PIVOTAL EVENTS

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Signs Of The Times:

Last Year:

"Luxury is Feeling No Pain"

"Pricey Wares of Burbury, LVMH, Hermes are Flying Off the Shelves"

– Wall Street Journal, October 17, 2007

"Ship Shortage Pushes Up Prices of Raw Materials"

– Wall street Journal, October 22, 2007

In that October the Baltic (BDI) was at 11039. After slumping to 5615 in January it rebounded to the record high of 11793 in June. Yesterday set new lows at 672, which is down 94%.

This Year:

"Metal Prices Fall Further Than During The Great Depression"

– Telegraph, December 2, 2008

"Salaried lawyers at top New York firms will get bonuses amounting to only a quarter of last year's."

– Bloomberg, November 26, 2008

Actually, there has been a night and day change in conventional wisdom since the confidence of last October-November. Today's shock and dismay is setting up the rebound rally that has been possible from the November low until around March-April.

* * * * *

Stock Markets: As we have been noting, sentiment has been devastated and dynamics have registered significant Downside Capitulation readings on our proprietary model. That is on the senior stock indexes as well as on commodities (CRB). Going the other way, there was a timely Upside Exhaustion reading on the Dollar Index. Not yet going the other way, we have yet to get the full Upside Exhaustion reading on the long bond.

The action since the November 20 low has been tentative, but seems to be recovering in price at the right time. The last high was DJIA 8831 last week and getting above this would break the overhead "ice". It could take well into January before the horrors of the crash are eclipsed by comfortably new recovery highs.

We have been describing the expected move out to spring as a tradable rally for investors and traders. It could carry most, if not all, sectors with it.

The attached study updates the classic fall crash pattern. The fit has been remarkable.

INTEREST RATES

The Long Bond continues its outstanding role as the only game in town is compelling a formidable rush to cover shorts. Our advice to traders to "play" the short side has been wrong for a couple of weeks of straight up action – complete with two gaps in the chart. The weekly RSI is a little over 70, which is near the level that has limited previous compulsive rallies.

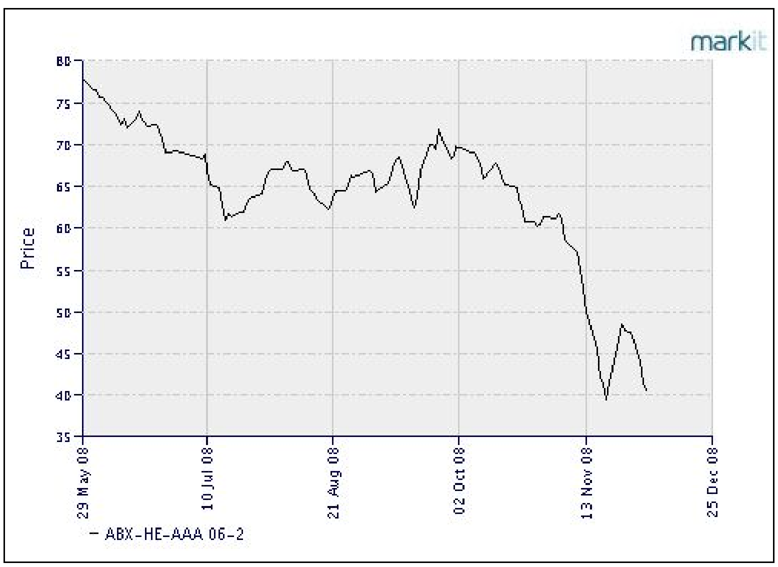
It is also close to registering an Upside Exhaustion reading, which we are monitoring.

The Yield Curve has steepened from the almost carefree days of early September. The 10s to 2s got out to 292 bps on Friday, and similarly, the 30s to 2s steepened from 195 bps to 342 bps, also on Friday. In the last few weeks this has been a panic. However, these have eased a little to 267 bps and 316 bps, respectively.

Any trend change here would support the possible stock rally. The reversal from inverted to steepening was expected to occur by June, 2007 and it was accomplished in that May, which signaled the beginning of the contraction.

Credit Spreads have continued under extreme pressure, with the spread for BBB widening out from 250 bps in early September to 720 bps this week. Credit spreads began to widen in June, 2007 providing the other signal of contraction.

