

# Baker Avenue Q2 2010 Update

## *A San Francisco Summer: Market Sentiment Turns Gloomy*

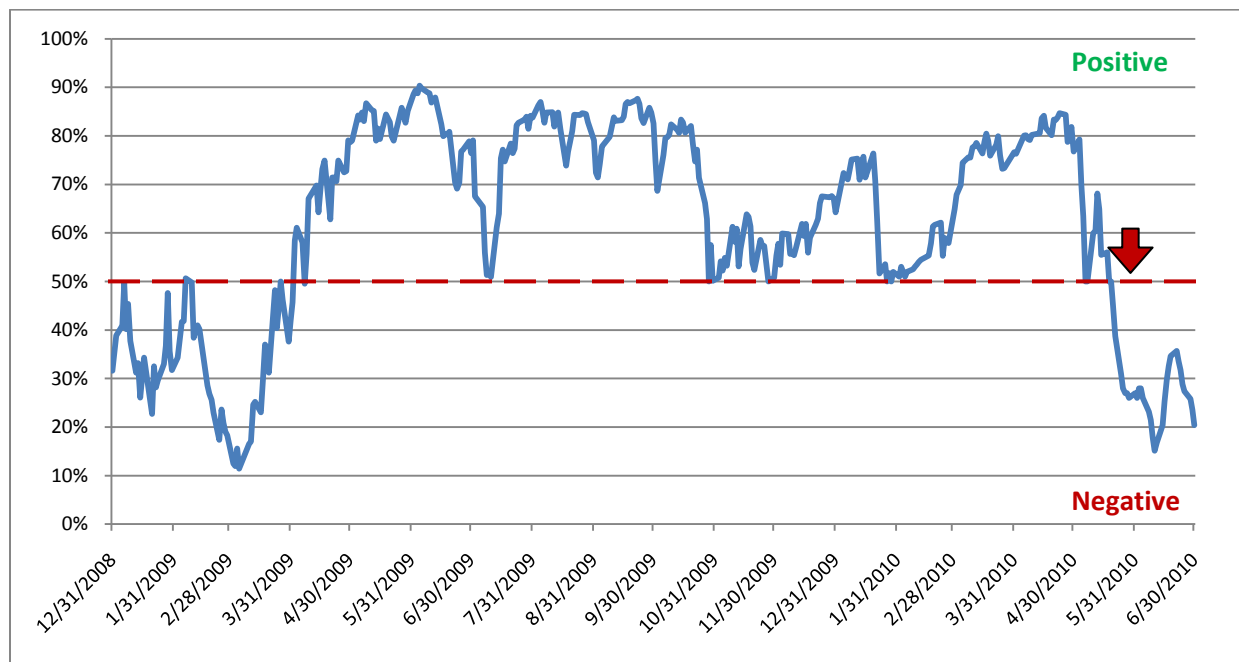
Mark Twain once quipped, “The coldest winter I ever spent was a summer in San Francisco.” Such could be said of this year’s summer climate for the market. After rising 5.4% in the first quarter, the S&P 500 Index tumbled -11.4% in the second quarter due to debt contagion fears in the Euro zone and continued fears of a potential double dip recession here in the US. It finished the midpoint of the year down -6.7%.<sup>i</sup>

Reflecting the precipitous decline in the second quarter, the Baker Avenue Market Sentiment Indicator (BAMSI) turned gloomy in May by dropping into bearish territory. It had stayed positive for an extended 13 months after turning positive in April 2009 (Chart 1).

**Consequently, we moved 100% to cash in the All Cap Core strategy with the objective of preserving capital.**

### CHART 1: Market Sentiment Turns Negative Indicating a High Risk Market

Baker Avenue Market Sentiment Indicator (BAMSI) December 31, 2008 – June 30, 2010



Source: Baker Avenue Asset Management

When the BAMSI turns negative, it indicates a turbulent and risky environment for stocks. Like a plane flying in stormy weather, the ride will typically be jarring and unpleasant. Worst yet, a plane flying in bad weather is always at high risk for a crash. In such an environment, our

objective is to first preserve capital. In other words, keep the plane on the tarmac until the storm has passed.

### High Volatility is Bad Weather for Stocks

While market volatility was in a general downward trend after the January – February correction, volatility broke out to new highs in May. Volatility skyrocketed from 22 and rose over 100% before hitting a peak near 46. Volatility retreated to more moderate levels recently, albeit still remaining elevated (Chart 2).

