TSG Weekly Market Watch October 5, 2007

Contributed by Administrator
Sunday, 07 October 2007
Last Updated Sunday, 14 October 2007

TSG Stock Market Letter Week Ending October 5, 2007 TradeSystemGuru.com Topics Discussed This Week: Indexes hit new highs but how are they really doing? A 'loonie' perspective... Market leaders keep on keepin’ on… ISM manufacturing and service indexes decline Pending homes registered largest drop on record Surfing the cash wave… INDEX Weekly Close Last Week Change Change% INDU 14,066.01 13,895.63 170.38 1.23% DJT 4,997.17 4,836.32 160.85 3.33% SPX 1,557.59 1,526.75 30.84 2.02% COMPX 2,780.32 2,701.50 78.82 2.92% RUT 844.88 805.39 39.49 4.90% Indexes hit new highs but how are they really doing? It was a good week capped by strong stock performances on Friday in the wake of stronger than expected non-farm payrolls numbers (see Chart 5 below). The Dow Industrials surged to a new high as did the S&P500 as traders made bets that the news would push stocks higher. But how are indexes really doing since the dollar decline began? A ‘Loonie’ Perspective Figure 1 – Chart of the S&P500 denominated in Canadian dollars (CAD$). Chart provided by GenesisFT.com As we see from Figure 1, the S&P500 Index priced in CAD$ has recovered just 30% of what it lost from 2000 through 2003. Although the index is up 27% from its 2003 lows in Canadian dollar terms, this performance pales in comparison to that of the Toronto TSX Index (denominated in Canadian dollars) which is up more than 127%. This is a real return of more than 5 times that of the SPX since the rally began more than four years ago. Technically Speaking This week we updated our chart (Figure 2) showing the effective Fed funds rate (EFFR) versus the Fed funds target rate (FFR) showing the restrictive action (raise EFFR above target rate) last Wednesday, Thursday and this Monday then stimulative (EFFR below FFR) Fed action last Friday and this Wednesday. It is interesting to compare the EFFR to Dow Jones Industrial Average performance. The Fed started seriously stimulating on August 10 following the second wave of big drops in stocks and has since pumped money into the system on Dow down days. It hiked on big up days like Monday when the Fed raised the EFFR from 4.58% to 4.92%. But don’t tell anyone or they may discontinue publishing this data like they did with M3 money supply once the market became too proficient at reading the signals. Figure 2 – Here is our updated daily chart of the effective Fed funds rate (EFFR). And the Fed expects us to believe that they are not politically motivated? This is a pre-election year and governments have demonstrated an all-too predictable habit of seriously stimulating the economy leading up to each election. Maybe I’m just a cynic but the Fed, if not the star player, has played a leading role. It has also taken a more pivotal part in this tragic comedy since 2000, a fact that serious traders and investors can ill afford to ignore. So how do we use this information to make money? Never bet against the Fed in a rally. The big caveat is that once markets begin to roll over in a bear market, even the mighty Fed becomes impotent in trying to orchestrate a reversal. In the first week of January 2001, the Fed cut the FFR from 6.5% to 6% and while the market rallied over the next few days, the S&P500 lost nearly 50% of its value over the ensuing two years even though the Fed aggressively cut the FFR to 1.5% (see http://tradesystemguru.com/content/view/88/58/#FFR). Here is what the other technicals are saying. Market leaders still heading on up… Although they suffered a sizable drop on Wednesday, Dan Zanger’s composite of market leaders listed in his Wednesday newsletter recovered nicely on Thursday and Friday for a weekly gain of nearly 6% compared to 2% for the S&P500, 3% for the Nasdaq Composite and 1.2% for the Dow. Dan remains bullish and continues to look for long trades only.

