Was King Solomon Correct?

"What has been will be again. What has been done, will be done again. There is nothing new under the sun."

King Solomon

Price action over time exhibits three "commonalities:" price rising, price falling, and price remaining the same (moving horizontally within finite bounds). These movements have occurred repeatedly because price reflects investor's emotional state of mind at any given point in time. Look back in history and we find so many markets that have been driven to astronomical heights by investors' emotions. There was the Tulip Bubble in 1593, when a person could trade a single tulip for an estate. The South Sea Bubble (1711) and John Law's Mississippi Bubble (1718-1720) were sensations of their times. In 1926, the Florida Real Estate crash left many is despair and in 1998 we saw the Asian crash. It seems that in each decade investors' emotions and optimism leads to greed then to fear and finally discouragement. These actions occur repeatedly and are reflected in price movements up, down and sideways.

In the financial arena people put their money on a certain asset based on their feeling at the time they invest. Buying pressure causes price to rise. When their feelings change, they may become despondent, even fearful, and therefore sell, causing prices to fall. Should investors have no opinion or are uncertain in taking action, prices remain relatively flat. Since emotions drive price, price becomes a proxy for the feelings market participant's exhibit.

Price marks perception at any given time. By studying buying and selling fluctuations and their associated patterns across time one might determine where price will move in the future.

Let us presume King Solomon was correct when he said “nothing new under the sun.” If this is true it may be possible to discern price action from the past and overlay that action on present price movement to discover where our equity markets may be headed in the near future.

To explore this concept further, let us examine the twelve years surrounding the market crashes of 1929 and 2000. Perhaps the market’s emotional psyche prior to and after each crash period will support King Solomon’s statement. First, looking at the 1925 to 1937 period, we find that these twelve years are important in projecting possible implications for present day investors.

