FURIOUS FINANCIAL FLUCTUATIONS

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"When you move in right up close to me
That's when I get the shakes all over me
Quivers down my backbone
I got the shakes down my knee bone
Yeah the tremors in my thigh bone
Shakin' all over". ("Shakin' All Over", by Johnny Kidd and the Pirates)

SHAKIN' ALL OVER

Burning passion for another is not the only love which makes us shake. When fear of losing substantial sums creeps up on numerous money lovers in intertwined financial playgrounds, both the players and their marketplaces can quiver violently.

Many pundits define a bear marketplace as a 20 percent slide from a noteworthy price top. Though the S+P 500 nosedived about 20 percent from its 5/2/11 high around 1371 to its 8/9/11 low near 1100, it then rallied sharply. On 8/9/11, the United States 10 year Treasury note touched yield lows of just over two percent. This matched the bottom achieved on 12/18/08 during the previous "flight to quality" panic in the (still-running) economic crisis that erupted in 2007. Given this equity and debt support, will things calm down much? No. The economic and political scenery has not sufficiently changed. Relationships within and between various financial arenas and their variables probably will vary to some extent as time passes, but the current entangled key financial factors will remain powerful, volatile, and intertwined. Although there will be occasional intermissions, turmoil in and between key equity, interest rate, currency, and commodity theaters therefore will not cease anytime soon.

Major fiscal deficit problems- and political party conflicts- persist in America, Europe, and elsewhere. Marketplace voyeurs increasingly tremble about slowing growth. Some are scared about a renewed recession. Yet won't supposedly cool-headed central bank chaperones such as the Federal Reserve as well as robust emerging nations such as China save the day? Some marketplace clairvoyants fret about deflation (insufficient inflation). However, other soothsayers point to inflation risks. After all, the Federal Reserve says it wants to create sufficient inflation. Moreover, it intends to keep pinning policy interest rates on the floor; only at end June did it halt its latest money printing blizzard. Maybe this restless watchdog will embark on a new round of quantitative easing if equities (the economy) sag further. In the United States, high unemployment, low consumer confidence, and a still-rather weak consumer balance sheet contrast with recent robust corporate earnings.

The broad real trade-weighted US dollar dwells at all-time lows. Yet many retain faith in the weak dollar equals strong stocks/strong dollar equals weak stocks hymn. In the past few years, the swooning dollar has tended to support commodity prices in dollar terms. Enthusiasm for commodities as an alternative investment also bolsters commodity prices. The potential for Middle Eastern upheaval helps to underpin the petroleum complex. However, commodity prices "in general" remain hostage to swings in worldwide economic optimism/pessimism, and particularly to trends in equity benchmarks such as the S+P 500. Thus bloody smashes to stocks have encouraged commodities to crater.

Despite the probability of some sharp ups and downs relative to current levels, what are longer run bottom lines for the general direction of key marketplaces? The S+P 500 will achieve new lows beneath 1100. The 1000/1050 range (recall the 2010 bottoms around the time of the Fed's quantitative easing policy) represents the next downside target. Commodities in general will tend to decline alongside stocks. The broad real trade-weighted dollar eventually will make new lows. The prior major support at 84.0 now represents major resistance. Key support for the dollar is at five and ten percent beneath this, at 79.8 (close to recent levels) and 75.6. The US 10 year Treasury note yield eventually will march toward four percent. However, climbing that high may take quite some time given the Fed fierce determination to hold short term rates low.

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Let's briefly promote a couple of tunes that should receive more fervent attention, even if they never headline the marketplace billboard's Top 40.

THE FED, INTEREST RATES, AND US

The Beatles sing in "Help!":
Help, I need somebody,
Help, not just anybody,
Help, you know I need someone, help.
When I was younger, so much younger than today,
I never needed anybody's help in any way.
But now these days are gone, I'm not so self assured
Now I find I've changed my mind and opened up the doors.
Help me if you can, I'm feeling down
And I do appreciate your being round.
Help me get my feet back on the ground,
Won't you please, please help me?"

