

## EPIC ADVISORS, LLC

Weekly Market Commentary

February 18, 2009

Sean Hannon, CFA, CFP

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Dow Theory relies on price action in the Dow Jones Industrial Average (Dow) and the Dow Jones Transportation Average (Transports) to determine the primary trend of the stock market. Among the main tenets of Dow Theory is that moves in each index must confirm one another. If the Transports and Dow set new lows at the same time, the primary trend is bearish. If the two diverge, with one setting a new low and the other refusing to confirm, the divergence indicates the possibility of change.

Until a week ago, the possibility of divergence existed. Unlike when markets crashed to new lows in a synchronized manner in November 2008, 2009 saw certain marks break lower while others held steady. Holding hope that the divergence would reverse the primary trend, I cautioned investors to watch closely. If the markets could move higher from this non-confirmation, the trend would change and we could safely reenter the markets.

The following chart compares the market lows reached last fall with the lows reached last week:

<u>Index</u>	<u>Market Low</u>	<u>Date of Market Low</u>	<u>Recent Low</u>	<u>Date of Recent Low</u>
Dow	7,552	11/20/08	7,553	2/17/09
Transports	2,804	2/17/09	2,804	2/17/09
NASDAQ	1,316	11/20/08	1,440	1/20/09
S&P 500	752	11/20/08	789	2/17/09
FTSE 100	3,781	11/21/08	3,999	2/18/09
DAX	4,127	11/21/08	2,849	2/18/09
NIKKEI 225	7,163	10/27/08	7,534	2/18/09

As markets moved in unison to the downside on Tuesday, the Transports set a new low and the Dow rested less than one point above a new low. However, the other markets have left some room for optimism. They've hit 2009 low points, but remain above the market bottom of November 2008. Therefore, investors must now question whether we are seeing a divergence that could change the primary trend or if a confirmation of the bear market lies around the corner.

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Those looking for divergence cling to aspects of the Dow that they believe minimize its effectiveness as a market proxy. The Dow is a price-weighted index where the higher the stock price, the more it affects the index's value. As many financial companies have plunged in value, the Dow is littered with sub-\$10 stocks that have little impact. Consider that Bank of America (BAC), Alcoa (AA), Citigroup (C), General Motors (GM), and General Electric (GE) have a combined weighting of 2.9%. If all five were to go bankrupt the U.S. economy would be devastated, yet the Dow would fall only 220 points. Such disconnect between the value of the Dow and its impact on the economy leaves many believing the Dow does not matter.

If you trust this thought process, you are comforted by the ability of the NASDAQ and S&P 500 to remain 9% and 5%, respectively, above their November lows. I find such comfort to be misplaced. With respect to similar groups, whether individual stocks or broad markets, divergences almost always result in lower prices. Instead of the weak stock rising in value to meet the stronger stock, the stronger usually breaks lower and confirms the bearish nature of the weaker. In the current environment, I expect the same pattern to hold with the Dow officially confirming the bear market in coming days and the NASDAQ and S&P 500 to weaken as well.

Six weeks into a new year, drama continues to unfold. I started the year with a fair-value target on the S&P 500 of 625. After the S&P 500 experienced its worst January ever, markets began firming and offered hope that the primary trend could change. As those hopes have been dashed, we are confronted with the realistic possibility that the S&P will approach my fair-value target and that it will take the Dow below 6,000.

Having suffered enormous loss of wealth over the past year, investors now must reassess their game plan. Expecting much lower prices, an exposure to stocks should be limited. However, bonds and cash pay minimal interest and have little value as long-term investments. Shorting makes sense to some, but strong bear market rallies can devastate a portfolio. Searching for return, I believe quickly realizing profits will prove the best long-term strategy. Remain hedged and book gains when they reach a reasonable level. Doing so will keep you liquid, solvent, and prepared for the time when this bear market eventually bottoms.