THE McCLELLAN MARKET REPORT

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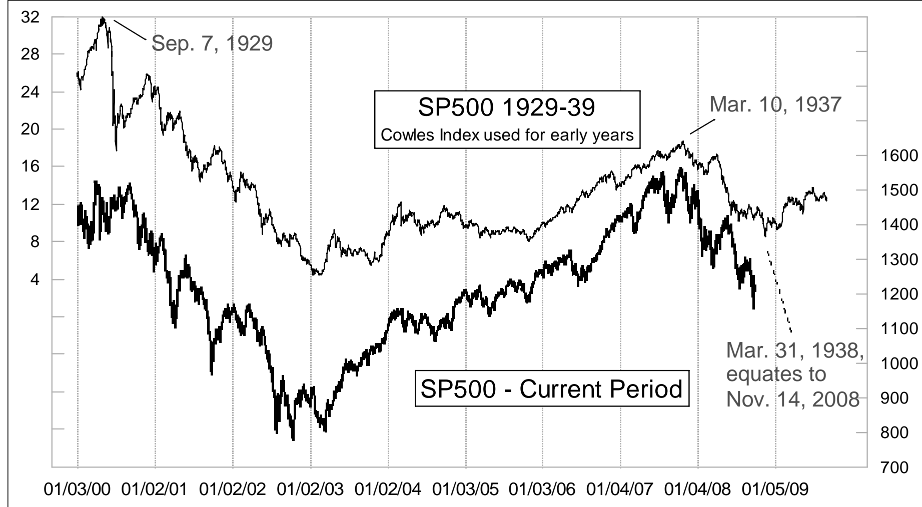
Prepared After the Market Close, September 23, 2008 Report #323, September 24, 2008

Mortgage Meltdown At Climax

With Congress meeting now to debate giving the Treasury Department and the Federal Reserve unprecedented new powers, the meltdown in the mortgage markets that has brought the US banking system to its knees appears to be reaching its climax.

A lot of people think that we are going through a repeat of the banking system collapse of the early 1930s, which followed the crash in 1929. Our first chart argues that we have already been through the equivalent of the early 1930s, at least as far as the behavior of stock prices is concerned, and that this current crisis is the equivalent of what happened in 1937-38. The circumstances then were greatly different from what we are going through now, but the price patterns of the SP500 then and now correlate quite nicely.



BOTTOM LINE

The federal government is wading into the mess of the financial markets, and that is rarely a good thing in the long run. History shows that energetic federal intervention tends to lengthen periods of distress rather than relieve them, as the 1930s and 1970s illustrate quite clearly. For now, the market is oversold enough to be building an important bottom, and that bottom construction process is not yet complete. Look for another dip on Sep. 29-30, and a top Oct. 1 as the short sale prohibition expires. Another bottom due Oct. 13-16 might bring an end to this bottom, but it is too soon to say. Sometime between now and December, we should see a bottom that brings at least a 50% retracement of the recent decline from Dow 14,000, and that would be a rally worth catching. Gold is not done going up, as the dollar is not done yet going down.

Historians disagree about the real causes of the 1937 recession, but it seems clear to most that it was an echo or aftershock of the 1929-32 stock decline and depression. Similarly, the real estate collapse and subprime mortgage crisis of this decade are the echo of the Internet bubble and collapse of the late 1990s.

The technology bubble and the phenomenon of "day trading" drew a lot of new players into the stock market. The decline from 2000-2002 pushed them back away again, and a lot of investors swore never to again invest in anything as ephemeral as stocks. They were going to be smarter, and stick to something safe and real, like real estate. That surge led to over participation in the real estate markets, and a new variety of speculation typified by the term "condo flipping". Now we are seeing the unwinding of that bubble.

If the 1930s example continues to be the model for current stock market behavior, then we are due to see a bottom very soon. If it were perfectly in time with the alignment shown above, then the bottom would equate to Nov. 14, 2008. But the alignments of equivalent structures have been less than perfect, even as the correlation has been there, so you should not chisel that date onto your trading calendar.

Instead, the proper way to process this information is to note that we are in the time neighborhood of an important bottom, and so we should turn to our confirming indicators for signs that a bottom is in. We address that in the discussion of the charts on page 3.

One other reason to look for a recovery in the overall stock market is the great potential for a big recovery in the battered financial stocks. We don't think that the Paulson/Bernanke bailout plan will be the agent of that recovery, but rather a different effect.

The chart at the top of page 2 shows an interesting relationship to which we were recently alerted by one of our subscribers. He has learned through years of reading about our Liquidity Waves principle to look for similar patterns at different times in different markets, and find the hidden relationship. You can learn more about that topic in the DVD available on our web site.

In this chart, we compare the behavior of the US Dollar Index to the share price of XLF, the S&P Financial Sector

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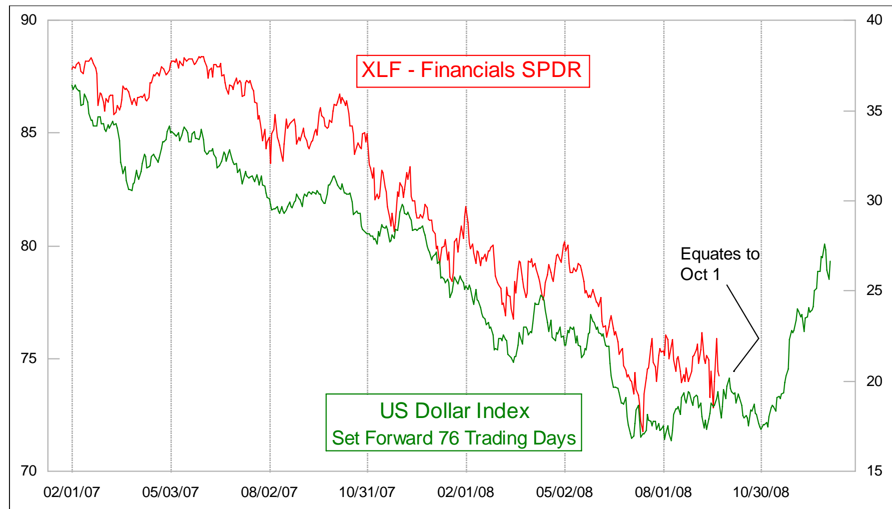
ETF. The data for the Dollar Index have been shifted forward in the chart by 76 trading days, or just under 4 months. There is a very nice correlation for the period shown, a period during which the US banking system has been under the greatest amount of stress.

