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Commentary

Market Opinions and Topics of Interest

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We're All Stock Traders Now

The S&P 500 had its first 2% correction in 228 days. February 27, 2006 was also the first 2%+ down-day since March 24, 2003, the middle of the Iraq War's "active" phase. This was one of its longest periods ever without such a single-day selloff.

Longest Periods Without A 2% Correction

S&P 500 Back To 1928

Starting Date	Ending Date	Actual Days	Trading Days	Gain
7/11/1928	12/6/1928	148	102	20.90%
5/14/1958	10/15/1958	154	107	21.59%
10/21/1960	4/24/1961	185	125	30.10%
11/22/1963	6/3/1964	194	131	14.19%
12/8/1994	7/19/1995	223	153	25.72%
7/13/2006	2/26/2007	228	156	18.85%
8/19/1953	6/8/1954	293	183	16.58%

The fireworks, especially yesterday morning, have been impressive indeed given the low volatility of the last few years.

What does it all mean and where do we go from here?

Center of the Universe

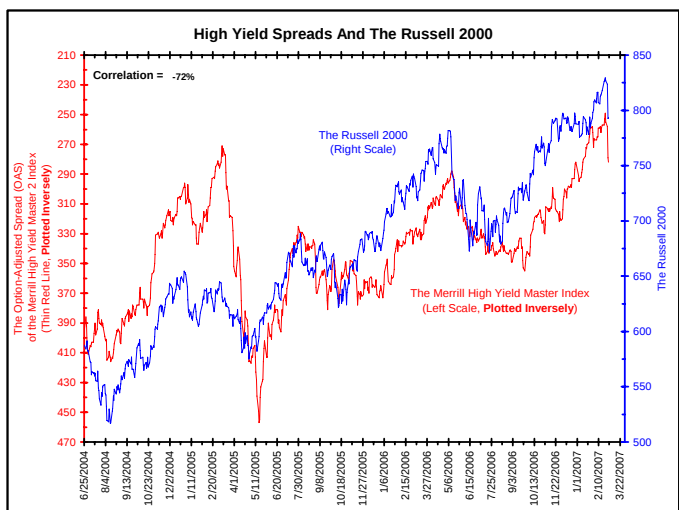
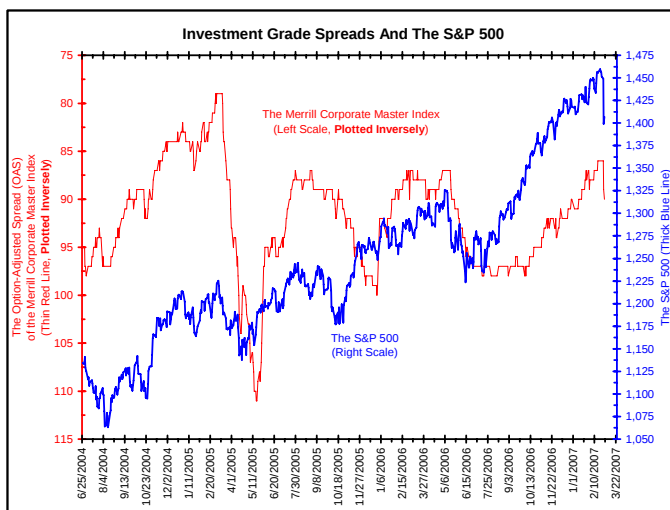
In a [Commentary](#) last month, we said:

