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MarketShadows

this issue

Event Horizon

Mistakes are for Repeating

How did the Federal Reserve precipitate the stock market collapse in 2008? Will it do it again?

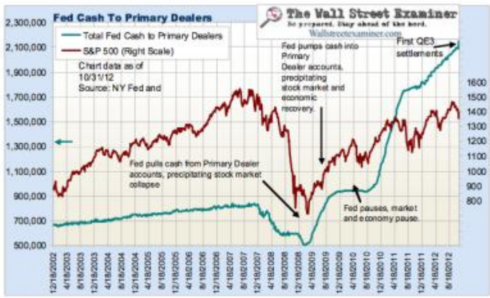
By Ilene with [Lee Adler of the Wall Street Examiner]

The Federal Reserve is the largest driver of stock prices. Stocks as a group are less dependent on the health of the economy, or quarterly earnings, or world events, than they are on the actions of the U.S. Fed and other powerful central banks.

[Lee Adler] described the actions of the federal government and the Federal Reserve in causing the stock market meltdown in 2008: "The Fed has near absolute control over the US stock market and the economy based on how much cash it pumps into [Primary Dealer] trading accounts."

> *The Fed's purchases [of Treasury debt] result in a credit to the Primary Dealer's account at the Fed, while the Fed's sales result in a debit to that account. That's how Fed purchases inject reserves into the system. The conduit is the Primary Dealer accounts. They then use that cash to trade their own accounts or lend to customers, pushing the markets higher when the Fed is buying on balance. ([Lee Adler on QE-Infinity])*

At the end of 2008, the government and the Fed panicked and pulled $700 billion out of the economy in raising [TARP] and funding it through debt sales [by the Treasury]. The Fed funded the debt through various "propping programs" that pulled enormous sums of cash out of the Primary Dealers' trading accounts. Draining the Primary Dealer accounts crashed the stock market. The economy followed stocks into a tailspin.



The mechanism:

> *When the Fed buys securities from the dealers it pumps cash into their trading accounts, the market rises and the economy tags along. When the Fed drained money from dealer accounts, especially in the face of the Treasury selling $700 billion in new debt over the same time window, the economy collapsed.*
>
> *It was just another one of the Fed's serial blunders. Some of its mistakes look good on the surface for a while, until the unintended consequences overwhelm the intended ones. That one went bad immediately.*

More at this [link].

"Gambling: The sure way of getting nothing for something."

Wilson Mizner

Mortgage-backed security (MBS)

A mortgage-backed security (MBS) is an asset-backed security that represents a claim on the cash flows from mortgage loans through a process known as securitization. The process of securitization is complicated, and is highly dependent on the jurisdiction within which the process is conducted. The basics are:

1. Mortgage loans (mortgage notes) are purchased from banks and other lenders, and possibly assigned to a special purpose vehicle (SPV)
2. The purchaser or assignee assembles these loans into collections, or "pools"
3. The purchaser or assignee securitizes the pools by issuing mortgage-backed securities

While a residential mortgage-backed security (RMBS) is secured by single-family or two to four family real estate, a commercial mortgage-backed security (CMBS) is secured by commercial and multifamily properties, such as apartment buildings, retail or office properties, hotels, schools, industrial properties and other commercial sites. A CMBS is usually structured as a different type of security than an RMBS.

These securitization trusts include government-sponsored enterprises and private entities which may offer credit enhancement features to mitigate the risk of prepayment and default associated with these mortgages. Since residential mortgages in the United States have the option to pay more than the required monthly payment (curtailment) or to pay off the loan in its entirety (prepayment), the monthly cash flow of an MBS is not known in advance, and therefore presents risk to MBS investors.

In the United States, the most common securitization trusts are Fannie Mae and Freddie Mac, U.S. government-sponsored enterprises. Ginnie Mae, a U.S. government-sponsored enterprise backed by the full faith and credit of the U.S. government, guarantees its investors receive timely payments, but buys limited numbers of mortgage notes. Some private institutions also securitize mortgages, known as "private-label" mortgage securities. Issuances of private-label mortgage-backed securities increased dramatically from 2001 to 2007, and then ended abruptly in 2008 when real estate markets began to falter.