We would urge caution in relying too greatly on this relationship, because when we look further back in time the correlation is not as good. The point is that this correlation may be just a temporary condition, or it might even be a spurious one, so while it is fascinating to watch and potentially useful to incorporate into our analysis, there is risk from relying too greatly on a new relationship that has not proven itself.

That said, there is a top in the Dollar Index that would equate to Oct. 1 for the XLF in this comparison. That is an interesting date because it is when the temporary order banning short sales of financial stocks is set to expire. The current condition is also interesting because it shows a big upsurge for the XLF beginning around the time of the presidential election. Should such a rally occur, we are certain that the victor in that election would claim credit for the rebound, but this chart says it is already baked in.



Bottom Line: We are nearing an important bottom for the stock market, and the prospect of improving fortunes for financial companies should be part of the upturn process. But we do not yet have confirming signs of a bottom in other charts, and those missing signs will need to appear before it is time to jump on the prospective new uptrend.

Page 3 Charts

Chart 1: The A-D Line failed to get a clear breakout to the up side and wound up collapsing to new lows. Last week's rally shows up as just a snap back up to the underside of the congested postings following the July low. Most of that advance was given back in the first two days of this week. It is going to take better upward movement of this index before it can be shown that the bulls are back in control.

Chart 2: The Daily Volume Line has shown much better strength, thanks in part to inflated volume last week during expiration. Last week's rally took this indicator back up to the high range of the post July range. The give back this week has been just back to the lows of the previous range. This leaves only a one-day spike below the July low and it will take more than that to demonstrate that the bears are in control. With neither the bulls or bears demonstrating control, we are left with the just the sideshow in the Senate.

Chart 3: The McClellan A-D Summation Index is poised to create a divergence with a higher low while prices move to lower lows. But that divergence is only on the bulls' wish list and not a reality. For now, the Summation Index is below zero and declining. That is consistent with prices moving lower, and the Composite and other price indicators have performed accordingly.

Chart 4: The Volume Summation left a big fat one-day island bottom posting on Sep. 17, and has continued to rise. Now it is at decision time, as it has risen to the downtrend line that can be drawn across the May and September tops. Either it has to break up through that downtrend, giving a boost to the bulls, or it will turn down immediately at the downtrend line putting any bullish indications on hold. With the A-D Summation declining and the Volume Summation rising it is like the stock market carriage being pulled in two different directions. Once both Summations are pulling in the same direction, prices will be moved in that direction.

Chart 5: The McClellan Oscillator moved from -263.7 on September 17 to +11.6 on September 19, a most dynamic move. In the first two days of this week, it moved back down to -134.8, just above the -138.2 posting on Sep. 18 that will try to act as support. It takes 2137 more advances on Sep. 24 to get the Oscillator back above zero. There were 2447 more advances on Friday on rumors of the administration's proposed $700 billion bailout. It will probably take Congressional action to generate a similar number of net advances.

Chart 6: The Volume Oscillator only took 2 days to get to +101505 from the low. It took 6 days to get to +102871 off the July low. It took 4 days to get back to near zero in July while it has only taken 2 days this trip. If the Volume Oscillator can stay above zero, that will drive the Volume Summation higher. But if it drops back below zero, that would leave a (huge) simple crossing back through zero and remove any thought that the bulls were back in control.

Chart 7: The DJIA Price Oscillator confirmed the price breakdown by turning down below zero. On the way down, it has had two 1-day bumps up. The bumpy nature of the move down suggests that the next move up might be stronger rather than weaker. There is a good chance that this indicator will make a divergent higher bottom as it did at the March 2008 low while price makes a lower low. The March low produced a decent rally, and there are indications that the next low will produce another.

Chart 8: The CBOE Volatility Index (VIX) is back up to the highest postings on the chart. Values in the 30s and 40s have successfully identified the more important price lows. As soon as this indicator drops back low enough to leave a high spike, a major price bottom will again be identified. It will probably take a drop back below the upper band to be completely convincing. So long as the VIX is above its upper band the possibility of a continuing price downtrend exists. The intraday high on Sep. 18 was 42.16 and provides a benchmark. This will be an important bottom, once it has been put in.

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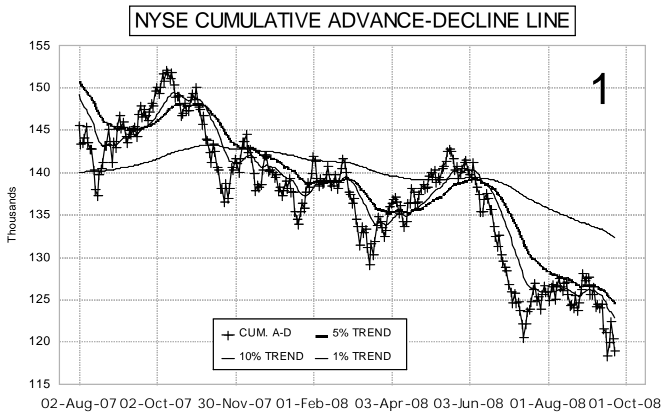

