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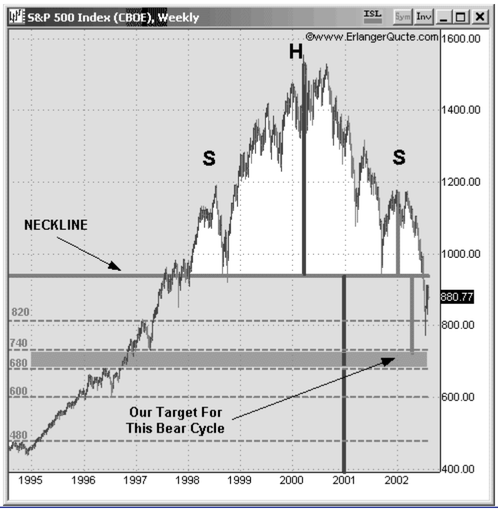
listeningin

No Cigar, Yet

Phil Erlanger's Technical Work Says Bear Still Has Work To Finish



Phil Erlanger is a rarity. A market seer who has been more right than wrong this year. The independent Boston-based technician and proprietor of www.Erlanger-SqueezePlay.com, an institutional service with a retail offshoot of growing popularity, generously shared his still-bearish thoughts this week.

Wednesday [10/9/02] was a fun day in the market–for bears. Reduced Maria to babbling about the sort of valuations that should excite investors with 10-15 year horizons. Then came Thursday's rally–

It is pretty interesting. Going down is good for me. But it seems to be doing so in measured steps. Definitely acting like a secular bear market.

And *not* one of those cute–and manageable–cyclical cubs. But you've been saying in recent days that perhaps the "big barf" bottom so many are looking for wouldn't happen–just because it's so fervently hoped for.

Well, I think we're actually getting a "big barf" now. It's just not going to be evidenced in the way we are used to seeing it *in a bull market*. I do ultimately think that there will be one day when the market just goes "Bleeeech" and then comes back. But by then, people will be so disgusted that they won't care. And that's the beauty of it. But this water-torture, 100, 200 points a day down, peppered with a couple of days that are up, is driving most people nuts. People think, "Well, the dock strike is being fixed." But the dock strike isn't the problem to begin with in this market. And the "solution" is pretty tenuous, to boot. It is almost the worst thing that could happen. They didn't solve the problem; they just compartmentalized it for a while. From its current state, it can only get worse. So the clouds are rather dark and voluminous. But at the same time, we *are* starting to get some pretty serious numbers on the volatility indices again. Tuesday we definitely had a barf mode in some individual stocks.

Like Cisco, you mean?

Exactly. That was a big barf, that $8.12. That could have been the low for CSCO. And we're still hitting stocks like General Electric (GE), General Motors (GM), Ford (F).

Do you believe, Ford bonds trading like junk?

Well, when a company like Ford cuts its dividend, that's not the end of the bad things. That's a pretty bad sign. They are in trouble. This is not confined to the U.S. It is like the X-files thing. "We are not alone."

You are just full of happy thoughts.

One of the things I am going to put in my next piece will be mystery chart. It is going to be of the Germany Fund–and most people will be shocked.

It has to look like half of the Grand Canyon.

It has just cratered. Many years ago, when I was at Fidelity, I called 8,000 on Japan as the ultimate support level–and we're only 500 points away. So this is obviously a planetary problem–just a cycle you have to go through. There are ebbs

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and flows. This is the ebb. We'll get past it, but there will be pain. My point is that if you are on the right side of this, you are loving it. I have lots of institutional clients–and 11,000 retail subscribers–who are loving it. Yet I'm still hearing on the TV–what's her name, the Money Honey, say, "You should be investing for the long term. 10-15 years. This one-year, two-year stuff is no good."

That's when I barfed.

