RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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LETTER 1338

**July 10, 2002**

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| **June 21, DJIA 9254.06; PTI 5269; A-D Ratio +1.19** |
| **June 28, DJIA 9239.25; PTI 5268; A-D Ratio +1.43** |
| **July 5, DJIA 9379.50; PTI 5259; A-D Ratio +.10** |
| **S&P Yield: 1.62% S&P p/e: 40.04** |
| **Gold 50-Day MA: 317.70** |

**THE PARTY IS OVER —** Investors are waking up from their long fantasy-dream of the 1990s. The dream was that they could buy any stock that had any kind of story, and that stock would go up. Techs, Internet, new concepts – just buy 'em and hold 'em for the long term.

It's a new world, and we're all part of it. If you're not a millionaire, you're a fool, and you're just "not getting it." The big thing, of course, was to have your broker cut you in on some of those IPOs. Why it's better than stealing, and it's legal. In the 1990's frenzy to get rich, values were totally ignored. And in the corporate whirl, options became the path to riches. Once you had your options, it was imperative to get the price of your stock up. And any way to get earnings up was OK, as long as you had a willing accountant and an equally willing underwriter for your stock.

Overstated earnings became the order of the day. "A penny better than expectations" became the song of CNBC. And people believed it. Pro forma earnings, operating earnings, any phony announcement of earnings sufficed to drive your stock higher. It was a picnic of lying and cheating, and everybody just had one hell of a time.

Options were not included as expenses, real expenses were hidden, and pension plan funding returns were overstated. You name it and corporations used it. As for dividends, who needs dividends? Nobody paid dividends. Of course, you need real earnings to pay out a dividend, but that didn't bother the new buyers. Dividends are for old ladies; real men want capital gains.

Today, as the claws of the bear dig deeper into the guts of investors, soberness has enveloped the stock market. The phony non-earnings of many of the hot stocks of the '90s is being dragged out into the open. The second psychological phase of the bear market is here. And skepticism, frustration, disappointment and anger are the order of the day.

**DIVIDENDS** – Have you noticed that there is an increasing amount of talk about dividends? Suddenly, the analysts are beginning to realize what dividends really mean. And what dividends mean are income – and the ability to compound. If you have nothing coming in, you can't compound. But if you have dividends coming in, then you are able to harness the most powerful force in the stock market – the power of compounding.

Here are some rather startling statistics received from John Mauldin of www.2000Wave.com. First, the largest component of stock market returns over the last 200 years up to 1982 was inflation. Now consider the following – if you invested $100 in the stock market in 1802 and you reinvested all dividends then you would now have $700 million (not figuring taxes, of course).

If you take out the effects of inflation you would still have the respectable amount of $37 million. But if you take out all dividends you would only have $2,099. Then the surprise – if you halted your $100 portfolio (no inflation and no dividends) in 1982 your portfolio would only be worth $400. And here's the shocker – by far the greatest part of the gains, over 80% of present value, came during the last very atypical 20 years.

What these studies show, writes John Mauldin, is "that conventional wisdom, which says equities get most of their value from capital appreciation is wrong. It is based on recent experience, and a bubbly mentality." The fact is that over an extended period of time the real appreciation comes from the power of compounding incoming dividends. Stock over time never grows faster than the growth of the economy. But since 1982 we've seen price/earnings ratios triple or more, and this extraordinary and atypical period will almost surely never be repeated in our lifetime. Thus we are reduced again to depending on dividends, some growth and the power of compounding.

But there are problems. One problem is that price/earnings ratios are now sky-high – over 40 for the S&P. The second problem is that dividends are extremely low – around 1.5% for the S&P — while a great many stocks pay no dividends at all.

Warren Buffett estimates or guesses that over the next ten years stocks will probably bring a total average return of perhaps 7% a year. If you figure in inflation of say 3.5% a year the real average return on stocks could be about 3.5% a year. Even that is doubtful, in my opinion, because dividends are now so low or in many cases totally lacking.

So what's the conclusion? Because we're in an ongoing bear market I believe it makes sense to be holding very few common stocks. Because the dollar is at risk and because all paper currencies are at risk, I think it makes sense to have up to 10% of your assets in gold or gold shares. Today, the only real source of current income is now from bonds and utility stocks. I think it makes sense to have most of your money in bills or notes or top-grade muni bonds with maturities out to 10 years – plus a smattering of utility stocks. I think it is also imperative to be **saving** so that you can add to the compounding process. In doing so, you will be doing exactly the opposite of what most Americans are now doing, which is going further into debt.

