

TECHNICAL ANALYSIS:

THE CHARTS TELL A STORY

A Presentation By

Frank D. Gretz

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**Before
The Baltimore CFA Society**

I want to thank you for the opportunity to speak to you today and, as it happens, for a chance to return to my home town. When I graduated from Georgetown, I intended to go to NY for a couple of years, learn the business, and then return to Baltimore-Washington. That was back in 1967. So learning the business, apparently, has taken a bit longer than I thought. Then too, NY can be a bit addictive.

So I understand I have the pleasure of speaking to my own kind, MTA's, and those of you of a fundamental persuasion. And that reminds me of the time a fundamental analyst and a technical analyst were having dinner. During the dinner a sharp knife fell from the table, the technical analyst moved his foot, but the sharp knife hit the foot of the fundamental analyst. When the technical analyst asked why he didn't move his foot, the fundamental analyst replied, "I thought it was going back up". Well, as we all know, 2008 was a year where you had to do a lot of foot moving. There were few, if any, places to hide.

Let me begin by giving you what I think is a very important perspective on technical analysis. Here is a chart of the NASDAQ back in the good old days – 2000. It was quite a climb to March 2000, and quite a subsequent fall. For the year the NAZ closed down almost 40%. Now here's a chart of Altria, then Philip Morris, covering the same period. The NAZ peaked and Philip Morris bottomed virtually together. Philip Morris ended 2000 up about 95%.

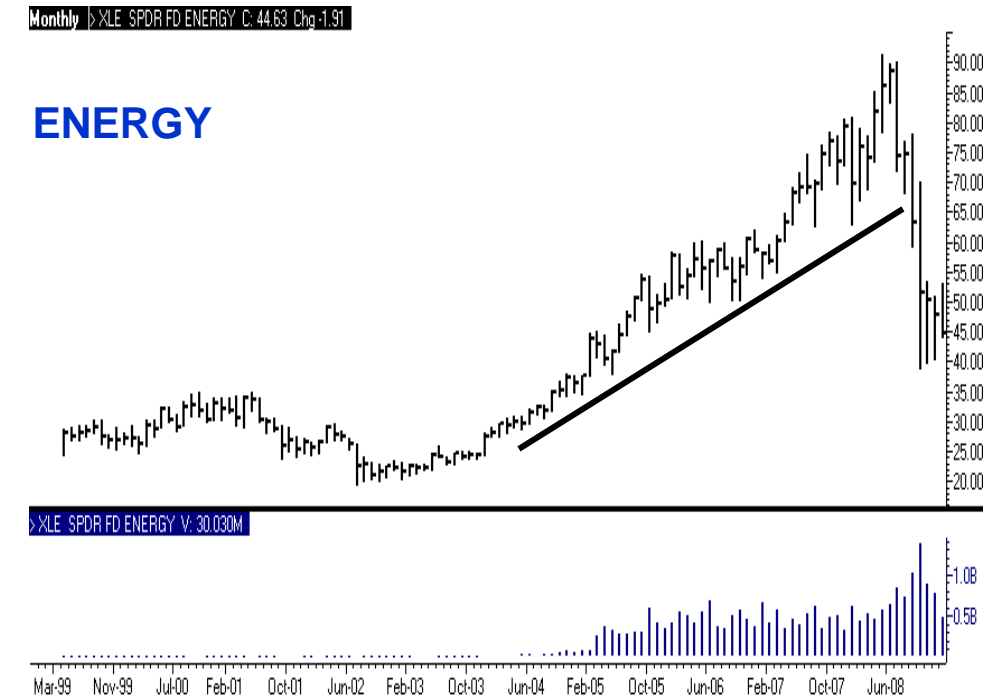
While this behavior of Philip Morris may sound bizarre, the explanation is quite simple. You probably have forgotten back then there was a big discovery that, after all, cigarette smoking doesn't cause cancer. That's why the stock rallied so sharply. Remember that? Actually, I am a little confused, it wasn't that. But now I remember – everyone promised to stop suing the cigarette companies. Remember that? Ok, I'm confused again, but now I think I've got it. Philip Morris was up 95% after the market peaked because everyone figured out that cigarettes were a growth business.

