

## Mr. Market Has Us Where He Wants Us

Previous Bottoms

by Don R. Hays

Summary: Many of the Bear and all the Bull traders took a plunge on the long side six times in the last 10 weeks on the sharp one-day reversals, supported by peaks in the put/call ratio above 100%, and each time have been washed out of the tub. Buying market “strength” has not worked, buying “weakness” has not worked. Historic signals have not worked. In the last two weeks, even many of the perennial bears have believed that a short-term buying opportunity was at hand.

What does history tell us about how to play these confusing kinds of times?

Do you buy strength, or weakness? The trading world is set to buy strength, but most “major” market bottoms spank this trading philosophy for the first few months.

You only learn in Bear Markets.

The Smart Money Index is telling a brighter story.

Maria scolded her panelists about looking for bottoms a couple of nights ago, raising her voice in obvious frustration and telling them that it was time to quit looking for bottoms, and start looking for good shorts. I don't blame her, after all they too had picked up on each of those previous six signals in the last 10 weeks, and excitedly pointed to the very visible signs that a major bottom had been made. And each time, one day of rally—yes a very spirited rally that usually created one of those exciting upside gaps, but it only faded away in the days ahead. And the fade was not just a gentle fade, but a dramatic plunge that has taken the NASDAQ 100 down by 34%, or the popular QQQ's from \$33.63 to yesterday's close of \$22.25. Now don't get too smug on me if you say I should have waited on the 2% upside confirmation on increasing volume. As you know, I also keep up with O'Neil's bottom-spotting technique, and 10 weeks ago that signal told us the one-day reversal was confirmed, and then three days later, Mr. Market pulled the trap door.

Can you imagine how dumb everyone feels? I don't have to imagine. You see I still have those QQQ's I bought at \$33.00, so I am right there with Maria, or at least my emotions are. But you know, it only took that big 490 point up-move in the Dow on Wednesday to start those visions of sugar plums dancing around in my head once again.

So what do we do Maria? Look for shorts? I don't think so. I'm no different than any of you. I only learn in bear markets, or when things are not going along according to MY plans and expectations. So I've spent a huge amount of time in the last 10 weeks, looking at every major bottom in the last 75 years. Yes, I've even been looking at 1929-33, and I finally have the answer. The answer is that every bottom is different. There is no neat little pattern to tell you a bottom has been made.

In many ways the momentum discipline is what the market is trying to wring out of the market. We now have around 6000 hedge funds so I am told. As you remember, it wasn't too long ago that George Soros and many of his better known compatriots were driven out of the business, or at least into retirement. But the riches that they had accumulated in those days before their business plan became the rage had engendered dreams of greatness, especially in the hearts of those that had been greatly enriched in the 1999-2000 period. The last year has not seen the birth of those 6000 hedge-funds. The major birthing process was back 2-3 years ago when the pickings were flush. It seemed so easy to trade the markets. Latch onto a trend, use a few little put/call ratios, or non-confirmations, and margin the ranch. Of course, stop losses are in place, but when you margin the ranch, those six stopped-out positions of the last 10 weeks have certainly produced a big whopping bruise.

There are no geniuses left. So what will Mr. Market do now. He's won. He has everyone waiting, waiting, waiting—afraid to do anything, except maybe look for good shorts.

