Alan M. Newman's Stock Market

CROSSCURRENTS

U.S. STOCK MARKET OUTLOOK for MARCH 12, 2007
DJIA 12276 - SPX 1402 - NASDAQ 2387

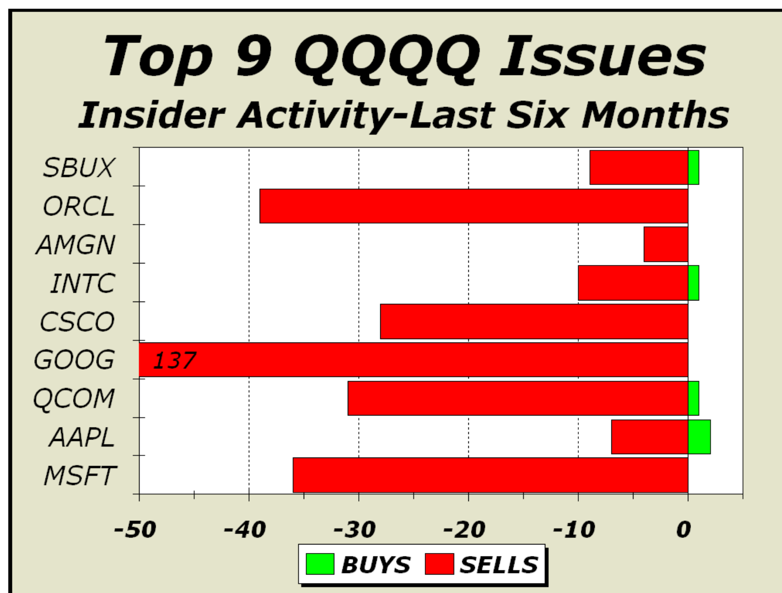
INSIDER SALES AT TOP NASDAQ COMPANIES ARE AS EMPHATIC AS ANYTIME IN THE LAST SEVERAL YEARS. WHY SHOULD INVESTORS BUY AND HOLD IF NO ONE ELSE DOES? MARGIN DEBT STILL RISING. *- NEXT ISSUE - APRIL 2, 2007 -*

The Good News From Insiders? There Is None.

Our last look at Nasdaq insiders took place in May of 2006 and it is high time we re-examined the sentiments of those who are at the helm of the nation's largest Nasdaq companies. We typically afford a view of the top ten constituents of the Nasdaq 100 Trust, a/k/a the QQQQs, but data for Comcast was not available at the time of publication, so we're going with the top ten minus CMCSA.

The good news? *There is none.* The ratio of sellers to buyers is the same 60-1 registered in May 2006, very dicey in our view. We've seen much lower ratios and 60-1 has been one of the highest. Although the Qs did move slightly higher in the intervening months from last May, the ratio of actual shares sold versus shares purchased was far better back then, at 1040-1. On this score, we can only wonder how much confidence insiders can possibly have at this point? For each share purchased in our new tally, they sold 7228, *one of the highest ratios we have ever seen.*

Bear in mind that the market capitalization for the top ten QQQQ constituents is over $1.1 trillion, roughly 6.2% of the entire U.S. market. If one in every $16 in total equity assets is so disdained by those who run the companies, why do the Qs remain so popular? While valuations are certainly not as stratospheric as they were in 1999 or early 2000, they still appear to be way out on line. Even after the recent mini-collapse, the average P/E was just shy of 30 and average price-to-sales was 5.5. Both measures implied a best case scenario priced into the shares for as far as the eye can see. A little over two years ago, our tally of QQQQ insiders was taken at similar valuation measurements, 32.8 P/E and 5.6 P/S. The difference then was that the seller-to-buyer ratio was only 11.6 to 1 versus the present 60 to 1. *And share sales are 95.6% higher now.* Try as we might, it's difficult to see where any value in the QQQQs could reside. Although prices did move sporadically higher from time to time after our February 2005 tally, it wasn't until August 2006 that they traded higher without looking back. *That's an 18-month stretch with no gain.* If the lack of confidence shown by insiders is any indication, it may be a very long time before the QQQQ sees higher levels than those seen before the recent swoon.



