

EPIC ADVISORS, LLC

Weekly Market Commentary

July 8, 2008

Sean Hannon, CFA, CFP

“Even though [most investors] are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices.”

– Warren Buffett

When writing this article each week, I am often confronted with an environment where little is clear. Markets rarely exist in a world where things are black and white. Instead we must make sense of shades of gray in order to determine the future. Today is a little different. Anyone who has not been heavily short for the past 8 weeks knows this has been a brutal market that is characterized by relentless selling, widespread damage and vanishing safe havens.

To review, on May 19th the Dow Jones Industrial Average (DJIA) closed above 13,000. Since then, a steady stream of selling has chopped 14% from the index as we now sit below 11,300. During this process, the previous market lows were quickly breached and the DJIA has officially entered bear market territory. In fact, the DJIA currently trades at a level that was last reached in August 2006. In 8 weeks, two years of performance has evaporated.

Within this decline a few interesting developments have occurred. First, the DJIA has led the other major indices lower. Typically, the DJIA shows strength. Currently it shows weakness. While this difference may be subtle, I believe it is important. As the DJIA represents a broad-based measure of business, its weakness shows how pervasive the economic slowdown and credit crisis have become.

Another interesting factor to the current decline is the steady, relentless nature in which it has occurred. Usually, a 14% drop in eight weeks would be accompanied by a washout where investors purge themselves of stocks and show clear signs of capitulation. With a clear reading from various fear indicators, one could be comfortable taking action. Today many of the sentiment indicators are mixed. While certain metrics indicate a bottom, others do not. This has made reading the tealeaves more difficult than usual.

Three common sentiment indicators I use are the VIX (a measure of investor fear based on option prices), the NYSE Bullish percentage (the percent of NYSE stocks who have bullish patterns on a point and figure chart) and the NYSE new highs – new lows (an indicator of how many stocks are reaching new highs versus those reaching new lows). Using these three, we see some clear patterns but also some level of disagreement.

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The VIX currently trades near 26. While this is high in relation to where it traded before the selloff began in mid-May, it is below where prior reversals have occurred. When the market temporarily bottomed in January and March, the VIX spiked above 30 and quickly reversed. During these spikes in January and March, the VIX traded nearly 10 points above its 10 day moving average (MA) and nearly 15 points above its 200 day MA. Today, the VIX is 2 points over its 10 day MA and 3 points above its 200 day MA. While fear has increased in the market, it has not reached the point of capitulation we would expect from major market bottoms.

For those searching for a quick bottom, the NYSE bullish percentage offers more comfort. At the current reading below 28%, less than 28% of all stocks traded on the New York Stock Exchange (NYSE) show bullish patterns. This reading is below the extreme reached in January when only 16% of stocks were bullish yet is in line with the level from where the March rally began. For me, this leads credence to the view that the markets may be scratching out a short term bottom that leads to a quick, powerful rally.

Finally, the new highs versus new lows offers further confusion. The current reading of -544 means that the sum of all new highs minus all new lows equals 544. Therefore, many more stocks are breaking lower than are heading higher. For some perspective, this indicator reached -850 at the January low and -650 at the March low. Therefore, stocks may be breaking down, but we have not reached an extreme that mandates a significant bottom.

The three indicators mentioned above are just some examples of data any investor can glean from the market. If we expanded our discussion from these three indicators to fifteen indicators, the same pattern would hold. Certain pieces of information point to an immediate rally while other show a lack of true fear. With such a mixed signal, you could argue a bearish, bullish or neutral view. While these arguments are interesting, I am more interested in being neither a bear nor bull. Instead I prefer to be correct. With that mandate there is a need to cut through the fog and develop a clear view of how to profit over the coming weeks, months and years.

Until now, I have focused upon general tools any investor could use. While these tools offer insight, they offer little competitive advantage. With thousands of profit seeking investors using the same information, you can reasonably expect your chance of gaining a true competitive advantage to diminish. Instead, I will turn to a proprietary model to guide me.

For years I have been using a timing model to both manage clients' portfolios and to gain a sense of market sentiment. Over the years it has served me well in both regards. Using the model, I

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assume a normal market environment to be one in which less than 80% of stocks in the model are either bullish or bearish. When a market goes beyond that 80% threshold I consider it to be an extreme movement (i.e. – 80% of stocks showing bullish signals would be an overbought market and 80% of stocks showing bearish signals would be an oversold market). Further, a market that goes 90% in either direction would be considered severely overbought or oversold.

So where are we now? Currently, my timing model is 96% short – the most severely oversold it has ever been. Since we are so oversold, shouldn't the market rally? While I am inclined to say yes, an oversold market can remain oversold for some time. However, it is important to consider what this reading of the timing model means and to think about what we can expect to happen over the coming weeks.

This past weekend, I used the long holiday to back test the timing model to 1998. Over the past ten years we have experienced many booming bull markets where prices went straight up and vicious corrections when it appeared the pain would never end. For this reason, I think the period tested offers a proper view of how the markets behave in very different environments.

Looking at the results, I found the outcome of severely overbought (greater than 90% bullish) and severely oversold (greater than 90% bearish) markets interesting. Over the past 10 years, my timing model has been severely overbought 9 times. During that period, the market remained overbought for an average of 35 days with the longest period being 65 days and the shortest period being 17 days. More importantly, from when the market became severely overbought until when it returned to a more normal reading, the S&P 500 returned an average of 3.72% with the maximum gain being 12.31% and the lowest gain being a loss of .88%. Therefore, an investor buying a severely overbought market stood an excellent chance of realizing gains in the future.

Conversely, the market has been severely oversold 4 times (not including the current severely oversold signal). In those environments the average time was 13 days with a maximum of 17 days and a minimum of 9 days. Interestingly, the S&P 500 returned an average of 6.18% with a maximum gain of 9.65% and a minimum gain of 4.03%. While severely oversold markets initially continued lower, buying in this environment eventually led to quick and significant gains.

So how do we distill all this data? The current severely oversold reading occurred on June 26th when the S&P 500 was trading at 1,283. We are now 8 days into this environment and have dropped over 3%. As of now we are approaching a price decline and day count where the market should begin to bottom and head higher. I admit this prediction at a moment when the markets are lower appears odd,

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but the tendency is for oversold markets to behave like rubber bands. The harder one pulls on the rubber band, the quicker is the snap back. We are approaching the rebound and need to position ourselves accordingly.

To navigate this market, I have become longer than at any point in the past two years. Over the past three weeks I have realized large gains on a number of my short positions. At the same moment I have been adding positions I view as inexpensive with the expectation of reaping profits in the future. Once my anticipated rally occurs, I will have the opportunity to reduce my net exposure and move to a more defensive posture. With little clarity on the true fundamentals of many industries and no clear example of investor capitulation, any rally we experience should be viewed as a temporary bounce in an ongoing bear market. At some point, a rally will be sustained, the bear will be vanquished and a new bull market will emerge. Unfortunately that day is still in the future. Until it arrives, sell strength, be cautious and capture whatever gains the market presents.