Stock Market Commentary
By: John Hegler
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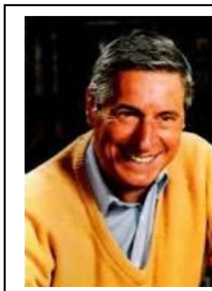
Dear Clients and Friends,

What volatile times we live in! It was just a short two months ago that the stock market was making all-time highs, and then the roof caved in by falling the fastest amount off of an all-time high in the shortest time. The Dow Jones Industrial Average closed at a record 29,551 on February 12, 2020 and then fell 37% in the next 40 days to close at 18,592 on March 23, 2020. Selling intensity reached a crescendo on March 16 by crashing 2,997 points, 12.9%, on that day. The main driver of the drop, of course, has been the sudden emergence of the worldwide coronavirus pandemic and the pandemic's possible effects on economic activity going forward. Some relief was mercifully forthcoming subsequent to the March 23 low, as the market rallied 30% off that low through April 27.

One of the most vicious declines in stock market history caused me to dust off volumes of writings from some of the stock market's greatest technicians. Jesse Livermore, Joe Granville and Edson Gould, all deceased, left a great impact on the field of technical analysis. Of course, there are many other masters of stock market analysis. But if you were a novice in the stock market, you would do well to study what these gentlemen had to say.

- Jesse Livermore was Wall Street's most prolific trader during the first three decades of the 20th century. He was tremendously disciplined and detailed in his analysis. He must have possessed a professional gambler's instinct since, once in a while, when the odds turned extremely favorable, he felt the need to "shoot the works". The classic novel, *Reminiscences of a Stock Operator*, was the story of the legendary Livermore's exploits on Wall Street. The 1940 book, *How to Trade in Stocks*, written by Livermore, is the Holy Grail for anyone wanting to trade stocks for a living.



- Joe Granville's career spanned from the 1950s until his death in 2013. He wrote technically oriented books and developed many technical metrics that are in use still today. He was quite a taskmaster; I can tell you. A number of years ago I was discussing a specific technical metric with him just after the market closed. He was taken aback and gave me a good 'talking to', because I did not know exactly how many new 52-week highs and lows were registered on that day! A stickler for detail he was.

- Edson Gould was a mysterious stock market forecaster and student of human nature who worked on Wall Street early in his career (from the 1920s to 1960s), before authoring a market letter from 1972-1982. He is credited with having made consistently stupendously accurate market forecasts and based his work largely on his observations regarding crowd psychology and the influence of the Federal Reserve Board on the market.

All three were amazing men. I have a lot to cover, so here goes!

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BULL/BEAR MARKET STATUS: A new bear market reared its ugly head on February 12 as the market declined 37% into the low of March 23. Below I discuss the possibility that the March 23 low was a bear market low and that a new bull market may have started the next day. How could that be? You would think that the news of a world-wide pandemic and the possibility of an economic depression would be dire enough to preclude the possibility of a new bull market emerging. So, what would one be looking for to determine if a significant bottom in the stock market was in place?

SIGNS OF A MAJOR STOCK MARKET BOTTOM.