Buy, Do Not Hold

Justin Lahart's February 26th WSJ article, which can be viewed at http://tinyurl.com/335jrf, pinned down one extremely important reason for a disconnect between price and valuations quite aptly as the journalist posited, "*Investors are trading so quickly they may not see the risks in the market for the speed.*" The accompanying chart (see next page) really tells the story, showing that as

(Continued on page 2)

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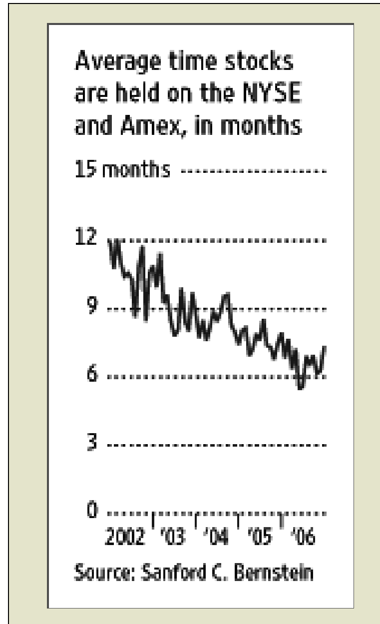
of mid-2006, the average holding period for stocks was only half of what it was five years ago. Although the holding period has lengthened a bit in the last year, *the trend is clearly to shorter holding periods.* Lahart's article goes on to cite that even in 1999, a time when the day trading mania was rife, the average holding period was a year. Worse yet, the last time the holding period was as brief as it was a few months ago was in 1929. Whoops. Why is this occurring? There are the obvious reasons such as the proliferation of derivatives, like options, the phenomenal growth in Exchange Traded Funds and hedge funds, but all of the reasons point to only one consequence. *Investment has been dis-incentived in favor of trading.* In an environment where performance is now measured on a monthly basis for hedge funds down to a daily basis for programs, the fundamental analysis of individual corporate prospects has become far too time consuming and far too expensive. *Thus, companies are now less likely to be priced on their individual prospects and are more likely to be priced upon their relationship to one another, to an index, or to a sector.*

The end result is that to a large degree, individual issues suffer gross pricing inefficiencies. The process spreads to entire sectors, entire indexes and finally, the entire stock market suffers pricing inefficiency. We can only reiterate that the present market fails and scores a D or worse on every valuation measure history has proved valid in the past. Explaining the lack of volatility, Lahart correctly deduces, "*It may be that the combined effect of all the sophisticated trading strategies in place today have put the stock market into a state of dynamic tension, where all the tugging and pulling effectively cancels each other out, muffling price movements*." Lahart finally concludes, "stop loss" strategies may have eventually have an outsized influence with the potential to "overwhelm the market." We cannot argue with that logic. Since there is apparently no long term horizon for investors anymore, why would anyone hold when the trend finally, as it eventually must, turns down?



When we turn the perspective to Exchange Traded Funds, holding periods become almost laughable for their lack of duration. The five ETFs pictured below were the five most heavily traded domestic ETFs last year. The Dow Diamonds were the tamest but still managed to turn over more than 26 times during the year, an average holding period of 9.6 days. The vaunted Spyders were turned over 40.8 times, or every 6.2 days. And the phenomenally popular QQQQs turned over 54.2 times, or every 4.6 days. An average holding period of less than one week!

We'll say it again, since it bears repeating: *investment has been dis-incentived in favor of trading*. Under the circumstances that prevail in the U.S. market today, there is every reason to believe that value is no longer a consideration in how a stock is priced. At last report, there are at least 8000 hedge funds trading more than $1.5 trillion in stocks, while 4800 mutual funds manage $6 trillion. Competition and performance amongst hedge funds is far more intensive than for mutual funds. The financial industry fought very diligently for years to convince investors that the long term would bury all mistakes, that the buy-and-hold philosophy was the road to riches. *However, all that has now changed.* Despite the advice of Wall Street to buy-and-hold, any rationale for confidence in the long term has completely evaporated as turnover has risen. *All that now matters is the short term.* For those knocking at the door hoping to find value, forget it. No one's home.

