

TSG Stock Market Letter March 7, 2008

Contributed by Matt Blackman
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TSG Stock Market Letter Week Ending March 7, 2008

Topics Discussed This Week: Bear getting the upper hand; Leaders turn down; Earnings compression continues; ISM and payrolls downside surprises; Going back in the credit time machine

INDEX	Weekly Close	Last Week	Change	Change%	INDU	11,893.69		
12,266.39	-372.70	-3.04%	DJT	4,490.24	4,550.58	-60.34	-1.33%	SPX
1,293.37	1,330.63	-37.26	-2.80%	COMPX	2,212.49	2,271.48	-58.99	-2.60%
RUT	660.11	686.18	-26.07	-3.80%	EEM	134.19	139.90	-5.71

4.08%

Bearish argument gathers momentum; It was another week in which commodities continued to soar with both oil and gold putting in new highs while stocks struggled. But as oil hit a new Monday, stocks managed to hold their ground. This is all the more amazing considering that construction spending and the ISM index both disappointed to the downside. On Tuesday, the Dow fell more than 200 points earlier in the day on more negative financial news but then recovered thanks to another report that monoline insurer Ambac was near a deal for more cash. The Dow again posted a modest gain of 41 points in spite of the fact that oil had jumped to another new high. But then came Thursday and with it more bad news for financials that mortgage investors were being served margin calls and that two, Carlyle Capital and Thornburg Mortgage had both failed to answer the call. As it stands, Carlyle has less than a billion dollars to cover more than \$22 billion in mortgage liabilities. Shares of Thornburg plunged more than 50% on the news. Friday was another bad day thanks to more negative payroll jobs news paring the Dow another 147 points. Last week we mentioned that the picture was getting clearer — the bearish case was looking more likely but both the Dow and S&P500 remained above major support levels. That ended this week as the Dow sliced through key support of 12,100 on Thursday while the S&P broke 1310, both ending the week at new daily and weekly 2008 lows. Technically Speaking Leaders turn down For the first time in four weeks, Dan Zanger's Sunday portfolio took a turn for the worse shedding more than 2%. This compared to losses for the Dow Industrials of 3% and 2.8% for the SPX. His 14 picks this week again included Mosaic (MOS), Research in Motion (RIMM), CF Industries (CF), Transocean (RIG), First Solar (FSLR), Potash (POT) as well as Mechel Open (MTL) and Devon Energy (DVN), Deere & Co (DE), Apache Corp (APA) and EOG Resources (EOG). But it also included bearish beneficiaries Proshares UltrashortQQQ (QID) and Proshares UltraShort500 (SDS). Figure 1 — Weekly performance of Zanger's market leaders compared to the S&P500 (SPX), the Dow Jones Industrial Average (DJX), Dow Transports (DTX) and Nasdaq Composite (IXIC). Data courtesy of The Zanger Report, performance chart courtesy of VectorVest.com. But as indexes again fell this week, they were ominously led by the MSCI Emerging Markets ETF to the downside with a drop of nearly 6%. Why is this ominous? Emerging markets have been the positive outlier when compared to US and European stocks and a sustained fall would be bad news for global markets. The only real bright spot is that Dow Transports were the best performer with a modest 1.3% drop in spite of spikes in oil. Volatility took another jump this week as the Market Volatility Index (VIX) rose to 27.49 from 26.54 last week and 24.06 two weeks ago. But as stocks took it on the chin again, the 17 commodities that make up the NYFE CRB Index held strong at 558.51 from 565.65 last week. It was the first weekly drop in seven weeks but the index remains above its upper 2-standard deviation trend channel, a level it has closed above now for twelve consecutive weeks. Gold closed exactly where it did last week at \$974.30/oz. from \$947.40 two weeks ago. It is still well into its strong seasonal performance period between the end of January and end of June. But there are other forces at work — namely a lack of will on the part of global central bankers who are following the Fed's lead to weaker currencies. Clearly the Fed has thrown inflation caution to the wind and has chosen to instead focus solely on kick-starting the economy. This has bullish implications for gold (and bearish for the dollar) as long as it continues. The dollar also dropped to another new all-time low as the U.S. Dollar Index fell to 73.001 from 73.75 last week, 75.57 two weeks ago and 76.21 three weeks ago. Meanwhile the NYMEX crude oil (continuous) remained above \$100 again to end the week at \$104.28 up from \$101.84 last week and \$98.81/bbl two weeks ago. This week, the U.S. prime bank rate again held steady at 6.00% as did the Fed funds rate at 3.0%. The 3-month London Interbank Offered Rate (LIBOR) fell to 2.93875% (from 3.0575% last week). Freddie Mac mortgage rates slipped to 6.03% (from 6.24% last week) for the 30-year fixed mortgage while the rate fell to 4.94% (from 5.11% last week) for the one-year adjustable rate (ARM). Let's see if this final break in mortgage rates is a trend or a flash in the pan. Earnings Earnings compression continues With 3399 companies (up from 3155 companies last week) now having reported Q4-07 results improvements fell again to -55% (from -54% last week) indicating that the earnings picture is also getting clearly worse. This compares to a drop of 21% (4205 companies) at the end of Q3-07 reporting season and a 13% jump in Q2-07. Economic Reports Here are the reports we were following this week. Chart 1 — January construction spending took another 1.7% turn for the worse for the fourth consecutive monthly drop as the long-term trend continued to deteriorate. ISM downside surprise Chart 2 — The February ISM index on Monday surprised to the downside again with the second contraction number in three months with a reading of 48.3. To those who have tracked the trend, the weak reading was of little surprise especially in the wake of the weak Chicago PMI reading last week. Chart 3 — February's weak manufacturing number was followed up by another

