Volume 6, No. 7

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Stock Market Bubbling Towards a Major Decline

Charles Biderman, CEO, TrimTabs.com

We remain aggressively bearish. Corporate selling remains huge and corporate buying non-existent. Yes, the stock market has continued to rise, even as our key liquidity measures have been bearish. There appear to be two sources of cash we had overlooked.

First, hedge funds now have more money than ever before and the effect of swinging from being under-invested at the end of March to at least fully invested, if not leveraged, has been huge. One major client tells of hedge funds now accounting for half the volume in the current momentum stocks – tech, media and telecom (TMT).

Second, retail investors, starting in April, have more and more aggressively traded, buying on margin the self-same "momo" TMT stocks favored by the hedge funds. Trading volume on TMT stocks was up fivefold in May from March at one major on-line broker while Dow-type stocks had only a minor increase in activity.

While we have been wrong as to the timing of a market sell-off, sooner rather than later, there will be a sharp market drop, with the only question being when.

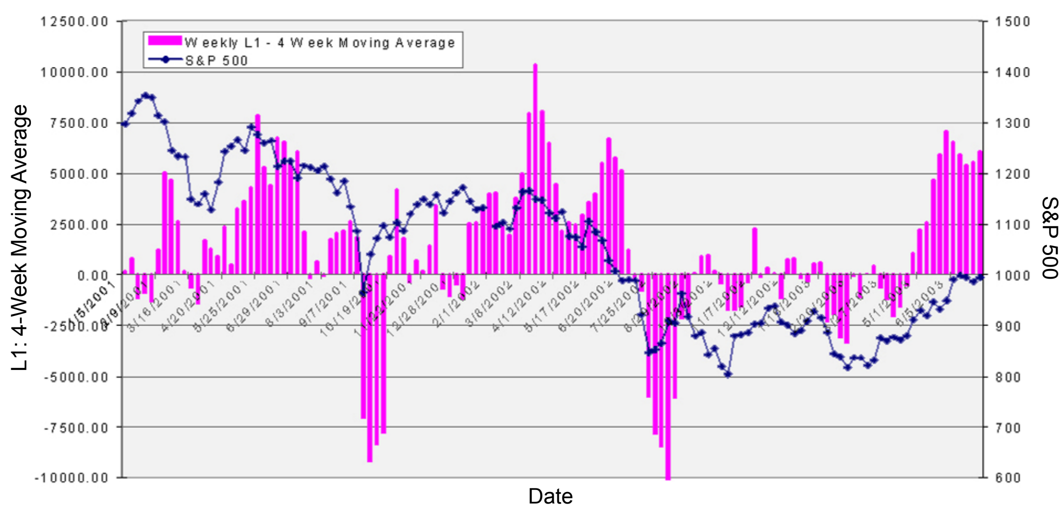
As we have done for the past four months, TrimTabs Financial Services offers readers of *Senior Consultant* a monthly liquidity analysis of the stock market to offer insight into the changing supply and demand for shares, which can anticipate market trends. A model paper portfolio based on our liquidity analysis was up 74% in 2002. For a detailed explanation of TrimTabs 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: (1) 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); (2) whether money is flowing into or out of mutual funds (L2); and (3) how much margin debt was used to purchase equity (L3, which lags the other indicators and is the least useful).

L1 has grown by $60 billion over the past 10 weeks through July 3. even after revising insider selling downwards $1.5 billion in June based upon recent Thomson data (insider selling usually starts to slow the weeks before and when earnings are released).

Despite the bearish L1 action, the market cap grew $1.26 trillion, or 11%, over the past 10 weeks to $12.74 trillion. Historically, the market cap goes the opposite direction from L1, while equity fund inflows are strong. This has always occurred at major turning

Figure 1.
S&P 500 vs. L1: 4-Week Moving Average
(January 2001 through July 10, 2003)



points in the stock market. That is one reason why we are aggressively bearish.

