

THE McCLELLAN MARKET REPORT

INSIDE

WHAT QE INFINITY MEANS	P. 1
POMOs SHOW MKT MOVES	P. 2
GOLD TO \$2900?!	P. 4
BC INDICATOR UPDATE	P. 5
TIMING MODELS	P. 6
T-NOTE COT DATA	P. 7
APPLE: THE GHOST OF RCA	P. 8

Prepared After the Market Close, September 25, 2012

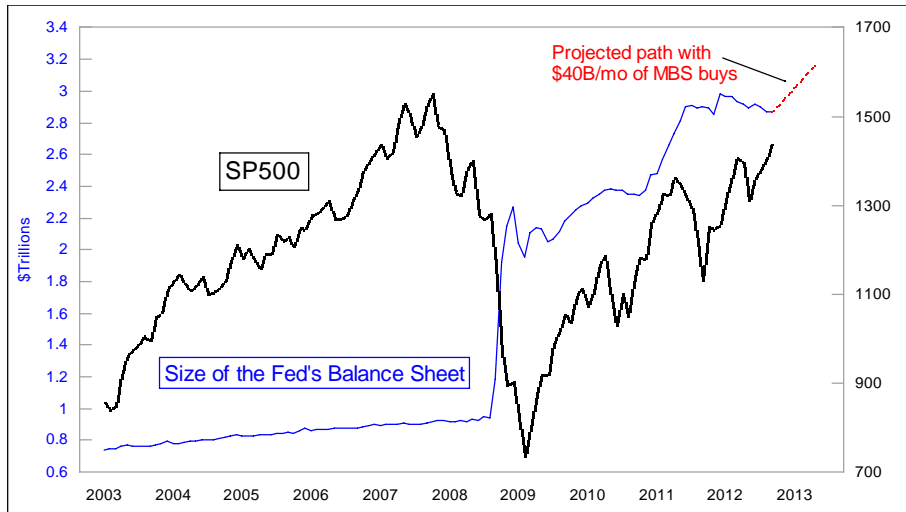
Report #419, September 26, 2012

Fed Turns Money Spigot Wide Open

The FOMC answered all of the questions about whether there would ever be a QE3 by announcing on Sep. 13 that it would be doing more QE for the indefinite future. Even though the past two rounds of QE have not had the desired effect of resuscitating the productive economy, the Fed seems to be adopting the slogan of "The beatings will continue until morale improves".

QE might not have done all that was desired for the unemployment rate, but it has been an unqualified boon to the stock market, at least during the periods when it was going on. When the Fed tried to pull away the punch-bowl, we got the Flash Crash of 2010 and the ugly decline of August 2011.

The FOMC's Sep. 13 announcement said that the Fed would be buying up \$40 billion of mortgage backed securities (MBS) per month, with no scheduled end date. The top chart compares the behavior of the SP500 to the size of the Fed's balance sheet, and we have



modeled in what an additional \$40 billion per month would look like, assuming that no counteracting changes were made. That's not necessarily a good assumption, because banking shifts and adjustments go on all the time. But it does help us to visualize what the effects of these big numbers would look like.

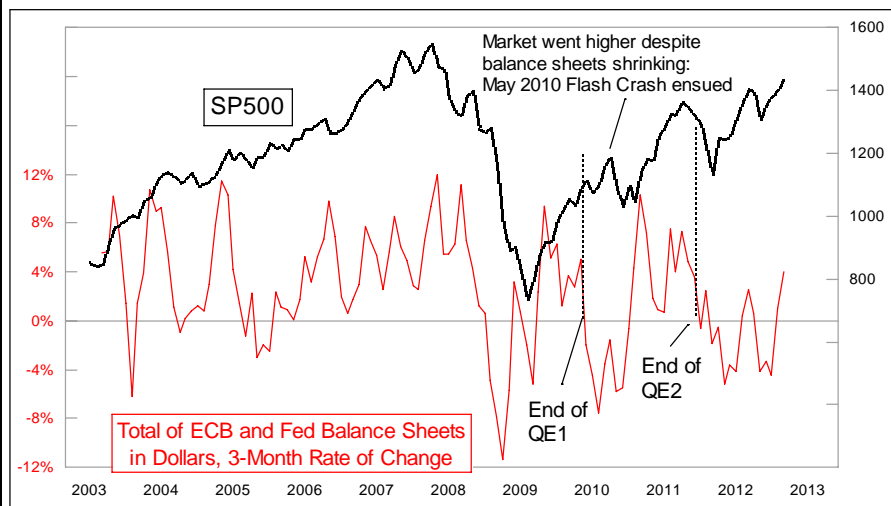
And it is not just the Fed's balance sheet which matters. Back on April 13 we published a [weekly Chart In Focus](#) article that featured the chart above, as

well as the one below that looks at the combination of the Fed's balance sheet and the ECB's. The lower line in the bottom chart looks at a 3-month rate of change in the combination of the two balance sheets, and you can see that there is a pretty good correlation.

The implication is that if the Fed is indeed going to be increasing the size of its balance sheet, and if the ECB is going to follow suit as [Mario Draghi has announced](#), then we should see several months of a positive rate of change,

BOTTOM LINE

By promising the markets the chance to pass "GO!" and collect \$40 billion each month, the Fed has changed the stock market picture dramatically. More QE is definitely bullish for the stock market, but now we don't know for how long. We still expect stocks to run upward into November, as suggested by our eurodollar COT leading indication, but then we'll have to see how the Fed is playing its cards. T-Bonds and T-Notes are poised to fall in price from here (rising yields), as lumber's rise over the past year points to a limited improvement in the economy. That may contain how long the Fed keeps up this round of QE. Gold is due for a mid-cycle dip as part of its 13-1/2 month cycle, with a bottom ideally in October. Gold does have an overbought condition to work off.



and thus a rising stock market.

The Fed's actions within the banking system also matter on a daily basis, not just on the monthly basis shown in the charts on page 1. The chart here on page 2 looks at the net value of all Permanent Open Market Operations (POMOs) done by the Fed. That plot is shifted forward by two days, to take out the lag induced by the 4-day look-back, and to reveal that the surges and pullbacks of Operation Twist correlate nicely with the SP500's behavior.

