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# Dow Theory Chartist

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Dow theory is a proven, reliable method of determining the direction of the primary trend of the market. The primary trend has traditionally been defined as a major trend of fixed degree, generally lasting at least a year or more. However, I have found the basic tenets of the theory can also effectively determine trend direction at variable degrees, both smaller and larger than the traditional primary trend. In fact, since it is necessary to determine the direction of the trends of one lesser degree to perform peak-and-trough progression analysis anyway, why not use the most reliable method of trend identification to identify it? On a relative basis, every degree of trend is comprised of similar trends of a smaller degree, and is itself, along with similar trends of the same degree, a component of a single larger degree trend. In essence, Dow theory can be applied at varying degrees of scale because the relationship of any trend relative to those of one larger and one smaller degree remains constant no matter the nominal degree.

It is not just the popular, mechanical part of the theory – peak-and-trough progression analysis and confirming averages – that can be universally applied to any degree, but also the concept of stages. While it is true that some of the characteristics of the various stages will change at different degrees (those related to valuation, for example), the purely psychological ones are inherent in all. To better explain this hypothesis, I bring into the mix a method that also addresses the psychological stages of a market trend: Elliott Wave theory.

Elliott Wave theory (EWT) is very similar to Dow theory in several aspects. An EWT motive wave is comprised of 5 waves: 3 impulsive and 2 corrective. A Dow theory primary trend is also comprised of 5 waves, referred to as stages, of which 3 are primary movements and 2 are secondary. The latter also recognizes that weak trends of secondary movements often terminate following the 2nd stage (3 movements), which are analogous to 3-wave correctives under the former. Cleary, both theories recognize that trends progress in patterned waves, or stages, that are recognizable at every degree.

Where the two theories differ is that EWT relies solely on the wave principle to determine trend direction, whereas under Dow theory, stages are a secondary consideration to the basic signaling technique of peak-and-trough progression analysis and confirmation of the two averages. Additionally, EWT applies a specific set of rules to its waves and attempts to be more precise in forecasting price movements (mainly based on Fibonacci relationships of wave lengths.) Dow theory never really has addressed the technical criteria for determining stage transition points nor is it concerned with forecasting the duration or size of a trend. Thus, each theory, on its own, has some drawbacks.

Fortunately, those shortcomings can be compensated for when the two methods are used in a complementary fashion. Specifically, the problem of technically identifying transition points of Dow theory stages can be fixed by using EWT for that purpose. In addition, the problem of identifying erroneous EWT counts late in a trend can be rectified by using the Dow theory signaling technique to confirm trend direction. EWT also allows for forecasting the size of a trend, which Dow theory does not. Thus, I believe combining the two methods creates a stronger, more accurate trend identification and forecasting system.

However, I will emphasize that just as in traditional Dow theory stages are a secondary consideration to the basic signaling technique, so is the use of Elliott waves to identify the stages secondary, or complementary, in this combined approach. Additionally, traditional technical analysis is always an important supplementary tool.

