Stock Market Barometer

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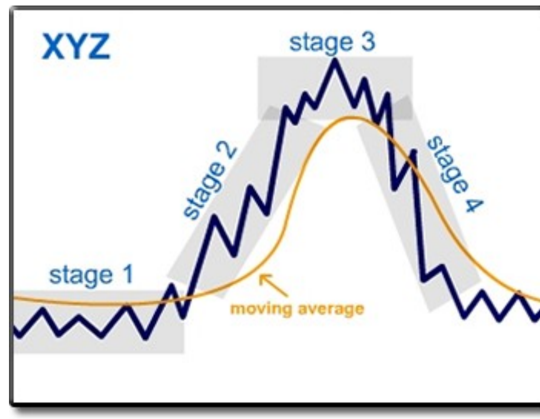
First Quarter is Now In the Rearview Mirror—Mike Swanson



It's April the 1st. I hope you had a nice Easter and were able to take some time out to spend with your family and friends. Spring is in the air and the flowers are starting to bloom. I'm trying to grow some rose bushes. It's already April and the first quarter of 2013 has quickly come and gone. It's been a good quarter for the US stock market. On Thursday the S&P 500 closed at a new high. It's up about 10% so far this year. At the same time gold and gold stocks have acted weaker than the market and have yet to really start their next big rally yet, while European markets and most global markets spent February and March correcting.

A lot of people are now saying that the only thing you can invest in is US stocks. This action has them convinced. While US investors have pulled money out of the markets in 2011 and 2012 they are now putting money back into them. In the last quarter of 2012 the US market lagged markets all over the world, but in the last two months that didn't happen so they are now convinced that the US market is the place to be.

I think they are wrong and right at the same time. I know you must think that sounds funny. Before I tell you what I mean let me share with you some things I have learned from investing over 15 years now.

First of all everyone has a tendency to talk up

Quote of the month:

""*Knowing reality* means constructing systems of transformations that correspond, more or less adequately, to *reality*." - Jean Piaget their own positions and no one really knows what is going to happen. Once someone buys a stock or makes an investment in a market, whether that be in the US stock market, gold, a country overseas like say China, or in something like real estate, people have a tendency to convince themselves that they have made the correct decision.

This is why sentiment survey polls such as the investors intelligence survey tends to show that people get extremely bearish at key market bottoms and overly bullish at market tops. People tend to remain bullish and hopeful as long as they hold on to their stocks and get bearish after they sell. Bear markets end when people sell out in mass - everyone who might sell does— so on bear market bottoms bearish sentiment becomes widespread.

Think back to 2005 and how people talked about real estate back then. A lot of Americans were buying condos, taking out second mortgages, and buying interest only loans to afford a house, all on the rational that housing prices always go up. Then they got creamed.

In 2009 we saw a massive bear market bottom. The people that cashed out of stocks put their money into CD's and bonds for safety. The experience of holding through the 2008 stock market crash taught them that the stock market was a dangerous place to keep their money so they got out and went into safety. They bought CD's that pay nothing.

Now we are going into the fourth year of this current cyclical bull market and many of these CD's are coming due. What are these people going to do with this money?

The stock market is at highs and the TV is bullish on the market. If they don't buy stocks now and the market goes up without them they will feel like they are missing out. So they are doing what every herd following American is doing now and buying stocks.

This is the "money on the sidelines" that CNBC talking heads are yapping about. It is a factor in the market. The problem is this money is not unlimited and one day the masses will run out of money to put into the market. Many now are retired and need money to live off of. No one wants to put all of their money in the market anymore either. But no one will want to miss out completely on a bull market either— so yes there is a big pool of money in CD's that is going into stocks now.

The problem is that people doing this are doing so in reaction to market movements and without a real investment strategy. They piled into CD's at the wrong time and will end up piling into stocks at the wrong time too. Very few people are capable to learning from their investing mistakes. That is not to say that we are at a market top or that I think the bull market is over— I think this bull market is going to continue until it sucks all of the money out of the masses that it can and then it will peak out and crush them. We are going to see another financial wipe-out on the part of the public just like we saw in 2008 when the next bear market comes and the next recession— but I think we are years away from either. The point is no matter what happens in the economy as more and more people get into this market more and more people will get bullish and we will hear all kinds of rationalizes about why you now have to be in stocks.

