Correction or Asset Bear Markets?

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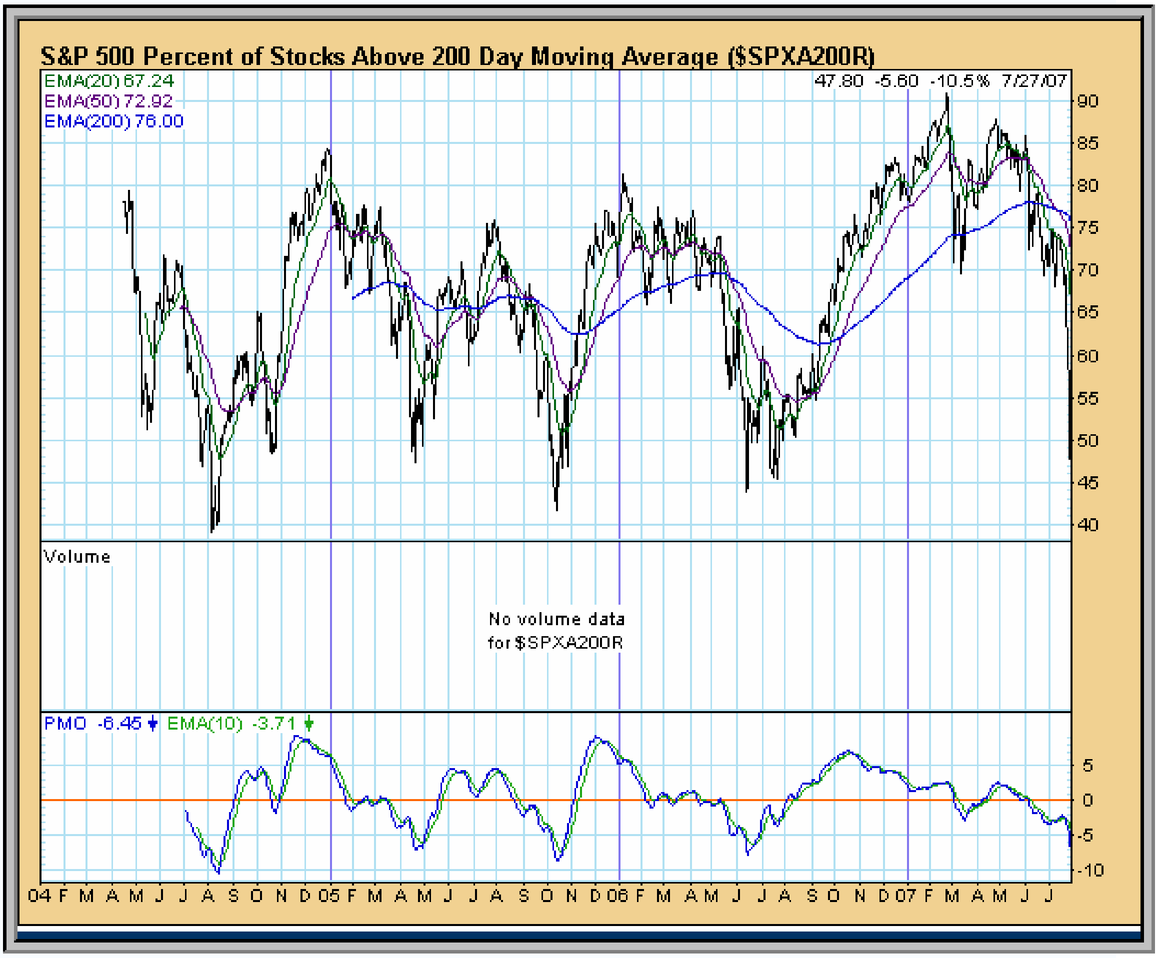
Recently, Michael Kahn, who writes technical comments for Barron's, highlighted the fact that according to the Hindenburg Omen the US stock market had given several strong sell signals in July (see Figure 1).

