

February 4, 2008

Not all trends are alike. Some are driven by positive feedback. Positive feedback prevails when a price trend attracts new traders who participate in the direction of the trend. Those new participants move the market further in the direction of the trend, attracting yet more participants, and so on. During positive feedback periods trends are self-generating and we may have confidence that present trends are likely to continue. I refer to such markets as 'momentum-driven'.

Momentum-driven periods reward those trading with the trend with alpha at relatively low risk. The best trades then are near the extremes of relative strength, making trade selection straight-forward. If the trend is up, the strongest stocks from the strongest groups are the best buy candidates, and if the trend is down, weak stocks from the weakest groups make the best short candidates. The Spread, our key strategic indicator, rises when momentum is present.

At other times, negative feedback animates the market. During these periods, traders in the aggregate behave as contrarians. When prices get 'too low', traders buy, and when they get 'too high', traders sell. Like the thermostat in the room you're sitting in now, negative feedback regulates prices, typically confining price within a range.

When markets are driven by negative feedback, trends are generally short-lived and unreliable. A rising market may be overwhelmed at any point by contrarian sellers, and a declining market is likely to encounter a strong bid by bargain-hunters. In the absence of a reliable trend, risk-reward is poor. Nor can we confidently select which groups will offer the best forward returns, long or short. Bottom line, trading during periods of negative-feedback is dangerous, and cash is usually the best remedy. When negative feedback is driving prices, The Spread falls.

While contrarian rallies and declines are often merely counter-trend corrections and should be monitored from the sidelines, there is one sort of contrarian rally which cannot be ignored. This sort of rally comes after a relatively severe momentum-driven decline (otherwise referred to as a 'bear market'). During such rallies, oversold laggards are bid up aggressively by bargain-hunting contrarians as well as by traders covering shorts. After a severe decline, a recovery rally may continue ex-momentum for a relatively long period. Importantly, such rallies amount to more than merely counter-trend rallies, and may indeed constitute the first stage of a new bull market.

In his 1967 paper, *Relative Strength as a Criterion for Investment Selection*, Robert Levy confirms this observation:

Utilization of the continuation of [the] relative strength concept produces superior profits during all periods *except those periods immediately succeeding a comparatively weak market.*

Once the initial contrarian phase of a new bull market has convinced traders that a new bullish trend is underway, traders develop confidence in the direction of price and begin to chase leaders. At that point, the rally morphs into a momentum-driven trend, and a new bull market is confirmed.

One condition for a first-phase bull market rally has now been met, namely, a prior decline under momentum. From its October closing high, the SP-500 declined a little more than 16% to its closing low in January. A second condition has also been met: the rally since mid-January has been sparked by a strong bid for laggards.

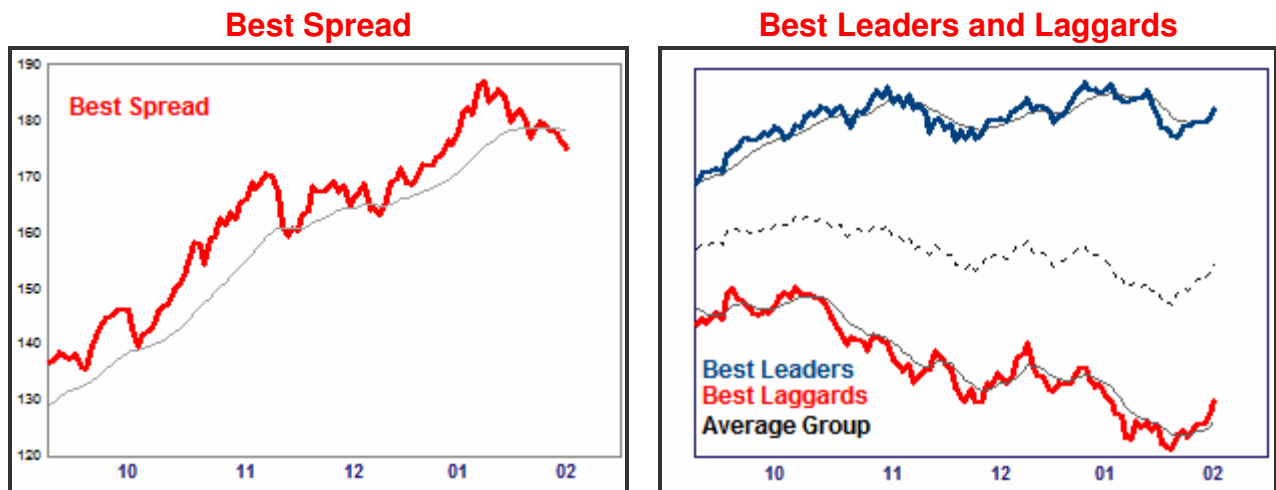
However, *any* contrarian rally following a momentum decline presents a strategic quandary since there is no way to tell the initial, contrarian phase of a new bull market from a merely corrective bear market rally. Technically, the two are identical. Both are reactions to momentum declines, and both are led by stocks from laggard groups. Fundamentally, the news is typically bad in either event.

