

## MARKET COMMENT

### IT'S NOT "HOW LOW", BUT "HOW L—O—N—G"

September 6, 2007

The party was abruptly interrupted. There was panic at the pool. But now that the storm has calmed, the question arises: "Is it safe to get back in the water?" Our answer is clear – the ongoing recovery rally is most likely to fail and should be followed by a test of the August low. The next low may not be lower, but it may take some time to get there.

**MARKETS NOW:** Since late June, Market Comment has been on the alert for a "short sharp shock" and suggested the early July advance as a "selling opportunity before a cyclical descent." Many negative factors were cited, among them:

- The 39-week cycle appears to have "left-translated" and is pointing down;
- The months of September and October are historically weak;
- The "seventh year of the decade" has a nasty track record (see our "The seventh year itch – MKT-160, March 19, 2007).

The action of the last few weeks confirmed our forecast. After months of speculative activity and sky-high expectations, the North American markets needed only a nudge to be pushed over the edge. The "excuse" (the subprime saga, the economy, the failed breakout) has arrived on time, triggering waves of heavy selling. The markets made a primary low on August 16, as evidenced by a record volume-reversal (the so-called 10-to-1 day) and extreme volatility.

The decline in the market affected the investor's mood. The latest readings from the American Association of Individual Investors show that bears now outnumber bulls (43.1% vs. 41.3%) and a similar conclusion is apparent in the Hulbert Stock Newsletter Sentiment Index, suggesting that the average short-term market timer is out of the greater stock market.

**Do these readings suggest that the worst is over for stocks?**

They certainly suggest the significance of the August low; however, they still leave room for more "flashy" readings that could accompany the anticipated test of the August 16<sup>th</sup> low, for a number of reasons:

- the advance is characterized by low volume, is running against a heavy wall of resistance and has negative cyclical/seasonal factors,
- the "back-to-school" period has a long history of weak showings,
- September has a history of being the worst month of the year,
- the "left-hand translated" 39-week cycle is pointing down until October.

Therefore, it seems that (notwithstanding Mr. Bernanke's

speech last Friday) October will be the most probable time to stage a test of the August low. This is supported by precedents (1970, 1974, 1987, 1998, 2002), which show that the secondary low usually occurs 6-9 weeks after the primary low. It is possible that the markets will stay above their primary low on a closing basis ("not how low, but how long") -- more evidence should become available in late-September.

**The emotional dynamics of the July-August decline, the August 16<sup>th</sup> reversal and the historical records show a strong probability that after the current recovery rally the markets will stage a retest of their August low in about 6-9 weeks.**

**STOCKS COMMENT:** Since late July, we have closed out numerous positions in anticipation of a weaker market. These stocks violated their 200-day moving averages during the recent decline, which, in many cases, also turned down. These stocks should be avoided as they are most likely to fall further and under-perform. At the same time, the stocks that remain on the BUY&SELL list show good relative strength and should survive.

We have begun to publish a "shopping list". Should the stocks on this list stay above or in close proximity to their 200-day moving averages by mid or late-October, they will become the premier buying candidates for the next bull market and will be moved from the "shopping list" to a "buy list".

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