

The STA's annual dinner was held on Wednesday 16th September at the National Liberal Club. The event was extremely well attended and we were delighted that so many of our colleagues from AFATE were able to join us. When the committee were planning the dinner at the beginning of the year, equity markets were making lower lows and sentiment indicators were all plunging so it was decided that people would probably like to have an after-dinner speaker who would cheer them up. As a result, we invited Stephen Grant, an award winning comedian and radio presenter. This was just the bear trap that Mr Market was waiting for; no sooner had we issued the invitation than equities started to rally. However the improved market background notwithstanding, Stephen soon had his audience in gales of laughter and proved to be a very popular choice of speaker.

As delegates gathered in Chicago for the 22nd Annual IFTA Conference in October the Olympic 2016 flags were still fluttering disconsolately and there was a general air of disappointment that the Windy City had not been successful in its bid to host the Olympic games. But our hosts, AAPT, had lined up such an excellent programme of speakers and activities that spirits quickly lifted.

In a talk titled 'The Neuroscience of Technical Analysis', Professor Andrew Lo looked at the markets from the perspective of behavioural finance. Based on research he carried out 20 years ago, Professor Lo was one of the first academics to accept that the random walk hypothesis is not consistent with financial data. The reason for this he explained is that the major flaw with economists' view of markets is that it is predicated on the assumption that individuals behave rationally. But individuals are not rational and they do not therefore follow the rational behaviour embedded in economic theory. Individuals make mistakes but they learn from these mistakes and adapt their behaviour. These characteristics are reflected in the market. It is therefore more appropriate to borrow from the laws of biology rather than physics to frame a new model for interpreting market behaviour.

Amongst delegates and speakers alike, opinion was sharply polarised between those who believed the market was in the grips of a sustainable uptrend and those who felt we were tracing out the first half of a W-shape. Representing the STA, Tony Plummer and Robin Griffiths both put forward the bearish case in excellent presentations.

We received a good response to our request for suggestions for speakers at the monthly meetings. A number of people suggested inviting Bob Prechter and we are delighted to say that he has agreed to come and speak to the STA in February. In order to fit in with Bob's travel schedule we will be moving the meeting to Monday, 8th February. Please note that this meeting will only be open to members of the STA.

2010 MONTHLY MEETING DATES

Monday 8th February

Tuesday 9th March

Tuesday 13th April

Tuesday 11th May

Tuesday 8th June

Tuesday 6th July

Tuesday 14th September

Tuesday 12th October

Tuesday 9th November

Tuesday 14th December

IN THIS ISSUE

- | | | |
|-----------|--|----------------------------------|
| 2 | STA diploma results | |
| 3 | Book reviews | C. Lambert and D. Owen |
| 4 | Market Outlook for 2010 | |
| | – Fixed Income | R. Adcock |
| | – Commodities | C. Hine |
| | – Equities | N. Merrell |
| | – Currencies | S. Devani |
| 8 | Time of day ranges and trend persistence | L. Raschke and N. Bahadur |
| 11 | Zen lessons in market analysis | J. P. Hussman |

SPEAKERS AT MONTHLY MEETINGS

8th February "Real-Time Application of the Elliott Wave Principle" – Robert R. Prechter Jr. CMT President, Elliott Wave Int. and Executive Director, Socionomics Institute

9th March "Profiting from technical analysis as a private trader" – Malcolm Pryor

N.B. Unless otherwise stated, the monthly meetings will take place at the British Bankers Association, Pinners Hall, 105–108 Old Broad Street, London EC2N 1EX at 6.00 p.m.

Networking

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Please keep the articles coming in – the success of the Journal depends on its authors, and we would like to thank all those who have supported us with their high standard of work. The aim is to make the Journal a valuable showcase for members' research – as well as to inform and entertain readers.

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STA diploma results

Bronwen Wood Memorial Award

The Bronwen Wood Memorial Award is given to the candidate with the best mark above 90 per cent in the diploma examination, and this year the winner is David Thomas. Congratulations to David.

Distinction

Mr Ian Quigley

Ms Pei Phing Wong

Mr Gurpreet Singh Ubhi

Pass

Mr Anastasiou Adamos

Mr Michalis Andreou

Mr Zubeir Bham

Mr Ashish Bhatia

Mr Daniel John Biggs

Mr Martin Cass

Mr Gilles Everling

Mr Sinan James Isilay

Mr Nimit Khamar

Mr Faisal Khoori

Mr Theodoros Kolokoudias

Mr Antonio Francisco Lourenco

Mr Joaquin Monfort

Mr Barry David Moore

Mr Catalin Nicolae Plapcianu

Mr Abhisar Upadhyay

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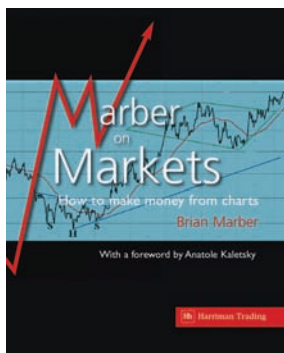
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Book reviews

Marber on Markets

by Brian Marber – *Harriman House*.

Hardback, 324 pages, price £34.99



One of the best after dinner speakers I have ever heard was at an STA dinner more than 10 years ago. The speech was given by a member of the Irish Dáil (the principal chamber of the Irish parliament) called Senator Donal Lydon. As well as being a member of parliament, Senator Lydon was also a psychologist who specialised in stress-related problems. In between telling

a series of extremely amusing shaggy-dog stories that had his audience laughing until tears rolled down their cheeks, he dropped in little pearls of wisdom about how to reduce stress levels. *Marber on Markets* is rather similar in that it is full of amusing anecdotes which are interspersed with telling insights about the practical application of technical analysts.

Marber on Markets does not set out to be a textbook on technical analysis – Marber was asked by the publishers to write up a plain man's guide of techniques that he has found useful in the 54 years that he has been involved in the markets. The book is amusingly written and in a style that even those with no prior knowledge of technical analysis will find easy to get to grips with the subject. But it is his half century of experience that is the core of this book.

Despite not setting out to be a standard text-book, there are clear explanations of most of the basic tenets of technical analysis together with explanations about why Marber finds various techniques and indicators useful (there is only passing reference to any methodology that he doesn't use). He is refreshingly honest about making mistakes or "Marber pratfalls" as he calls them on the grounds that "Although when you make money you can learn something about making it, you learn far more by losing it, then finding out how to stop doing so."

There isn't a single indicator or system that Marber hasn't tried and he spells out clearly what he finds works well for him. For example, when writing about the Rate-of-Change indicator he explains that he uses a 63-day period for the London market. Would a much shorter or much longer period than 63 days be better? "No." retorts Marber, "I've done the work and got the answer: 63 days works best."

We all know that the acid test of the markets is survival and Marber is probably the longest surviving technical analyst in the London market (we would be very interested to hear from anyone that has been involved in the markets for longer).

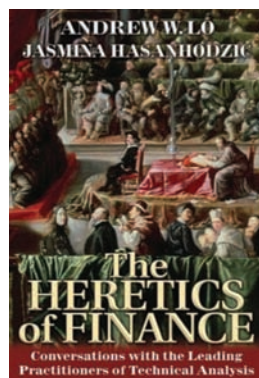
This book will be an invaluable vade mecum for anyone starting out in the financial markets and even seasoned players will enjoy its wit and wisdom.

Deborah Owen

The Heretics of Finance

by Andrew W Lo and Jasmina Hasanhodzic – *Bloomberg Press*

Hardback, 256 pages, price \$29.95



The title of this book immediately caught my eye. When I realised it was about technical analysts I was even more interested – and somewhat surprised. I have never seen myself as a heretic. I was never much of a rebel at school, and my first 10-15 years in the work place (mostly as a broker on LIFFE) weren't exactly non-conformist.

I have been a board member of the UK Society of Technical Analysts since 2003 and my fellow board members, whilst being a diverse group, couldn't by any stretch of the imagination be described as financial dissenters.

But I guess we are in a minority, in that we are still classed as "the others" (or even "the nutters") when it comes to analysing the markets and making judgement calls on the future direction of markets. Banks and institutions still have enormous research departments full of economists covering different sectors and asset classes. By contrast, few institutions have large departments of technical analysts (which may explain why so many of these companies are in such a mess).

So "heretics" may not be the best title as far as a proper description of the animal is concerned, but it certainly caught my attention. The book is essentially a series of interviews with the US's top technical analysts. A couple of Canadians are included but there is no representation from the rest of the world, which is disappointing. *The Heretics of Finance* is essentially a technical analysis version of "Market Wizards", the highly successful series of interviews with top traders written by Jack Schwager (which I recommend to anyone starting off trading the markets).

