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What's Wrong With This Market?

The top in the stock market (which I originally forecast for late August) has not come to pass. Prices have been able to persistently move higher, defying ongoing negative divergences, multiple MACD sells, cyclical turning points, seasonal tendencies, and sour fundamentals. This rally is defying all odds. *What gives?*

The fundamentals continue to deteriorate. The banks persist in reducing loan exposure in an effort to build up their balance sheets, and this process will go on for many years to come. Meanwhile, the government will continue to replace bad private debt with unlimited public debt ... but there is no long term benefit from these stimulus programs. The money has a short term effect, of course, but it provides no lasting benefit. It is a little like borrowing money to cover your bar tab. Once the buzz is over, you still owe the money ... plus interest.

Something that has not sunk into the public mind set is that when the government creates a \$1.5 trillion deficit - and plans to do so at the tune of \$1 trillion a year for the next 10 years - this money actually has to be financed. Someone has to buy the bonds. This is not a theoretical exercise on paper. It is reality. The Fed can and has been monetizing the debt by buying bonds post auction from participating dealers. This is a little underhanded, but it's not entirely obfuscated. There are limits, though, as to how far they can go with this. Someone has to lend the government the money. It will get borrowed, but at what long term cost?

A study by Dr. Peter Bernholz finds that the trigger for the last "12 largest hyperinflations" occurred when the government's deficit exceeded 40% of its expenditures. The OMB projects this number for 2009 at 43.3% and for 2010 at 39.9%. That's scary.

Taxes will be raised, and some states have already increased their sales and real estate taxes. I read in a John Mauldin piece recently that a 1% increase in taxes will reduce GDP by 3% over the ensuing years. The tax man cometh, and he isn't going to help the economy recover.

Besides consumers, small- to medium-sized businesses are being encumbered with higher taxes, so I wouldn't look for any significant help from them going forward. It is business investment by small- and medium-sized firms that is responsible for 85% of the new job creation in this country. Bottom line, the situation is bad, and it's getting worse, regardless of the Dow reaching 10,000.

Looking over the averages, I see some danger points. The S&P 500 must hold above 1,020, and the Dow Industrials needs to maintain above 9,430. Those levels may seem comfortable; and if hit, that would leave 5% or 6% on the table

from current levels. Considering the overly bullish consensus flowing through the markets these days, you need to keep in mind these fail safe parameters. If this market suddenly falls off a cliff, we can't say we didn't see it coming. This is a time to embrace reason over emotion. If you are riding the wave, keep an eye on your back side. The best way to do that is to mind our timing models - Palio and the Nasdaq Slow Tracker. Thus far, Palio continues on a buy signal, as does the Nasdaq Slow Tracker - although the Slow Tracker will issue a sell if the Nasdaq Composite falls to 2,040 or lower.

When the correction sets in, I believe it will be the beginning of the next intermediate leg in the bear market which began in March of 2000 when the Nasdaq peaked at 5,000. Initially, all asset classes will participate in the selling as traders and investors alike feel the present comfort replaced once again by fear. They will sell everything. However, savvy investors and the pros (having already sold) will be ready to take advantage of the weakness. Incidentally, I notice that insider selling has been unusually heavy of late.

The difference will be that these early sellers will initially invest in those asset classes that suffered the least in the past selloffs, and that would be precious metals. The mining stocks did, indeed, get flayed last year, but the metals themselves held up remarkably well. Precious metals and the mining stocks will be the "go to" investment class once the selling begins. I don't expect all that much damage in the metals.

Hold your precious metals. I know you are anxious and feel like you need to jump in and buy more now, but this simply is not the time to do that. Lady luck and emotion are not good investment advisors.

Gold still has the potential to correct to \$950 or less December basis. Remember, this stuff is volatile. A 10% correction is nothing for this market. My critical price point (CPP) for gold is \$985.40 basis December. If gold hits that level, it will assuredly fall further, with \$950 a decent downside target.

The dollar is oversold and overvalued at this point. The key price level that would put our work positive on the Dollar Index is 77.74 on the up side, which is a ways away. If the reversal price is adjusted down, I will note the change in the online updates. Once the market averages turn down, you will likely see some carry trade unwinding as dollars are purchased to pay off loans. This will weigh on gold and crude oil in the short run, but will provide buying opportunities in these sectors.

The heart of the matter may be found in the Dow/gold ratio. This ratio should be at the core of your investment strategy. The ratio topped out at 43.7 in 1999, and it has been falling since. The key to that 1999 top was a shift in relative value and thus in relative performance from financial (paper) assets to tangible assets. Since then, gold has moved from \$250/oz. to over \$1,000/oz. while the Nasdaq has fallen from 5,000 to 2,000. Do you remember that the dot-coms were the new paradigm back then and that the gold bugs "didn't get it"? That is a little like the stuff we are hearing now about the new bull market in stocks.

The Dow/gold ratio is currently 9.50 after moving up from a low of 7.00 last March. At 9.50, we are not at the bargain level in tangibles any longer. There are higher prices ahead for commodities, but this is not the beginning of the bull and careful buying is important. You will do better sticking with your commodities until the Dow/gold ratio falls under 5. Ultimately, it will fall to 2, and then we can talk about a new bull market in stocks.

What to do. I believe that energy investments are not at a low risk buy point here, although they are looking very good for the long term. Hold you energy positions and wait for a better place to buy. Hold your commodity-advantaged assets. It is not the time for long term tangible asset investors to either buy or sell. I think we will see an excellent buying opportunity for the metals by Thanksgiving. Wait for it.

If you have a mind to trade, don't convert your long term investment positions into trading positions. If you want a decent trade, buy **ProShares Short S&P 500 ETF** (SH-NYSE-\$54.29) on a buy stop at \$58.50. That is, if SH trades up to \$58.50, you should buy. Once the trade fills, we will have a sell stop for you on the Tuesday and Thursday updates.