Fullermoney

Please note: This is a compilation of Comment of the Day for Subscribers, which appeared on the www.fullermoney.com website during the last week. Subscribers are encouraged to login at their convenience, to read the daily coverage and use the many other site facilities, including the Library of charts.

Monday 27th October 2008

Alex Seagle's Ruminations of The Contrary Investor: Timber & the Beaufort Scale - My thanks to Alex Seagle of Fraser Management Associates for his latest letter, which is a welcome change from the daily noise from Wall Street. Here is the opening:

Readers know that the Contrary Investor has advocated positioning assets to participate in the impact of increased hurricane activity in the Gulf of Mexico and Atlantic seaboard for some time. Hurricane activity has historically trended through roughly 20 year periods of higher and lower than normal periods, and our research indicates that we entered a period of higher than normal activity in the mid 1990s. The 2004 and 2005 hurricane seasons in the U.S. bore out this conviction - there were no "atheists in the foxholes" during this period. Indeed, the damage from the 2005 hurricane season alone was greater than the combined total for the 1950s, 60s, 70s and 80s, inflation-adjusted.

Now Hurricanes Gustav and Ike have barrelled through, wreaking havoc to the tune of billions of dollars, and the hurricane season doesn't officially end until November 30th. Interestingly, there are some very mundane ways to participate in the recovery and rebuilding efforts that could yield profits for investors. In this, and the following article we would like to examine two distinct opportunities. Both involve the basic materials needed to address the damage inflicted by Gustav, and more dramatically, Ike.

My comment - Subscribers wishing to see price charts for the shares mentioned can find them in the International Equity Library section on this site. Just click on that heading and use the Search facility. Here also is the September issue of The Contrary Investor, which is just as relevant today.

Email of the day - Questions on a number of forecasts by Nouriel Roubini:

"I greatly appreciate all the helpful information on your website, and the opportunity to have attended the Chart Seminar last November. Today I have some questions about Nouriel Roubini and his recent (Oct. 24, 2008) statements about the market, and whether you agree. Roubini has seemed to be unusually accurate in his predictions dating back 1 or 2 years. My questions are:

1. Roubini is beginning to believe we will be involved in a L-shaped and lengthy recession similar to Japan, lasting for years, consistent with a bubble implosion. What are your thoughts?

2. He believes the US stock market (Dow) will drop another 20 to 30 percent, down to perhaps 6900 to 6000. How likely do you feel this is?

3. He believes the economy will not bottom until perhaps the Fall of 2009. Is this likely?

4. He suggests people avoid investments in commodities, stocks, housing, and that they avoid the US dollar (which is doing well currently). He recommends safe, large government short term treasury investments perhaps in Japan or Europe. What are your thoughts?

5. He claims that the global stock and other markets are dysfunctional. He states that "they are not working." What are our views?

6. He states the collapse is worse than he had expected and happened far faster than he had predicted. Events he thought might take two years happened in seven months--such as the end of the investment bank business model in the US. He described it as a "financial train wreck."

7. He mentions that pension plans have had losses of between 30 to 50 percent, for people, like baby boomers, close to retirement. Are these figures about right? What will the impact of this be?

8. My own belief is that we are looking at something that will be so painful for so many people that they will never want to invest in stocks ever again. I heard somewhere that many former investors were so traumatized by the stock market crash of 1929, that it took decades for stocks again to be a fashionable investment in the US. Is this correct? Is it likely that the CNBC commentators who expect a big rush of people back into the market when the bottom is finally reached will prove to be sadly disappointed--many people will avoid any mutual fund or ETF or stock like the plague for the rest of their lives. Perhaps, we will never see the volume that existed prior to July 2008 for several decades in the Western markets. What are your thoughts about all this?

"I greatly appreciate your invaluable website. I appreciate any response you have time to give."

My comment - Thank you for your thoughtful comments and continued interest in Fullermoney. It was a pleasure to meet you last November.

I would not and could not comment on everyone's views but Nouriel Roubini has certainly become one of the formulators of public opinion over the last year or more, and these are general interest points. Here are my thoughts, using the same numbered sequence:

1. I would expect an L-shaped recession and / or slow recovery for countries nearest to the epicentre of today's credit problems. A Japan-style deflation and economic slough is a risk, but would occur in response to policy mistakes, hopefully avoidable. Economies with current account surpluses and / or high savings rates should recover much more quickly.

2. I do not know where the Dow will bottom; price forecasts are guesswork but I think I know what needs to take place before we see another bull market (*see the feature below*).

3. Sounds reasonable, although this is also guesswork and may depend on policies. However I expect some emerging markets to lead the eventual US economic recovery.

4. The selling of those assets will obviously be finite. You will find my thoughts on capitulation, deleveraging and the carry trade currencies in the feature below. As an investor I have always favoured a 'just in case' cash holding, which could also be in short-term treasuries. For me, this feels comfortable at the moment.

5. I agree that markets are not functioning properly, evidenced by the extreme volatility. This increases risk and is extremely damaging to sentiment.

6. The speed and extent of the problems is stupefying.

7. I would agree with those figures, and counting. I think the impact will be slower economic growth and delayed retirements, where the latter are possible.

8. I think your post 1929 summary of equity revulsion is correct, but that is the most extreme example. Some people also said they would never trust the stock market again following the 1987 Crash, but that feeling lasted less than a year, although anxieties rose in October for several years. I suspect 1974 could turn out to be the closest parallel. Back then many people said they would not trust the stock market again, and although it rebounded quickly in 1975, the Dow then went into a long, dull trading range until 1982. This occurred despite steady growth in corporate profits. Consequently valuations were compressed to some of their best levels ever, with the S&P 500 Index yielding 6.21% in 2Q 1982, compared to 3.57% today. Remember, Japan among emerging markets at the time was an outstanding performer, as I mentioned and illustrated last week. The reality is that no one knows what will happen over the next few years, never mind the next decade. However I will be very surprised if at least some stock markets do not do very well over that period. The charts will show us the leaders, just as they did in 2003, not to mention earlier cycles. The drivers, I suspect, will be corporate earnings, fashion and momentum investing.

Capitulation: When the Market Throws in the Towel - My thanks to a subscriber for this interesting item by Jason Zweig at The Intelligent Investor. Here is a sample:

There's a belief that the market can hit bottom only when vast numbers of investors finally capitulate, throwing in the towel and selling off the last of their stock portfolios. In theory, if you could spot this moment, you could make a killing buying at the bottom.

There are two problems here. First, capitulation is almost impossible to define. Second, even if you could get a positive ID on capitulation, that might not do you any good. Market lows aren't necessarily marked by tidal waves of frantic selling; just as frequently, stocks bottom out in a dull and lonely atmosphere as trading dries up and most investors no longer even care. Bear markets often end not in capitulation but stupefaction.

"The idea is, 'We'll know we've hit bottom when the fat lady capitulates,' " says finance professor Robert A. Schwartz of Baruch College at the City University of New York. "But she could just sputter instead, or capitulate more than once, or slowly slide around along the bottom." Warns Prof. Schwartz: "On the way down, you get a lot of faux capitulation. And how do you know, until after the fact, whether it is friend or faux?"

Oddly, even market pundits who believe in capitulation admit they can't define it. "Capitulation is a state of mind, without any specific definition," says Al Goldman, chief market strategist for Wachovia Securities. "You can't measure it; it's best identified in hindsight." Hugh A. Johnson, chief investment officer at Johnson Illington Advisors, says almost wistfully: "I wish I could quantify it for you so I could say, 'Here, this is capitulation.' But a lot of this is anecdotal. Talk to enough investors and you get an idea of whether we have capitulation."

My view - I think we know capitulation selling when we see it, because markets accelerate lower on increasing volume. A bull market is usually punctuated by one or two corrections each year, which usually end with a degree of capitulation selling.

Consider this 10-year monthly chart of the S&P 500 Index. As the S&P rose above its approximate mean represented by the 200-day moving average (MA) in the latter stages of the 1990's bull market, it became temporarily overextended and increasingly susceptible to a mean reversion towards the MA. You can see four reactions or corrections of two to three consecutive months' duration during this period, denoted by red candlesticks, which briefly took the S&P beneath its MA.

Confirmation of that bull's demise occurred in 2000, when the MA was not only breeched more significantly, but also turned downwards. Bear markets are certainly characterized by waves of capitulation selling, which are generally more severe than bull market corrections, because the primary trend is downwards. You can see four waves of capitulation selling during the 2000-2002 bear trend, commencing with the first move off the high. Each of these overextensions relative to the MA was followed by a reversion rally to the mean, before the selling resumed.

