March 21, 2011

4:26 PM EDT

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Good Til Close

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Look no further than last Friday's sunny 75 degree day and today's snowy, rainy 35 degree to know spring has officially hit New England! Thankfully for my daughter, her softball practice was yesterday and not today because there is zero chance she would stand outside in this weather chasing and hitting that ball. We're also in full birthday mode in our house with my wife's last month and the little guy's big #3 yesterday.

Last week, we were talking about the markets reaction to the disaster in Japan (see article below) and what seemed like the pullback everyone has been talking about since last year. When stocks are ripping higher and folks are stuck with cash waiting to buy, it's always interesting to hear
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their commentary.

For much of January and February, the majority of interviews I saw were centered on investors agreeing that the stock market was bullish and heading higher, but wanted to buy into a bit of weakness. The higher stocks went, the more uncomfortable it became on that group. They just needed a few percent pullback to deploy their capital. It all seems so logical. Just like it did last April leading up to the Flash Crash and 16% decline during spring.

Except something happened on the way to the dance! When markets finally give the masses what they want, it's amazing how few folks enact their original plan. The staunch bulls become tepid cows who no longer want to buy. They reason themselves into keeping that cash because of some news event. This time around, it was Japan. But it's really the same thing over and over and over.

If you have ever used a GTC order in stocks, it means the order to buy or sell is Good Til Cancelled. That also stands for Good Til CLOSE, since so many people change the order when price gets close to where they want to execute a trade.

My sense is that when stocks pulled back in the 4-7% range I've been writing about for some time, most people froze and did nothing. From my seat, we used the pullback to commit our cash as well as rebalance portfolios for the move I expect next quarter. But as you will read shortly, I am anything but married to this in the short-term.

If you find yourself thinking and behaving like I mentioned above, and would like some help, please feel free to reach out with any questions or comments by calling the office directly at 203.389.3553 or hitting reply to this email.

FYI, I will be on CNBC's The Call this Thursday (March 24) at 11:05am.

Japan... Buying or Selling Opportunity

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Two Sunday's ago, I was riding the chairlift my ski friend Don and he asked/stated that it seemed like a good time to short the Japanese stock market. My response was that I would rather look for the panic buying opportunity. I think that struck him as odd. Let me explain.