If the current contrarian rally is a just a bear market correction, then holding cash makes sense, since such rallies may reverse without warning. But occasionally, as we have observed, contrarian rallies persist, and, despite hazards, at some point we must make a decision to trade if only to protect performance against a rising bogey.

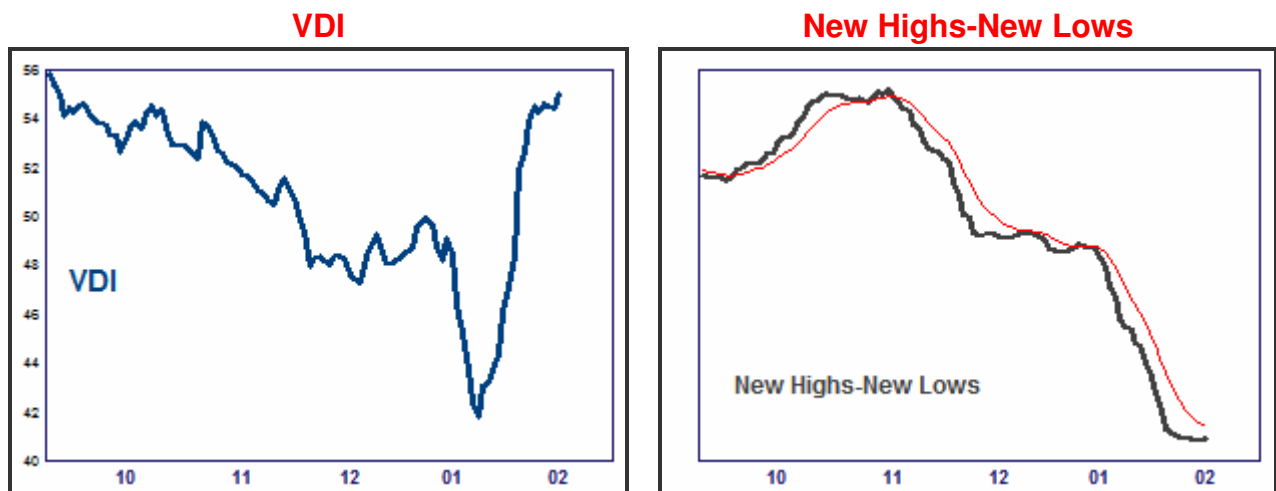
At what point should we decide to participate in a contrarian rally?

Ultimately it comes down to our confidence in the new trend. In the absence of momentum (a rising Spread) what gives us confidence that a contrarian trend may persist? The answer, I believe, is *clear evidence of strength*.

In next panel, note that as of Friday The Best Spread continues to fall, evidence that contrarians are in control. Note, too, that both Best Leaders and Best Laggards are now rising above their ascending critical moving averages (CMAs). Are rallies above their respective CMAs by both leaders and laggards enough to warrant taking long positions?