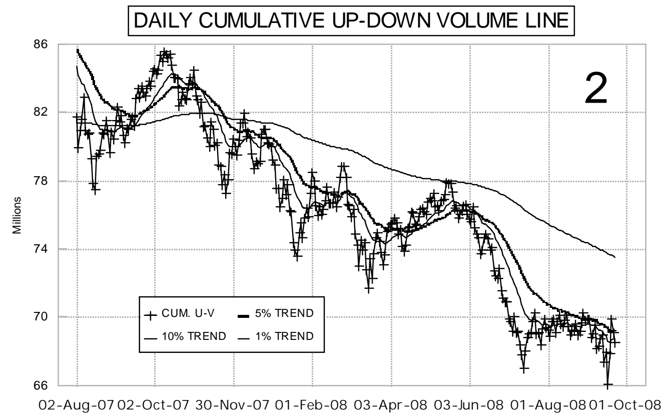

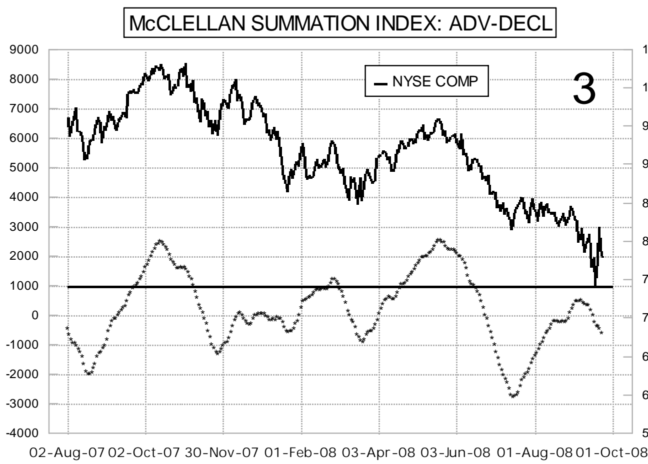

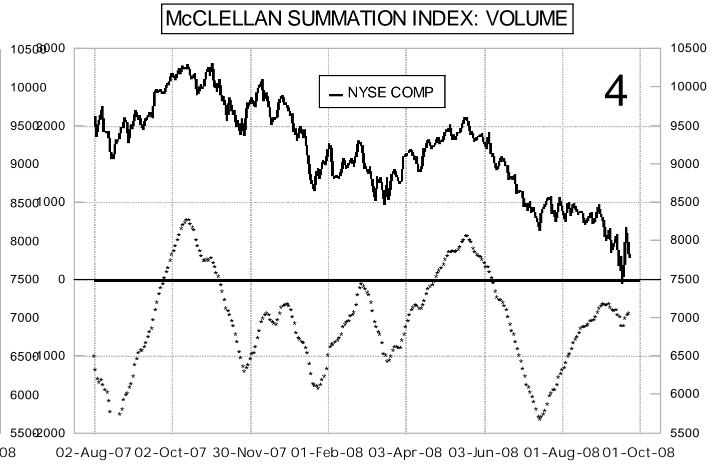

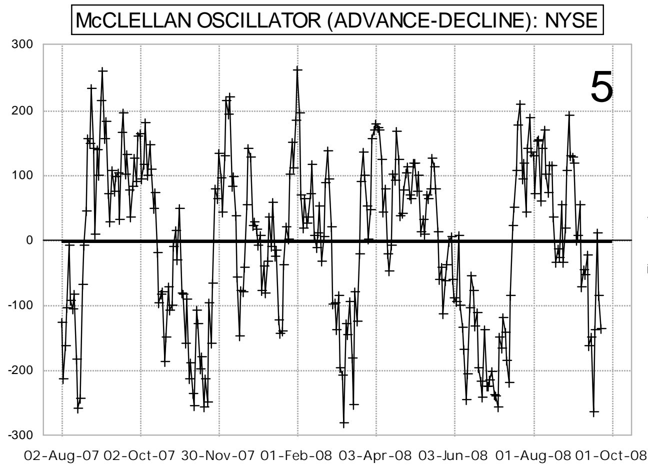

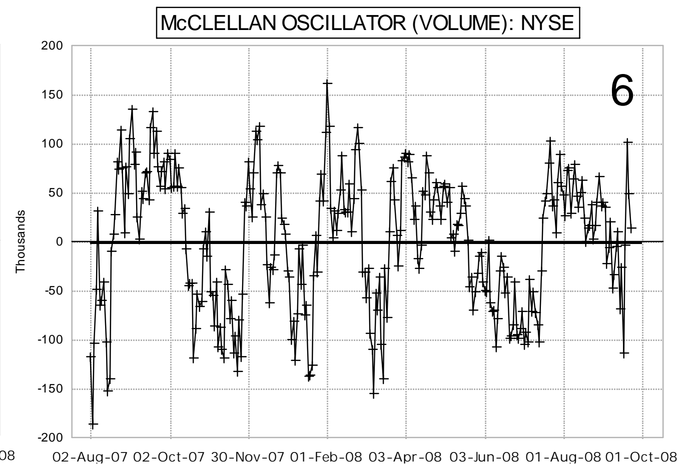

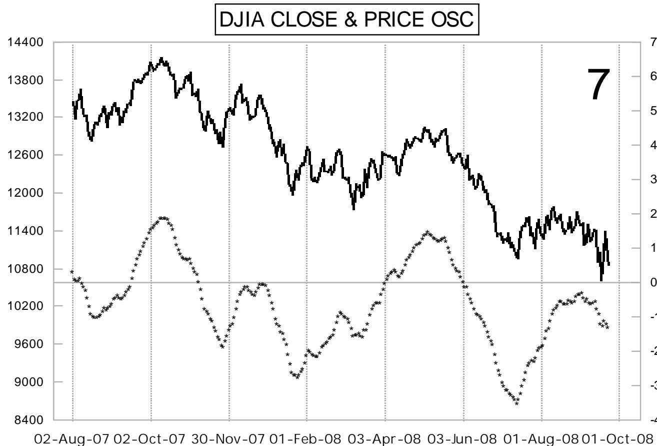

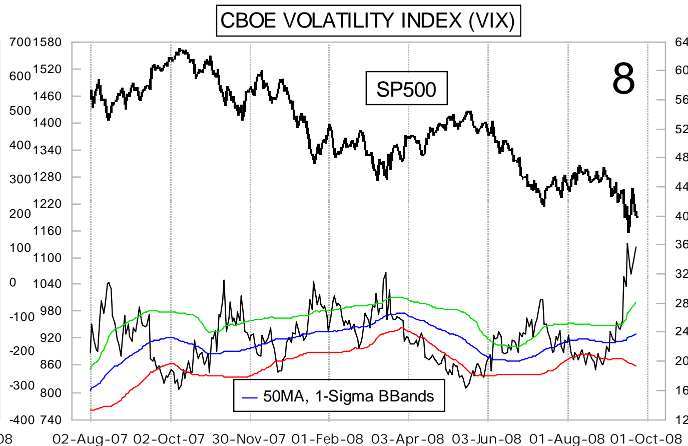

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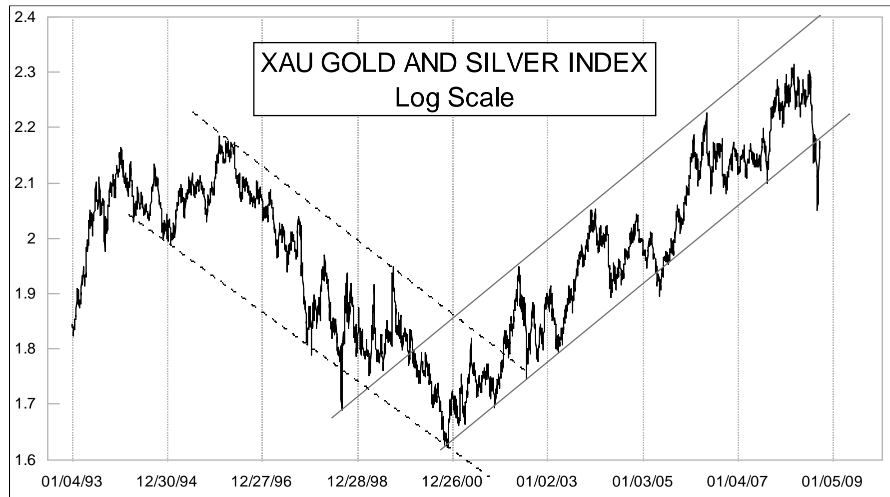
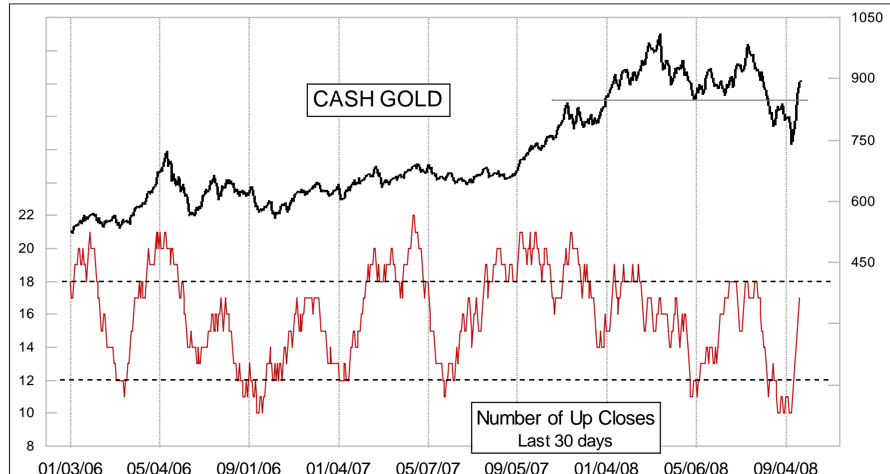
Monster Rebound Takes Gold Back Up Rapidly

The oversold condition in gold finally mattered, and so did the overbought condition in the dollar. Those two conspired to bring about one of the fastest rallies that gold prices have ever seen. December gold futures bottomed at $745.50/oz on a closing basis on Sep. 11, and zoomed up to $897 just a week later. After just one day's break, gold traders extended that gain to a closing high of $909/oz on Sep. 22.

