

TSG Stock Market Letter March 14, 2008

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TSG Stock Market Letter Week Ending March 14, 2008

Topics Discussed This Week: Bears retake Wall Street? Leaders turn up again... Earnings still declining Budget deficit hits new all-time high Government adds liquidity but does it address the real problem? Six reasons for concern The high price of misplaced hope

INDEX Weekly Close Last

Week Change % INDU 11,951.09 11,893.69 57.40 0.48% DJT 4,506.57 4,490.24 16.33 0.36% SPX 1,288.14 1,293.37 -5.23 -0.40% COMPX 2,212.49 2,212.49 0.00 0.00% RUT 662.90 660.11 2.79 0.42% EEM 131.21 134.19 -2.98 -2.22%

Bailout euphoria fades, bears retake control Monday ‐ It was another week of fear and loathing punctuated by brief periods of euphoria thanks to renewed bailout hopes. It was a rough start to the week as the Dow shed more than 150 points Monday on more financial woes. There were obviously those in the know about mounting Bear Stearns problems and the stock dropped 11% to start the week after Moody's downgraded more of their credit securities. Tuesday ‐ Heli Ben renewed hopes that the money fairy would make all our credit concerns disappear ‐ this latest plan worth more than \$200 billion to exchange illiquid mortgage securities for Treasuries. It caused the Dow to rally more than 400 points for the biggest jump in five years. Wednesday ‐ Doubts about the efficacy of the bailout were confirmed as forex traders dumped the dollar. This and the reality that commodity prices were still on fire as oil breached \$110/bbl and gold closed in on \$1000 hit home caused the Dow to lose nearly 50 points. Thursday ‐ The Dow dropped more than 200 points in early trading but a late day rally pushed the index into positive territory ‐ the late day lift coming on news that rating agency S&P had expressed a highly suspect opinion that the worst of the credit losses were now behind us. Friday ‐ The world gained greater insight into financial problems as big-five Wall Street firm Bear Stearns went hat in hand looking for infusions from the Fed and other banks to avoid running out of cash. It was a poignant reminder that credit fears were still very much justified. It was also the first time a non-bank was given access to the Fed's discount window... Technically Speaking Leaders turn up Dan Zanger's Sunday portfolio was back in the lead to higher territory gaining more than 5% while the major indexes ended basically flat on the week. Dan's 7 picks again included Mosaic (MOS), Transocean (RIG), Devon Energy (DVN), Apache Corp (APA) and EOG Resources (EOG). Apple (AAPL) was also back on the list. But gone were the ultra short plays 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. However, after losing nearly 6% last week, the MSCI Emerging Markets ETF (EEM) was again the worst performer falling another 2% as the high-flying emerging markets continue to feel the pinch of retracting credit and widening spreads between Treasuries and riskier bonds. As of March 17, the EEM was very close to putting in a bearish head & shoulders top pattern with minimum target of 86, 32% below Monday's close (see chart). Weekly chart of the EEM showing head & shoulders pattern and minimum target. Chart by GenesisFT.com As mentioned last week, emerging markets have helped buoy international markets when compared to US and European stocks and a sustained fall would be bad news all around. Volatility took yet another jump this week as the Market Volatility Index (VIX) rose to 31.16 from 27.49 last week and 26.54 the week before. The 17 commodities that make up the NYFE CRB Index turned north again rallying to 563.48 from 558.51 last week and 565.65 two weeks ago. Although the index remains above its upper 2-standard deviation trend channel, a level it has closed above now for thirteen consecutive weeks, the index is showing signs of tiring. Gold again moved higher, this week closing above the major level of \$1000/oz before backing off to close the week at \$999.80 up from \$974.30 last week and \$947.40 three weeks ago. It is still well into its strong seasonal performance period between the end of January and end of June. But other forces ‐ namely a lack of will on the part of global central bankers who are following the Fed's lead to weaker currencies and the latest Fed bailout while deemed necessary to help homeowners and markets ‐ have bullish implications for gold (and bearish for the dollar). Speaking of the dollar, it was another bad week and the third of strong losses and yet another new all-time low as the U.S. Dollar Index ended the week at 71.66 from 73.001 last week and 73.75 two weeks ago. Meanwhile the NYMEX crude oil (continuous) remained above \$100 for the third consecutive week closing at \$108.66 from \$104.28 last week and \$101.84 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% although we find out next week if the latter will fall again. The 3-month London Interbank Offered Rate (LIBOR) slipped again to 2.76375% from 2.93875% last week. But all the bailout talk has done little to help beleaguered mortgage debtors as Freddie Mac mortgage rates moved higher again to 6.13% (from 6.03% last week) for the 30-year fixed mortgage while the rate jumped to 5.14% (from 4.94% last week) for the one-year adjustable rate (ARM). Earnings Earnings compression continues A total of 3596 companies have now reported Q4-07 earnings on Wall Street (up from 3399 companies last week). Average improvements fell again to -56% (from -55% last week) indicating that the earnings picture is certainly not improving. 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 ‐ The trade gap expanded modestly to -\$58.2 billion in January from a downward revision of -\$57.86 billion the month before. But the real budget story this week was the government budget deficit of \$175 billion for the month of February, a whopping 46% bigger than that of February 2007 and a new all-time spending record. Now that the economic slowdown is confirmed, the realization is sinking in that government has squandered the opportunity to build a

