TSG Weekly Stock Market Watch

Week Ending May 18, 2007
TradeSystemGuru.com

- **Another culprit in the real estate and sub-prime melt.**
- **What changes in money supply could be trying to tell us.**
- **Top 52-week global performers.**
- **Commodity prices may have seen their best days.**
- **More bad housing news.**

Of Auctions, Money Supply and Global Liquidity

May has so far been a very good month for auction houses and to owners of expensive art. On Tuesday, Sotheby's set yet another new high for a painting as Mark Rothko's "White Center (Yellow, Pink and Lavender on Rose)" sold for just under $73 million, nearly double the estimated price of $40 million.

Then at a Christie's auction, Andy Warhol's "Green Car Crash" more the doubled its estimated selling price when an anonymous buyer paid nearly $72 million in New York. His "Lemon Marilyn" sold for an incredible $28 million. Over the past two weeks these two auction houses sold works totalling $1.43 billion, nearly double the previous $865 million record set in May 2006.

As one long-time auction attendee observed, "money no longer seems to have any meaning," and the nationalities of those anteing up big bucks for works of art has dramatically changed thanks in large measure to the drop in the greenback. At Christie's May 9 auction just 29% of the buyers were Americans, versus 51% at the auction held last spring and more than 80% just a few months before. Europeans have increased thanks in no small measure to the fact that the euro has jumped more than 50% against the dollar since mid-2001.

Auction madness is just one more manifestation of the rivers of cash circling the globe these days driving prices for everything from the price of a gas to corporate acquisitions into the stratosphere. It is a result of many factors including the emergence of China as an economic power that is generating new millionaires with lots of US dollars to spend and the burgeoning baby boom demographic now in their major spending years (45 – 54 age group) as we discussed last a couple of weeks ago. The more than $500 billion US deficit with OPEC nations is another factor that has led to a massive redistribution of greenbacks that need to be spent somewhere.

But there is growing evidence that the days of easiest money may be behind us. The sub-prime and real estate meltdown in many parts of the US is one indication. Nothing lasts for ever but anytime change occurs there has to be a reason. In this case money supply is a potential culprit.

As we see from Figure 1, the Fed has been curtailing money supply in an attempt to control inflationary pressures without putting up interest rates since 2002. And now with the ground swell of discontent surrounding the sub-prime fiasco, rising rates are the last thing the market needs. There is also an election approaching and rising rates would dampen an already struggling economy. But real inflation is well above the Fed's 1 – 2% target so they must do something and cutting back money supply is the answer. The predictable impact is being felt in weaker parts of the economy first. If history is any guide, it will also impact other economies.

