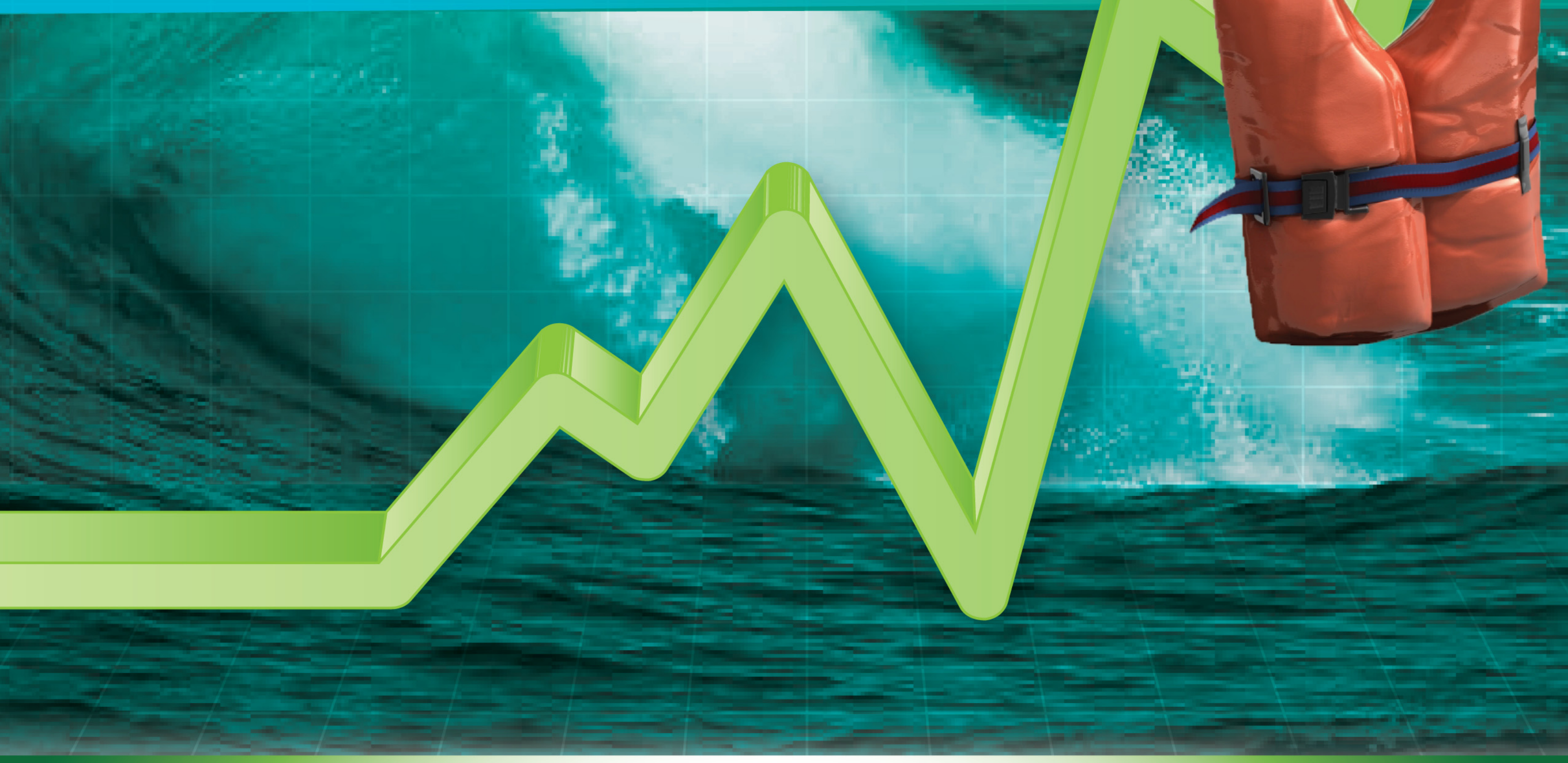
The Investor's Survival Guide

3 Market Scenarios and How to Deal with Each of Them



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Introduction

What if we have another recession and the market tumbles 30, 40, 50%?

What if the worst is behind us and we start a new generation of growth and prosperity?

