June 15, 2013

the X-factor Report
by Lance Roberts

Market Strategies, Economic Analysis, Risk Management

Initial Sell Signal Approaches

All of a sudden volatility has come back. Over the last several weeks we have seen sharp one day selloffs that has sent the media into an absolute frenzy followed by large surges the next day with the media telling you now is the time to jump in. For the average investor it has been more than just a little confusing as to what should be done with portfolios.

Before we get into this week's missive I have a few announcements to make:

1) Over the next few weeks the X-Factor report will transition to an HTML format for easier reading and sharing. No more PDF's to download and open.

2) During this process the newsletter will be broken out into three components consisting of a technical review of the markets, an expanded sector analysis with recommendations and an expanded and improved 401k plan manager and investment model. These will all reside on the website, for members only, under the RESOURCES tab.

Since I am doing primarily economic and major market analysis during the week in the Daily X-Change blog postings I am going to spend the bulk of my time on the weekends focusing on investment strategy and risk analysis.

3) Lastly, we are about to rebuild our radio production and broadcasting studio to accommodate for video production as well. We will begin later this summer producing more content, both audio and video, for delivery to our forthcoming mobile app and Streettalk Radio which will be a 24-hour stream of interviews, shows and financial education.

I am very excited about the new product offerings we will have for you in the near future to help you manage your money better. As always if you have suggestions, or comments, I would love to have them. *Email me.*

Inside This Issue:

Just A Pullback For Now

It is sometimes very confusing for investors to discern what they should be doing because of the day to day noise from the media. As I stated above; the media attributes whatever is happening during a particular trading session to the news item of the moment – whether it is relevant or not.

This presents a real difficulty for investors to navigate the management of their portfolio - which is why most individuals simply don't. This is why we encourage you to step back from the day to day *"noise"* to see the bigger picture. It is much like art – take a look at a very famous work of art below.

When you stand too close to the painting you lose perspective, detail and the connectivity of the overall painting. However, if you step back you see Claude Monet's *"Sunrise."*

This is the primary problem for fundamental investors. The focus on financial ratios, historical comparisons and valuations keeps analysts, and portfolio

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managers, standing too close to the market. This is why they consistently miss the detail and connectivity of the overall environment.

This is also the same problem that individuals face daily when reading the latest headlines or listening to the financial media. Daily headlines rarely have anything to do with market action in the short term. However, each day, we are inundated with the details of some economic, or corporate, report that is responsible for moving the entire market. Even though this is absolutely not the case; individuals, and professionals, continue to stand too close to the painting and miss the broader detail.

Take a look at the chart below.

It is clear that the market is declining so you should sell and get out…right?

Let’s take a step back and look at the next chart.

When we look at a weekly chart a very different picture emerges that shows a *“consolidation”* process occurring which has previously led to the next leg up in the current upward trend. However, even this chart, due to the shortness of its time frame, doesn’t give us a real picture of what is currently occurring in the market.

Let’s take another step backward. As we look at the chart on the next page, which shows an 18-month period, an entirely different picture emerges.

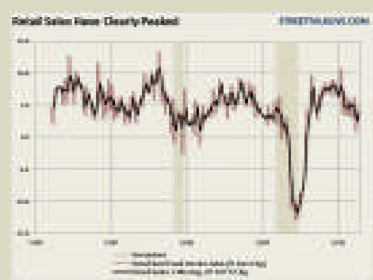
RECOMMENDED READING

Economy In Pictures

I present 12 charts on different aspects of the economy. You decide.

Consumer Confidence Spurs Retail Sales

Retail sales jumped more than expected in the latest report follow a surge in the asset markets. With the markets now in trouble – will sales fall as well?



VIDEOS – Fox 26 & CNBC

Discussions on the latest employment reports.