Actually there is only one possible explanation why MO was up 95% in 2000, that's supply and demand. By March of 2000, like most "old economy" stocks, MO was completely sold out. No one wanted them. The "new economy" stocks were all the rage, the NAZ, the CSCO's, the SUN's and many that are no longer with us, including Nortel. Just as the bubble and the over-owned Naz peaked because there were no more buyers left, MO went up because there were no more sellers left. It's about supply and demand, and technical analysis is above all else an analysis of supply and demand. When most think of technical analysis they think of charts, but the charts are a tool that we technicians use. As I like to say, "the charts tell a story" and that story is about supply and demand.



So what creates supply and demand? The answer of course is many things. As we saw in 2000 and again last year, the overall trend in the market can have a significant impact on individual stock prices, as much as 50-70%, studies have found. Identifying the overall trend in stock prices isn't always easy, but it doesn't have to be complicated. Looking back at the S&P 500 over the last few years, moving averages or simple trend lines have done a pretty good in making it clear when things have changed.

Another important influence on supply and demand is group behavior. In the first half of last year there was plenty of money to be made in commodity stocks. Of course, that was provided you sold them in July where again, a little trend line analysis would have helped. As it happens, the extent of the declines there make me think their leadership days may be over. Much like the first half of last year, commodity stocks also led in the '70's. Meanwhile the "nifty-fifty" stocks which led the '70-'72 bear market died. Had you bought KO, a real buy and hold company, at the end of 1972, you didn't get your money back until 1986. In 1981 KO sold for 8x with a 6% yield, and during this time earnings never missed a beat. But as inflation and commodity stocks peaked in the early 80's, beneficiaries like KO and consumer non-discretionary stocks assumed a leadership role. The 90's of course, belonged to tech and financials. So clearly, where you are in the market can be important to profitable investing.



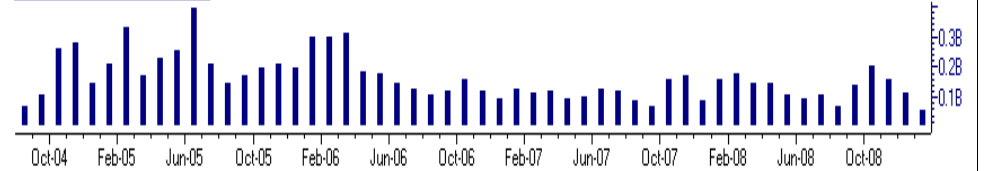
Finally, at the risk of being drummed out of the MTA, supply and demand can be about fundamentals, those “special situations” which really are special. The trouble here, however, is that many times those fundamentals aren’t so easily knowable. Studies have found that in most years the best performing stocks are those where analysts underestimated earnings, while the worst performing stocks were those where analysts overestimated earnings. If you think about the dramatic rise in Google, for example, you’ll recall that analyst’s estimates followed the stock higher. And then, of course, there’s the recent sad example of Satyam, where the fundamentals were fictional, but the warning signs in the chart had been clear for quite some time. So even where “fundamentals” are the driver the charts, with their simple price and volume lines, often do a good job of spotting fundamental changes.