Both of the co-authors are from an academic background so might have been expected to be imbued with what they themselves describe as "the disdain and disrespect that most academics have for charting". But, as long ago as 1988, following a study of weekly US stock returns from 1956 to 1985, Andrew Lo co-authored a paper which rejected the random walk hypothesis (Lo, A., and C. Mackinlay. Stock market prices do not follow random walks: Evidence from a simple specification test. *Review of Financial Studies* 1:41-66).

The collapse of the LTCM Fund did a lot to promote the cause of technical analysis. Those Random Walkers, who had randomly walked into Wall Street from academia, came to very public grief whilst our merry band of heretics are still very much in business.

continues on page 10

Market outlook for 2010

Fixed Interest

By Richard Adcock

The end of 2008 was very bullish for bond markets but, having seen such aggressive downside acceleration in yields during December 2008, it was always going to be difficult to maintain such momentum without some sort of corrective activity to unwind extremes. This proved the case and, during the early part of 2009, a sharp rally in yields materialised posting highs for the year in June, followed by choppy range trades into the end of the year. However, taking the year as a whole, our view is that this activity has highlighted a process of sentiment change that will result in higher yields over the coming 12 months.

US 10 Years

The classic definition of a bearish trend in yields is a series of higher highs/higher lows, with each setback reflecting a 'weak test' of the previous downside extreme, before the upside is resumed, surpassing the previous peak. Now, take a look at the chart of US 10 Year yields, where 2009 has traced out such a sentiment shift.



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The rally in yields into the February 2009 high appeared simply a limited corrective move against the on-going downtrend, with the risk for resumption at any time to break under the 2.09 December 2008 extreme. However, 2.47 marked the extent of the move, as fresh selling pressure materialised, driving yields higher again some way above the December low, or in other words a 'weak test' of a previous low. Further confirmation came from a break of the February 2009 high; the first sign a bearish trend was beginning to form.

While a range trade developed between the 4.00 high and the support marked by the 3.11 February 2009 peak, even this appears to be little more than another 'weak test' from which higher yields in Nov/Dec 2009 left the September 2009 extreme at 3.10 as the 'last significant low' of the developing bearish trend.

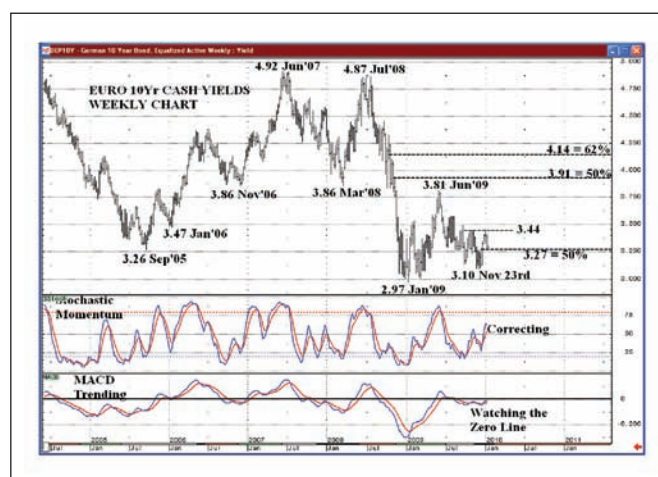
The latest 4.00 high is now critical, with any break developing the bearish trend and exposing the market to further liquidation. This week has seen a recovery materialise, but there is little that can be classed as bullish, with nothing more than limited retracements and no reversal patterns forming. As such, we look for a test of the previous 4.00 high, with breaks triggering a resumption of the bearish trend, exposing 10's to the long term downtrend in place and developing since the May 2009 yield highs at 4.69.



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Euro 10 Years

While it could be argued that the picture for Bund yields isn't as bearish as US 10 Yrs and Gilts (see below) 2009 has still traced out the classic set-up, reflecting a bearish sentiment change. Having rallied strongly into the June 2009 yield high, the move lower between June 2009 and November 2009 looks very much like another 'weak test' of the January extreme, from which upside pressure on yields has developed again. True, a rally has also developed here this week but, so far, this is failing at the mid-point



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of the December trade at 3.27, maintaining the risk for breaks above the 'last significant high' at 3.44.

Our conclusion for Bund yields is that, while they can outperform other markets during any sell-off, the market is still in a phase of sentiment change that will see higher levels over the coming months. A break above the 3.44 October 2009 high will confirm the longer term bearish potential, triggering upside to at least the resistance offered by the 50% retracement of the entire 2008/2009 bull move and June 2009 high at 3.81/91, the likely target point.

UK Gilts

With Gilt yields already testing the 'last significant high' of the downtrend in place since July 2007 at 4.10 (which is also the 50% retracement of the Jun'08/Mar'09 bull trade) longer term bearish risks appear greater here. A recovery has developed this week, but there is no evidence of any bullish reversal patterns forming and the 38% retracement of the Nov/Dec'09 up trade at 3.87 remains intact. With the momentum/trending relationship also bearish (the MACD above zero and momentum rising) the expectation is for a retest and break of 4.10, confirming the shift sentiment is complete and that yields are definitely trading within a bearish trend.



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A close above the 4.10 high and retracement will be the next bearish trigger for Gilts, instilling fresh liquidation for the coming months. Such action will target first the higher 62% level at 4.37 and then the 4.80 October 2008 extreme.

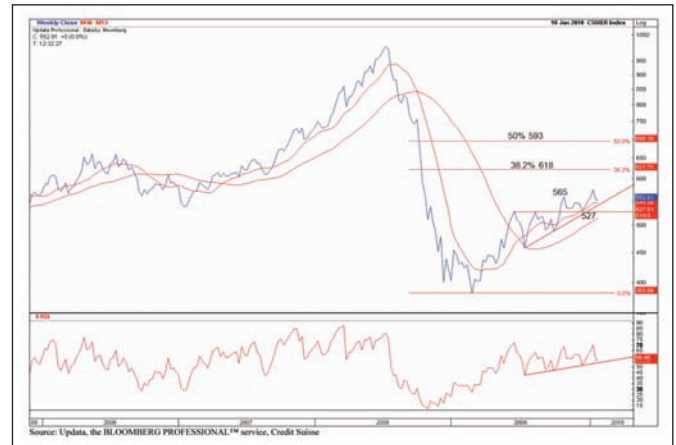
Conclusion

While in each case the 'last significant high' of the recent downtrend in yields still needs to give way on a closing basis, we believe the activity in 2009 marks important and bearish sentiment changes for global bonds. The recent rallies have done little to change this perspective and the risk is for new failures to test and break the important levels given above, triggering the next phase of liquidation. We are bearish of bonds for 2010, projecting significantly higher yield levels across the board.

Richard Adcock, Head of Global Technical Strategy, UBS

Commodities

By Christopher Hine



Source: Uputa, the BLOOMBERG PROFESSIONAL(tm) service, Credit Suisse

Last year saw a widespread recovery for commodities, following the demolition that occurred during the 2008 market turmoil. WTI crude oil has managed to recover back towards the \$80 region, copper has staged a sharp turnaround, recouping much of its losses and gold has surged to new record highs. This recovery can be graphically seen in the above chart of the Credit Suisse Commodities Benchmark index (CSCB), which measures a broad basket of commodities, and is equivalent to the CRB index or the Goldman Sachs Commodity Index. Stripping out the energy component from the broader index, which is the largest weighting, would lead to an even more bullish picture.

So where does that leave us looking forward into 2010? Using the Credit Suisse Commodities Benchmark index as a broad measure of commodity trends, it can be seen that the pattern of higher highs and lows that commenced from the 2009 base remains firmly in place. This positive backdrop, coupled with ongoing support from rising intermediate moving averages, leads us to look for further commodity strength into the first quarter of 2010, with the potential to spill over into the second quarter. Upside targets are now located at the 38.2% retracement of the 2008 collapse, which is roughly 12% above current levels.

Within the broad commodity rally, we look for industrial commodities to assume relative leadership. We therefore expect industrial metals to continue to outperform and for copper to push into the \$8200 region. We look for WTI crude oil to stage an eventual advance into the \$86 region, with scope to push up towards \$90. Precious metals should also benefit with gold going back to the December 2009 high at \$1227 and potentially onto the \$1300 region. Within the precious metals, we are more enthusiastic about platinum and palladium, which have assumed leadership in this sector, and look for them to press onto \$1800 and \$480 respectively.

The risk to this positive outlook would occur only if the index retreated back below the December 2009 low at 527, which is roughly 5% beneath current levels. A decisive move below here would damage the uptrend and potentially signal that a top was in place.

