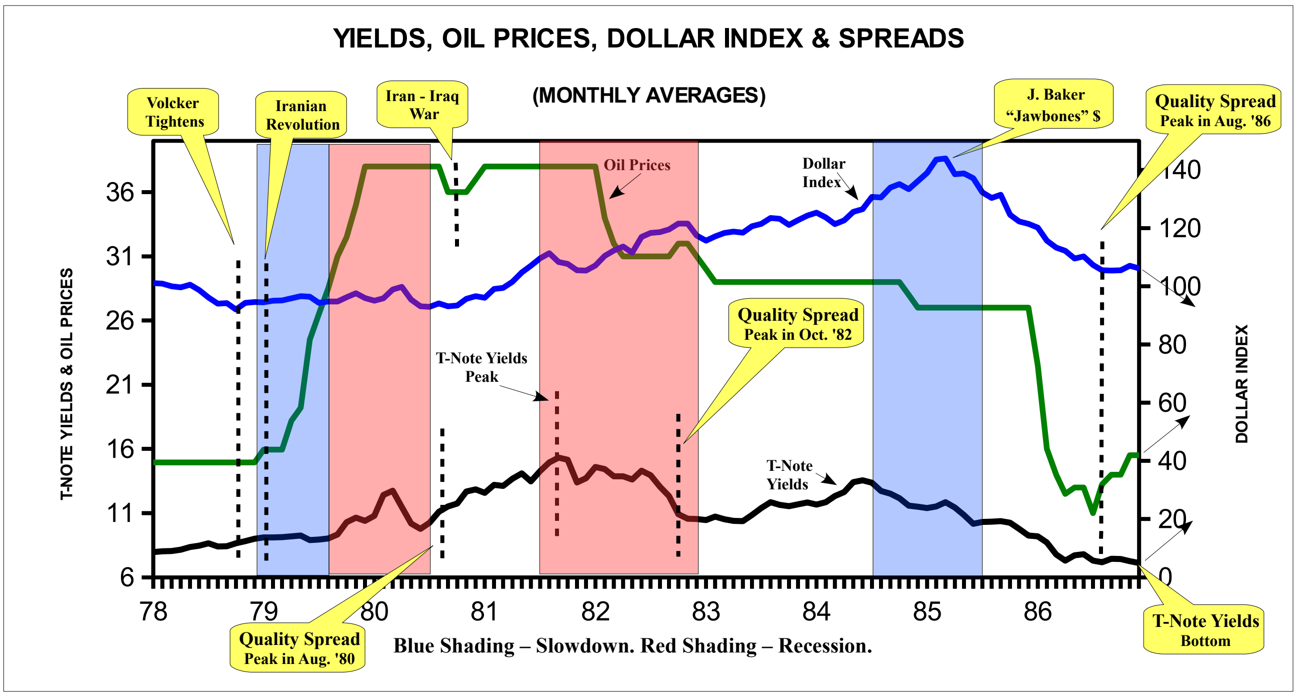
BUSINESS CYCLE DEVELOPMENTS

Quality spreads usually peak at a business cycle trough. When the economy starts to improve concerns about bankruptcy and default fade, due to the imminent recovery; therefore spreads fall. This didn't happen in the mid 1980's. Spreads continued to widen for 13 months after the 1984-85 slowdown ended. Today, we're six months past the May 2014 recovery and spreads are still widening. The circumstances today are very similar to what occurred in the mid 1980's.

Volcker began halting the upward pressure on prices in 1979 and the impact was felt for nine years. Despite the initial spike in oil prices, due to Iran's war, commodity prices fell on a secular path as the economy cyclically expanded and contracted four times over nine years. The dollar rallied, as it was a safe-haven from war and the fall in oil prices. Spreads didn't fall, as usual, after the 1984-85 slowing, but continued to widen until oil prices and commodity prices stopped falling in August 1986. T-Note yields also fell until Jan. '87, five months after spreads peaked and 13 months after the economy recovered in 1985. This is unusual, as yields normally bottom with an economic recovery. Oil production loans busted almost every large Texas and Oklahoma bank in the mid to late 1980's. Finally the RTC Act passed Congress in 1989, auctioning off the marginal bank and savings & loan assets.



That's yesterday. The Volcker- like "discipline" for this current deflationary crisis was the Credit Crunch of 2007 and we're still working through it. Today, the dollar has climbed since the summer of 2011, when the EU Crisis surfaced. China's slowing pushes commodity prices lower and the dollar becomes a safe haven again, putting even more downward price pressure on **commodity based loans** as it strengthens. Private and corporate sectors have deleveraged for this deflation, but not all the governments or central banks. Markets want to clear prices at lower levels, but politicians and central banks are failing to hold off the price declines, even with competitive devaluations and various QE's. The U.S. economy has slowed within a few months after each QE has ended – see August 26th update. Spreads will likely continue to widen until commodities stop falling, as in 1986. This also implies that yields will not rise until spreads peak or fear exits the market place, so plan on an outlier bottom in yields. Equity markets are expected to continue to do well, as they did in the mid-to-late 1980's.