

My Two Cents – Time to Sell the Rallies

My intent today is to zero in on what I believe are the most important fundamental and technical investment points, update you on a few market and investor sentiment charts, and share with you my two cents as to why I believe it is time to “Sell the Rallies”. I have sent out a series of emails since the crisis began encouraging an investment game plan. You can find them on our web site under the [Market Commentary](#) tab.

[December 23, 2008: You Will Get The Chance](#)

“Be Patient, you’ll get that chance”. I simply felt that history has shown that post crash reversion recovery bounces are attractive and would allow for an exit at much better levels – expect a 50% to 60% rally from the market bottom. And added, “This is a “you’ll get that chance” to exit higher rally. Don’t get greedy, have a plan and commit to execute that plan.”

[June 18, 2009 Update: Watch Out For The Next Left Hook!](#)

Post crash market recoveries gain 50% to 60%. It is about supply and demand and investor psychology. The S&P 500 index was at 900 and I felt we would see 1000 and 1100 in fairly short order, but this would be the time to be careful.

[September 25, 2009 Update: "Sell when everyone else is buying."](#)

Sir John Templeton’s sage advice.

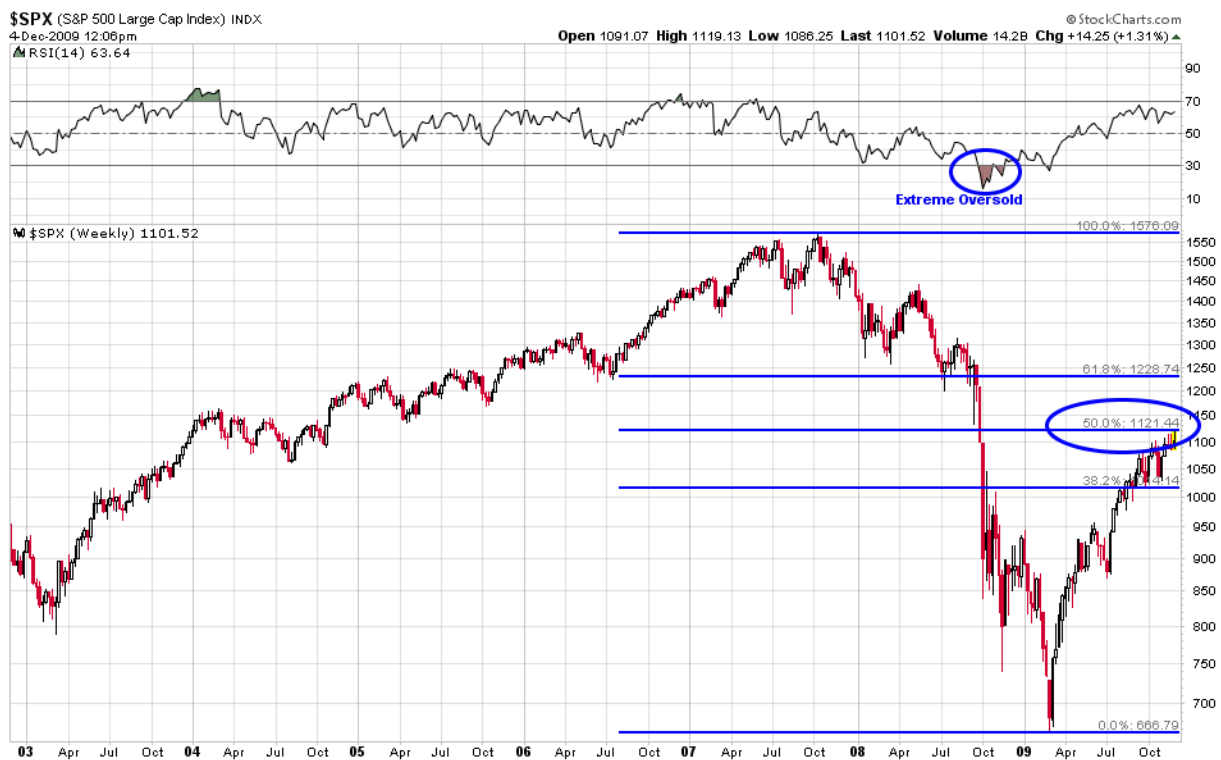
I suggested that there would come a time when it would be difficult to exit the stock market, for all would feel safe again, and to have a plan in place and be prepared to act on that plan. Today I believe it is time to act. The following is how I see the investment landscape today.

