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Investment Strategy: Revised

"1-800-GET-ME-OUT?!"

The “S” word makes most investors uneasy. They find the “B” word, “buying,” much more pleasant. Why is perhaps best explained in a book written by Justin and Robert Mamis titled “When to Sell.” Following are several poignant excerpts from that book:

> “Stocks are bought not in fear but in hope. No matter what the stock did in the past it assumes a new life once a purchaser owns it, and he looks forward to a rosy future – after all, that’s why he singled it out in the first place. But these simple expectations become complicated by what actually happens. The stock acquires a new past, beginning from the moment of purchase, and with that past comes new doubts, new concerns, and conflicts. The purchaser’s stock portfolio quickly becomes a portfolio of psychic dilemmas, with ego, id, superego, and reality in a state of constant battle.”
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> “The public is most comfortable when they are sitting with losses. Because if their stocks are down from where they bought them, they don’t have to worry about them. Once he’s got a loss, the typical investor is sure he isn’t going to sell. He bears the lower price because in his mind it is temporary and ridiculous; it’ll eventually go away if he doesn’t worry about it. So selling at a loss becomes absolutely out of the question. And since it is out of the question, and his mind is made up for him, the struggle of any potential decision vanishes and he is able to sit comfortably with the loss.”
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> “To the public mind, selling is never sound. It always conveys the possibility of being wrong twice: first, admitting that they’ve made a buying error; second, admitting that they might be wrong in selling out. And if the stock has actually gone up, they are tormented; should they take a profit or hold for a bigger one? That creates anxiety, and anxiety breeds mistakes. But as long as they’ve got losses, and never have to decide, they can sit back comfortably and dream instead.”
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> “Through the entire market cycle lurks the fear of finalizing the deed, of taking it from dream to reality by selling. By not selling, by tightly holding on to his stocks, the investor never has to face reality.”

Yet, “selling” seemed to be on the market’s mind late last week punctuated by Friday’s Dow Dive of ~275 points. Said decline left the senior index down 8.74% from its May 1st closing high (13279.32) into Friday’s close (12118.57). While not all that big of a decline, it brought back memories of the past two years’ May – July corrections of 17% and 20%, respectively. Yet, investors should keep in mind that since 1928 there have been 294 pullbacks of 5% or more. Ninety four of them have been moderate (>10%), 43 have been severe (>15%) and 25 have been bear markets (>20%). What is interesting to me is that since last October 4th’s “undercut low” the chant from most investors has been, “We want a pullback to become more fully invested.” Now that we have the pullback everyone is in panic mode (again). To borrow a line from George Bernard Shaw – There are two tragedies in life; one is not to get your heart’s desire, the other is to get it! The “heart’s desire” for the bulls since last October has been the fact the markets have ignored all of the bad news. Verily, the senior index has turned a deaf ear to the worsening Euroquake situation, Iran, softening economic trends, deflationary dives in commodities, etc. Of course that “deaf ear” stance has changed over the past four weeks.

Indeed, the Dow’s decline is now 22 sessions long. Such “selling stampedes” typically last 17 – 25 sessions before they exhaust themselves; it just seems to be the rhythm of the thing. This has been my observation over the years in that it takes this long to get participants bearish enough to finally panic and throw in the towel by selling their stocks. While it is true some stampedes have lasted more than 25 sessions, it is rare to have one run more than 30 sessions. Today is session 23 on the downside. Obviously Friday’s Fade took out my failsafe point of 1290 on the S&P 500 (SPX/1278.04), leaving the DJIA (INDU/12118.57), the S&P 500, and the NASDAQ Composite (COMP/2747.48) all below their respective 200-day moving averages (DMAs). The bears will be quick to point out this is what happened right before the crashes of 1929 and 1987. However, the bullish argument is that over the past 20 years a break below the 200-DMA by the SPX, after it has stayed above it for three months, has typically led to a rally. Also worth noting is the decline has left most of the oversold indicators I rely on pretty oversold. Nevertheless, I told “callers” on Friday that when markets get into one of these selling squalls they rarely bottom on a Friday. What tends to happen is participants go home and brood about their losses over the weekend and “show up” on Monday in selling mode, which often leads to “turning Tuesday”

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(read: recoil rebound). Accordingly, the SPX needs to quickly recapture 1290, and stay above that level, if a rally is to commence. On the other hand, if the SPX merely bounces back up to 1290, and then falls sharply back, I would view that as a bearish sign requiring more downside hedging and/or the raising of some more cash. Fortunately, we recommended raising cash in February – April. Unfortunately, we recommended judiciously putting some of the cash back to work (but not much of it) into somewhat more defensive names like 3.8%-yielding Rayonier (RYN/$42.18), which has a Strong Buy rating from our fundamental analyst.

While Euroquake has been on center stage for weeks, Friday's shockingly weak employment report brought the focus back to the economy and jobs. The 69,000 private sector payroll growth figure was well below the estimate of 150,000 and just to add pain to injury the unemployment rate ticked up to 8.2% from 8.1%. Still, investors should remember unadjusted private-sector payrolls have risen by 1.983 million over the trailing 12 months for roughly a 165,000 monthly average jobs gain. As our economist, Dr. Scott Brown, notes, "That's not bad, but it is far short of what's needed to make up ground lost during the economic downturn." Now for weeks I have been discussing the weakening economic reports. That string of weakness continued last week given that of the 21 economic releases, 18 were weaker than expected, two were in line, and only one exceeded the estimate (that would be Continuing Claims). This softening trend could still just be a weather-related issue combined with skewed seasonal adjustments; the next few months will decide.

The call for this week: Friday was the first day of hurricane season here in Florida, yet the storm didn't hit our beaches but rather blew onto the Street of Dreams with a 275-point "storm surge." The media attributed Friday's Flop entirely to the disappointing employment numbers, but the truth was the market was already headed down before the release of those numbers. And when the SPX's 1290 level was breached, the rout was on. The result left all of the indexes we monitor near their lows of the day and the three major market indices (INDU, SPX, COMP) below their respective 200-DMAs for the first time in about five months. The bears will be quick to point out this is what happened right before the crashes of 1929 and 1987. However, the bullish argument is that over the past 20 years a break below the 200-DMA by the SPX, after it has stayed above it for three months, has typically led to a rally. And despite the break below my 1290 pivot point I can't shake the feeling that all of this is just part of the bottoming process.

P.S. – I am on the road again this week seeing accounts and speaking at conferences.

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