Now this is the masses. The professional is not that much different. The money manager and fund manager tends to talk up his positions too with all kinds of theories and has no idea what is going to happen in the future.

People no matter who they are tend to get into the habit of thinking that they are invested in the best things in the world and any other investment choice is bad or a mistake. They like to think to do something they are not doing is dangerous that way they convince themselves that they are not missing out on anything.

So a US stock market investor convinces himself that gold is risky and that Europe is dangerous. While someone invested not in the US stock market but in only gold or only CD's convinced himself that the US stock market is too dangerous. If you talk to such a person they will tell you that it is going to crash. They'll say it is just short covering making the market go up or Bernanke money printing and once it stops it will all crash. If they are pseudo-intellectual about it they might reference Elliot Wave Theory and Robert Prechter.

To give you one example in the professional world though one of the biggest money managers is Ken Fisher. If you read any of his books or writings every single argument he makes has two purposes— to say that you should buy and hold forever and that the US stock market is the best place to invest in the world and is completely safe. No matter what happens or what his arguments are this is what he is telling you. Some of his reasons are good and some are faulty. Well, his business is to get control of people's money and invest it for them in stocks. If people lose faith in the stock market they may take his money away from him and do something else with it— so he is always selling people on what is in his financial best interest.

I'm not trying to single out Fisher. He's just well known so I figure you have heard of him. The point is this is what just about everyone does. The whole business of money management is people saying my investment strategy is best and everything else is too risky for you.

The truth is though that no one really knows what is going to happen in the future. All we have to go by on is what is happening at the moment and in past history to try to get an idea of what might happen.

I have a Masters Degree in history and have read lots of history books over the years. I spent much of last year doing an intensive study of the first twenty years of the Cold War and have a draft of a book done

that I wrote about it. I thought I knew a whole lot about it before doing this, but what I discovered is that it turned out I didn't know as much as I thought. One of the biggest factors in this years was the fact the Soviet Union had no capability to launch a real nuclear attack against the United States until 1964. In the 1950's they didn't even have a bomber capable of flying to the United States and back, but the United States had the capability to launch a "first strike" and wipe them out without the Russians retaliating for several years.

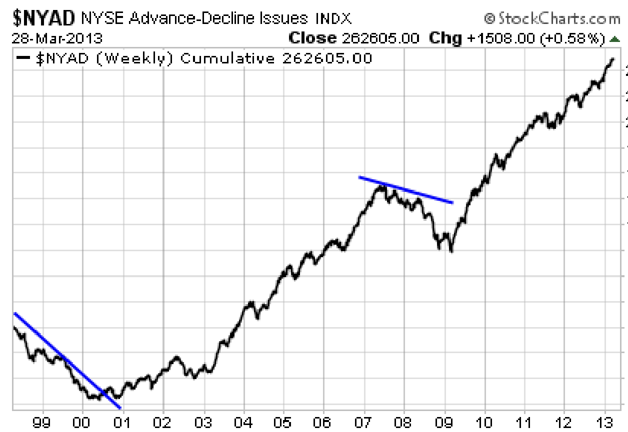
That fact had a defining impact on the relationship between the Soviet Union and the United States during this time. But I never knew that and thought I knew a lot. It isn't really written about in the history books and I've never seen it mentioned on the "history channel."

I can mention other examples. The point is here I am thinking I know a lot about this era in the past and some of the most important facts I did not know. It is even harder to know what is happening now and even harder to try to predict what will happen tomorrow. We live in a time when the era that we were born in is fading away and a new one is coming. It is hard to understand what is happening right in front of us, much less predict the future.

What investors and traders tend to do is rationalize their investment decisions and turn them into something akin to religious beliefs. They also tend to look at the action of the moment and make way too much out of it. What happens on any given day in the market rarely means much going forward - and the same goes for what happens in any given quarter.