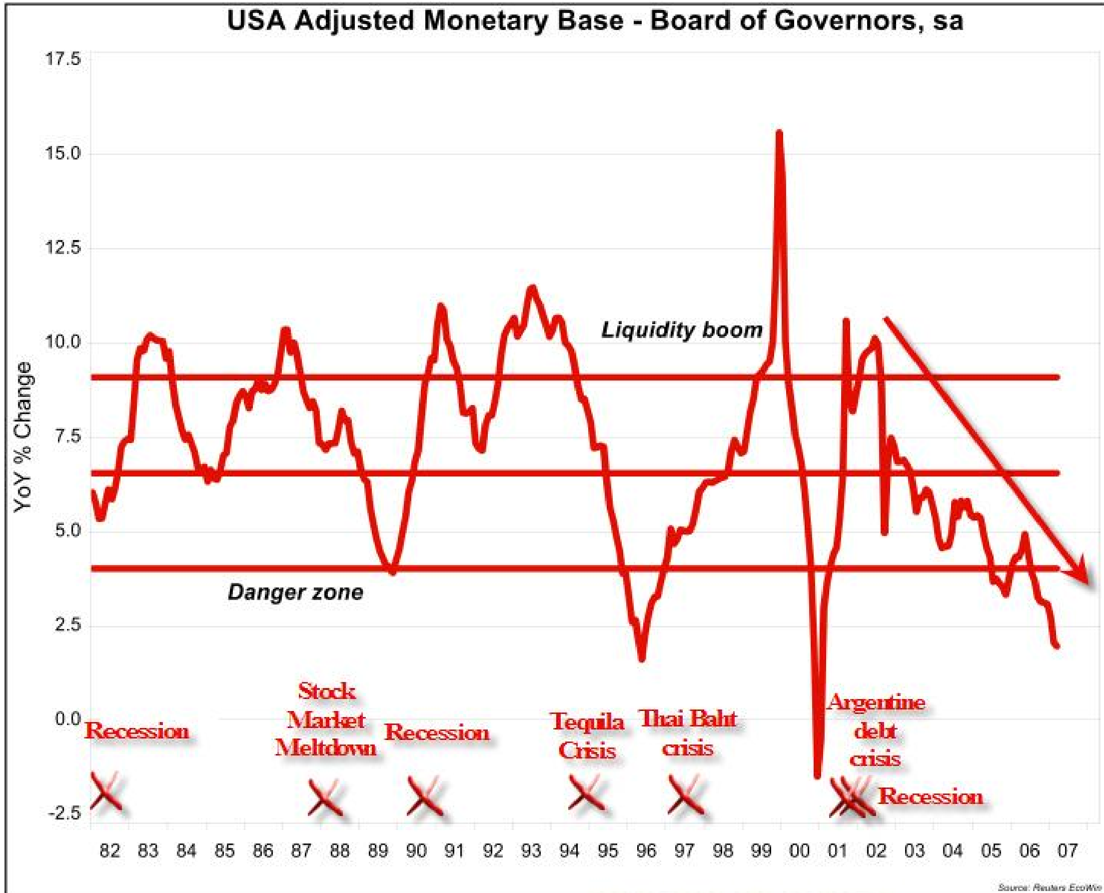

Figure 1 – Adjusted monetary base chart showing money supply in the danger zone. Previous peaks and reductions occurred in advance of the 2001-2 recession, Thai baht and Asian contagion in 1997 that preceded the stock market decline of 1998 and money supply cut that started before the 1987 stock market crash. Chart by GaveKal.com

Another side effect of falling money supply as the consumer begins go to feel the pinch, is a shrinking trade deficit. As we see from Figure 2, a swelling trade deficit is good for the rest of the world. But each time trade deficits have dropped financial trouble has erupted somewhere. This time, it's the sub-prime debacle. Past examples include the Argentine debt crisis in 2001, the Asian contagion in 1997 that led to the

stock market correction of 1998, the tequila crisis in 1994 and the bankruptcy of the Soviet Union in the early 1990s.

