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GETTING TECHNICAL

It's a Rally -- But in a Bear Market

Markets' Mood

By MICHAEL KAHN | MORE ARTICLES BY AUTHOR

Technicals support continued strength in the stock market for the short term, but not beyond.

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THE STOCK MARKET HAS FOUND A BOTTOM -- but not *the* bottom. So enjoy this rebound while it lasts, because it looks like a bear-market rally.

Reasons to expect further gains include the intensity of buying seen over the past week in the most beaten-down sectors -- banks, brokers, mortgages and even home building. While former leaders, most notably energy and basic materials, have had a very rough month, money leaving these groups has found new homes. This sector rotation is a very healthy condition for the stock market.

But the most compelling argument for continued short-term strength I see is the dollar. As I wrote in this space a week ago (see "The Dollar Holds the Key," July 16), as long as the greenback stayed weak, U.S. financial assets were fighting an uphill battle. But the technical breakdown in the dollar failed, and now the currency is showing signs of strength.

It seems to be all about confidence right now, and currencies reflect confidence in the economy and its stewards. But as noted last week, whatever gains we've seen in the dollar are a "ripple in the ocean" in a very long bear market. Dollar gains remain very much a short-term phenomenon at this time.

If that is the case, my conclusion is that the stock market has not reversed to the upside either. We have seen a bottom, and current stock gains are part of a bear-market rally.

The increase in prices has not been accompanied by a true swelling in demand. The desire not to be short this market seems to be greater than the need to be long. All over the financial media we can find stories about the stock market experiencing "the mother of all short squeezes," or the scramble to buy stocks to pay back losing bets that prices would continue to fall.

Phil Erlanger, president of the research firm that bears his name, has been following short selling in the market for many years and has quantified its technical meaning. "Clearly there was a short covering rally in the financials but as a sector, short [selling] intensity rankings for financials were below average with the exception of issues like Fannie Mae." He adds, "The key is not that there was excessive short selling, but excessive SEC pressure put on the shorts by singling out selected financials for more stringent rules."

In other words, it was an extra-market condition that triggered the buying. When the shorts are covered, or bought back, the sector will head back down, he adds. To which I would add that the rest

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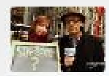

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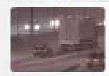

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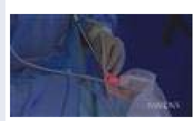

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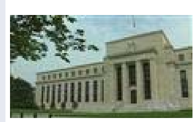

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of the market will, too, as this fuel runs dry.

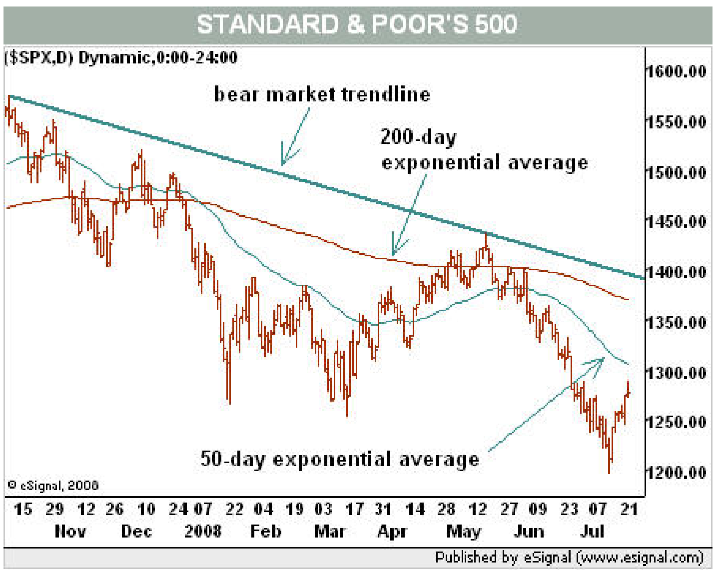
Another technical reason why the current rally is of the bear-market variety is that the market has yet to signal the urgency to buy and not just bottom-fish for a quick trade that usually accompanies major changes of a trend from down to up.

Richard Dickson of Lowry's Reports says that there have been no intense buying days, what his firm labels "90% upside days," since the market's lows were notched.

And notwithstanding talk that a "follow-through day" (FTD) has been triggered, it has not. According to this signal's creator, Investor's Business Daily founder William O'Neil, an FTD signals the influx of true demand and not just bottom-fishing. Prices must rise more than 1.5% on increased volume between four to seven days after the rally attempt begins. That's yet to be seen.

But the market is the final arbiter. A chart of the Standard & Poor's 500 shows just how many roadblocks lie ahead for the bulls before we can even consider that the tide has truly turned (see Chart 1).

Chart 1



Not only is the index very far from challenging its major bear-market trendline from the October peak, but its key 50-day moving average also is still falling. Investors, on average, who bought what they thought was a cheap market anytime in the past 10 weeks remain underwater; that creates the impetus for them to sell at their first chance to break even.

With money flowing into financials and very strong relative performance by small-capitalization stocks, this rally should have some legs, possibly reaching the trendline highlighted on the S&P chart in the 1350 area.

Just be forewarned that it's also been more than a week into a huge rebound without a significant corrective dip, so expect some reverses.

The market enjoyed a nice run from its March lows into May. Can this bounce match that one? For now, the evidence favors the bulls. But it would still be a rally in a bear market.

Also read Getting Technical, Sector Alert:
"You Heard It Here: A Bottom for Financials," *July 21*.

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Michael Kahn, author of three books on technical analysis, former Chief Technical Analyst for