

Basic Points

Babel in Bond-Land

June 15, 2007

Produced by BMO Financial Group
Distributed by BMO Capital Markets



Basic Points

An Investment Journal

Donald G. M. Coxe

Global Portfolio Strategist, BMO Financial Group

(312) 461-5365

e-mail: don.coxe@bmo.com

Research/Editing

Angela Trudeau

e-mail: angela.trudeau@shaw.ca

Production/
Distribution

Anna Goduco (print orders and mailing lists)

e-mail: basicpoints@bmo.com

Babel in Bond-Land

Overview



Two months ago, we reluctantly abandoned our quarter-century conviction that long bonds were a core investment that would continue to outperform short bonds and cash—as they had for all rolling five-year periods since Reagan’s election. We announced that a long-term bear market in bonds was coming.

At the time we wrote, the overwhelming investment consensus was that the Fed’s next change in policy would be to cut rates. Disagreements were limited to how many cuts loomed within the next year. Our argument that the Fed was more likely to boost rates than cut them was greeted with widespread surprise.

This month we update our analysis, reflecting clients’ questions and suggestions. We remain of the view that our target for the next two years is, at minimum, a 200 bp increase in long Treasury yields, accompanied by a return toward normalcy in yield spreads—and in the supply of liquidity.

As our model for analysis of the structural weaknesses in the US debt market, we have chosen the Tower of Babel. Each decade seems to produce its own form of collective financial hubris that leads to a meltdown. In the 70s it was Third World bank loans; in the 80s it was portfolio insurance; in the 90s it was Collateralized Mortgage Obligations and Long-Term Capital Management. In this decade it is collateralized debt products that seek to make Risk disappear from cash markets into a tower inhabited by investment banks and hedge funds in which the shared language is algorithms. Like all past Babels, this one will, at some point, self-destruct.

We are leaving our cautious Recommended Asset Mix unchanged.

Recommended Asset Allocation

American Portfolios

U.S. Pension Fund		
	Allocations	Change
Domestic Equities	27	unch
Foreign Equities	29	unch
Domestic Bonds	12	unch
Long-Duration Bonds	0	unch
Foreign Bonds	15	unch
Cash	17	unch

Foreign Equity Allocations		
	Allocations	Change
European Equities	6	unch
Japanese and Asian Equities	6	unch
Canadian & Australian Equities	6	unch
Emerging Markets	11	unch

Bond Durations		
	Years	Change
Global	4.25	unch
US	4.50	unch
Canada	4.75	unch

Babel in Bond-Land

This story from Genesis has never failed to captivate students of human nature. In recent years, it has been the basis of a splendid novel by A.S. Byatt, and an Academy Award-winning film directed by Alejandro Inarritu.

Although hubris is at the core of the story, what distinguishes it from the Greek tradition is that the sinful action motivated by pride is a collective attempt to challenge Heaven through the use of technology, not an individual affront to the gods rooted in human fate.

On the plain of Shinar, (today's Iraqi province of Kurdistan), fourth generation descendents of Noah became consumed with pride in their mastery of a new technology. They convinced themselves that bricks and mortar—the Big New Idea of the post-diluvian age—could be used to “build us a city and a tower, whose top may reach unto Heaven, and let us make a name, lest we be scattered abroad upon the face of the whole earth.”

God considered this challenge, noting that “Behold, the people is one, and they all have one language...and now nothing shall be restrained from them, which they have imagined to do.”

His response: “Go to, let us go down, and there confound their language, that they may not understand one another's speech.” Thus were born the multitudinous languages of the world. (There are still some diehards who yearn for Esperanto—that once-fashionable idea of returning to the linguistic unity of the pre-Babel world. Shaw was its most noted enthusiast, and his Estate still gets revenues to fund research toward a global language from the royalties on *My Fair Lady*.)

The rise and fall of Babel is a useful model for appraising the characteristic financial hubris of our time—the conception, birth, growth and metastasizing of complex over-the-counter risk-management instruments.

Until recently, the pricing of corporate debt risk had been achieved through the dual systems of bank lending practices and open-market trading in bonds, short-term paper, and, more recently, futures.

Since 1970, systemic risk within the financial system had been priced primarily through the Eurodollar market, which was the first global liquidity pool not directly related to a specific central bank's open-market activities.

**bricks and mortar—
the Big New Idea of the
post-diluvian age...**



...more and more products whose pricing became more and more opaque.

The spread between the rate on the front-month Eurodollar future and the front-month T-Bill future (the TED Spread) became the thermometer of the health of the global banking system. From 1976 through 1998, it never failed to climb sharply before a financial crisis. It is, therefore an ominous sign that it has been climbing sharply in the past week—to its highest levels in years. To date, no other important risk indicators confirm its warning, but clients should be watching it. It has moved from 63 to 92; should it break through par, we would expect signs of stress for some major financial institutions. What distinguishes this TED Bear is the collapse in T-Bill yields: three-month bills now offer a miserly 4.64%, a remarkable 61 bp under the fed funds rate. As long-Treasury yields skyrocketed, T-Bill rates fell, indicating a massive duration shift among large—presumably foreign—holders. Because LIBOR rates did not climb, as they usually do during a TED crisis, this apparent TED perturbation, which is unaccompanied by a rise in gold and/or a fall in the dollar, may justify the tentative appraisal that “It’s different this time.”

The first large-scale use of new kinds of instruments designed to offload risk was the so-called portfolio insurance of the 1980s. Over-confidence in the efficacy of these products was that era’s defining hubris—which was punished in the Crash of 1987.

Moore’s Law was the technological foundation of the hubristic evolution of the 1990s. As chips became progressively more powerful, and as algorithms became more sophisticated, and as more and more mathematics wizards migrated from universities and research institutes to Wall Street, investment banks began designing more and more products whose pricing became more and more opaque. Sell-side computers talked to buy-side computers, and their shared language fed the growing confidence that risk could be profitably managed outside the well-watched public markets. This was the growth of privately-financed and priced markets at a time private equity was also growing rapidly. Occasional flameouts involving the new structures of that time, Structured Products—such as the implosion of David Askin’s firm—were barely noticed, as confidence in geeks, nerds and PhDs continued to grow. (David, who is a personal friend, was one of the geniuses who built Drexel and the mortgage-backed bond market; that a hedge fund investing in mortgage products built by someone so brilliant, experienced, and honest could vaporize within hours was an early-warning sign of the limits of risk-offloading into an ether produced by the output from investment bank computers.)