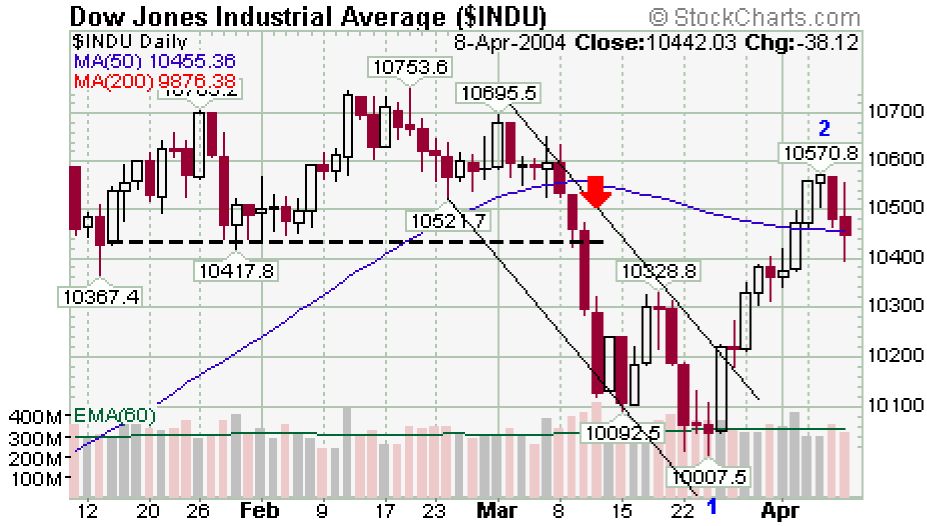
*To summarize , I prefer to use the basic principles of Dow Theory, combined with some elements of Elliott Wave Theory in order to refine the identification of stages, and supplemented with other traditional technical analysis techniques, for the purpose of identifying trend direction and develop price and time forecasts at several degrees.* In this issue, I analyze the intermediate, primary and secular degree trends of the Dow Jones Industrial (DJIA) and Transportation (DJTA) averages.

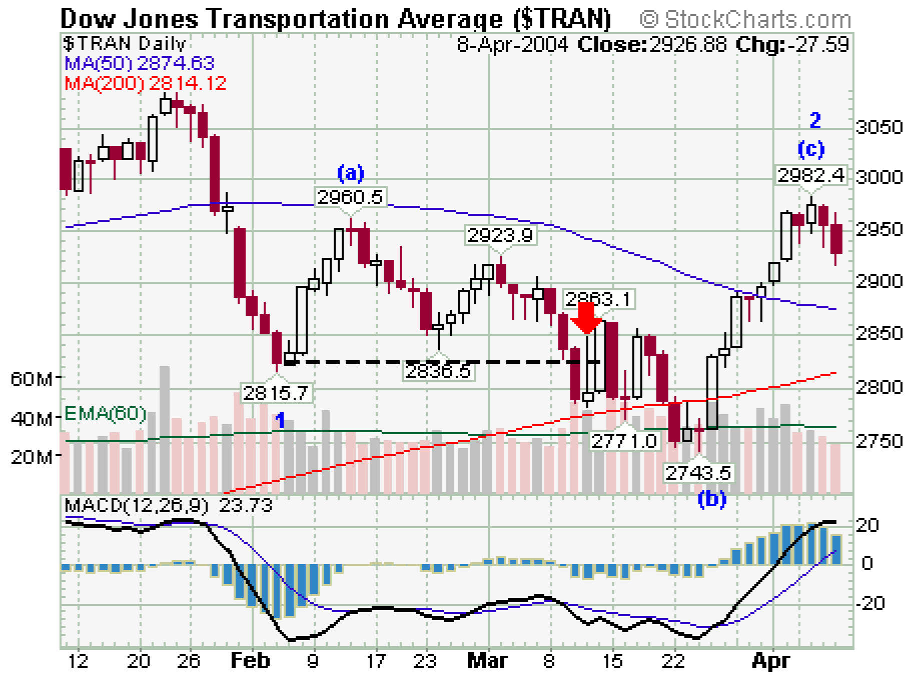
## Intermediate Trend is Down

An intermediate sell signal was confirmed on March 10, 2004, as noted in my special report of the same date. The sell signal was preceded, in usual fashion, by a non-confirmation warning by the Dow Jones Transportation Average (DJTA.) The signal officially reversed the 11-month intermediate up trend that began on March 12, 2003 and was confirmed on May 2 of the same year. At this point, it would take closing highs above the previous peaks of 10737 for the Dow Jones Industrial Average (DJIA) and 3080 for the DJTA to reverse the sell signal.

The current trend made a short-term trough on March 24 and has since reversed up in what appears to be a stage 1 secondary reaction. The reaction highs of the short-term counter trends have thus far retraced 75% and 69% of the previous declines for the DJIA and DJTA, respectively. Sharp reaction rallies most commonly occur in stage 1, as they are mistakenly assumed to be a continuation of the previous trend. These short-term rallies should terminate before retracing 100% if they are indeed reactionary.

