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**TECHNICAL SCOOP FOR OCTOBER 6, 2008**

**Charts and technical commentary by David Chapman**

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## **THE FINANCIAL PANIC OF 2008**

Investors can be forgiven if they have only now realized that what they have been going through in the markets of late is of historic proportions. Financial panics are rare events but when they occur they generally wipe out at least half and sometimes more of investors' stock market wealth. Capitalism, it seems, has a knack for creative destruction. Does that mean that investors should never invest in the stock market? Of course not. Eventually it recovers, but it usually takes years.

Does that mean that given the events of the past couple of weeks that everyone should now join the panic? That is definitely a more difficult question to answer because in a panic sell off even the good is thrown out with the bad and it is a more a case of bids just disappearing then it is that there is something fundamentally wrong with many stocks including preferred shares of blue chip companies. At the end of the day quality will recover faster than the fundamentally unsound. The rapidity and broadness of the decline has even caught us off guard.

Financial panics have been around at least as long as organized economies. The first recorded panic in modern economies was in 1819. At its heart was a failure of the banking system following the War of 1812. It was preceded by a change in monetary policy caused by heavy borrowings to finance the war, and the monetary expansion in turn spurred an expansion of banks and bank notes. The resulting speculative investment led inevitably to collapse, with bank failures, bank runs and

bankruptcies.

We can suppose that at least this time the mania wasn't tulips, so there is at least a chance that this one might reasonably recover in our lifetimes and some will recover a lot faster than others. And unlike in the 1800s, people don't go to prison for their debts. But we can't help but note that there are already countless people in the US who are homeless while more than 29 million, roughly 10 per cent of the population subsist on food stamps. Many are living in their cars or tent cities or FEMA trailer parks. (Think of the survivors from the hurricanes: many Katrina survivors and former New Orleans residents still live in slum trailer parks.) Amongst the proposals to come out of the 1819 panic were debt relief, public works, and regulation that at the time targeted anti-usury laws.

We are providing a little table of panics and depressions/recessions below. It shows that they do pass, and then markets go on to new highs. But it sometimes took years before new highs were seen. While we are referring primarily to US panics and depressions, the impact was usually felt worldwide. At the heart of most of them was monetary expansion and a mania, followed by the inevitable collapse. Note: Stock Market refers to the Dow Jones Industrials or its predecessors.

Panics and Depressions	Dates	Duration	Prime area of collapse	Years to Stock Market New Highs following start of Depression/Recession /Panic
Panic of 1797	1797-1800	3 years	Commerce and real estate	NA
Panic of 1819	1819-1824	5 years	Bank failures	NA
Panic of 1837	1837-1843	6 years	Bank failures, currency collapse	NA
Panic of 1857	1857-1860	3 years	Railroads and real estate	NA
Panic of 1873	1873-1879	6 years	Bank failures	NA
Depression	1873-1896	23 years	Global depression despite huge economic expansion	NA
Panic of 1893	1893-1896	3 years	Railroads and run on gold	1905 – level exceeded in 1899 and 1901 but could not be sustained
Panic of 1907	1907-1908	1 year	Bank failures caused by new financial instruments	1915 – came close in 1909
Great Depression	1929-1939	10 years	Stock market crash, bank failures, bank runs, trade wars	1954

Panic of 1937	1937-1942	5 years	War scares, WW2, Wall Street scandals – actually part of Great Depression above	1949 – level exceeded in 1946 but could not be sustained.
1973 oil crisis	1973-1975	2 years	Quadrupling of oil prices, inflation from Vietnam War	1983 – equalled levels in 1980 and 1981
Panic of 1987 Early 1990's Recession	1987 1990-1991	4 years	Dollar crisis, program trading, illiquidity, real estate	1991 – went above in 1990 but couldn't hold the level
2000 dot.com bubble	2001-2003	2 years	Dot.com bubble, Sep 11, accounting scandals	? – Went above in 2006-2007 but has been unable to hold the level
Panic of 2008	2008-?	?	Real estate, bank failures, illiquidity	?

