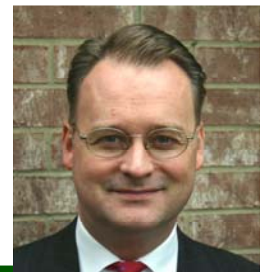
Cornerstone Report:

Weekly Market Update



June 7, 2012

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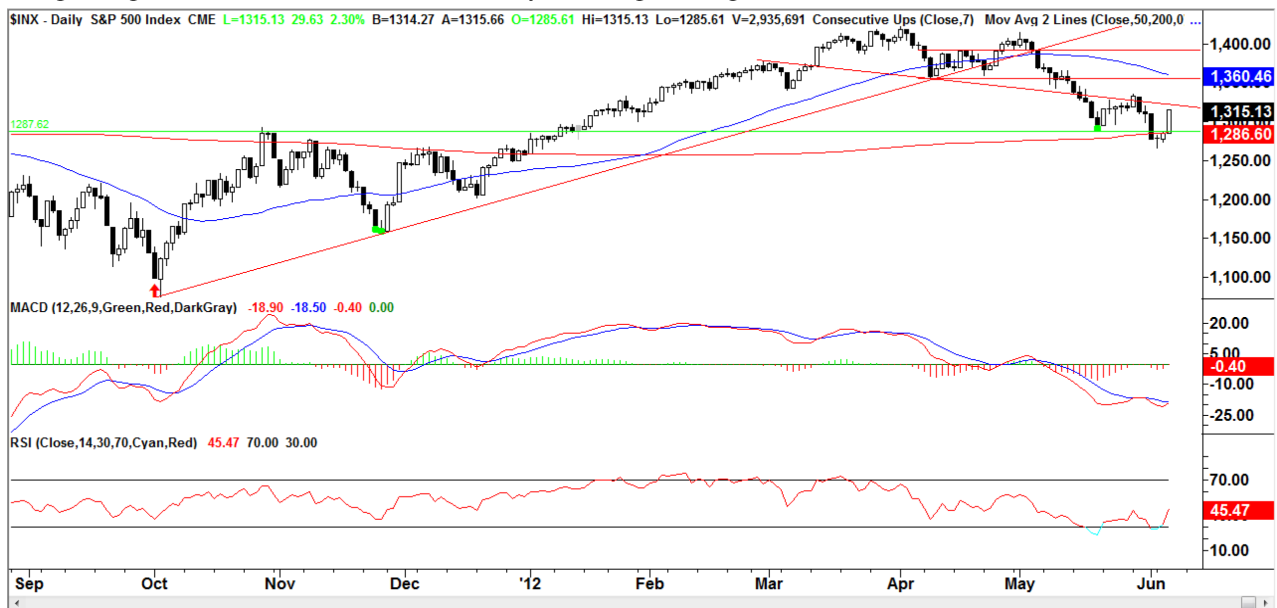
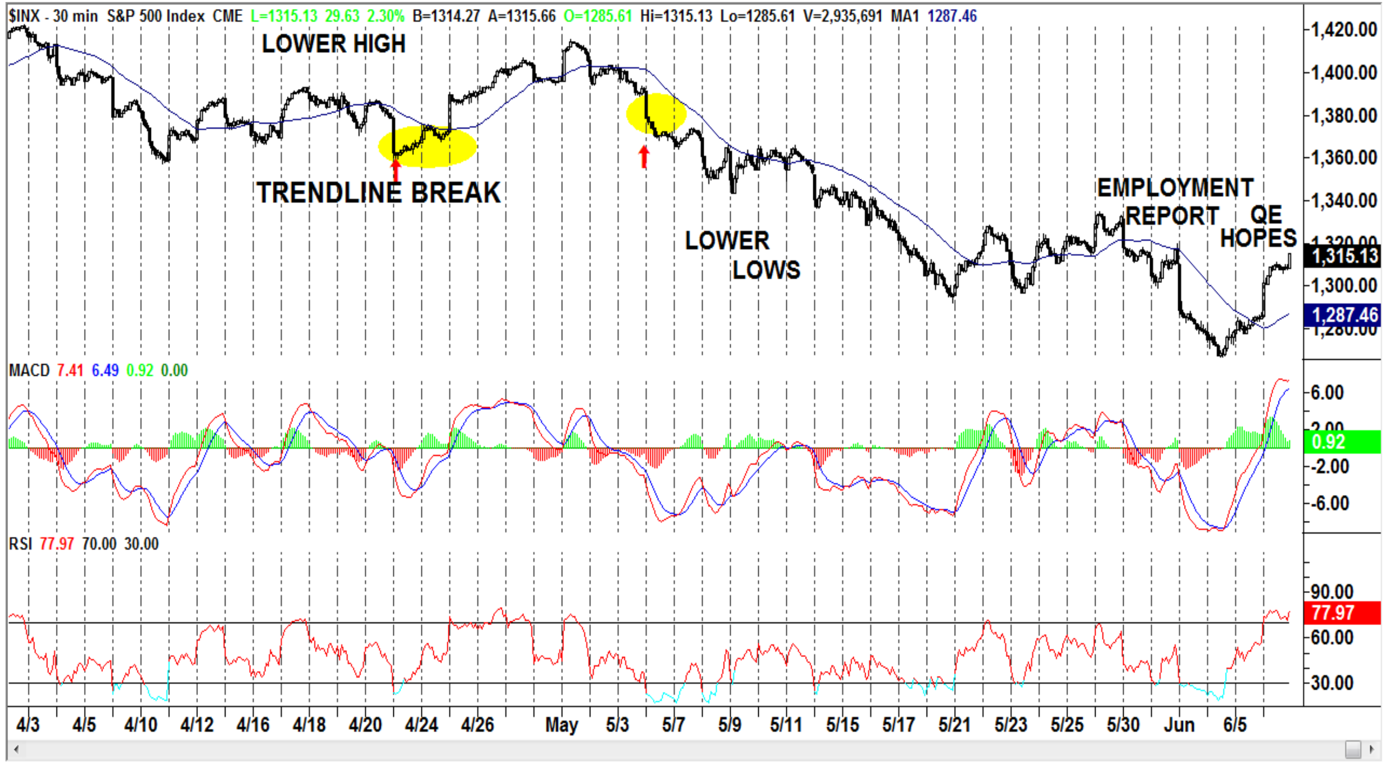
Changing the Way America Thinks About Investing.™

