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INSIDE

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By Gail Dudack

Not-So-Scary

Record Levels Of Margin Debt Not Pointing To Speculative Excess

This week we look at margin debt because recent reports from the NYSE show that it rose to an all time high of $275.38 billion in December. The combined margin debt for all NYSE and NASD firms was $294.9 billion in November, also a record. The NASD has not yet reported December's margin debt figures but we estimate that combined margin debt was about $300 billion at year-end, another record. On page 4 we show combined margin debt as a percentage of nominal GDP (with estimates for 4Q06). (THIS IS A SPECIAL TREAT FOR THE BEARS.) At the end of 2006, it jumped to levels last seen in the November 1999 to November 2000 period. In November 1999, we found margin debt to be an excellent indication of speculation heating up at the end of the bubble.

As an indicator, an even more reliable ratio is margin debt to capitalization. These charts are on page 5. The bottom chart shows the combined NYSE/NASD margin debt as a percentage NYSE/NASDAQ market capitalization; it too is at its highest level since 1999-2000. In November this hit 1.53%, a fraction above the 2 standard deviation line of 1.51%.

On page 6 we have a chart of the two-month growth rate in margin debt and compare it to a two-month change in the Wilshire 5000 (a short cut for market capitalization). This shows a sharp acceleration in margin debt in November/December and one that is not explained by an increase in market capitalization. The growth in debt is not as extreme as that seen in late 1999-2000; nonetheless, this collection of indicators displays obvious signs of escalating leverage in the market.

But, there are two important offsetting factors:

First, free credit, as a percentage of total margin debt was 57.8% at year-end, well above average and well above the 24% seen in November 1999. See page 7. The importance of this should not be understated. Margin debt is a major risk in the event of a sharp sell-off in prices. As prices fall and collateral in margin accounts declines, investors are likely to get margin calls and be forced to sell positions. This forced liquidation is often a major force at the end of a bear market cycle. But today, investors have healthy balances that could provide a cushion in the event of a decline in the market.

Second, the NYSE short interest ratio was 6.7 in January and hit a cyclical high of 7.0 in September. See page 8. January's ratio indicates that NYSE short positions represent 6.7 days of average daily volume. This is not very far from the record short interest ratio of 7.5 days recorded in September 1996. This creates an interesting twist on the high level of margin debt. Keep in mind that shorting is done only in margin accounts, and that margin can just as easily be used to short stock as to buy stock. In other words, the current margin debt position is more likely to generate a panic short-covering rally in the event of a sharp rise in prices as it could generate panic selling in the event of a decline in prices.

Like all technical or fundamental indicators, one needs to be aware of the overall environment to interpret statistics correctly. At first, we were a bit worried to see the high level of margin debt. But as we studied the general background of the market, we believe the odds favor more upside to the market than many expect.

The SP500 is trading at 16.4X DRG estimated 2006 earnings ($87.00) and at 15.2X 2007 estimated earnings of $94.00. A 15 to 19 multiple on forward earnings is "average" during a period of low inflation; therefore we believe the market is solid and attractively valued. Note, without any multiple expansion an 8% earnings forecast for 2007 creates a 1540 target in the SP500, which is where the consensus clus-

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Kathryn M. Welling
Editor and Publisher

Jean M. Galvin
Business Manager and Webmaster

Karin-Marie Fitzpatrick
Editorial Assistant

Alexander Isley Inc.
Graphic Design

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Editorial and partnership offices are located at 145 Mason Street Greenwich, CT 06830.
Telephone: (203) 861-9814
Fax: (203) 618-1752
Email: welling@weedenco.com
jean_galvin@weedenco.com.

