Samex Capital's Stock Market

CROSSCURRENTS

U.S. STOCK MARKET OUTLOOK for OCTOBER 17, 2005
DJIA 10287 - SPX 1186 - NASDAQ 2064

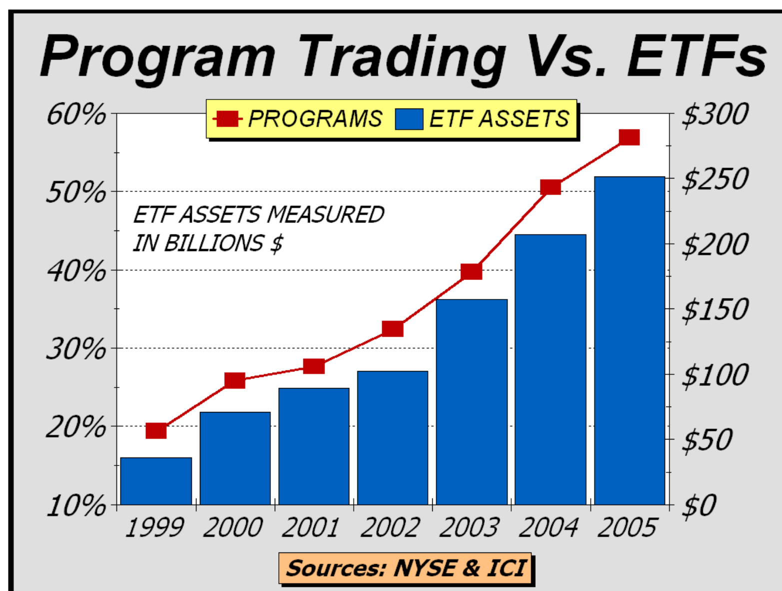
Q: HOW CAN STOCKS BE FAIRLY PRICED WHEN FUNDAMENTALS DO NOT MATTER? A: THEY CANNOT. TOBIN'S Q RATIO STILL SAYS STOCK PRICES ARE WAY OUT OF LINE. WHAT IS THE SEC HIDING? ***- NEXT ISSUE - OCTOBER 31, 2005 -***

Not Your Father's Stock Market Anymore

Crosscurrents has been on the warpath versus Program Trading for a long, long time, actually since our newsletter was first published in May 1990. Over the past year and change, we have probably featured charts showing how programs were overtaking all other types of traditional investment at least a dozen times. Unfortunately, the trend towards automated trading continues to build momentum.

For the week ended September 16th, trading totaled 9.33 billion shares on the New York Stock Exchange. Programs accounted for 6.61 billion, or 70.9% of the total, *the third largest percentage of program trading ever recorded.* And if that was not enough, it was reported that brokerage firms executed an *additional* 4.2 billion shares of program trading *away* from the NYSE. Are we the only observers who are uncomfortable with the rapid expansion of this kind of trading?

By definition, program trading involves the "simultaneous purchase or sale of at least 15 different stocks with a total value of $1 million or more." It is clear that the execution of a trade for a single stock at any point in time - whatever the size of the trade - may be reasonably expected to reflect company fundamentals and an educated estimate of fair valuations. But the simultaneous purchase or sale of at least 15 different stocks cannot function under the same assumptions!



Our colleague, Jim Bianco (www.biancoresearch.com), has repeatedly linked the growth of program trading with the growth of Exchange Traded Funds (ETFs). Both are growing at phenomenal rates. NYSE program volume has expanded at a 32% rate over the last five years. ETF assets have expanded at a 29% rate over the last five years. Our featured chart amply illustrates the inclined path each takes.

But finally, recognition is appearing that the status quo may not be beneficial. Barron's Jack Willoughby recently quoted Bianco, "The majority of trading is no longer investors buying a stock based on a company's fundamentals, it's program traders buying groups of stocks and making macro plays."

