RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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LETTER 1370

May 12, 2004

April 23, DJIA 10472.84; PTI 5397; A-D Ratio +14.93
April 30, DJIA 10225.57; PTI 5378; A-D Ratio +13.56
May 7, DJIA 10117.34; PTI 5372; A-D Ratio +12.62
S&P Yield: 1.75% S&P p/e: 22.54
Gold 50-Day MA: 404.70

THIS IS THE WAY MAY BEGAN — Let's start with today's "hot items." First, Wall Street's current fad is the jobless claims. The latest data told us that jobless claims were down 25,000 to 315,000, "lowest since the year 2000." Hey, good enough! Everybody's going back to work.

Here are a few more items. California brought out $7.9 billion of the new California munis, and they were snapped up at prices up to a 4.83 yield for the long-dated issues. Good enough. And talking about finance, Mr. Bush is asking Congress for an early $25 billion down-payment to cover costs in Iraq and Afghanistan. David Obey, top Dem on the House Appropriations Committee, said the Bush request falls short by about $40 billion of what will be needed. Bush is "cooling it" on the money requests because of the coming election.

Here's another item — an early Picasso sold at auction yesterday for a record $104.2 million. Sotheby's loved the results of the whole auction. The auctioneer said the bidding was "thrilling, incredible fun." Lastly, Adidas is bringing out a new high-tech running shoe (forget those lousy sneakers). The price will be $250, probably a record for a running shoe. Fun, fun, fun.

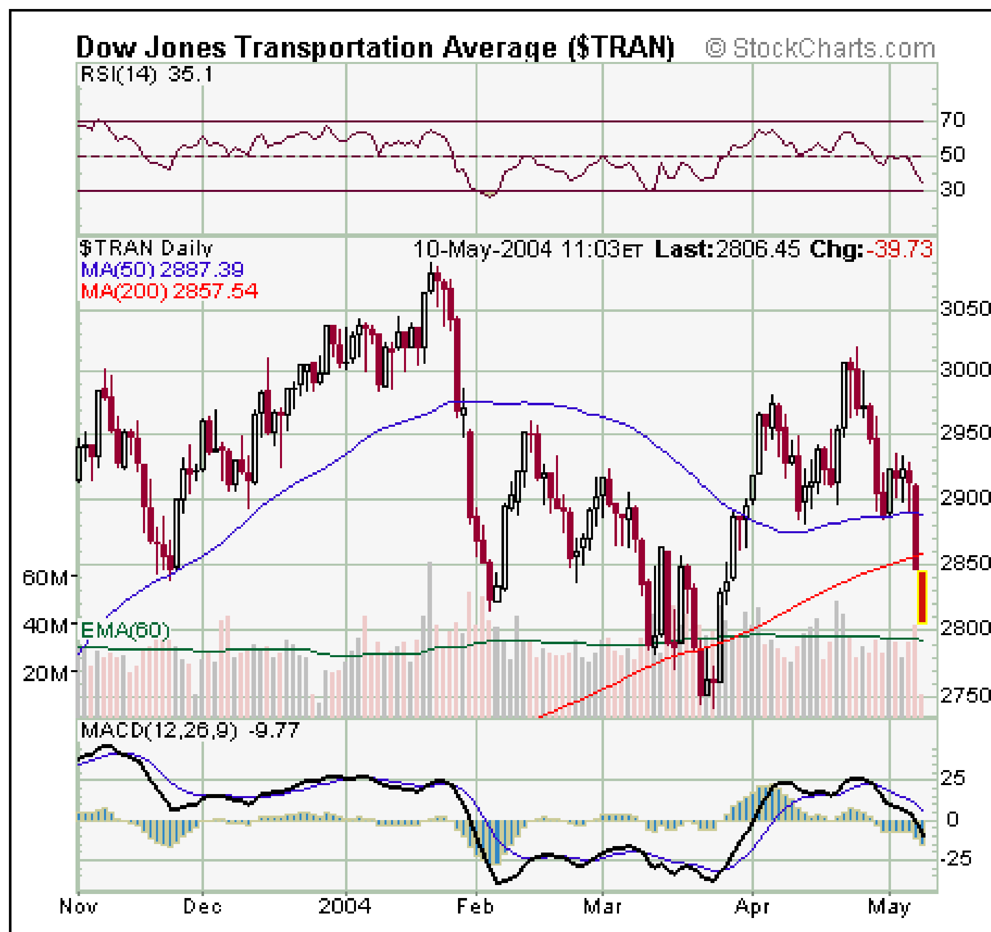
On to more serious matters (as if a $104 million Picasso isn't serious enough). On the left we see a chart of the D-J Industrial Average. Since its recent peak of 10737.70, the Dow has traced out a series of **declining tops.** The figures run like this — February 11, the Dow's peak closing was **10737.70**

