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Will price action save the day?

Massive (and expected) fund selling wiped out prices in July. Now, prices are no longer going down on bad news...just as the masses are finally "buying" into the bear market. So what's gives? **Price Action** – as I have suggested over the last few weeks, price action has created the trading band that was required before we could expect to build a low and move forward.

The Bubble Boom

There's Another Great Bubble Ahead and the Time to Buy Is Now!

In Brief: As we move into October our technical indicators are showing strong signs of a final bottom. We saw extreme signs of capitulation in all of the key technical indicators in late July when we gave a strong buy signal. Now we are seeing signs of a classic retest of those lows on lower volume very similar to the 1974 bottom. This recent wave of selling in September has seen reduced levels of hedging by the large institutional investors, increased buying by the smart money, and strong inside buying by technology executives. This means that the individual investors, or "dumb money" are the ones selling and that would strongly suggest that this is the last wave down and a bottom is at hand. Our targets for this last wave of selling have been 7400-7550 for the Dow, and 1100-1150 on the Nasdaq. The Dow hit our targets on September 30th and the Nasdaq could follow by October 1st. We are advising aggressive investors to buy here. More cautious investors may want to wait for an initial reversal up, and then a follow through rally of 2% or higher on rising volume over the next week or so. All of our technical analysis and our more critical fundamental analysis of demographic and technology trends suggest that we are finally at "**The Buy Opportunity of a Lifetime**".

Most experts are strongly suggesting that we have seen a classic bubble and that the stock market boom is over for many years or decades to come. We couldn't disagree more. This entire boom has been a bubble boom, with the first bubble from 1985 to 1987, and the second from 1995 into early 2000. And these bubbles and crashes have been strongly paralleling the 1902 to 1929 bull market on an 80-year lag on our New Economy cycle. Nearly every major bull market sees three major advances with corrections in between before peaking. Hence, there should clearly be one more major advance and another great bubble ahead. A broader view of the long-term bull market, that actually began around 1780, shows that we have seen each wave move up more exponentially. This would suggest that the next bubble is likely to be as extreme as the Roaring 20s bull market from 1922 to 1929, and perhaps even more so. We are projecting that it is very likely that investors who have the conviction and courage to buy here are going to see higher average annual compound returns than they would have seen in the last great bull wave from late 1990 into early 2000. Even if we are overly optimistic based on very compelling demographic trends, investors should still be rewarded by buying at a time like now simply based on the compelling decennial (10-year) cycle and the 4-year Presidential cycle in stocks that has been surprisingly con-

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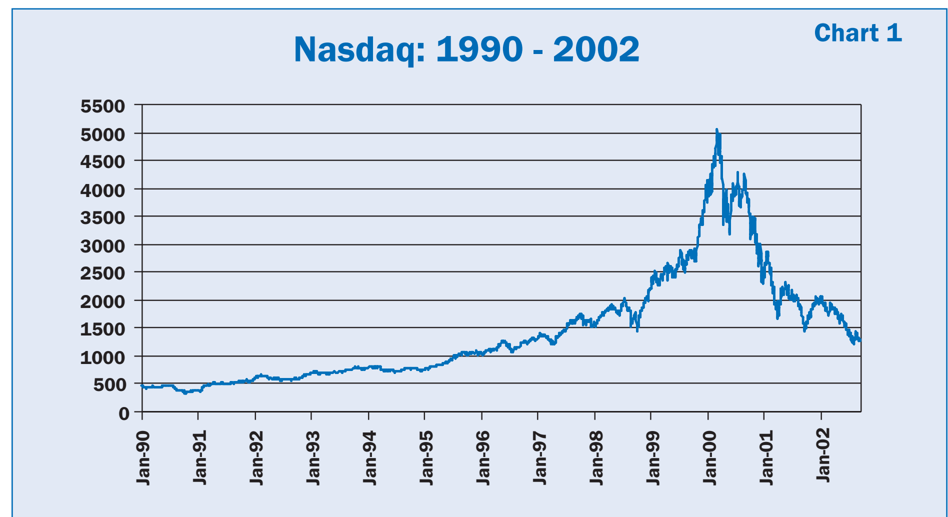
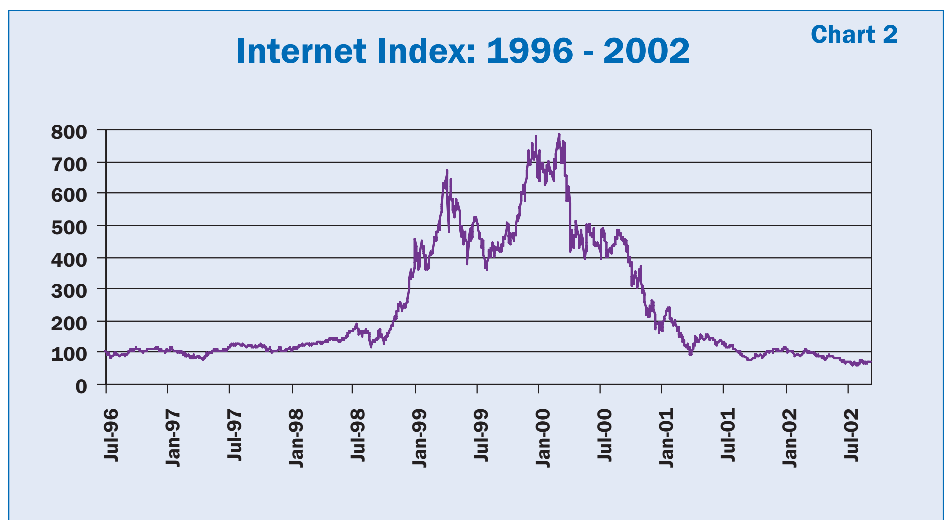
sistent back to 1900. We are more bullish than at any time in two decades of economic analysis and are issuing our strongest buy signal ever.

A History of Stock Market Bubbles

In this issue we are going to focus on the biggest topic of this time: stock market bubbles. We have obviously just lived through an extreme bubble in Internet and dot-com small cap stocks and a substantial bubble in technology stocks. The common wisdom is that once you've seen a bubble the markets don't go to new highs for decades, which is often true, but often it is not. It is first important to note, as Jeremy Siegel (author of ***Stocks for the Long Run***) has, that this bubble largely occurred in the tech sectors and not in the broader markets. In 2000 the Dow went to the top of our Dow Channel and has had a correction of 36%, slightly less than it did in 1987. If you take the technology stocks out of the Dow or S&P 500 then you would get a more normal periodic correction within a bull market that naturally occurs every several years.

It was leading large cap Internet stocks like AOL that had price/earnings ratios (P/Es) of over 400. It was the new emerging dot-coms that had huge valuations with no earnings in sight and totally unproven business models. This represented a true and extreme stock market bubble and the crash that has followed has been extreme. Recently the Nasdaq was down 76% (Chart 1) and the great majority of dot-coms are gone with the Internet Index down 92% (Chart 2). A substantial portion of the larger technology stocks, like Lucent, are mortally wounded and will likely never see new highs again. But we are forecasting, against popular opinion, that many of the larger technology companies with leadership positions and strong business models, like Microsoft, Intel or Cisco, will see major new highs in the coming decade.





Let's start by looking at the history of major stock market bubbles in the past and the psychology that causes them. The truth is, every time we get an extended strong boom in the economy or in particular leading sectors, we get substantial overvaluation. This results from the Human Model of Forecasting (Chart 3) that we first displayed in ***The Great Boom Ahead***. We have a consistent tendency to project recent trends in a straight line into the future, whereas the reality of life is that trends move in a cyclical or curvilinear manner. Hence, we have a grave misperception of reality just as we do of risk (as we covered in the August issue). The longer the trends go up and the stronger the advances the more bullish we get about the future. And remember, the stock market values stocks by projecting their earnings many years into the future. When the cycle finally slows and reverses,

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The Human Model of Forecasting

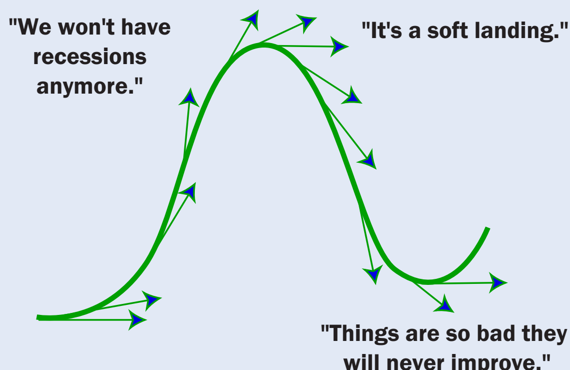

Chart 3

stocks have excessive valuations and then correct excessively. At the bottom of the slowdown, we project slow growth or decline many years into the future. Hence, during the correction we expect very undervalued levels as we don't anticipate the strong rebound that typically follows.

