Addicted to Profits

October 2007 Dave Skarica, Editor Volume IX Issue X

# Pullback then Big Rally?

## Stock Market

We were shocked back in September when the at least by the Dow went to new highs. We expected a rally but nothing that extreme. However, there is precedent for a large rally, new high then large pullback before the real bull market began.

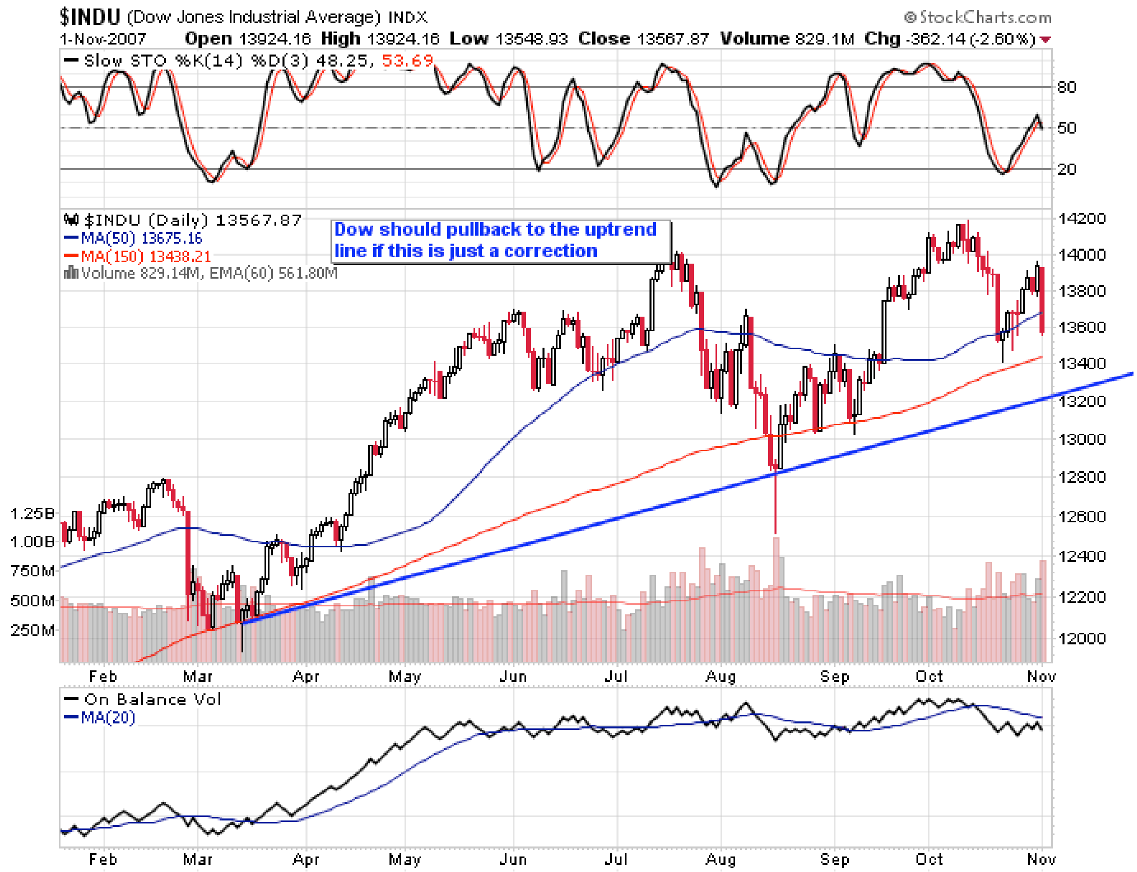
**Does 2007 = 1997**

While history never repeats itself exactly there are usually time frames which are most similar. For example, the Japanese bust of 1990 to 1992, NASDAQ bust of 2000 to 2002 and Stock Market crash of 1929 to 1932 had similarities in trading patters and percentage declines.

I have looked through dozens of past market corrections to see what this one most resembles. I have narrowed it down to two, both in the mid to late nineties.

On a charting basis this looks most like the 1997 correction. Like 1997 this correction was quick and fast. It lasted about three weeks from early October to Late October, it took about 14% off the Dow, this one took about 10% OFF THE DOW. The Dow retreated from 8200 to 7000 in 1997. It then rebounded to 8200 by early December before pulling back to 7400 in January 1998.

