Tuesday, February 27. 2007

BOOM! Down Goes The Market!

Oh boy - or is that "oh buy!"

Let's be honest here. The **fear factor** is out on Wall Street - and Main Street.

As well, to some degree, it should be. Fear and Greed are the twins that rule the markets, and they are always, to one degree or another, in evidence on the Street.

The old saying is that you buy when Fear is the only thing you can see on the Street, and you sell when Greed is the only thing you can see. And there's some truth in that - if you can discern what's actually there.

Of course its easy to say and hard to do when the markets are pushing new highs - or lows.

So what really happened today?

Let's take a look.

Over in China the government started talking about placing a capital gains tax out there - a first for China with its new marketplace. Of course the Chinese have been playing the same sort of games that other asian nations did a decade+ ago, mortgaging homes to buy stocks. And why not - the market over there was up more than 100% in the last year.

So they started to sell. Then something ugly happened - the Chinese have this rule that caps off losses, and closes the market in a given issue when it drops more than a certain amount. As stocks hit those limit downs, people discovered *they couldn't sell at all!*

Well, how much is a stock certificate worth *if you can't sell it at any price?* We know the answer to that, right? **It's only remaining use is as toilet paper or fire starters!**

That spooked people badly in other markets, which reacted badly too, and down went the FTSE and DAX. And THAT lent momentum over here.

So - was there a reason for the US market to drop 3+% in a day? Not really. But does there have to be a reason? No. There frequently isn't. Its a called a correction, and they happen all the time. Or at least they used to. 2% corrections, historically, are an "8 times a year" thing.

But the last one, for us, was almost a year ago.

We were massively overdue, and when things started to unravel the big institutional guys (and us small retail folks) saw the downdraft and we hit the **SELL NOW DAMNIT**! button.

Well, some of us did. I unloaded a few individual issues that I had 100% gains in - and why not? They weren't part my long-term portfolio and it was a damn good excuse to take the profit and bank it. The rest? I stood pat.

Tomorrow will come, the Sun will rise like it always does. And, in all probability, it won't be over tomorrow. Not yet anyway. But let's look at the analytics on this - 7 out of 10 times, the S&P has reversed the next day and closed up 1%+.

I wouldn't be surprised to find out that someone or something - a hedge fund or similar - "blows up" over this.

But are we in some kind of underlying crisis? That's the real question.

And.... for now.... the answer is "No".

Now are there issues down the road for the economy? Yes. There is an ongoing blow-up in the subprime credit market. This is not new though - and the stocks associated with this were already taken to the woodshed, tarred, feathered and beaten to a pulp. That show has already had its first run.

So what else? There's an issue with business inventories and capital spending (called "capex" in the industry.) How serious it it? The data's not in. But this is a potential issue down the road, as CapEx tends to foretell the economic future six to twelve months out.

But does this foretell a *recession*, which would be a good reason for a bear market - and a 20% decline in US Stock Prices? I don't see it.

What else?

There were plenty of margin calls issued this afternoon. I suspect that a big part of that 200-point gap-down this afternoon was an impending house call - or perhaps an *actual* one. Those *can* happen intraday and they're ugly. If some big investment house or hedge fund got one, and started it, computers can take over - once triggers are set a "piling on" effect occurs and in seconds billions of dollars worth of sell orders flood the markets as internal liquidity and margin equity limits are violated. Exactly where those are can't be known in advance, but they sure contribute to the mess.

What can we learn from the chart today? Two things - the 500-point downdraft *did not hold.* There was a near-immediate retracement of the entire thing. But then selling resumed, and half of the bounce was given back. So, from a standpoint of *is it over*, the answer, from a standpoint of simply looking at the chart, says *no, it is not.*

Will it be tomorrow? I don't know. Neither does anyone else. *Chasing bottoms is not productive.*

If you bailed today, then wait until the reversal has confirmed before you jump back in. You have to have a test of the previous low and it has to hold. So this means we need to see 100 down on the Dow tomorrow, but can't penetrate it. If that was to happen, it might indeed be a bottom, at least in the short term.

If you *did not* bail today, don't be tempted to do it tomorrow - or worse, to short in the morning! The reversal, when it comes, will likely be quite violent and you're almost certain to miss it if you're not in. The time to get out was *yesterday* - you missed it - so hold on. If you *did* get out today, wait until we have the reversal before you set your re-entry. You might miss the first percent of the comeback, but that's better than getting whacked with *another* 3-5% loss.

While you're waiting, make a list of things you want to own and the prices you'd like to pay. If you want to own WalMart, but didn't want to pay $50, you might be able to get it at $45 in a week or so. Target was over $60, might be able to own that at $55. Exxon-Mobil was expensive at $75, but it might be able to be owned at $65. There's a real opportunity to pick off some low-hanging fruit, and if you liked these stocks at their old prices, then why not buy 'em at a 5-10% - or larger - discount?

If you're a long-term investor and have some money on the side, when the market turns this is a clear opportunity. If you were considering dollar-cost averaging in, you might want to think about lump-summing in once the market turns, provided you're going into a broad index or basket of stocks - otherwise you need to be doing your shopping and investigation. For obvious reasons you don't want to be in any of the catalysts for this - for example, sub-prime lending.

On balance, however, consider this - is the US Economy any different today than it was yesterday? Has anything happened *here* to change your view of the next 12 months economic-wise in the United States?

If you judge not, then this isn't the time to hit the **SELL** button for your portfolio. Quite to the contrary - its time to play on other people's fear.

The way to make money in the market is to be greedy when everyone else is fearful.

And when everyone else is greedy, that's when *you* get fear as your religion.

Posted by Karl Denninger at 19:40