Some Thoughts on Market Timing

We Lost One of the Really Good Guys
Hundreds of Billions in Losses? Really?
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Where Has the Year Gone?
New Mexico, Cabo, LA, Winnipeg,
Las Vegas, Thailand, and Japan

By John Mauldin

I am neither a market timer nor the son of a market timer. I left my office in the Texas Rangers ballpark this year, and they went to the World Series. I bought Dallas Cowboys season tickets for the first time in 50 years, as they went down in flames. But I do know a few very good timers, and they are sending out warnings. Today, we look at a few of these, as it might pay to hedge some of your equity portfolio as we go into the New Year. I also answer some questions as to my view of the municipal bond market, given the *60 Minutes* report of last week. The answers may surprise you. And as we approach the end of the year, I suggest a place where your help is most needed. I will try to keep it shorter, as there are more important things at this time of the year than the markets.

A little housekeeping. I will not be doing an Outside the Box next Monday or an e-letter next Friday. I am off on a little R&R with my youngest son. But I will be back in full swing come the first of the year and will do my annual forecast issue the first Friday evening in January.

We Lost One of the Really Good Guys

In January I wrote about my friend Walt Ratterman, who was at the Hotel Montana in Haiti when the earthquake hit. Walt's wife Jeanne received an email only 10 minutes before the quake, which placed him in the courtyard, where he would have been OK. After the quake there was an eerie silence as we waited for Walt to call. We all assumed he was helping those injured in the quake and that he and his friends would surface when they got a break. Those who knew Walt understand the passion he brought to many relief operations. Walt was known for sneaking into Myanmar in the bottom of a boat where, if discovered, he would have been summarily executed. Walt was the subject of the documentary *Beyond the Call,* which showed him braving Afghanistan a month after 9/11, Myanmar, and the most dangerous region of the Philippines.

Walt's love of helping people who, for no fault of their own, couldn't help themselves caused him to relocate his family to the West Coast, to be better able to continue his work. Walt traveled the world to help the needy, visiting Asia, Africa, South America, and Central America. Each time, he brought food, medical relief, and solar power, and had a sustaining impact on all the lives he touched. Walt was part of a team brought into Haiti by USAID (United States Agency for International Development) to bring solar power to Haiti. Walt was working there on several projects, including a few hospitals where electricity brought them out of the dark ages, allowing them to perform surgeries and other treatments that were unavailable in Haiti previously. Many of the projects were completed prior to the quake and provided much-needed support for the injured, saving countless lives.

The great irony is that Walt almost never stayed in nice hotels. He stayed with those he helped. Alas, for his family friends and the world, we lost him at that hotel.

As long-time readers know, I have helped him and Ed Artis raise money for Knightsbridge every year at Christmas, and my readers have been generous. This year the team at Knightsbridge are working on a very special project in the Philippines to create a registry of children with cleft palates and other similar issues, so that it will be easier to find and help them when teams of doctors that they help organize come to repair their faces. Then they will start in other countries like Burma and Vietnam.

This very complex series of National Cleft Registries will have a huge impact on the quality of life for thousands of children and young adults suffering from cleft lips and cleft palates in the countries where we will set up these registries.

They also have 5 containers of needed medical supplies ready to ship to the Philippines in January alone.

Ed Artis, the founder of Knightsbridge, is another one of the really good guys. He was also featured in the documentary *Beyond the Call,* which aired on many PBS stations and on the National Geographic Channel. These guys take no salary, have no overhead, and donate their time. You can see more about what they do by reading the posts on their Current Missions Blog, located at: http://currentmissions.blogspot.com/

And here is how you can make a donation.

Immediate Donations can be made online via PayPal on their web site, which is located at http://www.kbi.org .

