October 5, 2009

Hi Everyone,

Stocks have been on a wild ride the last couple of weeks in anticipation of a decision on short-term interest rates from the Federal Reserve's policy-making committee and the jobs report. Flat, down, up, way up, and then way down again. Anyone wishing for a little more volatility than the utter flatness of the past week finally got what they wanted.

Investors were looking for clues that the Fed had changed its view on the recovery of the U.S. economy or its plans to keep buying Treasuries and mortgages. Bears wanted the Fed to say everything is so awesome now that they're planning to raise rates soon. Bulls wanted the Fed to say things are improving so slowly that they'll have to keep rates low a long time.

In the end, as usual, neither side got what it wanted though the Fed's statement certainly leaned toward the bulls' point of view. Policy makers said they see improvements, but are on *high alert* for problems. I still think they're on hold through the end of next year at least.

If you've been with us a while, you know that my point of view is that the Fed and other central banks believe they will only get one shot at fixing the global financial crisis. And as a result, they are locking arms and confronting the problem together with everything they have. *It's the nuclear option*.

There has been no incrementalism in the past nine months, and I don't expect any now. That is, *they're not taking one small step and seeing how it works out.* And then trying another step and waiting again. None of that. It's all or nothing, go big or go home. And my belief is that they are not going to stop until the job is not just accomplished but far in the rear-view mirror.

It's All or Nothing

The document that I believe is relevant for today's investor is not a book but a speech and a series of statements that Ben Bernanke made before he became Federal Reserve chairman about why the Great Depression was prolonged in the latter part of the 1930s. Bernanke, an expert on the Depression, observed that the United States economy was responding well to the Franklin D. Roosevelt administration's fiscal and monetary medicine after it took office in 1932. Gross domestic product declines leveled out and began to reverse back up, unemployment was rising from a low level, and the stock market rose more than 350% from its 1932 low until late 1936.

At that point, FDR, his advisors, and Federal Reserve chief *Marriner Stoddard Eccles*, determined that the coast was clear and it was time to rein in the deficit spending and raise interest rates to make sure that the nascent growth didn't get out of hand and create inflation. Keep in mind that the United States could look across the ocean at the *Weimar Republic* in the mid-1930s and see how hyperinflation had ravaged Germany and caused tremendous social unrest. They felt that they needed to prevent an American version.

So starting in early 1937, *Eccles started raising interest rates and FDR raised taxes.* And, well, it didn't turn out so hot. In fact, the combination of tight fiscal and monetary policy crushed the nascent economic recovery and sent the stock market down another 40% — and that in turn kicked off a whole new leg of the Depression.

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Bernanke and other advisors to President Obama know this history very well. And Bernanke, in particular, has said it was a huge error on the part of the Fed and government. In fact Bernanke has been quoted as telling Rose Friedman, the wife and collaborator of the great monetarist Milton Friedman, that he recognized the Fed played a terrible hand in the Depression and promised her that it would not happen again.

Now this is not just ancient history. Bernanke and others, including Treasury Secretary Tim Geithner, have also said more recently, usually in guarded language, that they do not plan to raise rates anytime soon. And in fact, I would go farther and state that I believe they will even purposefully overshoot the mark. So if you think about the 1930s time frame, and think that the 1932-1936 period was roughly four years, and that even a 350% rise in the market did not get things going again well enough, my guess is that they will attempt to at least match that time span, if not go a lot longer.

As a result, just to throw out a hypothesis, we can even state that it's possible the real "new normal" that people should be thinking about is one in which interest rates stay very low for a very long time. Much like they have in Japan, though hopefully with a different outcome.

A Bullish New Normal

So what happens if interest rates stay low? Well, it's great for banks, and it should be great for industry. The credit market certainly thinks so, because it is currently engaged in an absolutely rip-roaring bull market that keeps shocking veteran observers with its gale-force proportions.

If you need evidence that this is so, then you need look no farther than the recent spate of merger proposals, ranging from the Kraft bid for Cadbury to the Dell bid for Perot Systems, and many overseas, such as the Suntory bid for Orangina. These kinds of offers were not made when the credit markets were closed last year. Now that it's easy to borrow for such deals, CEOs are salivating at the opportunity to use someone else's money to add to their own bottom line.

All you need to do to revive the go-go 2003-2007 era is add corporate stock buybacks to the mix. Buybacks are accomplished with borrowed money, of course. And that mood is already stirring, as Citigroup analysts reported this week that the believe BHP Billiton (BHP) is planning a whopping $17 billion buyback.

