

# 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 24th November 2008

Tim Price: The politics of NAV - [Here is another interesting report on human frailty and bubbles, published by PFP Wealth Management. It is posted without further comment, but here is the opening quote:](#)

"When you're young it's fantastically important what sort of car you're seen to be driving..

"Take your BMW, Alex.. it isn't simply a means of transport, it's a symbol of your position in society, your manhood..

"But when you get to my age and position, things like that appear silly and trifling; a car really ceases to have value as a status symbol..

"That's why I got the helicopter."

- Rupert to Alex, in "Alex?", by Charles Peattie and Russell Taylor.

## Email of the day (1) - [On gold](#):

"Just heard Peter Schiff talking on Bloomberg about the Dow continuing to go down against gold. When you look at the 50 year Dow/Gold chart you can see its underperformance. That would seem to indicate that you're better off in gold than equities. Also is it possible to have charts for gold relative to other indices. Wondering what your thoughts are on this subject."

My comment - [First, on relative or ratio charts, you can create any comparison you like in the customisable Chart Library for subscribers. Just bring up your chart of gold or whatever, click on the "Charting" option \(second from the left on the black bar\) and customise. You can save those setting as Preset templates, should you wish to. For detailed instructions, use the Library's "Help" features \(right side of black bar\).](#)

[We like gold](#) on its own merits, but our tactical mantra is that it is best purchased following setbacks. Fullermoney has also beat the drum for the [Dow/Gold Ratio](#) ever since it began to break down from that top area in 2001. [We were looking for at least 15, with an outside chance of 5. With the Ratio](#)

currently at 10, we maintain that we have seen the best part of this contraction, although there is no sign that it is over.

Capitalism Faces Its Greatest Challenge - My thanks to a subscriber for this [link](#) to Donald Coxe's Basic Points (click on "try clicking on this link", then click on the "Upload" button). It is a superbly written and interesting letter. Here is the introduction:

The global financial crisis that began on Wall Street could mark the end of the Reagan-Thatcher era in which capitalist economic principles gained acceptance across most of the world.

Wall Street's excesses and blunders sent the US and much of the world into recession. The worst month for US stocks in decades amid panic about a 1929-style collapse also proved to be the crucial factor in turning an electorally decisive 6% of undecided American voters into enthusiastic Democratic voters, electing a President and Congress determined to change the consensus on the respective roles of capitalist principles and government in the economy. Although Barack Obama's long campaign promising change had been imprecise about just what that change would be, after the TARP (Troubled Asset Relief Programme) congressional vote fiasco, most voters became convinced it would start with a return to pre-Reagan principles about the respective powers and privileges of government and the markets.

Somewhere, Milton Friedman is musing at the dramatic vindication of one of his core principles: the main problem with socialism is socialism; the main problem with capitalism is capitalists.

The tragedy is that it was one, numerically small, group of misbehaving capitalists that delivered this challenge to Adam Smith-style concepts of economic freedom as the most effective-and ultimately fairest-economic system.

My view - Milton Friedman's dictum above has seldom been more apt. I maintain that the USA's long-term recovery prospects are dependent in no small part on its ability to rein in cowboy capitalists who have been gaming the system from the top for too many years. Sensible regulation would help and I hope we will see it from the Obama administration, with Republican support, but the problem is mainly one of ethics. Meanwhile, I suspect that capitalism will continue to flourish in many regions of the globe, as this difficult recession ends next year.

Donald Coxe points out a potential long-term risk for the USA, which is seldom mentioned:

What may help keep the door shut on Reaganism is that the percentage of Americans of voting age who pay income taxes has fallen to just over 50%. One effect of Barack Obama's proposed tax changes, some analysts suggest, could drive that rate down to the tipping point where the majority of voters pay

no taxes. Historically, societies in which most adults pay no taxes have tended to succumb to bread and circus demagoguery, as politicians compete with each other to offer bigger "soak the rich" handouts to voters who know they won't have to pick up any part of the tab.

In terms of timing, this is a particularly interesting section from Donald Coxe's latest Basic Points:

1. [Ed: introduction to the *Ted Spread* is highly recommended] TED peaked around 500 when Lehman collapsed and broke 200 last Friday. It is currently 197. We suspect that if it breaks 150 and stays there for at least a week, the financial crisis part of this drama, while not humdrum, will no longer command center stage.

That means, it will be time to start buying stocks, *if...*

2. The Bank Stock Index continues to outperform the S&P  
Since the Midnight Massacre, the BKX has been outperforming the S&P on a relative basis, for more than the requisite six weeks.

That means, it will be time to start buying stocks, *if...*

3. The VIX Index retreats  
Although the VIX leaps when there is serious trouble for stocks, it is actually a volatility index, not a measure of actual risk. It measures, for traders of S&P Futures, how wide is the price range of options on the S&P.

As long as the S&P is trading in a +30 range day after day, the stock market is still fibrillating, and the patient is not yet ready to go walking in the park with a cane. It needs to retreat from its manic zone.

That means, it will be time to start buying stocks, *if...*

4. The Yen and the US Dollar Decline  
In an Orwellian paradox-Weakness is Strength-the yen and the dollar have outperformed other currencies. The yen and dollar indices are the currencies in which debt is denominated. They have been elevated sharply due to the deleveraging process; as US investors sell assets outside the US and repay debts inside the US, the dollar rises. The yen, as the instrument of the carry trade, suffers the same ignoble boost. By outperforming Eurodollars, pounds and other major currencies, they have been giving warning signals. They should revert to normalcy, and turn negative, when the distress sales of hedge fund assets and of bankrupt assets have dwindled.

When all four indicators have confirmed, it will be time to start buying stocks.

Veteran subscribers will know that all of these points would be on Fullermoney's wish list, but I suspect that when they are all in place, leading stock markets will have already established their next uptrend.

Here are a few additional thoughts:

The Ted Spread has edged higher [recently](#) and it currently at 216 basis points. Sometimes hyphenating the name, I included an [item](#): "Ted-Spread: Don't take your eye off it" on 3rd October. Recently, it has edged higher following a big correction and I would prefer to see it back beneath 100 before concluding that the banking system was really functioning properly. However that is an ideal condition and my guess is that the recession will be over by then, in which case stock markets will be higher.

Regarding Donald Coxe's second point, the need for relative strength by [US financials](#)...yes, under normal conditions, which these certainly are not. Today's problem is one of dilution for minority shareholders' interests, so I am wary of troubled banking sectors, despite assuming that the bailouts will continue, and eventually work. As a global investor, I would rather look for leadership from bank indices, untainted by the derivatives crisis, in countries or regions where I wish to invest.

Regarding VIX ([daily](#) & [weekly](#)), I am heartened to see it falling back from recent resistance just over 80. At Fullermoney, we maintain that spikes in VIX signal climactic lows for the US stock market. Also, a confident (bullish) VIX ranges beneath 20, but Wall Street's next uptrend should be well established by then.

For this cycle, we maintain that a weaker US dollar and yen are crucial signals, as they would indicate a cessation in forced deleveraging. Recently, we have seen some dynamics in both directions, suggesting at least a pause for the greenback. Today's downward dynamic by the US Dollar Index ([daily](#) & [weekly](#)) looks encouraging, not least because it was preceded by a failed break above 88. Delegates to TCS will also recognise the bearish, rising wedge characteristics of a steep uptrend between 84 and 88, but flattening tangent created by highs in the 88 region.

Significant downside follow through would indicate a Type-2 top (extreme reaction against the prevailing trend). This may or may not occur but the point is: recent action looks topy and a new closing high is now required to reaffirm the uptrend since July. Importantly, [EUR/JPY](#) is forming the third upward dynamic since the late-October low.

As we have been mentioning recently, the most obvious beneficiaries of a weaker dollar and yen would be commodities and stock markets. Both asset classes are oversold and short positions are probably substantial, giving rise to the rebounds seen by [gold](#) commencing last week and 10% gains for some European stock market indices, including [DAX](#) today.

Email of the day (2) - On hedging long positions:

"How about giving your thoughts on hedging strategies for those of us long at this time in FM themes.....I was thinking about a bear market ETF of some kind and gold has been quite good as well. I agree that it's too late to sell but perhaps not too late to try and minimize the impact of any further downside risk."

My comment - We have long favoured gold as part of a diversified portfolio. As for hedging with short themes, I do not think the time to do that is when markets are deeply oversold (evidenced by overextensions relative to 200-day moving averages, best seen on weekly charts), central banks are reflate and everyone knows stock markets are overdue for a technical rebound during a seasonally bullish period. The time to reconsider a hedge short, I suggest, is when stock markets have experienced a rebound, which is looking overstretched and losing momentum.

My personal account: Natural gas long opened, BLWM long position increased, long opened in platinum - The first trade is a late report. Having seeing gold surge on Friday, with the USD continuing to show signs of losing momentum and having read the Browning report forecast for cold weather prior to posting it last week, I bought some [natural gas](#), paying \$6.512 for a January position. Today, with the USD starting to crack this morning, I doubled up on my [BlackRock World Mining Trust](#) trade, paying 221.8p for a March contract. I also bought [platinum](#), the cheapest of the precious metals in my view, paying \$864.6 for a January position.

This looks like the beginning of the long awaited rally in commodities and stock markets. I will discuss this in tonight's Audio.

Email of the day (3) - [On being suspicious of equities](#):

"This downturn in share prices has made retail investors like me somewhat suspicious of ever investing in equities. Some of my family friends have lost almost their life savings which were invested in shares. Is this the end of Financial mkts as we know it?

"And why does the Dow Jones start falling within the last 15 mins of the day? Some conspiracy?

"Your comments please."

My comment - The losses are painful and a steep learning curve for any of us. However, we can also be our own best contrary indicators. The cry: "I will never trust the stock market again", has been heard or felt near the bottom of the worst bear markets throughout history. People who know their market history regard it as a buy signal.

Additional Commentary by Eoin Treacy

Email of the day (1) - [on hedging and lessons learnt](#):

"With regard to your commentary on the S&P 500's technical action on Friday I'd just like to add a comment. Where investors face a dichotomy between pulling out (because the market(s) may head further south) and hanging in for

the long term (because we all know that these will come back in the fullness of time) there is a non-mutually exclusive alternative, i.e. sell down a portion of each of the investments in the portfolio and sell down some more if the index drops to another self determined level or below a selected moving average. This enables you to sleep a little better, have funds for the inevitable rally. By doing this you may miss the first ~10% of a rally (except for what remains in the portfolio) but I think that is more than acceptable in current circumstances.

"As the next rally may be a bear rally and not a new bull there will likely be strong resistance at prior levels of consolidation and all of us need to think about a sell strategy near these levels if we are not prepared to countenance a return to the bear. Again one can consider partial sales at these levels.

"I have learned so much this past year and only wish I could live long enough to experience another one of these severe market corrections! The first lesson: is to trust your "inner voice" your gut or whatever you want to call it. If in doubt get out! The next lesson: for long drawn out corrections is to sell where prices drop below selected moving averages and buy back in the same proportions when they recover above these MA's (hopefully at a lower level). This creates a phased panic vs panicking early or far too late.

"As always the word Family comes before Finances in any dictionary as it should be in our thinking. We have all lost significant funds in this correction but spare a moment for all those who have lost their family; such a crisis would far exceed any financial loss.

"Perhaps more of your collective wisdom subscribers may like to add their lessons learnt over the past year so as to benefit the remainder. As always thank you for a great service and could I encourage lots of subscribers to ask more questions because these have broadened my and I'm sure many others perspective enormously.

"I'm looking forward to meeting you at the May chart seminar in London whilst the bride of 25 years and I enjoy a month in Paris. Hopefully all our charts will be pointing up!"

My comment - Thank you for this thoughtful contribution which I'm sure will be of interest to other subscribers and I'm looking forward to meeting you next year. Paris in the late spring is lovely, you'll have a great time. Facing a significant paper loss, but unwilling to crystallise losses, many investors are considering hedging at least part of their long position. This adds to the already considerable net short position and leaves investors exposed to a short covering rally. (Please also see David's piece on hedging above.)

From a behavioural perspective, the crowd has accepted as a given that rallies cannot be sustained and that the greatest risks are for a further down-leg. Evidence to countermand this view is thin on the ground right now, but when a strategy is adopted as foolproof by the crowd, it is usually in its final stage of reliability.

As well as the lessons you mention, I am conscious of allowing vanity to overpower my analysis. I concentrated on my favourite markets, which were performing, rather than remaining abreast of the implications of what was happening in the wider market. I don't intend to succumb to this analytical myopia again.

Our most recent experience has been to trade conservatively and to take profits when we see them. In 2003-2006, following a major bear move, many investors had undergone a similar conditioning process, albeit over a somewhat longer period of time. When the recovery gets underway, the temptation to do in the next cycle what we wish we had done in the last is very strong. In 2003-2006, this led many investors to sell too early because they had been conditioned by the expectation that rallies could not be sustained. This is a temptation we should be aware of when evidence develops that the market is stabilizing.

We have maintained for a number of weeks now that the [Dollar](#) is the key to any potential significant rally for oversold markets. The Dollar Index surged upwards from the consolidation below 74 and accelerated towards current levels in the subsequent three months. The current reaction is no larger than that which took place in September but that is where the similarities end. The Index has lost momentum by spending considerably more time going sideways and has just posted a third upside failure. These are potential Type-2 topping characteristics. For the Dollar to reaffirm its uptrend, it needs to sustain a move above 88 beyond a few days. If this is a Type-2 top, then we would expect a massive reaction against the prevailing trend in the shape of an incontrovertible downward dynamic.

If this action occurs, it would provide a powerful catalyst for short covering across a range of asset classes. The ones most likely to perform in an environment are those where the largest short positions are present; namely commodity shares, some precious metals, emerging market equities and of course currencies other than the dollar and yen.

India Emerging for Mobius Followers Picking Bottom - This [article](#) by Anil Varma and M.C. Govardhana Rangan for Bloomberg covers the improving sentiment towards Indian investments. Here is a section from the conclusion:

Slowing global growth may benefit India by giving the Reserve Bank of India "scope" to cut rates after crude-oil prices tumbled 60 percent in four months, Mobius said. India is a "very large market" that isn't highly linked to the global economy, he said.

Inflation, which cooled to 8.9 percent from a 16-year high of 12.91 percent in August, will slow to 5 percent in June, HDFC's Mistry predicts. Fair value for the rupee would be between 40 per dollar and 44 within 12 months as India's trade deficit narrows, he said.

"Inflation is behind us," said Mistry, 53. "Over one to three years, I am extremely bullish on Indian stocks."

State Bank's Bhatt predicts the currency will appreciate to 45 next year because 80 percent of foreign funds have already left the stock market. India has "huge pent up demand" should housing prices and mortgage rates fall because 90 percent of households can't afford to buy a home, he said.

A drop in India's home loan rates to below 10 percent, from as high as 14 percent, will "kick-start consumer buying," ICICI Chief Executive Officer K.V. Kamath, 61, said in a Nov. 17 interview.