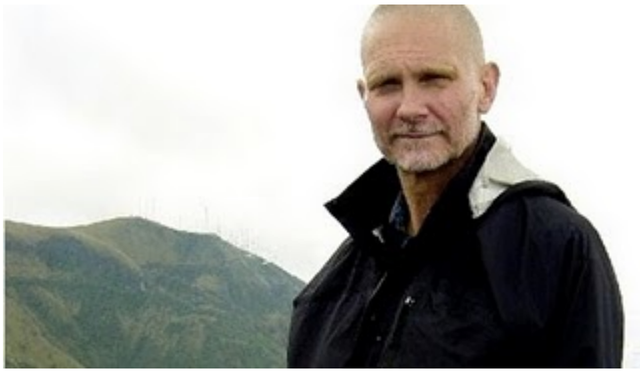
Or via checks, ONLY made payable to and mailed to:

Steps For Recovery
P.O. Box 67522
Century City, CA 90067

(A California 501(c) 3 Tax Exempt Corporation
Federal ID # 95-4472343)

PLEASE ... Clearly mark your donation, if made by check, "FOR KNIGHTSBRIDGE." (Checks that go to the Philippines, where Ed now lives, take forever to get there and get cashed. Steps for Recovery forwards the money to Ed, and you can claim a tax-deductible donation.)

Join me in honoring a true fallen hero one last time. Walt Ratterman, Rest in Peace.



Hundreds of Billions in Losses? Really?

I have been asked what I think about the recent *60 Minutes* piece where Meredith Whitney said there would be hundreds of billions of dollar of losses in the municipal bond market. Should we all sell our municipal bonds?

The short answer is that all bond risk is specific to the issuer, so you or your surrogates need to do their homework. But in general, I have real doubts that there will be "hundreds of billions" of losses in the municipal bond market. Whitney said she did not expect defaults from the states, so that leaves just local entities. The worst year on record for losses was 2008, with just over $8 billion. The municipal-bond industry insists bankruptcy filings will remain rare. There were 10 municipal filings in 2009 and five so far this year, according to James Spiotto, a lawyer at Chapman & Cutler. Since the law was created in the 1930s, there have been only about 600 cases.

"Most defaults in the modern era aren't governmental or what we might call municipal at all. The majority are corporate or nonprofit borrowings in the guise of some municipal conduit – nursing homes, housing developments, biofuel refineries – so they could qualify for tax-free financing." (Bloomberg) These are mostly deals where investors are reaching for yield and should pay attention to the source of funds for repayment.

It would take a default by almost every major municipal issuer, and a lot of small ones, to create a hundred billion in defaults, something not likely to happen. Will there be some? Sure. There always are. It is just hard to see it being anywhere close to that much in the next few years, which is her time frame.

As Joe Mysak of Bloomberg wrote:

"And yet – hundreds of billions of dollars in default? The number is in the realm of the fabulous. If pressed, I would say that we might see between 100 and 200 municipal defaults next year, maybe totaling in the $5 billion or $10 billion range.

"…'Debt levels for U.S. local and state governments are relatively low, with annual debt service representing a relatively small part of budgets,' Fitch Ratings said in a special report in November.

"Entitled 'U.S. State and Local Government Bond Credit Quality: More Sparks Than Fire,' the report said, 'The tax-supported debt of an average state is equal to just 3 percent - 4 percent of personal income, and local debt roughly 3 percent - 5 percent of property value. Debt service is generally less than 10 percent of a state or local government's budget, and in many cases much less.' "

That is not to say I don't see risk. I have written often that I think states, counties, and municipalities, hospital and school districts, etc. will come under increasingly intense pressure. The problems with New Jersey, California, Illinois et al. are well-known.

We are going to see massive cuts in all sorts of services and public employment and increases in taxes at all levels. As the stimulus to states winds down, the budget pressures will ratchet up. The part of the *60 Minutes* presentation I think you should pay attention to is the section with Governor Christie of New Jersey. That is the reality many states face. They are forced to make spending cuts. Sooner or later every state will have to adopt that approach, even California. Although the idea of Jerry Brown facing down unions and slashing budgets is one that does convey a small sense of irony.

I think the risk is not from holding municipal bonds (although I am not discounting that risk) but in living in areas where budgets are going to be strained. If I were moving, I would want to check on the financial strength of the state and locality I was moving to. If street budgets gets slashed or taxes raised, if police and fire service becomes an issue, or reduced maintenance of parks, etc., then you might think about another locality. Things will normalize, and Whitney is right to call our attention to the severity of the crisis – getting back to a New Normal will be a bumpy ride for many localities.

