

INFORMATION, TIME AND RISK

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“The nature of risk is highly sensitive to whether we act before or after we have all the information in hand. This is just another way of saying that risk and time are only opposite sides of the same coin, because the availability of information increases with the passage of time. Thus, risk, time and information interact upon one another in complex and subtle ways.”

From keynote address by Peter L. Bernstein upon receiving the Inaugural Distinguished Scholar Award from the Southwestern Economic Association, Dallas, March 4, 1994.

The reader should keep in mind that any discussion of the financial markets is of necessity a discussion of constantly changing statistics and other data. This article was originally written in May 1994 and was submitted to the *MTA Journal* at that time. Therefore, while the data used herein were current as of May 20, 1994, such data applied to any specific situation described may no longer be applicable. The same caveat applies to the *Sequel*, which was written and submitted on November 11, 1994 market close, and briefly discusses how each of the theories or methods described herein worked or failed to work during the period subsequent to May 20, 1994.

SYNOPSIS

This article outlines the core theories of Charles H. Dow and Edson Gould. Three of Gould's methods used to forecast stock prices, which are based on quantifying investor psychology, are described and then illustrated using current data. Several forecasts are then made based on how Gould's three methods and those of the author combine, in the author's opinion, to operate in current financial markets. Future levels of interest rates, stock prices, an industry group, the technology sector, as well as two individual stocks, are estimated. A sequel, written six months after the original article was submitted, discusses how the forecasts turned out.

DOW'S THEORIES

The granddaddy of all stock market technical studies is the Dow Theory, which was originated by Charles H. Dow around the turn of the century. According to Dow, major bull or bear trends are indicated when the *Dow Jones Industrial* and *Transportation* averages, one after the other, set new highs or lows. A divergence between the indices often indicates a potential turning point in the underlying trend of the stock market. Dow set the stage for the later theories, still used and elaborated on by market analysts today, of what may broadly be defined as divergence analysis. That is the study of divergences among and between a broader universe of indices and indicators than were available to Dow. Dow's theory was used in the context of his basic commandment: “To know values is to know the meaning of the market.”¹ But Dow also said that wise investors, knowing values above all else, buy them when there is no competition from the crowd. Indeed, they buy them from the crowd during periods of mass pessimism, and sell them to the crowd in return for cash during late stages of advancing markets. The stock market as a whole, said Dow, “represents a serious, well-considered effort on the part of farsighted and well-informed men to adjust prices to such values as exist or which are expected to exist in the not too remote future.”²

GOULD'S THEORIES

Edson Gould, who first studied the Dow Theory, was a practicing market analyst for more than fifty years between the early 1920s and late 1970s. His main focus was on forecasting the stock market. Though a student of physics and the harmonics of music, as well as business cycles and Greek civilization, each of which he believed helped explain certain aspects of how the stock market behaved, he came to believe, after reading Gustave LeBon's classic, *The Crowd*,³ that “the action of the stock market is nothing more nor less than a manifestation of mass crowd psychology in action.”⁴

The methods and techniques Gould utilized in his service, *Findings & Forecasts*, attempted to “...integrate the many economic, monetary and psychological factors that set the level and cause the changes in stock prices.”⁵ He regarded the economic factors as important but typically late so far as the stock market is concerned. He regarded the monetary factors as crucial for the stock market and typically early. Whereas, he believed that, “Of all three sets of factors, the psychological factors are by far the most important – in fact, the dominant factors affecting the cyclical swings of stock prices.”⁶

THESIS

It follows from the above that one of the most important aspects of all in successfully analyzing the stock market is measuring investor sentiment. The consensus view, the most difficult factor of all to gauge accurately, can be glimpsed at times – and only in part-through not only such transaction-based data as put/call ratios, premiums and open interests, but also poll-based data such as the weekly *Investors Intelligence* reports of what percentage of investment advisors are bullish or bearish. Whereas the author regularly screens such data for extremes, the theories and methods which are derived from Gould and are discussed below are, in an of themselves, measures of the behavior of the investment crowd and, in his opinion, more practically useful in making and implementing investment decisions. And inasmuch as they are also applied to the monetary factors, a bond market opinion is derived therefrom, as well.

The index and stock charts used to illustrate this article are of:

1. Treasury Bonds Nearest Futures, Monthly
2. Treasury Bonds Nearest Futures, Weekly
3. New York Stock Exchange Financials Index, Weekly Standard & Poor's 40 Utility Stock Composite, Weekly
4. Standard & Poors 400 Industrial Stocks Composite, Monthly
5. Drug Shares Index, Weekly Close (Sum of BMY, LLY, MKC, MRK, PFE, UPJ x 4.50541)
6. TXB-Hambrecht & Quist Technology Stock Index Less CBOE Biotechnology Stock Index, Weekly Average
7. Merck (MRK), Weekly
8. U.S. Robotics (USRX), Daily

GOULD'S METHODS AND TECHNIQUES

Edson Gould is, perhaps, best known for his monetary rule and valuation barometer: His *Three-Step-and-Stumble Rule* states that, “Whenever any one of the three rates set by monetary authorities – the rediscount rate,

the rate for bank reserve requirements, and margin requirements on stocks – increases three times in succession ... invariably ... the stock market has subsequently ... suffered a sizable setback.³⁷ Whereas his *Senti-Meter* is, “the ratio of the Dow Jones Industrial Average to the average rate of annual cash dividends paid on that average.”³⁸ When the *Senti-Meter* reads \$30 per \$1 of dividends or more it indicates a high and risky market. A reading of \$15 or less indicates a relatively low and cheap market.