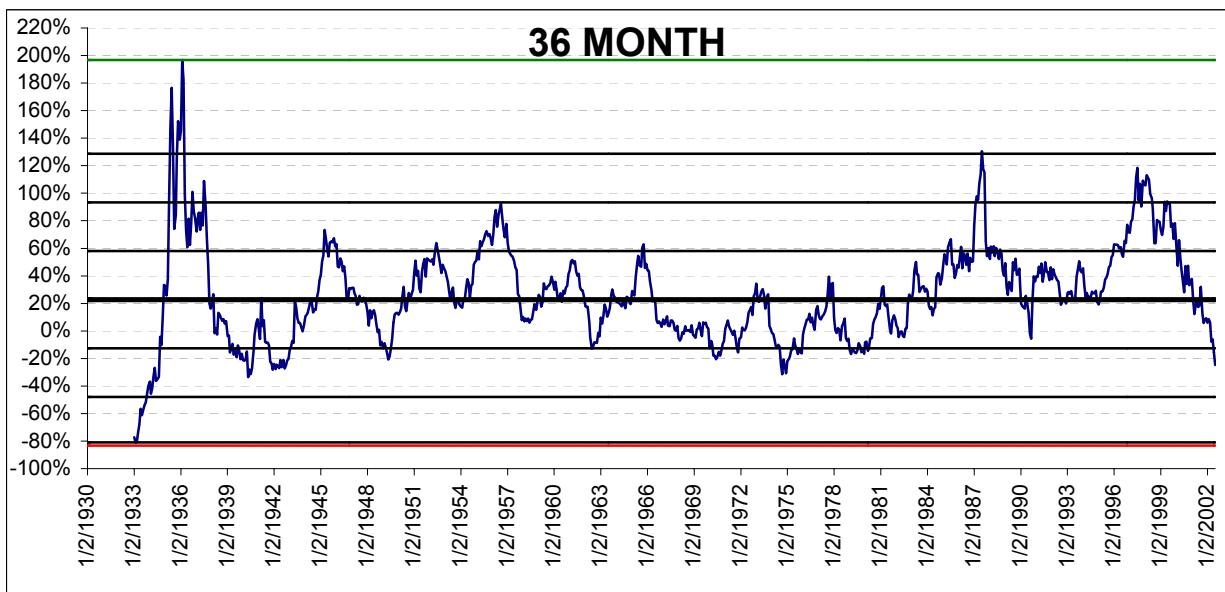
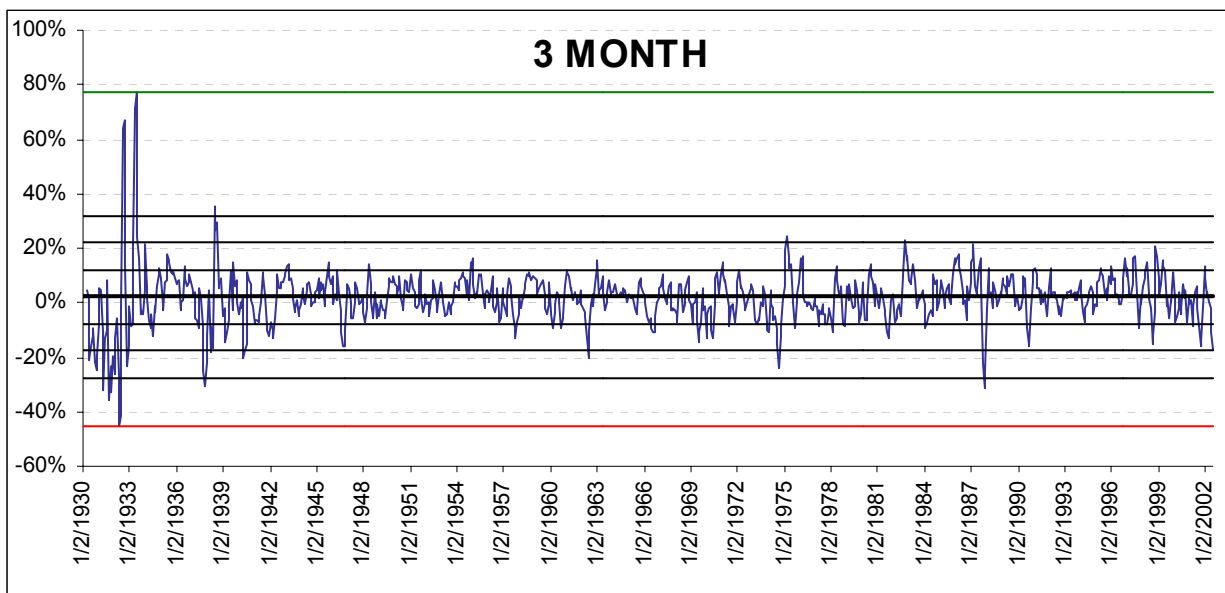
So here is what I think. I believe that instead of buying strength, in the next three months you will have to buy weakness. Hey, that sounds like a value-investor, and I'm not. I'm a top-down, and my beliefs have not been dented in the least by my current humility.

But when I look at every market for the last 75 years, I find the following statistics of performance. This is for the Dow Jones Industrial Average, simply because it is the only average that is still around from that time. Admittedly, the Dow is not the index that captures the Technology Revolution times of today. It is still more the proxy for the Industrial Revolution.