On the "if there's a crisis there must be an opportunity" note, my friend David Kotok of Cumberland Advisors writes about finding AAA-rated (and checked by his firm) municipal bonds paying 6% tax-free. There is value out there if you or someone who manages your money can look for it

Some Thoughts on Market Timing

This last week has seen a number of people I highly respect issuing warnings about a stock market correction. Some are from services I get, which I cannot quote without permission, but we are going to review three that I think sum up the current market situation. There are just a lot of warning flags. We will look at John Hussman, the always fascinating Tyler Durden of Zero Hedge, and Jonathan Tepper of Variant Perception in London. As I said at the beginning of the letter, I am not a short-term market timer, and you can't use my writings to time the markets in the short term. But I can pass on wisdom from those I respect.

First, from John Hussman, whom I consider a must-read. (http://www.hussmanfunds.com/wmc/wmc101213.htm)

"In recent weeks, the U.S. stock market has been characterized by an overvalued, overbought, overbullish, rising-yields syndrome that has historically been hostile to stocks. Last week, the situation became much more pointed. Past instances have been associated with such uniformly negative outcomes that the current situation has to be accompanied by the word 'warning.'

"The following set of conditions is one way to capture the basic 'overvalued, overbought, overbullish, rising-yields' syndrome:

1) S&P 500 more than 8% above its 52 week (exponential) average
2) S&P 500 more than 50% above its 4-year low
3) Shiller P/E greater than 18
4) 10-year Treasury yield higher than 6 months earlier
5) Advisory bullishness > 47%, with bearishness < 27% (**Investor's Intelligence**)

"[These are observationally equivalent to criteria I noted in the July 16, 2007 comment, A Who's Who of Awful Times to Invest. The Shiller P/E is used in place of the price/peak earnings ratio (as the latter can be corrupted when prior peak earnings reflect unusually elevated profit margins). Also, it's sufficient for the market to have advanced substantially from its 4-year low, regardless of whether that advance represents a 4-year high. I've added elevated bullish sentiment with a 20 point spread to capture the "overbullish" part of the syndrome, which doesn't change the set of warnings, but narrows the number of weeks at each peak to the most extreme observations].

"The historical instances corresponding to these conditions are as follows:

December 1972 - January 1973 (followed by a 48% collapse over the next 21 months)

August - September 1987 (followed by a 34% plunge over the following 3 months)

July 1998 (followed abruptly by an 18% loss over the following 3 months)

July 1999 (followed by a 12% market loss over the next 3 months)

January 2000 (followed by a spike 10% loss over the next 6 weeks)

March 2000 (followed by a spike loss of 12% over 3 weeks, and a 49% loss into 2002)

July 2007 (followed by a 57% market plunge over the following 21 months)

January 2010 (followed by a 7% "air pocket" loss over the next 4 weeks)

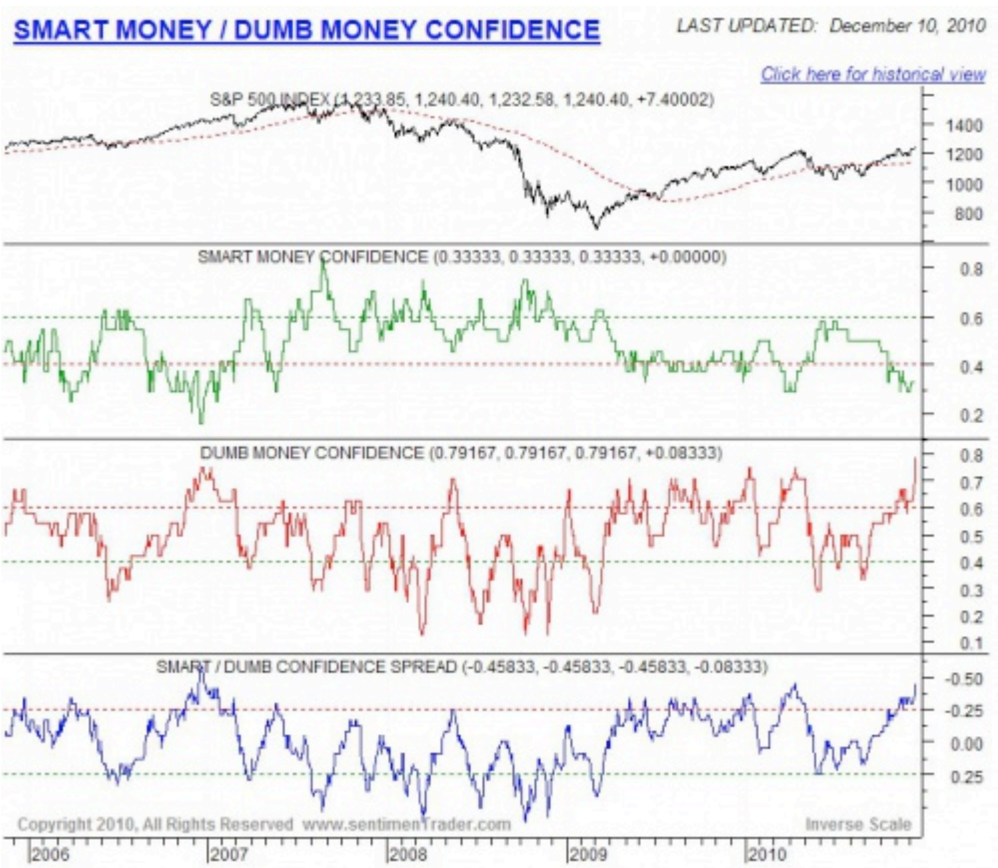
April 2010 (followed by a 17% market loss over the following 3 months)

