September 14, 2013

the X-factor Report

by Lance Roberts

Market Strategies, Economic Analysis, Risk Management

Is The Sell Signal Still Valid?

Before we get into this week's missive **I just wanted to thank you** for all of the kind, supportive and enlightening emails over the past week regarding the rollout of our new firm:

STA Wealth Management

As you are already aware; the current website design, newsletter, and services are once again being modified due to your comments, suggestions and criticisms. While it is impossible to satisfy every request we have made great strides in meeting many of the objectives you have set for us.

I would like to ask you once again to complete our current, very short, survey as we move into the final phase of our redesign. You input is highly valued.

Click Here For A Quick Survey

I hope that you will continue enjoying the newsletter and the soon to be redesigned website. I also encourage you to ***continue emailing*** your comments, criticisms and suggestions so that I can continue to provide you with the information that you need to manage your money better.

One last bit of housekeeping. The last week of September I will be in New York on a media campaign to roll out the new firm and portfolio management strategies. Therefore, daily postings and the newsletter are likely to be very light.

Beginning in October the Daily X-Change postings will be a bit more frequent, but shorter reads, with occasional long form reads as topics require. We will also begin posting one to two minute video clips as well.

With all that being said…let's move on to what you really want to know. Did the rally last week reverse our *"sell signal."*

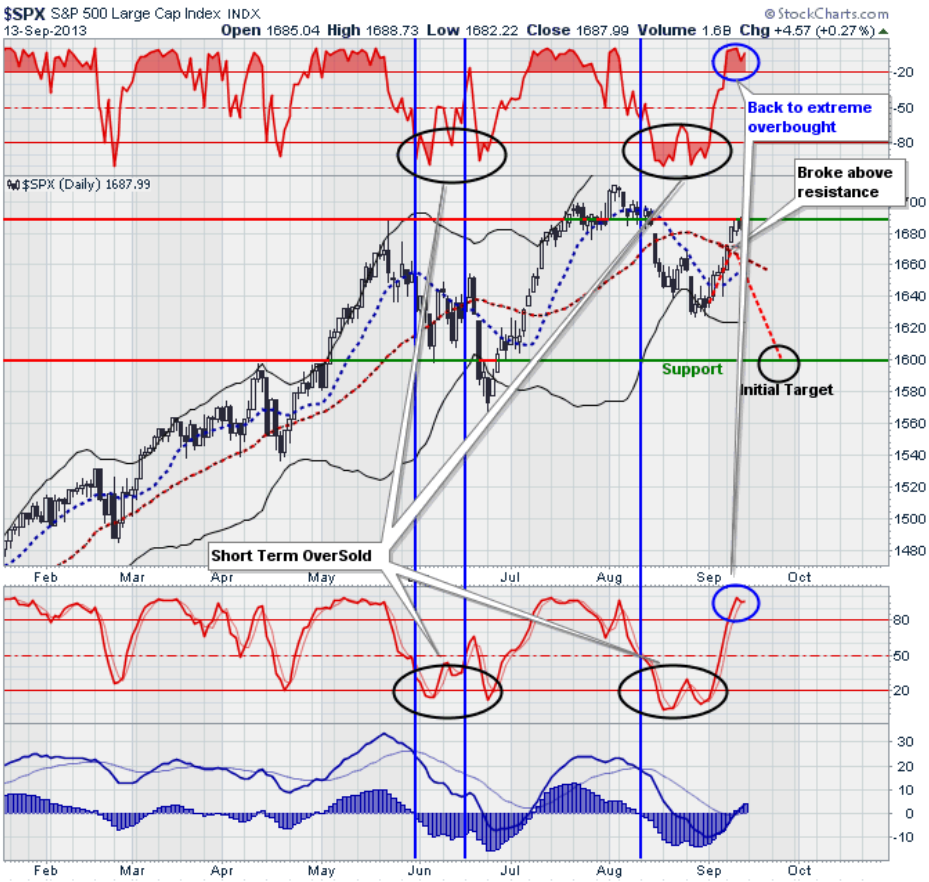
Inside This Issue:

Did The Rally Reverse The "Sell Signal"

That one question dominated my inbox last week. I almost got to the point of just cutting and pasting answers to emails for the sake of expediency. However, I personally responded to each and every one as always.

Last week I specifically stated that:

> *"The KEY POINT here is that the market is likely oversold enough to warrant a bounce next week that could be fairly substantial. This bounce will provide the media bulls with ammunition that the short term selloff is over and the 'bull is back in charge' through the end of the year.*
>
> *Therefore, the currently rally continues to MOST LIKELY be an opportunity to reduce portfolio allocations and reduce risk. Last week I posted a chart showing the deeply oversold condition of the market. These 'oversold' conditions act like 'fuel in a gas tank' for the markets. Market corrections lead to a pent up demand of buyers, and an exhaustion of sellers, which facilitates sharp reversions. The chart below is the updated DAILY chart from the last two weeks. I have left the previous markings which details the previous oversold condition so that you can see that the very small rally last week has already consumed much of the 'fuel' already."*



Now that we are back to much OVERBOUGHT conditions there is likely not much room left to the current rally. The fact that this rally has not

broken out to new highs, which it has done every time before, is also concerning.

