Monday, September 25, 2006

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Market Commentary: Turning Logic on Its Head

Was the verdict as to whether the market was merely in pullback mode or rolling over delivered unequivocally with Monday's strong rally?

Perhaps, as the **S&P 500** marginally, but finally, eclipsed the May 5 closing high. However, the markets are notorious for being perverse -- many times just as the all-clear appears to be sounded and the breakout buyers rush in, the advance is ending.

Ditto the downside -- many times a new breakdown from what looks like a possible bottom in a persistent decline marks a capitulation and the end of a selloff.

Such may be the case in oil and the oil stocks on Monday. The **U.S. Oil Fund** (USO) gapped down to a new low for the move on Monday, but reversed, tracing out an outside day up. This price action traces out the up-down-up sequence I mentioned last week that often plays out at turning points.

I have been stating that oil should see no more than one to two days of rally attempts until $61 a barrel is tagged. Oil reversed up from below $60 on Monday. I also went on to say that once $61 was tagged, the most likely date to look for a reversal was Sept. 23.

Because Sept. 23 was a Saturday, that suggested a Friday/Monday turning point. The Square of Nine Calculator shows the Law of Vibration between the $77 high on oil and the decline to $61 being 180 degrees down, as well as the date of Sept. 23 being 90 degrees from both.

As the chart of the U.S. Oil Fund shows, oil closed on its low for the move on Friday, leaving a "bearish" outside day down. This left most traders with the expectation for lower prices. However, the USO gapped down to a new 60-day low, which was close to the low for the session, and traded up, leaving an outside day up.

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This left a Gilligan Buy Signal (as explained in my book *Hit and Run Trading*, a Gilligan Buy Signal is a gap down to a new 60-day low that reverses up for bottoms and vice-versa for tops). This suggests at the very least a retracement in the sector, as Friday's outside day down was offset or engulfed by Monday's outside day up -- this is bullish action.

Tangentially, just as the "breakout" in the S&P appears poised for continuation higher, a quick downside reversal at this point, offsetting Monday's rally, would be a monkey wrench in the notion of sustainably higher prices.

Last week, I mentioned that mutual funds would not like to show heavy positions in the suffering oil sector going into quarter-end, and that consequently, hedge funds may lean into the short side to take advantage of this situation. However, mutual funds already may have lightened up sufficiently in the oils ahead of this week, as evidenced by the plumb-line drop in the oil stocks.

Consequently, some hedge funds that have kept doing what has been working may get caught in a counterintuitive trade, as the oils appeared poised for a retracement rally. Remember, the penthouses of Wall Street are lined with the counterintuitive.

At the same time, it's important to remember that many hedge funds are driven by the low spark of 30-something well-heeled Boyz -- as evidenced by recent blowups by hedge funds.

As impressive as Monday's reversal from the red looks, the market may not have slammed the gavel down on a bullish verdict. As suggested in the previous column, much of Monday's rally may be due to quarter-end window-dressing.

One report I heard on Monday stated that third-quarter performance looks to go out as the best third-quarter performance in nine years. Hard to believe, but that would explain the need for mutual funds to be buyers into the weekend.

Conclusion: The market started down on schedule, but turned back up as large programs were unleashed, driving the S&P back through the key 1318 pivot. The reversal occurred as the S&P tagged its 20-day moving average, and once again constructively held the Sept. 5 high. With Monday's thrust off the 20-DMA to new swing highs, and because this is the last week before quarter-end, we may yet see the new headline high in the **Dow**, as well as the 1340/ 1350 S&P level, which has been a long outstanding potential target.

However, if Monday was a one-day program and a large fund simply has an agenda to break them out in order to sell them, keep in mind that a lot of damage could be done if the S&P offsets Monday's price action quickly. So I would be careful of buying any dip as the S&P may be tracing out a mirror image of the USO.

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Strategy: The tape was bullish on Monday. Consequently, I would not short into strength but would look to short weakness back below Monday's low this week for a number of reasons:

• The current seasonality is the weakest of the year.

• A low is due in the four-year cycle, and I doubt very much that the drop into the June/July low was that four-year cycle low. Numerous time counts and square-outs and other large cycles in my work are due to exert downside pressure.

• At the same time that these cycles and the four-year cycle -- which has been one of the most reliable market pulses -- is due to play out, remember also that there has not been a 10% correction since 2003.

If you're interested in learning more about the Square of Nine Calculator, click here for my course.

