LETTER FROM THE EDITOR

Magazine covers are a widely followed market indicator. Paul MacRae Montgomery first noted the link between covers and markets and explained that popular media can be a contrary indicator of the markets. Covers have also been the subject of academic research that supported their use as an indicator. A 2007 paper by three University of Richmond professors, *Are Cover Stories Effective Contrarian Indicators*, “study found a statistically significant correlation between appearance on the cover of one of the magazines and the subsequent performance of the company’s stock.”

This month, Tom Vician provides a survey of the magazine indicator with a number of charts. Technical analysis is built on charts and Tom’s work is helpful for technicians who want to understand this indicator in historical context. We conclude this issue with a classical interpretation of charts prepared by Susan Berger, who learned to analyze charts while working for John Edwards. Her work shows how durable the basic principles of technical analysis are and how ideas contained in books written nearly seventy years ago are still relevant. If you would like to comment on Technically Speaking or share your work with the MTA membership, please email us at editor@mta.org.

Michael Carr

November 2013

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Skewed sentiment is an important coincident indicator at market turns. By definition, financial markets are most bullish in optimism at major tops and most bearishly pessimistic at major bottoms. Magazine covers can act as a sentiment thermometer at market turns of different time constants. Covers are one tool hanging in the trader’s workshop that can help spot a heavily bunched herd. With this white paper, I intend to place a general, stylized framework around the use of magazine covers as contrarian market indicators to better define their usefulness. Topics include: magazine types, magazine cover content, and the noise problem.

Magazine Types

The most coincident covers tend to come from broad, national news/commentary magazines because they rarely touch upon economics and mirror hot trending topics to draw the widest viewership. Time and Newsweek fit this category. Both appeal to a vast common audience and channel the current public zeitgeist in their cover stories. With emotional financial covers, these magazines show the current trend’s obvious, conventional “wisdom-ness.” It’s the final “Aha!” moment for the market’s current direction. These magazines rarely have financial covers, and the signals tend to be more robust when they occur.

Professional industry magazine covers like Barron’s or The Economist are second tier. They carry less weight because they appeal to a vastly smaller audience. This tends to lessen the societal abreactive, pervasive qualities needed to manifest at major turns. Moreover, their covers appear much more frequently. This can dilute signal intensity and increase noise. When these covers do coincide, the increased frequency generally speaks to a shorter time constant for the signal. Time and Newsweek rarely have covers – one, maybe two per year. The financial trend must have tremendous momentum to displace anything else vying for the coveted front page given the public’s general distaste for economics. Conversely Barron’s has between four and eight cover calls per year with the typically histrionic cartoon bull and bear slugging it out “Spy vs. Spy” style. Barron’s, like The Economist, sells to industry professionals and highly focused retail investors – not the broad masses.

Magazine Cover Content

There are two parts to the cover: graphics and wording. Idealized, the cover graphics must be very emotional and histrionic in the direction of the trend. For up-trends, it must show greed, gloat, glowing satisfaction, and/or euphoria with present financial times. There is nothing to fear. Relax – it’s obvious you can. Look at how well everyone is doing. For downtrends, the cover must show fear, dread, panic and/or doom. Look up. Notice the sky is twelve inches from your head and closing. Aggressive doomsday prepping is not a mild, higher functioning form of DSM-5 paranoid schizophrenia, but rather a great, timely strategy.

The wording has important characteristics. Generally, the bigger the font, the better they show highly charged emotional content. Second, the cover
comment must be broad, declarative and “standing its ground” in the direction of an established trend. Here is a stylized and real example:

This Newsweek cover graphic is jingoistic and bullish using declarative large font that takes a stand “America’s BACK!” It comes after a clear uptrend begins to round and stall. This cover preceded the 2010 FlashCrash and a subsequent peak to trough decline of nearly 19% in the SP 500 future. This was a nice signal to avoid all the mayhem surrounding this high frequency trading debacle.

Conversely, logical covers fail to coincide with turning points because they show little emotion and make meek, if any, declarations. By definition, financial markets are most sure of themselves at extremes, either up or down. Here is an example:

The picture is clearly bearish and emotional with the swirling vortex of financial firms falling into the abyss. However, the meek “What next?” fails miserably to mirror the doom of the picture. It fails the declarative, stand your ground statement requirement. What next? A freight train's worth of panicked selling slamming bids - that's what’s next.

This is where many get confused with magazine covers. The above cover appears bearish and it is - but only partially. Covers need congruity between the picture and the wording. Words must show conviction - to take that stand and stick that neck out preferably all the way. In this case after such a huge decline, the wording shows a clear lack of certainty stating “What’s next?” It is the tell that this cover is premature. People are most sure at tops and bottoms – good times will never end euphoria or the sky is falling doomsday prepping. When magazine covers mirror this fully and completely, there are higher odds that trend change is afoot from extremely skewed sentiment.
Lastly, the above cover is from the Economist – a professional industry magazine. While The Economist and Barron’s covers do coincide with important turns, their noise ratio is higher.