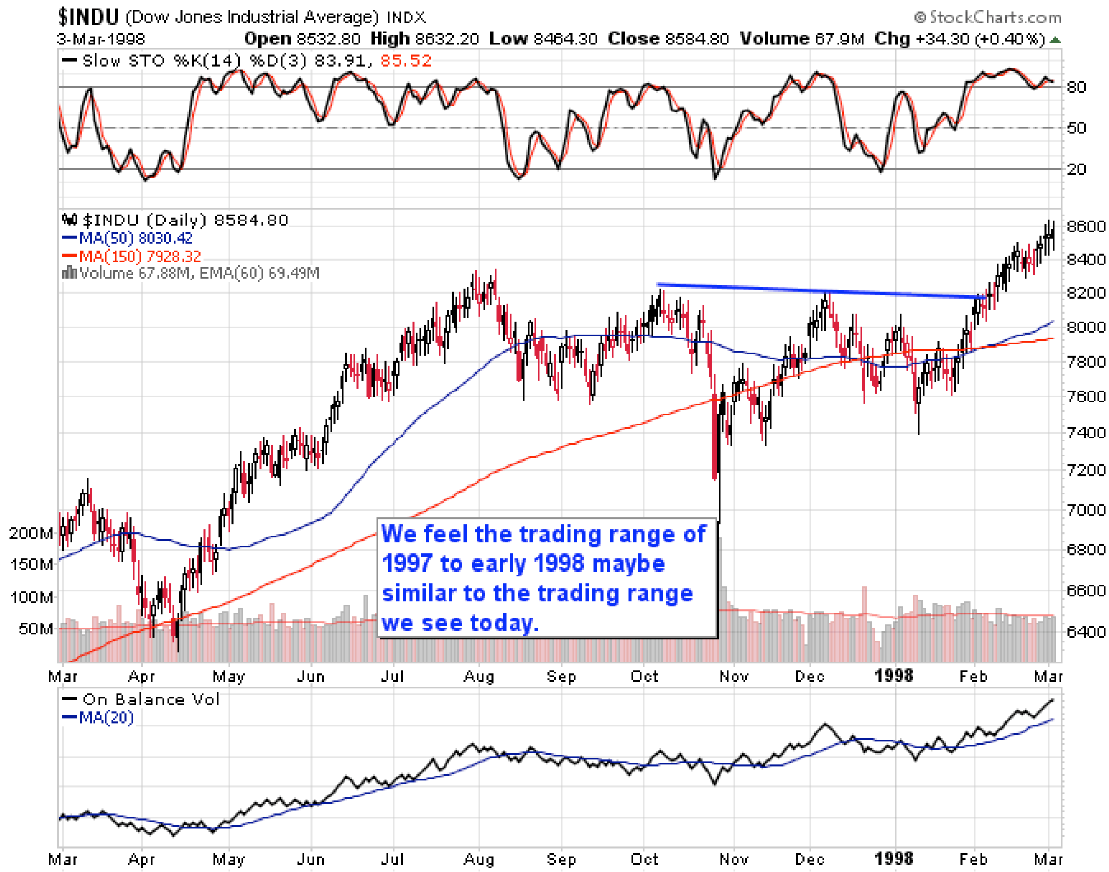
Like 1997 within a month the Dow was trading near new highs, reaching a new high by late November 1997. There was then a pullback for about a month as just stated. If we were to see a similar pullback of 2/3rds it would mean the Dow would pullback to 13,000 or so before taking off once more.




This is sort of what we see happening.

Another interesting scenario is the 1998 scenario. Fundamentally this decline is most similar to the 1998 financial crisis (just insert subprime instead of the LTCM hedge fund debacle). The Fed cutting rates. After the surprise rate cut like 1998 the market took off and went to its old high (at this time it was 9400 rather) then there was a quick pullback to 8700 before the market took off and rallied through out 1999.