Source: Wikipedia.com

(Click on charts to enlarge)

Market-Moving Forces

This week, Lee Adler of the Wall Street Examiner shares his work on the flow of money between the Treasury, the Fed, Foreign Central Banks, and the financial markets. Lee's observations provide unique and critical information for making any long-term investment decisions.

Highlights from Lee's Withholding Taxes Bounce Back But Treasury Supply Will Pound Market This Week.

Comments by Ilene in blue italics.

Several of the key bullet points:

- The Treasury announced and floated $20 billion in cash management bills (CMBs) last week. It was the third consecutive such weekly offering. $45 billion in CMBs over the past 2 weeks. It blunted the effect of the Fed's addition of $59.5 billion in cash to Primary Dealer accounts via its forward MBS purchases.

The Treasury's offering of CMBs to the Primary Dealers (PDs) took liquidity from the PD's trading accounts and gave it to the Treasury, leaving less money for the PDs to buy stocks and commodities: $59.5B – 45B = $14.5B.

The $14.5 billion in cash that was not absorbed by the CMBs may have helped fuel the upturn in stocks last week.

- The next big round of Treasury supply will settle Thursday and Friday with an estimated $77 billion in new paper scheduled to settle. That should unsettle the markets late in the week, and possibly early the following week.

The market has to absorb a sum of $77B in new Treasury paper. Some of the money to purchase Treasuries will come from the PDs (not all of it). Money buying treasuries will not be available to prop up stocks and commodities. $77B of supply typically requires some amount of something else to be liquidated, so there's usually selling pressure somewhere for a couple of days right around the settlement. It can't be completely isolated from whatever else is going on, but it tilts the playing field.

- No Fed MBS (mortgage back security) purchases are at this time.

The PDs will not be receiving MBS money from the Fed to offset the $77B going to the Treasury. This should put a strain on the stock market towards the end of next week.

- Treasury supply will be light for the remainder of the month. The Fed has scheduled $70 billion in MBS purchase settlements for December 12-20, with another $10 billion or so to possibly be scheduled. That cash will set the markets up for a Santa Claus rally.

This $70B in MBS purchases will flow from the Fed to the PDs, giving the PDs liquidity to buy stocks and commodities. After the Nov. 30 Treasury supply of $77B, is out of the way, the MBS settlements of $70B will hit the markets. This money from the Fed to the PDs will set the market up for a rally.

- Banks and Foreign Central Banks (FCBs) have cut back in their buying of Treasuries in recent weeks, but public buying has continued at very strong levels. Without strong bank and FCB participation, the question becomes whether private investors may become the ultimate bag holders yet again.

The following chart shows that the Primary Dealers' Treasury holdings have reached the downtrend line from their peak in June.

More at this link.

Charting the Universe

Bullish Breakout

Courtesy of Springheel Jack. Springheel Jack's charts can be followed on a daily basis at his website, Channels & Patterns.

Friday was a key day for equities, even though it was the half-day after Thanksgiving and volume was low. At the start of the day, the SPX faced a double trendline resistance in the 1400 area. SPX broke confidently above the resistance lines, and the 100 daily moving average in the 1407 area. It closed at 1409.

I would have expected resistance levels to hold if there was going to be much further downside before Christmas. I am now leaning bullish into the new year.

Here's the SPX daily chart, showing the big rising wedge from the October 2011 low:

I turning generally bullish for at least a few weeks or months, as the overall setup on equities suggests that a more significant top may not be far away. Let's look at the rising wedge on SPX. That has broken back up over the broken rising wedge support trendline now, but that doesn't mean that the pattern has failed, or that it has already played out. These patterns often see a significant move up after the first break downwards, and those moves up can often make new highs.

A good example of that is the rising wedge that formed on oil between June and September, shown below on the USO ETF. After the initial break down in late August, USO went on to make a (2%) higher high in September to form the second top on a double or "M top."

Only after that second high did the main decline begin, with the first decline having set up the valley low on that pattern indicating to a target at 33. Since then, a falling wedge (the bullish equivalent of a bearish rising wedge) has formed with a double-bottom formed at the low there. Advances or declines on these patterns often end with a second reversal pattern. If SPX goes on to establish a double-top then the second high would usually be within 3% of the first high.

