Is It Safe To Go Back In The Water Yet?

Is a market bottom formed quietly or violently? In physical commodities, the answer invariably is quietly, which must be very discouraging to gold bugs who have witnessed their favorite metal languish for nearly two decades. In equities, the answer is violently within a broader bullish trend and quietly within a bear market. The analysis presented below suggests we're in a bear market and won't see a quiet bottom for quite a while.

Last week was violent. It included a plunge toward lows for the year in major indices, followed by the second-largest daily percentage gain ever for the NASDAQ Composite. We need to interpret whether this action is telling us the worst is now over. Volatility patterns will be the key to this analysis.

Volatility is the market's price for uncertainty, a sort of thermometer for risk. It is normal for stock market volatility to increase as prices fall; few investors are naturally short stock, and demand for insurance jumps as stock prices fall. Volatility can, however, increase during rallies as well if market participants are uncomfortable with the market's lofty valuations. This happened during the October 1999 - March 2000 NASDAQ rally (see "The Energizer NASDAQ," February 9, 2000).

In all cases, volatility must be taken in line with investor expectations. A bull market that has continued, with only minor and short-lived exceptions, since August 1982 has spoiled us all. As a result, we feel entitled to ongoing gains in our portfolios. In psychological terms, we've "anchored" to these expectations, and as a result, we react with fear and dread when these expectations are challenged.

All investors accept some measure of gain retracement: Who expects the market to rise continuously? Therefore, the small dips should not and do not provoke fear, as measured by greater volatility. The big drops, however, should and do provoke ever-greater surges in volatility.

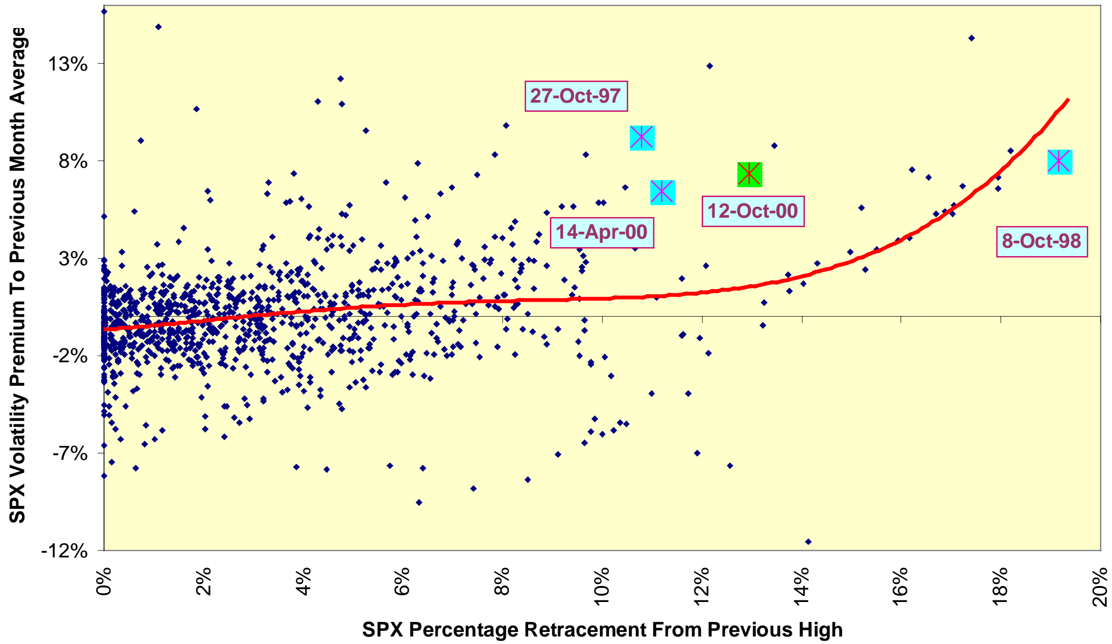
Feeling For A Bottom

We can combine these two measures, volatility and retracement of gain, to gauge whether the market has at last reached its violent capitulation. Two graphs are presented below, one for the S&P 500 (SPX) and one for the NASDAQ 100 (NDX). Each trading day since the end of October 1996 is represented by where it stands relative to the previous month's average volatility and where it stands relative to the market's last new high. A trend curve is added to highlight the relationship.