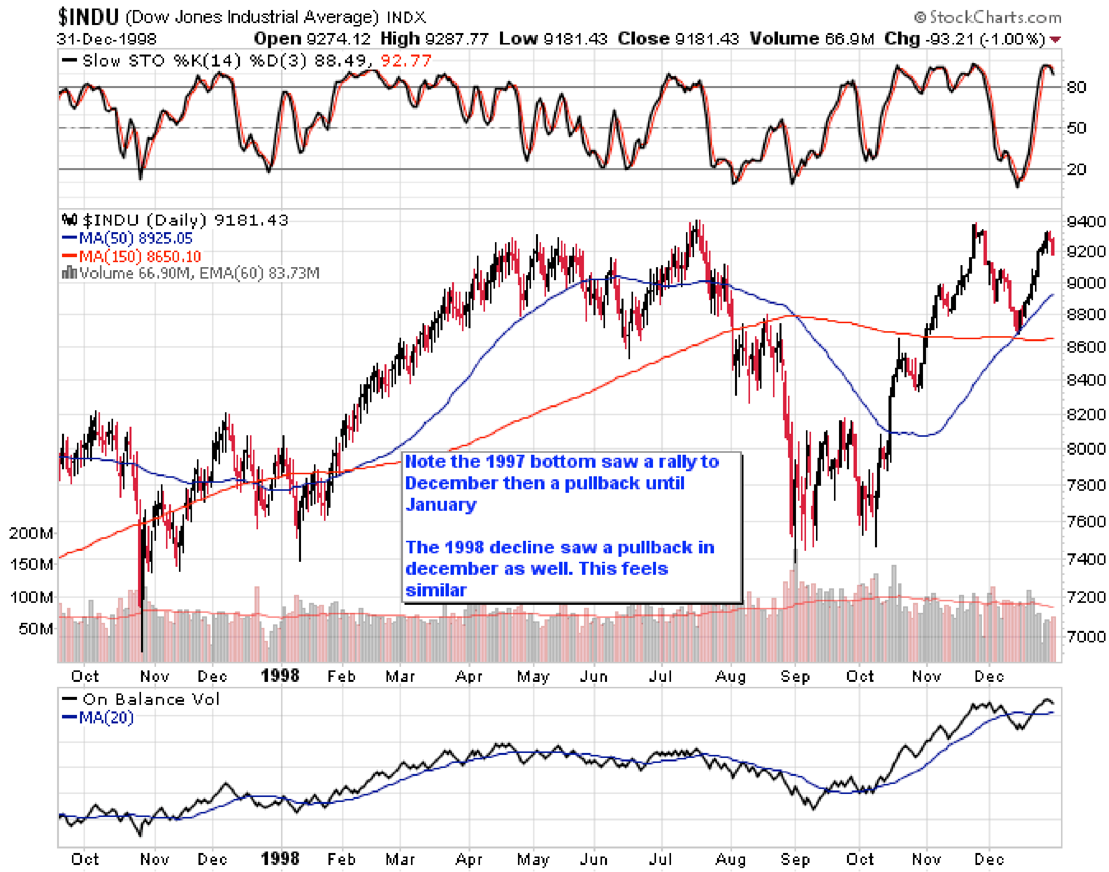
Again this is also possible and a 7% decline like late 1998 would take us back to that 13000 level. Although we have to see increasingly it looks like the 13500 low reached last week will end up being the markets correction low.



$INDU (Dow Jones Industrial Average) INDX
© StockCharts.com
3-Mar-1998
Open 8532.80 High 8632.20 Low 8464.30 Close 8584.80 Volume 67.9M Chg +34.30 (+0.40%)
Slow STO %K(14) %D(3) 83.91, 85.52
$INDU (Daily) 8584.80
MA(50) 8030.42
MA(150) 7928.32
Volume 67.88M, EMA(60) 69.49M
We feel the trading range of 1997 to early 1998 maybe similar to the trading range we see today.
On Balance Vol
MA(20)
Mar Apr May Jun Jul Aug Sep Oct Nov Dec 1998 Feb Mar


## Seasonality is on the market's side

We must remember that we are also entering the seasonality strong period for the stock market. As discussed before declines in 1966, 1970, 1974, 1978, 1979, 1987, 1990, 1994, 1998, 1999, 2002 all ended in October. This is the time of year that declines usually end not




begin which is why we think any pullback will just be a pullback and not the start of a major bear market.

Some Indicators did get overbought during the market rally. Let's take a look at them.

# The VIX

Investopedia Says... The first VIX, introduced by the CBOE in 1993, was a weighted measure of the implied volatility of eight S&P 100 at-the-money put and call options. Ten years later, it expanded to use options based on a broader index, the S&P 500, which allows for a more accurate view of investors' expectations on future market volatility. VIX values greater than 30 are generally associated with a large amount of volatility as a result of investor fear or uncertainty, while values below 20 generally correspond to less stressful, even complacent, times in the markets. Source: Investopedia


At the bottom of the market on August 16th, 2007 the VIX got up to over 35 an extreme reading. We found that a good trading bottoms the VIX often gets above 35, this being 2001, 2002, 1998, 1997 etc… This is a sign that investors are paying up for options most noticeably put options.

