Alan M. Newman's Stock Market

CROSSCURRENTS

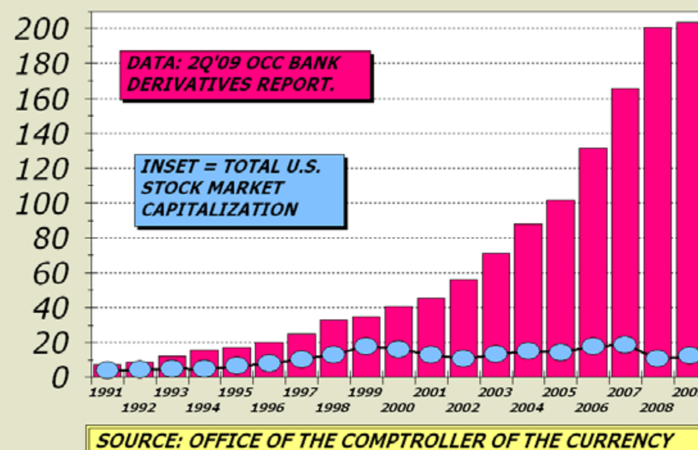
U.S. STOCK MARKET OUTLOOK for NOVEMBER 9, 2009
DJIA 10,023 - SPX 1069 - NASDAQ 2112

NOTIONAL VALUES OF DERIVATIVES CLIMBS TO 14.5 TIMES GROSS DOMESTIC PRODUCT. GOLDMAN SACHS CREDIT EXPOSURE NOW 9 TIMES RISK BASED CAPITAL. RETAIL INSIDER SELLING EXPLODES. *- NEXT ISSUE - NOVEMBER 30, 2009 -*

Capital Is Still Moving Into Derivatives, Not Concrete.

Every few months we focus on the rapid growth of derivative products, their effects and the implications for the future. We began this journey in January 1999 when we created the Pictures of a Stock Market Mania website. Our commentaries and charts obviously hit a nerve as our readership expanded and we now have an audience comprised of viewers from 175 countries around the globe.

Our stance has always been that the largely unregulated and unfettered growth of derivatives placed undue strains on the financial system and was bound to catalyze dramatic failures on a somewhat regular, if infrequent basis. Clearly, the stock market Crash of 1987 was a derivatives failure. Stock futures trading had exploded as institutions foolishly believed they found a way to insure their portfolios against losses. If only the world was that simple! Then in 1998, Long Term Capital Management foolishly believed it had found a way to pile on leverage without increasing risks to the breaking point. Although they would only extract a tiny percentage of profit from each of their derivative contracts, the extent of their leverage meant huge profits....as long as the models worked. The models failed, LTCM failed and the entire financial system nearly came crashing down. The hiatus was only nine years. Another nine years elapsed before we suffered the worst financial crisis since the 1929 stock market crash decimated America's wealth and placed the population in a relative dark age for another decade to come. The 2007 episode was also predicated on "models" that might function in a perfect derivative world, but the past is a stern teacher and it is painfully obvious that we will never live in a perfect world, derivative or otherwise.



Amazingly, notional values of derivatives have continued to grow, and reached $203.5 TRILLION by the end of the second quarter of 2009. While the ratio of notional values versus total stock market capitalization has contracted nominally from 18.9 to 16.6, the ratio of notional values versus gross domestic product has risen from 14.1 to 14.5. Only a decade ago, those respective ratios were only 2.0 and 3.6. We're not talking just "growth" here, we are looking at a runaway train. Is there anyone in the world who believes this pace can continue? Extrapolating at the rate of the last five years alone, in another five years, notional values of derivative products would total $560 trillion. If GDP grows at 5% per year, the ratio of notional values to GDP would reach a staggering 30.8. Ian McAvity (see http://www.topline-charts.com/Deliberations.htm) has pointed out many times how economic growth

(Continued on page 2)

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(Continued from page 1)
has been fueled by the rapid expansion of debt in America, positing that every dollar increase in GDP requires at least $3.50 in new debt [NOTE: McAvity computes that recently, every dollar of growth has required as much as $7 in new debt]. If that pace can be sustained, then surely pigs can fly. But we digress....

