

The Blue Chip Report

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Alan's Monthly market commentary including guidance on when to buy and when to sell

The purpose of this market discussion is to enhance the Active Fund Management strategy by including some discretionary analysis. Whilst this opinion is intended to provide you with additional guidance, it is not a compulsory part of the strategy.

All eyes on China and a bit of economic stimulation

It's school holidays across most of the country at the moment (so many of us are distracted), the U.S. is up a bit (the SP-500 index is up about 1% this week), we're up a bit (the All Ords is up about 1% this week) and the Shanghai Composite still hasn't made up its mind. So once again I reiterate; our market won't break up through 5,000 points unless both the U.S. and China rally together. So its all eyes on China and there are only two charts that really warrant our attention.



And this means that the current guidelines remain in effect;

The bottom line is that the current situation remains somewhat precarious and therefore we should be maintaining a defensive posture. This means definitely not opening any new positions at this stage and continuing to manage our BCR portfolios with end-of-day stop losses. Thus, if a sudden and aggressive downside breakout were to occur on the Shanghai Composite index then I wouldn't want to wait for the end of the week before executing my stop losses.

Furthermore if you've been following my recommendations reasonably closely then you should own around 3 to 5 shares right now. If you own more than 5 then I would seriously consider selling down to a maximum of 5 positions. I definitely wouldn't be sleeping too well at night if I had more than 50% of my capital exposed to the current market.

I have also had quite a few enquiries from subscribers on the use of end-of-day stop losses and so at the end of this commentary I will take a moment to clarify this subject. But first I want to revisit the phenomenon of the major consolidation patterns we are experiencing at the moment and put them into some historical context for you.

Of course I've already shown you the consolidation pattern on the Shanghai Composite index on the last page. When markets consolidate, their trading range gradually diminishes over time into a moment of stillness, thus forming a large triangular pattern. This process is fairly painful as the market is effectively shutting down, or even 'dying' if you like.

What's more, if one takes the state of a financial market to be a representation of the underlying economy then this is a very worrying sign. Anyway you've probably felt the pain from our recent consolidation as the All Ords has also been forming a triangle for a considerable period...



As the trading range of our market has diminished, so has the effectiveness of many trading systems, including mine. Trend trading was the first strategy to suffer and, more recently, even the Breakout trading system has come under considerable pressure. The expectancy of the my Breakout trading system over the past 12 months is positive (which means it made money) but over the past 6 months it's been negative. These results include all trades generated by the system and I'm happy to send you a spreadsheet of these results on request; alan@actvest.com

So in the current climate we either continue to trade and don't complain about the short term results or we withdraw from the market and wait for markets to collectively breakout...up or down. I lean towards the latter approach as I see little point in being exposed to market risk if I'm not receiving a commensurate reward. And in fact I expressed this view back in mid-May.

These prolonged periods of consolidation normally occur after bull runs as investors and traders collectively withdraw from the markets and go away to lick their wounds. But if you are feeling a bit despondent and frustrated with the current market conditions then spare a thought for those who endured the consolidation period that occurred after the 1929 Stockmarket Crash. This consolidation period is representative of the Great Depression of the 1930s.



This of course was a very painful period in the U.S. (and around the world) and the introduction of Keynesian economic measures from the late 1960s appears to have prevented another period of consolidation occurring on the back of the 1950/1960s bull market. The U.S. gradually left the Gold Standard from the late 1960s and so John Connolly, the secretary of the U.S. Treasury in the early 1970s, was free to print money (among other measures) to stimulate the U.S. economy. Whilst these measures didn't make the market rise, it does appear that they prevented the market from entering into a consolidation phase, as would normally have been expected.



So it's probably no wonder that they are repeating the exercise now with fairly similar results...



Of course I'm expecting one more major down cycle to occur in the U.S., as it did in the 1970s. But it would appear that Keynesian economic measures have saved the U.S. from repeating the painful exercise of enduring another depression. And one may ask why our Reserve Bank is threatening to raise interest rates going forward when our Stockmarket remains trapped in a consolidation pattern. Thus I personally wouldn't mind a bit of economic stimulation right now

Finally, let's take a look at end-of-day stop losses which I am recommending at the moment in light of our current precarious circumstances (ie. the pending breakout in the Chinese market). Firstly please note that the use of EOD stops will not improve overall trading performance but provides superior capital protection. In fact they can be something of a nuisance because you may sell a share when it breaches its stop loss on an end-of-day basis, only to buy it back again when the market begins to recover. Hence we don't remove shares from the BCR sharelist unless they actually breach their respective stop losses on an end-of-week basis. Take BLY...



BLY breached its EOD stop loss last week but remains on the list. What's more, you have up to one week to sell it. If you have any further queries on this then e-mail me at alan@actvest.com

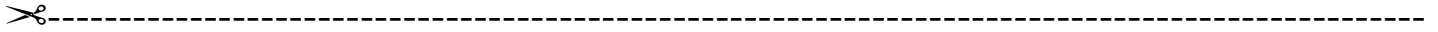
ASX200 Search Results

RBA Cash Rate Target = **4.75%**

Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group	Stop Loss(\$)
ILU	Iluka Resources	17.52	97.42	16996228	Materials	14.02
LNC	Linc Energy	2.85	71.99	1225823	Energy	2.52
AGO	Atlas Iron	3.90	60.24	4998940	Materials	3.18
MIN	Mineral Resources	12.39	43.70	1111755	Materials	10.78
CQO	Charter Hall Office REIT	3.49	43.13	2373125	Real Estate	2.91
SVW	Seven Network	9.91	35.57	480532	Media	7.93
MND	Monadelphous Group	19.30	35.34	1484756	Capital Goods	17.92
BLY	Boart Longyear	4.05	33.13	2764456	Capital Goods	3.88
FMG	Fortescue Metals Group	6.53	33.10	19945066	Materials	5.50
GNC	Grain Corp	8.14	30.53	2295237	Food Beverage & Tobacco	6.70
RHC	Ramsay Health Care	17.71	29.28	1717861	Health Care	15.15
LLC	Lend Lease Corp.	9.26	27.09	4340518	Real Estate	7.41
CGF	Challenger Financial Services	4.92	25.56	2385573	Diversified Financials	4.03

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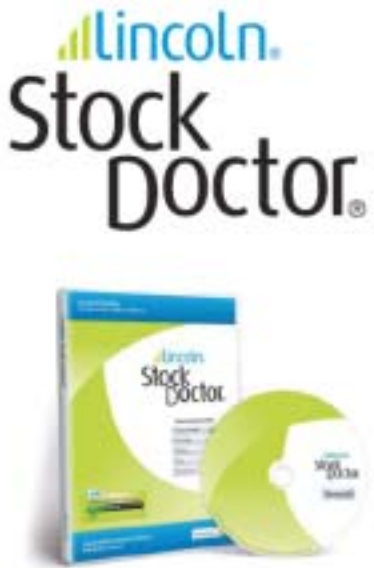
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