CYCLICAL INVESTING BULLETIN

David L. Smith, Editor

January 4, 2007

OIL CRASHES. RECESSION COMING?

As of the close on Wednesday, January 3, 2007

DJIA: 12,474	S&P 500: 1,416	NASDAQ: 2,415	
DIA: 124.41	SPY: 141.62	QQQ: 43.24	
Treasury Yields	2-yr.: 4.758%	10-yr: 4.658 %	30-yr.: 4.763%
€uro: $1.31/€	British Pound: $1.95/£	¥en: 119.39/$	
FXE: 131.72	FXB: 195.13		
Oil (Nymex): $58.32	USO: $49.40	OIH: 133.35	
PWE: 29.00	CNE: 13.25		
Gold: $627/oz.	StreetTRACKS Gold (GLD): $62.28		

Yesterday, the first day of trading in 2007, I was within hours of forwarding my year-end *Comment* when extraordinary gyrations in virtually all markets caused me to pause and ponder the message of the markets. The market turmoil began in the morning as oil prices started what would be the most precipitous slide since April 2005, the NYMEX contract eventually free-falling $2.73 a barrel from $61.05 to close at $58.32. The initial reason given was the unusually warm temperatures experienced in the Northeast so far (New Yorkers were in shirtsleeves), giving rise to forecasts of warmer-than-usual winter and, therefore, reduced demand for heating oil. Some oil commentators on CNBC also expressed skepticism about OPEC's resolve to cut production by 1.2 million barrels a day beginning in November with an additional 0.5 million barrel-a-day cut planned for February 2007. The drop in oil prices gathered momentum late in the day, when minutes of the Fed meeting of December 12, 2006 were released, in which some members expressed reservations about economic growth:

- "Economic activity was increasing at a subdued rate during the second half of the year"
- "The contraction in homebuilding was continuing to restrain overall activity, and a step-down in motor vehicle output held down industrial production."
- "Several members judged that the subdued tone of some incoming indicators meant that the downside risks to economic growth in the near term had increased a little and become a bit more broadly based than previously thought."

The prospect of weaker-than-expected U.S. economic growth implies corresponding weakness in oil demand, depressing oil prices. Yesterday's decline in oil prices created all manner of technical breakdowns in oil-related investments, about which more later.

Significantly, the Fed's comments also moved the stock, bond, gold and currency markets. Early in the day, the Dow had skyrocketed 144 points to an all-time intraday high of 12,630, fueled by an encouraging report from the Institute of Supply Management

(ISM) showing a modest rebound in manufacturing from borderline recession levels. However, as soon as the Fed's minutes were published in the afternoon, the market reversed sharply, plunging to an intraday low of 12,373, a 257 (2%) swing. Moving toward the close, the Dow recovered somewhat, ending the day at 12,474, up 11.35 for the day while the S&P 500 shed 2 points. Nevertheless, concerns about weak future economic growth made a noteworthy statement, reflected in the 1.2% decline in the Dow . Traders apparently crossed over the line where slower economic growth is regarded as good news, (implying Fed easing and a soft landing), to the point where slower growth raises fears of recession. Such fears seem to be carrying over today, with the Dow off by over 50 points as this is written.

