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Investment Strategy

"LOSE CASH"

> "Poor Grenville runs a fund, one of a group of funds, and he is in charge of $100 million or so.
>
> . . . I asked Charley why Grenville was suddenly Poor Grenville.
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> 'Poor Grenville,' said Charley, 'has gotten caught with twenty-five million in cash. It's a disaster. How would you like to have twenty-five million in cash with the Buy Signals you've just seen? Poor Grenville has to lose his cash, right away.'
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> I know it sounds little funny that having $25 million in cash is a disaster. It sounds just as funny to me as the phrase 'lose cash.' When it isn't your cash in the first place and all you are doing is taking the cash – somebody else's – and buying stocks with it. But professional money managers love to say, 'We lost five million in cash this afternoon,' meaning they bought stocks with it. I guess it sounds professional.
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> . . . As to why Poor Grenville's $25 million in cash was a major disaster that is more comprehensible. Grenville should have all $100 million fully invested if the market is coming off the floor; his fund is 'performance-oriented,' trying for big capital gains. If Poor Grenville has $25 million in cash he guessed dead wrong at the bottom of the market, and in one career you don't get too many chances like that. Poor Grenville had gotten himself all ready for a big drop in October and now in January the market turned around and ran away without him. He has to make it up in a hurry."
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> . . . *The Money Game*, by Adam Smith 1967

Can you imagine all the "Poor Grenvilles" out there desperately trying to "lose cash" as the S&P 500 (SPX/1404.17) broke out to a new reaction high last week? To be sure, the 2011 year-end "bear boos" about how bad the first half of 2012 was going to be caused many of the Grenvilles to raised cash expecting stocks to sag further in the coming year. Much to their consternations, the SPX is off to its eighth best start of the year; and, according to the sagacious folks at Bespoke Investment Group (as paraphrased by me):

"In the tables below, we highlight the prior ten best starts for the S&P 500 and look at the performance of the index over the rest of the year. As shown, most of the time when the index starts off strong, it also traded higher for the rest of the year. In seven out of the ten prior best starts, the S&P 500 saw gains from March through year end."

Of course such alluring metrics, combined with the underinvested Grenvilles of the world, raise the question, "Could we get a 'melt up' into the end of the quarter?" While anything is possible, I would be surprised to see such a move. Admittedly, after being extremely bullish at the October 4, 2011 "undercut low" of 1075 basis the SPX, and constructive on equities coming into the new year, I turned more cautious (but not bearish) when the "buying stampede" ended on January 26, 2012. Accordingly, I could be biased about not expecting a "melt up." Nevertheless, the equity markets haven't really done much since January 26th – that is until last Tuesday – when J.P. Morgan (JPM/$44.57/Strong Buy) surprisingly raised its dividend right before the release of the Fed's Bank Stress Test. The result produced a Dow Wow of ~218-points, 128 of which came in the final hour of trading, vaulting the senior index to a new reaction high. Similarly, the positive "stress test" news drove the KBW Banking Index (BKX/$49.74) to new reaction highs as most of the bank stocks "danced" higher on the tape. Meanwhile, that same day, yields across the entire yield spectrum broke out of massive basing formations, and are now challenging the yield yelps of last October, as can be seen in the nearby chart of the 10-year T'note.

Recall, one of the reasons for last October's "undercut low" was a rise in the interest rates. And if I had to pick THE singularly most important chart of last week, it would be the chart of the 10-year T'note and its concomitant price collapses (read: higher interest rates). Therefore, I have not changed my cautionary stance of the past four weeks believing that all the good news is on the table. Moreover, while the overbought condition referenced weeks ago has been corrected to a more neutral position, the equity market's

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"internal energy" is now completely used up according to my studies. In economic terms, the recent data is regrettably becoming more mixed. Of the 18 reports released last week, seven came in stronger than expected, eight were weaker, and three were inline. As the prescient folks at FWFI-Gallup write:

"The rapid decline in the jobless rate in the past few months has defied expectations; some economists argue that the widely-followed seasonally-adjusted numbers may be too good to be true. Some suspect the government's formulas for smoothing out seasonal factors may be inadvertently inflating the numbers. Gallup chief economist Dennis Jacobe figures that, without those seasonal adjustments, the jobless rate has actually been rising for the past three months, hitting 9.1 percent in January. 'We think that the improvement over the last few months dramatically overstates the underlying improvement,' said Goldman Sachs economist Andrew Tilton. 'You will not see that rate of improvement going forward'."

