THE McCLELLAN MARKET REPORT

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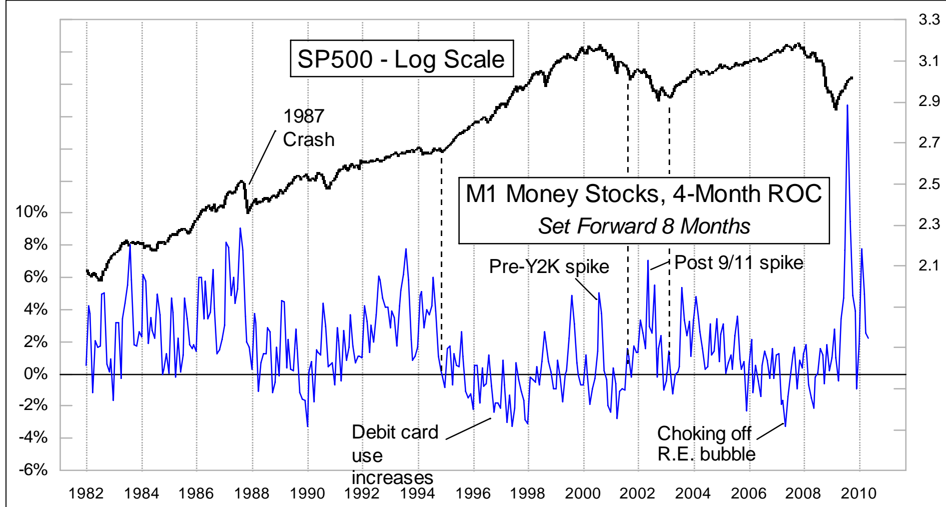
Prepared After the Market Close, October 13, 2009 Report #348, October 14, 2009

Market Remains Strong Despite Bumpy M1 Growth



Several weeks ago, we looked ahead using the leading indication from M1 growth shown in the first chart and foresaw problems for the market in September and October. What we saw was that the 4-month growth rate in M1 had spiked up in a huge way at the end of 2008, and then the Fed slammed on the brakes a bit too rapidly, causing money supply growth to come to a screeching halt.

Previously, that sort of behavior had caused big problems for the stock market. Most notably, a similar M1 growth spike and drop pattern in late 1986 had correctly forecasted the illiquidity that led to the October 1987 crash. Other spikes and drops in 2000 and 2001 led to their own illiquidity events in the stock market. So it was with good historical basis that we expected we should see a similar illiquidity event in 2009 because of the turbulence in the money supply.

Instead, the stock market remains in a strong and steady uptrend, and as we discuss elsewhere in this issue it seems poised to continue that behavior. So what was different this time?

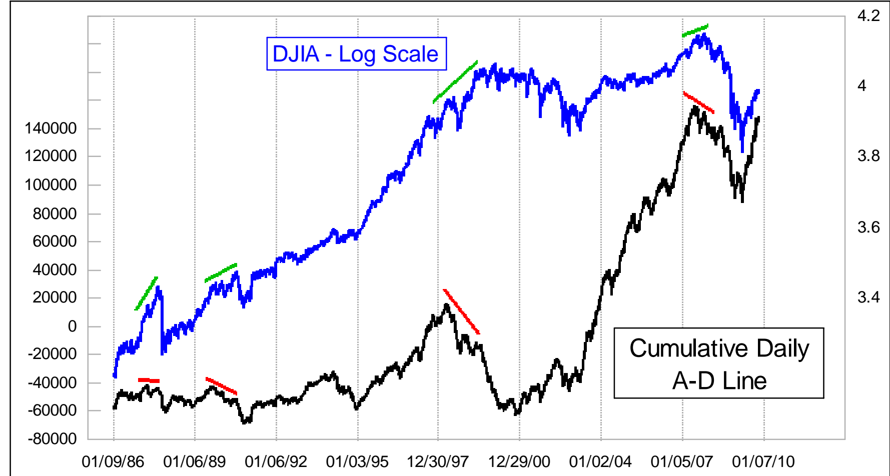
The best answer is that liquidity has remained strong, and appears to be springing forth from other sources than the M1 growth stream. The best measure of healthy or weak liquidity is the NYSE's A-D Line, and it is rising as steeply as we have ever seen.

The lower chart on page 1 takes a long look at this indicator (which can be seen in greater detail in Chart 1 on page 3). When there are divergences between stock prices and the A-D Line, it tells us that there is a big problem with liquidity. That was the case back in 1987, and also at other times when the market got into real trouble.

With no divergence now, the market is in a position of greater strength,

BOTTOM LINE

Cutting rates to zero and printing money like crazy are working to lift the stock market. Eventually, those factors will lead to price inflation, but we are not seeing that yet. Instead, leading indicators point to continued low short term interest rates until at least late 2010. Right now, stocks are still trending higher, and could do so through November. December could see a stumble; we'll know more as it gets closer. Gold should definitely see a stumble into a major cycle low due in December. Right now, gold prices are getting overbought, and likely to see an end to the blowoff up move around Oct. 19. That date should also see a brief top for the stock market, although not an end to the uptrend.



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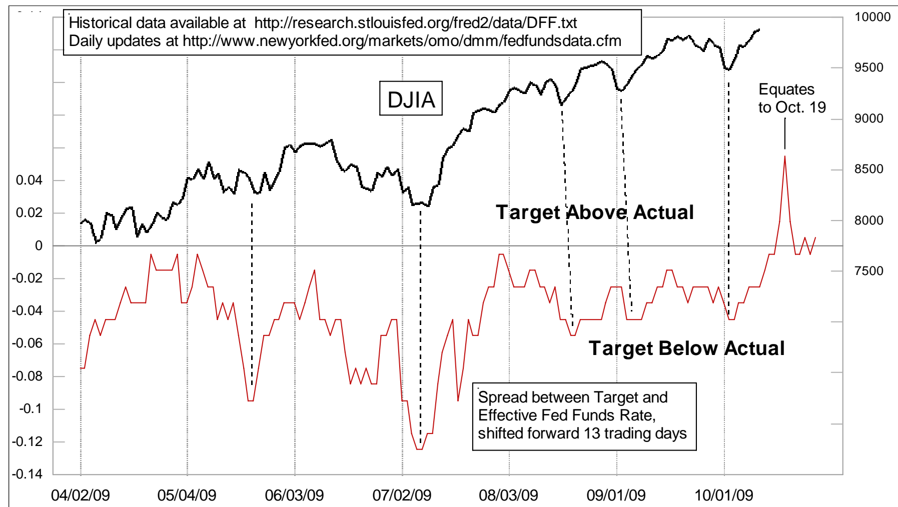
greater liquidity, and so the effects of that stumble in M1 growth late last year do not seem to matter.