You can also see a successful test of the 2002 lows in 1Q 2003, before the S&P rallied to break the sequence of lower rally highs, and the MA also turned upwards, confirming that a bull market had commenced. The uptrend was remarkably consistent, with temporary overextensions on the upside punctuated by sideways to slightly lower ranging consolidations back to the MA.

At Fullermoney, I fretted a bit when MAs for the S&P and other indices turned downwards following a sharp decline at yearend 2007, but should have shouted about it - continuously - in Comment of the Day and Audios. Why didn't I shout about it? I believe it was mainly due to too much emphasis on short-term data, plus the temptation to focus on a dwindling band of trends that were still appreciating. I cannot roll the clock back, unfortunately, but both Eoin and I are determined to ensure that Fullermoney does not make that mistake again.

What about the S&P now? We have had several waves of capitulation selling, as repeatedly mentioned, and certainly none more severe than during this month's enormous decline. The article above mentions stupefaction, which is certainly the appropriate noun. Most of us feel stupefied by this traumatic event. Our brains have been numbed by the previously rare but now daily occurrence of huge percentage moves, mostly on the downside.

Consequently, potential buyers are inert, content to watch since the fear of further losses is greater than the fear of having a rally run away from them. Bargain hunters are understandably tentative, nibbling on an incremental basis. Cost averaging on this basis is not a bad strategy for the long term but it will not provide the bullish demand signal that many people have been looking or hoping for.

Meanwhile, stock markets are being driven down by forced selling from those who must deleverage - from hedge funds to oligarchs and other large investors - because they face margin calls or redemptions. This process remains self-feeding. In addition to the credit crunch, it may also be contributing to recessionary forces as the stock market tail wags the economic dog.

How will we know that capitulation selling and deleveraging is mostly over? One sign would be a loss of downside momentum by stock markets beyond the brief pause that we have seen recently. However, I think we may also need to see some weakness in the two main carry trade currencies during recent years - the Japanese yen and US dollar. Their considerable strength since July is the inverse mirror image of asset deleveraging, as people scramble to repay their liabilities in JPY and USD.

In conclusion, for evidence of a stock market low, I would look for a loss of downside momentum by share indices, coinciding with a loss of upside momentum for the yen and US dollar. Meanwhile, the proximity of the 2002 bear market lows for the S&P, plus its current downside overextension relative to the MA, suggest that some mean reversion is overdue. If accompanied by weaker carry trade currencies, we should see a rally towards the declining

MA. However if the yen and dollar remain firm, we may only see a ranging reversion towards the declining MA. Recently, the S&P (weekly & daily) paused in its decline following the 10th October low, but remains barely steady near that level. Moreover, stock market indices for most other countries have already broken downwards once again.

Lastly, many people feel that the fundamentals are much worse today than in 2002. They certainly have a point. Therefore, a cautious investor may prefer to wait for evidence of new bull markets before significantly increasing equity exposure. The technical signals would be base formation development followed by breaks above the 200-day MAs, which also turn upwards. I do not know when that will occur but the charts will certainly show us.

Additional Commentary by Eoin Treacy

Gold in a Credit Crisis - Thanks to a subscriber for this interesting interview by Jon Nadler from Kitco Bullion dealers which is in tune with our own view on gold. It appeared in Seeking Alpha on October 24th. Here is a section:

HAI: So what do you see in the future for the major precious metals: gold, silver, platinum and palladium?

Nadler: The industrial white metals will reflect the health or lack thereof in the demand for each of them. Silver is still probably the best play among the white metals, given its low costs. Palladium might be as well, since it can substitute for gold and platinum at high prices, and people may look to cut costs. Both of those have been quite a bit oversold, and one can expect some relative strength there.

I think you're scraping the bottom of the barrel at $750/ounce platinum and $150/ounce palladium. Silver is probably almost there already: $7.50-$8.50/ounce would be a bargain for silver.

We're seeing in India this week that the festival season might turn into a silver festival rather than a gold festival, and Indians are quite happy buying silver below $10/ounce. The upside, however, for gold, silver and palladium is limited.

We don't normally make projections except twice a year, but I should think platinum has no trouble coming back to $950-$1,250/ounce range, with palladium in the $210-$280/ounce area.

As for silver, if we can get back to $13-$14/ounce area by the middle of next year, that would be great. I'm not one who puts much stock in the theory that the gold/silver ratio should be 60-to-1 or 80-to-1, but 25-to-1 sounds more reasonable.

That doesn't imply gold can't go its own way. People are wishing for a decoupling of gold from other commodities and a reattribution of its monetary attributes. I'm not sure I expect that, given its recent performance over the past three months or so. Some stability in a decent range of $650-$850/ounce is OK; it's nothing to lament. If everything else is falling, and falling a lot, gold staying put is OK. It's not the hyper end-of-the-world scenario people get so revved up about, but it's OK.

My view - The fact that gold has been a relative outperformer during one of the most volatile stock market episodes in history is a testament to its status as a long-term store of value. Gold, with Treasuries, the Yen and the Dollar has been one of the prime beneficiaries of cashflows as positions are liquidated. This relative strength is likely to continue as long as investors continue to seek a safe haven from the deleveraging process.

However, gold is characteristically a volatile entity in its own right. Particularly in the current environment, it is seldom rewarding to pay up for the metal and it is best bought following corrections. Gold posted another lower low last week but rallied well on Friday. It would need to sustain a move below $680 to question scope for some additional short-term upside. A sustained move above $900 would break the progression of lower highs and suggest the bulls have regained the upper hand.

Oil sands projects slashed as credit crisis hits Alberta - Thanks to a subscriber for this interesting article by Norval Scott for globeinvestor.com. Here is a section:

The full force of the global financial crisis has finally hit the oil sands, delaying two of Canada's largest energy projects and tempering Alberta's economic boom.

Suncor Energy Inc. said yesterday that it is slashing its expected spending in 2009 by one-third because of uncertainty over oil prices and credit availability.

Part of the reduction will affect the $20.6-billion Voyageur oil sands project the company is developing, meaning its upgrader will be delayed by one year.

Meanwhile, the consortium behind the $23.8-billion Fort Hills project, led by Petro-Canada, said it could also delay building its planned upgrader, instead constructing only its planned oil sands mine in order to get crude to market more quickly and cheaply.

The announcements mean that the upgraders at two of the most expensive energy projects ever proposed in Canada now face delays because of the financial crisis, which has sent oil prices plummeting and made credit harder to find.

Upgraders are expensive processing facilities that turn oil sands bitumen crude into a lighter synthetic product that can be handled by more refineries. Alberta is keen to ensure that they are built within the province so that it, rather than the U.S., benefits from the lucrative work through the creation of jobs and extra income.

The announcements come after other companies, including the Nexen Inc.-OPTI Canada partnership and privately held BA Energy Inc., announced delays at smaller projects in recent weeks.

The sudden rash of postponements signals a potential end to Alberta's cycle of spiralling costs caused by worker and material scarcity, which has forced the price of new projects through the roof and crippled regional productivity.

My view - This article from Reuters, contributed by the same subscriber covers measures being taken by Teck Cominco to deal with the credit squeeze. It is inevitable that commodity companies will shelve or slowdown the pace of expansion as profits decline. Marginal operations are already being closed and cuts to capital expenditure budgets imply future supply will also be curtailed. Burst housing bubbles and a slowing global economy are driving this decline and slowing demand. Metal and energy prices have yet to find a floor as deleveraging continues. This process is likely to force a further contraction in mine expansion and should eventually help to the market to find equilibrium.

Email of the day (1) - on the accumulation of wealth in the baby boom generation:

"I wonder if you would like to comment on an observation of mine. I think for the first time in history, retired people are currently quite affluent compared with the general population. At the same time, young people starting their careers have probably never been more indebted through student loans, credit cards and mortgages on expensive property. In other words, there has effectively been a huge transfer of wealth from the young to the old.

"My question is this. As everything appears to revert to the norm in the long-term, how can this situation unwind and what would be the implications?

"Is this just another symptom of the long-term money supply/house price bubble?"

My comment - Thank you for an interesting observation and question. It would be incorrect to call the accumulation of wealth in older people's hands a transfer because today's young people never had the money in the first place. This was at least in part due to the economic expansion and years of relative peace which followed World War II. Many of the relatively older, wealthier generation were simply in the right place, at the right time and were the right age to benefit from economic conditions. As a result, their now mature children will be one of the first generations to inherit wealth en-masse. In this way the concentration will eventually dissipate. However, what is of much more pressing concern, for a number of countries, are unfunded pension liabilities.

