WallStreetWindow Monthly

Stock Market Barometer

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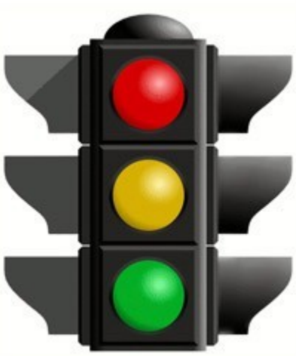
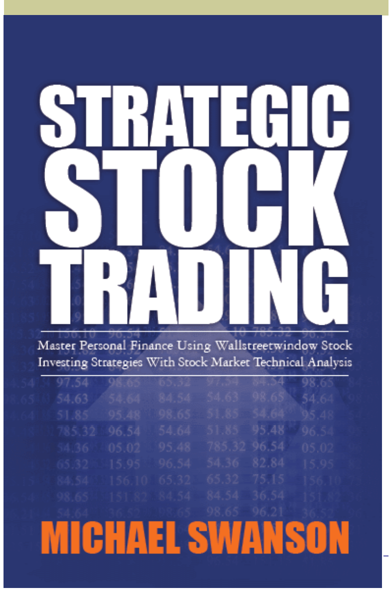
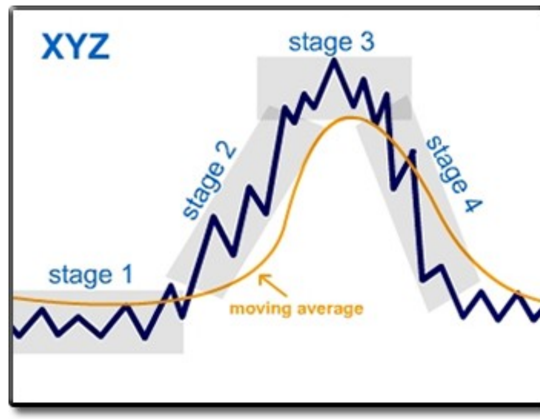


"The next bear market is going to be very serious business."



When Will The Next Bear Market Start? - Mike Swanson



When will the next bear market start? The last bear market came to an end in 2009 so this is the sixth year of this bull cycle. We are now in a stage three topping market that will lead to a new bear market once it comes to an end.

Bull markets are defined by a market that is making higher highs and higher lows while bear markets make lower lows and lower highs. During a bull market the long-term 150 and 200-day moving averages act as support and during a bear market they act as resistance.

During a stage three topping market these moving averages start to flatten out and go sideways. The same thing happens in a stage one basing market. Both of these are periods of transition even though while they happen most people have no idea that it is a transition period, because they do not really understand market cycles and CNBC doesn't tell them what is happening.

One problem of course is that no one wants to think about tops or being cautious in a market when they own stocks and have seen them go up for a few years while in a bear market everyone is too scared by the declines they have seen in past years to think about buying again.

But these are the most important and critical times that come for an investor, because they bring a change of trend that lasts for years. You do not want to hold stocks in a bear market. Instead you want to sell stocks and if you want to make money you want to short them.

We are in a stage three topping market in the US stock market, but I cannot predict to you the exact day, week, or even month that it will come to an end. But it is not important to make such predictions, because all we need to do is identify the turning point when we see it happen. Once it comes I plan on shorting stocks to make money in the next bear market.

I'm not perfect, but I did it in the last two bear markets and plan on doing it again in the next one.

Now there are three conditions that make for a stage three top and we have all of them in place no matter what US stock market bulls say.

Those conditions are:

1) wildly bullish sentiment, which surveys such as Investors Intelligence show us is the case and has been the case for over a year in the market. This is the best sentiment survey there is and it actually shows that the number of people bearish on the market reached a level so low that the last time it has been this low was way back in 1987 before the stock market crash of that year.

Now a problem with sentiment surveys is that they are not really good for exactly timing the stock market.

2) Crazy valuations, which we certainly have in the market and no one even denies anymore. The cyclically adjusted P/E ratio for the S&P 500 has only been as high as it is now two other times in its entire history and that was back in 1999 and 1929. Other simple metrics such as P/E ratios and P/S ratios for almost all big cap stocks are at crazy levels. Spend a few minutes looking through the valuation data for the DOW 30 and you can see what I mean for yourself.

Now stock market bulls respond to this by either saying that valuations do not matter, because the Fed has interest rates at zero so the dividends that stocks pay make stocks worth more or else by simply ignoring valuations all together. Instead they just assume the stock market will go up forever and get angry if you talk about valuations to them. These type of people tend to invest in slogans such as "the Fed has our backs," "Obama has made a new economy," or "hold favorite companies forever and never sell."

