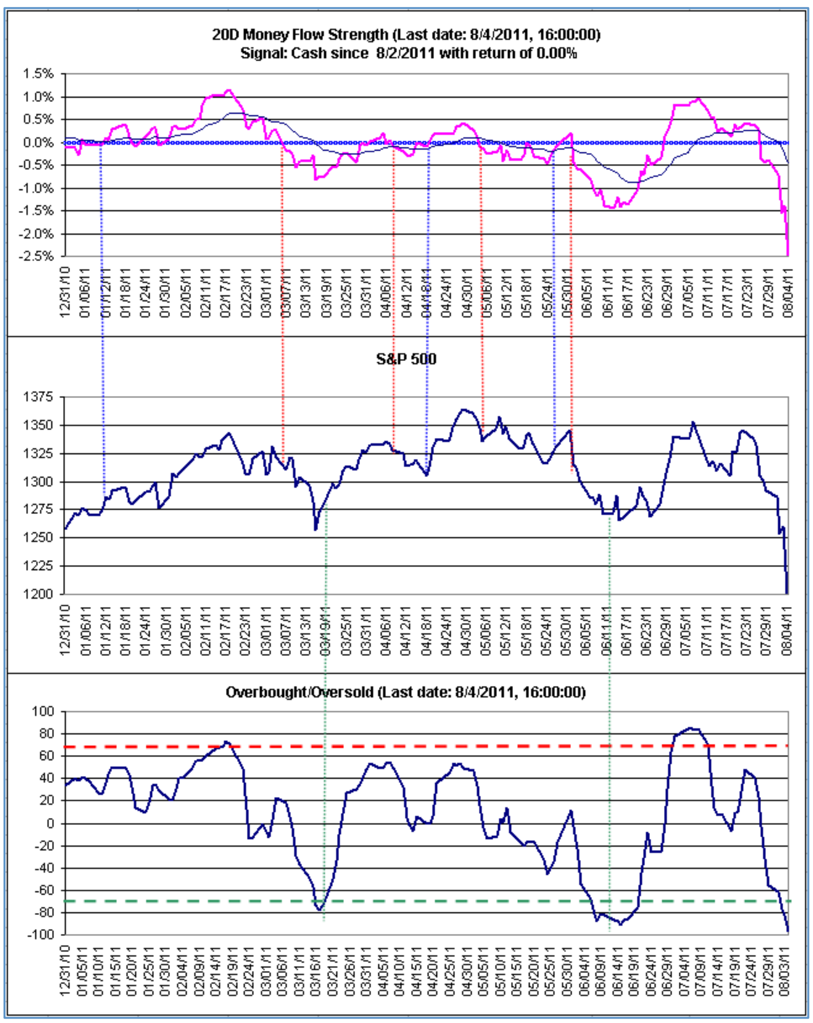
<u>Weekly Review: 8/5/2011</u>

By Eric Coleman

Sometimes, only heightened situational awareness coupled with discernment and experience, prepares one for the carnage experienced this week. Ultimately, clues from the 20-day MF late last week and early this week hopefully kept forum participants in cash, lightly exposed, or short over the past several days. As Billy noted, capital preservation in such periods is critical. Besides, not being part and parcel of such selling keeps one's mental energy available for deployment when opportunities eventually arise.

If there were doubts about Mike Scott's low road scenario, then most have vanished. The failure of positive technical follow-through in some of the healthier issues showing signs of early accumulation or pocket pivots was an early warning sign that the legs of any potential up-leg were quite brittle – on the verge of being broken.

The first market cycle I experienced was the bear market that started in 2007. I cannot predict the extent to which the current cycle may delve, but I interpret the selling wave experienced this week as a sign of more weakness to come. Given the potent selling, a bounce or short-covering rally should be expected; nonetheless, enough evidence has mounted, to suggest a deep correction that could morph into a bear market.



<u>Effective Volume</u>:

Money aggressively moved out of the market this week. One sees here that new shorts are significantly more risky, as the probability of a technical bounce is now quite elevated; however, a final capitulatory selling wave is not out of the question – an event that day-traders may find lucrative.

Money has moved out with such vigor that the recent selling wave does *not* constitute a pullback. The severity of the decline leaves the market in a position for an eventual bounce that could be rather violent. The sustainability of any bounce is highly questionable, though, and in this participant's view, likely to fail.