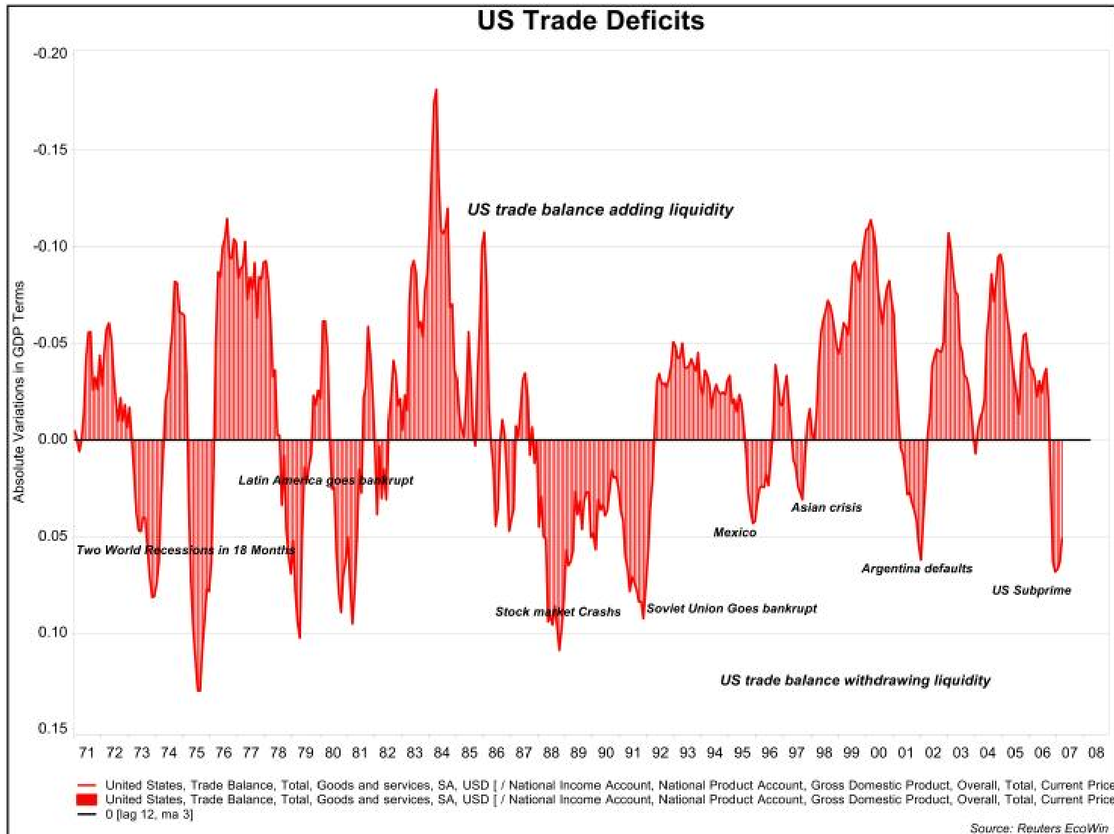

Figure 2 – This chart shows US trade deficits and the result of past efforts to rein them in. When the US consumer goes on a spending spree to buy foreign goods, it may be bad for the current account balance sheet but it has proven beneficial for emerging market suppliers of these goods and conversely, when the US attempts to reduce the trade deficits, emerging nations usually gets hurt as we see from the annotations on this chart. Chart by GaveKal.com

Commodity prices are starting to feel the pinch. Precious metal prices have been strong until recently but the price of the basket of commodities making up the CRB Index is falling. On a monthly basis, the index peaked in July 2006 and has fallen 10% since as we see from Figure 3.

Figure 3 – Commodity prices have topped out, at least for the time being as this 30-year monthly chart of the Commodity Research Bureau (CRB) Index of a basket of commodities shows. Curtailing money supply is one possible cause of this drop but growth in economic powerhouses China and India continues unabated. Chart by Metastock.com

Stocks Still on a Tear

INDEX	YoYChg%	52-Week High
Peru Lima General	207.62	22,964.40
China Shanghai Composite	151.45	4,030.26
WILSHIRE REIT TOTAL	79.78	51,567.40
MEXICO INDEX	53.21	285.61
Mexico IPC	52.00	30,676.30
Chile IPSA	48.87	3,247.27
Philippines PSE Composite	46.40	3,449.18
Malaysia KLSE Composite	43.67	1,363.40
Singapore Straits Times	40.84	3,512.40
Johannesburg All Shares	40.26	28,671.50
Spain Madrid General	35.58	1,671.06
Indonesia Jakarta Composite	35.26	2,063.76
Argentina MerVal	32.07	2,216.60
India BSE 30	30.76	14,538.90
Egypt CMA	30.09	2,647.10
Venezuela IBC	29.99	59,413.30
Belgium BEL-20	28.27	4,749.45
Hong Kong Hang Seng	28.15	20,904.80
EURONEXT 100	25.65	1,058.57
Austria ATX	25.28	4,818.82

Table 1 – The top-performing global indexes over the last year (as of May 18) with only one US index – the Wilshire REIT Total – making the cut. Column two shows the percentage increase in index values over the last 52 weeks. Table constructed in Metastock.com

However, falling money supply has had little impact on stock prices as indexes around the world again hit new highs this week. Table 1 shows the top twenty 52-week performing major indexes. Note that with the exception of the Wilshire REIT Total Index, there is an absence of US performers.

