Scaling Price Chart Data

R.N Elliott in essence conveyed the following:

“As a general practice, to exclusively use either log or arithmetic scale is erroneous and deprives the analyst of their respective value and utility. The arithmetic scale should always be employed unless and until the log scale is warranted.”

In a movement of five waves upward, a “base line” is drawn against the touch points of waves 2 and 4, then a “parallel line” against the end of wave 3. Figure 1 below shows and example.

Elliott went on to say:

“Usually wave 5 will end approximately at the parallel line when arithmetic scale is used. However, if wave 5 exceeds the parallel line considerably, and the composition of wave 5 indicates that it has not completed its pattern, then the entire movement from beginning of wave 1 should be graphed in log scale. The end of wave 5 may reach, but not exceed the parallel line. For example, if the same data were plotted on both scales, the charts would appear as in Figures 2 and 3.”

“When log scale becomes necessary, inflation is likely present. If log scale is used and inflation is not present, wave 5 will fail to reach the parallel line by a wide margin, as illustrated in Figure 4.”

Scaling Perceptions In The Global Equity Boom

By Joe Russo

LONG TERM TREND CHANNELS

Price Channel Analysis is a highly effective method by which to monitor key pivot points, trajectories, and the general boundaries within a given trend. No matter the time frame, from 60-minutes to 60-years, applying price channel analysis yields an accurate account of trend integrity.

Channeling price data also happens to be one of the essential components of Elliott Wave Theory. Channeling is the only way in which to monitor the classic five-wave impulse pattern identified by Elliott.

PERCEPTIONS

Value is clearly a subjective perception. General investment postures (long, short, or flat) are contingent upon an (assumed accurate) perception that future values will continue to rise, go nowhere, or fall.

As such, price charts are essential in monitoring the present and historical nature in which the marketplace collectively perceives value. In this vein, it is critical to be aware of how the chart data under observation has been scaled. This is especially critical when studying longer-term price series. In many instances, the difference between arithmetic, and log scaled data will have profound effect on the general historical perceptions portrayed by the series.

DEGREES OF TREND

Further, such significant differences pose a great threat of inaccuracy to the Elliott Wave analyst or chartist who fails to study trend channels and wave structures resident in both series.

Unique to Elliott Wave Theory are several designations noting specific degrees of trend. The smaller fractal trends accumulate in advancing harmony to comprise the larger Primary, or long-term trends.

Incorporating dual scaling into one’s analysis will provide broader perception as to the potential longer-term intent of the market.

EQUAL WEIGHTS AND MEASURES

We can view price data in either arithmetic, or log scale. Arithmetic scale measures the progressions from the lowest data point on a chart to the highest in equal increments.
MTA Members And Affiliates,

As we rapidly approach the Holiday season, we often reflect on the year just past and think about the year ahead of us. At the MTA Headquarters, we are not different. We look back at this last year as a period of significant and often negative tumultuous change. It was not an easy period for the MTA—personal relationships became strained, process improvements were put into a state of flux and the Association changed many of its leadership positions. However, having worked through our required adjustments, we enter 2007 confident that our active Board, our specific process-change initiatives underway and our strategic vision for the future. Exciting times are ahead for the MTA in 2007 and your Headquarters staff enters 2007 with the enthusiasm and the vision to serve our MTA members and affiliates better than ever before in our history. We will not rest until this is accomplished.

One of the first events as we enter 2007 is the Mid-Winter retreat being held on January 19th and 20th in Miami Beach. This event is turning out to be one of our best seminars ever! Our guest speakers and sponsors are all lined-up and the agenda is packed with interesting information sharing and networking events. In addition, in a return to an MTA time-honored event, we will be giving MTA Service and Annual Awards at our closing dinner, acknowledging members and staff that have made such a contribution to the MTA over the years. Don’t miss this event……

On behalf of the Board and the Headquarters staff, I want to wish you and your families the best during this Holiday period. Happy New Year and see you in the New Year.

Best regards,

From the Executive’s Desk

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From the Editor’s Desk

In recent issues I have repeatedly asked for input from the membership, and this month you see that the response has been very positive.

