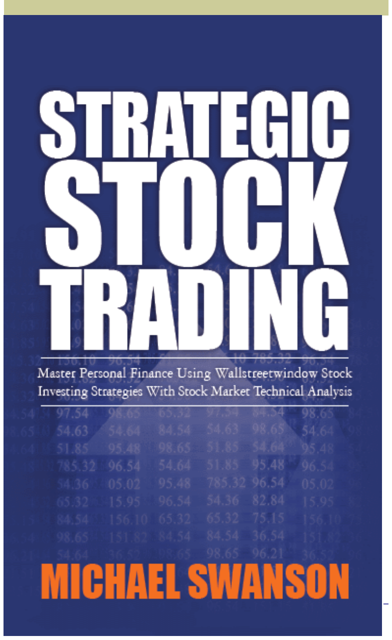
WallStreetWindow Monthly

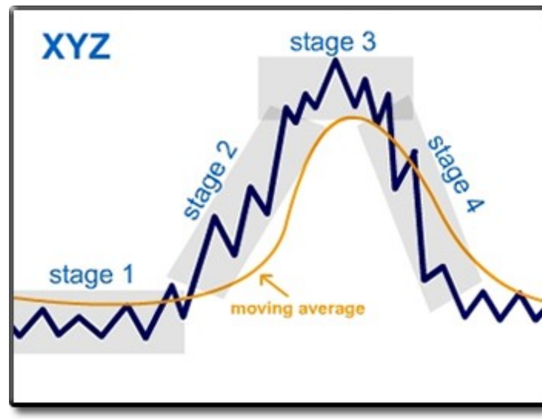
Stock Market Barometer

Quote of the month:

"In any investment you expect to have fun and make money" - Michael Jordan



Embrace a Correction! —Mike Swanson (06/02/13)



Nothing goes straight up forever. People forget that fact though after a market goes up for week after week. People don't think logically when it comes to investing and trading. They tend to act on emotional fears. And the biggest fear that motives people when it comes to their decisions in the stock market isn't the fear of losing money, but the fear of missing out. This is why people hold during a bear market and why so many people get trapped buying into tops.

And they rationalize their decisions. It isn't just regular investors that do this, but hedge fund managers and money managers. That is why as the market went higher in May if you watched CNBC you saw crazy arguments to rationalize buying into a hyperbolic rally(the stock market went up 8% in four weeks) - the biggest one being that despite the S&P 500 now trading at a cyclically adjusted P/E of 24 and having risen to a new high it is actually cheap, because interest rates are zero. The people saying this were in fact saying forget traditional stock market valuation metrics that have historically worked for the past 100 years. These metrics mean nothing, because we are in a new era of zero interest rates. With rates at zero stocks are worth more, because many of them have a higher dividend yield than the yield that treasury bonds will earn you. Therefore they are cheap and will go up forever. I saw someone make the idiotic claim that the DOW is going to 60,000. Talk about reckless hype!

Well, whenever you get big bull markets that cause the stock market to get expensive people lose their heads and come up with some new theory on why we are now in a new era in which old metrics mean nothing. Back in 2000 the talk was that we were in a "new economy" that meant that the economy would grow forever thanks to the Internet. Once that bubble bust people argued that Alan Greenspan was so smart that he could manage interest rates so that the stock market would not decline. Yes people said that back then.

When he created a housing bubble and it popped and caused the bear market crash of 2008 CNBC talking heads simply said you can't fight the Fed. They are printing money. That didn't stop the crash.

And now that the market has gone up CNBC talking heads were once again proclaiming that we are in some sort of "new" economy thanks to zero interest rates and a need for yield from dividend stocks.

The problem is zero interest rates are not going to last forever. One day interest rates will go up and once that happens the whole logic of buying stocks, because they yield more than bonds, will be demolished and a vicious bear market will begin.