We have very few records of larger, more prolonged depressions, although many of the recessions of the 19th and early 20th centuries took on characteristics of depressions. The two most noteworthy economic depressions were those of 1873-96 that lasted 23 years, and the Great Depression that lasted 20 years when one takes into consideration the war years of WW2. Curiously enough, the Depression that started in 1873 and the Great Depression were roughly 56 years apart whether you go start to start or trough to final trough. This is the famous Kondratieff cycle. We are reproducing the known Kondratieff cycles that are generally accepted by most analysts. We noted this cycle in a *Technical Scoop* dated July 29, 2002.

### The Kondratieff Cycle

Spring (expansion)	Summer (recession)	Autumn (plateau)	Winter (depression)
1784-1800	1800-1816 (War of 1812)	1816-1835 ("Era of Good Feelings")	1835-1844 (Mexican American War)
1845-1858	1859-1864 (American Civil War)	1864-1874 ("Reconstruction")	1875-1896 (Spanish American War)
1896-1907	1907-1920 (World War 1)	1920-1929 ("Roaring 20's")	1929-1949 (World War 2)
1949-1966	1966-1982 (Vietnam War)	1982-2000 ("New World Order")	2000-? (War on Terror? Or?)

There is no hard and fast rule as to when the trough or the final trough of the winter period should occur. Those above occurred 50-60 years from the start of the spring expansion. Given the tools of modern economies, the final trough on this one may not occur until somewhere out to 2016-20 although some are pointing to 2011-12. Significant wars also occur during these long trough periods. The so-called War on Terror has now been going on for seven years. There have been incidents or threats

that could expand this war beyond Afghanistan and Iraq, primarily Iran and Russia (Georgia conflict), but both of these have taken a back seat to the current financial crisis. Pakistan is currently falling into the abyss of civil war and illegal attacks by the USA. The consequences are unknown.

None of this precludes some very impressive rallies during depressions. The stock market rally of 2002-07 already ranks in length with the stock market rally of 1932-37. And in terms of strength and recovery from the previous low, the recent rally was more powerful as we generally exceeded the old highs of 2000 while the 1932-37 rally did not.

But the current collapse that started from July 2007 has now exceeded the 1937-38 bear market in time. That bear initially bottomed in April 1938 taking off roughly 48 per cent. A feeble irregular recovery that actually recouped roughly 60% at the highs made its final top in 1939-1940 before plunging again to its final lows in 1942. Thus far this one has shed 27 per cent (DJI) and it has not yet bottomed. Some hope may be in the offing as we are reminded that last year's market topped on October 9, while the important 1998 and 2002 lows occurred on October 1 and October 10 respectively. Anniversary dates are often quite important for highs and lows.

Our thoughts on this current Kondratieff winter was that we would see a prolonged period of rises and falls in the market that would be more similar to the stock market of 1966-82. If anything, the 80 per cent collapse in the NASDAQ 2000-02 because of the bursting of the dot-com and tech bubble was more reminiscent of the Dow Jones Industrials collapse of 1929-32 that lost 89 per cent. The dot.com collapse may have already satisfied the premise that a market can lose up to 90 per cent of its value in these panics.

In looking at the bear markets of the past century, only the Great Depression saw a 90 per cent collapse. The others were around 50 per cent, and we continue to believe that despite the financial problems coming out of this panic, that will be the general level of collapse this time around as well. That calls for the S&P 500 to fall roughly to the levels seen in 2002 near 750-800 and the Dow Jones Industrials to fall to 7,000-8,000.

Some markets have already had severe corrections and in any collapse some companies disappear altogether or see the shareholders almost wiped out (Bear Stearns, Fannie Mae, Freddie Mac, AIG, Lehman Brothers, Washington Mutual, and Wachovia). There will be more but those thus far have been the most significant.

We do eventually recover as the above table attests, but it takes many years in some cases. Take the Japanese Nikkei for example. That market topped in December 1989 and still stands at less than one-third of the 1989 top. Clearly that is one market that is going to take many years before the levels of 39,000 are seen again. We are now 18 years and counting. But again none of that precludes powerful bear market rallies or particular sectors that will outperform the broader market.

