

# PRIVATE WEALTH ADVISORY

A PHOENIX CAPITAL RESEARCH PUBLICATION

APRIL 14, 2010

## A Blow Off Top? Pt 1

If stocks were at a critical juncture last issue, this issue they appear to have the makings of a blow-off top.

First and foremost we have the commencement of earnings season this week. The likelihood of fantastic earnings is actually quite high because the Year-over-Year results will look stellar due to the fact that this time last year, we were at the absolute pit of the Financial Crisis.

Most corporations do their absolute best to spin earnings results to sound better than they really are. If sequential Quarterly results sound great (this quarter is better than the last) they will focus on that fact. However, if Year over Year results sounds better they will focus on that instead.

This charade works because most analysts, traders, and professional investors don't bother reading beyond headlines in earnings announcements anymore. If you'll recall, the first quarter of 2009 was the absolute pit of the Financial Crisis.

Consequently, the sequential Quarterly results (2Q09 vs. 1Q09, and 3Q09 vs. 2Q09) showed improvement. This fact was emphasized in press releases resulting in stocks rallying strongly during both the 2Q09 and 3Q09 earnings seasons. Meanwhile, Year over Year results were abysmal (a fact I emphasized in several 2009 *Private Wealth Advisories*).

However, now that we're in 1Q10, it is highly likely that earnings announcements will emphasize the facts that Year over Year results are looking better, largely due to the fact that this time last year, the financial markets/ US economy were imploding. Consequently, it is very likely we will see stocks rally this week on proclamations that Obama's Stimulus worked and the US economy is in recovery because corporations are showing improved results from 1Q09.

A second reason we should see a blow-off top in stocks is that this week is options expiration week. As I've noted in numerous issues of *Private Wealth Advisory*, these weeks usually feature the greatest ramp jobs Wall Street can pull off to in order to fleece options traders, forcing them to cover their positions in the red.

This fleecing is further aided by the Federal Reserve which tends to make its largest capital infusions to the markets on options expiration week (these weeks are bold in the graph below)

<b>Week</b>	<b>Fed Action</b>
<b>March 17</b>	<b>+\$25 billion</b>
March 11 2010	+\$2 billion
March 4 2010	-\$5 billion
February 25 2010	+\$8 billion
<b>February 18 2010</b>	<b>+\$21 billion</b>
February 11 2010	+\$7 billion
February 4 2010	+2 billion
January 28 2010	-\$4 billion
January 21 2010	-\$39 billion
<b>January 14 2010</b>	<b>+\$56 billion</b>
January 7 2010	+\$1 billion
December 31 2009	-\$1 billion
December 28 2009	+\$35 million
<b>December 17 2009</b>	<b>+\$49 billion</b>
December 10 2009	-\$17 billion
December 3 2009	-\$2 billion
November 27 2009	-\$2 billion
<b>November 19 2009</b>	<b>+\$73 billion</b>
November 12 2009	-\$30 billion
November 5 2009	+\$3 billion
October 29 2009	-\$39 billion
October 22 2009	+\$8 billion
<b>October 15 2009</b>	<b>+\$54 billion</b>
October 8 2009	-\$3 billion
October 1 2009	-\$17 billion
September 24 2009	+\$18 billion
<b>September 17 2009</b>	<b>+\$51 billion</b>
September 10 2009	+\$4 billion
September 3 2009	+\$8 billion
August 27 2009	+\$14 billion
<b>August 20 2009</b>	<b>+\$46 billion</b>
August 13 2009	+\$25 billion
August 6 2009	-\$11 billion
July 30 2009	-\$38 billion
July 23 2009	-\$33 billion
<b>July 16 2009</b>	<b>+\$80 billion</b>

Now that the Fed's Quantitative Easing programs have ended, the Fed will have to perform "stealth" infusions in order to maintain this pattern. On that note, this week will be crucial for investors in terms of gauging whether the Fed has indeed exited its stimulus efforts or if it will continue to provide liquidity and stimulus via less overt methods.

Finally, we have little if any “risk” being priced into the market as indicated by the fact that the Volatility Index (which measures sentiment for options investors) falling back into non-Crisis/ non-recessionary levels.

If you’re unfamiliar with the Volatility Index or VIX as it is commonly called, it measures the premium options investors are willing to pay in order to protect their portfolios. Because of this, a high VIX reading indicates that options investors are “worried” and therefore willing to pay extra to protect themselves from a collapse. In contrast, a low VIX reading indicates that options investors are “complacent” and consequently see little reason to pay extra for protection against a drop in the market.

Below is a 20-year chart of the VIX.