What if the economy has bottomed, but we just have slow economic growth for years to come?

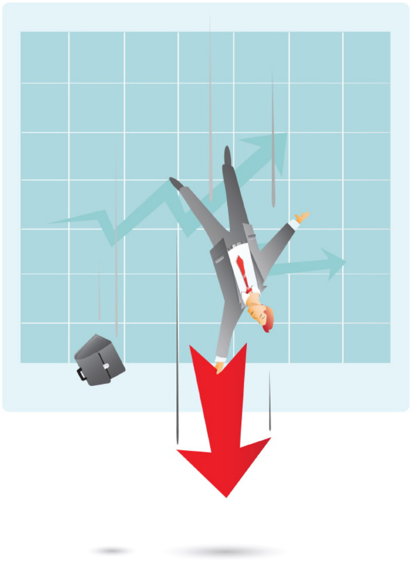
If you are 100% confident that you know which of these scenarios is correct, then you are just kidding yourself. The economy and the stock market are simply too complex for anyone to know with such exact certainty. Meaning that not you, nor me, nor Cramer, nor Buffet, nor anybody has this one down pat.

This Survival Guide was designed to help you explore all the possible scenarios to determine which economic case will prevail. Better yet, we will discuss investment strategies to maximize profits in that environment. And yes, we can make profits in each and every one of these environments.

Let's get started!

Steve Reitmeister
Executive Vice President, Zacks.com

What if We Have Another Recession?



This is the worst case scenario for the economy and society as a whole. But with Europe on the brink and our own government trillions in debt, we have to assume it's a real possibility.

Here are the signs to look for:

- **General Economic Weakness:** There are a number of key economic indicators to look out for. Since consumer activity accounts for 70% of the economy, then deteriorating retail sales is a very bad sign. Also watch the employment figures. Recent reports have been decent. If they start to backslide, then it spells trouble. On the manufacturing side the key report to focus on is the monthly ISM Manufacturing survey.

- **Corporate Earnings Trouble:** This has been the strongest area of the economic recovery and earnings so far in 2011 are set to make all time highs. If that story changes and earnings estimates start to head lower, then that bodes ill for stock prices. (Gladly that is not now the case.)

- **More Banking Trouble:** We swept a lot of bad loans under the rug and haven't heard a peep from that group in a long time. And certainly if the problems from European banks and governments boil over it would negatively affect many of our top banking institutions. So if the government's stress tests were not adequate or there are more bad loan boogeyman looming about, then we are right back where we started with this mess in 2008.

- **Deflation:** Meaning the cost for goods start getting cheaper. It sounds nice on the surface, but it's a deadly economic disease that took hold of the US during the Great Depression. It also spelled disaster in Japan during the 1990's which they call the "Lost Decade".

Clearly any of these items coming to the surface would result in renewed panic and a tumbling market. Here is how to profit in this environment:

- Sell all small cap, aggressive or speculative stocks: These stocks go down first…and they go down the most.

- IF you are going to own any stocks, then they need to be the bluest of blue chips with large dividends in defensive industries like food, healthcare, utilities etc. Note these will generally go down too…just less than more speculative issues.

- Short the Market: I believe the best way to do this is with inverse ETF's that allow you to profit as the market goes down. There are also "Ultra" inverse ETF's that can give you extra exposure to amplify your potential profits (and potential losses if you guess wrong).

- Nothing wrong with having a lot of cash on hand. Or gold as a safe haven.

The odds of you seeing these signs clearly and perfectly timing your way into the proper trades are very low. Just realize that it's better to be a shade late to the party, than not show up all. That should put you in the right frame of mind.

What if We Start a New Generation of Growth & Prosperity?

This is the one we all hope for, but fear is too good to be true after all the recent economic scares. Yet it is clear that the coordination of Government actions around the globe in 2008/2009 did thwart the 2nd Great Depression. And that same coordinated effort may keep Europe from doing the same in the present day. This may lay the groundwork for a new prolonged era of economic growth and well being.

Here we have the inverse of the first scenario. Meaning that we hear less and less about sovereign debt and banking crises. The unemployment rate will start heading lower. Inflation stays around a normal 2-3% range. Consumer and manufacturing indicators show even more improvement and GDP numbers continually come in at +3% or better.

