A STOCK MARKET CORRECTION SURVIVAL GUIDE
What You Need To Do Now

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CONCLUSION

The start of a major correction rarely begins with one catalyst. Instead, they commence in response to multiple events, often within a week of one another. In my view, this has just happened in the past two trading sessions and investors must act quickly and decisively in the near term. The good news is that money can be made even in the throes of a corrective phase and we provide you with specific guidance in this special report.

INTRODUCTION

"The four most dangerous words in investing are: this time it's different."
Sir John Templeton

Mid-morning on Wednesday, July 30th, we viewed early economic and market events as a signal that the stock market rally was officially over and that we in fact entered into the start of a corrective phase a week earlier when the S&P 500 Index reached the 1991 mark. We issued a blog on our website and throughout cyberspace proclaiming the market top. The combination of Wednesday's events (in the AM and PM) with Thursday's economic news prompted the biggest stock selloff in months and only affirms the thesis made in the blog.

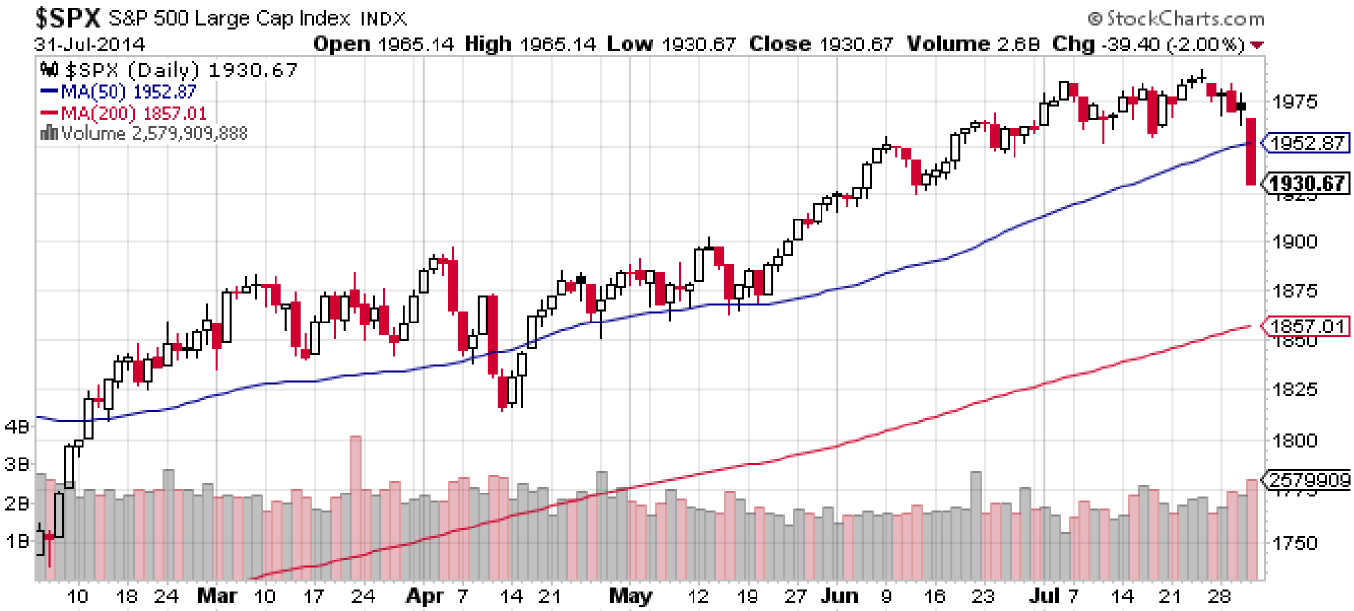

Figure 1: S&P 200-Day Performance

While others may argue otherwise and trading on Friday may be a temporary return to a bullish stance, we deem the situation urgent enough to produce this special report with the intention of explaining the current correction and providing guidance on how to respond to it.

THE BACKGROUND

We have been anxious since February but since the early spring we have cautioned that we believed that we are in the 8th inning of the long bull market rally and originally thought that a correction could start in April/May when Q1 GDP figures and Q1 financials results were slated for reporting. While stocks took it on the chin pretty hard a small rally did ensue. How interesting that in our view, the unusually high GDP growth for Q2 appears to be the first catalyst, rather than the declining Q1 GDP figure due to the harsh winter season, as we projected.

