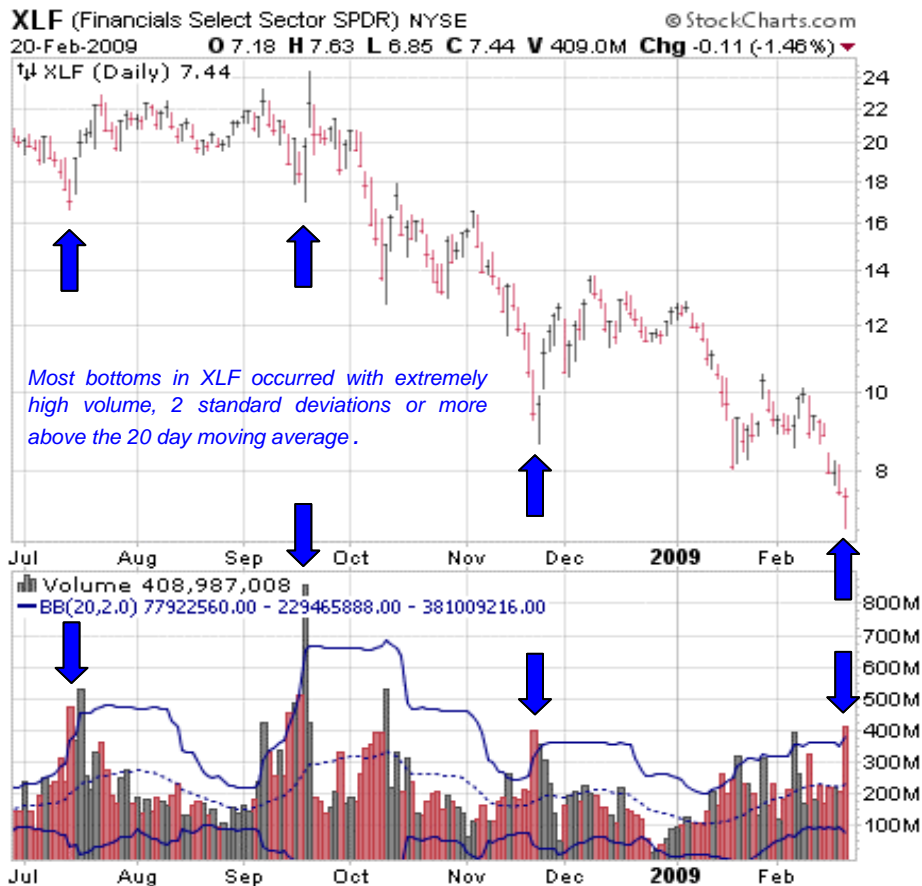




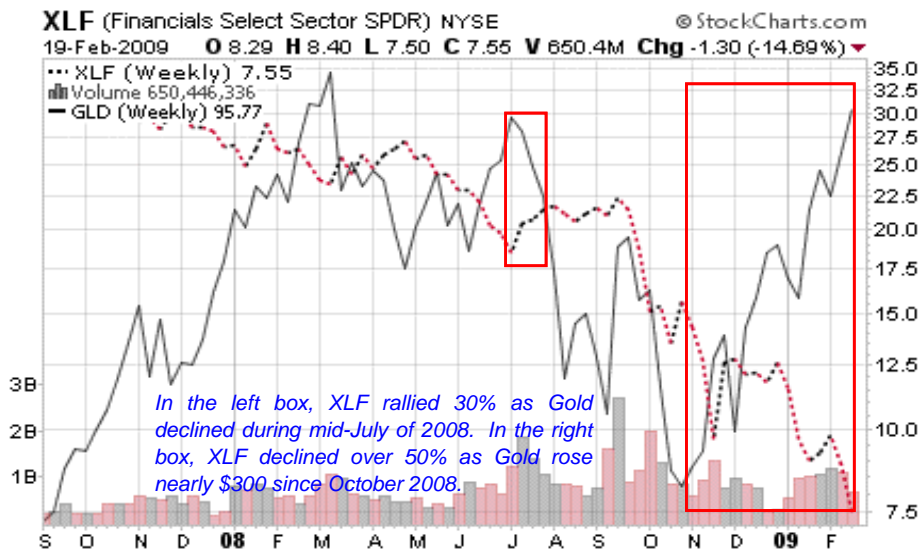
OUTLOOK

"The Uncrowded Trade: Long Financials"
2/19/2009

Financial stocks have been completely annihilated as they are getting hit by a relentless barrage of bad news. At first, it was revelations relating to subprime mortgage exposure, off-balance sheet positions in complex debt obligations, and then write-downs on assets that have been marked down to lower than expected levels. The end result has not been pretty. The combined market capitalization of the ten largest financial-services companies in the S&P 500 has now declined to \$298.6 billion from a peak of \$1.249 trillion in late October 2007. In addition, XLF, the most popular financial ETF, has been hammered over the last few years as it had negative returns of -19.17% in 2007, -54.91% in 2008, and is already down over 40% in 2009.



When will the bleeding stop? We think a short-term rally is in store for financials given the extreme fear in the financial sector and divergence between the financial sector and Gold. Signs of fear in the financial sector can come in many different forms. One thing that caught our eye was the extremely high volume of XLF on Friday, 2/20/09. On that day, the volume of XLF surpassed 400 million shares which was over 2 standard deviations above its 20 day moving average. By looking at the first graph, you can see that most bottoms in XLF coincided with a surge in volume, 2 standard deviations or more above the 20 day moving average. Extremely high volume can serve as a sign of capitulation as investors sell their positions en masse and run to the exit doors at the same time.



The other thing we noticed is a extreme divergence between the financial sector and Gold. As you can see in the second graph, there is a strong inverse correlation between XLF (financial sector etf) and Gold. As Gold (solid line) rises, XLF (dotted line) falls and vice versa. When Gold was falling in mid-July of 2008, XLF rallied 30% from 17.17 on 7/15/08 to 22.46 on 7/23/08. Since October of 2008 until now, Gold has risen from the low 700's to over 1000. XLF, on the other hand, has declined well over 50% since October of 2008. We think the inverse relationship between the financial sector can be explained by the level of confidence in the financial system. When confidence is low as it is now, investors flee financial stocks in favor of tangible assets like Gold. That is understandable given that investors are unsure about the value of toxic assets underlying financial companies while they know what they are getting with Gold.

