

July 25, 2008

DJIA: 11,349

Wells Fargo was one thing, even Bank of America . . . but Wachovia? Wells Fargo (29) got the Financial ball rolling last week and B of A (31) proved a nice follow-up, but Tuesday's rally in Wachovia (16) pretty much told the story. The No. 4 U.S. bank swung to a Q2 loss of close to \$9 bil., a loss of \$1.27 a share and some 49 cents less than expected. It also wrote down some \$6 bil., plans to cut 5% of its staff and cut its quarterly dividend to 5 cents from 37.5 cents. As you might expect, the stock opened lower, trading down as much as \$1.5. That lasted all of 30 minutes, after which the stock proceeded to close at \$13.15, up almost 30% on the day and up some 45% from the low. The rather unmistakable message – like WFC and BAC before it – the stock was sold out. The rally wasn't because of "good news" and the rally wasn't so much about the buying. Stocks can rise with relative ease when the selling is done, and the recent action in these stocks pretty much says for now, the selling got overdone.

The moves in many of these Bank stocks almost defies explanation. Take Bank of America. If you want to argue that at the 7/15 low of 18.4 BAC was undervalued, that's fine. But if it's about "valuation," that was some epiphany that took the stock to 34.25 in just six days. That's something like \$80 billion in market-cap. If you want to argue that on a "technical" basis at 18.4 BAC was extended in its downtrend, that too is fine. But being slightly extended on the downside explains a bounce, not a move to 34.25 and short term very extended on the upside. As we suggested above, stocks can rally easily when the selling is done, and being soldout certainly has something to do with the move. But it seems too that there's something here to do with the nature of the markets these days, a lot of short selling. And, it couldn't be more perfect that just when everyone starts complaining about short selling, the buying/covering by the short sellers resulted in these outsized, upside moves in stocks like BAC. No one is complaining now.

Of course, not every Bank is Bank of America, Wells Fargo or even Wachovia. There's also Washington Mutual (4) which, on similarly crummy news, rallied for an hour Wednesday before it reversed to close sharply lower. Easy to say in retrospect, but that was probably the tip-off that the "rally on bad news" game was over and, hence, Thursday's selloff. In terms of the Financial ETF (XLF), there also might be some insight from the March low. The recent rally carried 23% in 6 days, the March rallied carried 23% in 4 days. After the March low the XLF trended higher to the early May peak, but the overall rally only carried 26%. The best part of the rally was the first leg up and that seems likely to be true this time as well. After all, while the short term downtrend may have been broken, the overall trend remains down, and will take longer than you want to think about to reverse. However, like March at least a temporary low in these stocks seems to be in place, and that can't be bad for the overall market as well.

Meanwhile, the rally in the Financials isn't the only big reversal. This year "the trade" has been buy Commodities, short Financials. And, indeed, Commodity stocks have had their own reversal, in their case to the downside. And these reversals seem to have a lot in common in that they were both due, so to speak, and in both cases sentiment had become pretty much one-sided. And while it's true that the long term trend in Commodities like Oil is up, and the long term trend in Financials is down, these countertrend rallies can last a while. Very often they last long enough or don't reverse until there is some change in sentiment – you'll start to wonder if the Commodity trade is over and begin to believe the Banks have hit bottom. If Oil comes down another \$20, you'll suddenly hear about a big new increase in supply and a surprising drop in demand. If Oil trades down to \$100/barrel and the stocks follow, they'll tell you this company or that company will still make a ton of money. But the stocks will track the commodity, just as they did on the way up.

Thursday was as surprisingly bad as the prior six days were surprisingly good. But just as a couple of good days don't necessarily prove predictive – 6 of the 10 biggest up days for the Financials occurred this year, that is, in a downtrend – one bad day has little predictive value as well. Our guess, and it's little more than that, is we've made some sort of low for the time being, for the time being we're at least through going down. But the overall trend is down, so the market really has to prove itself on the upside. One way to do that would be to avoid much more weakness. We shouldn't, for example, just give back all of the gains of the last week. The next step would be to again see some good buying – good volume and good breadth. The news is unlikely to get much better, it never is at the bottom. As during the six day rally, however, the market has to get to the point where the bad news is discounted, the market can ignore it.

Frank D. Gretz

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