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2010 and beyond. What does it hold????

In the complicated financial and economic World of today everybody (including ourselves) is trying to figure out 2 things

- Where are we?
- Where are we going?

Is it 1929-1932? Is it 1976-1980? Is it 1980-1982.? Is it 1994 etc. etc. What is the same?? What is different? Why might the future be the same? Why might the future be different?

This document will attempt to be our (CitiFXtechnicals) "roadmap to the future" We will look to answer (or at least pontificate) how we got here, where we are and ultimately (and most importantly) where we might be going.

Before we even begin it is obvious that one size does not fit all when it comes to financial markets .Where there are similarities with history...it is not exactly the same. In looking forward in many cases there are different new potential dynamics to before. The "preferred" comparison to history is not the same across asset classes. What we have in effect is a number of different histories and therefore a number of likely different futures.

We will be wrestling with phrases like. Does history repeat itself? Do people learn from mistakes they read about or only mistakes they make? Do we have to recognize that the fact we even have "history" suggests that we can see things happen that have never happened before (that is how history is made)

One thing is for sure. From a financial market/economic perspective we have gone through something that most people have never experienced in their lifetime. This by definition raises the spectre of outcomes in the future that might not even be close to "consensus" view at this point in time. The greatest skill to have in the months and possibly years ahead in trying to figure this out may actually be an "open mind". Accept nothing. Question everything. Do not presume the correlations of today will be the correlations of tomorrow. With that approach there is at least a possibility that you have a "fighting chance" in figuring out the "path to the future"

Enough pontificating (well not really- there will be plenty in the pages ahead)

We will look across markets and articulate

- Where we think we are
- Where we think we are going
- Why we think it will happen
- What we are looking at that could either validate OR question this view

As always, this will remain a work in progress. Things are unlikely to unfold exactly as we see them today. New events/dynamics will or course shape the direction and conviction going forward. What this document will be is our "starting point" as of today that we will look to build on and adjust going forward.

We will not focus on everything out there (Or we and you could be here for a very long time) but rather of the dynamics/charts that we think are the most compelling at this time.

We hope you enjoy.

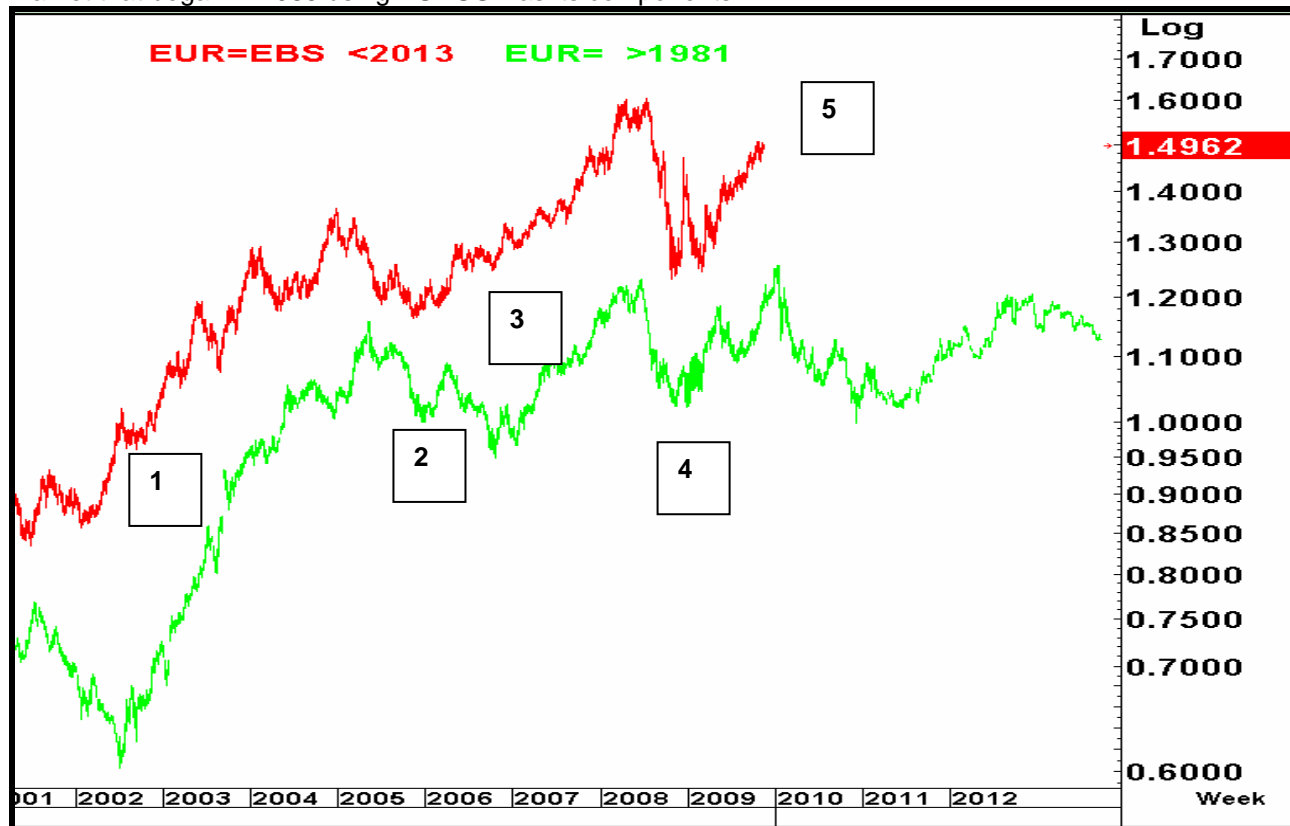
Tom,Shyam, Aron.

Topics we will cover in this document are:

- **FX- Are we in the 1991-1992 dynamic?**
- **Gold- The forgotten currency. A reverse of 1980-2000 or repeat of 1976-1980?**
- **Crude- A downturn like 1990-1991 but no obvious correlation to what happens next**
- **Fixed income- It began in 1981 but could have ended in 2008.**
- **Which approach is next- the “Greenspan put” or the “Volcker pragmatism”? (1989,2000 or 1983??)**
- **Equities- 1929-1942 remains our overwhelming favourite overlay**
- **Conclusions:**

FX- Are we in the 1991-1992 dynamic?

Our starting point here is of course the overlay of EURUSD today and that seen during the last USD bear market that began in 1985 using EURUSD as its components.



Source: Aspen Graphics / Reuters/EBS 16 Nov. '09

1. We have constantly watched this chart since 2004. Initially in 2004 after we saw the period of significant USD weakness since 2002 we looked back to find the last time we saw a period of USD weakness of this magnitude. The period we came up with was the accelerated period of USD weakness seen in 1985-1987. In fact, contrary to popular perception this has not been some calamitous and unprecedented event with regard to the USD. The 1985-1987 move was the equivalent of a move from 0.56 to 1.31 (Or about 87%) while the 2002-2004 move was from around .85 to 1.36 (around 60%- with the low to high move from the .8200 level seen in 2000 was just shy of 67%). The 1985-1987 move saw its main catalyst in the form of the plaza accord:

(The Plaza Accord or Plaza Agreement was an agreement between the governments of France, West Germany, Japan, the United States and the United Kingdom, agreeing to depreciate the US dollar in relation to the Japanese yen and German Deutsche Mark by intervening in currency markets. The five governments signed the accord on September 22, 1985 at the Plaza Hotel in New York City. Source- Wikipedia).

The 2002-2004 move had more traditional dynamics centered on economic slowdown, Fed easing, Equity market falls etc following a very strong USD in prior years as capital flowed into the U.S. markets and assets during the technology boom etc.

2. We then saw a period of USD strength in 1988 into 1989 just as we did in 2005. In 1988-1989 that fall in EURUSD was about 23% while the 2004-2005 fall was only 15%. The 1987 stock market crash never gave us an economic recession and the economy continued to perform well. The Fed reduced interest rates in a knee-jerk reaction to that crash to 6.5% but then resumed the tightening cycle to 9.75% by Feb. 1989. The USD stayed firm until the next easing cycle began in June 1989. The 2005 fall in EURUSD was predominately about HIA (The homeland investment act discussed later)
3. The trend re-emerged in 1989-1991 sending EURUSD (as its components) to new highs just as it did in 2005-2008. In 1989-1991 that was a move of just over 40% while in 2006-2008 it was a move of

around 38% (Interestingly for the first time the move was very similar in percentage terms (Although the time frame of the move was slower in the 2005-2008 period at around 34 months compared to 23 months in 1989-1991.) Of course we all know that 1989-1991 was a period of aggressive Fed easing from 9.75% to an eventual 3% low in 1992 as the credit/housing/savings and loan crises sent the economy into recession (Sound familiar). Amazingly despite the fact that we were watching this chart initially from a simple overlay/analog perspective (Existing bear market compared to prior bear market for the USD) the fundamental picture converged to the technical picture- not vice versa.

4. Then in 1991 we saw a sharp fall away in EURUSD by just over 21% in 5 months compared to just over 23% in 2008 over about 4 ½ months. This was the first trending move that saw a bigger percentage move in quicker time than that seen in the prior trend. One could argue that both of these developments were “event driven” as is often the case with sharp moves like this. In both instances the USD was at the peak of a sharp downtrend driven by similar factors as per above. At the same time in both instances the situation was made worse by a huge Oil spike (From \$15 to \$40 over 4 months in 1990 (or about 166%) and from \$86 to \$147 over 5 months in 2008 (or about 71%). The 1990 move was driven by the Iraq invasion of Kuwait leading to both the oil price hike and the continuation of USD weakness. In 2008 the surge was more due to financial market bubbles/excess. By end Feb 1991 Crude was back to \$17.50 and by Dec 2008 it was amazingly back below \$33. As Gulf War 1 began in early 1991 and in the background the Soviet Union crumbled we saw the USD strengthen dramatically. In 2008 the asset market/liquidity collapse was the event that saw sharp USD demand.
5. The lows in EURUSD were established in July 1991 and October 2008 respectively. In 1991 that became a platform that saw EURUSD rally just under 31% over 14 months. A repeat of that move would give us a EURUSD exchange rate of 1.6100 by end December this year. As we know not all these moves have been identical in depth and timing but the relationship has certainly got closer.

Grid comparing the 2 bear markets for the USD

| 1985-1992 | | | | 2002-2009 | | | |
|-----------|--------|----------------|------------------------------------------------|-----------|-----------|----------------|--------------------------------------------|
| Years | Months | EURUSD% Change | Context | Year | Months | EURUSD% Change | Context |
| 1985-1987 | 34 | +87% | Plaza Accord | 2002-2004 | 34 | +60% | Post Internet Boom |
| 1988-1989 | 17 | -23% | Fed tightened to 9.75% | 2004-2005 | 11 | -15% | HIA |
| 1989-1991 | 23 | +40% | Fed Easing/S&L Crisis | 2006-2008 | 34 | +38% | Housing/credit crisis and Fed easing cycle |
| 1991 | 5 | -21% | Post Oil Spike/Kuwait Invasion | 2008 | 4.5 | -23% | Liquidity crunch |
| 1991-1992 | 14 | +31% | Fed continued cutting from 5.75% to the 3% low | 2008-2009 | 13-So far | +21%-So far | Credit Crisis Recovery (?) |

Other points worth noting are the timings and depth of the overall moves.

- o **1985-1992 bear market:**
- o From the low to the high was a move of **159% over just over 7 ½ years.**
- o **Present bear market:** Using the absolute low of .8228 in October 2000 this bear market has been in pace over **9 years and has seen a low to high move of 95%.** That would make it much slower and less aggressive than the last bear market. If we use a starting points as just below .8600 in Jan 2002 (Which is our bias given that this was really when the bear market for the USD began in earnest having chopped around between October 2000 and end January 2002) then it would have argued something in the region of us being over **7 ½ years through this move and sitting about 75% off the lows.**
- o If we wanted to be “way out there” we could say “USD crisis what crisis” or “Call that a bear market, let me show you a bear market” A low to high move in percentage terms equal to that seen from 1985-1992 would give a EURUSD exchange rate of aboutwait for it.....**2.15.**

After September 1992 we saw a period of USD strength against the EURO that saw it fall from nearly 1.46 to the low just over .8200 in 2000. This came in the period leading into the technology revolution and a continued structural bull markets in assets:

- Equities after their 1987 hiccup remained in a structural bull market with the odd cyclical bear market until their peak in 2000
- Housing had bottomed in early 1991 and began a bull market that lasted 15 years into early 2006 (In the last 50 years outside of this time we had never seen a bull market longer than 6 years)
- Fixed income remained in a continual structural bull market interspersed with cyclical bear markets until a higher peak in price/ low in yields in December 2008.
- Overlaid on this was a boom in credit that began in the early 1980's and continued all the way into 2007. Until the "beginning of the end" i.e. the Equity market blow up that started in 2000, we had the perfect storm of bull markets in assets and credit which stimulated the consumer. This led to strong economic growth (leveraged), low unemployment (leveraged), strong wealth creation through assets markets (leveraged) and as the economy became more global with the U.S. leading the way
 - An external appetite for U.S. assets
 - A build up in reserves of the instrument that was now backing the global financial system- the USD, causing
 - A multi year period of USD strength before in 2002 the World began to change again.