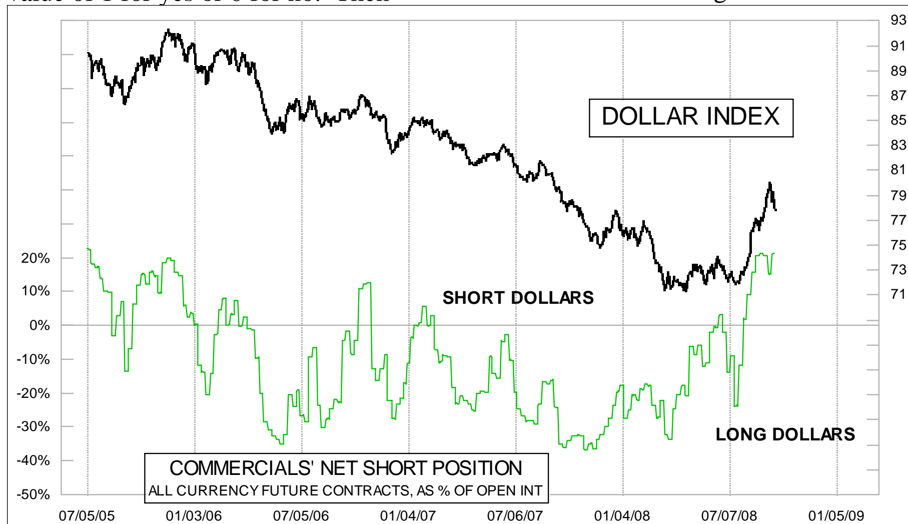
The resurgence in gold prices has brought gold and silver mining stocks along for the ride. The GDM Index moved up 36% from its Sep. 9 closing low, and the XAU moved up 33%. The XAU is shown in the top chart on page 4 in logarithmic scaling, and this chart takes a very long look back at the XAU's behavior. Going into the 2001 bottom for gold prices, the XAU had been in a downward sloping trend channel. The new bull market of the 2000s broke the XAU out of that downtrend channel, and established an upward trending channel which has now been broken. September's big rebound has merely served to take the XAU back up to touch the lower channel line.