Figure 1: Hindenburg Omen Sell Signals

Source: Ameribrokers, Michael Kahn, Barron's

Normally a single signal is not of great significance, but when several signals occur within a short period of time, the odds for a stock market crash increase. As of Tuesday, July 23, the Hindenburg signal had fired at least eight times over the previous six weeks. The Hindenburg Omen is the alignment of several technical factors that measure the underlying condition of the stock market and warns of either impending market crashes or severe declines. According to Wikipedia, "the rationale behind the indicator is that, under normal conditions, either a substantial number of stocks establish new annual highs or a large number set new lows - but not both. Large new highs and large new lows simultaneously indicate a period of extreme divergence in the stock market. Such divergence is not usually conducive to future rising prices. A healthy market requires some degree of internal uniformity, whether the direction of that uniformity is up or down". Now, I have to stress that the Hindenburg Omen does not always work, but there are other factors to consider, which would argue for more market weakness ahead. First, it is remarkable that so close to a market high the number of 52-weeks new lows has expanded so dramatically (new lows: July 25: 412, July 26: 732, July 27: 400). Not surprisingly the percentage of shares above their 200-day moving average has dropped to below 50% (see Figure 2).

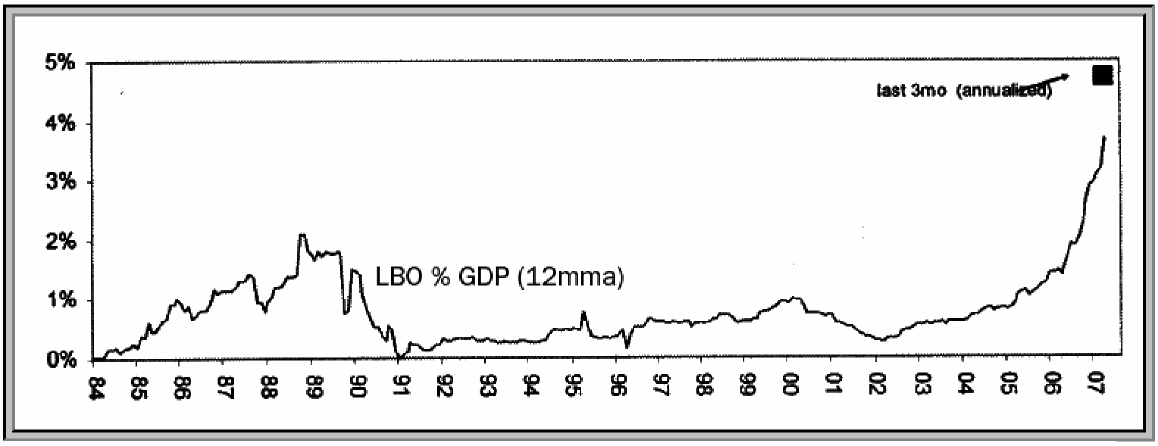
Figure 2: Internal Market Conditions weakened since February!



Source: www.decisionpoint.com

As can be seen from Figure 2, the internal conditions of the US stock market began to deteriorate after the February stock market high with fewer and fewer stocks trading above their 200-day moving average. Simply put, the US stock market continued to rise into the July peak, but fewer and fewer shares were driving the advance. Specifically, the advance after the late February/early March sell-off was driven by energy and oil servicing stocks, and companies with large overseas earnings or by companies that were taken over in financial history's largest LBO boom (see Figure 3)

