

In Depth Tom McClellan

By Molly Schilling

Tom McClellan is the editor of "The McClellan Market Report" a comprehensive daily, as well as bimonthly analysis of market activity and trends. Tom's work is characterized by a succinct articulation of an elaborate array of technical tools and barometers, and is invariably punctuated by insightful, informative and historically relevant anecdotes. Tom's style of writing has an unmistakable charm, with touches of humor and irony, ever endearing him to his many readers.

He is the son of the legendary Sherman McClellan and his late wife, Marian McClellan, both of whom were honored in 2004 with a Lifetime Achievement Award by the Market Technicians Association. [Ed. note: You can read Sherman's remarks from that awards ceremony at http://www.mcoscillator.com/reports/special/MTA_speech.html, and also read a booklet that was given to attendees about the McClellans' work at http://www.mcoscillator.com/reports/special/McClellan_MTAaward.pdf] Sherman McClellan is currently a member of the Board of Directors for the Market Technicians Association, and he works integrally with Tom on the research and writing of their Daily Edition and twice monthly McClellan Market Report newsletters.

To the great chagrin of this interviewer (who is a Tom McClellan fan), this interview was conducted by phone...

Molly Schilling [MS]: You publish *The McClellan Market Report* as a bimonthly newsletter as well as a Daily Edition.

Tom McClellan [TM]: The bimonthly news-

letter examines the larger issues and cycles that affect the overall structure of the market. The Daily Edition keeps a close focus on the very near term.

MS: Tell me about the McClellan Oscillator.

TM: The Oscillator looks at the difference between two moving averages of the daily breadth. It can be thought of as an "accelerometer" for the Advance-Decline line. It reflects accelerations that are taking place in the slope of the A-D line. I should emphasize that the McClellan Oscillator is not the only tool in our tool box. There are days when it has nothing to say -- just like every other indicator that we use. The art of being a technician is to look at many different indicators and tools, and figure out which ones best convey the most reliable meaning at the time.

MS: Does the McClellan Oscillator tell us anything about the current state of liquidity in the market?

TM: Yes -- because the A-D line is the closest thing we have to a "liquidometer". You can't really talk about liquidity in terms of being an actual thing -- you can't see it, touch it, feel it -- there's no way to measure liquidity. But everybody knows that liquidity is important. So, the Oscillator can be a kind of a reflection of liquidity.

The A-D line can only be strong -- by definition -- when more stocks are going up than are going down. And we find that, in those instances, liquidity is plentiful. You can have a market where only the strongest are surviving and the biggest of the large caps are hogging all the liquidity while the A-D line goes down. We saw that in 1999 and 2000. That's a problematic condition. But if you have an A-D line that's going up, and if it's making new highs like we are seeing this year, then the market is immunized to a great extent from calamity and ruin.

We did a study recently, looking back all the

way to 1977. We posed the question that if you were at a three year high right now in the A-D line and you knew nothing else, what would the chance be of a really bad drawdown? It turned out that the chance was very, very small. You can have a small, garden variety correction following a new high in the A-D Line, but that is the extent of it.

So, for the current market, I would venture to say that we're not going to see more than a 10% drawdown over the next three months if the A-D line is currently reaching new highs.

MS: The A-D line is a "breadth" indicator?

TM: Yes, when the A-D Line is strong, there is sufficient money out there wanting to come into the market, which allows the majority of stocks to go up. Now, as a digression, I like to say that there are two fundamental factors that matter when it comes to the overall market: (1) how much money is out there, and (2) how much does that money want to be invested in stocks? As you change either of those factors, you change the value of the stock market. Remember, we're talking about the overall market. You can forget yields, you can forget earnings rates, you can forget inflation -- these are the only two factors that really matter.

MS: What about black box trading-- does that affect liquidity?