We showed this chart a month or so ago, which Fidelity had titled "Lather, Rinse, Repeat". I've moved the arrow from the upper left to its current position to represent my view of the market's current psychology. The "outlook deteriorates" is recently represented by the latest U.S. economic news, capped by last Friday's weak employment report. Markets are beginning to anticipate action from the Fed—not surprising, as this is what the conditioning has been, and recent Fed statements have been hinting at the possibility, although with to specifics. Bernanke is on deck today, and you can bet that the markets will be parsing his every word.

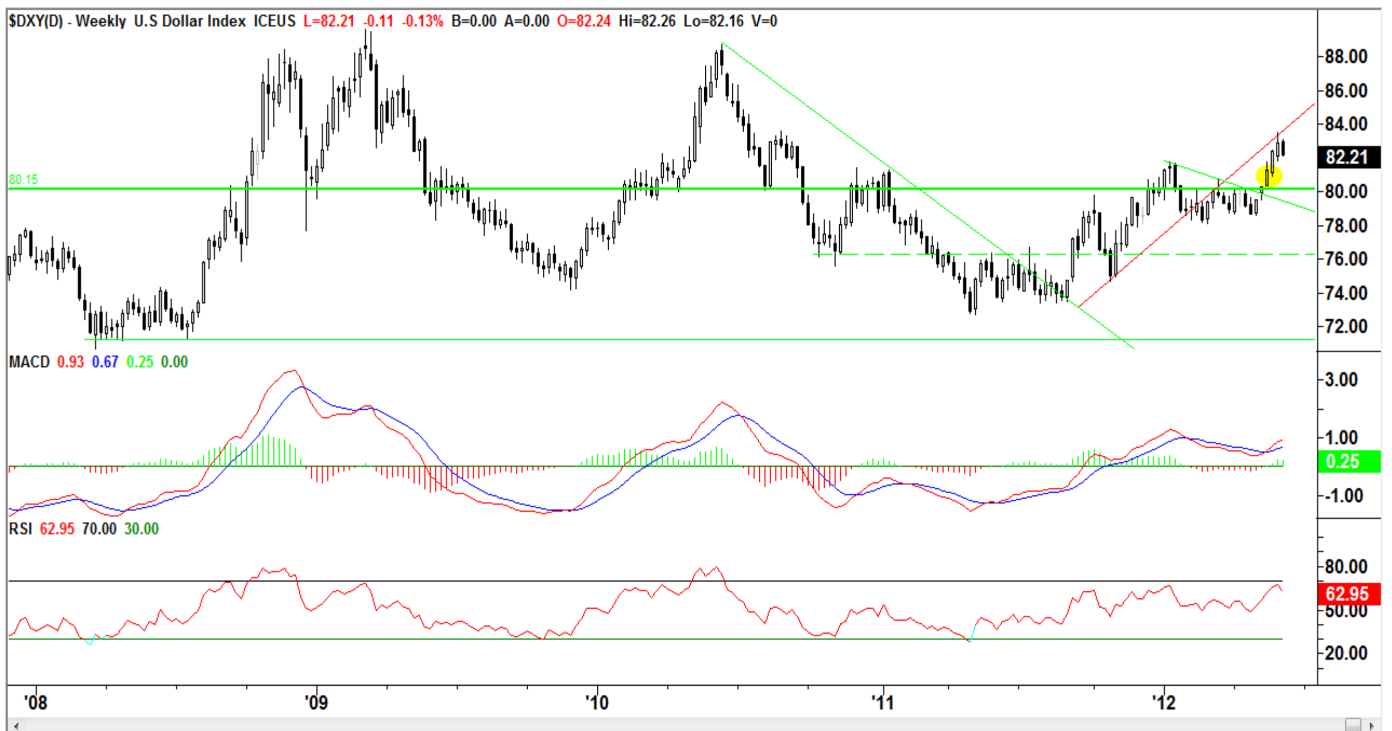
Wednesday was the market's biggest gain in quite some time, more than reversing Friday's big loss, and getting stocks back above the 200-day moving average (red).