- At major stock market bottoms the economic (and other) news is always bad. If the news were good, the market would have already seen its bottom and would have been advancing well ahead of the emergence of good news. So, the news is **ALWAYS** bad at bottoms, as it certainly was on March 23. ***First sign – the news is terrible at bottoms.***
- At major bottoms the public dumps stock late in the decline out of pure fear and panic and without regard to the intrinsic value of what they are selling. Stocks go "on sale" here, but apparently no one wants them. This scenario occurred in spades and continued in the weeks following March 23. ***Second sign – panic selling/wholesale dumping stocks late in a decline.***
- Signs of extreme selling intensity appear, similar to that which occurred close to the stock market crash of October 22, 1987 and the financial panic of 2008-2009. Nine "90 percent down" days occurred during February and March 2020. 90% down days are days in which more than 90% of volume is to the downside. This was unusually persistent selling occurring in unusually trying economic times. On March 22 there were 2,235 new 52-week lows registered on the New York Stock Exchange, rivalling the all-time high watermark of 2,901 new 52-week lows registered on October 10, 2008. I thought I'd never see anything close to the 2008 new-low statistic, but we came close. The point is that, as in 2008, this number of new 52-week lows just might turn out to be as bad as it gets. In the 2008-2009 episode, from that day, October 10, that statistic was never again exceeded. The market had begun to heal internally until the final bear market price low of March 9, 2009. On that day 377 stocks made new 52-week lows, a substantial improvement from October 10, 2008. So far, the healing process seems to be taking place, as 52-week lows began to noticeably shrink into the March 23 price low (only 805 new lows on that day and steady improvement since then). ***Third sign – great selling intensity, evidence of internal healing.***
- The recognition of terminal "leaps" either to the upside or downside. A "leap" is a near vertical move in price (either up or down). The term for near-vertical moves to the upside is that the stock has gone "parabolic". Parabolic moves were seen in early February, 2020 - speculative stocks Tesla and Virgin Galactic. If you were to turn the charts of the Dow Jones Industrial Average and S&P 500 index upside down through the March 23 lows, the charts would resemble the parabolic chart patterns of Tesla and Virgin. In other words, the indices were "leaps" to the downside, patterns that are always terminal. ***Fourth sign – "leaps are always terminal" (Granville Market Letter, March 11, 2010).***
- Another sign of a bottom is when the continued bad news is beginning to be contained by the market. The market's reaction to bad news is recognition and acceptance and not resultant in a move down in price. For example, on three consecutive recent Thursdays new first-time jobless claims were announced and set records for the worst economic statistics ever released in the history of the United States. And yet the market rallied strongly on each of those days, strong evidence that bad economic news is beginning to be "absorbed" by the market in a positive way. ***Fifth sign – news containment: the stock market is beginning to fully discount continuing bad news.***

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THE PSYCHOLOGICAL PHASES OF BULL AND BEAR MARKETS. I have attached a summary of the three psychological phases of both bull and bear markets as authored by Joe Granville in his 1963 book, *Key to Stock Market Profits*. Many people might dismiss such a book written so long ago. The stock market has greatly changed since then, so how could a book authored in 1963 still be relevant today? The answer is that the "phase" analysis is based on the human emotions of fear and greed that have NOT changed one iota, nor will they change 100 years from now. Many market technicians past and present have acknowledged the existence of three phases for bull and bear market cycles, but it was Granville that thought it useful to describe each phase in much detail.

Briefly summarized, the three phases are:

BULL: Phase I) Following a bear market, the economic and other news is still very bad (reflective of recessionary conditions) and the last thing anyone expects is for a new bull market to start; Phase II) Acceptance of bullish conditions as the economy improves, general recognition of improving earnings; Phase III) Economic conditions and corporate earnings are glowing, stock prices are high, greater stock market participation by "the public" very late in the "bull" cycle; evidence of stock speculation.

BEAR: Phase I) The news is still very good, the public loves the market, but there is technical deterioration and the first sharp decline off an all-time high is recorded; Phase II) The signs of economic deterioration are in full view and the bear market becomes generally recognized; Phase III) The market continues down, the news is still bad and getting worse, the selling intensifies (as described above – "signs of a stock market bottom"). Professional investors, "the smart money", begin to position themselves for the next bull market.

WHERE IS THE MARKET POSITIONED NOW? In my opinion, we are in the 'zone' of transitioning from Bear Phase III to Bull Phase I and probably have entered the sweet zone of Bull Market Phase I. I would note that of the three bull phases, the **MOST PROFITABLE** investing zone is Bull Phase I as stock prices are rapidly recovering from great bargains found in Bear Phase III. Below, I refer to specific bullet points from the Granville analysis and comment accordingly.