From very modest beginnings in 1993, ETFs are now a huge business and have attracted more than one-quarter of a trillion dollars in assets. Although this represents less than 2% of total market capitalization, bear in mind ETFs have not been around all that long. Growth did not begin to accelerate rapidly until 2000, when assets rocketed from $36 billion the prior year to $71 billion. By contrast, mutual fund capitalization was as low as 6.4% less than 14 years ago, but has now grown to 22.5% of the whole stock asset pie.

Of course, much of the growth in mutual funds has come from indexing, yet another methodology in which fundamentals are not considered and a strategy that also

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drives a large part of programs. Although the S&P 500 Index is actively "managed" by a selection committee, the criteria used are faulted, inefficient and arbitrary, such as a move last year to remove all remaining foreign issues from the index. See Jon D. Markman's excellent piece at http://moneycentral.msn.com/content/P25387.asp for a perfect explanation of why the selection process fails.

Thus, *we find ourselves ensconced in an environment where the majority of trading and investment have nothing at all to do with individual company prospects,* just sophisticated *trading* strategies that hopefully, will take advantage of extremely small discrepancies in perceived pricing anomalies. If this is the path to riches, the road must indeed be paved with pitfalls.

We repeat for the umpteenth time, if the majority of transactions now effected on our major exchanges no longer reflect the fundamentals or prospects of publicly traded corporations, there cannot be a reasonable expectation that stocks are reasonably valued. Thus, we can only assume that stocks are *not* fairly priced. If this is the case, our $15 trillion market is as risky as it has ever been.

Q-spensive

The "Q" ratio was devised by James Tobin of Yale University, Nobel Laureate in Economics, who hypothesized that the combined market value of all the companies on the stock market should be about equal to their replacement costs. Sounds reasonable, no? Why would anyone pay $2 for something that can be replaced for $1? The ratio is calculated as the market value of a firm's assets divided by the replacement value of the firm's assets. Below a value of 1, the firm's shares are cheap. Above 1, the firm's shares are expensive, since one would be better off starting the company from scratch. For nearly a century (until 1995), just before stock valuations began running wild, the Q Ratio averaged 1.01, offering concrete evidence that the ratio was a valid measurement of fair valuations. The evidence was confirmed by the huge leveraged buy-out craze beginning in 1981, when the U.S. market was quite cheap. Valuations were so attractive that 1550 companies went private between 1981-1988. In that period of time, Q averaged .68, which meant that the average LBO theoretically was worth 47% to the buyer (100/68).

Data for 2005 has not yet been presented on the Smithers & Co. website, thus the picture you see here is for Q at the end of 2004. Clearly, stocks are implied to be twice what they are really worth. It's difficult to believe that stocks got much cheaper in 2005

Opaque "Transparency"

Hidden in the business section of the NY Post on October 1st was a brief Bloomberg article headlined, "SEC HIDES MOST SECRETS IN GOV'T." Predictably and to our shame, very few observers seem to have noticed and the thrust of the article continues to be ignored. According to a recent report, the Securities and Exchange Commission has rebuffed requests for information from internal records under the Freedom of Information Act more often than almost every government agency, including the CIA and Pentagon. Only 34% of the 3830 petitions processed last year were granted.

The report by the Coalition of Journalists for Open Government claimed that nearly one in five of the SEC's denials that were appealed were overturned and that its year-end backlog of 8635 requests was bigger than all but four agencies surveyed. Most interestingly, the overview of Edward Fleischman, 73, a former SEC commissioner, was that "The SEC has never applied the same standards to itself that it applies to the companies it regulates."

For what it's worth department: our own search for the truth, commencing with our series of articles on the huge problems of "naked" shorting that effectively counterfeits stock in the U.S. market, took a logical turn on August 31st, when we filed an Freedom Of Information Act request with the SEC. The request was for the total number of shares in failed deliveries of Overstock.com on August 1, 2005. We specified Overstock, since we had already identified the company as a "target" for destruction by short sellers. We also specified a single date of August 1st, both to ease the task for the SEC and to ensure "stale" data that could not possibly have any consequence on current trading.

