Walter Deemer's

MARKET STRATEGIES AND INSIGHTS

...for Sophisticated Institutional Investors

April 28, 2012

KATE WELLING INTERVIEW

In case you missed it, the latest issue of Welling on Wall Street featured an interview with me. While I was in the process of plugging "Deemer On Technical Analysis" Kate managed to extract quite a few market comments from me, and I think you'll find it very interesting reading. It's attached, with permission, to this memo.

("Welling on Wall Street? I thought it was Welling@Weeden." No; after 13 years Kate's entrepreneurial urge took over and she set sail on her own at the beginning of the month. Institutional investors who knew her at Weeden and want to find out about her new venture – the publication looks exactly the same as it did at Weeden -- can contact Pete Arnold at (646) 998-6496 or e-mail him at Pete@WellingonWallSt.com... and if you've never seen Kate's publication Pete'll send you the next two issues for free so you can take a look.)

-- Walter Deemer

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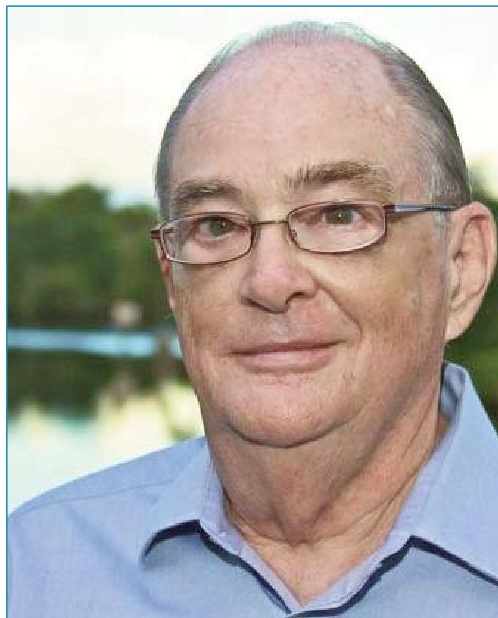
Finding Signal In Noise

Walt Deemer, Dean of Technical Analysis, On Seeing With Charts

With the market's underlying bipolar tendencies, which had been blessedly sublimated during the first quarter's bracing rally showing themselves more and more often of late, I placed a call earlier this week to Port St. Lucie, FL. That is where ***Walter Deemer****, long the technical analyst of choice for the often-secretive institutional mega-portfolio set, these days chooses to pass his days not only market watching, but in more bucolic riverfront pursuits, like bird watching. When, that is, he isn't engaged in public service: Promoting the book on technical analysis for the 401-K investor crowd that he and co-author* ***Susan Cragin*** *published earlier this year.*



It's a task, Walt grumbles, not made easy by his publishing company's insistence on titling the volume, "Deemer on Technical Analysis." *His working title, Walt avers, would have caught a lot more eyes on* ***Amazon****, and even in book stores:* "Kinky Sex, Graphic Violence and Technical Analysis, Buy This Book and You'll Be Batting .333"

Under either name, it's a great read, as fascinating for its priceless collection of anecdotes about crucial junctures in investment history as it is clear and straightforward about the technical analysis tools and insights it shares. I am delighted that Walt is allowing me to present a sample chapter at the end of this interview. First, though, to the nitty gritty. What Walt is seeing, here and now, in this market. Listen in.

KMW

What's going on? Is there a dominant technical theme in this market, Walt?

Well, *very* long term, it's that, according to the Kondratieff cycle, we've just worked our way through an extended period of global euphoria, and turned the corner onto the cycle's downswing when the U.S. peaked in 2007. It sure looks to me like what we are in is the inevitable period of cooling off and debt contraction that old Nikolai theorized must follow every 54 years or so – to set the stage for another great upswing in the markets and global economies – one that perhaps your grandchildren will enjoy.

