



## TSG Stock Market Letter

Week Ending June 8, 2007

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

- **ECB and RB New Zealand rate hikes prompt inflation concerns.**
- **Bonds hit by major sell-off.**
- **Stocks suffer largest one-week drop since March.**
- **But lower stock prices prompt buying Friday.**
- **Recent bond sell-off and trendline break – a sign of more to come?**

This week, bonds took center stage as the European Central Bank (ECB) sparked inflation concerns by raising their key overnight rate 25 basis points to 4%. Two days later the Reserve Bank of New Zealand joined the party raising its key lending overnight rate to 8% and pushing the New Zealand dollar to a 22-year high in the process. In both cases, higher than expected inflation were the catalysts.

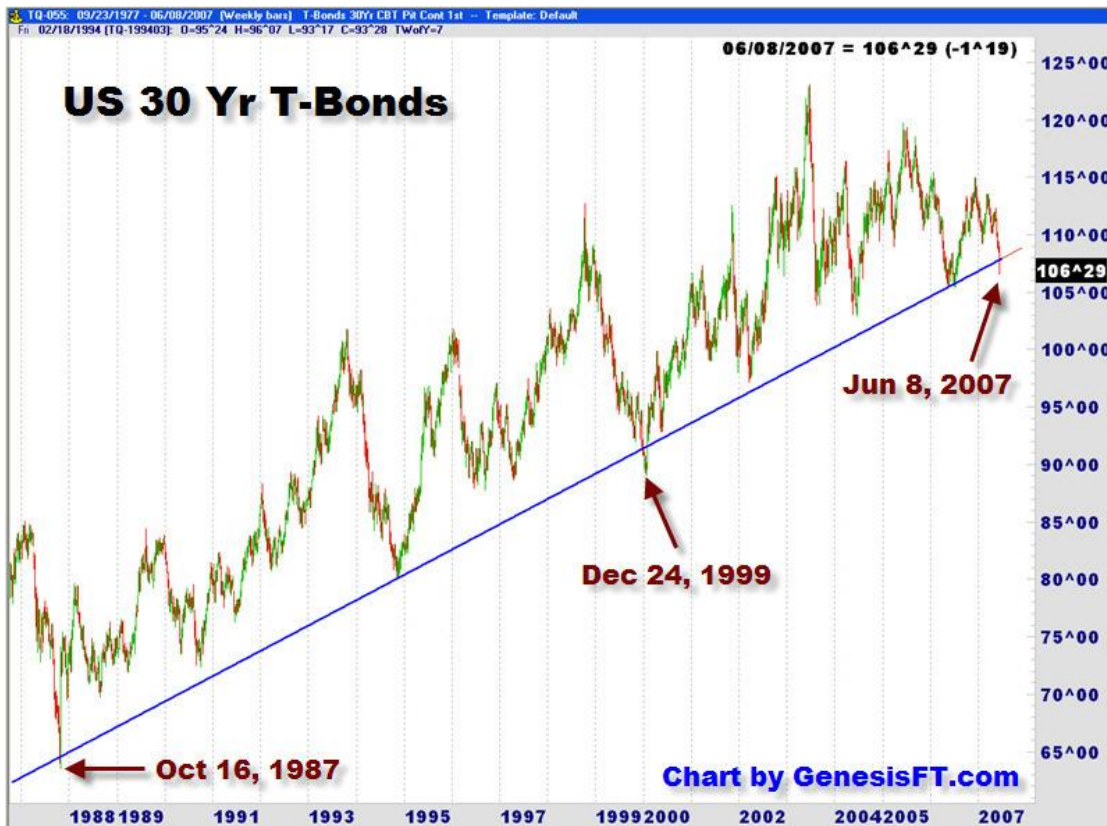


Figure 1 – Weekly chart of 30 year US T-Bonds showing recent break in the long-term trendline which spooked markets this week. Other trendline breaks occurred October 16, 1987 the week the Dow dropped more than 20%, December 1999, not long before the Nasdaq melted in March 2000 and then the recent breach this week. Chart [GenesisFT.com](http://GenesisFT.com)

New Zealand has the second highest interest rates of the Western world behind Iceland and mortgage rates have risen to 10% and above. But the flow of hot money thanks to the carry trade (global investors borrow money in Japan at rates as low as 0.25% to invest in high interest rate jurisdictions like Iceland and New Zealand) has been spurring inflation necessitating that central banks in target countries keep raising rates. The problem is that this has created a self-fuelling problem – hot international money flows into high interest rate nations, which in turn raise rates to cool their economies, which in turn attracts more capital...