A steeply rising A-D Line is a big indicator of healthy liquidity, and it is usually followed by a long period of rising stock prices. There can be minor bumps and corrections along the way, but we should assume that there are still higher highs ahead for quite a while until we start to see a fall off in the ascent angle of the A-D Line.

Looking at the shorter term picture, the incremental driver of stock market liquidity continues to be what the NY Fed is doing in the overnight auction of bank reserves known as Fed Funds. The FOMC sets the "target" rate for those exchanges of excess reserves among the Fed's member banks, but the actual or "effective" rate is the product of an auction process. The NY Fed's Domestic Trading Desk is supposed to act like a market maker, adding or withdrawing reserves so that the effective rate is close to the FOMC's target.

This chart shows the spread between the target rate and the actual rate, shifted forward by 13 trading days to show how it has been leading stock price movements. It has not always worked this way, but it is working nicely right now. It will be particularly interesting to see how prices behave after we pass that Oct. 19 top target. We do not have a particularly good confirmation of that date from our Timing Models (see page 6) as an important top date.

Bottom Line: Liquidity from whatever source is flooding into the market right now, and that should bring a continued uptrend for several more months. We should see a brief top between now and around Oct. 19, something which should be only a temporary interruption.



Page 3 Charts

Chart 1: The A-D Line continues into new recovery highs and is now only 7948 net advances away from the all time high of 157028 on our arbitrary scale on the left side of the chart. The A-D Line has had 61425 net advances through October 12 from the March 9 low. This is an amazingly steep and impressive advance, an average of 401 net advances per trading day, and is a testament to the unprecedented liquidity pumped into the economic system by the Fed, the US Treasury, and foreign central banks.

Chart 2: The Daily Volume Line has not been as enthusiastic as the A-D Line. It has only recovered 66% of the decline from the June 4, 2007 high to the March 9, 2009 low. So far in October it has not made a new recovery high, putting in a divergence with prices and the A-D Line's higher high. The first divergence in June led to further consolidation culminating with the July low. Of course a further advance over the next week could still take the Volume Line to a new recovery high removing the divergence.

Chart 3: The McClellan A-D Summation Index made its high of +5600 on September 22 and has been forming a horizontal ledge near +4500 while stock prices have made marginally higher highs. We like to say that ledges are made to fall off of, and the Summation has already broken to the right of an uptrend line that can be drawn across the March and July bottoms. This is demonstrating the loss of upward momentum for the advance off the March low. It is important to note that seeing a reduction in upward acceleration can just mean a slower pace of continuing advance. Crashes do not arise from such a strong Summation Index condition.

Chart 4: The Volume Summation is also showing only a horizontal move rather than an actual advance as prices make marginally higher highs. A similar situation can be seen at the June price high. The Volume Summation has also broken an uptrend line that can be drawn across its March and July lows. This is not indicative of a major top, just an expected normal development following a rally as powerful as the one since the March low.

Chart 5: The McClellan Oscillator showed only a brief 3 days barely above zero before dropping back below zero. The three lower lows and now the simple zero crossing above and back down through zero warn that the bulls are running out of fuel. This could lead to a little longer term price consolidation.

Chart 6: The Volume Oscillator only managed a weak one day above zero**.** It also shows the three lower lows that can be seen on the A-D Oscillator. Should this Oscillator remain below zero, that will pull the Summation lower. That would pull prices lower. But sometimes it takes more than just one crossing through zero to get all the bullishness worked off.

Chart 7: The DJIA Price Oscillator is showing a bumpy down move following a smooth move up off the July low. This gives the expectation that once this indicator gets fully consolidated and back down to a neutral level, then the next advance should be reasonably powerful. This is not unexpected following one of the handful of highest Price Oscillator highs ever seen following the rally off the July low. Bumpiness implies weakness for the side on which it forms, so a bumpy down move means that the bears are weak and disorganized, while the smooth bulls are still in control of the larger picture.

Chart 8: The CBOE Volatility Index (VIX) bumped up above the upper band twice to mark the early September and October lows. Now it is back below the lower band and this could mark a price top, if it quickly moves back up above the lower band, or it could identify a continuing uptrend in prices by staying below the lower band for an extended time. A crossing above the 50-day MA (currently at 25.15) would be a sign of a change in trend direction for stock prices

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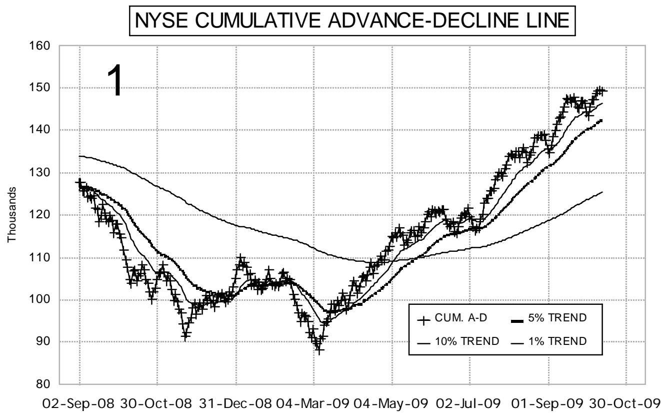

