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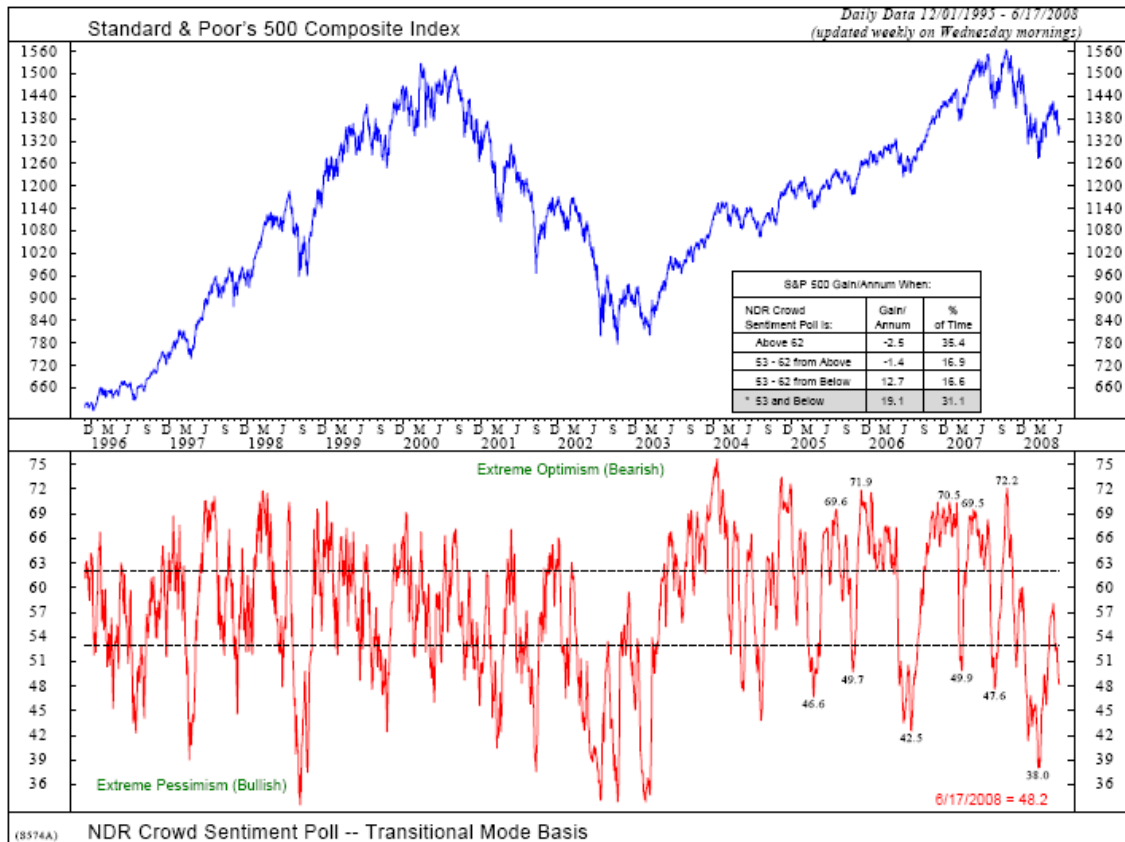
Bill O'Grady, Chief Investment Strategist

## Consolidation Continues

- To review, the S&P 500 peaked on October 11, 2007 at 1576.09. It hit a low of 1256.98 on March 17, 2008, a 20.3% decline. Since declines of more than 10% typically signal the onset of a cyclical bear market, technically, that is the equity market's current condition. From the March 17 low, the market lifted 14.6% to its most recent high of 1440.24, made on May 19. And finally, that rally ran out of gas, and prices have settled back to the 1325-1335 area, roughly an 8.0% decline from the May 19 high. Since early January, the S&P 500 has been trading between 1275 to 1425.
- We view market action as consistent with consolidation. Such periods of sideways price action are consistent with a market trying to distill divergent information. On the bearish side, sluggish economic growth, inflation concerns and disappointing earnings have pressed the market lower. On the bullish side, Federal Reserve policy makers have aggressively lowered rates which is usually supportive for equities, and the economy, though sluggish, has performed better than what is usually seen in a recession.
- Thus, the equity markets now rest in a 'decision box' of sorts. We expect the markets to remain in this box until the preponderance of the evidence suggests that the market should break out of this box.
- As we stated last week, if the Federal Reserve is forced to raise rates prematurely to curtail inflation expectations, we believe there is risk of a deep recession, ala' the 1974-75 and the 1981-82 periods. This would likely lead to a downside breakout from the decision box. *Downside Risk -- An estimation of a security's potential to suffer a decline in price if the market conditions turn bad.*
- On the other hand, if policy makers are able to stem rising inflation fears by other means, e.g., jawboning, dollar intervention, a deep recession will probably be avoided and the breakout would be to the upside, in our opinion.
- Complicating the issue is that market participants attempt to discount the future. Thus, if the preponderance of investors anticipate "bad" things are on the horizon, they generally begin selling immediately to protect their portfolio. The converse is true as well. Thus, investor sentiment readings can offer an insight into how investors are leaning. These readings can take the form of volume indicators (volume should confirm the trend, so falling volume into a price rally is typically viewed as a negative sign), breadth (the wider the dispersion of buying or selling, the greater confidence one can have in a trend), volatility (rising volatility tends to signal trend changes) and investor surveys can all signal when investors have become extremely bearish or bullish. This is where the adage beware of the crowd at extremes comes from. When investors are "too happy" it tends to signal the end of an uptrend and visa versa.
- Ned Davis Research (NDR) maintains a list of 12 "bottoming" indicators that suggest when a market's pessimism has become so extreme that prices are poised to recover. Currently, half of those indicators are into extreme pessimism territory, which implies that we haven't seen enough investor pessimism to signal a bottom but the process is probably underway.
- In this week's chart of the week, we feature the Ned Davis crowd sentiment indicator.

*Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.*

## Chart of the Week:



Source: Ned Davis Research

The upper line shows the S&P 500. The lower line shows the NDR Crowd Sentiment Poll. Sentiment has turned down into a zone which is signaling pessimism but it has not reached a level below 36 which signaled the recovery in 2003. The current reading would suggest we are approaching a level which could trigger a recovery, although we still expect any lift will simply move to the higher end of the recent range. If we were to see a sharper decline in sentiment, it would indicate that the market is laying the groundwork for a more significant recovery.

Bill O'Grady (314) 955-3064

0608-90614

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