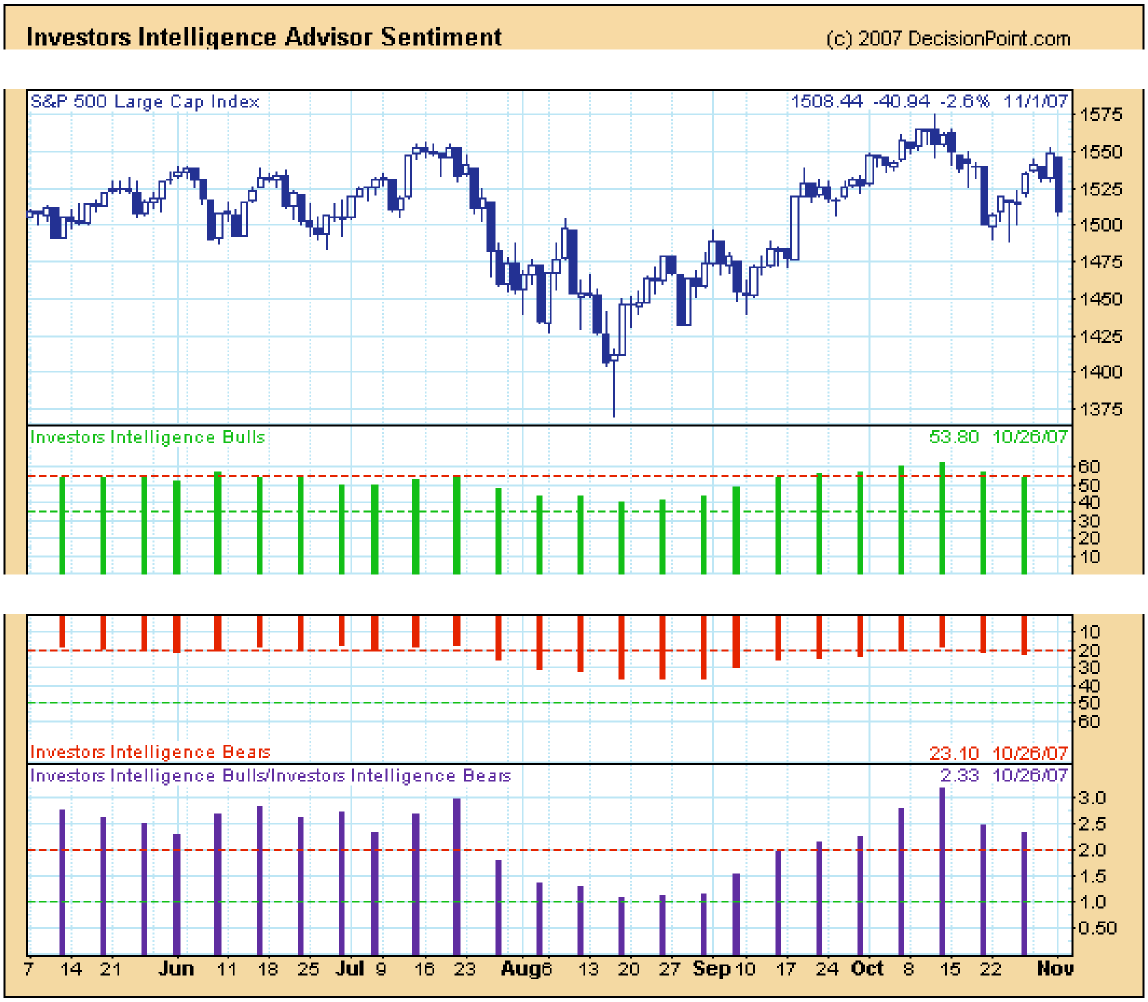
As we have often said in this publication when the VIX is high you buy, when it is low you go.

On the most recent rally the VIX got back down into the teens. On the big decline on October 19th, 2007 the VIX got back up to near 23. The dip into the teens was a sign of complacency and lead to the market decline of the past week or so. Of course what we would like to see is the market decline a bit more and the VIX rise to the 30 area, which would give us a good buy signal.

**Investor's Intelligence** --- Each week the service Investors Intelligence surveys some 140 financial newsletter writers to determine whether they are leaning bullish or bearish towards the markets.

What I like to do in Investors Intelligence is throw out the neutrals and divide the bulls by the bears. Usually when the bulls out number the bears by a 2 to 1 ratio and especially

2.5 to 1 the market is going to top out. This occurred at before the correction this spring and at the market top in the summer. The week of the market top the reading was 3 to 1! (showed 55% bulls to only 18% bears!)




At the bottom of the market in late August investors Digest got back down to 1 to 1.