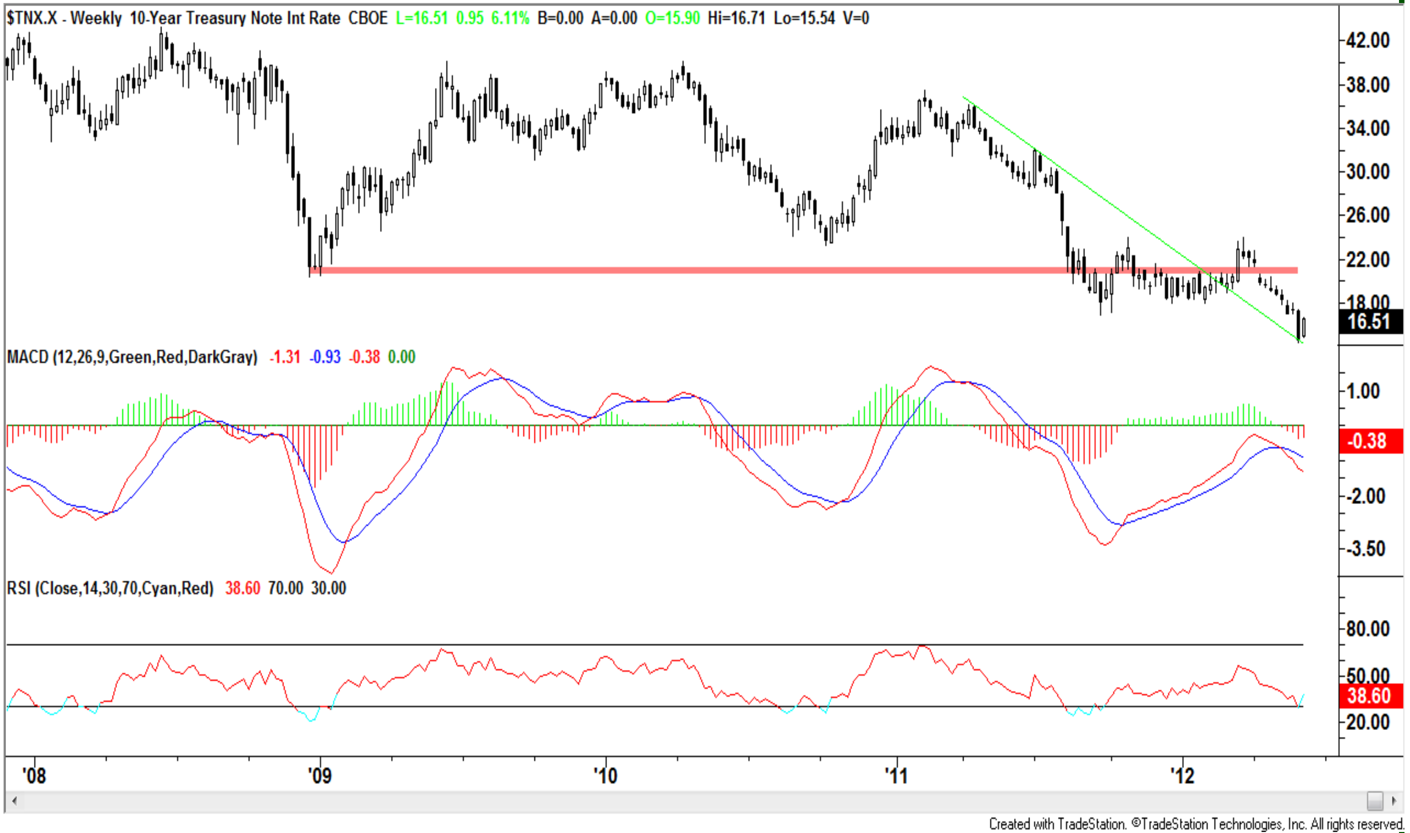
Looking at the intraday chart, we can see that a downtrend remains in place over the last couple of months, although there's now a rally attempt underway. The first important step would be to move above last week's highs around 1330.



Dreams of QE or other Fed intervention have reversed or at least stalled the prior "flight to safety". The dollar's advance has run out of steam for now…

