

Don't Go Where The Markets Are - Go To Where They're Going

It's hard to justify a portion of the January Bear Market selloff when you go back and review the earnings reports of Apple, Research in Motion and Google. Where's the justification for selling off Apple \$60 when it remains one of the true growth names in the U.S. with no exposure to mortgage risk? But I say only a portion of the market is undeserved of the Bear, the banks and lenders and mortgage insurers remain the center of the carnage due to billions in bad mortgages.

This all started primarily due to mortgage defaults in the range of 40-50% in California and Florida. The defaults created massive questions about the validity of the value of mortgages written by: Countrywide Credit, Washington Mutual, Citigroup, National City, Wells Fargo and Wachovia. Should we extend the calamities of the mortgage issuers to Google, RIMM, Apple, and Vimplecom? That seems like the wrong bet to me.

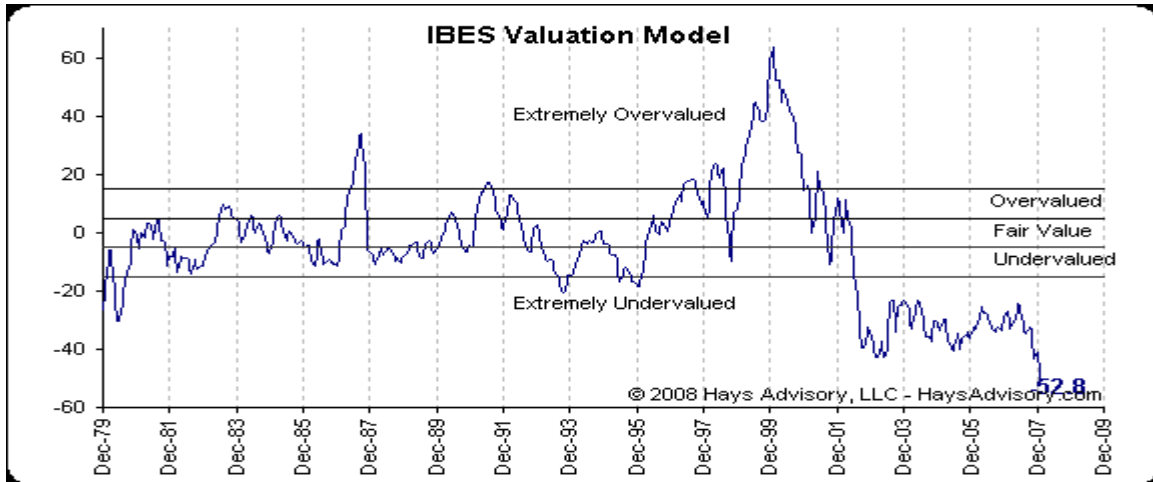
The problems have been exacerbated by the perception that Bernanke at the Fed just didn't get it. Fed Governors seemed oblivious to the domino effect of the credit problems by focusing on inflation. But this Tuesday, January 22 the markets forced his hand and he cut by 75 basis points. This means the days of the Bear Market are numbered and the Fed will probably move from being behind the curve to moving ahead of it. The stimulus derived by this new round of mortgage refi's and bipartisan fiscal stimulus will engage the economy six months from now, but for the moment nobody cares.

This has been an unusual Bear Market in that all three of the three basic ingredients for a Bear (high stock valuations – investor exuberance and a Fed raising rates) were absent. This is probably due to the speed of decision making of the market's dominant investors (hedge funds) and rapidity of information processing via the Internet and direct access trading. But is the lack of previously essential ingredients of a Bear the start of a new trend? One incident does not make a trend but it deserves close attention. Had we had some sort of excessive enthusiasm in the late Fall of '07 we would have raised more cash. The drop is painful but from experience the pain of the decline is lessened by the speed of the decline. In other words, at least we don't have to wait 10 months for the Bear to live its life; this Bear will likely be about 4 months.

