

I'm Not Dead, I'm Editing. There Is A Difference

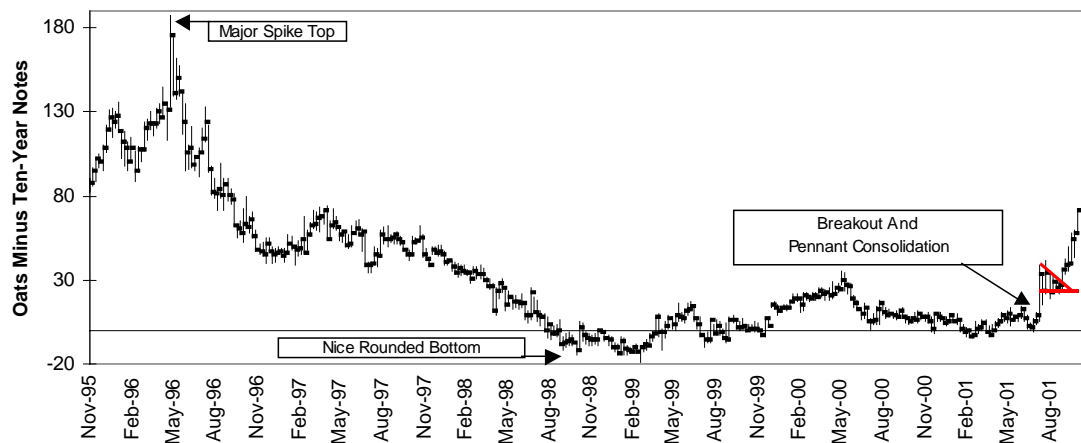
Mario Lemieux did it. Michael Jordan did it. And now, your loyal correspondent is pretending to do it. Not come out of retirement into overpaid decrepitude, no, that would be too simple. Not return from the land beyond the Styx or even the Hudson, that's way too dramatic even in these times of government-sponsored faith-based initiatives, whatever they are. It's time to return temporarily from the land of editing to catch up on the oats/notes and HU/NG spreads, introduce a new indicator to our already-bulging arsenal, and bestow this year's Abby for fearless forecasting and perspicacious prognostication.

The oats/notes spread, for the uninitiated, is the difference between the first month contracts of oats and Ten-year Treasury notes. That's it. Simple. The Hemingway of contrived spreads (the data are real, however). A detour into deliberately spurious data analysis that should, but never does, derail the smug and wholly unjustifiable self-importance of celebrity market technicians. Over the years, this encapsulation of the epic struggle between physical and financial futures has proven remarkably prescient in calling major financial events. Think of it as feng shui on a chart.

It's not messing around right now, either. Who cares whether note yields have plunged as the stock market completed its two-year giant slalom into a tree? Oats are on a rampage, pure and simple, and all experienced grain traders know that where oats go, the rest of the complex surely will follow. Ignore the snow and ice on the ground and start buying in anticipation of this summer's drought. Beans in the fives, baby.

This is nothing short of an airtight case for impending hyperinflation. The beans fly and the bonds die. Gold could push back toward levels first reached in 1979, a time when the Shah was still in power and it was the Russians taking time out of their busy schedules to pound large chunks of Afghan rubble into small chunks of Afghan rubble.

Oats / Notes: Look Out Above



The oats/notes spread isn't just a single timeframe wonder; it should be part of every trader's toolbox regardless of trading style. It works just as well on the technician's daily bar chart as it does on the more leisurely weekly chart preferred by those who wish to trade it fundamentally.

Oats/Notes: Multiple Time Frame Analysis



All HU/NG Up

As good as the oats/notes spread has been, the unleaded gasoline / natural gas (HU/NG) spread has been better. There is no spread between gasoline and natural gas, you say? As discussed last year, (see "We've Lost That Bullish Feeling," Futures, January 2001) we can convert gasoline prices from cents per gallon to dollars per million BTU by multiplying it by .0799. Is there an economic link? Yes, the use of compressed natural gas as a vehicular fuel. Should you believe this? Let the data speak, my friends. And remember, we warned last year that the HU/NG spread was flashing ominous warning signs for the Nasdaq in 2001:

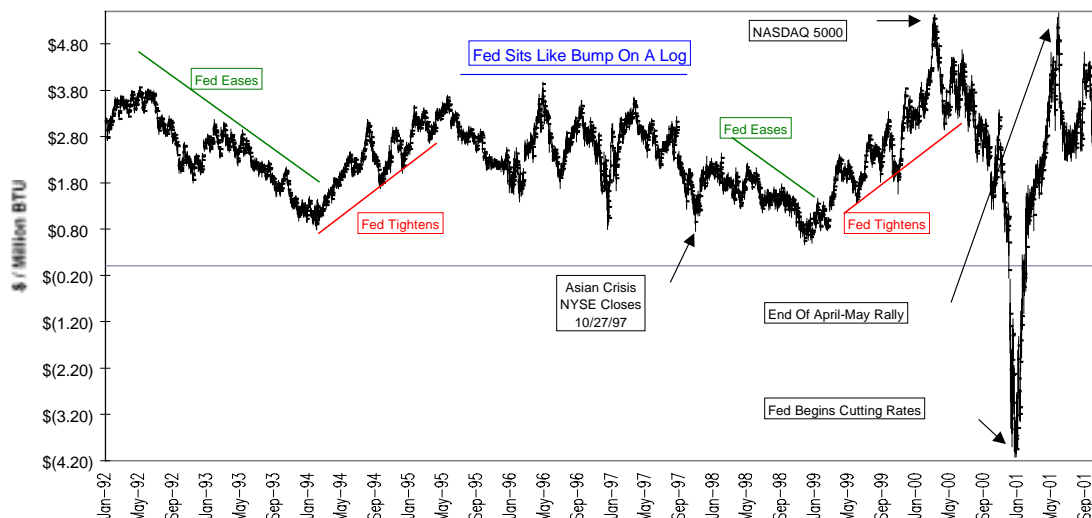
At the mid-November time of this writing, the HU/NG is still pointed lower. The implications for the NASDAQ and its still-lofty P/E of 121 are not encouraging, to say the least. Over the long-term, there's even more cause for concern. A structural change in the electrical utility industry has made natural gas the marginal fuel of choice. This produced 2000's record price levels for natural gas and kept the HU/NG under major pressure. The situation for 2001 does not look much better unless we either 1) stop using electricity, or 2) find a few natural gas fields quickly.

The Nasdaq collapsed and California entered a major, largely self-inflicted, electric power crisis in short order. Coincidence? That's what "they" would like you to believe.

We can construct the continuous front month future of the HU/NG spread going back to the start of the natural gas contract. Going into 2001, the general pattern had been for the HU/NG to rise during Federal Reserve tightening cycles and to fall as the Fed eased credit. It was different this time, however. The Nasdaq peaked on March 10, 2000, a mere two days after the HU/NG peaked on March 8, 2000. The dual bear market continued into this winter, and the HU/NG broke to all-time lows until the Fed began easing credit on January 3, 2001. Then, in a major reversal of its historical pattern, the HU/NG spread shot higher during an easing cycle and peaked on May 24, just two days after the Nasdaq's spring rally expired.

Does the FOMC study the HU/NG chart during its meetings? They'll deny it, of course, but the pattern's getting a little too obvious. Besides, considering the way these guys have made a hash of things since 1999, how much worse of would we be if they did in fact rely on the HU/NG spread?

The HUNG Spread: The Fed Watcher's Friend



Cover Your ARS

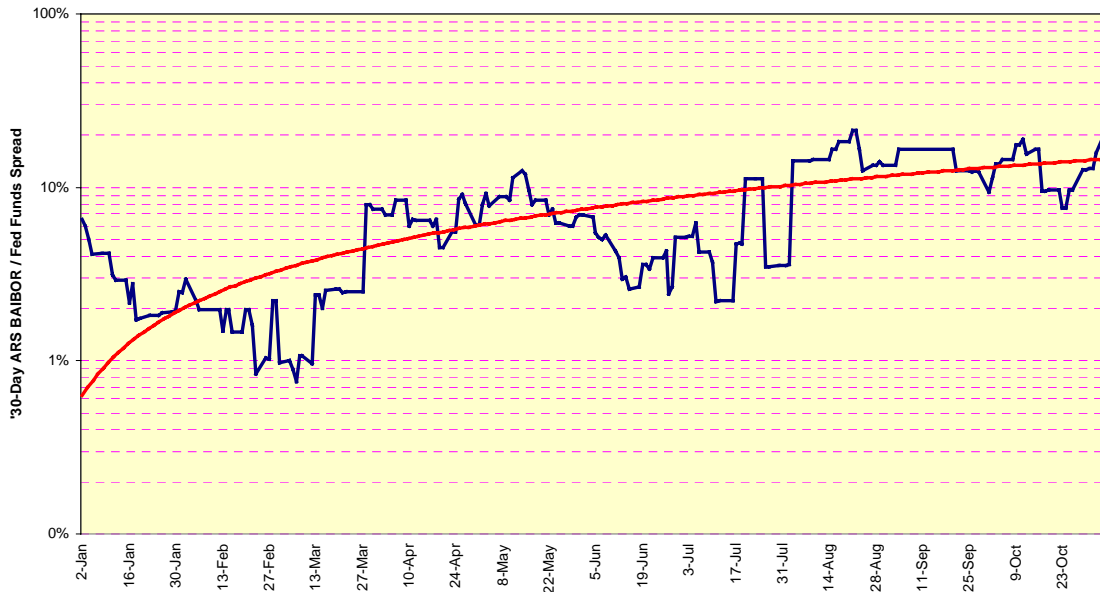
Let's turn now to the central reality of international economics: Someone's currency always is getting trashed.

