

## Stock Market Report

31 October 2009

### Correction or Consolidation

It appears we may have finally reached a peak and entered a correction in the market that we have been expecting to occur in the September and October period. The question now is how far this correction will fall. Market peaks were seen on the Dow Jones, S&P 500 and All Ordinaries during October, as various technical indicators are signalling that stock markets are rolling over. The steep rebound was unsustainable so even mainstream media commentators have been suggesting that an end or pause of the rally is inevitable.

An interesting observation however was seeing many stocks provide entry signals during October, which is unusual if the general market is about to form a major peak and followed by a significant retracement. This suggests that there is a level of probability that the current correction may be a quick pullback within a further uptrend. This means that it may be prudent to hold our nerve on some open positions while also being disciplined where there are strong and clear sell signals. There have also been many false breakouts suggesting that stocks are somehow being manipulated to move beyond resistance levels just before a negative announcement. The extreme volatility of late which has been a characteristic of the market for the past two years has also made it challenging in making decisions with regard to market and stock price direction.



The falling \$US and rising \$AUS has negatively impacted certain stocks and the market correction is correlating to a potential rebound in the \$US. The Australian dollar was surging toward parity with the \$US, however it now looks to be easing off and retreating as the \$US changes trend. However, the US money printing strategy to pay debts will continue to debase the \$US in the long term, so we expect the \$AUS to move beyond parity at some point in the future which will lead to further increases in interest rates. Gold has broken out of a major resistance level and rising in a volatile manner as the traders enter the gold market. Many investors are moving into the safe haven commodity in anticipation of a pullback or significant fall in the general markets and the falling \$US.

The Reserve Bank of Australia surprised many by raising interest rates and making Australia the first country in the G20 to do so. As a result of positive employment figures and a potential end of the recession, the RBA has now followed up with another 0.25% increase in November. However, reading between the lines, it appears the RBA is really targeting the overpriced housing market which is still being propped up by stimulus, grants and of course the best stimulus of all, media hype that creates FOMO (Fear Of Missing Out), a psychological condition that causes people to do things that don't make fundamental or economic sense. The mirage of economic recovery that has led to a stock market and real estate rebound and an increase in confidence has increased the appetite for risk by some traders and investors resulting in demand for blue chip stocks.

There are many new homeowners that are about to find out how rising interest rates impact their budgets and also the value of their homes. There are many who have purchased homes based on a 100% mortgage and the home owners grant and so will risk losing their homes as interest rates continue to rise. This will be a miserable experience for them, as well as having a negative impact on the property market and general economy. The government's manipulation of the property market has been immoral and has been done purely to serve the bank's interests. This is the result when there is central planning for money in a free market system.

*"I feel the true value of the markets have not been realised due to the valiant efforts of central banks, and to a lesser extent governments to prevent a global recession. Liquidity boosts and heavy rate cuts have prevented complete capitulation, but we still seem to be slowly dying a death of a thousand cuts."* Marc Kimsey on Bloomberg.

### The Australian Market - rally stalls for a rest or change in trend

The All Ordinaries (XAO) continued to rise in October to a high of 4,897.50 points, just shy of the 50% retracement level at 4,962.85 points, where it has found resistance and proceeded to fall away in the last week of October, closing the month at 4,646.90 points after forming a low of 4,563.20 points.

We wrote in the September market report: *Given that it (XAO) made new yearly highs increases the probability for a run up to the 5,000 points region which coincides with the 50% retracement level at 4,962.85 points. We have also stated since the August report: There is still the possibility of a further rally given that the market has breached the 38.2% retracement level, so the 50% is very likely. However, we are still expecting the market to peak sometime in the next month based on a number of technical indicators, but there is no technical confirmation of a change in trend at this stage.*

As we suggested last month, the XAO has potentially reached its upper target zone as it now appears to be finding resistance at the various significant levels that were discussed our previous report. The most obvious is the critical 50% retracement level that we have already discussed above and the 4,700 region that the XAO tested in the last 3 weeks of the September which coincides with a 100% price extension (4,735.90 points) of the first leg up (ABC on the weekly chart below) from the March 09 low indicating a possible top of third leg up from the July 09 low.

**All Ordinaries Weekly Chart**

**All Ordinaries Monthly Chart**


There is also the overhead resistance of the Aug 08 low at 4,829 points (dotted line on weekly chart above) where the market moved in a sideways distribution pattern between Jul and Sept 08 before resuming its downtrend. The Jun 06 low of 4,726 points (dashed line on monthly chart above) may also be providing resistance to the current uptrend.

The XAO has been rising in a channel (see dashed lines on weekly chart above) from the March low and has been bumping along the underside of the top resistance line similar to the first leg up. It is now pulling back within the channel where it will most likely test the lower channel. A breakout of this channel usually results in a continuation in the breakout direction; therefore a close below the lower line will be a bearish signal.

There is also no Dow Theory exit pattern (a lower low after a lower high) on the weekly chart so a change of trend is unconfirmed and so there is still the possibility that this move may be a short term pullback within the up-trend. Therefore, we will need to wait to see how the weekly bars unfold in order to get a clearer picture of where the market is heading. The market may move back up and test the recent October high at 4,897 points and either break through the high which would indicate a further rise or find resistance and fall away to commence a downtrend.

