

# TSG Stock Market Letter June 29, 2007

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TSG Stock Market Letter Week Ending June 29, 2007 TradeSystemGuru.com Topics Discussed This Week: Property markets & Making sense of data discrepancies. A better week for markets. Fed holds rate but inflation concerns remain. New and existing home prices fall as inventory levels surge. Economic growth continues to slow in Q1. The stock-bond disconnect - what does it mean for markets?

(Also available in pdf format at <http://tradesystemguru.com/PDF/2007/June29.pdf> )

This week we got another blast of housing data so I decided it was a good time to take a thorough look at each in an effort to determine what it means for the real estate market going forward. Making Sense in the Housing Maelstrom The challenge with making sense of the reams of housing-related reports released each month, is overcoming the temptation to get caught up in something I'll call data minutia overload. Last week, there were data released on the National Association of Home Builders housing market index, housing permits and housing starts. This week we had to digest existing and new home sales as well as the National Association of Realtors, Commerce Department and S&P Case-Shiller home price indexes. There was also the Office of Housing Enterprise Oversight index to digest. Next week we get hit with pending home sales. In any given week or month, some numbers are up and some are down. It is hard enough for professional analysts and statisticians to make sense of what it all means. What is the average investor to do? Figure 1 & The 10-city home price index of homes that have sold multiple times dropped 2.69% in April from the previous year. Home prices doubled between 1999 and 2006. The Case-Shiller 20-city composite home price index (not shown) that provides data back to year 2000, hit 218.93 in April down 2.13% from April 2006. As far as home price indexes go, the S&P Case-Shiller home price index is considered a superior measure to median price data tracked by the Commerce Department and the National Real Estate Association (NRA) because it follows multiple sales on the same property. Unlike the quarterly price index produced by the Office of Federal Housing Enterprise Oversight, the S&P Case-Shiller index does not include refinancings and it also includes sales of homes with mortgages larger than \$417,000 not included in OFHEO figures. OFHEO has another index to track pair-sales data which like Case-Shiller does not include re-financings but it uses different regional data. In general, not only does the Case-Shiller data present an overall realistic look at national home prices, it is less prone to statistical anomalies resulting from month-to-month price variations. For this reason, it is the index used to price the new housing futures traded on the Chicago Merchantile Exchange (CME) and our index of choice. As we see in the chart shown in Figure 1, the Shiller-Case 10-city composite index (which goes back to 1987) peaked in 2006 and has dropped steadily since. Data released this week showed that home prices dropped 2.69% from April 2006, the largest price decline since September 1991. The orange dashed line in Figure 1 shows the linear regression trendline which is currently at 179.45. What's the significance? For prices to simply revert to trend, they still have more than 18% to fall nationwide.

Figure 2 & Chart showing year-over-year percentage rate of change in 10-city composite home price index. Figure 2 shows annual percent rate of change in Figure 1. Home prices hit a maximum annual appreciation rate (above 20%) in mid-2004 and didn't really begin to rapidly decelerate until 2007. As we see, the last time the index dipped into negative territory in 1990, it took six years for prices to begin appreciating again highlighting the length of time it takes for property price trend to change direction.

Figure 3 & Bob Shiller's chart showing long-term home prices after adjusting for inflation compared to building costs, population and interest rates. From a trader's perspective looking at the home price index as an oscillator like the relative strength index (RSI), the brown dashed horizontal line at 125 represents an overbought level and the green dashed line at 75, oversold. With the index currently near 200 and falling, it was more overbought in 2006 than ever before and is now flashing the most powerful sell signal in history. Figure 3 shows the longer-term picture of home prices after adjusting for inflation. In the 110 years leading up to 2000, home prices fluctuated between an index value of 80 and 125. But then the situation changed dramatically as prices exploded over the next five years to hit 200 in 2006, more than 50% higher than at any time in history. The orange dashed line in Figure 3 shows the linear regression trendline that currently sits at 124. At a current reading of 196, inflation adjusted home prices have more than 36% to fall just to get back to the trendline. This end would also be achieved if home prices remained flat for the next 15 years assuming inflation were to average of 2.5% annually. But given that prices are declining at an accelerating rate, the chances that they will level out anytime soon must be considered remote.