Margin Debt Expands Again, Risk Rises

During the month of February, another $8.3 billion was put to work via the use of leverage in the form of additional margin debt. Expansions in margin debt have a very strong correlation with rising stock averages. Since the October 2002 bottom, stock prices were up in roughly 80% of the months in which margin debt expanded. Inflows provide support for prices and fuel the demand for rising prices. *Margin debt provides the same impetus.* The only difference is that as leverage builds, so must risk. Mutual fund inflows have averaged roughly $12.4 billion per month since the October 2000 bottom, clearly providing the lion's share for net demand. How-

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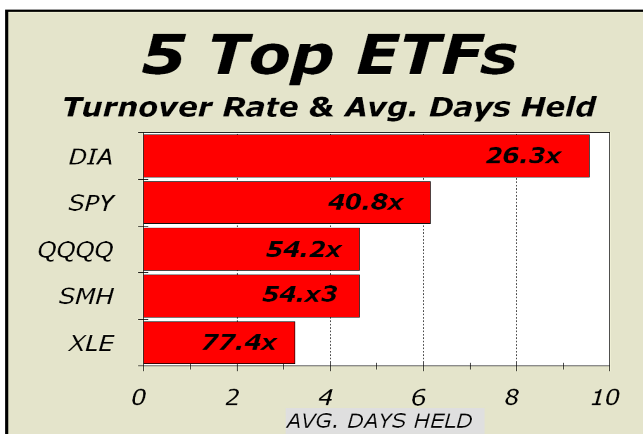

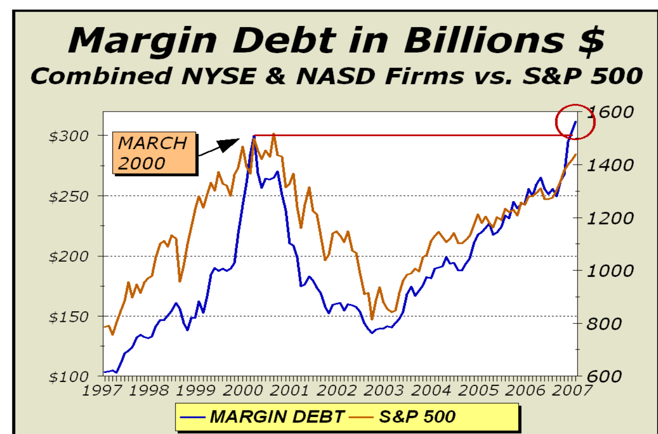

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ever, *since last August, monthly expansion in total margin debt has also averaged $12.4 billion per month*, massaging net demand to extremely high levels. And of course, as prices rise, there is even *more* impetus to trade on margin and increased margin tallies become somewhat of a self-fulfilling event.

Margin debt levels are now 3.6% higher than in March 2000. While there is no way to infer that today's market shares the same degree of insanity as in 2000, there can be no doubt that risks have risen substantially and represent a very real threat. *As the February 27th mini-collapse proved, it is far easier to spook a market strung out on leverage and highly focused on trading, rather than investment.* The tremendous damage wrought from the March 2000 high to the October 2002 low was not caused by mutual fund outflows. In fact, during that period of time, mutual funds had net inflows of $185 billion. *The damage was wrought as margin debt contracted by $163 billion.* This was not just portfolio adjustments in progress. Remember, investing doesn't matter anymore—it's all about trading. *This was scared money.* And next time, it will likely be *terrified* money when margin debt contracts.

The <u>Only</u> Good News....

Yes, we admit, there is one factor to give bears pause. But only one factor. When stocks achieved their manic peak in March 2000, there was a cash cushion of $178.7 billion in mutual funds (see arrow on chart at bottom left). As of January 31st, there was $241.6 billion in cash. On a relative level, there is still virtually nothing to cheer about, since January's cash-to-assets ratio of 4% is identical to the level of March 2000. *However, it is probably fair to infer that the additional $62.9 billion available today may be able to at least, temporarily, keep the bears at bay.* Our call for a "modest downside" of 3.6% to 4.7% (see our March 5th website update at http://www.cross-currents.net/outlook.htm and the previous January 31st update at http://www.cross-currents.net/subscribers/tech013107.htm) was based on this factor and has thus far, proved correct. *We expect to turn far more bearish during the summer.*

"....A Possible Cover-Up"

Andrew Clark's February 27th article (http://tinyurl.com/2kfsrc) in the UK's Guardian featured comments from Gary Aguirre, whom the SEC fired some months back after his investigation of Morgan Stanley's John Mack apparently went too far. Mack is about as powerful as they come on Wall Street and make no mistake, this is the most powerful and influential lobby of all. *Nothing gets in the way of Wall Street.* The SEC's action to fire Aguirre came soon after he garnered "praise from his supervisors for his 'unmatched dedication' and 'high-quality contributions'. The commendations clearly belie any later attempt to denigrate Aguirre's investigation. Then again, the criteria to promote investigators may simply be compliance to the needs of Wall Street's lobby, rather than any public need. The cartoon at left is roughly four years old but the point seems just as valid now. Clark also commented that the senate's judiciary committee released interim findings, concluding, "*At best, the picture shows extraordinarily lax enforcement by the SEC. At worst, the picture is colored with overtones of a possible cover-up.*" Strong words! And in other words, business as usual. Nothing has changed. The watchdog still sleeps.