However, during this market rally investor’s got way too bullish. In the most recent poll before the publication of this before the market correction showed over 62% bulls to only 19% bears or a ratio of 3.21 to 1.

Now a high reading does not mean the market has to crash or correct significantly. This was the highest reading since late 2004 and when that happened the market corrected a few percent then moved higher.

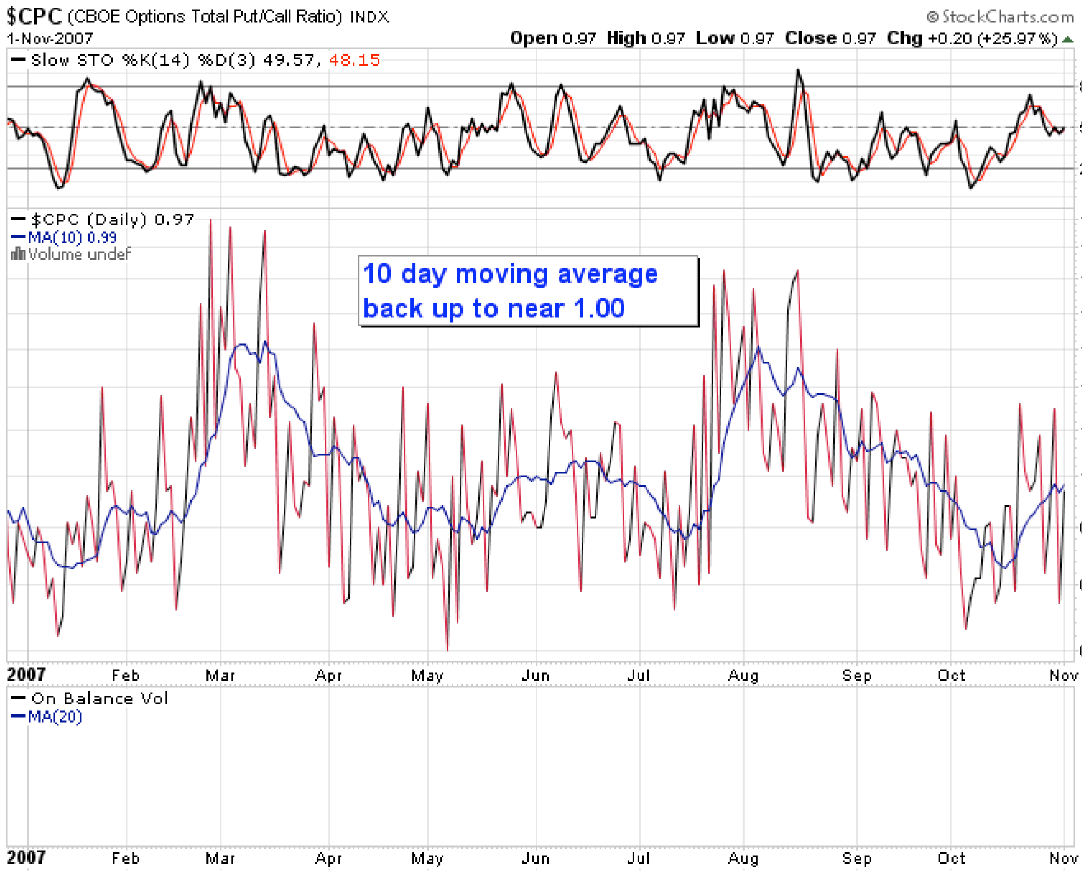
We have found is that many times after bottoms in the first rally positive sentiment really spikes up this happened in the summer of 2003, in mid 2004 early 1991, early 1998 and o many other occasions. What usually occur is after the blast off from the bottom is the market get s over bought people get too bullish then there is a pullback that washes this bullish sentiment away. We are looking for such a pullback at the moment.

# The Put/Call Ratio

A ratio of the trading volume of put options to call options. It is used to gauge investor sentiment.

Investopedia Says... For example, a high volume of puts compared to calls indicates a bearish sentiment in the market.

The ratio we watch is the CBOE Put/Call ratio and we watch the 10-day moving average, which smoothens out the readings.




We find that when the average gets down to .80 to .90 you want to start watching out for a possible market top. For example, we saw that earlier this year before the market corrected. But, like most technical indicators this indicator tends to work better at market bottoms. The reason for this is fear is a more intense emotion than greed so the same types of panic and market behavior occur at bottoms.

At the bottoms in March and August of this year the put/call ratio hit extreme levels on the 10 day moving average of 1.30. The equity put/call ratio which just tracks put and call buying for individual equity hit .80 this are the highest levels of the past 20 years or so! They coincided with those bottoms.