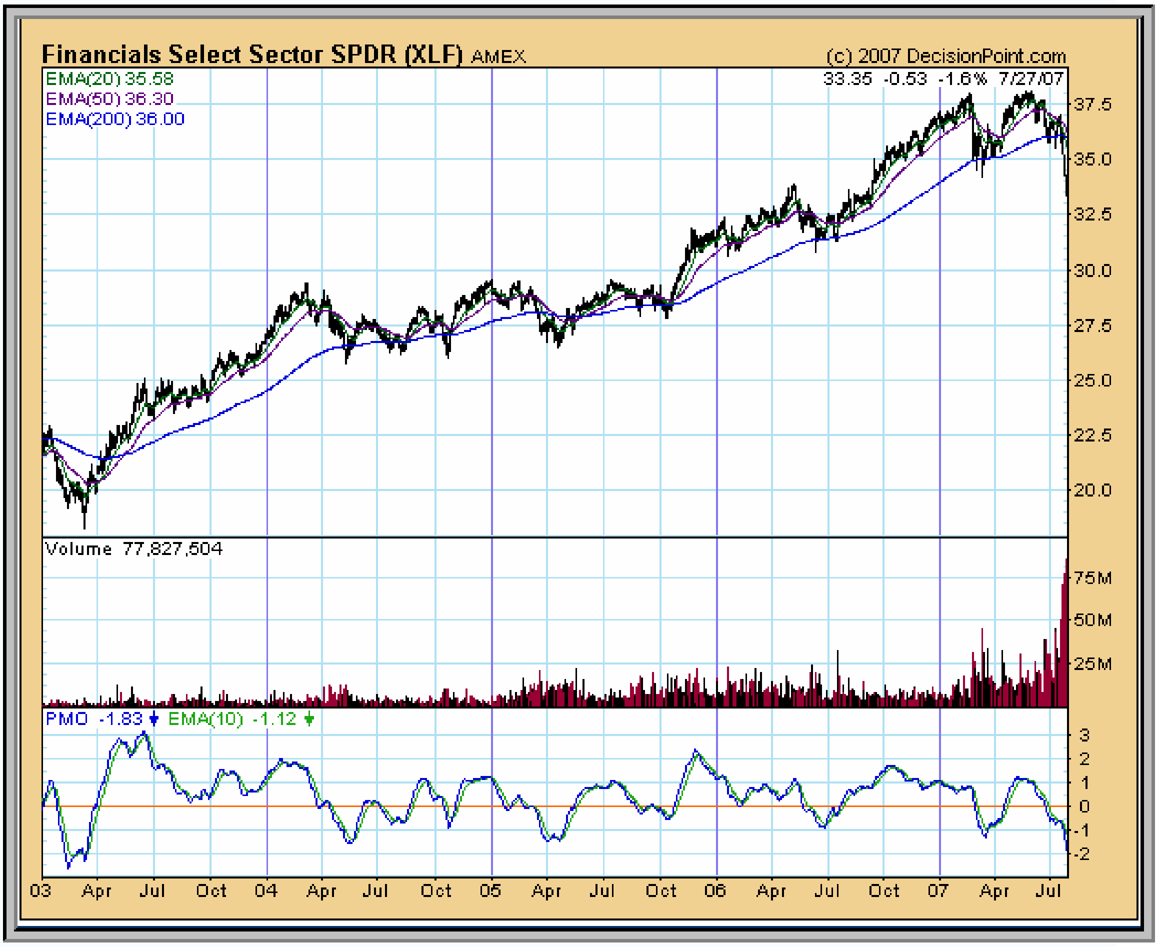
Figure 3: Leverage Buyouts at Close to 5% of GDP – an All Time Record (latest three months annualized)



Source: Bridgewater Associates

For my taste the US stock market's advance was particularly suspect because of the failure of brokerage stocks to better their February highs and because of the collapse of sub-prime lenders. Moreover, as pointed out in earlier reports, the continuous underperformance of financial stocks was a very negative indicator, since financial stocks – in particular brokerage shares – had led the advance which began in October 2002. This was a particularly negative omen for a credit addicted economy, such as the US has become, and for the credit driven global asset bubble (see Figure 4).

Figure 4: Financial Stocks leading the Market Up and Down



Source: www.decisionpoint.com

Now, I am aware that most market observers will argue that there is nothing to worry about and that we are in the midst of a sharp correction, such as we experienced in May/June 2006 or between February 22 and March 14 of this year. Since these corrections led to over-sold technical readings and were followed by higher prices, the view is, therefore, that stocks will shortly recover and make new highs. However, that is far from certain for a variety of reasons.

I remember well how, following a period of poor performance, in 1981/82 the US stock market took off like a rocket in August 1982. Suddenly, the number of stocks hitting twelve months new highs exploded and the market became very quickly over-bought (see Figure 5). The S&P 500 was already enormously overbought in technical terms following its rise from 102 on August 12, 1982 to 126 on September 17, but as can be seen from Figure 4, the S&P then continued its ascent to 144 in December 1982, and to 171 in June 1983!

