Approaching the Top of the Trading Range

April 20, 2009

Dateline: Savu Savu, Fiji, Jean Michel Cousteau Resort

When you approach the top of a trading range it looks no different from Fiji than it does from the Napa Valley. That seems to be what happened on Friday, April 17, 2009. The S&P 500 topped out just shy of 875 before backing off in the last few minutes of the trading day. We have been telling you that this should be the top of the range for the short term. As the trading day progressed on Friday Lee took action to provide protection to the models should the market back off during the week of April 20-25 as we expect.

He reduced several of the equity positions we have recently put on and added short positions as hedges for some of the models.

There is one funny thing about viewing the markets from this vantage point. As I am drafting this it is already Saturday afternoon in Fiji, even though it is still Friday afternoon in California. I have often thought that there should be some advantage to being on this side of the dateline. "Yesterday" has already happened here. Shouldn't I have been able to see what happened and benefited by it? It has always felt like that is the way it should be, but the "dateline" doesn't provide that advantage. That is too bad!

In any event the markets did what we expected last week and that is good enough for now.

We told you that if the S&P 500 approached 875 we might adjust our outlook for its trading range. We have been saying that we expect a range between 875 and 730 for the near term. We are tightening our expectations at this point and targeting the next move down to be no more than to 805.

Our base expectation is that the market could now take up to a two week breather and consolidate down to that 805 level before starting the next move higher to the 935-950 range.

We are starting to see the possibility of an "inverse head and shoulders" pattern forming up on the daily charts of several of the major stock averages. This is a particularly bullish pattern. The completion of this pattern over the next several weeks is the "base expectation" referred to here.

The only problem is that we really won't know until we get there, and a lot could go wrong along the way. The markets have come a long way from the bottom. We have pointed out several times that most of that move has been engineered by the PPT. During the past week and a half the market has gotten support and new legs from better than expected earnings from many financial stocks. It is important to understand that earnings expectations have been ratcheted so far down for most financial companies that they can't help but beat the reduced expectations. So it is hard to get too excited about their results. Wells Fargo is the possible exception.

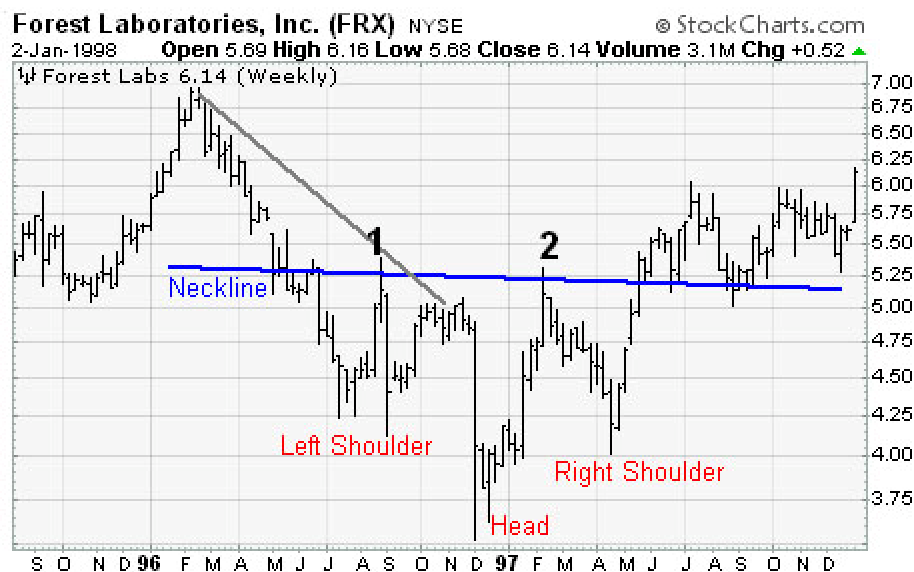
The market has also shaken off a lot of continuing bad news. The consensus seems to be that the market is strengthening on news that is "less bad". The coming week will mark an important test for that

consensus view; last week saw 30 earnings reports, and they were heavily weighted towards finance. The coming week will have 130 S&P 500 companies reporting so we'll know a lot more by next Friday.

For the benefit of our non professional readers here is a primer on "inverse head and shoulders" from Stockcharts.com:

The Head and Shoulders bottom is referred to sometimes as an Inverse Head and Shoulders. The pattern shares many common characteristics with its comparable partner, but relies more heavily on volume patterns for confirmation.