#### Credit-Default Swaps

The cost to protect bonds of ICICI from default fell to 875 basis points from a record 1,794 reached on Oct. 27, according to CMA Datavision prices. A basis point, or 0.01 percentage point, on a credit-default swap contract protecting \$10 million of debt from default for five years is equivalent to \$1,000 a year.

Credit-default swaps, contracts conceived to protect bondholders against default, pay the buyer face value in exchange for the underlying securities or the cash equivalent should a borrower fail to adhere to its debt agreements. An increase indicates deterioration in the perception of credit quality; a decline signals the opposite.

"India will survive the crisis," said Sergey Dergachev, an emerging-market money manager at Union Investment in Frankfurt, which has \$233 billion in assets. "Growth will weaken, but India will be in much better shape than many other much more open economies."

#### Buying Rupees

He bought rupee forwards, or contracts that allow for the purchase of the currency at current prices for delivery at a specified time and date.

Indian banks have about \$1 billion of foreign-currency securities tied to failed or stressed institutions, including bankrupt Lehman, out of total debt assets of \$510 billion, according to central bank estimates. That contrasts with almost \$1 trillion in writedowns by financial institutions worldwide.

ICICI's capital stands at about 14 percent of assets, compared with the 8 percent recommended by the Bank for International Settlements in Basel, Switzerland.

"The Indian financial system got cleared up five years back and thereafter has not ventured into anything which should cause worry," Kamath said.

State Bank of India and HDFC are in "pretty good shape" to expand lending, said Jeffrey Chowdhry, who manages \$2 billion as head of emerging-market equities in London at F&C. After slumping 74 percent this year, ICICI trades at 0.8 times its book value, compared with 1.1 times for Bank of China Ltd., the nation's fourth-biggest lender.

"We are like kids in a candy shop," Chowdhry said. "We can see lots of companies that we want to be buying at this level on a two to-three year view

because we know we'll make a lot of money."

**My view** - There is no denying that the impact of recession in the USA and Europe is being felt in Asia economies. However, the falls experienced by their stock markets are pricing in a much more severe reaction than seems likely when one considers how little exposure Asian banks have to toxic subprime debt. Trade between Asian countries and between other emerging markets has grown considerably in the last decade and should also help to cushion economies as recessions drag for more traditional trading partners. India's domestic demand plays a greater role in GDP growth than for many other Asian economies.

The stock market pulled back significantly as the [Rupee](#) fell and investors withdrew funds. In the last month, the Dollar has had its largest fall to date against the [Rupee](#), within the short-term uptrend and needs to sustain a move above R50 to question scope for further weakness. If the Rupee begins to strengthen, it will quickly move from being considered a headwind to a tailwind for the stock market.

The [Bombay Banks](#) Index found at least short-term support above the October lows and would need to sustain a move below 4000 to question scope for some further higher to lateral ranging. It has been [outperforming](#) the Sensex since July but has lost momentum over the last month. The move below 0.51 suggests we may be entering at least a short-term phase when the wider market will outperform. The [Sensex](#) meanwhile also found support above the October lows and would need to sustain a move below 8000 to question scope for further higher to lateral ranging.

**On Nordic Power markets** - A large number of delegates at the recent Chart Seminar were involved in trading the Nordic Power markets. I thought I would review those markets today as an exercise in commonality. The influences on this market have changed considerably over the last few years and oil now plays an important lead role in determining the direction of the market. In the past, weather had a much greater impact because of the heavy reliance on hydro electricity. It is necessary to be aware of how other energy related commodities trade because of the illiquid nature of power markets and their propensity to gap when something happens in the USA after the markets in Scandinavia close.

[Oil](#) remains in a medium-term downtrend, but is overextended by any measure and has posted two impressive upward dynamics this month. The most recent of these was today and the market would now need to sustain a move to new reaction lows to question scope for some additional upside. [Heating oil](#) and [gasoline](#) have similar chart patterns.

[Coal](#) prices had not updated on Bloomberg at the time of writing, but as of Friday, had fallen back from their accelerated peak to test the 2004 highs. Prices are likely to advance today based on the oil market's performance but need to break the progression of lower highs to indicate the bulls have regained the upper hand.

[Natural Gas](#) fell abruptly from the highs near \$14 and began to lose momentum as it fell below \$8. It found support near \$6 and would need to sustain a move below that level to question scope for some further higher to lateral ranging.

[Uranium](#) also fell abruptly its accelerated highs. It found support recently near \$45 and needs to break the progression of lower highs to suggest the bulls have regained the upper hand.

The most liquid [1st Quarter Nordpool](#) contract encountered resistance near the 2006 highs between July and September. The market distributed briefly below the previous ranging phase and fell further in November. Friday saw the first bullish activity in [two-weeks](#). Considering the potential for the Dollar to be forming a top and commodities oversold condition; becoming increasingly bearish might not be the wisest decision.

The [1st Year Nordpool](#) contract consolidated below the 2006 highs from late 2007 until early 2008. The break above 55 in early May completed this consolidation and prices surged to 70 in a month. This accelerated short-term advance was capped with an impressive key day reversal and while prices rallied somewhat in August, the move was not strong enough to threaten the highs. Prices broke downwards again in early October and following a brief distribution sold-off heavily in November. Bears will say that it has not [rallied](#) more than it did during its distribution but the commonality across the sector suggests that this market needs to sustain a move below 38 to question scope for further support building in the current area with a view to higher levels in the short to medium term.

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

"Please add the chart for [Lyxor Gold Bullion Securities in GBP-symbol GBSS](#)."

My comment - Thank you for this interesting suggestion which has been added to the Chart Library. Gold's relative strength and the Pound's weakness are exemplified by this chart which shows gold in Pounds making new highs.

[S&P 500](#) and [Dow Jones Industrials Average](#) divergence from 200-day moving average - We first posted this indicator on [October 10th](#) when the relevant spreadsheet was created for us by a subscriber. We intend to add it as a permanent feature to the Chart Library at some future date, but I will continue to update these charts on a weekly basis until then.

Over the last month, these indicators have remained in the region of their historic lows; more or less mimicking what the stock market has done. Mean reversion is not yet taking place to any significant degree but the extent of the oversold condition suggest that it is only a matter of time.

Today's interesting charts - [Upward dynamics across a whole range markets today can all be monitored in the Chart Library.](#)

UK (FTSE-100) - finds [support](#) near the late-October lows and posts another impressive upward dynamic. A sustained move to new lows would now be needed to question scope for some additional short-term upside.

Germany - finds [support](#) near the psychological 4000 and posts another impressive upward dynamic. A sustained move below that level would now be needed to question scope for a retest of the upper side of the short-term range.

AMEX Goldbugs - [rallied](#) impressively on Friday and followed through with today. A sustained move below 150 would now be needed to question scope for some additional upside.

Last week's signups for the Free (Abbreviated) Comment of the Day - [For the week of November 16th new signups, including subscribers and pre-subscribers, live in the following countries or regions: Australia, Brazil, Greece, Ireland, Netherlands, Singapore, Spain, Sweden, the UK and the USA - 10 in total. In descending order, which topped the list in terms of the last week's new signups? It was the USA, UK and Australia.](#)

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 25th November 2008

Barton Biggs: We are in for the mother of all bear market rallies - [My thanks to a subscriber for this article](#) (also in [PDF](#) format, in case FT link is dropped) from the Financial Times. Here is the opening:

Before we all are swept away into total despair, let's take a step back and imagine what could get stocks around the world going up for a while. Bear in mind that I am hedge fund manager, have been wrong on the severity and duration of this panic, and that at this moment I am close to shore. In other words - I have little risk on.

First, let me point out that by definition the bottom of a bear market has to be the point of maximum bearishness. Thus sentiment becomes a crucial indicator.

The systematic work that we do on measuring sentiment (and we monitor

about twenty indicators for the US and a dozen or so for other equity markets) show very extreme and in many cases record levels of bearishness. Obviously not every indicator is at an all-time high, and in some the history is short, but the message is powerful. Furthermore there is compelling evidence that investors, hedge funds, pension and mutual funds, and the public are not just talking bearish, they have raised astounding amounts of cash.

I am chastened by the fact that all the data we look at are from the last forty years which was really just one great magnificent secular bull market of wealth creation marked by periodic bears that were buying opportunities. No one knows what levels of pessimism were necessary to spawn the 40 per cent 1929 rally during a massive secular bear market. Nevertheless I've never seen capitulation and despair like this. We must be pretty close to maximum bearishness.

Second, valuations are cheap. There's no point in going into an elaborate dissertation; it's an inexact science. Using the best historic measures, normalised earnings, book value, and free cash flow, stocks around the world are very cheap, but not as cheap in absolute terms or versus interest rates as they were in the 1930s or at the 1974 bottom. Nevertheless, the 4 per cent dividend return on the S&P 500 exceeds the yield on the ten and thirty year Treasury bonds for the first time in fifty years. If emerging market equities, where the growth is, at six to eight times earnings are not cheap I don't know what is.

Third, stock markets have been obliterated and are deeply oversold. Even dead cats bounce. The Dow has had the steepest decline since the 1930s, and the spread between the price and the 200 day moving average at 34 per cent is the greatest since July 19, 1932. The US market is down almost 50 per cent from its highs, Europe is off 55 per cent, and emerging markets, 65 per cent with some unfortunates like Russia off 70 per cent. History shows that even in enduring, secular bear markets there are not just 20 per cent bounces but usually one 30 to 50 per cent rally. We should be due.

As far as the economic fundamentals are concerned, investor and consumer confidence have been ravaged by the sudden violence of the global recession. It is going to be deep and it may be long lasting. The bears say at best it will be like Japan's on-going slow death. At worst, it will be a replay of the 1930s.

I think both these outcomes are highly unlikely. The so-called authorities have learned from the policy errors of the past, and the response this time, while not perfect, has been faster and far bigger. The effects are just beginning to be felt. In fact the stimulus has been unprecedented and there is almost sure to be more on the way beginning with the new Obama Administration. The authorities seem to understand that they have to risk overkill.

My view - [Veteran subscribers will know that this is closer to my own view than most other copy posted. However I too had way underestimated the scale of the west's credit / solvency problems \(banking scams?\) and the collateral damage they would cause. Moreover, I do not know how all of this](#)

will play out, but also suspect it will be different from the USA's 1930s experience or Japan's slow motion deflation of the 1990s and beyond.

Both of those periods were made far worse by policy errors, mainly in the form of too tight monetary policies. In the 1930s, the USA had no safety net in the form of deposit guarantees and very few welfare policies for the unemployed. Consequently, savings were wiped out as banks, which were often far more reputable than what we have recently witnessed, failed during the Great Depression. Having lost both their savings and jobs, many people were destitute.

In Japan during the 1990s, BoJ governor Yasushi Mieno wiped out asset inflation, but at the cost of a lengthy deflation. Japan had zombie banks for a long period but few savers lost their capital. Welfare helped to mitigate hardship for the unemployed.

In the present crisis, the USA has guaranteed bank deposits, as has the UK and Euroland countries. There are extensive welfare systems which are about to become even more generous. Nevertheless the problem of a bust credit cycle is potentially more serious than any previous economic difficulty that most of us have experienced.

Monetary authorities now recognise this risk. However in their understandable determination to avoid an extended deflation, an effort which I suspect will succeed, they may create a serious inflationary problem for the future. This was always a risk in a fiat money system.

Governments will inevitably and perhaps correctly always combat the crisis staring them in the face. This being disinflation which could turn into deflation, they are now erring, perhaps massively in the USA and UK, on the side of future inflation. I am sure government spokesmen would disagree, saying the measures are temporary, and will be countered by both higher taxes and higher interest rates as economies recover.

This may sound easy in theory but could prove difficult in practice. Talk of "irrational exuberance", or words to that effect, may be greeted with widespread condemnation, as Alan Greenspan found in [1996](#). Moreover, higher interest rates and taxes could easily result in stagflation.

Meanwhile, as carry trade deleveraging winds down, the [US dollar](#) should once again become the litmus test for US economic policy. The portents are not good in my opinion. If you agree, this makes precious metals even more interesting, although for more active investors, they should probably be traded on a buy-low-sell-high basis.

Like Barton Biggs, I also look for a significant (mean reversion) technical rally. However, if this occurs, I may participate through my trading account rather than reducing my cash position, particularly if stock market indices show little in the form of base formations, as is the case today. There are also practical, personal considerations which may influence my choice. Always aiming to live off my trading account, I have grown hungry since Q1.

Email of the day - On Barton Biggs, from the subscriber who thoughtfully provided the article above:

"This is an article in the FT today by Barton Biggs of hedge fund fame that may be of interest to subscribers. It echoes a number of recent comments that we may be near at least a major intermediate bottom based on sentiment, being oversold and valuation grounds. However, as I believe you have argued, he would like to see spreads in the credit markets come in a bit more before committing his money to the market."

My comment - Yes, the most cautious approach for conservative investors holding cash today would be to retain a significant portion of this capital until most of the technical and fundamental factors line up favourably. Most stock markets could be some months into their next uptrends by that time, but in bull markets the best gains usually occur well after base formations have been completed. Currently, Barton Biggs is not expecting more than an oversold rally and I agree with that.

Here are my best case and worst scenarios:

Best case: Stock market indices have already seen their bear market lows or are very close to them. The base building process is commencing and some significant technical rallies occur over the next few months. These are then followed by pullbacks during which most indices find support above their earlier lows, followed by right-hand extension base development lasting a number of months. Those patterns then support new bull markets, which are unlikely to be seriously endangered until some months after central banks embark on a new round of monetary tightening.

Worst case: We do not get that much of a technical rally, or even if Barton Biggs is right, stock markets then fall back, finding only temporary support near their former lows before extending their overall downward trends. Significant additional declines occur in a deflationary environment. Valuations return to historically attractive levels, with the S&P 500 Index yielding over 6%, compared to today's level of 3.54%. It takes many more years before the [S&P](#) exceeds its 2000 and 2007 peaks near 1600.

What do I expect? I hope for the former, think it is more likely but fear the latter. Also, the outcome could be something in between, in which case stock markets in Asian-led higher growth economies would significantly outperform the West. More importantly, the charts will show us.

My personal portfolio: Natural gas long stopped out and repurchased lower - In ranging markets, let alone volatile conditions, I am inclined to place a breakeven or slightly in the money stop on a position that moves into profit. I did this with [natural gas](#) yesterday and my January NG purchase at \$6.512 on 21st November was stopped out this afternoon at \$6.00, including spread-bet dealing costs. I bought it back at \$6.412 this evening, suspecting that NG is a [Baby Steps](#), buy-low-sell-high within the range situation.

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Additional Commentary by Eoin Treacy

Soros and other funds buy major coal equities at fire sale prices - [Thanks to a subscriber for this article by Dorothy Kosich for Mineweb.com covering renewed demand for coal related equities. Here it is in full:](#)

Über investor George Soros bought a 2% stake or 2.9 million shares of Arch Coal, the nation's second largest coal producer, during the third quarter, as Citadel Investment Group and Invesco Ltd. snapped up 3.5 million shares of Peabody Coal, the biggest U.S. coal miner.

SEC third-quarter 2008 filings show Soros also bought 833,658 shares of another U.S. coal miner, Consol Energy, as well as purchase another 490,000 shares of Brazilian iron ore mega-miner CVRD (Vale).