Such thinking seems to be smart thinking in a bull market, but becomes stupid thinking in a bear market. But the real problem with valuation metrics is that they are not exact timing devices either so people who watch daily gyrations in the market feel justified in not paying attention to fundamentals and valuations.

3)Internal deterioration inside the stock market, which is taking place now. What this means is that fewer and fewer stocks go up as a market tops out and many stocks and entire sectors go into bear markets of their own. Eventually more stocks are actually going down than up, but the market averages continue to appear to look fine so few realize what is happening. Then suddenly the last few stocks that are still going up begin to go down and follow everything else lower. Then the market averages fall below their 200 and 150-day long-term moving averages and a full blown bear market begins.

This is the key thing to watch for during a stage three top, because once it gets extreme it becomes an incredibly reliable indicator that a new bear market has now begun and action can be taken such as shorting stocks and cutting back long positions drastically.

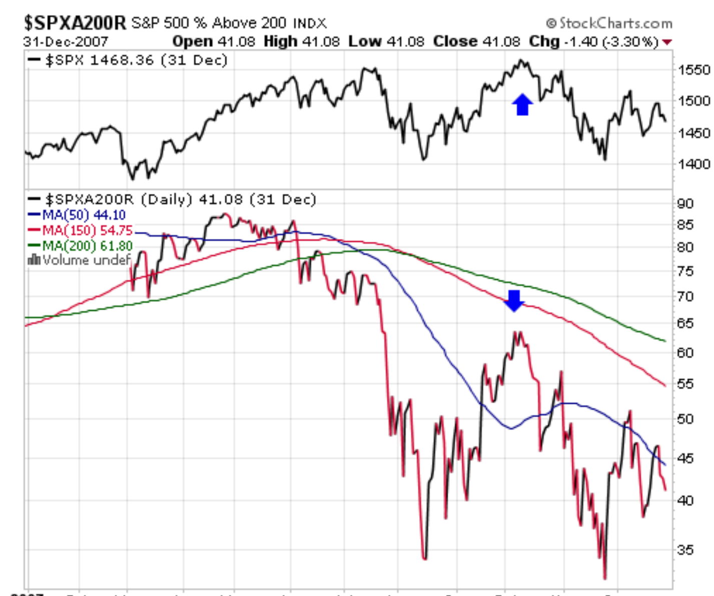
And we can watch for this going forward so that we will know when the moment is at hand.

People like to use tools such as the advance/decline line, which is a simple running total of the number of stocks going up versus the number of stocks going down day after day to measure this. I find other indicators to be superior though. The problem is the A/D throws in counts funds too.

I mainly use two. They are TC2000, which is a computer program that breaks up the stock market into over 230 sectors. That way I can track all of the sectors in the market and see what they are doing. There is a free version at freestockcharts.com.

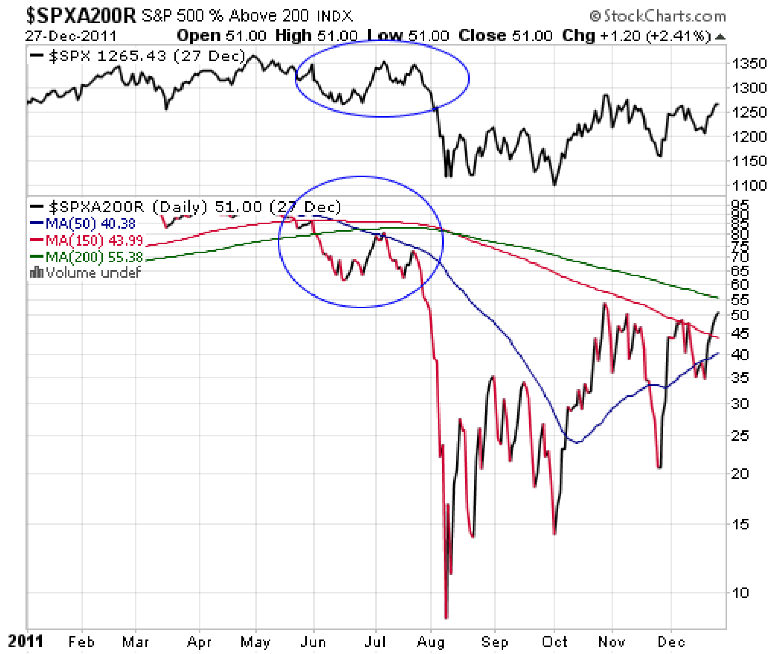
And I also look at the percentage of stocks above and below their 200-day moving averages on the various exchanges to see the internal performance of the stocks inside of these averages.

