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Investment Strategy

"It's 11:01?"

"It's 11:01 p.m., do you know where your children are?" . . . is a phrase that haunted me during my teen years as every night our local news anchor would begin his broadcast with that exact question, reminding my parents that I was out past my curfew. Similarly, investors asked themselves last week, "It's 1101, do you know where your stocks are?" as on Wednesday the Doleful Dow dove through last Monday's intraday low of 1188.36 and headed for the Netherlands. In this case, the Netherlands would be the region below the August 9th intraday "selling climax" low of 1101.54. For seven weeks I have discussed the importance of holding above the 1100 level, or only marginally violating it, if our analogue to the October 1978 and October 1979 bottoming sequence is going to continue to play. So far, the correlation (R^2) between then and now is remarkable. How much longer that R^2 extends is unclear, but as long as the 1100 holds we are sticking with this analogue that has served us so well.

Of course, given that strategy has surfaced questions about how much cash we would raise if 1100 is broken. My response has been, "We recommended raising roughly 30% cash back in the March-April timeframe. Another 5% was raised when the S&P 500 (SPX/1136.43) violated the 1320 level and 5% more was harvested when the SPX traveled below its July reaction low of 1295.92." While it is true we recommended putting some of that capital back to work seven weeks ago near the selling-climax lows, using a dividend-paying stock whose share price had collapsed to what our fundamental analysts thought were "absolute lows," we have still been pretty circumspect in recommitting capital to the broad stock market until it is apparent THE bottom has been recorded.

Last week's Dow Dump of 6.4% was the worst Weekly Wilt since October 2008, which if you will recall was when the "bottoming process" began as on 10/10/08 ninety-three percent of the stocks traded on the NYSE made New Annual Lows and we were bullish. Like in October of 2008 the news backdrop surrounding last week's "wilt" was grim. Worries centered on the Greek Gotcha', slowing economies, credit spreads, commodity crashes, ineffective governments, a fickle Fed, Brazilian import tariffs, class warfare, etc., leaving participants' frustration levels elevated. That frustration is being increasingly reflected in my emails, aka "hate mail," because I have tried to stay constructive on stocks after their generational oversold reading of August 8-9. Such a swelling of "hate mail" has historically had bullish implications for stocks. For example, early last week some of our financial advisors objected to my reference to "class warfare" in regards to President Obama's proposed new tax regime. I would remind those folks that, "According to the Tax Foundation, after the 1929 crash, Congress proceeded to raise the top marginal tax rate from 25% to 63% by the end of Hoover's term. As you may recall, hiking those rates may have made folks feel that rates were more equitable but it sure didn't help the economy." Another email referenced last Monday's letter where I quoted the sagacious GaveKal organization and its potential solution to the Greek dilemma. This emailer's verbiage read:

> "Really? I mean really?! How stupid do you think I am? Who believes that to apply a 'global tax cut in Europe' would have 'little direct impact on the German tax payer'?! This assumes that the German government has a way to replace all those tax credits that they gave to the banks with Greek bonds losses. Why? Because tax credits are not something the banks are going to repay to the German government."

It is really too bad that emailer missed the entire point of the GaveKal quote since it was intended to show that there are many "out of the box" solutions to Greece's woes whether GaveKal's idea is implementable or not. Then I have received numerous "pings" about my inability to turn bearish; and, to all of those folks I have this to say. To my knowledge Raymond James was the only investment bank to write about the Dow Theory "sell signal" of September 1999 and tell investors not to let anything go more than 15% - 20% against them. I also wrote about the Dow Theory "buy signal" of June 2003, as well as the "sell signal" of November 2007. Most recently, I wrote about the "sell signal" that occurred on August 4, 2011 and opined I hoped it would prove false like the "flash crash" sell-signal of May 6, 2010 . . . QED!

The reason I revisit my "hate mail" thesis this morning is because it speaks to the frustration level investors are currently feeling. Participants that didn't raise some cash in March and April are frustrated because they have seen the value of their portfolios decline. Participants who did raise cash are frustrated because they didn't raise enough cash. Participants that panicked, and sold everything seven weeks ago, are frustrated as they have watched stocks like EV Energy Partners (EVEP/$70.50/Strong Buy) rally from its August 8th intraday low of $53.10 into last Tuesday's intraday high of $77.77. Indeed, just about everybody is frustrated, making my best observation – it is difficult to find any optimists around. The situation currently at the focal point of the world's problems

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appears to be Greece, as comparisons abound about how a Greek default would push the planet into the sort of financial fiasco that followed the Lehman paroxysm. And with that analogue I take exception.