Meanwhile Chicago-based hedge fund Citadel bought 1,688,088 shares of Peabody Energy as New York's Invesco Ltd. made a dozen purchases of Peabody stock, totaling in excess of 3.5 million shares. SEC filings show that Invesco also has holdings of more than 1.5 million shares of Teck, as well as shares in Canadian gold miner Agnico Eagle.

As shares of coal mining companies have dropped along with the rest of commodities, investors have embarked on snapping up coal equities at fire sale prices. For instance Bloomberg reported that T. Rowe has bought Peabody, Arch, Consol Energy and Indonesia's PT Bumi Resources.

Daniel Rice--manager of BlackRock Advisors Inc.'s Global Resources Fund, which is also among the largest holders of Peabody and Arch-told Bloomberg Monday, "Coal is the best commodity to get into right now. It's a lot less sensitive to downturns because it is needed for basic power generation, and demand is growing."

[My view - Coal remains one of the most widely used methods of producing electricity and this is not about to change any time soon. Steel production is likely to contract as global growth slows, but will certainly not disappear given the infrastructure projects in the planning stages and under construction globally. Coal prices accelerated to a high in late June, riding the coattails of](#)

the powerful move in the oil market and now remains in a medium-term downtrend.

[Coal](#) futures have fallen considerably more than spot prices such as [Big Sandy Barge](#) but both remain in medium-term downtrends whose hallmark is a progression of lower highs. These sequences need to be broken before investors will have faith in the ability of the commodity to sustain anything more than a technical rally.

However, while coal prices have fallen considerably, coal related equity prices have collapsed. The [Bloomberg World Coal Index](#) has fallen almost 80% from its peak to last week's low. Some individual stocks have fallen even further. One has to accept the fact that this sector was inflated by speculative buying and was looking frothy up near the highs but it has since been deserted by speculators and has returned to levels not seen since 2005. The downtrend has lost momentum over the last six weeks and the recent fall below 200 is a potentially failed downside break. This is another potential Type-2 ending in development and a sustained move to new lows would be needed to question recovery potential.

[Peabody Energy](#) broke upwards from a more than two-year consolidation in May and surged to almost \$90. The advance was capped with an emphatic weekly key reversal, with considerable follow through two-weeks later. It remains in a consistent, although increasingly overextended downtrend. The share broke downwards from the short-term range last week and while it has rallied over the last two days, it needs to sustain a push back above \$30 to question scope for further lower to lateral ranging.

[Arch Coal](#) shares a similar pattern to Peabody above and has fallen just as abruptly. The downtrend over the last few months has been quite consistent and a sustained move above \$22 would break the progression of lower highs.

[Consol Energy](#) broke upwards from a ranging consolidation in October 2007 and moved into a relatively volatile uptrend which accelerated in its latter stage. The share encountered resistance near \$120 and pulled back sharply into a consistent downtrend which has been losing momentum of late. It now needs to sustain a move below \$20 to question scope for some additional higher to lateral ranging.

[Macarthur Coal](#), quoted in Australia, broke upwards in late 2006 and accelerated to its peak near AU\$20 in June. It has since given up the entire advance. A sustained move back above AU\$5 is needed to question potential for some additional lower to lateral ranging.

[China Shenhua Energy](#) maintained a gradually steepening uptrend from its IPO to the accelerated peak near HK\$58. Following some right-hand extension below the high, it broke down once more in early March and moved into a downtrend. The share found support late last week above the October lows and would need to sustain a move below HK\$8 to question scope for some additional higher to lateral ranging.

[Exxaro](#), listed in South Africa, accelerated in the latter stages of what had been a relatively consistent uptrend before moving to a medium-term downtrend. The most recent range is no larger than that posted between July and September but it is significantly lower down. It has not fallen to the same extent as some of the other companies and today's action was positive. However, a sustained move above ZAR7500 would break the progression of lower highs and suggest the bulls are regaining the upper hand.

[Bumi Resources](#), quoted in Indonesia, fell by 92% from its peak to the low posted on Friday. Trading over the last week has been curtailed but one has to ask whether such a large producer will be allowed to go bankrupt. If not, then this company is cheap. However, time will be needed for a base to be built before the share can sustain anything more than a technical rally.

All of the above charts have sustained significant falls and a period of support building is needed to settle investor's nerves. However, the falls experienced by these shares have far outstripped that of the commodity. Trading at these levels, coals shares are priced for a global depression and in the absence of such an event they have good recovery potential.

China as White Knight - Thanks to a subscriber for this interesting [report](#) by Foo Choy Peng of UOB Securities covering the stimulus packages announced by the various Chinese states. Here is a section from the opening:

Chinese provinces announced Rmb13 trillion pump-priming packages. In the past week or so, Chinese provinces tried to outdo one another with astronomical pump-priming measures totalling about Rmb 13 trillion to shore up their local economies. Like the central government's Rmb 4 trillion package, the provinces' plans are vague on details, especially the funding sources, although they are likely to be smaller than the headline numbers suggest.

Still, it does not matter how much eventually is spent next year and in 2010. What really matters is that Beijing has sent a powerful message to the world: by hook or by crook, it will do whatever it needs to achieve at least 8% growth in 2009 to stave off mounting worker unrest - and help the world along the way.

And if it succeeds in achieving that - our bets are that it is likely to, given its financial resources as well as political will and agenda - it will single-handedly account for around 25% of the worlds GDP growth next year. This will, as Beijing suggests, be its biggest contribution to the world, which should presage a bigger voice in international bodies such as the International Monetary Fund and the World Bank further down the road.

My view - China can be distinguished from other countries attempting to stimulate their economies by the fact that it has vast reserves of cash with which to accomplish the task. Much is being made of whether the announced packages are new money or are part of development plans already in place. However, this is to miss the point that China has not had to rein in its

infrastructure spending one iota since the beginning of the credit crisis and is in fact expanding its ambitions to new projects.

The legitimacy of the communist government is built on being able to manage the economy and provide work for millions of new members of the labour force each year. This is gradually helping to improve the lot of many people and the middle class has expanded rapidly. As long as this trend is maintained, political stability is relatively assured because protests are unlikely to have the critical mass necessary to force a regime change. For now, the present government can point to its economic successes as justification for its rule. The Communists want to remain in power and will do whatever is necessary to accomplish their goals.

The current slowdown was manufactured by raising rates and reserve requirements to deflate 2007's property and stock market bubbles. They have the capacity to manufacture a recovery, but it will take time and the relative health of the global economy will play no small part.

The [Shanghai A-share](#) market remains in an overall downtrend but is losing [momentum](#). The moving average is gradually moving back towards the price and a further period of base building would appear to be needed before a recovery can take place.

The Paradox of Deleveraging Will Be Broken - This interesting, [academic article](#) by Paul McCulley from Pimco, which appeared in John Mauldin's "Outside The Box" newsletter today highlights an important behavioural point. Here is a section:

Thus, the genius of banking, if you want to call it that, is simple: a bank can take more risk on the asset side of its balance sheet than the liability side can notionally support, because a goodly portion of the liability side, notably deposits, is de facto of perpetual maturity, although it is notionally of finite maturity, as short as one day in the case of demand deposits.

It's the same alchemy that permits mutual funds to commit to next-day redemption at tonight's NAV, even though all reasonable people know that a mutual fund - with the possible exception of a money market fund - could not possibly liquidate all assets on the wire tomorrow at tonight's NAV marks. Systemically, it's the illusion of liquidity, as so elegantly described by John Maynard Keynes:

"The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only. But a little consideration of this expedient brings us up against a dilemma, and shows us how the liquidity of investment markets often facilitates, though it sometimes impedes, the course of new investment. "For the fact that each individual investor flatters himself that his commitment is 'liquid' (though this cannot be true for all investors collectively) calms his

nerves and makes him much more willing to run a risk. If individual purchases of investments were rendered illiquid, this might seriously impede new investment, so long as alternative ways in which to hold his savings are available to the individual. This is the dilemma.

"So long as it is open to the individual to employ his wealth in hoarding or lending money, the alternative of purchasing actual capital assets cannot be rendered sufficiently attractive (especially to the man who does not manage the capital assets and knows very little about them), except by organizing markets wherein these assets can be easily realized for money."

My view - As human beings we are hardwired to expect a pattern to continue once recognised. This occurs even though, if we think about it objectively, we admit that it cannot go on interminably. Take the example of a light switch. We know that the more times we turn it on and off, the more likely it is for the bulb to blow. In the rational world, if we had to bet on the probability of when the element would break, we would assign a slightly greater possibility to it happening, following each successive throwing of the switch. Nevertheless, on the day the bulb finally fails, we are almost universally surprised that it has occurred.

When we add money and leverage to the equation the emotional quotient become much larger. From a rational perspective, we know that no trading strategy is 100% reliable, but emotionally we attach greater weight to actions that make us money even though we know they cannot last. In an accelerating trend, many investors tend to increase positions because they want to take the greatest possible advantage of the money making opportunity. Rationally we know that nothing can accelerate forever, but emotionally we convince ourselves the situation will continue for a while longer.

Over the last decade, investors learned to become comfortable with buying credits of lesser quality. The first time someone would have bought a credit with a lower rating, it would have been deemed a larger risk, however fast forward to 2007 and the market for instruments with a shady credit quality had exploded because people were making money following this course of action. Rationally, we can look back and say that buying instruments backed by less credit worthy companies or individuals is a recipe for disaster. Emotionally, however, as long as the strategy is seen to be working, the risks are, to a large extent, ignored.

The challenge as investors is to be aware of this tendency to ignore risk when we are employing a trading strategy that works and exaggerate the risk when that strategy fails. If can maintain that introspective scrutiny, we will be able to participate in trends that are in form and exit when that condition changes.

Email of the day - on looking for a bottom:

"I am so enjoying your consistency! Right when I want to respond to the doomsday types, that this is a "wealth" crisis, let's try not to make it a "health"

crisis I know we must be closer to a base. Watching some of my favourite leading stocks drop to such low levels is literally making my mouth water. It's encouraging to feel I am not alone."

My comment - Thank you for such a pragmatic email. It is hard for people who have sold losing positions to hear that we think the medium-term outlook is bullish because they are now emotionally invested in the market moving lower. There is no doubt that time is needed for volatility to settle down before many will have the confidence to return to investing, but if one looks beyond the end of the year, 2009 will almost certainly be a better year for investors than 2008.

## Tuesday 25th November 2008

Barton Biggs: We are in for the mother of all bear market rallies - My thanks to a subscriber for this [article](#) (also in [PDF](#) format, in case FT link is dropped) from the Financial Times. Here is the opening:

Before we all are swept away into total despair, let's take a step back and imagine what could get stocks around the world going up for a while. Bear in mind that I am hedge fund manager, have been wrong on the severity and duration of this panic, and that at this moment I am close to shore. In other words - I have little risk on.

First, let me point out that by definition the bottom of a bear market has to be the point of maximum bearishness. Thus sentiment becomes a crucial indicator.

The systematic work that we do on measuring sentiment (and we monitor about twenty indicators for the US and a dozen or so for other equity markets) show very extreme and in many cases record levels of bearishness. Obviously not every indicator is at an all-time high, and in some the history is short, but the message is powerful. Furthermore there is compelling evidence that investors, hedge funds, pension and mutual funds, and the public are not just talking bearish, they have raised astounding amounts of cash.

I am chastened by the fact that all the data we look at are from the last forty years which was really just one great magnificent secular bull market of wealth creation marked by periodic bears that were buying opportunities. No one knows what levels of pessimism were necessary to spawn the 40 per cent 1929 rally during a massive secular bear market. Nevertheless I've never seen capitulation and despair like this. We must be pretty close to maximum bearishness.

Second, valuations are cheap. There's no point in going into an elaborate dissertation; it's an inexact science. Using the best historic measures, normalised earnings, book value, and free cash flow, stocks around the world are very cheap, but not as cheap in absolute terms or versus interest rates as they were in the 1930s or at the 1974 bottom. Nevertheless, the 4 per cent dividend return on the S&P 500 exceeds the yield on the ten and thirty year Treasury bonds for the first time in fifty years. If emerging market equities,

where the growth is, at six to eight times earnings are not cheap I don't know what is.

Third, stock markets have been obliterated and are deeply oversold. Even dead cats bounce. The Dow has had the steepest decline since the 1930s, and the spread between the price and the 200 day moving average at 34 per cent is the greatest since July 19, 1932. The US market is down almost 50 per cent from its highs, Europe is off 55 per cent, and emerging markets, 65 per cent with some unfortunates like Russia off 70 per cent. History shows that even in enduring, secular bear markets there are not just 20 per cent bounces but usually one 30 to 50 per cent rally. We should be due.

As far as the economic fundamentals are concerned, investor and consumer confidence have been ravaged by the sudden violence of the global recession. It is going to be deep and it may be long lasting. The bears say at best it will be like Japan's on-going slow death. At worst, it will be a replay of the 1930s.

I think both these outcomes are highly unlikely. The so-called authorities have learned from the policy errors of the past, and the response this time, while not perfect, has been faster and far bigger. The effects are just beginning to be felt. In fact the stimulus has been unprecedented and there is almost sure to be more on the way beginning with the new Obama Administration. The authorities seem to understand that they have to risk overkill.

My view - Veteran subscribers will know that this is closer to my own view than most other copy posted. However I too had way underestimated the scale of the west's credit / solvency problems (banking scams?) and the collateral damage they would cause. Moreover, I do not know how all of this will play out, but also suspect it will be different from the USA's 1930s experience or Japan's slow motion deflation of the 1990s and beyond.

Both of those periods were made far worse by policy errors, mainly in the form of too tight monetary policies. In the 1930s, the USA had no safety net in the form of deposit guarantees and very few welfare policies for the unemployed. Consequently, savings were wiped out as banks, which were often far more reputable than what we have recently witnessed, failed during the Great Depression. Having lost both their savings and jobs, many people were destitute.

In Japan during the 1990s, BoJ governor Yasushi Mieno wiped out asset inflation, but at the cost of a lengthy deflation. Japan had zombie banks for a long period but few savers lost their capital. Welfare helped to mitigate hardship for the unemployed.

In the present crisis, the USA has guaranteed bank deposits, as has the UK and Euroland countries. There are extensive welfare systems which are about to become even more generous. Nevertheless the problem of a bust credit cycle is potentially more serious than any previous economic difficulty that most of us have experienced.

Monetary authorities now recognise this risk. However in their understandable determination to avoid an extended deflation, an effort which I suspect will succeed, they may create a serious inflationary problem for the future. This was always a risk in a fiat money system.

Governments will inevitably and perhaps correctly always combat the crisis staring them in the face. This being disinflation which could turn into deflation, they are now erring, perhaps massively in the USA and UK, on the side of future inflation. I am sure government spokesmen would disagree, saying the measures are temporary, and will be countered by both higher taxes and higher interest rates as economies recover.

This may sound easy in theory but could prove difficult in practice. Talk of "irrational exuberance", or words to that effect, may be greeted with widespread condemnation, as Alan Greenspan found in [1996](#). Moreover, higher interest rates and taxes could easily result in stagflation.