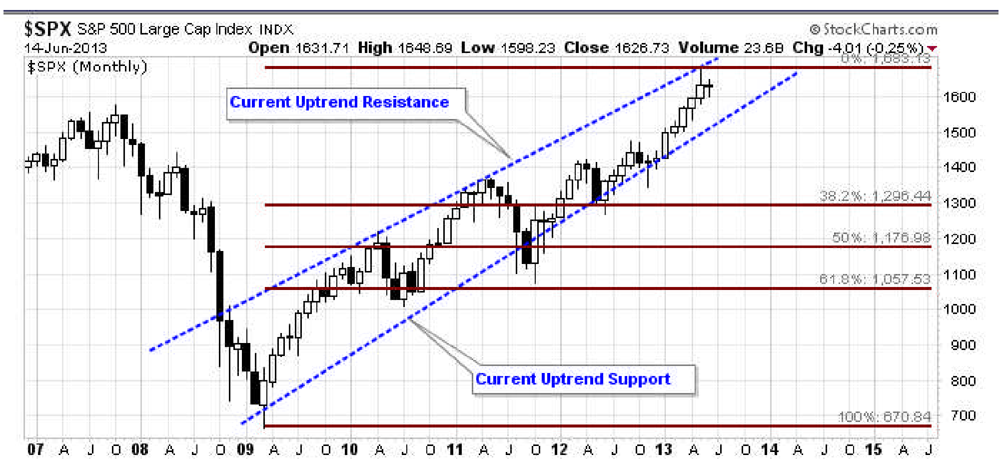
FOX 26 Interview With Mike Isocvitz

CNBC Panel Discussion

The dashed blue line is the current longer term upward *"bullish"* trend of the market. The dashed red lines boarder the shorter term bull trends. If you notice each time the shorter bull trend was broken the markets corrected back to the longer term bullish trend.

Currently, the market has not violated its current bullish trend just yet. This is specifically the reason why I have been stating on the daily radio program that while the market is experiencing a *"pullback"* there is no evidence a broader correction under way. This is also why I have not reduced equity exposure in the 401k-plan manager below.

However, even this chart doesn't tell us everything we need to know. If we step back further and view a monthly chart



Correction? What correction? As an investor with a longer term perspective - when viewing the broader picture in full we can see that there is little reason to be concerned. The current bullish trend (*blue dashed lines*) is still very much intact from the March 2009 lows and the market remains near its all-time highs.

However, there is a reason to be concerned. The red lines are retracement levels which are where the markets would likely correct during a full-fledged correction. This is why a break below 1600 on the S&P 500 is so critical to watch. We can see from the chart above that when the markets were previously near this level it experienced a fairly sharp correction. What is lacking currently is a catalyst.

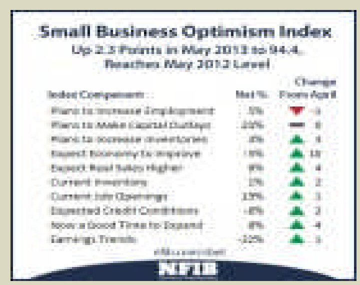
RECOMMENDED READING

Gallup: Consumer Spending Is Up – Retail Sales Down

The recent rise in asset markets has spurred consumer spending and sentiment. However, longer term retail sales data still declines. What gives?

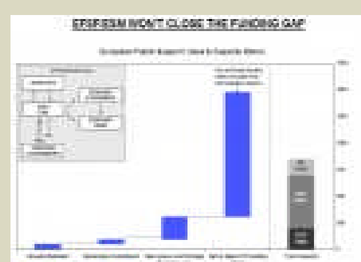
NFIB: Optimism Improves

Small businesses optimism improved in the latest report but the headlines should have read "Optimism less negative."



Eurozone Crisis Set To Flare Up?

Is the Eurozone crisis a simmering fire waiting to ignite?



Therefore, like with art, if you view a painting in different ways you will discern differences in color, texture and strokes. This is why we use different forms of analysis on the data to see if there are *"signs"* that can tell us the difference between a *"pullback"* and a *"correction."*

A Sell Signal Approaches

For analysis purposes we will use a chart that is 3-years in duration to maintain consistency. We will start with a basic chart and then layer analysis onto the chart so you can see the broader picture developing.

The chart below shows a basic chart with two moving averages overlaid. The blue line is a short term moving average and the red line is an intermediate term.

The reason that we use two moving average is that tells us several things:

1) The moving averages themselves are like "gravity" to market prices. The further that prices move away from the underlying average the more likely that a correction will occur. In order for there to be a moving average; prices must have traded both above and below that average in the past. Therefore, prices cannot remain indefinitely deviated above or below the average.

2) When the short term moving average crosses the longer term moving average it generates a *"buy"* or *"sell"* signal. When prices are rising, or falling, enough to trigger a *"crossover"* of the two averages it denotes a positive or negative trend in price. I have notated the last three moving average crossover signals on the chart above.

