*Walter Deemer's*

# MARKET STRATEGIES AND INSIGHTS

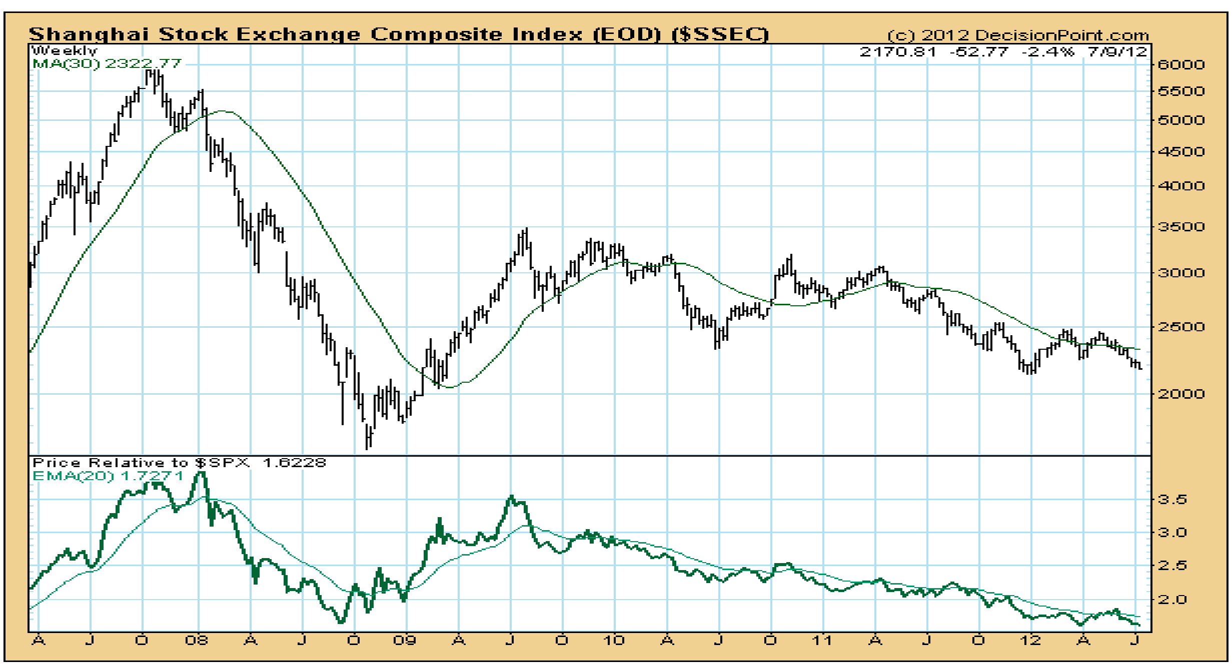
*...for Sophisticated Institutional Investors*

July 13, 2012

THINK ABOUT THE RISK -- PLEASE

Although investors are generally cautious, very few seem to be really bearish. This, however, is Year Four of the Four-Year Cycle, when risks are at their peak, and history tells us that there is a very real possibility that the S&P could break 1000 before the next Four-Year bottom which is due in the first half of next year. The probability of a 25%-plus decline, admittedly, is not 100% -- but it's not zero, either. All investors, from trillion-dollar investment managers to independent financial advisors, should therefore think very carefully about whether the risk of such a decline is high enough to do something about it.

To start off, let's begin with a look at – and defense of -- the Four-Year Cycle, which I discussed at length in my book "Deemer On Technical Analysis". The Four-Year Cycle, as you're about to see, is currently very much in evidence in markets all around the world. They all bottomed in late 2008-early 2009 – the last Four-Year Cycle low. The downward phase of the next Four-Year Cycle then surfaced initially in China, the first major market to top out (the following charts are all weekly charts from early 2007 from the invaluable DecisionPoint.com site):

