



WallStreetWindow PowerPicks

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Are We In a Bear Market?

In last month's November monthly newsletter titled *Something is Wrong with the Banks*, I told you that there were danger signs in the market that pointed to a likely correction. At the time, we saw several key technical indicators, such as the advance decline/line, positioning themselves identically to where they were right as the market topped out in July. At the same time, market sentiment, as measured by the Investors Intelligence Survey, reached a manic high associated with important market tops.

I also expressed concern that banking stocks appeared to be breaking down and would likely drag the market lower. I recommended caution, saying that you should lighten up on positions if you had large ones and prepare yourself mentally for a decline, even in gold stocks. One should have cash on hand or raise cash to take advantage of any such correction.

Here's an excerpt:

"Mining stocks have a tendency to go through 10-30% corrections once or twice a year, the last one being in August. That really leaves investors with two choices to profit in this gold stock bull market. They can either buy and hold stocks, ignoring the periodic corrections, or try to time the tops and bottoms. Holding means allowing for the possibility of price declines of 15-30% at times - think back to August - and not selling. I can't do that myself, and don't see how anyone could do that if they were fully invested. The best way to attempt that kind of buy-and-hold strategy would be to hold only a 10-20% position. One could hold a 10-20% position and trade with the rest of the account."

We have indeed seen a correction in the market and a 13% decline in the XAU from its November high. Gold stocks were showing strength a month ago and I didn't expect them to fall as much as

they did, but we are where we are. With gold stocks we appear to be in the middle of a typical 10-30% correction that occurs once or twice a year and leads to a great buying opportunity once it comes to an end.

I do think gold stocks are going to go a bit lower from here. But once the decline comes to an end, one should use the correction to add to their positions or initiate new ones. In an update I sent out a few weeks ago, I mentioned that I was not going to add anymore stocks to the WSW Power Picks list until the decline is over. Last week we saw a large bounce in the major market averages that has seemingly convinced almost everyone that the decline is, in fact, over. However, I do not hold this opinion, and do not think it is a good time to initiate new positions or add on to them quite yet.

I'll discuss the short-term action and what type of movements we can expect to see in the market in a few minutes. But first I want to discuss with you the possibility that the action we are currently seeing in the DOW, S&P 500, and the Nasdaq is, in fact, the beginnings of a bear market.

First, let me clarify that I define a bear market a bit differently than most. Talking heads on CNBC like to say that a bear market is when a market declines by 20%. Since the DOW fell here only about 10% they say it isn't a bear market.

I define a bear market as simply one in which the overall trend is down. Every market or stock for that matter goes through cycles. Stan Weinstein, author of How to Profit in Bull and Bear Markets, calls these cycles phases or stages.

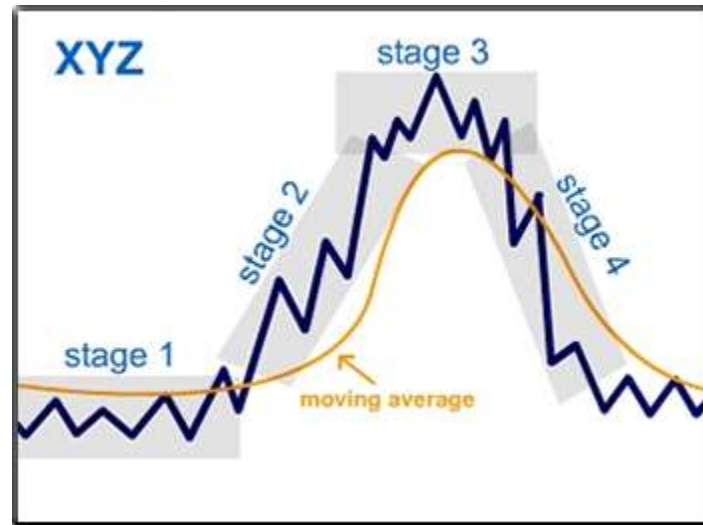
Investor University - Understanding the Life Cycle of a Stock or Market

Weinstein's breaks the cycle up into 4 phases:

- 1 - Share Accumulation / Basing / Consolidation
- 2 - Mark Up / Rising Prices / Bull market
- 3 - Share Distribution / Topping
- 4 - Share Liquidation / Declining Prices / Bear Market

Each of these four phases is characterized by a distinct pattern caused by the market forces of supply and demand. In some phases, buyers have the upper hand and in other phases, sellers do.