Here is another example from September 2012 Time Magazine:

![Time Magazine Cover](image)

This cover has bullish graphics but suffers a “logical statement” problem as well. It’s explaining versus evoking a “Let them eat cake” moment for the New York financial juggernauts. Where’s the gloat in wordage? There is none. Moreover, the cover is a call specifically on Wall Street versus the general economy.

Here are bearish covers from both Barron’s and the Economist that coincided with a bottom:

![Barron's and Economist Covers](image)

The Barron's cover arrived first. It was clearly bearish in graphic, message, but a second tier publication. Then an immediate second cover from The Economist arrived. While it does have small font, it was clearly declarative with “BE AFRAID” and the swirling vortex of a black hole graphic at the eye catching center of the page. It took an emotional stand and stuck its neck out. The combination of both covers individually meeting the emotional requirements created a two-is-better-than-one confirmation. Note the length of the uptrend afterwards from these second tier magazines.

To recap: The cover image’s graphics must be emotionally evocative in the direction of the trend. Statement wording must show declarative conviction with the trend. It must stand its ground and stick its neck out. At tops it must show greed, gloat, satisfaction, or euphoria. At bottoms it must show fear, dread, panic and/or doom. Ideally, the wording is in large, pronounced font which aligns with the declaration itself and the cover "sticking its neck out." Logical statements or explanations fail the emotional, declarative components. They are a head-fake.
The Noise Problem

Covers suffer from noise. Some of this stems from loose definition of the salient points behind effective covers or the failure to apply definitions correctly. Others times the signal can have too much lag and is just poor – plain and simple. Indicators are naturally imperfect. From my back-test by hand of magazine covers at subsequent turning points, signals that coincide immediately tend to do so within a six trading day window from the cover date. Outside of six days, odds rise that either a trading range develops or an outright failed signal has occurred.

Here is an example that took nine days to stall. Then it took four more weeks to make its first lower low. The “Tough Stuff” initial cover shows a trading range was imminent – in hindsight - at higher levels than when the cover appeared.

The Barron’s 14,165 cover, while declarative with the specific figure, offers no graphic emotional content – just a blue background and green up arrow.

This is another head-fake. The “See You Later?” cover had message conflict with the question mark in its declarative statement. Additionally, it has second tier status. The market did turn higher coincidentally with the cover before rolling over a final time for new lows and losses before bottoming. Welcome head-fake and whipsaw if you fail to note the “?” showing lack of statement and emotional congruity.

Here is a Newsweek example from May 2012 that I posted on my blog at the time:

Note the cover coinciding with a double top and key break of trend. Here is the result:
The image is evocatively bullish with the Superman economic metaphor. While it is smaller font and ends with a "why," the statement prior to it is clearly declarative and takes a stand before becoming logical. Moreover, it is a first tier magazine that quickly coincides with a trend line break.

Here is a signal one month early from the classic Time “Home $weet Home” housing market cover in late June 2005:

From a secular perspective, it was a fantastic cover. It clearly met all criteria for a coincident emotional magazine cover, showed a major top was at hand in the space, and preceded a large, multi-year decline. From a short to intermediate time constant, the market stalled at the cover release for a seemingly positive signal. Then, it whipsawed higher into its final exhaustive blow-off top we see with hindsight benefit. In this time constant it is a failed signal. Most who discuss this particular cover avoid highlighting this trading fact.

Note that the final four week rally was yet another very steep, sharp move. I suggest drawing a simple support speed-line trend line (not shown) off those four weeks’ lows as they develop. Coupled with the ebullient cover, this gives perspective of a terminal move. It has higher trading odds as a technical climax/blowoff top. This provides important trading context while waiting for price to confirm.

Lastly, here is a chart from a 2004 Economist cover coinciding with a bottom in the dollar.
The cover meets all criteria but there is no confirming second cover for this second tier magazine. Yet, it coincides within three weeks of a multi-month bottom. My takeaway here is the appearance of the cover right into the maw of a steep downtrend well underway for nearly three months is the key factor. Despite its second “tier-ness,” the Economist cover dramatically mirrored sentiment and appeared at the end of a well-established price down trend. Note that it did take nearly three weeks to complete the bottoming process after the cover appeared with a second test of the early December low.

**Conclusion**

Magazine covers can act as coincident, convergent indicators at market turns of various time constants. The crowd is leaning heavily one way, and magazine covers capture that financial zeitgeist. Sometimes covers coincide with the outright reversal of price trend into a sustained move the other way – a V-top or bottom. At other moments covers coincide with volatile trading ranges that a trader might enjoy reducing risk in his book to avoid mirroring volatile, trendless action of the market. Sometimes covers just fail to work – not all are created equal and indicators are imperfect. Lastly, there may be a delay and lag to the signal. But they do work, and there is a framework for them. In another installment, I will discuss trend following, whipsaw and risk management tactics surrounding the appearance of dramatic magazine covers. For now, I hope this piece gives the reader an initial framework around a more profitable use of magazine covers at market turns.

