in the history of the asset class.
3. EM is discounting a more than 50% decline in EPS (vs -67% in 1997/8 and -18% in 2001/02). Yet EPS is still growing at 16% yoy currently (We expect +5% to 7% over next 12 months). MS economists forecast 5.5% GDP growth in EM in 2009.
4. On 13th October we upgraded to maximum overweight following our bonds/equities/cash framework. The implied potential upside to our scenario weighted target price of 980 for MSCI EM through June-2009 is 57%.
5. Positive catalysts in the near term: a) Aggressive financial sector intervention by G7 and b) lower EM inflation allowing more countries to follow China's lead in easing monetary policy.
6. EM ROE (17.0%) is holding up better than DM (13.8%). Net Debt / Market Cap is 15% (weighted) for top 60 stocks.
7. Main risks are: a) weakness in commodity prices, b) further rally in the US dollar and c) pro-cyclical fund redemptions.
8. At the regional level we are more positive on Asia vs H1. We bought back selectively in Asian Financials and Technology two months ago and reduced Energy and Telcos somewhat.

My view - The [MSCI Emerging Markets Index](#) remains in a consistent if overstretched downtrend. However, as cited above, it is more overextended relative to its long-term moving average than at any time in its history. This should provide fuel for at least a short-term, and probably medium-term, rally once the market finds support. The Index posted a new low on Friday and needs to sustain a move above 685 to break the progression of lower rally highs, which have been the hallmark of the trend to date.

The inverse [correlation](#) between a host of emerging market equity indices and the US Dollar is also of interest. As the US [Dollar Index](#) broke above 74, a wide number of emerging markets moved into steep downtrends which have left them very overextended. The Dollar is now likewise overstretched but shows no evidence just yet that it is topping out. It would need to sustain a move below 82 to question scope for further upside. The [Japanese Yen Trade Weighted Index](#) is also worthy of mention. Following the fall below 110 in [2001](#), the Index has been ranging in a long base until quite recently. It broke upwards this month and would need to sustain a move below 110 to question scope for some additional upside.

Appreciation by the Dollar and Yen are due in at least part to the closing of carry trades and liquidation of leveraged positions, perceptions that interest rate spreads will tighten and momentum trading. Investors in emerging markets from 2003 had the dual benefits of stock market performance and a weak US Dollar and Yen. Now that these currencies have moved to outperformance, investors need to keep a closer eye on currency fluctuations

when investing in emerging markets. When the Dollar and Yen top out, a significant headwind will have turned into a tailwind for stock markets generally.

Libor for Euros Declines to Lowest Level Since Lehman Collapse - [Thanks to a subscriber for this interesting article by Gavin Finch for Bloomberg covering the thawing of the interbank lending market. Here is a section:](#)

The cost of borrowing in euros for three months fell to the lowest level since before Lehman Brothers Holdings Inc. collapsed as governments stepped up efforts to boost bank balance sheets and policy makers offered cash to revive lending.

The London interbank offered rate, or Libor, that banks charge each other for such loans dropped 3 basis points to 4.96 percent today, the British Bankers' Association said. That's the lowest level since Sept. 12, the Friday before Lehman failed. The overnight dollar rate slid 23 basis points to 1.28 percent, below the Federal Reserve's target for the first time since Oct. 3.

"The initiatives that governments have taken are beginning to work," said Laurence Mutkin, the London-based head of European fixed-income strategy at Morgan Stanley. "We're seeing a lot of improvement."

Governments worldwide have introduced measures to shore up bank balance sheets after money markets seized up following the Lehman bankruptcy on Sept. 15. The French government will inject 10.5 billion euros (\$14 billion) into BNP Paribas SA, Societe Generale SA and four other domestic banks as they tap for the first time the 360 billion-euro rescue package unveiled this month.

Interbank rates have tumbled in the past week after policy makers in Europe offered lenders unlimited dollar funding. The European Central Bank and the Bank of England today made available as much U.S. currency as required. The ECB allotted \$101.93 billion of 28-day cash at a fixed rate of 2.11 percent, while U.K. policy makers loaned \$26 billion.

My view - [ECU Libor fell back to the level it traded at for much of 2008 in the last few days. This article by Candice Zachariahs and Garfield Reynolds also for Bloomberg covers the easing of lending conditions in the Asian region.](#)

The recent easing of the [TED](#) and [OIS](#) spreads is being following with commensurate moves in other regions. This is a positive for the global banking sector and suggests that concerted central bank actions are finally having an impact on the interbank market. These spreads appear to have topped out and while volatility remains high, the likelihood that they are going to set new highs is diminishing rapidly.

China Caps Bank Overhaul With \$19 Billion Agricultural Bank Aid - [This article by Luo Jun for Bloomberg covers the conclusion of China's recapitalization of its banking sector. Here is a section:](#)

Agricultural Bank of China will get \$19 billion from the government, paving the way for the lender to sell shares to the public and capping a decade-long bailout of the nation's banking industry.

Central Huijin Investment Co., a unit of China's sovereign wealth fund, will inject the cash and take a 50 percent stake, Agricultural Bank Vice President Pan Gongsheng said at a press conference in Beijing today. China's finance ministry will hold the rest, he said.

“This culminates years and hundreds of billions of dollars of backstopping of China's banking industry,” said David Liao, who helps manage \$975 million at HSBC Jintrust Fund Management Co. in Shanghai. “From now on, Chinese banks are supposed to walk on their own and the current economic downturn gives them the opportunity to prove themselves in terms of risk management and internal controls.”

