

Stock Market Report

30 September 2009

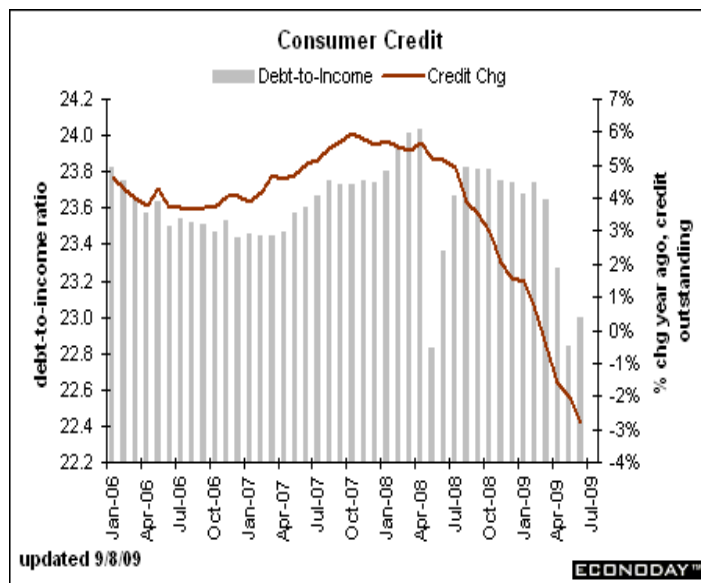
Let the Trend be your Friend

Stock markets continue to rise and make new highs for the year even though most financial news is based on 'better than expected' or 'less bad' economic data, and so is perceived as positive. The \$AUS has continued to rise while the \$US dollar falls; oil has traded within a sideways band; and gold is testing major highs.

The Australian unemployment rate has risen only slightly however number of hours worked has dropped, which undoubtedly results in falls in income, while US unemployment also rose slightly to 9.8%, which is really much higher according to *shadowstats.com*. The rebound in US manufacturing is stalling and leading to jobs growth concerns. The better than expected results from the earnings season appears to be mostly as a result of cost cutting rather than revenue growth. Corporations slashed production faster than demand fell to reduce the build-up in inventories. Commercial loan defaults are rising and multiple US banks are still going broke.

As a result of falling corporate earnings, price-to-earnings (PE) ratios are rising far above the corporate earnings that support them. The S&P 500's seven-month rise has pushed its PE ratio to the highest levels since 2004. The measure was valued at 20.2 times its companies' reported operating profits on Sept. 22, according to Bloomberg data. "This puts the market 35% overvalued, on a cyclically adjusted PE basis," says Smithers & Co. The annual dividend yield for the Dow has dropped from 4.7% in March to 2.95%, the same as in September 1929. The Baltic Dry Index which tracks worldwide international shipping prices of various dry bulk cargoes is retreating after peaking in June this year.

The demand for credit and consumption continues to fall in the US due to the rising savings rate and consumers paying down debt in order to survive financially, which increases the potential for deflation (see chart below). Total consumer credit is also contracting, and the rate of contraction is accelerating. Deflation is quietly overtaking industries and most real estate markets in the world are deteriorating further.



Nouriel Roubini stated, "The real economy is barely recovering while markets are going this way. I see the risk of a correction, especially when the markets now realize that the recovery is not rapid and V-shaped, but more like U-shaped. That might be in the fourth quarter or the first quarter of next year. Markets have gone up too much, too soon, too fast," Roubini said in an interview in Istanbul on Oct. 3. There have been very few corrections since the March lows except with the 2nd leg down of this rally from mid June to mid July and it was mild.

Hedge fund manager Peter Thiel told the *Wall Street Journal*, "The recovery is not real...Deep structural problems haven't been solved and it's unclear how we will create jobs and get the economy growing again - that's long been my thesis and it still is."

"I have rarely been so convinced that the next broader market move is down," says Benjamin Bornstein of Prospero Capital Management in Chicago. "The problem is that governments do not create income or wealth, and current stimulus equates to a future tax liability. That will become a major concern in mid-2010 when the stimulus is done."

The International Monetary Fund warned that government stimulus programs are a problem for banks because government borrowing draws capital away from the private sector, which includes businesses that can invest in projects that generate a real return. The borrowing for stimulus produces higher debt and inflation that potentially leads to higher interest rates.

