

EPIC INSIGHTS

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THE WEEK AHEAD

Despite seeing the Dow Jones Industrial Average (Dow) record a modest 0.1% gain, the tone of the market continues to darken. After a large 236-point gain Monday, when 90% of stocks were higher, momentum ceased. Giving back a large one-day move is not unusual, but the method of doing so is troubling. With the exception of Thursday, the Dow was initially higher each day. However, as the hours progressed sellers emerged and prices declined. When handicapping a market, it is not enough to stare at the broad indices to glean insight as to the direction of prices. Instead, we must look under the surface for deeper meaning. Doing so reveals that a market that starts strong and slowly declines is very bearish. It indicates that investors are selling into rallies as opposed to buying dips. With this shift in psychology

Figure 1 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior
Monday	5/25	Memorial Day Holiday		Markets Closed	
Tuesday	5/26	Case Shiller Home Price Index (YoY)	9:00 AM	-18.7%	-18.2%
		Consumer Confidence	10:00 AM	43.0	39.2
Wednesday	5/27	SPLS Earnings	BMO	\$0.22	\$0.30
		Existing Home Sales	10:00 AM	4.66M	4.57M
		Existing Home Sales (MoM)	10:00 AM	2.0%	-3.0%
Thursday	5/28	COST Earnings	BMO	\$0.53	\$0.68
		Initial Jobless Claims	8:30 AM	630k	631k
		Continuing Jobless Claims	8:30 AM	6740k	6662k
		Durable Goods Orders	8:30 AM	0.4%	-0.8%
		Durables Ex Transportation	8:30 AM	-0.3%	-0.6%
		New Home Sales	10:00 AM	360k	356k
		New Home Sales (MoM)	10:00 AM	1.1%	-0.6%
Friday	5/29	TIF Earnings	BMO	\$0.20	\$0.50
		GDP - 1Q (Preliminary)	8:30 AM	-5.5%	-6.1%
		Personal Consumption	8:30 AM	2.0%	2.2%
		U. of Michigan Confidence	10:00 AM	68.0	67.9

Note: BMO = Before Market Opens, AMC = After Market Closes
Note: All times are Eastern Standard Time (EST)
Source: Bloomberg

during the coming weeks I will be focused on two distinct prices—the Dow's recent high (8,574) and its 50-day moving average (8,002). For the market tone to become more bullish, we will need a successful test of the 50-day moving average followed by a move above the recent high. Given the tight range of these two numbers, we should see this event over the coming weeks.

In recent weeks the news cycle has driven stock

prices. This pattern will continue in the upcoming week of 5/25 to 5/29 (**Figure 1**). As two familiar stories, housing and employment, dominate, investors will have an opportunity to gauge the effectiveness of the various government stimulus programs. For the specifics of the week, **Monday** is the Memorial Day Holiday and all U.S. markets will be closed. **Tuesday** features the Case Shiller Home Price index showing an 18% decline in housing prices while consumer confidence

increases. **Wednesday** has existing home sales, which are expected to increase from last month's large drop. **Thursday** offers reports on durable goods, new home sales, and the weekly employment report. As usual, my focus remains on the latter. Large spikes lower in initial claims have an excellent track record of predicting the end of recessions. For months I have waited for such an event to take place, but all spikes have proven to be fleeting events that were quickly reversed. I am keeping my eyes open for a large spike lower, but I fear that it remains well into the future. Further, I also am monitoring the continuing claims with great interest. Over recent months governments have been viewed as the only sources of financial stability. However, as interest rates and budget deficits rise, the ability of governments to spend indiscriminately decreases. As continuing claims ratchet higher, budget strains bring closer the moment when stimulus is removed from the system. Were that to occur, I fear the consequences. **Friday** ends the week with the initial report of 1st-quarter gross domestic product



(GDP) expected to show the economy contracted 5.5%.

TECHNICAL TRADE

As I have mentioned many times, I always prefer simple technical patterns over quantitative models. When we complicate our analyses, we increase our risk. If a faulty input or one stray assumption works its way into the model, a generally sound approach can yield terrible results. Instead, by relying upon simple approaches we can clearly determine patterns that signal us to either buy or sell.

One approach I use often is trading channels. A channel consists of two different

trendlines which act as guides to prices. The first is a traditional trendline which determines the direction of prices. The second line, the channel line, acts as a buffer that keeps price movements in line. By using both pieces of information, we are able to effectively trade within an existing pattern and increase our returns.

