

TSG Weekly Market Watch August 17, 2007

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Topics Discussed This Week:

Central bankers try to wean markets… and then came Helicopter Ben. The fundamental Maginot Line... Polishing up our crystal ball. Volatility takes center stage again. Market leaders turn down harder. More bad news from home builders Good news, bad action.

Central bankers try to wean markets… and then came Helicopter Ben It was another week of mayhem in the markets. On Monday and Tuesday central banks around the world curtailed their infusions of cash but it seems global stock markets had become used to liquidity input. As central banks were cutting back on Tuesday the Dow fell more than 200 points then another 167 points on Wednesday. Then on Thursday, the Dow dropped more than 320 points by mid-day before a late day rally moved the index to within 15 points of even. On Friday, Helicopter Ben showed his hand by coming to their rescue again – this time in the form of a 50 basis-point drop in the discount rate – making good his threat to throw money out of helicopters to offset the threat of deflation.

Figure 1 – Chart showing the trajectory of the Fed discount rate (Primary credit) from the low of 2% in 2004 to the latest rate of 6.25% on Wednesday with the surprise 50 basis-point cut by the Fed on Friday. The only problem is that there was no threat of deflation and in fact real inflation is running in excess of 5%. The quick cut dropped the discount rate from 6.25% to 5.75% and signalled a clear bias in favor of the beleaguered housing market. But it also showed that inflation concerns would take a back seat from now on.

This latest action by the Fed poses two pivotal questions. Was the fate of global markets more grave than most of us suspected or was Ben caving to pressure to lend a hand to those ‘victims’ of the sub-prime mess? And what about the U.S. dollar – was it being offered as the sacrificial lamb? There is little doubt that the Fed has been under pressure to address the mortgage mess especially given that both the House and Senate are fettered by Democrat majorities and this is a pre-election year. Did this latest move mean that Ben had finally succumbed? Remember the good old days (as late as late month) when analysts bent over backwards to tell us that the sub-prime market represented no more than 1-3% (depending on who you listened to) of the total mortgage market so a non-factor in the health of the housing market and certainly no concern for the overall market? Until recently the Fed shared this view. But as markets around the world roiled and the number of institutional victims climbed, there has been enough eating crow to make you think it had become a popular new dish. Only time will tell if dropping rates and flooding the world with cash again was the right move. After all, a similar move by Sir Alan of Fed nearly six years ago worked even if it came at the cost of creating a global property bubble (not to mention the host of other bubbles) that got us in this mess in the first place. What happens if markets continue to fall next week? Will the Fed take similar action by dropping the more important Fed funds rate? And if that fails to work, what next? If this latest move is any indication, it is obvious that the Fed is only too willing to sooth short-term pain by greatly increasing the potential for long-term torture which bodes well for neither the strength of the dollar nor the viability of the U.S. economy going forward. The fundamental Maginot Line… At the onset of World War II the French confidently believed they were safe behind the impenetrable Maginot Line from a German attack. But the error in this assumption soon became painfully clear when a powerful blitzkrieg force simply came around it. The concrete line of fortifications and immovable guns had proven completely useless. An arrogant but false sense of security was as much to blame for the defeat of the French as was the swift and decisive German attack. Not a shot was fired from the Maginot Line.

There is evidence that many analysts and investors continue to place the same faith on fundamentals to protect them from harm as did the French on the Maginot Line more than sixty years ago. As we have said before, there is no evidence that fundamentals provide any warning of impending economic trouble and in fact, the evidence is quite to the contrary. They instead indicate that everything is rosy until after the portfolio damage is done. We were again reminded of the dangers with this line of thinking by comments by Dan Zanger in his August 12th newsletter. “Two of the most brutal and crushing trading days [August 11 and 12] I've experienced since the market breaks of 2000 as the market opened with back to back days of massive opening gaps down with leading stocks plunging from \$10 to \$18 in just two days. By the way there were 3 massive down events in 2000, March, September and a brutal gap down on the leading stocks in November. And oh yeah, I remember John Chambers the CEO of Cisco Systems (CSCO) saying in November of 2000 that he saw no sign of slowing and business was as strong as ever. I believe he said this last week too.” Figure 2 – Anybody see any signs of an impending recession in the GDP numbers leading up to 2000? To demonstrate, let’s take a look at some charts. The first appeared in John Mauldin’s Outside the Box last week in a piece by economist Asha Bangalore who used the chart below as part of an argument that while there was no economic trouble on the horizon, he questioned the Fed wisdom of not cutting rates to help the economy. That Cisco’s Chambers saw no sign of slowing [economy] and that business was as strong as ever in 2000 is supported by the charts. As we see in Figure 2, there is no economic hint whatsoever of the market fall coming in March in the GDP numbers leading up to 2000.

