

Client Bulletin

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July 21, 2010

THE DEATH CROSS

What an expression! *The Death Cross* is an investment term used when the S&P 50 day moving average crosses down below the S&P 200 day moving average (ma). See the below chart where the 50 day ma line moves below the 200 day ma line. That is the Death Cross and it occurred on July 1st.

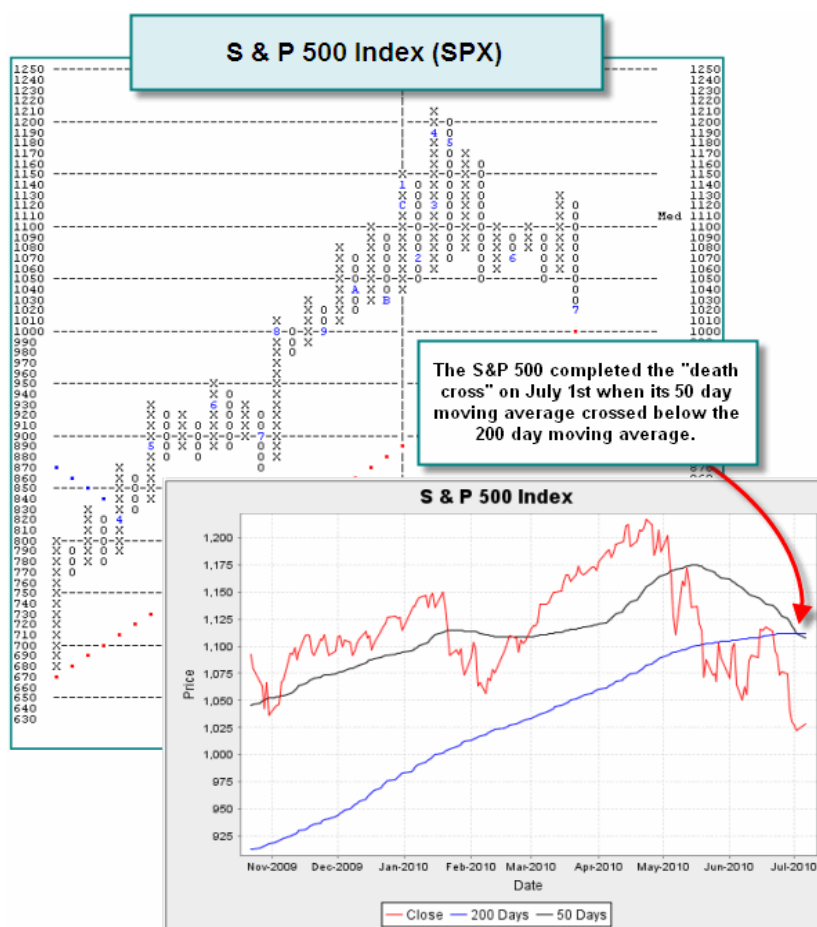


chart courtesy of Dorsey Wright & Associates

What's a moving average? A moving average is a way of depicting in chart form, and smoothing out (by arithmetic averaging) the price movement in a security, a market index, or for that matter anything that fluctuates quantitatively over time. Moving averages are calculated and charted for a specific period of time (e.g. 200 days). A 200 day ma is updated every day using the past 200 days thus the term moving. Two or more time periods are chosen so that you will graphically see when short term conditions are beginning to change relative to long term conditions. In other words, when a shorter-time 50 day moving average crosses down through a 200 day moving average it means that recent conditions have changed and changed for the worse. Vice-versa, if the 50 day moving average had been moving along under a 200 day moving average and then crossed to the upside, that would indicate that recent conditions are changing for the better. The unknown always is that we never know for sure when the short term is going to turn into the long term until after sufficient time has elapsed.

The expression *The Death Cross* obviously suggests something bad has happened and portends trouble ahead. In fact when looking at its history, by itself it is not a reliable or for-sure indicator. In other words, despite the emotion-filled phrase, sometimes bad things follow and sometimes not. Using statistically or empirically-based indicators is never a for-sure thing. They help stack the odds in your favor but we never know which way the odds will play out. (continued on next page)

That being said, most of us I believe would rather have the odds stacked in our favor.