March 1 peak — **10678.14.**
April 6 peak — **10570.87.**
April 27 peak — **10478.16.**

What this means is that each rally off the March low has been weaker than the preceding. Not good. The Dow is now trading below its 50-day moving average, which is the blue line on the chart. The red line is the 200-day MA of the Dow. The 200-day MA stands at 10005.91. However, I believe the key number for the Dow is the March 24 closing low of **10048.23.** If that low is violated, it will put the whole year 2004 in jeopardy, as far as the stock market is concerned.

The next chart below shows the D-J Transportation Average. This "companion" Average has formed a potential "head-and-shoulders top," and recently it's been bouncing off its 50-day moving average which stands today at 2889. The important March low for the Transports was recorded on March 22 at **2750.80.**

If the Dow breaks its March low of **10048.23,** it would have to be confirmed by the Transports violating their own low of **2750.80.** So to repeat, the two critical numbers to watch are — **Dow 10048.23**
Transports . . . 2750.80.



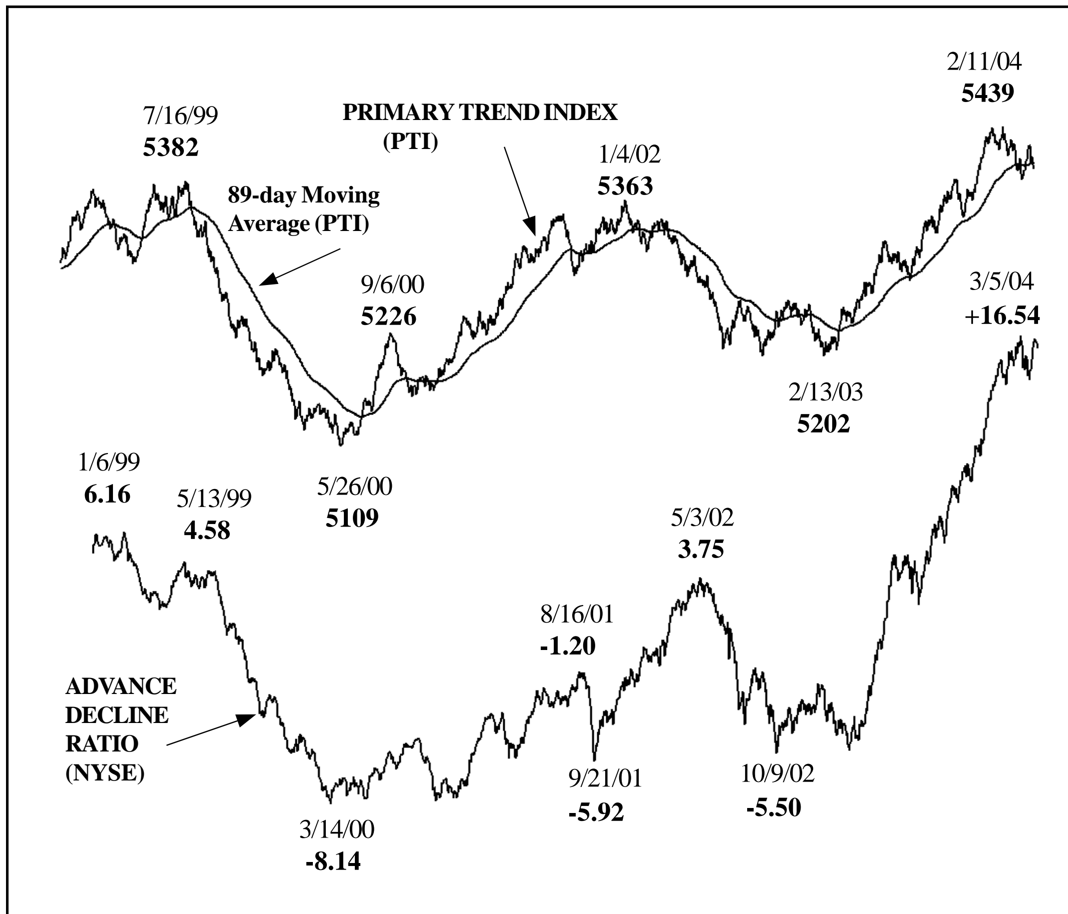
As long as one or both Averages hold above the above numbers, you can say that the structure of the Averages is at least holding together, and that's a plus. Conversely, if both Averages violate their respective March lows, the whole stock market picture turns bearish in a major way. To me that would mean that the market was once again in the grip of the bear.