Fast forward to today and the picture is much different from the -2.1% GDP decline in Q1 that somehow included decent stock earnings reports. The preliminary government report issued on Wednesday showed that the U.S. generated 4% real GDP growth for 2Q14. Plus, employment figures released the same day were very favorable (although we take them several grains of salt.) The scary aspect of this GDP figure is the magnitude of growth spurred by consumer spending, which typically prompts inflation concerns and the roadmap to potential monetary policy shifts.

Truth be told, the market had an opportunity to respond positively to the GDP figure. Despite that good news, trading was poor and rallies were unsustainable, even following positive comments from the Federal Reserve regarding the economy and near term policy that suggested the bond buying will continue. Even the all clear sound roared regarding inflation.

To make matters worse and ensure our fate, yesterday, Argentina defaulted on its debt for the second time in 13 years. This news rocked the already fragile market and shook the sturdiest investor to his core. When combined with the poor performance in the face of good news the day before, it is clear that the 5-year party is now over.

As illustrated in the chart of a S&P 500 Index ETF (NYSE – SPY) and a Russell 2000 Index ETF (NYSE – IWM), the market has truly rocked since 2009.

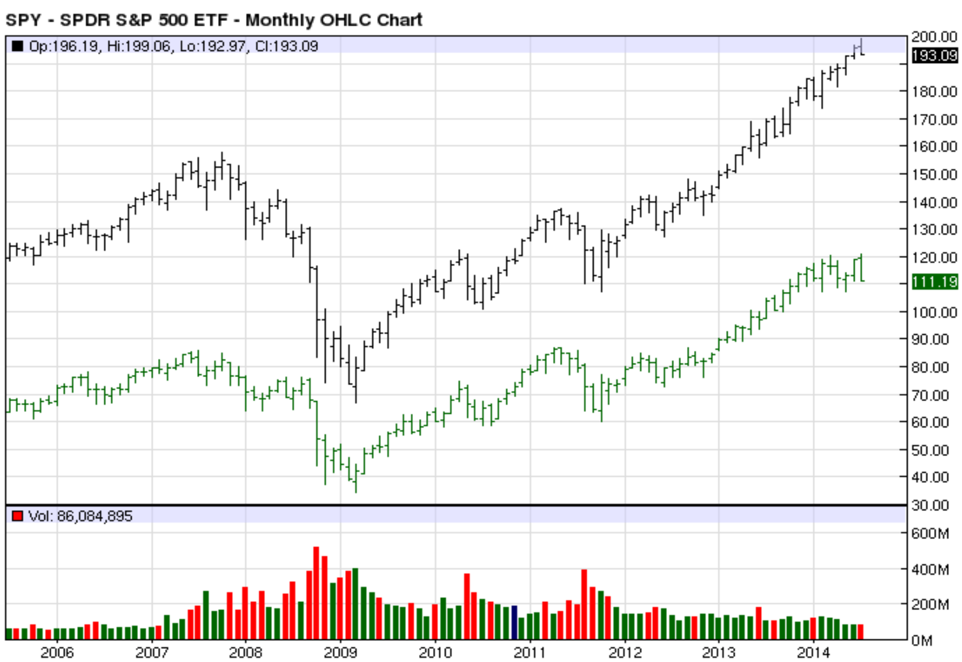

Figure 2: SPY and IWM 5 Year Performance

As a result, we have enjoyed remarkably high consumer confidence and unwavering belief in the upward trajectory of the stock market, especially in the past few months which has provided a platform for scary complacency. This complacency lulled us into low volatility which made traders run for the hills as volumes have dropped considerably and value ranges stayed the course upward. Amazingly, this has occurred despite the near correction in the small cap segment in 2014. By the way, many Street observers claim that volumes are down because of the big interest and buying of ETFs by retail investors. Yet, the ETF volume, as evidenced above, has shrunk dramatically, making the argument weak and invalid. Rather, we believe that the reduced ETF volume is due to the reduction of hedging by traders and investors that used ETFs as a hedge or leverage. That volume should increase as a consistent return to volatility commences. Volatility in this instance is our friend.

