Walter Deemer's

MARKET STRATEGIES AND INSIGHTS

...for Sophisticated Institutional Investors

June 12, 2015

THE BIGGEST RISK FACTOR

The biggest risk factor in the stock market? It may be bonds!

I seem to be constantly hearing about the growing illiquidity in the debt markets; illiquidity that has been attributed, at least in part, to the new capital requirements on bond dealers. This growing illiquidity has been dramatically underscored by the incredible short-term volatility in Treasuries of late. Someday, interest rates are going to go back up to more normal levels (a process which may have already begun); when they do, bond prices will, of course, go down. When they do, owners of bonds, including many hedge funds with highly-leveraged positions, will be confronted with increasingly-losing positions. If they try to reduce exposure all at once it may overwhelm the now-much less liquid bond dealers – meaning that they would have to sell what they can sell rather than what they would like to sell. (And if the process ultimately leads to margin calls…)

What would be the easiest thing for them to sell under that scenario? Stocks. Which is why I don't think it is far-fetched at all to suggest that the biggest risk factor in the stock market here just may be bonds.

More On Bull Market Extension IV. Last week's discussion of Bull Market Extensions generated several questions and comments. My responses follow.

"Why wasn't October 2011 a Four-Year Cycle bottom? After all, the S&P fell 21.6%, the media's definition of a bear market, between May and October of 2011. Furthermore, the October 2011 low was eight years, or two four-year cycles, after the 2003 low."

The March 2009 was clearly a Four-Year Cycle low (chart, next page), and I don't think the market could have possibly made another one only 2½ years later. For the moment, though, let's skip the rather technical details why I don't think it was possible

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for October 2011 to have been a Four-Year Cycle low and simply assume it was. The implications for the market are nevertheless similar: the next Four-Year Cycle low would be due four years after October 2011 – or late this year – so a bear market would have to unfold between now and then.

The bottom line, in other words, is that whether we are in Bull Market Extension IV, as I believe we are, or rather heading for a Four-Year Cycle low late this year, the outlook in both cases is for some tough sledding ahead. We're either looking at a worse-than-average post-Bull Market Extension decline or "just" a 20%-plus bear market.

"You once mentioned that the low following the 2007 Bull Market Extension was made an unprecedented 29 months behind schedule. This Four-Cycle low was supposed to occur in

March 2013, and 29 months after that is next month. This Four-Year Cycle low is thus going to be even more unprecedented. What say you?"

The "even more unprecedented" is not really surprising given that QE, QE II and QE III injected an unprecedented amount of liquidity into the system for an unprecedentedly long time.

"We've had two Bull Market Extensions in a row. Does this mean the Four-Year Cycle isn't working any more?"

No! The Four-Year Cycle is <u>not</u> an economic cycle nor a political cycle (the so-called "Presidential cycle) – <u>it is a psychological (emotional) cycle</u>. Investors' emotions are constantly shifting from optimism, (greed) to pessimism (fear), and history tells us that it usually takes four years for this psychological cycle to run its course. And despite all the technological "advances" in the financial markets, market participants are still people -- and people still have emotions. The psychologically-based Four-Year Cycle is not dead.

The Market Now. The market's internals remain soft, especially as reflected by the advance-decline line (chart, next page). In addition, neither last Thursday's 84% downside day nor the 82% upside day Wednesday breached the 90% level that usually identifies a significant short-term market bottom. The market therefore does not appear to have enough strength here to make a decisive new high.

This week's bounce off the 2072 level, however, did increase the significance of the 2070 level, the early-May low. A close below there might thus have more consequences now that it would have had before. It would still take a close below the March low of 2040, however, to confirm that the trend has reversed.

Leadership. Consumer Discretionary, Information Technology, Regional Banks and – especially -- Healthcare (including Biotech). A word of warning with regard to the Biotech area, though; it went parabolic back in March, and parabolic advances don't correct by going sideways (even though this one has – so far). Whether this will lead to something more than a short-term correction in biotechs, however, may depend on the

overall market environment more than anything else. Most Asian markets are also strong. In the meantime, Consumer Staples, Emerging Markets, Transportation, Utilities and Energy are weak (it is unclear just how far along in a potential basing process energy stocks are, but it is way too soon to remove the "weak" label). In addition, European markets are deteriorating in spite of Mr. Draghi's feverish printing.

