



October 10, 2008: Bottom of Historic Bear Market

Internal Bottom, With the Last Two Months as Bottom Camouflage

By Don R Hays

Summary: After the drubbing we Long-Only stock investors have taken in the last 14 months, every prognostication is spoken with a little nervous tremor in our voice, but it sure is looking more and more like that MOST BULLISH P-1 psychological signal given on October 9th called the “internal” (and most important) bottom in the worst 12 months’ bear market in our 40-year career.

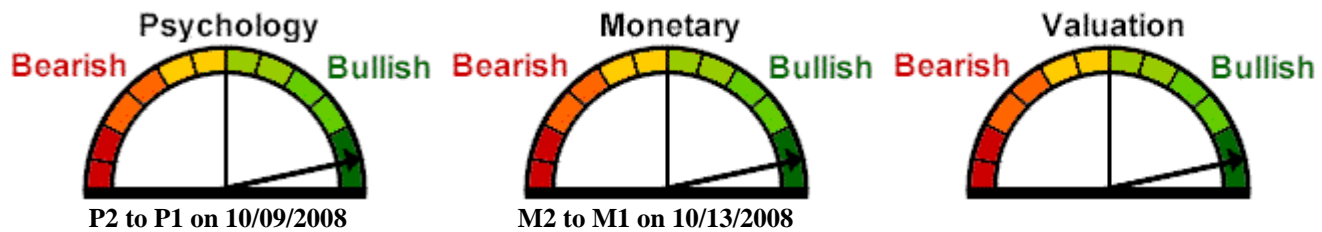
Of course Mr. Market never makes it easy, so he has hidden this bottoming formation with a master camouflage as he drove the major indices to that final low on November 21st, but it wasn’t even close as to the number of stocks on the NYSE or the NASDAQ that also followed the indices into that new low territory.

But you know, it took that last “shaking” to wake up those hawkish Fed Presidents, Mr. Plosser, Mr. Lacker, Mr. Hoenig, and Mr. Fisher, from their “raising rate” trance, into now allowing the Fed Funds target to actually track the market 3-month t-bill rate. I hope they can be kept awake for at least a season to allow the bruises to heal. It sounds like they are committed to listening to the market, and the stock market sounded a mighty starting gun.

Jason Goepfert who tracks everything in his www.sentimentrader.com site, from sunspots to bunions and how they affect the trading patterns of the market, tells us that moves like yesterday after FOMC announcements have only occurred four times since 1995. His work shows that in all cases, equities pulled back over the next 1-4 days, but then resumed a rally lasting from a few weeks to a few months. In every instance the S&P held above their pre-announcement level.

We are looking at everything in relation to the “box of camouflage” that has enveloped the market since October 10th, 2008. We believe this will prove to be very much like so many other major bottoming formations in history. We have looked at the stock market since its official beginning back in 1897, and we see so many of these severe bear markets that have seen the Dow lose 20% plus in relation to its 5-year moving average. There is a huge probability that once the trend turns up it will not look backward. So if you want to use just the 50-day moving average as your guide, we are very close to that upward signal.

