THE Weekly View
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Asset Management • Investment Strategy • Advice

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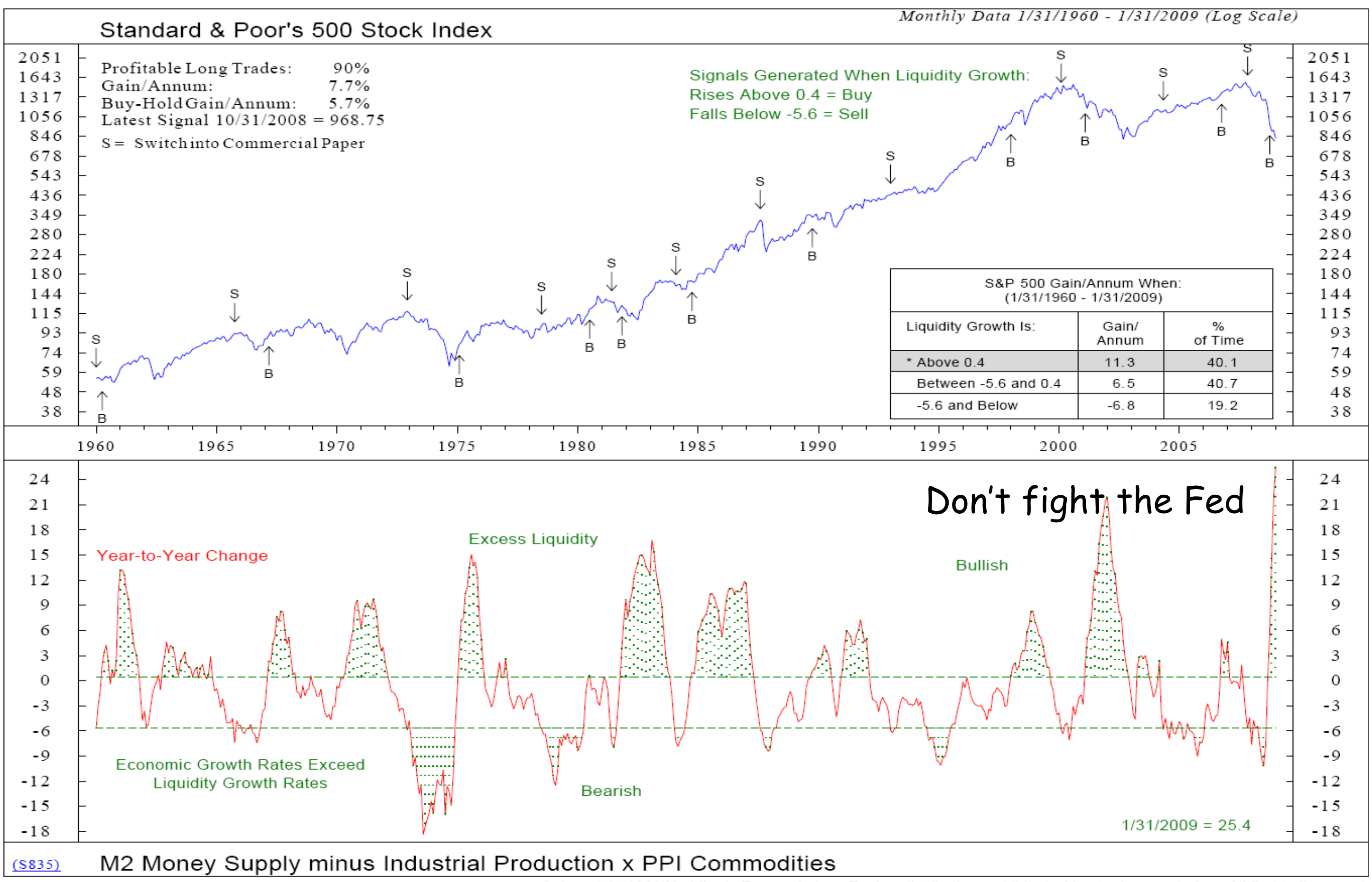
Back to Basics: Our Three Rules Imply Caution But Not Total Pessimism

The retest of the November 2008 and the October 2002 lows by the major stock market indexes has significant technical implications. In our view, a successful test will confirm the ongoing bottoming process, whereas a decisive breakdown will increase the likelihood of further material downside for stocks. In unsettling times, we look to our three investing rules for guidance.