U.S. Oil Fund (USO) -- 10-Minute

(A 10-minute chart of the USO for Friday and Monday showed how a reversal was carved out and how Monday's price action engulfed Friday's.)

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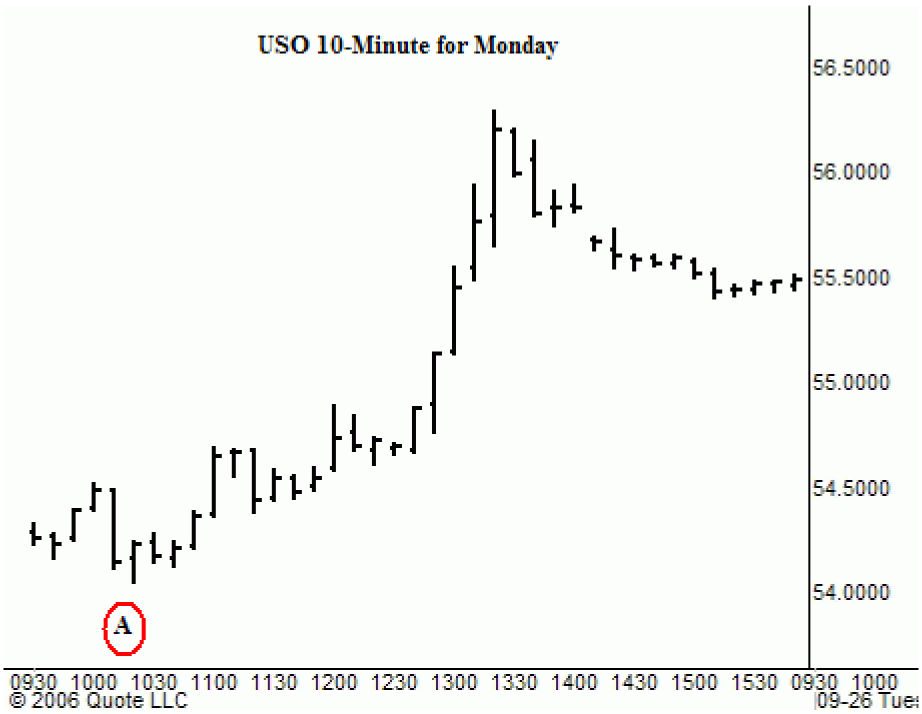
U.S. Oil Fund -- 10-Minute



(The USO gapped down to a new 60-day low on Monday but quickly made a low (A).)

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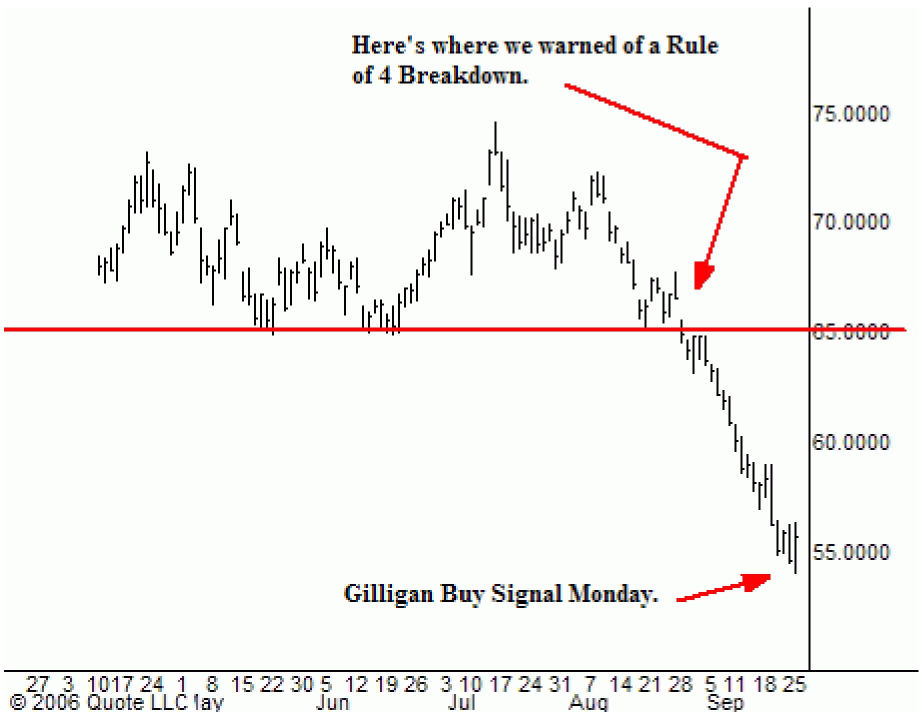
U.S. Oil Fund (USO) -- Daily