So going back to the USD and the leaving the "history lesson" to one side. We have seen the past. We see the present. What does the future hold? Is the dynamic going to continue? We are still very much of the view that we will see another move higher in EURUSD towards new highs in the move (Low 1.60's) by late this year or maybe into 2010. That is all well and good but we are already at 1.50. Much more important is ...what will we do next??? If this overlay were to remain valid it would suggest many years of USD strength in front of us thereafter. If not, could we see even more USD weakness than already seen. This really will be a work in progress but we feel an important thing to do in this regard is to look at what type of things could be important here. This list is not exhaustive by any means and at the end of it we do have a bias which as we said will of course likely be a work in progress for some time to come.

Factors that could create another sustained period of USD strength (By sustained we mean at least multi-month if not multi-year and probably at least 15-25% USD appreciation):

- **Intervention:** We know that the Plaza accord of 1985 was instrumental in the trend that saw a sustained trending move in the USD (Then USD weakness). While a co-ordinated commitment to intervention would without doubt be a big development it does not look to be in the pipeline. The USD is not collapsing. It is weakening when there are few inflation pressures in the U.S. and monetary and fiscal policy is stretched. Gradual weakening is not disruptive (Even the Europeans talk about aggressive moves more so than direction). A weakening USD helps U.S. multi-national companies recover, devalues debt, revalues assets etc. etc.
- **Fed hikes.** While this would certainly likely cause a knee-jerk reaction in favour of the USD (especially if close to its lows at the time) its ability to create a sustainable rally would likely be path dependent on how robust a recovery was taking place and whether that would translate into demand for U.S. assets and/or cross border flows. In itself it would not likely be trend changing.
- **Another credit crisis:** At this point there is nothing that seems to point to this. Credit spreads have improved, financial de-leveraging has taken place and we now appear to be in a period of "economic deleveraging. This is likely to stretch over a more sustained period of time and create less "fear and volatility"
- **H.I.A. 2:** If economic recovery is not forthcoming this could gain favour as a possible stimulus measure. HIA 1 (Homeland investment act) took place in 2005 and encouraged U.S. corporations to repatriate profits held overseas for a variety of investment purposes. Favourable tax treatment was the "carrot" that induced this. We did indeed see significant repatriation in 2005 that saw substantial USD demand and a fall in EURUSD from 1.3670 to 1.1640 as the market got caught short USD and reserve diversification seemed to go a little quieter.
- **Huge external demand for U.S. assets:** A big ask given that Equity markets are unchanged for a decade and have just had a huge multi month bounce. Treasury issuance given the size of the deficit

is a concern and housing remains in the doldrums. At this point there are also few signs of big overseas M&A demand for U.S. companies.

- **Big move to greater fiscal and monetary discipline** : As we have seen with a lot of companies, policies that are potentially positive for the business model by repairing the balance sheet, taking the pain, becoming more mean and lean can be rewarded with a positive move in the share price. We continue to view the USD as the “share price” of the U.S. economy. Such policies on a monetary and fiscal basis might indeed be “supportive of the share price” but we still seem to be in the “share dilution” mode as long as we can continue to “issue” (print) more shares. A “strong share price” is in the interests of the “company” but is unlikely to materialize until tough decisions are made and the “company” itself shows signs of returning to strength. At this point...we do not appear to be heading in this direction.
- **A change in policy in Asia/EM:** Asia and China in particular are reluctant to allow their currencies to appreciate significantly against the USD. This is also become true of other countries such as Brazil and could extend to others (e.g. South Africa). While this continues to be the case and in the absence of a significant revaluation on the CNY against the USD these countries are going to acquire more and more “shares” in U.S.A. Inc. As a consequence, in today’s global economy, they are likely to diversify those “shares” further into other “Countries/Economic zones Inc.” with Europe being the area in the developed World with comparable size and breadth.
- **Financial and or economic shock in Euro zone:** The trouble with this is that firstly it cannot be “planned for” People have tried that trade on a number of occasions in the last few years to no avail. Also as we saw with Japan and to a lesser extent recently with the U.S. trouble at home can also lead to a repatriation of funds. So it is not clear that such a development would be conclusively bearish the EURO.

Factors that could see the USD continue to weaken for even longer and even farther than our 1.60+ bias against EURUSD

- **Monetary policy:** Zero per cent interest rates speak for themselves and if sustained would likely allow the USD to retain that funding currency status. Even a hike, while likely to give short-term boost may not in itself change the trend.
- **Fiscal policy:** Remaining expansionary to support recovery while monetary policy is also extremely expansionary.
- **Triple deficits:** Trade, current account and budget deficits remain a drag. While we may have seen some improvement on the trade side (partially from Oil) the budget deficit has deteriorated (with potential implications on current account as well). The playing field is not level. You need a significant amount of USD demand just to balance out the ongoing flow of USD supply.
- **Reserve diversification:** As mentioned above the present reserve diversification policies create ongoing USD supply with the EURO being the main “beneficiary” of those flows. That is before you think about the policy that has been going on for many years of building “outsize” levels of USD reserves as the economy became more global. As a consequence these reserve holders became more tied to the USD and a consequence more tied to U.S. monetary and fiscal policies. For a FIAT currency to be a backing for the system it requires discipline and confidence. One might argue that the U.S. has not had/does not have the first and the reserve holders do not have the second.
- **European versus U.S. policy:** There is a phrase “be careful what you wish for”. The Euro zone was established to be an economic and financial zone to compete with that of the U.S. with the EURO being the linchpin. Nowadays you hear that the intention was not to provide an alternative reserve currency. Too late...it is here. In addition as it becomes obvious that “members” of the Euro will be “protected” within the fold you really create a “de facto” European bond market. While we still see the existence of spreads between German 10 year yields and other members they have narrowed significantly from their highs. Unfortunately the likes of Ireland, Spain etc. will likely have to pay a heavy price for this support in the area of fiscal consolidation and will have no “out” through the interest rate structure or exchange rate which they do not control. The power now lies firmly with the centre (Germany). Ironically because of history one might argue that the great fear in Germany would likely be the history of the “Weimar Republic” and hyper inflation while in the U.S. the fear from history is the “Great depression” and the “Japan lost decade” as a consequence of deflation. While time will tell what the outcome is it does not take a rocket scientist to see which policy is more likely to retain the “real value” of the “share price” a.k.a. the currency. For us, Europe, and thereby the EURO wins this battle hands down

- **Comparison to previous downturns in the U.S. over last quarter of a century:** We are looking at the most severe housing and credit crisis of this generation and see equity markets unchanged for pretty much a decade (and S&P still 30%+ off the 2007 high). Given the expansionary monetary and fiscal policies we see now and also given that this is a more severe backdrop than any seen in this quarter century it is not a stretch by any means to expect more USD weakness than in other episodes. Do not get us wrong, we do not think the USD will actually collapse. Why? There is a phrase attributed to a well known business figure that purports to go something like. "If I owe you a million dollars I have a problem. If I owe you a billion dollars you have a problem" The reserve holders in this World "have a problem." They are too exposed to the USD and U.S. fixed income but to just go and sell is like "shooting your toes off". We believe it is far more likely that you will see a "managed depreciation" of the USD over time similar to how the developed world had a managed rebalancing of their Gold reserves into the lows in 1999-2001. (That was an almost 20 year downturn in Gold) While Gold had interim periods of strength it did not stop going down until those central banks got to their preferred level of "diversification". If you do not believe the reserve holders of today have "got to where they are going" it is hard to see where the period of sustainable USD strength comes from.

Put in perspective: Since the period of trending USD weakness began in 2002 with the exception of the "event driven demand for U.S. Dollars (HIA in 2005 and the credit squeeze of 2008) EURUSD has never fallen high to low more that 11.7 big figures.

When we examine the factors on both sides we cannot help but feel "skewed" towards the idea that not only could we see a further move to and above 1.60 in the months ahead but that there is a real danger that this trend will be longer and go further than just about anybody is thinking at the moment.

In this instance while there could be leads and lags elsewhere this dynamic is likely to be also evident against other developed and possibly developing currencies.

Some interesting calendar events in this prior period were:

8/9/1989 – Financial Institutions Reform, Recovery, and Enforcement Act

- created Office of Thrift Supervision (regulation of savings institutions)
- created Federal Housing Finance Board (overlook 12 federal home loan banks)
- created Savings Association Insurance Fund (continued insurance fund for thrift institutions, insured savings and loan accounts up to \$100k)
- Freddie and Fannie were given additional responsibility to support mortgages for low/moderate income families

Banks under conservatorship or receivership (not cost, assets covered)

1989 – RTC covers \$134 billion (318 thrifts) 1990 - RTC covers \$129 billion (213 thrifts)

1991 - RTC covers \$79 billion

Gold- The forgotten currency. A reverse of 1980-2000/repeat of 1976-1980

A smarter man than us recently said that Gold is his favourite “**CURRENCY**” ...not commodity “**CURRENCY**”

That to us sums all the below in a nutshell. In fact not only is it also our favourite CURRENCY but also our favourite asset.

Gold-weekly chart



Source: Aspen Graphics / Reuters 17 Nov. '09

- Gold continues to trade well technically having broken out of the triangle formation and through the neckline of the inverted head and shoulders.
- Subsequently that neckline was re-tested before it moved higher to new all time highs. This head and shoulders targets a move towards \$1,340 and we would not be surprised to see this level by end Q1 2010.

However, overall we retain our view that Gold will eventually rise above \$2000. Funnily enough you will often hear mentioned in “fundamental circles” that on an inflation adjusted basis the peak in Gold at \$873 in 1980 would translate into a price of around \$2,000+ in today’s terms.

Our target above \$2,000 is more simplistic.

Gold-Monthly chart



Source: Aspen Graphics / Reuters 17 Nov. '09

- The last bull market in Gold (1976-1980) was a move (low to high) of 764% (Just happens to be our favourite Fibonacci number).
- A replication of that percentage move off the \$253 low would give a level of \$2,185
- If the present pace of appreciation was maintained (No acceleration or deceleration to this trend of impulsive moves and consolidation periods) then end of 2012 would actually be the logical timeframe.
- For choice, we would think it could be earlier as strong trends often reach their peak with an acceleration in the move. A classic example of this was seen in the last bull market. It took 3 years and 2 months to rally \$340 (from \$101-\$441). It then corrected to \$365 the following month and rallied another \$408 in 2 months to the Jan. 1980 high at \$873. (Event risk did help here with the Russian invasion of Afghanistan)

We have on a number of occasions expressed the view (and still do) that this does not look to be an "inflation hedge" move but rather a confluence of other factors.

- USD weakness: This is the basic argument that the USD is weak, Gold is priced in USD, therefore Gold goes up. This ignores the fact that during the material periods of USD strength (USD-Index) since the peak in 2001 the dynamic has been
 - **2001-2002:** USD-Index bounces over 8% but Gold in this period loses only just over 2%
 - **2003:** USD-index again bounces over 8% and Gold **RISES** about 4%
 - **2004:** USD index rises 9% and Gold falls 8%
 - **2005:** USD-index rises 15% and Gold falls about 3%
 - **2008-2009:** USD-index rises nearly 27% and Gold falls about 7%

Grid of Gold DXY dynamic- Sows Gold outperforms other DXY components during periods of USD strength.

| Year | DXY % Change | Gold % Change |
|-----------|--------------|---------------|
| 2001-2002 | +8% | -2% |
| 2003 | +8% | +4% |
| 2004 | +9% | -8% |
| 2005 | +15% | -3% |
| 2008-2009 | +27% | -7% |

Since July 2001 the USD has lost over 300% against Gold while the USD within the USD-index has lost 60% (Inverted USD-Index so as to compare like with like by making USD the term currency). So the argument that this is just about USD weakness shows up for what it is. Utter nonsense. In the same period the Equity market is down about 13% (S&P)

So bottom line on every significant USD rally during this period Gold has fallen less against the strong USD than the other components of the USD-index and in one instance actually rose against a rising USD. In reality 2008-2009 was probably its most impressive performance when it lost just 7% against a USD that rose nearly 27% against the index components.