Now I want to add one more element to this mix: You've probably heard that the government wants to rein in executive pay at banks. And you may have heard that the industry is grudgingly going along. Well some of the experts that I talk to say that the banks are going along because they plan on augmenting executives' reduced salaries not with options, this time, because that is frowned upon, but with grants of common stock.

And because they won't want to dilute shareholders by issuing new stock to execs, my sources say that banks will actually buy back existing stock to give away as compensation. That is a very interesting concept, because it will have the dual effect of reducing the share count while at the same time raising earnings per share figures and cutting price/earnings multiples — a triple whammy.

That would be very clever. No one really expects bank execs to have to go shoeless, do they? Or even be forced to give up their Ferragamo shoe collection? Nah. They will always just find a new scam.

In summary, as long as the Fed is on investors' side with low rates, it looks to me that we can retain our bullish posture. That doesn't mean that there won't be bumps in the road — and sometimes *pretty*

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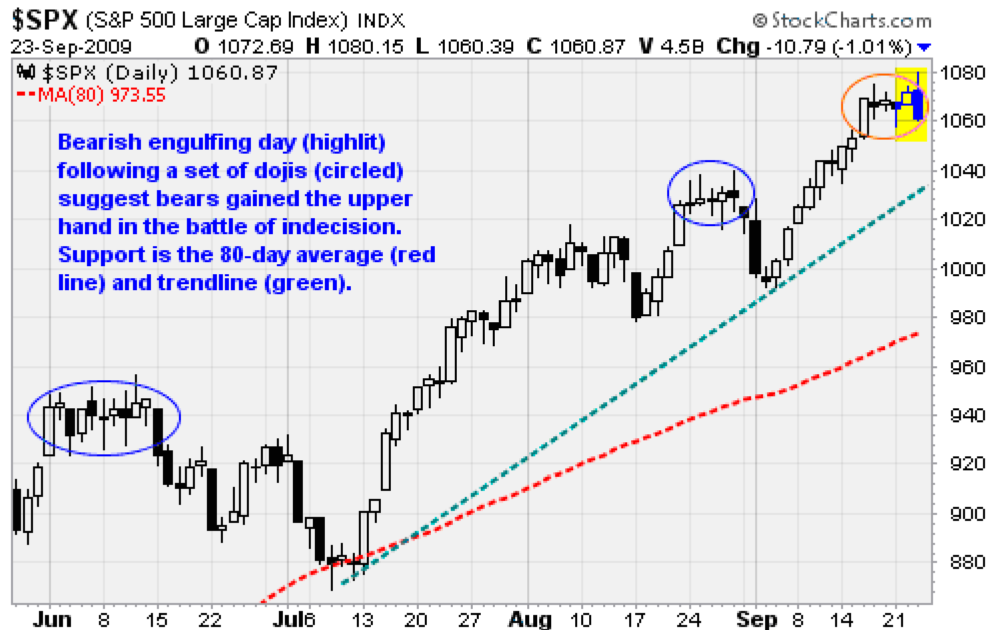
nasty ones. Only that the primary trend is up, so that all dips of 5% to 15% are buying opportunities, not opportunities to panic.

A Break for the Bulls?



Last week Wednesday, we had one of those out-of-the-blue declines that make people nervous. The finish to the session was very weak, leaving the daily charts looking as if a false breakout took place after the Fed news. Technicians call this a "negative outside day" or "bearish engulfing day" or "key reversal," and that is how serious pullbacks often begin — particularly on the sort of high volume that emerged in the late afternoon, and also particularly after a set of "dojis," which are flat, non-volatile days showing both an equilibrium of buyers and sellers and indecision. (I'll add a chart shortly showing you what I mean.)

When you combine rising volume with a 1% decline and strongly negative breadth of 4-1 for the big indexes Thursday, though, you get what technicians call a "distribution day." It's like a bad hair day, but with securities. Basically it just shows that sellers gained the upper hand.

Now even the greatest bull in the world will tell you that he gets a little antsy in periods like this where the market has really gone up a lot lately without a break. It's like eating ice cream every day without going out for some exercise. It's sort of nice for awhile, but it gets indulgent. Bulls need a break. They would prefer to see a dip on which to renew their buying. And my expectation is that they will get one now.

We must not get too excited and think it's time to go crazy with selling everything. There are a few very weak charts out there, to be sure, but I don't think that's the right play. The right thing to do now is to chill out a bit, let the decline come in to support if that's what destiny has in mind, and wait for the next opportunity add to our investment portfolios.