However, as I also stated last week:

Again, this is just a "wild @$$ guess" at what I think the markets will do based on current price trends, support and resistance points. *Anything is possible and portfolio management actions will have to be adjusted accordingly as the market develops.*

*Again**, I cannot restate enough, the issuance of the "confirmed sell" signal is NOT a sell everything and run to cash type of thing.*** *It is simply a signal that suggests that the current market is going through a corrective phase and that we need to reduce our equity risk accordingly, raise some cash, and be prepared to act on the next buying opportunity when it presents itself.*

As long term investors, and portfolio managers, our goal is simple "buy low" and "sell high." If we don't sell some things along the way, maintain our portfolios and pay attention to our money – inevitably we will wind up making decisions based on "panic" rather than "logic." Unfortunately, emotionally based decisions rarely work out well.

Pay attention the market over the next couple weeks and reduce allocation models accordingly."

While the "*bounce*" exceeded previous expectation levels, due to a greater impact of short covering than anticipated, the rise did allow for portfolios to be realigned fully with our target allocation model. However, did this short term rally reverse the intermediate term "*confirmed sell signal*" issued two weeks ago? The chart on the next page shows the market versus the confirming buy/sell signal.

What is important to notice is that following the previous selloff in the market – stocks reached a new closing high as they entered overbought territory. This followed a 110 point rally in the index. From that point to the next closing peak was only 40 points. However, NO SELL SIGNAL was ever issued.

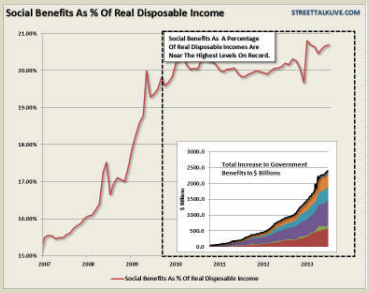
RECOMMENDED READING

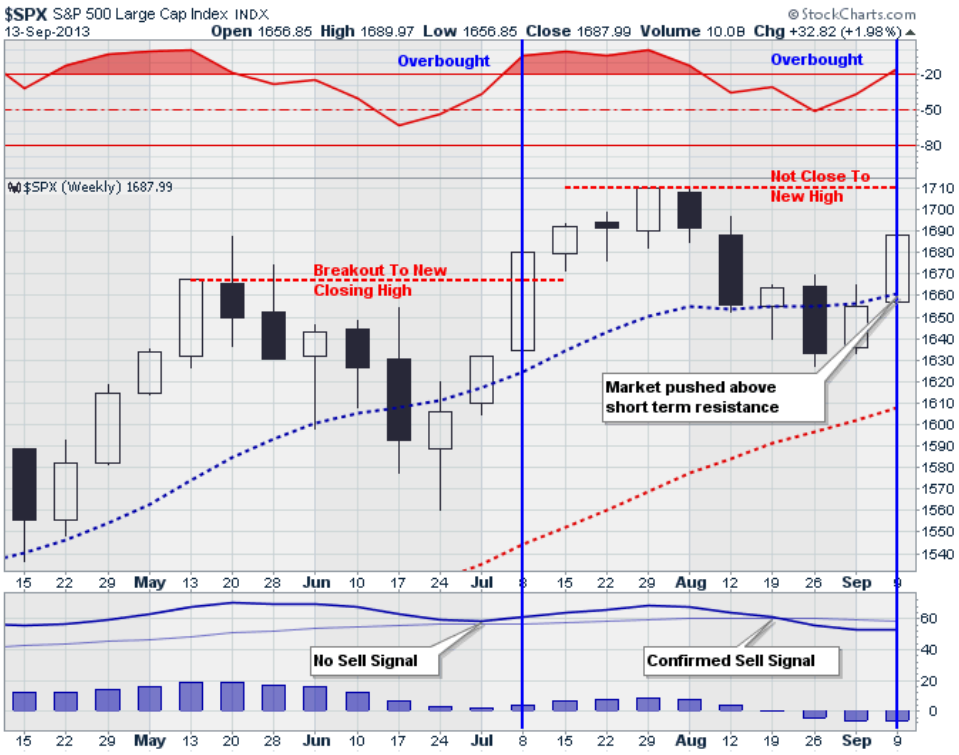
Why Benchmarking Your Portfolio Is A Losing Bet

While Wall Street chides you into chasing benchmark indexes the reality is that the deck has always been stacked against you.