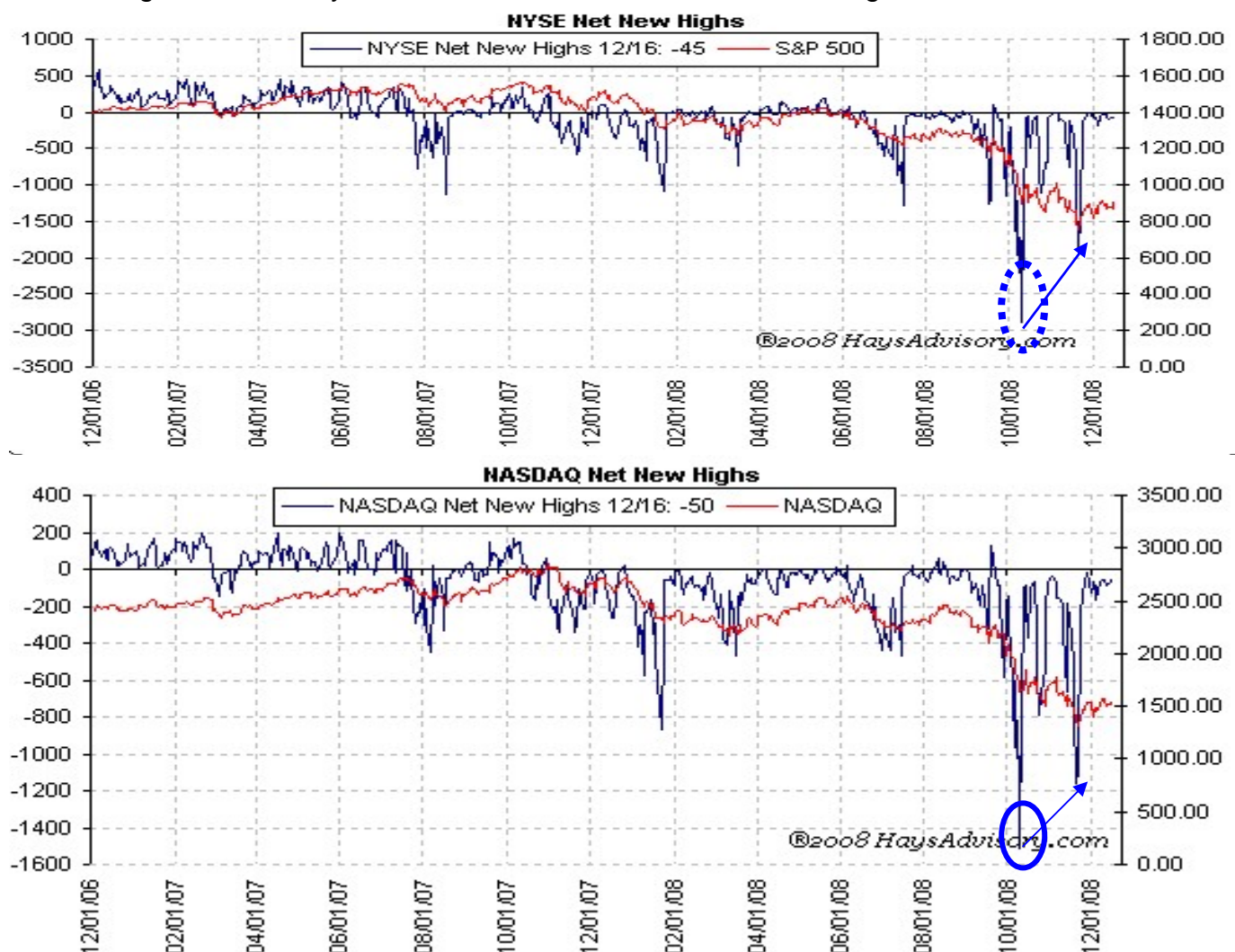
Psychology, Valuation, and possibly in the next day or two (okay, maybe week or two) we will also have Momentum teamed up to kill the Bear.



Internal bottoms can only be verified in hindsight, but there is little doubt that the level of fear by those historically very "wrong" groups of investors (i.e. equity option traders, Rydex traders, 10-day Arms, Option Volatility gauges), and the level of optimism by the very smart, astute investors--as measured so effectively by things like insider buy/sell ratios, reached historic levels on