July 13, 2013

the X-factor Report

by Lance Roberts

Market Strategies, Economic Analysis, Risk Management

Market Correction Averted

In last weekend's missive I stated that I would be traveling this week with my family for our annual summer *"kid's vacation."* I am not sure exactly why they call it a *"vacation"* because when you are traveling with four kids it is a tremendous amount of work and stress. Of course, the entire process would simply be impossible without my lovely wife who is a great *"team player,"* organizer, tour guide and nucleus of the family. These excursions are the events that I cherish the most due to the memories they generate.

However, due to the fact that I am sitting on an airplane as I write this, I must apologize in advance for largely condensed letter this week. Next week I will return and will be able to provide a full analysis of the markets and any changes to our investment strategy.

In the meantime, as I sit strapped into a metal tube being propelled through the air by four mechanical devices that are controlling a steady explosion of highly flammable liquids, it gives me a moment to contemplate the current state of the markets and world that we live in today.

As I look around the cabin there seems to be complete confidence that the thousands of parts that comprise the aircraft will function in perfect harmony allowing us to reach our destination safely. In many ways, this complete faith in the *"system"* is much the same as market participants have placed into our central bankers of the world today. It is, of course, inevitable that eventually something will go wrong and a *"crash"* will occur whether it is due to a mechanical malfunction, or like the recent crash of the Asiana airliner in San Francisco, simply pilot error.

Currently, the world has placed the same *"blind faith"* into a small group of central bankers who have taken over control of the global financial markets. The belief is that through continued infusions of liquidity, and suppressed interest rates, that the world can somehow *"heal itself"* from the excessive debt levels that led to the financial crisis by increasing those debt levels even further.

Inside This Issue:

With each passing year the financial markets have continued to be propelled higher by the continued injections of *"fuel"* with hopes that the ultimate destination will be a return to normalized economic growth. However, despite the continued promises by these same central bankers that their *"piloting"* and *"navigation"* skills will certainly result in a safe arrival to the intended destination – there are currently many warning lights and buzzers sounding that suggest that something may be wrong with the aircraft.

However, unbeknownst to the "passengers" of what is occurring in the pilot's cabin, the information flow is controlled in order to keep a *"panic"* from occurring. This is why, despite the data to the contrary, the Federal Reserve portrays an unwavering *"confidence"* that the ongoing operations are functioning normally. Any message that begins to erode the *"faith"* of the passengers would lead to a *"panic"* and a breakdown in the economic system.

This past week we got a glimpse that the Federal Reserve has recognized that something is wrong with the system. That, and the aversion of a *"confirmed sell signal,"* are the subjects of this week's missive.

Bernanke Reverses Course

At the beginning of June we began discussing the approach of an initial *"sell"* signal. I stated at that time that the onset of such a signal would be a ***"warning"*** that you should begin paying much closer attention to what is happening inside of your portfolio. The selloff that began in late May coincided with mounting expectations that the Federal Reserve would begin reducing their monetary interventions later this summer and cease the program entirely by 2014.

As I discussed in *"The Diminishing Effects Of QE Programs"* the economy remains far too weak for the Federal Reserve to begin reducing support for the financial markets anytime soon. I stated:

*"...the real issue is that IF the recent negative trends in consumption, employment and inflationary pressures do not start to reverse it is highly likely that **the Fed will not be able to extract the monetary supports anytime soon**. The recent increases in interest rates, combined with still very weak wage growth, higher costs of living and still elevated unemployment is likely to keep the Fed engaged for the foreseeable future as **any attempt to remove its 'invisible hand' is likely to result in unexpected instability in the financial markets and economy**."*

