EPIC INSIGHTS

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THE WEEK AHEAD

This week the coil finally sprang. Since early May, the Dow Jones Industrial Average (Dow) had been caught in a narrow trading range with the 200-day moving average (MA) acting as the ceiling and the 50-day moving average acting as the floor (**Figure 1**). Last week I compared this compressing range to a coil. Having been squeezed tightly for too long, I expected the range to break with prices moving sharply in either direction. With the Dow 3.1% higher on the week, we have seen prices move up to the top end of the trading range as well as above the 200-day MA. From here, I expect prices to move above 9,100 over the coming weeks. Such a move would provide investors 4% returns. This is a positive number. However, if instead a correction back to the lower end of the previous trading range happens, it would deliver 6.5% losses.

Figure 1 Dow Jones Industrial Average January 2009 - June 2009

Source: Stockcharts.com

Given that the downside risk is greater than the upside potential, becoming long in this market carries great risks.

Facing this conundrum, we must devise a reasonable game plan. I have often stated that by trading within a primary trend, we increase our odds of success. The question is whether this powerful move represents the beginning of a new bull market or a sustained correction in an ongoing bear market. When examining broad market trends, I do not like relying upon one data point, but prefer to study the actions of many indices to determine whether the market's primary trend has changed. When markets appeared to be firming in February, I alerted subscribers that things were weaker than they appeared. With some indices breaking to new lows and others holding firm, the divergence indicated that prices would continue falling. As we dropped to the March lows, the merit of looking for confirmation was proven.

Examining the data illustrating the current market highs (**Figure 2**), I am optimistic, but cautious. Of eleven major indices, seven reached annual highs this past week. While the timing varies somewhat, I am impressed that so many markets are behaving so well. However, I remain concerned that the four markets that have not confirmed new highs are on average 4.7% below their 2009 peaks. To resolve these differences either the weaker indices will rally sharply to new highs or the stronger indices will begin retreating. History has taught us that such divergences do not typically end well. Usually the strong succumb to weakness and head lower. Until we see the lagging indices push higher, caution is warranted. With the risk of loss exceeding the potential gain, there is no need to chase this rally.

Recently the market has reacted to the news cycle. The upcoming week of 6/8 to 6/12 (**Figure 3**) will test this streak. With little market-moving information being released, we should expect to see prices keyed

Figure 2 2009 Index Highs

Index	2009 High	Date of High	Current Price	% From New High
Dow Jones Industrial	9,035	1/2/2009	8,763	-3.0%
Dow Jones Transport	3,717	1/6/2009	3,350	-9.9%
NASDAQ	1,850	6/4/2009	1,849	0.0%
S&P 500	945	6/2/2009	940	-0.5%
Russell 3000	551	6/2/2009	549	-0.4%
FTSE 100	4,639	1/6/2009	4,439	-4.3%
DAX Index	5,144	6/2/2009	5,077	-1.3%
CAC 40	3,396	1/6/2009	3,339	-1.7%
NIKKEI 225	9,768	6/5/2009	9,768	0.0%
Hang Sang	18,889	6/1/2009	18,680	-1.1%
Brazil Bovespa	54,486	6/1/2009	53,341	-2.1%

Figure 3 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior
Monday	6/8	Fed's Governor Tarullo's Speech	12:30 PM		
Tuesday	6/9	Wholesale Inventories	10:00 AM	-1.0%	-1.6%
Wednesday	6/10	Trade Balance	10:00 AM	-$28.7B	-$27.6B
		Monthly Budget Statement	2:00 PM	-$175.0B	-$165.9B
		Fed's Beige Book	2:00 PM		
Thursday	6/11	Advance Retail Sales	8:30 AM	0.3%	-0.4%
		Retail Sales Less Autos	8:30 AM	0.2%	-0.5%
		Initial Jobless Claims	8:30 AM	613k	621k
		Continuing Jobless Claims	8:30 AM	6770k	6735k
		Business Inventories	10:00 AM	-1.0%	-1.0%
Friday	6/12	U. of Michigan Confidence	8:30 AM	68.6	68.7