Figure 3 – Weekly performance of Zanger’s market leaders compared to the S&P500 (SPX), the Dow Jones Industrial Average (DJX) and Nasdaq Composite (IXIC). Data courtesy of The Zanger Report, performance chart courtesy of VectorVest.com . Since the third week in August, trading volumes have been below average and that continued this week. But although the Dow Industrials remains above its upper 2-standard deviation trend channel, it underperformed the S&P500 and Nasdaq Composite this week. But the Dow is exhibiting a bullish continuation candlestick pattern on the daily chart called the Rising Three Method which is five day pattern similar to a bullish flag pattern which bodes well for higher prices ahead. And small caps, which had been lagging, did very well this week to take top honors in the major index performance category. Part of that may have been the result of stronger than usual USD performance (see below). And after surging to a multi-year high August 17 the Market Volatility Index (VIX) settled again this week to 16.91 from 18 last week and 24.92 three weeks ago as risk appreciation (fear) continues to leak out of the market. Commodities took a bit of a break this week as the NYFE CRB Index closed at 442.73 and still glued to its upper 2-standard deviation (2 sigma) trend channel. It was down from 447.56 last week and back to where it was two weeks ago (442.91). After being in extremely overbought territory, the index was overdue for a rest. After giving up some of its gains on Tuesday, gold also had another reasonably good week as the yellow metal closed at $747.4/oz. up from $742.7 last week. It will be interesting to see how it does in the coming weeks. Gold exhibits strong seasonality and this season typically ends September 30. This year however, the season could well be extended by further easing by the Fed. It was the best week in the last two months for the greenback as the U.S. Dollar Index recovered slightly to 78.24 from an all-time low of 77.63. However, there are still no technical or fundamental signs that the current downtrend will reverse anytime soon. NYMEX crude oil (continuous) also backed off a little this week to close at $80.62/bbl down from $81.66 last week thanks to stronger inventory numbers and a brief surge in the dollar. And the MSCI Emerging Market Index ETF (EEM) also continued to power higher and is now well above its 2 standard-

deviation upper trend channel line putting it in extremely overbought territory. The index gained another 5% as it ended the week at 157.07 up from 149.45 last week. Earnings Q3-07 reporting season commenced this week and with a total of 384 companies having reported, improvements over the same quarter last year rang in at a healthy 9% compared to a final 13% improvement in Q2-07. Economic Reports Here’s what the charts had to say this week. ISM manufacturing and service indexes decline again

Chart 1 – September’s ISM manufacturing index dropped to 52 from 52.9 in August for the fourth consecutive drop. The two-year trend remains negative.

Chart 2 – As promised last week, we constructed a chart of the Institute of Supply Management’s non-manufacturing or service index showing the fourth consecutive monthly drop in September to 54.8 from 55.8 in August. But as you can see the trend is as negative for the service sector as it is for the manufacturing index in chart 1 even though the former is farther from the contraction threshold (50%).

In the Guerite Advisor’s October newsletter, Hugh Moore shared how he uses two economic indicators to warn of trouble on the horizon. We have quoted Hugh before, most recently with regards to his firm’s Guerite Indicator based on twelve different metrics that includes residential fixed investment (see http://tradesystemguru.com/content/view/82/58/#Wrap) Here is what he had to say this week. “Real Equipment and Software Fixed Investment (RESFI) measures corporate America's willingness to invest in additional productive capacity. Businesses add additional production capacity to meet anticipated customer demand. However, if businesses believe that additional capacity is not needed and that it will not earn a return on investment, then will not invest in equipment, software and other fixed assets.” “Since 1960, RESFI has been an excellent barometer for the general economy and recessions in particular. In fact, each time the year-over-year increase in RESFI has fallen below zero, a recession has followed, with two exceptions. The two exceptions were the "mini-recession" of 1967 and the mid-decade slowdown of the 1980's. Both periods produced shallow and short-lived signals. The current RESFI reading has been negative for two quarters and shallow like the two exceptions noted above. A prolonged or increasingly negative signal would indicate a very high-risk of recession.” Chart 3 – Real equipment & software fixed investment from Guerite Advisors showing the latest recession warning. The second indicator Moore discusses is the Institute of Supply Management (ISM) Manufacturing Index. Each time it has dropped below 45 corresponded with a recession with only one false reading and that was in 1967 at the start of a protracted bear market. While the ISM is currently 52, he warns that a continued drop would be cause for concern. Unfortunately, by the time it hits 45 a recession is “already well underway,” according to Moore.