October 9th and 10th. Historically, these kinds of levels will stop even the most ferocious herd of bears.

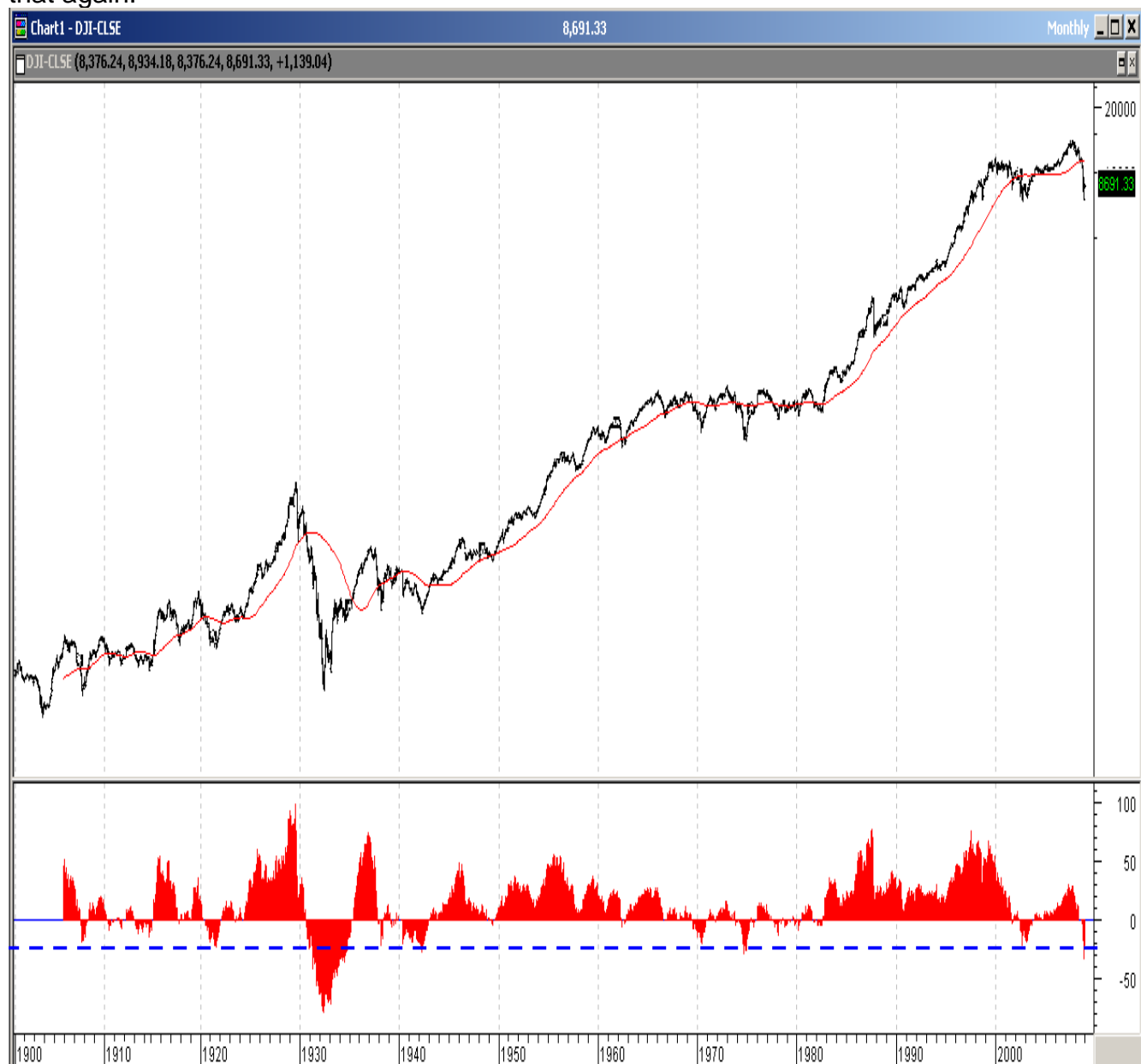
There is little doubt as well, that the yield curve (the most accurate of all monetary gauges) reached the steepest and most bullish slope in history as of the data on October 13th. And when you flip over to the Valuation, according to the very accurate long-term (5-year) correlation of the Value-Line Appreciation Potential, we find that in 40 years the stock market has only been this cheap at two prior spots in history—1974 and 1982.