A very bright financial advisor said to me recently that he is advising his clients that the bad news ahead is that we have 7-10 years of low to no equity returns ahead of us but the good news is that we are half-way there with 10 years of no returns behind us. Could he be right?

We have witnessed one of the most explosive equity market rallies since the 1930's, both in terms of percentage gain and time frame. A rare market environment. Can one expect it to continue? Let’s look at it from a probability point of view. What are some of the smartest fundamental minds in the business saying? To read the full report, click on the link at the top or the attachment. Also included is the most recent NDR Crowd Sentiment Poll chart (hint - it is in the "bearish" zone).

The fundamental picture:

Valuations are high at 26 times earnings. This puts fair value in the S&P 500 Index at approximately 850. A +1% standard deviation move to the upside puts the S&P at 1130. Today, December 4, 2009 the market stands at 1100 (after hitting an intraday high of 1119 – a 50% retracement from the S&P 500 high of 1575 to the low of 666 – see chart below). A -1% standard deviation move puts the S&P at 550. Simply, we are at the very high end of the valuation range with a lot of problems tied to many years of excess. How can we possibly grow earnings at a rate that can support current prices? Yes, the market could push higher on continued low volume to 1200. But is the extra 10% worth the roughly 25% downside risk back to 850 (fair value) or the 50% downside risk to 550? Seems to me to make more sense to sell at the high end of the valuation range and buy at the low end of the valuation range; or at the very least at fair value.



Note: Investors lost 57.7% from 1576 to the 666 low. They have gained 68% back from the low. One still needs to make another 43% from here to get back to the high. So the basic question is, can we drive earnings quickly enough to justify the current high valuations? Let's take a look.

The consumer drives two thirds of the economy. The consumer is retrenched and focused on paying down debt and saving, not spending.

As John Mauldin recently reported in his November 13, 2009 newsletter, "If this is Recovery..." (<http://www.2000wave.com/article.asp?id=mwo111309>)

"There is a very revealing study by the Pew Center on state taxes, called "Beyond California" (<http://www.pewcenteronthestates.org/>). Everyone knows how bad California

is. The Pew Center looks at how the rest of the states are doing, and focuses on 10 states that also have severe problems. Sales tax receipts are down 14% in Arizona, and state income taxes are down 32%.

On average, revenues are down almost 12%. Oregon has seen their revenues collapse a stunning 19%. New York is down 17%, with a deficit of 32%. Illinois has a projected deficit of 47% of its budget, second only to California with 49%. You can see how your state fares at:

http://downloads.pewcenteronthestates.org/Beyond_California_Appendix.pdf.

The Liscio Report notes that all states had negative year-over-year sales tax collections in October, and the weighted average decrease was 10.2%, down from a negative 7.2% in September. (www.theliscioreport.com)”

Consumer sentiment indicators are negative. Why? The consumer is tapped out. Nearly one third of all mortgages are under water (the house is worth less than the outstanding mortgage balance). Credit cards are maxed out and home equity lines of credits are capped and/or pulled back. Unemployment is roughly 10%. Where are the new jobs going to come from? Are employers ready to hire today? Government stimulus has gone to the banks and bank lending to businesses has dropped \$250 billion. It is not in the system. The velocity of money is dead.

Local and State governments are in dire financial shape, state pensions are underfunded, and they will need to both borrow and raise taxes. Our federal government is running up trillion dollar deficits, financed by massive borrowing (issuing bonds that the very banks they bailed out are buying vs. using that capital to lend into the system). It is going to be tough to grow earnings with rising government debt, the unwinding of massive amount of private sector leverage, and the near 100% probability of much higher tax rates at all levels: local, state and federal.

Two of the smartest fundamental guys on the planet, Mohammad El-Erian and Bill Gross from Pimco said recently, “*The six-month rally in risk assets, while still continuously supported by policymakers, is likely at its pinnacle.*” El-Erian and Gross believe stocks will return 4% on average over the next 7-10 years and bonds returning 2% as we work our way to a “new normal” as they have coined it.