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Many have joyously seized upon the Federal Reserve's 8/9/11 statement that "economic conditions…are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013" as demonstrating a near-certainty (or at least a very high probability) regarding the actual path for future Fed interest rates. Admittedly, in its effort to resuscitate the economy, boost consumer net worth, and reduce unemployment, the Fed has successfully kept rates depressed.

However, close review of the Fed's language suggest the Fed retains more flexibility to alter current rate policy than many believe. First, "exceptionally low levels" does not rule out an increase from current levels. Even a one percent Fed Funds rate from many perspectives remains exceptionally low, both from the standpoint of that number relative to zero as well as in comparison to current and anticipated inflation measures. Second, this is what the Fed "currently anticipates" regarding economic conditions. Thus it may change its opinion later. Its comments regarding action "as appropriate" regarding adjustment of securities holdings, other policy tools, and continued assessment of the economic outlook confirm this potential for interest rate (and other) policy change.

Why place blind faith in the 2013 low rate policy, for the Fed confesses it changes its viewpoints? In addition, consider the Fed's policy track record relative to its "original" expectations. Economic growth has been considerably lower than the Fed "had expected". The Fed "now

expects" a slower pace of recovery. Just as the Fed this month adjusted its policy by speaking of low Fed Funds through mid-2013, it eventually may alter its present course. Historians recall that the Fed's quantitative easing floods likewise represented policy changes due to marketplace developments. Besides, how accurate were the Fed's economic forecasts in 2007 and 2008, at the dawn and during the early stages of the acceleration of the economic crisis? So as Fed expectations change, so may its actions, whether on rates, quantitative easing, or otherwise.

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A shivering Fed may decide to engage in further quantitative easing (QE3), especially if stocks collapse toward the range- around S+P 500 1000/1050- that helped to inspire the QE2 dance. All else equal, a renewed deluge of money printing tends to raise inflationary risks and increase the odds of US dollar tumbles. Maybe the Fed is more terrified regarding current and prospective US economic strength (and deflation) than it confesses.

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Incidentally, how weak "really" is the economy given the Fed's insistence on keeping the Federal Funds rates near zero rather than raising it to one percent or higher? For example, will a one percent Federal Funds level crush corporate earnings or consumer confidence? It the economic environment is not in dreadful shape, would a one percent upward move up in rates right now murder economic growth? US inflation is not zero or forecast to be so. Flight to quality fears obviously influence government rate levels and trends. But shouldn't savers (creditors) receive some interest earnings at the short end of the US government yield curve? Picture a time horizon out to two years or so. Wouldn't somewhat higher yields help protect the shaky US dollar from further major slippage? Some other regions (including the European Central Bank) raised policy rates in recent months.

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Now picture someone offered an allegedly golden opportunity to buy longer term US government notes or bonds. Take the 10 year note as a benchmark. Won't players want to receive a real return relative to an inflation rate? Put issues of foreign ownership and currency trends on the sideline for a moment.

Anyway, the Fed still remains ferociously committed to ignite and sustain sufficient inflation. It probably currently interprets "price stability" and "inflation, over time…at levels consistent with its mandate" as an inflation rate of two percent. But haven't some inflation measures edged toward such a level? A few gurus have argued for the option of a greater inflation rate than two percent to spur growth (see Kenneth Rogoff's view of "moderate inflation of say four to six per cent for several years"; Financial Times, 8/9/11, p9). Will current US note and bond holders be happy about four to six percent inflation? However, the Fed probably has not embraced this even more forceful inflation level target.