Basic Points

Then came Long-Term Capital Management. As we have remarked, that meltdown occurred due to a heretofore-unknown condition—a critical mass of Nobel economists. Unlike previous implosions, this collapse had momentous consequences for the financial markets and the US economy. Rushing to save such prominent members of the Nobility from the embarrassment of bankruptcy and huge lawsuits, Alan Greenspan helped orchestrate a Fed bailout that averted bankruptcy. To ensure the success of his rescue mission, he flooded the system with torrents of liquidity at a time when Nasdaq had already begun to levitate out of the Layer of Wild Enthusiasm into the Anoxic Idiocy Belt beyond. Those boomers who put Cisco into their 401(k)s when it was the world's biggest market cap company have Sir Alan to thank. (He has doubtless been seriously thanked by his fellow famed economists.)

It is as if Zimbabwe's dollar had become a store of value more esteemed than the greenback.

This decade has seen a new kind of hubris—the transfer of financial risk from publicly-traded bonds and loans to privately produced and priced instruments. Risk has been excreted from junk into Towers in the Sky through Credit Default Swaps, Collateralized Debt Obligations, and other financial androids that multiply at unimaginable speed. Nor has their reproduction rate been constrained by anything so trivial as the volume of products they purport to insure: the face value of the derivatives that seem to absorb the risk (and necrotic odors) in corporate credits ranges, we are told, to somewhere between ten and twenty times the face value of the underlying junk. These spawn of the intermarriage of math wizards and computers float up and mingle with each other somewhere in the Van Allen Belt above the two Greenwiches—London and Connecticut.

Alchemy this majestic is beyond the dreams of Medieval and Renaissance wizards. As for the scale of these acts of creation, they make Saruman's spawning of thousands of orcs look like mere child's play.

The result of this removal of risk from cash markets is that, in this decade, the higher the quality of debt instruments, the worse has been their comparative rate of return to investors. Bad is Good; Terrible is Better. It is as if Zimbabwe's dollar had become a store of value more esteemed than the greenback. (Perhaps that comparison helps to explain why the UN, in its latest—and historically consistent—display of wisdom, has anointed Zimbabwe as the head of the Committee on Sustainable Development. We were impressed that the UN stood so firmly by its principles in that decision, and assume Mugabe got the nod over Castro because of questions about the Stalinista's health.)



...we hope that when one or more of this year's crop of baby Babelists screams in death agonies, they will not be rescued *à la* LTCM.

In the Wall Street replay of Babel, the best brains in London and New York unite to build sky-high towers whose value is set not by open markets, but by investment bankers and hedge funds, using their own electronic linguistics. Designing, creating and marketing new instruments, and tranches is a high-margin business for Bear Stearns and other Keepers of the Arcana. The hedge funds who buy these electronic creatures participate in a cost relationship in which the pricing is handled between famously good friends. The SEC has, of course, no authority to participate in those transactions and valuations. It consoles itself by multiplying the rules, regulations and procedures imposed on old-fashioned mutual fund managers, thereby driving up the cost of compliance so high that many medium-sized organizations are being forced into mergers. A huge firm that commits large-scale violations of the rules simply writes two checks—one to the SEC and the other to its software suppliers—and gets back to marketing its funds. While this micro-analysis of funds invested in publicly-traded securities marked-to-market under rigorous systems occupies the SEC, the multi-trillion-dollar swapping of swaps and other privately-valued instruments proceeds unfettered and unfazed.

We are certainly not arguing that the hedge funds need to be tightly regulated. But we hope that when one or more of this year's crop of baby Babelists screams in death agonies, they will not be rescued *à la* LTCM. The Greenspan Put should have departed the Fed along with its eponym.

Castles in the air exist, by their nature, in the eyes of beholders. The foundations of investment aero-edifices are in the valuations of the tens of trillions' worth of neo-assets. Moody's and the other rating services rate the Collateralized Debt Obligations and other exotica that are held by banks, mutual funds and other traditional institutions. These vehicles abound in the courtyards around the Tower. Their valuations depend on assumptions based on market performance over a few months or years. Long-Term Capital, we recall, had what John Meriwether and his Nobel partners claimed was the world's greatest financial data bank, containing minute-by-minute trading information on a world of asset classes. When it imploded, they defended themselves by saying that the Russian default was a high deviation event outside their historical data base.

Their data, we would later learn, extended all the way back.....to 1991.

Basic Points

The Nobility saw no reason for including the unpleasantness of October 1987 in their merry machines.

(Mr. Meriwether, the beneficiary of the bailout, has been named, we are informed by the wise and witty Stephanie Pomboy, Man of the Year by an organization of hedge funds. Words flail us.)

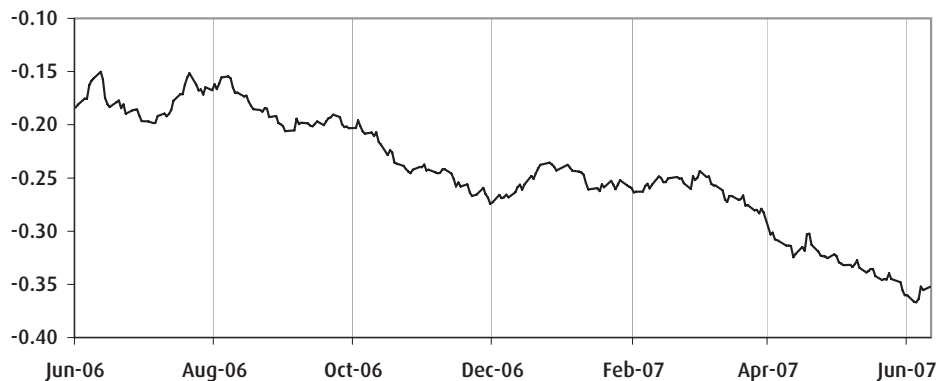
Long-Term Capital fell, in part, because it made a big bad bet on Russia. These days, those who make big bad bets on Russia may find, to their surprise, that their lifespan no longer correlates to the actuarial tables.

This latest attempt at Babelism will, like its predecessors, fail. The new financial system that measures itself in the trillions of dollars disdains price discovery in major public markets, justifying its clandestine procedures and outsized profits by the genius of its participants and the power of its computing systems. The systemic risk that brought down Long-Term Capital Markets is now extravasated through the investment banks which daily spawn new risk-swallowing Pac-men.

