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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 19th January 2009

Commentary by Eoin Treacy

EU Sees Europe in Deepest Slump in the Euro's 10-Year History - [This article by Brian Swint for Bloomberg covers the effect the credit / solvency crisis is having on the European economy. Here it is in full:](#)

The euro-area economy will contract for the first time since the currency was introduced a decade ago, the European Commission forecast, cutting its outlook for the region.

The economy of the 16 countries sharing the euro will shrink 1.9 percent this year, the Brussels-based commission said today, revising a November estimate for growth of 0.1 percent. The forecast is bigger than the 0.5 percent contraction predicted by the European Central Bank last month.

The ECB last week reduced interest rates to match the lowest since the euro's launch in 1999 to tackle a recession that may see 11 of the euro-area economies shrink this year. Germany, France and Spain have orchestrated bank rescues and fiscal- stimulus packages to bolster their economies.

"The measures to stabilize the financial market, the easing of monetary policies and the economic-recovery plans will enable us to put a floor under the deterioration of the economy," EU Monetary Affairs Commissioner Joaquin Almunia said in a statement. They will "create the conditions for a gradual recovery in the second part of 2009."

The economic slump deepened in the fourth quarter, according to the commission, which estimates that gross domestic product shrank by 1.5 percent in the final three months of the year after a 0.2 percent contraction in the previous two quarters. The economy will continue to contract in the first two quarters of this year, it said.

Financial Crisis

The ECB has offered additional funds to banks as they nurse losses from the global financial crisis. German Chancellor Angela Merkel this month planned a second stimulus plan of as much as 50 billion euros (\$66 billion) that includes tax cuts and aid to the country's automobile industry. France has approved a 26 billion- euro stimulus program.

The euro area will return to growth next year with an expansion of 0.4 percent, today's forecasts show. This year, Ireland will contract 5 percent, Germany 2.3 percent and economic output in Spain will drop 2 percent. The economy of the 27 countries in the European Union will shrink 1.8 percent this year, according to the commission forecasts.

The U.K., a member of the EU that doesn't use the euro, today announced the second bank rescue in three months, proposing insurance to underwrite mortgage-backed debt and toxic assets. The government also gave the Bank of England authority to buy assets as a tool of monetary policy as the benchmark U.K. interest rate approaches zero.

Trichet said Jan. 15 that the latest data point to a more "significant slowing down" than projected in the ECB's December forecasts. European confidence has plunged to the lowest on record, industrial production posted its biggest annual drop in 18 years in November and unemployment rose to 7.8 percent, a two-year high.

Economists expect the ECB's key rate to drop to 1.5 percent from the current 2 percent in March, according to the median of 39 forecasts in Bloomberg News survey.

My view - The effect the credit / solvency crisis is having varies considerably between countries; as illustrated by sovereign spreads over the European (German) benchmark. The launch of the Euro in 1999 was presaged by yields for all Eurozone members moving to a level more in line with German yields. For countries such as [Austria](#), [Belgium](#), [France](#), [Finland](#) and the [Netherlands](#) this meant that yields had to rise in order to reach this benchmark. In other words, the introduction of the Euro meant that borrowing costs would rise for these countries. By comparison yields for [Italian](#), [Greek](#) and [Spanish](#) bonds fell rapidly in the run-up to the launch of the Euro. For [Ireland](#) and [Portugal](#), the contraction occurred a couple of years prior to 1998.

Borrowing costs fell considerably for all five of these countries in what was seen as a one time event in order to facilitate the launch of the single currency. The same interest rate now prevails in the Eurozone along with the single currency, regardless of any consideration of how appropriate it is to individual countries. (For the purposes of this piece I have excluded Luxembourg, Malta, Cyprus, Slovakia and Slovenia because they do not have deep enough bond markets to create a generic 10yr yield chart.

This realignment assumed that the additional risk of default in countries such as Italy, Spain, Greece, Ireland and Portugal would be made up for by the inclusion of more credit worthy countries such as Austria, Belgium, France and the Netherlands. The first recession in a decade is now testing this hypothesis and the downgrading of some of the countries in the Eurozone reflects the stresses in the system. This [story](#) by Emma Ross-Thomas and Esteban Duarte for Bloomberg has more details on the relevant downgrades.

All countries in the Eurozone are now seeing their government bond spreads widen relative to German yields. This is an indication that all countries took part in the access to abundant credit made possible by the launch of the Euro and are now suffering the consequences. Some are being more affected than others. Spreads for Spain, Greece, Italy and Ireland have expanded most. These were some of the countries where borrowing costs had fallen most in order to join the Euro and where most use was made of the ability to access cheap credit. Without the single currency they would never have been able to borrow at such low rates, but they are now constricted by being unable to devalue their currencies in order to help them through the crisis.

This is the first real test for the single currency. If it can survive the credit / solvency crisis without seeing some countries dropping out or its efficacy being called into question; then it stands a good chance of surviving for the longer-term as a viable entity. This may well depend on how long the crisis drags on. Spreads of more than 250 basis points over Bunds, for Greek government bonds are not encouraging for its long-term participation. Investors will no doubt remember there were significant questions about the Greek government's financial probity in the figures submitted to the European Commission prior to its entry into the single currency. Time will tell, but it will be a worthwhile exercise to monitor these spreads going forward.

It is also interesting to see that in the [UK](#), where control of interest rates is maintained by the BOE, that the brunt of the country's risk reassessment has been borne by the [Pound](#) rather than government bonds. The spread over Bunds has been in a volatile downtrend since late 2005 and tested parity recently. The government bond spread has been contracting in line with the Pound's decline against the Euro; both appear to have turned around the same time.

The [Swiss](#) government bond spread continues to narrow as the European benchmark [yield](#) falls faster than the yield on the Swiss [10yr](#). A sustained move below -0.85 would be needed to question potential for some further tightening.

Hussman Funds: The Long-Term Gets Shorter - Thanks to a subscriber for this excellent [report](#) by John P. Hussman which contrasts the duration of the S&P 500 with that of the 10yr Treasury. I rate the chart he posts as unmissable. Here is a section:

It should be clear that the run to the 2000 stock market peak represented terribly careless investor behavior, as the S&P 500 was driven to a duration over over 90 years. That is, only an investor with a horizon of 90-years could be confident that the terminal value of their investment would not be sensitive to the fluctuations in the market over the course of that holding period.

In contrast, an investor with a 5, 10, or 20 year horizon was entirely at the mercy of market direction. In contrast, look at 1982. At that time, the 10-year Treasury bond had a duration of just 6 years (due to the very high coupon payments and yield-to-maturity available), while the S&P 500 had an

extraordinarily low duration of just 16 years. Given those durations, an investor with 15-20 years to invest could literally plow their entire portfolio into stocks and long-term bonds, in expectation of very high long-term returns, with the additional comfort that their financial security did not rely on the direction of the markets, thanks to the ability to reinvest generous coupon payments and dividends.

Presently, the duration of stocks has fallen to about one-third of what it was in 2000. Stock durations aren't particularly low on a historical basis, but are out of the range that I've considered ridiculously dangerous since the late 1990's. In contrast, bond durations as of the end of 2008 were higher than at any time since the early 1950's, so that an investor in 10-30 year Treasury bonds is presently assured of a low yield-to-maturity if the bond is held for the long-term, while being at the mercy of market direction even to achieve that low rate of return.

My view - At today's valuations, Treasuries don't look like good value. Yields are paltry and considering the duration, one would have to be extremely bearish of equities not to assume they will outperform over a reasonably long holding period. .

This may help to explain the relative attractiveness of [3-month Treasury Bills](#) for cash holdings. Yields are close to zero, but one is not risking the loss of a long-term return, because they are liquid and cash will be easily available when one wants to eventually move it into a higher yielding asset with a longer duration. When 3mth yields move meaningfully away from 0%, we will have a good signal that the massive cash reserves on the sidelines are being redeployed.

On Target - Thanks to Martin Spring for his ever-interesting [newsletter](#) which this month concentrates on bailouts and the extent of the recession. Here is a section on Asian valuations:

One reason why equities of Asia outside Japan have been outperforming global indexes in the rally of recent weeks is that investors are attracted to their higher and seemingly more secure income yields.

The FT reports that average dividend yields of 4.8 per cent are 2.4 percentage points above US Treasuries' and 1.9 points better than Asian bonds.

Dividend payments "are not sacrosanct - but relative to profits, they tend to be stable. During the Asian crisis a decade ago, dividends were down by a fifth, while net earnings fell by three-quarters. Since then, corporates have radically improved net debt to equity ratios and interest cover, suggesting that many may be able to ride out plunging demand without sacrificing their dividends."

The investment bank CLSA Asia-Pacific Markets comments: "The valuation investment case for Asia has become increasingly attractive as a result of last quarter's steep falls, even allowing for obvious earnings growth risks."

Its universe of 690 Asian stocks outside Japan has been trading at 10.8 times forecast 2009 earnings, even assuming an earnings decline of about 10 per cent this year.

And Asian companies have healthy corporate balance sheets. "The net gearing of companies under CLSA coverage has declined from 68 per cent in 1998 to an estimated 23 per cent at the end of 2008."

My view - Asian governments and companies were deeply affected by the Asian Financial Crisis more than a decade ago and instituted the changes necessary to avoid the worst excesses evident at the time. This has insulated many markets from the over leverage which has been a factor in the demise of so many Western stock markets.

One need only look at the relative performance of Asian Banks to their counterparts in [Europe](#), the [UK](#) and the [USA](#). There is no denying that the global seizing up of the credit markets has had a drastic effect on high beta Asian stock markets. However, the outperformance of Asian banks versus those in the West is a clear indication that when liquidity begins to flow once more, Asian stock markets will be the best position to benefit.

Please note - [David is away today](#).

Tuesday 20th January 2009

President Obama takes charge: will this improve market sentiment? - [My thanks to a subscriber for this topical item from JP Morgan, posted in full:](#)

The 44th president of the United States will inherit some tough challenges when he is sworn into office today. But since his election victory, Barack Obama has moved swiftly to put the tools in place to promote economic growth - good news for investors in US equities.

Despite his assertion that there is "only one president at a time," Mr Obama hit the ground running after his November election win, and has moved quickly to put the tools in place for swift action on the economy.

