THE FINANCIAL COMMENTATOR

A Guide to Federal Reserve Monetary Policy, the Economy, and Financial Markets

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Special Update – September 1, 2010

STOCKS

In the August 15 letter, I suggested*, "Aggressive investors can establish short positions, by either buying the short S&P ETF SH or SDS, which will approximate a 200% over time. I would recommend scaling into positions, since there is a good chance of a bounce back toward 1,090-1,100. Conversely, a decline below 1,056 would suggest the rout is on*." On August 17 and 18, the S&P traded above 1,090, topping at 1100.14 on the 17th. I expected the S&P to break below 1,040, which would be signaled once 1,056 was taken out. The market tested the zone between 1,040 and 1,050 for six consecutive days. The more often a support area is tested, the ranks of buyers is gradually thinned out, which frequently leads to a break down. Didn't happen this time. Positive manufacturing news out of China and a better than expected ISM survey of manufacturing in the U.S., launched a sharp rally today that was certainly aided by a far amount of short covering.

From a fundamental point of view, not much has changed. The U.S. economy is going to slow going into year end, and some of the expected slowdown is already priced into the market. But I can't see the market launching a sustained rally in coming months in the face of down beat economic reports. This suggests that the current rally will prove to be another opportunity to sell into strength, and go short. Sooner or later, the S&P will drop below 1,040. The most recent defense of 1,040 will only serve to increase selling pressure once the dam breaks. However, in the short run, the market has a few things going for it. Sentiment got a bit pessimistic, with a lot of attention given to the Hindenburg Omen, a technical indicator, which has a batting average of 25% in calling market crashes. Seasonality is also supportive going into the Labor Day weekend. So the market could push higher, and potentially 'breakout' above 1,100. That would set the stage for a run to 1,130. But what makes bear market rallies so tough to gauge is that they can end on a dime, especially if supported by a faulty fundamental premise, ie, 'the economy may not be as bad as we thought'.

Although the Major Trend Indicator has not reversed (it is still on the sell short signal), I covered positions in SH when the S&P closed the gap at 1,067 and pushed above 1,069. The risk is that today's rally will fade quickly, and the market will sell off on the jobs report on Friday. I'm comfortable being flat going into the employment report, since trading will be thin prior to the holiday, which could ramp volatility. The .618% retracement of the recent decline (1,130-1,040) is 1,096, and the most recent high is 1,100. I would recommend a stop above 1,100 on at least half of the short position, if you're willing to ride through a *potential* move to 1,130.

I don't think there is much the Fed can do to get the economy going, although they will try. However, to the extent that others believe the Fed can make a difference, in the short run, they

won’t do much selling, and will rejoice over any piece of less than awful economic news. Longer term, I think my assessment will be on target, but I don’t want to get run over.

Bottom line, this is a time to exercise a bit of caution on the short side and a measure of patience.

DOLLAR

As mentioned in the August 15 letter, investors can establish a half position (half of whatever you would normally take) in the Dollar bullish ETF UUP on a pullback below $23.80, using $23.35 as a stop.

GOLD

The following is from the July 13 letter. Short GLD, the gold ETF at 120.50, with a stop at $123.50. This trade was triggered on August 19. GLD closed at $121.69 today.

I hope your Labor Day weekend is spent with family and friends.

Jim Welsh