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

off technical patterns more than specific news items. For the specifics of the week, **Monday** is highlighted by Federal Reserve (Fed) governor Tarullo giving a speech entitled "Financial Regulation in the Wake of the Crisis." **Tuesday** features wholesale inventories. **Wednesday** brings the Fed's Beige Book. **Thursday** offers reports on retail sales and the weekly employment report. With last week's decline in jobs lost, investors will focus upon the weekly reports. Spikes lower in initial claims have an excellent history of predicting the end of recessions. With the rate if job loss slowing, we are all anxious for the news on this front to continue to improve. **Friday** ends the week with the University of Michigan confidence report.

TECHNICAL TRADE

Commodity markets have been very strong lately. Nowhere is that more evident than in the price of oil. Since bottoming below $34 in mid-February, oil has more than doubled in four months, and energy companies have done very well.

A case in point is ConocoPhillips (COP). COP's stock has increased over 40% from its March low. Along its rise, the stock provided interesting technical patterns that we can now use to judge future price movements.

A pattern I often look for on charts is the reversal. For a reversal to occur, we need to see an existing trend and then price actions that run counter to that trend. A bottom reversal begins with a downtrend. From there, we look for the daily price to open below the prior day's close and then close higher on the day. For a top reversal, the opposite occurs. We look for an existing uptrend and then a stock to open higher on the day, yet close lower. When such movements occur on higher than average volume, validity is added to the reversal.

COP has experienced both a bottom reversal and a top reversal (**Figure 4**).When COP bottomed in March, we saw an upside reversal as the stock opened below the prior close and then closed higher on the day (blue circle). This marked a bottom in the shares that led to the sharp rally mentioned earlier. Now the opposite is occurring. Last Friday the shares opened higher and then closed lower (black circle). This brought shares to the edge of the current uptrend and shows that any weakness will violate the trend that supported the move higher. Ominously, just as the bottom reversal occurred on above-average volume, so did the top reversal.

Figure 4 ConocoPhillips December 2008 – June 2009

Source: Stockcharts.com

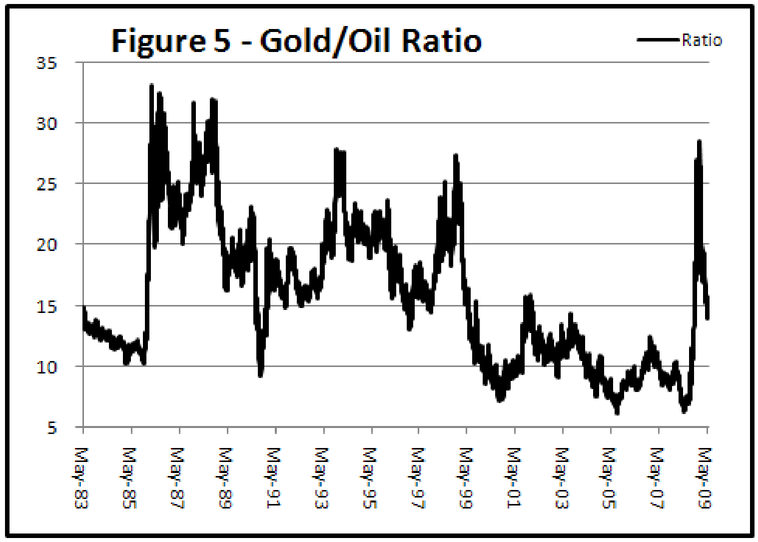
This pattern alone is enough to consider shorting COP, but if you examine the price structure of oil the reasons grow. With oil sitting just beneath the annual high, bullish investors are looking to push prices higher. However, the contango is widening, which indicates that prices are topping. The oil market is in contango when future months' prices are higher than the current month. When this occurs, the proper trade is to buy oil in the current month, put it into storage, and then deliver in the future at the higher price. As this trade occurs, supply grows. With excess supply, growing demand will initially be met by the supply in storage. Only when the contango narrows will we begin to see the effect of increasing demand leading to higher oil prices.

