



Bull Bear Reviewsm with Michael J. Chapman, CFP



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- **Interest rates key to market & economy**
- **SWF's adds new source of liquidity**

In my opinion, the thing most likely to effect the future direction of the stock market is the 10-year interest rate. As the ten-year treasury rate climbs you will see an increase in mortgage rates.

Mortgage experts estimate that 1.5 trillion adjustable rate mortgages will come due in 2007. If rates continue to climb (the 10-year treasury rate has risen from 4.5% to 4.85% in the last 60 days), these adjustable rate loans will reset at higher rates, which translates into higher monthly mortgage payments. Add \$4.00 per gallon gas and the consumer will experience a real crunch in discretionary income.

Higher rates will also give stock market investors an appealing low risk place to go with investment assets. The trend in the ten-year Treasury bond turns down this week and I am adding that to the negative side of our ledger.

John Mauldin, in his weekly e-mail "Thoughts from the Frontline", discusses Sovereign Wealth Funds or SWFs www.frontlinethoughts.com. It seems that foreign Governments are now using their excess reserves to get into the private equity game. In the past, these short term funds

were placed in high grade bonds such as U.S. Treasuries. Morgan Stanley estimates total wealth in these funds to be \$2.5 trillion, far more than what is currently being handled by hedge funds. Additionally, they estimate that these funds will grow at \$500 billion per year for the next five to six years.

Norway has a \$300 billion fund. Russia is planning a \$50 billion fund, and Abu Dhabi has an estimated \$875 billion fund.

This will continue to add tremendous liquidity to the world stock markets. It will mean more equities in private hands and fewer shares available. Fewer shares outstanding should mean higher relative stock prices (higher p/e multiples).

On The Upside

Trends are all positive. My proprietary trend indicator is up. The slope of the 21, 50 and 200 day moving averages is up. However, momentum is slowing and I expect a test of support levels this week. As long as price remains above **13,290** in the Dow and **1,497** and **1860** in the S&P and Nasdaq 100 indexes respectively, all lights are green.

According to Thomson Financial, 2006 was a record year for global merger and acquisition activity, hitting 3.77 trillion and topping the record set in 2000 of \$3.44 trillion. This trend has continued in 2007 and private equity firms

BULL BEAR REVIEW 05-29-2007

Bull (up)

Trend

Liquidity and Free Cash Flow

Oil Prices are in a Weekly Downtrend

Commitment of Traders

SPX 1,515 NDX 1,892 DJI 13,490

Bear (down)

Inverted Yield Curve

Housing Market Fall Out

Adviser Sentiment

Divergence in price and market breadth

Restrictive Monetary Policy in China

U.S. 10 year bond in down trend

Major Cyclical low due late 4th quarter

and Sovereign Wealth Funds (SWFs) should keep this trend in place for the rest of the year.

A recent *Fortune Magazine* article discussed the ten biggest private equity firms. By their calculations these top ten firms have \$250 Billion in cash. They will borrow up to 10 times that amount in doing their deals (hence the term “leveraged buy out”) which means they have buying power of \$2.5 Trillion. You also have the phenomena of SWFs which Morgan Stanley estimates contain 2.5 trillion dollars. This is adding tremendous **liquidity** to the market thus driving it higher during good times and supporting it during sell offs.

Oil prices are \$63.5/brrl. The price of oil is in a confirmed down trend.

Commitment of Traders released on Friday show the large commercial trader still net long and the large speculator short. The buying power to propel this market to new highs will likely come from the large speculator as they cover their shorts and go long. It’s possible (not probable) that the commercial trader is wrong and they will be forced to cover, which would accelerate a down move. The next three to four weeks should be interesting.

On the Downside

Three-month treasury bills are yielding more than the ten- and thirty-year treasury bonds and have been since June of 2006. This is what is called an **inverted yield curve** and is an important “red flag” because this condition has resulted in a recession seven out of the last eight occurrences. There has not been a recession since 1950 that was not preceded by a 10 to 20 percent decline in the stock market.

The **housing market fall out** remains the wild card. What we know about the housing market cycles are that the average length of time from peak to trough is 27 months. This down move started in January of 2006 and therefore likely has another 12 months. In the past 40 years private residential construction has never contracted to this extent without triggering a recession. Housing inventories are at a 16-year high (8.1 months at the current rate of sales). Existing home sales in March fell 8.4% the largest amount in 18 years. April new homes sales were back up, but this number is probably misleading. The April new home sales number has been revised lower each of the past three years. Both new and existing home sales are down 10.6 percent versus year ago levels. Jim Stack is doing a good job of tracking the unwinding of the housing bubble. Go to www.investech.com to find three great charts that tell the story. Jim updates these charts regularly. Go to www.lenderimplode.com to track the demise of the sub prime industry.

Investor Intelligence reports **adviser sentiment** is now at a bearish level. Advisers bullish have reached 54.3% while those bearish are at 20.7%. This contrary indicator is not a good short-term timing indicator, but it does add weight to bearish side of the ledger.

Divergences continue to suggest caution. Stock and bond indexes have taken separate paths, the advance decline line is starting to show a narrowing of breadth, and the Dow Jones Industrial Average has continued to climb 430 points since the last high made by the Dow Transportation Average on April 25th. Unless the transportation index breaks out to new highs soon a “Dow Theory” sell signal will be given.

The Dow Jones Industrial Utility index is no longer in an up trend.

Restrictive Monetary Policy by China’s Central Bank could be a showstopper. China has a problem with speculation in its stock market. The central planners are aware of the problem and are trying to quell enthusiasm with higher interest rates and restrictive monetary policies. There will be some fall out worldwide when their market corrects.

The 3.3-year **cycle low** is due late in 2007 early 2008. This cycle low has marked many significant lows over the past twenty-five years including the 1987 crash low.

Your Bull Bear Review Analyst,

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