Stock Market Report

30 November 2009

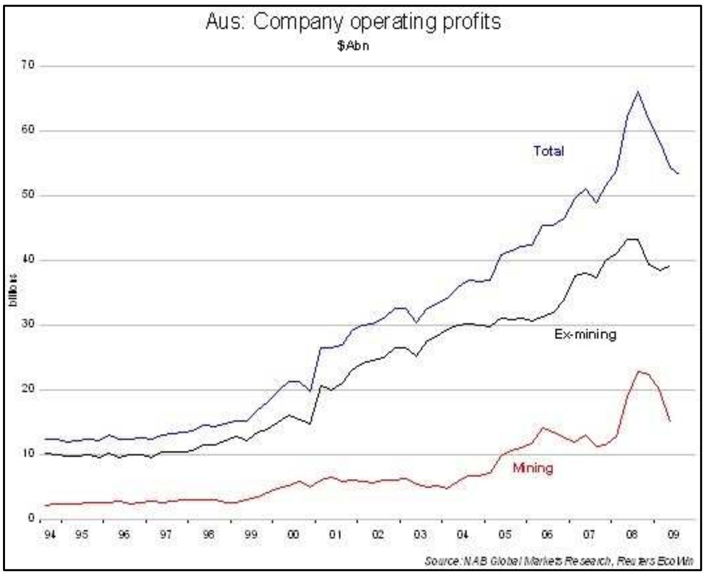
Market Moving Sideways

Stock markets across the world appear to be rolling over, however rather than selling off into a confirmed downtrend, they are moving into a sideways pattern where recent highs and lows are often tested until there is a clear breakout to either the upside or downside. A sideways pattern generally indicates a period of consolidation comprising of either accumulation, which often occurs at market bottoms, or distribution, which often occurs within a downtrend or at market tops. The market could go either way after these phases and provide either a continuation from the accumulation phase and continue moving up or provide a reversal from the distribution phase by falling away in a downtrend.

The S&P500 has rallied 63 percent since the March 9 lows, the steepest advance since the Great Depression, driven mainly by record-low interest rates and about $12 trillion in stimulus from governments worldwide. The Dow Jones is also testing its key resistance level of 10,319 points (50% retracement level), while the FTSE 100 and ASX 200 have tested their key levels of 5,000 points. A breakout to the upside would confirm a continuation of the uptrend, while respect of these levels would warn of a secondary correction.

Bloomberg reports: Job losses are making it difficult for consumer spending to gain traction, indicating the recovery will be slow to develop entering 2010. The lack of spending, which accounts for about 70 percent of growth, and unemployment above 10 percent are reasons why Federal Reserve policy makers have repeated pledges to keep their key interest rate near zero for an “extended period.” “We just see the service sector continuing to lag manufacturing in the recovery,” said Kim Whelan, an analyst at Wells Fargo Securities in Charlotte, North Carolina. “It reflects weakness in consumer incomes and consumer spending, and with the labour market still in an extremely weakened state, we won’t see too many gains.”

Peter Jankovskis, who helps manage more than $1.5 billion at Oakbrook Investments in Lisle, Illinois stated recently: “The stock market has gotten ahead of itself and to sustain those values going forward we’ll need to see real economic growth. Durable goods orders were a fairly good report, but it was not really able to move the market. The weakness in consumer spending is still the key issue to be resolved.”



The global financial crisis (GFC) caused a sudden reduction in leverage in the financial sector that led to falls in asset values, so the most highly leveraged entities either went broke or were forced to sell assets and preserve capital. As the Banks cut back lending and raised capital in order to preserve capital, the credit crisis moved from the financial sector to the business sector that did not qualify for government bailouts. The crisis then hit the households or private sector, which began saving more and spending less, and completing the cycle by impacting corporate and bank profits. Debt is switching from the private sector to the public sector in order to fill the gap.

Central banks and governments set out to stop the downward spiral by supporting asset prices and stabilise bank balance sheets with stimulus packages, bailouts, emergency low interest rates and the suspension of mark-to-market accounting rules. It has worked by creating the appearance of stability and confidence and the banks have shown earnings growth, however it has not improved the quality of those bank assets purchased with borrowed money, so there will likely be further write-downs at some point in the future.

The question is how much of it will stand up once the stimulus and low interest rates are removed. Monetary policy has attempted to revive an economic growth model that is driven by credit fuelled asset inflation, the model that created the GFC bubble that burst.

