



UNION SECURITIES LTD.

WEEKEND COMMENTARY FOR DECEMBER 10, 2007

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THE PRESIDENTIAL CYCLE BUSH's (AND PAULSON's) PLAN TO SAVE THE WORLD GEOPOLITICS AGAIN


THE PRESIDENTIAL CYCLE

Next year is a Presidential election year. Presidential years tend to be good for the markets. Since the Dow Jones Industrials (DJI) was started back in 1881 we have had 31 elections. Of those, 20 were up years and 11 down years.

On top of that, we are entering a year ending in "8". Since the inception of the DJI, out of 12 years ending in 8, ten were up and only two were down. Presidential elections also often occur in a year ending in 8. This is the sixth since 1900. Only one of them was down (1948, 60 years ago).

We have often talked about the 60-year cycle (and its corollaries, the 30-year half-cycle and 90-year one-and-a-half cycle. One half-cycle ago was 1978, and that too was a down year. Ninety years ago, in 1918, we had an up year (after a devastating down year in 1917).

This year, a year ending in 7, was supposed to be a financial panic year. Well it happened and it didn't. We got our financial panic with the sub-prime mortgage meltdown and scary market drops in March and August and November. But unlike previous financial panic years that we have noted – 1887, 1907, 1917, 1937, 1957, 1977 and 1987 and even to some extent 1997 (Asian flu crisis) – we are not going to have a down year unless things dramatically change between now and December 31.



We attest that to the fact that Federal Reserve along with the rest of the world's central banks poured hundreds of billions of dollars into the market in an attempt to stave off a market collapse. We have no doubt that if that had not happened we would have had a devastating meltdown.

So was it the right thing to do, or was it merely prolonging the agony? Time will tell. But we do know that over the past several weeks the market has absorbed a lot of the cash and effectively we have gone nowhere. Unless the Fed and other central banks are willing to provide further cash to bail out the financial markets, we cannot avoid at some point in time a more serious market meltdown. Irrespective, the ability of the market to go higher is limited, although as we point out in our S&P 500 technical commentary we can't rule out a run to new highs if we were to break higher.

Again we hark back to the Japanese situation of the 1990s, where providing oodles of cash to the market and lowering interest rates to zero did very little to bring the market out of its downward funk. The meltdown lasted for years and structurally the banking system was bankrupt. The same thing could occur in America even as SIVs and others pour funds in to save Citibank.


High oil prices, a US dollar still primed for further devaluation (particularly if the Fed cuts interest rates aggressively) and the meltdown in the housing markets and its potential for a negative impact on consumer spending are all pointing to a weak 2008 that may turn into a full blown recession. The system needs cleansing, and to prolong the agony will not prevent the inevitable. This is one Presidential election year where we would not get overly bullish. Indeed given the results on the 60 and 30 year cycles this might be a Presidential and year ending in '8' that actually falls. We continue to look for weakness through the early part of the year and after a good low into April/May we would look for a rally to develop.

BUSH's (AND PAULSON's) PLAN TO SAVE THE WORLD

We guess they had to try something. In October, sales of existing homes plunged 23.5 per cent from the previous year. Housing prices on new homes fell 13 per cent over the past year, foreclosures skyrocketed by 94 per cent over last October.

Inventories are at almost a record high of 10.8 months and are expected to climb further. Hardest hit areas have been California, Nevada, Arizona and Florida. Maybe the rest of the country doesn't care if California sweats it a little. In 2008 we note that there are \$362 billion of adjustable rate mortgages to be reset and another \$152 billion of adjustable rate loans. Foreclosures this year are estimated at 1.35 million and next year they are looking for 1.4 million more.

Crawling out of the woodwork with grim looks on their faces, Treasury Secretary Paulson (formerly of Goldman Sachs, which helped create this mess) and President Bush announced a bill that puts a freeze on rate hikes for all those ARMs for the next two years. Or, as they put it, to develop a process for borrowers who may be eligible for modifications and refinancings to prevent them from losing their homes. The market cheered. What a plan! What a couple of guys! Riding to the rescue to save all those homeowners from living on the street. I guess they didn't listen to incoming BofC Governor Mark Carney or outgoing BofC governor David Dodge who did not see it as their role to bail out the market. But then this is not the Fed this is the Treasury.