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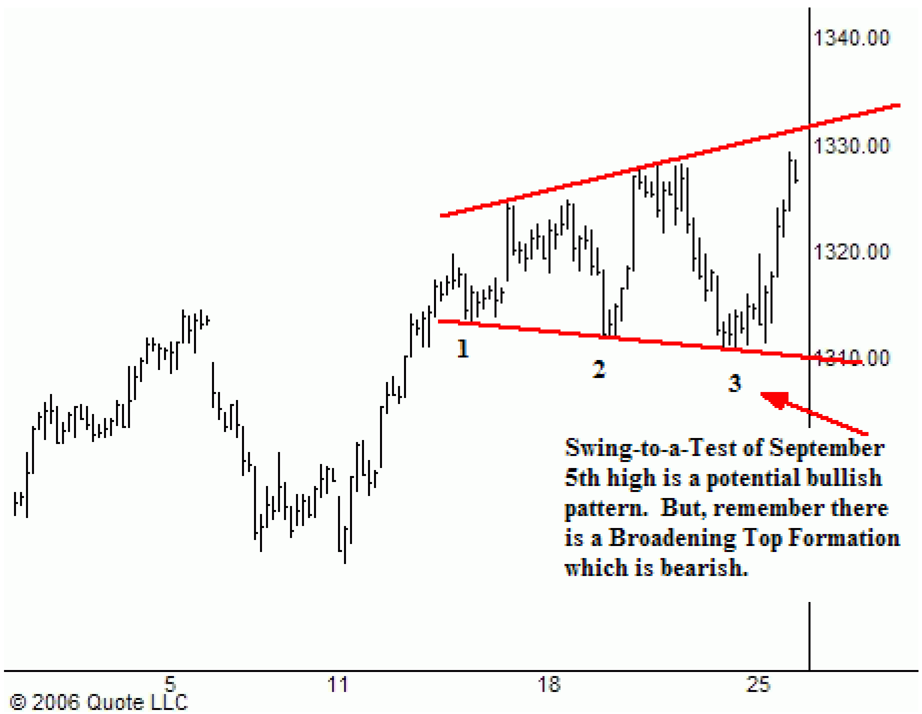
S&P 500 -- Daily



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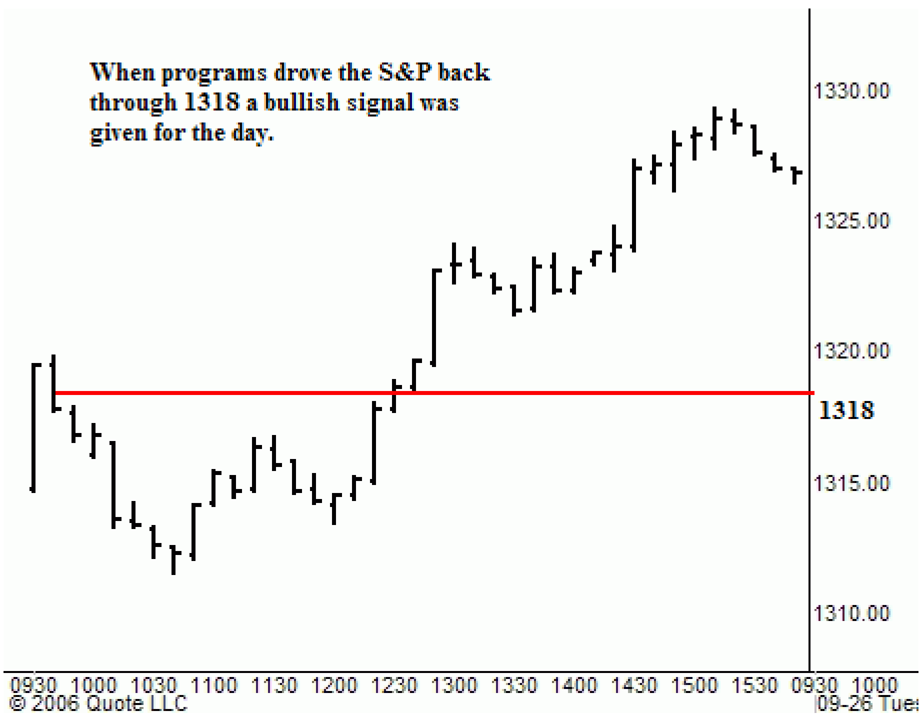
Pivot Points

