Melt up, or melt down?
8/25/2007

The perceived chaos of the past few weeks have prompted some members wondering if this is a crash, or are we entering the dreaded bear market. I say “perceived” because if you look at the numbers, and not the noise from the media, both the Dow and SP500 have only pulled back about 10% from the top, which is a normal and healthy correction. Therefore, it is premature to call this a crash, let alone a bear market.

I have addressed the issues regarding a bull market, a bear market, and a crash many times in the past few months, long before the recent sell off so that our members do not panic and make poor choices. You can find these articles in the tutorial section in our members only website.

Today, I want to show you my own approach to the markets for the next few months. Whether we will see a meltdown, or a melt up, I want to be prepared as always. Except for new members, most of you have seen my plans in anticipation of a melt up in the gold sector these past few months. Obviously that did not happen, and we escaped relatively unharmed as a result of good planning and discipline. But had gold gone to the moon, we would have been there.

Lets go right to it….

Yes, the same SPX chart I have shown many times before.

Since bottoming in Oct 2002, all three sectors of gold, energy, and tech (growth) have been in sync with the SPX, although not necessarily on a day to day basis.

$HUI – has rallied from near 100 to currently 325.

$NDX – has rallied from near 1000 to currently 1960.

$OSX – has rallied from near 1000 to currently 268.

The long term trends in all three sectors are up, period.

Melt down scenario

Lets first look at the worst case scenario, and get the fear out of the way.

- If the bears are correct, and we are at the beginning of a bear market, the SPX chart above will not break out to new highs.
- Prices will then break below the June 2006 low thus taking out the 4 yr cycle low and the bullish cycle is toast. By doing so, prices will be below the 50ema and likely to test the 200ema just like the bear market of 2000 – 2002.
- All three sectors will likely follow the SPX and we can trade the short set ups. If gold and gold stocks buck the trend and rally, then great, we will deal with it, with pleasure.

Melt up scenario

Now the good news.

- The SPX multi year "cup with handle" pattern is a bullish pattern, and the pullback since July is the start of a process building that handle, which could mean very sharp short term up and down price action as we saw these past two weeks, and likely more to come.
- Once a breakout is confirmed, and if we do not have any positions, a "cost average" buying program by scaling up in all three sectors can be employed, similar to our "plan B" on the gold sector recently. Although I will likely weigh heavily on the gold sector and will have a separate trading plan for it. Of course, cost averaging may not be necessary as there has to be some decent set ups among all the ETFs we track. Point is, we do not want to sit in cash once there is a breakout on the SPX, which is less than 100 points from current level.

Summary

As expected, we did get some buy signals this week in some of the ETFs, and more will occur the next few days unless we have another collapse. A spike up following a spike down results in a "V" bottom which makes it difficult to execute our buy signals. But that can be a blessing in disguise because spikes are seldom sustainable as we have witnessed many times before. Therefore, from risk management point of view, I will only enter the markets if we have low risk set ups, and tread carefully just in case the bears are correct. And if I am correct on the SPX's cup with handle pattern, it makes even better sense to stay out of the markets due to the zigzag price action so typical during a tight consolidation. Therefore, aggressive buying without the proper set ups right now is not warranted. But I will leave that decision to members, as it is my job to present the signals and set ups as they appear. Everyone has a different comfort zone and you must know what yours is.

It has been frustrating being flat so far in 2007, but I am staying disciplined with Warren Buffett's two rules in investing.
Rule #1 – don't lose money.
Rule #2 – do not forget rule #1.

End of tutorial