If there is a crisis coming up, and I believe there is, it is liable to be a crisis of debt and income – too much debt and too little income. One reason Japan has been able to withstand a dozen years of no-growth and recession or semi-recessionary conditions is because the Japanese people are huge, almost obsessive savers. Americans, on the other hand, are spenders and certainly not savers.

What about gold and gold shares? This is the insurance sector of your portfolio. We have just seen the bursting of the greatest speculative bubble in stock market history. The aftermath of this busted bubble is apt to be dramatic and surprising. The first easily identified reaction to the bubble bursting has been the collapse of the Nasdaq, one of the greatest collapses of a major stock average in US history.

There are bound to be other manifestations that we do not yet know about. When these adverse conditions hit — stocks, housing and even the dollar itself could come into question. At that time investors may flock to the only currency that stands on its own and is not a creation of some government. That currency is gold. And that's why we hold gold or gold shares. It's because gold is the only real money, and when the chips are down, ultimate safety comes in the form of real money, gold.

**THOUGHTS ON THINGS TO COME** – The great Japanese bubble started to burst in late 1989. Today the Japanese Nikkei stock average is down roughly 75% from its peak. Over the last year the Nikkei has moved basically sideways in the 11,000 area. The fact is that after a dozen years of bear market there's still no real recovery out of Japan.

With the bursting of the great US stock market bubble, I have to wonder whether we're not going to follow the Japanese path. But there is that problem of very low savings on the part of US families. In the US, whatever wealth US consumers have seems to lie in the rising value of their homes. Therefore, one of the greatest dangers would be a top-out of home prices. The lastest statistics show that Americans in May bought houses at the greatest rate in almost seven years. Housing starts increased 11.6% to a pace of 1.733 million homes in May. Americans now seem to be abandoning hopes of making money in the stock market – instead they are flocking to buy homes.

**ARE WE IN A REAL ESTATE BUBBLE?** I grew up listening to my father, who was a real estate manager and expert, as he talked endlessly about real estate and real estate values. And, of course, in the '30s and '40s real estate was a lot different than it is today. By that I mean that real estate was in a state of depression.

In those days to rent an apartment on Park Avenue my father would have to call on the prospective tenant, negotiate, argue, sell, and finally, hopefully, dad would sign up the tenant for a one year lease – more years if possible.

As far as values, I learned that no matter what you pay for a piece of real estate, it will cost you 10% to carry it (that includes loss of interest if you had held the cash, and the cost of upkeep and repairs). So even today if you buy a home for say $300,000, you'd better figure that one way or another it's going to cost you $30,000 a year to keep the place.

**QUESTION-** When is real estate or a home a good value? Here's my formula, and it's an easy one. If you buy a home or even a condo and say it costs you $500,000, and the upkeep costs you $50,000 – can you rent the place and at least cover your costs, which are $50,000? If you can cover your costs, it's not a bad deal, and, of course, you have to like the place.

If you can't cover the costs by renting, you may love the place, but it's not a bargain. What you have then is called "pride of ownership." If you're in an era of rising real estate prices as now, then you've bought a speculation, not a bargain. Now I maintain that today it's almost impossible to buy a home and cover the cost of that home if you try to rent it. Thus, today, real estate is a speculation. If you love the home you live in then consider it a "loved speculation," but a speculative holding nonetheless.

But is real estate in a bubble mode? I think so. Over the last few years a great portion of US real estate in "nice" places has appreciated by about 20%. Here in San Diego County real estate prices are sky-high. In La Jolla a decent three-bedroom home can run up to a million dollars and more. These are homes that were originally built for maybe $25,000 to $50,000. The real estate bubble is here. I feel it in my bones and I sense it in my guts. Real estate is hard to buy in a bubble. The seller is the boss. In a severe and protracted bear market, real estate is an illiquid "dog." I've been there too.

The current argument goes that the population is rising and there aren't enough houses being built. Yeah, I've heard that one before. Believe me, with today's high debt and fragile financing – before this bear market is over real estate will come down in price, and I mean come down big time. So at today's prices, my advice is to enjoy your home. You had better, because it's almost surely overpriced.

As for buying a home in today's market, I'd say buy it because you want it. It's always cheaper to rent than to buy, but if you can spare the money and you love the house, why hell, just buy it. But don't, by any means, think you've bought a lifetime bargain. There are no bargains in real estate today. There never are when the sector is in a bubble.

**NOTES & QUOTES** – My old friend, Bob Prechter of Elliott Wave fame, has written a new book that I just received. The book is entitled, " Conquer the Crash" (Wiley Publishers). After reading the book carefully, I am saying that this is "must reading" for anyone who has even the slightest interest in the stock market and his or her own investing.

