

Deer In Headlights

If you think you have just been through a month like no other in the market, you're right. One thing separating this market from any in our memories is the level of absolute panic and despair. You can usually count on some of the popular financial media to be bullish in the face of contrary evidence. Not this time. We've been amazed by the total negativity from every corner.

While we believe in giving the straight goods there is a point at which "yelling fire!" in the theatre" becomes meaningless and counterproductive. Everyone knows the markets are crappy; repeating the obvious doesn't impart any useful information. It also generated a level of panic that has kept people from making any sort of financial decisions that could be delayed. This applies companies as well as individuals.

The net effect was to vaporize demand at all levels and at every stage of the supply chain. The fallout from this was drops in sales in October that look terrifying; autos down 30-50% in the US, same store retail sales estimated to be down 10%, raw material indices falling off a cliff.

The trend was obvious before any of these numbers came out. It's the scale that is at issue, especially in areas far removed from the US epicenter. October was pure "deer in headlights".

Extrapolating last month's numbers yields something that looks like a depression. We don't think that is a realistic assessment. The US, Britain and a few other areas will have deep recessions, but many other areas *should* fare better. How much better will be impossible to judge until people stop being barraged by daily gloom and doom out of Wall St and we see more "normal" behavior.

We're not saying things are going to be rosy any time soon. We do think however that some of the scary statistics from overseas are partly based on people avoiding decisions until the dust clears. In many cases they are in economies that are seeing little contraction. Unless the whole world falls into the sort of hole the US is in some of that activity should resume once the panic subsides.

Until we see at least a couple of months of "post apocalypse" numbers from different trading blocks it will be very difficult even guess what the worldwide economy will look like next year.

October's numbers and probably Novembers' will be dominated by the lack of financial lubricants that caused the economic engine to grind to a halt last month. On that note, we see some good news and some concerns which we will lay out below in that order.

MONEY AT WORK

The vast sums of money governments everywhere are throwing at the markets are finally starting to work. LIBOR spreads have fallen by 2.5% in the past three weeks and are now at levels only 30-40 basis points above historical norms. 40 basis points is a lot for a measure like LIBOR so things are still not "normal" but that is as good as its likely to get for the next several months. Commercial paper yields have also dropped precipitously though it's too early to tell how much of that is just brute force buying on the part of the US Fed. We think there is some real improvement here too but the level of issuance is still low. This means companies are still living hand to mouth. We won't see a drop in layoffs until that improves.

On a more sobering note, we remind you of the ultimate cost of Japan's brush with financial death almost two decades ago. That was \$3 trillion and the current mess is bigger so don't be surprised to see even more government money thrown at these problems soon.

SWAP MEET

The other piece of good news is one we expected but most of the market didn't. We were almost alone in underplaying the threat posed by the unregulated CDS market.

This wasn't based on naïveté on our part. Eric wrote his undergrad thesis on index contracts back around the time of the last ice age when most people couldn't even spell "CDS" or "ETF". Based on that experience we assume that most of these contracts would either offset each other or at least be of the "zero sum" variety where one party's gain on a CDS equalled their loss on the underlying instrument.

Based on numbers just released on the CDS market and the outcome of a couple of debt auctions to set CDS payouts that optimism seems to be justified so far.

Lehman's auctions led to only about \$5 billion changing hands. Stories abounded about hundreds of billions in CDS losses from LEH's debt so that figure was a relief. More recently, a report by Depository Trust and Clearing Corp reported outstanding CDS of \$33 Trillion, about half the amount estimated a month ago.

Interestingly, a large percentage of these are CDS against Indices and government debt rather than individual companies and there appear to be smaller amounts spread across a far larger number of markets and entities than previously thought. Again, this is actually good news; the impact of an individual failure would be smaller than feared. Note too that the scary looking totals are not "netted out". The actual amount of net at risk money is a fraction, hopefully a small fraction, of the totals.

While we were less worried about swaps than most we agree that having this amount of outstanding agreements in an opaque unregulated market is ridiculous. Some of last months pain could have been avoided if the main players in these markets were more upfront and transparent. Time for a real market for this stuff.

