THE LONGWAVE ANALYST

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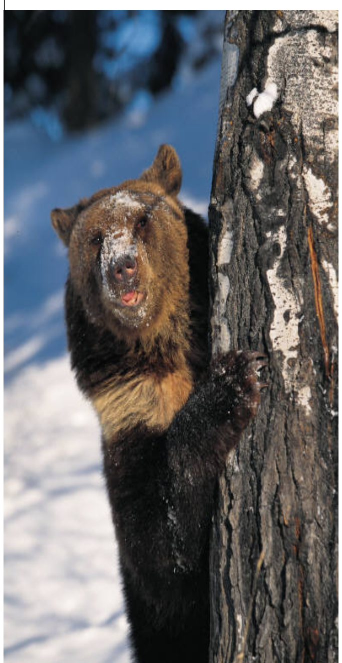
FORWARD WITHOUT FEAR

Ian Gordon Economic Forecaster & Interpreter of the KONDRATIEFF CYCLE

Those who cannot remember the past are condemned to repeat it. Santayana

Volume 1 Issue 2, March 26-April 1, 2008

WINTER WARNING



In The Financial Times Insight Column of March 18th, 2008, David Roche wrote an article suggesting that commodities could fall by as much as 30%. The following is the gist of Mr. Roche's article. (All quotations, unless specifically identified, are attributable to this article.)

Speculation in commodities now accounts for more than 50% of trading. But the notional value of commodity derivatives is only 1/10th the global equity market valuation. "The rush to commodities by investors has been like squeezing a quart into a pint pot."

Global growth is in rapid decline. "Recession will ensue and no region or asset class will be immune from its ravages."

Europe will not escape the recession. Consumer and business confidence is falling. Housing prices, mortgage approvals and new housing starts in the UK, Ireland and Spain are down sharply. European export growth has stopped.

The 700 million people living in Western Europe and the US account for 47% of total world GDP, and more than 50% of the global private consumption growth. A recession in these two locales would require that the rest of the world increase demand by 3%-4% to make up the shortfall.

Chinese demand has accounted for 50% to 100% of the marginal increase in global demand for a wide range of commodities. China is the largest importer of many different metals. "Thus its impact on global supply/demand balance, and on pricing, has been dramatic."

About 50% of the commodities that China consumes are processed for export. So its demand for industrial metals and energy is dependent on global demand for its products. Since 2005 net exports have been responsible for more than 67% of China's real GDP growth.

Food prices are rising at 23% per year and general inflation is also increasing rapidly. Wages are spiraling. "With inflation at a 12-year high, the People's Bank of China finds itself presiding over a negative real prime lending rate, excessive money supply growth and a trade-weighted exchange rate that is weaker than it was 10 years ago."

China will have to tighten monetary policy to contain inflation, which is producing growing citizen unrest. "Growth will be the fall guy. Already export growth is taking a tumble as global demand drops off."

Mr. Roche estimates a 3% drop in China's growth rate to 8%. This coupled with a recession in Europe and America, "would remove the ex-ante global supply/demand deficit from energy markets and push most industrial metals, including steel and copper, into significant surplus."

"On that basis, we can expect the price for refined oil to fall 30% and industrial metals by 20-30 percent. The big fall is coming."

It appears that Mr. Roche reaches his conclusions for a 30% drop in prices on the basis of an economic slowdown in China and recessions in Europe and the USA.

There is no mention of the impact on commodity prices resulting from speculator selling. But selling from this quarter began last week. "Hedge funds and other investors have pulled out of the red-hot commodity markets nearly as quickly as they piled in, driven by concerns over wild volatility or the need to raise cash." McCarthy, Shawn and Parkinson, David: Commodities continue slide as wild week ends-Hedge funds. - Investors further retreat from oil, metals and gold after credit woes take toll on futures markets. The Globe and Mail, Friday March 21st, 2008.

Richard Briggs a broker with derivatives trading house MF Global in Montreal said, "They're being forced to cover." "It's all kind of imploding." Ibid

"Traders and fund managers working in the trenches say the flight from commodities was driven by acute liquidity problems facing the financial community. Debt-laden speculative investors are being forced to sell their holdings to raise cash to meet margin calls and growing collateral demands from their financers and primary brokers, who themselves are in need of cash." Ibid

Henry Cohen, manager of Toronto-based hedge fund Full Circle Energy said, "It's just starting. There's huge amounts of unwinding that has to be done here. The amount that's put there is enormous. It could take months, and it could take $20 to $30 off the price of oil." Ibid

Mr. Roche has been far too optimistic in his economic slowdown projections. Given that it's the Kondratieff winter, world economies are likely to enter economic depressions not the relatively tame slowdown that he forecasts for China and the mild recessions that he anticipates will hit Europe and the USA.

Importantly, he shows the correlation between an economic slowdown and commodity demand. I just think that the slowdown will be much more acute than he is predicting and that demand will effectively dry up. Hence commodity prices are likely to crash. $0.60 a pound for copper, anyone?

Commodity Research Bureau Index. Monthly Chart. Current Price $383.52. Chart Courtesy of Reuters

To avoid a monthly key point reversal, the CRB price must close March above $412.76. A key point reversal is a reliable indicator of trend change.

So commodity prices are falling and destined to fall much further, as the speculators continue to unwind their positions and the American and European recessions begin to bite.

These economies account for almost half of the world economy. When they slow down the world must slow down with them.