Last week, the Democratic Party unveiled its much-anticipated USD 825 billion stimulus plan, a package of tax cuts and public spending designed to stem the economic slide and kickstart growth. Mr Obama said the plan, which he is keen to see passed before Congress goes into recess in mid-February, aims to save or create up to 4 million jobs.

In addition, Mr Obama has successfully lobbied Congress for the release of the second half of the USD 700 billion set aside by the Troubled Asset Relief Program (TARP), avoiding a potentially messy battle in the first few weeks of his administration. Lawmakers criticised the Bush administration's use of the first half of the funds, citing the lack of transparency and lack of conditions attached to bank aid, but Obama's team have provided assurances that these concerns will be addressed.

The "who's who" list of choices to fill key positions in Mr Obama's cabinet has also generated positive marks. Among the appointments are Hillary Clinton as secretary of state and Timothy Geithner, the former president and CEO of the New York Federal Reserve, as treasury secretary. Other economic hard-hitters in the team include Lawrence Summers, former treasury secretary in Bill Clinton's administration, and Paul Volcker, a former Fed chairman.

Consequences for investors

For investors considering increasing their allocation to US equities, all this may be good news. Valuations are becoming extremely attractive by many measures, with price/earnings ratios near historic lows, but the market has remained highly volatile. For a sustainable equity rally, investor sentiment undoubtedly needs to improve.

A change in leadership from the Bush administration, with its historic-low approval ratings, to a new Obama administration with a focus on change, has led many Americans and non-Americans alike to feel a new optimism. This may be just the catalyst the market needs, particularly if leading economic indicators begin to bottom out during the spring. The swift progress through Congress of Mr Obama's stimulus package should also have far-reaching effects for the economy and for US businesses, with infrastructure, clean energy and technology companies among those set to gain.

While it is difficult, if not impossible, to predict when the economy will begin to stabilise and eventually grow again, it is worth remembering that markets typically recover well ahead of the economy. In addition, many economists and market strategists are predicting the US will be the first economy to recover due to the speed and extent of the actions taken by US authorities relative to the rest of the world.

These steps appear to have succeeded in avoiding the event investors most feared in autumn 2008: a total collapse of the financial system. Whether they will succeed in bringing the US out of recession is another question; however, we are now, at least, in more familiar territory, compared to the extremely uncertain future we faced only four months ago.

Moreover, the US equity market has historically generated strong returns after downturns - for example, following a 38% decline between 2000 and 2002 after the bursting of dotcom bubble, the S&P 500 returned 83% from 2003 to 2007. And this is not an isolated case: after falling 65% from 1929 to 1932 due to the Great Depression, the S&P 500 returned 190% between 1933 and 1936 (source: S&P, Factset, JPMorgan).

My view - Barack Obama commences his presidency today against what is arguably the worst economic background for the USA in living memory. Since every American knows this, intellectually or viscerally, it is a measure of the man that expectations are so high.

Are expectations unrealistically high? Probably, but this might possibly work to the new president's advantage. All but America's most bitter enemies will hope that president Obama succeeds. Good will and cooperation are necessary when addressing a national crisis.

History shows that most great leaders faced daunting challenges. In fact, one is unlikely to be remembered as a famous and much admired leader without overcoming considerable obstacles while in office. "Cometh the hour, cometh the man."

Will Obama be good for the stock market? Not today, perhaps, but almost certainly over the course of what should be two terms in office, health permitting. In terms of market performance, it is better to be elected president near the bottom of a bear market than at the top of a bull trend.

I am sure that JP Morgan would regard their script above as a best case scenario, shades of the famous slogan: "Merrill Lynch is bullish on America", introduced in 1971. Nevertheless, if we say what does the US economy and stock market need most today, confidence would certainly be high on the list.

If any leader is likely to improve America's self-confidence at an extremely difficult time, it is likely to be the intelligent, articulate, likable and charismatic Barack Obama. The remaining question is when? We do not know but the markets will show us. Meanwhile, I though he gave a great inauguration speech and will leave you with my sister's comment:

"Superb, gracious, sweeping, tough, sober evocation of the best in us."

Corporate fraud shows up first in the price charts - A colourful friend, now retired, was one of those larger than life characters managing money in Hong Kong some years ago. On one of my latter visits to the former British Colony, he regaled me with the story of his near arrest for insider trading by the Fraud Squad.

His apparent 'crime' had been to buy a large position in a share a day before it received a takeover bid. Several officers arrived at his office shortly after the bid and asked him: "Did you have insider information?"

He surprised them by cheekily replying: "Yes." As they reached for the handcuffs, he produced his "insider information" - a chart showing a decisive breakout from a trading range, before the takeover bid had been announced.

My friend's point: Usually someone, or more likely a group of individuals actually in possession of insider information, seek to profit from it. In the case of a pending bid, their buying activity moves the price, often creating a dynamic, which observers of price charts are likely to spot. All they know is that there are more buyers than sellers and that the instrument in question is suddenly showing relative strength. There are plenty of worse reasons for buying shares.

The same principle works in reverse. The latest story of major corporate fraud concerns Satyam Computer. I will declare at the outset that I certainly did not anticipate the Satyam scam. In fact, I do not think that I had ever looked at a chart of Satyam, until I heard about the scandal. Nevertheless, long before corporate scams become evident to regulators, and perhaps even auditors, insiders are selling.

Last Friday, I read this interesting and related article by Sundeep Tucker for the Financial Times:

Asian debacles highlight need for reform and greater scrutiny - On the FT's website this [article](#) ([PDF](#) also provided as link may require registration) appears under the heading: Insight: "Asian governance needs reform." Here is the opening:

It was not only investors who were hoodwinked by B. Ramalinga Raju, the former chairman of Satyam Computer Services. Just over a year ago the self-confessed fraudster collected the prestigious Ernst & Young India Entrepreneur of the Year gong. At the awards ceremony Rajiv Memani, country head for E&Y, saluted Satyam's "transformational vision and leadership" while K.V. Kamath, a corporate titan, added that Mr Raju had "used the spirit of entrepreneurship?..?..?to meet and exceed analyst expectations".

While the fraud revelations sorely embarrass corporate India, it is institutional investors who are nursing heavy losses. Top of the list is Aberdeen Asset Management, whose Asian unit liquidated its 9 per cent Satyam holding following Mr Raju's confession last week.

The episode, which has severely jolted investors' faith in Indian auditing and governance standards, follows a string of high-profile corporate debacles in Asia.

In October, Citic Pacific revealed more than \$2bn in potential losses on foreign exchange contracts. The Hong Kong-listed conglomerate waited weeks to announce the gap in its accounts, angering investors and sparking a regulatory probe that is ongoing.

Foreign investors are shunning Bumi Resources - a former favourite - after the Indonesian miner recently made several opaque acquisitions that appeared linked to its dominant shareholder, the powerful Bakrie family.

In the past five years developing Asia's leading stock markets benefited from tens of billions of dollars in net inflows as overseas portfolio investors sought exposure to some of the world's fastest growing companies.

The global financial crisis sparked a capital flight: more than \$10bn in Indian equities alone was repatriated last year, according to official figures. Markets such as India rely heavily on portfolio inflows to drive growth and the Satyam affair has ensured that every company in the country is going to have to fight harder to attract capital.

In fact, the spectre of so many naked swimmers is forcing global institutional investors to fundamentally reassess their engagement with Asian markets where governance and audit standards are perceived to be weak.

Issuers and promoters in the region should beware this revised mindset and the effect it will have on their cost of capital.

Corporate fraud is an ethical problem and very damaging as we all know. However my point regarding this article is that where major fraud is occurring, the share will significantly underperform in most instances. Consider this weekly [chart](#) of Satyam. It actually peaked in January 2007, whereas India's [Sensex Index](#) did not reach its high until a year later, in January 2008. Satyam was a significant underperformer, well before fraud was disclosed.

My point about charts and Satyam is not that price action signals fraud. Shares can underperform for many reasons. However I cannot think of an instance of corporate fraud where the share price did not significantly underperform, well before the scam was revealed. Someone obviously knew and had been selling, long before the story surfaced.

For investors and traders, I do not know of a more practical tool than the price chart. At Fullermoney, we are less interested in grand opinions, than what the market is actually saying in terms of its performance.

My personal portfolio: ArcelorMittal long increased - This is a delayed report for a position purchased last Friday, when I was away. I continue to regard [ArcelorMittal](#) as an [invest grade](#) share, currently showing evidence of base formation development. Having had two-thirds of my position stopped out the week before last, I repurchased half of that on 16th of January at the somewhat lower price of €17.79 for a June contract. This price includes spread-bet dealing costs.

Email of the day - On contangos, coffee, gold and oil:

"First I wish both of you, your families and specially Mrs Fuller a happy, healthy and prosperous year 2009.

"On contango and the false impressions of second month charts. I can be wrong, but I have often the impression that several subscribers don't know exactly the implications of contango and backwardation. I would therefore give the example of the closure of coffee NY on the 15th January. For clarity, please write it as a column and not on one line:

March 2009 113.90 cents per pound
May 2009 115.95
July 2009 118.00
September 2009 119.90
December 2009 122.80

March 2010 125.50

"One could have the impression that the market considers that coffee will be more expensive in 12 months time. Could be. But imagine that the market finally stays completely stable. Spot is now at 113.90. Well, if it is at 113.90 in a year's time (which is complete stability of the physical commodity) and if we would buy now on March of next year we would lose $125.50 - 113.90 = 11.60$ or 9.24 %. In fact contango is a sign of permanent oversupply in the short term.

"Now a recent bad experience and expensive lesson. Looking at the overlay of Fullermoney charts of gold and oil I thought to be clever a few weeks ago to sell gold and buy oil. On a moment or another their graphs should come closer to each other. And I still think they will, but the problem is that in order to avoid physical delivery on what is called the first notice day I bought the second month oil, and the day it became the spot month it plunged. Have a look on your contango graphs on oil. They suddenly broadened dramatically, probably because of a sudden enormous oversupply. Here again : the switches in a contango market are very important and can cost much money.

"I take the opportunity to make also a comment on that very horrendous year 2008. My lesson is that we should apply more what we have learned in the chart seminar. The market was trending, and we should not have listened to our feelings about fundamentals, also not for the long-term Fullermoney themes and preferred long-term investments.

"Last point. The Atlantis China Fortune Fund has not been updated in the charts since the 6th October 2008.

"Hoping to have contributed a little bit to our club that you animate so well I send you my kindest regards."

