The bear is dead, long live the bear

Commentary: Yet more evidence we're in a bear-market rally

By Mark Hulbert, MarketWatch

ANNANDALE, Va. (MarketWatch) -- "I've lived through a lot of bear markets, and I must say I've never seen sentiment change so quickly after an horrendous drop in the market."

So wrote Richard Russell, editor of Dow Theory Letters, after the close on Monday, following yet another impressive day for stocks, in which the Dow Jones Industrial Average) tacked on another 214 points.
Is Russell right to worry about the quick jump in sentiment?
I tried to shed some light on this question last week, when I compared what's happened to several sentiment indexes since the March 9 low with how they have behaved at the beginnings of past bull markets.

However, several of you pointed out, quite correctly, that my analysis was incomplete. I should have also looked to see how these sentiment indexes have behaved during past bear-market rallies. Only if sentiment trends were different on those occasions than at the beginnings of new bull markets would I be justified in drawing any conclusions from what's happened in recent weeks.
In this column I attempt to fill in the gap.

What I found reinforces the conclusion I reached last week: There is a good possibility that the market's rise since March 9 is a bear-market rally rather than the beginning of a new bull market.
To be sure, recent history provides few data points on which to rest this analysis, since it has been rare, during an ongoing bear market, for stocks to rally by more than 20% -- as they have since March 9.
In fact, according to a study conducted by James Stack, editor of the InvesTech Market Analyst newsletter, there have been only two occasions since 1940 in which the S&P 500 index has done so: The first was the rally that took place from Sept. 21, 2001, through Jan. 4, 2002, and the second was the rally that started last Nov. 20 and lasted through Jan. 6 of this year.

According to at least two sentiment indexes, sentiment behaved far differently during those two bear market rallies than they did at the beginnings of past bull markets.
Consider first the Hulbert Stock Newsletter Sentiment Index (HSNSI), which reflects the average recommended equity exposure among a subset of short-term stock market timing newsletters. In the wake of the first of these two bear market rallies, the HSNSI jumped 85.8 percentage points, and in the wake of the second by 62.4 percentage points.
That compares to an average jump of just 29.3 percentage points during the first eight weeks of past bull markets.

Clearly, advisers have tended to become far more exuberant in the wake of bear-market rallies than when new bull markets are actually beginning.

With this background, we can turn our attention to the HSNSI's behavior since the March 9 market low. It has jumped 53.8 percentage points, which is closer to the bear-market rally end of the spectrum.
A similar story is being told by the sentiment survey conducted weekly by the American Association of Individual Investors, in which members who visit the organization's Web site are asked to indicate whether they are bullish, bearish or neutral on the stock market. To distill these readings into a single sentiment number, I follow the lead of some past researchers in calculating a ratio of those who say they are bullish to the total who report being either bullish or bearish.

This ratio jumped by 26.6 percentage points during the bear market rally in late 2001 and early 2002, and by 28.2 percentage points in the rally that began last November 20. Those jumps were about triple the average gain of just 9.8 percentage points during the first eight weeks of past bull markets.
And how much has this AAII ratio risen since March 9? By 24.1 percentage points, quite close to the jumps witnessed during past bear-market rallies, and far more than the increases seen at the beginnings of past bull markets.

To be sure, these comparisons don't amount to a guarantee that the rise since March 9 is a bear market rally. Because there are so few data points, this analysis has to be more suggestive than conclusive.
Still, I find it very suggestive that the quick rise in sentiment since March 9 is far more consistent with what has happened during prior bear-market rallies.

Mark Hulbert is the founder of Hulbert Financial Digest in Annandale, Va. He has been tracking the advice of more than 160 financial newsletters since 1980.