When will this new Babel totter?

Already, the Bank Stock Index (BKX) is in a sustained Relative Strength bear market against the S&P:

**Relative Strength of the Bank Index (BKX) versus the S&P 500
June 2006 to June 2007**



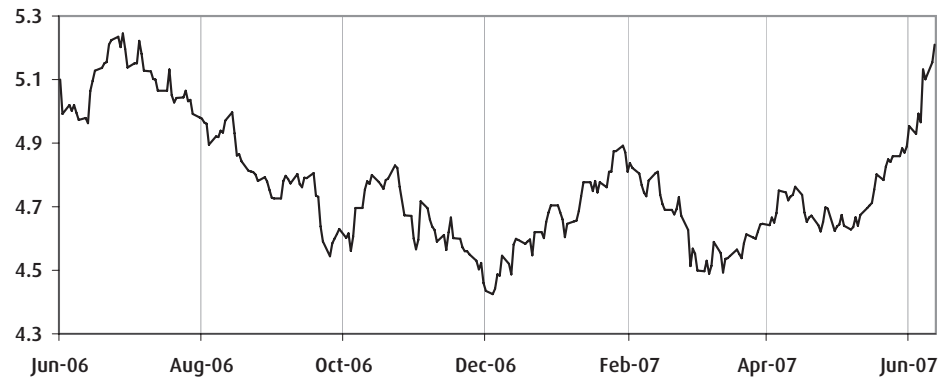
**systemic risk...
is now extravasated
through the
investment banks
which daily
spawn new
risk-swallowing
Pac-men.**



**this liquidity...
seems to come
not from central
banks, but from
nowhere.
It will return
there someday.**

Moreover, the bond bull market that began shortly after Reagan's inauguration appears to have broken down decisively. When the yield on the Ten-Year Treasury broke through 5.1%, it broke the long downtrend line dating back to the Reagan era.

**10-Year Treasury Bond Yield
June 2006 to June 2007**



Everyone believes we are awash in liquidity. But what does that term really mean?

What has been growing at astounding rates is what we call Real, Effective Global Liquidity. This is frictionless money that flows effortlessly from high-savings areas to low-savings areas, across national and currency boundaries. This is money on screens—not in pockets. It is the product of the interaction of the creation of the euro as a currency pool the size of the Eurodollar pool, the burgeoning foreign exchange reserves of Asia and OPEC, the rapid growth of what are called Sovereign Wealth Funds—government-owned or managed funds that are not held within foreign exchange reserves, and the boundless growth of currency and interest-rate derivatives that absorb risk from cash markets.

Yes, we are awash in liquidity.

But, to the extent this liquidity is artificially manufactured, it seems to come not from central banks, but from nowhere.

It will return there someday.

Here is now dawning another new day...

Into eternity this new day was born,

Into eternity at night 'twill return.

What may help speed its return is the onset of food-price inflation.

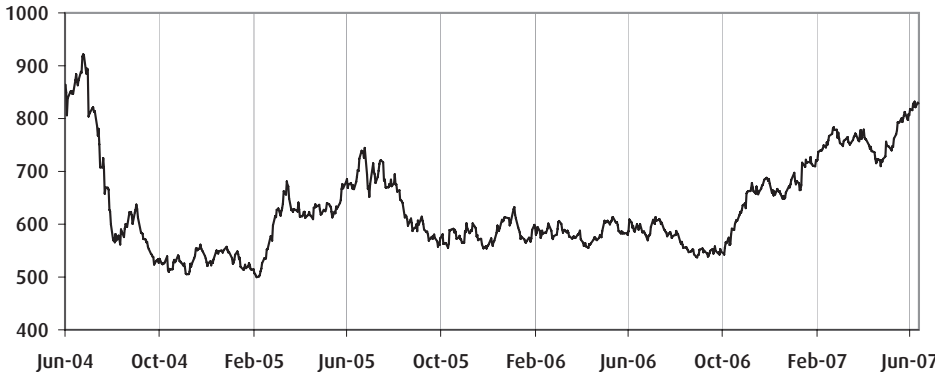
Basic Points

So, What's This Got To Do With the Price of Eggs?

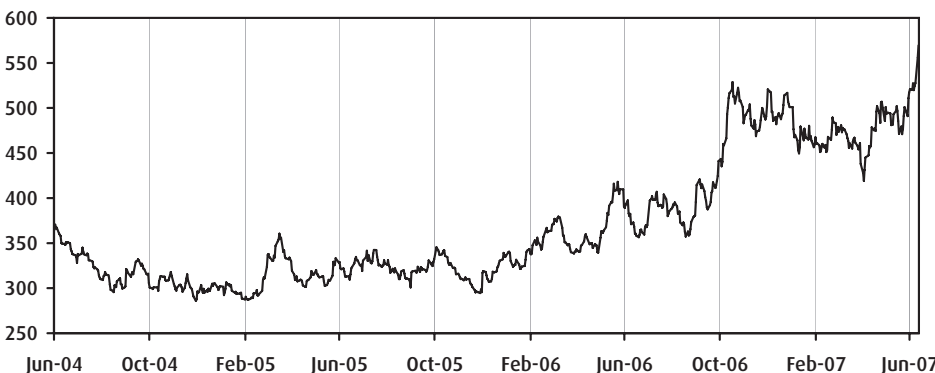
Corn
June 2004 to June 2007



Soybeans
June 2004 to June 2007



Wheat
June 2004 to June 2007





**the May PPI
was issued...
Raw foodstuffs
were up 31.2%.**

Egg prices in April were up 18% year-over-year. But they were a comparative bargain, as the total raw foodstuff PPI was up 26%. Fully processed food, however, which is what gets measured in CPI, (but is banned from the Core Index), was up merely 8%. Those numbers did not get chewed on by the Street. Indeed, some of the nation's best-known economists stated that the April inflation numbers were so benign that the Fed would be easing sooner, rather than later.

As this was being written, the May PPI was issued. It was up 4.1% year-over-year, but, subtracting food and energy, it was up a barely-visible 1.6%. Consumer foods were up slightly more than in April at 8.5%. *Raw foodstuffs were up 31.2%*. Those of us with long memories recall that in the 1970s, it was raw foodstuffs that were the first PPI component to soar at high double-digit rates, well before the CPI reached double-digits.