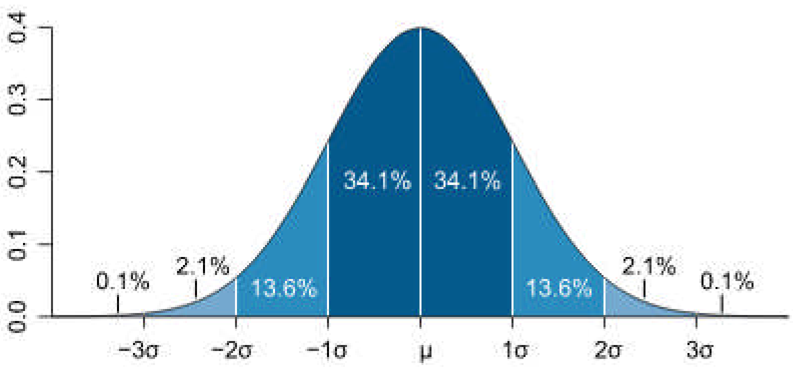
3) The angle of the moving averages (either rising or falling) denotes the overall trend in price. Regardless of the underlying fundamentals if moving averages are trending negatively you do not want to be a buyer.

Currently, the short term moving average is so far above the longer term average that there is little risk of the markets throwing off a crossover sell signal anytime soon. However, notice above how the markets behaved when the short term average was this above the longer term average in the past.

Let’s add the next layer of analysis which measures standard deviation. As we have discussed in the past “Bollinger Bands” are a technical tool that measures the deviation in the current price from the underlying moving average.

*(**For new readers:** In statistics and probability theory, standard deviation shows how much variation or dispersion exists from the average (mean), or expected value.*

In a normal distribution of data, as shown by the bell curve below, ONE standard deviation from the mean encompasses 68.2% of all data in the distribution (in our case price movement). TWO deviations account for 95.4% of all potential price movement while THREE deviations account for 99.8%. There when prices reach two and three standard deviations above or below their mean the majority of the probable price movement has been achieved.)



As we stated above prices can only move so far away from their long term average before *“gravity”* sucks prices back towards, or below, the average. The chart below adds a set of Bollinger Bands to our base chart which denotes 2-standard deviation above and below the long term moving average (red line).

As you can see, while it is “possible” for the markets to get to stay elevated at the extremes for some time – such extremes are not sustainable indefinitely without a correction back to the mean or beyond. However, while we know that the markets CAN maintain overbought conditions for some period of time other indicators can tell us potentially when the reversion back to the long term mean has begun.

Let's add an overbought/sold indicator to our base chart we are building.

(Note: This is a proprietary indicator that we use to manage client portfolios along with its settings. There I am not going to discuss it in great detail.)

As you can see when this indicator drops out of the top blue shaded area it has generally marked the beginning of bigger correction. The best buying opportunities occur when it gets to the blue shaded areas at the bottom of the scale.

Currently, the market has not dropped out of its overly bullish sentiment just yet and therefore, at this moment, we are still in the midst of a mild pullback, as we saw in March and April rather than a correction back to the mean.

By adding a price momentum indicator to our chart we can validate, or confirm, the validity of our proprietary indicator above. In the chart below I have taken the price chart above and added a price momentum indicator to the bottom.

As you will see in the chart on the next page; in order to discern between a short term pullback within an ongoing uptrend and a full blown correction it requires that the proprietary signal at the top is confirmed by weakening price momentum at the bottom.

In March of 2011, as Japan was struck by an earthquake and tsunami, the markets pulled back. However, while the price momentum indicator registered a sell signal; our proprietary indicator did not. However, in late May as the debt ceiling drama begin to surface, both indicators dropped in unison warning that a bigger correction was on the way. In July of 2011 the correction hit the markets and it hit hard.

Currently, we have a March of 2011 scenario on our hands as the price momentum indicator is registering a sell signal but our proprietary indicator is NOT…at least not yet.

So far, none of our signals are indicating that the current selloffs in the markets over the last three weeks are anything other than a normal garden variety pullback.

The last transformation below will be the addition of two indicators which can provide a *"warning"* and a *"confirmation"* of an impending correction.

