# Three Charts Every Investor Should Know About

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By Dennis Slothower, Editor—Stealth Stocks

After the worst bear market that investors have had to endure since the great Depression, it is only natural that investors have grown pessimistic and skeptical about the market's prospects for the 4th quarter of 2002 and 2003. This bear market has not been of your garden-variety type. The NASDAQ Composite Index has fallen 75 percent of its value since its highs in March of 2000. Not even in the great Depression did any index fall that fast and that far in any eighteen-month period in history.

Our country is in the early stages of war with the terrorists. Uncertainties about the future have created a sense of foreboding and gloom, as investors ponder what the full impact to the U.S. economy will be as we begin to fight terrorism worldwide. The Federal Reserve has cut interest rates over eleven times in order to stimulate growth. Not since the Camelot days of President Kennedy have interest rates been this low and still, where is the economic recovery? Why should investors believe that 2002-2003 will provide an environment for a substantial recovery in the stock market?

After studying and trading the stock market for over twenty years, I suggest the answer lies in the following three charts that I will share with you.  While most pundits on Wall Street try to guess a companies earnings for the next quarter, or what the unemployment number will be next Friday, I have relied on these charts to guide me through the perilous waters of Wall Street. First, I would like to share with the you the importance of cycles.

### Cycles and How They Influence Markets

One of the most important things an investor must learn is that the markets are influenced by cycles. As Walter Bressert wrote some years ago in his book, "**The Power of Oscillator/Cycle Combinations**":

> *"Everything in nature moves in cycles…our solar system moves in a cycle around the center of the Milky Way galaxy…the planets move in precise and predictable cycles around the sun…the cycle of the tilt of the earth causes the cycle of the seasons…the rotation of the earth produces the cycle of night and day…the full moon occurs with predictable regularity as do the rise and fall of the tides. Each year geese migrate, animals hibernate, and salmon swim upstream to spawn, to mention just a few of the seasonal cycles we are familiar with…Other cycles are such an intimate part of our daily life that it may be hard to think of them as cycles. The cycle of sleep is experienced by most of us every 16 hours or so. Both men and women experience a monthly cycle of emotional highs and lows. These are all cycles we can understand and accept because we have an understanding of the underlying cause of these cycles."*

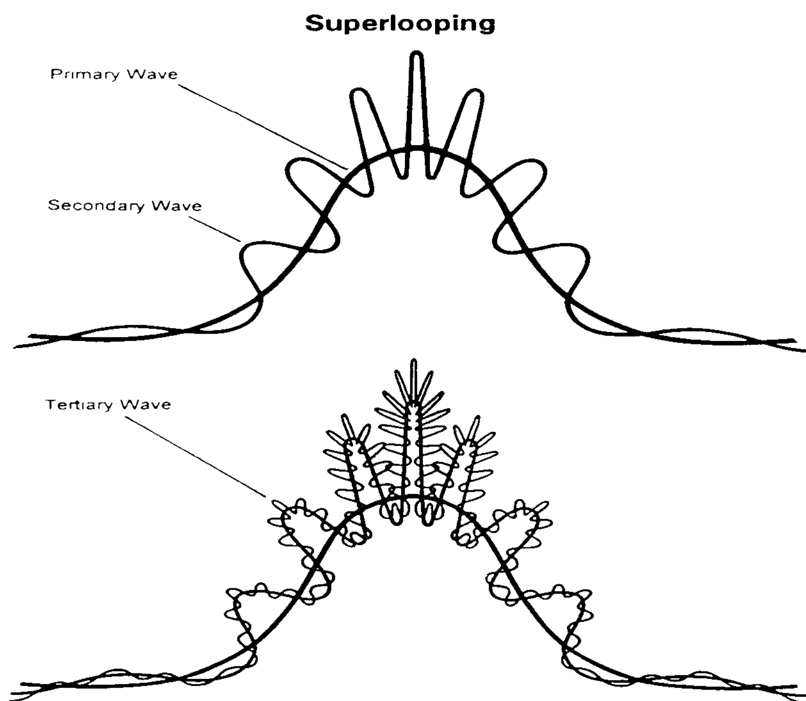
Understanding cycles in the financial markets can improve your results dramatically if you understand cycles in general. The value of cycles over most fundamental and technical analysis is the anticipatory value they offer in the financial markets. Knowing for example of a high probability of a cyclical top or bottom, can

help you plan strategy to maximize profits and reduce risk. Knowing that cycles affect market prices is of little more than passing interest for a market analyst and trader, unless the cycles can be used to identify tops and bottoms. It must also give indications of future price activity in both time and price. Herein lies the challenge presented to the cycle analyst.