December 2010 ….?????"

Next we visit with Tyler Durden of Zero Hedge, whom I have never met, but meeting him is on my list. He brings to our attention the work of the team at Sentiment Trader.

"Courtesy of www.sentimentrader.com we can observe just how irrational the market has become... As to how much longer it can sustain this, feel free to address your questions to the Chairman (Bernanke).

"First, we present the confidence of smart and dumb money. Never before has it been as self-gratifying for 'dumb money' advocates (i.e., those who do nothing but 'trade the tape') to exude a sense of complacent all-knowingness. After all, they will always be able to sell just ahead of the wipe out...



"For those confused by what the distinction is, here is Sentiment Trader's explanation:

"Generally, we want to follow the Smart Money traders – we want to bet on a market rally when they are confident of rising prices, and we want to be short (or in cash) when they are expecting a market decline. We also call this measure the 'Buy Confidence' indicator – it tells us how much confidence we should have in buying the market.

“Examples of some Smart Money indicators include the OEX put/call and open interest ratios, commercial hedger positions in the equity index futures, and the current relationship between stocks and bonds.

“In contrast to the Smart Money, we want to do the opposite of what the Dumb Money is doing. These traders have proven themselves over history to be terrible at market timing. They get very bullish after a market rally, and bearish after a market fall. By the time the majority of them catch on to a trend, it’s too late – the trend is about to reverse. That's why we call this the ‘Sell Confidence"’indicator too, as it tells us how confident we should be in selling the market.

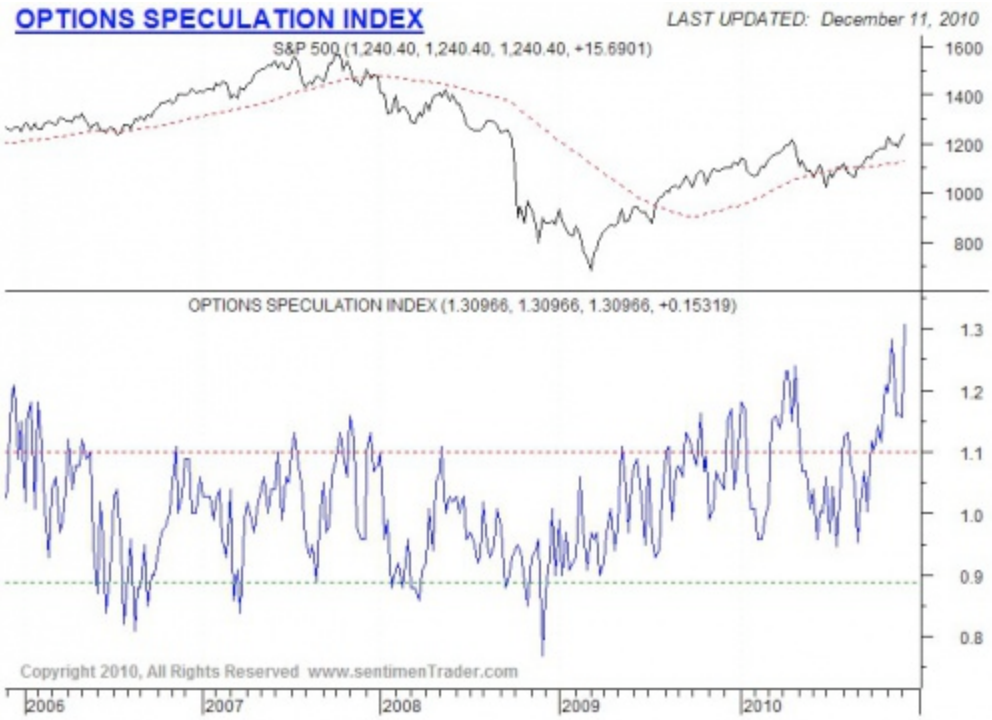
“Examples of some Dumb Money indicators include the equity-only put/call ratio, the flow into and out of the Rydex series of index mutual funds, and small speculators in equity index futures contracts.

