



## TSG Weekly Stock Market Letter

Week Ending April 20, 2007

[TradeSystemGuru.com](http://TradeSystemGuru.com)

- **Takeoff eh? – More inflationary signs from the Great White North.**
- **Indexes hit new all-time highs as the rally gets a boost.**
- **Investor’s view on bad housing news? Ignore it.**
- **Real wage boost – What does this mean for markets?**

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Last week we looked at the Dow denominated in both euros and gold. This week I'd like to continue with that thought by examining an index that is popular with resource investors – the Canadian Toronto Stock Exchange Index or TSX. As we have mentioned before, 2007 is pre-election year which has historically been the kindest of the four-year election cycle to stocks since the beginning of the Twentieth Century. Over this period, the two years leading up to each election have returned 93% of Dow Industrial Average gains versus just 7% for the two years after an election.

Given that the ratio for the Canadian TSX is even higher at 97% in the two pre-election years versus just 3% in the two post-election years, what are possible explanations for the fact that a foreign exchange would be more heavily impacted by the US election cycle than US exchanges themselves?

Since the TSX is a resource-based index, precious metals are likely suspects. Commodities are another. How have they performed in the two years leading up to US elections versus the two post-election years?

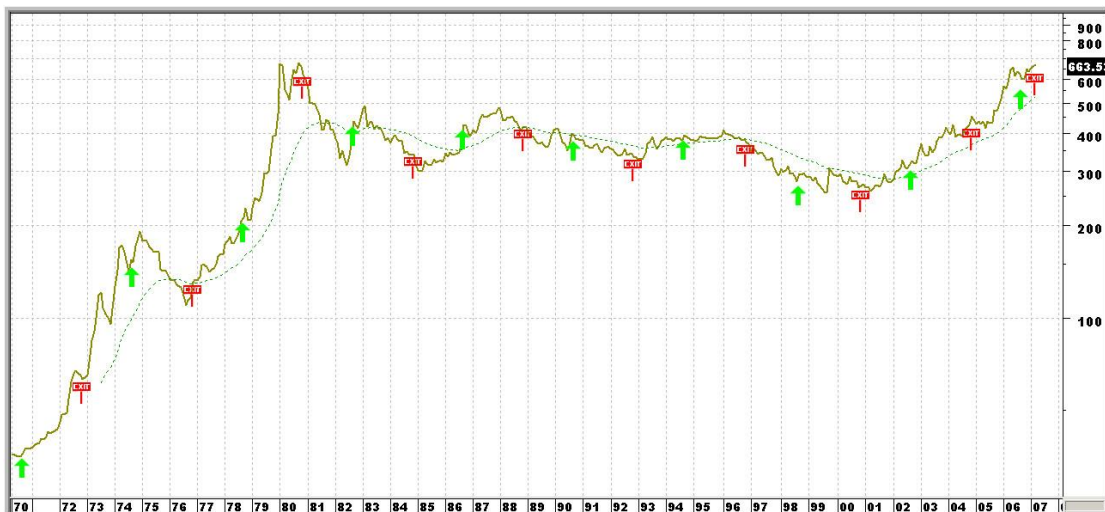


Figure 1 – Weekly chart of Engelhard Gold from 1970 to present showing pre-election buy (green arrows) and sell signals (red signs). Historic data – Pring.com Chart by Metastock.com

By buying gold two years before and selling immediately following each election in a total of 10 trades between 1970 and 2007, the pre-election trader would have captured 65% of the returns enjoyed by a buy and hold strategy.

Silver showed a more impressive pre-election performance. From 1950 through 2007, silver increased in value 18 times in US dollar terms. In 15 trades, the pre-election trader would have outperformed the buy and hold silver investor by a ratio of 1.29 to 1 handily outperforming the pre-election gold trader. The silver trader would have been better off being out of the market altogether in the post election years.



Figure 2 – Pre-election buy and sell signals on weekly chart of silver from 1950 to present complete with a bullish long-term cup and handle pattern (red curved line). Historic data – Pring.com Chart by Metastock.com

