TSG Weekly Stock Market Watch

Week Ending June 1, 2007

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- **Emerging market performances compared**
- **Slicing and dicing the big spender impact**
- **GDP disappoints while consumer spending surges**
- **Q1-06 home prices both up 4.3% and down 1.4% over Q1-06?**
- **New jobs nearly double last month's number.**

Chasing the BRIC

It was another exciting week on global markets as the Chinese government made its next move to let some helium out of their rapidly rising market balloon, tripling the tax on trading transactions from 0.1% to 0.3% on Wednesday. It immediately triggered a 7% daily drop in the Shanghai Composite Index but the fallout wasn't as severe as the 9% drop on February 27th that had a negative impact on global markets (see Figure 1). Instead of rattling the Dow like last time however, the index rose more than 111 points the same day.

Given the dramatic rise in the Shanghai Composite, increasing the tax from $1 to $3 per $1,000 transaction will have about the same impact as a large bug hitting the windshield of a small car. It hearkens back to similar action by the government to remove the peg of the Yuan to the US dollar by letting it move a few cents, which has also had minimal real impact. Even after Wednesday's 7% drop, the index was still up more than 51% since December 30, 2006 which works out to an average daily gain in excess of 0.5%. In other words, investors will recover the cost of the increase in transaction tax in less than one day given current performance! As if to prove the point, the Shanghai Composite rebounded 1.4% the day after the government announcement.

Looking at the bigger picture however, even with its impressive move in the last year, Shanghai Composite performance pails when comparing it to other BRIC nations (Brazil, Russia and India) over the long haul (see Figure 1). Russia was up 500%, Brazil 440% and India 410% compared to 280% for China from the end of 2002 to April 30, 2007.

In 2007 however, the Chinese market tops the list. The Brazil Bovespa and India BSE 30 were up 18.1% and 4.5% respectively while the Russia Moscow Time Index was down 12.8% versus the better than 50% jump for the Shanghai Composite in 2007. At its present rate, it won't take the Chinese market long to catch the other BRIC nations long-term rise.

According to Economist, the value of shares traded worldwide on all stock exchanges increased by 28% last year, to $69.8 trillion. That is roughly six times the size of US GDP and emerging market performance was one big reason for the surge.

