

ChartWorks

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Important Stock Market Change

The stock market plunge into the January washout was led by another failure in sub-prime mortgage bonds and accompanied by revelations about bad banking practices. That low was tested in March by more news about the consequences of reckless financial dealings – specifically the Bear Sterns disaster.

As the liquidity pressures concluded in January, our work suggested a general revival of the "good stuff" with grain and base metal prices rallying into March-April. Crude had a possible high in March or May. Corporate credit spreads were also likely to narrow into the potential seasonal reversal in May.

We have covered this in a timely manner in our regular publications and now Ross has built a thorough case for a significant change in the stock markets.

The overall point is – is the market up when it should be and is the Fed being applauded again? The answers are yes.

Our work in January discussed the 1930 rally into April of that year as an example of the initial rebound after the abrupt climax of a great financial mania. This was a near-term guide, that seemed to be supported by a longer term example. This was the 5-year bull market out of the post-1929 bear, which ran into the spring of 1937. This bull market has run five years. Both models have provided guidance, and on the bigger picture the key is pattern recognition and Ross features the salient points.

With the weak close on Friday, the DJIA clocked an outside reversal to the downside. In so many words, the index set a higher high than the week before and then set a lower low and a lower close – on the week. This doesn't happen very often, and the following focuses on the pattern. It should be reviewed keeping in mind that the worst of the sub-prime bonds have broken down and there are banking blunders that have been committed but not yet discovered.

Looking at history we find there are a limited number of occurrences of a similar setup to what we have now (*retracement rally to Std Dev Band, overbought Summation Index followed by outside reversal*). They are the weeks of Jan. 2, 1998; Nov. 2, 1973; June 10, 1960; Aug. 20, 1937 and June 10, 1930. Of all these examples only the 1998 occurrence failed to produce a sizeable correction. That means recent action is following a fairly reliable path to a significant decline.

- April 25th registered the first overbought in our Summation Index since last summer. Prices topped four weeks later (*similar to the other examples*).
- Test of upper standard deviation band May 19th.
- Non-confirmation between the Dow Industrials and the Dow Transports this month.
- Put/Call ratio into a level of complacency (*i.e. dangerous*).
- The Dow Industrials, S&P 500 and NASDAQ have established a reversal this week (*exceeding the previous week's high followed by a close below the previous week's low*).



The charts below show the 1973 and 1937 examples.

1973



1937





The Put/Call Ratio



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