

42.45	40.60	27.08	+0.12	2.09%	1.40M
27.15	26.07	22.47	+0.46	2.09%	34.841M
22.59	21.71	22.47	-1.26	-5.12%	8.842M
23.97	22.74	23.37	+12.40	3.27%	1.104M
391.70	377.43	391.55	+0.74	0.78%	1.104M
95.67	93.96	95.61	+0.74	0.78%	1.104M
25.32	24.74	25.22	+0.42	1.69%	82.022M
24.89	24.35	24.82	+0.30	1.22%	7.433M

Reality Bites:

What you Need to do RIGHT NOW
to Protect Your Portfolio
From the Next recession

By Rick Pendergraft

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It's Different This Time Around

How many times have you heard “it’s different this time around?” I recall hearing it quite a bit back in 1999 when the equities markets were screaming higher at an unsustainable pace. It’s different this time around because the technology improvements are increasing productivity and the Internet is changing everything.

“It’s different this time around” was applied to everything from the inverted yield curve to the over-inflated P/E ratios to the weakening Gross Domestic Product (GDP) numbers. All the perma-bulls were looking for any reason for the incredible run in stocks to keep going, and a lot of investors were sucked in by this reasoning.

In hindsight, it’s always easier to see the warning signs, but it’s not always easy to hear and heed them when the euphoria is going on all around you. I think back to conversations I had with two professors when I was finishing my degree in the summer of 1999. One professor, who shall remain nameless, was talking about dumping some money he had just received into a “go-go” fund that had gone up 50 percent each of the two previous years. He couldn’t remember the name of the mutual fund and he didn’t seem concerned about it either. It was bound to just keep going up, or so he thought.

The second conversation was with my monetary economics professor. Dr. Robert Premus had worked at the Fed during Paul Volcker’s time as the Fed Chairman and had learned first hand what goes on behind the scenes at the Federal Reserve. I remember talking about the inverted yield curve and how he had pointed out to me that every time the yield curve inverted, a recession followed shortly thereafter.

I wish I could look back and say that I took full advantage of this information and made a mint in the market by shorting a bunch of the high-flying tech stocks heading into 2000. But that didn’t happen. I did, however, take most of my money out of the market and invested it in a property in North Carolina. This was a coincidence and not any great investing move on my part. It just happened that my wife and I were looking to move from Ohio down to the Charlotte area and we found a property we liked and so we bought it in the summer of 1999. We sold it three years ago (just before prices took off) for a small gain (around 10 percent). While we didn’t make a fortune on the property, we also didn’t lose our shirts in the stock market.

So What Does All of This Have to do With Now?

I’m hearing those words again - “it’s different this time around.” In case you haven’t noticed, an inversion occurred last July and the yield on the 3-month is still higher than the 10-year. The following table shows the inversions that have occurred during the past 40 years and the ensuing recessionary periods.

Yield Curve Inversion	Recessionary Period	GDP Growth
7/2000-1/2001	7/2000-9/2001	Negative 3 out of 5 quarters from Q3/2000-Q3/2001
5/1989-8/1989	7/1990-3/1991	Flat to negative three straight quarters from Q3/1990-Q1/1991
10/1980-9/1981	4/1980-9/1982	Negative 6 out of 10 quarters from Q2/1980-Q3/1982
11/1978-5/1980	4/1980-9/1982	Negative 6 out of 10 quarters from Q2/1980-Q3/1982
6/1973-11/1974	7/1973-3/1975	Negative 5 out of 7 quarters from Q3/1973-Q1/1975
12/1968-2/1970	10/1969-12/1970	Negative 3 out of 5 quarters from Q/1969-Q4/1970

We haven't seen negative numbers on the GDP reports yet, but last week's came in at 1.3-percent growth, the first time since the fourth quarter of 2005 that we've seen a reading under two percent. Prior to that, you'd have to go back to the first quarter of 2001 to see a reading below two percent.

So I have to ask - is "it different this time around?"

If you believe, as I do, that the leading indicators report is a peek into the future of the GDP, we may see some harsh numbers coming down the road. I wrote two recent articles for *Investor's Daily Edge* that dealt with the leading indicators report and its predictive powers.

From the March 26 issue:

"According to Briefing.com, 'the recession alarms go off when the cumulative 6 month decline exceeds -1% amid a string of three or more consecutive monthly declines. No recession warning bells yet.' The cumulative number for the last five months is -0.2. That makes next month's Leading Indicators report extremely important. If negative again, it would mark the third consecutive such month. More importantly, depending how low the number is, the cumulative decline for six months could reach the negative one-percent level. If it's -0.8 or worse, or if the February figure is revised downward (as January's was), it could send dangerous smoke signals about the U.S. economy."

From the April 23 issue:

“...the March Leading Indicators report was released and it showed a reading of 0.1 percent, matching the consensus estimate. But February’s reading was revised lower to -0.6 percent from the originally reported -0.5 percent. The clip above mentions how the six-month cumulative reaching negative one percent is an ominous sign for the economy, especially if it comes during a three-month stretch of declines.

“Well, the March report halted the string of declines for now, but what if the March number gets revised lower next month the way February was last week and the way the January reading was revised lower in March? There is little wiggle room for the March number to be revised lower without it becoming negative.

“Something else to consider is that the five-month cumulative is still sitting at -0.2 percent, but the oldest of these five numbers are the November (flat) and December (up 0.6 percent) reports. When these two numbers drop off in the next two months, it will be very important to see what they are replaced with for April and May. If the numbers for these two months are negative or only slightly positive, the six-month cumulative number will have a hard time staying above the magic number of -1.0 percent.”