As an example, examine the term structure during this year. When oil bottomed in February, the difference between spot prices and the one-year forward price was $22. By the end of April, the difference was $10.50 and this week it bottomed on Monday, June 1, at $5. On Friday, the difference had widened to $7.70. With a narrowing contango supporting the push to higher oil prices, we should expect the widening difference to push prices lower. As oil prices fall, COP will follow.

Combining the technical and fundamental views, COP is an excellent short sale candidate. Since oil prices can swing wildly, I will take a cautious approach by starting small and adding as the market moves in our favor. Following this strategy, **I recommend a 2% short position in COP as this week's technical trade.**

FUNDAMENTAL TRADE

When investing, I always want to maximize my gains. This leads me on a quest to find mispriced securities that can be purchased at low levels and then sold at higher prices in the future. However, I am equally concerned with risk. We never know with certitude which direction the markets will travel. Therefore, we must consider what can go wrong as well as right with each investment.



Looking for low risk and steady gains, I often gravitate to pair trades. By being long of one instrument and short a related instrument, I can eliminate the market's general direction and focus on the basis between these instruments. If the trade is structured correctly, the basis will move in our favor and gains will come our way.

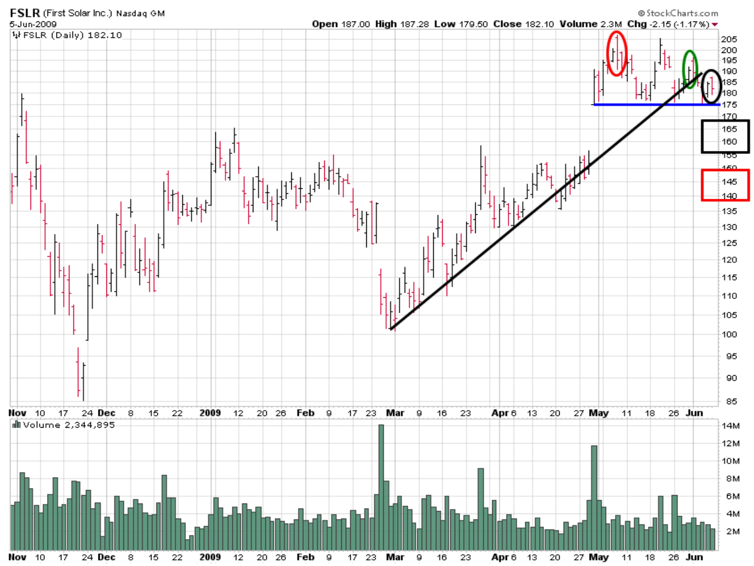
A recent example of this approach is a trade we entered on April 20—long oil and short gold. When I decided upon that trade, I examined the long-term relationship between oil and gold. On average, we should be able to purchase 13 to 15 barrels of oil for each ounce of gold. While this ratio holds over the 1-, 5-, 20-, and 25-year time periods, the volatility in the trend is extreme (**Figure 5**). By going long oil and short gold when the ratio is well above historical standards, we profit when the ratio reverts to more normal levels.

When we entered this trade, the ratio stood at 19.2 with gold fetching $885 per ounce and oil less than $46 per barrel. Since then, the ratio has dropped to 14 with gold rising 12% and oil increasing 49%. By remaining patient and allowing the trade to move in our favor, we did not need to speculate on the direction of each commodity, but instead gained by watching the basis change.