Our answer from the SEC was drafted on September 27th, denying our request and citing Exemption 4 of SEC regulations as reasons, stating that the release of the data ".... could cause substantial competitive harm to the submitter." How that could possibly be the case with stale data is beyond our comprehension but the SEC simply does not care, nor do any of the other agencies or departments such as the DTCC, the NSCC, the NYSE nor Nasdaq. *The stock market is not run for the benefit of the public.* It is now run to spite the public. Yes, we can still invest or trade and make money but the arena is not your father's stock market anymore. Supposedly, transparency is the linchpin of a fair securities market. Unfortunately, opaqueness is
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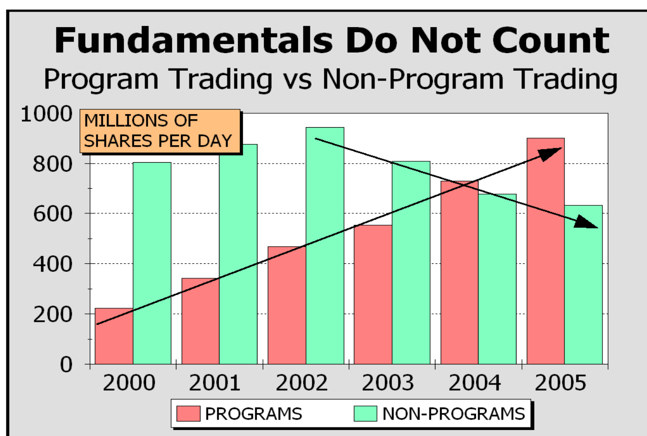

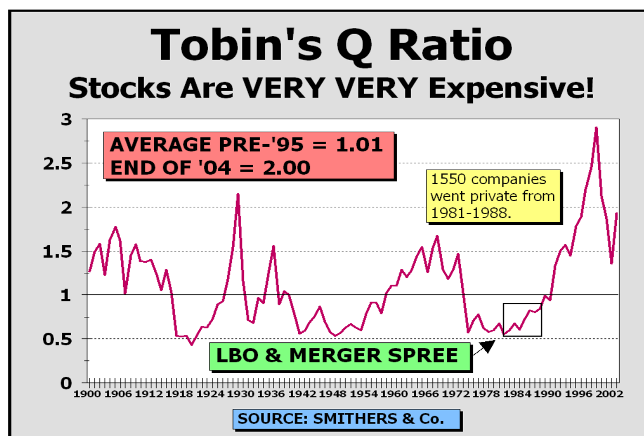

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the order of the day. *We have appealed the SEC's decision to deny access to the data. We will keep you informed.*

How long have we been harping on the problems of failed deliveries of securities in the U.S. markets? Close to a year. We have repeated all too often with near zero outside recognition of the circumstances, that the biggest story of the year was waiting in the wings. We have no way of knowing for sure, but Refco could be the tip of the iceberg. Refco's (RFX) initial public offering took place less than two months ago and the company may now be insolvent (see http://www.nypost.com/business/55422.htm). Looking for a catalyst for a huge market decline based on a derivative event? Can there be a greater confidence breaker than a huge IPO that busts in less than two months? RFX raised $670 million but those shares are now worth only $240 million and the market cap, recently as high as $3.8 billion, is now a mere billion. CEO Richard Bennett is blamed for hiding over $500 million in bad debts that one of his companies owed to Refco while Refco was paying Mr. Bennett $3.27 million to run RFX. Chalk up yet another episode of investors be damned. Trading in the shares have been halted while the mess is sorted out. Sadly, the U.S. markets are possibly less trustable and dependable now than they have ever been.