The Rise Of The Welfare State

A recent trip to Walmart showed me why the rise of government dependency is likely here to stay.





There are two primary differences currently:

1. A confirmed sell signal was issued two weeks ago. That signal is still in place and has NOT been reversed.

2. The market has now returned to being overbought without the market attaining a new high close.

This suggests that the market, despite the oversold bounce over the last two weeks, is still likely in a corrective phase. Until the market breaks out to a new high and the confirmed sell signal is reversed investors should err to the side of caution.

That DOES NOT mean sell everything and go hide in cash, buy gold, ammo and can goods, or build a bunker in your backyard. It just simply means that you should pay attention to your hard earned savings.

Since the sell signal has not been reversed we remain allocated at 75% of our target allocation. When the sell signal is reversed we will recommend upping portfolio exposure accordingly.

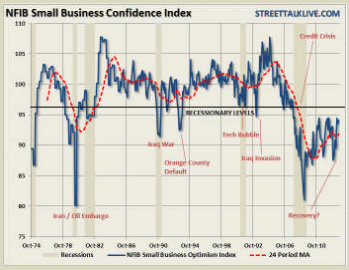
In this regard, for new readers, I have updated the portfolio management instructions from the past two weeks.

1) The S&P 500 found resistance at 1690 last week. If the market is able to rally on Monday due to the "just reached deal on Syria" above that resistance level – old highs will be the next target.

RECOMMENDED READING

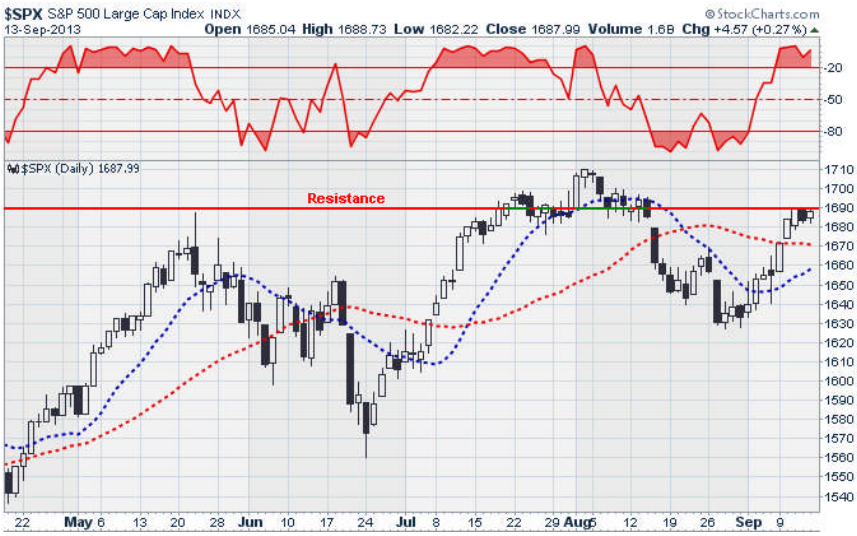
NFIB: "Small Business Going Nowhere"

"Overall, the Index of Optimism says the small business sector is going nowhere and that's what it feels like. Consumer sentiment is falling so there is no wind in the sails of the consumption barge. It floats, but no speed"



Commercial Lending Suggests Weak Employment

By now most people have realized that the August employment report was weak…however, commercial lending trends have been predicting such weakness for the last several months.



2) As stated above; review your current holdings and ask yourself "why" you own a specific position. If the position in underperforming, and the only case you can make for owning it is "well, 'soandso' on TV said it was a good idea," then this is a good position to sell. Such positions would currently include gold and emerging markets.

Positions that lag when markets are rising tend to fall faster than the market during the decline. Therefore, if you don't really understand why you own it – get rid of it now.

*3) Positions that are pacing, or outperforming, the market as a whole should be kept but reduced now to raise cash and reduce portfolio risk. Positions that outperform on the way up tend not to fall as fast as the market on the decline, however, they will decline**. Take some profits.***

*4) All funds in a given category (growth, value, large, mid, small, etc.) all tend to track the broad market index fairly closely. Therefore, use the rally to consolidate the 3-5 large cap funds in your portfolio into a single holding. The same goes for mid-cap, small-cap, international, etc. Diversification is not about the number of funds that you own **but the non-correlation between the various assets.** You can have a fully diversified portfolio with just 3-5 funds in total.*

*5) Do not rely solely on other people's opinions – **including mine.** I take a lot of time, do a lot of research and analysis, in order to come to my opinion – but it is JUST an opinion. Take some responsibility for YOUR SAVINGS and learn what you are investing in and why. Too many individuals invest in the financial markets with no real interest, understanding, or desire to learn about what they are doing. They only invest in the financial markets because they are told they must. **There is no requirement you invest at all.***

As a I discussed last week that is a good chance that my current assessment of the market is wrong. It is for this very reason that I continue to closely monitor the markets utilizing a variety of different tools, economic, fundamental and technical, to make decisions. It is also why we have changed the way that we manage portfolios so that we can be more responsive to a market that is moving faster, is more volatile, and is more manipulated by major firms than ever before.