This is the easiest environment to spot. And the easiest environment in which to profit in the stock market as most everything will rise. However here are some tips to maximize your returns:

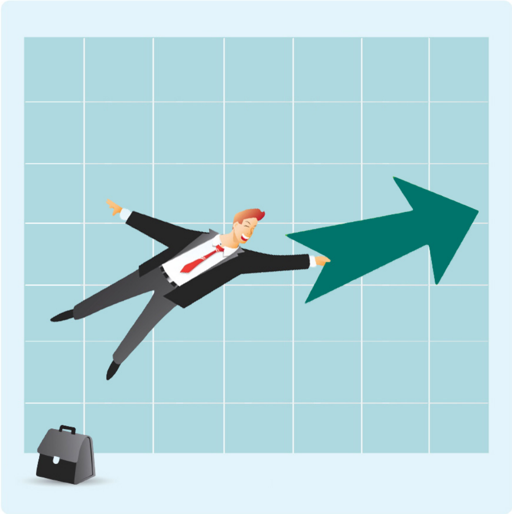
- Small caps outperform large caps during bull market phases. The key is to own enough of them in your portfolio to diversify away the risk of owning just 1 or 2.

- Higher beta stocks will provide outsized returns. Yes, many of them are small caps. Yet you will find plenty of mid and large caps that offer that extra “oomph” when the market moves higher.

- Earnings Momentum: Stocks that consistently beat earnings expectations and receive higher estimates have the best track record. The Zacks Rank makes it easier to spot these stocks. Our #1 Ranked strong buys have provided a +26% average annual return since 1988.

What if it’s Just a Slow Growth/ Muddle Through Economy?

Here we have the scenario between the two previous examples. That is where the economy doesn’t fall into a recession NOR does it seem to get much better either. This is called the slow growth or Muddle Through economy which is pretty much what has been on tap the last couple of years.



The signs to notice this predicament are easy. Most of the indicators of the economy just get stuck at the recent modest levels and don’t improve much more. Perhaps the easiest way to gauge this would be following GDP. If it winds up between 0 and 3% growth, then we are in a muddle through economy.

The market, however, can follow two very different paths during these times. And each requires radically different tactics to be successful.

Path 1- Range Bound Market

This would entail the market, just like the economy, going basically nowhere for an extended period of time. We often call this a range bound market as it just trades within a narrow 10-15% band.

These markets are actually easy to profit in. That’s because most companies will have modest earnings growth. But the few that are mightily trumping their earnings expectations each quarter will attract the most investor attention and rise in price.

You will find these stocks by concentrating on the best stocks in the best industries. The best industries are those with the healthiest earnings outlooks (easily found with the Zacks Industry Rank). And then you pick the stocks with the best earnings outlooks within those industries (using the Zacks Rank for stocks). Also in this environment you shouldn't try to be too aggressive. Concentrate on mid-cap and large-cap stocks which provide a bit more safety. A dash of dividend never hurt anyone either.

Path 2- Volatile Market

Here you have a market that keeps misreading economic signals. You will see big 20-30% run ups on renewed hopes of economic improvement. This is followed by an equal sized downturn as people discover that the growth prospects were just a mirage. At the end of the day the market goes nowhere like Path 1, yet it just keeps flying above and below the breakeven level.

This environment is trickier, but can be tamed. You just need to apply market timing with a dash of common sense. If the market tumbles and it seems overdone because the fundamentals haven't really changed, then buy up good stocks like noted in Path 1 above. When the rally gets overextended and signs of economic growth are missing, then take your profits. Rinse and repeat as many times as needed.

Conclusion

Which case will emerge? And when will it happen?

Your best bet is to keep checking in with us at www.Zacks.com. Our experts will continue sharing views on where the economy stands and better yet, how to profit in that environment.

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Contact Information

Telephone: 312.265.9339
Toll-free: 1.800.767.3771 ext. 9339
e-mail: support@zacks.com

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The return numbers presented assume no transaction costs. Details of how Zacks calculates performance for the Zacks Rank Portfolios and strategies is available at: http://www.zacks.com/performance.