



OUTLOOK

"More Risk than Reward"
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The S&P 500 definitely did not live up to our expectations for a rally since our outlook in the last quarter of 2008. Yes, all the traditional oversold and sentiment indicators were off the charts and flashing buy signals at the time but they were of little value in gauging the bottom of this market. What we observed from this market is that traditional buy indicators do not work effectively in a long-term down trending market.



We define a long-term down trending market as one when the 50 day moving average of the S&P 500 is below the 200 day moving average. The S&P 500 began its long-term down trend in December of 2007 when the 50 day moving average crossed below the 200 day moving average. Since then, the S&P 500 has mounted several 20+ percent rallies but none of them have been sustainable. Now the market has mounted another 20+ percent rally in the last 4 weeks. So the million dollar question is are we in a new bull market or in a bear market rally? Given that the 50 day moving average is still significantly below the 200 day moving average for the S&P 500, we believe that this is another bear market rally within a long-term down trending market. In addition, bear market rallies are typically very sharp and brief in nature which seems to describe the current rally of 20+ percent in the S&P 500 within the last 4 weeks.

At this point, we believe the risk clearly outweighs the reward in this market. With over 70% of the stocks in the S&P 500 above their 50 day moving average, the S&P 500 has reached an overbought level which has typically preceded a pullback, especially in this bear market where the 50 day average is below the 200 day moving average for the S&P 500. In addition, the S&P 500 is now extremely overvalued with its PE of 56 based on trailing earnings. In order for its PE ratio to revert to historical norms, the S&P 500 would either have to fall significantly or earnings would have to rise sharply. Sure, the market could continue to rally more. But why squeeze a few more percent on the upside given the risk of losing substantially more on the downside? For now, we have sold into this rally to raise cash for opportunities with a better risk reward ratio.

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