Here are those setups shown below on the USO daily chart. On a break above 33, USO would have a double-bottom target in the 34.7 area, where it would hit an established resistance zone in the 34.6 to 35 range:

That brings me to this week's trade setup on Vodafone (VOD). On the VOD chart, a rising wedge has formed and broken down, and the overall setup for the chart is bearish. However there is a bounce opportunity here if we see a retracement early next week, which we would normally see at the start of the week after Thanksgiving.

More at this link.

Double Top

The double top is a frequent price formation at the end of a bull market. It appears as two consecutive peaks of approximately the same price on a price-versus-time chart of a market. The two peaks are separated by a minimum in price, a valley. The price level of this minimum is called the neck line of the formation. The formation is completed and confirmed when the price falls below the neck line, indicating that further price decline is imminent or highly likely.

The double top pattern shows that demand is outpacing supply (buyers predominate) up to the first top, causing prices to rise. The supply-demand balance then reverses; supply outpaces demand (sellers predominate), causing prices to fall. After a price valley, buyers again predominate and prices rise. If traders see that prices are not pushing past their level at the first top, sellers may again prevail, lowering prices and causing a double top to form. It is generally regarded as a bearish signal if prices drop below the neck line.

The time between the two peaks is also a determining factor for the existence of a double top pattern. If the tops appear at the same level but are very close in time, then the probability is high that they are part of the consolidation and the trend will resume.

Volume is another indicator for interpreting this formation. Price reaches the first peak on increased volume then falls down the valley with low volume. Another attempt on the rally up to the second peak should be on a lower volume.

Source: Wikipedia.com

(Click on charts to enlarge)

Spring-heeled Jack

Spring-heeled Jack is a character in English folklore of the Victorian era who was known for his startling jumps. The first claimed sighting of Spring-heeled Jack was in 1837. Later sightings were reported all over England and were especially prevalent

Exploration into Value Stocks

[Paul's Asset Management likes Calamos Asset Management]

By Ilene with Dr. Paul Price of Beating Buffett

Money management firm Calamos Asset Management (CLMS) has been making money for clients and shareholders by buying and selling stocks. Describing itself a little fancier, its website says: "Calamos Investments® is a global investment firm committed to excellence in investment management and client service. The firm has served the needs of institutional and individual investors for over 30 years by offering a range of global investment solutions to work within a client's asset allocation framework. Calamos has been chosen by a diverse global base of clients to provide investment expertise across asset classes."

CLMS trades publicly. Insiders and institutional owners hold about 95% of its shares, with insiders and 5% owners holding 9%, and institutions and mutual funds owning 86%. Dr. Paul Price believes the stock represents solid value, and he had included it in Paul's Virtual Value Portfolio (screenshot below), created on 10/28/12. CLMS was trading at $10.87. Now it's trading at $9.51. Paul's buying more and increasing the Market Shadows Virtual Portfolio position to 5%. (Originally, virtual portfolio position allocations were approximately 3%. We put 70% of our virtual cash into 23 stocks on 10/28, 3% each. Paul plans to increase CLMS to 5% on Monday.)

Paul believes the company's low profile could quickly translate into rally potential because public awareness of the company right now is low, while its beta (volatility) is high (1.80). Paul notes,

> *Price action dating back to 2009 bears this out. Over the past 44 months, there have been four rallies to peaks of $14.10 – $17.40. Each move occurred over relatively short periods, typically during bull runs in the overall market.*
>
> *Friday's closing quote of $9.51 is near multi-year nadirs. That is despite expectations for a positive year-over-year earnings comparison. A mid-year 2012 dividend increase to 11-cents quarterly provides a well-covered and very attractive 4.63% current yield. Today's valuation looks very much as it did at the previous two 'best buying opportunities' since 2009." (Yield To The Obvious – Calamos Asset Management)*

CLMS more than doubled from its 2010's low to its high point in early 2011. The subsequent selloff provided a 50% move in five months.

(Chart note: the figures in the boxes represent the price, P/E, and dividend yield at the point that the stars are indicating.)

