The $VIX, the Dow, and China.
3/15/2008

In the past few days, I have received some questions from a few members. These questions cannot be answered in a few words, and because other members may be interested, I have prepared this special report so that everyone knows what I am seeing. I may not be correct in all of my analysis, but it is the best within my knowledge and these analyses are based on current observations.

There were three areas of interests:
#1 – The $VIX.
#2 – head and shoulder pattern in the Dow.
#3 – The Chinese market.

#1 – The $VIX

Often referred to as the "fear index". This indicator measures the fluctuations in options premiums at CBOE. Higher readings in the VIX, derived from prices paid for Standard & Poor's 500 Index options, indicate traders expect larger share-price swings in the next 30 days. The $VIX is only effective in times when volatility has increased, such as during a major correction, or in a bear market. During a bull market, the $VIX does not fluctuate much as demand for put options is kept at a minimum, but occasionally will spike due to sudden events but usually calms down almost immediately.

As you can see, the $VIX woke up during the second half of 2007, with the first fear spike in August, again in Nov, in January, and again this week. Because this week the $VIX has reached levels of previous fear peaks, some analysts are suggesting we are at a major bottom. I have no opinion on that. What is obvious to me is that if the $VIX turns down here, we can expect another relief rally. But if $VIX breaks out, we are into new territory, and a potential major panic until the Feds intervene again. One thing for sure: volatility is here to stay until this major correction or bear market is over. Do not trade based on the $VIX alone.

Here is the chart of the $SPX, with blue arrows marking the fear peaks from the $VIX chart on previous page.
Fear peak in August – produced a 200 point rally, challenging the 2000 high of 1575.
Fear peak in Nov – only produced a rally half the size of the one in August.
Fear peak in January – small relief rally was capped at the 50ema resistance.
Fear peak this week – testing the January low. A bounce here will likely visit the 50ema again, or even the 200ema if we get a huge surprise from the Feds next week. Any disappointment will likely see a panic sell off with $VIX breaking out.

Summary

Many traders and investors have forgotten what it was like to be in a very volatile environment, and the next few months or years will help us re-live some of those periods between 2000 and 2003. Last time was the tech bubble, this time is the housing market, credit market, and God knows what else. As suggested previously, folks holding a significant long term portfolio should be hedging with an inversed ETF such as SDS, or go partially or completely into cash, or a combination of both. Capital preservation has priority over capital gains during a major correction or bear market. The $VIX will not calm down until we are well into the next bull market.

#2 – Head & shoulder pattern in the Dow.

Actually there are more than one H&S pattern in the Dow chart.

A smaller H&S pattern was confirmed when neckline was broken in December, with downside target of 12000 achieved this week.

There is a bigger H&S pattern also in progress, with neckline being broken this week also. Downside price target for the bigger pattern is 10400.

Also notice that prices this week have broken below the 2007 pivot support at 12220 area, therefore, the 2008 pivot resistance is now at 12750 where the right shoulder is (circled). Any rally should not exceed 12750 on a weekly close basis.

What if I am wrong?

Similar to the $SPX as shown before, if the Dow can manage to close above 14000 some time this year, we will see an outside yearly bar, because we have already seen a lower low. A lower low and a higher high is an outside reversal.

From the best of my knowledge, there has not been an outside reversal year in my 30+ years of investing. If and when that happens, jump back in with both feet.