Also based upon history, both the S&P 500 and NASDAQ have ended lower each July since 1997. The three main reasons why July have been weak in the past are the same as what exists now:

1. Heavy corporate selling of new shares in July before August vacations slows Wall Street's ability to print and sell new shares;
2. PM's slowly drifting away from their trading desks to vacation sites apparently slows their desire to make new purchases.
3. Historically, July, August and September have been the three slowest months for equity fund inflows. Obviously, individuals don't buy stocks either when they go on vacation.

All of our major liquidity indicators started July extremely bearish. There were $50 billion of new offerings in May and June combined, that's the biggest two months since $52 billion during May and June 2002.

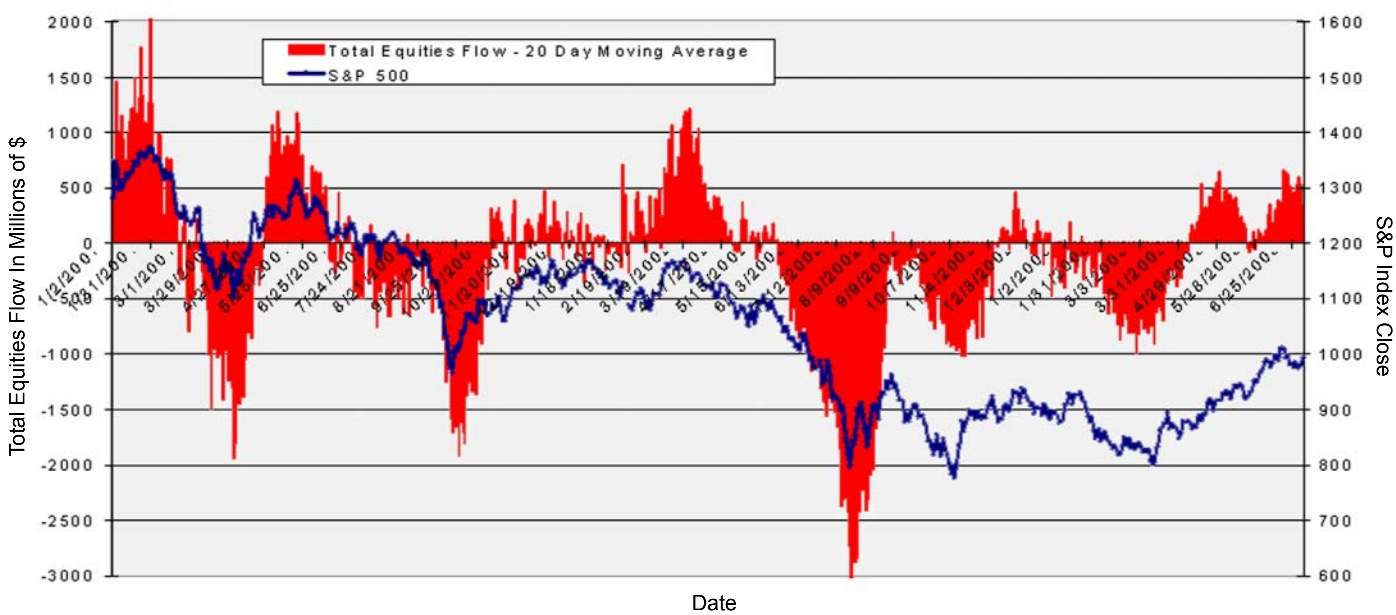
By the way, the NDX ended June 2002 at 1,051 but then dropped to 894 by July 25. Our estimate of insider selling during May and June is also at multi-year highs. There were $4 billion of new offerings sold last week, despite the stock market being open for just three and a half days. What's more, Dealogic tells us that there's plenty of potential new offerings still wanting to get sold this summer, with a handful already on this week's calendar.

Corporate buying continues to be virtually non-existent. Indeed, backing out the Oracle-Peoplesoft-JD Edwards soap opera, there has been less than $3 billion of new corporate buying the past four weeks. For all of June, corporate buying increases only to $4.2 billion, after backing out a $5 billion Wal-Mart buyback. (Wal-Mart has been buying back about $1 billion of their own shares each and every quarter, and the early June announcement was nothing more than replenishing a depleting buyback authorization.) The last time there were less new cash takeovers and buybacks than the adjusted $4.2 billion in June was $4.0 billion in February 1997. The NASDAQ Composite closed February 1997 at 1,309 and then dropped to 1,222 by the end of March 1997.