Tom Vician has been a financial professional since 1993 when he began his financial career with Merrill Lynch. Tom started his statement-auditable trading track record in 1994 when he apprenticed with one of the world's top traders. From 2006 to 2010, Tom managed a $20 million book of accredited investors for an emerging hedge fund/CPO. Currently, he trades professionally and manages a portfolio of private assets. Tom is quoted in the revised edition of the book “Trend Following” by Michael Covel, has been quoted in Reuters, and has been published in the Market Technicians Association newsletter (Nov 2013). Tom has the following licenses: Series 3, 63, 65 and a clean U-4. He is a Chartered Market Technician Level 3 candidate. Additional information about Tom’s methods can be found at [http://www.trendfollowingtrader.com](http://www.trendfollowingtrader.com).
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TRADE LIKE A STOCK MARKET WIZARD - HOW TO ACHIEVE SUPERPERFORMANCE IN STOCKS IN ANY MARKET BY MARK MINERVINI
REVIEWED BY LANCE MCDONALD, CMT

Mark Minervini’s new book *Trade Like A Stock Market Wizard - How To Achieve Superperformance In Stock In Any Market* (McGraw Hill, 2013) is a look into the mind and strategy of a top stock trader. Minervini will be a recognizable name to many whether they know him as a 1997 U.S. Investing Champion, a regular guest on financial television or being in the elite group of traders to be featured in Jack Schwager’s *Stock Market Wizard* series of books.

Minervini goes beyond strategy and throughout the book sprinkles wisdom gained through decades of experience, along with motivation. It is like having a coach giving you “atta boys” as you learn a new skill. This is a very quotable book, so have a fresh highlighter when you read it.

The core of Minervini’s investment success is what he calls the SEPA Strategy, which is an acronym for Specific Entry Point Analysis. There are five key elements to SEPA:

1) Trend
2) Fundamentals
3) Catalyst
4) Entry Points
5) Exit Points

Minervini’s approach to stocks has a distinct William O’Neil flavor (*Investor’s Business Daily*), but where O’Neil will look at fundamentals first, Minervini’s first step is to take a technical screen of the market and get potential stock candidates from thousands to hundreds. There are many stock screening tools available to investors and most should be able to handle the parameters shown in the book. Stockcharts.com is a widely used charting tool on the web and the Trend Template, as it is called in the book, was quickly built in the Stockcharts.com scanning tool (Stockcharts.com Extra subscription required for stock scans.) This was also quickly built in Trade Navigator.

After the technical screen (Trend), stocks then go through a fundamental screen. “Stocks that meet the Trend Template are then screened through a series of filters that are based on earnings, sales and margin growth, relative strength, and price volatility. Approximately 95% of all stocks that qualify under the Trend Template fail to pass through this screen.” These first two steps get the investor a list of potential stock candidates that are manageable, which is good because as the list of companies shrinks, the amount of manual review increases. According to Minervini, “If you want consistent superperformance, you will need to roll up your sleeves and do some old-fashioned manual analysis.”
One of Minervini’s secrets is to build a watch list during market pullbacks. “Market leaders tend to stand out best during an intermediate market correction or in the later stages of a bear market. More than 90% of superperformance stocks emerge from bear market and general market correction. The key is to do your homework while the market is down; then you will be prepared to make big profits when it turns up.”

This book is filled with many great nuggets, which is another reason the book is so memorable. A few quotes that stand out to me:

- “We are not forecasters; we are interpreters.”
- “To master the craft of speculation, you must face your destructive capacity.”
- “If you’re not feeling stupid, you’re not managing risk.”
- “Good trading is boring; bad trading is exciting and makes the hair on the back of your neck stand up. You can be a bored rich trader or a thrill-seeking gambler. It’s entirely your choice.”

Minervini presents a well-rounded approach to investing including technicals, fundamentals, trade and risk management as well as sentiment and psychology of leading stocks. There should be something here for most investors.

Lance McDonald, CMT is President of Lexington Capital, LLC where he invests in futures, FOREX and equities as well as publishes technical research. Prior to this role, Lance was an Investment Product Specialist at AEGON USA Investment Management (AUIM) where he was responsible for marketing institutional investment strategies as well as providing technical analysis on equities, treasuries, currencies and fixed income for a $3 billion portfolio. Lance received his B.S. in Social Science from Crown College (Minneapolis, MN), M.A. in Organizational Leadership from Crown College (Minneapolis, MN) and M.B.A. in Finance from the University of St. Thomas (Minneapolis, MN). More information is at www.LexingtonCapitalLLC.com.
WHY IS MY STOCK GOING DOWN?
THE SUPREME FUNDAMENTAL
BY MARK MINERVINI

Editor’s note: This was originally published at Mark Minervini’s Official Blog and is republished here with permission.