I have labeled the bottom of minor wave 1 for the DJTA at the February trough of 2815. The corrective wave 2, which may or may not be complete, is interpreted as an expanded flat and contained the orthodox short-term bottom (wave (b).) The DJIA, on the other hand, is interpreted as having completed minor wave 1 at its orthodox bottom on March 24, and has completed, or is in the process of completing, a sharp wave 2 in the form of a zigzag correction. Although the DJTA led the DJIA into the trough of the 1st stage of this intermediate decline, as is typical, the averages seem to be aligning to decline in unison in wave 3. If wave 2 ended as labeled, the wave 3 declines will bring prices down to at least 9824 on the DJIA and 2701 on the DJTA, but probably much lower.






The NYSE Advance-Decline line has remained below its March peak during the recent short-term up trend, thus confirming its reactionary nature. The Summation Index (see chart in next section – Primary Trend) also is in a downtrend and trading below its 35-day moving average. All major diffusion indicators are also on sell status. The S&P 500 Bullish Percent Index has dropped below its 52 week moving average for the first time in over a year. The previous 4 times it did this it eventually bottomed below 30. As of Friday's close it still remains at a very high 77. The Volatility Index (VXO) is barely off its recent lows, closing last week at 15.83. Clearly the low volatility readings reflect a high level of complacency. In sum, overbought but declining breadth indicators, in addition to an overall lack of fear, point to the probable continuation of the current intermediate down trend to new lows.

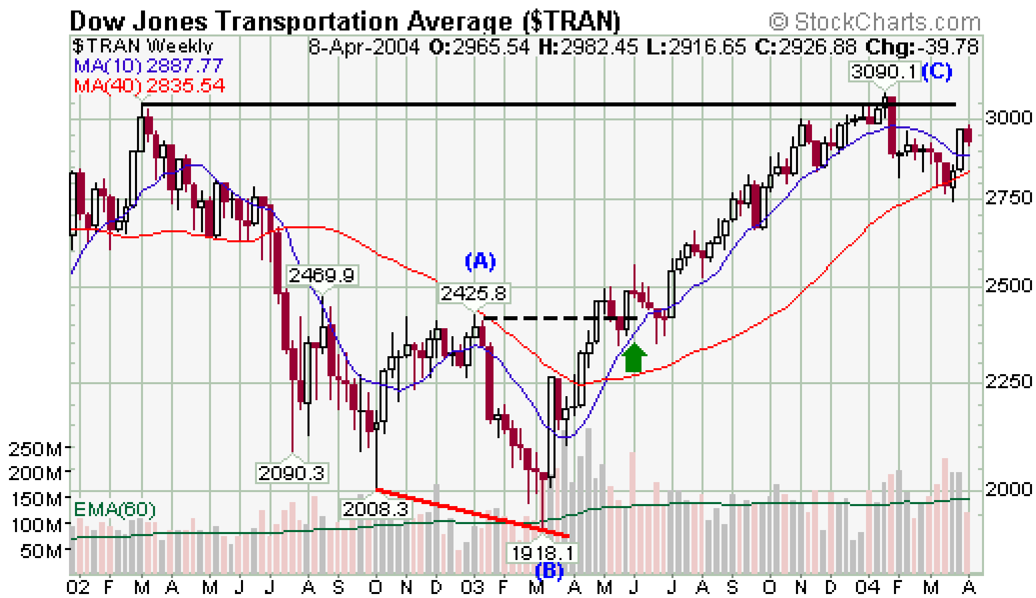

As for when this intermediate trend may be complete, cycle analysis points to June as a strong possibility since it contains the next expected nominal troughs for the 10 and 20-week cycles. Another date to keep in mind is April 26, which is the next Bradley Siderograph turn date. The Siderograph does not predict direction but only turn points (+/- a week or so), and has done so very effectively over the past few years. Its best fit into my forecast is that wave 2 continues into the Bradley turn window and then declines swiftly into the final two stages of this intermediate decline, ultimately bottoming in June. (For more on the Bradley Siderograph I recommend you check out "Amanita Market Forecasting" at *www.amanita.at*.)

