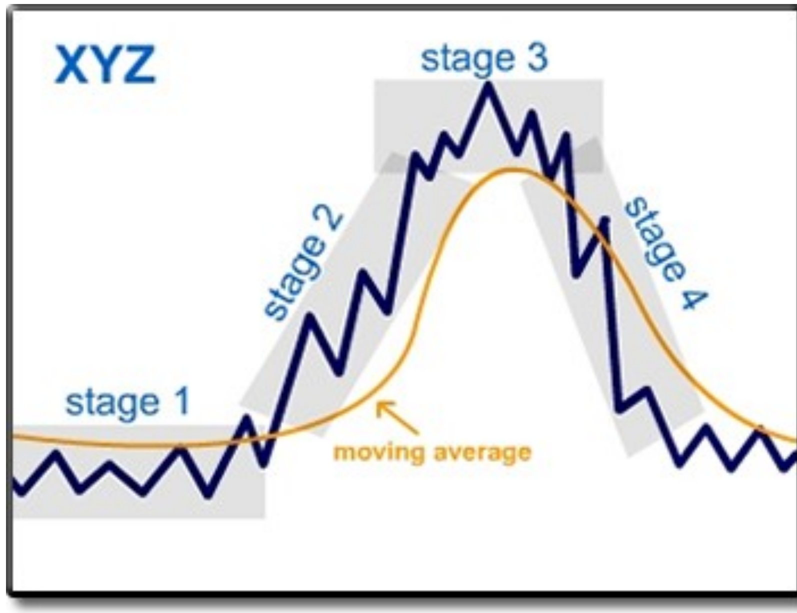
WallStreetWindow PowerInvestor

Cash Reserves As A Strategic Position —Mike Swanson (03/08/15)



In 2012 I put my money in a basket of European stocks and ETF's in August of that year. I also bought some gold stocks around September and saw them pop up and then turn down to stop me out near even. I held those European positions for big gains though until February of last year when I announced that I sold them and went into cash. They topped out a few weeks later and fell until most of them put in bottoms at the end of the year.

My selling sparked a lot of anger among people at the time. When you talk about making money in the financial markets cash is not a position that makes sense to people and it makes people angry to be told to sell. People want trades and they want action. No one wants to hear someone say that they are bearish on the stock market. If James Cramer told people to get out of the stock market his ratings would collapse and he would be taken off the TV. His advertisers would demand it! All the masses want is to believe and be told that the stock market will go up forever for them. And they want constant trades and picks to be a part of the action.

The Investors Intelligence poll hit 59% bull the other week and according to a new Gallup survey 75% of people responding to a recent poll said that they plan on holding all of their stock market positions and "riding out" any drop in the markets. 44% of them said they would use "volatility" to buy more.

I have been investing and trading in the markets now for over 16 years and have seen several bear and bull market cycles. I have made money and at times taken hits. I have also learned lessons from my mistakes and the mistakes of others. The biggest mistake people make when it comes to investing is to put themselves in a position in which they become completely dependent on one trend of one market and almost everyone makes this mistake.

The individual American investor is told to put all of their money into the US stock market and to believe that it will go up forever. To control risk they are told to put a portion of their money into bonds.

Most professionals either manage the money of small investors so do the same thing out of fear that if they do something different and the market goes up without them their clients will crucify them. The result is an echochamber in which everyone is bullish on the stock market all of the time for the most part.

No one can get out because they are scared to miss out. So when the bear market inevitably comes they get crushed. As a result they go on a repeating cycle of boom and bust.

The other thing professionals may do is find an alternative trend and ride that out until it comes to an end.

That can lead to similar mistakes though. The problem is when you focus on one market or one trend you miss out on other opportunities and the lack of diversification ultimately bites you.

In 1999 I was a short-term trader in tech stocks. Then in April of 2000 I became someone who trades on the short-side of the stock market. I made a lot of money shorting the stock market from 2000-2002. I also bought gold stocks in 2002 so made money there too.

For the next several years I focused on those two things. So I missed the bottom in the US stock market in 2003 and tried to short the market until that summer. I also focused on gold and mining stocks so made some big swings in that until 2006 so it wasn’t that big of a deal.

In 2007 I didn’t do much trading at all and in 2008 I went long gold and once again short sold stocks. I got stopped out of gold for near break even in August of 2008 and made a complete killing in the 2008 stock market crash.

However I continued to be bearish on the market on the bottom and didn’t recognize the bottom until June/July 2009 and then I did some trading on the long side for the next year or so.

The reason I missed the bottom is because I was taking big positions on the short side and focusing all my effort on that one trend. It is the focus on ONE TREND or ONE MARKET that causes people to make mistakes. This led me taking hits getting into gold and gold stocks last year.