Normally there is a pretty good correlation, but the FOMC's Sep. 13 announcement brought a big celebratory rally for stock prices that was not part of the POMO program. We liken it to when an asteroid falls into the ocean, it tends to overwhelm the surf forecast.

One interesting point about this POMO data is that the Fed tells us a month in advance what it is planning to do, and then tells us the same day what it actually did. The red portion of the plot shows the remaining portion of the announced purchases and sales, and it suggests that there is an up move coming for stocks in the next few days. We will get the next month's schedule on Sep. 28.

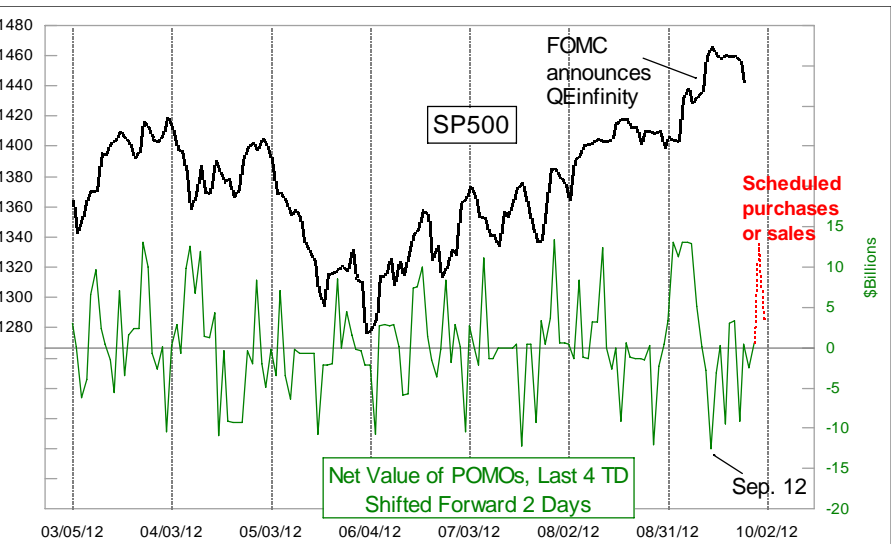
Bottom Line: Quantitative Easing (QE) may not have saved the economy yet, but it has been bullish for the stock market whenever it is used.

Page 3 Charts

Chart 1: The A-D Line has pulled back down to its 10% Trend from the all time high that it made on Sept. 14. That would be just a normal consolidation event, if it is able to stabilize near this level. The lower left to upper right pattern on this chart is clear evidence that the Federal Reserve is being effective in providing liquidity to the market.

Chart 2: The Daily Volume Line gave a mighty effort, but was not able to make a new higher high on Sept. 14. There has been an orderly pullback down toward the 10% Trend. Should there be another surge higher following this consolidation, then it should be able to get that mission accomplished just as it did earlier this year in the move up and away from the 1% Trend.

Chart 3: The McClellan A-D Summation Index moved up 3 ticks short of 1000 points from September 5 to 21. That was a big enough show of energy to pop the NYSE Composite above a downtrend line originating in 2007 that



had resisted all the previous breakout attempts. Anytime a trendline is broken there is the expectation that there will be a pullback to or toward the trendline. That appears to be what is taking place now, with the Summation Index having topped out and now in a decline from its lofty +3689 high. With no divergences evident yet, the path should be clear to higher price highs on the next Summation up move.

Chart 4: The Volume Summation continued its progression of higher highs and higher lows in September. In the center of the chart, there was a much lower divergent top on the Volume Summation to go with the highest price highs of last spring's top. With the Federal Reserve continuing to pump up the economy with QE3, it is very unlikely that a final price top would be put in just as this new QE program is getting started. The stock market did not top until after the end of each of the three prior programs, QE1, QE2 and the Twist. With no announced end to QE3 that could make identifying the end of this current uptrend much more difficult. But its end should drive the Summations well below zero, just as the end of the prior three efforts did.