Christopher Hine is a technical analyst with Credit Suisse

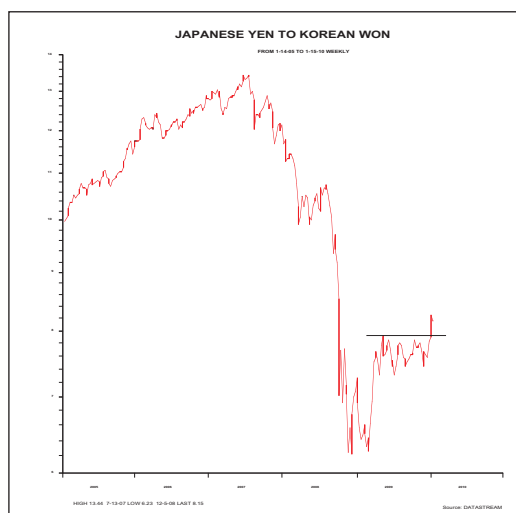
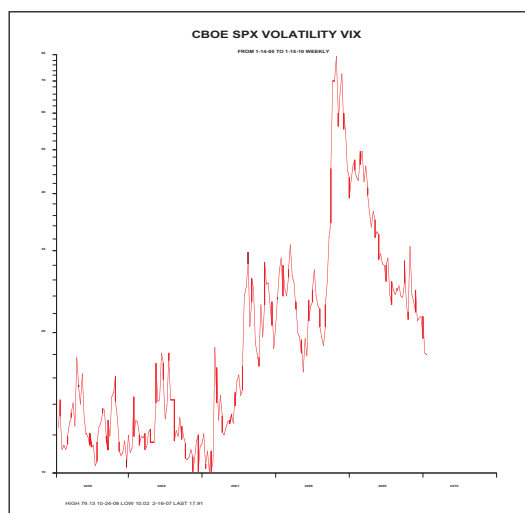
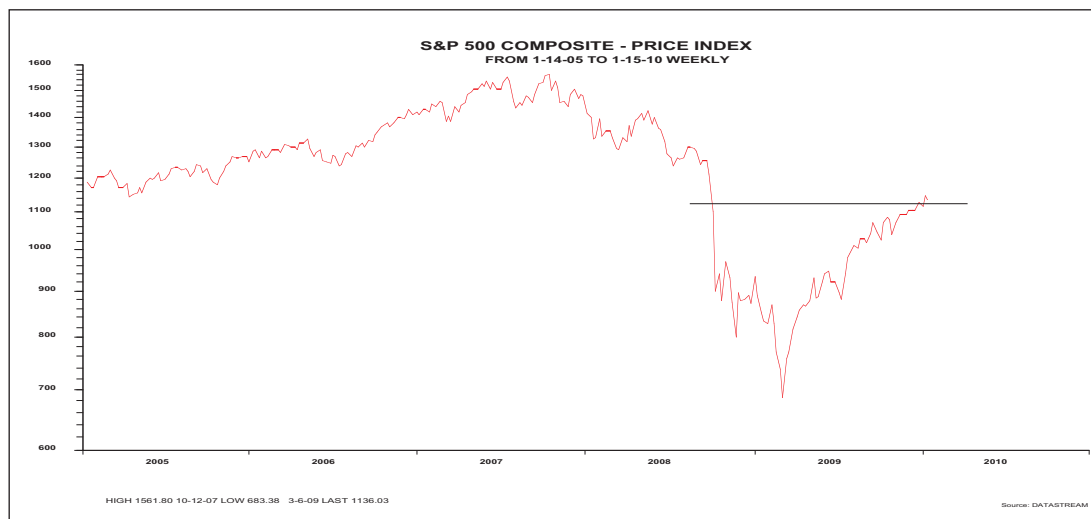
Equities

By Nicola Merrell

“New highs are bullish” and “Don’t fight the trend” are treated with a degree of flippancy by some. But, when looking at global equity markets, my advice would be to ignore this sort of approach at your peril.

The only remaining area where we really need to see a clear bullish indicator is the sector trends – a sign that investors are positioning their portfolios for a long term upward move. We have seen some indication of this with defensive

stock underperformance and industrials breaking higher. But there are not really enough stocks featuring yet to give a dependable signal. The other thing that really bothers us is that we continue to see insufficient volume to trust the move completely. We can argue until the end of time whether absolute volume levels will ever return to the heady levels of recent years. But we cannot argue that higher volume on down days (whether on an absolute daily rate of 1m or 100m) compared to up days paints a particularly bullish picture. We therefore need to see further sector confirmation but also a pick up in volume on up days would be very nice.



The S&P Composite has broken its 50% retracement level of the 2007/2009 downtrend. This is normally seen as a tipping point in favour of the continuation of the previous move, in this case the bullish trend. This, together with the fact that we are seeing a plethora of other equity markets breaking through resistance levels from their summer 2008 lows to make clear new breakouts, suggests the bulls are taking control again.

The really interesting thing since the start of 2010 has been the performance of indicators that we watch as barometers of risk. The VIX has made new lows, the breadth figures are starting to improve again, the number of US stocks exceeding their 200-day moving average has increased beyond the November highs and the Won-Yen cross rate has broken above 8. This latter rate has given us very good signals of equity market direction over the past couple of years.

Conclusion

- New highs are bullish
- 50% retracement of 2007/09 fall on the S&P Composite has been exceeded
- Dow Theory buy signal confirmed
- European markets which had been lagging behind are breaking higher now
- Breadth is improving
- Investor confidence picking up
- Nikkei interesting but not TOPIX
- Emerging Markets at key point, China disappoints
- Sector trends improving
- Leadership picked up in the last week, more volume would be nice
- Equities still better than bonds?

Nicola Merrell Partner, Technical Research, Redburn Partners,

Currencies

By Shyam Devani

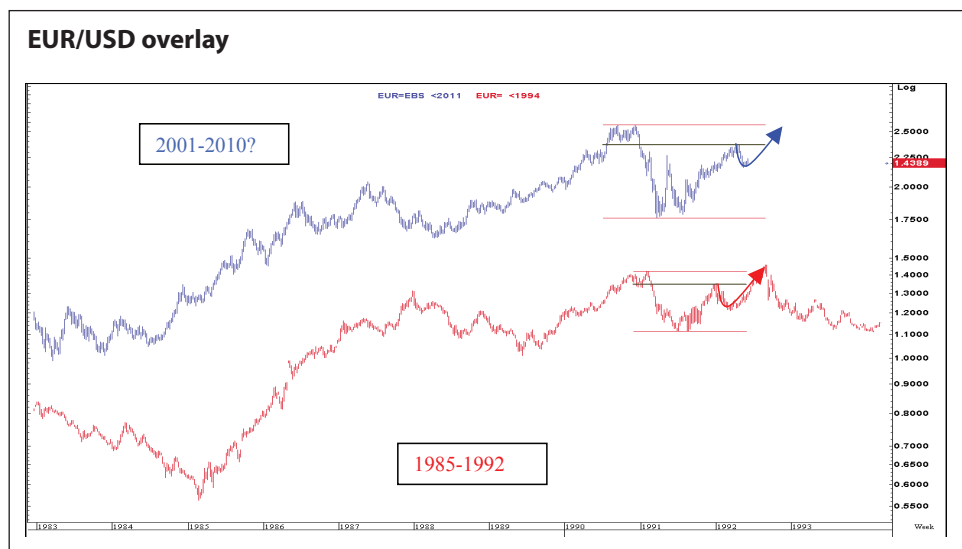


The chart above shows the long term uptrend in EUR/USD that really got under way in 2001 - 2002

The two highlighted periods of US dollar strength were both event-driven. Throughout 2005 it was the HIA that led to US dollar strength and in 2008 it was the credit crisis. Outside these two event-driven periods, the largest correction down on EUR/USD has been 11.7 big figures or 10%.

Does the current long term bear market in the USD look similar to the last significant USD bear market?

The overlay below shows EUR/USD throughout the 1985-1992 period and the current situation. Technically, it is a good overlay and, while there may be some differences, on the whole the price



action is fairly similar. What makes this more interesting is that the two time periods saw a relatively similar dynamic on the economic side, namely a housing led downturn in the US, a banking crisis (savings and loans and the credit crunch), a turn in the interest rate cycle and a turn in the unemployment cycle, albeit of different magnitudes.

The recent fall in EUR/USD since the high in November 2009 looks similar to the fall seen in Jan – Feb 1992 when EUR/USD turned from the 76.4% Fibonacci retracement against the February 1991 high. The November 2009 high was also the 76.4% retracement against the all- time high

in July 2008. From that correction down in EUR/USD in early 1992, the pair turned back up and made a new high for the trend.

