Fullermoney

Global Strategy and Investment Trends by David Fuller **www.fullermoney.com**

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 22nd December 2008

Howard Marks of Oaktree: Volatility + Leverage = Dynamite - My thanks to a subscriber for this thoughtful and informative memo from Howard Marks of Oaktree. Here is a sample:

The problem is that extreme volatility and loss surface only infrequently. And as time passes without that happening, it appears more and more likely that it'll never happen - that assumptions regarding risk were too conservative. Thus it becomes tempting to relax rules and increase leverage. And often this is done just before the risk finally rears its head. As Nassim Nicholas Taleb wrote in *Fooled by Randomness*:

"*Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security . . . Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. . . . One is thus capable of unwittingly playing Russian roulette - and calling it by some alternative "low risk" name.*"

The financial institutions played a high-risk game thinking it was a low-risk game, all because their assumptions on losses and volatility were too low. We'd be watching an entirely different picture if only they'd said, "This stuff is potentially risky. Since home prices have gone up so much and mortgages have been available so easily, there just might be widespread declines in home prices this time. So we're only going to lever up half as much as past performance might suggest."

It's easy to say they should have made more conservative assumptions. But how conservative? You can't run a business on the basis of worst-case assumptions. You wouldn't be able to do anything. And anyway, a "worst-case assumption" is really a misnomer; there's no such thing, short of a total loss. Now we know the quants shouldn't have assumed there couldn't be a nationwide decline in home prices. But once you grant that such a decline can happen - for the first time - what extent should you prepare for? Two percent? Ten? Fifty?

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One of my favorite adages concerns the six-foot-tall man who drowned crossing the stream that was five feet deep on average. It's not enough to survive in the investment world on average; you have to survive every moment. The unusual turbulence of the last two years - and especially the last three months - made it possible for that six-foot-tall man to drown in a stream that was two feet deep on average. Should the possibility of today's events have been anticipated? It's hard to say it should have been. And yet, it's incumbent upon investors to prepare for adversity. The juxtaposition of these sentences introduces an interesting conundrum.

My view - I strongly recommend that you read the rest of this educative report, even though many of you will say that as investors rather than traders, you do not use leverage yourself. That may be true, but many others do, so we need to spot the warning signs because everyone will be affected when things go seriously wrong.

The breakdown of the credit cycle may yet prove to be a 'once in a century' problem, as some have stated. However, during more than four decades in this business, I cannot think of many years when bubbles have not occurred somewhere around the world. Bubbles great and small have always occurred, and always will, because they are part of the human condition. All bubbles eventually burst because they are temporary aberrations based on delusions.

Given a few years' practical experience and a sense of market history, most investors will be reasonably good at identifying bubbles. In fact, it is not a bad idea to participate in a bubble, provided it is recognised for what it is, so that one can exit in time.

Those who look at price charts should be in little doubt as to when bubbles form, or in the case of mini bubbles, when markets become temporarily overextended. Their trends accelerate to a greater or lesser degree. This can also be seen as an overextension relative to the trend mean, usually represented by a moving average (MA).

For instance, look at this 10-year monthly chart of gold. Every time it pulled to far away from its MA, it became increasingly susceptible to gravitation back to at least the mean. We have also seen this with downside extensions more recently. You can see similar overextensions relative to the MA for stock markets, represented here by these charts of the MSCI World Free Index (monthly & weekly).

Fortunately, most bubbles are local so there is little collateral damage elsewhere. However the giant, multiyear and even multigenerational bubbles affect everyone, as we have seen over the last two years.

Our challenge going forward, I suggest, is not to identify the next global credit and insolvency crisis, because most of us are unlikely to live that long. In an uncertain world, we can be reasonably sure that the 2007-2008 (and counting) bubble implosion will not be repeated for a very long time.

However there will be lots of smaller bubbles for as long as markets exist. One of our challenges will be to recognise them and to control our use of leverage, either directly or on others' behalf. Another challenge will be to recover psychologically from the trauma of this year's experience, so that we are able to participate successfully in the next bullish phase.

In addition to recognising bubbles and other overheated markets on price charts, you will probably know about them because everyone is seemingly participating or at least talking about them. The fatal aspect of a bubble is certainty - that it will not only continue but is comparatively risk free, usually because of some new paradigm. Everyone wants a piece of the action.

In our rational and analytical minds, we know that bubbles are manias and that they burst. However an expanding bubble is seductive because it is so satisfying, both financially and emotionally, while it is still expanding. If we believe the new paradigm hype - 'safe as houses', 'tech always goes up', 'markets will uncouple', 'the world is running out of oil', 'risk has been securitised and passed to those who can afford it', - we are almost certainly in denial.

After bubbles burst and markets crash, it is easy to become emotionally trapped by extreme pessimism, particularly if we have lost money. Sadly, some investors are so traumatised by the worst global bear markets, which are relatively infrequent, that they never participate in the splendid recovery that inevitably follows.