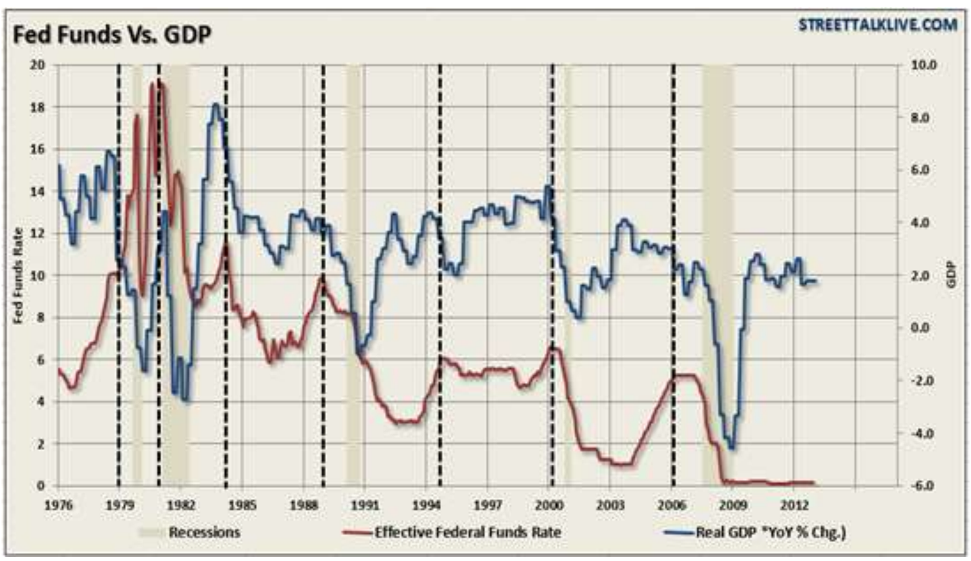
Consequently, the *"trial 'tapering' balloon"* lofted by the Federal Reserve after the last FOMC fell quickly to earth as stock prices sagged, which began to erode consumer confidence, and interest rates spiked sharply higher putting economic growth in danger. Those realties pushed the Federal Reserve to back pedal on their *"tapering"* stance as Ben Bernanke clearly stated that:

"I think you can only conclude that highly accommodative monetary policy for the foreseeable future is what's needed in the U.S. economy. And I guess the final thing I would say in terms of risks of course is that we have seen some

tightening of financial conditions**, and that if, as I've said and as I said in my press conference and other places that **if financial conditions were to tighten to the extent that they jeopardize the achievement of our inflation and employment objectives then we would have to push back against that."

There was a clear confirmation by the Fed to market participants that the Federal Reserve will not take away accommodation because they cannot afford to let the markets *"tighten."* Rising interest rates and falling asset markets are one thing and put the economy at risk. However, the lack of inflation is also a real concern. As I discussed in *"What Inflation Says About Bonds & The Fed:"*

*"**It is highly unlikely the Fed will substantially reduce interventions in the short term.** More likely the Fed is likely to try and talk markets down by increasing expectations of future declines in bond purchases. Most importantly, however, the Fed will likely emphasize their 'accommodative policy stance' going forward. **In a weak economic growth environment the Fed cannot begin a program of boosting overnight lending rates. As the chart below shows, every time the Fed has embarked on such a program to increase borrowing costs it has led to an economic recession or worse.***



*The real concern for investors, and individuals, is the actual economy. We are likely experiencing more than just a 'soft patch' currently despite the mainstream analysts' rhetoric to the contrary. There is clearly something amiss within the economic landscape and the ongoing decline of inflationary pressures longer term is likely telling us just that. **The big question for the Fed is how to get themselves out of the 'liquidity trap' they have gotten themselves into without cratering the economy, and the financial markets, in the process.** As I said recently this is the same question that Japan is trying to figure out as well."*

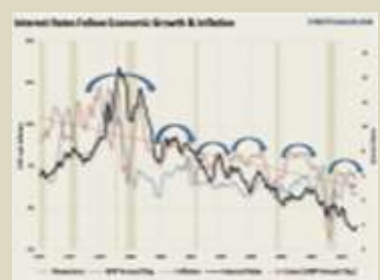
RECOMMENDED READING

What Is A "Liquidity Trap" And Why Is Bernanke Caught In It?

I have spoken, and written, much lately about the fact that the Federal Reserve is beginning to realize that they are caught in a "liquidity trap." However, what exactly is a "liquidity trap?"

Reiterating Bond "Buy" – 35 Years Of History Confirms

A technical look at 35 years of history to support my recent calls to buy bonds.