At the time of this writing, Argentina has taken the lead in the 2001 basket case derby from early favorite Turkey. Here's a country self-sufficient in energy and a powerhouse in food exports that has managed through an iron-man streak of economic mismanagement of Ripkenesque proportions to retreat from the world's seventh-largest GDP in 1900 to its present morass. Their Peronist policies combined the finest logic of socialism with labor union thuggery to produce such chronic inflation that they resorted at times to simply lopping the last three zeroes off their currency and giving it a new name. Anyone remember the 1985 Austral Plan?

Finally, Argentina gave up on managing its peso (the ARS, in international currency shorthand) as a free-floating currency and pegged the ARS to the dollar. Not those useless Sacagawea faux-gold coins, either: You can't fob off second-rate money on Third World countries, not even one \$132 billion in the hole to the rest of the world. Argentina effectively ceded control of its monetary policy to Alan Greenspan. Great, he's probably unintelligible in Spanish, too.

Governments who meddle in the currency markets, and that's all of them, find out sooner or later you can fix the exchange rate or you can fix your interest rates, but you can't fix them both. The spread between thirty-day ARS in the Buenos Aires Interbank Offer market (BAIBOR) and U.S. federal funds has shot higher. The very same spread that was just over 1% in March 2001 approached 22% in November. The growing rate gap indicates that while Argentina suffered from higher interest rates in the U.S. in 1999 and 2000, it hasn't benefited a whit from the Fed's frantic rate cutting in 2001. This lose-lose outcome is the central banking version of the perfect storm. Why limit the spread to thirty-day maturity? No one will lend for a longer horizon in the BAIBOR market.

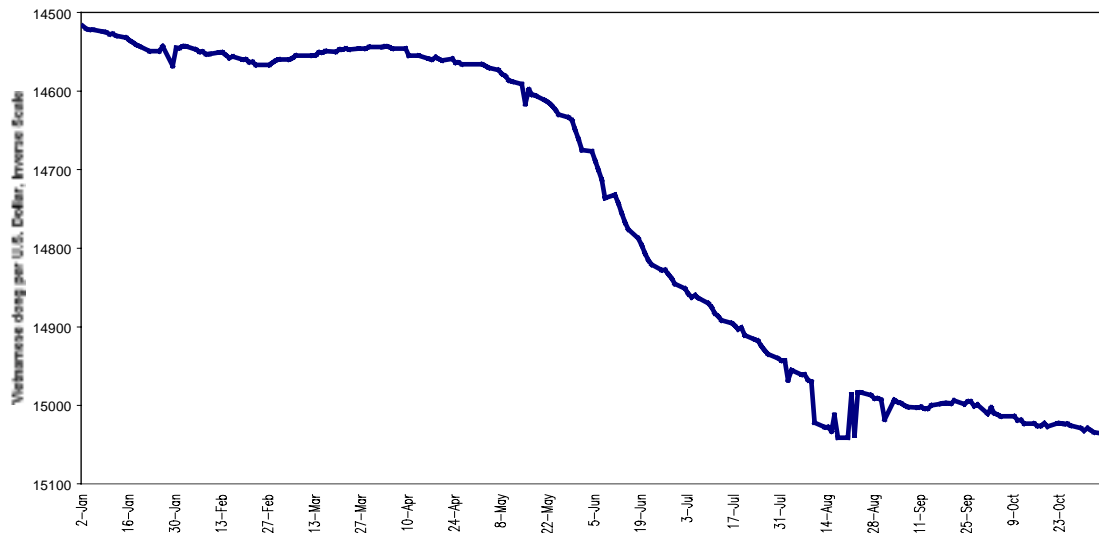
2001: An ARS Odyssey



Stretching Your Dong Budget

Well, it's one, two, three, what are we trading for? Another basket case is the Socialist Republic of Viet Nam, last seen bombing the coffee market down to three-decade lows. Its grab for coffee market share hasn't helped its currency, the dong (VND in shorthand), now trading at more than 15,000 to the dollar from 14,500 at the start of the year. An entertaining evening in Saigon could be both very cheap and very expensive simultaneously at those rates. Unlike the ARS, there is no market for thirty-day dong: What's the point of being a commie if you have an interbank market?