You’ll note that in the last 20 years the VIX has had three periods of elevation: the early ‘90s, the late ‘90s/ early ‘00s, and the Financial Crisis (2007-2009). During these times, the VIX entered an elevated range in which even the lows were *higher* than the highs that occurred during non-recessionary/ non-Crisis times.

In contrast, there are three periods in which investors believed that “all was well.” They were the mid-90s, the Housing Bubble (2004-2007), and most recently.

This low VIX reading confirms what low mutual fund cash levels, money market fund outflows, and insider selling/buying metrics have hinted at: that we are now

officially back to a “pre-Crisis/ 2007 environment” in terms of investor complacency. We are, in plain terms, back in a bubble.

This kind of atmosphere can result in a blow off top. I am sure many of you remember the 2006-2007 top that occurred. Stocks went virtually straight up for 18 months suffering only three corrections during that time.



The above chart shows that from June 2006 to the all-time high in stocks in October 2007, there were three rallies lasting nine months, five months, and two months respectively. We also saw two corrections of 5% (March '07) and 9% (July '07), respectively. Thus we see two trends:

- 1) Rallies of decreasing length
- 2) Corrections of increasing strength

I also wish to note that the first sign that we'd hit THE top in 2007 only occurred after the fact when the market corrected to a new lower low in December 2008.

**\$SPX (S&P 500 Large Cap Index) INDX**

© StockCharts.com

29-Feb-2008 4:00pm

**Last 1330.63 Volume 3.7B Chg -37.05 (-2.71%) ▼**

— \$SPX (Daily) 1330.63



In contrast, this latest rally started March 2009 has been far more choppy with numerous, small corrections throughout. This makes sense given that the 2006-2007 market was occurring during a full-blown bubble in a pre-Crisis environment. In contrast, the market today is operating in a clear post-Crisis environment in which the Federal Reserve is attempting to reflate an extremely damaged economy and financial system.

This is clear in the fact that the majority of the market rally begun in March 2009's gains occur over weekends and during the night sessions in the futures markets: times when trading volume is light and it's easy to push the market higher. It's also evident in the low volume we're seeing in the market (Citigroup, AIG, and other bankrupt firms continue to account for 25-40% of all market volume on the NYSE).

However, if we smooth over the market action from March 2009 to the present we see that the large moves have consisted of four rallies lasting four months, four months, three months, and two months (so far). We also see that these rallies have been broken up by corrections of 7% (June-July), 5% (October-November 2009), and 8% (January-February 2010).



Thus we see similar trends occurring today as in 2006-2007 (Rallies of decreasing length/ Corrections of increasing strength), though this time around the market action is in general sloppier and more volatile.

On that note, the technical picture for the market indicates that stocks are more extended above their 50-DMA than at any other point during the market rally.



At this point, the likelihood of a correction is extremely high. However, with the market completely detached from reality, things can continue overstretched far longer than one would expect.

On that note, while I have formally given up trying to call a top in the insanity we now call a stock market, I would like to point out that stocks are nearing their 200-weekly moving average at 1,225. A lot of market technicians believe this level will prove to be THE "top." I thought it worth mentioning for the traders among you.

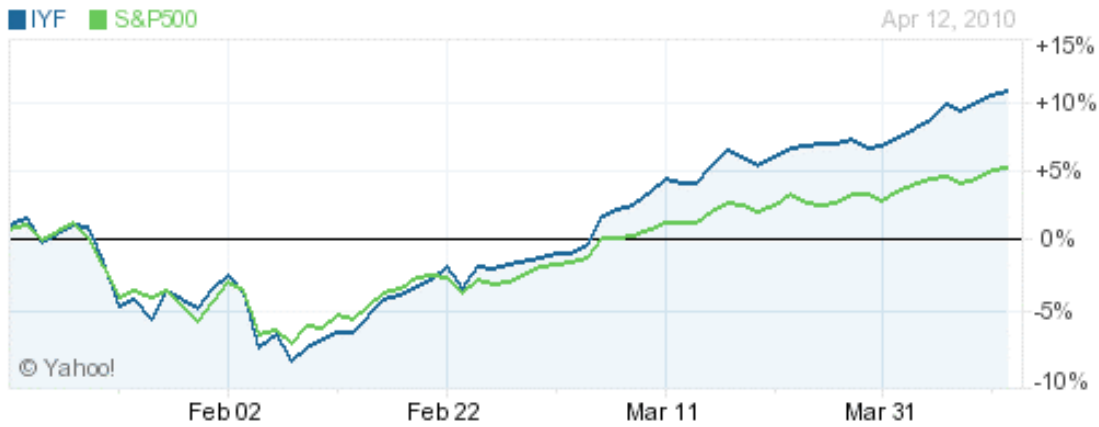


Another sign that we may be nearing a top comes from the sudden announcement that the big banks (Bank of America, JPMorgan Chase, and Wells Fargo) may have to set aside another \$30 billion to cover losses due to bad mortgages. Those of you who read me regularly will not be surprised by this announcement, however, this is the first time the mainstream media acknowledged this obvious fact.

