Alan M. Newman's Stock Market
CROSSCURRENTS

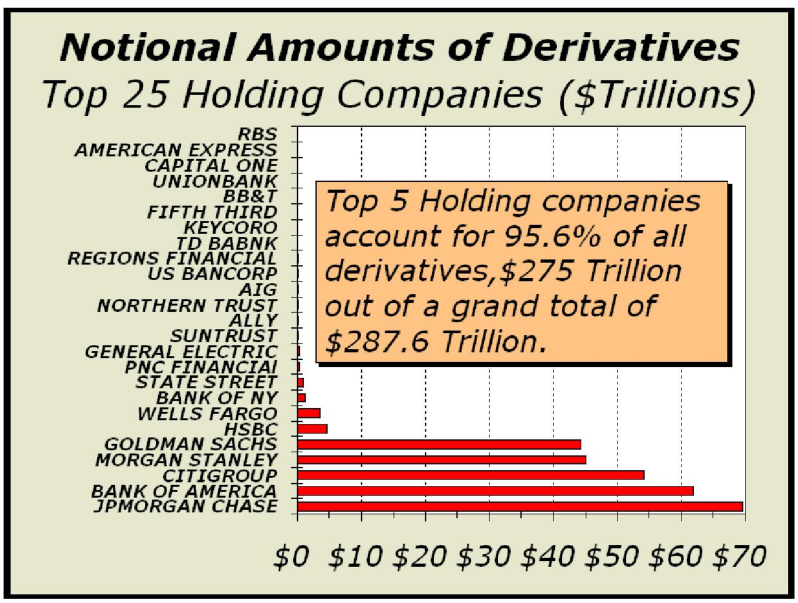
U.S. STOCK MARKET OUTLOOK for MAY 27, 2013
DJIA 15,303 - SPX 1649 - NASDAQ 3459

TOP FIVE BANK HOLDING COMPANIES NOW ACCOUNT FOR $275 TRILLION IN NOTIONAL VALUES OF DERIVATIVES, 17 TIMES GDP & 15 TIMES MARKET CAP. THE THIRD MANIA: UNMISTAKABLE SIGNS OF EUPHORIA. - NEXT ISSUE - JUNE 24, 2013 -

"...it does become difficult for us to prosecute them..."

On March 6th, U.S. Attorney General Eric Holder made a damning admission; that the government might have no option other than to allow an out of control banking industry dominated by a handful of major players take whatever liberties they wish in order to ensure profits, *including criminal activities*. As we witnessed in 2008, unfettered unethical and criminal behaviors resulted in monumental problems for our economy, taking us to the brink of financial collapse. Mr. Holder's succinct appraisal (see http://huff.to/XTwwDn) is testament to perhaps the worst problem the nation has faced in generations; *not only will big banks continue their nefarious ways, nothing will be done about it*. Forget any hue and cry. Given nearly three months since Mr. Holder's assessment and virtually no additional critique by the financial media, our ignorance is astonishing. Mr. Holder's words were crystal clear; "*I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps even the world economy.*"

The bad players have way too much clout. If there were any doubt that blame might be apportioned logically in the future, the doubt has now been completely and effectively removed by the government's claim that the very act of prosecution is likely to be unenforceable, else the world economy be sent into a tailspin. *As a result, we have likely ensured a never ending repetitive cycle of criminal activity.* This is in fact, the nature of the human beast. *If an advantage can possibly be taken, it will*. Criminal advantages require weighing the consequence of conviction. If there are no consequences, the rationale for such activity is *compelling*.



As of the end of 2012, the Office of the Comptroller of the Currency (OCC) tallied notional values of $223 trillion in derivative contracts for commercial banks. We have covered the subject for many years and have referred to this tally, which is interestingly, far from complete. The more encompassing category of bank "holding" companies changes the picture considerably. We will likely continue showing our original charts, with data back to 1991, when derivative constructs were still in their infancy, but the chart at left details bank *holding* companies and what you see now tops out at $287.6 trillion, an amount equivalent to fully 18 times the nations gross domestic product (GDP) and 15.7 times total stock market capitalization. While notional values do

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not directly equate to systemic risk, their size in relation to the economy and the national wealth, do indeed, represent a relative measure of systemic risk.

Although notional values for commercial banks remain 3.5% below their 2010 record peak, they are nevertheless, high enough to imply risks *very nearly* equivalent to those suffered previously. Financial constructs do not magically appear. They are designed and put together by mathematical models that simply cannot predict the future. Yet, the basic assumption is that they provide protection while fostering economic growth. *Both notions are grossly incorrect*. Breaking down the last 22 years into discrete periods always evidences more recent phases as sub par for growth and totally incapable of handling even the grayest of black swans.