Our point here is simple. Markets always get overvalued in cycles of growth and undervalued in cycles of slowing. **Bubbles always occur, it is simply a matter of degree**. The greatest overvaluation or bubble cycles occur when the economy is accelerating the strongest, which almost always occurs when powerful new technologies and growth industries first enter the mainstream on an S-Curve cycle. That is why the last major bubble in the U.S. economy occurred in the Roaring 20s and not in the post World War II boom. Of course, as new technologies accelerated again starting in the 1990s, we just experienced the next bubble, but again largely in technology stocks. We have been arguing since mid-2001 that modern day technology advances see two bubbles, like 1915 - 1919 and 1925 – 1929 before peaking and only then see a more extended long-term bear market. The crash of the first auto bubble, the tech stocks of that time, from late 1919 into early 1922 ended up being the greatest investment opportunity for stocks and tech stocks of the last century, whereas the crash of the second bubble from late 1929 into early 1932 represented the end of the great bull market for another decade.

The first major bubble in history that was fairly accurately measured was the tulip mania between 1634 and 1637. Prices started at about 1.20 Guilders and accelerated up 50 times in value in a little over two years to 60.00 Guilders. Then they crashed 99.8% to .10 Guilders in less than a year. That was the most extreme bubble up and down in measured history.

The next great bubble was the South Sea Company bubble into 1720. Here the value of this company's shares went up about 9 times from 110 to almost 1000 in one year from mid-1719 to mid-1720. It then crashed 93% to about 70 over the next two years. That bubble was more like the recent Internet bubble. The history here is more interesting. There had been a major expansion in population and economic growth in Europe starting in the late 1400s following the printing press, the last information revolution. The other major technology revolutions from the mid- to late 1400s included gunpowder and tall sailing ships with navigation advances that allowed them to sail long distances. The sailing revolution allowed not

Gouda Tulip Bulbs:
12/1/1634 - 2/5/1637

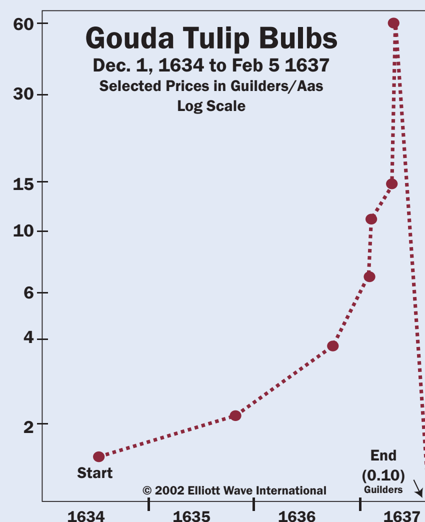

Chart 4

Source: Conquer the Crash, by Robert Prechter, page 80

South Sea Company:
1719 – 1722

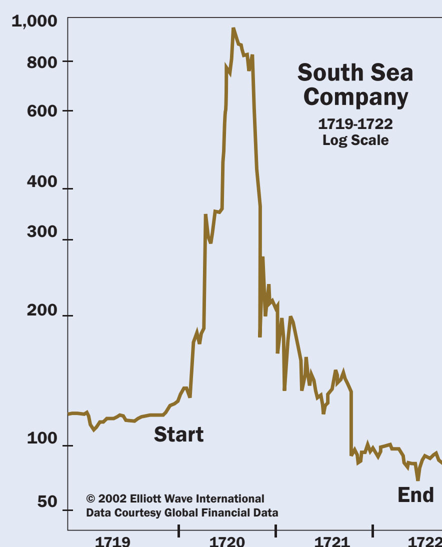

Chart 5

Source: Conquer the Crash, by Robert Prechter, page 80

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Source: Conquer the Crash, by Robert Prechter, page 33

Chart 6

only the discovery of America, but also a more lucrative spice and fabric trade with the Far East. The success of such trade lead to the first publicly owned companies where shares were sold to many individual investors in 1607. In essence this represented the raw beginnings of the stock markets. And of course, it was only a matter of time before human nature would generate a stock bubble.

By the early 1700s the population growth that had been leading the greatest economic expansion in history started to slow and that naturally lead to a major bear market. Chart 6, which was developed by Robert Prechter at Elliot Wave International, combines British stock prices as far back as they could be measured to around 1700 with U.S. stock prices from 1780 on. A 230-year plus bull market from around 1490 or earlier to 1720 was followed by the crash of the 1720 bubble representing the beginning of a 60-year bear market in stocks. We have pointed out in past books that there are greater long-term bull market cycles, which are followed by more extended bear markets. The most extended bear market in modern history was the Dark Ages beginning at the fall of Rome in the late 400s until the Crusades around 1000 – a five hundred year bear market! That extended depression saw the extreme wealth and urbanization of the Roman Empire deteriorate into a long period of feudal subsistence back into rural areas throughout Europe. Then there was a great expansion of population and a movement back to small cities from around 1000 to the mid-1350s followed by the Great Plague and a slowing of population growth and economic expansion into the 1400s. After that extended bear market growth exploded to an even greater degree again for centuries until the South Seas bubble burst. Chart 6 would suggest that we are in the fifth and final wave of the longer-term cycle that began around 1780. That would also suggest a longer period of stagnant economic activity following this fifth and final wave up, at least in the developed world where birth rates have been slowing since the peak of the baby boom generation.

After the predicted slowdown from around 2010 to 2022, there will be another bull market but it could end up merely being a strong "B" wave (bear market rally) that doesn't see new highs. It already appears very likely to us that the Nikkei will not make new highs in its next echo baby boom bull market from around 2004 to 2020, and hence has probably peaked for many decades to come – much like the South Seas bubble peak in 1720. This is why we are calling our next book, to be released around January 2004, ***The Last Great Bull Market.***

Let's look at Chart 6 and the larger Elliott Wave pattern of the bull market that started around 1780. The first larger wave up occurred from 1780 to 1832. There was a significant bubble into that peak and a strong crash that bottomed by 1837. The third long-term wave up occurred from 1837 to 1929. And we can look at that stronger bubble in Chart 7. After the crash of late 1919 to late 1921, the Dow went up 6 times into late 1929 in 8 years and went up 4 times from mid-1924 to late 1929 in just 5 years. The market almost doubled in the last year similar to the Nasdaq in 1999. Note that this bubble was nowhere near as extreme as the tulip and South Seas bubbles. But the aftermath saw an 87% decline between late 1929 and early 1932. That crash lasted 2 years and 10 months and erased more than all of the gains from the entire bull market from late 1921 to late 1929. Note that the 2000 – 2002 correction in the Dow has already gone 2 years and 8 months and according to the history of the length of the worst crashes should be at or very near its end.

