

Stock Market Report

31 August 2009

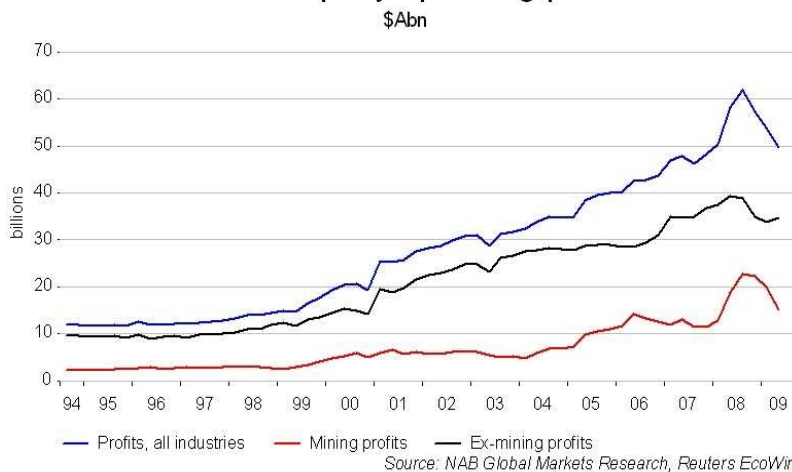
Is this a Bailout Bubble ?

The US markets have rallied 34% (Dow), 38% (S&P500), and 44% (Nasdaq) since their March lows, whilst the ASX200 has rallied over 40%. The rally began to slow toward the end of August, as investors were potentially contemplating how much bounce is left in this market. This outcome has more than fulfilled our expectation of a bear market rally that we have been expecting since late 2008.

A rise in confidence and optimism about the future has driven the market rebound, however the anomaly is that the jobs market is not improving and is likely to get worse. A media article recently reported that, "Investors are becoming more confident that the US will enjoy a robust, if jobless, recovery." How on earth do you have a jobless recovery when the economy is reliant on consumer spending?

The earnings season has been mixed with most companies forecasting difficult business conditions ahead. In relation to historical data comparison, the fourth quarter of 2008 was the only quarter that the total S&P companies posted losses since 1933, and the rate of falling earnings during the current economic contraction has exceeded the rate for every preceding recession in 100 years.

Aus: Company operating profits



Many analysts and investors believe the worst is over in Australia and we are in full recovery mode. And even if America is in serious trouble, China is buying our commodities and pushing our dollar higher.

We still believe it is a bear market rally similar to the post 1929 stock market crash. We think that it's going to take a long time, possibly up to a decade, to liquidate decade's worth of speculation and leverage, especially when you have central banks and governments applying stimulus measures to prevent the needed liquidation.

The stimulus process started in Japan in 1989 and is still going on 20 years later. The Japanese have been living with a short business cycle of 11 months on average since then, and so their stock market has moved up and down with the stimulus, but has had no growth and is still in a medium term downtrend.

The media will have you believe that the stimulus spending by the Australian federal government has avoided serious recession and retained positive GDP growth. "A rebound based on monetary inflation and government spending isn't a real rebound at all. It gives the appearance of normalcy and economic health through rising asset values and more transactions in the economy (which GDP itself measures). But unless there's a big pick up in business investment, the economy is not on any sounder long-term footing. In fact, it's worse. The illusion of prosperity created by stimulus spending induces people into maintaining debt loads they might otherwise reduce. Consumption patterns which ought to change in order to put the household and corporate balance sheets back in working order aren't changed at all. And when the government stimulus is withdrawn later---as it must be before higher fiscal deficits lead to rising interest rates---the economy reverts back to its pre-stimulus levels of growth-only without the underlying issues of over consumption and too much debt having been addressed." Bill Bonner, The Daily Reckoning.

The Australian newspaper reported last week, "A UN think tank on trade has warned that the current financial market rebound is not a 'real recovery' and that any world economic growth recorded in 2010 was unlikely to exceed 1.6 per cent." Supachai Panitchpakdi, secretary-general of the United Nations Conference on Trade and Development (UNCTAD) stated recently, "The depth of the recession has been so important that of course there will be a rebound ... but we still do not see that this is a real recovery. The actual increase in the commodities prices is mainly driven by appetite for more risk."

