WallStreetWindow Monthly

Stock Market Barometer

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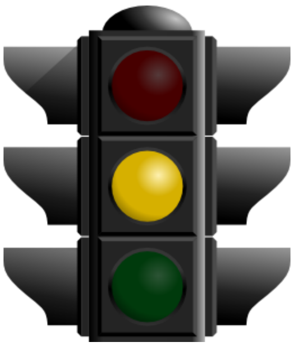
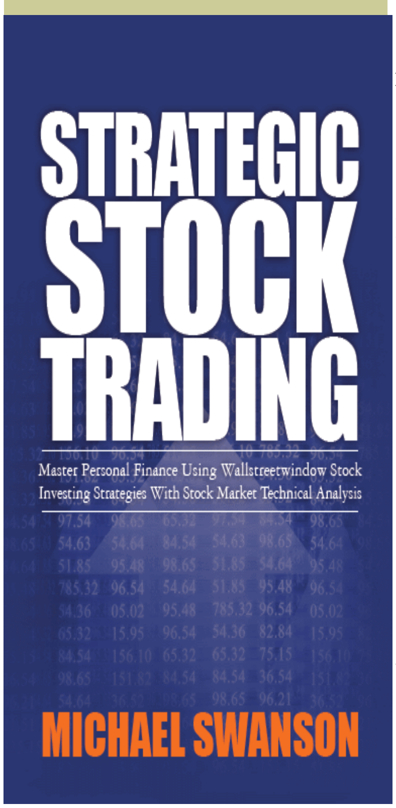


TREND ALERT — CORRECTION BEGINS, LOOK FOR SHARP DROP BOTTOM IN AUGUST



A Market Correction Is Here —Mike Swanson (08/03/2014)

We are now in a stock market correction. In the July issue of this newsletter on the trend alert box on the left I wrote "WATCH FOR BROAD US STOCK-MARKET RALLY TO MAKE CLIMATIC TOP." Well here we are.

Market corrections actually create opportunities to make money if you do not let yourself become a victim to one. They give you a chance to identify what will become the new leading sector by seeing what holds up during a correction. Typically the sectors that hold up the best during a broad market drop become the new leaders going forward. Once the drop is over you can buy into these sectors with much less risk than you would normally since much of the market risk has been taken away by the drop.

That is a TOUGH thing for most people to do, because all most people do is chase rallies so they love to buy into tops. Then they get stuck and scared when things drop and are unable to buy after a correction is over.

This is why over the past several months I have given warnings about the risks in this stock market over and over again. I believe all I have managed to do though is make people angry at me for doubting the stock market. Back in May I titled my monthly newsletter "Stage Three Tops Bring Misery Markets." What I meant is that they cause most people to buy into tops then lose on drops. Even though they know the risks they simply cannot help themselves.