contraction service index number of 48.3 on Wednesday that again was no surprise to the trend followers in the crowd.

Chart 4 – Meanwhile pending home sales were flat in January but the trend remains strongly negative. In lieu of any sustained pickup, we expect both new and existing home markets to continue to contract especially as long as foreclosures continue to swell unsold inventories. Chart 5 – On Friday, non-farm payrolls came in way below the consensus loss of 5,000 jobs with a drop of 63,000 in February, well below the last reading of -17,000. A continued loss in jobs is simply more bad economic news. But that analysts continue to be unpleasantly surprised shows how out of touch they are with the true situation. Something to keep in mind the next time someone tells you on TV that it's a good time to buy stocks. Next Week Here are the reports we'll be watching. - Monday, January Wholesale Trade (previous 1.1%). - Tuesday, January Trade Balance (previous -\$58.76 billion). - Thursday, February Import Prices (previous 1.7%), February Retail & Food Sales (previous 0.3%), Retail & Food Sales ex-autos (previous 0.3%). - Friday, February Consumer Price Index (previous 0.4%), CPI, ex-food & energy (previous 0.3%). Synopsis Going back in the credit derivative time machine It's hard to believe that it was just a little more than a year ago when the word "subprime" first became a cause for general investor concern and we were told by analysts not to worry. January 31, 2007 figures showed that GDP was growing at 4.4% and even though residential fixed investment had plummeted 19.2%, Global Insight chief economist Nariman Behravesh confidently claimed in the Wall Street Journal that "the soft landing is over, and I'm not even sure there was a landing." Richard Moody of Mission Residential was even more confident. "For all of our worries about the housing market acting as a drag on consumer spending, there was no evidence of this during the fourth quarter," he said in the article. But subprime problems were getting increasing attention in the media. Unfazed however, the National Association of Realtors reported that February 2007 existing home sales were "amazingly robust" having risen 3.9% to 6.69 million homes annually. In April, the NAR said it expected home sales to fall 2.2% in 2007 versus 2006. As it turns out, they dropped 22%, or 10 times the NAR estimate on a year-over-year basis but that is another story.

Lone Voice in the Wilderness But at the time there was at least one lone booming voice in the wilderness crying wolf. Jim Grant of Grant's Interest Rate Observer brought the true seriousness of the situation to the financial world's attention in a March 2007 Bloomberg interview. Here are a few snippets about that fascinating interview as discussed in our March 9, 2007 weekly newsletter. According to Grant, the troubled part of the mortgage market was immense, far larger than most analysts were letting on or at least that was the insinuation. The problem as he saw it was that "hundreds of billions of dollars of these 'science projects' of collateralized debt obligations and the like are sold in any year – immense amounts. What are they? You take a bunch of loans and then you fashion an asset backed security then take those loans and repackage them into a collateralized debt obligation or CDO. There can be a million individual loans in a CDO," he explained. "Now here is the magic and mystery of a CDO," Grant continued. "You can take 70% of a pile of triple-B minus (meaning marginal credit) and the rating agencies will bless it. They will say that 'we have studied the correlations and trends and we pronounce 70% of this pile of junk to be triple-A,' triple-A!" he exclaimed (emphasis is his not mine). What did Grant forecast at the time? "I think that the credit cycle will proceed, that risk will be re-priced and be recognized where it has not been recognized, debt will be more expensive and people will be hurt because they can't refinance (at least 20% of the loans written in the last two years would not qualify today under new lending guidelines) and the housing situation will be visibly worse." He wasn't just whistling Dixie. Now contrast Grant's outlook with comments from another analyst who was interviewed earlier in the week of March 9, 2007 who stated that the sub-prime situation currently only affected 10% of 7% of the market or just 0.7% of the borrowers. Meanwhile Grant's estimate that 40% of the mortgages issued in 2006 were either sub-prime or Alt-A mortgages (and therefore risky) proved far more accurate. Too bad more investors didn't take Grant's comments to heart. The April 13, 2007 Wall Street Journal included a survey of economists in which 20 of 54 cited soft capital spending as the chief risk to their forecasts that the economy would continue growing and avoid recession in 2007. The group estimated a 26% chance for recession over the next 12 months. Housing market concerns were growing but were still considered relatively minor, especially outside the U.S. In a May 17 speech in Chicago, newly appointed Fed Chair Ben Bernanke commented that the slowdown in the subprime mortgage market would put "some restraint" on home buying but said it shouldn't have much impact on the broader economy. At the time Bernanke still believed that U.S. home prices were rising because that is what year-over-year median home price data were saying at the time. "I think the market has already digested that housing news," Owen Fitzpatrick of Deutsche Bank was quoted as saying in the Wall Street Journal at the time. Those comments may seem miraculously myopic now but they reflected the common wisdom at the time. Then in June, the first serious subprime cracks began to appear (as Grant had accurately predicted) when Bear Stearns reported a 33% drop in net income due to risky mortgages as one of its hedge funds was trying to unload \$4 billion in mortgage-backed bonds. Goldman also posted a 1% decline in revenues due to subprime problems. Bank shares however, were barely affected. From June on however, the term "subprime" would become much more dominant in the financial news as financial share prices began to fall in earnest with each new piece of bad news. Meanwhile, NAR median home price data still showed U.S. home prices rising. They peaked a month later in July (seven months after the Case-Shiller home price index peaked). In July, Standard & Poor's and Moody's threatened to downgrade ratings on residential mortgage-backed securities then Moody's cut its rating on 399 classes of mortgage securities. It came at a time when investors had been doing their level best to convince themselves that housing problems were limited and the worst was over. But the rating cuts served as an undeniable wake-up call. The term "subprime" was appearing multiple times in weekly stock market commentaries. Here is an interesting comment from the Wall Street Journal on July 11 by Joanna