If not this time, how do we minimise the traps next time?

Recall one of the oldest adages known to all: 'Don't put all your eggs in one basket.' Some investors had all of their investment capital in property, others in shares. Surly it makes sense to have a mix, including gold, collectibles that one enjoys and a reasonable cash reserve. I received a certain amount of justifiable stick for not selling my equity investments when the trends rolled over, but at their peak they represented less that a third of my overall investments.

For most people, cash is seen as either 'trash' or 'king'. However we can treat cash as an investment, particularly if we aim to place it in high-yielding and / or strong currencies.

Leverage is not the enemy but it needs to be controlled. Too much leverage is, at best, an option on a trend continuing. At worst it is a gamble, not least if we hand over most of our capital to others who use leverage, supposedly on our behalf.

I have always used leverage in my personal trading accounts. However I have only come to grief when I have been overconfident and left myself unnecessarily exposed to an adverse move. I have done best, not surprisingly, when I have built up leveraged positions behind trailing stops in trending markets.

I conclude with a quote of my own, from The Chart Seminar: "Markets are man-made resources for us to harvest when the timing is right." We do not have to be geniuses to do this, and no one really is. However we do need to use our common sense, ideally at all times.

Clive Hale's View from the Bridge: All I want for Christmas - My thanks to Clive Hale for this item. Here is the opening:

Just a small government hand out would do nicely. After all the banks have had largesse pored on them one way or another and now car manufacturers and even hedge funds are getting into the line up. But is this benefitting the average "Joe"? Well some mortgage rates have come down but as with the falling crude oil price what you pay at the pump hasn't quite matched up. In January crude was $110 a barrel so at $2 to the pound as it was then that's the equivalent of £55. Today with crude at $40 and sterling at $1.50 that makes it £30 a barrel a fall of 45% in sterling terms. Back in January the average pump price for petrol was 110p; today 90p, a fall of 18%. I am sure there is a logical explanation…please let me know unless you work for an oil company.

My comment - Veteran subscribers with good memories may recall Clive Hale's notes, which disappeared for a number of years due to corporate bureaucracy. It is nice to have them back.

Additional Commentary by Eoin Treacy

TED Spread Narrows to Least Since Lehman on Rates, Cash Flood - This article by Matthew Brown for Bloomberg covers the continuing contraction of the TED and OIS spreads. Here is a section:

The TED spread, a gauge of banks' willingness to lend, slipped below 150 basis points for the first time since before the collapse of Lehman Brothers Holdings Inc. in September amid speculation U.S. borrowing costs near zero and promises of further government cash will help unfreeze credit.

The London interbank offered rate, or Libor, that banks say they charge each other for three-month dollar loans fell three basis points, or 0.03 percentage point, to 1.47 percent, the British Bankers' Association said today. The overnight dollar rate was little changed at 0.11 percent.

"There are expectations central banks will keep liquidity in the market and we have more or less a zero rate in the U.S., so over time the fixings should ease off," said Jan Misch, a money-market trader in Stuttgart at Landesbank Baden- Wuerttemberg, Germany's biggest state-owned lender. "After the turn of the New Year we should see a softening of these rates."

Central banks are pumping money into the financial system to combat the worst economic slump since the Great Depression.

Credit markets, which seized up after Lehman's bankruptcy, remain locked amid almost $1 trillion in losses and writedowns tied to mortgage-related securities. The Federal Reserve cut its benchmark rate to as low as zero last week and said it will flood the economy with cash.

TED Spread
The TED spread, the difference between what the U.S. government and banks pay to borrow for three months, decreased three basis points to 148 basis points, the least since Sept. 12. The measure remains historically high, having averaged 38 basis points in the year before the credit crisis began in August 2007.

The Libor-OIS spread, a gauge of cash scarcity favored by former Fed Chairman Alan Greenspan, narrowed three basis points to 126 basis points. The spread averaged 8 basis points in the year before the start of crunch and will narrow to 92 basis points by March, forwards contracts show.

Lower interest rates aren't being passed onto consumers. While the average cost of a fixed 30-year mortgage fell to 5.19 percent on Dec. 18, the gap versus three-month dollar Libor is at 371 basis points. It averaged 97 basis points in the 12 months before the crisis.

My view - The rapid expansion of these spreads coincided with the breakdown of the interbank lending market. This is slowly recovering and the spreads need to contract further to indicate that lending conditions between financial institutions are returning to more 'normal' conditions.

However, even though the rates at which banks lend to each other have eased from their peaks, banks have cut back significantly in the amount of money they are actually lending. This chart of the US Depository Institutions Aggregate Excess Reserves continues to climb well in excess of the amount that banks need to keep on deposit to fulfil their reserve requirements. This is a clear signal that bank balance sheets remain under pressure and that the problem of hard to value assets remains. This will also be an interesting measure to follow because when it peaks, banks will likely be on the road to recovery.

