

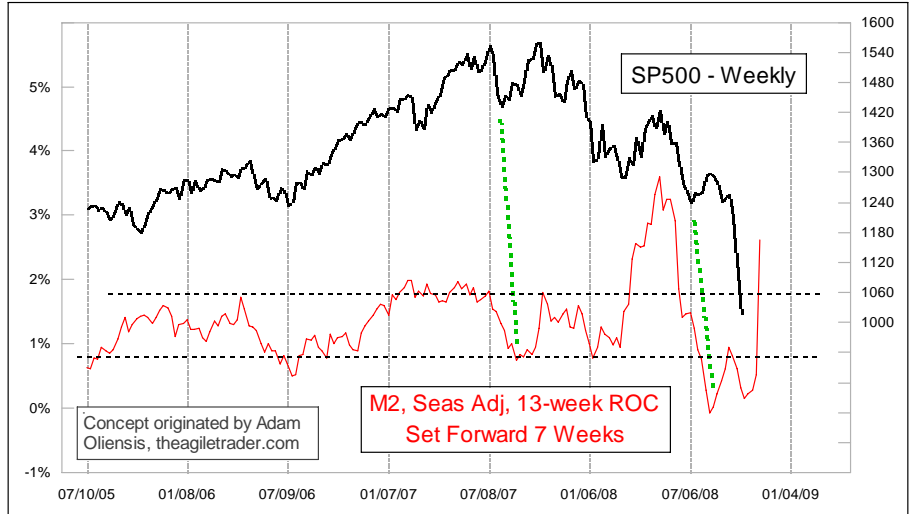
THE McCLELLAN MARKET REPORT

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Prepared After the Market Close, October 7, 2008 Report #324, October 8, 2008

Fed Using Fire Hose To Refill Liquidity Pool

The Federal Reserve has many levers of power at its disposal in order to ensure a liquid and efficient banking system, and it has been inventing a few new ones lately to try and solve the illiquidity problems that the Fed itself has created. You may recall that former Fed Chairman Greenspan got us on this roller coaster when he was fighting invisible inflation that was "over the horizon" back in 1999-2000. Then he responded to the collapse of the Internet bubble by lowering short term rates to 1%, and keeping them there for too long, thereby feeding the housing boom. Most recently, the Bernanke Fed failed to lower rates soon enough and fast enough in 2007, and has had to scramble to patch up the



damage this has caused.

One bit of recent scrambling has been to monkey around with the money supply. The top chart on page 1 shows a relationship first identified by Adam Oliensis, and it illustrates how the rate of change in M2 acts as a great leading indicator for stock prices. Adam uses an 8-week offset, and this one shows a 7-week offset. The point is the same either way.

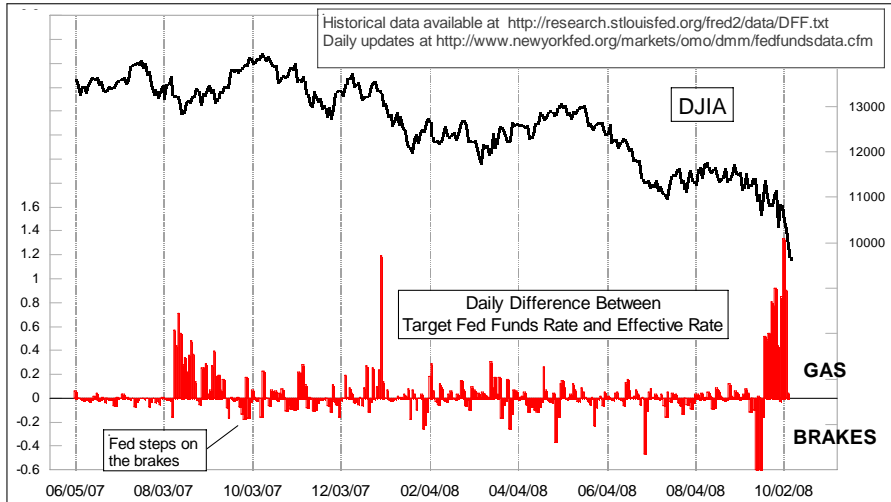
Back in March 2008, the Fed and the Treasury started boosting the money

supply to provide banks with liquidity, and the stock market followed the growth in M2 a few weeks later. But then the Fed yanked away the punch-bowl too quickly, and we saw M2 actually shrinking this summer, with predictable results. Now the latest efforts to buy commercial paper, to buy up distressed mortgage debt, etc. are bringing another surge in M2 growth, and it should begin to be felt very soon.

The Fed is also working to push liquidity into the banking system by

BOTTOM LINE

The old saying about politics and the press is that a politician should never get into an argument with any entity that buys ink by the barrel. Bears should keep that in mind, because the Fed has now fired up the printing presses and is back to printing money of all sorts to help rescue the strangling banking system. The Fed will win this battle, but we will not know for several months the real cost of that victory. Printing money to solve financial problems works in the short run, but that excess money soon finds its way into gold, and then into inflation about 14 months later. For now, know that the Fed has the printing presses going full blast at a time when the market is oversold to an historic degree. Look for a confusing bottom Oct. 13-16, and then a rally into the election. T-Bonds should give up their gains, won from the flight to quality. Gold should top Oct. 8-9, but then head higher again after a brief pause.



ignoring its own target rate for Fed Funds. The FOMC sets this target rate, and it is the task of the NY Fed's Domestic Trading Desk to add or subtract reserves in the overnight auction of loans among member banks in order to hit that target. The bars in this chart show when the target rate is over or under the effective rate. You can see at the left end of the chart that the Fed's efforts in August 2007 to add liquidity this way eventually helped push the stock market up out of that bottom, and toward a new high.

The Fed dropped the ball in mid-September, and allowed the effective rate to get all the way up to 2.80% (deep negative bars at the right end of the chart). Now the Fed is stomping on the gas again, and eventually this should have a similar outcome of pushing up stock prices.

