THE WALL STREET JOURNAL.
WSJ.com

Is Pessimism Good News?

Big money managers have turned bearish. Everyone's moving into cash. Could that mean the market is bound for a rally?

By BRETT ARENDS October 15th 2008

Is the stock market about to see a huge rally?

I know, I know. It just plummeted again. Am I crazy?

More importantly, only a sucker tries to predict short-term moves.

But the mood is so utterly bearish across the board right now that I am fighting the urge to turn into a raging bull.

Look at Merrill Lynch's latest fund manager survey. Every month, Merrill surveys the biggest money managers around the world to find out what they think about markets and what they are doing with their own portfolio.

Right now they hate almost everything except cash. Merrill calls the new survey, out Wednesday, "one of the most pessimistic" ever. "Over the past month, fund managers have lost faith in global growth, commodities, China's economy and emerging markets," the firm reports.

Sound bearish? That isn't. Quite the reverse: When the big money managers are very bearish, that's often positive. It means they are already out of the market. "Three factors are coming together that have tended to be associated with market rallies," reports Merrill. Fund managers say they have a low appetite with risk, they are holding very high amounts of cash, and yet a lot of them admit that equities are now undervalued. In fact the percentage of fund managers around the world who told Merrill that shares are now below fair value is the highest in a decade.

(Aside: Even Jeremy Grantham, the super-bear who anticipated this crisis better than anyone, now thinks stock markets are below fair value, although, as so often, he fears they may get even worse.)

The Merrill survey sometimes is an incredibly useful handbook for individual investors. It tells you what the big money crowd is thinking, and feeling, and where they have placed their chips. At market extremes, it is a wonderful contrarian indicator, or "magnetic south," pointing in exactly the wrong direction.

Thus fund managers were hugely bullish on European equities 16 months ago, just before those markets collapsed, and hugely bearish on Japan back in the spring of 2003, just as it hit rock bottom.

A staggering 93% today are blowing Bronx cheers at analysts' earnings forecasts. They think corporate earnings will disappoint in the year ahead. Indeed 51% believe forecasts are "far too high."

Of course this may leave more room for positive surprises than for disappointments.

And it isn't just the Merrill survey that's making me itch to be bullish.

Look at the market: It has so far failed to follow up on Monday's rebound. Everywhere you go, there huge skepticism about any rally. Worldwide share prices are worth 30% less than they were at the start of September, and nearly a fifth less than they were at the start of October, but unlike in 2001, or 2006, no one is calling this "a great buying opportunity." No one is jumping in.

The Wall Street Journal on Tuesday reported that a number of big hedge fund managers have also been moving heavily into cash in recent days. Some of them are frightened about the market chaos. It makes you wonder why they're hedge fund managers.

Maybe it doesn't mean a thing. Maybe the market is about to fall another 2,000 points.

But some old stock market hands sometimes talk about the "golf course" test: Be wary of any asset that fund managers are bragging about on the golf course. In 1999, they were all boasting to each other about all the dotcom stocks in their portfolios. Last year, it was all their emerging markets stocks.

Right now, it seems, everyone is bragging about how much they are holding in cash.