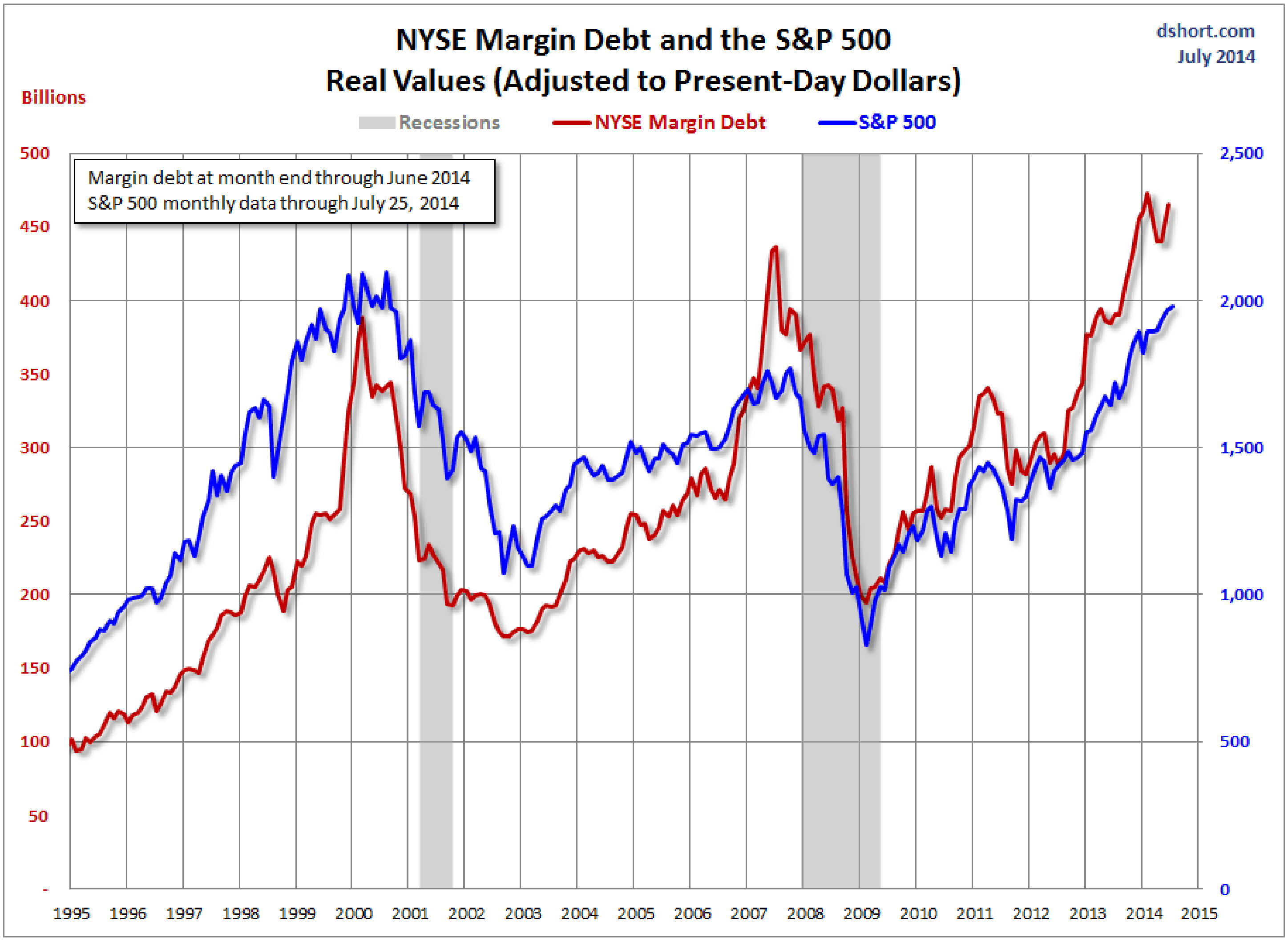
Anyone who knows any of the basics of fundamental analysis has known for some time that the stock market is overvalued. The S&P 500 has been trading with a cyclically adjusted P/E over 25 for over a year now. Many of the big name DOW stocks are trading with P/E's near 30 and a bubble has formed in silly tech stocks like Facebook and Yelp. Investor sentiment reached a true mania level with the Investors Intelligence survey reaching a level of bulls over the number of bears not seen since the top of 2007 and a few weeks before the 1987 stock market crash. Most bull markets last 3-5 years. It is unrealistic to think that this one somehow will do something that no other bull market has done EVER in history and go on forever. You get bull cycles and bear cycles. You cannot abolish weather seasons of Fall, Winter, and Spring. And you cannot stop a bear cycle from happening one day. You make money by investing at the START of a bull market and not five years after one has begun and things are overvalued and risky.

But none of that has mattered to people who have convinced themselves that valuations do not matter and the stock market can go up forever for them thanks to Federal Reserve action and "new" rules that have somehow abolished historic stock market bear and bull cycles. What we have seen is a dangerous herd form in the stock market over the past six months. And it is a frightening one.

I know how fanatical they are because I get angry emails from some of them all of the time just for warning against the risks in the stock market. Back in May I said I thought the stock market would rally into July and then it would probably top out. Once that rally started in May though I started to get very concerned about people so I titled my June newsletter "Is This the Last Hurrah For a Generation?" I talked about the Las Vegas Money Show I went to and how just about every single person there was very bullish on the stock market.