Until then, however, we will be paying the price. Confidence is shaken, valuation, earnings growth, economic and geopolitical issues, which were largely ignored, are now at the forefront of professional investors' sentiment. The good news is that the volume was higher during the 2% decline in the S&P 500 Index yesterday, though not appreciably so. That means more pain is sure to come. The fact remains that it is not different this time, as noted by the late Sir John Templeton above. And, corrections usually take more than one catalyst to wake us up, after all.

THE FUTURE

A correction is defined by Investopedia.com as:

"A reverse movement, usually negative, of at least 10% in a stock, bond, commodity or index to adjust for an overvaluation. Corrections are generally temporary price declines interrupting an uptrend in the market or an asset. A correction has a shorter duration than a bear market or a recession, but it can be a precursor to either."

Most prognosticators believe that we must have a few big down days before declaring a correction phase has begun or is about to commence. Essentially, they wait until it is down 5% or more before calling it. Wow. Courageous. Today, there is a school of thought that we are on the brink of a 20% hit prior to entering an elongated bear market. We are not so negative given the pure fact that equities are the place to be for most investors. Real estate is still mired in a price and value appreciation hurdle, and we remain in a low interest rate environment. Now if individuals could pull off an inversion scenario much like what is being done by U.S. health care companies buying European companies to reduce their tax burden, then that would be great---we would all gladly play games to decrease our taxes. In the absence of that unlikely event, reasonably priced equities with solid growth potential is the preferred liquid investment for the long haul.

For now we must endure the end of the Fed-induced bubble via bond buying next year, but inflation, potentially slower earnings growth, etc. Before we get to that point, we must get through the month of August. And it could be a bitch for us all.

Some of you may have seen Mark Hulbert's column with the thesis that August is a great month for investors. (I like Hulbert but I think his premise is flawed here.) Of course, his tabulations go all the way back to 1896. http://www.marketwatch.com/story/the-hidden-truth-about-the-market-in-august-2014-07-30?dist=tbeforebell

If one follows that line of thinking, then the monthly return average for August is indeed over 1%. However, if you look at 1950 to 2013, the decline is -0.24%. In a sense, it is a tale of 2 eras.

Our take is dramatically different. In our view, what is more relevant today is the direction in which the S&P 500 Index has performed in August since 2001. In general and especially in this century, some of the market's worst performing months have been August. To be fair, going back almost any number of years will illustrate that there are more up months than down in August. But, from 2001 – 2013, when there have been declines, the average drop has been -4.3%!

S&P 500 Index August Returns
2001 - 2013

Up Years		Down Years	
2012	1.98%	2013	-3.34%
2009	3.07%	2011	-5.70%
2008	1.06%	2010	-5.25%
2007	1.29%	2005	-1.12%
2006	1.98%	2001	-6.41%
2004	0.23%		
2003	1.79%		
2002	0.49%		

Table 1: August Monthly Returns
Source: http://www.MoneyChimp.com

But, if you do not believe us, check out this excerpt from Stock Trader's Almanac's recent publication:

Money flows from harvesting made August a great stock market month in the first half of the Twentieth Century. It was the best month from 1901 to 1951. In 1900, 37.5% of the population was farming. Now that less than 2% farm, August is amongst the worst months of the year. It is the worst DJIA and S&P 500 month since 1987 with average declines of 1.3% and 1.0% respectively. August is also the worst month for NASDAQ (–0.3%) and Russell 2000 (–0.7%) over the same time period.