Insiders Updated

Below right, an update to our featured front page chart in the December 18th issue. Insider activity averaged only 12.9 to 1 during 2006. The November surge to 33.5 to 1 has now been confirmed by February's renewed surge to 28.8 to 1. The relative optimism of last July led to the second longest rally in history without a 2% correction. Previously, ratios of roughly 26-1 in both March and July of 2005 pointed directly at corrections thereafter in the range of 6% to 7%. The picture below is as good a reason as any to believe the rally from the July 2006 bottom has concluded. There is clearly sufficient pessimism in place by those in the know to suggest that the remainder of the year will sustain quite a bit of downside pressure.

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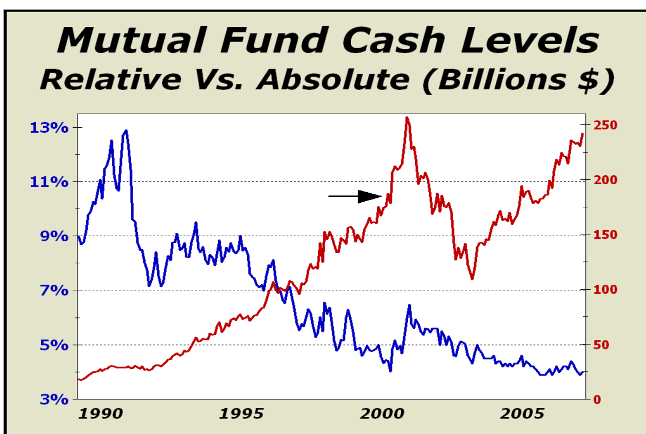