In the last forty years, as relative wealth and freedom have improved, the birth rate has declined. The situation where fewer numbers of working people have to pay the pensions of increasingly large numbers of retirees is simply untenable. However politically unpalatable it is for governments to deal with, there is simply no way future pension liabilities can be paid for under the current system. This probably means that some mix of measures such as smaller pensions, higher taxes, later retirement ages and greater immigration will have to be implemented, and adhered to, in order to deal with this issue.

Email of the day (2) - on The Chart Seminar:

"I am a complete beginner. I feel that there are great opportunities out there. I find your reports very interesting but find it difficult to understand all the terms used, especially in respect of charts. Looking at the attendees of your Chart Seminars I feel that I would be out of my depth.

"Is there a beginner's course? Or an introductory book on the subject that you could recommend?"

My comment - Thank you for an interesting email. It is not necessary to be an expert chart reader to attend the Chart Seminar although at least a basic knowledge of markets is a prerequisite. The most important thing to bring with you is your analytical curiosity. Over the course of the two days, we focus on behavioural, common sense methods of chart analysis and the direction the dialogue takes depends very much on the delegates.

As for some introductory reading, the Fullermoney.com site has a wealth of information that should be helpful. I would particularly suggest the Featured Articles section which includes many relevant sections for your search. Here also are links to The Chart Seminar brochure and delegates pack.

Today's interesting charts - Over the last 5-years, the Yen carry trade has been a popular source of funding for leveraged traders. This is now unwinding. The Chart Library has a number of overlay charts with the yen and different equity indices.

Japanese Yen & Nikkei 225 - the correlation between these two instruments remains extremely tight. The strength of the Yen continues to pose a stiff headwind to Japanese equities but when it turns, should provide a significant tailwind.

Nickel - bouncing from the psychological $10,000 level and would need to sustain a move below that level to question scope for some additional upside in the short term.

Hang Seng - accelerating lower in the textbook Type-1 ending signal, however, an upward dynamic is needed to check momentum beyond a brief pause.

Yen per 1 Australian Dollar - The Australian Dollar broke down from its short-term distribution on Friday and would need to sustain a move above ¥65 to question scope for some additional downside.

Email of the day (3, 4 & 5) - on additions to the Chart Library:

"Would you please add the following Commercial Property (mostly bricks and mortar not shares) UK authorised funds, which I have investments in and which your subscriber in Friday's daily comment may also be interested in:

New Star UK Property Acc (JXPAC) - last price 160.26 bid Norwich Property Inc (NUPRO) - last price 125.42 bid Prudential Property Pension Pre A - last price 979.60 Scottish Equitable Property Pension - last price 639.25

"My fellow subscriber may also be interested in New Star International Property Fund, which is already in the chart library. This fund is again a bricks and mortar fund with international investments but excluding UK."

And

"Would you please add the following UK authorised fund to the chart library:

Neptune Income A Acc (NEIAA) - last price 142.50"

And

"Could you please add the following ASX indices to the chart library? If they are already there then I apologise for my current a-stigmatised sight brought on by obsessive staring at charts resembling artillery trajectories.

XFL ASX 50 index
XMD Mid Cap 50 index
XSO Small ordinaries
XTL ASX 20 index
XTO ASX 100 index

"Addition of these indices will enable relative comparisons between small/medium/large caps."

My comment - Thank you all for these interesting suggestions which have been added to the Chart Library.

Last week's signups for the Free (Abbreviated) Comment of the Day - For the week of October 19th new signups, including subscribers and pre-subscribers, live in the following countries or regions: Australia, Austria, Bulgaria, Canada, Germany, India, Italy, Singapore, South Africa, Switzerland, Taiwan, the UAE, the UK and the USA - 14 in total. In descending order, which topped the list in terms of the last week's new signups? It was the USA, UK and Australia.

Thousands of people around the world receive Fullermoney's Free (Abbreviated) Comment of the Day, and their numbers steadily increase. Why do so many sign up? It is primarily due to word of mouth or word of press mention, from people who like Fullermoney's global perspective and our Empowerment Through Knowledge theme. Incidentally, on receiving our free daily email, you will not be contacted or solicited with advertisements and other marketing material. No one else will have access to your email address. We respect your privacy.

Tuesday 28th October 2008

Hong Kong Stocks at Cheapest in Decade Lure Investors - This article from Bloomberg may interest value investors and also price chart readers who are more inclined to regard a stock market collapse as a future opportunity rather than a portent of doom. Here is the opening:

Hong Kong's Hang Seng Index yesterday tumbled to its lowest valuation since the Asian financial crisis a decade ago after posting the worst performance this month among the 10 biggest equity markets.

The Hang Seng's 13 percent drop yesterday pushed its October decline to 39 percent and cut the index's price relative to net assets to 1.05, the lowest since September 1998. The slump is prompting Sentinel Asset Management and TCW Group, which together oversee more than $130 billion, to add to holdings in Hong Kong. The Hang Seng rallied 14 percent today.

``In the long-run, buying into this kind of forced liquidation, this kind of panic, this kind of fear, is going to make you money,'' said Kate Schapiro, a San Francisco-based international equity manager at Sentinel, which oversees $17 billion. ``We're not committing all the money on one day, but cautiously and bit by bit.''

The 42-company Hang Seng, down 60 percent from its peak a year ago, dropped as much as 15 percent yesterday, which would have been the biggest retreat since the 1989 Tiananmen Square crackdown in Beijing, as a jump in money-market rates by the most in a month heightened concern the credit crisis will ravage the city's banks and real-estate companies.

The last time the Hang Seng was as cheap on a price-to-book basis, the index rallied 76 percent over the next year.

My view - When investors see a stock market crash their main concern going forward is the outlook for corporate profits. The Hong Kong HSI Index, shown here on a monthly chart over 20 years has certainly discounted plenty of bad news. Some analysts expect no worse than a mild recession; others look at the financial crisis and fear far worse. However there is no crystal ball, so no one knows what the future holds.

However we can measure performances in a historic context. For instance, we know that market crashes are usually followed by recoveries although the time spent in convalescence (technically referred to as base building) can vary considerably. Value investors will be interested in Eoin's section on Price to Book and Price to Cash Flow, shown below.

We can also look at PERs and Yields, with one obvious caveat: earnings fall during economic slowdowns and dividends can also be cut. Nevertheless, the Hang Seng's single-figure PER and 5.5% Yield, according to Bloomberg, are certainly interesting, particularly for those of us who believe that China will remain a growth leader.

What else looks bombed out in terms of price action, current PERs and Yields?

Today, I am concentrating on Asia, which I maintain will lead the next global recovery. Staying with the China region, Hong Kong's HSCEI (H-Share) Index has fallen back to its 2004-2005 launch pad. Its current (historic) PER is 7.17 and Yield 4.62%. China's Shanghai Composite Index has fallen back into its former base, and while the valuation bubble has been deflated, it is more expensive than the Hong Kong at a PER of 12.72 and Yield of 2.32%. Also in the China region, Taiwan has fallen back to previous lows, has a PER of 7.36 and a whopping Yield of 8.6%.

Among Southeast Asia's stock markets, Indonesia has seen a significant retracement of its spectacular bull run, although it remains above its former base. The JCI Index has a current PER of 6.88 and Yields 6.17%. Malaysia's KLCI Index has fallen back into former support, has a PER of 9.02 and Yield of 7.02%. The Philippines PCOMP is close to its former base, has a PER of 7.61 and Yield of 7.22%. Singapore has less back history for the FSSTI Index but this market has seldom offered better value than today's PER of 5.29 and Yield of 6.45%. Thailand has fallen to its former base, has a PER of 6.09 and Yield of 8.17%.

India's NIFTY has not quite reached its former launch pad but is back to a single-figure PER at 9.36 but a Yield of 2.12%.

Lastly, Japan's Topix actually broke its 2003 low recently and has a current PER of 9.98 and Yield of 2.89%.

What do these Asian stock markets share in common? Japan excepted, a history of strong GDP growth, although this is currently under question as the economic outlook is a concern. However they have all experienced huge bear markets, taking valuations back to historically attractive levels, which are currently among the best available globally.