S&P 500 -- 10-Minute



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THE DAYTRADING REPORT

Chart 1

Crocs
(CROX:Nasdaq)
Long

Entry: 32.80
Stop: 31.80
Pattern: Expansion Breakout

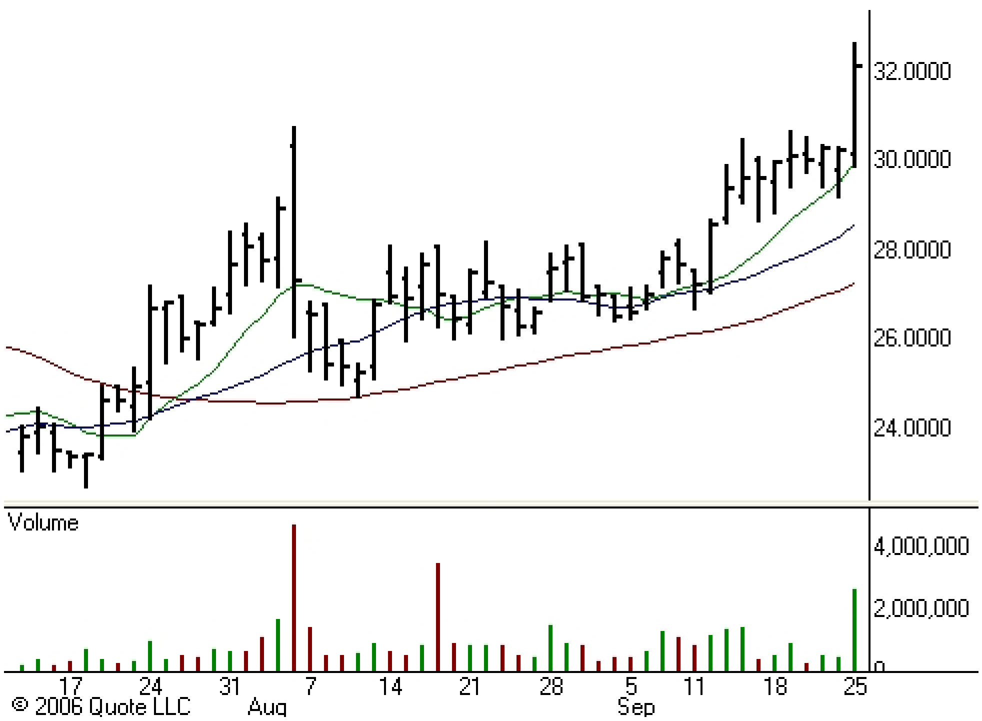

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Chart 2

Dril-Quip
(DRQ:NYSE)
Long

Entry: 63.60
Stop: 62.60
Pattern: Gilligan / *Lizard

Comments: Heads up as this one is extremely volatile.