The “AAA” sub-prime mortgage bond price crashed to 40 on November 20. The bounce was to 48 on November 24 and the action is testing the low. (Chart follows)



Some relief in this department would assist the pending stock rally.

Currencies: On the bigger picture, the Dollar Index registered an Upside Exhaustion in October, when we expected the rise to end as the liquidity panics ended – possibly by mid November.

This has been working out as the DX has firmed with each slump in the financial markets and declined with each recovery. The latest rally seems to be rolling over shy of the previous high.

In looking at the weekly RSI, the dollar accomplished a huge overbought and has quite a bit to work off yet.

This could be generally accomplished through the first quarter as orthodox investments recover into March-April.

Other currencies such as the Canadian and Euro would be generally firm.

US Foreign Affairs: The forthcoming administration is preconditioned against free trade and has dreamworld expectations about earnest dialogue with nations hostile to freedom. This will mean tedious bullying of American allies, and benighted schmoozing with their enemies.

Expect that at various times, almost every important currency will be the focus of mercantalist belligerence.

COMMENTS FOR ENERGY AND METAL PRODUCERS

Energy: Natural gas seems to be basing, and crude's decline continues. We have been expecting seasonal lows for both in December.

Last Friday's ChartWorks noted that crude had registered a Downside Capitulation, which is the first such weekly reading since 1986. The low could be accomplished within a week or so of the signal.

Investors and traders should be accumulating positions for a seasonal rally out to March. That's for stocks or oil itself.

As crude turns up it will help the general stock markets. On this, we prefer to work with evidence rather than conventional wisdom. During the early summer the street was professionally worrying that soaring crude prices were bad for the stock markets. Our response was that at the low for the S&P in October 2002, the price of crude was at 17 and our view then was that crude and the stock markets were starting a cyclical bull market. Our view through the late summer was that both were in a cyclical bear.

Once again empiricism trumps the theory that the economy would improve as crude declines.

Natural gas and the gas stocks will rally on the same move as well.

Base Metal Prices continue to weaken into a seasonal low. Our index has taken out the brief attempt to hold at 354 and has dropped to 319 today.

Needless to say, but metals have been trashed and within this copper has been registering Downside Capitulations on the weekly and now on the monthly. This goes along with the same weekly reading on the mining stocks (SPTMN).

We like playing the seasonals on the cyclicals and have been advising accumulation for a rally out to March.

Gold Sector: Last Tuesday our Gold Sector Update was sent out and that covered the longer-term, which will be outstanding.

Friday's ChartWorks included some work that expected the nominal price of gold to set a low sometime next week. This could provide an "optimum buying opportunity".

Gold's real price, as represented by our Gold/Commodities Index has been hot with the crash.

At 210 at the end of August it has soared to 393. This is suggesting a significant increase in operating margins for gold miners, as well as enhanced valuations of ore deposits. As gold mining stocks shake off the devastation of the crash they will become outstanding performers.

The gold/silver ratio rose in anticipating the crash, and the turn down will signal the general recovery out to the spring.

	FRI	**MON**	**TUES**	**WED**	**THUR** NOON
NOV/DECEMBER	**27**	**1**	**2**	**3**	**4**
BBB Spread	655	687	701	720	----
Treasury Curve	342	378	319	316	310
Base Metal Prices	782	828	769	743	729
Dollar Index	86.5	87.0	86.7	86.8	86.4
Gold	816.2	779.6	781.3	768.8	767
Gold/Commodities	383	374	391	393	----

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CLASSIC FALL CRASHES

(Updated)

There is an interesting seasonality to financial panics and the following paragraphs are from the October 14 version. The last part of this study reviews opportunities out to April.

One of the earliest fall financial disasters that is well-documented occurred in the money markets in Northern Italy. Cipolla's "The Monetary Policy of Fourteenth-Century Florence (1962)" starts with the chapter "The Great Crash Of 1343-1346". The main problem was a business slowdown and too much public debt. These instruments, which had been not transferable were declared negotiable on October 25, 1345, and with doubts about interest payments the market immediately collapsed. During the travail the author notes that there were "wild fluctuations" in the relative values of gold and silver.

