TSG Weekly Market Watch September 28, 2007

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TSG Stock Market Letter Week Ending September 28, 2007 TradeSystemGuru.com Topics Discussed This Week: Investors discount bad housing news but many opt for the sidelines Market leaders continue to point to higher prices ahead… Existing home sales figures confirm poor new housing data last week Case-Shiller home price index shows prices fell faster in July Mixed market signals…

INDEX	Weekly Close	Last Week	Change	Change%
INDU	13,895.63	13,820.19	75.44	0.55%
DJT	4,836.32	4,827.36	8.96	0.19%
SPX	1,526.75	1,525.75	1.00	0.07%
COMPX	2,701.50	2,671.22	30.28	1.13%
RUT	805.39	813.11	-7.72	-0.95%

Investors discount bad housing news but many stay on the sidelines Friday marked the end of Q3-07 which caused some to book profits but even with that downdraft, stocks managed to close higher. However, the fact that volumes remained below average through this week and last even through quadruple witching and quarter’s end shows that a lot of money is still sitting on the sidelines and for good reason. Even though Wall Street talking heads including Bernanke are doing their best to put a positive spin on the deteriorating housing and mortgage situation, the reality is that considerable risks remain. At least analysts have now given up their popular albeit foolish habit of trying to pick a bottom to the housing market. Every time they have tried to catch the proverbial falling knife, they got gored. Now there are no signs that things are improving but a very good chance that they could get a lot worse. There were signs that the credit contagion is spreading as news of the biggest U.S. bank failure in 14 years made headlines in the UK financial press on Saturday. NetBank, with $2.5 billion in assets, apparently waded into sub-prime mortgages late in the game. It was shut down and taken over by federal regulators on Friday. This won’t help assuage shattered nerves in the coming week. (See http://tinyurl.com/3ahyke) If there is a silver lining, it’s that consumers have so far remained oblivious. Technically Speaking Last week we mentioned that although the effective funds rate (EFFR) hit 5.41% on August 9, the market melt pushed the Fed and other central banks to pump large amounts of cash into the market over the next two weeks as we see from Figure 1 showing the EFFR dropping more than 70 basis points during the week of August 12 – 19. Those watching this metric saw the Fed broadcasting its intention to drop the Fed funds rate (FFR) more than a month before it occurred. According to the latest data however, the EFFR and FFR are back in line with each other but watch the EFFR. A significant drop will signal more cash infusions and likely rate cuts ahead. Figure 1 – Daily chart of the effective Fed funds rate (EFFR) versus the Fed funds target rate. Here is what the technicals are saying. Market leaders continue to point to higher prices ahead…

Dan Zanger’s composite of market leaders listed in his Wednesday newsletter again outperformed the broader market with a gain of nearly 4% on the week compared to 0.07% for the S&P500, 1.13% for the Nasdaq Composite and 0.55% for the Dow. Dan remains bullish and continues to look for long trades only. His leaders this week consisted of 9 stocks including past bullish favorites Baidu.com (BIDU), National Oilwell (NOV), MasterCard (MA), Wynn Resorts (WYNN) and Garmin (GRMN) as well as iSHaresFTSE/China (FXI), JA Solar (JASO), First Solar (FSLR) and Genco Shipping (GNK). Figure 2 – Weekly performance of Zanger’s market leaders compared to the SPY (proxy for the S&P500), the Dow Jones Industrial Average (DJX) and Nasdaq Composite (IXIC). Data courtesy of The Zanger Report, performance chart courtesy of VectorVest.com. Trading volumes were again below average this week. The Dow Industrials is now glued to its upper 2-standard deviation trend channel as investors have sought the safe haven of larger cap multinationals as the dollar falls – a good percentage of their earnings are in foreign currencies. Meanwhile, the broader market as shown by the S&P500 and NYSE Indexes remains above the trend channel mid-line and still looks bullish. But small caps have been lagging again as evidenced by the fact that the Russell 2000 was the only major index to lose ground this week. Figure 2B – Performance chart of Zanger’s top 8 performing stocks this week over the last five trading days. Chart provided by VectorVest.com Market leaders courtesy of ChartPattern.com And after surging to a multi-year high August 17 the Market Volatility Index (VIX) settled down further this week to 18 from 19 last week and 24.92 two weeks ago. This indicates that fear continues to come out of the market and is positive for stocks. Not surprisingly, commodities surged again this week well above the 2-standard deviation (2 sigma) trend channel top-line as the NYFE CRB Index closed at 447.56 up from 442.91 last week and 413.49 four weeks ago. This puts the CRB in extremely overbought territory. Gold also had another good week as the yellow metal surged another $10 to close at $742.7/oz. up from $732 last week and $675.80 four weeks ago. Investors are continuing to seek the security of gold as the dollar gets hammered. And so it was no surprise that the dollar again took it on the chin as the U.S. Dollar Index fell to another new all-time low of 77.63 down from 78.48 last week as it hit a new all-time low against the euro. Still no technical or fundamental signs that this trend will reverse soon. Pushed higher by a falling dollar, NYMEX crude oil (continuous) again surged this week closing at $81.66 up marginally from $81.62 last week. And the MSCI Emerging Market Index ETF (EEM) also continued to power higher above its 2 standard-deviation upper trend channel line putting it in extremely overbought territory as global investors continued to seek the haven of non-US dollar denominated assets. The index gained another 3% as it ended the week at 149.45 up from 145 last week. Earnings A few more stragglers reported this week bringing the total of companies having now reported Q2-07 earnings to 4192 (from 4121 companies last week). Year-over-year improvements returned to 13% up

from 12% last week. This compares to an 8% improvement for Q1-07 versus the same quarter the year before. Economic Reports Here’s what the charts had to say this week. Existing home sales figures confirm poor new housing data last week

Chart 1 – After another negative report from the National Association of Home Builders housing market index (HMI) which hit yet another low of 20 in September and the nearly 6% drop in housing permits and 2.6% fall in housing starts last week, existing homes data released this week showed another big drop for the sixth consecutive month in August with a reading of -4.3%.

