

September 2009

Turbulence Ahead

The markets are never easy. When it appears the coast is clear, something pops up to make things more complicated. As we have stated over the last few weeks, the markets have become over extended and excessively bullish. The same people who were declaring the end of the world six months ago are now saying that this is in fact the beginning of a new bull market. Such an opportunity surely cannot be missed, or should you run in the opposite direction?

These feelings of bullishness have been repeated in various research reports recently by many of the main investment banks and brokers. One stated in the title "Be Bullish" – I felt like I was reading a Nike ad and not a research report. Another title said "It's Beginning" – what's beginning, was I supposed to know, was it some kind of religious revival? I am not a contrarian by nature, only when the crowd's sentiment gets out-of-step with the fundamentals. In the current case, the markets have become way too bullish and the fundamentals are still lagging way behind. In this case, I am afraid to say, that it pays to be a contrarian.

There are three main trades that have become market wisdom recently; (1) it is time to get into equities, so pile back in before it goes up further, (2) emerging markets will lead the world from now on, and (3) the US\$ is headed for armegedon, so be sure to stack up on those solid emerging market currencies. Be very careful with all of these. The best place at present is be in cash, and in US\$, with some money in gold.

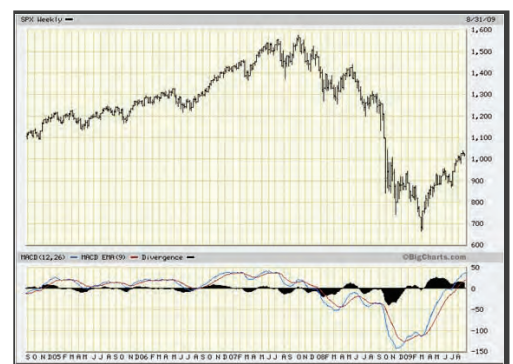
The underlying currents have shifted. The market, in the last few days, has begun to wonder how powerful the economic rebound will be. Due to the overly bullish market sentiment, it just took a few not-so-great macro figures for full confidence in the 'new bull market' to be tempered. The short term reversals appear fairly straightforward.



SP 500 Daily

The SP 500 is showing negative divergence, signaling coming difficulties in the short term. This should be enough to warn investors of a coming difficult phase in the market. The weekly chart shows a potential for a longer term correction as the MACD is setting itself up for a negative cross.

Such an MACD weekly cross is not imminent, but the gaping hole in the indicator begs the question of -- how much longer can it continue without a correction? And, how long would a correction last after such a massive run-up? It obviously cannot continue at such a pace for much longer and I believe the correction will come about shortly.



SP 500 Weekly

Somewhat surprisingly given the almost universal chorus adorning emerging markets, the EEM (the emerging markets US\$-based EFT) is nearer a correction. The following chart shows its weekly chart.

As can be seen the MACD indicator is starting to roll over. This does not mean that a market correction will turn into a bear market once again. It does mean that the market should stop going up and, under more optimistic conditions, will likely consolidate around currently levels. I expect the market to move sideways until around year-end, in other words, money invested in equities market generally will be dead money.



EEM Weekly

A key indicator as to fear in the market is the VIX, or traded volatility index. An increasing VIX means increasing uncertainty, which is negative for equities. The following daily chart shows that it has fallen considerably since the panic levels of late 2008. It also shows that perhaps it is starting a new uptrend in the last few days.

The weekly VIX shows an even worse scenario. Its MACD is crossing and it appears as if an increasing trend might be beginning – this scenario would abort the nascent bull market in equities that so many market analysts are discussing. Note the MACD cross as well as the fact that it is on a support trend line, meaning further declines look unlikely at present.



VIX Daily



VIX Weekly

The remaining key to our puzzle is the US\$. It has been so degraded recently that it appeared like a foregone conclusion that a collapse was imminent. In fact, the grandfather of equity investing, Warren Buffet, recently talked down the US\$ to such an extent that he appeared more like a currency trader than anything else. In the face of such calls of collapse, it has really not done much over the last month or so. In fact, in many ways, the US is proving much strong than most had thought. In addition, assuming a return to a more doubtful environment, I am still convinced international investors will run to the US\$ as it is still the most trusted currency globally.



DXY Daily

The US\$-index's RSI has been forming a very exact downtrend. It is not very common for such a trend to form with so many data points. Eventually, when this downtrend is broken, it should lead to a significant short term appreciation of the US\$. This could occur over the next month, so the US\$ should be watched closely. Long term, I believe a strong break of this downtrend will effectively end the bear market which began years ago.

The weekly US\$ chart shows an even more bullish outcome. Its MACD is about to roll over and its price level is about to break a downward resistance trend line. Assuming this trend gains a marginal amount of force over the coming weeks, a relatively strong trending market could begin with the US\$ appreciating against global currencies.

It appears like many of the rapid gains from earlier in the year are about to be questioned by the markets. If I am correct, by October 1, 2009, the US\$ bear market argument will be thrown into doubt, the economic recovery story will lose steam, and the pressure to buy emerging markets (now!) will dissipate. Fasten your seat belts, turbulence should begin shortly.



DXY Weekly