January 25, 2014

the X-factor Report
by Lance Roberts

Market Strategies, Economic Analysis, Risk Management

Portfolio Alert Signal Issued

The media scrambled last week to assign a *"reason"* as to why the market sold off. For the majority of market commentators, who do very little solid research or analysis, the selloff was due to the emerging market rout and currency swoon. This was not the *"cause"* but rather the *"effect"* of a *"de-risking" short squeeze* in the bond market and currency markets.

I have been writing in this missive for the last several months that emerging markets were not the *"nirvana"* of the next great market cycle due to the ongoing economic drag that faces these countries. I have also been consistently recommending that investors **eliminate all holdings in emerging markets as well**. That advice has consistently fallen on deaf ears.

The recent import data tells you all you need to know about the status of emerging market countries that are dependent upon our consumption for their livelihood. The chart below shows imports versus personal consumption.

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Suggested Reading

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- Repeating The Secular Bear Of the 70's

401k Plan Manager

- *** New Layout**
- Click Here For Current Model Allocation.

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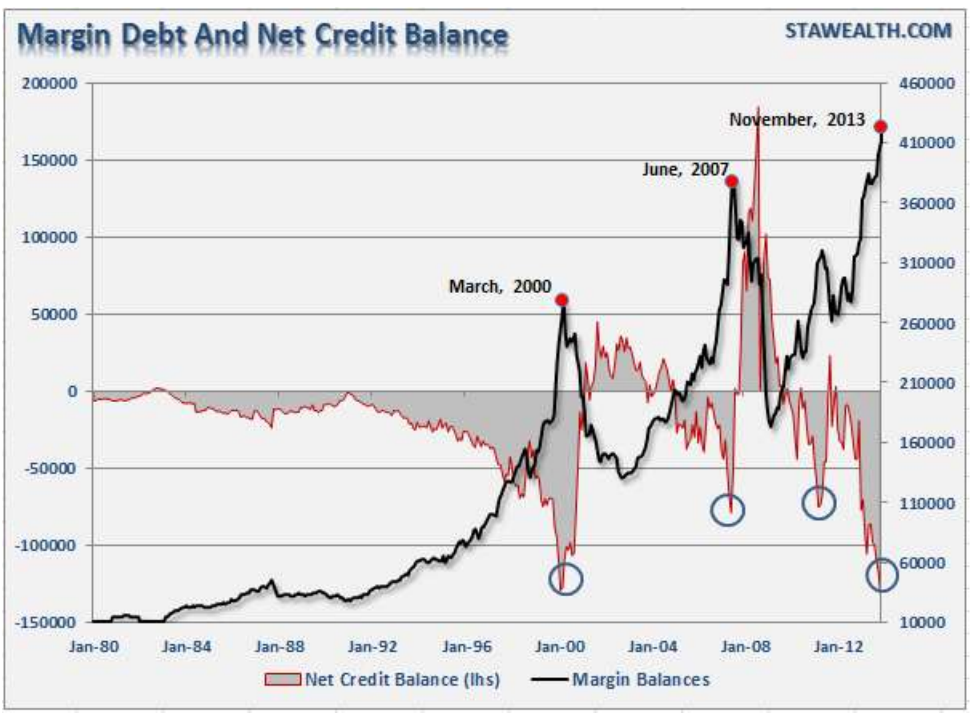
This chart also tells much about the real strength of the domestic economy which is the real reason behind this past week's sell off.

The majority of analysts and economist have, wrongly, been assuming that economic growth in the U.S. was set to surge this coming year. There is **NO evidence** that currently suggests that is the case. The chart of PCE above strongly suggests that the consumer is running "low on gas." Since PCE makes up roughly 70% of GDP this is really the only metric you need to watch.

However, the mistake that most portfolio managers, economists and analysts have made is that as the Federal Reserve tapered their bond buying program **interest rates would rise sharply.** This would be due to a stronger underlying economy and a "great rotation" from bonds to stocks as markets entered into the next secular bull market. *(To understand why this is a wrong assumption read this)* it would be due to a stronger underlying economy.

Unfortunately, as I have shown in the past, interest rates ALWAYS rise DURING the Fed's interventions as Wall Street sells bonds *(shorts)* to buy stocks on a leveraged basis. Take a look at margin debt on the NYSE which shows the amount of leverage being used to boost returns.



