

MORNING MARKET COMMENTS

by
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Close To The Top???

You only have to look at the recent titles of our market comments to know that the market is certainly following the script. I have been citing the 3-week cycle that has been ratcheting the S&P 500 back and forth from the bottom to the top of the declining trend channel since the last day of last year. That cycle pushed the S&P 500 almost perfectly to the 1410-1420 target level that we had expected, and even with that short-term cyclical high that was less than spectacular, the 10-day put/call ratio dropped to .42, which was the lowest in over a year. In other words, it took an even higher level of optimism by these typically wrong investors to push the market up to an even lower high. When more “energy” is being used to get up the hill, and each time you fail to get as high as the last time, it is inevitable that the vehicle is going to run out of gas before it gets over the peak and back to the easy coasting.

Of course, the NASDAQ has been in a world of its own, but even that characteristic is not unusual. On all market peaks the strong stocks stay strong right up to the last—suckering in the last of the victims—before it finally pulls the chute. And then those stocks turn out to be the weakest. Although everyone’s attention is not focused on the NASDAQ, it wasn’t too long ago that the S&P 500 was sharing that stage. But now that index is certainly not exciting anyone. The captain of that index was General Electric, but now that stock is in a very weak topping pattern. In the last 10 weeks it has dropped from 160 to 130, and if it drops under 125 it will set up another very weak technical condition. Of course, if I go back a year or so, then I could talk about Coca Cola that made an exuberant new high at 88 7/8 on July 17, 1998, when the bear market really began. At that time, everyone knew that Coca Cola was selling at an unbelievable price/earnings ratio, but it didn’t matter, every momentum investor had to buy it regardless and they knew that Coca Cola’s earnings were never disappointing. Well, you know the story, but the stock has now been almost cut in half to close yesterday at 47 5/8 experiencing an extremely weak break-down under its previous 48 support line. All these “great” perpetual stories run this gamut of emotional extremes, and that is what makes the market. But now do you hear any commentator talking about what a great company Coca Cola is? Jack Welch might want to move up his retirement day.

Another one of my themes in the last four weeks has been the new emergence of better relative performance by the NYSE unweighted index. We have shown you the graph from Decision Point of the bottoming formation that had been completed in the relative performance of the unweighted to the weighted index. Our premise had been that this could very well be the first sign that the average stock will outperform the weighted indices on the expected market weakness. So far that has been the case as well. It still isn’t something that will excite you, because the odds are extremely high that when the bear market finally burst out from under the camouflage, it will take almost all stocks down with it. But with the valuation of the typical stock already dramatically impacted

by the broad market bear market that has been in process for almost two years, the Value-Line survey shows the median price-earnings ratio of their 1700 stocks is only 13.4 times the earnings estimates for the 12-month period that ends six months from today. That is extremely low—down from its high of 19.7 on April 22, 1998--but even so it is interesting that this valuation technique dropped to only 10.6 during the October 1987 crash. So how low is low? The key is that the IBES valuation technique is still saying that the S&P 500 is 45% overvalued versus the 10-year Treasury note. This study has historically been very accurate at predicting the risk in that index. So relatively, that could mean that the typical stock is a much safer haven in the storm.

Other major concerns are lurking around every corner. The approaching election in Taiwan has been the deadline that China has given Taiwan to back off of their new call for total separation. The Chinese propaganda machine is really pouring out the venom, virtually promising a military action if Taiwan does not cave in. So far, the Taiwanese don't seem to be yielding.

I hope you had a chance to read my comments from Monday that compares this period as a mirror image to the 1989-92 period. I really think that is a very excellent example of how emotions and headlines go from one extreme to a mirror image. Since stock markets are so vulnerable to emotions, they also have those same "mirror-image" patterns. Certainly Greenspan's broad grins are an upside reflection of the grimaces that he was giving at the Humphrey Hawkins testimonies at that time. Today's adulation is also a major change from the cartoons and "digs" that the Senators were pouring on him at that time. But in 1992, after his policies had played havoc with the banking system, Greenspan changed his grimaces to a faint smile as he continued, month after month after month to bring the fed funds rate down. Now in the mirror image, he has turned that corner again from extolling the wonderful virtues of productivity to scorning the dark sides of productivity. We also believe that he is now smiling just a little less and the fed funds increases are no longer promising that they will do the trick. Now he is hinting that more increases are on the way. The March 21 FOMC meeting will be more prominent in the investor's mind in the weeks ahead

The action of the market since 12/31/99 is a signal that this new emerging personality is working. It will only be a matter of time before the NASDAQ and the hot stocks of today start turning into the scorned stocks of tomorrow. But that hasn't quite happened yet. Maybe the "5000" level will prove to be the mythical barrier that will be talked about in the years ahead, just as the 1000 level on the Dow was from 1966 to 1982.

There is a lot to talk about, but I'll save a little ammo for Friday. But I want to make sure you see the break-down by the Dow Transports under the October 1998 low. That is certainly not a good omen. We'll be watching the bank indices, since they are just walking a thin threshold from following that same pattern.

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