The chart on page 2 portrays these bars on a cumulative basis, like a cumulative A-D Line. Pushing the effective Fed Funds rate down below the target causes this line to rise. We are now witnessing the 4th episode of such action since the Fed changed to targeting the Fed Funds rate as its mechanism for executing monetary policy.

This big upsurge should be expected to bring a similar upsurge for stock prices, as all of that excess money eventually finds a home in stocks. One big problem for the longer term is that after each of the prior 3 episodes, the DJIA has eventually seen a lower low. Three episodes is not a very big sample size, and maybe this time it will be different. For now, however, we should count on a very robust bounce as all this new money goes to work.

Bottom Line: The Fed is trying to print its way out of the liquidity problems by throwing money at the banking system, and that strategy will ultimately work to push stock prices up over the next few weeks. Whether it creates other problems for 2009 remains to be seen.

Page 3 Charts

Chart 1: The A-D Line has accelerated its move down across the page following the passage of the \$700 Billion rescue bill into law. The wider recognition of the liquidity problems and the inherent delays in any government implementation of the rescue package left those needing immediate liquidity the choice of selling into the only liquid market in town. Willing buyers could only be found at lower prices.

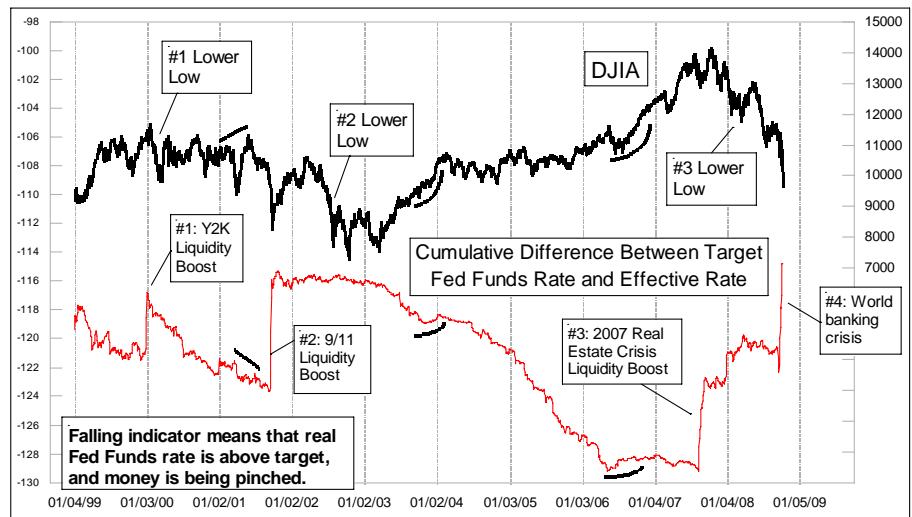


Chart 2: The Daily Volume Line appeared to be holding up very close to the vicinity of the July low. That support was violently broken in the first two days of this week. There is room now for this indicator to try to snap back up toward the July and September lows. The Volume Line is so far below its 1% Trend that a counter trend rally can begin at any time. It is almost back down to the highs that it made at the 2000 top. And it is so far down that even a really robust rally could turn out to be just a countertrend up move within a larger downtrend. But such a rally would still be worth chasing.

Chart 3: The McClellan A-D Summation Index accelerated after going down through zero, it accelerated after going down through -1000 and again today in going down through -2000. The issue to be decided by this indicator is whether it will reverse before reaching the level it saw at the July bottom, creating a somewhat bullish divergence, or whether it will make a more bearish lower low. With the Oscillator currently at -328, the Summation Index is falling fast, and it will take strong breadth numbers just to put on the brakes for this Summation decline.

Chart 4: The Volume Summation moved decisively below its Sep. 15 low in this week's selloff. It left a double top below zero that was similar to the structure preceding the selloff into the January low. Once this indicator reverses direction, there should be a significant price bounce. But so long as this indicator is heading south, lower price lows are still possible.

