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TAKING STOCK

Stocks May Be Settling In For Long Basing Period

By PALASH R. GHOSH

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The recent stock market rally from early March lows has provided investors with a glimmer of hope. But the continuing grim stream of economic news suggest the rally will soon run out of steam -- leading some observers to believe stocks will enter a basing period that could last many months, perhaps longer.

But that's not necessarily a bad thing.

Quite often when stocks settle into a basing environment, they are taking a pause, and perhaps preparing for a sustained rebound somewhere down the road. And given the lack of positive economic news, many traders appear to be buying stocks in anticipation of a recovery at least four to six months from current levels.

"In a basing period, stocks are in a long-term trading range, which might be narrow or somewhat wide, and this usually occurs after a major correction," said Tom Lydon, president of Global Trends Investments. "During these periods, rallies off the bottom tend to be quick and short-lived. As stocks spike, they reach a level of resistance that they cannot break through. Then they decline again, testing their previous lows."

Katie Stockton, chief market technician at MKM Partners, expects the market to enter a long-term basing period (lasting several months) and likely characterized by wide swings on an intermediate-term basis.

"A sustainable bull market needs a foundation, usually in the form of a trading range, and the major indices need time to create that foundation," she said.

"Typically, bases are characterized by positive divergences in momentum, breadth and leadership. This has occurred on the sector level, but not for the broader market. Volume tends to moderate during trading ranges because trading is indecisive, but this time might be different because of the expected intermediate-term volatility."

The trading range of the basing period typically is a function of the magnitude of the prior correction.

"We saw a decline of 50%-55% in the recent bear market decline," Lydon noted. "The rebound we just witnessed was about 20%-25% off the bottom, which represents a pretty tepid recovery."

Indeed, as Lydon pointed out, disappointing first quarter earnings -- which many expect - - could help the current rally peter out, leading the market to test new lows. But, on the bright side, equities will likely remain above those lows, buoyed by confidence in the government's stimulus packages and expectations of an economic recovery later in 2009 or early 2010.

"A basing period helps the market build up resistance," Lydon indicated. "Even if we get worse news on the economic or earnings fronts, stocks may have the resilience to keep above recent lows because a firm bottom has already been established."

Thus, setting a base can be a welcome development. It can mean stability, even if fundamentals are not that encouraging, reflecting the fact that the market is taking things in stride with the anticipation of positive economic/market news several months down the road.

What you want to see during a basing period, said Mark Arbeter, chief technical strategist at S&P, is higher volume as prices move towards the top of the base (accumulation) and lower volume as prices swing toward the lower end of the range.

"That sometimes is a clue that prices will eventually break to the upside," he noted.

For the record, Arbeter believes the market will undergo many more months of basing before a major bullish reversal pattern is complete.

But for investors who have suffered losses of 50% to 60%, a basing period would be downright relaxing and enjoyable.

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