



April 1, 2011	
End of Week #1894	
DJIA	12,376.72
CI	1647
NCI	1522
Ratio	1.083
S&P Ratio	1.075

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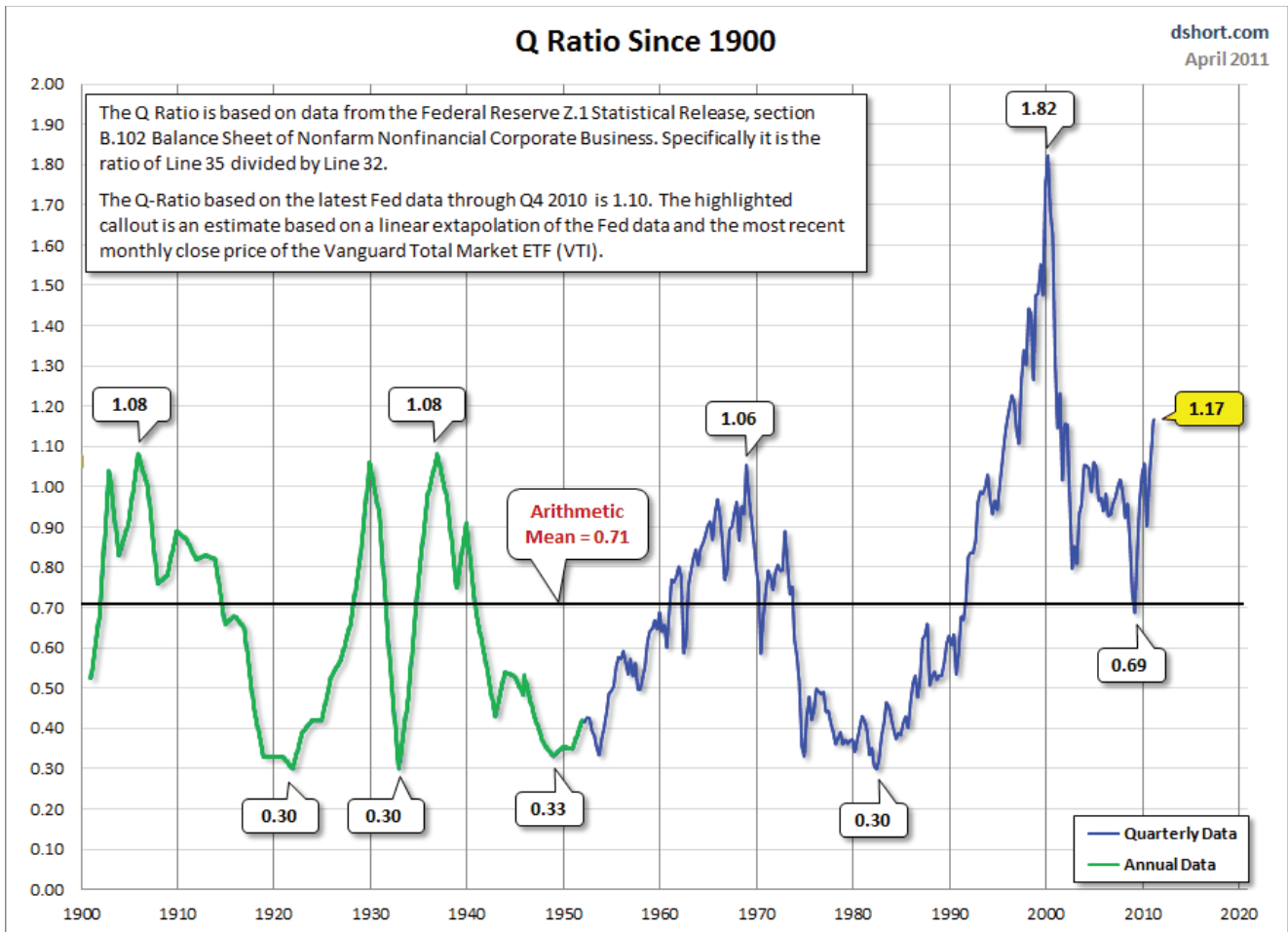
—THE CYCLES—