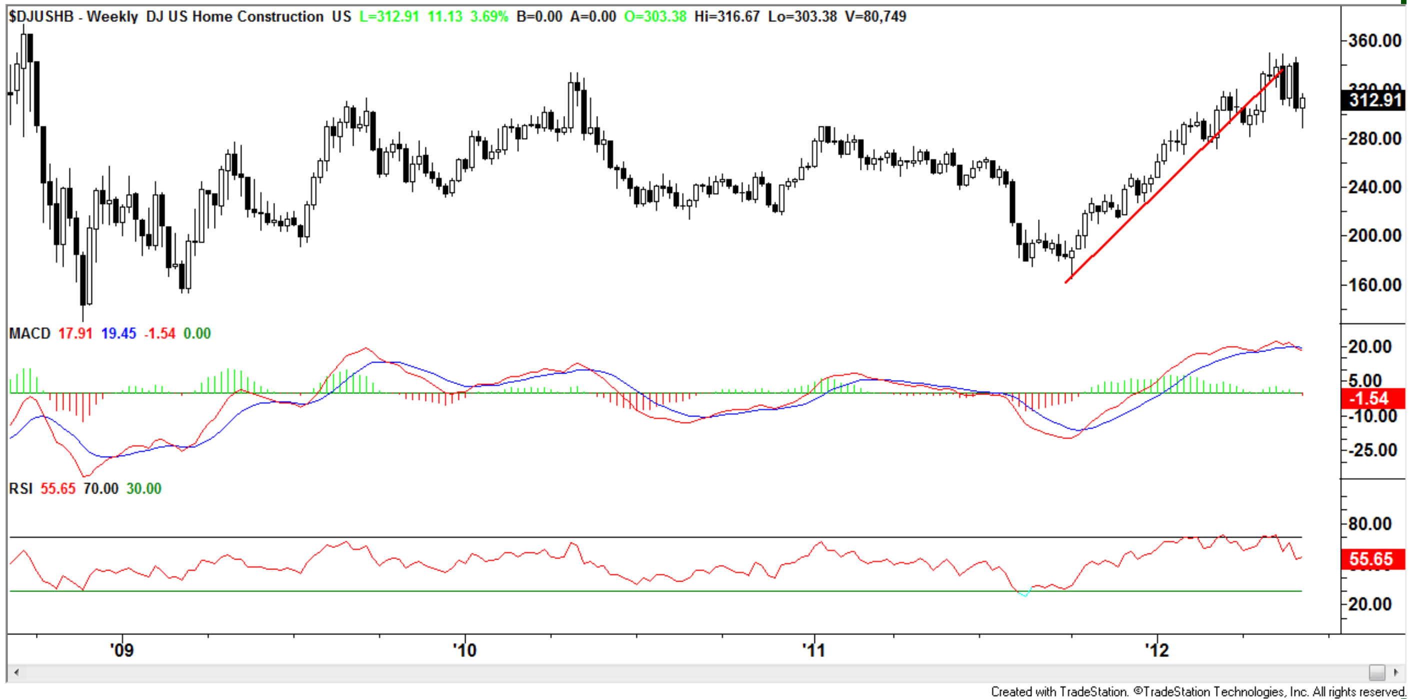


…and the rush into bonds has reversed, as yields have gained back a big part of last week's decline.