It is important to observe here that the 1920s bubble emerged not only around the peak of a new generation's

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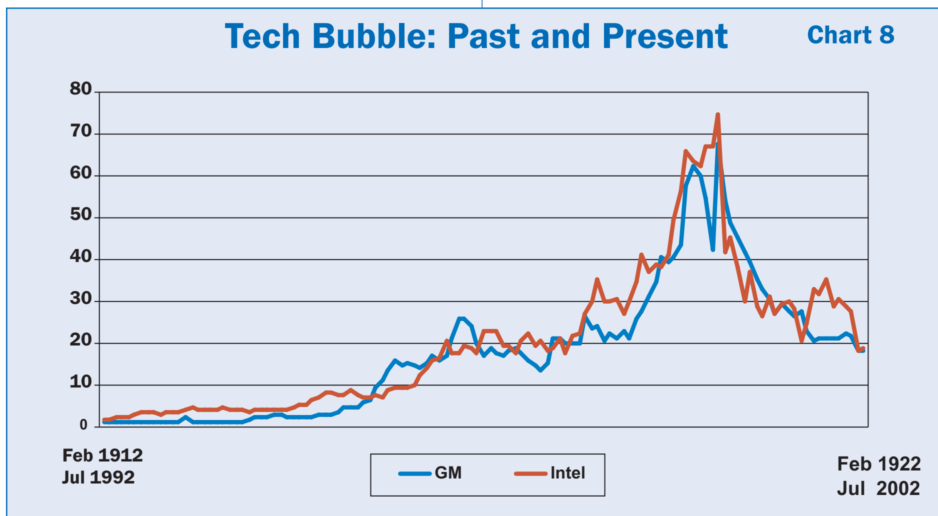
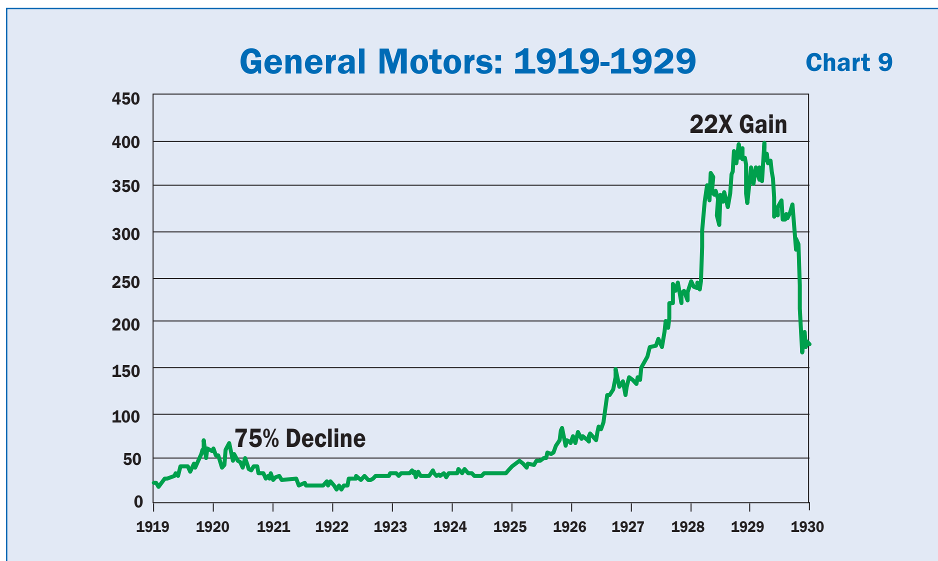
spending cycle, but the emergence of a new technology revolution moving mainstream. Autos, the central new technology, advanced from 10% to 90% penetration of urban households between 1914 and 1928. But first, there was a prominent bubble in technology and auto stocks from 1915 to late 1919. This is consistent with our 80-year innovation cycle model, which closely paralleled the most recent tech bubble from 1995 to 1999. Chart 8 shows how General Motors tracked Intel in the 1990s tech bubble almost perfectly 80 years ago. Most analysts and investors would have looked at the bubble and crash in the tech stocks and General Motors back then and thought, "this bull market is over"! But as you can see in Chart 9 General Motors went up 22 times from 1922 to 1929 for an average annual compound return of 57%. The second bubble into 1929 came at the end of the auto and technology S-Curve acceleration and was accompanied by the peak of the Henry Ford generation spending cycle. Hence, it initiated a longer-term bear market and period of consolidation in the economy, unlike the first bubble into late 1919.





We have shown in ***The Buy Opportunity of a Lifetime*** how following the crash into early 1922, the Dow went up 6 times, the auto index 12 times and General Motors 22 times into late 1929. There were clearly two bubbles as the new technology revolution emerged and the second bubble saw a greater and more extended decline from late 1929 into 1932. The crash of the first bubble into early 1922 created the greatest buying opportunity for stocks and technology in the last century. Even the crash into mid-1932 created a great intermediate term buying opportunity into 1937 wherein the Dow advanced 4.7 times in less than 5 years (Chart 7). The next major bull market didn't begin until the Bob Hope generation entered its spending

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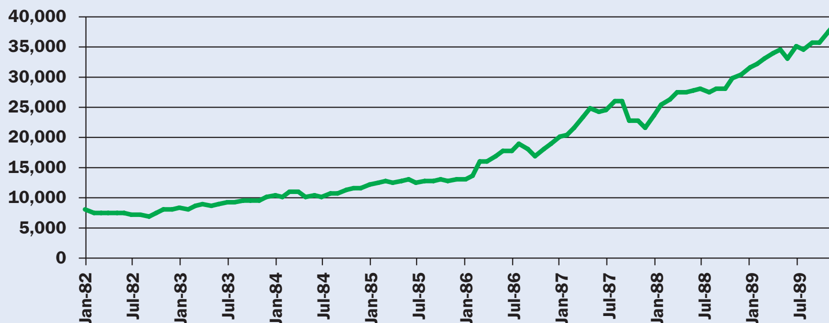

Nikkei Bubble: 1982 – 1989

Chart 9a

cycle from 1942 into 1968. That bull market was not as bubble-like since we didn't have the impact of radical new technologies suddenly emerging as only occurs about every 80 years or every other generation. Likewise, the crashes to follow in 1970 and 1973-1974 were strong but not as dramatic.

Another example of a major bubble occurred in Japan in late 1989 as you can see in Chart 9a. Japan had been emerging as a leading nation since the 1960s based on a new generation's spending wave that peaked almost two decades ahead of the U.S. baby boom. Japan's government had rigged its economy to favor key manufacturing industries and to leverage rising real estate prices through low cost corporate debt, creating both a stock bubble and a more extreme real estate bubble than has occurred anywhere in modern times. Despite those extremes, the advance in the Nikkei from 1982 to 1989 was almost exactly the same as in the Dow from 1924 to 1929, nearly 6 times. So this bubble was very similar to the 1929 bubble in the U.S. But this bubble also marked the peaking of a generation's spending cycle and the beginning of a long term bear market that has likely yet to have bottomed. Japan's spending wave points down until 2004 and doesn't turn up strongly until 2008 or 2009 into 2020.

The first and major crash to follow lasted 2 years and 4 months into April of 1992 and saw a 62% decline. But after a minor "B" wave rally into early 1996, the market has since declined 76% from its highs and could see a bit more in the next few years. Japan's extended bear market was bolstered by the fact that the rest of the world was booming in the 1990s and their strong export industries benefited. Since the echo baby boom to follow is much smaller than the previous generation, and because the world economy will be heading down after 2009 or so, the next bull-market is likely to be a larger "B" wave and not make new highs for many decades to come as we mentioned earlier.

That brings us to the latest bubble: the Internet and technology bubble of the late 1990s, which we show again in Chart 10. It is important to remember, as mentioned previously, that the recent stock bubble and crash from 2000 – 2002 was centered largely in the technology sectors. The most extreme bubble obviously came in the Internet sectors. The Internet hit 10% penetration of U.S. households in early 1996 and this sector started to emerge as a major new growth phenomenon. The real bubble only came from late 1998 into early 2000. In 1 1/2 years this index went up almost 7 times. Now that is extreme, more like the South Sea bubble from 1719 into 1720 (Chart 5).

