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# Beware the dead-cat bounce

I have been keeping an eye on the recent equity rallies, and I want to tell investors that I think they should remain a little bit cautious at this time. History is replete with liquidity-driven rallies within recessions that ultimately fail. I want to see the beginning of a long-term secular, sustainable bull market, and I do not have all the confirming signs of that right now.

We need to figure out if we are simply witnessing a short-term bear market rally or the beginning of a long-term bull market.

## Let's look to history for some patterns

The deeper the initial drop in stocks, the bigger the bounce. History shows that stock rallies are fairly frequent in the middle of a recession. It also shows that they often get smacked down. Right now, we are experiencing the biggest bounce the stock market has experienced since 1933, but it comes after the biggest drop since the Great Depression. So, I do not want to see our representatives and our clients get disillusioned again if this rally is unsustainable. What we might be hoping is the beginning of a secular bull market may really be only a temporary bull market.

There are certain characteristics that typify a rally within a recession as opposed to signs that a new and sustainable bull market is beginning. We are witnessing low volumes and still high volatility. I would rather see higher volume and lower volatility. Thus, we are not yet seeing the signs that a long-term upward trend has begun. Before a recovery, we often see about a 10-week rise in consumer discretionary stocks. That sector has rallied, but on a market-cap-weighted basis, not an equal-weighted basis. That means market breadth is lacking.

We need to see signs that credit markets have stabilized. These credit markets are slowly improving but are not functioning at prices that make the cost of capital affordable for many companies. The excess spreads are still very wide by historical standards. I believe we need to see a strong recovery in credit markets to confirm that a stock rally is sustainable.

We also have not seen confirmation from economic data. In particular, one number that came out of the jobs data last month was disturbing. Aggregate hours worked went down. That is typically the one forward-looking number that the government releases each month concerning jobs. Think of it this way: If you own a factory or a white-collar establishment and you think that the economy and demand for your products is getting better, rather than hire new expensive workers, you are going to have your existing workers work longer weeks. That is not happening and always does before the hiring begins. I think we need to see hiring increasing to see this negative period in the economy stabilize.

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### What does this rally feel and look like?

There is an awful lot of liquidity on the sidelines. And, there are a lot of pessimists and money managers who, despite being negative on the market, are suddenly piling into the market to catch up and make their funds look good. This looks and smells to me like a liquidity-driven bear market rally. So, I remain skeptical. However, I also think that the economy and the situation around the world were not as bad as the politicians and the press were saying back in November. I do think that things are not as quickly fixed as the market seems to be indicating.

### Is there good value for long-term investors?

I reiterate that there are still great values in the market. By historical standards, trailing four-month P/Es are low. Looking at trend earnings, from a Graham-Dodd model, this market ranks among the cheapest periods that we have been through. Earnings per share, dividend yields, and free cash-flow yields are all at historically low levels. But that does not mean that we are at a market bottom.

These periods of upsurges can be brought down by an uncertain market. This uncertainty can be exacerbated as we continue the first-quarter earnings season, especially since the preliminary numbers we are seeing are not very encouraging. I think it may be better to take the view that over the next five to six months we will see the equity market building a base that could eventually lead to rewards because of the existence of decent and historically cheap valuations.

Source: MFS research




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