Meanwhile, as carry trade deleveraging winds down, the [US dollar](#) should once again become the litmus test for US economic policy. The portents are not good in my opinion. If you agree, this makes precious metals even more interesting, although for more active investors, they should probably be traded on a buy-low-sell-high basis.

Like Barton Biggs, I also look for a significant (mean reversion) technical rally. However, if this occurs, I may participate through my trading account rather than reducing my cash position, particularly if stock market indices show little in the form of base formations, as is the case today. There are also practical, personal considerations which may influence my choice. Always aiming to live off my trading account, I have grown hungry since Q1.

Email of the day - On Barton Biggs, from the subscriber who thoughtfully provided the article above:

"This is an article in the FT today by Barton Biggs of hedge fund fame that may be of interest to subscribers. It echoes a number of recent comments that we may be near at least a major intermediate bottom based on sentiment, being oversold and valuation grounds. However, as I believe you have argued, he would like to see spreads in the credit markets come in a bit more before committing his money to the market."

My comment - Yes, the most cautious approach for conservative investors holding cash today would be to retain a significant portion of this capital until most of the technical and fundamental factors line up favourably. Most stock markets could be some months into their next uptrends by that time, but in bull markets the best gains usually occur well after base formations have been completed. Currently, Barton Biggs is not expecting more than an oversold rally and I agree with that.

Here are my best case and worst scenarios:

Best case: Stock market indices have already seen their bear market lows or are very close to them. The base building process is commencing and some significant technical rallies occur over the next few months. These are then followed by pullbacks during which most indices find support above their earlier lows, followed by right-hand extension base development lasting a number of months. Those patterns then support new bull markets, which are unlikely to be seriously endangered until some months after central banks embark on a new round of monetary tightening.

Worst case: We do not get that much of a technical rally, or even if Barton Biggs is right, stock markets then fall back, finding only temporary support near their former lows before extending their overall downward trends. Significant additional declines occur in a deflationary environment. Valuations return to historically attractive levels, with the S&P 500 Index yielding over 6%, compared to today's level of 3.54%. It takes many more years before the [S&P](#) exceeds its 2000 and 2007 peaks near 1600.

What do I expect? I hope for the former, think it is more likely but fear the latter. Also, the outcome could be something in between, in which case stock markets in Asian-led higher growth economies would significantly outperform the West. More importantly, the charts will show us.

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The Paradox of Deleveraging Will Be Broken - This interesting, academic [article](#) by Paul McCulley from Pimco, which appeared in John Mauldin's "Outside The Box" newsletter today highlights an important behavioural point. Here is a section:

Thus, the genius of banking, if you want to call it that, is simple: a bank can take more risk on the asset side of its balance sheet than the liability side can notionally support, because a goodly portion of the liability side, notably deposits, is de facto of perpetual maturity, although it is notionally of finite maturity, as short as one day in the case of demand deposits.

It's the same alchemy that permits mutual funds to commit to next-day redemption at tonight's NAV, even though all reasonable people know that a mutual fund - with the possible exception of a money market fund - could not possibly liquidate all assets on the wire tomorrow at tonight's NAV marks. Systemically, it's the illusion of liquidity, as so elegantly described by John Maynard Keynes:

"The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only. But a little consideration of this expedient brings us up against a dilemma, and shows us how the liquidity of investment markets often facilitates, though it sometimes impedes, the course of new investment. "For the fact that each individual investor flatters himself that his commitment is 'liquid' (though this cannot be true for all investors collectively) calms his nerves and makes him much more willing to run a risk. If individual purchases of investments were rendered illiquid, this might seriously impede new investment, so long as alternative ways in which to hold his savings are available to the individual. This is the dilemma.

"So long as it is open to the individual to employ his wealth in hoarding or lending money, the alternative of purchasing actual capital assets cannot be rendered sufficiently attractive (especially to the man who does not manage the capital assets and knows very little about them), except by organizing markets wherein these assets can be easily realized for money."

My view - As human beings we are hardwired to expect a pattern to continue once recognised. This occurs even though, if we think about it objectively, we admit that it cannot go on interminably. Take the example of a light switch. We know that the more times we turn it on and off, the more likely it is for the bulb to blow. In the rational world, if we had to bet on the probability of when the element would break, we would assign a slightly greater possibility to it happening, following each successive throwing of the switch. Nevertheless, on the day the bulb finally fails, we are almost universally surprised that it has occurred.

When we add money and leverage to the equation the emotional quotient become much larger. From a rational perspective, we know that no trading strategy is 100% reliable, but emotionally we attach greater weight to actions that make us money even though we know they cannot last. In an accelerating trend, many investors tend to increase positions because they want to take the greatest possible advantage of the money making opportunity. Rationally we know that nothing can accelerate forever, but emotionally we convince ourselves the situation will continue for a while longer.

Over the last decade, investors learned to become comfortable with buying credits of lesser quality. The first time someone would have bought a credit with a lower rating, it would have been deemed a larger risk, however fast forward to 2007 and the market for instruments with a shady credit quality had exploded because people were making money following this course of action. Rationally, we can look back and say that buying instruments backed by less credit worthy companies or individuals is a recipe for disaster. Emotionally, however, as long as the strategy is seen to be working, the risks are, to a large extent, ignored.

The challenge as investors is to be aware of this tendency to ignore risk when we are employing a trading strategy that works and exaggerate the risk when that strategy fails. If can maintain that introspective scrutiny, we will be able to participate in trends that are in form and exit when that condition changes.

Email of the day - on looking for a bottom:

"I am so enjoying your consistency! Right when I want to respond to the doomsday types, that this is a "wealth" crisis, let's try not to make it a "health" crisis I know we must be closer to a base. Watching some of my favourite leading stocks drop to such low levels is literally making my mouth water. It's encouraging to feel I am not alone."

My comment - Thank you for such a pragmatic email. It is hard for people who have sold losing positions to hear that we think the medium-term outlook is bullish because they are now emotionally invested in the market moving lower. There is no doubt that time is needed for volatility to settle down before many will have the confidence to return to investing, but if one looks beyond the end of the year, 2009 will almost certainly be a better year for investors than 2008.

### **Wednesday 26th November 2008**

The American Time Bomb - My thanks to a subscriber for the link to this Oscar-nominated documentary by David Walker, former comptroller at the US General Accounting Office, on the ballooning American deficit problems. Please note: I have just heard that this [film](#) may not be accessible in some countries outside the UK.

My view - The subject may sound dull to some of you. Trust me - this is riveting viewing. More importantly, it is a lesson for us all.

Email of the day - [On Barton Biggs article, posted yesterday:](#)

"The mutual fund gentlemen that states the bottom is near due to consumer sentiment is missing three very good variables. We need the consumer to pull us out of this mess by spending because we are no longer a manufacturing based society. How can that happen when jobs are being lost everyday? Secondly, the housing market is oversold and is the key to any recovery, and currently we have over a year's supply of unsold homes, even at distressed prices, along with a soon to be 9% unemployment. Thirdly, at no time in our Great Nation's history has the national debt been at 46 trillion or the currency not backed by gold. Sure we are acting quickly, why not, all we do is print more and more worthless paper. If the situation continues to deteriorate, trying to guess the bottom of the market will be the least of our worry's because we will need to save American society from itself."

My comment - I do not underestimate the problems but they can and will be solved, hopefully well before realising our worst fears. Additionally, every investor has at least some influence over their individual financial outcome. Let's treat an adverse situation as a challenge rather than a sentence to be endured.

Obama Names Volcker to Head Panel on Reviving Economy - [Here is news of another appointment for the incoming administration, reported by Bloomberg.](#) This is the opening:

President-elect Barack Obama named former Federal Reserve Chairman Paul Volcker to head a new White House economic board that will propose ways to revive growth as the U.S. grapples with an "economic crisis of historic proportions."

"At this defining moment for our nation, the old ways of thinking and acting just won't do," Obama said at a news conference in Chicago, his third in as many days.

Volcker, 81, will be chairman of the President's Economic Recovery Advisory Board. The panel's top staff official will be Austan Goolsbee, a University of Chicago economist who will also be a member of the president's Council of Economic Advisers.

The panel, which will include experts from outside government, will meet about once a month and periodically brief Obama with advice on how to shore up financial markets. Volcker's position will be part-time.

"Sometimes policymaking in Washington can become too insular," Obama said. "The walls of the echo chamber can sometimes keep out fresh voices and new ways of thinking -- and those who serve in Washington don't always

have a ground-level sense of which programs and policies are working."

My view - At 81, I assume that Paul Volcker would not have wanted the fulltime role of Treasury Secretary. However he is the ideal person to Chair a new White House economic board. This is a smart appointment by president-elect Obama.

Christopher Wood: The Fed Is Out of Ammunition - My thanks to a subscriber for this topical and educative [article](#) published in The Wall Street Journal ([PDF](#) also provided). Here is the opening:

With an estimated \$4 trillion in housing wealth and \$9 trillion in stock-market wealth destroyed so far in the United States, there is little doubt that we are witnessing a classic debt-deflation bust at work, characterized by falling prices, frozen credit markets and plummeting asset values.

Those who want to understand the mechanism might ponder Irving Fisher's comment in 1933: When it comes to booms gone bust, "over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money."

The growing risk of falling prices raises a challenge for one of the conventional wisdoms of the modern economics profession, and indeed modern central banking: the belief that it is impossible to have deflation in a fiat paper-money system. Yet U.S. core CPI fell by 0.1% month-on-month in October, the first such decline since December 1982.

The origins of the modern conventional wisdom lies in the simplistic monetarist interpretation of the Great Depression popularized by Milton Friedman and taught to generations of economics students ever since. This argued that the Great Depression could have been avoided if the Federal Reserve had been more proactive about printing money. Yet the Japanese experience of the 1990s -- persistent deflationary malaise unresponsive to near zero-percent interest rates -- shows that it is not so easy to inflate one's way out of a debt bust.

In the U.S., the Fed can only control the supply of money; it cannot control the velocity of money or the rate at which it turns over. The dramatic collapse in securitization over the past 18 months reflects the continuing collapse in velocity as financial engineering goes into reverse.

True, this will change one day. But for now, the issuance of nonagency mortgage-backed securities (MBS) in America has plunged by 98% year-on-year to a monthly average of \$0.82 billion in the past four months, down from a peak of \$136 billion in June 2006. There has been no new issuance in commercial MBS since July. This collapse in securitization is intensely deflationary.

It is also true that under Chairman Ben Bernanke, the Federal Reserve balance sheet continues to expand at a frantic rate, as do commercial-bank

total reserves in an effort to counter credit contraction. Thus, the Federal Reserve banks' total assets have increased by \$1.28 trillion since early September to \$2.19 trillion on Nov. 19. Likewise, the aggregate reserves of U.S. depository institutions have surged nearly 14-fold in the past two months to \$653 billion in the week ended Nov. 19 from \$47 billion at the beginning of September.

But the growth of excess reserves also reflects bank disinterest in lending the money. This suggests the banks only want to finance existing positions, such as where they have already made credit-line commitments.

Monetarist Bernanke and others blame Japan's postbubble deflationary downturn on policy errors by the Bank of Japan. But he and others are about to find out that monetary gymnastics are not as effective as they would like to think. So too will the Keynesians who view an aggressive fiscal policy as the best way to counter a deflationary slump. While public-works spending can blunt the downside and provide jobs, it remains the case that FDR's New Deal did not end the Great Depression.

My view - Having a great deal of respect for Christopher Wood, who also writes the *GREED & fear* letter for CLSA, I take his views very seriously indeed. However, while the Great Depression and Japan's difficult experience of the 1990s and beyond are the most relevant and also important historic examples for comparison, two previous instances of lengthy deflations for large economies are too few in my view to assume that the US government is out of ammunition.

I do not know how today's serious economic problems will play out for the USA, and neither does anyone else. All we know is that there will be the mother of all efforts to avoid another lengthy deflation. We are living through a fascinating and very scary chapter of economic history, and not just for the USA.

As investors, all of us have to make decisions on the basis of what we know, what we can see, and what we believe is appropriate for ourselves and our families. Speaking for myself, I believe that America's problems of debt and deficits are worse than for many other countries. More importantly, I will be guided by price charts, which reflect the collective decisions and views of everyone else. In terms of investment appropriateness, my current view is that I would rather watch developments in the USA than invest there.

The credit / solvency crisis is clearly America's biggest problem at this time. This is not necessarily true for all other countries, although all are obviously affected to a greater or lesser degree by developments in the USA. I suggest that the West's credit / solvency crisis was only the second biggest problem for Asia's developing economies.

Asia's biggest recent problem, I maintain, was inflation, not least from previously soaring energy and food prices. That crisis, which in comparison was the USA's second biggest problem, has largely disappeared today. I

suspect commodity inflation will not re-emerge for at least the next year or two, subject to supply, global GDP and the USD.

Consequently, I believe that developing Asia would be in an excellent position for recovery, were it not for the West's ongoing credit / solvency crisis. Therefore, the worse the USA's problems become, the more this will be a drag on Asia's own recovery. Conversely, if the USA somehow avoids a destructive deflation, Asia should still bounce back more quickly.

I will invest accordingly.

#### Additional Commentary by Eoin Treacy

Yield charts for corporate bond indices - Stock markets have been hit hard by the credit / solvency crisis, but in many respects the corporate bond market has been hit harder. Liquidity has almost dried up and accurate pricing is increasingly more difficult to come by. This situation is creating some interesting opportunities for those capable of bidding under the market for credits. This market could also provide us with a signal when conditions begin to ease because it is so much more illiquid at this stage than the equity markets.

With a view to monitoring this market I added spreads for USD Composite AAA, AA, A, BBB, BB, B, REIT BBB, Gas Transmission BBB, Media A, BBB, Tim Warner, Retail AA, A, BBB, BB. Industrial AAA, AA, A, BBB, BB, B, Telephone A, BBB, Rail Equipment A+, A, A-, First Mortgage Utilities AA, A, BBB and Utilities A to the Spreads & Overlays section of the Chart Library today. You will also be able to find the respective yield charts Bond Yields section by the end of tomorrow.

All of these spreads have expanded considerably since early October; when default risks were massively upgraded. None have yet formed a conclusive top. Some of the more highly rated instruments' spreads have lost momentum somewhat, but considerable contraction is needed to suggest that the damage done to confidence following the Lehman Brothers bankruptcy has been undone.

Investors fled the credit markets because of the fear that issuers will default on their debt. However, while one would expect the default rate to rise during a recession, the risk is probably being exaggerated and what liabilities exist are clearly concentrated in companies that relied most on access to cheap credit. Issuers with steady cash flows should be relatively safer bets. Importantly, the credit markets may react faster as investors return and could be a lead indicator for stock markets.

Email of the day (1) - on bond yields

"USD US Bank BBB 10yr - US 10yr Yields. Am I correct in thinking this spread is for BBB rated banks cost of borrowing?"

"It's increasing, indicating increased fear in lending. Why so when LIBOR and TED spread are falling back?"

&

"Treasury yield 3-month yields are virtually 0%. Does this indicate extreme fear. Should we expect this to rally as cash gets moved back into the stock market rally we're over due."

