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Investment Strategy

Roger Redux?!

"Who framed Roger Rabbit?!" . . . except in this case we are referring to Roger Blough. Return with us now to those thrilling days of yesteryear. The year was 1962, John Kennedy was President, and Roger Blough, the then CEO of U.S. Steel, had signed an agreement with President Kennedy not to raise prices. However, just four days later he raised steel prices right in President Kennedy's "face." The outraged President went after Mr. Blough and when Roger Blough tried to argue his point, Jack Kennedy stated, "My father told me that all steel men are *#@Q&%*!" The battle lines were thus drawn; government contacts were switched from U.S. Steel in favor of steel companies that didn't raise prices, and with that governmental incursion into corporate America, the D-J Industrial Average (DJIA) shed 26% in just six weeks. Fast forward to today. The major banks have paid outsized bonuses right in the "face" of President Obama; and, it appears he has gone after them. Accordingly, the stock market has gone into the dumper, as can be seen in the attendant chart (for the record, I am neither a Republican nor Democrat; so stated before I get another onslaught of hate mail). Whether the 1962 analogy continues to "fit" remains to be seen, but it is a very interesting comparison that participants should ponder since we continue to believe the markets are in "selling stampede" mode.

Recall that "selling stampedes" tend to last 17 – 25 sessions, with only one- to three-session counter-trend rallies, before they exhaust themselves on the downside. It just seems to be the rhythm of the "thing" in that it appears to take that long before everybody gets bearish enough to jettison their stocks and make a decent tradable low. While it's true some stampedes have lasted 25 – 30 sessions, it is rare to have one extend for more than 30 sessions. Therefore, we "put blinders on" to last Friday's late-day upside reversal, consistent with our mantra of "never on a Friday." That mantra was learned from numerous Friday "head fakes" implying that markets rarely bottom on a Friday once they are into a downtrend. Rather, participants tend to go home over the weekend, brood about their losses, and show up the following week in "sell mode." So, while the markets may attempt to build on Friday's late reversal, we have little confidence that any rally will last more than one to three sessions since today is only session 14 from the trading top of January 19th. That said, the equity markets are pretty oversold; and, our proprietary indicators do indeed suggest that a rally attempt is due.

Last Friday's reversal was likely driven by the fact that the various averages have corrected approximately 10% since history shows that in the first year of a "bull move" it is rare to see much more than a 10% correction. Consequently, the psychology of an underinvested portfolio manager goes like this: "The typical bull market lasts three to five years, so any correction is for buying." While we certainly hope that is the way it plays, we remain suspect this is the first leg of a new secular bull market. Rather, we think it is just another "bull move" within the context of the range-bound stock market we have been mired in for the last 10 years. Another driver of Friday's reversal could have been the "break" below 10,000 on the DJIA, which is also a psychological support level that should be respected. Then too, the White House's statement that the Healthcare Bill is probably "dead" may have triggered a positive response from the equity markets. Nevertheless, we doubt the political maneuvering is over on healthcare. However, the loss of political momentum inside the Beltway is amazing and potentially worrisome for the markets.

Be that as it may, many of the exchange-traded funds (ETFs) we monitor tested, and held, their respective 200-day moving averages (DMAs) last week, which could be yet another reason for a rally attempt. For example, look at the financials, as represented by the Financial Select Sector SPDR ETF (XLF/$13.94) that tested (and held) its 200-DMA, giving hope to investors in this complex. Another ETF we monitor, in an attempt to glean an edge, is the Market Vectors-RVE Hard Asset Producers (HAP/$30.78). Hereto, after plunging from its mid-January price peak, it tested (and held) its 200-DMA last week. Interestingly, many of the "hard asset" names, particularly some of the precious metals stocks, showed upside reversals on Friday. However, while we continue to like "stuff stocks" for the long-term (energy, timber, cement, water, precious/base metals, agriculture, etc.), we have been, and remain, cautious on them coming into the new year, fearful the dollar carry-trade was unwinding and that a whiff of deflation might be in the air. Ergo, on January 19th we wrote:

"Then there is 'Dr. Copper,' the metal with a Ph.D. in economics, which recently recorded a 12-month rolling rate of return in excess of 150%. Historically such a 'copper cropper' has marked a 'trading top' in copper and telegraphed caution for the equity markets."

More recently, in our verbal strategy comments, we have referenced the gold to silver ratio (the gold price divided by the silver price; currently ~71 to 1) by noting when that ratio has "spiked" like it has recently, it too has suggested caution. All said, we remain

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cautious until there are convincing signs that a bottom is in place for both stocks and commodities. We do believe, however, once this correction runs its course, the major averages will trade to new reaction highs. Inasmuch, we continue to monitor stocks for the investment account. In past missives we have mentioned a number of potential purchase candidates, most of which have actually declined over the past few weeks. That does not mean we have given up on them! Indeed, most of them remain on our "watch list." And, last week we added a few more when North American Energy Partners (NOA/$8.62/Strong Buy) reported a very strong earnings number. Subsequently, our Canadian analyst (Ben Cherniavsky) raised his estimates, as well as his price target, on the company's shares. NOA is a leading provider of earth-moving equipment, infrastructure, and construction services mainly in the Alberta Tar Sands area. As we understand the story, NOA has the largest fleet of Caterpillar equipment in Canada and is therefore the "swing provider" to the now improving Alberta Sands projects. For further information see Ben's recent report.