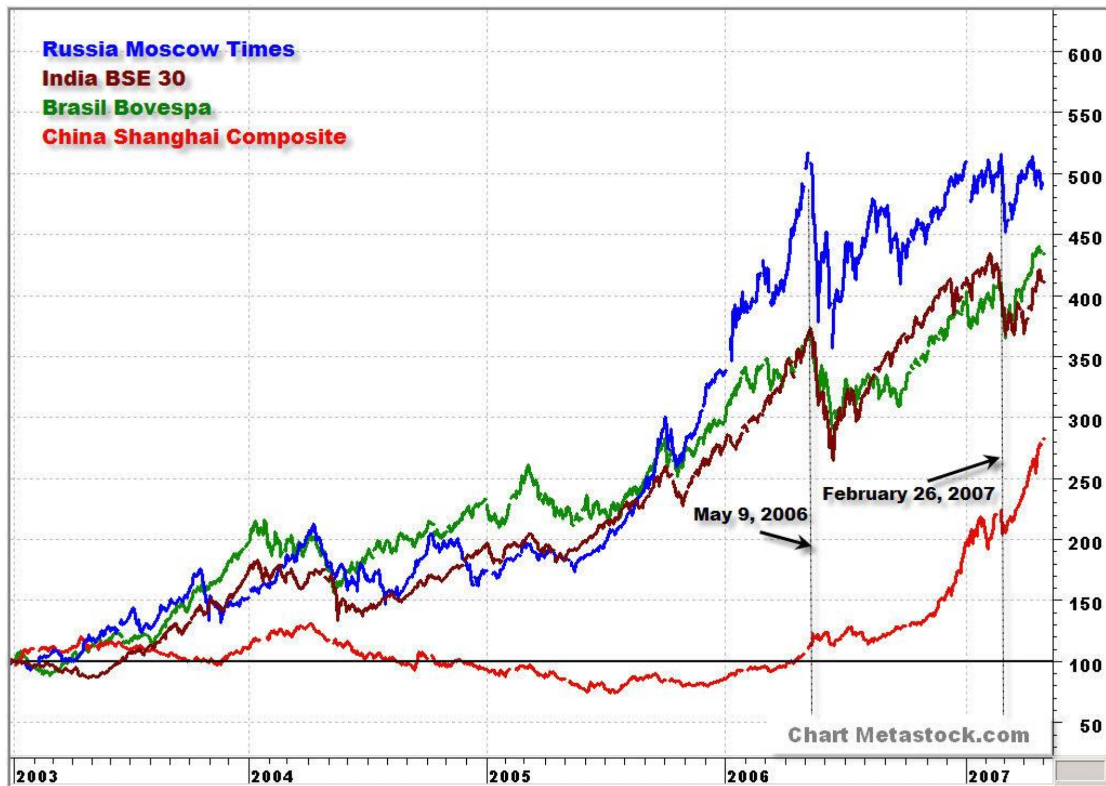

Figure 1 – Chart showing performance of the major indexes in emerging powerhouse BRIC nations (Brazil, Russia, India and China) between December 30, 2002 = 100 and the end of April 2007. Even though the Chinese Shanghai stock exchange has nearly tripled in the last year, it is the laggard compared to Brazil, Russia and India over the last four years – all of which have more than quadrupled since 2003. The S&P500 gained 68% percent (to 168 on this chart) over the same period. Dashed vertical lines show where each was the day before the last two major corrections began. Since 2007 began, Chinese Shanghai Composite, the Brazil Bovespa and India BSE 30 were up 51%, 18.1% and 4.5% respectively and the Russia Moscow Time Index was down 12.8% as of May 30.

Demographic Supercharger

Last week we took a more in-depth look at demographic research for further corroboration of the spending bubble theory. Harry Dent has built a career on applying the impact of demographics to markets and his past market calls have been impressively accurate.

Just for fun we decided to go through the exercise ourselves to see if we could replicate the findings of Dan Arnold (The Great Bust Ahead) and Dent. The results are shown in Figure 2 except that we separated the birth data from births plus immigration. The chart shows birth data lagged 49 years and immigration data 19

years (the average age of an immigrant is 30 years old) to determine when the number of big spenders in the population peaks. Consumer spending represents 70% of US GDP and the 45-54 age group represents those in their biggest earning and spending years – 49 years old is the mid-point.

