

Don't Look a Gift Horse in the Mouth

January 2010 Economic and Market Newsletter

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Time to sell?

The medieval proverb which is the title of this investment e-letter can be translated as *"when given a present, be grateful for your good fortune and don't look for more by examining it to assess its value"*. I am talking about your liquid investments, whether they be in domestic or international stocks, corporate or municipal bonds, commodities, and even Gold. Each of these has risen from their lows from November 2008 - March 2009 to their peaks in October - December 2009, 69% for the S&P 500, 117% for the MCSI Emerging Markets Index, to 144% for Oil, to 80% for Gold and 243% for Gold Miner stocks, and even 50% for Investment Grade Corporate Bonds and 31% for California Muni Bonds (measuring from the low to the recent peaks).

An analysis methodology that came close to forecasting this remarkable rally is technical analysis using the Elliott Wave Principle as captured by forecasts by Bob Prechter and his company Elliott Wave International. Prechter predicted a swift and sharp rally on Bloomberg in a March 2nd interview when the Dow was at 6,763, subsequent to which the March Elliott Wave Financial Forecast pegged the rally taking the Dow above 10,000¹. Prechter in his 2002 book, *Conquer the Crash*, also proposed that the "C" wave decline which actually started in Oct 2007 would be correlated among all the major markets, something he called the *"all the same market"* hypothesis. All major markets (domestic and global equities, most bonds, and metals and commodities) dropped almost simultaneously from late 2007/early 2008. But equally remarkably, all of these same markets rose near simultaneously between when they hit their bottoms between Nov 2008 and March 2009 and the highs they are making right now².

I have been generally aligned with Prechter's views and believe that the secular (long-term) bear market started in

¹ appearing in the public domain in an April 2nd Marketwatch article <http://www.marketwatch.com/story/elliott-waves-market-now-a-bearish?dist=SecMostRead%2CprintMidSection&print=true>

² Prechter's forecasts have not always worked this well. He is most famous for calling the bull market in the late 1970's and then forecasting the 1987 crash 2 weeks prior to it. However, he got bearish in the mid-1990's, 5 years before the great bull market of the 20th century finally peaked, and then again in the 2005 to 2007 timeframe. It is not that the Wave Principle failed in the 1990's or in the mid-2000's ... it did not. In both of those instances the market conformed to the tenets of the Wave Principle, but Prechter got bearish too early.

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January of 2000 and the recent equity rally from March 2009 is a bear market rally within the context of this secular bear market. In other words, this secular bear market and corresponding deflationary forces will likely re-emerge shortly and drive prices of most assets down to below the lows we saw in the last year. *"All the same market"* should continue unabated, and per the Wave Principle, there is no reason for this correlation to subside until this secular bear market is approaching maturity. Of course only time will tell.

In this letter I am making the case that we should evaluate what we have been given by the markets and re-allocate to prepare for a very uncertain time ahead.

But, I will not hold you to the literal title of this essay and will give you a not-so-brief treatise on why this is a gift and why this is one of the best times based on my analysis to receive this gift. My argument for a deflationary economy and for a secular bear market consists of 6 viewpoints, including the philosophical, macroeconomic, fundamental, and technical viewpoints as well as an identification of, in my opinion, the biggest driver of the rally since March 2009, all of which I will expand on and share supporting data.

I will also provide the bullish counterpoint and discuss a key technical indicator that could indicate whether a long-term bull market has started. This indicator, if triggered, would raise the probability on bullish long-term Elliott Wave interpretations and would require me to temper or abandon my deflationary views and investment bias to a neutral-to-inflationary bias.

In summary, the thesis of this letter is that the markets have given us a gift and that this is an excellent time to

- i) Take what the markets have given us with a timed exit for most liquid investments, and
- ii) Re-position and diversify investable funds into active investment strategies that err on the side of capital preservation while being flexible to adjust to the macroeconomic environment, whether deflationary or inflationary, in a timely manner.

Here is the rationale.