Summary

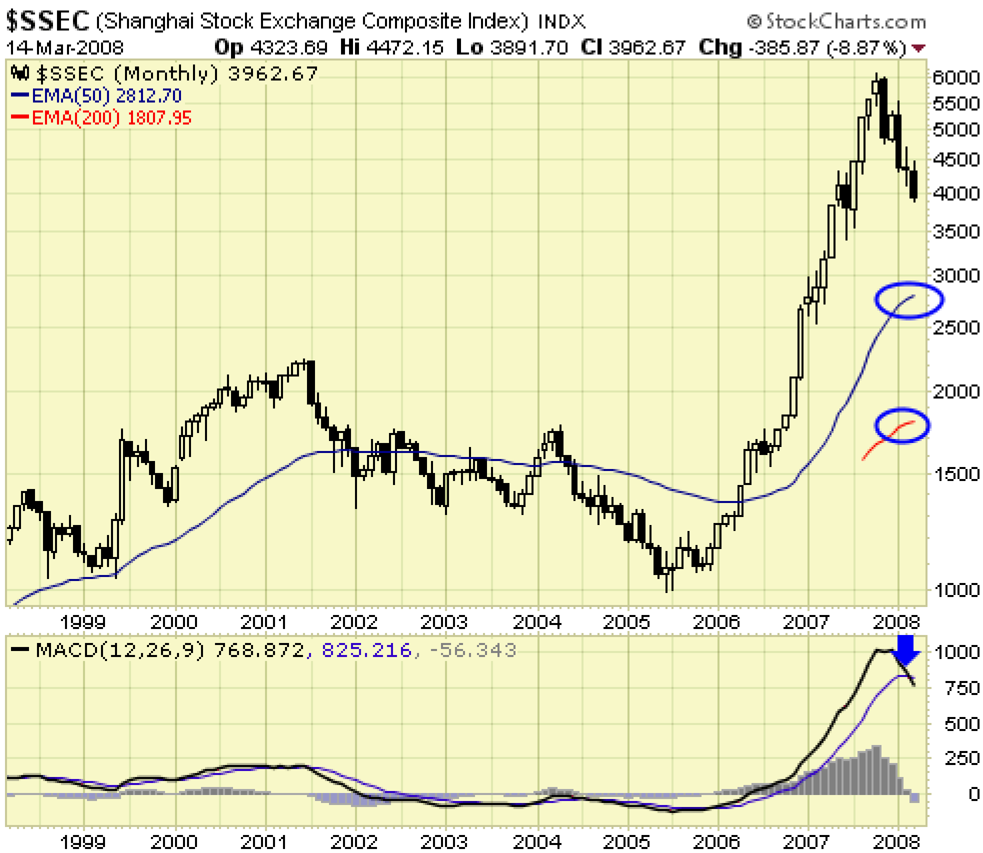
Some analysts are suggesting that 2008 will be a very bullish year because of this and that. Yes, I will agree if the 14000 level is exceeded on the Dow, and the 1575 in the $SPX. But with the 2007 yearly pivot support now broken on both the Dow and $SPX, and the Nasdaq in fact, it is highly unlikely that will happen. I am not predicting the end of the world, just what the $VIX is implying: that the next few months or years will be very volatile as the markets correct the gain from 2003 to 2007.

#3 – The China market

I posted a special report on China after my trip there in October:
http://www.simplyprofits.org/editorials/reports/How_high_will_the_dragon_fly.pdf
The sentiment was very bullish as many traders felt left out not being invested in China, somewhat similar to how some late comers are feeling about the gold market this week as gold touched the magical $1000. I am not suggesting that gold will suffer the same fate as Shanghai, but all markets correct sooner or later. As suggested in that special report, and

often in my updates, the best time to buy anything is at the beginning of a bull market, or after a major correction of a bull market. We can trade any market at anytime, but be vigilant that a correction within a bull market can start anytime, and manage risk accordingly. A major correction in the growth sector has begun. A major correction is likely to occur soon in the energy sector looking at the monthly chart of $OSX. Gold sector may or may not diverge, but a major correction will come, sooner or later.
Back to the China market. So, what has happened since my report posted on 10/31?

I visited the Shanghai exchange the day when it traded above 6000. Yes, it was euphoria. More so than when Nasdaq broke above 5000. This index was watched by billions of people in China, and billions others outside of China wishing they had a piece of the action. Many of our members were asking when I would track the Shanghai, and whether it was too late to buy, etc etc…..Here we are, five months later, and the Shanghai has lost over 30%. What we don't hear is how many Chinese people's lives have been ruined from this current correction. A mania takes a long time to unwind and the process has just begun. As we can see, the daily chart just had a bear cross this week as the Shanghai index is now officially in a bear market. But don't tell that to those who think this is the best buying opportunity. They will think you are crazy.
Some of our members took partial profits and tightened their stops on their Chinese holdings shortly after my 10/31 report, have been well rewarded.



From a long term perspective, a major sell signal will be confirmed at month end. The Chinese market will be joining the Dow, the $SPX, the Nasdaq, and other global indices in a major correction, or bear market in the foreseeable future. Monthly 50ema is at 2800 while 200ema is at 1800. Will it go that low? We don't know. But a major buy signal is likely to occur at one of these two EMAs, when this is all over. Yes, the best time to buy was in 2005 and 2006. But if we missed that, the next best time to buy is when this correction is over. Not before that.

Summary

Most of us who lived thru the Nasdaq meltdown and the two plus years of a major correction know exactly what the Chinese are going thru right now, and with a lot more pain to come. But most of those inside China have never heard of the Nasdaq, and never witnessed the devastation of those who were heavily exposed to tech stocks. According to some of my overseas sources, folks in China continue to buy the dips, betting on a bottom soon because of this and that. We do have many members from the Asia Pacific region, you are welcomed to forward this report to those who you care about. It may help to prevent personal financial crisis or disasters, as many of those playing the Chinese markets are chasing a dream, a little too late or much too early at this point.

End of report