With leverage now at levels exceeding that of the previous two speculative asset bubbles it is not hard to imagine that the next major market rout will be near cataclysmic.

However, when the Fed extracts liquidity (tapers) from the market the process runs in reverse. The chart below shows interest rates versus the various bond market interventions by the Federal Reserve.

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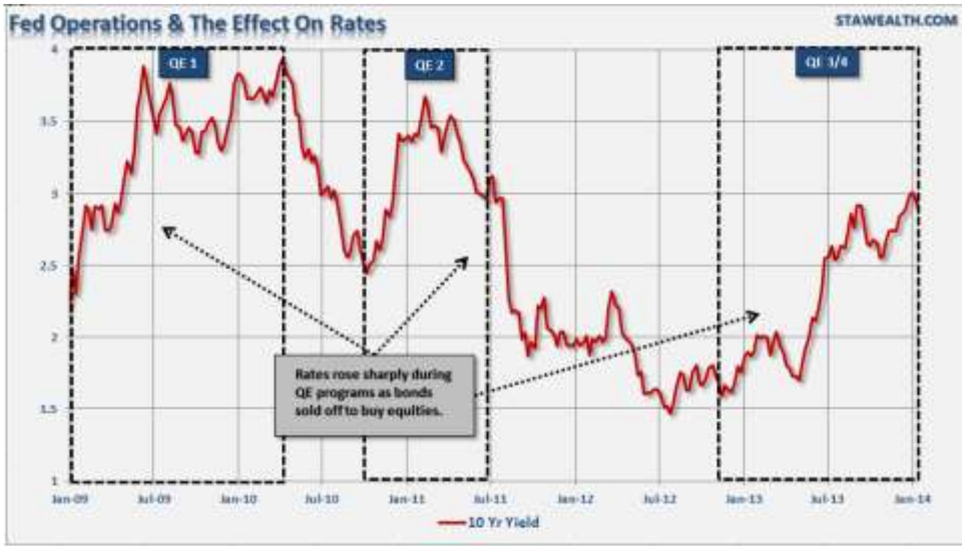
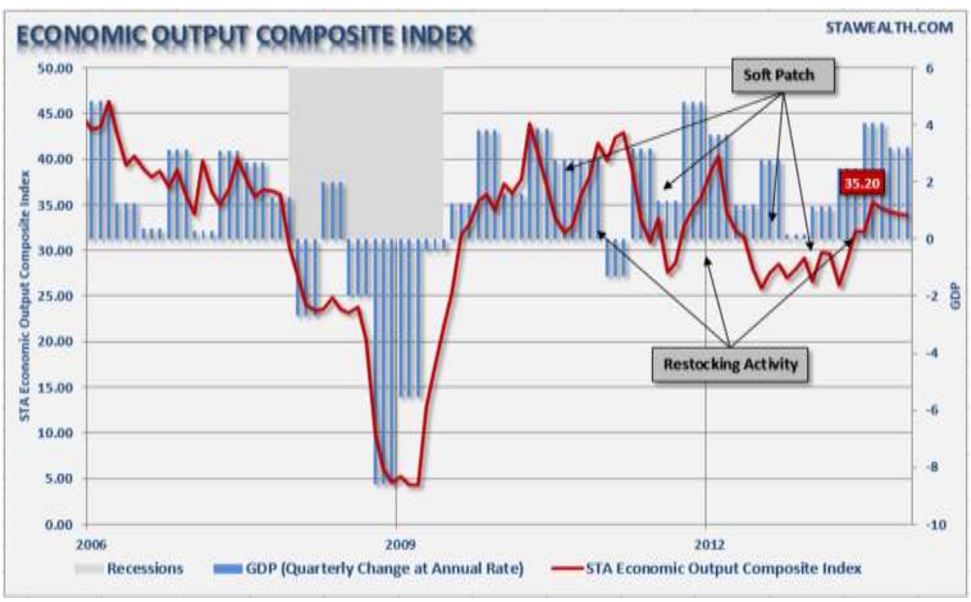
FEEDBACK