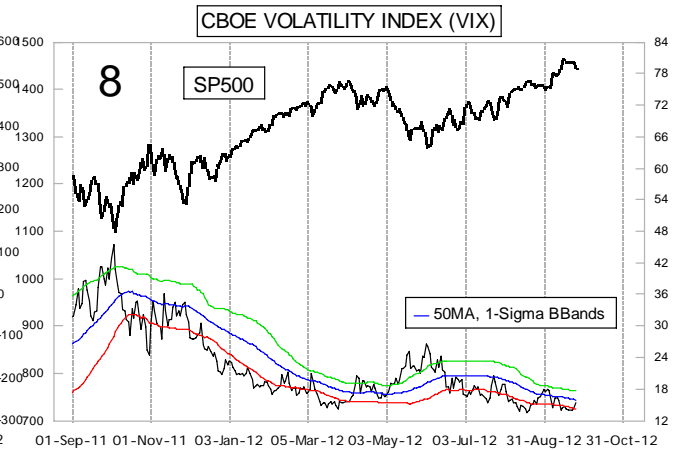
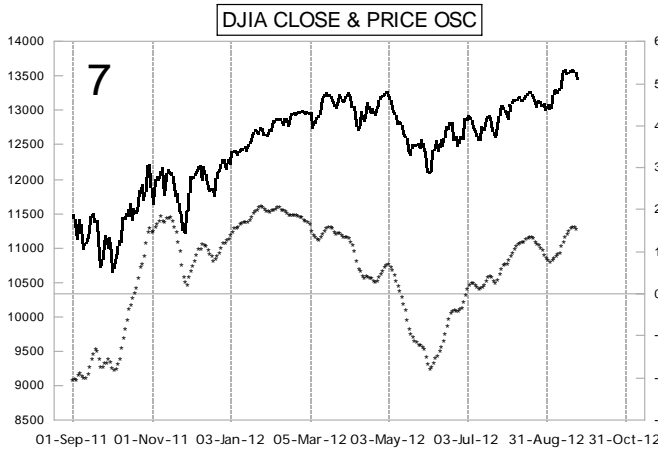
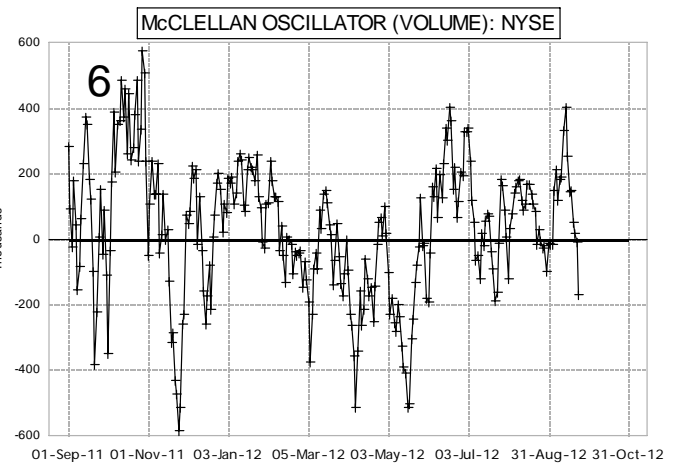
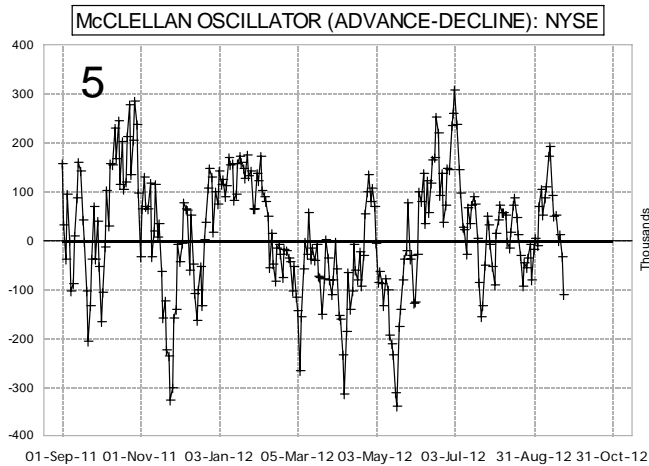
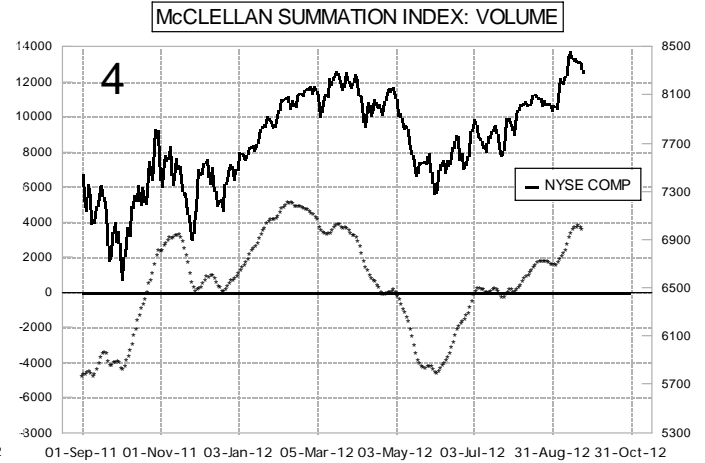
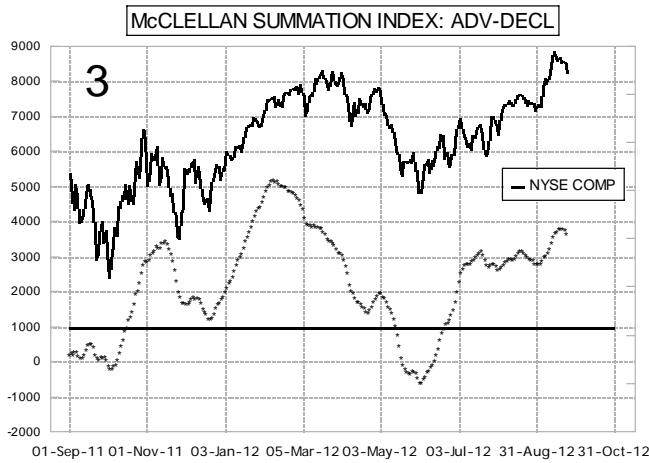
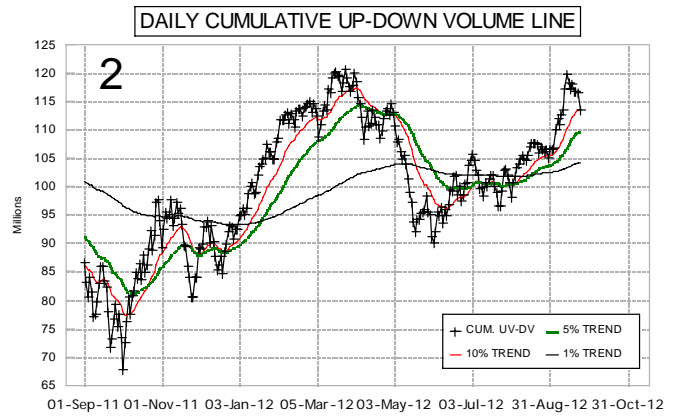
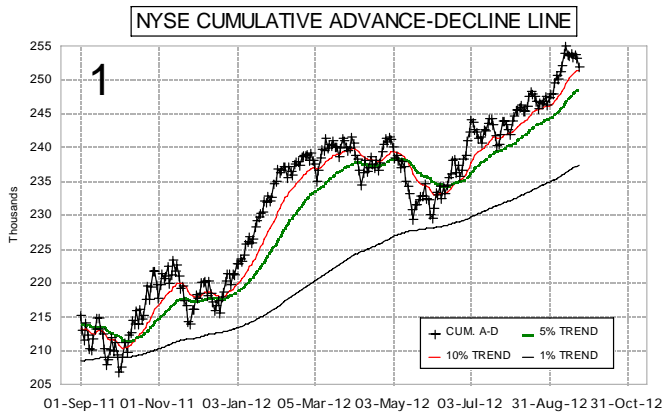
Chart 5: The McClellan Oscillator had a good pop up to +192 on Sept. 14, and that was high enough to show some initiation while at the same time pointing out that an overbought condition had arrived. The quick drop back below zero is working off that overbought condition. If the Fed is going to be effective with QE3, then the Oscillator should reflect that by returning back into to positive territory. How soon that occurs and with what kind of pattern should tell how effective the Fed is

going to be with that effort. Its monetary efforts might get overpowered by fiscal changes that show up as a result of the elections, or from the resolution of the "fiscal cliff" by Congress.