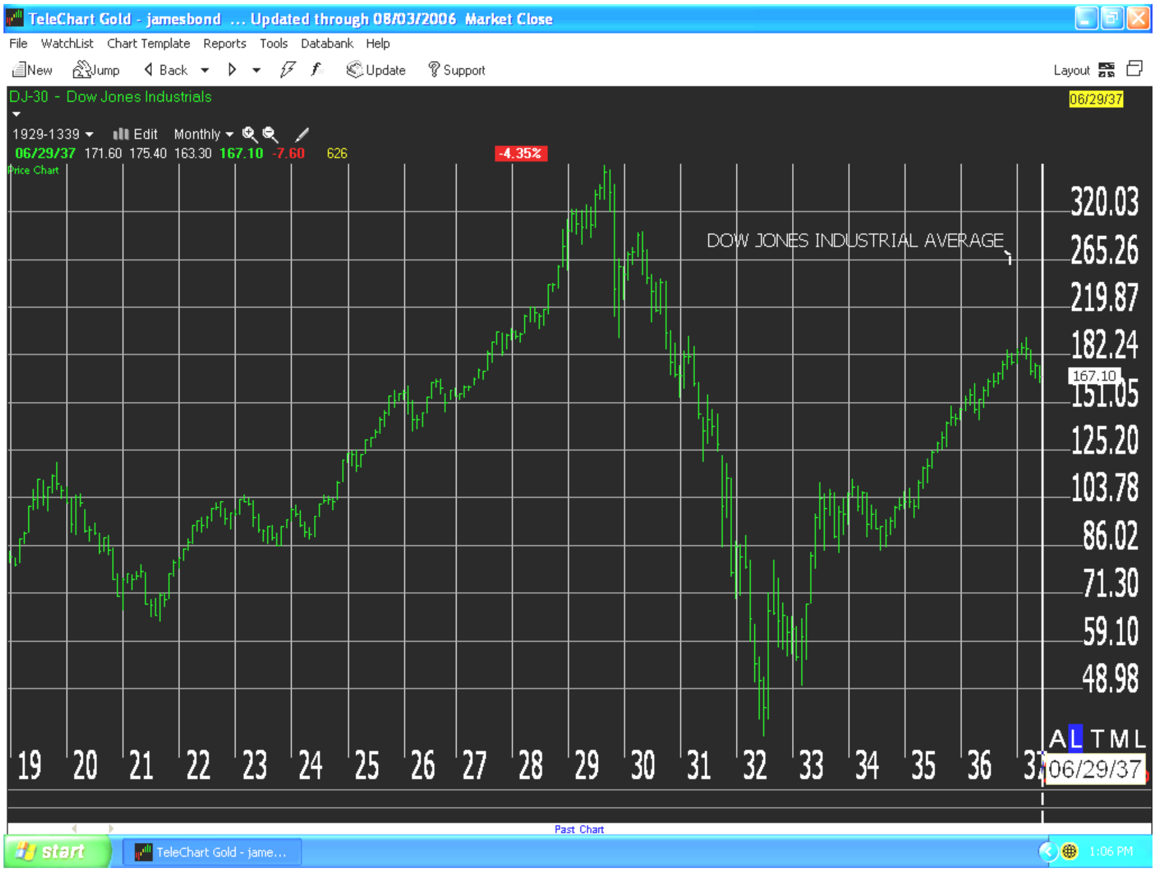
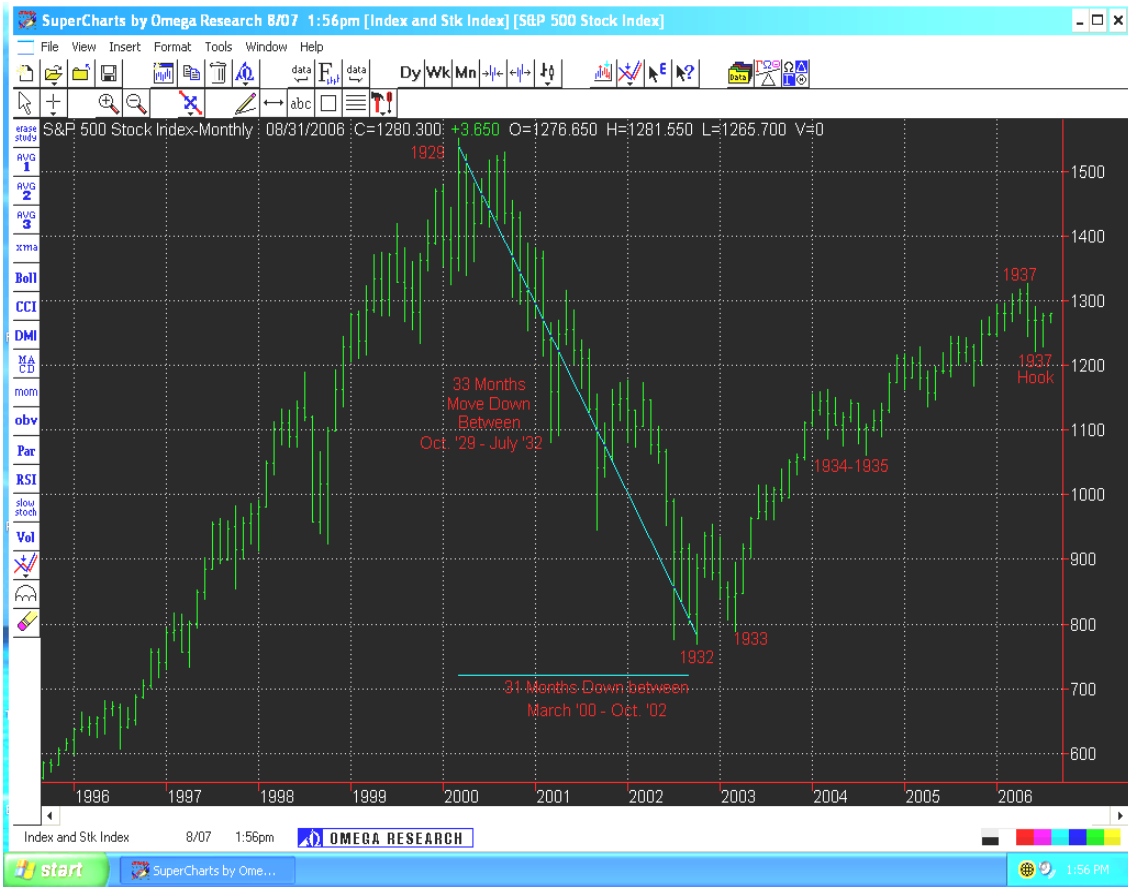