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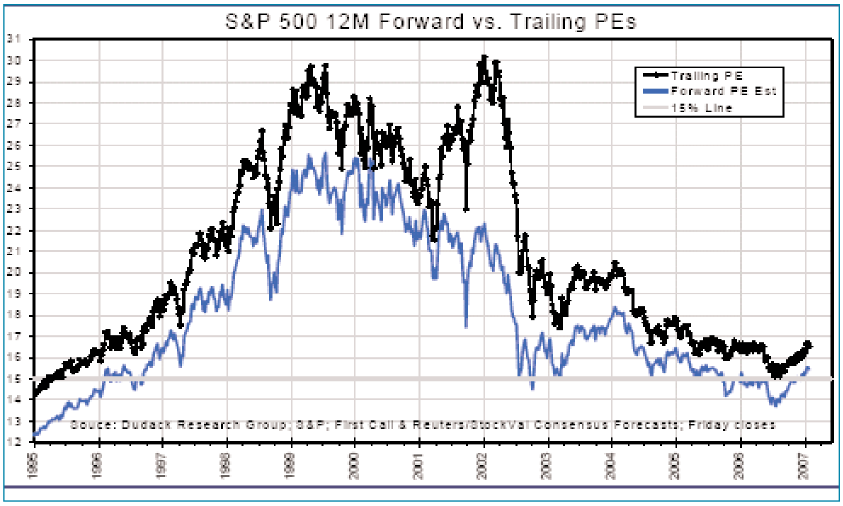
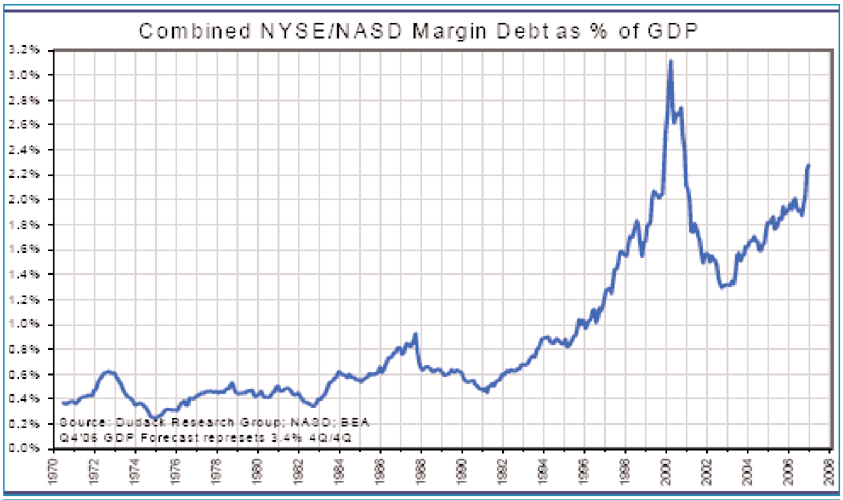
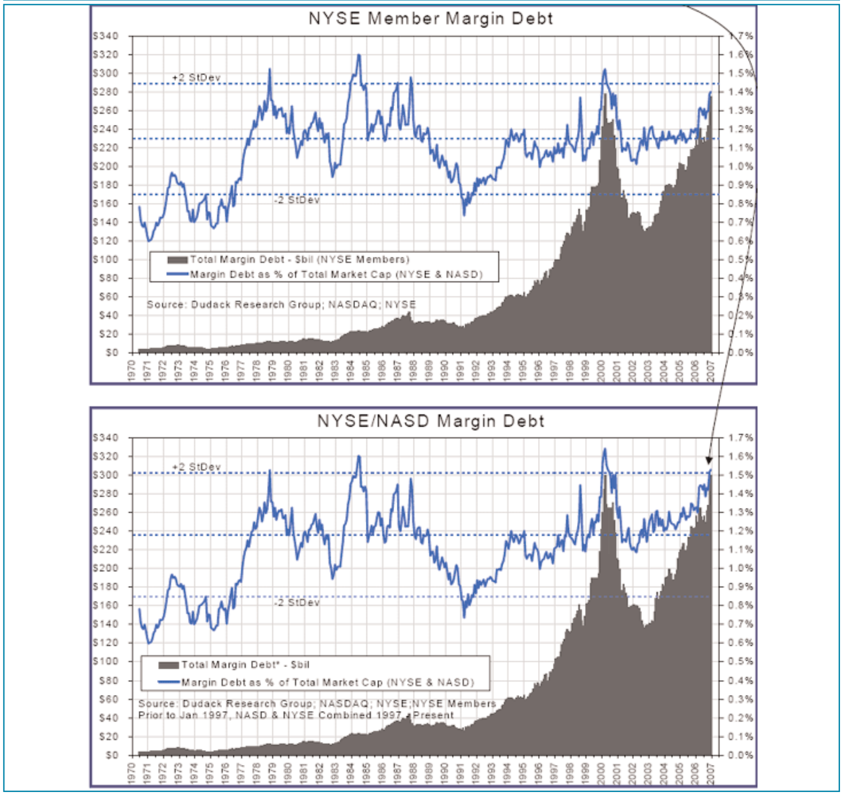
ters. We believe the market is more likely to beat the consensus view, than underperform.



