1st Quarter 2008
Commentary
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THE BEAR MARKET OF 2007-2008
OBJECT OF DESPAIR OR OPPORTUNITY?

THE BEAR CYCLE DESCRIPTION

The stock market has always been characterized by the existence of both bull markets (uptrends) and bear markets (downtrends). That is a fact and reality of the markets ever since the first stock was traded and it will always be.

Some market analysts define a bear market as being a market decline of 20% or more from identified index highs (DOW Jones Industrial Average or the S&P 500). I find this observation to be of no value; since the implication is that the investor should take some sort of action at such point a 20% decline has been registered - too late, in my opinion. The correct definition of bull and bear markets is that it is a bull market if the primary trend is up and a bear market if the primary trend is down. The trick is to identify the trend change from bull to bear as quickly as possible.

A majority of financial advisors are proponents of buying diversified baskets of equities or mutual funds and then holding them during all types of market environments. During market bull uptrends this contingent of advisors will often refer to the buy and hold philosophy as being the holy grail of investing, perhaps being the elusive 11th commandment. On CNBC a representative of a national brokerage firm once affirmed that "we want our clients fully invested in bull and bear markets alike". Huh? Why can't it be a skill set that the advisor possesses – and that is the development of a methodology that identifies bullish or bearish trends and then seeks to modify strategy during developing bearish trends, which after all, occur about 1/3rd of the time?

Eventually something happens that shakes up the generally accepted buy-and-hold philosophy, and that something is a market downturn that turns buy-and-hold investors into market timers. Then after the broker's statements are opened and the drawdowns in account values begin to get uncomfortably large, the clients of these advisors will nervously call them to tell them that this buy-and-hold business is not for them!

So my own thinking is to fully acknowledge that downtrends do, in fact, rear their ugly heads once in awhile and the prudent course of action is to accurately identify and then accept the evolving downtrend. The properly positioned investor will then be ready for the eventual emergence of the next uptrend. ***The greatest profit opportunities lie out of the despair of bear market bottoms!***

BEAR MARKET CHARACTERISTICS

PSYCHOLOGICAL PHASES. The bear movement is usually divided into three psychological phases. Since stock market tops are often recorded during periods of glowing economic news and euphoric bullish sentiment, the initial decline off of a price top is greeted by investor complacency and disbelief. After all, the economic news is so good the last thing that anyone would expect is the onset of a bear market. But while the averages have made new highs, market internals (measures of broad participation such advance-decline and new high-new low statistics) have begun to weaken some months prior to the final highs in the averages. During bear phase I, the first significant downside penetration of major index 200-day moving averages have been recorded and counter-trend rallies will get the averages popping above their 200-day averages, but not for long.

Phase II, often the longest of the three phases, is the process whereby the general mood of the media and market fundamentalists turns somber in response to obviously weakening economic conditions. The government has likely begun to recognize the economic "problems" whatever they may be at that particular time. In summary, the phase I emotion of complacency turns to concern in phase II. All bear markets contain counter-trend rallies, and it is somewhere in the middle of phase II that such a rally begins. But bear market rules apply and that is that bear rallies will ultimately fail. So the correct strategy is to take advantage of short-term profit potentials, where they may exist, and through the use of technical analysis, promptly return to some element of defensiveness prior to the start of bear phase III.

Bear phase III begins at such point that all of the signs of economic deterioration are in full view. Previously hopeful fundamentalists, and the buy-and-hold crowd become active sellers during this phase in direct response to negative economic news. The overriding emotion has now progressed from complacency (phase I), to concern (phase II), and finally to capitulation (phase III). In concert with negative economic news, investor sentiment has darkened during this phase. Perhaps books with titles something like "The End of Capitalistic System as We Know It", or "The Pending Economic Collapse" will reach the New York Times best seller list. Consumer confidence will likely reach multi-year lows during this phase. Phase III might be characterized by some negative major event that will intensify investor sentiment resulting in a plunge in the major averages to levels not thought possible. The end of the final bear phase will finally see the markets begin to ***contain*** bad economic news and market internals beginning to show subtle improvement. You now have arrived at the beginning of the new bull phase and a superior buying opportunity that comes around every five years or so.

DURATION FACTS. Since the 1920s the duration of bear markets, expressed in terms of months, have averaged approximately ½ the average length of bull markets (35 months). Fifteen identifiable bear markets since the 1920s have averaged 17 months in length with the average loss in the S&P 500 being 32.9%. The legendary Edson Gould noted that bear trends tend to last 1/3rd the length of extended bull markets (i.e. bull trends that substantially exceed average length). I would note that the bull trend from March 2003 to October 2007 ran for a total of 55 months implying that the subsequent bear trend may last for 18 months if Mr. Gould were still alive to opine on that topic.

CHARACTERISTICS OF COUNTER-TREND RALLYS. Rallies within bear markets tend to be sharply up but short-term in duration. This must necessarily be so, since if, on average, the bear does its destructive work in only 17 months, there's not much time for extended rallies. Sustained bear rallies lasting much more than 4-6 weeks and taking the averages up more than 10% are not the norm. But the norms are occasionally exceeded. For instance, during the lengthy 2000-2003 bear market an explosive rally at the end of 2002 produced a 19% rally that lasted about 3 months,

CURRENT STATUS. The market entered a bear-trend after a record in the Dow Jones Industrial Average was recorded on October 9, 2007 at a level of 14,165. At the date of this writing, the Dow Jones Industrial Average has fallen approximately 19% off of intraday highs recorded in October 2007. Indications of a possible top had been evolving throughout 2007 as each successive rallying phase during 2007 was less dynamic than the previous rallying phase; and each declining phase during 2007 demonstrated greater intensity than the prior declining phase – both of which were indications of a market gradually losing momentum. But of course, on the exact day of the top, it is not possible to know with certainty that the top is in, as it may be that the decline off of the top is simply corrective action preliminary to a new rally phase to a new high. The primary evidence of the change in trend are numerous and include: 1) each rally attempt after the October market high has failed to not only produce a new high, but has failed to hold above the 50 and 200 day moving averages, 2) directional downturns in trendlines of major market averages and for most foreign markets, for that matter. Definitionally, that is bear market action – downtrending trendlines which then act as upside resistance on counter-trend rally phases, the flip side of bull market action whereby corrections bring prices down to trendlines that act as support.