Another interesting chart to monitor is the Bankrate.com 30yr Mortgage Rates Index. Mortgage and FHA Mortgage rates tested the top of their three-year ranges in October and are now both falling back towards the lows posted in 2003. The lower these rates go, the better for borrowers either taking out new loans or resetting ARMs over the coming years. The 'teaser' rates which initially enticed people into these vehicles will not be on offer this time around but the lower the rate at which this resets occur the less pressure will be put on vulnerable home owners.

The non-recourse nature of the US mortgage market poses a threat to the housing market in a prolonged downturn because the temptation to just walk

away from a home in negative equity is too high for some. This means that the trend in foreclosures will also be worth keeping an eye on because it has now broken its progression of rising lows. This month's data will be worth watchin when it is released to observe whether the pace of foreclosures falls further or if November was an anomaly in a heretofore consistent trend.

Kentucky coal gasification project may power U.S. clean coal market opportunity - This article by Dorothy Kosich for Mineweb.com covers the continued interest in coal based gasification projects. Here is a section:

During gasification, coal is ground into small particles and mixed with water. The mixture is injected into a pressurized gasifier, along with pure oxygen. The intense heat inside the gasifier converts the coal into a synthetic gas. Sulfur, mercury and other pollutants are removed, carbon dioxide is scrubbed from the gas, and hydrogen and carbon monoxide are combined to create methane.

The plant is expected to deliver more than 2 trillion cubic feet of natural gas in its first 30 years. ConocoPhillips and Peabody believe the project may be "the first of many across the country that combine the capabilities of ConocoPhillips and Peabody to increase the diversity of America's energy portfolio."

"Converting coal to natural gas opens new markets for coal and allows the nation's largest energy resource to play a larger role in securing America's energy security," the companies said. "Innovative use of technology expands the market to secure American coal, which is in the best interest of the consumer."

In a news release, Peabody Senior Vice President of Btu Conversion and Strategic Planning Rick Bowen said, "We're creating a new model to deliver stable energy supplies, provide economic benefits and incorporate environmental solutions at a time when families and businesses are increasingly looking to clean coal to advance all of these goals."

As part of the project, the companies are working with academia, industry, government and NGOs to advance development of a regulatory and legal framework to make carbon storage viable and enable competitive project economics. They are also funding research on carbon storage in Western Kentucky.

World gasification capacity is forecast to grow by more than 70% by 2015 with more than 80% of that growth expected to occur in China. The Virginia-based Gasification Technology Council asserts that despite high construction costs and uncertainty concerning U.S. government policies, incentives, and regulations, gasification is expected to grow in the U.S. due to higher energy prices, tougher environmental regulations, and "a growing consensus that CO2 management will be required for electric power generation and manufacturing plants."

My view - Even though energy prices have fallen considerably from their peaks earlier this year, the environmental need to access relatively clean burning fuels remains undiminished. President-elect Obama has also suggested he favours a carbon trading scheme which would give clean energy technologies an advantage in competing against more traditional generation methods. In such a regulatory framework, the incentive to cut carbon emissions may be enough to overcome the increased capital outlay for such plants.

S&P 500 and Dow Jones Industrials Average divergence from their 200-day moving averages - We first posted this indicator on October 10th when the relevant spreadsheet was kindly forwarded by a subscriber. The indicator hit historically oversold levels in early October as the S&P 500 and Dow Jones Industrials hit important lows. The Indices and indicator both continue to consolidate above their October lows and mean reversion is certainly occurring.

Although both indices are likely to be well off there lows by the time it occurs; sustained moves above their moving averages will indicate that a new uptrend has commenced.

It's Just Time - Thanks to a subscriber for this report by Martin A. Armstrong former Chairman of Princeton Economics International on cycles. It is posted without further comment.

Email of the day (1) - additions to the Chart Library:

"Could you please add the following new sector ETF's Goldmining (AUCP, AUCO), Alt.Energy (ALTE, ALTP), Shipping (SHPP, SHIP), Agricultural Business (AGRP, AGRI), Coalmining (COAP, COAL), ETF Steel (STEE, & STEP). The codes are for USD and GBP ETF's. Thanks"

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

Email of the day (2) - on buying physical oil:

"Do you know of any ETF which tracks physical oil? Apparently they all track futures and not the physical commodity"

My comment - Thank you for an interesting question. The only funds I could find holding physical commodities are precious metal related. Oil is a bulky commodity and expensive to store so I have doubts as to viability of such a fund but if one exists I would be happy to add it to the Chart Library.

Last week's signups for the Free (Abbreviated) Comment of the Day - For the

week of December 14th new signups, including subscribers and pre-subscribers, live in the following countries or regions: Australia, Canada, Hong Kong, India, Ireland, Switzerland, the UK and the USA - 8 in total. In descending order, which topped the list in terms of the last week's new signups? It was the UK, the USA and India.

