

Dear Client:

As I mentioned in my Friday email, I took last week to really study the economy and markets, here are my conclusions in a nutshell:

Never before have I seen such a massive divergence between (a) the chronically dire situation on the ground in the real economy and (b) the suddenly optimistic psychology on Wall Street.

Reality:

1. An acceleration in job losses
2. A continuing sharp decline in consumption and retail sales
3. A record new surge in home foreclosures
4. A record plunge in the optimism of small business, leading to
5. An even steeper plunge in small business capital expenditures
6. A new collapse in commercial real estate
7. Rapidly shrinking world trade.

And, *at the same time*, we have a, six-week rally in the S&P 500 Index of 200 - very similar to a stock market rally that took place in the early 1930s.

This massive divergence - between Main Street reality and Wall Street fantasy - is precisely the kind of set-up that experienced advisors should be looking for to start establishing a strong position to profit from the next leg down.

Meanwhile, I've been waiting patiently, watching for signs of an end to this bear market rally. And now, I'm finally seeing evidence of a new downturn in the market:

* The medium-term indicators are losing momentum, a sign that the rally is getting tired: Investors yanked \$5.2 billion out of stock mutual funds last week. Bond funds had a reduction of inflows from \$6.7 billion the week before to just \$27 million last week.

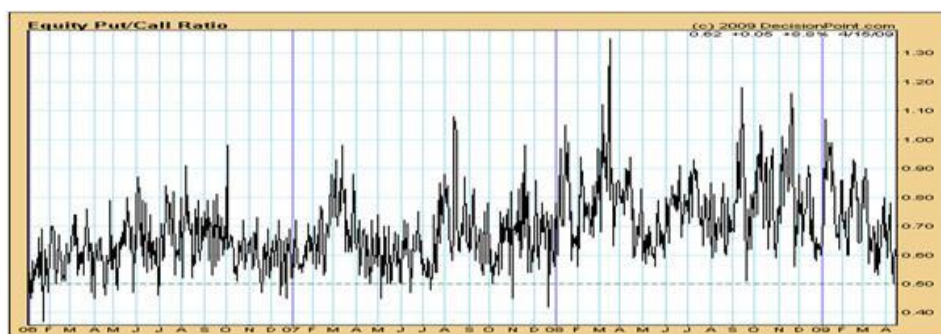
* Short-term momentum indicators are diverging from prices, a typical set-up before a trend reversal and

* The sentiment indicators - especially put-call ratios - are indicating excess optimism by speculators.

These put-call ratios are especially striking: With the CBOE put-call ratio at a meager 0.5, we actually registered *the lowest* reading of the year. This means investor demand for downside protection (with put options) is being abandoned in favor of plays on market strength (with call options).

It is a classic sign of a bear market rally nearing its final stages. Even during *bull markets* this kind of extreme sentiment is a red flag, signaling an impending correction. In a major bear market, it gives me confidence that a low risk entry point for an inverse ETF position is in the offing, and now's the time to start taking advantage of it.

S&P 500 and CBOE Equity Put-Call Ratio, 2006-2009



A reading of 0.50 of the equity put-call ratio is very low and probably signaling a euphoric end to this bear market rally. Source: www.decisionpoint.com

It's quite amazing how much six *short* weeks of rising prices can transform market sentiment. In early March the media was teeming with gloom and doom stories. But now unfounded optimism and complacency are back in spades, encouraged by a 30% stock market rally. **But when you step back and look at this bear market rally from a broader perspective, you'll see this correction still leaves the S&P 500 down more than 45% from its peak in October 2007.**

That's not exactly a stat bulls can brag about. But it certainly seems to have been enough to get them running again. And these are exactly the conditions I have been waiting for.

In planning our strategy, there are two risks I'm very aware of, and you should be too:

Risk #1. This bear market rally continues for a while longer, in an "overshoot rally" - the bulls' final attempt to get prices a bit higher before the big selling hits. In this scenario, any inverse position we purchase now will initially be in the negative, with a paper loss.

Risk #2. The market begins declining almost immediately. In this scenario, any inverse positions we purchase later will be more expensive, reducing our profit potential accordingly.

With these two risks in mind, my plan is to start legging into inverse positions starting *right now*, but to hold the bulk of our ammunition for a series of future purchases.

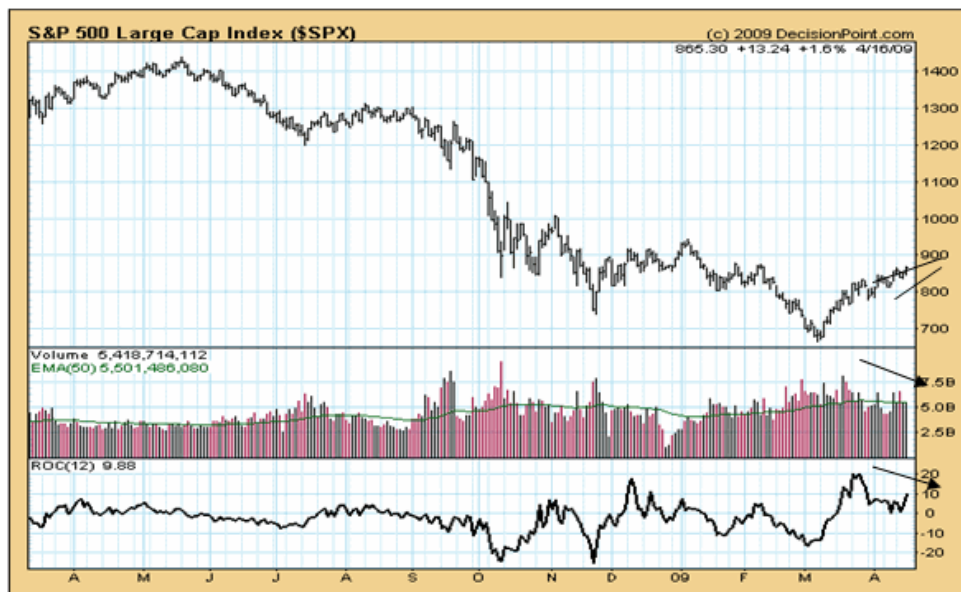
Bottom line: I want you to go into this trade with your eyes open, knowing that we might wind up in the negative in the initial going. And I want you to be ready and willing to add more positions regardless of the earlier results on the first position.

Today, I will be using 5 percent of our current portfolio to purchase **ProShares Short S&P500 ETF**, symbol **SH**. This inverse ETF is a play on a broad market decline, designed to appreciate by 1 percent for each 1 percent decline in the S&P 500 Index.

As I said, I do see the possibility of some additional rally in the S&P. But as I noted on Friday, I also see major overhead resistance between the 875 and 900 levels. Moreover, the market is already near the upper end of that resistance zone.

Additionally, wedges are typically bearish chart formations. And I see a very clear wedge formation which started at the end of March. Add to that, declining volume and fading momentum and the stock market looks even more vulnerable.

S&P 500, Volume, and RSI



Technical note: There is a bearish wedge formation, accompanied by declining volume and negative divergences of short-term momentum indicators. Source: www.decisionpoint.com

As I said on Friday, even if the rally were to continue some more, I do not see much leeway for it. There is another tight resistance zone between 900 and 935. And finally there is more resistance at the declining 200-day moving average - which stands at 985, but is continuing to fall.

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