August 1, 2007

Inside this issue...

As usual, I have lots to say and I am starting this late. For a long time, I couldn't wait for a good dose of volatility to return since I was running out of topics. Now, I have way too many topics and never enough time! I guess the latter is the better of the two.

What a ride it's been! Each time we have seen some huge intra day swings, I keep telling people it reminds me of Mr. Toad's Wild Ride at Disney World. What I haven't told them is that I haven't a clue what that ride even is! It just sounds good.

Crash card off the table

Over the weekend, I wrote a long update about the two possible scenarios I could see occurring. The first being an almost immediate low, while the second and less likely called for a mini crash.

Monday's action definitely took the crash card off the table by stemming the snowball effect, but it did little to reinforce any type of bottoming action. Tuesday totally caught me by surprise. I never saw that collapse coming, especially with it being month end and the internals being in good shape.

Today, Wednesday, was an easier type day as I was pretty much on guard for the market to form a trading bottom. But they didn't make it easy. Usually, markets in serious decline see their nastiest action earlier in the day and are in firming mode by lunch, followed by a late day surge to the close.

Today was very, very choppy and volatile with the final low not being seen until after the bonds closed at 3:00 PM. That's unusual. The last half hour today saw one of the most vertical late day charges I can remember in a long time.

Please keep this important tidbit in the back of your mind. When the stock market gets volatile and a correction sets in, the chances become even greater for a sharp snapback at any moment. Complacent traders are the ones who get caught and scramble to exit positions as they go vertically against them. Be careful!

Where are we?

Let's turn to where I think we are in the whole corrective process. It certainly looks like we have seen at least a short-term bottom in place. But to be fair, I thought the same thing earlier this week.

I don't want to bore you with all of the various indicators I look at, but we are seeing some truly oversold levels right here and have been since last Thursday. All of the NYSE advance/decline and up/down volume indicators are about as washed out as they ever get, very similar to the March low.

In any other market, I would be hitting the ceiling with excitement at the thought of being able to load the boat for a big rally. The problem I have is two fold; our intermediate-term model is still negative and we just saw a significant change by the SEC that I believe is affecting a lot of indicators.

SEC throws in a monkey wrench

In early July, the SEC eliminated the "uptick rule" for short sales. For those of you who have never shorted a stock, there was a rule in place forever that required a stock to trade higher than its previous price before you could sell it short, a bet on that stock going down.

That rule has been in place to prevent investors from piling on when a stock or market begins to snowball lower. I always thought it was unfair that they didn't do the same thing on the upside. It's ok to pile on when things go up, but not down. That's a topic for a different day.

Anyway, in early July that rule was eliminated by the SEC, making it easy for short sellers to get at a stock. The reason they got rid of the rule was because with the explosion of derivatives, it became too easy to short a stock anyway, off exchange. This leveled the playing field.

Since that rule changed, I have noticed some different behavior in the stock market that has been out of character. The bigger problem is that there is no real resource to go to for the answer or solution. Only time will tell, much like what happened when the SEC changed trading to decimals from 1/16 and 1/8 early this decade.

So, getting back to the action, if I saw this behavior in the 1990s, I would have been swinging from the rooftop, calling for a 10-15% rally. With all the rule changes this decade, it's definitely muted a lot of tried and true indicators.

What to do now

With all that out of the way, it still looks like the stock market should see a fairly decent rally this month. 5% would not surprise me at some point. If you are nimble enough to trade this, I urge you to be very careful. Should today's low be closed below, a sharp and fast collapse will likely occur to the final bottom.

Right now, my plan is to take August very slowly and cautiously. Our strategies had a great month in July and I rate it our best month of 2007. Since I do not have very high conviction and our models are not screaming, there is no sense for us to really push like we last did at the March bottom right to Dow 14,000.

Tidbits for the technician

Index wise, here are some comments for the chartists:

Dow - Held 38.2% retracement and reversed at the June lows

S&P 500 - Tested 200 day moving average today and the 50% retracement

Nasdaq 100 - Tested 38.2% retracement and 89 day ema

Russell 2000 - Except for reversing with the market, there is nothing constructive and should breach the March lows before all is done

If you are interested in learning about these comments, just email me and I will send you what I have and walk you through them.

I am about done for this update. While it looks like we should see some type of bounce, do not get complacent! Volatility should continue into the 4th quarter.

The best case for the market is that we have just seen the initial low and most of the price damage, which is followed by a 1-4 week rally and then another decline to revisit today's bottom before charging higher.

The flip side is that the July correction turns into a systemic problem that leads to much more on the downside and the first 10%+ correction in 52 months. If that's the eventual path, I fully expect to see a major hedge fund collapse, similar to Long Term Capital and Bernanke to swoop in and lower rates.

Without Bernanke lowering rates, which he won't do without a 10% decline, I do not see the bull market returning to its March - June form. While the Fed does meet next week, it's too early for them to do anything but nothing!

And with that... good night!

To Your Financial Success,

Paul Schatz
President
Heritage Capital LLC

1 Bradley Road Suite 202
Woodbridge CT 06525

203.389.3553 Phone
203.389.3550 Fax

www.InvestForTomorrow.com