On the cover, we present a rather detailed piece by Joe Russo in which he analyzes several world markets. For many, the most interesting part of this article will be his comparison of arithmetic versus logarithmic scaling on charts. Joe raises several interesting points, and supports his ideas with examples. It’s exactly the kind of work that needs to be done in technical analysis. For reasons I have never understood, chart scaling can become an emotional topic among technicians. Joe simply presents facts with charts, the essence of technical analysis at it’s finest.

Kim Husebye, CFA, CMT, also combines facts and charts in a shorter piece, fully exploring the Kondratieff Wave, an interesting theory familiar to most technicians. Kim’s short analysis should lead to some tradable insights with only a little thought.

After entering a trade based upon your interpretations of one of those articles, Matthew Caruso presents some thoughts on when to exit a trade. His work also combines well-written theory with charts illustrating his ideas.

Finally, from the membership, we received a book review from Scott Richter, CFA, CMT. There is also a lot happening within the MTA, and that is covered in this month’s newsletter. I hope that you’ll enjoying reading Technically Speaking, and we all hope that you will enjoy the upcoming holiday season.

Cordially,

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  • Rooms now based on availability

December 19th: Increase of Seminar Registration Fee
  • MTA Members & Affiliates would now pay $425
  • Non-MTA Members & Affiliates would now pay $625

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Harry E. Berry with wife Ann
John Bollinger, CFA, CMT
Whitney Broach
Andrew Burkly, CFA, CMT
Ed Carson
Whit Collier
Charles Cosse with wife Sandra
Jon Dahlberg with wife Laura
Frank Demaio
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December 2006
The Kondratieff Wave
By Kim Husebye, CFA, CMT

Nikolai Kondratieff (1892 – 1938) was a Russian economist who postulated that capitalist economies displayed long wave cycles of boom and bust of approximately 60 years’ duration. The Kondratieff wave cycle goes through four distinct phases of inflation (spring), stagflation (summer), disinflation (autumn) and deflation (winter). His study centered on prices and interest rates since the 1700’s, but interestingly, cycles of war, peace, famine and prosperity.

True to K-Wave prediction, deflation last took hold in the 1930’s, and long-term interest rates declined to a cycle low of 2.44% in 1946. Inflation subsequently followed from 1949-1966, then stagflation from 1966-1982. Long-term interest rates finally peaked at 13% in 1981, after rising for thirty-five years.

Disinflation commenced thereafter and continued until 2000, when stock markets topped out worldwide. Now we are in the winter deflation cycle which, according to Kondratieff theory, will be heralded by a general contraction of money, credit and asset prices. If we take half the cycle length of about 30 years, and add it to our time line from 1981, we can project a potential low in interest rates in 2011, plus or minus a few years. (Chart 1)

Like all such theories, the K-Wave Principle may or may not end up providing any predictive information about the market this time around. Remember that charts are the final arbiter on what ultimately works when it comes to proper timing of investment decisions.

It is ironic that a Russian would have made such insights to the cyclical behavior of capitalist economies at that time. Unfortunately for Kondratieff, Joseph Stalin viewed his theories as a criticism of the state’s collectivist policies and as a result he was jailed and later executed.

Kim Husebye, CFA, CMT, is Vice President, Centurion Investment Advisors Inc. in Toronto, Canada. He can be reached at 416.865.3357 or kh@ciainc.ca

* Centurion Investment Advisors Inc. is a member of the Investment Dealers’ Association and the Canadian Investor Protection Fund. The views expressed in this report are solely those of the author and do not reflect the views of Centurion Investment Advisors Inc.

Chart 1 Chart Courtesy of Hoisington Investment Management Company, Austin, TX

The Astute Investor
Reviewed By Scott Richter, CFA, CMT

The Astute Investor is an enlightening work by Dr. Eric L. Prentis. The book is a current era effort to build on the work done by Ben Graham in his day with The Intelligent Investor. While the title tagline “the secrets to make you rich”, is a bit frothy, I do believe this book allows every investor the opportunity to revisit and hone their understanding of the key dimensions of the financial markets.

That being said – what is this book all about? It is a system – both strategic and tactical - to win in the markets. Does it work? Well, to each his own (I use a fusion analysis myself). As to the results, I’ll leave it up to you to test the system (Dr. Prentis also manages money – you could test it with him as well).