Suppose the Fed devotedly undertakes as many rescue efforts as necessary to realize its dream of adequate inflation. Of course there's a risk that the economy declines so substantially that the Fed will be unable to do accomplish its plan. Flight to quality fears may impress some. Indeed, Japanese 10 year government bonds fell to under one percent in 2003 (.44pc on 6/11/03) and 2010 (.83pc on 10/6/10), so US yields may keep falling. Assume Fed enthusiasm for inflation succeeds in creating and sustaining an inflation rate (and inflationary expectations) around two percent. Absent flight to quality/safe haven or economic collapse arguments, why own a 10 year note yielding two percent if inflation will sustain levels of two percent? Watch bid cover ratios in Treasury auctions.

All else equal, if the Fed will ease as long and as much as it takes (to sustain economic growth/recovery, boost nominal household net worth, create inflation, reduce unemployment), American government (and other US) interest rates eventually go up. Lack of progress on solving near term and long run deficits also add to pressure for higher rates, as yield behavior on the European periphery (and elsewhere) show. Of course fiscal, inflationary, and other developments in Europe, China, and elsewhere affect US rate fluctuations.

The Fed and many other wizards are convinced the US has substantial resource slack (a notable output gap). But what if some of that so-called slack (potential output; spare capacity) was blasted away forever due to the recent downturn. Also, some of that alleged output gap may have traveled and been used overseas (due to lower costs). Such transferred output may not readily, if ever, return to American shores. Then, all else equal, the potential for US inflation could be greater than many observers assert.

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What about current overseas owners of US government debt? Keep dollar depreciation concerns on the side for a second. As existing Treasury obligations mature, most foreigners will not happily rollover into securities yielding half a percent or less. They may promenade further down the yield curve for their purchases, but if America suffers (or will suffer) from even modest inflation, nominal yields of two or three percent are unattractive.

Moreover, after the recent rate decline, since prices for outstanding US government securities have appreciated, why wait patiently for maturity, especially for low coupon ones? Not only is there rate risk, but also currency risk. Now let's suppose the dollar fell out of bed.

What about new net foreign buying of US government bills, notes, and bonds, whether from existing or other holders? At very low yields, given the Fed's urgent quest to generate sufficient inflation, new net foreign buying probably will be relatively feeble, particularly in relation to the bulk of upcoming US federal deficits. An ominous thought beckons- what about net foreign selling of Treasuries (and government agency securities)? Current low yields, inflation dangers, and fears of further dollar depreciation may unite, so some institutions and individuals- and even some nations- may reduce their Treasury (and dollar) exposure.

The US still needs those foreign buyers- though the Federal Reserve always could ravenously gobble up a heap of debt in another quantitative easing extravaganza.

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What about the "where else do/should we put our money" (to keep it safe) argument? Certainly if there appears to be a shortage of other high-quality debt securities, given America's still-strong credit rating and enormous and liquid government debt domain, many US and overseas players indeed will keep holding and buying Treasuries. However, they may not be as substantial net buyers as before.

Some marketplace stars perceive "high quality" government debt (especially short term obligations) as roughly a cash equivalent. In times of massive crisis, some quake about placing actual cash in banking institutions. They may choose to grasp Treasuries directly. Remember 2008! What if our bank fails? Or, what if banks or other key institutions with which our trusty bank does huge amounts of business collapse? Or, why put cash in "shadowy" financial institutions that deal with banks and governments yet remain substantially beyond regulatory oversight? Such terrors motivate scrambles to buy American (and other strong) government debt, even at paltry yields.

Even if a large bank or two blows up and burns to bits, will major governments and regulators permit the banking system in general to crumble? Anyway, assume our agitated world calms down somewhat, enabling "flight to quality" fears to abate somewhat, or substantially. In a current or potentially inflationary environment, very low yields will seem inadequate.

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Sustaining US Treasury and related dollar denominated interest rates at very low levels, when US inflation exists or looms, poses risks of further dollar depreciation.

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Monitor credit spreads. On the outlook for sufficient yields, those no longer (or less) enamored of Treasuries may choose to buy US corporate debt. Debt from other sovereigns and foreign corporations may allure some seekers. But if fears regarding creditworthiness of many corporations (and some states and municipalities) substantially jump, credit spreads versus Treasuries may widen.