Prechter lays out the case of an historic bear market, one that dwarfs anything that we've seen so far. To give you some idea of how bad Bob sees it, he writes, "To summarize, though my outlook may sound impossible, I am quite comfortable saying that the DJIA will go from *quintuple digits*, where it is today, to *triple digits*, an unprecedented amount." In other words, Prechter is saying that the Dow will fall from above 10000 to below 1000. Sound crazy, sound nutty? It doesn't when you read his reasoning and his analysis of what may lie ahead.

Prechter's fascinating chapters on the Federal reserve, the debt situation, and what he calls the coming deflation, is worth ten times the price of the book alone. Bob has spent years studying market psychology, and, of course, the Elliott Wave thesis. In fact, back in the '60's (or was it the '70's) I wrote quite a bit on Elliott myself, but since Prechter was far more steeped in Elliott than I was, I left him the field which he certainly enlarged on along with his friend and mine, the brilliant Jack Frost of Canada. So again I urge all my subscribers to buy the book, "Conquer the Crash." This is an amazing work, and one that is calculated to make you think deeply. I might even say that this book will astound you with its theses and its conclusions.

Subscribers may ask, "Russell, what do you think of Prechter's predictions and conclusions?" My answer is that I am completely open-minded. Prechter is a rare and talented market student, and what he's writing is not to be laughed at, even if it seems impossible or outlandish (in 1982 Dow 11722 seemed impossible and outlandish). A basic tenet of Dow Theory is that neither the duration nor the extent of a primary movement can be predicted in advance. Remember that and you'll never be surprised by what the stock market does.

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You may not realize it but the Germans have financed a large number of Hollywood movies. During the last five years $12 billion has quietly poured into Hollywood from Germany, bankrolling everything from art house hits to megaplex flops such as Travolta's "Battlefield Earth." But now the ocean of cash is suddenly threatening to evaporate because of the collapsing stock prices of German media companies and the German government's desire to limit generous tax write-offs.

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The Asian Tigers (Hong Kong, Malaysia, Singapore, South Korea, Thailand) are having a very difficult time trying to compete with China. *The Financial Times* quotes one analyst as saying that "the recent increase in Asian exports to China, of equipment and components, may in fact be just the first stage of China bringing in entire industries onshore, rather than a new and ongoing source of income for the tigers. It may, in fact, be the "Last Supper for the Tigers."

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Just got an e-mail from Europe; the subscriber writes that Europeans don't particularly want dollars and are trading the euro as if it already was worth a dollar.

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Brilliant economist Peter Bernstein shows a chart of two items — the earnings yield on common stocks and the yield on bonds. Beginning around 1990 for the first time in history the yield on bonds has remained below the earnings yield on stocks. There are probably a lot of ways of interpreting this, but my take is that stocks are far too expensive in relation to bonds. To bring the study to the absolute present, *Barron's* this week show the earnings yield on stocks (earnings divided by price) at 2.45 while the yield on the 10-year Treasury note is 4.85%.

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After a 10-year decline, crime is up again in the US. But how about this? In Britain over 50% of burglaries occur while the occupants are at home. Compare this with the US where only 13% of burglaries occur while the occupants are at home. Why the difference? US burglars admit to being more afraid of armed homeowners than they are of the police.

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Have you noticed how thin your favorite magazines are? The following from *The Financial Times*: From Madison Avenue to the boardrooms of the world's biggest media groups, you can almost hear the hands wringing as the worst advertising recession in recent memory wears stubbornly on.

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The following was on my July 1 site, but it is so important (meaning, of course, that I agree with it) that I wanted also to put it in this Letter for the benefit of my other subscribers who don't have computers and who therefore don't get on the site.

In the Bloomberg *Personal Finance* magazine (August issue) there's an excellent article by financier Larry Tisch, CEO and co-Chairman of Lowe's. Tisch's advice in short — better be in bonds.

A few quotes: "Nothing is cheap. Value investors are now having a very hard time trying to find stocks to buy. Small caps have put on a great show over the past year. But the easy money has been made.

"In the next few years I do think a lot of money will be made in the euro. Investors can buy euro bonds and get a current income as well as the benefits of currency appreciation. . . . Our trade deficit is out of control, there has to be a real weakening of the dollar.

