

September 21, 2009

Hi Everyone,

Stock and credit markets around the world stepped on the gas this past week in a continuation of the themes that we have been discussing here for the past few weeks. The global reflation trade is on full bore, and there's no stopping it, which is great news for us.

I think a lot of us are coming to the realization now that corporate and fund management insiders had been doing their best all summer to try to talk down the market because they wanted to buy stocks more cheaply themselves. Hedge fund managers who seldom talk to the press let out word from their summer hide-a-ways about how overvalued the market was. They talked about how overstressed and "tapped out" the consumer was. They talked about historic levels of deleveraging that needed to be done, how housing prices would decline forever, and how banks had holes in their balance sheets the size of moon craters.

It didn't work though; there was 3.9 trillion dollars in money markets in March and at the end of August, according to Investors News there still was 3.5 trillion in money markets of people still too concerned about the state of the economy to invest it. But, that is changing.

The bearish argument at times like these always sounds so plausible, and the manipulators know that. They recognize that intelligent negativity is like a mental corrosive. It eats away at the public's confidence. The bearish view makes the average investor think that there are hidden forces that will snatch their investments away and ruin their futures.

But all along, I believe they were just trying to scare us about the bogeyman under the bed. There was a time to be bearish and negative about the market, to be sure, but I do not think it is now. I have been saying since the end of June, that I feel that for the next 6-9 months the market will be up more than down.

Credit, Credit and More Credit

What are the difference between last year and this year? The list is long, but the key piece of evidence that I've found in support of the bullish argument is the behavior of the credit markets.

The debt markets are where the real action in the investing world occurs. Credit markets are more than five times larger than the equity market. The credit markets are where companies go to get financed. They are how states and cities fund themselves. They are how you finance big purchases, like a house or a car or the expansion of your manufacturing business.

Equity, in contrast, is a speculative play thing that tags along with its big brothers in credit. It has virtually no role in the corporate balance sheet except as a currency to buy other companies or compensate employees. It's just paper on which we speculate. Its value waxes and wanes with the emotions of the moment.

Textbooks say it is related to the value of corporate earnings growth, but by now we know that is nonsense. The value of equity is tied to investors' rising and falling desire to hold risky assets, a point of view that shows up in price/earnings multiples.

Last year, credit was under siege for a variety of very good reasons. Investors had overindulged on buying complicated debt derivatives tied to the crumbling U.S. housing market. Cash flows thinned. The derivatives blew up. Investors became disgusted. They started selling them all at any price. Short

sellers figured that out and pounced on credit themselves. It turned out that big investment banks were particularly vulnerable to short-selling through derivatives called credit default swaps, and sellers took advantage of this and absolutely crushed them—very nearly bringing the global financial system to its knees.

The Greatest Liquidity Wave in History

But all good things come to an end, and ultimately governments and central bankers figured out how to turn the tables on the credit short sellers. They unleashed the greatest liquidity wave in the history of the markets, cutting interest rates to almost zero, guaranteeing every kind of corporate debt, allowing banks to use anything in their buildings as collateral for new low-cost loans—even going so far as to basically issue the most important sort of short-term corporate credit, called commercial paper, themselves.

It took awhile, but policymakers worldwide—U.S., Europe, China, Russia, Japan—joined hands in an unprecedented show of combined force and have succeeded in reestablishing the creditworthiness of corporate debt. Starting in the early spring with the Chrysler bankruptcy, oddly enough, investors began to figure that out. And since then we have seen the greatest **credit** bull market in history.

By the end of the summer, bonds that Citigroup issued before the credit crisis in 2007 were suddenly worth more than when they were issued! The bonds that were issued at par in mid-2007, then lost almost 90% of their value by January 2009, had suddenly become fully valued again. The implications of this were stunning. It meant that Citigroup debt was trading as if the credit crisis never happened, and yet Citigroup equity was still trading at very low prices.

Of course the equity had been diluted with share offerings, but that's not the point. The point is that the credit market had led the equity market down a rat hole, and overly bullish stock investors never really caught onto that for about a year. And now credit markets were leading the equity market back up.