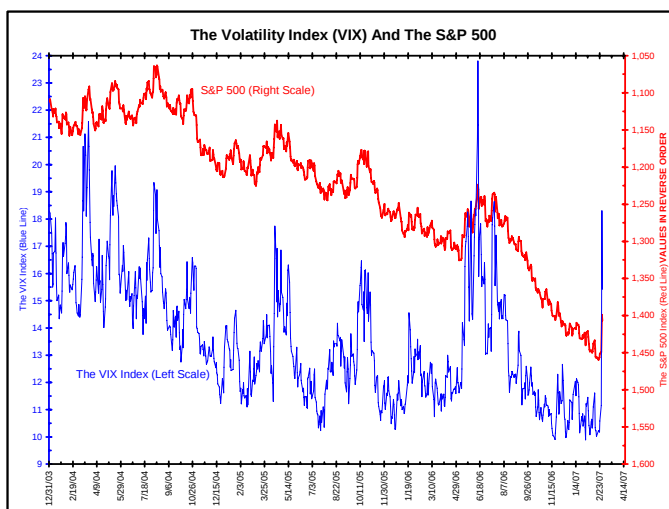
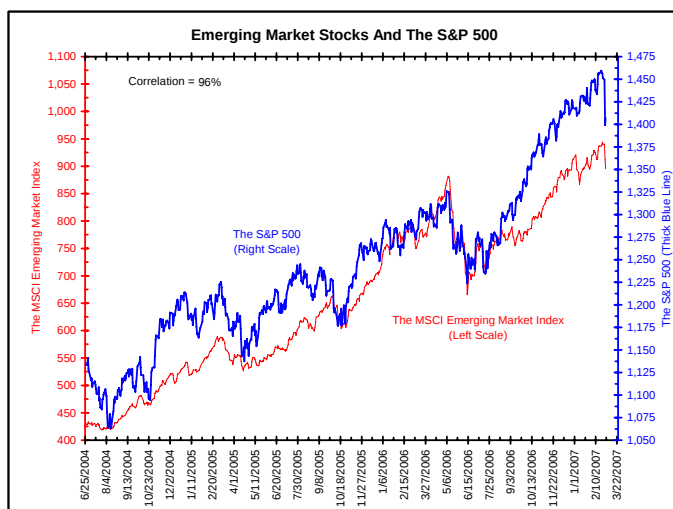
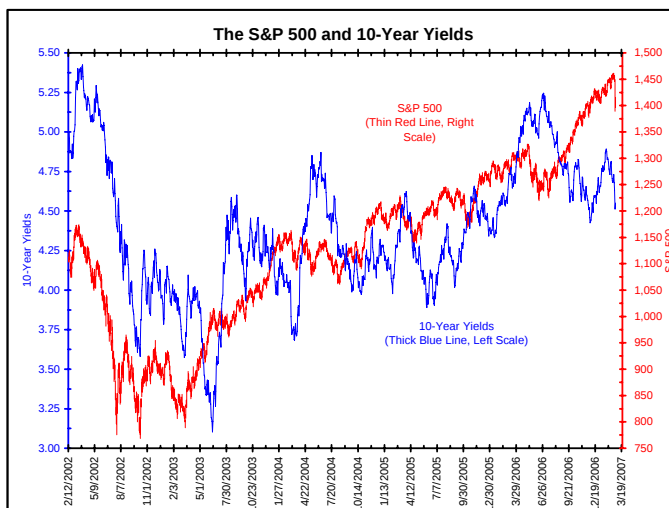
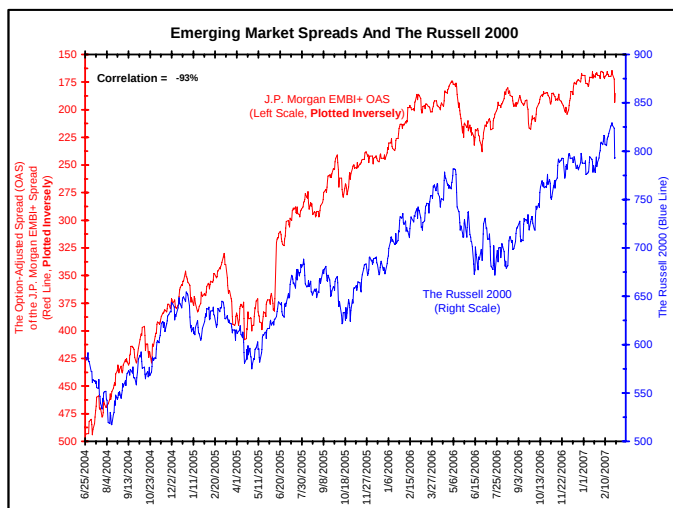
[T]he stock market heavily influences the economy and the deficit, it also influences interest rates as never before. This results in both interest rates and stock prices moving up and down together, in defiance to what most were taught in business school.

Most are having a tough time accepting this relationship. Therefore, many have not even addressed this issue. The few that do dismiss it as a divergence, implying it is a temporary situation.

In other words, the U.S. stock market is the center of the financial universe.

How important is the stock market? The next several charts show how closely other markets and volatility relate to U.S. equities.





