

December 28, 2007

DJIA: 13,360

Those nonrecurring losses . . . they just keep on recurring. In our hedge fund we've often longed to take a page from corporate America. Why not, we've wondered, make our losses, especially the really big screw-ups, nonrecurring? Bet that would help our performance. Of course, losses are part of any business, and for many corporations losses are anything but "nonrecurring." Treating them as such, however, has left stock market valuations a bit distorted. Earnings are soaring, stocks look cheap, the DJIA selling at a moderate 16.3 P/E at the end of June. Yet despite the earnings growth the DJIA book value has fallen and based on price-to-book, the DJIA doesn't look cheap at all. Think of the brokers and their years of great earnings which now have disappeared with the huge write-offs. In this era of financially engineered earnings the "one-shot write-down" is anything but that. And even if stocks were cheap, does it really matter? Stocks sell at fair value twice, once on the way up and once on the way down. But especially with stocks not looking so cheap, this is no time not to have the trend on your side.

And the trend is anything but healthy. Sure the averages for the most part act well enough, but in terms of the market's health that's not really what counts. The averages are what people watch, it's the average stock that counts and that's where the action has been poor for some time, and has worsened in the recent rally. While the NASDAQ, for example, held well above the August low in the November weakness, and has rallied back to the early December highs, breadth there is teetering around multi-year lows. All well and good for Apple (201), Google (705) and Research In Motion (119) that dominate that average, but like the dot-coms before them it seems a matter of time. The weak drag down the strong. Though not to the extreme, big board breadth also has lagged, leaving a series of divergences - a pattern wherein peaks in breadth, the Advance Decline Index, fail to match peaks in the Dow. This pattern of weak rallies that we've seen typically precedes more important weakness. Of course, there are many crosscurrents in December, it's not a good month analytically. And, as we've often stressed, divergences can go on for sometime. However, they never end well.

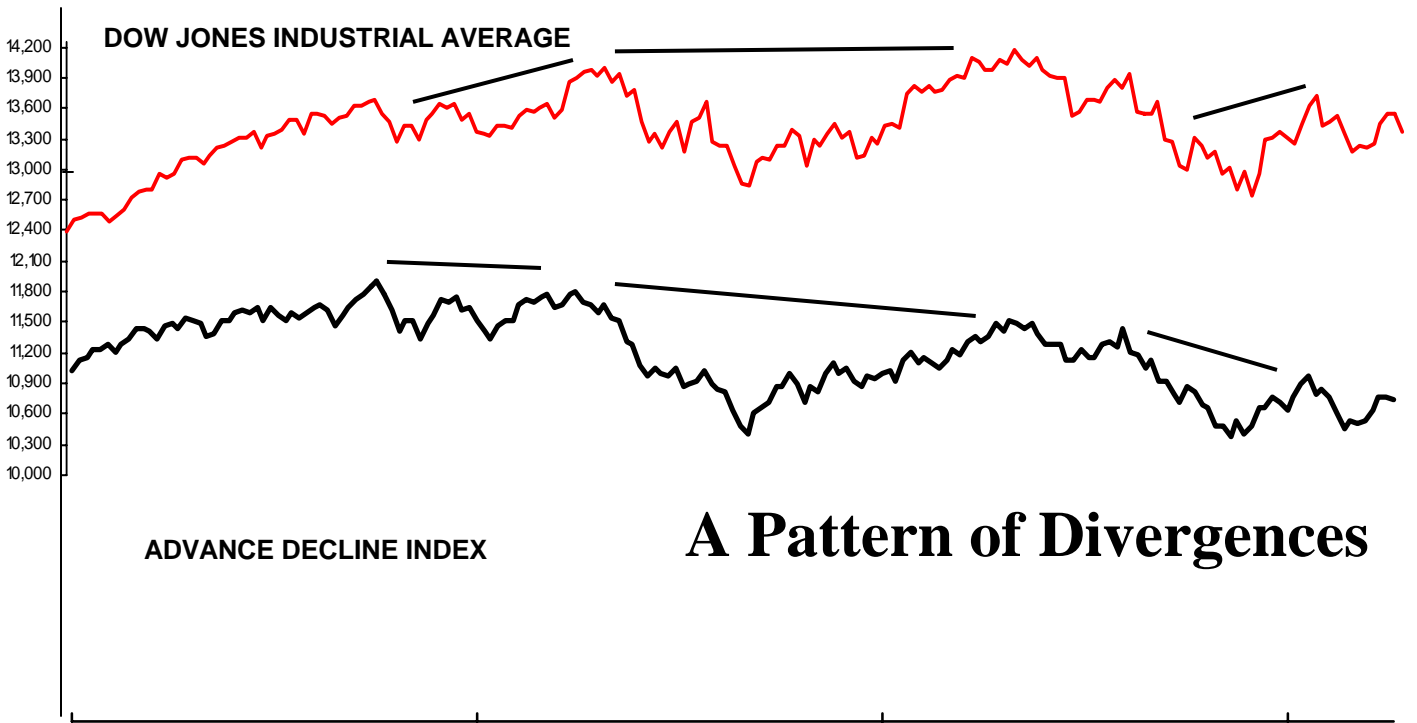
They say "don't fight the Fed." And historically, that's certainly been the case. Clearly the Fed has in mind to do all it can to make the world a better place, but it seems possible that the Fed may have lost its touch. With three cuts already behind us the S&P 500 Index remains below 1520, the level when the Fed first cut back on September 18. These things take time and after financial bubbles it often takes even more time, and a series of Fed ease before the markets get it. But a bigger problem may lie in the fact that much of the buildup in debt this time was outside the banking system over which the Fed has control. The vast changes that have so transformed the financial system, including exotic derivative instruments that most of us don't understand, seem likely to have left the Fed less effective. The great debate as to whether or not the overall economy will move to recession hardly seems relevant when crisis versus recession seems a more apt description of housing and much of the financial system. With most of these stocks holding, even the Homebuilders, the question becomes whether, or to what extent the bad news is discounted?

