Philequity Corner (July 21, 2008)
By Valentino Sy

Bear Watching

"*To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards*." - Sir John Templeton (who passed away last July 8, 2008)

While financial markets around the world have been gripped by fear and panic in recent weeks by the prospect of recession, stagflation and a systemic collapse in the US banking system, we suspect Templeton (one of the top contrarian investors of all time) would have remained calm, watching the bear market unfold and probably starting to look investing in some financial names by now.

It is darkest before dawn

"People are always asking me where the outlook is good, but that's the wrong question," Sir John explained in Forbes in 1995. "The right question is: Where is the outlook most miserable?" This is Templeton's famous "principle of maximum pessimism." It runs counter to basic human intuition.

This is why contrarian investing is so difficult but the reward for successfully betting against the crowd so compelling – which is precisely what happened to the battered US financials last week. At the start of the week, financial stocks plunged after IndyMac Bancorp collapsed in the third-largest bank failure in US history, then they surged after better-than-expected earnings report from Wells Fargo and Citigroup.

The AMEX Financial Select Sector SPDR (symbol: XLF) jumped 20.5 percent from historic lows on volume that was triple the previous weekly volumes for the past year. Individual financial stocks came off big from their lows. Bank of America (+49.1%), Citigroup (38.1%), and Wells Fargo (+36.2%). Even Merrill Lynch, which reported a disappointing $4.65 billion loss for the 2nd quarter, is up 30.8 percent from its low last week.

Selling Climax

An early sign of a bottom in a bear market is a sharp rally on huge volume. William O'Neil, one of the most followed investment gurus today and author of the book *How to Make Money in Stocks: A Winning System in Good Times and Bad*, says that this is easy enough to spot: "After stock prices have turned higher, a sharp advance on heavy volume serves as a confirmation the recovery is for real. This momentous trading session usually happens in the first few days of the upturn, when the averages turn…" Such a jump can only occur when a crowd of buyers has entered the market, which indicates that the gloom is beginning to lift and savvy investors have decided stocks are too cheap to pass up.

In market parlance, last week's move constitutes a "selling climax" where investors panic and dump all their holdings at once - causing a sharp decline in prices on heavy volume of trading followed by a rally. For technical analysts, such a pattern means that a short-term rally will soon follow since there are few sellers left after the climax. Sometimes, a selling climax can also signal the bottom of a bear market.

Bottom or bear market rally

Although some analysts argue that last week was a sign that financials have reached bottom and are headed to recovery, others say the rally will not be sustained because it was artificial, caused by the actions of short sellers and the federal government. The US Fed announced last week that it is drawing up plans to support Fannie Mae and Freddie Mac. Meanwhile, the Securities and Exchange Commission (SEC) issued a ruling prohibiting naked short-selling on financial stocks, in effect changing the rules of the game.

Opportunities in crisis

Nevertheless, history has shown that even bear market rallies provide excellent opportunities. During the previous US bear market which lasted from January 2000 to October 2002, there were two bear market rallies with gains of 24.6 percent and 33.1 percent.

US Bear Market Rallies			
DJIA	**Low**	**High**	**%Chg**
March 2001 - May 2001	9,106.54	11,350.05	24.6%
September 2001 - March 2002	8,062.34	10,728.87	33.1%

Source: Technistock, Philequity Research

Indeed, trying to catch the bottom is not without risks especially in the current crisis environment. However, this is the best time to go bear watching. We have to watch closely and study carefully the movements that this bear market makes. This is not the time to give up because the opportunities are huge, especially for the nimble and the timely.

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