I mentioned the minimum target for the next minor wave decline, but the ultimate price target for the entire intermediate down trend is much lower. The dominant price pattern of the preceding intermediate degree advance from March 2003 was a rising wedge, which is a common formation for a bear market rally. When wedges breakdown they often are completely retraced by the ensuing decline. Thus, I think a likely price target for this intermediate down trend is approximately the March lows, or the 7500-8000 range on the DJIA. (The chart shown below is the Diamonds (DIA), an ETF representing the Dow 30. Note the expanding volume since the peak, which confirms the breakdown.)


## Primary Trend Signal Remains Up, But Warning Signs Abound

Despite the potentially bearish implications of the recent intermediate degree trend change, the last primary degree signal was a buy signal which was given on June 2, 2003. To reverse that signal the averages need to form lower intermediate highs followed by lower lows, or break their previous intermediate lows (March 2003), whichever comes first. However, the fact that a primary sell signal has not yet developed does not preclude one from cautiously anticipating such an occurrence. This is where identifying stages and recognizing the nature of the trend relative to the trend of one higher degree becomes crucial. Specifically, when a peak is made at a point where it seems likely that 3 stages (5 waves) of the trend are complete, it should be considered as a possible termination point of the entire trend. Additionally, if the trend itself is considered to be a secondary reaction of a larger degree one, there is a strong possibility that it will terminate during stage 2 (3 waves.) I believe the peak reached in February of this year should be considered as a probable termination point of the entire primary bull market for reasons I will discuss.

Looking back at the action between the start of the primary bull market (October 2002) and the ultimate confirmation of it (June 2003), note that the DJIA preceded its higher high with a higher low, while the DJTA did not. An ideal buy signal is given when both averages precede a higher high with a higher low, but it is not a requirement. However, the lower low by the DJTA in March 2003 is a blemish that indicates some underlying weakness in the trend. In a strong trend the averages move together, confirming important peaks and troughs. This divergence also has important implications when assessing the progression of stages of the bull market when subjecting them to the rules of Elliott Wave.


Assuming the bull market began in October 2002, the DJIA had a brief stage 1 advance into December of that year followed by a secondary reaction that formed a higher low in March 2003. Then, a long, sustained 11-month stage 2 advance ensued; only recently topping out. Normally, this would be followed by another secondary reaction (wave 4), which may be in progress, followed by a terminal stage 3 (wave 5) advance that would likely take prices to new primary highs. However, there are some other considerations worth noting that raise doubt that this will be a normal 3-stage advance.

