Samex Capital's Stock Market

CROSSCURRENTS

U.S. STOCK MARKET OUTLOOK for NOVEMBER 14, 2005

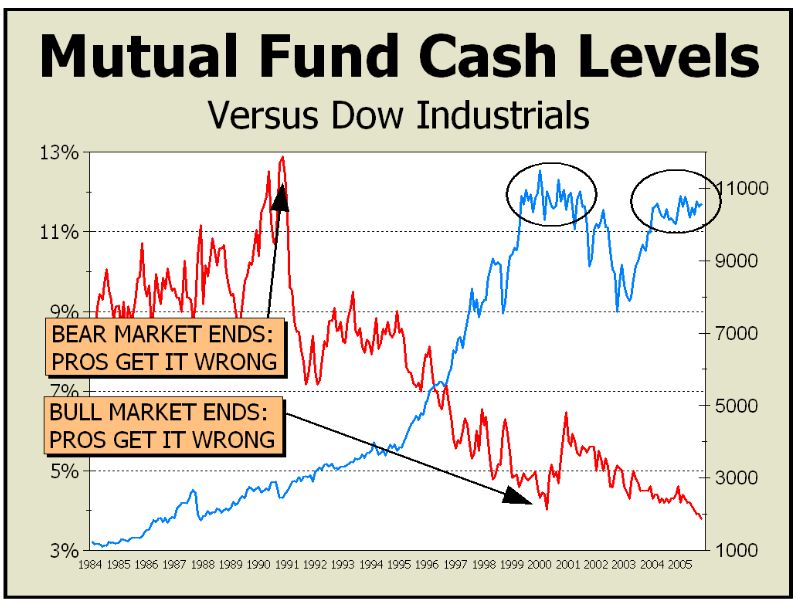
DJIA 10686 - SPX 1234 - NASDAQ 2202

DANGEROUS COMBINATION: LOW CASH LEVELS AND HIGH LEVERAGE. NASDAQ MARGIN DEBT HAS REACHED A RECORD HIGH. OVERSTOCK SHORT POSITIONS ARE NOW MORE THAN DOUBLE THE FLOAT.

- NEXT ISSUE - DECEMBER 5, 2005 -

"Dangerously Incorrect Homogeneity"

At the end of October, the Investment Company Institute reported that the cash-to-assets ratio of mutual funds fell to 3.8%, the lowest in stock market history. The prior record low of 3.9% came at the absolute peak of a secular bull market when the Dow ended the week of January 20, 1973 at 1046.42. It did not trade above that weekly close until the week of November 20, 1982, more than nine-and-a-half years later.



What drove mutual funds to reduce cash levels to the quick in 1972? Optimism. Ebullience. Confidence. Exuberance. And quite probably Euphoria. The catalyst was the "Nifty-Fifty," a select group of stock issues that were–believe it or not–actually regarded as "one decision" stocks; just buy 'em and forget about 'em. The posit was that they would rise forever. Really. Growth on a scale never imagined before. Thus, the likes of Polaroid, Levitz Furniture, Teleprompter and Digital Equipment were bid up while cash was spent down. And where are those four now? Either bankrupt or gone. The top ten picks of 160 money managers in the January 1973 issue of Institutional Investor magazine included the four mentioned above plus IBM, ITT, Kodak, Gillette, McDonald's and Motorola. It was what David Dreman termed "The Ascendancy of Groupthink," a process whereby professionals abandoned principles for the comfort and safety of being in the majority. If all others were buying the top ten, one would also need to buy the top ten as well in order to survive. However, as Dreman so cogently pointed out in his brilliant opus, Psychology and the Stock Market (ISBN 0-446-97071-9), "....highly cohesive groups will often develop dangerously incorrect homogeneity in their views," further claiming that "Groupthink may account for a significant portion of all professional investment errors." Proof could clearly be seen in the performance of stocks after mutuals reduced cash to a record low, a "dangerously incorrect homogeneity." Over the next two years, the S&P 500 fell by 42%. However, the Institutional Investor Top Ten fared even worse, plunging 40.4% in 1973 and 67% over the two years 1973-1974.