As an investor, you do not want to own a stock or hold in a market that is in liquidation. Nor do you want to buy a stock that is topping out.



Phase One - Accumulation / Basing / Consolidation

During the accumulation or basing phase, shares of a stock are transferred from weak hands to strong hands. This phase usually happens after a long decline or a lengthy advance in a stock. The stock trades in a very narrow range and appears to be dead money to the untrained eye or typical investor who has been holding it for a long time wondering why it won't go up.

They are correct to a certain degree, because - during this phase - the forces of supply and demand are roughly equal. Although there is no big buying excitement, there are no waves of sellers either. During this time, the average investor often sells out of fear that the stock will drop further or simple impatience.

The stock market discounts the future. The market does not move based on today's news, but on perceptions on what the future of the economy and business prospects will be. This is true with individual stocks also. The smart money, insiders and institutions, are the first to realize that a company's prospects are brightening. Towards the end of the basing phase they begin to heavily accumulate the company's stock. Often, although not always, the stock's trading volume will pick up towards the end of this phase and large 'big block' purchases will take place.

A trading range defines the price action in a base. Stocks that are basing bounce between a specific high and low price zone. Sellers often wait for the stock to go to the top of its range before they sell. By doing this they create an area of resistance, a price level the stock cannot trade through. When it reaches resistance it repeatedly falls back down. The more often it does this, the stronger the resistance. The basing phase lasts as long as resistance holds and the stock remains stuck in its trading range. As a general rule the longer this phase lasts the longer the second phase will last.

Phase Two - Mark Up / Rising Prices / Bull market

If the smart money continues to accumulate shares they will eventually run out of sellers to buy from. At this point, resistance gets taken out and the stock price clears its base. Bulls get the upper hand with the stock, not because there are suddenly more buyers interested in the stock, but because the sellers have disappeared.

Often - at the moment the stock breaks out of its basing phase - the fundamentals of a company are poor. However, even though this is the best time to buy a stock most analysts will be down on the stock and consequently your stockbroker will probably try to talk you out of buying.

But remember, the smart money buyers and stock prices themselves, are anticipating a positive future. You are always better off following their lead than the opinions of Wall Street analysts and most stockbrokers.

As demand outpaces supply, institutions and insiders will compete with one another to buy the stock. Their psychology begins to change. During the basing phase they bought on dips, now they do not mind buying as the stock price advances.

As the advance continues, eventually word gets out that the fundamentals of the company are improving or some positive development concerning the company becomes common knowledge. As this happens, the average investor and the general public becomes interested in the stock and begins to buy too. Analysts begin to put the stock on their recommendation lists.

Phase Three - Share Distribution / Topping

Eventually the stock gets ahead of itself and stops advancing. Perhaps the growth prospects for the company no longer look so grand. Or the stock has simply reached a high valuation. Whatever the case may be, at this point insiders and

institutions decide that it is time to sell and take profits.

They find plenty of willing buyers. In fact the news is often so good about the company that people are willing to pay any price for the stock. They saw it climb during its phase of rising prices and believe that it will keep going up. Analysts say it will and so do their brokers. Almost everyone is positive about the company.

Everyone that is, but the smart money sellers who know better. Although they carefully sell into rallies so as not to cause the stock price to collapse, the stock begins to flatten out and move sideways as it bounces off of new resistance and support levels. It trades in a range, just like it did during the basing phase, but with greater volatility and price swings. In this phase, though, the smart money is distributing their shares instead of accumulating them from other people.

This phase lasts as long as the selling and buying pressure remains equal. Once the buyers become exhausted the stock will break below its trading range and begin its liquidation phase, which is characterized by sharply falling prices.

Phase Four - Liquidation / Falling Prices / Bear Market

While a stock is being distributed and is topping out after a lengthy price advance, big players sell into rallies while the remaining true believers try to buy dips. After the demand for the stock becomes exhausted, sellers overtake buyers and no longer wait to unload their shares on rallies.

Despite the falling prices at the beginning of this phase the average investor remains bullish about the stock and believes the pullback is nothing but a temporary correction. The good news and business fundamentals have likely just reached their peak and the stock is still considered a hot issue by most analysts and stockbrokers. Buyers mistakenly believe that the stock is now cheap because it has dropped and become obsessed with trying to guess the bottom, thinking that the stock will return to its lofty price highs.