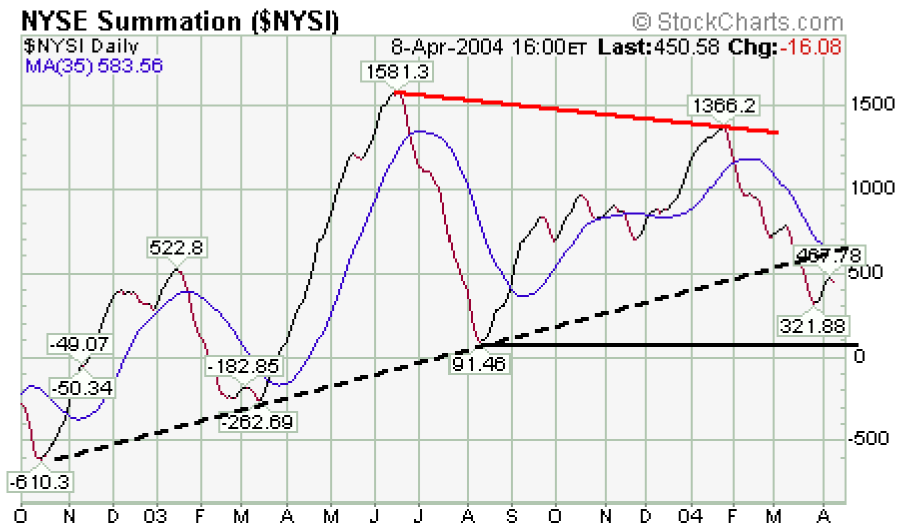
For one, the chart of the DJTA does not confirm the bullish labeling alternative of the DJIA. Specifically, the lower low made in March 2003 violates the basic EWT rule that wave 2 never moves beyond the start of wave 1. The preferred labeling for the DJTA then is a corrective A-B-C in the form of an expanded flat. This implies that its bull market will terminate following the completion of the 3rd wave (labeled C), which has already occurred based on the recent intermediate sell signal. This would be consistent with the expectation going into this primary bull market that it would be a secondary reaction to the larger degree, secular trend (more on that in the next section.) It further suggests that the DJIA also terminated its bull market with its recent primary high and its proper labeling is the bearish A-B-C corrective alternative.

Another point to note is that the 2nd stage advances reversed in the vicinity of the 2002 highs, which were the peaks of wave 4 of one lesser degree – a common target for the completion of a corrective wave of the same degree. In addition, the advances of the major averages halted at some key Fibonacci retracement levels - 78.6% for the DJIA and 50% for the S&P 500 – that frequently provide resistance to a corrective wave. . Thus, prices have reached what would be likely targets of a primary secondary correction on multiple counts.

One final, rather technical point has to due with the nature of the decline into the March 2003 trough. Specifically, that decline appears to have unfolded in 5 waves, which fooled many into taking it for the 1st leg of the next stage of the bear market (as I'm sure you recall.) As it turns out, it was not a motive but a corrective wave. A single, corrective 5 wave structure is always found in either wave C of a flat or a triangle. Since the first alternative does not fit at all, it must have been a triangle. In fact, the wedge pattern of the decline makes this apparent. This is a key point because triangles are only found in a position prior to the final wave of a pattern of one larger degree; i.e., as wave 4 in an impulse or wave B in an A-B-C. In this case, since it cannot be properly labeled as a wave 4, it must be a B. That implies that the subsequent wave, which just completed, was a terminal, corrective C.


The bullish alternative is that the primary bull market began in March 2003, rather than October 2002, and the higher low by the DJIA was a truncated 5th wave in the form of an ending diagonal. I believe this possibility is remote because the DJTA almost always leads the DJIA, thus it should have given the bullish divergence signal. Not to mention that the preceding intermediate decline into October 2002 counted as a clean 5 waves.

Breadth, on the other hand, gives somewhat mixed signals. The NYSE A-D line confirmed the recent highs at the primary degree but the Summation Index (shown below) peaked in June 2003. So while the actual number of advancers over decliners has not given any indication of a major reversal, the momentum of the trend has clearly slowed. In fact, the Summation Index has given a sell signal by breaking its trend lines drawn from 2002, which would be confirmed if it falls below its August 2003 trough. The conclusion drawn from this is that the current down trend may be of a degree commensurate with the advance off the October 2002 lows, but a decline of larger degree than that is not indicated.




The time cycle I'm predominantly focusing on at this degree is the 4-year, even though the next trough is not expected until 2006. It is an important consideration for 2004 because it contains the idealized mid-point of the cycle. If the cycle peaks to the left of the mid-point, called left translation, then the next trough would be expected to form a lower low than the previous one. When this cycle peaks, therefore, has a significant ramification on the expected nature of the ensuing decline. While any assumed mid-point has a wide margin of error, the idealized nominal one would be in the fall of 2004. Of course, actual peaks cannot be confirmed until well after the fact. Suffice it to say, however, that if a primary sell signal is given in the meantime, the top will almost certainly have been put in.