Lesser known and, perhaps, too arcane for many, the author has found that three of Gould’s methods and techniques are more practically useful in helping decide when and at what levels a given stock or price index is “too” high, or “too” low and what constitutes a sentiment extreme. With this background in mind, let’s examine Gould’s theories and applications of Resistance Line Measurement, Unit Measurement and the Rule of Three, as well as the author’s theory of the Cut-in-Half principle and its opposites.

RESISTANCE LINE MEASUREMENT

According to Gould, “... the market continually reveals a quantum of mass psychology comprising time and price. It follows that a sharp decline in a short period of time generates as much bearishness as a slow and minor decline over a long period of time.”³⁹ This theory, then, is based on three principal determinants of crowd psychology in the market place: price change itself, elapsed time to achieve it and the perceived amount of risk.

The resistance line theory attempts to measure these three elements of mass psychology mathematically, weighing both the vertical price change and the horizontal elapse of time. This measure of potential risk or reward must be keyed off whatever the investor regards as any pair of prices which consist of an important high and low of the particular security’s price history. Four of the charts which are discussed below illustrate how the resistance lines are applied.

The theory is that a trendline rising at one-third (or two-thirds) the rate of an advance movement is likely to produce resistance to subsequent decline, but, if violated, the decline will accelerate from the point of penetration. Similarly, a trendline declining at one-third (or two-thirds) the rate of a decline movement may provide resistance to a subsequent advance, but, if penetrated, the advance will accelerate from that point. Sometimes these resistance lines work, sometimes they don’t; they are not foolproof. But the author uses resistance lines because they seem to be more accurate than ordinary trendlines and – most importantly – because they can be drawn before the subsequent price action takes place.

LONG TREASURY BONDS

Let’s see how resistance line theory may be helpful this year in gauging when Treasury Bonds Nearest Futures, which have been falling mostly since their September 1993 peak, etch a major low. Inasmuch as these Treasuries, Monthly (Chart 1) made a major low in 1981 at 55.156 and more than doubled it at the 1993 high of 122.313, the most important set of resistance lines derive from that low and that high. Referring to the chart, we observe that the May 11, 1994 low of 101.125 slightly broke the rising 2/3 speed line before reversing upward to close May 20 at 105.000. Important here are the facts that this same resistance line approximately defined each of the 1987, 1990 and 1991 Treasury lows. Translated into an opinion on May 20, this means that Treasuries won’t decisively break par this year. Should they do so, it might imply the onset of a renewed inflationary cycle.

Moreover, the second of Gould’s methods, the unit measurement principle, also helps to determine the importance of the early-May intraday low of 101.125.

UNIT MEASUREMENT

This technique is sometimes helpful in estimating terminal phases of advances and declines, of both individual stocks and market indices. In

other words, what constitutes a price which is “too” high or “too” low. Its measurements are expressed in terms of bull and bear “units.” A bull unit consists of the number of points of an initial advance by a stock or price index following the bottom of a prior important decline, succeeded by a subsequent reaction which, however, remains above that bottom and then is followed by a second advance that goes beyond the first one. A bear unit is formed in the same manner but in the opposite direction. These measurements sometimes portend the length of an overall advance (or decline) and indicate levels at which a trend may meet resistance, or, at times, an extreme reversal.

Chart 1
Treasury Bonds Nearest Futures, Monthly

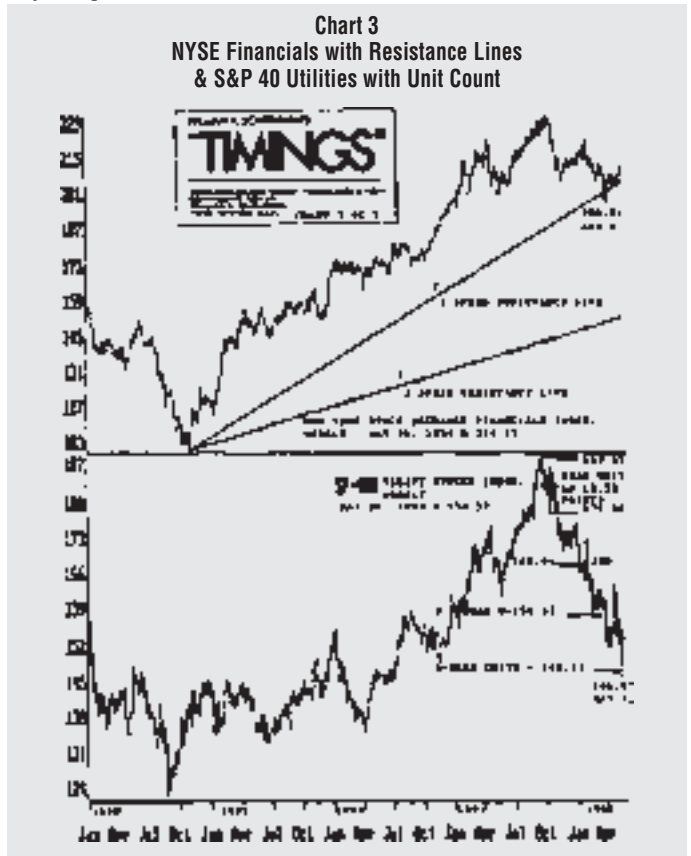


Chart 2
Treasury Bonds Nearest Futures, Weekly & Bear Unit Count



Price action with the primary trend frequently “works off” units three times (sometimes four times), in accordance with the Rule of Three, the basis of which is discussed below. In other words, for a move with the trend, expect three units, but be prepared for the fourth. One other important point about unit measurement is that recognition of the 2-unit level, by a sharp reaction from it, often indicates that following such a reaction the security will go all the way and work off three, or four units. Whereas recognition of that level which is defined by 2-1/3 units, without recognition of the 2-unit level (by resistance from it), is grounds for caution, especially for trend followers, since that is often the hallmark of a contratrend move.

