Become Like Water My Friend

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I used to love watching the History Channel. Back in the good ole days (which actually weren't too long ago), it would feature real historical content like documentaries, mini-series, and regular programs dedicated to some of the most interesting moments in which human beings have participated. When nothing else seemed to be on the other 300 stations, I could at least count on the History Channel to help kill a few minutes without killing my brain cells in the process. Nowadays, though, ratings trump all, and content providers have quickly learned that by throwing out some cheap reality show, they can attract more viewers by showing the inner workings of a pawn shop or the exciting life of a swamp person than they can with a seven-part series on the medieval feudal system (crazy, I know!). Consequently, I don't find myself stopping on the History Channel very often these days during the rare cases when I actually sit down and flip through the channels. Therefore, I was quite surprised last week when I realized I had been tuned into a biographical documentary on Bruce Lee for about 10 minutes before I discovered it was being shown on the History Channel.

Now, if you aren't very familiar with Bruce Lee, you should be, as he is certainly one of the most interesting characters in pop culture from the last 50 years. More than just a martial artist, Lee was an accomplished actor, filmmaker, and philosopher who managed to achieve more in his short 32 years of life than most who are afforded a full slate of time on this Earth. And while he spent much of his childhood in Hong Kong, Lee was actually born in San Francisco and later moved back to the U.S. where he completed his education, ultimately enrolling at the University of Washington where he studied drama, philosophy, and psychology. Of course, he'll always be most well-known for his remarkable martial arts abilities and charisma on camera, but it was his concern for the more cerebral arts that really interested me while I was watching the aforementioned documentary and it got me thinking that he would have probably made for a very good trader if that had been his chosen path. Take, for example, one of Lee's most famous quotes:

"You must be shapeless, formless, like water. When you pour water in a cup, it becomes the cup. When you pour water in a bottle, it becomes the bottle. When you pour water in a teapot, it becomes the teapot. Water can drip and it can crash. Become like water my friend."

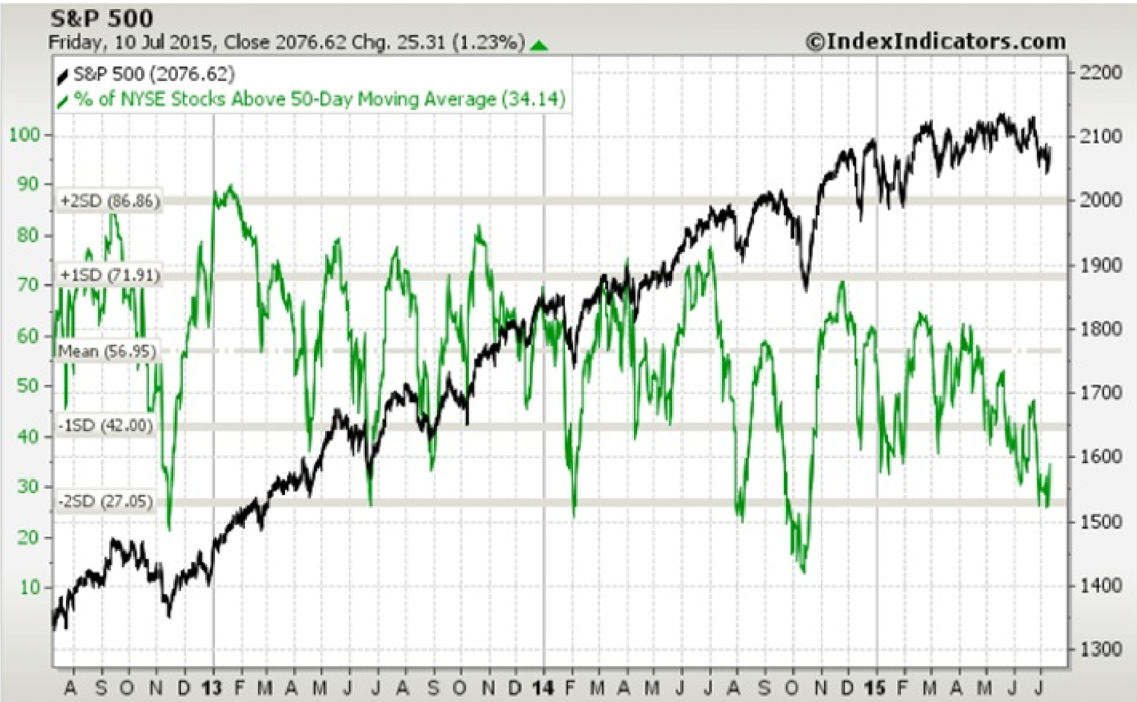
Now, I am fairly certain he wasn't referring to the attributes of a great trader here, but he might as well have been. The ability to adapt is of great importance, not only in life, but when tackling the financial markets too since they are always changing and require flexibility if you want to consistently outperform. It reminds me of another quote, this time by famous market wizard Ed Seykota: "The markets are the same now as they were five to ten years ago because they keep changing – just like they did then." Of course, there is a lot to be said for having an investment plan and sticking to it, but as this year has shown us, there are going to be times when it is difficult to make money and a little flexibility can go a long way toward helping smooth out that equity curve. And the continued volatility we have seen over the last few months may be here to stay for a while, as one of my major themes has been that without the added liquidity of the Fed, we are going to return to more of a stock-picker's market that will require being in the right sectors and stocks if you want to really make the kind of returns we all desire. So you must "become like water my friend" and adapt to whatever the market is giving you at the time, and right now I believe the market is setting up for a bit of a rebound.