The bailout will complete a reorganization of China's banking industry that's so far cost the government \$500 billion, after years of state-directed lending caused bad debts to balloon.

Unlike competitors such as Industrial & Commercial Bank of China Ltd., which sold stock when growth was booming, Agricultural Bank's overhaul comes as the global credit crunch saps demand for China's exports and equity offerings.

My view - China has successfully navigated its way through what could have been a cataclysm for its banking sector and is coming out the other end with a much more sound industry. The country has record high reserves and policy is turning towards growth. These are all positive tailwinds for the stock market once it finds a definitive bottom. Emerging market currencies have collapsed all over the world, with the notable exception of China, where the gradual appreciation has stalled. As long as the [Renminbi](#) does not accelerate lower this is also positive for inward investment.

The [Shanghai A-Share](#) market found support near 2000 in mid September, rallied well and has slowly fallen back to the test that psychological level. It needs to sustain a rally above 2500 to break the progression of lower rally highs which have been in place for the last 11 months.

Please note - I will away from the office tomorrow but will return on Friday.

Thursday 23rd October 2008

Long-term bear of equities is becoming less bearish - My thanks to a reader for this interesting [report](#) by Albert Edwards of Société Générale. Here is a section:

Both James Montier and I are agreed on one thing. In the short term, fundamentals often have very little bearing on market movements. Trending markets move in waves. In bear markets huge lurches down are often followed by significant rallies. After the recent market slump, currently investor

sentiment is pretty washed out. Bears currently outnumber bulls by some 30%. The ratio has now hit support in a bear-market downtrend (see chart below - the absent Andy and James would break my fingers if they saw me drawing support lines for sentiment indicators). An array of other technical indicators calls for a bear market bounce. At these times it often pays to be brave and disciplined even if one can't see any catalyst for a bounce.

Yet one thing has definitely changed in the bulls favour while I have been away. There is much more acceptance of how bad things are getting in the global economy. I see talk of deep recession cropping up more regularly. Recent dreadful data such as the US consumption data can scarcely get much worse. The US Chicago National Activity Index has collapsed to -2.6 in September - a level consistent with GDP contracting some 3% yoy (see chart below). In addition, I have seen increasing acceptance that emerging economies, and even China, could be headed into recession. And although this news has yet to be fully discounted by markets, at least the stench of the rotting global economic carcass now fills the nostrils of investors.

But it is in the area of valuation where the recent market slump allows us to be strategically somewhat less bearish (but let's face it, we were maximum bearish!). With equities down some 30% since the start of September, valuation levels have radically changed. Forward PEs have slumped into single digits in recent weeks, and even our preferred measures of valuation using cyclically adjusted eps look a lot cheaper too (see front cover chart).

Value investors are finding a lot more stocks worth buying. James Montier published an update of his regular deep value screen on 13 October link, and found a far larger number of stocks now pass the test. James even confessed to incipient bullishness! In addition, one of the most respected investors in the industry, Jeremy Grantham of GMO, has written recently that he can now find decent value opportunities and would become steady (not rapid) buyer at these levels. (I urge you to read his Q3 newsletter, link).

My view - There is often a long-term symmetry to forecasting results. Those who know the most about the risks behind a developing bubble do worst on the way up, but are eventually vindicated on the way down. This begs the question: Is there a practical formula that we can utilise for what is the financial equivalent of both running with the hares and hunting with the hounds? Yes, and I have discussed it before and it also features at [The Chart Seminar](#).

Ride the uptrend while it remains above an approximate mean such as the 200-day (40 week) moving average (MA) (often best seen on a weekly chart), provided the MA is also rising. Adopt a sceptical view regarding the increasingly self-justifying hype that accompanies every powerful uptrend. Listen to the bears for perspective, but let the trend guide your tactics, until one of two likely developments occurs.

The most fashionable trends will become parabolic, meaning that they accelerate way above their MAs. This indicates a buying climax and the appropriate tactic is to introduce a trailing stop (mental or actual) to protect

most of the gain, since the eventual and inevitable reaction is likely to be dramatic. If liquidity is likely to be a problem, investors with large positions may wish to lighten during the increasingly overextended acceleration phase.

Lesser uptrends will eventually lose momentum, often evidenced by a spillover into a choppy rangy phase. There may also be failed upward breaks during this period. If the trend is topping out, it will eventually break beneath its MA, which will also turn downwards. If one is still long at this stage, it is not because of the overall chart pattern, since the prior uptrend will have almost certainly lost all of its earlier consistency characteristics.

You can check out the template above at your leisure by reviewing weekly charts and their 200-day MAs in the Library. A big technical advantage is that the stronger performers will usually be the least difficult to monitor on price charts, because the supply / demand imbalance that produces big trends will also make their price action more consistent than with lesser moves.

All of the above also works on the way down. Recently, many stock markets have accelerated downwards and look overextended relative to their declining MAs. For this reason, at Fullermoney we would not be surprised to see a technical rebound before long. However, we will not have technical evidence that longer-term recoveries are underway until the 200-day MAs also turn upwards once again.

Lastly, Albert Edwards is forecasting 500 for the S&P 500 Index at some point next year. That is an extreme view, implying uncontrollable deleveraging and presumably massive bankruptcies. Consequently, I do not think it could be achieved without considerable policy errors. Fortunately, global monetary policy is now more conducive to a medium-term bottoming out and base building period for global stock markets. The biggest bulls are usually too optimistic and the biggest bears are usually too pessimistic.

