

# EPIC INSIGHTS

Midweek Commentary

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Financial markets depend upon rationality. Acknowledging the work of practitioners of behavioral finance to debunk the myth of efficient markets, we should never forget that temporary bouts of irrational investor emotion at times completely overwhelm a rational process of making investment decisions. However, if markets always acted in a random, irrational manner, no amount of study or discipline would allow for consistent positive results. Instead, chance would dominate and only those who are lucky would prosper.

Buying stocks based on valuation criteria and macroeconomic considerations demonstrates a belief that over time the fundamentals of businesses and the economy will create value. As a proponent of this view, I have found the market's recent action troubling. Using the Value Line median P/E as a measure of the value in stocks, we now see stock prices at levels as high as typical market peaks. Examining the macro-environment, a weak dollar, which typically strips value from equity markets, has accompanied a continual boom in stock prices. As momentum has trumped all else, the irrational has been driving the market.

With little to support the massive rally in stocks other than the fact that they continue higher, I have found the past few weeks very challenging. Eventually, what should drive stocks will, and we can watch for signs of this eventuality to indicate our next steps. There are signs that the time is now.

Brazil's Bovespa stock market has been among the biggest gainers this year as it is 79% higher since the beginning of the year. Since the consolidation low in early July, the Bovespa rally of 39% has topped the Dow Jones Industrial Average's (Dow) impressive 24% gain, making Brazil a perfect example of the momentum-fueled environment we face.

After the Bovespa set a new annual high Monday, Brazilian officials announced that they would tax foreign purchases of stocks and bonds. The Bovespa proceeded to decline 2.9%--a rational result which shows that markets are becoming sensitive to more than just continuing momentum.

Turning to currencies, the surprise move by the Australian central bank to increase interest rates a few weeks ago led to a run on the U.S. dollar (USD). Among the main beneficiaries were commodity resource countries. The surprise move had a great effect on the Canadian dollar (CAD), causing it to rally 7% in two weeks. With the appearance of parity looming, the decision by the Canadian central bank to leave interest rates unchanged led to a quick 2.1% decline in the CAD. Again, rational behavior trumped emotion.

Some will look at these select events as isolated in nature and therefore unimportant to the global capital markets. Doing so would be a mistake. Both trades were indicative of the momentum-fueled capital markets that have lifted all asset prices in the face of weak fundamentals. Stocks are not cheap, and the economy, while improving, is a long way from health. Instead, an emotion-driven rally dependent on incremental capital to drive prices higher is facing a true test of resolve.

Technicals initially drove this market higher, and as graphs of the Bovespa (**Figure 1**) and CAD (**Figure 2**) show, important reversals have occurred (red circles). If the technicals begin to erode, what some felt was a one-off instance of little importance will now be seen as the canary in the coal mine. Stocks may continue higher in the short term, but as I have been stressing for weeks, they are not cheap, and each incremental purchase at these elevated heights carries much more risk than potential return.