January 21, 2008: the Fed has lowered the Fed Funds rate by 75 basis points and the markets sold off in waterfall fashion but a crash was avoided by the Fed actions. This is very good news and a strong antidote for stabilizing world markets. I am seeing peak readings in sentiment indicators, put/call ratios and the VIX that have occurred at the bottoms of previous Bear markets including the worst of my lifetime (2002) and the probability of the markets putting in a floor to build from is growing high. By the time you read this, the market floor will probably be in place but there will be 2 or 3 retests of the lows before a significant advance will take place.

A by-product of declining interest rates is that the relative value of stocks increases and the value of bonds decreases. Stocks are more undervalued now than they were in the dark days of 2002. At present levels our model shows stocks 52% undervalued relative to bonds, a phenomenal figure.

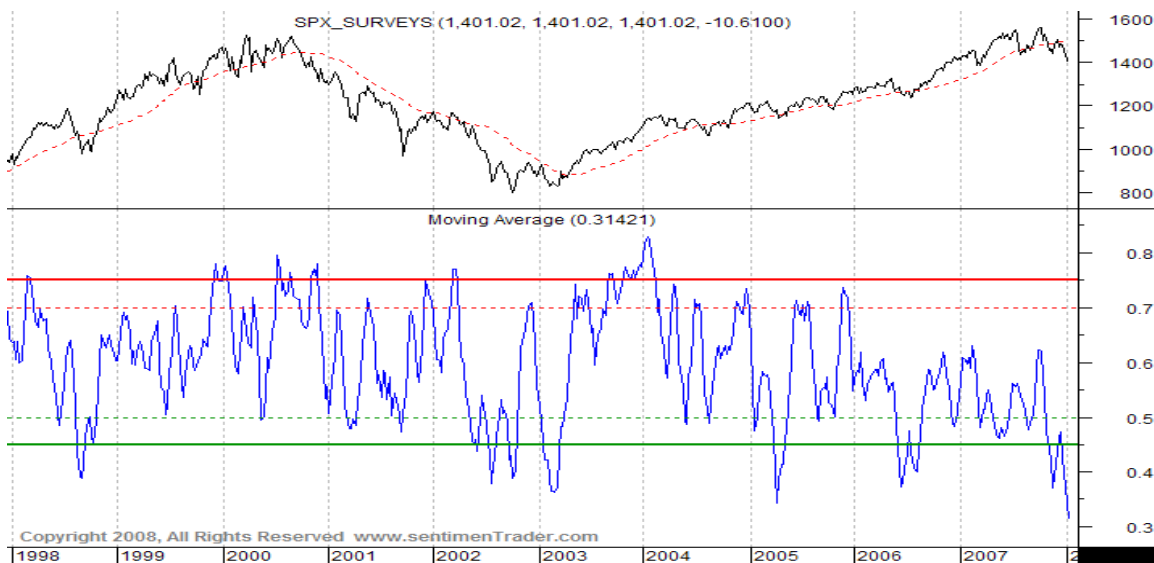
US stocks are unusually cheap:



There is little doubt in my mind that a recession is upon us and although recessions are typically fairly brief (a matter of months) there will be a growing assumption that stocks have adjusted to the recession and in a matter of months will begin to discount the emergence from recession.

Discounting the emergence from recession will be especially visible if the administration and Fed officials take decisive action to stabilize credit and mortgage markets. This is why its so critical to realize that's its too late to sell since the stock market rapidly discounts news into the future. Despite the appearance of a tardy Fed, eventually the full impact of the rate cuts will have their effect and with the addition of election pressures to create stimulus packages we will soon work out of the recession.

