A Sliver of Light

March 17, 2008
Weekly Market Beat

Just another normal raucous week in the financial markets. No sooner did the Fed announce on Tuesday still another “credit facility” to help the orderly functioning of the financial markets, than we hear of Bear Stearns having a liquidity crisis. Counter-parties of that broker were demanding more loan collateral (which happened to be plunging mortgage securities), credit lines were cancelled, and clients who bought credit default insurance from Bear Stearns were pulling out of those transactions, demanding that Bear Stearns buy them back. The broker was allegedly on the brink of insolvency because of the resulting cash drain on the firm.

The hastily arranged bailout Thursday night of Bear Stearns by the Fed and JP Morgan Chase allowed JP Morgan to sell Bear Stearns collateral (mortgage securities) to the Fed for 28 days, providing temporary cash for the broker to meet liquidity demands. This action set market expectations onto a new perch of uncertainty about who was next (Lehman most mentioned) and whether “Feddie” (the Fed) was joining Freddie Mac and Fannie Mae in being a major buyer of mortgage securities (and mortgages themselves), and formally establishing the U.S. as “Bailout Nation”. The odds are, however, that JP Morgan will wind up acquiring Bear Stearns with financing support from the Fed.

Of course, if you snoozed through the entire week and looked at the Dow Jones Industrial Average at Friday’s close, you would have yawned at the fact that index was actually ahead by a mere 0.5%, but what a wild ride it was. The Dow traveled 847 points during the week to end only a net 57 points higher. Talk about volatility. Tuesday’s 417 point gain was the biggest one-day rally in five years.

Speaking of volatility, I want to revisit a Widely followed measure of volatility of the S&P 500, called the VIX. We talked about this measure in the January 28, 2008 *Weekly Market Beat*. As you may recall this is a measure of the market’s expectation of the movement in the S&P 500 over a 30 day period. The higher the reading the more uncertain are investors about the future. The graph below shows the VIX in the top clip and the S&P 500 on the bottom.

One can see that market uncertainty is near recent extremes (top arrows), but during such times of high anxiety, the stock market has been in the neighborhood of a low (bottom arrows). It may not have been the ultimate low point, but meaningful market rallies usually begin around such periods of extreme fear. If a short-term low is approaching, what are the prospects for market gains? One benchmark is the former support levels for the S&P 500. We would expect that these levels would offer resistance on any rally. The AB line in the bottom clip shows that a level of around 1,400 on the S&P 500 would most probably be the extent of an upside movement from here. That would be about a 9% gain.

With bearish sentiment at near extreme levels, and market anxiety over another bailout shoe to drop, stocks may be ready to fool the majority and stage a spirited rally. This week's Fed meeting outcome may offer some positive market surprises. The Fed may do this through a display of its willingness to deeply cut the Fed funds rate or through an accompanying commentary about its willingness to do what it takes to stabilize the credit markets by accepting less than AAA-rated mortgage collateral from brokers directly, in exchange for Treasuries or cash.

My view continues to be that we remain in a bear market downtrend, but sharp rallies during bear markets may occur frequently. In fact, according to Ned Davis Research, the median gain for rallies in bear markets since 1929 has been 11.5%, and last about seven weeks. The sharpest rally since the October 2007 market peak occurred from November 26-December 10 of last year when the S&P 500 rallied 7.7% and lasted only 14 days. The latest rally from the January 22 low to the February 1 high was 6.5% lasting a mere eight days. Both of these advances are decidedly modest, based on history. A rally in stocks from here, however, can give investors an opportunity to re-appraise their risk tolerance and provide an opportunity to adjust their portfolios in the event of another leg down.

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*There will be no **Weekly Market Beat** next week*

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