A common theme in all depressions is massive bank failure. Great depressions are all about a collapse in the banking system and debt implosion. We (and many others) had constantly noted that this time would be no different, and that the massive debt build-up of the past two decades along with the proliferation of new instruments and derivatives was going to end in a disaster. The disaster is now unfolding, and the panicky body language of people such as Henry Paulson and George W. Bush is obvious. Fed Chairman Bernanke is trying to act coolly but even he now seems out of his depth as would we suspect most if not all of us.

When the leaders are in panic mode and out of their depth, we have a lot to be worried about. What was once limited to the purveyors of doom and gloom has become mainstream headlines. It seemed that this weekend's *Globe & Mail* Report on Business was entirely devoted to the crisis. Its headlines screamed "The gloom spreads north" and "The end of the American order" (*Globe and Mail*, October 4, 2008). But prior to that the daily headlines screamed about the huge gyrations in the markets.

Nothing has been spared. The gold bugs, oil barons and agriculture kings have all experienced collapses along with everybody else. Cash has been king, but even those thinking they were comfortably safe in money market deposits have discovered that even that is not safe (see especially the asset-backed commercial paper collapse). Only government Treasury Bills are a safe haven, and there yields have fallen practically to zero. Has many are going to discover the only true safe haven will be gold.

In order to bail out and protect the financial system the central banks have been flooding it with liquidity. And still the stock market falls. They announce a \$700 billion (and more) bailout plan and the stock market falls. Of course there are many unanswered questions about this bailout: the price they will pay for the securities; mark-to-market issues (the financial institutions do not want to mark the toxic debt to market – assuming there is one); how the federal government will take on this debt (there is nothing there right now, no systems, no infrastructure and no people – it takes months to set this stuff up but we understand it has to be up and running in a month).

The Federal Reserve and other central banks including the Bank of Canada have pumped billions and collectively trillions into the markets to keep them afloat. They have loosened their requirements for collateral and have been taking on lesser quality debt in order to provide the system with funds. Banks have literally stopped lending to each other.

The spread between Treasury Bills and three-month Eurodollars has exploded from 130 bp to 390 bp since mid-September. In July 2007 it was 30 bp. It hit a high of over 500 bp. Commercial paper spreads have also widened considerably from the same 130 bp in mid-September to over 400 bp today. The US commercial paper market is shrinking, reflecting the collapse in credit. Outstandings on commercial paper continue to fall, now standing at \$1.54 trillion, down from \$1.64 trillion a week ago a record decline. And according to statistics almost 30 per cent of the commercial paper market is asset-backed commercial paper (ABCP) which like here in Canada is pretty much frozen.

The Credit Default Swap (CDS) market is imploding. With the instituting of a ban on short selling this market has literally seized up. AIG a huge writer of CDS's has been unable to honour its obligations. What ones that still exist have widened so dramatically they no longer make sense and will probably never be honoured.

Credit is drying up. Not only are homeowners going under and being foreclosed (at least one in 10 in the US now), corporations are finding their credit access frozen or withdrawn, and municipalities cannot access credit and many are on the brink of going under. The State of California is seeking funds. The credit crunch is spreading through the entire US economy, Europe, and now into Canada. Without credit the entire economy could seize up and bankruptcies could mount at an incredible pace to the accompaniment of sharply rising unemployment.

The US has been reporting job losses for months, the latest being a loss of 159,000

in September. Officially over 750,000 jobs have been lost this year in the US even as Canada has actually added jobs. The jobless rate in the US sits at 6.1 per cent, unchanged from a month ago but only because tens of thousands dropped out of the labour force. They are not counted. If you count these workers and override other government methods used to lower the official rate, the real jobless rate is closer to 14.5 per cent according to [www.shadowstats.com](http://www.shadowstats.com). Even the Bureau of Labour's broadest measurement puts it near 11 per cent. Canada, with a more accurate measurement of unemployment, continues to report the official rate at 6.1 per cent.