I believe it is time to reconsider Asian recovery funds and trackers, many of which are listed in the Chart Library. Of course there are many unanswered questions, from the economic outlook to the extent of base formation development that we will see. For the time being, I am just watching but this review, along with the Price to Book and Price to Cash flow data below, tell me that I should consider buying rather than selling Asian stock markets.

Tim Price: Schroedinger's cat revisited - This letter, published by PFP Wealth Management is always interesting. It is posted without further comment.

Browning Newsletter: Winter Outlook - This letter on global climate change, published by Fraser Management Associates, is always informative. It too is posted without further comment. Here also is the September issue, which is still relevant today.

Additional Commentary by Eoin Treacy

German Regulator Looking Into Volkswagen Trading - Thanks to a subscriber for this story by Alexis Xydias for Bloomberg and this report from Bernstein Research on the recent activity in Volkswagen shares. Here is a section from the story:

Germany's financial-markets regulator is looking into trading of Volkswagen AG shares after Porsche SE's plan to raise its stake in the automaker triggered a fourfold increase in two days.

BaFin is monitoring Volkswagen and hasn't started a formal probe, said spokeswoman Anja Engelland. The gains follow Porsche's Oct. 26 announcement that it plans to increase the stake in Volkswagen to 75 percent. The move forced short-sellers to cover their bets on a decline in the stock.

Volkswagen, Europe's biggest carmaker, is the most shorted stock in Germany's benchmark DAX Index. The so-called short squeeze today pushed the value of Wolfsburg, Germany-based Volkswagen's common shares as high as 296 billion euros ($370 billion), more than Exxon Mobil Corp.'s $343 billion at yesterday's close in New York, according to data compiled by Bloomberg.

``The regulator needs to investigate,'' said Piers Hillier, head of European equities at WestLB Mellon Asset Management U.K.
Ltd. in London. ``The bigger question has to be why they have not done so already. If ever there was an example of market manipulation, this is it. Porsche's stake-building process is at best obscure.''

Porsche said Oct. 26 that the maker of the 911 sports car plans to increase its Volkswagen holding from 42.6 percent, spurring short-sellers to buy from a shrinking pool of stock to close their positions. Volkswagen is the world's 16th-largest company by sales, data compiled by Bloomberg show.

No Formal Inquiry
BaFin is analyzing trading in Volkswagen stock, though it hasn't opened a formal inquiry into whether there's any manipulation and ``pure cash-settled options do not require disclosure'' under the country's laws, said Engelland, a spokeswoman for the Bonn-based agency. Results from any analysis are unlikely this week, she added.

Michael Brendel, a Volkswagen spokesman, said the company doesn't comment on its stock price. Frank Gaube and Frank Scholtys, spokesmen for Stuttgart, Germany-based Porsche, didn't immediately respond to two messages left at their office or to a message left on Gaube's mobile-phone voicemail seeking comment.

About 12.9 percent of Volkswagen's common stock was on loan as of Oct. 23, mostly for short sales, the highest proportion of any company on the DAX, according to London-based Data Explorers.

``One of the biggest risks with the herd mentality approach to shorting is that a lot of money can be made at the outset,''
said Ed Oliver, a senior business consultant at Spitalfields Advisors, a London-based firm specializing in securities lending. ``But you can end up losing the whole of it when you try to close the position. There's no limit.''

Volkswagen Shares
Stuttgart, Germany-based Porsche added to an earlier 35 percent stake and said two days ago that it holds options for another 31.5 percent. Volkswagen rose as much as 485.01 euros today, or 93 percent, to 1,005.01 euros and was trading at 885.11 euros at 5:26 p.m. in Frankfurt.

Porsche might not raise its stake in Volkswagen at the levels the share price reached today, and may have announced its right to boost its holding to gain from options investments, according to Equinet AG's Tim Schuldt.

``Why did Porsche lay out its full option position, which is clearly an invitation for hedge funds to buy VW shares in order to squeeze the shorts?'' Schuldt, a Frankfurt-based analyst, said.

My view - This must be one of the biggest short squeezes in history. Porsche, albeit trading close to the edge of what is acceptable, have played the situation expertly and are reaping the benefits. As an event it is something of a bell ringer and short sellers are likely to be more cautious as a result. Hedge funds have done extremely well from shorting various sectors over the last few months, but if potential acquirers are becoming active on the long side, it is a dangerous time to be short. Investor anxiety remains at elevated levels but we need to recognize this for the signal it provides: short sellers no longer have it all their own way.

Standard Chartered: The economic and financial outlook - Thanks to a subscriber for this transcript of a lecture given by Dr Gerard Lyons on the state of the global markets during early October. Here is a section

In terms of the domestically driven economies, the focus is on China. There used to be a saying in the City that it is never too early to panic. And in some respects that is what is already happening in Beijing - albeit in a controlled way. After rapid economic growth in recent years China looks set to slow. This slowdown could be far more dramatic than imagined. I have continued to say that whilst the trend for China - and indeed India - is up, one should not underestimate the volatility along that upward trend. This is partly because

China lacks the policy tools and institutions that we take for granted in the West. But in addition it reflects where China is in terms of its development - a heavily investment driven economy, reflecting imbalanced growth in recent years. As we saw with the crisis hit economies after the Asian crisis, and as we have seen during phases of both South Korea's and Japan's development, significant setbacks are possible, particularly if investment takes a hit.

China could slow to 4% growth or less next year. Whilst this would still be positive growth it would represent a hard landing for an economy that has been growing at double-digit rates in recent years. These downside risks need to be taken seriously as they are perfectly consistent with an economy that could rebound strongly in the future.

The slowdown we are already seeing and these downside risks have already led to a shift in monetary policy, with lower interest rates having been unveiled and a shift in currency policy away from appreciation towards stability. But it is fiscal policy that will come to China's rescue. The government's finances are in good shape, running a budget surplus in the last two years. Already plans are being put in place for a huge fiscal boost, the size and timing of which will be heavily influenced by the extent of the downturn. China will use fiscal policy as America did with FDR in the thirties and as Japan did in its lost-decade of the 90s. Such policy measures may allow the economic growth to hover around 7% in the next two years, still healthy by global standards but still a hard enough landing for China.

Whilst it is fiscal policy that one should focus on, clearly China's currency policy is important. There has to be a high probability that an incoming US President, say Obama, will cite China as a 'currency manipulator' come next spring. One challenge for China is that as it moves into higher-value added exports and as its trade surplus stays high, its currency will have to appreciate, which in turn will reduce the competitiveness of low value added producers. In turn they will have to focus on the domestic market, and it will be to India, and even parts of Africa that we will in the future look to produce low-value added exports. This cycle may happen far more quickly in China than it did in either Korea or Japan, two countries that also moved from low value-added exports to more upmarket products. How China's currency moves in the near term will have a large bearing on currency policy across Asia.

But, generally speaking, in the year ahead we should expect to see more pro-growth polices across Asia. And in this environment we are likely to see greater interest rate convergence across the globe, as rates fall in emerging economies, in addition to the cuts seen across the advanced economies.

My view - A constant theme at Fullermoney over the last year, particularly in the Audios has been the comparison of the Wobbly West with the Enterprising East. Asian economies are in a much steadier financial situation today than they were during the Asian Financial Crisis. Many countries have learned from that painful experience and have avoided the dangers of being overly leveraged and under capitalised.

As recessions take hold in the US and Europe, Asian economies will also feel a pinch but they are in much better positions to emerge stronger from this trauma that at any time in their past. China in particular has the resources necessary to cushion the impact of slowing global markets on its internal economy. The extent to which growth slows is anyone's guess, but what is beyond question is that the Chinese have the reserves necessary to continue with their infrastructure development and to develop the domestic consumer economy further. Asian economies should emerge from global recession faster than the rest of the world and China remains the most likely to continue to lead in terms of GDP growth.

Email of the day (1) - on price / book values:

"I noticed Bloomberg has Japan's Price/Book. Could you add this to the chart library and any other markets?

"Shares on the Topix index, the broadest gauge of Japan's stock market, trade at 0.89 times book value, the first time the average has been below 1"

My comment - Thank you for this interesting statistic. Following a search on Bloomberg, I added Price to Book ratio charts for the Topix, Nikkei-225, Topix 2nd Section, India Sensex, India's Nifty 50, Mexico and the Renaissance Capital Central Asian Markets Index to the Chart Library. When a whole index is trading at below its book value, one has to question how much further it can fall before investors start to look at it as a bargain.

All three of the Japanese indices are trading below their book value. The 2nd section traded at 0.62 in late 2002 but advanced spectacularly from that level in the coming years. Right now it is at an even lower level as are the Topix 1st section and Nikkei 225. This is unprecedented in the last 19 years and suggests we are getting increasingly close to a low in terms of valuations.