That's a steaming pile of horse dung! I'm sorry, but that's like saying, "walk into the casino and keep betting on red, forever, and you'll do fine." It's insane. The stock market is a risk environment and you have to be very, very good in order to beat the odds. Or you have to put your money with people who are very, very good. Now, I have worked for the best and brightest in the business, and yet that is a level of trust that I could not transfer. I just would never do that, having seen what I have seen. And knowing what I know. There are more people in this game than should be in this game. You need to understand the playing field, and yet people don't have a clue. This ethic that you have to invest for the long term is totally wrong. Not that I am saying you should whip back and forth and day trade–that's totally wrong, too. My ethic is that you have to analyze the market for what it is. Position your portfolio to exploit the factors as they unfold. Sometimes that means you have to trade quickly. Other times, it means you have to stay in there and give it a chance to work out. But you have to have a disciplined methodology. The factors that you look at have to be simple, and not overwork the plumbing. You just have to have a process that works. It does not have to be mine, though I think mine is the best on the planet. It just really has to be something that works. You also have to be flexible. Sometimes the effectiveness of one indicator or another will go down. So I am always trying to second-guess. Sometimes you see that in my writing, I'm trying to second-guess opinions or strategies or projections that I have made. Like the big barf. I start to question that when I hear other people talking about the big barf–saying that's what we need.

If not that, what? More water torture?

I don't know. But you see what I am doing, don't you? I'm not pressing my bets here. I am taking my bets off the table as we go. The market is always an uncertainty; it's always a risk. You never know for sure. But I don't have to make every dime in a move. I am quite happy with my 30% gain the Rydex fund, with my 20% gain in the Spyders and the 15% gain in the Diamonds. Even with my 10% gains in the QQQs, which are a big ripoff because they haven't reflected the decline in the Nasdaq. At bottom, my long-term outlook is more about process than about "buy a portfolio and forget about it." It is a distinction that most people don't understand, and it's why most people don't win in the long run.

Which explains why your model portfolio is almost entirely in cash here. [See table, opposite.]

It is *now*. We've had tremendous action in our model portfolio from day 1–although we have mostly cash now, we have a lot more of it than we started out with [A full recounting is a available on the w@w website, and is kept up-to-date at www.ErlangerSqueezePlay.com]. So we're ready for the next advance stage, if and when it begins. The next major play after this decline phase runs out, will be to the upside. But I don't expect anything greater than 20% perhaps. That's the max.

> **"The next major play after this decline phase runs out will be to the upside. But I don't expect anything greater than 20%, perhaps. That's the max."**

So just enough of an upmove to get everyone talking about a new "bull market?"

That's because they're wearing secular bull market eyeglasses. You have to look at the primary secular trend as a decline. Now, in a secular bull market, when prices are going up on a long-term basis, people look at a correction–define a bear market as a drop of 20%–and usually, that's about it. In a long-term bull cycle, a 20% bear market is pretty much all you get. Well, that is going to be true in reverse now. Where the bear declines are much larger percentage moves and the bull markets are technically corrections to the primary bear trend. So that means that the "bull markets" could be anywhere from 10%-20%. What's interesting here is that if you look at the S&P 500, we're below 800 now. If you tack on 20%, where does that get you?

Not very high–960 or so.

And do you remember what 960 is? That's the neckline, the heart of the neckline of the head and shoulders top pattern. [See chart, page 1] So we have gone down enough to give us what I would consider to be the maximum potential for a bear secular trend corrective rally. You have to think of it in those terms, because that's what the big picture is saying. The big picture is that it's not all over. It's not going to be a brand new bull market, where you get the roaring '90s again. There are a lot of problems that aren't going to go away instantly. So you're only going to get a shift that corrects the primary bear trend. At least until proven otherwise–I'd love to see that neckline get violated; broken to the upside. That would change things quite dramatically.

But you're not holding out a lot of hope.

So far, everything has been precisely what one would expect, given my thesis that this is a long-term secular bear that will last probably through this decade. It's not going to be easy. You have to follow the bouncing ball and you have to have a methodology that's not going to get you too far off base.

Like yours?