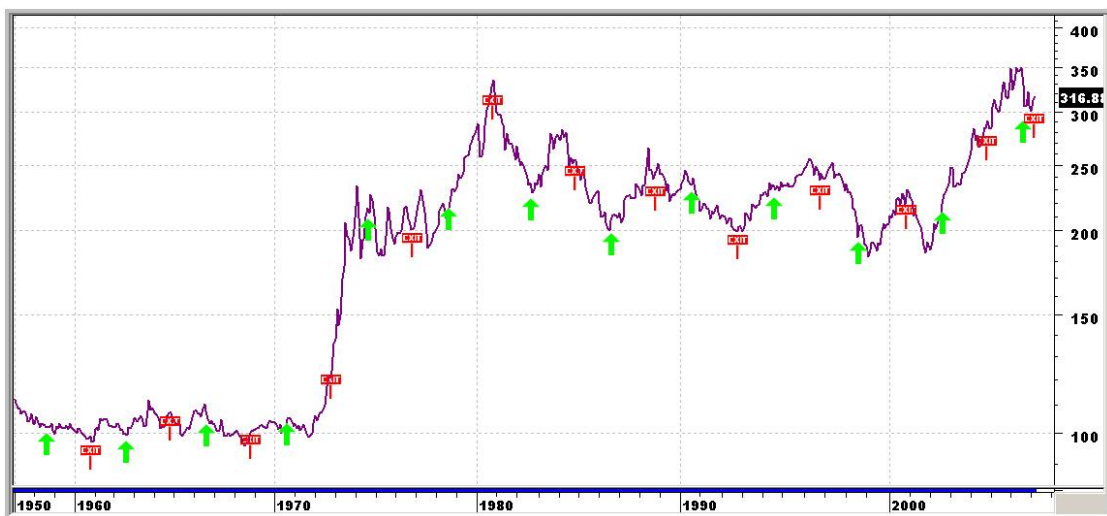


Figure 3 – Weekly chart showing pre-election trades for the CRB Index from 1957 through 2007. Historic data – Pring.com Chart by Metastock.com

Finally, we tested a basket of commodities that includes everything from metals and energy to food stuffs represented by the Commodity Research Bureau (CRB) Index. This should give us a better idea of how futures responded to pre-election pumping of the economy by incumbent governments in attempts to gain voter support.

Like silver, buying the CRB Index for the two years before each election and selling just after it handily outperformed a buy and hold over the period by a ratio of 1.27 to 1. The trader again was better off being out of commodities market in post election years.

So why has the TSX done even better than the Dow Industrial Average in pre-election years? Rising commodity prices are inflationary and as we all know commodities have been on a tear – more clear evidence of governments using inflation to stimulate the economy. With an approaching election, inflation pressure should remain high and that will be good for commodity prices into election year. And unless inflation gets completely out of hand, don't expect the Fed to try to ruin the party with higher rates till after they are over.

Now let's check in on what happened in the stock market this week.

INDEX	Weekly Close	Last Week	Change	Change%
INDU	12,961.98	12,612.13	349.85	2.77%
DJT	5,205.86	5,035.00	170.86	3.39%
SPX	1484.35	1452.85	31.50	2.17%
COMPX	2526.39	2491.94	34.45	1.38%
RUT	828.86	819.38	9.48	1.16%

### Summary

This was the third consecutive week of across-the-board gains for the major indexes that in every case in the table above, beat last week's performance. The Dow Transports again led the pack and is now up 14% in 2006 dwarfing the Dow Industrials gain of 4%. Earnings also continued to improve this week with a few companies handily beating analyst estimates. Investors have taken a damn-the-torpedoes approach throwing caution to the wind in the hopes of cashing in on the expected rally from here.

Another side benefit of a falling dollar is that it makes dollar denominated assets seem cheap and is starting to attract foreign investment. However, this strategy only works if the dollar stabilizes from here which is a bit of a long shot given that Europe and Japan are raising interest rates while the U.S. seems more likely to leave them alone or even lower them. At the end of the day it will be foreign demand for Treasuries and other U.S. investments that will determine our rates, the price we pay for being beholden to foreigners for our standard of living.

### **Technically Speaking**

Stock momentum increased this week as the Dow hit yet another new all-time high along with new highs for the Dow Transports Average, NYSE Index and Russell 2000. The S&P500 put in a six year high and Nasdaq Composite a five year high.

The Philadelphia Housing Index (HGX) bounced this week above its 200-day MA and is now challenging its 50-day MA as bottom pickers moved in hoping that the worst for the sector was over.

Commodities corrected this week as the NYFE CRB Index closed at 405.32 down from 409.66 last week.

The big drop in Shanghai stocks on Thursday rattled gold investors temporarily but by close of Friday the metal had gained back all territory lost plus some. June gold closed at \$695.80 up from \$689.90 last week.

NYMEX crude oil (June07) closed Friday at \$64.11 up from \$63.63 last week.

Meanwhile greenback weakness continued as the U.S. Dollar Index closed at 81.64 down from 81.93 last week as it slid toward the December 2004 low of 80.53. If that level is breached, next stop is the 1995 low of 80.05 then the 1992 low of 78.33. Below that, we enter territory uncharted in recent times.

