

Banks

Another "Widows and Orphans" Short

Great manias in financial and tangible assets have been methodical in their euphoric climax and consequent contractions. With six now recorded since the first one in 1720, it has been fascinating to watch this one track its way through the typical post-bubble path--now to twenty months after the stock market peak when global credit markets would start another phase of distress.

The signal for the beginning of the contraction has been the reversal in the yield curve. Typically, the boom can run for 12 to 16 months against an inverted curve, as the demand for margin by speculators drives short-rates up faster than long-rates. While rising interest rates seem to worry Wall Street strategists, history records that troubles begin when the curve reverses to steepening and short-dated market rates of interest start a steep decline. It has been prudent to recognize that this along with declining Treasury bill rates is one of the warnings about the end of a speculative frenzy and its inevitable collapse.

This time around, the curve inverted in early 2006, and the 16 months counted out to June, 2007, which we frequently discussed. Included was the seasonal tendency of credit spreads narrowing into to May, and then if the party has been wild enough--reversing to disaster. By mid June, the curve and spreads had changed enough to conclude that the greatest train wreck in the history of credit had begun, making banks and financials a "Widows and Orphans Short."

The next step in the path was that as credit became more stringent through the summer of 2008, our conclusions were that a typical fall crash was possible and considered the 1929 and 1873 examples would provide reliable guidance. This worked out rather well, setting up the possibility of a dramatic revival in animated spirits to around April-May. On the equivalent move in 1930, Barron's wrote that it would be "difficult to quench the fires of enthusiasm." This spring the equivalent move in commodities, corporate bonds and stocks ran into early June--close enough--when a number of our indicators registered excessive speculation. Also the run against the dollar became overdone.

Where the fall crash and its rebound have been the main events, the next one is determined by the twenty-month count following the 1929 and 1873 bubbles. Credit markets then took a turn for the worse.

June is the fateful month and one key signal would be another reversal in the yield curve--this time to flattening, which could be soon followed by spread widening.

When steepening started in 2007 standard research applauded it as banks usually make better spreads, but we noted that steepening at the end of mania signals financial distress. Our concern about the reversal to flattening in June is that it indicates the resumption of

illiquidity. And the reversal in the curve last week was a "heads up" on a market change that could hit inappropriately positioned traders. It will also change orthodoxy about the "benefits" of steepening.

On timing and credit market change that is global in nature, most bank stocks in most countries are again vulnerable. Over the past two years market forces have assigned the always specious notion of a national economy that can be managed to the dust heap of history.

Technical Comment

Since it was developed in 1997, our proprietary Bank Trading Guide has provided a number of reliable "sells", that usually lead the high by a few weeks. An outstanding one was when LTCM collapsed. It does not provide "buys".

Our last entry into banks and financials was in mid February on the plunge in the BKX (US bank index) to 19.5 and then in early March when the index had plunged to 18. Quite simply, the sector was devastated and we were looking for good time out in April-May. The rally was a quick double to 43 in early May when the advice was to begin lightening up, with more aggressive selling reserved until our Guide gave the signal.

More recently, we have noted that it has become more volatile, which is usually preliminary to an important reversal.

Ross has updated the Guide and added to it, and the charts follow.

When the Bank Trading Guide becomes overbought along with independent market readings there has a tendency create a high in the BKX within the next ten days and then decline by 10% to 17% during the following three to five weeks. We have entered the period of anticipated weakness.