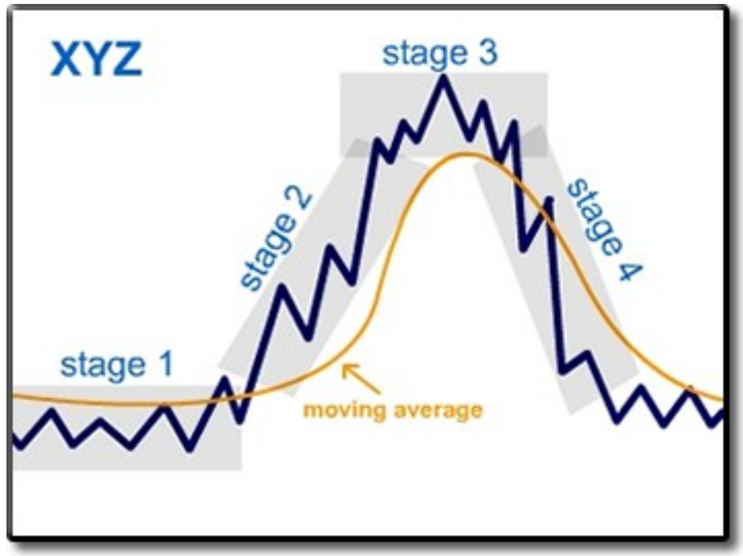
I talked about the herd in the market and the one that truly is frightening. I saw two bear markets before. One in 2000 and 2007. People lost money, but something different is happening now. Many people after the 2008 crash got out of the stock market. Most sold out from 2009 through 2011 and never got back in and probably never will.

The dangerous herd in the market now are the people who did not sell out in that bear market. They held on and now that the market has gone back up for them over the past few years these people have convinced themselves that holding forever is now the smart thing to do. They write things like this, which I am taking from a yahoo message board this weekend: "Ten years without gains is not unprecedented. I'm retired and have been in the game for a long time. Especially because of dividends I believe it pays to ride out the bad markets."



These are the people who now believe investment strategies, valuations, and risk control do not matter. They think the Federal Reserve will bail them out if the market falls so they think they do not have to be responsible for their own actions. And if the market falls they will even demand bailouts for themselves in money printing even if that means destroying the US dollar and even the American economy from inflation. They won't care what harm inflation will do and this is why these people are a potentially dangerous element in society. These people think they are smart, because they feel rich, but after the next bear market comes they will wipe themselves out. They think they are smart because they held, but what really happened is that they learned ABSOLUTELY NOTHING from the last two bear markets. That is why this bull market is their "last hurrah."

I talked about all of this in my June newsletter and it made a lot of people very angry. But it's the truth! It isn't just me saying people are in a herd and doing crazy things. The statistics show that a mad level of margin debt has built up the stock market. Look at the chart of margin debt from the website dshort.com on the top of this page. You have



to be completely crazy to borrow money five years into a bull market like this. And people have done just that!

This is why the stock market is now in a correction. Two weeks ago we saw a bunch of companies report "good" earnings only to see their stocks drop anyway. That was a tip-off that the rally was done and a correction was coming. Last week the US government reported that the GDP grew 4% in the last quarter. That news didn't matter. When good news no longer matters you are no longer in a market rally, but in some sort of a correction.

Is this the start of a new bear market? Well, I define a bear market as a market in which most sectors in the market are below their 200-day moving averages and the market as a whole is in a stage four decline with the long-term 200 and 150-day moving averages curling down. The US stock market is not in that position right now, but it could very well be before the year is over. I think it probably will be, but we will see plenty of warning signs over the next two months before it rolls over. I'm not going to scream sell to people until the US stock market is clearly in a bear market.

And even in bear markets there are ways to make money. There are strategies that can be used to generate gains in a market decline and even sectors that tend to go up in bear markets. The important thing is that you have to make adjustments when a market environment changes. The problem is few people make any adjustments or changes. They just want to buy and hold forever so that they do not have to make any decisions and risk being "wrong" and alone watching the market go up and everyone else make money. Then they feel like they made a mistake. But if they hold and lose money with everyone else they can still get the benefits of being a member of the herd and play the victim card with everyone else.