**Currency review: Monitoring the USD's trends** - Another technical review of currencies seems timely because the explosive trends for the US dollar and Japanese yen since July tell us a considerable amount about what is going on in the financial world. As carry trade currencies, due to their low interest rates and weak trends prior to the reversals in July, the dollar and yen surges confirm an ongoing scramble to reduce liabilities and deleverage. Of course we also see this from the weakness of asset prices.

US Dollar Index ([monthly](#), [weekly](#) & [daily](#)) - Significantly, the US Dollar Index has pushed well above its earlier historic lows in the 78 to 80 region. However the uptrend appears temporarily overstretched once again and resistance has been encountered near 86 over the last two days. Consequently the potential for a pause and reaction is much increased. However it would require a move beneath 82 to question seriously the overall upward trend.

USD/JPY ([monthly](#), [weekly](#) & [daily](#)) - The yen has been the strongest currency in the world since July and the dollar is currently testing its March low against the Japanese currency. Some temporary steadying may be seen near current

levels but a move above Y103 would be required to suggest more enduring support.

USD/CHF ([monthly](#), [weekly](#) & [daily](#)) - The dollar has pushed above its earlier troughs in 1995/6 and 2004/5 and a slide beneath SF1.113 would be required to question current scope for further strength towards the next region of potential resistance near SF1.2

EUR/USD ([monthly](#), [weekly](#) & [daily](#)) - The euro's plunge is at least temporarily overextended and the former trading range is likely to cushion downside scope before long. However a move above \$1.35 would be required to question further the overall downward trend.

GBP/USD ([monthly](#), [weekly](#) & [daily](#)) - Sterling also looks overextended but a move above \$1.73 would be required to suggest more than a technical rally within the downtrend.

EUR/GBP ([monthly](#), [weekly](#) & [daily](#)) - The euro has experienced a ranging mean reversion consolidation against sterling since April. Within this pattern, small breaks beneath £0.78 have not been maintained and a move beneath £0.769 is now required to offset current scope for at least a test of the upper boundary.

USD/CNY ([monthly](#), [weekly](#) & [daily](#)) - The dollar had steadied in a reversion to the mean (200-day MA) against the renminbi and a downward break would be required to signal renewed weakness for the greenback.

AUD/USD ([monthly](#), [weekly](#) & [daily](#)) - The Australian dollar has had one of the biggest falls against the US currency but has ranged for most of this month, unwinding some of the oversold condition. A sustained move above US\$0.725 is required to confirm that a significant low has been established.

NZD/USD ([monthly](#), [weekly](#) & [daily](#)) - Similarly, the New Zealand dollar has been correcting a short-term oversold condition but is now retesting its lows. Consequently a sustained push above US\$0.636 is needed to confirm a significant low near current levels.

GBP/NZD ([monthly](#), [weekly](#) & [daily](#)) - The pound fell back sharply following its spike above NZ\$3.00 earlier this month but has steadied near NZ\$2.70. A move beneath this level is required to indicate a further test of underlying trading.

New Zealand [Cuts](#) Key Rate By 100 Basis Points to 6.5% - Rates are coming down in most countries but this is a big reduction by the Reserve Bank. I mention this because a few subscribers followed my move from sterling into NZ\$ last year. My monthly rollover last week went through at a surprising 8.03% as banks are forced to pay up for cash. However I will be fortunate to receive more than 6.5% on the next rollover and it will be less if the credit crisis eases. Meanwhile, my average return of approximately 8.25% has been eroded somewhat by sterling's small appreciation versus the NZ\$.

Nevertheless I will hold on to this position for a while longer, for the compounding return during uncertain times and because I also expect UK rates to move lower.

The Curse of the Value Manager - My thanks to a subscriber for this interesting [report](#) from the venerable Jeremy Grantham of GMO. Here is a candid section:

We at GMO have a strong value bias, and our curse, therefore, like all value managers, is being too early. In 1998 we saw horribly overpriced stocks that at 21 times earnings equaled the two previous great bubbles of 1929 and 1965. Seeing this new "peak," we were sellers far, far too early, only to watch it go to 35 times earnings! And as it went up, so many of our clients went with it, reminding us that career risk is really the only other thing that matters. The other side of the coin is that only sleepy value managers buy brilliantly cheap stocks: industrious, wide-awake value managers buy them when they are merely very nicely cheap, and suffer badly when they become - as they sometimes do - spectacularly cheap. I said as far back as 1999, while suffering from selling too soon, that my next big mistake would be buying too soon. This probably sounded ridiculous for someone who was regarded as a perma bear, but I meant it. With 14 years of an overpriced S&P, one feels like a perma bear just as I felt like a perma bull at the end of 13 years of underpriced markets from 1973-86. But that was long ago. Well, surprisingly, here we are again. Finally! On October 10th we can say that, with the S&P at 900, stocks are cheap in the U.S. and cheaper still overseas. We will therefore be steady buyers at these prices. Not necessarily rapid buyers, in fact probably not, but steady buyers. But we have no illusions. Timing is difficult and is apparently not usually our skill set, although we got desperately and atypically lucky moving rapidly to underweight in emerging equities three months ago. That aside, we play the numbers. And we recognize the real possibilities of severe and typical overruns. We also recognize that the current crisis comes with possibly unique dangers of a global meltdown. We recognize, in short, that we are very probably buying too soon. Caveat emptor.