“What’s making the market go up?” “Why is my stock going down when the company has a great product and they just reported good earnings?” I’m asked questions like these all the time. Making money and controlling risk depends far more on discerning a stock’s probable price direction than knowing the “why” behind that movement. Indeed, often you will learn the “why” well after the opportunity to avoid loss or reap gain has passed. The only true answer for why your stock is moving up or down is that more dollars are bidding than offering and vice versa.

Armed with an appreciation of the law of supply/demand, you can learn how to position your portfolio in stocks that have a good chance of attracting willing buyers who will bid your shares up—even though you may never know exactly why this is happening except perhaps in hindsight. Conversely, vigilant surveillance of price action can warn you to stay away from brewing disasters before share prices commence a severe discounting of the still-hidden problems at the business level.

The study of price and volume is referred to as Technical Analysis. I believe it is just as “technical” to number-crunch “fundamentals” in a spreadsheet to make buy or sell decisions based on ratios or formulas as it is to simply watch whether a stock is under accumulation or distribution (in other words, being bought or sold in size)

Few people know how to recognize accumulation or distribution correctly, which often leads to the conclusion that it can’t be done or that it is ineffective. I have found the opposite to be true. A stock’s price tells you exactly where supply and demand intersect to value the company at any given point in time. It is the law of supply and demand—the most fundamentally important element of any auction marketplace in action.

Buyers seek to pay the lowest price possible. However, there are others in the market competing for the same stock; as a result, they often have to pay up. The same is true for sellers. Seeking to dispose of their shares at the highest possible price, they must compete with others who are trying to do the same, and they often must settle for less. Actual trades are based on an auction market model where a potential buyer bids a specific price for a stock and a potential seller asks or offers a specific price for the stock. When the bid and ask prices match, a sale takes place on a first-come, first-served basis.

THE SUPREME FUNDAMENTAL

In an auction market, the law of supply and demand ultimately establishes current value. At the end of the day, this fundamental force determines the direction of a stock’s price—plain and simple. If you have a willing buyer, whatever you’re selling is worth the price that the buyer will
pay. This is an important concept to understand if you want real success in the stock market.

In the conventional language of Wall Street, people label the study of price and volume as “technical analysis,” while they are pleased to award the term “fundamental analysis” to the study of earnings and other “serious” variables of corporate performance. The bias embedded in this nomenclature leads people astray—some to their ruin.

Supply and demand is the most fundamental element of any auction market. I’m not interested in theories of what a security “should” be worth; I care about its worth now. **A stock is like a painting, it’s only worth what someone else is willing to pay.** I’m looking for situations where there are willing buyers. Just as back in the days when farmers bartered cattle for corn or hogs for wheat, supply and demand always drives price. No matter how much technology we introduce to make markets faster and more efficient, these mechanisms get their marching orders from the price collision of supply and demand.

The market exhibits P/E characteristics as well. A prevalence of high P/E ratios is a function of bull markets; a prevalence of low P/Es is a function of bear markets. In times of confidence, investors are more willing to pay more premium than in times of uncertainty. As far as individual stocks are concerned, the pitfall of relying on a valuation measure such as the P/E ratio is that it can cause an investor to ignore the single-most valuable piece of information available: the supreme fundamental—**supply and demand.**

I recommend spending a significant amount of time and effort to learn how to correctly interpret the market forces of supply and demand. Learn to interpret supply and demand correctly, and you will make and preserve far more money than would be possible buying stocks that sell at supposed discounts to book value or have a low P/E.

Mark Minervini one of America’s most successful stock investors and the Author of the best-selling book *Trade Like A Stock Market Wizard; How to Achieve Superperformance in Stocks.* He is featured in Jack Schwager’s *Stock Market Wizards; Conversations with America’s Top Stock Traders.*

Using his SEPA® trading strategy, in a five-and-a-half-year period Minervini generated a 220 percent average annual return with only one losing quarter. To put that in perspective, a $100,000 account would explode to over $30 million with those returns. In 1997, Minervini won the U.S. Investing Championship with a 155% annual return. For additional information, please visit [http://minervini.com/index.php](http://minervini.com/index.php)
GEORGE LINDSAY TRAINING COURSE: 1921-1942 LONG CYCLE BY ED CARLSON, CMT
REVIEWED BY MIKE CARR, CMT

George Lindsay’s work was largely lost to time until several years ago when Ed Carlson located old newsletters and pieced together the methods that Lindsay used. The reason Lindsay’s work was lost was simply that he had never published a comprehensive description of how he forecast price moves. Instead, Lindsay wrote newsletters that offered real-time examples of his work. His forecasts were accurate and his work was important but like many analysts from that time, his work was not fully explained.