Chart 6: The Volume Oscillator also put in a quite satisfactory high to confirm the NYSE Comp's breakout. It has been more one sided than the A-D Oscillator by spending much more time and at greater amplitude on the north side of zero following the June 4 low. With the Volume Summation up at such high levels, it will be difficult for the Oscillator to make more than low level moves above zero.

Chart 7: The DJIA Price Oscillator ran to a higher high as the DJIA broke out above the highs that it made last spring. A pullback to test those spring highs could be setting up the extension of the price move that would be expected with the Fed's introduction of QE3. If the Price Oscillator can stay up in the +100 to +200 area, then a quite satisfactory trending price move can result, just as it did in the middle of the chart while Operation Twist was taking place.

Chart 8: The CBOE Volatility Index (VIX) dropped below last spring's low as the SP500 probed those price highs recently. The SP500 backed off while the VIX bumped up through its 50-day moving average. That turned out to be the set up for the SP500 (and DJIA) breaking out to higher highs, while the VIX dropped back below its lower band. The upper band is very close to the downtrend line that can be drawn across the Nov. 9 and June 4 VIX tops. So, any serious penetration of the upper band could be an indication of a more serious price drop and VIX run up.

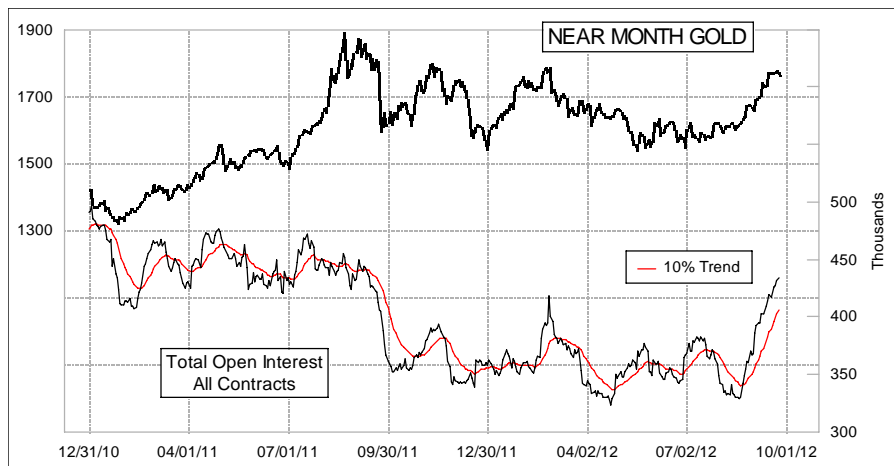


Mid-Cycle Low For Gold Due in Oct.

Gold has had quite a nice run upward in honor of the upward phase of its 13-1/2 month cycle. That cycle is usually all about marking the important bottoms for gold prices, although this latest one had the unusual behavior of splitting into two separate lows, each equidistant from the ideal cycle bottom date. That is not unprecedented. We saw a similar split like this back in 2006, at the left end of the chart. And the 9-month cycle for stock prices split into two separate bottoms back in the fall of 1998, on Aug. 31 and Oct. 8 of that year, when the ideal cycle low was due in September. So it can happen.

One other attribute of this cycle is that it typically sees a mid-cycle low right as the cycle is topping out. This is known in cycle terms as a “half-period harmonic”, meaning that there is a half-cycle embedded within the larger and more important 13-1/2 month cycle. That mid-cycle low is ideally due in October, but it is not a very punctual phenomenon. You cannot set your watch by it, but it is still real enough that it can be useful to know when it is due, and thus what to expect prices to do as it draws nearer.

The run up in gold prices attracted a lot of attention, from the surge into gold bullion ETFs we discussed last time to a rise in total open interest of gold futures. That latter item is shown in the middle chart, and it generally rises and falls along with gold prices. It is when we see a really dramatic rise in open interest that we can infer that sentiment may have run a bit too far. That seems to be the case now, since the rise in gold open interest has been much bigger and



more rapid than we have seen on past gold price rallies. We often get asked about how far gold prices can run up, and that is a hard question to answer especially when we don't know for how long the Fed will keep running the printing presses. But there is one measuring technique that we have borrowed from conventional bar chart analysis that may have some utility.

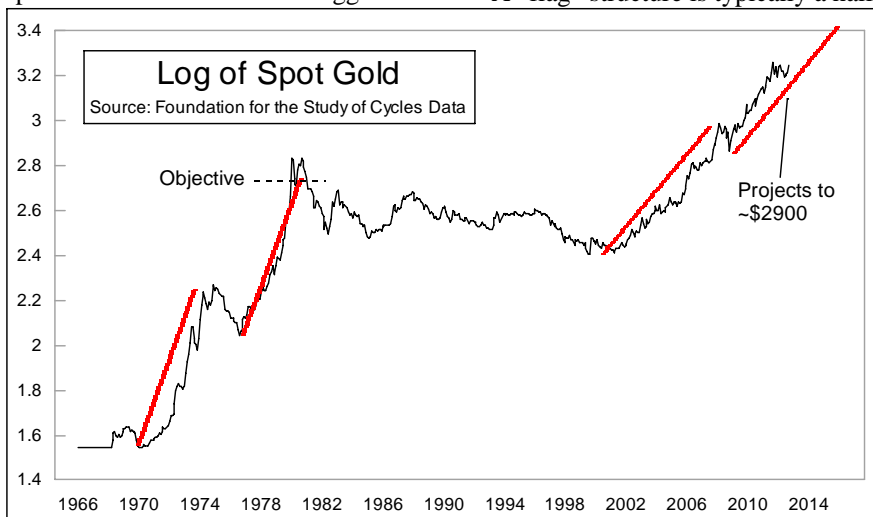
A “flag” structure is typically a half-

way measuring structure for a trending move. Edwards and Magee wrote about them extensively. A lot of the stock market bar charting techniques do not work the same when transplanted to other markets, and so we are leery about applying them to a commodity market such as gold. But there is sufficient precedent to show that they can work.