So the stage was certainly set on October 10th, and this is what we got.



You can see the red line (indices) continued to be dragged down until that low on November 21st, but it is significant that we did not see nearly as many stocks tagging along. Don't get me wrong, we had a very scary new low, and it opened up the sweat glands very profusely, but that is what it took.

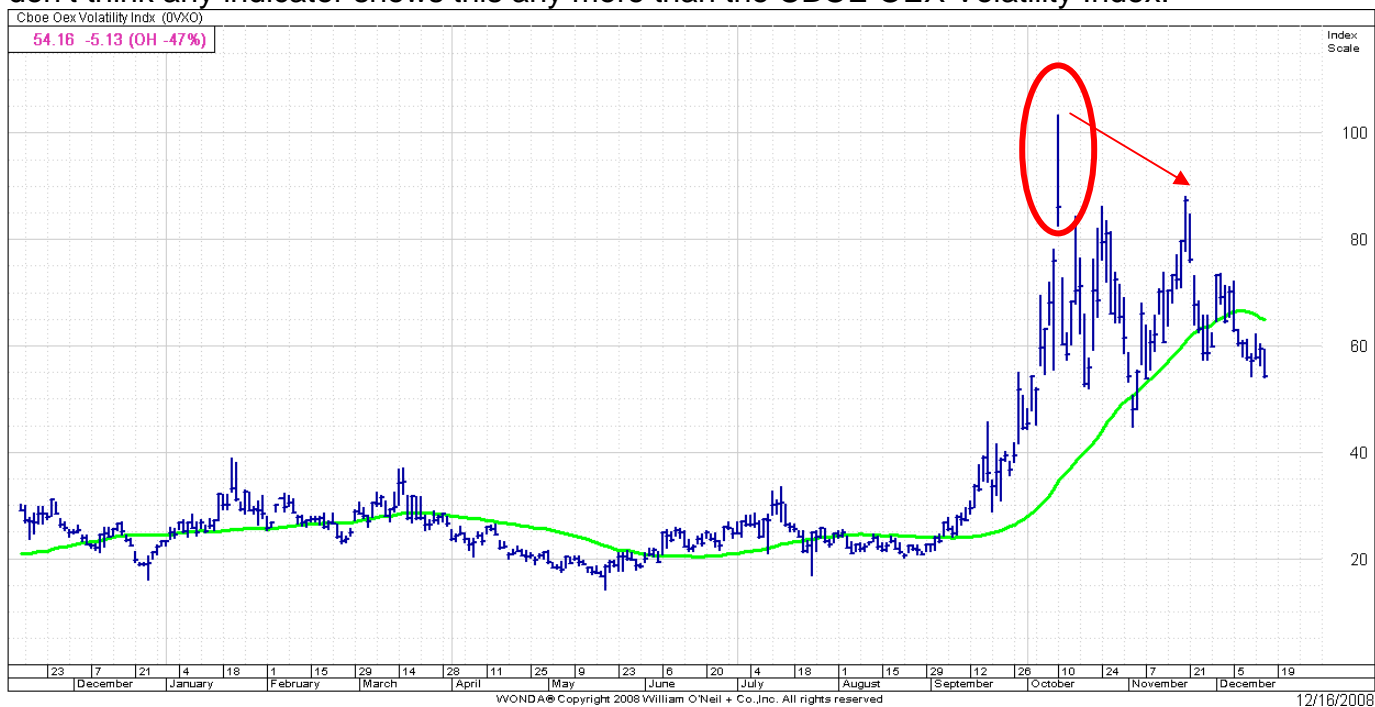
I also want to remind you of the chart we've put in this report a couple of days ago of the Dow Jones Industrial Average, and plotted the deviation from its 5-year moving average. Let me add that again.



