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Investment Strategy
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Jeffrey D. Saut, (727) 567-2644, Jeffrey.Saut@RaymondJames.com **February 28, 2011**

Investment Strategy

"Oil That Is..."

> "You might think that institutions, with their large staffs of highly paid and experienced investment professionals, would be a force of stability and reason in the financial markets. They are not. Stocks heavily owned and constantly monitored by institutions have often been among the most inappropriately valued.
>
> Ben Graham told a story 40 years ago that illustrates why investment professionals behave as they do. An oil prospector, moving to his heavenly reward, was met by St. Peter with bad news. 'You're qualified for residence,' said St. Peter, 'but, as you can see, the compound reserved for oil men is packed. There's no way to squeeze you in.' After thinking a moment, the prospector asked if he might say just four words to the present occupants. That seemed harmless to St. Peter, so the prospector cupped his hands and yelled, 'Oil discovered in hell.' Immediately the gate to the compound opened and all the oil men marched out to head for the nether regions. Impressed, St. Peter invited the prospector to move in and make himself comfortable. The prospector paused. 'No,' he said, 'I think I'll go along with the rest of the boys. There might be some truth to that rumor after all'."

. . . Berkshire Hathaway annual report – 1984

"Oil that is, black gold, Texas tea," as the song about poor, but wise, Jed Clampett (Buddy Ebsen) goes, who got rich in the hit series The Beverly Hillbillies by discovering oil on his property. Similarly, investors have become enriched recently by owning oil stocks. Verily, crude oil has surged from ~$84 per barrel in mid-February into last week's parabolic peak of $103.41 with an attendant ascent for most oil stocks. Obviously, the driver for Texas Tea's triumph has been the recent unrest in the Middle East. As stated in Friday's verbal strategy comments, "Libya is particularly troubling because I think there is a fifty-fifty chance that Gaddafi, rather than cede power, will begin blowing up Libyan oil pipelines to send a message to protestors – it's either me or chaos." No wonder oil soared pondering what would happen if 1.6 million barrels a day were suspended from world supplies, not to mention what happens if Algeria is next (Algeria produces 1.25 million barrels per day). To that point, while it is unknowable how high oil prices will travel if the unrest spreads, it is worth noting that oil prices tagged what many technical analysts term a major upside price objective last week. Indeed, a Fibonacci 61.8% retracement of oil's price decline from $147.27 (July 2008) to $33.20 (January 2009) yields a price target of $103.69. Accordingly, while last week's intra-day price high of $103.41 was not exact, it was close enough to qualify as "price objective achieved." While I am not a big believer in "Ouija Board" analysis, in a past life I have studied Fibonacci, Gann, Elliott Wave, etc. and found them somewhat useful at tipping points.

Speaking of "tipping points," the prescient folks at GaveKal recently scribed the following, as paraphrased by me:

> "In recent years, investors have become used to an environment whereby a weak US$ usually meant an easy monetary policy from the Fed, which in turn meant greater risk taking and growth in emerging markets, rising commodity prices and higher equity prices. . . . But in the past week or so, this usual balance between the US$ and risk assets seems to have broken down, most likely because the rise in commodity prices is no longer a sign of global growth but instead a source of growing concerns. . . . Whether the US$100/bbl price tag now attached to oil represents some kind of psychological barrier or a real economic hurdle, the positive dynamic of the past few months has now rolled over and we clearly seem to be at an important tipping point for a number of prices. . . . Now if the US$ bounces from here, it is likely that oil will follow food prices into their recent consolidation, allowing for equities to once again bounce back. However, if the US$ melts down, or if oil shoots up on further Middle East unrest, then it is hard to see how equities will maintain the past few months' uptrend. So it does seem that we are at an important tipping point not just for the US$, but for most asset prices as well, which should not come as such a surprise since most assets in the world are priced off of the US$. (*That*) reality brings us back to a point Charles has been very vocal about over the past couple of months: we are rapidly reaching the stage in the cycle where the Fed needs to start tackling the weakness of the US$, and the surge in commodities, or risk undermining the very (*economic*) recovery it managed to jump-start. With that in mind, we would not be surprised if, in the coming days and weeks, various Fed directors come out to sound somewhat more hawkish in a bid to prevent commodities from further undermining the current recovery. . . . Anyway, with so many unanswered questions, it is not surprising that equity markets are taking a breather."