A bounce can occur within a new intermediate-term downtrend. An objective perspective of market structure is revealed by a review of both weekly and daily market stages.

Weekly Stages Table: 8/5/2011

SPY	Current Weekly Stage is 3-1 (Early Distribution) Has been in the current weekly stage for 6 week(s)
QQQ	Current Weekly Stage is 3-1 (Early Distribution) Has been in the current weekly stage for 7 week(s)
DIA	Current Weekly Stage is 3-1 (Early Distribution) Has been in the current weekly stage for 3 week(s)
IWM	Current Weekly Stage is 3-1 (Early Distribution) Has been in the current weekly stage for 6 week(s)

Failure of the weekly sub-stages to more quickly revert to any early accumulation mode is disconcerting. While the 3-1 early-distribution sub-stage leaves open the opportunity for longs and is neutral to slightly bullish, the daily stages indicate that the current weekly structure may ultimately resolve to the downside.

Daily Stages Table: 8/5/2011

SPY	Current Stage is 3-2 (Mid Distribution) Has been in current stage for 2 day(s)
QQQ	Current Stage is 3-2 (Mid Distribution) Has been in current stage for 1 day(s)
DIA	Current Stage is 3-2 (Mid Distribution) Has been in current stage for 1 day(s)
IWM	Current Stage is 3-2 (Mid Distribution) Has been in current stage for 3 day(s)

Given the sharp declines, any possibility of recovering into more bullish stages without first visiting the even more bearish stages, is a low probability bet.

Late Stage Failed Bases and Vulnerable Leaders

A material concern highlighted in my last report was " . . . *the spectacular earnings collapses witnessed during the past week.* " While other technical indicators gave ominous signs, that sucking sound that accompanies any liquidity crush coinciding with earnings is extremely bearish. The prevalence of such negative reactions, though, is what truly distinguished this earnings season from others more recent.

Charles from The Kirk Report recently highlighted the masses that are still hiding in some of the remaining leaders – AAPL, LULU, and GMCR to name some of the few that are still standing, albeit on shaky ground. My stance is that the current correction will not resolve to the upside until deeper sell-offs hit these remaining targets. Given the late-stage moves of each of the issues mentioned above, the probability of severe sell-offs, especially on any disappointing news, increases each day.

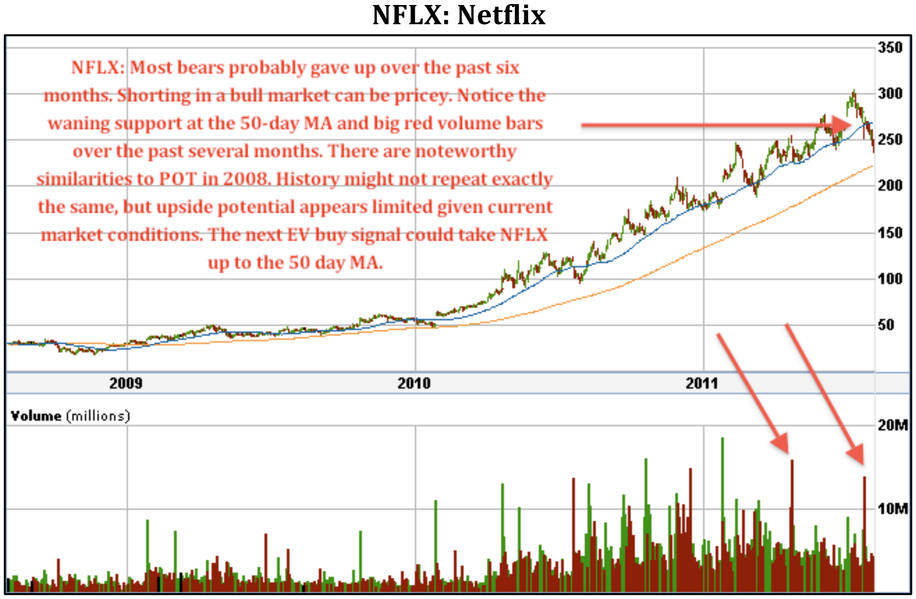
Some stocks form long and grinding tops that oscillate between overbought and oversold readings for months at a time. A positive market backdrop may prevent such stocks from entering strong decline stages, as market breadth may be supportive enough for a top to evolve into a range rather than outright liquidation.