A Philosophical View

Fed Chairman, Ben Bernanke, is the Time Magazine Man of the Year for 2009 for supposedly engineering our economy out of what would have otherwise been a depression. However, as I explained in my Deflation versus Inflation e-letter, one does not solve a problem of individual, corporate, and government insolvency driven by unsustainable debt loads, which has been manifesting itself in a deflationary environment, by more of the same, i.e. more debt or by encouraging more spending. All he and the Treasury Secretary, Geithner, have succeeded in doing, I believe, is to put the global deflation at bay for a while at an unbelievable cost. In the Bible in John 12:24, Jesus Christ referencing his crucifixion later in the Passover week and his subsequent profound influence on people and the world, gives us a principle that holds in much of life, *"Truly, truly, I say to you, unless a grain of wheat falls into the earth and dies, it remains alone; but if it dies, it bears much fruit"*. Bear markets purge corruptions and excesses in the economy. Secular bear markets do so in significant ways. It is like the old economy dies, and a new one is born that can grow unfettered by old ways and old sins. Bernanke is trying to keep the patient on life support rather than allowing death, prolonging the agony. All the *"green shoots"* we have purportedly been seeing in 2009 are the antithesis of that, weeds, as should soon become apparent.

The Macroeconomic View

The current tussle between deflation and inflation is the defining boundary for macroeconomic trends. Deflation was winning through 2008 and early 2009. Global GDP's, international trade, employment, capacity utilization, Consumer prices, housing, etc. all were dropping steeply in late 2008 and through the first half of 2009, until the unprecedented stimulus started to take effect. In the second half of 2009 however, almost every economic measure has moderated in its rate of fall or started to see modest increases. The Fed and the treasury are doing everything they can to cause inflation. We have a propped up economy. Does this mean we are done with deflation? Maybe, if these machinations had been successful in changing people's mindset, which has undergone an earth shift. People and companies are spending less and deleveraging because they have clued on to what is happening. They are borrowing less. Some key examples are as follows -

- The U.S. personal savings rate is now at 4.5% of personal disposable income (12 month average), the highest since the late 1990's and has been steadily rising for the last 2 years³.
- The money given to the banks to prop up their decimated balance sheets is not being loaned out either, because of hoarding as President Obama is accusing the "fat cat bankers" of, or simply because people are borrowing less. Bank lending saw the sharpest 1 quarter drop of 3% for Q309 since data collection began in 1984, and makes it a fifth consecutive quarter of lending declines. The declines were broad based, i.e. included both business and consumer loans⁴.
- Total consumer debt started shrinking for the first time since 1940 in mid-2008 (except for a -1.84% blip from Nov 1990 to Jun 1992 which was addressed by effectively eliminating the requirement for banks to maintain 10% cash reserves in 1991 due to a new loophole) and has continued to decline almost every month since, dropping almost 4% since the peak. This is massively deflationary⁵.
- A huge overhang in housing supply has started to break loose again. John Mauldin in his Dec 19th E-letter mentioned that residential delinquencies jumped up from 7.8% in Q209 to reach 9% in Q309. He also quoted an observation by Frank Veneroso in that E-letter that taken on aggregate, all houses with a mortgage have a loan to value ratio approaching 100%, with close to half having negative equity. Another wave of mortgage resets in 2010 as is expected for Option ARMs, combined with the bad unemployment situation will result in even more foreclosures as people walk away from their underwater homes. Any housing demand created by tax credits or financed by 3.5% down payment loans funded by the FHA (i.e. the taxpayer), which is the government's last ditch effort to keep home prices from continuing to spiral downward, could easily be overwhelmed by this new flood of foreclosures that is coming. Ominously, demand itself is down, with the latest pending home sales for November

³ <http://research.stlouisfed.org/fred2/data/PSAVERT.txt>

⁴ <http://online.wsj.com/article/SB125907631604662501.html>

⁵ http://www.federalreserve.gov/releases/g19/hist/cc_hist_sa.txt

crashing 16% from the October numbers after 6 straight months of rises.

