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Liquidity Analysis: Is The Market Rally Teetering?

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Liquidity remains very bearish, indicating that the stock market's rally is teetering on the rails. Institutional investors – particularly pension funds, SARS-rattled Asian investors – are driving prices higher, and the momentum crowd is only too happy to amp up the party. But companies are responding by selling shares into the market, and it's only a matter of time before the supply of shares outstrips demand.

Liquidity analysis can't time a market turn, it can only show that a rise or fall is imminent. We have been too early in timing market turns before, and our May 8, 2003 bearish call is looking premature. But the longer this rally goes on, the more significant the subsequent correction will be. When the pension buying dries up, the frenzy of corporate selling will catch up with a vengeance.

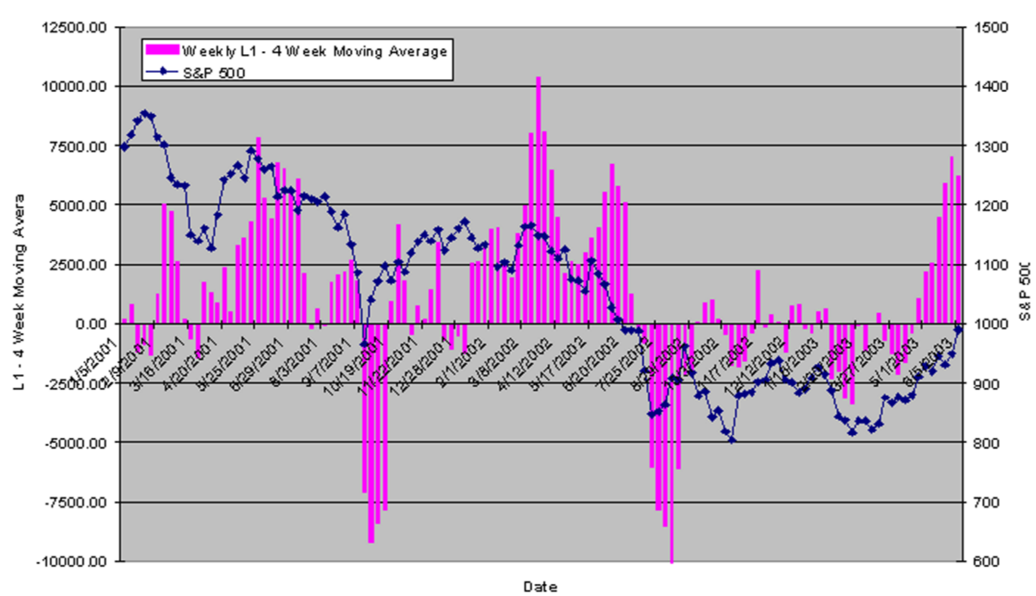
The five-week total is a whopping $29 billion of net new shares sucking cash out of the checking accounts of stock market participants. The current four-week average of L1 growth is $6.3 billion. The last time the four week average of L1 was bigger was the week ending June 6, 2002 when the S&P 500 closed at 1027 – on its way straight down to 800 by the third week in July.

As we have done for the past three months, Trim Tabs Financial Services offers readers of *Senior Consultant* a monthly liquidity analysis of the stock market to offer them insight into the changing supply and demand for shares, which can anticipate market trends. A model paper portfolio based on our liquidity analysis was up 74% in 2002. For a detailed explanation of Trim Tabs liquidity analysis, please reference our first article, "Liquidity Theory: A Means to Achieve Absolute Positive Returns in Any Investment Environment?" *Senior Consultant,* March 2003, (http://www.srconsultant.com/Articles/2003-03-Biderman-Schnapp-Liquidity-Theory.pdf).

To summarize, we measure liquidity in three ways: whether companies are net buyers or sellers of stock through cash takeovers, stock buybacks, stock offerings or insider selling (L1, the most important liquidity indicator); whether money is flowing into or out of mutual funds (L2); and how much margin debt was used to purchase equity (L3, which lags the other indicators and is the least useful).

Companies remain strongly bearish, despite the market's sustained gains. New offerings and insider selling combined have been almost $2 billion per day

S&P 500 vs. L1 – 4-Week Moving Average
January 2001 through Present



starting on May 8 and continuing through the month. New offerings continue to blossom forth each day, somewhat like mushrooms in response to the flood of liquidity being provided by the continuous wave of buying.

Insider selling has been averaging about $3 billion per week between the last week of April – which is when the 1Q earnings release season ended – and the last week of May. Therefore, May historically is a big month for insider selling. However, the identity of the sellers this go-around are what's most impressive. There has been a huge outpouring of shares from some of the smartest and best entrepreneurs of recent times. Ted Turner, Michael Dell and Steve Ballmer sold mega amounts of shares. So did insiders at E-Bay and Yahoo.

Meanwhile, corporate buying slowed through the month of May as the market rose, suggesting that corporations were putting little faith in the rally, except for its potential to offload their shares into eager hands. Newly announced stock buybacks dipped below $1 billion for the first time in six weeks in the week through May 20, reaching $833 million, less than a third of the amount in the week ended May 1.

We use newly announced buybacks as a proxy for actual buybacks. We have no ability to track buybacks in anything close to real-time. We have proposed to the SEC that companies be required to report buybacks in real-time; we even offered to track it and report it on-line. With that said, historically there appears to be a relationship between actual buybacks and announced. That's not to say that some companies could be aggressively buying shares, despite the dearth of new announcements. However, in aggregate, it's hard to believe corporate buying is anything but nil.

