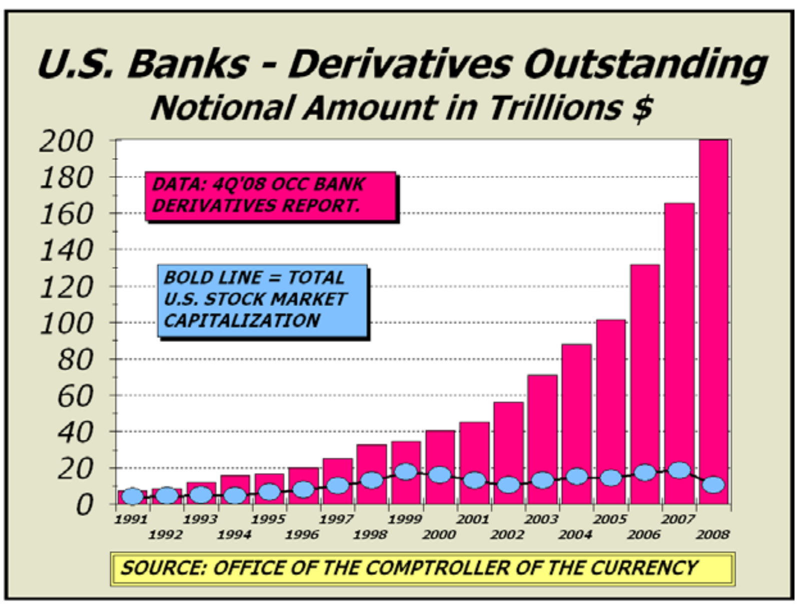
Alan M. Newman's Stock Market
CROSSCURRENTS

U.S. STOCK MARKET OUTLOOK for JUNE 1, 2009
DJIA 8500 - SPX 919 - NASDAQ 1774

DERIVATIVE GROWTH SLOWS 13% FOR REST OF WORLD, BUT GROWS 21% FOR U.S. BANKS IN 2008. AVERAGE CREDIT EXPOSURE FOR THE TOP FIVE U.S. BANKS IS NEARLY FIVE TIMES RISK BASED CAPITAL. *- NEXT ISSUE - JUNE 22, 2009 -*

Risk Exposures Are Still Dramatically High!

In the chaos that followed the Crash of 1987, your Editor wrote a series of articles about the use of derivatives and how they set the stage for an inevitable dénouement. It was all about options and futures, the same instruments that initially set the stage for bull market growth. It was no coincidence that the very first stock index futures began trading in February 1982, only six months before the great bull market began. And it was no coincidence that stock index futures played a huge role in so-called portfolio insurance, a mechanism that ensured the eventual downside cascade. The technique "insured" paper gains by selling a set amount of stock futures every time prices dipped by 3%. Trouble was, the technique was incredibly successful and as word of its utility spread, all the major players adopted similar methods. Before the Crash, it was estimated that there was $90 billion worth of portfolio insurance, more than 3% of U.S. market capitalization. When prices corrected as they inevitably must, one after another insurer kicked in programmed sales, creating a cascading effect that eventually became unstoppable. On Monday, October 19, 1987, a broker representing Wells Fargo entered the pit in Chicago at the market open and sold $600 million of stock futures. Stocks on the NYSE had no choice but to follow the lead of the futures. The market was crushed.



What incredible irony! The instrument of destruction was the very same derivative that purportedly afforded a convenient hedge and "insurance," a simple transference of risk from one party to another. What no one realized were two simple truths. One, risk can never be completely removed from the arena, risk can only be transferred. Two, the more risks are transferred, assumptions increase that still more risk can be accommodated. In the case of the U.S. stock market in 1987, these assumptions created an environment that no price was too high since risk could supposedly and immediately be transferred to others.

Precisely the same environment was created as the total notional value of derivatives expanded rapidly in the last decade. As players laid off risk, the total risk in any particular market never went away and was merely moved from various players to other players. However, the strong assumption remained. The lay off of risks seemed to indicate that still more risk could be accommodated. *Thus, more risks were taken.* Obviously, the reasoning was fallacious.