CLMS's forward P/E is 11.5. The recent tops came with CLMS at higher than 15x that year's EPS. The stock is undervalued on a P/E basis and on a price/book basis–it's trading at a slight discount to book value. Prior to 2008's market meltdown, CMLS shares were high-fliers. Average P/Es were above 20x. Regression to the mean would move the stock to trade at a P/E of ~ 15 over the course of the next year. That would move the shares into the $13 area, about 35% higher. Paul believes the shares are currently trading at a low-risk valuation, with a substantial upside.

More at this link.

Spreadsheet for Paul's Virtual Value Portfolio is in development. Paul typically buys equal dollar weightings of each stock rather than specific numbers of shares. It doesn't matter if they fall into odd lots.

Paul may buy or sell shares in these stocks and others with no notice to us, although he intends to keep us apprised of his activities regarding stocks in the Virtual Value Portfolio.

Glimpse of the Future

From Fed, with Love, to Primary Dealers

Courtesy of [Lee Adler of the Wall Street Examiner]

(Excerpts from [Fed To Market: Can You Say 'Ho, Ho, Ho?' Professional Editon])

Ilene's comments in blue italics.

The composite liquidity indicator rose last week mostly due to the Fed's first MBS purchase settlements under QE3.

The Fed bought Mortgage Backed Securities (MBS) according to the new quantitative easing (QE3, aka QE-Infinity) program announced in September 2012. The money went into the [Primary Dealers'] trading accounts. Lee's proprietary liquidity indicator (below) has been drifting higher.

Note: Primary dealers serve as the New York Fed's trading counterparties in implementing the Fed's monetary policy. In more ordinary terms, the Primary Dealers are the big investment banks such as Goldman Sachs, JP Morgan, Barclays Capital, Citigroup Global Markets, Credit Suisse Securities, Deutsche Bank, HSBC Securities (USA), Jefferies & Company, Morgan Stanley, Nomura Securities, UBS Securities and others ([list]).

Composite Liquidity Indicator

The uptrend in market liquidity is still firmly in place. The composite liquidity indicator will make new highs each month ahead as the Fed continues to settle its QE3 MBS purchases, pumping cash into Primary Dealer trading accounts.

Money from the Fed, with love, to Primary Dealers.

When the Primary Dealers are flush with cash, stocks benefit–the Primary Dealers buy not only Treasuries, but also stocks and commodities.

As QE3 cash hits the system, it should have both a direct impact and it should also flow through several of the other components of this index. Any deviation from that expectation could be a sign of fundamental problems, with fictitious capital vaporization always lurking just behind the "all is well" façade.

The Fed's purchases from Primary Dealers carry the heaviest weighting in the index (the composite liquidity indicator). Foreign central bank purchases are the second most important weight. It has turned modestly bearish. The trend of bank net deposit inflows, not from money market funds, remains very bullish. Bank trading accounts of non Treasury and Agency issues has turned short term bearish and neutral in the bigger picture. That indicator could turn bearish on further weakness, but I would suspect that QE3 cash would bolster this indicator in the months ahead. Bank net purchases of Treasuries and Agencies are neutral, and could break either way in the weeks ahead. QE3 cash flows should now also give an upward push to this indicator.

A fair question would be if this indicator is so bullish, why have stocks been weak lately? The answer is probably partly because of the $70 billion in Cash Management Bills that the Treasury has sold in the past 3 weeks. That has been like a cash call on the Primary Dealers, hampering their ability to deploy cash to drive stocks and commodities higher. However, it hasn't hurt the Treasury market which continued to attract foreign flight capital and domestic public demand as well, until the past 3 days.

It is unlikely that the Treasury will continue to vacuum up all available cash with cash management bills in the months ahead, and the next big round of QE3 cash will hit the market in mid December. Can you say, "Ho, Ho, Ho?"

QE1, QE2, and QE3

The expression "QE2" became a "ubiquitous nickname" in 2010, when used to refer to a second round of quantitative easing by central banks in the United States. Retrospectively, the round of quantitative easing preceding QE2 may be called "QE1". Similarly, "QE3" refers to the third round of quantitative easing following QE2.