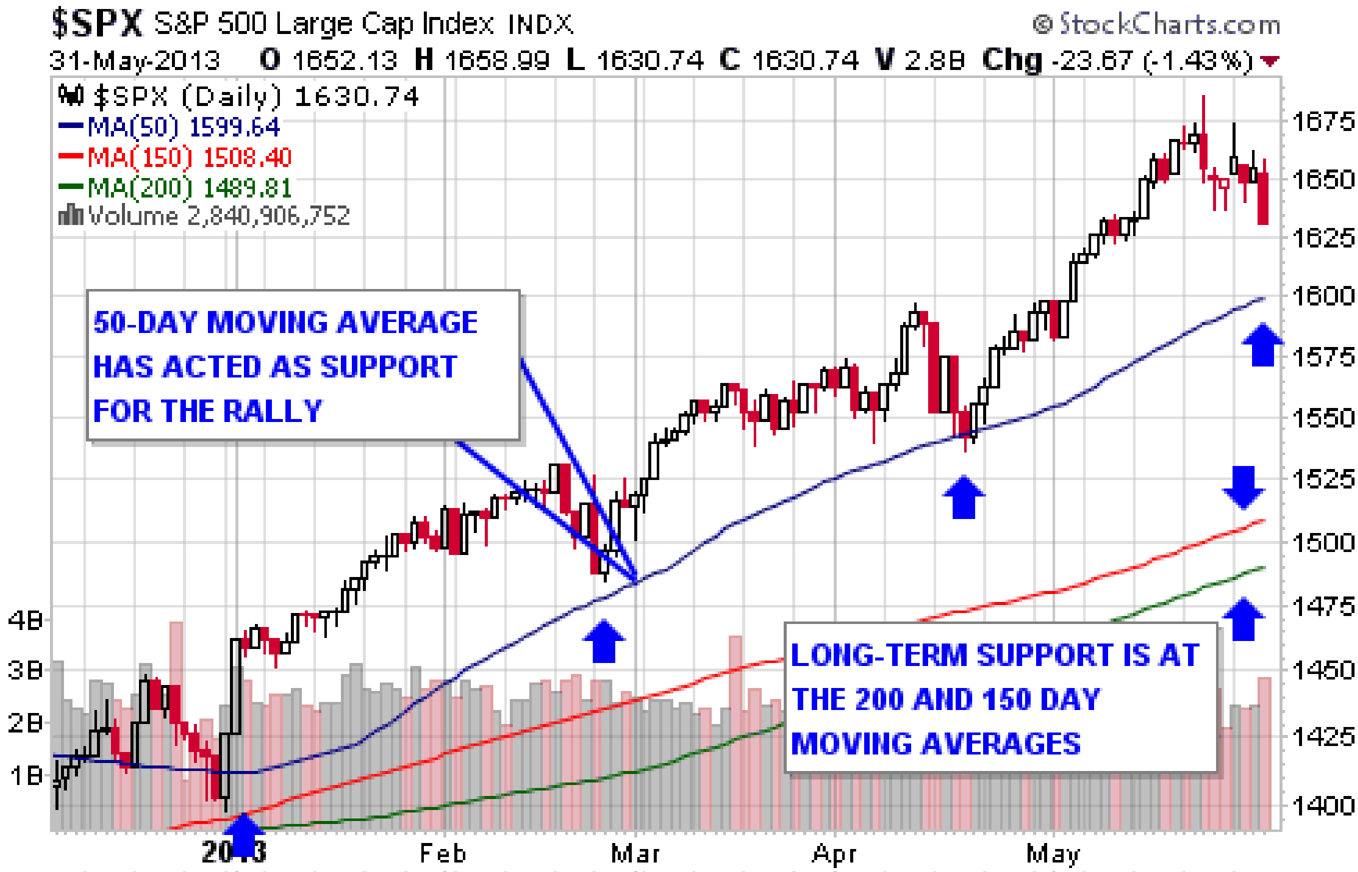
I do not think we are at that point at all. In fact I do not see any sign that a new bear market is happening and do not think that one is likely to occur for at least another year and maybe even longer than that.

The point is that the US stock market got overbought and overvalued in May after rallying for six straight months and going practically straight up for four weeks starting in the middle of April to make what appears to be a climatic top. Parabolic rallies are never a great time to buy stocks just as crashes are never a good time to sell stocks.

It's logical to buy stocks to invest in them when they are cheap after a bear market is over or to buy them during a bull market on pullbacks. It really makes no sense and is very risky to buy into climatic rallies. But people did it in May - and the pro's on TV that were doing it were using the rational that it is different now because rates are zero to justify their actions. Then regular people who are anxious about missing out hear this and end up buying into a top.