Economist Tony Makin of Griffith University has warned that unproductive spending should be called fiscal 'repression' rather than stimulus and would not justify the debt required to fund it. He also noted that public spending on highly productive infrastructure might be worthwhile if the rate of return exceeded the interest bills incurred to service government debt.

The recent recovery is the result of money printing and once again easy monetary policy by central banks. The problem is that this type of monetary policy doesn't create real growth and eventually leads to asset deflation, so commodities including gold and stock prices will fall. However central banks will add further stimulus which will cause rising inflation and then a rise in the gold price. If stock markets begin to fall again and the \$US rises, then gold may well fall back again after recently breaking the highs and then rise substantially beyond the \$1,033 level.

It was reported in *The Australian Financial Review* 21/9/09, "But other economists are expected to warn the Senate today that the fiscal stimulus did not prevent a recession and could in fact prolong the domestic downturn in the way similar measures did in the Great Depression and in Japan during the 1990's."

The central banking policy of inflating debt away eventually hits a wall because maintaining artificially low interest rates by understating the inflation rate creates imbalances in the economy in terms of extreme debt levels and discourages savings. The inflation rate or CPI is understated so that the government does not need to increase pension and retirement obligations at the true indexed rate. The economy wants to deflate as a result of the build up of imbalances but central banks and governments try to fight deflation with easy monetary policy and stimulus.

The Elliott Wave Theorist, Sept 09: "The latest rally in stocks and commodities has accompanied the temporary return of inflation, which in turn has brought signs of an impending official 'recovery'. But it is mostly another illusion borne of optimism, as a weak dollar – a result of expanded credit – has once again puffed up the economic data."

This is debt deflation rather than a classic inventory-led downturn, so it's our belief that the financial crisis is in hibernation before it becomes a debt crisis.

The Australian Market - sharp rally continues as a countertrend push

The All Ordinaries (XAO) continued to rise in September to a high of 4,761.8 points, closing the month at a new yearly high of 4,739.3 points. Given that it 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.

However, the market found some resistance when the 4,700-4,800 range was tested for the last 3 consecutive weeks of the month with highs of 4,746 points (18/09/09), 4,741 points (25/09/09) and 4,761 points (02/10/09) respectively. The XAO then closed lower at 4,606.1 points by the end of the week on the 2/10/09 in which the end of the month occurred mid-week, indicating a potential for a peak of the uptrend.

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.

All Ordinaries Weekly Chart



All Ordinaries Monthly Chart



The XAO has potentially reached its upper target zone in terms of **price, pattern & time**.

In terms of price, the resistance level in the 4,700 region that we mentioned earlier that the XAO tested in the last 3 weeks of the month also 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. There is also the critical 50% retracement level overhead at near 5,000 points that we have already discussed above.

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.”*

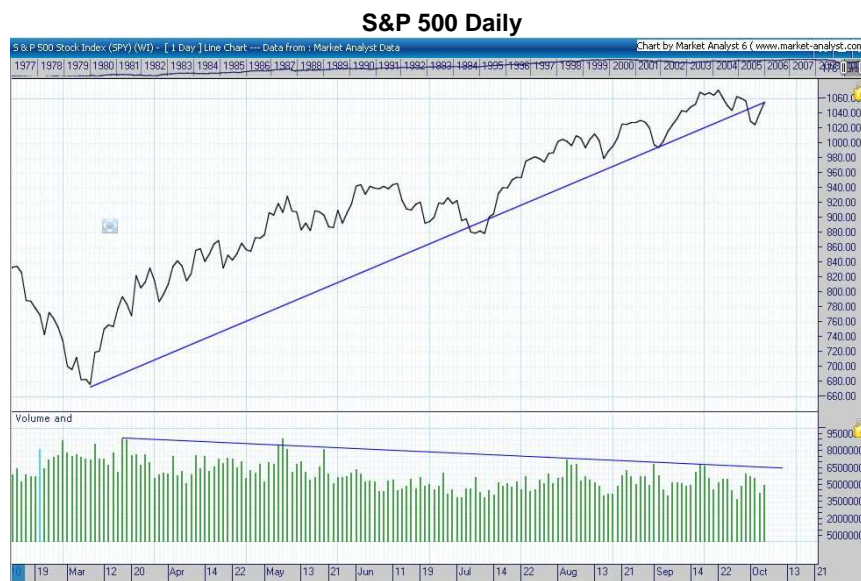
In relation to pattern, there is overhead resistance at the Aug 08 low of 4,829 points (dotted line on weekly chart above) where the market moved in a sideways distribution pattern between Jul and Sept 08 before resuming its downtrend. The Jun 06 low of 4,726 points (dashed line on monthly chart above)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

The XAO has risen 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, so a reversal off the line is quite probable where the price action will test the lower channel. A breakout of this channel usually results in continuation in the breakout direction, therefore a close below the lower line will be a bearish signal.