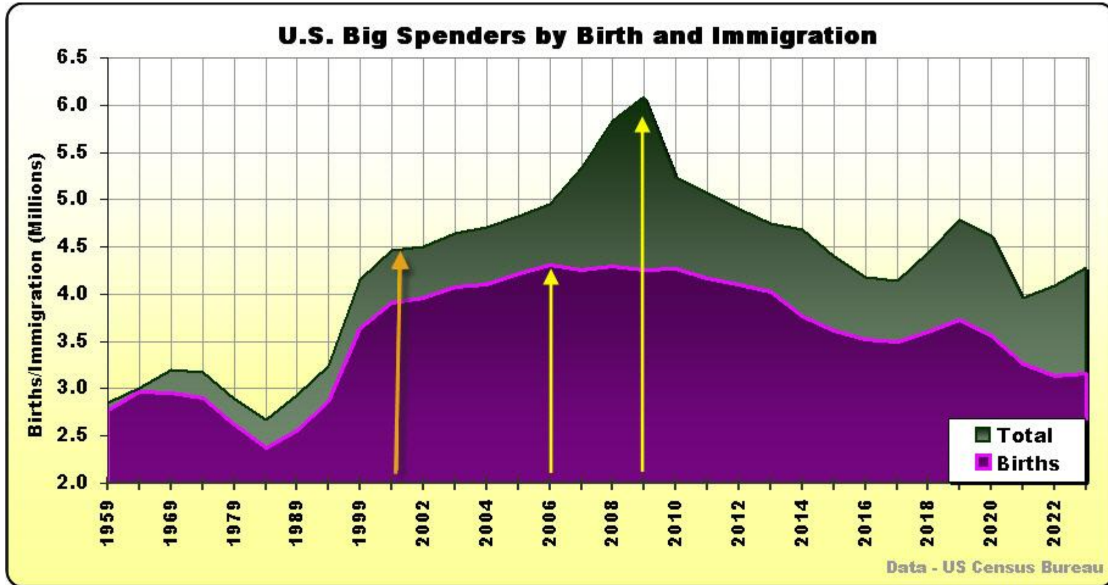

Figure 2 – Our demographic chart of the number of 'big spenders' in the US economy showing the number of 49 year-olds that peaked in 2006 (first yellow arrow) using US Census birth statistics only (purple) and total when immigration is added (green) showing the dramatic peak in 2009 (second yellow arrow). This supports Harry Dent's forecast that the Dow Industrial Average will peak that year.

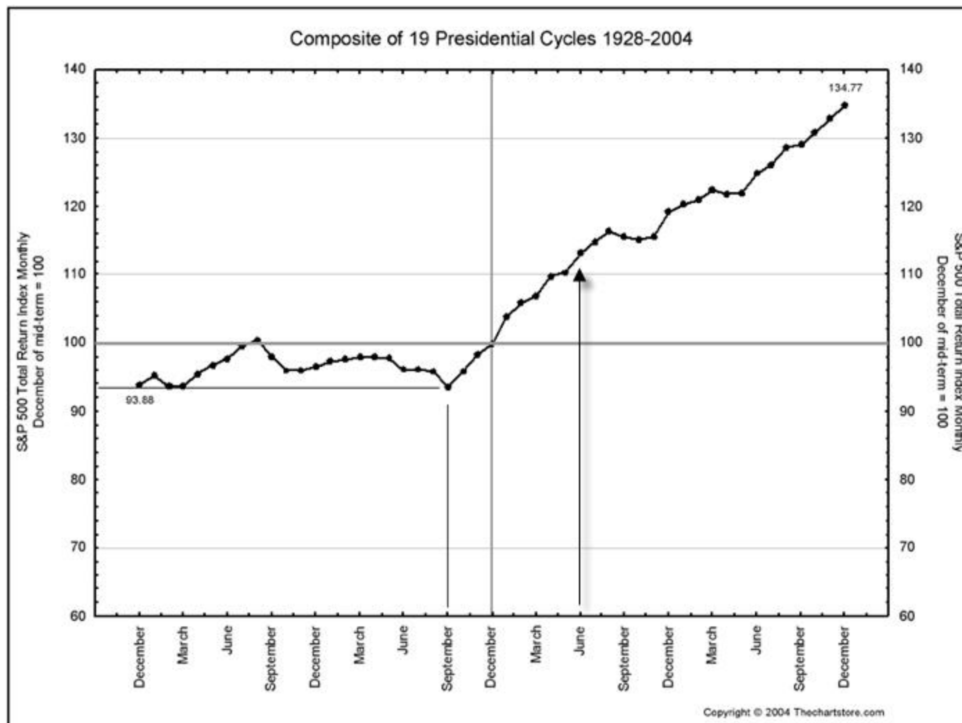

Figure 3 – As well as the big spender lift, there is the election cycle updraft through 2008 to consider as we see from this chart showing the composite of the last 19 presidential cycles. Arrow shows where we are right now. On average the S&P500 has gained another 18% from here to December of the election year. Chart www.theChartStore.com

As we see from Figure 2, the last peak occurred in the late-1960s and the last trough in 1984 which corresponded with the approximate beginning of the last 18 year bull market. Note that after rapidly increasing since 1984, a levelling off in the rate of growth of big spenders in 2000 was enough to contribute to the recession of 2001-2 (orange arrow). Figure 2 also shows that U.S. born 49 year-olds peaked in 2006 but when immigration is included, there is a dramatic big-spender peak in 2009. Further, a similar trend exists in the global spending wave that also peaks around 2009-2010 according Harry Dent. This will continue to provide strong uplift to markets and economies around the world. Figure 4 shows Dent's U.S. Spending Wave chart compared to the inflation-adjusted performance of Dow Jones Industrial Average.