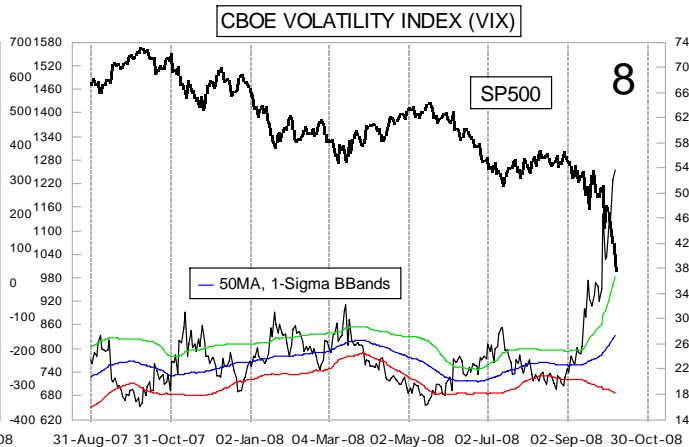
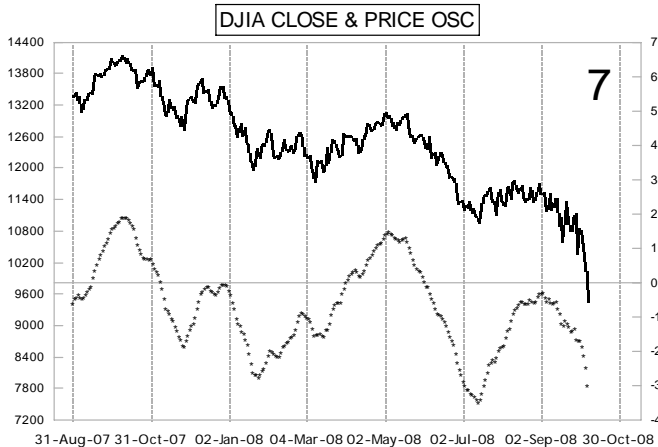
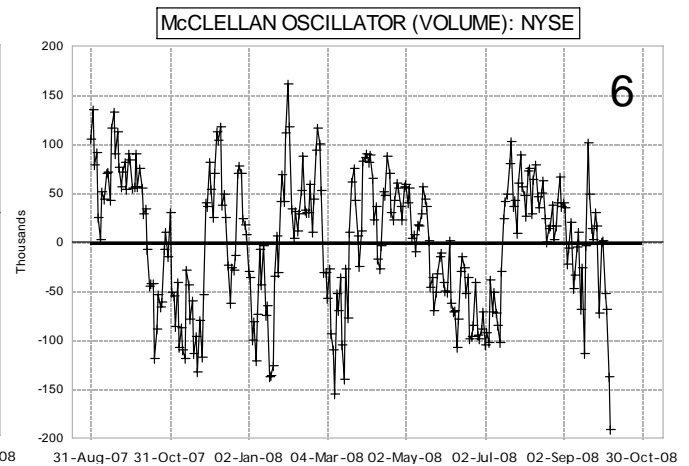
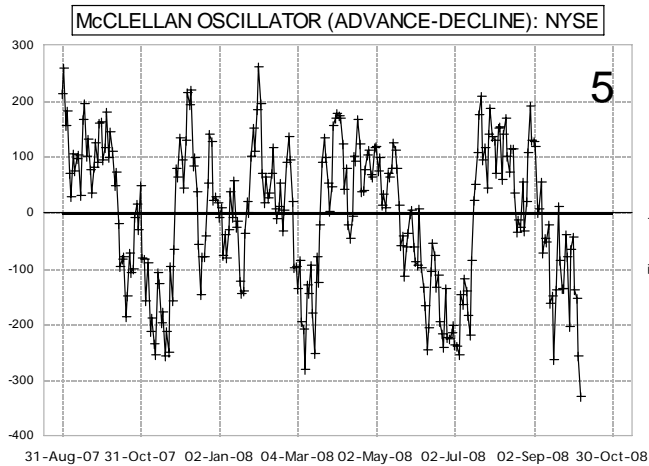
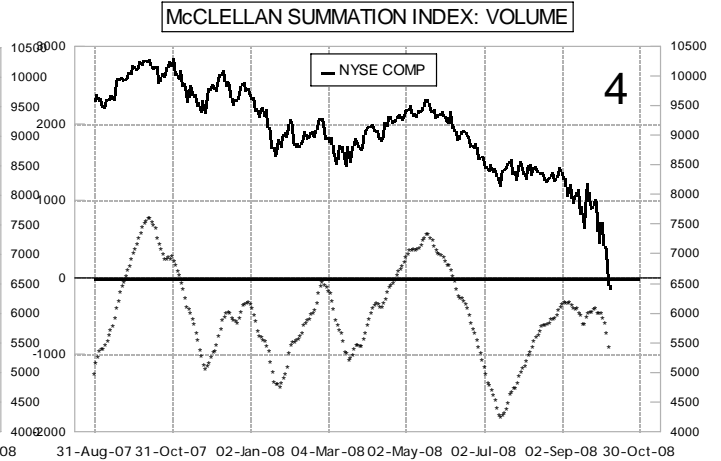
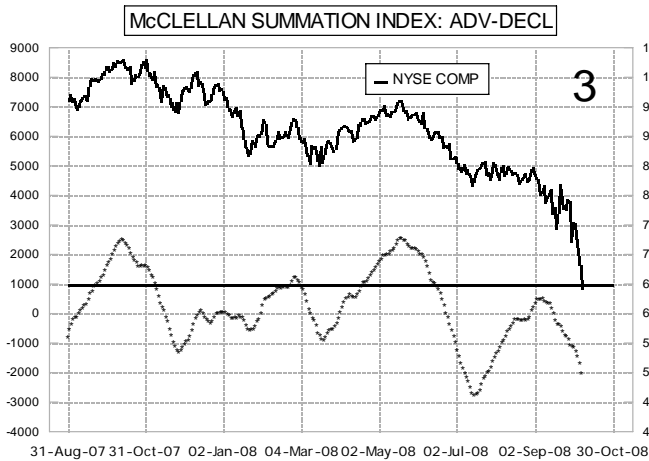
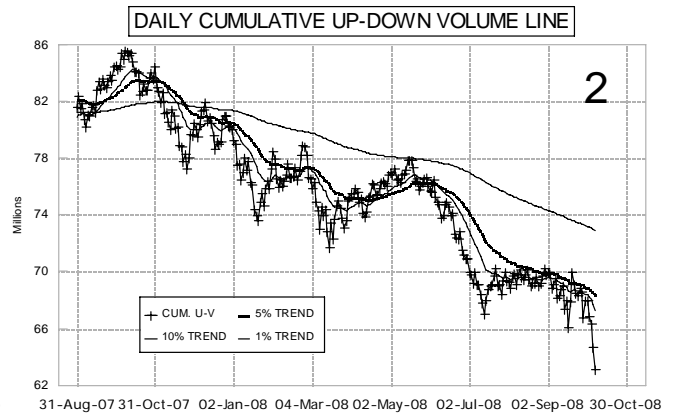
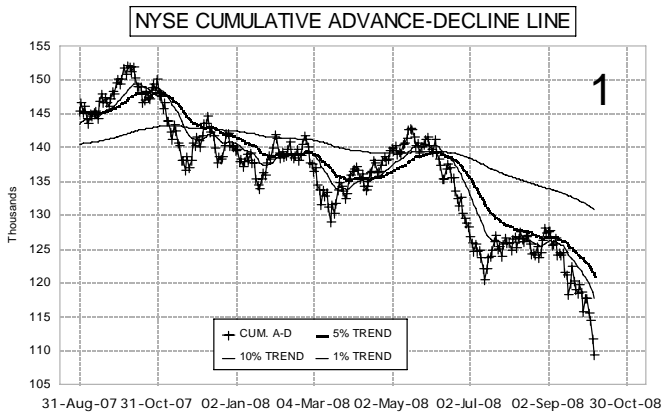
Chart 5: The McClellan Oscillator was pushed down to -328.5, almost as low as the -344.3 reading seen on July 27,

2007, just off the left of the chart. That July 2007 low was followed by the Fed stomping on the gas, helping provide money to lift the market out of an over-sold condition just like they are doing now. Whether this current effort brings a rally lasting more than 2-3 months remains to be seen.

