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Investment Strategy
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Investment Strategy

"Ouch"

"Markets fluctuate, but when the economy is growing you ride out those fluctuations. When the economy is contracting, however, you have to become more defensive; you have to manage the risk of those market fluctuations."

. . . Rob Stein, *Astor Asset Management*

The market kept sinking as Rob and I chatted last Friday about the "state of the state." I told him I was doing a lot of hand holding because most participants didn't follow the advice of raising more cash in portfolios as certain support levels were violated to the downside over the last 30 days. While intuitively I concur with Rob's thoughts about "Riding out market fluctuations when the economy is expanding," my risk management discipline forced me to raise more cash again on Friday, even though I believe the stock market is in the process of making a significant "low." Ideally that "low" should come in the 1230 – 1250 zone [basis the S&P 500 (SPX/1270.98)]; although the SPX doesn't really care about where I think the "low" should come. The 1250 area is particularly interesting since it targets the March 16, 2011 intraday reaction "low" (1249.05), as well as the SPX's 200-DMA (1253.48). It would seem fitting, however, following the end of the eight-month Buying Stampede, for a Selling Stampede to begin.

Recall the DJIA's Buying Stampede commenced on September 1, 2010, and continued uninterrupted until May 31, 2011, with never anything more than a one- to three-session pause/pullback. Verily, last Monday marked the first time the DJIA (INDU/11951.91) closed lower in four consecutive sessions, thus ending the longest upside stampede chronicled in my notes of over 40 years. If we have spilled over into a Selling Stampede, this is session 9 in what typical should be 17 – 25 sessions on the downside. That would imply a "low" of some significance is due over the next two weeks in the aforementioned 1230 – 1250 zone. Still, I am not certain we are in a Selling Stampede; and therefore, am not sure this selling-squall will last the typical 17 – 25 sessions.

Said sense is reinforced by the fact that, despite last Thursday's "throwback rally," the equity markets remain pretty oversold. Indeed, only 15.6% of the SPX stocks are above their respective 50-day moving averages (DMAs), which is down from ~80% a few months ago. Or how about this from our friends at Bespoke, "61.4% of the SPX's stocks are oversold. The current oversold level is only the 27th time since 1990 that more than 60% of the stocks in the index have been [*this*] oversold." Then there are other finger to wallet ratios, like the CBOE Equity Put/Call ratio, which at 0.99 (nearly one "put" traded for every "call" traded) is at the highest ratio (the most bears) of the entire two-year bull move. As for sentiment, hereto the numbers are eschewed too bearishly with the AAII figures showing only 24.4% of individual investors bullish. On this point, I have always been amazed as to why the American public is sooooo quick to embrace the negatives. That negativism was bolstered last week by CNBC's Bill Griffeth in his interview with Walter Zimmerman. To wit:

Bill Griffeth: "Time for talking numbers and we're looking at this debate that continues to range whether or not the economy is vulnerable to a double dip recession. Our next guest says many of the charts he's looking at are saying the possibility of a double dip recession are alive and well right now, and he says there's evidence also that the stock market could return to the lows that we saw in March of 2009, way back two years ago. Joining us with all that happy news, Walter Zimmerman is the chief technical analyst at United-Icap. Walter, good to see you again, welcome back."

Walter Zimmerman: "Thank you. Good to be here."

Griffeth: "We start with the Commodities Research Bureau Index (the CRB) – which you say has a very high predictive value over the last 50 years. What's it telling you right now?"

Zimmerman: "When you look at the rally from the March '09 lows, it stopped precisely right where a bear market correction should have stopped – the 390 area. And, the shape of the rally from the lows of '09 to the recent highs was a classic bear market correction (a, b, c type, three legged advance). Right into the March 2nd peak in the CRB you had very bearish sentiment and momentum divergent sell signals. This rally from the CRB was impressive. It has everybody concerned about inflation, and that's something to be concerned about. But, the CRB is a leading indicator. And right now it is saying that there is the high risk that inflation has peaked and commodity prices have turned south."

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Griffeth: "What about oil? What are the charts telling you there?"

