RAYMOND JAMES

Investment Strategy
Published by Raymond James & Associates

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"Perspective; or where you stand is a function of where you sit!"

Roger Horchow, in the book he wrote with his daughter Sally (*The Art of Friendship*), relates the following great story to illustrate the point that active listening opens up a world of potential relationships (as paraphrased):

> *My friend Dick Bass (now in his 70s) has traveled far and wide and had many adventures. His achievements include being the first person to climb the highest peak on each of the seven continents, as well as being the oldest person (by five years) to climb Mount Everest (at the age of 55). He once told me a story of a plane ride, on which he sat next to a nice man who listened to him go on for hours about the treacherous peaks of Everest and McKinley, the time he almost died in the Himalayas, and his upcoming plan to re-climb Everest. He also expressed the feeling that standing on a mountain peak and looking down made most of his worries, problems, apprehensions, etc. seem much smaller than they were at sea level. It's just the perspective of looking down from a peak of over 20,000 feet. Right before the plane landed, Bass turned to the man sitting next to him and said, "After all this, I don't think I've introduced myself. My name is Dick Bass." The man shook his hand, and responded, "Hi, I'm Neil Armstrong. Nice to meet you."*

"Perspective" is the capacity to view things in their true relations or relative importance. And last Thursday the stock market's perspective changed abruptly. The day started out well enough with an opening 20-point "pop" to the upside, but from there the Dow Dive commenced. The *causa proxima* for the "dive" was more softening economic reports from China and Germany followed by a lame Philly Fed report, which saw that index accelerate its swoon from May's -5.8 reading to -16.6. Later in the session news broke that Moody's was going to downgrade a bunch of banks and the sellers piled on. Why anyone would pay attention to the same organization that had Enron and Bear Stearns rated "investment grade" just days before they were goners is a mystery to me, but there you have it. As Bill Gross said, "[Rating agencies] are like an idiot savant with a full command of the mathematics, but no idea how to apply them." Nevertheless, stocks stumbled on the news, leaving the senior index (INDU/12640.78) off 251 points and the S&P 500 (SPX/1335.02) down a large 30 points. While I was actually looking for a pullback, because on Wednesday the NYSE McClellan Oscillator was just about as overbought as it ever gets, I wasn't expecting anything like what we got on Thursday. The tumble qualified as a 90% Downside Day, meaning that 90% of total volume traded, and 90% of the total points traded, both came in on the downside. Regrettably, given that the decline came off Tuesday's reaction rally high suggests Thursday's Trouncing likely did not exhaust all of the sellers. Accordingly, I told participants in Friday's verbal strategy comments to put "blinders on" for that day's trading action because it was meaningless until we see what is going to happen this week.

That said, Thursday's decline did not revert any of my "risk indicators" to negative readings, at least as of yet. Therefore, I am still treating the June 4th intraday reaction "low" of ~1266 (basis the SPX) as THE daily, and intermediate-term, low for this cycle. Moreover, the short-term "pivot line" levels of 1319 (SPX), 760 (RUT), and 2836 (COMP) continue to stand as key levels of support until they don't. As for the money flow models, as provided by my Atlanta-based friend Jim Kennedy of Divergence Analysis:

> "Our 'dead cat bounce' price levels were almost reached in today's rebound. There were no signals present at today's close, and as models stand now, recent highs would have to be challenged before any signal could develop. Of course, the models can develop something earlier over a few days trading. [Further], our risk indicators remain upward, so momentum remains positive, and we have not seen any development that should send prices downward. [However], there is a 'flare warning' on the volatility model, so a 'head's up' is at hand for swings, nervous traders, etc."

Hence, while we have stopped recommitting the cash raised following the end of the "buying stampede" on 1/26/12, we continue to think the print "low" of June 4th will prove to be the "low" of the current cycle. Worth mentioning is that the Volatility Index (VIX/18.11) remains below its 50-day moving average (DMA), which is currently at 20.50. Typically when the VIX is below its 50-DMA the equity markets are in an uptrend. This is especially true when the SPX is above its 50-DMA. And, while that was the case, with Thursday's decline the SPX is again below its 50-DMA of 1344.93. Moreover, Friday's bounce came on the lowest volume in a month, which implies the rally is not to be trusted, at least not until there is more clarity this week. Ergo, we continue to exercise the rarest commodity on Wall Street, patience.

Today, the markets will put "rabbit ears" on for the Supreme Court's decision on Obamacare. Last week our healthcare analyst, John Ransom, had this to say (as paraphrased):

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John thinks the most likely Supreme Court outcome (>50%) is a split decision, which would see the mandate shot down with the rest of the law remaining intact. If correct, in the short term there should be a clarity rally for the providers given the generation-low P/E multiples for stocks like HCA (HCA/$26.25/Strong Buy). But in the intermediate term, short-term relief should give way to concerns/uncertainty about the post-2013 world (the fiscal cliff, debt ceiling, 2012 election, sequestrations, and the view that Washington may move toward a grand bargain on deficits and taxes in 2013). If part of the law is upheld, John's sense is the device tax (the most burdensome aspect of reform for device companies) would likely go through. Again, his estimates would not change, and he would not anticipate much of a reaction in medical device and hospital supply stocks. In the unlikely (<25%) event the entire law is struck down, he expects the most significant impact to be on managed care. The Medicaid managed care names would potentially see the most downside given their outsized exposure to expansion. Additionally, he would expect a modest rally in the device and pharmaceutical sectors. The third scenario is the unlikely event (<25%) the entire law is upheld, then the providers should surge as their current valuations don't reflect the potential of 35 million new customers. In addition to the traditional providers (like hospitals), investors should consider the drug distributors (high fixed costs, leveraged to incremental volumes).

The call for this week: A lot has been written recently about a Dow Theory "sell signal" that allegedly occurred when the Industrials and the Trannies both closed below their respective April 2012 reaction "lows." Of course that event came following the Dow Theory upside non-confirmation that I wrote about in May when the INDU broke to a new reaction high, but the TRAN did not. That was just another reason for raising some cash, which we did. However, that does not constitute a Dow Theory "sell signal," at least not the way I was taught. For me to get a "sell signal" would require both averages to travel below their November 25, 2011 closing lows of 11231.78 and 4533.44, respectively. Unless there is some sort of Black Swan event, I don't expect that to happen. Still, to me Friday was merely a reprieve from Thursday's selling-squall. That seems to be confirmed this morning with the pre-opening SPX futures down some 10 points. I expect some posturing out of Germany early in the week before it agrees to turn on the printing press and rescue Spain, which formally asked for aid over the weekend. If correct, the stock market should continue down into a bottom late this week or early next week. This is why we adhere to Benjamin Graham's mantra, "The essence of portfolio management is the management of *risks* not *returns*." Risk control is a careful aligning of interests combined with a balance between greed and fear. Above all it is the willingness to hold cash when opportunities are scarce and the odds are not tipped in our favor. We continue to invest accordingly.

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Risk Factors

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