



Don't Fear September's Bear

Why the summer rally could continue into 2010.

By Steve Schaefer
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You can't turn on a financial news channel without hearing it: September is traditionally a rocky month for stocks. But this year, when scores of conventional indicators have proven unable to forecast the market, an old trading maxim is no reason to batten down the hatches.

"Just because it's hurricane season doesn't mean everyone has to board up their homes," says Richard Ross, head of global technical strategy at New York brokerage firm Auerbach and Grayson. From a technical standpoint, Ross said the door to higher prices is unlocked, now it's up to investors to walk through.

One snag holding traders back may be having missed out on the bounce off the March lows in the Standard & Poor's 500. Traders need to "have a short memory, like a golfer who just three-putted," in order to avoid letting missed opportunities cloud judgment, Ross said.

There's a long list of high-profile stocks--particularly financial names like AIG (AIG - news - people), Fannie Mae (FNM - news - people) and Freddie Mac (FRE - news - people)--that people missed the boat on, but compounding that mistake can make things even worse. "Just because you missed buying Citigroup (C - news - people) at a buck a share doesn't mean you can't still have upside getting in at \$5 a share," Ross offers as one example.

Waiting for a pullback is not a winning strategy, or much of a strategy at all, Ross said, but there are signs of short-term turbulence with traders back from the long Labor Day weekend. For one thing, coming into September 91% of U.S. stocks were trading above their 200-day moving averages, a 90% swing from February when just 1% were at such levels. The bulk of the move is thanks to the market's steep rally, but the last time that percentage of stocks were above 200-day moving averages it preceded an 8% pullback after a 44% rally in 2004. That period was followed by an extended bull run, so Ross said it offers encouraging symmetry and more evidence that any hiccup is not a signal that the rally is overdone.

Ross expects the next leg of the market's move higher will come when companies are able to show a return to growth on the revenue side. Second quarter corporate earnings were able to top subdued estimates on the profit side, but mainly by cost-cutting or slashing production, measures that took a toll on the top line.

Randy Cass, founder Boston research firm FirstCoverage uses sell-side research to track investor attitudes. He's seen a continued bullish sentiment from sell-side institutions since February that has persisted other than a brief blip in early July.

He points out that there is an inertia built into the present rally that makes sell-side firms reluctant to call an end to the run until there is a convincing data point to trigger a switch.

It takes a lot to make a switch from a bullish move to a bearish one and vice versa, Cass said. He compared the sideways move of the past two weeks to "death by paper cuts." The market may not be building its advance, but the listless action isn't enough to create a real turn in sentiment.

"A lot of people are motivated to keep this market heavy in the green at year-end," Cass said, agreeing that many financial advisors that were late to get into the rally are still hoping they can show clients a solid performance by the year-end. (See "Fund Managers Fight For 2009 Gains.")

Bill Stone, chief investment strategist at PNC Wealth Management, isn't buying the September weakness forecast either. In a Sept. 8 note, Stone suggests that the question investors should be asking is not whether they should move to the sidelines, but "what is the possible cost of being wrong and not being invested during a good month of September?"

Wall Street is getting on board, too. A smattering of post-Labor Day reports from a number of firms showed a more positive outlook. David Bianco, the head of U.S. equity strategy at Banc of America Securities-Merrill Lynch, has a 12-month S&P 500 target of 1,200, which would tack on another 16% to the current rally by this time next year.

Perhaps most important, the BAS-ML outlook steers clients away from waiting for a pullback, warning that there is no clear catalyst for a sharp, if temporary pullback and finding that GDP and analyst EPS estimates "appear well within reach."

Furthermore, Bianco and his colleagues poke a hole in the seasonality argument, arguing that while September and October are the worst average return months, "they have also delivered some of the best monthly returns in market history." Volatility is to be expected since the fall marks the beginning of make or break time for businesses and money managers, but Bianco rejects seasonality as an investment strategy, citing the failure of "sell in May" this year.

Citigroup's chief U.S. equity strategist Tobias Levkovich is slightly more cautious than Bianco, setting a 2010 year-end S&P 500 target of 1,100, but he sees encouraging signs for equities early next year before economic factors and taxation worries sap some of the rally's strength midway through 2010. Even Citi's more modest growth prediction still offers 6.5% of upside over the next year-plus.

Richard Hughes, co-president of Portfolio Management Consultants, a firm that advises independent financial advisors, said one way to help investors avoid chasing returns or missing out on big rallies is sector rotation. The strategy allocates assets by looking at the ten S&P 500 sectors on four levels (fundamentals, technicals, risk and macroeconomic conditions), then evaluating each against U.S. fixed-income, independent of other sectors, and making a judgment call about where to make bets.