

ASK SLIM

I'll share a quick history of my trading career and let you decide. I've been a trader for 31 years. My trading career began in 1974, at 24 years of age, on the Chicago Board Options Exchange (CBOE). Over the 17 years I was a member of the CBOE, I traded in nearly every pit on that floor. Much of that time was spent in the chaotic OEX pit. Over the years I was a member of the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT). I have traded "off the floor" since 1984.

In this column, I will answer your questions on the technical and psychological aspects of trading and trading methodologies. Oh, and the next question would be, why the name "Slim?" My badge on the CBOE was "SLM" (Steven L. Miller). Other traders gave me that nickname on my first day of trading, back in 1974. So, ask Slim!



Dear Slim,

If one is long XYZ stock with a reasonable profit, what strategy would you advise to protect oneself from an earnings shocker prior to the earnings release? Often when quarterly earnings miss consensus forecast (negative earnings surprise) the stock tanks. In the instance that I got caught, obviously I could have sold the stock prior to the release. But everything looked good, including the stock making a new 52-week high before the negative quarterly report.

—JDC, via e-mail

Dear JDC,

A stock trades up to a 52-week high because investors expect a strong performance out of the company. Often, expectations are unreasonably high, pushing the value of the stock to a level that is exuberant. This is when a stock is most susceptible to an "earnings shocker." If the company had issued guidance, saying that earnings were going to be lower than expected, the stock would have declined before the earnings were released. Thus, it's not just at the scheduled earnings report that a stock is at risk.

Unfortunately, there are not a lot of great choices to protect you from being blindsided by a company missing earnings. There are a couple of strategies that will work for stocks with listed options. You can buy a put against your positions, which will protect you against a big decline. However, before earnings are released, implied volatilities rise, making option prices high as investors reach for this protection. That makes insuring yourself with puts very expensive. Another choice is to sell a near-the-money call against the position (covered write), which actually takes advantage of the high premiums around an earnings release. This will give you two- to five-percent downside protection, but will cap your upside participation.

Using options to protect you before earnings might have tax consequences. So seek advice from a tax professional before choosing one of these strategies.

Slim's Stock Market Predictions for 2006

A few years ago, a reader asked me about my stock market opinion. That gave birth to my annual January predictions. My analysis comes from three decades of studying the technical and cyclical aspects of the markets. Much of what you will read below is fundamental in nature. However, as a true technician, I believe all of the rationale explaining market moves is reflected in the charts, even before the reasons are apparent. And in what often feels like chaos in the markets are repetitive patterns. These cycles are visible in the charts. They hold messages to the future. I read them.

In the January 2005 issue of SFO, I said:

"I see the stock market making its high early in the year once again, with the Dow Jones Industrial Average making a top of 10,750 in February or March. By spring '05, the bears will be in control. The low for the year should come in September or October, with the Dow hitting 8700."

This was the third year in a row that I timed the market well. The DJIA made its closing high on March 4 at 10,940 and then went into a swoon that took it down near 10,000 in April. After staying in a tight range, the stock market moved lower again into the fall, making a low on October 12 below 10,200. Then a brisk rally in November brought the market back to the high for the year. I missed the March high by 190 points on the Dow. However, because 2005 had the narrowest trading range in decades (on a percentage basis), I missed the low by some 1,300 points.

In my opinion, the coming year will bring some real fireworks. This situation is quite unique. This is the first time in more than 70 years that the stock market is 34 months off a major cyclical low and still has not made a new high. In fact, the NASDAQ, which lost 83 percent of its value in the 2000-2002 bear, has removed only 23 percent of the loss. This is quite negative. The closest pattern to this was in 1930 (ugh!), when the stock market regained half of its losses after the Crash of '29 and then went to new lows as the Depression took hold.

Interest rates are going to be a factor this year. Last year, while the FOMC was raising short-term rates, long-term rates held steady. Alan Greenspan seemed frustrated by this condition, referring to the situation as a "conundrum." There were two reasons long-term rates resisted

the Fed's actions. First, energy prices skyrocketed, which made investors nervous about an impending economic slowdown. Second, the dollar turned very strong, mostly because of Europe's economic woes. This brought a flow of funds into U.S. Treasuries, keeping rates under pressure.

For the coming year, due to a large supply, energy prices will stabilize or decline. Also, there are sure to be improvements in Europe, especially after the low point around the riots in France. Another factor is the huge amount of Petrodollars that are moving into hard assets. All of this will bring a renewal of dollar weakness, reversing the situation that created supply in Treasuries and kept long-term rates low. Furthermore, the FOMC will complete their mission of moving to a "neutral" Fed funds rate, probably by the second or third meeting under Bernanke. Paradoxically, the bond market will see this as stimulative. All of these factors will cause long-term rates to spike upward this year. We could see 5.5 percent on the ten-year note and 7.5 percent on mortgages.

The effects of rising long-term rates will be felt most by the consumer, who has lived on the now-dying refinancing boom and has not added to savings during the economic recovery. Investors are going to get very uneasy as all of this unfolds.

Thus, I believe the mini-bull market of the previous three years is going to end, and the stock market will enter the next leg of the bear that started back in 2000.

For 2006, I expect the stock market to peak in March or April with the DJIA moving to a recovery high at 11,375. Historically, when a bull market is very long, the following bear market is relatively short in duration – six to nine months. Because the bear has a lot to do in a short time, correcting the previous rally, declines are very sharp. That should mean the stock market will be quite weak right into the end of the year. Thus, I'll call the low in November, with the DJIA down about 27 percent from its peak, at 8303. ■

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SEND ME YOUR
QUESTIONS!
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