As I have notated below the two blue indicators are called moving average convergence/divergence indicators (MACD) which measures the strength, direction, momentum and duration of prices. The problem for fundamentally based investors is that things such as valuation, earnings, etc. are fine for telling you *"WHAT"* to buy – however, they are horrible indicators for telling you *"WHEN"* to buy or sell.

*(**Note:** I am not advocating market TIMING – which is trying to be either "all in" or "all out" of the market. This is not a winning strategy. However, I am advocating using price analysis to determine optimal times to manage portfolio risk by increasing or decreasing exposure to equities. Furthermore, as opposed to the mainstream media that tells you that you should "buy and hold," the whole premise of investing is to "buy low" and "sell high." **How can you do that if you don't know where "high" and "low" exist?"**)*

As you can see in the chart above the top of the two MACD indicators tends to give *"early warning"* signals. These warning signals are just that – a *"warning"* that you should start to pay very close attention to your portfolio.

When a warning is given you should undertake the following portfolio actions:

1) *Review all holdings in the portfolio fundamentally to determine if anything has changed within the fundamental storyline.*

2) *Review each positions weight relative to the portfolio. Assume that each position in a portfolio was 5%. Trim back positions that are now greater than 5% back to portfolio weight. (It is not uncommon that when a warning is issued that the market will continue to rise – therefore, we only want to trim profits)*

3) *Positions that are fundamentally broken, lagging or otherwise not performing should be sold in their entirety UNLESS they are a hedge against a correction. Positions that are lagging during a market rally tend to lead on a market decline.*

4) *Do not sell winners to buy losers. Hold cash as a hedge against the coming correction. Notice that all warnings above are eventually followed by a sell signal and a market correction.*

Notice that in the chart above the SELL Signals in the bottom most MACD indicator ALWAYS align with the signals of the other indicators. When all of these signals align it is always in conjunction with a market correction.

Currently, the top of the two MACD indicators is very close to issuing a "warning." It will take a VERY strong rally next week to keep that from happening.

Next week if the warning is issued I will go through more detail on what actions should be taken. The one caveat is the ongoing Federal Reserve interventions and their effect on asset prices. However, regardless of what I *"think"* might happen it is the signals that we must follow.

The body of historical evidence is heavily weighted in the favor of these indicators being right. Are they wrong sometimes? Absolutely. There are no indicators, strategies or disciplines that are correct 100% of the time. In baseball the leading batters are hitting only a little better than 30% of the times they are at bat. To win at investing you just need to get more wins than losses but, most importantly, keep the losses to a minimum.

If you think that every position you buy is going to be a winner, or you expect your advisor to only buy winners, then you should NOT BE INVESTING. It is an unrealistic expectation. Have a loser in your portfolio is just a reality of investing – it does not mean you, or your advisor, is loser for making a mistake. Limit the loss, correct the problem and move on.

This is why the greatest investors in history all have the same investing rule in one form or another:

"Cut your losers short and let your winners run."

It seems simple – but it is an extremely tough rule to follow.

No Signal Yet – But It's Coming

I have gone way long this week so I will wrap it up. While there is no *"warning"* signal as of this week; I can assure you that it is coming. Behind that *"warning"* a *"sell"* signal will follow along witha correction.

There are more than enough signs both economically and fundamentally that the current extension of the cyclical bull market is well beyond its norm. There are only two questions that remain to be answered: timing and depth.

Currently I am fairly confident, which is subject to change depending on market action, that the timing of the *"warning"* is fairly soon. The depth of the *"correction"* is another matter entirely. That is something we will only be able to discern once it truly begins. However, I will continue to monitor the markets each week as things develop and keep you apprised accordingly.

Have a great week.
Lance Roberts

Sector Analysis

Oil And Energy Stocks

Since the beginning of this year we have been discussing the "pennant pattern" that has been forming in oil prices warning that when it broke out of this very constrained range prices would either likely rocket higher or plunge lower. While it is too early to tell just yet it appears that oil prices may be trying to break out to the upside. Economically this isn't a good thing.

However, we have also been saying that the divergence between oil stocks and oil prices was at abnormal levels. So, oil prices with catch up with oil stocks, or, they will meet in the middle.

US Dollar

As I have been stating for the last couple of months the rally in the dollar was unsustainable. The dollar wrestled with a topping process at 83 on the index and ultimately failed.

With the dollar now down back through both moving averages, which should have provided some support, it is likely the dollar will retest the bottom of the trading range at 79-80.