At critical tops there is a huge divergence between the internal action in the market and the stock market averages. For example look at the chart on the right, which is the stock market top in October of 2007, which I have highlighted in the arrow pointing to the ultimate top the S&P 500 made in the last bull market.



Going into that final top there was a sharp and fast drop that August that smashed the internals. In fact at the end of the correction in August less than 35%

of the stocks inside the S&P 500 were above their 200-day moving averages. This is when Cramer famously got on TV and demanded that Ben Bernanke cut interest rates.

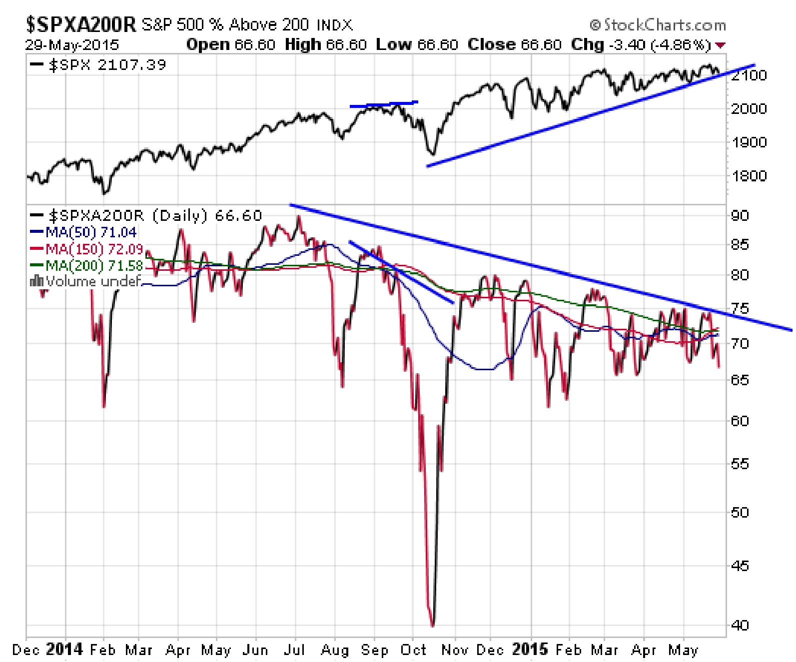


So he cut the bank discount rate. The market then rallied into October as he cut the Fed Funds rate in September. At the time almost everyone was saying that the Fed was going to lower rates so the stock market would just keep going up and everything was fine. But it wasn't.

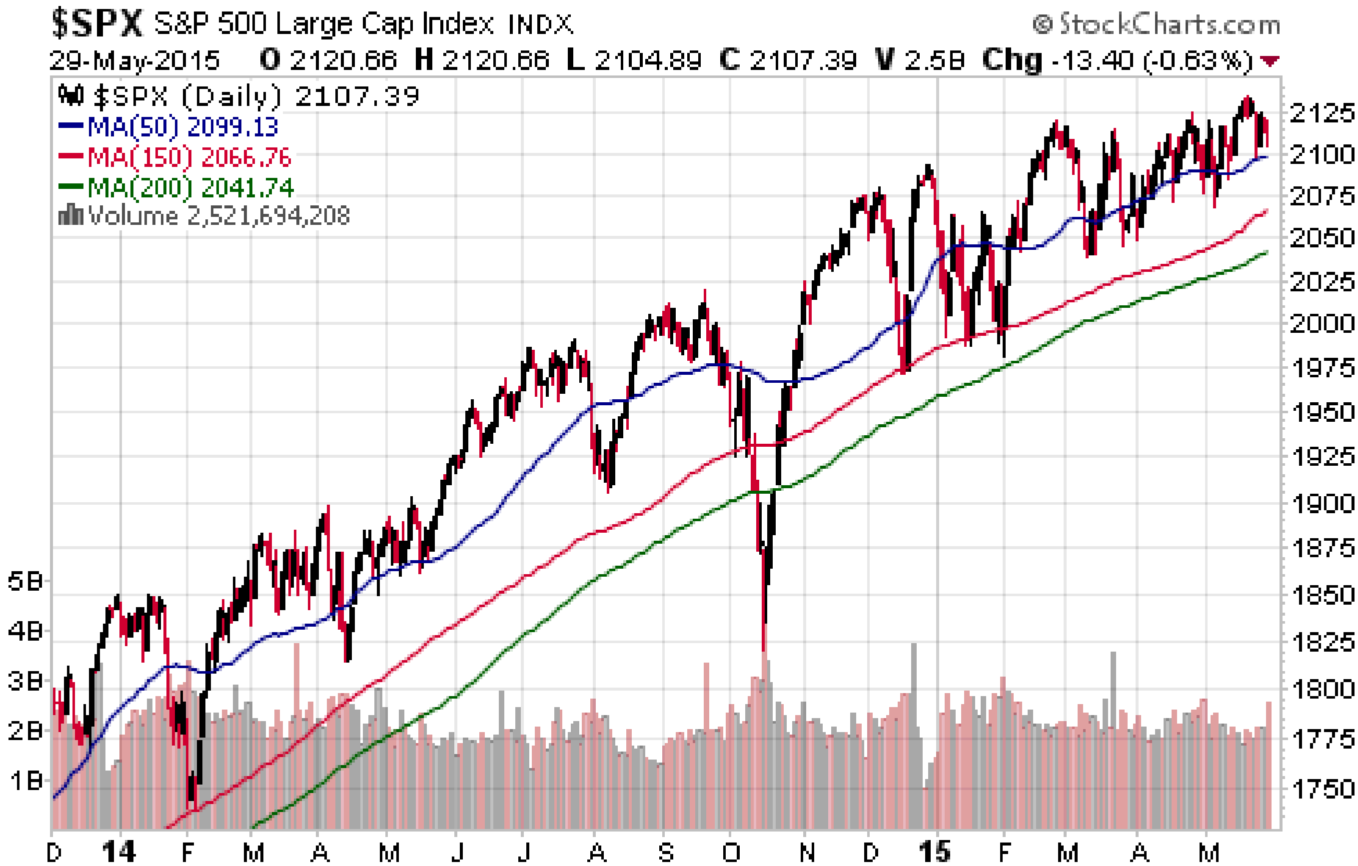
The internals did not go up with the market and topped out in October well below their highs of that summer while the S&P 500 made one final last gasp higher. The weakness in the internals warned of what was to come. And at the time the majority of the TC2000 sectors were well below their 200-day moving averages deep in bull markets of their.