By the end of 2008, the Office of the Comptroller of the Currency (OCC) reported that U.S. banks had accumulated a record $200 trillion in notional values of derivative

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products, including SWAPS, futures and options. The ratio of derivative notional values to stock market capitalization had never before been as high as 9:1. *Despite the near total collapse of the financial markets, notional values rose 21% last year and the ratio of total notional values of derivatives soared to a level nearly 19 times total stock market capitalization.*

Interestingly, the Bank for International Settlements recently reported that worldwide, total notional values had actually declined 13.4% to $592 trillion by the end of last year, which seemingly indicates that U.S. banks took on more risks as banks outside the U.S. shed risks (see Bloomberg news—http://tinyurl.com/p2fp7e). As our featured chart clearly illustrates, the spectre of risk has not diminished and in fact, appears larger than ever.

Derivative growth versus GDP has been just as startling as our comparison to market capitalization. As the mania for stocks ended nine years ago, notional values were still only four times GDP. At the end of 2008, notional values were 14 times GDP. Worldwide, notional values are estimated to be nine times world GDP. From this aspect, it would seem convincingly clear that systemic risk is ongoing and huge. Below left, the shift of Goldman Sachs (GS) into the role of bank holding company (see http://tinyurl.com/3jkez7) has exposed yet another potential Frankenstein monster. Credit exposures are well more than ten times risk based capital, the largest ratio we have ever covered in our reports. The top five banks account for 95.6% of all derivatives and their average credit exposure is 489% of their risk based capital.

Equally astonishing, these top five banks carry portfolios totaling $191.5 trillion in notional values while maintaining assets worth only $4.8 trillion, a mere 2.5% of notional values. We have long maintained that a worst case derivative disaster could result in a wipeout of assets equal to 1% to 2% of total notional values, which would likely threaten the long term viability of these five banks. Overall banking system losses already exceed $1.3 trillion and potential for further trouble could take this figure to the $2 trillion mark. Under the circumstances that witnessed the implosion of Bear Stearns and Lehman Bros. and the troubles faced by Washington Mutual, Wachovia, Merrill Lynch, Citigroup and Bank of America, it is quite disheartening to see the OCC's fourth quarter report for 2008. Notional values surged 21% last year, soaring 14% in the last quarter alone, when if anything, one could easily have presumed notional values would contract as prices throughout the financial world collapsed. Notional values have doubled in only three years!

Our last chart is derived from page 22 of the OCC's report (http://www.occ.treas.gov/deriv/deriv.htm) and compares derivatives to total assets. Over the years, the ratios have climbed so high that the chart does not afford the same perspectives as before. For the older banks, the ratio of derivatives to assets ranges from 20:1 to 50:1. *The ratio for new bank holding company Goldman Sachs is an incredible 186:1.* The action in JP Morgan Chase and Goldman Sachs will continue to function as a harbinger of what is to come. *Thus far, the system still stands and functions, but any future threats to either JPM or GS will have the potential to fracture, disrupt and undo any hope of recovery for years to come.*

More ETF Thoughts

A subscriber recently voiced his concern that GLD (SPDR Gold Shares ETF - see http://tinyurl.com/qy7xfj for explanation) might be "getting too big," and asked if folks might be better off owning physical gold, rather than a security that purports to own the bullion. GLD's assets have grown to $31.5 billion since its creation in November 2004 as an all-purpose vehicle for those who wished to own gold without the need to store the physical metal. Despite its size, GLD can only be "too big" if demand for gold decreases from this point. Given our long range view that gold is in the midst of a super bull market which should carry prices far higher, any security backed by physical ownership of gold should perform relative to bullion.

As for personal considerations for ownership of GLD, if one believes the physical metal will continue to rise in price, exchange traded funds like GLD still make sense, but then again, shares of gold stocks make sense too. And so does the physical metal itself, either in the form of bullion or coins. Thus, in our view, the proper question is not if GLD is "too big," but the reasoning for owning gold. If the primary reason for owning gold is concern for a very worst case scenario in the future, where even survival might be at stake, then coins like Krugerrands and Maple Leafs make the most sense. That said, we are most definitely not in the camp of a worst case scenario. If the rationale is simply higher gold prices, then gold in any form, including an ETF, makes sense.