You know of course where his theory took Kondratieff –

Sure. To Siberia, for glorifying capitalism. But he was right in the sense that there *are* long-

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term swings in social psychology and sentiment from euphoria to despair and back again. One big problem people have with Kondratieff cycles is that their length can't be precisely defined. But that's because, I think, they are a multi-generational phenomenon, and folks are living longer nowadays. It takes about two generations for people to forget the mistakes of the past, and massively repeat them – and that very human proclivity produces very real long-term swings in economic activity and investor enthusiasm. As **Bob Farrell** has famously said, "History doesn't repeat itself exactly, but human behavior does."

You're not implying though, that the markets and global economies are now trapped on a one-way street: Down?
Not at all, that's the very long-term secular trend, but markets always fluctuate and there's another cycle that's posing the most interesting questions today. It's the Kitchin, or four-year cycle, which basically says the market makes a major bottom every four years or so.

"The interesting thing about all three of these bull market extensions we have seen since WWII is that they were all followed by a much-nastier-than-usual-decline."

"Or so"?
Every once in awhile, and this data goes back to World War II, the four-year cycle gets a little bit out of whack but it gets back on track soon afterwards. So for example, there was a low in 1957. That was one your grandfather may have told you about. Then, according to the cycle, there was supposed to be a next low in late 1961; there wasn't. The DJIA made a high that December instead. But the market paid the price for that bull market extension the next spring in what became known as the "crash of 1962," plunging from 725 in March to a bottom of 520 in June. It was an intense, emotional selloff that those of us who lived through it will never forget. On May 29, 1962, the NYSE ticker ran so late it didn't finish printing the day's transactions until after 8 pm. But after that nasty 1962 low, the cycle started clicking off every four years, again, like clockwork: 1966, 1970, 1974, 1978, 1982, 1986 – oops, the market kept rising in '86, and that was the second extension of the four-year cycle. Which was followed by the low in 1987.

Also a rather memorable one if you lived through it, the crash of 1987. Complete with Black Monday's 22%-plus swan dive.
Memorable, yes. But then after that one, the market reverted to its previous four-year pattern. The next low in the progression happened when it was supposed to, in 1990, even though the previous one had come a year late, in '87. So we were back on track again. And we had four-year cycle lows in 1990, 1994, 1998, 2002, 2006 – oops, that was late, too, giving us a third extension of the four-year bull cycle. We didn't have our low until 2008.

"Our low" is such a mild way to describe a credit crisis that seemingly took not just the stock markets but the entire financial system to the edge of the abyss.
Exactly. The interesting thing about all three of these bull market extensions we have seen since WWII is that they were all followed by a much-nastier-than-usual-decline. In other words, the excesses apparently had more time to build up. So there were more excesses to correct. Certainly that was the case in 2006 and 2007. We were supposed to have a normal correction; instead, the market and the economy kept getting stimulated and that created a lot more excesses to work off.

So the message of a bull market that extends for more than four years is "look out below!"?
Yes, rather than a sign of strength, it's a warning that structural excesses are being built up that will have to be dealt with in the not-too-distant future. I mean, a bear market corrects the excesses of the prior bull market. A bull market corrects the excesses of the prior bear market. It's that simple. That's why God made bull and

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bear markets – whoever the God of Wall Street is.

Now there's a question! One thing we know is that the market isn't reverting to its old four-year schedule; we didn't set any lows in 2010, or 2011, for that matter.
Right, but based on the fact that the market's last low was either in the fourth quarter 2008 or the first quarter 2009, depending on what index you use, adding four years to that brings us to conclude that a low is supposed to come in the fourth quarter of this year or the first or second quarters of next year – unless we get another extension because of QE3 – or whatever QE we're up to – or something like that. In which case, the subsequent correction would be expected to be that much nastier.

