July 29, 2007

Warning: This issue is long and important.

It's already late and I want to get this issue out tonight so you can digest it before the stock market opens in the morning. I apologize in advance for any spelling or grammatical errors in my rush.

What a week! WOW!! If you ain't having fun in this kind of market, you probably never will. This kind of action separates the professionals from the pretenders. And no, you don't always have to be on the right side of the market to recognize opportunities.

Think about it. How difficult is it to make money in a straight up stock market? Just throw some darts at a mutual fund price page and chances are you will do just fine.

I am sure everyone was making decent money the past few months. It was fairly easy, wasn't it? Almost like having the answers to a test the day before you take it.

But something changed dramatically this month, didn't it? I know you weren't surprised since I have written about it before. A good ole bull market correction has set in! Let's talk about it.

As you already know, our stock market models turned very positive in mid March at the bottom. And they stayed long and strong right through the end of the quarter and into July. We didn't do a whole lot of work in the second quarter, but our performance was outstanding. Hopefully, yours was too as it doesn't get much easier!

With June yielding the weakest results of the second quarter, the stock market had the feel of another burst higher coming in July as I previously mentioned. Thankfully, we were not disappointed as the first two and a half weeks of July were almost a straight up affair, giving us some dizzying paper profits.

If you read the last Street$marts I sent or recall the comparison I have been making to the 1987 market, the stock market was supposed to peak sometime in mid-July.

Let me pause here and say that just because I found this comparison and it's been spot on accurate since March, our models do not and will not trade based on it.

Rather, they use some fairly sophisticated and some fairly simple, time tested formulas to gauge risk across the US financial markets. That's how we invest your money.

As some of the major indexes broke out to new highs in early July, led by the Dow Jones Industrials, others did not, confirming a caution flag I had been discussing for a while. One of things we look for as a cautionary sign is a "narrowing" of a rally. That means that as the popular indexes go higher and higher, fewer and fewer sectors and even fewer stocks go along for the ride, until finally the stock market begins to fall under its own weight.

The reason this occurs is because most of the widely followed benchmarks, like the S&P 500 and Nasdaq 100, are capitalization weighted, meaning that all stocks are not created equal. Rather, the larger the company, the more weight it is given in an index.

If you take the Nasdaq 100, depending on exactly when you take a snapshot, roughly 35% of that index is dominated by just a few stocks like Microsoft, Intel, Cisco, Google and Apple. So imagine those five stocks are super strong, but many others are not. They can actually mask underlying weakness, which is a cautionary sign.

This is exactly what we have seen so far in July with the Dow, S&P 500 and Nasdaq 100. The S&P 400 (mid cap) and Russell 2000 (small cap) did not make new highs when its cousins did.

On July 13, it became apparent that all was not right in market land. Not only was the rally starting to peeter out, but the credit markets were in complete collapse and a full pipeline of LBOs from all those private equity firms needed to be priced and sold to investors.

With both investment models on the verge of turning negative, we began to take action. On July 16, 17, 18 and 19, our intermediate-term model officially turned negative with price action confirming this immediately. Wholesale changes were made to all portfolios.

I was ecstatic to be able to lock in some super profits made since the March bottom. Clients just love when we protect what they earn!

Additionally, a few strategies took positions in instruments that would profit from a stock market decline. For now, we'll call those folks the most fortunate ones! As we all know, it doesn't always happen like this so let's enjoy it while we have it. I did some "wound licking" myself in the first quarter and it's just not fun!

The six day decline has been nothing short of a dramatic, waterfall affair. And to be perfectly frank, I wasn't expecting such carnage so soon.

This looks to me like your typical bull market correction, lasting a few weeks to a few months. After tomorrow, I can wage an estimate on magnitude and tighten up the time frame.

What's interesting about the recent peak was that it wasn't that easy to forecast. Yes, our model did turn negative and we acted on that, but the usual clues were missing.

We did not get the usual surge in investor optimism like we had last May. This top can be characterized by only a few strong stocks holding up the indexes, while the foundation badly eroded. That was not the case in March.

When the Dow, S&P 500 and Nasdaq 100 surged to new highs earlier this month, it looked like it just couldn't get any better. That's another clue that a turn may not be too far off.

Breakouts are fine and usually lead to a larger move, but when they fail, the price action can get nasty. The beginning of this decline looked like nothing more than a normal pause until Thursday. If the market was going to stay very healthy and immediately returns to new highs, Thursday should not have occurred. That was a major problem.

After the close, I ran some numbers and saw some encouraging signs, a few similar to what we saw in March.

-Record NYSE Volume
-Record Nasdaq Volume
-Record ETF Volume
-Historic Extreme Decliners/Advancers
-Historic Extreme Down Volume/Up Volume
-Extreme Put Option Buying
-The Gaps Filled (mentioned in a previous email)

That information had me on guard for a possible trading bottom on Friday, especially if the open was weak and we saw another flush out of sellers. By 10:00 am, it looked very promising.

That all changed during the last hour as we saw a true collapse to close at the very low on the session and week. If it wasn't a Friday, I would have thought that the next day could be a bottom. And while tomorrow very well may be a low, there is one other scenario.

All of the indicators and models we follow are based on history. None have 100% accuracy, but they do a very good job the vast majority of the time. Thursday's price, volume and internal action should have been enough to halt the collapse. Friday's action certainly is enough in more than 90% of the cases.

The only parallel I can find historically is some kind of mini crash if the market does not hold together right away. We saw that in April 2000, August 1998, October 1997, October 1989 and October 1987. While it's still the far less probable scenario, nonetheless, it is possible.

The more likely path is for some follow through Monday morning with the usual margin call selling and a steady firming after lunch and into the close. That would set the stage for a short-term rally, followed by another decline in August to finish up the correction.

Monday is about as pivotal a day in the stock as we've seen since the bull market began in 2002. If you want to be bullish, hope for an ugly opening half hour to wash the sellers out with a steady climb from the lows the rest of the day on heavy volume.

If you want to be bearish, you either hope tomorrow is some type of mini crash or the market opens up strong and stays strong all day on light volume. That would most likely lead to another bout of selling in the not too distant future.

Me? I just want to make money for our clients and will let the models do the work. Whatever happens tomorrow, there is a very powerful short-term rally not too far away. That's the case whether we see another 1% on the downside or 10%.

I will certainly stay in touch as events dictate. One thing about me, I rarely get tongue tied!

If you are interested in seeing what I am trying to describe in this email, just let me know and I can attach a few charts.

Finally, this is one of those "bell ringing" periods when you should be adding money to your account or opening an account if you aren't already a client. I strongly suggested this in March and again in June and the results speak for themselves!

If you did not make money during the rally or are unhappy with your investment performance, I urge you to PLEASE contact me directly. We'll schedule a call or meeting and there is no cost to you, but could save your portfolio.

Thank you for reading this very long and hopefully beneficial issue!

To Your Financial Success,

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