Chart courtesy of Worden Bros. – TC2005 - Tel: 800-776-4940

First let's look at the price action of the Dow Jones Industrial Averages (DJIA) from the 1920's through June 1937. Observing the chart pattern only and do not concerning yourself with either the x or y axis. Next, compare the pattern nuances for this period (from 1925–1937) on the next chart, the SP500, for the period 1995-2006. Does our original premise of price exhibiting three "commonalities" hold true? Do emotional patterns relative to price; seem to correspond over these time frames?



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The above chart shows the SP500 as it looks today. Significant commonalities in emotional patterns exhibited through price are overlaid from the 1925-1937 DJIA charts unto our present day SP500 chart. Our presumption is that the DJIA was "the market," society's proxy for the emotions of the roaring twenties and the New Deal '30's from 1925–1937. The SP500 is the, "market," a proxy for the current day.

From the corresponding tops in both averages in 1929 and in 2000, “fear” exhibited itself for approximately the same number of months; 33 months of fear to the July ’32 bottom and again from the top of the DJIA, a 31 months period of “fear” to the October 2002 bottom.

A technical re-test of price from each bottom was accomplished within 6-8 months of each low. In 1933 price dropped to re-test the low at 50.16 on the DJIA while the 2003 re-test dipped as low as 788.90 on the SP500 before the start of the Iraq invasion in 2003. A recovery rally from these re-tests to a consolidation was achieved before moving to higher prices. A consolidation in price on the SP500 from late 2003 to the Bush re-election in November 2004 corresponds to the 1934-1935 DJIA consolidation. The subsequent moves to higher highs on both charts lasted approximately two years. The DJIA highs in 1937 ended with the “1937 Hook” formed from the February 1937 high of 194.40 to the August 1937 high of 190.05. Our current Hook appears to be forming with the May 2006 high of 1326.70 on the SP500 and a low that appears from our recent May 2006 sell-off. A subsequent move back to the 1325 area on the SP500 will complete the hook; a “setting of the hook,” so to speak, before the next significant move in price.

In both examples we witness five sequential patterns of emotion forming over an almost identical period in time; a re-test, a recovery rally, consolidation, a move to higher prices and now, the hook. Nikolai Kondratieff, if he were alive, might point to a K-Wave association relative to the 71 year time period between our two examples. K-Wave theory would have us believe these sequences result from a long-wave cycle, corresponding to repetitive social, economic and emotional patterns repeating themselves every 70-75 years.

The pattern similarities observed in these study periods (1932-1937 and 2002-2006) reflect similar investor emotions of those willing to participate in a market coming off panic bottoms after long price declines.

To summarize, following the bottoms of 1932 and 2002, price/emotional recovery appear to exhibit not only similar patterns relative to fear (falling prices 1929-1932 and 2000-2003), uncertainty (consolidation in 1934-1935 and 2003-2004) and optimism (rising prices 1935-1937 and 2005-2006), but exhibit these commonalities within similar time frames.

What is next?