The Price/Book chart for the Sensex is also worthy of notice. Peaks in the Price to Book ratio have corresponded with peaks important peaks in the equity market on several important occasions in the last twenty years. The most obvious were in 1992, 1994, and 2008. The ratio is approaching the area around 2 times which has been an area of potential support on a number of previous occasions. It that is to be case this time, it needs to begin to build support around current levels.

Email of the day (2) - on price to Free Cash Flow ratios:

"Very interesting chart showing the correlation, but it raises a question in my mind - i.e.: which came first... the chicken or the egg??? Could it not be that when the Nikkei goes up it pulls the Yen with it??

"Another question: Taking the current market situations into account there is a big emphasis being placed on share fundamentals. Now we all know where to find P/E ratios, but it seems that many deep value managers place a lot of value on a "Strong Free Cash Flow". It would be very interesting to know if there is a source that expresses the Free Cash Flow of companies in some sort of ratio. Or perhaps you know of a Fund that focuses on this fundamental.

"I look forward to reading any comments you may have on the above."

My comment - Thank you for some interesting questions. I think it is unlikely that the direction of the Nikkei alone exerts a pivot influence on the direction of the Yen considering how large a market that it is. The simplest explanation is when the Yen is depressed, either due to carry trades or simply unfavourably wide interest rate differentials; it has an undue effect on Japanese exporters which hits earnings expectations.

I have also seen commentary on the desirability of high levels of Free Cash Flows, but 'strong' is a relative term and I wasn't sure where to start, I searched Bloomberg for all shares with a Price / Free Cash Flow ratio < 10, Cash Dividend Cover > 1 and Market Cap > $5 Billion. The resulting list has 150 shares from 16 countries. I included the dividend cover ratio criteria because I thought investors would be interested in companies capable of maintaining their dividends.

Fundamental analysis is not our speciality so if subscribers know of other criteria which may also be useful please let me know and I will attempt to incorporate them into this search.

What is immediately obvious from this list is that it contains shares which have performed well such as Wells Fargo and those which have been sold aggressively such as Mosaic.

Email of the day (3) - on The Chart Seminar and yields:

"I attended your chart seminar last Fall (07) and wish it made me more disciplined than I've acted this past year. While my commodity trading has been disciplined and decisions made on price charts, I have held equity positions through this bloodbath. Why? I'm not sure other than maybe treating equity holdings more as "long term investments". I hope to change my behavior moving forward. With that said I would like to attend your chart seminar again but want to know if there are any plans to hold one in the US any time soon? I hope so!

"On a side note, I understand that the current dividend yield of US equities is higher than the rate of 30 year Treasuries which apparently has never happened (?). If this is indeed the case, arguments about "value" should be done on a relative basis - i.e.: versus alternatives - such as treasury yields.

"Thoughts? "

My comment - Thank you for your kind words and I remember you well from The Chart Seminar. Your story about your Liscannor stone fireplace has stayed with me. I have every intention of taking The Chart Seminar to the USA at some point, but given the economic environment, it won't be in 2009. On the other hand, London is a considerably cheaper place to visit now than it was last year.

This spread of the yield on US Treasuries over the yield on the S&P 500 hasn't quite reached parity yet but it is certainly at an interesting level. This chart is another indication that fear remains the dominant emotion among investors. When the spread turns upwards, it is likely to indicate investors are refocusing on equities.

Hindsight is 20/20 and we all seek to do better next time. However, there is a temptation to do in the next cycle what we wished we had done in the last one. In 2003, many investors sold too early because they had been conditioned by the bear market to sell on the first rally. This is why keeping an eye on the moving average as an indication of trend consistency is useful. Also see David's section on trend consistency in yesterday's Comment of the Day for more on this subject.

Wednesday 29th October 2008

Commentary by Eoin Treacy

Eye on the Market - Thanks to a subscriber for this even-handed commentary by Michael Cembalest for JP Morgan. Here is a section:

The more pressing question now is what to do with investment portfolios. Crises like the one we have just lived through can do long-term damage to financial markets. Japan's equity investment culture never recovered from the Nikkei's meteoric rise (when it doubled from 1986 to 1990) and subsequent collapse. According to IMF Global Financial Stability Reports, Japanese households own 6% in equities, among the lowest in both developed and developing economies. For individual and institutional investors around the world experiencing their second investment shock in a decade, a similar quasi-permanent reduction in risk appetite may be part of the future landscape.

The alternative point of view is that a collapse of this magnitude yields creative destruction, leaving in its wake lower valuations, more chastened financial institutions, more focused and cynical regulators, and a better foundation for investing. In the wake of the 1970s fiasco, efforts by regulators and the private sector to bring down inflation and address the U.S. productivity decline were slowly put in place. Both led to better markets that followed, when equities outperformed cash and bonds for the next 30 years. In the 1930s, the public sector created a broad range of safety nets and institutional separations of church and state to benefit workers, investors and companies; these efforts were successful as well over subsequent decades. And after the Depression of 1890's, triggered by a productivity surge and collapse in agricultural prices, the initial stirrings of government involvement with financial markets began, in contrast to the laissez-faire capitalism that preceded it. Markets recovered, but were met with the Panic of 1907, which itself created the impetus for establishing the Federal Reserve.

"The Awful Truth" was a movie with Cary Grant and Irene Dunne released in 1937, the last time 10 year trailing returns were negative. That the future would provide healthy returns for equity risk seemed remote then, as most people focused on the miseries of the past (the same goes for the mid 1970s). We don't know where the bottom is, but after a 20% decline in earnings, a 44% decline in equity prices and a 33% decline in P/E multiples from peak levels, this is as bad as bear markets tend to get. There may be more shoes to drop (selling by European banks and highly leveraged hedge funds); after all, who heard of Kaupthing before all this started (a)? But we don't think a further credit contraction and more forced selling will change the future contour of the chart. After this calamity, public and private sector responses to mistakes of the prior decade, combined with trailing P/E multiples of around 12, should help future equity returns outperform bonds and cash. That we and others did not position for this decline in advance does not change the nature of a discussion about the future. We believe that the TARP conversion into an equity injection plan will mark the beginning of the long road back, as we wrote on October 14th. Markets probably won't stabilize permanently until banks and broker-dealers raise common equity to absorb future losses, so the TARP needs to serve as a bridge to finding the true clearing price for a private sector solution. But the re-building of the financial sector has begun, which is where the clean-up has to start.

My view - I found this to be a useful commentary for anyone thinking of partaking in the capitulation trade. This has been a truly traumatic couple of months for anyone with long positions and I imagine recent action has been hair-raising for those with short positions as well. However, our most recent experience is generally not a good barometer with which to make decisions on our market positions. This is as true following a meteoric rise as following a cataclysmic fall.

The extent to which central bankers and governments are becoming involved to avert a doomsday scenario is a clear indication, to me, that we have entered the endgame for this bear market. The more pressing question is what the recovery will look like? Given the downward acceleration and damage to investor confidence, it will take time for investors to have faith in financial institutions once more. This means that the more time markets spend building support, the better the prospects for the next bull run.

Email of the day (1) - on largest daily rises for the Dow Jones Industrials:

"Here is a factoid to note in light of yesterday's 889 point gain on the Dow: Of the TOP 20 largest daily percentage gains in Dow's history only 3 have taken place Outside the Great Depression of 1929-1939. Two of them occurred this month alone, and the other in the crash period of 1987.

"TOP 20 Percentage Gains in DOW History

"1.) 3/15/1933 15.34% Great Depression
2.) 10/06/1931 14.87% Great Depression
3.) 10/30/1929 12.34% Great Depression

4.) 9/21/1932 11.36% Great Depression
5.) 10/13/2008 11.08% Two Weeks Ago!!
6.) 10/28/2008 10.88% Today!!
7.) 10/21/1987 10.15% 11 years ago
8.) 8/03/1932 9.52% Great Depression
9.) 2/11/1932 9.47% Great Depression
10.) Through 20) All happened during the Great Depression!

"Large percentage gains on the DOW as one economist put it, "Are not a sign of healing or cure, but of an ever sickening economy!""

My comment - Thank you for these interesting statistics. They illustrate that times of extreme volatility present days of spectacular rises as well as falls. We cover the subject of dynamic moves in great depth at The Chart Seminar.