My view - Jeremy Grantham's highly educative reports are extremely useful for all students of the markets. This one starts with a review of the problems, including failures of governance, discusses post bubble developments in an historic context, and has some non consensus views on China.

Following the current bear trend, as delineated by the performance of stock market indices, a concern of mine is that we may actually be in the generational long period of valuation contraction that I often mentioned earlier in the decade. We last saw this from mid-1960s, leading to the grinding bear market in 1973 and particularly 1974. A strong rebound followed in 1975 but the [Dow](#) could not rally above its glass ceiling near 1025 until 1982, when the next great bull market occurred.

If that were the case, and I only mention it as a possibility, then we could be over halfway through the next decade before the Dow and [S&P500 Index](#)

reach new all-time highs. We can envisage this possibility on fundamental grounds. Today, of course, most investors would be thrilled for another sniff at the highs by Wall Street in the next few years.

Once this bear market has clearly ended, a broadly rangebound Wall Street would not be a negative influence on the next big thing. In the 1970s, [Japan](#) was the most important emerging market story. It produced a powerful and fundamentally driven bull market, which eventually morphed into one of the history's biggest bubbles.

If any country can produce a similar growth story and stock market performance, most of us would nominate China as the leading candidate, although possibly rivalled by India. However Japan was the emerging manufacturing powerhouse in the 1970s and 1980s, just as China is today.

Jeremy Grantham is a dissenting voice and you will find his assessment on page 7 of his latest report. Here is the opening paragraph:

I suggested last quarter that it was ridiculous to expect great financial and economic skills from the Chinese government, which is faced with the spectacularly complicated task of maintaining the highest economic growth rate in history. "Surely they will stumble," I said. Well, the more I think about it, the more likely it seems that this is both the most likely and most dangerous disappointment (even shock) that awaits the current consensus.

All governments stumble from time to time but China's economic performance has certainly been impressive to date, including reining in their bubble without creating a slump. Although that risk may still exist, given the global economic slowdown, which I suspect will end sometime next year.

Based on the evidence so far, China's present cadre of authoritarian capitalist rulers are very smart. They are also highly trained, both at home and abroad, unlike some of our political leaders who are chosen during popularity contests. Nevertheless we live in challenging and uncertain times, so it may be prudent to wait for the price charts to show us which stock markets will be the next big leaders.

Please note - Eoin is away today.

### **Friday 24th October 2008**

King's speech has set back stability, but the sentiment was right - [Here is the opening from an interesting article](#) by Damian Reece of The Telegraph:

As policy tools go, speeches can be pretty blunt instruments. That's never stopped members of the Bank of England's Monetary Policy Committee, which this year have kept up a torrent of speaking engagements to give their interest rate decisions some context. But most have been dull if worthy.

However, Tuesday's speech in Leeds by Bank Governor Mervyn King was a

humdinger, helping sterling to fall the most in 16 years against the dollar. King, like Gordon Brown yesterday, admitted to the existence of recession, so finally catching up with the rest of us. But King's speech also signalled that he thought sterling was too high, especially as the foreign capital we'd been importing to fund our debt-fuelled spending binge was no longer required. The currency certainly reacted to this reminder, probably over-reacted. But a cheaper currency certainly helps stimulate at least parts of the economy and does the job of one of King's interest rate cuts.

However, such a large and sudden fall in sterling can be extremely damaging, especially if you're an importer, buying in dollars and selling in pounds. Many retailers, particularly in clothing, find themselves in this situation, so yesterday's King-inspired lurch down in sterling was extremely unhelpful. The fall will simply squeeze margins, bring on losses and force even more job cuts and a further step down in economic activity.

King wanted Tuesday to mark the start of the "long march back to boredom and stability". Instead it set the start of that journey back. But at least his sentiment was right and it was a message the banks, and government, would do well to heed.

GSK strategy should reassure us all

One company able to show the benefits of a falling pound to its shareholders, just a few hours after King's speech, was GlaxoSmithKline. But GSK was interesting yesterday for more than just the earnings boost from a weak pound and strong dollar.

Since meltdown Monday on September 16, we've had the peak of the credit crisis, a banking crisis and the official realisation of recession. It's been a busy old time. But in all this noise the voice of business has been lost. A refreshing sound yesterday was Andrew Witty, GSK chief executive. He runs one of those many global businesses caught in the global downturn whose success, or failure, will help dictate the pace of recovery both in the real economy and the stock market.

My view - In the midst of financial shock and awe, competitive devaluation has gone from an occasional consideration to a priority. Countries scrambling for a shrinking export market hope to secure a competitive currency advantage. They will not fret if most non essential imports cost more, benefiting local producers where possible, and perhaps encouraging people to reduce debt and save more.

With deflationary ice ascendant, central banks will not have to worry about inflationary fire over the next year or two.

They are cutting rates and pumping in vast amounts of liquidity. People will look at the markets and the commercial banks reluctance to lend, and they will repeat: 'It isn't working.' So, central banks will continue to cut rates and throw money into a temporarily illiquid system.

This will work, eventually and in a manner of speaking, because having crossed their policy Rubicon, governments and their central banks are moving ahead of the curve in their determination not to repeat the USA's policy errors of the 1930s or Japan's of the 1990s. However it will not prevent difficult economic conditions for many countries, and a probable worldwide recession defined by the IMF as GDP growth of 3% or less.

