



## Time to Cash In?

The overall market tone remains bullish though volumes are still light. It's an impressive turnaround from the "world is ending" scenarios being outlined only a few months ago. Many more analysts and commentators have turned bullish in the last couple of weeks. While the bearish population is still healthy, which may explain the lighter volumes, growing bullishness could become a contrary indicator.

The scale of the move off the March bottom makes traders nervous. We need to remember that this move came after the worst market decline in over 70 years. The 50% rally for the major indices still leaves them 35% below their 2007 highs. So while this year's rally is impressive, especially given the breadth of the problems that caused the crash, the bounce is not quite the raging irrationality some see it as.

We said earlier in this rally that we were concerned about a revisit to the year's lows. It's not news that the economic backdrop that led to the market collapse is more dire than any other in recent (or not so recent) memory. We don't see convincing evidence that everything is "fixed". There is still room for disaster, especially in the financial sector, but we would rather work with the market than try and tell it what to do. The odds of a correction are high but a full retest of the lows now seems a lot less likely.

We accept the conventional wisdom that the world's major markets are in a secular bear market that began in 2000. If this is an "average" secular bear, we are half way through it. Any bear market rally needs to be treated gingerly so we will keep suggesting you take enough profits to stay liquid and lower your holding costs as much as possible.

We looked at the S&P during the last secular bear in the 1970's for some insight on how far a bear market rally can go. The S&P chart for this period appears on the following page. As you can see the market basically "went nowhere" from 1968 to 1982, but that flat period included sustained rallies of 55%, 60% and 80%. A more recent example is the rally that occurred from 2003 to 2007. Bear market rally it may have been, but a 4-year 90% rally leaves room for a lot of profitable trading. One could refuse to trade during secular bear markets, that's an individual choice, but it's hard to make money sitting on the sidelines for 18 years.

We've seen new bearish lectures about how the market has again gone nowhere for 15 years. True, if you do a straight line point to point measurement using carefully selected dates, but not very meaningful or useful.



If you buy your portfolio on one day then bury the certificates in your back yard for 20 years, then yes, you had better pick the right day to buy and sell everything. If you treat stocks as trading vehicles, and we certainly do, the obsession with the species of the rally seems overdone. The best one can do is look for undervalued situations on an individual basis where new information can change the market's view of the company. Accept it's a bear market and make a habit of always taking profits on strong upward moves, letting the market show you the low before buying again, and try to "play with house money" as much as possible. We think that is sensible advice in any market.

Our concerns about a retest stemmed from the market action of 2000 to 2003. There was a retesting of the lows that occurred within 2 years of the market top. That has many traders nervous as we move towards the second anniversary of the current bear move. Arguably however, the March bottom was the main retest of last autumn's lows, which became a rout thanks to more bad news from the financial and auto sectors. If that's the case we may see much more mild corrections along the way until this rally runs its course.

This recovery looks even more jobless than the early recovery from 2000. The consumer saved the day early this decade, but we can't see it happening this time. However, production indices have turned positive worldwide and we appear to be at the start of a new inventory cycle. Companies rebuilding inventories could generate good (not great) GDP growth for a couple of quarters.

Based on the strong productivity growth numbers recently put out, this inventory rebuild could also generate good — or at least better than expected — profit growth for several quarters. While that productivity growth owes much to a lack of new hiring, the bottom line numbers could be good enough to keep the rally going through the fall if there are no new financial disasters. Going into Q4, the year over year profit comparisons get much easier. Favorable comparisons between this year's lousy and last year's just awful bottom line numbers is something of an optical illusion, but rallies have run on less in the past.

## **The Bear over There**

While the world as a whole is in a secular bear market, the developing countries that are the commodity demand drivers look better. Long term charts for Shanghai, Mumbai, and San Paulo show all of these markets still appear to be in long term up trends, albeit with a really nasty dive last year.

Serious caution is still needed when dealing with Shanghai, or any emerging market bourse, since any economy's emergence will produce sharply overbought periods and subsequent nasty downturns. However, the Panda bear should continue to be much easier to approach than the Grizzly bear stalking western markets. [Grizzlies, we could note, rarely ever come into camp unless you are foolish enough to leave food out for them. However, once they arrive they do tend to stay].

Importantly, the bourses like Canada's and Australia's in countries that supply the emerging markets' demand for commodities are also not in the secular bears. Both comfortably exceeded their 2000 highs in 2007 and neither breached 2002 lows earlier this year. The bankers in both of these countries were less stupid than those in New York or London, but the heavy resource weighting in Toronto and Sydney has at least as much to do with their bounce. They hearken back to the last sustained resource bull of the 1970s.

The 1970s was a period of high inflation, which certainly isn't a problem at the moment, which became the main driver of that resource bull. High inflation was partly the result of the massive and self reinforcing price jump for crude oil, but a major expansion of the industrialized world's paid workforce because of the baby-boom and a much greater participation of women was also a major factor.

The fundamentals surrounding current commodity price gains are somewhat different. New demand from a major expansion of the "emerging world's" paid workforce is certainly a factor, but the other driver is a lack of supply to meet this demand because it was preceded by a weak investment period for the resource sector.

The 70s resource bull and the current one are in fact linked - oversupply from a heavy investment into resources in the 70s eventually killed off that resource bull. That, in turn, caused the period of weak intervening commodities investment that has set up this new secular bull.

What is also common to both the 70s and now, and we think quite normal, is for secular equities bears and secular commodity bull markets to occur simultaneously. We are not trying to reinvent the wheel in expecting the commodity sectors to act separately from western stock markets. While we can't expect resource stocks to buck the trend in a major sell off, the strength of the markets in metal consumer and producer countries implies this sector will continue to outperform. That view is taking hold more broadly, so now the real trick is to focus in on the right sub-sectors within the broader commodities space. As pointed out on page 1, right now gold and silver are most capable of going against the overall market trend if big markets keep weakening.

We don't see a strength for a broader recovery until employment starts to grow in the west. Though employment stats are a trailing indicator in most recessions, we have to side with those who think the developed markets are ahead of themselves. They usually are at this part of the cycle. What equity markets do is project economic change several quarters out, and they did see the current bounce beginning in March. The key now will be getting through the dangerous months of September-October with economic numbers that remain at least positive. We are still anticipating a near term correction, but if no new catastrophes occur it is possible we have seen the low for this part of the cycle. On a global average basis, that is.



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