Saut Strategy

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"I have been as half as many places as my luggage!"

. . . Bob Hope

I have many times referred to the quote, "I have been as half as many places as my luggage!" because of my travel schedule. As a sidebar, in pretravel preparations lay out all your clothes and all your money. Then take out half of your clothes but double your money. So, over the past few weeks I was in North Carolina, Chicago, Hollywood Florida, Boca Raton, Miami, etc. While traveling is exciting, it tends to take my eye off the stock market "ball." Indeed, three weeks ago I wrote about the fact that my short-term proprietary model flashed a short-term (ST) "sell signal." Since then stocks have either declined or "parked" in their place. That "sell signal" was followed by two consecutive 80% "downside days" meaning that 80% of the upside to downside volume came on the downside, and that 80% of the total points traded also came in on the downside. While that is extreme selling, it was NOT as oversold as the markets were at last October's lows where a similar sequence took place. Subsequently, we have been bombarded with the question, "Is that it? Is that the pullback you have been looking for over the last few weeks?" My response has been, "Quite frankly, I just do not know."

The cause of the selling squall has been the perfect trifecta. The coronavirus, the weak PMIs, and the impeachment. While the stock market was already very overbought, and well extended above its 200-day moving average (the S&P 500's 200-DMA is currently at 3011.88 while the index was trading at ~3320) we were due for a pullback and the trifecta just served as the catalyst. Speaking to the coronavirus, I was told over the weekend, from what I consider to be a reliable source, there is a cure for said virus. My source said that a doctor in a lab at the city of Wuhan, central China's Hubei province, had told him the Chinese needed three weeks to test the cure and if it works an announcement would be forthcoming. He also said that in the hinterlands of China they eat rats, snakes, etc. so, there is always going to be some kind of virus in China. Now I do not know if the cure story is true, but if so, it would go a long way in settling the equity markets. We see support for the S&P 500 (SPX/3225.52) at the current levels and then between 3180 – 3200). This week the impeachment squall likely goes away and if the coronavirus story is true two of the trifectas get resolved. As for the weak PMIs, we think the economy is just fine and will strengthen in the back half of the year.

While we have been cautious, and have raised some cash, since our short-term model's sell signal of three weeks ago, we have not been deterred on our secular bull market theme. Dow Theory remains "bulled up" and the primary trend of the stock market is up. As the must have Lowry's Research service writes:

Lowry's Net Percent Spread between Buying Power and Selling Pressure reached its highest point since mid-April of 2019 – a reflection of rising Demand and falling Supply. Our key breadth metrics – Lowry's Operating Companies Only (OCO) Cumulative Adv-Dec Line, along with each OCO market capitalization segment's respective Adv-Dec Line, reached new all-time highs. Lowry's Percent of OCO Stocks Within 2%, 5%, and 10% of 52-Week Highs reached their highest levels in 2 years, as did Lowry's Percent of OCO Stocks at New Highs. These new multi-year highs reflected a broad and robust advance that was still strengthening. Lowry's Percent of NYSE Issues Above 30-Week Moving Averages also achieved its highest reading in 2 years.

Obviously, we agree with the good folks at Lowry's. So, since our trader's sell signal the SPX has declined about 3.6%, although it feels like the decline has been much worse than that. While this week will tell if the decline continues, the secular bull market remains intact. Indeed, last week I sent out Seth Klarman's (arguably the smartest guy in the room) letter from his flagship money management firm Baupost to a few folks. My pal, and master stock market analyst, Leon Tuey replied:

I wonder if Seth read the study by Donaldson Lufkin on what drives stock prices? In the early 70s when I first got in the investment business, I read the voluminous study. The study concluded that it's earnings momentum that really drive stock prices. Also, long ago, someone asked Marty Whitman what he thought about diversification. His reply: "A damn poor surrogate for knowledge." That can also be said about value vs. growth, passive vs. active.

The job of a fund manager is not only to seek out situations that represent low-risk, high-reward, but to ensure that they will outperform, a task that is well-nigh impossible for most. Most practitioners don't know how a bull market begins and how it ends. Moreover, being conservative, they always buy "blue-chips", but in a bull market, they don't provide the biggest returns; it's the mid-cap, small-cap, high beta issues that give investors the biggest bang for the buck. Furthermore, they always hold some cash. In a bull market, holding cash is a handicap and prevents one from outperforming. In addition, they don't listen to the market as they rather tell the market what they think. These and many others are reasons why their track record is so dismal.

Well said Leon, and that is what Andrew, Harry, and I attempt to do at Saut Strategy (www.sautstrategy.com). To that point, we heard an interesting stock story in our travels last week. The name of the company is Profound Medical (PROF/$16.69). According to Yahoo Finance:

Profound Medical Corp. operates as a medical technology company focuses on magnetic resonance guided ablation procedures in Canada, Germany, and Finland. It is developing a treatment to ablate the prostate gland in prostate cancer patients, treatment of uterine fibroids and nerves, and palliative pain treatment for patients with metastatic bone disease. The company is headquartered in Mississauga, Canada.

As we understand the story, PROF has a method of cleaning out all the bad stuff in the prostrate, which is a huge addressable market. They are inline for a C-code license. C codes – items and services for outpatient use, pass-through devices, drugs and biologicals, new technology and other services. For those of you that followed us on Flexion (FLXN/$17.52), when FLXN got its C-code the shares lifted from roughly $12 to $23.

The call for this week: This week should tell us if the selling continues, if the consolidation plays, or if the equity markets are setup to rally again. Our short-term proprietary model is still negatively configured. Our internal energy model is still out of energy, so as Andrew Adams wrote last Wednesday, "We remain in wait and see mode." And then there was this from a really smart portfolio manager:

You may recall that back in the latter part of December I became cautious, not because I saw coronavirus on the horizon, but because I felt that risk-reward was no longer compelling in the short term given less friendly valuations and complacent investor sentiment. So, it seems coronavirus is now giving investors a convenient excuse to take some profits after such a strong rally off the October lows. Now given the reasons I've highlighted above in addition to global central banks that remain very accommodative, and an economy that remains in expansion, I expect this correction will most likely resolve itself in the 3100-2900 zone for the S&P 500. So, at worst something along the lines of a 10-12% pullback, but not as bad as the more recent growth scares as we saw back in early 2016 or the 4th quarter 2018. We are still in one of the most powerful secular bull markets in history that still has years to run so any short-term weakness we see should be used to increase your equity exposure. I still like economically sensitive and secular growth themes such as technology. I'm also looking at the hospitality and travel stocks since they now exhibit compelling valuations and demographic tailwinds from the Millenial and Generation Z crowd who value experiences over stuff.

This morning, however, the preopening S&P 500 futures are better by some 20-points on less worries about the virus.