Overall from a medium term perspective, we would not be surprised to see a new all time high above 1.60+ on EUR/USD.

In the short term, the correction down in EURUSD now looks to be over as it consolidates or bounces from just above the 200-day moving average. The first chart also shows the 55-week moving average as an important support pivot for EUR/USD ever since this uptrend really took hold. It currently stands at 1.3964.

If we are wrong in our short term bullish EUR/USD analysis/ outlook, a breach of the 200-day moving average would suggest a test of the 55-week moving average at 1.3964 is possible. A 10% correction down from the November 2009 high (1.5145) would take EUR/USD below 1.37. Even this would, on the long term chart, be considered a correction down in the uptrend. If we are wrong on our short term bullish EURUSD stance, it would not change the long term bullish picture and we would not be surprised at that stage to see EUR/USD turn back up from the medium – long term support areas in the high 1.30's

Shyam Devani, Citibank

Time of day ranges and trend persistence

This article is a summary of a talk given at the IFTA conference in Chicago in October 2009 By Linda Raschke and Nigel Bahadur

At the LBR group we have carried out research into price behaviour in order to give contextual analysis to our trading activities. The work was designed to see if there were any “sweet spots” in the data and also whether there was a way of identifying durable and robust trends from which we could initiate trading strategies with a greater than normal degree of confidence that they would be successful.

Terms of reference

We started with the premise that we would limit our modelling to just one or two variables with no more than one “filter” over a large sample size. If we found minimal variance in the test results from one year to the next, we could assume with a high confidence factor that the result would continue to repeat in the future.

By breaking down data into smaller “chunks”, yet still maintaining a high sample size, tendencies become apparent that are not discernible when all the data are lumped together. Aberrations in price behaviour can be modelled if the anomalies occur equally across a diverse group of markets over a wide spread of time periods.

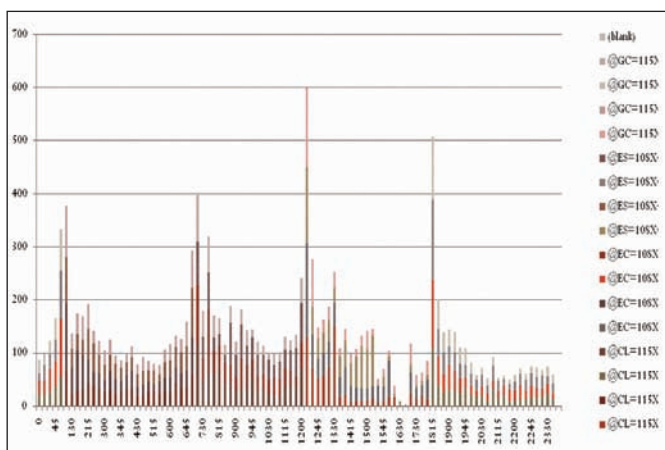
This article will examine two aspects of market behaviour which became apparent from our research.

1. Time of day analysis

Our first studies were confined to examining when the highs or lows for the day session on the S&P index were made. We broke the 7.30-3.15 CST trading day into 15-minute segments. We found that one third of the time, the highs and lows were made in the first two 15-minute periods or the last two 15 minute time periods.

When we expanded our analysis and looked at the statistics over a 24-hour period for the euro, crude oil, gold and the S&P index, the results did not appear as meaningful since they were diluted by the increased number of time periods.

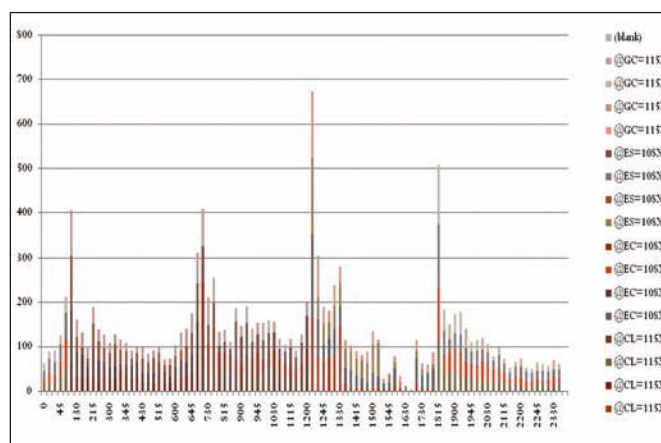
Chart 1: High Times



Since the data was meaningful with respect to the NYSE day session, we broke the data down into four sub-groups. These were:

6pm-1am CST 1am-7am CST 7am-12pm CST 12pm-6pm CST

Chart 2: Low Times



There was a distinct “crowd behaviour” or sense of urgency in trading at the opening and closing of the session in that highs or lows tended to be made around the same time frame.

Charts 1 and 2 demonstrate that significant turning points occur around the opening and closing times of the various world markets with maximum opportunities occurring within the first hour of trading. Last year 53 per cent of the day’s range occurred within the first hour of the session.

Historical analysis

We also looked at whether there has been any shift in respect of trading ranges over time as many day traders have observed that the moves “seem” to happen overnight these days.

Chart 3: 1990s vs 2000s: trend of ranges on the S&P index

Year	First Hour Range vs Day Range	Year	First Hour Range vs Day Range
1991	43%	2001	52%
1992	47%	2002	49%
1993	48%	2003	56%
1994	48%	2004	47%
1995	46%	2005	45%
1996	43%	2006	50%
1997	40%	2007	46%
1998	43%	2008	45%
1999	46%	2009	53%

An examination of the data showed that the “pit” day session range in the S&P is still much greater than the globex range and also constitutes a significant percentage of the 24 hour range.

Although there has been an increasing tendency for most of the range to occur overnight, it has not yet reached the point that there is no opportunity to day trade.

Chart 4: Range Analysis and Trends for the past eight years in the S&P index

Year	Data	Grand Total	First Hour Range vs Day Range	Overnight Range vs Day Range	Day Session vs 24 Hr Range
2001	Average of GlobexRange	10.09			
	Average of DayRange	21.07			
	Average of FirstHourRange	10.86			
	Average of 24HrDayRange	23.75	52%	48%	89%
2002	Average of GlobexRange	10.26			
	Average of DayRange	20.28			
	Average of FirstHourRange	9.98			
	Average of 24HrDayRange	22.71	49%	51%	89%
2003	Average of GlobexRange	7.16			
	Average of DayRange	13.72			
	Average of FirstHourRange	7.64			
	Average of 24HrDayRange	15.24	56%	52%	90%
2004	Average of GlobexRange	5.62			
	Average of DayRange	11.03			
	Average of FirstHourRange	5.23			
	Average of 24HrDayRange	12.32	47%	51%	90%
2005	Average of GlobexRange	4.99			
	Average of DayRange	10.97			
	Average of FirstHourRange	4.93			
	Average of 24HrDayRange	12.02	45%	45%	91%
2006	Average of GlobexRange	5.68			
	Average of DayRange	11.43			
	Average of FirstHourRange	5.74			
	Average of 24HrDayRange	12.70	50%	50%	90%
2007	Average of GlobexRange	10.15			
	Average of DayRange	17.24			
	Average of FirstHourRange	7.88			
	Average of 24HrDayRange	20.03	46%	59%	86%
2008	Average of GlobexRange	19.07			
	Average of DayRange	31.21			
	Average of FirstHourRange	14.02			
	Average of 24HrDayRange	36.45	45%	61%	86%
2009	Average of GlobexRange	13.25			
	Average of DayRange	19.51			
	Average of FirstHourRange	10.43			
	Average of 24HrDayRange	23.68	53%	68%	82%

2. Persistency of trends – extended runs and aberrations

Persistence of trend is an important characteristic to be able to gauge when trading. Our analysis tried to answer the following questions:

- At what points do “extended runs” or strong trends feed upon themselves and lead to continuation?
- How long can the run progress before you have a greater chance of reversal than continuation? i.e: What happens when an extended run gets “mature”?
- What happens if you get a pull-back after an extended run of various lengths? Do you get continuation or a reversal?

Extended runs

We can define an extended run as a series of consecutive closes on one side of a short period simple moving average (SMA). For the purpose of this article, we will use the 5 period simple moving average. However, 4 SMA, 3 SMA and 6 SMA work just as well for modelling this behaviour. Our analysis covered the following markets using 10 years of data (1998-2008) which were tested using daily charts:

- S&P e-mini
- Nasdaq 100 e-mini
- Russell 2000 e-mini
- Dow e-mini
- 30 year bonds
- 10 year notes
- Gold
- Silver
- Copper
- Soy Beans
- Wheat
- Corn
- EC (Euro-Currency)
- Japanese Yen
- British Pound
- Natural Gas
- Crude Oil
- Sugar
- Cotton
- Coffee
- Live Cattle
- Live Hogs

Testing futures contracts is tricky. Because they are short lived in duration, stringing together a set of contracts requires an “adjustment” to have the results make sense.

