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5-STEP INVESTING

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Step 1 – Broad Market Trend

Primary Trend:	Upward.	Started March 6, 2009 at 6626.
Intermediate Trend:	Upward.	Started February 12, 2010 at 10012.

The Dow Jones Industrial Average (^DJI) declined 5.7% last week, finishing at 10,380.

Last week was an interesting week but it was hardly conclusive. From a long-term perspective, as you can see above, the ^DJI has fallen below a trend line that was established in early 2009. Trend lines are judged in their importance by their length and by the number of times they "work". As you can see from the above, this lower purple trend line held support in July, 2009 and in early 2010. The crossing of ^DJI below this trend line is a significant event and indicates a change of character in the market.

With weekly volatility this dramatic it is important to step away a bit from the traditional technical indicators, as they can be misleading. The market character has changed, and in the broad it has 3 options for the next few weeks. They are as follows:

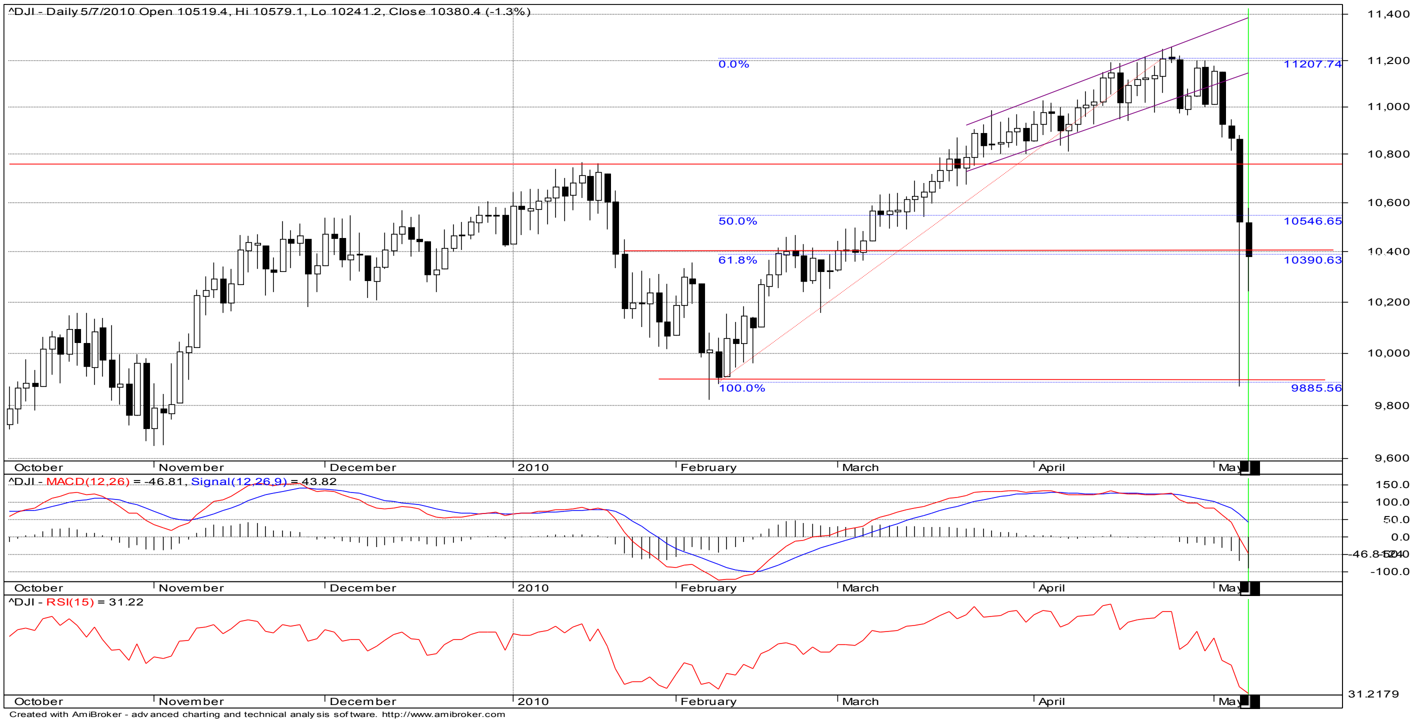
1) The uptrend continues. The first sign of this is that the ^DJI will gain 2.1% back up above the 10600 lower trend line and continue to a gain of 8.7% to challenge the red 11283 Fibonacci line. While the market may be oversold in the short term, most technicians including myself view this situation as unlikely.
2) The market settles into a "ranging" market, meaning it moves sideways for awhile. At this point it would likely settle into a range between 10000 and 11283. This would likely occur if there were a continued variety of mixed economic and political signals.
3) The market rises slightly at or above the lower purple trend line, around 10700, and then dives downward below 10000. This would quantitatively establish an intermediate-term change in the market.