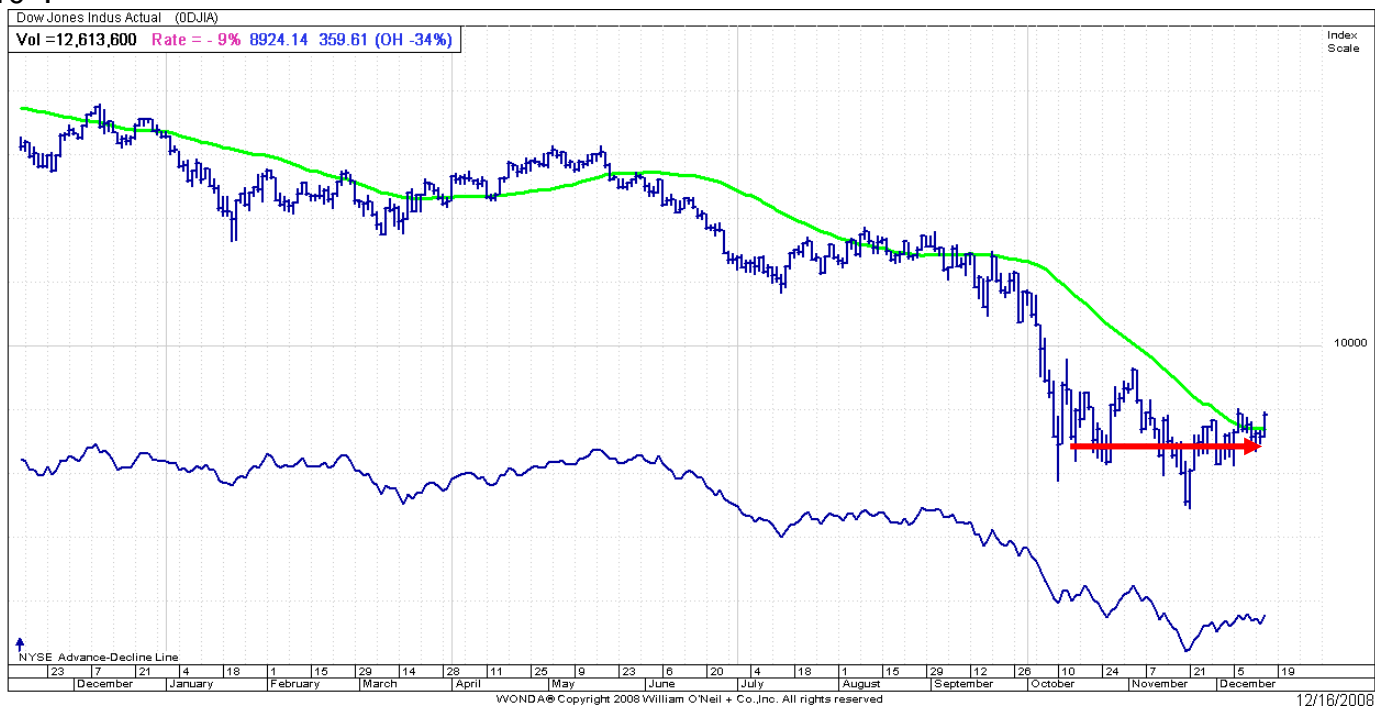
You can see that the deviation from that moving average has just dropped down to similar levels reached in every "worst" case of the last century except the 1932 example. This "deviation from trend" is interesting, because you typically get it when the preceding 5-years have produced some peak optimism, and then the trap door is sprung and it absolutely annihilates the optimistic spirits. No-one can tell for sure that this is not another replay of 1932, but the action of the Fed, the unilateral action of the international community, the action of the Treasury provides so much support that was not available or even understood in 1929-32, it eliminates that experience re-occurring in today's environment in our opinion.

