

EPIC INSIGHTS

Midweek Commentary

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Sir Isaac Newton's first law of motion states that an object in motion will stay in motion unless acted upon by an external force. Following this law, our minds tend to extrapolate the recent past. We expect that which has occurred recently to act as the dominant force going forward.

In the markets, this tendency is a major hurdle. Often times, prices move about for unknown reasons and the constant fluctuations in price are nothing other than noise. No stock market trend extends indefinitely with rallies leading to declines. However those espousing Newton's first law will expect the recent past to forecast the immediate future.

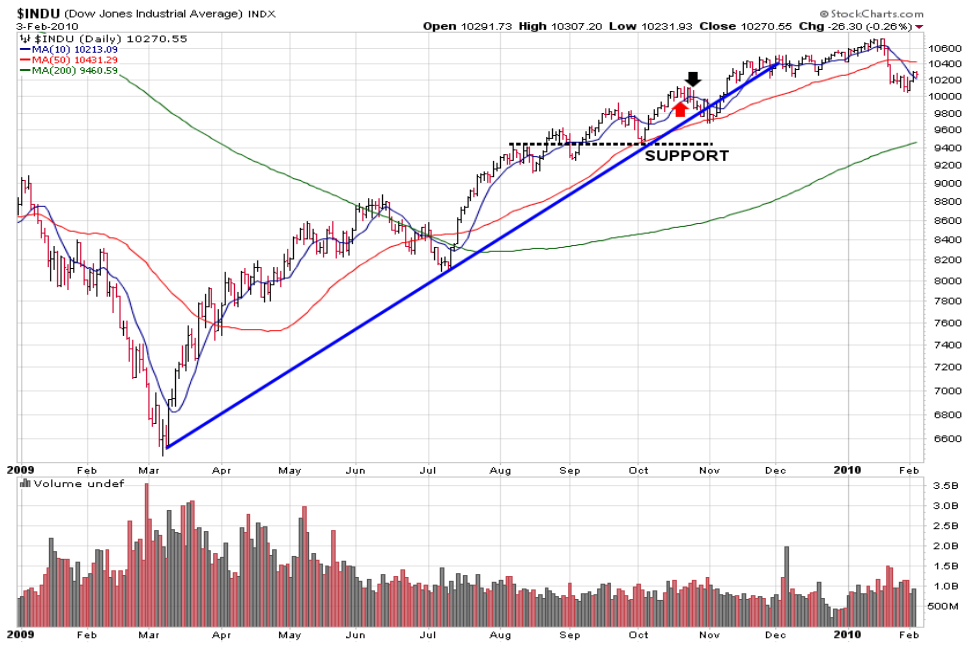
This tendency is what makes the market's performance over the last three weeks so difficult to decipher. Overnight, we went from market strength to relentless selling that pushed the Dow Jones Industrial Average (Dow) below its 50% retracement level and within 67 points of the psychologically important price of 10,000.

As the Dow's 6% two-week drop raised alarm, this week has seen a series of triple-digit gains that has brought the Dow within 87 points of its important 50% retracement level. Such an abrupt reversal from immediate declines to surprising strength has many guessing if we are witnessing the market's typical counter-cyclical moves within the long-term uptrend from last March's lows or a pause before prices again move lower.

When dealing with such complex decisions, I like to look beneath the headline price movements and study the market internals. Using this approach, current strength is nothing more than a consolidation following a steep sell-off. As the Dow has rallied, both the NYSE Bullish percentage and my proprietary timing model have been relatively unchanged. Also, the number of new highs has seen a modest expansion from 22 on Friday's close to 63 today. This remains well below the 492 new highs achieved on January 11.