One of our main supply-and-demand indicators has also just recently moved from an offensive or wealth accumulation mode, to a defensive or wealth preservation mode. Another set of indicators, specifically, relative strength indicators, have been signaling since May that the two top-ranking asset classes in terms of relative strength are cash and fixed income. That has not changed and suggests that an overweighting should be assigned to these asset classes (cash and fixed income) over domestic and international stocks, commodities, and foreign currencies. What's basically happened is that more of our indicators have aligned to emphasize caution in terms of stock, commodity, and foreign currency investing. In essence, we're in a wealth preservation stance.

That does not mean that we pull completely out of the equity and other markets and go completely to cash and fixed income. It does mean that we reduce exposure, place more of our assets in safer havens, and also place emphasis on stocks that generate and grow their dividends. That investment strategy for equities will pay dividends over the short term while giving the equities time to realize expected capital gains over the longer term. At the same time we adhere to a disciplined exit strategy on all of our securities. While doing these things we continue to build a watch list of strong investment candidates to buy at a good price point as the reward/risk situation improves.

One of the dilemmas right now is that high quality fixed income securities generally are paying very low returns. Moving significant assets into fixed income securities such as treasuries or corporate bonds may seem like a safe move but if interest rates go up the investor could lose on both ends. In a rising-rate scenario, the investor could watch the value of fixed income securities go down and also could be getting less income having locked into lower rates. A laddered strategy in fixed income investing by staggering the maturity dates is as usual an important strategy to consider.

Some stocks are generating good yields but if the stock market deteriorates further from here those same stocks could be purchased at a lower price with a higher yield. Even if we expect that the stock market and those stocks will deteriorate in price, the investor would still get paid while waiting for the stocks to cycle up in value as the company prospers and the market recovers. I want to emphasize that there are never any guarantees with regard to stock prices or stock dividends so it's important to be comfortable with the financial strength, long term business prospects, and governance of the company itself and to continually monitor individual issues and have that exit strategy in place to keep small losses from turning into large losses.

Currently there is fundamental and technical evidence of more systemic risk and downside in the equity markets. As I've mentioned many times the employment situation is critical to future economic conditions. Several factors will affect employment. Health care policy, the upcoming financial reform policy, tax policy, and energy policy are all key factors. When settled out and better understood and integrated into private sector economic decisions, these key policy areas will shape the future in terms of employment, economic growth and capital market performance. The door therefore, is currently open to a great deal of short term uncertainty and risk irrespective of asset class other than cash. Even with cash there is risk that other asset classes will surprise and move rapidly to the upside leaving those holding cash, holding the bag, so to speak. *(continued)*

Our assessment for some time has been that a reasonable valuation for the S&P 500 should range between 900 and 1,000. *Should*, however, whether right or wrong, does not matter with the stock market. It can and does fluctuate to extreme overbought and oversold valuations and no one with any consistency can predict where it will go over short term periods.

To sum up, we are currently in a defensive or wealth preservation posture. That does not mean that portfolio values will not fluctuate. If the market goes down portfolio values will also go down to the extent they have exposure to the market. That is why dividends are important and also why patience and a longer term perspective is important. Right now, the overweight emphasis in most of our portfolios is in the cash and fixed income asset classes. In most portfolios we also hold modest positions in dividend-generating equity securities, precious metals, and natural gas. Along with all other asset classes we also monitor the US and foreign currency situation so as to consider taking advantage of that asset class as opportunities arise.

In line with our investment management mantra, *First Do No Harm and make Money** (please read the footnote) we continually monitor and adjust our portfolios when our fundamental and supply-and-demand research and analysis suggest that adjustments are in order.

Given the ups-and-downs in the markets and the uncertain fundamental economic situation, and the recent change in one of our main supply-and-demand risk indicators, this Client Bulletin, a supplement to our Newsletter, is intended to help keep you informed and updated.

*There is no risk-free investment! Investment portfolio values fluctuate and past performance is never a guarantee of future results. "Do no harm" translates into structuring and managing an investment portfolio to conform to a client's investment objectives, risk tolerance and time horizon. Proactive asset allocation, both diversification across and within asset classes, and continual monitoring and risk management of each position are methods we use in structuring and managing portfolios. Our tactical asset allocation approach includes corroborating fundamental research, with capital markets supply-and-demand research, also called technical research. At times we will use conservative hedging techniques to limit downside risk.