Figure 2 – Daily chart of the 30-year T-Bonds showing price gapped down on Thursday through long-term uptrend support in Figure 1. Chart [GenesisFT.com](http://GenesisFT.com)

Unlike in the past however, the international interest rate hikes this week triggered a major sell off in bonds in the U.S., helping to drive yields higher. This widened the gap between two and ten year yields to 0.09%, which is the largest in a year as the yield curve moved from inverted to flat. The rate hikes were good for the dollar and triggered a flight to safety as currency investors sought the refuge of the greenback. Stock investors also saw the three day drop as an opportunity to buy stocks at a discount if the nearly 160 rise in the Dow on Friday is any indication. So far at least, the damage has been contained.

But the bad news is that the trend to higher rates will put added pressure on U.S. borrowers already struggling with high mortgage and credit card debt as well as take the shine off stocks. As is evident in Figure 1, the last two times bonds have broken uptrend support (October 16, 1987 and December 24, 2000), a stock melt down has occurred either around the same time or shortly afterwards.

The most recent rate hikes and the inflationary pressure which prompted them decrease the probability of a Fed funds rate cut in the near future as many investors

had hoped. The question is, how quickly will rates have to rise to satisfy central bankers around the world and what will it do to the U.S. economy struggling to hang on to growth mode?

One big concern is the waning interest for U.S. Treasuries from Asian central banks of late. Asian nations have been major bond buyers, a practice that has helped keep rates low in the last two years. This is bound to increase emerging market risk premiums that have been at historic lows, significantly higher as global investors react to this yield wake-up call and higher rates. An increasing cost of money will be bad for stocks in emerging and developed countries alike.

Now let's check in on what happened in markets this week.

INDEX	Weekly Close	Last Week	Change	Change%
INDU	13,424.39	13,668.11	-243.72	-1.78%
DJT	5,120.00	5,326.01	-206.01	-3.87%
SPX	1507.67	1536.34	-28.67	-1.87%
COMPX	2573.54	2613.92	-40.38	-1.54%
RUT	835.31	853.45	-18.14	-2.13%

### Summary

After all-greens for the major indexes last week, it was payback time this week as stocks suffered three major down days in a row. The good news is that they rebounded nicely on Friday thanks to softening oil prices and a weaker than expected trade deficit. But even with the 157.66 Friday rally in the Dow, it was still down almost 2% on the week.

### Technically Speaking

After making stellar gains over the last few weeks, the major indexes took a break this week but uptrends in the Dow Industrials, NYSE, DJ Transports, Russell 2000 and MSCI Emerging Market ETF and even the Nasdaq Composite and DJ Utilities Average are still very much alive and well.

Commodities also got hit this week as the NYFE CRB Index dropped to 403.93 from 411.74 last week with the biggest drop coming Friday, thanks to a greenback rally.

Gold also took it on the chin this week as interest rates surged pulling the continuous Aug07 contract back down to \$650.30 from \$676.30 last week.

As mentioned, the drop in bonds and jump in yields was good for the greenback. After dropping for the first three days of the week, the U.S. Dollar Index rallied to close at 82.69 from 82.32 last week. Although a continued upward trend in yields will be good for the dollar, it will be a challenge for stocks.

NYMEX crude oil (continuous July07) took a bit of a breather again this week closing at \$64.76, down from \$64.90 last week.

The MSCI Emerging Market Index ETF (EEM) closed at 126.10 down from 130.13 last week.

### Earnings

With a total of 4084 companies (up from 4054 last week) having reported earnings for Q1-2007, results again held steady with an improvement for the third week coming of 9% versus the same quarter last year.