The Internet index has crashed 92% from the highs and has wiped out more than all of the gains since 1996. Many of the smaller dot-com stocks have vanished or are down more like 99%. Again, this shows that bubbles are a matter of degree. Here we had more dramatic gains based on very questionable business models and rare profits to be found – more like

Internet Bubble: 1998 - 2000

Chart 10

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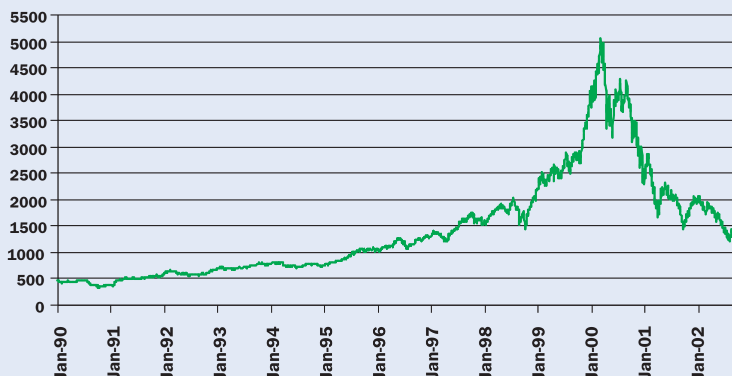
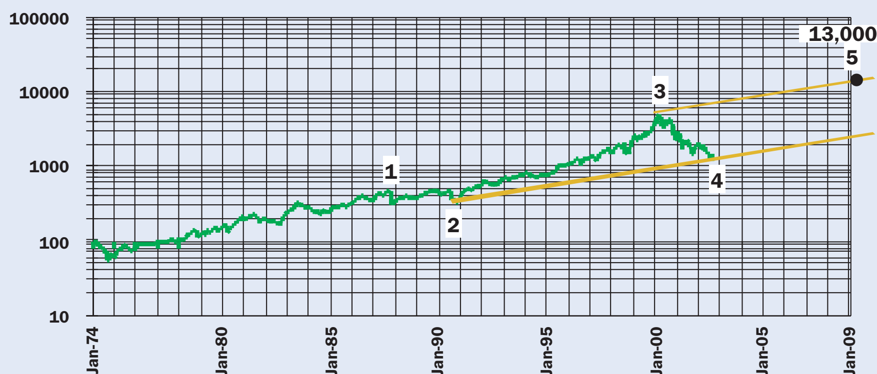
The Nasdaq Bubble Chart 11



Nasdaq: 1974 – 2008 Chart 12



the tulip bubble. It is unlikely that this index will make new highs even though Internet adoption is only at 50% as of 2001 and should advance to around 90% by 2007. The driving technologies in this broader revolution are semiconductor chips and software. The Internet allows computers, communications devices and content to be greatly leveraged, but is not a highly profitable product or infrastructure in itself. And again, when we see a crash wipe out more than all of the gains from the previous bull market then it is likely to have peaked for a long time, like the Dow and auto index from 1929 to 1932.

Now, let's look at the Nasdaq bubble in the late 1990s in Chart 11. The bubble really started in 1995 and accelerated from late 1998 to early 2000. From the beginning of 1995 the Nasdaq went up 6.7 times and advanced 3.7 times from late 1998 into early 2000. That is stronger than the Dow's advance in the Roaring 20s or the Nikkei in the 1980s, but still not an extreme bubble – nothing like the Internet. The crash to follow has seen the Nasdaq decline 76%. But that has only taken us back to levels seen in 1997 and has not erased all of the gains of the last bull wave that began in late 1990. That allows for the potential of another wave up in this bull market. We get a better perspective if we look at the Nasdaq (Chart 12) over its entire bull market on a logarithmic chart. Any technical analyst worth his or her salt uses logarithmic graphs to put long-term trends into perspective. Many analysts use arithmetic charts when trying to show the extremes of bubbles to scare people into their extreme bear market scenarios.

Projections for the Last Great Bull Market

The strongest emerging innovation in technical analysis is The Elliot Wave. This method says that most bull markets emerge in three major waves up before peaking: a 1st wave advance followed by a 2nd wave correction; then a 3rd wave advance, which tends to be the longest and largest wave, followed by a 4th wave correction; then finally a 5th wave advance before peaking longer-term. The Nasdaq in this chart clearly seems to have seen its 1st wave up into 1987 and then its 3rd wave up into early 2000. If we looked at this chart on technical factors alone, we would assume it has a substantial 5th wave to come. The 4th wave correction has not taken out the 1st wave high. If it had that would suggest a peak is already at hand. A 4th wave correction following an extreme 3rd wave advance would also be expected to see the strongest correction.

One of the best ways to project the 5th wave target is to draw a bottom trend line through the 2nd and 4th wave lows and then a parallel line through the 3rd wave peak extending forward. By late 2008, when we roughly project this bull market will end (give or take a year) due to saturation of new technologies and peak

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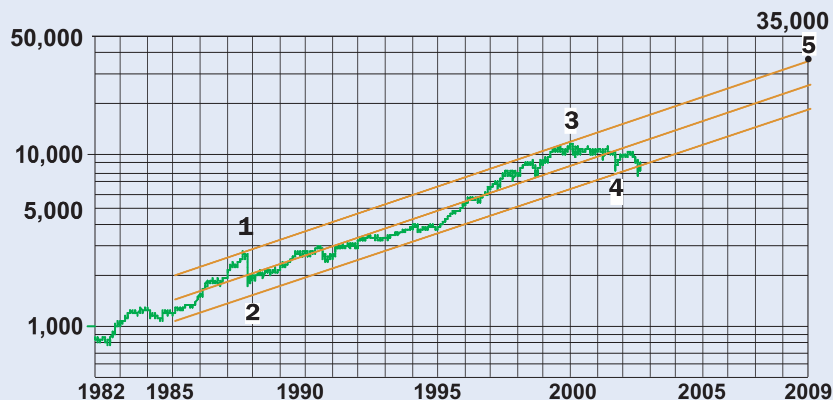


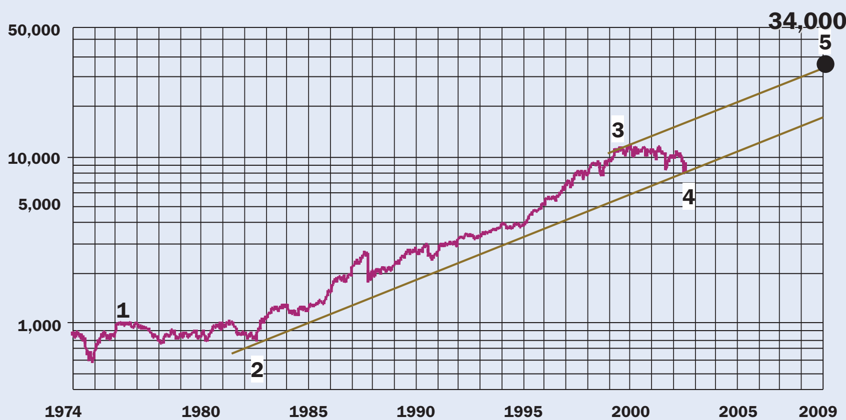
baby boom spending, this channel would be projecting a Nasdaq of approximately 13,000. That would represent an 11 times gain from its recent lows, similar to the 12 times gain of the auto index in the Roaring 20s. Now the Nasdaq may not get that high or could go even higher. But a Nasdaq of 13,000 by late 2008 would imply average annual compound gains of 39%. Even if the gains were half that most investors would be happy campers after this humbling correction.

If we go back to the Dow we can make similar projections and with a higher degree of confidence given the more orderly advances and corrections in the Dow during this bull market. Since 1997 we developed The Dow Channel (Chart 13) as our primary valuation tool for the broader markets and to make rough projections for a potential peak target around late 2008. This channel plotted much better than most with the ability to draw parallel lines through a series of lows. It also accurately predicted the rough time frame for a market peak in early 2000 as we hit the top trend line for the first time since 1987. That channel was projecting a Dow of about 35,000 by late 2008. But that channel was finally broken marginally in July of 2002. This channel first gave an extreme buy signal at around 8000 in late September of 2001 (which still would have been a great place to buy).

Channels can be broken slightly on the up or downside and still remain valid. In fact, just the trend line through the tops can often be a good indicator of the ultimate topping targets. The best and most reliable channels, like the Dow Channel in Chart 13, are drawn through both the 1st and 3rd wave tops as well as the 2nd and 4th wave lows. But just in case this channel doesn't hold as accurately after the brief break of the lower trend-line in July 2002, we have drawn two alternate channels. The good news is that they both point nearly as high.

