BY VICTOR NIEDERHOFFER AND LAUREL KENNER

Would a bear shift if it could? The Specs present the "permabears" with the bullish case for the stock market, and ponder the psychology of cult behavior.

Q: When are you two going to cease your constant trumpeting of the bullish case? Previously you hung your hats on low interest rates, but now that the 10-year rate has gone up 40 percent, from 3.1 percent to 4.4 percent, that plank is gone. You know the market's going down. Stop your cheerleading to the unwashed, who don't know better.

Vic: A good way to forecast the market is to compare the estimated earnings yield of the Standard & Poor's 500 at year-end to the rate on the 10-year T-note. The difference between those rates (as of the beginning of the year) correlates well — about 20 percent — with the subsequent change of the S&P over the last 50 years. The best forecasting equation between the two, based on regression methods, is:

Next year's S&P change =
7 percent + 8 * (estimated S&P yield less 10-year T-note yield)

This forecast is a systematic quantification of what is called the "Fed Model." It works predictively, and based on yield comparisons and the supply-demand situation, we repeatedly predicted in numerous articles (available on our Web site, www.dailyspeculations.com and CNBC Money's www.moneycentral.com) that stocks would be up about 15 percent in 2003.

We arrived at that number by using the equation. At the beginning of the year, estimated earnings yields were five percent and T-note yields were four percent. The estimated change in the S&P500 was therefore seven percent + eight percent = 15 percent. In mid-October, the S&Pwas up 18 percent on the year.

Since we made our prediction, stocks have rallied and bond yields have gone down. The forecast will be much less bullish for next year, but we hold to our prediction for 2003. Indeed, our working forecast is that stocks will close 2003 at a high for the year.

Laurel: Meanwhile, the chronic bears have dug into their positions. The question at the beginning of the column, with its accusation that we are coldheartedly misleading readers with optimistic conclusions, is the most frequent feedback we receive from readers.

We divide the reasons for bearishness into seven general categories:

- Post-bubble blues;
- Investors still hope stocks will rise again, and not until the last ember of hope is gone can the bull market resume;
- Scandals have left so much distrust on Main Street that investors will shun the market for years to come;
- The economy is too poor to support a rise in stocks;
- Investors fail to realize that the economy is in the soup, and their mistaken views are a sign that the market is topping;
- The Good Old Days of the 1950s and 1960s when stocks sold at reasonable values are gone forever; and
- Institutional and retail fund managers' cash levels are too low to feed a rally.

You can find each of these reasons in the near-100 percent consistently bearish columns of Bill Fleckenstein, David Tice, Alan Abelson or any of the other major well-known pessimists. All of these are now lashing out with renewed vigor, as so often occurs when belief systems are crushed by facts.

In our book, *Practical Speculation*, we conducted a case study of 10 years of persistent bearishness during one of the greatest secular stock market advances in history. We then took some of the major propaganda techniques — bandwagon, glittering generality, etc. — and used them to explain the continuing allure of the bears.

Vic: We ask all the bears of this world to answer the following questions before unloading their negativism on us:

1. What makes you think conditions are so much worse today than the average conditions that prevailed during the 20th century, when almost every market in the world returned 1.5 million percent from buy-and-hold, as documented by the Triumphal Trio (Elroy Dimson, Paul Marsh and Mike Staunton) in the best market book of the century, *Triumph of the Optimists*.

2. Has the market anticipated the conditions you posit, and will the future realizations of the events you fear be worse or better than your hope for calamity?

3. Do you have any quantitative evidence the effect on the stock market would be negative if the conditions you believe will occur actually do materialize?

4. Are there any positive conditions you have not mentioned or considered that might counterbalance your negative beliefs?

5. What would it take to change your views?

We have come in contact with many bears, some even more negative than today's questioner, through the Spec List affinity group we oversee and our columns. We believe we have saved many of them considerable damage to their financial and mental equilibrium by posing these questions and asking them to answer them before burying us with the latest ephemeral negative about our society or the economy.

My new partner, Steve Wisdom, has come up with an indirect approach. He recently asked all members of our firm to perform the following exercise: Go through the millions of words on the Internet systematically each day and pick out the 10 most negative things about the economy or the stock market that are mentioned. Display and fit them into as many of the above categories as you can, and see how closely it resembles the next issue of the leading financial weekly's columnist or any of the other ursine gurus you follow. It's a salutary exercise for what it teaches you about programming, psychology and trading.

Laurel: The plodding earnestness of the bears reminds our friend Dr. Brett Steenbarger, author of *The Psychology of Trading* and associate professor of psychiatry and behavioral sciences at SUNY Upstate Medical University, of social psychologist Leon Festinger's research into the belief systems of cults: "When their predictions of the end of the world did not materialize, elaborate rationales were offered as to why the anticipated events did not occur," Steenbarger wrote us. "This allowed the members to actually solidify their cultish beliefs."

Festinger referred to this process of hardening beliefs as "cognitive dissonance." In the face of evidence the world wasn't going to hell in a hand basket, the cult members experienced a conflict between their actions and their expectations — and sought to resolve that conflict by creating further justification for their actions.

An analogy between cults and the "permabears" may not be so far afield, according to Steenbarger. "One wonders," he wrote, "how much of a similar dynamic animates the motivations of permabears, who amplify their predictions of a market plunge in the face of a 30-percent market rise."

Sociologist Robert Jay Lifton observed a number of cults in action and found several common elements, including "mystical manipulation," in which the group lets new members in on secret, privileged information; "milieu control," where alternative sources of information are filtered out; a demand for purity in beliefs; and a recurring theme that members will be "saved" by their special affiliation and beliefs.

"Perhaps being a permabear has less to do with markets per se and speaks more to people's needs for meaning and belonging: the desire to be part of a special group, bonded by beliefs and purpose," Steenbarger concluded. "How sad it is when such normal human longings render susceptible people unfit to deal with the objective realities of life and markets."

Have a question about trading? Trader Victor Niederhoffer and financial writer Laurel Kenner, co-authors of "Practical Speculation" (John Wiley & Sons, 2003), provide practical and hard-hitting answers. Send questions to gbuch@bloomberg.net.

For more information about the authors see p. 10.