&

"Should we expect end of month stock/bonds portfolio re-balancing from fund managers as stocks as a percentage of their portfolio would be lopsided due to the declines in stock markets. Some forced buyers would be nice!"

"Finally, is there a spread (or proxy) which shows the cost of borrowing for the different rated corporate companies AAA, BBA, BBB etc."

My comment - Thank you for some interesting questions which I'm sure will be of interest to other subscribers. The [spread](#) of BBB Banks over Treasuries is more a measure of the risk being attached to the banks themselves, rather than a comment on how expensive it is for them to raise money. M&T Bank Corp, Banco Populaire Puerto Rico, Cathay Bank, Citizens Bank / Flint Michigan, Provident Bank, Webster Bank, Sovereign Bank, Bank of Oklahoma, Zions Bancorporation, Huntingdon National Bank among others are all contained in the US BBB Bank yield curve. The expanding spread suggests that investors are more concerned with the business models of these banks rather than their cost of funding.

LIBOR (London Interbank Offered Rate) is an average of the cost of the borrowing between the members of the LIBOR panel. These are generally fairly reputable firms, although recently even that has been called into question. For banks not covered by Libor, price discovery is best found by calling up a credit desk and asking for how the credit default swaps for a 5-yr bond is trading.

Unfortunately, since CDS are traded over-the-counter and banks jealously protect their prices, no composite exists so we cannot post these rates in the Chart Library.

The [TED](#) (3-mth Libor - 3-mth T-Bills) and [OIS](#) (3-mth Libor - 3-mth Overnight Indexed Swaps) spreads have contracted considerably but need to continue to tighten before interbank lending conditions could be considered normal.

[3-month yields](#) near zero suggest that investors have no faith in any other asset other than government backed securities. This is unsustainable because while for the short-term people can afford not to earn a return on their cash, over the medium-term inflation will eat away at their reserves. Of

course, deflation is the primary worry for investors today, but it has also been labeled public enemy #1 by central bankers. 3-month yields are an interesting instrument to monitor, because when it begins to turn upwards, it should be a fairly reliable indicator that cash is moving away from safe havens and towards more risky assets such as equities, corporate bonds and commodities.

Index tracking funds will be reweighting portfolios over the coming days, not least because the MSCI Indices reweighted yesterday as well as it being close to the end of the month. However, this has so far failed to result in significant further bullish activity for most indices. Personally, I would not be inclined to base my investment decisions on such a fickle timing issue beyond the very short term.

The upward dynamics posted by a large number of stock market indices late last week, in the region of the late October lows are of more technical importance. They suggest demand is returning at an obvious level of potential support.

Brazilian Farm Credit Shrinks; Growers Reduce Crops - Thanks to a subscriber for this [article](#) by Carlos Caminada for Bloomberg covering the effects of the credit crisis on farmers. Here is a section:

Terra received only 10,000 reais (\$4,300) of the 35,000- real loan he needed this month, so trees that should yield 250 bags of coffee next season will likely produce just 170, he said. Terra is planning to pick up extra work as a farmhand to support his wife and two sons.

"It's kind of impossible to keep going like this," said Terra, 29, who grows arabica coffee on about 10 hectares (25 acres) in Bom Jesus da Penha, a city in the southeastern state of Minas Gerais. "I don't know what will happen."

The collapse of global credit markets that is pushing the U.S., Europe and Japan into simultaneous recessions for the first time since World War II also threatens farmers in Brazil, the world's biggest grower of coffee, oranges and sugar cane, the second-largest producer of soybeans and third-biggest of corn. Smaller harvests in Brazil may increase costs of commodities next year, said Andre Pessoa, an analyst at Agroconsult who conducts the country's broadest crop survey.

"When we look ahead, we see demand continuing to grow, while supply will face difficulties," Pessoa said in an interview from the Florianopolis, Brazil-based company.

Futures contracts in Chicago show corn will jump 18 percent by the end of 2009 to \$4.175 a bushel and soybeans will gain 2.2 percent to \$9.02 a bushel. Coffee will rise 10 percent to \$1.258 a pound, according to contracts in New York.

## Crop Shortfall

Reduced fertilizer use will lower Brazil's soybean output as much as 2.7 percent, while corn may decline 7.3 percent, the government said Nov. 6. Brazil's coffee harvest may drop 26 percent next year, said Lucio Araujo, the commercial director at Cooxupe, a cooperative representing 11,000 growers in the Guaxupe region.

Brazilian growers were short of at least 15 billion reais needed to invest in crops, Agriculture Minister Reinhold Stephanes said Oct. 9. Banks and financial companies worldwide, suffering from \$969.5 billion of losses and writedowns since the start of 2007, are restricting credit as they struggle to replenish reserves, according to data compiled by Bloomberg.

"This will be the harvest of uncertainty," said Carlos Augustin, who grows cotton and soybeans on about 30,000 hectares in Mato Grosso, Brazil's biggest soybean-growing state. "Losses are guaranteed."

My view - Agriculture related commodities have fallen considerably over the last six months with grain prices halving and other soft commodities also falling sharply. No one is any doubt that speculative buying caused commodities to soar to new highs earlier this year but there were also sound fundamental reasons for the advance to begin with.

Global inventories remain at historically low levels despite record yields over the last decade. The cost of production has also increased over that time period and demand has increased with the improving diets of hundreds of millions of new middle class consumers across Asia. One might argue that consumption will fall in a global recession and this is true for non-essential items. However, the bulk of demand growth over the last few years has come from countries likely to be less affected by the global slowdown so demand may not fall as much as forecast.

Corn, soybeans and wheat have all fallen considerably from their highs and lost momentum over the last month. Their downtrends remain in place and sustained moves above 425¢, 975¢ and 600¢ respectively are needed to break the progression of lower highs and suggest that demand is regaining the upper hand.

Oats remains in a consistent though increasingly overextended downtrend. a sustained move above 250¢ would be needed to question scope for further downside.

Rough rice has also fallen considerably from its accelerated high and needs to sustain a move above \$16 to break the progression of lower highs.

Arabica coffee broke its consistent progression of rising lows in September and has since found at least short-term support near \$110. A sustained move above \$120 would be needed to suggest the bulls have regained the upper hand.

Robusta coffee also broke its progression of higher lows in September but found support above \$1500 and rallied. A sustained move below that level

would now be needed to question scope for some additional higher to lateral ranging.

[Orange Juice](#) remains in a consistent uptrend and a sustained move above \$90 would be needed to question scope for some additional downside.

[Sugar](#) has been a relative performer among soft commodities because it did not take part in the accelerations earlier this year. It fell back from \$14 in early October but found support above 10¢ and would need to sustain a move below the latter level to question scope for further higher to lateral ranging.

[Cocoa](#) fell sharply from its July highs but found support over the last month near \$2000 and would need to sustain a move below that level to question scope for a recovery over the medium-term. Traded on Liffe and in Pounds, [cocoa](#) found support above £1200 and surged upwards. A sustained move below £1450 would now be needed to question scope for some additional upside.

While Cocoa is the clear leader among this group of commodities, the rest have still to show signs that demand is returning in force. However, if yields are as low next year as are being currently forecast, this sector could easily return to prominence at some point in 2009, so it is worth monitoring.

Today's interesting charts - The Chart Library has a comprehensive selection of credit spreads which may be of interest to subscribers.

Nikkei 225 - the [downtrend](#) has lost momentum after accelerating to 7000. A sustained move below that level would be needed to question scope for further higher to lateral ranging.

South Africa - finds [support](#) near the late October lows and would need to sustain a move below 18000 to question potential for some additional higher to lateral ranging.

Philadelphia Gold & Silver Index - found [support](#) above the October lows and would need to sustain a move below 70 to question potential for some additional upside.

Email of the day (2, 3, 4 & 5) - on additions to the Chart Library:

"Could you please add Xtreme Coil Drilling ([XDC CN](#)), traded on the TSX, to the Chart Library?"

"Thank you!"

And

"Could you please add the [Marlborough](#) ETF commodity fund to the Library?  
Thanks"

And

"Please add [ZKB GOLD ETF](#) listed on the Switzerland Stock Exchange to the chart library. The symbol is ZGLD and the ISIN is CH0024391002."

And

"Please would you add MM:IN ([Mahindra & Mahindra](#)) to the Library?"

My comment - Thank you all for these interesting suggestions which have now been added to the Chart Library.

#### **Thursday 27th November 2008**

International Energy Agency's Executive Summary - My thanks to a subscriber for pointing out this important summary by the IEA. It is posted in the Subscriber's Area but here is the opening:

The world's energy system is at a crossroads. Current global trends in energy supply and consumption are patently unsustainable - environmentally, economically, socially. But that can - and must - be altered; there's still time to change the road we're on. It is not an exaggeration to claim that the future of human prosperity depends on how successfully we tackle the two central energy challenges facing us today: securing the supply of reliable and affordable energy; and effecting a rapid transformation to a low-carbon, efficient and environmentally benign system of energy supply. What is needed is nothing short of an energy revolution. This World Energy Outlook demonstrates how that might be achieved through decisive policy action and at what cost. It also describes the consequences of failure.

Oil is the world's vital source of energy and will remain so for many years to come, even under the most optimistic of assumptions about the pace of development and deployment of alternative technology. But the sources of oil to meet rising demand, the cost of producing it and the prices that consumers will need to pay for it are extremely uncertain, perhaps more than ever. The surge in prices in recent years culminating in the price spike of 2008, coupled with much greater short-term price volatility, have highlighted just how sensitive prices are to short-term market imbalances. They have also alerted people to the ultimately finite nature of oil (and natural gas) resources. In fact, the immediate risk to supply is not one of a lack of global resources, but rather a lack of investment where it is needed. Upstream investment has been rising rapidly in nominal terms, but much of the increase is due to surging costs and the need to combat rising decline rates - especially in higher-cost provinces outside of OPEC. Today, most capital goes to exploring for and developing high-cost reserves, partly because of limitations on international oil company access to the cheapest resources. Expanding production in the lowest-cost countries will be central to meeting the world's needs at reasonable cost in the face of dwindling resources in most parts of the world and accelerating decline rates everywhere.

Preventing catastrophic and irreversible damage to the global climate ultimately requires a major decarbonisation of the world energy sources. On current trends, energy-related emissions of carbon-dioxide (CO<sub>2</sub>) and other greenhouse gases will rise inexorably, pushing up average global temperature by as much as 6°C in the long term. Strong, urgent action is needed to curb these trends. The 15th Conference of the Parties, to be held in Copenhagen in November 2009, provides a vital opportunity to negotiate a new global climate-change policy regime for beyond 2012 (the final year of coverage of the first commitment period of the Kyoto Protocol). The conference will need to put in place a framework for long-term co-operative action to bring the world onto a well-defined policy path towards a clear, quantified global goal for the stabilisation of greenhouse gases in the atmosphere. It will also need to ensure broad participation and put in place robust policy mechanisms to achieve the agreed objective. The energy sector will have to play the central role in curbing emissions - through major improvements in efficiency and rapid switching to renewables and other low-carbon technologies, such as carbon capture and storage (CCS).

And here is the concluding paragraph:

The energy future will be very different

For all the uncertainties highlighted in this report, we can be certain that the energy world will look a lot different in 2030 than it does today. The world energy system will be transformed, but not necessarily in the way we would like to see. We can be confident of some of the trends highlighted in this report: the growing weight of China, India, the Middle East and other non-OECD regions in energy markets and in CO<sub>2</sub> emissions; the rapidly increasing dominance of national oil companies; and the emergence of low-carbon energy technologies. And while market imbalances could temporarily cause prices to fall back, it is becoming increasingly apparent that the era of cheap oil is over. But many of the key policy drivers (not to mention other, external factors) remain in doubt. It is within the power of all governments, of producing and consuming countries alike, acting alone or together, to steer the world towards a cleaner, cleverer and more competitive energy system. Time is running out and the time to act is now.

My view - I do not think that many sensible people would disagree with the IEA's premise that we need to develop cleaner energy and renewable energy - without delay. Moreover, we cannot responsibly gamble that the IEA is wrong.

Email of the day (1) - [On a bearish commodity forecast:](#)

"I saw this on Mineweb. It caught me off guard a bit as I respect the managers of the BlackRock fund. I also buy into the theory that next to financial stocks, commodity stocks have been slammed the hardest because of the massive Hedge Fund redemptions. It turns out that so many Hedge Funds were into the financials short and commodities long trade. When the Lehman Brothers debacle happened, Hedge Funds needed to sell and sell fast and the most

obvious things to sell were the commodities where they had amassed huge profits. So I believe they are overdone to the downside, and we just need to wait it out until the sentiment improves. So many of their balance sheets remain pristine. Then I read the following. It's what I call a head spinner."

My comment - [Thanks for the article \(see below\)](#). I agree with you, although I am not so sure about the pristine balance sheets, although some are clearly in good shape.

Evy Hambro: Years of depressed pricing ahead for commodity stocks - [Many thanks for this article from Mineweb, via Reuters](#):

Commodities markets are facing years of depressed pricing as users of everything from Malaysian tin to South African platinum see orders dry up and cancel raw material shipments, BlackRock World Mining Fund, the world's largest commodities fund, said on Tuesday.

Steel makers worldwide are reducing inventories rather than make more steel, lowering demand for iron ore and coking coal, while a collapse in car making has left South Africa's once-booming platinum industry in tatters, Evy Hambro, the \$4.7 billion fund's manager told a media teleconference.

Tin production alone is down 20 percent in the last few months and armada-sized fleets of empty oil and ore freighters idle off once-bustling ports in Singapore and China.

"It doesn't matter which commodity you are exposed to, they all are doing it tough," Hambro said during a visit to Sydney.

He predicted the "total and utter collapse in demand" underway is likely to last for the next three to five years at least.

"We've even had some companies coming through our offices in London telling us that even if they were giving away the products, their customers simply wouldn't take them," he said.

In sharp contrast to a few months ago, when buyers were stepping over each other to get their hands on limited supplies of steel, aluminium, copper and other industrial staples, the global financial meltdown is turning the commodities sector upside down, according to Hambro.

"The forced deleveraging that's taking place in financial markets has created necessary sellers meeting with reluctant buyers," Hambro said.

A lack of credit available to commodities traders, which is forcing even more tonnages on to already-flooded markets at bargain-basement prices, was exacerbating the situation, and resulting in forced liquidations of physical metal, he said. Production cuts by suppliers were so far insufficient to combat the oversupply, he said.

Oz Minerals Ltd (OZL.AX) said on Tuesday it would reduce production at its

loss-making Century zinc mine in northeast Australia by almost 4 percent to 495,000 tonnes in 2009 from a forecast 515,000 tonnes,

Mining heavyweights Vale (VALE5.SA) (RIO.N) and BHP Billiton Ltd/Plc (BHP.AX) (BLT.L) (BILJ.J) have already turned down iron ore production in Brazil, while Rio Tinto (RIO.AX) (RIO.L) is cutting fourth-quarter output in Australia 10 percent. (Reporting by James Regan)

**My view** - In discussing this article, Eoin and I agreed that it seemed unduly pessimistic. Approximately seven years ago, Fullermoney was an early advocate of the commodity supercycle hypothesis, mainly due to rapid economic growth as more economies with large and increasing populations embraced Capitalist economic systems, and also profited from globalisation. This led to a global infrastructure boom and increased demand for all commodities from the rapidly growing middle classes in these countries.