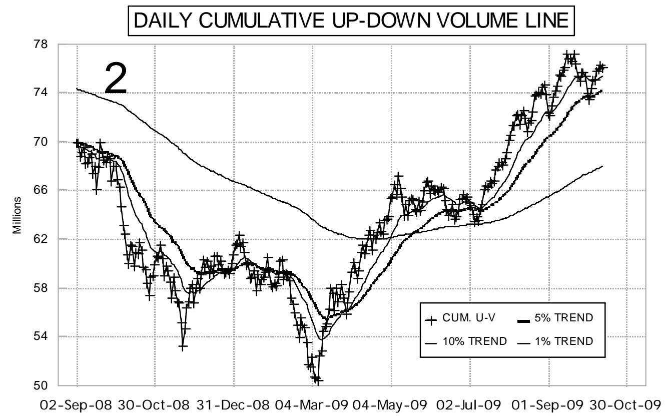

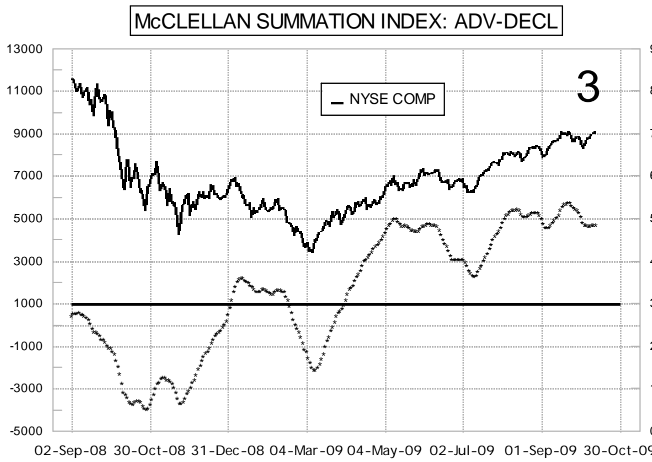

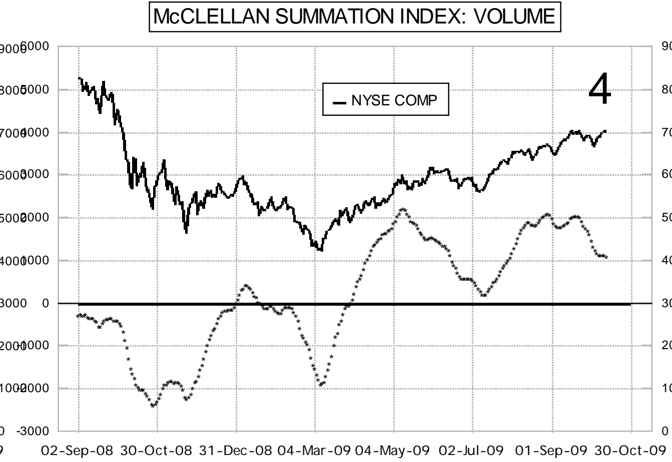

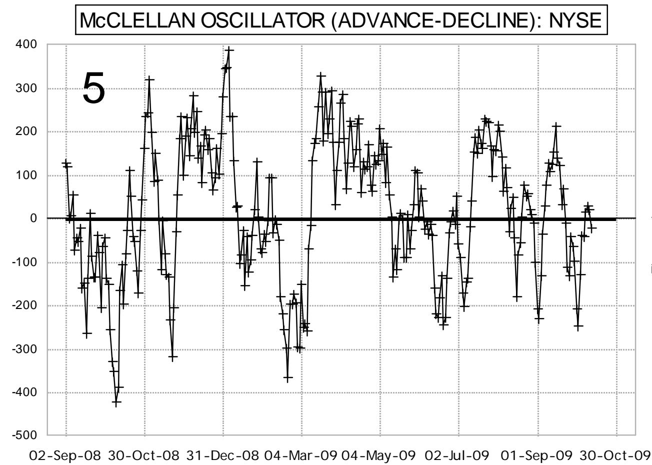

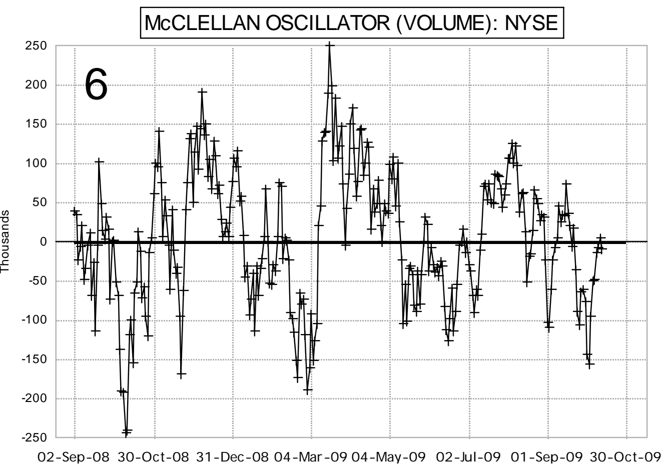

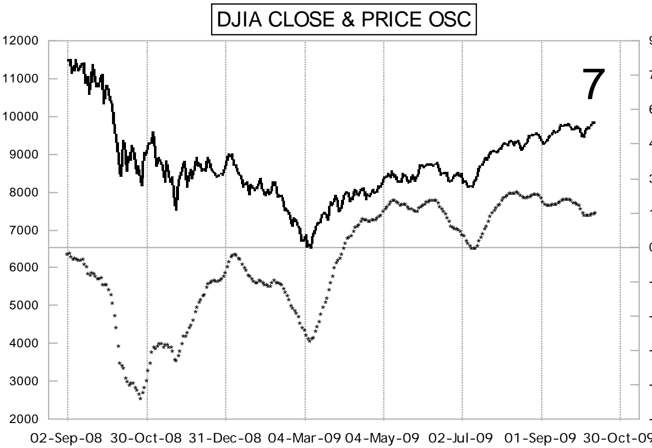

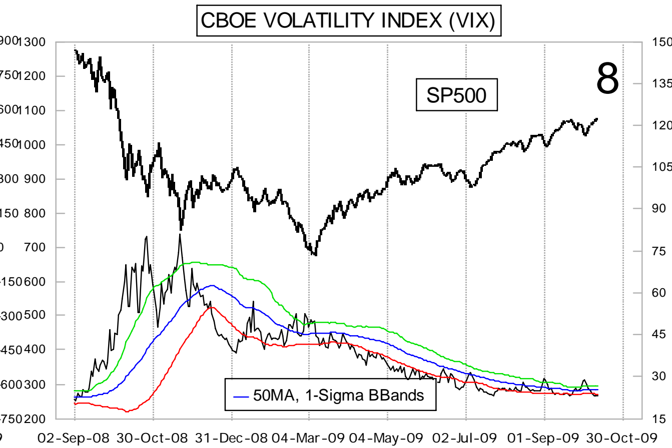

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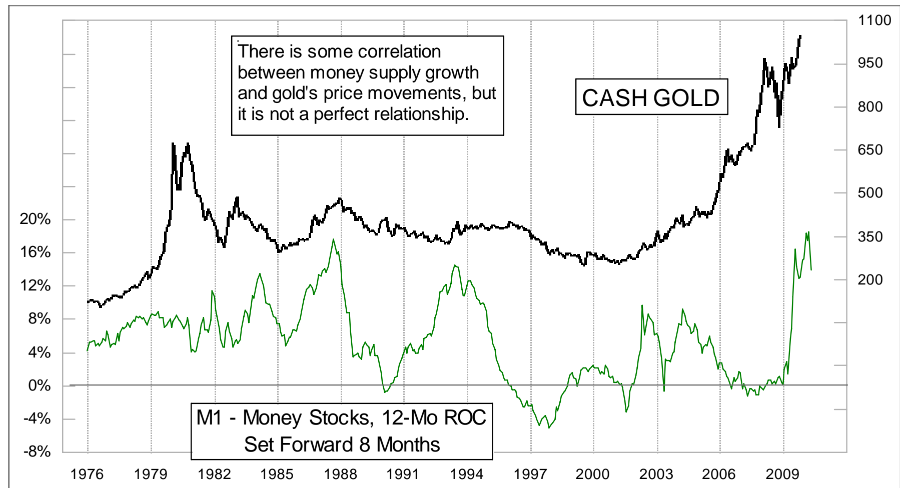
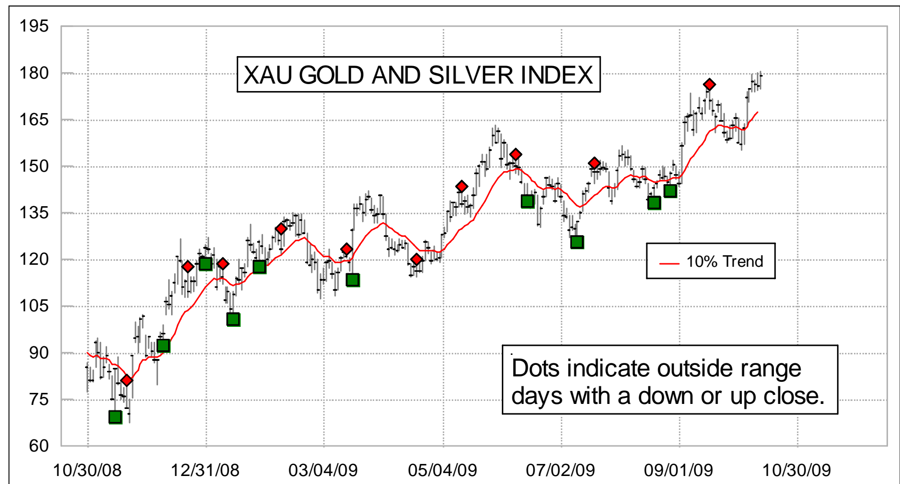
Money Supply is Just One Factor For Gold Rise

A reader wrote to ask whether the M1 growth which seems to forecast stock price movements also works for gold. It is a great question, and actually the theory of gold value suggests that the correlation should be much greater between gold and money supply than for the stock market. But as with most theories about the financial markets, the reality is a lot more complicated.

The top chart on page 4 shows a 12-month rate of change of the money supply measure M1 (currency, traveler's checks, demand deposits, and other checkable deposits). It is shifted forward by 8 months to improve the correlation with gold