Rule #1: Don't Fight the Fed. The Fed is fully engaged

We can now also add congress and the Treasury to our first rule, Don't Fight the Fed. The problem is that this cycle is clearly different – it is not simply a business cycle caused by monetary tightening, but rather a structural deleveraging of the private sector coupled with a collapse in asset prices and a banking system going through a solvency crisis. Thus the monetary response has had to be different while fiscal policy is enacted. In our judgment, government is fully engaged and is finally having some success in restoring confidence to the credit markets as evidenced by narrowing spreads and record issuance for investment grade corporate bonds.

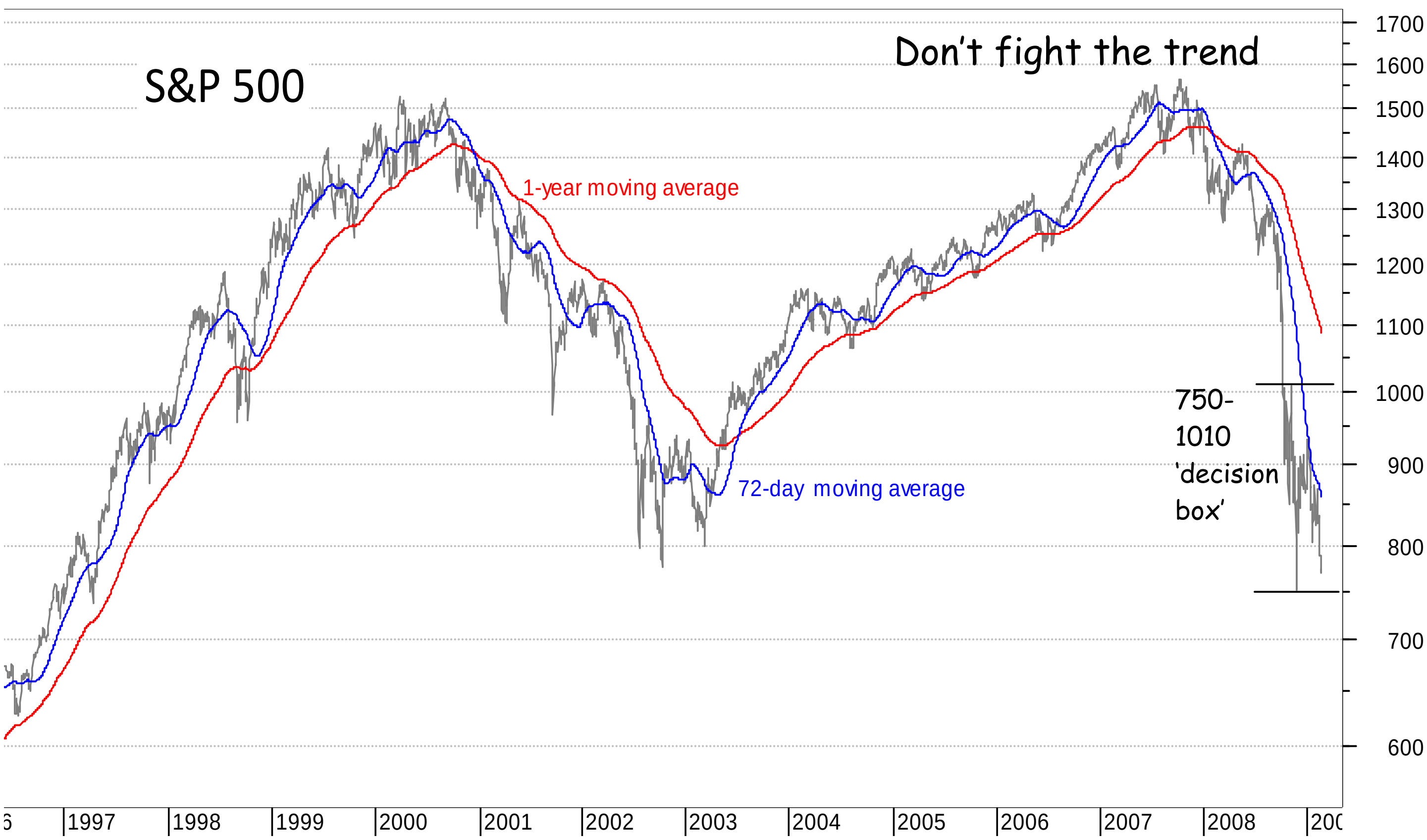