It is also very likely that the market is in a stage three topping market. This is why this monthly newsletter has the alarming tone it does in it. I'm very worried many people are just going to hurt themselves and if I make thousands angry, but manage to help a few hundred people in the end then it's worth it. However, I am not going to tell everyone to sell before we are clearly in a bear market, because if the stock market were to go up into a big end of the year rally for another few percent or something then the herd will crucify me. This is one reason why most Wall

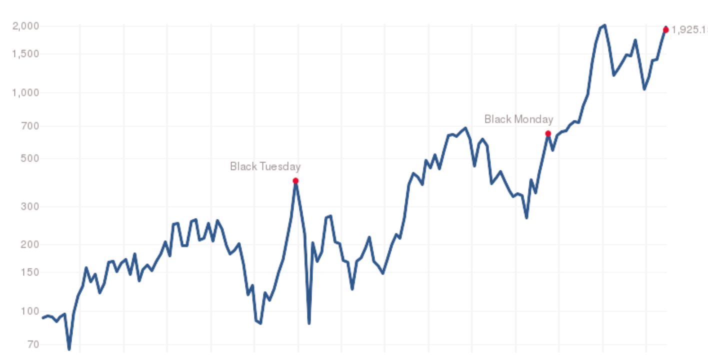
Street people are simply bullish all of the time. Who wants to be attacked? And what's the use when few will listen anyway?

The real risks people face in the stock market isn't that the stock market is going to go to zero or the DOW is going to fall to 4,000 or some silly low level, but that there won't be a V bottom in the stock market after the next bear market like there was after the last two. The 2008 stock market crash was bad, but it only took the stock market a few months to bottom and base afterwards. After the next bear market though we could easily see a stage one base that takes a year or longer to play out. We have seen a long drawn out stage one base in gold, commodities, and mining stocks since the spring of 2013.

If someone is say 70 years old can they afford to lose money in a two year long bear market and then sit there watching things go sideways for another two years after that? Probably not. They'll probably sell out after the bottom. I believe US stock market investors will eventually go through what gold investors went through last year. And right now even though the GDX gold stock ETF is up 23% so far year to date they talk like they are still losing money. I know because I get emails from terrified gold investors all of the time too.

One's perspective on a financial market often is simply the result of where one got in at. So yes someone who bought gold stocks in 2011 and never sold has suffered so much pain in the past few years that it is hard for them to feel optimistic about mining stocks. Whereas for someone like me who has simply averaged in over the past few months it is easy to be optimistic when you look at the charts.

So those who held on in 2008 now feel euphoric and feel smarter than those that sold out long ago and never got back in. But if they never sell how will they fell after the next bear market strikes? And there is also a big inflation risk in the US stock market. In the 1970's if you look at a typical US stock market chart it looks like things went sideways, but if you adjust the chart for inflation people actually saw their wealth erode away. The same thing can happen again over the course of the rest of this decade. Look at the stock market adjusted for inflation in the chart to the right. People got crushed in the 1970's and during WWI. And even in the past ten years inflation has hurt investors more than they realize.



The good news is that you can usually identify a bear market as it starts. Rarely does a market go up for five years and then just top out and go straight down for months on end. That is why you have stage three tops.

During a stage three top a market goes sideways in an up and down range during which the sectors that make it up deteriorate and go into bear markets of their own. That process takes time. We have seen weakness in many sectors this year and fewer of them participate in the most recent rally, but not many sectors are in bear markets yet. However they could be by the time this correction is over.

Once this correction ends we will get another market rally. We will have to watch things carefully during that rally to determine whether or not we truly face the dangers of a new bear market in the US stock market or whether I'm just being overly concerned for you. I'm not concerned about myself, because I'm invested in gold, silver, and mining stocks and not US stock market centric finds. I think we'll be able to make a final verdict in September, because I think this current correction is likely to end this month. And you'll be able to make money out off all of this.

What this correction will enable us to do is buy into sectors that are holding up relative to the rest of the US stock market and it doesn't matter if a bear market is coming or not. In fact when the broad market rolls over into a bear market there usually is a sector or asset class that starts a bull market at the same time.

So in March and April of 2000 as the US stock market topped out tobacco and utility stocks began new bull markets that lasted for several years as the rest of the market fell. In 2007 treasury bonds and the US dollar index did the same thing that Fall as the US stock market crumbled. And right now gold and mining stocks are positioned to begin a new bull market even if the rest of the stock market turns bearish. In fact gold could easily end up becoming a safe haven in the next US stock market bear market.