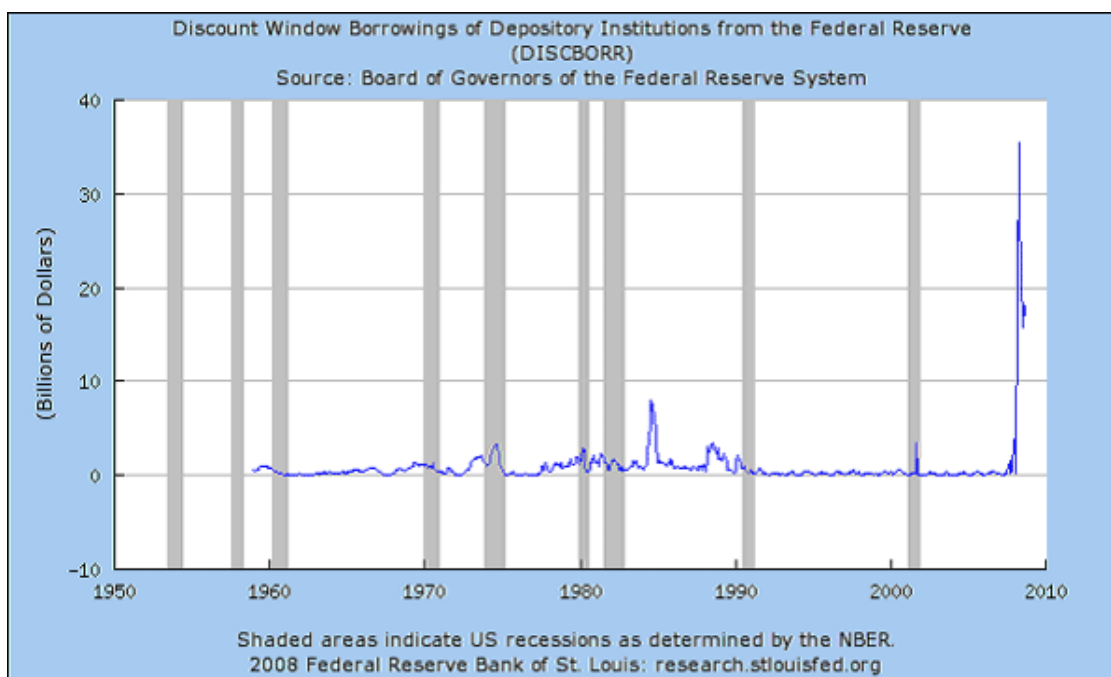
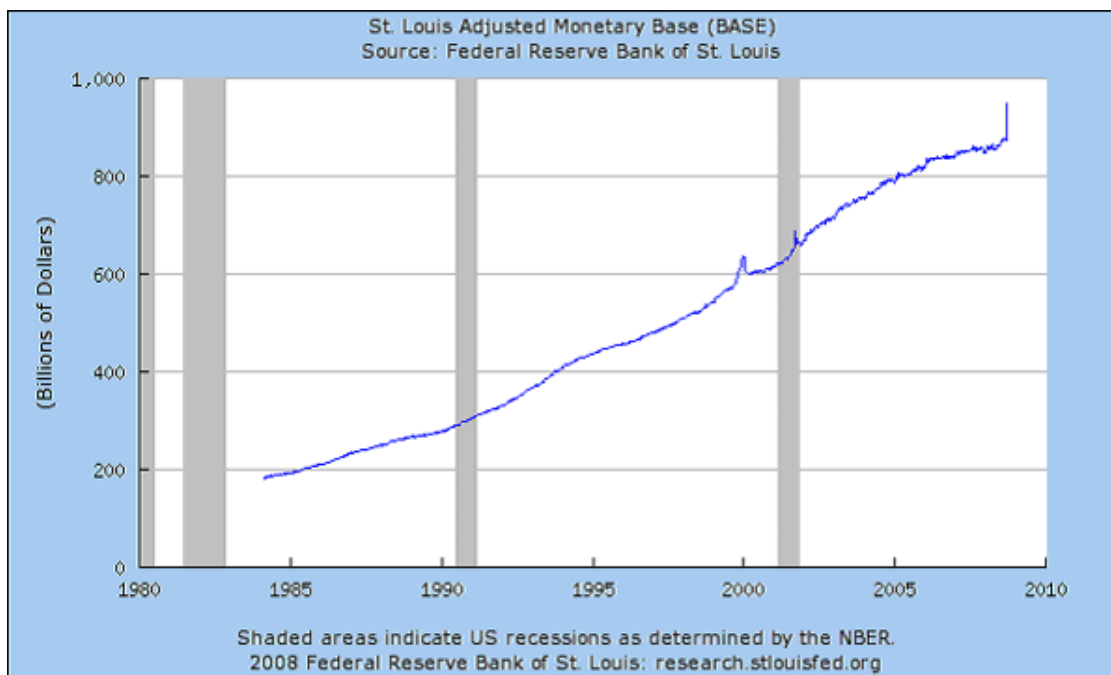