Of course I'm going to say that. But why not? The standard operating procedure has failed for so long–when the bull

Bear Tracks: Erlanger Model Portfolio's Only Currently Open Positions

Stock Symbol	Short or Long	Company Name	Date of Opening	Basis Trade	Price as of 10/08/2002	Delta Trade	Days in	Status	P&L%
QQQ	Short	NASDAQ 100 Tracking Stock	08/07/2002	$22.27	$20.16	-2.11	64	Open	9.47%
RYTPX	Long	Rydex Tempest 5000 Fund	8/28/2002	$93.93	$123.78	29.85	43	Open	31.78%

market was in its sweet spot, most people shied away from it. The wall of worry was huge. The short selling was widespread and massive. Now, the short selling on a relative basis is still light. *It is still light.* I am hoping that the October numbers, which will be as of this Thursday, will show massive short selling. I'd love to see that. Because that would be another clue that we're going to get our 20% rally corrective bull rally. I'm not going to call it a "bull market," because that implies to people that the primary trend is a bullish one–and it's not. I'm going to call it "a secular bear market corrective bull rally," when it comes–or something like that. I'll have to come up with a catchier name.

A pseudo bull?

Something like that.

Let's go back to square 1. What the heck is a squeezeometer?

Let me start with my investment philosophy, because that will trickle down into what I use–

Then we'd better go back even further. What went wrong in your early childhood to lead you into technical market analysis?

Is that what happened? I grew up in New York City and way back in grade school had a step-cousin in Merrill Lynch's training program. He took me on a tour of the floor of the NYSE and out to lunch. That kind of put the carrot out there; showed me what that world was like. This was in the late '60s. When I got out of college in '76, I became a stockbroker in Boston but gravitated more toward the research end of things. This was before there were personal computers. In fact, when the Apple 2 Plus came out, I was probably one of the first buyers. I certainly was one of the first to program market-oriented software on it. Now, it was not very elegant–but back then, it caused a bit of a stir. So I was a stockbroker developing code on the side for my own use and other stockbrokers, seeing what I was doing, wanted to buy the program. Ultimately, a large producer at Advest, who had bought it and liked the philosophies that came with it, introduced me to their research department. That is how I became their chief technical analyst.

How did you happen to start following short selling?

A *Wall Street Journal* reporter, Pam Sebastian, actually encouraged me to get into it. She used to do the short interest reports almost every month in the 1980s, after calling a lot of analysts for commentary. But there was a little trick to calculating the ratio. The numerator was obvious, but the denominator wasn't because the NYSE never reported the average daily volume over the period–and the number of days in the periods weren't standardized. So it took some legwork and calculating. I would consistently get it right and other analysts would get it wrong. Finally, she just stopped asking everyone else and left the job to me. Then one day she asked what else I was doing and I mentioned a backburner project. This was back when arb stocks were big and people were saying arb activity was skewing short interest data. I told her I wanted to weed out all the arb stocks and just look at the non-arb ones to get a truer measure of at-risk short selling. When she said, "Wow, that would be interesting," the back-burner project quickly became a front-burner project. I told my boss at Advest that he was giving me two weeks off to keypunch all the data into my little Apple. First, I had to go down to the NYSE and–with a security guard standing over my shoulder–photocopy all of the short interest reports, going back 5 years. It was all on hard copy. And the Exchange has since thrown all that stuff out! As far as I know, I am the only one with short interest data going back into the '70s. Anyway, I put in the sweat equity, came up with an "at-risk" short interest ratio, which wasn't the Holy Grail, but was interesting, and she wrote a Heard on the Street article about it. which was great.

Your first 15 minutes of fame–

But then, just because I had this database, I started looking at it. And my jaw dropped. You could see the short interest build up as a stock or an industry group would go to a low. And when the short interest got to a high level, that was pretty much the end of the down move. A new bull phase would start. Which wouldn't end until the shorts pretty much were wiped out. There was just this continuous ebb and flow. When I saw that, I really did discover what, for me, has become the Holy Grail. Or as close to it as you're going to find in the stock market. Obviously, I have refined it, but it's not really more complicated than that.

That seems more than a little counter-intuitive to me. I have a prejudice that, at least traditionally, shorts have tended to be more often right than wrong. They tend to do more and better research, etc., before risking going against the herd.

I don't dispute that. In fact, that is part of the process. Basically, let me give you my lecture on research. I don't know if I should say this–but when I hear about all of these complex models that weight the evidence of 70 indicators, that is pure bullshit. I am old enough, I can say that.

Okay, now defend it.