BEAR Phase III:
- Public has turned completely sour on the market and responds to every bit of bad news with heavy selling,
- Late in the phase, many stocks stop going down. This will be evidenced by a diminishing number of new lows as the averages make new lows (discussed above),
- News: The business press is now full of reports about flat or declining earnings, the smart money trader, with the help of the media, is pretty sure of getting all the stock he wants at his price.
- The time is right for a major event to occur that will intensify public pessimism to such a fine point that DJIA will descend to another series of lows, below anything thought possible when the bear market began.

BULL PHASE I:
- Things look terrible (news was bleak as of March 23). Examples of recent headlines from two media outlets featuring sour news: "Global Recession Likely Under Way, IMF Says"; "UK Economy Could Shrink 35% This Quarter", "World Facing Great Depression". Some of the

coronavirus news has improved somewhat since March 23, in that curves have flattened and even begun to improve. The prospect of re-opening America again for business is a positive development.
- A point in the Dow has been reached that just might later on be identified as a major bottom, which is in this instance could be March 23.

COMPARISON TO PAST "CRASHING" MARKETS

I point out that in the 2008-2009 bear market, the peak reading in 52-week new lows occurred on October 10, 2008, nearly 5 months prior to the price lows in major stock indices recorded on March 8, 2009. If that pattern were to play out in 2020, then the eventual bear market end could be a number of months out.

In the aftermath of the October 22, 1987 crash, the market rallied sharply after printing a new low on the morning of the next day, only to re-test that low during the next 60 days, before establishing an uptrend through the end of 1988. I find it noteworthy that the intra-day low recorded on Tuesday, Oct 23, 1987 still stands as a low that has not been pierced since, almost thirty-three years later!

FUNDAMENTAL ANALYSIS

The stock market as measured by the S&P 500 index peaked on February 19, 2020 at 3,386. Earnings of the components of the S&P 500 index were approximately $170 per share, reflecting a trailing price-earnings ratio of 20.

With the economic damage already inflicted on the economy as a result of the coronavirus tragedy, it is unlikely that the US economy can return to where it was prior to the tragedy any time soon. Although a rebound off very low levels of economic activity is expected in the second half of 2020, many economists are not expecting a return to "normal" for several years. This is hard to argue against given the amount of obvious economic damage being done as a result of the shutdown. While the thrust of this commentary is to argue that a new bull market has begun, I would argue that the fundamental of corporate earnings prospects places on upper limit on the market averages. This is based strictly on ability to forecast earnings that is not even forecastable at this time. If earnings per share could approach a level of 90% of $170 and assuming a 20 PE ratio for normalized earnings, then the ceiling for the S&P 500 would be computed to be 3,047, only 7% higher than the close on April 27. So, considering that the S&P 500 has rallied 28% off of its March 23 low, the potential for further upward movement could stall until the visibility of future earnings improves.

BUILDING BLOCKS (Granville Market Letter, Dec. 3, 2009): Granville's description of the "One Small Step" required to get a bull market started was so well done, that I will quote his narrative here rather than attempt to paraphrase it. "One Small Step – President Kennedy visualized our going to the moon many years before the spectacular July 1969 landing. In his speech announcing his dream he made a very famous statement. He said 'To make a 1000-foot walk it starts with one small step'. To start every new bull market, we start with that one small step. We cannot do it unless our legs can make that important first step into its new uptrend and now has the energy to walk or run to its own private "moon". That first step in 2009, as Granville saw it, was the registration of 2,901 new 52-week lows on the New York Stock Exchange on October 10, 2008, an event that he described as " something in stock market history that had never been seen before and probably will never be seen again". Twelve years later his statement still prophetically stands. And thus, the first building block of a new bull market has begun in March 2020, the technical metric of the number of stocks making new 52-week lows (2,235) demonstrating steady improvement through the date of this commentary. The Building Block, or "one small step", has been set.

THE STOCK MARKET CLOCK (*How to Trade in Stocks* written by Jesse Livermore in 1940): "Investors should not dwell too strongly on actual conditions because the course of the market is always six to nine months ahead of actual conditions". This means that one would expect the market to bottom out 6-9 months prior to the trough of economic activity. If March 23 turns out to be the stock market bottom, then the math would point to a trough of economic activity (the trough of the recession) to be somewhere between the end of Q3 and the end of 2020. This scenario seems to fit neatly with projections of many economists as the negative effects of America's "shutdown" begin to fade.