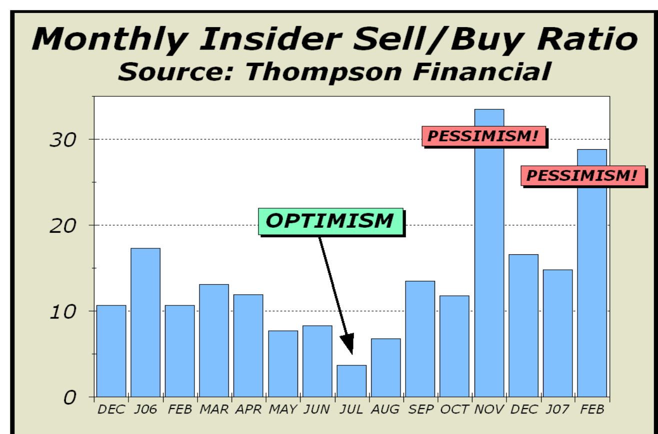

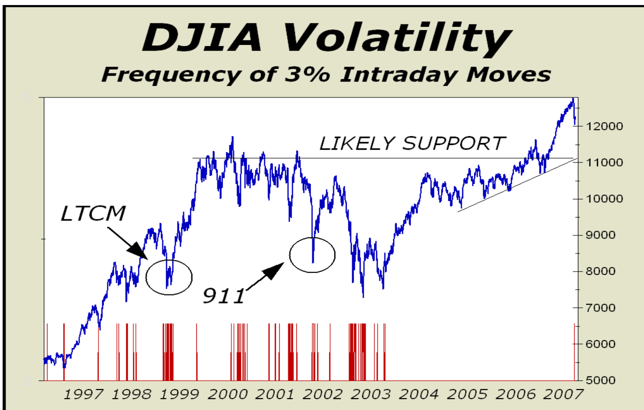

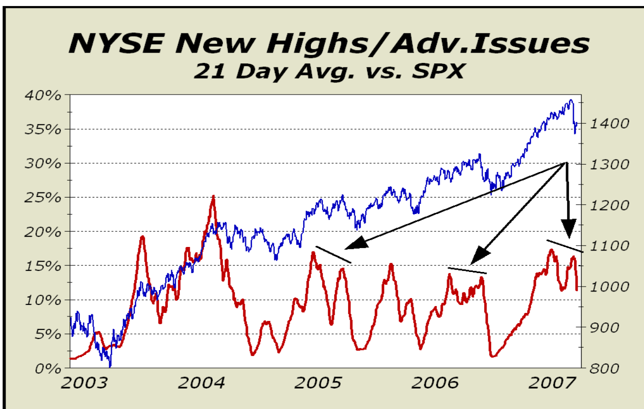

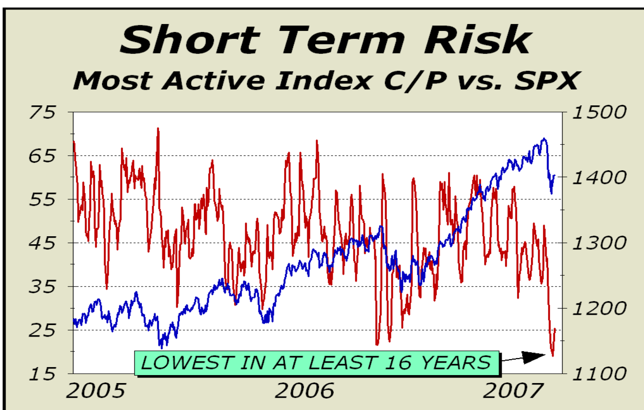

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Finally. After four years of nothing in the way of intraday volatility, a modicum of excitement entered the picture leaving both bulls and bears with a sour taste. Bulls had their hearts in their mouths as one day erased all of the year's gains to date and bears continued on agita watch as the mini-collapse refused to escalate into something more awful. Pass the Maalox. We all need it.

If there's a lesson, it is that "complacency" is no longer in the vocabulary. We would not be the slightest bit surprised to see volatility now escalate; a/k/a "normal" levels. From 1991 through January 2003, moves of 3% occurred 3.8% of the time, or every 26.5 trading sessions. Although there have been some pretty great upside days, for every two on the upside, *there have been three on the downside.* In a nutshell, although volatility gives one the opportunity to profit handsomely, it also gives one the opportunity to go way wrong in either direction. Since more doubt is now expected to enter into the decision making process, this development also cuts a swath through the bull case. Coincidentally, our interpretation shows fairly decent support at roughly Dow 11,100, equivalent to a 12.6% decline from the highs and in line with our expectations for later in the year.

NYSE new highs as a percentage of advancing issues traded has pulled back as expected. The indicator has not quite taken out the January lows and as a result, awaits a more negative divergence. However, we expect the indicator to trend somewhat lower and the extent of the decline will tell us a lot about whatever dynamic potential remains for stocks. Most of our other indicators of the market's internal dynamics are consistent with the early phase of a genuine stock market correction, rather than a simple pullback. Given the seasonal aspects, we believe it is prudent to temper our bear temperament, since April 15th and the end of IRA contributions is only a month away. Historically, the S&P 500 is up over 1% in both March and April and April is the second biggest month for fund inflows. Patience seems well advised.

Our 21-day measure of Emotional Intensity registered a buy signal on Tuesday, confirmed on Thursday. Perhaps more importantly, our measure of short term risk fell to the lowest level we have seen over the 16 years of data we have compiled. The data is based on a 6-day weighted average of money traded in certain index puts and calls. This is not a buy signal! As the action into the lows of 2006 amply illustrated, the initial weakness was repeated as the correction unfolded into July. Our interpretation of the data suggests that risks are relatively low *until* a larger "bounce" in our indicator is visible.

We still like Tom McClellan's reference to a "rogue wave" as the best explanation for February 27th. It wasn't China, it wasn't the Yen, it wasn't sub-prime mortgages. *Simply put, the second longest rally in stock market history without a 2% correction was destined to end.*

☑☑☑☑☑

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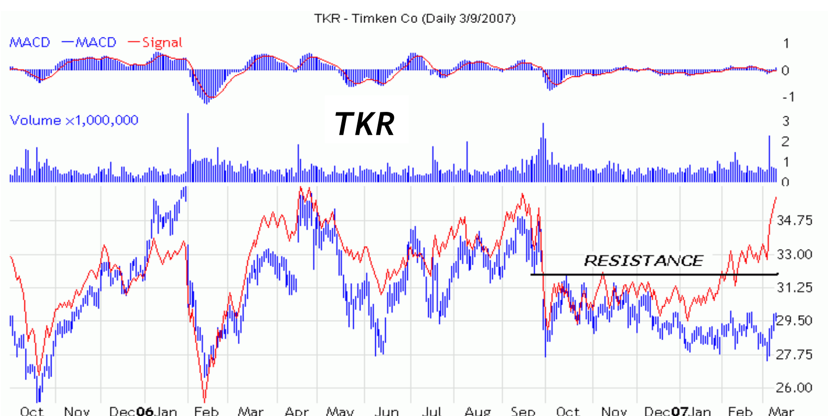
- Rationales & Targets -

