Minyanville

September 19, 2011 Monday 2:41 PM EST

# The 1978-79 Market Declines and Today: Deja Vu?

**LENGTH:** 1725 words

"All fixed set patterns are incapable of adaptability or pliability. The truth is outside of all fixed patterns."

--Bruce Lee

In this business many pundits attempt to "paint" the current pricing action in the various markets to that of past markets. An example would be comparing the Dow's post-2000 chart pattern with that of the Japanese stock market following its 1989 peak. Such comparisons tend to work until they don't, which is why I rarely embrace analogues. That said, over the past 41 years I have observed a few comparisons that have had fairly good correlations to what was occurring at the time and have used them to help allay panic among investors at inappropriate times. Most recently, I have suggested the "panic lows" of August 4 and 8 showed such extreme panic-selling readings that participants had to go back to May 13, 1940, when the Germany Army broke through the Maginot Line and invaded France, to find similar panic levels. (See Why the Markets May Be Oversold.) That observation was consistent with the analogue I have been using for two months.

Assuredly, I have been comparing the recent decline, and subsequent bottoming pattern, to that of the October 1978 and October 1979 sequences. So far, the correlation (R) has been remarkable. How long this R will continue is anyone's guess, but if it does you will observe that the Dow still has the potential for more pullbacks, as can be seen in the charts at the end of this article of the 1978-79 era. Importantly, however, if the correlation holds, even if we violate the recent reaction August "lows," the equity markets shouldn't go decisively lower. While my analogue seems pretty good so far, my friends at Lowry Research may have "one upped" me in an excellent report titled "It's Dj Vu All Over Again: The 1946 Market and Today."

Lowry also begins its narrative by stating it is not a fan of analogues. With that caveat, the report notes some instructive parallels between the current market and that of 1946. Speaking to the August 4 and 9, 2011, mini-crash "panic lows," Lowry opines it has been extremely rare when 98% or 99% Downside Days (where 98% of the total points traded were negative and 98% of the total volume traded came on the downside) occurred within one day of each other, or very close to each other, as happened on 8/4/11 (Thursday) and 8/8/11 (Monday). The other instances where they were close together are November 3 and 5 of 1948 and September 3 and 9 of 1946. Because it is often referred to as "The Crash of 1946," the 1946 affair is worthy of further analysis.

At the September 1946 Downside Days "lows" the selling was intense following an already panic decline of more than 15% in a very short period of time, similar to what happened into the aforementioned August 2011 "panic low." Moreover, in 1946, before said decline began, there was what a technical analyst would deem a "head and shoulders top" chart formation. The same formation can be observed forming between March and August 1, 2011. Also strikingly similar were divergences between the price indexes and the advance-decline line, as well as a 4% drop by the Dow during the first three days of September. Lowry goes on to note (as paraphrased by me):

These many similarities between today and the 1946 market got us wondering about exactly what was going on in '46 in terms of current events and the US economy. As usual, the Internet came to the rescue in the form of a report put out by the Cato Institute in May/June 2010 entitled "Stimulus by Spending Cuts: Lessons from 1946." The gist of the article is that, in 1946, one of the great worries of the day was the potential for a renewed Depression. Worries centered around what would happen while the wartime economy was transitioning to a peacetime economy. The report cites "leading Keynesian economists" as being concerned because government spending (for WWII) had been the only thing that ended the Great Depression and that a removal of government spending in 1946 could lead to another economic crash. ... One difference between then and now is that many private economists today see less government intervention as a positive influence toward improved economic growth. However, that opinion does not appear to have much traction within the current Administration.

Lowry concludes by stating, "The market tops in 1946 and 2011 appear to have a lot in common, both in terms of market action and economic backdrop." Plainly I agree and would note that despite the bear market that ensued between the bull market "top" of 1946, and the bear market "low" of 1949, the Dow Industrials never appreciably fell below those "panic lows" of September 1946. A similar statement can be made about my October 1978 and 1979 analogues. I urge you to obtain the Lowry report for further examination. Obviously, today worries center on a slowing economy, too much debt, a dysfunctional government, and the European mess. Recently, the European Eruption has taken front stage. In last week's verbal comments I suggested the Greek Gotcha could be solved in a number of ways. To reductio ad absurdum, Greece could sell the Acropolis and pay off its debts. A better solution, however, might be to shift from the current European strategy of attempting to manage all the potential defaults, to one of managing only system-threatening defaults like Italy and Spain. This strategy would allow non system-threatening defaults to occur, potentially making lenders much more responsible.