The bottom chart shows gold prices plotted on a logarithmic scale. At the left end of the chart is the big run up that occurred during the 1970s, after President Nixon finally broke the gold standard. There was a big initial surge upward to a top at the end of 1974, just before Americans were finally allowed to start owning gold in 1975, and the rest of the world tried to front-run that expected bump in demand.

Taking the height of that initial runup and using it as a measuring “flag pole”, we find that the second run upward out of the pause did meet the upside objective. In fact it exceeded that objective slightly, which is fine for how these measuring objectives work.

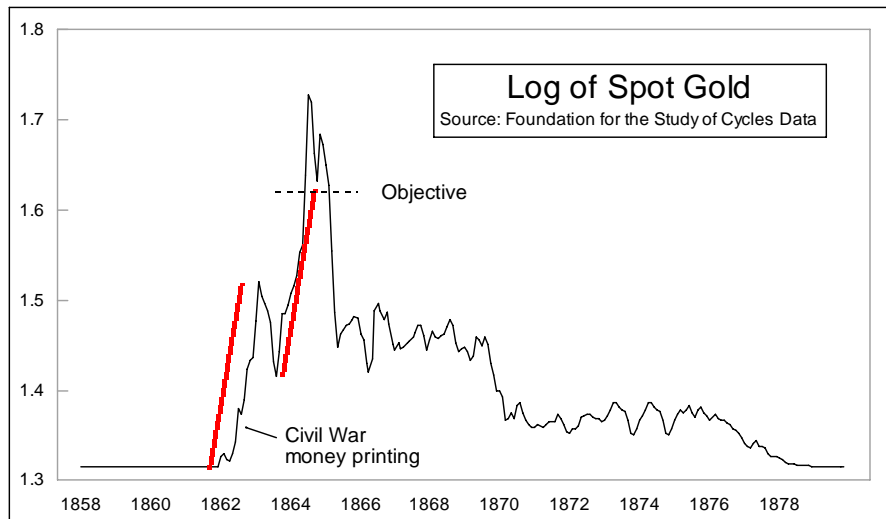
At the right side of the chart, we see similar behavior, with a rapid run up into the early 2008 top. If the big cor-



rection that year is a halfway measuring structure, then that projects to an upside objective of around \$2900. We could get more precise in our calculations, but that would not be warranted by how these things work.

There is even older precedent for using this technique on gold prices. Back in the 1860s, the U.S. government had to print a bunch of extra money to help fund the Civil War, and then later "reconstruction". There was a big initial surge to a top in February 1863, then a drop from \$33.18 to \$26/oz that year before gold surged again to a final high of \$53.35 in July 1864. On a logarithmically scaled chart, we can see that the upside objective conferred by that halfway pause was indeed met and exceeded. So this appears to be a legitimate measuring methodology for really big time frame moves in gold prices.

Could gold go on beyond \$2900/oz? Certainly it could, especially if the Fed keeps interest rates at zero, and keeps



growing M1 at more than 9% per year. And in each of the examples shown here, gold prices have exceeded the flags' measuring objectives.

BC Indicator

When we first shared our BC Indicator a few years ago, we labeled it as "experimental" because we had not done all of the testing and investigation that we think is needed to fully understand it. We still have not done all that we should, but we rolled it out because it was definitely interesting enough to want to share.

The exact methodology of it is still proprietary, but it would be fair to say that it is a collection of lesser cycles that can be projected out well into the future. One look at the chart below makes it obvious that there is some kind of interesting relationship between BC and the movements of the stock market, although exactly what that is seems changeable.

The turning points that BC shows do seem to matter, but early on in our stud-

ies we found that sometimes it can invert. That's why we still label its turning points as "implied" tops or bottoms in the table on page 6.

BC caught the timing of the recent up move and top pretty well, although interestingly the magnitudes that BC shows do not necessarily match up all that well with how prices actually behave. The 9/21 top shown by BC hardly seemed like anything, compared to the 8/13 top, but it brought a big price response.

It is also interesting that what we call the little "saddle" wiggles do not necessarily have to be tops or bottoms, but instead they tend to mark a volatility cluster for prices, after which the market gets back to doing what it was doing before.

Up ahead, BC calls for an implied bottom due Oct. 24, and an implied top just after the election. Neither of those has yet been confirmed by our regular Timing Model signals. But the implication of a post-election swoon is an interesting one to contemplate.



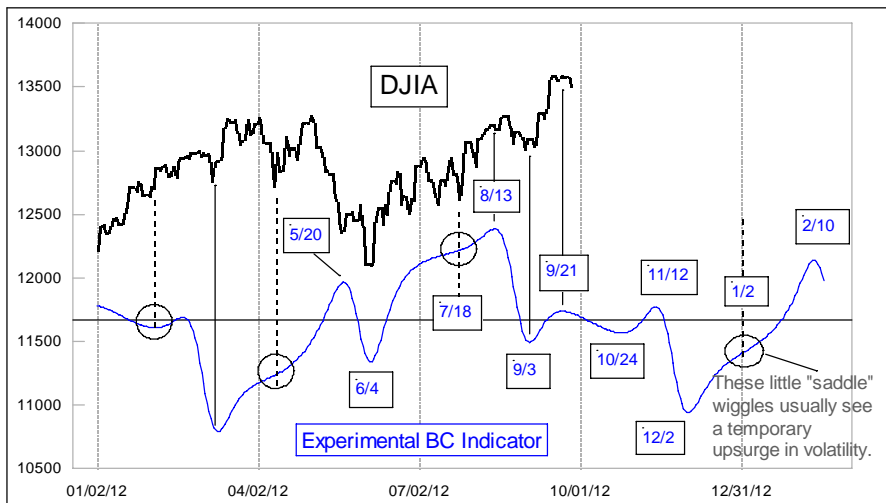
Sherman McClellan
Publisher

Tom McClellan
Editor

The McClellan Market Report,
ISSN 1094-8163, is published 24
times a year by email & web access.
Annual subscription rate: \$195

