

# Alan M. Newman's Stock Market CROSSCURRENTS

U.S. STOCK MARKET OUTLOOK for NOVEMBER 29, 2015  
DJIA 17,798 - SPX 2090 - NASDAQ 5127 - GOLD BULLION 1056

**TOTAL NOTIONAL VALUES IN DERIVATIVES HAVE CONTRACTED 16% SINCE 2013 PEAK, BUT THE RISKS OF ANOTHER FIASCO REMAIN. GOLD WEIGHED DOWN BY STRONG DOLLAR, DOING FINE VS. EURO & YEN. - NEXT ISSUE - DECEMBER 28, 2015 -**

## ⌘ 198 Trillion Reasons To Fear Another Fiasco. ⌘

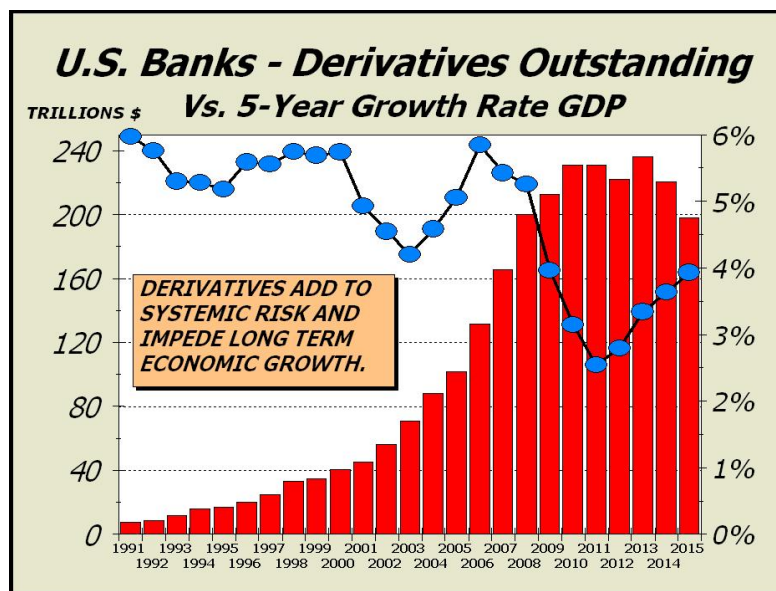
Although your Editor has been a market observer for 51 years, the first 23 years were relatively tame. There was a great bull market, then a horrific bear market and then another great bull market. Nothing truly out of the ordinary and unsurprisingly "normal." Things began to get a lot more interesting when the stock market suffered a bona fide crash in 1987, the worst implosion since 1929 and bad enough to create concerns of a total financial collapse. Six months later, we wrote an in-depth analysis of the crash, concluding that risk parameters had changed dramatically and permanently. One of the key drivers for this metamorphosis was the establishment of stock index futures trading in 1982, providing the first ever opportunity to trade a derivative based on stock prices, instead of trading the underlying asset—stocks. While there was an options market for certain stocks at the time, options were infrequently traded and quotes were almost by appointment. However, as time passed, trading in the S&P stock index futures enabled a more relevant options market and finally provided the impetus for more fu-

tures. When Dow Jones refused to allow futures based on their Industrial index, the XMI major market index was created and began trading on April 29, 1983. This new index represented 20 "blue chip" industrial issues, and thus approximated the venerable Dow Industrials.

times the \$4 trillion value of the stock market. Growth wasn't just rapid, it was astonishing. By 1998, notional values reached almost \$33 trillion, 2.56 times the \$12.86 trillion value of the stock market. As in 1987, there was a brief timeout as the entire financial system was threatened by the collapse of Long Term Capital Management. This time, the Federal Reserve had to step in and broker a deal to stop the bleeding, practically issuing ultimatums to certain Wall Street firms to stop the bleeding. Savvier minds than ours felt we might be only hours from a total financial collapse. That's how bad it was.

Brief timeouts aside, nothing would stop the growth in derivatives. By 2007, the year the housing bubble peaked and another stock mania saw the Dow first hit the 14,000 mark, notional values of derivatives reached \$165.6 trillion, close to *nine* times total stock market capitalization of \$18.8 trillion. Of course, this marked yet another timeout, this time not so brief.