This from John Hussman recently caught my eye, “*In my estimation, there is still close to an 80% probability (Bayes' Rule) that a second market plunge and economic downturn will unfold during the coming year. This is not certainty, but the evidence that we've observed in the equity market, labor market, and credit markets to-date is simply much more consistent with the recent advance being a component of a more drawn-out and painful deleveraging cycle. Meanwhile, valuations are clearly unfavorable here, and even under the "typical post-war recovery" scenario, we are observing an increasing number of internal divergences and non-confirmations in market action.*”

I'm on a roll so I'll continue. Bear with me.

And from one of my favorite economists, David Rosenberg:

Why this is not the onset of a new secular bull market - Comparisons with August 1982

- *P/E Multiples were 8x, not 26x.*
- *Dividend yields were 6%, not sub-2%.*
- *The stock market was trading at a discount to book, not a 2x premium.*
- *Monetary policy was aimed at reducing money growth and inflation rates, not creating both as is the case now.*
- *Fiscal policy was aimed at reducing nondefense spending, not accelerating it.*
- *Deficits were peaking and coming down, not surging to 10%+ relative to GDP.*
- *Global trade barriers were being torn down; not erected.*
- *Deregulation back then was in; today it is all about re-regulation and government ownership.*
- *Union membership was on the way down; today it is back on the rise.*
- *The dollar was entering a Plaza Accord bull market, not a mercantilist bear market.*
- *Credit, household balance sheets and participation rates were expanding, not contracting.*
- *Tax rates, income, capital gains and dividends, were declining then; rising now.*

David continues, *“In 1982, Ronald Reagan was President (two consecutive terms as Governor of California), Don Regan was Treasury Secretary (35 years of financial sector experience), Martin Feldstein as the Chief Economic Advisor to President Reagan (the dean of business cycle determination), and Paul Volcker was Fed Chairman (9 years of prior financial sector experience). Compare and contrast to Barrack Obama (junior senator from Illinois for 3 years); Timothy Geithner (21 years experience in government, three years as a lobbyist); Larry Summers (no private sector experience; 27 years of academia and government) and Ben Bernanke (no private sector experience; 30 years of academia and government).*

Which team do you think deserved the higher multiple — the one with actual experience in the real world or the one immersed in academia and government?

To this end, we could only read with amusement the admonishing that the President took on his trip to Asia over U.S. policies which seem to be aimed at breeding more asset bubbles and blazing a trail for anti-competitive trade frictions — see China’s Blunt Talk for Obama. You can’t make this stuff up.”

And nicely summed up in Ned Davis Research’s December 2009 Special Report: *“This review of secular bull and bear markets has demonstrated that a market’s secular state has a lot to do with investor and consumer sentiment, and the extent to which the sentiment is aligned with the economic fundamentals. Secular bull markets and secular bear market trends end with valuation extremes.”* (Secular means long-term trend) Eight to 10 times PE ratios are valuation extremes, not 26.

Enough on the fundamental side, let's take a look at the technical picture. I continue to believe that the current rally is a supply and demand phenomenon and that in addition to valuation levels it is important to pay close attention to investor sentiment and other technical indicators.

The Technical picture:

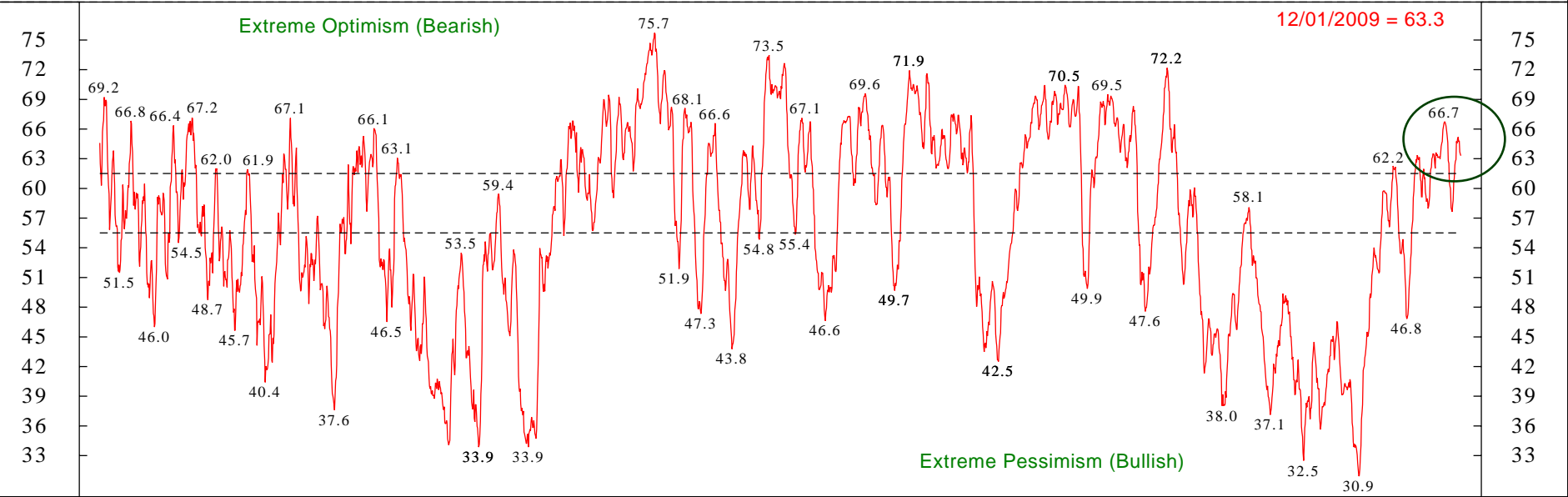
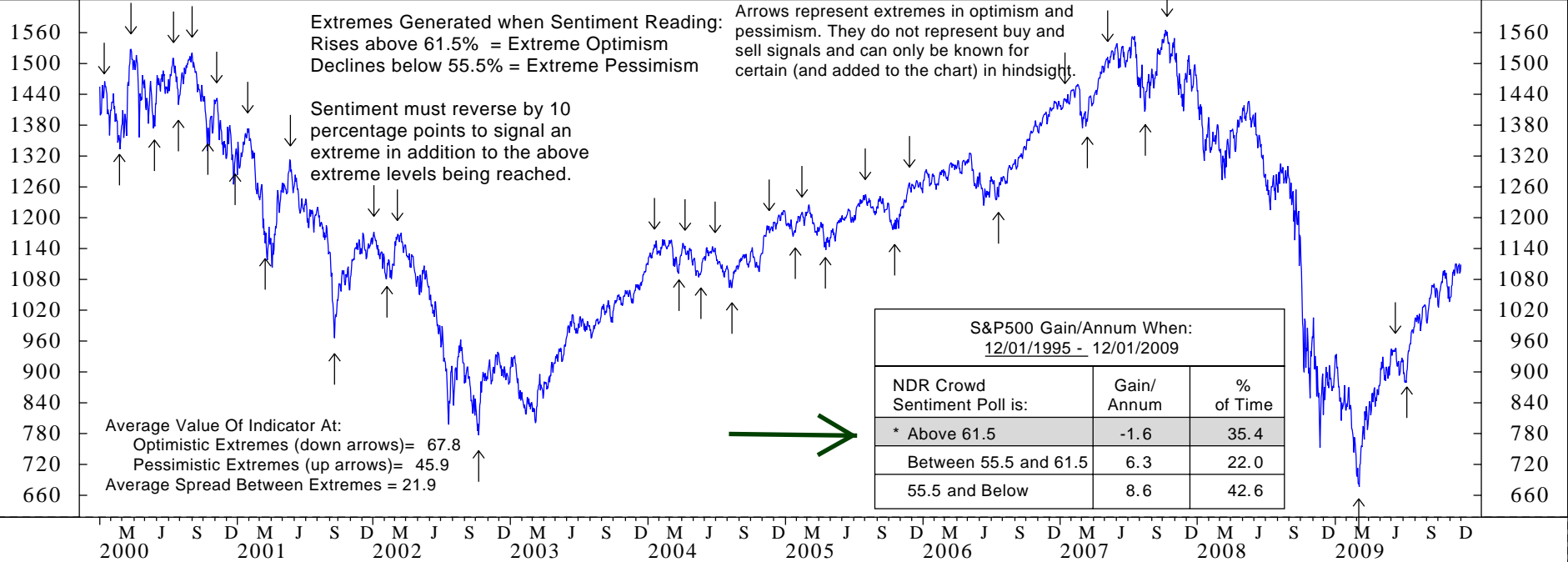
I am seeing a number of negative divergences (technical warning signs). Volume has recently fell to new lows into a rally where the Dow Jones Industrial Average made new highs. Not good. While buying demand has remained above selling supply, it appears that buying demand has peaked.

