

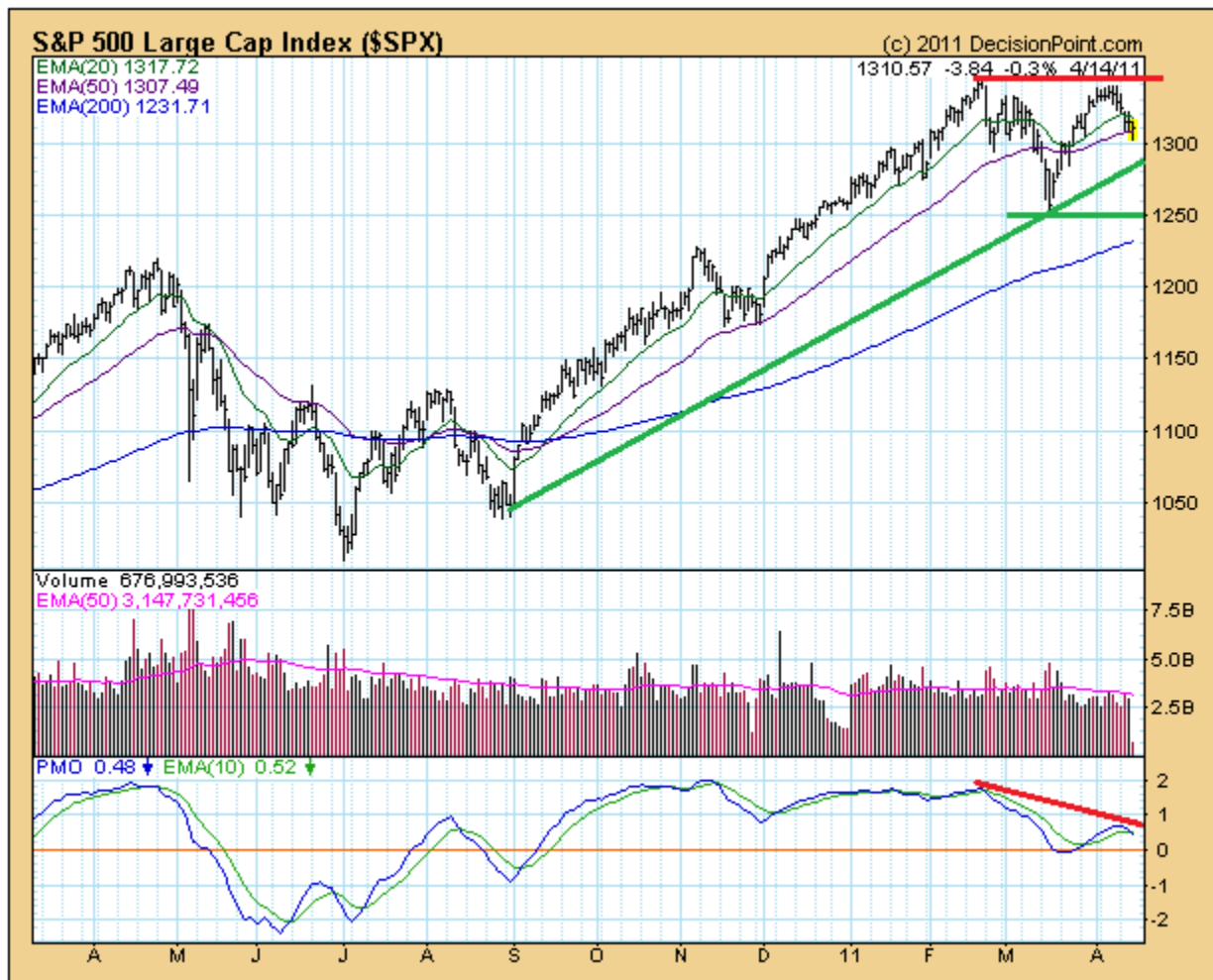


## Dynamic Investing Alert: April 15, 2011

By Art Nunes, CMT

### Stock Market Enters Period of Indecision

Longer-term, the bias remains to the upside for the major stock market indices. Near term, however, weakness continues and the short-term market action is giving mixed signals. In the chart below you can see that after hitting a new bull market high in February the S&P 500 stock index appears to have entered a trading range (1,250-1,344) to consolidate it's over 28% gain since September 1, 2010 and to evaluate the many concerns investors now have including: The impact of high commodity prices on the economy and inflation, whether governments around the world will responsibly deal with their rapidly growing deficits and national debt and whether either of these issues will result in very high interest rates that could act as the catalyst for the start of another bear market. That's the "bearish" case for stocks and if the odds favor that outcome in



the weeks ahead we will have no choice but to reduce risk significantly in the portfolios that we manage. The bullish case on the other hand is that corporate earnings will continue rising and beating Wall Street forecasts for the majority of companies, that there will be positive resolutions to the aforementioned concerns and that the bull market will resume for the rest of this year after a temporary pause.

Near-term outlook: Many of the short and medium term “trend following” indicators that we monitor have weakened considerably the past few weeks but they still haven’t reached the point where the market typically bottoms. This means that stock prices will likely be weak and at best remain within this trading range for awhile. The next month will be chock full of earnings reports, political policy discussions and geopolitical events any of which could cause stocks to break out of the trading range to the upside or to the downside. Things are not so bad that they can’t be turned around quickly, but a retest of the recent S&P 500 low of 1,250 could be in the cards.

Longer-term outlook: First and foremost the stock market’s longer-term trends in both price and relative performance continue to rise, so until those changes we should limit selling to weaker holdings and not make a wholesale risk reduction effort at this point. Secondly, current fundamental market conditions still favor higher stock prices for the remainder of the year:

- *Stock valuations are still low.* For example, the price to earnings ratio (P/E) for the S&P 500 stock index is currently about 12.9 based on the IBES analysts (12) month forward earnings forecast of \$101.78. A P/E of 15 – 16 would be more in line with the market’s historical average. Some would say that an earnings forecast is simply a “guess” and not worth considering. I would agree if the “trend” in the forecasted earnings was not rising as it continues to do. Some day Wall Street analysts will overshoot with their forecasts but until they do I think it’s reasonable to use their current forecast in our thinking.