But we kept and can keep our heads. Since making a peak on May 22 the S&P 500 has pulled back about 4.6%. Corrections are normal in a bull market and are not something to get scared about. In fact you should EMBRACE a correction and use it as a buying opportunity.

I think the best thing you can do right now is figure out what you need to do to be able to buy after a correction plays out. The first thing you need to do is tell yourself not to be scared of one. Then you gotta figure out if you need to do anything with your account to be able to ride one out. If you just have a portion of your money in the US stock market then you don't really need to worry. If you are on margin though



than you probably need to do some selling. Everyone has to make their decisions based on their personality and needs. But you need to plan and decide. For me last month I just sold three small positions and bought the SDS ultra-short S&P 500 ETF as a hedge. I also put a cash deposit in my account the other day, because I truly believe that there is going to be good stuff to buy in June and I want more money to do it with.

Ten percent corrections are typical in the most bullish of markets. Corrections serve to shake out emotional traders who buy into tops and are quick to sell so they transfer shares from weak hands to strong hands that buy on dips. If the market were to keep going up at the rate it was rising in April and May it would go up 8% a month(it went up 8% from its April low to May peak) and be at 2891 by December (that is what an 8% gain every month from now on would do). That would be nuts. Nothing can go straight up forever so corrections recharge bull markets to enable them to keep going.

Right now the S&P 500 has support at its 50-day moving average. It would take a drop of 6.2% from its May high to reach it. A 10% drop would take it down to 1518. The 150 and 200 day moving averages act as long-term support in bull markets. They are in the 1508-1489 zone.

I cannot predict at what price point a correction will end at and I am not going to pretend to be able to do so. What I can tell you is what I will look for as evidence that a correction is over. Corrections typically end with some panic selling and anxiety in the market. They often

end with a day in which 90% of the volume on the NYSE is on the sell side. You can track that by going to Yahoo Finance and clicking Investing at the top navbar and then Market Overview. They also end with a move up in the put/call ratio above one, sometimes for a few days, and a spike in the VIX, which tracks the premium traders pay for volatility in the options market. What typically happens at the end of a correction is people panic and some of them instead of selling their positions buy puts as hedge. Their buying drives up the volatility premiums.

We last saw a spike in the VIX that took it above its upper 200-day Bollinger Band back in December when people got worked up over the supposed "fiscal cliff" and caused the stock market to drop. That turned out to be a great buying opportunity. It would take a move to 20 cause a similar spike in the VIX from here. The faster the market were to correct the quicker this would happen and the faster the correction will end. But regardless my plan for June is to simply watch the market and wait for these signs that a correction is over. I will then sell my SDS hedge and do more buying. To prepare I'm going to be researching new stocks every week and putting together more lists of potential buys in Power Investor reports.

Right now I am still most interested in buying mining stocks. Really I am not that interested in buying into the overvalued US stock market that has already gone up for four years. I like the more cheaply valued markets in Europe that put in a bear market bottom a year ago and are just a few months into a new bull market as opposed to buying something already in a mature bull market as the US stock market is. There is simply more upside in some of the markets outside of the US at this point in time. I already am positioned in these overseas markets and am happy to just keep holding those investments.

And there is more upside in gold and commodity stocks too that had been in a bear market since the Fall of 2011 and crashed in April and have been in what looks like the process of building a bottoming base ever since. In fact since the S&P 500 made its May peak the HUI gold stock index has outperformed the US stock market. No one is talking about mining stocks anymore on TV, because almost everyone that had been bullish on them either sold out way before the crash happened or finally sold on the crash. Since there is hardly anyone in them anymore almost no one is bullish on them.

I laid out way in April how I thought they would trade and so far they are sticking to that scenario— I said I thought they would rally up and then test their lows (they ended up breaking them) and then bounce and spend another four weeks or so pausing in what would be a box formation base with resistance now in the 295-300 area of the HUI. It will likely stay below this level for the next 2-4 weeks and continue to base. If it does that and then breaks out I believe it will begin a new bull market.

Mining stocks would then more than double over the next twelve months and probably go up much more than that over the next few years. There are so many commodity stocks that have been completely beaten down over the past year that will go up even more than that. My job over the next few weeks is to research them. You also got energy stocks and solar stocks. Coal stocks. It is a big sector with lots of opportunities. June will be a key month for the rest of the year. This should be the critical bottoming time for commodity related investments.

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