To this point, at the February/March market low (S&P 500 Index 666), the American Association of Individual Investors poll showed the average investor allocated 45% of his/her portfolio to cash. We viewed this record large cash position as rocket fuel for the expected rally (50% to 60% from the market low). That has now occurred. Importantly, at the market high of 1550 in 2007, the allocation to cash was 19%. That was at the market top. Today the average investor has 19% allocated to cash. Volume is at record lows, volatility is low, and available cash is low. Risk is much higher than it appears. One of the keys to me is Investor Sentiment – as Sir John said, “Sell when everyone else is buying”. Following is the most recent NDR Crowd Sentiment poll. Note the performance of the S&P 500 when readings are in the Extreme Optimism (Bearish) zone. We are in that zone today.

[Page down for NDR Crowd Sentiment chart](#)

S&P 500 Composite Index

Daily Data 1/03/2000 - 12/01/2009
(updated weekly on Wednesday mornings)



(S574) NDR Crowd Sentiment Poll

So what do you do now? Buy into the stock market when everyone else is buying? After a 60+% gain from the March low? Unfortunately, that is exactly what the majority tends to do. We humans seem to always get sucked into a false sense of comfort.

In previous communications I reflected that based on the equity market's behavioral patterns, after a waterfall/crash decline, the average gain is approximately 50 to 60% and the market achieves that return in roughly 7.5 months. How many months has it been since the early March 2009 low? How much of a return have we had off of that low?

I have had my bumps over the years and have learned a great deal, yet I still reflect on Sir John Templeton's advice and how hard it is to follow in real life. "Buy when everyone else is selling and sell when everyone else is buying". Simply, understand investor behavior patterns and do the opposite at market extremes. You may have a few bad days and get some extra ribbing from your buddies (just as I did with all of my caution prior to the market meltdown and with my advice back in December to set a firm game plan in place... "you'll get the chance"), yet I believe it will serve you well in the end. Investing is a marathon – not a sprint.

Game Plan:

We recently held an advisor conference here in Philadelphia with 117 advisors from across the country. I offered a general investment game plan. Here is the idea. The old 60% Stocks / 40% Bonds way of investing does not work in long-term secular bear markets. As a simple starting point, the new standard is 33% Stocks, 33% Bonds, and 33% Alternative/Absolute Return Strategies. Of course, some portfolios may be 25%, 25%, 50% or they could look more like Yale's at 75% Alternative/Absolutes. But this exercise is to shape an idea.

33% Stock allocation –trade this portion more tactically; tied to investor sentiment extremes (more appropriate in a long-term secular bear). Can you afford another 30% to 40% market correction? I believe it is time to **Sell the Rallies**. Then, be patient and tactically increase allocations to equities when Investor Sentiment moves back to the Extreme Pessimism (Bullish) zone. That time will come again soon enough.

33% Bond allocation – Tax frees are attractive; ladder the maturities (perhaps 4-5 year maturities) to take advantage of eventually higher interest rates.

33% Alternative/Absolute Return allocation - find non-correlating strategies and blend them into their own portfolio. This is especially important in long-term secular bear markets.

Taken together, it is critical to shape an investment plan that is focused on your goals, needs and risk tolerance over the next 1, 3 and 5 years or more. Talk with your CMG investment advisor to review and update your overall investment game plan. If you are an advisor or broker, give us a call to find out how you can plug into our platform of liquid and transparent absolute return strategies.

As always, please feel free to call me if you have any questions.

With kind regards,
Steve

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