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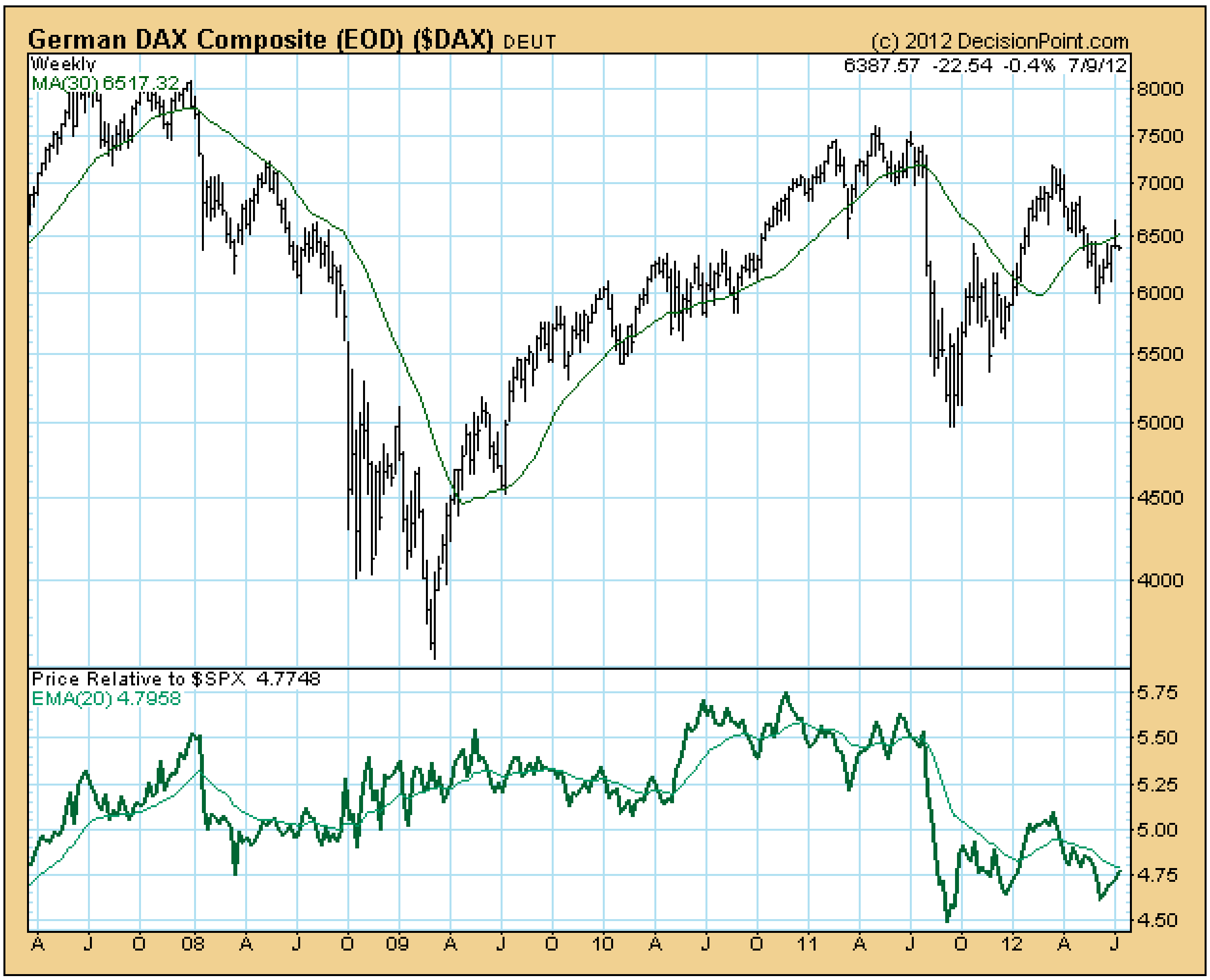
The Italian market, one of the weakest European markets, quickly followed the Chinese market and peaked just a few months later. (Since a "normal" Four-Year Cycle consists of 2-2½ up years followed by a 1½-2 year decline, the Chinese and Italian markets' inability to rally for even a year was a sign that their underlying trends – a concept I also discussed in my book -- were unusually weak.)