We see Groupthink hard at work today in the acceptance of even lower levels of cash as appropriate. Of course, a significant part of twenty-first century Groupthink has been enabled by adherence to indexing as savior. Index assets never have a cash component; instead, by definition the indexes are invested solely in the indexes. On that score alone, index funds have reduced the cash ratios of mutuals but additionally, Groupthink has forced active managers to pare cash ratios as well - in order to survive. Fidelity Magellan is one of the largest actively managed mutual funds of all time, now running roughly $51 billion in assets. The fund grew so large in the late 1990s that it was closed to new investors. Six of its top ten hold-

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ing are Dow Industrial stocks. Nine of the top ten are amongst the very largest U.S. stocks, essentially mirroring the makeup of the S&P 500 index. So, how can Magellan compete with the index? It must either make huge bets on smaller companies or cut cash ratios to the smallest possible amount. In fact, Magellan currently holds 1.8% cash, far lower than the average mutual fund.

Thus, whether we view the trend towards indexing or the trend towards lower cash ratios for actively managed funds, we see Groupthink at work and a "dangerously incorrect homogeneity." Toss in the expansion of margin debt from the lows of September 2002 and we can theorize a third instance of Groupthink at work. Total margin debt is up 80% from the lows of September 2002 and is now above the level achieved at the end December 1999, *only a scant ten weeks before the stock market mania began to implode in March 2000.*

Incredible as it may seem, the shift towards the use of leverage is worse now. At the end of 1999, total stock market capitalization was $16.1 trillion, supported by $242 billion in margin debt, roughly 1.50% of total cap. As of the end of September, total stock market capitalization was $15.1 trillion, supported by $245 billion in margin debt, about 1.62% of total cap. Worse yet, let's focus on Nasdaq where margin debt is now at a brand spanking new record high, 25.7% higher than at the end of March 2000. As well, consider that Nasdaq traded then at 4573, 108% higher than last Friday's close of 2202. Leverage as a percentage of Nasdaq market capitalization is now FAR HIGHER than at the very peak of the mania.

Isn't it stunning that the media continues to focus on a housing bubble and to ignore what is once again happening in stocks? So, there you have it—a combination of less cash and more leverage—perfect ingredients for another blowup and most observers seem oblivious. A perfect scenario for a reversal.

Screw The Shareholders

In the October 17th issue of Crosscurrents (see "Opaque" Transparency, page 3), we mentioned that Dr. Patrick Byrne's August purchase of 25,000 shares of Overstock shares for over $1 million was not settled and delivered for more than 50 days. According to Byrne's broker, the seller's broker was Morgan Stanley. Dr. Byrne is the CEO of OSTK. One would think the CEO would receive his shares in a timely manner, no?

Why did it take so long? The reported answer from the Morgan Stanley people after repeated pressured to deliver was the following, "you have to understand that this is an extremely hot stock". We kid you not. Does this mean not too hot for Morgan to naked short but way too hot to deliver to the CEO? *Makes one wonder, did Morgan have a hand in easing down the share price in order to finally cover and deliver?*

What we didn't mention in the October 17th issue was that Dr. Byrne's father had also purchased shares, and that those shares had not been delivered as well. At the time, Dr. Byrne preferred to keep his father's business out of view. Finally, the implications of the situation are far too important not to reveal.

As of November 4th, roughly one-third of Jack Byrne's recent 200,000 share purchase of Overstock shares still had not been delivered, *nearly 90 days after the order was executed.* According to Mr. Byrne, his broker informed him that they had not been able to get the shares delivered from the seller's broker and that *there was no expected date for their delivery.* Happily, we can report the shares were finally delivered.