prices. Even after making this adjustment, we can see that rising M1 growth does not always lead to higher gold prices, but there does seem to be a relationship there.





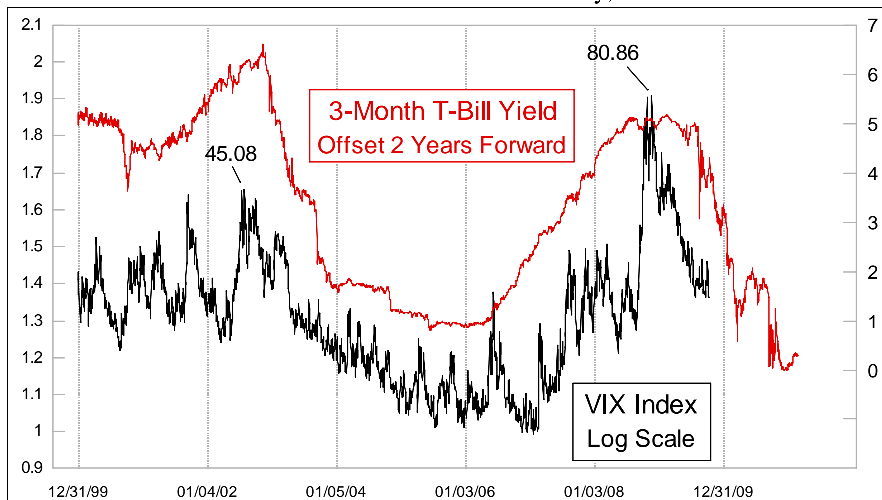
Back in early 2008, gold was making its first run at $1000 even though M1 growth had not given the green light for that move. Gold subsequently fell back to $712, then moved up again in sync with the leading indication from M1. It was as if gold had jumped the gun and had to come back to the starting line for a restart.

We mentioned in MMR 347 that a 13-1/2 month cycle low for gold prices is due in December, and we still expect that to matter. So at some point, this current rally should stall out and gold prices should move sideways to downward into that cycle low. One key indication to look for in a strong rally is an outside day reversal bar, sometimes called a "key reversal". Not all outside days are reversal bars. First, there has to be a trend to be reversed, and second, the direction of the closing price change has to be opposite to the existing trend.