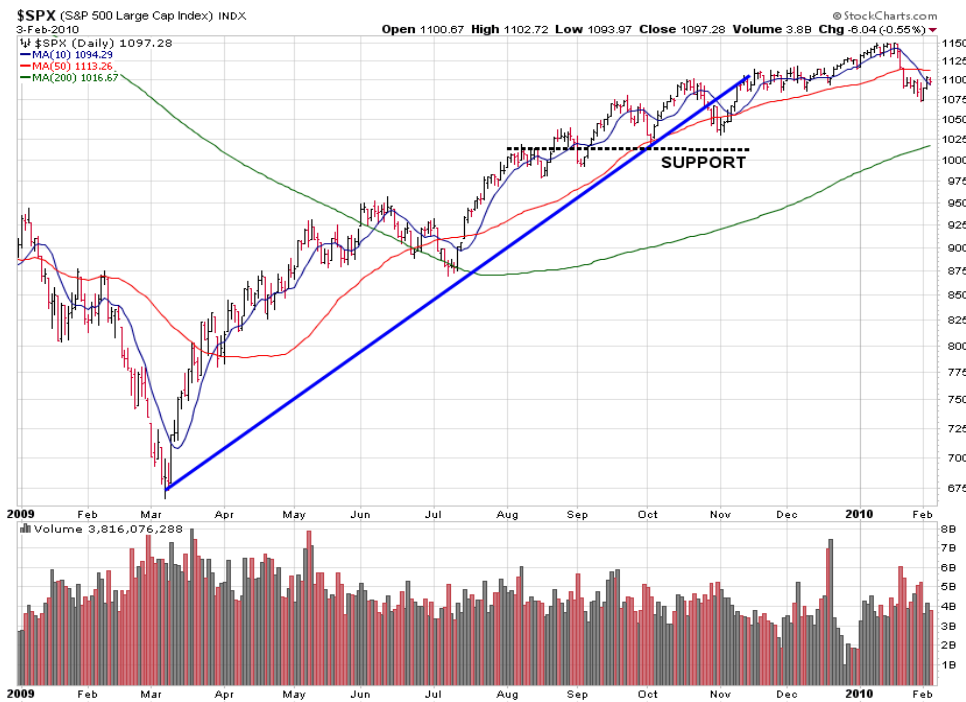
With little internal strength to support the recent rally, I believe we are witnessing a pause before prices fall again. The Dow, S&P 500, and NASDAQ are still below their 50-day moving averages (MA). Until we see the 50-day MA average topped (10,431, 1,113, and 2,229 for the Dow, S&P 500, and NASDAQ, respectively) I will view the recent rally as a consolidation before prices fall anew. Shorting stocks into a market showing great strength is both painful and frustrating, but if prices soon head lower, it will prove to be the proper trade. A strategy that uses the broad market's 50-day moving average as a stop-loss offers great potential return with limited downside risk.

Dow Jones Industrial Average January 2009 - January 2010



Source: Stockcharts.com

S&P 500 January 2009 - January 2010



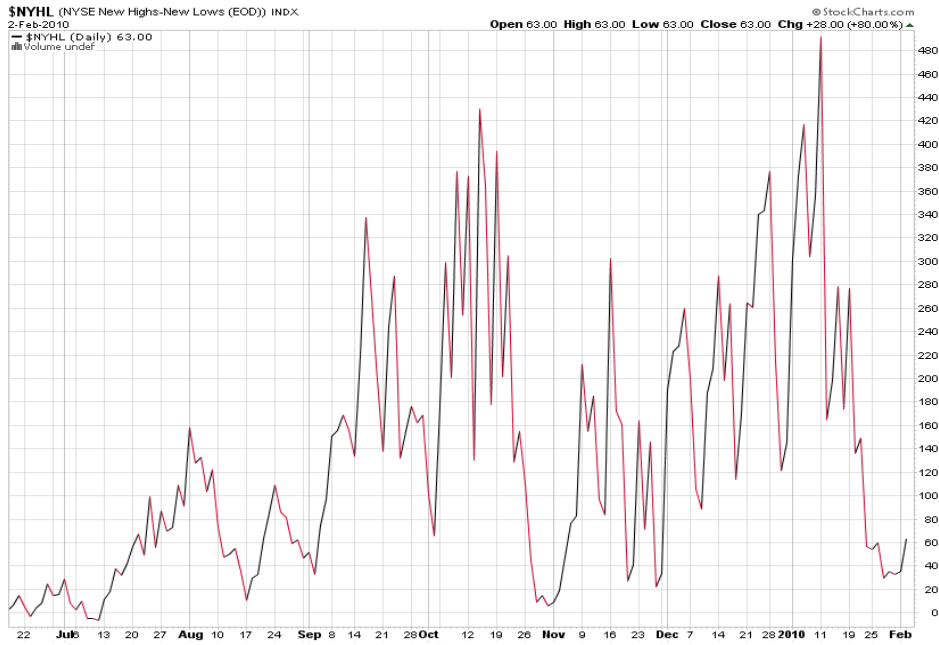
Source: Stockcharts.com

NYSE Bullish Percent Index May 2009 - January 2010



Source: Stockcharts.com

NYSE New Highs/New Lows Index June 2009 - January 2010



Source: Stockcharts.com