

TSG Weekly Market Watch May 2, 2008

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 Sunday, 04 May 2008
 Last Updated Sunday, 11 May 2008

TSG Stock Market Letter Week Ending May 2, 2008

Topics Discussed This Week:

* Stocks point higher

* But leaders sag

* Earnings weakness continues

* Existing home prices hit another low

* Seeing the GDP number for what it is

	INDEX	Weekly Close	Last Week	Change	Change%				
INDU	13,058.20	12,891.86	166.34	1.29%	DJT	5,308.58	5,117.37	191.21	3.74%
SPX	1,413.90	1,397.84	16.06	1.15%	COMPX	2,476.99	2,422.93	54.06	2.23%
RUT	725.74	721.88	3.86	0.53%	EEM	149.64	146.3	3.34	2.28%

Quote of the week – “Mortgage loans are moving underwater at a very sharp pace, far more than suggested by aggregate home price data,” according to an April 29th Barclays Capital report showing that about half of the subprime and Alt-A mortgages issued in 2006-7 may be worth more than the homes (see article ‘More Subprime’ below). Blue chips point higher… Monday – A weak start to the week with the Dow dropping 20 points with investors fretting over the weak economy while they awaited the Fed’s interest rate announcement Wednesday. Tuesday – More worrying went on ahead of the Fed funds rate announcement with the Dow dropping another 40 points. The largest annual drop in the Case-Shiller home price index didn’t help. Wednesday – Finally the waiting was over and investors got what most expected which was a 25-basis rate cut in the funds rate to 2%. But it was the somber tone and suggestion that this was the end of cuts for the foreseeable future in the Fed’s language that caused distain and the Dow to end the day in negative territory if only by 12 points. Thursday – But on Thursday, the fretting ended as investors focused on the positives thanks in a large part to a firming up of the dollar and drop in oil prices. An end to rate cuts would be positive for the greenback and help reduce the cost of energy in the U.S. and that would be decidedly good for the consumer and markets. The Dow closed back up above 13,000 on the day with the blue-chip index gaining 190 points, erasing the losses of the prior three days. Friday – Investors optimism pushed the Dow over 13,000 for the first time since January 4 as the index added another 48 points on the day driven in part by relief that non-farm payrolls jobs losses weren’t as bad as expected (see below). Hopes again grew that the worst of the credit crisis was over amid signs of credit spreads returning to more normal levels – even the great Oracle of Omaha added his voice to this camp this week (see article “Buffett” below). Technically Speaking But leaders sag Dan Zanger’s 13 Sunday picks this week included Baidu.com (BIDU), Mosaic (MOS) and Potash (POT), Agrium (AGU), CF Industries (CF), Transocean (RIG), Sohu.com (SOHU), EOG Resources (EOG), Dryships (DRYS), China Life (LFC), Deere & Co (DE), Goldman Sachs (GS), and iSharesFTSE/China (FXI). As a group, they underperformed the rest of the market which is bearish. Figure 1 – Weekly five-day 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. Over the last three weeks volumes on the NYSE have remained below average while the indexes have moved higher. That is inherently bearish. Rallies occurring without strong volume are suspect because it means that there is a lack of commitment from buyers. The Nasdaq shows a similar pattern over the last three weeks. Analysts and pundits may be talking the market up but there has yet to be any evidence that investors and traders are buying it in significant numbers. Volatility continued to fall again this week as the Market Volatility Index (VIX) dropped to 18.18 from 19.59 last week and 23.46 the week before. While generally bullish, volatility can surge in a heartbeat. The 17 commodities that make up the NYFE CRB Index continued to drop this week to 532.97 from 542.68 last week and 537.81 the week before. On a weekly basis the index remains well above the 2 standard deviation top trendline but has broken below the channel mid-line on the daily chart. And gold fell again this week to close at \$858.10 from \$889.50 last week and \$927.60 the week before on the 100oz continuous contract. While gold is in its strong seasonal performance period between the end of January and end of June, it continues to show signs of weakness. After seven weeks trapped in a bearish flag chart pattern that generally implies lower prices ahead, the dollar surged out of the pattern this week even as the Fed lowered interest rates. This confirms the volume-volatility capitulation spike we observed two weeks ago which often accompanies a bottom as the U.S. Dollar Index strengthened to 73.50 from 72.79 last week and from 71.80 the week before. Crude took a much needed break for the first four days of the week then rallied on Friday as the NYMEX crude oil continuous contract closed at \$116/bbl from \$118.91/bbl last week. It was the ninth consecutive week that it remained above \$100. This week the Fed funds target rate dropped to 2%. The 3-month London Interbank Offered Rate (LIBOR) fell to 2.77% (from 2.9125% last week and 2.7131% the week before) showing that commercial credit markets are easing somewhat. The true test will be how long this trend continues. LIBOR is the benchmark for \$900 billion in subprime mortgage loans which typically adjust to it every six months. According to data company Dealogic, corporations around the world have the interest rates on roughly \$9 trillion in debt pegged to LIBOR and rates on more than \$380 trillion in derivative interest rate swaps also are based on LIBOR. But Freddie Mac mortgage rates moved up to 6.06%(from 6.03% last week and 5.88% two weeks ago) for the 30-year fixed mortgage while the one-year adjustable rate mortgage (ARM) rate held at 5.29% from last week up from 5.18% two weeks ago. Earnings Earnings weakness continues Q1-08 earnings season hit the half-way market this