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 23rd December 2008

James Grant: Is the Medicine Worse Than the Illness - My thanks to a subscriber for this outstanding, educative essay by James Grant for The Wall Street Journal. Here is the opening:

It is a sorry place at which we Americans find ourselves this none-too-festive holiday season. The biggest names on Wall Street have gone to their rewards or into partnership with the U.S. Treasury. Foreigners stare wide-eyed from across the waters. A $50 billion Ponzi scheme (baited with, of all things in this age of excess, the promise of low, spuriously predictable returns)? Interest rates over which tiny Japanese rates fairly tower? Regulatory policy seemingly set by a weather vane? A Federal Reserve that can't make up its mind: Is it in the business of central banking or of central planning? And to think -- our disappointed foreign friends mutter -- all of these enormities taking place under a Republican administration.

Trust itself entered a bear market in 2008, complementing and perhaps surpassing the selloffs in stocks, mortgages and commodities. Never to be confused with angels, we humans seem to outdo ourselves when money is on the line. So it is that Bernard Madoff, supposed pillar of the community, stands accused of perpetrating one of the greatest hoaxes since John Law discovered the inflationary possibilities of paper money in the early 18th century.

Barely nudging Mr. Madoff out of the top of the news was the Federal Reserve's announcement last Tuesday that it intends to debase its own paper money. The year just ending has been a time of confusion as much as it has been of loss. But here, at least, was the bright beam of clarity. Specifically, the Fed pledged to print dollars in unlimited volume and to trim its funds rate, if necessary, all the way to zero. Nor would it rest on its laurels even at an interest rate low enough to drive the creditor class back to work. It would, on the contrary, "continue to consider ways of using its balance sheet to further support credit markets and economic activity."

Wall Street that day did handsprings. Even government securities prices raced higher, as if, somehow, Treasury bonds were not denominated in the currency with which the Fed had announced its intention to paper the face of the earth. Economic commentators praised the central bank's determination to fight deflation -- that is, to reinstate inflation. All hands, including President-elect Obama, seemed to agree that wholesale money-printing was the answer to the nation's prayers.

One market, only, registered a protest. The Fed's declaration of inflationary intent knocked the dollar for a loop against gold and foreign currencies. In many different languages and from many time zones came the question, "Tell me, again, now that the dollar yields so little, why do we own it?"

It was on Oct. 6, 1979, that then-Fed Chairman Paul A. Volcker vowed to print less money to bring down inflation. So doing, he closed one monetary era and opened another. With Tuesday's promise to print much more money, the Federal Reserve of Ben S. Bernanke has opened its own new era. Whether Mr. Bernanke's policy of debasement will lead to as happy an outcome as that which crowned the Volcker anti-inflation initiative is, however, doubtful. Whatever the road to riches might be paved with, it isn't little green pieces of paper stamped "legal tender."

Our troubles, over which we will certainly prevail, stem from a basic contradiction. The dollar is the world's currency, yet the Fed is America's central bank. Mr. Bernanke's remit is to promote low inflation, high employment and solvent finance -- in the 50 states. He wishes the Chinese well, of course, and the French and the Singaporeans and all the rest besides, but they don't pay his salary.

They do, however, buy the U.S. Treasury's bonds, which frames the emerging American dilemma. If the Fed is going to create boatloads of depreciating, non-yielding dollar bills, who will absorb them? Who will finance the Obama administration's looming titanic fiscal deficits? Who will finance America's annual surplus of consumption over production (after 25 more or less continuous years, almost a national trait)? Inflation is a kind of governmentally sanctioned white-collar crime. Every crime needs a dupe. Now that the Fed has announced its plan to deceive, where will it find its victims?

My view - Those who read James Grant's full essay will find one of the best brief histories of US monetary policy, including some earlier prescient forecasts regarding the long-term hazards of fiat currency regimes.

Ben Bernanke has based much of his career on the study of deflation - its causes and cures (*see also three earlier items discussing his November 2002 speech: Deflation: Making Sure "It" Doesn't Happen Here*) - so he presumably feels that he was born to handle this challenge.

I would not bet against his chances of 'success', but all investors need to consider the consequences.

Creditor nations have been willing to lend to the USA because it has long been the world's biggest consumer of manufactured goods. However in a prolonged period of slow economic growth for the world's largest economy, they may reconsider this investment, as James Grant suggests. As a busy street merchant selling candied walnuts in Hong Kong said to me when I hesitated regarding a potential purchase many years ago: "You no buy...goodbye."

I also believe that long-term risks for the US Dollar Index (historic & daily) have increased, and that US Treasury bond yields (monthly & daily) will move significantly higher once the Fed's quantitative easing ends. However that may not occur until there is some clear evidence that the economy's slide into a deep recession is ending.

Precious metals remain an interesting portfolio diversification in this environment, although prices are likely to remain volatile. However Fullermoney has long maintained that positions in precious metals are best accumulated on weakness and reduced on strength.

Email of the day - On Bernanke's policies:

"…please convey to Mrs Fuller our prayers for a healthy 2009, for you too, and above all much intuition and inspiration.