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And take a "breather" indeed with the S&P 500 (SPX/1319.88) surrendering 3.7% from the previous Friday's intra-day high (1344.07) into last Thursday's intra-day low (1294.26) before firming on Friday emboldened by news Saudi Arabia would step up production to plug any crude oil shortfall. Now call me cynical, but I doubt the Saudis have the capacity to accomplish their pledge and therefore am also skeptical of Friday's rally. Inasmuch, I think what we have seen is just the opening salvo in a correction that will likely be in the 5% to 10% range before ending. Reinforcing that sense, the recent stock "high" was accompanied by the most bullish stock sentiment since the DJIA's peak in October 2007 (69% "Bulls" according to Market Vane); as well, the Volatility Index (VIX/19.22) recorded its lowest reading since the summer of 2007 (read: too much complacency). Ladies and gentlemen, it is rare to see those kind of extreme readings worked off in a mere three sessions. So yeah, I believe the correction has more to run, yet I continue to think it is a mistake to become too bearish.

Consistent with that strategy, I am going to begin committing some of the cash raised over the past eight weeks back into stocks, preferably during bouts of weakness. Moreover, one of the good things about a market decline is that it gives you a chance to see which stocks hold up better than others. Since the beginning of the year I have suggested 19 stocks and closed-end funds from Raymond James' coverage universe for your "watch list." Of those, these are the ones that have held up the best: Altera Corp. (ALTR); CA Inc. (CA); Celestica Inc. (CLS); Skyworks Solutions (SWKS); Stanley Furniture Company (STLY); Stanley Black & Decker (SWK); Tempur Pedic International (TPX); The Williams Companies (WMB); and closed-end fund Royce Value Trust (RVT).

The call for this week: Last Tuesday was a 90% Downside Day whereby 90% of the total points, and total volume, was on the downside. It was the second 90% Downside Day of the year; and, we almost had a third as January 28th came within 0.05% of qualifying. History shows that such Downside Days are quickly followed by a rally attempt before the short-term correction resumes. Thus it should not be assumed Friday's Fling ended the correction. In fact, under the surface Friday's action didn't look all that strong. This does not mean you should "dump" stocks here. The time to raise cash was over the past eight weeks, not now. That said, by my pencil the intermediate trend of the stock market is "up," and therefore it is an opportune time to consider purchase of select stocks on your "watch list," preferably during pullbacks. As the keen-sighted folks at Bespoke observe (as paraphrased by me): 1) the big stocks in the S&P 500 have held up better than the smaller names; 2) stocks with the best valuations have held up better than ones with high P/E multiples; 3) stocks with high dividends have outperformed; 4) stocks with high short interest have done worse than low shorted stocks; 5) stocks with low institutional ownership have outperformed; and 6) stocks with high international revenues have underperformed domestic names.

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Company Citations

Company Name	Ticker	Exchange	Currency	Closing Price	RJ Rating	RJ Entity
Altera Corporation	ALTR	NASDAQ	$	42.63	1	RJ & Associates
CA Technologies	CA	NASDAQ	$	24.74	1	RJ & Associates
Celestica, Inc.	CLS	NYSE	$	11.91	2	RJ & Associates
Royce Value Trust Inc.	RVT	NYSE	$	15.23	NC	
Skyworks Solutions	SWKS	NASDAQ	$	35.99	2	RJ & Associates
Stanley Black & Decker	SWK	NYSE	$	75.11	1	RJ & Associates
Stanley Furniture	STLY	NASDAQ	$	5.63	1	RJ & Associates
Tempur-Pedic International Inc.	TPX	NYSE	$	47.11	1	RJ & Associates
The Williams Companies, Inc.	WMB	NYSE	$	30.26	2	RJ & Associates

Notes: Prices are as of the most recent close on the indicated exchange and may not be in US$. See Disclosure section for rating definitions. Stocks that do not trade on a U.S. national exchange may not be approved for sale in all U.S. states. NC=not covered.

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