Monthly > GOOG GOOGLE INC C: 285.83 Chg -13.84

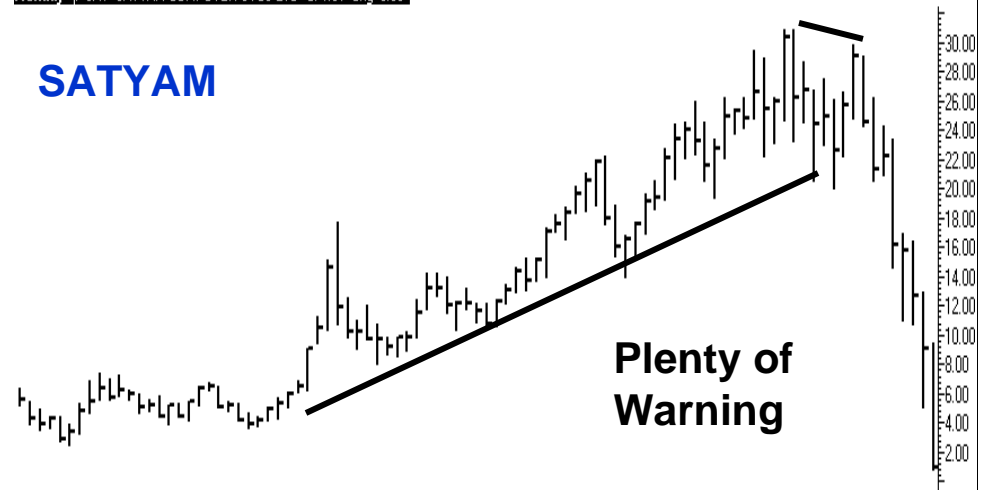
GOOGLE



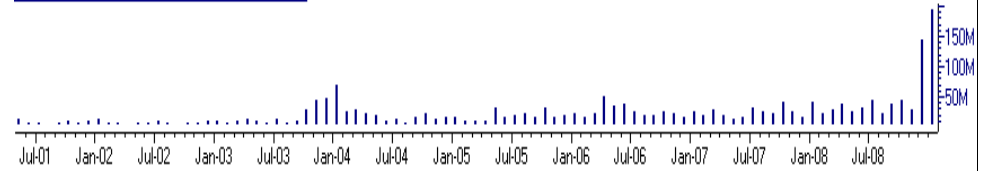
> GOOG GOOGLE INC V: 4.102M



SATYAM



> SAY SATYAM COMPUTER SVCS LTD V: 4.880M



So . . . where does all of this leave us now? I think the market made a low in the Fall that should last and that prices should head higher at least into the Spring. The background for that low was a market extremely oversold. In that regard, one of my favorite indicators is the percent of NYSE stocks above their 200 day moving average. This indicator moves within a range of 20% to 80%, 20% representing a very oversold or sold out market. Back in October this reached 1%, a record low, and lower than the 2% following the sharp sell-off in 1987.

Within this background October saw a wash out low; record volume and downside extremes.

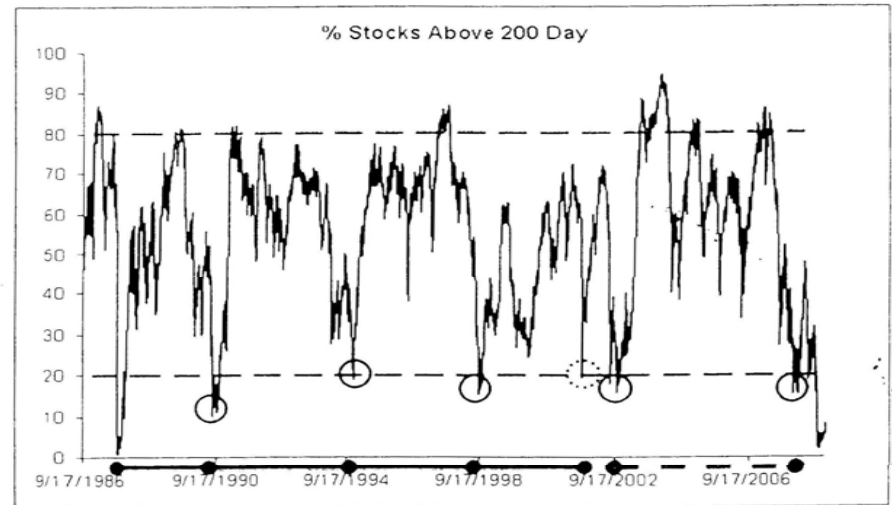
*The difference between the S&P 500 and its 200 day moving average reached minus 22%, a level seen at other important lows.