At left below, a chart we shown at least a dozen times over the last few years. The top five banks account for 97% of all derivatives and their total credit exposure is a combined average of 324% of their total risk based capital. And incredibly, that ratio is down from our last report through the fourth quarter of 2008, when it reached 489%. When Goldman Sachs was granted bank status by the Federal Reserve, the company overnight became the most phenomenal public entity ever featured in the OCC's quarterly reports on derivatives (see http://www.occ.treas.gov/deriv/deriv.htm). Goldman's credit exposure is now more than nine times its risk based capital. The company has a market cap of $91.5 billion but controls $40.48 trillion in notional values of derivatives. Goldman's assets total a mere $120 billion. And if that is scary, consider that since our last report, Goldman's assets have dwindled from $162 billion and derivatives have expanded from $30.28 trillion. The situation can grown to such bizarre extremes that parody has entered the picture, as witness this fantasy cooked up by the Borowitz Report (see http://borowitzreport.com/article.aspx?ID=7047). Clearly, there is now ample speculation that Goldman has way too big a role than comfort dictates. An outsized number of government bigwigs are Goldman alumni, such as former Treasury Secretary Henry Paulson. A decade ago, Robert Rubin, another former Goldman Alum, was also Treasury Secretary. Factor in stories such as Kurt Nimmo's October 15th piece (see http://tinyurl.com/ygrnool) and whatever confidence might be left in the system quickly fades.

- REALITY CHECK -

"...our financial system is gasping for capital because of...excess leverage and speculation...you need capital to alight somewhere and to build concrete things, rather than buying things and selling things."

- George Phalen, Chairman NYSE
In response to the crash of 1987

At right below, we have culled our usual perspective of the seven largest banks down to four. Just the four banks pictured below represent 94% of all derivative products peddled with elan by their proprietors, confident that mathematics will carry the days, weeks, months and years without cause for regulation and without significant odds for eventual failure. We hasten to point out the smaller line of bars, barely visible, represent the total assets of the banks in view. As we have stated before on many occasions, the utilization of these contracts and models have allowed banks to take on extraordinary risks and leverage. *Just as entropy cannot be removed from a closed universe, risk can never be removed from a closed financial system*. The more the players rely on hedges and mathematical models, the less reliability for forecasted human response and eventually, a corrupted model.

The OCC publishes metrics in every report, including detailing how gross negative fair values are countered by gross positive fair values, resulting in a "netting" benefit for banks. In the Q2'07 report, netting benefits granted a "net current credit exposure of $199 billion, but also specified a "potential future exposure" metric that curiously, is no longer published. That metric was $1.659 trillion, which coincidentally, is almost precisely the amounts lost by financial companies to date in the wake of this fiasco. As of Q2'09, netting benefits run $166 billion but gross negative fair values are close to $4.5 trillion. *Heaven forfend losses ever reach those levels*.

Those who know us from many years ago, know our former propensity for optimism and bullishness. As the market for derivative products has expanded, our former bullish tendencies contracted and were replaced by realism. As the Chairman of the NYSE once observed (see inset), *the future is built upon concrete, technology and the workforce, not financial contrivance*. Amen.

The Retail Sector Has Topped

We strongly urge subscribers to revisit the March 30th issue, "Evidence That The Retail Sector Is Sold Out." (see http://www.crosscurrents.net/z033009k.pdf) Our page one chart showed that insiders had pulled back dramatically from their normal stance. The top ten retailers as represented in the Retail HOLDRs Trust (RTH) sold only 1.83 million shares in the previous six months, as opposed to an average of

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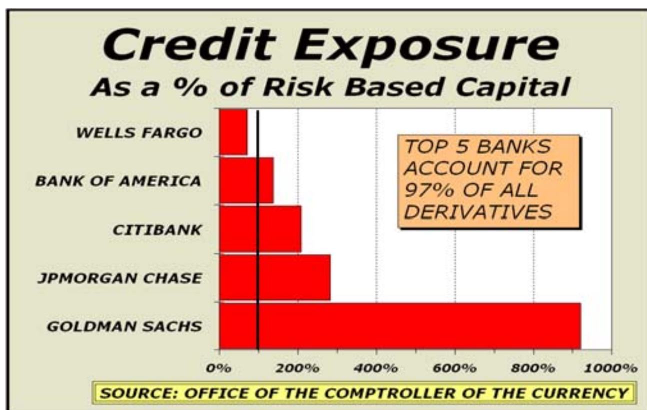