Last quarter the US stock market did better than world markets, but the quarter before that the US stock market lagged. Which quarter is the important one then? The most accurate way to figure out what is happening in the stock market is to look at the larger trends on charts going back for years and just looking at the long-term moving averages and phase analysis to figure out whether what you are looking at is in a bear market or a bull market or something in between. In the end that is all you need to know. You don't need to figure anything else out really. You just need to know what the big trend is and then figure out what is the best way for you to participate in it. In bull markets the best way to do that is buy new positions on pullbacks.

I still believe we are in new bull markets in Europe and world markets, that gold and commodities will start one this year, and the US is still in a bull market, but will likely lag these other markets over the next few years due to the higher valuation of the US stock market when compared with other world markets and the fact that it is now four years into its cyclical bull markets while these other markets are in their first year.



I see no sign that the bull market in the US is over. The is a chart of the advance/decline line on the NYSE. It divides the number of advancing stocks by the number of declining stocks. You can see that it is going straight up. That means that a lot of stocks and sectors are participating in the stock market rally.

As bull markets reach their end money starts to move into fewer and fewer stocks, because so many have simply become so overvalued that smart money refuses to buy them anymore and many start to see selling. Some stocks though become glamour stocks that become favorites with professionals and the public. They become the stock market leaders and at the end they usually are the only things still going up.

At the end of a bull market many stocks and sectors are actually already in bear markets. You can see how the advance/decline line went into a downtrend and diverged away from the stock market averages in 2000 and 2007 before they topped out and went into bear markets. In the summer of 2007 most sectors in the US stock market were already below their 200-day moving averages while the stock market continued higher. If you were reading me back in the December of 2007 you'll remember how I pointed this out and called for a vicious bear market.

Nothing like this is happening now and if is going to happen soon it would take months for it to unfold.

This is why I do not think we are at some sort of major stock market top. Yes we can easily see a correction this year at some point like we saw happen twice last year, but a correction of 5-10% is no big deal and would not represent a massive stock market top.

I can't predict what year this bull market will end. That would be just guessing. But this makes me think we are at least a year away from the end of this cyclical bull market, and my guess is that its actually a few years away. I doubt we're going to go straight up though for years on end. We'll probably see a big sideways range once the current rally ends.

So I think people are right to be bullish on the US stock market, but wrong to go totally crazy. I think those that think we are some new secular bull market or golden age for the US stock market are wrong and that one day this bull market will come to an end just like the last two did. Stock market cycles are not going to go away.

So I think those that say I am going to just invest in US stocks and not worry about anything else are making a mistake and so are those that are taking all of their money out of CD's or things not doing well and putting it all into US stocks are making a mistake too even if that is what they are being told they should do on CNBC.

And that leads me to another lesson I've learned over the years that I want to share with you. The key factor to making money in the long run is not a trading system, a trading method, or stock picking system, but how you manage your money. It is all about the size of the positions you take and doing a little diversification. It's best to invest not in one market or one sector, but in a couple of them. That way when one lags you'll usually see another do well and not get all stressed out about it.

If you put all of your money in one stock and it went up a lot you could make a lot of money, but you would stress yourself out like crazy if you did that even if it worked, because you would end up worrying about every little gyration the stock makes. You'd find it impossible to hold.

The same is true though if you put all of your money into the US stock market or gold stocks, or whatever. Putting your money all into one investment sector and holding is tough to do. You are best to pick a few markets and sectors and put a portion of your money into each one. Maybe even having a portion of your money in savings and cash wouldn't be a bad idea either.

Also if you invest in a few different markets it is much easier for you to look at them in an objective manner, because you have less of your money and your ego tied up in them. You are much less likely to just rationalize what you are doing and lose touch with the reality of the market trends.

How much someone should divide their money up into different things is really something best decided by the individual doing it. Everyone has a different comfort level and it can change overtime. I always feel more comfortable having larger positions in an ETF than in an individual stock. So for example I bought three new stocks last week. Each position took up less than 2% of my account. All of them were linked to Greece and two to the shipping sector.