The middle chart shows that gold prices certainly deserved to bounce, based on the oversold reading in the indicator featured in that chart. It is a simple indicator to construct in any spreadsheet program. Just use the =IF function in Excel (or @IF for old 1-2-3 users like us) to see if the close is higher than the prior close, and assign a value of 1 for yes or 0 for no. Then count the total of the last 30 days' readings to get this indicator. Readings below 12 show an oversold condition, which we are just now seeing gold climb out of. The string of up days has just about taken this indicator to an overbought reading, where we would worry about the rally running out of gas.

But the commercial gold traders are still at a relatively low net short position as discussed in our last issue, meaning that they expect gold to rise. Supporting that idea is the fact that currency futures traders are now net short the dollar in a big way, as shown in the lower chart on page 4. This indicator is based on combining all of the commercials' net positions in every currency futures contract, weighted according to the values of each type of contract. Commercials are especially net short the dollar versus the pound and the euro right now. This suggests that the Dollar Index has some room to fall from here before the commercials would be switching to a bottoming indication for the dollar. And as the Dollar Index falls, gold should get a boost.



Bottom Line: Gold finally responded to the big oversold condition with a very robust bounce. There is some cause for worry about a short term top for gold based on the severity of that bounce, but a continuing decline in the dollar should help gold sustain the rally for several more weeks.

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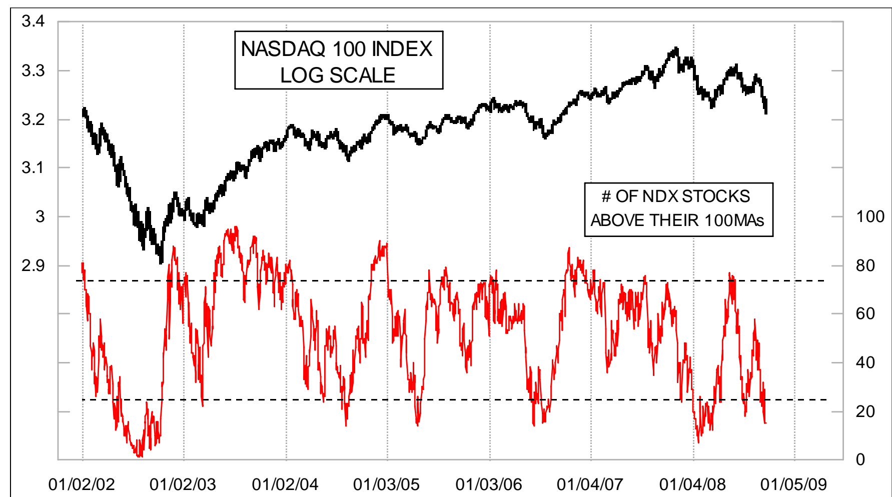
Nearing a Major Bottom

One of the categories of breadth indicators that we probably don't talk about enough has to do with examining a set of stocks, and looking for each stock's current state regarding some criterion such as rising trend, above or below a moving average, etc. This is a fruitful area for analysis, provided that one utilizes a proper sample group of stocks, and provided that the analysis is done in an historically relevant way.

In the top chart on page 5, we show an indicator that measures the number of stocks in the Nasdaq 100 whose share prices are above their 100-day simple moving averages (SMA). When first constructing this indicator, we initially tried a 200-day SMA, but found that the 100-day gave better indications.



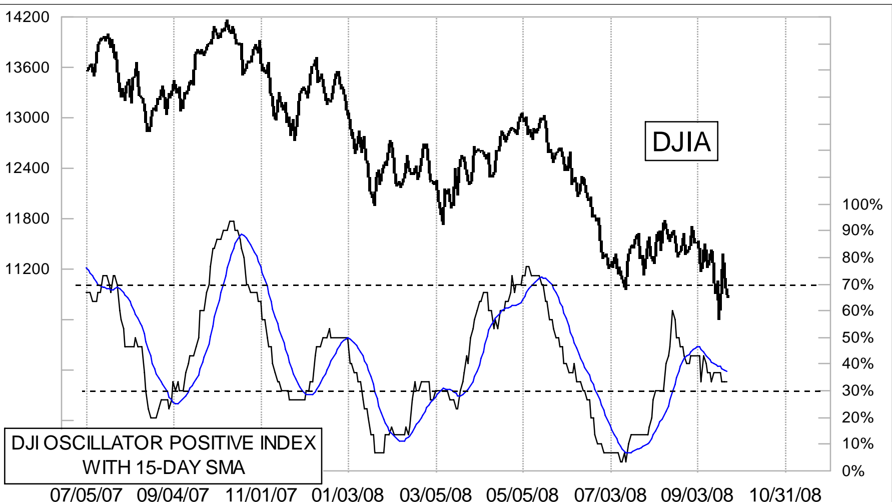
Right now this indicator is sitting at a reading of 15, meaning that only 15 of those issues are in an uptrend according to that way of defining it. A different definition would yield a different result.

The reason why this is important is that anytime this indicator gets down below 25, that episode is associated with an important bottom for the Nasdaq 100 and indeed for the overall stock market. The problem is that the bottom does not have to be already here just because the indicator gets down to a low reading. All we know is that once the bottom does come, it will have been an important bottom. We have to rely on other indications to tell us that the bottom is (or was) here.

The lower chart on page 5 uses a similar methodology of looking at a sample of stocks and gauging them according to some measure. In this case, it is the 30 stocks which make up the DJIA, and the indicator looks at the Price Oscillators of each of the 30 stocks to see how many of them are above zero. It does not care whether they are rising or falling, just whether or not they are above zero.

It turns out that this simple indicator is a really good measure of which direction the dominant trend is going. When the indicator moves above or below its 15-day SMA, it signals a trend change. Like most indicators of trend direction, such signals usually come a few days late because the reversal has to flip around the Price Oscillators.