Ed searched for copies of those newsletters and confirmed that Lindsay’s work was useful. He also discovered that Lindsay’s work was difficult to understand. Lindsay was a great market forecaster but he was not great at writing about what he did so that others could apply his techniques. In the past several years, Ed Carlson has done his best to correct that situation by reintroducing Lindsay’s work to a new generation and for the first time presenting that work in a way that anyone can understand. In doing so, he has demonstrated that Lindsay’s work has withstood the test of time and is still applicable in today’s market.

In the most general terms, Lindsay used price charts to identify potential turning points. He did this by realizing that the same general pattern unfolded over many years and that regularity could be used to forecast significant market turning points. His approach was highly disciplined and highly rewarding.

The chart below shows how one pattern Lindsay used occurred over and over again in the stock market from 1798 to 1949.
This pattern is what Lindsay called the “Long Cycle” and each one lasted about twenty years. The Long Cycle could be divided into two Multiple Cycles and each Multiple Cycle is composed of two to four Basic Cycles.

This description is the highest level overview of the work but it expresses the general idea. In some ways, Lindsay’s work is similar to parts of the more widely known techniques developed by Elliott or Gann. In all three approaches, there are cycles, targets derived from the cycles and smaller cycles within the large cycle. Practitioners of those disciplines may want to consider reviewing the Lindsay Training Course as a way to supplement and confirm their analysis. Lindsay, however, differs from Elliott and Gann in a number of significant ways and analysts can benefit from Lindsay’s work without any understanding of those other techniques.

Elliott, Gann and Lindsay have all provided a way to determine when a market turn is expected. To me, the biggest difference may be found in the fact that Elliott and Gann incorporated cycles they found in nature while Lindsay used only the market action. Lindsay seemed to have felt that markets were independent entities and there was no need for market action to reflect anything other than human emotions.

As an example of how markets of today are similar to the market of 1798, Ed has updated Lindsay’s Long Cycle history. In the next chart, Ed highlights the Long Cycles that have occurred since Lindsay published his study that ended in 1949.

In the Lindsay Training Course, detailed instructions are provided showing how to identify the Long Cycle and its components. Explanations are supplemented with charts that are easy to follow and comprehensive. This is a step-by-step guide that requires no additional knowledge to implement.

Armed with an understanding of the techniques, technical analysts will be able to expand the work and discover potential applications in other markets and in different time frames.

Technical analysis has a rich history but, unfortunately, much of it has been forgotten. Lindsay is one example of a chapter that had been forgotten until Ed Carlson rediscovered his work and presented it in George Lindsay and the
Art of Technical Analysis (FT Press, 2011). Since then, Ed has added another book, three DVDs and now this Course to the Body of Knowledge.

Analysts investing time in the George Lindsay Training Course may discover new uses for work that was forgotten for decades. They will certainly discover probable turning dates for the current market cycle and the ones that will follow in the years ahead.

Note: Ed Carlson will be giving a presentation on his book in the MTA’s Educational Web Series. To register for this free webcast, visit http://go.mta.org/3638

Ed Carlson, CMT, author of George Lindsay and the Art of Technical Analysis, An Aid to Timing (published in English, Japanese, and Chinese), and the George Lindsay Training Course, is an independent trader and consultant based in Seattle, Washington. Carlson is a contributor to Technical Analysis of Stocks and Commodities Magazine. He also manages the website SeattleTechnicalAdvisors.com, where he publishes daily and weekly commentary. He spent twenty years as a stockbroker and holds an M.B.A. from Wichita State University.
## Investment Courses For Professionals

A sample of a growing list of fundamental and technical courses is shown below. The courses are associated with global destinations and dates, both for open and private client formats. They are produced by various knowledge vendors throughout the world. Details can be provided by contacting NYIF.COM, or John Palicka (palicka@pipeline.com).