The publication date of this newsletter, April 1, 2011, marks the beginning of the month that will contain the potential resolution of two patterns we have discussed over the past few months. The first scheduled resolution is that of the 784.143 calendar day pattern which points to April 3, 2011, the Sunday following this newsletter's publication date. Remember, although we seek exactness in a lot of our cycles, this particular cycle is given more leeway. Some of its resolutions have, indeed, occurred almost exactly on the calculated date but others have missed the mark by a month or more. In fact, the last scheduled resolution was due on February 8, 2009. The important turn did not come until almost exactly one month later, the very important low established in early March 2009. But the importance of that turn somewhat made up for the lack of accuracy in locating it.

This particular cycle pattern is perhaps the most disconcerting one of the ones scheduled to resolve in the near future. If the pattern does resolve in an important turning point, it is difficult to imagine how that turning point would be anything but a top. After all, as recently as Thursday, March 31, the daily advance decline line of the New York Stock Exchange

registered a new all-time high. Arguing against the possibility of a high of importance being registered within a few trading days are the outstanding upside projections calling for significantly higher prices. We will discuss those projections later on in today's newsletter but we should make it clear that they are calling for prices to advance at least another 13% or so for the S&P 500 Composite Index based on the nominal four-year upside projection for that indicator. Despite many factors arguing against any high of importance in the high-cap indexes being registered over the next several weeks, we should allow for the possibility that a resolution of this particular cycle over the next week or two could mark a more important top than would now seem possible.

The other pattern scheduled to resolve in the month of April is the right side of a T based on Terry Laundry's T Theory. We conducted our own analysis of the market data on the cumulative daily advance decline data of the New York Stock Exchange using Terry's T Theory and came up with the possibility, if not probability, of a potentially very important top in the daily advance decline line. Using trading days to calculate the potential top leads to a date of April 27, less than four weeks away. Perhaps, if an important top is registered on the advance



decline line over the next three-four weeks, it will correspond with the resolution of the cycle discussed above.

Frankly, we find it difficult to come up with a logical scenario for the market that fits in well with the patterns we have discussed over the last several months. Remember, there is a 212 week cycle that is due to resolve in early July and that cycle has virtually always been followed by an advancing market over the next six months with little downside risk. That would imply that there should be little market risk from whatever low is registered around early July of this year through the next six months carrying into January 2012.

Let's not forget that the market is scheduled to see an important top on the advance decline line later this month. It is difficult to reconcile that possibility with the probability based on patterns going back almost 75 years that the market will see an uptrend between early July 2011 and early January 2012. One of the possibilities would be to see a very sharp market decline from late April into early July and then a slow climb back carrying into the end of this year or the beginning of 2012.

We always seem to find ourselves drawn to charts and data that attempt to view the long-term valuation picture of the stock market. Much of it has to do with the fact that we have considered the market very overvalued on an absolute basis going back to at least the mid-1990s. We learned some painful lessons at the end of that decade because the market just spit in the eye of the valuations and continued to defy historical overvaluation measurements for several years as it moved into the new millennium. The ultimate lesson learned was that market valuation should never be used for short to intermediate term market timing. Nevertheless, the extreme overvaluation currently seen in the stock market should allow investors to see that the next decade in the stock market could well be as non-productive as the 10 years that preceded it.

The valuation picture on the front page of today's newsletter is courtesy of dshort.com. It shows a long-term chart of the so-called Q-Ratio. Here is how the Investopedia website describes the Q-Ratio:

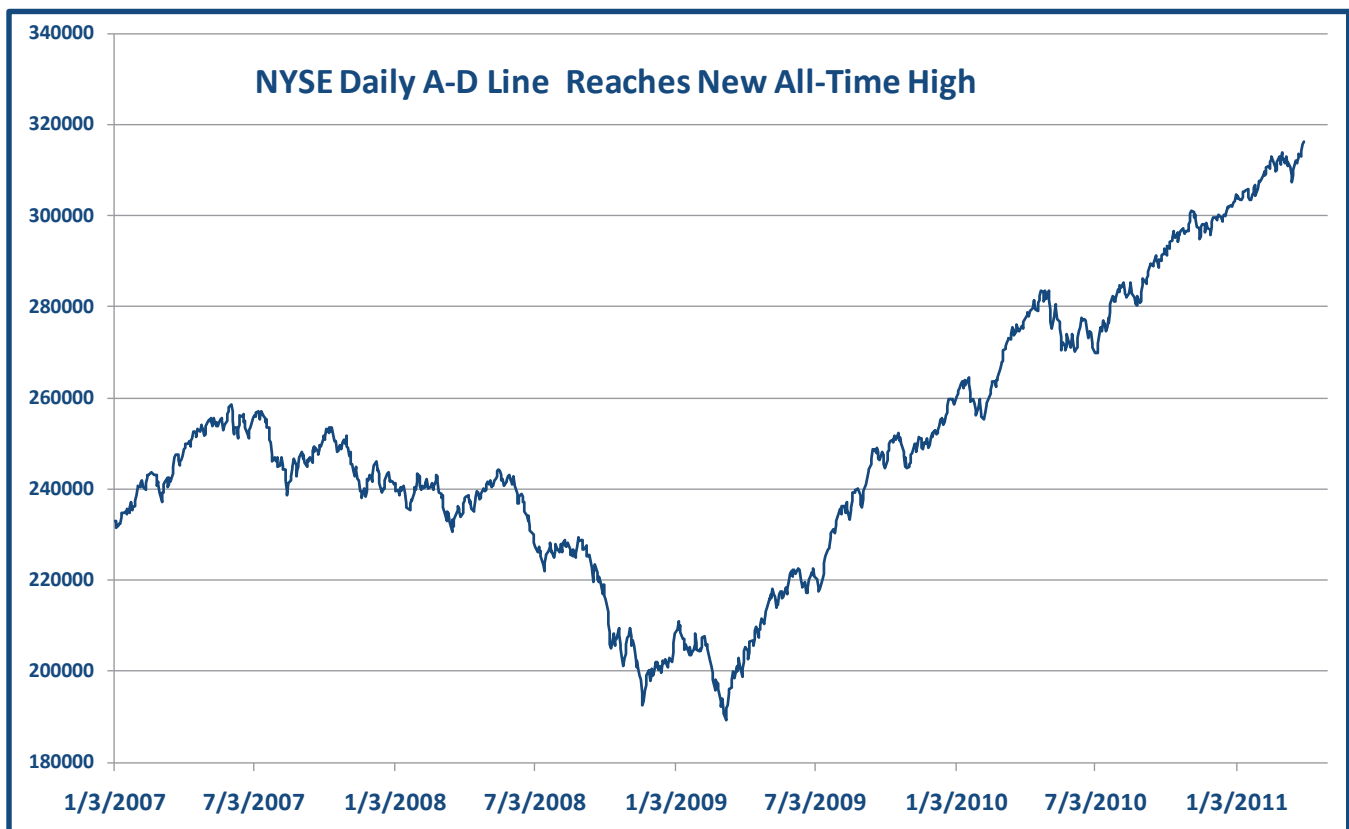
What Does Q Ratio (Tobin's Q Ratio) Mean?

A ratio devised by James Tobin of Yale University, Nobel laureate in economics, who hypothesized that the combined market value of all the companies on the stock market should be about equal to their replacement costs. The Q ratio is calculated as the market value of a company divided by the replacement value of the firm's assets:

$$\text{Q Ratio} = \frac{\text{Total Market Value of Firm}}{\text{Total Asset Value}}$$

The importance of long-term valuation pictures such as the Q Ratio shown in the front page chart and the historical dividend yield picture we presented recently and the Schiller P/E ratio which measures price against a ten-year earnings picture—the importance of those valuation pictures relates to the markets long-term prospects. History teaches us that it is foolish to believe "this time is different." You should not make short to intermediate term market decisions based on long-term valuation levels, but you should surely focus on those valuation levels when planning your investments over the next decade. The only time the current Q Ratio, which is now estimated to be between 1.16 and 1.22, has been higher over the last century was in the final manic years leading up to the 2000 top.