Although Refco is best known for providing execution and clearing services for exchange-traded derivatives and brokerage services in the fixed income and foreign exchange markets, they also deal in stocks. Please direct your attention to http://tinyurl.com/93qj5, where you will read about the involvement of Refco with naked short selling of Sedona Corp., a Pennsylvania software that was shorted out of existence a few years ago. Where the problems begin and end is not for us to tell you - we can only point out that they are occurring and that they are significant. Still not sure? Witness Dr. Patrick Byrne's revelation last week that his purchase of 25,000 shares of Overstock shares was not settled/delivered for more than 50 days from of all folks, Morgan Stanley. Dr. Byrne is the CEO of OSTK. How can anyone believe anymore that transparency exists in the U.S. market? Opacity? For sure.

- DECENNIAL CYCLE FLOP IN PROGRESS -

	YR. BEGIN	TO OCT.17	GAIN	YR. END
1905	69.61	81.48	17.1%	38.2%
1915	54.58	93.34	71.0%	81.7%
1925	120.51	149.56	24.1%	30.0%
1935	104.46	137.15	31.3%	38.5%
1945	152.88	185.98	21.7%	26.6%
1955	407.17	446.9	9.8%	20.8%
1965	879.78	945.07	7.4%	10.9%
1975	619.84	851.46	37.4%	38.3%
1985	1215.55	1371.3	12.8%	27.7%
1995	3874.48	4796.67	23.8%	33.5%
2005	10783.01	10287.34	-4.6%	???

Year "5" Flop?

Back in the November 1, 2004 issue, we pointed to the Decennial Cycle, in which the years ending in "5" have been nothing short of sensational. In the last dozen years ending in "5," gains have averaged a phenomenal 30.7%, with only 1895 finishing with less than a 10% gain. Who wants to bet against that kind of record? But we discussed the year 5s in the Decennial Cycle and claimed, "there is more to this story and as tempting as the (Cycle) appears, it is clearly not a guarantee..." Seems we nailed this one....so far.

Our table illustrates gains for the last ten years ending in "5" up to October 17th, the same date as today, and subsequently, the gains for the entire year. The present year appears to be way out of whack and if the Dow does not catch fire quickly, the Year "5" of the Decennial Cycle will be a huge flop.

In our December 6th issue, we showed why the Year "5" could flop and you see the reason repeated at bottom right on this page. The 1st year of the Presidential Cycle also seems to favor the current year, averaging a 3.1% gain, so at first glance it would appear that the coincidence of both cycles favor stocks. But again, there is more to the story than meets the eye.

Looking more deeply into the Presidential Cycle, we can see that losses were the order in the prior secular bear market while gains were the order in the secular bull market that followed. If we are correct in our assumption that a secular bear market is still in progress, then the Presidential Cycle favors the downside and Year "5" string of resounding gains could end with a whimper.

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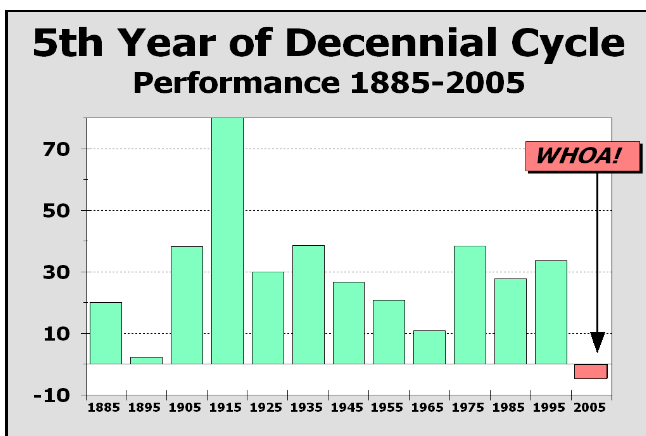