Within a few weeks the DOW, S&P 500, and Nasdaq all went down and below their 200-day moving averages too. The ensuing bear market was a disaster. The same sort of internal action occurred in the summer of 2000 and it actually happened back in 2010 going into the flash crash and again in 2011 when the S&P 500 and DOW last had real corrections of over ten percent as you can see on the chart above.

Now look at the chart below to see where things stand now. The percentage of stocks above their 200-day moving averages for the S&P 500 has been trending down slowly for 11 months now. There was damage done in October during that temporary market drop and then a sharp rebound into Thanksgiving, but since then this indicator has simply been drifting sideways.



But it will tell us when the next bear market is really about to begin. No one can predict the future. We cannot tell when the next bear market is coming. But with this indicator



we can tell when it is about to begin and that is all we need to know.

Once the percentage of stocks above the S&P 500 has a sharp drop and then fails to come back to its recent highs while the stock market has a rally back up we will know that the stock market is about to enter a true bear market. It would essentially be the same pattern of 2007 and past major market tops repeating again.

It will take a drop to or below the 150 and 200-day moving averages on the major stock market indices to cause the internals to get beat up enough for something like this to happen.

The thing is the US stock market averages could easily do this within the next six weeks. We saw them go sideways from February to mid-May and then have a false breakout that took them nowhere. They look like they are in a position to pullback and the long-term moving averages are so close that it won't take much of a pullback to make them go through them like they did in October.

In fact it seems likely to me. The negative scenario then would involve a pullback to the moving averages over the course of the next six weeks that smashes the internals. Let's say for arguments sake the market pulls back into the end of June and then rallies into the middle of July when the next round of earnings reports starts to come out (the market tends to rally into quarterly earnings season and make a top somewhere during it). If the internals were to get smashed in June and fail to

rally back up with the market and diverge away from it then we would know we will then be facing a full blown bear attack. We'd be able to adapt in July and actually position ourselves to make money.

This is not to predict that all of these things are going to happen. I just know a bear market is going to come at the end of this stage three top and I know how stage three tops end and bear markets start. If a bear market is going to start this summer this is the way it would play out.

You may not be bearish on the market or worried about it. I know most people simply aren't right now. But no one should be complacent and just think things will go up forever. Armed with knowledge you know what to keep your eyes on. I still recommend people raise at least a 10% cash reserve position at this point in the market cycle and put another 10% of their money in gold as a safe haven for what is going to come, because we are not just facing a potential US stock market bear market this time, but a bear market in bonds, which will make gold go up. And gold is in a stage one base poised to begin a stage two bull market of its own this year.

But if the internals act like this and a bear market becomes imminent I plan on personally shorting stocks, making recommendations for short sells in the Power Investor Service and publicly telling people to have much more than a 10% cash reserve position in their accounts, because the next bear market is going to be a very serious business.

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