If not fighting the Fed seems a good thing, then how about not fighting the People's Bank of China? That Bank's recent announcement of a 100 b.p. increase in banks' reserve requirements to 14.5%, twice the size of this year's nine previous hikes, seems an important signal that Beijing is serious about its shift to a tight monetary policy. In the meantime, rates have gone from 5.5% to 7.5%, just as investors have fallen in love with China and other emerging markets. Once perceived as the riskiest and as such the hardest hit in global selloffs, emerging markets are the darlings of the global boom. Thanks to the perception of "decoupling," that is, a detachment from developed economies, emerging markets have been all the rage. Of course, not that long ago so too was the housing market because, as we know, home prices never go down. In terms of the Chinese stock market, investors there have opened 46 million trading accounts this year, nine times the number last year. Truly low quality stocks sell for 40-50X earnings. Meanwhile, the FXI, China's 25 big companies, looks more and more like the NAZ in 2000.

While the financial crisis and attendant writeoffs are on everyone's mind, perhaps the unraveling of the China bubble should be. And then there's that matter of the nuclear capability in Pakistan, apparently a place where Osama calls home. In the stock market, as often as not it's where you're not looking that gets you, subprime being a good example. Financial stocks peaked back in February though it wasn't until August that we first heard the term, "subprime." We can sit here now and say most stocks peaked back in May, or February in the case of the NASDAQ. And we can say with some certainty that that, too, will bring no good, though we can't say just what the excuse may be. Sure the market may survive this for a time, and January typically is seasonally strong. The technical background, however, says risk has increased, as the market has become that much more narrow.

Frank D. Gretz

STOCK AVERAGE VS. AVERAGE STOCK



A Pattern of Divergences

Apr-02-07

Jun-29-07

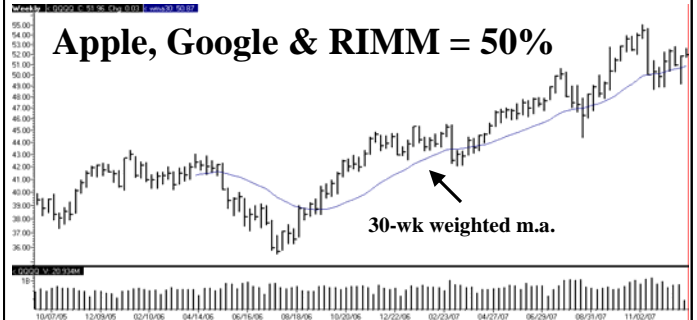
Sep-27-07

Dec-27-07

BROKERS (XBD - 207) - WEEKLY



POWERSHARES QQQ (QQQQ - 52) - WEEKLY



HOMEBUILDERS (XHB - 19) - WEEKLY



FINANCIALS (XLF - 29) - WEEKLY



I SHARES CHINA (FXI - 172) - WEEKLY



I SHARES EMERGING MRKTS (EEM - 152) - WEEKLY