Bill King of the *King Report* posits that it's quite possible the Federal Reserve's entire game plan for addressing the Crisis was to give the banks one full year of easy money (combined with lax accounting standards) to build up their balance sheets before letting the next wave of defaults and bad-mortgage bets hit the market. Now that stocks have retrenched 50% of their losses from the 2007 peak, the market is most certainly in a better position to stomach another round of capital issues.

This might, also explain why financials stocks have been some of the top performers in the most recent months (along with retailers and REITs).

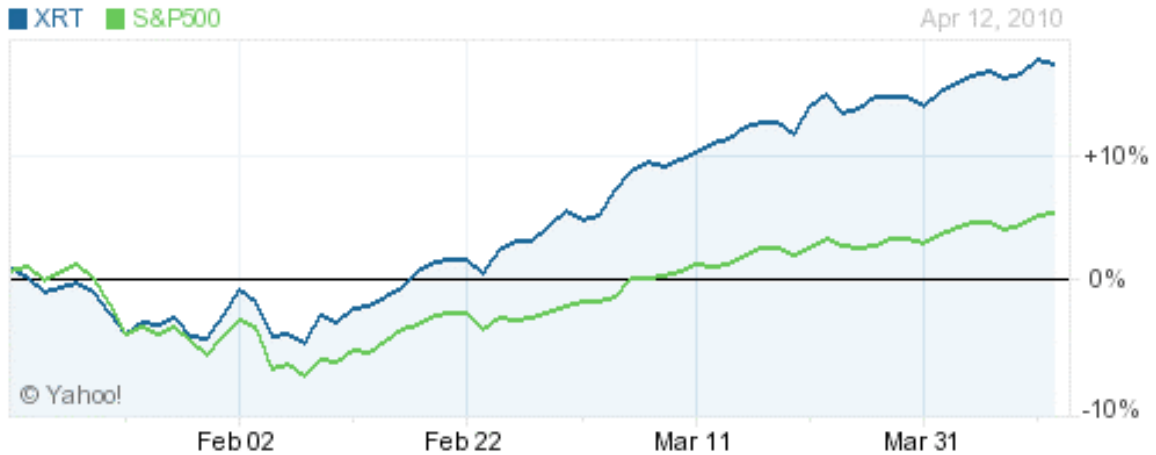
### Financials vs. the S&P 500: iShares Trust (Barclays Global)



### REITs vs. the S&P 500 Vanguard Specialized REIT Index



### Retailers vs. the S&P 500 SPDR Series Trust SPDR Retail E





The above three charts reveal in plain terms just how absurd our stock market has become. Here we have three of the most damaged sectors in the economy. Banks, as everyone knows, are sitting atop trillions in additional losses. REITs are in trouble because real estate values continue to plummet and commercial mortgage delinquencies are soaring. As for retailers, the continued deleveraging (consumer credit fell \$10 billion in March) and debt saturation makes the likelihood of an increase in spending minimal.

And yet all three sectors have seen blistering stock performances in the last two months. In plain terms, we are in a market that completely defies logic; a kind of “opposite-ville” where the most damaged sectors are the top performers. It is also a strong indication that we are indeed in a bubble similar to that in the late ‘90s and the Housing Boom (2003-2007).

This, in turn confirms what I noted in last issue, that these same sectors (retail, financials, REITs) will be the worst performers during the next market downturn. On that note, I am looking for two “triggers” to strike to indicate that THE top is in and that we are headed for a major downturn.

The first is a new lower low similar to the one accomplished in early 2008 (see the chart on page 5). With the most recent correction (January-February 2010) ending at a closing low of 1,056 on the S&P 500, *that* is the level we need to violate in order for us to say with some certainty that THE top is in.

The second item I am looking for is a break below the 50-DMA, followed by a FAILED re-test of that level. As noted in last issue, this “trigger” hit clearly before the 1987 Crash, the 2007 top, and the 2008 Crash. It also hit before the Tech Crash, though the chart was generally much messier that time around.

Today, the S&P 500’s 50-DMA is at 1,134, roughly 5% below the market’s current levels. If stocks begin to turn down from here (rather than entering the “blow off” top I suggested in this issue’s lead) then this is the level to watch. A violation of the 50-DMA would trigger numerous “stop” orders for the momentum quant funds that are dominating the market’s action today. If the market broke below the 50-DMA and then FAILED to reclaim that level, this would likely very quickly trigger a panic.

