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Investment Strategy

"Be Water, My Friend!"

"Empty your mind; be formless, shapeless – like water. Now you can put water into a cup, it becomes the cup, you can put water into a bottle, it becomes the bottle, you can put water into a teapot, and it becomes the teapot. Water can flow or it can crash. Be water, my friend."

. . . Bruce Lee

While Bruce Lee's quote obviously pertains to the martial arts, it is also appropriate for the financial markets. To be sure, in the markets investors need to be adaptable and have the ability to adjust to the environment. You must be flexible; or, as the old sailor's axiom states – you can't change the direction of the wind, but you can adjust the sails. And clearly the stock market's "winds" have been in a downdraft with the month of May going into the record books as the worst May for the S&P 500 (SPX/1089.41) since 1962. Granted, the May Melt could have been worse if the SPX had stayed at last Tuesday's low of 1040.78, but as stated in that morning's strategy comments – most of my oversold indicators are about as compressed as they ever get. My friends at the invaluable Bespoke Investment Group put it this way, "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."

Subsequently, the SPX experienced a ~6% rally that took it back to its still upward sloping 200-day moving average (DMA). Most technical analysts would note the 200-DMA is a natural place to expect some sort of consolidation and/or pullback, and that's exactly what we got last Friday. The media's *causa proxima* for Friday's Fade was Fitch's downgrade of Spain's sovereign debt. When I was asked about that on CNBC last Friday I opined the markets should not be all that surprised by said downgrade; and, I really don't understand why anybody pays much attention to the rating agencies given their abysmal track record. CNBC's always insightful Bob Pisani "called" me on that comment and suggested that while he tended to agree, participants should pay attention to the rating agencies. Still, in my opinion, Fitch's downgrade was a joke because everybody knows going down only one notch on Spain's rating, from AAA rating to AA+, is not sufficient. Here's the text from Fitch's own website as to what an AA rating means:

"AA ratings denote expectations of very low default risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events."

Observe that an "AA" rating isn't as good as an "AA+" rating. Also observe the statement "very strong capacity for payment of financial commitments." And if you don't believe me, watch this: http://www.abc.net.au/news/video/2010/05/20/2905304.htm

This week, however, the markets will have to deal with another disappointment as BP's (BP/$42.95/Market Perform) top-kill operation failed to stop the tragedy in the Gulf. While horrific, I continue to think this tragedy assures the viability of Alberta's Athabasca oil sands deposit. Canada is a stable country and the oil sands require no drilling. Indeed, the Athabasca deposit is 54,000 square miles of oil-soaked earth believed to contain roughly 1.7 trillion barrels of oil. Even without the Gulf catastrophe, the oilsand metrics were improving with higher oil prices, lower natural gas prices, and low light-to-heavy crude oil differentials all contributing to a more constructive environment. While our Canadian-based energy analyst (Justin Bouchard) follows numerous oil sands companies, my favorite in his coverage list continues to be 3%-yielding Cenovus (CVE/$26.94/Outperform). Cenovus should provide more information on its development plans at this month's Investor Day on June 17th. As well, I continue to like North American Energy Partners (NOA/$9.75), which is also followed by our Canadian analysts with a Strong Buy rating.

As for the Bruce Lee quote – "Be water, my friend" – one of my long-standing themes has been water. Indeed, for decades I have argued that water is the ultimate resource. Currently, water usage is rising at twice the rate of worldwide population growth. Moreover, a third of the Earth's population lives in water-stressed countries. Given urbanization, agriculture, industrialization, and the growing population, demand for clean water going forward should grow at an alarming rate. Yet, the supply of clean water remains relatively static. I was reminded of the current water situation by Minyanville's must-have "Buzz and Banter" again last week. The blog was posted by Professor Ryan Krueger. To wit, "I've said for the past several years that water is the most uninvestable sure thing of my career. There is nothing I'm more convinced of as a natural resource whose value is higher than we currently price it. But that does not mean it is easy to find stocks to benefit from that theme." And with that statement, I take exception because over the years investors in water stocks have made huge amounts of money. In fact, I wrote a 100-page industry

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report on water in 1989 that contained 20 individual stock recommendations. Most of those companies have been acquired by the GE's of the world.

There are a number of funds that play to the water theme. Three of them are First Trust ISE Water Index Fund (FIW/$18.65), Claymore S&P Global Water Index ETF (CGW/$16.66), and PowerShares Water Resources Portfolio (PHO/$16.27). According to "Seeking Alpha":

> "All three funds provide diversified exposure to the water industry, but with important differences. The most obvious is geography: the First Trust (FIW) and PowerShares (PHO) funds are U.S.-focused funds, while the Claymore (CGW) fund has a major global tilt: the U.S. may have the largest single country weight in the index (28%), but it's followed closely by France (20%), Japan (16%) and the UK (14%). The rest of the fund is divided among 11 other countries."

There is, however, another PowerShares ETF that is water centric. PowerShares Global Water Portfolio (PIO/$16.57) is based on the Palisades Global Water Index and its modified equal-weighted portfolio is re-balanced and reconstituted quarterly. For individual water stock ideas all one needs to do is look at the stocks in the portfolios of these funds.

The call for this week: Bruce Lee also remarked, "Notice that the stiffest tree is most easily cracked, while the bamboo, or willow, survives by bending with the wind." Clearly, we "bent with the wind" during the May Mauling by recommending selling the downside hedge positions that were layered into portfolios during April's stock market rise. The question now becomes – will the Dow Theory "sell signal," registered in that mauling, be reversed? By my pencil that would require a closing price by the D-J Industrials above 11205.03 with a confirmation from the Transports above 4806.01. This week should be key in starting to answer that question since a move above the DJIA's 200-DMA (10282.07) implies the recent bounce off of the key support levels suggests a sustainable "low" might be in place. However, if those February 8th lows of 9908.39 (DJIA), and 3792.89 (Transports) are broken, it would reinforce the Dow Theory "sell signal" of May 20th. Accordingly, I am cautious on the major averages, bullish on crude oil and natural gas, and bearish on Treasury bonds/notes. Yet, I am short-term bullish on the euro around the 120 level, as well as bullish on the Canadian Dollar. Unfortunately, I will not be around to see how things turn out since I am leaving the country for the next two weeks. In my absence I counsel for caution, believing the best strategy is now defense (rather than offense) until the "sell signal" is reversed. Be careful out there . . .

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