"One question: when Mr. Bernanke says that he will print as much money as is necessary to stop the deflation, is he not being trapped like the Yugoslavians, the Argentines and the Germans? Isn't this the same theory?

"May the New Year make us all forget the 2008...

"I mean forget because of joy and happiness, not because of disaster and ruin. I have never seen faces amongst my friends such as the ones I've seen in the last two weeks..."

My comment - Thank you so much for this thoughtful email. I can guarantee much perspiration on behalf of this site and our collective effort, and hopefully that will lead to some timely intuition and inspiration.

Regarding Mr Bernanke: no two monetary crises are exactly the same but I agree that there will be some inflationary problems, eventually, although perhaps not before the process of deleveraging ends and insolvency problems are stemmed.

Thanks also for your positive attitude regarding 2009. Everyone is affected by a financial meltdown. Beyond the valuable lessons learned, I feel that we should not dwell too long on money lost. That can be corrosive, and after all, we can make the money back. The important thing is to remain healthy, positive about life in general, and focussed on the market challenge.

My personal portfolio: Silver futures long stopped out and replaced; a gold futures long opened - The first trade is a delayed report. Knowing that I had to be away from the markets on Friday, I had placed what I hoped was a sufficiently loose in-the-money stop on my silver long to see me through the day. However it was triggered on Friday, with the help of a firmer US dollar, causing me to sell March silver at $10.60 on 19th December against my purchase at $10.31 on 15th December. Suspecting that the $'s bounce is only technical, I reopened my silver long today at $10.66 for a March position. I bought too soon as it turned out and later doubled this position paying $10.40 for another March stake. I also reopened a gold long today, paying $843.6 for a February position. This was a little below where I had last taken profits last week. These prices include spread-bet dealing costs.

Additional Commentary by Eoin Treacy

Email of the day (1, 2 & 3) - on commercial property:

"Could you please add the following US commercial property indices? SPXCUSAP, SPXCUSOF, SPXCUSRE, SPXCUSWA. These indices cover US commercial real estate prices for apartments, offices, retail and warehouses and are all Bloomberg codes. Thanks."

And

"After looking at the chart for US commercial real estate prices (SPXCUS) I am wondering whether this will be last shoe to drop as at present it appears to have been quite resilient but looks like it could soon drop of the edge of the cliff. Please also see the attached report from Bloomberg.

And

"Following on from my earlier mail please find attached the latest report on US commercial property prices
I have asked today for the 4 property indices to be added to the library due to their importance and relevance. What is useful about these indices is that they track the actual price per sq ft."

My comment - Thank you for suggesting the addition of these indices which can now be found in the Income, REITS & Fixed Income Indices and Funds section of the Chart Library. All of these indices have lost upward momentum over the last couple of years and show Type-2 topping characteristics.

Here is the Bloomberg article mentioned above in full:

MetLife Inc. and Prudential Financial Inc., the largest U.S. life insurers, declined in New York trading on concern that losses on commercial mortgages will surge as the recession deepens.

No. 1 MetLife dropped $4.53, or 12 percent, to $32.88 at 4:02 p.m. in New York Stock Exchange composite trading. Prudential, based in Newark, New Jersey, fell $2.99, or 9.9 percent to $26.35. Lincoln National Corp. declined 13 percent.

Life insurers have cut jobs, curtailed stock buybacks and reduced dividends as losses on stocks, asset-backed securities and corporate debt deplete capital. The industry, which puts about 10 percent of its invested assets in commercial mortgages, may see losses rise to the highest levels since the early 1990s, according to Randy Binner, a life insurance industry analyst at Friedman, Billings, Ramsey Group Inc.

Commercial mortgage defaults are "certainly on the forefront of the radar screen," Binner, said in an interview. Binner lowered his stock recommendation on Prudential to "market perform" today from "outperform."

Prudential and Philadelphia-based Lincoln National have each plunged about 72 percent this year, compared with the 47 percent fall at New York-based MetLife.

U.S. commercial properties at risk of default could triple if rental income on apartments, offices and retail buildings drops even five percent, according to New York-based real estate analysts at Reis Inc.

Apartments, Offices
MetLife's commercial mortgage portfolio totals about $36 billion and accounts for about 12 percent of invested assets. The insurer also has $15.9 billion in securities linked to other loans on commercial property.

MetLife has "a defensive position" in commercial mortgages, Chief Investment Officer Steven Kandarian told investors on an Oct. 30 conference call. The portfolio's average loan-to-value ratio is 57 percent, and as of Sept. 30 less than $2 million of the loans were delinquent, Kandarian said.

Commercial property generally has longer leases so prices can be insulated from a minor economic downturn. However, commercial property is unlikely to escape unscathed from the current recession and these indices would need to sustain moves to new highs to question potential for some further downside.