Chart 2 - Perhaps more concerning was the surge in the inventory of unsold homes to an 18-year high with 4.581 million existing homes on the market in August. It is interesting to note that according to data published by the National Association of Realtors, while the number of homes for sale increased by just 0.44% from the month before, the time to sell a home surged 5.3% in August which is a 10 months supply thanks to deteriorating sales –the highest inventory on record according to Economist magazine. Case-Shiller home price index shows prices fell faster in July

Chart 3 – Regarded as more reliable by a number of analysts than National Association of Realtors (NAR) and Office of Housing Enterprise Oversights’ (OFHEO) median existing home price data, the S&P Case-Shiller 20 city composite home price index (HPI) fell again in July (last week we reported the fall in June) and the rate at which prices are falling continued to accelerate. This index is far more accurate for a number of reasons; the most important of which is that median prices are skewed because higher-end property sales and prices lag since this is the last segment of the market to roll-over. This characteristic can be dangerous in that it gives those who follow it (including Ben Bernanke) a false sense of security – a skew which has been further exacerbated by generous incentives being offered by both builders and home sellers. Since the Case-Shiller HPI only tracks repeat or paired sales, it is less prone to this major weakness. In June, year-over-year prices fell 3.4% and in July the rate of decline climbed to 3.9%. As we see in the lower chart in Chart 3 above, there is still no sign of slowing in the rate of change in home price declines. One last point that bears repeating – this is the first time in history that U.S. home prices have fallen in the absence of a recession and they have now been falling for a year according to the Case-Shiller HPI. Chart 4 – While durable goods registered a larger than expected drop in August (-4.9%), it was no big surprise. Durable goods have been basically flat since the beginning of the year. Chart 5 – Then on Thursday, August new home sales also surprised to the downside with a drop of 8.3% from July. Inventories also climbed 8% to an 8.2 month supply from July. It was another week of bad news for builders as it was reported that major builder DR Horton Inc. (DHI) is auctioning homes this weekend at prices starting at 50% off earlier prices and the second largest builder in the nation, Lennar Corp. reported a net loss of $514 million for the quarter ending August 31. That was nearly six times the loss expected by analysts according to the Wall Street Journal. KB Homes also recorded a loss in Q3. In a separate report Friday, construction spending increased 0.2% in August up from -0.4% in July but the 2-year trend remains negative. Chart 6 – But it wasn’t all bad news this week as the final GDP report for Q2-07 showed a rise of 3.8%. It was lower than the last estimate of the 4% rate originally reported by the Commerce Department. But residential fixed investment (RFI), the GDP component that measures spending on housing related items and an important recession warning indicator, fell 11.8% compared to Q1 spending that fell 16.3%. Overall, the GDP picture continued to deteriorate as evidenced by the trendline. In a separate report Friday, personal income rose 0.3%, while personal spending increased 0.6%.

Chart 7 – No explanation necessary here. Even though the Chicago PMI has risen over the last three months, the two-year trend remains strongly negative. Next Week Here are the reports we’ll be watching. Next week we will begin tracking the non-manufacturing or service industry ISM next week due to the increasing importance services are now playing in the economy. Monday, September ISM manufacturing business index (previous 52.9). Tuesday, August pending home sales (previous -12.2%). Wednesday, September Challenger layoffs (previous 85.2%), September ISM non-manufacturing business index (previous 55.8). Friday, September nonfarm payrolls (previous -4K), September unemployment rate (previous 4.6%), August consumer credit (previous $7.5 billion). Synopsis Mixed signals… Lots of moving parts in the markets next week. Even though they were up on the week, Zanger’s market leaders dropped on Friday which is not normally a good sign. But was this simply due to quarterly profit taking or evidence of the beginning of a sell off? Only time will tell but the failure of NetBank and the resulting increase in market jitters won’t help. Investors discounted bad housing news this week but if Tuesday’s pending home sales again surprise to the downside, they might not be so sanguine in the days ahead, especially if there is more bad credit news. Another indication of the level of concern was the higher than normal rate of the 3-month LIBOR (London Interbank Offered Rate). Why is this important? It is used to calculate interest rates for a range of financial instruments including $150 trillion in derivatives according to a study by the University of Edinburgh plus billions in mortgages in the US. Normally, the 3-month USD LIBOR rate tracks the Fed funds rate but lately they have gone in opposite directions. Two weeks ago the LIBOR surged to 5.72% but even after the 50 basis-point drop in the FFR last Tuesday to 4.75%, the LIBOR actually went up to 5.23%. This means that the millions of homeowners facing resets in mortgages indexed to LIBOR will not enjoy any of the benefit of the FFR drop, at least over the short-term. It also means that as long as investors remain nervous, further drops in the FFR will offer either limited or no relief.--- If you find this newsletter insightful, please feel free to forward this newsletter and share it with a friend (or simply have them opt-in free from our home page

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