Visa, Mastercard, and Discover cards
accepted, or mail payment to:
McClellan Financial Publications
P.O. Box 39779
Lakewood, WA 98496-3779
Phone (253) 581-4889 fax:584-8194
Subscriptions: (800) 872-3737
or at www.mcoscillator.com
email: tom@mcoscillator.com

©2012. All rights reserved. Any reproduction of the words, graphs, tables, or analysis, in whole or in part, without the express consent of McClellan Financial Publications is strictly prohibited. Analysis is derived from data believed to be accurate, but such accuracy or completeness cannot be guaranteed. It should not be assumed that such analysis, past or future, will be profitable or will equal past performance or guarantee future performance or trends. Information is provided to assist readers in forming their own understanding of market structure and no statements made herein should be construed as recommending any specific course of action. All trading and investment decisions are the sole responsibility of the reader. From time to time the principals of McClellan Financial Publications may have open positions in the markets covered.



TIMING MODELS

Stock Indices (DJIA, SPX, Nasdaq, NYSE Comp., etc.)				Bond Market (Corporate & Treasuries)			
SIGNAL	SOURCE	PREDICTED	ACTUAL	SIGNAL	SOURCE	PREDICTED	ACTUAL
	Top Nasdaq ST Price Osc	Sep 5	Sep 7		Bottom T-Bond Close/Sum	Sep 5	Sep 7
	Top NYSE Summ Index	Sep 10	Sep 7		Bottom TYX ST Price Osc	Sep 5-10	Sep 7
O	Bottom DJIA ST Price Osc	Sep 10	Sep 10	Bottom	T-Bond Price Osc	Oct 1	
O	Bottom NDX Summation	Sep 10	Sep 10	Bottom	T-Bond ST Price Osc	Oct 5	
O	Bottom SP500 ST Price Osc	Sep 12	Sep 10	Bottom	TYX Price Osc	Oct 30	
O	Bottom Uncommon A-D Osc	Sep 13-14	Sep 10	Gold and Precious Metals Stocks			
O	Bottom DJIA ST Price Osc	Sep 14	Sep 10	SIGNAL	SOURCE	PREDICTED	ACTUAL
	Bottom NYSE A-D Osc	Sep 19	Sep 18	Bottom	XAU ST Price Osc	Sep 7	Sep 5
	Bottom NDX Summation	Sep 19-24	Sep 18	Top	XAU ST Price Osc	Sep 24	Sep 21
	Bottom NYSE A-D Osc	Sep 27		Bottom	Gold Close/Sum	Sep 27	
	Bottom Nasdaq Price Osc	Sep 28		Top	XAU Price Osc	Oct 9	
	Top SP500 ST Price Osc	Sep 28		Top	XAU Close/Sum	Oct 12	
	Bottom SP500 Up-Down Osc	Oct 2		Top	XAU Up-Down Osc	Oct 12	
	Bottom NDX A-D Osc	Oct 8		Top	XAU Up-Down Osc	Oct 24	
	Bottom NYSE Summ Index	Oct 10		<p>“Event” risk like The “implied top” that was suggested</p> <p>this is a factor at any time, and can trump other technical factors if the event is big enough. That appears to be the case with the Fed promising to drop money out of helicopters well into the indefinite future.</p> <p>The “implied top” that was suggested by our experimental BC indicator did seem to turn out right. You can see a chart and more discussion of that on page 5.</p>			
	Top NYSE A-D Osc	Oct 10-11		What To Expect			
	Top DJIA ST Price Osc	Oct 11		<p>We are not seeing any major (bold lettered) signals for the stock market, nor any big clusters of signals. We still do not have any signals for the major top for November that is forecasted by our eurodollar COT leading indication, as discussed in MMR 417. There is one implied top from the BC Indicator due Nov. 12, which would match nicely with the eurodollar COT message.</p> <p>T-Bond signals have almost totally dried up, except for a pair of bottoms due Oct. 1 and 5, which sort of match a minor stock market top due Friday, Sep. 28.</p> <p>In the gold table, we have an unusual cluster of top signals generated by indicators for the XAU, calling for a top due Oct. 9-12. That may be related to a pair of stock market tops due Oct. 10-11.</p>			
	Bottom Uncommon A-D Osc	Oct 15		<p>Several readers wrote to ask what it means when the table shows only bottom signals for a protracted period, as was the case in our last Report. It really only means that these are the signals that have been generated. A turn can certainly come without a signal to foretell it, and so if there are two widely-spaced bottoms then we just have to infer that sometime between them there will be an intervening top.</p>			
	Bottom Nasdaq A-D Osc	Oct 15		<p>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.</p> <p>The BC indicator is an experimental new tool, not related in method to the other signals.</p> <p>“Actual” dates listed for NYSE Indices are for the NYSE Comp/Dow Jones Industrial Average. Letter groups (A, B, C, etc.) denote clusters of signals. ST Prc Osc means “Short Term Price Oscillator.”</p> <p>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.</p>			
Experimental New Indicator, “BC”							
	Predicted Signal		How It Turned Out				
	Implied Top	Sep 21	Top	Sep 20			
	Implied Bottom	Oct 24					
	Implied Top	Nov 21					
	Implied Bottom	Dec 2					

The Signals

These signals detect the ripples in the liquidity stream, ripples which can have echoes later on in price behavior. They have been shown over the years to work pretty well, as long as somebody or something does not intervene to interfere with the normal market operation.

We saw just such an interference this month, when the FOMC did a giant “cannonball” jump into that liquidity stream with its announcement of QEinfinity. The waves from that move served to swamp the market’s own natural waves, and only now are things starting to settle down and get back to normal.

The immediate effect was to dampen out the mid-September bottom cluster (O). Things appear to be dampening down now, and stocks appear to have started to dip out of the recent plateau, toward 2 bottoms due Sep. 27-28.