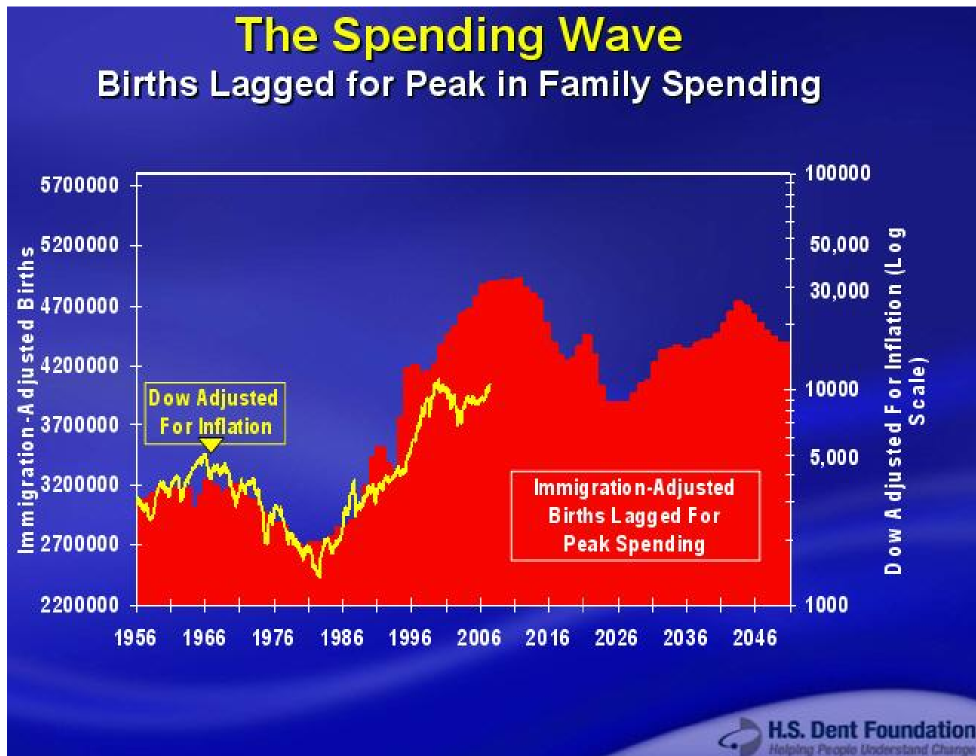

Figure 4 – Chart showing Dow adjusted for inflation (log scale) compared to the big spender's wave. It is interesting to note that the correlation between the two appears to be weakening suggesting the Dow will not move north of 30,000 by 2009 as the chart suggests. However, markets will continue to enjoy a demographic uplift till then.

We have written about the challenges facing markets for the last few months and must admit that we had expected more of a correction by now. We are not alone as evidenced by the record-high NYSE short-interest of 3.1% (see Synopsis).

However, something is definitely different this time as evidenced by the apparent disconnect in a number of historic relationships that have provided advance warning of market downturns in the past. They include the significant drop in fixed residential investment from past highs (see Economic Reports), the decade-long correlation between the NAHB housing market index and the SPX as well as an inverted yield curve that have historically presaged recessions or serious bear markets but appear to have either broken down or at a minimum have been seriously delayed. There are other bullish forces at work to upset the balance as evidenced not only by strong market performance in the U.S. but as we saw above, incredible emerging market gains.

Given the rapid home price appreciation and sub-prime mortgage meltdown, one would think that things might be worse on the housing front. However, according to one estimate, nation-wide home prices were still rising as of Q1-07 (see Economic Reports). Big spenders are still buying homes and taking advantage of incentives being offered if the 16% jump in April in new home sales is any guide.

Examples discussed above as well as the apparent weakening of the Dow-demographic relationship confirm an important market principle. Although markets and cycles may rhyme, they are never identical. This makes forecasting an even bigger challenge.

But it will be even more destructive to ignore the impact of demographic forces altogether on markets and the economy.

Now let's check in on what happened in markets this week.

INDEX	Weekly Close	Last Week	Change	Change%
INDU	13,668.11	13,507.28	160.83	1.19%
DJT	5,326.01	5,147.58	178.43	3.47%
SPX	1536.34	1515.73	20.61	1.36%
COMPX	2613.92	2557.19	56.73	2.22%
RUT	853.45	829.93	23.52	2.83%

Summary
After poor performances last week it was back to all-greens for the major indexes this week as the Dow Transports and Russell 2000 made their best weekly gains since March 23. And while oil prices didn't rise, they didn't fall much either. Ditto for the dollar. It appears that investors bought the dips last week however, but volumes were low thanks to the Memorial Day holiday on Monday making it difficult to conclusively determine that buyers were jumping in en mass.