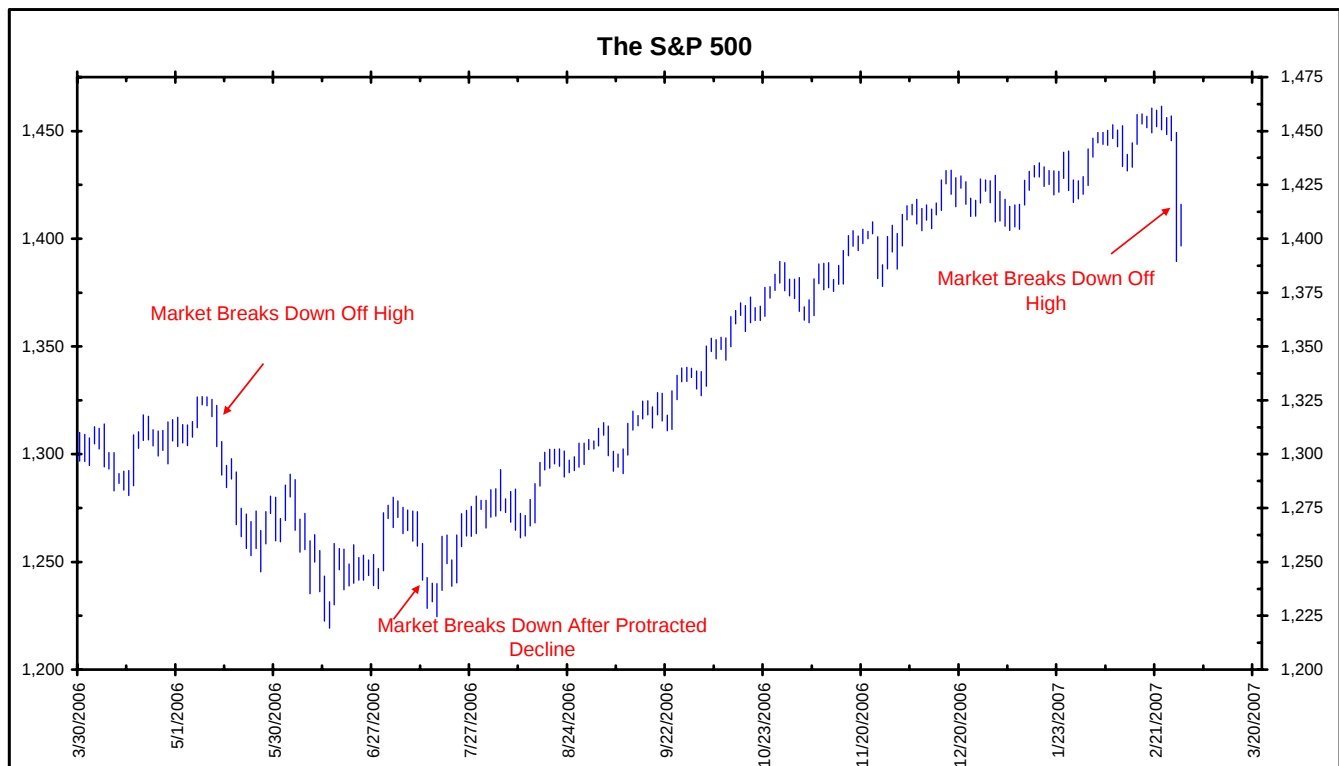
Even before the stock market got exciting, we argued that most other markets took their lead from U.S. equities. Although this global downturn started in China, the U.S. market is likely to provide the stopping point by virtue of its leadership role amongst world bourses.

What's Next For Stocks

When a market breaks hard, the question to ask is if it broke off a high or after a period of protracted weakness. We believe the context of a market break matters to the outlook for that market.

When a market breaks off a high, (see early May in the chart on the next page) it often marks the **beginning** of a correction. When a market breaks after a period of protracted weakness, (see early July on the next page) it often marks the **end** of a correction.

As Tuesday's decline occurred near a high, and after 228 days without a 2% correction, we would look for more correction ahead. If, after a period of protracted weakness, we see a similar decline, we would say it is more likely to mark a low.



There are exceptions to every rule. For instance, the October 27, 1997 500+ DJIA decline broke off a high and lasted only two days. Many thought the Friday, October 16, 1987 decline of 108 points was "it" only to see the stock market have its worst one-day decline in history on Monday, October 19, 1987. That said, more often than not, we believe this handy rule works.

Conclusion

We put stock market corrections into two camps, financial and economic/fundamental. *Financial corrections* are part of the normal ups and downs in an asset class and do not represent any change in the broader economic or fundamental sense. Such corrections should not carry more than 10%.

Economic or fundamental corrections represent the market reassessing its view of the economic or the fundamental health of an asset class. Such corrections often carry well past 10%.

Since the break was near the February 20 high, we believe it is the start of a *financial correction* and not an *economic or fundamental correction*. As such, we do not expect this correction to see

the major stock indices fall more than 10%. We expect other markets to take their lead from stocks accordingly.

The present 4% correction, therefore, is already halfway to its target if it is in fact a financial correction.

Why do we believe this to be a financial correction? Our sense is after 228 days without a 2% decline, many were waiting for a sign that the market was going to break. Whether it was due to China, Greenspan's recession comment or just because it was Tuesday does not matter. Once the market looked like it was having its first correction since July, everyone rushed to get out.

If, on the other hand, this correction carries more than 10%, we would have to reassess this view. Until then, we expect the market to struggle the next few months, frustrate those who are long and bottom when too much bearishness sets in. Only then will the market bottom and stage a meaningful rally. All other markets will then follow suit.

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