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Get Ready For An Oversold Stock Rally

John Dobosz, 08.20.04, 2:19 PM ET

From high oil prices to a seemingly sputtering economy--not to mention recurrent threats of terrorist attacks on U.S. soil--investors have been understandably unexcited about buying stocks this summer. In fact, the enthusiasm has been on the side of selling them, which has historically been a reliable indicator that a good time for buying is close at hand. The logic is that if everybody is bullish, they're already in the market so further upside is limited, but pessimistic investors--and committed short-sellers--represent future buyers and fuel to drive any rally higher. Because of the rampant gloominess we see today, say several market technicians, don't be surprised to see stocks stage a respectable rally to finish the year.

Several of the sentiment indicators tracked by **Jason Goepfert** at [Sentimentrader.com](#) have reached bearish extremes. Goepfert keeps tabs on flows into bullish and bearish Rydex funds to use as contrary indicators. On August 9, \$38 million moved out of the bullish index funds and \$92 million went into the bearish funds. This \$130 million move was the biggest bearish shift since Aug. 6, 2003--the exact low for the S&P 500 during last year's summer swoon. Rydex also offers leveraged bearish funds, like **Tempest** ([RYTPX](#)) and **Venture** ([RYVNX](#)), which gain \$2 for every \$1 decline in the S&P 500 and Ndaq 100, respectively. The total dollar value of assets in these aggressively bearish funds grew to \$1.22 billion last week, nearly equal to the all-time record of \$1.25 billion on Feb. 12, 2003--one month before stocks exploded to the upside.

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Michael Burke and **John Gray** of [Investors Intelligence](#) maintain one of the most widely watched measures of sentiment which tracks the opinions of 130 independent financial newsletter writers. From the most recent results published on Wednesday, the percentage of bullish advisers dropped to 43.6% from 48.4% the week before. Bears shot to a 16-month high at 28.7%, up from 24.2%. Adviser sentiment is a contrary indicator and, usually, a growing percentage of bears precede a rising market.

Additional data from Investors Intelligence suggest some selling pressure has been relieved. Last week saw just 12 stocks reach a buying climax, while there were 114 selling climaxes--a sharp reversal from the week before when there were 146 buying climaxes and 28 selling climaxes. A selling climax is when a stock hits a 12-month low but then closes the week higher, while a buying climax is the opposite. "Historically, on a stock basis, we have found that people who sell into buying climaxes are proven to have done the right thing about 80% of the time after four months, while the same is true for people buying into selling climaxes," says Burke.

Jim Stack of [InvesTech Research](#) in Whitefish, Mont., has been picking up strong signals that the market is putting in a bottom, too. Earlier this month, Stack's proprietary "pressure factor" model, which measures overbought and oversold extremes, registered its fourth-most oversold reading in 35 years. The last such extreme was reached during the March 2003 retest of bear market lows and the most oversold reading came on Black Monday in October 1987.

Stack also turns to sentiment as a guide, referring to the American Association of Individual Investors' (AAII) latest survey, showing a bullish reading of 31%, a reading just below the 33% bullish number in March 2003, and just above the 29% in October 2002. Both instances turned out to be significant bottoms.

Rallying off of a bottom is more of a process than an event, and usually requires a retest of the lows, as was the case in October 2002 and March 2003. Although the market has rallied higher this week--the **Spider ETF** (amex: [SPY - news - people](#)) is up more than 2.5% since last Friday--the market may not hold these gains and it would come as no surprise to **Marvin Appel** of [Gerald Appel's Systems & Forecasts](#).

"Market internals are positive in that small caps and market breadth have performed well in recent days. MACD buy signals are coming in as well. Also, this week's gains have come in the setting of record-high oil prices," says Appel. "Although I still think the market will retest recent lows before staging a full intermediate term rally, downside risk from current levels appears limited to under 3% in the S&P 500," he says. If the Nasdaq closes the week at or above 1801.16, Appel advises buying three ETFs: the **Diamonds Trust** (amex: [DIA - news - people](#)), **Nasdaq 100 Trust** (amex: [QQQ - news - people](#)) and **iShares S&P 600 Small Cap** (amex: [IJR - news - people](#)) to ride the traditional election year rally.

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