Hope Springs Eternal, But Not Yet

For a column such as this to construct a bullish or a bearish argument for any market, sector, or individual issue would be inappropriate. Those arguments are to be found in abundance elsewhere at various decibel levels. The task here is more objective, and that is to let the data speak. The market is its own best advocate, and since it's going to do what it's going to do anyway, we might as well try to be on the right side of things regardless of direction. The alternative is membership Wall Street's Society of Fallen Gurus, an amalgamation of outcasts who remained wedded to a single outlook for too long.

Life in general and markets in particular can be cruel. Bad things happen to good people, to good companies, and to good industries; such is the modus operandi of a massacre. To those who protest that the technology and telecommunications industries will grow and will become even more important over time, I agree. However, large industries and great companies may or may not make great stocks. Market leaders of the past include steel, auto, and oil, and yet we have not been looking to USX, General Motors, or Exxon Mobil for leadership even though these industries have continued to grow in both size and economic importance. Shirley Temple may have been a better actress at age 20 than at age 5, but who cared?

Many of the opinions expressed here recently have been characterized as bearish. Both this characterization and the underlying market analyses, therefore, have been correct. To those who protest still this is not a bear market, condolences are offered: The present state of affairs should be no more confusing than your gender identification. As an inveterate long-term optimist on the abilities of mankind, the economy, and market, I'd rather be wrong, but this would be a disservice to all.

Time Preference

We have to decide at all times whether we are being investors who are betting on the long-term economic signal of economic growth dominating the short-term noise of the markets, or whether we are being traders betting on that same noise. Both approaches have their strengths and weaknesses. The natural return on financial assets makes time the investor's friend, but at the cost of having to endure painful markets such as the one we've been living through. Time tends to be a trader's enemy: Every day, you have to wake up, strap on the six-shooter, and walk down Main Street. Eventually, no matter how good you are, you'll meet just one person a little bit faster, and one's all it takes.

Traders' worst urges are compounded by the agency problems in modern investing. Fund managers are rewarded on relative performance and assets under management. Since no one really gets paid for managing risk, assets accrue to top performers, who are often the top risk-takers. Once a rally starts or even appears impending, the incentives for both short-term traders and agents for long-term investors to buy aggressively become overwhelming.

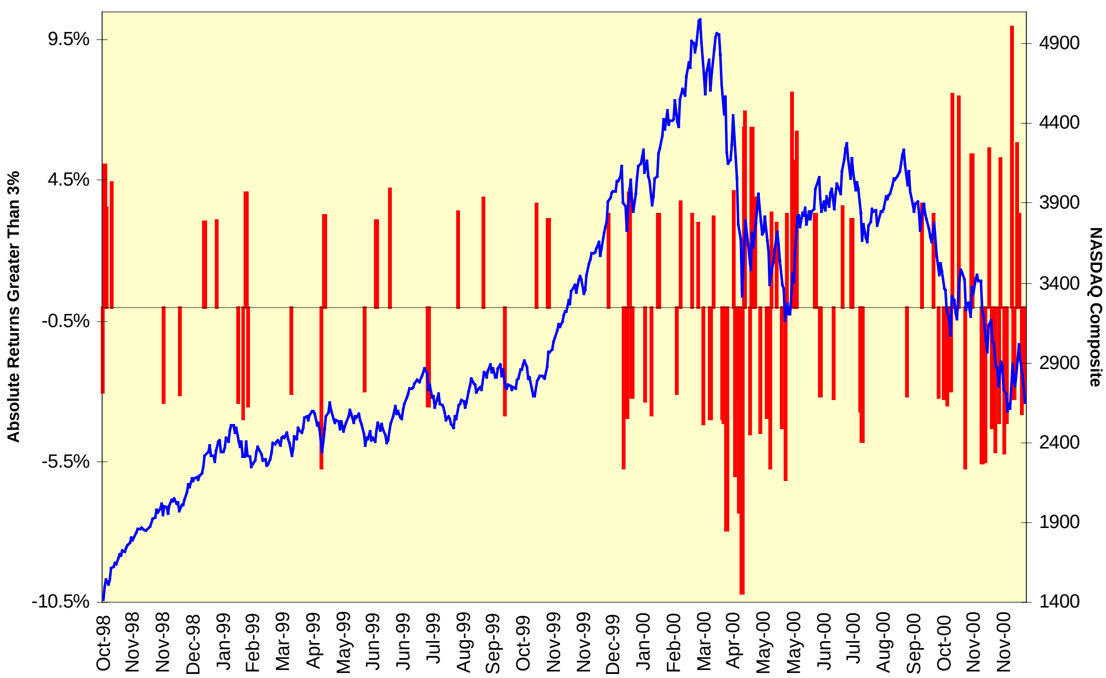
Pop-Pop, Fizz-Fizz, That's What A Bear Rally Is

We've had an extraordinary number of sharp rallies since the present leg of the downturn began on September 1, and that's no accident. No trader or money manager worth his salt can afford to miss the start of a renewed charge to the upside. Clearly the sky's the limit; if we could take the NASDAQ to a P/E of 400 once, we certainly can do it again.

Moreover, market mechanics aid in the process of both large single-day drops in bull markets and rallies in bear markets. In both cases, traders close winning positions to capture profits and open new positions in hopes of jumping on a trend reversal. This is consistent with the maxim that markets move most violently, especially on news, when the consensus is wrong.

We can see this clearly for the NASDAQ Composite since the general market low of October 1998. The slow rally up through October 1999 was characterized by a moderate number of days with absolute price changes greater than 3%. During the October 1999 - March 2000 sharp rally the number of large down days picked up significantly, and remained quite high until support was found in late May. But note how the number of large up days picked up as well during this period, and especially during the October - December 2000 period. The net result of all these rallies has been new lows.

Big Days And Big Trends



Looking For Hope

When will all this end? The one-day spike bottom, the buy-the-dip routine, is a short-term trader's signpost in a bull market. It's the right tool for the right task. However, bottoms in bear markets are formed more quietly over time. Long-term investors will participate as a matter of course.

Will a new, long-term bull market start with a big, one-day breakout? Quite possibly: It did in August 1982, and later again in January 1991. And many allegedly long-term investors may not be fully in at this point. So what: In a long-term trend, your entry point is irrelevant. Besides, you'll have a lot more money at your disposal than those short-term guys who kept getting it wrong, one day at a time.