“Our Confidence indices are presented on a scale of 0% to 100%. When the Smart Money Confidence is at 100%, it means that those most correct on market direction are 100% confident of a rising market … and we want to be right alongside them. When it is at 0%, it means that these good market timers are 0% confident in a rally, and we want to be in cash or even short when confidence is very low.

“We can use the Dumb Money Confidence in a similar, but opposite, manner. For example, if the Dumb Money Confidence is at 100%, then that means that these bad market timers are supremely confident in a market rally. **And history suggests that when these traders are confident, we should be very, very worried that the market is about to decline.** When the Dumb Money Confidence is at 0%, then from a contrary perspective we should be concentrating on the long side, expecting these traders to be wrong again and the market to rally.

“In practice, our Confidence Indexes rarely get below 30% or above 70%. Usually, they stay between 40% and 60%. When they move outside of those bands, it’s time to pay attention!

“Next up we look at the Options Speculation index, which, not surprisingly, is far beyond the highest it has been in the past 5 years, possibly ever.



"While it is rather self-explanatory, here is the official interpretation of the chart: The Options Speculation Index takes data from all the U.S. options exchanges and looks at opening transactions. We total the number of transactions with a bullish bias (call buying and put selling) and also the number of those with a bearish bias (put buying and call selling). The Index is a ratio of the total bullish transactions to the total bearish transactions. The red and green bands on the chart are 2 standard deviations from the one-year average of the index.

"**Like most other put/call ratios, this is a contrary indicator, so when we see excessive speculative activity (i.e. the indicator moves outside of the upper red trading band), it means that traders are very confident of a rising market, and we usually see just the opposite.**

"When we see too much risk-aversion and the indicator moves below the lower green trading band, then we're at a pessimistic extreme and we typically see a market rebound shortly thereafter."

They go on to give us other indicators of sentiment at the limits, which you can read about here. http://www.zerohedge.com/article/charting-ridiculously-extreme-market-which-dumb-money-most-confident-it-has-been-5-years. But this gives you a flavor.

And then we come to my friend and the co-author of my new book, Jonathan Tepper of Variant Perception. His firm is usually bullish, but they released a report last Friday that started out:

"We recommend hedging equity portfolios and reducing market exposure.

Extremes in bullish sentiment, overbought conditions, rising yield levels and extremes in correlation between asset classes spells short-term trouble for equity markets.

"Almost all our sell indicators are going off and we recommend hedging portfolios or reducing exposure. The last time all our sell signals went off was in early January and late April. Both cases led to short-term stock market weakness.