We used CSI Data to provide the Futures data stream for these models. We used their software to specify that contracts should automatically roll over using 2 consecutive days of increase in open-interest/volume. Data was imported into Tradestation and all testing done on that platform.

The rules of the model were defined as follows:

1. After “N” (or greater than “N”) consecutive closes on one side of the short period SMA (in our case 5 period SMA), enter on close of day “N” in the direction of that impulse. Eg: If you have “10” closes above the 5 SMA, go long on the close of day 10.
2. Exit “Y” days after entry. This is a time based exit with no money management stop. An addition of a money management stop is an excellent area to do further modelling. ATR functions such as 3 Average True Ranges or a channel based stop such as the lowest low or highest high of the last 4 bars are appropriate.

Chart 5: Mini Dow Futures



Chart 5 above shows that the first trade was a small loss. The second trade captured a big win. The win/loss ratio for this strategy is around 50% but the winners greatly exceed the losers. This methodology will do best across a portfolio as odds increase of capturing an “outlier”. In this example, a trade is entered after 10 consecutive closes on one side of the SMA and exited 10 days later.

Chart 6: Natural Gas

Chart 6 above shows an example of enter on close of day 6, exit 6 days later. 1 long and 2 shorts. You can easily see how this is analogous to an actuarial table – playing for a window and not so dependent on whether you enter or exit on day 6,7,8...etc.

Our results showed that the optimum trading strategy was to enter a trade after 10 consecutive closes on one side of the 5 period SMA and to exit 10 days later. Trading just one contract per market gave an overall profit over the last 10 years of 362,000. Removing the largest winning market still gave a profit of 150,000 on one contract per market.

Reversals

Our work also investigated at what point it was better to enter a reversal trend because an existing trend had become too mature. Here the rules were:

1. After "N" (or greater than "N") consecutive closes on one side of the short SMA (in our case 5 period SMA), when there is a close on the other side of the SMA, enter a trade in that direction. For example, if you have "N" closes above the 5 SMA and then the price closes below the 5 SMA, go short.
2. Exit "Y" days after entry. Our results showed that the optimum set up for a reversal trade is after a market has a run of 19 consecutive closes on one side of the short term moving average.

Conclusion

An extended run of around 7-9 consecutive closes on one side of the short term SMA has a higher probability of continuing than not. It's a younger trend so pullbacks can still be considered corrective and the trend given the benefit of the doubt.

An extended run of 19+ consecutive closes on one side of the short term SMA has a higher probability of FAILING to continue. It's a mature trend. Pull stops up tighter.

An extended run of 9-12 can be entered right away and exited 8-10 days later. This reinforces the first point above – the trend is most likely to continue.

Continued from page 3

What is more, the band is drawing in more converts as successive crashes have highlighted the shortcomings of taking a purely fundamental approach to investing.

In reviewing this book I must declare a prejudice – I am already a firm believer in technical analysis. For me this was a fascinating journey into the minds of the leading lights of my industry, although I do feel it could have been edited a bit in places. The repetition of the same questions to all the interviewees could perhaps have thrown up some different perspectives but most of the replies covered very much the same ground – especially when it came to the balance of intuition versus method.

I was interested to see Lo and Hasanahodzic asked each of the analysts what they thought of astrology and whether this had a place in technical analysis. I must confess to being relieved that most shared my view that some of the bad press that technical analysis has received over the years is due the emphasis that some technical analysts put on using moon cycles and alignment of the planets to predict market moves. Last year the STA invited a leading exponent of "Financial Astronomy" to speak at one of our monthly meetings. We have rarely had a speaker that polarised opinion as much as she did! The crux of the opinion in *The Heretics of Finance* was that this sort of talk doesn't help our cause. Saying that, it is a measure of how broad-minded most technical analysts are that both Ralph Acampora and Alan Shaw pointed out that they couldn't possibly criticise something that they hadn't properly researched.

Confronted by the increasing evidence of the success of technical analysis, academics are having to reassess the merits of randomly walking down Wall Street. One of the impediments to establishing a meaningful dialogue between academics and practitioners is that they approach the subject from very different standpoints. As scientists, the academics are looking for ways to formalise the subject so that they measure its results but the essence of technical analysis is its lack of standardisation. *The Heretics of Finance* makes a useful first step in trying to develop a common language between academics and technicians.

All in all I liked this book and would give it a 7.5/10 rating. It may have been a tad longer than it needed to be, but it provided a useful insight into the methodology of technical analysis. Given that the random walk hypothesis, which used to be "considered gospel truth by the high priests of academic finance", is being increasingly called into question, perhaps a more appropriate title would have "The Lutherans of Finance".

Clive Lambert

Data Request

A member of the STA is trying to obtain accurate FT 30 and FTSE 100 data to two decimal places (High Low Close with or without Volume), from their inception dates. Does anyone have this information? If so could you please let Katie Abberton know and she will put you in touch with the member.

Anyone able to supply this data will receive in exchange a Dow data file in excel format from its inception date of Oct 1928 to the present together with a Mathematical Grid with three simultaneous degrees of trend set within a Base 10 grid with Channel Shift.

Zen lessons in market analysis

This is a summary of a presentation given at the IFTA conference in October 2009

By John P. Hussman, Ph.D.

"The best way of preparing for the future is to take good care of the present, because we know that, if the present is made up of the past, then the future will be made up of the present. All we need to be responsible for is the present moment. Only the present is within our reach. To care for the present is to care for the future." Thich Nhat Hanh

This article is dedicated to my dear friend Thich Nhat Hanh, a Vietnamese Buddhist monk.

The practice of tending to the present moment – responding to prevailing conditions rather than relying on forecasts – is central to our investment discipline.

Focusing on the present moment doesn't imply ignoring the past or failing to consider the future. It's clear, for example, that we put a great deal of attention on estimating future cash flows and discounting them appropriately in order to evaluate whether various investments are priced to deliver satisfactory long-term returns. We certainly devote our attention to macroeconomic pressures and latent risks that threaten to become full-blown crises later. Still, we rarely make near term forecasts. Nor do we answer surveys like "where do you think the S&P 500 will be at year-end?" – a question that falls entirely outside of our way of thinking – like asking Columbus what sort of trees he thinks are planted along the edge of the Earth. The reason we avoid forecasts, very simply, is that they are not required, and that they can be a hindrance.

Expectations

One of the major debates among investors is between buy-and-hold investing and market timing. Think of the market as a big hat that has both red and green marbles in it, red corresponding to declines, and green corresponding to advances. The buy-and-hold investor essentially believes that it is impossible to predict which colour marble will be drawn next, but that on average the marbles will be green. So the buy-and-hold approach simply holds on, regardless of prevailing conditions. The market return expected by a buy-and-hold investor is the "unconditional expected return" – something that has historically been about 10% annually. Let's call this $E[R]$.

In contrast, a forecaster does believe that the next draw can be predicted given some information "X". As that information varies, forecasters will decide to buy or sell. But forecasters typically do something extra. Generally speaking, forecasters are not content with dealing with the present moment, and instead are prone to making bold forecasts about the next month, quarter, year, or even an entire stream of future returns (bull markets and bear markets).

The problem with this, in our view, is that it implicitly assumes that the information set "X" will remain constant. Worse, the size of the forecasts is generally far too large to be rational. A good forecast is most often a humble one.

Robert Hall of Stanford University (also the chair of the NBER Business Cycle Dating Committee that officially dates the beginning and end of recessions) calls this the Iron Law of Econometrics – the variance of a proper forecasting approach will always be smaller than the variance of the actual data. The reason is that, if actual returns are equal to expected returns plus a random error,

$$R = E[R] + e$$

then a proper forecast is one where the errors are independent of (not correlated with) the expected returns. That means that the variance of actual returns – call it $V(R)$ – must be equal to the variance of your expected returns $V(E[R])$ plus the variance of the error terms $V(e)$. As long as there is any forecast error at all, an efficient forecast will always be one where your expected returns are less variable than what actually takes place. Forecasters hate this, because they like to make big, flamboyant predictions about a whole string of events, rather than focusing on the present moment.

Consider that hat full of marbles again. Suppose you are told that 80% of the marbles are green, and that 10 marbles will be drawn (with replacement). If someone asks your forecast, it's very likely that you'll be comfortable predicting that 8 of the marbles will probably be green.