When major news, earnings, economic, geopolitical, etc. hits, there is typically an immediate reaction in the financial markets, and many times an overreaction. Think of the initial shock of the event. Apple blows out
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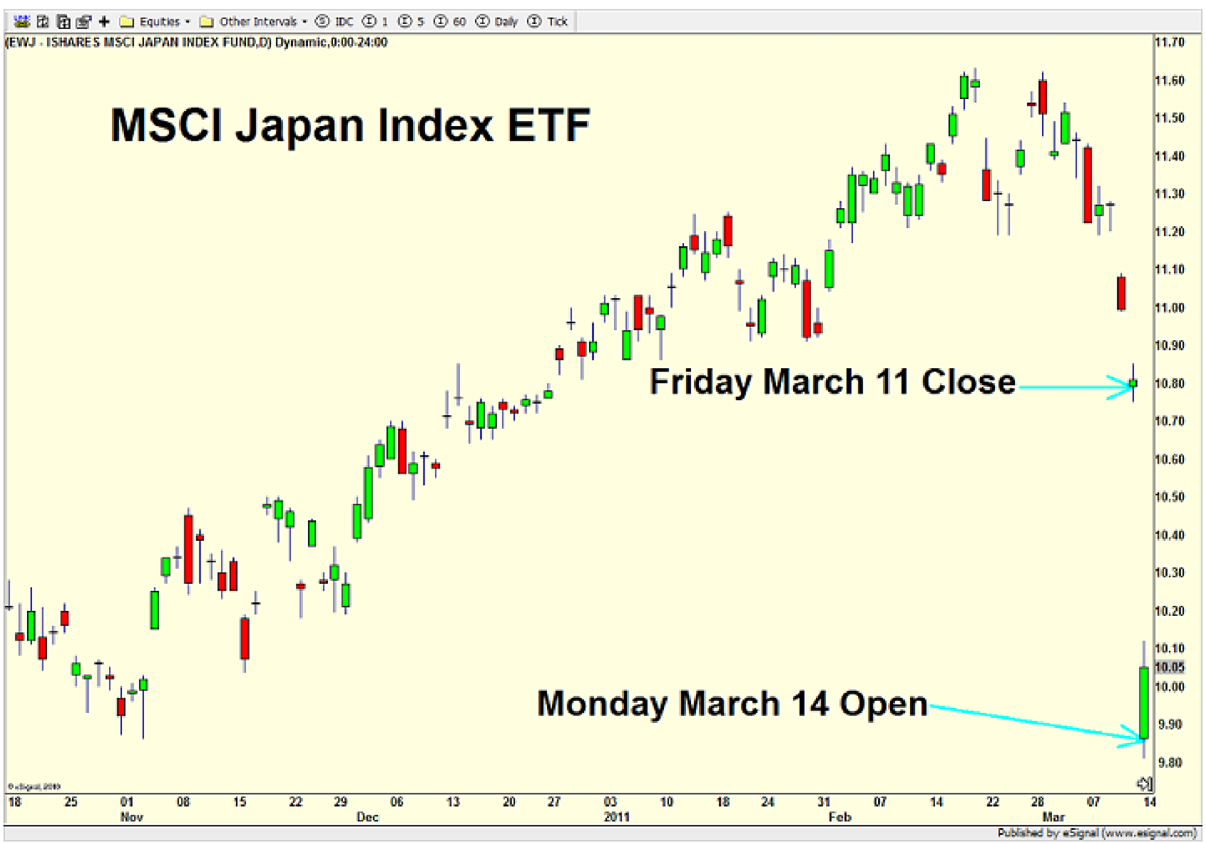
on earnings and the masses all want to get onboard. Unemployment comes in much worse than expected and everyone wants to sell. Lunatics fly planes into buildings. I think you get the picture.

Once the news is in the public domain, there is no longer an edge. All of the available news is factored into the market, at least for the time being until the situation takes a big turn. Intuitively, most investors react to news and investor with the news, i.e. selling into bad news and buying into good news.