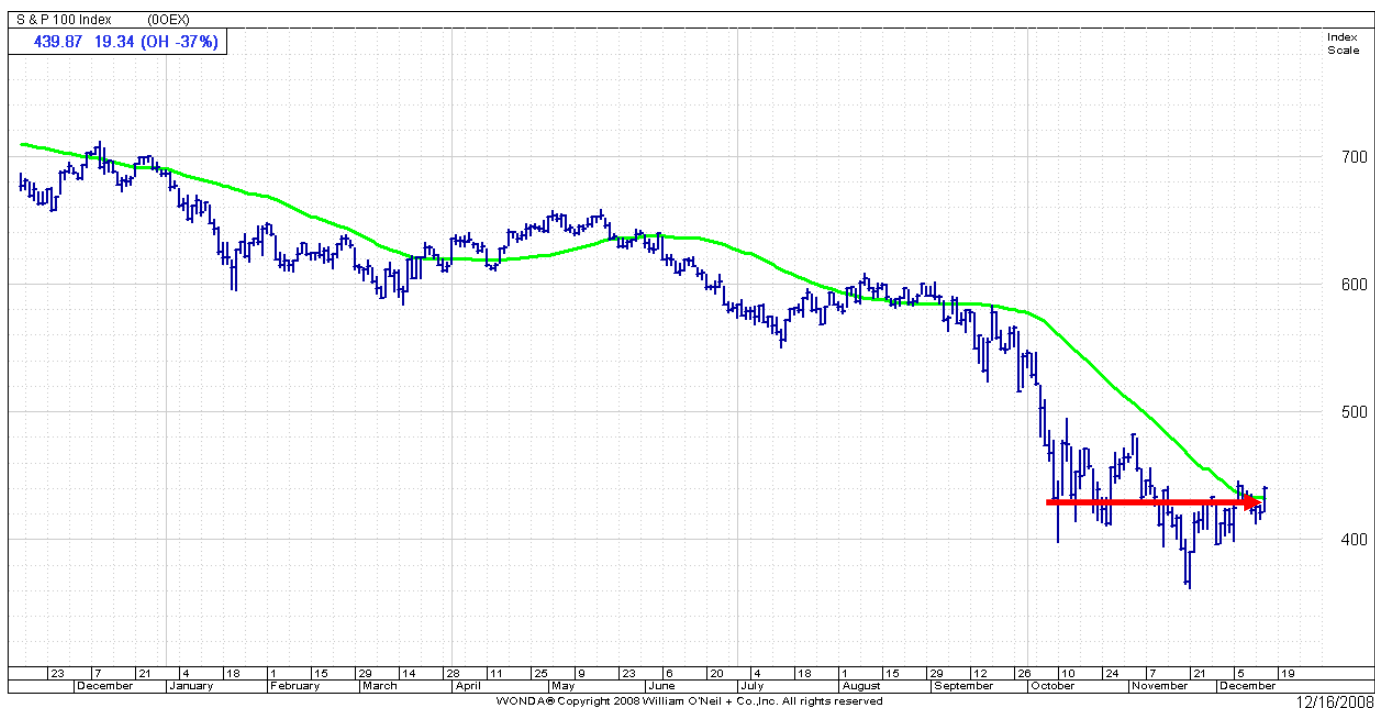
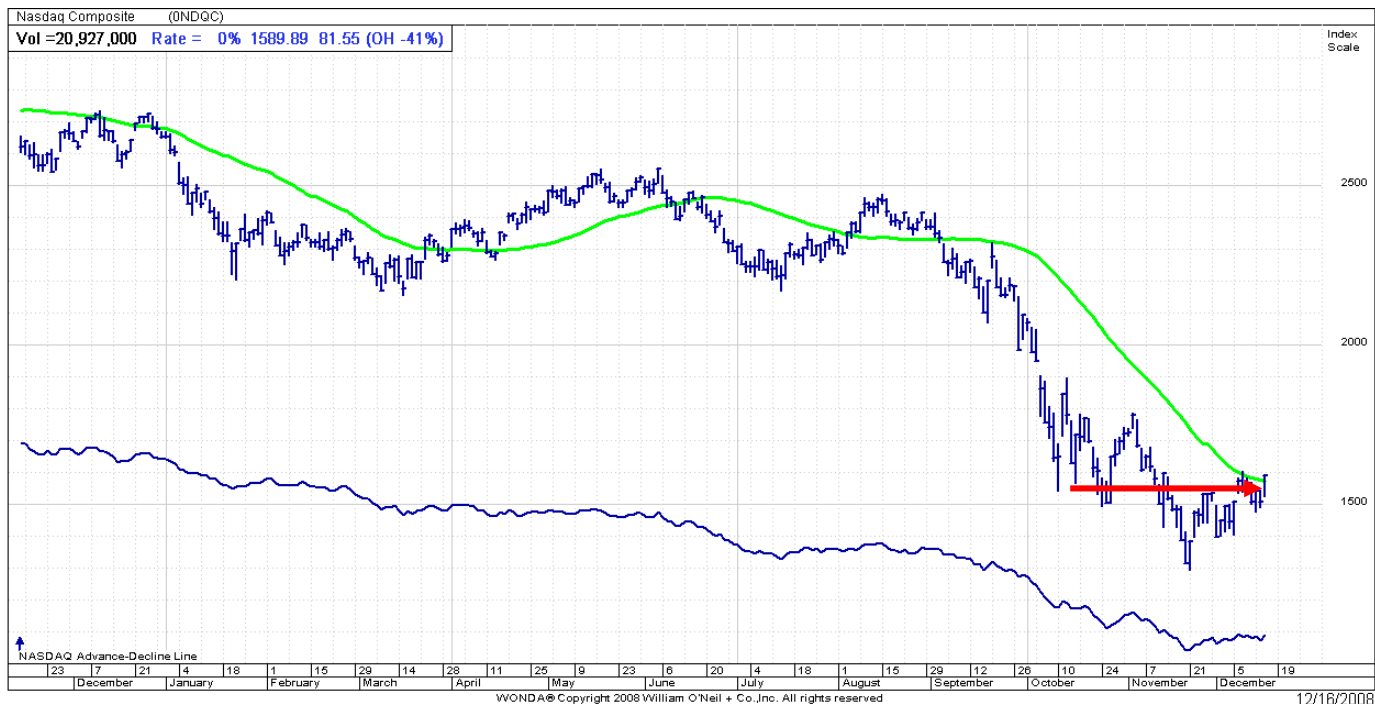
The investors of today, however, were being forced on November 21st to look into that cavern, and had to calculate whether or not they could weather the storm. Many could not, and as a result threw in the towel.

