

“The Davich Perspective”

July 6th, 2010

“What Everyone Knows Is Not Worth Knowing?” or “Equities At Distinct/Important Crossroads”



My thoughts that the market could move to new highs this summer were dashed in June by an overwhelming sequence of underwhelming news. Anemic job growth, global debt issues, a stalled real estate market, some disappointing earnings reports and concern about the economic policies of the current administration derailed what appeared to be a promising summer rally. The ten trading days previous to the holiday weekend saw most of the major indices retreat 10% and more.

There could still be a summer rally, but the chances of making new highs seem remote considering the recent damage. Actually the **possibility** of the next leg down in the Secular Bear Market appears to have become more pronounced. One of the key reasons I felt the market had the fuel for another move higher was the probability of one more better-than-average corporate earnings season. The season begins next week with Alcoa on Monday (did you know that Alcoa always kicks off the earnings season?). With the lackluster announcements of late I am guessing that the second quarter earnings will be okay, but the outlook on the third quarter may be ratcheted down. Corporate balance sheets are mostly in good shape, it is the government and consumers that are particularly lopsided to the debt side.

The technical picture for equities has some cross currents working also. The Head and Shoulders pattern is considered to be one of the more reliable patterns in Technical Analysis and it often denotes a market top and ensuing correction. The chart here shows a clearly developed H&S pattern for the S&P 500. The head is April's peak at 1220 and the neckline was the recent support level at 1040. The rule of thumb is that when the neckline is substantively pierced, the subsequent drop is roughly equal to the distance from the neckline to the head. Subtracting 1040 from 1220 leaves 180 points, which measures to the 860 level as a target for this correction. That would be a better than 15% drop from current levels, which would not be much fun for anyone but those who are on the sidelines or short the market.



A couple of things stand out for me which challenge that precarious outcome from occurring. First is the common knowledge among most market professionals and many non-professionals about this Head and Shoulders pattern unfolding. CNBC talking heads mention it on a daily basis. Five years ago this type of technical analysis would have flown under their radar. A legend in the technical analysis arena is

gentleman by the name of Joe Granville. Joe coined a phrase that is dead-on regarding the stock market, but is also useful in other situations, "What everyone knows is not worth knowing." The widespread awareness of this pattern leads me to believe it may not play out the way most think it will.

The second data point that challenges the correction outcome is the lower frame of the chart. The Moving Average Convergence Divergence (MACD) is an internal indicator that I use extensively in my work. As you probably know I try to avoid using too much technical jargon in this space, but sometimes a little can explain a lot. As you can see the S&P 500 index itself pierced the 1040 level last week and made a new low for the year. However the MACD indicator did not confirm that low, indicating that the selling might be running its course? Many other indices and sectors are showing a similar positive divergence. For technicians this is an interesting time as two usually dependable key indicators are at distinct odds with each other.

One more technical data point that seems to side with the bottoming process in stocks. The relationship with stocks and bonds has been an inverse one for the last decade. Interestingly when I entered the business in the eighties it was a more positively correlated relationship. It does fascinate me how these relationships wander in and out within the financial markets. Anyway, the chart here is that of the 30 Year Treasury Bond and you can see it has had a move up of late as equities retreated. The MACD in the bottom frame has not confirmed this new high, just as it did not confirm the new low in stocks. Again this indicator is suggesting that bonds may be topping, supporting the bottoming process for stocks. Alright no more charts for the rest of the letter.



When I developed the Dynamic Asset Allocation Strategy I often wondered if the indicators I used which worked so well would lose their luster. I noticed more and more commentary in the media that referred to indicators I used in DAAS. I imagined that these indicators would morph as they became more prevalent, and as Joe said "What everyone knows is not worth knowing." Having these indicators currently at odds with each other might be part of that process. Indicators and relationships appear and disappear on a consistent basis in this never ending mystery of "What will the markets do next?" Keeps me on my toes.

My best guess right now is that we may thrash about in a trading range making little progress for the next few months. As I mentioned above the cross currents fundamentally are also at odds with each other. I cannot remember an earnings season that will hold so much important information than the one starting next week. I can see one day an important company gives some constructive guidance and the market is up big, only to have an equally important company disappoint the next day driving the market to give back all of the previous days gains. If you have some passing interest in what drives the markets, paying attention to the earnings announcements for the next month should hold some keys to the next intermediate term direction for equities.

The possibility of another steep correction is still there and an ostrich strategy is certainly not recommended. For information about how a tactical or dynamic strategy might work within your portfolio [click here](#). My next missive should have some interesting info regarding what news has unfolded and how it has affected the markets. Till then,

gnatt

Did You Know

Congress Gets It Wrong Again - For the last 5 years, Congress has reported that the Chinese currency renminbi is undervalued by as much as 40%, providing an unfair advantage to Chinese exporters and a financial headwind for US exporters. A study released earlier this month by a US research institution reduced the level of estimated undervaluation for the renminbi to 24% (source: Peterson Institution for International Economics). Keeping their currency weak allows the Chinese to increase their exports as foreigners can purchase Chinese goods cheaper. This has been at the core of the issues US policymakers have had with the Chinese for the last decade.

Final Thought

"The gap in our economy is between what we have and what we think we ought to have - and that is a moral problem, not an economic one" - Paul Heyne.

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