

Market Strategy

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**EQUITY
 RESEARCH**

March 24, 2008

Investment Strategy**“1 – 2 – 3”**

The year was 1965. The song lyrics were “1 – 2 – 3, oh, that’s how elementary it’s gonna be” . . . except in today’s case it isn’t Len Barry singing, but Howard Marks, co-founder of the brilliant Oaktree Capital Management organization. As reprised in Friday’s *Wall Street Journal*:

“Fortunately, one of the most valuable lessons of my career came in the early 1970s, when I learned about the three stages of a bull market: The first, when a few forward-looking people begin to believe things will get better. The second, when most investors realize improvement is actually underway. And third, when everyone’s sure things will get better forever. Buying during the first stage can be highly profitable, while buying during the last will carry you over the cliff with the rest of the herd.

“To aid in your consideration of the future, I’ve formulated the converse of the above, the three stages of a bear market: [First] When just a few prudent investors recognize that despite the prevailing bullishness, things won’t always be rosy. [Second] When most investors recognize things are deteriorating. And, [Third] When everyone’s convinced things can only get worse. Certainly we are [currently] well into the second of these three stages. . . . One of these days, though, we will reach the third stage, and the herd will give up on there being a solution. And unless the financial world really does end, we’re likely to encounter the investment opportunity of a lifetime. *Major bottoms occur when everyone forgets that the tide also comes in. Those are the times we live for.*”

We don’t know if Mr. Marks is right about which stage the equity markets are “in,” but we think we know that in the short/intermediate term, the “herd” has given up on stocks. Indeed, in last Tuesday’s verbal strategy comments we stated that to a one, every media person we talked to on the previous Friday, and again on that Monday, was incredulous that we could actually be bullish on equities. To be sure, everywhere we look the stock market sentiment is about as dower as we can ever remember. In fact, I don’t recall it being this negative back in the summer of 1974 when the DJIA had shed nearly 50% of its value from its January 1973 high! Consequently, we reiterated to the media our strategy that last January’s “lows” were being retested and that said retest would likely be successful.

Our bullish confidence level rose materially when last Tuesday’s Dow Wow (+420 points) finally proved to be a 90% Upside Day after the previous Tuesday’s Dow Delight (+416 points) failed to qualify. The reason for our increased confidence is best explained by the Lowry’s organization. To wit:

“Past experience shows that 90% Down Days are typically followed by one of three patterns: (1) a 90% Up Day occurring quickly after the 90% Down Day would suggest that a sustained rally lasting about two or more months is likely; (2) the absence of a 90% Up Day during a snap-back rally would suggest that a brief recovery rally lasting 2 to 7 trading days would most likely be followed by new lows in price and additional 90% Down Days. Such rallies should be used to sell stocks; (3) the lack of any snap-back rally within a few days after the last 90% Down Day would suggest a sustained market decline is underway that will probably produce additional 90% Down Days.”

Given that we have recently experienced numerous 90% Downside Days, to finally get a 90% Up Day was a welcome sign. This was especially true, as repeatedly noted in our strategy comments, since we were also witnessing a plethora of downside “non confirmations” from various market indices. As a sidebar, a 9:1 day, either on the downside or the upside, is NOT the same thing as a 90% day. Nevertheless, the prior two Tuesdays did indeed qualify as 9:1 upside volume days, rendering a rare “Double Nine-To-One” bullish

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signal. As Mark Hulbert states, "This indicator is based on the volume of all NYSE-listed stocks that go up on a given day, expressed as a percentage of the total volume of all stocks that rose or fell on that day." When two 9:1 Up Days occur within a relatively short period of time, the signal is called a "Double Nine-To-One" signal; and, it is bullish.