The chart above measures excess liquidity by subtracting economic activity (measured by industrial production times commodity producer prices) from money supply (M2) growth. This measure shows there is record excess liquidity, but it also reflects collapsing production and pricing power as much as it does increasing money supply – a 'liquidity trap.'

Hence, the government is actively working to restore normal credit market functioning but it is a daunting task. Government efforts combined with the unprecedented expansion of the Fed's balance sheet to $1.8 trillion, near 0% interest rates, and the Fed's vow to "employ all available tools to promote the resumption of sustainable economic growth" tell us that the Fed is in the stock market's corner.

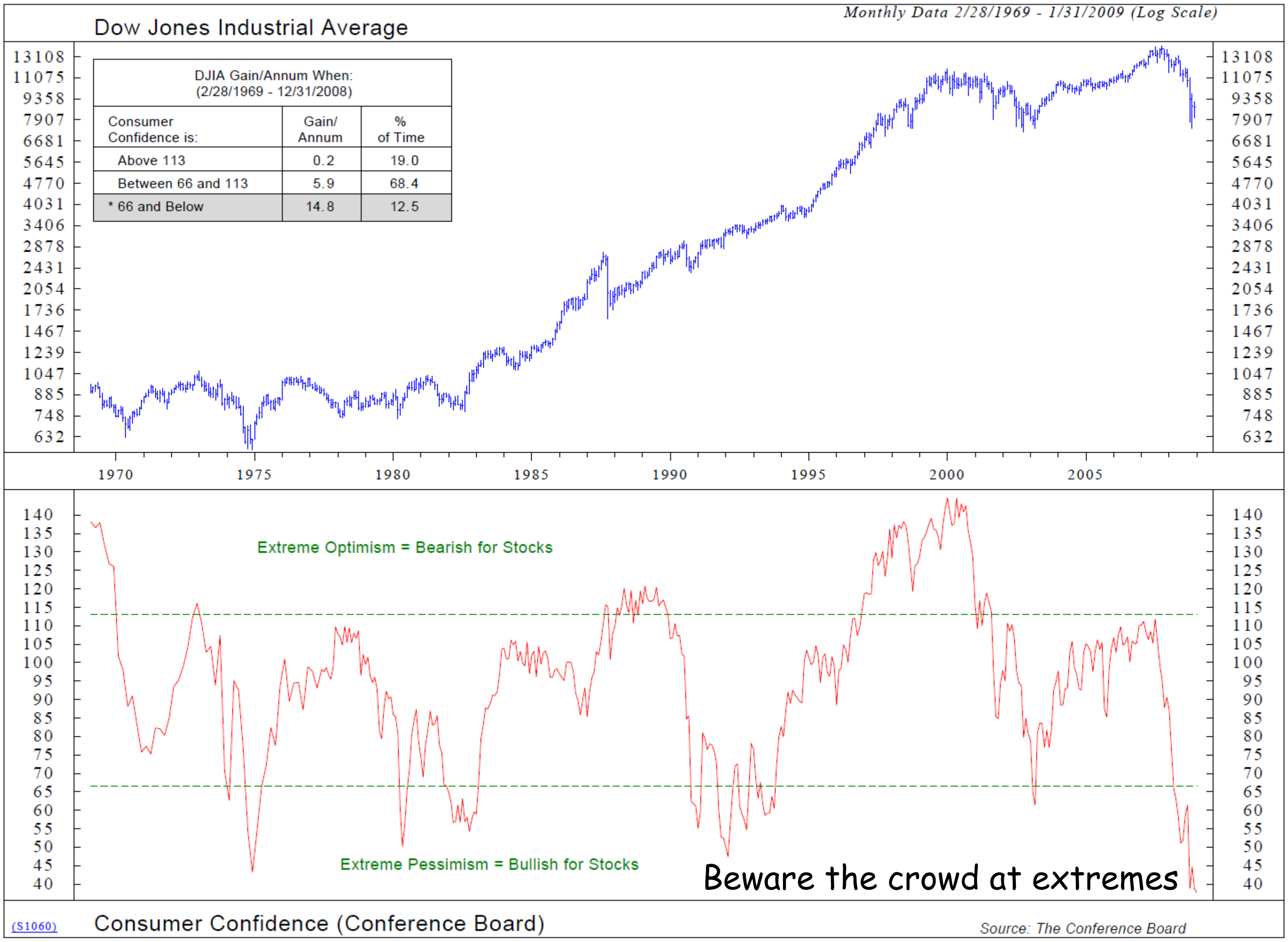
Rule #2: Don't Fight the Trend. The Trend is down