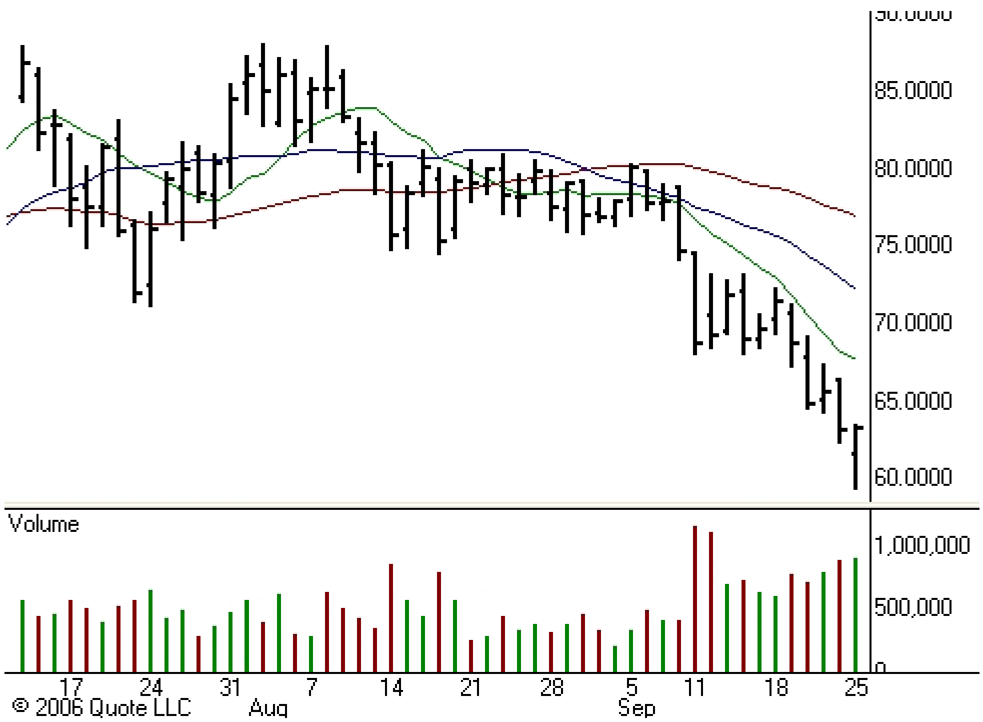

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Chart 3

Express Scripts
(ESRX:Nasdaq)
Short

Entry: 76.25
Stop: 77.25
Pattern: Expansion Pivot

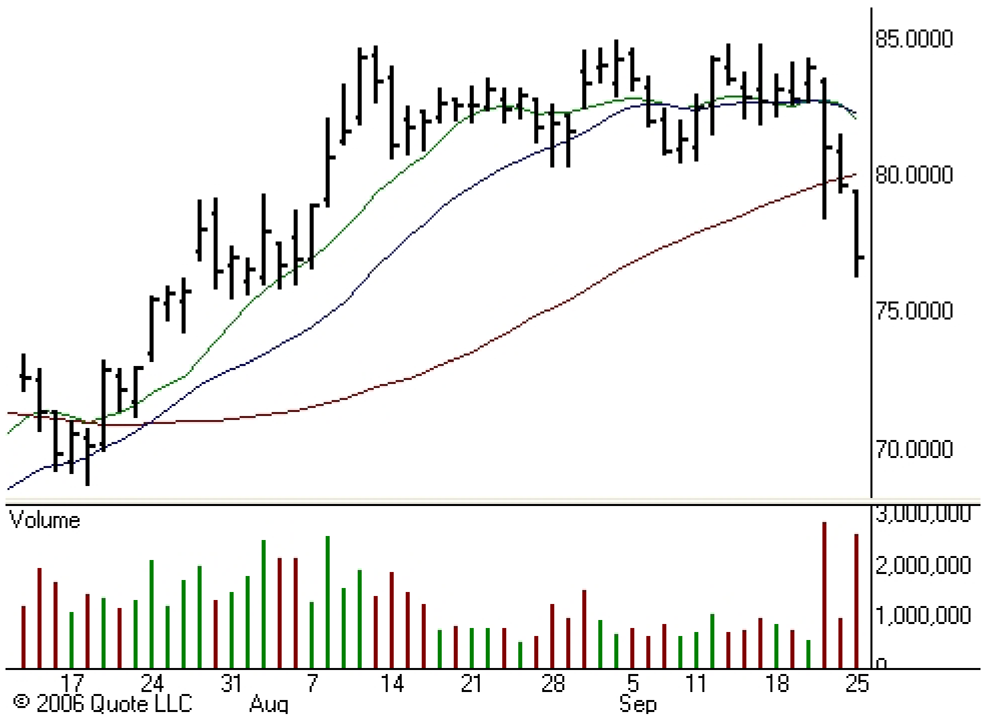

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Chart 4

Avid Technology
(AVID:Nasdaq)
Long

Entry: 44.10
Stop: 43.10
Pattern: Expansion Breakout / 180