### CHART 2: Volatility Index Spikes to New Highs

Volatility Index (VIX) January 1, 2010 - June 30, 2010



Source: StockCharts.com

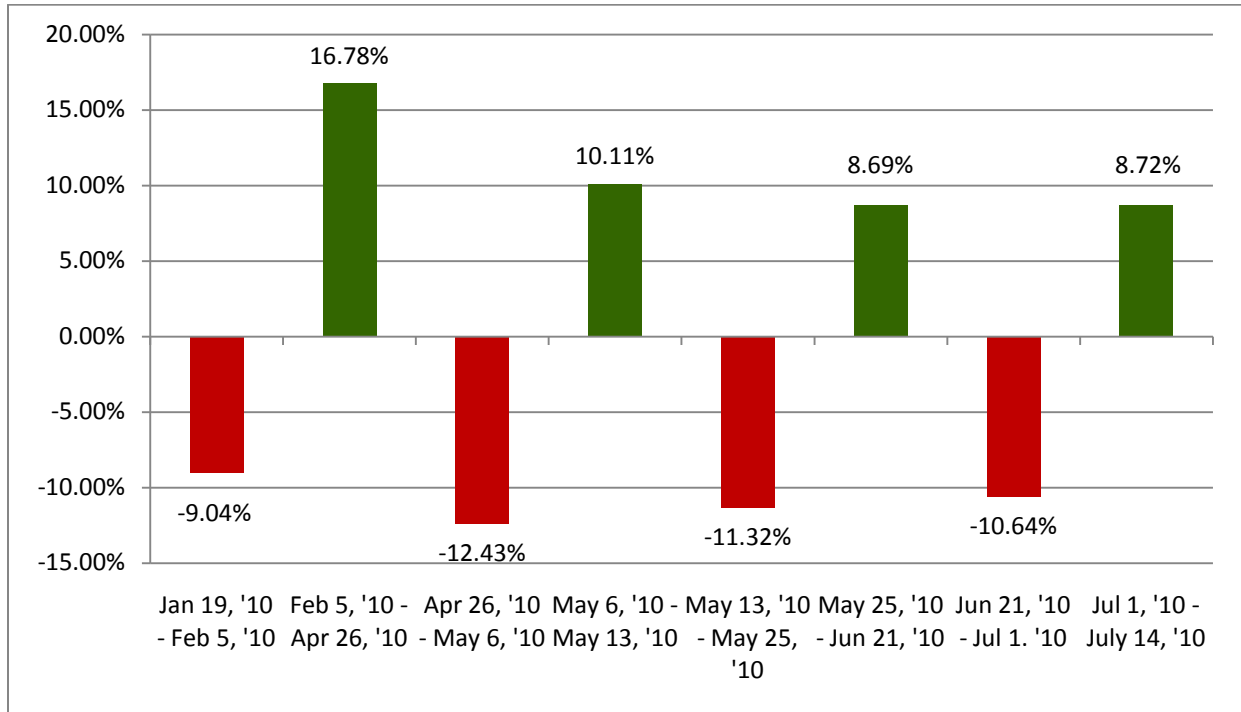
Since the beginning of the year, we have experienced extreme turbulence in the market. While some market analysts view the recent decline from the April highs as just a correction, other analysts view this recent decline as the first leg of a major decline.

While market corrections are not unusual, what is remarkable is the number of large price swings we have had. Year-to-date, the high volatility environment has caused eight significant price swings with a magnitude of between 8-17%, with an average magnitude of 11%. How would you like to be flying with that type of turbulence on a plane? Keep in mind that the average historical return *in any given year* is about 9-10% in the stock market since 1970.

While the current environment is a day trader's paradise, it has been a frustrating experience for steadfast bulls or bears as there has been no clear market direction (Chart 3).

**CHART 3: Large Price Swings Indicate Market Turbulence**

S&P 500 Returns: January – July 2010



Source: Baker Avenue Asset Management

The dynamic and quick changes in sector leadership over the past six months also reflect the unusual market volatility we have seen. The year started off with the healthcare and consumer staples sectors performing the best as the Greek debt contagion scare rattled markets globally. The healthcare and consumer staples sectors are usually viewed as the defensive sectors in the economy. The defensive posture in the market was followed by hopefulness on the economy as consumer cyclicals, financials, and industrials performed the best from February through April. These sectors tend to do the best when there is optimism about the economy. This optimism faded quickly as new economic data indicated that the recovery was slowing. Defensive sectors like consumer staples, telecom, utilities, and healthcare again led the way to close out the mid-year (Chart 4).