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In a low-yield landscape, so long as substantial economic weakness does not appear imminent, some financial pilgrims will cart their beloved cash into US and related stock marketplaces. Some will shift some funds into alternative "investments" such as commodities. The Fed, as before, backs enthusiastic stock buying, for higher equity prices help to rebuild shattered consumer balance sheets and bolster consumer and business confidence. Or other assets like stocks or commodities.

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Chairman Bernanke speaks at the Jackson Hole conference on 8/26/11. The Fed meets 9/20/11 and 11/1-2/11. The International Monetary Fund and World Bank Fall Meetings are 9/23-25/11.

STOCKS AND COMMODITIES: SOME TWISTS AND SHOUTS

"Well, shake it up baby, now…
Twist and shout…
Come on baby
Come on and work it on out." "Twist and Shout" (by Phil Medley and Bert Russell)

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Reviewing the CFTC's agriculture Index Trader data alongside NYMEX petroleum complex net noncommercial long statistics provides insight regarding the interrelationships of commodity and US equity price trends.

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Note the similar timing for peaks in US stocks and many commodities. The S+P 500 made its recent high around 1371 on 5/2/11. The broad Goldman Sachs Commodity Index highs were about 762 on 4/11 and 4/28/11 at 762. The broad GSCI declined over 21 percent from these levels to its recent August depths. Brent/North Sea crude oil likewise reached its tops around 12700 on those days. NYMEX (nearest futures continuation) crude oil's plateau was on 5/2/11 near 11485. The highs in the Goldman Sachs US Agriculture Index occurred a bit earlier than those in petroleum, on 3/4/11 at 571, with the second top on 4/8/11 at 567.

The CFTC's CIT Report for a dozen agricultural commodities details holdings by Index Traders. The Index Trader fraternity is a rough proxy for the buy and hold for the long run alternative investment clans. Although this Report does not include base or precious metals, or petroleum and natural gas, patterns in the CIT regarding these alternative investors in agriculture probably roughly are paralleled in other areas. After all, alternative investments in commodities often are distributed through or in relation to broad indices including a fascinating assortment of commodities. These IT statistics do not include over-the-counter marketplaces.

Recent highs in gross and net IT length (futures and options combined) admittedly fell somewhat short of those achieved in calendar 2010. Recall the 1.84mm contract gross high on 5/4/10 (as the Ag Index was in a downtrend, making a bottom on 6/7/10 at 281); remember the May and August 2010 net IT long highs around 1.63mm. The GS Ag Index reached new highs in 2011, even though 2011's gross and net long IT statistics have not exceeded those 2010 heights.

Yet let's peer further into the IT statistics. Observers still should study IT trends alongside price fluctuations for the GS Agricultural Index and equity benchmarks such as the S+P 500.

The recent gross high in long open interest for Index Traders in the CIT Report was 4/5/11, or around 1.83 million contracts. The recent net long top for Index Traders ("IT") was 4/26/11's 1.53 million contracts. The S+P 500 attained its high not long after this.

This 4/26/11 net length equaled about 23.6pc of total open interest. Although the net length varies between the agricultural commodities, this percentage indicates the substantial role of this investment class within the trading universe. Going back to the start of IT data at end 2006, the average net IT long has been just over twenty-five percent of total open interest.

Anyway, as of 8/9/11, gross IT length was about 1.69mm contracts, a decline of about 7.8pc from the April 2011 high. Net IT longs were about 24.0pc of open interest, or 1.40mm contracts. Thus as the Goldman Sachs Agriculture Index has fallen, so has IT length. This parallels the decline in equity prices. So far the IT open interest decline has been fairly modest, even the Ag Index price eroded 21.1pc to about 450 on 7/11/11.