Despite the rapidity and high level of job losses, the US is not reporting any official recession. Retail sales and industrial production have moved into negative territory, the IMS numbers and the PMI numbers all report levels under 50 (a sign of a recession). Consumer confidence continues to wane. Again [www.shadowstats.com](http://www.shadowstats.com) reports that it believes the US has been in a recession since 2005, and that GDP growth, rather than being the officially reported 2.0 per cent, is actually minus two per cent.

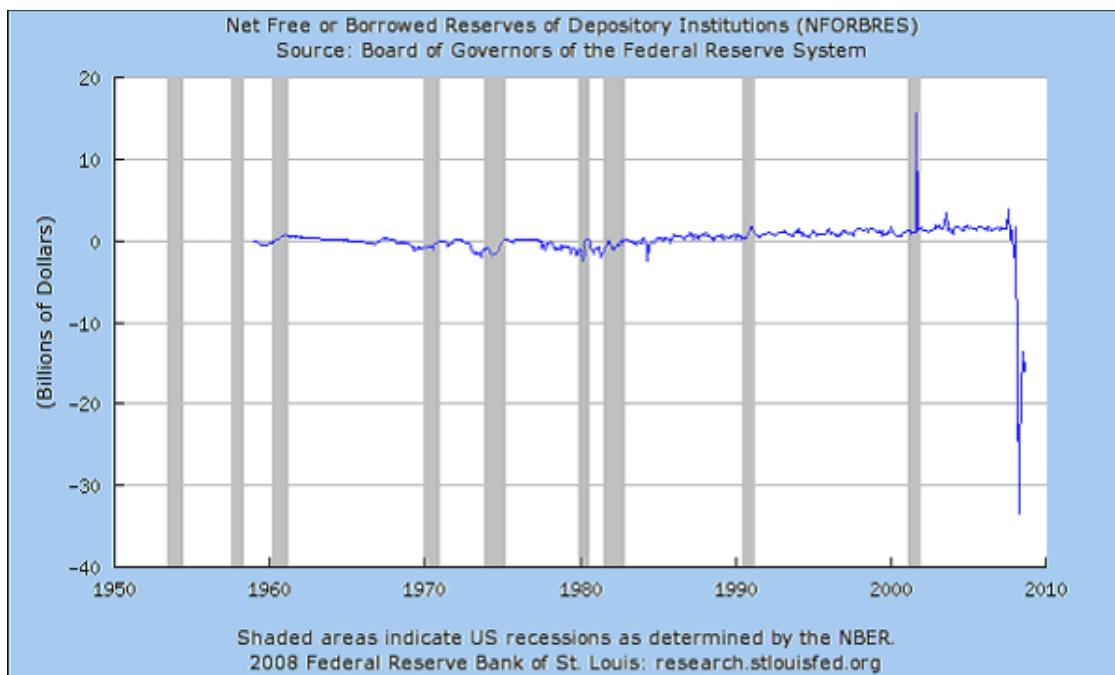
**The huge flows of funds into the financial system are highly inflationary. The Fed lends funds to the private financial system and in turn takes back securities and increasingly illiquid securities. That in turn is increasing the money supply. While M2 has slowed sharply to the recent 2.8 per cent growth over the latest 13 weeks, the year-over-year growth is still just under six per cent. The unreported M3 is still estimated to be very high, at a year-over-year 14 per cent. But we have witnessed an explosion in the monetary base (M1) with the commensurate huge leap in discount window borrowings. Our two charts below attest to this explosion.**