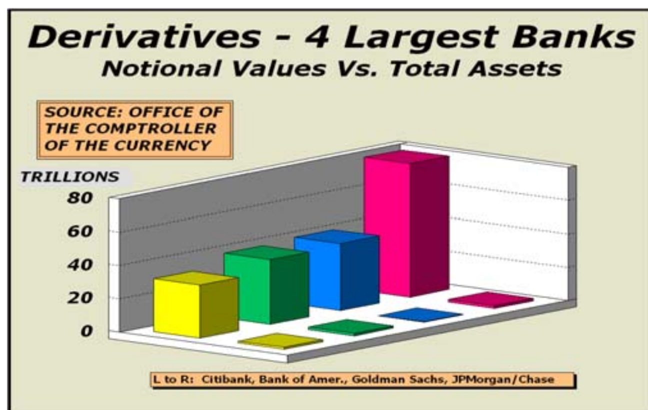

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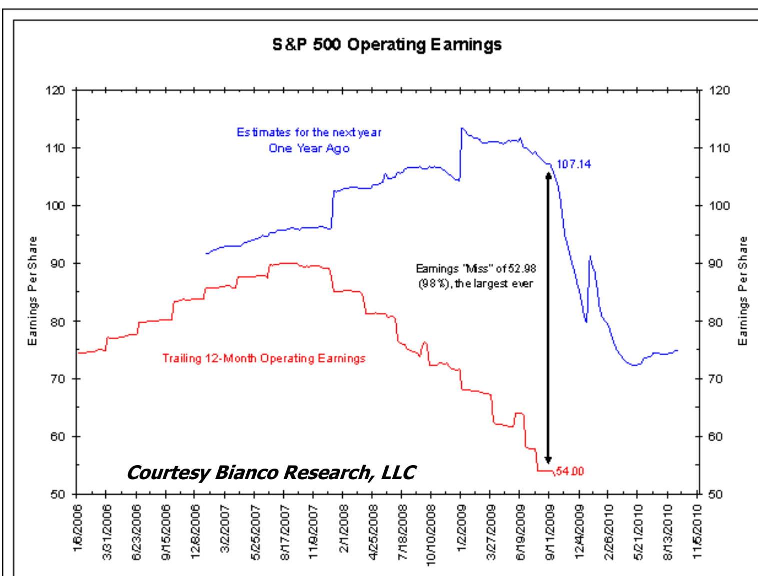
roughly 10-1/2 million shares in our previous five tallies dating back to December 2006. The RTH bottomed on March 6th at $60.23, 13 days before our chart was created and our premise that the sector was sold out was clearly justified. By October 20th, the trust peaked at $93.96, a 56% rally.

However, as our chart below left illustrates, insiders were already beginning to expand their selling by an interim tally in August. By last Friday, when we again tallied the stats, insiders sales over the prior six month period had exploded to 16.3 million shares, almost nine times the rate in the spring! Apparently, the environment has changed. What was cheap is no longer cheap and the logical inference is that going forward, the economy is not expected to be all that robust. Given the third quarter GDP report and all the accompanying hullabaloo about the end of the recession, the chart below implies either a flat economy or even a double dip into recession. Look at the comparisons; the only two other late year tallies were in 2006 and 2008 and selling was relatively restrained in both. Clearly, retailers are selling their shares in droves and only weeks before the beginning of the holiday season that accounts for 30% of all retail sales.

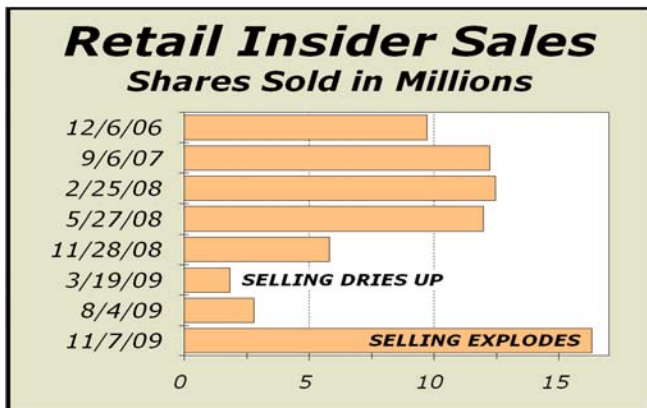
As well, analyst ratings have ticked up markedly and if there's any metric we might dismiss as utterly contrarian, that would be analyst ratings (see chart below right). As prices in the sector moved up 56%, analyst sell ratings dipped from 6.8% to 3.9%. Buy ratings have surged, from 47.5% to 61.2%. The RTH was above the current share price for much of the four year period from 2004 to 2008, when GDP averaged 4.7%. Is the retail sector a buy now? With even the huge stimulus only capable of 3.5% growth, the sector is now overbought and has likely topped.