With this in mind, I highlight POT as a precedent from 2007/8 that offers insight into potential scenarios for some of the last leading stocks. A primary difference between now and 2008, though, is that the severity of the selling may be less exacerbated. Of course, the market may prove otherwise and daily analysis and observation is critical.

POT: Potash of Saskatchewan 2008

If we are indeed in a bear market, then some of the bull market leaders have potential to witness similar fates. On the other hand, liquidation in 2008 was so severe that such declines may not be as orderly or rapid. Nonetheless, troublesome signs are emerging for recent bull market favorites:

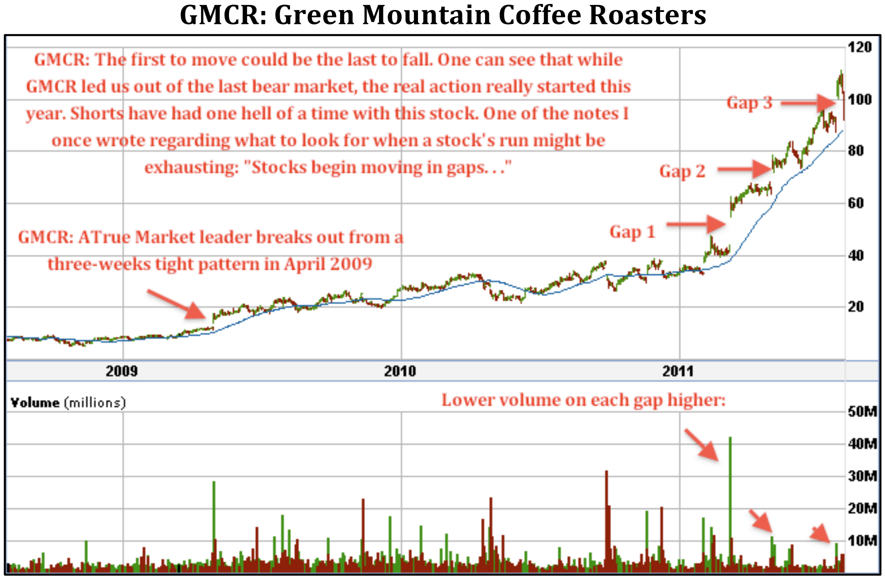
NFLX: Netflix



FOSL: Fossil, Inc

LULU: Lululemon Athletica

GMCR: Green Mountain Coffee Roasters



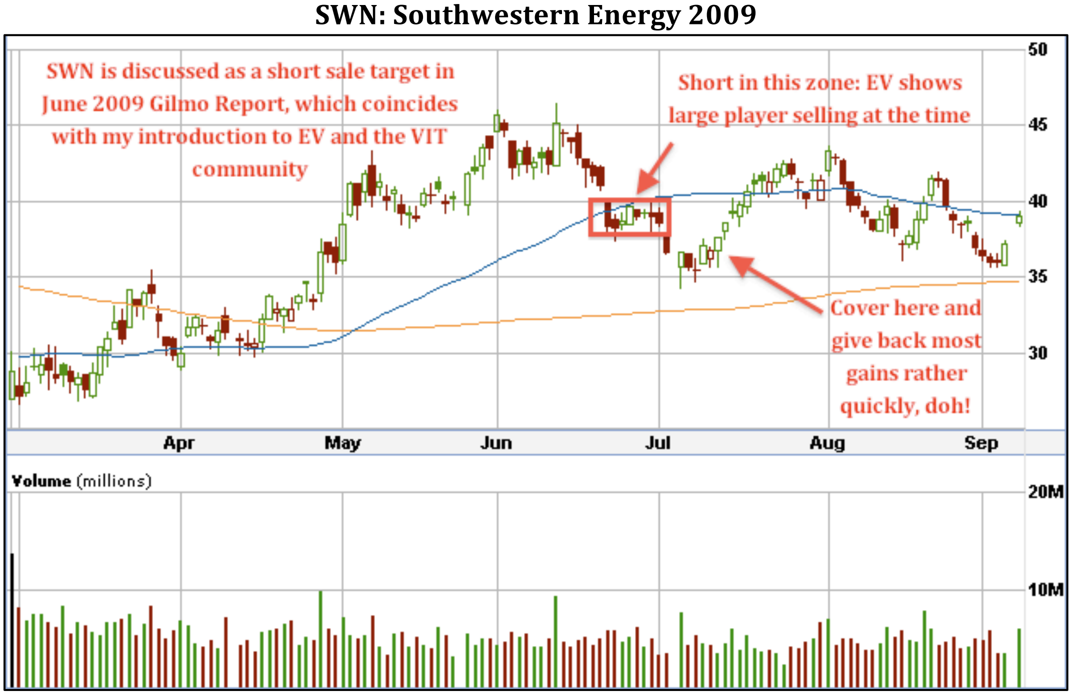
AAPL: Apple Computer

Short Setups and Lessons:

For those who have not perused the extensive Value in Time Archive, I share below some valuable feedback that Mike Scott shared when I asked some questions about my first short sale in June 2009 of SWN:

Typically I try to hold short positions for around 20% gains and then quickly close them. This statement needs more explanation. First I don't like to initiate a short position that doesn't have an expectation of 20% profit, that expectation is based on the following rules . . . Second, have a price level that you will bail out at . . . Third, cover short positions when they undercut a prior low . . . Fourth, cover short positions when the price undercuts a major moving average (50 or 200). This would be the 200 around 32.5 in the case of SWN. Fifth, cover all short positions if the market confirms a new rally.

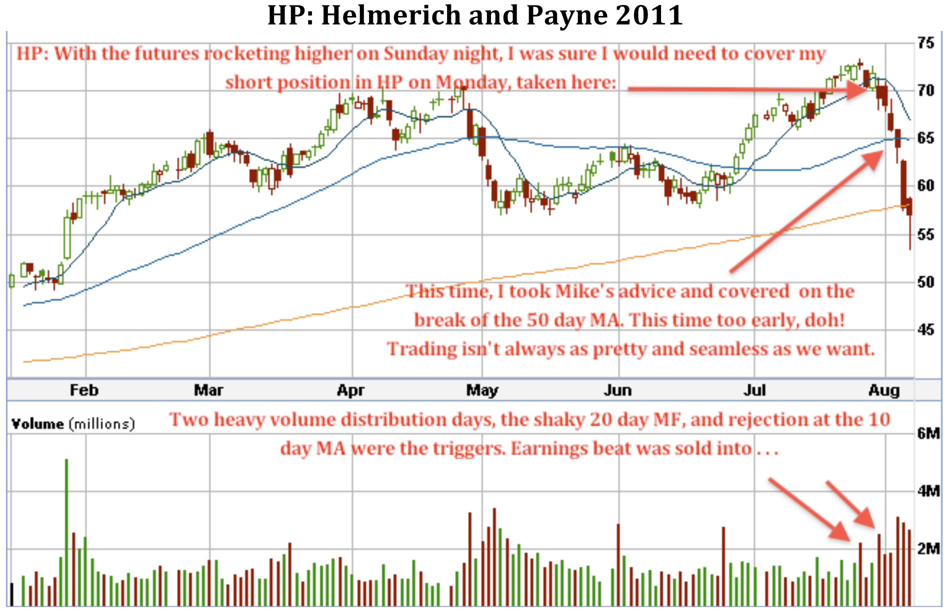
SWN: Southwestern Energy 2009



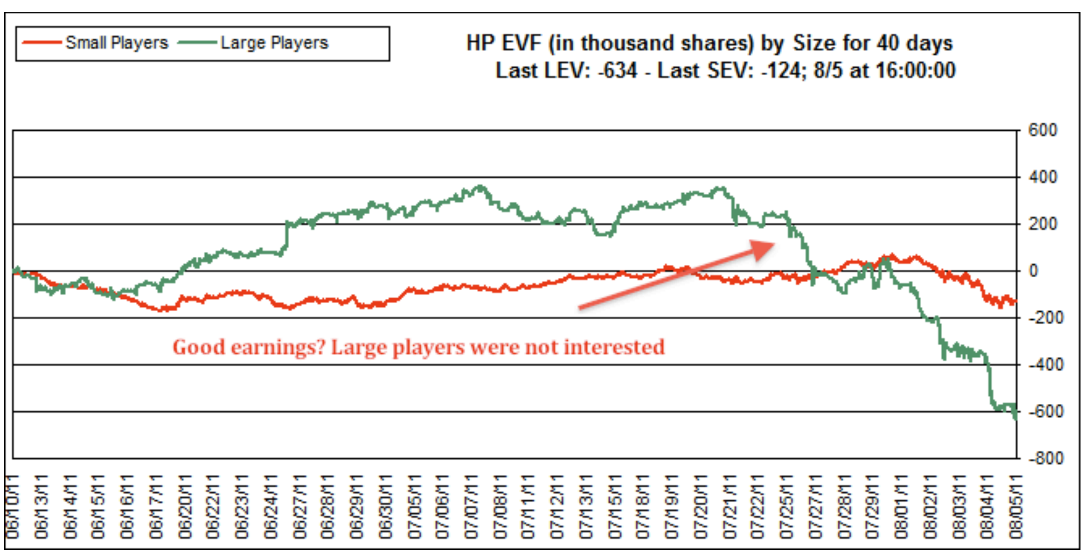
What one sees is that short-side gains might quickly evaporate; therefore, covering into selling waves helps preserve open profits and protect against losses. One lesson that I learned is that profit targets must be fluid in such discretionary setups. My anticipation of an undercut of the 200-day MA turned a good and profitable trade into one that was merely "scratch." Nothing in the market comes easy.