I think that the current bear move has progressed well into phase II where sentiment has generally turned somber in response to negative economic news. The government has identified this bear market's particular "problem" and is taking steps to fix it. Of course that problem is the slowing economy initiated by the sub-prime mess and credit crunch. This is good news as far as I am concerned, in that the market has begun the process of digesting negative fundamental news. Eventually stock prices will fully discount important bad news that is "out there" or on the horizon.

The bear trend is currently 6 months old, but already has done a fair amount of damage to investor sentiment – a necessary prerequisite to getting us to a long-term bottom. And the decline has been of above-average intensity as measured by the number of 90% down days registered since October 2007 and the months prior. A 90% down day is defined as a day in which total down volume exceeds 90% of total and total points lost exceed 90% of total point change. Since February 2007 until late March 2008 there have been 22 90% down days. In comparison the total 90% down days contained in the 20th century's second worst bear market (1973-1974) were 13[1]. So by this metric, the bear phase is well underway and arguably approaching maturity.

On a shorter-term basis, the market's technical parameters that I track are lining up in support of a rally attempt to occur at anytime within the next couple of weeks. So would this rally be the mid-bear phase II rally referred to above, or the kickoff of a brand new bull market? The intensity of the market's decline since late last year has caused numerous indicators to fall to oversold levels found at many major stock market bottoms. But during severe bear trends, oversold conditions always have the possibility of becoming even more oversold as the bear movement proceeds into its final phase. I would be more supportive of the idea that a major bottom is nearby if more time had elapsed since the market top in early October 07 because only time can cause the full transgression of sentiment from phase I complacency to phase III capitulation. So my conclusion for the time being is that the next rally attempt will represent a counter-trend bear market rally, but potentially profitable rally nevertheless.

SUMMARY: THE BEAR MARKET SCORECARD

- What phase is in place? Phase I passed by several months ago as the severe decline of January 2008 erased the excitement and froth of the prior bull market. Phase II looks to be in process as negative economic news is acknowledged by the government, and is now fully visible. Investor sentiment has turned negative but has not yet reached levels reached at past major market bottoms.

[1] 90% down-day data courtesy of Lowry's Reports

- Intensity. Rally attempts during the first several months of the bear market have been sharp but short. Declines have been unusually intense as measured by high number of 90% down days (see description above). One conclusion could be that much of the intensity of a typical bear market is already in the rear view mirror, and that the bear cycle is moving towards a conclusion in the not-so-distant future.

- I noted that the Conference Board Consumer Confidence index released last week had fallen to a five year low, matching a level last reached in March 2003. Perhaps coincidentally, or perhaps not, the final bottom of the 2000-2003 bear market, was reached in March 2003.

- A financial book written by Mr. Charles Morris entitle "The Trillion Dollar Meltdown: Easy Money, High Rollers and Great Credit Crash" has gotten some attention lately although it has not reached the NY Time best seller list. Books that describe catastrophic economic activity would be expected to become popular somewhere in the vicinity of stock market bottoms.

- Technical condition of the market. While the market made a low in January, the road since then has been a rough and volatile one. However, the internal condition of the market has actually improved somewhat while the averages at the end of March are not far from the January lows. For instance. new operating company 52 week lows as of January 22 stood at 707 while total new lows recorded on March 28th had improved to a level of just 33, while the DOW trades only 2% higher than its Jan. 22nd close. Other technical indicators illustrate an improving market underneath the surface.

- Mid cycle rally potential. The intensity of the decline so far has been to drive some sentiment and technical indicators down to oversold levels that could support a mid-cycle rally attempt in the very near future.

- In response to weakening economic conditions and the sub-prime crisis, the Federal Reserve Board in a full mode of monetary easing that will be bullish at some point.

CURRENT STRATEGIES IN PLACE

Prudent strategy begins with acceptance of the bear trend and that patience becomes your most valuable attribute as the progression to the next major bottom continues. The natural inclination all investors have is that you need "to do" something or work harder to achieve returns, while perhaps the best policy during a bear trend is "to do less", relax and wait for a market environment that gives you higher odds of success.

Some profit opportunities still exist during bear trends. For instance, a mid-cycle rally is becoming long overdue, and in light of improving market technicals, this rally could be profitably exploited. Secondly, the strategy of out-of-the-money call writing is a profitable endeavor since high volatility enhances call premium – in other words we're getting paid better these days for selling call options. A third example is that the number of stocks and ETFs that yield double digits, with reasonable risk is unusually high at this time. As some high yield stocks have dropped in price, their yields increase as a result. So the opportunities to compound cash returns are unusually plentiful at this time. And fourth, through the proliferation of ETFs, (exchange-traded-funds), "either/or" trading opportunities exist. By this I mean the investor has the opportunity to exploit a trend movement in a particular investment area, such as energy, commodities, interest rates, etc., and not be exposed to single security risk.