

# MARKET STRATEGIES AND INSIGHTS

*...for Sophisticated Institutional Investors*

January 18, 2002

## THE BEST ECONOMIC FORECASTER IS PROBING FOR A BOTTOM

**SUMMARY AND CONCLUSIONS.** The market is not acting well despite some pretty strong indications of a short-term bottom (probably because it is having a tough time deciding just where the economic trough is), but could start to act better at any time now. The main theme of leadership for the foreseeable future, meanwhile, should be mid-cap and small-cap stocks (growth and value alike).

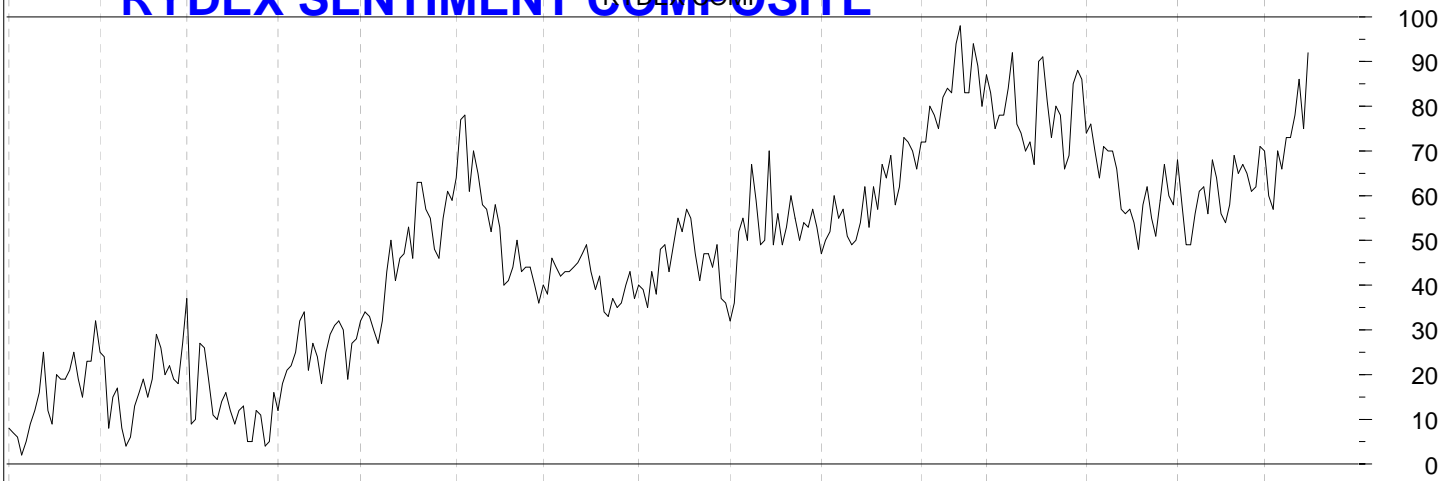
**BOOK PARTY!** Dean LeBaron's 1999 book, which the U. K. publisher never really promoted in the U. S., has just been reprinted by John Wiley & Sons under the new title: "Dean LeBaron's Treasury Of Investment Wisdom; 30 Great Investing Minds". (I am <blush> one of the 30.) To celebrate, Dean is throwing a virtual book party where "you can view and send messages to the authors and other partygoers you meet in the active party bulletin board. Dean and his coauthors will be available throughout the week, often online, to discuss current conditions, the books, or anything else, and a number of the 30 investment gurus profiled in Treasury Of Investment Wisdom will drop by to join the conversation." Like everything Dean does, it'll be different – and fun; join in by going to <http://www.deanlebaron.com/bookparty> between the 23rd and the 29th.

**THE BEST ECONOMIC FORECASTER PROBES FOR A BOTTOM.** The stock market has been staging a rather determined decline during the past week or so in the face of some pretty strong indications of a short-term bottom. The fact that the decline is taking place despite those indications that a bottom is at hand is disturbing, since it means that the market's underlying trend may – MAY -- have weakened significantly in the past few weeks. It is way too premature to jump to that conclusion, though, and we suspect the real problem here is that the stock market, in its role as a leading economic indicator, is having a tough time deciding just where the economic trough is.

The stock market long ago proved that it is the best economic forecaster of all; last year, for example, it was in trouble well before economists detected any problems in the "Goldilocks economy". At cyclical lows, the stock market – which is a leading economic indicator -- tends to bottom about six months ahead of the economy. More reliably – and much more

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importantly as far as investors are concerned -- it then stages the broad and powerful advance that heralds a new bull market 2-3 months before the economic trough. We have been uneasy about the fact that the market has not generated "breakaway momentum" (the broad and powerful advance that heralds a new bull market) this time around; thus, although the stock market has been known to launch a bull market without generating breakaway momentum, the market's current sluggishness appears to be saying that the economic trough won't be until at least March or April. Also, somewhat paradoxically: the more the market goes down over the short-term, the more likely it is to generate breakaway momentum when it snaps back afterwards. Whatever the case, the market is likely to remain in some sort of malaise until we get to within 2-3 months of the economic trough, at which point it should stage its traditional response: a broad and powerful rally. But -- since there's a chance it has already staged all of the "broad and powerful rally" it's going to this time around, fully-invested positions are very much called for here. We should also note that major bankruptcies usually occur AFTER a major bottom, so K-Mart should thus NOT be a significant market factor.