First of all, I defy anyone to find 70 indicators that are specifically independent of each other and that have anything to do with stock prices. If you do, you get the prize. But even if you did, the model would be immense. Let's just cut that roughly in half, to make it simple, and say we had a 38-factor model. Let's make it simple again and say that there are only five ways to interpret each factor–very negative, negative, neutral, positive or very positive. So how many different patterns of 38 indicators would you have to recognize to understand the implication of each possible mix of indicators?

A very large number, I'd bet.

The formula is 5 to the 38th power. Now, there is a thing in statistics called degrees of freedom, which says that in order for a model like that to be anything but mush you would need about 2 million years of data. Even if you only have 10 indicators–which brings into the mix just about every macro analyst out there, there still are not enough degrees of freedom to say that the model is worth anything. This is what is so counter-intuitive–the effectiveness of a model is inversely related to the number of factors that are components of that model. The fewer the factors you use, the more reliable the model becomes. This is the exact opposite of what most people think, but if you start with just one factor and then add another you now have 25 different possible outcomes–and it's possible to measure that accurately, if you have enough data. But if you add another factor, the potential outcomes go up to 300 or so. So my shtick on research is: "Find the one, two or maybe three factors that are the most effective." You had better be sure that what you are looking at is worth a damn and works because adding anything else not only wastes time

Tempting: Erlanger's Current Type 1 "Short Squeezes"

Symbol	Issue	Price 10/09/02	Power Rank	Tech Rank	Short Rank	Group	Group	Option Trading Rank
UL	Unilever Plc	$36.00	100%	100%	99%	4	Packaged Foods	
YELL	Yellow Corp	$26.55	100%	100%	100%	18	Trucking	0
DELL	Dell Computer Corp	$25.00	99%	100%	97%	94	Electronic Data Processing	55.72
ERTS	Electronic Arts Inc	$64.73	97%	100%	91%	56	Recreational Products/Toys	84.88
APOL	Apollo Group Inc Cl A	$43.31	92%	100%	76%	19	Other Consumer Services	99.78
ESRX	Express Scripts Inc	$50.66	92%	100%	75%	6	Drug Store Chains	68.08
QCOM	Qualcomm Inc	$27.91	92%	100%	75%	37	Telecommunications Equip.	57.01
ROAD	Roadway Express Inc	$35.25	92%	100%	77%	18	Trucking	78.89
PG	Procter & Gamble Co	$88.19	91%	100%	72%	10	Packaged Goods/Cosmetics	97.03
CL	Colgate-Palmolive Co	$54.58	89%	100%	68%	10	Packaged Goods/Cosmetics	53.66
AFL	AFLAC Inc	$29.02	86%	90%	77%	64	Accident &amp Health Insurance	97.81
NXTL	Nextel Communications A	$7.32	86%	90%	79%	17	Cellular Telephone	16.3
EBAY	Ebay Inc	$53.01	83%	80%	90%	121	Internet	77.51
MMM	3M Company	$112.32	80%	80%	80%	77	Diversified Manufacture	93.02
PFE	Pfizer Inc	$29.25	80%	70%	100%	44	Major Pharmaceuticals	75.92
PAYX	Paychex Inc	$23.00	77%	70%	92%	81	Diversified Commercial Services	28.67
MSFT	Microsoft Corp	$43.99	75%	80%	66%	98	Computer Software	81.08
WFC	Wells Fargo & Co New	$44.60	75%	80%	64%	122	Major Banks	57.77
YHOO	Yahoo! Inc	$9.98	72%	70%	75%	121	Internet	0
COL	Rockwell Collins Inc	$20.88	67%	70%	60%	125	Aerospace	88.21

but muddies up the process statistically.

But that's no mean feat.

Clearly, the fundamental analysts have been unable to find the critical factors. Or if they had, what they were doing is now illegal. Regulation FD rendered every fundamental model illegal or useless.

Spoken like a confirmed technician. Fundamental research doesn't *have* to depend on inside information.

Well, to my mind, the market is really governed by the laws of physics–*stock market physics*. Generally, when a majority has placed its bet, it is only a question of time before things start to happen that diverge from the expectations of that majority bet–and even if events go along with that bet, the money already has been placed. It is a supply and demand environment.

