

EQUITIES PERSPECTIVE

August 22, 2008

DJIA: 11,430

On a role . . . reversal. The most striking aspect of the market's action since the July 15 low has been the strength in the formerly weak Financials, and the weakness in the formerly strong Commodity stocks. We can't remember a time when a leadership group, as the Commodities have been, turned weak and yet the market rallied. And while a decline in commodity prices obviously is a good thing, like March the basis of the rally seems more about the perceived survival of the Financial sector. Of course, survival here isn't really the issue as much as the seeming "capitulation" phase these stocks reached back on July 15. In other words, the stocks became stretched to the downside while sentiment was bleak, and this type of panic low is often followed by a strong rally. However, since the last bull market was all about the Financials, it would be most unusual to see them lead in the next. That's just the way it is. The NAZ, for example, remains 50% below its bubble peak in 2000. Cisco (25), certainly not the worst of the Techs, is yet to make it back to its 2000 peak of 82. And then there are others, like the aptly named Exodus.

The leadership aspect aside, it clearly seems important for the overall market that Financial stocks at least hold. Using the XLF ETF as a proxy, they're doing that, just barely. But the pattern to this point has matched that of March and April almost precisely. Back then, and like now so far, the rally off the low proved the best part of the gain. Back then, however, the second little test in mid-April held the lows of the first test at the end of March. And that's where we are at present, down to the level of the late July test or correction around 19.5-20. Nothing is carved in stone, but if the Financials have indeed put in a decent low, you would expect that support to hold. In the meantime, you could argue the action in the group isn't all that bad considering Fannie (5) and Freddie (3) seem about to disappear, with Lehman possibly not far behind. Then, too, that picture of JP Morgan (36) is more than a little disturbing, particularly if you consider them the best of breed.

Ironically, Homebuilders have acted a bit better than the Financials lately. And, of course, the news there doesn't get any better with housing starts hitting a new low in July, thanks in part to elevated mortgage rates. When you think that nearly 30% of people who bought since '03 have homes worth less than their mortgages, you have to wonder if supply will ever quit. Obviously the collapse in these shares has gone a long way toward discounting the bad news, particularly that leg down ending in January. And the recent action could be seen as a bottom or something that could turn into a bottom. As you can see from the chart, however, this would not be the first false dawn. And here, too, a little trendline analysis should prove useful. A break in the uptrend from the July low could result in yet another leg down, a wave 5 as it happens. Throw in the bankruptcy of one of the weaker ones and that, finally, could prove the low.

Back at the 2002-2003 low, NYSE stocks above their 200 day moving average reached its low at 19% in October 2002. Despite the market's "test" before the sharp rally in March, the subsequent low in stocks above their 200 day was 27% in January 2003. This positive divergence clearly proved important then. It seems worth keeping in mind, therefore, that a somewhat similar divergence is in place now. Stocks above their 200 day fell as low as 15% - a real downside extreme - in both January and March. However, despite lower lows in the averages in July, the recent low in this measure was 20%. That suggests that in January more stocks had bottomed, more stocks were in uptrends, than either in January or March, a positive divergence. From 15% in mid-March this measure reached 49% in May. This time, however, the rebound in this measure has reached only 32%, and that's a worry.

Like the Financials, the market averages themselves pretty much have traced out a pattern similar to that of the March-April recovery though, so far, the current recovery hasn't been as good. In the event, the March recovery basically ended when the uptrends, as measured by simple little uptrend lines, were broken. Life isn't always that easy, but we would take any similar such break as at least a serious warning. In the meantime, a few other things suggest the recovery is a bit more fragile. Over the last week or so we've seen a few one-sided negative breadth days. And over the last couple of weeks volume has tended to expand as often into weakness as into strength. Almost as importantly, on the two decent up days in the last couple of weeks volume contracted, typically another sign of waning buying interest. And without the Commodity stock leadership there is no leadership. Overall daily New Highs were 17 on Wednesday, the lowest we remember seeing on an up day in a market in a rally phase. Still, our guess is that the rally, such as it is, stretches out a bit more, but unlikely past the seasonally weak period beginning mid-September.

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STOCK AVERAGE VS. AVERAGE STOCK