CLICK TO SEND COMMENTS



The real reason behind the sell off this past week was the realization that the economy is not as strong as previously expected. I discussed this specifically last week in my report on *the most important economic indicator – CFNAI.*

"The chart below, which is the Economic Output Composite Index, shows this declining trend of 'soft patches' and 'recoveries' since the end of the last recession. (For a description of the underlying construction of the index click here)"



Of course, with literally EVERYONE on the same side of the trade *(long stocks – short bonds and currency)* it only took a small shift in sentiment to begin a more significant reversal in the markets. This is one of the primary reasons that following the sharp spike in rates to 3.0% last summer, which was driven by emerging market liquidations rather than Fed *"taper talk"* as widely believed, I stated we would have lower rates by December. I missed it by a month.

The chart below shows the correlation between interest rates and stocks prices.

RECOMMENDED READING

First Signs Of Panic

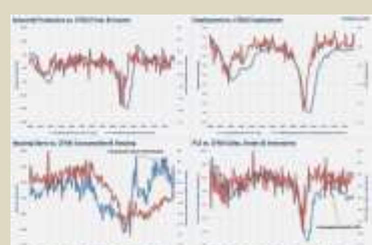
Market sell off wakes investors up from their complacency slumber.

5 Things To Ponder

Valuations, Triggers and Income Inequality.

CFNAI: Summer Of Recovery Or A Bounce?

The CFNAI is arguably one of the most important economic indicators I follow. It currently suggests that the economy is weaker than thought.



That reversion in assets has now triggered a PORTFOLIO ALERT signal which is the focus of this week's missive.

Portfolio Alert – Pay Attention

Four decades ago fundamental arguments over valuation, earnings, profits and economic variables were important in portfolio management as the **average hold time for positions ran about 6 years**. With such a long holding period these fundamental arguments played an important role.

However, in the fast paced, information overloaded, and manipulated markets of the 21st century driven by program and high frequency trading, **hold times have now dropped to as little as 5 days.** That's right – long term investing is now down to a week.

Therefore, while discussions over economics, earnings, and other fundamental factors can certainly be interesting – they have almost nothing to do with the outcome of your investments today. This is why I rely so heavily on price trend and momentum as it tells you what investors are doing versus what you "hope" will happen.

It is from this basis that I developed a series of 4 signals to drive portfolio allocation models. However, since I do believe in long term investing, the signals are based on weekly data to smooth out portfolio volatility and position turnover.

The signals are as follows:

Alert Signal *– Pay attention*
Sell Signal 1 *– Reduce equity allocation by 25%*
Sell Signal 2 *– Reduce equity allocation by 25%*
Sell Signal 3 *– Reduce equity allocation by 25%*

As you will notice that would only take portfolios down by 75% at the max. I would most likely never recommend going below that level of exposure as it

RECOMMENDED READING

JOLT Quit/Discharge Ratio

The quit/discharge ratio is now at the highest level since 2008.