It is with some measure of irony that we also report Jack Byrne was just named Chairman of Overstock. Imagine that, the *Chairman* had great difficulty receiving delivery of shares purchased on the open market. To boot, Dr. Byrne's brother purchased 50,000 shares and only received delivery after telling his broker he would not accept interest charges on the margin until the shares were actually delivered. The shares finally showed up after his broker threatened the seller's broker with reporting the failed delivery. *But wait, it gets weirder.*

According to Dr. Byrne, a close associate was thinking about buying even more stock, *but was told by his broker that they would only buy the shares if there would be no subsequent request for delivery.* According to Patrick Byrne, that associate's broker responded, "the order would not likely be filled if he insisted on delivery, because no broker would sell them on that basis."

Chew on that a moment, if you will....

Why would the broker turn down the order?! Why should it be impossible for the seller's brokers to settle these transactions? Perhaps the brokers *never* had the shares to begin with? Perhaps the sell side of the transactions were not entered into in good faith? Perhaps this type of transaction is the rule and not the exception and most of us only receive a book entry of so-called ownership, when in reality, the shares may have been *created* as the result of a naked short position taken by the market maker and not borrowed from an actual shareholder? *Does anyone see where this is headed???*

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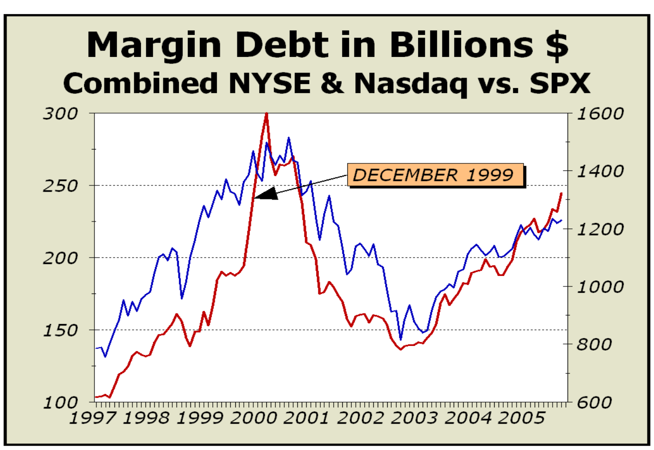

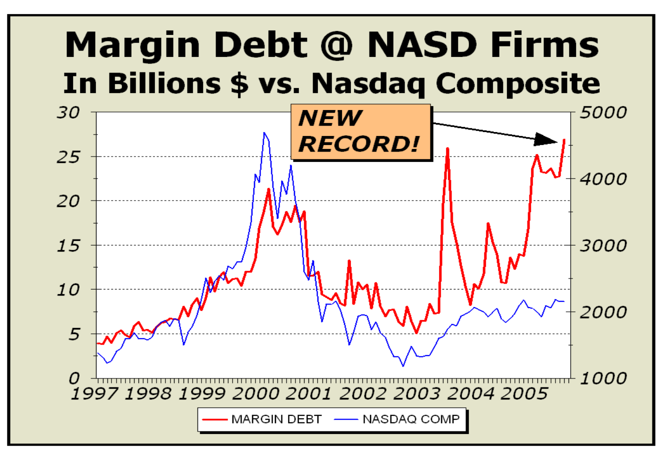

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Enough questions. We need answers. The Nasdaq Threshold list confirms that failures to deliver Overstock shares have endured for 145 days. That is at least 95,000 shares but undelivered shares could be as many as several million. No one knows! Actually, that statement is untrue. As Dr. Byrne reminds us, since the stock appears on the Nasdaq Threshold list each day, *someone* must know but no one is telling. Your Editor's FOIA appeal of the denied request for the number of shares of Overstock that had failed-to-deliver on August 1st is still in limbo, *although the data demanded by us is now way beyond stale.*

From our viewpoint, we see sufficient evidence that the system is horribly broken and no one can fix it because the process of even admitting it is broken will forever change the landscape. It is sufficiently discomforting to realize that at this time, at least 25.4 million shares of Overstock are "owned" while only 18.7 million are authorized, the remainder "created" by short sales, a process that cheats the basic economic tenet of supply and demand and in the meantime, hampers any effort the company might require to raise new capital, and also leaves shareholders with a smaller piece of the company than they bargained for.