**Taught by John Palicka CFA CMT**

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<td>This is a professional approach that blends fundamental, technical, behavioral and quant strategies.</td>
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<td><strong>EQUITY PORTFOLIO MANAGER</strong>-</td>
<td>Serious managers will utilize this course to analyze leading Wall Street valuation models and investment strategies for equities using fundamental, behavioral/technical and quant approaches, and then study how these are modified by the best performing equity portfolio managers to produce risk-adjusted excess returns.</td>
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<td><strong>INVESTMENT FUND SELECTION</strong>-</td>
<td>This is a must attend course for all professionals involved in the selection and management of third-party investment managers.</td>
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<tr>
<td><strong>TECHNICAL ANALYSIS CMT 1</strong>-</td>
<td>A must attend course for investment professionals wishing to gain the CMT Level I professional qualification in Technical Analysis from the Market Technicians Association (MTA).</td>
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<tr>
<td><strong>INTRODUCTION TO STEALTH TRADING USING FUSION, ALGORITHMS, AND DERIVATIVES FOR PROFESSIONALS</strong>-</td>
<td>Today, portfolio managers increasingly must use stealth trading in order to disguise their intentions and thus benefit from best execution.</td>
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<td><strong>ADVANCED CAPITAL MARKETS ANALYSIS</strong></td>
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<td>Spot, forwards, futures, swaps, options, and statistical issues are discussed in dynamic capital market strategies.</td>
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<td><strong>STRATEGIC GOLD INVESTING</strong></td>
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<td>Gold has been one of the very few assets to have created wealth in the past several years. Gold offers investment opportunities for investors, traders, and financial engineers.</td>
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<td><strong>GLOBAL SMALL CAP INVESTING</strong></td>
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<td>Global small cap stocks offer investors the ability to participate in the world’s future big winners.</td>
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<td><strong>PORTABLE WEALTH INVESTING</strong></td>
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<td>Portable Wealth (PW) management offers investment opportunities for wealthy investors and their advisors. PW can generate attractive risk-adjusted excess returns to traditional and alternative investments.</td>
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Instructor John Palicka CFA CMT is a top-ranked portfolio manager of Global Emerging Growth Capital (WWW.GLGEGC.COM) with over 30 years experience of managing $ billions. He has doubled client money, on average, every 4 1/2 years since 1980*. His high course ratings from major investment firms reflect clear interpretations and practical applications of complex topics; knowledge applied to examples and cases found in the current worldwide and GCC marketplace; his experience with specific situations actually encountered in his career and consulting contracts that parallel the learning topics. John has an MBA from Columbia University and also teaches these courses for leading training institutions, including The New York Institute of Finance (WWW.NYIF.COM).

* Past performance is no guarantee of future results.
Reflecting on Bill Gross’ recent investor letter re: Ray Dalio’s “Beautiful Deleveraging”

“The last time the U.S. economy was this highly levered (early 1940s) it took over 25 years of 10-year Treasury rates averaging 3% less than nominal GDP to accomplish a ‘beautiful deleveraging.’” – Bill Gross

Starting with the big picture.

We constructed this chart of the S&P, U.S. Nominal GDP Growth, and U.S. 10-Year Treasury Yields:

1) Since the 2000 peak in Stocks, the U.S. has experienced two major deleveraging / deflationary events.
2) Both events occurred simultaneously with U.S. Nominal GDP Growth falling below U.S. 10-Year Treasury Yields. We’ll call this the Dalio Spread – discussed extensively in recent years by Ray Dalio of Bridgewater.
3) The first event covered the bulk of the 2000-2003 bear market in Stocks. Nominal growth stabilized above Nominal Yields by mid-late 2003 (the Dalio Spread turned positive), as the Bull market got its legs.
4) The second event almost pinpointed the 2007 top in Stocks, and lasted until mid-2010, just as the S&P hit its low for that year, around 1000. It missed the 50% rally from the 2009 lows, but when the Dalio Spread turned positive again, its high value provided a tailwind that lifted the equity market by another 70% since then.

A closer look at the recent history reveals the lowest “cushion” (Dalio Spread) since 2011.

The last time this happened, the market (not the Fed) self-corrected through a sharp downward adjustment in rates only a few months later. This eased the pain of deleveraging and allowed the recovery to continue.
During the corrective phase, Equities suffered the largest drawdown since the Bull market began.

Noting this similarly low cushion today, the market will have to price a solution to the following equation:

1) If Growth picks up and Yields keep rising, as economists currently believe, Dalio’s Spread will probably not rise enough (a healthy increase should be around 100-140bps) to provide a sustained tailwind for asset prices.

2) What is the configuration of incoming data that achieves this incremental 100-140bps, and its likelihood?

3) With developed economies still highly levered, Stock Bulls should argue (hope) that this is achieved with Nominal Growth rising 100-140bps from here (to mid 4%), while Yields stabilize or even fall. In the eighteen quarters from the 2009 trough to date, this level of nominal growth was only achieved in five. Even worse, out of these five, yields actually rose 30bps and 80bps in two, and stayed flat or declined 40bps/50bps in three.

