The Bear Market Rally Continues

April 6, 2009

Dear Client,

I'm buried monitoring the markets ... scrutinizing them virtually 24/7 ... checking every piece of news I can get my hands on.

I also have three Index charts on my trading screen: A monthly chart, a daily chart, and a 60-minute chart to check the short-term moves.

That's because there's a lot going on in the markets. They need to be monitored closely. Miss a development — no matter how small it may seem — and it can cost you big time!

If you are happy with what Shari and I are doing for you and you do not feel that you need to see us for a second meeting this year, we would appreciate having the time to monitor what is going on. Last year we were able to save you a lot of money, this year we want to focus on making you money.

The strongest rallies typically happen during the worst bear markets. And while nimble traders can try to profit from them, conservative investors are better off using the rallies to lighten up on long positions they're still holding. The risk involved with going against the larger trend is just too high.

Each week, I gather economic and other relevant news that sets the landscape up for our positions. Upon review, this week's file was shocking -- more so because a good deal of it went beyond the understandable focus on General Motors Here's, what I uncovered that people in the real world were worried about this past week:

* Automatic Data Processing reported its worst-ever employment data as the private sector lost 663,000 jobs in March -- well above consensus estimates. There was not a single ray of anything remotely resembling light or hope in the report.

* The Organization for Economic Cooperation and Development said GDP in the developed world will fall by an average of 4.3%, unemployment at year-end 2010 will hit or top 10% in many countries and overall worldwide GDP will fall 2.7% -- the largest contraction since World War II, and led by a 13.9% decline in worldwide trade.

* According to housing analytics firm Case-Shiller, home prices fell more than 19% year-over-year. They are down 29% from their peak in mid-2006 and are now around September 2003 levels. Merrill Lynch analysts said they expect an additional 10%-15% downside is still likely.

* FHA loans are defaulting at more than twice the rate they did just a short time ago, and that rate could rise as the economy continues to soften.

* The monthly Conference Board Consumer Confidence Index came in at 26, consensus estimates were for 28, and anything under 50 means confidence is poor.

* The Asia Development Bank reduced the 2009 GDP forecast for China from 8.2% to 7%. According to other sources, China won't do even that well.

* Euro zone unemployment hit 8.5%, far above the consensus estimates in February.

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There's more, such as, GM being given 60 days to get its act together or face bankruptcy, but you get the picture.

The key thing to take away from this discussion is housing and home prices. As long as home prices fall, foreclosures will increase and that puts more pressure on prices. Forty-five percent of existing home sales were foreclosures or short sales. And as long as home prices continue to fall, consumers will continue to keep their money close to them, banks will have more bad loans and the economy will slide.

While the gains in the markets look good, the hard numbers still show that there is still much work to be done to get the economy back on track.

The major focus of this month's issue is to give you a direct warning: If you know of anyone that is still holding government bonds in their portfolios or 401ks they need to sell them now.

We have watched as toxic paper has gone from the subprime mortgages to big banks and spill into Corporate America. Now brace yourself for the next shoe to drop in this massive debt crisis: government bonds.

The single thread that connects each phase is toxic assets and bad debts. At each step of the way, institutions holding the toxic assets have been severely punished – even massacred – by the marketplace. Examples: Countrywide, plunged from $45 to $4.25. Fannie Mae, fell from $70 to a mere 30 cents. Bank of America, which bought Countrywide, crashed from $39 to $2.53 within just a few months.

And now, I believe it is the U.S. government's turn. The U.S. government has assumed responsibility for at least $2 trillion in toxic assets. So it should come as no surprise that the government's most volatile securities – bonds – will be the next victim of the market's revenge.

Throw in all the traditional reasons for selling bonds – a ballooning budget deficit, *plus* Fed money printing, and you have the recipe for a perfect storm in the largest debt market of all: government bonds. So please heed this warning.

Back to Today, I want to tell you why I believe the current rally is not a major trend change, and why the bear market will reassert itself soon enough. I see at least four reasons…

First, stocks are still not cheap. In fact, based on historical dividend yields and price-to-earnings ratios, I consider the market rather expensive!

Second, there is still no sign of a housing turnaround. If you take the S&P Case-Shiller House Price Index and divide it by the median family income, you'll see that this basic measure of housing affordability is still 20% above its 40-year average. It's also 35% above the lows reached in the 1970s and as recently as 1998!

In other words, prices can — and should — fall a lot more. Looking at the inventory of unsold new homes supports this conclusion. Even after a slight drop in February, it would still take 12.2 months to sell all the homes on the market, which is still a much higher number than we saw during the worst recessionary times in 1974 or 1980-82. Until we see this inventory drop sharply, we can't consider the housing massacre over.