**These huge increases are indicative of a system that will explode money and is now verging on what one would call Weimar Republic economics. We are not using wheelbarrows yet, but the suggestion is that this could cause an**

**inflationary depression rather than a deflationary one. These are then ideal conditions for gold, despite the recent sharp set back. Irrespective even in a deflationary collapse, a hard currency asset such as gold will benefit as it did in the 1930s (Gold stocks rose as a proxy for gold that was fixed at \$35).**



At the other end, the net free or borrowed reserves have gone into negative overdrive. This chart tells us that banking system has no free reserves but instead have borrowed heavily at the Federal Reserve Discount Window. As the chart below attests, we have never seen such levels since numbers started back in the 1950s.



Reserve balances of the depository institutions have exploded the balance sheet of the Federal Reserve. The taking-on of other instruments including ABCP, auction credits, dealer paper, and other assets has replaced US Treasury bonds and bills. The result is that the quality of the Federal Reserve's balance is deteriorating, even as it has doubled in a year. They are creating money out of thin air on one hand and turning their balance sheet into a junk bond portfolio on the other hand. One has to start to wonder about the credit quality of the Federal Reserve.

Meanwhile we are being kept afloat by a flood of money from other central banks (foreign official and international accounts) that exploded another \$43 billion in the latest reporting week. The Fed also recently arranged a \$600 billion currency swap with other central banks. That puts huge amounts of US dollars into their hands, which they can use to buy US Treasury securities. This puts additional demand credit on for US Treasuries and is probably behind the huge run up in the US dollar recently. Combine this with the general run out of other securities into US Treasuries and this may help explain the dollar rally.

**But it won't last. And when the dollar starts to fall, as they will have to allow it to do, then gold will rise. We notice that despite the fall in both the Dow Jones Industrials and Gold this past week, the DJI/gold ratio still moved in favour of gold. The ratio now stands near 12.5 down from a recent high of just over 15. We are still are calling for it to fall to at least 2:1, which is the level seen in the 1930s. All of these factors tell us that despite the recent drop in gold prices, gold is a buy and should be purchased by investors. If the DJI were to fall to our levels of 7000-8000 then at our 2:1 ratio gold would rise to \$3,500 to \$4,000 – a long way from the current \$830. Even a 3:1 ratio suggests gold at \$2,300 to \$2,700. The double top on the DJI/Gold ratio suggests a fall to at least 6:1 and therefore a price of Gold of \$1,700 assuming the DJI stands still. Even a DOW INDEX fall to the aforementioned 7000-8000 suggests Gold at \$1,200 to \$1,300.**



**In 1970 US debt was \$389 billion and gold was fixed at \$35 an ounce. Today debt is estimated to be around \$9.5 trillion and for the gold/debt ratio to be the same as in 1970, gold would have to be at least the \$850 it is near today. Given the recent attendant rise in the debt ceiling as proposed to \$11.5 trillion that suggests gold at least \$1050. But in 1940 gold was also only \$35 and the debt was only \$43 billion. That suggests a gold price closer to \$7,700. The reality is probably somewhere in between.**

But near-future US debt is unknown, given the huge sums being committed to the bailouts of Fannie Mae and Freddie Mac and others. US debt could rise to \$13 trillion. The debt limit has already been increased to \$10.6 trillion and it is proposed because of the current bailout to hike it \$11.5 trillion. The spectre has been raised of a downgrade of US debt. As well the days of the US Dollar as the world's reserve currency may also be numbered. There is talk in many European capitals in particular of a new Bretton Woods as the only way that the world's financial system can be saved.