In fact it is mining stocks that are actually holding up well so far in this market correction. Even though they did not breakout last week of their stage one base after testing recent resistance they are still holding support in their July trading range. Since its May low the HUI gold stock index has been outperforming the price of gold and the US stock market. Now it may be continue to be held down in the next few weeks under pressure from a broad market correction, but once the correction is over I expect we'll see them take off and go through the 245-250 level to begin a new bull market. Really at this point 245 is the real resistance level to keep your eye on. But you can see how they are doing better than the market in the next chart. The sectors that display strong relative strength during a market correction are the ones to buy as a correction ends. They

are the ones that lead. Mining stocks did not breakout into a new bull market last week, but they are showing their strength to us.

If the stock market falls we may see CNBC's Steve LIESman appear on TV this month and say that he has "leaks" from the Federal Reserve telling him that they may consider holding off on any further QE money printing reductions at their September Fed meeting to wait and see if the economy and the stock market need it. He did this in February when the market fell a few days off of its high. If the Fed gives him this message than

gold prices will explode higher, because it will show that they will reverse course and print money if a bear market comes. The thing is your lucky to get another chance to buy gold stocks this month, and a US broad market dip makes buying even safer once it is completed. So how long can this correction last?

Most corrections last a few weeks in the stock market and they tend to end with a bout of short-term panic and increased selling pressure. We haven't seen that yet. You often get two leg downs in a market correction and we probably just completed the first one last week. Often the second leg down is of the same size drop as the first one.

You can see an example of this back in January and February. If this correction were to play out in the same fashion as the last one it would end with the S&P 500 falling somewhere around the 1840-1850 level. 1858 is where its 200-day moving average is. If it trades down like that it'll pause for a few days here and then start falling again by the end of the week.

In the short-term I see very little upside to the stock market in this position, beyond a little bounce for a few days. The big drop Thursday has damaged it so much that it is very unlikely that it will be able to just go straight back up without the correction continuing. The best case scenario and one very unlikely is that the market holds up here and bases for a week and then just keeps going up. I think this is a real correction we have going one now and if we are actually heading for a bear market his fall it could even fall harder than it did in January and February.

The danger to the market is the margin debt herd. People who bought on the top on margin will be forced to sell if the markets falls hard and that can create a huge bout of short-term volatility in the stock market.

We could even see something similar to the "flash crash" of 2011. That occurred when the DOW fell off of its highs for a few days and then went through its 200-day moving average to trigger a 1000 point intraday drop from forced sellers and computer robots. The DOW bottomed during that day and came back on the close.

I saw two other days just like it that I have never forgotten that served as preludes to a new bear market. One occurred in August of 2007. A rally ended that year in July just like it has done this year and then

fell into August. The DOW fell for about two weeks and closed below its 150-day moving average and right on its 200-day moving average. The next morning it had a big bout of heavy selling that took the DOW down close to 500 points. It reversed in the afternoon and managed to close in the green. The Fed lowered its discount rate. The market then rallied into October and I warned of a new bear market, because among other things there was practically zero participa-tion in the market sectors on that final rally. Only a few stocks were driving most of the gains in the S&P 500 and the Nasdaq. The stage three top was over.

In March of 2000 there was also a similar wild "flash crash" type of day in the Nasdaq as the market rolled over into a new bear market. The Nasdaq made a double top in March of that year and as it fell had a crazy day in which it dropped about 10% during the day and then managed to finish the day near even. It was a big warning sign that the stock market was in trouble and something was wrong, just as the wild day in August of 2007 was a similar warning.

We could see a day like this happen again during this correction. I cannot predict that of course, but I bring it up for an important reason. If you see the market have some big giant "flash crash" type down day sometime this month you should not get scared and sell during that day. In fact it would likely mark the end of this correction. It would be a time to buy. If such a day happens I think the market will rally for a few weeks like it did in 2007 and not just keep dropping like it did in 2000. Things are not as extreme as they were then.

Right now I'm not so much worried about the stock market falling, but mentally preparing myself to possibly do more buying if it does. So I am making myself and you aware that a "flash crash" would be such a time. That's why I'm bringing that possibility to your attention. And mining stocks are the best buy candidates out there. I will send updates once I think we are near a bottom in the Power Investor Service and may decide to take a short hedge if we bounce for a few days. A Power Investor alert will of course be sent if I do that too.

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