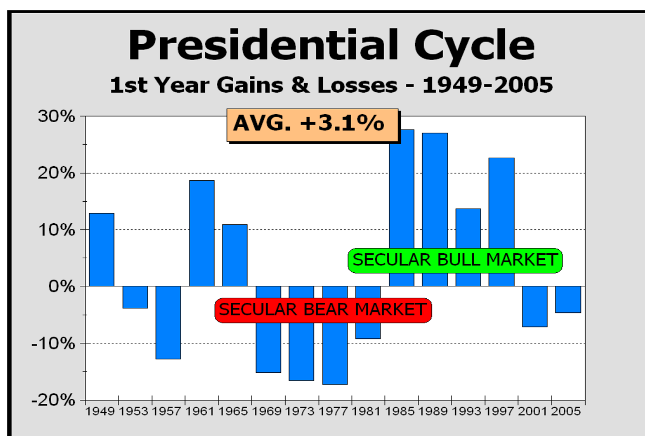

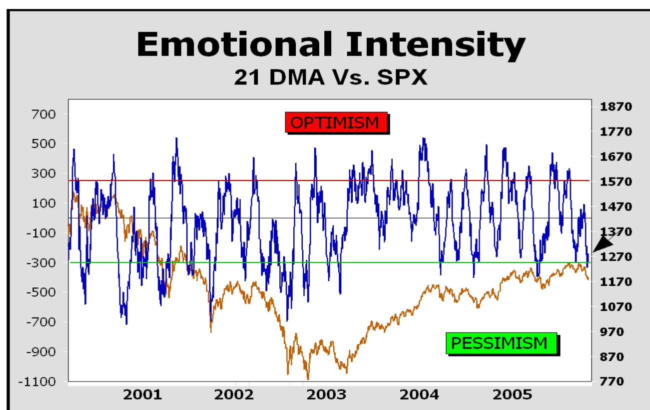

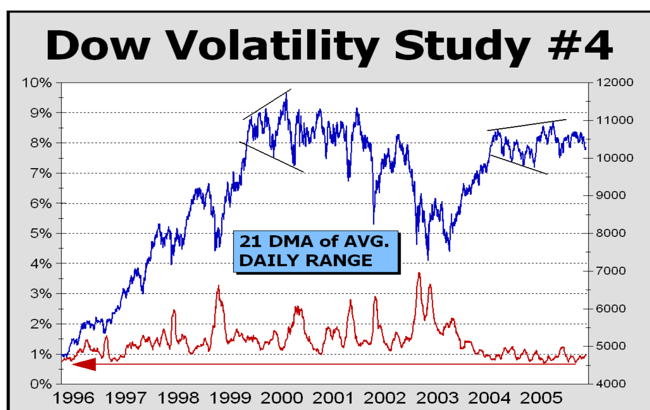

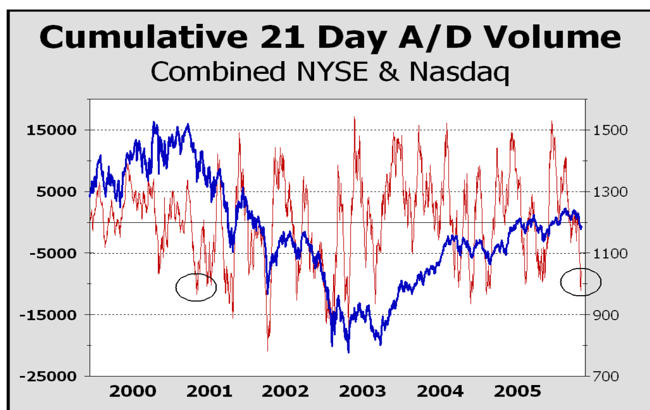

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Much of our work now shows an oversold condition, but only for the short term. Intermediate and longer term indicators have hardly budged, implying that a much larger correction is unfolding, albeit slowly.

Our principal measurement of emotion has turned positive, unconfirmed by the shorter 10-day and 15-day versions, neither of which achieved positions that would indicate excessive pessimism. In fact, Tuesday's bottom was clearly less emphatic than any "bottom" dating back to early 2000. It's probably best to assume a bounce here, rather than a "Buy" signal.