*12 month lows spiked to 92% of all NYSE stocks while new highs disappeared. There was no place to hide, characteristic of a wash out low.

On the sentiment side, the Fall also seems characteristic of an important low. The top of a market is the point of maximum optimism - the bottom is the point of maximum pessimism. We've seen the most pessimism in 40 years, based on the Consumer Confidence Index. Last fall that pessimism combined with fear, extreme readings in the Volatility Index, seemed to confirm the washout lows in the market.

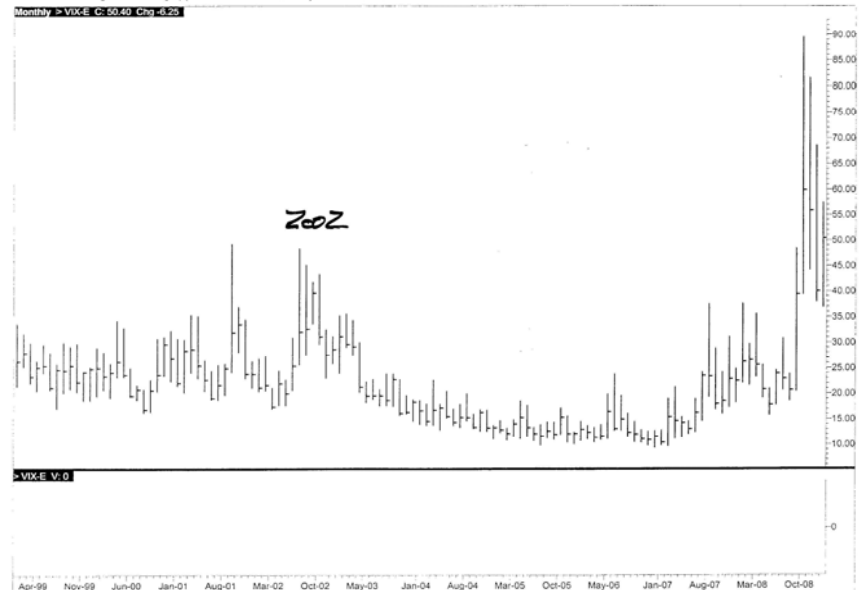
November saw a successful test of the October low. The market averages moved below the October lows but the "average stock" did not. The level of 12 month new lows was much less in November vs. October, and volume was also much less. In other words, despite lower lows in the averages selling pressure was much less. That's the definition of a "successful test".