This week, a short sale of HP shows that I covered too early. The experience and practice is crucial, though. Ultimately, bear markets require quicker action and therefore, cash or tactical short positions with clear rules for when to cover remain necessary.

HP: Helmerich and Payne 2011



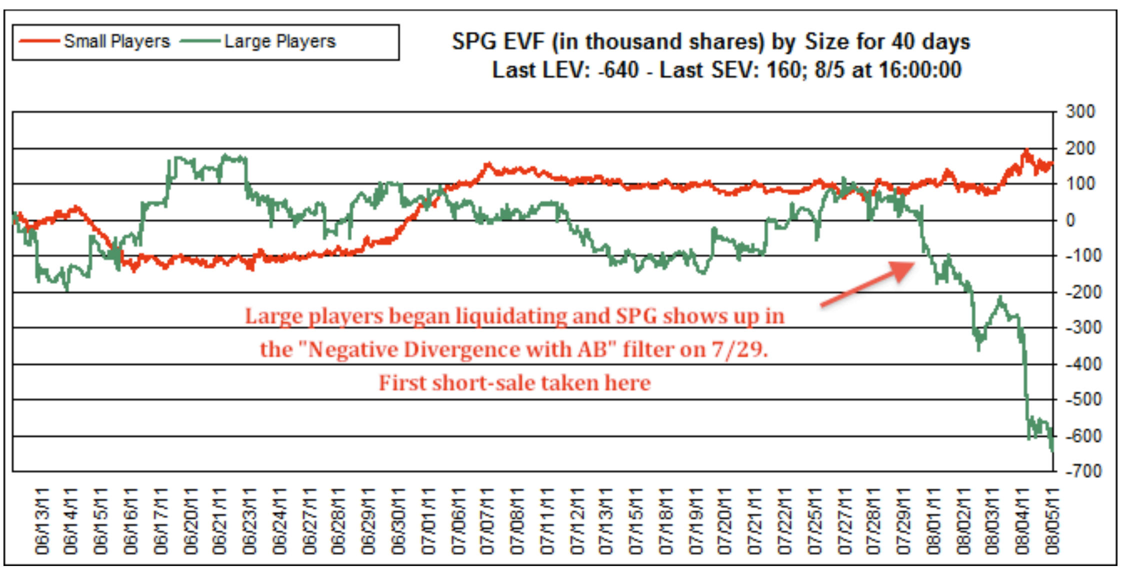
Effective Volume shows large players liquidating as early as last week . . .



Some of the leaders discussed above will obviously be placed on short-sale watch. A few caveats to pay attention to with any short sale that might be taken are the size of the company, the date of an earnings release, average volume, and float. No one wants to be caught in a takeover or earnings squeeze. Highlighted below is an evolving short-target that I will likely revisit in the coming days and weeks ahead

Here, SPG finds little support at the 50 day MA. The market is starting to go into liquidation mode and price careens toward the 200 day MA. If SPG was running on bull market fumes, then any attempt to rally will likely be rejected on a sharp bounce to the 115 zone; however, such damage might simply result in a sideways "ledging" type of move. One characteristic seen in many stocks that have recently broken down is an inability to rally much beyond the lows of the selloff.