At left below, the trend for notional values of derivatives for commercial banks is compared to the 5-year growth rate in GDP. Although the pattern is not straight down, we interpret the upswing from 2001-2006 as one significantly impacted by a Federal Reserve policy intentionally laying the groundwork for the huge housing mania that followed. It is no coincidence that this strategy was accompanied by extremely rapid growth in derivatives. From the end of 2000 to the end of 2007, total notional values of derivatives expanded by an astounding 22.3% annually.

Clearly, the further growth of notional values has accomplished nothing of substance, but rather a continued decline in economic growth. The single most salient factor that has gone almost entirely unnoticed is that these financial constructs cannot possibly function as intended when they are used on such a widespread basis. Ironically, the implied protections offered by CDOs, SWAPS and the like actually *encourage* additional risk taking. This is a paradox that is roundly ignored. While it certainly seems possible for single entities to remove risk, risk reduction on a widespread scale is impossible. *Systemic risk is inviolable*. Risk may not be removed from any closed economic system, risk may only be transferred from one entity to another. We need no additional proof beyond the 1998 collapse of Long Term Capital management and the near financial collapse of 2008. *The size of notional values of derivatives remains a constant threat and will continue to suppress longer term economic growth*.

Given the admission that larger banks may now be in a position to flout the law without fear of prosecution, the odds have risen dramatically that such a situation will occur. As we have previously discussed (see page four, "Off The Hook", April 8th issue), the statute of limitations ensures that criminal activity from the previous housing bust can no longer be prosecuted. Simply put, the temptation to play in a criminal manner is now a compelling choice and it is ridiculously easy when financial constructs can be utilized to tilt the playing field as they were before with sub prime mortgages. Ultimately, the public cannot possibly benefit. Investors cannot benefit. The larger banks shown on our featured chart will benefit, but only until such time as they egregiously misjudge the consequences to the markets, the economy and the country. Perhaps criminal charges would indeed, have a negative impact on the U.S and world economy. *The lack of criminal charges will also have the same negative impact*.

Long Term Returns

The greatest bull market in history, culminating with the tech mania, had an incredible effect on twenty-year annualized returns. Despite two of the most memorable collapses in stock market history, when stocks were cut in half from 2000-2003 and then cut in half again from 2007-2009, twenty-year annualized returns for the Dow Industrials remain quite robust, at 7.6%, ex-dividends. The historical record clearly places these returns at the very top end of a scale showing a far lower 5.17% annualized average for 96 years dating back to 1917. Clearly, the most recent period is head and shoulders above the past. In fact, during the 78 years from 1917-1995, twenty–year annualized returns averaged only 4%. Can returns remain at the elevated levels seen since 1995? *Not a chance*.

The simplest reason is that asset classes must compete or perish. The principal differentiating factor is risk. Thus, bonds will typically grow at a far lower rate than stocks, because the return is relatively assured. However, if stocks could be counted on to return 7.6% over all twenty-year periods, there would be almost no incentive for bonds to even exist. It is also important to understand that the huge secular bull run from the 1982 lows came only after stocks suffered through an extremely long period of underperformance from the mid-1960s, when the Dow first hit the 1000 mark. After 16 years, the Dow was at 776.

Thus, we are strongly inclined to believe that twenty-year annualized returns must decline to historically valid levels as time passes. While a correction or bear market

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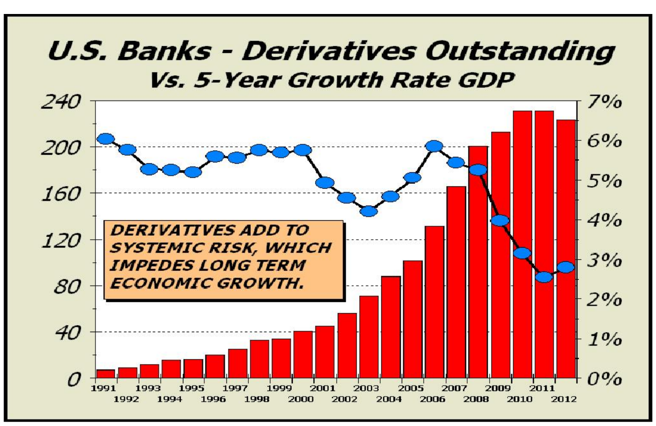

