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INTELLECTUAL AMMUNITION

Don't Believe Everything You Read Over and Over Again

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A feature on the front page of the Sunday New York Times business section begins with a myth we've heard over and over and over for the last month.

> *With the broad stock market averages up almost 20 percent from their September lows, it is clear that investors not only believe the recession is ending almost as soon as it began, they also think the recovery will wow.*

By repeating this myth, can we make it true? Are we like the children in the audience of Peter Pan, trying to make Tinkerbell get well by believing in her?

I am skeptical, and neither does the subject of the Sunday *Times* feature, **James Paulsen**, Chief Investment Officer at **Wells Capital Management**. I may quibble with Paulsen over particulars (see "Deflation: The Good, The Bad and The Ugly" November 20), but I share his long-standing worries about how difficult it will be to recover from a recession following a boom of historical proportions.

What would be entailed in believing? It seems that we would have to agree to three logical steps.

First, we would have to agree that the 20% rally in stocks from the September lows is special and noteworthy -- that it is more than mere background noise, that it is an effect that deserves having a cause attached to it.

Second, we would have to agree (even if we didn't accept the exaggeration that "it is clear") that the cause is investor beliefs about the nature of the recession -- as opposed to something else on investors' minds (such as their belief in some other forecasted development, their changing attitude toward risk, the amount of attention they are paying to their investments, or their relative lack of enthusiasm for competing investments).

Third, if we agree that the rally is important and that it is about recession beliefs, then we would have to *further* agree that it is about two *specific* beliefs -- that "the recession is ending," and that "the recovery will wow."

I can't agree with any of these three steps -- not in the context of the monumental boom-and-bust cycle that the markets have gone through. And *that's* the context that is specifically recognized in my worries and in Paulsen's.

Just take a look at the charts below. Since the top of the market in March 2000, 20% moves have been a dime a dozen. Well, I don't know about the dime, but there have been literally a dozen of them -- at least if you add up all the moves in the S&P 500 *and* the NASDAQ. The S&P has had four 20%-plus moves (two up and two down), and the NASDAQ has had eight (four up and four down). The charts show the 20% declines in pink, and the 20% rallies in blue.

S&P 500
Daily, as of December 21, 2001

NASDAQ Composite
Daily, as of December 21, 2001

So big fluctuations are common nowadays. This last one doesn't necessarily command a grandiose causal explanation. But *even if it did* -- it's not obvious at all to me that the explanation is a "wow" recovery. The rally in the S&P has brought it back to the levels of August 29, and the rally in the NASDAQ has brought it back to the levels of August 14. If those levels *today* indicate a "wow" recovery, why didn't those same levels *in August* indicate the same thing? And if they *did* -- why should we believe them *now*?

But let's assume for a minute that we *do* believe them. What should we *do* about it?

It's one thing to believe that the stock market is an accurate forecasting mechanism and that it is forecasting recovery -- "wow" or otherwise. But it would be a logical error to let that belief in recovery translate into a forecast of higher stock prices to come. To expect that would be to believe (on the one hand) that markets are prescient enough to predict recovery, but that (on the other hand) they *aren't* prescient enough to have fully discounted for that same recovery. Because if they *had* fully discounted it, then it would be too late to buy. Notions of recovery can just drop entirely out of the algebra of reasoning -- it's just momentum at that point: stocks are going to go up because they have gone up already.

It's not going to be that simple to make Tinkerbell well again -- or to make money on it.