Now suppose the first marble is drawn, and suddenly, someone switches the hat, right in front of you. What happens to your confidence in your forecast? Well, it should collapse, because suddenly you're facing a new X. If the information set X can change, then it is not reasonable to make forecasts that assume that it will be constant over the forecast horizon.

So if we don't want to assume that market returns are simply constant at 10% regardless of valuations or other conditions, and we also don't want to make inefficient forecasts, what is the alternative?

For us, it is to focus on the present moment. We focus on "conditional expected returns" – the return we can expect, given the particular information set X that we have in hand. This is generally written $E[R | X]$. But unlike forecasters, we recognise that the predictable component of market behaviour for any given period is so small, relative to random noise, that making specific forecasts is futile. We take our information set one X at a time, and we rely on discipline and the law of large numbers to mute the impact of that random noise over the long-term.

Specifically, we can go back over history and use observable conditions such as valuations, market action, overbought/oversold status, macroeconomic factors, and so on to separate history into various "bins." Each bin represents a combination of observable conditions occurring together (what I've called "X"). Then we can ask, for every observation in the bin, what was the market return over a short subsequent period like a week or a month. Each bin

then can be associated with a particular expected return and risk profile. Our basic practice is to align our investment position with the set of conditions that we observe at each moment, and to shift our position as the evidence shifts.

Rather than treating the next week, month, quarter or year as a horizon that demands a specific “forecast,” we simply treat each realisation as part of a “repeated game,” and rely on the law of large numbers – that is, the idea that if we follow our discipline period after period after period, over time our inevitable errors will average out, and our long-term results will be largely what we expect. The best way to take good care of the future is to take good care of the present moment.

But isn't $E[R | X]$ a forecast?

One might object that by aligning our investment position with the average return/risk profile associated with a given set of conditions, we must, by definition, be forecasting. This is true in the sense that we do have some expectation that market returns under a given set of conditions will be satisfactory or unsatisfactory, given the risks involved. But we differ from “forecasters” in recognising that the expected return $E[R | X]$ for any short period of time is overwhelmed several times over by the conditional error term “ u .” It is only over many, many repetitions that the error terms dampen out.

This is a property that statisticians call “consistency.” Specifically, if a process is consistent, then as you increase the number of observations some random outcome, the average value of your observations will tend toward the true “population” average.

[Geek's Note: If $R = E[R | X] + u$, then over N repetitions, the standard deviation of the average error is the standard deviation of the actual error terms, divided by the square root of N . So if your conditional error terms tend to have a mean of zero, plus or minus 2.5% on a weekly basis, you would expect that over 100 weeks, your average error would be zero, with a standard deviation of about 0.25%. Over a full market cycle, you will have made a lot of individual mistakes in your investment position, but as long as your errors are not systematic, the combination of discipline and the law of large numbers will work strongly in your favour. Your results will be largely as you expected despite the fact that you made lots of individual errors along the way].

This is basically the dynamic at work when you sail a boat. If you hop into a sailboat and start across Lake Michigan, it is not particularly helpful to make predictions about the direction and speed of the wind over your entire journey. Much better to align your sails as those conditions change, making numerous modest errors, but getting across the lake.

Inquiry

“Suppose the mind consciousness is observing an elephant walking. During the time of observation, the object of mind consciousness may not be the elephant in and of itself. It may only be a mental construction of the elephant based on previous images of elephants that have been imprinted in store consciousness.

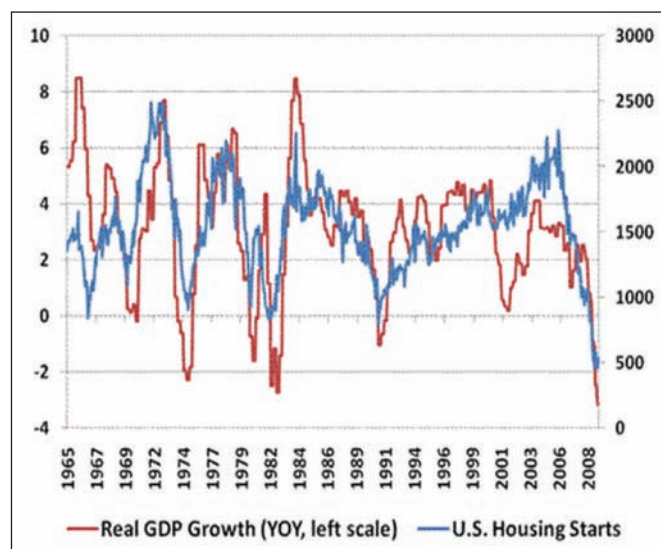
“Inquiry means not using the mental creation, but allowing yourself to get in touch, and to try to see how things truly are. We practice not to

be influenced by the name, because when we are caught in the name we can't see reality.” Thich Nhat Hanh

It is important that we don't place so much emphasis on “average outcomes” that we ignore the facts about particular instances. We still have to look carefully at reality to make sure that we aren't assuming away particular features that are important.

This is a risk that market participants seem to be taking here in a major way. Specifically, we have seen a great number of research reports with the basic thesis of “The recession is over. Here is how the market (or the economy, or employment, etc) has performed after a recession is over.” The difficulty is that these are basically attempts to say “here is an elephant” and then immediately move to describing elephants in general, when in fact, this particular elephant is very likely to be pink, or white. Specifically, valuations here are far different than they have been at the beginning of the typical economic expansion. Moreover, economic expansions have historically always been paced by rapid expansion in debt-financed classes of expenditure such as housing, capital spending, and sustained (not just one-off cash for clunkers) demand for automobiles. In prior recoveries, debt-financed expenditures have turned up quickly and have typically led other classes of expenditure by nearly a year.

Real GDP Growth and US Housing Starts

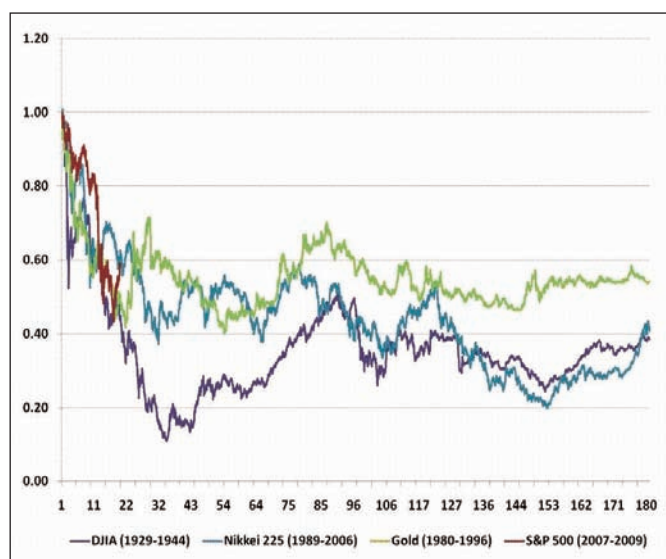


If we want to see things as they truly are, we have to look both at the elephant, and at anything that might set this particular elephant apart. With regard to the investment markets, if we suspect that the particular features of the present situation make things “different” than they have been historically, then it is best to look closely and get more data.

As an example, during the late 1990s, it was often argued that technological innovation had changed the economy so profoundly that the market valuations of the time were actually reasonable, if not incredibly attractive (remember Dow 35,000?). So we had to open ourselves to the possibility that things were different in an important way. But when we actually looked at the data, there was simply no historical example – in any productivity spurt since the Industrial Revolution – that could support the sort of growth rates that were implicitly priced into stocks.

When we look at the current market environment today, it is clear that the enthusiasm about the market here is largely based on the idea that the recent recession is over, and that the economy will form a “V” shaped recovery similar, but much stronger quantitatively, to standard post-war recoveries. This is a very difficult argument to make, because the drivers of economic growth that existed in typical economic recoveries – particularly debt origination and consumption growth – are very compromised at present. Our perspective on the ongoing credit risk in the economy is much like that of economists Kenneth Rogoff and Carmen Reinhart, who foresaw the recent financial crisis, and are far less sanguine about the prospects for sustained recovery.

This is a subject that I have struggled with in recent months. Even if we could assume that the recent crisis was a standard post-war downturn, and that we are now in a standard post-war recovery, valuations would still concern us because at these levels, stocks are not priced to deliver satisfactory long-term returns in any event. However, we would have a greater willingness to take a moderate speculative exposure based on market action and prospects for sustained economic improvement. On the other hand, when we include other post-crash periods into our data set, and allow for the possibility that those instances better describe present conditions, the case for accepting speculative exposure is much more limited. Of specific concern is the tendency in those periods for strong advances (as we’ve seen in recent months) to be followed by spectacular failures.