A weakening dollar continues to push the MSCI Emerging Market Index ETF (EEM) that represents a basket of foreign currencies higher as it closed at 123.16 up from 122.97 last week. This shows that the Shanghai market drop has done little to shake global investor complacency.

### **Earnings**

After getting off to a slow start last week, earnings reporting for Q1-2007 looked better. With 770 companies having reported (up from 440 last week), Q1 earnings improvements over Q1-2006 moved up to 4% from 2% last week.

### **Economic Reports**

Here's what the charts had to say this week.

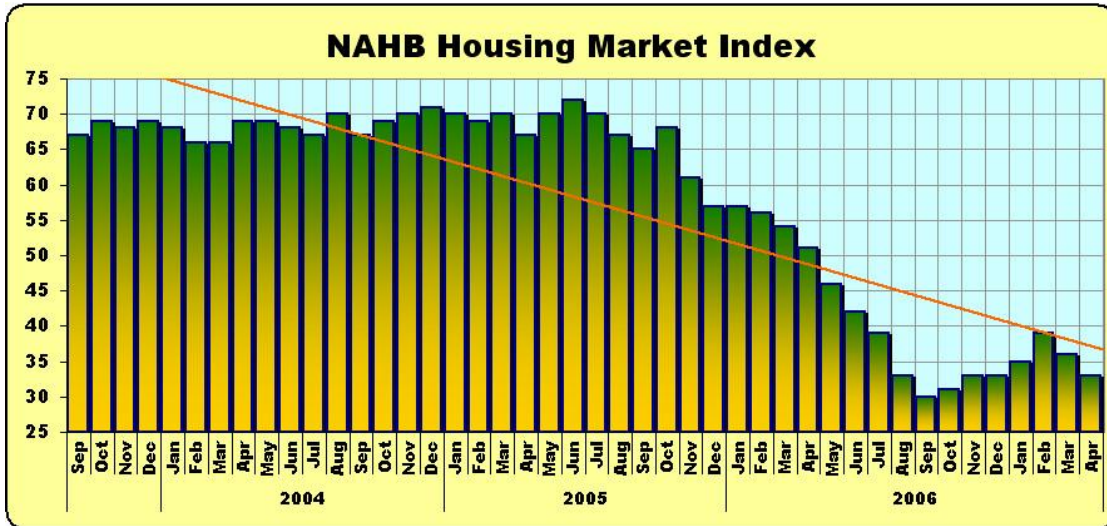


Chart 1 – The National Association of Home Builders housing market index dropped again in April to 33 the lowest level since December. It was the second consecutive monthly drop but strangely this index is now receiving less attention from the financial media which means investors are more likely to discount bad news in the recent market run-up.



Chart 2 – Housing starts rose 0.8% in March versus the consensus expectation of a 1.6% drop. Meanwhile, the February number was revised downward from 9% to 7.6%.

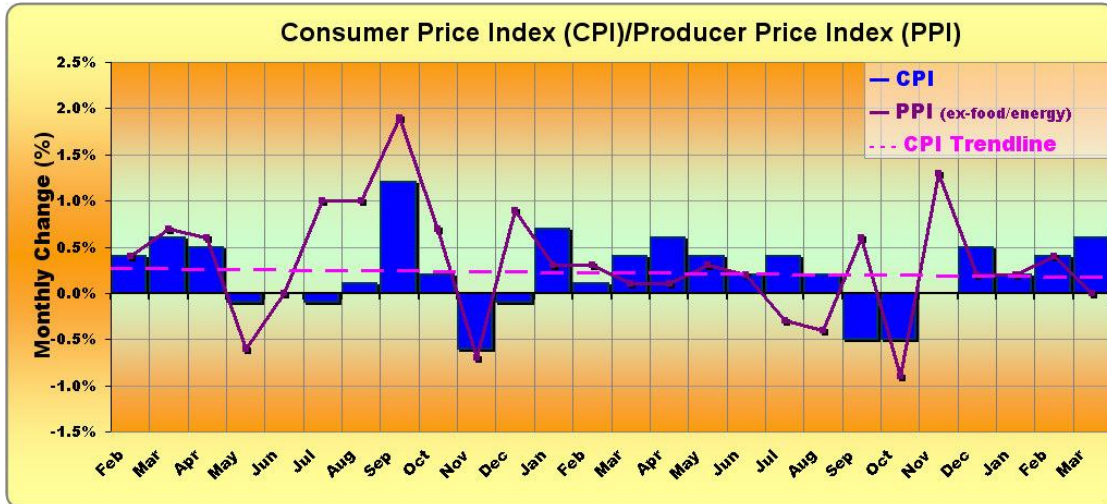


Chart 3 – The producer price index (ex-food and energy) was unchanged this month versus a consumer price index that rose 0.6% as the Fed inflation model continued to show increasing inflation pressure. Markets appear to have come to terms with the expectation that interest rates will not fall but are still hoping they won't rise.