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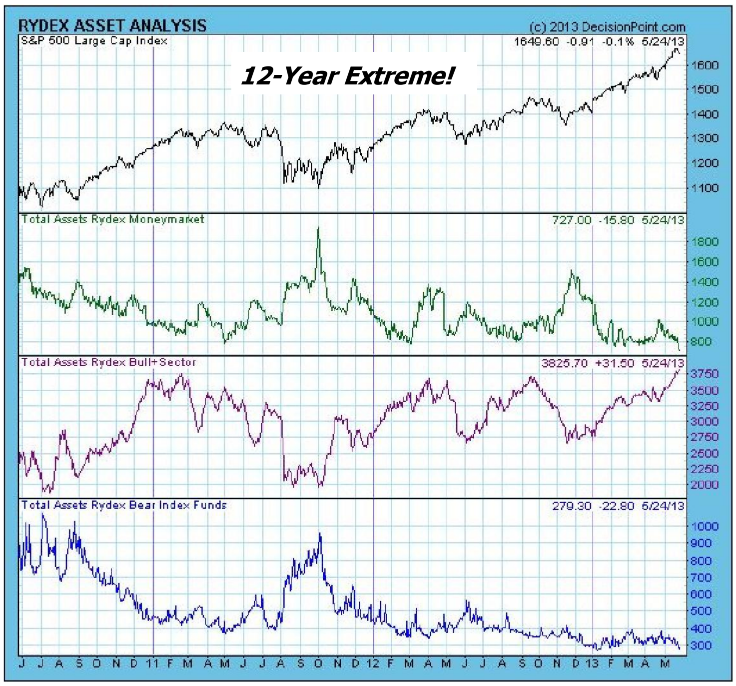
might achieve those levels sooner, all of the scenarios we extrapolate today seem lousy. If we are correct, the future for stocks is not at all attractive. If the Dow falls to 10,000, the historical average of 5% annualized gains over twenty-year periods would not be achieved until February 2015. At Dow 12,000, it would require an additional ten weeks out to May 2015. Even at Dow 15,000, meaning a relatively sideways jaunt for prices, the journey would take us out to March 2016 before our implied norm would occur. Add into the mix the expectation from any of these points would realistically still be gains of only 5% per year and the current level of excitement and euphoria is unmistakeable; a third phase of mania, following the tech madness that ended in 2000 and the housing and stock boom that ended in 2007.

Third Mania Ending

The first of the manias we have referred to was clearly the public at its most rabid, eager to dive into Nasdaq at a 250 P/E and daily prognostications of higher prices. The second was built on perceptions of a permanent wealth effect, that permanently higher housing values would mean more money for stocks resulting in a virtuous cycle. Given that investor's stock wealth was cut in half twice and the public has pulled $600 billion from portfolios, the current phase appears to be primarily limited to one of the most prolific episodes of Groupthink practiced by Wall Street professionals, including hedge funds.

However, the signals of euphoria abound in all the same places we have seen them before, both for professionals and for the public. On Friday, FINRA released the April margin stats showing leverage rose to the second highest level in market history, only a stone's throw away from the record high of May 2007. Given the slim gains in April and a burst of energy in May, we are likely at a brand new record

