

## “Bear Trap”

StockCharts.com defines a Bear Trap as, “A situation that occurs when stock prices break below a significant level and generate a sell signal, but then reverse course and negate the sell signal.”

While that’s the formal definition, I have often referred to “Bear Traps” as “Undercut Lows.” The biggest one in recent history occurred on October 4, 2011. Hence, on October 10, 2011, I wrote:

“An ‘Undercut Low’ is when a much watched level, like the panic low of early August (1101.54 basis the S&P 500), is violated on the downside just enough to get everyone really bearish and cause them to sell out their portfolios. Subsequently, the indices turn up and rally, ‘locking in’ a low. And, that was our bet last Tuesday (October 4, 2011) when in that morning’s verbal strategy comments we recommended buying the index of your choice on the belief we were going to experience an ‘Undercut Low’.”

I revisit the “Undercut Low” thesis today because it appears that is precisely what happened last Monday afternoon when the S&P 500 (SPX/1265.35) knifed through its previous reaction low of 1209.47. That breakdown caused the esteemed Lowry’s Research Organization to write:

“Since the December 7th high, Buying Power has lost 21 points versus a gain of 12 points in Selling Pressure. The end result of this lack of Demand has been a decline that apparently completed a topping pattern with yesterday’s decline [12-19-11]. The lack of buying, thus far, suggests lower prices are likely needed to generate enough Demand for anything more than a very brief rebound rally. And, with no areas of identifiable Demand above the November 25th low, the most likely near term path for the market is to test that November low [1158.67]. Since 90% Down Days can be followed by rebound rallies, a move higher over the next couple of days cannot be ruled out. But, unless strong Demand suddenly reappears – and there seems to be little reason at present to expect this to happen – any rebound will likely be short-lived and of interest only to the most nimble traders.”

To be sure, last Monday’s Dow Downer (-100.13) proved to be just a near 90% Downside Day, meaning that while 90% plus of Total Volume traded came in on the downside, only 89.95% of Total Points lost came “in” on the downside for a “miss” of 0.05%. Interestingly, as the good folks at Lowry’s noted, last Monday’s near 90% Downside Day was indeed followed by a rally – and a really big one (DJIA +337 points). That surge also turned out to be a 96% session, except this time it was an Upside Day as the string of 100 plus point days continued. Amazingly, year to date, there have now been 52 hundred point or greater Upside Days and 49 hundred point or more Downside Days. Such action caused Jim Grant to write, “In the entire history of the S&P 500, there has never been a day when all 500 stocks in the index go up or all 500 go down. There have been 11 days when 490-plus stocks all moved in the same direction on a given day. Of those 11 instances, six have occurred since July 2011.” Unfortunately, we expect the volatility to continue in 2012.

Speaking to 2012, I remain steadfast in the belief there will be no recession, nor will Euroquake pull us into one. I also embrace the theme that the nation is moving in the direction of energy self-sufficiency and that an American manufacturing renaissance is taking place. Moreover, there appears to be the hint of a housing recovery, as well as a technology revolution. Combine these beliefs with the demographics of a baby boom echo, which should foster a new cadre of investors, and I think the SPX will have a mid- to high-single-digit return in 2012. If you layer in a 3-4% dividend yield on top of said return, the allure of equities becomes pretty compelling.

As for themes, technology is at the core of several of our themes. Indeed, I think we are on the cusp of some substantial technological changes that will act as an economic propellant. Much smarter mobile devices is one such theme. I also like the idea of “Fast Data” as the software industry is commencing a revolution in database and application software. Similarly, investing in automation (read: technology) should also have favorable tailwinds in the new year. Additionally, there should be a tidal wave of mergers and acquisitions (M&A) in the energy space as big oil’s free cash flow spurs M&A activity. Specifically, we think the MLPs, which trade at EBITDA multiples of between 8x and 9x, will acquire E&P “C-corporations” that trade for under 5x EBITDA (read: accretive acquisitions). Then there is health care, where innovators should enjoy pricing power; and while not per se an innovator, our analysts’ long standing recommendation on CVS (CVS/\$40.99/Outperform) has finally paid off as the shares challenged the all-

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time highs last week. That caused our health care team to write, "CVS remains well positioned to benefit from the market disruption driven by the Walgreen (WAG/\$35.34/Market Perform)/Express Scripts (ESRX/\$45.25/Outperform) dispute and the pending acquisition of Medco (MHS/\$56.10/Market Perform) by Express Scripts. Selling-season momentum continues with the company adding \$2 billion in net new business since last quarter's update bringing the total to \$6.8 billion. CVS' 2012 EPS guidance of \$3.15-3.25 does not include any benefit from increased foot traffic associated with the Walgreen/Express Scripts dispute, which could add \$0.08-0.11 per share."

In conclusion, I leave with this advice from Jeremy Grantham for 2012:

"Avoid low quality U.S. stocks, but otherwise have a near normal weighting in global equities. Tilt, where possible, to safety. Try to avoid duration risk in bonds. For the long term they are desperately unattractive. Don't be too proud (or short-term greedy) to have substantial cash reserves. Admittedly, this is a point where we at GMO try to be clever and do a little better than the minus 1% real [return] on cash – and, so far, with decent success. I like (personally) resource in the ground on a 10-year horizon, but I am nibbling very slowly because, as per my Quarterly Letter on resources in April 2011, I fear a major short-term decline in commodities based on a combination of less bad weather – which has been bad, but indeed less bad – and economic weakness, especially in China. Prices have declined, often substantially, since that letter. However, I believe chances for further price declines in resources are still better than 50/50 as China and the world slow down for a while, and the weather becomes a bit more stable."

**The call for today:** I closed last Monday's strategy letter by stating, "I think the SPX made its low last week at 1209.47. I also believe the Dollar Index made its high last week because I think Mr. Bernanke wants a lower U.S. dollar. If those thoughts prove correct, the CRB Commodity Index has likely made a double bottom in the charts and crude oil should be headed higher." While the 1209.47 level was violated last Monday afternoon, and because I eat my own cooking that breakdown caused me to raise some more cash, I still had a 3%+ gain for accounts in Tuesday's Dow Delight. As well, the other insights of higher oil, higher CRB, and lower U.S. dollar proved generally correct. Furthermore, last week's Dow Wow (+3.61%) lifted the DJIA (INDU/12294.00) substantially above its 200-day moving average (11938.02). That surge broke the senior index out above a spread triple-top, bringing into view its next level of overhead resistance between 12720 and 12808, which could happen this week since over the past 83 years (since 1928) the last week of the year has been "up" 77% of the time.

P.S. – I am exhausted from my travels and this year's volatility, so I am giving myself the rest of the week off. Subsequently, there will be no verbal strategy comments for the week . . .

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