



# MARKET OUTLOOK

A publication of Strategis Financial Group and MarketOwl.com

## Waiting for a correction that is overdue

It has been about a year since Strategis moved most client assets to money market funds. For the most part, that is where the money has remained ever since.

Over the past eight weeks the markets have rallied strongly and there are a few analysts and economists saying that the recession is over. While we certainly all would like the economy to recover as quickly as possible, other technical and fundamental indicators are showing that market risk remains at a high level.

Many analysts warn that the bad days are not over. For example, Niels C. Jensen, of Absolute Return Partners in London, in May wrote: "The dangerous conclusion to draw from the experience of the past few weeks is that all is now well and dandy and it is time to load up on

stocks again. I cannot emphasize it strongly enough: The bull market of March-April 2009 is almost certainly a bear market rally ..."

The chart below provides support to the idea that the market's worst days might still be ahead. Earnings on the S&P 500 are at their lowest level in the past 75 years. It will be difficult for stocks to long sustain any advance without earnings growth.

Upon his departure from Merrill Lynch in early May 2009, economist David Rosenberg said that the bear market rally was over and he expected to see the markets correct. He reiterated that opinion later in the month after joining Gluskin Sheff.

Howard Davidowitz, chairman of Davidowitz & Associates, said "We're in a complete mess and the consumer is smart enough to know it. If the consumer isn't

petrified, he or she is a damn fool. "The worst is yet to come with consumers and banks," he said. "This country is going into a 10-year decline. Living standards will never be the same."

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**—Richard Fisher**

During an appearance at a banking convention in San Antonio, Texas, Richard Fisher, president of the Federal Reserve Bank of Dallas, said unemployment will probably hit double digits and Americans should brace themselves for a slow recovery after the recession ends.

He said that consumers in the United States and overseas will continue to spend cautiously because of fears about losing their jobs or homes.

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In the current quarter, Fisher said he expects the pace of decline will moderate. The economy is "likely to bounce along the bottom for a while, perhaps punching through to positive growth as 2010 dawns," he said.

Comments like these remind us



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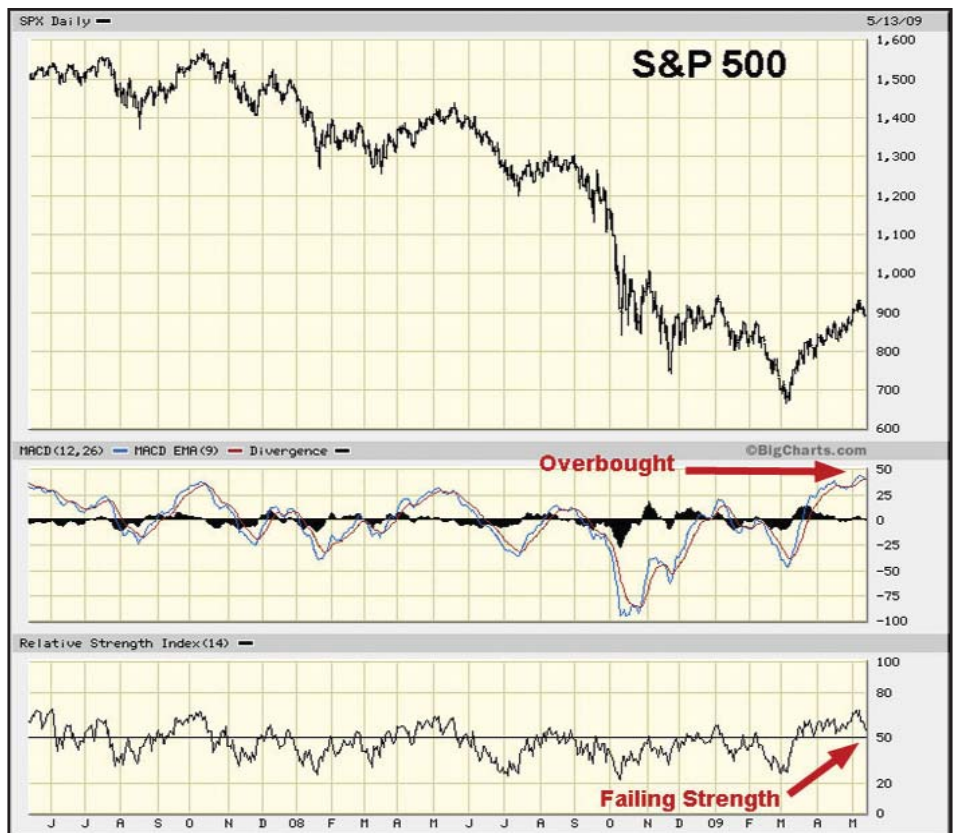
that there are many reasons to be cautious right now. This is also supported by our own analysis.