Chart 6: The Volume Oscillator has made its lowest posting since the July 2007 low. If we adjust for the changing amounts of NYSE volume, the Ratio-Adjusted Volume Oscillator (not shown) is almost equal to its July 2007 low. This all confirms the torrid wash-out indications seen in so many indicators, and it will prove to be associated with a very important market bottom.

Chart 7: The DJIA Price Oscillator is showing the largest separation of postings on the chart with the October 7 posting of -312.3, which was 55.3 lower than the previous day. It is now clear that the small bumps up during the latest move down were fishhook structures that result in very fast moves in the opposite direction. It will be hard to stop this indicator before it gets to the level of its July 15, 2008 low of -359.8. Only an extreme, exhaustive selloff can produce these sorts of readings.

Chart 8: The CBOE Volatility Index (VIX) has exploded higher requiring rescaling the chart. Its posting of 53.68 was its highest for the move. But its intraday high of 54.19 was lower than the 58.24 posting on the previous day. There are times when the highest spike occurs at the price low and other times when lower price lows are possible as the index bounces up while above its upper band. This indicator will confirm the beginning of a higher price move upon dropping below its upper band.

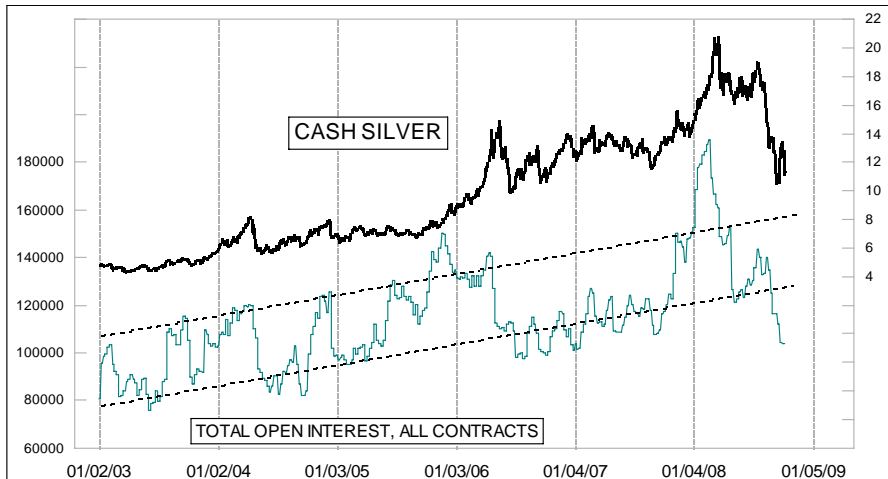
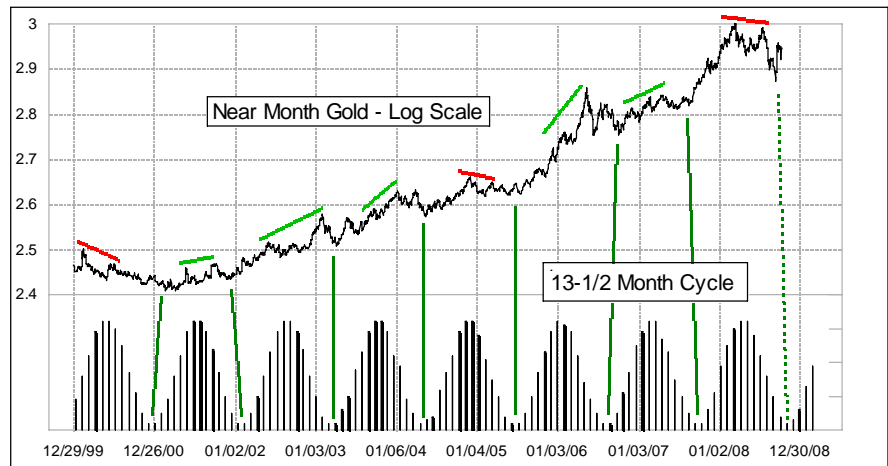


New Cyclic Up Phase for Gold

The 13-1/2 month cycle in gold prices has been calling for a bottom near the end of 2008, and that bottom appears to have come in just a little bit ahead of schedule. Such variation is not unusual for this or any other cycle in the financial markets. We are inferring that this cycle bottom has been put in by virtue of the fact that a seemingly important bottom has appeared in proximity to when this cycle low was due, and a strong upward initiation has taken place as is normal for the commencement of the upward phase of this cycle.

While we are on the topic of this cycle, there is an important aspect to its analysis which will be useful a few months from now, and which is indicated by the red and green divergence or confirmation marks on the gold price plot. Those are meant to indicate that when a price high occurs early in this cycle, it is bad news for gold prices and a lower price low should be seen at the 13-1/2 month cycle low. A high which arrives late in the cycle, known as "right translation", is a bullish piece of information which implies continuing strength for gold prices. That is not an important factor right now, but it will be important in the coming months as we see whether gold tops early, or instead continues trending higher.

The middle chart implies that we are on the cusp of an important rally for the precious metals. Futures traders have been scared out of the silver market by the recent liquidity crisis, resulting in a very low level of total open interest in silver futures. Over the last several years, total open interest has been in a