Question — Russell, your PTI is now bearish, your high-low studies are bearish, much of your technical work is bearish, and now you say that the Dow and the Transports have to break their March lows before we can say that the bear has the market in its grip again. Please explain.

Answer — True, my studies have turned bearish, but these are simply studies I follow or studies I've developed to help me follow the "internal structure" of the market. But for the ultimate "truth," I depend on Dow Theory. I can be bearish as hell based on my PTI or the advance-decline ratio or high-lows or their market action — but the final judge is the Dow Theory.

And from a Dow Theory standpoint, important secondary lows must be violated before I can say that the primary bear trend has once again "taken over." That's the importance of the March lows in the Industrial and Transportation Averages. BOTH of those lows must be violated before I can say with certainty that the primary bear trend has again asserted itself.

In the meantime, I can say, as I've been saying week after week that "I don't like the market action. As far as I'm concerned, it's bearish."



One difficulty here has to do with the **fragile balance between inflation and deflation.** I feel that we are on the fulcrum, and the balance could go either way. For instance, today or at least this morning the 30-year T-bond and the 10- year T-note both sank to new lows, meaning interest rates rose to new highs. That's bearish for the economy, and it puts pressure on American consumers.

This morning June crude oil bounced around its 13-year high of 39.50, and at this level gas and oil prices will stay high. These oil and gas prices work as a tax on all consumers, and to this extent it's deflationary. Gold and silver can't seem to get anywhere on the upside, and this also smacks of deflation. On the side of inflation, the stock market continues to at least "hold together," and the March lows in the Dow and the Transports have still not been violated. The Fed is basically hell-bent on inflating the economy, and we can see that in the Fed's reluctance to raise short rates.

Inflation in **prices** is still the order of the day — we see it in medical bills, college bills, food, services — and the hundreds of sundry items that we have to buy every day, week or every month. To put it succinctly, there's no clear trend pointing to inflation or deflation. At least, that's what the markets are telling me.

I've heard it a thousand times — deflation is a contraction in the money supply. Right, but if consumers cut back, if they stop borrowing and start paying off their debt, that process will hit money volatility and will also tend to shrink the money supply. And that's monetary deflation. In other words, price deflation can lead to monetary deflation.

It seems to me that the Fed is starting to lose the battle to inflate. The Fed is not inflating the money supply fast enough to offset the forces of deflation.

I want to remind subscribers that what we're experiencing now has never occurred before in world history! What I'm referring to is the "sudden" entrance of 2.5 billion people (a third of the world's population) into the global market. Of course, I'm talking about China, India and much of Asia. This mass of people will work for one-fifth of what Americans will work for, they will work longer hours. And the irony is that both China and India have huge unemployment problems. This is the real force for deflation. And it's not something the Fed or anyone else can control.

FUN IN MAY — Uh oh, Russell's out of step again. On the cover of May 1, 2004 *Barron's* we read in huge letters — **"Bear Overboard!"** and we see a grinning bull tossing a trussed-up bear off a boat into the water. In the feature article entitled **"Just Resting,"** *Barron's* illustrates the situation with a picture of a laid-back bull smiling and clearly just resting. The article states, "More than 61% of the investment professionals responding to *Barron's* latest Big Money Poll call themselves bullish or very bullish about the prospects for US stocks through the end of the year. . . Only 12% of the Big Money managers currently call themselves bearish, a historically low reading, albeit consistent with last fall's tally."