Soaring margin debt in both the stock market and economic cycle is an example of how extreme the market is. Our guess is that margin debt has been most used to help buy those stocks that have soared the highest so far this year. Margin debt at NYSE member firms, which includes borrowing against NASDAQ stocks, rose by $10 billion in May 2003, or 7.7%. This is the biggest one-month dollar-gain since $12.7 billion in March 2000 and the biggest percentage gain since 9.5% in February 2000. In other words, margin debt in May grew fast at the top of the biggest market bubble in many a decade. What's more, how much more margin debt was added in June when everyone became totally convinced that stock market will keep going higher?

We also guess that foreign buying of US equities increased dramatically in May and June. Unfortunately, data on net foreign buying of US equities is provided by the US Treasury after a two month lag. According to the most recent data available, in April 2003, foreign buying picked up to $3.3 billion from $2.8 billion in March and actual net selling during January and February. Our bet is that foreign

Figure 2.
S&P 500 vs. Total Equities Flow: 20-Day Moving Average
(January 2001 to July 10, 2003)



Ph 804-643-1075 ■ Fax 804-643-1544

All Major Liquidity Indicators At Bearish Extremes to Start July 2003

Year End	S&P 500	Market Cap	L1: Net Float	$ Cash Acq New	Cash Acq Comp	Stock Buy-	Equity Offering	Insider Selling	Foreign Buys	All Equity Flow	L2: US Fund Flow	Equity Funds Total Assets	Equity Funds % Cash	L3: Margin Debt
1995	616	7,310	-69,208	89,000	82,939	101114	86,770	32,118	11,240	120,046	118,525	1,073	7.6	15,194
1996	741	8,954	-107,479	71,223	71,382	181759	98,850	46,706	12,511	216,874	175,609	1,468	5.3	24,220
1997	970	11,560	-40,449	101,146	97,728	133825	132,592	60,792	65,870	227,142	189,058	2,052	4.8	28,930
1998	1,229	13,860	-101,807	157,342	149,507	105700	89,974	68,652	53,978	157,342	149,507	2,590	4.7	15,670
1999	1,469	17,619	-69,036	232,949	153,555	174432	180,303	131,604	107,807	186,713	175,440	3,455	4.2	87,610
2000	1,329	16,396	72,623	235,990	226,290	221903	259,146	268,140	174,002	309,400	259,600	3,419	5.5	-29,697
2001	1,148	14,435	260,572	93,889	149,059	237675	317,067	293,440	116,390	32,252	55,356	2,984	4.9	-46,600
Jun-02	990	13,216	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	12,144	-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	11,564	-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	10,377	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	11,134	-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	11,781	-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	11,147	-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	11,147	87,087	35,839	35,689	149454	197,540	78,650	49,442	-28,572	-25,409	2,250	5.7	-15,870
Jan-03	856	10,886	-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	10,634	-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	10,665	-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	11,571	2,344	6,319	2,857	7,731	13,141	6,000	3,357	16,096	12,521	2,405	4.2	30
May-03	964	12,330	21,764	2,148	1,885	6,650	24,874	14,000	n/a	12,113	12,603	2,572	4.2	10,440
Jun-03	975	12,500	21,756	9,780	1,356	6,599	25,830	9,500	n/a	10,800	11,100	n/a	n/a	n/a
Jan-Jun 02			109,535	16,949	23,439	61,131	142,976	46,800	29,129	52,909	46,189	n/a	n/a	-2,620
Jan-Jun 03			28,574	26,205	17,540	72,169	93,512	42,850	n/a	28,173	26,295	n/a	n/a	12,020

buying surged during May and June 2003. Remember, the monthly record for net foreign buying was $27 billion for both February and March 2000, or $54 billion combined, compared with net foreign buying of $49 billion for all of 2002.

