The CJ Investment Newsletter

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Charting a Course

Quick Look

Market	**Next Expected Move**
?	

	Sept	**YTD**
DJI	**<1.47%>**	**<8.63%>**
COMP	**<3.27%>**	**<2.45%>**
SPX	**<2.64%>**	**<6.75%>**
Gold	**<1.68%>**	**<5.85%>**

	Oct	**YTD**
DJI	8.47%	**<0.90%>**
COMP	9.38%	6.71%
SPX	8.30%	0.99%
Gold	2.39%	**<3.61%>**

- Despite October's bounce, it would appear there is a bearish change in the direction of the investment markets for 2015.
- We review and discuss current *CJC2 Indicator* charts, especially in the context of previous market tops as a means to gauge or at least indicate current market prospects.

Why use TA (Charting)?

One of the more famous and respected market analysts of all time would have to be Richard Russell. In the past, you have read me refer to him and to his work on a regular basis. Recently, his advanced age and a few TIA incidents have diminished his once razor sharp analysis of the markets.

He was probably the greatest expert of all time on Dow Theory, which was one of the first, if not THE first TA (Technical Analysis) systems for attempting to determine market direction and timing. He was also one of the world's leading experts on Elliott Wave Theory (EWT), a method of reading and predicting market or security moves that we have never mastered at TCM sufficiently well to use as a predictive tool. In all fairness to us, Elliott Wave Theory is quite arcane. It is not nearly as widely used as Dow Theory or many of the other charting techniques and systems we use here at TCM.

Eventually, he abandoned writing about EWT to focus on Dow Theory, leaving that exercise to Robert Prechter, who is probably the leading expert in history related to the understanding and use of EWT. Please notice that these men are often considered to understand their particular methods better than their founders, Charles Dow and R.N. Elliott did.

For the most part, TA uses charts that are created from price and volume data over time to analyze and predict current and future market conditions. There are dozens, if not hundreds of indicators and other information that are derived from these two data series.

> Russell had an excellent way of explaining why an analyst would want to use TA as a measurement and predictive tool. *He stated that the value of TA, or charting, was that it could tell an analyst* ***what*** *was likely to happen, even though it could not tell the analyst* ***why***. He rightly stated that *why* the markets do what they do at a particular time might not be understood until years later, when that knowledge would no longer be useful for making investing decisions.

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"If the natural tendencies of mankind are so bad that it is not safe to permit people to be free, how is it that the tendencies of these organizers are always good? Do not the legislators and their appointed agents also belong to the human race? Or do they believe that they themselves are made of a finer clay than the rest of mankind?" – Frederic Bastiat, *The Law*

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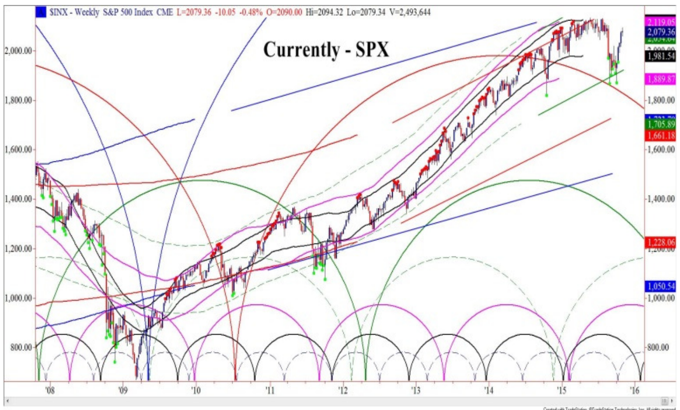
In fact, there is a joke that rather encapsulates this thinking:
"What do you call being early on Wall Street?"
"Being wrong."

Current Charts

Let's begin our discussion by looking at a current simplified *CJC2* chart of the S&P 500 (SPX).



Please review on your own before reading on.

Remember that the *CJC2* charting technology was specifically devised to enable those who don't understand the underlying math still to spot macro trends of an index or single security. Specifically, the nested bands and their underlying defining cycles should, both individually and collectively, predict, at a minimum, turning points where the security has reached a peak or a bottom. Peaks occur where the security touches the upper band; bottoms occur where the security touches the bottom band. One last major point: *for a particular band, once the security has reached a peak or a bottom and changes direction, it should continue to move towards a new bottom or peak until reached.* We call it the rule of full expression.

Admittedly, a *CJC2* chart is not 100% predictive, but neither is any other current TA method or combination. Although, after using this method for years, TCM believes the *CJC2* to be substantially accurate. The technique has been refined over the years and is more accurate than it was in its original form in the early 2000's. One of the biggest problems to overcome was the distortion of the markets created by the massive injections of M0 into the monetary base since 9/2008. A few years later, we finally figured out how to "factor out" the massive changes to the money supply through applying a correction factor to the upper and lower bands, keeping them from spreading out to the point they no longer meaningfully contained the true movements of the security or the index being charted.

Once the correction factors were applied, the *CJC2* Indicator was unaffected by the market distortions that the Fed created. Those distortions plagued the original *CJC* Indicator that served us so well for so many years. However, many ***other*** widely used TA indicators are still "broken" (distorted) from the actions the Fed has taken for the last *7 years*.

Because of the backward shifting of the channels for mathematical reasons, we had to learn how to use band extensions to estimate our best guess as to the future direction of the channel itself. The actual channel is curvilinear. Band extensions, because we did not want to introduce hope or other emotions into our work, are linear and marked by strict drawing rules. Therefore, band extensions are subject to what we call deflections, as you will see below.

Too geeky? Sorry. Welcome to our world. But, we'll stop geeking for now and move back on point.