Corporate Profits And Income Inequality

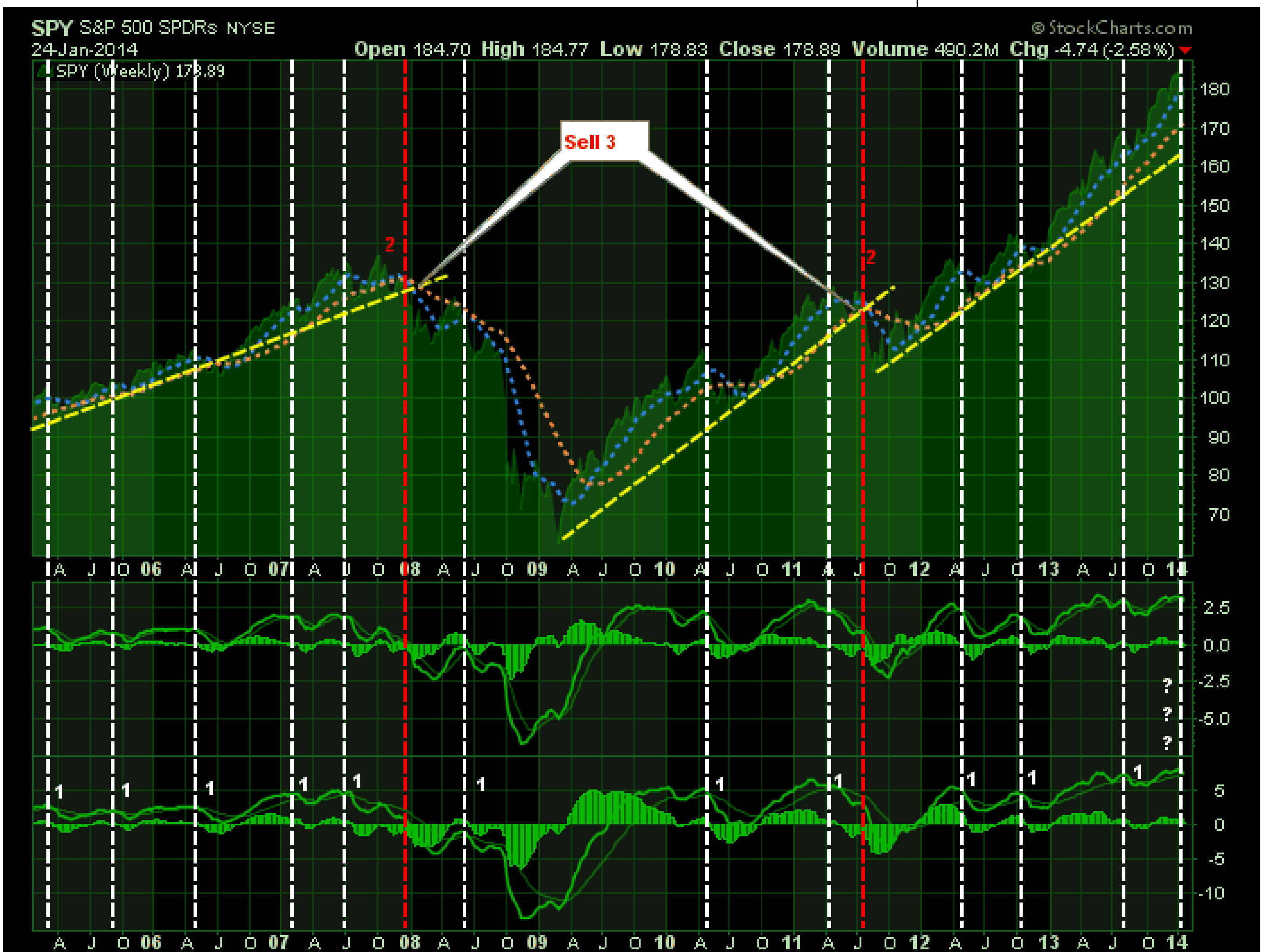
The President has launched into his "income inequality" campaign but it is his very policies that are promoting it.

Past Is Prologue: Repeating The Secular Bear Of The 70's

Is it 1994 or 1997 in the markets? The reality may be that it is more like 1972.

is simply too hard to get back into the markets once they have bottomed. By always maintaining a small piece of exposure to equities in portfolios it is easier to add to existing positions when the sell signals above begin to reverse back to buy signals.

The chart below shows the market from 2008 to present and the relevant buy/sell signals as they occurred. It is a little busy, but you will get the idea.



I have excluded the "ALERT" signals to reduce the clutter in the chart but be aware the "ALERT" signals have ALWAYS preceded the first **Sell Signal** as shown by the vertical white lines. It is important to notice that the ALERT and first SELL signals helped you avoid the bigger market downturns while keeping you invested during the rising trend.

The vertical red lines illustrate the only two second level sell signals that would have reduced equity exposure by 50%. Both of these were followed, fairly quickly by the third sell signal which reduced portfolios to just 25% of total equity exposure.

The same portfolio allocation model below shows how the migration works to reduce overall portfolio risk and conserve investment capital.