The second chart above shows the XAU, and we have labeled all outside days with a red or green dot to show the direction of price change. when you see a green dot after a decline, it is a good bet that you are seeing an upward reversal. Similarly, a red dot at an overbought condition is a good sign of a top. Seeing a green dot after an advance is not a sign of a reversal.

The last red dot marked a nice top on Sep. 17. Now we are in a new advance, so it will be important to watch for one of these outside day reversals to mark a meaningful top for gold prices and for gold stocks. This is the sort of event that we try to address (when it appears) for subscribers to our *Daily Edition*. If you are not currently a subscriber, you can see samples and sign up on our web site.

Bottom Line: Gold is rising strongly now, but is getting overbought. With an important cycle bottom due in December, we should be watching for signs of a blowoff top, or an actual downward reversal.



VIX Decline Right On Schedule

We have made the point before that short term interest rates provide a leading indication for what the VIX will do. The bottom chart on page 4 updates that relationship, and shows that the drop in

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the VIX from 80 to the 20s is only part of the total decline that should be expected.

The VIX's closing high at 80.86 came about 2 years after the peak in short term interest rates. As the stock market has recovered, the decline in VIX values has matched the drop in interest rates. Given the 2-year lag, the VIX still has a long way to go downward before it reaches the lowest levels it should see for this move. And once the Fed does start raising short term rates, the VIX won't echo that raise until the 2-year lag period has gone by. **Bottom Line**: It has been a long time since VIX values in the low teens were considered normal, but we are headed there again.

Historical Analog Update

The charts on page 5 update a couple of historical analogs that seem to have meaning for the current market. While all such analogs eventually see their correlation break up, these ones still appear to be working at the moment.

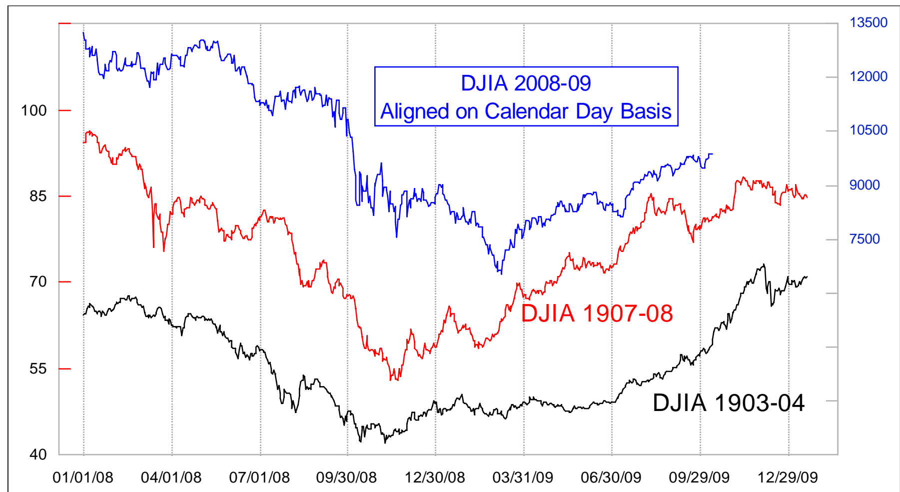
The top chart compares the 2008 financial panic to the twin panics seen more than 100 years. Back in 1903 and 1907, there was no Federal Reserve to cause a bubble and then burst it, but the market still went through declines similar to what we saw in 2008. Banker J.P. Morgan had to play the role of Fed chairman, organizing the efforts of private banks to provide liquidity to the overall system and prevent a total collapse. Interestingly, those two panics were cited as justification for establishing the Federal Reserve system in 1913.

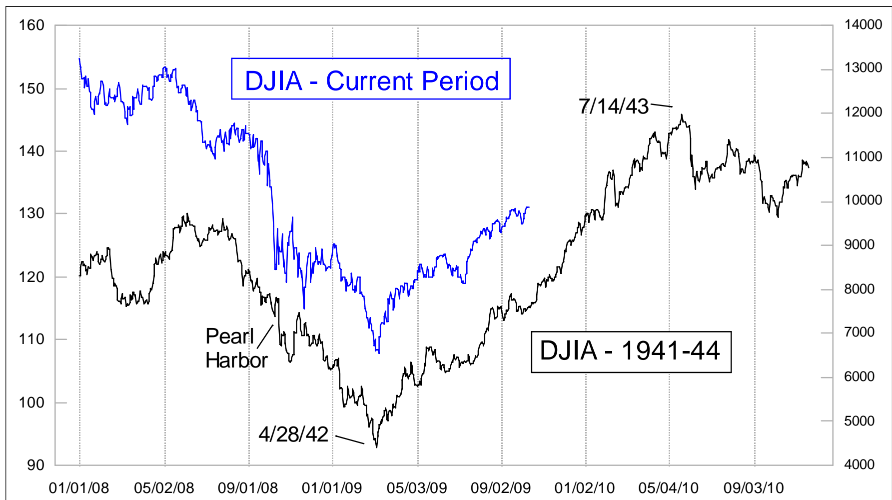
While the patterns are not identical, there is a lot of similarity including the minor dip we did see in September. Now we are in a period when those earlier patterns say we should see rising prices, perhaps pausing for a correction of some kind in December. Not seen off the right end of this chart is continued uptrends which occurred in both of those earlier periods.

The chart below shows a different type of market meltdown, one that was not the result of excessive speculation but rather because of the start of WWII. In late 1941, a decline was already underway when Pearl Harbor was attacked on Dec. 7. That attack accelerated the decline, and then prices rebounded back to get on the prior slope before continuing the decline. The market bottomed April 28, 1942, and finally started upward after an American victory in the Battle of the Coral Sea, May 4-8, 1942.

In 2008, the stock market was already in a decline when the collapse of Lehman Brothers accelerated the drop. Prices rebounded briefly, as in 1941, but then resumed the decline to the March 9 bottom. Since March, the structure of the uptrend has been very similar to what happened in 1942-43.