Reviewing the SPX chart above, we can see that the index reached a multiple channel top a few months ago and has begun moving downward towards the bottoms of those channels. Let's focus on the two longest channels – the blue and the red channels, from widest to next widest.

It clearly appears that tops (peaks) seem to have been put in on all the channels, but especially the blue and red ones. *Please go back and review the major point in italics a few paragraphs above*. Almost needless to say, TCM believes we have finally reached a major top, from which a significant bear market will ensue.

If you watch a lot of CNBC or Fox Business, you will see many technical analysts that use linear, hand-drawn channels to determine potential future movements. TCM opines that such methods do NOT highlight, nor predict turning points, as accurately as the *CJC2* indicator. You will hear terms such as ascending or descending triangle and support or resistance in such discussions. We were so disappointed in such analysis that we were actually spurred to create the *CJC*, and later, the *CJC2* indicators.

All that being said, the chart (even with the *CJC2 Indicator* applied) could still be interpreted as a continuing bull market that has just taken a temporary pause before resuming its upward move towards a

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final peak. After all, see how long the SPX bounced along the bottom of the blue channel from 2009 through 2012. However, after reviewing thousands of these charts over the years, we think the top was reached a few months ago and we are now headed towards the other side of the band.

And that wouldn't be so bad, would it? After all, the chart indicates that the bottom of the blue band for the SPX would be around 1600 or perhaps higher, provided it took longer than we anticipate to reach the channel bottom. Remember when we discussed *band extensions and band deflections* in column 2 of the previous page? There's the rub…

Look at the chart of the SPX from a comparable time after the peak in 2007 and the beginning of the 2007-2009 bear market, below.

It doesn't look that dissimilar from the current period, does it? You may notice that the price action went through the top of the red band, but the blue band is still significantly upward sloping. However, the downward move within the red band does appear to be strong enough to indicate that it should carry to the other side of the band. Notice also how the red cycle indicator peaks just before the actual index peak. You can barely see the downward movement of the blue cycle to the immediate right of the index action on the extreme right of the chart.

This is also happening now. You can't see it on the current chart on page two, but the blue cycle also peaked above the top of the current SPX index action. If you look closely, you can see several of the shorter cycle tops that coincide with the overall top on both charts.

Now, let's look at a similar chart about 6 months after the March, 2009 bear market bottom. (Next column below Recommended Reading box.)

Recommended Reading

http://www.realclearmarkets.com

Unlike we have done in the past, we are recommending that your regularly check out the above website. Many of you know the website www.realclearpolitics.com. This is a sister site with an emphasis on investment markets and economics. The real benefits on this market site are:

- The articles, which are reprinted from other sources, are usually short and to the point.
- The articles cover a large number of investing topics, allowing you, if you wish, to stay current on various developments and trends in investing and the economy.
- They are generally non-technical and are easily readable by people who are not, and probably don't want to be, financial gurus or geeks.
- The articles seem to represent fairly the most common political points of view somewhat evenly. At least, as evenly as a site with a pro-business and investing emphasis can be.

Notice how the band extensions *deflected downward* from their positions on the chart showing the beginning of the bear market? This is extremely common when a major, multi-band market top is reached. Effectively, this downward deflection of the bands lowered the "projected" bottom of the SPX *from about 1600 to around 800.* (The actual closing bottom of the SPX in the last bear market was 676.53.)

Just so you won't think we're using a selective pair of charts from the last bear market to prove our point, let's look at the beginning and end of the previous major bear market from 2000-2003. Please review the charts on the next page.

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The deflection of the blue band is a narrower angle, but still changes your estimated intersection from about 900-1000 to below 800. Given that the SPX is above 2000 now, a similar percentage change translates to a 400-point difference in today's index. The red band deflects more than the blue, but the reverse was true in 2007-2009. If we had been willing to break our rules regarding how to draw band extensions, the deflection of the blue channel would have been much more dramatic. But then, our rules are designed not to introduce our own prejudice or judgment into their drawing. We would no longer be working with the *data*; we would be working with our *assumptions*. Now, look at the chart of the SPX on page two. Do you see it the same way you did before?

Still, just take a look at how the last two bear markets started and how they finished, understanding that the band extensions will be deflected downward *significantly*, making the potential loss from holding through the bear market without using protection a very large loss, indeed. Such protection comes from greater cash balances, dividend paying stocks, bond investments, and pure bear market plays. That is, the investments TCM clients have been in for a while.

In many past issues, we have discussed economic theory (which is often quite arcane) to put forward the simple, but understandable maxim: *You can't create something from nothing*. Applied to our current situation, it means *adding counting units (US$) cannot and will not create wealth*. Real wealth has to be created through effort, not dilution of the money supply. It's really more a case of "You can fool some of the people all of the time..."

After the 2000-3 bear market and recession, the government forced Fed corresponding banks to lend to borrowers who couldn't otherwise qualify for loans. The Fed accommodated those banks, including lowering interest rates. We all saw how that ended in the 2008-9 recession/bear market. The government's and Fed's solution? *Lower short-term interest rates to zero (ZIRP) and keep them there for 7 years.* That's a bit like drinking a quart of whiskey to cure the hangover you had last night – and then do it every day for 7 more years. Review of our charts indicates no amount of ZIRP will ward off the coming hangover. The Fed was foolhardy ever to think otherwise.

Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF's, ETF's, open-end mutual funds, and derivatives). Essentially, it reflects what I'm actually doing with my clients.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I consider important when investing may help you. I'd also love to hear any questions or comments you may have about my letter.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I analyze the markets and economy, as well as how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please contact me for more information.