OK, that appears to be the professional view. But it's not my view. My view is that an important market top has been completed, and that the primary bear market is ready to assert itself again.

A bit of history — following the 1929 crash, the market turned up in November of that year and a big upside correction advanced the market to an April 1930 recovery high. Volume was greater on the correction into the 1930 high than it was during most of 1929. Investors piled wholesale into the market again, believing that the bull market had revived. But, in April 1930, the stock market turned down again, and the rest is history. Reporting on the situation, Dow Theorist Robert Rhea wrote that far more money was lost during the rest of 1930 than was lost during the 1929 crash.

Now, a few technical notes on the current situation. *Lowry's* in their weekend report notes that since April 27 their Selling Pressure Index rose by 17 points, the greatest three-day increase in their Selling Pressure Index in the last 15 months. By April 29 the *Lowry's* Buying Power Index dropped to its lowest level in over a month. *Lowry's* correctly asks, "Does this represent a sudden change in market psychology?"

At the same time, the advance-decline ratios on the NYSE and the Nasdaq have been plunging. There have been many comments regarding the validity of the NYSE A-D ratio, since it now contains over 50% interest-sensitive issues such as preferreds and closed-end funds. My comment is that the A-D ratio is still useful, since interest rates have such a large influence on stock prices. Nevertheless, I run an operating-companies-only advance-decline ratio, and this index topped out on April 5. So any way you look at it, the majority of stocks on the NYSE (and the Nasdaq and the Amex) are heading down.

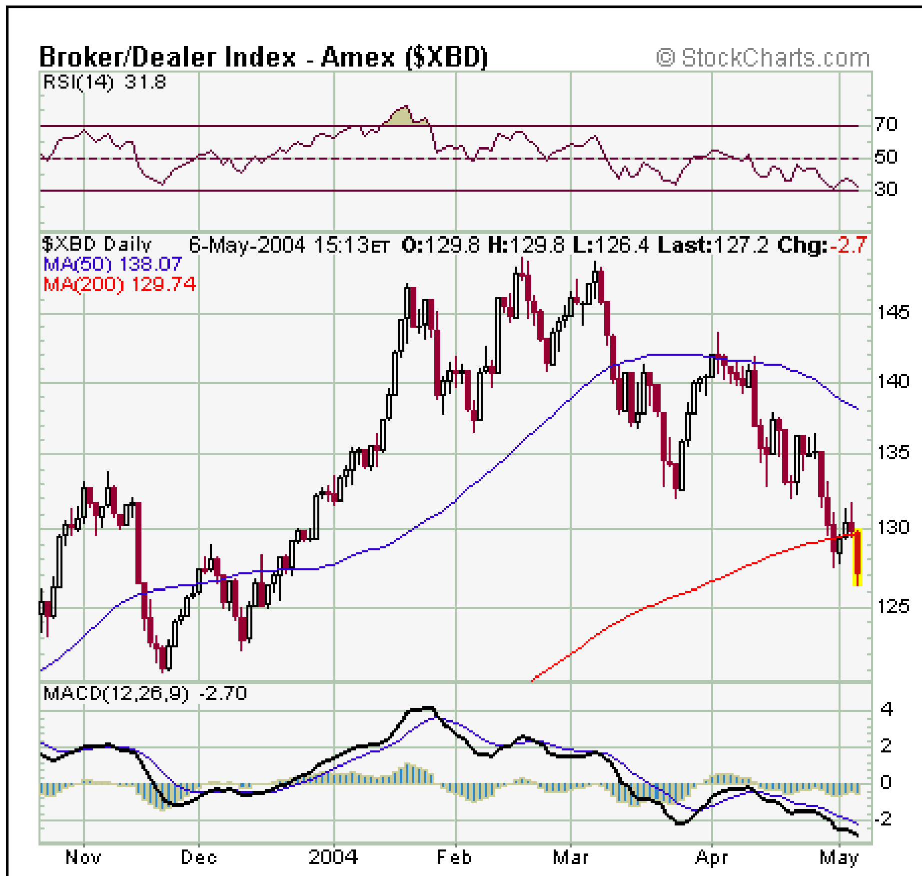
As subscribers know, I pay a lot of attention to new 52-week highs and new 52-week lows on the NYSE. I run five-day totals of each, and I take careful note of these totals, particularly on the rare reversals. Here's a recent record of the difference between the five-day totals of new highs and the five-day totals of new lows.