When I see this recession predictor signaling that a potential recession is on the horizon along with the inverted yield curve and its past history of predicting recessions, I really have to question those who think something is different this time around. I’m not saying that the market is going to tank tomorrow or maybe not even next month, but I am certainly keeping my eyes and ears open.

Another factor in my current cautious stance toward the market is the disconnect between the economy and the market. During a recent stretch, the Dow was higher 19 out of 21 days. Statistically, the Dow moves higher around 55 percent of the time on a daily basis. A stretch of up days like we’ve had is a statistical anomaly. And for it to come as virtually every indicator shows a slowing economy is very scary. When the market does correct, the higher the optimism, the more pain that will be felt when the market starts heading down.

Taking on Debt to Invest

One of the most telling signs of irrational behavior is when margin debt is running high. Back in 1999 and early 2000, margin debt for clients of NYSE member firms exceeded \$250 billion for the first time in history. Care to guess where the April report shows the current margin debt? Not quite at \$250 billion, but the reading of \$241 billion is the highest since September 2000.

Some consider borrowing on margin to be too risky for them, but consider some of the stories out of China right now. I have read reports of people borrowing against their credit cards or even their homes to invest in the stock market. Now that's risky!

But that is how irrational investors are currently, not just in this country, but in other countries as well. The normally conservative Chinese society has taken to borrowing against their credit cards in order to invest in stocks.

The Shanghai Composite Index (SSEC) has risen more than 40 percent so far this year after gaining 130 percent last year. Given these staggering returns, it's no wonder people are borrowing to invest. However, the economic situation in the United States could put a stop to the boom in China.

According to the CIA World Factbook, more than 21 percent of China's exports are shipped to U.S. consumers. If we go into a recession, it will likely slow the Chinese economy as well. And if the Chinese government finally succumbs to the pressure to allow the yuan to float against other currencies, you will certainly see a dramatic rise in the yuan versus the dollar. This would impair China, as their goods sold in the U.S. would become more expensive.

What Should You Do?

As a short-term speculator, I don't make trades or recommendations based on economic data. I watch for a shift in the trend in the market. The market is still in an uptrend and may remain that way for a while, but when it does turn lower it will be a sharp and vicious decline if investor behavior continues to be irrational.

I am not going to recommend that you rush out and sell all of your stock holdings. I'm also not saying you should rush out and load up on puts. But I do believe it would be prudent to take some gains off the table on any long positions you may have. It might not be a bad idea to buy some long-term puts on some of the big ETFs, such as the AMEX Diamonds Trust (DIA), the Spyzers (SPY), or the Nasdaq-100 Trust (QQQQ). These long-term puts can serve as insurance for your portfolio should we see a major correction. A small amount invested in long-term puts can make up for some, if not all, of your losses on your stock portfolio.

Moving money out of stocks and into cash or bonds could serve you well over the next few quarters. I don't think it's time yet, but if the economic indicators continue to slide and it becomes increasingly likely that a recession is upon us, these adjustments to your investment allocation will pay off greatly.

I am not one of these perma-bears who is always looking for a crash, but I also am not a perma-bull who thinks the market only goes one way. I believe very strongly in playing

both sides of the market. But when investor optimism is running high, it's time to be worried about a pullback. And right now is one of those times.

As the editor of the *ETF Options Trader*, it is my job to make you money regardless of market conditions. If I can save you some money because of a heads-up special report like this one, that is a bonus.

Good luck and good trading,

Rick

Meet the Team

Rick Pendergraft, Editor of *Reality Bites*

Mr. Pendergraft has worked in the finance industry for over 10 years. He has been trading options and providing market insights for the past five years. He was a Schaeffer's Research top trader on two separate occasions, and is frequently quoted in such publications as *Business Week*, *Forbes*, *USA Today*, *The New York Times*, and *The Washington Post*.

Charles Delvalle, Editor of *The Silver Report*

Mr. Delvalle is the editor of the "Macro Minute" section monthly publication *Income* and is contributing editor to our financial e-zine *Investor's Daily Edge*. He has been trading stocks and commodities for over six years, and is a self-taught market timing professional specializing in technical and value analysis. He handles all product support for ETR's financial publications and ensures that you receive your alerts and issues in a timely fashion. He also handles subscriber account questions and website updates. If you have any questions, please send them to support@earlytorise.com

Andrew M. Gordon, Editor-in-Chief of *INCOME* and *The Wealth Advantage*

Mr. Gordon's business experience is far-reaching. He has managed a maritime telecom project for the Malacca Straits, property projects in central Jakarta, a road construction project in southern Sumatra, vapor recovery projects in Shanghai, and environmental missions all over Asia. He has worked with Dow Chemical, Allegheny Petroleum, and X-Chem. In 1997, he started his own international environmental consultancy practice, GMI International Inc.

Mr. Gordon is also the author of several books, including *China's Oil and Gas Industry* (McGraw Hill), *The World Coal Market* (Pasha Publications), *Telecommunications in Russia and China* (Frost and Sullivan), and *Global Offset and Counter Trade Practices* (First International Corp.).

MaryEllen Tribby, Executive Publisher

Ms. Tribby has been in the publishing business for over 20 years. Her resume includes such organizations as *Forbes*, *Times Mirror Magazines*, *Crain's New York Business*, and, most recently, *Weiss Research*, where she served as President. Ms. Tribby came to our organization with a commitment to provide the best possible products and services to the investor community.

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