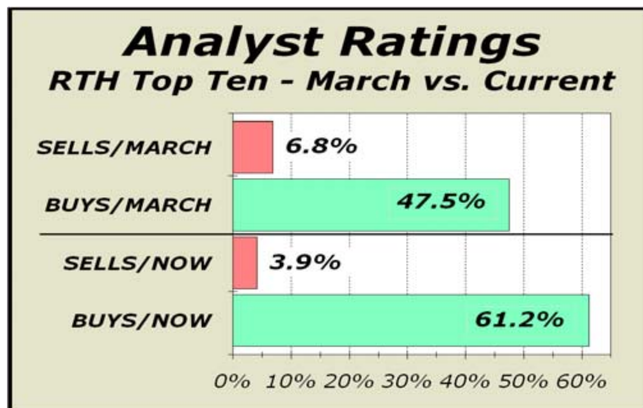


Earnings Estimates

Jim Bianco's biancoresearch.com is one of the best resources for info that we have ever had the pleasure of visiting and Jim is clearly one of the savviest minds on Wall St. The chart at center comes to us courtesy of Jim and quite properly illustrates the old adage. "take it with a grain of salt." Analyst's earnings projections have been far off the mark for too long for us to get excited. In fact, according to http://tinyurl.com/y8efs7b, the last time the majority of companies failed to beat their forecasted earnings was roughly 13 years ago, thus Mr. Bianco muses sarcastically, "*why did the stock market ever go down in the last half-generation?*" So, how do companies seemingly always beat their estimates? Estimates change as time passes and what you read about are only the sound bites from the last estimate generated perhaps only a few weeks before the announcement. As Bianco correctly opines, "*We have likened this to the point spread in a football game getting reset with 1 minute left to play.*" The chart at center illustrates estimates (top line) that were generated a year in advance. As you can readily see, analysts have consistently overstated the bullish case and have done so as far back as we can remember.

Despite the Q3 report on GDP, the economy is anything but robust and is only barely on the mend. The $787 billion stimulus is not likely to be repeated and in any event, has still not resulted in job growth. Cash for Clunkers was a dud and despite the renewal of the $8000 tax credit for new home buyers, a cursory look at the chart of the XHB Homebuilders ETF suggests job growth will remain wanting for quite some time to come. Bianco says "*investor relation departments....do everything in their power to make sure the headlines say their company beat earnings estimates. But, beating the last estimate has no economic value. To gain any insight on the economy based on earnings estimates one must take a longer-term view.*" That longer term view is not encouraging at all. ☑☑☑☑☑





We have shown our top left chart several times recently but it keeps on getting more interesting. The Dow has been overlaid lagged by *exactly* one year. A bull market requires stocks. With more stocks, there is more interest and higher prices. Less stocks, less interest, lower prices. At least this is what the pattern implies. The number of stocks trading daily peaked on October 17, 2008 and the Dow peaked almost exactly one year later, on October 19th. Also of great interest, our ten-day moving average may have bottomed as of October 14th. Given our forecast that the bear market would end in October 2010, if we are correct, the lagged Dow would nail the bottom as well as the top. Stay tuned.

Net new highs for Nasdaq have recently taken a hit and are hovering right above the zero line. For five consecutive days, new lows exceeded new highs, the first time we have seen that circumstance since March. The circled area shows the only period where a retreat from a peak was followed by higher prices. Even then, Nasdaq suffered an interim correction of 10%. The present correction stopped at 6%. More downside should be in store.

