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Investment Strategy

Selling Stampede?

> "The World MSCI has now fallen for six consecutive days and shed -5.6% in the process. Over the same period, 1-month T-bill yields have fallen into negative territory and the US$ index has broken back above its 200-day moving average (an upside breakout not seen since August 2008). This combination of events has undeniably re-hashed a lot of bad memories for some clients. As an old friend put it: 'The last time I saw the MSCI fall for six days with no rally, UST yields in negative territory and the US$ shoot up simultaneously was in August 2008 . . . and I didn't like the rest of the movie!' Just like in the summer of 2008, the fear of a debt crisis is at the centre of the current shakedown. Back then, it was of course Lehman. And today, it is obviously Greece."
>
> . . . GaveKal (1/28/10)

It should be noted, however, that in the summer of 2008 the leverage in the financial system was far greater than it is today; and, the derivative "spider web" that had been knitted into balance sheets was legend. As the brainy GaveKal folks observe, "Almost every financial market participant is now operating with far less leverage and there are risk managers looming behind every equity and bond trader." Accordingly, we think the odds of another post-Lehman type of meltdown are *de minimis*. Further, we believe the decline that began on January 20th is merely the normal correction everybody has been looking for since July. Buttressing that view is the fact the advance/decline line is firm (read: the breadth is still good), the number of new annual lows on the NYSE is not expanding, the yield curve remains steep, none of our proprietary intermediate indicators have rendered a "sell signal," and the list goes on. All of this suggests the cyclical bull-market is still intact and stock prices should find support at, or above, the 200-day moving average (DMA), which is currently at approximately 1013 basis the S&P 500 (SPX/1073.87). Moreover, readers of these missives should not have been surprised by the recent stock slide.

Indeed, we have repeatedly written about how the first few weeks of the new year are littered with examples of "head fakes," both on the upside and the downside. As well, history shows early January is also littered with "trading tops." Therefore, we counseled for caution upon entering 2010 and we have the hate mail to prove it. Additionally, the 2003/2004 template we have been using since May of 2009 also hinted that a stock market decline should be expected. Recall, the SPX bottomed in March 2003 and rallied. The first leg of that rally peaked in late-May/early-June. From there, stocks flopped/chopped around, but never really gave back much ground. Then stage 2 of the rally began, which carried stocks higher into January 2004. The first leg of that 2003/2004 rally was driven by liquidity, while the second leg was spurred by improving earnings and fundamentals. If that sounds familiar, it should, because that is pretty much the sequence we have seen since the March 2009 "lows." If that pattern continues to play, it calls for roughly a 10% correction and then a resumption of the rally.

To be sure, we have (and continue) to opine that with credit spreads back to pre-Lehman bankruptcy levels, and improving fundamentals, there is no reason the SPX should not "fill" the downside vacuum created in the charts by said bankruptcy. As often stated, that gives the SPX an upside target of 1200 – 1250. Hence, while we hedged some long stock positions for a correction, and recommended cash in trading accounts, we continue to favor the strategy of holding fundamentally sound, long-term investment positions and adding to such positions when signs of a bottom develop. The question then becomes, "What type of stocks should be accumulated?" If global growth remains strong, deep cyclics, transports, materials, energy, etc. are likely the stocks of choice. If, however, the central banks begin providing less liquidity, or the U.S. dollar continues to strengthen (the Dollar Index broke above its 200-DMA last week), or China continues its monetary tightening cycle, then overweighting technology, healthcare, consumer staples, and select emerging/frontier markets is the preferred strategy. Since we are currently in "cautionary mode," we are opting for the latter sectors.

Speaking to the strong economy point, Friday's headline GDP figure of +5.7% was met with a Dow Delight that rallied the senior index 120 points within the first hour of trading. From there, however, stocks slid into the close, leaving the DJIA down 53 points for the session, and off some 6% since the decline began. The reason for Friday's fade was likely in the details of the GDP report. As our economist, Dr. Scott Brown, wrote early Friday morning:

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> "Real GDP rose at a 5.7% annual rate in the advance estimate for 4Q09 (median forecast: +4.7%), boosted largely by inventories. A slower pace of inventory reduction added 3.39 percentage points to the headline GDP figure. Real Final Sales (GDP less inventories) rose 2.2%, better than expected (median forecast: 1.6%). Domestic Final Sales (GDP less inventories and net exports), the best measure of underlying domestic demand, rose at a 1.7% annual rate (about as expected). The bottom line is that it was a stronger than expected headline figure, but underlying domestic demand was relatively lackluster, consistent with a gradual economic recovery. Equity futures are higher, but the enthusiasm may not last as market participants sift through the details."

Clearly, Scott's – "Enthusiasm may not last as market participants sift through the details" – was an excellent observation! Yet while economic figures come and go, the real question for us remains, "Is this a rally within the ongoing trading range we have been mired in for the last 10 years, or are we in a new secular bull market?" Plainly, we would like to believe it is a new secular bull market. However, if we are going to err, we will err on the side of conservatism, leaving us with, "Only a rally within the context of a range-bound stock market." Of course if we are wrong, accounts will still stand to benefit handsomely. If we are right, we should continue to accrue the type of portfolio returns, based on our range-bound strategy, that have afforded accounts respectable risk-adjusted results.

In last week's letter we suggested the stock market's recent decline has given us the ability to see which RJ&A research universe stocks have resisted the overall price decline the best (read: good relative strength). That list can be retrieved from you financial advisor. This morning, we offer you another name from one of our research correspondents, which is favorably rated. To wit, biotech leader Celgene (CELG/$56.78). Celgene is in year three of its rollout and has the fastest launch of a hematology product ever, which should exceed $2 billion this year. For the first time ever, three trials have been halted in less than a year due to hitting their "end points" and this should lead to higher sales. A real key for the story is March 4th, which is the company's first R&D day in years, where it will review the 20 phase three trials. This is the fastest growing EPS story in the S&P 500. The company's patent projection is solid. Its internal goal is for 25-30% earnings growth. Celgene appears unique since it owns its drugs, it has no debt, $3 billion in cash, gross margins exceed 90%, and it has hidden assets. For example, Celgene's production plant in Switzerland was opened last year and the Swiss gave the company a ZERO percent tax rate for a decade. So to a major drug company, this could represent something else that would have it look at Celgene, which we think is the last of the true growth major biotechs as its patent protection on Revlimid goes until 2026. If Celgene gets another drug, and it has those shots on goal, it could become bigger than Amgen (AMGN/$58.48) in market capitalization.

The call for this week: Potentially, today is session 9 of a selling-stampede, which has often been chronicled in these reports. Recall that such stampedes tend to last 17 to 25 sessions, with only one- to three-session counter-trend rallies, before they exhaust themselves on the downside. The January "stock sprawl" has left all of the averages we follow down year-to-date, as well as below their respective December "lows," thus evoking Lucien Hooper's warning, "If the December low is violated any time in the first quarter of the new year, watch out!" Accordingly, we remain cautious.

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