STOCKS ABOVE 200 DAY



12/87	9/90	12/94	9/98	11/08
2%	11%	2%	14%	1%

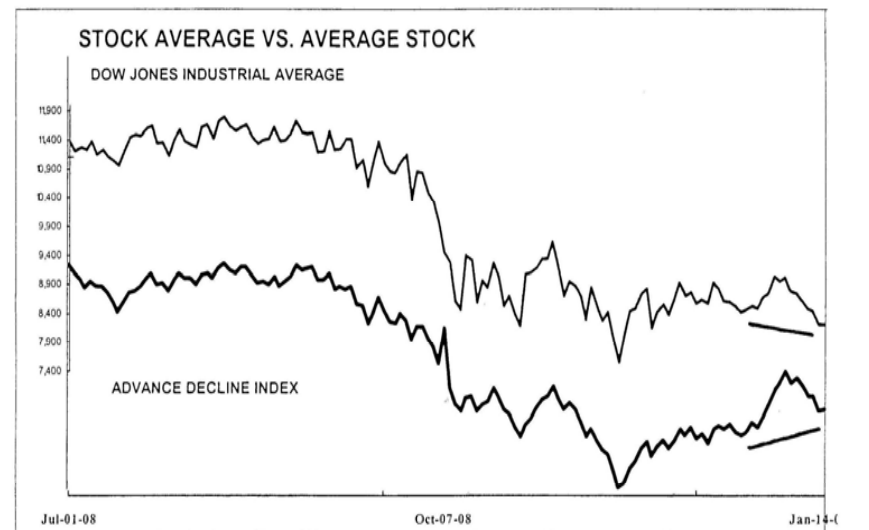
VOLATILITY INDEX



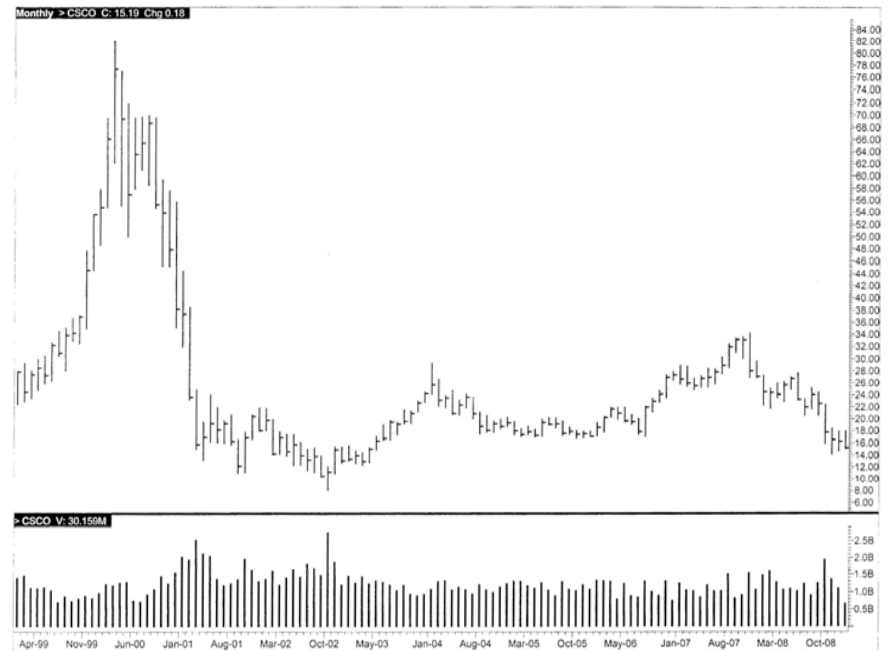
Since then we've seen some decent upside momentum in December and early January, though it has remained pretty much a struggle, or trading range at best. I'm still optimistic we will come out of this to the upside and, at least, muddle higher into the Spring. With that wash-out low in October and the test in November, it seems to me that a lot of bad news is already priced in. A positive sign has been market breadth or the Advance-Decline Index. This index measures the "average stock" as I like to put it, vs. the stock averages. As you can see, breadth has been outperforming the market averages. That's just not a pattern that typically gets the market in trouble. Indeed, it's just the opposite.

What we need to see is some upside momentum, a good kick to the upside. It's one thing to say things are stretched to the downside, but things can stay stretched or get more stretched. Stocks above their 200 day moving average got down to 1% in November, but the best they have done so far is 8%. It would be nice to see enough rally to get this at least up to 20-30%. Similarly it would be nice to see the averages move back above their recent trading ranges.

As to where you want to be in this market, that's a bit more tricky. As I said earlier, I am not sure you want to go back to energy and other commodities. Certainly they should rally sharply but the extent of the weakness there calls into question the overall uptrends. And certainly you don't want to be in Financials. When leadership ends it stays ended for a long time, think of the tech stocks after 2000. Most of the Dot.Coms are no longer with us and even one of the best of them, CSCO, is yet to make it back to the 2000 peak of 85.