In previous months we wrote: *"The 50% retracement level of 4,962.85 points is now looking quite interesting as a potential target. There is also the distinct possibility of a rally to the 61.8% level at 5,400 points region based on the higher end of Elliott Wave projections, however given the undercurrent of negative fundamentals this would be a low probability scenario."*

**Outlook**

We believe that equity markets are potentially overextended and so a correction may be overdue, but this does not prevent markets from rising even further. As we have stated previously, the strength of the rally suggests that the market is being pushed higher by investor and trader sentiment that perceives that the March low is a significant bottom and that they may be missing out on a major bull run. As a result, the trend has continued rising and the power of sentiment can overwhelm and produce outcomes that are at odds with the fundamentals. However, we continue to be mindful that market rallies that are not driven by improving fundamentals do not last, and so we are prepared for a significant peak and reversal of the up-trend.

Corporate earnings are still down by 20% or more and while unemployment levels are still quite low in Australia, personal incomes are definitely down due to a reduction in work hours. The global financial system remains fragile and western economies are still addicted to leveraged finance. The central banks and governments are trying to prevent deleveraging and deflation with lower interest rates and stimulus packages. This produces further debt for both the private and public sectors which is being serviced with easy money and money printing that depreciates currencies and reduces the standard of living. The central banks and government have learned nothing from the lessons of the financial crisis and are creating another bubble in asset prices in order to prevent deflation.

We agree with Harry Dent, stated in his latest report: *"This rally continues to show the characteristics of a bear market rally: a nearly straight up advance with minor pauses and on declining volume. Some of our technical indicators suggest strongly that we are not yet near a top. However, others have shown extremely overbought short- to intermediate-term readings. The truth is we have been due for a short-term correction, but stocks are also likely to extend their rally for months. Given that this rally has already broken the records, we don't want to fight the obvious. The markets keep edging upward, and investors seem to assume that a recovery will continue until*

*there are signs that something is wrong.....We have said from the beginning that the banks were already dead in 2005 when they lent aggressively against home prices that doubled or more in 5 years. The government and banks are checkmated—period! There is no way out of this crisis other than a deleveraging or “detox,” which will, paradoxically, be good for our economy and for our children long term. The economy cannot grow again until this deleveraging occurs. Such deleveraging occurred into 1933 in the Great Depression, three and one-half years after the stock peak in late 1929. At that time, the Fed and government did not try so strongly as they are now to prevent or push out the crisis. We will be lucky to come out of this situation by sometime between 2012 and early 2013, given that the government has suppressed this necessary crisis by at least a year or two.”*

The September and October period is significant as a potential market top with a history of peaks and declines dating back to the 1700's most accurately. The duration of the current rally of approximately is consistent with bear market rallies and investor psychology measured by the Daily Sentiment Index (DSI) is still high at 90% bulls on the Dow Jones, an extreme measure consistent with other major market peaks. The media hype of a recovery is everywhere and history shows that the final stages of a rally will often attempt to make fools of as many opponents of the rally as possible.

### Summary - Strategy and Recommendation

We have been cautiously bullish despite underlying fundamental problems with the economy. The borrow and spend strategy will have a short term positive effect, but longer term the bailouts will turn out to be unsustainable because of the debt that it creates. The stock markets ultimately reflect these problems by falling in value which is why we have taken a cautious and short term view in this high risk environment.

We continue to hold most current open positions with the view of taking advantage of any further rise in the market to a yearly or major high, however there have been a couple of trades that have been exited for profit and a stop loss. As a result, our stop loss or exit levels are constantly being revised on our current open positions. The key as always will be exiting open positions if the markets move into a confirmed down-trend.

Our strategy is primarily based on analysing stock charts and the general market in order to identify a trend and so we will exit only when there is sufficient confirmation that the trend is changing direction. The beauty of technical analysis is that it allows you to stay with the trend in order to maximise profits, even though it may be in conflict with the fundamentals. The underlying fundamentals eventually influence the market to change the trend where technical analysis provides an exit point.

Longer term we believe the markets will unfold in a broad sideways pattern over the next few years similar to the patterns seen during the 1930's and 1960's whereby recoveries or rallies occur as a result of economic stimulus and China demand, while being muted by the underlying deleveraging of previous debt build up. The Dow Jones had broken the 1,000 level for the first time by 1968, but then traded within the 800-900 points range for the next 15 years. Holding Dow stocks during that period of rising inflation resulted in a 60-70% loss of value.

Therefore, we believe the ongoing investment strategy will require disciplined active management and the buy and hold strategy will simply not produce satisfactory results.

Our strategy gave us the ability to protect our investor's capital by exiting our positions in 2007 and early 2008 and cutting losses short with the use of a stop loss strategy with limited open positions during 2008 and most of the portfolio sitting in cash. Our unique investment style has allowed our investors to have the cash and confidence to re-enter the market and also adjust the strategy to allow us to profit within what is very likely to be a short to medium term rally which may require a similar exit strategy that was employed in late 2007.

**“Take care to sell your horse before he dies. The art of life is passing losses on.” Robert Frost**



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