Now we are equipped to develop a second opinion about Treasury Bonds Nearest Futures, Weekly, which is illustrated in Chart 2. Referring to the chart, we observe that these Treasuries etched a bear unit of 4-7/8 points by their initial September 7-22, 1993 decline from 122.313 to 117.438. According to unit measurement theory, then, the contratrend, upward reaction from the 2-bear unit level of 112.563, which was reached at the November 23 low of 112.031, implied that Treasuries would go down all the way – to work off either 3 or 4 bear units to 107.688, or 102.813, respectively. With the actual intraday May 11 low of 101.125, this close – less than 2 percent away-recognition of the theoretically maximum 4-bear unit count, also leads to the conclusion that that was a low in Treasuries of major importance.



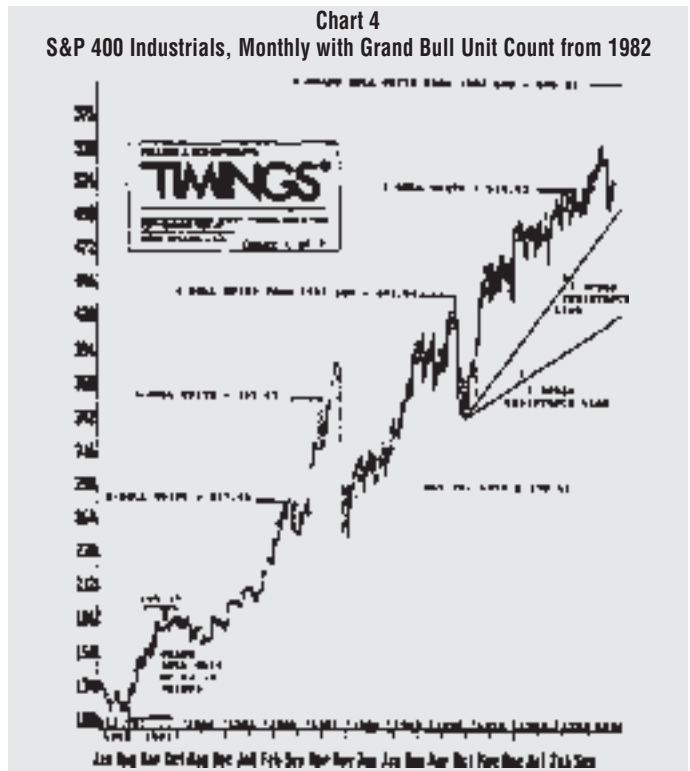
INTEREST-SENSITIVE STOCK MARKET INDICES

Because of the importance of the monetary factors, ideally the resistance line and unit measurement theories should also be reflected in interest-sensitive stock market indices. Sure enough, the New York Stock Exchange Financials and Standard & Poors 40 Utilities indices (both on Chart 3) did, so far, in 1994 faithfully reflect both resistance line measurement and unit measurement theory, respectively. Referring to the chart, we ob-

serve that the Financials’ week of April 8, 1994 low of 200.01 and all subsequent lows, which were higher (itself a positive divergence), reversed upward above the rising 2/3 speed resistance line from the 1990 low. Gould always said that the ability of a price index to stay above its rising 2/3 speed resistance lines during reactions was the hallmark of a powerful advance.

Whereas the S&P 40 Utilities, which etched a bear unit of 10.29 points by the September 17-October 15, 1993 decline from 189.49 to 179.20, worked off a fairly precise 4-bear unit count to 148.33, compared to the actual May 13 low of 146.85. Close enough. Moreover, these Utilities also respected their rising 2/3 speed resistance line from the 1981 low, which approximated this 4-bear unit count.

It logically follows from each of these two theories that should the aforesaid risk parameters of these three interest-sensitive indices – Treasuries, NYSE Financials, S&P 40 Utilities – be decisively downside penetrated on a closing basis that the bear market in bonds not only had more to go on the downside but also that stocks might have begun a bear market as well. However, the author does not believe that is the case at May 20, 1994, as we examine next.



A STOCK MARKET ROAD-MAP

Gould also said that over longer periods of time unit measurement was useful, too: “A ‘grand unit’ is, as the name implies, a big unit sometimes taking months to complete and years to confirm.”¹⁰ We think this theory has been remarkably accurate since the stock market’s 1982 low and that it is relevant now. Referring to Standard & Poors 400 Industrials (Chart 4) we observe that during the 14-month long 1982-1983 advance from 113.08 to 195.25, a grand bull unit of 82.19 points was etched – the 10-month-long 1983-1984 decline to 167.64 not exceeding the 1982 low.