Chart 14 plots the channel in the more typical way as we did for the Nasdaq in Chart 12, with a top trend-line from the 3rd wave forward parallel to a bottom trend-line through the 2nd and 4th waves. This chart projects a Dow of about 34,000 by late 2008, very similar to the original Dow Channel.

We take a much different view in Chart 15 where we begin the bull market from late 1974, an alternative but equally valid Elliott Wave count. We first draw the top of the trend line through the 1st and 3rd wave highs. And then draw the bottom trend line through the 2nd wave low in late 1982 and a potential 4th wave low. This approach projects a Dow of about 30,000 by late 2008. Even at this lower projection the average annual compound returns from late 2002 would be 22%. At the higher target of 35,000 those gains would be



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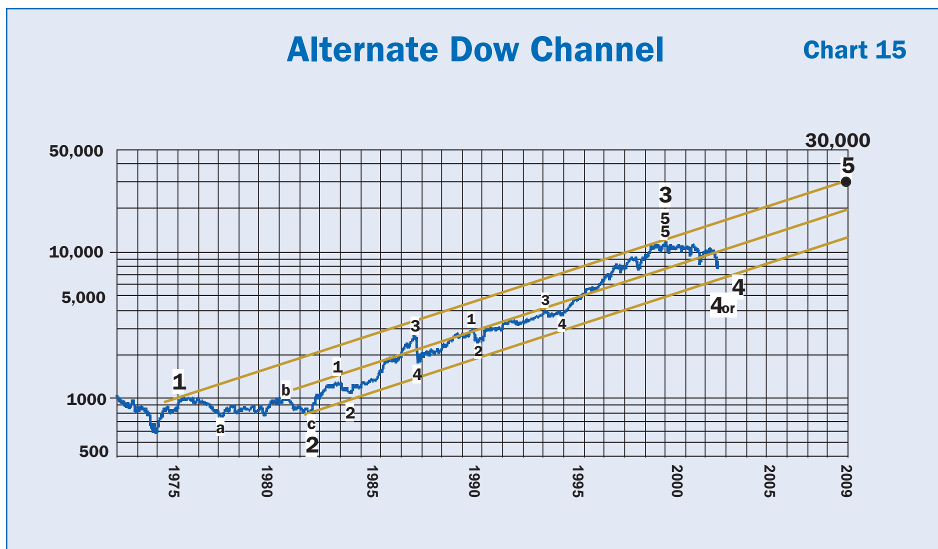


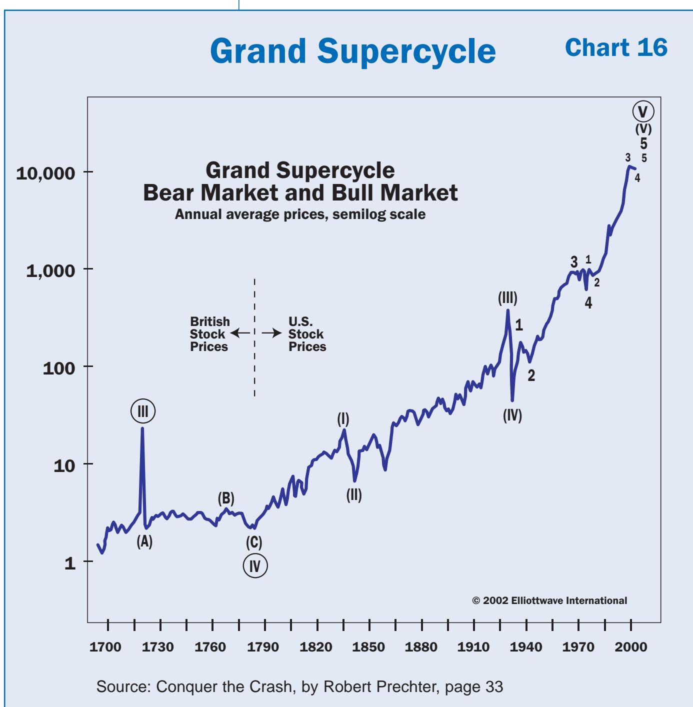
25%. Again, we are not saying these are the only scenarios, just the most likely and the most consistent with the previous trends in the bull market thus far. But like the Nasdaq, the best Elliott Wave counts strongly suggest that there is a substantial 5th wave ahead, which should reward investors handsomely after this extreme correction.

Here's the biggest reason we favor a very strong advance in the Nasdaq and Dow rather than just modest new highs in this last wave of this unprecedented bull market that began in the early 1980s resulting in the two best (and very likely three) back to back decades in U.S. history. If we look at Chart 16 (a repeat of Chart 6 earlier), the Elliott Wave analysis back to the 1700s, it seems clear that we are in the late stages of a larger long-term bull market that began following the 60-year correction after the collapse of the 1720 South Seas bubble. The first wave peaked in 1832 and the 3rd wave peaked in 1929. We appear to be about to enter the 5th and final wave of the larger 5th wave that started in 1932.

Notice that since 1780 when this greater bull market began, that the trends have been accelerating in each wave into a larger, longer-term bubble even on a logarithmic graph. Would anyone expect that the final wave of such an accelerating and extreme long-term bubble would not be dramatic? The final advance into the top of the first wave in 1832 was dramatic. The final advance of the 3rd wave into 1929 was even more dramatic. Since this larger 5th wave since 1932 has already been more exponential than the previous wave, we find it hard to believe we are not about to enter at least as great a bubble as occurred in the Roaring 20s – possibly even greater.

What are the more extreme upside targets? The Dow could break above its original channel (Chart 12) similar to the break below in 2002 and possibly reach 40,000 by late 2008. It is very likely that the bull market could last into 2009, which could send the Dow to 40,000 or higher. But the real bubble is again likely to occur to extremes in the Nasdaq. In Chart 16 we draw a trend-line through the tops of the Nasdaq since the bull market there clearly began in 1974. That trend-line points to about 20,000 by late 2008 and even higher if the bull market extends into 2009. That would truly be astounding and would represent a 16.8 times gains from the lows in late July of 2002 and compound average annual gains of 47%.

How could this possibly occur after everyone just witnessed such a bubble and crash? The truth is that it doesn't take most people long to forget even hard lessons when strong gains stimulate the greed emotions again. If the tech sectors return to very high growth and out-performance after



Source: Conquer the Crash, by Robert Prechter, page 33

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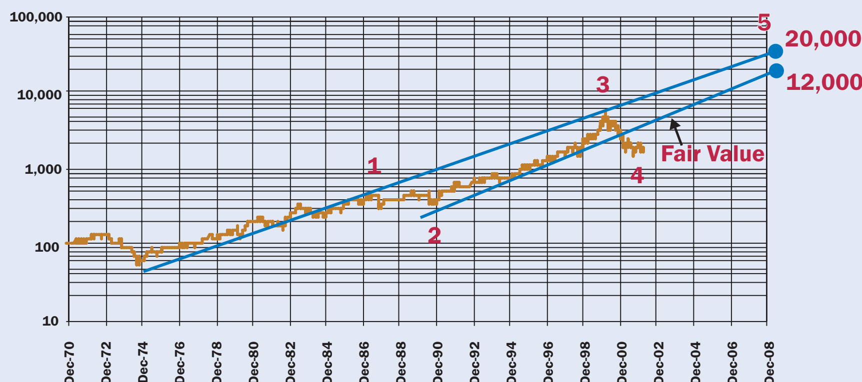
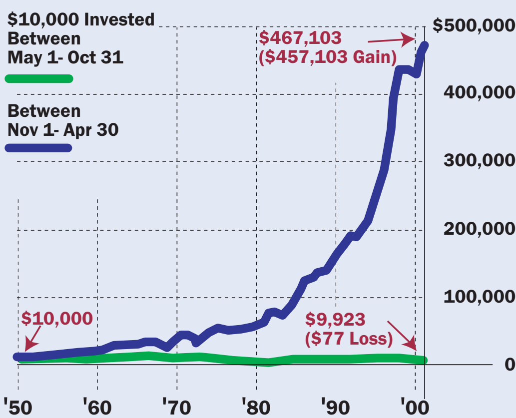


such a crash, as our fundamental indicators strongly suggest, investors could become even more convinced that we are in a new economy and that the economy will boom indefinitely and that technology will keep cranking out strong productivity advances. That bubble is likely to concentrate to the greatest extremes in broadband technologies and biotech, which appear to be the next great frontiers in the information revolution. Is that the most likely scenario? No, but we wouldn't consider it improbable either.

