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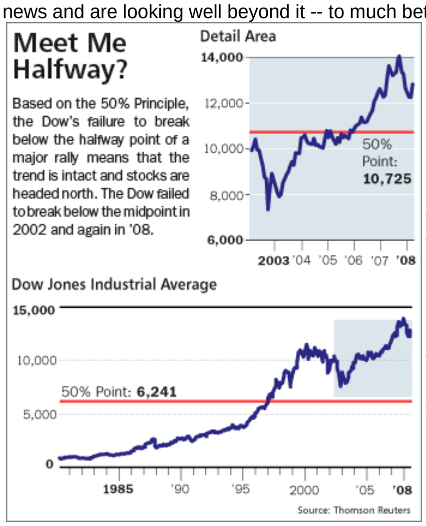
A Rally With Serious Muscle

By RICHARD RUSSELL

THE STOCK MARKET IS A discounting mechanism, the closest thing we have to a crystal ball. This year, it's been advancing in the face of what many economists describe as the worst business and economic situation since the Great Depression. That suggests that stocks have already "absorbed" the bad news and are looking well beyond it -- to much better times ahead.



A plethora of technical indicators tells me that the great bull market that began in the early 1980s is still intact, and that new highs are coming, maybe not immediately, but in the weeks and months ahead.

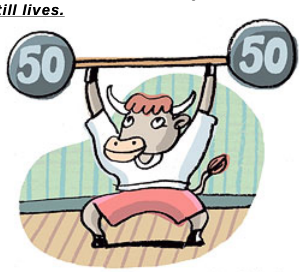
Let's take one confirming indicator whose use I have studied over many decades: the so-called 50% Principle, which I learned about from E. George Schaefer, the great Dow Theorist who published from the late 1940s to the '70s. Schaefer traced his understanding of the concept to the pioneering work of Charles Dow, who took special note of the market's level midway, or 50%, between a major advance and decline. The 50% Principle, named by Schaefer, tells us that the primary trend of the market remains intact and bullish if the Dow doesn't break below this midway point in the course of a pullback.

Schaefer, who applied his studies to the Dow, emphasized that this tool should be used only in reference to major market movements, not short moves of a few hundred points over a month or so. I used it in the early 2000s to determine that the bull market wasn't dead, but on the mend.

The bull-market move from the 1980 low of 759.13 to the 2000 high of 11,722.98 had as its midpoint Dow 6,241. In January 2000, the Dow stopped rising and started heading down, in what was widely assumed to be a bear market. But the decline halted on Oct. 9, 2002, at Dow 7,286.27, about 1,000 points above the 6,241 midpoint of the 1980-2000 advance. Thus, based on the 50% Principle, the market's primary trend remained bullish.

Interestingly, at the 2002 low, the Dow was selling for a hefty 20 times earnings while yielding a meager 2%. For that reason, too, I believed the bull market was still in its "expensive" and speculative phase, and that there would be a major recovery, with probable new highs.

The Dow peaked again on Oct. 9, 2007, at 14,164.53, which meant the midway point between its '02 low (7,286.27) and its new high was 10,725. In the subsequent sell-off, the industrials bottomed on March 10 at 11,740.15 -- again, about a thousand points above the midpoint of the 2002-'07 rally. ***So, the bull market still lives.***



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Valuations, Dow Theory and record short-interest all tell the same story. Stocks are going up.

The findings of the 50% Principle are confirmed by other technical trends. The Dow made a closing low of 11,971.19 on Jan. 22, a session in which 1,114 stocks, or one out of three, hit new lows on the New York Stock Exchange. Since then, the new-lows list has contracted dramatically, which means stocks are pulling back on down days but not breaking support -- an important difference.

Dow Theory bolsters the bullish case. On Jan. 22, the Dow transports recorded a low, along with the industrials. A rally ensued, followed by a decline in which the industrials broke to a further low that was "unconfirmed" by the stronger transportation average. From there, the transports headed higher, dragging the industrials along. In April, both the industrials and the transports rallied above their February peaks. This was a Dow Theory bull signal and reconfirmation of the primary bull trend. Recently, both averages climbed to new recovery highs, another sign the market was ignoring depressing business and economic news.

A final study contributing to the bullish case is the short interest on the NYSE. It has reached a record 15.2 billion shares. In order to make money, short-sellers need a declining market, preferably one that's falling amid rising volume, which is unlikely to occur. My guess is the short-sellers eventually will have to cover their positions -- that is, repurchase the borrowed shares they had sold -- resulting in a potentially explosive rally.

If the Dow hits new highs in the months or year ahead, many stocks will, too. Implicit in this forecast is the assumption the U.S. economy will improve as well. In sum, I see the bull market ending with a surge in both stocks and the economy, surprising almost everyone along the way.

RICHARD RUSSELL edits the Dow Theory Letter in La Jolla, Calif.