This indicator also can give important readings based on its raw value. Above 70 or below 30 are important thresholds for overbought or oversold readings. We would expect that the sort of bottom being formed right now ought to be important enough to merit an indicator reading down below 30, if it is going to produce a rally worth catching as we suspect. Currently, this indicator is not there yet, which says that the bottom formation process still has some time yet to run before it is complete. And the indicator is still below its 15-day SMA, telling us that for now the trend direction is still downward.



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TIMING MODELS

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

	Signal	Source	Predicted	Actual
	Bottom	NYSE A-D Summ	Sep 9	Sep 9
	Bottom	Nasdaq Close/Sum	Sep 11	Sep 9
B	Bottom	SP500 ST Price Osc	Sep 15	Sep 17
B	Bottom	DJIA ST Price Osc	Sep 16	Sep 17
B	Bottom	NDX A-D Osc	Sep 16	Sep 17
B	Bottom	Nasdaq A-D Osc	Sep 18	Sep 17
	Top	Nasdaq ST Price Osc	Sep 18	Sep 19
	Top	Nasdaq A-D Osc	Sep 25	
C	Bottom	Nasdaq Up-Dn Osc	Sep 29	
C	Bottom	Nasdaq A-D Osc	Sep 29	
C	Bottom	DJIA Close/Sum	Sep 30	
C	Bottom	Uncommon A-D Osc	Sep 30	
	Top	DJIA ST Price Osc	Oct 1	
	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	
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	

Bond Market (Corporate & Treasuries)

	Signal	Source	Predicted	Actual
	Top	**T-Bond Stochastic**	**Sep 8**	Sep 9
C	Top	T-Bond Stochastic	Sep 29	
	Bottom	T-Bond Stochastic	Oct 24	
	Bottom	T-Bond ST Price Osc	Oct 27	
	Bottom	**T-Bond Price Osc**	**Nov 17**	

Gold and Precious Metals Stocks

Signal	Source	Predicted	Actual
Top	Gold ST Price Osc	Sep 16	Sep 18
Bottom	XAU ST Price Osc	Sep 23	
Bottom	Gold ST Price Osc	Oct 2	
Bottom	Gold Up-Dn Osc	Oct 2	
Top	XAU Up-Dn Osc	Oct 9	
Top	[Dollar Index Bottom]	Oct 14	

The Signals

We noted last time a cluster of bottom signals for the stock market labeled with the letter B, saying that a bottom was due Sep. 15-18. That bottom did indeed arrive with a washout low on Sep. 17, followed by a 2-day pop into options expiration.

For our newer readers, the letters we assign to these clusters do not have any sort of ranking implication. We are just identifying similar signals that are closely arranged in time, and thus which are likely describing a single event. The appearance of more signals for a top or bottom implies greater importance for that event. It is like a 747 jet having a larger “radar signature” than a hummingbird.

Two more bottom clusters have appeared since our last Report. Cluster C says a bottom is due Sep. 29-30, and then Cluster D shows a bottom due Oct. 13-16. That later cluster also contains one bold-lettered bottom signal, meaning that this one signal appears more important than other signals based on a subjective analysis of the particular traits of that signal. Someday we will get the book written which will reveal all of the details about these signals.

At this point, it is impossible to know which of the upcoming bottom clusters will see the lower price bottom. Our sense coming into this week was that the Cluster B bottom would be the one that the stock market went down into, and some later bottom would be the one that prices go up out of. That is still a good model for thinking about this bottoming process. If we had to guess, the Oct. 13-16 bottom signals looks like the best candidate for the bottom to go up out of.

It is also interesting to note that while our stock market signals show a bottom due Sep. 29-30, we have a top signal for T-Bonds due at that same time. And gold shows 2 separate signals for Oct. 2, which is around the same time and the day after the short sale rule is due to expire. The “interesting” times are not yet behind us.

What To Expect

Stocks are thrashing around in a complex bottoming process which is not yet finished. Look for another low in this bottoming event on Sep. 29-30, then a brief top Oct. 1 as the short sale rule expires. Another bottom is due Oct. 13-16.

T-Bonds have already had a blowoff top to a ridiculously overvalued price. We should not see bond prices go back there for a long time, if ever. But look for a brief flight to quality rally to a top Sep. 29 as stocks are making an equivalent bottom then.

Gold prices are going to continue being slaved to the movements of the dollar, and overreactions to banking news. Look for short term bottoms Sep. 23 and Oct. 2, but that should be seen in the context of a resumed uptrend.

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**.