Based on the Dalio Spread, and its relationship with asset prices during this ongoing 15-year secular deleveraging, from these starting levels (Dalio Spread of 0.4972 as of the close on October 3, 2013) only one combination below is strongly supportive of Equities, and no combination is sustainably bearish Bond prices:

<table>
<thead>
<tr>
<th>Nominal Yields</th>
<th>Rise</th>
<th>Fall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rises</td>
<td>Dalio Spread remains tenuously above zero, with limited upside</td>
<td>Dalio Spread rises strongly, supportive of asset prices</td>
</tr>
<tr>
<td></td>
<td>Leads to deflationary/deleveraging event/asset price collapse</td>
<td>Negative for asset prices until Yields fall (150-250bps) below growth</td>
</tr>
</tbody>
</table>

Revisiting our June Strategic Report: “Growth, Rates, and Inflation”

1) The U.S. 10-Year Treasury Yields rise over the last year has now been equivalent to 65% of the prevailing Inflation Rate. This ranks as the
fourth highest extreme in history. In June, we used this relationship to, in no uncertain terms, state that Bonds were at a strategic buying point. Yields rose another 30bps over the next two months, and have quickly fallen back to those June levels. **However our ‘Inflation Rule’ remains historically elevated, and unless price inflation begins to pick up aggressively (an outcome we believe is unlikely), strategic portfolios should consider increasing duration here.**

2) Once more revisiting our June Strategic Report, the U.S. Treasury 10-Year Yield’s rise over the last year has now been equivalent to 32% of the prevailing Nominal Growth Rate. In June, we used this relationship to, in no uncertain terms, state that Bonds were at a strategic buying point. Nominal Yields have risen too fast relative to realized Nominal Growth, acting as an indirect tax to growth – a conclusion similar to what the Dalio Spread shows us today.

**Thoughts on the U.S. Dollar**

We have been structurally bullish the U.S. Dollar since March 2011. We continue to believe the U.S. Dollar is in a secular Bull market (more on this later in the section). However, while not outright bearish, we’ve not been constructive on the broad Dollar since our July 15 Market Report, which in hindsight turned out to be four trading days after Dollar’s high for the year. At the time, we observed a great deal of speculative interest in the Dollar against nearly all major currencies, and decided to quietly step aside.

This is what we wrote on July 15:

“The US Dollar is overbought and over-believed. Between April/Sept 2011, we produced several reports calling for the beginning of a secular, 5-10 year bull market in the US Dollar. We still hold this view. Tactically however, today we see completely opposite trade conditions, versus what we saw in the summer of 2011. At the time, we were universally bullish the US Dollar –
and specifically recommended buying vs “every other currency in the world”. Today, tactically we think the Dollar Index will surprise everyone – by being at best dead money for 2-6 months. This is not a USDEM call. We use the Dollar Index for a reason – the USD might rally against some of the Index’s currencies, but it won’t be a broad-based move, preventing this basket index from posting meaningful gains. This will surprise many people. A great deal of money is staked on US being “better that the rest”. US Equities and the Dollar have rallied most of the year—every global equity mandate is now overweight both. In addition, if we are correct about a fall in US Rates, lower rate differentials should be another headwind for the overall attractiveness of the Dollar vs other majors.”

Since then, U.S. Equities have gone nowhere (S&P -0.22%, Dow -3.15%, Nasdaq +4.35%, Russell +2.65%) and the Dollar fell 4%.

In a follow-up report on August 28, we wrote:

“If we take a close look at the 1995 and 2011 bottoms, this is what we see (rescaled to size):

Should the Dollar consolidate around the 200-day moving average over the next 3-6 months, revisiting the bottom of the suggested trading range, we will send an alert and buy if positioning gets cleared out (likely). We do believe a strong Dollar breakout is coming, but we don’t think it is
immediate. However, we stand watch for any signs of the DXY breaking above 85 with FORCE, and will react to the message if necessary.”

This is what the chart looks like today – never a dull moment in this business:

Patiently awaited for two months, speculative behavior toward the Dollar has been fully cleared.

Below, combined U.S. Dollar positioning, ex-JPY. In Green, **Commercials** are now back to long and increasing positions, while **Large Speculator** (Red) positioning is now short, and **Small Speculator** (Beige) positions are plunging into shorts and probably within 2-3 weeks of another extreme low.

This behavior is observed individually for EUR, GBP, CAD, and CHF, a collective weight of over 80% of the DXY:
**EURO** – Small Speculators back to Long, Large Speculators and Commercials now back to positioning consistent with major tops in the currency

- *We look to sell EUR around 1.3650-1.3750 in coming weeks.*

**BRITISH POUND** – Approaching 4-year resistance with positioning within 1-3 weeks of another extreme

- *We are sellers of GBP today.*

**CANADIAN DOLLAR** – Struggling to achieve further gains, with positioning within 1-3 weeks of another speculative buying extreme

- *We look to sell CAD around 1.0200-1.0250 in coming weeks.*

**SWISS FRANC** – Strong surge in buying by Large and Small Speculators, within 1-2 weeks of a major extreme. Commercial positioning plunging into short territory

- *We look to sell CHF around 0.8900-0.8950 in coming weeks.*
Further, based on a number of proprietary estimates, we believe the U.S. Dollar Index may now be within 2% of a major intermediate bottom.

Below is Archaea’s proprietary currency model, for which we track a U.S. Dollar Index Sub-Model:

1) While price may be very close to bottoming, it could take a few weeks as the model completes this projected pattern. Strategic portfolios should already consider long Dollar allocations over this time frame.