I have also found it easier to average your money in overtime in a market instead of just putting it all into use at once. The longer I have been doing this the more I have tended to want to try to buy and hold for a longer time horizon. I really do very little short-term trading anymore. My ideas is to have core positions and more trading positions and if I buy something and it goes up enough that I can hold it through a 10-15% correction with no trouble the more I am likely to consider that to be a core position.

I've just gone through a pullback in most of my positions due to the correction in the European markets so I'm not really looking to trim anything now, but more focused on buying more. At the moment I'm about 89% invested. The time to trim really is after a big rally. Then look to see what you don't want to keep holding or what is lagging in your account for potential sells.

Right now we are in a strange position in the financial markets. The S&P and DOW have made new highs while commodities and Europe have corrected. So to me right now its scary to buy in the US at the moment until there is a correction. It also makes me nervous about buying much of anything else. In a perfect world the US market would have pulled back too in February and March and we would have seen some climatic bearish sentiment. That would have taken away the risk in buying now completely.

The problem is that its hard to just rigidly worry too much though, because at some point these markets may just diverge away from the US stock market. Europe did it in December and can do it again. Gold has done it in the past too. In 2005 gold stocks went crazy while the S&P 500 just went sideways. So I'm just watching them carefully in case they start to do that. I'm really keeping my eye on the mining and commodity stocks carefully right now in particular.

In the end though these are bull markets and you want to buy dips in bull markets.

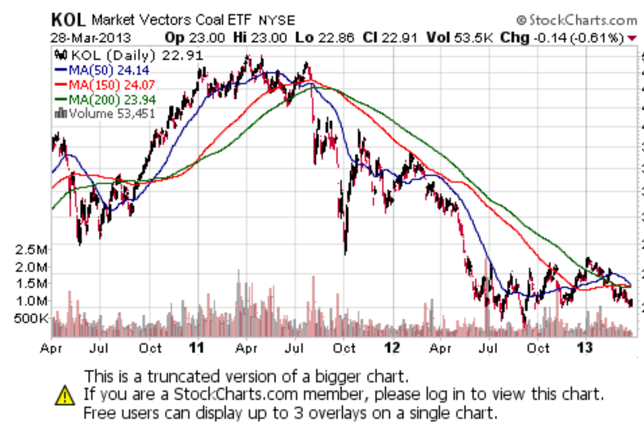
I think we've likely seen a bottom in the European markets. Some of them such as Italy, Spain, and Greece corrected so much in February and March that they gave back around 50% of the gains they made since their 2012 bottoms.

We also saw the Cyprus crisis reach an ending phase and these markets fell into it so perhaps with the news there done they will now go up. This is why I did a little more buying in Greece last week.

At the moment though the sector that looks like it is in the position to go up the most to me over the next few months is the shipping stock sector. I sent a power investor report several weeks ago highlighting what I think are the best stocks in the sector and I bought ESEA, VLCCF, GLBS and NMM last month.

This sector tends to go up and down with the Baltic Dry Index, which tracks rates shipping companies are charging their customers. Its sensitive to commodity prices and economic growth rates. It appears to have created a reverse head and shoulders bottom formation over the course of the past twelve months.

I also bought into the coal mining sector through the ETF KOL and RNO. The sector is trading in what looks like a stage one base. I think commodities as a whole are going to turn up into a new bull market and KOL should follow.



Gold stocks saw heavy selling the first quarter of 2013 and actually were among the worst performing sectors in the entire stock market. Same goes for silver stocks. I still believe they are going to turn up this year and go into a new bull run of there own, but before that happens they will likely build a base first to launch off of much like they did from April to August of last year.

So I would look for gold stocks to bounce up and then go sideways before going into a bull run. I plan on buying some mining stocks at some point this year.

As we enter this new quarter we have many things to be excited about in the markets. There are fewer naysayers now then there were at the start of the year when it comes to the stock market, but there are still a few around that will probably never go away. I'm not listening to them. This is still a bull market and there is no sign that it is over. There are still opportunities to make money. Not everything has gone straight up the past few months and there are still sectors basing and in a position to transition into a new bull market this year. I think that is where the money is to be made and that is what I'm paying attention to.