**Jeffrey D. Saut,** (727) 567-2644, Jeffrey.Saut@RaymondJames.com
**Investment Strategy**

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## Dow Theory Sell Signal?

We arrived in San Francisco around noon last Monday. After a quick lunch with friends in Atherton, followed by another short visit with more friends in Los Altos, Cheryl and I pulled up to the hotel De Anza in San Jose (a wonderfully refurbished 1920s hotel with a great Italian restaurant named La Pastaia). After checking in I warped into the Internet only to find my email "box" slammed with questions about Dow Theory. Those questions were kindled by some alleged pundit who appeared on CNBC and declared that a Dow Theory "sell signal" had been rendered. While it is true that there are numerous practitioners of Dow Theory, over the years I have learned that many of them do not interpret the theory the way I was taught.

Charles Dow began publishing *The Wall Street Journal* in 1889. Considered a very astute stock market observer, Dow wrote a number of editorials wherein the concept of Dow Theory originated. Those theories were expanded on by S.A. Nelson, in collaboration with Charles Dow, in a series of *WSJ* editorials titled, "The ABCs of Stock Speculation." At the end of those quips resided a footnote that read "Dow Theory." Shortly after Dow's death, William P. Hamilton became editor of the *WSJ* and wrote hundreds of similar editorials, leading to his epic book "The Stock Market Barometer." It was Hamilton who first wrote about the "confirmation principal" between The D-J Industrials (DJIA) and The D-J Transports (DJTA), which to me is the bedrock of Dow Theory. Following Hamilton's death in 1930 his student, Robert Rhea, began publishing a market letter titled "Dow Theory Comment." Rhea "called" the bottom of the stock market in July of 1932, as well as the subsequent downturn of 1937. Rhea died in 1939, leaving Dow Theory fallow until the 1940s when the great Dow Theorist George Schaefer resurrected it. To me, these folks were the "expanders" of Charles Dow's original stock market observations. And to my knowledge the only market maven of today that really understands, and adheres to, the brilliant work of those Dow Theorist icons is Richard Russell of "Dow Theory Letters" fame.

While I could certainly respond as to why there was NO "sell signal" last Monday, Dick Russell explained the situation in his always excellent letter dated October 26, 2009 (the brackets are my inserts). To wit:

> "The secret of the direction of the great primary trend of the market lies in the **secondary reaction and what happens AFTER a secondary reaction.** A secondary reaction usually takes three weeks to three months in duration while correcting one-third to two-thirds of the previous move. Since the March low, we have yet to experience a true secondary reaction. And I'm wondering whether we could be on the edge of a secondary reaction now. Following a secondary (reaction), if BOTH Averages (Industrials and Transports) rise to new highs, the primary trend is taken to be bullish. Following the lows of a secondary reaction, there will be a rally. If (that) rally fails to take both Averages to new highs, and the Averages then turn down and break to new (reaction) lows, the primary trend is taken to be as bearish. Secondary reactions often start with one of the Averages sinking while the other Average continues to the upside."

Well said Dick Russell. We, therefore, told our callers, "How can you have a sell-signal when we have not even experienced a downside secondary reaction since the March lows?" Indeed, you need a downside reaction, which "sets" the reaction lows, followed by a rally. If that rally fails to make a new reaction high, and subsequently breaks below the aforementioned reaction lows, then (and only then) will we have a Dow Theory "sell signal," at least as I understand Dow Theory.

For the record, the recent closing price reaction "highs" are 10092.19 for the DJIA and 4045.11 for the DJTA. Measuring from those highs suggests a one-third "give back" would leave the DJIA at ~8910 and the DJTA at ~3412. That would be consistent with our comments in which we stated that we thought any correction would probably be contained between the 50-day moving average (DMA) and the 200-DMA. In the Dow's case the 50-DMA is currently at ~9718 and the 200-DMA at ~8593, while the Transport's 50-DMA resides near 3613 and the 200-DMA around 3269. Of course the markets can do anything, but I would be surprised if the Averages correct by more than one-third. Nevertheless, we have been pretty cautious since the latter part of September, fearing that the vacuum created by the July to September melt-up might get "filled" to the downside once quarter-end window dressing is over. Initially that strategy looked good, and then it looked bad; but all said, the Averages are only marginally below where they were when we turned cautious. Yet, we are still cautious.

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In the way of a follow up to last week's comments about, "farmland being the only asset class left behind by the rally in everything;" most of the publically traded Ukrainian agricultural companies we gave to our liaison desk for your consideration turned out to be available only to institutional investors. As for the companies mentioned in the *Barron's* article that boost agricultural productivity, the readily available ones to U.S. investors are: Agrium (AGU/$46.95), Archer Daniels (ADM/$30.12), Bunge (BG/$57.06), Monsanto (MON/$67.18), and Mosaic (MOS/$46.73). Sticking with the agricultural theme, this week's *Barron's* had another ag-related story titled "Hogs Climb Out of the Mud." The article speaks of the two-year nightmare hog producers have experienced as prices plunged while feed prices rose. The article concludes that the bottom is now "in" for hog prices. We wrote about this same scenario late last summer, noting that many hog farmers were slaughtering their breeding-stock because they couldn't afford to feed them. Our conclusion was that when the cycle turned, and demand picked up, hog prices might rise faster than most expect since it takes roughly 18 months to rebuild one's breeding stock. Our vehicle of choice to play this theme was the iPath DJ-UBS Livestock Exchange Traded Note (COW/$28.20), which is ~68% live cattle and ~32% lean hogs. However, like our stock trading strategy over the past four weeks, COW is not much higher now than it was when we first mentioned it. Still, we like the hog/cattle theme.

Coincidentally, in Friday's *WSJ* there was yet another article about agriculture titled, "Late Harvest Sows Problems for Farmers." Said article speaks to this year's late harvest due to wet weather. As written, "On Monday, the U.S. Department of Agriculture said just 20% of the corn crop had been harvested in the major corn producing states, compared with 58% on average by this point in 2004 through 2008." Moreover, the grain crop is just too wet, and therefore subject to mold, especially in the warm delta region. Wet conditions also suggest a late start for next spring's planting, as well as the potential of compacting dirt in fields that could hurt future crop yields. Meanwhile, global grain inventories are at record lows. Hereto, we wrote about this situation months ago and recommended a number of vehicles playing to this theme like: PowerShares DB Agriculture Fund (DBA/$25.57), GreenHaven Continuous Commodity Fund (GCC/$25.10) and iPath UBS Grain ETN (JJG/$38.00). As always, the terms and details of such funds should be vetted thoroughly before purchase.

**The call for this week**: When the going gets tough the tough go on the road. That's what we did last week and that's what we are doing again this week, so once again these will likely be the last strategy comments of the week. Nevertheless, last week's "wilt" left everything we follow lower except for the U.S. Dollar Index. And while the DJIA (9712.73) averted a loss in October, none of the other indices we monitor did. Indeed, the S&P 500 (SPX/1036.19) slid 3.9%, bringing its two-week retreat to 5.6%. While our sense is that we are into a secondary correction, our proprietary overbought/oversold indicator is VERY oversold and the number of S&P 500 stocks that are above their 50-DMAs has fallen from more than 90% to 33.2%. Consequently, we continue to think it is a mistake to get too bearish. Ergo, until Dow Theory "tells us" otherwise, we think the primary trend remains UP, and we continue to trade, and invest, accordingly.



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