Another stock we added to our "watch list" is Cenovus Energy (CVE/$23.70/Outperform), which is also followed by Canadian research team with an Outperform rating. CVE was created when EnCana (ECA/$30.45/Outperform) split itself into two companies. Our analyst Justin Bouchard notes that CVE holds some of the best "in situ" leases in the Alberta Tar Sands with roughly 40 billion barrels in place. With solid capital efficiencies, and a technological leader, CVE expects to add incremental oil sands production at a capital efficiency of approximately $20,000 per flowing barrel, the lowest in the industry. At an attractive valuation, and with self-funding growth, we find CVE interesting. Hereto, for further information see Justin's reports.

The third name we added to our list was Walter Energy (WLT/$67.54/Outperform), which is followed by Jim Rollyson and our Houston-based energy team. As one of the leading exporters of metallurgical coal, as well as a producer of steam coal, coal bed methane gas, metallurgical coke, and other related products, Walter should do well as demand from the emerging/frontier markets continues to ramp.

The call for this week: Economist, historian, and savvy seer Eliot Janeway stated decades ago, "When the White House is in trouble, the markets are in trouble!" Plainly, we agree and would add that the January Barometer has registered a cautionary signal, as has Lucien Hooper's December Low indicator. That said, Friday's turnaround, accompanied by pretty oversold readings, should lead to some sort of one- to three-session rally attempt. To that point, the NASDAQ 100 (NDX/1746.12) was "up" last week (+0.29%), as was Info Tech (+0.72%), Materials (+0.83%), and Natural Gas (+6.7%); so they may lead the "bounce." Luckily, we have investments in all of these complexes. However, at session 14, in the envisioned 17- to 25-session "selling stampede, we remain cautious.

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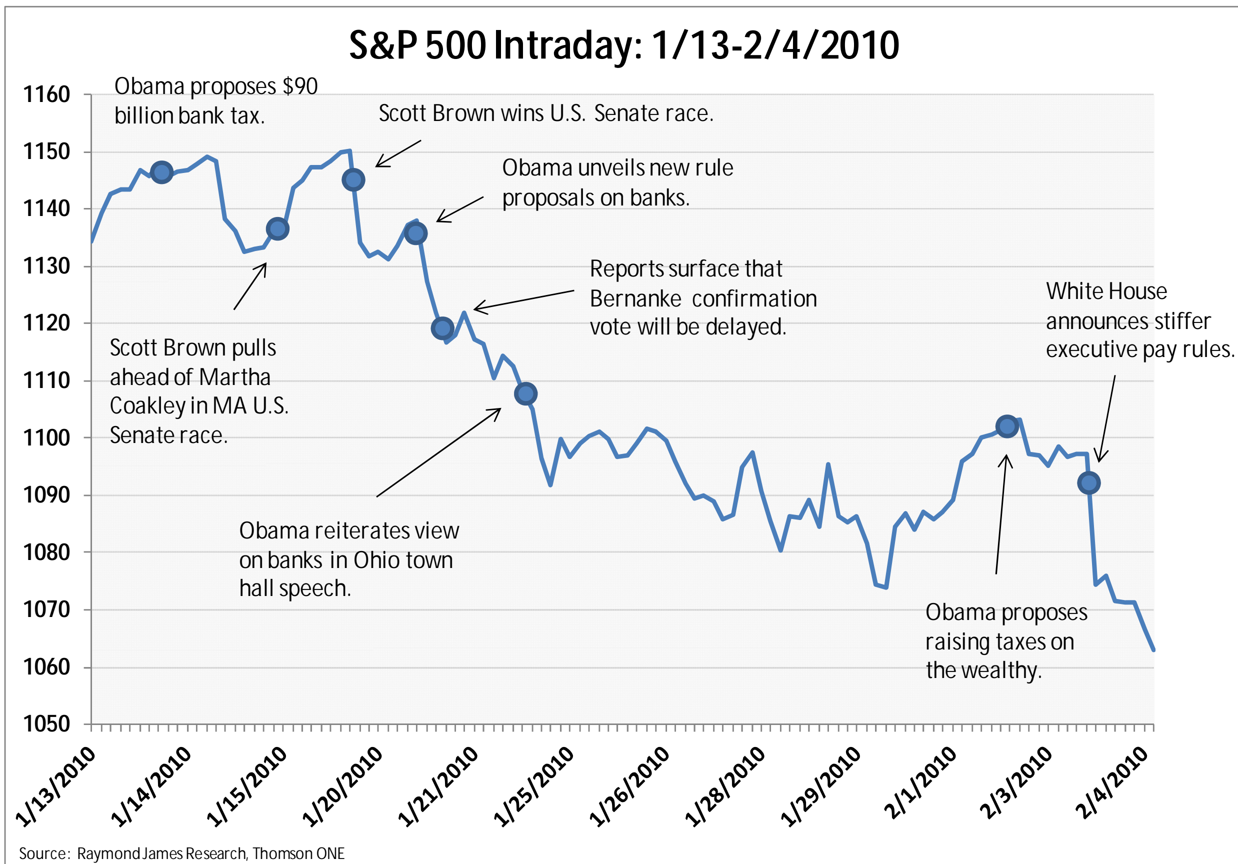

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