The secret to entering and exiting the market lies in the investor's ability to determine what cycle is dominating price behavior and where the market is in that cycle. Our objective is to buy low and sell higher. To do this, we must first be able to identify when a cycle or a wave in the market has bottomed. Once the cycle has bottomed, the trend will be up until the cycle peaks. Once the cycle peaks and turns down, the trend will be down until the cycle bottoms again. During the Persian Gulf War and the recent war with the Taliban, most people have been amazed at the sophistication of modern weaponry. So called smart bombs with satellite, laser, and computer guidance systems can be directed at a target with pinpoint accuracy.

These smart bombs scan a large area as they seek their targets. Then they narrow the area into smaller and smaller sections, ultimately guiding the bomb into a very small point on the target. You have probably seen on television how a smart bomb can be guided right into a small window of a warehouse. Investors need to take this same approach. This is the macro-to-micro approach of identifying what is happening and what is about to happen in the marketplace. We must first analyze the long-term cycles and keep narrowing them down to smaller and smaller cycles, in order to get pinpoint accuracy with our entry and exits.

To understand which cycle dominates the marketplace, it is important to understand that the market is like the ocean tide, where a smaller wave is actually part of a larger wave. The tide comes in, but it doesn't come in all at once. It comes in with a series of smaller waves, each wave succeeded by another one. Even these smaller waves have ripples going counter to the larger waves, but all are part of the series of movements of the major trend of the tide. The stock market behaves in much the same way, with one wave or cycle part of a larger cycle—a cycle within a cycle.

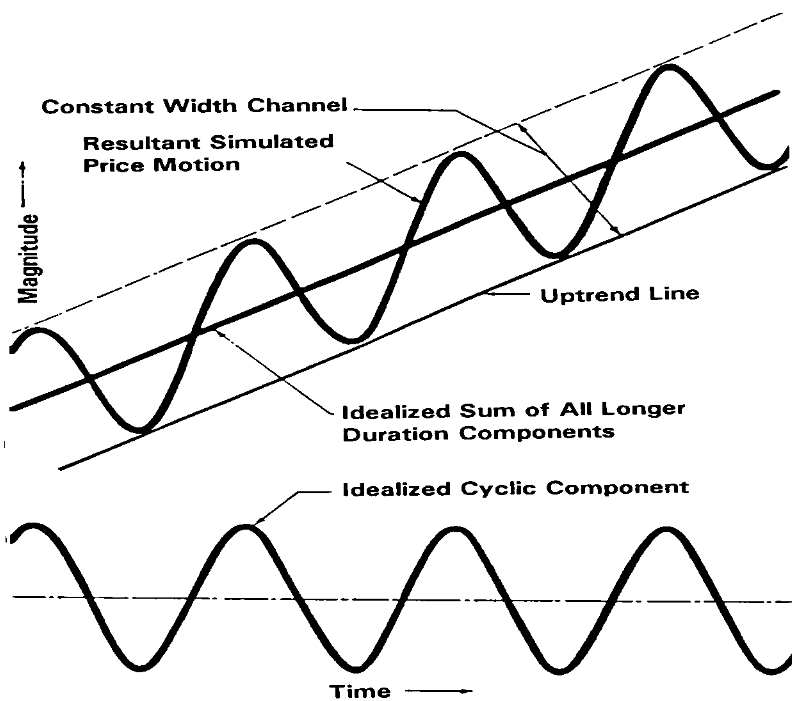



To measure a wave or a cycle one must have the right tools. If you are a doctor interested in measuring your patient's heartbeat, you use an EKG machine. An EKG is an oscillator. Oscillators measure fluctuating pulses, waves or cycles. Professional traders use oscillators to measure the various cycles to determine when to buy and when to sell. Ideally, we want to buy low when the market is oversold and we want to sell high when it is overbought. Later, I will share with you how best to measure cycles—but first, we should consider some other basics such as time and price.

### Time and Price

To measure various cycles, we must first appreciate the different ways to measure time and price, the two key components to determine the high and lows of a cycle. We measure time by years, quarters, months, weeks, days, hours and minutes. Time is measured by smaller and smaller periods.

As time divides, cycles divide into smaller time sequences. To be successful at trading, we must understand which time sequence we are dealing with in order to forecast which cycle will dominate the market.




Charts measure different time periods. A bar chart, for example measures the range, or the high and low of a certain time period. One bar line represents the range of price for a particular period. One vertical line on a bar chart might represent the prices of the highs, the lows and closes for a month, a week or a day. Herein lies the secret to measuring cycles. A different time period produces a different cycle. Starting with the big picture we can identify these various sub-cycles and how the correlated with one another.