Nor were there any fundamental signs in the overall market as evidenced by the VectorVest Composite Index of 8,000 plus stocks on U.S. exchanges leading into 2000. In Figure 3 we see a cross-section of fundamentals leading up to the

market peak on March 10, 2000 in the lower sub-graph. Earnings growth (GRT) for stocks was increasing, earnings per share (EPS) were stable as were growth to PE (GPE) and price to sales (PS). It was only after stocks had already fallen out of bed that corporate fundamentals began to deteriorate.

Figure 3 – Chart of the VectorVest Composite of approximately 8000 stocks trading on U.S. exchanges leading up to the market top in March 2000. As you can see, there are no signs of any fundamental problems leading up to the peak (see green rectangle). Earnings growth (GRT), earnings per share (EPS), Growth to PE (GPE) and price to sales (PS) gave no indication of an impending market top before it happened. Even after the peak GRT continued to ramp up and did not start to fall until September 2000. But after that, it was downhill and over the next year the market dropped more than 35%. Chart by VectorVest.com

The point is that waiting for the fundamentals to warn of a coming recession is like waiting for the gun to go off before ducking. This approach is flawed for two reasons. As we see above, fundamentals lag price and secondly, it is not a recession that should concern us. It's the bear market preceding a recession that does the most damage. Thinking that we are protected by strong fundamentals leads to tears as investors learned over the last two weeks. Polishing up our crystal ball – Strangely, the flight to quality this week was not to U.S. Treasuries but to the yen as the carry traders (who have been borrowing yen to buy high-yielding New Zealand bonds etc.) continued to rapidly unwind their positions. The Japanese yen registered multi-year high rates of appreciation against the Australian and New Zealand dollars this week. As carry trade investors run for cover, they are taking money out of riskier economies and that is widening the liquidity crunch. Will global central banks and the latest Fed action fix the problem? If history is any guide, the answer is probably yes but it will only last for a limited time. What investors need to focus on now is the future.

Inflation is now a lower Fed priority but it is the largest threat to a portfolio long-term if not addressed. How inflation proof is your portfolio?

	INDEX	Weekly Close	Last Week	Change	Change%	INDU	
13,079.08	13,239.54	-160.46	-1.21%	DJT	4,767.98	4,961.73	-193.75 -3.90%
SPX	1,445.94	1,453.64	-7.70	-0.53%	COMPX	2,505.03	2,544.89 -39.86
-1.57%	RUT	786.03	788.78	-2.75	-0.35%	Volatility takes center stage again It	

was another wild week on markets as bulls and bears again went head to head. But the bears got the royal shaft on Friday as the Fed cut the discount rate by 50 basis-points pushing the Dow up more than 300 points in early morning trading. A triple witching week meant that a host of options expired this week, forcing investors to either close or roll their positions, and only added to the volatility. Technically Speaking – Thanks to more intervention by the global plunge protection team again and then the Fed this week, a significant market plunge was averted. As was the case last week, technicals aren't of much use when manipulation rules the day. But there are always some technical gems to be gleaned. Market Leaders Turn Down Harder – Last week Zanger's market leaders were down 3.9% compared to the Standard & Poor's Depository Receipts SPYDR (SPY) drop of 4% drop over the last month. This week Zanger's composite of stocks outperformed except this time it was to the downside with a monthly drop of 15% versus a 9% drop for the SPY as of Wednesday's close. More importantly, Dan has now switched his bias from longs to shorts. Headlining his group of seven market leaders as of August 15 were Intercontinental Exchange (ICE) with a bearish and rare double left shoulder Head & Shoulders pattern (short candidate), Research in Motion (RIMM) (short candidate), fertilizer leader Potash (POT) (short candidate) and Goldman Sachs (GS) (short candidate). As a secondary point of reference, his composite of nine market leaders from a month ago (July 18) including such stars as RIMM, AAPL, BIDU, GOOG, and AMZN are down more than 13% over the last month.

Figure 1 – Market leaders are now outperforming the SPY to the downside. Data courtesy of The Zanger Report.

On the major index front, the Dow Jones Industrials joined the other indexes this week in dropping below its 2-standard deviation trend channel support line and it also broke below its 200-day moving average intraday on Thursday before the index powered back above it to rally higher on Friday thanks to powerful help from the Fed. The action on Thursday produced a bullish doji candlestick pattern with a very long buying tail which showed that buyers were in control of the market later in the day. This pattern often accompanies short-term reversals. While the S&P500, Dow Transports, NYSE Index and Russell 2000 showed similar action, they all remain below their 200-day moving averages while the Nasdaq Composite broke back above its 200-day MA (and lower trend channel) on Friday. Meanwhile, the Market Volatility Index (VIX) hit a high of 30.83 on Thursday not seen since March 2003. This increases the likelihood that stocks may be at a short-term bottom. Commodities also took a hit this week as the NYFE CRB Index dropped briefly below its long-term 2-standard deviation lower trend channel and its 200-day MA before recovering to close just above it on Friday. The index closed at 403.72 down from 415.83 last week. Gold also took a beating this week losing nearly \$20 on Thursday before recovering to close at \$667.10 down from \$675.10 last week. The interest rate drop was decidedly bad for the greenback over the last two days as the U.S. Dollar Index gave back some of the gains enjoyed over the last week when it appeared the Fed would hold pat on rates. It closed the week at 81.36 higher than last weeks close of 80.60 but off its mid-week high of 81.94. Meanwhile, NYMEX crude oil (continuous) hovered around its 50-day moving average as the commodity closed at \$71.98/bbl up from \$71.25 last week but down from \$75.37 two weeks ago. Any break during the summer driving season is appreciated by drivers. Emerging markets also experienced a drubbing this week as MSCI Emerging Market Index ETF (EEM) closed the week at 122.25 down from 127.55 last week.

