BUSINESS

Bearish mood at 4-year low

Decrease could be cause for concern as investors become too optimistic

By Adam Shell
USA TODAY

NEW YORK — Where have all the scaredy-cat bears gone? And what does growing investor optimism say about the future direction of stock prices?

Two days before the market low in March, a record seven out of 10 investors polled by the American Association of Individual Investors said they were "bearish" on stocks. They feared the market, which had already lost more than half of its value, would keep tumbling.

But by the end of 2009, with stocks 65 percent higher, the number of "bearish" retail investors had dwindled to 23 percent, a level last seen four years ago.

Similarly, nearly half (47 percent) of investment newsletter editors were "bearish" on stocks near the March 9 bear market low. But by Christmas Eve, the number of bears had plunged to less than 16 percent, the lowest reading since April 1987, says Mike Burke, co-editor of Investors Intelligence, which conducts a weekly Advisors Sentiment poll.

The fading of bearish sentiment could be a good thing, showing investors no longer fear a collapse of the financial system or a 1930s-style depression.

But from a contrarian market standpoint, the decrease in fear and pessimism could be cause for concern. Why? Normally, a shrinking bear population signals trouble for stocks, as it suggests investors are veering toward complacency, becoming too optimistic and playing down risks.

History has shown that when optimism soars and pessimism dries up, stock rallies often fade. So what message is sentiment sending now?

There is a belief that while bearishness is declining, bullishness has yet to reach the level of euphoria that has historically signaled market tops. In the latest poll, published last week, 48.3 percent of investment advisers were bullish, or confident stocks would move higher. That is far below the 60 percent bullishness that often precedes a top, Burke says.

"A big surge in bulls would be negative," Burke says.

Bullishness is not off the charts when it comes to retail investors, either, says Mike O'Rourke, market strategist at BTIG. Using the Jan. 7 AAII data, which showed 41 percent bullish (long-term average is 39 percent) and 26 percent bearish (average 30 percent), he says if you calculate the amount of bulls in relation to the investors that offered a bullish or bearish opinion, bulls equal 61 percent. That's below the 70 percent bullish reading that suggests optimism is too high and stocks are vulnerable.

"I don't think bears are an endangered species, there's still lots of skepticism," O'Rourke says. But the bullish reading of 68 percent at year's end is worrisome: "My guard is up. It raises a red flag."

After reviewing market valuations and rising bullish sentiment, Ned Davis of Ned Davis Research concluded: "The market is overvalued and over-believed." Still, with stocks and interest rates still positive, he remains bullish for now.