Having marked these prices in our portfolio each week, we have accounted for the gains. However, we must also worry about the risks. Since we have traded to the middle of the long-term range, I question how much upside remains. Factor in my bearish view of crude given the widening contango and I easily foresee oil dropping to $57 to $60 per barrel. Were that to occur, we would need to see gold retreat to between $800 and $840 to maintain the current ratio and below that for us to realize additional gains. Considering the fear over fiat currencies, the push toward commodities, and the fact that gold has not consistently traded below $850 for a prolonged period since last fall, the likelihood of gold falling enough to either maintain or tighten this basis is unlikely.

Many investors do a nice job of determining which trades to enter. However, few of them are disciplined enough to decide the correct time to exit. In many of my newsletters, I have demonstrated the discipline to exit trades when the time is right and our performance

Figure 6 First Solar November 2008 – June 2009



Source: Stockcharts.com

has shown positive results. Now is one of those times we must head for the door. I **recommend exiting the gold/oil pair trade as this week's fundamental trade. This can be accomplished by selling the position in USO and covering the short position in GLD.**

Option Trade

Volatility is the lifeblood of option markets. Although there are multiple inputs to option pricing models, changes in volatility lead to the largest price swings. For us to profit from volatility, we need a catalyst. Looking at the calendar for next week on page 2, no such event exists. Therefore, determining and acting on a new trade idea will not be the most efficient use of our time or capital.

Instead, I will revisit one of our existing positions. Of the six option trades currently in the portfolio, the one attracting the largest amount of capital and the largest potential swing in performance is the short position of First Solar (FSLR) June 145 calls.

The FSLR position has been a wild ride. As the chart shows (Figure 6), large swings have made this trade profitable one minute and disastrous the next. However, that is the past and we are always focused on the future.

Being short of calls is equivalent to being short of the stock. This means that as FSLR declines, we profit. Based on technical analysis, I like our odds.

When FSLR gapped higher after reporting better than forecast earnings, $175 became an important support level (blue line) that has allowed the shares to move higher. Twice the stock rallied to $205 and stalled, thus marking a potential double top. Currently we see FSLR trading below its existing uptrend (black line) yet still holding above the support level. In most stocks, I would consider this a gray area where prices are marking time until deciding which trend to follow. FSLR is different. Three times we have seen the stock carve out top reversals which led to lower prices. While the first two reversals ceased declining above the support level, I expect the most recent reversal to cause support to fail over coming days.

Looking at the reversals, the first occurred (red circle) with the stock trading near $205 and then fell $25 over the next five days. The second reversal (green circle) occurred near $200 and saw prices fall $20 over the next three days. The most recent reversal (black circle) occurred Friday with the stock trading above $185. If the pattern of $20 to $25 declines continues, we should see FSLR fall below support sometime next week.

If support is given, the bottom will fall out of this stock. Initially we will see shares fall toward $165 (black box), but the price should ultimately settle near $140 (red box). Were this to occur, our short option position would expire worthless and the position would mark one of the largest single gains in the portfolio's history.

The coming week should offer some interesting fireworks. We will be watching the action on FSLR closely and determining which actions will allow us to maximize gains on the falling shares.

CURRENT RECOMMENDATIONS

Entering last week, we expected a sharp market move, but were unwilling to bet on the direction. Instead, we entered the week with a 15% position in stocks. Believing that a time would present itself when we could safely trade within an existing trend, prudence governed our actions.

Looking at the week's results we performed as expected. For the week, we had a 0.1 beta and should have expected the portfolio to move 10% of the S&P 500. As the S&P 500 increased 2.3% for the week, our 0.4% return should be considered a positive result.

Since inception we show a gain of 20.6% versus a decline of 3.0% for the S&P 500 (Figure 7). Based on the market's move higher last week, I believe we are entering a period when trades should become bullish as prices move higher. We may be getting closer to that day, but I am not yet prepared to declare the moment is here. Instead, the actions recommended this week will make our portfolio slightly more conservative. With limited exposure, low risk, and large portfolio returns, we can rest on our laurels for now while eyeing the moment when trades present themselves that allow us to earn our next 20%.