Those comments sparked this insight from the brilliant editor of Zero Edge, Tyler Durden, who remarked:

"Earlier we described why it is clear that the Fed will need to print exponentially to fill the void of the crunch in consolidated credit money but why does Bernanke remain so hedged and guarded in his optimism when the market is tearing bears' arms-and-legs off and every talking head from here to Tokyo is claiming we have reached the nirvana of self-sustaining recovery. It's the data stupid. Simply put, as the chart below shows (see chart), the strength of trend of key US data over the past three months has been disappointing in aggregate and the worrying similarities between 2011 is only too real a problem for Ben and his buddies if they take away the Kool-Aid too early once again and let us drink our own stale sugar-free water."

The call for this week: Study the chart from the good folks at Zero Hedge. There is a remarkable similarity to the divergence that took place between stock prices and U.S. Economic Data Trends in April 2011 right before the SPX shed 8%. Take that in concert with what happened to interest rates last week, a dearth of internal energy for the equity markets, a S&P 500 that is 2 standard deviations above its 50-day moving average, rumors Operation Twist is over, Chinese consternations, regulators gone wild, rising gasoline prices, massive corporate insider selling, and my sense that in the short run all of the good news is on the table, and it appears as if the easy money has been made. That said, I still would not get too bearish because I do expect stocks to be higher by year end. Moreover, last Tuesday's upside breakout turned out to be the first 90% Upside Day of this year meaning that 90% of total volume traded came in on the upside as did 90% of total points traded. To negate that action would require a sell-off on heavy volume that results in a closing price below the previous rally's closing high of 1374.09 on the SPX. Still, the stock market may have enough "forereach" (a term for you nautical types) to tag 1420, but in my opinion the *game's not worth the candle*. For investors not sharing my cautionary counsel, I continue to like the strategy of buying stocks that have recently declined for "one-off" reasons where the bullish fundamental story is still intact. Names along this line, which have a Strong Buy rating from our fundamental analysts, include: Acme Packet (APKT/$27.55), Nuance (NUAN/$26.15), and Vocus (VOCS/$13.04). For further information please see our analysts' recent comments.

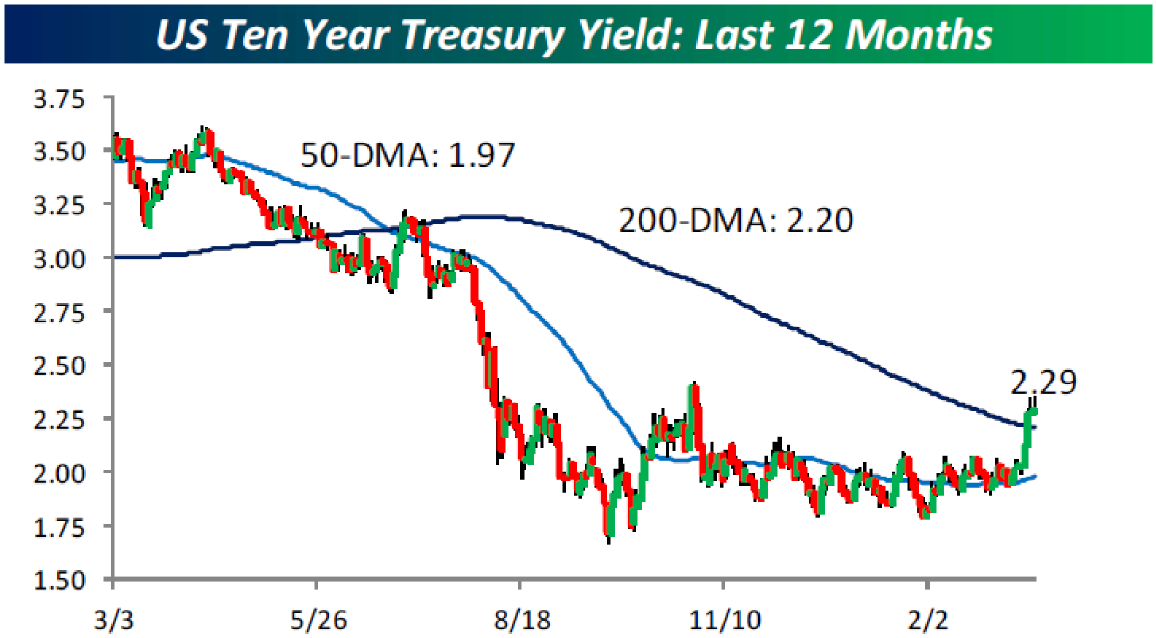

Chart Courtesy of Bespoke Investment Group

Chart Courtesy of Zero Hedge

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