

June 27, 2008

DJIA: 11,453

Hope may spring eternal . . . but the charts suggest otherwise. There isn't much here by way of consolation. The Dow is at a two year low and the S&P is close. The market has accelerated to the downside, with horrible breadth and expanding volume. From 49% in mid-May, NYSE stocks above their 200 day moving average have dropped to 26% – three quarters of NYSE stocks are in downtrends. From less than 100 in mid-May, daily New Lows have jumped to 600+. The Financials look bottomless, losing more than 20% in June alone, and now the Techs, even RIMM (124), Google (528), Apple (168) and Amazon (76), are being dragged down as well. Suddenly, “the recovery” is over. And without a breadth “divergence” though days like Monday, with a flat Dow and 2-to-1 negative breadth, apparently proved divergent enough. Perhaps the worst part, as yet there's no Bear Stearns, there's no catalyst for panic. The VIX or Volatility Index is at 24, unlike the 34+ readings of January and March. As horrific as Thursday was, complacency still rules.

On Tuesday Treasury Secretary Paulson said the housing market will likely bottom by year-end, and the economy will show signs of recovery. With 10 months worth of unsold homes out there that will take some doing. Home prices have extended their record slide, as prices in 20 big-cities fell 15.3% in April versus a year earlier. Meanwhile, the Fed tells us that downside risks to growth have “diminished.” What is it these people are looking at? The Consumer Confidence Index in June fell far more than expected, reaching its lowest level since '92. With soaring energy costs, a weak job market, housing woes and inflation expectations at a record high, buying plans are at long time lows. Sure it's darkest just before the dawn, but it's also plenty dark well before the dawn. To their credit most of the Homebuilders are holding their January lows, not so inconsequential in light of the news. With the recent backup in interest rates, though, “hope” also seems the operative word here. And as for hope, it seems clear that somehow this housing bubble has to stop unwinding for anything good to happen.

