How Cabot Spots Major Market Bottoms

As a bear market goes down, down, down month after month, fundamental analysts will begin to trot out the "evidence" that a market turn is around the bend — GDP is growing handsomely, earnings growth is just around the corner, Fed policy is accommodative, fiscal policy is out and out bullish, the technology spending cycle is turning for the better, valuations have now returned to reasonable levels, manufacturing is on the rebound, job losses have stabilized and job growth is beginning, etc., etc., etc.

These statements are nice to listen to. In fact, some will be indisputably true. *But what most investors fail to realize is that none of the above reasons are necessarily consistent with market bottoms.*

It's true! Sure, sometimes, when valuations drop to a given level relative to interest rates, the market hits bottom and starts advancing. But not always! And sometimes, when GDP grows at 4% or more, the market hits bottom and starts advancing. But not always!

We've been students of the markets for decades now and have been publishing investment advice for 37 years. We study the market itself and have seen any and every type of bull and bear market the financial gods have to offer. *And we've been able to use this experience to find three common traits that each and every bear market bottom has had in common.* By following these guidelines, we've always been able to get on board relatively early in each new bull cycle.

Below we'll detail these three traits, followed by some examples of past market bottoms and how we were able to take advantage of them.

Extreme Pessimism

Psychology in the market swings back and forth between greed and fear. Some of these swings are relatively minor. But at major market turning points, emotions can go to extremes.

At the end of bear markets, for example, pessimism is rampant. And we're not simply referring to investors' market outlook. Oftentimes, there is an unusual or what we like to term a "bizarre" event, that strikes concern into the public's mindset. This occurs within weeks of a major bottom, because the market prices in all the bad news ahead of time. As the environment improves, a new bull is born.

Your job is to keep your eyes and ears peeled for truly outstanding negative news items. Is the stock market all over the covers of the non-financial magazines? Is a financial event overseas rocking the market and grabbing the headlines of all the newspapers? The bigger and more negative a news story, the better. It creates fear, which leads to panic selling, which clears the way for future market gains.

Also, keep your eye on some tried and true sentiment indicators, such as put-call ratios, spikes in volatility, and the number of newsletters that are bullish or bearish. High put-call option ratios are good to see, as are a large percentage of the investment newsletters being bearish.

In total, always keep alert for wildly negative news items related to the market. Incredibly negative news, along with rampant bearishness among investors, often occurs within days or weeks of major market bottoms.

Sudden Strength in Major Market Indexes

With bad news swirling everywhere you look, market strength is unexpected. Investors are thinking in terms of losses, not profits. Any rally in the market is seen as a selling opportunity … as simply another bear market rally.

But at some point, soon after a rally attempt gets under way, the major market indexes will show renewed signs of strength. Big up days on heavy volume soon after a market low, *along with continued upside action*, are a significant clue that institutional investors are back on the bull side.

To determine if you're actually seeing a change in trend, look to our trusty indicators. For the intermediate-term perspective, Cabot Tides does an excellent job of keeping you on the right side of the market. *A bullish signal from this trend-following indicator can come within a couple of weeks of a major bottom*. When things turn for the better, this indicator will be one of the first to tell us so.

The Cabot Trend Lines speak to us regarding the longer-term trend of the market. Buy signals from this indicator come later than those of Cabot Tides but act as solid confirmation that a bullish trend is in place. It's not unusual for both of these indicators to be flashing green, declaring an uptrending market, while most investors remain in disbelief.

Which brings up another point: *The market tells its own story best*. So believe what it tells you! Preconceived notions will get you nowhere. If stocks begin to power ahead and our trend-following indicators turn positive, assume the market has changed course. It's tough to put your ego in your back pocket, but it's the best way to make money in the market.

Growth Stocks Roar Ahead

What good are tremendous negativity and rising market indexes if stocks we can make money with do not advance? This last trait is extremely important. Every major bottom we've seen has been accompanied by dozens of growth stocks powering ahead week after week. Many of them will come out of nowhere to hit new price and relative performance (RP) highs.

What do we mean by a growth stock? We could write a whole other article on the subject, but generally we're referring to a company with a big idea, an idea that can drive sales and earnings much higher in the future. Of course, ideas alone don't cut it — the vast majority of stocks we focus on have strong sales and earnings growth and hold leading positions in their industries.

During a down market, you should be keeping a revolving watch list of great growth stocks (we show you ours in the Letter when we have a high cash position in the Model Portfolio) you can jump on when a bull market returns. Usually the best growth stocks will reach new peaks soon after the turn comes. The first ones out of the gate almost always run the farthest in the ensuing bull move.

Remember that you should be watching growth stocks that resist the market's doldrums best. Those with negative momentum (downtrending RP lines) shouldn't be in your portfolio. *In fact, if the major indexes turn higher but the strength is mainly from beaten-down stocks, the market advance can easily peter out*. Sure, the dogs of the market can bounce for a few weeks, but they are unlikely to lead any real advance. We saw this in the last quarter of 2001, when the indexes rallied strongly……but they were led by those lagging big technology stocks. The rally failed in less than four months and was followed by a huge collapse.

Major Market Bottoms of the Past

The Worst Bear Market of Your Lifetime: 2002-2003

From peak to trough, the Nasdaq Composite fell 78% during this mega-bear market, while the S&P 500 was off a full 50% at its low during 2002. Such a huge decline generally requires a rather huge bottom with truly extreme levels of pessimism. And that's what we saw at the end of this bear market.

After the post-9/11 rally failed, stocks were battered by a sheer lack of faith. Enron and Worldcom were

the culprits, with investors wondering just how much they could trust Corporate America (and their accountants). Even conservative blue chip stocks were battered, and gaggles of solid companies were in the low-priced category, trading below 10.

