Bad Signs And Fragile Lines

With apologies to the Five Man Electrical Band....

And the line said
Long-hurting bullish people, don't try to buy
So I tucked my cash up under my hat and I went in to ask them why
They said "You look like a fine upstanding bear, I think you'll do"
So I took off my hat and said, "Imagine that, me buying from you!"

Whoa, lines, lines, everywhere a line
Marking out resistance, busting my behind
Sell this, don't buy that, can't you read the lines?

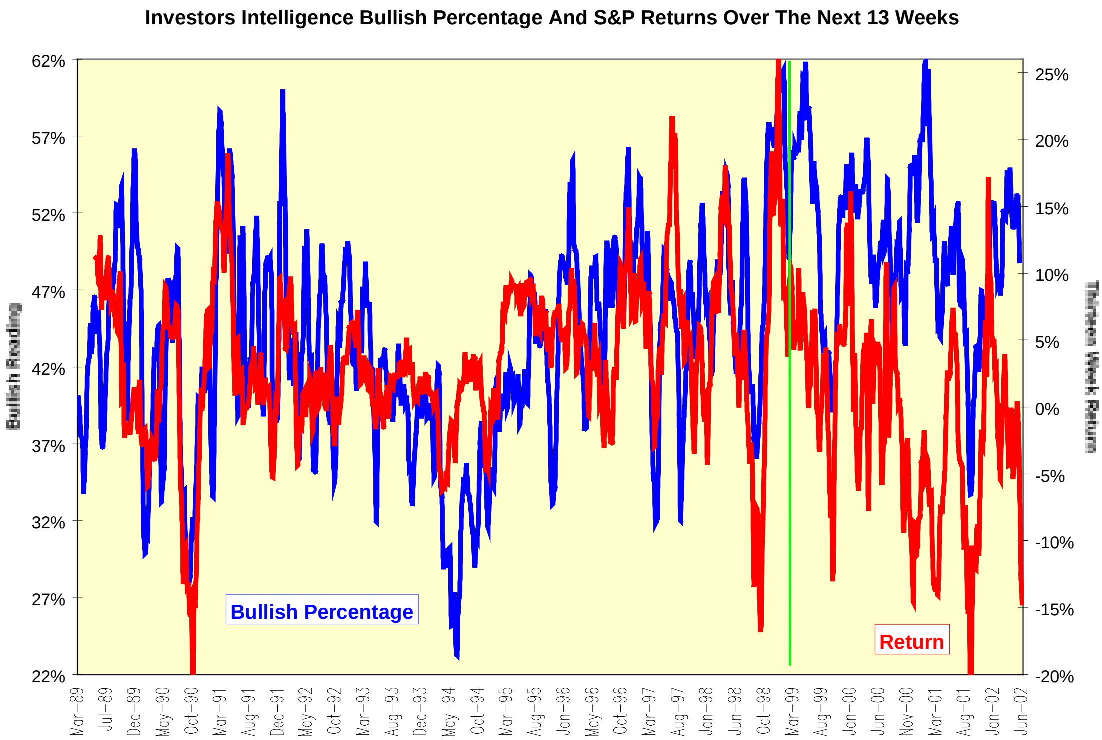
And the line said, "anybody caught investing will be shot on sight
So I put my stops under the line and yelled at them
"Hey, what gives you the right?
To put up a line to scare me out or to keep all the short sellers in
If Graham and Dodd were here they'd tell it to your face
Man, you're some kind of sinner"

Well, not really. Just like the general who runs to the head of the troops, investors and traders should make their first task finding the path of least resistance in a market. That has been lower in an almost demoralizing fashion for more than two years now.

If stocks deserve to be lower, if this is their fair value, then so be it. The market does not owe us overvaluation and unrealistic expectations. The long-term damage from mispriced markets can be significant; they encourage over-investment and then over-capacity in favored sectors such as technology and telecommunication. Under-investment, as reflected in the unwillingness of investors to accept risk, is just as bad as it starves entrepreneurs and worthy ventures of needed capital.

So, let's stop this fool's game of wondering if each and every support line on the chart will hold as the winner in some real-life Armageddon. We're at levels first crossed in 1997, so we've marched back and forth over the same chart points several times, and we can ascribe deep meaning to whatever critical levels we choose. Instead, let's get down to work in assessing the real problem, a loss of confidence, by taking a look at three psychological variables.