In another effort to cool stock and real estate markets the Chinese government recently opened the door to allow the Chinese to invest in foreign markets. To start only the Hong Kong Hang Seng is allowed but the list will grow. Gold, a perennial favorite among investors in that country, may be one victim and a possible reason for that metal's decline in recent weeks according to GaveKal Research.

Global risk premiums also remain low and investor complacency remains near record levels. International investors have shown little if any concern about the cut in money supply and it has had little impact on their investing habits. Part of this is due to the fact that the carry trade is still very much alive and well thanks to high interest rates in nations like New Zealand, Australia nations, Brazil, Turkey and some other emerging countries compared to those in Japan.

In spite of this tightening however, GaveKal Research concludes their 75-page quarterly strategy chart book of May 17th entitled "So What Now?" that the outlook for equity markets is bullish for the foreseeable future. They believe that as in 2003, equities are now 33% undervalued and while price-earnings ratios aren't cheap and haven't been since 1990, neither are they expensive. Corporate profits remain robust and real interest rates on government bonds in major industrialized nations (US, Japan, Germany and the UK) have converged around 2% (which they say is a conundrum in an of itself) remain cheap by historic standards – all of which are positive for stocks.

In their opinion, risks to the current period of growth include a possible increase in rates as a result of policy change at the PoBC (People's Bank of China) to let the Yuan float in an effort to handle runaway markets there. That could hike rates, foment to a rapid drop in Chinese GDP growth and destabilize global markets but view the probabilities of such events as low.

Like Bernanke and company, GaveKal downplay the risk of widening contagion thanks to the sub-prime and homebuilder meltdown in the US. We don't agree. The slow-motion drag from falling real estate prices and the sub-prime fallout continues to gain momentum so it's too soon to conclude that the threat has passed in our opinion. But it's also too soon yet to conclude that the impact on stock prices will be significant, especially with the threat of inflation decreasing.

So even with the bricks of falling money supply, a shrinking trade deficit and dropping commodity prices being added to the proverbial wall of worry that forever plagues a bull market, it looks to be full speed ahead for equities markets, at least until some event occurs to change this prognosis.

Now let's check in on what happened in the stock market this week.

INDEX	Weekly Close	Last Week	Change	Change%
INDU	13,556.53	13,326.22	230.31	1.73%
DJT	5,213.71	5,165.92	47.79	0.93%
SPX	1522.75	1505.85	16.90	1.12%
COMPX	2558.45	2562.22	-3.77	-0.15%
RUT	823.66	829.54	-5.88	-0.71%

Summary
For the second week indexes recorded somewhat mixed results with the large caps doing well and techs and small caps struggling. On Friday, the S&P500 Index closed less than 5 points off its all-time high of 1527.46 of March 23, 2000.

Technically Speaking
Stock momentum remains strong as the Dow Industrials, NYSE Index and a number of other large cap indexes continued to soar. As well as hitting new highs, the DJIA, NYSE, DJT, Toronto TSX and MSCI World Index are up 21.6%, 21%, 12.7%, 22.2% and 11.1% respectively in the last 52-weeks.

But commodities continued to correct this week as the NYFE CRB Index closed at 404.14 down from 405.71 last week.

Meanwhile gold dropped again this week closing at $661.70 down from $672.30 last week and $690.00 two weeks ago. It also broke down through an up trendline that had supported the metal since October as well as a head & shoulders top neckline in a pattern that began forming around the same time. Gold bugs will be watching this carefully as it has bearish overtones.

NYMEX crude oil (continuous) rose again to close at $65.98 up from $62.37 pushing gas prices at the pump higher across the country. In the process it broke above its 50 and 200-day moving averages thanks in large part to summer driving season demand.

Meanwhile the greenback finished its third week of rallying suggesting that currency traders see a greater chance of the Fed standing pat or even rising interest rates while reducing money supply, both of which bode well for the buck. The U.S. Dollar Index closed at 82.11 up from 82.02 last week.

The MSCI Emerging Market Index ETF (EEM) closed at 126.85, up from 125.95 last week and 123.16 two weeks ago reflecting the strong performance in emerging market stocks.