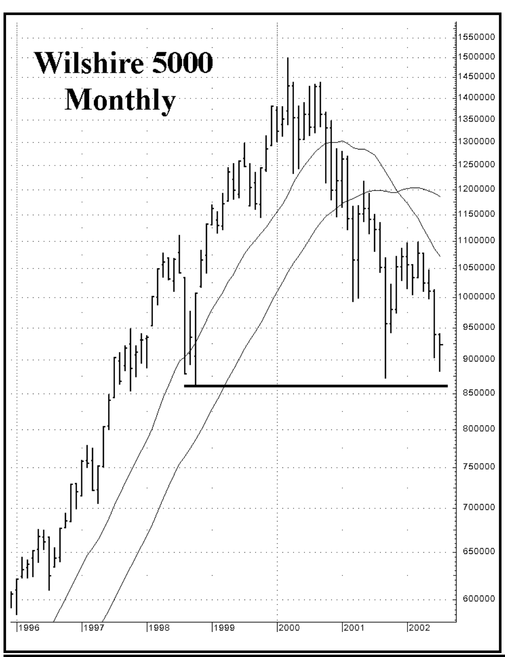
"The challenge for investors will be that before moving to bonds or TIPS or the euro, they will have to sell stocks. Don't say, 'What if I sell, and it goes up?' Let it go up. Who cares? Don't worry about the money you might have made. Worry about not losing money. People forget that when they sit on a bad investment, they are losing the profit they could be making by investing money at 5.5% or 6 % and compounding it. Instead, they make nothing further -- and risk watching the market fall."

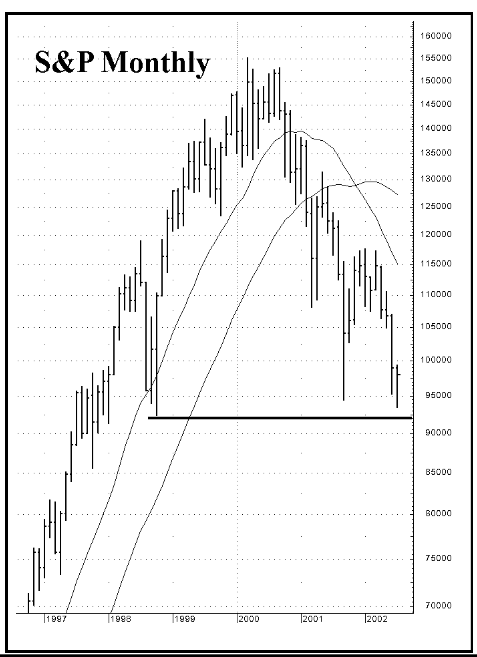
**CHARTS -** Daily price action can be confusing. In the short term the market can do anything. For this reason it's always important to keep your eye on the big picture. One way of doing that is to watch the monthly charts.

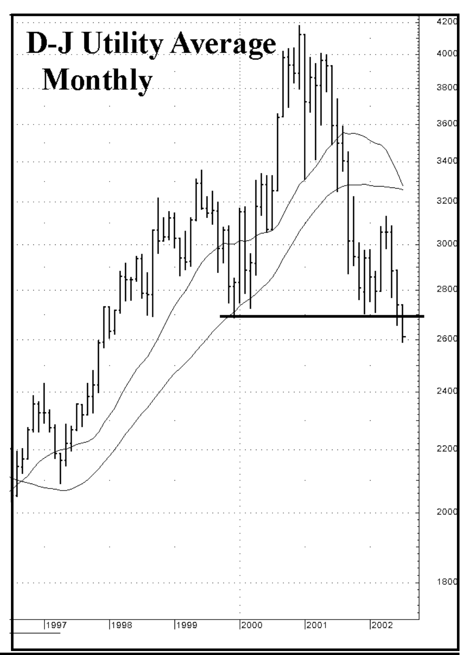
I'll start with the very broad Wilshire 5000. Here we see a giant "head-and-shoulders top" pattern with the "neckline" or support line coming in at about 8,700. Note also that the 20-month moving average has crossed below the 40-month MA. The 20-month MA is now declining rapidly with the Wilshire far below the 20-month MA.

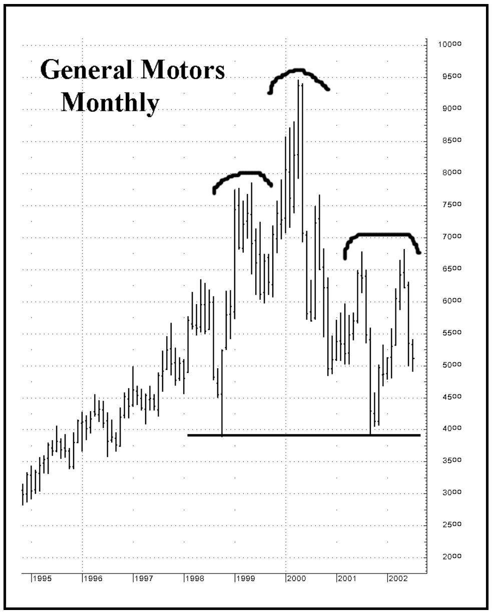
The next chart shows the monthly S&P 500 (this is the index the pros watch), and here we see the same structure as the Wilshire. It's a giant top with support at 945.