My comment - Many thanks for a thoughtful, informative email, and also your good wishes which I return in kind.

I think you are right in what you say regarding the implications of contango and backwardation. In this environment of near zero short-term interest rates in the USA, I believe US contracts would have very small contangos under normal circumstances, reflecting the cost of the carry only.

The fact that coffee and a number of other commodities have surprisingly large contangos suggests to me that, despite global deleveraging, there are still some very large speculative long positions out there, which have nothing to do with the usual producer and consumer activity. Tracker funds spring to mind.

I welcome your comment on 2008, and others have expressed similar views at one time or another. Any time that we put conviction before the practical trend-following disciplines of The Chart Seminar, we are increasing risk.

The Atlantis China Fortune Fund is not updating in the Library because it is officially suspended due to a few illiquid positions. I personally have no problem with this suspension because many markets have yet to emerge from what have been abnormal conditions. However the daily NAV is available on their [website](#) and can also be forwarded to you by email from Atlantis. Just ask Sarah Elton - Sarah.Elton@atlantis-investment.com. The current NAV for 19th January is US\$1.1640.

Additional Commentary by Eoin Treacy

Email of the day (1) - on the underperformance of bank indices:

"Last week many Bank and Financial indices broke once more to the downside. This was not mentioned in Comment of the Day or the Friday audio.

"Given that the above is usually a lead indicator for stock markets. How worried should we be?"

My comment - Thank you for this interesting email. I was sure I mentioned the underperformance of the banks when talking about the competition between bullish and bearish arguments in the Friday audio but, if not, I apologise. However, David definitely mentioned this underperformance on [Wednesday](#) in Comment of the Day and in the Audio.

The downward breaks experienced by a number of Western banking indices over the last week are significant and suggest we can expect further moves by the respective governments to shore up their financial sectors. This relative weakness poses a headwind for their wider markets.

When bank indices began to underperform in 2007, they had an incredibly large weighting in most country indices. The performance of bank shares was important both in terms of their high relative weightings and because of their status as lead indicators. However, bank sectors are now a considerably smaller weighting in most indices. This lessens the intrinsic importance of the banks sector to the performance of the wider market, but the psychological impact is undiminished.

The performance of bank sectors is a major drag on sentiment. Dividends are being eliminated and a process of nationalisation is underway in a number of Western countries. However, one should not forget that many other companies will not need government support, will not eliminate their dividend and as such are likely to be relative performers in this environment.

In addition, an interesting dichotomy exists between markets where banks are underperforming and where they are outperforming. Bank indices in the USA ([S&P500 Banks](#), [Philadelphia Banks](#), [Regional Banks](#)) Europe ([DJ Euro Stoxx Banks](#)), the [UK](#), [France](#), [Germany](#), [Norway](#), [Finland](#), [Sweden](#), [Italy](#) and [Ireland](#) all made new lows in the last week. Internationally, the [Chinese](#) bank

index is closest to the upper side of its range. No other bank index, I know of, is showing such relative strength. All Asian bank indices remain within their ranges. The marked underperformance of the USA and much of Europe is a clear indication that this is where the bulk of financial risk is focused.

Pound Tumbles as U.K. Bank Plan Fuels Concern Crisis Deepening - [This article by Lukanyo Mnyanda and Ron Harui covers the continued weakness of sterling relative to a number of other currencies. Here it is in full:](#)

The pound dropped to a record low against the yen and breached \$1.40 for the first time since 2001 as the U.K.'s bank-bailout plan raised concern the global financial crisis is worsening.

The British currency also had its biggest drop against the euro in a month after the U.K. government said it will spend an extra 100 billion pounds (\$142 billion) to support the nation's banks, a second lifeline in three months, and increase its stake in Royal Bank of Scotland Group Plc. The Australian and New Zealand dollars slumped a second day against the yen as Asian and European stocks declined. The dollar rose versus the euro.

"Worries about the banking crisis are leading to more risk aversion," said Antje Praefcke, a currency strategist in Frankfurt at Commerzbank AG. "The market isn't convinced, for the moment at least, that there'll be a light at the end of the tunnel."

The pound slid to 126.88 yen as of 9:26 a.m. in London from 130.71 yesterday and traded at an all-time low of 126.66. It weakened to \$1.3966, from \$1.4420, the lowest level since June 2001, and to 92.84 pence per euro, from 90.59 pence. The yen climbed to 117.42 per euro from 118.47, and was at 90.93 against the dollar from 90.64.

"I would urge you to sell any sterling you might have," said Jim Rogers, chairman of Singapore-based Rogers Holdings, in an interview with Bloomberg Television. "It's finished. I hate to say it, but I would not put any money in the U.K."

Rogers correctly predicted the start of the commodities rally in 1999. In January 2008, he advised investors to sell the U.S. currency. The Dollar Index traded on ICE futures, which tracks the greenback against six major trading partners, rose 6 percent last year.

My view - The Pound is a victim of the economic problems in the UK and its weakness is seen as at least part of the solution to those issues. However, the speed with which the currency has lost value has surprised most investors and it remains one of the world's weakest currencies. The question before us is whether, among today's extensive weakness, there are any discernable bottoming characteristics?

The Pound accelerated lower against the [US Dollar](#) from early August before losing momentum from November. However, today's powerful reassertion of

the downtrend suggests the Pound can get weaker (Dollar stronger) from here. A sustained move back above \$1.44 would be needed to question scope for some further downside.

The Pound accelerated lower against the [Japanese Yen](#) from September and has lost some of its momentum over the last few months. However, a sustained move above ¥140 would be needed to question scope for further weakness.

The Pound accelerated lower against the [Euro](#) but found support above parity and rallied impressively from early January. It has begun to weaken again over the last couple of weeks but would need to sustain a move to new lows to question potential for base formation development around current levels.

The Pound rallied well against the [Australian Dollar](#) from early January and a sustained move to new lows would be needed to question scope for some additional higher to lateral ranging.

The Pound also rallied impressively against the [New Zealand Dollar](#) from the beginning of the year, but encountered resistance last week and posted a third lower high. A sustained move above NZ\$2.75 is needed to question potential for some further lower to lateral ranging.

The Pound is weakest against the resurgent Dollar and Yen. It posted impressive upward dynamics against other currencies, not least the Euro, in early January and while the chances are good that this was a pivotal move for the Pound, it needs to find support above its recent lows against these currencies to sustain this view.

Email of the day (2) - on long-term bond price charts:

"The long term bond chart in Friday's Comment of the Day has a common error that does change the picture somewhat. The chart up to the Dec 99 period is based on a 8% coupon underlying bond but changes to a 6% coupon underlying bond in Jan 2000. That is why there appears to be a big drop down at that point. You need to look for a backward adjusted chart, which is a pain but necessary because it changes the highs relation ship on the chart and also lowers the low. I run into this problem a lot when taking a really long view. Example [here](#):

"Oh, as a subscriber for many years I can say the site gets better all the time."

My comment - Thank you for your kind words and this interesting contribution, made in the spirit of Empowerment Through Knowledge. The coupon change issue has long been a problem for looking at long-term bond prices. It is for this reason that I also posted long-term [yield charts](#) which do not suffer from the coupon change problem.

Email of the day (3) - on customising p&f scales:

"It does not come as a great surprise, but the chart library appears unable to show p&f charts for RBS, it simply says "no plot possible at this scale"?"

My comment - Thank you for highlighting this issue which is common in instruments which have experienced exceptionally large declines. It is easily resolved by customising the box size.

The "no plot possible at this scale sign" is posted when the charting engine cannot make an illustration based on the requested settings. The p&f scale will default to 1% until you change it. RBS' current price is around 13p, from 50p last week. A 1% scale would attempt to draw a chart with a box size of 0.1p which is not currently possible. However, you can customise the box size to whatever you like.

Simply click on the Charting tab in the black bar above the chart and click on p&f. In the Box Size dropdown menu select custom and in the new box, type your preferred box size. Here are examples for 5, 7 and 10. You will notice that the larger the box size, the more condensed the data becomes. Larger box sizes will show more back history.

Email of the day (4) - on Education shares:

"Hope all is well. I have noticed that the S&P1500 Education Services Index has made a new high. Presumably this is partly defensive but also on the back of potential increased spending by Obama.

"Some of the stocks have consolidated and could be a buy on a break higher. The sector index is very overbought on relative though and I wonder, will this become a case of the rumour having already been bought and the fact will be sold once Obama comes in?"

"The stocks that I noticed trading above long term moving averages were: APOL, CECO, COCO, CPLA, DV, ESI, LOPE, STRA, UTI. Do any of the collective know these and have anything to say on them? Looking at a few of their web sites, although there is the usual mention of CSR (corporate social responsibility), there is nothing to suggest that they are anything other than normal, profit maximising companies, instead of being run by a trusteeship with primarily CSR type goals."

My comment - Thank you for thoughtful email contributed in the spirit of Empowerment Through Knowledge. You rightfully point out that the Education sector is a relative performer and a number of these shares have interesting chart patterns. Education may well benefit from an Obama presidency and these will be interesting companies to monitor, to see if they can maintain their relative strength in the coming months.

Apollo Group, is the only share large enough to make the S&P500 and best reflects the Index's performance. It bottomed early in 2008 and has been a relative performer since. The share is now looking overextended as it

approaches \$100 and the 2004 highs but a downward dynamic would be needed to check momentum beyond a brief pause.

DeVry jumped from \$40 to almost \$60 in a late 2007 and has spent the last 15-months consolidating the move. It is now testing the highs and a sustained move below \$51 would be needed to question potential for an upside break.

ITT Educational Services Inc. collapsed in late 2007 before finding support near \$40 and rallying sharply. It broke upwards in spectacular fashion, from a 6-month range last week and would need to sustain a move back below \$100 to question scope for some additional upside.

Strayer Education remains in a volatile uptrend, where a progression of higher lows is the most consistent factor. It would need to break that sequence, with a sustained move below \$187 to question scope for some additional upside.

Universal Technical Institute, Career Education Corp and Corinthian Colleges all share base formation characteristics. Universal Technical Institute would need to sustain a move below \$15.50 to question scope for some additional upside. Career Education Corp has been ranging below \$20 for most of the last year, but broke upwards last week. A sustained move below \$17 would now be needed to question scope for some further upside. Corinthian Colleges has been in a ranging phase for much of the last 4+ years. It is now testing the upper side of the base and a sustained move below \$15 would be needed to question potential for an upside break.

