

In his January 2 comment, Bob Farrell noted that “The idea that 2011 was a flat year...is more fanciful than real.” Despite the fact that the indexes were little changed for the year, there was substantial fluctuation and volatility. The S&P 500 was up 9% in the first four months of the year, peaking on May 6 (the anniversary of the Flash Crash) at 1370.50. From there the index fell 21% or into bear market territory. The initial low was 1101.50 reached on August 9. On a daily chart, the stretched appearance of the ranges is evidence of increased volatility.

The downtrend which started in May was interrupted by a brief rally between August 8 and Labor Day. This carried the S & P 500 up 11.7%. However, the market rally attempt faltered on September 16 as the S & P was unable to punch through 1230.71, the recent high. The market established a lower low on October 4 at 1074.77. This proved to be the bottom; however, that was not clear at the time. One clue that it might have been was the positive reversal that took place that trading day, i.e. the market retreated and then rallied to close high in the day’s range. However, bottoms are easier to discern in hindsight than at the time. The market’s subsequent action (a rally) confirmed that the bottom for the cycle had been reached. By October 27 (seventeen trading days) the market rallied 20%. To paraphrase Charles Dickens, it was both the best of times (+20%) and the worst of times (the lower low). October 2011 turned out to be the second best October ever.

The move up stopped around the 200-day moving average. The next retrenchment saw the market decline 10% and stopped at 1158.66 at the end of November. That marked the worst Thanksgiving week loss ever. Note the November low was a higher low than the October 4 bottom. From the October 4 low through year end the market rallied 17% and continues to rally into the New Year. In fact, December 20 marked a follow-thru day, meaning that the rally attempt was confirmed. The follow-through was late by historical standards (the 17th day of the rally), but since the market continues to go up and leading stocks are acting better, it is working. What, you might ask, is important about a follow-through day? It is a signal that it’s okay to buy fundamentally and technically strong stocks anew after a period of uncertainty and consolidation.

You might also ask, “What about Europe?” The backdrop for the decline that started in May was the “news out of Europe.” The concern over Europe in May, not even new news then, clouded everything. Investors were scared and they sold stock. And they kept selling every rally until near year end.

Ted Mc Lyman’s book, Money Makes Me Crazy, discusses people’s “money behavior”. Based on his research “humans” are not “hard wired” to handle money. Humans make money decisions haphazardly and without understanding their “money temperament.” Money decisions are not based on objective assessment or disciplines, but on emotions. To paraphrase an investor friend of mine, rules are designed to replace haphazard action or emotional reactions. With the memory of 2008 fresh in most investor’s minds and “fear of contagion” front and center, it’s easy to comprehend why fear ruled the market for the better part of the year.

There are numerous verities in the market, many of which were on display last year: investors were fearful when they should have been greedy or complacent when they should have been defensive; their emotions ruled—and this is not limited to individual investors, when having and following rules, not relying on haphazard behavior would be more effective; bear markets always end. The evidence currently suggests this one has ended. To cite a few examples to support this view: the market is shifting back to cyclical stocks, the accumulation-distribution rating of the indexes now sit at B whereas in late July the rating was the lowest possible, E; the advance-decline line on the NYSE is marking not only higher lows, but higher highs and new highs continue to dwarf new lows on the NASDAQ, the market-leading index and distribution days are falling from the count. These are signs of an improving market.

How much improvement can be expected? Probably a lot more than most strategists and market observers envision. Why? Because the market is “inherently deceptive” and most are predisposed to believe the worst, not something better, lies ahead. As mentioned in previous letters, the market is better at interpreting the news than the news is at directing the market’s action. Last week Standard & Poor’s did what investors have been afraid of for months: they downgraded the debt of nine European nations and markets rallied as it has been doing since the October bottom.

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