Fullermoney also pointed out that it would take a global recession to interrupt this supercycle significantly, although it was unlikely to derail it. This contention will be tested over the next few years because we certainly have a global recession. Moreover, an increasing number of people now believe that the world's largest economy is moving into a depression, with some other countries likely to follow.

Fullermoney maintains that although a global recession (defined by the IMF as worldwide GDP growth of less than 3 percent) is still steepening, we will not see the policy errors capable of turning it into a depression. All of the world's important economies are now actively engaged in reflationary efforts, albeit somewhat belatedly as governments have always been crisis oriented and therefore reactive rather than anticipatory.

Moreover, significant factors contributing to the global recession, not least for non western countries, are no longer a problem. I am of course referring to the year's earlier spikes in food and particularly energy prices. Past oil spikes have always caused recessions, as I have pointed out before, and this year's surge by crude to \$147 is no exception. Today's price for [crude](#) is stimulative for the global economy, predominantly oil exporters excepted, although it will obviously take time for the earlier shock to filter through the economic system.

With all the depression talk, and credit markets still impaired, it is hardly surprising that many orders have been cancelled, as Evy Hambro reports above. This is the immediate crisis that governments must address successfully. It takes time but they will not fail for lack of effort, including infrastructure spend, as we hear from president-elect Obama and see with China (*see also Eoin's item on this subject below*).

We all know that economic conditions are tough out there right now. However it strikes me as unrealistically pessimistic to think that the collapse in demand will "last for the next three to five years at least", as the article above states, although this is not a direct quote. I think industrial metals will be early beneficiaries of reflationary efforts. Meanwhile, production will be lowered to steady prices and the cost of production is falling rapidly.

Email of the day (2) - [On the safety of segregated accounts:](#)

"The recent failures of financial institutions have certainly highlighted the need to take precautions to protect your investment funds and any advice you can share with me would be greatly appreciated.

"I have experienced the misfortune of having a brokerage (Global Trader Europe) go into Administration (February 2008) and am still "patiently" waiting for a refund of my funds that were in a segregated account. Unfortunately, the wheels in these liquidations seem to move very slowly!

"I gathered that you used IGIndex for some of your trading and I have opened an account with them. Reading in the press last week that they had suffered fairly large losses through clients with uncovered positions made me realise that default risk is not an impossibility if they do not control their own risks properly. It would obviously be devastating if I was able to make some trading profits (not easy in today's markets) only to lose my capital through default by IG. Am I correct in assuming that funds in a Retail Account are covered up to £50000 by the Financial Services Compensation Scheme? Furthermore, if my balance was to exceed £50000 would you suggest opening another account with a different institution?

"My question above relates to the fact that I would prefer to build up longer term investment positions in my Spreadbetting account to try and avoid capital gains tax in the future, albeit that it will no doubt be far more stressful than buying funds or equities in the normal manner. Or would you (with your considerable experience) recommend that I only use IGIndex for short term trading positions?

"I appreciate that this is not a normal question, but your views would be much appreciated."

My comment - [Thank you for an interesting email and your questions, which will be of interest to many subscribers. I hope your funds with Global Trader Europe are refunded, in full and soon.](#)

[I knew and liked the founders of both IG Index and City Index, and have traded with both firms since their inception. I believe they are very good at controlling their risks, but there is no such thing as risk-free environment, as you know. Given the extraordinary volatility in recent months, I am not surprised that firms have incurred some bad debts. It has happened before and no doubt will again in future.](#)

[I believe you are right concerning the Financial Services Compensation Scheme, but have asked for confirmation of this. For convenience and efficiency, I personally would not wish to be monitoring more than two spread-betting accounts. Moreover, as these are leveraged accounts, if your strategies were working you would have opportunities to draw down cash levels as net profitable trades became self-financing.](#)

Spread-betting is not for everyone, but if you are accustomed to it, I see no reason not to use these firms for some of your longer-term investments. However, based on my own experience, I do best when building up positions incrementally within trends, and maintaining money control disciplines. When I stray from this path, it can be unnecessarily expensive.

My personal portfolio: Natural gas profit taken - Having to leave the office early yesterday, and seeing that [natural gas](#) had rallied from the lower side of its trading range, I placed a tight stop on my long position. This was stopped out early this morning resulting in the sale of my January NG position at \$6.90, against my purchase at \$6.412 on 26th November. These prices include all spread-bet dealing costs.

Additional Commentary by Eoin Treacy

Mind Matters: The road to revulsion and the creation of value - Thanks to a subscriber for this excellent [report](#) by James Montier for SocGen, which is very much in line with our view that value is rapidly appearing in a number of asset classes. I also commend it to subscribers for its wonderful long-term charts, not least for volatility. Here is a section:

Perhaps the only solace to investors is that the road to revulsion ends in an investment nirvana - unambiguously cheap assets. The latest addition to the portfolio of deep-value opportunities comes from fixed-income land. The yields on BAA-rated bonds are pricing an environment akin to the 1930. Senior secured debt is available for 50-70c on the dollar.

Equity markets are also offering opportunities. Even at the market level, equities are looking attractive. The US is trading on a Graham and Dodd PE of 15x, against an average of 18x since 1871. The UK is trading on 12x such a measure, against 16x since 1927. Could markets go lower? Of course. But from a long-term perspective they are attractive!

Whilst this may not be the 1930s, it is informative to see what happened to drag markets down to their all-time lows. Mapped onto today, the 1930s would require (reported) earnings to halve from current levels. Of course, equities are a claim on long-term cash flows, and as such very little of their value comes from the near term (less than 10% in a typical DCF), so if markets did follow the 1930s example, it would be a generational opportunity to buy.??

From a bottom-up perspective, the opportunities are even more compelling. In Europe and the UK nearly one in ten stocks is passing our augmented Ben Graham screen. In Japan and Asia one in five stocks is passing the screen! Even 15 stocks within the S&P500 are showing up as deep-value opportunities (a full list appears on page 12 onwards). Some have argued that value stocks did particularly poorly during the Great Depression. The data show that they did no better or worse than other equities but did eventually rebound faster.

Perhaps it is time to reintroduce the late, great Bob Kirby's idea of the coffee can portfolio - a basket of stocks that one would be happy to hide under the mattress and forget about. Of course, such an approach requires a long time horizon. Sadly, the institutional imperative to perform on all time horizons combined with the mad world of modern risk management hamper most investors' abilities to exploit the opportunities.

My view - Angst, fear and anxiety are all related emotions which come to the fore when we feel under pressure and begin to doubt our abilities as investors. However, when we see a market fall such as that of the last few months, we have to rein in the temptation to succumb to such emotions. It will prove more profitable over the medium to longer-term, to turn objective about the opportunities we are being presented with sooner rather than later.

This does not mean one piles into the market with every spare unit of currency right now, but it is a time to begin to think about the shares one wants to own in a recovery environment. From a value perspective there are a number of instruments which have been hit particularly hard and somewhat unjustifiably by the credit / solvency crisis. We now need to begin to think more about recovery potential rather than further potential losses. Stocks and corporate bonds are no longer expensive, some are downright cheap. We have not reached the deep value levels seen in the past, but these need not necessarily appear at the numerical low for the market, if they appear at all. However, one looks at the market, given the extent of the fall, this is not a time to become increasingly bearish, but is one in which to make provisions and possible purchases for a recovery scenario.

The [S&P 500](#) broke downwards from its short-term range last week, but pushed back up into the range this week, in what looks like a failed downside break. A retest of the psychological 1000 level now looks more likely but a sustained move above that level is needed to suggest that demand is regaining the upper hand.

Obama to Boost Stimulus With Funds for Roads - This [article](#) by Matthew Benjamin for Bloomberg covers the companies which stand to benefit from the proposed boost to US infrastructure spending. Here is a section:

President-elect Barack Obama, encouraged by congressional Democrats, will propose early next year an economic-stimulus package three times larger than one he was discussing only weeks ago, with the main focus on infrastructure, aides and lawmakers said.

The package, aimed at ending the worst U.S. economic slump in at least a quarter-century, probably won't be submitted until January, giving up any chance of passing a stimulus plan during a lame-duck session of Congress next month.

An infusion of as much as \$700 billion is warranted, according to Senator Dick Durbin of Illinois, the No. 2 ranking Democrat in the Senate and Obama's closest ally in Congress. The plan would create jobs and boost sales at

companies including Caterpillar Inc., the largest maker of construction equipment, and engineering firm Fluor Corp.

"You better stimulate with a number that will create measurable economic growth," Durbin said in an interview. Obama, who said during a press conference yesterday that he had to deal with an "economic crisis of historic proportions," declined to give a range for the new package he favors. Still, he made Durbin's point that it will have to be big enough to restore confidence.

The spending will be "of a size and scope that is necessary to get this economy back on track" and "significant enough that it really gives a jolt to the economy," he said.

Obama will hold another press conference today to discuss overhauling government spending, during which he will announce Peter Orszag, head of the Congressional Budget Office, as his budget director, according to a Democratic aide.

#### Fueling Jobs, Growth

During the presidential campaign, Obama, 47, proposed a \$175 billion plan with tax-rebate checks for consumers as well as spending on school repairs, roads and bridges, aid to states, and tax credits for job creation.

Since the Nov. 4 election, the government reported the jobless rate climbed to 6.5 percent in October, the highest since 1994, with retail sales and consumer prices plunging the most on record. Federal Reserve policy makers now expect the economy to contract through the middle of 2009, with analysts forecasting the worst recession since at least the early 1980s.

Aides to Obama say Lawrence Summers, named yesterday as director of the National Economic Council, favors spending as much as possible to spark growth.

Many Democrats say much of the money should be used to jumpstart federal infrastructure projects because that would create jobs and fuel economic growth.

#### 'The Big Number'

Laura Tyson, an economic adviser to Obama, said a program may be used to finance highway projects, alternative-energy initiatives, tax cuts, education programs and aid to state governments struggling to balance their budgets.

Tyson said the package could total as much as \$600 billion over the next two years as the administration seeks to offset a decline in consumer spending. She said the size of the proposed stimulus has grown as the economic outlook has worsened.

"If the economy is faltering at a faster pace than expected, which does seem to be the case right now, then you want to go for the big number -- you want to go for the \$600 billion range,"

Tyson, who previously served as President Bill Clinton's top economic adviser, said in an interview with Bloomberg Television.

Caterpillar, based in Peoria, Illinois, has said the U.S. needs as much as \$700 billion in new roads, bridges, airports and ports to remain competitive with countries such as China. Public projects account for about 30 percent of total construction spending in the U.S., and may help blunt declines in residential building, Ann Duignan, an analyst with JPMorgan Chase & Co. in New York, wrote in a note yesterday.

My view - Fullermoney has long predicted that the USA had no choice but to increase infrastructure spending if it wanted to remain competitive and the credit / solvency crisis is providing the catalyst. As the number of unemployed climbs, particularly in the building sector, it is the government's responsibility to step in for as long as it takes the corporate sector to recover. Infrastructure spending will play a significant role in the attempts to stimulate the economy and there are a relatively small number of companies which stand to benefit. (Also see Comment of the Day on August [30th](#) and [31st](#) 2007)

[Granite Construction](#) (P/E 14.04, DY 1.24%) peaked near \$75 in July 2007 and quickly fell to near \$30, where it began to build support. It broke downwards once more in early October but this was not sustained and the share rallied impressively. It broke upwards from the yearlong range this week but is looking somewhat overextended in the very short-term. Rising lows were the hallmark of its advance until it peaked in 2007 and they may yet be again. A sustained break of the lows near \$29 would be needed to question scope for further upside over the medium term.

[URS Corp](#), (P/E 13.64) a civil engineering firm, hit a peak near \$65 in late 2007 and fell aggressively before finding support above \$30. Following a medium-term rally, it broke downwards once more in October but found support near \$20 and is now rallying impressively. It is now testing the 200-day moving average but a sustained move below \$22 would be needed to question potential for some additional upside over the medium term.

[Sterling Construction](#), (P/E 11.33) accelerated impressively in late 2005 and hit a marginal new high in early 2007 but subsequently moved into a lengthy ranging phase. It broke downwards in October but rallied impressively this week and would need to sustain a move below \$10 to question recovery potential.

[Meadow Valley](#) (8.45) a heavy construction contractor, rallied impressively to its peak in early 2006 and subsequently moved into a ranging phase. It broke briefly below the lower side of that congestion area this month but has since rallied strongly. It is now testing the progression of lower highs and needs to sustain a move above \$11 to indicate that the bulls are regaining the upper hand.

[Astec Industries](#) (10.13) a construction machinery company, also broke downwards from a medium-term congestion area in October but found

support near \$20 and rallied well this week. A sustained move to new lows would be needed to question recovery potential.

[Fluor](#) (P/E 13.28 DY 1.12%), an engineering company, hit a penultimate high in late 2007 following an impressive acceleration and eventually topped out near \$100 in June. It has since retraced almost the entire uptrend but found support near \$30 in late October and rallied impressively this week. A sustained move to new lows would be needed to question scope for further upside.

[Jacobs Engineering Group](#) (P/E 12.67) also peaked near \$100. It broke downwards from the ranging top formation in September and retraced almost its entire advance. It found support near \$30 and also rallied impressively this week. A sustained move to new lows would be needed to question recovery potential.

[KBR](#) (P/E 8.74, DY 1.46%), an engineering and construction company, rallied well following its IPO but topped out near \$45 in late 2007. It has since fallen considerably below its debut price and remains in a consistent downtrend. It found support near \$10 this week but needs to sustain a move above \$15 break the progression of lower highs.

[Caterpillar](#) (6.47, 4.27%) completed a Type-3 top in early September and quickly fell to test the upper side of the first step above the long-term base. It is currently ranging above \$30 and would need to sustain a move below that level to question scope for further higher to lateral ranging.

The first five companies in the section above are the clear leaders for this move, suggesting that they are considered the best placed to benefit from infrastructure spending. The latter four have the common fact that they have all fallen considerably and are beginning to find support. They are also likely to perform well in a recovery scenario but perhaps more in a catch-up move rather than in a leadership role.

I believe that this is a time we need to start looking for the leading sectors in any nascent recovery. The infrastructure shares are candidates, but there will be others which we can all watch for. Our Collective vigilance and diligence on this matter should lead us to profitable investments when a recovery takes hold.

Mineweb.com: 'Structural deficit' in gold supply could send prices higher - This article by Dorothy Kosich covers the improved relative prospects for gold shares. Here it is in full:

Based on the assumption that current strong physical gold demand highlights an existing supply deficit, Toronto's Wellington West Capital Markets forecasts that, "if the increased structural deficit in gold supply continues, gold prices should adjust higher."

Wellington metals analysts also advised, "Given the potential change in

market fundamentals, we believe it is time investors revisit investing in the junior and intermediate gold producers."

