

EPIC ADVISORS, LLC

Weekly Market Commentary

September 2, 2008

Sean Hannon, CFA, CFP

T.S. Eliot was a poet, dramatist and literary critic who received the Nobel Prize for Literature in 1948. Born in the United States, Eliot moved to the United Kingdom in 1914 and became a British subject in 1927. Often considered the greatest poet of the 20th century, Eliot has been claimed by both American and English literary circles as one of their own.

As a leading Modernist poet, Eliot used free verse and developed lasting works that remain vivid to this day. In *The Wasteland*, Eliot describes April as the cruelest month. At the end of *The Hollow Man*, he intones that the world ends not with a bang, but a whimper. His dire views often capture the feelings of a post-World War I world in which despair and disillusionment trump hope for a better future.

While Eliot's mark in literary circles has continued to influence poets for over 80 years, his lesson to investors is much less clear. As investors, we know that April is not the cruelest month. History has taught us that September is the worst month for the markets and that many of the large, surprising down moves occur during October. Further, bear markets do not end with whimper, but with sharp capitulation. A series of high volume days where selling sharply outweighs buying often represent that a bear market bottom is forming. Typically, sharp upswings will confirm this bottom as investors rush to buy new bargain priced stocks.

Looking back over the past year, we have experienced repeated negative events yet do not see any price action that indicates a typical bear market bottom. The Dow Jones Industrial Average (DJIA) peaked at 14,164 on October 9, 2007. From there we have seen a series of panic lows that were quickly erased. Looking at a one year chart, the DJIA hit an all-time high October 9th, dropped 640 points (4.5%) over the next 8 days and then rallied 410 points (3%) over the following 8 days, From there, another low occurred November 12th as the DJIA dropped 6.7% over 13 days and then rallied 5.7% over the next 19 days. The rally was short-lived as the DJIA dropped 4% over 6 days and then rallied 3% in 6 days.

As 2007 ended, most investors were experiencing motion sickness as the overall market remained in a tight range yet lashed back and forth. Looking at my commentary from that time period, in the September 11th commentary (http://www.epicadvisorsllc.com/images/Weekly_2007-09-11.pdf) I described the stock market as a roller coaster. Price would go up and down, yet finish at the same point from which they started. When I made that comment, the DJIA traded at 13,308. The DJIA ended 2007 at 13,264 - a move of 42 points. The volatility had been brutal, but the index remained unchanged.

Having seen the broad market unchanged over 3 months and every meaningful decline accompanied by a sharp rally, investors began 2008 in a hopeful mood. Their hopes were quickly

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dashed as the DJIA dropped 9.8% over the first 14 trading days. However, a rally materialized as the DJIA snapped 6.50% higher over an 8 day span. Markets remained calm for a few weeks until the Bear Stearns panic dropped the DJIA 7.50% in 10 days. Of course, a V-shaped rally quickly worked off the decline and the DJIA was 7.50% higher in less than one month.

As calm settled into the market after the March low, volatility began declining and investors became more optimistic. After all, one of the worst credit environments in history, a terrible economy and rising commodity prices had led to many sharp market declines, but those declines were always corrected with a quick-V shaped recovery. If the market could withstand all this negativity, perhaps it was forecasting better times ahead. With many believing the market knows all, it seemed simple and plausible to remain bullish in the face of negative news.

For anyone who is a short term trader, this viewpoint is understandable. Buying dips led to gains so why not continue? However, the big picture was more ominous. Within the multiple reversals, the DJIA had been experiencing lower lows. From a technical perspective, this trend needed to change before the market could sustain a move higher. Similarly, V-shaped moves are good for traders yet bad for investors. These sharp price swings are indicative of what occurs during bear markets – not bull markets. Consider that during the bear market from 2000 – 2003 when the DJIA dropped 36%, daily moves of greater than 2% in either direction occurred 107 times. Conversely the bull market from 2003 – 2007 saw the DJIA rally 88% and had daily moves of greater than 2% only 18 times. So far, the current bear market has sheared 18.50% off the DJIA and has experienced greater than 2% moves 28 times. If history is destined to repeat itself, we should expect more wild swings with lower share prices to come.

The most recent sharp decline occurred from May 19th – July 15th as the DJIA dropped 16% in 2 months. A recovery allowed the DJIA to rally 7.50% in less than a month and now trades within 200 points of that recovery high. A one month view of the market shows a period of higher lows as the July 15th price has not been tested and the DJIA slowly climbs into resistance. Given this productive move over the past 6 weeks, is now the time to declare the worst is behind us and to become aggressively long of this market?

My answer is no. While the rally has been welcome and provided an opportunity to be aggressive to the long side (http://www.epicadvisorsllc.com/images/Weekly_2008-07-08.pdf), that opportunity has now passed. During this rally, volume has dropped and breadth has been weak. I have seen no urgent move by the investing public to buy stocks and a rally with such weak underpinnings can be expected to quickly reverse. On August 13th, I detailed my long term macro viewpoint that we are

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heading for a period of low to no growth (http://www.epicadvisorsllc.com/images/Weekly_2008-08-13.pdf). Owning broad market positions during this period will be frustrating. Instead investors must seek return in more focused strategies and let their exposure drift away from index determined weightings.

With the market entering the historically most dangerous period of the year, in a world where geopolitical tensions are increasing, the equity market's current move is weak, my timing model is overbought and investor sentiment indicators show the absence of concern, I am extremely worried about what lies ahead. Having continually traded this market for the past year, I have great familiarity with the many false bottoms we have seen. As a long biased investor, I am thankful for selloffs that provide an opportunity to own stocks at low prices. At the same time, a down trending market causes losses as the investment I own lose value. However, when one considers that few investments offer rates of return that will allow for people to grow wealth over time, we find ourselves buying equities that offer a margin of safety and provide solid dividend yields with the expectation of strong gains in the future.

While I have traded the rallies that have occurred, I never viewed the ultimate market bottom to have occurred. Market bottoms occur when all have abandoned hope and violent selling washes over the investment landscape. Still mired in a bear market, this large spread pessimism is absent. Markets rarely discount the same bad information twice. We have seen bank failures, housing problems, high gas prices and eroding confidence. Since all of the negativity in the news has yet to knock this market to a point where all abandon hope, I fear a cataclysmic event over the next few months will deliver the final blow. Unlike Eliot's admonishment of how the world ends, this bear market is bound to end with a bang, not a whimper. Investors would be well advised to reduce risk, hedge their positions and prepare for the rocky storms ahead.