Email of the day (5&6) - on additions to the Chart Library:

"Can you please add to the chart library following equity funds?"

"UBS (Lux) Equity Sicav - Brazil (USD)
Bloomberg Ticker UBSBRAB LX

"UBS (Lux) Equity Sicav - Russia (USD)
Bloomberg Ticker UBSLERB LX

"UBS (Lux) Equity Fund - USA (USD)
Bloomberg Ticker UBSEUSI LX

"Thanks a lot for the excellent service!"

And

"I wonder if the above share (ULTRA S&P PROSHARES (NYSE:SSO)) may please be included in our chart library?"

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

Wednesday 21st January 2009

A 'Responsibility' Era - This is an interesting [editorial](#) ([PDF also supplied as link may require registration](#)) on Obama's inauguration speech, from a paper likely to be among his harsher critics. Here is the opening:

Whatever your partisan inclinations, the sight yesterday of two million Americans cheering the peaceful transfer of power to a new President should stir some patriotic pride. Mr. Obama more than met the moment with an Inaugural Address that invoked America's historical purposes and optimism, as well as a bracing challenge to lift -- as he might put it in a less formal setting -- our national game.

We were especially taken with President Obama's call for "a new era of responsibility." This is the phrase his press folks had leaked the day before, and if they did so to drive the theme home, so much the better. This is a useful message for Americans of all walks of life to hear -- from Wall Street CEOs to unmarried fathers to AARP lobbyists in Washington. The prosperity of recent decades has produced a culture of entitlement and sometimes even of complacency.

In several ways, Mr. Obama was calling Americans to larger purposes that will require more work and sacrifice. In diagnosing the cause of our economic distress, he scored not only the easy mark of "greed" but also stressed "our collective failure to make hard choices and prepare the nation for a new age." He might have been referring to home buyers who took out "liar loans," Senators who got sweetheart mortgages, and executives who walked away with bonuses for profits that proved illusory.

While the President argued that we face a "crisis," and spoke of "gathering clouds and raging storms," he pushed back against the "nagging fear that America's decline is inevitable, and that the next generation must lower its sights." He acknowledged that "the challenges we face are real," but added: "[K]now this, America -- they will be met."

My view - I can recall all the US presidential inauguration speeches since JFK's in 1960. After listening to Obama's speech for a second time last night, I regard it as the best that I have heard.

Now the hard work begins.

Obama and the Perils of Popularity - My thanks to a subscriber for this informative, historic [review](#) of market events following previous US presidential elections, by Edward Kerschner and Michael Geraghty of Citigroup Global Markets. Here are some bullet points:

- One risk: The Presidential election cycle - During the four years of a President's term, the post-election year has, historically, been the worst for stocks, with first-term Presidents being associated with the weakest performance.

- Another risk: The "popularity gap" - The gap between Obama's "favourable opinion" rating and George W. Bush's "job approval" rating is the widest in the postwar period.
- High expectations for five newcomers - High expectations (as indicated by the gap between incoming "favorable opinion" ratings and outgoing "job approval" ratings) for Presidents Eisenhower, Reagan, Carter, and Nixon were, for the most part, not met in the immediate aftermath of their inaugurations, with only JFK successfully creating an environment that proved favorable for stocks in the post-election year.
- Low expectations leave room for upside surprise - While high expectations have, historically, mostly been associated with poor equity performance in the post-election year, low expectations (e.g., for Clinton, G.H.W. Bush, G.W. Bush) have mostly been associated with good performance.
- Three strikes against Obama? - The median performance of the DJIA in the post-election year of the five "high expectation" Presidents was -9%, versus -5% for eight postwar first-term Presidents, and -1% for all postwar Presidents.
- Or a JFK parallel? - Obama shares a few things in common with first-termer JFK: they were both Democrats replacing a Republican incumbent, they were both young and inexperienced, and they both had a large working majority. In the post-election year, JFK's team created a favorable environment for investors.

My view - Historically, the first two years of a presidential cycle are associated with underperformance relative to the latter two years of a four-year term. This was due to the incoming administration's efforts to first clean the Augean stables of inflationary pressures, before ramping the economy during the latter two years, in an effort to retain the White House at the next election.

We can tear up this script in 2009 because 2007 and particularly 2008 were disastrous for stock markets, due to the 'perfect storm' of a credit and insolvency crisis, plus spikes in commodity prices, not least for crude oil.

Consequently, recent and continuing efforts by all governments are stimulative, in an attempt to stem a vicious recession and head off a destructive deflation. For the USA, much of this stimulus came from the outgoing administration over the last year or more, and it will certainly continue with the Obama regime. While it has been notably unsuccessful so far, it will succeed at some point. Signs of an economic recovery in the second half of 2009 would be a best-case result.

Meanwhile, one of president Obama's biggest challenges is to restore confidence. When he succeeds, improved sentiment will be reflected by Wall Street and other stock markets, which will almost certainly turn upwards ahead of the global economy. [China](#), provided it maintains current relative strength, remains Fullermoney's candidate for upside leadership among major stock markets. (See also my comments on Obama and the stock market, posted yesterday.)

Email of the day - [On market view](#):

"My gut tells me to be bullish, my eyes tell me to be bearish, but my mind tells me to be chicken. As you'd probably figured out, I'm one confused creature! So, I'm just fence-sitting, trying not to fall off."

My comment - [Thank you for your candour](#). I expect many readers feel similarly. If so, it is the bears selling short who show the animal spirits, lacking among the wannabe bulls. Some of the bears I read about 'know the US is in a depression', and perhaps the world, and they 'know stock markets will fall at least another 20 percent.' Each subscriber will have their own views as to whether or not this is a contrary indicator.

The breakdown in European and USA bank share indices is a serious concern and ongoing headwind for broader stock market indices. While it remains hard to see why anyone would want to buy bank shares when creeping nationalisation is occurring, wiping out shareholders' equity in the process, it is also testimony to our serious economic problems.

I suspect a rapid and complete nationalisation of troubled banking sectors would be better for stock markets, if only because it would remove uncertainty. That may be necessary but so far governments have been reluctant to follow this route. (*See also Eoin's feature on banking sectors, posted yesterday.*)

Meanwhile Western stock markets are oversold in the short term following a persistent slide commencing in the first week of January. This has steadily eroded support within the trading ranges, including closes beneath the early-December lows, often mentioned in [Comment of the Day](#) and [Audios](#). The [S&P 500](#), [DJIA](#) and most [European](#) indices are testing their November lows.

While at least some temporary steadying would normally be expected near these levels, following sustained declines to reach them, upward dynamics are required to reaffirm those prior support levels, and to remain consistent with base formation development. Conversely, sustained breaks to new lows would reaffirm the overall downward trends and indicate further weakness to follow.

Additional Commentary by Eoin Treacy

Email of the day (1) - [on 2009 earnings estimates](#):

"Do you have data on the 2009 P/E for the DJ 30 stocks and can you confirm the historic P/E average? Also how many of the DJ 30 are actually trading at an expected 2009 loss?"

My comment - [Thank you for this interesting question](#). Earnings estimates are not our area of expertise and I certainly do not claim any particular knowledge

of the subject. Forecasts, of any description, are at best a guess as to what will occur in the future and should be viewed with the informed scepticism they deserve. That is as applicable to technical forecasts as it is to fundamental ones.

History shows us that analysts' earnings estimates are generally too cautious at the beginning of new bull move and become overly optimistic closer to the top. On the way down, they mostly under estimate the extent of the slowdown and over estimate it towards the lows. Throughout the course of the current decline analysts' estimates have failed to predict the extent of the decline and many commentators argue that the bearish outlook is not yet reflected in the expected earnings for 2009.

This [chart](#) of the Dow Jones' historic P/E from 1992 shows the peak below 30 and the abrupt fall to below 10 in the last few months. The Dow's Estimated P/E [chart](#) only has a couple of years back history, but has been much more volatile as opinions as to the direction of the market are revised constantly. At present, the Estimated P/E for 2009 of 14.41 suggests earnings are expected to fall further. The question these charts do not answer, and no one else can either, is to what extent this estimate reflects what is actually going to happen.

Taking the above into account; this [spreadsheet](#) contains the Historic P/E, the 5yr Average P/E and Estimated P/E for 2009 and 2010 for the members of the Dow Jones Industrial Average. You'll notice that the relatively high valuations of the last 5-years have resulted in a high mean level for most shares.

Bloomberg do not have produce a 2009 Estimated P/E for Alcoa, General Motors and Citigroup, so these companies may be most at risk of returning a loss this year. Intel's 2009 Estimated P/E of 26.46 is considerably higher than its current historic P/E of 11.28. The Estimated level falls to 15.27 in 2010. If my interpretation is correction, this would suggest that earnings are expected to fall this year, but stabilize in 2010.

JP Morgan and Bank of America have by far the largest negative gap between their 2009 Estimated P/E and their current historic P/Es. This would suggest that either prices are going to fall considerably or earnings will rise. In my view, the former is more likely.

In technical terms, [Intel](#) fell aggressively from August to the November lows and continues to range around that area. A sustained move above \$15 is needed to indicate the bulls have regained the upper hand.

[Bank of America](#) is in a volatile downtrend which is gathering pace. An upward dynamic would be needed to check momentum beyond a brief pause. [JP Morgan](#) held up relatively well until November and came under renewed pressure in January. The volatility in this share is breathtaking and an upward dynamic is needed to check momentum beyond a brief pause.

Email of the day (2) - on Fed efforts to support bond prices:

"I thought this article on Bloomberg may add further insight to your comments on the outlook for bond prices. I fully sympathise with your views about the avalanche of new bond issuance that may come but, this article explains Government keenness to keep yields low. Hope it helps a bit."

My comment - [Thank you for this interesting article contributed in the Spirit of Empowerment Through Knowledge](#)

U.S. Yields Flattened; Fed Seeks Lower Mortgage Rates - [This is the article mentioned above by Liz Capo McCormick and Dakin Campbell for Bloomberg. Here is a section:](#)

Monetary and fiscal efforts will be successful in reflatting the economy, with yields on 10-year notes climbing to as high as 2.75 percent in the first half of the year, Credit Suisse Group AG strategists Dominic Konstam and Carl Lantz wrote in a Jan. 16 report. Investors should be cautious about positioning for the sell-off now, with several false starts likely before the curve steepening begins in earnest, they wrote.