### Economic Reports

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

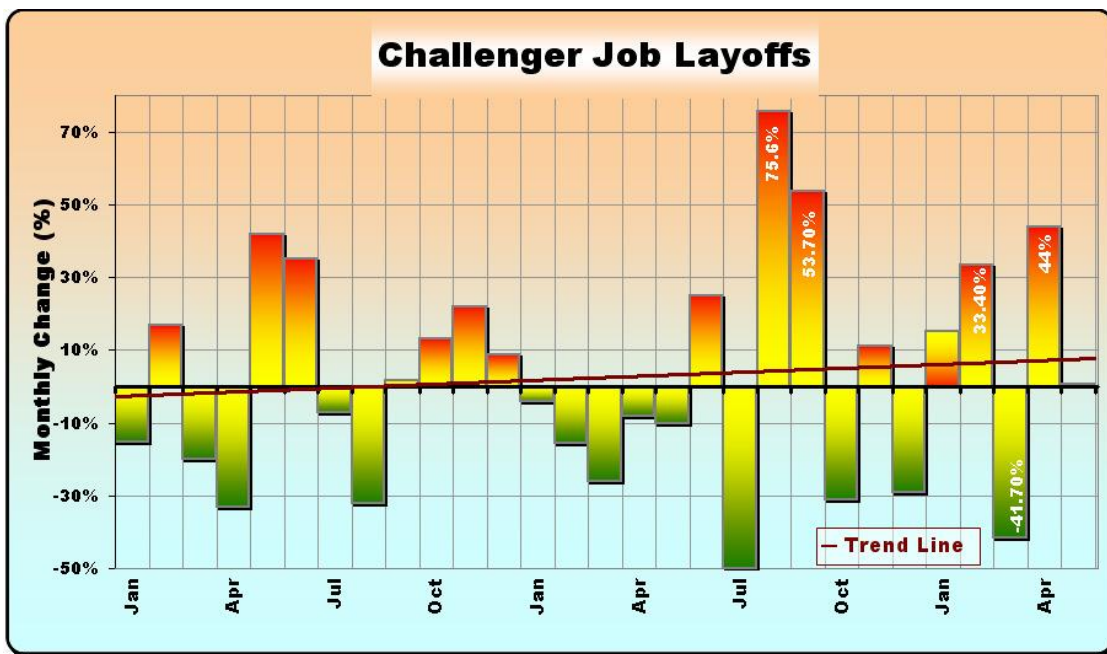


Chart 1 – Layoffs grew by just 0.6% in May according Challenger, Gray and Christmas. According to the firm, employers announced plans to cut more than 71,000 jobs up 32% from the same period a year ago. Overall, job cuts announced this year are still 8.5% below last year.

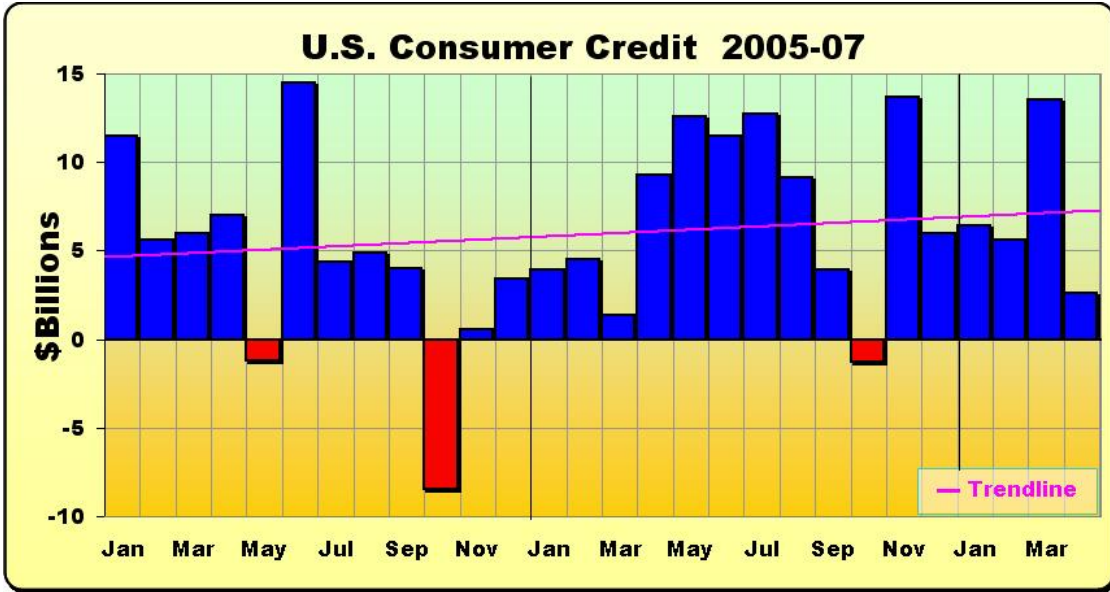


Chart 2 – The latest Federal Reserve data showed a cutback consumer spending which may indicate that credit card use and mortgage equity withdrawals are falling according to the Wall Street Journal. April consumer credit grew by \$2.6 billion versus an expected increase of \$5.8 billion. The slowdown stemmed from a decline in credit card debt, which fell by \$400 million to \$887.2 billion. Homeowner equity also declined to 52.7% in Q1-07, the lowest level on record thanks to stagnating home prices. The rise in bond yields this week means borrowers will be paying even higher rates on loans going forward. As we see from the chart however, the overall trend remains positive thanks in a large part to the growth in the number of the big spenders discussed last week.