Technically Speaking
Stock momentum resumed this week as the Dow Industrials, NYSE, DJ Transports, Russell 2000 and MSCI Emerging Market ETF were among the indexes to put in new

all-time highs. Even the Dow Jones Utility Index, which led the index drop last week after it fell more than 4%, rallied for three out of four days this week.

Commodities also rallied again this week as the NYFE CRB Index moved up from last week's close in spite of a firm dollar.

Meanwhile gold got back on the rally train this week as the continuous Aug07 contract surged 2.3% to $676.30 from $661.40 last week, good news as long as it continues given than our gold cycle shows strength from the end of January and to the end of May.

NYMEX crude oil (continuous July07) took a bit of a breather again this week closing at $64.90 down from $65.20 last week but prices at the gas pump remain high.

As mentioned above, the greenback after rallying over the last four weeks also took a break as the U.S. Dollar Index closed at 82.32 off from 82.27 last week. As mentioned last week, the rally looks to be tiring if declining momentum and volume are any indications.

Thanks to a Friday surge, the MSCI Emerging Market Index ETF (EEM) that closed up and 130.13 up from 125.75 last week as emerging markets, including the Chinese Shanghai Composite, shrugged off the latest attempt by the Chinese government to prick the rally balloon in that country with higher taxes on transactions.

Earnings
With a total of 4054 companies (up from 4037 last week) having reported earnings for Q1-2007, results again held steady with an improvement for the third week coming of 9% versus the same quarter last year. As we said last week, but for a few stragglers earnings season is over and with it any chance that earnings improvements will match the 33% level that occurred for Q4-06 season.

Economic Reports
Here's what the charts had to say in this holiday-shortened week.

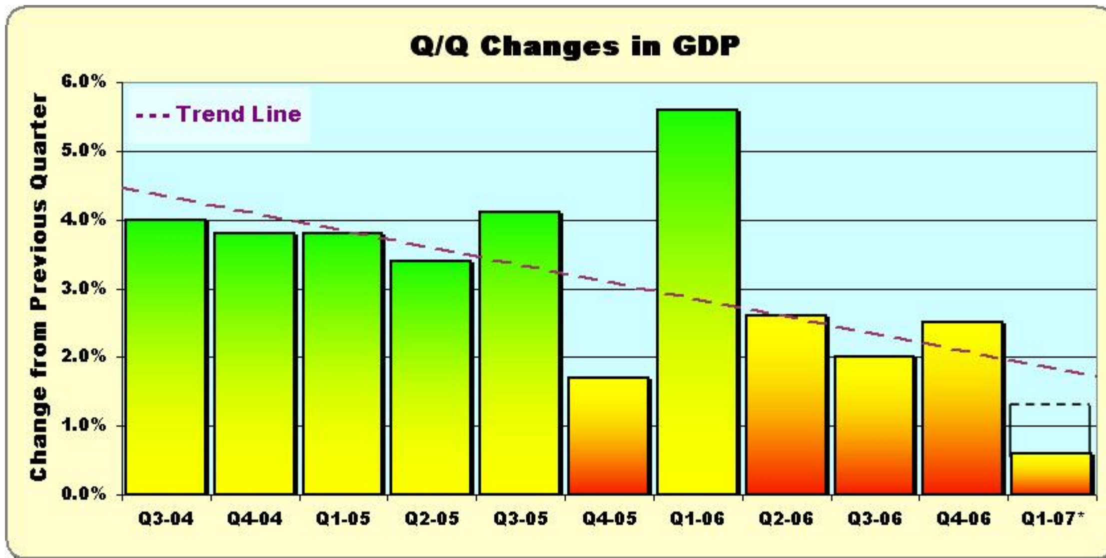

Chart 1 – GDP continued to weaken this month coming it at 0.6% according to the preliminary estimate released Thursday cutting the previous 1.3% growth rate in more than half (see dashed black line). It was the slowest pace in more than four years according to Bloomberg. While investors are hoping for an interest rate cut, the Fed threw cold water on that on Wednesday, saying that there was considerable uncertainty that inflation pressures would slow. Inflation remains its predominant concern and the Fed views the inflation threat as "elevated." It remains to be seen if the most recent GDP data released a day later will cause the Fed to re-evaluate. A jump in consumer spending, which accounts for 70% of the economy, was one of the few pieces of good economic news on Thursday. Consumer spending was revised up to an annual rate of 4.4% from the initial estimate of 3.8%, the largest gain in a year – a major pillar of the economy along with corporate profits.