Figure 5: S&P 500, 1982 -1983

Source: **www.decisionpoint.com**

So, the same way the stock market remained over-bought for a very long time in 1982/83, it could remain over-sold for a long time in 2007. But the crux of the matter is that, for stocks hitting 12 months new highs to explode on the upside in 1982, they had to have been basing for a long time while the indices (as can be seen from Figure 5) were still declining. But now we have the same situation in reverse. For 52 weeks new lows to increase suddenly so sharply a large number of stocks must have broken down from extended topping formations. Take as an example J.P. Morgan Chase (JPM). The stock formed a top between February and July 2007 and suddenly broke down over the last ten trading days (see Figure 6). The problem, now, is that the top between February and July will act as a barrier of resistance which makes it difficult to achieve a new all-time high in the future.

Figure 6: J.P. Morgan Chase, 2004 – 2007

Source: www.decisionpoint.com

A technical analyst, Peter Mauthe, recently commented that "a real correction is clearly under way. This correction should set up a great buying opportunity! Start building your buy list because the rally that erupts from the low of the next several weeks should be a very profitable one." I am sure there will be shortly a sharp rebound to work off the current over-sold condition, but new highs are not very likely (certainly not in Euro terms). Moreover, what is interesting about the current sell-off is that it was not accompanied by very negative sentiment. I am here quoting from the trading desk of a top tier bank:

"During previous crashes our net ETF flow has always been pretty consistent. At first sign of trouble, it's a rush to the exits. And we get buried under a heap of SPY as portfolio managers try to lock in the measly 150 BP they are up for the year before it evaporates. This happened with great behavioral finance splendor back in April 2005, and again in the summer 2006, and to a lesser extend this February.

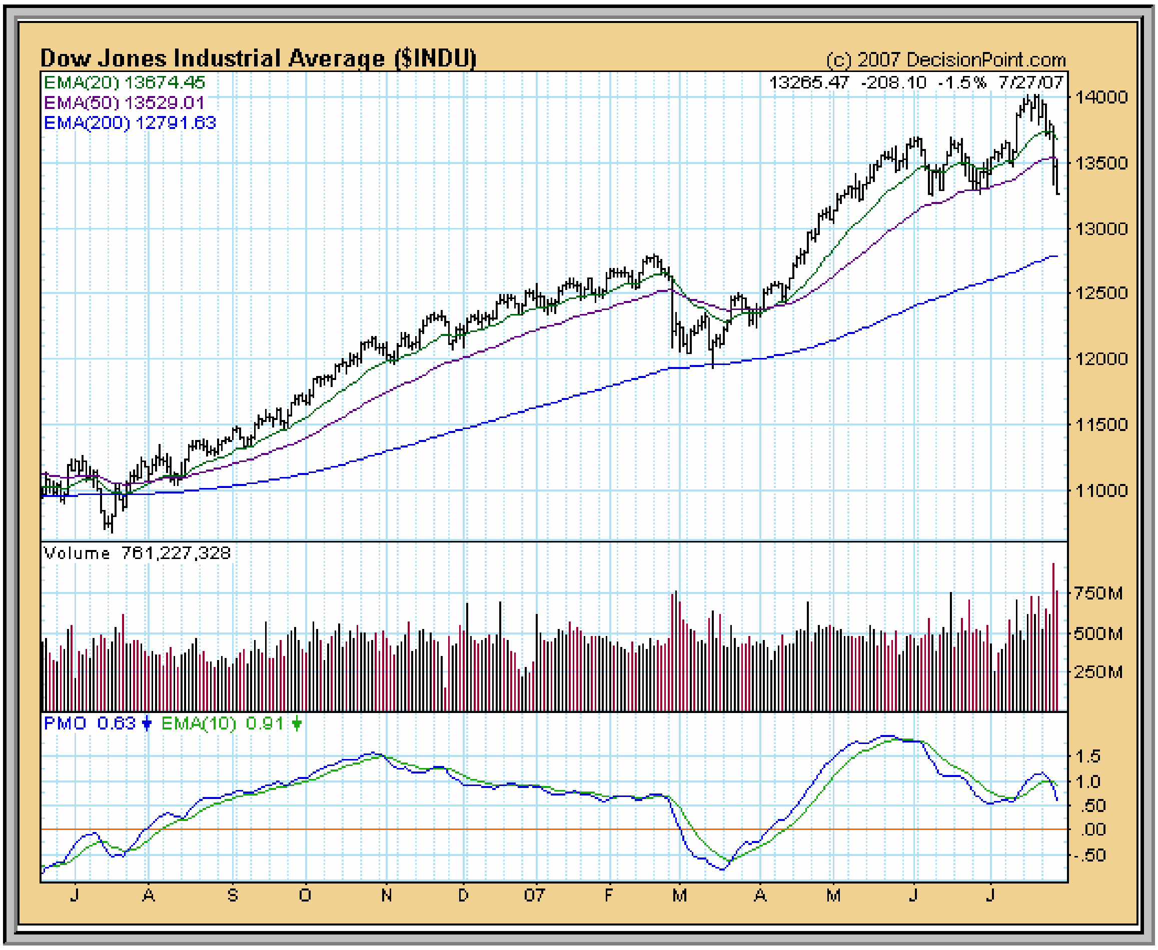
Fast-forward to today, where we are in the midst of what potentially is the gravest financial situation in the last five years, and our ETF flows are as follows:

July 24: After an all-day annihilation, we get no flows until the close where there is a flurry of buying, playing for a bounce.
July 25: No obvious direction to the flows until ½ hour after Beige Book, where we break a 3-day downtrend and spark off a 10-handle squeeze, sucking in, once again, a flurry of buy orders.
July 26: We are better to buy over the day. There is much greater concern playing a squeeze than avoiding a train wreck.

Why is this going on? My hunch is that most folks are having a good year and they are playing with house money. Why not leverage up and play for a recovery, like what has always happened since 2003?
7 years in the markets and 3 years in ETFs may not seem like a lot of experience, but it is enough to know what unalloyed speculation looks like. In my humble opinion, spelled out for emphasis, we are nowhere near the end. This is not even the first inning, or even the national anthem. We're across the street at Stan's
And! Carry unwind is just beginning.
Yesterday (July 27) on the ETF desk we traded a robust $ 2,074,544,384 in flows. $1,083,525,376 were buys, (991,019,008) were sells".

I do agree with the observations of this trader. The initial decline from the S&P 500 peak at 1555 and Dow top above 14,000 on July 16 was accompanied by total complacency (as was the collapse earlier this year of the sub-prime lenders). And even today, after a near 100 points drop in the S&P 500, investors seem more concerned about missing the next rally than avoiding, as the trader remarked above, the train wreck.
Another point: If one looks at the recent market action we see a sharp recovery following the March 2007 lows until the end of May. Then we have a trading range and a break out on the up-side in mid July, probably partly fueled by a well-known technical analyst who after having been bearish during the entire 2002 – 2007 bull market suddenly (and in my opinion inexplicably) turned bullish (see Figure 7). But, and this is the point, the break-out on the up-side was a "false break-out" move, as it quickly reversed. When this occurs the counter move is usually very powerful.

Figure 7: The US Stock Markets False July 2007 Up-side Breakout!



Source: www.decisionpoint.com

False breakout moves frequently occur near market lows and market peaks. Near market lows, the selling pressure becomes exhausted and new lows are followed by a quick reversal to the up-side (the August 1982 low was a false break out move on the downside – see Figure 5). At market peaks, false up-side breakout moves are frequently triggered by the last bears throwing in the towel and are reversed by the smart money selling. I mentioned in an earlier report the perfect timing of Sam Zell who sold in February 2007 his Equity Office Property Trust to Blackstone for $ 23 billion – right at the peak of the REIT sector. It would seem that Stephen Schwarzman and Pete Peterson also timed the listing of Blackstone perfectly (see Figure 8)

Figure 8: Another Visionary holding the Money while the Investors hold the Vision!

