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Market Messages

March 10, 2008
Weekly Market Beat

It was just another normal difficult week for the stock market. The Dow dropped 3%, the S&P 500 fell 2.8% and the Nasdaq closed 2.6% lower. All three indexes finished at fresh 52 week closing lows. The negative news from the economy and the credit markets got even worse through the week as margin calls against mortgage companies and hedge funds were followed by a surprisingly weak February jobs report released on Friday. The S&P 500 is now down 11.5% since the beginning of the year.

The cognitive dissonance among the Wall Street smarty-pants is something to behold. Clinging to views and opinions in stark contrast to the message of the market is normal fare when a bear phase is in progress. I described some of this in last week's March *Investment Commentary*. Expect Wall Street's eternal optimism to terminate only at the market's low.

There's a lot to worry about, from the wobbly credit market and plunging home prices to the growing perception of policymakers' inability to stem the erosion of asset deflation along side surging commodity prices. Financial markets both reflect and anticipate outcomes and their message is downbeat. Of course, markets also over-and under shoot "reality" and you have to be careful to look beyond just market prices themselves to other market data that can help to filter out noise and help to judge the market's message.

The chart below shows the daily closing prices of the S&P 500 along with the number of stocks on the New York Stock Exchange (NYSE) that recorded their 52 week price lows.

Notice that at the three most recent lows in the S&P 500 (green circles) that the number of stocks reaching their 52 week lows rose sharply, suggesting panic selling, marking a bottom from which 6-12% advances occurred. Last week's important drop of the S&P 500 below the January closing low did not reflect the gloom that usually accompanies market bottoms, as barely 10% of NYSE stocks were at their yearly price lows. This suggests that there is more downside to come before pessimism is pronounced enough to establish a market bottom.

Just as important are areas of market support and resistance that can be gleaned from price movements over the past couple of years. As you see in the chart below, the S&P 500 has broken strong levels of support that held prices up over the past two years. The two blue horizontal lines in the top clip show the support areas that gave way in January, leading to the intra-day price low in the S&P 500 of 1275 on the 22nd (though it closed at 1310, above Friday's close of 1293). What is telling about the subsequent rally from that low point is it stopped in the former support area, which then acted as resistance to further gains. This is typical of bear market rallies, as former buyers who bought stocks at levels near the first two green arrows in the top clip, now rush to "get out even".

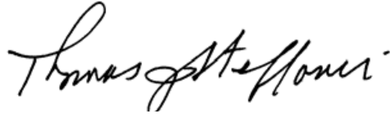
The bottom clip shows a measure of price momentum. That measure has turned down (red arrow) suggesting further declines in the S&P 500 are probable. How much further?
One possibility is the 1225 area (green horizontal line) which could offer support. That would be another 5% from current levels, and would represent a decline of 22% from the October high.

But there are other possibilities. According to Ned Davis Research, the average decline for a bear market since 1929 has been 30%, and has lasted about 12 months. If the current bear market follows the "average", we could expect the S&P 500 to bottom around 1100 in about seven months. The median decline is 27% (1150 on the S&P 500) lasting nine months.

The economic and financial market dynamics surrounding equity bear markets have their unique features that can make the magnitude of stock market declines depart meaningfully from the average. The financial market dislocations today appear as serious as those in the 1970's. Then, the hyper-inflationary economy, oil supply disruptions, and bank failures wrought havoc with regulatory policies, created massive investor apprehension and uncertainty, spurred new international capital requirements, and increased regulatory oversight. Stocks fell by 45% between 1973 and 1974.

Today, much of the financial market infrastructure is outside of direct regulatory oversight and may not be able to withstand the torrent of credit failures emanating from such an important part of the economy – housing and the conduits

financing it. The ripple effects of the housing bubble-burst are becoming more visible and the traditional policy responses are being acknowledged as incapable of stemming the deterioration in household net-worth and financial institution asset values. Heretofore policy options considered too far reaching are now possible, including mortgage principal forgiveness and Federal agency refinancing of delinquent mortgages. These measures can have far reaching effects on the integrity of private contracts, the future shape of the mortgage securities market, and the availability of credit. Let's hope that all of this has (mostly) been discounted in equity prices.



Thomas J. Steffanci, Ph.D.
President and Chief Investment Officer

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Glencrest Investment Advisors, Inc. • 1490 Claremont Boulevard, Suite 100 • Claremont, CA 91711
(800) 257- 6650 • Fax (909) 447-2098 • www.gleninvest.com