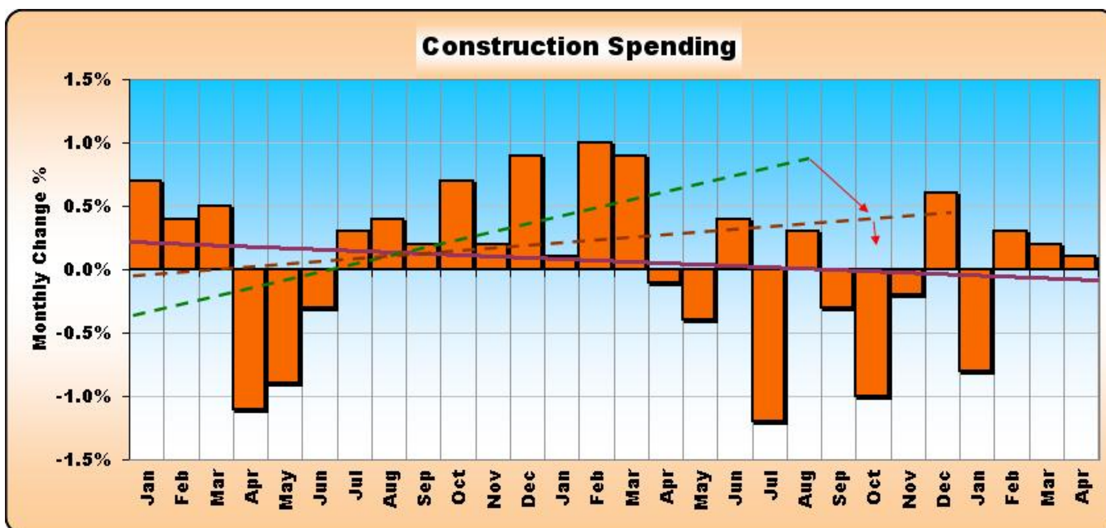

Chart 2 – Construction spending increased 0.1% in April versus the consensus estimate that it would be unchanged. Residential construction fell by 0.9% while non-residential increased by 1.1%. In a separate report residential fixed investment (RFI) that includes spending on housing, a reliable inflation warning indicator in the past

according to Hugh Moore of Guerite Advisors, plunged another 15% in the Q1-2007 compared to a drop of 20% for Q4-2006. In a CNBC interview this week, he said he believed the housing fallout was only about two-thirds done. According to his firm's research, in the past seven housing declines since 1960, on average RFI falls about 30% which it has now done. Of the seven past housing declines, six have ended in full-blown recessions and one a mini-recession. What may save us this time or at least ameliorate the impact of the housing downturn is the big-spending phenomenon discussed in the introduction.