We believe it is shameful that the mainstream financial media has paid so little attention to this worsening situation. But like Wall St. itself, it's all about selling. Do we really believe CNBC would ever genuinely focus on an exposé that might drive investors away from the market? Sadly, the Cramer franchise is worth multiples of any enlightenment offered by Ron Insana, one of very few to focus on the problem.

Of the company's 18.695 million shares, over 8 million are owned by the Byrnes and another 6.1 million are in the hands of just the top ten institutional holders. Dr. Byrne estimates that "friends" have between 1.4 to 2.4 million shares. For kicks, we'll just take the lower number. That's 15.5 million, leaving a float of under 3.2 million shares, *yet there are over 6.7 million shares sold short.* Given that a lot more institutions own Overstock than the top ten we just mentioned, we can make the case that the total short position exceeds the available float by an even (much) larger ratio.

And what of Wall St.? Hey, the magic is real. Sell a share, whether you have it or not. Then sell that *same* share again to another owner. And possibly again. And again. *How good does that get for the brokerage industry?* In our view, way too good. And precisely the reason why we expect it will get worse. Business is far too important, no matter the consequences. *Screw the shareholders.*

- REALITY CHECK -

"The trade deficit released this morning was nothing short of jaw dropping, logging an all time high of $66.1 BILLION last month! China alone accounts for about a third of this gap. We imported over $171 BILLION dollars worth of goods last month. To put this number into perspective, every man, woman and child in this country (nearly 300 million) imported about $570 worth of goods from abroad; $2,280 for a family of four. Even if you believe that our economy is growing at 3.8% (wink, wink), this pace of imports and trade deficits is not sustainable. The US economy in our opinion is standing on shaky ground to say the least."

- Jeffrey A. Hirsch, Stock Trader's Almanac
http://www.stocktradersalmanac.com/

Gold Still Acts Well

Despite the protestations of many seasoned observers that gold is on the verge of a significant correction, the yellow metal acts well and gold shares, in the form of the XAU and HUI indexes are not far from making new highs.

We are also in the correction camp but are not looking for anymore than a nominal downside, to perhaps no lower than $430 per ounce. *A larger correction—perhaps 15%—is still possible in gold shares.* However, even if the economy begins to suffer and energy prices and inflation begin to subside, we still see a super bull market in progress, which should act to limit the downside.

The chart at bottom left very clearly illustrates two distinct phases. In the first, the popularity of hard assets like precious metals, gave way to a surge in the popularity of paper assets. The arrows tell you all you need to know. The second phase, underway now for several years, is just the reverse. Thus, we expect the Dow/Gold Ratio, now at 23 to 1, to endure a steep slip slide in the years to come, conceivably to wind up somewhere under 10 to 1. The move will likely come as a result of a combination of lower stock prices and higher gold prices.

Note that the February 2003 bottom for the ratio at 22 to 1 is still in place. If that bottom is taken out, we would expect gold to be in the midst of another surge. Although virtually everyone expects major resistance at the $500 level, the number is only a psychological barrier.

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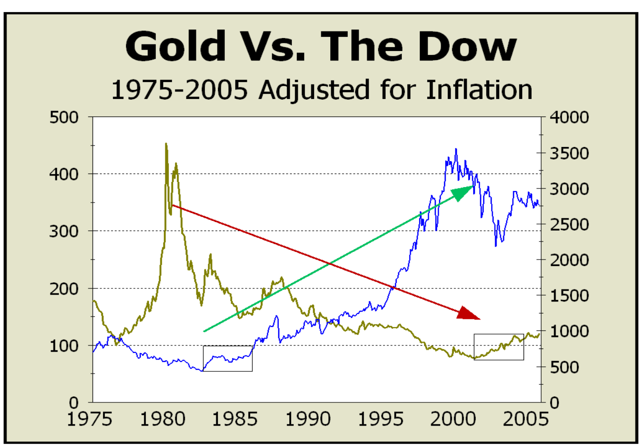