Ironically, the reader's question brought another question to

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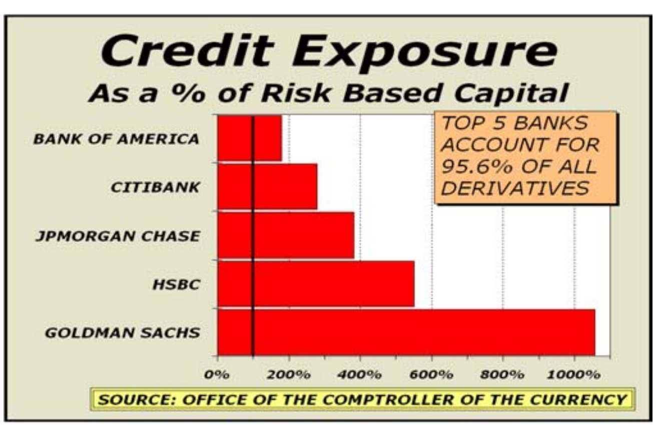

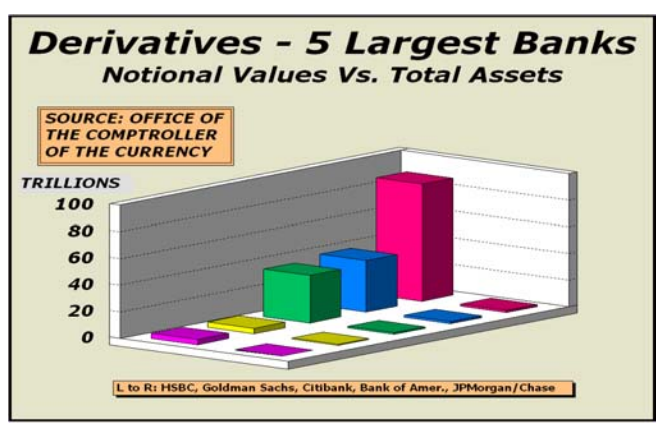

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mind, involving our quest to uncover systemic problems in the U.S. stock market. While examining the statistics for GLD, we noted a short position a bit under 3% of the outstanding shares. No big deal, just a bit of noise. Curious, we then entered SPY, the SPDR S&P 500 ETF, and found a short interest equal to 53% of outstanding shares (see http://tinyurl.com/p3cnen). Bear in mind, the trust's shares are backed by ownership of the S&P 500 constituents. Thus, the portfolio is designed and enabled to mimic the price action of the S&P 500 index. However, the huge short position changes the equation dramatically. Remember, every share of the trust that is shorted has to find a buyer. Thus, not only are there 528 million shares of the trust outstanding and owned, there are also the shares "owned" on the flip side of the 280 million share short position. The 528 million shares outstanding are backed by real shares owned by the trust, but what are the other 280 million "share entitlements" backed by? Anything at all? The ultimate irony is that since the supply of trust "shares" has been dramatically and artificially inflated by short sales, we can easily make the case that the S&P 500 index is *undervalued*, constrained by a system that completely undermines the economic concept of share capitalization. This is an important reason why we believe the March bottom may either have been all the bears wrote or their next chapter can only mirror and not exceed what we have already experienced. *The real threat is that the broken short sale mechanism ensures still more supply down the road and will tend to keep a lid on prices for years to come.*