Confirming Sell Signal Avoided

For the stock market; the reversal of the stance by the Federal Reserve gave Wall Street the *"green light"* to pile back into equities. As I stated previously in the analysis of the initial *"sell"* signal I stated that:

"These warning signals are just that – a 'warning' that you should start to pay very close attention to your portfolio. When all of these signals align it is always in conjunction with a market correction. Currently, the [indicators] are close to issuing a 'warning.' ***It will take a VERY strong rally to keep that from happening."***

That is exactly what has occurred. The rally that began three weeks ago, after breaking short term support, has been strong enough to keep the *"confirming sell signal"* from being triggered as shown in the chart below.

More importantly, the Fed's announcement that their *"highly accommodative"* policies will remain in place alleviated market participant fears, at least in the short term, which has subsequently vaulted stocks out of the negative downtrend in June. This short term reversal also keeps the longer term uptrend intact maintaining equity allocations at target weightings for the time being.

The chart below, as discussed in last week's missive ["Is The Correction Over:"]

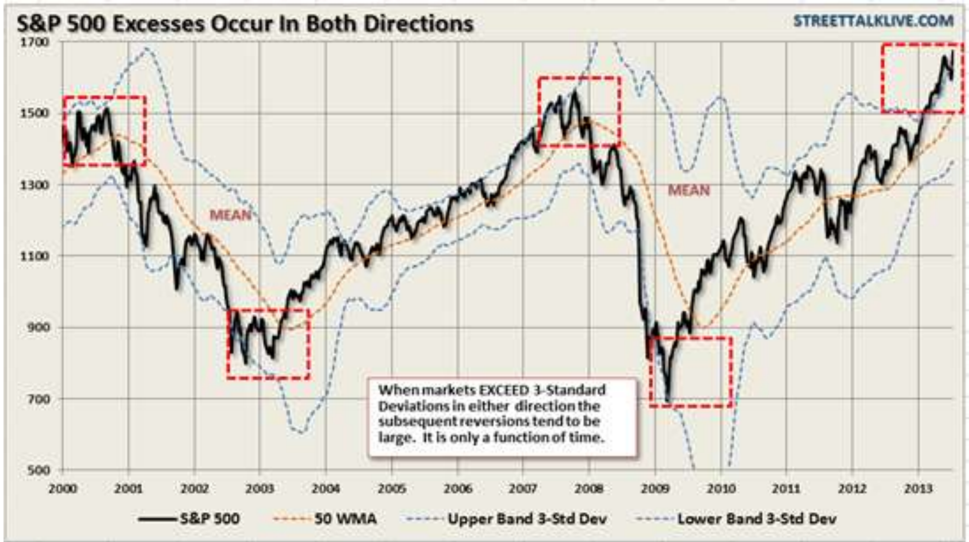
"For longer term investors it will be critical for the markets to reverse the longer term "initial sell signal" that was triggered [in June] without the "confirming sell signal" being initiated. In order for this to occur the market will need to rally above 1630 on the S&P 500 next week and rally towards old market highs. This is shown in the chart below.

The downtrends, as denoted by the green dashed lines, are notable as they tend to predict the direction of prices in the coming weeks ahead. However, with the Federal Reserve on tap to inject $45 billion in bonds in July it is unclear just how large the current correction might be."