In the broad view, these are the options. It will play out over the next several weeks.

Step 2 – Near Term Market Trend

Intermediate Trend. Upward. Started February 8, 2010 at 10195.

Short Term Trend. Downward. Started May 6, 2010 at 10520.



Last week I remarked "This is the strongest evidence to date of the short-term market correction that has been some time in coming. You can at least expect a correction down to 10758 (the horizontal red line) and if it goes down past that point then we'll reevaluate."

Well, we have seen at least part of the expected correction. The ^DJI is now at a very critical point.

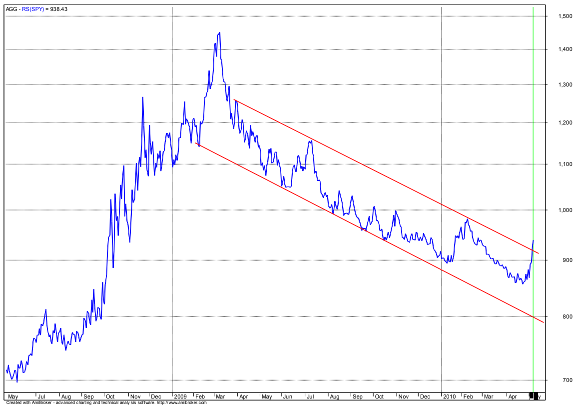
1) It is near the red 10400 line, which represent the top of the last up-wave.
2) It is near the 61.8% Fibonacci retracement line, which would be a traditional line separating an ordinary short-term retracement from a much more important longer-term change in tone.
3) It dropped very fast, and up-trends or downtrends at that speed are usually not completed without some additional, slower-paced movement in the same direction.
4) The weakening at the top of this Intermediate trend occurred during fairly good economic, political, and international news. Bad news can and probably will continue to be an accelerator downward.

The overall situation is dicey. If ^DJI moves upward, look for some resistance initially at the red 10758 line. If the ^DJI moves downward, it could easily fall to the 100% retracement line at around 10000. These two potential moves are around 400 points each and in opposite directions. Again, this is a dangerous market in which to be an intermediate or longer term investor. Care should be taken and stop losses should be appropriate.

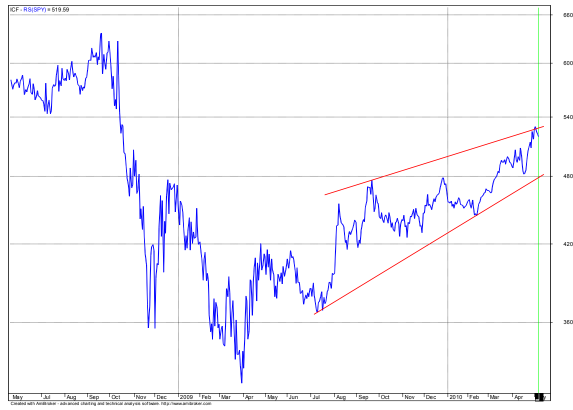
Step 3 – Asset Classes

The charts below are <u>not</u> the price of the security. They are the ratio of the price of certain ETFs to the value of the SPY (S&P 500 ETF).

