

Market Outlook

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Planning to Remain Seated

The writings of John Maynard Keynes, the British economist who rose to fame during the depression of the 1930s, have become a byword among professional economists and government policy makers. "Keynesian economics" have ruled economic policy in the western world from the New Deal of FDR to today.

What is less well known about Keynes is that he was a shrewd investor, and quite well known among the players of the London Stock Exchange. During the 1930s, he split his week between King's College in Cambridge, where he did his teaching, and London, where he busied himself speculating in currencies, commodities, and stocks. He was also on the board of a number of investment and insurance companies, and in fact served as the chairman of one. He was a master of markets and their psychology. As bursar of King's College – during the Great Depression – he increased the college's endowment tenfold. He also made himself very wealthy managing his own portfolio, despite periodic reverses. He did not hesitate to take risks.

Keynes addressed the reality of market psychology in Chapter 12 of his famous book "The General Theory of Employment, Interest and Money." In it he states that investors are driven by "animal spirits" in the quest for profits, not simply dry cost/benefit analysis. "Thus if animal spirits are



dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die..."

He also expounded on the idea that stock market investors can play the game for themselves, and drew the distinction between "investing" for the very long term, and "speculation." While speculators actually served a useful purpose in their

tendency to even out market imbalances, Keynes cautioned that the game was rife with risk and did not always have a happy ending. He wrote "For it is, so to speak, a game of...Musical Chairs-a pastime in which he is victor who...secures a chair for himself when the music stops. These games can be played with zest and enjoyment, though all players know that...when the music stops some of the players will find themselves unseated."

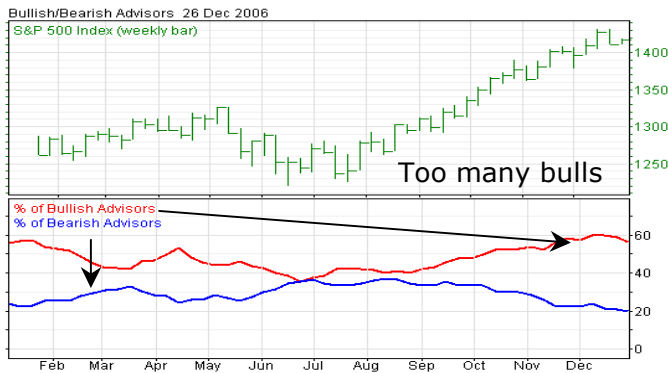
Keep Your Eye on That Chair

After the spirited rally since the summer lows, I believe it is time to keep one's eyes on the chair of choice, as it seems likely the music is about to stop playing.

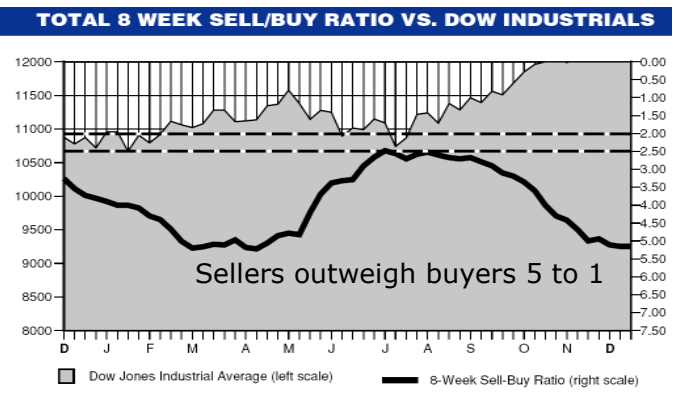
The "mosaic" of evidence that is coming together is painting a picture of risk outweighing reward. The current attitude among investors seems to be that the music will play forever, which any common sense investor knows to be untrue. It is time to make preparation for a weak market.

The prevailing bullish psychology is clearly evident in *Investor's Intelligence* weekly sentiment readings among investment newsletter writers. During the summer lows, those professing a bullish outlook were a measly 35% of the total, matched by a high

reading of 35% saying they were bearish on the market. Today, those numbers have shot off in opposite directions, with the bulls at 60%, and the bears at 19%. This is a contrarian indicator, and shows way too many investors in the bullish camp. These readings are consistent with those in the past that have marked meaningful highs in stocks, and imply that the band is getting tired.



Another piece of the mosaic is insider selling (the legal kind), which has risen to extremely high levels. While insider selling is only a rough guide to timing a market top or bottom, it is a very useful gauge of the attitude of corporate management. If buying prevails, it is a good indication that stocks are viewed as a bargain by those who know their companies best. Prevalent selling, in contrast, implies shares are fully valued, and insiders are not going to stick around for fear of losing their gains.



Broadly based price momentum measures have also begun to falter. While the media typically focuses on price, looking below the surface is often more illuminating. Like a doctor who measures blood pressure, temperature, and pulse to discover his outwardly healthy patient is rather sickly inside,

these indicators help assess the health of the market. The readings are ominous, and further evidence that the music is about to stop playing. The most common measures are stocks are above their 10-week moving average (about 3 months of time), and stocks above their 30-week moving average (nearly a year of time). The 10-week measure is rather fast moving, while the 30-week measure is pretty slow. Nearly all indexes now show these to be turning down, led by the NASDAQ and small-cap indexes.

The Dow Jones stocks above their 30-week moving average illustrates the point nicely. The Dow hit a record high as of this writing (12/27/06) of 12,500, and the media whooped it up with glee. But take a look at the 30-week moving average chart. It has clearly turned down, indicating fewer stocks are able to hold above the long-term moving average. In other words, they are dropping in price, and providing early warning to attentive investors that the last refrain is being sung. This “divergence” between price and indicator is usually a portent of changes to come.



The finishing touch of the mosaic is the knot in my stomach. My intuition, is telling me that after the uninterrupted rally of the past six months, a correction is brewing. Is this little voice worth listening to? Is it too risky or unconventional? I don't think so, for as Keynes wrote, “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.” Keep your eye on that chair.