Given that the USD has been in a bear market over this period the picture is clear. Since the unraveling of the heady days of the FIAT currency/asset market bubbles began with the Equity market turn in 2000 Gold has been the dominant “currency” in the developed world. This after being held down artificially by the constant sales of Gold reserves by developed nation countries into the low.

We have articulated before and will do so again that the belief that we were in this great economic moderation of unparalleled prosperity over this period was (to some extent) a mirage. Policymakers believed there was no inflation and continually drove interest rates lower as a consequence. The reality is there was little inflation in the “traditional” sense at consumer level.

Productivity, low wage settlements, technological revolution, cheaper goods from developed nations with managed currency regimes etc all served to fuel this. **The reality is that there was huge inflation. Where?**

- Credit
- Fixed income markets
- Equity markets
- Housing markets
- Reserve accumulation (Reserve accumulation stopped the USD falling to where it should thereby preventing the natural balancing process that should have led to a weaker currency, inflation, funding issues etc)

But this is not inflation that you would buy Gold to hedge against. During most of this period a “blind man” was an “investment Guru” You just needed to own the asset (Fixed income, credit, housing, equities etc). There was no need for the piece of “useless yellow metal that earns nothing” It was, by definition, the ultimate “Global Ponzi scheme” (You borrow money from us to buy our goods. We lend you the money back to buy more goods. We build up savings. You build up debt. We restrict the weakness of your currency so you can continue to buy our goods in a non-inflationary environment. This reduces your interest rates allowing you to borrow more money against the inflated assets to buy more of our goods. Happy days.

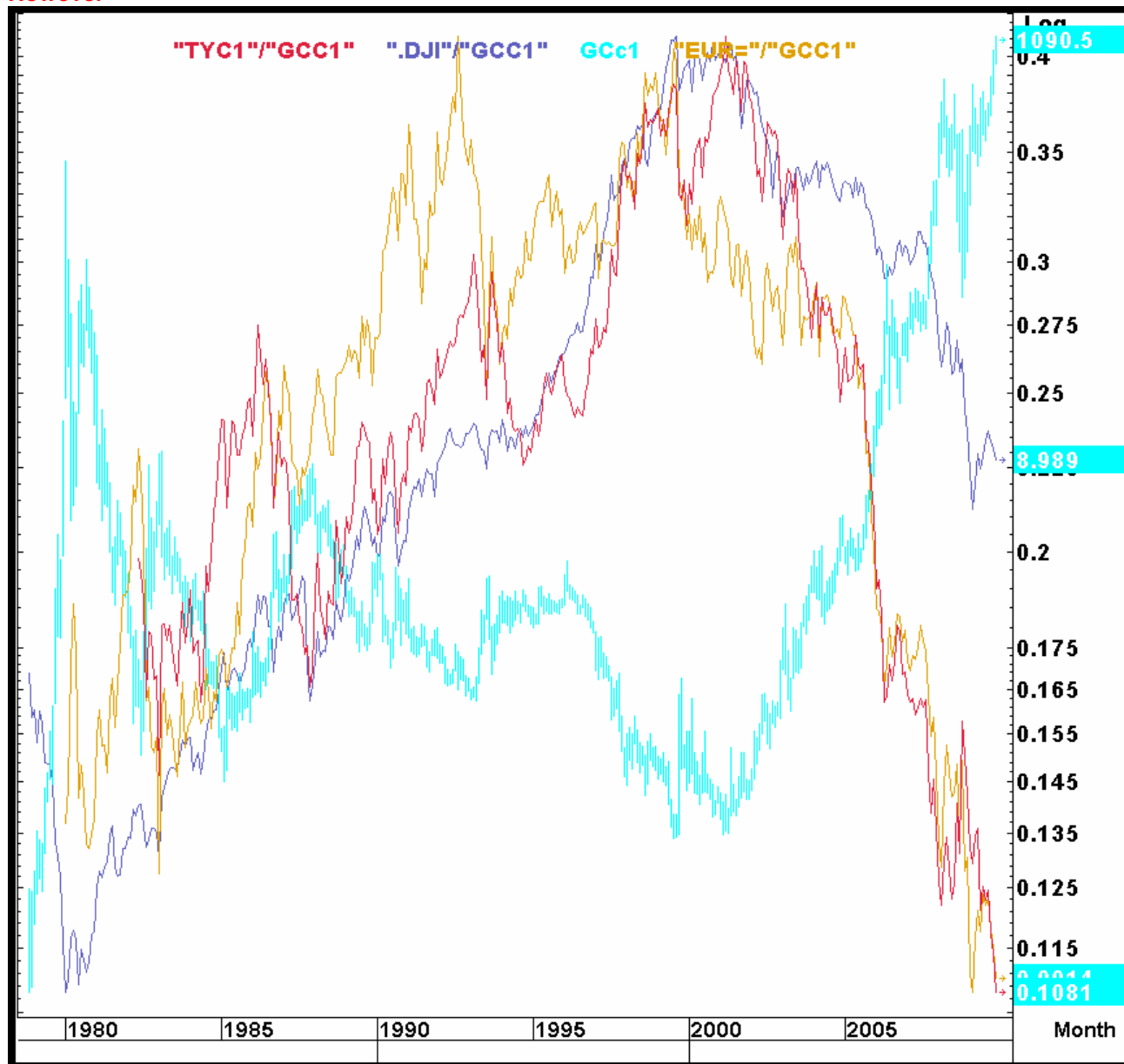
However it is a bit of a shame that when the music stops all your discretionary purchases made with credit are obsolete. You have no savings. You have built up huge debt. Your assets are falling in value and your inflated wealth is now deflating. Have a good day.

We (The savers), however are in a strong fiscal position with large reserves and savings which will now “tide us through” for some time to come. In addition we will now diversify our “stash” into other FIAT currencies and assets (Including Gold whose supply you cannot increase on an infinite basis courtesy of Hewlett Packard (Printers) and Hammermill (Paper))

But we digress...back to the “yellow stuff”

As we can see below. During the period of “Economic moderation” and “Nirvana” in asset markets. Gold was “not needed” the FIAT currency system was “just fine without it thanks”

However



Source: Aspen Graphics / Reuters 05 Nov. '09

Since 2001 the shoe has been firmly on the other foot and Gold has been an out performing asset...period.

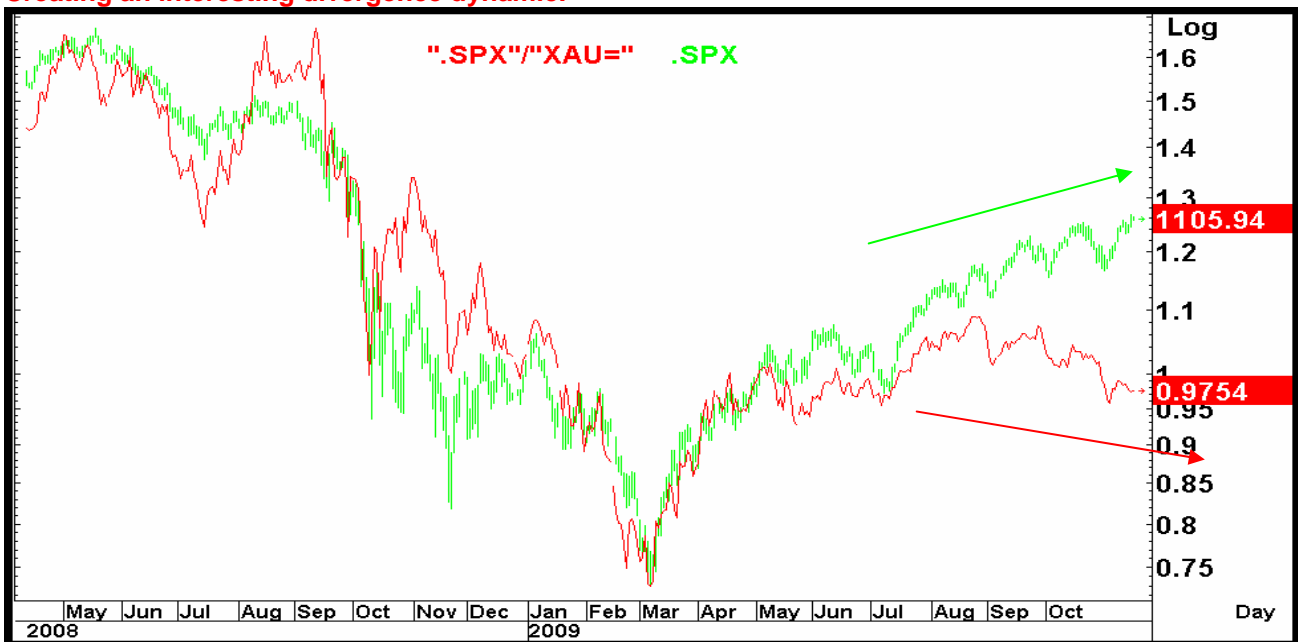
At this juncture, given the continued financial and in particular economic uncertainty, we continue to believe that Gold will retain the “store of value” moniker that has served so well over the last 8-9 years.

Since August Gold has started to outperform the S&P again



Source: Aspen Graphics / Reuters 17 Nov. '09

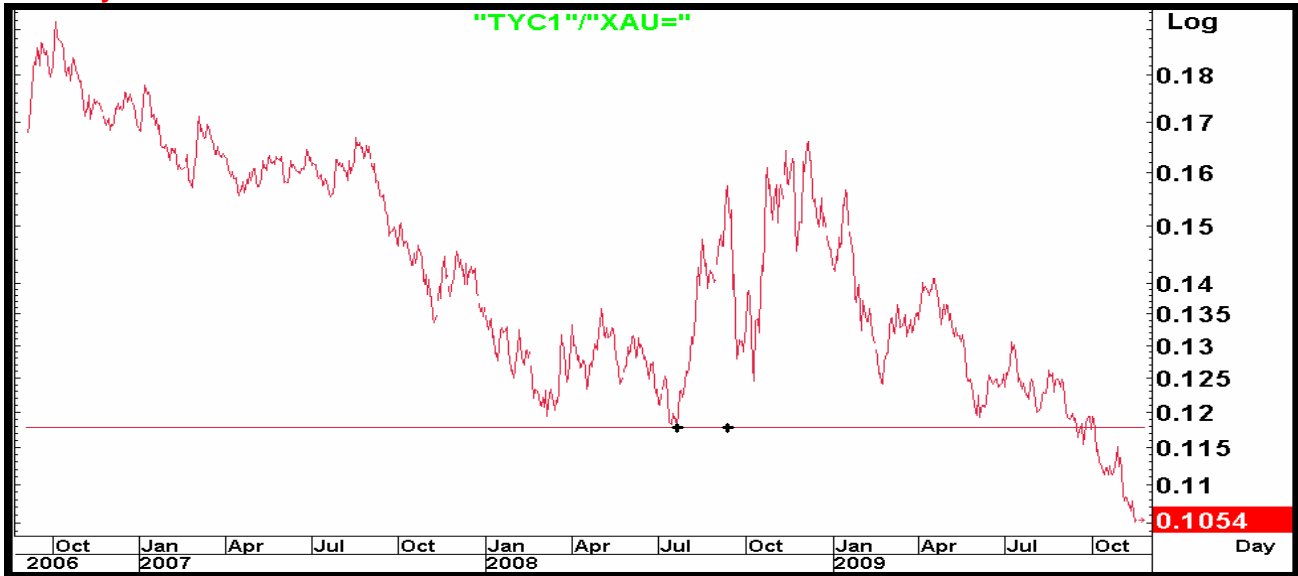
Creating an interesting divergence dynamic.