Concern about higher borrowing costs rose in the first week of the year as government bonds fell, sparking losses of 1.1 percent through Jan. 8, according to New York-based Merrill Lynch & Co.'s Treasury Master Index, the worst start since before 1986.

While analysts expect 10-year yields to rise this year, they reduced their forecasts in the past month.

The median estimate of 58 economists and strategists surveyed by Bloomberg News is for 10-year yields to rise to 2.55 percent by June, compared with expectations for 3.1 percent in a December poll. The yield curve will be 1.6 percentage points at mid-year, down from 1.9 percentages in last month's poll.

Buying Mortgages

The problem for the Fed is that credit costs for households and businesses haven't followed yields on Treasury debt lower, even though policy makers reduced their target rate from 4.25 percent in January 2008.

Thirty-year, fixed-rate mortgages averaged 4.96 percent last week, according to McLean, Virginia-based mortgage finance company Freddie Mac, or 2.64 percentage points more than 10-year Treasuries. Before the credit markets began to seize up in the second half of 2007, the difference averaged about 1.78 percentage points since the start of the decade. Companies must pay an average of 9.25 percent to raise money in the bond market, up from 6.54 percent a year ago, Merrill Lynch index data show.

Mortgage, Consumer Rates

"The Fed wants to keep borrowing rates from going up," said Stuart Spodek, co-head of U.S. bonds in New York at BlackRock Advisors Inc., which manages \$502 billion in debt. "They are trying to target the mortgage rate primarily, and ensuring that intermediate or longer Treasuries don't rise rapidly or sell off meaningfully is a way to do that."

The Fed already started buying securities to influence consumer rates, purchasing the first of \$500 billion of mortgage-backed bonds.

Anchoring the outlook for a flatter yield curve the next few months are expectations the Fed will keep its target rate pinned near zero through much of 2010, Barclays' Goyal said. The curve flattened by 0.25 percentage point between June 2003 and June 2004, when the Fed held its target rate at 1 percent.

The central bank will keep its target within a range of zero to 0.25 percent through the fourth quarter, according to the median forecast of 61 economists surveyed by Bloomberg News.

"From a historical perspective once the Fed gets to the end of an easing cycle, that is when the cyclical flattening of the yield curve begins," said Robert Tipp, chief strategist for fixed income in Newark, New Jersey, at Prudential Investment Management, which oversees more than \$200 billion of bonds.

My view - The Fed have stated on a number of occasions that they are, and will continue to, purchase long-dated Treasuries. This has been a critical technical support for the market and may help to explain the tails on the daily candles over the last week. Mortgage rates are now almost as low as they were in 2003, depending on whether one looks at [FHA](#) backed or [regular](#) rates but need to fall significantly further to approach the 'teaser' rates which were available during the housing market's expansion. Large numbers of ARM mortgages reset this year and this event could set off another wave of foreclosures unless resets take place at suitably low levels. The stubbornly high mortgage rate [spread](#) over Treasuries remains a headache for policy makers, but I question whether it will contract without some sort of direct intervention by the Fed to force banks to cut their margins.

Given the extent of the additional borrowing needed to fund the deficit and stimulus packages, the Treasury will need more buyers of its debt than the Federal Reserve. US based momentum players aside; the relative attractiveness of the US Treasury market, to foreigners, is supported by the strength of the [US Dollar](#). Treasuries are retesting their highs in terms of both the [Euro](#) and [British Pound](#) due to the relative strength of the Dollar. The Dollar Index pushed back into the December top formation yesterday and sustained the move today. Its advance from the lows near 78 is now looking somewhat overextended, as it approaches the highs near 88, but a downward dynamic is needed to reaffirm resistance around this area.

Cogent arguments can be made to explain why Treasury prices can stay higher for longer. However, these views are premised on the belief that the

stimulus packages and bank bailouts will fail to adequately deal with deflationary pressures. They could be right, but the price will be the final arbiter.

The [price](#) of the 30yr Treasury accelerated to a high near 142 in late December and broke downwards on New Year's Eve. It found support near 132 a week later and rallied to 138 by January 15th. However, it failed at this level and is now testing the short-term lows once more. The tails on the daily candles, this week, suggest someone is buying as it approaches the short-term lows. This means that a sustained move below 132 is needed to reaffirm the short-term downtrend, while a move above 138 would indicate the bulls have regained the upper hand, at least in the short term.

Email of the day (3) - on a long-term chart of the British Pound versus the US Dollar:

"In light of the sterling drop versus the USD is it at all possible to put up on the website a chart that is longer than 20 years? I understand that the 1.40 level has held for the past 23 years (on a monthly basis) but am very curious to see where the next level of support might be now we are trading below 1.38. Very many thanks "

My comment - Thank you for this interesting email. It is possible to customize any chart to display 50-years of data, or as much as we have, using the Charting Tool. For the British Pound versus the US Dollar, our data goes back to 1971. To access it, select the chart from the menu, or find it using the Search, and click on Charting in the black bar immediately above the chart area. From the 'Period' menu select 50 Years [max] and hit Apply.

This has been the [Pound's](#) swiftest decline since the UK was forced to drop out of the European Exchange Rate Mechanism in 1992. The \$1.40 level has offered support on a number of occasions since 1986, and on a strict monthly closing basis, this remains true, since January has not yet ended. For example, in June [2001](#), the Pound spent most of the month well below \$1.40 before rallying back above it. The region of \$1.40 is a potential area of support but need not be sacrosanct. The currency has fallen for the last five consecutive months and on this long-term view, the first clear up month is likely to mark a medium-term bottom.

Email of the day (4) - on additions to the Chart Library:

"Thanks as ever for a wonderful service. May the Lord grant you all unnaturally long life to continue leading us confused souls through the maze of mirrors that is modern day capital markets.

"Please can you add the top three constituents of the Bloomberg Dry Ships Index as individual charts. These are STX Pan Ocean Ltd ([STX SP](#)), Diana Shipping ([DSX US](#)), Pacific Basin Shipping Ltd ([2343 HK](#)) and Compagnie Maritime Belge SA ([CMB BB](#))."

My comment - Thank you for your kind words and we both intend to be around for a long time to come. Thank you also for these interesting suggestions, but all of these shares, could already be found in the International Equity Library except STX Pan Ocean Ltd. This has now been added.

We realise that the existence of two separate searches is burdensome when trying to find what you want and are working towards combining them. In the meantime, might I suggest a routine for searching for anything in the Chart Library:

First, put the name / ticker of the instrument into the search and hit find. If you do not get the desired result, click on the 'Search the International Equity Library' tab to the right of the search box. This will bring up the search box for the International Equity Library. Just click on the 'Search' button, to search the equity database.

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.

Oil - sustains yesterday's [rally](#), which occurred in conjunction with the contract rollover. The [base](#) formation development hypothesis remains in place but volatility is likely to remain high. A sustained move below \$32 would be needed to question this view.

Wheat - failed near [650¢](#) and would need to sustain a move above 600¢ to question scope for some further lower to lateral ranging.

Aluminium - breaks below [\\$1500](#), reasserting the downtrend, and needs to sustain a move back above that level to question potential for some additional downside.

Thursday 22nd January 2009

Commentary by Eoin Treacy

Sir Mervin King's speech to the CBI Dinner in Nottingham on January 20th - Thanks to a subscriber for this [speech](#) by Mervin King where he outlines what assets and under what circumstances the Bank of England will use its new ability to purchase securities. Here is a section:

Despite those big cuts, there remains a risk that inflation will fall below 2%. The disruption to the banking system has impaired the effectiveness of our conventional interest rate instrument. And with Bank Rate already at its lowest level in the Bank's history, it is sensible for the MPC to prepare for the possibility - and I stress that we are not there yet - that it may need to move beyond the conventional instrument of Bank Rate and consider a range of

unconventional measures. They would take the form of purchases by the Bank of England of a range of financial assets in order to expand the amount of reserves held by commercial banks and to increase the availability of credit to companies. That should encourage the banking system to expand the supply of broad money by lending to the private sector and also help companies to raise finance from capital markets.

The conventional approach to such unconventional measures is to buy assets, such as government securities or gilts, which are traded in liquid markets to boost the supply of money. Provided the additional reserves are not simply hoarded by banks, as happened to some extent in Japan earlier in this decade, such asset purchases can increase the supply of broad money and credit and the liquidity of private sector portfolios, raising spending. The effectiveness of this approach is likely to be enhanced by the clear commitment by the MPC to take the measures necessary to meet the inflation target in the medium term.

In addition to these conventional measures there are also unconventional measures. When credit markets are dysfunctional, as some are at present, targeted purchases by the Bank of England of assets may improve liquidity in markets for those credit instruments. The objective of such purchases would be not only to boost the supply of broad money but also to increase liquidity and trading activity in the markets for those assets. A reduction in the illiquidity premium for a particular credit instrument might help to stimulate issuance by corporate borrowers and the resumption of capital market flows, thus reducing reliance on bank lending. It could also raise the values of assets that are currently under-priced because of high illiquidity premia, helping to strengthen the balance sheets of banks and other financial institutions.

Yesterday the Government authorised the Bank of England to conduct such operations, financed by the issue of Treasury Bills, in order to improve the flow of credit to companies. But at some point the Monetary Policy Committee might wish to adopt these unconventional measures as an instrument of monetary policy.

In conducting such operations, it is important to choose the markets in which to intervene extremely carefully. There is a fine dividing line between helping to oil the wheels in markets which are temporarily impaired, and artificially supporting markets in which there is no underlying demand. That is why, as Federal Reserve Chairman Bernanke said in London last week, central banks will look to intervene only in markets that "normally play major roles" in the functioning of the financial system. Therefore, the Bank will need to be satisfied that there is a genuine private demand for an asset in normal conditions before it would be eligible for the asset purchase facility. We are aiming to complement and stimulate private demand, not substitute for it.

My view - There is significant leeway for the Bank of England to buy financial instruments which are deemed to be essential to the smooth operation of the financial markets; should the need arise. I'm not sure about the difference between adding liquidity because credit has dried up and replacing investor demand in questionable assets. In the majority of cases, investor demand has

dried up because there remain unanswered questions as to the viability of the assets? This means that the Bank of England can act in a market which is now illiquid, but may become more liquid due to its actions, even if initially it is taking the place of investors who have deserted the market.