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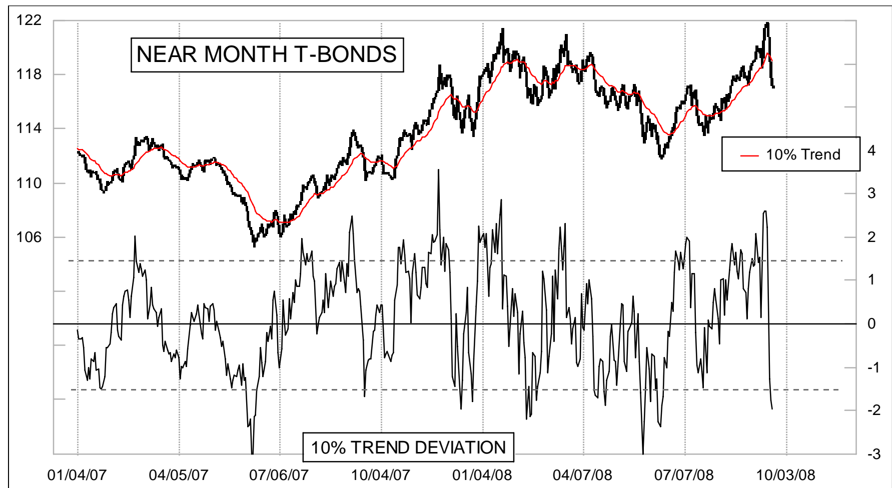
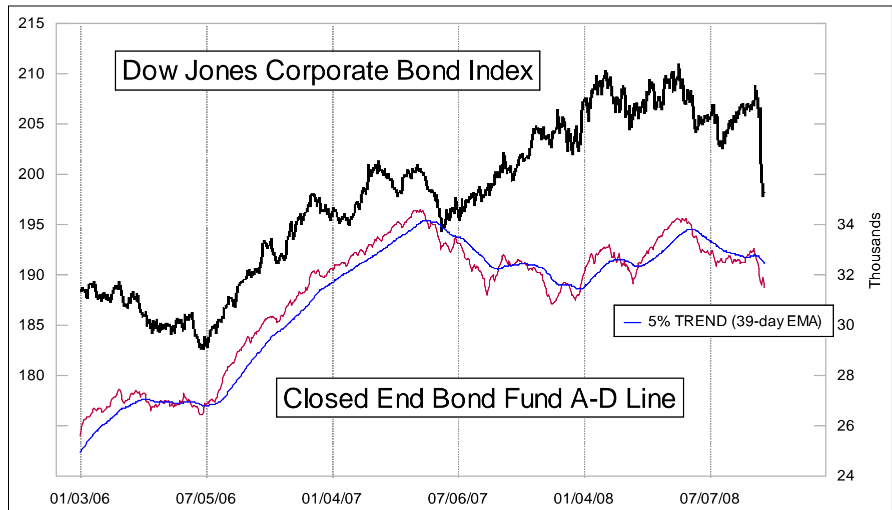
T-Bond Blowoff Top Finally Breaks

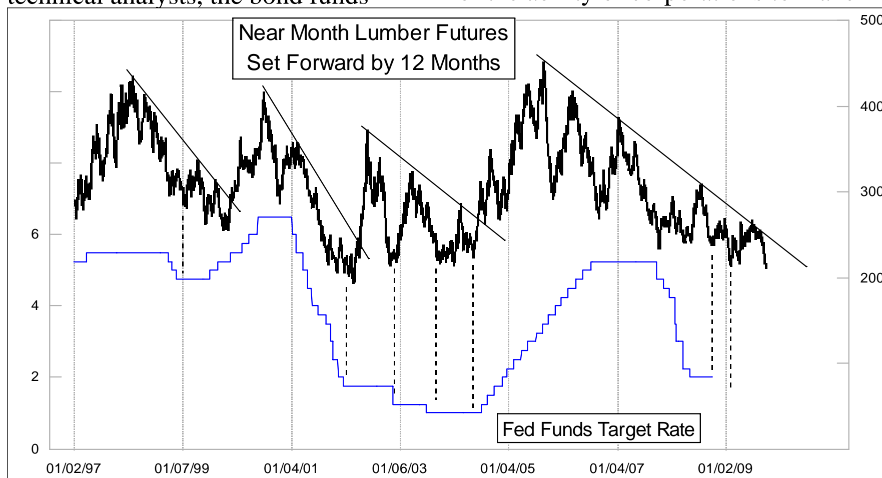




For the last 3 months, T-Bonds have been benefiting from the "flight to quality" trade out of stocks. But that suddenly changed last week as stock prices reached an initial washout bottom. A two-day rally for stocks into the quarterly expiration sent traders fleeing out of T-Bonds, and even though that stock rally has died, the flight out of T-Bonds has continued. It is a case of the old story about "return of capital" being more important than "return on capital". If everyone is scrambling for a chair on the dance floor, one can reasonably assume that the music has stopped playing, and that is enough justification to start scrambling, or so goes the logic in the bond market.

The initial decline in T-Bond prices has taken the December contract down almost 5 full points in just a week's time. The top chart shows that this sudden drop has taken the closing price far below its 10% Trend, such that the indicator in this chart is now at an oversold level. This indicator simply measures how far the price is away from the 10% Trend. This is obviously an oversold reading, and worthy of at least a temporary upward retracement move. But the important point to note is that after a long period of positive readings, the first oversold indication is almost never the final bottom for a down move. We can see a bounce, but we should also see a lower low before this selloff is done.

The second chart looks at some of the internal breadth data that we calculate ourselves, based on the issues traded on the NYSE. We have found that contrary to popular opinion among technical analysts, the bond funds traded on the NYSE are not polluting the composite A-D data. If anything, they are making it better, because they are among the most liquidity sensitive issues. This A-D Line has been dropping sharply in recent days, almost as sharply as the Dow Jones Corporate Bond Index which is reported each week in *Barron's*. Traders have been abandoning corporate bonds over fears of the ability of corporations to make payments, and that has similarly affected the closed end bond funds on the NYSE.



The final chart updates a relationship we have shown before, and given the events of the past week it may not provide answers to the most pertinent questions but it is still worth covering. When first studying lumber futures prices earlier this year, we found that they tend to lead the Fed Funds rate by about a year. In this chart, the lumber price plot is set forward by one year to illustrate this effect. Lumber recently plunged to a new multi-year low, which means that we are likely at least a year away from the need to worry about a Fed rate hike.

We are certain that the topic will come up about the need for the Fed to fight consumer inflation through rate hikes, but the sensitivity of the Fed to economic conditions, such as those which govern lumber prices, will likely keep the FOMC on hold for a while.