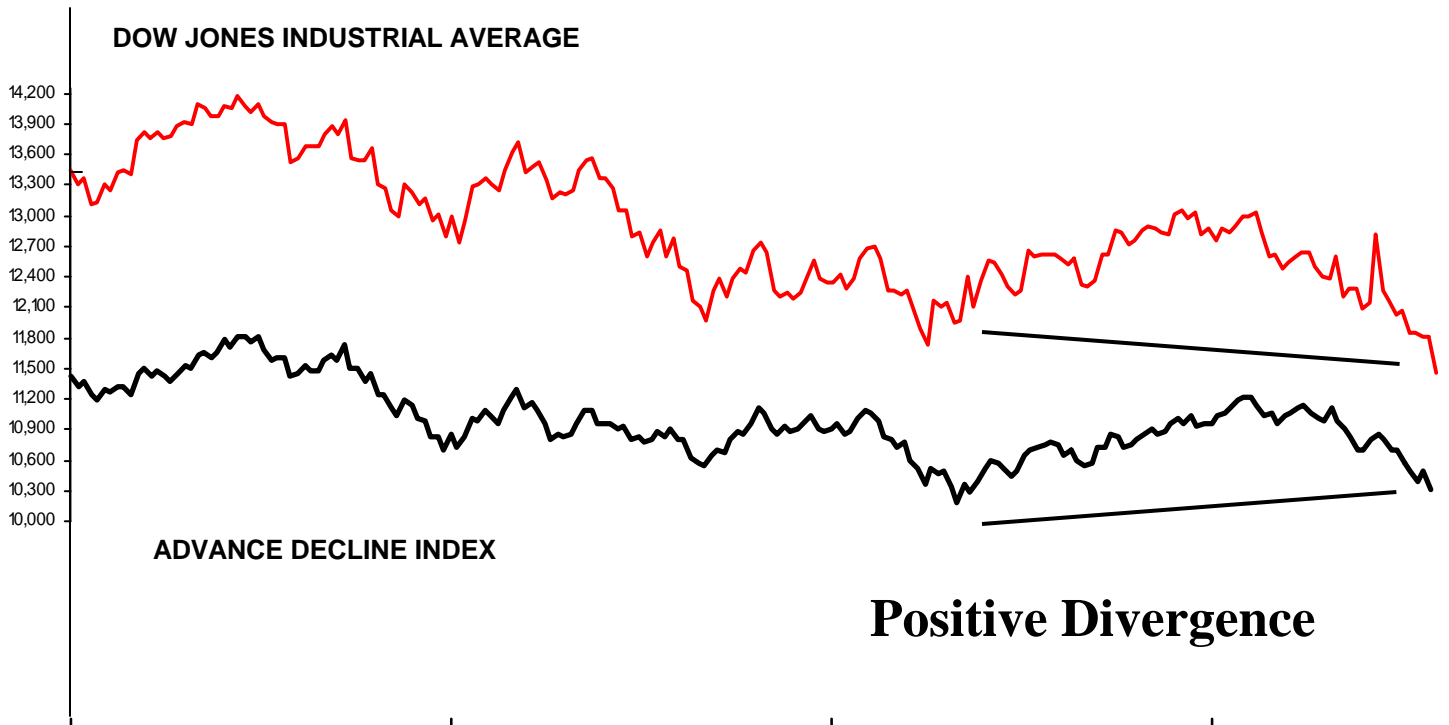
Another not so wonderful sign for the economy was the news out of UPS (62) this week and FedEx (81) last week. Citing higher fuel prices and a slowing economy, neither had much nice to say. And, because of the economy, the floods or whatever, suddenly the Rails aren't acting all that well. As a result, the Transportation Average suddenly isn't acting so well, breaking the January uptrend. Clearly the Transports continue to outperform, much as the Commodity sector. Indeed, we've argued they're pretty much one and the same, with the Rails driving the Transports and Commodities driving the Rails. Then there's the math, with the \$1 move in Union Pacific at \$75 being the same as a \$1 move in Jetblue at \$4. And, of course, it's the Transports good luck that the Airlines are not higher priced in that their downtrend has been as impressive as has been the Rails' uptrend. It is what it is, but the uptrend in the Transports doesn't seem so impressive as an economic prognostication and, in the event, it is now weakening.

The Oil market Wednesday acted as though it expected the Fed to raise, or at least be more hawkish about inflation. A rise in rates to fight inflation would help the dollar and that, in turn, would hurt commodities like Oil. And Oil was down early, but on the Fed news rallied sharply. While a rate rise seemed unlikely, higher rates would have cooled Oil, but so too would a slowdown where it all started – the developing economies. Many central banks have been forced to aggressively tighten to slow growth and fight inflation pressures. The lagged effects of these actions likely means that a growth slowdown lies ahead for places like China, and equity markets already appear to be pricing in slower growth ahead – the Shanghai stock exchange is down more than 40% this year. If the typical six month lead time between these equity markets and commodities prices continues to work, commodity prices should correct in the second half. And, in the case of Oil, there's the matter that sentiment is at an extreme, and the stocks have been lagging the commodity – the Oil Index (XLF) is now higher than it was a month ago.

Of course, there's always reason to hope. From a longer term perspective, not the next couple of weeks or even months, a reason to hope is when consumers don't. The Consumer Confidence report alluded to above is a monthly update on how the consumer “feels.” In terms of equity prices, it is one of the most lagging indicators around and offers little insight – except at extremes. At 50, or anything below 60, 96% of the time the market has delivered positive returns over the next 12 months. And, the average return was 19%. From a shorter term perspective there's also reason for hope. While the Dow is at a new low, the Advance Decline Index is not – a positive divergence. Even the S&P is above the March lows, another positive divergence. And on a short term basis, the market of course is oversold, as oversold as March though not as oversold as January. Still, the best to be hoped for here is a bounce, not a good recovery.

Frank D. Gretz

STOCK AVERAGE VS. AVERAGE STOCK



Positive Divergence

Sep-04-07

Nov-14-07

Jan-31-08

Apr-15-08

Jun-26-08