Typically we see channels form when prices are moving in one direction. As the market attempts to determine the extent and duration of a move, channels serve investors well. In these instances, we must determine the trend and the channel, and trade while the pattern exists.

When the channel fails we move on to new ideas.

While most stocks follow this single-channel rule, others do not. On occasion, a stock will show multiple channels within the same chart. When that happens our lives are simplified. Instead of constantly looking for new ideas, we can focus on one stock and determine where the next channel is forming on its chart.

Such a search brings us to our next investment idea—the SPDR S&P Homebuilders ETF (XHB) (**Figure 2**). Over the past six months, XHB has travelled in consistent trading channels between \$1.50 and \$2.50 wide. Initially, a sideways channel (black lines) acted as consolidation. When that channel was failing, a downward channel (red lines) formed. This pattern drove prices to a new low before giving way to a strong upward channel (blue lines) which took the stock 81% higher in two months. In the portfolio created in this newsletter, we were long the stock as prices moved higher from the lows and exited three weeks ago when I indicated that the upward channel

was failing. Time now shows that the failure not only ended the initial move higher, but also created a new downward channel (green lines).

Looking at this evolution, there are two things I find striking. The first is that XHB consistently trades in channels, regardless of direction. This pattern adds weight to the belief that the channel will hold. Secondly, when channels end, they transition into a new channel. Such action will help us in determining when the pattern is breaking and also in predicting what the next movement shall be.

With a clear downtrend in place, we can focus on price targets. Most of these channels have existed for two months. Based on that time horizon, a decline to \$10 is reasonable.

However, were the market to turn lower, a revisit of the recent low of \$8 is possible as well.

Having established the downside target, we are prepared to trade this week. With a determined pattern that has consistently guided prices, **I recommend a 2% short position in XHB as this week's technical trade.**

FUNDAMENTAL TRADE

Economic textbooks teach us that money should be both a medium of exchange and a store of value. Its use as a medium of exchange is straightforward. As long as two parties agree that they are exchanging items of value, they do not care what actual form the currency holds. From wampum to pieces of paper, if value is perceived exchange occurs. When it comes to money's role as a store of value, things become more complicated. For centuries, money has been backed by some tangible asset, namely gold. However, when President Nixon closed the gold window in the 1970s, we embarked on a new path—that of fiat money.

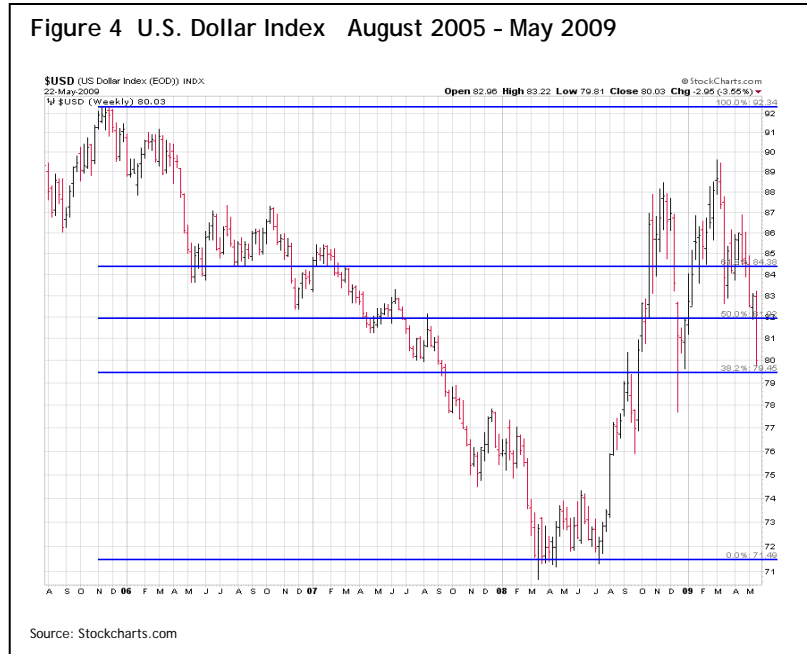
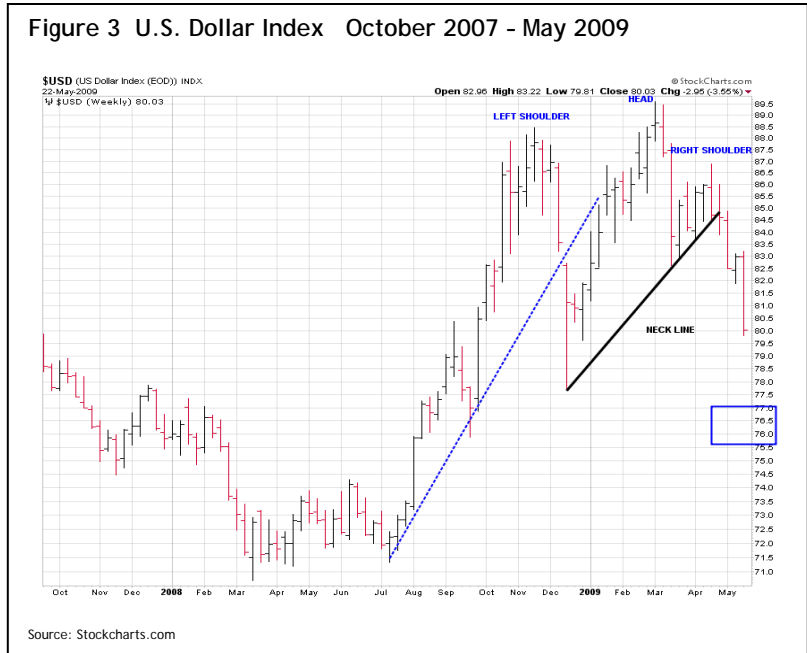
Fiat money is backed by nothing other than a country's willingness to accept it for payment. With a guarantee that consists of only a promise, it is questionable how a fiat system can replicate a tangible asset as a store of value.