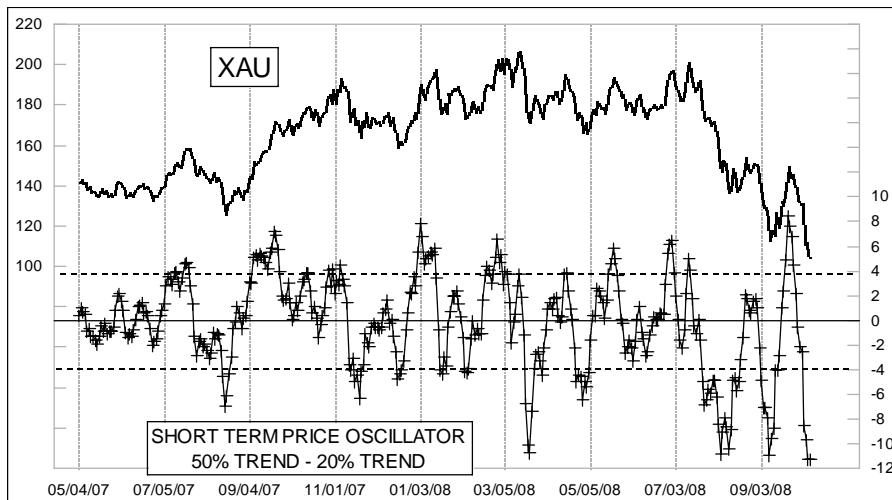


rising trend channel, with excursions outside of that channel marking important highs and lows for silver prices. This current excursion below the lower channel line is the biggest deviation outside of "normal" bounds that we have seen in years, and it means that we are either at an important bottom for silver prices, or else the whole model of how this works is changing in a dramatic new way. For now, it seems most likely that we are seeing a great over-

sold opportunity for this, the most speculative of the precious metals. Unfortunately for shareholders of mining companies, the rally in gold has thus far been no help to the gold mining stocks. The XAU and GDM Indices have plunged to new multi-year lows as stock investors have sold anything they could in the face of the credit crisis. In other words, this decline in the mining stocks is not something which is explainable by the movements of gold prices, and for that reason it is a down move that is likely to be quickly adjusted to get these mining stocks back in line with where gold is.

The lower chart shows the Short Term Price Oscillator for the XAU, and it is down to its lowest level in years. Even if gold stocks don't start an uptrend, they should at the very least see a robust bounce just to work off this oversold condition.

Bottom Line: Gold appears to have made an important cycle bottom and started upward. Gold stocks are lagging behind, which means that they should zoom upward quickly like a slingshot once the credit crisis abates.

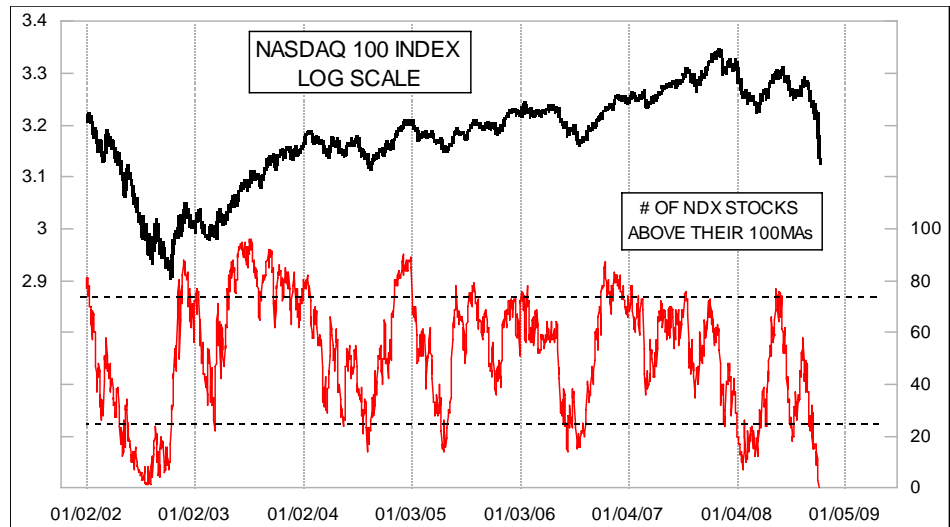


No Doubt It's A Major Bottom

We hate reruns generally, but we had to show this chart again. We showed the top chart on page 5 in the same place in our last Report, calling attention to what was then a very oversold reading indicative of a major bottom being formed. Since then, it has gone all the way to zero, which means that not a single component of the Nasdaq 100 Index is currently above its own 100-day simple moving average.

It takes a lot of energy to achieve such a level of unanimity, either positive or negative, and the exhaustion of so much energy sets up a condition where prices can bounce back really fast.

We have gathered the price data on



the NDX stocks needed to construct this indicator going back as far as 1993, and in that time this is the first time it has ever gone to zero. It got down to 1 a couple of times, once at the July 2002 bottom seen at the left end of the screen, and also in the days just after the 9/11 attacks. In each case, there was a strong rally in the Nasdaq 100, even though it did not ultimately lead to a sustained uptrend. We should expect no less this time.

But at hypersold conditions like this, and like the -312 reading seen on Sep. 21, 2001, the selling can all get washed out at once, and the rebound can start before you know it. Given the nature of this oversold condition, once the Fed's money boosting actions get traction, it will not be surprising to see the DJIA shoot up 500 points a day for a couple of days or more, so be ready for the whiplash.

A similar oversold condition exists for the overall Nasdaq market. The chart below shows the raw McClellan A-D Oscillator for the overall Nasdaq market. It got down to -297 on Oct. 7, which is the lowest reading we have seen since the days just after the 9/11 attacks. It is even lower than the worst readings seen at the bottoms in 2002.

On a separate note, we put NYSE McClellan Oscillator data our web site, for free at the Data page. McClellan Oscillator values for the Nasdaq and the Nasdaq 100 stocks are included in a big table of data in our *Daily Edition*, which is available by separate subscription. We also include the value for the Nasdaq 100 indicator in the chart above, plus several others of value. And we wrap up each day's analysis with our "Current Opinions" for stocks, bonds, and gold. You can see examples of our *Daily Edition* and sign up for a subscription by visiting our web site.

Ordinarily, an oversold reading on this or other A-D Oscillator is not necessarily a mark of the final bottom. Often, a bit more declining work is needed to put in a divergent condition between prices and other indicators.