week and the good news is that the broad spectrum of companies tracked by the Wall Street Journal showed another slight improvement from last week. The bad news is that with a total of 2058 companies having reported so far, (1275 companies last week) average earnings are down 19% (-20% last week) from Q1-07. This compares to -22% two weeks ago and -17% three weeks ago. Looking at past seasons, there was a drop of 57% for final Q4-07 (3900 companies), a 21% drop (4205 companies) for Q3-07 and a 13% jump for Q2-07. Economic Reports It was a busier week of economic reports as we approached month end. Here are the reports we were following. Existing home prices register biggest drops yet

Chart 1 – On Tuesday, we learned that the S&P Case-Shiller Home Price Index showed that home prices for the 10-city composite index fell 13.6% in February from a year ago. The 20-city composite index fell 12.7% over the same period (shown here). Seventeen of the 20 metropolitan areas in the US registered record low annual drops, 10 of which were double digit declines according to the report. In only one area, Charlotte NC, did prices record annual gains. Both indexes show no end in sight to price declines. As we learned last week, since March 2007 median prices have fallen 8% but are down 13% from their peak in September 2006.

Chart 2 – The Purchasing Managers Index (PMI) remained in contraction territory for the fourth consecutive month with a reading of 48.3 basically unchanged from last month.

Chart 3 – The weak PMI reading was confirmed by the broader ISM manufacturing report that registered 48.6 in April, unchanged from last month. It was the fourth reading in contraction territory in the last five. Not shown is the trend line which remains strongly negative.

Chart 4 – Construction spending in March continued to decline dropping 1.1% down from 0.3% in February.