CISCO

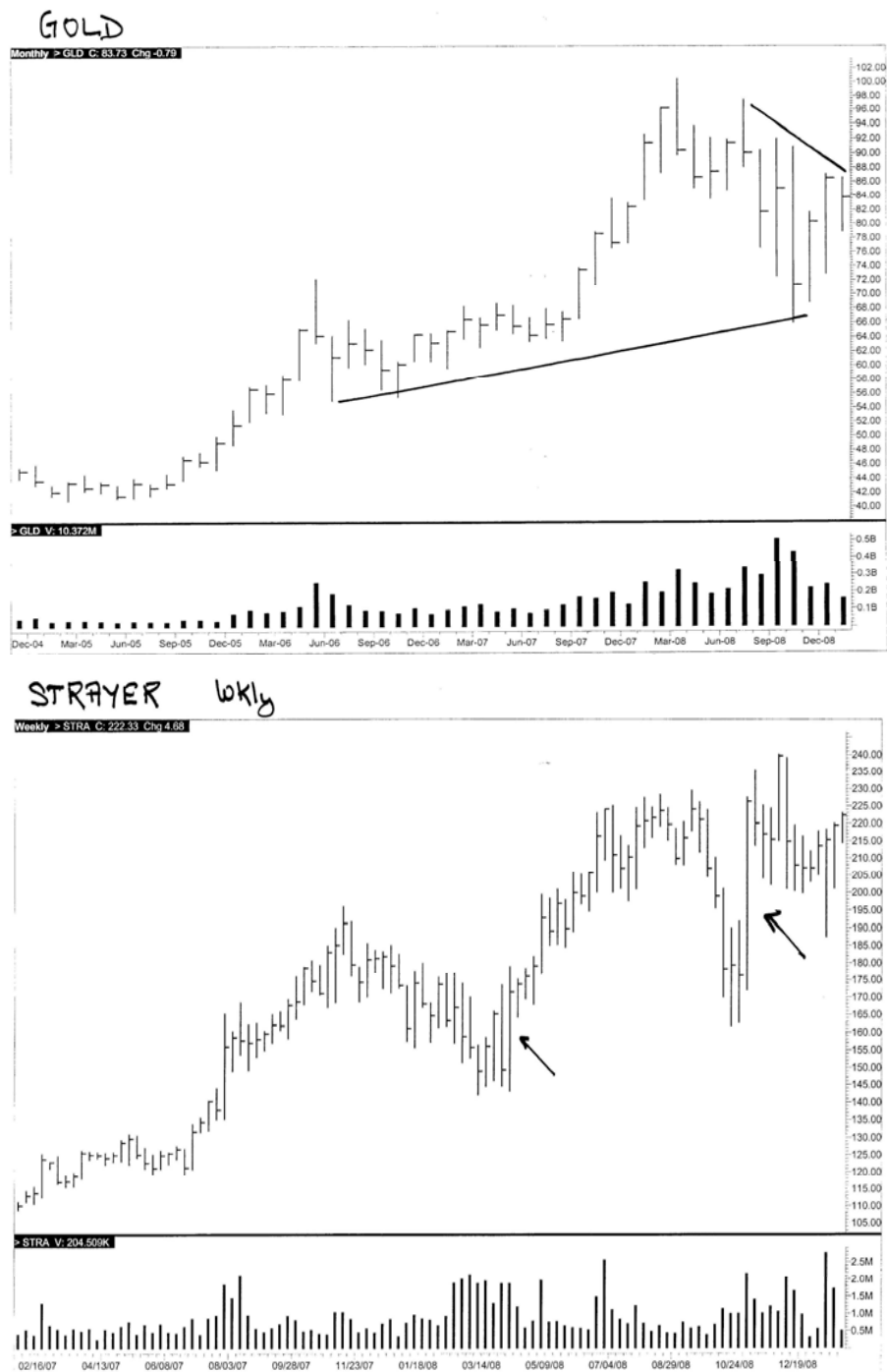


An exception to the commodity weakness could be gold. Gold peaked back in March, well ahead of the other commodities. After a correction of about 30% and reaching extreme oversold levels, gold made a bottom in November. As you can see, the overall uptrend in gold is still very much left intact. In the last secular bull market in gold from \$35 to \$800 back in 1980, gold had several corrections similar to this one. All that is needed now is to see the downtrend broken, around 90 on the ETF.