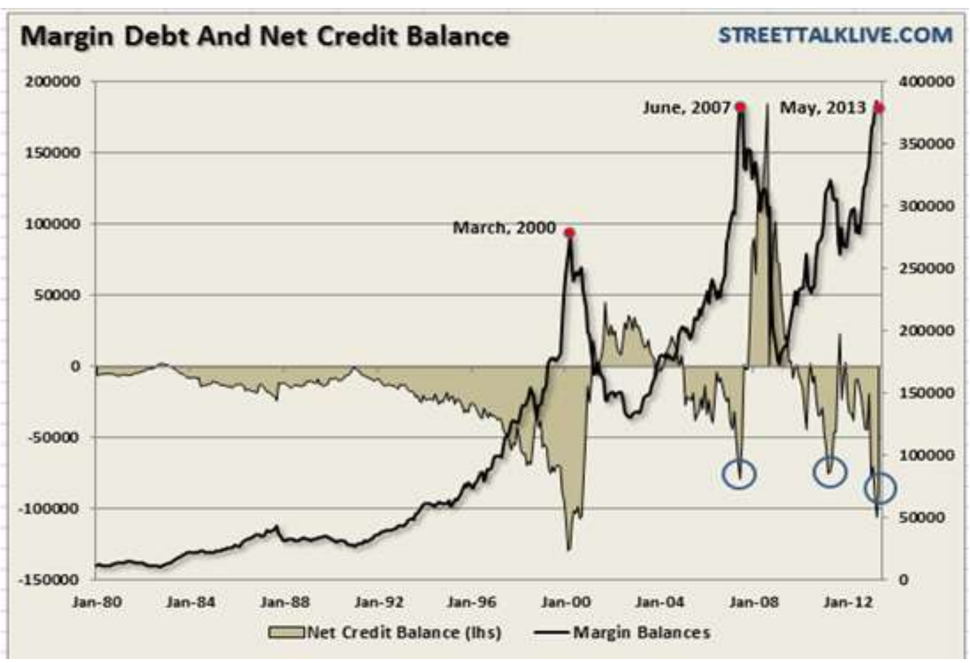
That has now occurred with the markets now wrestling with all-time highs. As you can see in the chart above; the recent correction was the smallest of the last four, however, when these previous downtrends were positively broken it led to further advances in the markets.

Still Overbought, Bullish & Extended

The bad news is that the market remains extended to the upside as the recent correction was not large enough to reverse the longer term overbought conditions of the market. The first chart below shows a weekly long term view of the S&P 500 Index with a 50-week moving average and bands representing 3-standard deviations above and below the long term average.



As you can see the only times in history where the market has deviated this far above its long term moving average has been at the peak of every prior bull market cycle. However, the risk of more significant correction occurring from such extreme deviations is compounded when fuelled by leverage and speculation. The next chart shows the level of margin debt on stocks.



The problem, of course, is when a more significant correction begins it will be fuelled by the unwinding of leverage.

It is very important to understand that there are two VERY DIFFERENT dynamics at work currently. The economic and fundamental environment is clearly weakening. However, asset prices are being pushed higher by continued injections of liquidity. Ultimately, this dislocation between fantasy and reality will reconnect and will be very painful for most investors. However, the timing of that event, due to the ongoing market manipulations is currently unknown.

Therefore, as we will discuss below, we have to take actions within portfolios in the short term to participate with the liquidity propelled markets. This is certainly not a long term or *"risk free"* view but just an understanding that in the short term we cannot successfully *"fight the Fed"* and win.

While we continue to remain invested in the financial markets, as long as they are trending positively, we remain extremely concerned about the weakening economic and fundamental data both domestically and globally. Liquidity programs **DO NOT** create organic economic activity but rather create a *"Potemkin" facade* that hides the underlying reality. As I stated above, eventually, the reality will assert itself, and when it does, it has historically not been kind to investors.

Portfolios Remain At Target Allocations

While the recent correction was not large enough to provide an ideal entry level for adding equity exposure; it also did not warrant any changes to our portfolio allocation model.

Part of the process that I recommended following the initiation of the *"warning signal"* was to sell positions that were technically, or fundamentally, broken. I also suggested taking profits in positions that had reached extreme over bought conditions. Those actions raised cash in portfolios that can now be selectively redeployed bringing equity exposure back up to target weights. Furthermore, as I wrote recently in *"Reiterating Bond 'Buy',"* it is also an ideal time to bring bond weightings up to target allocations as well.

While this is NOT an ideal entry point; the current analysis suggests that **the next level of resistance for the S&P 500 will be around 1700.**

That level could be attained very quickly even as the markets have already moved back into daily, and weekly, overbought conditions. The sustainability of the current rally will depend much on a continued LACK of headwinds, earnings beating much lowered estimates and economic data that continues to muddle along. However, there are substantial issues on the horizon that could quickly change this view. The rapid decline in economic activity in China, the bubbling issues in the Euro-zone and the upcoming debt ceiling debate could roil the markets and quickly awaken the overly complacent *"zombie"* herd sending investors panicking for the exits.

Have a great week….see you when I get back.

Lance Roberts

401K Plan Manager

Bernanke's comments last week that *"accommodative policy"* was here to stay sent the markets soaring back to new highs keeping the *"confirming sell signal"* that we have been watching for over the last weeks from triggering.