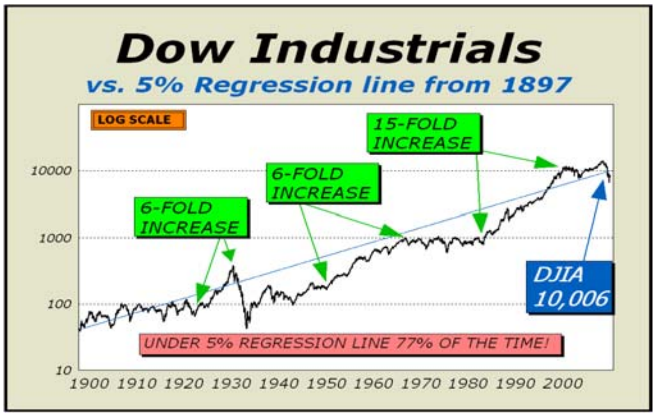
Best Case Is Modestly Better

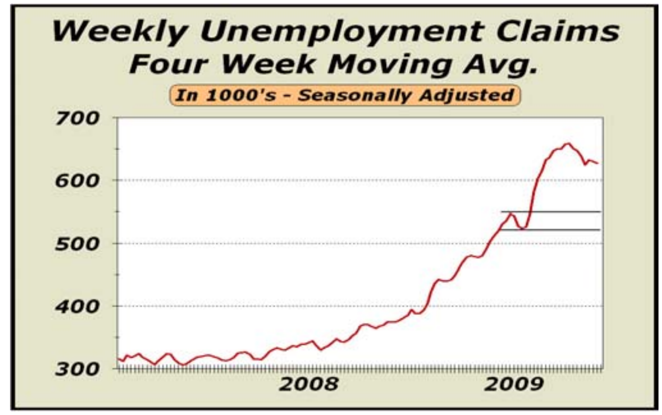
As the rally in stocks has endured, there seem to be many more strategists joining the bull camp with pronouncements that a new bull market is in progress. We've seen prognostications for far higher prices, even Dow 14,000. A move of that significance would quite obviously carry the S&P and Nasdaq along for the ride but requires some pretty hefty assumptions. Such as? Dividend payouts have actually fallen over the last year and although yields are higher, they are higher because prices are still so much lower than a year ago. S&P 500 dividend payouts are down an astonishing 21% over the last year. Assuming they do not decline further and actually rise 10% from here, a 14,000 Dow would place the S&P somewhere in the vicinity of 1500, not far off the all time peak. However, our assumptions would take yields down to 1.66% and unfortunately, that would mean either investors have once again taken leave of their senses or yet another horrifying bear market will be imminent. *There have been only ten years in which payouts have ended the year below 2%* (1996 through 2006, except 2002). Interestingly, the Dow ended 1996 at 6448 and traded as low at 6469 in March. Sans decent dividends, stocks are nowhere near as attractive as presumed!

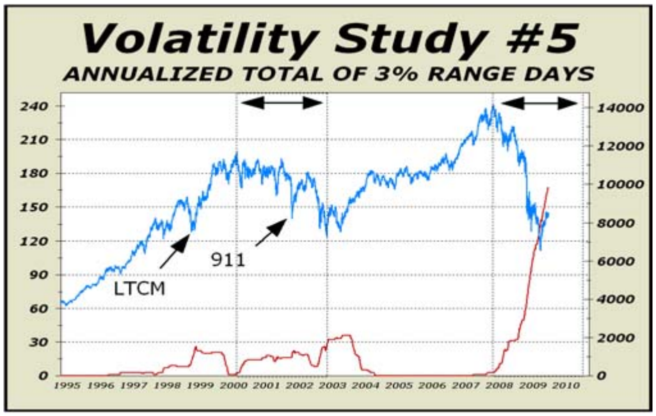
Logically, our best case continues to be the 5% regression line, which will likely now function as resistance for prices, perhaps for years to come. Although the notion of long term investing worked extremely well during the super bull market, over time, history has shown all one should expect is approximately 5% per annum. In fact, if you take all 20-year rolling periods back to 1917, the average annualized gain is 5.09%, ex-dividends. Of course, this also points out why dividends are so important, since over time, they have accounted for over 4% annualized, a substantial portion of all gains experienced by investors for many decades. The regression line today stands at Dow 10,006 and is moving north at a pace of less than 10 Dow points per week. *It will arrive at the 14,000 mark in mid-April 2016, almost seven years from now. Sounds just about right.*

No Turn Yet

Our updated Weekly Unemployment Claims chart (below right) still does not evidence a turn for the better in the economy. The little blip seen in recent weeks could be nothing more than a corrective move, as was the dip late last year. There remain significant considerations for the economy, including gasoline prices, which have now doubled from late last year, just as the vacation season is about to begin. If prices remain high or surge higher, many families will likely stay home and spend less. ☑☑☑☑☑







Alan M. Newman's Stock Market

CROSSCURRENTS

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Alan M. Newman, Editor

The time finally appears right to show our NYSE Cumulative high/low indicator. The negative divergence into the 2000 manic peak was as huge as any we've seen as was the positive divergence into the October 2002 bottom. Of course, divergences can brew for an awfully long time. That said, we take divergences as serious warnings and they are certainly capable of signaling interim reversals. The current sideways march (see highlighted area) in the face of an enormous near 40% rally from print low to print high basis the S&P, is a distinct negative for stocks.