There are also unseen consequences of the credit crunch. Not only is it impacting consumers but it is also impacting corporations potentially compromising projects or even payrolls. In the commodity sector those exploring for oil, gas and other commodities including gold will put projects on hold. While demand may flag because of the slowing economy, the lack of new resources will be paid for down the road with higher prices. Municipalities and US States are also being facing a cash crunch and many municipalities sit on the brink of bankruptcy. The State of California has suggested it will need a financial bailout from the Federal Government of at least \$7 billion. Small but potentially telling.

Over 60 per cent of the world's oil is shipped and tankers need to be financed and built to replace aging ones. This could eventually result in a capacity shortage of tankers and put a squeeze on oil prices. Oil prices remain above long-term support zones near \$80 and we see that as the worst case in this correction. Below that,

many projects come into question. Some production could even shut down, particularly here in Canada where the high extraction costs of the oil sands require prices of at least \$80.

With both energy and precious metals remaining in longer term bull markets but intermediate bear markets we can't help but note that the oil and gas stocks are trading as if oil was \$60 or lower, not the current price near \$100. Gold stocks are also cheap as the HUI Gold Bugs Index is trading as if gold were \$500-\$600 and not the current \$830. **Rather than the current levels being the time to sell HUI, it may be the time to buy HUI.**



These are scary times. As a veteran in the markets we have never seen anything like this. We were there for the 1987 stock market crash but as scary as it was at the time it was largely a one off event. This time it is different. While we underestimated the correction in the energy and precious metals sectors and now the agriculture stocks, we firmly believe they will not only outperform going forward, they will remain places to be invested in irrespective that many of them are trading at 52-week lows. Conditions have never been better, and once the short-term conditions keeping the US dollar up artificially come to an end, these sectors will rise again.

There is a considerable amount of cash sitting on the sidelines primarily in pension funds and sovereign investment funds. Hedge funds are imploding along with many financial institutions. Many hedge funds are limiting withdrawals as they cannot exit the market in an orderly fashion. Even the vaunted private equity funds who mastered the art of leveraged buyouts (LBO's) are experiencing problems. The heyday of the hedge funds may be passing along with a lot of other things.

There are apparently quiet and some not so quiet bank runs going on. Recall that Northern Rock in Britain was seized by the Government because of bank runs. There were a number of US banks including IndyMac Bancorp that were seized by the Federal authorities because a bank run had started. Similar occurrences were happening with Washington Mutual and others. A bank run is happening in Britain

right now as thousand of British accounts are fleeing British banks for Irish banks since the Irish banks started offering savers a blanket guarantee.

This could raise the possibility of a bank holiday. We say that referring only to the USA and not Canada. Canadian banks, while having taken losses are far better capitalized and were not involved to the same extent in the sea of toxic paper washing out the US banks. Recall that in March 1933 Roosevelt declared a bank holiday shortly after taking office. He also started confiscating the gold of private citizens. The bank holiday was to be for 4 days so that inspectors could examine banks and those that were financially secure received a stamp of approval. Thousands failed though leaving many penniless. Of course the US started with some 28,000 banks back in 1930 so there were many corner banks that were not viable in the first place. The banking collapse of the 1930's gave birth to the Federal Deposit Insurance Corporation (FDIC).

During the Argentina collapse of 1999-2002 there was a serious run on banks. As a result the government declared a bank holiday that lasted a year except for minor withdrawals. Argentineans took to the streets attacking and burning banks and clashing with troops.

One should ensure your debt is eradicated, that you have cash reserves on hand, and that you own gold (and by extension silver) as they have a long history of acting as currency. It is only since 1971 when we went full blown into fiat currencies that gold ceased to be money or that is what the monetary authorities led you to believe. There were other periods of debauching gold in order to inflate the money supply usually to print money to finance wars. The massive monetary and debt inflation since 1971 has left us living in a world of financial illusion. The illusion it now seems is coming apart in the "Financial Panic of 2008".

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**Note: Chart created using Omega TradeStation. Chart data supplied by Dial Data.**

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