For those who are still holding onto the SMH short, we're no longer confident that this position will work out, at least over the short term. ***The obvious negative for stocks is that risk has finally entered the vocabulary for bulls. The obvious positive is that the seasonal effects can be quite strong into mid-April.*** Short term upside potential (as opposed to the Intermediate Term boundaries shown in our "Current Forecast" at right) should be limited to a test of the closing highs seen only 14 trading sessions ago, some 4.1% higher. Downside risk extends to probably no more than a very shallow penetration beyond the 2% required to reach the lows seen only five trading sessions ago. Seems to us that if downside risks outweighed upside potential for the next few weeks, breadth should have been worse and new lows should have expanded more. We see a series of feints and stabs over the next few weeks, nothing serious either way.

LONG CANDIDATE: Timken Company (TKR). Although TKR has been on something of a slow fade since the break last autumn, the pickup in On Balance Volume is too tempting to ignore. The three recent line drives up to near $30 confirm strong resistance, which will be followed by more resistance at $32. However, it does very much appear that accumulation is underway. Another move to positive MACD on Friday could be the catalyst.

SHORT CANDIDATE: Apple, Inc. (AAPL). Apple peaked with the announcement of the iPhone and we'd like to know what news could possibly remain to juice the shares even further? Seems all the good news is priced in. A potential head-and-shoulders top and now the shares are having problems holding the 50-day moving average. Also, too many negative divergences scream risk. Oh and by the way, huge insider sales.



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The Psychology of the Market

Strategists: No longer reported by Barron's
Newsletter Writers: 3 Week Bull/Bear Ratio: 2.0 Optimistic
AAII: 3 Week Bull/Bear Ratio: 1.2 Neutral
Mutual Funds: 4.0% cash: Extremely Optimistic
Rydex Ratio Sentiment: 2.0 Optimism Fading
(Bull & Sector Funds vs. Bear Funds)
Crosscurrents Emotion-Based Indicators: Bullish
SHORT TERM OUTLOOK: CAUTIOUSLY BULLISH

Crosscurrents Current Forecast

VERY SHORT TERM = BULLISH
INTERMEDIATE UPSIDE POTENTIAL +4% to +5%
INTERMEDIATE DOWNSIDE RISK -6% to –11%

Crosscurrents '06 Investment Stance

RETAINED FROM PREVIOUS YEAR OR EARLIER
iShares Lehman TIPS Bond Fund (TIP) +13.1
iShares Japan Index (EWJ) - "half" position +24.6%
NEWMONT MINING (NEM) 10% LONG +7.7%
2006 POSITIONS STILL OPEN AT END OF YEAR
Bristol-Myers-Squibb (BMY) 10% LONG +19.1%
Archer-Daniels-Midland (ADM) 10% LONG +23.9%
2006—INVESTMENT STANCE—POSITIONS CLOSED
Archer-Daniels-Midland (ADM) 10% LONG +66.0%
Pharmaceutical HOLDRs (PPH) 10% LONG +7.9%
Percentage gains (losses) include dividends
"Retained" ideas priced from inception
Vs. DJIA +16.3% SPX +13.6% Nasdaq +9.5%
AVG. GAIN FOR 2006 NEW IDEAS +29.2%

Crosscurrents '07 Investment Stance

RETAINED FROM PREVIOUS YEAR OR EARLIER
iShares Japan Index (EWJ) - "half" position +38.9%
NEWMONT MINING (NEM) 10% LONG +1.7%
Bristol-Myers-Squibb (BMY) 10% LONG +24.0%
Archer-Daniels-Midland (ADM) 10% LONG +35.3%
NEW IDEAS FOR 2007
CNOOC LTD. (CEO) 10% LONG –13.7%
iShares Japan Index (EWJ) - 10% LONG +3.3%
PowerShares China Portfolio (PGJ) 5% LONG –4.6%
Vs. DJIA –1.6% SPX –1.2% Nasdaq –1.1%

Crosscurrents '07 Trading Stance

(IDEAS LEFTOVER FROM 2006)
Retail HOLDRs Trust (RTH) 10% SHORT –5.3% CLOSED
Semiconductor Trust (SMH) 15% SHORT –5.3% CLOSED

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