

PROTECTING YOUR FUNDS

"Safety First" Market Timing for Conservative Mutual Fund Investors

26 May, 1995

Volume 3, Issue 5

IN SEARCH OF THE UNDISCOVERED OPPORTUNITY

If you follow the financial markets, then you have surely heard since mid January that the Dow Jones Industrial Average (the market measure to most of the media) cannot sustain these levels. If while you followed the markets, you also read **this** highly informative publication, then you would have read in the December issue, my reasoning for the Dow reaching 4500 in '95. The strength of the lower channel penetration by the Dow (see *Funds in the Spotlight*) and stronger than normal market momentum led me to believe that a race for the upper channel limits had begun. Now, I know that the Dow has not reached 4500. **Yet.** But, it is only May and it's a lot closer to my target than the financial press's December consensus of the Dow dropping to 3600.

As I explained in the December newsletter and many times since, a technical analyst rarely knows what the driving force is behind the market when they get the signal to enter. However, it's human nature and human curiosity to want the answer. Time usually offers the full story a month or so into the move.

However, this market has still not revealed its true sponsor.

There are two commonly excepted schools of thought in the financial markets. The first and by far the oldest is the Fundamentalist. This group's search for value caused them to miss most of the rally. The fundamentalist's bread and butter is the classics Dividend Yield Theory. In the Dividend Yield Theory the fatal number signaling a correction is emanate is the S&P yield any where below 3%. We were at 3% in the end of 1994, which means that from a fundamental perspective a rally was not possible between then and now. So, they chose to sit until forced in by the markets continued growth. The 15% climb simply could not have happened. Never the less, here we stand with the Dow knocking at 4500 and dividend yield at 2.5% — **the lowest level of the century.** Considering the simple mathematics, it would take a 30% correction to get us back to slightly neutral or 4% S&P dividend yield. The fundamentalists may be right and the market will probably ex-

Continued on page 3

FUNDS IN THE SPOTLIGHT

This month, we take another look at Dow Jones Industrial Average. Yes, I know that it's not a mutual fund; but, this is my newsletter.

If you look at the chart below you can see that the last time we penetrated the upper resistance trend line was in '87 and that ultimately crashed. If the bonds push the market through the line then go with it, but watch out. We have been turned back for now. We'll just have to wait and see what the Federal Reserve does next. If they actively lower interest rates then we could see a thrust through the upper line. In technical analysis this upper trend line would then become the lower support line. If this upper line hold, then we should see prices drop to the bottom of the channel.

MANAGED ACCOUNT PERFORMANCE

Account Type	Year to date Returns	Annual Projection at current return
Managed Income	9.04	21.70
Managed Tax-Free	7.52	18.04
Income & Growth	11.04	26.50
Domestic Growth	17.67	42.41

*Returns achieved through 5/26/95 with approximately one half the risk of a buy-and-hold strategy.

FUNDS IN THE SPOTLIGHT



Garry Graham, CFP, CMT
Portfolio Manager

17011 Beach Blvd., Suite 1270
Huntington Beach CA 92647

(800) 910-8800

STATUS OF TIMING MODELS

PORTFOLIO	STATUS	CURRENT SIGNAL	SIGNAL DATE
Managed Income	Green light.....	Buy	(12/30/95)
Managed Tax-free.....	Green light.....	Buy	(01/06/95)
Conservative Growth.....	Yellow turning Red.....	Buy	(04/12/95)

CURRENT OUTLOOK:

Growth Markets:

If you read the cover story, then you know that I am inversely correlating movement of the market to the direction of the U.S. Dollar, which renewed its extended decline this week. If the dollar keeps going down, then the stock market should continue to climb. However, the dollar is what I believe started this rally, but it is not the only deciding factor within the market. There are two others that concern me more: the price movement up to the top of the trading range and the prospect of the Federal Reserve easing rates to restimulate the economy.

In connection to the cover story and the December newsletter, the Dow has now reached the top of the channel as I foretold. This overhead trendline (see graph on page 1) has proven to be a formidable resistance at least four times in the past and should be again. This week we hit this trendline ceiling and bounced off it twice. This is the making of a possible top for the market. We have reached this barrier after a long, hard and tiring run up in the averages. A pull back would not only be in order, but also healthy for the markets long term growth. But there is a problem.