Gold advanced to a record $1,226.56 an ounce in November, as investors seek protection against the prospect of currency devaluation and the potential for inflation, both as a result of money printing. Gold could go much higher if the world's entire monetary order shifts away from the U.S. dollar. The Independent's Robert Fisk wrote in an article, "The demise of the dollar," that, "Gulf Arabs are planning - along with China, Russia, Japan and France - to end dollar dealings for oil, moving instead to a basket of currencies including the Japanese yen and Chinese Yuan, the euro, gold and a new, unified currency planned for nations in the Gulf Cooperation Council, including Saudi Arabia, Abu Dhabi, Kuwait and Qatar...The transitional currency in the move away from dollars, according to Chinese banking sources, may well be gold." Well then, that changes everything. In this role, gold becomes a hedge against devaluation in the U.S. dollar. It's not so much a hedge against inflation (a systematic increase in the supply of dollars printed to hold up the U.S. banking sector and finance a grasping Federal government) as it is a move to protect assets against a sudden dollar collapse.

The Australian Market - rally pause or the end

The All Ordinaries (XAO) has followed most other major indexes and moved into a sideways pattern since pulling back strongly in late October and early November. The XAO has not even been close to testing the October high of 4,897.50 points, so the 50% retracement level at 4,962.85 points has been respected and proved to be a resistance level.

All Ordinaries Weekly Chart

All Ordinaries Monthly Chart

As we suggested in previous reports, the XAO has potentially reached either an upper target zone or a consolidation point as it now appears to be consistently finding resistance at the various significant resistance levels that we have highlighted. The most obvious are the critical 50% retracement level and the 4,700 points region where there is a cluster of resistance points including the Jun 06 low of 4,726 points (see XAO monthly chart above) and 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 a third leg up from the July 09 low. The XAO tested the 4,700 points region in the last 3 weeks of September and has had trouble closing above that level for the whole of November.

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."*

The Aug 08 low at 4,829 points and Sept 08 high at 5,250 points (dotted lines on weekly chart above) where the market moved in a sideways distribution pattern in 2008 before resuming its downtrend may prove to be a major resistance area for 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 moving sideways within the channel where it will most likely test the lower channel line. 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 still no Dow Theory exit pattern (a lower low after a lower high) on the weekly chart so a change of trend is unconfirmed and there is still the possibility that this move may be a short term pullback or consolidation 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.

Outlook

As a result of the obvious fundamental shortcomings that we have already covered, in particular relating to consumer spending and corporate earnings, we have concerns about the strength of economy and thus the sustainability of the stock market rally.

We therefore believe that equity markets are potentially overextended and so a correction may be imminent. 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. This does not prevent markets from rising even further, although we believe we are in the high-risk period based on both fundamental and technical indicators. The $US is looking oversold and stocks are looking overbought, so the reflation of most asset markets is looking over cooked.

Even with the strong rise of stock markets this year, the global financial system is still weighed down by debt. The massive global debt burden is not supported by assets that are unable to generate sufficient income to service the debt. This will likely cause another deleveraging process where debts are liquidated and asset values are forcibly written down.

Will the Dubai sovereign debt crisis be the catalyst for a stock market reversal into another down trend that we have been expecting to begin sometime in September or October this year, or will it just be a temporary setback with another bailout that defers the inevitable. We will need to wait and see because the markets are not confirming any particular direction yet. It's just another reminder to the economy that debt is a real problem, in particular in the real estate sector where money has been misallocated in an industry that really does not produce anything in terms of real economic growth. As a result, the Dubai crisis increases the possibility of a sovereign debt crisis of a major economy.

Harry Dent: "The U.S. government has not addressed the root cause of this crisis, which stems from massive overlending against residential and commercial real estate and toxic debt securities that are still in the system. Instead they have spent or guaranteed trillions of dollars to keep the financial system afloat, in hopes that the economy will return back to normal slowly, as will home prices. The economy will not return to normal over the next decade, and home prices will not return back to 2006 levels. Hence, the government's stimulus plan will fail and the banking crisis will come back even stronger. The government has allowed banks to continue to make toxic loans and investment firms to continue to make highly leveraged investments with high bonuses to incentives. Again, the government treated the symptoms, not the cause, which only puts off the crisis and makes it worse ultimately."