Thereafter, the S&P 400 steadily rose until hitting the 1986 peak of 282.87, which was less than 2 percent above the 2-bull unit count at 277.46. The subsequent 12 percent reaction to that year’s September low of 252.07 constituted recognition that the unit measurement principle was operative, and that the S&P 400 would go on to work off at least 3 or 4 bull units.

From the 1986 low, the S&P 400 gathered steam and began to accelerate in 1987, reaching the 3-bull unit count of 359.65 in June. That level was potentially an important peak level in accordance with the theory – expect three units. During the next two months the S&P 400 overshot the 3-bull unit count but peaked 9.7 percent higher (intraday) in August, followed by the crash.

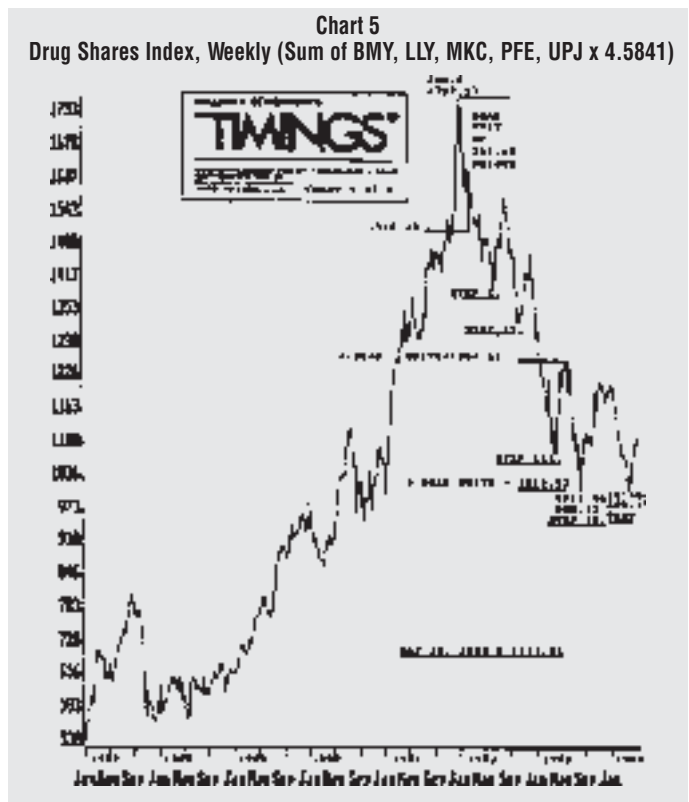
From the 1987 crash low, stocks steadily rose until hitting the July 1990 peak of 438.56 which was less than one percent below the 4-bull unit count to 441.84. That was a perfect fourth and final move, according to Gould's unit measurement theory. During the next three months stocks fell by 21 percent.

Of current relevance, in the author's opinion and experience, is that sometimes unit counts will work off a double set of units, i.e., 6 or 8 units. This appears to be the current case for the S&P 400 Industrials, which, rising from the October 1990 low of 345.79, recognized the five-bull unit count to 524.03 repeatedly last year by resisting further advance. However, by late-1993 that level was decisively exceeded. This means to us that the theory is saying the stock market should continue to rise until reaching at least the 6-bull unit count to 606.22, before the bull market which began from the 1982 low is over.

In 1994 the S&P 400 Industrials advanced further to reach the 560.88 level in February, before reacting to the April 20th low of 507.36, a drop of 9.5 percent. Referring again to Chart 4, we further observe that during the February-April reaction the rising 2/3 speed resistance line from the 1990 low, which during April was at the 500 level, was effective in defining that month's low. This means we believe current risk from the May 20th close of 530.88 approximates four percent, say 510, whereas potential reward – to 606.22 – would be a gain of 14 percent. Those seem like good odds.

THE RULE OF THREE

Now, we examine the third of Edson Gould's theories, the Rule of Three. For reasons about which people have speculated for thousands of years, the number “three” and “four” have a meaning of finality about them. For example, Aristotle said, the “Triad is the number of the whole, inasmuch as it contains a beginning, a middle and an end.” This concept may be deeply rooted in the natural family unit of father, mother and child, which is given religious expression in the concept of the Holy Trinity. The financial markets, which, after all, reflect human emotions, also frequently act in the same way. Sometimes there is a fourth movement, which usually is characterized as a “now and never” action, climactic in nature. (Three strikes you're out; four balls take a walk). That financial markets and individual stocks typically – but not always – move in a series of three or four steps is apparent in both very short-term moves as well as those encompassing months and even years.



DRUG SHARES INDEX

However, to simply illustrate the Rule of Three we next examine the Drug Shares Index (Chart 5), a composite of Bristol Meyers, Lilly, Marion Merrill Dow, Merck, Pfizer and Upjohn. Between January 8, 1992 and August 13, 1993 the Drugs dropped 42.8 percent in a classic bear market, which consisted of four steps down. Also, helping define the fourth step as the final one was the fact that the August 13, 1993 low of 1011.46 closely approximated the 3-bear unit count from the 1992 peak, at 1012.93.

After rallying 20 percent from the 1993 low, to 1217.04 on January 14, 1994, the Drugs came down again to etch a successful test of last year's low, at the April 15, 1994 low of 1014.84. In other words, we are confident that a classic double bottom has been put in place for this group. Additionally, as illustrated later, another yardstick of extreme investor behavior targeted both Lilly and Merck as having etched final lows last year and this year.