The sentiment measures we monitor are quite conflicted. However, the last time extreme pessimism was visible for our key indicator was on March 16th. Almost eight months without any correction capable of triggering even one small bout of pessimism may sound great in theory but is more likely a warning sign of extreme complacency.

Inferior Fundamentals

The 60% rally in stock prices and the accompanying conversion of vocal bears to compliant bulls is as extraordinary a circumstance as we have seen in 45 years of following the arena. There have been only six 60% rallies in the last three decades and all were accompanied by vastly superior fundamentals. The proof is at http://ow.ly/vmN1. While we cannot completely exclude a much better environment somewhere down the road, it can only happen with employment growth. So far, not good, not good at all.

☑☑☑☑☑

THANKS TO:
STEVE HOCHBERG
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FOR COVERAGE OF OUR COMMENTARY

☑☑☑☑☑

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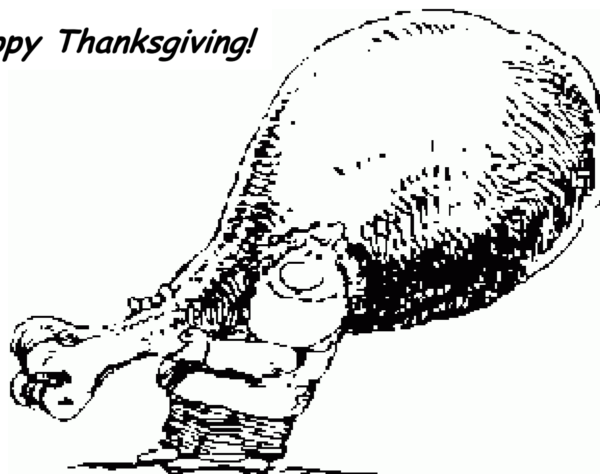
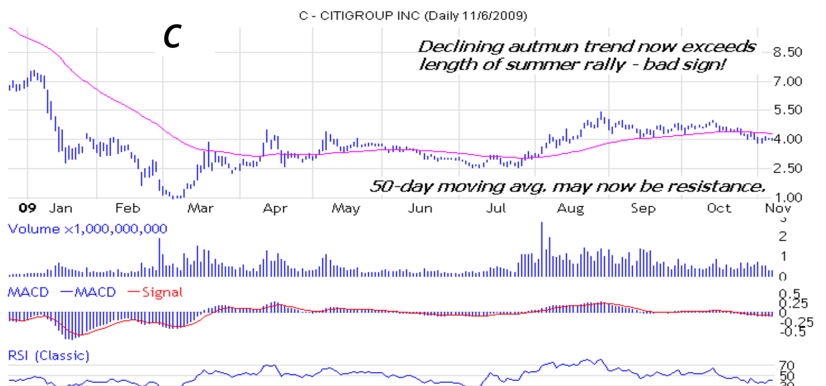
Happy Thanksgiving!