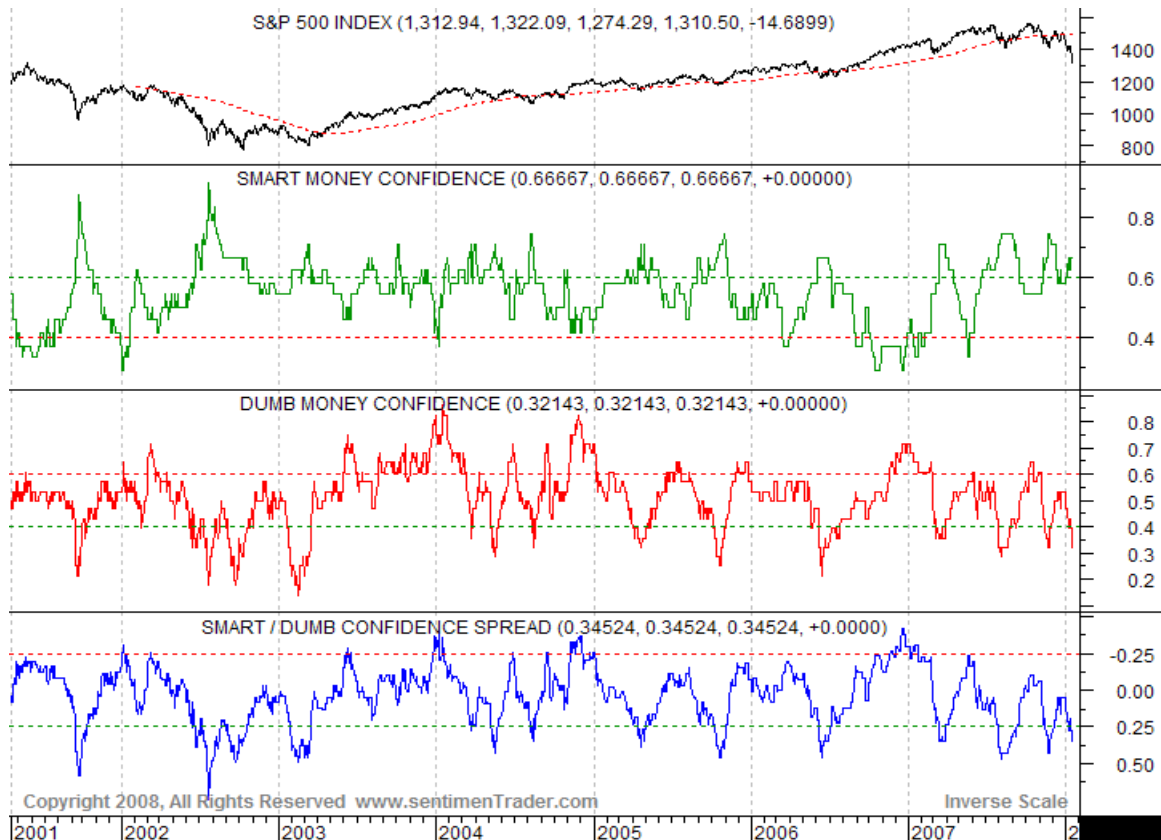
What is especially amazing to me is the level of fear that is reflected in statistical trading patterns of typical wrong way investors like the American Assoc. of Individual Investors. Note the chart below; they're more bearish now than they were in 2002. With this type of emotion existent the bottom of the market is near.



Typical wrong-way investors are leaning to an extreme once again: AAII Bull/Bear ratio

The AAI (American Association of Independent Investors) percentage of bears rose to 59.0% this week from 54.4% the prior week. This reading is an extraordinarily elevated level. The last time the AAI % Bears was this high was October 18, 1990 after Iraq's invasion of Kuwait and before Operation Desert Storm began on January 17, 1991. The peak of the 1990-1991 recession also occurred during 4Q 1990 as GDP fell 3.0%. The S&P 500 rose 65% over the next three years after this peak in bearishness. Since 1987 the AAI Bull/Bear ratio has reached this level 23 times, in the following 12 months the average gain of the SP500 was 21.75%. There were NO instances of a decline.