**58.4 Years-The Yearly or Grand Super Cycle**

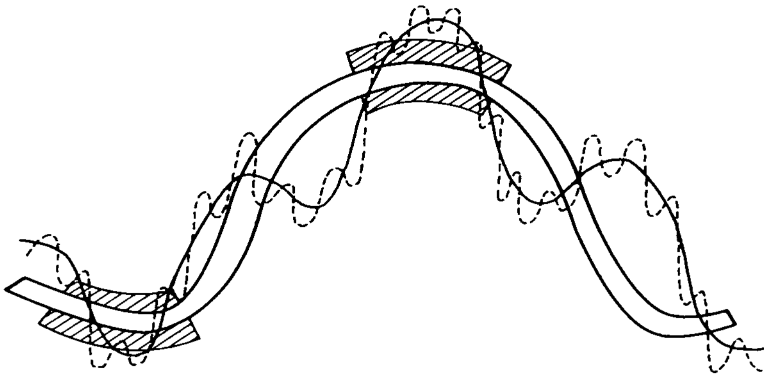
All cycles have a fundamental basis to them. The largest of these cycles is the Super Cycle lasting approximately 50 to 60 years, from trough to trough. Nicholai Kondratieff, an obscure Russian economist, first discovered the super cycle. He observed in 1926 that the United States had undergone three long economic waves, each lasting 50 to 54 years. Brown and Hopkins of the London School of Economics noted similar regular 50- to 52- year cycles of prices in the United Kingdom between 1271 and 1954. Kondratieff used wholesale prices as the focal point of his observations. He noted that each wave had three phases: an upward wave, lasting about 20 years; a transition or plateau period of 7 to 10 years; and a downward wave again of about 20 years. Kondratieff noted that each upward wave had rising prices, the plateau stable prices, and the downward wave declining prices. He also noted that a war was associated with both the beginning and the end of each upward wave.

In simple terms, this Super cycle is divided into separate stages between inflationary and disinflationary periods, each lasting between 20 to 30 years. The inflationary cycles are initiated by a major war, in which the government incurs horrendous levels of debt. Historically, the government simply prints more money to pay for these debts by sharply increasing the growth rate of the money supply and sustaining high levels for long periods of time, creating inflationary pressures that can last up to 20 years or longer if the debt is substantial enough.

When inflation becomes unbearable, the Federal Reserve begins to cool the economy down by initiating a series of severe recessions, followed by long periods of slow growth in the money supply. This is the disinflationary part of the cycle. For the last 20 years, under Paul Volcher's and Alan Greenspan's Federal Reserve administrations, the economy has been managed in a disinflationary environment. The price of gold, which was over $500 an ounce at one point in the early 80's, reached a low of $250 an ounce in early 2001. If we take government yield prices, which reflect the government's attempt to regulate the inflation/deflationary economy by raising and lowering interest rates back to the year 1727, there have been exactly four troughs or bottoms in the Super cycle: 1727, 1830, 1890, 1946 and with such low government yields, that we have now be close to the bottom for the fifth time. As we enter into a new world war with terrorist nations, it seems to follow that we could be seeing the end of the disinflationary environment as we begin a new inflationary economy.

## The 4-Year, Monthly, or Presidential Cycle

Subdividing the cycle period again to monthly data we see a 4-year cycle emerge. This has been called the Presidential Cycle. Just after a new president is elected, prices tend to fall for 18 to 24 months. In the remaining two years of a presidential term of office (beginning 4th quarter 2002), stocks tend to rally again right after the mid-term Congressional elections.



Keep in mind that while these cycles do tend to repeat themselves with a certain degree of periodicity, all cycles are dominated by fundamental events and circumstances. The presidential cycle is a dominant cycle that repeats itself with the election of a new president but each smaller sub-cycle is greatly influenced by the larger cycle in which it is subordinate too.

Much like the moon is subordinate to our earth, the earth subordinate to the sun, the sun and our solar system subordinate to our galaxy and so on. Being aware of each cycle period and how it might be influenced by the larger cycle is very useful anticipatory information regarding the markets.

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Each week I send out a market update to all my subscribers of Stealth Stocks. Before making any recommendations on which stocks to buy, I first outline what cycle we are in. I reference the charts so I can see the big picture and continually narrow my focus. Once a month I send all my subscribers a printed newsletter which takes into account not only cycles but a whole host of other factors which influence the market.

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