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Investment Strategy

"The Philosophy of Tops"

> "Everyone kept saying 'a top is not in place yet.' They persistently pointed to the 'normally reached' levels of this or that statistic that were not yet there to reinforce their desire to remain bullish. . . . Apart from statistical measures of increasing blindness, this unwillingness to acknowledge what they themselves were already feeling revealed a comfortableness, a confidence, a conviction that whatever was happening – short-term survivable dips – would continue . . . until 'the top,' like a strip tease artiste of our youth would with decorum appear on stage, bow, and then, accompanied by applause from all the bulls eager to cash in on their excitement, would begin to twirl its statistical tassels in front of everyone.
>
> I've gotten so old I can't remember the names of those ladies at the Old Howard, but I can remember that all you got was a flash of this or that, before they waltzed off. Stock market tops are like that. You know it's there somewhere if you squint hard enough, but you never quite see it, so you keep waiting for more. And then, in the end, as the curtain comes down on the bull market you realize that the one rule about tops is not that they provide this or that signal, but that they come before anyone is ready."
>
> . . . Justin Mamis

I recalled this quote from historian, author, and stock market guru Justin Mamis last week while contemplating the probabilities of a "top" for the recent stock market rally. Of particular interest is his last sentence, "One rule about tops is not that they provide this or that signal, but that they come before anyone is ready." In the current case very few are ready for a "market top" given the consensus opinion that the recent Dow Wow is the start of another leg to the upside. Our analysis, however, suggests the extreme oversold condition that spawned the rally has evaporated, leaving all of our indicators just about as overbought as they ever get (see chart on page 3). To be sure, the S&P 500 (SPX/1465.77) has gone parabolic over the past few weeks, while the Russell 2000 (RUT/864.70) is challenging all-time highs. An overbought condition can be resolved in one of two ways. First, the SPX can pause and move sideways while the overbought condition is remedied. Second, the SPX can pull back to what had previously been an overhead resistance level, but now becomes a support zone. In the current case that would entail a pullback to 1400 – 1422 for the SPX. Importantly, when the stock market generates an overbought condition of this magnitude it suggests there is more strength coming in the future after the overbought condition is rectified. Indeed, uptrends typically do not end on really high overbought readings from the NYSE McClellan Oscillator. So, while I think we are reaching for a short-term "trading top," I believe that following some kind of pullback the major market indices will go higher.

Of course, the rise in equity prices, combined with an improving real estate market, has bolstered consumer confidence. That certainly was reflected in Friday's University of Michigan Confidence report, which came in 5.2 points above expectations. Normally one would think that is good news, but as the sagacious folks at Bespoke Investment Group write:

> "The most positive report of the week was Friday's University of Michigan Confidence reading that came in at 79.2, which is just below the multi-year high of 79.3 made back in May. While the actual reading came in just below its highs from May, the amount that the number beat expectations by was the highest seen since late 2008. . . . Since 1999, this sentiment reading has only beaten expectations by more than 5 points 11 other times. Below we highlight how the S&P 500 has performed over the next week, month and three months following the 11 other times that Michigan Confidence has beaten expectations by more than 5 points. Unfortunately, big upside surprises in the reading haven't been great for stock prices. Over all three time frames, the S&P 500 has averaged declines. (Although the median change over the next month and 3 months has been positive due to big declines following periods in 2008 and 2000.)"

So while I am not bearish, I would be cautious about plowing into new positions. And, we saw some of that caution on Friday as sellers showed up in many of the strong momentum stocks.

Meanwhile, the U.S. Dollar Index (@DX.1/78.84) continued its decline as it fell through its 200-day moving average and looks destined to visit 75.00. In past missives I have commented on my sense that we would see a weaker dollar for a multiplicity of reasons. Plainly, the dollar's weakness has helped our bullish recommendation on gold of a few weeks ago. In fact, I have written that gold has been telegraphing QE3 for weeks as it began to rally rather sharply. What is particularly interesting to me is for the