April 22 plus 155 (meaning that the five-day totals of new highs were 155 more than the five-day totals of new lows).
April 23 plus 48.
April 26 minus 122 (here's the reversal).
April 27 minus 198.
April 28 minus 207.
April 29 minus 237.
April 30 minus 280.

I find these figures scary. They show a trend decline in upside breakouts and a trend increase in downside breakdowns.

More technical evidence can be seen in the massive top and subsequent breakdown in my PTI. We also saw a new low in my Big Money Breadth Index on April 30, 2004. On the April 9 site I drew attention to the very rare "double non-confirmation" that had appeared in the D-J Average — with first the Industrials and then the Transports turning weak.

Putting it all together, my position is that the stock market since September 2002 has been in a typical bear market upside correction. Then, during the first quarter of 2004, the market formed a massive top, and now the primary bear market is



ready to assert itself. Unfortunately, during the bear market correction of 2002-2004, millions of Americans loaded up with stocks, mutual funds and refinancing cash (which they have spent). We have also seen what amounts to a buying-frenzy in homes, many purchased with little cash down and variable-rate mortgages.

On top of everything else, debt levels have been built to enormous levels, spurred by the Fed's artificial low interest rates. With short rates held at less than 1%, the Fed has rendered cash as something to be avoided, since at historically low interest rates, savers were literally driven out of cash and into well, "anything but cash."

Which reminds me of the old Wall Street adage which runs, "More money has been lost in the search for yield than any other financial endeavor."

Next, I want to show a few charts. Probably no sector of the market is more sensitive to coming events than the broker-dealers. This group lives on retail and institutional commissions, deals, IPOs, mergers, etc. And this group tends to sense the financial future early, very early. Above we see the daily Broker-Dealer Index. The chart is self-explanatory.

Housing has been one of the mainstays of this bear market rally. "You want to do something smart — buy a house, buy two houses, pay as little as you can down, and take out a variable-rate mortgage. You'll probably double your money in a year or so. This is a golden opportunity. Buy brother, buy!"

And they did — by the millions. The die is cast. The chart to the right is similarly self-explanatory.

INVESTMENT POSITION - The chart below tells what is probably the most important story of the day. This is a daily chart of the bellwether 10-year Treasury note. The yield of this note sets the long mortgage rate. What we see here is a steady drop in the 10- year note down to the support at 110. On Friday, the 110 support level was violated, and yields rose to a new high.

The problem now is that there is a huge mass of debt under the US economy; I call this mass "Greenspan's Debt-Bubble." If rising rates hit the debt-bubble, there's a good chance that the debt-bubble will burst. That would bring on a rush for cash as corporations and consumers struggle to carry their debts. What's needed to carry debts is cash. In the US cash is called dollars.

This brings me to the ideal investment position. Let's not mince words – the ideal position right now is cash in the form of dollars. Gold is the insurance policy, and there's no telling when the insurance policy might be needed. If a crunch in the US economy develops, if deflation envelopes the economy, then the very viability of the dollar could come into question. If that were to happen, there'd be a panic to move into real, intrinsic money – gold.

In the meantime, those of us who are totally in dollars (very few, I presume) are in the best position. Those of us who are in dollars and gold are not happy, but we're better off than the vast majority. Meanwhile, the best policy is to "sit and watch." There's a bear market in progress, and he who **LOSES LEAST** will be the eventual winner.

Just a reminder for those who own the chart books, the new 2003 pages are ready, and the price is $5 for the page of the D-J Averages and $5 for the new A-D ratio page. Please send your money in now; we do not accept credit card orders under $50. Send your checks to Dow Theory Letters, PO Box 1759, La Jolla CA 92038

Next Mailing: Thursday, June 3, 2004