### Next Week

Here are the economic reports we'll be watching.

- Tuesday, March existing home sales (previous 3.9%).
- Wednesday, March durable goods orders (previous 2.5%), March new home sales (previous -3.9%). PM - Federal Reserve's Beige Book.
- Friday, Q1-07 GDP, advance (previous 2.5%), April U. Mich. consumer sentiment index, final (previous 85.3).

### Synopsis

Let's take a look at a leading market indicator that we haven't discussed in a while – real average hourly earnings – and what it may be telling us about the inflation picture.

In his book entitled Ahead of the Curve ([www.aheadofthecurve-thebook.com](http://www.aheadofthecurve-thebook.com)), Wall Street analyst Joe Ellis separated coincident and lagging economic indicators from those he demonstrated to be true market leaders. One that made the cut was real average hourly earnings (annualized rate of change of average hourly earnings divided by the personal consumption expenditures (PCE) deflator).

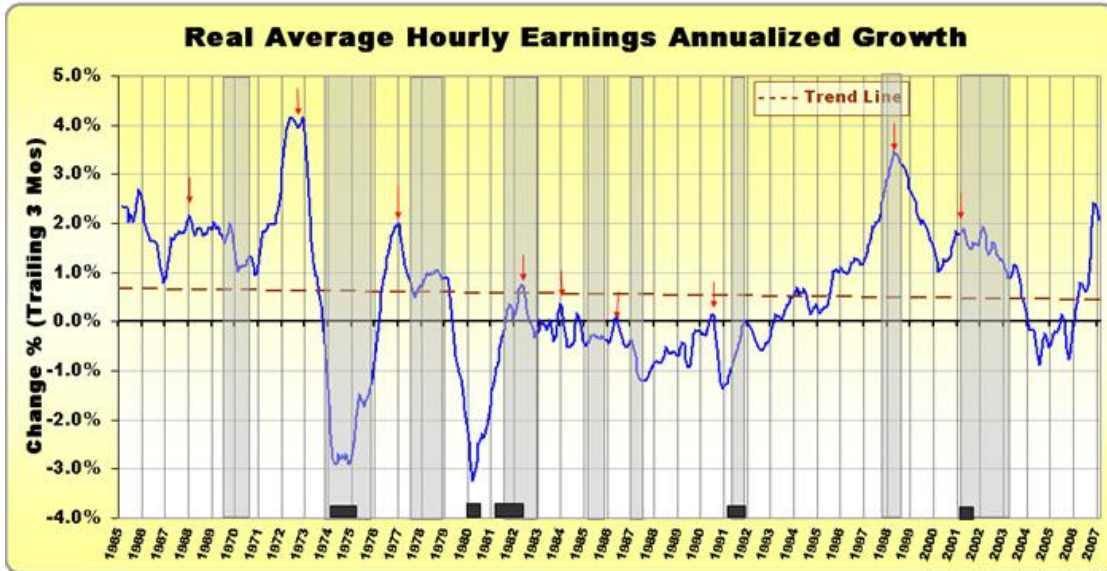


Chart 4 – Chart showing Dow adjusted for inflation using the Fed’s inflation measure that currently shows annual inflation running at around 2.7%. Gray rectangles indicate bear markets, red arrows peaks in RAHE and black rectangles recessions.

The graph he presented (see Figure 1) showed that peaks in real average hourly earnings (RAHE) preceded bear markets (gray zones). Black rectangles indicate recessions. As we see, while RAHE were negative from 2004 to 2006, they sharply accelerated in early 2006 and currently sit above 2% at a level not seen since 1999. While it’s too early to say if the recent high is a peak, the graph shows how quickly average earnings have risen in real terms and this is adding inflationary pressure. Last time around, RAHE peaked 18 months before the Nasdaq and S&P500 peaked and the tech bear market began.

So what do we look for? If real inflation accelerates faster than wages, real wages will begin to fall. Consumer spending holds the key. Once it begins to decline in earnest, a decline in stocks won’t be far behind. But in the meantime barring any unexpected geopolitical events, inflation while not great for the US dollar, will be good for precious metals and should continue to push stocks higher.

On a final note, Friday marked the expiration of stock options and with short interest on the NYSE at record levels there was uncertainty as to what that might mean for stocks. We now have our answer and it appears that a number of shorts covered their bets driving stock prices even higher. A large short interest can cause a short squeeze and push stocks even higher in a rally as short traders betting that prices will fall capitulate and cover. A high put-call ratio (as exists today) is viewed by some as a contrarian indicator and a reason to go long.

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