The comments by Andrew Witty of GSK are interesting and make sense to me, particularly this portion:

I don't know when this gruesome economic period will end but I do know what signs of recovery I look for. An increase in merger and acquisition activity is one of them as the strong devour the weak, or at least pick up quality at bargain prices.

The eventual return of commercially driven M&A activity (rather than the shotgun banking weddings that we have seen to date) will be a sign of recovery. Recessions are extremely unpleasant for those most affected and this one looks more damaging than most, but I maintain that the more successful companies will re-emerge with even better long-term prospects.

[GSK](#) may be among them, although I find pharmaceutical companies difficult to fathom. [BHP](#) and [Rio](#) are also mentioned in the article above. They will suffer profit downturns just like everyone else. However this has been more than discounted by the stock market slump and the big miners will be able to acquire more valuable resources in the ground at reasonable prices. Their operating costs will also be lower as the next upturn commences. I am very likely to increase my investment in this sector as some point.

Email of the day (1) - [On Jeremy Grantham's comments](#):

I have gladly renewed my FullerMoney subscription for a third time, taking advantage of the generous discount.

"I note that you believe that the stock markets will be significantly higher two or three years from now. Jeremy Grantham who played his cards superbly going into this financial crisis believes that the lows will come in sometime between now and 2010. He points out (in his October 17th letter) that after 20 years equities have only now come down to their long term trend (2% real return rate) and that past bear markets have always over-corrected (on three occasions by more than 50% below the trend line). This time he says a cautious investor should be prepared for a 20% overcorrection. Most investors (and he includes himself in this category) will make the mistake of buying too soon. My question to David is, for your current investments, will you continue a buy-and-hold strategy or will you lighten-up once you ascertain the next relief rally is over in the hope of avoiding a deeper correction?"

"By the way both Jeremy Grantham and Christopher Wood believe that the economic downturn in China will be much greater than anticipated. The unknowns are 1) how much of this is already discounted in the markets and 2)

what stimulatory economic measures the government will take in the coming months. I guess the charts will tell.

"Also, could you please include the (Donald) Coxe Commodity Strategy Fund listed on the Toronto Stock Exchange in the Chart Library."

My comment - Many thanks for your continued interest in Fullermoney, and also for your emails which are always of general interest.

I have great respect for Jeremy Grantham and subscribers will find a link to his fine report in yesterday's Comment of the Day. There is an important question as to whether stock markets bottom in this cycle against the background of reasonably attractive valuations, which by many measures we see today, not least for emerging markets, or whether global problems are so dire that shares fall to extreme undervaluations.

Until we know with hindsight that stock markets have bottomed, there is a risk of a downside overshoot, given the severity of the credit, deleveraging and insolvency crises that we discuss daily. Technically, 1974 was an index overshoot, but US valuations did not reach their nadir until 2Q 1982, when the S&P 500 Index yielded 6.21%, as I have mentioned before (*see also historic charts posted yesterday in the Grantham item*).

Regarding your question concerning my personal positions, I would certainly hope to sell any trading positions that I may have following a relief rally. However I personally would be less likely to sell my long-term unleveraged SIPPs and ISA positions, but it might depend on the extent of that rally and whether or not I had added to any of them beforehand.

I too maintain that China's economic downturn will be greater than generally anticipated, but much of that may now be priced into the market.

Donald Coxe's Commodity Strategy [Fund](#) is already in the Library. To see it again, just type - Coxe - in the first Library, not the International Equity Library.

An impossible crash brought Keynes back to life - [Here is the opening from a topical article](#) by Lord Skidelsky, writing for The Times:

When Alistair Darling said that "much of what Keynes wrote still makes sense", anyone under 40 might well have asked: "And who on earth is Keynes"?

When I first started writing about him in the early 1970s, John Maynard Keynes was a name to conjure with - not in the league of Led Zeppelin, to be sure, but certainly familiar to the mythical educated layman. Economic policy was "Keynesian" - that is, governments aimed to keep unemployment below the "magic" figure of one million, as they had for the previous 30 years, by expanding public spending or cutting taxes.

Then Keynesian policy suddenly became obsolete and the theory that backed

it was consigned to history's dustbin. He might have been a great economist, right for his times - the Great Depression of the 1930s - but he had nothing to offer the modern world, and moreover was responsible for the "stagflation" of the 1970s. In her assault on inflation, Margaret Thatcher put the Keynesian engines into reverse and created three million unemployed. Keynes seemed as dead as the dodo.

In fact, while dead to the public, Keynes lived a ghostly half-life in the corridors of the Bank of England and the Treasury. In setting interest rates, the Bank continued to pay attention to what was happening to output, the amount of economic activity, as well as inflation - although the inflation rate was its only "target". Gordon Brown's fiscal rules allowed for the influence of the "automatic stabilisers": the movement of the budget into deficit or surplus as the economy slowed or speeded up.

But basically the authorities relied on "managing expectations", by the gentlest adjustments to interest rates, to keep us in perpetual non-inflationary boom; we lived in a world from which inflations and depressions had been banished, and for which Keynes was no longer needed.

For ten years the new formula worked. We were blessed with what Mervyn King, the Governor of the Bank of England, called a "nice" environment - a combination of strong growth in the US and Far East and the downward pressure on prices of a competitive globalising economy. More fundamentally, Keynesian economics was rejected by most of the economic profession as having caused inflation in the 1970s.

