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DJIA: 11,229

Fannie Mae . . . Freddie will. The GSE's need capital. That less than surprising news has sent the stocks spiraling downward, while just how much dough, when and from where is anything but clear. In May Freddie said it would raise \$55 billion in capital to shore up its balance sheet but, owing to "minor accounting issues," the deal is yet to be completed. Not too long ago the office of Federal Housing Enterprise Oversight guesstimated that loans on their balance sheets and mortgages guaranteed are 81 times Fannie's net worth and 167 times Freddie's. Even using book value by the more forgiving usual accounting standards, Fannie is leveraged at 20-to-1 and Freddie at 30-to-1. Rather than playing savior to a housing market suffering steep home price declines, it seems more reasonable that, like other players in the mortgage market, the two companies should be reducing their risk profiles in order to survive the worst housing bust in decades. While these "government sponsored enterprises" are not government guaranteed enterprises, we all understand these companies aren't going away. The stocks, however, could be another matter.

When it comes to Fannie (14) and Freddie (8) the news is hardly new. What is new is that the stocks are as weak as they are. There have been times when both have seemed in a world of their own, impervious to bad news, they're too big to fail and all that. And part no doubt is the market – in bad markets there's no good news and bad news is a disaster. It's also true that in bad markets they get to everything, and what is new is that that process may have gotten started late last week. For quite some time there have been two segments of this market, and those have been at opposite extremes – the Commodity stocks have been extreme to the upside and Financial stocks have been extreme to the downside. While there's no sign of a meaningful low in the Financials, last week's weakness in many Oil, Coal, Ag and Steel stocks was surprising in its degree. Those breaks likely mark peaks in these stocks and set the stage for further weakness. While the overall uptrends are intact, weakness here is part of the normal course of things – they get to everything before it's over.

When it comes to the Commodity stocks, and Oil especially, even the likes of Warren Buffet tell us that prices are being driven by demand, not speculation. Certainly the demand is there, but so too it would seem is the speculation. From a demand standpoint, China has accounted for roughly 80% of the world's incremental oil consumption over the past couple of years, a time during which the commodity climbed from \$50 a barrel. Clearly there's something to the idea of "China-driven commodity demand." But similarly, back in 2000 there was a real demand for Cisco's routers and, more recently, a real demand for housing – the poor immigrants and all. But we all know there was plenty of speculation in Cisco at 84 and no money down housing, and the same seems true now of commodities. An environment of negative real interest rates is particularly conducive to the speculation we've seen in different sectors of the economy and asset markets – NASDAQ in 2000, housing in 2006 and commodities now. Of course, no one complained when speculation was driving up their NASDAQ stocks or the price of their house, but when the price of food and gas goes up, we'll have none of that speculation.

The bad news on Fannie and Freddie could be just what the market needs. After all, the market doesn't make lows on good news, just think back to the March low on the Bear Stearns' news. Another thing that could help is further weakness in the commodity stocks. It's not a bear market until they sell "my stocks" so to speak, more weakness there would be a bit of a rude awakening. In the event, something seems needed to shake things up a bit, to get the downside volume, the capitulation for a good low. But there is some good news on the sentiment/capitulation front. The latest survey of market newsletters showed the most pessimistic levels in 14 years – just 27% of news letters are bullish, the smallest percentage since July 1994. Like everyone else letter writers tend to be wrong at the turns, present company excluded of course. While these and some other surveys are encouraging, they're not the best of short term timing tools. In that regard we would watch the VIX or Volatility Index. The VIX is a measure of to what extent OEX options are selling above or below their fair values. When the VIX goes up it is not so much a sign market volatility is up, rather it's a sign that options are selling at higher premiums and that tends to happen in extreme declines. We doubt we'll see a good turn without a VIX at least above 30.

The market this week has been more than a little confounding. If you can figure out what Tuesday's 150 point rally was all about, then tell us what Wednesday's 230 point decline was all about. And then there's Thursday's 89 point advance on the back of a 15 year low in Freddie Mac. But if Tuesday was a good day, 2-to-1 up market breadth, and Wednesday was a bad day, 2-to-1 down market breadth, Thursday was the kind of day that scares us. Thursday saw only 100 more advancing than declining issues, pretty skimpy for an 80 point rally. And there have been several such days in the last couple of weeks – a rising or flat Dow, with flat or negative breadth – and these days have led to nothing good. Thursday was only the second day in the last ten that breadth has been positive at all. If breadth tells you what the average stock is doing, and the average stock speaks to the internal healthy the market, this isn't good. Sure the market and particularly the Financials are stretched to the downside, but without some sort of Bear Stearns washout like March, it's hard to trust any rally here.

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