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Investment Strategy
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"White Noise?"

> "Investing in the financial markets necessarily involves one's ability to change perspectives over time. Often the job of assessing what is important at any particular point becomes increasingly difficult in a period of heightened short-term volatility. Not difficult in terms of staying focused on the factual reality of the economy, corporate earnings, etc., but difficult in that the financial media feels compelled to come up with rationales for daily movements in asset prices. Possibly the single greatest task of any investor today is filtering out white noise. And there's more of the white noise than ever before."
>
> . . . The Contrary Investor.com

So said the *Contrary Investor*; and I could not agree more given my sense that the media remains "long" volatility. Indeed, every time volatility increases, so do my phone calls from the financial media as they feel "compelled to come up with rationales for daily movements in asset prices;" last week was no exception. Verily, the week seemed to build on the previous week's smack down with Bloomberg's Erik Schatzker, who I actually like very much, but challenged me on the point that it was the media that first termed the "fiscal cliff" Armageddon. I had averred that it would certainly not be Armageddon, holding fast to the belief that when something absolutely had to happen inside the D.C. Beltway it has typically happened. My comments were:

> "We should not forget that Congress has a magic eraser. No matter what they do, with a few strokes of a pen everything goes back to effectively January 1, 2013 and the Fiscal Cliff will take its place on the great wall of media creations (remember Y2K?). Whether you call it Armageddon, or an 'orchestrated drama' (Tim Geithner's term), there is nothing in my bag of tricks that suggests this is the beginning of a massive decline for stocks."

Obviously, those comments proved prophetic as the last minute "stick save" by Congress produced a pretty rare event on the Street of Dreams. To wit, last Monday we experienced a 90% Upside Volume Day that was followed by another 90% Upside Volume Day on Wednesday. Ninety percent Upside Volume Days are when 90% of total volume traded, both "up" and "down" volume, comes in on the upside. Such back-to-back sessions are pretty rare, especially at the beginning of a New Year. In fact, my notes show that the last time we saw such an occurrence was on January 2, 1987 (Friday), and again on January 5, 1987 (Monday), setting the stage for a rally that would peak on April 7, 1987 after a 24.5% "run." While I am not predicting the same for 2013, back-to-back 90% Upside Days are a powerful indication of pent-up "Demand," especially when they come after five sessions on the downside like they did this time. Adding to the euphoria was a new all-time high in the Russell 2000 (RUT/879.15) and a five-year high in the iShares High yield Corporate Bond Fund (HYG/$94.00). Meanwhile, we got sharp rallies in the dividend payers (REITs, MLPs, etc.) on the muted change in dividend and capital gains treatment. The history of back-to-back 90% Upside Volume Days was highlighted in our technical analyst Art Huprich's comments Thursday afternoon, noting that according to the *Sentimentrader*, back-to-back 90% Upside Days tend to lead to a gain of 6.1% (median) one month later 83% of the time; and gains of 12.8% (median) three months later 100% of the time. For more information, see Art's report here.

My second "smack down" occurred last week with CNBC's Simon Hobbs, another anchor I like, who interrupted me in mid-sentence, as basically being naïve about the Washington Waltz. Having lived inside the Beltway for years I assured him I am anything but naïve regarding the workings of Capitol Hill. What caused the verbal exchange can be seen here: http://video.cnbc.com/gallery/?video=3000138690&play=1). That exchange was sparked by the observation that going into the "fiscal cliff" the media's focus was intensely on a "cliff dive" that would prove to be Armageddon. Amazingly once that proved to be false, the headlines immediately refreshed to forebodings about the "debt ceiling," entitlement reduction clashes, government shutdowns, etc. Yet while participants focused on the "trees" they failed to see the "forest," because what really happened early last week was that our government became a little less dysfunctional! Now readers of these reports know that I have long railed about the increasing dysfunction of our government, but maybe, just maybe, that changed at the margin last week when Congress came together and averted "the cliff." If so, what we should see going forward is a Republican House of Representatives that stops trying to tear down everything President Obama stands for and attempts to refocus the discussion with a tilt toward trying to "shape" the outcome of future policy. Ladies and gentlemen, if that happens it is very bullish not only for the economy, but the stock market as well. One mutual fund I own that embraces these views is GaveKal Knowledge Leaders Fund (GAVAX/$11.91),

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managed by my fried Steve Vanneli. Another fund I own that benefits from a similar scenario is the Putnam Spectrum Fund (PYSAX/$30.37), managed by another friend, David Glancy, who is one of the better stock pickers I know.

