

Client Bulletin

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INVESTMENT SITUATION: ON THE DEFENSE in BAD FIELD POSITION

The November newsletter, *Rocky the Sea Monster*, was going beyond the point of brevity so I decided to cut it short, and write this separate bulletin covering our current market assessment.

Several weeks ago on October 28th our two supply-and-demand main market indicators turned defensive and put us into a wealth preservation mode. Specifically both our NYSE (about 2,800 stocks) and our world index (about 20,000 stocks) indicators flashed warnings that we were back in a defensive mode. I might add that this also happened in July. That July episode turned out to be a head fake in which we lost some value and also some opportunity, to the extent that we had reduced exposure to market risk. Our downside risk then was a 15% further loss. In any case right now our two main indicators are again suggesting increased risk and therefore increased caution. This is based on our supply and demand research. Specifically 6% or more stocks on each of these indices, NYSE & our world index, gave new sell signals.



If the market moves down there are several floors of support on the downside. Using the S&P 500 as a guide, about 1100 as I write, its support levels are roughly at 1055, then 975, and then 925. If the rally continues, the upside could be 1200 or higher. Most markets remain in a positive trend even with the defense being on the field.

Our fundamental research has been flashing many positive signs of recovery. What however remains very bothersome is that the alleged recovery is primarily based on public sector spending, and corporate earnings. Public spending, still flowing into the economy, and bailouts can't continue as they have. Corporate earnings are largely a result of layoffs, cost cutting, and high productivity numbers. With continued unemployment and weak consumer spending, future corporate earnings are suspect. Credit for small business, that typically employs more than half our workforce, is still log-jammed. Also, banks continue working under loosey-goosey accounting standards. A few months ago in *Temple of Doom* (September 2009 newsletter) I talked about facades. In my view, we still have a façade problem on many economic and investment fronts and the stock market has soared in spite of it.

We are at the beginning of a second wave of home mortgage resets (this time Alt-A and option ARM's) that are being accompanied by increasing unemployment. This new wave of new problem mortgages (the toxic sub-prime mortgage problem remains a messy work in process) coincides with an enormous backlog of foreclosures yet to be figured out. While the original sub-prime problems were geographically concentrated in CA, FL, and NV, mortgage problems are now becoming more geographically dispersed with this new wave of foreclosures. Combining increased unemployment with the new wave of residential mortgage resets suggests continued and more geographically-spread economic headwinds. Yes there are still serious problems underlying the economy and the capital markets.

Global central banks have been flooding the system with liquidity and that I believe is part of the reason for the markets' stellar rise. Also, the *weak dollar* is attracting foreign investment in our equity markets since they can buy our securities at an attractive price given the strength of their currencies.

Some central banks have already begun tightening. A skittish investor community when it begins to expect a tightening of rates could bring the equity markets tumbling down as fast as you can blink your eye – well maybe not that fast – but you get the idea. *(continued on next page)*

(continued) Are we facing imminent small scale attacks on the home front by Al Qaeda groups? I hope not but if it happened it would play havoc with many aspects of our lives including the economy and the markets.

Given the above food for thought let's look specifically at the realm of investing and what we are doing in our efforts to be wise and prudent stewards in our goal ***"To do no harm and to make money"**** (please read the footnote). First, I'd like to reiterate my premise that "To build wealth through investing is not so much chasing high returns as it is avoiding large, hard-to recover losses."

If the current economic and world environment is jolted, the markets could tumble down very rapidly. We have not yet seen a serious test of the March lows, and historically, retests of such lows are normal events. Trying to determine the when with any accuracy is folly. But retests of lows should be expected as a normal happening and that has not yet occurred with respect to the March lows.

I recently spoke to a new friend who had pulled out of the markets at a substantial loss in the turbulence of the 2008 meltdown. Her comment to me was that she had no idea what to do with that money in terms of investing it. And I believe that her sentiment is easy to understand and can also be multiplied by millions of people who have lost trust and confidence in the system, and are very confused as to how all of this mayhem will turn out.

Going whole hog in one direction, *being fully invested*, **or** in the other direction, *being totally out of the market*, *does not have to be the only answer*. Our approach, primarily because we still see a disconnect between public-domain fundamental research and our technical or supply-and-demand research, has been to err on the side of caution. That means we remain invested in equities, but also have some powder dry in cash, foreign currencies and other assets not correlated to equities. We recognize that we are sacrificing opportunity but believe it is the prudent move, given the level of risk. A rapid downturn could quickly erase gains before protective action could be effected. In a nutshell, our rationale is to have some market exposure to participate in the upside, and some money on the side as a cushion in case of a rapid downturn.

Reiterating, about two weeks ago on October 28th our main technical indicators put us on the defense. Who knows how it will turn out, but for now we are on the defense. We had been at a high level of risk before going on the defense (Oct 28th) and at that high level of risk had put tight stops on our positions. Many of those stops hit and were liquidated during the ups and downs of October. That is the reason you may have noticed sell confirmations in October. It was a normal part of our risk management process.

As I write this, many indices and securities have again moved toward or above their recent October 19th highs. Remember however, that most indices are still well below their highs of October 2007. Divergences are occurring here. In other words, some indices and some securities are moving above those October highs and some are not. The indices and securities moving above the October highs are areas of strength that we want to consider if conditions change and suggest more upside to this rally. We have identified those strong areas and will make appropriate moves into those areas of strength if we see demand regaining control to the point that we move back to a wealth accumulation posture.

To sum up, we are on the defensive in wealth preservation mode, and given the high level of risk both technical and fundamental, we believe that the prudent course right now is to remain partly invested in equities and partly on the sidelines in cash and other asset classes not correlated to the equity markets.

We have also identified and continue to identify areas of strength in which to invest as conditions change back to a wealth accumulation posture.

*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 risk tolerance and time horizon. Proactive asset allocation, diversification within asset classes, and continual monitoring and risk management of each position are methods we use in structuring and managing portfolios. Our 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.