TECHNOLOGY AND GROWTH STOCKS

No discussion of the stock market would be complete without addressing the role of the technology and growth sectors. They are important not only because they often represent the fastest growing companies, but also, as I stated in my book which was first published in 1970, "...glamour/growth stocks which, because they are highly volatile – ordinarily two-and-a-half times more so than those in the DJIA – are favorite vehicles of sophisticated investors."¹¹ This volatility provides greater time opportunity than is available in the behavior of most other stocks.

Edson Gould, "put together the first 'glamour average' back in 1960,"¹² though, surprisingly, the pamphlet, *A Vital Anatomy*, from which we've also earlier quoted various Gould statements about his theories and methods, says nothing whatsoever about "glamour" stocks. Having originally gotten this idea from Gould in the late 1960s I created my own "Glamour Price Index," which consisted of the stocks of eleven highly-regarded, well-known, technology-oriented companies.¹³ However, in the most recent

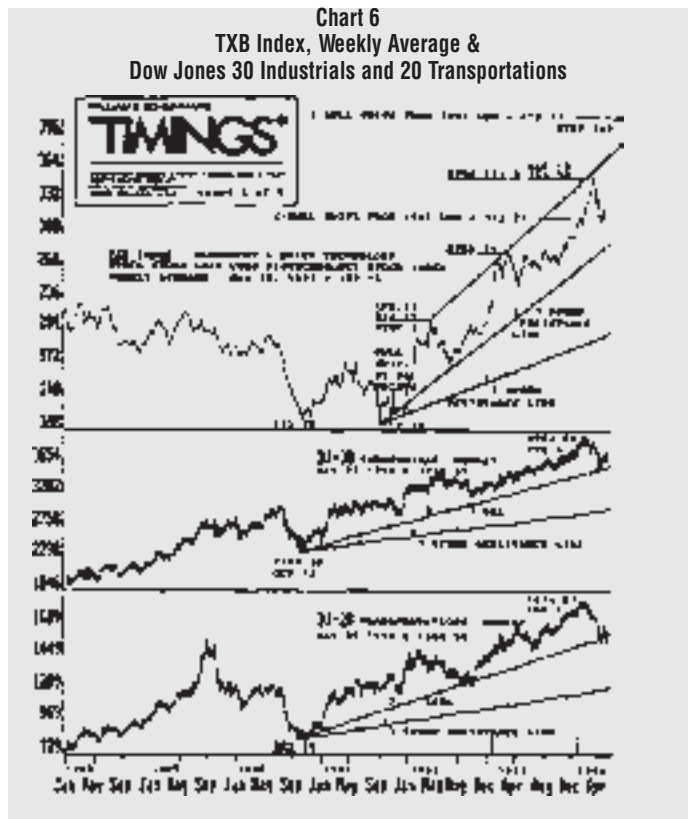
edition of my book, I noted that in recent years I've scrapped my original "Glamour" and several other technology- or growth-based indices in favor of the more representative Hambrecht & Quist Technology Stock Index¹⁴ and its sub-index of even more rapidly growing, smaller companies, the H&Q Growth Stocks Index. But inasmuch as the H&Q indices include stocks in the biotechnology sector, which I believe march to a different tune than other growth and technology types, I also have created two other indices which consist of the numerical values of each of the respective H&Q indices less the CBOE Biotechnology Stock Index. Hence, in the technology and growth sectors, we examine these five different indices:

1. **H&Q Technology Stock Index**, which is comprised of the publicly traded stocks of 200 technology companies, broadly defined in five basic groups: Computer Hardware, Computer Software, Communications, Semiconductors, Health Care (within which is a Biotechnology sub-index). The index was originally conceived in the 1970s as a price-weighted index. In 1985 it was reconstructed and market capitalization weighted. Changes in the index occur as mergers, acquisitions and failures dictate – not infrequently.
2. **H&Q Growth Stock Index** is a subset of the Technology Index and is comprised of all companies in the Technology Index which have annual revenues of less than \$300 million. Companies are removed every January if they have passed \$300 million in revenues.
3. **CBOE Biotechnology Stock Index**
4. **TXB Index**, which is the H&Q Technologies Excluding Biotechs
5. **GXB Index**, which is H&Q Growth Stocks Excluding Biotechs

THE TXB INDEX

Of these five indices, the author thinks the TXB Index is both the most representative of the overall technology sector as well as being the most orthodox in reflecting investor psychology. We examine it next. Referring to Chart 6, we observe that between their respective 1990 lows and 1994 highs (through May 20, 1994), whereas the DJIA gained almost 71 percent and the Dow Transportations rose more than 131 percent, the TXB Index more than tripled. So much for volatility!

We also observe that at its March 18, 1994 peak, the TXB Index completed a third step up from its 1991 low. In accordance with the Rule of Three, this allows for either the possibility that that was a final step, or allows for the emergence of a fourth and final higher high, after the current reaction is over. We favor the latter possibility and believe Gould's two other theories provide well-defined potential risk and reward parameters for the outcome we envisage.



As to risk in the TXB Index, which at May 20, 1994 was down 14-1/2 percent from its March 18 peak, it must not break below the rising 2/3 speed resistance line from the 1991 low, in order to maintain its bullish uptrend, in accordance with Resistance Line Theory. Inasmuch as TXB closed at 303.15 on May 20, and the aforesaid 2/3 speed line was nearing the 287 level, that means we think that risk of this date approximates 5 percent.