<b>DJIA HISTORICAL RETURNS (1930-2002)</b>						
	<b>3 MONTH</b>	<b>6 MONTH</b>	<b>9 MONTH</b>	<b>12 MONTH</b>	<b>24 MONTH</b>	<b>36 MONTH</b>
<b>MEAN</b>	1.7%	3.5%	5.4%	7.5%	16.3%	26.2%
<b>MEDIAN</b>	2.1%	3.8%	5.6%	6.7%	15.1%	22.7%
<b>MIN</b>	-45.1%	-52.4%	-67.9%	-71.5%	-83.8%	-81.0%
<b>MAX</b>	77.1%	99.2%	90.9%	129.2%	123.8%	196.7%
<b>+/- STD DEV (68% OF CASES)</b>	9.9%	13.7%	16.9%	20.5%	28.2%	35.3%
<b>+/- STD DEV X 2 (95% OF CASES)</b>	19.7%	27.4%	33.9%	40.9%	56.5%	70.7%
<b>+/- STD DEV X 3 (99% OF CASES)</b>	29.6%	41.1%	50.8%	61.4%	84.7%	106.0%
<b>DJIA NOW</b>	-17.7%	-17.0%	-14.2%	-21.7%	-22.6%	-24.6%
<b>NASDAQ 100 NOW</b>	-28.5%	-36.2%	-38.5%	-46.6%	-76.6%	-60.0%

I'm sure that most of you are familiar with the standard deviations shown below, but it simply says that in 68% of the times the indices will produce gains in a range of the mean statistic plus or minus the number included in the "first" standard deviation. The second standard deviation range gives a zone when added or subtracted from the mean number will include 95% of the cases in this 75 year period. And the third range produced will include 99% of all the examples in this time period.

You can do your own arithmetic, but you can see that even the Dow Jones Industrial Average is now in at least the 2<sup>nd</sup> standard deviation range over all time periods. Ladies and Gentlemen, you are seeing something that only happens in very rare times in U.S. history. To help you see these rare times, let me show you the actual charts of the 3-month rolling performance of the DJIA and the 36-month rolling performance.



I want to make two main points here. To begin with, the 36-month chart corresponds with what a good friend and a psychologist told me years ago, in that your emotions are always a reflection of what has happened over the last three years. I have told this story before, but the practical example for this would be a marriage. If your wife (or husband) has been sweet and lovable for the last 18 years, as this bull market was from 1982 until 2000, and then all of a sudden turns into a real grump, you would forgive her (or him) thinking, oh, she's just having a bad period. She'll get back to normal in a few more weeks or months. But if that grump continues for another year, your patience is growing a little thin, but you still remember the good old gal, so you try to help her by encouraging and counseling. But if it continues for the third year, it's all over. You are married to a witch, and she'll never be any better.

We all agree with Business Week don't we? Stocks will never be good again. Well my friends, it must be time to look for good shorts.

You can see for the 36 months it has only been this bad on four different junctures in U.S. history. Those times were 1932, 1940-42, 1974, and now. I recognize that the 1932 example is out there in plain sight, and is still very ominous, but I am going to take the liberty of saying that the NASDAQ 100 of 2002 is much more symbolic of the Dow Jones Industrial Average of 1932 than the Dow of today is. If that makes sense to you, it means that I am comparing the NASDAQ 100's performance for all those ranges in the table above to the extreme case of the Dow back in 1929-32, and its carnage in all those time periods listed in the table above is not too far from reaching that most extreme case in 1932.

I do not think we are even close to the conditions of 1929-32. I believe strongly that the system of safeguards today is far superior to the safeguards of that day that were virtually not existent. I do not think the fraud and deception of today is anywhere close to what I've read about in 1929-32, but I have given you this extreme example to show you that even if we were in that unimaginable environment, purchases made in the depth of the 1929-32 period when the DJIA was down the 81% that the NASDAQ 100 is down today from its all-time record high (even though they would have experienced 9% more loss in the last days of the decline) would have made it back within one month after the actual bottom. And in the next five years you would have made 166% on the "too-soon" investment.