Sherman McClellan
Publisher

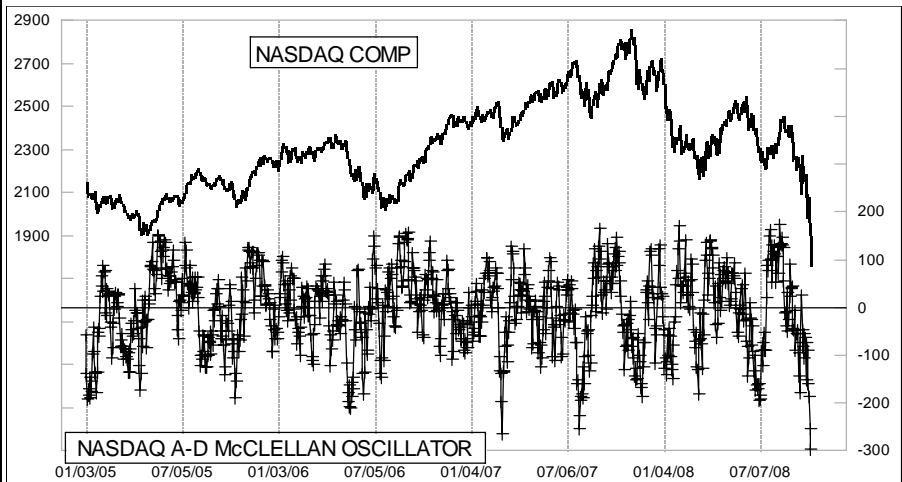
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TIMING MODELS

| Stock Indices (DJIA, SPX, Nasdaq, NYSE Comp., etc.) | | | | Bond Market (Corporate & Treasuries) | | | | |
|---|---------------|-------------------------|------------------|--------------------------------------|---------------|-------------------------|---------------|--------|
| SIGNAL | SOURCE | PREDICTED | ACTUAL | SIGNAL | SOURCE | PREDICTED | ACTUAL | |
| | Top | Nasdaq A-D Osc | Sep 25 | Sep 26 | C Top | T-Bond Stochastic | Sep 29 | Sep 29 |
| C | Bottom | Nasdaq Up-Dn Osc | Sep 29 | Sep 29 | Bottom | T-Bond Stochastic | Oct 24 | |
| C | Bottom | Nasdaq A-D Osc | Sep 29 | Sep 29 | Bottom | T-Bond ST Price Osc | Oct 27 | |
| C | Bottom | DJIA Close/Sum | Sep 30 | Sep 29 | Bottom | T-Bond Price Osc | Nov 17 | |
| C | Bottom | Uncommon A-D Osc | Sep 30 | Sep 29 | | | | |
| | Top | DJIA ST Price Osc | Oct 1 | Sep 30 | | | | |
| | Bottom | SP500 Close/Sum | Oct 2 | --- | | | | |
| | Top | SP500 Close/Sum | Oct 9 | | | | | |
| | Bottom | NYSE Volume Osc | Oct 10 | | | | | |
| D | Bottom | NDX A-D Osc | Oct 13 | | | | | |
| | Top | Uncommon A-D Osc | Oct 15 | | | | | |
| | Top | SP500 ST Price Osc | Oct 15 | | | | | |
| D | Bottom | Nasdaq Price Osc | Oct 13-16 | | | | | |
| D | Bottom | Nasdaq A-D Osc | Oct 16 | | | | | |
| | Top | DJIA ST Price Osc | Oct 30 | | | | | |
| | Top | Nasdaq A-D Osc | Nov 5 | | | | | |

| Gold and Precious Metals Stocks | | | | |
|---------------------------------|--------|-----------------------|-----------|-------|
| SIGNAL | SOURCE | PREDICTED | ACTUAL | |
| | Bottom | XAU ST Price Osc | Sep 23 | --- |
| | Bottom | Gold ST Price Osc | Oct 2 | Oct 3 |
| | Bottom | Gold Up-Dn Osc | Oct 2 | Oct 3 |
| | Top | Gold Close/Sum | Oct 8 | |
| | Top | XAU Up-Dn Osc | Oct 9 | |
| | Top | [Dollar Index Bottom] | Oct 14 | |
| | Bottom | Gold Price Osc | Oct 23-24 | |
| | Top | Gold ST Price Osc | Oct 31 | |
| | Top | Gold ST Price Osc | Nov 26 | |

The Signals

The stock market bottom that was suggested by cluster C (Sep. 29-30) surely did come in as scheduled, but that was not enough to stop the overall decline. All it did was cause a 777 point crash day for the DJIA, and then a one-day relief rally before further selling came in.

That same action also helped to fulfill the T-Bond top that was due Sep. 29, which we had previously included into the "cluster C" group of signals. T-Bonds have now stopped displaying independent behavior, and appear to be just doing the mirror image of whatever happens in the stock market. That means "flight to quality" on down days for stocks, and panic selling of T-Bonds on up days for stocks. Given the huge price volatility in long-term T-Bonds, it is little wonder that bond players are foregoing the 4% yield on the 30-year T-Bonds and are hiding in the 1 to 3 month paper, where they get no yield but at least they don't get seasick.

We have been looking ahead for the

last few weeks to the next cluster of signals labeled cluster D, due Oct. 13-16. It appears that the fortitude of this cluster may now be more in doubt because of the arrival of two subsequent signals calling for a top Oct. 15. It is hard to know what this might mean. It could be that recent interventions by the Fed have disrupted the flows of liquidity, and upset the ripples in the liquidity stream which generate these signals. So the forces which might previously have brought about that Oct. 13-16 bottom are being met by new forces resulting from the various interventions. These opposing forces may cancel each other out, or may cause a lot of volatility like protons being smashed against each other in CERN's Large Hadron Collider.

Gold made the bottom which was scheduled for Oct. 2 one day late, but saw a big jump as traders decided that gold was now part of the "flight to quality". It made that jump in spite of the dollar continuing to be strong..

What To Expect

Stocks show a picture that is now less clear, as the bottom due Oct. 13-16 has two top signals due Oct. 15 coming right in the middle of that time window. It is important to remember that these signals detect the ripples in the liquidity stream, and those effects can get overcome when the Fed is using a fire hose to reliquify the markets.

T-Bonds are now doing functionally the opposite of whatever stock prices do, so making independent interpretations is not helpful right now. Bonds will start marching to their own drummer again someday, perhaps later this month. Look for T-Bonds to make a bottom Oct. 24-27, and perhaps cause a stock top then in sympathy.