With earnings season gearing up, combined with still lofty expectations for corporate earnings, there is a concern as to the sustainability of the current rally. However, the reversal, and the breakout of the downtrend, does suggest that the current bullish trend remains intact and that equity exposure can be increased in portfolios.

Depending on your personal risk tolerance level; if your portfolio is currently **UNDERWEIGHT** equities and/or bonds those areas can be added to. Again, as I stated, I do not have a high degree of confidence in the current rally but we must adhere to the current price momentum of the markets.

As a side note it is interesting to note the increase in frequency of "buy" and "sell" signals since the Fed began intervening in the market. We continue to highly recommend that you rebalance this week to the current allocation levels if you have not done so already.

If you need help after reading the alert; don't hesitate to ***contact me***.

[Suggestions Wanted]

I am in the process of revamping the newsletter and the 401k plan manager for the new website. If there is anything that you would like to see added to the 401k plan manager please email me.

Common 401K Plan Holdings By Class

Cash
- *Stable Value*
- *Money Market*
- *Retirement Savings Trust*
- *Fidelity MIP Fund*
- *G-Fund*
- *Short Term Bond*

Fixed Income
- *Pimco Total Return*
- *Pimco Real Return*
- *Pimco Investment Grade Bond*
- *Vanguard Intermediate Bond*
- *Vanguard Total Bond Market*
- *Babson Bond Fund*
- *Lord Abbett Income*
- *Fidelity Corporate Bond*
- *Western Asset Mortgage Backed Bond*
- *Blackrock Total Return*
- *Blackrock Intermediate Bond*
- *American Funds Bond Fund Of America*
- *Dodge & Cox Income Fund*
- *Doubleline Total Return*
- *F-Fund*

The above represents a selection of some of the most common funds found in 401k plans. ***If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.*** All funds perform relatively similarly within their respective fund classes.

I will modify this list over time as the asset allocation model changes to reflect international holdings, emerging markets, commodities, etc. as the model changes to reflect the addition of those holdings.

Email me if you need further assistance.

Equity

Large Cap
- *Vanguard Total Stock Market*
- *Vanguard S&P 500 Index*
- *Vanguard Capital Opportunities*
- *Vanguard PrimeCap*
- *Vanguard Growth Index*
- *Fidelity Magellan*
- *Fidelity Large Cap Growth*
- *Fidelity Blue Chip*
- *Fidelity Capital Appreciation*
- *Dodge & Cox Stock*
- *Hartford Capital Appreciation*
- *American Funds AMCAP*
- *American Funds Growth Fund Of America*
- *Oakmark Growth Fund*
- *C-Fund (Common Assets)*
- *ALL TARGET DATE FUNDS 2020 or Later*

Balanced Funds
- *Vanguard Balanced Index*
- *Vanguard Wellington Fund*
- *Vanguard Windsor Fund*
- *Vanguard Asset Allocation*
- *Fidelity Balanced Fund*
- *Fidelity Equity Income*
- *Fidelity Growth & Income*
- *American Funds Balanced*
- *American Funds Income Fund*
- *ALL TARGET DATE FUNDS 2020 or Sooner*

Small/Mid Cap
- *Vanguard Mid Cap Growth*
- *Fidelity Mid Cap Growth*
- *Artisan Mid Cap*
- *Goldman Sachs Growth Opportunities*
- *Harbor Mid Cap Growth*
- *Goldman Sachs Small/Mid Cap Opp.*
- *Fidelity Low Price Stock Fund*
- *Columbia Acorn US*
- *Federated Kaufman Small Cap*
- *Invesco Small Cap*

Current 401k Allocation Model

5.00% **Cash + All Future Contributions**

Primary concern is the protection of investment capital

Examples: Stable Value, Money Market, Retirement Reserves

35.00% **Fixed Income (Bonds)**

Bond Funds reflect the direction of interest rates

Examples: Short Duration, Total Return and Real Return Funds

60.00% **Equity (Stocks)**

The vast majority of stock funds track an index.
Therefore, select on ONE fund from each category.
Keep it Simple.

30% Equity Income, Balanced or Conservative Allocation
20% Large Cap Growth (S&P 500 Index)
10% Mid Cap Growth

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