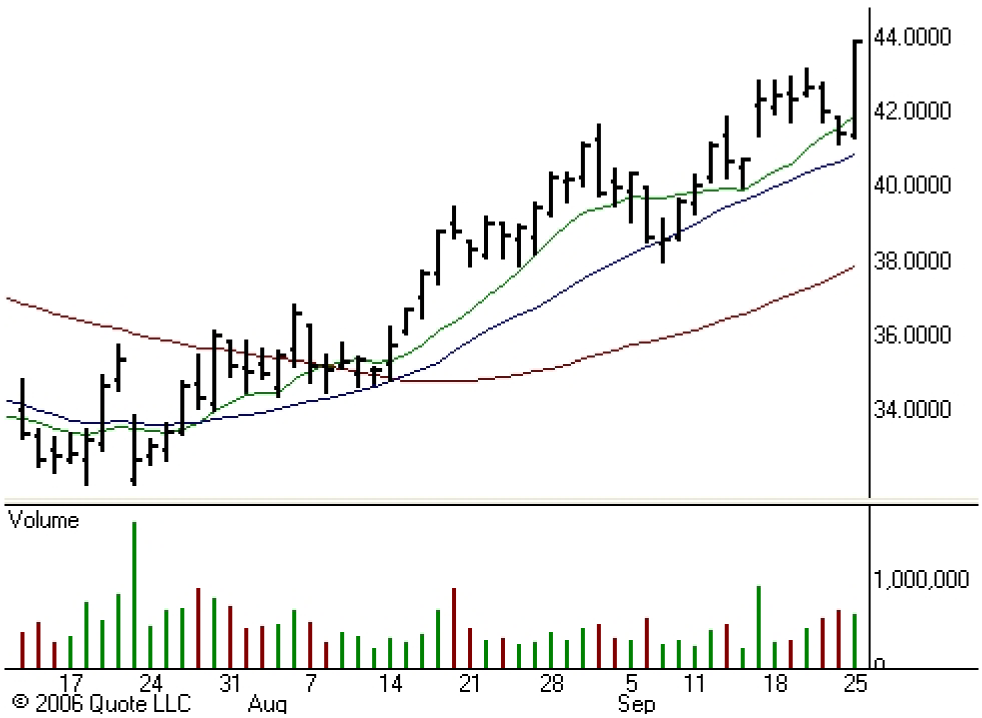

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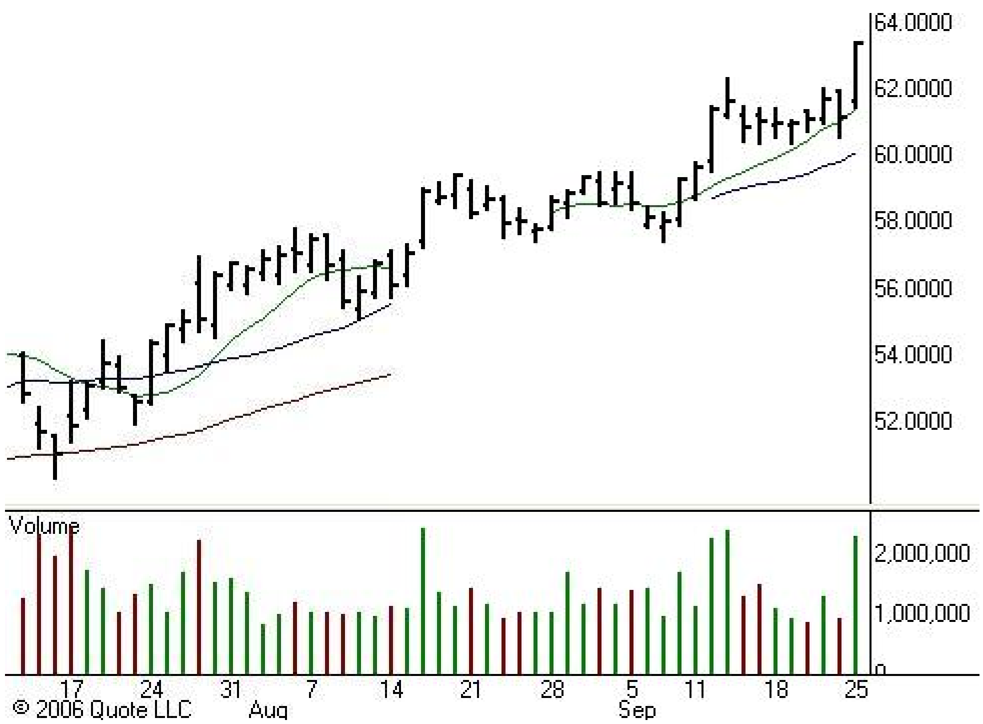
Chart 5

Harley-Davidson
(HOG:NYSE)
Long

Entry: 63.60
Stop: 62.60
Pattern: Expansion Breakout



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THE SWING REPORT

Chart 1

Baker Hughes
(BHI:NYSE)
Long

Entry: 64.40
Stop: 62.40
Initial Target: 66.40 (trade toward)