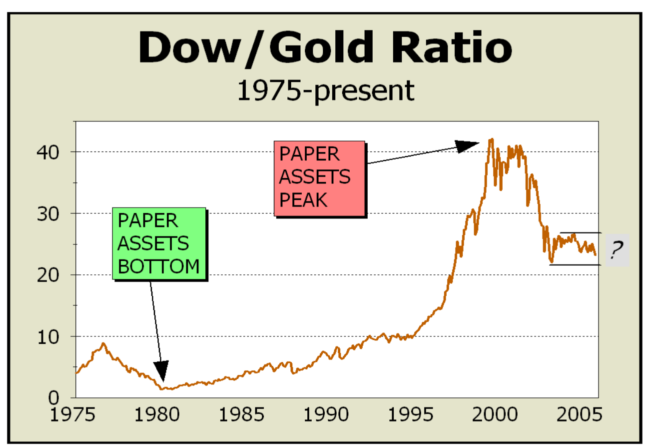

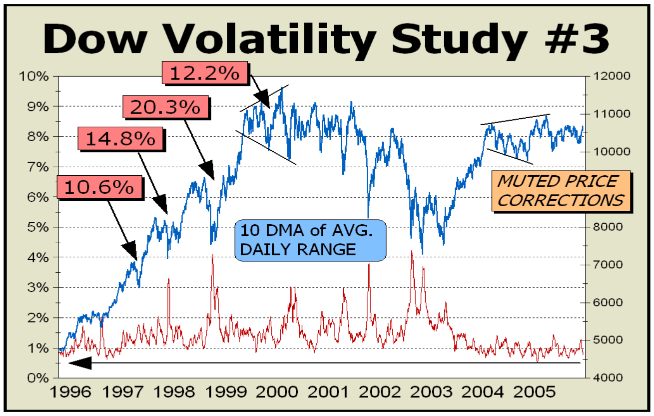

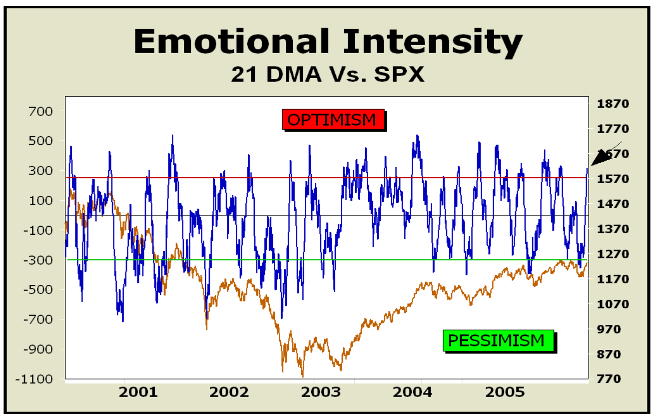

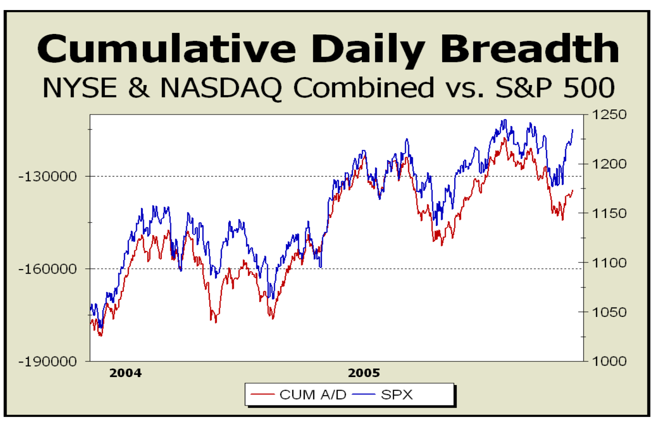

Samex Capital's Stock Market

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Alan M. Newman, Editor

Volatility has fallen again for most of our studies, and again is near decade old lows. Low volatility can feed a bull market, just like the old adage, "never sell a dull market short." However, this is also the kind of circumstance that leads to a blind side attack against the bulls, just like another old adage, "the calm before the storm." Given that the fundamental background is perilously weak (read higher interest rates, higher inflation, an unpopular President, energy prices, waning consumer confidence, etc.), it is quite astonishing that price movement remains so tame. Best bet: keep looking over your shoulder!

Emotional Intensity is still climbing and by definition, must be interpreted as bullish. However, all three incarnations of this indicator are now "extended" above the line that denotes optimism and only a cross back below that line is construed as a sell signal. There is no way to tell if the signal is imminent and it is possible that emotions could range at or near "optimism" for a while longer. *The most logical way to look at the rally is that it is in a "topping" phase.* Extreme caution is warranted.

More evidence that the rally is topping comes from a look at combined cumulative daily breadth. Clearly, the broader market has not picked up steam as the averages have. The divergence between breadth and price is somewhat startling, when you consider the sudden return to optimism. Why are folks so darn bullish if *less* stocks are rising....?

A Few Comparisons