The main prescription of the "new" classical economics was to minimise the role of government and let markets do their job. It rested on an assumption that if economic agents are rational - the key assumption on which the claim of economics to be a science is based - the market system accurately prices all trades at each moment in time. If this is so, boom-bust cycles must be caused by outside "shocks" - wars, revolutions, above all political interference with the delicate adjustment mechanisms of the "invisible hand" of the market.

But this view has been blown sky-high by the present crisis. For this crisis was generated by the market system itself, not some outside "shock"; moreover, within a system that had been extensively deregulated in line with mainstream teaching. The automatically self-correcting market system to which the economics profession has mostly paid homage has been shown to be violently unstable. And this is exactly how Keynes expected it to behave.

My comment - [To quote Richard Nixon's statement in 1971: "We are all Keynesians now."](#)

Mike Lenhoff: [Revisiting the Portfolio Builder - My thanks to Tony Smith of Brewin Dolphin for this informative report by his colleague. Here is a brief sample:](#)

If their adjustment is anything to go by, equity markets are now discounting an earnings recession at least on a par with that of the early 1980s. And that was bad - worse even than the early 1990s recession!

The prevailing pressures are already disinflationary and will be compounded as profitability suffers and jobs go. The risk that asset price deflation in the financial markets and in the housing market extends to goods and services raises the sense of urgency in bringing interest rates down. Thus, in re-thinking the view, my expectation is that UK Bank Rate will fall to around 2.5 percent by this time next year.

As the chart above shows, historic p/e ratios for world equity markets are back to levels last seen in the early 1980s. The shorter series in the chart, which is all that is available, also shows that the current prospective p/e ratio is as low as it has ever been.

My view - I agree with Mike Lenhoff's outlook for UK interest rates and maintain that they will also decline significantly in most other countries. This will increase the appeal of high-yielding equities and corporate bonds. Opinions inevitably vary as to the timing of new investments but this need not deter us from thinking about potential candidates. I would welcome further reports on equity selection over the next few months, as they could be useful for the Collective.

Email of the day (2) - [On assessing a once-in-a-lifetime situation:](#)

"Thank goodness for a forum such as Fullermoney and the input from subscribers in turbulent times. In that spirit, I would be much more confident to invest according to chart patterns if this were a typical bear market. In the "typical" case, central banks lower rates and pump liquidity into markets, and in short order markets resume their up-trends, followed by an economic recovery, a la 1973-4, 1987-8 and 2002-3. The chart action in such typical bear markets or corrections repeats itself with some regularity.

"Now we have central banks taking unprecedented and experimental steps to restart the entire world's banking/investing mechanisms. The amounts of liquidity are so staggering as to defy comparison to previous central bank interventions. There seems no way to put odds on the outcome of this once-in-a-lifetime situation, not even comparable to 1873, 1929-32 or other great melt downs, which occurred under different conditions and with different responses. Is it really "not" different this time? Can we be comfortable estimating the odds of an oncoming recession, depression, inflation, or stagflation, each of which calls for a completely different investing strategy?

"It seems that the markets are appropriate for short-term trading only, not investing, Mr. Buffet notwithstanding.

My comment - [Thanks for your own contributions to the Collective's discussions and for raising questions relevant to all of us.](#)

Extreme market moves are often humbling in that they exceed our expectations and also the boundaries of our experience. Consequently one feels deskilled and overwhelmed. At such times, simple yet practical and disciplined strategies can work best. For instance, it is costly to ignore the market trend - up or down.

In big bull markets we have an opportunity cost if we jump out too soon, and we can lose all our profits if we stay in too long. With hindsight, on examining the price chart for any previous bull trend of consequence, and also its eventual end, the entry and exit points in terms of significant momentum changes are usually apparent, even to the less experienced observer. Consequently, our errors in tactics are usually the consequence of our hopes and expectations, rather than market action.

It is easy to underestimate the more severe bear markets because there are many more examples of lesser downturns. Once the enormity of the big downtrend's fundamental causes are fully in the public domain, one can be forgiven for thinking that markets will never recover. Despondency is a characteristic of late stage bear markets.

As the current bear has claimed each market victim, occasional rallies from temporarily oversold conditions have not broken the overall downtrend, most easily seen with a trend-smoothing mean such as the 200-day (40-week) moving average (MA).

I agree that the credit and insolvency problems exceed our personal experience, as does the response, current and pending, from governments and their central banks. However unless we think that stock markets will never recover - I feel certain that they will eventually recover - the technical evidence should look similar to upside down mirror images of the top formations. In other words, the Type-1,2 and 3 bottom formation patterns, which you and many other veteran subscribers will recall from TCS and also illustrated examples in Comment of the Day over the years.

Currently, we see plenty of overstretched Type-1 accelerated downtrends. These should lead to technical rebounds before long. Thereafter, I suspect stock markets will experience pullbacks and right-hand extension base formation development, some of which may be lengthy. We will have confirmation that the next bull market is underway when stock market indices are trending higher above rising 200-day MAs.

Friday evening humour - My thanks to my daughter Laurel for this item. You may have seen this before, as it makes the rounds from time to time, usually with a different title and last line. If you have not seen it, a little light relief never hurts.

How the bailout works...

Young Chuck moved to Texas and bought a Donkey from a farmer for \$100. The farmer agreed to deliver the Donkey the next day.

The next day the farmer drove up and said, 'Sorry son, but I have some bad news, the donkey died.'

Chuck replied, 'Well, then just give me my money back.'

The farmer said, 'Can't do that. I went and spent it already.'