Turning to the stock market, I am currently short-term conflicted. While the long-term case remains strongly bullish based on a more collegial Congress, a continuation of the housing boom, strengthening auto sales, improving employment, low inflation, liquidity, etc., the short-term is becoming suspect. First, there is a tendency for the equity markets to record a temporary peak in early January. Second, bond yields spiked higher last week as did the S&P 500 futures. Historically, when interest rates and stock prices make new 50-day highs simultaneously the result has been at best a pause and at worse a 4%+ decline. Third, the McClellan Oscillator remains overbought in the short-term (see chart on page 3). Fourth, a basket of the highest shorted stocks dramatically outperformed the SPX last week, implying a massive short squeeze with many of the shorts being "run in" (read: less demand to buy). Fifth, the surge reflected by the back-to-back 90% Upside Days has temporarily exhausted Demand. Sixth, our Eurodollar Commitment of Traders chart, which has done a really good job of forecasting the stock market's short-term direction, is calling for a slight pullback here (see chart on page 3). Accordingly, if I could script it, I would look for an attempt to challenge the September 2012 intraday reaction high of 1475 this week. That attempt should fail, just like the multiple attempts to surmount the 1420 – 1430 resistance zone on the way up that we suggested would take multiple tries to surmount; and, it did. If correct, the failure at 1475 should cause a pullback into early February, which should be bought. As for which sectors to buy, I like all of the sectors except for Consumer Staples because they look expensive to me as too many portfolio managers have tried to "hide out" in them, worried about the Presidential election, the "cliff," Euroquake, the debt ceiling, etc.

The call for this week: We now have two conflicting mantras. First, "If the bulls fail to call, the bears may roam on Broad and Wall" (we got no Santa rally last year). Second, "So goes the first week of the new year, so goes the month, and so goes the year" (the SPX was up 4.57% last week). Of course I really like the "December Low Indicator" that I related to the folks at the *Stock Trader's Almanac* years ago, and still graces that publication. To wit, "Pay attention to the December low. If that low is violated during the first quarter of the New Year, watch out." For the record, last December's closing "low" was 12938.11. Then there are the plethora of questions I have received about Dow Theory given the recent strength of the Transports. While the D-J Transports (TRAN/5534.06) have tagged a new reaction high, so far it has not been confirmed by a like move from the D-J Industrials (INDU/13435.21) to a new reaction high (read: upside non-confirmation). This could also prove to be a short-term negative when combined with all the other short-term negatives mentioned in this report. That said, if the Industrials confirm the Trannies by breaking above their October 5, 2012 reaction high of 13610.15 that would be a Dow Theory "buy signal." However, if you want to think about a new secular bull market (as stated, I think there is a 25% possibility we are already in one), a break by the Trannies to new all-time highs above their July 7, 2011 high of 5618.25, confirmed by a new all-time closing high in the Dow above its October 9, 2007 high of 14164.53, would imply we are indeed in a new secular "bull market.

P.S.: As a sidebar, I am conducting a conference call with portfolio manager David Glancy, who is one of the best stock pickers I know, and manages the Putnam Spectrum Fund (PYSAX/$30.37). The call is scheduled for tomorrow at 4:15 p.m. where there will be some discussion of the macro picture, but the real discussion will center on which stocks look particularly attractive currently. The dial in number is (877) 917-1553 (pass code: RJAMES).

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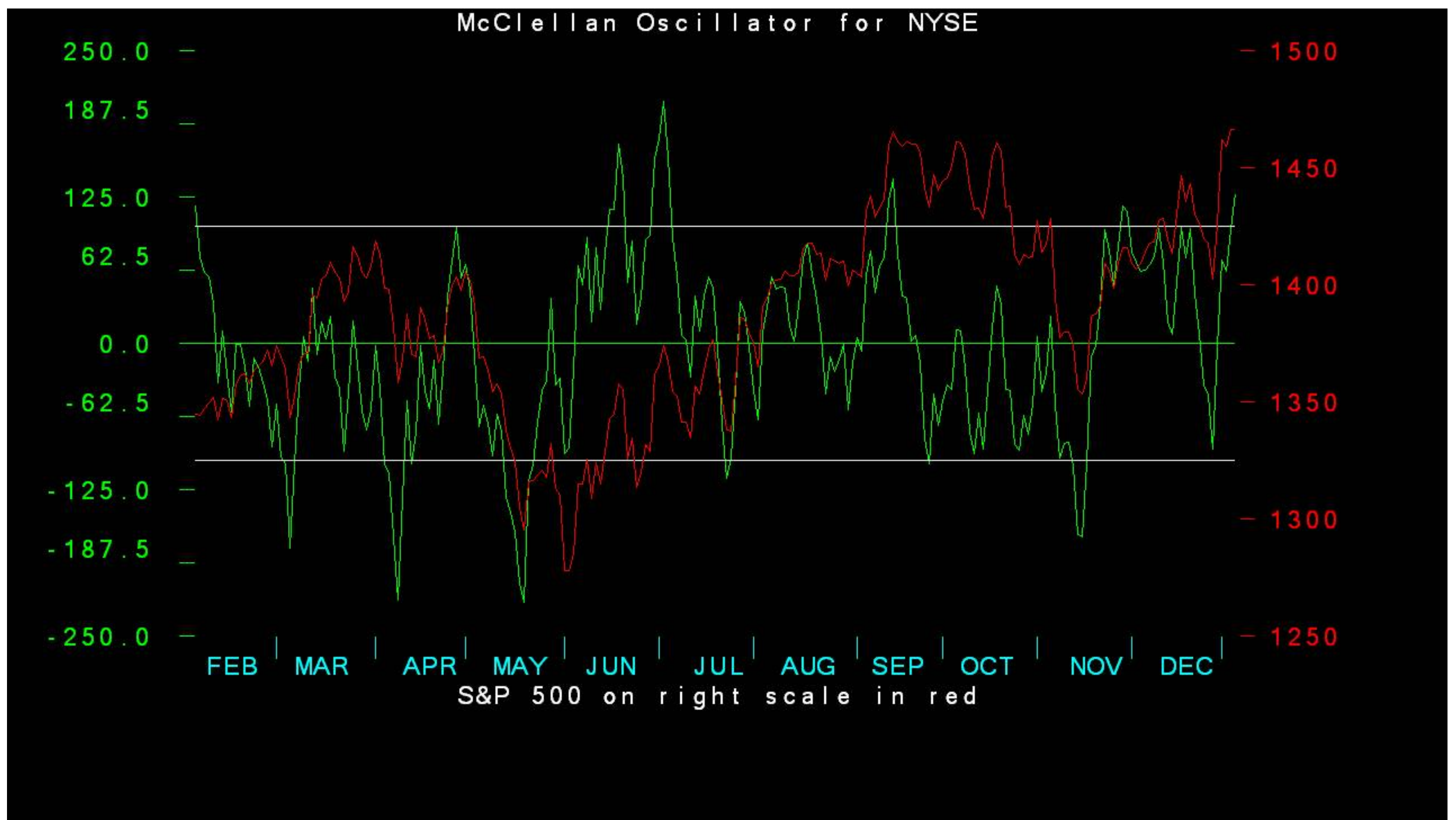