All 3 of these comparison periods suggest that the current market has more upside movement yet to come.





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TIMING MODELS

Stock Indices (DJIA, SPX, Nasdaq, NYSE Comp., etc.)

	Signal	Source	Predicted	Actual
K	Top	SP500 ST Price Osc	Sep 21	Sep 22
K	Top	DJIA ST Price Osc	Sep 22	Sep 22
K	Top	NYSE A-D Osc	Sep 22	Sep 22
K	Top	SP500 Stochastic	Sep 24	Sep 22
K	Top	Nasdaq ST Price Osc	Sep 25	Sep 22
	Top	NYSE Volume Osc	Sep 28	Sep 28
	Top	NDX A-D Osc	Sep 28	Sep 28
	Top	NYSE A-D Summ	Oct 9	forming
	Top	SP500 Up-Dn Osc	Oct 9	forming
	Top	**DJIA Price Osc**	**Oct 13-19**	forming
	Bottom	Nasdaq A-D Osc	Oct 23	
	Top	Nasdaq Up-Dn Osc	Oct 26	
	Top	SP500 ST Price Osc	Nov 3	
	Top	NYSE Vol. Summ	Nov 3	
	Bottom	NYSE Vol. Osc	Nov 6	
	Bottom	Nasdaq A-D Osc	Nov 9	
	Bottom	DJIA ST Price Osc	Nov 17	
	Top	DJIA ST Price Osc	Nov 19	
	Bottom	NDX A-D Osc	Dec 11	

Experimental New Indicator, "BC"

Predicted Signal		**How It Turned Out**	
Implied Top	July 24	Top	July 27
Implied Bottom	Aug 26-27	Top(inverted)	Aug 27
Implied Top	Sep 12	Top	Sep 18
Implied Bottom	Oct 3	Bottom	Oct 2
Implied Top (weak)	Dec 6		
Implied Bottom	Dec 31		

Bond Market (Corporate & Treasuries)

Signal	Source	Predicted	Actual
Bottom	T-Bond Stochastic	Oct 1	Sep 30
Top	T-Bond Stochastic	Oct 12	Oct 7
Top	**T-Bond Close/Sum**	**Oct 16**	
Top	T-Bond ST Price Osc	Oct 20-21	
Bottom	T-Bond Stochastic	Nov 20	

Gold and Precious Metals Stocks

Signal	Source	Predicted	Actual
Bottom	Gold Close/Sum	Sep 24	Sep 25
Top	[Dollar Index Bottom]	Sep 28	Sep 30
Bottom	Gold ST Price Osc	Oct 1	Oct 1
Bottom	[Dollar Index Top]	Oct 2	Oct 1
Bottom	XAU ST Price Osc	Oct 7	Oct 9
Bottom	Gold ST Price Osc	Oct 8	Oct 9
Bottom	**[Dollar Index Top]**	**Oct 13**	Oct 9
Top	Gold ST Price Osc	Oct 19	
Bottom	[Dollar Index Top]	Oct 28-29	
Bottom	Gold ST Price Osc	Oct 29	
Top	XAU ST Price Osc	Oct 30	
Bottom	[Dollar Index Top]	Nov 2	
Top	[Dollar Index Bottom]	Nov 9	
Bottom	[Dollar Index Top]	Nov 13	
Top	[Dollar Index Bottom]	Nov 17-18	

The Signals

We have just been through a period when we had a huge number of signals being generated by these indicators, and now we are back to a slower rate of new signal generation. Whether or not signals appear depends on the nature of the values seen in the indicators for which this technique works (it does not work on all indicators), and so we have to accept that sometimes it will get quiet out there.

The Sep. 21-25 cluster of tops was fulfilled by a relatively minor top, with a bottom Sep. 25 that was not detected ahead of time by these signals. The next top also came in on schedule Sep. 28. Again, no standard signals showed it, but another bottom came Oct. 2 (which was in keeping with the BC Indicator's signal). This illustrates that just because we see a period with nothing but top signals, that does not mean there will be no bottoms. We have to infer that the bottoms are out there, lying undetected ahead of time.

3 separate signals called for a gold bottom Oct. 7-13, and it came on Oct. 9. The important point to understand is that gold is in such a strong uptrend at the moment that bottoms are much less noticeable, like the waves from a rock thrown into a fast-flowing stream.

What To Expect

A top of some sort appears to be forming now in stock prices. The chart on page 2 says the ideal date should be Oct. 19. Tops are generally more diffuse than bottoms, so we are now within an acceptable time window for that top to arrive. Our experimental BC indicator is now in a fairly quiet period, not offering much to say about the market. The Dec. 31 implied bottom is similar to the one we just had Oct. 3, so it ought to have significance when it arrives.

Bonds have an important top due Oct. 16 and should see more downside movement afterward.

Gold signals are rather mixed; a top due Oct. 19 is likely to apply to both gold and stocks, since they are well correlated at the moment.

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.

The BC indicator is an experimental new tool, not related in method to the other signals.

"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**.