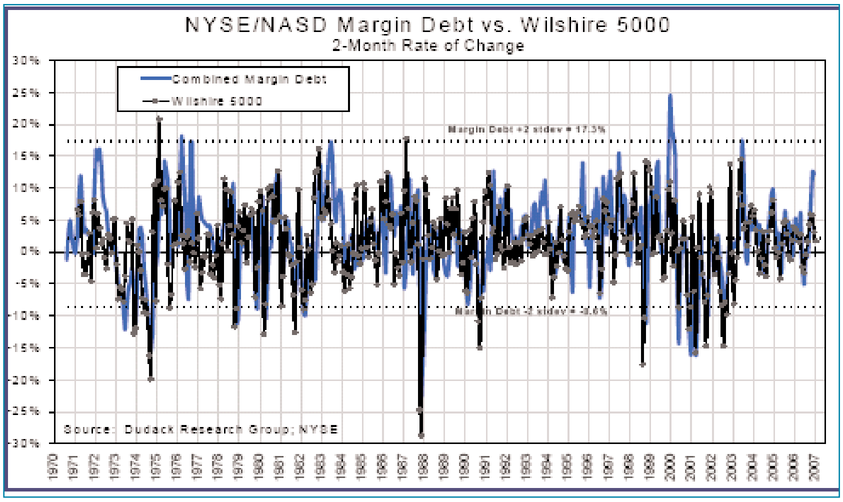
But there is leverage in the market. Note the rise in margin debt in relation to nominal GDP. However, this chart reflects both the recent increase in margin debt and the sluggish economy in 2006.



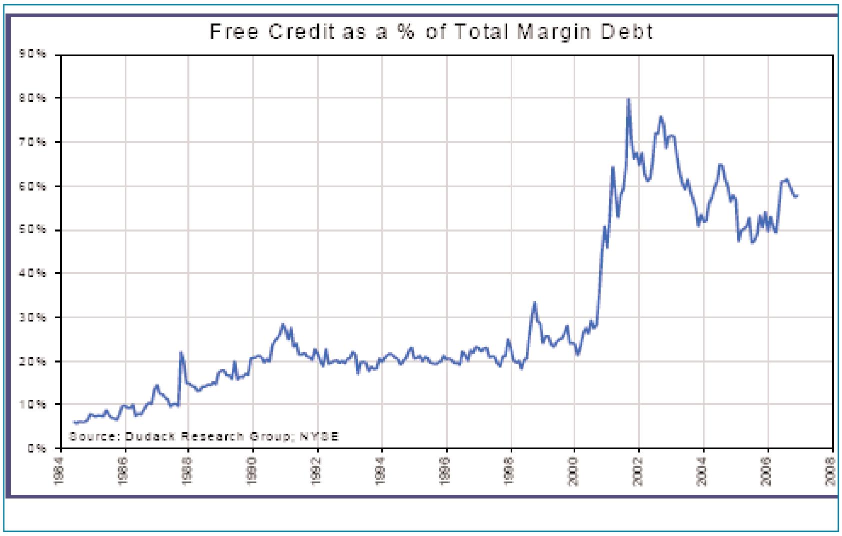
The appropriate comparison in our opinion is margin debt as a percentage of total market capitalization. The NYSE debt alone has not moved into dangerous territory, but the combined NYSE and NASD debt is now 1.53% of market cap. This is high by historical standards.



The sharp pick-up in margin debt began in November 2006. This is reminiscent of the sharp escalation in margin debt that we monitored in November 1999, but it is not as extreme.

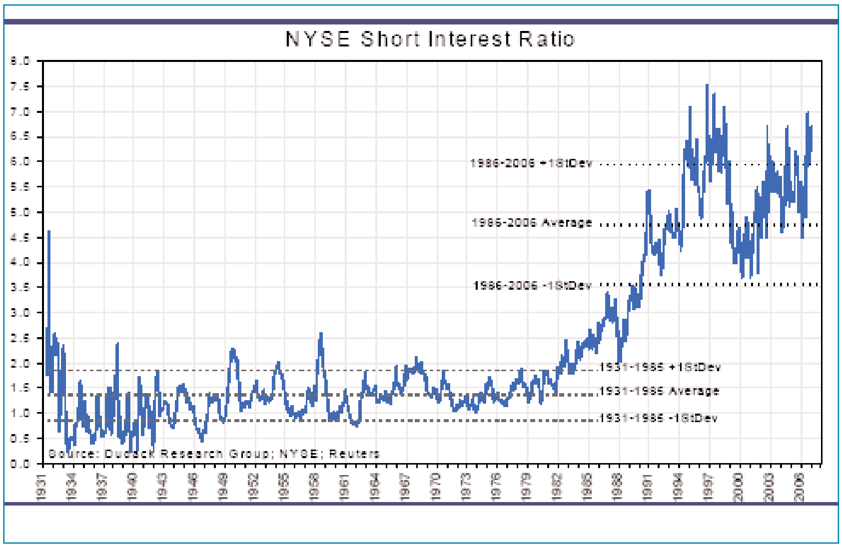


And free credit in margin accounts is still much higher than it was in 1999 – which implies there is nice "credit" cushion if stock prices fall.



Perhaps the best news regarding margin debt is that short interest is also very high. Total short interest on the NYSE represented 6.7 days of trading volume in January and it hit a recent peak of 7 day's trading in September.

Keep in mind that margin can be used to buy long or sell short; all shorting must be done in a margin account. In other words, the stock market could as easily face a buying panic (short covering) rally as a forced sell-off sometime in 2007.



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