Declines in the dollar usually lead bigger corrections in the stock market, and with sell signals approaching, it is likely that this time will not be different. The dollar is getting oversold short term and could bounce but it appears the path of least resistance is currently lower.

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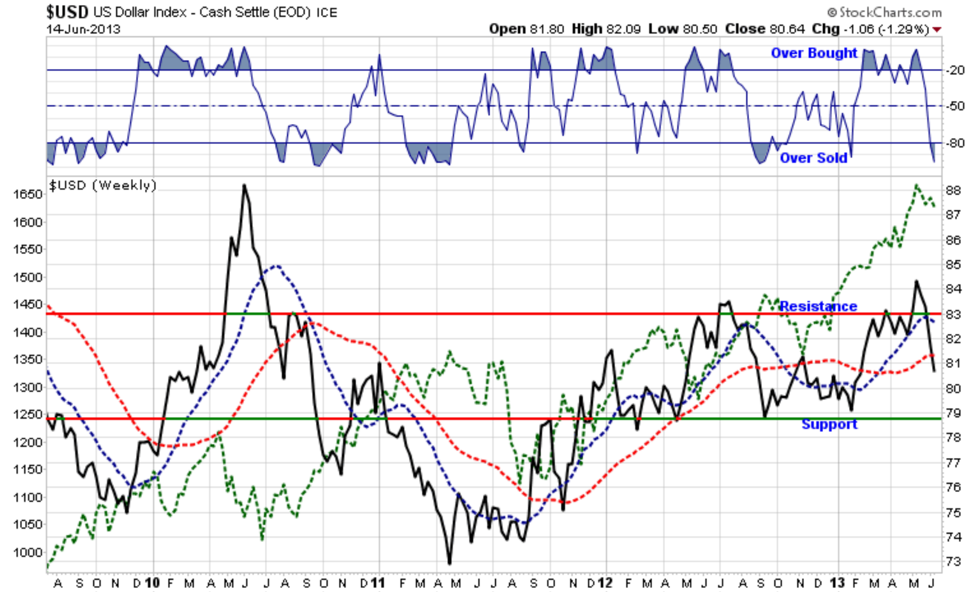

Interest Rates & Bonds

There has been much hoopla over the end of the bond bull market as rates have recently spiked higher. I would like to put an end to this myth.

As shown in the chart below interest rates always rise during QE programs from the Fed and then fall when they are withdrawn. This is because bonds are sold to buy stocks when the Fed is pumping up asset markets. However, when the Fed begins to withdraw interventions; money runs back into bonds for safety from a falling stock market.

The reality is that interest rates are acting completely normal for a QE program and when the Fed begins to "taper" off their buying – interest rates will fall back towards 1% again.

This means that right now is a prime buying opportunity to increase fixed income holdings for eventual capital appreciation.

Gold

Gold has now gotten to extreme oversold conditions and is holding support. As shown in the chart this is the most that it has been oversold since the financial crisis. However, it has also not been the oversold since early 2000.

While gold is still on a major sell signal and should be sold on any rallies to $1450; the metal is getting to a point to where we are likely to see an upward push in price. This will likely coincide with further stock market deterioration later this summer.

At some point we will likely see gold turn back into a bullish trend. When that happens we will begin recommending adding exposure. However, for now, as I stated gold should be sold in its entirely on any rally.

See you next week.

Lance Roberts

THE ROAD TO RETIREMENT

Three Dirty Words

There are three dirty words that can become extremely costly to you as you head towards retirement: Procrastination, Rationalization and Ignorance.

These three words keep you from doing the things necessary to secure you retirement. Procrastination leads to a lack of planning, rationalization leads to a lack of preparation and simple ignorance leads to a lack action.

This is why at Streettalk Advisors and Streettalk Insurance we start with the construction of a financial plan and an education process to inform you about what you need to have a successful retirement. While Lance can certainly handle your investments; it is my job to make sure you are doing the right thing with your insurance coverage.

LIMRA says that there are about 35 million adults in our country who admit that they believe they should be carrying life insurance, but they aren't. Surprisingly enough, these are not people who have never received an illustration, proposal or visited with an insurance agent. In fact, many of these people have done their homework enough to know that life insurance, especially term insurance is so **inexpensive** that almost not one of them notes it as the reason they haven't purchased.