Source: www.decisionpoint.com

I have focused in this report more on the technical than the fundamental side of analysis. But, I explained the problems in the CDO market in depth in the July report. Also, in the past I have emphasized that in a credit driven economy a slowdown in credit growth wrecks havoc in asset markets and the economy. In the US, growth in credit began to slow down for the household sector in 2006 and has now spread - to the total surprise of the goldilocks crowd - to the financial sector.

It is not the Fed that has tightened monetary conditions but the market as a result of losses in the credit market. Suddenly the availability of credit has diminished, which under normal conditions should stabilize and even strengthen the US dollar, and as explained in last month's report, the Japanese Yen. As of mid July sentiment for the US dollar was extremely negative and, therefore, a more meaningful US dollar low is possible (see Figure 9).

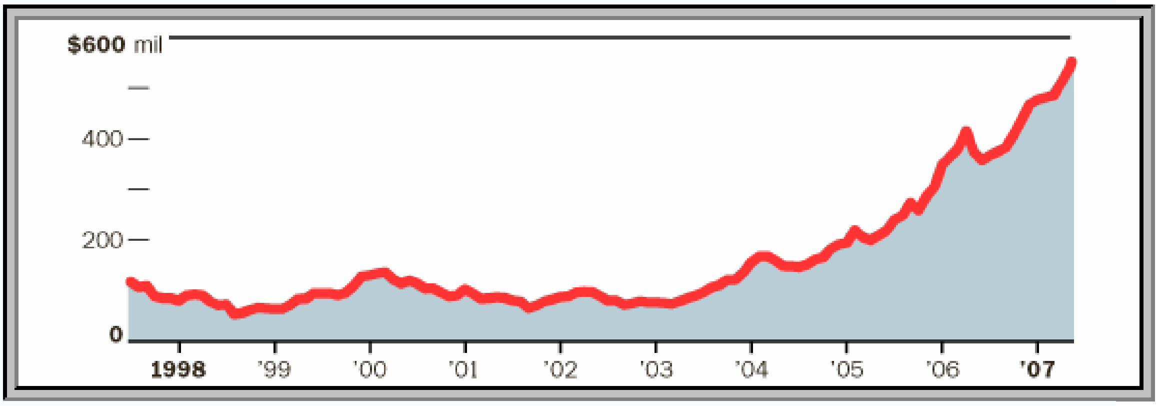
Figure 9: Euro versus US Dollar

Source: www.decisionpoint.com

Still, to go long the US dollar is a relatively low confidence bet, as we should expect on further stock market weakness the Fed to cut interest rates.

Also, it would be wrong to think that the problems in the US credit market will be isolated and not impact asset markets outside the US. Tighter lending standards and higher borrowing costs in the US (as a result of spreads widening) will spread to other markets around the world. And since foreign markets outperformed the US since 2003 by such a wide margin some hefty corrections/crashes should be expected there as well. On a recent trip to the US it came to my attention that a very large number of family offices and pension funds, which before hardly ever owned emerging and other foreign market equities, suddenly had up to 50% of their money overseas. As can be seen from Figure 10, assets in emerging market funds have more than trebled since 2003. The enthusiasm for foreign markets is certainly reason for some concern!