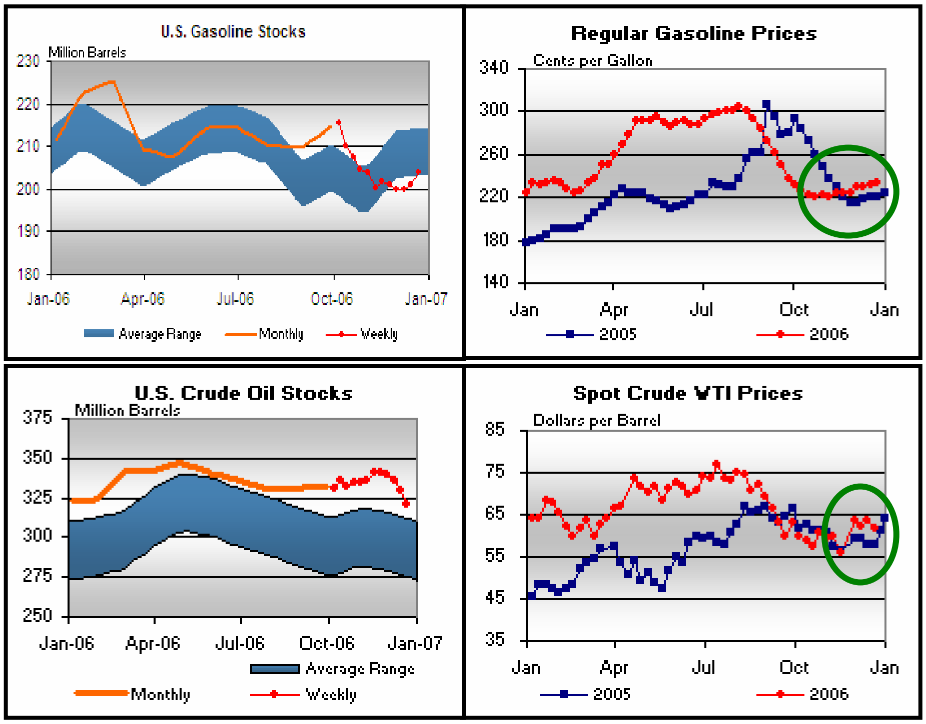
Fear of recession could also be deduced from the failure of stocks to rally despite a nearly 5% plunge in oil prices yesterday and further declines today. Lower oil prices imply less inflation, lower interest rates, stronger consumer spending, lower costs for business and economic stimulus generally – all positives for the stock market, as we saw when oil prices swooned late last year. Yesterday, however, stock traders began overlooking these bullish implications and focused on oil's more sinister message of softening oil demand due to weak economic growth.

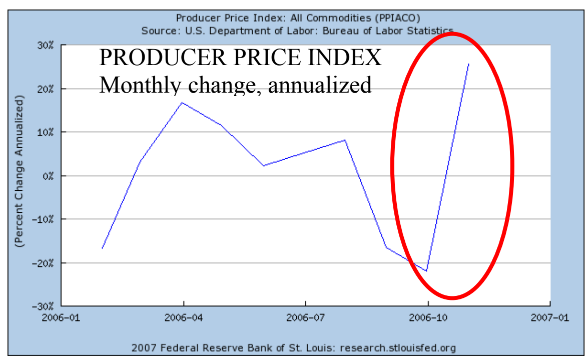
Bond buyers, as you might expect, liked the news from the Fed, inasmuch as the reduced demand for credit implicit in a weak economy tends to push interest rates down, bond prices up. Accordingly, the yield on the Treasury's benchmark 10-year note plunged 42 basis points from 4.70% to 4.658%. The rally in bonds has carried over into today's trading ahead of the employment report to be released tomorrow.

Gold investors also behaved like they expected a recession. A weak economy implies an abatement of inflation, thereby undermining one of the main supports for gold prices, which typically fall during recessions. Spot gold, which had jumped to $644 an ounce early yesterday, plunged as low as $625 before closing in New York at $627. A 22-cent drop in the price of January's copper futures contract (to $2.63 a pound) added a confirming note from the base metals pits.

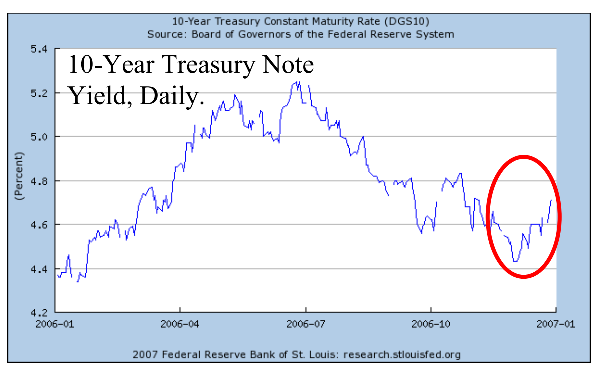
The behavior of the dollar, on the other hand, seemed out of synch with the rest of the markets. The dollar typically falls during a recession in response to falling yields on dollar-denominated debt instruments – the wider the disparity between U.S. and foreign yields, the greater the weakness in the dollar. Yesterday, however, despite falling U.S. and rising European interest rates (Japanese markets were closed), the dollar strengthened. I can only surmise such gains came from purchases of U.S. debt instruments by Asian governments, in a last-ditch attempt to counter a slide toward recession by their largest customer.