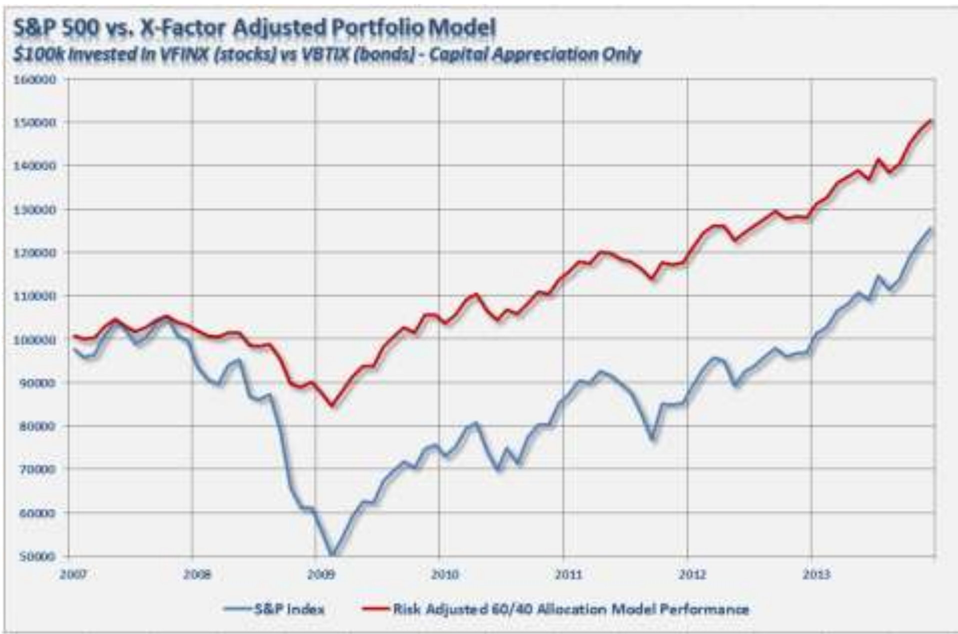
For More On Our Analysis Read:

Clarifying Overbought, Extended & Bullish

Also:

Initial Sell Signal Approaches

The chart below is a representation of the performance differential between a buy and hold S&P 500 portfolio and a 60/40 portfolio (using VFINX and VBTIX as proxies for stocks and bonds) and adjusting the allocation model relative to the buy and sell signals listed above.



The current PORTFOLIO ALERT does not require any changes to portfolio holdings as of yet. However, it is very likely that in the next week, or so, if market action does not improve that an initial sell signal will be issued.

Analyzing The Market

The market rout this week did break psychological support at 1800 which is a short term negative for the market. Importantly, the market also tripped a short term sell signal which suggests that rallies should be used to rebalance portfolios by taking profits and reducing laggards.

However, as shown in the chart below, the bullish trend line remains intact and does not warrant more negative actions currently.

(In a moment I will analyze major market sectors and provided rebalancing recommendations.)

This does not mean that further actions will not be warranted in the next few days or weeks. We will need to continue to monitor both the markets and portfolios accordingly.

I suspect that this selloff is likely the beginning of topping process leading to a *bigger correction (10-15%) in the market later* this year. However, that is just an assumption at the moment based on historical precedents.

The market chart above identifies important levels of support. Any violation of the bullish trends will require a reduction in equity exposure to protect portfolio capital. This is part of the *"sell discipline"* that all investors should maintain when investing their savings. Importantly, these types of selloffs generally indicate more volatility in the short term.

The current bull market and economic cycles are extremely long in the tooth and we are likely nearer their end *(next 12-24 months)* than the beginning. While it is important to be invested in the markets as they are rising, it is more important to be aware of the turning points. Unfortunately, there are few people that will tell you when it is time to actually ***"sell."*** As I quoted in Friday's *"Things To Ponder:"*

> *"INVESTORS get bombarded with advice over whether to buy shares.* ***Much of this comes from interested parties; brokers or fund managers, whose salaries are dependent on getting them to buy stocks. The media chips in too, but most reporting consists of trend following; if*** *the market goes up, journalists quote someone who can explain why the market has gone up*
>
> .
>
> ***The problem with this approach is that investors (and commentators) can get carried away with the crowd.*** *Of course,* ***everyone is bullish when the market is at an all-time high;***

that is why the market is high. *What* ***we need is a reliable valuation measure. Then you can sit back and say "buy when the market is cheap" and sell, or at least not buy, when it is dear."***

One thing is for sure...the market is currently neither cheap nor safe. Pay attention.