We are in risk management mode. Not only is the primary trend down (we use the one year moving average to measure the primary trend) but so are our favorite shorter term moving averages (72 and 29-day). Furthermore, both the S&P 500 and the Dow Jones Industrial Average are sitting on critical long-term support. This can be clearly seen in our chart below. The S&P 500 is testing not only its November 2008 lows, but also the approximate levels that held three times to form the 2002-2003 bear market bottom. As long as these levels hold, our central case of 2009 as a "bottoming process" year remains intact but a decisive break below this zone will foreshadow a longer and deeper bear market in our opinion. We see the next area of technical support between 600 and 650 for the S&P 500.



Rule #3: Beware the Crowd at Extremes. Consumer pessimism at 40-year record

History shows that when confidence reaches extremes, like today, the odds have favored a reversal. Our third chart illustrates the relationship of consumer confidence and stock market performance. When consumer confidence is below 67, as it is currently, the Dow Jones Industrials has historically gained nearly 15% per annum. Consumer confidence has been below 67 only 12.5% of the time in the last 40 years. Investor risk appetite has also collapsed, as reflected by 2.8% 10-year Treasury yields and $3.9 trillion (or 42% of the value of US stocks according to Ned Davis Research) sitting in money market funds earning around 1%. Of our three rules, this one currently argues most strongly against becoming too bearish, especially for investors with longer time horizons.



Conclusion: Despite the support of the Fed and bearish sentiment extremes, value has been eclipsed by powerful downward momentum. There is no denying the S&P 500's perilous technical position along with many global equity markets. Ned Davis recently pointed out the importance of focusing on how markets "are acting" rather than how they "should be acting." Thus, if stocks breakdown, we will evaluate our tactical game plan and consider further defensive measures. The technical warning signals of the current retest were evident in January when we raised cash (see Stock Rally Over – Retest of November Lows Likely, *The Weekly View* 1/20/09) and we have been in risk management mode ever since. An investor's timeframe is the principal consideration when value and momentum are so opposed, in our view. Longer time horizon investors should place greater weight on value and contrarian indicators like sentiment, but we expect both price and economic momentum to continue to dominate the short term.

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