If my current assessment of the market is wrong – that is actually good. It will mean the markets are rising and we can increase our allocation in our portfolios back up to full exposure. If I am right – then our cautious stance as of late will pay off as our portfolios will outperform the broader market indices.

However, if I am wrong, I will change my view. At the current time, however, there is nothing that suggests my current view is wrong but that could change next week.

A Listing Of Headwinds

There is a litany of issues currently facing the markets and the economy ahead. Here are a few:

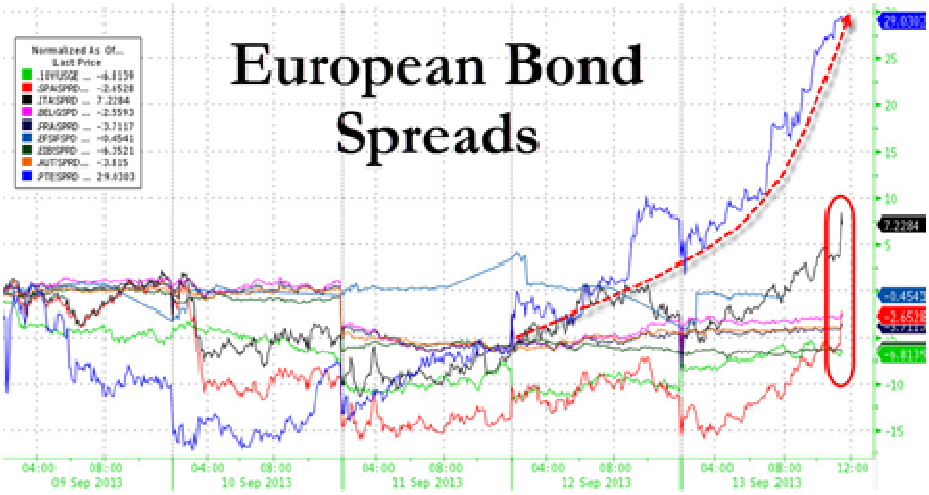
1) **Syria:** While there has been a tentative agreement between Syria, the U.S. and Russia, to destroy Syria's arsenal of chemical weapons – the reality is that this is the same *"dog and pony"* show we witnessed with the WMD inspectors in Iraq. Syria will agree to comply up front and then move their weapons to other locations subsequently such as Iraq and Lebanon. They will only allow the U.N. inspectors to *"see what they want them to see"* and *"compliance"* will be nothing more than an act. This is assuming the Syrian rebels will even let the inspectors into the country. The reality is that in the next few months we will likely be once again talking about limited strikes in Syria.

2) **Debt Ceiling:** We are once again facing the dreaded "debt ceiling debate" where the issues will be increases in spending combined with increases in taxes. What will be critical to the markets is whether, or note, the "debt default" card is once again played. While the government will NOT default on its debt, as they can print currency to pay obligations, the rhetoric will be a negative for the market.

3) **Eurozone Elections:** Angela Merkel is up for re-election in Germany and it is currently estimated that it will be an easy victory for her. However, we have seen such proclamations go awry before and a defeat could cause concerns throughout the Eurozone.

4) **Interest Rates:** The recent surge in interest rates, as shown in the chart below, is not unprecedented during QE programs.

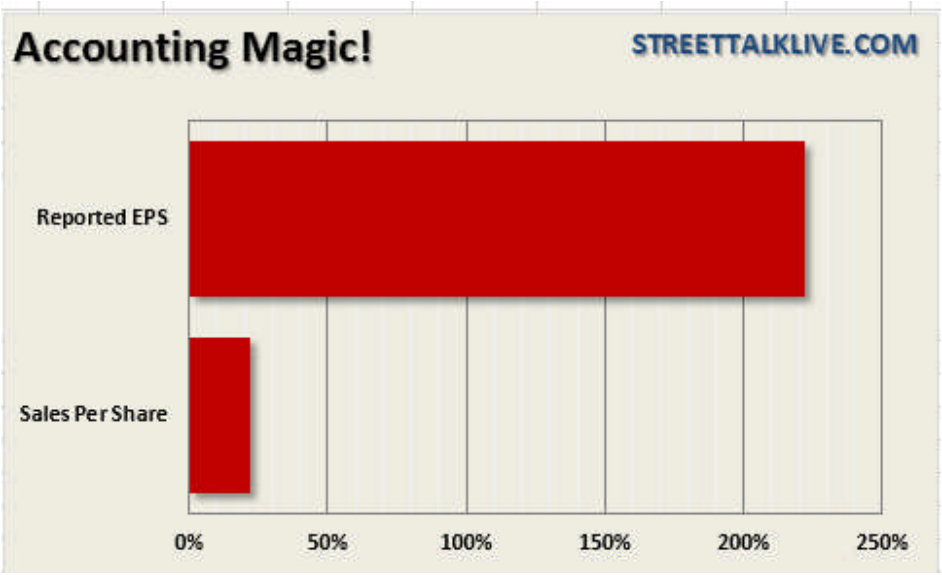
However, it is not just in the U.S. that rates are increasing. European bond spreads are surging as well.