This deleveraging has hit the top lines (revenues are flat-to-down in 2009) of companies throughout this year, but cost cutting has allowed companies to focus investor attention to bottom line growth. But bottom line (or profit) growth is not sustainable through cost cutting alone and requires growth in revenues. Cracks are already showing with 2 downward revisions of the showcase Q309 GDP which should have seen all the benefits of the stimulus package in addition to “Cash for Clunkers” and the home buyer credit. The initial Q3 GDP was said to be 3.9%, then revised downward to 2.8% in November, to be revised further downward to 2.2% in December. 2.2% is all the growth this economy can muster while being maxed out on steroids.

The Fundamental View ... or lack of it

There is a time for fundamental analysis, however the middle of a secular bear market isn't one of them. Crazy things happen at such times, like trailing⁶ S&P500 companies' 12 mo P/E ratios hitting 47 compared to 35 at the Jan 2000 and 18 at the Oct 2007 stock market peaks⁷. Global markets have been behaving irrationally for the last 2+ years calling into question Buy and Hold and its celebrated theoretical bases, the Efficient Market Hypothesis (EMH) and its offspring Modern Portfolio Theory (MPT), the underlying random walk model, Utility and Value Theory, and the Capital Asset Pricing Model (CAPM). EMH is the idea that security prices are rationally determined, reflect all available information, and seek equilibrium. MPT, which resulted in a shared Nobel Prize in 1990 for its founder Harry Markowitz, puts forward the concept of diversification and the thesis that a portfolio can be constructed on the “Efficient Frontier” that optimally balances risk and reward from a “uncorrelated” selection of investments. The random walk hypothesis is a financial theory stating that stock market prices evolve

⁶ The 12-mo trailing P/E ratio above contains Q109 to Q309 actual earnings and Q409 earnings projections which is much more reasonable compared with the 2010 projections used when calculating the more popular forward looking P/E ratios used by Wall Street to make the market look less inflated.

⁷ <http://www.dshort.com/articles/2009/SP-Composite-pe-ratios.html> for the current trailing 12-mo PE and <http://static.seekingalpha.com/uploads/2008/5/14/spxpe60.png> for historical trailing 12 mo PE's

according to a random walk per the bell curve or Gaussian distribution and thus the prices of the stock market cannot be predicted. Utility theory is built on the tenet that people act rationally with regards to their financial decisions. CAPM is a method of accounting for the value of an asset using some fundamental characteristic of the asset, like future dividends, etc.

Two aspects of market behavior have boggled the fundamentalists' minds

- High correlation between different asset classes both on the way down (Oct 2007 to March 2009) and on the way up (March 2009 till now).
- Significant price movements in short periods of time unexplained by corresponding changes in underlying demand. Two examples are
 1. Crude oil which dropped 80% in the course of 7 months in 2008/2009 while Oil demand in the US was estimated by the EIA to fall by only 4% between 2008 and 2009⁸.
 2. An unprecedented 67% rise in US equities from the March 2009 low to their highest points in Nov/Dec. In the words of Dave Rosenberg (who was the chief economist for Merrill Lynch for many years) in his Sep 18th Breakfast with Dave e-letter “*Never before has the S&P 500 rallied 60% from a low in such a short time frame as six months. And never before have we seen the S&P 500 rally 60% over an interval in which there were 2.5 million job losses. What is normal is that we see more than two million jobs being created during a rally as large as this. In fact, what is normal is for the market to rally 20% from the trough to the time the recession ends. By the time we are up 60%, the economy is typically well into the third year of recovery; we are not usually engaged in a debate as to what month the recession ended. In other words, we are witnessing a market event that is outside the distribution curve*”.

Dave also says in the same article that the S&P500 is discounting future earnings that even the bullish consensus does not see happening for another 2 or 3 years, i.e. **this is a deeply overvalued market**. Hardly the kind of market you want to hang-onto or worse, invest into, for the sake of the old Buy-and-Hold times or of good-ol' Efficient Markets. Especially given the concept of

⁸ http://www.eia.doe.gov/steo#US_Crude_Oil_And_Liquid_Fuels

diversification from MPT is discredited, and the markets are not behaving efficiently, rationally, reflecting all available information, or are in any sense connected with the fundamental characteristics of the assets they purport to set the price for.

