Walter Deemer's

MARKET STRATEGIES AND INSIGHTS

...for Sophisticated Institutional Investors

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A DECISIVE BREAKDOWN. WILL ARMAGEDDON FOLLOW --
OR JUST ANOTHER TEST OF THE LOWS (OR EVEN LESS)?

The S&P fell through its 868-875 support rather emphatically on Friday; after five straight down days that took the S&P right down to its support level, it could only manage a one-day rally before the selling resumed in full force. The breakdown has very negative intermediate-term implications; the S&P has now completed a three-month head-and-shoulders top that yields an objective down in the 785-790 area, and Friday's breakdown was about as clear-cut and decisive a breakdown as one will ever see in the stock market.

But hold on a minute: the breakdown comes against a very bearish background. Rydex players (whom I am convinced represent hedge fund activity in general, and are thus the tip of a very big iceberg) pumped a massive $535 million into Rydex's bearish funds during the six days ending last Thursday (Friday's figures are not yet available). This drove bearish fund assets above the October record of $1606 million to a new-record $1659 million – and Friday's increase in the bearish funds' NAV's suggests that the total is now probably close to $1740 million. The $535 million inflow means 32% of the money in Rydex's bearish funds has come in during just the last six days; an orgy of bearishness which suggests that a lot of negative sentiment is already in the market. In addition, sentiment measures in other markets suggest that they, too, are close to major inflection points; bullish sentiment on the dollar is as low as 12% in some surveys (Market Vane) and bullish sentiment on gold as high as 88% (Market Vane and Jake Bernstein). It's not just the stock market that is at a sentiment extreme here.

We thus have a clash between a record amount of active bearishness in the stock market, which is positive, and a decisive breakdown in the averages on Friday; a clash which is taking place against our basic working assumption that the stock market made a four-year cycle low last July-October. This sets up three possible scenarios, which are:

1. A decline that falls short of the market's downside objectives. Given the intense amount of bearishness and the supposedly positive influences of the four-year cycle, this could happen. The biggest problem with this scenario, though, is that it means that one is fighting the tape – and it has not paid to fight the tape on the downside for the past several years. If this happiest of the three possibilities is to come to pass, then, the market is going to have to break out of its current tailspin – and quickly; it has generated a lot of downside momentum during the last seven days, and it must break that downward spiral soon if the S&P is to have any chance of holding well above its prior lows.

2. A test of the July-October lows. This, I suspect, is the most likely scenario at this point; every downside breakout in the market during the past several years has turned out to be a significant one, and the three-month head-and shoulders top that has just been completed yields a downside objective of 785-790. This objective is about 10 points above last July's

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intraday low and about 20 points above October's intraday low and 10 above October's closing low, which would all correspond with a successful (albeit deep) test. It goes without saying, of course, that a decline below 800 would not be at all pleasant to live through -- and there can be no guarantee beforehand that a test of a prior low will be successful (although it should be if the four-year cycle is where it is supposed to be).

3. <u>A new leg on the downside.</u> I feel strongly that last July was a benchmark low in the stock market, that last October was a successful test of that low, and the combination was a four-year cycle low – all of which argue strongly against the market staging a new leg on the downside here. As we illustrated in our last report, though, the market's recent failure to get through its late-November high, 939, is ominously similar to its failure last March to get through 1170, a failure which led to the April-July bloodbath in the market, and another such bloodbath is thus a very real possibility here. The four-year cycle, though, should mean that the possibility is only a minimal one.

The Bottom Line. Despite my conviction that the market made a four-year cycle low last July-October, I made a pact with myself that if the S&P broke 868, thus setting up at least the possibility of another test of the prior lows, that I'd take some defensive steps. Specifically, I planned to sell one of my four mutual funds and put the proceeds into a Rydex leveraged short fund (thereby reducing my long exposure form 100% to 25%). Given the huge increase in Rydex bearish fund assets during the last six days, though, I just can't bring myself to do that right now. This could turn out to be a huge mistake – but if the market HAS made a four-year cycle low, as I am convinced it has, this decline could reverse suddenly and without much notice. (The reversal could also – finally – lead to a breakaway-momentum generating advance and a 90% Upside Day, although a day that generated the criteria we've been looking for to confirm that a new upleg has begun – a day with advances more than four times declines, upside volume more than nine times downside volume and total volume over two billion shares -- would be cause enough for celebration.)

Whatever the case, if the market has, indeed, made a four-year cycle low the odds of a pleasant surprise are higher than they've been for the last several years, and I am thus going to hold my long positions, for better or for worse, here. I fully recognize, though, that this would have been a terrible strategy to follow after similar breakdowns during the past several years, and I also realize that other people's thresholds of pain may not be as high as I think mine is. If you'd like to take some defensive steps until the market generates those start-of-a-new-upleg criteria, then, I can assure you that you won't be fighting the tape.

-- *Walter Deemer*