- *Monetary conditions are as good as it gets.* Despite the recent rise in Treasury bond rates they are still low, the yield curve is very steep (the difference in interest rates between short and long-term maturities) and the money supply is growing nicely. These conditions make it favorable to borrow and to lend. So far banks are lending but not near the rate that is normal based on their current level of excess reserves. Also, individuals and businesses have not been borrowing at normal levels to purchase assets and grow their business. Once “normal” levels of lending and borrowing are reached again (the “velocity” of money) economic growth should accelerate.
- *Investors are still very skeptical about this bull market.* The short term investor surveys have swung from very bullish to very bearish with every rally and correction but longer term sentiment still remains very bearish as evidenced by the net outflows from US stock mutual funds since the bull market began (they’ve invested over \$200 billion into bond funds). These bearish actions by investors mean that there is significant buying power available that will eventually come into the market.

- *The US Dollar is in a bear market.* Certain types of assets typically perform well during a declining US Dollar environment and they include: international stocks and bonds, commodities and US companies with a large export business. These are areas we are looking to invest cash going forward. A declining US Dollar is not necessarily a bad thing so long as it is an orderly decline.

What we are doing: We monitor the financial markets and our existing holdings daily and we'll sell the ones whose longer-term trend in price or relative performance reverse down. So long as the market's longer-term price trend remains up we plan to invest cash available in areas that are in strong up trends in price and are ranked high in terms of relative strength. BUT wait to buy them until they trade near their 50 day moving average (don't chase prices). IF the near term weakness for stocks looks like it is turning into something more severe we will reduce risk significantly but we are a long ways away from that at this point.

**Non Dynamic Investing investors:** If we are not currently helping you to manage your portfolio with our *Dynamic Investing* process please call us to discuss the various ways we can incorporate it into the management of your portfolio.

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