The chart at right includes a couple of indicators that help us determine the market's likely direction and its risk level. I used the S&P 500 because it is currently performing better than the Dow Jones Industrial Average but not as good as the Nasdaq. The middle portion is a moving average convergence divergence (MACD). This tool is quite accurate at identifying market turning points. Right now it is showing that the S&P 500 index is very overbought and that a change in direction should soon occur.

Over the two-year period covered by this chart, the MACD has not previously reached the current high level. On two occasions when it came close to this level, significant corrections occurred. This indicator is showing that there is currently a high probability that a significant downturn is imminent.

If this were a typical retracement in a bull market, the most logical level of support for the index would be near 800—about 11% below the current level. Because this is still a bear market, the index could fall farther and retest the old low below 700. Or it could even decline more and establish a new low.

Of course, there is no guarantee that there will be a major correction. Certainly the government is doing all it can to bolster the markets at these levels. But even during powerful bull markets we could expect to see a pro-



longed sideways consolidation after a steep climb like the markets have experienced the past several weeks.

The bottom portion of the chart is a relative strength index (RSI). Normally, the RSI must trend above 50 in order for an investment to have enough momentum to sustain an advance. In the current case, the RSI for this index has been above 50 since mid-March. But it is now falling and could drop below the 50 level. While it is certainly possible for the index to renew its advance and for the RSI to begin climbing again, right

now the falling RSI is another indicator showing that market risk is currently increasing.

Many fundamental factors continue to show the economy is in turmoil. Jobless claims rose May 13 and the national unemployment level is approaching 9%. A report earlier in the week showed continued erosion in the value of homes. Retail sales

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numbers have fallen. A recent Producer Price Index showed a surge in food prices in April. And for two consecutive quarters, Gross Domestic Product (GDP) has declined by more than 6%.

A May 19 article on Bloomberg.com noted that executives and insiders at U.S. firms are selling heavily into the steepest rally since the 1930s. Insider selling is considered a warning sign because company executives have more information about their companies' prospects than anyone else. The current rate of selling is the fastest since October 2007—the peak prior to this bear market.

We all hope for a quick end to this recession and we want to see a strong and healthy stock market. But based on the evidence available right now, the risk that the market will fall again remains unacceptably high.

We are not the only advisors or analysts with these misgivings. John Mauldin, best-selling author and recognized financial expert, is also editor of the free *Thoughts From the Frontline* that goes to over one million readers each week. (For more information on John or his FREE weekly economic letter go to: <http://www.frontlinethoughts.com/learnmore>)

In a recent email to subscribers, he wrote:

*"Today, there are those who say the stock market will start rising six months before the economy does. And maybe it will. I don't know. The predisposition of this market is down. Valuations are not at a level that has spawned major bull markets in the past. At the beginning of real bull markets, volume is strong and rising. Now it is weak (modest at best) and shows no real sign of becoming strong, especially going into summer."*

*"Further, this rally has all the earmarks of a major short squeeze. Regulators have recently (and correctly) been enforcing short selling rules that require stock to be delivered and settled on short trades. This may be a one-time event. When the short squeeze is over, the buying will stop and the market will drop. Remember,*

*it takes buying and lot of it to move a market up but only a lack of buying to create a bear market. ...*

*"Capacity utilization is at its lowest point since they began tracking it. The National Federation of Business says a recent survey shows none of the responders plans to raise prices, which is not a sign of business strength."*

*"Banks are not yet lending, and the past quarter's positive performance was mostly accounting gimmicks. ...*

*"Maybe this time it's different. But when I survey the economic landscape, I see lots of opportunity for disappointments and missed targets. And bear market rallies are killed by disappointments and missed expectations."*

*"To be long this market going into summer you need to be brave or have very serious stops on your portfolio. I think the possibility of missed expectations at the end of the second quarter is high. It could be ugly."*

As always, we are keeping a close eye on the markets. But based on our experience and on a range of technical indicators, the current rally seems to be unsustainable for much longer.