Here’s what I liked about the book:

- The book is a holistic effort. It struck me as a “Cliff’s Notes” of the financial markets all in one place. There’s something for everyone.
- It builds up the reader’s skills starting from the beginning. It does so by setting the stage for an investor by covering all of the fundamentals required to make intelligent decisions. Dr. Prentis covered the markets (both stock and bond), EMH (in its various forms), industry work, and company analysis. He did a particularly fine job covering bonds and the structure of interest rates. The same is true with market psychology and sentiment. Lastly, he did a comprehensive job of addressing retirement planning.
- The book integrated the use of Internet

continued on page 5
The Absolute Investor
continued from page 4

tools and websites in the analysis to support one’s decision making. Dr. Prentis took great care in not leaving the reader hanging when it came to gathering the data for the analysis.

• He presented a truly repeatable “process” for approaching the markets. The process was a practical ten-step outline for investment decision-making. It included how to calculate a corporation’s intrinsic value and margin of safety multiples. Dr. Prentis suggested that one might use this methodology to invest more like Warren Buffet.

• Lastly, Dr. Prentis advocated the validity of Technical Analysis in his Discounted Market Hypothesis (DMH) by using the 9-month MA trend-line of the S&P 500 as a valid economic and market barometer.

On the flip side, what could Dr. Prentis have done better in his writing that could have made a difference for my read of the book?

I have several suggestions:

• From a content perspective the book is a mile wide and an inch deep. While it covers nearly every topic in the financial markets, it can often times be general and vague. It often left me hungry for more depth on a subject area to truly understand it.

• His tone towards the markets appeared to be one that implied it was easy to make money in the markets. All one simply had to know was how to do it. (p. 29). It is my perception that this tone could lead to a false sense of confidence in one’s ability to master the markets. Practically, it’s not as easy as it looks, and overconfidence can leave one facing losses and draw downs that demoralize a novice investor.

• From an aesthetic perspective, it would have helped to have a more robust set of figures and illustrations. The illustrations used were generated in Microsoft Excel and were spartan to say the least. Dr. Prentis could have perked up the visuals through the use of any standard technical analysis package.

• From an investment standpoint, use of the “Fed” model as one’s market trigger is challenged. There are numerous issues with the Fed model that are well documented (quality of earnings, role of inflation in mispricing, behavioral description vs. economic accuracy and predictiveness). One has to use this model with a clear understanding of the assumptions before using it as one’s primary input for buying the market. Additionally, the Fed Model’s focus on the S&P 500 is a bit myopic. That being said, a focus on the S&P 500 would have kept investors out of the gains in the mid, small, international and emerging markets that have occurred since 2002. We are only recently experiencing large cap outperformance to the alternative asset classes.

• Additionally, from an investment perspective, it seems a bit of a stretch to me to radically beat the markets and “get rich” when 90% of one’s portfolio strategy is to hold the S&P 500. I look at this as being 90% of the market. As to the other 10% being an individual stock holding – fundamental analysis is unlikely to allow the risk management and timing necessary to capitalize on excessive returns. If anything, one opens oneself up to increased systematic risk with a one stock holding.

• From a technician’s perspective, the use of TA and the definitions of technical terms could have been stronger in my opinion (but I’m biased as a CMT). Nonetheless, Dr. Prentis did give technical analysis and market cycles a strong endorsement. Additionally, it was my perception that relying on a S&P 200 day MA crossover as one’s market trigger would get one into the markets too late to profit, and get one out of markets long after the damage is done.

So what’s the bottom line on The Astute Investor? I would give it solid marks when it comes to completeness and investment process. As I suggested earlier – there is something for everyone. I would give it less solid marks when it comes to the use of technical analysis and market timing.

All in all – the book was an enjoyable read. As to making money with Dr. Prentis’ method – I’ll leave that up to you!
Learning When To Take Profits

By Matthew Caruso

When traders learn about technical analysis, they most often learn how to use indicators and how to read chart patterns in order to enter a trade. The topic of how to exit a winning trade is often ignored and as a result, many traders exit their trades too early or too late, giving up potential profit. Many traders use subjective points, or exit at price targets generated by chart patterns and point and figure charts. Although these are all valid forms of exit, perhaps an approach based on statistical measures would help to improve the timing of when to exit a trade.