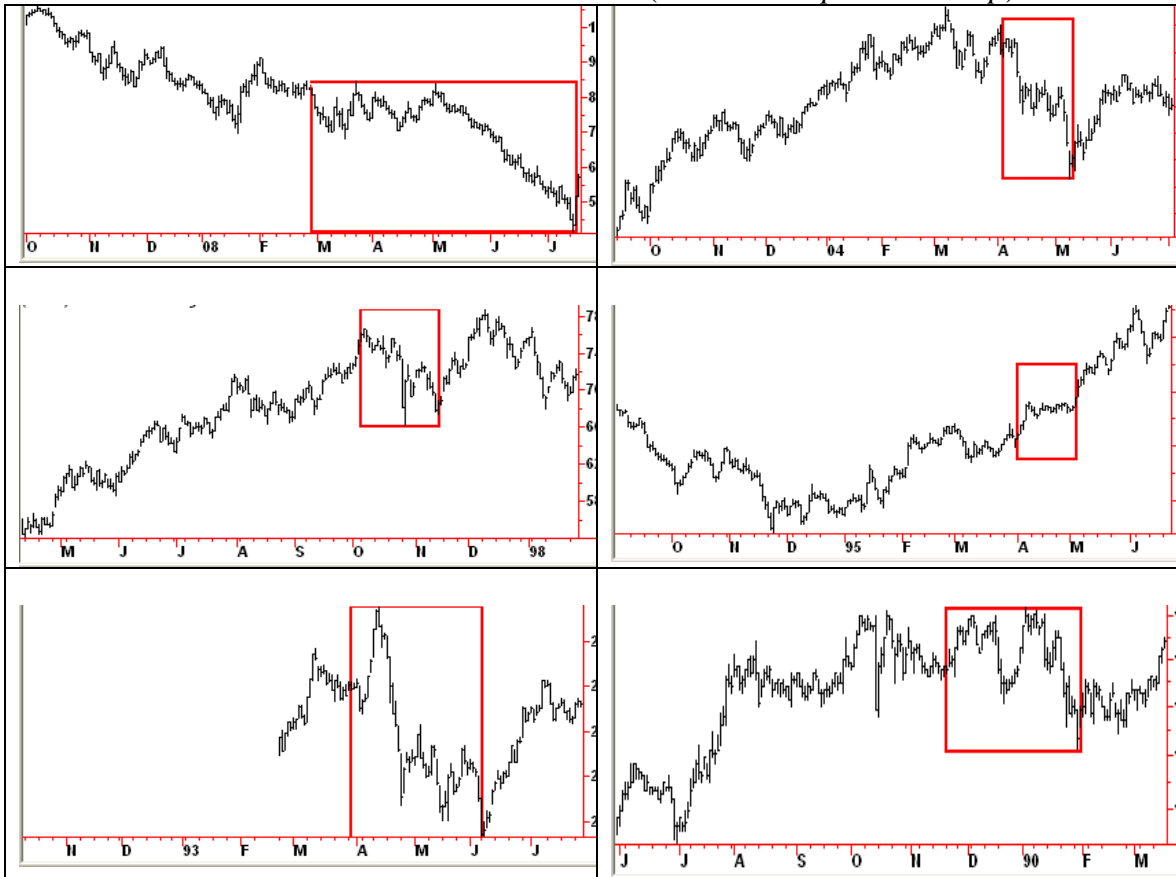
	Sell Signal	Max offside		Max Potential		Trading Days
11/20/1989	1.577	1.70	-8%	1.41	10%	48
3/30/1993	27.94	29.66	-6%	24.70	12%	47
4/3/1995	28.42	29.59	-4%	28.42	0%	0
10/6/1997	75.96	76.57	-1%	66.27	13%	16
4/5/2004	100.68	100.68	0%	90.62	10%	24
2/25/2008	88.35	88.72	0%	73.22	17%	13

	Signal	Potential for this move	
5/28/2009	36.72	33.05	10%
		30.48	17%

BKX



There are six occurrences since 1986 (*the '89 example is Citicorp*).



The opinions in this report are solely those of the author. The information herein was obtained from various sources; however we do not guarantee its accuracy or completeness. This research report is prepared for general circulation and is circulated for general information only. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized.

Investors should note that income from such securities, if any, may fluctuate and that each security's price or value may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Neither the information nor any opinion expressed constitutes an offer to buy or sell any securities or options or futures contracts. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk. Moreover, from time to time, members of the Institutional Advisors team may be long or short positions discussed in our publications.

BOB HOYE, INSTITUTIONAL ADVISORS
EMAIL bobhoye@institutionaladvisors.com
WEBSITE www.institutionaladvisors.com