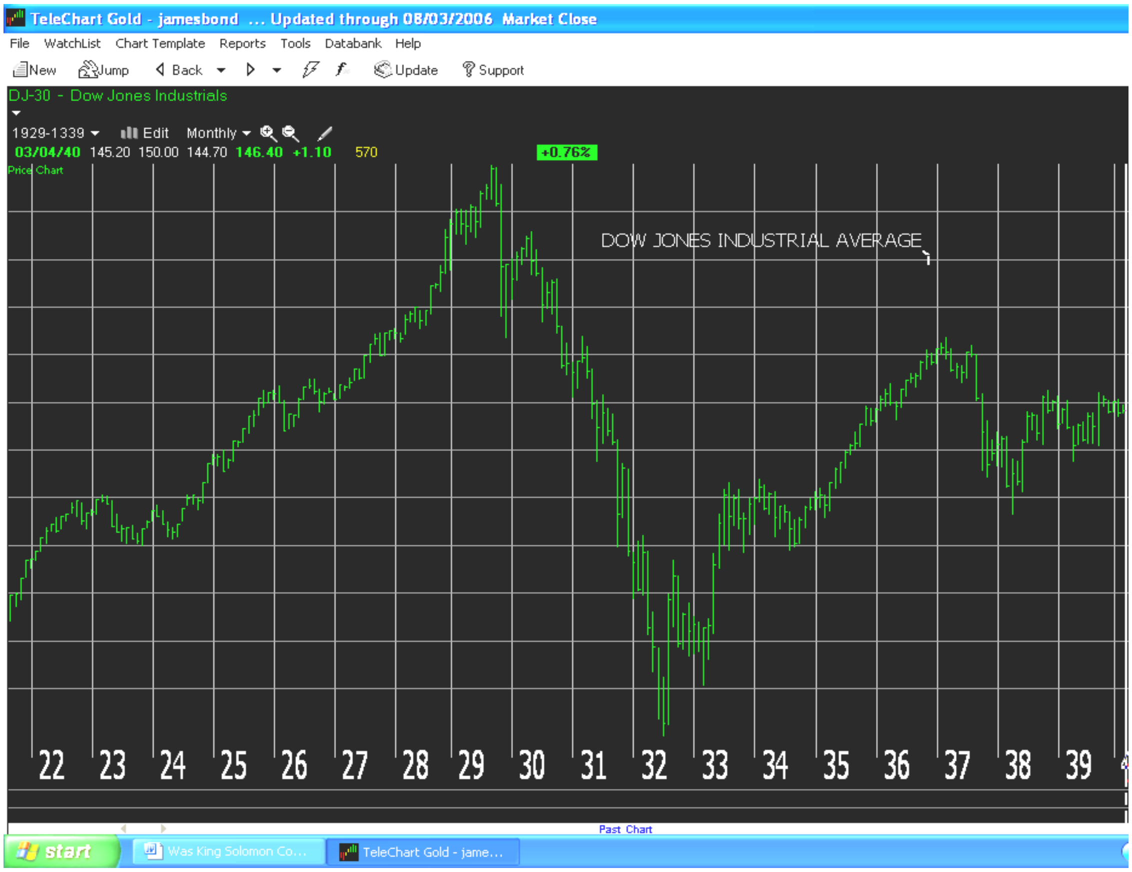


Chart courtesy of Worden Bros. – TC2005 – Tel: 800-776-4940

No one knows what is next, but if the current market, as measured by the SP500, were to continue to follow the pattern of the DJIA from the 1925-1937 period then we could be in for a modern day "Roosevelt Recession," coined by historians for the 1937 recession lasting from August 1937 to March of 1938. Notice the subsequent price drop from the 1937 Hook on the DJIA chart to the 1938 low. That drop took only seven months!

Granted, the U.S. is not in the middle of a New Deal, nor are we in the midst of a Great Depression. Some may argue that a "global marketplace" would mitigate a price collapse and the "New Paradigmer's" might dismiss this thought straight out since the Old Days have no place in our present day markets.
Nevertheless, the past twelve years, from the beginning of the Internet Revolution, to present day do have an uncanny resemblance to the twelve years from 1925 to 1937 following the nuance of price. A breakout from a consolidation of 85 to 105 on the DJIA from February 1922 to November 1924 propelled the DJIA to the dizzying 1929 highs over a similar period in time, 59 months. The break out in price on the SP500 at the start of the technology boom in February 1995 lasted 61 months until March 2000. The denouement and subsequent recovery brings us to present day.