The ever popular Bollinger Bands are bands that expand and contract according to a security’s volatility. The bands are placed two standard deviations from the security’s 20 day moving average. Standard deviations measure the dispersion of a set of data from its mean. Two standard deviations from the mean encompass approximately 95% of the data depending on the length of the moving average. Knowing this we can quickly come to the conclusion that prices will most often be within the bands and seldom outside them as can be seen in Figure 1.

Using this information, a derivative oscillator of the Bollinger Bands which is called %b, can help pinpoint when prices are exceeding the two standard deviations bandwidth and are at a statistical extreme. The %b measures where prices are in relation to the Bollinger Bands. A reading of 100 in the %b means that the price is equal to the upper band, and a measure of 0 means the price is equal to the lower band. Therefore a sensible profit taking strategy would be that once...
the %b exceeds 100 or 0 and begins to turn in the opposite direction (revert to the mean), traders should reduce the size or close their positions. Figure 2 is a chart of the S&P 500 where %b pivot points have been flagged.

As can be seen in Figure 2, prices tend to change direction after a %b pivot has been signaled, as flagged by the red and green arrows. A %b pivot occurs when the %b turns down once above 100 or turns up once below 0. Unlike a trailing stop, the %b can be used as a leading indicator for taking profits. Waiting for prices to cross a trailing stop, which is a lagging indicator, before exiting a position can often leave a trader with less profit. The %b works best with stocks that have a strong tendency to follow a cyclical rhythm because it pinpoints where the cycle has hit its high or low. Figure 3 displays Accredited Home Lenders (LEND) which has been following a nice cycle in recent months. Each %b pivot was right on the mark and flagged a cycle high or low.

This indicator of course is not the Holy Grail for profit taking. Point B in figure three displays a cycle high where the %b missed the mark and did not exceed the 100 level in order to signal a pivot point. For this reason it is recommended that a loose trailing stop be used with the %b at all times so that such occurrences such as at B where the indicator fails to hit an extreme will not lead to a total loss of profit. This is not the indicator’s only drawback. In strong trending markets the indicator can occasionally produce an early pivot point as in point A of Figure 2. At point A the trend did pause but soon after the pivot exploded higher. For this reason selling only partial positions at a pivot point can be a sensible idea. It should be noted however that pivot points which are followed by a negative divergence have an increased likelihood of pinpointing a trend reversal. Point C in Figure 3 flags a negative divergence in the %b while it is at an extreme and it occurred at the top of move.

In conclusion, %b pivots can help swing traders and cyclical traders exit out at the high of short term trends with a high degree of accuracy. For traders who implement a trend following strategy, the %b can flag points where partial profits can be taken or where trailing stops can be tightened.

Matthew Caruso is an experienced independent trader. He has recently passed his level 3 CMT exam and is currently an active trader and analyst for www.analyzingmarkets.com.

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Figure 3 - Cycle highs and lows flagged in LEND
Scaling Perceptions In The Global Equity Boom  
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In contrast, the log scale measures the lowest to highest data points in percentage terms. To attain the broadest perspective of past and current price behavior, both studies are essential to observe.

In studying both series, we have made a strident effort to crosscheck and reconcile the analysis collectively. In doing so, the wave structures perceived in both scales are in harmony.

Failure to take both price scales under collective study, may lead to flawed perceptions in wave counts, and trend channels. More importantly, failure to observe both may dramatically skew assessments relative to the degrees of trend currently in force.

• At the end of the day, the goal of this piece is to assist in broadening perspectives of general perception relative to amplitudes, durations, and numerous degrees of trend currently at work in the global market place.

• Before we get to our charts, let us first explore some insights on both scaling and channeling from the very founder of Elliott Wave Theory, R.N. Elliott.

TIPPING THE SCALES OF PERCEPTION

Exclusive use of the log chart on this market would persuade general perception toward fitting the upward choppy price action from ’97 through the ‘03 low as that of a “third” and “fourth wave” terminals of sorts. In fact, this was our prevailing view prior to taking the arithmetic scale under collective observation.