Whereas potential reward of a possible fourth and final rise of the TXB Index we think may be estimated through the Unit Measurement method. Referring again to Chart 6, we further observe that the TXB Index etched a bull unit of 99.96 points by its initial advance from the September 20, 1991 low of 112.29 to the April 24, 1992 high of 212.25. The 2-bull unit level of 312.21 was briefly recognized by its one-week reaction from near that level in early 1994, before advancing to the higher March 18 all-time high. Assuming then, that the aforesaid resistance line risk parameter holds on the current reaction, we believe that potential reward from the May 20 level is about 35 percent to the 3-bull unit count at 412.17.

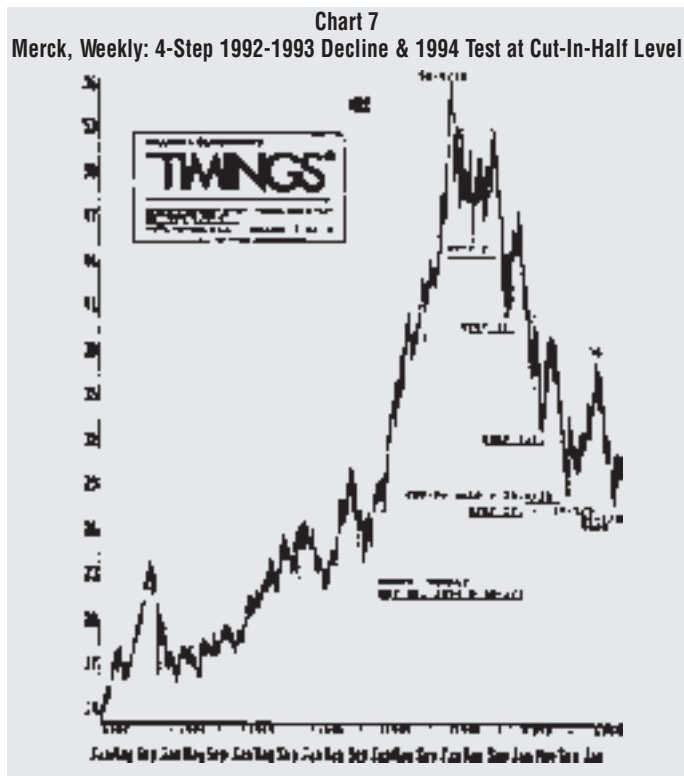
These sound like favorable odds of 7-to-1 between possible risk and reward, in the author's opinion. I note, too, that an overhead trend, which is projected through the 1992, 1993 and March-1994 peaks and which also parallels the rising 2/3 speed resistance line, approximates the 400 level by year-end 1994, as well. In other words, the author believes that the TXB Index will rise by about one-third before this sector is vulnerable to a bear market.

BEAR MARKET

After the reward area is approximated, that's from where I think a bear market in technology and growth, as well as one for the stock market, overall, may begin. That there will likely be a bear market between now and 1995 is suggested by the facts that every single "5" year in this century has been an up year, which means that there "should" be an intervening bear market before the 1995 bull market begins. However, an alternative sce-

nario is simply that it will take between now and year-end 1994 for the reward area to be reached.

If that proves to be the case and the stock market rises to record levels and nears the potential reward areas we have outlined herein, by year-end 1994 (possibly narrowly extending into early 1995), that would be the fourth consecutive up year – a possible “final” up year, according to the Rule of Three. In that event, 1995, especially if perceived by “too” many as always an up year since it is a “5” year, would then set the stage for it to become the first down “5” year during the past century, in the author’s opinion, i.e., 1995 happens in second-half 1994.



THE CUT-IN-HALF RULE AND ITS OPPOSITE

The fourth gauge for measuring investor extremes is conceptually the simplest of all – the Cut-In-Half Rule and its opposite. Briefly stated, when an important stock or price index loses 50 percent of its value, a rally or even major reversal often originates from near that level. Keep in mind that the Cut-In-Half Rule and a 50 Percent Retracement are quite different. For example, two stocks each base at the level of 50 and both rise to 100. If one declines to 75, before advancing once again, it has retraced 50 percent of its advance from 50 to 100. However, if the other one drops back to 50 from 100, it has been “cut-in-half.” A textbook example of the Cut-in-Half Rule is shown in Chart 7 of Merck, which we discuss below.