As the market cascaded into July, with the Dow falling to 7,500 (down from its then all-time peak of 11,700), investors were finally throwing in the towel. When we asked our local barber about the market, he informed us that "all those guys [referring to CEOs and the big investment houses] are a bunch of crooks." Imagine! At the Dow's low that month, a huge 916 stocks hit new 52-week lows on the NYSE.

That was the first low. By October, the market was in the soup again, with the Nasdaq and Dow reaching new lows, while the S&P 500 held up better. By October 9 – the day the bear market officially ended – a mere 28% of newsletters were bullish. That was the lowest figure in twenty years!

And the third bottom (we told you it took a long time for this bear market to end) came in March 2003, just before the start of the Iraq war. Put-call ratios were skyrocketing, money was pouring into funds that would profit from a market decline, and so-called perma-bears (those investors who are always bearish) were getting lots of time on CNBC. It was a classic panicky bottom.

As it became clear the war would go forward soon, the market shot ahead like a rocket. All the indexes bottomed on March 13, 2003 – and our Cabot Tides and Cabot Trend Lines gave near-simultaneous buy signals just a week later! A blast-off! Stocks of all stripes rocketed higher, as the bear market created attractive valuations for a variety of excited growth companies. Our Model Portfolio, which was down a few percent for the year at that point, finished 2003 up well over 50%.

The Asian Contagion and Ruble Waterfall: 1998

The year 1998 started off well enough. The market was rising, Internet stocks were just beginning to catch some of the spotlight and most investors were making money. But then, following the prior year's brief currency crisis, more Asian countries, along with Russia, saw their currencies swoon in a matter of weeks. Fraught with fear, investors in the U.S. began dumping shares, fearful weakness overseas would lead to recession in the U.S.

As the Nasdaq plunged as much as 33% and the Dow nearly 20% (all in just three months!), fear rose to feverish heights. Magazines and newspapers were writing stories about how the deflation and depression that were hitting many Asian countries would seep into the U.S. economy. The hedge fund Long-Term Capital Management went under, threatening to blow up the markets, as its derivative positions would have to be unwound. The put-call ratio jumped above 1.0 in early October, and more investment newsletters were classified as bearish than bullish.

Then, out of nowhere, the market began to soar. Cabot Tides flashed a buy signal just two weeks after the early October bottom. The Cabot Trend Lines followed with their own buy signal a week after that. We were off to the races! Scores upon scores of high technology stocks jumped through the roof. Cabot's Model Portfolio bought shares of Yahoo! (which rose as much as 567% before ultimately topping out), gave Amazon.com a buy rating (it was in the portfolio since January of that year) and saw holding Qwest Communications more than double from that point.

From its low in mid-October, the Model Portfolio gained 42% through the end of the year, then rose another 83% in 1999 as the bull market roared ahead.

The Gulf War Uncertainty: 1990 & 1991

Looking back on the first Gulf War, it's hard to believe how worried many were about the conflict. Plenty of people talked about another Vietnam, thinking that we might get bogged down in a prolonged battle. Iraq, at the time, had the fourth largest army in the world — and they seemed intent on battling to the last man. War, while on the minds of Americans today, was an uncommon event a decade and a half ago.

Because of the uncertainty that accompanies war, the stock market began sliding in mid-July of 1990. It didn't stop until both the Dow and S&P 500 had lost more than 20%. Oil prices were sky high. The economy was in recession, as the savings and loan crisis was weighing heavily on our country's banking

sector. Nothing much seemed right with the world. Consider that, in September, only 25% of newsletters were bullish, down from 46% three months earlier.

Then the market began to rally in early October. It wasn't overly explosive, but the trend definitely turned higher. Cabot Tides gave a buy signal in early November, with the Cabot Trend Lines following up later that month. Though most investors were fearful of war, the stock market was trending higher by the end of the year.

Once the bombing began in early 1991, the market soared as investors realized this war would be over in weeks, not months. Cabot's Model Portfolio rode the backs of American Power Conversion (more than tripled in 1991) and Home Depot (up about 170%) — both of which had buy ratings during the first Letter of 1991, before the war started — to a 81% return that year.

America losing its way: 1974 & 1975

The greatest bear market since the 1930s came about for good reason: Interest rates were reaching 50 – year highs, inflation was accelerating to a pace unseen before, energy prices were rocketing higher as the oil embargo took hold, the economy was sputtering out and confidence in our country's leadership was crushed thanks to the Watergate scandal. In all, the Dow lost more than 46% of its value during the painful 1973-1974 bear market, while many of the bluest of blue chip stocks cratered much more.

Investors were turned off by the market. And business was horrendous. Consider that, in the first ten days of November, 1974, General Motors sold 43% (!) fewer cars than during the same period of 1973. Talk about bad news! Good old GM, one of the best known firms in the world, was in its own depression!

Investor despair was everywhere. But the market bottomed out in December of 1974, beginning to shrug off the incredibly bad news. By the start of 1975, our Cabot Trend Lines of the day (they were based on the Dow Industrials and Dow Transports) flashed a new buy signal. This sudden strength caught many by surprise, but our first Letter of 1975 was titled "BUY — BUY — BUY— BUY — BUY — BUY— BUY — BUY." It turned out to be a great year; Archer Daniels (it was a growth stock back then!) more than doubled and U.S. Steel gave us handsome gains as well, leading the parade of profitable recommendations.

Conclusions

Bear markets come and go. They are not permanent, though just when they're near an end, most investors fear they will last forever! By connecting the three dots we've laid out — extreme pessimism and unusual bad news, sudden market strength and dozens of growth stocks breaking out to new highs — you can identify major bottoms as well … and be one of the first to jump onboard the big winners of the baby bull market.

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