Earnings
With a total of 3927 companies (up from 3404 last week) having reported earnings for Q1-2007 again held steady with an improvement this week of 9% versus the same quarter last year. With earnings season winding down, there is little chance that the improvement will match the 33% level hit for Q4-07 (see chart).

Chart 1 – Chart showing the annual change in quarterly profits over the last three years using data from the Wall Street Journal's coverage of more than 4000 corporate reports. Certainly looks like earnings growth is declining.

Economic Reports

Here's what the charts had to say this week.

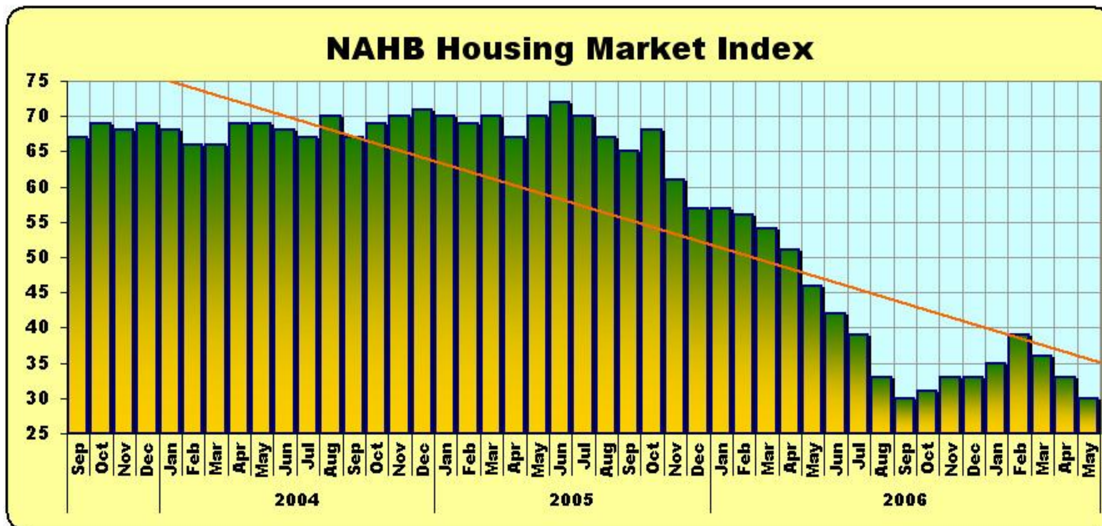

Chart 2 – The National Association of Home Builders housing market index dropped back to 30, the low hit last September as builder optimism further faded in the wake of the sub-prime contagion that continues to spread. The number prompted NABH spokesman David Seiders to comment that he'd underestimated the severity of the downturn a few months ago. The big drop in permits confirms builder's pessimism.

Chart 3 – Housing starts hit a seasonally adjusted annual rate of 1.53 million for April, an increase of 2.5% from March but as we see from figure 3, starts have vacillated back and forth for the last few months.