Could home prices drop 18% or even 36% over the next few years? This scenario is not only possible but probable given the findings of Jeremy Grantham in his examination of 18 major financial bubbles throughout history. In every case, prices reverted to the mean (regression line) or lower, no exceptions. Is also important to point out that a 36% price drop would put prices at a previous bubble high. Another truth about bubbles is that prices usually drop well below the prevailing trendline before markets recover. (For those who missed the link to his 'bubble-everywhere' Q1-2007 newsletter can read it at <http://tinyurl.com/278nvb#bubble> register free to do so <http://www.gmo.com> )

And only recently have investors begun to appreciate the risks to both the housing and stock markets as a result of what James Grant of Grant's Interest Rate Review called "wild and woolly, wholly reckless" lending practices that dominated the mortgage market. Please see the links at the end of this section to some very interesting articles that outline the growing risks and what fallout could do. It isn't pretty. Once the housing data noise is stripped away, the longer trend picture becomes clear. Industry cheerleaders, the most vocal of which was David Lereah of the NAR, continually proclaimed each time the numbers improved in the last year that the worst was over. But each time they were wrong. On a side note, Lereah is no longer with the NAR. However, for those who bought into this argument and either held on to homes with unaffordable payments hoping for a quick home-price recovery or worse or who bought convinced that prices had stabilized, the damage is done.

As we are seeing now, real estate trends last much longer than most expect both when they rise and when they fall. We are currently in the early innings of price declines and only time will tell how far we have to go or when the bottom will come. The good news for buyers is that when prices have finally stopped falling, it generally takes years for the market to begin to appreciate again. Those with the knowledge of the market and demographics driving it will be able to purchase the property they desire for their price and terms. But patience is the key. Growing Fallout in the Subprime Market article links The Poison in Your Pension <http://www.bloomberg.com/news/marketsmag/pensions.pdf> S&P, Moody's Mask \$200 Billion of Subprime Bond Risk

<http://www.bloomberg.com/apps/news?pid=20601109&sid=ag8P5Or55avc&refer=exclusive> Fitch, S&P Warn Investors About Subprime Mortgage CDOs, Bonds

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFmS14SrROTQ> Now let's check in on what happened in stock markets over the last week.

INDEX	Weekly Close	Last Week	Change	Change%	INDU	13,408.79
13,360.26	48.53	0.36%	DJT	5,098.64	5,108.22	-9.58
1503.28	1502.56	0.72	0.05%	COMPX	2603.23	2588.96
RUT	833.59	834.75	-1.16	-0.14%	Summary	It was the last week in June and the end of Q2-07. With the exception of Dow Transports and the Russell 2000, the stocks moved modestly higher this week as sub-prime woes continued to dog the market. Friday's discovery of two car bombs in London reminded investors that terrorism remains a real threat. While stock performance was nothing to write home about, it was certainly better than 1-2% index drops last week. Technically Speaking The double top we discussed last week in the Dow Industrial Average with a neckline at 13,270 has yet to be confirmed since the 90 point drop needed to confirm it never occurred. The DJIA now sits perched on its 50-day moving average. A similar situation exists for the double top pattern on the S&P500 with neckline at 1490 except that the index closed just below its 50-day moving average.

Commodities rallied for the last three days of the week pushing the NYFE CRB Index up to 410.36 up from 408.41 last week.

Rising rates took their toll on gold last week but as rates eased this week and the dollar weakened, gold rallied over the last three days to close at \$651.60 but still off its close last Friday of \$657.10. After peaking on June 14, the greenback has been dropping and it was another tough week. The U.S. Dollar Index closed the week at 81.92 down from 82.11 last Friday which is interesting given the recent flight to quality by investors that should have been good for it thanks is part to the sub-prime storm.

It was another strong week for oil as the NYMEX crude oil (continuous) surged to close at \$70.68 up from \$69.14 last week.

On the international front, the MSCI Emerging Market Index ETF (EEM) rallied for the last three trading days to close at 131.65 up from 131.44 last Friday.

Earnings With a total of 4222 companies (up from 4194 last week) having reported earnings for Q1-2007, the improvement versus the same quarter last year held steady at 8% from 9% two weeks ago. Economic Reports In its statement on Thursday, the Federal Open Market Committee held pat on interest rates while it left the door open to future rate hikes citing that "a sustained moderation in inflation pressures has yet to be convincingly demonstrated." The Fed has remained strongly focused on core inflation (that does not include food, energy costs or real housing costs for buyers). The core instead relies on a metric that makes up 40% of the core inflation model called owner equivalent rents (OERs) — a very subjective estimate of the rent owners would have to pay if they were renting the home they owned. Thanks to a continued contagion in the sub-prime market that is quickly spreading to the larger Alt-A market, OERs continue to get pushed higher as fewer people buy and a growing number of those who have see their homes fall into foreclosure pushing them to find other accommodation. The good news is that home prices and precious metals have been falling lately which shows a true decline in inflationary pressure. Here's what the charts had to say this week.