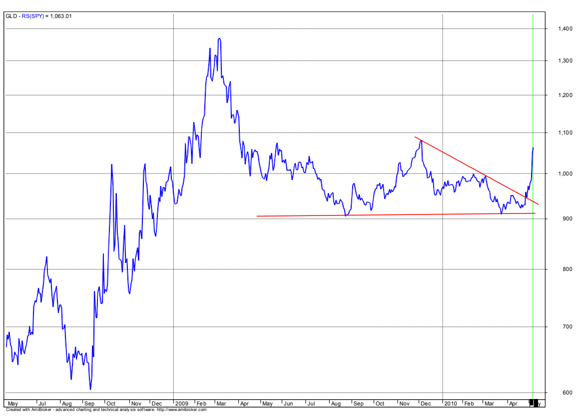
Bonds (AGG) the "recent uptick" that I mentioned last week turned into an upward cross of the trend line and a change in character. Bonds are now officially strengthening relative to the market in general.



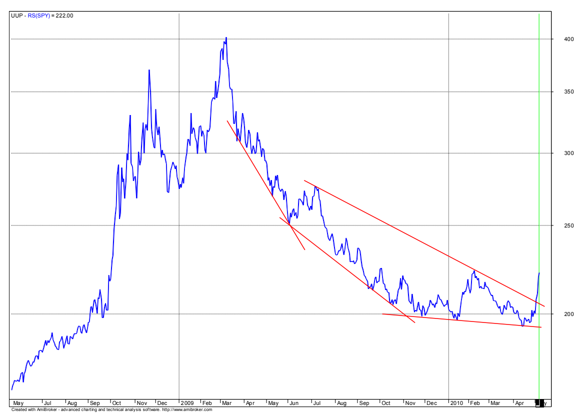
Real Estate (ICF) continues to outperform relative to the S&P 500. However, you must honor the BUY and SELL signals. It could outperform but just be falling slower. I'd be wary of it right at the moment.



Gold (GLD) has broken out above the triangle that was spoken of last week. It is showing strength relative to the overall market. At least in the short term, coupled with the Bond strength above, this confirms a weakening of the overall market and a movement of monies to the safety of GLD. (I said the above last week, and it of course validated and still true).



Dollar (UUP) the triangle mentioned last week has resolved itself to the upside. With the troubles of the Euro and general instability in world markets, the Dollar has strengthened, just as we began to see some weeks ago.



Step 4 – Current Portfolios

ETF Hedge Fund

It is not every week that the market drops 5%. As an Intermediate-term investor, you are not a “trader”. This newsletter is designed for people who intend to get better-than-average returns with lower than average risk, and do so themselves. As last week demonstrated, you can protect gains and grow wealth if you are patient, and precise in your investments.

This newsletter is also designed for people who don't want to have to watch the market daily and worry about being in or being out. Many people see last week's volatility as an opportunity, but an intermediate term investor sees last week as the beginning of some short-term unpredictability in the market. Most market risk can be managed, but extraordinary markets are dangerous in that way.

The S&P 500 (SPY) and Real Estate (ICF) portions of the ETF Hedge Fund are presently stopped out. As is our custom, we will wait a week or two and let the market decide direction before we convert the cash back into a working investment. So at this point, you will have Bonds, Gold, and the US Dollar in your active portfolio.

I am taking the extraordinary step this week of suggesting that you sit on your positions. Keep your stops in place on active positions but take no new positions. What is likely to happen is the market will make a 5% move over a period of days in one direction or the other, and then correct. That will tend to wipe out your stop losses on both sides, and since I have the BUY stops set high, you'll just get whipsawed and lose money.

Sometimes it is best to be in cash, out of the market entirely. Wait until the money is “just lying there” to pick up. This is not one of those times.