US equity funds got just over $25 billion in new cash during April and May. If our June estimate is light by just $2 billion, then US equity funds will again have received a $40 billion inflow during the second quarter of 2003. That would be the biggest inflow since $40 billion poured in during the first quarter of 2002. Of course, the biggest quarterly inflow into US equity funds was $92.9 billion during the first quarter of 2000. The biggest month was when $35.5 billion poured into US equity funds in February 2000. Anyone remember Janus?

Historically, July is the second slowest month for equity fund inflows, with just 4.4% of the yearly total, after September's 3.8%. January is the biggest month for new cash with 13.3%. No surprise, August is the third worst month for inflows at 5.6%. Obviously, neither investors nor PM's, when on vacation, like to add new investments; while natural selling always occurs.

Meanwhile, wages and salaries subject to withholding grew by 2.6% this May and June vs. May-June 2002. May 2003 had one less business day than May 2002, but June this year had one extra day than last June so combining the two months makes sense. What's interesting is that the 2.6% increase during the last two months is exactly the same as the year-to-date gain. That compares with a 2.6% drop in withholding collections the last six months of 2002 vs. the last six months of 2001. However, since there also was a tax rate cut in 2002 vs. 2001 withholding, the actual pre-tax growth rate was around 1.0% and the after-tax increase around 2.0%.

In other words, the US economy has been slowly getting better at a consistent pace that will be boosted by the recent tax rate cut. Will the Laffer curve actually work here, meaning lower withholding rates spur the overall economy and pre-tax wages and salaries grow faster than before? If the Laffer curve does work, we would expect to see the year-over-year change in withholding grow to 0%. That would be the best of all possible worlds for the US Treasury as well, meaning that the rate cut will be financed out of growing receipts.

To summarize then, the last time L1 was this weak and L2 this strong was during the first quarter of 2002. In March 2002, the NDX peaked at 1,555 on March 8 before selling off to 1,452 at the end of March, on the way down to 897 by July 23, 2002. This time, the NDX peaked June 18, 2003 at 1,248, after a 22.5% gain from the end of March, before selling off to 1,205 as of July 10, 2003. What makes the stock market even more vulnerable to a big drop here is the potential for margin calls among those who bought the individual stocks that make up the NDX in May and June, using leverage.

The rumor that Neuberger Berman will be bought by Lehman Brothers is just icing on the cake. A sign of a market top is when the smart brokers sell out to the dummies. It would be hard not to have made big bucks dealing in bonds since 2000. However, to believe that Lehman can take that bond market "expertise" and make money running a "smart guy" outfit like Neuberger is beyond belief. The heirs of Roy are among the smartest on the street. DLJ, a leading edge firm in its day, sold itself to a foreign bank for $13.4 billion in cash the week that the S&P 500 top ticked at 1,521 in August 2000. No surprise that it would happen again now. We will sell eight NDX September futures, adding to our current position of short six S&P 500s. While the notational amount of the eight NDX is $964, 000 (1,205 x $100 x 8), or just 69% of our model portfolio, the extra volatility scares us into shorting just eight rather than 11.

LU, NT, NXTL, IACI, YHOO and BGEN are up over 30% during the past few months and have all been volume leaders. It stands to reason that if individuals have been using margin debt to bolster their play, it has been into the above stocks. We are not officially recommending anything here, but the trades do look rather obvious.

By now every reader knows how bullish investors are here. The AAII survey of over 70% bullishness with single-digit bearishness is the most bullish since January 2000. To add to the bullish sentiment indicators, CNBC did a recent Squawk Back poll where 63% of respondents thought the Dow would top 9,500 by Labor Day, and only 37% said below 8,500.

The bottom line: The US stock market has bubbled to an unsustainable high and will drop, with many hot stocks, dropping fastest of all. That does not mean the US economy is not recovering. All it means is that stock prices have risen too far too fast. ■

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.

Notes

SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-643-1075 ■ Fax 804-643-1544
www.SrConsultant.com