Each of the past two times that L1 has grown this fast, back in April and June 2002, the market had sold off big time before L1 peaked. What's keeping the market up here? The old story in the stock market: what's most costly is what one doesn't know. Apparently, pension funds starting in April decided to move more aggressively into stocks during the post-Iraq euphoria. Foreigners, particularly Asians, perhaps SARS-related, followed along. Similarly, some European pension funds have to stay at least 50% in U.S. stocks. Reportedly, the decline in the dollar created some one-time buying recently.

That created a nice tidal wave that other investors could follow. In particular, many of those followers were hedge funds. Hedge funds supposedly started April with very high cash levels. Other than liquidity theory, the only other overall strategy that works and then only some of the time, is "momentum investing." Right now is when momentum investors are heavily buying the recent big winners.

The result is an S&P 500 up all of 3.6% since we first turned bearish the week ending May 2 until the month's end. Yes, the NASDAQ 100 is up a more impressive 5.5% – from 1,136 to Friday's close at 1,198. In other words, with net corporate selling of $25 billion over the past four weeks, a huge amount of money had to be used up in pushing the S&P 500 up 3.6%. Yes, state pension funds will be selling bonds here and using the proceeds to buy stocks.

Historically, pension fund rebalancing has helped stocks for about a month or so, before running out of steam. What we're using for an example is the October-November 2001 timeframe. Starting in October, pension funds sold $100 billion in bonds to buy stocks. By the time December started and new offerings came pouring out in earnest, the market eventually broke down.

We remain bearish, but cautiously bearish. Our key liquidity indicator, L1, remains wildly bearish. However, L2, had not turned bearish by the end of May, which would be big inflows in the face of heavy corporate selling. The recent "virtually no inflow," despite the market gains, does have us a bit concerned.

Corporate investors have always been the best leading indicator of future market direction. The only "problem" is occasionally they are early. Those newly bullish keep forgetting that corporate America can print lots of new shares that get sold overnight these days. ■

About the Author

Charles Biderman began Trim Tabs Financial Services in 1990 to provide unique investment ideas to portfolio managers. Over time, Charles began developing Liquidity Theory as the key to the stock market. Prior to starting TrimTabs.com, Charles, a Harvard MBA, was associate editor of Barron's *Financial Weekly* and a successful real estate investor.

TrimTabs.com Monthly Liquidity Table

Year End	S&P 500	Market	L1 Net Float New	$Cash Acq Comp	Acq Backback	Cash Offering	Stock Selling	Equity Buys	Insider Equity	All Foreign Flow	L2 US Funds Flows	Equity Funds Total Assets	Equity Funds % Cash	L3 Margin Debt
1995	616	7	-69,208	89,000	82,939	101,114	86,770	32,118	11,240	120,046	118,525	1,073	7.6	15,194
1996	741	9	-107,479	71,223	71,382	181,759	98,850	46,706	12,511	216,874	175,609	1,468	5.3	24,220
1997	970	12	-40,449	101,146	97,728	133,825	132,592	60,792	65,870	227,142	189,058	2,052	4.8	28,930
1998	1229	14	-101,807	157,342	149,507	105,700	89,974	68,652	53,978	157,342	149,507	2,590	4.7	15,670
1999	1469	18	-69,036	232,949	153,555	174,432	180,303	131,604	107,807	186,713	175,440	3,455	4.2	87,610
2000	1329	16	72,623	235,990	226,290	221,903	259,146	268,140	174,002	309,400	259,600	3,419	5.5	-29,697
2001	1148	14,435	260,572	93,889	149,059	237,675	317,067	293440	121100	32,252	55,356	2,984	4.9	-46,600
May-02	1067	14	27,391	5,856	4,611	5,189	26,821	11,200	-314	4,875	2,900	2,901	4.9	-80
Jun-02	990	13	6,982	1,177	3,536	22,337	25,582	5,700	4,045	-18,045	-18,700	2,666	4.4	-4,590
Jul-02	912	12	-8,836	1,301	2,302	25,719	12,817	5,700	9,653	-52,628	-49,032	2,391	4.3	-10,110
Aug-02	916	12	-8,985	1,584	1,470	13,964	875	5,650	4,614	-3,063	-561	2,404	4.8	-3,360
Sep-02	815	10	3,209	2,775	954	7,018	7,546	4,850	-6,466	-16,078	-14,467	2,168	4.9	-2,590
Oct-02	886	11	-3,769	2,476	2,610	15,649	10,701	3,700	3,616	-7,709	-7,480	2,305	4.8	320
Nov-02	936	12	-33	3,110	3,789	19,419	14,622	8,100	6,480	5,744	5,408	2,444	4.8	2,490
Dec-02	880	11	-174	7,644	1,125	6,554	8,003	3,850	2,416	-7,747	-5,466	2,250	5.7	1,320
2002	880	11	87,087	35,839	35,689	149,454	197,540	78,650	49,442	-28,572	-25,409	2,250	5.7	-15,870
Jan-03	856	11	-8,892	2,425	6,863	22,518	14,179	3,350	-2,782	-466	-1,440	2,309	4.4	530
Feb-03	841	11	-4,447	3,445	3,184	12,654	7,765	3,800	-2,089	-11,105	-10,599	2,202	4.1	-880
Mar-03	848	11	-3,951	2,088	1,395	16,017	7,723	6,200	2,840	-276	1,096	2,221	4.6	1,900
Apr-03	917	12	2,344	6,319	2,857	7,731	13,141	6,000	n/a	16,096	12,521	2,405	4.2	30
May-03	964	12	21,764	2,148	1,885	6,650	24,874	14,000	n/a	-917	228	n/a	n/a	n/a
Jan-May 02			102,553	15,772	19,903	38,794	117,394	41,100	n/a	70,954	64,889			1,970
Jan-May 03			6,818	16,425	16,184	65,570	67,682	33,350	n/a	3,343	1,820			1,580