Having been in the business for a few thousand years now I can share plenty of stories about the cost of waiting. A case that will stick with me forever was a man who was nearing retirement, a few years away from it, when he approached me about life insurance to supplement his retirement plan. He had two options with retirement. He could take less per month and have his wife receive the full amount upon his death, or he could take more per month and, even though his retirement benefit would not go to his wife if he died, he could take out life insurance to make up the difference. On paper it was a no brainer. He was healthy and the cost of the insurance was great. Typically, this is almost referred to as *"the rule".*

{For many of you who know me you could say that I'm not one of those rabid dog, got you by the leg, closing sales people. I prefer to let folks pull the trigger at their own pace. I will occasionally remind them that life insurance is important because people do die unexpectedly and I will sometimes let them know if their foot dragging is going to run them into the next age bracket. I don't push. I don't like it so I don't do it.}

As this scenario drug into a second year, with the *"rationalization"* that he was waiting for the newest review of his retirement planning dollars, he went through an age change and the insurance was still a good deal because of his stellar health.

The price was so good that he could easily afford it even if he took the retirement option that provided less income. I can recall telling him it might be a good idea to apply, get approved and put a policy in force which he could always drop at some future date.

As more *"procrastination"* and *"rationalization"* set in – the end of the second year approached since this whole process began. One afternoon I called him with one of my regularly scheduled follow up calls. When he answered the phone I had a very hard time understanding him and assumed we had a bad connection.

After the brief "hello's" he asked me if the last quotes I had sent him were still good as he was now ready to move ahead.

I quickly reviewed the file, checked his age and assured him that the quotes were good as long as his health was still the same.

Well, you can probably guess what is coming. We weren't have a bad telephone connection – he proceeded to inform me that he was just out of the hospital after suffering a massive stroke. He was partially paralyzed and required 24-hour care.

The problem is that once an event such as this occurs not only were the quotes off the table, but I had to inform him that there was no chance of getting him life insurance at the current time. The absolute best case is that it could be literally years before anything could be bought affordably.

The problem was that he had already retired and had chosen the option with no survivor benefits **before** he had this stroke. He died about a year after that leaving his wife no other means of income other than what few assets they had in the bank.

The cost of *"ignorance"* about what will happen in the future can ruin the best laid plans. Insurance is a *"hedge"* against the risk of something going wrong. We all plan to live *"forever"* – the simple reality is that there is only one entity that knows when our time is up.

The right insurance can supplement retirement incomes with tax free money, benefits for loved ones and protection from government taxation.

The cost of "procrastination" and "rationalization" isn't always a tale of higher premiums simply because you're older. Too often it's about health changes that can turn a good opportunity for family protection, or retirement income, into a nightmare. "Ignorance" about what insurance can do as a benefit to your financial and estate planning process is simply, well, ignorant. We are all ignorant about our futures and the possibilities of cancer, illness or accidents.

While we can help you with **rationalization** and **ignorance** – **procrastination** is up to you. Call me today to get your financial planning process started.