*(Continued on page 2)*



The bull market for stocks provided for growth in stock derivatives and this success spawned the realization that just about anything could be replicated with a derivative. Within a decade, there were derivatives of just about every stripe. By 1991, the notional values of all derivatives totaled \$7.4 trillion, 1.8

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(Continued from page 1)

By the bottom of the economic recession in March 2009, Citigroup (C) had become a penny stock, falling 98.3% from its December 2006 high. Much the same circumstance played out for other major banks, such as Bank of America (BAC) and HSBC, and stocks were cut neatly in half. However, despite this third incredible collapse, there seemed no way to deter the long term rationale of the large banks that the larger their derivative portfolios, the better off we all would be. Of course, the conduct of the large banks in creating additional trillions in notional values of derivatives was clearly aided by a pliant Federal Reserve and U.S. Congress. By 2013, total notional values were \$236 trillion. If you've never seen this number, we show it below.

**\$236,000,000,000,000**

That was the saturation point, the peak in notional values and perhaps the point at which the major players finally realized that yet another debacle was inevitable. Clearly, risk exposures were ignored in 1987, 1998 and 2008, resulting in gigantic dislocations in our markets. Worse yet, as our featured chart on page one clearly illustrates, the rapid growth in derivatives has been accompanied by a far lower long term rate of economic growth. While banks may have presumed economic growth would be enhanced by derivatives, the opposite has shown to be true.

Finally, there seems to be some recognition that risk exposures remain gigantic. In the second quarter of 2015, total notional derivatives fell \$5.2 trillion, or 2.6%, to \$197.9 trillion, the lowest level since the third quarter of 2008, but nearly 20% higher than at the end of 2007. De-

ivative contracts remain concentrated in interest rate products, which comprise nearly 78% of total derivative notional values.

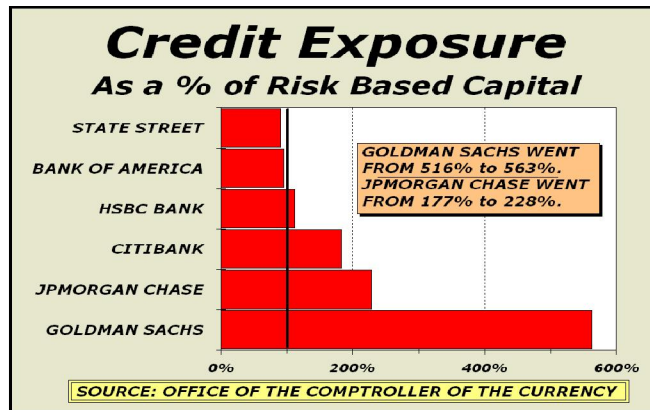
So-called "Level 3" assets are assets where fair value cannot be determined by using observable inputs, such as market prices. Another way of assessing market risk is presumed to be the volume of and changes in level 3 trading assets. Since the

ways as it has been—exposures are far too concentrated in too few companies, which subjects the financial system to inordinate and intolerable risks that cannot be calculated. At bottom right, any reasonable person would wonder why the total assets of these commercial banks need be dwarfed to the extent shown by notional values of their derivative portfolios.

At center, referencing credit exposures as a percentage of risk based capital shows pretty much the same picture as we have shown for many years. Despite the apparent recent increase in recognition that derivative portfolios may carry unwelcome risks, *several of the largest banks have actually raised their risk profile.* Goldman Sachs (GS) is number three in total notional values and JPMorgan Chase is number one. In fact, credit exposure as a percentage of risk based capital also rose for Citibank, number two on notional values, but the percentage increase from our last assessment was only nominal.

A near collapse in 1987. Eleven years later in 1998, a near collapse. Ten years later in 2008, a dramatic bubble burst leading to another near collapse. While the math is only coincidental, we believe the threat of a yet another derivative fiasco is real. Yes, the situation may not be quite as bad as before. We used to have 236 trillion reasons why, now we only have 198 trillion reasons. We'd love to believe that banks have learned their lesson but honestly folks, who paid for all their incompetence? *The rest of us did.* We believe the odds for another disaster are way too high. ☑☑☑☑

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peak of the financial crisis at the end of 2008, major dealers have sharply reduced the volume of level 3 trading assets. Nevertheless, Level 3 assets held by banks total \$50.4 billion and estimates of their fair value can only be assumed. Given that the total of Level 3 assets has contracted by more than 75% from their peak in 2008, this speaks volumes about how reluctant banks formerly were to face the truth.

Meanwhile, in contrast to insured commercial banks, bank holding companies still have derivative portfolios encompassing \$255.2 trillion, of which only four banks account for 91.6% of the total. At left below, looking at insured commercial banks, we see that 7 banks alone account for 97.6% of all notional values in derivatives. Our complaint is al-