Gold's bounce should see a top Oct. 8-9, then another top Oct. 14 before we see prices move sideways toward a bottom due Oct. 23-24. That Oct. 23-24 bottom will likely be tied to the T-Bond bottom due Oct. 24-27.

HOW THEY WORK

These timing models are based on our proprietary calculation method. This technique involves a computationally complex comparison of two or more carefully selected indicator values. This yields the date and direction of a projected future turning point. Making several such comparisons can help paint a picture, one reversal point at a time, of the future structure.

Once generated, signals remain in effect, though the result can have greater or lesser significance based on what the market is doing when the date arrives. Certain indicators are slightly less accurate in pinpointing the exact date, so we may print a range of dates. Price Oscillators and Summation Index signals are usually more important, though sometimes not as precise in time. Uncommon A-D refers to an oscillator derived from NYSE stocks that are not part of the Common Only list in Barron's. Dates in bold denote signals of greater potential strength according to our research.

These models do not catch every market turn, but the signals usually show some effect in the market action. It is important to understand that the market does not have to go up from a bottom; it may just stop going down. It does not have to go down from a top, it may just stop going up. Some bottoms turn out to be just a flat spot before a continuation up.

"Actual" dates listed for NYSE Indices are for the NYSE Comp/Dow Jones Industrial Average. Letter groups denote clusters of signals. ST Prc Osc means "Short Term Price Oscillator."

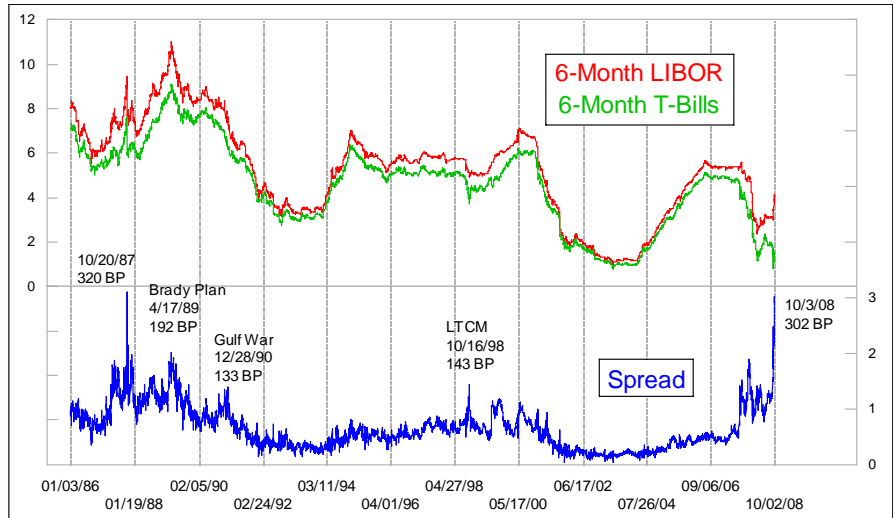
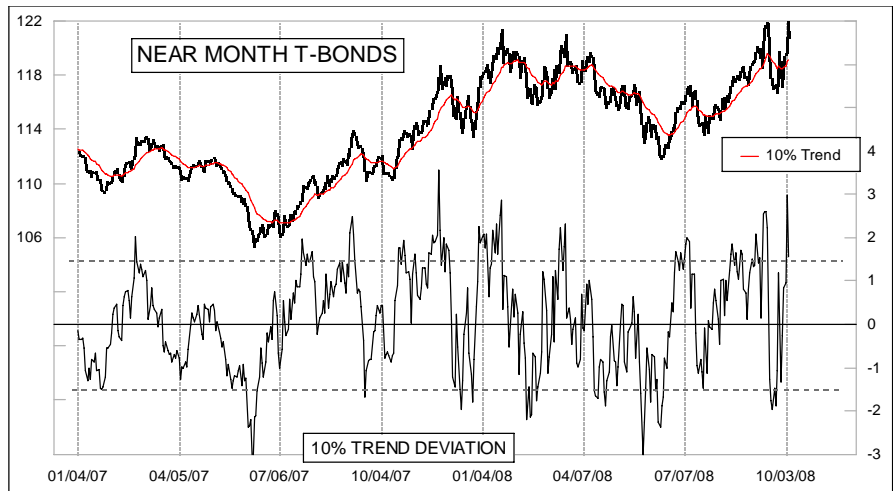
Past performance of these mathematically generated turning point projections in no way guarantees future results. These dates may be useful in planning for the future, or giving greater confidence at turning points. **We would not, however, attempt to trade any of the markets based solely on these models.**

T-Bonds Are Mirror Of Stock Carnage

We showed the top chart in our last Report to convey the message that the uptrend in T-Bonds had finally broken, and that the initial downward surge had taken T-Bonds to an oversold condition. Since then, bonds have prospered again in proportion to the damage to stock prices. T-Bonds of all stripes have benefited from the “flight to quality” trade, taking the December T-Bond contract back up to revisit its Sep. 17 high.

But flight to quality is a double-edged sword, for as the panic into the stock market bottom giveth to T-Bonds, the rapid rise out of an oversold stock market bottom taketh away from T-Bonds as investors sell out of “quality” to fund their purchases into the rebounding stock market. Bond market players should fully expect the low long term bond yields to go the way of the dodo bird very soon, once the Fed’s fire hose approach starts to get some traction.

At the shorter end of the yield curve, there is a similar flight to quality that is making traders feel compelled to accept close to zero percent yields on short term Treasury debt, even as yields go up on other paper formerly thought of as being of high quality. The middle chart is inspired by one recently created by Ron Griess, of thechartstore.com. It looks at the yields on both 6-month LIBOR (London Interbank Offered Rate) and 6-month T-Bills, along with the spread between those two rates. The spread tends to spike up to a high level at times of financial crises. We have labeled a few of these on the chart. The Brady Plan in 1989 refers to a bail-out plan for Mexican debt, for those



whose memories don’t go back that far.