In fact, the longer and greater the price advance in phase two the more popular the stock will remain during the beginning of the phase four decline. However, buyers in phase four become bagholders for the smart money sellers.

Phase four begins with the average investor full of hope, then holding in disbelief, and finally selling near the bottom in

outright panic as phase four ends and the basing phase begins.

Most people think that stocks bottom when prices get so cheap that institutions and big money start to buy and that tops happen when all of a sudden people start to sell. Things don't exactly work like that.

You see stock market bear declines end, not when big money buyers come in to support the stock, but when every last bagholder has sold in a panic. Basically, since there are no more sellers left, the stock begins to hold its ground - and thus the cycle repeats itself starting over with Phase One - Accumulation / Basing / Consolidation.

This why you get a final wave of panic selling at the end of a large price decline. All the average investors who bought on hope throw in the towel in a final burst of panic. And since there is no one left to sell, and likely not many buyers interested - you get the sideways basing action that is characteristic of phase one after a bear market bottom.

The most profitable time to buy into a stock is at the end of phase one - which just happens to be the time of the heaviest insider interest. This is the most profitable buy point I know of. It allows you to actually buy in low - with the insiders - and eventually sell high when the general public, who knows very little, will willingly buy your shares and play the role of the greater fool.

A simple way to tell what stage a market or stock is in is to look at its price in relation to its 150-day moving average and observe the slope of the moving average. If the moving average is flat, then the market you are looking at is in a stage one basing phase. If the prices of the market or stock you are looking at are above the 150-day moving average and that average is sloping up, then it is in a bullish phase. However, if the prices of the market are below the 150-day moving average and that average is sloping down, you are witnessing a bear market in action. Stan Weinstein goes so far as to advocate lightening up on positions drastically if the market goes below its 150-day moving average for several weeks.



For the past four years, the broad market has been in a stage two bull market. It began this bull market after going through a stage one accumulation phase in the first half of 2003. During this accumulation phase, the slope of the S&P 500's 150-day moving average changed from moving down to up as the market ended its accumulation phase and entered a bull market.

Ever since then, the 150-day moving average has acted as support for the S&P 500 and has been rising. However, since July, the momentum of this moving average has dissipated and the moving average is now moving at a flat angle with the S&P 500 below it. If the S&P 500 closes below this moving average at the end of December, then it will drag it down enough to form a downsloping moving average. If the S&P 500 were to close right on it or barely above it at the end of the year and then close below it at the end of January, that would also be enough to cause it to slope down and have the signature of a stage four bear decline.

Currently the S&P 500's 150-day moving average is right at 1500.

From the perspective then of using the 150-day moving average and its position in stage market analysis with the S&P 500 it is not quite in a bear market yet, but is in danger of entering one. The same holds for the DOW and Nasdaq.

However, the broad market has also shown all of the characteristics associated with a market making a stage three top, which precedes bear markets. The chart pattern from July to October appears to be a double top in the S&P 500. Even though the DOW made a new 52-high in October, it had so little follow through that one could argue that it appears to be a double top as well. If the market averages were to close below their August lows, then such a price topping formation would be complete.

More importantly, there have been serious warning signs all year of deterioration in the bull cycle. With each successive month, the sectors and stocks participating in market rallies have shrunk, meaning that the rallies have been led by fewer stocks and sectors. For example, the Worden Brothers TC2007 software breaks the market up into 239 sectors. Since January 1st until today, 110 out of 239 sectors are underperforming the market. Eighty-seven sectors are in the red, despite the S&P 500 still having a gain for the year. Most of these sectors are so far below their 150-day moving averages that those moving averages are already sloping down. In other words, 36% of the stock market is already in a bear market.



The poor leadership and breadth in the market is clearly visible in charts of the advance decline line for the various market averages and other telling indicators such as the number of stocks making new highs versus lows.

In July, all of these internal indicators began to break apart and fail to confirm the rally. When the S&P 500, DOW, and Nasdaq all made new highs in October the divergences became even greater, giving us a strong warning that a correction was upon us.

These types of divergences and warnings are characteristic of a stock market in the process of making a stage three top.