TM: No, not really. Traders who engage in black box trading would likely still have that money invested in stocks if the black boxes did not exist, so black boxes do not affect the "how much money" part of the equation. It could be said that any type of rapid trading affects the other part -- the "how interested" part in a more rapid way. Black box trading takes advantage of market inefficiencies in a faster and more responsive way than we humans can. So the advent of these tools that allow us to trade without touching anything has, in effect,

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tended to remove opportunities that used to be there for traders to make profits. It takes away the size of the arbitrage possibilities. Consequently, we're actually in a much less volatile market now than we used to be many years ago.

Back in the 1970s you could beat the market trading an index if you had a simple, single moving average crossover signal. You buy when it went above that average and you sell when it went below. You can't beat the market by doing that now because those opportunities get seized upon too quickly by the black box tools. The ironic thing is that even though you could have beaten the market years ago with a simple moving average strategy, you actually could not have executed it because we didn't have index options, discount brokers, no-load funds, and online trading.

MS: Can you say something about MZM and M3 and the different money supply indicators? Is their growth inflating the money supply too quickly?

TM: It is impossible to know that by the process of measuring those money supply gauges directly. One might think that having money supply grow faster than the economy would be inflationary, and right now that is what we have with the US Dollar. An economy is evaluated by its GDP - if the GDP stays the same size and the money supply increases, then you can have an inflationary problem. That's a problem for the guys that control the spigots on creating more money -- it's a problem to know if they're creating too much. When we talk about dollars in this respect, we're talking about the dollar economy -- and the dollar economy is a worldwide economy. We can measure US GDP for investment purposes because we can effectively observe our own GDP. But when people from Mexico, Columbia, Poland, or Mozambique have dollars in their pockets, it is still part of that dollar money supply. As more countries use the dollar as their mode of currency, we can actually create more dollars because the size of the dollar economy is expanding to absorb them.

But how do you measure that? You can't go to Mozambique and ask "are you using dollars today more or less than you did five years ago?" So all you can really do is look at what effect it has on things that matter, like inflation rates, or liquidity in terms of the A-D line, or stock prices. It's a problem, and that's what the Federal Reserve has to pay more attention to.

In any case, liquidity is strong right now... and a strong market like this tends to stay strong for several more weeks or months. Eventually you will start to see momentum divergences, you will start to see breadth divergences, and you will start to see other signs of weakness before the final signs come, and we don't have any of those yet. I do see those coming later this year, in September/October. We seem, generally, to have difficulty in the market

at that time of the year anyway, and I think we're shaping up to have some this year, especially.

MS: What about the third year presidential pattern?

TM: We are in the third year of the current presidential term right now, and I measure those years not from January 1st, but from November 1st. The reason for that is because that's when the election is, the first part of November. Wall Street tends to start reacting to the results of the election as soon as it knows them, as opposed to waiting around to react to the new guy when he's inaugurated.

The third year of a presidential term is always an up year, unless you're in the middle of the Great Depression in 1931, or unless Hitler is marching through Poland in 1939. If you don't have conditions as severe as that, then the third year is an up year.

We're enjoying an up year right now, a year which is supposed to be an up year -- this is when things are going well and things are expected to go well. We don't have to worry about an election yet, and we don't have to worry about the discomfort of the first couple of years of a presidential term.

So this is when the market tends to do well, and it is doing well, right on schedule. But the autumn of the third year of a presidential term tends to be a really rough time, especially when it's in the second term of a presidential period in office. Reagan's second term included the 1987 crash in October of his third year. Back in 1959, in Eisenhower's second term, September was just a really rough month. I expect that we'll have similar difficulties this time when we get to the fall of 2007 -- just because that's the way the pattern tends to go.

MS: So right now, the market continues to look good to you. What would change that?

TM: Seeing the strong NYSE A-D line, seeing the major indices making new all-time highs in some cases, and six and a half year highs in other cases -- those are signs that the market is doing what it's supposed to do. Now, the autumn of the third year is the time that we predict and expect that we will have problems. So sometime between now and then we're going to look for the breadth numbers to start flattening out or even weakening, we're going to look for places where the major indices make higher highs but not at the same rate. And the Dow Theory folks are going to look for new highs in the Industrials, but not in the Transports, those kinds of things. We'll start looking for those signs as we get closer to August and September.