It is, after all, an auction market.

Exactly. So the trick is to make your big bets when you reach those juicy moments in time when the vast majority has gorged themselves on their expectations and the market starts to move the other way. So my main model is a two-factor model. It includes sentiment to measure what the majority is saying and price action to see whether moves are with or against that majority.

Sentiment can be measured at least a zillion ways.

True, but that's where short-selling comes in. Actual investment/trading commitments are more powerful measures of sentiment, to my way of thinking, than opinions. And short-selling is the quintessential sentiment indicator. It can be associated with specific stocks, industry groups, sectors, markets and index derivatives. Short sellers, because they must buy back the stock they've sold short to close their positions, represent future potential demand for a stock. And extremely heavy short selling is a sign of crowd bearishness. Conversely, we interpret times when short selling is light as periods when margin debt is most likely most extended–and so as a sign of crowd bullishness.

And that's what your "short rank" measures?

Yes, it tells you how intense the short selling is on a stock-specific basis. The range of potential values is from 0% to 100%. We look at the short selling of each equity issue on a weighted basis going back five years, if possible, then determine where the current amount of short selling ranks relative to each issue's history of short selling. So, a value of 100% indicates a new high in short selling, and 0%, a new low. Still, if I see too many bears, I don't automatically buy the stock. I wait until the market tells me that those bears are wrong. So your prejudice about short sellers–that they are often right–I absolutely agree with. We call that a Type 3–the shorts are right because bearishness is building up but prices are remaining weak. We follow those situations and wait until the bearishness builds to such a massive point that it becomes a setup for a short squeeze.

What tells you when that tipping point is hit?

We wait until we actually see the price action confirmed by a variety of techniques. We model relative strength, for example, on a non-linear basis to measure it in a very quantitatively accurate way.

Which means what, freed of jargon?

Relative strength is a great indicator, very time-tested. But it has some flaws. What you really want out of a relative strength indicator is the pattern of relative strength, the shape of relative strength, not the absolute number. So we use non-linear modeling to classify the shape of each relative strength line. This methodology generates a more accurate measure without an increase

Erlanger Squeeze Play Definitions, Disclosures, Disclaimers

Short Rank: The Erlanger Short Rank measures how intense the short selling is on a stock specific basis. The range of potential values is from 0% to 100%. We look at the short selling of each equity issue on a weighted basis going back five years (if there is that much data). We then determine where the current amount of short selling ranks relative to each issue's history of short selling. A value of 100% would indicate a new high amount of short selling for the past five years. A value of 0% would indicate a new low amount of short selling for the past five years. A value of 50% would indicate an average amount of short selling for the past five years. With this measure, we answer the question "How intense is the short selling for a stock?" in a way where we can compare one stock to another (statisticians call this normalization).

Technical Rank: The Erlanger Technical Rank is a very special statistic and it ranges from 10% to 100%. It is a nonlinear modeling of each issue's strength relative to the S&P 500. Many years ago we used advanced computational pattern recognition methods to allow the computer to interpret relative strength patterns in the same way a technical analyst would. We were able to do this, allowing the computer to score relative strength patterns on thousands of stocks at a moment's notice. Each issue's relative strength pattern falls into one of ten distinct patterns we have defined. The higher the Technical rank, the stronger is the pattern of relative strength.

Group Rank: Currently we track 139 industry groups. We calculate the Power Rank for each component issue for each group and average them to get the average Power Rank of the issues in each group. We sort from highest Power Rank to lowest, giving a rank of 1 to the highest and 139 to the lowest.

Options Trading Rank: We combine various options series into one normalized index to get an overall picture of sentiment derived from options trading. We call it the Trading Index. Its purpose is to highlight the sentiment of equity options traders and at the same time reflect the momentum of sentiment. The trading index is on a 0% to 100% scale. One hundred percent (100%) reflects extreme dominance of put activity over call activity, and therefore represents an excess of bearish sentiment. Zero percent (0%) reflects extreme dominance of call activity over put activity, and represents an excess of bullish sentiment.