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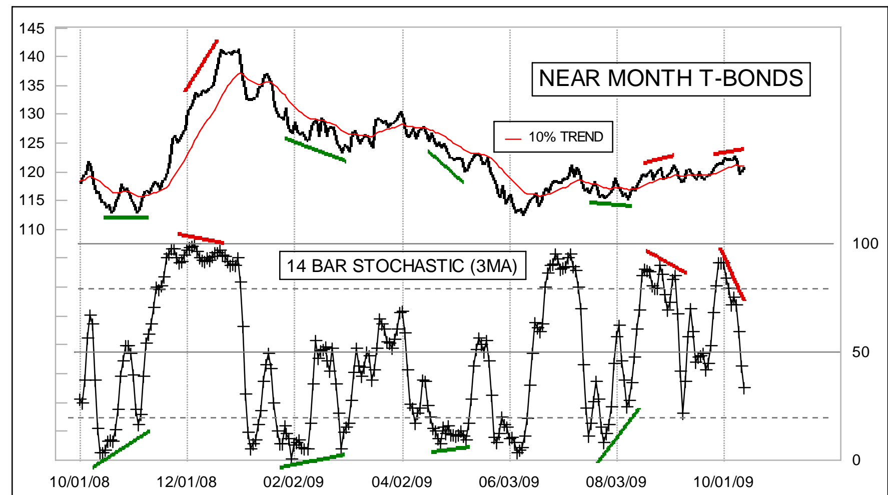
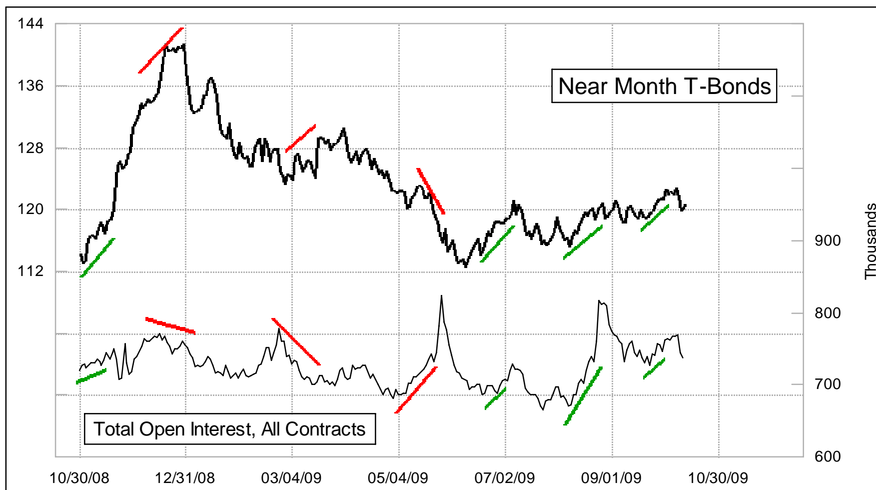
T-Bonds Head Down For Now, But Not Forever

After putting in a divergent top relative to the 14-3 stochastic oscillator in the top chart, T-Bonds have made a big downward swoon. Now bond prices appear to be heading back up to test the underside of the 10% Trend before more downward work, but it should not be a lengthy decline.

This 14-3 stochastic oscillator has some really interesting uses, when interpreted correctly. It obviously can show overbought and oversold conditions. It can also tell us when a up or down move is likely to be a trending move by forming complex structures on one side or the other of the 50 line, its neutral level. When choppiness exists above or below the 50 line, it says that that side is the strong side of the market. This presumption continues until a divergence is seen between prices and the 14-3 stochastic. It is after a divergence is in place that an overbought or oversold condition is much more likely to matter.

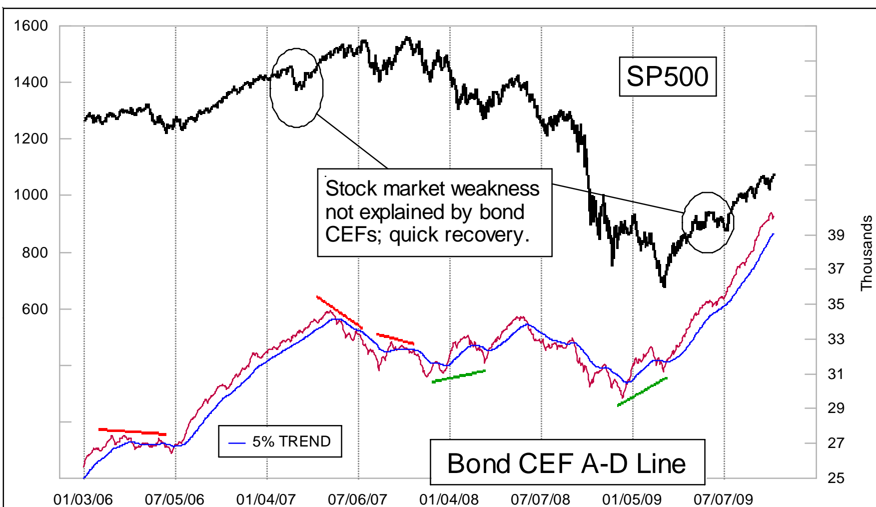


The divergent top we just saw coupled with the plunge below 50 say that the bears are in charge for now. How long they will remain in charge is yet to be determined, but we do not yet have even an oversold condition to point to, which would say that the rubber band is stretched.



The middle chart tells us that this down move is not likely to become a dominant downtrending move. The reason we can say that is the continued positive correlation between prices and open interest. When it comes to T-Bonds, open interest will tend to increase as prices are moving in the direction of the dominant trend. Because of that behavior, open interest declares for us which is the dominant direction.

By moving downward now along with prices, after having moved upward with prices, open interest is staying positive correlated to prices and is thus telling us this is just a "correction" within what is still an uptrend. If, on the other hand, we were to see open interest rising as prices declined, that would be a statement that the dominant trend direction is downward. Without that message, we should still assume that bonds are in a larger uptrend, within which this down move is just a correction.



The bottom chart updates the A-D Line for bond closed end funds (CEFs) traded on the NYSE, which we showed last issue. There was a two-day hiccup within the strong uptrend of this A-D Line just recently, but nothing big enough to interrupt the strong trend. This A-D Line gives us good early warnings of illiquidity problems that would hurt the stock market, and right now it is saying that liquidity is just fine, thanks to all the money printing the Fed has been doing. Eventually that money printing will bring price inflation, but it is not showing up yet.

Bottom Line: Bonds are moving down from a short term overbought situation, but this is just a correction within a larger uptrend.

