

## "Shrugging Off Bad News!"

Most traders, and investors, seem to become convinced of the genuineness of a movement in either direction only when it approaches a culmination. . . . One reliable indication of the start of an upward swing is afforded when, after a period of declining prices or, less frequently, dullness, the market advances or refuses to go down following the receipt of bad news. News can seldom be utilized by the public for market purposes, even when its authenticity is beyond question. For instance, if tomorrow morning's newspapers should announce the death of the President or the failure of a great 'corner house,' or the complete destruction of Gary, Indiana, it is more likely that stocks sold on the news would bring the lowest prices of the day, for the very good reason that each seller would be competing with thousands of other sellers who would have learned the news at the same time.

. . . *One-Way Pockets*, by Don Guyon; 1917

One of my early mentors in this business was Lucien Hooper; strategist, analyst, economist, stock market historian, the longest contributing columnist to *Forbes*, and my friend. I can hear his sage words like it was yesterday. The year was 1971, and we had just walked across the floor of the American Stock Exchange. As we headed down the attendant staircase for lunch at "Harry at the Amex" Lucien said, "Jeffrey, when markets ignore bad news, that's good news!" Said statement has stuck with me ever since; and, it is just as true today as it was 41 years ago. Fast forward, over the past few weeks the equity markets have had to endure a plethora of bad news – China's slowing economy, rising interest rates, \$4.00 per gallon gasoline, a dysfunctional government, Iran, etc., yet the equity markets have refused to surrender much ground. Last week was no exception, for despite the negative news backdrop the senior index (INDU/13212.04) gained 1%. Such action remains consistent with my mantra for this year, "You can get cautious, but DO NOT get bearish." However, many investors are either bearish, or frozen like a deer in the headlights of a car, having been stung in last year's June – August angst because they didn't manage the risk when they should have.

Recall, it was in March/April of last year that I recommended raising cash. At the time the major "push back" from accounts was, "The stock market is going up, why should I raise cash?" And that was the exact reason you should have been raising cash and rebalancing portfolios. Most did not heed that strategy and subsequently suffered through a ~20% decline only to liquidate their portfolios around August 8th when the equity markets were in the process of bottoming. At the time I was actually recommending putting cash back to work based on the fact that we were experiencing a climactic capitulation of historic proportions. Indeed, at the August 8th "low" less than 2% of all stocks traded were "up" on the day. As written, "You have to go back to May 13, 1940 to find another session whereby less than 2% of all stocks traded were 'green' on the day. Interestingly, on 5/13/40 the German army punched a 60-mile wide hole in the Maginot Line and invaded France, leaving everyone thinking, "It's the end of the world as we know it!"

Luckily, at those August lows, I began using the analogy of the declines that occurred in October 1978 and October 1979 (see the charts on page 3). Those late-1970s October declines came out of the blue, and were equally as debilitating as the June – August 2011 affair. They also ended with a selling climax like that seen on August 8, 2011. As written at the time, post the selling-climax the subsequent trading patterns of October 1978 and 1979 saw a bottoming sequence that left the senior index bobbing and weaving for seven to eight weeks followed by an "undercut low" (a low below the selling-climax low) that was for buying. Studying the attendant charts shows the correlation between the October 1978 and 1979 bottoming sequences and last year's bottoming sequence, which is what gave me the conviction to recommend buying the October 4, 2011 "undercut low." Since then, I have been pretty bullish, save my caution of the past number of weeks. Indeed, for the past month I have averred that the overbought condition of the indices could be corrected in one of two ways. They could either correct with the perfunctory 5-8% pullback, or they could trade sideways while the stock market's overbought condition was corrected, and the market's internal energy was rebuilt. Obviously, at least so far, it has been a sideways affair, which brings us to the start of the new quarter.

So, what's in store going forward? I believe the Federal Reserve wants Wall Street to inflate; and, with the Presidential elections looming, President Obama will likely do everything in his power to keep the stock market ebullient. Thus, investors should be prepared for further policies designed to stimulate the economy, which should allow stocks to travel higher even if they do pause, or stumble, in the near-term on concerns the fundamentals are turning squirrely. Nevertheless, what many investors don't understand is that in the short/intermediate-term there is not a linear relationship between the fundamentals and the stock

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market's directionality. Manifestly, it is the dilution of our currency, with a concurrent decline in its value due to a massive increase in the money supply, which is causing money to flow into assets of all kinds, including stocks. And that, ladies and gentlemen, is the natural reaction to the flood of liquidity injected into the system by the world's central banks. I don't think it will end anytime soon.

Meanwhile, the overbought condition, as reflected by the NYSE McClellan Oscillator, that got us worried following the end of the "buying stampede" at the end of January, has been corrected; and the stock market's internal energy is being rebuilt. Verily, our daily internal energy indicator has lifted from a "totally used up" 30 reading on March 19th to 50 as of last Friday. For a full charge of energy that indicator needs to be above 55. The weekly energy indicator, however, is still around the 30 level. Hereto, for a full charge of energy the weekly needs to be above 55. Accordingly, my sense is that the equity markets need another few weeks of convalescing, probably in a range between 1385 and 1420 basis the S&P 500 (SPX/1408.47), before they are ready to re-rally. The big test for this week should be Friday's employment report, which is anticipated to be bad. Still, as long as the SPX resides above 1385 the bullish case remains intact.

Speaking to the economy, while last week's +3% GDP report was in the forefront, less noticed was the GDI report. Surprisingly, the Gross Domestic Income report rose a larger than expected 4.4%. This is not an unimportant observation because the GDI measures all the wages and profits in the economy while the GDP measures only spending. Theoretically, the GDP and GDI reports should be the same. To me, this is just further evidence that the economy is not sinking back into recession. Another boost for the equity markets last week seemed to be the tone of the questioning by the Supremes suggesting Obamacare may be in more trouble than expected. Such news continues to be a nightmare for the underinvested crowd; and the world remains profoundly underinvested in U.S. equities.

**The call for this week:** March came in like a bear, but went out like a bull, capping the best first quarter since 1998. For the quarter the SPX gained 11.99% for its 10th best start of the year ever. For me it was almost like déjà vu as I recalled the best first quarter of my lifetime, which was 1975's surge of 21.59%. Why déjà vu? Well, it is because I began writing strategy in November of 1974 with the line, "I believe now is the time to accumulate stocks." At the time the Dow was trading below 600, having fallen from its March high of 891 for a 34% decline. Similarly, on October 3, 2011, in a report titled "Undercut Low" I recommended buying stocks following the Dow's decline of ~20%. As stated at the time, "I have been adamant since March 2009 that like the 'nominal' price low of December 1974 this wide-swinging trading range market saw its nominal price in March 2009. Last October I suggested what we could currently be experiencing is similar to the "valuation" low of August 1982 because the SPX was trading below 10x forward earnings estimates with an earnings yield of over 10%, rendering an equity risk premium of more than 8% for valuation metrics not seen in decades. I still believe that is the case.

October 1978 and 1979 Mini-Crashes and Subsequent Bottoming Process



July – August 2011 Mini-Crash and Subsequent Bottoming Process



Source: Thomson Reuters.

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