For nearly 40 years, people have ignored this problem as central bankers managed the supply of fiat

currency, markets moved higher, wealth was created, and living standards improved. Now all of that is changing. As central banks worldwide print more currency and governments increase their debts, fear of an increasing money supply has called into question the future of fiat money.

As a pure example, consider the U.S. dollar. The U.S. dollar serves as the world's reserve currency. The U.S. dollar has often been seen as a safe haven in an uncertain world. When markets were imploding last fall, the U.S. dollar raced higher as investors sought a secure place for their money. Now that flow is reversing. Fearful of mounting budget deficits, a Federal Reserve (Fed) that will continue to increase the money supply, and a political climate that is anti-capitalistic, the dollar has entered a free fall as investors flee.

One way to determine both the path and duration of a downward move in the dollar is to use technical analysis. Weekly charts (Figure 3) illustrate that the dollar has created a head and shoulders top that



points to lower values. A head and shoulders involves a rally within an existing uptrend (blue line) to create the left shoulder, a decline followed by a rally to a new high to create the

head, and a final decline and rally which fails to top the recent high thus creating the right shoulder. Given their complex nature, head and shoulders are unique patterns with great

predictive powers. Having carved one for the U.S. dollar, we should expect it to decline at least an additional 5% over the coming weeks.

Fibonacci retracements (**Figure 4**) show that any additional dollar weakness will lead to a likely retest of the 2008 lows. Were this to occur, we should expect a decline closer to 10%.

Expecting dollar weakness, we must now determine an investment approach. Some will look to companies with large foreign exposure, while others will consider currency ETFs. I will take a different approach by focusing on an asset class that will perform well when the dollar weakens, but that also diversifies our existing portfolio risk: commodities.

Commodity prices are influenced by factors ranging from economic growth to the weather. However, a weak dollar trumps all else. With most commodities priced in dollars, dollar weakness has little effect on demand as well as little effect on the actual cost to a non-U.S. commodity user, but it does cause huge swings in prices. When the dollar drops, commodity prices

increase. From a risk-management view, commodities have low correlations with other asset classes and provide risk reduction when combined with an existing portfolio.

For retail investors, many ETFs provide commodity exposure. I prefer the Powershares DB Commodity Index Tracking Fund (DBC). Based on the Deutsche Bank Commodity Index, DBC is diversified across energy, metals, and agriculture to provide broad-based commodity exposure. Using this ETF allows the investor to focus on the general direction of the asset class instead of trying to determine which segment of the market will do better than others. Looking to profit from a falling dollar while reducing portfolio risk, **I recommend a 3% position in DBC as this week's fundamental trade.**

OPTION TRADE

Markets are always based on uncertainty and disagreement. Different investors look at the same data, determine how they think markets will react, and take positions to support their viewpoints. When all these opinions are combined, prices represent

the aggregate view of where we are going.