Pattern: *Gilligan / LROD

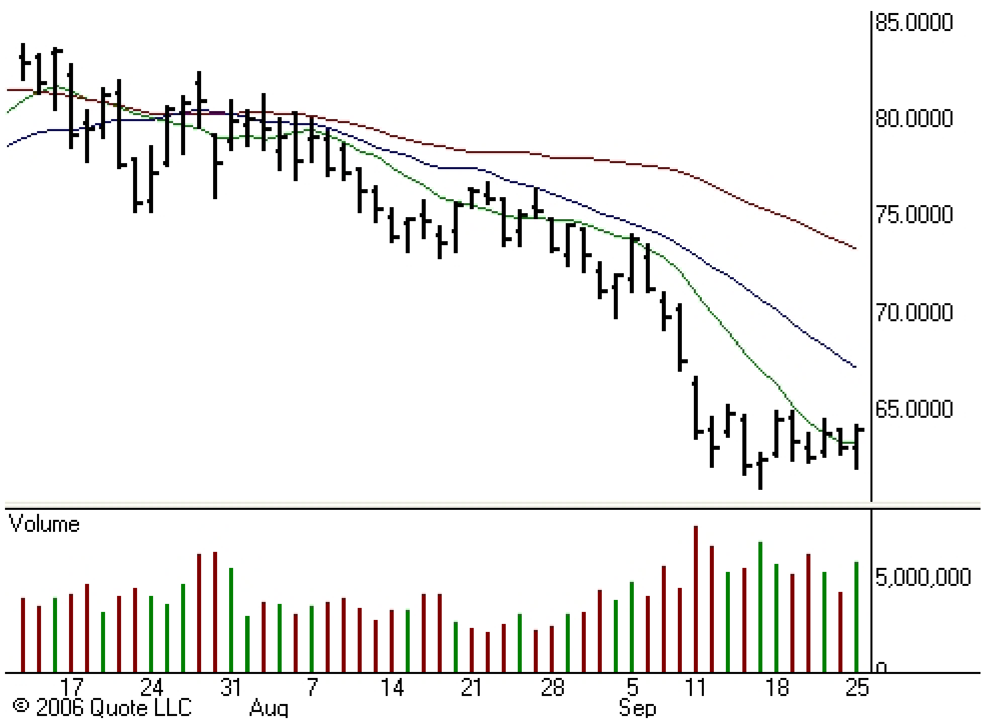

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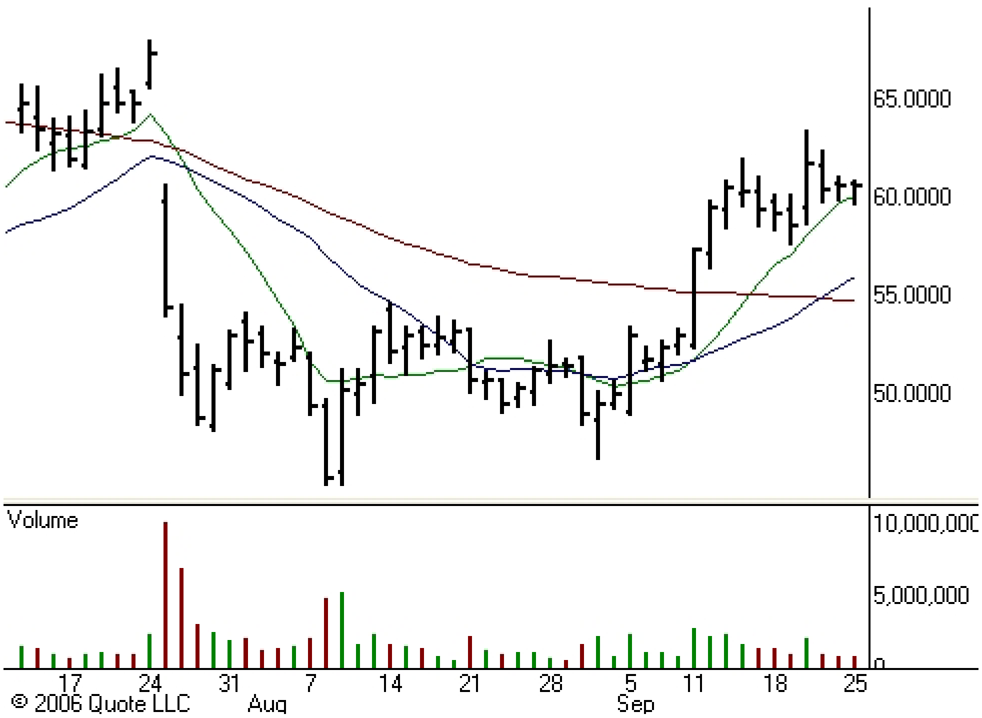
Chart 2