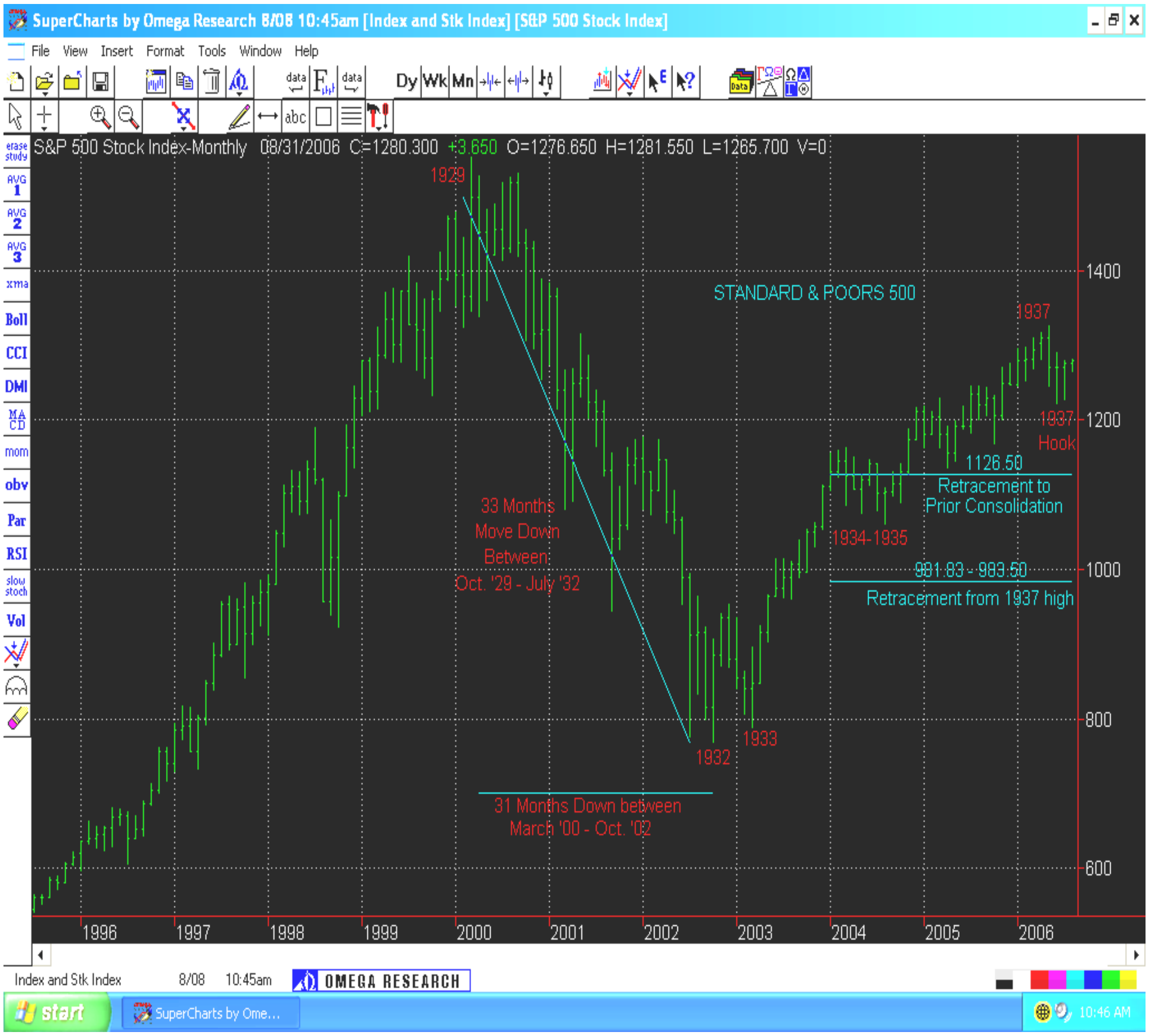
While a similar drop from the 1937 highs to the 1938 lows may appear severe, there is precedence for a recession in 2006-2007 that fits into technical and historical time frames. Coupling the fundamentals of today's global and economic backdrop with historical and technical precedents we find similarities to the 1937-1938 recession.