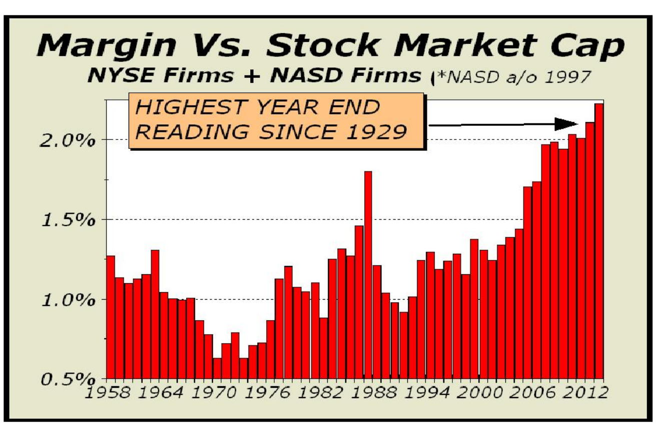


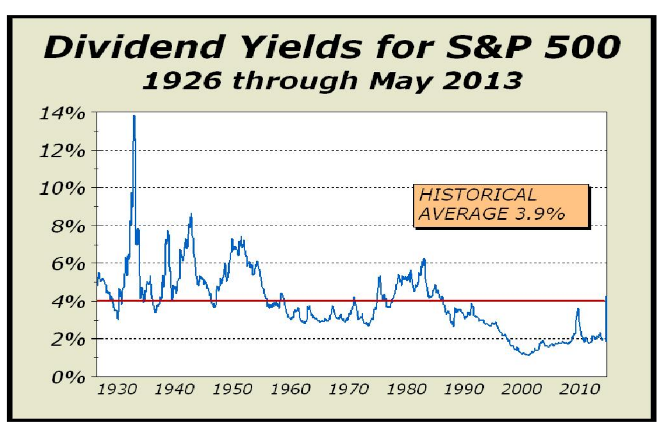
high at this very moment, possibly by a wide margin as well. When measured versus GDP (see page three of the April 29th issue), margin debt is at the same levels the market reversed and collapsed in 2000 and 2007. *But even those comparisons pale in the face of the chart at lower left, showing margin debt relative to total stock market capitalization.*

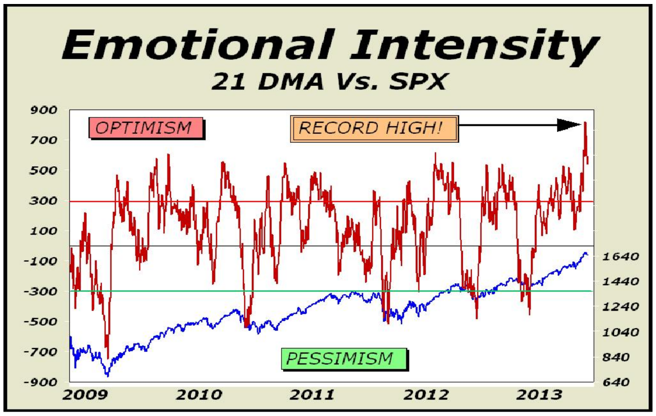
We also see clear evidence of euphoria in the Rydex Ratio charts (courtesy of Carl Swenlin's Decisionpoint, see www.decisionpoint.com). As of last Friday's close, there were $13.70 in Rydex bull and sector funds for every $1 in bear index funds. The Rydex Ratio, which divides bear and money market assets by bull assets fell to 26%. Both of these measurements are the most lunatic we have seen since the tech mania and they are so far in excess of the norm of recent months that we can only conclude that a major top is upon us. While we have had difficulty timing the expected reversal, *last week's action should be sufficient to end the lunacy.*

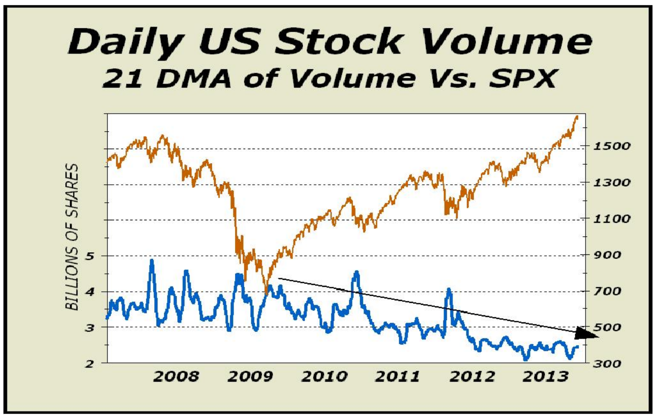
Investors Can't Win

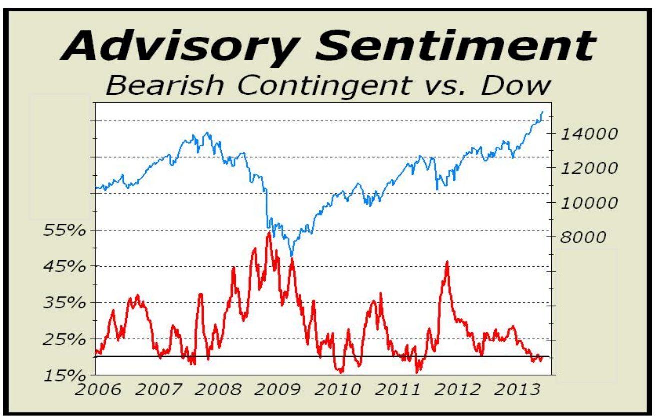
Recently, we featured a chart of cyclically adjusted price earnings multiples (CAPE) and commented on Tobin's Q Ratio, two important measures showing a hugely overvalued stock market. Below right, dividend yields for the S&P 500 point to the very same circumstance, a hugely overvalued stock market. Until 2000, dividends yields averaged a generous 4.27%, thus stocks were typically a great investment. Decent gains on an annualized basis plus dividends and even the prospect of dividend growth gave investors the best of all possible worlds. However, the modern era of manias has afforded no such generosity. S&P dividend yields since the 2000 mania top have averaged a paltry 1.85%, less than half the historic average. Of course, we live in an era of insider sales and insiders don't want dividends paid to stockholders. *Investors cannot win.* ☑☑☑☑☑