Large players do not support SPG since last week, after appearing in the *Negative Divergence with LEV* scan:



RVBD highlights the way market conditions affect a short sale. Notice how the previous 20 day MF buy signal took RVBD on a nice 25% rally from the lows of the prior range. At that time, the market was still catching a bid and RVBD had one last gasp. Mike Scott highlighted RVBD as an example of using P/E expansion to determine price targets and his analysis was on the spot. A key trait in bear markets will be an inability to rally, or very v-shaped moves that are immediately turned back. EV reveals if large players are buying and/or covering. RVBD chart highlighted below:

Finally, I reviewed a passage from an essay written by Pascal in 2009. This passage remained at the front of my mind when Monday's opening gap began losing steam. From his article titled Monitoring a Buy Signal Using the 20-day MF written in October 2009:

The previous 8 occurrences where we touched this sweet "-65" oversold line were not the signal to "buy all you can," but to "stay short all you can," because from those points you would have another 2-3 days of nasty selling in front of you.

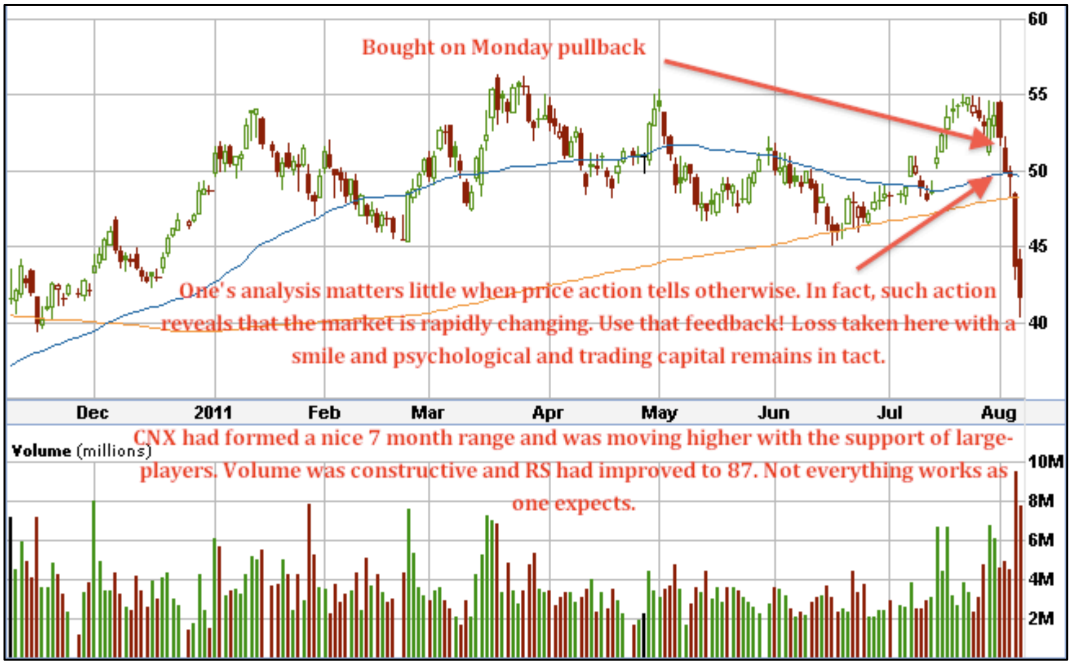
In other words, when the market is oversold and money is aggressively moving out, there is little need to step in front of the freight train of sellers. In fact, when the initial turn down begins picking up steam, there is likely a vacuum of buyers and short selling can yield significant profits.