surplus when the times were good. The stream of bailouts will pressure government finances further. According to estimates, the Fed has so far committed approximately \$400 billion in assets in current programs or roughly half of the total assets currently available to the agency. And now the Bush administration is projecting a \$410 billion dollar government deficit for the fiscal year ending September 30 which is approaching the \$430 spent in 2004. However, after spending more than one-third of that total in a month, the chances of coming in at or below expectations are fading. During the first five months of fiscal 2008, the budget deficit totaled \$263.26 billion, 62% bigger than the \$162.16 billion deficit in the same period during fiscal year 2007. It doesn't take a fiscal genius to figure out what will happen when the recession (which both the government and Fed are downplaying) finally descends. Consumer spending takes a hit Chart 2 – Food & retail sales fell 0.6% and ex-autos fell 0.2% in January which was no surprise in the wake of the 0.6% drop in retail spending in February. Meanwhile, the Consumer Price Index showed a modest rise of 0.2% in February which belies the record commodity prices and rapidly rising everyday prices for food, energy and the cost of living. Next Week Here are the reports we'll be watching. - Monday, Q4-07 Current Account Balance (previous - \$178.5 billion), January Treasury International Capital Flows (previous \$45.2 billion), March NAHB Housing Market Index (previous 20).- Tuesday, February Producer Price Index (previous 1.0%), PPI ex-food & energy (previous 0.4%), February Housing Starts (previous 0.8%), Federal Reserve interest rate decision (previous 3%). - Thursday, March Philadelphia Fed Business Index (previous -24.0). Synopsis Government adds liquidity but will it address the real problem? Six reasons for concern While stock traders began to party again after hearing news of the Fed March 11 credit bailout, currency traders were betting it wouldn't work. After staging a brief rally on Tuesday, the US dollar fell to a new all-time low against the euro Wednesday as confidence that the Fed move would solve the credit crisis and economic fallout proved short-lived. Hopes have run high that the \$250 bailout by the Fed and other central banks would prove the requisite panacea and many analysts are again calling a bottom in stocks. But here are six reasons why the bulls will be disappointed. 1) Much more subprime pain to come. According to a Bloomberg March 11 article (see article “Moody's, S&P Defer Cuts” below.) “Even after downgrading almost 10,000 subprime-mortgage bonds, Standard & Poor's and Moody's Investors Service haven't cut the ones that matter most: AAA securities that are the mainstays of bank and insurance company investments. None of the 80 AAA securities in ABX indexes that track subprime bonds meet the criteria S&P had even before it toughened ratings standards in February, according to data compiled by Bloomberg. A bond sold by Deutsche Bank AG in May 2006 is AAA at both companies even though 43 percent of the underlying mortgages are delinquent. Sticking to the rules would strip at least \$120 billion in bonds of their AAA status, extending the pain of a mortgage crisis that's triggered \$188 billion in writedowns for the world's largest financial firms. AAA debt fell as low as 61 cents on the dollar after record home foreclosures and a decline to AA may push the value of the debt to 26 cents, according to Credit Suisse Group. ``The fact that they've kept those ratings where they are is laughable," said Kyle Bass, chief executive officer of Hayman Capital Partners, a Dallas-based hedge fund that made \$500 million last year betting lower-rated subprime-mortgage bonds would decline in value. ``Downgrades of AAA and AA bonds are imminent, and they're going to be significant."” So what happens to the Fed requirement that any collateral exchanged for Treasuries not be subject to a downgrade? According to the article, all but six of the 80 AAA ABX subprime bonds failed an S&P test for investment grade status. As I understand the program, they will not qualify for the Fed collateral exchange. So which funds really benefit? 