Ossinger. "The subprime-mortgage issue has been a worry for stocks for months, but problem spots have been revealing themselves only sporadically. The market's late-February dive was based partly on concerns about subprime, but the issue stayed dormant for some time after that, resurfacing in force when two Bear Stearns hedge funds nearly blew up based on their subprime investments. Continued weakness in housing and an increase in mortgage defaults have kept those worries simmering. But in a world of increasingly complex financial derivatives and other instruments, it is basically impossible to determine what the impact of weakness in subprime will be until the fallout reveals itself, bit by bit." However, investors were still sanguine about the future of stocks. In the same article Robert Harrington head of block origination at UBS was quoted as saying in what now seems the epitome of misguided hope, "The market isn't convinced that [the subprime issue] is going to spill over into a real liquidity crunch. It could be just a re-pricing of risk." The predominant sentiment among financial analysts steadfastly held that the subprime problem was "contained";

Forecast Fiasco In summary, a problem that only a few months ago was estimated (other than by a few with foresight) to be "contained" to a few hundred million dollars, has somehow grown to trillion dollar proportions today. This is summed up in the March 7, 2008 Bloomberg article entitled US Mortgage Market Needs \$1 Trillion. "The \$1 trillion U.S. home-mortgage market needs about \$1 trillion in new investment to halt a slide in prices that began last year, according to analysts at Friedman, Billings, Ramsey & Co." It demonstrated how much the appreciation for the breadth of the credit problem in the US and around the world has changed in a few short months. But are we again drastically underestimating the severity of the problem? You will notice that the \$1 trillion shortfall is limited to mortgage losses and does not include other credit markets that are suffering similar challenges. (Yet this loss represents less than 10% of all mortgages currently outstanding today. Is it realistic to believe that more than 90% of mortgages today will be current a year from now as home prices continue to drop?) Other markets include merger & acquisitions, leveraged buyouts, corporate and commercial loans, auto loans, credit card and student loans and a host of other loans – most of which have enjoyed support from an array of complex derivative instruments about which a very select few have any real understanding. I have yet to see any credible estimates about how big the problems are in these markets. Whatever happens, one thing is becoming painfully clear. Like a new and dreadful pandemic, this credit crunch is rapidly spreading and still no one has expressed any real estimate about how big it could eventually grow. Could it be a fear of rattling markets or that such an estimate could become a self-fulfilling prophecy? It is certainly not the kind of topic that would be welcomed by the political establishment in an election year. Perhaps for the same reasons no one has discussed how much this situation will be exacerbated by job losses and continued economic slowdown when recession hits the US and other industrialized nations – an outcome that is now looking increasingly likely. But pretending it doesn't exist will not make it go away and has the potential to instead make the problem larger than it could have been – if that is possible.

Stories of interest this week… U.S. Mortgage Market Needs \$1 Trillion, Analysts Say Citigroup May Need
 Cash as Losses Mount, Dubai Says Thornburg Can't Meet Margin Calls, Survival in Doubt Auction Supply
 'Tsunami' Portends Municipal Losses Fed Beige Book Reports Growth Has Slowed Since Start of Year
 Buffett: US essentially in recession
 World bankers ask what went wrong?
 Australia's Economy Grows at Slowest Pace in a Year Asian Stocks Fall for Fifth Day; Nippon Steel, Cnooc
 Decline

James Grant March 07 subprime interview on Bloomberg -----

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