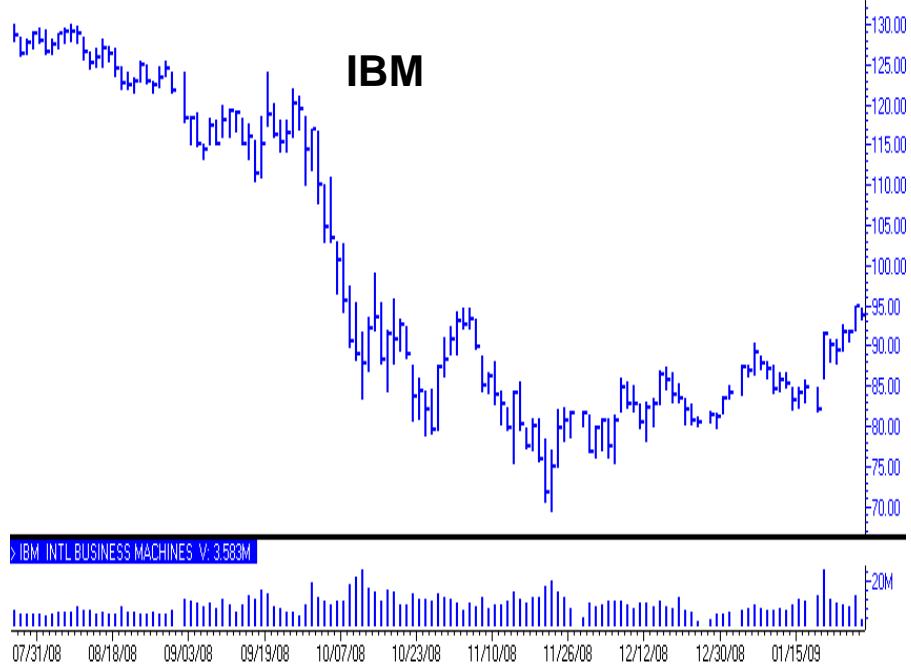
Another area that seems attractive are the education stocks. There are several but let me show you what attracts me here. When I look at individual chart patterns I like to see dramatic or dynamic moves. Take a look at Apollo and Strayer Education, though many in this group look attractive. Moves like this don't happen by chance. They signify a change and that change is typically a change about the fundamentals. I also think price gaps send the same message, but even more dramatically. As I think we all know, a gap occurs when the day's low is higher than the previous day's high, thus leaving a gap on the chart. This to me is perhaps the best example of dynamic price action. After all, it takes a lot of money to push a stock up or down enough to cause a gap. I may not know the reason, but I'm comfortable going with the idea that the reason is a good one.

Strayer and several education stocks have had upside gaps, and another stock with a recent price gap is Family Dollar, though that still has to push through 29-30 to break out. And on a more speculative vein, Palm also had a gap recently. Also, though they lack the overall uptrend, I'm also impressed by last week's gaps in both IBM and Apple. For both, that seems an important change.