Pending home sales register largest annual drop on record

Chart 4 – Pending home sales tumbled again with a 6.5% drop in August from July. Year-over-year, pending sales were down 21.5% from August 2006. There was a little good news however, as the National Association of Realtors revised the July reading upward from -12.2% to -10.7%.

Chart 5 – Looking at the bigger picture of pending home sales on a year-over-year basis, we see that the 21.5% drop in August was the largest on this chart and in fact was the largest since the indicator’s inception in 2001 according to the Wall Street Journal. Since peaking in April 2005, the index has fallen a 32.5%. Pending sales of existing-homes activity is a forward looking indicator, according to the National Association of Realtors and is based on contracts signed but the transaction has not closed which typically occurs over the next 30 to 60 days. But a major weakness of the index is that cancelled sales and those failing to complete are not taken into account. Annual changes in the index are more closely related to actual market performance than are month-to-month comparisons according to the NAR website. An index of 100 is equal to the average level of contract activity during 2001, which was the first year to be examined as well as the first of five consecutive record years for existing-home sales. The index value was 85.5 in August, the lowest reading since 2001.

Chart 6 – Good news for stock traders on Friday with the release of data showing not only an increase of 110,000 new jobs in September but a drastic revision from -4,000 to +89,000 !!!??? in August. But as stock traders demonstrated on Friday, who cares why there was a huge swing in August and better than the ADP/Macroeconomic Advisors expected (+58,000) number in September, buying was the order of the day. But rather than get tied up in the minutia, better to look at the bigger picture and as we can see from this chart it (and just about every other economic data set) has been steadily deteriorating. Chart 7 – Consumers have been taking the same approach to the credit crunch. Damn the bad news and borrow, borrow, borrow to buy, buy, buy! Who can blame them? Might as well trade those declining greenbacks as fast as you can for real goods before they get even more expensive. Next Week Here are the reports we’ll be watching. Wednesday, August wholesale trade (previous 0.2%). Thursday, August trade deficit (previous $59.25 billion), September import prices (previous -0.3%). Friday, September Producer Price Index (previous -1.4%), PPI, ex-food & energy (previous +0.2%), September retail & food sales (previous 0.3%), retail & food sales ex-autos (previous -0.4%), August business inventories (previous 0.5%).

Synopsis Surfing the cash wave… As we see, this rally has been great for non-dollar denominated assets and investments. The Fed and the political powers are betting that voters have been too busy at the malls to notice but at some point the masses will realize that as the dollar declines, they are unwitting participants in a serious game of musical chairs. While politicians continue to do what they can to keep the music playing, the Fed and other central banks have been pumping out newly minted dollars and investors and markets around the world have been riding the wave. The

nasty side-effect is that as the greenback slides, real incomes have fallen and while markets can rally for decades, there is only so far that the dollar can drop before it becomes virtually worthless.   What happens then and when will that be? No one really knows for sure, but most of us understand that the current situation can’t continue indefinitely. The quickest way to stop the dollar’s decline is to raise rates but that would foment an even more severe burst of the housing bubble and crimp economic growth – two outcomes that would spell disaster for the incumbent party in the upcoming election. But at the end of the day, we will have little choice and the most likely solution is an event that removes excesses built up over time. In other words a serious recession.   In the meantime, make money while the cash pumps and printing presses are running flat out as the incumbent government does whatever it can to get re-elected. This strategy should include participation in non-dollar denominated assets and markets or at a minimum, investments that are inflation protected. Not only will this insulate you from further dollar declines, you have a better chance at some real gains while emerging and commodity-based markets boil in the oceans of cash.   -- 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 http://www.tradesystemguru.com to be added).   Disclaimer

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