Much of this belief is based on sentiment and the fact that there still exists tremendous negativity out there at the moment. Many investors still cannot fathom how this bull market can continue, particularly without some sort of correction to make stocks look more attractive. However, I would argue that we have already experienced a stealth correction, much like we did last summer when the major averages did not really fall much, but the average stock did. That appears to be what we are seeing right now, as only about 34% of equities on the New York Stock Exchange are above their respective 50-day moving average, near levels that have historically been associated with short-term market bottoms (see chart #1 on page 3). What's more, the current five-day moving average of the Equity Put/Call Ratio is also near extreme levels, since many more investors are buying puts than calls at the moment in anticipation of lower prices. While this may sound like a negative, these investors do not have a great track record of positioning correctly in front of inflection points. As you can see in chart #2, typically when the Put/Call Ratio gets this extended, it leads to higher stock prices and I think we're all hoping this happens once more (there have been six times in the past three years when the ratio reached two standard deviations above its mean and all led to a market rally not too long afterward). And with earnings season beginning to ramp up, we may finally get a catalyst to break us out of the Greece/China stranglehold that has gripped the markets for weeks now.

Speaking of earnings season, a study done by Bespoke Investment Group gives further hope that we may be in for some positive markets in the near-term since it appears that analyst expectations have been falling recently, a contrarian signal that has actually led to positive results in recent history. Per Bespoke, “in the 18 prior quarters where analysts were more negative than positive, the S&P 500 averaged a gain of 2.41% (median: +3.65%) with positive returns 83% of the time [in the six-week period beginning the Friday before the start of earnings season].” That’s not exactly blockbuster performance, to be sure, but it at least means that expectations might be low enough that we will see some positive surprises that can help move the market higher and bring us closer to the 10%-12% total returns we expected coming into this year.

And that leaves the **call for the week:** Stocks will try to extend their momentum from Friday’s positive session to further shake off the oversold readings that I have pointed out here and that Jeff Saut mentioned in his commentaries last week. With two recent 90% downside days, sentiment may have reached its nadir in the near-term, and if the S&P 500 can get back above 2090 and take out a couple of resistance lines in the process, I think it will be set up to take another shot at the all-time highs (see chart #3). Last week, the S&P 500 touched its 200-day moving average for the first time since last October, and, if you will remember, stocks went on a nice little run back at that time after doing so, rallying almost 15% before any sort of meaningful pause. I’m not saying that will happen again, but if earnings can come in better than expected, the Greece noise settles down, and if we have already seen the worst of China’s sell-off, we may just be set up to surprise a lot of those negative investors. So continue to be flexible. Become like water my friend.

Chart 1



Source: IndexIndicators.com

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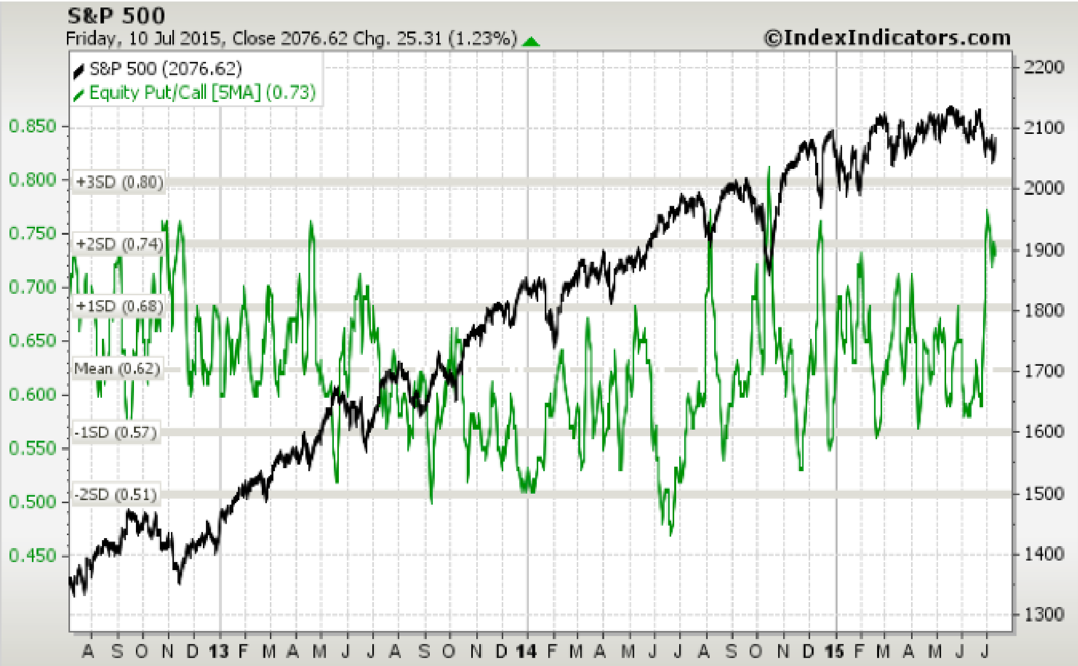
Chart 2



Source: IndexIndicators.com

Click here to enlarge

Chart 3

Source: TC2000

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