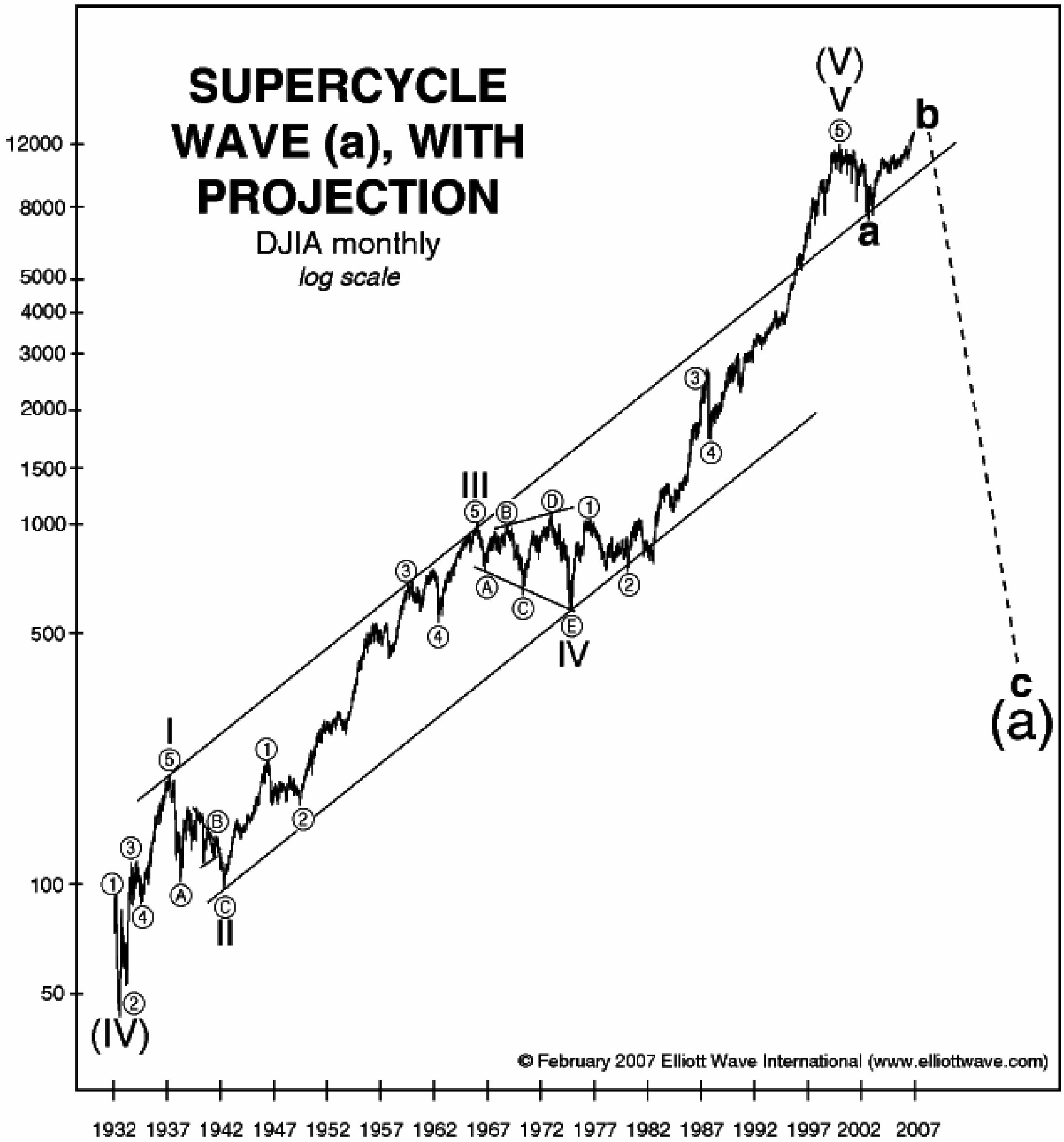
Figure 10: Assets in Emerging Market Funds



Source: Barron's

There is no doubt that from time to time stock markets will rebound sharply. However, given the high probability of the US economy moving shortly into recession (if inflation was properly measured the economy would already be in stagflation) and with an increasing number of companies reporting disappointing earnings (cost pressure leading to a margin squeeze) I would be inclined to reduce positions on rebounds. This time the decline could be far more severe than what we saw in the second half of 2005, in May/June 2006, and in February/March of this year. Moreover, as explained above, new stock market highs are unlikely for the rest of the year. I am however, doubtful that the "Supercycle" will turn down to where Robert Prechter thinks it will decline to (see Figure 11). On any further severe market weakness the Fed and the Treasury will come up with some hyper-inflating tricks.

Figure 11: The View of a Pessimist!



Source: www.elliottwave.com

In June, we recommended the purchase or Two Year treasury notes. The yields having declined from over 5% to around 4.5% makes these notes less interesting (see Figure 12)

Figure 12: US Two Year Treasury Note Yield, February – July 2007

Source: Mizuho Corporate Bank

I am enclosing an excellent article by Professor Paul Cantor about capitalism, big business, and the determination of some individuals to fight the government. The article is an extremely good read, written in perfect English, but obviously unsuitable for the rushed executive.