September Strength

So now what? Well, stocks started this week on a down stroke amid new fears that the Chinese government was paring back on infrastructure construction, that the commodity rally had peaked and that the United States was starting a trade war. Yet once the doors had been open for trading on Monday for an hour, the U.S. and European markets' reaction to the supposed news was indifference.

By the way, this just goes to show that the futures trading overnight are really very thin and can be pushed around by a few big traders trying to paint the tape in their own direction. We can't fall for it. It's just one more way that insiders try to manipulate public opinion, especially over the weekend.

Another big issue for traders this month is that rumors of a September collapse have so far proven to be just another round of those ghost stories. I knew not to fall for this one, because I looked at charts in August that showed several positive September outcomes of the past in market climates that were the most similar to the present.

Of course, the month still has *8 trading days* left in it, but the odds of a significant deterioration decline every day. I don't want to sound complacent, because I'm still on high alert, but the two reasons for this should be fairly obvious and they both have to do with why the month has a bad reputation.

First, September is the last month of the third quarter. If companies believe that they are going to miss consensus third-quarter earnings estimates, or their own prior estimate range, then most believe they need to tell investors that before earnings reporting season begins on October 1.

Before companies had sophisticated customer sales and business modeling software, it was often hard for chief financial officers to get a grip on how their quarters were running until they were done. Now CFOs can push a button and see how sales are running vs. their plan at any time in the last month of the quarter. Some executives may wait until the last week of the quarter to confess shortfalls—typically after haranguing their sales managers to close any lingering deals pronto—but most of them these days do so by the middle of the month to avoid customer lawsuits accusing them of withholding material information.

This month, not only have there not been many negative preannouncements surprises, there have actually been several high-profile *positive* preannouncements from big companies like Intel and Texas Instruments. So the bottom line is that as every day passes, you get farther away from the times when really bad news is mostly likely to have been announced.

Just to show you how tough this period has been for bears, consider the statement made Tuesday by big U.S. steelmaker Nucor. The company issued a dramatically lower forecast for the third quarter, saying it expects a loss for the quarter three times the size that investors were expecting. It also said it sees little improvement in real demand and warned the U.S. economy is still fragile. Its business was terrible, investors were right. But the stock rose 2.2% Tuesday because the news wasn't as bad as many had feared.

Second, the more that September puts up positive numbers the more that *mutual fund managers'* benchmark return for the month rises. So any managers that came into the month neutral or bearish start to get very worried about missing the performance bar if they are wrong by mid-month. Salaries, bonuses and reputations hang in the balance, so any managers who are less than fully invested, will start to feel pressure to get into the market—and in a hurry.

This is called the "salary drive" in the mutual fund business, and it's a much more powerful force than concerns about valuations, or fears that the market is overbought, or other niceties. And the issue is exacerbated because many hedge funds close their fiscal year at the end of September, so their personal total annual bonus and funds' "high watermark" lines—which determine if they are above or below their one-year performance thresholds—are drawn on the last day of this month.

A Good Time for Us

Meanwhile, the news is in good shape. We're not seeing a robust recovery in the United States, which is ok because that will keep the Federal Reserve's hands off the interest rates, but we are seeing one overseas, which is great because that is the source of most of the growth in the world.

Key news items to focus on: August retail sales rose by the largest amount in more than three years, reversing July's modest decline, helped by gains that went beyond the "Cash for Clunkers" sales. Meanwhile, Goldman Sachs chief economist Jim O'Neill said in a report that the global recovery is "beyond a V shape," and added the recovery will surprise markets with upside. Putting aside the NUE news, earnings updates this week from laggards like Monsanto and Illinois Tool works were positive.

The bottom line is that I think there is still plenty of negativity to fuel a continued rise in the markets as short-covering by the bears continues. *There may be multi-day declines*, of course, and I actually hope that there are, as overbought conditions must be relieved, so October may be *less kind* to us,

but in general we are moving into a time of year that is seasonally bullish. Most people may be surprised to see how far this move can go.

As I said, I'm always on high alert, and this doesn't mean that I am thinking that 2010 and beyond is going to be fine – far from it, but I think the last part of 2009 is shaping up to be very exciting for us.

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Sources: Investors Business Daily, Investment News, Jon Markman, Traders Advantage

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