—Flint Stephens

*Mr. Stephens is marketing director and a financial advisor for Strategis Financial Group. He has been a writer and editor for numerous investment publications. He has a masters degree in communications from Brigham Young University.*

## Shorting the markets can cause increased exposure to risk

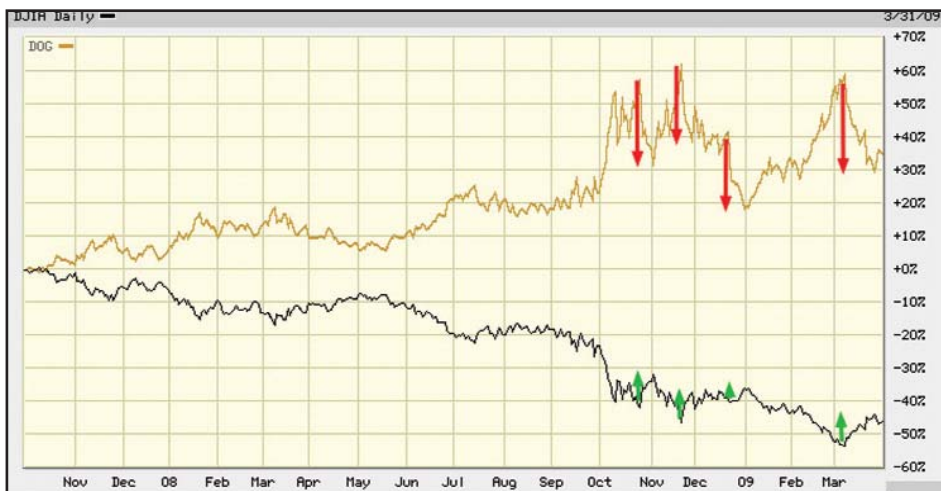
One of the more common questions we receive is why we don't take more short positions "so my account can make money in a bear market."

For those who don't know, shorting involves selling stock and then buying it back at what one hopes is a lower price. When it works as planned, the investor profits the difference between the selling price and the lower buying price. Naked short selling means the investor borrows the stock that he sells short.

In the past, shorting was considered a speculative practice not suited for retirement accounts or conservative investors. But with the introduction of short mutual funds, the practice gained more widespread acceptance—especially as the companies that offered these funds advertised them as a means to make money when the markets go down.

Today there are short funds for many common index funds. In theory, these funds move exactly inverse of the index they short. In addition, many companies offer enhanced Beta short funds. I'll explain that concept, but first let's go back to the initial question.

As investment managers who practice active risk management, whenever we enter a position on a client's behalf, we must consider the damage that can occur if we are



wrong and the market does exactly the opposite of what we expect.

During a prolonged bear market like we are currently experiencing, our focus shifts from trying to make money to doing all we can to protect client assets.

We use a variety of tools to help us make decisions about when to buy or sell. Our trading systems are geared toward longer-term trends. We make no attempt to participate in short trends that might last only a few days. This helps us avoid dangerous whipsaw trades and helps reduce our overall risk exposure.

Even in a prolonged bear market like we are currently experiencing, many of the downward moves are sharp and severe, lasting only a few days. In other words, by the time our indicators signal us to take a short position, most of the damage would already be done. Taking a short-term short position at those times would put assets at risk of a market retracement with a limited potential reward.

Making the situation even more complicated is the fact that during periods of high market volatility, most short funds do not behave as advertised. Let's go back to the topic of Beta and then I can explain specifically what I mean.

In the investing world, Beta is a measure of volatility correlation. Usually, the S&P 500 is used as the benchmark for measurement. An investment that is perfectly correlated or inversely correlated to the S&P 500 would have a Beta of 1.0. An investment that had double the volatility of the S&P 500 would have a Beta of 2.0.

The chart on the previous page shows the daily price movement of the Dow Jones Industrial Average (black line), compared to DOG, ProShares Short Dow 30, an ETF that shorts the Dow (gold line). This chart covers the period from October 2007 until March 31, 2009.

This fund is promoted as having a Beta of 1.0. In other words, it should have a perfect inverse correlation with the Dow.

For the first year portrayed, that correlation is fairly true. But look what happens beginning in October 2008. The volatility of DOG suddenly becomes much greater than its benchmark index.

I added the green and red arrows so you could see the difference in amplitude between the two positions. All of a sudden the downward moves of DOG are four or five times as volatile as the corresponding upward moves on the Dow.

Notice also that for the period depicted in this chart, the Dow was down about 46%, while DOG was up

only about 35%. That is an 11% spread on two positions that should have a 1-to-1 correlated return. At times this fund is falling or rising by double digits in a single session—much more than the index it is supposed to be mirroring.

Because these short funds do not behave as they should, it makes it very risky to use them. We sometimes will take a position in a short fund, but it is usually with only a small portion of the assets. We also sometimes use short funds to hedge a long position that we do not want to sell.

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