While differing opinions are needed to create a market, at times emotions are driven to such extremes that price swings are exaggerated. Having experienced such an environment last fall, I believe we are set to embark on a similar journey.

As the financial crisis has destroyed wealth, it has also led to unprecedented measures intended to contain the damage. The Federal Reserve (Fed) sees deflation on every corner and embarks on a money-printing spree. The federal government guarantees any and all public debts, abrogates contracts, and changes long-standing bankruptcy procedures under the guise of improving the economy. While I am troubled by these actions and believe they will all end badly, historians will be the ones on record to determine whether these measures were well-planned programs during times of crisis or severely overreaching ideas resulting in more harm than good. Historians will have the benefit of hindsight, but as investors we must act now.

Without a crystal ball to help me see how this process will unfold, it is difficult to take definitive views. However, there is one area in which I am convinced we can see the future—volatility. Despite policy-makers' best intentions, all their actions have led to unintended consequences. As the federal programs multiply I expect this pattern to continue and volatility to spike higher.

We are now seeing the groundwork for a sustained increase in volatility. The best way to measure option volatility is via the CBOE Volatility Index (VIX). Since peaking in December, VIX has been in a steady downtrend (Figure 5). Recently it has been guided lower by a downward channel (blue lines). While an initial glimpse appears bearish, I think this chart offers two hints at a sustained increase.

VIX recently bounced off 28—a level that launched the huge increase in September 2008. Secondly, we have seen a move above the 10-day moving average. Were VIX to continue increasing, we would see the 10-day MA turn higher and the downtrend violated. Both events would speak to



higher volatility levels and should occur within the next week.

Expecting higher volatility on both a technical and fundamental basis, we will construct a trade that will profit from this movement. The purest approach is to use VIX options. Looking at current prices, the market is expecting the VIX to continue lower. This allows us to construct a profitable trade with minimal expense. Since I think the technicals will look much different in one week, I will be using July options to position for the move. With VIX trading at 32.6, I will use the July 32.50 calls (**VIX+GZ**). With a low cost and a strike at-the-money, we should expect

these options to closely track any increase in volatility. Looking to profit from a move higher, I **recommend a 2% position in VIX+GZ as this week's option trade.** This equates to five contracts for my portfolio. Adjust the quantity to conform to your portfolio.

CURRENT RECOMMENDATIONS

This week was a study in contrasts. In a week where the market was flat, one would expect the directional trades to suffer while pair trades held their own. However, the opposite occurred. We saw our bond positions and many individual stocks perform

well, but our option positions and pair trades moved against us. While we know one week does not make a trend, we will watch this pattern and take whatever actions are needed to allow the portfolio to grow.

For the week we saw a 0.4% increase while the S&P 500 increased 0.5%. The ability to track market gains and limit losses has led to excellent results with little volatility and reasonable current income. **Since inception we show a gain of 19.1% versus a decline of 8.4% for the S&P 500 (Figure 6).** When you consider that we have never been more than 50% invested at any time and that our current portfolio is only 12% invested in the equity markets, both the absolute and relative returns are very impressive.

Over the next few weeks, the markets should break from their tight trading range. By remaining risk averse and well hedged, we will be able to respond to the market's direction and position for future gains. Over the coming week, we will maintain our positions while continuing to search for opportunities.