The Elliott Wave count on the Dow Jones is satisfying a wave pattern to a potential stopping point at 9,924 points high on the Dow. The Dow reached a high of 9,937.72 on the last Friday in September and has since fallen away to form a low of 9,378 points by the following Friday 2/10/09. The Elliott Wave Financial Forecast, Sept 09 Issue stated, “Yes, it’s only been 6 months of rally, and that’s not long for a rise of Primary degree. But the overriding mission of a second wave rally in a big bear market is to re-create the enthusiasm that existed at the high. With the market having clearly accomplished this feat, we see no reason to second-guess the situation or anticipate higher prices.”

From a time perspective, 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 6 months is consistent with bear market rallies and investor psychology measured by the Daily Sentiment Index (DSI) is high at 92% bulls on the S&P 500, 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.

The chart above shows that volume on the S&P500 has been falling with the rise since March which is a worrying sign, indicating that as prices increase less investors are willing to commit further to the rising prices which then leads to a peak.



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 investors and traders that perceive that the March low is a significant bottom and that they may be missing out on a major bull run.

Although we have been expecting the market to top out based on lacking fundamentals and a maturing technical rally, the trend has continued rising and we know from experience that the power of sentiment can overwhelm and produce outcomes that are at odds with the fundamentals. The concern is that the financial system remains fragile and the economy is addicted to finance. Central banks and governments are either in denial of or indifferent to the consequences of money printing which depreciates currency and reduces the standard of living.

Therefore, 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 market reversal. A sustainable long term trend would comprise substantial investment supported by improving fundamentals and expanding volume or else the market will run out of steam as the short term players lose interest.

So given that our strategy is primarily based on analysing stock charts in order to identify a trend and at the moment the trend is still rising, we can **let the trend be our friend** but we also need to watch the speed. And what a bounce in terms of speed. This rise has been very steep and you can see the difference with the rise out of the March 2003 low which was much shallower on the monthly chart of the All Ordinaries. If it's a dead cat bounce, then it's bounced on a trampoline. To expect the market to continue rising at this rate would be extremely optimistic.

That's the beauty of technical analysis, it allows you to stay with the trend and let your profits run, 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.

Robert Prechter, 60, of Elliott Wave International said he's basing his prediction for a decline on chart patterns, dividend yields and extreme levels of investor optimism. The combined dividend yield for the 30 stocks in the Dow Jones Industrial Average is too low at 2.94 percent, he said, citing an analysis of the 1929 market peak. "Stocks are still in the most expensive area in history," he said. "Stocks, commodities and real-estate will suffer from a rebound in the U.S. dollar," Prechter said.

The longer the rally persists, the more dangerous it becomes and September/October has a history of peaks and declines.

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. Stock markets reflect these problems by falling in value which is why we have taken a cautious and short term view in this high risk environment.

The trends are now becoming harder to read as this bear market rally matures, especially because it still doesn't appear to be confirming a reversal. The key as always will be exiting our open positions if the markets rolls over.

We will continue to hold current open positions with the view of taking advantage of any further rise in the market to a yearly or major high. While we are still bullish on the energy sector, we must be prepared if this market rally ends sometime in the near future in which case we expect oil and energy prices to fall. Although we see energy stocks as a long term investment, they are still prone to fall significantly in a bear market, as most stocks go down. As a result, our stop loss or exit levels are constantly being revised on our current open positions.

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. 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 new positions taken during 2008 while most of the portfolio was sitting in cash. Our unique investment style has allowed our investors to have the money and confidence to re-enter the market and also adjust our 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.

Therefore, in the likelihood that the stock market forms a major peak and moves into another down trend, we may be attempting to take advantage of the move by trading short positions (profit from a falling share price). Please let us know if you will be interested in participating in this exercise or whether you will be content to simply exit most positions and move into cash until it becomes appropriate to enter new long positions again after the market confirms a significant bottom.

"There are two times in a man's life when he should not speculate: When he can't afford it, and when he can." Mark Twain.



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