The problem lies in the Federal Reserve's management of the so called soft landing. The single factor which is likely to kill the bull market in both stock and bonds will be an inflationary surprise in the months ahead. The common perception is that slower economic growth means less inflation. This perception is simply wrong. The relationship between economic growth and inflation is negative and statistically significant. Slower

economic growth implies higher inflation, not lower inflation. The Federal Reserve spent the last year and a half raising rates to cool off the economy and head off inflation. They have managed to cool off the economy, but they are about to heat up inflation.

The Fed. is obviously not reading my newsletter, because they have started an unannounced easing by markedly increasing the rate of growth in currency and bank reserves. This may appear good news on the surface and it explains why the Utilities have continue to hold up under the broad market's selling pressure. However, unlike the past years, now the other components of inflation have changed direction with the monetary velocity increasing and output growth weakening. Lower output growth means fewer goods being made. Eased credit leads to lower interest rates and consequently more borrowing. Increased velocity signifies that people are taking advantage of the credit and spending the money. This recipe spells out the perfect mixture for mean dose of inflation. The classic equation of more dollars chasing fewer goods equals inflation. Cut the supply of good even further through the Clinton administration's proposed 100% import tariff and watch just how fast prices climb.

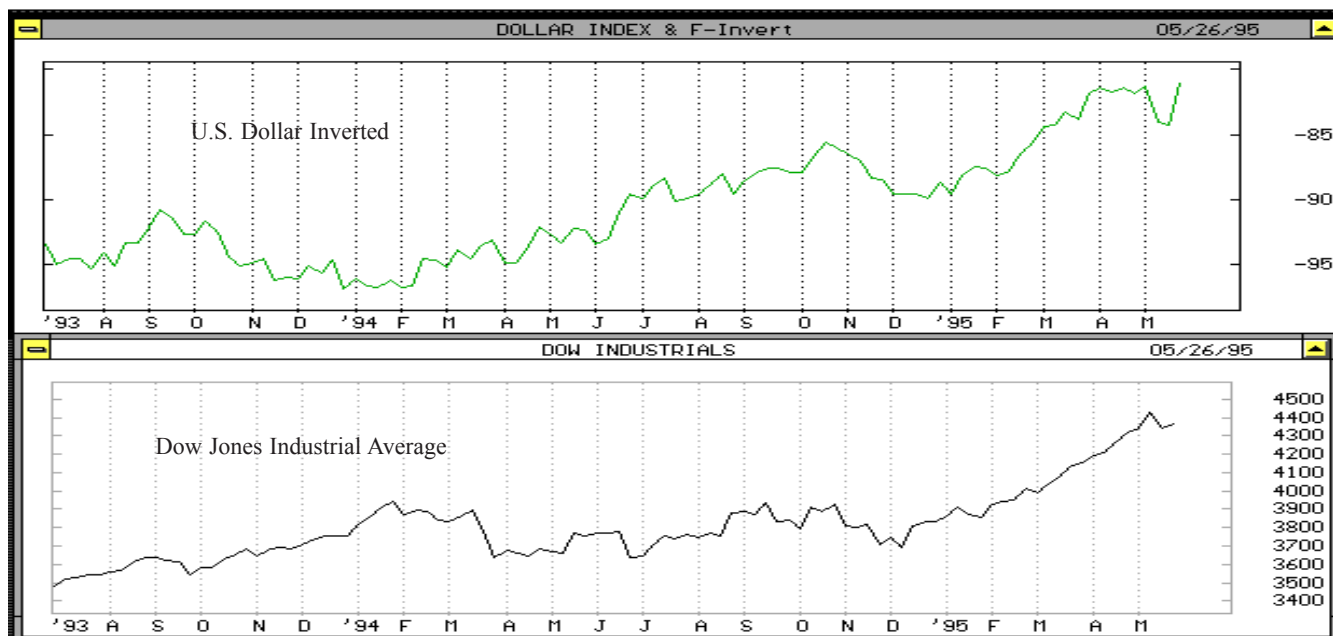
As news of the credit easing leaks out, the market may spur to new highs, right through the upper resistance line.... just like 1987, the year of Black Monday. These rallies are powerful and fast but have fatal consequences for the buy-and-hold investor. They most often cause crashes or mini crashes.

