Market Update

From: Mike Sullivan
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Subject: **'All Clear' Again? Or Is Another Fed Bubble Bursting??**

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In just 3 short days, Friday 8/21 through Tuesday 8/25, the S&P 500 took back roughly 14 months of gains. In those same days, the Dow Jones Industrial Average lost 1,324 points from16,990 to 15,666.

On Wednesday 8/26, the snap-back rally we suspected in our e-mail Update may be on the way materialized in spades as the major stock indices all rallied led by the Dow which jumped 620 points, or 3.9%. At the open today it appears the indices may jump another 1%. We'll see how we finish!

How do things go from so panicky to so jubilant in a matter of hours? We'll address the mechanics in a moment, but let's get a visual perspective of where we are as we open the day on the 27th, then we can dissect what may have just occurred … different from the financial media soundbites of course:

Obviously, the celebrated bounce-back is very welcome by all investors, us included. The important thing is to understand what it means, and to determine what to do with it! Note that the bounce from 8/27 is being hailed for being the biggest bounce since 2008. Note that in 2008 we were in a ferocious *bear market*, one that would last for many more months until Wall Street successfully coerced Washington into boosting the bail-outs and changing FASB accounting rules. How did that work out for them?! (Hint: the record real estate prices in Manhattan and record bonuses are a good indicator.)

As far as the mechanics go, note on the chart that the 3-day beat-down took the index on Monday morning *below* the lows from October (which reversed when Fed president Jim Bullard stated the Fed may be willing to keep the Quantitative Easing (money printing) going because of market turmoil. Ignoring the fact that the markets broke on Monday in a 'flash crash' in which many stocks stopped trading, and the big momentum stocks that are used to move the market experienced explosive ranges (like Netflix which dropped from $104 to $85 before closing at $97), this 'flash-crash' opportunistically allowed the High Frequency Traders to drop the market underneath the October lows where there awaited all kinds of 'limit orders' put in place by smaller or slower investors. (The limit orders essentially say for instance 'if the stock drops to this level, limit my losses and sell my shares at $90'.) All of those shares were scooped upon the cheap, the losses locked in for the smaller investors, and the high speed traders on Wall Street had successfully piled up low-cost shares.

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The panic also successfully attracted a lot of traders who establish 'short' positions (meaning those who anticipate a security will decline in price so they borrow shares, then sell them anticipating they will be able to buy them back lower, banking a profit). If the shares instead rise in price, short-sellers lose money. Yesterday, Wednesday the 26th, was a massive 'short-squeeze' in which prices were suddenly reversed upward, then squeezed further upward steadily and relentlessly, causing short-sellers to panic an buy their shares back … adding to the buying frenzy. It continues on Thursday.

For perspective, on Tuesday the 25th 167 of the S&P 500 stocks fell over 2%. On Wednesday, 19 of them jumped more than 5%. As we indicated in past updates a handful of momentum stocks (like the Netflix example above) can move the index itself a great deal. Guess which stocks were in the 19? If you guessed many of the most potent, index-moving stocks, you would be correct.

Regarding the transition from panic to jubilation, those are precisely the emotions that allow such volatile swings to take place. And, the emotions are intense because there is *a lot* of money at stake. Since Wednesday the 19th, when the Fed released its minutes and the International Monetary Fund announced its decision to *not* include the Chinese yuan in the SDR (its reserve currency basket), every investor or trader who bought into the market or already had a position in it has been bludgeoned.

More important, as is the case in rapidly declining bear markets, the emotional panic comes from the monetary loss that expands rapidly when there is no bounce, literally no chance to 'get out near where I got in'. The panic is real because the monetary losses on the wrong side of the trade are real. In a decline like this one the pain of loss is typically magnified overnight as the pros, in particular big Wall Street trading desks, beat-down the 'futures', using a modest amount of capital to do so. The rest of the investing world wakes up to markets that open much lower than they closed the day before and the selling resumes. Skeptical? Here is Jim Cramer, one of CNBC's favorite spokesmen, who tells investors precisely how it's done! This is precisely what happened on Monday. In terms of 'big picture', here are the two major feats that the one-week decline may have just accomplished:

- The decline, however orchestrated, gave the Fed cover to *not* raise interest rates. Two Fed speakers yesterday indicated as much. Wall Street celebrates rates staying low: companies can buy back shares at cheap borrowing costs and home and car loans can keep rates low too. More debt! Only Grandma loses as her savings earn zero, so she now has to buy riskier assets.
- The panic allowed *somebody* to buy all kinds of shares on the cheap. On Tuesday the 18th when the market was 'saved' at its 200 day moving average, Goldman Sachs reported the strongest day since 2011 for its 'buy-backs' desk, the unit that uses S&P 500 company money to buy back a company's own stock. We suspect they did a lot of that Wednesday. If so, companies bought their shares back cheap, and since fewer shares exist now, their *earnings per share* can look better once more in the next reporting season. Market tricks meet accounting tricks!

If so, the Fed will get to look like it knows what it is doing again and a 'market' recovery can go on for a while longer. That there were all kinds of smaller, slower traders and investors that may have been steam-rolled in this skit will likely remain a non-issue for captured regulators … "those are just the risks of being in the 'market'. Meanwhile, 'experts' today are again stating that the Fed can now raise rates and show it as a sign of strength, the same notion that struck terror into hearts just yesterday!

So, having peeked behind the curtain at how market sausage is really made, what to do?

- Remember that bear market rallies are some of the strongest rallies. Look at where we are on the chart and determine whether any rally is an opportunity to reduce risk or not.
- Monitor the issues that matter: China dumping U.S. Treasuries, the fate of the dollar as the Reserve Currency, and the health of the American Consumer, particularly the middle class.
- For long term investors, the key factor for a reallocation decision should be the *fundamental* strength of the economy and the likelihood for success by the Fed, manipulation or not.

As always, call us if we can assist you making sense of things!: (614) 734-WLTH (9584).