Buy/Sell Analysis

The following table is based on the technical trend analysis of each sector and whether or not it is leading or lagging the overall major market index.

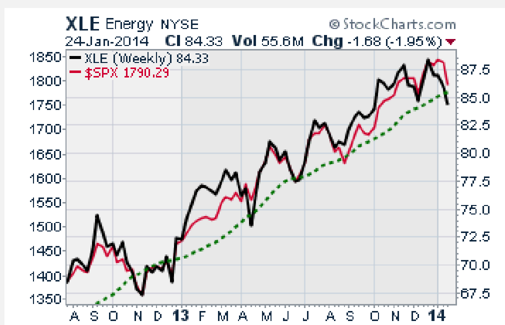
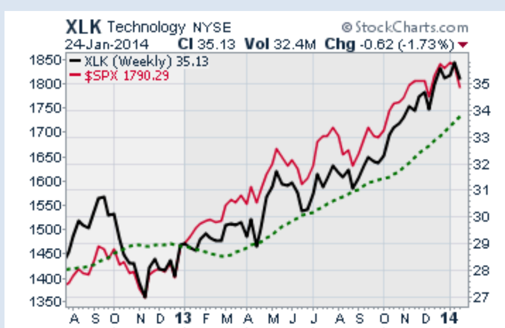
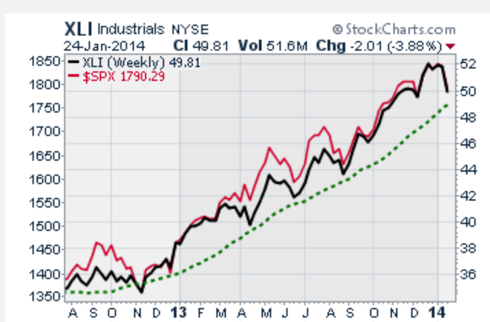
First, let me give you some definitions:

Sell: Sell Entire Position

Take Profits: Sell position back down to original portfolio weighting
(ie. When position was bought it was 5% of portfolio and has grown to 8%. Sell enough shares to return the position back to a 5% weighting)

Reduce: Reduce weighting in portfolio.
(ie. Position was originally 5%. Reduce to 3% weighting.)

Hold: No changes needed

Sector	Analysis	Action	Chart
Energy	Broke bullish trend line support	Reduce	
Technology	Extended but technically stable	Take Profits	
Industrials	Testing support. Technically stable	Hold	

Sector	Analysis	Action	Chart
Staples	Testing support but under-performing broad market.	Take Profits	
Discretionary	Currently holding support. Technically stable.	Hold	
Utilities	Under performing broad market.	Reduce	
Financials	Testing support. Technically stable.	Hold	
Basic Materials	Testing support. Technically stable.	Take Profits	

Sector	Analysis	Action	Chart
HealthCare	Extended but technically stable.	Take Profits	
Real Estate	Grossly lagging broad market. Negative trend.	Sell	
Emerging Markets	Since early 2013 I have advised "selling" this sector	Sell	
Developed International	Broke rising trend line. Failure confirms weakness.	Reduce	
Gold	Still in major downtrend and on long term sell signal.	Sell	

Sector	Analysis	Action	Chart
Gold Miners	Long term sell signal and downtrend still intact.	Sell	
Oil	Currently on a sell signal. Energy stocks grossly detached.	Puts Energy Stocks At Risk	
US Dollar	Dollar trending lower. Implies further deflation pressures.	Likely will equate to weaker econ. data	
Bonds	Bonds have turned up onto buy signal.	Hold	
Interest Rates	Interest falling with rotation from stocks to bonds	Hold Bonds	

What is important to understand is that there is an extremely high correlation between the major sectors of the S&P 500 and the index as a whole. In other words – there is little safety in trying to hide in defensive sectors of the market during a correction. There is also very little advantage to owning anything other than just a broad market index unless you do it very tactically as I discuss each week in this missive.

Time To Dust Of That "Sell" Discipline

It has been quite some time since you have had to actually consider selling positions in a portfolio. However, it is after extremely large runs in the markets that *"complacency"* runs high and *"greed"* overtakes logic.