Source: www.erlangersqueezeplay.com

Vulnerable: Erlanger's Current Type 4 "Long Squeezes"

Symbol	Issue	Price 10/09/02	Power Rank	Tech Rank	Short Rank	Group Rank	Group	Option Trading Rank
VRTS	Veritas Software Corp	$12.87	7%	10%	2%	98	Computer Software	33.63
MXIM	Maxim Integrated Prods	$21.35	8%	10%	3%	137	Semiconductors	66.14
MCD	McDonalds Corp	$16.56	9%	10%	7%	72	Restaurants	58.5
NSM	National Semiconductor	$10.62	9%	10%	7%	137	Semiconductors	66.38
SLB	Schlumberger Ltd	$34.27	10%	10%	9%	51	Oilfield Equip. &amp Services	81.69
GE	General Electric Co	$22.00	12%	10%	17%	77	Diversified Manufacture	73.69
IR	Ingersoll-Rand Ltd Cl A	$29.84	12%	10%	16%	65	Industrial Machinery/Components	100
MO	Philip Morris Companies	$36.63	12%	10%	16%	123	Tobacco	52.32
CSC	Computer Sciences Corp	$24.56	15%	10%	24%	90	Military/Government/Technical	74.95
HD	Home Depot Inc	$23.66	15%	10%	25%	82	Building Materials Chains	91.01
BAX	Baxter International Inc	$28.27	19%	20%	16%	44	Major Pharmaceuticals	80.01
CSX	CSX Corp	$25.57	20%	20%	20%	93	Railroads	61.29
INTC	Intel Corp	$13.46	20%	20%	19%	137	Semiconductors	69.86
BAC	Bank Of America Corp	$54.15	24%	30%	12%	122	Major Banks	74.96
R	Ryder Systems Inc	$21.68	29%	30%	27%	115	Rental/Leasing Companies	96.17
AOL	AOL Time Warner	$10.74	30%	30%	29%	121	Internet	32.05

in signal volatility, making it superior to linear techniques such as slope or rate-of-change computations. That's what we call a stock's "technical rank."

I imagine that it takes more computer power to work that out than you had in your old Apple.

Yes, but it's not really all that complex. It essentially boils down to asking if the stock is relatively strong or relatively weak according to the way that I would read a chart. I measure that against how intense the short selling is to come up with one number we call our power rank–and that gives me my squeeze plays. Essentially, the higher the power rank, the stronger a stock relative's strength pattern is and the greater the short selling is, constituting a potential for a short squeeze. The implication, in other words, is that the short selling crowd is wrong. Often, when short sellers get caught in such a squeeze, the market moves against them until they capitulate–which we see as a decline in the stock's Erlanger short rank. On the other hand, the lower the power rank, the weaker a stock's relative price action is, and the scarcer its shorts (or, effectively, the more numerous the bulls)–meaning there's a potential for what I call a long squeeze.

And that's how you group stocks into your various "types" or categories?

Yes, we categorize stocks according to our price action and sentiment indicators as Types 1 through 4. Type 1 is what we like to buy–a short squeeze with a heavy Erlanger short rank and a strong Erlanger technical rank. Type 2, we call "recognized strength." These are holds with light Erlanger short ranks and strong technical ranks. Type 3s, we refer to as "the shorts are right." We like to avoid these. These are stocks whose relative strength is weak but the short selling is heavy. In other words, the trend of weakness is recognized and most expect declining prices to continue, so the shorts are correct. But we also view these issues as potential turnarounds– the selling has largely already taken place. Type 3s often turn into Type 1s at some point, so a strategy of observance is appropriate, waiting for signs of relative strength to trigger a buy. However, if a stock goes from a Type 3 to a Type 4, it is in real trouble – this means the stock was unable to rise even after the shorts covered. In other words, the shorts took their profits too soon. Finally, we have long squeezes, Type 4, which are the sorts of stocks we like to short. These are stocks whose relative strength is very weak, but which have attracted very little short selling. We interpret this as a sign of extremely bullish expectations.

Okay, if you concentrate on price action and sentiment, as reflected in short selling, why do I see a lot of options data on your web site?