Chart 5 – The number of jobs lost moderated in April to 20,000 from 80,000 in March but it's important to remember that these numbers are often revised up to a year later so this could change. The consensus estimate was for a loss of 75,000 jobs. The weak dollar has been a boon for companies with overseas operations and has boosted U.S. exports. In other news, we learned that the Q1-08 GDP grew 0.6% in the last estimate which was exactly where it was in Q4-07 but again, the NBER often revises this data up to 12 or months later so this number will undoubtedly change. Based on the situation with an election approaching and recent GDP report from Canada, it is highly likely that the economy shrank (see Synopsis below). So far economic weakness has caused a significant drop in consumer spending which advanced 0.4% in March versus February which is somewhat surprising given the big jumps in oil in the last quarter. Again, these data lag so we'll have to wait and see for subsequent reports to see if the negative impact on the consumer is increasing. The ISM service index report Monday will give us a better idea how this important sector is faring in the slowdown. Next Week Here are the economic reports we'll be watching next week. - Monday, April ISM Non-Manufacturing (Service) Index (previous 49.6). - Wednesday, Q1-08 Productivity (preliminary), previous 1.9%, March Pending Home Sales Index (previous -1.9%), March Consumer Credit (previous \$5.28 billion). - Thursday, March Wholesale Trade (previous 1.1%). - Friday, March Trade Balance (previous \$62.3 billion). Synopsis Seeing the GDP number for what it is… deceptive I was interested to see that GDP growth in our northern neighbor, Canada, was negative again in February with a drop of 0.2% for the second consecutive monthly drop. Given that it is a resource based economy that has had stronger economic growth than the U.S., how is it possible that their economy contracted there while ours expanded? There are two possible explanations. First, the growth in the U.S. in Q1-08 was only possible due to a buildup in inventories. This was because consumer spending is slowing and products aren't selling. But because inventory growth is a metric used to measure GDP growth, this buildup resulted in positive economic growth when in actual fact it's another sign of a weakening economy. The natural response will be to lower inventories to match falling demand and this will mean weaker performance in subsequent quarters and I have little doubt that the Q1 number will be revised downward. But there are larger forces at work. Last week we discussed the fact that over the last one hundred years, governments have done their level best to put the voter in the best possible mood leading into each election. These efforts to “shamelessly manipulate the economy,” according to Edward Tufte in his 1978 book Political Control of the Economy have had very real ramifications.

We discussed the fact that stocks in the two years before each election have outperformed the two-years after each election by a ratio of more than 13:1 from 1902 through 2006. That is no accident. Governments have also shown that they are getting better at juicing economies leading into elections. A strategy that bought the Dow 30 at the mid-term year low 25 months before each election and sold at the end of November in each election year would not have had one losing pre-election period since 1942! This compares to an overall performance of 19 winning pre-election periods out of 27 between 1902 and 2006. So are the same government forces that drive pre-election economies also capable of manipulating the data to make it look better than it really is? That is a matter of conjecture and to prove such an allegation would take concrete evidence. But given the strong manifestation of economic manipulation in stock performance, a similar ‘optimization’ in the data must be considered a real possibility. As a result, unless the economy really falls out of bed in the next few months we may not know whether we are now in recession until after the election is over given the fact that data revisions can occur up to a year or more after their initial release. One thing is clear. If data were to confirm a recession before the election is decided, it would further diminish the Republican Party's chances at the polls in November. Certainly not something the party needs or wants given that the positive view of Republicans currently sits at an abysmal 27% of voters. Only 21% approve of Mr. Bush's handling of the economy – a point not lost on the Republican political machine or on the politically motivated minions in the various data statistical tracking agencies. But while the political spin machine will do its best to put a positive spin on the economy (and the data), the market will not be so easily fooled. Stories of interest this week… Buffett Says Credit Crisis Ebbs for Wall Street Firms

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aeLirKvQi5jw&refer=home> Fed 'Rogue Operation' Spurs Further Bailout Calls

<http://www.bloomberg.com/apps/news?pid=20601109&sid=a1ctn1Xfq5Do&refer=exclusive> U.S. Lexus, Mercedes Sales Fall as Affluent Succumb to Slowdown

<http://www.bloomberg.com/apps/news?pid=20601109&sid=aXgObEkELJcw&refer=exclusive> More Subprime, Alt-A Mortgages May Head 'Underwater' (Update1)

<http://www.bloomberg.com/apps/news?pid=20601110&sid=a8ICfnqBcJU4> Countrywide Reports \$893 Million Loss From Bad Loans

<http://www.bloomberg.com/apps/news?pid=20601110&refer=&sid=aCoMaf9zLCHw> Countrywide Rating Cut to 'Junk' By Standard & Poor's

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aNssWctbuukA> Bernanke May Have to Follow Volcker to Avoid Being Tagged Burns

<http://www.bloomberg.com/apps/news?pid=20601109&sid=aBid7AnvOvNA&refer=exclusive> U.S. Economy: Consumer Confidence Falls, House Prices Decline

<http://www.bloomberg.com/apps/news?pid=20601087&sid=agQQsnDV3HII&refer=home> Bonds, Stocks Show Bernanke Fixing Financial System

<http://www.bloomberg.com/apps/news?pid=20601087&sid=adS3jA7wCyBQ&refer=home> -----

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