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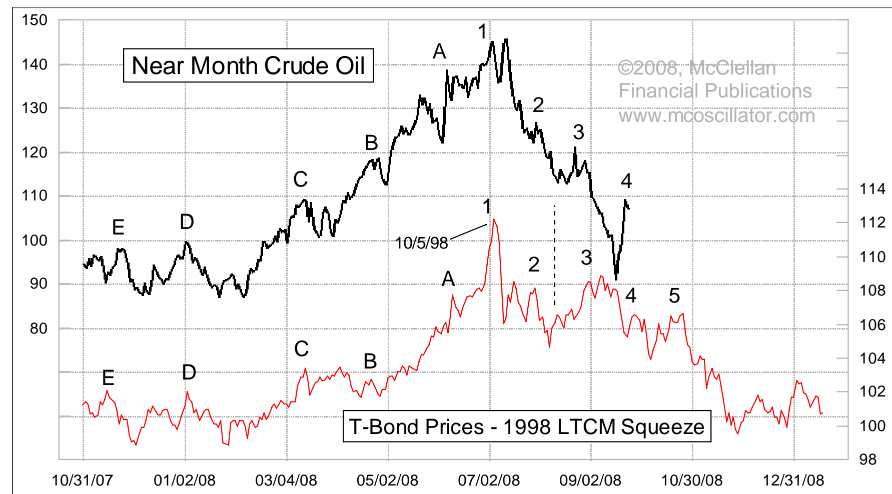
Oil Update

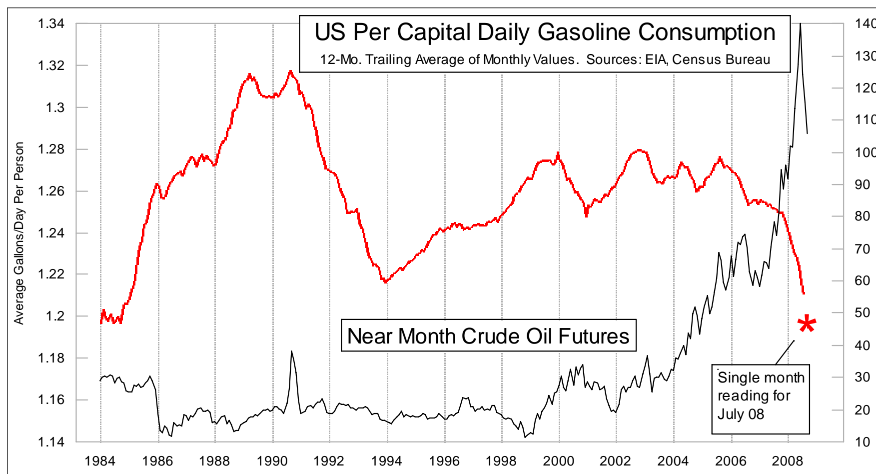
The oil price climb to above $140/barrel occupied a lot of the public's attention just a few months ago. It has been replaced as the dominant story in the financial news by the collapse of more banks and the various actions by the federal government to intervene.

Back in Report #321, we introduced the comparison shown at right, which looks at the current chart pattern in crude oil prices versus the price pattern of T-Bonds back in 1998. You may recall that bond prices saw a big blow-off top in October 1998 related to the collapse of the money management firm Long Term Capital Management (LTCM). Bond prices kept moving too far for LTCM's short positions to stand, and the attempts to unwind those positions contributed to furthering the up move.

A similar dynamic has occurred in oil prices this summer, with the role of LTCM being played this time by energy trading firm SemGroup. But more important to us than the dynamics of the setups was the way that the chart patterns of each have been so similar. We have added alphanumeric labels to some key points of similarity in each pattern. They line up pretty well, but not perfectly, since history never repeats itself exactly. Looking forward from here, we see a generally weak sideways move to point #5, which is just around the time of the presidential elections, and then a further drop.

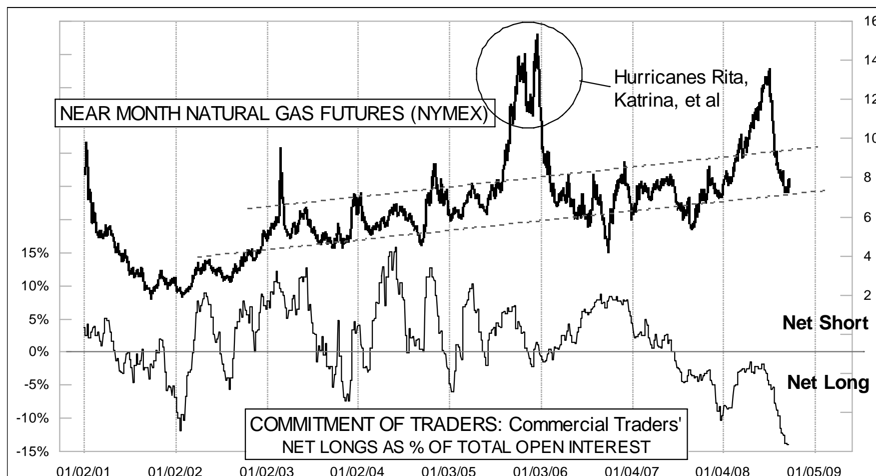


Part of the drop so far in oil prices has been related to the unwinding of complex trading positions, but part of it also has been through the demand destruction brought about by the high oil prices. The middle chart updates our look at per capita gasoline consumption in the US, which has now fallen to its lowest level since the early 1980s. The red line in this chart is a 12-month trailing average, which helps to smooth out the seasonal effects of summer driving. The big asterisk shows July's single month value, which is well below that average. That is noteworthy because July typically sees higher than average consumption. This is the first July in many years to see a single month reading below the 12 month average.



This drop in consumption is the result of all of the measures Americans are taking to use less gas, everything from buying smaller cars to avoiding trips. But we have still only dropped 5% from the peak in 2005. There is still a lot more room for gasoline consumption to fall as people make lifestyle changes, and that will likely keep oil prices from getting back to $140 for a long time.

The situation for natural gas looks much more bullish, and not just because T. Boone Pickens wants to power cars and buses with it. The bottom chart shows that commercial traders of natural gas futures are at their biggest net long position in the history of the COT data (since 1986). Natural gas prices came down hard from the July peak, in sympathy with the decline in crude oil. These smart money traders are betting that the big decline in natural gas was overdone. Interestingly, the commercials are around neutral in their crude oil positions. That tells us that the natural gas market shows much more of a bullish opportunity at the moment than oil does.



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