Increases in borrowing costs negatively impact economic growth. This is true for both the U.S. and the very weak Eurozone economies. Importantly, the recent surge in interest rates has not yet completely worked their way into the economy. This means that we are likely to see further economic weakness going into the end of the year.

5) **Economy:** The economy seems to be showing some short terms signs of recovery on some fronts. However, at the moment, these bounces in the data appear to be nothing more than just "restocking" activity given the weakness seen in the consumer spending and confidence data. Higher rates will have a negative impact, as discussed above, on consumption which will be reflected in a slowing of economic growth through the end of the year.

6) **Earnings / Revenue:** As discussed recently corporate earnings appear to be peaking as cost cutting has likely reached the limits of its effectiveness. As shown revenue growth remains extremely weak. This is reflective of the sluggish economy and consumer and will be difficult for the market to continue to justify current valuation levels.



8) **The Fed "Taper:"** The market is trying to come to grips with the reality that the Fed is likely to begin tapering their bond purchases soon. The belief is currently that the economy is now able to sustain itself with reduced Federal Reserve assistance. Mohammed El-Erian summed this up well:

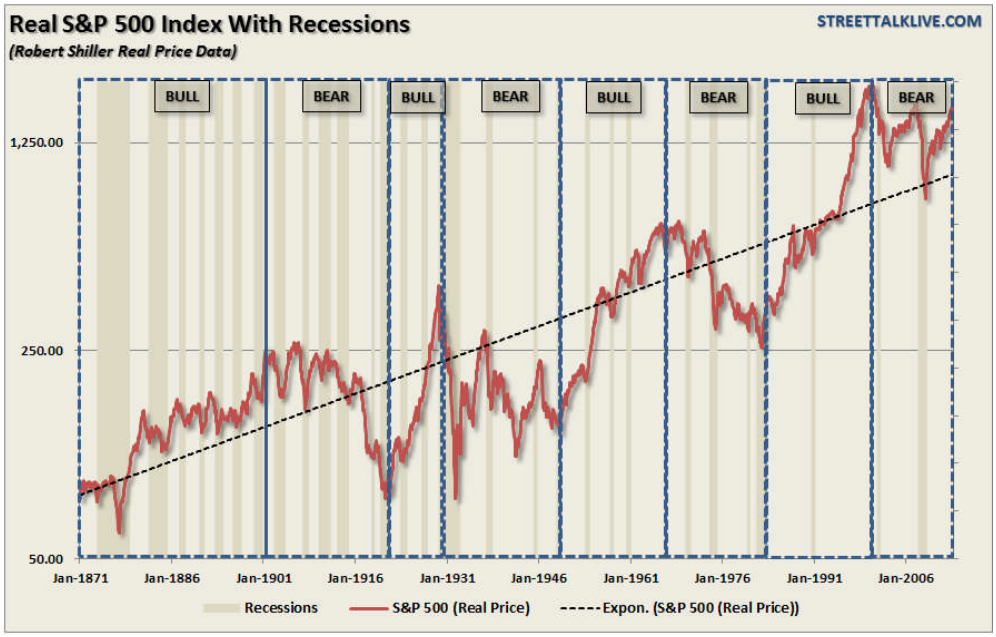
> "As much as we wish for otherwise (particularly in view of the most positive high-frequency data), **there is still not enough evidence to conclude that the U.S. economy will be able to emerge decisively and durably from its low growth equilibrium in the next few quarters.** The impact of sluggish domestic components of aggregate demand is compounded by declining growth in emerging economies, insufficient structural reforms and public infrastructure investments, and stubborn residual pockets of excessive leverage – all of which limit the expansion propensity of corporate America, the one component of the private sector with the wallet (but not the will as yet) to spend.
>
> Congressional political polarization is not helping the outlook for a high and durable fundamental U.S. recovery. At a time when the economy needs a tailwind from Capitol Hill, lawmakers risk creating renewed headwinds when they finally turn their attention to steps to keep the government running and lift the debt ceiling.
>
> As for the Fed, we should all hope for "good" reasons for it to taper – meaning that the central bank has strong reasons to believe that the U.S. economy is approaching "escape velocity." But the Fed could also taper for "bad" reasons – that is to say that its prolonged experimentation with unconventional monetary policy threatens to create too much collateral damage and unintended consequences (including concerns about misallocation of resources, excessive risk-taking and damage to the functioning of certain markets).
>
> In all likelihood, the Fed will taper for a mix of reasons. Specifically, it will likely be comforted by the notion that the American economy continues to heal, but also frustrated by the gradualism of the recovery and the threat of collateral damage. **Meanwhile, look for the Fed to try to compensate the potential contractionary impact of tapering by evolving its forward guidance policy."**