Remember, today’s market is dominated by machines and algorithms, NOT human beings. Because of this, panic selling will pick up much, much faster than in 2007 should stocks seriously break down.

On a final note pertaining to quant funds, their domination of the market also helps to explain why the market action has been so “choppy” since March 2009. As noted earlier in this issue, the rallies we see today are no the nice smoothly rising ones that occurred prior to the market top in 2007. Instead, they are rough, occurring in fits and bursts, a sign that the market is being thrown back and forth quickly due to

large orders coming in and exiting the market rapidly (a sure sign of quant involvement).

**Graham's note: WATCH the 50-DMA closely. We came close to FAILING to break above this level in February. When we DO fail to reclaim it (after falling below it) it will trigger "Sell" signals market wide.**



Concerning stocks' action today, I note that stocks have rallied to test the upper band of the trading channel they've established over the course of the rally March 2009. This pattern is clearest in the NASDAQ which has lead the other indexes:



But you can also see where are quite close for the S&P 500 too:



These charts leave us with two likely outcomes:

- 1) Stocks either correct now and fall back within the channel
- 2) Stocks enter a total blow-off top in which the bears completely capitulate

Indeed, the only thing stopping me from believing THE top is in is the fact that short interest remains near its 2010 highs on the NYSE. Short interest measures the number of shares that are short in the market at any given time. As I write this, there are currently 13.9 billion shares short on the NYSE. That's down from the 2010 high of 14.1 billion shares which was hit on March 15, but it's still elevated from the start of the year (13 billion shares were short on January 1, 2010).

This is cause for concern because it indicates we could see a final blow off top in which stocks went completely parabolic as the shorts covered. **On that note, I want to alert you to the fact that our one current short Limited Brands (LTD) stopped out Tuesday April 13 at the close.**

When we entered our short on LTD I said to use a 10% stop loss which meant we'd cover if LTD closed above \$27.08. On Tuesday it closed at \$27.19. I didn't send out an update because LTD clearly was going to post a brief correction which would allow for a better place to cover. As I suspected, LTD *did* correct today, so if you have not already covered this position do so now.

**Action to take: Cover your Limited Brand (LTD) short.**

The remainder of this week's issue will be out tomorrow after the market's close. I want to see the action tomorrow in the AM before determining how to proceed. With stocks literally *at* the trendline in the Nasdaq, I am tempted to both open longs (to play the blow-off top) AND open shorts (to play a correction). But unfortunately, the market's action today really leaves me uncertain which way to move.

So this week's issue will be a double header: half published today, the other half tomorrow. I am sorry for this, I know you want everything in one piece, but the problem with writing newsletters is that the market doesn't give a hoot for publishing schedules. And I don't want to commit to playing the market on way or the other right the second.

On that note, check your inbox tomorrow after the market closes (4:00PM Eastern Time) for the remainder of this week's issue. Until then...

Good Investing!

Graham Summers

### If You HAVE To Own Stocks Portfolio

Company	Symbol	Buy Date	Buy/Short Price	Current Price	Gain/Loss
Coke	TWM	3/30/10	\$55.00	\$54.95	0%
Budweiser	BUD	3/30/10	\$50.45	\$51.46	2%
Johnson & Johnson	JNJ	3/30/10	\$65.20	\$65.49	0%
Wal-Mart	WMT	3/30/10	\$54.64	\$54.64	-2%
Exxon Mobil	XOM	3/30/10	\$66.98	\$68.61	2%

### Stocks Come Unhinged Portfolio

Company	Symbol	Buy Date	Buy/Short Price	Current Price	Gain/Loss
DSW (SHORT)	DSW	N/A	N/A	NOT YET	
Wells Fargo (SHORT)	WFC	N/A	N/A	NOT YET	
Limited Brands (SHORT)	LTD	3/31/10	\$24.62	COVER \$17.03	-9%

### Bullion Portfolio

Company	Buy Date	Buy Price	Current Price	Gain/Loss
Gold	3/17/10	\$1,120.00	\$1,156.20	3%
Silver	3/17/10	\$17.50	\$18.46	5%

### Coming Crisis Portfolio: Positions We Will Buy When the Next Crisis Hits

Investment	Symbol	Reasons to buy when the Crisis hits
UltraShort Emerging Markets ETF	EEV	Sovereign debt default, end of liquidity rally, capital withdrawals on flight to safety
UltraShort Russell 2000	TWM	The WORST index in the US, comprised of junk and unprofitable companies
UltraShort Real Estate	SRS	Second wave of mortgage rate resets, continued increase in defaults in housing,
UltraShort Materials	SMN	Economic Depression
UltraShort Financial	SKF	Derivative exposure, systemic insolvency