September 8, 2009

Hi Everyone,

Stocks took a bit of a breather this past week, which is typical for the last half of August into Labor Day as Wall Street is on vacation. This is not a time of year when fund managers make big decisions about the direction of their portfolios. That is what the start of September is for.

You may have heard that September has a reputation for being quite a minefield for stocks, and that it tends to be the worst month of the year. That is true during bear markets, but not in bull cycles. And in years when bull cycles are just getting started, it has not presented much of an obstacle at all. I believe we are currently in a “bull cycle.”

Despite this, we are nearing a critical juncture.

Equity markets are leading indicators and in late September, as Wall Street contemplates the coming earnings announcements in October, it will also be looking at Q1 and Q2 of 2010. And looking ahead I believe it will see that the current recovery is actually the second leg (up leg) of a "W" shaped recession.

Recent moves of the market have been based on a statistical recovery of GDP -- essentially, the push up the slope in the middle of the "W." Then, after a quarter or two of data that looks good but doesn’t really say much, I think the economy will begin to slide again on the next (and second) down leg of the "W."

This could happen as soon as late September or early October, but, that being said, we have to trade the entire "W" and we are currently seeing a market that's enjoying the statistical bounce up the middle of the "W."

SHORT-TERM MARKET OUTLOOK

All technical indicators are flashing green and the market should go up, but it's fighting some serious headwinds, and I expect any move up to be sluggish during the next two weeks. So for now, I'm maintaining more long-side positions than usual for us in anticipation of the real possibility of a major spike after Labor Day.

The higher up we go -- driven by irrational optimism and/or the momentum in day trading -- the sharper the decline will be when the market rolls over. It's a scenario that has many professional traders scared and, therefore, cautious - that’s why the headwinds I mentioned above that are holding the market back a bit.

Another factor is day-to-day rotation of money from emerging markets, like China, into U.S. and European markets. As China's market buckled, money came to the U.S. stock and bond markets.

This trend could continue for awhile, but this money influx favors more conservative stocks and has broken the relationship of the dollar, optimism about the economy and bond prices. Instead of falling, bond prices have risen meaning interest rates are dropping again.

The bottom line is that the S&P 500 will push sluggishly forward and will either hit a true ceiling at around 1045 to 1065, or set the stage for the next move up to around 1100.

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WHEN A 'V' BECOMES A 'W'

From an economic perspective, we are headed to a sluggish and jobless statistical recovery from the recession. There most likely will be a pop in GDP in the 3rd quarter based on one-time inventory re-stocking and changes in the relative levels of imports and exports. The market knows this, has traded this information and is now looking for the next leg of the trade.

And, this incremental improvement -- with a host of economic data coming out as "less bad" -- has helped fuel the market's V-shaped rise during the past five months.

But, the market has come up so far and so fast that the data is going to have to go from "less bad" to "good" to turn this recovery into a sustainable bull market.

And, unfortunately, many of the real-world indicators continue to decline. For example, on Friday, the market moved up sharply due to a rise in home sales as traders ignored the second paragraph in the press releases which showed home inventories climbed faster than sales.

According to the Case Shiller Index, home prices seemed to stabilize -- although Robert Shiller said the economy is less forecastable, the market is apt to be flat and there is no certainty this is a bottom.

The index could start going down again once the peak summer sales season is over.

Real unemployment -- including discouraged workers no longer looking for work and part-timers wanting to work full time -- is between 19% and 20%, and climbing.

Consumer confidence rose last month to the mid 50s on the strength of the Michigan Survey Index, and we need a 90 for confidence to be positive.

All of this will lead, at best, to sideways growth and the more likely scenario of another downturn next year turning the "V" into a "W."

When and How Do We Trade It?

First, we kept this in mind when we purchased Fidelity High Income, SPHIX and Fidelity Strategic Bond Fund, FSICX as well as Fidelity Four in One Index, FFNOX in July. We did not want to have any that we had to hold past Oct. 1: As second-quarter earnings come out, so will forecasts for the fourth quarter and 2010. And, this could turn market sentiment one way or the other. Given the current overbought conditions in the marketplace, there is a good chance the market will turn down.

If that is the case, many stocks sensitive to economic growth -- such as consumer discretionary stocks, homebuilders, basic materials, shippers and, last but not least, the banks -- will head back down.

Second, we likely have several more weeks of bullish momentum before earnings and forecasts come into focus again, so we have taken advantage of this phenomenon by purchasing SPY and MDY. These are two exchange traded funds that follow large and mid-size company stocks and therefore are more aggressive in nature. We have put in stop losses on these two ETFs because of their aggressiveness and we are able to get out of either of these two funds in a moments notice.

Also, be ready for one or two new purchases as I expect to see a rebound in international funds coming soon. We'll be realistic about the market circumstances and make money, which is our

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ultimate goal. But be prepared for quick exits if markets turn for the worse as we near the end of September.

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