

EQUITIES PERSPECTIVE

February 29, 2008
DJIA: 12,582

Flagging, coiling, triangulating . . . call it what you like, they're going nowhere. These various terms from technical analysis simply mean we're range-bound. And, when you think about it, that's not altogether bad. After all, the dollar is at an all-time low against the Euro, housing weakness seems forever, there's slower economic growth in the U.S. and Europe, profit growth in the U.S. is under pressure and commodity prices, particularly agriculture, are soaring. Then there's the matter of what subprime writeoffs have done to the adequacy of bank capital. And, as a result, banks continue to tighten lending standards, meaning the problem now is not one of the cost of capital but, rather, its availability. And that won't change with the lower rates that everyone clamors for. Indeed lower rates only seem to serve to lower the dollar, making food and energy all the more expensive. With all this as background, it's a wonder the market has held up as well as it has. Then, too, the market is this discounting mechanism, it always turns long before the news turns good.

From a fundamental standpoint, the market's problems all began with the "financial crisis," a crisis still ongoing. Back in February 2007, before any of us heard of "subprime," before any of us knew there was about to be a financial crisis, Financial stocks peaked. And there's little doubt that before the financial crisis itself ends, these stocks will discount the problem's end. That's why their own recent holding pattern could be important. Time will tell, and all that, and once again observing will prove more useful than predicting. Using the Financial ETF as a proxy, a daily chart shows a rally that has stalled, though not necessarily ended. The more disturbing pattern shows up in a weekly chart. That shows a pattern that had become stretched to the downside and now has rallied, as it has done previously. Unfortunately, though, the overall downtrend remains very much intact. Like the overall market, and perhaps more so for the XLF, taking out the lower bound of the recent range would not be good.

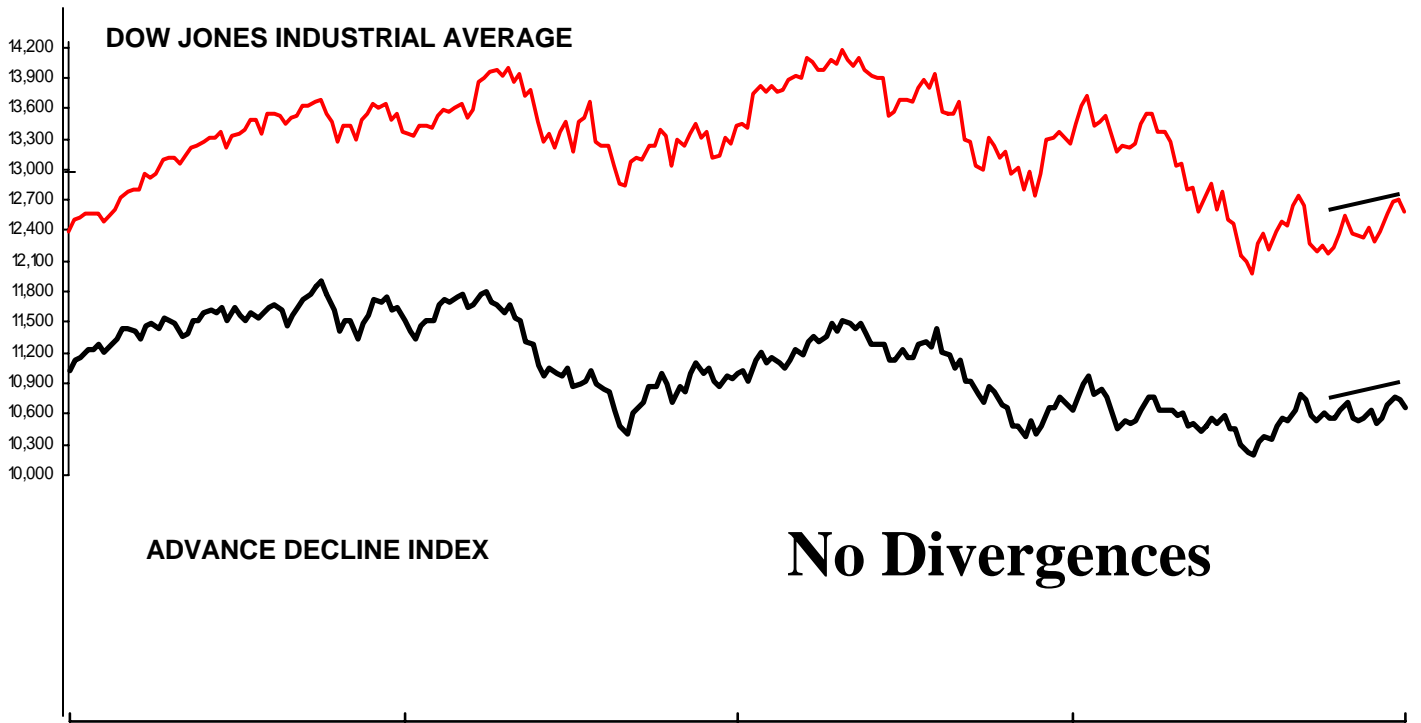
If the fundamental start to the market's problems was the financial crisis, the technical start to the market's problems was all about divergences. We got into a pattern where strength in the market averages masked weakness in the average stock. Of course, nowhere was that more extreme than on the NASDAQ where a few good Apple's (128), so to speak, accounted for almost half of the gain in that average. Meanwhile, NASDAQ breadth was making new lows with some regularity. As is typical in the case of divergences, the bad drag down the good – see Apple and Google (470), for example – rather than vice versa. What has been an important positive in this rally is that on the NYSE no divergences are evident. Market breadth has been commensurate with the market averages. And that, simply put, is not typically how the market gets into big trouble. Had the rally from the January lows been accompanied by poor breadth, that is, had there been divergences, we would be pounding on the table negative. But divergence-wise, so far so good.

If anything might give one pause when it comes to this idea of "discounting," what's that rally in the Homebuilders all about? It's one thing for the Banks to rally while no one, most of all them, know how much toxic waste they're sitting on. But when it comes to the housing market, we all have a pretty good idea of what's happened there. Home prices in 20 major U.S. cities fell a record 9.1% versus a year earlier, according to the respected S&P/Case Shiller Index. New home sales are at a 13-year low, 57% below their August '05 peak. Or, perhaps even more scary, more than 10% of homeowners hold mortgages higher than what their houses are worth. But then, consider the price action of the stocks. With the Homebuilder ETF as proxy the stocks, though somewhat off their highs, to this point have rallied more than 30% from their early January lows. Discounting a turn, or bear market rally? Like the Financial Index it's too early to say. Like the Financial Index, for the Homebuilders the overall trend remains down.

Nothing is carved in stone, markets do go down without big-time divergences. But the idea behind divergences is that of a weak rally. This by no means has been your stampede-buying off the lows recovery, and hence the overall trend we think remains down, but the rally isn't all that bad. Even Thursday's selling wasn't so dramatic, certainly no more so than was Monday or Tuesday's buying, which included 3-to-1 and 2-to-1 breadth, respectively. Most stocks at least are holding. Daily New Lows on all exchanges have been less than 200 since the January 22 low. On the NYSE stocks above their 200 day moving average at 25% are well off their low of 15%, but linger below their February 1 peak of 28% - another trading range. There are few clues in the technical background as to the outcome of this trading range, other than the fact that the overall trend is down. Still, we would be surprised not to see a weak rally, more divergences, prior to any important new downleg. So, we continue to give the recovery the benefit of the doubt.

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STOCK AVERAGE VS. AVERAGE STOCK



Apr-02-07

Jul-20-07

Nov-06-07

Feb-28-08