Source: Aspen Graphics / Reuters 17 Nov. '09

- Pretty much since the rally in equities began in March the S&P has been in the “ascendancy” when it comes to Gold- Outperforming all the way up...UNTIL
- In August the S&P hit a new trend high as did the S&P Gold ratio (S&P rules the roost). However since then as the S&P went on to set a higher high in September and again in October and November the ratio set lower highs i.e. Gold started to outperform. In fact in the chart above you actually have quadruple divergence between the ratio and the S&P. This does not have to mean that the S&P is going to take a big hit but rather that its days as an out performer to Gold may be numbered at this point.

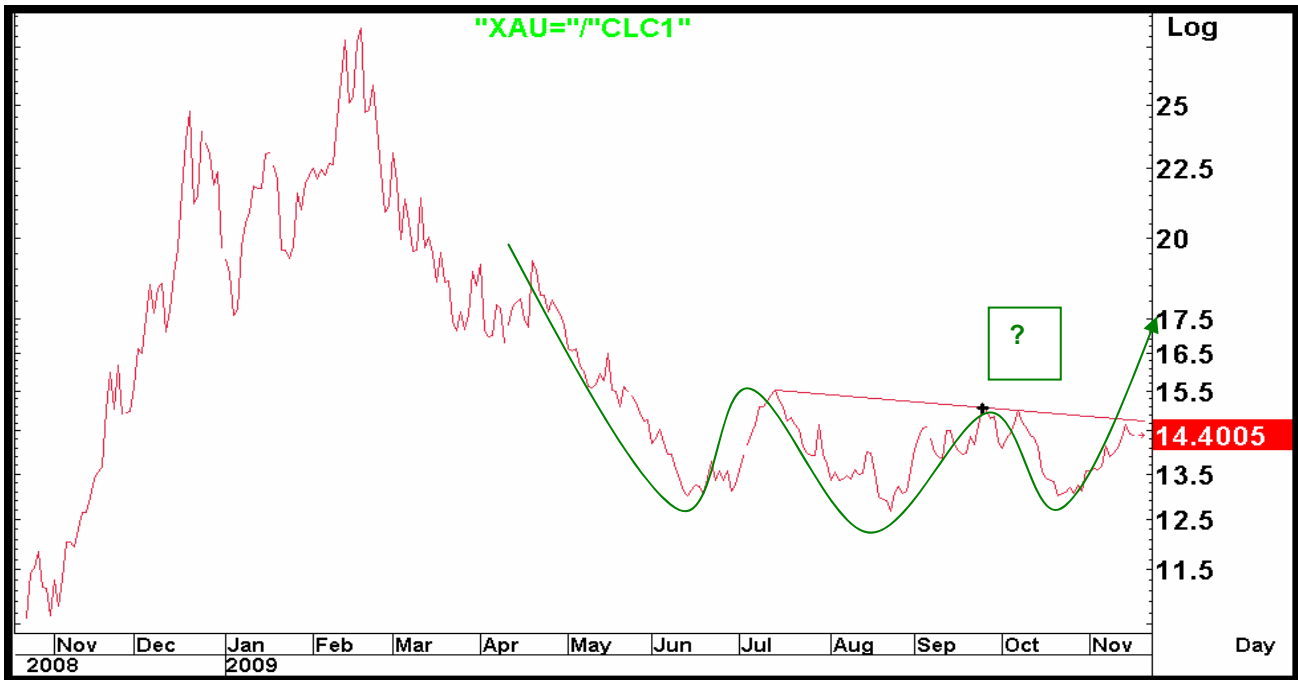
U.S. 10 year note versus Gold



Source: Aspen Graphics / Reuters 17 Nov. '09

- After the peak in December 2008 fixed income has been under performing Gold in a fairly straight line fashion with this ratio breaking to new lows in the move in recent weeks.

Gold/crude ratio

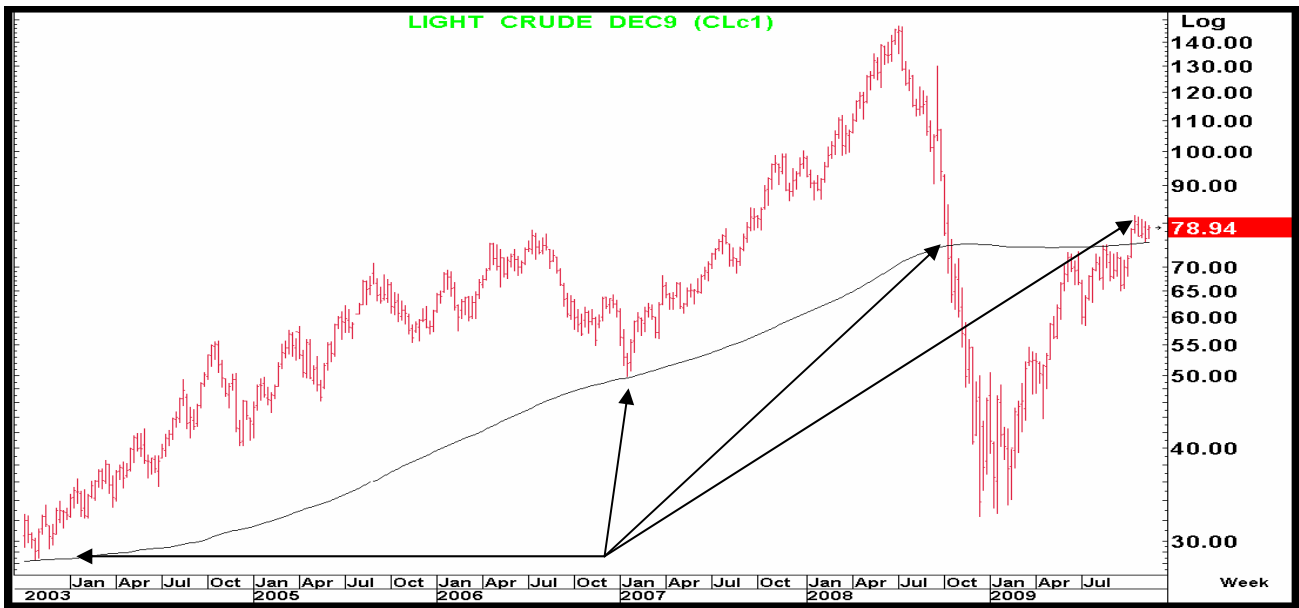


Source: Aspen Graphics / Reuters 17 Nov. '09

- Since Starting its rally in February Crude is up about 140% and continually out performed gold into August.
- Now however this ratio looks to be forming an inverted head and shoulders pattern with a neckline at 14.83.
- A break above here would complete this pattern and target a move towards 17.5
- Such a move would suggest that Gold could out perform Crude by as much as 25-30%

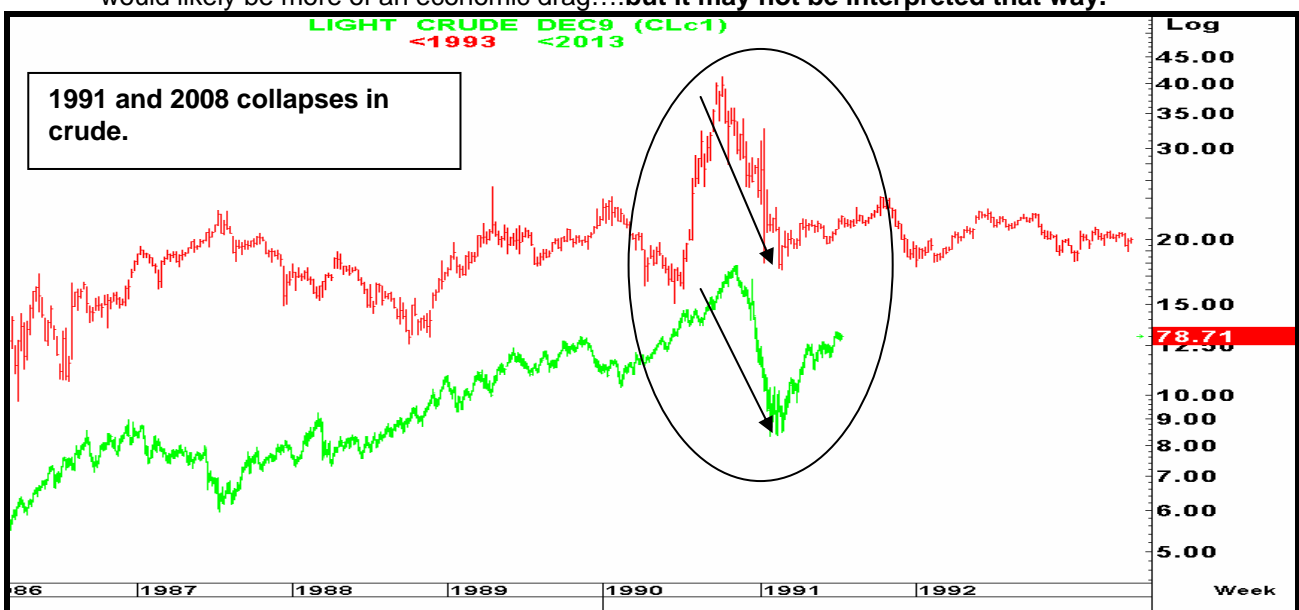
So not only do we believe that Gold is setting up for a period of good performance against the USD, we also believe it may be re-asserting strength against other currencies and asset classes as we head towards 2010

Crude- A downturn like 1990-1991 but no obvious correlation to what happens next



Source: Aspen Graphics / Reuters 16 Nov. '09

- Since Crude Oil started the strong rally off the 200 week moving average in October 2003 at \$28.28 (A move that took us to new all time highs and well beyond) this average has been pivotal in its major moves and corrections for Oil.
- In Jan 2007 it was revisited during the downward correction that took Crude to \$49.90 when the 200 week moving average stood at \$49.66. This became the platform for another rally that took us to the all time high above \$147 in July 2008.
- The next time the 200 week moving average was tested was during the **week of 13th October 2008** when it stood at **\$74.71**. The weekly close below this average that week set in motion the next leg lower that culminated in the move to \$32.40 by December that year.
- The subsequent rally tested this average (and held) in June and again in August and amazingly it broke on a **3rd test in the exact same week that it tested and broke last year**.
- Since then Crude has been consolidating above this moving average break and looks to be setting up for another move higher to at least \$85 if not above \$100 in the weeks and months ahead.
- **IF** this happens what will be important is not just where it goes but why. Given the present consumer dynamics it is hard to believe that this is about domestic U.S. demand and therefore such a move would likely be more of an economic drag....**but it may not be interpreted that way.**



Fixed income- It began in 1981 but could have ended in 2008.

- Often it is the case that our starting point in our “pontifications” about the World comes from a compelling long-term chart.

*****Below is just such an example from a bulletin in early March 2007*****

While we found it hard to imagine that we would see a move of the magnitude suggested in the chart (And in fact yields in the following months actually did head up to post a marginally higher high in the trend) It did focus on the directional bias and the need to figure out what was going on....and we know what happened thereafter

U.S. 10 year yield chart



Source: Aspen Graphics / Reuters/March 2007

Remains another compelling chart with a well-defined channel that has captured the significant peaks and troughs of the last 15+ years. With the troughs very symmetrical at 1993,1998 and 2003 and the peaks in 1989,1994,2000 and 2006 it shows the strength of the trend with each subsequent trough being achieved at quicker periods (Last 3 troughs are 5 years apart with peak 6 years apart)

The above picture suggests that the next trough in yields could be

1. As early as late 2008
2. Lower than that seen in 2003 (which was 3.07%). In fact a continuation of the last 15 years would suggest (extreme we know) levels closer to 2%.

We fully accept that a trend of lower highs and lower lows cannot go on forever (because as Japan saw...you eventually reach Zero). Time will tell if this really becomes a move towards 2% but whatever the case we firmly believe that significantly lower levels than we are seeing today are achievable.

(Oops)

Obviously that is now ancient history but is a good precursor for the chart below.