7) **Eurozone:** As discussed above the rise in interest rates will ultimately impact the solvency of the Eurozone countries who have done nothing to begin to repair their balance sheets. More needs for bailouts are likely coming sooner than expected and the real question is will the ECB have enough money on hand, and cooperation from Germany in particular, to continue to solve the financial issues going forward.

Market Rally To Nowhere

There is simply one thing that is more important to remember than any of these other short term events – the market rally could certainly go further, however, it will also eventually end.

The chart below is a 113 year, inflation adjusted, chart of the S&P 500.



There are three things to understand:

1) Return on investment is SIGNIFICANTLY impacted by WHERE you started investing during a given cycle.

2) All market rallies eventually corrected and all corrections eventually ended. What made the difference over the long term was not catching the declines.

3) Believing that "this time is different" is a fool's dream that always turns into a nightmare. Every secular bull market was believed to be different.

The technical indicators currently suggest that the market is likely approaching the end of the current oversold rally. This is does not mean that the markets cannot attain a new high. It is certainly possible. However, the economic and fundamental cycles are now very long into normalized recoveries which suggest that we are nearer the end of the current cycle than the beginning.

Have a great week.

Lance Roberts

Sector Analysis

Major Markets

S&P 500
Action: Hold/Rebalance

Market held support last week, however, the confirmed sell signal remains. With conditions back to short term overbought the markets are likely closer to the next peak than not. If that peak occurs lower than the previous peak and the market then breaks the blue dashed line – it will be the completion of a market top which could indicate lower lows to come. For now continue to rebalance portfolios to target weight but limit buying of new positions.

International Markets
Action: Hold/Reduce

International markets continue to struggle with multiyear tops and extreme overbought conditions. This is not a great place to adding international exposure.

For now, if you must own international markets, reduce overweight positions to 5% of portfolios or less.

Emerging Markets
Action: Sell/Reduce

There continues to be little improvement in the fundamentals of emerging markets. Furthermore, the technical setup of emerging markets also remains poor.

Limit exposure to emerging markets for now. We have been suggesting a zero weight position for some time and that has not changed currently.

Basic Materials

Action: Hold

Despite weak economic data money continues to chase basic material stocks. Currently at new highs from the post-recession lows basic materials have continued to perform well.

Currently, more than 2-standard deviations above the long term weekly mean – these stocks are at a point that have generally marked the peak of their advance over the last couple of years. Taking profits seems like a reasonable suggestion.

Energy

Action: Hold/Rebalance

With a short term resolution to Syria it is likely that oil prices will retrace some of their recent gains in the weeks ahead. With energy stocks now once again overbought and at the top of their recent ranges it is likely a good idea to take some profits currently.

Technology

Action: Hold

Technology continues to trade within a very tight range. Overbought conditions apply and it certainly wouldn't be a bad idea to clip some profits in positions that are overweight in the portfolio.

S&P 500 Sectors - Weak

Staples
Action: Hold

Staples failed recently at their double top but held support at their longer term moving average. Hold positions for now but be prepared to take profits around $42 on any retracement.

$39 is going to be an important support/stop level.

Utilities
Action: Hold/Reduce On Rallies

Utilities broke their long term moving average in recent weeks but are still above critical support at $36. Hold for now but look to reduce positions on rallies back to the long term moving average.

I still think that rates will begin a retracement later this year which should be supportive of utilities. Currently, however, the technicals are not supportive of utility stocks.

Real Estate
Action: Hold/Reduce On Rallies

Rising interest rates is not only impacting utilities but has brought real estate investments under extreme pressure. Real estate shares are currently oversold which makes them a "hold" currently but should be sold on rallies to the long term moving average.

Interest Rates

Outlook: Overbought

Interest continue to be grossly overbought after the breakout of the consolidation pattern. I continue to reiterate that we are likely near the top of this particular surge so panic selling bond holding is not a great idea.

The target on a retracement in rates is now 2.2% which is up slightly from the 2.1% a few weeks ago.