So who is going to pay for this sham? The bondholders? They won't get the money they expected. Don't ask them to invest in mortgage-backed securities again. Maybe instead it will trigger a run on the MBS market that is already on its knees. And the message to foreign investors is "don't invest in America".

Paulson and Bush seem to forget investors' rights (not that we have any sympathy with them) but what they are doing here is rewriting the terms of the contract. Start preparing the lawsuits.

Or maybe it's the taxpayer who will foot the bill. Here we wouldn't be surprised, but if the taxpayer is smart he should then revolt. Why should he bail out Wall Street? Merely because he has done it before? But the reality here is that this is a global crisis as this paper (junk paper is being charitable now) is all over the world. Structured finance should become a bad word, but it probably won't, because coming up with these gimmicks is how Wall Street (and Bay Street) survive.

We read about how E*Trade liquidated its \$3.1 billion of asset-backed securities. They got anywhere from 11 cents to 27 cents on the dollar for it. Boy that ought to warm bankers' hearts. But what was interesting was that some 60 per cent of this portfolio was rated Double A or higher. And all they got was 11 cents to 27 cents on the dollar for this prime rated paper? Whew! Prime paper is outright junk.

Excuse us, but there are trillions of dollars of this paper sitting in hedge funds, banks, mutual funds, pension funds, insurance companies, foreign banks and retirement funds. Okay, maybe trillions is a stretch, but then again there is over \$1 trillion of asset-backed commercial paper (ABCP) alone in the USA outstanding (and another \$35 billion or so here in Canada and with other types of paper over \$100 billion). So maybe a few trillion is not a stretch.

This paper is sitting all over the street – everybody owns it. It includes some of the biggest names in banking, pensions, insurance, mutual funds, etc. So Paulson and Bush coming up with this half-baked plan (in an upcoming election year) to try and save the day just stinks of desperation. It is not a plan. It is just a recipe for more chaos.

Bill Gross of PIMCO, who we have some respect for, says what is going on is the equivalent of the "breakdown of our modern banking system". For years the banking system has been able to magically create money out of nothing. We have been living in a world of illusion and now the illusion is being peeled away.

So are we going to have a complete and utter collapse? The Great Depression of the 2000s? Well, at this time we are sticking to our more conservative forecast that somehow we will muddle through, but that some pain will have to be suffered by all, and unfortunately the innocent meaning the guy on Main Street will probably pay a higher price possibly losing his job.

But by the way, we still want to reiterate you to hold gold through this crisis, and in hard form – bullion, not necessarily stocks (although exposure is still worth it). We believe gold (and probably silver and platinum as well) will decouple from the metals market and continue to rise. After all, gold is money and it is real. Not so the funny money that now lines our wallets.



GEOPOLITICS AGAIN

There were a couple of interesting things from the geopolitical front over the past week or so that may or may not have a bearing on things to come.

First was the recent elections in Russia, where to no one's surprise Putin's party won handily. Naturally it brought all sorts of negative comments from the West. But then Russians have a history of actually preferring dictators, and at least Putin has brought some order and some prosperity back to Russia after the depression of the 1990s. Rising oil prices helped. No wonder western liberal parties were shut out.

But the reality is that during that period, knowing full well that Russia had lots of oil, the US (sorry, read US corporations) made quite an attempt to take over Russian oil companies and so bring the Russian oil industry under US control. Other American corporations were making all sorts of attempts to move into Russia. Couple this with the oligarchs who pilfered Russia, and the Russian people were happy to see the back of them.

Secondly, the Russians had gotten tired of the US pushing them around in their neighbourhood, cozying up to dictators just as bad as or worse than anything Russia had before. Think of countries like Uzbekistan. And with increasingly US military outposts literally on the border of Russia this was not an acceptable turn of events. Finally the attempts by the US to place missiles in Eastern Europe (Poland and the Czech Republic), ostensibly to stop missiles from Iran, was just too close to home.

Also Iran played a role. While Russia is really no friend of Iran, they could not stand by and possibly see another country fall under American control or influence. So it is now: attack Iran and you attack Russia.