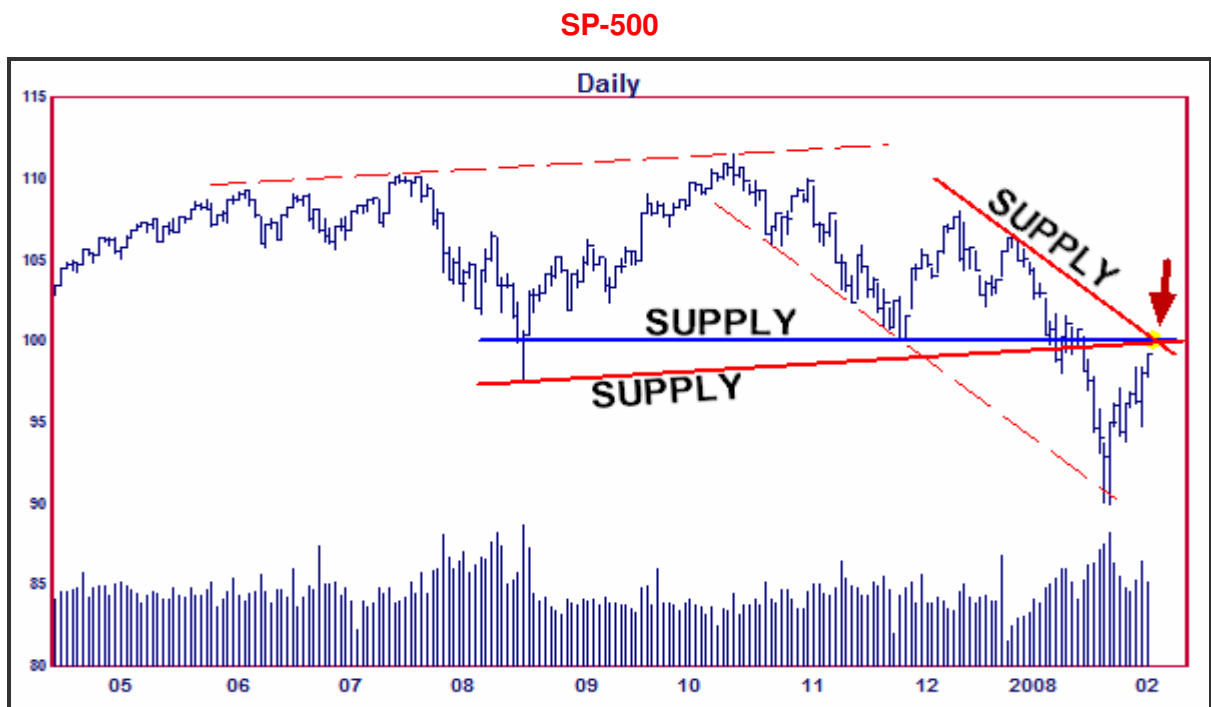
When the Force (of momentum) is with you, CMAs are very useful in triggering new positions as well as in stopping failed trades. Of course rallies or declines which evidence no momentum will also move these sensitive averages. But without momentum, extra care should be exercised before entering trades based solely on these measures. By themselves critical moving averages offer little mojo during contrarian periods and their use in the absence of other evidence may draw us into risky positions.



But there are other markers to which we may appeal. New Highs minus New Lows (NH-NL) cannot tell us whether or not trends are driven by momentum, but NH-NL has proven to be a very reliable indicator of the intermediate price trend. In the above panel of charts, note that NH-NL has been falling relentlessly since late October but has begun to improve in recent sessions. Should the indicator turn up and break decisively above its moving average, evidence for taking long positions will strengthen considerably, even in the absence of momentum.

The pronounced rally in the Volatility Desirability Index (VDI) is positive but not definitive since a rally by this indicator is characteristic of any rally following a bearish move.

What we need is a confirming test of some sort, something that demonstrates a degree of strength which is unexpected of a rally which is merely corrective. I submit the following: In the next chart of the SP-500 I have drawn two sets of trend channels in red and have indicated a level of strong former support, now supply, in blue. As it happens, there is a nexus of what appears to be very formidable supply just above the market (arrow). This is an area where we may reasonably anticipate that demand will be severely tested. The market, as measured by the SP-500, will either break above--and remain above--this intersection of supply, or it won't.



Let's review our strategic options:

The Model Portfolio is in cash, so we are currently as neutral as is possible. If this rally demonstrates convincing strength, we will go long, with or without momentum. Stock selection will depend on the direction of The Spread. If the rally picks up momentum (rising Spread), our decision to go long will be easy, and we will select strong stocks from the strongest groups. If a strong but contrarian rally develops (falling Spread), we will opt to defend against the risk of a rising bogey despite the risks inherent to trading a contrarian market. In the latter case, our selections will index the rally.

Of course the rally could also fail, in which case we will remain in cash so long as The Spread continues to decline. However, should momentum begin to propel a further decline we will short weak stocks from the weakest groups.

SP-500

	Model	SP-500
February	0.0%	1.2%
YTD	1.8%	-4.9%
Since 01/06	75.7%	11.8%