Briefly, only one of the examples cited above occurred as part of a medium-term downtrend. That was the whipsaw move on October 30th 1929. All of the others either marked significant medium-term lows or occurred as important cyclical upswings were beginning.

What I find interesting about these statistics is that two of the Dow's largest upside moves in history occurred in the last couple of weeks and from the same region. In The Chart Seminar, we refer to this type of activity as bullish trampolining. What do these massive upside moves tell us? They indicate that demand is returning in force above 8000. Can the market still go lower? That is certainly a possibility, but considering the size of the downward move, the over extension relative to the 200 day moving average and the internal dynamics of the current range; the upside can probably be given the benefit of the doubt at least in the short to medium term. For the medium-term downtrend to be reasserted, it would need to sustain a significant move below 8000.

I don't know what this says about the economy other than the stock market is generally most volatile in times of economic stress.

On a bell curve of S&P 500 index performance - Thanks to a number of subscribers for this impressive graphic created by Value Square Asset Management at Yale University. It helps to further illustrate just how extraordinary the current market action is. This year's performance may only be comparable to 1931, to date, but it implies that next year will be better and let's not forget that this year isn't over yet.

Email of the day (2) - on Venn diagrams of Bank capitalisation:

"The attached has to be seen to be believed!"

My comment - Thank you for this interesting graphic which clearly shows which banks have been least affected by the credit crisis. The last year has seen the most over leveraged institutions fall foul of their lax approach to an increasingly risky situation. However, other banks such as HSBC and JP Morgan are coming through relatively unscathed. It is from these institutions we can expect sector leadership to develop during the next bull market.

Today's interesting charts - The Chart Library has two Search Engines. One searches the more than 17,000 equities, funds and ETFs in the International Equity Library. The other searches through the rest of the Chart Library for indices, commodities, currencies bond prices and yields, ratios, spreads and overlays. You can also customise these charts and save any of them in your Favourites section. Check the Library's Help section for further details.

Germany - holds yesterday's impressive gains and would need to sustain a move below 4000 to offset potential for some additional higher to lateral ranging.

Oil - largest up day in almost a month, as it challenges the integrity of the tight medium-term downtrend. A sustained move below $60 would now be needed to question scope for some additional upside.

Japanese Yen per 1 Euro - the Euro is rallying well from deeply oversold territory in what is a larger move, from a lower level, than any of the distributions to date. A sustained move below ¥115 would now be needed to question potential for some additional upside.

Tin - rallying well from the psychological $10,000 level in a move similar in size to that seen in August. So far, the move has succeeded in breaking the short-term downtrend and a sustained move below $10,000 would be needed to offset potential for some higher to lateral ranging.

Email of the day (3) - on point and figure charts:

"It occurs often that a chart in points and figures suddenly presents the evolution of the prices on a much shorter period of a couple of months instead of a couple of years. Examples: KBC in Belgium, PPR in France, Premier Foods in U.K. This takes of course much perspective away. Is there a particular reason for this and can it be avoided?"

My comment - Thank you for this question which I'm sure will also be of interest to other subscribers looking at point and figure (p&f) charts. The main benefit of p&f charts is that they help to net out the 'noise' of intraday moves because they only register price moves greater than a predetermined amount. This grants greater perspective and allows us to find consistency characteristics more easily. The problem with creating an automated system for plotting these charts is that to create a truly useful chart one really needs to monitor it and adjust the box size constantly to take account of the price movements.

In the International Equity Library, the default is a 1% box size. This means that whenever you first look at a p&f chart in the International Equity Library it will attempt to draw the chart with a 1% box size. In the main part of the Chart Library, I occasionally adjust box sizes for the best fit, but admit it has been some time since I last completed this operation.

Since all of the shares you mention have fallen considerably over the last few months, the 1% is no longer appropriate for them. If you want to get the entire top to bottom move on the chart, you will need to change the box size to your own custom size or select something like a 3% box size. Here are some examples. KBC (1%, 3%), PPR (1%, 5%) and Premier Foods (1%, 4%).

To change the box size for any p&f chart, click on the Charting tab at the top of the chart. Select your box size from the drop down menu or select 'Custom' to enter your own. Then hit Apply.

Email of the day (4) - on finding bonds in the Chart Library:

"I am being really thick but I cannot find Index Linked Gilts in the chart library. I can find TIPS but no OATS etc. please could you illuminate."

My comment - You're not being thick and I realise it is sometimes difficult to find exactly what one wants in the Chart Library. We are working to make it easier.

We have some inflation linked bonds in the Chart Library. If you type 'linked' into the search you will find a number of Inflation Linked bond indices as well as some UK Index linked bonds. However, we only have a small number of individual bonds in the Chart Library. This is why you will not find OATS (French government bonds). However, we do have government bond yields for a large number of countries, including France, in the Bond Yields section.

Please note - David is away today but will return tomorrow.

Thursday 30th October 2008

Commentary by Eoin Treacy

Dollar, Yen Fall as Rate Cuts, Stock Rally Boost Risk Appetite - This article by Lukanyo Mnyanda for Bloomberg covers the current important activity in the currency markets. Here it is a section:

The dollar and the yen fell as a wave of global interest-rate cuts sparked a rally in stocks, boosting demand for higher-yielding assets.

The greenback slid for a third day against the euro after the Federal Reserve reduced its target lending rate to 1 percent and agreed to provide $120 billion to the central banks of Brazil, Mexico, South Korea and Singapore. The yen dropped to a one-week low versus the European currency on speculation the Bank of Japan will lower borrowing costs when it meets tomorrow.
South Korea's won jumped the most in a decade.

``The central banks have shown they're ready and willing to do what's necessary to deal with the crisis and the correction in the dollar and yen will continue near term,'' said Henrik Gullberg, a currency strategist in London at Deutsche Bank AG, the world's biggest foreign-exchange trader. ``We're seeing a continuation of gains in the risk-appetite currencies and the central bank moves have reinforced that.''

The dollar fell to $1.3292 per euro, the lowest since Oct. 21, and traded at $1.3086 as of 11:33 a.m. in London from $1.2963 yesterday. The yen weakened to 98.58 per dollar from 97.39. The euro gained to 129.01 yen from 126.26 yen.

The won jumped 14 percent to 1,250.50 per dollar, the biggest advance since January 1998. The currency two days ago sank to a decade-low of 1,495 as mounting risk aversion prompted investors to dump emerging-market assets.

The hryvnia rose the most against the dollar since the Ukrainian currency's introduction in 1996 after Reuters cited an unidentified central bank official as saying the Natsionalnyi Bank Ukrainy may step in to halt any declines. It jumped 11.2 percent to 6.2675 per dollar at 12:58 p.m. in Kiev, after its 10 percent drop to a record low yesterday.

Stocks Rally

Stocks rallied worldwide. The MSCI World Index added 2.6 percent to 948.59 at 11:02 a.m. in London, advancing for a third day, the longest winning streak in two months. Europe's Dow Jones Stoxx 600 Index increased 2.5 percent with all 18 western European markets advancing.

Futures on the Standard & Poor's 500 Index for December delivery climbed 2.8 percent. Japan's Nikkei 225 Stock Average climbed 10 percent and South Korea's Kospi index surged 12 percent, the biggest advance since at least 1980.

U.S. policy makers reduced the fed funds target by a half- percentage point to 1 percent yesterday, matching a level reached in June 2003 and before that during the Dwight Eisenhower administration in the late 1950s.

My view - This week has seen some extremely large moves in the currency markets. Over the last few months, two of the main beneficiaries of the liquidation of carry trades have been the US Dollar and especially the Japanese Yen. Both of these currencies have rallied in impressive fashion and their strength has been a considerable headwind for commodity and many equity markets. In fact there is a clear correlation between the rally in these currencies and the weakness of emerging market stock indices. (Also See Comment of the Day on October 16th). The question now is whether this headwind is turning into a tailwind.

The Yen has gone from being one of the weakest currencies in the world to one of the strongest in a very short time. This has seen it advance considerably in a clearly accelerated move which is now under pressure. This week saw the Yen fall further and faster against the British Pound, US Dollar, Euro, Swiss Franc, South African Rand, Swedish Krona, Canadian Dollar, Australian Dollar, New Zealand Dollar, Singapore Dollar, Hong Kong Dollar, Indian Rupee, Brazilian Real, Russian Ruble and Chinese Yuan, than at any time in the last few months. This is clearly a larger reaction and from a higher area than any previous consolidation. Although the Yen found a least short-term support today, it needs to sustain moves to significant new highs to question scope for a further retracement of recent gains.