This is one of our favourite fixed income charts here which is the continuation chart in price of the long bond (30 year)



Source: Aspen Graphics / Reuters 16 Nov. '09

- In January of this year we put out a note stating that we thought the Dec 2008 high in price (Low in yield) signaled the culmination of a 27 year bull market in U.S. Government bonds.
- As usual the original focus was very much technical in the belief that this was just a classic chart.
- What you see is the initial acceleration higher in the early 1980's as the U.S. economy went into a severe recession on the back of the aggressive tightening by the Volcker Fed to weed out inflation.
- Following the sharp fall in 1986-1987 and the stock market crash of 1987 under a new Chairman at the Fed (Alan Greenspan) the "Greenspan put" was born. Thereafter any "hiccups" in the asset markets/the economy/employment were quickly addressed with Fed easing (All gain no pain) while tightening of policy was much slower (Fed waiting until it was sure the all clear had arrived) We therefore went through this huge period of economic moderation, bullish credit markets, bullish equity markets, bullish fixed income markets and "peace in our time"
- Of course this can only continue until you run out of space ...well ZERO% Fed funds rate during a bear market in Equities, housing and credit all at the same time is running out of space. Fixed income exploded to the highs in the second half of last year as the financial crisis kicked in. thereafter we saw one of the largest down months in the history of this bull market in January. We fell below the breakout point of the prior 5 year consolidation and have since been range trading while struggling to regain those levels around 123. If we eventually head lower again and break the base of this channel (around 111) we will be looking at a likelihood of seeing something that has not happened in this whole period-A bear market in fixed income where 10 year yields could post a higher high after years of lower highs and lower lows (i.e. above the 5.33% peak of the last cycle and likely as high as 6% by 2012)
- **What will cause this if it happens?** At this point it is hard to see that the argument is one of inflation. With a sluggish economy, high levels of unemployment, low wage settlements, commodities a long way from the highs (Crude in particular) and our view of a managed depreciation of the USD it is hard to see the inflation focus. You cannot rule it out as inflation is essentially a monetary phenomenon but the down turns of the last 25+ years have tended to suppress consumer inflation for as much as 4 years at a time. (Asset inflation...well that is a very different ball game)
- So at this point our concern is more about supply and dangers like
 - Continued fiscal deterioration in a sluggish economy
 - Foreign holders seeing this getting more inclined to shift down the curve and/or reallocate to tighter Fiscal/monetary regimes like Europe for example.
- All it really takes is for the U.S. to change from being **THE** Reserve currency of the World and **THE** bond market to being the **MAJOR** reserve currency and the **MAJOR** bond market while running the largest peacetime fiscal deficit and it does not take a genius to work out that the cost of funding may not be sustainable at these low levels.

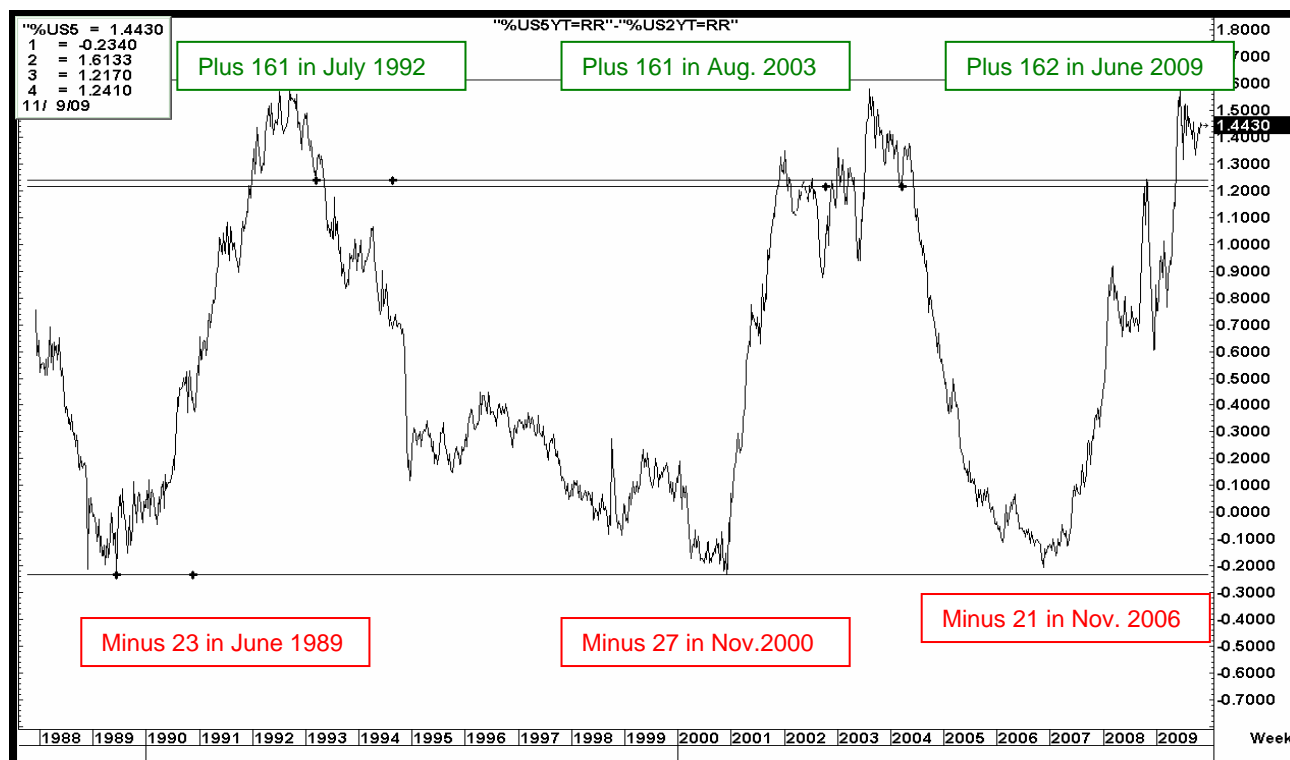
The other interest rate market chart that we are watching closely is the one below.

Market Commentary

Which approach is next- the “Greenspan put” or the “Volcker pragmatism”? (1989, 2000 or 1983???)

- **U.S. 2's versus 5's yield curve (Re-print from our chart of the week last week)**

Is this the best interest rate chart on the planet for the last 20 years? Probably



Source: Aspen Graphics / Reuters 12 Nov. '09

- So essentially the 20 year range for this chart has been encompassed by 2 levels (minus 20 and + 160 basis points).
- It has moved marginally through these levels on both sides 3 times each but has never been able to sustain a move further.
- Taking this 1 step further each time it has inverted more than 20 basis points it has provided us with 4 things
 - A base in the move
 - A warning that “all was not right” leading to asset market stress and an economic downturn
 - A Fed easing cycle.
- **1989:**
- Low is put in on 16th June.
- **Fed makes its first cut** in the cycle from the 9.75% tightening high **on 5 June 1989** to 9.625%. This would be a cycle that would eventually bottom out in Sept 1992 at 3%.
- The 1989-1991 period was characterised by a housing downturn, savings and loan crisis, economic recession etc. Housing starts would base on Jan 1991 but unemployment would not peak until June 1992 while core PCE (Inflation) would continue in a straight line lower until January 1994 at 2% from a 4.7% double peak in Feb 1989 and Sept. 1990.
- **A new tightening cycle did not start until Feb 1994** as inflation started to tick up slightly and the January print on the unemployment rate was down to 6.6% from the 7.8% peak.

This was the classic Alan Greenspan Fed cycle (Born I suspect of him having just taken over at the Fed prior to the baptism of fire of the 1987 stock market crash during a period of more hawkish rhetoric). The stage was set for policy here. It was- Be very quick to ease if warning signs develop but very slow to tighten until you were sure that you had the all clear.

This over the years became affectionately known as the “Greenspan put” (Personally we would have a very different and less affectionate description)

- **2000:**
- Low is put in on 27th November
- **Fed makes its first cut** in the cycle from the 6.5% tightening high on 03 Jan 2001 (Slight lag compared to 1989). This would be a cycle that would eventually bottom out in June 2003 at 1%.
- The 2000-2002 period was characterised by an equity market downturn with no credit squeeze or housing issues like we saw in 1989-1991 and indeed 1980-1982. Housing starts actually continued to rise in 2000-2002 having turned in Jan 1991. So in fact housing had already been in a “bull market” for 9 years (In the past 50 years there had never been a continual bull market in housing for longer than 6 years). This was important because this resilience in housing and lack of credit stresses fed all this liquidity into the transmission mechanism. Consumers got more and cheaper credit, were able to take equity out of their property etc and the underlying economic downturn was much more mild than the 1980-82 and 1989-91 periods.
- Unemployment peaked in June 2003 and core PCE hit its 1.4% low the same month.
- **A new tightening cycle did not start until June 2004** with core **PCE** at 2.2% and the May print on the unemployment rate was down to 5.6% from the 6.3% peak.

(Note: the Fed did engage in some “tinkering” with rates in the 1995-1996 periods (6% to 5.25%); 1997 (5.25% to 5.5%); 1998 (5.5% to 4.75%); 1999-2000 (4.75% to 6.5%). This was just “managing” the tightening cycle every time there was a “hiccup” and remained very supportive of the housing market overall. This helped to provide us ultimately with a 15 year bull market in housing when in the last 50 years we had never had one longer than 6 years (Oh dear)

- **2006:**
- Low is put in on 24th November- But there is a new “sheriff” in town. This indicator has dominated the economic cycles for a quarter of century and has only hit this point twice prior in that period.
 - 1989 during the housing/credit/savings and loan crisis.
 - 2000 during the aggressive 2 ½ year bear market in equities
- Both these events induced an economic slowdown (The worse one, by definition, the one that came from credit and housing).
- This new Fed was establishing its credentials. In particular questions were being raised about their “inflation fighting: credentials” (Helicopter Ben etc). In addition all the “talking heads” were saying “it’s different this time”. “The inverted yield curve is a distortion caused by the Sovereign wealth funds loving our bonds” Yeah right....how wrong could that view have been. However as a consequence.....
- **Fed makes its first cut in the cycle from the 5.25% tightening high 18 Sept 2007** (huge lag compared to 1989 and 2000). This would be a cycle that would eventually bottom out in December 2008 at 0-0.25%. (We presume bottom out because there really is nowhere left to go)
- The 2007-2009 period was characterised by
 - The worst credit crisis of our generation
 - The worst housing crisis of our generation
 - A banking crisis that made 1989-1991 look like a “walk in the park” and brought back memories of 1907 and J.P. Morgan “et al” coming to the rescue (Not really-not even I am that old)
 - Broken transmission mechanism (Money/credit not flowing through to consumers)
 - Global domino effect
 - Highest “peacetime” fiscal deficit...indeed one might argue the biggest fiscal/monetary stimulus in the history of mankind.
- Unemployment has just hit 10.2% (A post war peak only exceeded in 1982 at 10.8%) and core PCE stands at a cycle low of 1.3%

The history of those prior 2 events saw a new tightening cycle (on average) 4 years after the easing cycle began. If that were replicated then we may not see tightening until end 2011. Maybe that is a danger but some things we have to remember are

- The prior actions were those of a Greenspan Fed
- This Fed already tried to break with that pattern by delaying the easing cycle significantly in 2007 while establishing their inflation credentials.
- 5.25% in Fed funds was not what caused this problem. Sure, those rates had to be cut aggressively as the “world imploded” during the financial deleveraging when we “threw the kitchen sink” at this. That, however, does that mean they are appropriate at this level today? If anything people would argue that “too low rates” consistently over the past 20 years combined with ever cheaper and ever

easier credit is what got us here. Are we going to make the same mistake again? There is that danger. Why? Because authorities are afraid. They are afraid about the fact that we “went to the abyss” They are afraid what would happen if we “rolled over again”. In May 1983 with unemployment at 10.1% and the Fed funds rate at 8.5% what did Paul Volcker do? He **RAISED** rates.

- In 1984 he started easing again but more importantly he showed a willingness to do the “right thing” even though it was not the “easy thing” Most important that was on both sides- easing and tightening. Since then the bias has always been more protective and less about “re-loading your bullets” (He gets my Central banker of the century vote)

What is the ZERO interest rate policy achieving?

- Steep yield curve for banks with effectively free money. While this is important in the recapitalisation process it could also prevent money flowing out through the transmission mechanism. Why would you make consumer or commercial loans in a sluggish economy which by definition have “risk” when you can pretty much invest in treasuries risk free?
- Hurting the prudent/aging savers. Zero interest rates provide the saver with no return on income which has to by definition crimp their spending habits.
- Creating a danger of the same problem that got us here in the first place- Cheap money flowing into financial assets and creating bubbles again.
- Fiscal deterioration. If this money does not flow into the economy at zero per cent interest rates then fiscal stimulus is the only other way. This raises the spectre of supply issues in treasuries which will keep longer end yields higher than they should be creating even less encouragement for banks to lend and stimulate consumers/businesses. In addition further fiscal deterioration combined with a zero interest rate policy cannot be good for the USD and serve to further debase its value (Have all the “dye in the wool” fundamentalists yet figured out why despite them calling the demise on Gold at each new \$100 rise it keeps going up? I thought not.)