China May Spur Consumer Spending After Lowering Rates - This article by Li Yanping and Kevin Hamlin for Bloomberg covers the possible measures China may introduce to spur growth. Here is a section from the conclusion:

To fund measures to boost consumption, the government can sustain a deficit of as much as 900 billion yuan next year, widening from this year's shortfall of 180 billion yuan, according to Xing Ziqiang, an economist at China International Capital Corp. in Beijing.

One area the government is targeting is the property market: Home transactions fell 21 percent in the first 11 months of 2008.

China this week gave local governments more power to support the real estate market and pledged to build 1.3 million homes for low-income families over the next two years. Last week the State Council lowered home transaction taxes.

Measures to support consumption are also necessary as unemployment in the world's most populous nation rises.

In 2008 more than 10 million migrant workers had lost their jobs as of the end of November, Caijing Magazine reported Dec. 17, citing an unidentified labor ministry official. Uniden Corp., a Japanese maker of wireless communication gear including cordless phones, said this month it will eliminate 6,200 jobs in China.

The People's Bank of China's rate cuts yesterday were smaller than expected, according to economists at Daiwa Institute of Research, HSBC Holdings and Capital Economics. Further reductions are expected after the New Year, the economists said.

"We expect another 27 basis-point cut within the next few weeks and at least a further 54 basis points by the end of the second quarter of 2009," said Williams of Capital Economics.

"However, it is fiscal policy that matters now."

My view - Developing the domestic consumer economy is a stated aim of the current administration as they attempt to move China from a purely export focused market to a more diversified economy. This will take time but has moved up the list of priorities significantly as the USA and Europe continue to slow.

Email of the day (4) - on the UK TED spread equivalent:

"The UK Libor-UK 3month T-bill spread is not updating. The T-bill contract has rolled and needs replacing. This chart library is so useful now I don't have daily access to Bloomberg and I hope you don't mind me using the odd one to illustrate the "View"."

My comment - Thank you for your kind words and we are happy for our charts to be used in any publication provided they are attributed. I'm afraid Bloomberg appear to be having difficulties acquiring accurate yields for UK 3-month T-Bills so we have no way of posting relevant pricing until this is corrected. Might I suggest that those with access to Bloomberg and interested in seeing this highly relevant spread in the Chart Library, lobby Bloomberg to have the data updated correctly.

Email of the day (5) - on additions to the chart Library:

"Could you please add the Neptune Japan Opportunities Fund to the library? Thanks.

My comment - Thank you for this suggestion which has now been added to the Chart Library.

Email of the day (6) - on Martin A. Armstrong:

"Readers of Martin A. Armstrong's "It's Just Time" may be interested to read his entry on Wikipedia."

My comment - Thank you for this additional information.

Wednesday 24th December 2008

Nouriel Roubini: Light at the end of the tunnel after a year of stagnation - This is a transcript of an interesting interview with Nouriel Roubini, conducted by Aline van Duyn of the Financial Times (*link above may require registration so a PDF is also provided*). Here is the opening:

FT: What's in store for 2009?

NR: It is going to be a year of economic stagnation and recession for most of the global economy with deflationary pressures . . . I expect a global recession and a severe one.

FT: So you think next year will probably be the worst year?

NR: Yes. I see a recession throughout 2009 . . . and maybe there will be return to positive economic growth by 2010.

FT: What other policy actions do you think need to be taken?

NR: Well, part of the answer is the degree of these policy actions. For example, in the US monetary policy right now is very aggressive . . . I believe the ECB is behind the curve . . . But also on top of everything else I think that we have to recapitalise financial institutions much faster, more aggressively in the US. We also need a plan to reduce the debt burden of households that are now distressed and bankrupt.

FT: So it is going to cost the taxpayer a lot more?

NR: The fiscal deficit in the US is going to be huge; at least $1,000bn in 2010; another $1,000bn in 2011.

FT: Is there a risk that the capitalist system doesn't recover from this shock?

NR: We are going to avoid the Great Depression and a severe recession even if there is a risk of protracted slow economic growth. So I don't think this is the end of capitalism, of market economies, but it suggests that really there are

significant market failures, that markets don't self-regulate each other.

My view - Nouriel Roubini expects another 15 to 20 percent downside risk for stock markets because "macro news is going to be much worse than expected." With all the talk of a depression in the USA, which Roubini does not expect, investors are hardly optimistic about the economic outlook over the next 6 to 12 months.

Gauging the extent to which anticipated problems have been discounted by markets is an art rather than a science. We can be more precise about technical signals. Global stock market indices are mostly ranging at present. Therefore they cannot retest their October-November troughs without first taking out the early-December reaction lows, illustrated with the MSCI World Free Index (weekly & daily). Thereafter, new closing lows within the overall downtrends would be required to further open the door to Mr Roubini's market forecast. The charts will show us.

Industry Trends in the Downturn: A Snapshot - My thanks to a subscriber for this interesting item from McKinsey. Here is a brief section:

Steel

As credit markets capsized in the third quarter of 2008, construction projects slowed and consumer spending decreased, stalling growth in the steel industry. Nonetheless, our research indicates that the long-term strength of global steel intensity (the amount of steel needed per dollar of global GDP) will probably fuel growing demand for many years to come, to as much as two billion tons annually by 2025.