Chart 1 — On Monday it was announced that existing homes sales dropped 0.3% in May while the median home priced declined to \$223,700, down 2.1% from May 2006. Although the drop was small, the real story was the 5% increase in inventories of unsold homes to 4.43 million for sale which is an 8.9 month supply versus and 8.4 month supply at the end of April. It will be very difficult for home prices to stabilize given that much overhang.

Chart 2 — Meanwhile on Tuesday it was reported that new homes sales for May dropped 1.6% and April new homes sales were revised to 13% from 16.2%. On an annual basis, home sales in May were 16% lower than May 2006. As we saw in existing homes, most prescient are inventories which rose to 536,000 new homes listed, a 7.1 month supply up from 542,000 in April that at the time was a 7.0 month supply. The median price of a new home fell 0.9% to \$236,100 in May.

Chart 3 — In the final report Q1-2007 GDP growth registered an anemic 0.7%, which was an improvement from the last estimate of 0.6% but well off the initial estimate of 1.3% and Q4-06 growth rate of 2.5%. It was also a far cry from the 5.6% rate at which the economy grew in Q1-06. As this chart shows, the economy is definitely

slowing but the question of whether we go into recession or have a soft landing remains to be answered.

Chart 4 &ndash; While the April number was revised from 0.6% to 1.1%, May Durable goods dropped 2.8% adding more clouds to those hoping for a pickup in economic growth. Defined as big ticket items (like appliances) designed to last three or more years, the decline was led by a 22.7% drop in aircraft orders. Orders for capital goods (that don't include aircraft and defense goods) dropped 3%. The consensus among economists is for a big pickup in Q2-07 with estimates ranging to 4% growth but many wisely revised their estimates downward following weak GDP and durable goods reports. Rising interest rates will increase the cost of holding durable goods inventories as well as reduce consumer demand.

Chart 5 &ndash; Construction spending growth beat expectations in May rising 0.9% thanks in a large part to a 2.2% spending surge in public projects. However, residential construction fell 0.8% in May and year-over-year residential construction spending is down 17.3% from last May. Underlying continued strength in the commercial sector, non-residential construction surged 2.5% with factory spending jumping 6.1%. Next Week Here are the economic reports we'll be watching. - Monday, June ISM manufacturing index (previous 55.0). - Tuesday, May factory orders (previous 0.3%), May pending home sales (previous -3.2%). - Wednesday, July 4 Holiday. - Thursday, June Challenger layoffs (previous 0.6%), June ISM non-manufacturing (previous 59.7). - Friday, June non-farm payrolls (previous 157,000) and June unemployment (previous 4.5%). Synopsis Since peaking on June 13, both the 30-year and 10-year U.S. Treasury yields have dropped &ndash; 150 basis-points on the 30-year and 167 bp on the 10-year. The price for a 30-year T-Bond closed at 107<sup>24</sup> up from an intraday low of 104<sup>24</sup> two weeks ago. Although this should have been good news, so far it has done little to calm nervous stock investors. The stock reaction highlights a situation that erupted back in 1998 in the wake of the Asian contagion that saw stocks and bonds begin moving in opposite directions for the first time since the 1930s. Initially sparked by deflationary pressure from Asia, the continuing stock-bond disconnect shows that this pressure remains. While stocks have rallied since 2003, bonds have experienced a bear market (see Chart 6). Chart 6 &ndash; Weekly chart of 30-year T-Bonds showing the bounce off long-term support. While this should be good news for stocks, if the decoupling between stocks and bonds that started in 1998 continues, it means stocks will drop lower. This situation could also be viewed as a warning sign. The last time bonds penetrated their long-term support line (blue) was in late 1999 to early 2000 just three months before the Nasdaq began its long decline. Continued increases in bond prices show a flight to quality as investors flee emerging market debt instruments in favor of those in the U.S. But as long as this trend continues, chances that some sort of trouble will erupt in emerging markets rises with it. That along with growing problems with sub-prime mortgage instruments, as evidenced by the Bear-Stearns revelations recently, is what is keeping tensions high.

Given the change in the stock-bond relationship since 1998, a rise in bonds (and drop in yields) will mean a drop in stocks. But even if bonds reverse and begin to fall, it will mean higher yields and higher interest rates in mortgage and lending circles. This will not only be bad for home owners, consumers and retail investors, it will take its toll on corporations, M&A deals and emerging markets alike as investors develop a whole appreciation and respect for risk.

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