In our next book, ***The Last Great Bull Market***, we will go into more depth to show how levels of bubbles and strong corrections occur more often than you would expect during ongoing bull markets. Airline stocks crashed 62% from 1945 to 1948 and 63% from 1990 to 1994 and have continued to rally to major new highs until a possible peak in 2000 with no extended bear markets. The dramatic movie industry has also seen crashes of 77% without entering an extended bear market and rallied strongly ever since, even through the second half of the bear market in the 1970s. The homebuilding stocks continue to boom but saw a 58% correction in the early 1980s and a 62% correction in the early 1990s. The Hong Kong market has been in a strong bull market since 1974 and has seen two major corrections in excess of 60%. And, of course, there was the auto bubble and 70% crash in the early 20s that was followed by the Roaring 20s boom.

The point is that strong advances are typically followed by strong corrections even in an ongoing bull market.



Source: Barron's, Sept. 16, 2002, page 19; The Hirsch Organization

You don't get high returns without high risks! But we are going to end this special edition of the newsletter by looking at some very powerful cycles in the stock market that would also suggest reasonable to strong gains in the years ahead without any input from our demographic and technology models.

Strong Recurring Cycles in the Stock Market That All Say the Time to Buy Is Now

There is a simple analysis of an annual cycle in stocks by Yale Hirsch (***Stock Traders Almanac***) that goes back to 1950 and shows that all of the net gains in the stock market each year tend to be made in the six months between November and April. Similarly, an investor would have no gains over time from buying each year only between May and October when more of the corrections occur. Why is this the good annual season for stocks? There is tax selling into September or November for reducing tax exposure (selling losers to offset the gains of your winners) and then there is buying back again after that as well as year-end bonuses, dividends and tax refunds through April that add to investor buying power.

This doesn't happen in each year, but there is a clear bias. There have been a number of years where stocks were up from May to October, like 1999. There were 21 losing periods since 1950 from May to October, but only 12 for November to April. Chart 18 shows that an investor starting with $10,000 in 1950 would have seen it grow to $467,100 by April of 2002 if it was invested only between November and April, but

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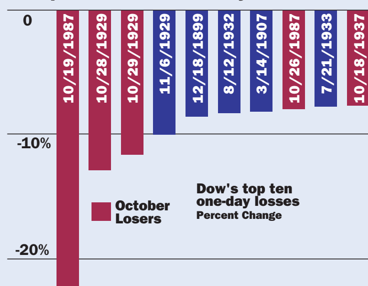
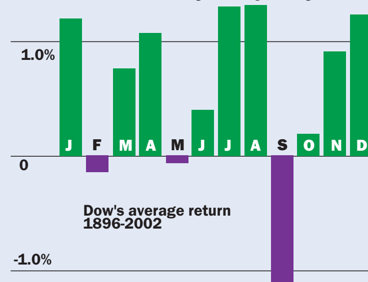
Good and Bad Months Annually Since 1896

Despite some dark days...



October isn't really so spooky



Source: Fortune, Sept. 30, 2002, page 186

Chart 19

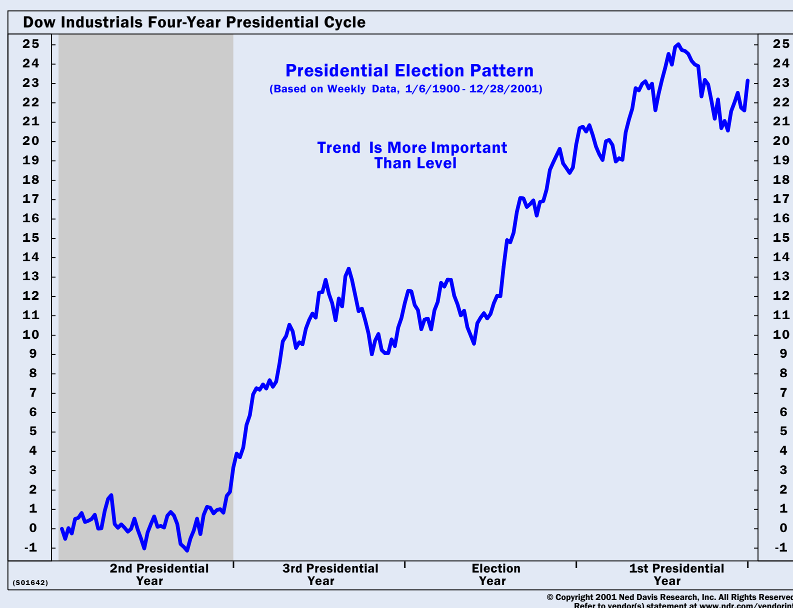
would have had a slight loss to $9,923 if it were invested only from May through October each year. This annual seasonal cycle would suggest that investors should be moving strongly back into stocks by the end of October.

Most people think that October is typically the worst month of the year for stocks due to high profile crashes like 1987 and 1929. The market bottoms of 1990 and 1998 also occurred in October. But the truth is that September is the worst month if we go back and average the returns in each month since 1896 in Chart 19. September is when the tax selling season really hits. Many down years in October have simply been follow-through declines to the downturns that started in September. This could occur again this time, but our technical indicators strongly suggest that we should see a final bottom to this correction between late September and early October. So, we think now is the time to start buying aggressively. More cautious investors may want to wait until October has passed. The other correction months tend to be February (following strong January gains from buying back after tax selling) and May (the beginning of the bad season). Chart 19 shows that on average there is a strong string of good months between November and April, with February being the only exception. We also tend to get summer rallies in July and August.

There is a four-year Presidential cycle that we have also covered in our books and past newsletters that is surprisingly consistent over time. Chart 20 shows research from Ned Davis that has averaged out performance of the Dow in each year of the Presidential cycle. The market tends to be down from late in the 1st year of office into late in the 2nd year or mid-term elections. We are right at the point where this cycle tends to bottom in late 2002. Then there is a strong rally from late in the 2nd year until late in the 3rd year. The Dow is up on average just over 50% in such a rally. This cycle would be suggesting a very strong rally from around now into late 2003, especially given the extreme level of this crash. A 50% gain on the Dow would take it back to around 11,300 next year. Then there is a mild consolidation on average from late in the 3rd year into around the middle of the 4th year. Then we typically see another very strong wave up into the election and the 1st year of the next term. This cycle would suggest that it is highly likely that we will see a strong

Four-Year Presidential Cycle

Chart 20



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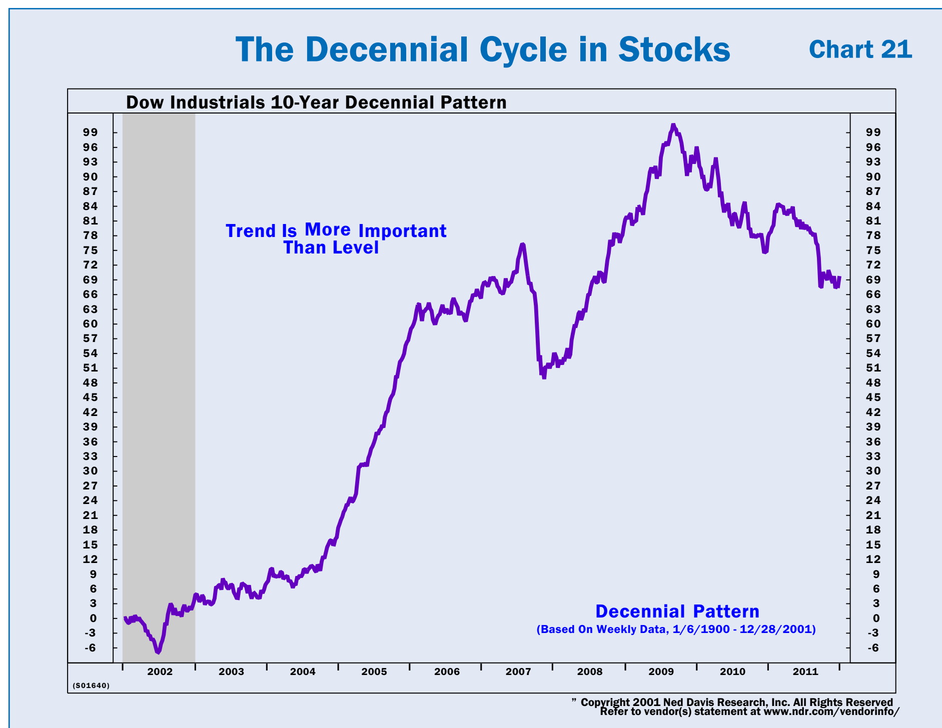
advance from mid-2004 into late 2005 to follow the initial 2003 rebound. Again, this cycle says to buy right about now – between late September and late October.