That's another way of getting at my niche in the market. Short interest data is stock-specific. And there aren't a lot of other stock-specific ways to measure sentiment–except options trading. So I follow it, too. We have a database of stock-specific options information, so we can measure put/call ratios, and call/put ratios in terms of volume, open interest, options premiums and total dollar money flow. So we get a beat on what is going on in the options arena. But methodology is more short-term oriented than I am, really. I am not a short-term guy. I don't try to catch every turn in the stock market even if they are 350 points. I just try to capture the meaty part of the mood and let everyone else beat himself to death.

And you use the options work to–

We use put/call ratios to measure the ebb and flow of bearish sentiment and call/put ratios to better see the bullish swings in sentiment. At extremes, they can be great setups for contrary trades.

Okay, so back to your squeezeometer–

Well, the concept of advancing and declining market phases is clearly at the core of our research. In both bull and bear phases there is a constant swing from an excess of bullish sentiment to an excess of bearish sentiment. And the market seems to wait for an excess to appear before shifting direction. Hence, each "phase" is a squeeze play. And these phases also tend to occur on short-term, intermediate-term, long-term and even mega-term bases–which we measure based on hourly, daily weekly and monthly data, respectively. The squeezeometer is simply a table designed to indicate which phase is underway for each of the four time periods–and further, by dividing each phase into four sections, to show where we are in that trend–at a turn in direction, early in its establishment, in the sweet spot, or on its last legs. So there are eight rows in every column–but only one cell is active in each one. An active cell is identified by colors and numbers. Mature trends are colored yellow, because conservative tactics are usually appropriate at such times. Other cells are colored either green or red.

And the numbers inside the active cells mean what?

They show the readings of our buy or sell confidence indexes–the buy confidence index in the four advance phase stages, and the sell confidence indexes in the declining ones. Typically, confidence is high as a move begins and then tapers off. Currently, for the mega trend, sell confidence is very high–because the short ratios are near multi-decade lows. As I said, despite what you hear on TV, there is relatively little short-selling in this market.

Which raises the question of just what all the hedge funds are using to hedge their positions?

Most of those hedge funds are not doing real hedging!

No kidding.

Hey, you would think that with this kind of action, the short interest ratios on the ETFs would be sky-high. They are not. We track them every month as the data comes out. There is a lot of stuff that doesn't add up right now, so it isn't easy. I have been as right as anybody I know in this market–and it has been a ball-buster It is what I call a complex market; it just doesn't go anybody's way for very long.

That sounds like an old-fashioned textbook definition of a bear market again.
It is, of a secular bear market, like I said. A bear market in a cyclical bull market is quite short but very satisfying. By contrast, we can't get a crash out of this market.

You are actually pulling for one?
Until we get some sort of clean-out, every rally is just protecting hope. I am not saying that the market can't rally from here. But if it does, all we'll be doing is setting the stage of a further decline, and that is not good. The larger picture, which is what most people have forgotten about, is that the exact worst thing you want this month is to see a peak of optimism. Octobers are really usually about seeing a peak in pessimism. I don't want to step out of my realm of two-factor models, but it certainly looks like the rest of the world isn't doing too well. Sentiment is not where we need to see it for the longer picture. It may very well be for the short term. But the worst thing we could do for the long term would be to get short-term sentiment up to a fully blown market peak point of bullishness while we are at five- and six-year lows. It is just not going to help things.

Yet haven't you heard? Bottom-calling is the new national pastime.
We have to get to a point where people *hate* stocks. Where you mention stocks to them and you walk away with a bloody nose. We are not at that point. There may be a lot of frustrated people and perhaps maybe even a certain level of disgust. But I don't see 8%, 10%, 15% cash levels in Magellan–or any mutual fund.

Nope, I see bull market cash levels.
Exactly. They have essentially leveraged their equity exposure by meeting their redemptions with cash, instead of selling shares. I mean that is a hell of a bet. That is like gambling when it comes up black five times and so you put all your money on red because "it has got to come up red next time." Well guess what? That is wrong. You are bucking against the trend. And this is a hell of a time to be betting the entire farm on a trend that has not shown up yet. That's food for thought. But what I like about my methodology is that I can think what the hell I want but ultimately I have to follow the bouncing ball. That is why I have never led anybody too far astray. I don't think much of anybody's market opinion–and I only think a little bit better about my own Market opinions are what people should least rely on. They should buy and sell based on data or factors that are disciplined and only take risks they are comfortable with. For me, that means basing decisions on price action and sentiment.