I have heard stories of people in the gold industry who have been in that sector since the 1970's and have made and lost huge amounts of money in each bull and bear cycle.

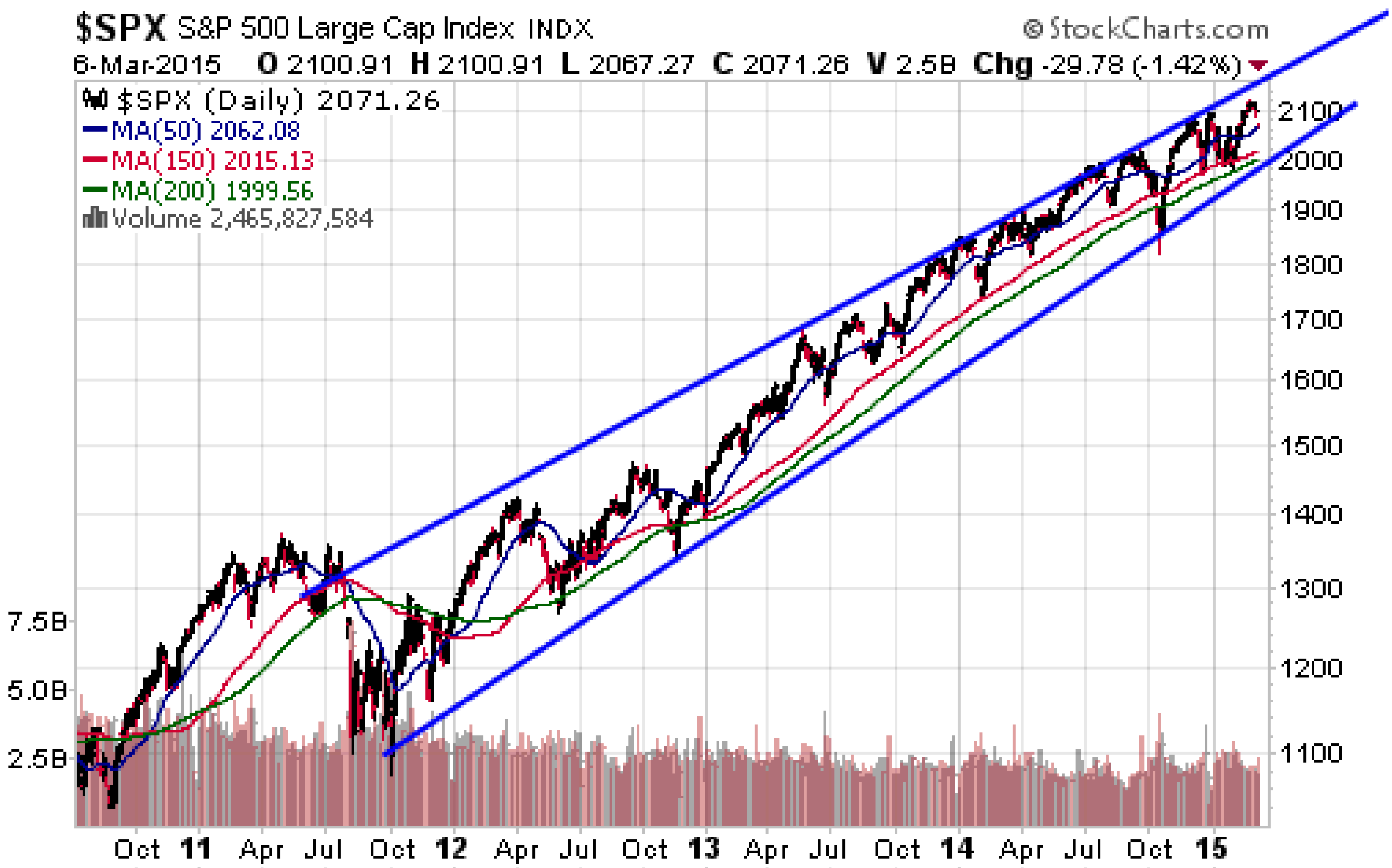
The way to escape this cycle of mistake and disaster is to invest in multiple markets and asset classes and engage in periodic rebalancing to maintain a fairly fixed asset allocation. For example you put 20% say in US stocks, 20% in bonds, 20% in gold, 20% in foreign stocks, and 20% in some special sector. If you would have put 33% in SPY, 33% TLT, and 33% in gld in 2007 and rebalanced those positions every month to maintain that allocation you would have barely lost anything in 2008 and beaten the market all of the way up until the present.