Update your stop losses on any existing investments. Every investment should have a stop loss.

						Stop Market	
Security	Weight	Long-Term	Medium Term	Short Term	Price Now	BUY	SELL
SPY (S&P 500 ETF)	Underweight	Stop (May 4) (117.06)	Stop (May 4) (117.06)	Stop (May 4) (117.06)	111.26		
AGG (Bond ETF)	Overweight	HOLD	HOLD	HOLD	104.89		$104.21
ICF (REIT ETF)	At weight	Stop (May 6) (58.17)	Stop (May 6) (58.17)	Stop (May 6) (58.17)	57.81		
GLD (Gold ETF)	Overweight	HOLD	HOLD	HOLD	118.27		$112.61
UUP (Dollar ETF)	Overweight	HOLD	HOLD	HOLD	24.7		$24.25
DOG (S&P Inverse)	None yet	HOLD	HOLD	HOLD	51.64		$48.80
MUB (Tax Advantaged Bond)	At weight	HOLD	HOLD	HOLD	103.78		$103.12

Recommended Weights for Portfolios

	Conservative	Aggressive
S&P 500	0%	0%
Bonds/Cash	100%	100%
Real Estate	0%	0%
Gold	0%	0%

Step 5 – New Ideas

None this week.

The Final Word

We are still operating inside of a primary uptrend that started back in March, 2009. But note the lower trend line at around 111 and how close we are presently (111.26) to that trend line. The way these trend lines work, you'll need a material move below the trend line to argue that the trend is no longer valid.

If the SPY drops below 110 and stays there for 3+ days, you should consider shifting a material fraction of your 401K mutual fund monies that are stock equities based to safer Bond funds are money market. You probably won't see that downward movement in the earlier part of this week since we are so oversold, so the clock may not start ticking on Monday. But this is what you should watch for.

Appendix: Important Details

Rules for Placing Trades

1) When you place a BUY order, you will also place an associated SELL order for the same security. This is designed to keep you free of constantly checking progress of the trade, and it is designed to build the discipline of always having a set of stops in place to control downside risk. This can be automated on TD Ameritrade by using what are referred to as "Conditional Orders". On Schwab these are referred to as "Bracket Orders". Lacking these automated tools, once you execute the BUY order you can go in the day after the BUY and manually place the protective stop.
2) All of your orders (BUY and SELL) will be done using Stop Market orders. That is, on a BUY order the market price must rise to a particular price before you BUY. This gives you initial confirmation that the market price is moving in the expected direction. On a SELL order the market price must fall to a particular price before you SELL.

Rules for Adding New Money to Existing Portfolios or Building from Scratch

1) Only add new monies to securities with BUY in Long-Term, Medium Term and Short Term. Otherwise, keep the money in a money market fund.
2) Do not increase the overall size of the portfolio more than 12% a week, in order to limit market risk.
3) Always enter the noted stop loss amount with each investment. Do not enter a purchase without an associated stop loss amount.

Rules for 401K Portfolios

Segment your 401K portfolio offerings into Equity, Bond, and Money Market. Most equity funds (Large Cap, Small Cap, International, Growth, Value) are very tightly correlated and should be considered as a single asset class. Of these, if you have an S&P Index fund, choose this as your Equity fund. Most bond funds (government, mortgage) are tightly correlated. Of these, if you have a government bond fund, choose this as your Bond fund. You typically will not have a Real Estate or Gold option for 401K portfolios.

1) Apply the Medium Term recommendations above to these two fund options by using the Bonds recommendation for the Bond fund, and the S&P recommendation for the Equity fund. Calculate the percent allocation for the equity fund as the sum of the S&P, Real Estate, and Gold recommendations.
2) Remember that most 401K options have limitations on the frequency with which you can trade the funds or other fund-specific limitations.
3) Avoid using the "target date" funds, as they remain invested in the market at a 65-80% level regardless of market trend.