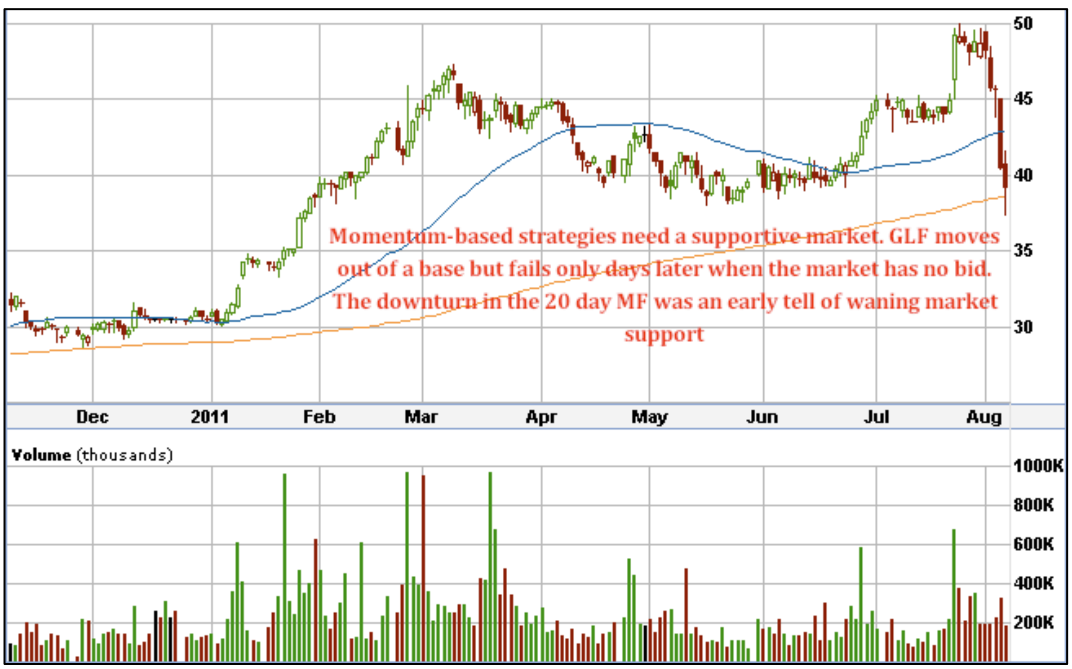
The above examples highlight a few important facts:

- Shorting is a different game than going long
    - Profit targets are essential and Mike's advice highlights a few ways for determining when to cover a short position
- When the market is catching a bid, shorts can often turn tail, which is why monitoring the status of the 20 day MF is critical
- A move toward oversold levels often confirms the short stance. When the move accelerates into levels such as those seen this week, then covering is prudent. In fact, early signs of an aggressive selling wave are revealed by a sharp move downward whereby shorts might be held into any vacuum of demand.

Reviewing Some Recently Highlighted Stocks:

Especially when one is trading discretionarily, the need for stop losses or daily monitoring of a position with an exit plan is crucial. Almost all stocks discussed recently fell victim to the selling. A couple examples are discussed below. First, review CNX, which was a position I exited when the original analysis miserably failed. Last week, CNX appeared on the verge of moving out of a well-defined range. Large players were buying the previous week and volume was encouraging; however, the general market easily overwhelmed these positive traits. CNX reinforces the utter necessity of quickly taking action when an expected outcome does not materialize.

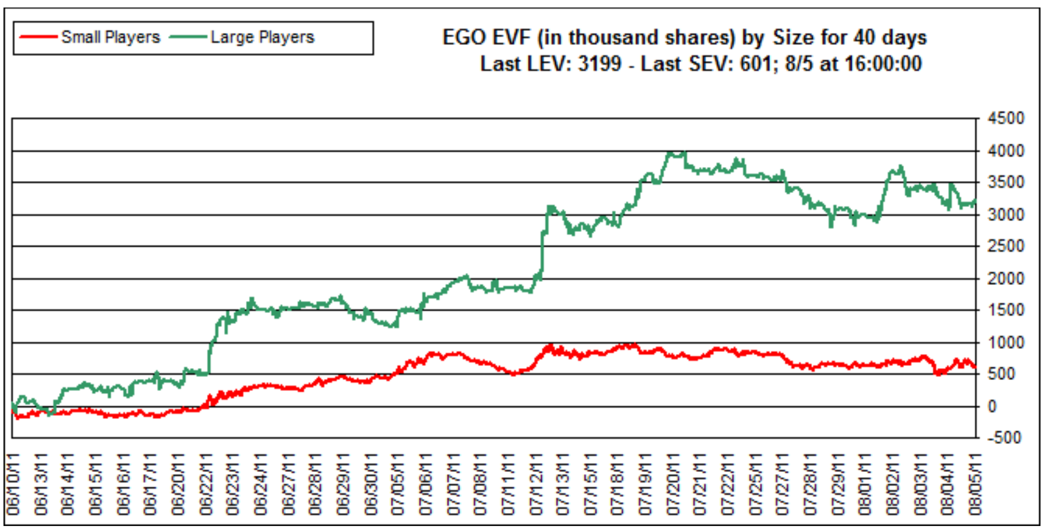




A discretionary investor/trader must be willing to forgo their analysis when price confirms otherwise. Of course, that is why some move toward a mechanical strategy. For a trader, using one's positions as feedback is crucial for taking swift action.

