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STRATEGIES

The Stars Have Yet to Align for Stocks

By MARK HULBERT

CONDITIONS are most ripe for a bear market to end and a new bull market to begin when investor sentiment and fundamental and technical factors are all in alignment. Unfortunately, the rally that began three weeks ago is fully supported by investor sentiment alone, suggesting that the bottom of this bear market has not yet been reached.

First, consider the technical evidence. Compared with the initial rallies after previous bear-market bottoms, the rally that began in mid-July has been disturbingly weak. In fact, during the first days of the climb, a relatively large number of stocks actually fell. That has led many analysts to conclude that the upward trend is likely to fizzle.

Take note of one particular indicator — based on the proportion of shares trading on the New York Stock Exchange that rise in price in a given session. If July 15 were the bear-market low, according to many technical analysts, there should have been at least one trading session in the subsequent rally in which at least 90 percent of total trading volume was from shares rising in price.

Martin Zweig, president of Zweig-DiMenna Associates, a hedge fund firm in New York, calls such days "9-to-1 up days." In his 1986 book, "Winning on Wall Street," Mr. Zweig wrote that "every bull market in history, and many good intermediate advances, have been launched with a buying stampede that included one or more 9-to-1 up days."

The market's rally over the last three weeks hasn't satisfied this precondition. This may seem surprising, because there have been three days — July 16, 17 and 29 — when the Dow Jones industrial average has risen by well more than 200 points. But the volume of rising shares on the Big Board never exceeded 82 percent on any of those days; on one of the three, July 17, it reached just 71 percent.

Now consider the stock market's fundamental foundation: stocks are still not cheap, at least in relation to corporate earnings. On the contrary, the market remains more expensive than it has been at most other times in recent decades.

This is well illustrated by the price-to-earnings ratio for stocks in the Standard & Poor's 500 index. It is now at 20.0 when calculated on the basis of trailing 12-month earnings, according to Clifford S. Asness, managing principal at AQR Capital Management, a hedge fund firm in Greenwich, Conn.; that is higher than 73 percent of the readings dating back to 1965.

To be sure, corporate earnings are typically depressed during bear markets, thus inflating the P/E ratio. But even when taking this tendency into account, the market's current ratio is well above historical norms.

This is demonstrated by the ratio of price to an average of inflation-adjusted earnings over the trailing 10-year period. Such a metric was proposed more than a decade ago by Robert J. Shiller, the Yale economics and finance professor, and John Y. Campbell, the Harvard economics professor, in part to sidestep the complexities caused by artificially high P/E ratios at bear-market bottoms.

Using that 10-year measure for the S.& P. 500, the ratio is now 21.8, or higher than 66 percent of comparable readings back to 1965, Mr. Asness said.

CLEARLY, stocks are not as overvalued today as they were in early 2000, just before the Internet bubble burst and the bear market of 2000 to 2002 began. Nevertheless, the market remains far closer to the expensive than to the cheap end of the valuation spectrum.

Investor sentiment is the one arena that provides strong support for a new bull market. Investment advisers are now more pessimistic than they have been since early 1995, according to Michael Burke and John Gray, editors of Investors Intelligence, a newsletter based in Larchmont, N.Y. This is an encouraging sign, they wrote to subscribers in late July, because market bottoms are typically accompanied by exceptionally high levels of despair. Sentiment alone, however, is not a strong foundation for a bull market. History suggests that when this bear market hits bottom — whenever that may be — stocks will have more attractive valuations and the subsequent market rally will be broader than the recent surge.

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