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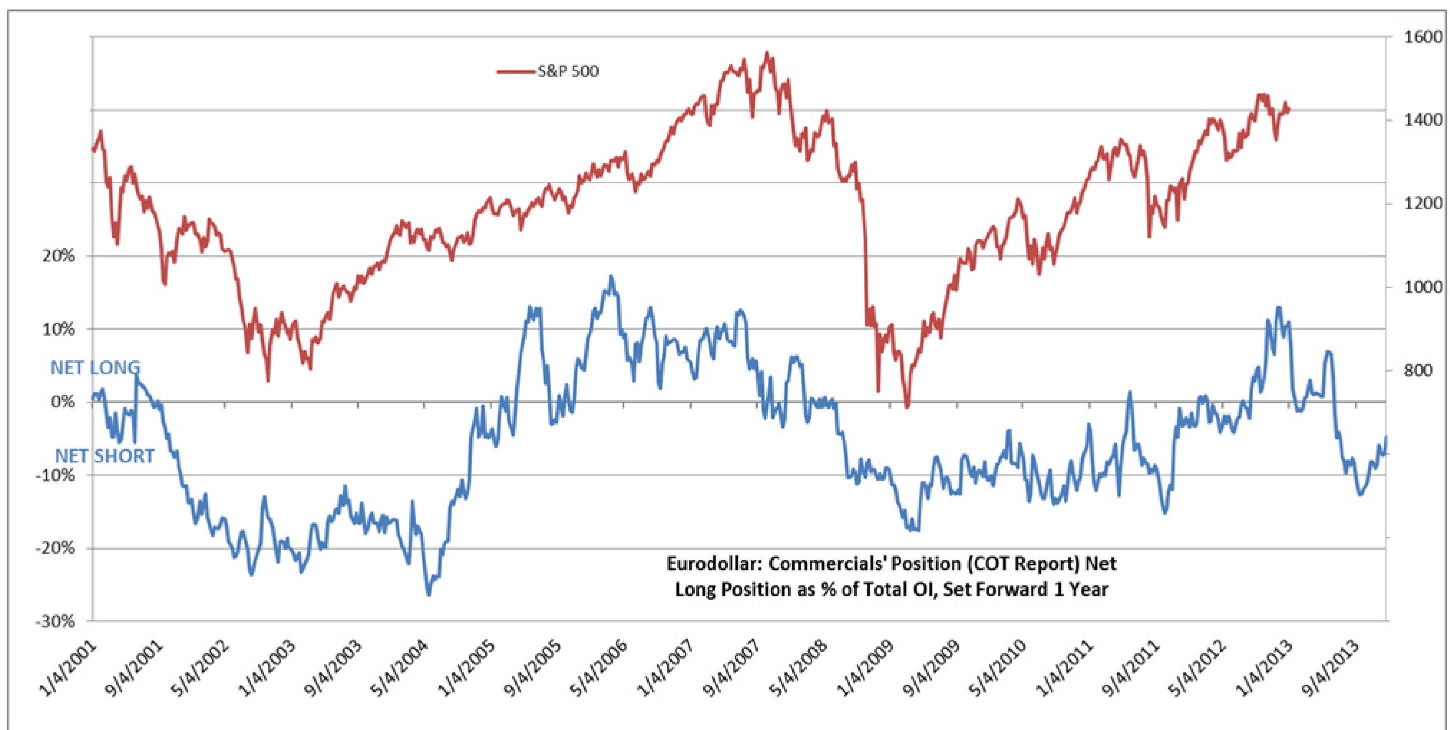

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Market Perform (Hold)	42%	34%	64%	36%	8%	26%	0%	0%
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