There is a 10-year or decade cycle in stocks that is even more powerful for creating effective investment strategies. Ned Davis has again in Chart 21 gone back to 1900 and averaged out the stock market's gains in each year of every decade. Note that in this chart Davis is starting in 2002, the "2" year and projecting forward for the next 10 years for present application rather than starting in the "0" year as he normally does. The results are very insightful. The truth is that almost all of the gains in the stock market come in the second half of every decade from the 5 through the 9 years (like 1995 to 1999). As we have observed in our 10-year "Decade Hangover Cycle", the advances and economic booms in most decades tend to be followed by consolidations of such gains in the early years of each new decade. And that is what this cycle clearly shows over time. The markets tend to be down from the 0 year into the 2 year, then rebound modestly in the 3 and 4 years, typically just offsetting the downturns in the 0 – 2 years. Then all of the net gains are made between the 5 and 9 years when the markets tend to accelerate strongly.

Now just as in the annual and four-year cycles discussed above, every decade obviously doesn't work out exactly in this manner. And there are a whole range of cycles we have covered including the 4, 8, 10, 14, 20 and 40-year cycles that have their differing impacts in each decade. But the long-term correlation with this



cycle in most decades is uncanny. The broader deviations come more from the strength of the fundamental trends in each decade. The 1990s was a very strong decade for fundamental trends, both from the baby boom spending trends and the S-Curve acceleration in information technologies. Hence, it had less downward bias in the 0 to 2 years. But even in that decade the markets were down in the 0 year and the gains in the market were more modest through the 4 year in 1994. Then the markets exploded from 1995 through early 2000 with a greater strength than average. Clearly, most of the gains in the 1990s market occurred between 1995 and 1999, the 5 to 9 years. The worst decade for fundamentals in the last century was the 1930s. In that decade the market was down much stronger than average in the 0 to 2 years, from 1930 to 1932. Then it advanced strongly again into early 1937 for 5 years and still held most of the gains until the next crash in 1940 – 1942, the bad 0 to 2 years of the next decade.

If you knew nothing else, the best times to buy stocks would be mid- to late in the 2 year of every decade and you would expect the greatest acceleration of gains between the 5 and 9 years. Then you would sell late in the 9 year and buy back again mid- to late in the 2 year again. Doing this would not only produce much greater returns long term. But you would have also avoided most of the worst stock corrections including 1930 – 1932, 1940 – 1942, 1960 – 1962 and 1980 – 1982, but you wouldn't have avoided 1987 and 1973-1974. The 1970s is the only decade out of the last ten where you would have suffered very minor losses by buying late in the 2 year and holding for the rest of the decade. Even in the 1970s bear market, respectable gains were made from 1975 through 1979 – the 5 to 9 years. In that case due to the strong downward bias (and the 8 and 14-year cycles), the market was down strongly in the 0, 3 and 4 years.

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To get a better feel for this cycle look back at the 1980s. The decade started with two corrections and recessions in 1980 and 1982, recovered strongly into 1983 and then took off from 1985 through 1989 with a brief shock in 1987 – and remember the 7 years often have sharp corrections towards the end in this decennial cycle. The 1960s saw two corrections in 1960 and 1962 (stronger on the 4-year cycle in 1962) and then steady gains through 1968. The 1950s saw steadier gains throughout the decade with minor corrections in 1950, 1954 and 1958 (all on the 4-year cycle), as the trends were almost all positive in that decade. The 1940s saw strong corrections in 1940 – 1942 and then gains into 1946 and then was mildly down for most of the rest of the decade. And of course, the Roaring 20s started out with two very strong down years in 1920 and 1921 and ended up with very strong gains for the rest of the decade that accelerated between 1925 and 1929.

Over the last century every 5 year has been up. That has typically been the strongest year on average. The next best year has been the 8 year with 8 out of 10 up. The 7 and 9 years tend to see sharp rallies and then a fall off late in the year for mildly positive net gains. The 3, 4, and 6 years also tend to be moderately positive. The 0 year is clearly the worst followed by the 1 year, with the 2 year down early with a rally late in the year for a slight net loss on average.

If we take this cycle and superimpose it onto the coming 10 years from 2002 through 2011 as Davis has done in Chart 21, we get a picture similar to what we are forecasting based on our fundamental outlook in demographics and technology cycles. The biggest differences in reality should be threefold. First this decade should be stronger than average like the 1990s or 1920s due to very strong fundamental trends, especially following the under-valuation from this extreme crash. Second, we should have a stronger than average rebound in 2003, more like 50%, coming out of this 4-year cycle correction. Third, we have a stronger and even more consistent 8-year cycle due to hit in mid- to late 2006 which should make that year weaker than normal especially between May and October with a stronger rebound into 2007 which isn't likely to see a strong set-back.

To summarize, here's the best picture of how we see the coming decade playing out. A strong rebound from late 2002 into 2003 lasting through most if not all of the year. Then a moderate pullback in early to mid-2004 to retrace some of those gains. Then a very strong rally from mid-to late 2004 through 2005 and likely into early to mid-2006. Then a 20% plus correction into late 2006 (stronger for the Nasdaq). By late 2004 or early 2005 the tech stocks should start to lead strongly again as they did from late 1924 to 1929 and from late 1994 through 1999. Then we should see a very strong tech-lead bubble through 2007 and 2008 that could extend into 2009. Then we expect the beginning of the next great, extended bear market starting by late 2009.

Why Such a Bubble Market?

Let's end by reviewing the reasons that this unprecedented boom has been characterized by bubbles and why we will see another ahead. 1987 was actually the first bubble in this boom and was followed by the sharpest short-term correction in U.S. history. There was actually a similar peak in 1907 followed by a sharp crash 80-years ago. That bubble was followed by the tech-lead bubble into early 2000 that paralled the bubble into late 1919, 80 years ago. The correction to follow has been the largest in any leading sector in this boom. But that correction has already lasted longer than most major corrections including 1973 –74 in the U.S. and the 1990 – 1992 correction in Japan. The first, and often the last crash, of every major bubble in history has never lasted past 2 years and 10 months as occurred from late 1929 into mid-1932. And there have never been more than three successive down years in the U.S. market.

