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STOCK MARKET AND CREDIT CONTAGION ?

- Stock market weakness late last week and extending into Monday was generally attributed to an unsettling inflation number and renewing strength in crude oil.
- The bank index (BKX) had two noticeably big bar down days on Friday and Monday. The surge from 115.78 early in January to 121.2 on Wednesday was in the face of negative momentum divergence.
- Within this, Citigroup (C) did an outside reversal to the downside on Monday. From the high of 56.44 in late December, yesterday's low of 52.18 took out the initial low of 53 set in mid-January. Accompanied by distribution, this is concerning.
- This seems to be early in the pattern that brought HSBC (HBC) down from 97.78 in early November to today's low of 87.80, which extends the downtrend.

This, the third largest bank, by market cap, revealed a few weeks ago that their portfolio of sub-prime mortgage bonds had turned from good to bad in only two months. This probably covered November and December. A serious price decline is suggesting a serious liquidity problem.

In looking at the price index for the BBB mortgage sector, this was at 100.5 in late August, 99 in mid-November, and 96 in late December. This likely represents the sudden change in HSBC's appraisal of the sector.

Erosion since then has been severe, with 93 recorded in early February, from which the price has slumped to 76.8 on the latest quote. It seems that HSBC took the initial hit on about a 5% drop in price. During February, the plunge amounts to around 18%.

Of course, we don't know if the announced write-off included their whole position or just the damage on the initial price drop.

Time will tell, but today's whack to many sectors is critical and fascinating.

The February 12 ChartWorks reviewed the "Pi Cycle", which called for a spike in the leading components of the boom running up to around February 26. The key to this is the zoom and then break.

The 9% plunge in China's stock exchange, while gathering the headlines, should be viewed as the catalyst on a very timely reversal of fortune.

The extent of this will be determined by the market. If the test of the highs rolls over, then an intermediate decline is possible. Of interest is that other items in the boom have been hit as well. These include a sharp decline in base metals, agricultural commodities, as well as gold and silver.

Within the latter, as this is being written, gold is down a dollar while silver is down 14 cents. As mentioned, for a strong warning on overall speculative animation silver should be down in the order of 20 cents as gold is down only a dollar.

- Showing that there are two sides to a market, this morning's headlines included:

"Freddie to Shun Subprime Loans"

"Fannie: No Worry"

Either way – this should worry the taxpayer.

- Probability suggests that this reversal will be as significant as the one On May 11, 2006.

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