Raising interest rates (at the right time) will

- Re-establish the sense of independence at the Fed
- Show increased monetary responsibility (which should be accompanied by fiscal responsibility-likely in the form of controlling expenses rather than raising taxes.) Look at the model of U.S. corporations over the last 12 months. It a time of growth almost without exception controls on spending are loosened. During difficult times that should be the first “port of call” both for businesses and Governments.
- Stabilise the USD (Share price of the country) and potentially encourage investment into real assets and Treasuries (Sound fiscal and monetary policies)
- A sound FIAT currency structure requires discipline and confidence. If we institute the first we will likely earn the second.
- Provide renewed “bullets” in the now “empty gun” that can be used at a later stage if necessary.

But here is the “million Dollar question”. When is the right time???

As we said, using the “Greenspan Fed” model we could be looking at end 2011. Is that the model we want to follow?

Right now is obviously not the right time. We are at the cycle high in unemployment with no certainty that this is a peak. Inflation remains low- although let us be careful here. Inflation has been trending lower for this last quarter century of “economic moderation”.

This has come through a variety of sources including low wage adjustments, perceived growth in productivity, technological advances, cheaper goods from managed currency regime countries etc.

At the same time inflation in financial markets (leverage), credit, housing, equities has been rampant. It has encouraged the growth of credit versus assets to create wealth and has now imploded like a “deck of cards”

Do we really want to go back there?

In 2007, 2008 and 2009 the rhetoric from the Fed has always taken on a more positive tone in the earlier part of the year

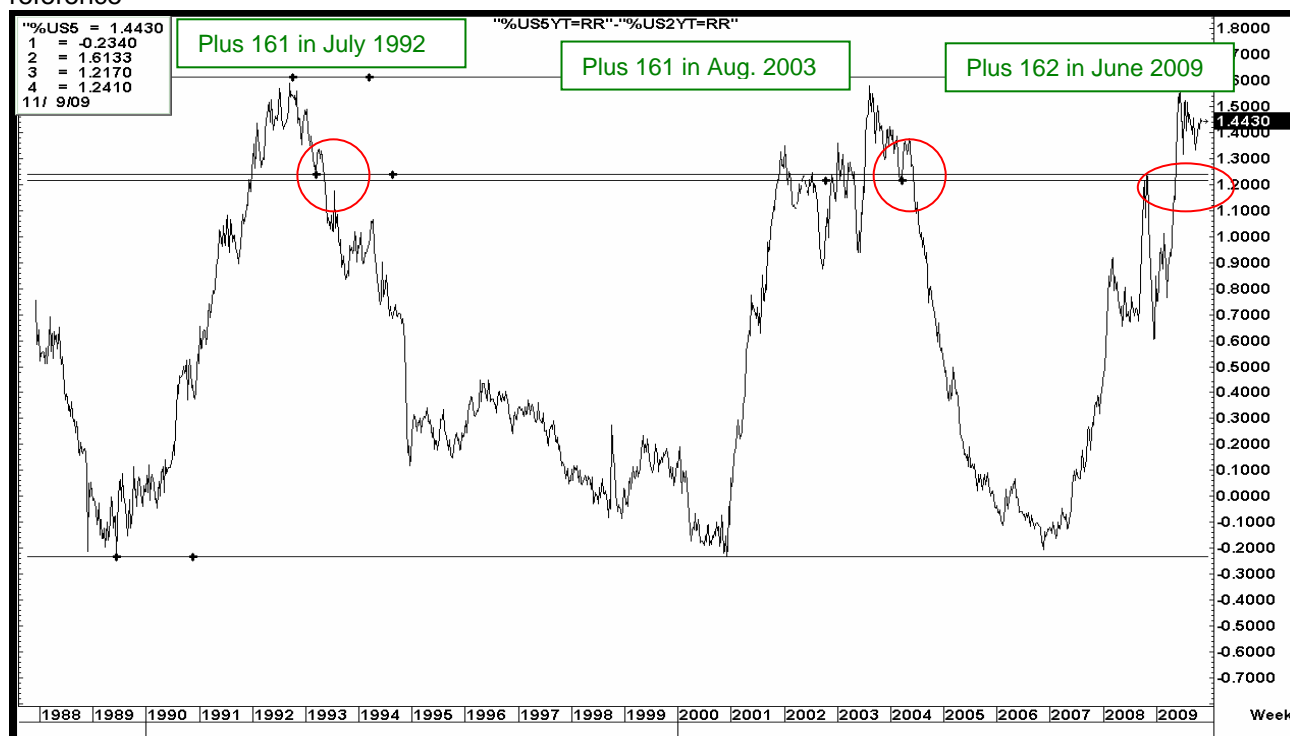
- **2007:** Suggesting that a rate hike to control inflation was as likely as an ease
- **2008:** Suggesting financial market and housing stability and a return to growth might lead to rate rises later in the year
- **2009:** Suggesting that the unprecedented monetary and fiscal stimulus was creating the “green shoots of recovery” This one at least has got some traction albeit more in financial markets than the underlying economy. At minimum it has crossed us over from financial deleveraging and the

emergency measures associated with that to economic deleveraging.(repair of consumer/financial institution and ultimately Government balance sheets) The argument being that economic deleveraging would be less impulsive and take place over a longer period and require a more balanced response

We are heading into the prime “retail sales” season and there is no good reason to sound a “hawkish tone” this side of year end

(As indeed we saw yesterday in Chairman Bernanke’s comments)

So as we go into a New Year in 2010 what may guide us to the likely outcome? We think the curve chart combined with our favourite “techamental” indicator” should be watched closely. We put the chart in again for reference



Source: Aspen Graphics / Reuters 12 Nov. '09

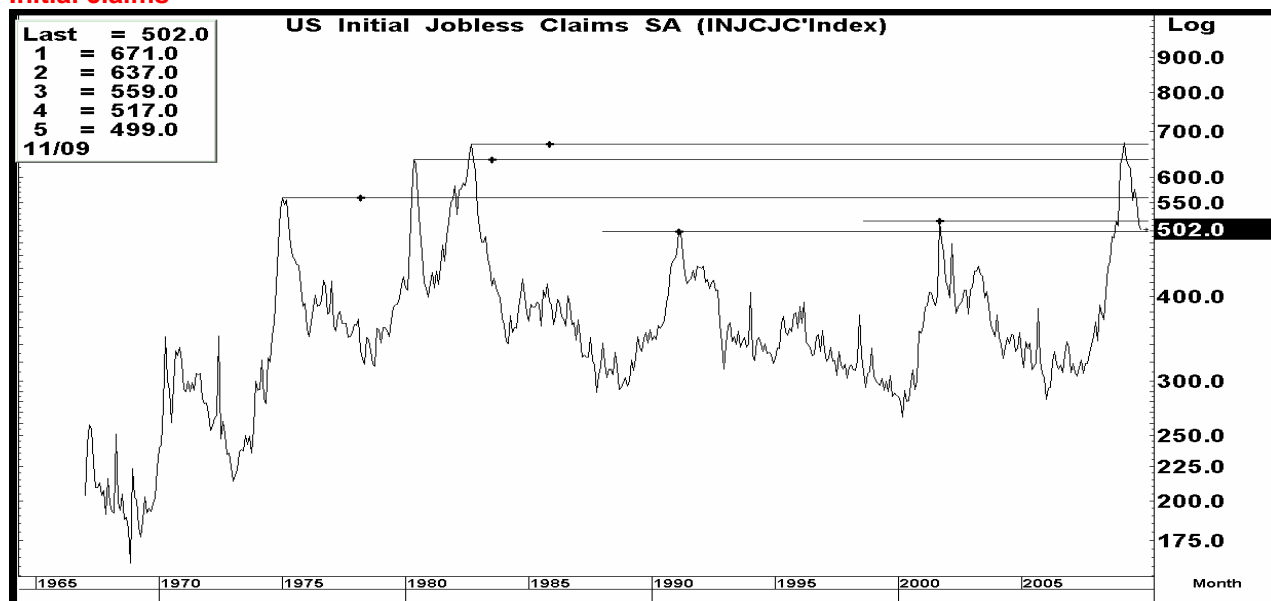
- We already know how pivotal the 160 basis point level has been in past cycles. We also know that there was an 18 month timeframe from the peak in 1992 to the Fed starting to tighten in Jan 1994. That time frame was much shorter after the 2003 peak at 10 months before the tightening began in June 2004.(Average 24 months). That provides a range this time of April 2010 to June 2011
- The big question is whether we have once again peaked at this level and will trend lower. Back over 160 basis points again would obviously question this but what would support it?
- Outside of the plus 160 and minus 20 basis point numbers we can see that the area around plus 120-125 basis points has been key. When we broke below here after the 1992 peak we never looked back as was the case after the 2003 peak. In fact on the way up this time it was also a very important resistance. All this leads us to believe that we will likely get our next signal both for the curve and the overall direction in interest rates from a break of either 120-125 basis points or 160 basis points decisively
- The breaks lower took place in May 1993 and June 2004 respectively.(So a lead of 8 months the first time and pretty much concurrent the second time. At the time of the break in 1993 2 year yields were about 100 basis points steep to fed funds and around 120 basis points steep by the time they tightened in Jan 1994. In 2004 2 year yields were closer to 200 basis points steep to Fed funds when this level broke hence an almost immediate reaction.
- It is worth looking further at the dynamics of a break either side because it is not just what the curve is doing but also likely what the components are doing that will be important.

Let's look at 4 likely scenarios

1. **160 goes with a move higher in longer term yields:** Would suggest that either inflation or supply concerns are sending longer term yields higher but that a Fed move is not likely. Hard to see the inflation dynamic kicking in knowing the lag effect we have seen previously. This would therefore not suggest a good outcome with a sluggish economy still in need of fiscal stimulus.
2. **160 goes with a sharp move lower in 2 year yields:** Seems unlikely given how low 2 year yields already are. Would again be concerning if it happens because it would suggest sluggish economy and or possible re-emergence of risk concerns
3. **120-125 goes due to a sharp fall in 5 year yields:** Strong alarm bells as this would seem to suggest a bull flattening which would likely mean increased deflationary fears which would not be constructive for a debt laden economy or for Equities.
4. **120-125 goes with 5 year yields holding up/rising but 2 year yields rising more:** This would appear to be the only potentially win-win outcome. Suggests economic improvement, maybe even a little inflation. Economic improvement would be good for the fiscal outlook and potential treasury supply issues while a bit of inflation in a debt laden economy would not be a bad thing. Could also be USD supportive for a while as improved economic and fiscal picture with a suggestion of a tightening bias returning from the Fed would look to be the best/ most stable of all Worlds. The initial liquidity reaction on Equities might not be great but it would likely be positive over time.

As we mentioned above one of our favourite "Techamental" indicators is worth watching here.