The analysts said their data indicates that a Central Bank Gold Agreement (CBGA) signatory "has become a gold buyer, putting further pressure on the existing supply deficit in the bullion market." In their analysis, Wellington suggests that China is building a strategic gold reserve.

Meanwhile, possible Russian, Ecuadorian and Iranian gold liquidation in the face of internal credit woes "has not fazed the market," the analysts advised.

Analysts Catherine Gignac, Paolo Lostritto, John Miniotis, and Ryan Walker also noted that investment demand for physical gold increased by 179% in the third quarter of this year.

"Severe stock shortages of bars and coins were reported among bullion dealers in many parts of the world. A continuation of strong gold investment demand has been seen so far in Q4/08, leading to the Perth Mint being forced to suspend orders until January," they said.

Wellington also urged precious metals investors, who "are expected to initially focus on large, capitalized liquid producers" to consider coming down the food chain. "If the market starts to regain confidence and applies higher future gold prices, we would expect more speculative funds to invest in intermediate and junior gold producers."

"Funds should continue to focus on well-managed senior producers but we believe it prudent to start considering the junior and intermediate gold space," the analysts advised.

In their research for the third quarter of this year, Wellington's analysis found that, despite a 19% increase in gold average gold price, gold mining production fell 2%, costs rose 37%, and margins declined by 13%, resulting in operating cash flows declining an average 29% for the group. "We note that debt levels are rising for most of the companies, in comparison to previous years when equity financing was more common."

The analysts also discovered that the relationship with the price of gold relative to the price of oil began to break down in October, resulting in the price of gold only decreasing by 8.1% since the end of September while the price of WTI crude oil decreased 51%.

My view - Gold remains a relative performer when compared to most equities and other commodities. In a number of [currencies](#) it has recently made new highs and while in most cases it was unable to sustain them, the case for gold as a hedge against financial turmoil remains intact. In US Dollar terms, gold topped out near the psychological \$1000 level in March and remains in medium-term downtrend. It found support in late October near [\\$700](#) and has rallied well since. However, it needs to break the progression of lower highs to suggest that the bulls have regained the upper hand. In light of this action, now might be an opportune time to look at some relevant gold ratios.

Gold began to move into an uptrend against [oil](#) from September and is looking overextended following an incredible run to the upside. It encountered resistance near 16 and, while to date this reaction is no larger than those seen previously, a sustained move above that level would be needed to reassert the uptrend and offset scope for some additional downside.

Gold outperformed [Silver](#) from August but began to lose momentum as it tested the 85 level. It would now need to sustain a move above 85 to reassert the uptrend and question potential for top formation development.

Gold accelerated to a high of over 11 against the [Philadelphia Gold & Silver Index](#) and 4.8 against the [Amex Goldbugs Index](#). It pulled back sharply against both indices and failed on subsequent rallies to challenge the highs. Sustained moves above 10.7 and 4.5 respectively would be needed to question potential for gold shares to outperform gold.

The [Philadelphia Gold & Silver Index](#) and [Amex Goldbugs Index](#) both found support above the late October lows in the last week and rallied impressively to break above their early November highs. This is the first higher low and higher high in months and they would need to sustain moves below 68 and 160 to question recovery potential.

When taken in aggregate, these ratios suggest that gold shares, silver and oil are all moving into phases where they could outperform the US Dollar gold price.

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

"Thanks for an excellent service. I am glad to see David include scenario analysis in some of his reviews. I.e.: worst case vs. best case. This helps me a lot understand what's going on out there. Can you include [EEV](#) in the chart library please? It's a short on emerging markets and another tool in the FM war chest."

My comment - [Thank you for your kind feedback and I can confirm that that this suggestion has been added to the Chart Library.](#)

### **Friday 28th November 2008**

Gold Poised for Biggest Monthly Gain Since 1999 as Dollar Drops - [Here is the opening from Bloomberg's report](#) today:

Gold headed for its biggest monthly advance since 1999 in London as a weaker dollar increased the appeal of the metal as a hedge against further declines in the U.S. currency.

The dollar is poised for a third monthly decline against the yen and its first monthly loss versus the euro since June. Gold prices have also been buoyed by demand for physical metal and exchange-traded funds. Gold demand rose 18 percent in the third quarter, the World Gold Council said this month.

"The dollar weakness is one reason but demand has also turned out to be stronger than expected in the third quarter," said Dan Smith, a Standard Chartered Plc analyst in London. Gold may reach \$850 an ounce by the end of the year, he said.

My view - Since 2001 most Fullermoney subscriber's have had an interest in [gold](#) and its sister precious metals. This is certainly understandable in a fiat currency world of often exploding [money supply](#), where no government wants a strong currency, and financial market sentiment is pulled back and forth, on the one hand between disinflationary/deflationary fears and on the other hand inflationary concerns.

To us, the case for a precious metals component in one's portfolio is obvious, although this certainly does not mean that it is a consensus view, which would be a contrary indicator. We also feel that precious metals positions need to be managed, for best results, due to ongoing volatility. Gold has been a relative performer during the waves of asset deleveraging seen this year, but it has not been immune.

The intriguing question is: what next for this sector?

Yesterday, Eoin had an interesting feature on the improving performance of gold shares relative to bullion, following their earlier weakness during the overall stock market sell-off. He also pointed out that silver was moving into a phase where it could outperform gold once again.

Fullermoney has long maintained that [silver](#) is high-beta gold, and will appeal to investors and speculators when the sector is in fashion. [Platinum](#) was an incredible outperformer up until its peak in March, before becoming a massive underperformer during the sell-off commencing in July. The reason, I assume, is that platinum was favoured earlier because of its industrial uses and shunned for the same reason more recently.

There is logic to this, although I think the selling is overdone. More importantly, this [monthly chart](#) of platinum relative to gold shows how cheap the white metal has become. This [daily chart](#) shows platinum losing downward momentum relative to gold and I would not be surprised to see the long progression of lower rally highs decisively broken before long. As precious metals become fashionable once again, platinum will be revered for its beauty and scarcity.

By typing 'platinum' in the Chart Library's General Search facility, subscribers will see plenty of data on the metal, plus some funds, an [ETF](#), and [Impala](#) which shows evidence of base formation development. By typing 'platinum' in the International Library Search, you will see a separate list including funds and shares. All of these are potentially interesting, although I feel the time for the [E-TRACS UBS Short Platinum ETN](#) has passed. For personal reasons of tax, leverage and convenience, I am currently participating via spread-bet positions in [platinum](#) futures. These are not for everyone, I emphasise.

Email of the day (1) - [On energy funds and Rio Tinto](#):

"Keep up the good work - it's appreciated and it's even a little strange at the moment, the internals (e.g. mine) are sensing a near end to this capitulation. Don't ask why, but it's the first time! Anyway, a couple of, hopefully, quick ones for you!

"On 19th November you mentioned an interest in the Energy (including alternatives) sector and that it would be one in which you would more than likely be interested in in the near future. You then provided the link to the various instruments in the Chart library. Is there any way you can maybe focus a little more on this and narrow the selection down a little more allowing us to do our own homework in a maybe more focused area.

"Is RIO not an ideal candidate for at least some nibbling by holders and non holders alike?

My view - I have always felt that one's intuition (what blokeish types call 'market feel') was important.

In providing that link on 19 November, I was aiming to teach newer subscribers how to fish in the Library.

You can easily spot the energy funds. Also, while we always advise subscribers to do their own due diligence in any financial situation, I maintain that sector timing is usually more important than the actual fund vehicle, if we are considering established fund managers and known firms. Incidentally, as you probably realise, subscribers have been instrumental in requesting the inclusion of funds which they think are of interest. As a Collective, it may not be a good idea for many of us to have invested in the same fund, when it is time to eventually consider exiting that position.

Regarding Rio Tinto ([weekly](#) & [daily](#)), and I should also comment on the recent BHP Billiton ([weekly](#) & [daily](#)) announcement that it was no longer interested in the proposed takeover, luck has favoured the latter company. Given the market meltdown, weaker economic climate and credit constraints, successful takeovers in the last couple of years now look expensive. In swallowing Alcan, [Rio](#) (see third and fourth items under 'Structure') has a higher debt gearing than [BHP](#). The market has been efficient in adjusting to the announcement, so on conventional data such as PER and Yield, [Rio](#) now looks cheaper than [BHP](#).

However I think BHP is in the much stronger position today, due to the luck of being unable to consummate the takeover of Rio, for which it had lobbied so actively. BHP will presumably now purchase distressed miners with attractive reserves, ironically, some of which may come from Rio. As for Rio, if it wants to lower its debt gearing, it will have to divest itself of assets in a buyer's market.

I will hold onto Rio for its long-term recovery potential. But the safest play of the sector, I believe, is via BRWM ([weekly](#) & [daily](#)). Here are some related articles:

Rio's Credit Rating May Be Downgraded on Debt, [S&P Says](#)

BHP Billiton still in market for top tier mining assets - [except gold](#)

Outlook for Asia 2009 - My thanks to a subscriber for this highly informative blockbuster [report](#) from Daiwa Institute of Research. I am unable to copy any of it as a sample but you can see it in full. Before deciding to print a copy, please note that it contains 172 pages.

My view - The Daiwa report is a valuable reference work for anyone investing in the world's most dynamic growth region. You should find charts for most of the shares mentioned in the Subscriber's Library (international equity section) and if not, we can add them on request.

Email of the day (2) - [More on the Evy Hambro presentation](#):

"A colleague attended an Evy Hambro presentation at a mid-sized insto broker in Sydney yesterday (and in fact was sitting next to Evy so is well placed to comment) and the brokers summary of the presentation and the presentation itself are attached. The Mineweb author must have had a bad hair day and couldn't have been more wrong. In summary, the gist of what was said was that demand has collapsed at present, credit markets are contributing to that and inventories are building rapidly partly because of the LC issue i.e. lots of shipping isn't happening. Underlying demand still exists, however, and will eventually eat into inventories. Given how rapidly supply is being retrenched, prices will pop when demand returns. His guess as to timing is next year. Nothing like the 3-5 year demand catastrophe a la Mineweb.

"Many thanks for all your thoughtful insights.

"Here's hoping for some sanity returning to the world and world markets!"

My comment - Thank you so much for your kind words and thoughtfulness in pointing out inaccuracies in the Mineweb item, via Reuters. I am glad I pointed out that the very bearish conclusion reported by Reuters was not a direct quote (see *yesterday's email of the day (1)* and *accompanying article*).

Thanks also for Evy Hambro's PowerPoint [presentation](#), which will be of considerable interest to many of your fellow subscribers.

My personal portfolio: Platinum long increased, silver long opened - I doubled my [platinum](#) long today, paying \$888.2 for another January position. I also bought [silver](#), paying \$10.335 for a March position. These prices include spread-bet dealing costs.

Email of the day (3) - [More on the Evy Hambro presentation](#):

"Further to, or rather perhaps, contrary to your posting of Mineweb's interpretation of Evy Hambros' comments, I forward a [link](#) to Melbourne's The Age which carries a more optimistic reporting of Mr Hambro's comments."

My comment - [Many thanks, this seems a good deal more accurate and compliments the PowerPoint presentation.](#)

Email of the day (4) - [On solving the US housing glut](#):

"One way to soak up the housing glut in the US is to allow for Retirement Visas. If the US would issue this type of visa there are numerous people around the world who would purchase housing and live the rest of their days in the security the US has to offer.

"I have tried to push this idea with Obama's team but fear I cannot get through to the right people, maybe you can!"

My comment - [Not a bad idea - keep trying.](#)

[If you have an elegant property in mind with a great view, 50-metre swimming pool, nearby lake and tennis court in a gated community, please let me know.](#)

[On second thought, if stock markets tumble again you may have to scale my request down to slim metallic in a trailer park.](#)

Chicken - [Thanksgiving fare from my sister Meredith and brother-in-law Jim](#):

Why Did the Chicken Cross the Road?

*SARAH PALIN*: Before it got to the other side, I shot the chicken, cleaned and dressed it, and had chicken burgers for lunch.

*BARACK OBAMA*: The chicken crossed the road because it was time for a change! The chicken wanted change!

*JOHN MC CAIN*: My friends that chicken crossed the road because he recognized the need to engage in cooperation and dialogue with all the chickens on the other side of the road.

*HILLARY CLINTON*: When I was First Lady, I personally helped that little chicken to cross the road. This experience makes me uniquely qualified to ensure right from Day One that every chicken in this country gets the chance it deserves to cross the road. But then, this really isn't about me.

*GEORGE W. BUSH*: We don't really care why the chicken crossed the road. We just want to know if the chicken is on our side of the road, or not. The chicken is either against us, or for us. There is no middle ground here.

*DICK CHENEY*: Where's my gun?

*COLIN POWELL*: Now to the left of the screen, you can clearly see the satellite image of the chicken crossing the road.

*BILL CLINTON:* I did not cross the road with that chicken. What is your definition of chicken?

*AL GORE:* I invented the chicken.

*JOHN KERRY:* Although I voted to let the chicken cross the road, I am now against it! It was the wrong road to cross, and I was misled about the chicken's intentions. I am not for it now and will remain against it.

*AL SHARPTON:* Why are all the chickens white? We need some black chickens.

*DR. PHIL:* The problem we have here is that this chicken doesn't realize that he must first deal with the problem on this side of the road before it goes after the problem on the other side of the road. What we need to do is help him realize how stupid he's acting by not taking on his current problems before adding new problems.

*OPRAH:* Well, I understand that the chicken is having problems, which is why he wants to cross this road so bad. So instead of having the chicken learn from his mistakes and take falls, which is a part of life, I'm going to give this chicken a car so that he can just drive across the road and not live his life like the rest of the chickens.

*ANDERSON COOPER, CNN:* We have reason to believe there is a chicken, but we have not yet been allowed access to the other side of the road.

*NANCY GRACE:* That chicken crossed the road because he's guilty! You can see it in his eyes and the way he walks.

*PAT BUCHANAN:* To steal the job of a decent, hardworking American.

*MARTHA STEWART:* No one called me to warn me which way that chicken was going. I had a standing order at the Farmer's Market to sell my eggs when the price dropped to a certain level. No little bird gave me any insider information.

*DR SEUSS:* Did the chicken cross the road? Did he cross it with a toad? Yes, the chicken crossed the road, but why it crossed I've not been told.

*ERNEST HEMINGWAY:* To die in the rain, alone.

*GRANDPA:* In my day we didn't ask why the chicken crossed the road. Somebody told us the chicken crossed the road, and that was good enough.

*BARBARA WALTERS:* Isn't that interesting? In a few moments, we will be listening to the chicken tell, for the first time, the heart-warming story of how it experienced a serious case of molting, and went on to accomplish its lifelong dream of crossing the road.

*ARISTOTLE:* It is the nature of chickens to cross the road.

*JOHN LENNON:* Imagine all the chickens in the world crossing roads together, in peace.

*BILL GATES:* I have just released eChicken 2008, which will not only cross roads, but will lay eggs, file your important documents, and balance your checkbook. Internet Explorer is an integral part of eChicken 2008. This new platform is much more stable and will never crash or need to be rebooted.