On this rally the 10-day moving average of the put/call ratio got down to 0.82 and the equity put/call ratio got down to 0.57. This was the lowest ratio in the put/call ratio since January and the lowest level on the equity put/call ratio since July. This is a sign that there is too much call buying and we need a pullback.

The put/call ratio went to 1.16 the day of the decline and the equity put/call ratio 0.73. These are not extreme levels but a sign that put buying is starting to go into the right level. If we get a further decline we look for this too spike up.

## Stocks Trading Above Moving Averages

Among the most popular technical indicators, moving averages are used to gauge the direction of the current trend. Every type of moving average (commonly written in this tutorial as MA) is a mathematical result that is calculated by averaging a number of past data points. Once determined, the resulting average is then plotted onto a chart in order to allow traders to look at smoothed data rather than focusing on the day-to-day price fluctuations that are inherent in all financial markets.

The simplest form of a moving average, appropriately known as a simple moving average (SMA), is calculated by taking the arithmetic mean of a given set of values. For example, to calculate a basic 10-day moving average you would add up the closing prices from the past 10 days and then divide the result by 10. In Figure 1, the sum of the prices for the past 10 days (110) is divided by the number of days (10) to arrive at the 10-day average. If a trader wishes to see a 50-day average instead, the same type of calculation would be made, but it would include the prices over the past 50 days. The resulting average below (11) takes into account the past 10 data points in order to give traders an idea of how an asset is priced relative to the past 10 days.

A very interesting indicator is the % of stocks trading above their moving average. Specifically the 20, 50 and 200 day moving average when stocks trade above their moving average it is considered bullish, below bearish. However, there are extremes. When too many stocks trade above their moving averages it is a sign that the market is over bought, too many below over sold.

This indicator Is not great at tops often for months and months a high percentage of stocks will trade above their 200, 50 and 20 day moving averages. It is good at spotting bottoms however.

The key number we look at for the 200 day moving average is 30%, for the 50 day moving average is 20% and 20 day moving average is 20%. When only 30% of stocks are trading above their 200 day moving average and 20% above their 50 and 20 day moving averages we find it is a sign that the market is oversold and nearing a bottom.

For example at the market bottom in 2002 les than 20% of stocks were trading above their 50 and 20 day moving averages and 200 day moving averages.

At the 1994 and 1998 market bottoms less than 30% of stocks traded above their 200 day moving averages.


Now only that there are extreme extremes. For example at the 2002 bear market bottom only about 10% of stocks were trading above their 200 day moving averages. At the 2002 bottom less than 10% OF STOCKS were trading above their 50 and 20 day moving averages.

At the bottom in August the readings dip below 10% for both the 50 and 20 day moving average. However, we did not see the readings get really extreme for the 200 day as it just got down to 31%. WE HOPE on a further market pullback we see less than 30% of stocks trade above their 200 day moving averages, as that will be a sign to buy.