Unwinding of the US Dollar Carry Trade

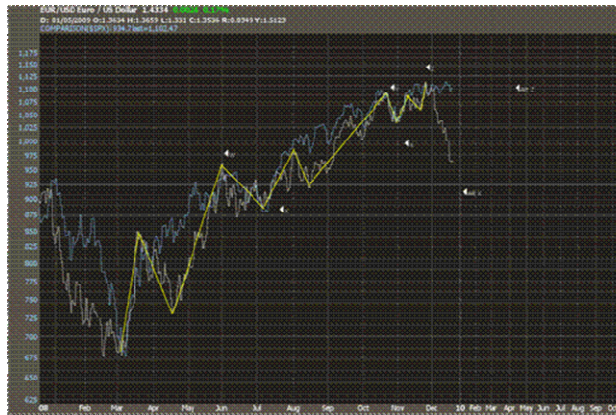


Chart 1 The Euro/US Dollar exchange rate (in white right scale) shown simultaneously with the S&P 500 (in blue left scale) for 2009 drawn using www.prophet.net. Note the close correlation. Solid Yellow lines are the Elliott Wave labeling for the (corrective) rally in the Euro since March.

If not for fundamentals, or animal spirits, what has been the cause for the US market to rise 67% from its low in March, along with most of the global markets? An irrational market still requires a rational reason to levitate, right? Well, there happens to be one which Sherlock Holmes would approve of. Holmes liked to say “when you have eliminated the impossible, whatever remains, however improbable, must be the truth”. Let me first explain the term, show you a chart and then the jigsaw puzzle will hopefully fall into place. A Carry Trade occurs because of interest rate differentials in the currency markets where speculators or those with access to government money at short term rates, borrow a currency that has a low short term interest rate, (i.e. the US Dollar) and purchase and hold another currency which is yielding a higher interest rate OR purchase assets which the speculator assumes will go up in value (everything else like US stocks, global stocks, Hong Kong apartments, etc.).

A rollicking carry trade has been occurring with the US Dollar since last November, and since March the focus of carry trade speculators (or someone with access to near zero interest US dollars) shifted to US and global stocks among other assets. Chart 1 above shows the EUR/USD

currency pair (in white), which is the exchange rate in dollars to purchase a Euro, graphed with the S&P500 (in blue) between January 2009 and now. Do you see the remarkable correlation between these two unrelated indices? Since trading volumes for the currency markets are 100X larger than the global stock markets⁹, one can make a simple conclusion that the carry trade in the US Dollar is what is behind a bulk of the market rise this year. That is the only conceivable reason for so tight a correlation. This trade works well if the dollar is dropping and/or the stock market is rising. However, if either or both of the assets start moving in the opposite direction, the speculators are forced to liquidate which then creates a reverse trade that can spiral into a significant market drop or develop into a crash.

Nouriel Roubini, an economics professor at the NYU Stern School of Business, one of the few economists who correctly forecast the recession of 2008, calls this the “mother of all carry trades” and forecasted in a Nov 1st, 2009 *Financial Times* article¹⁰, “But one day this bubble will burst, leading to the biggest co-ordinated asset bust ever: if factors lead the dollar to reverse and suddenly appreciate – as was seen in previous reversals, such as the yen-funded carry trade – the leveraged carry trade will have to be suddenly closed as investors cover their dollar shorts. A stampede will occur as closing long leveraged risky asset positions across all asset classes funded by dollar shorts triggers a co-ordinated collapse of all those risky assets – equities, commodities, emerging market asset classes and credit instruments”.

We actually know what happens to stock and bond markets when a carry trade supporting it collapses. As Dr. Roubini mentioned, the US and global stock market rise from 2004 to 2007 was actually fueled by a very similar carry trade, this time with the Japanese Yen. Chart 2 catalogs the machinations that occurred in the S&P500 and the Yen (in terms of the Euro/Yen pair this time) between 2004 and 2008. Notice the tight correlation between the rise of the S&P in conjunction with the Euro/Yen exchange rate between late 2003 and 2007, and the near simultaneous crash in both in 2008. This time around, the “carry trade” has moved much faster (in months instead of years) and the unwind may occur faster as well. Actually one of the two major underpinnings of the carry trade is already failing. The US Dollar rose

⁹ http://www.marketforex.net/forex_equities.html

¹⁰ <http://www.ft.com/cms/s/0/9a5b3216-c70b-11de-bb6f-00144feab49a.html>

almost 5% in the 14 trading days between Dec 1st to Dec 18th, erasing over 4 months of losses in 1/8th the time. As I mentioned, this carry trade is extremely leveraged and the trade is doomed if either the dollar rises (which it has started to) or the market falls, or both.