SHORT SNIPPETS

- **MONETARY AND FISCAL POLICY**. The Federal Reserve Board and the US Treasury is pulling out "all the stops" in an effort to backstop the economy. The monetary spigots are wide open, with the Fed providing maximum monetary accommodation and the US treasury providing maximum stimulation through federal spending. It pays not to "fight the Fed".

- **INSIDER BUYING**. (Source is Washington Service: a provider of insider-trading and data analytics): Insiders have been heavy buyers of stocks lately – the ratio of companies with insider buying compared to insider selling is at 1.75 for March 2020; the highest level since March 2009, the last major stock market bottom.

- **MORE JESSE LIVERMORE**. Rehashing things discussed above; Livermore referred to market turning points as "pivotal points". He wrote "Increased volume is an essential element in understanding pivotal points – it must be present to confirm the pivotal points. This battle, this war, between buyers and sellers causes the stock (or index) to reverse its direction, top out, or bottom out in a decline. It is the start of a new direction in trend for the stock (or index)". This volume spurt was evident in total S&P 500 index volume in the weeks up to the March 23rd bottom.

- **THE 50% RULE**. "If we rally more than 50% off the bottom, then the bear market is over", meaning the bear market lows will not be penetrated. From the February 2020 high points of the Dow Jones Industrial Average (29,551) and S&P 500 (3,386) indices, the points lost for each index into the March 23 lows were 10,959 and 1,149 points, respectively. The 50% rule would then be activated at the following levels: Dow Jones Industrial Average - 24,071 and S&P 500 index – 2,811. A furious stock market rally on April 17th resulted in the averages closing at 24,242 and 2,874, respectively, both punching through the 50% threshold.

BEARISH ALTERNATIVE SCENARIO. Of course, it is possible that the bullish outlook as outlined above is incorrect. The bearish scenario could be outlined as follows:

- It is rare that a bear market would take such little time from start to finish. Although bear markets generally take less calendar time than bull markets, the approximately 40-day bear market duration (February 12 to March 23, 2020) does not seem likely.

- The strong rally that has transpired from March 23 through late April can neatly fit into the “Rally That Fools the Majority” referred to in Granville’s Bear Phase II description. He described the rally as a mid-bear market “Judas” rally that draws the public back into the market just in time for the announcement of a “very disturbing piece of business news”.

- For that piece of news to be negative enough to cause the market to resume its downward descent, the news item could only be in reference to two topics: 1) whereas the current market is absorbing ongoing news about the coronavirus problem in a bullish way the coronavirus news would have to be that the pandemic is NOT progressing in a favorable manner – that is, perhaps the “flattening of the curve for new cases and deaths” are not flattening at all, but are reversing upward; 2) while the economic fallout from the pandemic is as dire as I have ever witnessed in my lifetime, the fallout would have to be worse than generally thought. Prevailing discussions by most economists is that the economy will bottom out during the 2nd or 3rd quarter with an “L” or “U” or “V” shaped recovery. Conditions could turn bearish if the timing of the bottom became uncertain and if the economic descent turns out to be deeper than generally thought.

- Perhaps the end of the 2020 bear market might drag out similar to the 2008-2009 bear. In that episode, the “technical” low occurred in October 2008, which preceded the price low by five months.

My observation: Granville wrote that it wasn’t until “the subsurface signs of business deterioration are completely in view that one can be sure that bear phase III is about to get underway”. I would argue that the signs of business deterioration are FULLY in view and have been since March. In my opinion, the suddenness of appearance of the coronavirus epidemic along with its economic effects, has sped up the bear cycle into a short period of time. So, it makes sense to me that the bear market, as short as it was, had reached maturity since the “bad news” is in full view.

SUMMARY: Conditions are bullish. And since the rate of economic improvement promises to take place over a number of years, the current bull cycle promises to be a lengthy one.

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