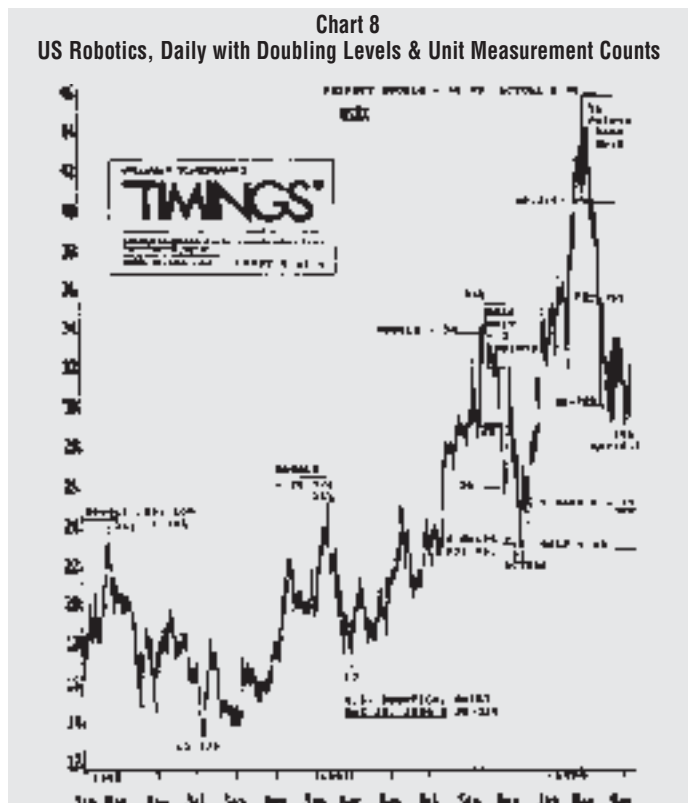
Why the Cut-In-Half Rule and its related spinoffs often work is probably because the investor crowd quantifies 50 percent off the top as “too” cheap. Whereas the opposite is that after an important stock or index doubles it often runs into trouble. At that point, investors tend to take at least some profits. But since some indices, individual stocks, commodities and interest-bearing securities are more volatile than others, this same yardstick is sometimes extended on the way up to a triple, quadruple, quintuple, or even a sextuple, (with low price stocks sometimes squaring their lows). Whereas, on the way down there is sometimes a double cut-in-half (off 75 percent), or – more rarely – a triple cut-in-half (87-1/2 percent off the top). Keep in mind, however, that in applying these Cut-In-Half yardsticks as potential long entry points, one should be satisfied that the company’s bal-

ance sheet is not in serious question.

STOCK SELECTIONS

Though it can be repeatedly demonstrated that these four theories of investor behavior are constantly operating in all financial markets, in the author’s opinion, it does not necessarily follow that one can readily use them in every instance. Sometimes the units are not readily discernible and the resistance lines don’t work. Moreover, sometimes there is a fifth step in an overall advance or decline movement, which appears to contradict the Rule of Three – though a case might be made that such a fifth step represents an undercut (or overcut) test of the fourth step.

However, after using these theories over time to make day-to-day investment decisions, I have found that they are valuable when discernible and add confidence to a decision. That is particularly the case when more than one theory appears to be operative in a given situation.



For example, referring to Chart 7 of Merck (MRK @ 30-1/4), we can observe that when it closely approximated its theoretical cut-in-half level of 28-9/32 during August 1993, at the actual low of 28-5/8, on a fourth (and presumably final) step down from the January 3, 1992 peak of 56-9/16, it appears to have constituted a classic buying juncture. Thereafter rallying to 38 by January 5, 1994, Merck subsequently tested last year’s low at this year’s April 15, 18 lows both at 28-1/8. This makes me confident that the cut-in-half level was, or approximated, a final low, especially since there is no great mystery about Merck’s fundamentals and fifty percent off the top seems a reasonable – if not “too” great – a discount for those investors critical of the Clintons’ health care plans.

More volatile technology and growth stocks sometime reflect these theoretical principles of how crowd behavior plays out in the financial markets in an extraordinary way. For example, referring to Chart 8 of U.S. Robotics (USRX @ 30-3/4), a world-wide leader in data communications, we can observe that after doubling the late-1991 low of 12-1/4 by the early-1992 high of 24-1/4, Robotics dropped sharply (off 45 percent). Whereas the early-1993 high of 25-1/2 almost doubled the summer-1992 low of 13-3/8. Then the March 1993 low of 17 was

slightly more than doubled at the October high of 35-1/4, whereas the subsequent decline to 23 worked off an almost-perfect 4-bear unit count to 23-1/4.

Moreover, this year's high of 46 (on March 8) was a perfect double, from which a reaction has begun, with a bear unit of 5-1/4 points already etched and confirmed (by a lower low), and more recently appearing to recognize the 3-bear unit level of 30-1/4, by the May 10-11 lows of 29-1/4, as the new low from which to key off. That the stock of a single company could have gone through so many extreme bull and bear moves, in such a short period of time, shows not only that Alvin Toffler's "Future Shock"¹⁵ has arrived on Wall Street but also that traditional Wall Street research is incapable of dealing with it effectively. The arrival of "future shock," what some now call the information age, also presents a challenge to stock market technicians – to do their homework in order to stay ahead of the curve.

May 22, 1994

SEQUEL

At Market Close November 11, 1994:

What Happened During the Subsequent Six Months

Treasury Bonds Nearest Futures (Charts 1 and 2) perfectly tested their May 11 low at their virtually identical July 11 low of 100.0625 – compared to the May 11, 100.2500 (the numerical value of the Futures are about one point lower than shown on the chart because the Nearest Futures had rolled over from June's to September's, and currently December's). Thereafter Treasuries rallied back to the August 5 high of 105.21875, then slowly eroded until par was broken at the September 22 close of 99.40625. At that point we conceded the 13-year long uptrend in Treasuries was clearly broken and that the major trend inference of bonds should be assumed as being down. By November 11, Treasuries slumped even more, closing at 96.0625. Moreover, since this break of the grand resistance line of Treasuries also took out the 4-bear unit count level, it implies to us that ultimately at least six bear units will be worked off. That level is 93.0625.