April was the month that corn prices were the subjects of cover stories in two unlikely journals—*Fortune* and *Foreign Affairs*. That corn's price is as high as an elephant's eye should not, in itself, attract lengthy coverage in the journals of record for boom and bust, and war and peace. The core theme of both articles was the threat of global food inflation *caused by American policies on ethanol*. The only reason corn prices are high, say these Manhattan agriculturists, is the heavily-politicized program of promoting ethanol as a gasoline additive to reduce the nation's dependency on oil.

The *Fortune* and *Foreign Affairs* attacks on ethanol are part of the backlash against Washington's focus on corn-based fuel. The winners from the ethanol-boom have included, of course, Archer Daniels Midland, which pioneered both ethanol and the practice of politicizing it, and more than 70 locally-owned corn refineries. Already, roughly 20% of the nation's corn output goes into gas tanks rather than into bovine, ovine, or porcine stomachs. The losers from this "green energy" enthusiasm have begun to protest. The losers aren't just big businesses which rely on cheap grains. They include family farms, dairies, ranchers, and consumers. The American chicken industry, which is faced with huge cost increases, is heavily concentrated. However, although giants such as Smithfield dominate the pork industry, many family farms continue to market hogs. Many more produce milk. Corn at \$4 a bushel is a challenge to a large swath of US agricultural operations. But what makes that challenge truly terrifying for many small-scale hog or milk producers is that corn in the next four years is priced *well above \$4*. Worse: if all the ethanol refineries that are talked about actually get built, ethanol production in 2009 could be ten billion gallons, slightly more than double 2006 production.

Basic Points

Back-to-back high grain prices have never occurred before: throughout history, when grain prices soared, it was a one-off event caused by bad weather in major growing regions. Now, the futures markets price in expensive corn, oats, soybeans and sorghum, while assuming that the weather will remain benign and the demand will continue to exceed supply.

Result: a fast-spreading campaign to propagate the story that family farms, ranches dairies and consumers are being hurt by Washington's ethanol-protecting tariffs and subsidy policies, which are leading to diversion of too much of the nation's corn away from animal feed to biofuel.

Nor is the opposition confined to the USA.

For the first time, there is now a global corn arbitrage out of Chicago. India's National Egg Council is demanding that Delhi protect it from "abuse of futures" that has raised the costs of egg production by 70%. The Egg Council, which produces most of the nation's eggs, has long bought corn from farmers by offering them such quantity of rupees as its bureaucrats and economists thought fit. The Council was the dominant purchaser. Now, broadband has brought the Internet to farming villages and towns, and the Chicago Board of Trade website tells farmers what their crops are worth. *Result: globalization-induced inflation that originates two blocks from where this piece is written.*

But ethanol is not the biggest story in grains. It is merely another example of well-intended government intervention based on outdated data. At the time ADM and the congressional delegations from Iowa, Illinois, Minnesota, Ohio and Missouri were urging that *New York Times'* Thomas Friedman's demands that the nation find substitutes for Arab and Iranian oil be met, nobody bothered to check the USDA's data on global feed grain consumption.

What happened with meat, eggs and milk was what had happened with oil—the assumption that those billions of people in China and India don't really matter much to us, except in terms of giving us cheap goods and services. That they could be raising our cost of living by driving up the cost of what we eat, and how we heat—that's a bizarre idea. The tax-exempt *boulevardiers* of the International Energy Agency kept ignoring China's surging oil demands because China wasn't a member of the OECD, which meant consumers were shocked by \$50 oil, and assumed there had to be a conspiracy.

Naturally, nobody in power learned anything from that experience in bureaucratic obfuscation.

...globalization-induced inflation that originates two blocks from where this piece is written.



What BHP's Chip Goodyear calls the supercycle for energy and metals has been joined by a supercycle in grains.

Here are extracts from the USDA's report on global production of grains and meats. If you look at the annual increases in meat and dairy production worldwide, you will see that they are growing more rapidly than oil:

**Global Supply and Utilization of Grains
April 2007**

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 F	2006/07 F
	<i>Million units</i>						
Wheat							
Production (metric tons)	581.5	581.1	567.6	554.6	628.6	620.6	593.1
Consumption (metric tons)	583.9	585.0	603.8	588.5	610.0	624.4	619.3
Ending stocks (metric tons)	206.5	202.7	166.6	132.7	151.2	147.5	121.2
Coarse grains							
Production (metric tons)	862.3	893.7	875.1	915.9	1,014.0	977.5	966.7
Consumption (metric tons)	884.4	906.6	902.3	945.9	975.9	989.1	1,014.5
Ending stocks (metric tons)	210.1	197.1	169.9	139.9	178.0	166.4	118.6
Oilseeds							
Production (metric tons)	314.0	324.9	330.0	334.9	381.2	390.3	402.9
Ending stocks (metric tons)	39.5	41.7	48.1	44.3	56.8	63.3	67.4
	2001	2002	2003	2004	2005	2006 P	2007F
Beef and Pork							
Production (metric tons)	133.2	139.3	140.6	144.1	148.6	153.3	158.1
Broilers and Turkeys							
Production (metric tons)	57.1	59.2	59.2	60.8	63.9	64.9	66.0
Dairy							
Milk production (metric tons)	384.8	395.0	399.0	406.1	414.0	423.3	432.2

Source: USDA Economic Research Service, Agricultural Outlook: Statistical Indicators, April 2007: <http://www.ers.usda.gov/Publications/AgOutlook/AOTables/>

Those numbers document the next phase of the bourgeoisie of China and India. Demographers estimate that about 40 million people-per-year enter the middle class in those countries—meaning that they move into dwellings with indoor plumbing, electricity, and basic appliances, with expectations of owning cars. That powerful trend, as we have been writing since 2002, is the cause of \$65 oil, \$3.00 copper, and \$18 nickel.

What BHP's Chip Goodyear calls the supercycle for energy and metals has been joined by a supercycle in grains. The slow growth in demand in the OECD for oil and metals could have been easily accommodated at rock-bottom Triple Waterfall Crash prices. Most Street economists, strategists and commodity analysts continued to project oil and metal demand the way they always had—based on OECD statistics. As late as 2004, in the midst of a massive commodity boom, "Sell" recommendations came on base metal stocks whenever the Non-Farm Payroll number came in below forecasts. Some of the Street's big names tried to justify their hopelessly inaccurate forecasts by

Basic Points

alleging conspiracies, and secret commodity reserves. Then they began to argue that China's economy was on the edge of a major slowdown or an outright crash—which would send oil, copper and nickel back to their comfort zones (\$30, \$.85, and \$3.50, respectively.)