D.R. Barton, Jr for Van Tharp Institute is suggesting that there is data supporting the fact that surprisingly, only about 10% of the multi-trillion dollar cash has flowed back into the stock market via mutual funds since the March lows meaning there is lots of cash still sitting on the sidelines. This tends to confirm our belief that the rally has been driven by the US banks trading with the bailout money.

It also means there is either further upside potential if the money on the sidelines enters the market or that another significant correction with a milder upward rebound will be needed to win the trust of retail investors. We tend to favour the second view. The recent rally was just too quick and caught many by surprise given the dramatic fall from 2007. Therefore, it is quite likely that many investors and fund managers will be eager to re-invest on a stock market correction because they missed the boat on the recent rally and will probably attempt to bottom pick the market. However, without the support of the stimulus money from the banks, the market may roll down a shallow slope where again it will require a significant upside move to provide the confirmation needed to entice technical traders and fundamental investors.

We believe that 2010 will continue to be a challenging investment environment because although there is confidence about a sustained recovery at present, the growth prospects will be drawn into question as a result of reduced consumer spending and stimulus packages wearing off. Any recovery will be driven by false sentiment, and therefore susceptible to setbacks. And we think we'll see one in 2010. Bill Evans, Westpac Bank Chief Economist stated, "Funding issues and the soft consumer will hold things back." The AFR recently reported that wages growth is the slowest in 5 years as a result of rising unemployment and reduced work hours.

Dave Rosenberg: "Price gains in the stock market have generally occurred with **low volume**. There are limited buyers - hedge funds and flash traders - but no sellers (not yet, anyway). And, we saw in yesterday's decline that volume climbed across the board, and the number of high-volume selloffs is a major red flag that should not be ignored."

Summary - Strategy and Recommendation

A significant correction that we have been expecting has been averted so far and the market has moved into a sideways pattern. As a result, the price action in the market over the last month has not clarified the bigger picture at all.

Therefore, we will continue to hold current open positions with the view of taking advantage of any further rise in the market or until we are provided with individual exit signals. We have seen price falls in individual stocks recently where what appear to be entry patterns are suddenly hit with a bout of selling that breaks through stop loss levels. There has been little warning before the price falls, making some investments quite difficult at the moment, as seen with some stocks currently held and recently sold. This is an early warning signal to be cautious.

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. 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.

US traders have pumped our markets and our currency all year, fuelled by the cheap money that the US Fed has been issuing at extreme low interest rates. This is the "carry trade", where the traders borrow cheap money to invest in riskier assets for a higher return and Australia's resource sector fits the bill perfectly. But you now get the feeling that traders may be happy with the rally between March and October. However, Helicopter Ben has made it clear that he plans to keep interest rates low for a quite a while yet.

We expect commodity prices to continue to support resource stocks. Goldman Sachs and even "Dr. Doom" Nouriel Roubini expect commodity shortages to really kick in next year as the global economy starts a gradual recovery. Whatever the outcome for the economy we think that energy and precious metals will do well.

Our focus has turned to Gold since it broke through the $1,033.90 major high. Although gold has been a hedge against a falling $US, we believe that Gold should continue to rise even if the $US rises because it will remain a hedge against potential inflation. We believe that given the way fiscal policy is unfolding, then Gold and cash will be the place to be for a certain period.

Bloomberg reports: “Central banks will become net buyers of gold this year for the first time since 1988,” according to New York-based researcher CPM Group. India, China, Russia, Sri Lanka and Mauritius have all added to their reserves. Interest in gold has increased dramatically and the huge surge in the gold price makes it vulnerable to a short term pullback. However, the medium term outlook remains positive for gold with interest rates and $US remaining low. In addition, there are enough monetarists concerned about hyperinflation to ensure gold remains an inflation hedge.

China, the world’s largest producer of gold, has an “extremely low” percentage of bullion in its reserves, implying that it may need to buy just to maintain a constant proportion, **Rozanna Wozniak**, investment research manager at the World Gold Council, said Nov. 29. The country overtook South Africa to become the world’s largest producer in 2007 and the World Gold Council said in July that the nation may pass India as the biggest consumer.

At this stage we need to wait for the market to clarify where it is going before we start making decision with regard to our current holdings or any potential purchases.

As this is the last monthly report for 2009, we would like to wish you all a Merry Christmas and a Happy New Year and thank everyone for their support and feedback during the year.

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Equities Advisor - Authorised Representative