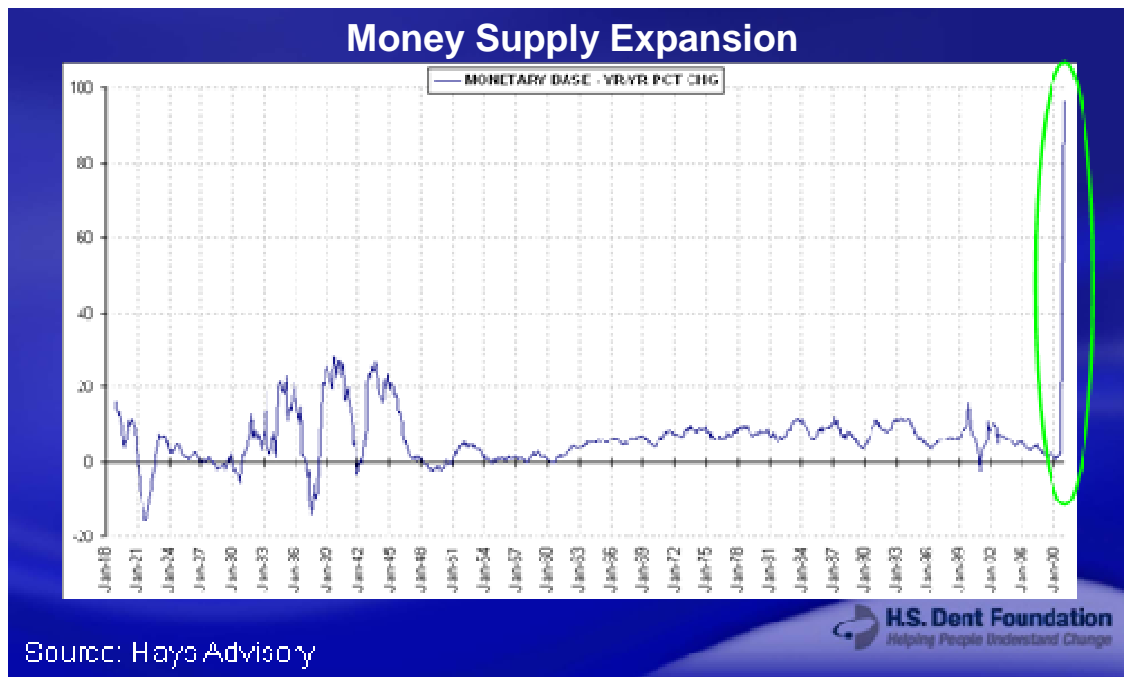
The RBA is now indicating that interest rates may rise as they believe a recovery is under way and inflation will not ease as much as was expected, however it was only a few months ago that they were concerned about a recession and it has still not really ruled it out completely. The June quarter GDP rise of 0.6% and a slump in the terms of trade (export income) shows that the economy barely grew, indicating that inflation should not be a problem. The growth has been achieved through government stimulus and monetary easing, which would be making the RBA cautious about raising rates when simply decreasing the government's spending would achieve the same outcome and stop further government debt.

The problem has been and still is excessive debt on a global scale due to credit expansion, which has been facilitated by the central banking system, in particular the US Federal Reserve. Most economists and governments believe that a central bank is necessary for

maximum growth and to smooth out the business cycles. However this is arguable, and is a short term fix, in the long term the massive debt collapses of its own weight.

Governments and most economists believe that the Federal Reserve Board has learned to control both money and the economy, with many believing that it also has the power to manipulate the stock market. The fact is that the US produced greater economic growth in the 19th century without a central bank than in the twentieth century with one. In the latter half of the 20th century, real economic growth in Hong Kong exceeded that of every other country in the world, and it had no central bank.

Prior to 1933, a dollar was defined as a certain amount of gold. After that year the US Government outlawed gold ownership so that Federal Reserve notes became legal tender. The US Treasury sells Treasury bonds to the Federal Reserve with money created by a computer stroke, a bookkeeping entry that allows the Fed, by law, to fabricate a checking account for the seller in exchange for the bonds. The money from 'thin air' is then transferred to the US government which pays interest on the bonds held by the Fed. This process is often referred to as "monetizing" the debt, whereby the Fed turns government bonds into money. It is like counterfeit money has been slipped into circulation.



See short video: [Fractional Banking and the Federal Reserve System Explained!](#)

By creating the new money and then allowing banks to use the money to make new loans, it expanded the supply of credit well beyond the supply of money. In the early 1990's, the Federal Reserve governor Alan Greenspan took the whole thing even further by removing banks' reserve requirements almost entirely, which meant that banks could lend on every new dollar deposited over and over which made the multiplier effect virtually unlimited. The whole process produced what is often referred to as the 'Fiat Money' system which has created inflation via both money creation and credit expansion. Talk about taking something to the nth degree. Andrew Haldane, Bank of England executive director of financial stability in a speech recently, "compared the banking system over the last 20 years to the South Sea bubble of the early 18th century."