But you're asking me to guess what the trigger will be, or what may be the trigger that will be cited by the national media, which is often different?

MS: Exactly.

TM: The thing that I have my eye on that worries me the most right now is the absolute ballistic trajectory of the Chinese stock market.

Back in 2001 the Shanghai stock exchange index had an ascent rate similar to what we're seeing right now, they had difficulties, and that was all part of the worldwide liquidity trough that we had in 2001 and 2002. Traders started piling up losses and needed to cover their margin calls by selling other assets, which included US holdings, which caused our investors to sell their holdings to meet margin calls -- and we went into a downward spiral.

We're in an upward spiral at the moment, but if I was looking as to where a problem might originate, China would be a logical place to look. And we saw evidence of that in the 400 point drop on February 27th in the Dow. That drop originated from a big sell-off of 8% to 10% in China that led to sales in all the rest of the markets around the world as people went for the liquidity of cash. Granted, it was a momentary liquidity problem that got resolved in a couple of weeks, but the idea is that there's a big puddle of gasoline over there and one spark dropping could start a brush fire that might burn the forest down.

MS: Can you be more specific as to what could trigger a problem in China?

TM: Well, our stock market will keep going up as long as the amount of money out there increases and the willingness of that money to be invested continues to increase, that's what I was saying before. But if China starts to have a banking crisis because they're building too much too fast, then that can obviously be a problem -- we've seen that lots of times in our own housing industry in this country. We're still going through a little bit of an upset with the home builders.

China is trying to grow at a much greater rate and they're not all that experienced. And there's a huge gap between the standard of living of the average American and the standard of living of the average Chinese person.

That gap is rapidly shrinking as the Chinese economy is doing well, and as their standard of living is rapidly scaling up. But I don't see China continuing to use concrete, and rebar and copper at this current rate of growth forever, because at some point they'll achieve a certain standard of living beyond which it's not worth working that hard to go further.

But for right now looking at the view from my foxhole, we're in a period when the stock market is supposed to go up -- it is going up -- it's great that it's going up all around the world. But the fact that all of our financial markets are increasingly linked increases the bounty of the advance, but it also increases the risk that problems elsewhere can cause problems for us -- that a contagious infection can occur in other markets.

As a digression, our financial crash of 1929 led to all sorts of liquidity problems in Europe. Great Britain was a well-established financial community, much more so than the US was in the '20s. They were a much bigger, wealthy nation, but they still got sucked down in the same hole that we

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got sucked down into as a result of the 1929 crash. So, problems can come from another market away from ours. Even though the US is the biggest guy in town, we can still get hurt by the up-and-comers that run themselves into trouble. We've seen a lot of examples of it throughout history.

MS: Any sign of a recession?

TM: No, I don't see any huge amounts of doom coming on now. That's another thing that you don't get when the A-D line is strong, you don't get a recession. Even if the Fed is tightening, you do not get a recession. But if the Fed starts raising rates into a weak Advance-Decline line, then you do get a recession. A recession has not shown up on my radar just yet.

I will say though that 2008 is not going to be the same kind of year we're experiencing now. Getting back to second term presidents, which we have one right now, Bush is in his second term. When the election in 2008 comes around, we are guaranteed to have somebody new, there's no other choice. And Wall Street doesn't like unknowns.

If you look at the field of candidates, Wall Street could probably handle any of them and do okay, and keep on getting down to business and doing what it does. And the reality of any of them would be fine for the markets, but it's the not knowing that

terrifies people and will terrify people increasingly throughout 2008 as we head up to that election. The best example is the 1960 election, Wall Street was terribly afraid that the apple cart was going to get upset, the stability and the prosperity of the Eisenhower years throughout the '50s were going to get upset if we changed parties in the White House. And if that young, upstart kid Kennedy were to get elected, that really scared them.

