



Now that was ugly

There is no putting any lipstick on that pig. That was an ugly day. The Nasdaq Composite and the S&P 500 closed at new lows for the year. The DJIA managed to close above its recent October 10 low. Trading was halted in Brazil today after their market plunged 10%.

Just before the close we got an email from a new client asking: **“Another scary day. You think your call for option #1 – and recommendation to go all cash – is right?”**

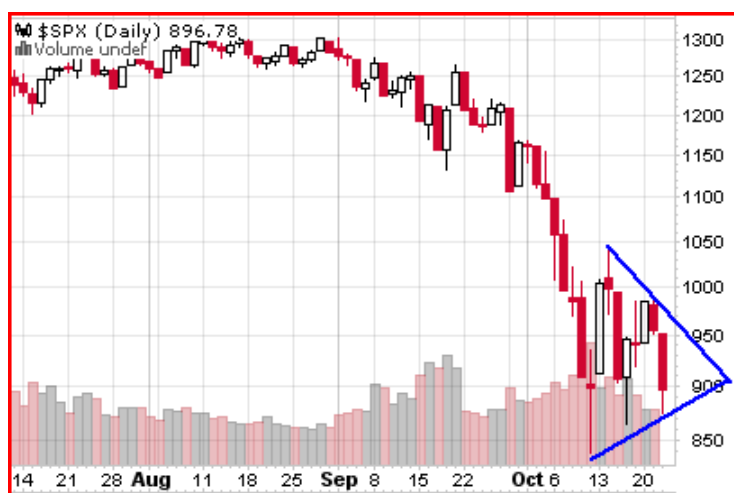
Unfortunately it is too early to know with certainty. Here is a chart of the S&P 500. Before explaining this chart I will tell you that you could substitute any major U.S. stock average and they all look a like at this point.

The pattern at the bottom right corner of the chart is a “flag” or “pennant”. Flags and pennants are patterns that mark a period of consolidation before a previous move resumes. These patterns are usually preceded by a sharp advance or decline (**as in the current case**) with heavy volume, and **mark a mid-point of the move.**

Let me translate that for you. This chart pattern is a “resting” period. In this case, the market has collapsed over the last two months and now seems to be taking a rest. It isn’t going down, and it isn’t going up. It is currently trading in a broad range. Unfortunately this pattern usually ends with the prior trend reasserting itself. Therefore it is most likely this pennant will be resolved by the market tumbling more after taking this brief rest.

Today’s tumble took us down to the line that forms the bottom of the pennant. It is reasonable to expect that the next move is UP, probably back to around 950-965 on the S&P 500. How high we go is also a function of time. If it happened in one day (like tomorrow) we would probably get back to 965 or so. If it takes a day, or two or three, you could expect the rally to be smaller. The blue lines contain the probable size of the moves. The pattern is completed as the moves get smaller and smaller as the market compresses itself into the cone of the pennant. The pattern is often completed at the point where the two blue lines come together.

Then the market breaks one way or the other. If this pennant resolves itself in the usual way the move will be down. Therefore Option #1, calling for another big move down, is still very much a possibility



This pennant is forming very quickly and distinctly. A couple of short days ago you couldn’t have described what was happening in the market as a pennant formation. Charts tell stories about market conditions, but the story develops each day. This pennant could go away tomorrow with a big rally or a big sell off that violates the blue boundaries of the pennant. Either way the process of forming the pennant would have been ended prematurely. It is also possible that this pennant could change shape and get longer, and therefore take more time to resolve the future trend.

But, enough “charting”. Based on what I

know today it is frankly looking like we may have stepped back into equities too soon. The good news is that it was a baby step. It may wind up costing real money in the end, but small amounts. We may get lucky and get back today's losses tomorrow. That does seem to happen a lot lately and the next move for this pennant should be up.

Either way though, we are done buying until this pennant resolves itself. If it does happen to break to the upside, that would have to be interpreted as VERY BULLISH. It would be unusual and BULLISH. It would be time to do more buying.

If the market breaks down that would dash our hopes for any year end rally and put us aggressively back in the bear camp. Despite the fact that I said only a couple of days ago that it is getting to late to short the market in 2008, shorting would be the right thing to do. It would be reasonable to assume that the next support for the S&P 500 would be at about the 830 level. That is about 7% lower than tonight's close. If that level doesn't hold then the 657 level becomes a major line in the sand. That is 26% lower. These levels are "fibonacci retracements" of approximately 50% and 62% of the total bull market move from 1982 through 2007.