And a quick note on the Financial sector: I had been calling it a deteriorating sector (with the exception of Regional Banks) even though it was performing better of late. My cautious stance was largely in anticipation that this traditionally-early-to-turn-up-and-down sector was vulnerable given the age of the bull market. It broke out to the upside this week, however, underscoring once again the perils of anticipatory analysis.

Fidelity Sector Funds. 77% positive vs. 85% a week ago. Switching program holdings: #1 Biotechnology, #4 Medical Delivery and #6 Electronics.

-- Walter Deemer

FIDELITY	PRICES (in cents)					DTR STRENGTH RATINGS				
SECTOR FUND	Jun 10	Jun 3	May 27	May 20	R/C	Jun 10	Jun 3	May 27	May 20	May 13
Biotech	26380	26386	26467	26197	-55	110	165	212	176	107
IT Services	4010	4009	3977	4003	-24	103	127	137	149	114
Pharmaceutical	2396	2408	2411	2399	-29	92	121	158	122	84
Medical Del	9116	9096	9148	9160	-8	85	93	129	115	73
Banking	2786	2717	2687	2693	2	82	80	86	85	61
Electronics	8627	8729	8822	8545	-45	71	116	161	109	56
Healthcare	23829	24048	24205	24056	-43	65	109	150	111	73
Technology	12460	12551	12556	12401	-28	61	88	112	84	58
Retailing	9491	9560	9415	9472	-14	57	70	80	82	74
Broker/Invest	7763	7690	7645	7651	-9	55	64	75	68	40
Leisure	14095	14067	13991	14127	-9	55	64	81	77	57
Automotive	4746	4769	4764	4763	-21	52	72	102	92	72
Consumer Finance	1394	1390	1388	1396	-14	51	65	79	85	60
Medical Equip	3850	3900	3882	3901	-54	49	103	119	103	78
Multimedia	8296	8354	8367	8228	-27	43	69	94	69	22
Environmental	2089	2089	2089	2086	-19	40	59	76	68	42
Insurance	6874	6838	6785	6852	-11	40	50	62	68	35
Software	11672	11744	11738	11746	-25	38	63	80	65	39
Financial	9137	9111	9102	9134	-11	37	48	62	63	36
Consumer Discr	3451	3472	3452	3465	-18	33	51	73	69	51
Wireless	947	955	964	950	-29	32	61	85	58	32
Comm Equip	3242	3279	3266	3260	-45	29	75	88	67	31
Indust Equip	3763	3773	3778	3796	-33	25	58	81	80	47
Chemicals	14926	15048	14923	14951	-18	22	40	58	54	15
Industrials	3232	3232	3225	3244	-23	18	41	60	58	31
Materials	7996	8058	8048	8045	-17	16	33	59	51	14
* * S&P 500	210520	211407	212348	212585	-22	16	37	61	51	28
Defense/Aero	12138	12297	12387	12504	-28	11	39	70	76	46
Computers	8238	8321	8292	8224	-38	11	49	69	44	16
Telecommun	6304	6357	6351	6327	-20	9	29	43	41	20
Constr/Hous'g	5749	5819	5821	5838	-19	6	25	49	51	47
* * T Bills	1984	1984	1984	1984	0	0	0	0	0	0
Airlines	6996	7161	7045	7123	-35	-3	32	36	32	23
Consumer Stpls	9400	9494	9641	9689	-17	-16	1	29	26	15
Utilities	6970	7030	7192	7218	-17	-34	-17	17	7	-27
Gold	1697	1724	1720	1782	-16	-41	-25	-47	-22	24
Nat Resource	3189	3164	3185	3216	-29	-42	-13	14	20	14
** Emerging Mkts	4044	4091	4207	4275	-35	-42	-7	38	59	51
Transport'n	8564	8701	8606	8681	-33	-42	-9	-4	-14	-30
Energy	4644	4604	4633	4674	-30	-43	-13	14	20	11
Energy Serv	5822	5775	5769	5760	-47	-44	3	29	22	42
Natural Gas	3243	3249	3307	3341	-47	-64	-17	22	31	31