Chart 2 The Euro/Yen exchange rate (in white right scale) shown simultaneously with the S&P 500 (in blue left scale) using www.prophet.net. Note the close correlation from late 2003.

Now you know the most likely reason for why the market rose since March. It is not fundamental progress, but pure speculation (or worse, manipulation) based on cheap money. Is that the kind of rally you want to remain a part of? You do not want to wait until the “stampede” occurs.

Viewpoint from Classic Technical Analysis

Markets have their own language and Technical Analysis is the body of knowledge used to read this language. We will look at analysis of the markets using four methods of technical analysis that will provide insight on whether we are approaching a top of significance and whether the market rally from March was the beginning of a new bull market or does the rally look like a rally within the context of a larger bear market.

i) Dow Theory

Originally developed by Charles Dow in the late 1800’s, the most famous living proponent of which is the venerable Richard Russell who has been studying the markets and writing the “Dow Theory Letters” since 1958, the oldest service continuously written by one person in the business. Russell gained wide recognition via a series of over 30 Dow Theory and technical articles that he wrote for Barron’s during the late-’50s through the ’90s. Russell was the first (in 1960) to recommend gold stocks. He

called the top of the 1949-’66 bull market. And almost to the day he called the bottom of the great 1972-’74 bear market, and the beginning of the great bull market which started in December 1974. Mr. Russell had this to say in his Dec 9th letter taken from an excerpt released to *The Daily Crux* web-news service¹¹ “As subscribers must know by now, I haven’t liked the stock market. I can’t tell with any certainty at this time, but this bear market rally could be in the process of topping out. If it is, I think we’re in for a vicious collapse. Remember, rallies in a primary bear market are movements against the main force or tide of the market. In other words, during a rally, the bear forces have been held back. When a bear market rally breaks up, the market tends to make up for lost time. That means the declines tend to be rapid, violent and vicious. As I said, I can’t tell with certainty whether the advance from the March low is breathing its last. But if it is -- watch out; it’s not going to be pretty. By the way, IF the advance from the March low is topping out, here are the implications. It would mean that all the Fed’s machinations and efforts to halt the deflation have gone to waste. Furthermore, if the March lows are violated (and nobody believes they will be) we will probably be in the final and most costly and frightening leg of this bear market.”

ii) Declining Volume in the rally

Many commentators and technical analysts have noticed that the volume profile of the rally for March does not look like a bull market rally but rather looks like a classic bear market rally, i.e. initial volume was not very high with volume for subsequent sub-rallies dropping significantly, with the last couple of legs, in October/November and then in December being weaker still. Claus Vogt of Weiss Research in his Dec 30th Money and Markets update says “according to this rule, the rally of the past months has to be treated with great caution ... especially notable and technically unhealthy was the pattern of rising volume during short term corrections (during the rally). Sound corrections are earmarked by low and declining volume. Taken together, the stock market rise from the March 2009 low has the look of a bear market rally ...”.

iii) Investor Sentiment

In his book *Conquer the Crash*, Prechter says “The engine of high stock market valuation is widely shared optimism. The greater the degree of advance that is ending, the

¹¹ http://www.thedailycrux.com/content/3567/Richard_Russell

greater the optimism at its peak ... Bull markets, they say, climb a "wall of worry". I like to add "and bear markets slide down a Slope of Hope". Warren Buffett echoed the same idea when he said, "Be fearful when others are greedy and greedy only when others are fearful". Hence investor sentiment is a contrarian indicator. There are many ways of measuring investor sentiment, from the ratio of Puts to Calls for Options traders, to trader or advisor/money manager or economist sentiment, to the cash-to-asset ratio for mutual funds, to equities as a percentage of assets under institutional management, etc.