But doesn't that fly in the face of the widely held expectation that the stock markets will be just fine this year, because the powers that be have every incentive to keep the party going at least through November's presidential election?
Yes, but given a choice between the four-year cycle and the presidential cycle, I go with the four-year cycle. I suspect the presidential cycle worked as well as it did for as long as it did because it was lined up pretty well with the four-year cycle. But the four year cycles can adjust, as we've been describing, and presidential elections cannot. That's why, in my opinion, the presidential cycle has recently gotten screwed up, and 2009 and 2010 were not the cruddy years in the market that the followers of the presidential cycle predicted. The Fed was stimulating like crazy during those years, which is not what the Machiavellian principles underlying the presidential cycle called for. So now the question is if it'll continue doing so to keep the electorate happy all through 2012.

That seems to be a favorite wager these days.
Well, the Fed *can* goose markets, no question, for a while. But it just seems far-fetched to me to assume that the Fed has *always*, historically, pulled strings – and succeeded in boosting the market – to get the party in power reelected. And, now that the presidential cycle is no longer neatly aligned with the four-year cycle, I don't put much stock in it.

It sometimes seems the field of technical analysis is strewn with the carcasses of indicators that worked great for a while — until they didn't. Why should anybody pay attention to the cycles or other technical tools?
Because technical analysis is analyzing the prices of stocks – and that's what people buy. If you buy a stock, you own a piece of paper. If you buy a mutual fund, you own a bunch of these pieces of paper. You don't own part of the economy. You own bunches of pieces of paper that represent part ownership of companies. But it's not a one-to-one correlation.

Not by a long shot.
So technical analysis analyzes those pieces of paper, the stocks that you buy, rather than the companies that issue the stocks, which are *not* what you actually buy. You buy pieces of paper; stocks.

You're saying the prices of stocks only occasionally — at best — reflect the issuing companies' fundamentals?
Yes. This goes to my favorite chart of all time, which is in my book – the chart of **McDonald's** (MCD) during the 1970s.

Back when the fast food behemoth made hamburger out of bulls on the Nifty Fifty?
The stock went from trading at 75 times earnings to 7½ times earnings over that span, and I'm talking about earnings, not estimates. Its earnings growth rate was 25% compounded throughout the decade – and they never missed a quarter. So if I had been a fundamental analyst with perfect foresight and said, in the year of our Lord, 1973, with McDonald's trading at 75 times earnings, that the company's earnings were going to grow at 25% compounded for the next seven years, you would have said that the stock was a screaming buy. If I then would have added, and of course, they won't even miss a quarter during that time, you would have said, oh, this is a cinch.
Yet the stock didn't go anywhere and the multiple contracted all the way down to 7½ times earnings. So McDonald's, the company, did exactly what a bullish analyst would have forecast. It did wonderfully. But McDonald's, the stock, did not. And you, as the investor, owned the stock, which was not doing well, rather than the company, which was doing wonderfully.

What you're pointing out is that entry price matters, a lot, in successful investing —
Yes, here's what happened. In 1973, McDonald's

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Apple: A Possible Sucessor To McDonald's?

stock price had been driven, by Nifty Fifty euphoria over its future earnings prospects, to an extreme valuation. But once that emotional peak was reached, the stock was finished and stopped going up; it's future earnings prospects had been more than adequately discounted at 75 times earnings. And McDonald's was luckier than most companies in that position. Because its earnings actually did keep growing as the stock had anticipated in 1973, its price went more sideways in subsequent years than down.
Granted, if I had worked for **Warren Buffett**, who buys companies, my attitude would be completely different. But I didn't work for Warren Buffett, I worked for investment managers and they bought stocks. I perceived that my duty was to analyze stocks and, lumping all the stocks together, the stock market. So I used technical analysis to analyze the stocks which they bought, rather than companies which they didn't, and technical analysis to analyze the stock market which they could buy, and not the economy which they cannot buy.

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Okay, I just glanced at my TV screen and Apple (AAPL) is up 30 bucks. What does that tell you?
It must have had a good earnings report.

That sounds like an awfully fundamental explanation — and I was just about to observe that Mickey D's was pretty much the Apple of its day, at least at the start of the period shown in your favorite chart.
Pretty much. It could do no wrong. None of the Nifty Fifty could. It was very strange. They were the "one decision" stocks. People fell in love. The only way that you could get anybody at Putnam [where Walt spent many years as head of market analysis] to sell McDonald's when it was trading at 75 times earnings, was to pry the certificates out of the money manager's cold dead hands.