Alan M. Newman's Stock Market

CROSSCURRENTS

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Alan M. Newman, Editor

Our Emotional Intensity indicator hit another record high last week, and this one was a record by a wide margin. In fact, all three incarnations of the indicator ran to new records. We admit we've seen far greater activity in index call buying in the past, but our indicator measures the relation of call to put buying and at the moment, the relationship is bizarre. Historically, more money flows into puts, since fear is a stronger emotion that greed. Not so anymore. *Much* more money flows into calls and puts lose premium at a far more rapid rate than we have ever seen. Given how extended the indicators are, it's difficult to believe anything other than a huge reversal in mood and soon.

Clearly, prices have been going up for a long time but they have been rising on less volume for several years now. Ironically, we are reading more and more comments about the birth of a new secular bull market and the stance of bulls has become particularly aggressive in recent weeks. But, as we see at center left, the trend for volume remains lower, testament to a tired bull phase. It is very late in the game.

The mood is shockingly one sided from so many perspectives, particularly professionals. The cash-to-assets ratio (not pictured) for mutual funds traded down to 3.9% in December 1972, a record not exceeded for 35 years until March 2007, only a few months before a enormous peak in prices. Since then, over the last six years, the cash-to-assets ratio has *averaged* 3.9%. At bottom left, the Investor's Intelligence weekly tally shows the bearish contingent under 20% for eight of the last ten weeks. A bear contingent under 20% has coincided fairly well in the past with price peaks.

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WE WILL BE ON A MONTHLY PUBLISHING SCHEDULE UNTIL MID-OCTOBER .

Alan Abelson
1925-2013

When Alan Abelson began writing Up & Down Wall Street for Barron's in 1966, I became an instant fan. His command of the language was extraordinary and he used his knowledge to accentuate every essay with candor and wit. I don't think I ever missed one of his columns.

I'm so jealous of any of you who may have worked closely with him or knew him personally and took pride in his considerable skills. Although I spoke with Alan several times, I never met him, even after my better half prodded me constantly to visit Barron's offices and at least spend a few minutes in person with the man who graciously and often quoted my own work in his weekly column. He has my eternal gratitude for allowing me some measure of exposure in an environment ridiculously corrupted by bad advice and bad players.

Thank you for your many years of perceptive commentary, Mr. Abelson. Your words have been heeded. Skepticism is so often the sword of truth and that weapon needs to wielded constantly. I will greatly miss your wit and your wisdom.

Alan M. Newman, Editor
Crosscurrents

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THANKS TO:
DAVID ROBINSON
Bull & Bear's Monetary Digest
www.thebullandbear.com

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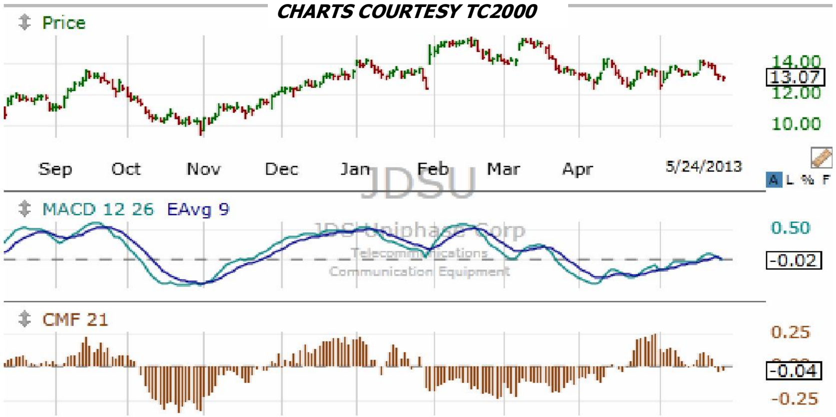
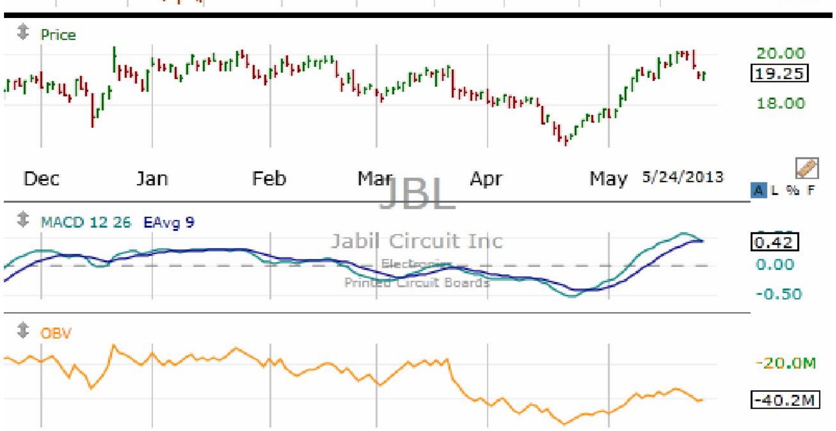
- Rationales & Targets -