2) Home price declines are still accelerating. According to the latest estimates somewhere between 8 and 11 million American households are now in a negative equity position (mortgage worth more than the home). So far home price declines have occurred in the absence of a recession and it looks increasingly likely that a recession is coming (if it isn't already here). This means more home price declines are likely. So what does this mean for all the mortgage bonds floating around out there? Bonds that qualify as investment grade today will not qualify tomorrow. Rating agency models discounted the probability of housing price declines which turned out to be colossal errors in judgment. And now at least one major rating agency would have us believe that the worst of the mortgage problems and defaults are behind us, just one day before the Bear Stearns announcement? What was that famous Chinese proverb? Fool me once shame on you, fool me twice shame on me. Too bad Bernanke and his minions at the Fed seem to have forgotten it… A little over six months ago Bernanke claimed that home prices were stable. Now he should know better but his policies still depend on this mistaken assumption. 3) The Fed bailout provides short-term liquidity. What happens when the 28-day period in which the Fed will provide liquidity elapses? The Fed has also said it would discount the value of bond collateral. By how much? Do banks get to discount them again before taking them back after the 28 day period has elapsed? I trust that the Fed has no plans to be the buyer of last resort for these instruments. It would mean this liability would ultimately be passed on to the taxpayer. In other words, the Fed is betting that a one-month injection of liquidity will fix the problem. Unfortunately, if the problem is one of systemic insolvency as opposed to a shortage of liquidity, the Fed move will prove woefully inadequate. Is the Fed simply throwing more money into a credit black hole? 4) The current housing (and credit) bubbles took years to form and were powered by the creation of trillions in derivatives. The credit default swap market alone doubled in 2006 and 2007 and at latest count had grown to more than \$40 trillion. The chances that any multi-billion dollar bailout attempts by government or quasi government agency like the Fed will re-inflate these bubbles are effectively zero. It's like trying to fix a hole in a dam with bubblegum. According to the latest estimate by Friedman, Billings and Ramsey the \$11 trillion mortgage market needs about \$1 trillion in new investment to halt the slide in bond prices that began last year. But that estimate assumes that payments on more than 90% of US mortgages will remain current and prices stabilize. Is this realistic assumption given the scope of home price declines and the amount of zero down, no doc, liar mortgages etc. that were issued especially if we enter a recession? There are roughly 2 million homes in foreclosure now but what motivation do homeowners have to maintain their payments on the roughly 10 million more homes that have dropped in value below the mortgage amount? 5) Can this or any bailout halt the economic slide that our indicators have been telling us for months now will result in a recession? Can the Fed or government reverse the economic cycle? Can they prevent