Figure 6 Portfolio Composition and Performance

Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
ABFS	98	\$23.74	\$26.57	\$2,327	\$2,604	2%
AMZN	(32)	\$73.96	\$75.64	(\$2,367)	(\$2,420)	-2%
BZF	163	\$19.62	\$22.26	\$3,198	\$3,628	3%
EFA	(67)	\$31.60	\$46.04	(\$2,117)	(\$3,085)	-3%
EVF	1,236	\$3.32	\$4.60	\$4,104	\$5,686	5%
EWA	264	\$11.41	\$15.81	\$3,012	\$4,174	4%
EWC	184	\$16.34	\$21.51	\$3,007	\$3,958	3%
EWZ	88	\$34.17	\$51.66	\$3,007	\$4,546	4%
GE	135	\$14.68	\$13.10	\$1,982	\$1,769	1%
GIS	37	\$58.05	\$52.65	\$2,148	\$1,948	2%
GLD	(55)	\$86.03	\$94.15	(\$4,732)	(\$5,178)	-4%
GS	30	\$119.34	\$136.35	\$3,580	\$4,091	3%
HYG	41	\$75.25	\$77.05	\$3,085	\$3,159	3%
JPM	110	\$31.86	\$34.41	\$3,505	\$3,785	3%
KO	72	\$42.20	\$47.30	\$3,038	\$3,406	3%
LOD	31	\$100.19	\$96.88	\$3,106	\$3,003	3%
MOT	490	\$4.19	\$5.90	\$2,053	\$2,891	2%
MS	(165)	\$21.60	\$28.23	(\$3,564)	(\$4,658)	-4%
MSFT	100	\$19.90	\$19.75	\$1,990	\$1,975	2%
NLS	363	\$2.83	\$1.55	\$1,027	\$563	0%
NOK	189	\$15.90	\$14.66	\$3,005	\$2,771	2%
PFE	126	\$15.76	\$14.96	\$1,986	\$1,885	2%
QQQQ	(36)	\$26.09	\$33.54	(\$939)	(\$1,207)	-1%
TBT	90	\$40.19	\$53.57	\$3,617	\$4,821	4%
USO	170	\$27.72	\$33.70	\$4,712	\$5,729	5%
FSLR June 145 Call	(300)	\$36.00	\$41.00	(\$10,800)	(\$12,300)	-10%
MA Jan 90 Put	100	\$7.00	\$3.60	\$700	\$360	0%
SPY Sep 77 Call	(300)	\$3.50	\$13.20	(\$1,050)	(\$3,960)	-3%
SPY Sep 77 Put	300	\$13.60	\$4.00	\$4,080	\$1,200	1%
Cash Position					\$84,004	71%
Portfolio Total					\$119,145	
<i>Portfolio Metrics:</i>						
Portfolio Return						19.1%
S&P 500 Return						-8.4%
Portfolio Beta						0.3
Portfolio Yield						1.9%
Equity Exposure						12%
Net Exposure						29%
Total Exposure						62%

USERS' GUIDE

This guide describes how to use the data provided in the newsletter by section. The key to each section is as follows:

The Week Ahead – Here I identify economic reports, earnings releases, and other events that could lead to swings in stock prices. Note that I only list items I find relevant and ignore many pieces of data that other investors may find notable. This is not meant to be a complete list of upcoming events for the next week.

Technical Trade – I prefer to use simple trends and moving averages to identify trading opportunities.

This section either provides a new trade idea or revisits a prior trade. All new trades are accompanied by prices at which the trade should be closed. For me, ending price is the only one that matters and will be used to judge trends, stop-loss price, and other pieces of information.

Fundamental Trade – As a long-term value investor, I use this section to highlight my research. I never use stops on fundamental

positions, but revisit the investment rationale when a stock moves 20% against me. Upon review, I must either increase or close out the position—maintaining the status quo is never an option.

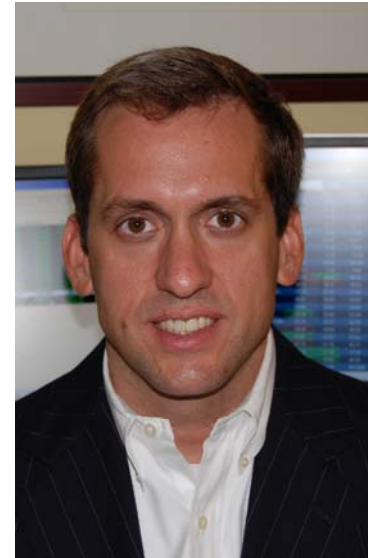
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

General Comments – Here I share any relevant thoughts I may have on topics ranging from the capital markets to the economy to politics.

Current Recommendations – This section is where I track my investment recommendations and performance. All trades are based on a portfolio size of \$100,000 as of 11/1/08 and will be scaled to represent the portfolio weightings mentioned throughout the newsletter. All new positions will be initiated at the opening market price each Monday morning, and closing trades will be based upon closing prices mentioned in the newsletter. Cash balances will earn LIBOR -100 basis points with no transaction fees charged.

Author Profile

Sean Hannon, CFA, CFP, is the President of [EPIC Advisors LLC](#). EPIC is a Registered Investment Advisor offering separately managed accounts to clients ranging from high-net worth individuals to young families who are just starting to invest in the market. Sean has over 10 years of financial services experience, having worked for both Goldman Sachs and JP Morgan Chase prior to starting EPIC. Through solid research and disciplined risk management, EPIC portfolios have been able to outperform during various market cycles.



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