STOCK MARKET CORRECTION SURVIVAL GUIDE, II

What You Should and Shouldn't Do

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CONCLUSION

Stocks had one of the largest intraday declines in years before recovering strongly by day's end. Some investors may be inclined to view this move as a sign the worst is over and that stocks are primed to move higher. That may be true, but not in the categories or segments touted by conventional wisdom thinkers.

INTRODUCTION

"I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said."
Alan Greenspan

Figure 1: S&P Intraday Performance
Source: Yahoo! Finance

At its trough yesterday, the S&P 500 Index was down about 3% before closing down .81%. We have seen a series of sharp daily declines in stocks and oil prices of late, along with a related rise in the yield of the ten year note as investors have been increasingly bearish about the global economy's health. The drop in big cap stocks follows a correction already achieved in small caps. Does yesterday's late day strength portend equity gains ahead for the broader market, or is it a false signal? What will go up and what will go down? Sometimes when things are at their murkiest it isn't a bad thing for those willing to lift up the hood and look at the engine.

THE BIG DOGS BACKGROUND

We officially called the market top in late July and early September gains notwithstanding, the last couple of weeks have been dreadful for investors. Although we officially hit the corrective phase for small caps with the 10%+ drop from its peak for the Russell 2000 Index following our death cross warning, we had not yet hit that mark in big caps. As we have noted in the recent editions of our weekly newsletter *The Goldman Guide*, big cap stocks also need to reach corrective and capitulation phases before investors can breathe easy and see daylight.

We should note that during the recent decline in big caps, volume in the S&P 500 Index's correlated ETF S&P 500 SPDR (NYSE-SPY) has been on a tear. Yesterday this ETF traded 380 million shares, up from 215 million the day before and a paltry 76 million a month ago.

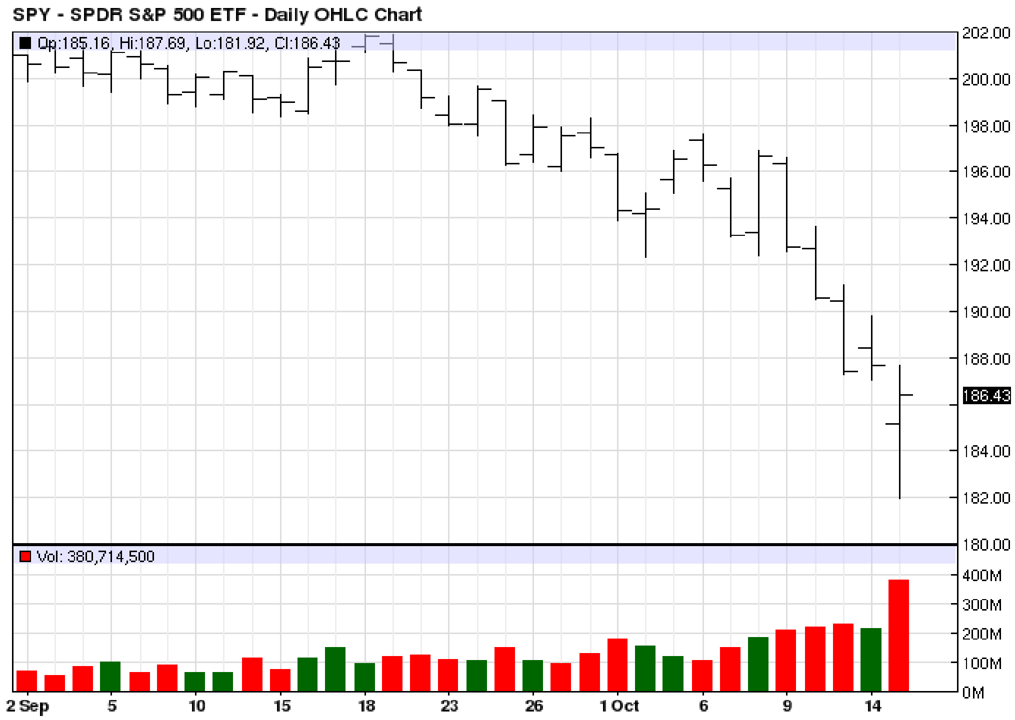

Figure 2: S&P Trading and Volume Sept 2014 – Oct 15, 2014
Source: www.Barchart.com

In addition to the huge SPY volume, the major indices' trading volume was 24-27% higher than normal.

Optimistic investors are likely saying that yesterday's trading volume and performance is great news, the worst of the downturn is over, and bargains abound. While that may be true to a degree, we caution that it is dangerous to think that the bullish nature of the end of day rise is a signal to jump back in with both feet.

Let's put this in perspective. The S&P 500 hasn't even hit the 10% decline mark---it needs to drop by 10% from its peak to be in a true corrective phase. The big volume could indicate that even though it did not hit 10%, the "throw in the towel" action by investors was in full swing. Unfortunately, corrections rarely stop at 10% and then go back up. Instead, stocks drift lower and can have additional albeit less severe capitulation events, with the total downturn lasting months not just a couple of weeks.

Truth be told, we believe that the big down move is probably behind us and some technicians would say that the move higher at day's end is indicative of a short term double bottom and that the magnitude of the rise is bullish. However, as we noted in our recent edition of the Guide, we might need to see another 3-6% decline before we would feel confident in the risk/reward/valuation is reasonable relative to historical trends.

THE REAL INDICATORS

In our view, the biggest takeaway from yesterday's trading activity/performance had nothing to do with the big cap turnaround. In fact, while the broader market was tanking, small caps were riding higher---exactly as we predicted would occur earlier this month.