2) This short-term bottoming process should coincide with positioning reaching extremes, as suggested in the previous charts.

3) The ultimate resolution of the current setup is very likely to be a strong, global Dollar rally.

History is on our side.

Below is Archaea’s currency model for the previous secular Bull market in the U.S. Dollar (1991-2001).

Note the identical evolution of signals, and ultimately the break of the model line, which identified the end of the Bull market.

Once the secular line was established (after two bottoms), our Dollar Model has precisely identified both the 2011 and 2012 bottoms.

Interestingly in both recent cases, while the model did not call the true price bottom, it entered the market almost perfectly ahead of the acceleration point.

We believe:
Until our model line is clearly broken, the Dollar is objectively in a secular Bull market, and soon approaching another strategic buying point – further supported by the disappearance of speculative interest.

Reflecting on Equities

August was an important month for markets, in our opinion.

In early August our intermediate Equity models began triggering sells on several major market indices – many of which, despite some new highs in September, are again trading below their August sells.

For example, the FTSE’s and AS51’s August breaks are shown below, respectively. No bounce was recorded in September, and both models have weakened further.

The untold story, and we believe where the key is hidden, lies in Europe:

1) We did not sell the DAX or CAC in August (fortunately) – as their respective models never broke down.
2) The red circle below shows the DAX’s August bottom, and how close the model got to issuing a sell signal. Note the similarity with the CAC, in the second chart.
3) While the ensuing price rallies have been strong, both models have weakened enough to risk breaking our trigger level, should these indexes turn down from here.
We believe these patterns capture the relative strength in the European equity space to date—but just as they held in August, and have become leaders in the recent rally, once they join in global markets should once more become aligned to the downside.

Finally, revisiting our Risk Model, unless markets can produce a short-term aggressive rally from here, that relieves the weakening conditions we observe across the board, we believe the August sell signal is still fully in play, and Equities are setting up for a failure event similar to October 2007, August 2008, April 2010, May 2011, and July 2011 – illustrated by the horizontal blue resistance line below.

As always, we will continue to monitor and follow-up with clients on specific, relevant triggers mentioned throughout this report – most importantly, when we observe our Dollar model signal another potential bottom, or when we see European indices finally break their trigger levels.
Rafael Diamond, CFA, is Founding Partner of Archaea Capital Research. Archaea specializes in discretionary and quantitative macro investment analysis for institutional investors. Archaea employs proprietary global macro, asset allocation, fundamental, quantitative, and technical research models to produce economic reports, portfolio changes, and price forecasts for fixed income, currencies, equities, and commodities markets. Prior to founding Archaea, Mr. Diamond worked as senior advisor and macro researcher for fourteen years at two major banks, covering pension funds, hedge funds, and family offices. For additional information, email info@archaeacap.com.
**CHART OF THE MONTH: INDICATOR SUMMARY**

BY SUSAN BERGER

*Editor’s note: This was originally published in the beginning of October and is republished here to demonstrate how effective chart analysis can be.*

The NASDAQ is a classic Major Base Breakout and you would expect to see the uptrend continue.

On the weekly chart, you can see that the trend is accelerating. The huge percentage blast out of tight trading ranges propelled a lot of large cap stocks recently. It looks like the acceleration will continue.
The S&P 500 also broke out of a Major Base and should continue to go higher.

The uptrend continues to be intact on the weekly chart with no signs, so far, of acceleration in this index.

Again, this is a Major Base Breakout that should continue higher.
With a Major Base Breakout and strong uptrend, the Russell is currently out-performing the S&P 500.

However, the weekly chart is flat to lower this year relative to the NASDAQ, and shows no acceleration.

The Transportation Average is keeping up nicely, but even more important, a break above 15,700 in the Dow Jones Industrial Average would confirm another Dow Theory Bullish signal.

Bond yields have likely bottomed, but it takes years to change the direction from down to up. Currently yields are pulling back from resistance, and heading down.
Sectors are responding to the pullback in yields. Housing is not breaking down, but still looks sideways.

Utilities also look sideways, with a risk that they are forming a top.

REITs also look sideways. There are so many more REITs than I ever recall seeing. There may be a message there.

The Drug Index broke to the upside of the tight consolidation, so the uptrend is intact and strong. Staples had a small break to the upside.
Materials look strong.

There is momentum in the uptrends that continue to be strong, and I’m still seeing new breakouts.

Susan Berger worked with John Magee from 1968 until his retirement and then worked as a technical analyst at Fidelity Investments. She now provides independent research and additional information can be found at http://susanbergerstocks.com/. 
AUTHOR GUIDELINES

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Submissions should not use text boxes or advanced text formatting, as they make it more difficult for our staff to implement into our newsletter layout.

Please send any material you would to have considered for publication before the 20th of the month. We will work to include anything received by that date in the next issue.