



Bull Bear Reviewsm with Michael J. Chapman, CFP



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- **New highs by end of August**
- **Commercials still long**
- **Rates have fallen 40 bp**

I believe we are near the lows for this pull back and the next move will be to new highs. Key financial stocks appear to have completed five wave patterns to the down side and should move back up in price. They will likely fail to make new highs setting up a classic divergence with the major indexes and creating a reliable sell signal some time in August.

The commercial traders continue to buy this market and are long record levels. They report on Tuesdays after the close and these stats are released to the public on Fridays. This Fridays report will be telling since it will include their activity on Tuesday's big sell off.

Interest rates (10-year treasury yield) have fallen from a June 13th high of 5.3 percent to tonight's 4.9 % close. This drop of 40 basis points should help the stock market. The bad news is A: The junk to quality credit spread continues to widen making it more expensive to finance M&A activity, and; B: This correction back down in rates has been an A,B,C zig zag pattern and both down legs (A&C)

where 30 basis points in price and 13 trading days in time. This means the correction in rates is likely over and that the next move will be back up.

On The Upside

Trend is up up in the DJIA, the S&P 500 and the NASDAQ 100 indexes. Stops are at 13,400, 1496 and 1996 (closing basis) respectively. The NDX index is leading this break out.

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 it may set a private-equity record with \$115 billion in buy outs announced. For the year through May we are at \$315 billion in private equity buy outs (Thompson Financial). Private equity firms and Sovereign Wealth Funds (SWFs) should keep the record merger and acquisition trend in place for the rest of the year, barring a continued rise in interest rates.

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,

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Bull (up)

Liquidity and Free Cash Flow

Commercials Net Long

SPX 1,518 NDX 2,011 DJI 13,785

Bear (down)

Inverted Yield Curve

Housing Market Fall Out

Adviser Sentiment

Rising World Interest Rates

Major Cyclical low due late 4th quarter

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.

On the Downside

From June of 2006 until late May of 2007, the 3-month T-Bill was yielding more than the 10- and 30-year bond rates. 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 (8.9 months at the current rate of sales). Existing home sales in May fell .3%. Both new and existing home sales are down 10.6 percent versus year ago levels. Building activity is down 24% from 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 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 49.4% while those bearish are at 18.0%. This contrary indicator is not a good short-term timing indicator but does add weight to bearish side of the ledger.

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,

Michael J. Chapman, CFP

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