A more out-of-the-box solution has been proffered by the eclectic thinkers at the insightful GaveKal organization:

"One elegant solution might be to transform these (Greek bond) losses into tax credits against the different governments and to accept these tax credits as primary capital for regulatory purposes. Let us assume a German bank, which carries (EURO)10 billion in Greek bonds on its books. These bonds would receive a 50% haircut, so the bank would have to eat a loss of (EURO)5 billion, and could then become technically insolvent -- not

an acceptable resolution. If we were to apply our solution, the bank would instead be left with (EURO)5 billion worth of Greek bonds and (EURO)5 billion in tax credits, which would then be accepted by the regulators as primary capital. In accounting terms, an asset worth (EURO)10 billion would be replaced by two assets: one against the Greek government (a bond), one against the German government (a tax credit) and the sum of the two would remain at (EURO)10 billion. The banks could then sell these tax credits to other banks, or even to non-financial institutions or individuals, to replace with cash if they so decide. Such a solution would amount to a global tax cut in Europe, but more importantly, it would have little direct impact on the German taxpayer."

Turning to our dysfunctional government, we are about to get another serving of its dysfunction with the innocuous "Jobs Bill," which to me is "Puddintane, Puddintane, ask me again and I'll tell you the same." To be sure, I am in agreement with the statement made on CNBC last week, "CEOs to Obama: 'Get Out of the Way -- For Job Creation!'" In the recondite Jobs Bill there is actually an overarching position that, "denial of employment opportunities to individuals because of their status as unemployed is discriminatory." Ladies and gentlemen, that means an unemployed construction worker, applying for computer technician's job, can sue if he doesn't get considered for the job. It does not mean he will win, but he can still sue. To an already clogged judicial system such provisions are insane (can you spell tort reform?!). Truly, our elected leaders just don't seem to get it. And that's why Democratic strategist James Carville, who has never before uttered a "dig" at any Democrat, advised the Obama administration to panic. I have discussed the palpable, common-sense sea change occurring inside the D.C. beltway for months and it seems to be escalating.

The call for this week: Well, I have been laid up with a hyper-extended Achilles tendon since last Thursday and consequently unable to walk. The stock market, however, has been doing some "walking" of its own as last week the SP 500 sprung from Monday's intraday low (1,136.07) into Friday's intraday high (1,220.06) for a 7.4% intraday Weekly Wow with all five sessions in the green. In last Monday's missive I had suggested the previous week's pullback could constitute a retest of the all important 1,100 -- 1120 support level for the (SPX). The Spoo's surge allowed the (SPX) to surpass two of my bullish trigger points at 1,172 and 1,206 and thus leaves it in position to challenge the recent reaction high ~1230, which is also slightly above its 50-day moving average (or DMA) of 1,228.54. Bettering those levels, on a closing basis, would bring into view the 1,260 to 1,280 level, which is where the (SPX)'s 200-DMA resides at 1,283.58.

Week-over-week the Dow closed better by 4.70%, but the economically-sensitive Dow Jones Transportation Average (^DJT) gained 6.77%, reinforcing my "no recession" belief. Also bolstering that view was a 7.05% weekly win for the Information Technology sector, which is good for my firm's analyst's recommendation on Tangoe (TNGO) (Strong Buy), as well as a 6.92% lift in the Consumer Discretionary space, which is good for our analyst's recommendation on Darden (DRI) (Outperform). And don't look now, but the Nasdaq posted its best weekly advance in two years! Nevertheless, it would not surprise me to see more pullback attempts, consistent with all of the aforementioned bottoming sequences.

And, this morning the preopening futures are indeed lower on renewed Greek default worries, a class warfare tax proposal by the Obama administration, an Angela Merkel rebuff, and the list goes on. Still, as stated since August 10, I remain constructive provided the 1,100 level on the (SPX) is not decisively violated to the downside. In such a "whippy," hopefully bottoming, environment it pays to be flexible, so I leave you with yet another Bruce Lee quote. To wit, "If you put water into a cup, it becomes the cup. You put water into a bottle; it becomes the bottle. You put it into a teapot; it becomes the teapot. Water can flow, or it can crash. Be water, my friend ... "

October 1978 and October 1979 Declines

July-August 2011 Decline