And then it turned around and made the others wish they were dead, right?
Right. It came back and it killed the people who had bought it at those extreme multiples – eventually. But at first, circa 1973, money came pouring into the Nifty Fifty growth shops. They were the only game in town. **Carl Hathaway** at **J.P. Morgan** got all of the media attention back then, but Putnam was no slouch in that category, either. And then, it went the other way.

With a vengeance. It took growth portfolios a long time to recover from that little misadventure.
That reminds me of an anecdote in the book, the story of **Baxter**, **U.S. Steel** (X) and **John Maurice**. [See below.] The problem was that Putnam was a growth stock shop and not designed, not setup, to be where the best action was. It was designed to be in growth stocks, do or die. So they went into growth stocks – and then they died. That story is about how one day at the height of the Nifty Fifty madness, Maurice, who was one of the most astute money managers I have ever worked with, and contrarian if there ever was one, asked a young PM if he ever wondered if U.S. Steel, then selling at 5 times, might not be a better buy than Baxter, which the youngster was buying at 50 times. Of course the younger man was incredulous at the suggestion. And of course, Maurice was right.

U.S. Steel wasn't nifty, but it was a better stock to buy in 1973?
Exactly. U.S. Steel, made a low in 1973, but then it *didn't* make a new low when the market tanked in 1974.

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Implying that it was likely to be a market leader in the next bull cycle?
Exactly. As Bob Farrell has said, leadership in a bull market usually telegraphs its intentions during the preceding bear market. And U.S. Steel was an absolutely classic case. U.S. Steel had been washed out ever since its little run-in with President Kennedy precipitated the crash in 1962. It was thoroughly washed out, thoroughly under-owned, thoroughly unloved and it wasn't going down anymore. It was selling at only five times earnings. But that young manager wouldn't listen to Maurice, and certainly not to me. That's why I tried to sprinkle anecdotes throughout the book. They're about things I actually wrote, back in the day, or things I personally experienced, to make my points with real people and real situations in the market. Which is why so many are set at Putnam.

Okay, but what about Apple?
Again, I have worked for some real geniuses and I will quote from my No. 1 mentor: Mr. Farrell says that parabolic advances usually go further than generally expected – but they do *not* correct by going sideways. I've certainly watched that happen a number of times. And I'm usually early. Sometimes crazy early.
It's like the tech thing in 2000. I mean we all knew it was getting overdone and we were all too early - well, at least I was. I just didn't expect it to go quite as far as it did. But ultimately when it corrected it made up for lost time.

There's another story in your book I got a particular kick out of — something about a fishing expedition?
The fable of the fishing boat.

How about retelling it?
I can't add anything to what I wrote. I really can't. I happen to think it's the best thing I ever wrote. It was as subtle as a brick but nobody really got it. I think it made my point as caustically as a point can be made – even to its ultimate subtlety about the story being found washed up on Bear Island. "The manuscript...was originally discovered washed up on a desolate island above the north coast of Norway, about halfway to Spitsbergen."

That's an actual place?
Yes, you can look it up in an Atlas. There is a Bear Island, that's exactly where it is; it is barren and it's not hospitable. I thought that was the ultimate irony in the story and it was right under the money managers' noses, but they never looked it up.