Figure 7 Portfolio Composition and Performance

Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
ABFS	98	$23.74	$29.01	$2,327	$2,843	2%
AMZN	(32)	$73.96	$87.56	($2,367)	($2,802)	-2%
BZF	163	$19.62	$22.95	$3,198	$3,741	3%
DBC	164	$21.77	$23.89	$3,570	$3,918	3%
EFA	(67)	$31.60	$47.29	($2,117)	($3,168)	-3%
EVF	1,236	$3.32	$4.70	$4,104	$5,809	5%
EWA	264	$11.41	$16.85	$3,012	$4,448	4%
EWC	184	$16.34	$22.78	$3,007	$4,192	3%
EWZ	88	$34.17	$55.88	$3,007	$4,917	4%
GE	135	$14.68	$13.54	$1,982	$1,828	2%
GIS	37	$58.05	$52.16	$2,148	$1,930	2%
GLD	(55)	$86.03	$93.71	($4,732)	($5,154)	-4%
GS	30	$119.34	$149.01	$3,580	$4,470	4%
HYG	41	$75.25	$78.76	$3,085	$3,229	3%
JPM	110	$31.86	$34.55	$3,505	$3,801	3%
KO	72	$42.20	$49.44	$3,038	$3,560	3%
LQD	31	$100.19	$97.70	$3,106	$3,029	3%
MOT	490	$4.19	$6.24	$2,053	$3,058	3%
MS	(165)	$21.60	$30.97	($3,564)	($5,110)	-4%
MSFT	100	$19.90	$22.14	$1,990	$2,214	2%
NLS	363	$2.83	$1.39	$1,027	$505	0%
NOK	189	$15.90	$15.22	$3,005	$2,877	2%
PFE	126	$15.76	$14.51	$1,986	$1,828	2%
QQQQ	(36)	$26.09	$36.78	($939)	($1,324)	-1%
TBT	90	$40.19	$56.94	$3,617	$5,125	4%
USO	170	$27.72	$37.40	$4,712	$6,358	5%
WMT	72	$50.18	$51.07	$3,613	$3,677	3%
XHB	(197)	$12.12	$12.27	($2,387.64)	($2,417)	-2%
DIA July 83/86 Strangle	500	$6.85	$6.95	$3,425	$3,475	3%
FSLR June 145 Call	(300)	$36.00	$37.50	($10,800)	($11,250)	-9%
MA Jan 90 Put	100	$7.00	$1.50	$700	$150	0%
SPY Sep 77 Call	(300)	$3.50	$17.00	($1,050)	($5,100)	-4%
SPY Sep 77 Put	300	$13.60	$1.70	$4,080	$510	0%
VIX July 32.50 Call	500	$4.40	$3.50	$2,200	$1,750	1%
Cash Position					$73,706	61%
Portfolio Total					$120,621	

Portfolio Metrics:

Portfolio Return	20.6%
S&P 500 Return	-3.0%
Portfolio Beta	0.1
Portfolio Yield	1.9%
Equity Exposure	21%
Net Exposure	39%
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.

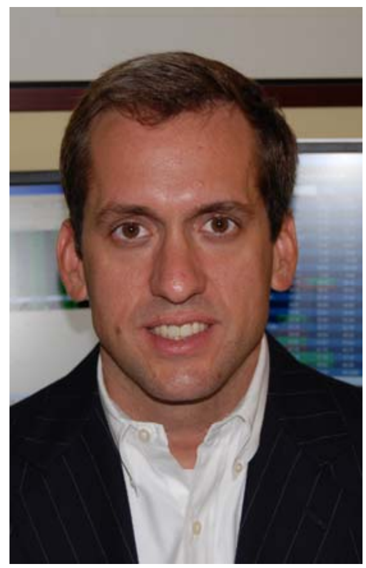
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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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