

BY STEPHEN BRENNAN

# Waiting for a Spark

THE FIRST NINE MONTHS OF THE YEAR have been a horrible time to own stocks, and it's been especially rough for semiconductor stocks. As September comes to a close, the S&P 500, Nasdaq and Philadelphia Semiconductor Index have fallen approximately 30, 40 and 55 percent. The price swings for semiconductor stocks are without precedent. Optimism has largely been extinguished, and many investors have simply thrown in the towel and given up on stocks, especially those of technology companies.

Ironically, this is all good news for the long-term investor. The stock market is now waiting for a spark to ignite the fuel that will power a new bull market. Perhaps by the time this column goes to print that fire will be burning, or perhaps stocks will still be grinding lower. But after my long-running bearishness, I continue to believe now – as I have since the end of July – that this market is now more likely to rise than to fall.

## FUEL FOR THE FIRE

Bull markets require fuel to rise. The more fuel, the higher and longer they can go, so perversely the worse this bear market gets, the better the bull market we can expect. There are two principal ingredients for a bull market: cash on the sidelines and depressed stock prices. It was not until the June and July sell-offs that large collections of this fuel were amassed. Now, after huge investor outflows away from stocks and into money markets, real estate, gold, bonds and other non-equity investments, there is a significant amount of money on the sidelines – money that could go into stocks. More surprising still is the fact that at today's price levels you can actually make a value investment argument for many technology stocks – a situation few thought could occur in this decade.

Along with these two ingredients there is even more dry wood out there. As I wrote in my last column, cost structures are now exceptionally lean at many companies, and there is considerable profit potential. Moreover, many weak companies have died or been consumed, with the survivors gaining market share and potential pricing power. Even as some companies have warned on revenues, many of them still managed to


meet earnings expectations due to these factors. In early 2000 I remarked to many friends that stocks were priced to perfection; today they appear valued for adversity. In other words, the odds have shifted to favoring rising prices over declining ones.

## WHERE'S THE DEMAND?

Of course all the dry wood in the world will not result in a fire unless something lights it, and stocks will continue to grind lower until there is some sign of returning demand. An occasional short-covering rally may make some smoke, but only resuming demand will create a fire. Signs that corporate revenues are rising instead of falling are the sparks this market needs in order to get it going, and when these sparks catch, the potential for stocks is much greater than many believe.

The simplest formula for beating the stock market is to buy during periods of extreme pessimism and sell during exceptional optimism. In other words, look to buy when there is substantial cash on the sidelines and depressed prices, and seek to sell when this fuel has been dissipated. In short: now is a nice time for some buying if you have the requisite patience to stick with a contrarian strategy. If not, you can wait for some signs of returning demand, but if you wait until everyone is comfortable that the market has turned around you will instead find yourself at the next great selling opportunity.

## PRELIMINARY REPORT CARD

So far this year my advice has been far better than most, but far from perfect. My guidance to stay out of the market until the end of July was solid, as the S&P 500 fell more than 20 percent and semiconductor stocks declined over 40 percent. On the other hand my prediction for a market bottom in July appears mixed at the moment with the Nasdaq and semiconductor stocks having fallen below the levels I set, while the Dow has bounced off its level and the S&P 500 remains above. My March prediction for a double-dip recession no longer seems so far-fetched, and as to my recent bullishness and a call for a strong late-year rally, only time will tell. 

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