Bottom line: In recent *Reports* and *Comments,* I projected the following scenario: a post-election bounce in oil prices prompting a surge in inflation and higher interest rates, followed by a downturn in stocks in anticipation of an imminent recession. Indeed, we saw the predicted post-election reduction in oil and gasoline stocks accompanied b**y a** rebound in energy prices, with oil climbing from a recent low around $55 a barrel to $65 as I predicted in my last *Report.*





We also saw a sharp upswing in inflation at the producer price level. The headline PPI shot up 2% in November (an annualized rate of about 24%), thanks to a 6.1% surge in energy prices. The core PPI, excluding food and energy, rose by a hefty 1.3% (about 15% annualized). The increases in producer prices have not yet percolated through to the consumer price index, which was virtually unchanged in November.



And finally, we also saw an increase in market interest rates, with the yield on the Treasury's benchmark 10-year note rising 27 basis points, from the recent low of 4.43% to 4.7% at year end.

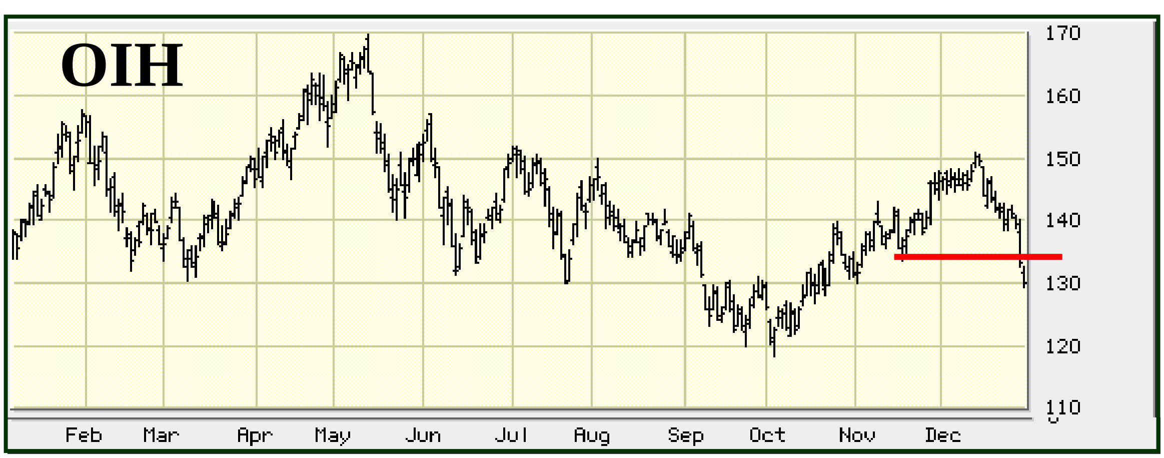
In my December 31, 2006 *Comment* which was to be mailed yesterday, I voiced expectations of yet further increases in oil prices, inflation and interest rates before the recession materialized with a downturn in stocks likely to begin around the beginning of 2007. *<u>However, yesterday's market action may be signaling that we have seen all the rebound in oil and gasoline prices we're going to get, and that recession is imminent, prompting the beginning of the anticipated bear market in stocks, retreat in energy and gold prices and rally in bonds.</u>*

One of the lessons I've learned over the past 22 years of forecasting, is to recognize when the forecasted events have run their course, even though the magnitude and the timing of the events (though usually not the sequence) may differ somewhat from what I expected. Yesterday's market action may well portend another such instance.

Accordingly, I'm reassessing my outlook and formulating a significant shift in investment strategy. A summary of my current strategy appears below with further elaboration to follow, once I have had the opportunity to gather my thoughts, re-think the data and reformulate my year-end *Comment*. I anticipate the *Comment* will be sent next Monday morning before the markets open.