The Dollar also rallied impressively over the last few months and encountered resistance this week. However, the commonality of this move is far less clear cut with the Dollar than for the Yen. The Dollar Index's rally broke its almost three-year downtrend and forced investors to reassess the medium-term prospects for the currency. It encountered resistance this week near 88, but this is so far an equal sized reaction to that posted in September. It needs to now encounter resistance below 88 and sustain a move below 84 to confirm that it has hit a medium-term peak.

Against the Yen, South African Rand, Swedish Krona, Canadian Dollar, Australian Dollar, New Zealand Dollar, Singapore Dollar, South Korean Won, Taiwan Dollar, Indonesian Rupiah, Brazilian Real, Slovakian Koruna and Ukranian Hryvnia, the US Dollar has had a larger reaction than any seen to date within the medium-term uptrend. In some cases this has been a massive reversal so it is reasonable to expect that for these currencies the prospects that the greenback has hit an important peak are quite high.

However, there are some notable exceptions. The US Dollar found support against the Euro, Swiss Franc and British Pound today, in what is a proxy for the action of the Dollar Index commented on above.

The US Dollar posted its largest reaction, against the Russian Ruble this week, but did not remain weak beyond an intraday move. It held its rally today. A downward dynamic is now needed to question potential for some additional upside in the short term.

The Dollar hit a new multi-decade high this week against the Indian Rupee and is also hitting new highs against the Philippine Peso and Thai Baht. It has so far remained relatively close to these elevated levels and a downward dynamic would now be needed to check the momentum of this consistent uptrend.

There are a number of messages, contained in these charts The Dollar remains strongest against those major currencies with the greatest room for interest rate differentials to contract. This at least in part helps to explain the relative weakness of the British Pound and Euro.

Concerns about the ability to maintain current account deficits in a tightening credit environment may be a drag on the performance of the Rupee and the Philippine Peso while political factors may be helping to keep the Thai Baht and Russian Ruble weak. For the majority of other emerging economies, the Dollar appears to have hit a medium-term high which should help to change a significant headwind into a tailwind. The commodity markets are likely to remain volatile as they are move strongly influenced by the Dollar's strength or weakness against the major G7 currencies.

Email of the day (1) - on the Irish market:

"Would Eoin be able to give us an opinion on the Irish market as I notice it is trading on a PER of 3.9 and it seems to have gone from a high flying growth market to a bit of a laggard."

My comment - I am very conscious of the fact that I may have a biased opinion when commenting on the Irish market because I live here and feel distressed by the despondency gripping the market presently. However some factors seem clear; In the Irish market as well as everywhere else, governance is everything. Fiscally responsible practices were not put in place during the boom years; rather the opposite. This led to government finances being overly reliant on the property sector which is now collapsing. Regulation of the banking industry has been lax and there appears to be little in the measures put in place to date to force reform.

The Irish market has fallen by more than 70% which makes it one of the worst performing European stock markets. From February 2007, the ISEQ has been unable to sustain rallies of more than about 1000 points. The market accelerated lower as it fell though 6000 and distributed once more near 4000. The downtrend lost momentum as it fell through 3000 and appears to be finding support above 2500. Time will be needed to build a base before it can justify anything more than a technical rally.

Email of the day (2) - on the capitalisation of banks in yesterday's Comment of the Day:

"The Venn diagrams are not faithfully presented -- the DIAMETER of the circles is in proportion to the market capitalization, not the AREA. So JP Morgan has lost 11% value ($165b down to $147b) compared to say CitiGroup lost 68% value ($255b down to $82b) -- but the AREA reduction on the respective circles shows 21% reduction and 90% respectively.

"Things might be bad, but they are not as bad as this graph suggests. And (surprise, surprise) JP Morgan is relatively not quite as better than their peers as the graphs suggest!"

My comment - Thank you for your vigilance in pointing out this inconsistency. However, the fact remains that the banks which weather the current storm best will possess a competitive advantage relative to more distressed companies.

Email of the day (3) - on customizing charts using the Charting tool:

"Do you have listed or can you list the Momentum Index which is a 200 day moving average of the NYSE advance decline line? Also is it possible to add two charts on one page. Top item would be the dji and the bottom would be a weekly high /low index for the NYSE excluding preferreds and warrants as calculated weekly."

My comment - Thank you for an interesting question and yes it is possible to complete both of these operations. The Momentum Index, as you call it, is not listed as a separate instrument on Bloomberg so we do not have it as an individual entry in the Chart Library. However, we can plot the Cumulative Advance-Decline Line for NYSE stocks and put a 200-day moving average on it. Simply search for NYSE, select the Advance-Decline Line you wish and click on the Charting tab in the upper left hand corner of the chart area. Next Select Moving Average from the Analysis dropdown menu. 200-day is the default but you can change it if you wish. Then hit Apply. You should get a chart that looks like this.

To create a comparison chart; select the Dow Jones Industrials and hit the Charting tab. Select Comparison from the Analysis menu. The High-Low Index is not on the drop down so you will need to hit the 'Other Instrument' tab. In the Search box in the bottom right type 'NYSE' and hit Go. In the North American Indices section you will NYSE High-Low Index. Click on it. Next hit Apply. The resulting chart should look like this.

Today's interesting charts - The Chart Library is filled with currency crosses which may be of interest to subscribers.

Australia ASX 200 - attempting to push back above the psychological 4000 level and would need to sustain a move below 3750 to question scope for some additional higher to lateral ranging.

Chile - in the face of a falling copper price and weak global stock markets, this index continues to outperform. A sustained move below 11,000 would now be needed to question scope for further higher to lateral ranging.

Soybeans - steadying above 800¢, having almost halved since early July. A sustained move below that level would now be needed to question potential for further higher to lateral ranging.

Email of the day (4) - on p&f charting and an addition to the Chart Library:

"That explanation you gave of how to alter the % box size for the p&f charts was an insight I badly needed. No doubt I should have been able to work it out for myself or find it in the instructions. However, after these free-fall declines I can now make the p&f talk to me by increasing the % as you suggest.

"Can you add Argo Investments (ARG) to the Aussie shares in the chart library?"

My comment - Thank you for your kind words and I am glad to hear that you will be able to make better use of the Chart Library's p&f functionality. I have added Argo Investments to the International Equity section.

Email of the day (5 & 6) - on additions to the Chart Library:

"At your convenience, please add the following to the chart library:

"Proshares Short Russell 2000 (RWM)
iShares Russell 2000 (IWM)"

And

"Would you kindly add following Bloomberg tickers at the FM database?

"COP:CN (CORO MINING)
KRN:GR (KRONES)

"Many thanks in advance,"

My comment - Thank you for these interesting suggestions which have now been added to the Chart Library.

Please note - David is away today.

Friday 31st October 2008

Commentary by Eoin Treacy

S&P 500 and Dow Jones Industrials Average divergence from 200-day moving average - On October 10th I said I would post an indicator of how much both the Dow and S&P500 have diverged from their respective 200-day moving averages once a week until it is quite clear that the indicators hit important lows. We appear to be in that bottoming range.

I rate this study as important because it serves to remind us that the current environment is extraordinary in terms of how overextended markets have become relative to their long-term averages. Statistically, a reversion to the mean remains the most likely scenario in the short to medium term. Where markets consolidate subsequent to that move will be an important marker for the shape of any potential recovery.

To date, the S&P500 hit a low of 0.68 on the 10th while the Dow hit a low on the 20th at 0.56. Both of these readings are historically low, with the Dow not being so overextended since the 1930s. From these lows they rallied to 0.73 and 0.766 respectively, today. Historically, important lows for this indicator have preceded important medium to longer-term turning points.

You will notice that this week's charts are for a somewhat contracted history. The reason for this is because when I converted the chart into a JPEG, it was losing the detail at the right hand side of the chart. You can find the longer-term charts in Comment of the Day on October 10th.

Email of the day (1) - on the potential for the bear case to come to fruition:

"As a long only investor I have been listening with interest (and not a little hope!) to your observations about the prospects for short/medium term rally.

"Beyond a small rally there are a number of commentators, such as Full Circle Asset Management (in their 360 Newsletter) and Elliott Wave International, suggesting that the current downturn is a resumption of the bear market which began in 2001, with just a bear market rally from 2003-2007, and we should expect "substantial" falls ahead before we bottom. Here's something in a similar vein:

"The bigger the party, the longer it takes to clear up the mess" by Jeff Randall in the Daily Telegraph: [Ed. Dated October 29th 2008]

Here's a representative excerpt:

I mention this as an antidote to those who keep telling me that because share prices have dropped sharply in recent days they must be cheap. These are the same people who said that British equities represented "remarkable value" when the FTSE 100 fell back through 6,000, then 5,000 and finally 4,000.