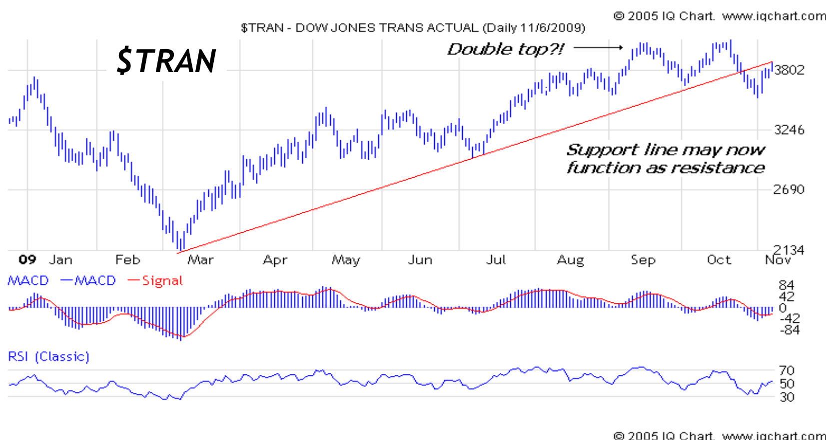


- Rationales & Targets -

In the last issue, we forecast that "*at the end of September [the mutual funds cash-to-assets ratio] was likely down to 3.8% or worse.*" The ICI's September update confirmed we nailed it—3.8%. We are compelled to reiterate, the only lower readings were from March to September 2007, one of the most significant tops in market history. Given the continuing advance in prices, it is possible that the ratio is now quite near the all time low of 3.5% in June & July 2007. Yet another cycle of manic behavior by portfolio managers is simply totally ignored by the financial media. There is a vast complacency visible on the TV news and in print, a gestalt that reiterates the probability of economic recovery and higher stock prices with almost zero concern for the failing fundamentals. On one hand, the stock market seems to be forecasting a bright Christmas and robust retail sales. But as we show on our chart on page three, bottom left, retailers have likely discounted quite the opposite. Why wouldn't they? Jobs are still being shed at a distressing pace. Unfortunately, there is ample precedent for another dip into recession. *Lower prices should lie ahead.*

Re last week's ideas, IWM was on target, dropping 10% in less than two weeks and the rally since could well be failing. If IBM follows, the stock market correction will be a fait accompli. Incidentally, check out RIMM and our chart in the Sept. 28th issue. Below, Citigroup (C) topped in late August, well before the other major banks, which topped in mid-October. Last week's low was the worst performance since August 17th and does not augur well. And last week, Bank America (BAC) traded at a more than three-month low. Then there's the Dow Transports ($TRAN), supposedly taking a pulse of the economy. We do not like what we see. Contrary to the complacency visible elsewhere, we are quite worried.





Our recent interview with Aegean Capital's Ike Iossif
http://marketviews.tv/channels/central.htm

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The Psychology of the Market

Inv. Intell.: 13 Wk. Bull/Bear Ratio 2.1 Highly Optimistic
AAII: 3 Week Bull/Bear Ratio: 0.7 Pessimistic
Mutual Funds: 3.8% cash: Euphoric!!!
Crosscurrents Emotion-Based Indicators:
NEUTRAL—OPTIMISM FADING

Intermediate Term Forecast

CLOSE UNDER DOW 9700 SHOULD TRIGGER A HUGE SELL OFF
REWARD/RISK RATIO IS HORRIBLE
UPSIDE POTENTIAL = LESS THAN 2%
DOWNSIDE RISK = 19%

Crosscurrents '04 Investment Stance
AVG. GAIN FOR ALL POSITIONS +17.0% Vs. DJIA +1.9%
Crosscurrents '05 Investment Stance
AVG. GAIN FOR ALL POSITIONS +32.0% Vs. DJIA –0.6%
Crossscurrents '06 Investment Stance
AVG. GAIN FOR ALL NEW IDEAS +29.2% Vs. DJIA +16.3%
Crossscurrents '07 Investment Stance
AVG. GAIN FOR ALL NEW IDEAS +53.5% Vs. DJIA +6.4%
Crossscurrents '08 Investment Stance
AVG. LOSS FOR ALL POSITIONS –14.3% Vs. DJIA –33.8%

Crosscurrents '09 Investment Stance

RETAINED FROM PREVIOUS YEAR OR EARLIER
Newmont Mining (NEM) 15% LONG +19.1%
Vimpel-Communications (VIP) 5% LONG +95.7% **CLOSED**
China Medical Tech. (CMED) 5% LONG –23.8%
Paraxel Int'l. (PRXL) 5% LONG +17.5% **CLOSED**
AVERAGE GAIN +24.8%
Vs. DJIA +14.2% SPX +18.4% Nasdaq +34.0%
"Retained" ideas priced from inception
Percentage gains (losses) include dividends

POSSIBLE FUTURE ADDITIONS

Pfizer Inc. (PFE) 3.8% dividend yield
Altria Group (MO) 7.3% dividend yield
AT&T Inc. (T) 6.3% dividend yield
ShengaTech Inc. (SDTH) 13 P/E - China/Speculative
Potash Corp. of Saskatchewan, Inc. (POT) 19 P/E
Express Scripts Inc. (ESRX) - 19 forward P/E
Suntech Power Holdings Co., Ltd. (STP) - China/Spec.
TransMontaigne Partners LP (TLP) - 9.5% yield

Crosscurrents '09 Trading Stance

Express Scripts (ESRX) 5% LONG +6.5% **CLOSED**
Paraxel Int'l. (PRXL) 5% LONG +1.5% **CLOSED**
Powershares QQQ Trust (QQQQ) 10% SHORT –26.1%