So we weren't surprised when the same savants (1) failed to predict soaring grain prices, and then, (2) blamed them on ethanol.

There probably aren't enough hectares under cultivation in the world to supply the corn, soybeans, barley, sorghum, alfalfa, and oats needed for the livestock that will be needed to satisfy current Asian dietary demands—even without ethanol, and other grain and soybean-based biofuels.

The next time you hear some economist or analyst blaming food inflation on ethanol, ask him or her why the world now has the all-time low carry-over of feed grains, soybeans and wheat in relation to consumption. Ethanol accounts for less than 10% of global corn production and isn't a factor in consumption of the other grains—or soybeans.

We are definitely not fans of ethanol, because the assumptions underlying its efficacy arguments are, like so much of the "analysis" from leading global warmists, dubious.

We certainly do not recommend the shares of ethanol producers. Ethanol, buoyed up by subsidies, and protected by tariffs, was a very profitable product when corn was \$2.50 or less and natural gas was \$7 or less, and oil was over \$65.

An ethanol refinery's costs are, basically, corn and natural gas. Everything else is trivial compared to those items.

Ethanol's "crack spread" means producers are, in effect, long gasoline and short corn and natural gas.

Unlike some Canadian economists, we have never believed oil was likely to go to \$100 in this decade—apart from a geopolitical event that closed the Strait of Hormuz or shut down Saudi production.

On the other hand, disappointing weather in the US Midwest is a predictable event.

Or, it should be.

**we weren't surprised
when the same savants
(1) failed to predict
soaring grain prices,
and then,
(2) blamed them
on ethanol.**



...when a major Midwest crop failure occurs, it will be the global food equivalent of an Al Qaeda bomb strike that shuts down Saudi Arabian oil production...

Global Feed Need: Stormy Weather in the Midwest

One could assume, based on historical data, that there would be damaging weather in the corn belt at least once every decade, with a full-blown drought every 19 years. Other weather problems that have led to major yield reductions have included late frosts in Spring, lack of rainfall during pollination in July, floods, and early frosts in autumn.

But the last time there was a crop failure or even a significant yield reduction in the nation's midsection, George H.W. Bush was President and Bill Clinton was still known as Governor Clinton.

As things stand now, there is a high probability that there will be a second Clinton Presidency before there will be a Midwest crop failure.

We have been surprised to learn how many clients are surprised when we tell them of the fifteen-year winning streak. Global warmists have convinced an amazing number of people that the weather has gone amok. Any time there is a flood or hurricane or drought, some experts emerge to warn us that this disaster could have been predicted. We are to blame, because of the way we pump CO₂ into the air.

There will be a corn crop failure one of these years. Speculators have bet on a drought many more times than one has occurred. Current record prices for grains reflect the latest of these weather bets. Maybe they'll be right this time; maybe not. But someday a drought will come.

And with it, disaster.

We now know that when a major Midwest crop failure occurs, it will be the global food equivalent of an Al Qaeda bomb strike that shuts down Saudi Arabian oil production for months. Coming at a time of a worldwide shortage of feed grains and wheat, it will send food inflation to peaks not seen since 1974. The force of those shock waves would trigger food riots across the world and topple some precarious Third World governments. It will send food inflation to peaks not seen since 1974.

In this year's US growing season, the annual worry about a return of drought has been joined by wondering whether honeybee Colony Collapse Disorder (CCD) will seriously undermine production of fruits and vegetables.

We have commented previously that alfalfa is the crop whose failure due to reduced bee pollination would have the greatest impact on food prices. Alfalfa is 100% insect-pollinated—60% honeybee pollinated. It is also the

Basic Points

backbone of pastures and hayfields across the land. In particular, it is crucial for dairy farmers. Without alfalfa, feeding the Holsteins and Guernseys corn and soybean meal would be ruinously expensive for most family farms.

We are grateful for the correspondence we have received from several US and Canadian readers with agricultural backgrounds. They disagree with the USDA report on the importance of bees in pasturage and hay. They have pointed out that the honey bee's importance in alfalfa pollination is a regional matter. Another bee species, the alfalfa leafcutter bee, is the prime pollinator in northern areas. Also, there are two markets for alfalfa—for feed, as pasturage and hay—and for seeds. Our readers points out that alfalfa is a perennial. Some also believe that if the seed crop fails, farmers can buy seed overseas. (CCD has been reported in nine countries there.)

Both the CCD Report to Congress and USDA Impact of Pollinator report *combined* values for direct pollination of crops, such as almonds, apples or alfalfa seed, with those indirectly affected such as alfalfa for hay (needing seed for replanting). Particularly for alfalfa, crop impacts will be spread out across several years. The experts agree a significant loss of honeybees will affect crop production levels and pollination costs, but predicting the scope of impacts, particularly economic impacts, is a source of considerable disagreement.

We are pleased that alfalfa crops may not be at risk. While the cause of CCD remains a mystery and bee disappearance continues, this remains a “known unknown” for crop production in the US.

We have, however, received confirmation from other readers that our bee fears are not misplaced. Some have suggested that the (mostly) American practice of transporting bees to many locations during the year may have overstressed the bees and made them prone to some autoimmune disease. Declining bee populations in the past 20 years, and monoculture farming have made this practice a necessity. Only 5% of American honey bees are kept in one location to produce honey: the other 95% are taken around the nation by lone beekeepers, who (presumably) drive in trucks with hives, a rifle and a guitar in the back, and listen to country music. This rugged individualism helps explain why beekeepers never became entitled to a slick Washington lobby, or to a large, solicitous group of bureaucrats whose job was to ensure that they always got their share of the appropriations. Beekeepers are themselves endangered by CCD; Many beekeeping operations of the type who provide crop pollination services to farmers will be hard-pressed to

**...lone beekeepers,
who (presumably)
drive in trucks with
hives, a rifle and a
guitar in the back,
and listen to
country music.**



As wheat, corn and other grains soar to new highs...bond prices worldwide sink.

recover financially from this malady, the latest of many expensive blows to their livestock in the past decade. This industry like so many is experiencing a demographic challenge—the average age of beekeepers is approaching 55. Facing an unknown peril and years of expensive hive rebuilding costs, the concern is that many beekeepers may simply decide, like the bees, to leave the hives behind and move on, or retire.