In 2008, the price peak in the GS Ag Index was 513 on 2/27/08. The Ag Index pinnacle was reached before the gross long IT highs of about 1.95mm contracts on 4/22/08 and 5/13/08, and the net IT long summit of 1.78mm contracts on 5/13/08. These closely preceded the final high in the S+P 500, 5/19/08 at 1440. The final high in the GS Ag Index at 496 was 6/26/08, in between the S+P 500 and petroleum peaks. Everyone recalls the subsequent equity and petroleum price collapse, which accelerated in autumn 2008. Index Trader length and the Ag Index fell too. The Ag Index reached its bottom on 12/5/08 around 247. Around the time of the major low in the S+P 500 on 3/6/09 at 667, IT holdings made their trough. Gross length was about 1.09 million contracts on 2/24/09, with net IT length 923 thousand contracts.

2011 is not necessarily 2008/2009. Yet given the rough linkage in recent years between commodity price trends (and alternative investment enthusiasm) and equity movements, players should analyze the price and time patterns for the GS Ag Index and the S+P 500 alongside IT statistics. Gazing forward, further declines (renewed bull moves) in the GS Ag Index price and IT length and falls (renewed rally) in the S+P 500 would confirm each other. The 2008/09 story shows that dramatic price drops can shake even long run commodity investors out of their positions.

Let's visit the NYMEX petroleum complex Commitments of Traders information in this context of stock and commodity price trends. Use the benchmark crude, heating oil, and RBOB (gasoline) contracts (futures and options combined), and focus on net noncommercial length ("NCL"). The net NCL petroleum group includes various crews of investors and speculators. In any event, it is not precisely the same as the Index Trader group of agriculture.

Around the time of recent mountaintops in Brent/North Sea and NYMEX crude oil, NYMEX net NCL achieved new all-time records. The 427,000 contracts of 3/8/11 were roughly matched by 4/5/11's 426m (11.5pc of open interest) and 4/26/11's 422m (also 11.5pc). As a percentage of total open interest, the net NCL pinnacle was about 11.6 percent on 3/29/11). These NCL percentages were the highest since June 2004. As of 8/9/11, as petroleum prices generally have fallen, the net NCL position dropped to about 250m contracts, with the net NCL percentage descending to under 6.9pc.

Visit earlier stages of the moves in the petroleum complex and the S+P 500. Recall the quantitative easing policies unveiled by the Federal Reserve in August/November 2010. The key S+P 500 low was 8/27/10 at 1040. The NYMEX crude low was 8/25/10 at 7076. NYMEX net NCL length bottomed at 8/31/10 around 116m contracts (3.5pc of total open interest). Around the time of the interim high in the S+P 500 on 4/26/10 at 1220, NYMEX crude made an interim top at 8715 on 5/3/10. Petroleum complex net NCL reached a high of about 306m on 5/4/10.

Thus recent data shows the merit of watching petroleum complex net NCL trends alongside petroleum and equity price moves.

What about the more distant past of 2008/09? They suggest that one should be cautious about interpreting these relationships between net NCL petroleum open interest and petroleum and stock prices. However, the data remains suggestive.

Although the absolute price lows in petroleum preceded the S+P 500's 3/6/09 bottom at 667, the NYMEX petroleum complex net NCL length made its final low of 131m contracts near that date, on 3/10/09. Note, however, that during the marketplace meltdown, the low in petroleum's net NCL of 73m was 10/7/08, several months earlier (and before the end 2008/early 2009 petroleum price bottom). Yet the highs in net NCL in the NYMEX petroleum complex in 2007 (9/18/07 at 236m) and 2008 (4/22/08 at 238m) were close in time to key tops in the S+P 500 (10/11/07 at 1576 and 5/19/08 at 1440). The 4/22/08 net NCL high was close in time to, although not immediately before, the peak in NYMEX crude oil (and Brent) over 14700 on 7/11/08. Yet the net NCL on 7/8/08 had fallen (to 153m contracts).