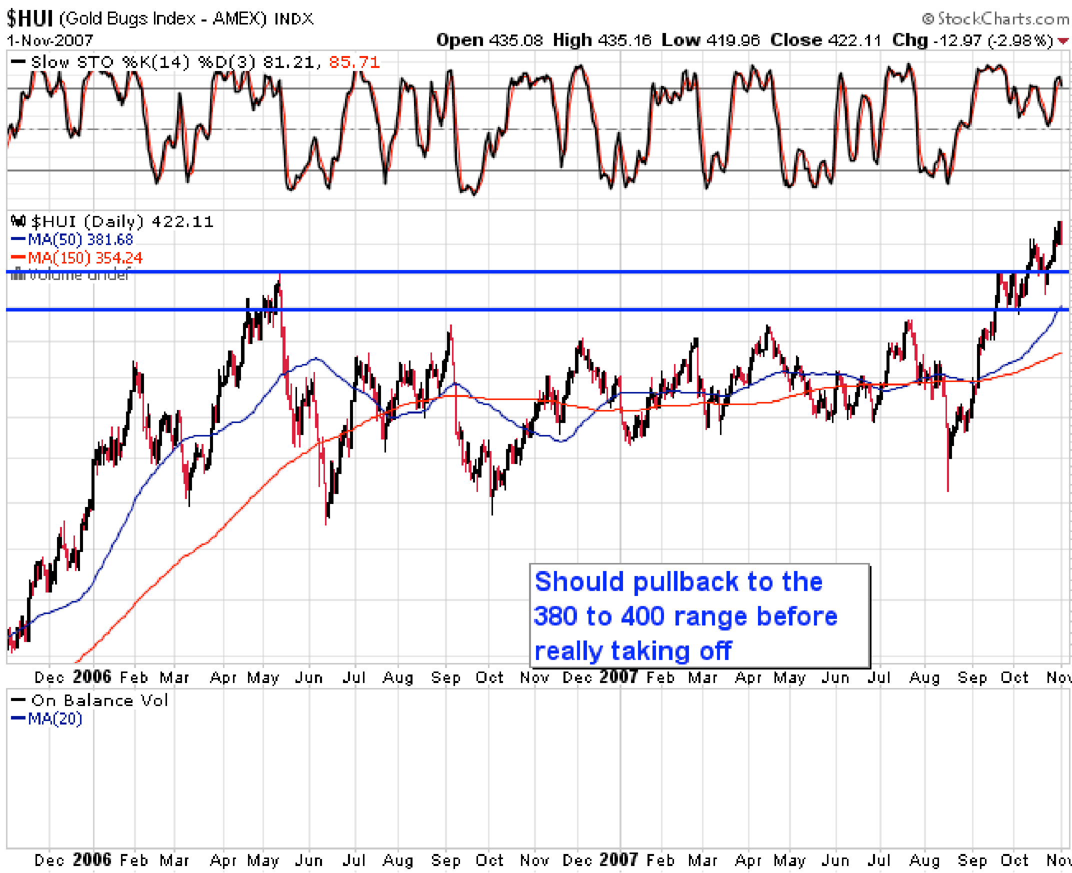
As we write 47% of stocks are above their 200 day moving averages, 39% above their 50 day and 25% above their 20 day moving average.

**Conclusion**

As we can see from the above indicators. Indicators got too bullish during this market rally and we would like to see some further declines to get to move oversold conditions and a market bottom.

# Gold and Gold Stocks

# Breakout here we come! But Pullback first.



It is amazing the more you do this game the more help that history can give you and the more you learn from trading.

In the past when the HUI broke its all time high of 400 I would have been buying like crazy and telling the subscribers to do the same. However, what we have learned from past gold breakouts, is when gold stocks are at or near a breakout they almost always see a small pullback before climbing again in price.

For example, on December 2005 when the HUI got near its high of 250 it pulledback to 220 before taking off breaking out in January 2006 and ultimately climbing to 400 in the spring of 2005.

In early 2003 the HUI got up to its high of 155 then declined about 20% to 120 before breaking out and rising to 250 on the next move.

In 2001 the HUI peaked at 80 it broke out in early 2002 to 90. It then pulled back to 80 before going to 155 in the summer of 2002.

The common trading pattern is that gold stocks will go to their old high or even slightly break out then pullback 10-20% before going gang busters. We will have more on the rallies a bit later.

Currently, the HUI's old high of 400 was breached in October as the HUI climbed to 423. It stands at 405 as we write. If it were to pullback around 40% it would fall to around 380 or so. That would be the time to be buying gold stocks.

How high will gold stocks go on the next move.

I would like to quote one of our past historical studies for this:
The last and most interesting point. We have done a study of the past rallies and pullbacks in the gold market during the current bull market. It is just a case of simple mathematics.

Since the first move from the bottom in November 2000, there have been 3 major rallies in the gold market and 4 pullbacks. Let's take a look at them:

(i) The first pullback was from 80 to 60 in the HUI, a loss of 33% that lasted 6 months from May 2001 to November 2001. This was followed by a rally of over 150% from November 2001 to May 2002. This took the HUI index to 155.

(ii) The second pullback then was from May 2002 to July 2002. This saw the HUI lose nearly 40% of its value, falling to a low of 90. It then chopped along until April 2003 when it began another major surge that took it to over 250 in December 2003/January 2004. This was a gain of over 170% from bottom to top.

(iii) After the top in January 2004 at 255 the HUI declined to 160 in both May 2004 and May 2005 for a loss of 37%. It then spiked to 400 in May 2006. This was a gain again of 150% from top to bottom.

(iv) The HUI has declined to as low as 270 in June 2006 and October 2006 from its high of 400 or a loss of 33%.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So what comes next? From the above study we can see that the declines in gold stocks during this bull market were usually anywhere from 33 to 40% and the increases anywhere from 150% to 170% (I did not include the first move in the HUI from 38 to 150 or a gain of 300% because the first move up in a bull market is usually the greatest in % terms because stocks are coming from such depressed levels). Therefore, if the HUI climbs 150 to 170% from its most recent low of 270 it tells us that the next intermediate top should be seen around 680 to 750 on the HUI until the next major pullback.