So we have to be very careful about how we name things. When people label stocks as being in a “bull market,” the implicit suggestion is that stocks will continue to advance for a sustained period of time. When people say that the recession has ended and we’re now in a “recovery,” the temptation is to look at how the market has performed in previous recoveries, without noting the profound differences between those instances and the current environment.

As Thay says, “We practice not to be influenced by the name, because when we are caught in the name, we can’t see reality.” The picture in our head can be very influenced by the words we attach to it.

As Zig Ziglar says, “You can tell your wife that she looks like the first day of spring, or you can tell her that she looks like the last day of a long, hard winter. There is a difference.”

Koans

In Zen, there is a teaching tool known as a “koan” – a question that serves as the object of meditation, and is intended to reveal something about teachings like mindfulness and interconnectedness. Western observers sometimes mistake these for riddles, non-sequiturs, or nonsensical statements, but if you look at them carefully, they are questions or stories intended to prompt the listener to see things as they really are.

A riddle is something like this:

Q: “How does a Zen monk know his pizza is enlightened?”

A: “It’s one with everything.”

Here is a koan:

A novice monk approaches his teacher and asks, “Is this a bull market or a bear market?” The teacher replies, “If it is a warm day, and I say that it is winter, will you still wear your heaviest coat?”

Causes and Conditions

“This is, because that is. This is not, because that is not.” Buddha

“The seed and the fruit are not two different things. The fruit is already contained in the seed. It’s waiting for different conditions in order to be able to manifest. The fruit doesn’t have a separate existence; it’s a formation. Using the word “formation” reminds us that there is no separate existence in it. There is only a coming together of many, many conditions.” Thich Nhat Hanh

When we think about events, either in our daily lives, or in the market or the economy, it is important that we don’t think of them as simply existing or coming out of nowhere. This is, because that is. This is not, because that is not. We cannot create or remove a condition, expect it to emerge or expect it to disappear, without understanding the seed that produces it, and the causes and conditions that allow it to spring up.

Generally speaking, the seed we water is the one that grows. That’s why if we spend our energy thinking about what we don’t want, what we don’t like, what is wrong – we’ll tend to nurture and strengthen exactly the wrong things. If we water the seeds of peace, understanding, empathy, happiness, and so on, those are the seeds that will grow.

The basic condition for anything to emerge is for the seed to exist. But that is not enough. The seeds of a bear market are often fully present in the later stages of a bull market – over valuation, excessive speculation, acceptance of risk without sufficient compensation, extension of credit to poor credit risks, belief in the sustained growth of cyclical businesses, over confidence, and so forth.

But in order to manifest as a flower, or a weed, or as fruit, other conditions have to be present. Buddhists distinguish two kinds – “same direction” and “opposing direction.”

Conditions in the opposing direction tend to hold back the manifestation of the seed, but can also force it to become stronger before it manifests. If you plant a seed in firmer soil, the roots may be forced to dig deeper in order to establish themselves and find water, whereas a seed in easier soil may grow more quickly but

have weaker foundations, so it can be uprooted easily. Conditions in the same direction are those like water and sunlight, which provide the background environment necessary for the seed to grow.

Some of our best investment insights have been driven by this focus on causes and conditions. These often take the form of “Aunt Minnies” – sets of conditions that may not mean much by themselves, but have very strong implications when they occur together (a person may have one feature or another, but if you have just the right combination, you know it’s Aunt Minnie). To find Aunt Minnies, we look for a seed, identify conditions in the opposing direction (if any) that have made the seed strong, and then look for conditions in the same direction that are capable of bringing the seed to fruition.

Many of my concerns about the markets in recent years have emerged because too often, financial market participants and policy makers focus on manifestations rather than causes and conditions. This is why investors produced the dot-com bubble, the tech bubble, the mortgage bubble, the debt-financed private equity bubble and the commodity bubble without thinking of the seeds of crisis that were latently emerging, or how violently they would manifest. Our policy makers have bailed out poorly run financials by creating massive federal deficits, and think they’ve solved the problem in the same way as someone who runs over a weed with the lawnmower. The roots have simply grown deeper, because the seeds are still there, but we’ve applied a few conditions in the opposing direction. My geopolitical views are largely the same. This is, because that is. This is not, because that is not.

We can have an overvalued market and the seeds of a bear market, but if we apply opposing conditions in the form of easy money in order to prop up the market and prevent the consequences of bad behaviour, the seed will simply grow stronger, and its ultimate manifestation will be more powerful. We can have a mortgage market that is setting new records for delinquencies and foreclosures every month, combined with increasing unemployment and a heavy reset schedule on Alt-A’s and option-ARMs that is just now picking up. But if we lower the bar on financial reporting, fail to restructure debt, and ignore the strengthening seed because we’re single-mindedly enthusiastic about the thin-rooted green shoots of stabilisation – born solely of a burst of fiscal profligacy – then we’ll predictably be blindsided when the problems re-emerge.

Predictably blindsided. That’s happened again and again in recent years. And it happens when we fail to think about the seeds we are watering. If we look only for fruit and ignore the seeds of crisis, then every bit of fruit will be followed by crisis, and nobody will understand why.

Interbeing

“As thin as this sheet of paper is, it contains everything in the universe in it.” Thich Nhat Hanh

If you look closely at a sheet of paper, you can see the clouds, the rain, the soil, the sunshine, the mill, the truck, and so forth, because without these things, there would be no sheet of paper. In Buddhist terms, the paper is “empty” and has no self. That doesn’t mean that

the paper is not there, but rather that the paper is made entirely of non-paper elements. Empty of self means full of everything non-self.

There’s a phrase *alambana pratiyaya* – which means that object and subject are always born together. The idea of interbeing is that nothing has a separate existence – that each thing is connected to the others. It’s an inherently peaceful way of thinking, because it recognises that we are all made of the same substance, that to take care of others is to take care of ourselves, and that we can only understand something if we understand the context that surrounds it.

So here’s a koan –

“What is the sound of one hand clapping?”

If you think about it as a riddle, you’ll keep looking for the punch line. But the koan is really about encouraging the listener to consider the true nature of things. Nothing is possible in the absence of interbeing. Subject and object must occur together or nothing manifests at all.

Here’s another one –

“If a tree falls in the forest and nobody is there to hear it, does it make a sound?”

Our immediate impulse is to think, of course it makes a sound. But look more carefully. If a tree falls, it certainly will make the air move, but what is sound? Sound is the interpretation that our brains give to those air vibrations. If we are not there, the air vibrates, but is the experience of sound there? One might think, but wait, we could put a microphone there in the forest. But what is the microphone picking up? The air vibrations. If we play that recording on a video monitor with no speakers, you’ll see visual images, but no sound. In order to get sound, you have to have speakers, and the speakers simply take the recorded signals and turn them back into air vibrations, which become what we call “sound” when there is a brain to interpret them. Subject and object have to occur together.

So here’s another koan –

“If a share of stock is sold in a forest, and nobody is around to buy it, does it still generate a fall?”

The immediate implication of interbeing is that we are forced to think about “general equilibrium” rather than imagining that one side of a trade can exist without the other. This immediately clarifies all sorts of misconceptions that we could fall victim to if we aren’t careful.

For example, it immediately tells us that “cash on the sidelines” is not a useful concept, except as a measure of issuance. Whatever “cash” is there on the sidelines exists because government has created paper money, or the Treasury has issued bills, or because companies have issued commercial paper. Until those securities are actually physically retired, they will and must remain “on the sidelines” because somebody will have to hold them.

If Mickey wants to sell his money market fund to buy stocks, the money market fund has to sell commercial paper to Nicky, whose

cash goes to Mickey, who uses it to buy stocks from Ricky. In the end, the commercial paper Mickey used to have is now held by Nicky. The cash that Nicky used to have is now held by Ricky, and the stock that Ricky used to have is now held by Mickey. There is exactly the same amount of “cash on the sidelines” after this transaction as there was before it.

Similarly, money never moves “into” or “out of” a secondary market, or from one sector to another. If I bring \$1 “into” the stock market, that same dollar goes back “out” a moment later in the hands of a seller. If it did not, there would be no trade, no fill.

We can talk about differences in eagerness or in pressure as moving stock prices. But we cannot talk about money going in or money going out. We cannot talk about supply being greater than demand or vice versa. In equilibrium, the two must be equal.

One of the most useful ways of interpreting price and volume behaviour is this: if something makes a given trader want to buy, the price must move in a way that either removes that impulse or induces another trader to sell. There is no other option.

Here's another koan:

A novice monk approaches his teacher and asks “What is the price movement of one share being bought?” The teacher holds out a cypress leaf in his palm and asks, “Did I catch the leaf as it fell from the tree, or did I raise it from the ground?”