The new food inflation is, to us, simply the next chapter in a story we have been telling each month for six years.

The soaring New Asian Middle Class's appetite for oil gave the world \$65 oil. Its appetite for electricity, indoor plumbing and air conditioners gave the world \$3 copper. Its appetite for meat and dairy products has given us \$4 corn and \$8.30 soybeans.

The ethanol campaign is part of an attempt to use biofuels—corn, soybeans, sugar, animal fats, wood chips, etc.—to prevent oil prices from reaching \$100. The articulate Thomas Friedman and his supporters have a strong case: sitting back and doing nothing about our dependence on oil virtually guarantees endless growth in cash flows for supporters of Islamic terror operations. President Ahmadinejad has proclaimed that his country is producing nuclear fission and “the clock has begun ticking” on the destruction of Israel. Paying a little more for meat and milk to ensure that the clock ticks much longer than he expects is an attractive strategy.

When the ethanol boom was starting to build momentum, everyone assumed corn would stay cheap and plenteous forever—just as everybody who mattered figured oil and metal prices would stay low forever. To date, the marginal demand for corn for fuel has produced far greater grain price boosts than it has moderated demand for petroleum. This is another example of The Law of Unintended Effect.

Not all their assumptions have been proved wrong: they assumed that Midwest growing weather would always be good.

As wheat, corn and other grains soar to new highs, and 70% increases in pork prices drive Chinese CPI to 3.4%—well above the upper limit of inflation Beijing finds tolerable—bond prices worldwide sink.

The worst is yet to come.

The Big Bad Bond Bear

We are on record as predicting that long US Treasury yields will reach at least 6.75% within two years. That surge in yields will not be enough to keep the greenback from falling to new lows—or to keep gold from reaching new highs.

Last month, we suggested that four surpluses had undergirded the twenty-five-year-long bond bull market—energy, metals, food, and labor.

The first two surpluses had vanished by 2003.

The food surplus vanished late last year.

The labor surplus is already gone in many parts of the world. We believe that workers have entered a long-term period of growth in incomes and power after history-making union defeats at the hands of Thatcher and Reagan launched two decades of declining relative incomes and power.

Last week, the Labor Department's announcement that Q1 unit labor costs had risen three times as fast as previously estimated was the big contributor to a 129 point Dow droop.

Despite the major gains in oil and gas prices, energy has not created big inflation pressures—as measured by CPI. Neither have the huge runups in base metal prices.

In part, energy's muted impact was due to the Katrina squeeze on natural gas, followed by a collapse, at a time oil prices were trading mostly in the \$60 range.

If natural gas prices should break out toward \$10 this winter, the CPI will almost certainly reflect energy inflation.

The best hope for food price inflation is that it manages to stay in the high single-digit range. A big assist comes from the plunge in sugar prices: sugar is a food-price heavyweight because of its ubiquity in processed foods and beverages. With corn no longer in surplus, sugar might be able to regain at least some of the market share it lost to corn fructose—and thereby restrain some of the inflationary impact of the boom in feed grains. Should sugar prices remain at these levels, the pressure on the US to admit Brazilian and Caribbean sugar-based ethanol will become so intense that even Senators

The best hope for food price inflation is that it manages to stay in the high single-digit range.



The food price inflation we shall soon be experiencing is unlike any predecessor, because it comes without a crop failure.

Grassley and Obama may not be able to hold back the tide. To date, the power of a Dominican Republic-based family has been able to keep US sugar prices far above global prices, thereby costing many thousands of jobs in the confectionery industry. We have been told by a person who attended one of the family's glittering social extravaganzas that the clan's leader was one of only five or six people who were privileged to reach President Clinton by phone almost without regard to his activity at the time.

(Incidentally, Canada has been a big beneficiary of this protectionism of a vested interest that benefits a wealthy family and, incidentally, devastates the Everglades by draining the Park's water to produce sugar that could be purchased far cheaper abroad. Candy factories that had been prominent features of the economy in Chicago and Michigan for decades have been shuttered, because Canadian candy makers buy their sugar in the global free market, and then ship candy to US consumers. Even Chicago's powerful mayor Richard Daley wasn't able to break the sugar interest's control of the leaders in the Democratic Party. Within the Republican Party, Bob Dole remains the spokesman for the Kansas sugar beet producers, but he needs the Florida Cubans to hold the party together in its sugar programs.)

The food price inflation we shall soon be experiencing is unlike any predecessor, because it comes without a crop failure. Therefore, once it arrives, it will not disappear as a result of a barn-bursting crop. At some point, it might even put pressure on the Core inflation number.

The sudden selloff in bonds has produced a flood of Street analysis. On at least one point the bulls are in agreement: bond yields are unaffected by any risk from food-price inflation. In assessing that torrent of research, we see that the economists still talk about inflation risk and Fed policy in terms of Core—not Nominal—inflation. The Fed, we are told, continues to watch the Core Personal Consumption Expenditure reading as its guide.

The bulls' case was presented elegantly in the Lex column of the *Financial Times* on June 12th. "The relationship between food prices and inflation has been weakening for decades. In the late 1940s food accounted for 43% of the US consumer price index. By 1975, when food and oil shocks had pushed inflation into double digits, it was down to a quarter and its weight in the basket is just 14 % now." The article concludes with a fine touch of sarcasm, "Pricier cucumbers are unlikely to herald the return of stagflation just yet."

Basic Points

We have devoted so much of our—and our readers’—time on foods for three reasons:

1. Falling or stable food prices were a pillar of the decades of disinflation that gave us the roaring bull markets of our time. The fall of even a small pillar in the Parthenon was always noticed with alarm.
2. Food and energy are commodities people buy every week, and their perceptions about inflation are likely to change from benign to concerned when their basic essentials no longer behave benignly. We believe labor is going to have more power in the years and decades to come, (because of scarcity), so workers’ perceptions of economic reality may become, perhaps, more important than the views of those who delete food and fuels from their computations as sheer noise.
3. The downside of globalization is that we have global pricing of energy and basic food products, which means soaring demand abroad injects food and energy inflation into the serene world of the OECD upper middle class. It also means that wage rates abroad must rise: Meat is 7% of Chinese CPI and pork is up 71%. That global wage arbitrage out of China that infuriates Lou Dobbs and delights bond buyers may not be as powerful in the future as it has been in the recent past.