The US pointed out how the Russians roughed up the opposition and conducted possibly fraudulent elections, but the US should look at their own allies such as Pakistan, Egypt, Iraq even, Morocco and Uzbekistan. These are no pillars of democracy, and Russia looks good beside most of them. And to twist it a little one has to remember the controversy over the Diebold touch screen, no paper trail voting machines in Florida and Ohio that delivered the 2004 election to Bush. Let's also remember that dissent in America today is often only allowed in enclosed pens well away from the parties it is being directed at. America itself is no Pollyanna when it comes to democracy.

So today's world has once again the Russians and the Americans facing off (and as well the Chinese and the Americans) and it is occurring all along the Russian border and even manifests itself in claims to Arctic sovereignty and in places such as Kosovo (watch that to come to a head early in the New Year). They won't admit it, but Russia's new-found muscle is no accident and is a direct response to American hegemony in Russia's sphere of influence.

The second one of course was the announcement from the National Intelligence Estimate (NIE) that Iran ended its nuclear aims in 2003. This was consistent with what had long been reported by the UN's IAEA – that there was no evidence of a strong nuclear program in Iran. But for political reasons Iran probably wanted to make believe they were doing something which as a member of the nuclear proliferation treaty was their right. Remember, non signers to the nuclear proliferation treaty include Pakistan, India and Israel, all of whom really do have nuclear weapons.



Naturally this announcement by the NIE flew in the face of everything the Bush administration had preached for years. But one of their own agencies pointing this out doesn't stop them. They were led by Bush, Cheney and Defence Secretary Robert Gates right back at it that Iran was a threat. And of course it also ratcheted up the rhetoric from Israel as well.


There are probably a number of reasons why no attack against Iran has happened yet. The key period could be the first quarter or so of 2008. It's an election year, every Presidential candidate has heaped rhetoric against Iran, and it is not going to stop. We still view it as a question of when an attack will be conducted against Iran, not if. They still need to manufacture the reason. And when it happens things just won't be the same.

ECONOMIC INDICATORS

<http://biz.yahoo.com/c/ec/200750.html>

Another busy week for economic numbers. The big day is Tuesday, with the Fed at 2:15 for the FOMC statement. The market will be focused on that. But they may wish to have a look at the trade balance on Wednesday, which should be lower. Retail sales are out on Thursday and that will give us some insight as to whether the consumer is still spending. PPI is also out on Thursday, and CPI on Friday. Don't expect much there as we are only too well aware the manipulation of inflation numbers.

Date	Time (ET)	Statistic	For	Briefing Forecast	Market Expects	Prior
Dec 10	10:00 AM	Pending Home Sales	Oct	-	-	0.2%
Dec 11	10:00 AM	Wholesale Inventories	Oct	0.5%	0.5%	0.8%
Dec 11	2:15 PM	FOMC policy statement	-	-	-	-
Dec 12	8:30 AM	Export Prices ex-ag.	Nov	NA	NA	0.5%
Dec 12	8:30 AM	Import Prices ex-oil	Nov	NA	NA	0.5%
Dec 12	8:30 AM	Trade Balance	Oct	-\$57.5B	-\$57.0B	-\$56.5B
Dec 12	10:30 AM	Crude Inventories	12/07	NA	NA	-7913K
Dec 12	2:00 PM	Treasury Budget	Nov	-\$100.0B	-\$75.0B	-\$75.6B
Dec 13	8:30 AM	Retail Sales	Nov	0.8%	0.5%	0.2%
Dec 13	8:30 AM	Retail Sales ex-auto	Nov	0.8%	0.6%	0.2%
Dec 13	8:30 AM	PPI	Nov	2.0%	1.5%	0.1%
Dec 13	8:30 AM	Core PPI	Nov	0.2%	0.2%	0.0%
Dec 13	8:30 AM	Initial Claims	12/08	340K	335K	338K
Dec 13	10:00 AM	Business Inventories	Oct	0.3%	0.3%	0.4%
Dec 14	8:30 AM	CPI	Nov	0.7%	0.6%	0.3%
Dec 14	8:30 AM	Core CPI	Nov	0.2%	0.2%	0.2%
Dec 14	9:15 AM	Industrial Production	Nov	0.3%	0.1%	-0.5%
Dec 14	9:15 AM	Capacity Utilization	Nov	81.8%	81.7%	81.7%



Charts created using Omega TradeStation 2000i. Chart data supplied by Dial Data.

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