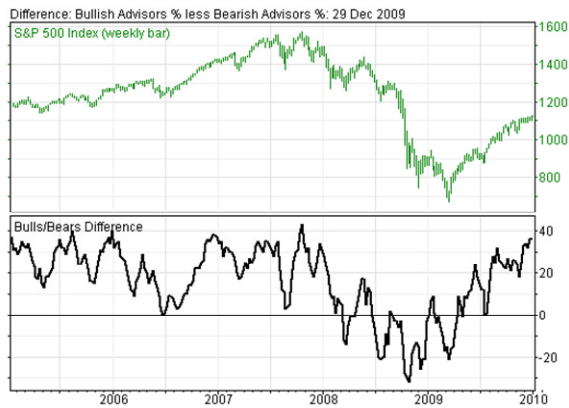


Chart 3 Drawn from the results of a weekly survey conducted by Investor Intelligence of Financial Advisors, the chart measures the difference between the percentage of bullish financial advisors and the percentage of bearish financial advisors, shown against the S&P 500 Index.

Chart 3 above shows one such indicator, the results of a weekly survey of Financial Advisors sentiment conducted by Investor Intelligence¹² for data thru Dec 29th, 2009. Mark Hulbert of Marketwatch commended this indicator in the summer of 2007 before the turn-down, saying "Investor Intelligence's track record suggests we pay attention to what Burke and Gray have to say. In fact, their stock-market timing advice is tied for third place right now for performance since 1985 among all the market timing newsletters tracked by the Hulbert Financial Digest. Stock market bulls, take note". The lower chart in Chart 3 is the %age of Bullish advisors less the %age of Bearish advisors, and is shown against the S&P 500 index. Note how the current readings of this indicator are almost at the same level as the October 2007 extreme, while the S&P is still 29% below that peak. Interestingly, the actual percentage of purely bearish advisors (excludes those merely expecting a stock market correction) is even lower than its

¹² Taken from http://www.investorsintelligence.com/x/gadas0707.html?gclid=C M7C3-T-i58CFREMDQod_22hGw

Oct 2007 low (made when the Dow made its all time high) at < 17%. Financial advisors (and money managers) have the uncanny knack of being most optimistic near stock market tops and most pessimistic near the bottoms, i.e. being very poor timers of the markets. Market timing gets a bad rap in large part due to the failure of these "experts".

iv) Long-term Trendlines

In preparing for my CMT (Chartered Market Technical Analyst) certification exams a couple of months ago I was studying the section on long-term trendlines that provide support and resistance to price trends. Long-term trendlines are very rare for bear markets both for indices and individual stocks, but we can find an excellent one for the Nasdaq Composite index from its January 2000 peak through its October 2007 peak (solid yellow line in Chart 4 below). In technical market terms, the longer term a trendline is and the more rallies it has repelled previously, the more important it becomes as a resistance point for future rallies. This trendline has done just that, it repelled the massive market rally from 2003 to 2007, and then subsequent smaller rallies in May 2008 and August 2008 successfully.



Chart 4 Nasdaq Composite index from 2000 thru Dec 31st, 2009. Yellow line is the long term trendline (resistance line) drawn from the Jan 2000 peak connecting with the Oct 2007 peak (drawn with www.prophet.net). Elliott wave labelings are shown for reference and are from Elliott Wave Intl.

Another important observation is that on a daily basis the major domestic market indices are correlated, i.e. they generally rise and fall together, though one can outperform or underperform the other. Hence we would expect the other indices to slow and also reverse their advance if the Nasdaq is repelled by this long-term resistance line. If this market index correlation holds and

if you believe Technical Analysis works, this line may well be one of the clearest indicators and demarcations available for determining if the Secular Bear Market is over and a new Bull Market has begun. On the other hand, those who sold their equity holdings at any of the previous tests of this trendline are sitting with a nice profit. Is it time to sell again?