The 2008 Armageddon occurred because Lehman's bankruptcy fractured the financial system in unanticipated ways. The current crisis, however, was avoidable and has been hoisted on the country by the cowardice and incompetence of elected leaders on all sides of the political aisle. Unless there are significant policy shifts, and the U.S. starts to act like a real country instead of a failed state run by a bunch of fanatical factions, our government runs the risk of spiraling out of control with attendant economic and financial damage. That said, there are indeed some good things happening. As pointed out in an excellent article by Reuters' Alan Wheatley titled "Beyond the gloom, reforms bode well for growth" (as paraphrased by me):

> "Largely unnoticed by markets riveted by the drama of the day, more and more countries are successfully implementing complex, politically treacherous reforms needed to raise their long-term economic growth rates. . . . There's more appetite for reform today than there was 10 years ago; that's for sure. . . . We continue to believe that at some stage the markets will begin to acknowledge these reforms. This, in turn, should lead to a permanent reduction of the fiscal risk premium from very high levels currently."

Meanwhile, the SPX's 10.8% mauling from its July 21st intraday high into the August 9th intraday "climax low" has left ~52% of the S&P 500 stocks yielding more than the 10-year Treasury Bond and ~53% sporting P/E ratios of under 12x earnings. Moreover, consensus earnings estimates have not really come down all that much with this year's estimate pretty sticky at $98 and next year's hovering around $111. While I think those estimates are too high, even using my lower estimates produces a P/E ratio for the SPX of 11.8x in 2011 and 10.7x in 2012. If correct, such estimates render an earnings yield of ~9.3% for the SPX with an equity risk premium of ~7.5%. To be clear, my estimates assume no recession for the U.S. economy, a stance not shared by most. However, if we are entering a recession I have to ask why are Baltic freight rates rising, why are railroad shipments and intermodal loadings increasing, why is L.A. port traffic perky, why are RevPar (revenue per available room) numbers tacking at double digits, etc.? Additionally, why have tax collections in the 46 states that have reported them risen 11.4% (year-over-year) in 2Q11, the sixth consecutive quarter in which revenues were up. Tax revenues had declined significantly the five previous quarters. It has been the strongest showing since 2Q05. All states reported growth in personal income taxes. Both personal income and corporate tax revenues increased 16.5%; and, sales tax revenues rose 5.9% according to the Rockefeller Institute. Nope, I am still in the no recession camp because our economy has not built up any new excesses that need to be washed through the system.

The call for this week: Last week the Dow Jones Industrial Average (INDU/10771.48) broke below its intraday August 9th low of 10604.07, but the SPX did not violate its respective selling-climax low of 1101.54. Neither did a number of other much-watched indices. To me that sets-up the potential for a downside non-confirmation. This week should resolve the suspense. A decisive break below 1100 (5 – 10 points) would target 1020 -1030 according to our work. Whatever the resolution, we have done a fairly decent job of "calling" the stock market this year despite our terrible "call" that 2011 might just be the year of the banks. Fortunately, we avoided the marquee banks in favor of names like IBERIABANK Corp. (IBKC/$43.83/Strong Buy). But even though such names have held up better than their large cap brethren, we have still lost money and have moved on (read: sold our mistakes quickly). From here, my best idea for investing in banks is to use FBR Small Cap Financial Fund (FBRSX/$14.78). I have followed the fund's portfolio manager, David Ellison, since the 1980s when he was managing bank mutual funds at Fidelity. Interestingly, David went to 60% cash before 2008's Financial Fiasco, a feat that speaks to his risk-adjusted management style. Also consistent with our "cautious and conservative strategy until 'things' are resolved," is the Goldman Sachs Dynamic Allocation Fund (GDAFX/$10.19), which has about one-third of the stock market's downside but captures ~80% of the upside. As for fixed income allocations, I am still using Putnam Diversified Income Trust (PDINX/$7.39), the MainStay Floating Rate Fund (MXFAX/$9.11), and the Pioneer Floating Rate Fund (FLARX/$6.65).

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