A few of our volatility indicators have begun to expand quite slowly and certainly do not particularly illustrate any fear. It's quite interesting that the 21-day indicator shown at left illustrates virtually no movement while the 10-day indicator (not pictured) is similarly silent! If this is indeed the famous October bottom we've all been conditioned to expect, it is one of the tamest in history. Ah, but that is just the problem....the expectation of a turnaround outweighs the reality of a much larger correction in progress.

Cumulative 21-day Advancing/Declining volume is yet another indicator that appears to point to a reversal but as always, it is best to delve as deeply as possibly into the analysis. Our best comparison is with a similar decline (and subsequent bounce) that took place in the fall of 2000, namely October 12th. Although the SPX rallied close to 5% over the next 18 trading sessions, the next two years were down, down, and down more.

Whither Interest Rates

We are quite concerned that the Fed has the capacity to err quite significantly with a continuation of its current rate hike policy, sending the economy reeling rapidly into recession. The Conference Board recently reported that its Consumer Confidence Index plunged a huge 19 points in September, from 105.5 in August to just 86.6 in September. That was the biggest one-month drop in consumer confidence in 15 years. The last occasion was in 1990, when the economy stumbled. Last Friday, the University of Michigan's preliminary index of consumer sentiment unexpectedly decreased to 75.4, the lowest reading in more than 13 years. Ominous? Perhaps.

Although rates have already gone as high as we previously thought they might, the Fed Funds futures contract is still pointing higher and implies another hike next month and very good odds for yet another in December. The Fed seems reluctant to work against what the market believes will occur, but the market is quite obviously not always correct! However determined the Fed is to fight inflation, the government deficit must expand if the economy tanks and the economy will most certainly tank with current rate hike policy persisting into 2006. This alone would pressure the dollar and result in more inflation, exactly the opposite effect than intended.

Despite the odds implied by the Fed Funds futures contracts, we are still looking for a cessation of rate hikes—the sooner, the better.

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THANKS TO:

ANITA PELTONEN

BARRON'S MARKET WATCH FOR COVERAGE OF OUR COMMENTARY

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OUR 16th YEAR!

- Rationales & Targets -

Again, nothing has changed, except the persistent weakness portends a further decline in prices. Despite oversold conditions, sentiments are still unusually tame and by all rights, should illustrate far more widespread pessimism than currently visible. As we said in our last issue, we still believe *"we'll be bottom fishing under Dow 9100, SPX 1060 and Nasdaq 1885."* However, we must admit the odds are contracting each day as the negative seasonal influences rapidly wane.

In the meantime, we would place the probability of a "bounce" as high for the short term; perhaps only a few days. Too many are expecting the typical October turn, and that will likely provide the ammunition for a brief rally. The rejoicing should be brief, since that very attitude is likely to provide the impetus for another leg down. There still appears to be insufficient fear or concern that this correction can endure. Bear in mind that the bull market is already quite long in the tooth and is fighting versus the worst enemy of all—higher rates.

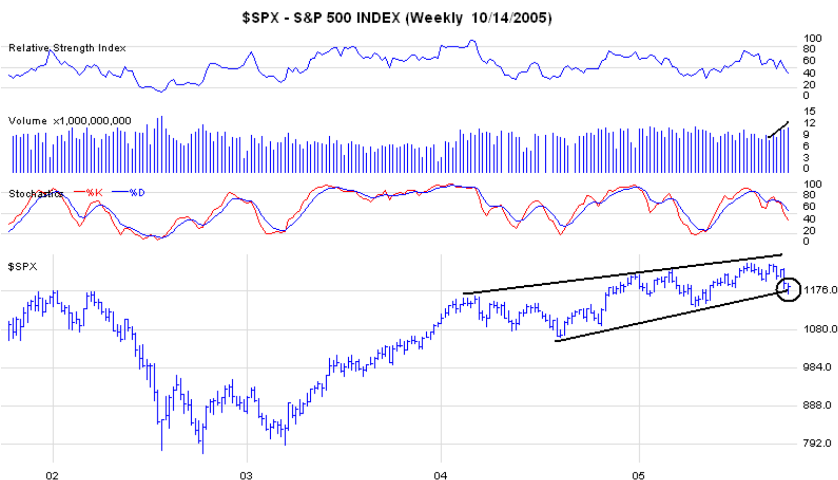
The situation with Refco has the potential to turn VERY ugly. We know about the money Bennett hid, but can we simply assume there was no additional liability hidden elsewhere? Also, do any of Refco present liabilities deal with the FTD problems that we have been focusing on? *We believe FTD problems could total in the billions.*