Prior to this, the debt was regarded as "a perfectly secure investment" that was yielding a return that was attractive to large and small investors. With the crash a contemporary chronicler, G. Villani, used the expression "mancamento della credenza", which translates as "want of credit". He also used the term "rimbalzo", which in today's terms meant "the multiplier effect", or a chain reaction contraction.

There were great market events through the 1500s and 1600s, and by the late 1600s there were enough participants, as well as a central bank with the powers of issuance, to say that fully modern markets had arrived. The selling climaxes of the initial phase of subsequent great financial disasters occurred in September-October. The test of the low typically happened in November. One example eventually cleared in January.

1929	**1873**	**1825**	**1772**	**1720**
Nov. 13	Nov. 7-15	Jan. 1826	Nov.	Nov. 20

The lows have been likely to be tested in November.

The action with the South Sea Bubble was so dramatic that researchers have assembled a complete and reliable record. Until the New York market developed and set its pattern of setting the highs in early September of 1929 and 1873, the peaks as set in London and Europe typically occurred in the May-June window. The crashes happened in the fall. In two examples, 1720 and 2008, the last panic set a low on November 20. Comparisons are tabled as follows:

CRASHES PRECENTAGE CHANGES
(DJIA CLOSE)

	High	**Initial Low**	**Rebound**	**Final Low**	**Full Decline**
2008	14165	8176 Oct. 27	9625 Nov. 4	7552 Nov. 20	
		-42%	+17.7%	-21.5%	-47%
1929	381	230 Oct. 29	258 Nov. 4	199 Nov. 20	
		-40%	+12%	-23%	-48%

The key events in the 1929 crash were the initial plunge, the rebound and the ultimate low. During that crash the Fed made a bold effort to provide liquidity, with little success in changing the basic features of a post-bubble crash. This time around, policymakers were very aggressive in providing liquidity and yet the disaster replicated previous examples with remarkable fidelity.

The next table links the basic pattern to the crash of 1873. The dates are from our notes from The Economist, which also reported the degree of the liquidity panics. Unfortunately, we don't have a daily stock index.

	1873	**1929**	**2008**
• Start of Crash	Early Sept.	Sept. 3	Aug. 28
• First Selling Concern	Ended Sept. 19	Ended Sept. 21	No Pause
• Heaviest Liquidation	Last Part of Oct.	Oct. 29	Oct. 27
• Low Volume Final Panic	Nov. 8	Nov. 13	Nov. 20
• Rebound Top	May 1874	April 17/30	? ?
• Bear Market Low	Mid 1877	Mid 1932	? ?

Of immediate interest is the rebound out of the season of panics.

In 1874 the relief rally, with a number of swings, made it out to May when the cyclical bear resumed. Within this, the mining and smelting index rallied into February-March and a more general index stumbled through through the summer and plunged in the fall.

From a close of 199 on November 20, 1929 the DJIA soared 48% to 294 on April 17, 1930. Beyond relief, this inspired visions of "New Industrial Eras" as well as "huge" speculation. The following quotes convey the spirit of the spring rebound. It's prudent to keep in mind that the cyclical low was 42 in 1932.

> ***"It is thus apparent that the public preference for stock is not only as marked as ever, but also the will to speculate is still a speculative factor not to be overlooked. The prompt return of huge speculation and the liberal manner in which current earnings are again being discounted indicate that it will be difficult to quench the fires of stock-market enthusiasm for long."***
>
> – Barron's The Trader, March 24, 1930
>
> ***"A New Industrial Era In the Making"***
>
> ***"A New High Level of Industrial Prosperity to Come From Engineering Revisions"***
>
> ***"Movement of stock prices since the first of the year have been of decidedly cheerful augury, it may be inferred to the point toward trade revival in substantial proportions some months hence."***
>
> – Wall Street Journal editorial, April 7, 1930

Of course, there is no guarantee that the pattern will continue to work out. But, then there is no guarantee that it won't.

In the meantime, there is exquisite irony in imagining how the interventionists would comprehend the remarkable replication of the classic crash. In their minds most everything is due to policy. Then why did they decide to have a crash? Just asking.