Contributing to this poor performance since 1987; the shortest bear market in history (45 days) caused by turmoil in Russia, the Asian currency crisis and the Long-Term Capital Management hedge fund debacle ending August 31, 1998 with the DJIA shedding 6.4% that day. DJIA dropped a record 1344.22 points for the month, off 15.1%—which is the second worst monthly percentage DJIA loss since 1950. Saddam Hussein *triggered a 10.0% slide in August 1990. The best DJIA gains occurred in 1982 (11.5%) and 1984 (9.8%) as bear markets ended. Sizeable back-to-back declines in 2010 and 2011 have widened Augusts' average losses.*

The first nine trading days of the month have exhibited weakness while mid-month is strongest. The end of August tends to get whacked as traders evacuate Wall Street for the summer finale. The last five days have suffered in 12 of the last 18 years with the S&P 500 up only four times on the next to last day in the past 18 years. In the last 18 years, the last five days of August have averaged losses of: Dow Jones Industrials, –1.4%; S&P 500, –1.3%; NASDAQ, –1.0% and Russell 2000, –0.3%.

From the technical perspective, things are also very bearish in the short term for stocks. As illustrated below, the S&P 500 Index now trades below the 50-day moving average and the MACD is very bearish near term. All of this points to real resistance at the 1960+ level, when it begins its attempt to return there.

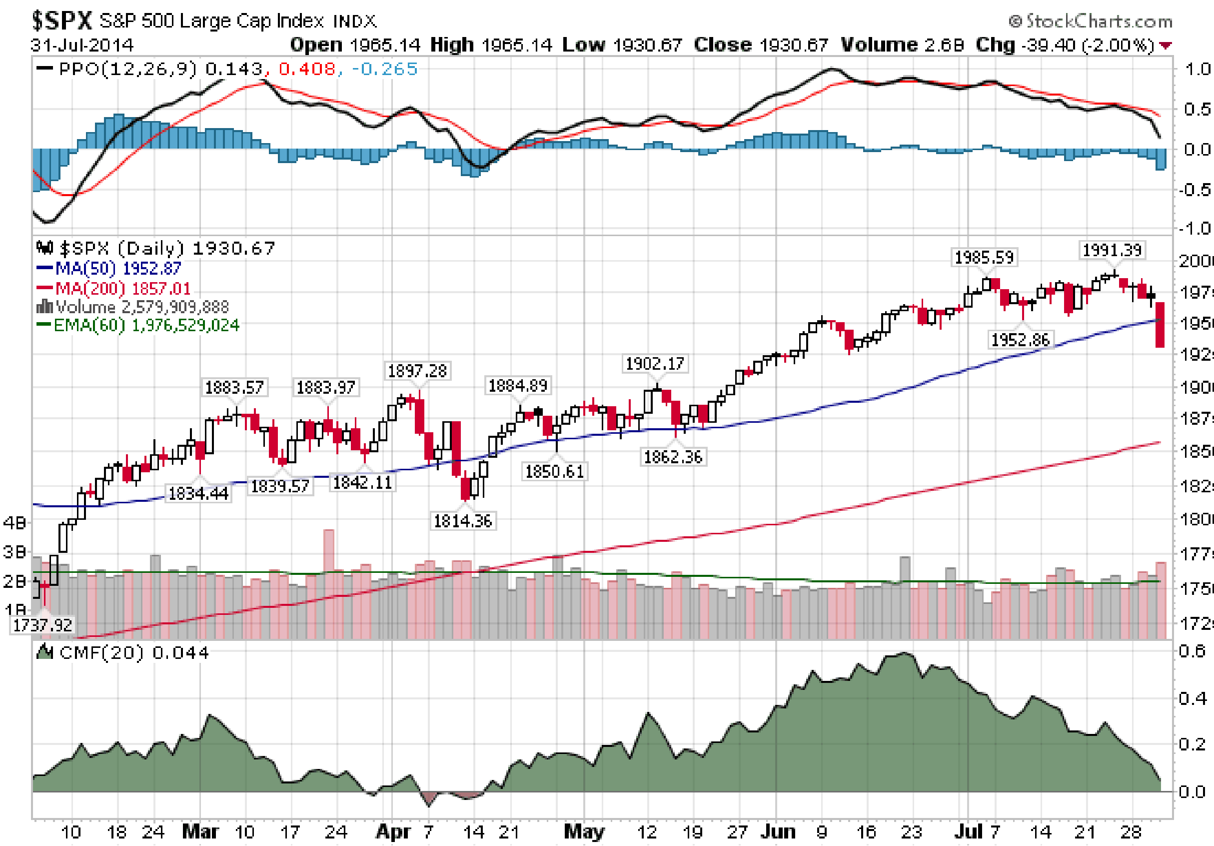

Figure 4: Big Technical Picture of S&P 500

Getting back to the correction scenario, the current standings of the major indices are as odd as they are divergent.