Lynette Lalanne
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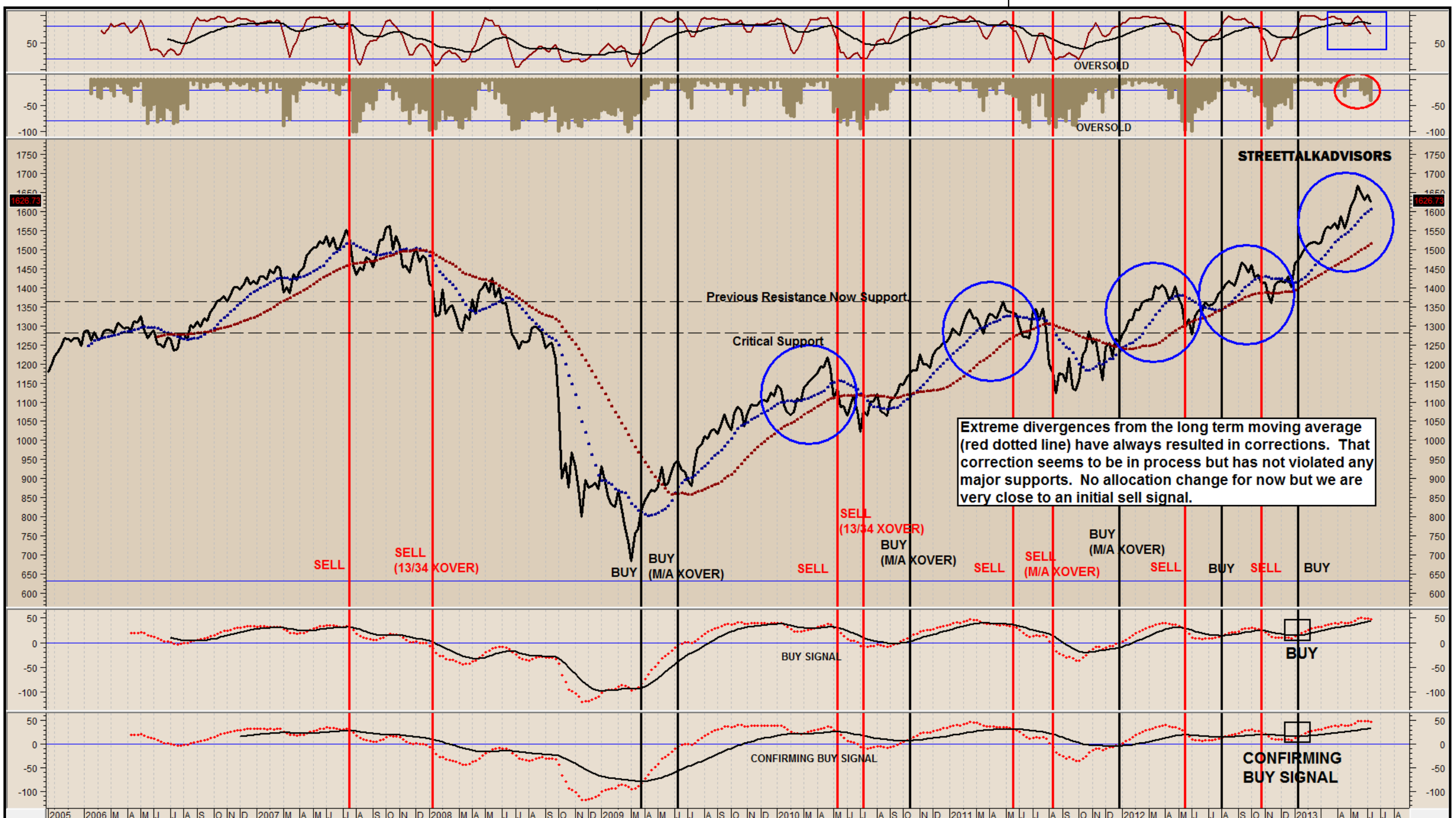
401K Plan Manager



There is no change from last week's instructions. We are getting close to an initial sell signal so continue to rebalance portfolios to target weightings **ONLY** by reducing equity exposure, if overweight equities, and increasing bond holdings to target model weights accordingly.

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

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)**

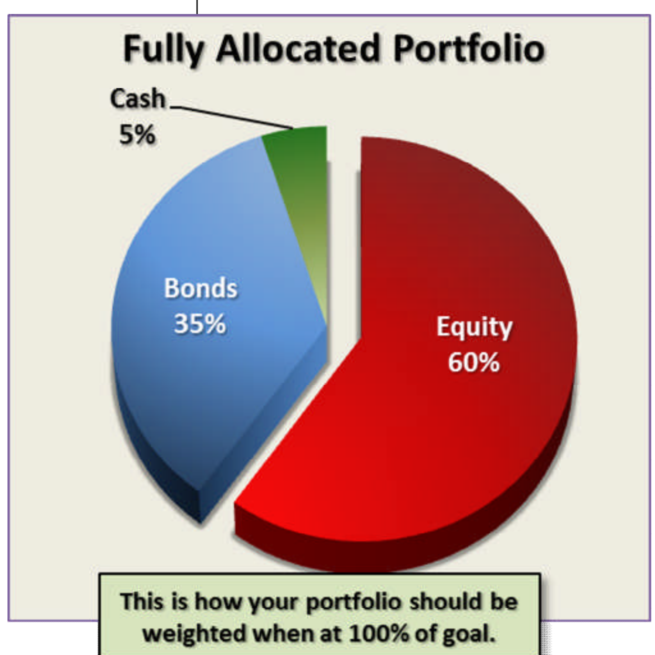
Bond Funds reflect the direction of interest rates

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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