That is how important diversification and investing in various asset classes and markets can be. It limits downside risk and can boost returns easily.

The only time it doesn't work is if everything were to crash. And right now we are facing a tough time. You see when the next bear market comes in the US stock market it is going to completely devastate people, because at some point it is likely to become correlated with a falling bond market as the bubble there bursts. Yes zero interest rates and negative yielding bonds spells global bond bubble.

The 1999 bear market was associated with the tech stock bubble implosion. The 2008 stock market crash was associated with a drop in real estate prices that brought a collapse in mortgage securities owned by Wall Street banks that destroyed their balance sheets. The next bear market will be linked to a secular top in global bond market and this is a top that may have already come in the US bond market. When you read stories saying that people are willing to lose money buying negative yielding bonds then you know you are seeing a dangerous bubble in the global financial markets. At the very least it's a sign of some wild imbalances in the world economy.

And we are seeing the risks and wild volatility grow. The Nasdaq went above 5000 briefly at the beginning of this month so that "news" has overshadowed the turmoil going on in the markets. In the past six months we have seen oil prices fall 50%. We are seeing negative interest rates on some bonds. European markets are up 18% across the board this year,



but for Americans European ETF's are simply going sideways because the Euro has been in a sharp decline. Last December the Russian stock market crashed as the ruble had a collapse. On Friday gold prices fell over 33 points in a single day. There are wild gyrations going on all over, but few pay attention to them because the Nasdaq went above 5,000, the stock market has gone up for over five years, and everything they hear on TV is bullish on the US stock market.

But the US stock market is overvalued with a cyclically adjusted P/E ratio over 27 and the only two times it has been higher than 27 was in 1999 and 1929. Wall Street bulls though have said that "valuations do not matter" and "price is reality" and as long as the market goes up they are right.

Since 2012 the stock market has been rising at a 45 degree angle "stairway to heaven rally." This is the last final bull market hurrah for a generation, because this is an unsustainable rate of market advance and when it breaks and the market smashes through its long-term moving averages or closes below it's lower support trendline it will go into a free fall.

I have been saying for over a year that the US stock market is too risky now to invest in due to valuations and sentiment. But I never said sell until the end of last September right before the market fell in October. In my view the market has been going through a stage three topping process since July really that will mark the transition into a new bear market that will be just as devastating as the two previous ones we have seen, because it will be linked to a bond market bear market and the Fed will not be able to lower rates or do much in response.

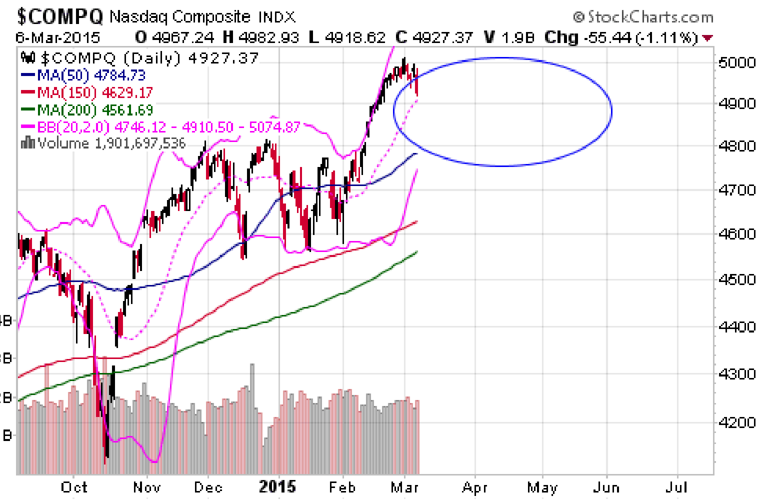
What makes a stage three topping market is an increase in market volatility and a narrowing in the sectors and stocks leading the market as many stocks and sectors simply begin to diverge away from the rising market averages and lag.

The most popular way to measure this is to look at the advance/decline line which is a simple ratio created by dividing the number of rising stocks by the number of falling stocks. When it comes to the Nasdaq it has been in a downtrend now since February of last year.

A more accurate and more meaningful way though to measure this is to look at the percentage of stocks above and below their 200-day moving averages. For the NYSE, S&P 500, and Nasdaq this all peaked out last year in the summer for all of them.

Interestingly on a short-term basis this ratio last peaked out in the middle of February and failed to go above that high when the Nasdaq went above 5000 at the start of this month. Even the number of stocks above their 200-day moving averages on the Nasdaq didn't go up on that day. Many big cap tech stocks have barely gone up much at all in the past few months and are on support. Look at INTC, IBM, and MSFT for example. Look at TSLA. Go through all of the DOW stocks and only MMM and V have been strong. Some seemingly "safe haven dividend" stocks such as MO fell hard on Friday for a 3.84% drop. It looks like it has had a huge reversal of its upward momentum.