According to Robert Prechter of Elliott Wave International, two things are required to produce credit expansion:

1. Expansionary psychology
2. The ability to service loans by paying the interest

Both of these are now under threat, in particular the second requirement as rising unemployment and/or falling wages and earnings compromise consumer and business spending and borrowing. The US Fed has literally nowhere to go with interest rates at already almost zero. In doing so, it has expended its power to stimulate if the economy resumes its contraction.

There have been two previous major deflationary depressions in the US, 1835-1842 and 1929-1932, and each one followed a period of substantial credit expansion. All credit expansion schemes have burst and the recent scheme adopted by the worldwide central banking system is the greatest ever. Since the collapse of Lehman Brothers, it appears as though the banking system is trying to preserve the status quo, and thereby reintroduce the money-shuffling arrangement that was so profitable up until the GFC.

The Australian Market – Rally is on borrowed time

After rising further in early August, the strength of the rally has waned somewhat and the market is now struggling to rise amid signs of indecision. Our expectation of a further rally into July/August after a pause in July was fulfilled and given the strong rally based on our commentary above we expect the market to peak sometime in September or October.

All Ordinaries Weekly Chart



All Ordinaries Monthly Chart



The All Ordinaries (XAO) still rose strongly during August to a high of 4,540.20 points, closing the month at a new short term high of 4,484.10 points. It also once again provided the classic Dow Theory pattern (a higher high after a higher low) that was provided in early June above the May high and again in late July above the June high, providing further confirmation for the existing uptrend. While the pattern also increases the probability that the market will continue to rise, the fact that the monthly close was below the high of 4,506.50 points of the week ending 14/8/09, could be indicating the potential for a peak of the uptrend.

In previous months we wrote: "We are expecting the XAO to reach our initial target of between 4,300 and 4,500 points which coincides with the Nov 08 high of 4,291.9 points and the 38.2% price retracement level of 4,512 points respectively. The 50% retracement level of 4,962.85 points is now looking quite interesting as a potential target. There is also the distinct possibility of a rally to the 61.8% level at 5,400 points region based on the higher end of Elliott Wave projections, however given the undercurrent of negative fundamentals this would be a low probability scenario." As you can see the initial target has been reached however the time cycle may be against any further rises to the higher target zones.

S&P 500 Daily



The chart above shows that volume on the S&P500 has been falling with the rise since March which is a worrying sign, indicating that as prices increase less investors are willing to commit further to the rising prices which then leads to a peak.

The low and mid cap stocks have been soaring in price on rising volume, a sign that the rally may be maturing due to the small trader entering the market late reluctant to buy the more expensive blue chip stocks.

Outlook

As we stated last month, the strength of the rally suggests that the market is being pushed higher by investors and traders that perceive that the March low is a significant bottom and that they may be missing out on a major rise. We continue to be mindful that market rallies that are not driven by improving fundamentals do not last, and so a reversal at any time is possible. A sustainable long term trend would need long-term investment supported by improving fundamentals and expanding volume or else the market will run out of steam as the short interest dwindles. If the long term investor is driving a stock market recovery then it is less likely that the current uptrend be categorised as a typical bear market rally.

We believe that long term investors entering this market are living in the hope that the March 09 low is the bottom of another long term bull market. Based on cycle analysis we still expect the US market, and for our market to most likely follow, to provide a major high with this rally and then move down to test either the Nov 08 or March 09 low or beyond. A continuation of the rally will no doubt be credited to central banking 'quantitative easing' and government stimulus; however this is likely to be temporary, while behind the scenes the recession will be grinding away.

The resources industry and China's demand for those resources is keeping Australia from moving into a severe recession or depression. The RBA Governor, Glenn Stevens stated recently, "If commodity prices do stay at their relatively high levels on the back of strong emerging world demand, the mineral extraction sector and all those parts of the Australian economy that service it and feel its flow-on effects will expand. Other sectors, will, relatively, contract over time. A significant structural rise in demand for energy and resources has occurred, as a result of the cumulative growth of the emerging world. This seems more likely to be a feature of the international economy for some time than to go away."