We believe overall labor costs will soon start to rise at rates that will register in both Core and Nominal CPI, but employers will doubtless absorb some of those cost increases before raising prices of their goods and services. Each day we read stories about labor shortages. Chicago Fed Governor Mike Moskow confirmed anecdotal evidence we had heard that many employers in this region are hoarding workers, fearing that if they lay them off, they may not be able to rehire them.

Conclusion

The bond bear has finally emerged from his den, drawn by the need for food.

He will become an increasing threat to the unwary.

The bond bear has finally emerged from his den, drawn by the need for food.

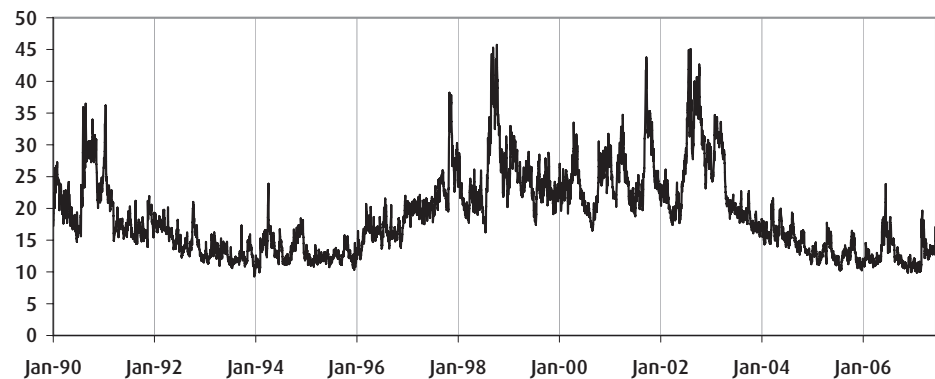


**The defining
excesses of this era
have permeated
and polluted
corporate and
home mortgage
debt.**

INVESTMENT ENVIRONMENT

One of the laments in hedge fund circles has been the disappearance of volatility. The VIX Index, which measures the activity in put options in the Chicago Board Options Exchange, is a widely-accepted measure of equity volatility. Its placidity in recent years reflects the lack of runaway Fear or Greed since Nasdaq's "correction" became Nasdaq's collapse.

**VIX Index
January 1990 to June 2007**



Whenever the entire global financial system reaches a point of inflection after a lengthy continuum, it experiences a surge in volatility. Suddenly, the fundamental price relationships that had long existed between bonds and stocks, and between sectors in the stock market, are called into question, then abandoned, and, after a period of turmoil, a new equilibrium emerges.

When Nasdaq peaked, plunged and went *pfftt*, the relative values of all other financial assets changed. Although few noticed it, the new stock market leadership would be commodities—the group that had experienced the years of ecstasy and the decades of agony thereafter during the first Triple Waterfall.

The coming point of inflection will not be equity-centered. The defining excesses of this era have permeated and polluted corporate and home mortgage debt. Therefore, the killing fields will be populated with fixed income instruments. The tens of trillions of derivatives that have been absorbing the risks in the real financial markets will surely undergo a population plunge that may recall the last years of the passenger pigeons and buffalos—or perhaps, today's honey bees.

Basic Points

This coming mass root canal without benefit of anaesthetic will occur because inflation re-emerged from its crypt. All relative pricings of assets are inflation-dependent. The greatest tribute to Thatcher and Reagan's success in defeating the inflation dragons comes monthly with the surveys of consumer expectations. They predicted double-digit inflation in the Jimmy Carter era and were correct—in both their forecasts about inflation and their purging of the President who had fiddled and lamented the national malaise while inflation burned. In recent years consumers have been predicting 3% or less.

The disappearance of the four kinds of excess inventories that suppressed inflation for so long means that we are at risk of a true inflation shock. First was energy, then metals, then food, and now workers. Meanwhile, the corporate sector worldwide still practices just-in-time inventory management. It is still chic to run lean inventories of raw materials—and staff.

When there are no price-stabilizing inventories except the Strategic Petroleum Reserves, then food, fuel and metal prices are in continuous risk of supply side shocks. A few offshore oil workers are kidnapped by MEND, a drought occurs in Ukraine, Peruvian copper miners go on strike...none of these events would have had great pricing impact during the 1980s and 1990s, because there were such large supply overhangs.

We agree that sustained inflation cannot occur without excess monetary growth. Otherwise, sudden price shocks simply redistribute shares of GDP and profits without creating a new, consistent, high level of overall pricing. Although central bankers in the disinflation era practiced the faith in monetarism with the zeal of Spanish bishops during the Inquisition practicing their faith, they have in recent years become more—how shall we say?—latitudinarian. The Fed no longer hymns the sanctity of monetarism. As for its putative devotion to the principles of Reagan, Volcker and Friedman, since Christmas it has been behaving more like the reformed Scrooge than his earlier version: M-2 has been growing at 7.4% and MZM 10%. The Private Equity firms could well be gloating, "God bless us every one!"

**This coming
mass root canal
without benefit
of anaesthetic...**



Is the ECB politicized, or is it simply reveling in Pohl-axing?

As a condition of agreeing to the creation of the European Central Bank, the Bundesbank insisted that this replacement bank be assigned a benchmark monetary growth target—4.5%. Karl Otto Pohl must be cursing himself for his naivete: the ECB has been above that target every month for six years, and recently it has been missing the mark (not, alas, the Deutschemerk, any more) so egregiously that one can only assume the target has come to resemble the Holy Grail or the Ark of the Covenant: a sublime symbol of sacred belief that may not really exist: Euromoney is now growing at 10.4%, a mere 131% above the Bundesbank-imposed maximum growth rate. Is the ECB politicized, or is it simply reveling in Pohl-axing?

Although global inflation remains restrained, money supply growth keeps climbing in such newly-important nations as China and India, with recent expansion in the 20% range in both those economies. To date, global excess monetary growth, levered up through the Babel towers, has mostly been absorbed in asset inflation. That energy and food prices have risen so smartly might give bondholders pause, but luckily all that money and all that leverage have gone into inflating the prices goods that aren't included in the Core inflation indices.