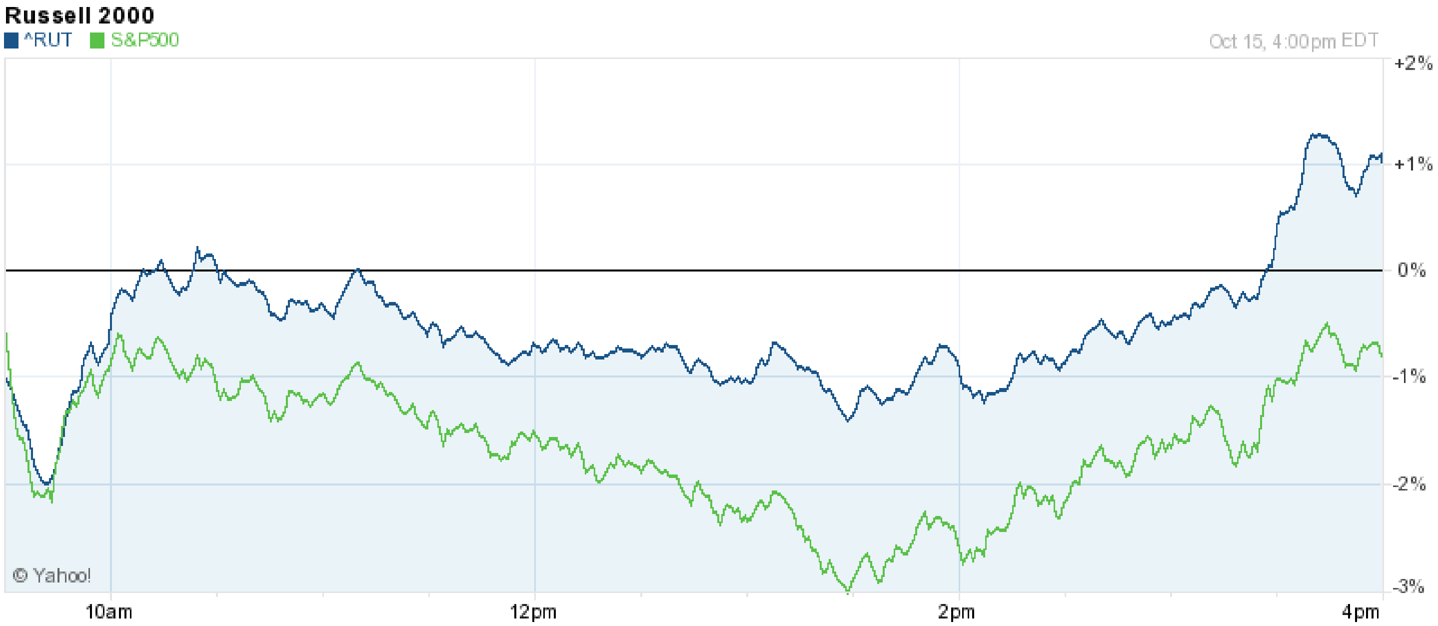

Figure 3: Russell 2000 and S&P 500 Intraday Performance
Source: Yahoo! Finance

Granted, the bulk of the Russell's move coincided with that of the broader market. Still, the intraday drops were not nearly as severe and the index remarkably ended up 1% for the day. But what was the real trigger here? A drop in ten year bond yields was no surprise given the economic news. However, the magnitude of it surely was. The overwhelming majority of the big decline in yields (which collapsed by 15% at one point) occurred within the first 30 minutes of equity trading. Following that event, yields steadily rose throughout the day, as did stock prices. Many investors tend to forget that bonds lead stocks, which is a key to understanding what happened to stocks, why, and what to expect ahead.

We surmise that big bets on bonds (migration from equities due to the European economic malaise) prompted the big buying in bonds, thus dropping yields. Once things settled down, and yields rose again, stock buying ensued. Unfortunately, while we would not expect massive moves into bonds like yesterday morning, economic concerns mean bond buying will continue while large scale stock buying is dangerous. We should note that bulls will cite the intraday boomerang in the DJ Transportation Average and some of the specific performance numbers as additional proof. We would caution against it, however.

Figure 4: Ten Year Note Intraday Performance
Source: Yahoo! Finance

For example, 40% of the volume on the NYSE was advancing volume while 19% of all NYSE stocks hit 52-week lows. Don't get us wrong---those are terrible numbers, but not quite capitulation. After all, the advance decline ratio of stocks was basically 50/50. It was even more pronounced for NASDAQ and even its advancing and declining volume was nearly 50/50.

WHAT TO DO

Folks, despite all of the crazy trading, the S&P 500 Index is still up for the year, so expect more downs than ups! With bonds declining, oil prices and oil stocks out of favor (yesterday's dead-cat bounce performance notwithstanding), and the impressive move by small caps, we believe that small is soon to be the only place to be and the index will likely begin basing soon. Meanwhile, big equities are at risk, and overall volatility in bonds and stocks will be with us for a while. It will be interesting to see how this quarter's earnings season shakes out, as well as economic data such as LEI to see how far down big caps will actually drop.

The good news is that October is half over and much of the damage has probably been done already. That means that we are closer to November and December, which have historically been great months for investors. Since 1950, the S&P 500 has jumped 1.35% in November and 1.62% in December. So, stay short term and small for now and do not commit new funds, until we get closer to year-end when equities in general will be on stronger footing.

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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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