We have repeated last issue's volatility chart to reinforce the point that expectations for a prolonged and substantial rally from here make little sense. The Dow's average daily change has been over 150 points for 18 months, an incredible length of time. Into the October 2007 high, daily changes averaged only 68 points! Given how much time was required for stocks to bottom in the prior cycle, a similar amount of time should be our logical expectation now, which would lead us to at least the end of July 2010. There were very two strong rallies within that bear cycle thus the present rally is a totally normal event.

Speculative Intensity hardly rose in the last three weeks and shows signs of topping, which would place Nasdaq's continuing relative over performance in doubt. Reversals are consistent with Nasdaq declines. Average daily volume rose quickly in the early part of Nasdaq's rally from the March bottom and has since ebbed, also a discouraging sign for bulls.

Volatility Is Not Bullish

The recent celebration of the decline in the CBOE Volatility Index (VIX) is likely quite premature. The VIX, currently just under 29, topped out at over 80 in November as stock prices collapsed. The VIX typically signals how much fear is present in the market and clearly, there was palpable fear last November. Strangely, as prices neared a frightful collapse in March and traded at a nine year low, the VIX managed to climb to only a bit above 50, far from the nervousness exhibited when the Dow was 2500 points and close to 40% higher. But by March, there were likely so many players out of the trading arena that no comparison could be fair. Indeed, in the past, a VIX near 30 was often a signal that fear was prevalent and that prices were in a corrective mode to the downside. *So much has changed that the VIX below 30 is now celebrated as a return to normal (see http://tinyurl/nfnmp8).* Wow. The more revealing truth is that readings over 30 are relatively rare and are typically present in times of great stress, like the fall of 1998, when LTCM nearly took us to the brink, and in 2002 as the fallout from the 2000 mania reached a crescendo. The eventual decline of the VIX to present levels was always predictable and does not automatically signify good times ahead. The VIX is not able to trade at much higher levels for any sustained length of time since fear always and forever must remove players from the arena, both bulls and bears. From the Friday, May 22nd close, the Dow advanced 246 points print basis on Monday and then reversed 243 points print basis to Tuesday's low. Volatility has not been abolished and the arena is still fraught with risk.

☑☑☑☑☑

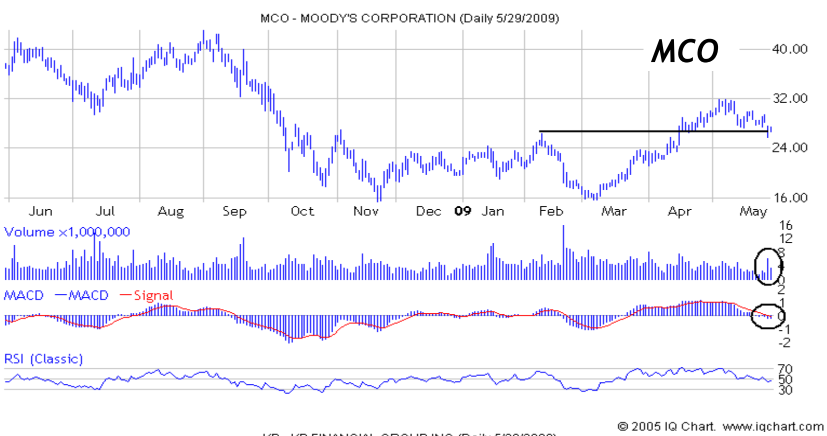
- Rationales & Targets -

Price momentum into early May was substantial and has been sufficient to place U.S. stocks in an apparent consolidation mode before the widely assumed next liftoff leg appears. Meanwhile, daily volatility has not subsided sufficiently to justify bullish assumptions, and this implies the reward to risk equation is still way too negative. ***Upside potential of roughly 6% against downside risk of 13% is never a good bet.***

However, we are not willing to carry our QQQQ short much further. Since the downside has not kicked in as expected, we must weigh the possibility that we are wrong and thus, we are now looking for an exit. Further out, we still see at least a modest retest of the March bottom, most likely in the autumn.