*ALBERT EINSTEIN:* Did the chicken really cross the road, or did the road move beneath the chicken?

*COLONEL SANDERS:* Did I miss one?

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

"The frontiers are not east or west, north or south, but wherever a man fronts a fact"

Henry David Thoreau

Additional Commentary by Eoin Treacy

Email of the day (1) - [on observations from the market:](#)

"If we look at two simple indicators:

Case Shiller 20 index in the chart library, there is no sign of it bottoming out.

"The 30 year US mortgage rate on Bloomberg it's the same as 1 year ago. No real improvement here.

"This says two things to me, there is no sign to the US housing market bottoming and the cost of mortgages are not being reduced due to I suppose to increased risk in lending and that cash is scarce, when banks don't want to lend to someone who could be out of a job next year.+ they need to hoard the cash for the own bad debts with seem to be mounting. Banks have spent the last 15 months lying through their yellow & tarnished teeth about the true value of this land fill on their books. They are a black hole as far as I can tell. Mark the market seems to be a thing of the past.

"If this is where the key problems started, shouldn't this be a leading indicator of a bottoming out process. I know you talk about markets discounting all the bad news but I don't agree that the grim economic news has been discounted by the market contention. We keep getting downside surprises versus expectations (if it's discounted how come economic forecasters keep getting it so wrong?) and analysts earnings estimates for the S&P 500 next year are still pie in the sky in terms of being on the ever optimistic side. I am waiting for forecasters to be more bearish and to forecast expected results worse than actual results turn out to be; then we'll know to be contrarian...

"I agree the charts will be our guide for exactly what's happening, but are you overly discounting all the bad news and just looking for the upside? Having been a subscriber to your web-site for the past year, I have read every comment of the day and listened to every audio. I have learned so much and I thank you for that. I think though your slightly biased to the upside always. No harm in this though. I subscribe to bearish commentators to get perspective in the market...

"I attended The Chart Seminar 2 weeks ago in London. I found this most useful and very enlightening.. I will use the information I learned here for the rest of my life. A common sense perspective to charting...Brilliant.

"On another point, you have been talking more on corporate bonds lately. Could you do a review of the market and the opportunities you see in select funds/companies with high yields. I am sure that would be of interest to other

subscribers. I am not knowledgeable in this area but want to learn more to take advantage of the opportunities which I see presenting themselves, but I can't yet take advantage of because I don't fully understand what I am doing. With your help I will in time though."

My comment - Thank you for this interesting email and it was a pleasure to meet you at the recent The Chart Seminar. I am delighted to hear you enjoyed the experience. You are correct that the [Case Shiller 20 Index](#) continues to decline. In the UK, the [HBOS UK House Price Index](#) has much more back history and illustrates the secular change in direction for house prices currently underway. In the early 1990s, negative equity was a byword for UK property but prices at their nadir fell **14.4%** and took 9-years before reaching a new high. To date, the Index has fallen 16.6% in a much shorter time and may take longer to rebound. This may also prove true for the USA's housing market.

Thank you for pointing out these charts of [US national average mortgage rates \(FHA\)](#) which as you point out are relatively unchanged from a year ago. However, you will also notice that they have moved considerably in the last year and are on a downward trajectory. As far as I know, mortgage rates in the USA are calculated from the yield on the [long bond](#), which has declined substantially over the last year. This may not be showing up in the rates offered to retail customers because of the liquidity crisis. However, if the credit markets thaw further, this may have significant repercussions for people whose mortgages reset in 2009.

That housing prices stop falling is probably a necessary condition for any improvement in the balance sheets of mortgage lenders and issuers of Collateralised Debt Obligations (CDO). However, real estate has been a leading asset class in a large number of developed countries for a long-time, so it is probably unreasonable to expect it to lead in a recovery scenario given the apparent secular change in direction for the asset class.

Email of the day (2) - on corporate bond investments:

"I did appreciate your Audio comments concerning the attractiveness of some AAA corporate bonds and quality shares which are potentially attractively priced in this period when so many are focused on the relative safety of government paper. I wondered if you might be able to give subscribers some examples that would point one in the right direction in pursuing further investigations of cash available, cash flow, future income and so on of potential candidates.

"Your continuing suggestions highlighting opportunities arising during this constantly changing investment environment are most valuable and appreciated."

My comment - Thank you for your kind words. There is no doubt that the corporate bond sector is throwing up interesting opportunities for those with the ability to exploit the market. However, the liquidity crisis is making it

difficult to ascertain accurate pricing and uncertainty remains high as to prospective defaults. This means that companies with high cash flows such as utilities, retailers, tobacco etc. are less likely to default than more liquidity dependent companies. If one is looking for individual bonds, I can think of no better place to begin than the [Fixed Income Investor](#) website managed by colleague and bond guru Mark Glowrey.

I do not know of an easy way to search the holdings of individual funds but would favour any that hold senior debt, of cash rich companies with a relatively high rating. We have added a large number of fixed income funds to the Chart Library over the last few weeks but members of the Fullermoney Collective are probably better placed than us to point out the best fund opportunities.

The iShares [GBP](#) Corporate Bond Fund topped out near 150 in 2006 and moved into a downtrend which gathered pace from the beginning of the year. It found support near 104 following a downward acceleration and would now need to sustain a move below that level to question scope for some further higher to lateral ranging.

The iShares [Euro](#) Corporate Bond Fund also accelerated lower in September and October but rebounded sharply. It is looking somewhat overextended at present but would need to sustain a move to new lows to question medium-term recovery potential

The iShares [US Dollar](#) Corporate Bond Fund is plotting a middle course between the above two funds. It has retraced approximately half its accelerated decline and would need to sustain a move below 70 to question medium-term recovery potential.

Hays Advisory: My Gut!! Vs. The Psychology Story - Thanks to a subscriber for forwarding and receiving permission to post this interesting [report](#) by Don R Hays. It covers a large number of statistical indicators which lead to his belief that the market is in a bottoming out process. It is posted without further comment but here is a section

Let me start with the defense of our belief that the October 10th low was and will be the low point for most stocks, and will prove to be the last internal bottom of this bear market. Nothing else sees the internals of the market during these junctures like the graph showing the net new lows on the NYSE and the NASDAQ. As you know, I've become increasingly dependent on the NASDAQ statistics, where there are fewer non-stock listings, but even on the NYSE the story is the same. The maximum of net new lows to date occurred on that October 10th low point when the VXO option volatility index hit that 100 level.

The evolution of the stock market since that October 10th panic has remained very intense, and no-one has escaped the damage to their psyche. Mark, Keith, Jeff and I have been chronicling our thoughts, and you can tell by the context of our remarks, and the contents of the letters that our emotions have

been impacted as well. No-one, from Warren Buffett, to the Baron Biggs CNBC interview this morning has escaped the intense pain and blow to their confidence. If you don't believe it, take a look at Warren Buffett's Berkshire Hathaway's stock price in recent days.

Berkshire Hathaway's stock hit a high a year ago, as CNBC had turned over their programming to his front yard, of \$150,000 a share, so the bottom last Thursday of \$74,000 had taken a big hit along with the rest of us.

You can see in the charts below, the evolution of the indicators that we've been witnessing each morning. To begin with, on Thursday of last week, the Rydex Asset Ratio, dropped down to 30.6% more bearish assets than bullish assets. This is extremely rare, showing the give-up that the emotions of last Thursday had induced.

Email of the day (3) - [on fund redemptions](#):

"Some interesting figures are out for mutual fund sales in the UK and US for October 08 have just been released. The [Investment Company Institute](#) .The figure for Oct net new cash flow -72,285 represents a very large proportion of the 195,373 YTD for 2008. The [figures](#) for UK also interesting

"The figures for US Stock funds show that they are down from 6,993 billion at the peak in Oct 2007 to 3,935.4 in Oct 2008!, with a 20% drop between Sept 08 and Oct 08 alone. Hope you find these links useful."

My comment - [Thank you for these interesting statistics which reiterate the signal from the surge in government bond prices, that investors are holding record amounts of cash. This reservoir of liquidity will be the fuel for the next bull market.](#)

[That does not mean that markets can not make new lows because time is still needed for investor panic to subside. However, all that cash cannot sit on the sidelines indefinitely, and when it begins to filter back into markets, short sellers will be put under increasing pressure. Signs remain positive that the bottoming out process has begun but volatility remains high. The longer markets go sideways, the more panic will dissipate. If incrementally higher reaction lows begin to emerge, we will be in a much better position to call the bottom for this decline.](#)

Email of the day (4) - [on inflation versus deflation](#):

"Important considerations:

"While I strongly believe that GDP and earnings do matter a great deal, it's important to note that it is neither GDP nor earnings that are the most significant driver to the stock market - inflation is. Clearly the deflation shock that we're living through has been reflected in stock prices. I'm not here to argue whether the market has at this point over/under discounted the deflation

we are experiencing and will experience in the future. But I am here to argue that the focus should be more focused on inflation, and less on GDP. Click on the "financial physics" presentation at the [URL](#) below to see the historic relationship between market returns and inflation:

"And for a somewhat extreme example, don't forget this old story. At one point in 2007 the Zimbabwe stock market was up over 12,000% over a 12 month period and CPI was over 1,700%. I know this is extreme, but sometimes extreme examples help us understand underlying [relationships](#) better.

"In the Bernanke [speech](#) "deflation, making sure it doesn't happen here" Bernanke credits a dollar devaluation of 40% versus gold by Roosevelt in 1934 for ending deflation "remarkably quickly". In 1934 the S&P rallied over 70%.

"So - what path will Bernanke take now? What will that mean for the U.S. dollar? What will that mean for inflation? What will that mean for the U.S. stock markets?

"While we live in a probabilistic world and almost nothing can be known with certainty, I think we can make an educated guess as to the answers to the questions, above."

My view - Thank for this considerable contribution and the associated links to a further large volume of research. I don't think anyone would argue with the dire effect inflation can have on one's wealth over the long-term. That is why inflation-adjusted charts are so useful for perspective. Arguably, the best bull-run in recent history has been the move from the early 1980s to the recent highs, which was broadly characterised by a disinflationary environment. Inflation remained low, while productivity and sales increased.

Right now, it remains to be seen whether the current disinflation turns into the outright deflation feared and forecast by so many investors. At Fullermoney, we would define destructive deflation as falls in sales, output and prices over a sustained period. By these criteria Japan deflated from the late 1980s because sales declined, productivity gains did not improve at the same rate as previously seen and prices declined across the board for goods, services, homes and food. In the USA today, sales are falling, output is decreasing and prices for house and financial assets have declined sharply but from historic highs. Food and household bills have moderated. So far this is more of a disinflation but the risks are to the downside.

The policy response to date has taken the risk of outright deflation very seriously and measures put in place have aggressively targeted a further move in that direction. If these measures are successful, and they are the most wide ranging anti-deflationary policies in history, then the by-product could easily be higher inflation over the medium-term. However, that is a far cry from the hyper-inflation experienced by Zimbabwe.

In such an environment Gold and TIPS are probably a reasonable hedge. Sock markets should perform reasonably well at the beginning of the cycle but

will come under pressure as interest rates are raised to combat an inflationary threat that enters the public consciousness.

Email of the day (5) - [on coal shares](#):

"Read your article about coal with interest. You might like to take a look at Yangzhou coal [YZC](#) currently on a prospective P/E of .2.34. whilst the authorities might pin the price down this looks absurdly cheap for a stock where so many new power stations are being built."

My comment - Thank you for this interesting suggestion which also helps to illustrate the extent to which coal shares have fallen. It fell precipitously to \$5 from over \$20 in June but is beginning to build support now. A sustained move below \$5 would be needed to question recovery potential over the medium to longer term.

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

"Could you please add the iShares Lehman Aggregate Bond Fund ([AGG](#)) to the library?"

And

"Could you please add the following which I understand is a corporate bond index - [Dow Jones Corporate Bond Index](#)."

My comment - Thank you for these interesting suggestions which have been added to the Chart Library.

Explanation of the unwillingness of banks to extend loans - Thanks to a subscriber for this interesting missive by Kevin Gaynor for RBS covering the need for an external catalyst to prompt banks to resume extending credit. It is posted with further comment but here is the full article:

The banking sector is in the midst of a classic "Prisoner's Dilemma" game. This results in lower than warranted lending and higher than warranted credit multiplier declines prompting larger than warranted velocity of money declines. But seen from the perspective of game theory, solutions to the problem become apparent very quickly. First, think through the game.

Let's say there are two banks in the economy. The economy has been hit by a default shock, and both banks have loan books that are at risk, but they cannot tell how at risk. Management jobs are at risk based on losses. The banks know that they're own lending decision will, when combined with the other bank's, drive the outlook for the economy and thus, ultimately, their loan losses and job prospects.

Each firm has two options - lend more or lend less. Think about Bank A. If it lends less and the other Bank lends it will win, because in the aggregate loan growth will be sub par leading to relatively high losses. Bank A will end up with smaller loan loss than Bank B. Jobs are retained and the stock does RELATIVELY well compared to Bank B. Bank A ends up with a dominant market position - the survivor bank's bias lets call it. If Bank A decides to lend more and the other Bank lends less then Bank A is toast. So, whatever Bank B decides to do, Bank A is better off with the lend less policy. Of course Bank B's decision making is exactly the same.

Pay off matrix

Bank B Lend More 2,2 Lend Less 0,3

Bank A Lend More 3,0 Lend Less 1,1

As a result both Banks decide to lend less in the vain hope they get a competitive advantage. All they get is a weaker economy and a lower overall pay-off since if they both decided to Lend More they would both get a higher payoff - but only if both do. Note that in the Lend Less strategy the aggregate pay off is the lowest - i.e. we all lose. In essence, what is rational on the part of the individual bank is irrationally negative in the aggregate for both the banks and the economy.

So what to do? You may recall my note about defaults being driven off 3 factors - cost/availability of capital, asset prices, and income. Government can try to prop up expectations on incomes through fiscal policy, they can cut interest rates and guarantee banks. But as long as the lending decision is still based on economic expectations about default and risk adjusted returns the game will continue until the default process has run its course - presumably taking sound businesses and banks with it. That's what policy should be trying to avoid.

There are solutions to this problem - to change the rules of the game and jump from the lend less solution to the lend more. Classically it requires the Banks commit credibly to each other that they will do it. That is problematical on two counts - one its collusion (even if its good collusion) and two there is a massive incentive to renege once the other has committed to increase its lines. In this case, I'm afraid the solution is to "socialise" the lending decision either through underwriting loans or removing the economic hit from taking the risk. That is even more government intervention in the system. The alternative is a tightening loan growth picture until the 3 drivers of default work themselves out. The decision is a political one.

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.](#)

British Pound per 1 Euro - the [Euro](#) is breaking downwards from the short-term range and needs to sustain a move back above 0.84 to question scope for some additional lower to lateral ranging.

Cocoa - breaks [upwards](#) to post a new short-term high and the upside can probably be given the benefit of the doubt in the absence of a sustained move below \$2000.

Australia - [rallying](#) well having found at least short-term support near 3200. A sustained move below that level would now be needed to question potential for some additional higher to lateral ranging.

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