I think a 38 % pull back is not out of line now. If the Dow surges through the overhead resistance just to collide with inflation down the road, we're talking about calamity.

Income Markets:

Coming up off a classic saucer bottom, the bonds have had a terrific run. We have already collected respectable returns for the year but I believe there is more to come. As I mentioned above, the Federal Reserve is quietly easing credit. You can always count on the Fed. to pick the worst of all possible choices. But, if they're going to do it, we might as well make money from it. Both the short term (5-year note) and the medium term (10-year note) have hit short term sell signal. However, the long bond is still growing strong. The high yield market (our current position) had a small hiccup; but, has now resumed its up trend. This market looks good for the foreseeable future. However, that wall of inflation will ultimately kill this market. Its like what your mother told you when you were growing up "Too much of a good thing can be bad for you." The Fed. easing will push the bonds higher; nevertheless, it will be their undoing in the end.

Not to worry, we will stay with them as long as they are going our direction. When they start to look shaky, we will head for the exits without as much as a look over our shoulder. Wow, this sounds a lot like another lesson from life I have recently experienced.



Continued from page 1

perience a 30% drop. Again, while they were preaching doom, we have made a healthy return.

The second main avenue of thought, Technical Analysis, has not fared much better. The meat and potatoes of this group is the Price Oscillator. The oscillator measures the difference between two moving averages of the Dow to produce a line that should coincide with the direction of the Dow, confirming the market. **When this line reaches the 70% mark, the hard core technician goes on red alert.** The 70% mark is an indicator of an overbought market. The oscillator hit the overbought mark in mid-December of 1994. (So much for the Oscillator)

Because the market has been trading in such a narrow trading range, many technicians forgot that in a strong trending market the oscillator will hit overbought and continue to rise off the momentum for quite a long time. Again, while this group, which I am technically one, fore told the end of the world. We made money. How can this be? Remember, I don't manage money on what I feel, rather on what the market tells me. If the market is going up and going up strong then we are in. There is a saying in this business, "Don't fight the tape." This translates to if you think the market should go down, but it is going up then buy. It's better to be wrong and make money than to be right and broke.

If the market is not working in conjunction with either of the two main schools of thought, then it must be working under the third, which I call the undiscovered opportunity. It is a market sponsor that has gone unnoticed by the crowd. It requires thinking outside the normal channels to look for something that is significantly different and powerful but at the same time hidden from plain view.

In my search for the underdiscovered opportunity, I heard of an article in *USA Today* that offered the new Republican Government as the impetus for the market rally. The idea of a new direction for fiscal management within the nation should be enough to spur market madness. Unfortunately, I have not figured out a way to compare market sentiment figures from the last time the Republicans held office with today's numbers. Forty years ago they did not keep such data. Being statistical by nature, I continued my search for a quantitative explanation that my computer and I could peruse. My search, as in many of my previous newsletters this last year, leads me back to the decline of the almighty U.S. Dollar.

The dollar has been quietly devalued by 20% against other world economic powers without even making the front page of the newspaper. For multinational corporations, of which the U.S. houses the lions share, this means that when these companies sell their goods overseas, they will bring home a 20% greater profit which will go straight to the bottom line. Even the fledgling General Motors can make a profit with a free 20% boost from international sales revenue. There is much more to confirm this scenario, such as oil prices climbing, as well as commodities of all types; but, this newsletter is only 3 pages long.

If the decline in the dollar is truly the undiscovered opportunity sponsoring this market rally, then it may be worth paying it some attention. When the fundamentals and the technicals are giving inconsistent reading with the movements of the market, we sometimes have to search deeper to keep that investment edge and stay ahead of the predominately money losing crowd. Since almost 2/3 of the money made in a new bull market is made in the first 1/3 of the time, it has proven profitable (17.67%) to distance ourselves for the so called experts.

MANAGED ACCOUNT SERVICE

While our workshops, seminars and newsletter attempt to keep our clients informed, there is no substitute for daily supervision and professional management that our managed account service provides. We offer a managed account service using only no-load mutual funds for individual investors, corporations, and institutions with \$50,000 to invest. Please send a note or call (800) 910-8800 for further details.