From the strictly technical perspective of bears, price analysts will tell you that breaking below 1,025 on the S&P 500 would make the short-term trend turn down, and breaking below 992 would turn the medium-term trend down. Bulls on the other hand were looking for some stabilization, **they got it!**

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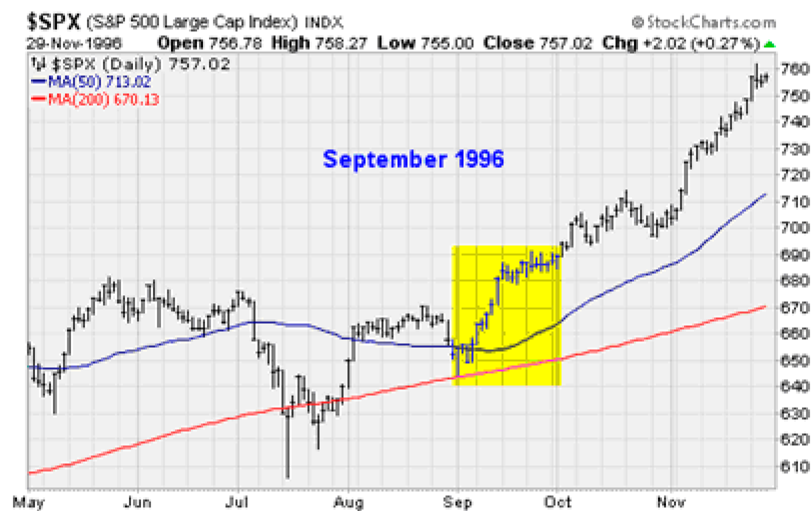
The S&P 500 was up 3.9% in September, which bears thought would be a lousy month. To fulfill bears' dreams, the S&P 500 would have had to close under 1020.62 to run into the red, and to 1014 to become what they consider to be an average negative September.

September Sizzle

At this point we're just having fun with numbers, but in case you were curious, the five Septembers of the last bull market, in 2003 to 2007, were -1%, -1%, +1%, +3% and +4%. Before that there were three bad Septembers in 2000, 2001 and 2002. From 1991 to 1999, the Septembers were -1%, 0%, -3%, -2%, 4%, 5%, 4%, 4%, -5%.

So basically about the best you could expect from a September, even during raging bull markets over the past 20 years, was 5%. That would have been 1,071, which we did hit on 9/22, although as I said we ended the month with a 3.9% gain or 1057.08.



Now before concluding, I just want to point out that the last +5% September actually occurred in a year whose spring-summer-autumn looks quite similar to the present. That was 1996, when as you can see in the chart above the market topped in May and June, bottomed in July, experienced a rather flattish August, began September with a jolt down, and then after a strong mid-September basically just chilled out sideways until October before bolting higher in November. I'm not normally one to pay much attention to analogs, but a scenario along these lines is plausible.

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(Now I am sure at this point you are dying to know what the very best Septembers of the past five decades were. And the answer is: +7% in 1973 and 1954.)

So how are we going to play this? Let's not forget that we are talking about averages of a single U.S. large-cap stock market index, the S&P 500. And we're only talking about the next week. After that, we get a whole new month to play with. And we're not talking about small caps, foreign markets or individual sectors that may have special wrinkles and potentials.

Given the idea that the next week might be flat, and that the first couple of weeks of October has a mild tendency to be negative, and that research shows that Oct. 10, on average, has been the best day to buy stocks for a one-day hold in the past century (except for, umm, well, 2007, when that date turned out to be a multiyear high), I think we have to tread lightly here for the moment.

However, the data, charts and surveys that I review continue to suggest to me that the fourth quarter will continue the strong upward trend of the past six months. In fact, there is potential for a real barnburner. Let's put it this way. If bulls can keep the market higher into the second or third week of October, then November and December could feature a slingshot move higher as bears abandon their standoffish point of view and buy high-beta stocks in a mad rush to try to catch up.

This is what happened in 1999, although the reasons are sort of lost in the sands of time. Most people remember that year featured a 101% gain for the Nasdaq 100. But they don't remember that it was a very choppy year that also featured four separate 10% drops, each of which got bears' hearts and dreams racing.

Yet bulls came back every time and overpowered their opposition, and when the short-sellers realized in mid-October that the gig was up, they were forced to come in from the cold and their short squeeze —covering shorted shares – resulted in one of the largest two-month pops higher in market history

I'm not saying that the economics are the same now; they're not. But the sentiment and market structure are very similar. In both cases bearish sentiment was palpable despite a 40% move into October for the Nasdaq 100. History never repeats exactly, but it's amazing how close it can get when human emotions and money are involved. You don't want to stand between a hedge fund manager and his payday, and if many are sitting on losses during a year that the indexes are showing gains of 20% to 40%, they will either grudgingly come into the market or they will go out of business. I think you know which option they will use.

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Sources: Jon Markman, MSN News, Chart of the Day, IBD News

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