## Secular Trend Assumed Down, But Not Without Reservations

The main reason I even look at this large of a degree of trend is to assess the nature of the subordinate primary trend. That is, to determine if the primary trend is a primary or secondary movement to the larger degree. This is important because, if it is primary, then a higher high would be expected to follow. Conversely, if it is secondary, a lower high followed by a lower low would be anticipated. Also, from an investment strategy perspective, I always advice investing with a trend only if it prevails in the same direction as the trend of one larger degree. For example, funds would not be committed to a primary up trend if the secular trend was down.

Assumptions based on anecdotal evidence, rather than waiting for a Dow theory signal, are more frequently necessary at relatively larger degrees of trend simply because of the length of time it takes for a confirmation signal to develop. A clean secular degree sell signal, for instance, requires two complete primary degrees and a third to give the signal. I'll use the recent activity of the DJIA as pertinent example. The DJIA completed an almost 3-year primary bear market that took it from the all-time highs of 2000 into a test of its 1998 lows in October 2002. From that point until now, about one and a half years, it has been in a primary bull market that has yet to be confirmed reversed. What would be required to develop from here to give a clean secular degree sell signal is for this primary bull market to peak below the 2000 high, thus making a lower high, and reverse into a primary bear market that penetrates the 2002 lows and is confirmed by the DJTA. By that point, the secular bear market would probably be at least 5 years old. If an assumption of a reversal were not made before that point, if would potentially have very detrimental ramifications on the performance of an asset allocation strategy that were still based on the hypothesis that it was a continuing secular bull market. I trust it already has in many instances. I, on the other hand, prefer to make assumptions on such a matter when there is a preponderance of evidence that supports it, thus risking erring on the side of caution, than resist using that evidence to rely solely on the mechanical signals, thus instead risking erring on the side of greed. The purpose of Dow theory from an investment strategy standpoint is to present opportunities to invest in an established trend, but never to require action. Everyone should be aware of their own risk/reward tolerance level before committing funds to the stock market.

As I've previously mentioned, a sell signal can also be interpreted when a confirmed lower low is made even though it is not preceded by a lower high. Many have made this exact interpretation on the DJIA when in October 2002 it briefly dropped below its 1998 trough, thus confirming the sell signal given a year earlier. I have conservatively not made this call because there is some question as to whether the 1998 decline was of the primary degree (I do not interpret it as such) or if the 2002 penetration was decisive (it was about 3% lower.)

Another reservation I have with the secular bear market theory has to do with the 3 stages, which are labeled below in Elliott Wave format to illustrate a bullish alternative:


This alternate count assumes that the previous secular degree bear market (cycle IV) completed in 1974, the orthodox low; which was followed by a primary bull market that lasted until 1976 and then a secondary reaction into the 1982 trough – which is where this chart picks up. There is some compelling evidence that supports the interpretation that the ensuing advance from 1982 through 2000 was of a single degree containing 5 waves, or 3 stages, which I will elaborate on shortly. Therefore, if that interpretation is accepted, the 1982-2000 bull market can only be the 3rd primary wave of a cycle degree wave that began in 1974 (shown here); or, a complete cycle degree wave that began in 1982.

I believe the internal labeling of the 1982-2000 period shown above is sound and is the best alternative. Some Fibonacci relationships that support the above count, at least on a relative basis, include: intermediate wave 3 was approximately 61.8% of primary wave 3, and intermediate wave 5 was precisely 61.8% of wave 3 of the same degree. In addition, the entire wave was the largest move in terms of points and percentage in history which supports it being a wave 3 – which are almost always the longest in an Elliott sequence. Furthermore, both intermediate waves 2 & 4 terminated in the vicinity of wave 4 of one lesser degree (not shown.)