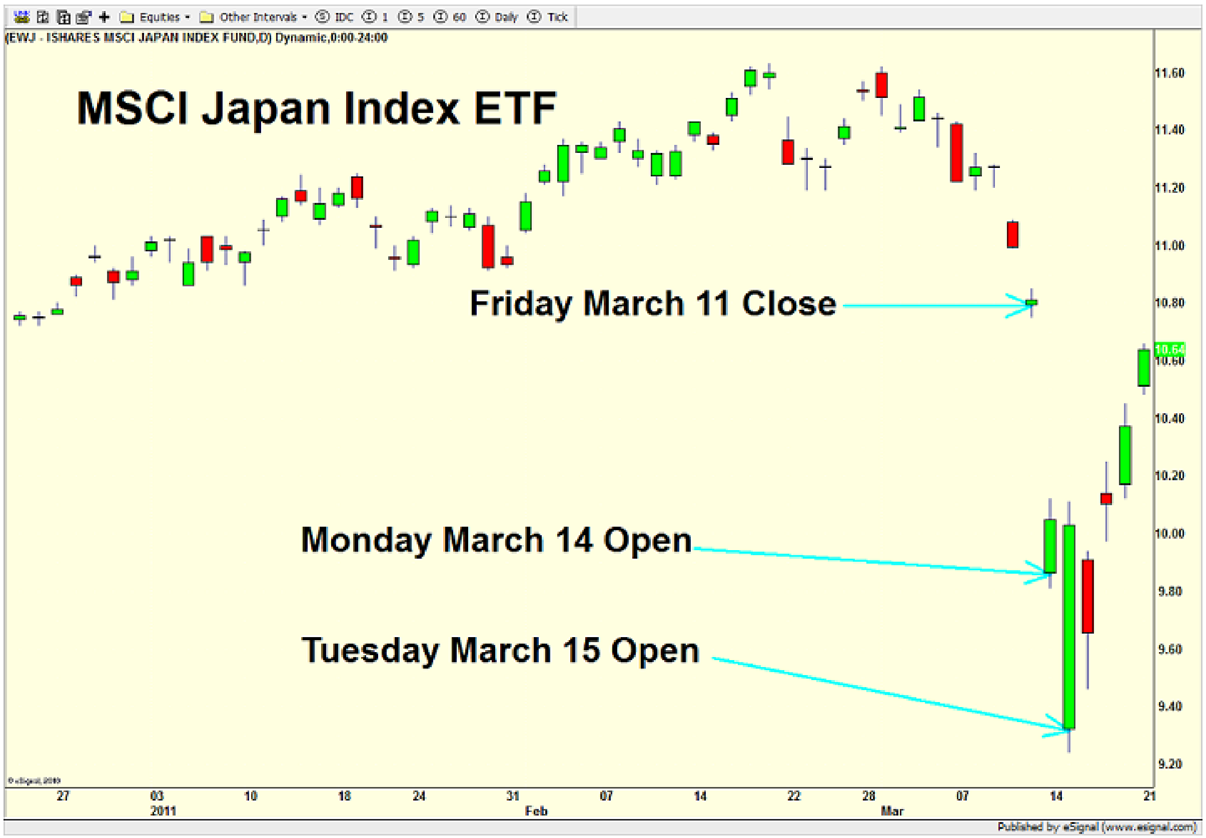
After 23 years in the business, I don't have all the answers and still have loads of question, but I have learned to buy when no one else wants to and sell when it seems idiotic to do so. Sometimes, I am early and other times I am spot on. But I live to invest with the minority. In more technical terms, it's called mean reversion; buying into weakness and selling into strength.

So after my conversation with Don last weekend, let's say you wanted to sell short the Japanese or even the U.S. stock market. We can use the exchange traded fund (ETF) that Ishares has on the MSCI Japan Index. It closed at 10.80 into the weekend as you can see from the chart below.



But it's now Sunday and you would have had to sell short at Monday's opening price, 9.86. At that point, the ETF was down 8.70% for the day and 15.21% since the peak. For me, that's an awful lot of price to give up in order to put a trade on. Now, if the events in Japan ended right there, the ETF would have likely rallied, but if things got out of control, the ETF would likely head much lower.

As you can see from the chart below, Japan did head lower right at the open Tuesday morning to 9.32, but closed the session above 10. And as I write this article Monday afternoon, it's trading at 10.64, up 8% from Monday's open and up 14% from the crash low.



It's still too early to know the final outcome, but from my seat, I would rather look for signs of panic selling to buy in to than try to hop on board a moving train that's long left the station.

I vividly remember the events after 9-11, waiting for the markets to reopen. When they finally did and I was looking to buy, that first down day of roughly 500 points saw very little panic. It was probably the most orderly 500 collapse in history! I went home that night with a bad feeling that serious pent up selling was coming. And although I was looking to commit cash and buy, I was still sitting on investments that would certainly get hit in the coming days.

In that case, it took about five trading days for true panic to set in, coincidentally as I was on my second bachelor party trip in two weeks. Waking up in Wisconsin to find the early indication of the Dow down another 500-700 points was definitely unsettling! But it also smacked of real despair and investor capitulation. You could have shorted our market any time during those first five days and you would have been ok for a few days. But once the market turned, stocks launched higher more than 20% in just a few short months. Again, I would rather digest the news, wait for my spot and go against the crowd.

Blue, Purple, Green, Orange for the Stock Market

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In the previous issue, I offered the following two scenarios for stocks.

Scenario A (in light blue on the chart below) - Stocks have a rough morning on Monday but the selling does not accelerate and the market begins to gather itself after the Fed meets on Tuesday. New 2011 highs are seen in April.