I don't think any indicator shows this any more than the CBOE OEX Volatility Index.

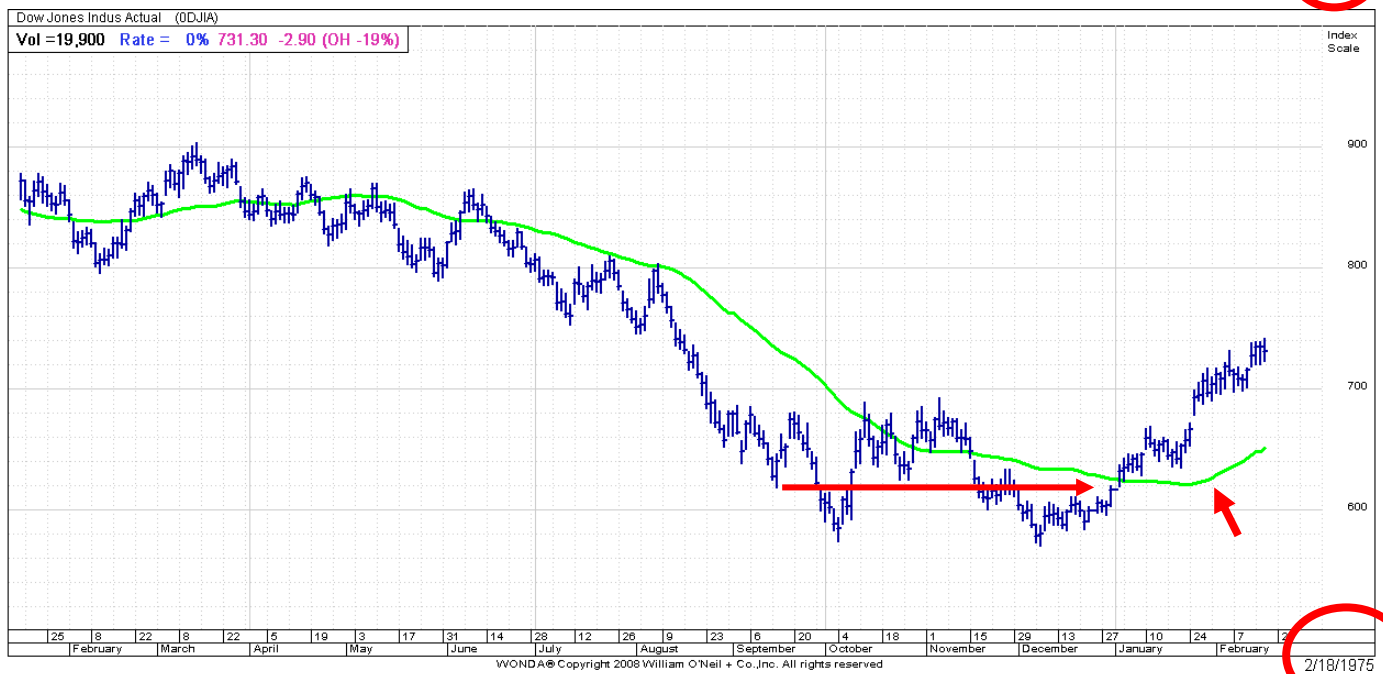
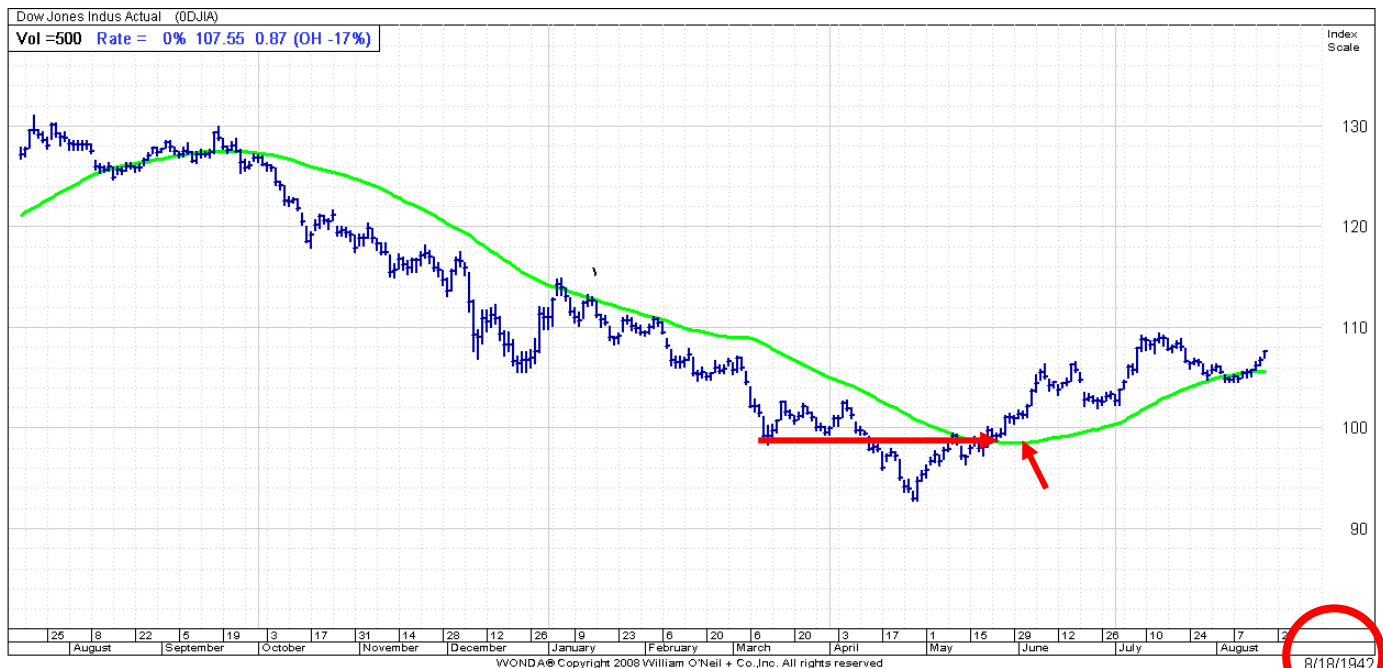