the country from going into recession? Not if history is any guide. More likely, the stock jump on Tuesday was part of a bear market rally that will end, just like those that resulted from past bailout hopes since November. As Joseph Mason commented in a Bloomberg interview March 12 (see link below), all Fed efforts so far have focused on providing liquidity but they do nothing to address the real problem of expanding credit losses. It's like throwing a pail of water at a house fire — it may feel like you are doing something to address the problem but it makes very little real difference. At the end of the day, someone has to take those losses including homeowners, consumers, corporations, banks, lenders, brokers and hedge funds etc. And as we learned again Friday, those losses are far from over. So far, the only credit problems being discussed are mortgage related. What about commercial, car, student, credit card, M&A, LBO and other loan markets? What happens when they begin to implode? 6) Growing list of lender and credit road kill — The litany of corporate victims of the credit crisis is long but one thing is clear. As the crisis has deepened, so has the size of its victims. The public first became aware of the scope of the problem with the default of mortgage lender New Century Financial little more than a year ago and the list of failed lenders now numbers in the hundreds. Recently, hedge funds have been added. But this week, that list grew to include the first major brokerage firm and elite member of the big-five Wall Street firms as the first non-bank to ever ask and gain access to the Fed discount window for assistance — the venerable 85-year old firm of Bear Stearns. With a market cap topping \$21 billion in 2007, it had recently dropped to \$5 billion amid rumors as to whether the company would survive. The next test will be the failure of a bank. But one thing is clear. Each time "the street" thinks the worst is over a bigger shoe drops sending nervous investors scurrying again for cover. The Price of Misplaced Hope Although there has been a flurry of action on Capital Hill to try and resolve the problem, the stark reality remains. Such attempts may provide short-term liquidity relief but they do nothing to address the heart of the problem and that is lender and borrower insolvency. No matter what central banks do, they cannot undue the years of irresponsible lending and the mounting losses in a falling property and asset market that will continue to impact economies. It is a sad reality that extended bear markets are punctuated by brief periods of euphoric hope in which prices are propelled significantly higher. We saw another clear indication of that in stock action this week. But although such a move may last for a week, a month or even a few months, it will ultimately fade as economic realities sink in and stocks sink to new lows. During the plunge of the Japanese Nikkei 225 from lofty heights near 40,000 in 1990, the index posted at least three major bear rallies of more than 50%. During the latest between 2003 and 2007, the Nikkei rallied more than 100% from 7,600 to more than 18,000 before rolling over. On Friday, the Nikkei closed at 12,242 — a 32% drop from its 2007 highs and down 70% from its peak nearly 18 years ago. Will the Dow suffer a similar fate? Let's hope not but the Nikkei does provide a poignant example of how powerful bear markets can be and how long they can last. It also shows how expensive misguided hope combined with the fatally flawed value investment approach to buy as prices are falling can be. There is an age-old adage on Wall Street that the time to buy is when there is blood in the streets. We have been hearing that a lot in the financial media lately as an excuse to buy. But in a true bear market, the blood begins to flow years before the hemorrhaging has ceased. Those who bought financials and homebuilders for example when there was blood in the streets last year have added their own blood to the mix. I've always found that it is best to wait until there is solid evidence that the blood flow has been contained and started to clot before jumping in to look for long-term bargains. And that time may still be a long way off. Stories of interest this week … Latest Fed \$200 Billion Mortgage Bailout Explained
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ai3MU.ZEZb44&refer=home> Joseph Mason — Fed's Plan Treats 'Symptoms,' Not 'Disease': Video
<http://www.bloomberg.com/avp/avp.htm?clipSRC=mms://media2.bloomberg.com/cache/vfTRj7EjHfuE.asf> Bernanke Discards Monetary History With Bear Stearns Bailout
http://www.bloomberg.com/apps/news?pid=20601087&sid=aY2RvFA.yO_Q&refer=home Emergency funding for Bear Stearns
<http://www.ft.com/cms/s/0/43697fa6-f1cb-11dc-9b45-0000779fd2ac.html> "Looks like the Bear is done."
http://www.forbes.com/2008/03/14/banking-fed-bear-biz-wall-cx_lm_0314bear2_print.html Moody's, S&P Defer Cuts on AAA Subprime, Hiding Loss
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aU9CQgvfHRzI&refer=home> Going, going, gone: a rising auction of scary scenarios
<http://www.ft.com/cms/s/0/0e63ad12-ef9c-11dc-8a17-0000779fd2ac.html> Commercial Borrowers Find What Citigroup Says Isn't What It Does
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aIGRziUnaXjE&refer=home> U.K. Housing Market Slump Becomes Worst Since 1990
<http://www.bloomberg.com/apps/news?pid=20601010&sid=aM6OTUuSVtko&refer=news>-----

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