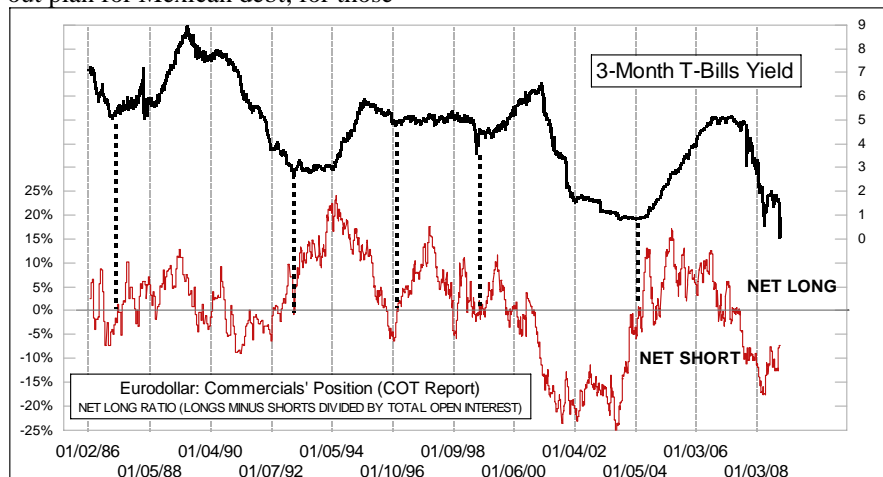
In each of these cases, what followed was a narrowing of the spread, and a rally for stock prices. There are two ways for a spread to narrow: either the LIBOR can come down, or T-Bill yields can go up. Since T-Bill yields are already on the floor, and since the LIBOR is unlikely to get down that low, the more likely outcome is for T-Bill

yields to work their way back up toward where other yields are.

We may not yet be quite at the point when short term rates start rising. The bottom chart shows the commercial traders’ net position in eurodollar futures contracts. Right now, they are still net short, betting on falling rates, but they have moved up toward neutral from the biggest net short position they had earlier this year.

The dashed vertical lines highlight the way that the commercials seem to mark a bottom for short term rates. Important bottoms for the 3-month T-Bill yield tend to arrive just as the commercials are moving from net short to net long, especially when there has been a long decline in yields. The commercials are still a while away from getting to neutral, but they are heading in that direction.

Bottom Line: Long term T-Bonds are back up to overbought, just as stock prices are really oversold. The squeeze that has forced traders into short term Treasuries should unwind very soon.

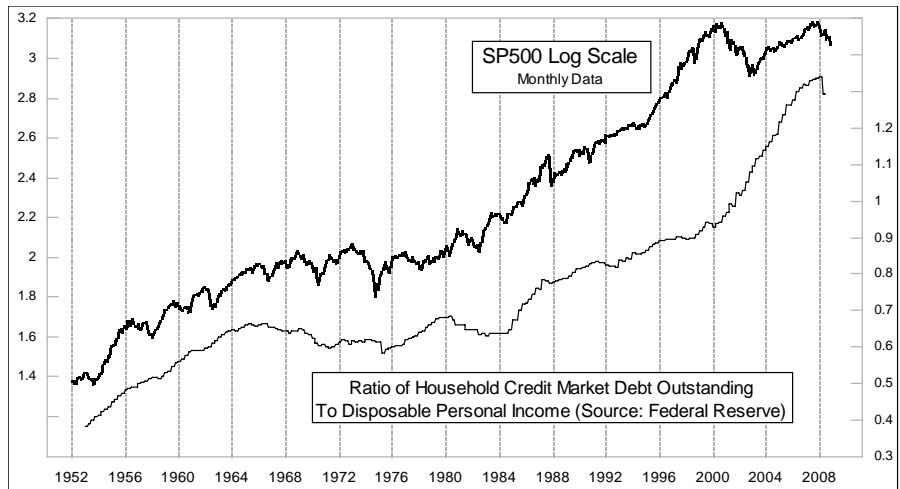


Consumer Debt Is What Killed Stock Market

If you ask just about any classically trained economist, he would tell you that the U.S. has a problem due to our low savings rate. While that may be true (or not, depending on how one measures), the more interesting point is that the strength of our economy and our stock market over the past 20+ years has come from Americans' willingness to increase their debt levels.

The top chart on page 8 shows an indicator we calculate based on two separate sets of data published by the St. Louis Fed. It shows that on average, the amount of household debt exceeds annual income by quite a bit.

This is not a problem for the stock market until consumers decide to change their behavior, something that they did earlier this year. The data for the 2nd quarter showed that total household debt still rose, but not nearly as fast as disposable income. That resulted



in the first quarterly drop for this ratio since the 1st quarter of 2002.

History shows that the stock market can undergo a meaningful decline even without consumers scaling back on their debt. But it is an absolute rule that if consumers reign in their expansion of debt, it will hurt the stock market, and we are seeing a great example of that right now. Remember also that this

change in consumer behavior arose before all of this discussion about commercial paper and credit market tightness. When people are willing and able to start going more into debt again, stocks will recover.

Stocks' Weakness Is Bad for McCain

The middle chart on page 8 updates one that we have shown previously. In the 2000 and 2004 elections, the movements of the DJIA served as a great leading indicator for the poll numbers of the incumbent party candidate, and this same dynamic is working again this year. The DJIA plot in this chart is offset forward by 8 trading days to reveal how the poll numbers match those moves.

Right now, Sen. McCain is the incumbent party candidate, and he is seeing his poll numbers suffer with each decline in the stock market. The continued plunge so far this month says that the worst is not over yet for McCain. There may still be time for McCain's fortunes to turn around in time for the election, provided that stock prices turn up strongly and soon.

Poll numbers aside, a down stock market during an election year has long meant trouble for the incumbent party. A great example of this is the election in 1960, when John F. Kennedy defeated then-VP Nixon. The stock market had been in decline for the first 10 months of 1960, and that helped to sway voters' opinions away from the incumbent party candidate.

The bottom chart compares the current market to 1960, and it is a pretty decent comparison. Worth noting is the steep advance out of the October 1960 lows, and advance which came too late to help Nixon.