And the fable is essentially about fishermen (PMs) who keep fishing despite considerable and mounting evidence that a storm (bear market) they've encountered will get worse.
Sure, the money managers I worked with at Putnam were fundamentally oriented; they thought their job was to buy the stocks with the best fundamentals, and not to worry about market conditions, while it was my job, as head of Putnam's market analysis department, to worry about them. During the later stages of a bear market, though, even the best stocks fall day after day – and fund managers get tired of hearing that even their most beloved darlings are going to stay under pressure. During the late 1970s bear market, I got frustrated trying to make them understand that bear markets trump even the best fundamentals, so I wrote the fable about the fishermen not understanding that their skills were no match for Mother Nature. See, my problem at Putnam and my challenge until I retired, was trying to say the same thing in different ways to try to make my point and to keep people interested and to try to make them think it was their decision rather than my decision. I kept trying different ways to say the same thing and get the message across – and I always tried to do it with a sense of humor. I figured my job at Putnam was to send the money managers into the trading room with the right tickets, either buy tickets or sell tickets. But that if I could send them in with a smile on their faces, so much the better. So I would attempt to make my point with a little levity where it was possible. And, even if I couldn't make them smile, at least I'd be smiling.

Switching back to the here and now, what do you think of the technical analysis you see being done today?
My own opinion is that it's often too short- term oriented. It's used as a trading device for trading purposes rather than long-term investing, the way that Bob Farrell used it, for instance. He never came in and said what the market was likely to do over the next week and a half or so. He was doing the broad themes and, I think, for institutional investors that's the best way to do it. One needs to look at charts – but one doesn't need to look at *intraday* charts.

Yet there's an army of quants looking at intra-minute movements now, playing stocks like so many spins in a casino.

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And as you know, the casino always wins. The casino has really nice, flashy slot machines, that light up and twinkle and everything. People come in and play them and watch their money get gobbled up. Well, some of the trading platforms are same way.

They dazzle you while they rob you blind.

Well, you said it. Ultimately, everything shows up in the chart. If you try to make sense out of intraday moves, God bless you, have fun. If you try to step back and look at the longer term, you can make sense out of it once you get rid of the noise – which, to me, is what investors should be doing – as opposed to traders. That is why I wrote the book for a typical 401-K owner; to tell them they should follow their investments using technical analysis – which is to say, look at a chart every once in awhile. They are available for free on the internet.

Then, when something is going wrong with the chart, they have to question why and see whether they want to stay with their investment, go to another investment or perhaps sidestep the market for a little while. And the 401-K owner has to do it because his broker probably won't do it for him.

You also make it pretty clear that you don't need a Ph.D. in physics to read a stock chart.

Absolutely not. No stock in an uptrend has ever gone bankrupt. My point is that if you own stocks that are in up trends and you own no stocks in down trends you'll probably do well.

I was very lucky in my career. I owe Bob Farrell more than anybody else, because he was nice enough to put up with me when I was a young kid and knew everything – until I grew older and realized that I did *not* know everything. Then he helped me learn. Then there were others like **Stan Berge** and **Tony Tabell** – I was lucky to have some of the best teachers in the world. But I was also lucky to be in the right place at the right time: Working for **Jerry Tsai** during the go-go years and seeing it from very much the inside, and then working at Putnam during the exploitation of the Nifty-Fifty and seeing that from the very inside; seeing how a major investment operation works, and being part of it from the inside. So I was lucky.

And now you're lucky that I just thought of something else. About the four-year cycle.

What about the four-year cycle?

It's more apparent in Europe right now than it is in the United States. In other words, you had a low in Europe in 2008, early 2009 and it looks like right now you're heading into another four year cycle low in most of the major European markets, certainly the peripherals. So the four year cycle is alive and well in Europe. The question is whether it comes and bites you from across the Atlantic.

What's your bet?

I was reminded of the old line from a Sherlock Holmes movie and book where Sherlock Holmes says something to the effect that "there's a wind coming out of the east". This is set in 1914. And Watson replies, "Oh, but it looks like it's a fair day." Sherlock says, "Well, that may be very true, Watson, but there is an ill wind coming from the east nonetheless, and the world is going to be different until it dies down again."

So the question today is whether there's an east wind coming for us or not. But there are certainly signs. The Spanish market has been within a couple of percentage points of its 2009 and low and the European banking stocks are virtually at their 2009 lows.

Let's hope they are *lows,* and not just waypoints as they sink lower.

Well, one would suspect they're waypoints on the way down – and the question is how much they will affect our markets.

Wow, Walter, thanks for the warning.

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