QE3 was announced on 13 September 2012. In an 11-to-1 vote, the Federal Reserve decided to launch a new $40 billion a month, open-ended, bond purchasing program of agency mortgage-backed securities and also to continue extremely low rates policy until at least mid-2015. According to NASDAQ.com, this is effectively a stimulus program which allows the Federal Reserve to relieve $40 billion dollars per month of commercial housing market debt risk with no maximum amount or time limit.[62] Ratings firm Egan-Jones said it believes the Fed's decision "will hurt the U.S. economy and, by extension, credit quality." As a result the firm once again slashed the U.S. bond rating bringing it down to AA-. Federal Reserve chairman Ben Bernanke acknowledged concerns about inflation.

Source: [Wikipedia.com]

Disclaimer

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Fed Cash To Primary Dealers

The Fed continues to pump cash into Primary Dealer trading accounts via its MBS purchases. This indicator (Fed Cash to Primary Dealers) has the heaviest weighting in the composite (top chart). With the Fed now set to buy even more paper from the dealers for an indefinite period, this input will remain bullish until the Fed changes course. The overall composite is likely to remain positive until that happens, in view of the weighting of this component.

Get regular updates the machinations of the Fed, Treasury, Primary Dealers and foreign central banks in the US market, in the Fed Report in the Professional Edition, Money Liquidity, and Real Estate Package. Click this link to try WSE's Professional Edition risk free for 30 days!

Data and Events

Mon, November 26	Tue, Nov 27	Wed, Nov 28	Thu, Nov 29	Fri, Nov 30
Japan BoJ Releases Minutes **Monday**	**China** Leading Index **Tuesday**	**Euro-Zone** Germany CPI (YoY) **8:00 AM**	**Switzerland** GDP (YoY) **1:45 AM**	**Euro-Zone** Unemployment Rate **5:00 AM**
US Chicago Fed National Activity Index **8:30 AM**	**Great Britain** GDP (YoY) **4:30 AM / 0.0%**	US New Home Sales **10:00 AM**	**Euro-Zone** Germany Unemployment **3:55 AM**	**Euro-Zone** CPI Estimate (YoY) **5:00 AM**
Euro-Zone ECB Constancio Speaks **9:00 AM**	Fed Fisher Speaks **6:00 AM**	EIA Petroleum Status Report **10:30 AM**	**Euro-Zone** Business Climate Indicator **5:00 AM**	**Canada** GDP (YoY) **8:30 AM**
US Dallas Fed Survey **10:30 AM**	Fed Lockhart Speaks **6:30 AM**	Fed Tarullo Speaks **12:15 PM**	Fed Fisher Speaks **6:00 AM**	US Personal Consumption Expenditure (YoY) **8:30 AM**
3-Month Bill Auction **11:30 AM**	Fed Bernanke Speaks **8:30 AM**	2-Yr Note Auction **1:00 PM**	US GDP **8:30 AM**	US Personal Income **8:30 AM**
6-Month Bill Auction **11:30 AM**	US Durable Goods Orders **8:30 AM**	Fed Beige Book **2:00 PM**	US Personal Consumption (Q3) **8:30 AM**	US Personal Spending **8:30 AM**
China Industrial Profits YTD **8:30 PM**	US Consumer Confidence **10:00 AM**	**Japan** Retail Trade (YoY) **6:50 PM**	US Initial Jobless Claims **8:30 AM**	Fed Kocherlakota Speaks **5:00 PM**
	US House Price Index **10:00 AM**		US Pending Home Sales **10:00 AM**	
	US Richmond Fed Manufacturing Index **10:00 AM**		EIA Natural Gas Report **10:30 AM**	
	4-Week Bill Auction **11:30 AM**		US Kansas City Fed Manufacturing Index **10:00 AM**	
	7-Yr Note Auction **1:00 PM**		5-Yr Note Auction **1:00 PM**	
			Japan Nomura/JMMA Manufacturing PMI **6:15 PM**	
			Japan Jobless Rate **6:30 PM**	
			Japan National CPI **6:30 PM**	

Legend
Credit Market
Equities Market
Energy
International
Fed Speak