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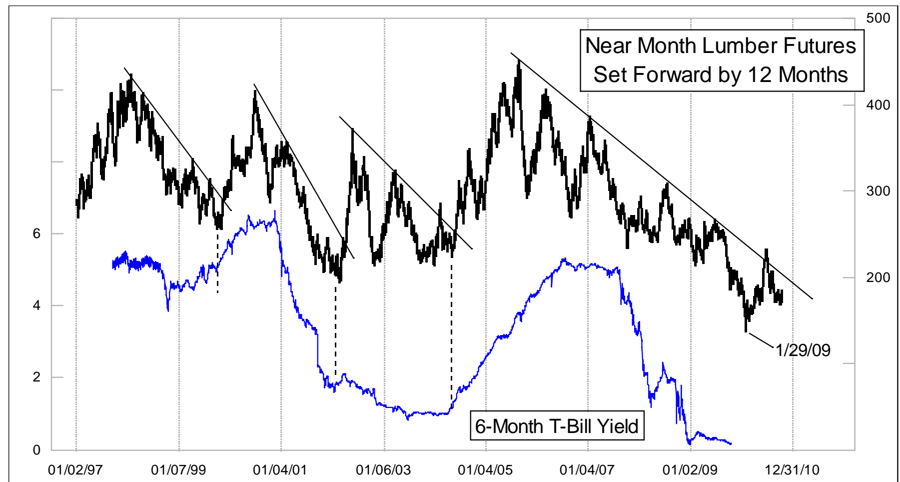
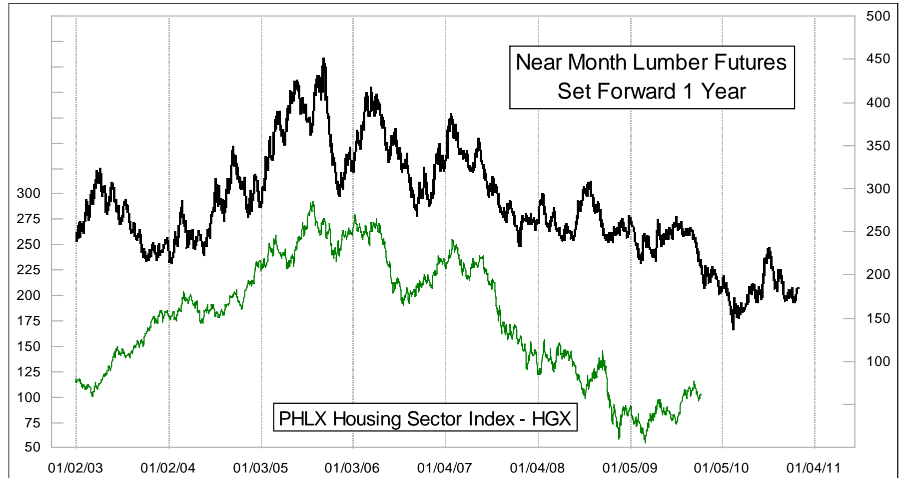
Lumber Says Rate Hikes Are A Long Way Off

It has only been within the last couple of years that we have come to better appreciate the price of lumber as an economic indicator. Lumber futures have been trading since 1973, but it is a really small and thinly traded commodity. The all time high for total open interest was 15,434 contracts back in early 2008, and right now there are only 10,125 contracts open (per the COT Report). So the price of lumber is a strange piece of data to call upon for expert opinion about the economy, but it is still a really good one.

The top chart shows lumber prices pushed forward by 1 year, and compared to the yield on 6-month T-Bills. We could have used 3-month bills, the Fed Funds rate, or just about any other measure of short term interest rates, and the relationship would be the same. Before an important rate move takes place, lumber prices will signal it a year in advance. Thus, the bottom in the 6-month T-Bill yield back in January was just the echo of a similar bottom in lumber prices a year before.

Interestingly, this chart reveals that we have not even gotten to the 1-year anniversary of the all-time low in lumber futures prices, seen on Jan. 29, 2009. A year will have to go by before interest rates are at the equivalent point. This chart also reveals that interest rates do not tend to start trending higher until a year after lumber prices break their own downtrend. Lumber tried to do that earlier this year, but that breakout attempt failed and the downtrend remains intact. So there is no prospect yet visible for an uptrend in short term rates.

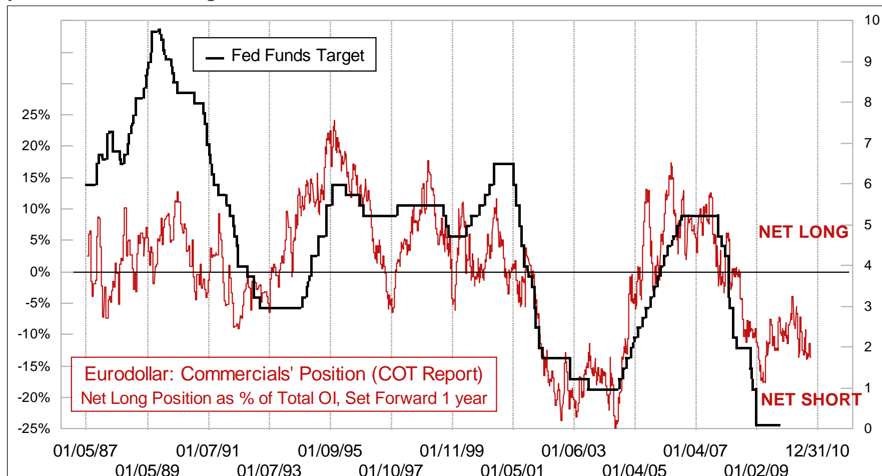




That is bad news for lots of sectors of the economy, since rates usually go up in response to improvement. If rates are not going to go up soon, that means no improvement soon. One area where this will be an obvious issue is housing. The middle chart uses the same one-year forward offset of lumber prices and compares it to the Philadelphia Exchange's Housing Sector Index (HGX). The correlation is not perfect, but it is pretty darned good. Right now, it says housing sector stocks should be heading downward again, although a bottom in January looks promising from a trading standpoint.

The same message about continued low interest rates is repeated by another source, shown in the bottom chart. This chart shows the net position of commercial traders of eurodollar futures contracts. Eurodollars are short term dollar denominated deposits available in Europe, and should not be confused with exchange rates.

The commercials' net position is shifted forward by a year, and compared to the Fed Funds target rate. We are past the point of an extreme bottom, but the Fed has not shown any signs of wanting to raise rates. And even if the FOMC did want to raise rates now, these traders are saying that there is another dip coming, of which we do not yet appear to have a visible bottom. In other words, short term interest rates should stay very low until at least late 2010, and possibly beyond.



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