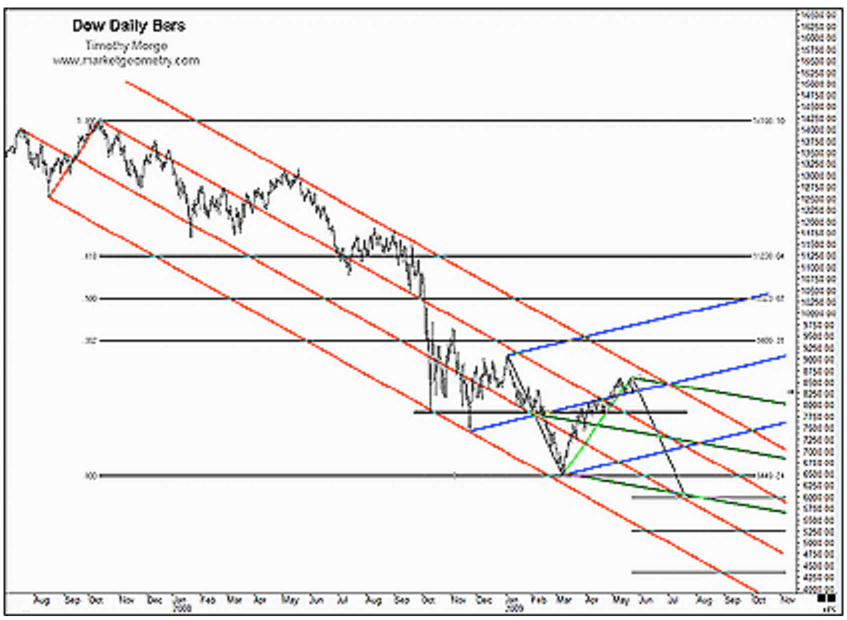
Tips for Traders | 5/26/2009 10:35:00 AM

Calling All Traders: Get Ready to Make Money Shorting the Market

I am not trying to paint a grim picture of the US stock market and the US economy. I sat quietly watching, carefully buying a few stocks and then taking profits as the markets rallied over the past three months. I still believe we'll see new lows in the US stock market, but I am a trader and am more than willing to buy a few stocks here and there in a countertrend rally.

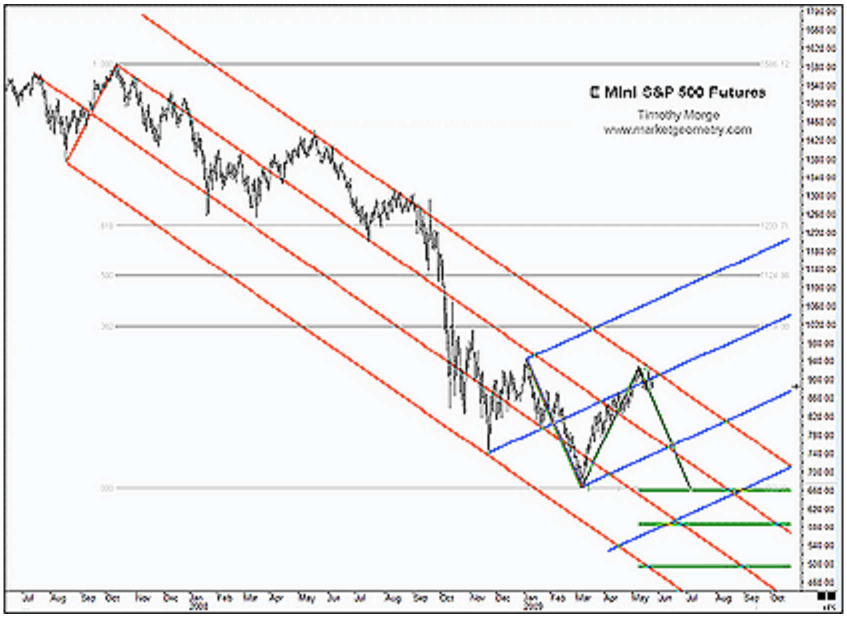
I know some of you think this three-month rally is the beginning of the turnaround. In fact, some of you have sent me e-mails asking if I have “thrown in the towel” on my call for new lows. The answer is simple: Price hasn't even approached the 38.2 retracement area measured from the stock market's 2007 highs and the recent lows. Until price breaches that minor retracement, it's as weak as a newborn pup and just as fragile. Let's look at an updated version of the chart I used when talking about the coming decline all the way back in November of 2007 during an interview at Traders Expo in Las Vegas:



The Dow has rallied fairly steadily for the past three months. Note that it rallied above the blue, up-sloping Median Line and spent some time above it, but was unable to pull away to the upside. As this week closed, price has closed right on the blue, up-sloping Median Line two days in a row—so we are left to see what next week brings.

If price breaks and closes below the blue, up-sloping Median Line several days in a row, it should accelerate and head to a re-test of the prior lows at 6600. Should it approach that level, I think it will find little support, and will instead accelerate through the prior lows.

Let's look at the S&P 500 chart to see if it is telling us a different story:



The e-mini S&P market tested the red, down-sloping upper Warning Line, which acted as good resistance many times earlier in the strong downtrend. Note that the S&P market was unable to rally above this line and turned lower. It has now penetrated and closed below the blue, up-sloping Median Line two days in a row, also giving a weekly close below the blue Median Line.