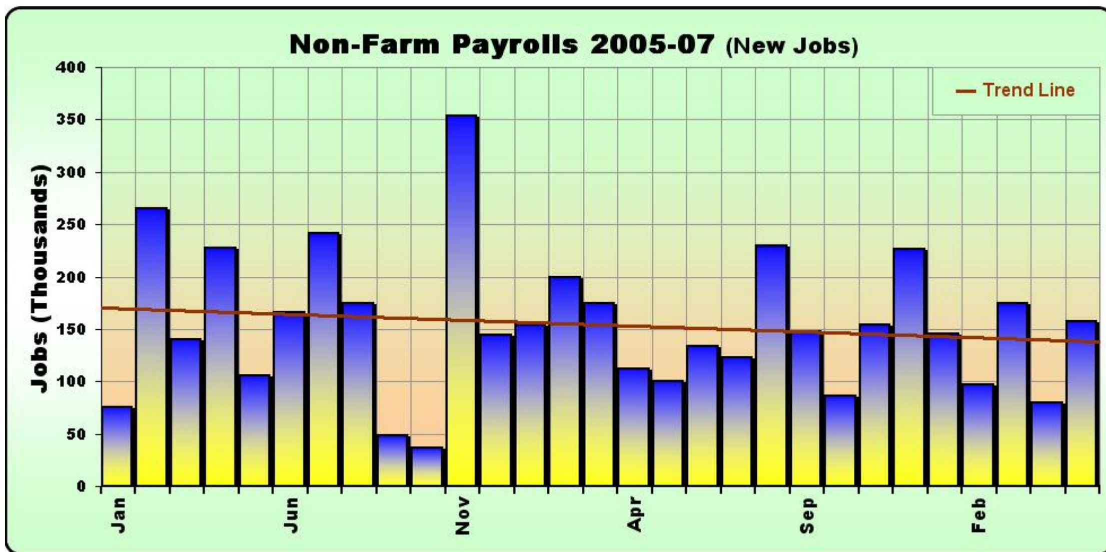

Chart 3 – Non-farm payrolls staged a comeback in May as 157,000 new jobs were created up from 80,000 (revised) in April. However, both March and April numbers were revised lower.

Chart 4 – It's been an interesting couple of weeks for real estate reports. Last week it was reported that while new home sales jumped 16.2%, existing home sales dropped 2.6% and the NAHB Housing Market Index dropped back to its September 16-year low of 30. It got even more confusing this week as the Office of Housing Enterprise

Oversight (OFHEO) reported that home prices rose 4.3% in Q1-07 but then the S&P/Case-Shiller Home Price Index showed that prices dropped 1.4% over the same period (from Q1-06). What gives? We will be discussing the different way each index is calculated next week but the bigger question is how is the real estate market really doing? There are signs that things aren't as bad as they seemed just two months ago. One caveat however, is that the important leading indicators, namely the NAHB HMI, pending home sales and housing permits are all down which does not bode well for the health of the new home market going forward. But underneath all the data are signs that the market is doing surprisingly well under the circumstances and resilient consumer spending is one reason.

Next Week
Here are the economic reports we'll be watching.

- Monday, April Factory Orders (previous 3.1%).
- Wednesday, May Challenger Layoffs (previous 44.2%), Q1-07 Revised Productivity (previous 1.7%).
- Thursday, April Wholesale Trade (previous 0.3%), April Consumer Credit (previous $13.5 billion).
- Friday, April Trade Deficit (previous $63.89 billion).

Synopsis
The amount of shares held short on the NYSE hit 3.1% of total shares listed, a level of short interest not seen since 1931 prompting a number of analysts to brim over the fact that it will help drive the rally higher. Could be, but the last time short-interest was this high in 1931, it turned out to be a pretty good bet (see Figure 5).

But the two periods are very different. In 1931, the market was in a major bear trend and the value of the Dow had been nearly cut in half in the previous two years. Today, the Dow and S&P are at new all-time highs and in strong rally mode.

The Leuthold Group which advises two-thirds of U.S. money managers maintains a NYSE short-sales ratio that has proven to be a good contrarian indicator and the higher it is, the better the chance that equities will head higher. In 2000, the ratio was 1.46 when the S&P peaked in March and it fell to 1.39 in January 2001, 21-months before the index hit bottom, according to Bloomberg. The ratio has been at 2.94 for the last two months: this highest since 1998. Leuthold considers a ratio reading above 2.45 to be bullish and one below 1.8 bearish. While their ratio did not exist in 1931, it certainly worked in 2000.

A short-squeeze can be a powerful driver and the higher the number of shares held short, the stronger the lift as traders rush to cover when price moves up. As John Bollinger once said, a trader is lucky if he can pick a top or bottom once in his career. The rest of the time they get it wrong, which is why this practice is called "trying to catch a falling knife." Given the current market both domestically and globally, strong consumer spending and growing number of big spenders, chances are better than 50-

50 that failing some unexpected event, the shorts on Wall Street have gotten it wrong again.

Figure 5 – Weekly chart of the Dow Jones showing where the market was the last time short-interest was at such extreme levels.

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