NSF

On the potential bad news side we would put the Treasury market going forward, which has been one of the stranger contradictions in a strange market.

Even though the US is the epicentre of the disaster, the US Dollar has surged and been the source of immense frustration for commodity followers. A surprising number of US analysts see this as a vote of confidence when its anything but in our opinion.

The rise in the US\$ is pure deleveraging and liquidity seeking. Hedge funds are repatriating and everyone else has been hiding in the Treasury market. It's no coincidence there has been a strong inverse correlation between stock markets and the US dollar lately. Whenever risk appetite increases a bit money flows out of the Treasury market and Dollar.

This brings us to the contradiction. Because terrorised fund managers have been piling into the Treasury market, Washington is presented with the best market it may ever see to raise money in. It hasn't been doing it at anywhere near the levels it needs to, however. Financing needs for the current quarter are estimated at \$550 billion, more than three times the amount expected a few months ago. Even this number may be understated since no one knows what President-elect Obama's spending plans will look like.

Just keeping up with all the bailouts announced to date could require as much as \$2 trillion in Treasury issuance before the middle of 2009. The markets have been treating all these programs like they are already funded.

Spare a thought for whomever the 'lucky' recipient of the Treasury post is in the Obama administration. They will have a very tough balancing act. In addition to bailing out everyone is sight they will have to sell enough paper to pay for it without driving rates higher.

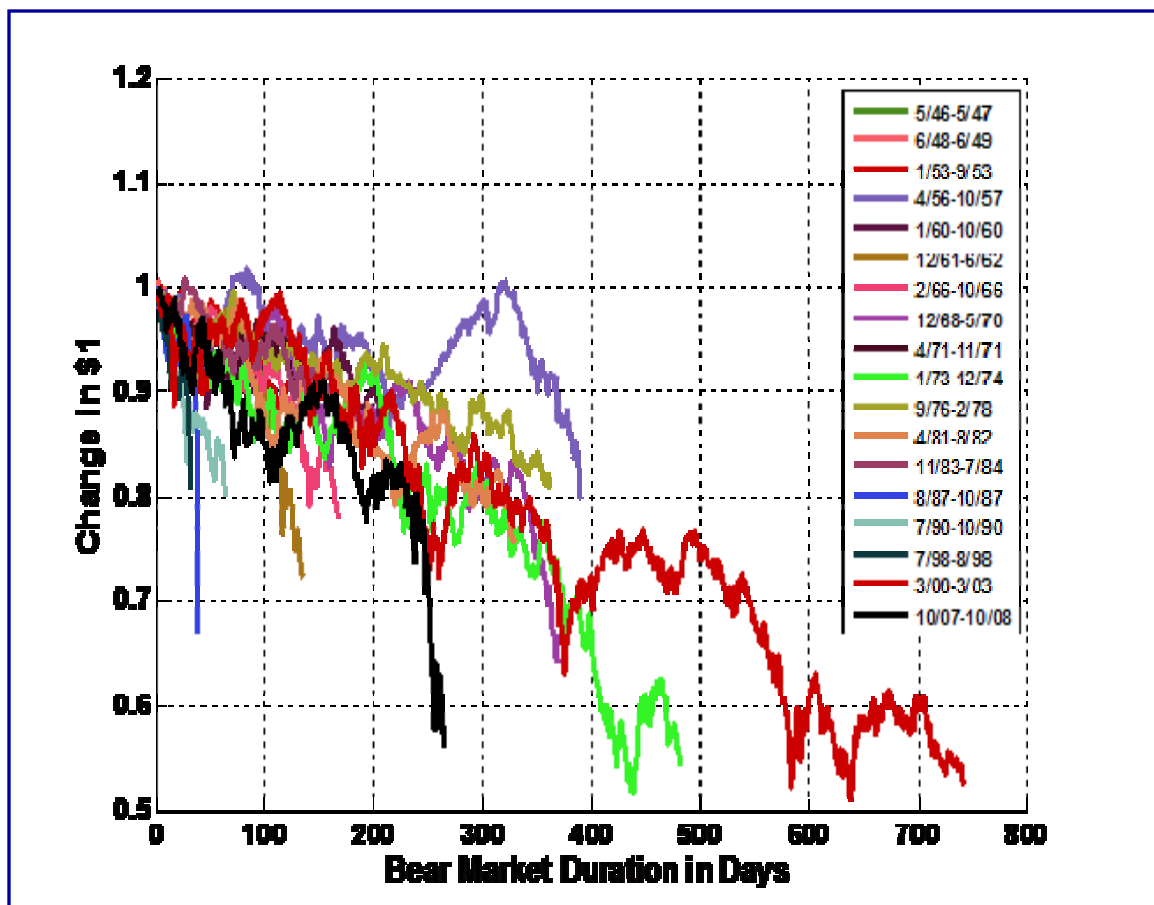
Even with the fear driven buying, longer rates are not that low, which accounts for mortgage rates not easing as much as hoped. With vast new sales on the way, there is a real danger rates could be pushed up. This is even truer with Democratic control of Washington since the market views them as a more "inflationary" administration. We think the bonds will get sold, but it will take some arm twisting.