Edwards and Magee, who have written the oldest and definitive text on Technical Analysis¹³, say in Chapter 15 of this textbook that one of the rare bear markets where such a long term trendline could be drawn was the 1929 to 1932 bear market, which is a market with many similarities to the current secular bear market from 2000, though it had a shorter timeline. Chart 5 gives us a sense of what happened after the long-term trend line was tested by significant bear market rallies during the Great Depression. The chart shows the Dow Jones Industrial Average from its 1929 peak through 1934 with a resistance line drawn from the 1929 peak touching the top of the point marked B in April of 1930. From the down arrow labeled 2 of C which was the last major test of the resistance line, the Dow fell >4X before it bottomed.



Chart 5 Dow Jones Industrial Average from 1929 to 1934 with the long term resistance line shown in Yellow, drawn using www.prophet.net. Elliott wave labelings are shown for reference and are from Elliott Wave Intl.

Viewpoint from the Elliott Wave Principle

The Elliott Wave Principle is named after the work of Ralph Nelson Elliott in the 1930's who when studying the markets uncovered a self-consistent fractal pattern based

¹³ "Technical Analysis of Stock Trends", Robert D. Edwards and John Magee, 9th Edition, CRC Press

on Fibonacci mathematics that the markets universally adhere to. He discovered that the markets were not random, but were structured and patterned per this specific fractal subsequently named the Elliott Wave fractal model and were hence probabilistically predictable in real time, sometimes with higher degrees of confidence. The principle formally falls under the realm of Technical Analysis, though Prechter, with whom I agree based on my own observation of the markets, subordinates the body of knowledge in field of Technical Analysis to the Elliott Wave Principle.

An Elliott Wave analyst observes that the markets are always on an Elliott Wave, his job being to determine which one for the fractal degree of interest. Since there are a multitude of potential wave patterns possible for the future that fit with the historical data, it makes sense that a common criticism is the subjectivity of the Wave Principle when used for real-time forecasting of the markets. However, a proper understanding of macroeconomics, experience with the markets, and use of other coincident technical indicators help the savvy analyst zero in on the highest probability wave possibilities and hence improve the accuracy of forecasts based on the Elliott Wave Principle. Prechter's organization does an excellent job and his forecasts on the market events since Oct 2007 have been almost spot on for the domestic markets¹⁴. I have developed some proprietary methods, innovations, and indicators to make the decision making process more objective and improve the accuracy of determining the actual wave the specific market is on. These methods have enabled me to develop and translate the Wave Principle based forecast for the major markets into a consistent and disciplined tactical asset allocation or market timing methodology which I use for managing client assets in my Absolute Return portfolios.

The scope of this essay does not allow a deeper discussion about the Elliott Wave Principle or the model itself, but I will convey some of the key published forecasts from Prechter's organization that my version of the analysis also supports, which will add further impetus to the thesis of this essay that this is a great time to exit most investment positions. This is summarized from Prechter's two 10 minute video interviews¹⁵ with Kevin Depew of

¹⁴ Prechter's key broadcast appearances since Oct 2007 http://www.elliottwave.com/subscribers/bloomberg_videos/default.aspx

¹⁵ <http://www.elliottwave.com/freeupdates/archives/2009/12/29/Video-Prechter-on-Elliott-Analysis-Early-Career-Deflation-and->

Minyanville on Nov 11th, 2009, and from his broadcast appearances referenced above.

- i) The market rally from March 2009 is corrective based on the Elliott Wave structure. The secular bear market will re-assert itself in 2010 and take the key US indices below their March 2009 lows. Ultimate bear market lows would bring the equity valuations down to historical levels seen at the end of previous secular bear markets, i.e. P/E ratios in the single digits.
- ii) The Wave principle calls for 5 “waves” for the decline that started in October 2007 of which we have completed 1 down (October 2007 to March 2009), and are completing 2 up (March 2009 to now), with 3 down, 4 up, and 5 down still to go. This would occur in a manner that rhymes with the wave structure of the Great Depression for the wave C in Chart 5. The Wave Principle calls for Wave 3 down to not be the shortest, and also to be the most intense and destructive of the down waves, which implies that 2008 was just a preview of things to come. It also implies that the current highs could remain in place for a long time, possibly over a decade.
- iii) The “*all the same market*” hypothesis will hold through the majority of the duration of the bear market driving all major asset classes (global equities, bonds, commodities, precious metals, etc.) excluding the dollar, and possibly US treasury bonds lower in rough synchronicity with the US equity market.