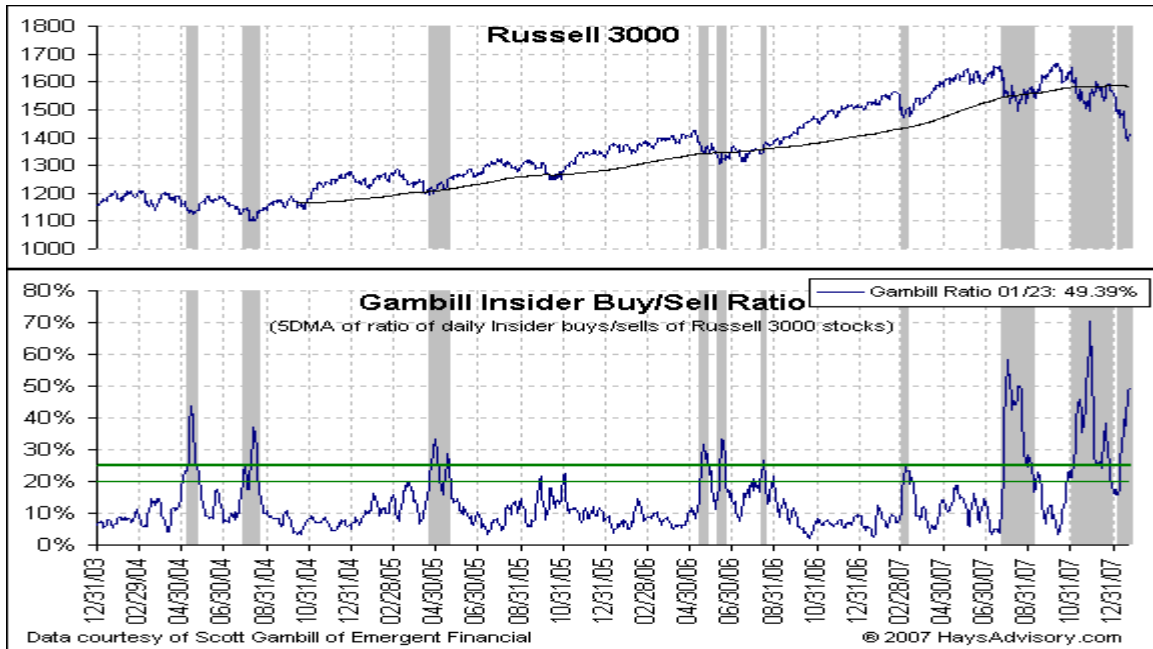
In further support of our thesis, one of my favorite graphs by Jason Goepfert reveal that the Smart Money and Dumb Money are once again at opposite extremes:



The blue line in the bottom graph is the most important, as it now states emotions are at an extreme and a counter trend move is near.

Major market moves occur when a minority opinion becomes the majority. The shift in sentiment forces market players to adjust to new circumstances and data.

Major Insider Buying: There's something else going on that validates and upcoming return to market highs: Insider Buying. The rate of Corporate Insiders buying stocks is sky high. Insiders tend to act like "smart money" as who else knows a company better than an insider?



Gambill Ratio: The stock market rises on average of 22% in 12 months when the Gambill Ratio rises above 25%. As the chart shows its actually at 49.39%. Insiders tend to prefer to buy their shares when they're cheap and business is good.

To sum it up: No doubt we've just experienced a wicked and frightful bear market. The culprits are isolated to mortgage related companies and insurers. But I think it's a very bad bet to assume that great growth companies like Apple, Google, Vimplecom, Research in Motion, Solar stocks, etc. should be thrown out with the Countrywide Credits and Ambacs of the world.

Where are stocks going? Once the market realized that the Fed will soon be moving ahead of the curve with accelerate Fed cuts and fiscal stimulus packages, along with the massive mortgage refinancing going on, we'll find this to be what will likely be a short recession. By 1/28 it appears the decline may be over and after a period of waffling, equities should move back higher. Hopefully we'll reach a point of excessive enthusiasm where we can take profits. This was not the case in 2007, where we never reached the point of excessive exuberance

Where will the next crop of great growth stocks come from? Probably from worldwide companies who're the top 5% in revenue and earnings growth...just the kind of stocks we have now. No changes there.

Look for a rally of major proportions, along the line of our current Presidents approval ratings commencing very soon. Sure, there should be one or two more retests of the lows that will frustrate and rattle investors. Market retests are like aftershocks from an earthquake. They're normal and part of the bottoming process but are lesser in terms of damage.

The next move should be sharply higher.

Sincerely,
 Brad Pappas