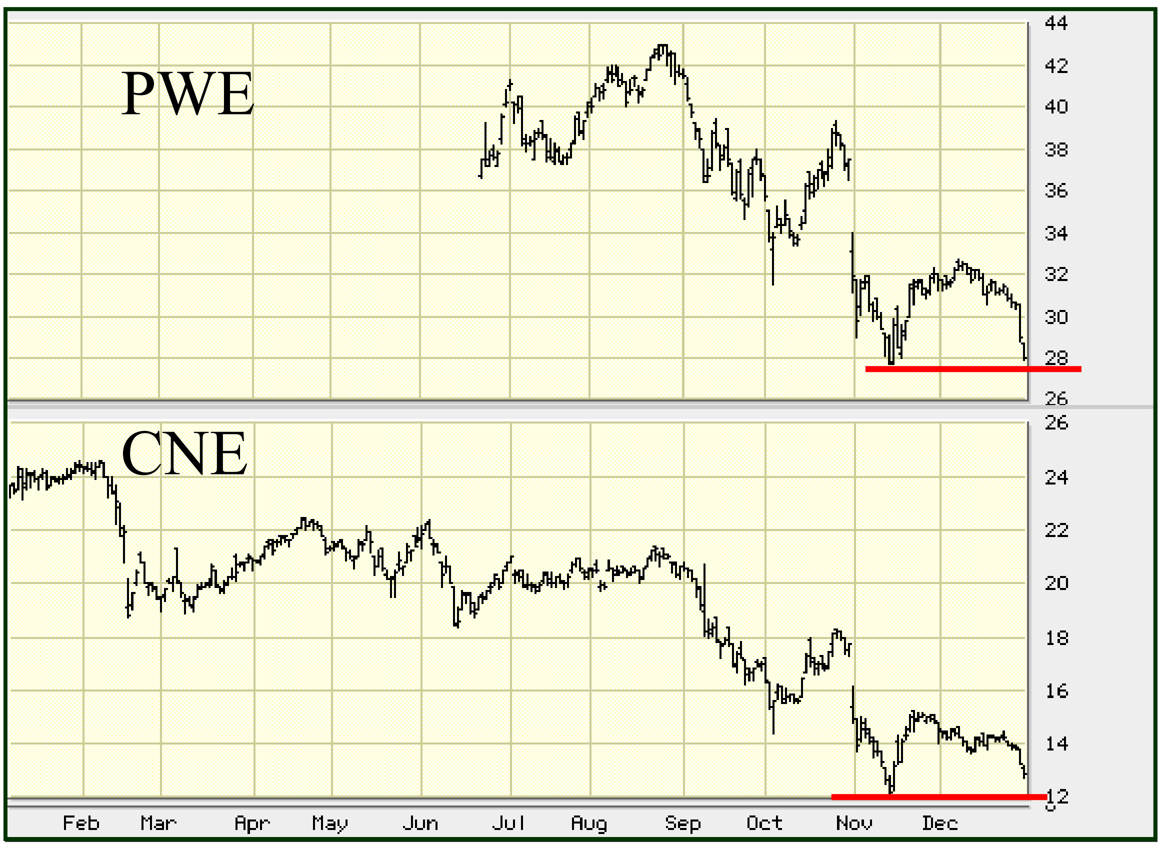
INVESTMENT STRATEGY:

OIL AND GAS: Underscoring the interpretation of events presented three paragraphs above is the devastating technical breakdown in oil, reflected in the price of US Oil Fund LP (USO) which fell below my line-in-the-sand at $50 yesterday and has continued losing ground today. Accordingly, aggressive, growth-oriented investors following my advice with a stop-loss at $50 should now be out of USO with a $2/share loss based on the October 31, 2006 entry recommendation at $52. That's a 4% loss on a 5% allocation or 0.2% loss of the aggressive, growth-oriented portfolio.



Likewise, aggressive, growth-oriented investors should have sold the 5% allocation in Oil Service Holders Trust (OIH), purchased October 30, 2006 at $132.70 at the recommended line-in-the-sand $135, realizing a $2.30/share profit (1.7%), which translates into a minuscule 0.085% gain for aggressive, growth-oriented portfolios.

As for the two Canadian Trusts, Canetic Resources (CNE) and Penn West Energy (PWE), on Friday October 27, 2006 I recommended their purchase the following week if they pulled back to $16.83 and $36 respectively. The pullback occurred early in the week, triggering the recommended purchases. But then, following the surprise "Halloween" proposal by the Canadian government to tax trusts as corporations, they promptly broke below my lines-in-the-sand at of $33.50 for PWE and $15.45 for CNE on Wednesday, November 1, 2006. Assuming the sales went off at the recommended stop-loss prices, aggressive, growth-oriented investors would have experienced a 7% loss on PWE and an 8% loss on CNE for a total portfolio loss of about ¾ of 1%. Accordingly, most of you are out of both trusts.