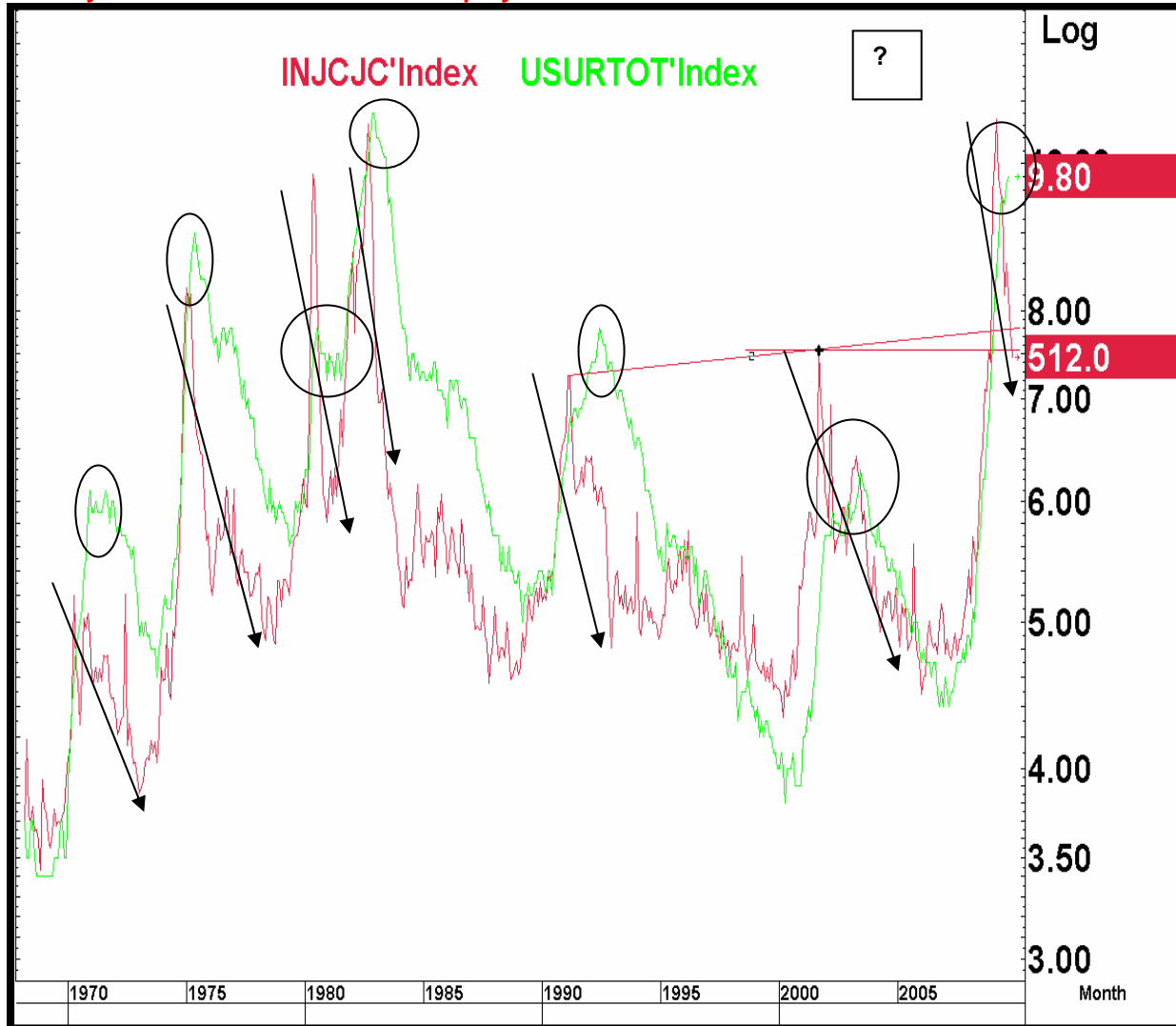
Initial claims



Source: Aspen Graphics / Bloomberg 12 Nov. '09

- Is now back below all but one (1991 peak of 499k) of the major peaks posted in the last 35 years.

Overlay of initial claims and the unemployment rate.



Source: Aspen Graphics / Bloomberg 12 Nov. '09

Looking at this chart it should not surprise you to see that initial claims are much more dynamic than the underlying unemployment rate. They tend to turn first and provide an early warning sign of the possible peak or trough in that rate of unemployment.

In Jan 2006 for example initial claims hit their low and turned. In October 2006 the unemployment rate hit its low of 4.4%.

Going back to initial claims, the peak we have hit in this cycle so far is 669k in March of this year. This is almost identical to that seen at the peak in Sept 1982 at 695k.

2 weeks ago we were (with the print of 512k) 157k off the peak. (Last week even lower at 502k) When did we get to that point in 1982? **By early December 1982 we were down at 533k, a week later at 516 k and a week later we crossed back below 500k just in time for Christmas.**

So we were at this point in the first week of December 1982. Of course in the first week of December 1982 we would have found out the November unemployment rate. What was it? It was 10.8% which turned out to be the peak in both the cycle from the 1979 low and ultimately the overall peak after the worst post war recession in this country. **That was a 4/10ths spike from the prior month which is exactly what happened 2 weeks ago in the unemployment rate.**

In addition at this point in 1982 non-farm payrolls had already hit the trend low and turned. At -124k in November 1982 following a -277k print in October we barely missed the first positive print the following month at -14 k and then surged to +225k in January 1983. We ended up with 3 out of 4 months positive at the start of 1983 with an average monthly gain of 150k and the Fed tightened in May. **Is next month in danger of providing a positive surprise?** Remember NFP lags initial claims and the unemployment rate lags

NFP. The December unemployment rate printed an equal high in 1982 to November but January 1983 saw it fall back by the 4/10ths spike seen in November to 10.4% and 10.1% by May.

Let us be realistic. Calling the peak on unemployment is likely an exercise in masochism but one thing is for sure looking at the chart above. This magnitude of improvement that we have now seen in initial claims has been consistent in suggesting at minimum an interim peak in the deterioration of the unemployment rate in the 70's and 80's (In addition it is also consistent with peaks being posted in 1992 and 2003.)

1975- Unemployment peaks at 9% in May. In the week straddling end May early June initial claims were 100k off their high

1980- Unemployment has interim peak at 7.8% In July. In the first week of August 1980 initial claims were 109k off their high

1982- Unemployment peaks at 10.80% in November (structural high). In the end November/first week of December initial claims were 138-162k off their high

1992- Rise in unemployment peaks in June at 7.8%. Initial claims in early July were over 100k off their high.

2003- Rise in unemployment peaks at 6.3% In June. In the first week of July 2003 initial claims were over 100k off their high

When these charts suggested initial claims were heading higher as was the unemployment rate (2007) there was widespread skepticism about our initial speculation that

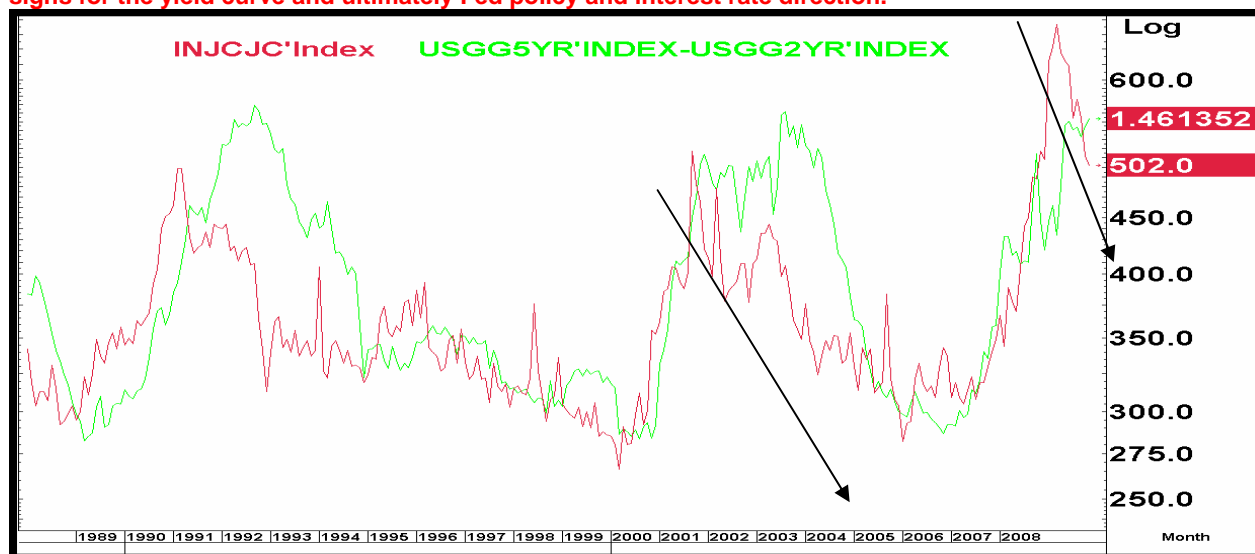
1. An unemployment low had been put in at 4.4% and
2. That we may head as high as 8.5% (Inverted head and shoulders target.) That was on a linear measured move basis. A %age change target would have suggested **10%**.

Now, everybody on the face of the planet is on board with the idea that this unemployment rate will just continue to deteriorate in a straight line. Nothing goes forever in a straight line. Since April 2008 we have had just 1 down tick in the unemployment rate (A 0.1% drop in July 2009) in a move from 5%

In the 13 year deterioration from 1969-1982 we saw a 1.5% drop in 1970-1973, a 3.4% drop from 1975-1979, a 0.6% drop in 1980.

We are by no means saying at this point that we may be about to put in the ultimate peak in this cycle. Time will tell on that. All we know is that for the past couple of years every consensus view has got caught out and maybe it is the turn of unemployment.

The other important dynamic is that initial claims in these periods (1989-1991 and 2000-2002) were early warning signs for the yield curve and ultimately Fed policy and interest rate direction.



- The only 3 periods of inversion past negative 20 on the curve coincide with the only 3 periods where initial claims pushed decisively below 300k. Once claims began to rise the curve stopped flattening as market conviction grew of a policy change
- In early 2004 and in 1993 the sharp improvement in initial claims was a precursor to a change in policy by the Fed.(Tightening) and a turn in the curve.
- At this level initial claims (In nominal terms are now back below the significant highs of 1982 and 2001 and just barely above the high of 1991 (499k). It looks increasingly like we could see that move into the 400's in the next couple of weeks as maybe a precursor to a surprise (positive) in the first week of December when payrolls are released and possibly a surprise dip in the unemployment rate slightly thereafter. If so that could lead to a change in assessment from interest rate markets and possibly even some more hawkish rhetoric in the New Year from the Fed

As always this is still all a work in progress but we are convinced that the dynamic in the indicators above (Initial claims, yield curve, 2 year yields to funds, 2 year yields directionally, 5 year yields directionally, NFP and ultimately the unemployment rate will provide the plank for market perception, Fed rhetoric and ultimately Fed action (or not) as we begin 2010.

For now our bias is to believe that the present monetary policy is as much about fear as anything...fear of the potential of another great depression, fear of a lost decade like Japan. Fear is not a good monetary policy. Yes we can couch it in terms of output gap and other economic indicators but the reality is that too low interest rates, not too high, helped us get into this mess. Where in life do you see that using the same decision making process that caused the problem to solve the problem works? We cannot think of one.

For now this policy/rhetoric does not seem to be changing and after yesterday it looks like we can be reasonably confident that it will not do so before year end. However watch out if the "patient goes into remission" and we get some further positive signs from initial claims and/or non-farm payrolls. This could lead to some back tracking in the "extended period of time" commentary and possibly even the Fed funds rate itself.

For now it is not happening and that should keep the USD under pressure into year end, squeeze Eurodollar futures even higher, support liquidity into equities, keep Gold bid and even keep fixed income in a range/slightly bid in the near term

Calendar events in this period of interest (early 1980's):

By Mid 1982 – FDIC purchased 870 million of bad loans in an effort to keep banks afloat.

7/1982 – Garn-St. Germain Depository Institutions Act – further deregulated banks and deregulated savings and loans. Greatly encouraged lending, in particular real estate, at a time when real estate lending collapsing. (Akin to MBS purchases, falsely deflating market mortgage rates at a time when housing has been crashing).

1982 – Tax Equity and Fiscal Responsibility Act of 1982 – instituted a 3 year, \$100 billion tax hike. This all went to corporations (largest tax hike since WW2)

1984 – Continental Illinois National Bank and Trust Company (7th largest bank w/ \$45 bill in assets) failed. Congress extended 4.5 billion to Continental Illinois because felt too big to fail.