Your models have kept you pretty much on the profitable side of the market in a year that has been brutal to most investors–
It is painfully simple. I am not talking about some kind of wave theory that has so many different possible outcomes that a computer can't figure it out. Or some kind of black box that nobody can understand. The short selling stuff is just measuring the data. It is not more complicated than that. But you do have to do it the right way and get the historical stock-by-stock perspective, which is a lot of grunt work that most people are too lazy to do. Basically I am just trying to catch waves, trying to catch the opportunities when they arise. And the lowest risk, the easiest waves to catch occur at extremes. The July low, I pinned to the hour, just about. We went long. Because *that* was an extreme. I had 100% buy readings across the board and we saw the fear that we needed. But then that quickly reverted back to a whole bunch of optimism in August. Maybe we were a tad early in starting to step aside in the first and second weeks of August, but the market did not go up very much after that. Now here we are again. I would love to go bullish again but we have nowhere near enough fear this time. We've cracked to lower lows and it is very organized, very complacent. These things are getting sucked down the drain and there is very little fear. While the volatility indices have finally started to stir, they're still low relative to what is going on with the stocks and it is pretty bizarre.

What do you think of the explanation that people have just given up on the Nasdaq stocks and are treating them like lottery tickets?
The human brain has a thing that I call a widget. It makes you feel that things that are closer to the ground, that are low, that are cheap, that have already come down a lot in price, are safe, secure. So it is a lot easier to buy Cisco at 10 than it was at 15. But of course they thought it was a lot easier to buy Cisco at 15 than it was at 20. So where does it finally end? It finally ends when everybody says "Oh God, Cisco has gone to 10. Get me out." That has not happened. On a broader basis, we just don't see that kind of fear in the face of declining prices. The best short squeeze, the best time to buy, is when you see strength and an uptick in short selling. In other words, when they doubt the strength. Conversely, how often have we heard the phrase, "the market climbs a wall of worry" and not really understood what it meant? Strength creates its own fear because of that widget in the brain. "Oh, this stock is high. I am way off the ground. If I buy here, look at all the money I could lose. It could go right back down." But the problem is that the human brain makes it easier for you to buy a downtrend than to buy an uptrend because it makes you feel like you are too late in the game.

You've talked a lot about the head and shoulders pattern in the S&P 500–
And when I mentioned it before it became activated by the break of the neckline, people were inclined to say, "bullshit. It's just technical."
Too simplistic to be believed.
Exactly. And if it did have any validity, they would say, "everybody is talking about that so it is meaningless." But that is sort of like painting the picture of the artist painting the picture. You can try to out-think stuff to the point where you can't function at all. would rather just say the pattern is developing; the pattern was validated. Then we bounced up and tested the neckline as resistance. We might do that again here. That is the only thing that could really screw me up here somewhat–the next four to five months could just be spent getting back to the neckline and then we'd drop big next year. But if it happens that way, the big picture is very, very pernicious. Essentially anybody who has bought stocks since 1997 is a loser, as of last Monday. That is a hell of a tremendous overhead supply. Every mutual fund, every 401K guy, pretty much everybody has lost money and some have lost huge. Well, that tends to make it tough to automatically switch into an accumulation mode, especially if the mutual funds have used up all their cash.

Exactly, buy with what?
Yes. How much wool do you want to pull over my eyes? Anything here that stirs the bullish pot is just lining things

So you expect–
I have had a nice scenario, especially from a seasonal standpoint where this month is a major low in the market. Which sets up for a nice bull phase next year. But I am starting to suspect we won't see it. If we had gone down to 740 or below, which is my target, then we could have a nice 30% rise back to the neckline next year–a nice bull market. But I would be surprised if we got above that neckline. And if we don't go that low between now and February, the upside to the neckline would be a pretty poor bull market and in fact wouldn't speak well for the large picture. Which would mean that my expectations for the next bull cycle become less hopeful.

Thanks, Phil.