It is important to examine that period leading up to the 2000 top, however, because it is an important lesson concerning the use of valuation tools. When the market began its amazing advance towards the important top in early 2000, it quickly climbed into uncharted waters. By mid-1995, the dividend yields on the Dow and the S&P were already moving



towards record lows and the Q Ratio was at upper levels never before seen in the modern history of the stock market. It would have been easy to get bearish on the market based on those items alone. We know only too well, because the overvaluation of the market based on its record low dividend yield was one of our big arguments against the market rally continuing beyond the mid-1990s. With that experience behind us, it is difficult to argue that the current market rally will necessarily end soon because of valuation levels. Nevertheless, we are also aware of the markets long-term cyclicality and that concept leads us to the conclusion that some time in the not-too-distant future the historic levels of overvaluation the market has experienced over the past decade and a half will almost surely lead to a period of historic undervaluation.

What kind of a decline can we expect if we are to see historic undervaluations in the popular market averages and indexes? Assuming everything else remains unchanged (it never does) a move on the Q Ratio from its current level around 1.20 to an undervaluation level of around 0.30 would imply a decline of around 75% in the popular market averages. Performing an equivalent exercise on the price to dividend ratio of the S&P, the current ratio of around 52 (price to dividend ratios are calculated by taking the reciprocal of the current dividend i.e. $1/0.0192$) might decline to prior historic undervaluation levels around 12. Assuming dividends remain the same (they almost surely would not), such a readjustment would imply a decline in the S&P of 76.9%. Granted, the foregoing can appear to be nothing more than a fanciful play on numbers, but the reality remains that markets have always swung from levels of overvaluation to levels of undervaluation. Usually levels of great overvaluation such as we have seen lead to periods of great undervaluation. It's called "cycles," and until they are outlawed, undervaluation will follow overvaluation as night fol-

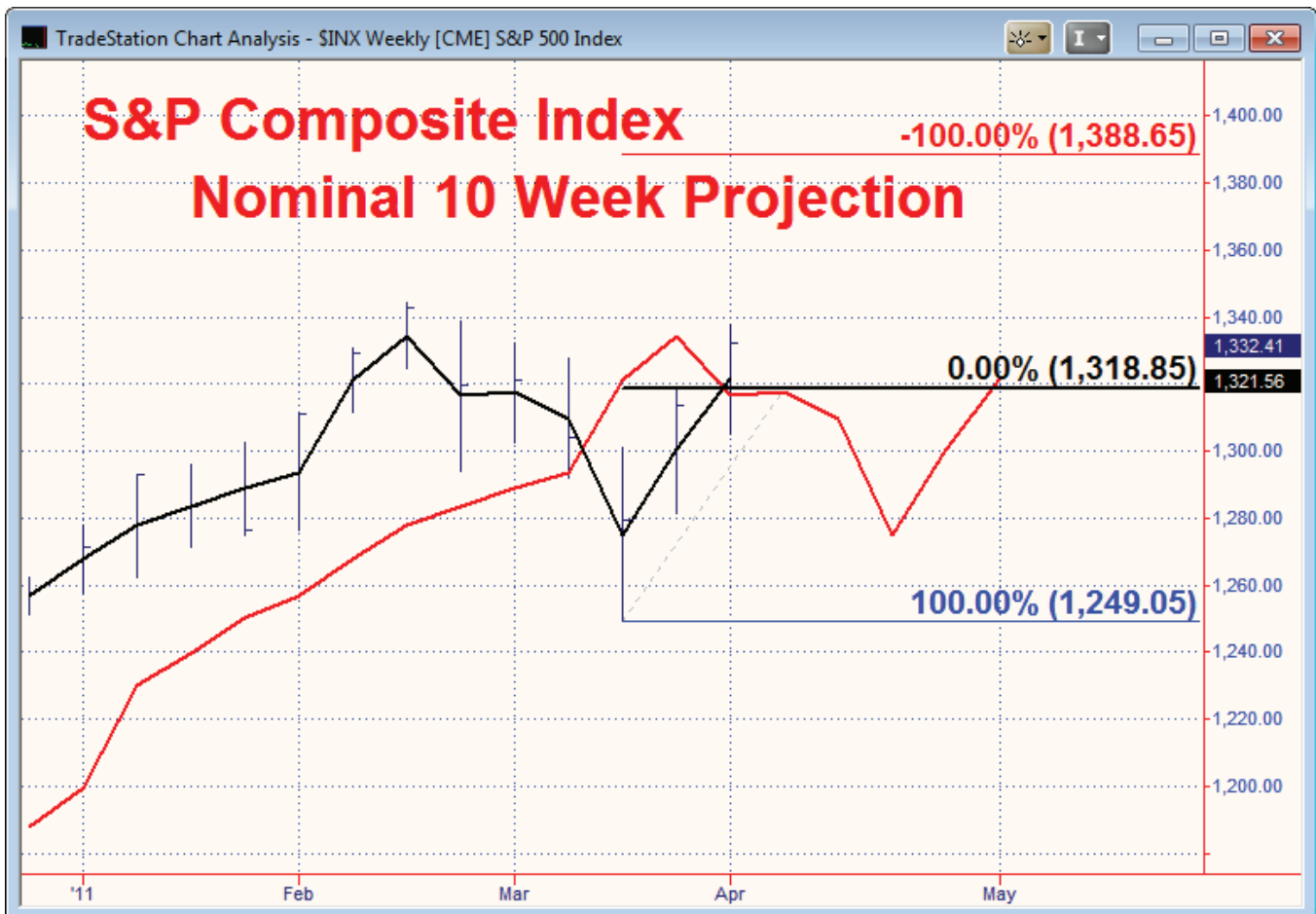
lows day.