However, we never changed our positive stock market opinion because the two interest-sensitive stock market bellwethers we mostly rely on remained intact, notwithstanding the break in bonds.

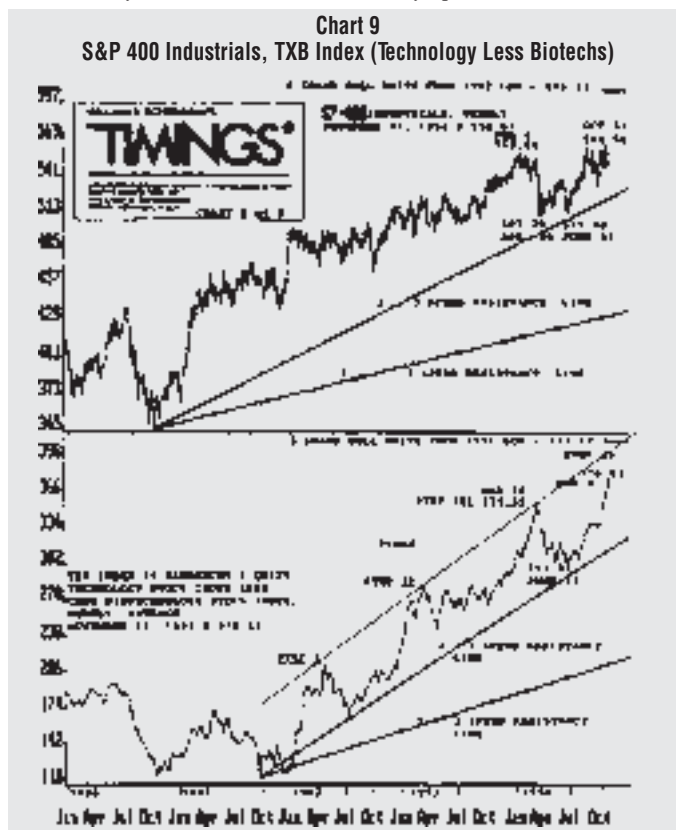
The **NYSE Financials** (Chart 3), which had hit an intraday low of 199.95 on April 4, closing May 20 at 214.27, slightly exceeded the 220 level during four days in June, then also slowly eroded until closing November 11 exactly at 199.56. While this does constitute a break of its resistance line, and hence is clearly negative as of November 11, it seems such an obvious "test" of the April 4 low, that it is conceivable to us the Financials may be able to mount at least a weak rally from here.

We draw this tentative conclusion because the third interest-sensitive index, **Standard & Poors 40 Utility Stock Index** (also on Chart 3), which closed November 11 at 148.51 – still above its May 13 low – we don't think will take out that level. Not only has the 4-bear unit count level of 148.33 been repeatedly and successfully tested during 15 trading days in October and November but is also defined by these Utilities' rising 2/3 speed resistance line from the March 1980 low. That is about as precise recognition of a Gouldian-defined risk parameter as it ever gets! Naturally, this also means that a decisive break of it would undoubtedly require some change in our current stock market opinion.

Our **Stock Market Road-Map for Standard & Poors 400 Industrials** (Chart 4 and Chart 9), successfully tested the April 20 low (507.30) at the June 27 low of 511.90, thereafter rising to an all time high of 564.50 on October 31. Closing November 11 at 550.87, potential reward has now moved down to only 10 percent whereas near-term risk remains about 4 percent (the rising 2/3 speed resistance line moving up to about 527). Not quite as good odds as on May 20.

The **Drug Shares Index** (Chart 5) was up almost 18 percent at Novem-

ber 11 from May 20 and we think is headed substantially higher. Though gaining almost 30 percent from its April low at the November 11 close of 1316.70, we think the Drugs will work off at least three bull units, a further gain of 25 percent from here. Three bull units were worked off on the way down, so why not three bull units on the way up?



The **TXB Index** (Technologies Less Biotechs) (Chart 6 and Chart 9), at its June 23 daily close of 293.97, never broke below its 2/3 speed resistance line risk parameter and subsequently rose 28.9 percent from that low to 378.83 on November 9. Obviously the odds of further gain from here have sharply deteriorated, potential remaining reward only a possible additional 8.8 percent, in our opinion. We have chosen to deal with this change of the odds by building cash as specific technology and growth components reach their individual, respective potential reward zones.

Merck (MRK @ 36-3/4) (Chart 7) hit a recovery high of 37-5/8 on November 10 and we believe is headed into the 44-45 zone. That is defined by both a bull unit count and an overhead declining 1/3 speed resistance line.

Whereas **U.S. Robotics** (USRX @ 38-3/4) (Chart 8) worked off a fourth bear unit at its June 2nd low of 24, then etched a new bull unit of 5-1/2 points by its subsequent initial rise to 29-1/2. USRX went on to slightly exceed the 3-bull unit count of 40-1/2, at the November 9 high of 42-1/4. The maximum upside potential we see from here, is a 4-bull unit count to 46, which would also be a prospective double top with the early-1994 peak.

CONCLUSION

I believe that this real-time experience in using the Gouldian theories amply demonstrates both their usefulness as well as their drawbacks, though only scratching the surface of their potential applications. Their key advantages are that Gould's quantifications of investor sentiment help one to both reach and act upon specific investment conclusions on a case by case basis, without being held hostage to an endless, self-imposed debate about what to do.

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