Scenario B (in light purple on the chart below) - Stocks open lower on Monday, accelerate during the day and close below the lows of last Friday, March 11. In that case, the 4-5% pullback ends up being 7-9% and we see a bottom by the end of March. From there, new 2011 highs are made later during the second quarter.

So now we know that scenario B is the most likely with A already being
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eliminated as you can see in the chart below. So far, the market seems like it really likes the purple path as it sold off almost exactly to the bottom of the arrow and has now bounced smartly.

So why am I not more convinced? I don't like the fact that the past three up days have seen all of the upside at the open and the market spent the rest of the day going sideways. That's not really strong conviction from key players. When I am bullish, I like when stocks open down or flat and spend the day rallying to their highs in the final hour of the day.

While I continue to believe that the stock market will see more new highs next quarter, I do not have a strong opinion (as hard to believe as that is) that it's straight up from here. Rather, as you can see from the final chart below, I offer two possible paths with the same outcome.

If the green path appears to be favored by the markets, we will likely stick with our current portfolios. If the orange path takes hold, there may be some opportunities. As always, we will take it one day at a time and see what the markets bring us.

Any questions or comments? Just hit REPLY and I will get back to you in a timely fashion.

Upcoming Appearances

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CNBC's The Call - March 24 at 11:05am

CNBC's Worldwide Exchange - March 30 at 5:30am

CNBC's Squawk on the Street - April 5 at 9:35am

You can view most of the past segments by clicking below.

Media Appearances
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(http://www.investfortomorrow.com/InMedia.asp)

Investment Quotes/Adages To Live By

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"When in doubt, get out!"

"If it's obvious, it's obviously wrong."

-Joe Granville

"It's ok to be wrong, but it's not ok to stay wrong."

"This time is different."

"The markets require the patience of a dozen men."

-Robert Rhea

"Luck is the residue of effort."

"The most bullish thing a market can do is go up in the face of bad news."

"The most bearish thing a market can do is go down in the face of good news."

"The market can stay irrational longer than you can stay solvent."

-John Maynard Keynes

"Government is best which governs least" - Thomas Jefferson

Inflation is the one form of taxation that can be imposed without legislation.

-Milton Friedman

"You cannot legislate the poor into freedom by legislating the wealthy out of freedom. What one person receives without working for, another person must work for without receiving. The government cannot give to anybody anything that the government does not first take from somebody else. When half of the people get the idea that they do not have to work because the other half is going to take care of them, and when the other half gets the idea that it does no good to work because somebody else is going to get what they work for,that my dear friend, is about the end of any nation. You cannot
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multiply wealth by dividing it." - Dr. Adrian Rogers, 1931

"Bear markets seem to be divided into three phases: the first being the abandonment of hopes upon which the final uprush of the preceding bull market was predicted; the second, the reflection of decreased earnings power and reduction of dividends, and the third representing distressed liquidation of securities which must be sold to meet living expenses. Each of these phases seems to be divided by a secondary reaction which is often erroneously assumed to be the beginning of a bull market."

- Robert Rhea via Tim Woods

"Free enterprise is a rough and competitive game. Nobody too big to fail. Nobody too small to succeed. It is a hell of a lot better than government control." - Ronald Reagan via Dan Kennedy

"A government big enough to give you everything you want is big enough to take everything you have." - Gerald Ford via Dan Kennedy

"The problem with socialism is that, sooner or later, you run out of other people's money." - Margaret Thatcher via Casey Research

"Diversification alone is no longer sufficient to temper risk... You need something more to manage risk well."

- Mohamed El-Erian

Friends And Family Plan

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Finally, as you know, our firm and this newsletter continue to grow mostly from your referrals. If you know anyone who is interested in securing their retirement, planning for it or just plain worried about it, please send them here. As always, thanks for thinking of us with your circle of family and friends.

Sign Up Here

You can also forward this email to family and friends by hitting the "forward email" hotlink at the bottom of this email.
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