I find the short-term action of the market very disconcerting right now. We saw the Nasdaq get above 5000 for a few hours and everyone get euphoric and have only seen hard selling for a few days as a result. And all of this followed a move with little volume and poor market participation. But more importantly it is all in the context of a stage three topping market, a market that had made its last bear market bottom six years ago, is wildly overvalued, and with volatility increasing in all sorts of markets and assets since this summer.



Just looking at a simple daily chart there are two obvious possibilities. The first is that the Nasdaq and the other major US market averages now consolidate in a trading range for several weeks with the 50-day moving average being a likely support area. They then breakout sometime after this month to go on another rally. Essentially it would be a repeat of what we have seen in all of the other little pullbacks during the "stairway to heaven" rally that began in December 2012.

The other possibility is just as simple and that is that the market has topped out for good and is going to go through the support levels of the "stairway to heaven" and begin a bear market disaster. In this scenario the market would likely continue its move down off of its high with a short-lived bounce off of its 50-day moving average or lower off of its long-term 150 and 200-day moving average, the latter being morel likely.

If the bear scenario happens the market could be down 25-30% off of its highs in a matter of months.

This is what you have to be prepared to lose if you want to stay fully invested in the US stock market. The problem is other markets are likely to drop too and it is hard to tell what will act as a safe haven.

On Friday besides the US dollar index the only other ticker I saw up on my screen was the UNG natural gas ETF. All other commodities were in the red and gold and silver were down too. Bonds were down and so were all world markets.

I do not like what I'm seeing in the markets right now at all. And on Friday I decided to raise cash and may go completely to cash this week.

Let me tell you the good news. There is a way to get rich in these markets with very little risk at all. I'd say practically none. I explained it to a friend of mine who is around 50 years old in October.

He has money in some CD's that are coming due and he had no idea what to do with it. I told him to just sit on the cash and wait for the next bear market and forget about doing anything with it. If he could just wait for the market to fall for a few years and then buy then that investment could make him rich. He held in 2008 and I told him to imagine if he had money to use in 2009 where he would be now. I said no one gets rich in the stock market by buying into markets that go up for six years and praying they go up higher. Warren Buffett cashed out in the late 1960's and bought back in 1975.

If you have cash reserves and raise cash and simply do that you can end up wealthy in a few years. For the past few months I have written about the need to diversify and invest in a mix of assets and how I plan on doing that and have been doing that.

I plan on going to mostly cash and simply waiting before reinvesting the money. I am 40 years old now and I know that the easiest way to make money going forward is to simply let the stock market drop and as the market drops we will see select asset classes, commodities, and world markets hold up as the market falls at some point and one by one breakout and begin bull markets of their own before the US stock market bottoms. We do not need to wait for a final bear market bottom for the US stock market for good investment buys a there will markets that break away from the bear.

In 1929 the gold and mining stocks fell in the first few months of the 1929 stock market crash, but then diverged away from the market and went up for years. In the 2000-2002 bear market they fell in the first half of 2000 and bottomed at the end of 2000 and took off in 2002. In the 2000-2002 bear market tobacco stocks and utilities made key bottoms just as the US market went into a bear market and began bull markets of their own. Russia also started a bull market around 2001. The next time the US stock market goes into a bear market the same sort of thing will happen. Whether that bear market starts this week or next year this is the single safest way to make the biggest returns out of the marketsxxxxx possible.

Most people cannot get out of the market though because they are afraid of missing out or are simply addicted to being in the stock market one way or the other. I am 40 years old and I feel no desire to engage in an incredibly risky market anymore until the risks subside. Until the market starts down every day from now it will simply get more and more risky. I think the bull market is over and the market is in trouble and that is why I am raising cash.

I will likely take some short positions against the market at some point this month and will help you do the same to profit from any market downside. But I plan on putting 15-20% chunks of my time at select markets and asset classes as the bear market unfolds. At this point though I fear that a steep market drop could temporarily make everything fall for a few months of time and I do not want to be a part of that possibility. The markets could fall 25-30% over the course of a few months.

I plan on investing for decades and therefore feel no need to take such a risk in order to be a part of a few months of possible returns in various markets. The perfect portfolio is one invested in a mix of asset classes that are trading non-correlated with another. Starting in December I invested my money in a mix of 20% positions, but at this point in time I do not know if it isx possible to own a portfolio that is invested in positions that are not trading in synch together, because last week just about every single market and asset class fell.

