Japan - A Short Market Slap, or Economic Malaise?

A StormGuard Perspective March, 16th 2011

This article is based on an email sent to SectorSurfers regarding questions about how the SectorSurfer algorithm was responding to the market pull-back associated with the late February Middle East protests and riots for democracy and the mid March Japanese earthquake and tsunami disaster.

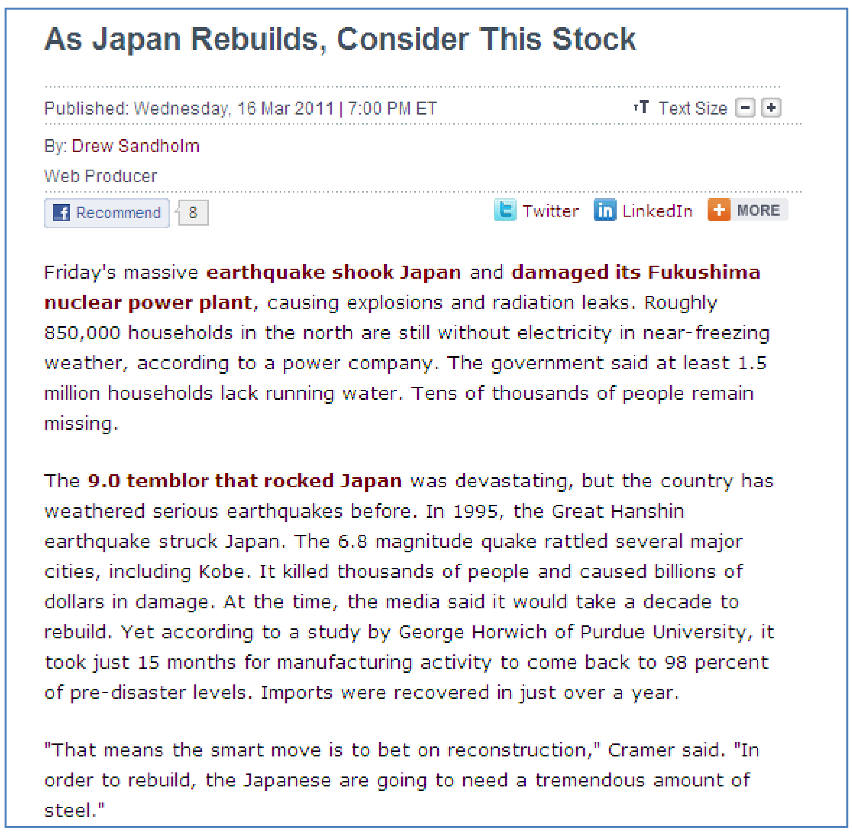
Dear SectorSurfer,

Not surprisingly I have received a number of email questions asking about when StormGuard will actually trigger. And, shouldn't it have saved my butt already?

As you may recall, the StormGuard feature of SectorSurfer is designed to over-ride the normal selection of the best fund in the Strategy and signal for you to move your money to the safety of a money market fund when a market storm arrives. So, what constitutes a market storm?

Let's start by looking at the March 16th 2011 one-year chart for the Dow Jones Industrial Average shown to the right. Although the prior few days of news from the middle-east and Japan did seem quite concerning, it is difficult to conclude from this chart that one should already be running for the hills. In perspective, the recent drop looks small in comparison to the "correction" that occurred during the prior summer (on left side).

Here is the operative question: ***Is this a short market slap, or the onset of economic malaise?*** For perspective on that, please consider what is said in the below CNBC article.



As Japan Rebuilds, Consider This Stock

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Friday's massive **earthquake shook Japan** and **damaged its Fukushima nuclear power plant**, causing explosions and radiation leaks. Roughly 850,000 households in the north are still without electricity in near-freezing weather, according to a power company. The government said at least 1.5 million households lack running water. Tens of thousands of people remain missing.

The **9.0 temblor that rocked Japan** was devastating, but the country has weathered serious earthquakes before. In 1995, the Great Hanshin earthquake struck Japan. The 6.8 magnitude quake rattled several major cities, including Kobe. It killed thousands of people and caused billions of dollars in damage. At the time, the media said it would take a decade to rebuild. Yet according to a study by George Horwich of Purdue University, it took just 15 months for manufacturing activity to come back to 98 percent of pre-disaster levels. Imports were recovered in just over a year.

"That means the smart move is to bet on reconstruction," Cramer said. "In order to rebuild, the Japanese are going to need a tremendous amount of steel."

Observational evidence from past similar events is that the current events are actually just as a short market slap. This is not at all the same as the 2001 systemic tech market bubble or the 2008 real estate bubble, each requiring the unwinding of past excesses. That is not to say that there aren't other possible bubbles out there, such as possible waves of state default on debt, but that's not what this is. This is a short market slap and does not require the unwinding of past excesses.

Still, one might ask when one could expect StormGuard to react? The period of market malaise we had late last spring and early summer is perfect for an example. StormGuard triggered for about 20% of Strategies at that time, but not quite for others (threshold depends on the nature of the funds in the Strategy). Thus, this period of time makes an excellent example of the minimum downturn behavior required before StormGuard will tell you to go to $CASH.

Ah, but why can't StormGuard get its butt in gear a bit faster? Consider the blip on the chart in the fall of 2010. If this blip were enough to trigger StormGuard, you would have gone to $CASH after about a 5% drop and then would not be sure to jump back in until it had again jumped back up to its prior high. In the course of those two transactions you would have locked in a whip-saw loss of about 5%. Thus, the optimum reaction time for StormGuard is one that waits long enough to avoid most of the whip-saw losses, but reacts soon enough to avoid the really big hits in true market storms. StormGuard cannot know which of these two cases is currently occurring, but its timing is optimized to give you the best odds based on the historical characteristics of market slaps and economic malaise.

In the end, you need to feel comfortable with what you do. I personally have second-guessed SectorSurfer numerous times over many years - sometimes feeling I was smarter, and sometimes saying oops! On balance I more often said oops. Even I took time to become comfortable enough to refrain from second-guessing.

To learn more about the StormGuard indicator, [click this link.]

Surf Well,

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