The index closed last night at 3926, about 43pc below its peak of 6930 (reached in December 1999). At that level, if you are prepared to take a very long view, the advice of the bulls will undoubtedly pay off. By a very long view, I don't mean the end of this year, or next, or even the one after. History tells us, the bigger the party, the longer it takes to clear up the mess.

Of course there are some positive factors which could soften the bear market like pro-active Central Bank intervention and Asian growth. I know anything is possible but do you have any view of how this is likely to play out?

Thanks, as always, for the calm and honest coverage in these turbulent times!

My view - Thank you for an interesting question. The important thing to remember about projections is that they are estimates of what an analyst expects and nothing more; my own included.

There has been a lot of talk about how current market activity resembles that of the Great Depression. Almost all investors have experienced significant losses this month and there is a temptation to extrapolate one's most recent experience into the medium-term. The similarities between the current environment and the early 1930s are well documented, in just about every financial publication, so let's look at some of the differences. The most obvious is that the 1929 peak occurred following a massive stock market acceleration. The Dow advanced by 380% from late in 1924 to the high in September 1929. In contrast, the Dow advanced by 91% from the 2003 lows to the 2007 highs.

Valuations were not a serious worry for investors when they peaked in 2007. In fact P/E ratios have been contracting steadily from the highs posted between 1999 and 2002. In 1929, as far as I know, valuations were much more akin to those seen during the Nasdaq bubble.

The bubbles that burst over the last 18-months are in the housing and credit markets. Here, spreads had compressed to unprecedented levels and properties were selling at levels well beyond the means of most normal home buyers. Stock market difficulties are a symptom of deleveraging brought on by the bursting of these bubbles rather than being the root cause themselves. One might argue that the result is the same. However, this difference may have an impact on the shape of any recovery.

Money markets suffered a seizure following the Lehman Brothers bankruptcy leaving them incapable of fulfilling their role of dispensing short-term loans. The TED and OIS spreads have since fallen considerably from their highs, indicating that the worst of that episode is passing. However, as with any traumatic events, time will be needed for conditions to return to a semblance of normality.

It is reasonable to expect that those markets most heavily effected by the constriction of credit availability, burst housing bubbles and slowing global growth will take the longest time to recover. However, that does not preclude other less affected markets for continuing to lead the world in terms of relative economic performance.

I don't know if we have seen the absolute low and neither does anyone else. What we do know is that markets are oversold by any measure one could choose to use and a reversionary rally remains likely. Considering the extent of the declines, high volatility and the damage done to confidence, consolidations following any rally could be potentially lengthy but each market will have to be taken on its individual merits. The extent to which credit markets free up will be an important indicator to watch.

China Shows Us How It's Done - Thanks to a subscriber for this interesting article by Rosalind Mathieson for Dow Jones Newswires covering the measures being taken in China to curb economic slowdown. Here is a section:

To that end, analysts are fulsome in their praise of the aggressive action taken by Beijing, after its third rate cut in seven weeks; China is showing its determination to support its economy, they say, and the rate cuts are a positive/welcome/smart/proactive step.

Certainly officials in Beijing are due some acknowledgment.

They haven't mucked about like others have, by chopping and changing policy on the run.

They've seemed focused and assured as the crisis worsens, while their counterparts in a fair few countries have floundered caught out by the impact and pace of the global economic slowdown and by the gyrations in financial markets.

They've also been lucky.

China has had a bit of time to develop some foresight, as the economy has come into this crisis with a lot more fat on its bones than other places, and there's been no massive exposure by its banks to the subprime debt mess in the U.S.

It has had some leeway to sit back and watch as things unfolded first in the U.S. and then Europe and Asia. It has had time to witness the policy blunders of other nations, including their sluggish reactions to the increased risks to growth and the fading inflation threat. It saw central banks hike rates in some places, only to cut them a few weeks later.

Having seen how other countries are coping and the various strategies they are deploying - from the fiscal to the monetary - Beijing has cherry-picked the best bits and used them for itself.

It has realized that rates are a blunt, and laggard, instrument. So it is taking very targeted fiscal action to support key sectors of the economy, and loosening the reins on the property sector; it has slowed the gains in its currency, the yuan, while still prodding exporters of low-value, cheap goods to move up the food chain to the higher-end of town.

While cutting lending rates it has moved periodically to protect deposit rates.

My view - Newly emergent economies have a considerable advantage in implementing best practices because they have the opportunity to learn from others mistakes. Many consumers in the emerging world are bypassing fixed line telephony entirely and going straight to mobile and wireless broadband. Likewise central bankers have the opportunity to learn from the mistakes made by other countries and adopt the best possible available practices.

It does China no harm to have a spare trillion dollars, to help prime the economy for any slowdown. Projections that the Chinese economy will slow more than forecast are gaining airtime as American and European economies move into recession. However, no one knows for sure how far it will slow. What we do know is that no other country is as well placed to weather this storm.

India's Stock Index Jumps Most in 4 Years; Reliance Lead Gains - This article by Pooja Thakur for Bloomberg covers today's action on the Indian stock market. Here is a section:

India's stock index surged the most in four years, led by energy and financial companies, after overseas central banks cut interest rates and Standard & Poor's said the nation's investment-grade credit rating is safe.

Reliance Industries Ltd., India's most valuable company, gained 15 percent, the biggest jump in 12 years. ICICI Bank Ltd., the second-largest lender, rose 16 percent after the International Monetary Fund doubled lending limits for emerging economies. Indian markets were closed yesterday for a holiday when the MSCI Asia Pacific Index surged 9 percent.

``The various liquidity measures taken by governments across the globe should start showing results in the next 15 days,'' said Jayesh Shroff, who helps manage the equivalent of $2.4 billion in equity at SBI Asset Management Co. in Mumbai.

The benchmark Bombay Stock Exchange Sensitive Index, or Sensex, rose 743.55, or 8.2 percent, to close at 9,788.06, the steepest one-day gain since May 18, 2004.

The S&P CNX Nifty Index on the National Stock Exchange climbed 188.55, or 7 percent, to 2,885.60. The BSE 200 Index rose 7 percent to 1,145.68. Nifty futures for November delivery added 176.55, or 6.5 percent, to 2,900. The Sensex has fallen 24 percent this month, the most on record, after a rout triggered by the global financial crisis.

Fed Loans

ICICI gained 16 percent to 398.75 rupees, its biggest advance since Oct. 13. India's investment-grade credit ratings were maintained by Standard & Poor's on optimism the nation's economic expansion won't be hurt by a global slowdown.

``The ratings reflect the country's strong economic growth prospects and its deep government debt market,'' S&P said in a statement. ``India's business environment is likely to improve in the years ahead, notwithstanding the current dislocations in global credit markets.''

Reliance Communications Ltd., India's second-largest mobile- phone operator, climbed 13 percent to 219.95 rupees after the Mumbai-based company reported second-quarter profit surged 18 percent, beating estimates.

Net income climbed to 15.3 billion rupees ($310 million) in the three months ended Sept. 30, from 13 billion rupees a year earlier, after the operator added a record number of uses in the world's second-fastest growing mobile-phone market.

Larger rival Bharti Airtel Ltd. gained 6 percent to 653.75 rupees. Net income at the New Delhi-based mobile-phone operator surged 27 percent to 20.5 billion rupees.

My view - The Sensex posted its first positive week in 6 as it rallied from 8000 to just below 10,000 over the last few days. The Index remains overextended relative to its moving average and would need to sustain a move below this week's lows to question scope for some additional higher to lateral ranging.

Today's interesting charts - The Chart Library has a wide number of Volatility Indices which may be of interest to subscribers.

VIX Index - continues to withdraw from the spectacular intra-month highs. However it needs to sustain a move back below 20 to signal a return to more normal trading conditions.

Taiwan - finds support at the lower side of the long-term range and would need to sustain a move below 4000 to question potential for some additional higher to lateral ranging.

Silver - encountering resistance near $10 but would need to sustain a move below $8 to question scope for some additional higher to lateral ranging.

Please note - David is well, but away from the office, probably until next Tuesday or Wednesday due to family medical reasons.

Quote of the week - on seeing what we want to see and what is actually there:

``Brain: an apparatus with which we think we think.''
Ambrose Bierce