Financia Capital

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Bearish… But Optimistic!

As we get ready to welcome the New Year, Sean, Steve, and I want to share with our friends and family our stock market outlook for 2002.

But first, how did we do in 2001? We give ourselves an A- for forecasting the overall direction of the market and a D+ for timing. Throughout this year, and for much of last year, we were vocal bears (much to your annoyance, we're sure!) Some may recall that, in May, we suggested that the worst was yet to come, even as the Nasdaq was enjoying a powerful 40% rally off its April lows and the experts were celebrating the birth of a new bull market. We can't recall anyone agreeing with us then, which only made us more bearish since the stock market loves to do the unexpected.

However, the three months since the September lows have been a humbling time for us, as the market has done what we least expected. We have attempted to go short on several occasions, only to be squeezed out by yet another powerful rally. We were confident that the market would see a massive sell-off in December, resulting from a combination of several factors, including earnings warnings for the fourth quarter and tax-loss selling. Instead, a series of not-as-bad-as-we-feared economic reports against the backdrop of our impressive military accomplishments in Afghanistan have caused economists to proclaim that the worst is over and that the recovery is already underway. Many of our friends who run small businesses in the Bay Area have echoed that sentiment with reports of increasing new orders (or at least some stabilization) in their own businesses, an experience likely shared by thousands of small business owners (and investors) around the country.

All of this has only added fuel to the rising stock market.

So do we remain stubbornly convinced that the bear market is not over? Or have we finally seen the light and recognized that 2002 will be a good year?

The answer is... both.

No, we're not trying to have our cake and eat it too. Without detailing all of the data we take into consideration, here is what we think:

1. The bear market is not over

There are too many factors that tell us that September was not the bottom. Late in a bear market, a consensus builds that stocks will never again be worth owning, as investors who have been pounded every time they "bought on the dips" simply lose faith. As one Wall Street Journal reporter wrote last year, in a bear market investor psychology goes from "complacency, to concern, to capitulation." Of course, capitulation is not easy to define, but, in our opinion, we did not see capitulation in September. Investors simply became too bullish again too fast. The same speculative names surged in just a few months (Brocade, for example, is up 190% since October 1st). A dozen IPOs hit the market in October, and several large mergers were announced. Charles Schwab appeared in television commercials smiling and telling concerned investors to "just relax." The cover of Barron's on September 24th depicted a muscular bull waving an American flag with a headline reading "It's Time to BUY STOCKS." The top stories in the news were about the war in Afghanistan and the anthrax scares, not about the stock market. We can go on and on, but in the end it all comes down to a subjective measure of investor concern turning into capitulation. In our opinion, we didn't get there.

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2. 2002 will be a good year for stocks.

This is an old bear market by any measure, and it is very unusual for U.S. markets to be down more than two years in a row. By our calculations (and opinions vary), the average bear market since World War II has lasted 13 months. Using March of 2000 as the beginning of the end of the bull market, the current bear market is going on 21 months. Forget interest rate cuts, forget fiscal stimulus, forget patriotic fervor, forget the notion that war is supposed to be good for the economy (at least when we win fast). In the end, our optimism comes down to market history: bear markets just don't last this long, and even so-called "secular bear markets" are punctuated by powerful cyclical rallies. Previous bear markets have also taught us that after the market declines by more than 40%, the risk of missing a new bull market becomes greater than the reward of avoiding the final leg(s) down of the bear market. Depending on the day of the week, the Nasdaq is down 60% from its all time high (though the Dow and S&P 500 are down considerably less). Of course, the Dow was down 89% at the 1932 bear market bottom, and Japan has endured a horrifying decade-long secular bear market, but both of these scenarios seem unlikely to us right now (though not impossible, as some would have you believe). In short, we look to history to tell us what will most likely happen, and what seems most likely based on the behavior of previous bear markets is that 2002 will be an up year.

The only way we can reconcile this seemingly-contradictory analysis is by making the following forecast: the first quarter (and possibly the second quarter) of 2002 will be a very bad time to own stocks, as investors finally lose hope. But the major market averages will be higher by the end of 2002 than they are today.

So, in spite of the dubious quality of our advice over the past few months, here is our recommendation for the near future: stay in cash. If you're really aggressive, by a put on the S&P 500 with a strike price of 1100 and a June expiration. But under no circumstances buy stocks until it is no longer possible to get the smell of investor disgust and dismay out of your clothing. Right now, the market smells too sweet.

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PS - If we are wrong (and being wrong is always a possibility), We'll know it soon. January is historically a very good month for stocks, and if the S&P 500 and the Dow can break out above their respective 200-day moving averages and stay there for a few weeks (as the Nasdaq has already done), then we will most likely throw in the towel and start buying stocks. Of course, when we do, you'll be the first to know.