This is the time where that "little voice" says – *"…but if I sell the market might go higher because of ____."*

These are all emotional biases that tend to get investors caught in major sell offs where the best laid plans quickly turn into tragic nightmares.

This is why having a strict sell discipline is so critically important. However, having a strict sell discipline and actually following it is what separates successful long term investors from everyone else.

In the world of investing – there are VERY few successful long term investors because of this very reason. The data shows that more than 80% of all individuals would be better off just saving cash in the bank versus investing in the financial markets.

It doesn't matter what you sell discipline is. It is just important that you have one and be ready to execute it as necessary.

What is currently happening in the markets is likely the initial stages of a more major market topping and correctionary process. There are plenty of available catalysts from China, to Japan to the emerging markets to fuel a further sell off in the months to come.

To be a good investor you need to follow investment advice from great investors rather than what you hear on television or read on some website. The following insights are from Paul Tudor Jones and a great way to wrap up this week's newsletter.

1. Markets have consistently experienced "100-year events" every five years. ***I am a slave to the tape*** *(price movement) and proud of it.*

2. Investors are hampered by fundamentals and trying to rationalize why something should go up or down. Usually, ***by the time that becomes evident, the move is already over.***

3. There is little useful information on fundamentals and it is largely imperfect. We just to go with the chart. ***Why work when Mr. Market can do it for you?***

4. There is no training — classroom or otherwise — ***that can prepare for trading the last third of a move,*** *whether it's the end of a bull market or the end of a bear market.* ***There's typically no logic to it; irrationality reigns supreme, and no class can teach what to do during that brief, volatile reign. The only way to learn how to trade during that last, exquisite third of a move is to do it, or, more precisely, live it.***

5. ***Fundamentals might be good for the first third****, or even the first 50 or 60 percent of a move, but* ***the last third of a great bull market is typically a blow-off, whereas the mania runs wild and prices go parabolic.***

6. If I have positions going against me, I get right out; if they are going for me, I keep them… ***Risk control is the most important thing in trading****.* ***If you have a losing position that is making you uncomfortable, the solution is very simple: Get out, because you can always get back in.***

*7****. Losers average down losers***

8. ***There's no reason to take substantial amounts of financial risk ever,*** *because you should always be able to find something where you can skew the reward risk relationship so greatly in your favor that you can take a variety of small investments with great reward risk opportunities that should give you minimum draw down pain and maximum upside opportunities.*

These are worthy thoughts to consider as it is important to remember that you, and I, **ARE NOT INVESTORS**. We are **SAVERS.** Ultimately, all we can do is control the investment risk within our own portfolios. Ignoring your money, and the inherent investment risk, will likely not end well.

Next week will be telling. Stay tuned.
Lance Roberts

401K Plan Manager

the X factor Report by Lance Roberts

Please read the missive above concerning the initial ALERT signal issued this week by the markets.

At the current time this is nothing more than a correction within an uptrend. However, these are the types of turns that can elicit much bigger moves to the downside.

If you are overweight equities, relative to model, sell down to model allocations.

If you are underweight equities hold tight and await the markets to tell us what to do next.

Rebalance fixed income and cash positions back to model weights.

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*

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.

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*

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

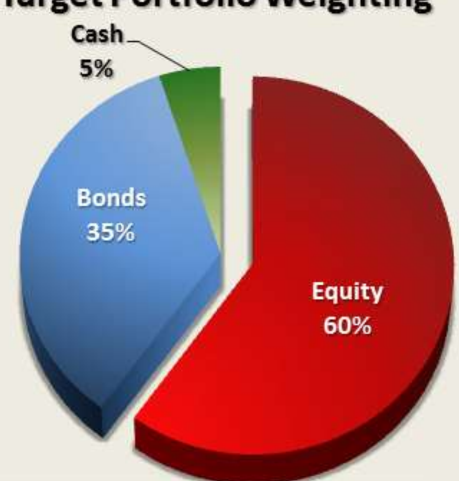
Examples: *Short Duration, Total Return and Real Return Funds*

60.00% **Equity (Stocks)**

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

25% Equity Income, Balanced or Conservative Allocation
25% Large Cap Growth (S&P 500 Index)
10% Mid Cap Growth

Target Portfolio Weighting



These are the allocation model weights that you are moving towards.

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