And the market slid downward all the way to the election in November of 1960. And then as soon as Kennedy got elected and he became a reality instead of just a possibility, the market was fine with that and it started rallying and rallying very strongly. In 1961 it was a great time for the stock market. So that's why I say, the market can handle any reality as soon as it becomes reality, but when it doesn't know, then it has the greatest problems.

MS: What about that "undecided" period in the Bush/Gore Election in 2000?

TM: That's a great question. And in fact, one of the things that we have done is we've taken some of the polling data from Gallup and we were able to forecast the outcome of that election by watching what the stock market does and knowing how that relates to the polling data. The movements of the Dow Jones Industrial Average tend to lead the poll numbers by about a week.

And so, on the Friday before that election between Gore and Bush in 2000, Bush had a six point lead. But we had seen the Dow go up very

strongly that week which tells us that the party in power should have his poll numbers go up also. That bump just had not been reflected yet in the poll numbers. So the week before that election, even though Bush had a six point lead, we said we think this election was going to be too close to call. And we were right, it was too close to call for six weeks, and the market didn't like that. The market slid down from that election all the way into mid-December when the Supreme Court finally made its ruling and Bush was declared the victor.

And as soon as he was declared the victor, as soon as Wall Street knew who they had to deal with, the market started rallying from that low in December of 2000 all the way up until inauguration day on January 20th of 2001. Of course, after inauguration day Bush could never hold up to the promise he held in everyone's imagination and all the wonderful things he talked about.

And that's also a natural thing, anytime you get a new president coming in (especially when you change parties) you go through a period in the whole first year where the new guy gets elected says, "oh, my gosh, it's even worse than I told you it was during the campaign. We got in here and you wouldn't believe all the skeletons in the closets, and it's a terrible situation. And the only way to save us all from terrible ruin is to get this new bill through Congress that I'm proposing... blah, blah, blah."

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You might recall that in 1993 with the GDP growing at 5% President Clinton at the time said, "this is the worst economy in 50 years and we need to pass his economic stimulus package through Congress." So it's the same game that gets played every time. You can fully expect in 2009, whoever wins office is going to discover that things are even worse than he said they were during the campaign, and that it will be a pretty depressing time, because people don't like hearing that things are worse. That's why the first and second years of a presidential term tend to be flat to downward for the stock market.

MS: How did the Oscillator come about originally?

TM: My parents created the McClellan Oscillator or the McClellan Summation Index back in 1969. A television personality, Gene Morgan, had a show called Charting the Market at KWHY-TV in California, beginning in the '60s and continuing into the '90s. He would use hand-drawn charts to look at the market every day, back when that was a pretty sacrilegious practice. He invited people who had an interesting or unique indicator to come on the show. My dad had been playing around with Advance-Decline statistics, and introduced his newfangled oscillator to Gene's audience. At the time, Gene had to call it something, so he called it Sherman McClellan's Oscillator or the McClellan Oscillator and that's how it came to be. Those indicators became a regular part of Gene's daily show.

One of Gene's friends and colleagues was a guy named Kennedy Gammage, who for years wrote *The Richland Report* newsletter. Kennedy and Gene Morgan were friends and did things together, and Kennedy picked this indicator up and said, "hey, this does some magical things," and he would write about it in his newsletter and put on a few seminars to train people about it.

MS: Both your parents were involved?

TM: My father was a finance major in college and my mother had majored in mathematics. She was one of those people who could balance her checkbook in her head. She was just a whiz with numbers, and did all the computations of these exponential moving averages on scrap paper so that they could then, together, update the charts with a pencil and a ruler and have something to look at.

My father had studied business and finance back in the '50s, and hoped to go to work somehow in that field. The 1957 bear market got in the way of that idea, and led to a 25% layoff in the brokerage industry. He originally began looking at price charts because his family had, for years, owned a farm in Illinois that they rented out. And the deal was that the owners got half the profit for the corn that was grown on the fields from the folks who were renting out the farm.

