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Investment Strategy: Revised

"She's Got Legs"

"She's got legs, she knows how to use them," the year was 1990 and the group – ZZ Top; except in this case I am not talking about the hit song, but rather the stock market for after a somewhat "kiss your sister" type session the Dow put "legs on" to the upside late last Friday. "She's got legs" indeed for the session may have locked up the lows, at least on a short-term basis. To be sure, the sequence was about right following the crashette of May 6th at ~1066 based on the S&P 500 (SPX/1087.69). Recall after that "flash crash" we got the perfunctory 1 – 3 session stabilization/bounce followed by the downside retest of that ~1066 intraday low. As stated, sometimes said low is marginally violated, but most of the time it is not. Obviously, the SPX's May 6th low was violated last week by Friday's intraday low of 1055.90.

Accompanying that low, however, were some pretty amazing statistics. For example, according to my friends at Bespoke Investment Group, as scribed last Thursday:

"The S&P 500 and all ten sectors are in extremely oversold territory. We recommend getting long here regardless of your long-term view of the market. Only 6% of S&P 500 stocks are trading above their 50-day moving averages. Only one percent of the Financial sector stocks are above their 50-DMAs, while not one single Energy stock is above its 50-DMA. (Moreover) The S&P 500 is currently three standard deviations below its 50-DMA. We believe the February lows will hold, and this market will bounce back, at least to its 50-DMA (currently at 1170.89) over the next month or so. At times like these, it may seem like it is more risky to get long than it is to get short, but history has shown that the exact opposite is true."

Well said, Bespoke; and I would add, at Friday's lows the SPX was an eye-popping 9.8% below its 50-DMA. Ladies and gentlemen, history suggests that betting on the downside when the SPX is more than 6% below its 50-DMA is a bad bet! And then on Friday there was this from Jason Goepfert's brilliant website (sentimentrader.com):

1) This is only the 6th time in history the S&P 500 futures have declined 5 days in a row and then gapped down (by) at least -1%. All five of the others closed above the opening price.
2) The total put/call ratio is poised to close at its 4th-highest level since modern reporting began in 1995. The other 3 were all clustered in late February, early March, of 2007 (right before a 12% rally).
3) The Up Issues Ratio is so low, at just under 4%, that only two other days since 1950 can match this bad breadth. They were 9/26/55 and 10/19/87 (the crash), after which we saw vicious short-term bounces.

Of course all of this comes after Jason's observation of May 7th (as paraphrased by me):

On Friday (May 7th) the ratio adjusted McClellan Oscillator dipped to an historic reading of -120, the 2nd-most oversold in more than 20 years. Let's go back to 1940 and look for any other time the Oscillator hit this level of oversold while in a bull market (defined as a rising 200-day moving average on the S&P 500) and see how the S&P performed going forward.

Jason then presents a table of the other five instances when the Oscillator has registered such oversold readings. One week later the S&P was, on average, 1.9% lower; while one month later, it was only 0.5% lower. However, after three months it was, on average, 4.2% higher; and, six month later its average gain was 6.9%. Accordingly, I have been advising accounts to sell the remaining downside hedge positions, as well as the "bets" on increased volatility, that were repeatedly recommended in these missives during the entire month of April, punctuated with the strategy report titled "Don't Wait for May To Go Away."

Yet despite Friday's Fling, the German Gotcha, the Euro's demise, the Grecian riots, the Gulf of Mexico mess, etc., by far the most controversial "thing" of the week, in fact I have never received so many questions, was Richard Russell's statement to "Get out of stocks and get into cash or gold." I have read Dick Russell since 1973 and have always found him to be the best keeper of Dow Theory. In fact, he is the only pundit who interprets Dow Theory the way I was taught. Like me, Richard correctly saw the Dow Theory "sell signal" in September 1999. Likewise, he wrote about the "buy signal" of June 2003, as well as the "sell signal" of November 2007. Then there was the Dow Theory "buy signal" of July 2009, which he identified, but pretty much ignored. Therefore

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when Dick Russell speaks, I listen. Still, a unilateral statement like – "Get out of stocks and get into cash or gold" – is reckless (in my opinion) even if it turns out to be right.

Indeed, since the mid-1970s, I have voiced the mantra, "There is ALWAYS a bull market somewhere and it is my job to try and find it." For example, even in the vicious bear market of 1973 – 1974, where the DJIA lost nearly 50% of its value, there were stocks that went up. That said, by my method of interpreting Dow Theory, there was a "sell signal" last week when the DJIA broke below its May 7th closing price of 10380.43 confirmed with a similar break by the Transports below their May 7th close of 4298.12. If past is prelude, however, so much energy has been expended in registering the signal typically the market rallies on said signal, especially given the aforementioned oversold metrics. While some modern-day Dow Theorists opine there has been no "sell signal," because there wasn't enough time between May 7th and the May 20th breakdown, I was not taught to view Dow Theory that way. Hence, if a rally develops, I will be watching the stock market's "internals" for signs of the rally's health. My "lens" will be indicators like Buying Power and Selling Pressure, Advance/Decline Lines, New Highs versus New Lows, on-balance volume, etc. as I think the strategy will be pruning weaker stocks from portfolios and becoming more defensive. The *quid pro quo* is, for last week's Dow Theory "sell signal" to be reversed requires the Industrials to close above 11205.03 confirmed by the Transports close above 4806.01 (IMO).

Speaking to "there is always a bull market somewhere," I was on CNBC last week with a particularly bright fellow. Todd Schoenberger, of LandColt Trading, talked about crude oil as being the world's future currency. Manifestly, I agree for a multiplicity of reasons and would note the disaster in the Gulf of Mexico pretty much assures the value of Alberta's Tar Sands, which is the second largest crude oil deposit on the plant. While there are a number of ways to invest in the Oil Sands, two of my favorites continue to be Cenovus Energy (CVE/$25.49/Outperform) and North American Energy Partners (NOA/$8.79/Strong Buy), both of which are followed by our Canadian-based energy analysts.

The call for this week: Last week the nearby crude oil contract went off the boards at its lowest price since September 2009. Similarly, the Commitment of Traders Report shows the lowest commitment to crude oil since, you guessed it, September 2009. The result has left West Texas Intermediate (WTI) crude prices below Brent Crude, which seldom happens. I think the concurrent contango is the temporary result of bloated inventories at the Cushing oil hub in Oklahoma that will be resolved in the months ahead with higher prices. Our favorite domestic names are: Concho Resources (CXO/$48.00/Strong Buy), Pioneer Natural (PXD/$59.45/Strong Buy), Whiting Petroleum (WLL/$75.93/Strong Buy), and Chevron (CVX/$74.48/Strong Buy). Meanwhile, the SPX marginally violated its intraday low of May 6th (~1066) last Friday, but the DJIA did not. Indeed, the Dow's May 6th intraday low was 9869.62, while its low last Friday was 9918.82. Given the extreme oversold condition, I thought that might be viewed as a downside non-confirmation and allow the equity markets to build on Friday's upside reversal. But, this morning it just isn't playing that way with futures off another 10-points, causing me to hope the February 2010 lows at 1045 will hold.

P.S. – "*The more corrupt the state, the more it legislates*" . . . Tacitus, 110 A.D.

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