NutriSystem
(NTRI:Nasdaq)
Long

Entry: **61.10**
Stop: **59.10**
Initial Target: **63.10 (trade toward)**

Pattern: Extended Level Boomer / NR7



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OBSERVATIONS AND TRAILING STOPS

-- On Monday you went short **Ipsco** (IPS) (short) around 83.15 on a gap open and then covered your first piece, locking in a gain of 2.00. You then lowered your stop for the second piece to the entry at 83.15 and were stopped out for a scratch.

-- Tuesday is day two in **Lufkin** (LUFK) (short). You are short from 52.75. On Monday you covered your first piece, locking in a gain of 2.00. Lower the stop to 51.25. As of Monday's close, you are up 1.96 on the second piece.

-- Tuesday is day two in **Essex Property Trust** (ESS) (long). You are long from 122.55 on a gap open. Maintain the stop at 120.40 and the initial target on trade toward 124.40. As of Monday's close, you are down 1.10.

-- Tuesday is day three in **Occidental Petroleum** (OXY) (long). You are long from 45.75. Maintain the stop at 43.75 and the initial target on trade toward 47.75. As of Monday's close, you are down 28 cents.

-- On Monday you were stopped out of your second piece of **Caterpillar** (CAT) (short) for a gain of 90 cents, after locking in a gain of 2.00 on the first piece.

-- Tuesday is day three in **United Parcel Service** (UPS) (short). You are short from 70.70. Maintain the stop at 72.70 and the initial target on trade toward 68.70. As of Monday's close, you are down 1.11.

-- Tuesday is day four in **TXU Corp.** (TXU) (short). You are short from 59.70. Maintain the stop at 61.70 and the initial target on trade toward 57.70. As of Monday's close, you are down 1.62.

-- Tuesday is day four in **Veritas** (VTS) (long). You are long from 65.10 on an ORB. Maintain the stop at 63.10 and the initial target on trade toward 67.10. As of Monday's close, you are down 50 cents.

-- On Monday you were stopped out of **Equinix** (EQIX) (short) for a scratch.

-- Tuesday is day six in **Rackable Systems** (RACK) (short). You are short from 26.75. Maintain the stop at 28.75 and the initial target on trade toward 24.75. As of Monday's close, you are down 98 cents.

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Notes and Guidelines

DayTrading Report:
Trades marked ▲ indicate stocks that are considered small-cap, trading 500K shares or less. As you know, thin stocks are generally more volatile and trade with a wider spread.

Trades marked * indicate patterns that don't conform to the original rules of the pattern but are defined as "in the spirit of" their namesakes.

The 1-Point Gap Rule: Any stock recommendation that opens 1 or more points above the listed entry price (for longs) or 1 or more points below the listed entry price (for shorts) should be ignored for the day. Please note that history suggests that entering a stock on a gap open increases your potential for a loss.

Reminders: A signal is not valid unless the stock trades at or above the listed entry price for longs and at or below the listed entry price for shorts. ***If a position moves 1 point in your favor in this choppy environment, it is a good idea to sell half the position and move your stop on the remaining position to break even.***

Charts: The green line is a simple 10-day moving average, the blue line is a simple 20-day moving average, and the red line is a simple 50-day moving average.

The Swing Report:
Trades marked ▲ indicate stocks that are considered small-cap, trading 500K shares or less. As you know, thin stocks are generally more volatile and trade with a wider spread.

Trades marked * indicate patterns that don't conform to the original rules of the pattern but are defined as "in the spirit of" their namesakes.

The 2-Point Gap Rule: Any stock recommendation that opens 2 or more points above the listed entry price (for longs) or 2 or more points below the listed entry price (for shorts) should be ignored for the day. Please note that history suggests that entering a stock on a gap open increases your potential for a loss.

Initial Target: Target price at which you should look to sell/cover half your position.

Reminders: A signal is not valid unless the stock trades at or above the listed entry price for longs and at or below the listed entry price for shorts. ***If a position moves 2 points or more in your favor in this choppy environment, it is a good idea to sell half the position and move your stop on the remaining position to break even.***

Charts: The green line is a simple 10-day moving average, the blue line is a simple 20-day moving average, and the red line is a simple 50-day moving average.

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