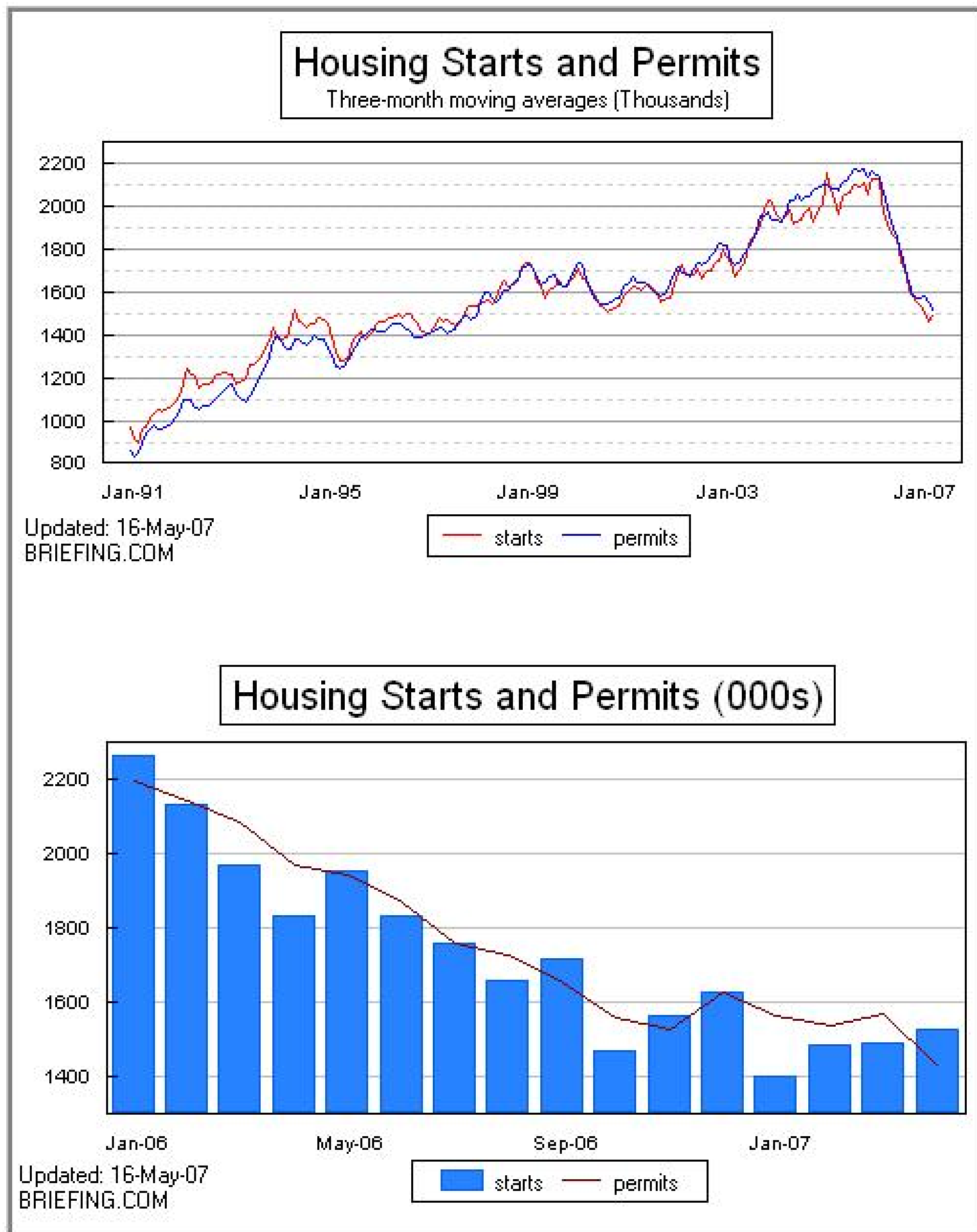

Chart 4 – While starts unexpectedly moved up in April, permits dropped 8.9% for the biggest monthly drop in 17 years according to Financial Times. A better advance indicator than starts, it signals further weakness in new housing demand ahead even though long-term interest rates have moderated.

Next Week

A relatively quiet week next week for economic reports. Here are the ones we'll be watching.

- Thursday, April durable goods orders (previous 3.7%), and April new home sales (previous 2.6%).
- Friday, April existing home sales (previous -8.4%).

Synopsis
The situation with falling monetary base discussed in the introduction appears to be exerting the desired effect on inflation and this is clearly visible in such inflation bellwethers as gold, silver and a broad array of commodities. A falling trade deficit is one more indication but the real concern is the impact this is having on consumer spending. Ben Bernanke is walking a fine line in his inflation battle with limited tools given where we are in the election cycle and other threats facing the US economy.

Where the more than 500% increase in the Fed funds rate between June 2004 and late 2006 failed to daunt the spendthrift consumer, cutting money supply appears to finally be doing the job. But once began, this trend is hard to reverse and since the Fed uses trailing indicators to gauge the success of this campaign, they risk going too far posing a risk to markets and the economy.

If you find this newsletter insightful, please feel free to forward this newsletter and share it with a friend (or simply have them send me an email at matt@tradesystemguru.com to be added).

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