Chart 3 – U.S. exports rose more than expected, helped by a weaker dollar and reduced U.S. demand for exported goods thanks to a slowing economy in April which helped to lower the trade deficit to \$58.5 billion. The Commerce Dept also announced that the March deficit had been revised down from \$63.89 to \$62.39 billion.

### Next Week

Here are the economic reports we'll be watching.

- Wednesday, May import prices (previous 1.3%), May retail & food sales (previous -0.2%), ex-autos (previous unchanged).
- Thursday, May PPI (previous +0.7%), ex-food & energy (previous unchanged).
- Friday, 1Q-07 Current Account (previous -\$195.8 billion), May CPI (previous 0.4%), ex-food & energy (previous +0.2%), April Treasury international capital flows (previous \$56.3 billion).

### Synopsis

We are coming into the summer doldrums and this week could well be an indication of more to come. Since 1971, June has been the third worst month for the Dow with an average monthly return of 0.3%. Over the last 35 years, August was the second worst with an average of -0.2% while September took the cake as the worst month of the year with an average of -1.5% according to the *Stock Trader's Almanac 2007*.

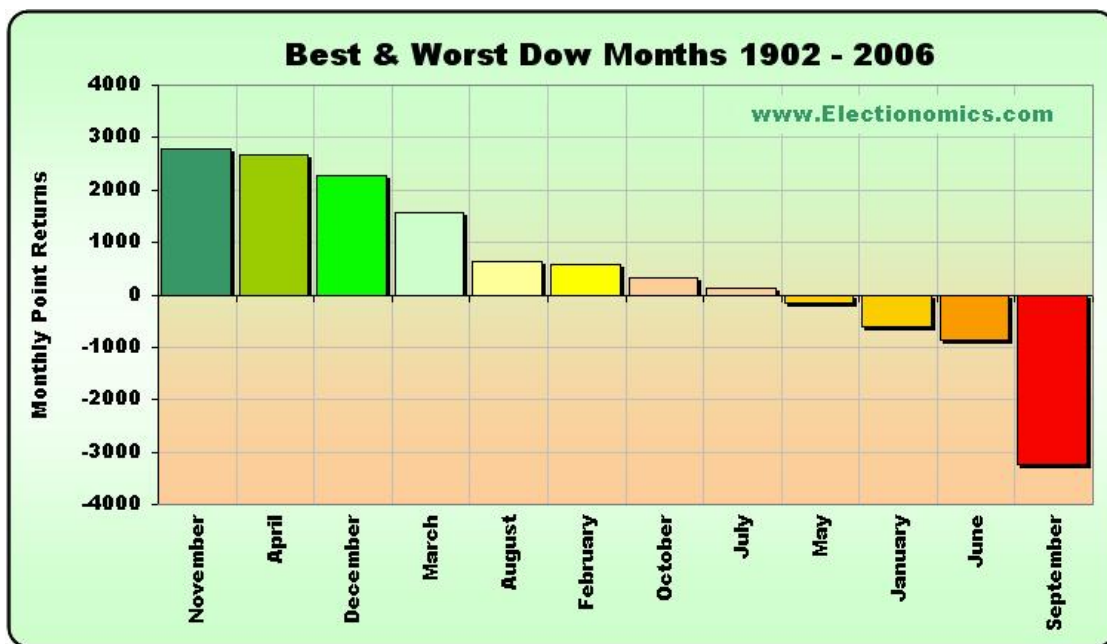


Chart 4 – Over the last 104 years, September the biggest losing month to be invested in the market. Those only invested during September would have lost 28% of their original investments. In comparison, those invested in June would have lost 7.4%. The best month was November with a gain over the period of 24.1% of the total Dow move.

Over the longer haul between 1902 and 2006 however, June was the second worst month of the year with a loss of 855.3 Dow points for those who bought at the beginning of the month and sold at the end. September was the worst by a wide margin with a loss nearly four times that of June at 3237.2 Dow points for those invested for the month. The Dow gained a total of 11,612 points between 1902 and 2006.

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