Copper. Monthly Chart. Current Price $262.25 Chart Courtesy of Reuters

To avoid a monthly key point reversal, the copper price must close the month above $385.50

Many, many very smart people are still projecting an inflationary outcome because of the Federal Reserve's inclination to resort to massive money growth. They talk about the 1970s and stagflation. Under normal circumstances inflation would be the obvious outcome. But these are not normal times. In spite of the Fed's propensity to create oodles of money to bail out the banks, that money is not moving through the banks into the economy. In fact the banks are getting positively stingy in making loans.

Prices are falling in virtually all things, presaging the onset of deflation. The pace of falling prices will quicken as increasing amounts of the enormous debt burden are eradicated. This will add further to creditors' woes, which will make money very scarce. The economy without the benefit of additional money will move from recession into the Kondratieff winter depression.

The Financial Times reported on Thursday March 20th that financial companies are cutting back on their New York office space due to the credit crisis. This is likely to flood the market with supply that will drive up vacancies and pull down rents. Already Wall Street has parted with more than 35,000 employees.

Apparently 1.8 million square feet of office space that has been occupied by financial service companies will be returned to the market this March. This will amount to a 10% increase in office space in the City.

Analysts are predicting increasing vacancies and falling rents in New York this year. New York City's Independent Budget Office expects at least another 20,000 financial service job losses over the next two years. I think this is a hopelessly optimistic number.

These high paying job losses have a direct negative impact on 3 to 4 other jobs in the city.

Wait until the stock bear market really starts to take hold and see vacancies skyrocket and the price of real estate in New York tumble like it has elsewhere in the country.

But why is gold the sine qua non investment during a deflationary depression? Usually when people talk about deflation, they talk about the price of gold dropping alongside all commodities. But deflation is always very tough on lenders and borrowers; many fail. Bank depositors run to get their cash out, lest their bank fails, and hoard cash and gold.

This happened during the banking crisis of the early 1930s (the previous Kondratieff winter), when 10,000 US banks failed. The hoarding of gold had become so prevalent that by 1932, the US had insufficient gold to back the dollar (At that time the US dollar was backed by gold at $20.67 per ounce). One of the first things President Roosevelt did on assuming office in March 1933 was to castigate the gold hoarders and confiscate their gold, so as to replenish the Treasury. Americans were forbidden to own gold from that time until 1973. This prohibition effectively weaned Americans off gold. They, for the most part, fail to comprehend its monetary prowess during rotten economic and financial times.

Alf Field has done a masterful job in calling the gold price through his Elliott Wave analysis. He has been kind enough to send me his 18th update. I will not go into the technicalities of Elliott Wave analysis, except to say that it promulgates that prices move in 5 waves. In the first, third and fifth waves, prices rise. The second and forth waves are corrective waves.

According to Alf we are in a major wave 3 move in the gold price. We have just completed minor wave 5 and major wave 1, in the price move in this major wave 3.

Alf had predicted a peak of $988.50 at the completion of the major up wave 1 and the minor wave 5. So the price of gold peaked, a smidgeon above his prediction. But that prediction was made months ago. That's pretty good. Now he says we are in the corrective major wave 2 and he anticipates that the gold price will fall to $850. But then comes the longest and strongest of the Elliot Waves; that is major wave 3.

His prediction from the bottom of corrective wave 2 at $850 per ounce to the top of wave 3; hold it, let the drums roll, is $1572. This will be followed by corrective wave 4, which will be followed by the final wave 5 up, of this 3rd Elliot wave. That 5th wave, Alf projects should take us above $2000 per ounce.

Ambrose Evans-Pritchard writing in The Telegraph-www.telegraph.co.uk on the 24th March, 2008 headlined his piece, "Fed's Rescue Halted A Derivatives Chernobyl."

"We may never know for sure whether the Federal Reserve's rescue of Bear Stearns averted a seizure of the $516 trillion derivatives system, the ultimate Chernobyl for global finance."

"'If the Fed had not stepped in, we would have had pandemonium,' said James Melcher, president of the New York hedge fund Balestra Capital."

"'There was the risk of a total meltdown at the beginning of last week. I don't think most people have any idea how bad this chain could have been, and I am still not sure that the Fed can maintain solvency of the US banking system."'

I suggested in last week's piece that derivatives could have played a significant part in the Fed induced panic bailout of Bear Stearns.

It is now reported that JP Morgan has quintupled its offer to Bear Stearns shareholders to $10 per share. This begs the question, why was the first offer so low? The probable answer is that any deal had to be announced before the market opened on Monday in order to avoid a stock market crash.

In today's Globe and Mail, Monday March 24th 2008, the headline on the front page of the Business Section read, "Retail Investors Prove Leery of Crawford's ABCP Rescue Plan." The plan devised by Purdy Crawford was to park the sub-prime debt of the banks and other investors, including private investors, off the balance sheets for a period of up to nine years.

Seems like a good deal for the banks, but what about the private clients who thought that their money was only being invested for a few months? Canaccord Capital, a Vancouver-based brokerage firm, has approximately $269 million of client money invested in this toxic paper.

Purdy's plan requires approval from a majority of investors holding ABCP paper. Each investor, regardless of the size of the holding has one vote. So the Caisse de depot et placement du Quebec, which holds $13.2 billion is counted equally with an investor, who may hold only $100,000 or less of this paper.

Purdy's solution is typical of many of the so called solutions to the credit crisis, that is, given time, these investments will be worth their original value. I say, "fat chance."

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