Gold

Outlook: Lower/Failed Rally As Expected

I have been discussing that gold was in the process of a reflex rally in a very significant downtrend. That rally failed last week as expected so the next retest of support will be critical in determining whether we can return to a bullish outlook on the metal or not.

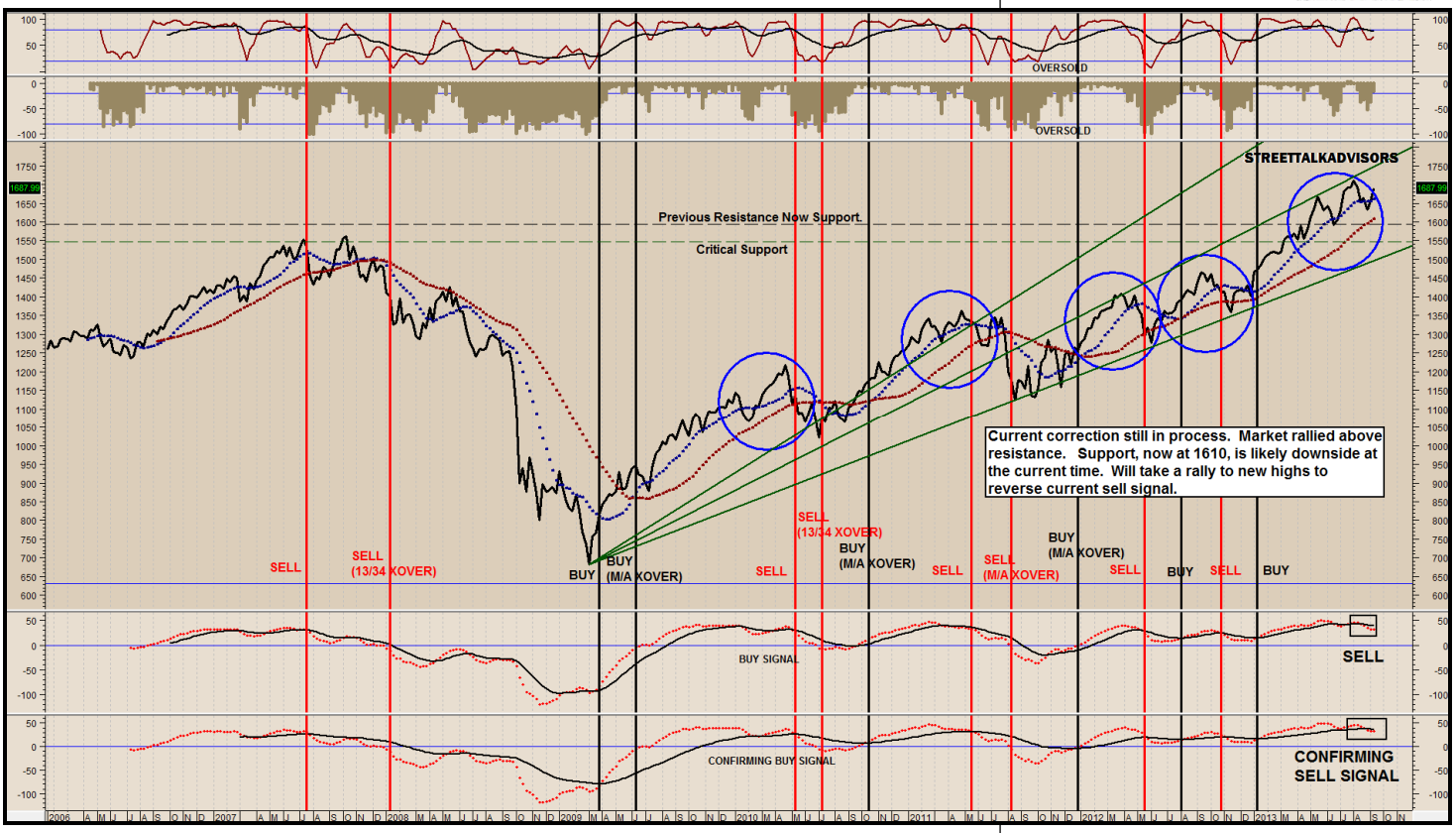
Dollar

Outlook: Retest Of Support Likely

The dollar rallied over the last couple of weeks to retest the long term moving average from below. That failed retest has turned that previous support into important resistance.

The dollar should retest lows at the blue support line in the next week or so ahead.

401K Plan Manager



The rally, as discussed above, did get above short term resistance but still remains on a confirmed "sell" signal. This means that we should still remain cautious with our allocations currently until price trends confirm that we are back on a "buy."

However, the market is once again in extreme overbought territory so it is not optimal to be adding NEW positions to portfolios at this time. However, it is a good time to be REDUCING laggards and loser in portfolios and rebalancing winners back to target weights.