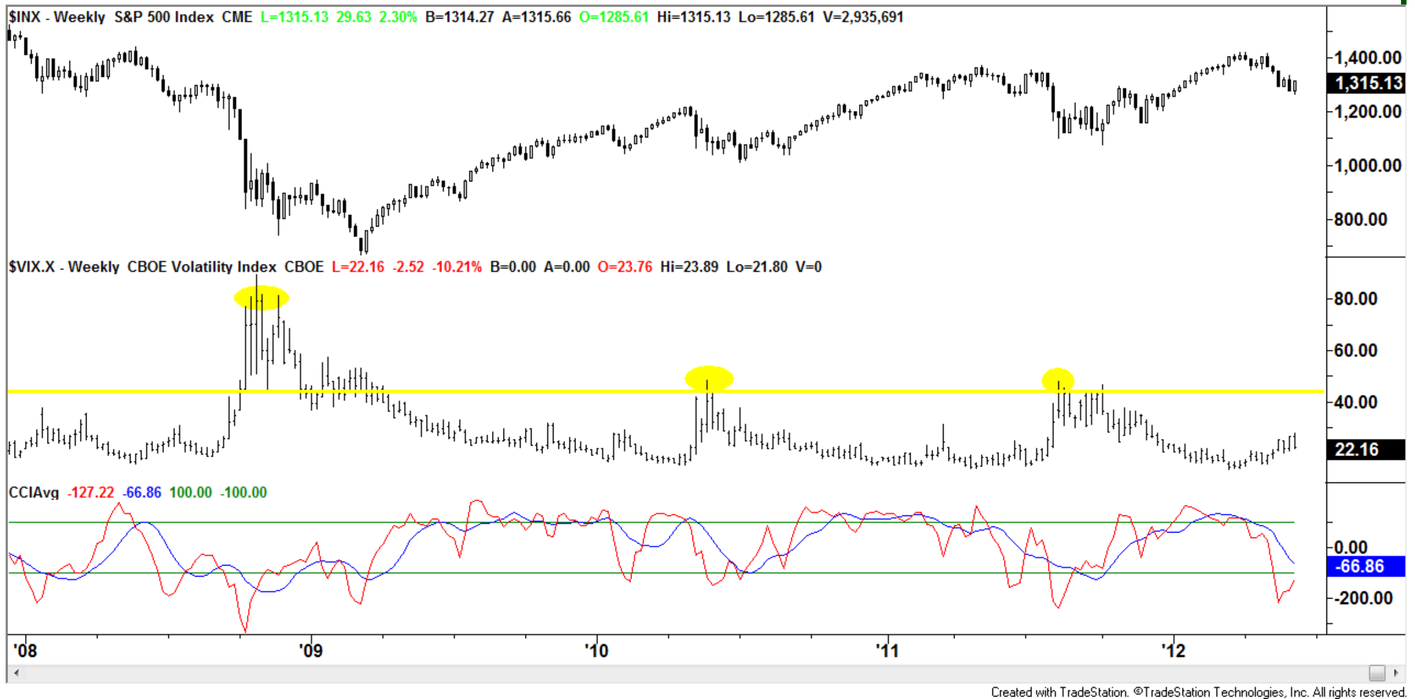


…and the weaker dollar has helped gold stay above its recent downtrend line, so it appears that for now the high $1500's are serving as solid support.

Homebuilders have been a leader to the upside, but with two big down weeks in the past month, and not much in the way of recovery, the chart is looking shaky.



Another background concern is that corrections usually end coincident with a sharp rise in volatility—the prior three incidents are highlighted. This time, there's been only a modest rise in the VIX, which is just above 20 (prior two corrections saw VIX rise above 40). So, with contrarian analysis saying that you want significant levels of fear to increase the likelihood of a low, that is a missing condition in the current market, despite the overall feeling of concern.



LAST WORD:

Remember that the cycle chart at the beginning of this letter is not a guarantee; it's just been the recent tendency. The Fed could act, and the market may not follow suit; the Fed could decline to act, and stocks may not crater. However, for now we believe it makes sense to follow the general guideline of this pattern, as government actions are so dominant in the economy at the moment, whether in Europe or at home.

The whole point of technical analysis is to be flexible to change as it happens, so any significant diversion from the accepted script will likely have big market impact that will require a course adjustment for tactical traders. Needless to say, it's not just the U.S. numbers that matter, and in fact with stocks only off 10% at their worst levels, the Fed might not be motivated enough to take action. However, in the context of continuing major stress and uncertainty in Europe, it's unlikely that central bankers will want to take chances, as the ongoing environment has more than a few similarities to 2008…

For stocks, defense remains the priority, although there may be some opportunities for shorter-term traders here. Fear and anxiety have been thick enough to spark a significant rally on any good news, in my opinion, although the staying power of any advance will have to be taken one step at a time, as always.

Essentially, we're back into the "risk on/risk off" mode that's been so familiar since the credit crisis began. It's unfortunate that government actions are the deciding factor to so many things in the markets, but that's the reality that all traders have to accept. If the market perceives Fed/Europe actions to be favorable, we're likely to see rising stocks, weakening U.S. bonds, weakening dollar and rising commodities. If not, "risk off" probably means more weakness in stocks and commodities, and rising dollar and bonds.

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