Fed Governor Ben Bernanke will assume the position of new Fed Chairman after Alan Greenspan retires in two months. What a difference a Chairman makes. The 30-year T-Bond was 8.9% when Greenspan was appointed and is close to 4.7% now. The Dollar traded at more than 145 Yen and now trades below 116 Yen. Greenspan took over in the midst of an institutional mini-bubble in stock prices, just four months before a crash, and Bernanke will take the helm in the midst of a housing bubble. Whoa. Did we say housing "bubble"? Scratch that. Looking back again, we see average single family home prices were $85,200 when Greenspan entered the picture. They are now $212,200. Huh? That's price appreciation of a tad over 5% per year. By contrast, the Dow soared from 2278 to 10,385, more than 8.5% per year. And the rate of inclined growth has been higher for Nasdaq, roughly 9%. But we are to believe a housing bubble is in progress? So, why do the media continue to focus on housing and ignore the continuing mania in stocks? Beats us.

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THANKS TO:

KATE WELLING

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www.weedenco.com/research/welling.html

FOR COVERAGE OF OUR COMMENTARY

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OUR 16th YEAR!

Happy Thanksgiving!

- Rationales & Targets -

Our prognosis in the last issue was correct. We are still looking for resistance at SPX 1245. Support remains at about the SPX 1168 level.

Adding to the background showing extreme optimism by mutual fund money managers, who are holding the smallest cash-to-assets ratio in stock market history, are John and Jane Doe. Last week, the Investment Company Institute revealed that 50.3% of U.S. households now own stock, either individually, through mutual funds and of course, mostly via retirement accounts such as 401(k)s. ***According to ICI, this is the very first time a majority of households were investing.***

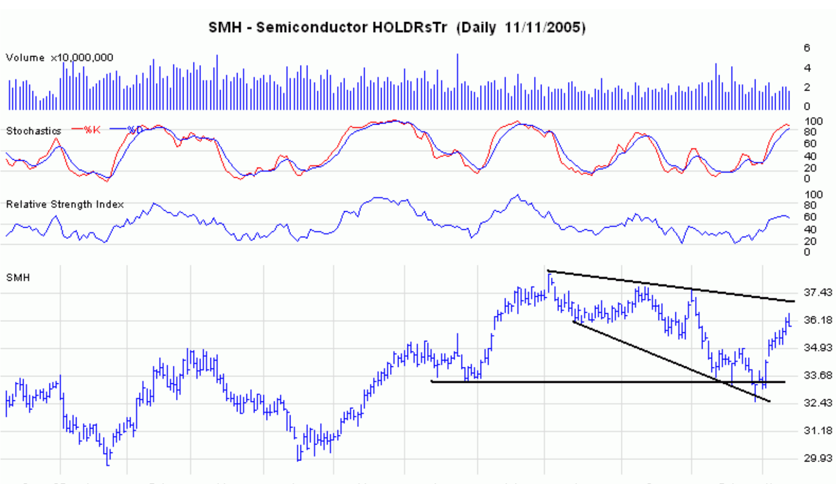
There's only one way to look at the developments of recent months. The public is extremely bullish on the prospects for stocks, not only with their aforementioned exposure but via the leverage evidenced in margin debt. Professionals are equally bullish, given the record low cash-to-assets ratio. So, who is not bullish?