However, if you stayed in, you will have suffered additional losses on paper, as PWE and CNE have continued to decline to $29 and $13.25, respectively, as of the close yesterday, with further weakness in evidence today. At this point, the depressed prices have pushed up the current yields to 12.8% and 18.56%, respectively, which should provide support at these levels. While these yields could be reduced if oil prices are depressed low enough for long enough, I rather doubt this will happen to any significant extent (for reasons I will explain in the next *Comment*). Yields of this order of magnitude, even with the proposed corporate tax in 4 years, are attractive enough to provide support at present price levels. Moreover, the current prices have not closed below my lines-in-the-sand at $28 and $12, respectively, offering the possibility of technical support at or near present levels. *Accordingly, I'm going to recommend holding on to the 5% allocation to each of these trusts, expecting a) these high yields to offset any further price erosion that might occur in sympathy will weak oil prices b) the possibility of rebounds as oil prices eventually firm up.* Those of you who are not currently invested in the trusts might consider them as a contrarian play when the current panic afflicting the oil markets plays out. I'll keep you posted.

GOLD: **Longtime subscribers entered the gold market at around $300 per my recommendation right after the 9/11/01 attack and exited with a handsome profit in September 2006 at $600.** Using streetTRACKS Gold (GLD), per my September 28, 2006 recommendation to buy at $57, aggressive growth-oriented investors re-entered the gold market on October 4, 2006 at that price. The most recent uptrend in gold initiated in early October 2006 remains intact, though right on the knife's edge at around $61.65 as this is written. Gold is currently responding (in tandem with plunging oil prices) to the prospects of disinflationary recession, it would seem. Accordingly, I would recommend selling the current 10% position in streetTRACKS Gold (GLD) at a new line-in-the-sand at $61.50 (out below-in above).

The NASDAQ and its surrogate NASDAQ 100 (QQQ) shows clear signs of a technical breakdown, having broken below its 4 ½-month uptrend in mid-December, establishing a series of descending lows and failing to break back above resistance just below $45. In accordance with my previously stated strategy, therefore, I recommend selling QQQ tomorrow, provided the stock does not break out above $44.90.

The Dow hasn't broken down technically yet, so continue to hold the recommended 10% allocation. However, the S&P 500 and its market surrogate, SPDR Trust 1 (SPY), have broken below its 5-month uptrend, though, unlike QQQ, they are not making lower lows, but rather establishing a sideways channel. So we'll give SPY the benefit of the doubt for now, and call for an exit if it fails to sustain support at $140.

FOREIGN CURRENCIES: Both the British pound and the euro are trading on the knife's edge of support. Their weakness does not make much sense in view of the recessionary message being sent by the other markets, particularly the decline in U.S. interest rates. Consequently, I can only conclude that their value is being influenced by the movement of reserves by Asian governments interested in staving off a recession in the U.S. in order to preserve their exports. Accordingly, it might be prudent to exit both ambits if technical support breaks down at $130.80 for the euro and $193.80 for the British pound.

ASSET ALLOCATION: Your personal asset allocation will depend on your particular risk tolerance and investment objectives. Here are some suggested guidelines, for a balanced asset allocation targets for both aggressive, growth-oriented and conservative, income-oriented liquid portfolios *based on current cyclical conditions.*

Aggressive, long-term, growth-oriented liquid portfolios:

- Hold 20% allocation to stocks but be ready to exit to money market (pending further redeployment) if trendlines of support are broken (see "Stocks"):
    - Hold 10% Diamonds Trust (DIA) recommended most recently on September 1, 2006 at $114.70, now trading at $124.41. Line-in-the sand at $123.
    - Hold 10% S&P Depositary Receipts (SPY) recommended most recently on 9/1/06 at $131.42, now trading at $141.62. Line-in-the-sand at $140.
    - Sell: 15% NASDAQ 100 Trust (QQQ or QQQQ) recommended most recently at $39.08 on 9/1/06, now trading at $44.06 (on 1/4/07). Re-enter if it rallies above $45.
- Hold 0%-10% oil-related investments (see "Oil and Gas" for explanation of the range):
    - Sold: 5% United States Oil Fund (USO), purchased October 30, 2006 at $52 at $50 line-in the-sand per November 28, 2006 recommendation.
    - Hold: 5% Penn West Energy Trust (PWE) most recently purchased October 30, 2006 $37, current price $29 yielding about 12%.
    - Hold: 5% Canetic Resources Trust (CNE) purchased October 30, 2006 at $17.50, current price $13.25 yielding about 18%.
    - Sold: 5% Oil Service Holders Trust (OIH), purchased October 30, 2006 at $132.70 at $135 line-in-the-sand.
- Hold 15%-25% in short-term sovereign debt denominated in €uros originally recommended April 28, 2006 at $1.26/€, now trading at $1.31/€. Line-in-the-sand at $1.308. Or hold Euro Currency Trust (FXE) a NYSE exchange-traded fund as a market surrogate, presently trading at $131.72 and yielding 2.9%, originally recommended July 24, 2006 at $126.45 yielding 2.24% at the time. Line-in-the-sand $130.80.
- Hold 15%-25% in short-term sovereign debt in British pounds, most recently recommended for growth-oriented portfolios at $1.86/£, currently trading at $1.95/£ yielding around 5% for bills maturing in 7 months. Hold British Pound Sterling Trust (FXB) a NYSE exchange-traded fund as a market surrogate, presently trading at $195.13, and yielding 4.02%, originally recommended on July 24, 2006 at $185.50 with a yield of 3.9% around the time when it first began trading. Line-in-the-sand at $193.80.
- Hold 5% physical gold (non-numismatic gold coins) originally recommended around $300 after 9/11/01.
- Hold 10% streetTRACKS Gold (GLD) per my September 28, 2006 recommendation at $57, reached on October 4, 2006, currently trading at $63.57. Line-in-the-sand at $61.50 (in above, out below).
- Buy 5%-35% 90-day Treasurys yielding 5.04%

Conservative, risk-averse, long-term, income-oriented liquid portfolios

- Hold: 50% in 90-day Treasurys currently yielding 5.04 % and/or investment grade corporate obligations of the similar maturities yielding 5.25% while awaiting higher interest rates and more attractive bond prices later on in the economic cycle.

Consider Citibank's 6% 6-mo. CD or 5% money-market account. Be ready to increase this allocation to 100% if the euro and British pounds fall below their lines-in-the-sand.

- Hold 25% in short-term sovereign debt denominated in €uros most recently recommended April 28, 2006 at $1.26/€, now trading at $1.31/€. You can use Euro Currency Trust (FXE) a NYSE exchange-traded fund as a market surrogate, presently trading at $131.72 and yielding 2.9%, originally recommended July 24, 2006 at $126.45 with a yield of 2.24% at the time. Line-in-the-sand $130.80
- Hold previously recommended positions of 25% in 2-year British Government bonds originally recommended on August 14, 2005 at $1.81/£, then yielding 4.22%, now trading at $1.95/£ and yielding around 5%. Or hold British Pound Sterling Trust (FXB) a NYSE exchange-traded fund as a market surrogate, presently trading at $195.90, and yielding 4.02%, originally recommended on July 24, 2006 at $185.50 with a yield of 3.9% around the time when it first began trading. Line-in-the-sand: $193.80

Illiquid portfolios/Direct Investments/Commodities/Special Situations:

Direct ownership of oil and gas reserves. These are illiquid, purchased back when oil was selling between $20-$30 a barrel and, therefore, long-term holdings.

That's a wrap. Look for the year-end Comment next Monday.

To *Cassandra Chronicles* subscribers, my apologies for the delay in writing overdue issues. I have only just managed to catch up with my obligations for *Cyclical Investing* following my down time due to surgery last summer. Moreover, I am working on some exciting material requiring a significant amount of reading and research. I can assure you, it will be worth the wait. Thank you for your patience.

If you would like to share the insight contained in *Cyclical Investing* and/or the *Cassandra Chronicles* with friends and colleagues, send along their names and e-mail addresses and we will be happy to oblige with a free 3-month trial subscription. Be sure to tell them to expect it so they won't think its SPAM.

I welcome your questions, suggestions or comments: davidlsmith@iname.com or call (713) 532-6090 during normal business hours.

Kind regards,

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