DJIA – down 3.4% from its high
S&P 500 – down 3.0% from its high
NASDAQ – down 2.6% from its high
Russell 2K – down 7.7% from its high

The Russell 2000 is on the brink of a correction and yet the NASDAQ Composite is furthest away? What does this mean?

The combination of economic breakdowns, so-so earnings, no strength or breadth in trading volume and activity, poor near term technical factors, and our dreaded August scenario means you need to go on vacation until we see some daylight in the fall. By then, the Russell 2000 Index will have breached the 10% mark and NASDAQ will not be too far behind, as the performance of the indices is right-sized. We believe that the high fliers will be the next to drop and we could see 10% drops or more from here with a typical year-end rally led by small caps and microcaps, the most beaten down category. What happens next year at this point is a mystery due in large part to the Fed. We will worry about that in December.

THE RESPONSE

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets."
Peter Lynch

Armed with the background and a sense of what we expect lies ahead is a path for what should you do today and for the near future. The key is to approach the market with a clean slate. Consider buying stock on big down days when you are most uncomfortable, especially in mid-August, as outlined above. John D. Rockefeller had it right: *"The way to make money is to buy when blood is running in the streets."*

Here are 13 steps to not only lasting through the correction in decent shape, but potentially with a few wins to boot.

Step #1: If you have profits in stocks, lock them in now. That is especially the case with high fliers carrying high valuations (like Twitter (NASDAQ – TWTR) which trades 25x this year's projected revenue.

Step #2: If you have paper losses, have those losses offset some of the profits. Do not take losses in stocks that you believe have long term (multi-year) unrealized potential.

Step #3: Do not sell stocks in which you have profits but believe that long term unrealized potential exists.

Step #4: Consider small investments in securities that have an inverse relationship with stocks such as gold, which could mount a comeback this year.

Step #5: By using a free online screening tool, find out which stocks were unscathed during the bloodbath and put them on your watch list as potential investments.

Step #6: We have promoted using VelocityShares Daily VIX Short Term ETN (NYSE – TVIX - $3.47) leveraged ETF (ETN) as a way to play volatility. If you have watched it or traded it in recent weeks, I am sure you have made a pretty penny. It seems that if timed right, a 5-15% intraday gain is not out of the question. There is a great deal of risk and one must watch it like a hawk, but it is a great trading tool due to its correlation to the VIX. Yesterday it closed up 16%. See our original blog for more information: http://www.goldmanresearch.com/20140708804/Daily-Blogs/beware-the-black-swan-short-the-market-with-this-etn.html

Step #7: With the return of volatility, opportunities in the equity trading world will re-surface. If you have the stomach for it, there are gains to be had.

Step #8: Seek out stocks that are non-correlated with the market. They could be very small stocks or underfollowed companies.

Step #9: Be patient. Stagger your investments and set 5-7% stop limits on sales, to account for potential big swings downward. It could save you heartache later.

Step #10: Lock in meaningful gains quickly lest you be caught on a big down day.

Step #11: While most investors' inclination would be to invest in health care, we would avoid it, with the exception of small cap special situations, which would be largely unaffected by market moves.

Step #12: Be a GARP investor in economically sensitive stocks, consumer stocks, and technology.

Baker's Dozen: Consider international exposure---Asia. Not Europe. Or Argentina---yet.

Senior Analyst: Robert Goldman

Rob Goldman founded Goldman Small Cap Research in 2009 and has over 20 years of investment and company research experience as a senior research analyst and as a portfolio and mutual fund manager. During his tenure as a sell side analyst, Rob was a senior member of Piper Jaffray's Technology and Communications teams. Prior to joining Piper, Rob led Josephthal & Co.'s Washington-based Emerging Growth Research Group. In addition to his sell-side experience Rob served as Chief Investment Officer of a boutique investment management firm and Blue and White Investment Management, where he managed Small Cap Growth portfolios and *The Blue and White Fund*.

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