We are used to thinking that the act of buying necessarily implies rising prices. But think about this for a second. In either case, the teacher gets the cypress leaf. What makes the difference so far as direction is concerned is where the pressure is coming from. If the cypress leaf is being offered down by gravity, it is caught on a decline. If the leaf is being lifted by the teacher, it is caught on an advance. Remember that. It is easy to get trapped in wrong thinking by people who talk about “cash on the sidelines” or talk about “investors” buying or selling in aggregate.

There was no excess of stock that was “sold” in March that has to be “bought” back now. Investors didn’t “get out” of the market last year, and we shouldn’t think that they have to “come into” the market now. Every share that was sold was bought. That has been true for every minute of every trading day since the beginning of the financial markets.

Prices and Volume

A good way to think about prices and trading volume is to abandon the idea that money goes in or out, and to think instead about the market as a collection of various groups. Imagine there being fundamental investors, who are interested primarily in value (buying on weakness and selling on strength), and technical investors, who are interested primarily in trends (selling on weakness and buying on strength). These people also trade on different horizons and base their trading on different extents of movement.

In this sort of equilibrium, trading volume is a measure of strong views and disagreement. As the market turns weaker, trend-following investors typically abandon stocks, while fundamental

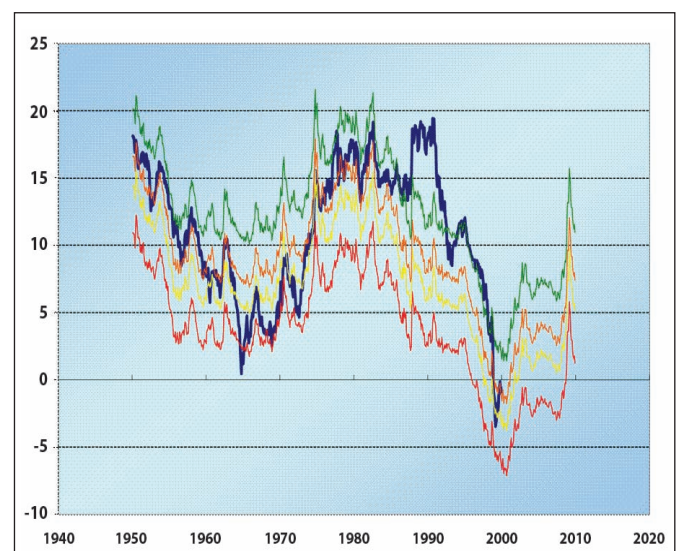
investors accumulate. The reverse is true on significant strength. So spikes in trading volume tend to occur primarily at extremes relative to the target prices of fundamental investors. Volume spikes also tend to be correlated with a series of positive or negative shocks that then abate. In contrast, dull volume is a measure of low sponsorship, strong agreement, and lack of external shocks.

Equally important is that net incipient buying from both technical and fundamental investors cannot exist, so large price movements are typically required to relieve the disequilibrium. If you've got an overvalued market which then loses technical support, the outcome can be extremely negative, because technical investors are prompted to sell, but fundamental investors have weak sponsorship at that point, so large price declines are required to induce the fundamental investors to absorb the supply.

By contrast, if you've got an undervalued market where fundamental investors raise their outlook, the demand from fundamental investors is not typically provided by technical investors (who would tend instead to buy on advances in price), so the price must increase enough to induce fundamental investors with shorter horizons to supply the stock.

All of these dynamics have been active in the market over the past two years, but the most significant outlier has clearly been the past few months, where volume behaviour has demonstrated much weaker sponsorship than we would have expected for an advance of this size. Normally, the volume characteristics we've seen have been much more typical of short-squeezes and less durable advances.

Presently, my primary concern is that stocks are now overvalued, to about the same extent as they were in the late 1960s, and just prior to the 1987 crash, but certainly less overvalued than they were at the 2000 or 2007 peaks. Our 10-year total return projection for the S&P 500 is centred modestly above 6% annually, even if one assumes that the long-term path of earnings has been unchanged by the events of recent years. If we assume that the economy will require a much longer period to recover than has been typical of post-war recessions, the prospects for long-term returns are lower, but we don't need to assume this in order to be concerned about



valuation here. (On the chart below the green, orange, yellow and red lines imply terminal price/peak earnings multiples of 20, 14, 11 and 7 a decade from now. The dark blue line charts actual annual total returns over the subsequent decade).

Though rich valuations and a fresh overbought condition in early October argue for tepid returns going forward, my expectation is that strong downward pressure would be most likely if market internals deteriorate somewhat – particularly in terms of breadth. Again, if technical investors are prompted to sell in an environment where sponsorship from fundamental investors is weak, large price changes may be required to relieve the disequilibrium.

A quick summary

Present moment, only moment. Sound investment does not require forecasts. It is enough to align the investment position with the prevailing, observable evidence.

Labels can help to classify, but they can also obscure truth. There is no quantitative substitute for mindfulness. That said, if “this time is different,” one should be able to find appropriate parallels using a sufficiently broad set of historical or international data.

The seed and the fruit are not two different things – significant market moves are generally the fruit of causes and conditions that latently precede them.

Everything, including the market, is ultimately empty of a separate self. One market can only be understood and analysed in the context of other markets and conditions. Supply and demand, in particular, should not be considered in isolation.

Finally, they would add something more, which is to breathe, bring yourself back to the present moment, and recognise that even the smallest, simplest thing can be the basic condition for your happiness.

“If you touch one thing with deep awareness, you touch everything.”

Market Climate

As of early October, the market climate for stocks remained characterised by unfavourable valuations, general strength on the basis of major indices, a few emerging divergences (one notable technical one being the non-confirmation between the Dow Industrials and Transports), and a fresh overbought condition resulting from the recent advance. On Friday, we closed the modest “anti-hedge” in index call options that we established on weakness a couple of weeks ago. Presently, the Strategic Growth Fund is tightly hedged.

The market is strenuously overbought – enough to suggest a weak prospective return per unit of market risk. That’s not to say that stocks can’t ultimately advance further, but even if we observe a further advance, it would be very likely that stocks would return to or breach current levels on a relief of that overbought condition. That’s another way of saying that near-term gains from these levels are unlikely to be sustained, which is why we closed that modest “anti hedge” last week.

Recently, incipient selling pressure has been met fairly quickly by demand from investors who feel that they have missed the advance. So what we’re seeing in trading volume appears to be a move from strong hands selling on strength and questionable economic developments, toward weak hands buying on the slightest relief of an overbought rally in an overvalued market. This is not a dynamic that we should expect indefinitely, especially if we observe earnings disappointments or a lack of significant economic improvements. Insider selling versus buying, in total dollar terms, has been particularly brisk (though the sell/buy ratios based on share counts are less dramatic), so there is early evidence that corporate insiders realise that investor perceptions are somewhat rich.

A few years ago, a world-class chess champion named Battsetseg Tsagaan told me that the two most important questions she asks during competition are “What is the opportunity” and “What is threatened?” – questions that I have made a habit, though imperfectly, of asking every morning when I review the portfolio of each of our funds. Battsetseg also told me “when your opponent moves something suspicious, there has to be something wrong” – an insight that should always be considered when the various elements of market action diverge from what would be expected in the context of other conditions.

I suspect that significant downside pressure, if it emerges, will tend to be associated with technical breakdowns and not simply a bit of bad news here or there. Market internals such as breadth and the extent of non-confirmations are very important here, because again, any significant selling pressure from technical investors is not likely to be met with robust demand from fundamental investors, and that implies significant price adjustments are possible if market internals begin to weaken.

In bonds, the market climate last week was characterised by modestly unfavourable yield levels and moderately favourable yield pressures. The recent decline in Treasury yields in recent weeks has been coupled with U.S. dollar weakness, which one would normally associate with a deterioration of economic expectations. In my view, the factor that would send Treasuries and the dollar in different directions would be an increase in credit concerns. Fears about credit have a tendency to push investors strongly toward default-free safe-havens, primarily U.S. Treasury assets, so you can get both downward pressure on Treasury yields and upward pressure on the U.S. dollar. That sort of behaviour is something we would take seriously as an early indicator of oncoming credit problems.

For now, the Strategic Total Return Fund continues to have a duration of about 3 years, in both TIPS and straight Treasuries, with about 1% of assets in precious metals shares, about 4% in foreign currencies, and about 4% in utility shares. While it’s true that there is a slight yield pickup from government backed mortgage securities, my impression is that the premium in these has been only temporarily compressed. While I don’t doubt the government backing on these instruments, there is enough risk of renewed discomfort among investors for mortgage-related securities in the next 6-8 months or so that wider risk spreads may be available later.

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