Long The Dong? Better You Than Me



We make our money in this business by being innovative, by providing liquidity, and by closing those little market inefficiencies we all find so annoying. If we're faced with the situation of high interest rates in Argentina and a weakening currency in Viet Nam, why doesn't some sharp financier arrange for Argentina

to borrow at ultra-low dollar rates and swap this exposure into dong? The resulting ARS/dong spread would be done in the finest tradition of such fancy-schmancy trading houses as the late Bankers Trust, the neutered Long Term Capital Management, and the current champion of too-smart-for-its-own-good, Enron. The line between fancy and pedestrian is terribly thin; Giuseppe Verdi is Italian for Joe Green, and we have football linemen thus monikered.

The ancients said that he whom the gods would destroy they first made mad. The equivalent today is they make you financially sophisticated and usually pretty arrogant to boot. It might be harmless fun to watch these guys pirouette themselves into the ground, but they usually cause a lot of damage to others in the process. Which brings us to our concluding subject...

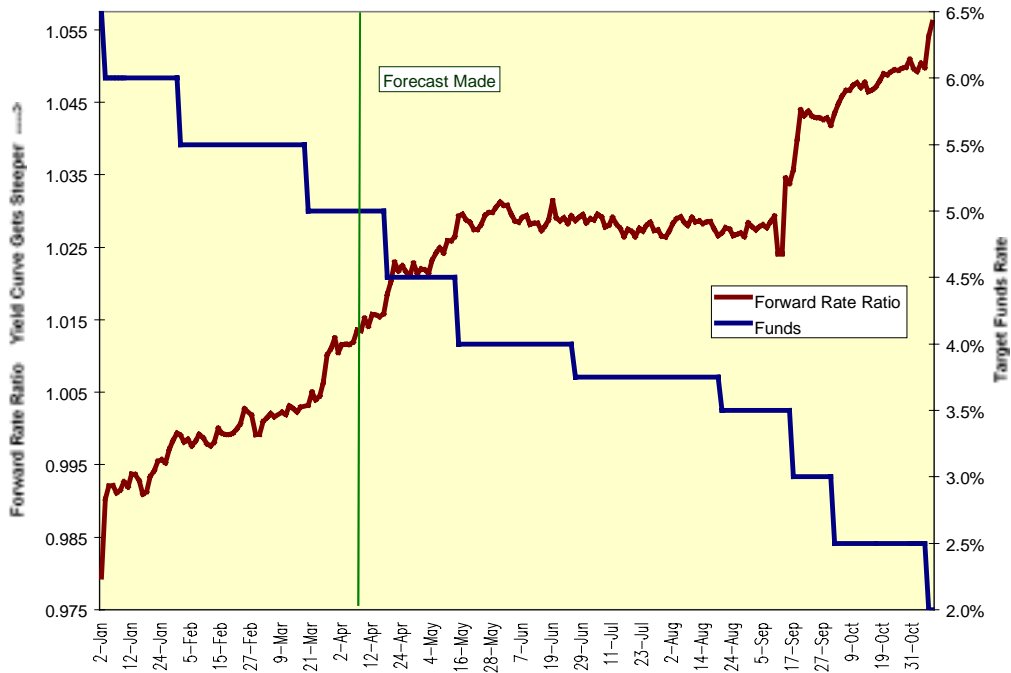
The Abby

Being covered in glory isn't all that bad when you consider some of the alternatives available. And what better substitute for glory than the Abby, awarded every year to someone willing to accept it? This year's competition was unusually tough in the negative department. Should we have chosen the members of the Federal Open Market Committee, who fresh after their disappointing 50 basis point rate cut on March 20, the third of ten so far this year, went on a spin tour to convince the public that things were really pretty good? Should we have chosen the collective membership of Wall Street's analyst community, who took the concept of shamelessness to new depths by slapping strong buy recommendations on anything with a pulse as the stock market came unglued? Should we have chosen Marc Rich, who embarrassed fugitive commodity traders everywhere by his association with former President Clinton?

No, the winner of our still-nonexistent but nevertheless handsome statuette featuring Druid inscriptions and a broken clock has to win it for something positive, for actually being right at least once. So, it is with great pleasure that we add the names of Beth Loeb and Darlene Demor to the honor roll containing this author, Ron McEwan and Chris Costakis. Their forecast, made after the aforementioned March rate cut, was twofold: First, the Fed would have to cut many more times, and second, the yield curve would continue to steepen and steepen dramatically.

Let's see how they did. We'll use the Fed's overnight funds rate target and as a proxy for yield curve steepness, the ratio of the forward rate between 6 months and five years to the five-year rate itself.

They Fought The Fed -- And Won!



The winning forecast and a winning trade. Will these two keep the hits coming in 2002? Maybe, but the whole point behind the Abby is that nobody who walks this earth gets it right all the time, pretenses notwithstanding. If the last two years didn't make certain people more humble, they certainly should have.