There is also sound evidence that supports the wave being the 3rd wave of a larger degree one that began in 1974, and not a terminal wave. The historic advance of 1982-2000 eclipsed the length of the 1974-76 advance by a factor of 25.9 times – or approximately a Fibonacci 26.18. Also, the 1976-1982 corrective wave 2 terminated in the vicinity of the 1976 wave 4 of one lesser degree. The recent decline that followed the top in 2000 also has characteristics of a corrective wave 4. First, its form was an expanding triangle. Some have interpreted this as a hitherto unseen leading expanding diagonal. But, of course, the most common position for this type of pattern is as a corrective wave prior to the final actionary wave of one larger degree. Furthermore, the decline bottomed at the 1998 low – or in the vicinity of wave 4 of one lesser degree. It also retraced a Fibonacci 38.2% of the previous wave - a common occurrence, especially at this degree.

Therefore, the 1982-2000 appears to be able to stand on its own as a 5-wave move of a single degree; and, the preceding and succeeding waves seem to fit well as bookends to an intermittent wave 3. In other words, there is sound technical evidence from an Elliott Wave perspective that supports the theory that a cycle degree wave began in 1974, and has completed primary waves 1 (1974-76), 2 (1976-1982), 3 (1982-2000), and 4 (2000-02), with the terminal wave 5 now in progress.

So now that I've all but shot down my assumption that a secular bear market began in 2000, you may ask why I cling to it? The answer is because the primary investing method I rely on is Dow theory, not Elliott Wave, and the most important concept of that theory is value (a little known fact.) The previously unseen high valuations in 2000, which have been frequently embellished, were completely characteristic of a 3rd stage of a large degree. That the 1982-2000 period can be technically counted to contain 3 complete stages makes it a strong possibility that the reversal in 2000 was of a commensurately large degree. While the temporarily bullish alternative outlined above is a very feasible possibility, to accept that, act on it *and wind up being wrong* could yield devastating results. In other words, knowing that even under what I see as the best case scenario, the 2002 bottom was the beginning of the end of the largest bull market in history, and not the beginning of a new secular bull market. The resulting reaction to the greatest bull market in history, whether it has begun are not, will be of a commensurately historic size based on the principle of proportionality. Therefore, I am content to trade at lower degrees rather than buy and hold, and I advise others to do the same.

## Summary

The assumed secular trend is down, the primary trend is up but with numerous reversal warning signs, the intermediate trend is confirmed down, and the short-term tend is up. Suffice it to say, there are many conflicting signals. I stated previously that I only recommend investing with a trend that is prevailing in the same as that of one larger degree. Using that criteria, none of the trends mentioned are on a buy signal or a sell signal. The closest set-up is for a short-term reversal that would turn it in the same direction as the intermediate trend, thus presenting a shorting opportunity for those speculators so inclined to play that direction.

On the other hand, a close by the DJIA above its previous closing high (10737 on 2/11/04) *that is confirmed by the Transports* would give a primary trend continuation signal. This would imply that a stage 3 advance is underway. The proper position in this instance would be to trade long at the intermediate and/or short-term degrees. However, beware that it would be expected to be the terminal stage of the entire advance off the 2002 lows so I would look for early warning signs to exit long positions rather than wait on a confirmed Dow Theory reversal signal.

Lastly, in my first newsletter I laid out a “road map” for the relative direction in price and time that I expect the Dow to take to the conclusion of the secular bear market. I will update its actual progress against the road map in each issue, revising it as required. At this early stage, there has been no deviation from that forecast. The major signpost for this year is to watch for indications of a primary degree reversal before the fall, or end of the year at the latest. That is because if the 2006 trough is to make a lower low than the previous one, as anticipated, it should peak to the left of the midpoint of the 4-year cycle; i.e. left translate. While actual price peaks cannot be confirmed until well after the fact, a primary degree reversal signal sometime late this year or even early 2005 would mean it almost certainly left translated, as long as the actual price high was in 2004 (the earlier the better.) As suggested in the primary degree analysis section in this newsletter, the recent intermediate top could end up being of primary degree. But it is far too early to assume that. It should be an interesting year.