In my last monthly letter, I mentioned the 1450 and 1400 levels as likely bottoming points for the S&P 500 if we get a correction. I had thought that once it bottomed the market would rally to new minor highs again. However, the action during the past few weeks has made me more negative about the market and I still have yet to see signs of a real bottom.

The psychology in a bull and bear market is much different when viewed from a contrarian perspective. Bull markets are said to climb a wall of worry as dips shake out weak hands leaving most behind. Bear markets fall on hope. As the market falls, people hold on or buy when they see the market bounce off of perceived support levels that "have" to be a bottom in their minds. As the market rallies and fails, they simply hold on in disbelief that a real bear market is at work. In other words, bear markets thrive on hope *and* denial.

What has troubled me is that there has been no real sign of fear during this recent decline. If someone had told me six weeks ago that the S&P 500 was going to fall to 1405, I would have thought that would bring a lot of fear into the market and shake people out. Instead, during this past drop, when the DOW broke 13,000 and the S&P 500 approached 1400, sentiment (according to the Investors Intelligence Survey) was subdued and options indicators such as the VIX and put/call ratio showed hardly any fear or panic at all. Almost everyone I have read on the Internet or talked with is also bullish with only a few exceptions.

What is more, the way the market has dropped and rallied is the same type of price action you see in bear markets. In bear markets the market trends down each month and has quick and sharp rallies between the declines. You have rallies that last 1-3 days and then fall apart. They are fueled by short-term

technical oversold conditions and short-covering. They also convince everyone that the market has bottomed, when, in fact, it has not. As the dips shake out weak hands in bull markets, 1 to 3 day wonder rallies create the hope and denial that feed bear markets.

Real bottoms come when fear enters the market after a decline. You can see the fear in the way the VIX and put/call ratios act as the market drops and has a panic washout. Almost without fail, the bottom comes in a final capitulation day in which the market opens down hard and has a large intraday reversal. We have yet to see any of these things happen and this fact has further convinced me that we are witnessing a real bear market.

This doesn't mean that the market can't stay afloat for a few more days or even a few more weeks, but we haven't seen the end of this correction yet.

In bear markets, money can be made by patiently shorting rallies and even going long when real bottoms occur. Money is lost by holding on to stocks and sectors indiscriminately or buying just because something has dropped and now "has" to go up. Most positions taken during a bear market require active trading within a shorter time frame to make money than is the case in a bull market.

It is also best to focus your money on the long side only in the few sectors that are bucking the overall downtrend of the bear market and are in bull cycles of their own. Even though they have been weak as of late, mining and commodity stocks are still in long-term bull cycles. They are still buys on the dip.

However, mining stock investors have to understand that their stocks are likely to be prone to even more violent rallies and declines in this type of broad market environment. Going forward, I expect mining stocks to rally to new 52-week highs when the broad market has rallies lasting 4-6 weeks and then being prone to violent profit taking in market downdrafts like we are seeing right now.

This means that in order to make money in this market, mining investors will have to simply hold a core 10-20% size position and be willing to ride out 10-30% corrections to profit from the bull trend in precious metals. Those who want to have a larger position will have to be willing to actively trade a portion of that position in order to manage the risks of broad market volatility.

This is what I do personally. My plan for this newsletter is to

recommend more mining and commodity related stock picks for you when those sectors are trending up, with an eye to making the recommendations near the end of dips, and simply waiting and advocating patience during corrections like we have experienced this past month.



At the moment, I think it is very likely that we'll see further weakness in gold stocks. That would, of course, make the stocks on the WSW Power Picks drop. I don't advocate buying them right at this moment, but they will all be buys on any further weakness.

Mining stocks have been trending sideways and fell down towards support, which is 400 on the HUI, on Friday. If they close below support this week they will likely fall further. Another 5-8% drop looks to be in the cards. If the HUI closes below 400, its next support level is at 374, which represents a 50%

retracement of the August low and November high. If we see such a dip it will be a great buying opportunity as I expect gold stocks to make new 52-week highs within 6-8 weeks later.

Gold stocks look poised to drop and I think that is a bad sign for the rest of the market in the short-term. Commodity stocks have been the strongest stocks all year, but when they have gone through periods of underperformance relative to the broad market, the broad market has followed them down. A sharp drop in gold stocks preceded the panic washout in the broad market in August and a correction in February and March. If gold stocks break down in the next few days, I expect the S&P 500 to follow suit and fall back down to its recent low of 1406.

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