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Investment Strategy

Investment Strategy: "It's Learning!"

Back in 1983 I was enthralled with the movie "War Games." According to Wikipedia:

> *WarGames* is a 1983 American Cold War science fiction film. The film stars Matthew Broderick, Dabney Coleman, John Woods, and Ally Sheedy. The film follows David Lightman (Broderick), a young computer hacker who unwittingly accesses WOPR (War Operation Plan Response), a United States military supercomputer originally programmed to predict possible outcomes of nuclear war. Lightman gets WOPR to run a nuclear war simulation, originally believing it to be a computer game. The computer, now tied into the nuclear weapons control system and unable to tell the difference between simulation and reality, attempts to start World War III.

The sequence from the movie that "stuck" with me was near the end where it was suggested that the WOPR computer was actually learning from the game simulations that any nuclear attack by the U.S. was a losing proposition (War Games). Similarly, it appears to us that President Trump is "learning" on the job, just like WOPR did in the movie. I mean just last week our president embraced many of the "things" he had campaigned against. Now it appears Janet Yellen may stay as Fed head, NATO is no longer obsolete, China doesn't manipulate its currency, the U.S. dollar is "too high," and the list goes on. Add to that a decidedly stiffer foreign policy strategy with the Syrian missile strike and the "Mother of All Bombs" (MOAB: the GBU-43/B) that was dropped on an ISIS bunker complex in the Achin district of eastern Afghanistan. Up until now the stock market has turned a deaf ear to such events, but that seemed to change late last week.

Indeed, to Andrew and me it has seemed quite eerie to see the stock market hanging in there given the geopolitical environment, the Atlanta Fed cutting its GDP growth estimate for 1Q17 in half (to +0.6% from +1.2%), the Federal Reserve raising interest rates, in-fighting in D.C., a potential Whitehouse staff shakeup, the potential for a confrontation with North Korea over the long weekend, China threatening to bomb North Korea's nuclear facilities if it crosses Beijing's "bottom line" (Bomb), and hereto the list goes on. As we suggested on TV last Thursday, "Who wants to be long trading positions going into the Easter weekend given the skein of events last week?!" Of course we have been pretty much of that mindset since the first week of February following our models' negative "flip" at the end of January. Meanwhile, many "seers" continue to come out with four or five new investment/trading ideas every day, but most of them are losing opportunities. As Warren Buffett says, "One or two good ideas a year are all you need!"

As for us, since going dormant at the beginning of February we too have listed a number of ideas for your potential "buy lists" if the equity markets ever managed to drop into our models' target zone of 2270 – 2280 so often mentioned in these missives. But to repeat, these are for your *potential* "buy lists" because as Warren Buffett points out:

> A long-term-oriented value investor is a batter in a game where no balls or strikes are called, allowing dozens, even hundreds, of pitches to go by, including many at which other batters would swing. Value investors are students of the game; they learn from every pitch, those at which they swing and those they let pass by. They are not influenced by the way others are performing; they are motivated only by their own results. They have infinite *patience* and are willing to wait until they are thrown a pitch they can handle – an undervalued investment opportunity.

Last week, however, after ignoring most of the geopolitical threats, the S&P 500 (SPX/2328.95) took a decided step toward our models' target level when the SPX broke below last Wednesday's intraday low (2341.18), as well as last Tuesday's intraday low (2337.25), to close at 2328.95 bringing into view the March 27 intraday low of 2322.25. If that level "falls" the odds of a test of our 2270 – 2280 target zone increase noticeably. So, the "polarity flip" we thought would occur last week arrived and as anticipate it was to the downside. It should also be noted that our measurement of the stock market's "internal energy" levels are almost back to a full charge implying if the downside gets going there is enough energy for a decent move. If that is the case, the strongest "energy flows" should come early this week suggesting the potential for a trading bottom late week. Also suggestive of a trading bottom are the Volatility Index (VIX/15.96), the CBOE Put/Call Ratio, and the sentiment readings.

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Consistent with these thoughts, we were intrigued by a list of companies compiled by Goldman Sach's David Kostin that he thinks can expand their profit margins by at least 50 basis points, and increase sales by more than 4%, in both 2017 and 2018. The names from said list that are rated positively by our fundamental analysts, and that screen positively on our models, include: Netflix (NFLX/$142.92/Outperform), Expedia (EXPE/$128.13/Outperform), Abbvie (ABBV/$64.13/Outperform), Masco (MAS/$33.09/Outperform), Qorvo (QRVO/$68.48/Outperform), and Nvidia (NVDA/$95.49/Strong Buy). Yet to reiterate, these names are for your *potential* "shopping list" because as Warren Buffett states, "One or two good ideas a year are all you need."

The call for this week: Last week Mark Hulbert published an excellent article about Dow Theory (Hulbert). He only made one mistake when he wrote that Dow Theory was created by William Peter Hamilton when in reality it was created by Charles Dow. Granted refinements were made to Dow Theory by Hamilton in the 1920s, Robert Rhea in the 1930s, George Schaefer, and my friend Richard Russell, but the theory originated with Charles Dow. There are not many of us left that IMO know how to correctly interpret Dow Theory, and by our pencil Dow Theory remains solidly bullish with the primary trend "up." So over the weekend nothing happened with North Korea and this morning the equity markets are giving a sigh of relieve with the preopening futures relatively flat. Yet, retail sales have fallen for the second month, Japan is readying for a North Korea emergency, Vice President Pence warns North Korea on U.S. resolve shown in Syria and Afghanistan, the Pentagon is protecting the U.S. electric grid, bank loan growth has stalled, bank stocks that have led the rally are now in full retreat, President Trump says, "North Korean problem will be taken care of," and the preopening S&P 500 futures are only off 3 points as we write at 5:00 a.m. In our view prudence demands caution here with the SPX only six points away from the March 27 reaction low of 2322.25.

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