Since we do not yet have fourth waves with which to connect the 2-4 data points for channeling purposes, we simply connect the anticipated 1-3 data points until a 4 wave invariably materializes and is confirmed.

The arithmetic chart on the right goes a long way in helping define degree of trend. From the ’91 low, both scales show five smaller degree waves (the fifth of which extended). In the both charts, the terminal to this extended fifth in ’97, at the time, conveyed a very real perception that the preceding five waves up comprised a potential “end” to the entire cyclical bull market. We can see how such a wide spread perception may have tried to manifest in observing the big decline that followed into the “w” wave low.

Fast forward toward 2000 using either scale, we are still likely to assume an ending diagonal to the larger move, or that wave three is extending in some fashion. It is not until well into the explosive recovery from the 2003 lows that the arithmetic scale (right) puts the count in a fresh perspective.

Contingent that our degree of trend analysis is generally correct, and that equity markets are not in some type of “blow-off” top similar to the NASDAQ in ’99, once (3) tops, we can expect (4) down to last at least 16 months or more. This is a minimum .236 duration response to the time span of the long and sideways (2) wave correction.

The most recent correction in May lasted only two months, and trimmed just 11.69% off the index.

Within four months from the May low, the market is already back up printing fresh historic highs. Such a quick and rapid recovery leaves the door open to a blow-off upon continuation of general parabolic advancement.

Because we have both charts labeled uniformly, India’s BSE does not appear to show that much discrepancy in comparative scaling at first glance.
However, if the arithmetic scale were absent in the analysis, one could clearly see how the log chart (left) may persuade the observer to count the first leg up off the ‘01 low as a first wave up vs a –d-wave within the larger 4 wave down.

Another notable difference is the perception of severity relative to the crash like 30% decline to (4) occurring in April and May of ’06. The decline to (2) in ’04 was a tad more severe, lasting a total of five months, and registering declines of 32%. However, the “number of points” lost in the (4) decline were far greater as illustrated via the arithmetic chart.

In total, from the 2001 low, the BSE has risen over 400%. Given this amplitude percentage advance, in concert with time maturity off the ‘01 cycle lows, odds favor the primary or intermediate bullish advance is nearing an end vs a new beginning.

According to R.N. Elliott, wave (5) will typically end at the top of the trend channel when the arithmetic scale is used. Should (5) exceed or throw over substantially prior to completing all required subdivisions, then use of the log scale is preferred. Further, if inflation is present (together with a glut of global liquidity in our present situation) wave (5) on the log scale (left) should too reach its upper trend channel boundary. Such projections would take the BSE up toward the 16,000 level.

As we can see by the arithmetic chart, the sharp parabolic ascent in the BSE is much closer to touching the upper channel than the log scale. In fact, if we were to slightly lower the upper channel line to the high in March vs the April top, the BSE would be within striking distance of the upper channel as of this writing.

Russia presents the most startling comparative contrast in observing arithmetic vs log scaling. From the 1998 lows, the RTS is up an astounding 4,500% in just eight short years! The log scale left is deceiving in that at first glance, it appears the most recent highs are just marginally above the 569 levels attained in 1997.

The ‘98 Primary “C” wave crash low occurred inside of 14 months, and destroyed the market entirely with a 93.2% wipeout. The famous US crash in 1929 of similar destruction took over twenty years to reclaim its former highs. The Russians did it in just five. Given the immense amplitude of the relatively short eight-year advance from a virtual “starting over” point, we must assume the RTS is putting in a first wave of cyclical advance.

This is where the arithmetic scale comes in quite handy relative to observing “degrees of trend” in proper perspective. When we view the chart on the right, we can follow five waves up of intermediate degree to the crest in 2004 marking Primary Wave 1. Thereafter, what would otherwise appear in log scale to be a fourth wave triangle in 2005 instead

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marks the base of Primary 2. The immense power and parabolic thrust of the ensuing Primary 3 is unmistakable in the arithmetic chart.

More importantly, it puts the context of any future correction of magnitude in proper perspective. Note the horizontal band we have placed on the log scale. Visually, it would appear that if the RTS were to correct down into that band, that it would not be such a big deal. On the contrary, a touch down into that band would represent a formidable bear market to the tune of 50-60%. In contrast, the powder blue horizontal Fibonacci retracements located on the right within the arithmetic chart shows just how devastating a 50% or 60% retracement would be.

