



Dynamic Investing Alert: June 8, 2011

By Art Nunes, CMT

A Replay of 2010?

Investors are starting to pick up on the similarity of this year's stock market action (and newspaper headlines) with that of 2010 suggesting that the market has entered into a "correction" like the one it went through from April to September of 2010. The reasons cited for last year's correction have resurfaced again: The Fed's QE2 (quantitative easing) will end soon, the European debt crisis and a weakening economy.



Source: Decisionpoint.com

Bull market correction: As investors evaluated similar problems last year they took the S&P 500 stock index down from its high in April of 1,217 and corrected it down to about 1,022. This decline amounted to about 35% of the bull market's advance up to that point from the 666 low it reached on March 9, 2009 (see chart above). At the time the 2010 correction was being heralded by many as the start of the next "bear market" so living through it was no fun for sure but in the end it turned out to be a "normal" bull market correction. Trend following 101 teaches us that markets will "correct" (give back) 33% to 50% of their previous advance so last year's "period of indecision" turned out to be a textbook bull market correction (20/20 hindsight is easy isn't it?). As it turned out the 2010 correction set the stage for the bull market's next advance up to the April 29, 2011

high of 1,370. IF the current correction turns out to be similar to last year's (gives back 35% of prior gain) it would take the S&P 500 index down to about 1,248 which is about 3% lower than today's price level. It's also the next level of price support at the March low of about 1,250 and slightly below the S&P 500's (200) day moving average. That is where the stock market appears to be headed in the near term. The bear market forecasters are coming out strong again but its way too early to tell whether they will be right this time around. All we can do is monitor market trends every day and if the correction starts to turn into something more severe we will sell stocks and reduce risk.

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 near term (days) and at best remain in a trading range medium term (weeks). Next month will be chock full of earnings reports, political policy discussions and potential geopolitical events any of which could cause stocks to break out of the trading range to the upside (bull market resumes) or to the downside (bear market starts). 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 looks likely at this point.

Longer-term outlook: First and foremost the stock market's longer-term trends in both price and relative performance continue to rise, so until that 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 12.3 based on the IBES analysts (12) month forward earnings forecast of \$104.84. 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 they get.* 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 cash reserves. Also, individuals and businesses have not been borrowing at normal levels to purchase assets and grow their businesses. 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 may 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 large export businesses. 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. A crashing US Dollar would be very bad however.
- *Market Trends rule.* Despite all of these “fundamental” positives we can’t ignore the clue’s the market gives us. I believe that the charts I post in my investment alerts provide us with a road map for where the market may be heading. The market’s pricing action in these charts is the result of everyone’s analysis of all known information. The market’s longer-term price trends tell us where the market is ‘likely” headed in the weeks and months ahead. Right now these trends are rising; however, if they reverse down we’ll need to act accordingly.

What we are doing: For now we have to assume that we are in another correction in an ongoing bull market. We are monitoring the markets and our existing holdings daily and we’ll sell the ones whose longer-term trend in price or relative performance reverse down. Our three Dynamic Investing model portfolios currently have a 20% cash allocation. 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 once the correction runs its course. BUT we’ll wait to buy them until they pullback towards their longer-term trend lines, stabilize in price and finally start turning back up. In other words we don’t want to chase price on the upside nor do we want to buy into a declining trend on the down side. IF the near term weakness for stocks starts turning into something more severe we will reduce risk significantly, but we are a ways away from that concern 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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