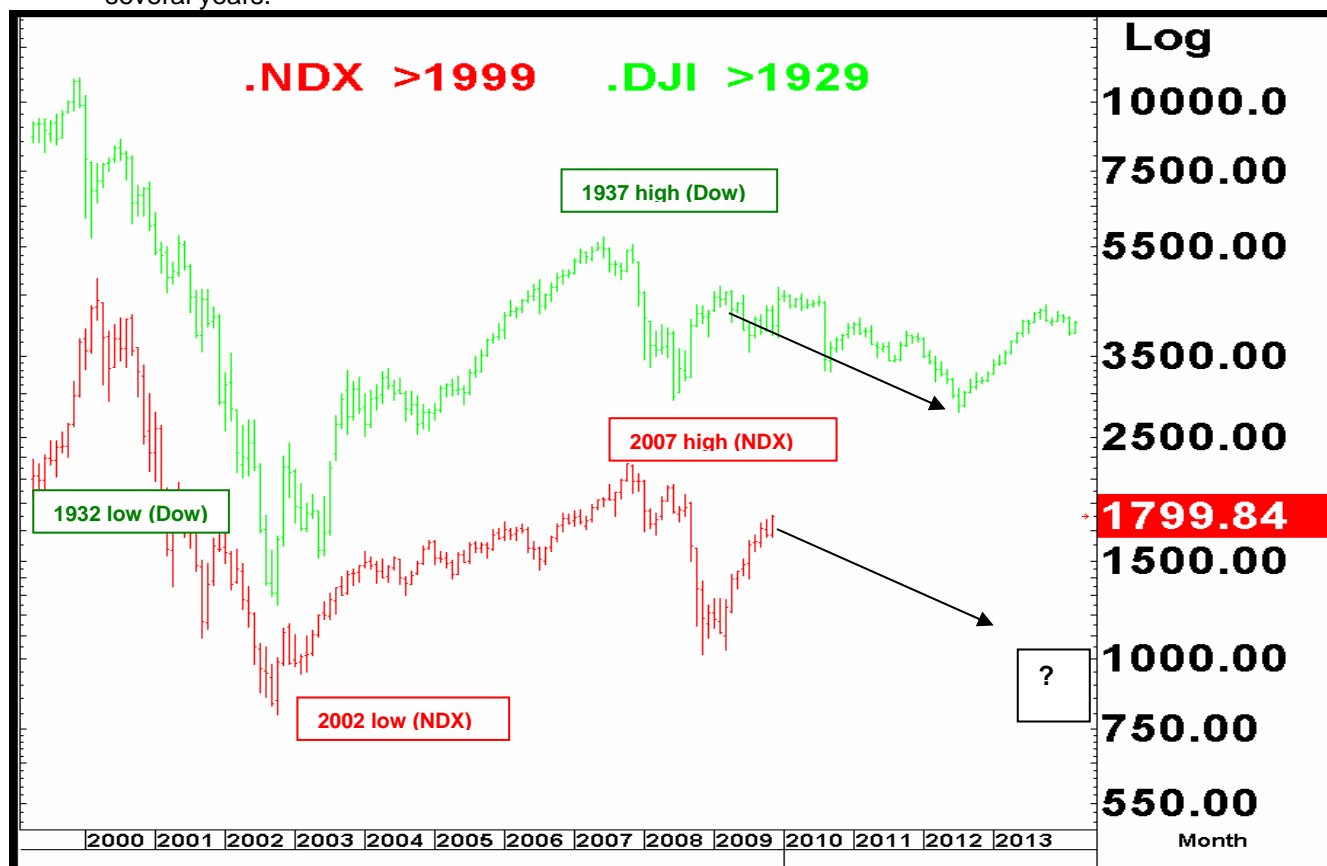
Happening again with other Asian economies today?

Rapidly growing economies in Asia appeared to be challenging America as economic powerhouses; Japan, in particular, with its emphasis on long-term planning and close coordination among corporations, banks, and government, seemed to offer an alternative model for economic growth.

Equities- 1929-1942 remains our overwhelming favourite overlay

Spooky Chart Update

- For those of you who have been following our market commentary for some time, you will remember that we have been looking at the *Spooky Chart* for years.
- As a reminder, the *Spooky Chart* is the overlay of the price action in stocks following the only two occasions where U.S. equities fell by more than 80%. Those two occasions were the Dow Jones Industrial Average from 1929 to 1932 (fell 89%) and the NASDAQ from 2000 to 2002 (fell 83%).
- The chart below shows the price action of the Dow Industrials through the 1930's and the NASDAQ throughout the 2000's. While one can list many differences between these periods, this chart shows the similarity in the behaviour of stocks both in terms of pattern and time throughout a window of several years.



Source: Aspen Graphics / Reuters 17 Nov '09

- Dow drops over 80% from Sep'29 to July'32 (34 months) while NDX drops over 80% from Mar '00 to Oct '02 (31 months).
- Dow posts bullish monthly reversal off trend low in July 1932. NDX posts bullish monthly reversal off trend low in October 2002.
- Dow rallies for 56 months (1932-1937) NDX rallies for 60 months (2002-2007)
- Dow falls over 50% over 12 months (1937-1938...credit crisis – sound familiar?). NDX falls over 50% in 13 months (2007-2008).
- Dow bounces over 60% in 8 months (1938)
- NDX bounces over 70% in 12 months (2009) (S&P and DJIA bounces are 8 months so far)

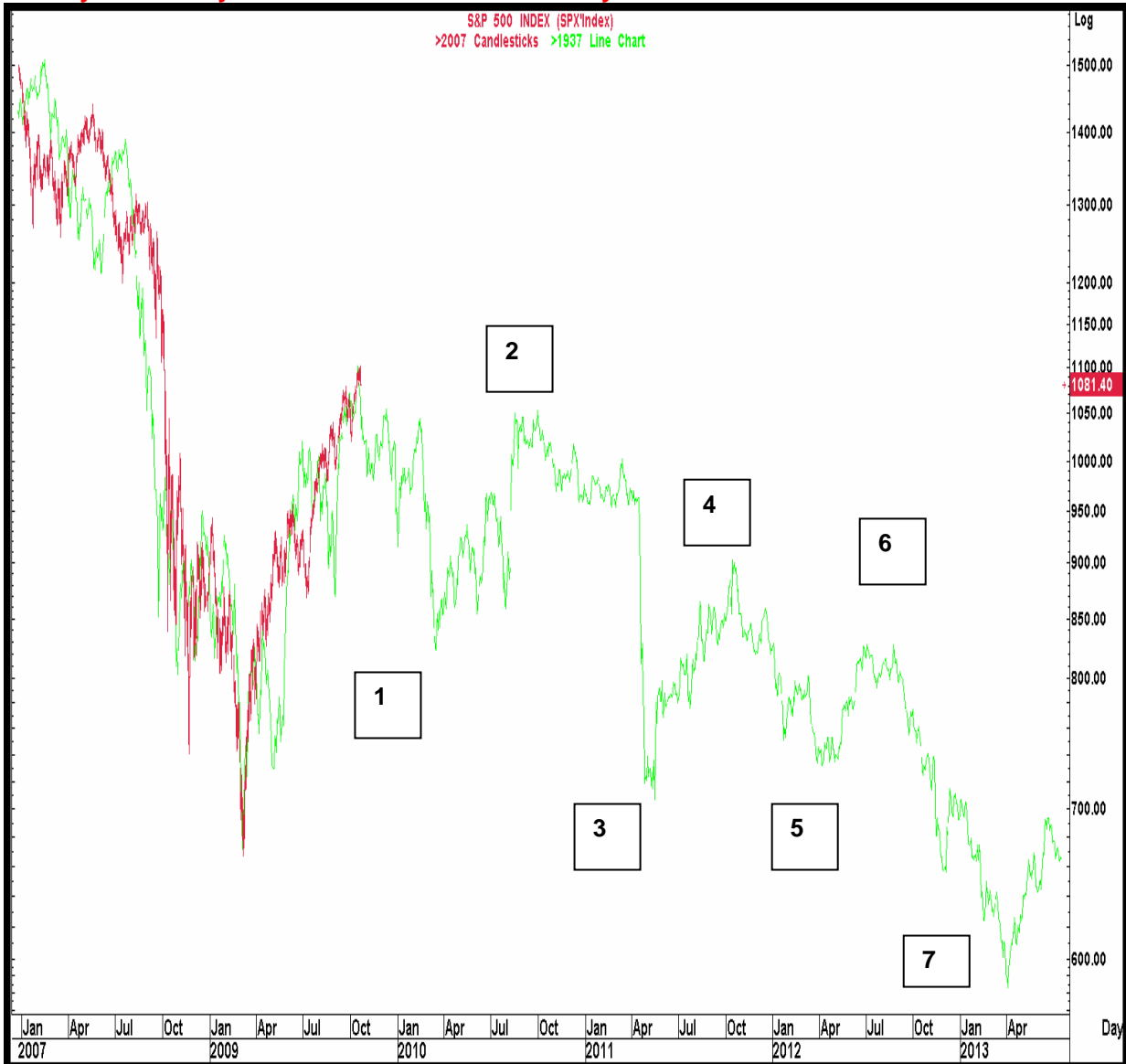
The Dow peaked and saw a renewed (choppy) bear market over the following 3 ½ years (1938-1942) that ultimately lost over 40% from the 1938 high. The 1937 high was not re-tested until 1946 and was not “decisively” left behind until 1950.

Have we just seen a similar technical pattern again which suggests that the stock market could be vulnerable medium term? We believe the answer is YES. However, in the short-term the calendar to year end favours the bulls and they appear to have the upper hand.

This **DOES NOT** mean that we will see panic in the market. We have argued for most of this year that the crisis that started in 2007 (before the stock market highs) has evolved from financial deleveraging to economic deleveraging. As a result the behaviour in prices is likely to be less impulsive and more start / stop with the likelihood of double digit percentage moves in both directions.

We appreciate that the *Spooky Chart* above is not going to provide guidance forever and at some point it will stop working (history does not repeat itself exactly).

Overlay of recovery after 1937-1938 fall and recovery after 2007-2009 fall



Source: Aspen Graphics / Reuters 22 Oct '09

- Resulted in choppy moves in both directions into the ultimate low in 1942 (3 ½ years after corrective peak.)
- Overall there were 7 very decisive moves
 1. A fall of about 24% in the first 5 months after the peak in a very choppy trading fashion.
 2. A subsequent bounce into Sept. 1939 that retraced most of that fall but failed to regain the 1938 high.
 3. A 30%+ fall into June 1940
 4. A 27%+ rally into November 1940
 5. A 14% fall into May 1941
 6. A 13% rally into July 1941
 7. A 28%+fall into the ultimate low in April 1942

So overall 7 moves in excess of 10% (4 down and 3 up) culminating in a move from the 1938 high to the 1942 low of over 40% i.e. A trading market with a bearish directional bias over 3 ½ years. This still remains our bias for the type of market we could see in an economic deleveraging environment.

For what it is worth there were sharp moves in both directions in 1939 but very little overall change with the market slightly down on the year. The significant annual falls were in 1940 (Down 13% on the year after being down over 26% at one stage) and 1941 (Down about 15%) In 1942 it was down about 16% at one stage but closed up about 8% and the bear market ended.

Conclusions:

FX:

- We remain firmly in the USD bearish camp and still look for EURUSD to head towards 1.60 and above in the coming months
- Thereafter remains a work in progress but at this point we remain concerned that the move could end up being even longer and higher.

Gold:

- We remain unabashed bulls for Gold into 2010 and beyond
- We believe \$1,300 plus is achievable –possibly as early as Q1 and that \$2,000+ could be seen by 2012 or earlier

Crude:

- The technical structure remains positive for \$85 and maybe even \$100+
- We struggle at this point to see a dynamic that might allow it to sustain that level let alone elevate above it next year.

Fixed income:

- We retain our medium term view that we will see long end yields higher again in 2010 and maybe for even longer. In the near term further consolidation/correction lower in yields is still possible.
- We continue to believe that 10 year U.S. yields could eventually head towards 6% (2012?)
- We think the Fed should tighten sooner rather than later but do not know if they will. We think the combination of 2's versus 5's, 2's versus Fed funds and the initial claims charts could provide the answer.

Equities:

- We retain our view that we are in an aggressive bear market rally (Cyclical bull market) within the structural bear market that will see us lower in the coming years.
- We believe we could even re-test and maybe break the 666 lows seen in the S&P this year on a multi year basis
- Even if that happens we think it can be a choppy period with good sized moves in both directions.

The rest of the World (extra note):

- The saving nations of the World are better positioned to be buffered against the dynamic above if it transpires as we think.
- However as we found out during the financial deleveraging of 2008 that a Global economy is closely intertwined/ inter dependent
- The speed of the “domino” effect in the financial crisis was breath taking. In economic deleveraging with a build up of savings and reserves and the diversification into hard assets/commodities the savers and commodity countries should do quite well on a relative basis for the foreseeable future. However in the absence of a robust recovery (Non stimulus /self sustaining) in the developed World they cannot ultimately remain immune

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Market Commentary

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