From a fundamental perspective, are macro-fundamentals today similar to the political and economic factors that may have brought on the 1937 recession? Panic Profits (Brown, McGraw Hill 1994, Table A-2 ***Almanac of Stock Market Panics and Panic Episodes***) summarizes world events in 1937: August 31- Sept. 22: Hitler, Mussolini confer. Japan wars on China. Sudden business collapse. Oct. 2- Oct. 18: London hit hard. War scare. Nov. 1-Nov 24: Industrial production, commodities in depression. 1938: Jan. 20 – Feb. 3- Bonds and utilities lead liquidation and fall beneath panic lows of autumn. Mar. 15- Mar. 31: Bonds smashed following Hitler's move on Austria.

One could compare today's Middle East tensions and the War on Terrorism to a Hitler-Mussolini campaign. Some Wall Street analysts have expressed the view of a commodities bubble on the horizon echoing a return to the 1937 commodities crash. On the bond front, the yield curve is approaching "inversion" status; characteristic of economic downturns. We have cited in ***AAMG Past Market Views*** our regard for the falling U.S. Dollar and its global implications, rising consumer debt, the effect of rising interest rates relative to a mature housing market and the rising cost of oil causing consumer's to tighten their discretionary spending to afford higher gas prices. The stage is set for a recession to some degree on a fundamental level, as well.

The Hirsh Organization noted recently in Stock Trader's Almanac 2006 (Wiley, 2006 p.34), "Of the 10 quadrennial cycles in the past 44 years, only one bottom was reached in the post-presidential year. All others came in midterm years." In other words, taking the 4-year Presidential cycle, each low within the 4-year time frame in the past 9 out of 10 Presidential terms comes during the mid-term elections. 2006 happens to be a mid-term election year.

Reviewing the SP500 chart and overlaying the potential price drops from the DJIA chart in 1937–1938 one can project two possible scenarios going forward:



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Upon a visual comparison, an SP500 retracement to 1126.50 would correspond to the 1938 low reached at 98.95 on the DJIA. This low rests in the middle of the 1934-1935 consolidation area on the DJIA corresponding to an area of consolidation and support found on the SP500 from November 2003 - October 2004.

On a percentage basis, the 1937-1938 Roosevelt Recession pulled price back 49% from the 1937 high. A similar percent drop would correspond to a drop on the SP500 to 983.50. A Fibonacci 61.8% retracement from the 2003 pivot low to the May 2006 high would equate to a drop down to 981.83. Either way, if King Solomon is correct, we are looking at a minimum of a 15.09% loss from the May 2006 high or a maximum loss of 25.84% should the SP500 move to 981.83. Wall Street characterizes a 20% drop in price as a recession. The combined average drop of the two retracements would define a recession.

The repetition of emotional patterns, reflected through price over time, coupled with the similarities in political and economic events over our study period appears to support King Solomon's aphorism. In this instance, modern day investors seem to be following similar patterns of their early 20th century predecessors. In our comparison, price movements over both periods appear to support the fact that investor returns from panic bottoms appear in a sequential set of ordered emotions reflected through price in the major market averages.

Time will tell whether the corresponding events after the Hook of 1937 on the DJIA will transpire on the present day SP500. Given the similarities in price, time and news during our two periods of study, vigilant investors might want to sleep with one eye open.

Carl C. Perthel
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