Bullish investment advisors, according to Investors Intelligence, are back above the 50% mark and are more than double those who count themselves as bears. Bulls have exceeded bears every weeks for nearly three years now. And the AAII survey of the "little guy" now shows 58.6% bulls versus only 23% bears, a very sharp turnaround in just two weeks.

Our indicators of emotion confirm that confidence is running extremely high. Wherever we look, we see virtually no hesitation to the bull case despite circumstances that would ordinarily rate huge red flags, like the continuing march of interest rates towards higher levels. ***We see all the hallmarks of a topping process in place.*** There appears to be little concern about the prospect for a large correction at this juncture. We suppose participants are depending upon favorable seasonality to take them into the spring without a problem. Not us. ***We're raising the red flag.***

Wireless Facilities (WFII) continued to breakout on November 3rd, trading as high as $7.25 on very strong volume and then disappointingly collapsed just two sessions later on a poor 4th quarter earnings forecast. We were stopped out, proof that no matter how good a chart may appear, there are never any guarantees. Our only choice: move on.

We're not about to short until we see a reversal commence, but the SMH Semiconductor Trust looks like a great candidate for the downside. The horizontal support line dating back to June broke quite easily and emphatically. Also, bottoms are falling at a steeper level than tops, a sign that traders are anxious to get out at the first opportunity. Plus, Relative Strength is rolling over and Stochastics appear poised to flash a "sell." Constituents are at www.etfconnect.com. TXN appears ready to short now.



FAIR WARNING & DISCLAIMER:

The Psychology of the Market

Strategists: 65.3% stocks - 10.7% cash: Still Complacent
Newsletter Writers: 10 Week Bull/Bear Ratio: 1.8 Optimistic
(AAII): 3 Week Bull/Bear Ratio: 1.4 Optimistic
Mutual Funds: 3.8% cash: ALL TIME RECORD LOW!
Rydex Sentiment: 2.9 Rapid Return To Optimism!
(Bull & Sector Funds vs. Bear Funds)
Put/Call Ratios (our indicators): BULLISH, BUT EXTENDED
SHORT TERM OUTLOOK: TOPPING/CAUTION!
INTERMEDIATE TERM OUTLOOK: NEUTRAL

Crosscurrents '05 Investment Stance

iShares Lehman TIPS Bond Fund (TIP)*
$104.98 now $103.06 +2.5% for 2005
+9.9% from inception in January 2004
iShares Japan Index Fund (EWJ) - "half" position
$10.60 now $12.34 +16.4%
GOLD shares (XAU/HUI proxy) 10% LONG
From 5/12/03 (XAU +55.8%)
NEWMONT MINING 10% LONG
$42.75 now $44.31 +4.1%*
*** includes dividends**
Vs. DJIA –0.9% SPX +1.9% Nasdaq +1.2%

Crosscurrents '05 Trading Stance

NEM (NYSE) = 20% LONG from 1/24/05 (+4.1%)*

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)
QQQQ = 30% SHORT +1.2% (CLOSED)
WFII = 20% LONG –14.2% (CLOSED)

We're removing the Trading Stance closeout target for Newmont Mining at $47.50. If the stock makes it there now, we would expect it to test the $50 level in short order.

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