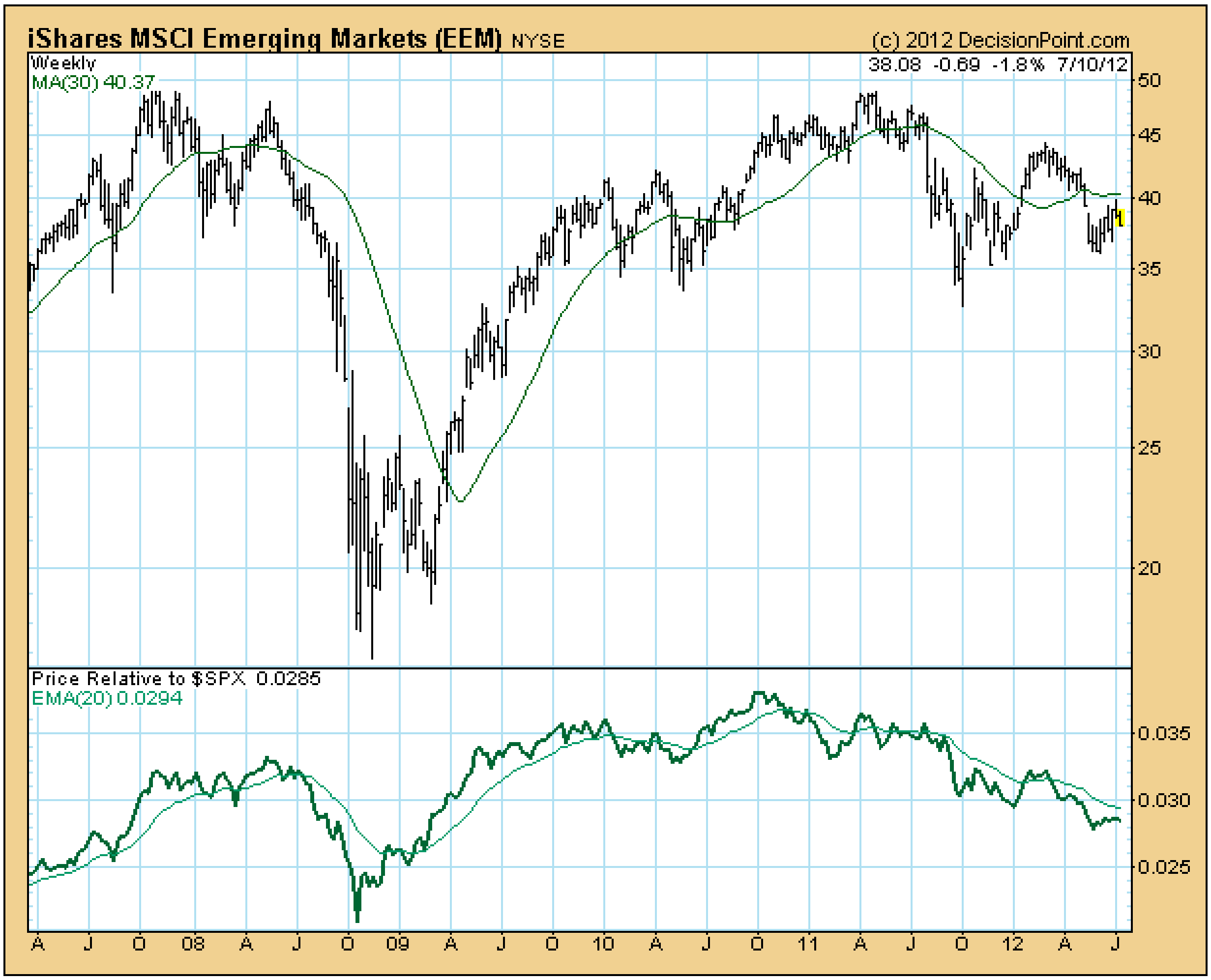
The Japanese market was the next major market to top out, a little more than a year after it made its Four-Year Cycle low:

The French market, meanwhile, staged a more normal Four-Year Cycle rally and peaked two years after its early-2009 low:

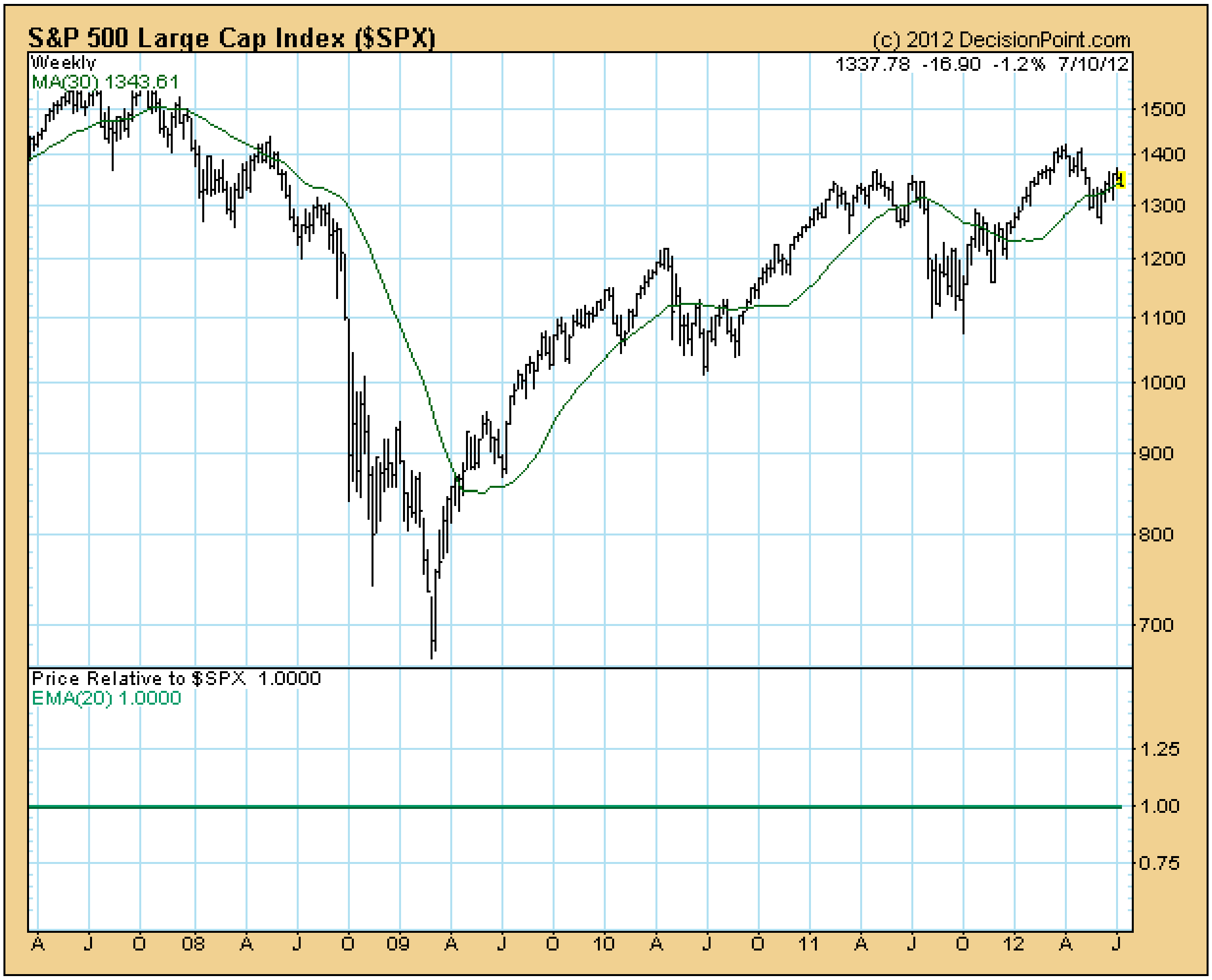
As did the much stronger German market. Although the DAX staged a much bigger rally than the French market did during its second upleg, from 2010 to 2011, it still topped out in the second quarter of 2011:



Emerging markets in general topped out at the same time. (Note the big relative strength divergences in 2009, at the bottom, and 2011, at the top, which foreshadowed the price reversals):



But there was one very significant outlier. This chart of the S&P shows the only major market in the world that managed to move above its 2011 high this year. (Which it did for what I think are fairly obvious reasons: if you ranked global economies by relative strength in early 2012, ours headed the list.)