If price shows any downside momentum at all in the next few weeks, I expect we will quickly revisit the lows made earlier in the year. And I do not think the lows for 2009 have been made yet. Let me show you a chart that tells just one reason why I think there is more downside price action to come…

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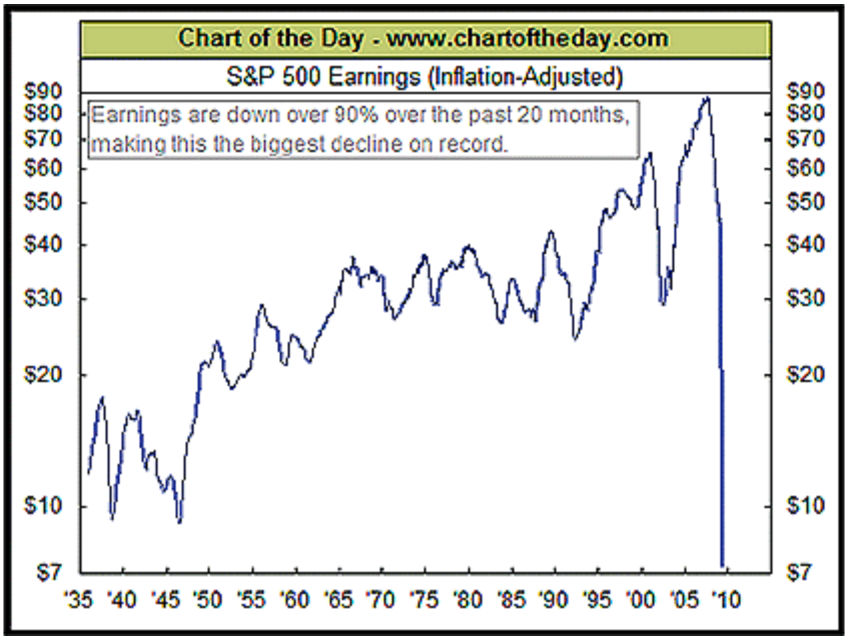
Here is a very chilling chart courtesy of ChartoftheDay.com. Many analysts have been talking about the current recession and comparing it to the economic troubles of the late 1970's and early 1980's (some refer to it as the Jimmy Carter troubles). I was an active professional trader during those times, and in my opinion, this economic downturn is much worse. I obviously was not around for the 1929-1936 depression era, but looking at the chart, you can see that the current economic environment is every bit as bad—if not worse than—The Great Depression.



I do not buy into the argument that the US government has more means to solve any economic crisis that arises. If they do, how did we get in such bad economic trouble? I also do not trust the people running the economic show; not from the past administrations and not from the current one. Many people have trumpeted our current Fed chairman as being the “best candidate” to get us out a steep recession because he studied The Great Depression. However, studying and putting cogent plans into action are two different things. So far, I see little to make me confident that anything but time will heal this economy, which was my opinion before our current Fed chairman was appointed. There is a season for all things, and I believe we will have to live through this season of severe economic downturn. And for the record, it is a depression, not a recession. I don't understand the media's reluctance to use the correct term for these tough times.

Now, we will look at two other charts that will show you why I am so worried that the already poor economic outlook may soon get decidedly worse.

Let's look at two other charts that will show you why I am so worried that the already poor economic outlook may soon get decidedly worse.

First, this is a chart of 30-year US bond yields. If you look at the chart, you will see that although our government has spent several trillion dollars and supposedly pumped a great deal of liquidity into the banking system to stabilize it and lower interest rates, in truth, interest rates have gone straight up all year! This does not translate into helping the average citizen with his troubled home loan or mortgage payment. There has been lots of talk, but the charts show little action, and in truth, the charts show a worsening condition!

Does anyone really want to buy our bonds and finance our growing debt? The price of the US 30-year bonds, as the increase in the yield clearly shows on the chart above, has gone down all year. We even sent the Secretary of State to China to ask them buy more US bonds. Their official response: They would wait to see if the value of the bonds held up, as well as monitor the value of the US dollar, because our government was growing our national debt at such an alarming rate!

Let's now look at the US dollar and see if it is helping the outlook for our economy:

The last article I wrote concerning the state of the economy pointed out that in my opinion, the bellwether indicator to watch would be the US dollar. I said that if the dollar began to weaken, I would expect US interest rates to follow higher, and the two coupled together would likely precede the next down leg in the US stock market. The chart above clearly shows that the dollar has declined dramatically against the euro and is currently showing no signs of life, and despite higher interest rates, investors and traders are flocking away from the US dollar as fast as they are flocking away from US bonds.

There are continuing rumors that the Chinese have begun to try to manage a small, controlled floating currency exchange within Hong Kong, probably as a prelude to openly floating their currency on the world market once they are sure the internal mechanisms are in place within their government infrastructure. If the Chinese do indeed let their currency float freely, there will be a huge outflow from the US dollar into the new, floating Chinese currency. This can only make things worse for the US dollar, US bonds, and the US stock market if it does happen.

I did not add a gold chart, oil chart, or a chart of one of the grain markets to this article. But if you look at those charts currently, you'll see that all of them are exploding in price again. The Fed did a good job trying to focus people's attention on deflation, but at the moment, it looks like the pressure is right back to the fight against inflation. And you would expect that, with the US government adding untold amounts of money to our mountain of debt.

If you don't want to buy the US dollar or US bonds, why would you be interested in holding US stocks? Would the last buyer please turn out the lights?

I wish you all good trading.
My heart goes out to those of you suffering in these difficult times.

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