Zimmerman: "Oil is 18% of the CRB. The WTI, to be good for new all-time highs, should have broken above 123. It only got up to 114; and it had the same warning sell signals in early May as the CRB did. So, everybody's concerned about higher oil prices, concerned about higher inflation. But if we talk the numbers, if we talk the actual price action, in these markets, it shows a much different picture. It shows price action consistent with the bear market correction and thereby the risk of another major leg down."

Griffen: "Quickly then, you're saying that's bearish for stocks as well, right?"

Zimmerman: "Yes, interest rates, stocks, and commodities, all move together. They track each other. There's this myth that lower commodity prices are bullish for the stock market, but if you look at the price action, if you look at history, that's not the case. Lower commodity prices tend to occur along with falling stock values."

Ladies and gentlemen, while equity markets can certainly do anything, if the SPX declines to the "lows" registered in March of 2009 (which is what Walter Zimmerman thinks), and if the current earnings estimates are anywhere near the mark, it would leave the S&P 500 trading at less than 6x earnings with a dividend yield (excluding any dividend increases) approaching 5%. I just don't believe this is "in the cards" given my assumption the economy is NOT going to "double dip." Accordingly, amid such market machination I think investors should keep their "heads" screwed-on straight and begin compiling their "buying lists." In addition to the numerous names repeatedly mentioned in these missives like IBERIABANK Corporation (IBKC/$55.45/Strong Buy); EV Energy Partners (EVEP/$52.49/Strong Buy); LINN Energy (LINE/$37.80/Strong Buy), etc., this morning we offer these names for your "shopping lists": Abbott Labs (ABT/$50.90/Outperform); Copa Holdings (CPA/$61.56/Strong Buy); Digital Realty Trust (DLR/$62.57/Strong Buy); and Norfolk Southern (NSC/$70.37/Strong Buy). For the full story on any of these positively rated stocks, please see our fundamental research on the company.

The call for this week: Last Friday a savvy institutional trading service sent out this very succinct headline, "[*A*] Corrective low draws near." The byline read, "Corrective low draws near as technical measures suggest that the current correction is nearing the end of its duration. Many gauges are now at levels where reversals often develop. Probability models are still indicating that the trough should occur in the second half of this month." Plainly, we agree and would note that despite the six-week stock slide there has been very little technical damage done to the major averages. To be sure, the SPX remains above its March 16th reaction low, as well as its 200-DMA. Moreover, stocks are currently deeply oversold. Accordingly, we agree that at least a trading bottom is near. Importantly, the quality of any ensuing rally, and yes Virginia there is always a "next rally," will tell us a lot about the current state of the equity markets. To me the only question in the near term is, "do we get a selling climax or a selling dry up?!"And for those timid souls *ascared* of the current environment, and therefore underinvested, we offer Goldman Sachs Dynamic Allocation Fund (GDAFX/$10.69). Said fund captures much of the stock market's upside, while affording less risk on the downside. For example, over a 15-year time frame (from 1995-2010), a 60% equity/40% bond portfolio allocation (S&P and Barclay's Cap Agg, respectively) has a minimum volatility of 4% and a maximum volatility of 30%, for a 26 pt spread. Meanwhile, the Goldman Sachs Dynamic Allocation Fund has a minimum volatility of 4% and a maximum volatility of 14% (with a target of 9%), which is a 10 pt spread. Therefore, GDAFX tightens the volatility spread on most traditional portfolios. And yes, in the rising interest rate environment we envision over the next five years, we still like the 5%+ yielding Putnam's Diversified Income Trust (PDINX/$8.14) for the fixed income side of asset allocation models.

P.S. – I am off to my old "stomping grounds" of Washington, D.C. to participate in the current "Weiner Roast." So, these will likely be the only strategy comments for this week. I'll be back next week with the "charcoaled" results. As a sidebar, of all the indices we monitor, the only ones with gains last week were the Goldman Sachs Commodity Index (+0.29%) and the Reuters-CRB Index (+0.32%). We continue to invest, and trade, accordingly . . .

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