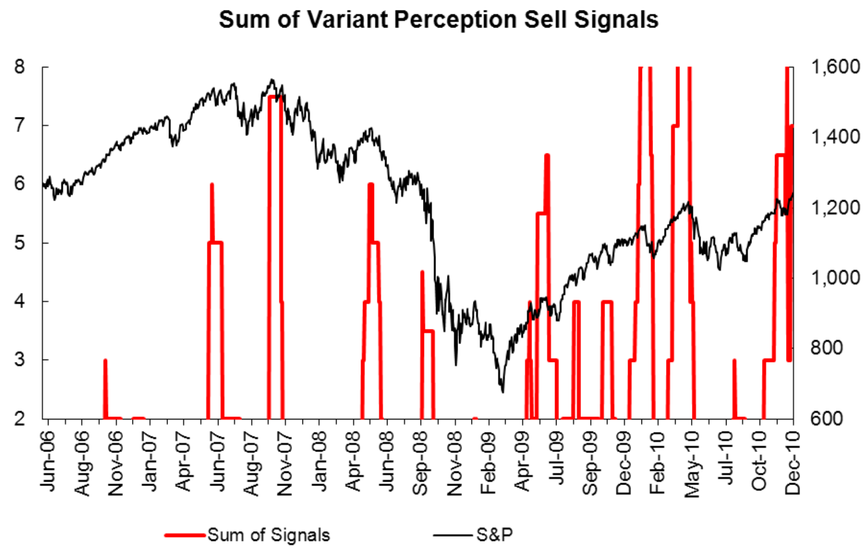
"Our longer-term cyclical view is intact. We continue to see the US and the world as being in a mid-cycle slowdown. Money growth is accelerating and the diffusion of OECD leading indicators is positive. We would be buyers of global equity markets on any sizeable correction."

They then proceed to give us a variety of warnings signs and charts. I will give you just a few of them.

"ALMOST ALL SELL SIGNALS GOING OFF; HEDGE PORTFOLIOS

"We are now seeing almost all our sell signals go off and we recommend clients hedge portfolios and reduce market exposure. We have advised clients in the past to hedge their portfolios and reduce exposure when all our sell signals have gone off. The last two times all our sell signals were activated was in January and April. In both cases the stock market performed very poorly one month out.

"We have continued to add new tools to our buy and sell signals. As the following chart shows, the sum of our signals is flashing a warning sign.



These signals typically lead to stock market sell-offs and forecast poor returns one month forward."

I could do several letters from people I highly respect who suggest that hedging your portfolio might be wise as we go into the New Year. But this has given you a sense of what I am reading.

As for actual timing? This market has been skewed by QE2. Things can remain irrational for longer than we would think. I would urge some real caution. As the guys at Variant note, there will be some opportunities to buy back in.

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New Mexico, Cabo, LA, Winnipeg,
Las Vegas, Thailand, and Japan

And with this missive, I sign off for the year. I will greet you again come the New Year and a new decade (although technically, I know, this will be year two of the second decade). Thank you for letting me into your world each week. It is one of my great pleasures.

Just a month ago it looked as if I would not be traveling all that much in the first part of 2011. That has certainly changed. Next week I go to Angel Fire, New Mexico with my youngest son Trey, where he will snowboard and I will read and do a little writing. Then we (Tiff, Ryan, and my granddaughter Lively) are off to Cabo San Lucas, where we will join the management team of Altegris for some planning for the New Year, as well as some R&R. Then to LA on the 15th for one day for a fundraiser with my friend Lee Stein. Then on to Winnipeg on the 21st for a speech. Then at the beginning of February I'll be in Las Vegas for an event with Steve Blumenthal and his team at CMG. I'll fly from there to Phuket, Thailand, and then spend a few days with my good friend Tony Sagami, who lives near Bangkok. I have never been and really look forward to it. And then a few weeks later I'll be in Tokyo with Chris Woods and CSLA, at their conference. And Europe in March. Wow! How did that happen?

All the kids are gathering at Dad's for Christmas. The house is already filling up. We finally got a tree up this afternoon and decorated. Tomorrow is the shopping I have put off for weeks. And then baking and cooking for Christmas. (Yes, I bake cakes and roast prime. I am actually quite good at it. Better than my market timing!) It is good for Dad to have all seven kids, spouses, and grandkids, as well as my 93-year-old mom at home! It does the heart good!

Meeting my friends in Pensacola last week reminded me how it is that the friends we make on our journey are our true riches. Timing? The issue there is making the time to enjoy them. It was good to meet with the Old Lions. I intend to do it more!

Have a great week. It is a wonderful time of the year and we should all enjoy it.

Your ready for some down time analyst,

John Mauldin