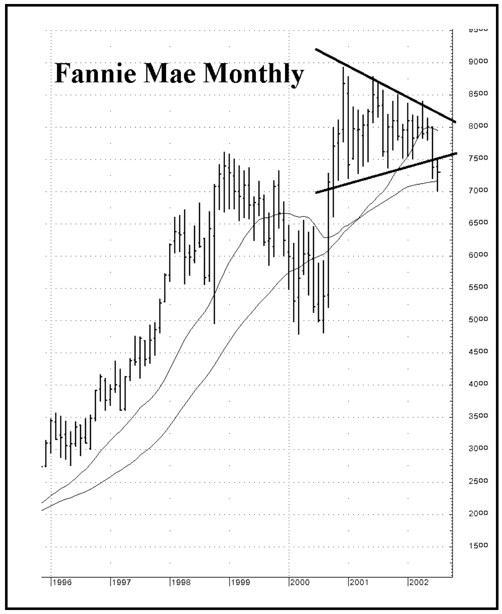
The next chart shows the D-J Utility Average and here again we see a huge "head-and-shoulders top." The only difference here is that the Utilities have violated their support at 270 and are now outstandingly weak. The Utility Average, historically, has tended to lead the rest of the market.

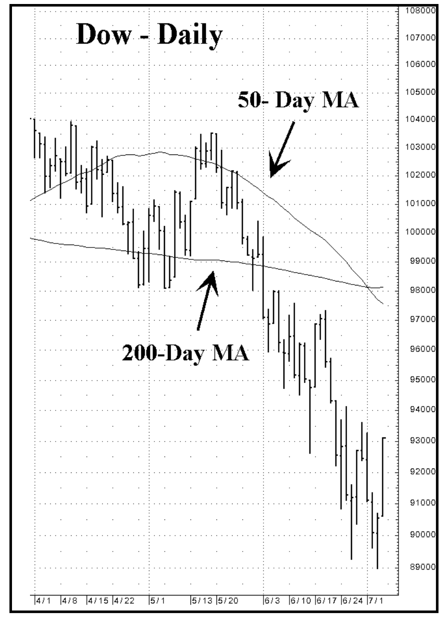





General Motors is doing the best of the US manufacturers. But the monthly chart is saying "top out." This does not bode well for the auto industry, which is one of the mainstays of the US economy.

The chart of Fannie Mae (a US sponsored agency) does not look promising. It took almost two years of monthly action to form this triangle. The triangle has now been violated – to the downside. FNM owns about 20% of all the mortgages in the nation. Not good.

For a shorter-term picture, I show here the daily Dow. Note that the 50-day MA has now crossed below the 200-day MA, and this puts a "technical ceiling" over the Dow at the area of the 50-day MA. The 200-day MA of the Dow stands at 9812 while the 50-day MA stands at 9753. The Dow is finally in the bearish position, below its 50-day MA while the 50-day MA in turn is below the 200-day MA.

**INVESTMENT POSITION AND LATE NOTES** – I guess you've noticed that from *Forbes* to *Barron's*, from *USA Today* to *Money* magazine, the dominant theme is what stock or stocks to buy. Yes, they admit, a lot of money has been lost in this "rotten" market (never "the bear market"), but nevertheless, there are still many stocks on the bargain table. Probably true, but the problem is that there is a slim chance that these publications can pick them. These are the same analysts and the same publications that never saw the bear market coming and still don't understand it – and yet they pose as experts.

There's only one expert, and that expert is THE MARKET. Before you call your broker and place a buy order on one of today's so-called bargains, may I suggest that you study the charts in this letter. Here you can see what the real expert, the stock market is telling us. It's telling us that the big picture is a definitive top in the major averages. The future for all of us is a process whereby these massive tops will break down – resulting in losses across the board.

So my best advice, based on what the market is telling me, is to get into cash, T-bills, top-grade bonds, some gold or gold shares for insurance, and exercise patience, a lot of patience. The bear is in no hurry. He knows that investors become impatient and do stupid things. In a bear market, the smartest thing you can do is to STAY OUT.

Remember, the market always wants what nobody else possesses. Right now, everybody has debt and nobody has cash. Cash, liquidity, no debt – this is the ideal position to be in. Who do you know that is in that position?

**Next Mailing: July 31, 2002**