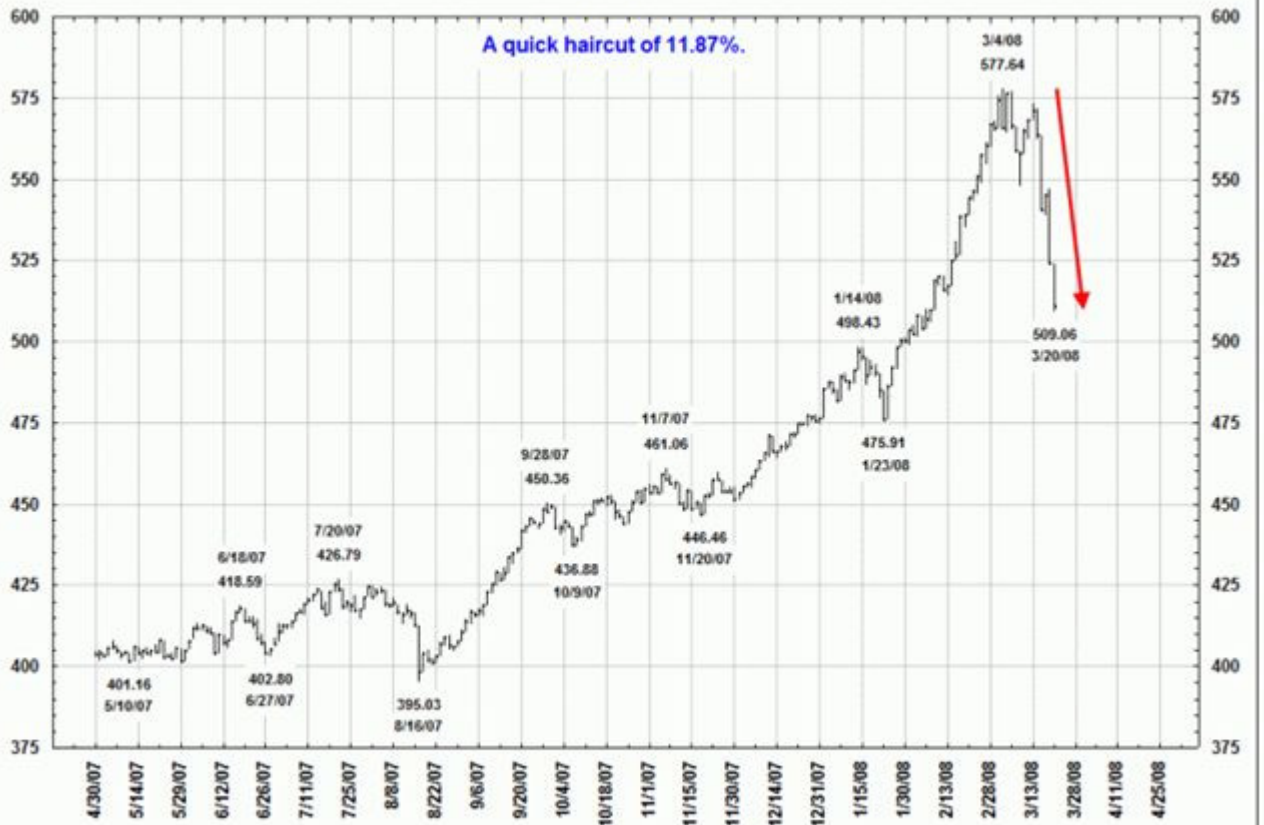
When we combine the downside non-confirmations, the "Double Nine-To-One" signal and the 90% Upside Day, we have to believe the bears have become exhausted and prices should generally be higher for awhile regardless of whether we are in a recession or a bear market. That said, longer term we remain cautious as we continue to respect the Dow Theory "sell signal" we wrote about when it occurred on November 21, 2007. That signal suggests a bear market began on July 19, 2007, which was the last time the DJIA and the D-J Transportation Averages (DJTA) recorded joint new closing highs of 14000.41 and 5446.49 respectively. Since the typical bear market lasts about 15 months, we think a cautious approach is still warranted.

As for last week's strength in equities, and concurrent weakness in commodities, we recently discussed a scenario that went something like this. What if the European Central Bank (ECB) has to cut interest rates because its economy is slowing? That in turn causes the U.S. dollar to rally, which weakens crude oil, thereby giving the U.S economy another HUGE dose of adrenaline in addition to the Herculean government-sponsored economic stimulus programs. If so, it would not be unexpected to see a pretty decent rally in the major market indices. "Will it happen?" we asked ourselves. "Well, it's no lead pipe cinch," asked and answered, "but we think the odds are tipped in favor of such a pattern." And that, ladies and gentlemen, is why we recommended rebalancing ALL of your long-held "stuff stock" positions (energy, timber, cement, base/precious-metals, etc.) late last year. Such a strategy of selling partial positions should have allowed some long-term capital gains to accrue to the portfolio, cash positions to build, gotten the stuff-stock portfolio weightings back inline with original objectives, and given the "cushion" to ride out declines like we saw last week. Granted, that strategy has looked pretty foolish in 2008 until last week, but then we have a history of looking foolish at short/intermediate-term inflection points.

So what do we do? Well, tactically our two largest trading positions remain the ProShares Ultra S&P 500 (SSO/\$66.40) and 5.5% yielding ProShares Ultra Real Estate (URE/\$33.30). In the investment account we were happy to see General Electric (GE/\$37.49) catch an upgrade from a major Wall Street firm with an attendant rally. Likewise, participants were given yet another chance to purchase Strong Buy rated Schering-Plough's (SGP/\$20.57) convertible preferred "B" shares below \$190 where they were yielding nearly 8% (terms should be checked before purchase). We have also been recommending Microsoft (MSFT/\$29.18) since our early-March institutional conference where we heard the story from a particularly bright portfolio manager. That story can be obtained from last Monday's written missive. While there are numerous other investment ideas that have been mentioned in these reports, to which we are still friendly, due to space constraints these will have to be it for this morning.

The call for this week: How bullish are "Double Nine-To-One" signals? According to professor David Aronson, as reprised by Mark Hulbert, "[we used] data from the beginning of 1942 through fall of 2006, and looked at what happens in the stock market in the 60-trading-day period following a . . . Double Nine-To-One signal, versus what happens the rest of the time. In those 60-trading-day windows, the S&P 500 index produced an average annualized return of over 22%, on the assumption that an investor entered the market on the close the day after the Double Nine-To-One signal was triggered and held until the end of the 60th trading day. In the non-signal periods the return averaged 4.5% annualized." When we combine the "Double Nine-To-One" signal, the 90% Upside Day, the observed downside non-confirmations, the most bearish sentiment readings in 15 years (read: bullishly), and a host of positive finger-to-wallet ratios, we can't help but remain bullish in the short/intermediate term, thinking the downside retest of the January "lows" will be successful. Yet by far the most stock-bullish event occurring last week was the "dive" in the Commodity Research Bureau's index of leading commodities as can be seen in the nearby chart from our friends at the invaluable service www.thechartstore.com. Verily, as Len Barry wrote, "it's so easy (it's so easy) like takin' candy (like takin' candy) from a baby." To which we add . . . "well, sometimes!"

Reuters/CRB Continuous Futures Index



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