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

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Investment Strategy

Everybody's Unhappy!?

> "Money managers are unhappy because 70% of them are lagging the S&P 500. Economists are unhappy because they do not know what to believe: this month's forecast of a strong economy or last month's forecast of a weak economy. Technicians are unhappy because the market refuses to correct and gets more and more extended. Foreigners are unhappy because due to their underinvested status in the U.S. they have missed a big double play: a big currency move plus a big stock market move. The public is unhappy because they just plain missed out on the party after being scared into cash. It almost seems ungrateful for so many to be unhappy about a market that has done so well. Unhappy people would prefer the market to correct to allow them to buy and feel happy, which is just the reason for a further rise? Frustrating the majority is the market's primary goal."
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> . . . Bob Farrell, *Merrill Lynch; September 1989*

The bears are unhappy since the Santa rally, which began last Thanksgiving, has given the short-sellers no comfortable place to cover their shorts. Last week the bears suffered even more angst as most of the indices I follow tagged new reaction highs. The upside skein from the December 19th "low" has left the senior index better by ~8.1%, and up an eye-popping 13.3% since Thanksgiving. Counting the trading days from that mid-December "low" shows the rally has now encompassed 21 sessions with no more than a 1 – 3 session pause and/or correction. That makes this a fairly long of tooth "buying stampede." Recall, buying-stampedes typically last 17 – 25 sessions, with only 1-3 session pauses/corrections along the way, before they exhaust themselves on the upside. It just seems to be the rhythm of the "thing" in that it takes that long to get participants bullish enough to throw in the towel and "buy 'em" right before the markets peak and have a downside correction. Moreover, during the current stampede just about everything has been "run," including all the sectors punctuated by the Banks +11.6% performance YTD. Accordingly, the only thing missing for a short-term "top" is a final burst to the upside driven by short-covering. My sense is this will occur into tomorrow night's State of the Union address, which should be followed by a post address letdown for the stock market.

To be sure, the recent rally has not been accompanied by a noticeable increase in Buying Demand as measured by Lowry's Buying Power Index. Rather the rally has occurred more from a reduction in Selling, which is reflected in Lowry's Selling Pressure Index. Then too, the percentage of stocks above their respective 10-day moving averages (DMAs) has failed to confirm the upside and the New High list is not expanding. In fact, 40% of my short-term indicators are now bearish and none are bullish. Meanwhile, the NYSE McClellan Oscillator is overbought, the stock market does not have much internal energy left for a big rally, the S&P 500 (SPX/1315.38) is three standard deviations above its 20-DMA, the Volatility Index (VIX/18.28) is telegraphing too much complacency, and we have negative seasonality for the next few weeks. Nevertheless, I continue to think it is a mistake to get too bearish because I believe any pullback in the various indices will be contained.

My bullishness was reinforced last week during a conversation with Frederick "Shad" Rowe, the sagacious general partner of Dallas-based Greenbrier Partners. Summing the conversation, we decided the world is becoming richer faster than debt is expanding. This is not an unimportant point since everyone seems to be focusing on the "debt bomb," which likely means it is the wrong question. Clearly, some folks are living above their means, some below, but many are living within their means, which can be seen in the Household Debt Service Ratio chart that is plumbing generational lows. Manifestly, the world is getting more prosperous and is producing more for less driven by technology. Truly, it is "one world" and we should start thinking of the U.S. as a state within that "one world." This view is plainly stated in Federal Express' annual report. To wit:

"We've reached a tipping point in how the world works. **The largest economy in the world is no longer the economy of any one country – it's the economy of global trade of goods and services**. Value: $18.3 trillion in 2010. At FedEx, our job is to facilitate these transactions, the heart of commerce, by providing access – moving goods across the global supply chain."

Or, how about this from Google's annual report:

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"Google is a global technology leader focused on improving the ways people connect with information. We aspire to build products that improve the lives of billions of people globally. **Our Mission is to organize the world's information and make it universally accessible and useful**."

One world indeed and there are actually a lot of good things happening. While the world is still a violent place, it is becoming less so as the wars we have been fighting come to an end. Additionally, the U.S. finally appears to be heading down the road of energy self-sufficiency, which should increase employment, and the U.S. dollar is currently the least unattractive currency in the world. Furthermore, as scribed in previous reports, there is a huge hidden layer of the U.S. economy that is becoming the engine of growth and wealth creation; and, this hidden layer is misrepresented in corporate financial reports. Surprisingly, the equity markets appear to value this hidden layer at approximately zero suggesting huge opportunity for investors to profit. The hidden layer referenced is Organizational Capital and Knowledge Capital, both of which reside under the macro moniker – Intangible Capital – so often mentioned in these missives. As the astute GaveKal organization writes:

> "When we account for intangibles the picture of the U.S. economy changes. It is revealed that we are saving more and investing more than we thought. This means our economy is much more dynamic than we thought. This result is relevant in view of the perception of a low rate of saving in the U.S. economy, particularly because existing measures exclude much of the investment in knowledge capital that is a defining feature of the modern U.S. economy. . . . Validating intangibles is the key to eliminating the guesswork in valuing a company correctly. Indeed, this 'new view' of intangibles suggests they are the missing link between financial accounting and financial valuation."

These observations, taken in concert amid the backdrop of a world that is profoundly underinvested in U.S. equities, continues to leave me walking on the "sunny side" of Wall Street even though in the very short term I am looking for a trading peak. During the envisioned decline investors should consider companies playing to the Intangible Capital theme. While participants should study all investment situations for themselves, some names for your consideration from our research universe playing to the Intangible Capital theme, and favorably rated by our fundamental analysts, include: Micron (MU/$7.76/Strong Buy), Analog Devices (ADI/$39.78/Strong Buy), Maxim Integrated Products (MXIM/27.83/Outperform), Texas Instruments (TXN/$33.64/Outperform), Xilinx (XLNX/$35.77/Outperform), Nuance (NUAN/$29.08/Strong Buy), Google (GOOG/$585.99/Outperform), Delta Air (DAL/$9.41/Outperform), and Urban Outfitters (URBN/$25.40/Outperform). Of course there is a way to purchase all of these companies that are accumulators of Intangible Capital (and more) via the GaveKal Platform Company Fund (GAVIX/$11.18).

The call for this week: Last Thanksgiving I suggested the Santa rally was beginning. I stuck with that "call" into the new year. On January 3, 2012 I stated that session felt like an "emotional peak" and that January 10, 2012 felt like the "price peak." Subsequently I wrote, "The only question in my mind is if the markets are going to have a pullback into the 1230 – 1240 support zone, or go sideways to correct their overbought condition and allow the internal energy to be rebuilt." So far, it has been a sideways consolidation until last week's upside breakout causing one old Wall Street wag to exclaim, "Breakout or fake-out?!" On a short-term basis I think it is a fake-out believing a trading top is due this week . . .

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