In addition, if you look at the timeframes from when the majority of gains occurred during this bull market you will see some similarities.

(i) The 2001 to 2002 rallies occurred from November 2001 to May 2002 or approximately 7 months in length.
(ii) While the 2002 bottom occurred in July, the majority of the rallies occurred from April 2003 to December 2003, or approximately 8 months.
(iii) The 2006 to 2007 rallies occurred from May 2006 to May 2007, and the real gains accelerated in November 2006; so depending how you look at it that rally lasted from 7 to 12 months.

Therefore we can see that these huge rallies tend to last 7 to 12 months in length. If this May bottom was the bottom before the next major gold rally, it tells us that gold stocks should rally to December 2007 to May 2008 with the HUI climbing to approximately the 650 to 800 area.

Only time will tell but this most recent rally may have been the start of a major BLAST OFF and next rally in the gold market.

## Addicted to Profits Watch List

| | Price (Watch) | Current Price | Current Rating |
|---|---|---|---|
| EQUITY POSITIONS (NON GOLD) | | | |
| Large Cap | | | |
| Yamana (YRI T AUY NY) | $3.86 (Oct 05) | $14.51 | ** Top |
| mid tier, production increasing botched takeover hurting stock | | | |
| Stop/Loss 8 | | | |
| Agnico Eagle (AEM NY, Toronto) | $36.50 (Aug 07) | $54.91 | **** Top |
| Gold large cap ramping up production | | | |

Intel (INTC Nasdaq 23.80 Aug 09 $26.50 *** Top tech name Stop?Loss 22
Eldorado (EGO, ELD T) $4.24 (Nov 05) $6.52 *** Solid
Producer Stopped out a t5.00 for gain of 20% readded at 4.24
Merill Lynch (MER NYSE) $70.25 (Aug 07) $62.19 *** broker way
to play bottoming period in market.
CIBC (CM Toronto) $87.00 (August 2007) $98.16 *** Top Canadian
bank hit in sell off
Mid Tier
Asian Dragon stopped out at 2.50 for a loss of 11% going to get
back in this sucker is cheap
Baja Mining (BAJ.v) $1.15 (Mar 06) $2.20 Stop
Loss 1.50 *** Copper play to be put into production in 2007
Capstone Gold (CSG T) $1.00 (Oct 05) $3.13 Stop
Loss 1.50 **** Top Silver Company, going into production,
undervalued
Consolidated Thompson (CLM T) $2.60 (Oct 06) $7.00 Stop
Loss 4.00 **** Huge potential as a base metal play
Endeavour Silver (EXK 3.55 $4.22 Stop/Loss 3.
Fortuna Silver Mines (FVI V) $1.40 (Oct 05) $3.09 Stop Loss
2.00 **** Peruvian Property in Production

Unigold (UGD V) $0.46 (Oct 06) $0.70 *** DR Play

Speculative

Small Cap

Ammex Gold Mining (AMXG OTC) $1.15 (Aug 06)
$0.20 *** Another Silver Play good bet under.20
International Pbx (PBX V) $0.40 (August 06)
$0.40 *** Strong Chilean Mining Play stopped out at
.40 readded at .40
Largo Resources (LGO V) $0.35 (Aug 07) 0.70 *** top junior hit
hard during correction
Paramount Gold (PDGP Pinks) $0.90 (Oct 05) $2.70 Stop
1.80 *** AMEX LISTING!
Thunderbird (formally MBA TBD) $0.30(June 06)
$0.55 *** producing natural gas well
Rimfire (RFM V) $1.07 (Oct 05) $1.98 Stop
1.40 *** Long term junior holding
Silverstone (SST V) $1.45 (Aug 07) $2.20 ***
stopped out at 2.00 for gain of 150% readded at 1.45
Fury Exploration $1.00 (May 06) $0.85 *** going into production next year
Prime City One Capital Corp 0.08 (Aug 08) $0.05 *** new merchant bank investment company just
started to trade
Micro Cap
Cityview (CTVWF) $0.07 $0.32 (Dec 06)
Hiuge move up over 300%!!! *** Stop/Loss .20

Full Metal Minerals (FMM V) $0.80 (Oct 05) $2.65 Stop
2.00 *** Great Management, range of properties

Trading Positions
VMS.v 0.18 (July 2007) $1.40** some recent good results take some off the table here! Up 800%!!!

Option and/or Short Positions

None ***

Mutual Fund Portfolio

None

* Donates Close End Fund

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