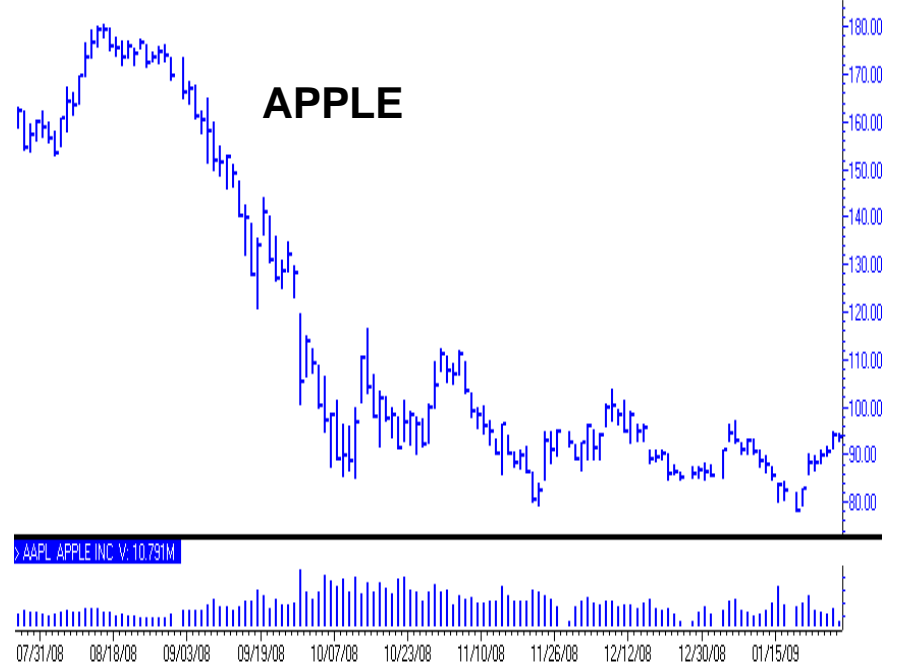
So these are some of the charts I think are telling a story now. Thank you very much.



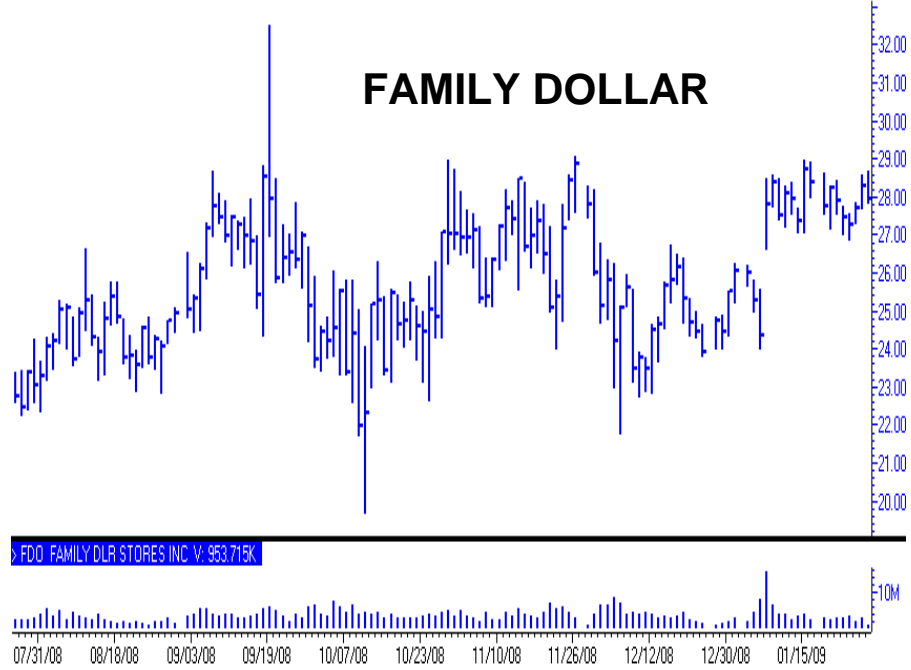
Daily > IBM INTL BUSINESS MACHINES C: 93.87 Chg -0.95



Daily > AAPL APPLE INC C: 93.72 Chg -0.48



Daily > FDO FAMILY DLR STORES INC C: 27.96 Chg -0.32



Daily > PALM PALM INC C: 7.96 Chg 0.13