The best bet is to allow the markets to tell us whether the bull can regain control. If Refco's crisis can be easily resolved, we would expect high odds for a turnaround and yet another test of resistance up around SPX 1245. The flip side of the coin is a derivative event in progress. Think 1998 and LTCM but on a smaller scale. Until we know, it's all about uncertainty. ***The stock market hates uncertainty.***

We are still reluctant to take on further Trading Stance positions, since downside volatility remains too tame to generate the kind of moves that pay off well. Last issue's focus on the SMH as a short idea worked out well enough, but only after the trust scarily surged 3.9% in two days.

Below, our weekly chart of the S&P 500 shows the index broke the support line of a rising wedge last week (see circled area), a distinctly negative development that forces us to maintain a bearish stance, while acknowledging the possibility of a very short term corrective rally. Wedge breaks typically measure back to their beginning point, in this case, under 1100. As well, note that volume has increased on the downside, another negative. Resistance should be expected just above SPX 1200.

We are quite happy to note that the constituents of our Investment Stance are outperforming the major averages by a wide margin.



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The Psychology of the Market

Strategists: 65.3% stocks - 10.7% cash: Still Complacent
Newsletter Writers: 10 Week Bull/Bear Ratio: 2.1 Optimistic
Public (AAII): 3 Week Bull/Bear Ratio: 1.1 Concerned
Mutual Funds: 3.9% cash: Euphoric!!!
Rydex Sentiment: 1.5 Concerned
(Bull & Sector Funds vs. Bear Funds)
Put/Call Ratios (our indicators): Neutral/Bullish
VERY SHORT TERM OUTLOOK: NEUTRAL/BULLISH
INTERMEDIATE TERM OUTLOOK: BEARISH

Crosscurrents '05 Investment Stance

iShares Lehman TIPS Bond Fund (TIP)*
$104.98 now $103.68 +2.7% for 2005
+10.2% from inception in January 2004
iShares Japan Index Fund (EWJ) - "half" position
$10.60 now $12.04 +13.6%
GOLD shares (XAU/HUI proxy) 10% LONG
From 5/12/03 (XAU +49.7%)
NEWMONT MINING 10% LONG
$42.75 now $44.98 +5.7%*
*** includes dividends**
Vs. DJIA –4.6% SPX –2.1% Nasdaq –5.1%

Crosscurrents '05 Trading Stance

NEM (NYSE) = 20% LONG from 1/24/05 (+5.7%)*
QQQQ = 30% SHORT from 7/18/05 (+1.8%)

FCS (NYSE) = 20% SHORT +11.0% (CLOSED)
SMH (AMEX) = 30% SHORT –1.8% (CLOSED)
UNH (NYSE) = 20% SHORT +0.7% (CLOSED)
SYMC (NASDAQ) = 20% LONG –4.7% (CLOSED)
JBX (NYSE) = 20% SHORT –5.7% (CLOSED)
XAU/HUI (GOLD SHARES) = 5% LONG +39.9% (CLOSED)
AU (NYSE) = 20% LONG +1.4%* (CLOSED)

We never got our sale price for Newmont Mining in the Trading Stance, missing by a mere $0.80. We're lowering our close out target to $47.50 for the time being but intend to retain our other gold positions through whatever correction arises. QQQQ will still be stopped above $40.14 and $35 remains our target.

"PICTURES OF A STOCK MARKET MANIA"

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