Given all the charts that preceded this one, though – and I could have shown you many, many more just like them – <u>I think the evidence is overwhelming that the Four-Year Cycle is unfolding quite normally in the global markets.</u> (And make no mistake: The Four-Year Cycle – which is a behavioral cycle, not an economic one -- exists in all global markets, not just our own; as a long-time friend in China who has studied their stock market very intensively reminded me in an e-mail last week: "There is a four year circle [cycle] in China stock market just like the four year circle in US stock markets, which is made clear in your book".)

This, in turn, means that our market is almost certainly going to be pulled down by the other, already-weak markets rather than the other way around due to the well-documented tendency for strong stocks, groups and markets to ultimately succumb to a bear market. One quick example should suffice: During the big 2008 decline, WalMart remained in an uptrend right up until the last week of September, when it made its high for the year. Alas; after that, the stock fell 25% in less than a month, and didn't manage to better that last-September 2008 high until this past May.

What, you ask, does all this have to do with the much-greater-than-generally-perceived risk that currently exists? Simply this: There are two traditional rules of thumb that analysts use to measure the potential downside risk in a bear market. The first one states that a bear market has to be a bigger decline than the biggest correction of the prior bull market. In this case, that "biggest correction" was last year's decline of 21.6% -- and a 21.6% decline here would take the S&P to 1115. In addition, legendary analyst Stan Berge maintained that a bear market always broke the first intermediate low of the prior bull market. The first intermediate low in this bull market was made in mid-2010, with the S&P at 1010.

The possibility of a decline below 1100 may seem rather far-fetched – but I'm afraid it's not; with the one exception of our market, <u>every market that I showed you in the preceding pages has already broken the first intermediate low of the prior bull market</u> – and the weakest (Italy and Spain) have broken their 2009 lows as well. <u>There is thus a good possibility – not 100%, but not zero either – that the S&P will trade both below 1100 and below 1000 before it makes its next Four-Year Cycle bottom that's due in the first half of next year.</u> It is this possibility (and as Stan Berge often reminded us, "We are dealing with probabilities, not certainties") that I think investors of all shapes and sizes need to think about here – very, very carefully.

How will we know if this bleak scenario is starting to play out? Watch the June lows; if and when they are broken (which may happen in other markets before our own) it will indicate that the traditional downside forces of Year Four of the Four-Year Cycle are starting to manifest themselves – in full force.

Let me conclude with a few philosophical thoughts:

● Even if the ultimate risk turns out to be something less than a decline below 1000... or even less than a decline below 1100... remember that a 15% decline looks a whole lot different after it has taken place than beforehand. Be mentally prepared.

● We are in a debt contraction environment here – and the metrics that worked so well during the decades-long debt expansion don't work like they used to. (This was driven home to me when a time-tested and heretofore-extremely reliable major trend model with dozens and dozens of inputs turned bullish in mid-2008 – at 1250.)

● Nobody loves a bear. If I'm right, the environment will become rather bleak, and there will be no joy on Wall Street. And if I'm wrong; well, being bearish in an unbearish environment causes one to lose friends rather quickly. I think, however, that the possibility that the market may decline significantly from here is great enough that all investors, from trillion-dollar investment managers to independent financial advisors, need to think very carefully about whether the risk of such a decline is high enough to do something about it. And the time to think about it is now – while the market is still up.

● Finally, the necessary caveat: If the Fed and/or European authorities start printing money like crazy all bets are off. But just temporarily; as we learned during the bull market extension in 2006-2007 (and the two prior bull market extensions in 1961 and 1986-1987), the extension only temporarily postpones the Four-Year Cycle low. It also makes the inevitable day of reckoning even worse when it finally comes, as I discussed in the section on Bull Market Extensions in "Deemer On Technical Analysis."

*-- Walter Deemer*