## CHART 4: Sector Swings Show Market Volatility

Sector Rotation: January 1, 2010 - June 30, 2010 (Best performing sector from top to bottom)

January	February	March	April	May	June
Healthcare	Cyclical	Financials	Cyclical	Telecom	Utilities
Staples	Industrials	Industrials	Industrials	Staples	Healthcare
Industrials	Materials	Materials	Energy	Utilities	Staples
Financials	Financials	Cyclical	Utilities	Healthcare	Telecom
Cyclical	Info Tech	Telecom	Telecom	Cyclical	Info Tech
Energy	Staples	Info Tech	Financials	Info Tech	Financials
Utilities	Energy	Staples	Info Tech	Industrials	Energy
Info Tech	Telecom	Energy	Materials	Financials	Industrials
Materials	Healthcare	Healthcare	Staples	Materials	Materials
Telecom	Utilities	Utilities	Healthcare	Energy	Cyclical

Source: Baker Avenue Asset Management

What are the causes of this heightened market volatility and what are the implications for investors? The main causes for the high volatility are uncertainty, lack of confidence, and lack of conviction by investors. Under such circumstances, movements in the market are largely driven by human emotion and that emotion now is *fear*. **Fear can cause panic and panic in turn can cause significant market declines.** With the BAMSII now in negative territory, investors should be reviewing the safety procedures and looking for the exit row if they are still navigating through this market storm.

### Stock Market Weather Forecasting

Our forecast for the remainder of the year is more market turbulence with a chance of clear skies towards the end of the year. The reasoning for this forecast is that we see many similarities between 2010's market actions and that of 2004. High market volatility characterized the first three quarters of 2004 as investors feared a double-dip recession due to high energy prices. Market analysts and economists feared that if the price of oil rose above \$40 per barrel, the nascent recovery in the economy would be jeopardized. The price of oil did

rise above \$40 per barrel in 2004 and did not stop climbing until it reached a peak of nearly \$140 per barrel before the start of the Great Recession in 2007-2008.<sup>ii</sup>

There is an ongoing joke in the world of academia that economists have successfully predicted nine out of the last five recessions. Today, various media outlets blare out the latest fears of a double-dip recession coupled with sensational predictions of how low the market can fall. It seems the lower and more outrageous the analyst's prediction is on the market indices, the more media coverage the analyst is likely to get. While there are valid arguments why a double-dip recession may occur, there are also reasons why it may not - like low interest rates to spur economic growth, low inflation, record corporate earnings, and continued growth in the economy albeit at a slower pace.

While market behavior does not always repeat, it often rhymes. After a period of a strongly trending environment, the market often goes through a period of rest or profit-taking called "consolidation" more commonly known as corrections. After a period of consolidation, markets more often than not resume the previous trend. The 2003-2004 and 2009-2010 price charts on the S&P 500 index are nearly identical in terms of their peaks and troughs. If 2010 mirrors the market action of 2004, we may be in a choppy, high volatility environment for a few more months before the potential for a market recovery near the end of the year (Chart 5).

### CHART 5: 2010 = 2004 déjà vu?

#### S&P 500 Index: Year 2003-2004 Market Recovery vs. 2009-2010 Market Recovery



Source: Baker Avenue Asset Management

The conclusion of the presidential and congressional elections spurred the market recovery in 2004 with the market rebounding nearly 12% from the October lows to close the year up nearly

11%. We believe there is a possibility of that recurring this year as the November elections are likely to be a net positive for the market. Early polls suggest there may be a restoration of a balance of power in the capital that may boost investor confidence. According to Strategas Research Partners, a leading institutional economic and market research firm, U.S. equities have advanced 15% on average in years when there was a Democratic president and a Republican majority in Congress. This is the highest return on average of any other political party combination.

## **Conclusion**

High market volatility characterized the first six months of 2010 and we forecast that it will likely be more of the same over the next few months. Uncertainty, lack of confidence, and lack of conviction by investors due to doubts of the economic recovery are the main causes for this market turbulence.

During these uncertain times, gyrations in the market are largely driven by human emotion now being gripped by fear, which may possibly lead to panic, and in turn lead to severe market declines due to indiscriminate selling. While we believe the market may have the potential for a year-end rebound, the BAMSI is now in negative territory indicating that market fears are rampant.

As such, we prefer to avoid the storm so that we can fly in friendlier and safer skies.

Sincerely,

Baker Avenue Asset Management, LP

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<sup>i</sup> Bloomberg Analytics

<sup>ii</sup> [www.opec.org](http://www.opec.org)

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