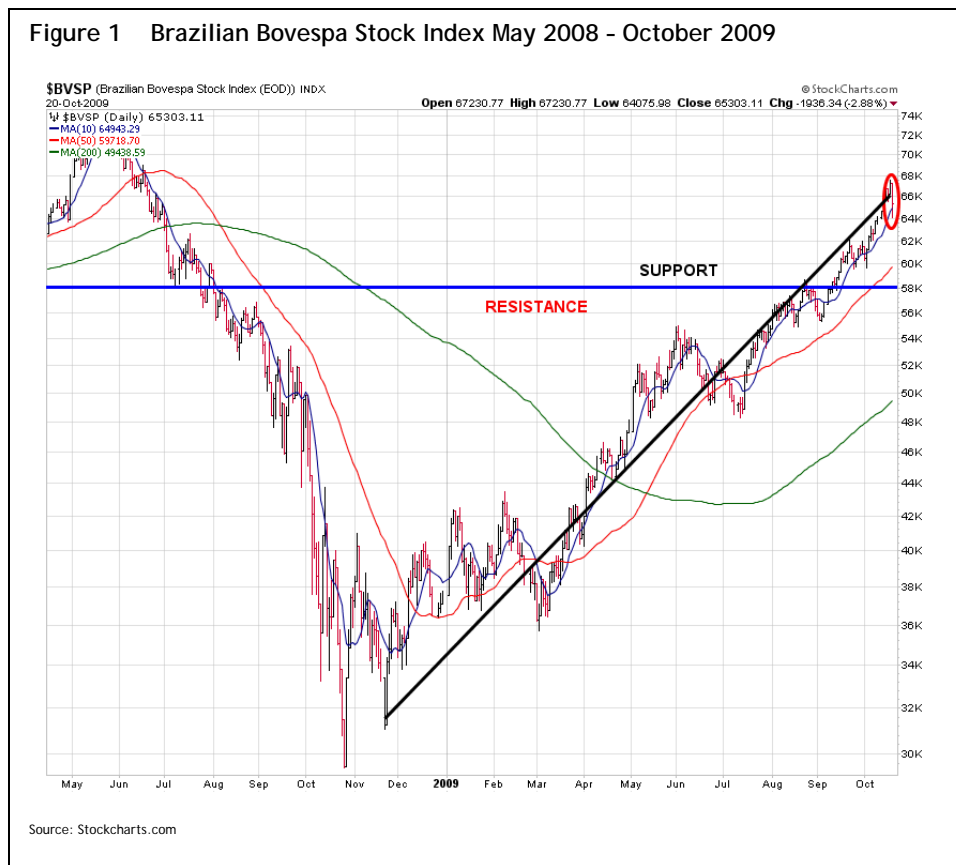
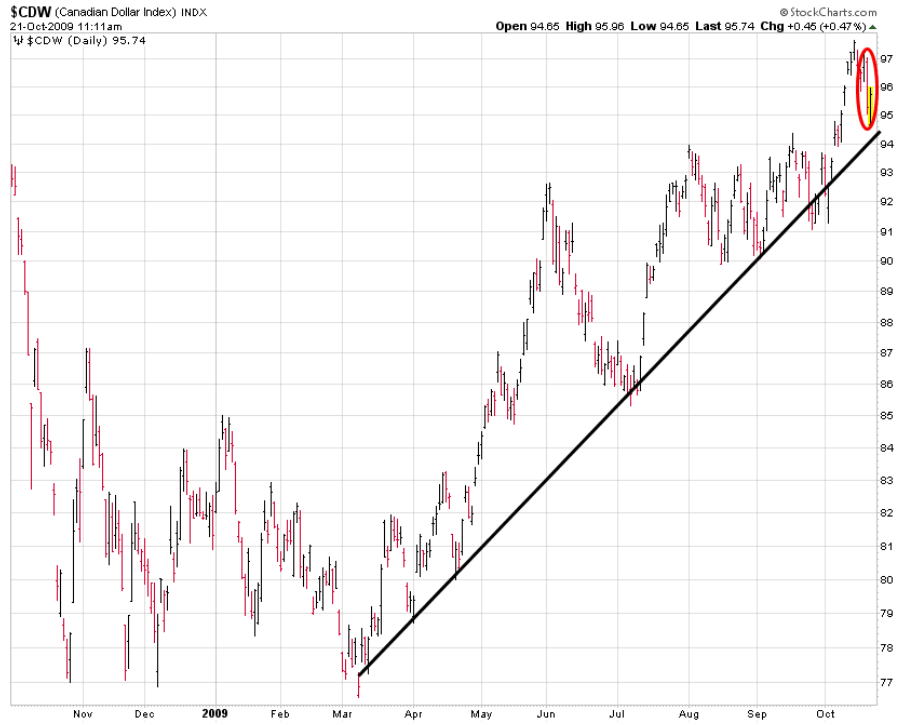


Figure 2 Canadian Dollar Index October 2008 - October 2009



Source: Stockcharts.com