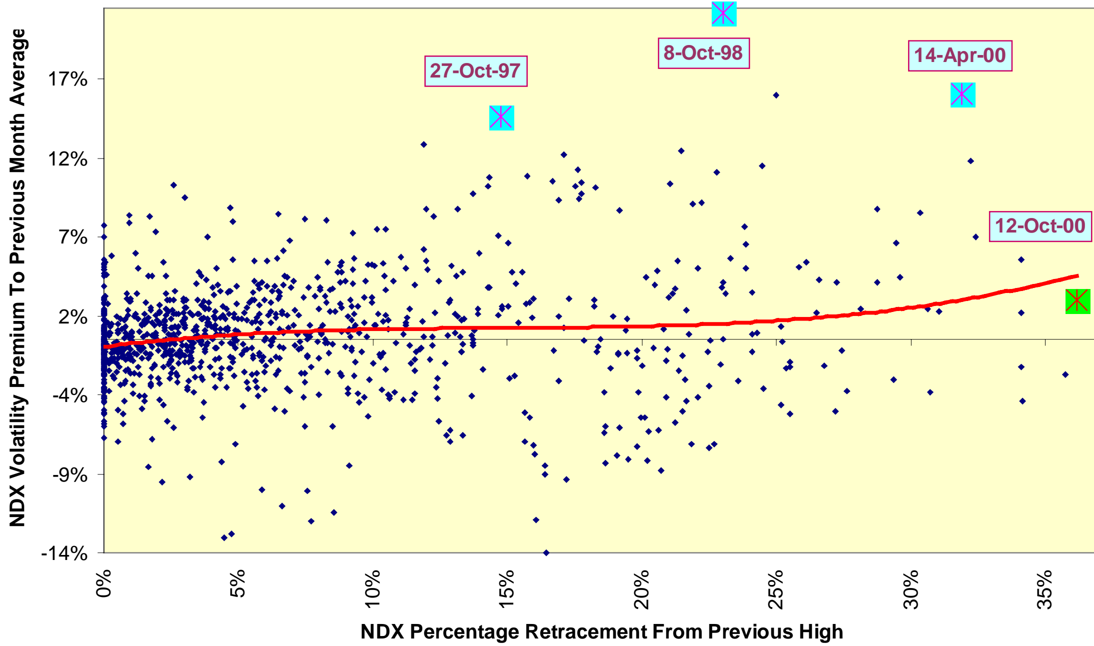
Four trading days are highlighted on each chart, three of which, oddly enough, come in Octobers:

1. The October 27, 1997 crash and early market closure representing the Asian crisis
2. The October 8, 1998 spike bottom representing the end of the Russian / Long Term Capital Management crises
3. The April 14, 2000 collapse representing the end of this spring's technology rout, and
4. The October 12, 2000 selloff, highlighted in green, representing the outbreak of violence in the Middle East.

Famous Bottoms 1: SPX Volatility As A Function Of Gain Retracement



Famous Bottoms 2: NDX Volatility As A Function Of Gain Retracement



Last week's drop in the SPX represented a larger retracement of gain than did the ones in October 1997 and this past April, but the retracement is well short of the 1998 episode. Moreover, the increase in volatility

over the previous month's average is not extraordinary by any means. We can surmise we have potential for further panic and further declines before a bottom is reached.

By this same analysis, the situation in the NDX is even more alarming. The drop on October 12, 2000 pushed the NDX to its greatest retracement of gain in more than 1,150 trading days, but its volatility level relative to that of the previous month is far below that of the other large drops. In other words, the NDX has been trading in a high volatility / falling price environment for so long that it has gotten used to it.

What Does A Bear Look Like?

The last major bear market was in 1973-1974. Organized options markets were in their infancy, and the NASDAQ itself was less than three years old. No statistical comparisons on the above method can be made between now and then. We can make some qualitative comparisons, however, the most obvious of which are Middle East unrest and rising oil prices, currency turmoil, (the world was just moving to floating exchange rates in 1973) the end of a previous narrowly-based market surge, (the Nifty Fifty) and slowing profit growth.

If we are in fact in a bear market, and the retracement of gain evidence in the NASDAQ is incontrovertible, we may take a while to return to bullish comforts. It's sad to note we did not regain 1929 highs until 1954, that we remained in a trading range from 1996 until 1982, and that the Japanese market is still trading at less than 40% of its 1989 high.