Back in late 1999, we were aghast to see prices surge to levels that implied 30%-35% growth rates for tech companies as far as the eye could see. We knew we were in a mania and we emphatically said so in each issue. By early 2000, we knew the end was close by. In the February 28th issue, our headline ended "Nasdaq crash now likely…." We cited valuations, margin debt and the low cash-to-assets ratio of mutual funds, the very same factors we have focused on here for many months. It still took another ten days for prices to bust the bubble in 2000 and we may still be a week or two from a similar top now, but we are as fearful today as we were more than 13 years ago. We believe the Fed's shift in attitude belies the recognition (finally!) that the stock market has indeed, gone to bubble extremes. We'd love to consider the possibility of a soft landing for stocks, but it is not a logical outcome. It's been over four years since we saw any real fear. It's not just optimism and euphoria, it's the complacency and smug attitude that nothing can go wrong. ***We expect it will.***

Two more short candidates but again, no point in taking action until a decline is underway, so use caution. JDS Uniphase (JDSU) has lost 16% while the Dow has gained 6% since mid-March, repeatedly testing support around $12.40. The evidence, including multiple rally failures, supports the case for an eventual breakdown, rather than consolidation. Six straight days on the downside might require a bit of bounce before the correction continues. Jabil Circuit (JBL) seems to have stiff resistance above $20.15 and internal dynamics are weakening. On Balance Volume suggests distribution, MACD has turned negative. Given the April breakdown took out support back to last October, the odds favor another downside test.

CHARTS COURTESY TC2000





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The Psychology of the Market

Invest. Intel.: 10 Week Bull/Bear Ratio 2.5 Over Optimistic
Rydex Assets: Bull & Sector/Bear Ratio: 13.7 Euphoria
Mutual Funds: 3.7% cash: Optimistic/Complacent

Crosscurrents Emotion Based Indicators:

Record High = Euphoria

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Short to Intermediate Term

WE SEE STRIKING SIMILARITIES TO EARLY MARCH 2000, PARTICULARLY AGGRESSIVELY OPTIMISTIC COMMENTS FROM PROFESSIONALS. FED HAS SET THE STAGE FOR A MORE REALISTIC APPRAISAL OF VALUATIONS. CORRECTION SHOULD BEGIN POST HOLIDAY.

Maximum Range Probabilities for 2013

NOMINAL NEW HIGH STILL POSSIBLE (+1%)
DOW LOW REMAINS 10,404 (-32%)

OUTLOOK UNTIL AT LEAST OCTOBER 2013
REWARD/RISK = RIDICULOUSLY POOR

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Spotlighted in recent issues:

We weren't going to bet either way, but both IBM and MMM got the "breathing room" we suggested was possible. While MMM registered a subsequent new high and is now off our watch list, IBM failed way short of its previous high and remains on our short candidate watch list.

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Crosscurrents '13 Investment Stance

Newmont Mining (NEM) 15% LONG
China Medical Tech. (CMED) 5% LONG
Global X Gold Explorers ETF (GLDX) 5% LONG
Eldorado Gold (Ego) 5% LONG
PetroBras (PBR) 5% LONG
Goldcorp (GG) 5% LONG
40% LONG (30% GOLD)
***RETAINED FROM PRIOR YEARS*

Powershares QQQ Trust (QQQQ) 10% SHORT
We intend to close out the QQQQ hedge as soon as practical.

Pictures of a Stock Market Mania

http://www.cross-currents/net/charts.htm