Unlike the crashes in1929 – 1932, 1973 – 1974, and 1990 – 1992 (in Japan) the demographic spending and technology cycles still point up very strongly into 2008/2009. These crashes also saw major deterioration in the economy by this late in the cycle, whereas we only experienced a minor recession and the economy has been recovering here. Hence, we see another strong bubble ahead – the third advance (or 5th wave) to complete a classic Elliott Wave pattern in this boom. The truth about this unprecedented bull market is that each major wave up has turned into a bubble and each bubble has been stronger than the previous one. The first bubble accelerated from 1985 to 1987 and the second from 1995 into early 2000. And we are very clearly forecasting a third and final bubble into 2008 or 2009 that could well be even more extreme than the recent bubble. And the crash to follow that final bubble will be both more

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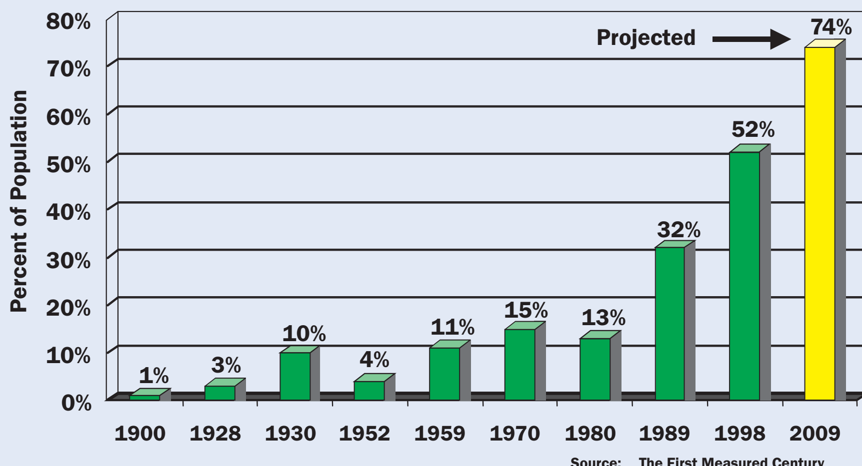

extreme and much longer in duration. We are forecasting that the next extended bear market will occur between 2010 and 2022 with the Dow being down 70% to 80% plus and the Nasdaq likely greater than 90%. The real reasons for the strong "bubble" nature of this boom are the following:

1) On the 80-year cycle we are in the Growth Boom stage wherein new technologies emerge rapidly into the mainstream in an S-Curve acceleration that creates dramatic growth and a race for leadership in new emerging technologies and industries. Such booms like 1902 – 1929 are always more dramatic and see accelerating bubbles as the cycle progresses. We saw a clear tech bubble from 1915 to 1919 and then a greater one from 1925 – 1929 after a severe crash into early 1922. We also saw stronger peaks and crashes in 1907 and 1914 (onset of World War II). All of these peaks and crashes to follow were closely parallel on an 80-year lag to the ones that occurred in 1987, 1993 - 1994, and 2000 – 2002. So this boom is very similar to the Growth Boom from 1902 – 1929. The Maturity Booms like 1942 – 1968 are more orderly and less dramatic in peaks and crashes.

2) The size of the baby boom generation here and around the world has further exaggerated both the innovation trends that lead to the first real information revolution since the printing press and the strength of this boom. This has further exaggerated everything from price-to-earning ratios (P/Es) on stocks to debt levels to the bubbles in this bubble-prone Growth Boom.

3) For the first time in history investing in stocks has become a mainstream trend with the advent of discount brokerage and 401K plans. Chart 22 shows an S-Curve in acceleration of equity investing by U.S. households that has mushroomed since 1980. This means many new, inexperienced investors entering the markets, which would clearly add to the formation of bubbles and public manias in the stock market. And many more new households will enter the equity markets in the coming decade to add to the next and perhaps greatest bubble in U.S. and modern history. Note that the worst bubbles in history occurred back in the 1600s and 1700s when investing was a new phenomenon and most investors were, hence, inexperienced.

4) As we showed in Chart 16, we appear to be heading into the final wave of a much larger bull market that started around 1780. Each wave of the stock market expansion has gotten more exponential and it is hard to believe that this final wave won't be the greatest. Bubbles are almost impossible to prevent. They start with inexperienced investors who aren't knowledgeable about appropriate ways to value stocks, like the E-traders in the late 1990s. But the strong returns in these accelerating sectors force institutional and mutual fund managers, as well as all investors to participate or fall far behind in performance. The bubbles finally end when everyone is in and there is no one else to keep buying.

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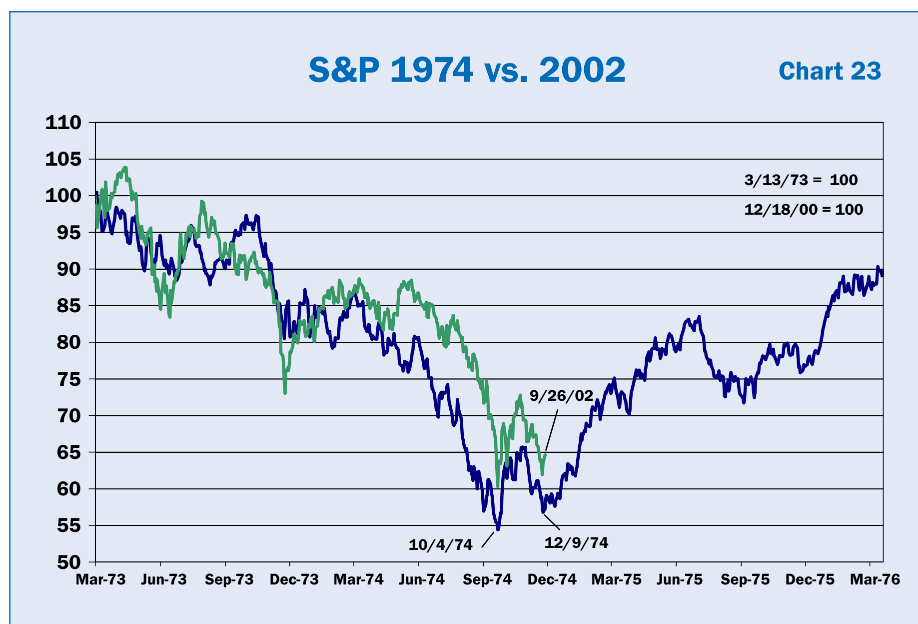
Parallels to the 1974 Crash, Bottom and Rebound

In the next section, we will review some of the key technical indicators that suggest a bottom is at hand with a change of direction in investment activity over the last month. If we look back at the last major correction with a similar magnitude and time frame that would bring us back to the 1973/1974 crash. Chart 23 shows how parallel the correction has been in the S&P 500, the best gauge of the broader large cap markets. The important focus here is that we saw a similar panic sell-off low in late 1974 followed by a modest rebound and a re-test of those lows a little over two months later. This is almost exactly what has occurred in the last two months. We saw a panic sell-off on high volume with extreme readings across the board in the best technical indicators, followed by a re-test in late September. The re-tests in both late 1974 and now occurred on much lower volume than the panic sell-offs that preceded. In this scenario, the Nasdaq made a slight new low, while the S&P 500 didn't. In 1974, the Dow, which represented the higher valuation "Nifty Fifty" stocks, made a slight new low -- while the S&P 500 didn't. This scenario would strongly suggest that the time to buy is here, between late September and early October on this low volume re-test pattern.

It's also important to note that the volume in the first few weeks of the rebound was not much higher at first back in 1974. After so many bottoms, rebounds and failures, investors are naturally skittish. But as you can see in Chart 23, there was indeed a very strong rebound of almost 50% over the next 6 months and a 64% rebound in a little over a year. Hence, we think many analysts may doubt the rally ahead citing that volume is not confirming the rally. We think the market would just be giving its final "fake-out" before finally taking off strongly. That is why we advise investing strongly again here in late September/early October.



Summary

Despite the very difficult and enduring crash of 2000 – 2002 we are more bullish than at any time in the last two decades of our forecasting work. All of our fundamental and cycle work suggests that investors are likely to see the highest average annual compound returns in history from late 2002 into 2008 or 2009, both in broader indices like the Dow and in the strongest sectors like technology, biotech, financial services, health care and Asia ex-Japan. We not only see a strong recovery into 2003, but an increasing rotation out of value stocks back into growth, out of small caps back into large caps, and out of bonds back into stocks. The most attractive arena for both returns and risks increasingly over the next 6 to 7 years should be large cap growth stocks – the very sector that almost no one wants to buy at this time. And, of course, that is what the time-tested principle of contrary thinking would strongly suggest now. We expect the large cap growth stocks, and especially the technology sector to lead strongly again from late 2004 into 2008 or 2009.

As we said in late 1992 in ***The Great Boom Ahead,*** "Get Ready" for the next great bull market and economic expansion. But in this case we will see the last great bull market for decades to come. This is your last chance to make extraordinary gains in your wealth. Those gains will allow you to sail through the next great winter and with our strategies you can continue to grow your wealth more modestly rather than lose most of it. But you have to have the guts and insights to buy here when no one else wants to.

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