Market Monitor
October 2008

Extremis!

- **Equity performance in September was as extremely negative as the last month of the bear market bottom in September 2002**
- **Crying wolf on capitulation is getting tiresome to investors, but the latest market sell-off has all the markings of climactic selling**
- **Amid the thick negative sentiment on equities, Warren Buffett is pouncing, and the performance of small stocks may be a sign that larger stocks are being oversold for deleveraging, rather than for fundamental reasons**

The only way to describe market performances for September is a wipe-out. All S&P sectors, investment styles, market capitalization segments, foreign markets, and 40 EquityCompass monitored stock attributes (momentum, quality, etc.) declined. For the books, the S&P 500 declined 9.1% in September and was the worst month of performance since September 2002, when the S&P 500 declined 10.9%. The S&P 500 low on September 29 brought the peak-to-trough decline to 29% in the bear cycle that began in October of last year. As it turned out, September 2002 marked the bottom of a long bear market, and that is perhaps the most constructive point to focus commentary for the month.

Capitulation, Again

Investors have heard the call of capitulation several times this year, beginning in January with the global panic caused by a rogue equity trader, to the St. Patrick's Day massacre of Bear Stearns. However, these events were mere warm-ups for September's incredible headlines: Federal Government Takeover of Fannie Mae and Freddie Mac, Lehman Brother's Bankruptcy, AIG's Bailout, Merrill Lynch's Shotgun Wedding to BankAmerica, FDIC Action to Close the Nation's Largest S&L As Well As Sever Wachovia's Banking Business, and Wall Street's Heavyweights Goldman Sachs and Morgan Stanley Seeking Bank Charters. We dare say that given September's events beforehand, most market watchers would estimate losses greater than what occurred, and would be astounded that the S&P 500 financial sector's decline was less than the overall market. If headlines make a capitulation in stocks, September has done the deed.

From a trading perspective, capitulation is associated with negative sentiment, high anxiety (VIX index), a large number of new 52-week lows, big net outflows from equity mutual funds, and record trading volume. All of these

Table 1

Extremis I

Company Name	Symbol	August 29	Sept. 30	Sept. Decline	52 Week High
American Int. Group	AIG	$21.49	$3.33	85%	$70.13
Fannie Mae	FNM	$6.84	$1.53	78%	$68.60
Freddie Mac	FRE	$4.51	$1.71	62%	$65.88
Morgan Stanley	MS	$40.83	$23.00	44%	$69.23
Goldman Sachs	GS	$163.97	$128.00	22%	$250.70
Wachovia	WB	$15.89	$3.50	78%	$52.25
Washington Mutual	WM	$4.05	$0.82	80%	$36.47

Source: EquityCompass Strategies

conditions have occurred in September. So once again, we will identify the 777 point decline in the Dow Jones on September 29 as the capitulation low. However, past capitulations suggest that a retest of lows is likely, albeit with less fanfare and lacking the intensity of the earlier sell-off.

As noted previously, the market decline in September is comparable performance-wise with the market bottom in September 2002. **Table 2** compares EquityCompass indices in the two periods. The EC indices are designed to measure the 50 stocks with the most extreme condition of various stock attributes. The picture from September 2008 looks as stressed in these measures as in 2002, although there are notable differences. In 2002, the bear market had been in train for some time (about 30 months), and had established contra-bull trends in several sectors

Table 2

Extremis II

Sept. 2002 vs. Sept. 2008

	Sept. 2002	Sept. 2008
EC Average Stock	-9.7%	-9.9%
S&P 500	-10.9%	-8.9%
Positive Momentum (PPS 1 - 4)	-6.4%	-10.5%
Negative Momentum (PPS 6 - 9)	-15.2%	-10.4%
Favorable Over-/Underreaction	-13.3%	-16.7%
Unfavorable Over-/Underreaction	-8.6%	-11.1%
Mega (Highest) Beta	-22.4%	-18.1%
Micro (Lowest Beta	-4.9%	-10.0%
Mega (Largest) Market Cap	-10.7%	-8.9%
Micro (Smallest) Market Cap	-9.9%	-18.2%
Mega (Highest) Projected EPS Growth	-10.4%	-16.0%
Micro (Lowest) Projected EPS Growth	-9.9%	-10.6%
Mega (Highest) Quality	-10.7%	-3.6%
Micro (Lowest) Quality	-18.1%	-17.6%
Mega (Highest) Valuation	-8.2%	-9.2%
Micro (Lowest) Valuation	-13.0%	-7.8%
Mega (Highest) Short Interest	-13.9%	-4.8%
Micro (Lowest) Short Interest	-7.5%	-15.5%
Mega (Highest) Consensus Analyst Rating	-5.6%	-9.2%
Micro (Lowest) Consensus Analyst Rating	-14.9%	-5.3%
Mega (Highest) Price	-6.2%	-14.1%
Micro (Lowest) Price	-24.2%	-24.8%
ADRs	-13.9%	-15.9%

All indices equal-weighted except S&P 500

Source: EquityCompass Strategies

and industry groups (i.e., Consumer Staples). The market bottom was marked by sharp disparity between positive and negative momentum stocks. In the current period, momentum trends are indistinguishable, which could be a sign of a wider capitulation than in 2002. Also, the disparity of the Mega/Micro Quality index suggests more risk aversion now than in the earlier period.

The Warren Buffett Way

Warren Buffett is quick to say that investors should not interpret his recent activity as a call that a market bottom is at hand. However, he also says that the price is right for taking major stakes in Goldman Sachs and General Electric, as well as for entire companies such as Constellation Energy. With a war chest, or net current assets estimated at $70 billion, Buffett has spent over $19 billion in September buying stocks, which suggests, at the very least, he feels the current market drubbing is providing an attractive buying opportunity. Additionally, Buffett indicated he would take a 1% interest in the $700 billion proposed Treasury bailout of mortgages. While most of us are reeling from an incredibly difficult month, the Oracle is pouncing.

Small-Caps Safe Harbor from Deleveraging?

The S&P Small Cap and Mid Cap indices are outperforming large stocks in 2008, declining 8.7% and 15.3%, respectively, versus the S&P 500, which is down 19.1%. Small stocks are usually a casualty in bear markets and their better relative performance has heads scratching. From a P/E standpoint, the Russell 2000 is trading at 14.6x consensus estimated earnings for the next 12 months, versus 12.0x for the large-cap Russell 1000. Both indices are trading with similar P/Es to estimated long-term EPS growth (PEG) multiples. An explanation worth considering is that an over-arching condition to almost all investment markets is deleveraging by financial institutions and hedge funds. Small-caps are generally not an area that large hedge funds can engage for liquidity reasons, and therefore are not being subjected to the liquidation occurring in larger stocks. The implication in this view is that larger stocks are being more heavily liquidated for deleveraging rather than for fundamental reasons—something entirely consistent with a bear market bottom.

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