Anyone with investments in the stock market has to face the question of what are they trying to do with their money? Most people just throw their money at the market and hope it goes up forever for them with no plan at all. Some try to make big returns from big trades, but in the long-run that is a tough game to play. Serious investors pick things to invest in when the time is right and are willing to sell or reduce risks when the risks grow.

And the risks have been growing all year and are growing every day. Last year I wrote several times that people who are over 65 years old might even want to consider taking their money out of the stock market completely. I cannot predict exactly what is going to happen in the markets and right now my fears of the market may not come to fruition immediately. Maybe the market will succeed in stabilizing here and will just consolidate and breakout again and then go into a real bear market later this or even next year.

No one can predict the future. But I can tell you this bear markets devastate those that try to hold through them. Since 1929 there have been 26 bear markets in the US stock market. The average one lasted 11 months and brought a 35% loss. The smallest loss was for 21% in 1949. The 2008 one brought losses over 60%.

The Federal Reserve has not abolished bear markets and no bull market goes up forever. You need to ask yourself one simple question and that is if you never plan on selling then how much are you willing to lose when the next bear market comes?

I see no reason why anyone over 65 should have 100% of their money in US stocks and bonds, because if the markets were to fall 35% they may never live long enough to recover their losses. There is no guarantee that the next bull market will go up as fast as this past one did and markets can go sideways for years after a bear market is over. Gold topped in 2011 and has yet to make it back to those highs and if the next bear market is associated with a bond bear market it will be a disaster for the US stock market.

I am not your investment advisor. In fact if I worked for a Wall Street firm I would not be able to even tell you what I have written in this report, because no broker or advisor can be allowed to tell people to sell and have some cash, because their clients would think they were crazy and the firms would get no benefit. There are no fees and trails to be made from cash positions and no dreams of big gains to believe in.

But cash can be a strategic position in an account, because a cash position enables one to buy things later when they go to lower prices. Even a 10% cash position can provide such a benefit than a zero sized cash position.

So I think everyone should consider selling at least something in their accounts to build some strategic cash reserves that they will be able to use later and reduce the risks of exposure now in the financial markets.

That is what I'm doing and I may go to 100% cash for a short period of time. As for gold it fell on Friday below recent support and so did the gold stocks. The drop frankly took me by surprise, as I expect the gold stocks to continue their relative strength against the metal.

If you take a look at the HUI gold stock index the action on Friday is very similar to what it did at the end of May and at the very end of October. It made a peak last year in March and corrected in May by falling just about every day.

It didn't really fall much, but made a slow drip drop with support around 210. Then it went below support in May and had a big one day plunge. It bottomed the following week and turned back up.

If the same sort of thing happens again then the HUI will bottom in a day or two and turn back up by the end of next week. Now it fell hard in October, but had a support level during the decline at the 180 level. When it went below that level towards the end of October it had a final giant one day plunge after which it fell to 150 and made a double bottom.

The point is that Friday's drop looks like the same type of action that happened when the HUI went below 180 in October and 210 in May. It will either bottom in the next few days or fall down to 150 and retest it's fall lows.

I'm surprised by the sudden weakness in gold and mining stocks, but I do not think it means gold is going to 900 an ounce or 1000 an ounce or some other crazy level, because according to the commitment of traders report there are roughly 9,000 net long contracts owned by small investors and 120,000 net short commercial contracts. If gold were to fall to 1,100 you would have zero net long contracts before then owned by small traders and they would have nothing to left sell. That's why gold did not go into a giant collapse last year even though the HUI fell so much.

I'm more concerned about the stock market simply causing weakness in everything for a period of time in a giant risk-off sell-off impacting gold then I am some weakness in simply gold itself. At some point even if gold were to decline further from here it would eventually break away from the stock market and go into a bull market even as the US stock market declines, because it will begin to act as a safe haven, which will become a necessity for people to own in a bond bear market as an alternative to debt instruments. It is just that in the first initial bear market move down gold could get taken town for a period of time along with everything else. That is what happened in the 1929 stock market crash and in the year 2000 and could be what is happening now.

There is instability and increasing volatility inside the US stock market, in stock markets all over the world, and in almost all asset classes. Even US bonds dumped on Friday even thoughx the DOW fell almost 300 points. And yet no one cares, because they are mesmerized by the fact that the Nasdaq hit 5000. But if you are invested in many US stocks look at your portfolio and see how many went up with the market this month and how many lagged, because most big cap stocks and stocks in general are lagging now and that is the real story. It is time to reduce risks. That may mean buying put options on positions, taking short positions, or raising a strategic cash position. But now is the time to do it and almost no one will say that as it is taboo to say when it comes to investing.

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