Counterpoint : The Bear market is over?

I would be remiss to not offer a counterpoint, which is also the general viewpoint with varying degrees of bullishness from top Wall Street firms to independent broker/dealers. Thomas Lee, the US Equity analyst of J.P. Morgan Chase, makes a statement that is representative of the Wall

[US-Dollar-Part-1.aspx](http://www.elliottwave.com/freeupdates/archives/2009/12/29/Video-Prechter-on-Personal-Finance-Timing-Bear-Market-Trading-and-Socionomics-Part-2.aspx) for part 1 and <http://www.elliottwave.com/freeupdates/archives/2009/12/29/Video-Prechter-on-Personal-Finance-Timing-Bear-Market-Trading-and-Socionomics-Part-2.aspx> for part 2 of the video interview with Kevin Depew of www.Minyanville.com

Street mainstream¹⁶, “*We’re probably still only in the early stages of a potentially big economic recovery but I think it’s probably not until well into next year that investors begin to broadly recognize it.*” Mr. Lee thinks there’s enough slack in the job market to keep inflation from becoming a near-term threat as companies begin hiring. That, in turn, should allow the Fed to keep interest rates low for a prolonged period of time, he says, which could provide a floor for the stock market. The thinking is supported by the expectation that corporate earnings will grow by 30% from 2009, thanks to aggressive cost cutting. This counterpoint basically says that the bear market, whether secular or otherwise, is over and that we started a new bull market in March 2009. Inflationists are also basically in this camp, differing from the mainstream of Wall Street on the extent of inflation expected over the next few years as a result of the unprecedented governmental stimulus applied since 2007, foreseeing a steep decline in the dollar and a significant increase in interest rates.

In terms of Chart 4, this scenario (whether growth-driven or inflation-driven) would be true if the Nasdaq breaks through its long-term trendline, rather than being repelled by it. This indicator, if triggered, would raise the probability on bullish long-term Elliott Wave interpretations and would require me to temper or abandon my deflationary views and investment bias to a neutral-to-inflationary bias. We are right at the cusp. Will the market break through this invisible but formidable barrier that has kept it back for almost the last 10 years? Has fundamental progress sneaked back on us under the cover of unsound fiscal and monetary policies? The moment of truth is upon us.

Conclusion

My assessment of available economic and market data leads me to be in the deflationist camp. David Calderwood, businessman and author, summarizes the deflation thesis aptly¹⁷, “*I think that the architects of our elastic fiat dollar may discover that the rubber buck they stretched for 75 years can still snap back. Should that occur, wiping out much of a lifetime of accumulated credit*

¹⁶ Wall Street Journal January 5th, 2010 article <http://online.wsj.com/article/SB10001424052748704162104574630242432745528.html>

¹⁷ in a Dec 18th article published on <http://www.lewrockwell.com/calderwood/calderwood42.1.html>

inflation in a bomb-like release of energy, it will punish everyone whose occupation and standard of living grew to rest on it: us all." The snap back which started in 2000 and then was kept at bay by the housing boom and the Yen carry trade from 2003 to 2007, restarted in earnest a couple of years ago. This time it has been held back by Bernanke's magic and the US Dollar carry trade for a shorter season. The season's end is at hand and those putting their faith in the market at this juncture could be sorry they did. Unfortunately in a prolonged deflationary environment, even traditionally "safe" or "un-correlated" investments like Corporate or Municipal Bonds, or Gold become iffy as we saw in 2008.

Contact me to setup appointments for an evaluation of your current investments and an exit strategy (including specific sell signals) if appropriate for your investments. Some of these decisions are made best in the context of a financial plan for your retirement needs based on realistic scenarios for the future. I am hence offering both the investment evaluation/exit strategy and developing a basic financial plan (if you don't have one) at no cost. The meetings will give me a chance to introduce my active investment management approach used in my Absolute Return portfolios and fee-based services.

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