You may recall in our July 15th newsletter called "It's a bear", we said that 25 year bull market was ending right before our very eyes. The only thing that keeps surprising me is the relentless speed with which that move is unwinding. We have already given back over 40% of that total move in one year. Remember it took 25 years to get to the top in October 2007.



There is another indicator related to pennant formations. It is called the "flag pole" and I will spare you the definition. But the flag pole for this pennant is about 200 S&P points. So if this pennant were to break down at about the 875-900 level it would be reasonable to assume, based on the size of the "flag pole", that we could drop another 200 points, or down to 675-700 on the S&P 500. That would put us down somewhere in the neighborhood of another 21%-24% down from here.

Any way you slice it this is not a pretty picture.

Now, that I have scared you half to death, I will tell you that this chart already bears signs that we are DRAMATICALLY OVERSOLD. What is known as the RSI (relative strength indicator) is at 20.48 on this 25 year weekly chart. IT HAS NEVER BEEN THAT LOW BEFORE.

This market is due for a BOUNCE.

Let me answer a couple more questions we have been getting.

- 1) How low will gold go?

It hit Paul VanEeden's "fair value" target today at about \$730. It is likely to stabilize in here for a while as the U.S. dollar also takes a rest and stops going up. Which takes us to question number 2.

2) How high will the dollar go?

We can't lie. We had no idea the dollar would move up as much as it has. We bought it weeks ago and sold it in a quick trade. It has done nothing but go up since. It is now as overbought as it has been in years and we expect it to pull back a little. As it does, gold will likely look like it is rallying. It should be a sucker rally. After taking a break we think the dollar has more room to run up. We expect the Euro to trade down as low as 1.22 soon. In this world of extremes it is quite possible the Dollar and the Euro could trade 1:1 before this move is over.

We would likely go long the dollar if it got a decent pullback from here.

3) How low will oil go?

Our "friend" tells us we are near the bottom, but having said that he has revised his target downward a couple of times. His recent target was \$65 per barrel. We are about there. Where we go from here is very much dependent on what OPEC does at their emergency meeting next week. If they can really muster the discipline to cut production by at least 1.5 million barrels then prices could hold in here or go lower. We question their ability to do that, but we will not know until after their meeting.

Remember that oil is priced in dollars (for the most part). Oil prices may be collapsing but the dollar is going straight up. Don't cry too much for OPEC.

More tomorrow.

All the best, PK

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Not all accounts managed by K&A are "modeled" accounts. We strongly urge our clients to understand which model, if any, are being used to manage their accounts.

As of July 3, 2007 Lee O'Dwyer joined K&A as a portfolio manager. Paul Krsek and Lee O'Dwyer frequently discuss investment ideas, model portfolio strategies and the investment policies of K&A. But when it comes to the implementation of those policies Krsek is primarily responsible to manage the accounts that fit into each model portfolio description. He generally makes all final investment and trading decisions relative to those accounts that are considered to be "modeled." However, in Krsek's absence O'Dwyer does have the authority to trade all client accounts. He has been actively trading accounts in the various models since joining K&A.

From time to time K&A receives requests from clients to purchase securities that are not included in the model portfolio to which they are assigned. Effective May 24, 2006 K&A has encouraged clients to hold such securities in a separate account for the client. Because K&A is a "fee only" registered investment advisor" it charges its normal management fee for monitoring such securities in the separate accounts in which they are held.

K&A makes every effort to exclude securities that are 'requested by the client' from the modeled portfolio accounts.

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Trades or adjustments to accounts mentioned in ELLUMINATION may or may not happen in every account managed by portfolio managers at K&A.

If you are not satisfied with the investment results in your account it is your responsibility to inform Krsek or Andrae and to discuss possible changes that can be made to the account to accommodate and satisfy your needs.

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Past performance should not be considered an indicator of potential future performance. If you do not consider yourself suitable, either emotionally or financially, to experience volatility and/or losses in financial markets, you should not invest.

From time to time Krsek lists the simple annual returns of the six model accounts in this newsletter. These accounts are "models" and do not represent the actual results accruing to individual accounts. Simple annual return does not represent "time weighted return" as reported individually to clients in their quarterly reports prepared using Centerpiece.

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Sincerely,

Paul Krsek
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