Similar to India, the Russian bourse lost over 30% in the two-month period of May/June 2006. The RTS has yet to better its historic May high as of this 11-13-2006 writing.

Brazil is another scale comparison that does not change perceptions all that much. One rather subtle but quite notable advantage offered by the arithmetic scale is its trend channeling attributes.

Thus far, the Bovespa appears to be ensconced in an extended x(5) wave of intermediate degree. Connecting the (2) – (4) touch points on the arithmetic scale appears to capture the bullish uptrend from 2002 much more efficiently than log scale.

The Bovespa is also up in excess of 400% from the 2002 lows. We suspect fair chance for a turn point of significance in March, April, or May of ’07. These three months mark 55-months (± / -) from the previous cycle lows.

The arithmetic scale has already thrown over the upper channel once, and is not that far from a second attempt. Of interest in the log scale, is the “back test” of the underside of its (2) – (4) channel line concurrent with the arithmetic scales “throw-over.”

Another general advantage of incorporating arithmetic charts is the ability to accurately measure pattern targets. We have noted a large inverse head and shoulder pattern on the arithmetic chart. We have drawn its slightly rising neckline in dotted green. From the arithmetic chart, it is easy to graphically measure the price objective for the pattern, and project it on the chart with proper reference perspective.

Per this patterns measuring objective, the Bovespa has breached this target intra-month for the second time. The first time was in May ’06, and the second in November of ’06. Thus far, the market has not yet bested its May high, nor has it been able to register a monthly close above the H&S patterns minimum target.

Second only to Russia, the Mexican Bolsa represents another stark example of how log vs arithmetic scaling may skew perceptions. In eleven years, the Bolsa is up over 1,500% from its 1995 lows.

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Scaling Perceptions In The Global Equity Boom

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Similar to Australia’s scale comparison, one may have been inclined to perceive the sideways movement from 2000 – 2003 on the log scale as that of a fourth wave triangle of sorts.

When looking more closely at the channeling attributes resident in the five waves of minor degree comprising the larger x(3), the arithmetic scale is at or near a boundary touch of the upper channel. Since the first wave of this Minor degree subdivision appears to have itself extended, the corresponding 5 in progress should not.

No doubt, the past eleven years have posted stellar gains for this market. It is undeniable however, not to sense a parabolic blow-off top in progress due to the lion’s share of those gains coming in just three short years from 2003 – 2006. Such rapid parabolic excesses are not readily visible in the log scale hence the benefits of observing both.

It seems prudent to end with a composite of all the worlds’ major stock indices in attempt to garnish a diversified and balanced view of the Global Equity Boom.

Like most individual Country Indices, the DJW also appears to be advancing off a 4th wave of primary degree. Here too, we are looking for a potential turn point in March, April, or May of ‘07. We have noted upside price targets based on Fibonacci projections and pattern objectives.

Do keep in mind that all such turn markers may represent either potential highs or lows of varying degrees.

This analysis was prepared by Joseph Russo, Publisher & Chief Market Analyst, Elliott Wave Technology. Joe has been studying Elliott Wave Theory and technical analysis of financial markets since 1991. He can be reached at joe.russo@elliottwavetechnology.com.

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If you are visiting any of these chapter areas over the next several months and might be willing to make a presentation to the local group, please contact the regional chapter chair as noted to work something out. Some are long-standing chapters, some are trying to get started, but ALL of them are in need of speakers now and then.

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Member Awareness

The MTA wants to actively create awareness on what our fellow MTA Members and Affiliates have distributed in the form of print and/or media communications to the general public.

If you can send us either the print copy of the communication, or an e-mail on how we might capture that data, the MTA will maintain a column in this Newsletter informing our membership of your fine work.

In addition, some of our Members and Affiliates periodically publicly speak to the on-line and television media regarding market trends and/or dynamics. If you know in advance of these public speaking arrangements, please inform us. We will make every attempt to capture and share this information as well.

Please contact Tim Licitra at Tim@mta.org for any questions regarding the implementation of this initiative.
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