Several readers wrote to ask what it means when the table shows only bottom signals for a protracted period, as was the case in our last Report. It really only means that these are the signals that have been generated. A turn can certainly come without a signal to foretell it, and so if there are two widely-spaced bottoms then we just have to infer that sometime between them there will be an intervening top.

HOW THEY WORK

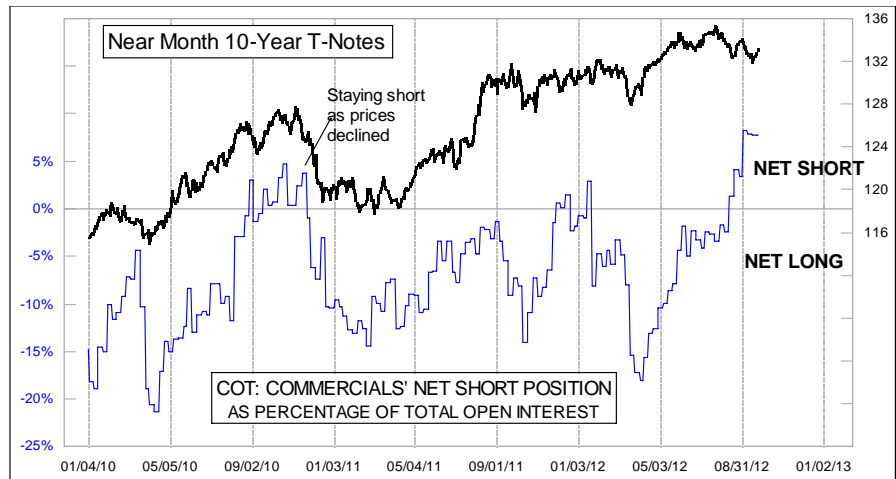
These timing models are based on our proprietary calculation method. This technique involves a computationally complex comparison of two or more carefully selected indicator values. This yields the date and direction of a projected future turning point. Making several such comparisons can help paint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

COT Data Say More Bond Price Decline Ahead

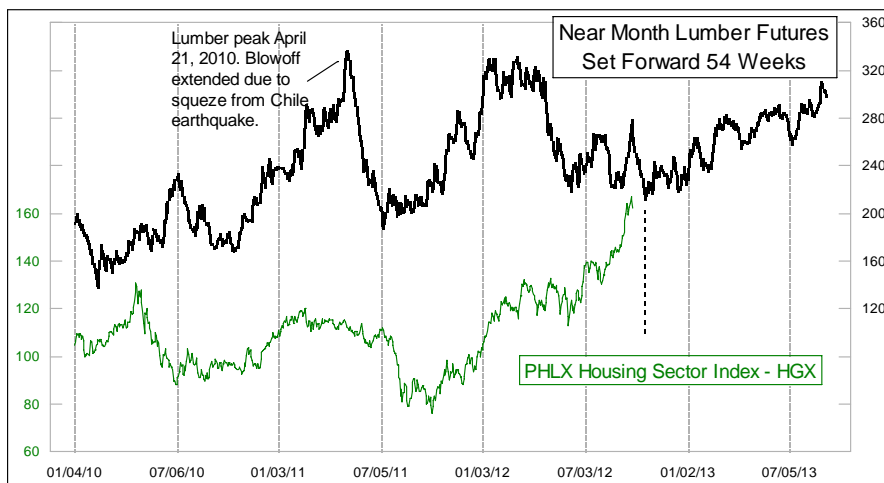
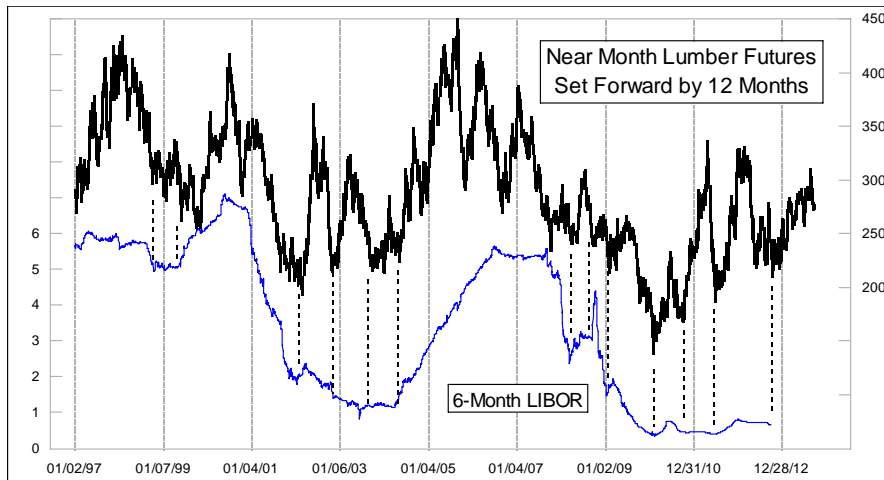
Every Friday in our *Daily Edition*, we feature updates on the most pertinent developments from the weekly Commitment of Traders (COT) Report, published on Fridays by the CFTC. It shows total open interest for a big variety of futures contracts, along with how many of those contracts are held by the various categories of traders. Futures brokers have to report these positions as of each Tuesday, and then the data all get tabulated for the Friday report.