As that market loses its attractiveness outflows should cap the US Dollar. We commented last month that we expected the dollar to top around November 4th. That wasn't the sarcasm it might have appeared to be; we thought a change in the White House would start people thinking.

The Dollar seems to be rolling over now. That is a good thing for the US, as exports have been the only bright spot for months. It may make those Treasuries easier to sell down the road. The surge in the Dollar simply added more currency risk for foreign buyers. Since large buyers are several hundred billion underwater on existing holdings that was not helpful.

URSINE PROFILE

We have a number of related topics we want to go into that we will deal with in the next *Journal*. For now, we want to leave you with an interesting chart, courtesy of Hussman Funds (hussmanfunds.com).



It's an overlay chart that shows the bear market (20% plus) declines since WWII, all 18 of them. It traces the percentage drops and the bear market duration for each fall. The current market is the black line (the chart is two weeks old; the line would be at about the 0.6 level now).

The chart displays what most of us already knew; this is one of the worse bear markets in decades. It also makes clear how rapidly most of the fall happened. Markets reached 40% falls much faster than in 1973/74 and twice as fast as in 2000-2003. No wonder the markets have terrified everyone.

The current recession could be as bad as 74-75 or 80-81. The first was an oil shock; the second was credit contraction due to sky high interest rates. The current version is consumer driven, which is the nastiest sort.

Those recessions lasted a year and a half. We expect this one will too. The good news is that we think the recession started in Q1 so we are well into it already. It will not be the same depth and duration everywhere though. We continue to think the US will bear the brunt of it. That is another reason we think the Dollar is topping. We do not expect the US to fare better than, say, the Eurozone. The EU is estimating 0.3% growth for Europe in 2009. We will be surprised if the US manages that much.

If we are right about the duration, the bottom in the markets should arrive "fairly" soon. Note the pattern for the other two 40% plus bears though. When the drop is this large, the bottom will be tested. The testing phase can contain tradable rallies and things may not get much worse in terms of the ultimate bottom but it's too early to relax. This is a hard market but one that can perhaps be worked with. Especially if the worlds growth areas start looking away from Wall St's headlights and focus on their own better short term prospects and potential. **Ω**

David Coffin and Eric Coffin are the editors of the HRA Journal, HRA Dispatch and HRA Special Delivery; a family of publications that are focused on metals exploration, development and production companies. Combined mining industry and market experience of over 50 years has made them among the most trusted independent analysts in the sector since they began publication of The Hard Rock Analyst in 1995. They were among the first to draw attention to the current commodities super cycle and the disastrous effects of massive forward gold hedging backed up by low grade mining in the 1990's. They have generated one of the best track records in the business thanks to decades of experience and contacts throughout the industry that help them get the story to their readers first. Please visit their website at www.hraadvisory.com for more information.

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