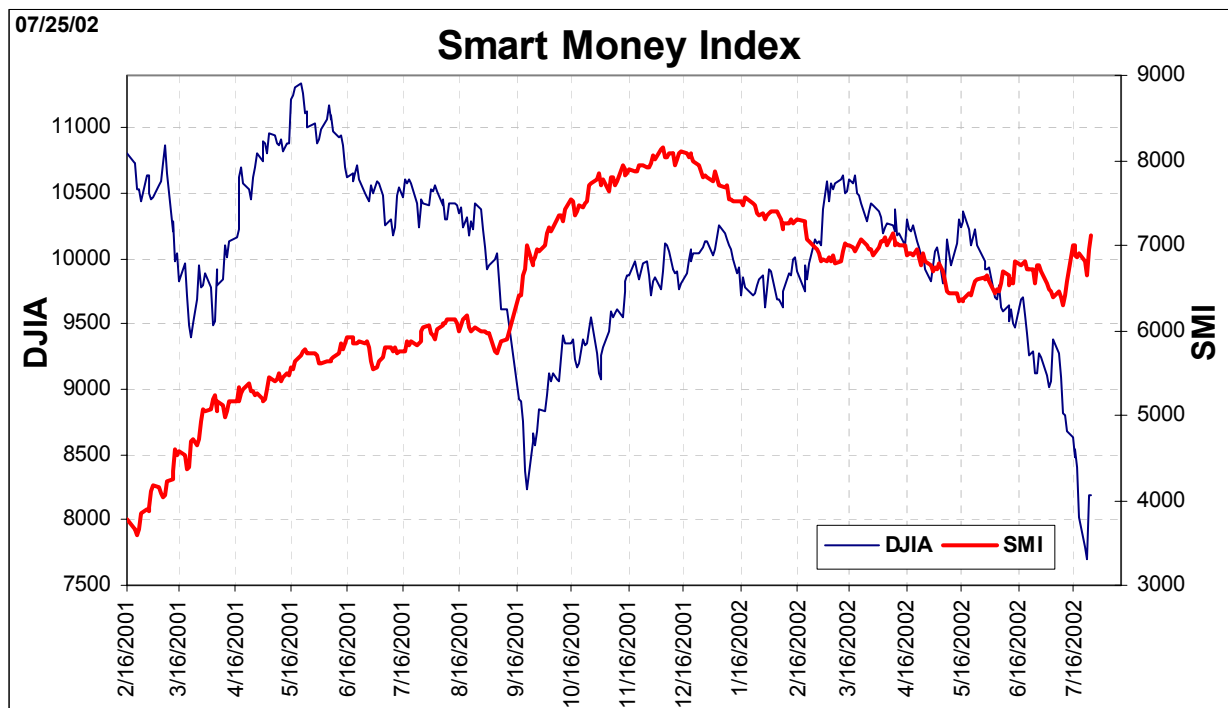
So here are the odds Mr. Market is giving you. He is giving you over the next three months 20 to 1 odds of making money. He is giving you odds that over the next 36 months your odds are even better than that, and especially if you believe as I do that the 1929-32 example is not appropriate to consider. As you look at the charts, you can see that this decline is very similar to creating the exact same conditions of producing the best buying opportunities of the last 50 years.

So what do you do? Once again, it depends on your time frame. From all the different bottoms that I have been poring over, there is no perfect example, but the most prevalent "best" technique is to buy weakness. In other words, use a very persistent

dollar cost averaging technique to leg in on the weak days. This assumes, of course, that you are already pretty heavily invested as I am, and that you only have 10-20% of cash assets that have been raised by your “critical decision” discipline. You can always see where this now-humble money manager is on our website under the asset allocation link. We list the theoretical and the actual. For long-term growth accounts, our actual cash reserves have been pushed up to 15.2%. It is our goal to always move back to the current theoretical allocation, so in the next few weeks and months that will be our purpose--drip back into the market on weakness.

Of course, you know that the market will win out. We won't do everything perfect this time either, but you don't have to. If you play the long-term odds, the short-term miscalculations will not be nearly as meaningful.

You have to look at the Smart Money Index this morning. It continues to move up, and has just made it's second higher high. I'm just going to show you the combined chart on this page, but if you want to see the dissected version you can go to this link: <http://www.haysmarketfocus.com/html/SMI.htm> Even the components, i.e. the smart component, is looking pretty good. The action of the NASDAQ 100 has been pretty coincident with this “smart” component, but the consolidated chart shown below is what this indicator has built its reputation on, so don't put too much individual emphasis on the action of the two different individual components that make up the indicator.



I'll see you on Monday my friends,

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