Chuck said, 'Ok, then, just bring me the dead donkey.'

The farmer asked, 'What ya gonna do with him?'

Chuck said, 'I'm going to raffle him off.'

The farmer said, 'You can't raffle off a dead donkey!'

Chuck said, 'Sure I can Watch me. I just won't tell anybody he's dead.'

A month later, the farmer met up with Chuck and asked, 'What happened with that dead donkey?'

Chuck said, 'I raffled him off. I sold 500 tickets at two dollars a piece and made \$998.'

The farmer said, 'Didn't anyone complain?'

Chuck said, 'Just the guy who won. So I gave him his two dollars back.'

Chuck now leads the US bank bailout team.

Quote of the week - [On the brain](#):

"Brain: an apparatus with which we think we think."  
Ambrose Bierce

Additional Commentary by Eoin Treacy

Email of the day (1) - [on commercial property contracts](#):

"I am concerned about the impact of recession on commercial property values and wondered if I might prevail on Eoin to use his considerable charting skills to produce charts of UK commercial property covering as many previous recessions as possible.

"I seem to recall that - unlike residential - commercial property came through 1990/92 virtually unscathed, but that was a pretty shallow recession and a peek at the 1970s and early 80s would be more instructive.

"If the same could be done for the US market and/or any other major market, that would be even better. But I am probably pushing my luck here.

"Thank you for a great service. Having been a subscriber since 1987 (with a short break in 1994), I have so far been one of the silent majority, but my length of membership speaks volumes and one day I might even write an essay about Fullermoney through the ages."

My comment - [Thank you for this inspiring email and interesting question. I found a number of commercial property indices on Bloomberg and have so far added those for the UK and USA. Commercial property prices are not immune from falling during a recession but should be less volatile than residential prices.](#)

At the Galway International Oyster Festival Ball last month, one of the people at our table was a well-to-do lawyer from Birmingham who mentioned that he had a number of clients involved in commercial property. They had leased their properties out on 25-year contracts and were not overly concerned with the prospect of a slowdown. Of course the risk is that one's tenants can go out of business if the credit squeeze and recession force them into an untenable situation.

Interestingly, the person on my other side owned a plastic moulding company in Yorkshire. He said that they continued to do very well as their main customers were from the mining industry. He expected things to slow significantly in the coming years because he was of the opinion that Chinese demand would slow down.

The CB Richard Ellis Rent Index for Commercial Property [All Levels](#) hit an important peak in 1990 and dropped 25% over the subsequent three years. From the 1993 lows, it advanced considerably and levelled out from November last year having almost doubled. In [inflation adjusted](#) terms, the 14-year rally only succeeded in challenging the 1990 highs in 2007 and has begun to pullback. It needs to sustain a move above 1.8 to question scope for some further retracement of these gains. Considering that this dataset was last updated on June 30th, conditions may have deteriorated since then. I have asked Bloomberg to update the Index.

The S&P/GRS Commercial Real Estate National [Composite](#) Index rallied impressively from 1994 before losing momentum from August last year. It needs to sustain a move above 155 to reaffirm this uptrend. In [inflation-adjusted](#) terms, the Index has already turned down and would need to sustain a move above 0.7 to question scope for downside.

Email of the day (2) - on important spreads:

"Is there a chart of long-term vs short-term interest rates in the UK or is the TED spread a valid proxy indicator?"

My comment - Thank you for this interesting question. The difference between long-term rates and short-term rates is a way of looking at whether the [yield curve](#) is inverted or not. Generally, an inverted yield curve is considered a drag on growth and can often be a lead indicator for a recession. Also see Comment of the Day on [August 5th](#) and [August 12th](#)) Right now, the UK yield curve is approaching parity once more.

The [UK equivalent](#) of the TED spread would be 3-month £ LIBOR - 3-month UK Treasury Bills. However, the Treasury Bill rate is no longer supported by Bloomberg. The last instance is on October 6th. They say they are actively looking for another price provider.

The [TED](#) and [OIS](#) spreads peaked on the 10th but nudged up somewhat today, they need to go back below 100 basis points, and stay there, to indicate a return to normal conditions

Gold Climbs in N.Y. as Investors Seek Haven >From Falling Shares - [This article by Pham-Duy Nguyen for Bloomberg covers today's activity in the gold market. Here it is in full:](#)

Gold climbed in New York, erasing earlier losses, as equities tumbled worldwide, boosting demand for the precious metal as a safe harbor. Silver fell.

U.S. Treasuries rose as investors bought government securities amid a worldwide collapse in shares. The dollar climbed as much as 1.9 percent against a weighted basket of six major currencies before paring gains.

“You're seeing some people buy gold because the panic about the stock market is setting in,” said Leonard Kaplan, president of Prospector Asset Management in Evanston, Illinois.

“Gold's rallied more than \$30 off its lows for the day.”

Gold futures for December delivery gained \$21.20, or 3 percent, to \$735.90 an ounce at 12:59 p.m. on the Comex division of the New York Mercantile Exchange. The metal is still down 6.6 percent this week.

Silver for December delivery fell 8.5 cents, or 0.9 percent, to \$9.30 an ounce. Before today, the metal dropped 36 percent in 2008 after seven straight annual gains.

The MSCI World Index of 23 developed markets has dropped 8.8 percent this week. Russia's Micex Stock Exchange stopped trading until Oct. 28 after shares slumped 14 percent. The Standard & Poor's 500 Index lost as much as 6.1 percent and the Dow Jones Industrial Average fell as much as 5.8 percent.