The Chinese stock market which doubled in nine months has recently topped out and is now down about 20%, however we still believe that the China industrialisation story is long term. Although there will be ups and downs, most likely due to over stimulation and stockpiling issues, the long term trend should be mostly up as a result of a rise in demand for energy and resources. China has accumulated large amounts of metals and the stockpiling, along with investors and speculators, has driven many metal prices considerably higher. As an example, the copper price is up more than 60% from \$1,400 to \$2,300 in the last 6 months, however, the price is still around half of the 2008 peak. Therefore it is very likely that an end of China's stockpiling of copper will restrain further price increases.

The recent spike in the gold price indicates a rising unease about the economic recovery. The traditional safe haven investment has risen while other commodity prices are falling, however gold is yet to break through significant highs at \$1,007 and \$1,033. Harry S Dent recently suggested, "The commodities that may see one more rally into late 2009 or early 2010 are the "crisis" commodities: gold, silver, oil and natural gas."

Elliott Wave analysis is suggesting that most stock markets are currently in a relief upward moving wave somewhere within the downward ABC pattern that began potentially in 2000 on the Dow and S&P500 and in 2007 on the All Ordinaries. As *Elliott Wave Principle* explains, "During the A wave of a bear market, the investment world is generally convinced that this reaction is just a pullback pursuant to the next leg of advance. The public surges to the buy side despite the first really technically damaging cracks in individual stock patterns. The B wave rallies that follow exhibit aggressive euphoria and denial." This supports the theory that the Dow and the S&P are already in Wave C down, but in a relief/rising rally within Wave C, while the All Ordinaries is possibly in an uptrend Wave B. The third and final leg down Wave C is therefore still yet to unfold. The possibility that the ABC pattern has completed in the move down from 2007 to 2009 is a low probability scenario.

Summary - Strategy and Recommendations

The profits on almost all of our open and closed positions are in excess of 10% and some are approaching 30% , with the exception of TAH which although slightly below or equal to our entry level, went ex-dividend on 11/8/09 and is due to pay a 30c dividend on 18/9/09. WPL has finally broken out and moved up and is due to pay a 55c dividend on 5/10/09. CBA is showing a lovely profit of around 23% and will also pay a \$1.15 dividend on 1/10/09.

The sale of BHP and CTX, at about 10% and 25% profit respectively, have proven to be worthwhile with both stocks drifting into a sideways pattern. Although there are some stocks giving buy signals, the potential upside may not be there at this possible late stage of the cycle. Having said that, we are watching gold closely for a confirmed breakout and Metcash and CSL are looking interesting.

We will continue to hold current open positions with the view of taking advantage of any further rise in the market to a yearly or major high between now and October. While we are still bullish on the energy sector for various reasons, we must be prepared if this market rally ends sometime in the next few months in which case we expect oil and energy prices to fall. Although we see energy stocks as a long term investment, they are still prone to fall significantly in a bear market, as most stocks go down. As a result, our stop loss or exit levels are constantly being revised on our current open positions.

Longer term we believe the markets will unfold in a broad sideways pattern over the next few years similar to the patterns seen during the 1930's and 1960's whereby recoveries or rallies occur as a result of economic stimulus and China demand, while being muted by the underlying deleveraging of previous debt build up. Therefore, we believe the ongoing investment strategy will require disciplined active management and the buy and hold strategy will simply not produce satisfactory results.

It has been interesting to discover that quite a few stock advisers have not been invested in this recent rally from the March low and one particular analyst has actually maintained short positions for the entire time which means that the portfolio is losing money with this rally. Most managed funds have just recouped a portion of the significant losses incurred as a result of holding through the downturn from the 2007 peak.

Our strategy gave us the ability to protect our investor's capital by exiting our positions in 2007 and early 2008 and cutting losses short with the use of a stop loss strategy with limited new positions taken during 2008 while most of the portfolio was sitting in cash. Our unique investment style has allowed our investors to have the money and confidence to re-enter the market and also adjust our strategy slightly to allow us to profit within what is very likely to be a short to medium term rally which may require a similar exit strategy that was employed in late 2007.

Therefore, in the likelihood that the stock market forms a major peak soon and continues the bear market by moving into another down trend, we may be attempting to take advantage of the move by trading short positions. Please let us know if you will be interested in participating in this exercise or whether you will be content to simply exit most positions and move into cash until it becomes appropriate to enter new long positions again after the market confirms a significant bottom.

"If everybody's thinking the same thing, then nobody's thinking." *George S. Patton*



Paul Tosin B.Bus
Equities Advisor - Authorised Representative

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