

EPIC ADVISORS, LLC

Weekly Market Commentary

June 24, 2009

Sean Hannon, CFA, CFP

Many investors like to view themselves as contrarian thinkers. Knowing that the popular, crowded trade offers little room for gains, they look for ideas that are correct, yet unpopular. By taking a position that reflects wisdom that others have not yet seen, when the market eventually realizes these views are correct investors receive both monetary gains and the satisfaction of moving ahead of the pack.

Although this approach is attractive, it is also tricky because it fails to account for the role of emotion in investing. Despite modern financial theory's reliance on unemotional investors acting in a rational way, people are often swayed by their environment and what they are witnessing. We may try to reduce outside influences over our decisions, but conquering this inherent bias is difficult.

A perfect example is the recent performance of the Dow Jones Industrial Average (Dow). On June 12, the Dow closed at 8,799. This value was above its 200-day moving average (MA), and finally put the Dow in positive territory for 2009. Most investors deduced that the technicals were strong, valuations reasonable, and future gains likely. However, with the Dow 34% above its March low, people were wary of chasing. If only prices would pull back 5 to 8%, this group was convinced they would buy the dip and ride prices even higher.

That dip has now occurred. Twice in the past six trading days we have seen large drops where down volume was over 90% of total volume. These 90% down days are typical of panicked selling and have quickly delivered the buying opportunity many hoped for just 10 days ago. With the Dow now resting below its 50-day MA, the question becomes whether people will actually buy the dip or continue heading for the exit.

Handicapping the odds of buyers emerging after a 5% drop may appear to be overly sensitive to small price moves, but I believe it is essential. Since the bear market and credit crisis gained momentum after the Lehman Brothers bankruptcy, psychology has mattered much more than hard data. Stock and bond prices swing wildly as investors gauge their emotions and react to news. Since March, we may have seen some incremental improvements in the economy, but nothing that suggested a 34% rally over three months was justified. Instead, the move from abject fear to unbridled hope serves as the backdrop. Were this mood to shift again, the damage could be swift and devastating.

As we watch the market over the next few days, I am awaiting the emergence of buyers. Were they to surface, it would signal that people believe the momentum of stocks will go higher and the psychology of the rally is intact. However, were prices to continue moving lower over the rest of the week, fear is likely returning and the mood is shifting.

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From its outset, I have never trusted this rally. The economy may be moving from horrible to bad, but the move from bad to good remains years into the future. Many stocks I watch are showing topping patterns and breaking lower. Should the rest of the market recognize this pattern, we could see a rush to the exits as investors believe lower prices are in the future. Just as joyful outlooks can lead to higher prices, mass fear can take prices lower.

For investors, the next few days are critical. If the Dow can successfully bounce above its 50-day MA or stabilize, investor optimism will build. However, should prices move toward 8,000, we will quickly see another 500-point drop, and the risk of retesting the March lows will increase. While I would like to think rational investors would not allow their emotions to swing so wildly one week to the next, the shifts are to be expected. By assessing the meanings of market actions, we can break this pattern and allow ourselves to react appropriately to the market's moves.