One market wizard we knew was famous for addressing the situation by saying to himself, "isn't this interesting?" and then proceed to quietly observe the situation unfolding, taking any needed action in the present. – Trade Like an O'Neil Disciple page 336

Most stocks that were showing interesting action as revealed by EV, as well as some technical improvement such as pocket pivots, are now very damaged. The only one I find that has held up relatively well is Eldorado Gold, EGO. This is not surprising given the surge in gold that coincides with amplified uncertainty.



Gold has been a safe haven, and I find it difficult to determine whether a parabolic move or vicious pullback is the next move. For now, waiting for the next EV Gold Stocks buy signal is the prudent course of action.

Conclusions:

The market finally revealed itself last week in a dramatic fashion. The 20-day MF shows that bounce is possible given the extent of recent selling, yet price action confirms no such scenario at the current moment. The weekly stage structure remains in a 3-1 early distribution phase, but the daily stage structure for the major index ETF's confirms the transition to a bearish mode.

Numerous leaders maintained some semblance of support until the end of the week. Such leaders are amongst the most vulnerable stocks in the current market, characterized by late stage bases and price receiving little buying interest at important moving averages. Leaders that led the way higher are not immune to selling and may setup on the short side. Clues of a major top will be swift rallies into resistance that stall in their tracks. Others may simply gap down and ledge sideways for a few days before heading lower, evidenced by stocks like RVBD and TZOO. Anyone that witnessed the selling of 2008 knows that years of hard fought gains can evaporate in a matter of days or even hours.

A review of the Gold Stocks sector shows few buying patterns of interest, although some remain above their respective 50 and 200 day moving averages. These include EGO and GOLD, but no buy signal has been issued, thus patiently staying on the sidelines while monitoring the unfolding situation is an appropriate strategy. When the market landscape provides more clarity, there is no doubt that a buying/covering surge could produce a significant bounce, if not a bear market rally.

When a bounce finally does materialize, the stocks with the worst RS will likely move higher on serious short covering buying; however, there currently appears to be a dearth of catalysts. Before QE2 was announced, healthy basing patterns were developed that were fuel for the rally. I see no such patterns suggesting that QE3 could launch a rally the likes of what was witnessed last year. Too many stocks are bruised and broken, or they have had impressive runs without the consolidation necessary to support higher prices. I'm going to pay particular attention the precious metals sector over the coming days. A sharp descent into the abyss has the possibility of attracting large players, which is something I will monitor.

Nonetheless, a bear market rally could eventually get underway, but the price hints that such a possibility is likely some days or weeks from now. For a more aggressive trader able to move intraday, selective short sales might be considered. Otherwise, cash and preservation of capital is of utmost importance, while one awaits the next buy signal. I highly recommend a review of Aly Khan Somani's CSI analysis, which provides a succinct overview of possible scenarios that may evolve over the course of the week based on various sentiment indicators, which are reaching extremes. A low probability scenario, though one I consider possible, is an outright crash whereby all indicators are rendered useless – one mustn't dismiss such a possibility . . .

To finish, I share a passage from a non-trading book called <u>The Rock Warrior's Way</u>, whose lessons translate well for trading. In times of uncertainty, reminding ourselves of the process is essential.

First, accept that life is hard, and that transforming our life – our abilities, which amount to much the same thing, is very hard. For a thousand reasons, we all have a part that wants to believe that the world was made just for us, and that the pearls of existence are our birthright. In a sense, they are – but we must dive deeply to find those pearls – down past our resistance and mechanical thinking and behavior, and that always involves hard, sustained, conscious, and disciplined effort. Few stumble across those pearls by fluke or good fortune, and if they do they typically lose them just as fast.

Second, the work is a process, and that process lasts a lifetime. Every time you gain a new plateau, a massif of unrealized potential soars above you. In this sense, you never "arrive" on the mountaintop once and for all . . . That leads us to the third and most important point: the qualities you bring to game day will be the exact same qualities you cultivate during practice.

When we start pushing the envelope our most entrenched habits almost always take over. How could it be otherwise? When the river runs smooth, we're all heroes. Only when the big water starts to roar can we find out where we stand and what we're made of. And the key word here is "made." What have we made ourselves?

- Arno Ilgner, <u>The Rock Warrior's Way</u>

Best to everyone,
Eric Coleman