If we can now step back and look at these last two months with this perspective, you can see this shake-out that now appears to have made a base with that level that was traced out on October 10th.



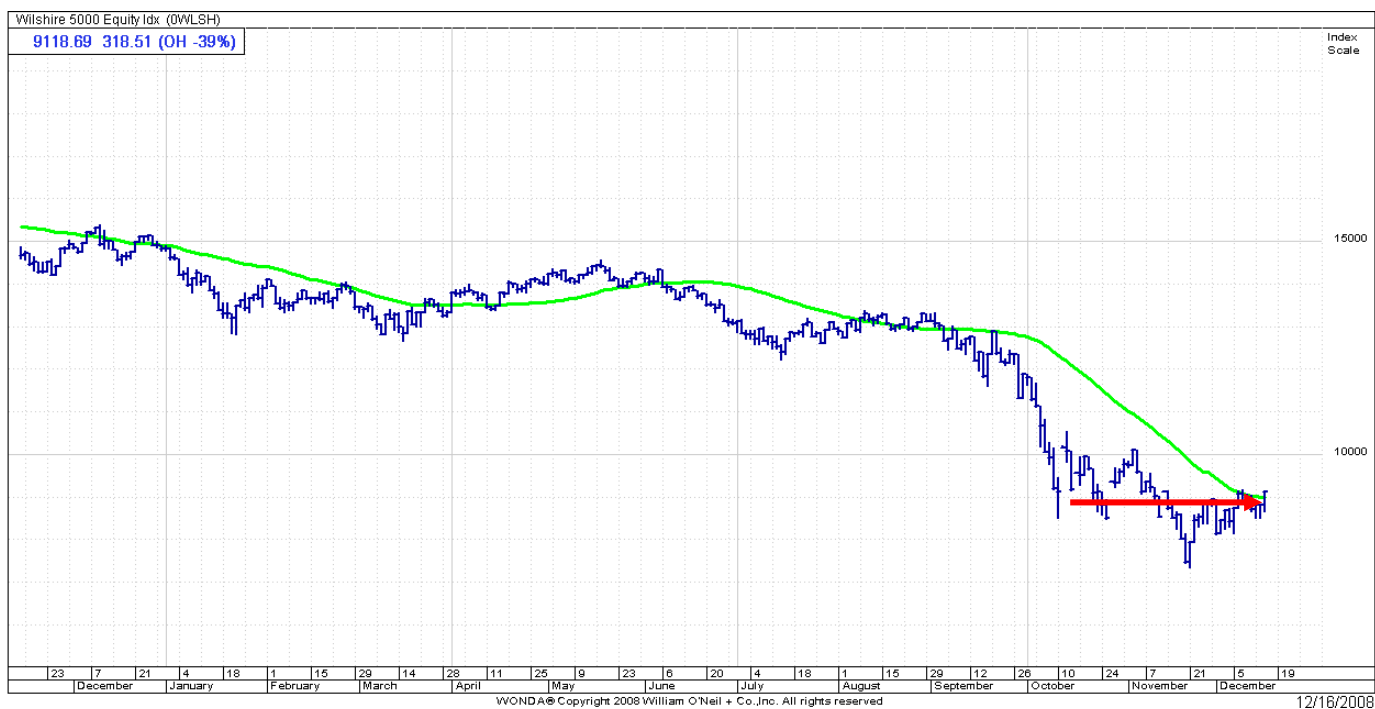
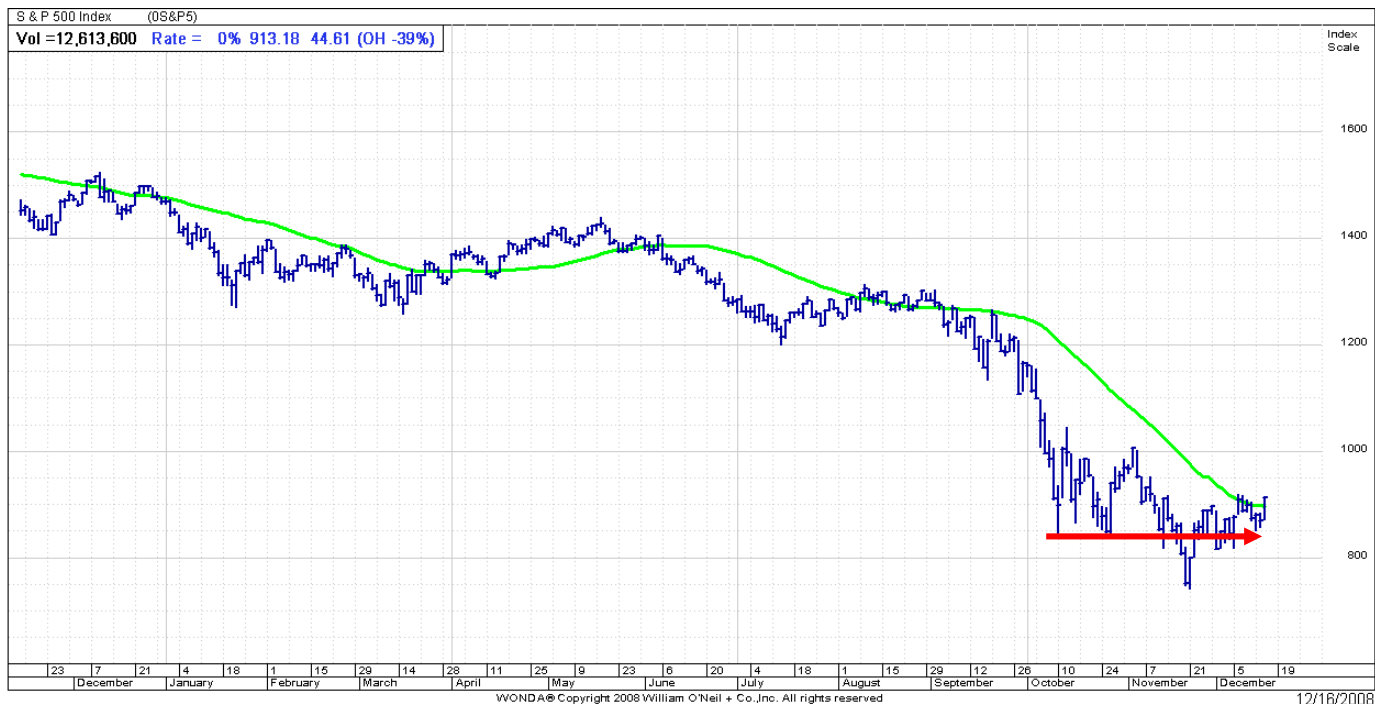


The green line is the 50-day moving average. If you look back to those other times when the deviation from the 5-year moving average has exceeded the -20% level, in the vast majority of cases the end of the devastation came concurrent with this 10-week moving average being penetrated and then turning up. Let's look at those two situations in 1942 and 1974 that have so much similarity with today's market.



So the bottom line—Psychology at P1, the yield curve is enormously bullish, and the Valuation is cheaper than all level of the stock market except for 1974 and 1982, and there is a very distinct bottoming process developing that looks so much like historic bottoms of the past.

Here is one more glimpse of today's stock market.



The 50-day moving average has not given that final confirmation by turning upward, but if Jason Goepfert's study is right regarding the next few weeks of months, it will only be a matter of time—a short time. Keep your fingers crossed.

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