THE NIGHTMARE SCENARIO.            Given the poor market action this week, we should probably mention our nightmare scenario. It goes like this: Thanks to aggressive and creative accounting, earnings can be anything a company's management wants them to be -- and the Enron fiasco reminds us that any resemblance between those reported "earnings" and what a company actually brings to the bottom line can be highly tenuous at best. Stocks will thus start to sell on dividend payouts, which are real, rather than earnings, which may or may not be -- and since dividends are historically low, stocks will work lower until they sell at more normal dividend yield levels.

This "nightmare scenario", I think, IS likely to come to pass -- but based on historical precedents it is likely to unfold gradually over the years rather than all at once. But I DO think that an increasing emphasis on dividends -- and on "real" earnings -- will be one of the main themes in this secular "non-bull market" we are now in.

THE MARKET NOW.            I noted on Monday, after outlining a number of bullish factors in my January 11<sup>th</sup> interim memo, that "the best buying opportunity since late October appears to be very close to hand". Unfortunately, the market has failed to respond, and we thus need to ask whether something is going wrong.

I think not; the evidence is continuing to mount that the market is, indeed, making an important bottom here. Chief among that evidence: our new Rydex Sentiment Composite

indicator, which we introduced to you in a memo on January 9th (copy enclosed; also see <http://www.walterdeemer.com/rydex.htm>) and which is currently at its highest (most bullish) reading since October. I realize that the bullish reading from this indicator is at odds with readings from some other sentiment indicators, particularly Investors Intelligence and Consensus Inc., but can only say that where a difference like this exists I am going to go with the indicator that measures actual money flows rather than the ones that reflect opinion polls (money talks and other stuff walks, as they say...). In addition, our old bread-and-butter indicator, the Fidelity sector fund cash/asset ratio, has been MUCH less volatile during the last two months than we have been used to, and we are concerned that something has happened which has dampened the indicator's volatility and thereby lessened its usefulness. Whatever the case, although the market is not "acting well" at the moment the evidence strongly suggests that it could start to act better at any time – and we want to be aboard when it does.

**LEADERSHIP.** The main theme of leadership for the foreseeable future should be mid-cap and small-cap stocks, which are still in the process of recovering from their five years of underperformance from 1994-1999. Mid- and small-cap indexes have already hit new highs in terms of relative strength, but since their best performance usually occurs later in an economic recovery, when investor confidence has built up further, their best performance should be still ahead of us. (Small growth stocks or small value stocks? Both look equally attractive here.) Some particularly good-looking areas: financial stocks (especially regional banks and regional brokers), biotechnology stocks (which are by far the best-looking aggressive growth area on a longer-term basis), and basic industrial, a/k/a "smokestack America" stocks (which have been hit a bit harder than most other areas of the market recently, thereby creating a bit more of a buying opportunity).

**STOCK COMMENTS.** We sent you a list of twelve especially attractive stocks on Monday; charts of six of them are on the facing page. (The other six, for the record, were Affiliated Computer Systems, Baker Hughes, Enzo Biochem, Imperial Oil, Intel and Rohm & Haas.)

**BEST IDEA OF THE WEEK.** Basic industrial ("smokestack America") stocks traditionally perform well in the relatively early stages of a cyclical recovery, and their current fairly steep correction should therefore be setting up a pretty good buying opportunity. There are very, very few basic industrial stocks that sport a "1" ranking in Value Line, but RPM is one of them, and the fact that it's just emerged from a two-year base makes it very attractive technically as well. RPM thus becomes our Best Idea Of The Week this week. (Full disclosure: One of our employees bought RPM this week.)

OUR OWN MONEY remains fully invested. Our portfolio is split evenly between mid-cap stocks (half in Kayne Anderson Rudnick Small Mid Cap, KASMX, and half in Vanguard Selected Value, VASVX) and small-cap stocks (half in Perkins Opportunity Fund, POFDX, a small small-cap growth fund, and half in Third Avenue Value, TAVFX, a small-cap value fund) – which means it is also split evenly between growth and value stocks. Our Fidelity Select money, meanwhile, is also 100% invested, split evenly between the Biotechnology, Home Finance and Industrial Materials funds.

THE BOND MARKET is in a big, wide-swinging trading range delineated by the early-November high and the December low. Bonds are staging a short-term rally at the moment, but at this stage of the economic cycle their upside potential may be somewhat on the limited side, and stocks definitely appear to have more upside potential than bonds do here.

BEST AND WORST GROUPS. Charts of the four best and worst-performing groups during the last seven weeks may be found, as usual, in the back of the report. There were no changes on either list this week.

OUR FIDELITY SECTOR FUND relative strength work deteriorated further on balance this week; two funds, Insurance and Medical Delivery, rose above the money market rate of return but seven others (Energy Services, Environmental, Retailing, Chemicals, Industrial Equipment, Cyclical and Paper) fell below it. Unfortunately, this all took the percentage of funds outperforming cash down to 60%, or out of overbought territory (above 66%) which triggered a “sell signal”. A quick rebound above 66% would cancel the “sell signal”, but it’s anyone’s guess if this will occur or not, and we can thus only keep our fingers crossed. The holdings in our switching program, meanwhile, are unchanged from last week: the #1 Gold fund, #2 Electronics fund and #4 Software.

THE MAJOR OVERSEAS MARKETS are, like our own, in recovery modes. The German market is significantly stronger than the U. K. market, and thus remains our market of choice if you want some overseas exposure. The Japanese market, meanwhile, is trailing behind the other major markets of the world, and we would wait for more of a bottom to develop before doing much buying there.

-- *Walter Deemer*