This new global inflation is a copy of the globalization-induced inflation the OECD has experienced from oil and metals: if it were not for the new middle class in China and India, oil would still be at \$30 or so a barrel, copper would still be at \$0.75 or so and nickel would still be at \$4 or so. The wage arbitrage from China and India has held down OECD inflation in finished goods and some services, whereas the commodity arbitrage has given us inflation in just about everything that we buy that isn't measured in Core Inflation.

If nominal inflation creeps into the Core and that form of inflation increases by 1.5 %, then mid- and long-term interest rates would have to rise by at least that amount. In the case of Treasuries, we think yields will rise more than the CPI, because (1) Treasury yields have been so suppressed for so long (as discussed in last month's issue), and (2) the dollar will be so weak that investors will demand a currency risk premium.

As Treasury yields rise and the dollar falls, Risk will re-enter the financial system, and the castles in the air will begin to crumble. Once that process begins to build momentum, it will not take long for the ingenious support systems of this latest Babel to commence eroding.

Basic Points

Yield spreads, which have been compressed far past the point of absurdity, will return to normalcy. Among the victims will be holders of the vast debt issued by private equity firms to finance their acquisitions. As their appetites grew, and as the balance sheets of their subsidiaries weakened, the firms responded...by convincing the Street to reduce or virtually eliminate the restrictions in covenants on their debts! Thus were born the cov-lite loans, this era's version of the Third World loans that made so many global banks look at once piteous and ridiculous in the 1980s. These symptoms of money mania will be a system stress point that will give way. As those corporate debts begin to weaken and rot, substantial numbers of structured products that managed to package this era's new kinds of mortgages—subprimes, AltAs, and AltBs—will already be getting marked down. The collapses and foreclosures that have already begun eroding the perceived quality of these Babel babies will mean widespread misery among the poor who thought they finally had their share of the American dream. Their misery will be unlikely to wound the Wall Street organizations that created and coined those temptations to personal disaster for the poor and uninformed. As for the cov-lite loans, their collapses could, perhaps, reduce the scale of some future birthday parties among the private equity super-rich.

Fortunately, most of the world doesn't have cov-lite loans, subprime loans, altAs, or other such soft and hard financial pornography. The global economy will not go into a tailspin. The really strong growth will continue to be in South and East Asia, which means commodity demand will remain high. Man doth not live by bad bonds alone—but by bread, meat, milk, oil, gas, coal, copper and aluminum.

The kinds of stocks we have been recommending for so long will become even more relatively attractive as more and more corporate structured debt begins to emit odors—and stops remitting interest payments. The mining, oil and food production stocks we espouse are—and will remain—formidable cash generators.

They still trade at a discount to the S&P. We think they'll be at even yield within three years—because investors will pay more for their earnings, and because the S&P's multiple will shrink by two points or so to reflect higher inflation and the unattractiveness of the dollar.

Fortunately, most of the world doesn't have cov-lite loans... or other such soft and hard financial pornography.



INVESTMENT RECOMMENDATIONS

1. Reduce overall portfolio exposure to bonds. The recent selloff has inflicted serious technical damage on most global bond markets and is a sign of how powerful this bear could be. Within the bond portfolio, move to higher quality and shorter duration issues. Long term and low quality were the winning strategies of this decade. They have become the losing strategies.
2. Continue to build commodity stock exposure within equity portfolios.
3. The most attractive stock group now is companies which benefit from food price inflation—such as meat packers and supermarkets—and those who help farmers to boost outputs, including the feed and seed companies, and the farm machinery manufacturers. The least attractive in the food sector is the ethanol producers. Being permanently short corn is being under permanent stress.
4. Remain overweight the base metal producers.
5. Remain overweight the oil sands producers, and market weight the other oil producers. Remain overweight the refiners and the offshore oil drillers.
6. Begin to build exposure to North American natural gas producers. We have not recommended exposure to gas stocks since Katrina, but now believe that gas could outperform oil next year.
7. Remain overweight gold and gold mining shares. Gold bugs sang so long that inflation had come back that many investors finally got tired of waiting for their claims to come true. But it also took a long time for the cicadas to return; they are back. So is food inflation.
8. The Canadian railways are beneficiaries of rising demand for commodities, including potash, grains and coal. That leverage to the commodity story means they could well be better values than their highly-publicized US counterparts.
9. The stock market keeps postponing the inevitable correction. When it finally does come, it could be ugly, because it will be accompanied by signs of rising inflation. Financial stocks are traditionally the most vulnerable to a correction caused by rising inflation and rising interest rates.

Disclosure Statement

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") and its affiliates make every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, neither BMO nor its affiliates have independently verified or make any representation or warranty, express or implied, in respect thereof, take no responsibility for any errors and omissions which may be contained herein or accept any liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO and/or its affiliates that is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO or its relevant affiliate directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments). BMO Nesbitt Burns Inc. and/or BMO Capital Markets Corp., subsidiaries of BMO, may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. "BMO Capital Markets" is a trade name used by the Bank of Montreal Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal, BMO Nesbitt Burns Inc., BMO Nesbitt Burns Ltée/Ltd., BMO Capital Markets Corp. and Harris N.A., and BMO Capital Markets Limited.

TO U.S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO Nesbitt Burns Inc., furnish this report to U.S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd.

TO U.K. RESIDENTS: The contents hereof are not directed at investors located in the U.K., other than persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

TM - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence.

© Copyright Bank of Montreal 2000

BMO Capital Markets Disclosures

Company Name	Stock Ticker	Disclosures
Archer Daniels Midland	ADM	
Bear Stearns	BSC	
Cisco Systems	CSCO	2
Dow Jones	DJ	
Moody's	MCO	
New York Times	NYT	
Smithfield Foods	SFD	

(1) BMO Capital Markets or its affiliates owns 1% or more of any class of common equity securities of the company.

(2) BMO Capital Markets or its affiliates makes a market in the security.

(3) BMO Capital Markets or its affiliates managed or co-managed a public offering of securities of the company in the past twelve months.

(4) BMO Capital Markets or its affiliates received compensation for investment banking services from the company in the past twelve months.

(5) BMO Capital Markets or its affiliates expects to receive or intends to seek compensation for investment banking services from the company in the next three months.

(6) BMO Capital Markets has a actual, material conflict of interest with the company.