Sentimental Fools
Many commentators, myself included, are wondering why their tried and true systems and methods aren't working very well anymore. Here's another one to add to the pile: Negative sentiment, which is regarded as a positive by market technicians, and vice versa. The concept here is simple, if most investors are bullish, then they've bought already.

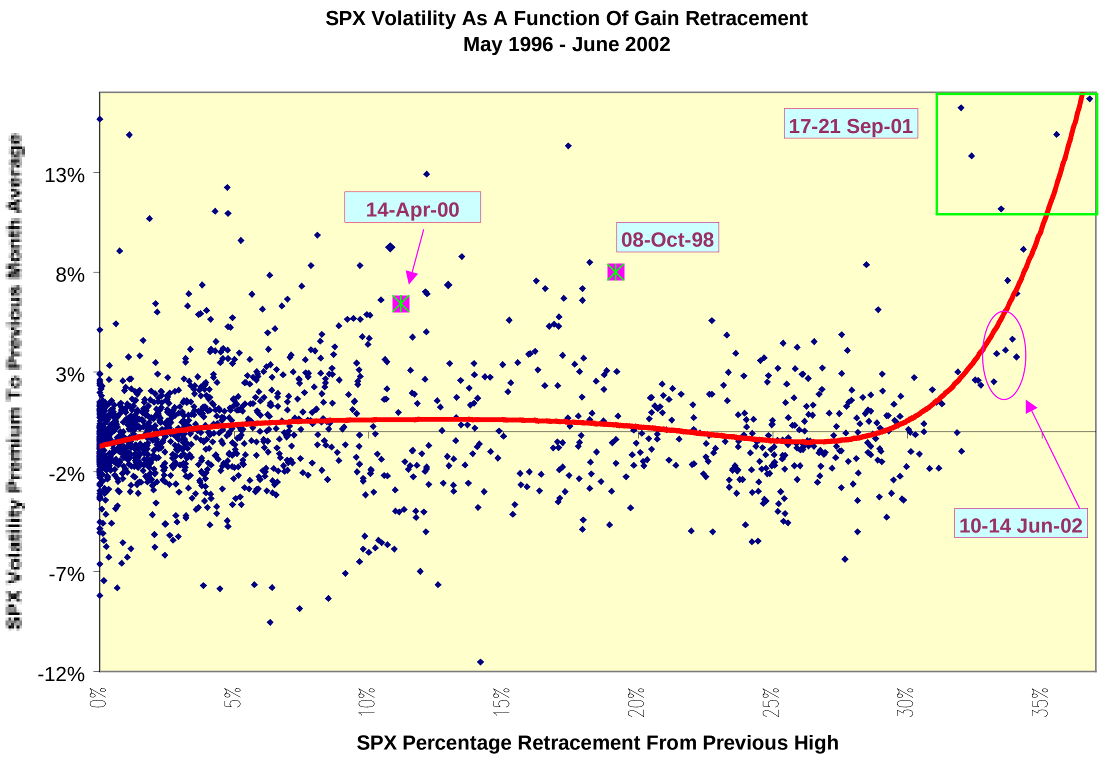


Actually, if we do some homework and take a look at the Investors Intelligence bullish readings with the returns on the S&P 500 for the next 13 weeks overlaid thereon, we find that investment advisors were surprisingly good throughout most of the 1990s as forecasters. However, the forecasting quality of this indicator deteriorated markedly after April 1999, and with the notable exception of a bearish call going into September 2001, the sentiment index hasn't been useful at all ever since.

It's not just your imagination. Nobody has been calling the big moves right ever since the bubble's last giddy year. In August 1999, I published an article elsewhere entitled "Everything You Know Is Wrong" detailing how the market had blown through all of the stop signs on the way higher. I could probably use the same title again in the other direction.

No Retracement of Gain, No Pain

An indicator published here twice before, once in the April 2000 breaking of the bubble and again last September combines two market-derived measures of anxiety. The first compares current volatility to the previous month's average. The second compares the current value of the market to its last new high; this is called retracement of gain, and is often a useful measure of how much pain we feel. In both instances, extreme combinations of these two, not absolute chart points, marked tradable bottoms.