As a major reversal pattern, the Head and Shoulders Bottom forms after a downtrend, and its completion marks a change in trend. The pattern contains three successive troughs with the middle trough (head) being the deepest and the two outside troughs (shoulders) being shallower. Ideally, the two shoulders would be equal in height and width. The reaction highs in the middle of the pattern can be connected to form resistance, or a neckline.



The price action forming both Head and Shoulders Top and Head and Shoulders Bottom patterns remains roughly the same, but reversed. The role of volume marks the biggest difference between the two. Generally speaking, volume plays a larger role in bottom formations than top formations. While an increase in volume on the neckline breakout for a Head and Shoulders Top is welcomed, it is absolutely required for a bottom.

Here is the current chart of the S&P 500. Several other major averages look very much like this one.

If this chart pattern completes as an "inverse head and shoulders" we will see the right shoulder form up over the next 15 trading days, or so, at levels just above 800 on the S&P. That would be followed by the move up back up to 875 to complete the neckline, followed by the high volume breakout to 925-950.

Does all this mean the bear market is over? There is no way you can reach that conclusion yet. But if this formation completes that will certainly give stronger technical support to the argument that a bottom is in. Over the next several newsletters I will also outline other technical signals to watch for confirmation that the worst is behind us for equities.

For now, let me relate a story to you before I close for the day.

We arrived at the airport in Nadi, Fiji last Tuesday. Our plane was late and therefore we missed the connecting flight to Savu Savu, which is on a different island. We ended up chartering a plane to make the 1 hour 10 minute flight to Savu Savu. We shared the charter with two businessmen from the USA who were flying to Savu Savu to meet with Tony Robins at his resort called Namale. It is down the road a piece from the Jean Michel Cousteau Resort and we have stayed there in the past.

We had plenty of time to talk about the markets while at the airport in Nadi and they asked me lots of questions. The first was "which economist do you consider to be the best?"

My answer was pretty simple and straightforward. We don't consider any of them to be the best, even though we read commentary by dozens of them. I went on to explain that only Roubini forecast what has happened to the general economy and the markets. But before he did so NO ONE had heard of him. So he had no credibility when he was warning of impending doom. When the S&P 500 was hitting 666 he was forecasting that it still had a long way to get to the bottom. He has clearly missed the turn. The

bottom line is that you couldn't rely on any economists that we know of to protect you from this bear market.

They asked me what analyst or research service we liked the best. I said NONE of them even though we subscribe to some of the "best" independent research available. Find me the credible research service that predicted either this bear market or the recent bottom of the market. We told you a few weeks ago in Ellumination about the "5 bearish" money managers that all started to turn bullish on or around March 9th. We admire their work and we did a "heads up" based on that work and started to get Fresnel and The New World invested. It has paid off as both models are now UP on the year. But there is not a research service that we know of that offered significant protection and worthy guidance through this bear market.

They asked me about whether or not we relied on "fundamental research". I told them we do TONS of it, and in this bear market it has been worth the value of the explosives it would take to blow it all up.

They asked me whether we rely on "quantitative analysis". I said, we use what we consider "the best", and it did us very little good in warning of this bear market.

Note: To the credit of ValuEngine, our main "quant" service, Richard Suttmeier was hired as their chief market strategist at the beginning of 2009. We were already consulting with Richard through another venue. He has been an extremely valuable addition at ValuEngine. Richard was one of the 5 bears that we refer to above who turned bullish in March.

Finally they asked, "Well then what is guiding you?" I said "charts"! Like it or not, charts have been the most reliable guides to navigating this bear market. They aren't perfect by ANY STRETCH OF THE IMAGINATION. But they have been "head and shoulders" better than any other resource.

Today is Saturday in Fiji. I calibrated my compass this morning and I went diving. I used my compass to guide me on a solo dive, just like Lee and I are using charts to guide us through these unprecedented market conditions. I have told you many times before in Ellumination; don't second guess your compass and don't second guess your charts. So far, so good!

From Lee, and our whole team, we wish you all the best,

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Not all accounts managed by 5T WEALTH MANAGEMENT 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 5T WEALTH MANAGEMENT as a portfolio manager. Paul Krsek and Lee O'Dwyer frequently discuss investment ideas, model portfolio strategies and the investment policies of 5T WEALTH MANAGEMENT. But when it comes to the implementation of those polices 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 5T WEALTH MANAGEMENT.

From time to time 5T WEALTH MANAGEMENT receives requests from clients to purchase securities that are not included in the model portfolio to which they are assigned. Effective May 24, 2006, 5T WEALTH MANAGEMENT has encouraged clients to hold such securities in a separate account for the client. Because 5T WEALTH MANAGEMENT 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.

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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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