With earnings season now behind us; we must begin to focus on the economics and the upcoming debt ceiling debate. Both are likely to keep volatility elevated in the near term.

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

[Suggestions Wanted]

I am in the process of revamping the newsletter and the 401k plan manager for the new website. If there is anything that you would like to see added to the 401k plan manager please email me.

Common 401K Plan Holdings By Class

Cash
- *Stable Value*
- *Money Market*
- *Retirement Savings Trust*
- *Fidelity MIP Fund*
- *G-Fund*
- *Short Term Bond*

Fixed Income
- *Pimco Total Return*
- *Pimco Real Return*
- *Pimco Investment Grade Bond*
- *Vanguard Intermediate Bond*
- *Vanguard Total Bond Market*
- *Babson Bond Fund*
- *Lord Abbett Income*
- *Fidelity Corporate Bond*
- *Western Asset Mortgage Backed Bond*
- *Blackrock Total Return*
- *Blackrock Intermediate Bond*
- *American Funds Bond Fund Of America*
- *Dodge & Cox Income Fund*
- *Doubleline Total Return*
- *F-Fund*

Equity

Large Cap
- *Vanguard Total Stock Market*
- *Vanguard S&P 500 Index*
- *Vanguard Capital Opportunities*
- *Vanguard PrimeCap*
- *Vanguard Growth Index*
- *Fidelity Magellan*
- *Fidelity Large Cap Growth*
- *Fidelity Blue Chip*
- *Fidelity Capital Appreciation*
- *Dodge & Cox Stock*
- *Hartford Capital Appreciation*
- *American Funds AMCAP*
- *American Funds Growth Fund Of America*
- *Oakmark Growth Fund*
- *C-Fund (Common Assets)*
- *ALL TARGET DATE FUNDS 2020 or Later*

Balanced Funds
- *Vanguard Balanced Index*
- *Vanguard Wellington Fund*
- *Vanguard Windsor Fund*
- *Vanguard Asset Allocation*
- *Fidelity Balanced Fund*
- *Fidelity Equity Income*
- *Fidelity Growth & Income*
- *American Funds Balanced*
- *American Funds Income Fund*
- *ALL TARGET DATE FUNDS 2020 or Sooner*

Small/Mid Cap
- *Vanguard Mid Cap Growth*
- *Fidelity Mid Cap Growth*
- *Artisan Mid Cap*
- *Goldman Sachs Growth Opportunities*
- *Harbor Mid Cap Growth*
- *Goldman Sachs Small/Mid Cap Opp.*
- *Fidelity Low Price Stock Fund*
- *Columbia Acorn US*
- *Federated Kaufman Small Cap*
- *Invesco Small Cap*

The above represents a selection of some of the most common funds found in 401k plans. *If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.* All funds perform relatively similarly within their respective fund classes.

I will modify this list over time as the asset allocation model changes to reflect international holdings, emerging markets, commodities, etc. as the model changes to reflect the addition of those holdings.

***Email me* if you need further assistance.**

Current 401k Allocation Model

20.00% 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

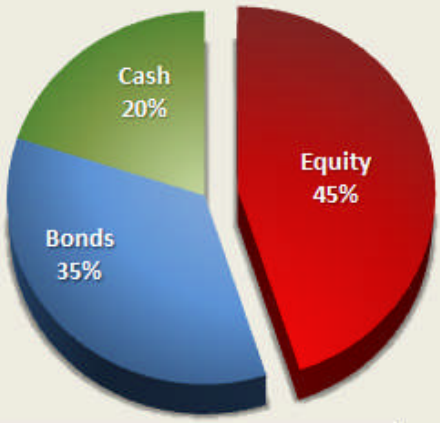
Examples: Short Duration, Total Return and Real Return Funds

45.00% Equity (Stocks)

The vast majority of stock funds track an index. Therefore, select on ONE fund from each category. Keep it Simple.

25% Equity Income, Balanced or Conservative Allocation
15% Large Cap Growth (S&P 500 Index)
5% Mid Cap Growth

Current Portfolio Weighting



This is how your portfolio should be currently weighted.

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Lance Roberts
Director of Fundamental & Economic Analysis

Michael Smith
Director of Alternative Investments

Luke Patterson
Chief Investment Officer

Hope Edick
Compliance Officer

Lynette Lalanne
General Partner – Streettalk Insurance

Office Location
One CityCentre
800 Town & Country Blvd.
Suite 410
Houston, TX 77024
Tel: 281-822-8800

Web Sites
www.streettalkadvisors.com

Email (For More Information)
Streettalk@streettalklive.com

FOR APPOINTMENTS

Brooke Sanders
fis@streettalkadvisors.com