The mutual fund cash-to-assets ratio fell to 5.2% in April and is presumably lower today, as price action in May likely afforded portfolio managers the optimism to keep the rally going. Optimism and complacency are building and are not consistent with the economic background. ***At this point, stocks are extremely vulnerable to bad news.***

A growing number of issues seem to be breaking down or on the verge even as market action remains in a consolidation mode. Moody's Corp. (MCO) looks particularly dangerous today, threatening a support level with Thursday's slide on almost 6 million shares. With MACD now in negative territory (see circled area), the outlook for this issue could be bleak for the short term. KB Financial Group Inc. (KB) also looks pretty sick, down six of the last seven trading sessions. Support is breaking as volume is rising, a horrible sign. We're not placing any additional shorts in the Trading Stance yet and are still waiting for the QQQQ to work out. The list of short candidates also includes Clarcor Inc. (CLC) and GATX Corp. (GMT).



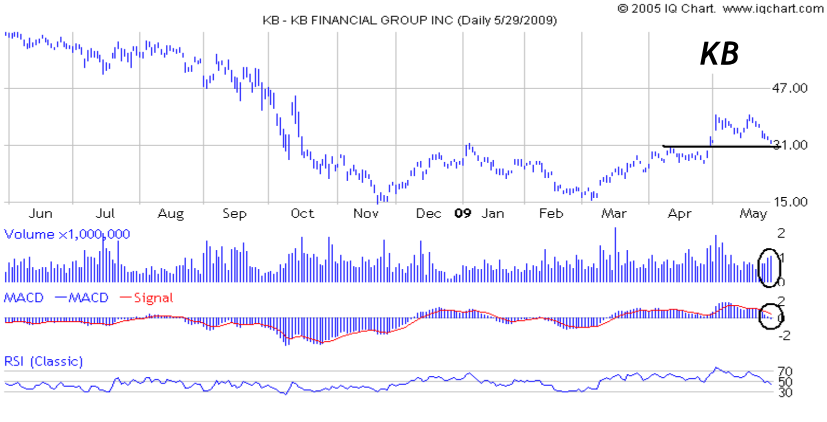


Chart Of The Month—Updated May 17th
http://www.cross-currents.net/monthly.htm

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The Psychology of the Market

Invest. Intelligence: 3 Wk. Bull/Bear Ratio 1.3 Complacent
AAII: 3 Week Bull/Bear Ratio: 0.9 Concerned
Mutual Funds: 5.2% cash: Optimism Returns!
Crosscurrents Emotion-Based Indicators:
Optimism Fading—Indicators on sell signal

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Intermediate Term Forecast

WE ARE STILL NEGATIVE
UPSIDE POTENTIAL = less than 6%
DOWNSIDE RISK = 13%
BEST CASE NOT WORTH THE RISK!

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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 +18.6%
Vimpel-Communications (VIP) 5% LONG +38.4%
China Medical Tech. (CMED) 5% LONG –3.1%
Paraxel Int'l. (PRXL) 5% LONG –7.6%
AVERAGE GAIN +14.1%
Vs. DJIA –3.2% SPX +1.8% Nasdaq +12.5%
"Retained" ideas priced from inception
Percentage gains (losses) include dividends

POSSIBLE ADDITIONS FOR 2009

Pfizer Inc. (PFE) 4.4% dividend yield
Altria Group (MO) 7.5% dividend yield
AT&T Inc. (T) 6.7% dividend yield
ShengaTech Inc. (SDTH) 7 P/E - China/Speculative
Potash Corp. of Saskatchewan, Inc. (POT) 11 P/E
Express Scripts Inc. (ESRX) - 15 forward P/E
Suntech Power Holdings Co., Ltd. (STP) - China
TransMontaigne Partners LP (TLP) - 10.6% yield
NO POSITIONS TAKEN YET

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 -4.7%