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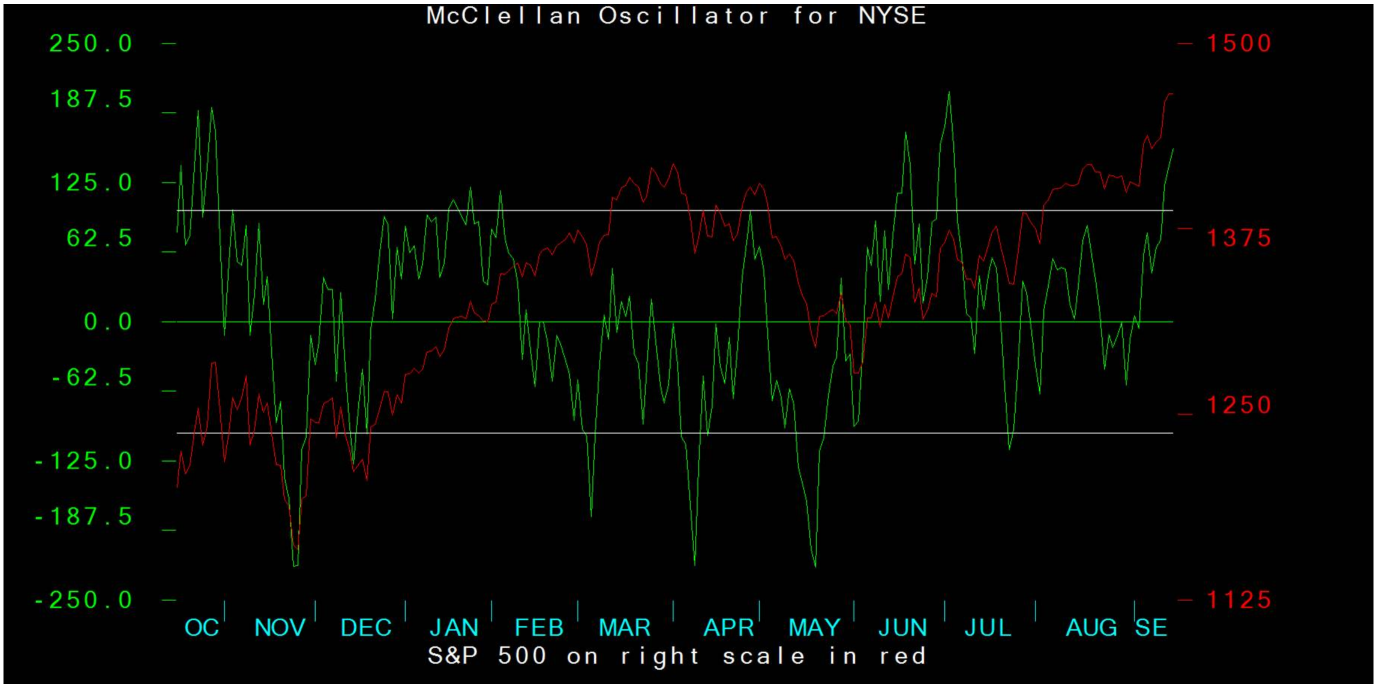
first time in a long while gold bullion and gold stocks are rising together. That doesn't always happen and it leads me to think the recent gold rally is for real. Moreover, many of the gold stocks are breaking out to the upside in the charts and they are doing so on expanding volume. We were early to gold's party back in 4Q01 when China joined the WTO and decided Chinese per capita incomes were going to rise with a concurrent rise in "stuff stocks" (energy, timber, cement, precious metals, etc.). While I doubt gold is going to stage a percentage move like it did back then, as we approach the strongest seasonal period for precious metals (October – January) we are thinking that if you don't have some exposure to the precious metals complex, now would be a good time to start. While there are a number of ways to get at said exposure, I have tended to use mutual funds. Last week while in New York City I met with the good folks at Van Eck. And a month ago I actually had dinner with the portfolio manager of Van Eck's International Gold Fund (INIVX/$20.36), namely Joe Foster, who spoke about some his favorite gold stocks, like Gold Corporation (GG/$46.20) and Eldorado Gold (EGO/$15.75).

The call for this week: To me the only question is if the stock market is going to correct its current overbought condition by going sideways, or if it is going to correct back to the 1400 – 1422 support. In either event I have been pretty confident that the Fed has already begun printing money. That has been eminently evident by the overall action in the commodity markets, the dollar, and the fact that stocks were unable to correct in the normal timing band for a daily cycle low. Indeed, I actually expected an easing of monetary policy out of last month's Fed meeting. At this point, we need to watch the pricing action of crude oil, for if it spikes higher it is going to be a decided drag on GDP. As Gary Savage points out:

> "Since QE is open ended this time there's no telling how far the rally could go before traders get nervous enough to initiate a profit taking event. As I said above, we aren't going to begin a bear market until oil spikes, so any corrective move is only going to be a profit taking event that will quickly be recovered by more QE. At this point I wouldn't expect any real profit taking until the S&P tests the all-time highs. I really doubt any sane traders are going to look for a significant correction immediately following the confirmation of QE unlimited. At this point any rational trader is getting long so they don't get left behind."



Source: Bloomberg.

Michigan Confidence Beats of More Than 5 Points

Date	Actual	Est.	vs. Est.	Next Week	Next Month	Next 3 Months
1/16/04	103.2	94.0	9.2	1.36	0.63	-0.35
9/12/08	73.1	64.0	9.1	0.27	-20.27	-30.21
10/12/00	83.4	76.0	7.4	4.44	1.62	-0.86
7/13/07	92.4	86.0	6.4	-1.19	-8.11	0.12
5/16/03	93.2	87.0	6.2	-1.17	6.97	4.91
6/17/05	94.8	88.8	6.0	-2.09	1.50	1.72
1/18/08	80.5	74.5	6.0	2.17	1.31	4.75
1/19/07	98.0	92.2	5.8	-0.58	1.90	3.76
10/13/06	92.3	86.5	5.8	0.22	2.02	4.76
11/9/00	83.5	78.0	5.5	-1.99	-2.07	-4.99
1/14/00	111.4	106.2	5.2	-4.34	-5.29	-7.41
9/14/12	79.2	74.0	5.2	?	?	?
			Average	-0.26	-1.80	-2.16
			Median	-0.58	1.31	0.12

Source: Bespoke Investment Group.

Company Citations

Company Name	Ticker	Exchange	Currency	Closing Price	RJ Rating	RJ Entity
Eldorado Gold Corp.	EGO	NYSE	US$	15.75	2	RJ LTD.
Goldcorp	GG	NYSE	US$	46.20	NC	

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