All that having been said, we just don't believe the market is ready yet to start retreating from these very heady overvaluation levels. In fact, as we noted above and as we have been noting for many months now, the nominal four-year projections for the Dow and the S&P have suggested that the tailwinds currently in effect will continue for at least another 12-13% on the upside. It will be our job to remain vigilant in our analysis so that, if those levels are not going to be reached, we issue a proper warning that the long-term tide is turning. That is not yet the current message that we see from the overall market.

— TECHNICAL INDICATORS —

The second chart in today's newsletter depicts the daily advance decline line of the New York Stock Exchange. Today, April 1, the advance decline line closed at a new all-time high. If we know that there have been very few instances in history where the advance decline line reached an important high coincident with or after an important high in the major indexes, then the fact that it is reaching all-time highs currently might not help us too much in our analysis. In fact, we do know that as long as the daily advance decline line continues to see new all-time highs, there is little chance that the popular market indexes have reached or are reaching important market highs.

If our analysis in our last newsletter concerning a potential top in the daily advance decline line at the end of this month turns out to be accurate, then we are confident that we will not see an important market top in the popular averages within the next month. There is almost always a lag between advance decline line tops and the tops in popular indexes. How



great a lag? There are no set rules. In 2007, the daily advance decline line reached its high on June 4 but the final market highs on the Dow and the S&P were not seen until just over four months later. That divergence can be seen in the page 2 chart of the daily advance decline line. The pattern leading up to the important top in early 2000 was quite different. The high on the advance decline line preceding that top in the popular averages occurred on April 3, 1998, almost 2 years prior to the final highs in the popular averages.

Those two examples lead us to the understanding that even if we do identify an important top in the advance decline line, that does not necessarily help us to identify subsequent important tops in the popular market indexes. It is perhaps possible, however, to construct a potential market scenario that would make sense based on the cycles we have been discussing and the usual time lags between advance decline line tops and ultimate tops in the overall market. Let's go forward with the idea that the daily advance decline line of the New York Stock Exchange will reach an important high on April 27 \pm a week or two. Within a few weeks after that date, our confidence will be enhanced if the advance decline line has reached a new all-time high within a few days of the April 27 date and has not gone any higher over the next week or two. That would be a good clue that the top projection could indeed be working out. Within a week or so of the end of April, we could begin to see a market decline of some substance. If the 212 week cycle discussed in detail in our last newsletter and referred to above continues its stellar consistency, we should see a market low somewhere near the beginning of July. The exact theoretical resolution date is July 4, a market holiday. It would be a good time to go and review the results of the market's progress in the six month periods following the ideal resolution date of the 212 week cycle. Since 1950, the worst market decline seen in the six months following the resolution of the 212 week cycle was 5.6%. The average of the worst declines in the following six months is an amazingly low 1.3%. Equally as impressive is the fact that six months after the ideal resolution date of the 212 week cycle, the DJIA had gained an average of 15.1%.