The corporate bond markets seized up considerably over the last year. Spreads have hit record highs as a result of the inability of prospective investors to ascertain reliable pricing. If the Bank of England begins to make purchases in this arena, it could give a significant boost to confidence and improve the ability of the market to function.

We can be sure that any purchases will be widely publicised in order to motivate investors to follow the bank's lead. Of course this will also provide ample opportunity to the central bank to divest itself of said assets; at a healthy profit. This is a prime example of how governments can change the rules to their liking. As a sovereign it is any country's right and they guard it jealously. Should any other entity act similarly, it would be accused of market manipulation.

This new legislation sends a clear signal that the UK government is willing to do whatever is necessary to achieve the goal of stabilising the financial system and the wider economy. Buying illiquid assets in the hope of encouraging investors to return to the markets is laudable but is unlikely to stop banks from hoarding reserves and refusing to lend except on the most punitive of terms. My intuition is that some further measure will be needed to address this issue. This could either be achieved through some form of legislation or outright nationalisation of the banking system. At present, I suspect both options are being considered.

There is also talk of having some tool, other than interest rates, to help manage the expansion of bank balance sheets in favourable economic conditions. One could argue that it already exists in the ability of central banks to raise or lower reserve requirements. If banks are being too blasé about who they lend money to, doesn't it make sense to force them to hold more in reserve to cover the possibility of a default. This measure is used in a number of Asian countries to seemingly good effect and I wonder why it is not more widely implemented in the West.

Speech by Sir John Gieve, Deputy Governor of the Bank of England: Economic prospects and the policy challenge - Thanks to a subscriber for this [speech](#) by Sir John Gieve at the Cityco Breakfast Meeting in Manchester on 16 January 2009. It foreshadows that given by Mervin King on the 20th above. It is posted without further comment but here is a section:

First, the full impact of the measures of the last few months have yet to be felt. In the UK, the Bank has cut interest rates from 5% to 1.5% since October, the government has cut taxes and expanded spending and the banking system has been supported through recapitalisation and improved access to funding and liquidity. These measures will have a growing effect, even if we do nothing more. While the transmission mechanism from official interest rates to

the economy has been impaired by the dislocation of financial markets, the cuts in interest rates are still having an impact. While the reductions in the income of savers have offset to some extent the benefits to borrowers in the household sector, the net gain to the company sector is clear.

The changes in interest rates have also accounted in part for the depreciation in the sterling exchange rate, which is down around a fifth in the past six months. No one who has lived through the 70s, 80s and early 90s will be complacent about a fall in sterling. But there is no doubt that an appreciable fall in the pound, such as we have seen, has been helpful both in supporting exports and import substitution in the short term and in encouraging the rebalancing of the economy that we need in the medium term.

My second point is that it is important to distinguish the medium term from the short term goals. In the medium term we need to see a rebalancing of the economy in the UK, and some other countries, with a higher savings rates, less leverage in the financial sector, and higher net exports. However if everyone tries to increase saving and cut borrowing immediately we could prolong the downturn painfully. If everyone plans for the worst, we are more likely to get it. That is why economists sometimes sound a bit like St Augustine who famously noted in his confessions "Make me chaste and continent, but not yet".

This apparent tension between the medium term and the short term is evident in the banking sector. One lesson of the last 18 months has been that in the medium term banks need to work with lower leverage and higher buffers of capital and liquidity. I have argued elsewhere that we need in future to relate these buffers to the state of the economic and financial cycle so that they expand in good times and are sufficient to cover the inevitable losses in bad times. In a sense the purpose of the recapitalisation in October was to put banks capital up to the level it should have been had such counter cyclical measures been in place. But, at the moment we are in the downswing and we need to allow the banks to use those cushions and reduce their capital ratios from the new and higher starting point.

Globe and Mail Watch out, world: Americans are saving again - [Thanks to a subscriber for this interesting article by Paul Kedrosky highlighting the uptick in the US savings rate. Here is a section:](#)

But in the end, fixating on those numbers misses everything that matters because that money has to come from somewhere. Your savings, in some sense, represent my lost income. Increased consumer savings is like extending a dam further into a river of money - call it personal income - and diverting some of the flow into a different river. Instead of going into the river called "consumer spending," more of it is going into the river called "savings."

To put it in context, a U.S. savings rate of minus 1 per cent meant roughly \$2-million a minute was flowing out of U.S. consumer savings into other things, mostly consumption, like TVs and home renovations, and so on. Or, on an annual basis, that worked out to almost \$1.3-trillion exiting the U.S. banking

system for other places.

Turn that around, however, and things get very different, very quickly. At a 3-per-cent savings rate, the United States will see \$3.8-trillion showing up next year in the banking system just from domestic savers. At 7 per cent, almost \$9-trillion will come rushing in as part of the savings tsunami. It is a fire hose of money pointed at the banks, and it's just beginning.

These are ear-popping figures. Three per cent, for example, produces almost five times as much in one-year U.S. capital inflows as the entirety of China's current Treasury holdings. It is four times as much as the proposed Obama stimulus plan. In short, at even relatively small changes, at least in percentage terms, the United States will rapidly transform its banking system and its capital markets.

All that money has to come from somewhere, however, and among the main sources will be the United States' largest trading partners, chief among them China. The U.S. economy is more than three times the size of China, and if you match the U.S. trade deficit against the Chinese trade surplus you'll see that China accounts for, on average, about 60 per cent of the U.S. deficit. As a result, China is going to need to find a way to replace more than 10 per cent of its gross domestic product if the U.S. savings rate returns to its historical norm. Making matters worse is that Chinese consumers are a smaller percentage of GDP than their U.S. counterparts, so to make the math work, Chinese consumers would have to up their buying by something like 25 per cent. Will it happen? No way.

My view - The decline in US savings has been assigned as one of the main factors which helped to fuel the housing boom, consumerism in the domestic USA and manufacturing across a large part of the developing world; not least China. The easy way to interpret this data is to assume that because people were saving less cash, they must have been spending it on consumables such as new TVs, cars and boats, as well as ploughing it into their homes. However, they were also doing something else; buying stocks and bonds (yield).

The US Personal Savings Rate as a Percentage of Disposable Personal Income topped out, in 1981, near 12% and declined to below 0% in 2005. Since then, the rate has ranged slightly above 0% and surged upwards in April last year. It is perhaps not so surprising to see the rate rise when a large market correction is underway, the important question now is whether the rate bottomed and is its direction reversing.

The low near -2.7% is probably the nadir for the 24yr downtrend. Whether the rate ever gets back to the pre-1981 average of circa 10% is debatable because savers now have so many more options than they did then. No one would argue that faith in the financial system is at rock bottom right now, but that does not change the fact that cash is a lousy investment over time. Investors might be slow to return to the markets and might even hold more cash in the future (probably a good thing for most households) but the relative attractiveness of financial assets to cash is high over the longer-term.

Email of the day (1) - [investing in higher yielding assets](#):

"With cash deposits rates at such low levels I am considering putting some of my low risk fund capital into High Yielding equities & Corporate Bonds (not alone here I am sure!) I am less experienced with Bonds & was hoping you could provide some thoughts as to what risk factors to consider.

"You have mentioned the iShares £ Corporate Bond ETF (SLXX) on a few occasions & I do have a small holding. The running yield is approx 7.2% & its price has not had the run of a lot of Corp Bonds / funds. I assume that this has something to do with the fact that approx 70% of this ETF's constituents are financials.

"Now apart from the likelihood of default of the underlying bonds, what from your experience are other risk factors that are going to influence the price of this ETF or other Corp Bonds over the short /medium term? (I assume the announcement from Mr King re the BOE buying corporate bonds will have some effect now!) Thanks for a great service & hopefully reply to this email.

"P.S. It was good to meet you at the Chart Seminar / Royal Festival Hall last November."

My comment - Thank you for your interesting question and it was also a pleasure to meet you and your colleagues at the November Chart Seminar. All three of you earned your Chart Seminar umbrellas with your lively contributions to the market discussion. For those who may be interested, there are still places available for the Dublin [Chart Seminar](#) on February 19th and 20th.

With regard to the bond markets, I can think of no better educational resource than the Fixed Income Investor site, managed by resident bond guru, Mark Glowrey. This link to the [Learn about Bonds](#) page should help to answer many of your questions about the fixed income market.

You will notice that at present [SLXX](#) is trading more like an equity fund than a bond fund. This was always true of high yield bonds but has recently also applied to higher grade bonds because the perceived risk of default is currently so elevated. Some of the constituents of the fund may benefit from any corporate bond purchases by the Bank of England, but I suspect they are most likely to buy bonds of UK companies denominated in Sterling. The fund is 43% banks but only 4 of the top-10 holdings are UK companies.

SLXX rallied well from the October lows to test the lower side of the previous range in late December but has since fallen back to test the lows. An upward dynamic is needed to offset scope for some additional downside.

Email of the day (2) - [on long-term charts](#):

"Saw your reader's request for Really Long Term Charts

"This [webpage](#) is on my FAVOURITES and I use it often

"You might like to note it.

My comment - Thank you for highlighting this site which offers a number of longer-term charts. I understand the raw data is also available for a fee.

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

"Would you please ask Eoin to add [WNA](#) Global Nuclear Energy Fund (NUKP) to the Chart Library?"

My comment - Thank you for the interesting suggestion. The fund has been added to the Chart Library.

Please note - [David is away today](#).

Friday 23rd January 2009

Jeremy Grantham: Obama and the Teflon Men - Thanks to the thoughtfulness of subscribers who contribute interesting reports in the spirit of Empowerment Through Knowledge, Fullermoney is able to post some of the best research and commentary available. Long an admirer of wise Jeremy Grantham of GMO, I think the January [issue](#) of his Quarterly Letter is one of the finest reports that I have seen. Here is the introduction:

With economies and financial markets, it seems that if you stare hard enough and long enough at the fog of battle, you occasionally get a glimpse of what may be going on when a favorable wind blows. This, for me, is decidedly not one of those occasions. It is obvious to all of us that these are momentous days in which government actions may well have make-or-break impact, but my confidence in government and leadership is at a low ebb. (Although I must admit my confidence has increased enormously in recent weeks in all areas outside of finance. Even in finance it has increased a little.) Economic advice for President Obama covers the waterfront, and even the near-consensus case for great stimulus is lacking in historical certainties or intellectual rigor. Everyone seems to be guessing at strategies and outcomes, knowing clearly that the best strategy would have been to have avoided getting into this pickle. The current disaster would have been easy to avoid by making a move against asset bubbles early in their lifecycle. It will, in contrast, be devilishly hard to get out of. But, we are deep in the pickle jar, and it seems likely that, in terms of economic pain, 2009 will be the worst year in the lives of the majority of Americans, Brits, and others. So break a leg, everyone!