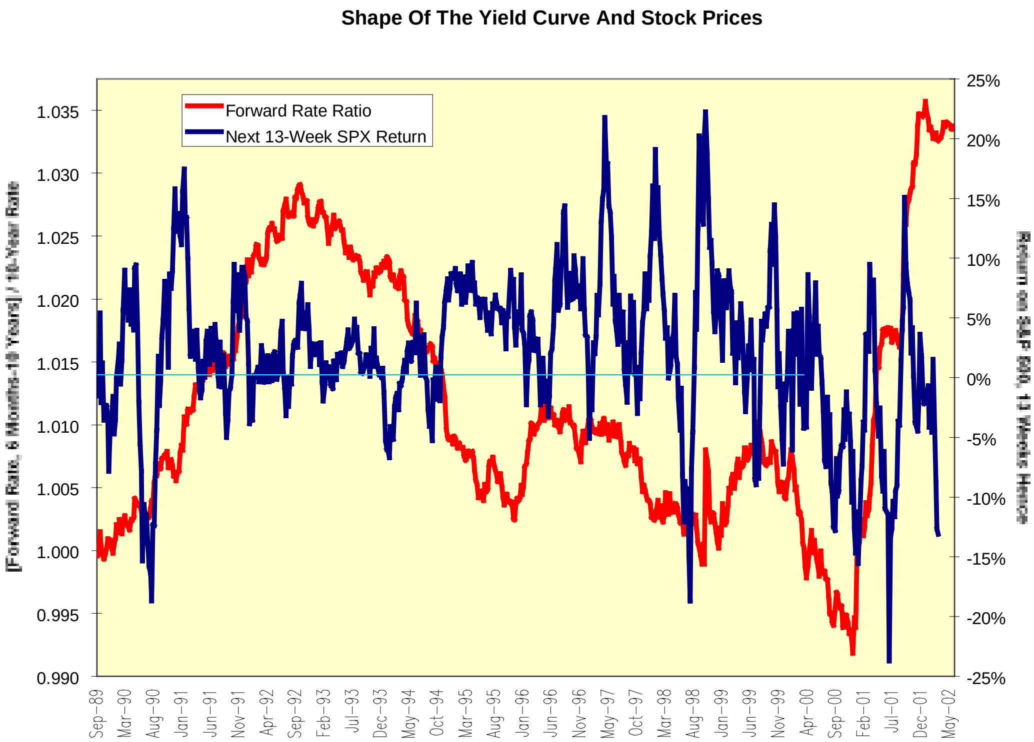
The present situation is not quite as extreme, and therefore unlikely to constitute a panic bottom. The retracement of gain is near a historic high, to be sure, but this has to be diluted somewhat by the fact that the high occurred in April 2000, and few are measuring their losses mentally from this point anymore. To some extent, time does heal wounds.

More important, the recent upturn in volatility is not as sharp as it was in previous bottoms. Present volatility is only 3-4% over the previous month's average, and that does not constitute a stampede for the exits.

Cash As Insurance

On a macroeconomic level, monetary policy becomes ineffective in a surplus capacity situation, as no one needs to borrow for investment purposes. On a microeconomic level, firms and individuals hoard cash as the central bank cuts rates even if the real after-tax return is near zero or even negative. This known penalty is like an insurance premium; you will take a small loss now to prevent a bigger loss later. In such as environment, the yield curve becomes steep as investors plow cash into money market funds, bank deposits and T-bills.

We can measure this steepness by the forward rate ratio. Here we'll use the forward rate from six months to ten years, or the rate at which we can borrow for ten years starting six months from now, and divide it by the ten-year rate. The ratio is still near an all-time high, which indicates a very strong preference for cash and an unwillingness to extend lending even to the government. This is risk aversion, and it's very hard to see risky assets like stocks rally when people just don't want to take risk.



Not a pretty picture, not when you look at the lines, not when you read the signs. This doesn't argue for a complete abandonment of equities – if we all did that, we'd all lose – but rather for equity exposure at the low end of your risk tolerance band. And remember the departing wisdom from The Five Man Electrical Band:

and the sign said, "everybody welcome. Come in, kneel down and pray"
and when they passed around the plate at the end of it all
I didn't have a penny to pay
So I got me a pen and a paper and I made up my own little sign
I said, "thank you Lord for thinkin' 'bout me. I'm alive and doin' fine"