The euro touched \$1.2497 today, a two-year low before paring losses. It reached a record \$1.6038 on July 15.

Earlier, gold dropped as much as 4.7 percent and was headed for the biggest weekly decline since Jan. 25, 1980.

“People are short covering,” said Joel Crane, metals strategist for Deutsche Bank AG in New York. “Some funds are forced to cover their positions after this week's unexpected drop.”

#### Crisis Spurred Gold

After the collapse of Lehman Brothers Holdings Inc. on Sept. 15 triggered a \$700 billion bailout package by the U.S. government, gold traded as high as \$936.30 on Oct. 10 as investors sought a haven. The metal also touched \$681 today as investors sold futures to cover losses in other markets.

“The market wants to liquidate everything, everywhere,” said Dennis Gartman, an economist and editor of the Suffolk, Virginia-based Gartman

Letter.

Investment in the SPDR Gold Trust, the biggest exchange-traded fund backed by bullion, fell to 747.1 metric tons yesterday. It reached a record 770.6 tons on Oct. 10.

Gold may fare better than other commodities as a global slowdown reduces demand for raw materials. The Reuters/Jefferies CRB Index of 19 commodities is down 28 percent this year, paced by a 32 percent decline in crude oil. Gold has lost 12 percent.

“There's some value going into the metal,” said Frank McGhee, head dealer at Integrated Brokerage Services LLC in Chicago. “Gold's overall value is holding. Investors should be safe-haven buying here but not using leveraged money. Gold can scream out and turn higher any time, but investors need to be comfortable that gold can go down before it goes higher.”

Gold may trade at \$600 to adjust for the value of the dollar, analysts at Deutsche Bank said today in a report.

My view - [Gold](#) encountered resistance near \$900 earlier this month. This area also coincided with the 200-day moving average. This was the third lower high in gold's medium-term downtrend. It posted another lower low this week as it broke below \$750. (Also see Comment of the Day on [October 9th.](#))

Today, gold posted a new reaction [low](#) near \$682 but rallied well from that level and would need to sustain a move below that area to question scope for some additional short-term upside. Also of note is that it found support at least short-term support when denominated in [Euros](#), [British Pounds](#), [Swiss Franc](#), [Australian Dollars](#) and [Canadian Dollars](#) among others. It would need to take out these lows on a sustained basis to question scope for some additional upside.

Email of the day (3) - on agriculture companies:

"All the agricultural products stocks such as Potash, Agrium etc are down significantly. It seems that food demand will not decrease because of credit crisis or recession. Do you think they would be a good buy at this time?

" Also are there any mutual or closed end funds that are concentrated in these stocks."

My comment - Thank you for an interesting question. [Potash](#) is a relatively rare resource and [companies](#) with access to it are probably in a better competitive advantage over the long term. You are correct that agriculture company prices have fallen considerably over the last few months and have become overextended relative to their moving averages. They are certainly more interesting at these prices but it depends on whether or not you want to buy before there is evidence of a base formation

However, it would be rash not to expect demand to fall during a global recession. As energy prices fall, the production of nitrogen based fertilisers become cheaper and adds an element of competition which was less apparent earlier this year.

There are a number of funds and ETFs focusing on this sector. The [iPath DJ-AIG Agriculture ETN](#) is one example but others can be found in the [Chart Library](#).

Email of the day (4) - [on industrial metals](#).

"Industrial metals are approaching levels that traded, in some cases, 20 twenty years ago, unadjusted. Is the commodity super cycle over after four years? The bubble view now seems the correct one..."

My comment - Thank you for an interesting question. We have said on a number of occasions over the last 6-years, that the only thing which could derail the secular bull in commodities is a global recession. This is now in play so industrial resource prices have been under considerable pressure.

Industrial metals have fallen sharply as each successively hit an accelerated peak. Throughout their advance, there were those who questioned the ability of metals to make new highs and to sustain breaks above their long-term bases. These views have come back into fashion as prices fall.

Most metals broke upwards sometime in 2003 and so far only [zinc](#) has fallen back into its base. The prospect of a global recession has led to demand destruction at the same time that mines have increased production. Marginal supply being withdrawn should eventually help to put a floor under markets. However, the shape of any recovery will be easier to predict once it is clear where these metals find support. As long as the credit crisis continues, raising capital for new infrastructure projects may be more difficult, but it is undeniable that the need for these new developments remains as strong as at any time in the last decade.

Email of the day (5) - [on the Baltic Dry Index](#):

"The Baltic dry index is down nearly to long term support levels. Do you think that this is now the main index to watch?"

My comment - I believe that this [Index](#) is a poor lead indicator of future global economic activity. For example, it hit a new high in May when the US economy had already slowed considerably and the seeds of the current malaise had already been sown. However, what we can see from this chart is that the cost of shipping has fallen back to the long-term average price which should provide no barrier to the shipping of commodities around the world recession aside.

Email of the day (6&7) - [on additions for the Chart Library](#):

"I wonder if you can obtain the chart for the Street TRACKS S&P/ASX 200 Fund ([STW](#) is the code on the Australian exchange). It is an investment fund that tracks the S&P/ASX 200 Accumulation Index.

"If it can be added to the chart library I would be most grateful."

And

"Any chance of adding the [Jupiter India Fund](#) to the chart library?"

My comment - [Thank you for these interesting suggestions which have both been added to the Chart Library.](#)

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