As recently as the 1990s, the maturing of markets in Europe and North America reduced the level of steel intensity as the demand curve for automobiles, refrigerators, and infrastructure leveled off (Exhibit 1). Since the turn of the decade, infrastructure and construction projects linked to urbanization-mostly in China but also in India, the Middle East, and other regions-have accounted for more than 35 percent of global steel demand and for more than half its growth. Demand for other metals, such as aluminium and copper, also exceeds GDP growth in these regions.

While their continuing development should support the industry over the long term, the immediate impact of the credit crunch will in all likelihood be reduced demand for steel-not only because end-user demand will diminish, but also because players along the supply chain will probably use up existing stocks. In addition, the crunch will inhibit short-term expansion plans for new steel-making and -mining capacity around the world, and that is likely to create a more volatile balance between demand and supply. Within a few years, however, expansion may resume as the industry works to keep up with growing demand in emerging markets.

My view - The markets have already priced in a massive drop in the consumption of steel and other industrial resources. However I think we will

actually see global demand rising once again in 2010, at the latest. I expect this to be led by Asia, but demand should also increase from the USA and some other developed countries as governments rely more heavily on infrastructure development in an effort to jumpstart their weak economies. However the biggest drop in demand is likely to come from the Middle East, at least until oil prices pick up once again. That will most likely require a synchronised economic recovery.

Which companies will be the winners and losers in this business?

Size matters in recessions, almost as much as a strong balance sheet. Industry leaders with more cash than debt will not only weather the economic storm, they will also buy valuable assets at fire sale prices. Two leading examples will be ArcelorMittal (MT NA) (monthly, weekly, daily & fundamental ratios), among steel producers and BHP Billiton (BLT LN) (monthly, weekly, daily & fundamental ratios) among the miners.

Taking a long-term view, I expect both of these companies to emerge from the current recession in stronger relative positions than ever before. BLT is already in my personal long-term investment portfolio and I will probably buy more in 2009. I will most likely add ArcelorMittal to my portfolio (note that 6.44% dividend, with 5.68 coverage!). In this environment of probable basing activity, shares are best purchased on easing.

My personal portfolio: Gold futures long increased - I doubled my small gold futures long this afternoon, paying $840 for an April position, including spread-bet dealing costs. My strategy is to nibble on easing and lighten on rallies.

Platinum is arguably the best value precious metal today - Markets are only efficient to the extent that they reflect sentiment. Today, many savvy investors want some gold in their portfolios. We agree and this site has previously discussed at length the reasons for doing so. A minority of precious metal enthusiasts also want silver, which Fullermoney has long argued, performs like high-beta gold. We too like silver.

Some of us also think that platinum is the best value precious metal today. I will let this ratio chart do the talking. Today, the price of platinum (weekly & daily) is only slightly higher than that of gold (weekly & daily). Consequently, platinum is trading near its lowest level relative to gold for at least 22 years (*Bloomberg does not have earlier data on platinum prices*). In this decade to date, platinum has traded at more than 2.2 times the price of gold on three occasions. Therefore in terms of relative values, we especially like platinum today.

Inevitably, there are reasons for such wide price swings. Almost all of the platinum produced today comes from South Africa. Supply disruptions, most recently due to power outages, caused the earlier scrambles for scarce supplies of platinum. This is not a problem today, at least not at the moment. Instead, people have shunned platinum because the global automobile

industry is in a slump. This reduces demand for platinum used in the manufacturing of catalytic converters.

That factor is certainly reflected by today's low price for platinum relative to gold. I believe investors are overlooking the possibility of supply disruptions in South Africa. Meanwhile, the white metal's price has flat lined in probable base formation development.

Note: in the interests of full disclosure, I personally have long positions in platinum, silver and gold futures.

Please note - There will be no Comment of the Day or Audio on the 25th and 26th of December due to the Christmas and Boxing Day holidays. The Chart Library, however, never rests and updates automatically.

Merry Christmas to all our readers.

Quote of the week - On a good life:

"Trust in a sufficiency of wealth as the by-product of a good life."
Anonymous

Additional Commentary by Eoin Treacy

Globeandmail.com: As forestry dies, lumber town starts drilling - This article by Dave Ebner covers the continued difficulties in the lumber industry and the potential from new natural gas discoveries across North America. Here is a section:

When Canfor Corp. announced the indefinite closure of its two forestry mills in Fort Nelson, in far northeastern British Columbia, Sylvain Provost decided to shut down his logging company.

He sent a fleet of bunchers, pickers and loaders worth about $5-million to auction, and got about half of that back. Now, instead of facing the manic three months when the swampy muskeg around Fort Nelson is frozen and foresters do their work, Mr. Provost is preparing a smaller version of his old company. This time he's going to work for natural gas companies.