Earnings – With 3764 companies having reported Q2 earnings as of August 16 (up from 2109 companies two weeks ago), earnings improvement jumped to 12% from 10% last week versus 8% for Q1-07 compared to the year before. Strong earnings have been another reason for investor confidence in stocks but it is important to point out that earnings are a lagging indicator. Economic Reports – Here's what the charts had to say this week. Chart 1 – July food and retails sales ex-autos rose 0.4% from a revised drop of 0.4% in June. Food and retail sales including autos in July rose 0.3% versus a fall of 0.7% in June showing that consumer spending has so far been immune to fallout from the credit crunch that has infected markets around the globe in spite of the fact that more than half of banks across the

nation have tightened credit standards according to a recent lending practices survey. Chart 2 – The deficit with international trading partners narrowed nearly 2% to \$58.14 billion in June extending a falling trend over the last year thanks to a rise in exports. This was in spite of rising oil prices. However, the deficit with China rose to \$21.2 billion up from \$20 billion in June and the gap with Japan, Europe and Canada also rose.

More bad news from home builders

Chart 3 – The National Association of Home Builders housing market index (HMI) hit its lowest level since the midst of the last housing recession in 1991 in August with a reading of 22 from 24 in July. It was the sixth consecutive monthly decline in this leading indicator and shows that builders are the most pessimistic they've been about the current state and the future of their industry since the last recession. Home builders are surveyed on three different aspects of the new home market: current single family home sales, sales expectations for the next six months and prospective buyer traffic through show homes. All three categories declined this month with homes sales dropping one point to 23, sales expectations falling two points to 32 and traffic falling three points to 16. A number of 50 or above reflects expansion and below it, contraction. This did not stop the National Association of Realtors head cheerleader Lawrence Yun from again putting a positive spin on the market as his organization announced that median home prices showed year-over-year increases in 97 of 149 metropolitan areas in the latest quarterly survey. “Although home prices are relatively flat, more metro areas are showing price gains with general improvement since bottoming out in the fourth quarter of 2006,” Yun said in a prepared statement on the NAR website. [There's that word “bottoming” so popular with industry cheerleaders again.] But on a national basis, NAR data showed that home prices declined 1.5% in the second quarter compared to the year before. [Bartender, I've have a few bottles of whatever Yun's drinking and fill the glasses of the 300 plus builders who participated in the NAHB survey this month!] As we mentioned last week, the highly respected Case-Shiller house price index is on track for a 7% decline in paired-sales price data for 2007, a much more reliable statistic than median prices. Meanwhile, in the same report the NAR also reported that national existing homes sales for Q2-07 declined 10.8% from the same quarter a year ago. [Torpedos? What torpedos? Ensign, put those men on watch who cried “torpedos” on report…oh, and take away their binoculars!] Chart 4 – July housing starts and housing permits both dropped this month with starts dropping more than 6% while permits dropped 2.8%. The fall in starts followed a 7 drop in permits last month. As you can see from the chart there is no evidence of any sort of “bottom” here in either which may help to explain builder pessimism in the NAHB survey. According to the Wall Street Journal, housing starts are now at a 10-year low amid tumbling sales and tightening credit. Year-over-year permits are down 21.03% with starts down 20.9%. Next Week Here are the ones we'll be watching. - Friday, July durable goods orders (previous 1.3%), July new home sales (previous -6.6%). Synopsis Good news, bad action. It is at times like these that investors and traders begin to ask that age old question – are we in a bear market or is this just a correction? An old saying has often been used in the pas to answer that question. Bad news, good action occurs in a bull market as investors discount the bad news and buy stocks regardless. However, good news, bad action refers to the fact that they discount good news in a bear market. There is little doubt that of late, the latter has certainly been truer. However, central banks and the Fed seem bound and determined to avoid a melt at any cost. But will this effort be enough to avert trouble in the future? While we won't know the answer for a few more days or even weeks, chances that the market will rally from here are good given the history of central bank intervention and the fact that this intervention has come at the expense of inflation worries and a strong dollar. Inflation while insidious on long-term performance, it is good for stocks short-term. --

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