So when you have this pile of corn that you're sitting on, you don't want to take it down to market in September/October when everybody else is harvesting it and the prices are depressed. You want to put it in the corn crib, and dry it out for a while and sell it later, perhaps in the spring when you can get a better price for it. So my dad was in charge of managing that farm and figuring out when to sell the corn. He had no idea how to do that, so he wanted to understand how corn prices moved, and he started looking at charts of corn prices to try to get a better understanding. It all followed from there.

My mom worked for a Naval Ordnance Research Company back in the '50s on one of the first practical computers that they were using to plot trajectories of naval gunfire. She initially got involved in following the stock market to support my dad, but she really got into market analysis. She was the one who came up with the idea for the McClellan Summation Index, drawing upon the notion, from calculus, of integrating the area under the curve. She was also a Girl Scout leader, PTA officer, church leader, community volunteer, business owner, grandmother, and caregiver for several friends and relatives. She passed away in 2003 -- she died of cancer.

After creating the indicators in 1969, my parents wrote a book in 1970 to introduce their indicators to the world, but the time wasn't right yet to make a business out of it all. They didn't have any PCs; if you wanted to do printing you either were faced with a mimeograph situation, or offset press, and offset printing has its own two-day delay. So the information is sitting there getting stale while the ink dries. Plus, they had three little kids to feed and put through college, and they looked at the situation then and they said, "we need to get a real job." So that was the avenue they pursued. My father worked in manufacturing, and they ended up buying a plastic injection molding business in 1976.

My dad has done some advisory work for institutional clients since the '80s just writing on his own, but we didn't get the newsletter started until 1995. I had gotten out of the Army in 1993 and wanted to go into the financial analysis business. I went to West Point -- graduated in 1982 and stayed in the Army for 11 years -- so I was around 33 years old when I joined the family business, and by that time, there were many more accessible ways to get the information out with computers and so on. We finally started a newsletter edition of *The McClellan Market Report* in 1995. Back then, we all gathered around the dining room table to stuff envelopes and put stamps on them. My kids eventually got really good at getting stamps on straight. Now, of course, we publish mostly over the Internet.

MS: What's your feeling about the current inflation situation?

TM: Good question -- and it's a terrible question right at the moment. One of the best tools that we've had for years is looking at the price of

gold as a leading indicator for the inflation rate as depicted by the CPI. If you take the price of gold and you slide it forward in a chart by 14 or 15 months it correlates with about a 75% to 80% accuracy to what the inflation rate does, up until about a year ago.

Gold going up to \$700 says that we should have the inflation rate going up to 8 to 10%, and we're not seeing that, so something got broken. And it may be a momentary anomaly and they'll get back in sync together, but for the last year and a half it hasn't been working like it's supposed to. Now, gold may be wrong by going up so high and mistakenly reflecting inflation that's not really there, or the CPI might be wrong and it's not really telling us the extent of inflation that's occurring that's just not being measured. You can argue all night about which of those is true.

I do know that inflation is a real factor for Iowa farmland which is appreciating about 11% to 12% per year, because when you get corn up to five bucks a bushel because everybody wants some ethanol, and then it suddenly becomes a whole lot more profitable to buy Iowa farm land and start growing something.

This concept of movements in one market leading to similar price structures later in other markets is a phenomenon we refer to as Liquidity Waves. We recently released a DVD about Liquidity Waves, shot at a seminar I did earlier this year in Dallas, and it is available on our web site.

MS: Lastly, do you think Ben Bernanke has a subscription to your Daily Edition?

TM: Well, he should, because in our history of writing the newsletter, we have been 100% accurate at predicting what the Fed should do. Now, predicting what the Fed actually does is a different story... but we've always been right about what they should do (tongue in cheek)...

MS: Thank you very much, Tom... this has been fun.

The McClellans are building a learning center on their web site to talk about the indicators and other work that they've done -- non time-sensitive topics of general interest about TA and the indicators. As Tom says, "Sort of a FAQ on steroids." Look for it -- free -- on their website: www.mcoscillator.com.



Molly Schilling is an independent trader and freelance writer.