Third, there is also a commercial real estate problem brewing. George Soros, perhaps the most famous hedge fund manager of all time and a serious student of macro economics, recently predicted a price decline of 30% for commercial properties. He said:

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"It is inevitable, it is written, everybody knows it, there are already some transactions which reflect and anticipate it, so we know, they will drop at least 30 percent."

I think Mr. Soros is right.

Take the John Hancock Tower in Boston. It's a prized piece of trophy real estate, the tallest building in New England, and it changed hands at $1.3 billion in 2006.

Well guess what? It was just re-sold in a foreclosure auction. The price? $660.6 million. Total decline in value? 49.2 percent in less than three years.

And although Mr. Soros was talking about the U.S. specifically, I think we will see the same trend around the world. That argues for a continued global recession.

The John Hancock Tower was just sold on the auction block for 49.2 percent less than it went for three years ago.

Fourth, basic technical analysis of the stock market supports the notion that what we're seeing now is nothing more than a bear market rally.

Let's consider one of the most common technical measures — the 200-day moving average.

Remember, bear markets don't turn on a dime. After a strong downtrend, the stock market needs time to sort things out, and usually spends many months forming a bottom. One stock after another goes through this process before breaking out to the upside. And a rising 200-day moving average confirms the turnaround.

A good example of this process is the behavior of the S&P 500 during the last cyclical bear market of 2000 to 2003.

Take a look at the following chart, and you'll see the huge bear market rallies on the way to the final low, as well as the bottom-building process which started in July 2002 and ended in May/June 2003. That's when the S&P broke out to the upside and the 200 day moving average turned and started to rise…

S&P 500 and 200-Day Moving Average, 2000 — 2003

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The last bear market had a number of rallies interrupt the severe downtrend. And the new bull market was preceded by a bottoming formation. There is no reason to expect a different pattern this time.

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Now look at today's situation in the following chart...

S&P 500 and 200-Day Moving Average, 2005 — 2009

I expect some continuation of the current bear market rally, probably a test of the steeply falling 200-day moving average.

As you can see, the 200-day moving average is up around the 1,000 level. And the market is nowhere near breaking through that level. So in the very *best case*, the market is *beginning* a bottoming process.

But even then, there is no need to rush. As a conservative investor, you're better off waiting for the 200-day moving average to start rising again. Otherwise, you risk catching a falling knife and losing 30% to 50%!

So I strongly recommend patience. I know rising stock prices make investors fearful of missing the bottom. Especially when the pundits come running back to give their same-old bullish advice. And it's certain that this choir will become louder and louder during the coming weeks if the rally continues.

But don't fall victim to the siren songs! I expect this bear market rally to last a few more weeks, maybe until June. An ideal price target would be somewhere around that falling 200-day moving average. During this cyclical bear it was tested just once before in May 2008. And the ensuing decline was extremely steep. So some kind of counter move was to be expected. But what we're seeing now is NOT a trend change. Not yet.

Meanwhile, Gold Is Taking a Breather...

The fundamentals for gold are nearly as good as they get. Bernanke and his colleagues are doing all they can to debase their respective currencies. The printing presses are running full speed. Government debt is going through the roof. Central banks are buying huge amounts of bonds and paying for them with this newly created money. All of this is very bullish for gold.

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The technical picture is also very convincing. In the following chart, you can see that gold touched $1,000 at the end of February before hitting some resistance. Until now, the ensuing correction was rather shallow, just back to upper support at $900.

A rising 200-day moving average and a neutral momentum indicator support my view of a coming break out to the upside!

The next important support level is the rising 200-day moving average at $860.

The momentum indicator already came back to the neutral zone (the bottom window of the chart above), and sentiment towards gold is rather cautious. That tells me that this consolidation phase could last a few weeks longer, but then a breakout above $1,000 is extremely likely.

My minimum price target based on the chart action is $1,300 for gold. And Kinross and Eldorado Gold, the two gold mining stocks in our portfolio, would profit handsomely from such a price rise.

So we will let this bear market rally run its course, we have started the month of April out well by picking up gains in UYG, DUG and QQQQ.

We will continue using tight stop losses and target margins, while keeping you informed through our weekly emails and monthly newsletters.

Val & Shari

Sources: Wall Street Journal, IBD, Market Watch, Money and Markets, MSN Money, Morningstar, Bloomberg News, NY Times, ChangeWave, NY Daily News, Time Magazine

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