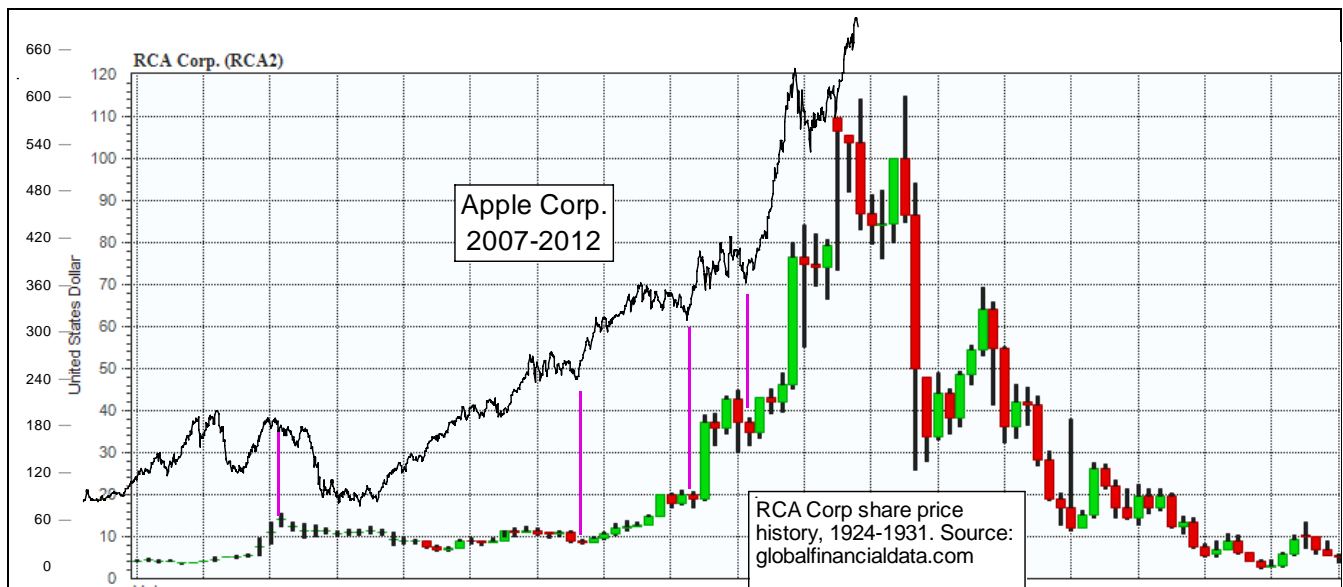
The “commercial” traders are the category for the largest traders, and they are presumably the smart money because they are the big money. So it has been fascinating to see a decline in T-Bond and T-Note prices since June 2012, while the commercial traders of T-Note futures have actually been upping their net short position as a group. Usually they will unwind a short position as a price decline progresses, and so to see them increase it is unusual



and perhaps telling behavior. It suggests that there is more of a price decline to come, or at least that was the meaning back in 2010 when they were exhibiting a similar behavior as a group. The idea that we could see a bond price decline is also borne out by the middle chart, which looks at the leading indication for interest rates that is given by lumber prices. In this case, we are displaying the 6-month LIBOR rate, but this relationship also works for other

interest rate series, with the exception of the shortest maturities which the Fed is artificially keeping at zero. The lumber price plot is shifted forward by a year to reveal how its movements tend to get echoed a year later in short term interest rates. Almost a year ago, lumber futures prices were bottoming, and since then have risen from the vicinity of 210 to above 300. This suggests that we should see a rise in short term rates as we head into 2013. But you may notice that this relationship does not work as well with the magnitude of the moves. It gets the timing of the turns pretty well, but how far the interest rates actually go can be affected by other factors. Rising rates imply a stronger economy, and thus a greater need for capital which creates competition for the available money. The rise in lumber prices since early 2009 has pointed to an improving economy, although lumber prices are still quite far from the heights that they saw at the peak of the housing bubble. The bottom chart uses the same technique of shifting lumber prices forward, but in this case we are looking at the HGX Index for the housing sector. It has had a nice run just recently, and gotten a lot of attention from the financial TV types. This chart reveals that the recent run up in the HGX was the echo of a similar pop in lumber futures prices just over a year before. Looking ahead, this relationship says that housing related stocks are due for a tumble into a bottom that equates to around Oct. 14, but then housing stocks should be able to trend higher in a more sustainable way heading into 2013. If so, that supports the idea of bond prices coming down, and rates going up.





Apple's Big Run Looks Strangely Familiar

Halloween is still over a month away, but it is not too soon to start getting warmed up for it with a scary looking chart. In thinking about Apple's impressive run recently, we got to contemplating other notable uptrends in technology stocks. Comparisons to the heyday of the Internet bubble in the late 1990s did not seem quite right, because that was a bubble that was spread out across anything tech-related. Apple seems to be a phenomenon all its own.

A better analog might be the rise and fall of the Radio Corporation of America, which is better known as RCA. The history, management style, and structure of Apple and RCA are vastly different stories. RCA was born out of the ending of a U.S. government monopoly over all radio communications as part of the war effort for WWI.

General Electric formed RCA and launched it on its way with sole-source government contracts that helped it grow into a major electronics company that pioneered many of the things we still use today, like the NTSC standard for televisions.

Apple, by comparison, was started by two guys in a garage, and grew without much government support or supervision. It had a much different approach to the market place as well as a different management style. One might think that this should lead to different stock price behavior, since those are the factors that we are told are important in business and investing.

And yet despite those differences, we still see such strong similarities in the structures of their price plots. The chart of RCA is one that we found at the web site of Global Financial Data, which is the leading provider of historical financial data for a variety of purposes. Their chart is republished here with permission. Check out their web

site at www.globalfinancialdata.com.

To create this comparison chart, we overlaid a chart of Apple Corp's price history, taking care to make sure that the horizontal time spacing was the same as the RCA chart (i.e. no accordion style stretching of time to make it fit). It is not an exact match, and indeed no pattern analog ever is. But there are enough points of similarity to say that this is a very interesting comparison.

The bubble in RCA's stock occurred in tandem with an overall stock market bubble in the late 1920s, something which it is hard to argue that we are seeing again now. So the dramatic decline that RCA saw from the 1929 top to 1932 was exacerbated by the overall decline in the stock market then, and thus we should not necessarily expect to see something that big happen to Apple just because of this comparison.

Still, with Apple zooming up so fast, and so similar to the structure of RCA's advance, it is hard not to think that the similarity might continue into the future. RCA went from \$10/share in 1925 to \$105 in 1929. Apple has also had a 10-fold increase from 2008 to 2012. RCA made a double top in 1929, and the timing of that second top for this analog equates to about January 2013 for Apple to make the corollary, if it is going to. That's coincidentally when we inaugurate whoever gets elected in November. Hmmmm....

As the largest cap stock in the U.S., Apple has a big weighting in the major averages. So if Apple is going to top in January as the RCA chart suggests, that would have big implications for things like the Nasdaq 100 shown at left.