Be aware that if we go back one more cycle to 1946, we can find an exception to the fabulous six month performance of the cycle since that time. From the ideal resolution date of July 1, 1946, the Dow saw a 21.0% decline within the next six months and ended the six month time span with a loss of 14.2%. We give you those statistics in the interest of honest reporting. We have never found a perfect pattern in the market but the 212 week cycle, especially over the past 60+ years, comes as close to perfect in leading into low risk six month market windows as we might wish for.

We also work with the daily advance decline line of the S&P 500. It is interesting to note that, although that daily advance decline line has not moved to new all-time high ground, it has definitely surpassed the highs reached in 2007 and over the past few days has now gone to its highest levels in almost 13 years. In that respect it is confirming the strength shown on the daily advance decline line of the New York Stock Exchange.

In the box at the top right of the front page on every newsletter, we always insert the data for the CI (Cycle Indicator), the NCI (Neutral Cycle Indicator), and the ratio between

them. The explanation for those indicators can be found at the following link that will take you to the section on technical indicators on our website:

<http://stockmarketcycles.com/technica.htm#The Cycle Indicator>

That ratio closed today at 1.083 on the New York Stock Exchange and at 1.075 for the S&P 500. In essence, those numbers indicate a market in a very overbought condition but you have to be careful in interpreting those numbers. Today's reading of 1.083 is getting very close to what we consider to be a benchmark reading of 1.095. As we say in our explanation of the indicator, readings of 1.095 and higher identify a very high upside momentum condition that usually leads to an ongoing and long-lasting market advance. In essence, there is a rather fine dividing line between readings around 1.080 which could be indicating a very overbought condition leading to an imminent market top and readings above 1.095 which tell us, in effect, that there is so much upside momentum it has become a bullish indication. For that reason, we will be watching these numbers closely. Actually, we believe the S&P 500 CI/NCI ratio will probably give us more accurate readings on the overall market and although today's reading of 1.075 is very high on that indicator, it is still a distance away from the 1.095 high momentum reading.

In the upcoming newsletter at the beginning of May, we will try to show you a long-term chart of the CI/NCI ratio. Because we are looking at the possibility of a potential top of importance in the advance decline line towards the end of April, next month could prove to be the ideal time to look at the advance decline line and the CI/NCI ratios to see if they are giving or have already given us important market information. If something important happens in that regard between now and the next newsletter, we will attempt to update you via the daily updates.

— MARKET PROJECTIONS —

For the next few months or longer, if it takes longer for the projections to be met, we will attempt to keep repeating the nominal four-year upside projections that have been generated for the Dow and the S&P. The Dow projection calls for a move to between 14,042-15,748. The equivalent S&P 500 projection calls for a move to between 1500.15-1736.56. When those projections were given and confirmed in September and October of last year, it would have been virtually impossible to invalidate them over the following 3 to 6 months. As the market gets closer and closer to the end of this year, if the indicators have failed to move up to the projected levels given above, it will become easier and easier to invalidate those upside projections.

— MUTUAL FUNDS —

Both Rydex and Fidelity switchers are in 100% cash positions. We had tentative instructions for Rydex switchers to buy the S&P 500 2X Strategy Fund (RYTNX) this morning but the price was outside of our parameters at the given time for the evaluation. We have two different specific model portfolios—one for Fidelity switchers and one for Rydex group switchers. How you distribute your own portfolio is up to you as an individual.

Next Publication Date: May 6, 2011

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