"I'll find work, I'm not too worried," Mr. Provost said. "Just a small crew, eight or 10 guys."

Across Canada, forestry is mired in a deep depression, with 40,000 jobs across the country shed over the last six years. In B.C., the toll has topped 10,000.

The pace of forestry's decline has only worsened as the global downturn has

intensified. It is one of the forces bringing economic growth in B.C. skidding to a screeching halt.

Fort Nelson is taking some of the hardest blows anywhere in the province. The town of 5,000 has lost a range of forestry operations, from the closure a decade ago of the world's most prolific chopstick factory to the shuttering of a sawmill in recent years.

This year, Canfor's two mills producing panels for residential construction in the United States and Central Canada went down. More than 400 direct jobs were lost.

Yet the town is not reeling. That's because 100 kilometres north of Fort Nelson, 2.5 km below the surface, an astounding amount of natural gas is trapped in almost-impermeable shale rock. It could be the biggest natural gas discovery in Canadian history.

The size and scope of the gas development will help to determine the shape of British Columbia's economy in the next decade. The most ambitious of projections, from consultancy Wood Mackenzie, suggests the area contains almost as much recoverable natural gas used to heat homes and power industry as Canada has in current proven reserves.

My view - The contraction of the homebuilding sector has devastated the lumber industry leading to mills closing and supply destruction. This contraction is created the fuel for the next big upside move and while we do not know when this will occur, prices are now at levels not seen in nearly 17-years. The threat from the mountain pine beetle may impede the ability of mills to provide timber when next demand returns which could further fuel an advance. For now, however, prices remain depressed.

Lumber has an erratic trading history and is prone to experience massive spikes which are subsequently completely countermanded. Lumber hit its last important peak in 2003 and remains in a downtrend where a progression of lower highs is the hallmark. The break below $200 in October saw prices fall to their lowest since 1991 and prices have since rallied somewhat. However, a sustained move above $200 is needed to offset scope for some lower to lateral ranging, while a move above $260 is needed to break the progression of lower major rally highs.

Natural gas is also prone to massive spikes to the upside and continues to convalesce following the last advance to nearly $14. The downtrend has lost significant momentum since July and while the progression of lower rally highs remains in place, the medium-term risks appear to be to the upside. A sustained move above $6 would indicate base formation development.

Gas Producers' Club, Based on OPEC, Will Have Doha Headquarters - This article by Lucian Kim and Stephen Bierman covers a significant policy success for Russia in setting up a natural gas organisation to rival OPEC. Here is a section:

Russia, Iran and other countries controlling the world's biggest natural-gas reserves agreed to coordinate forecasts, investments and relations with consumers to defend their market interests amid volatile energy prices.

The 15-member Gas Exporting Countries Forum, which adopted a charter in Moscow yesterday, will locate the headquarters of its new secretariat in Doha, Qatar, the biggest source for world liquefied natural gas shipments. LNG may eventually form the basis for more global gas trading.

Western consumer countries have warned against a "gas OPEC" modeled after the Organization of Petroleum Exporting Countries. Producers will face a challenge shaping the market, where 70 percent of gas is still sent by pipeline to regional consumers and no global benchmark price exists on an exchange.

"This is a significant event for the market," Russian President Dmitry Medvedev told reporters after the meeting.

"Global stability, energy security and the balance of interests between exporters, transit states and consumers depend on the agreed position of the exporting countries."

The charter transforms it from a loose, consultative body into a formal organization. Russia, which spearheaded the drive for closer coordination, says gas producers won't be able to copy OPEC and need a forum similar to the International Energy Agency, which represents consumer nations.

"A new organization was born today," Russian Energy Minister Sergei Shmatko said. "We didn't limit ourselves in any of the tasks facing gas producers. We agreed that nothing would be off-limits." The group will choose a secretary-general at its meeting next year, Shmatko said.

Regional Market
Unlike oil, which is traded internationally and has global exchange-based prices, gas is sold regionally, frequently under long-term, private contracts where pricing is more opaque. Where exchange-based prices exist, they reflect local supply and demand fluctuations.

On the New York Mercantile Exchange, U.S. natural gas futures fell to $5.294 per million British thermal units on Dec. 22, the lowest settlement since September 2006, before rallying yesterday. The decline reflects the drop in crude oil, which has fallen about 60 percent this year.

"Coordination will prevent unnecessary and harmful competition in the market that may be to the detriment of exports," Iranian Oil Minister Gholamhossein Nozari told the forum. Gas market participants should be able to "adjust and revise gas export prices whenever necessary." Yesterday's summit in Moscow was postponed several times amid reports that member nations disagreed over the group's future direction.

My comment - Russia has used natural gas as a tool to make its foreign policy points on a number of occasions over the last decade, not least in Europe. The creation of this co-ordinating group will not be welcomed outside the immediate members and has yet to show if it is even workable. However, it is a further escalation of efforts by commodity producers to leverage their international clout as suppliers of essential commodities.

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