It would be helpful at a time like this to have a Quarterly Letter that sounded convinced of something ... anything. So I apologize for overtly tickling around the edges. I do not apologize, though, for pointing you to the best thing I have read in *The New York Times* in a very long time: the article by Lewis and Einhorn¹ does a great job of summarizing where we are and how we got here,

as well as offering some helpful advice for the future. My contribution is to address a few peripheral topics that have accumulated over recent quarters as more important topics have dominated. Half of the mini topics are covered in this Letter, and the other half will be posted in a few weeks.

My view - Busy subscribers may be tempted to skip Jeremy Grantham's analysis, often presented in an historic context, and skip to the market conclusions. In my opinion that would be a mistake because the insights offered are of far greater practical value than many a course on finance. Some of you may wish to circulate Jeremy Grantham's report among family, friends and colleagues.

And what do we make of his market conclusions?

Note his bearish comments on government bonds, shared by Fullermoney. Note also that he expects inflationary pressures to return at some point. Will this cause gold to become the new bonds or cash in terms of flight to quality or safety?

I suspect so and will remain overweight in precious metals, which we expect to remain volatile and therefore maintain that they are best purchased following setbacks. [Gold](#) is safest, but also low-beta within the sector. Industrial metals are more speculative but dirt cheap and showing evidence of base formation development, aluminium excepted so far.

Jeremy Grantham reminds us that it is the nature of markets, which are driven by emotional and often leveraged traders and investors, to overcorrect. In other words, following big overshoots, up or down, we do not just see mean reversion in terms of valuations. Market momentum, driven by sentiment, usually causes the mean to be exceeded for a while.

Therefore we cannot rule out Jeremy Grantham's suggested overcorrection by the [S&P 500](#) to 600 or below at some point, although the downside move to date is still quite overstretched relative to the MA. Fundamentals will not determine the actual low, in my opinion, whether already seen or pending. That will be determined by sentiment and liquidity, as always. Currently, sentiment is diabolical but liquidity is increasingly abundant.

From an investment perspective, my preferred strategy would be to nibble on easing at high quality equities with decent and well covered yields. Actively managed accounts may wish to lighten positions on strength, in anticipation of a lengthy bottoming out and base building process.

Here is the two-part [article](#) by Michael Lewis and David Einhorn, mentioned above - well worth reading.

Puru Saxena: Birth of a New Cyclical Bull? - I always enjoy Puru Saxena's [Money Matters](#). There is nothing tentative or hedged about his views and he is interested in themes favoured by Fullermoney and many of our subscribers. Here is the opening:

BIG PICTURE - *"Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria"* - John Templeton, Founder of Templeton Funds

The coming year may go down in history as a wildly bullish one. After the shocking asset-liquidation witnessed in 2008, the following 12 months are likely to provide fantastic investment returns. Given the negative economic news and awful investor sentiment, my assessment may sound absurd but it looks as though the bear-market ended late last year and we are now in the early stages of a new cyclical bull-market. Below are some of the reasons why I believe the skies are clearing for a 4-5 year bull-market:

- *Surging liquidity - central banks have pumped trillions into the banking system*
- *Low-interest rates - yield on cash and cash equivalents is at a historical low*
- *Declining corporate bond yields - risk appetite is returning*
- *Declining Ted Spread - inter-banking lending rate has declined, a positive sign*
- *Low valuations - various stock markets are trading at very attractive multiples*
- *Horrendous investor sentiment - a contrary bullish indicator*
- *Volatility has peaked - VIX has topped out and is falling*
- *US Dollar rally has ended - bullish for the markets*
- *Global stock markets are making higher lows - sign of base building*
- *Huge amount of cash on the sidelines - US\$8.85 trillion or 74% of US market cap*

Now, I am well aware that the above prognosis goes against the mainstream bearish view. After all, most professional and amateur investors are very worried about the state of the global economy and many are expecting a horrendous economic depression. Furthermore, according to some prominent bears, our world is heading into a deflationary bust and the Dow Jones Industrial Average is about to contract by another 50-60%.

For sure, anything is possible in the business world, but at this stage, a 1929 style economic depression is out of the question. Back then, the US economy contracted by a whopping 46%, unemployment went through the roof and thousands of Americans lost their entire savings as roughly 5,000 banks went bust.

This time around, the US economy has barely shrunk, the unemployment rate is not even close to the 1982 recession and not a single person has lost money due to a bank-run. So, at least the current circumstances do not warrant a prolonged economic depression.

Let there be no doubt that the US economy is certainly struggling - housing starts, permits and home sales are at multi-decade lows, auto-sales have slumped, retail sales have contracted, unemployment is rising and manufacturing is at the lowest level since 1980. Despite all these negatives, the state of the world's largest economy is still nowhere near as bad as it was during the Great Depression.

It is interesting to note that Professor Nouriel Roubini (who correctly forecasted the extent of this economic slowdown) was recently interviewed by the Financial Times. During the interview he stated, "We are going to avoid the Great Depression and a severe recession even if there is a risk of protracted slow economic growth".

My comment - Having addressed some of these points recently and also in the opening feature above, I will just add that Puru Saxena's views are a useful counterweight, in terms of perspective, to some of the more extreme pessimism currently expressed.

Albert Edwards: US depression looking likely - My thanks to a subscriber for this equally emphatic [report](#) by Albert Edwards of Societe Generale. I suspect it has contributed to recent market weakness. Here is the opening:

After increasing our equity exposure at the end of October we believe that the market is set to quickly slide sharply towards our 500 target for the S&P. While economic data in developed economies increasingly reflects depression rather than a deep recession, the real surprise in 2009 may lie elsewhere. It is becoming clear that the Chinese economy is imploding and this raises the possibility of regime change. To prevent this, the authorities would likely devalue the Yuan. A subsequent trade war could see a re-run of the Great Depression.

- Economic data has been truly dreadful through the fourth quarter. Over a year ago we forecast deep US recession. As it had not suffered one since the early 1980s, we thought this outturn would shock. Yet recent data has been consistent with something far worse than deep recession. There is no agreed definition of a "depression" as opposed to a deep recession. But The Economist magazine is probably more qualified than many to take a view. They consider a peak-to-trough decline in GDP in excess of 10% a reasonable definition. We had been thinking of deep GDP declines of the order of 5% peak to trough but we are now thinking that this view might be too optimistic.

- But, until yesterday, equity markets had been paddling quite happily sideways for most of the last few months. They have been broadly flat since we increased our equity weighting sharply on 23 October. Within that time the intra-day 'peak'-to-trough' rally in the S&P was a creditable 28% from 740 low of Nov 21, but we do not claim to have captured that. Nevertheless we feel very comfortable that the technicals at the end of October cried out to close our extreme underweight equity exposure. They now tell us to cut exposure again.

- 2008 was a shock for investors. But 2009 could be an even bigger shock. There is evidence that the Chinese economy is imploding (see chart). Investors should consider what would happen if China descends into social chaos. Yuan devaluation could spark a 1930's style trade war. Do you really trust the politicians to "do the right thing"?

My view - Fullermoney aims to provide both sides of the analytical argument, not least when there is so much uncertainty. However our own preference is to both read and listen, while letting the markets show us the trends.

Technically, many stock markets are testing last year's lows, and a few have actually broken beneath them. While retests of lows are often a characteristic of base formation development, they can also be a precursor to the resumption of downtrends. If the ranging patterns formed since October and November are developing base formations, this is now for the bulls to prove, with upward dynamics and / or persistent rallies back to the upper-middle of these formations.

Today's interesting charts - View the price of gold in any currency, in the Subscriber's Customisable Chart Library:

Gold in Euros - Upside breakout following lengthy consolidation; would require move beneath €635 to question near-term scope for higher levels within secular uptrend.

Gold in SF - Similar to above and would require decline beneath SF980 to question near-term higher scope.

Gold in GBP - Extending strong advance and would require a decline beneath £600 to question short-term uptrend consistency.

Gold in AUD - Breakout and would require move beneath A\$1200 to signal upside failure.

Gold in CAD - Resumed advance following brief consolidation of breakout; would require fall beneath C\$1000 to question higher scope.

Gold in ZAR - Same as above and would require decline under R8000 to question higher scope.

Gold in SGD - Approaching test of 2008 peak; would need lower low to suggest more than temporary resistance near that level.

Gold in CNY - Broken progression of lower rally highs; would require move under R5750 to question near-term uptrend.

Gold in INR - Resumed advance following brief consolidation and would require a move beneath R40000 to suggest an upside failure.

Gold in USD - Resuming biggest rally since March 2008 peak, following consolidation; would require break beneath \$800 to seriously question scope for sideways to higher trading.

Conclusion - Veteran subscribers will recall that the best upside moves occur when gold is rallying against all currencies. This is currently the case, although it has yet to breakout on the upside against all of them. Nevertheless

this is also a period of seasonal strength for bullion. (See also my comments in response to the Jeremy Grantham item above.)

My personal portfolio: Hang Seng futures long rolled forward; platinum long increased - My purchase of the [Hong Kong Hang Seng Index](#) last month was the triumph of hope over experience and went against my advice (go figure?) which is to not pay up for anything in this environment. However I decided to hang on as stock markets are temporarily oversold and Asia is currently holding up better than the West. Accordingly, as my expiring January HSI was sold today at 12449 against my ill-timed purchase at 15675 on 6th January, I simultaneously purchased February HSI at 12454. Seeing gold and silver romp today, I increased my [platinum](#) long position by 50%, paying \$951 for another April position. These prices include all spread-bet dealing costs.

Quote of the week - On gold:

"Although gold and silver are not by nature money, money is by nature gold and silver."
Karl Marx

Additional Commentary by Eoin Treacy

Email of the day (1) - [on are commodities bouncing](#):

"I wonder whether you agree with the view expressed in this [article](#), which suggests that commodities in general are now bouncing back.

"The examples given in the article are limited. Does your broader survey of commodity charts support this view? As a holder of many commodity investments that I have continued to hold through this severe downturn and have no intention of selling, I am wondering if there is light at the end of the tunnel!"

My comment - Commodities span a very wide array of instruments so it only occurs quite rarely that they all advance at the same time. The [CRB](#) Index, which is heavily weighted to oil, is still the most often used measure of whether commodities as a group are appreciating. The Index peaked near 475 in July following an impressive advance of 50% in the preceding year. It has since fallen, extraordinarily consistently, to the lows above 200 in a mere 5 months. The downtrend is no longer consistent.

The rally from December 26th was equal in size to the largest reaction within the downtrend but served to break the progression of lower highs. The current range has gone sideways for longer and has posted a higher low. The massive downward acceleration was an ending signal (Type 1 as taught at [The Chart Seminar](#)) and the subsequent loss of momentum is a Type 2 bottoming characteristic. These signals suggest that base formation

development is underway. This phase could be potentially lengthy and is likely to be volatile, but the clear message is the potential upside now outweighs the potential downside, if one is prepared to take a medium-term view. This description could also be applied to the [oil](#) market but not all commodities are performing in a similar manner.

[Gold](#) has been a relative performer throughout the decline in the CRB and continues to attract investor demand as it rallies back towards the \$900 level. (Also see David's piece on gold above.) The bouncing description might be better applied to [Silver](#), [Platinum](#) and [Palladium](#). All three of these metals fell precipitously, but found support late last year and remain in ranging phases. Silver in particular, while characteristically volatile, is testing the upper side of its range. Sustained moves to new lows would be needed to question recovery potential for all three metals.

The Industrial metals remain the weak link in the commodity complex, [Aluminium](#) broke to new lows this week, while of the others [nickel](#) and [zinc](#) show the best signs of base formation development. However, they need to at least hold within their ranges to maintain this prognosis.

Interesting chart patterns are also developing in a number of soft commodities. [Robusta](#) Coffee broke its 5-yr progression of higher lows in September and fell to \$1580 by late October. It found support and rallied to \$2000 before pulling back and establishing a higher low. Robusta broke upwards again on Wednesday and improved upon that performance today. While it is now testing the lower side of the February - September range a sustained move below \$1980 would be needed to hinder scope for some additional upside. [Arabica](#) coffee is lagging Robusta. It broke its 5-yr progression of higher lows in early October and found support in December. It is now testing the upper side of the four-month range and a sustained move below 112¢ would be needed to question potential for an upside break.

[Sugar](#) peaked in early 2006, following a remarkable advance and did not participate in the appreciation for most commodities in the first part of 2008. However, sugar contracts did fall aggressively in sympathy with just about every other market from early October. ICE traded sugar found support above the June lows in late October and rallied to test 13¢ before consolidating. It broke above 12¢ this week and would need to sustain a move below 11.9¢ to question scope for some additional upside. [White Sugar](#), traded on Liffe, found support near 300¢ in early December and remains in a short-term uptrend. While it is now testing the early November high near 360¢, a sustained move below 330¢ would be needed to question upside potential.

[Cocoa](#) broke upwards from a multi-year consolidation in March 2007 and rallied to a high near \$3300 in July 2008. The ensuing correction saw cocoa prices fall to test the top of the 2003 - 2007 range before rallying impressively from the October lows. Prices encountered resistance near \$2700 but have rallied of late and are now testing that level once more. A sustained move below \$2400 would now be needed to question potential for some further upside. The [Liffe](#) quoted contract is not an exact corollary because it is denominated in Sterling. Due the currency effect, it broke upwards once more

yesterday and would need to sustain a move below £1850 to question scope for some additional upside.

The grains are also worthy of note. They did not experience the same percentage declines as the metals or energy complex and have been ranging for a number of months. [Soybeans](#), [Corn](#) and [Wheat](#) all experienced downward dynamics on January 12th but have steadied since. Sustained moves above the January highs are needed to question potential for some further lower to lateral ranging.

In summary, gold continues to lead on the upside, with the other precious metals showing the best signs of base formation. Oil appears to be in the early stages of base formation development. The call of base formation development for the industrial metals remains tentative. Among the soft commodities coffee, cocoa and sugar are showing relative strength while the grains continue to mostly range.

Email of the day (2) - on a full list of UK Listed ETFs:

"Hope you are well, this will allow me to ditch Sharecope and use your charts for everything, I would appreciate if you could add the following UK ETFs to the library, I believe it is a full list of UK ETFs but I am not certain but it should not only be of benefit to me but to others, and also save those emails asking for individual ones to be drip fed in the future. Thanks in advance."

My comment - Thank you for this exhaustive [list](#) and we are delighted that the features available in the Chart Library enable you to cut costs in other areas. We are always happy to add additional shares to the Chart Library when subscribers request them. I can confirm that all of these ETFs can now be found in the Chart Library.

Email of the day (3) - on the gold to S&P 500 ratio:

"This past Tuesday, the S&P500-to-gold ratio fell to less than 1. The last time it was at unity was 18 years ago."

My comment - Thank you for pointing out the relative outperformance of gold to most equity indices. The fact that the [S&P](#) has fallen to the same level as gold in US Dollars is less important than the direction of the trend which remains in secular decline. The more commonly watched ratio is for the [Dow](#) to Gold in US Dollars which is very similar. The best part of this relative move has already occurred, but we have no evidence it has ended.

From these long-term charts, we see that the Dow and S&P topped out near 42 and 5.5 respectively and continue to fall towards their long-term average levels of 5 and 0.5. We have continually used this chart as a proxy for the outperformance of precious metals relative to Wall Street since 2003 and watch them closely. However, we also know that there is a strong likelihood that their relative decline will overshoot before an equilibrium is attained. On

prior occasions, gold and the Dow have come back into a relative equilibrium, for a number of years, before the next equity bull market takes place, there is no reason to believe the same will not occur on this occasion.

Venn diagrams of the falling market capitalization of the banking sector - Thanks to a subscriber for this revealing [update](#) of a series of Venn Diagrams produced by JP Morgan on [October 20th](#). Thanks also to a subscriber who pointed out on that the diameter of the circles is what reflects the reduction in market cap rather than the area of the circles. (Please see Comment of the Day October 30th) Nonetheless these diagrams are powerful images of the relative decline in the market cap of a number of globally important banks.

This also helps to illustrate that the relative importance of the banking sector to the total market cap of wider market indices is much reduced. However, the psychological importance of the sector is probably stronger now than it was at the highs. This suggests that while the effectual headwind of banks breaking to the downside is much reduced for country indices, the psychological impact to sentiment is deleterious.

Housing Starts, Permits in U.S. Slump to Record Low - Thanks to a subscriber for this interesting [article](#) ([PDF](#)) by Timothy R. Homan for Bloomberg. I can confirm that charts for all of the important statistics mentioned in this article can now be found in the Chart Library. Here is a section:

U.S. builders broke ground in December on the fewest houses since record-keeping began as sales and credit dried up, signaling the real-estate slump will keep hurting economic growth.

Housing starts fell 16 percent last month to an annual rate of 550,000 that was less than forecast and the lowest since the government started compiling statistics in 1959, the Commerce Department said today in Washington. Building permits, an indicator of future projects, were also at a record low.

Builders, whose shares have lost 76 percent of their value over the last three years, are slashing prices to compete with a record number of foreclosed homes coming onto the market. Barack Obama's advisers say the president will use up to \$100 billion in financial-rescue funds to ease the mortgage crisis.

"Homebuilders have no choice," said Ryan Sweet, an economist at Moody's Economy.com Inc. in West Chester, Pennsylvania. "The market is bloated with excess supply and demand is weak. The pace of housing starts will remain depressed until 2011." Economy.com projected starts would drop to a 580,000 pace.

Another government report showed the number of Americans filing first-time claims for unemployment benefits rose last week, matching a 26-year high. Initial jobless claims increased by 62,000 to 589,000, more than forecast, in

the week ended Jan. 17, according to a Labor Department report today in Washington.

Worse Than Projected

Economists had forecast starts would drop to a 605,000 annual pace from a previously estimated November rate of 625,000, according to the median of 69 forecast in the Bloomberg survey.

Estimates ranged from 500,000 to 688,000. November starts were revised up to 651,000 in today's report.

For all of 2008, starts dropped 33 percent to 904,300, down from 1.335 million in 2007 and also the fewest since records began.

Building permits fell 11 percent in December to a 549,000 annual pace. They were forecast to drop to a 600,000 pace, according to the Bloomberg survey.

Home prices dropped 1.8 percent in November, the biggest decline since records began in 1991, the Federal Housing Finance Agency reported today. Values were down 11 percent from the peak reached in April 2007.

Construction of single-family homes dropped 14 percent to a 398,000 rate, today's report showed. Work on multifamily homes, such as townhouses and apartment buildings, decreased 20 percent from the prior month to an annual rate of 152,000.

My comment - The US housing market remains in the throes of a large contraction and many investors will not be satisfied that the worst is behind us until house prices stabilise. I added charts for Freddie Mac National 30yr Mortgage Rates, US Initial Jobless Claims, US New Building Permits and US New Home Starts to the Chart Library today. These will help us to monitor the progression of the housing bust and ongoing recession.

The Freddie Mac National [30yr Mortgage](#) Rate has considerably more back history than the Bankrate.com rates we have looked at previously. They strongly mirror the progression of US Treasury yields over the last two decades but diverged considerably over the last 18 months. The [spread](#) has [contracted](#) somewhat since the beginning of January but needs to fall considerably further to attain the mortgage rates needed to protect vulnerable homeowners facing ARM resets in 2009.

US Initial [Jobless](#) Claims surged in January and are now retesting the highs. Rising unemployment is a lagging indicator of recession and is unlikely to be a lead indicator of recovery.

Both US New Building [Permits](#) and US New Home [Starts](#) have fallen to levels not seen in the last 50 years. Both of these indices have historically been quite volatile with a series of booms and busts evident between 1970 and 1990. The advance from the early 1990s to the highs in late 2005 and early 2006 respectively was not the largest advance in the available data but it was by far the most persistent. Both of these indices are accelerating lower and

upward dynamics sustained beyond a couple of months, will likely signal they have bottomed. The subsequent convalescence is likely to be quite lengthy.

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