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Orderly markets steadily rise while reaching higher highs and dipping to higher lows, but invariably correct

Quick correction rebound is a double-edged sword

Keith Richards

The 1970s group ACE wrote a hit song called "How long has this been going on?" If they were investors in the current market climate, maybe Ace would have also asked, "How long can this keep going on?"

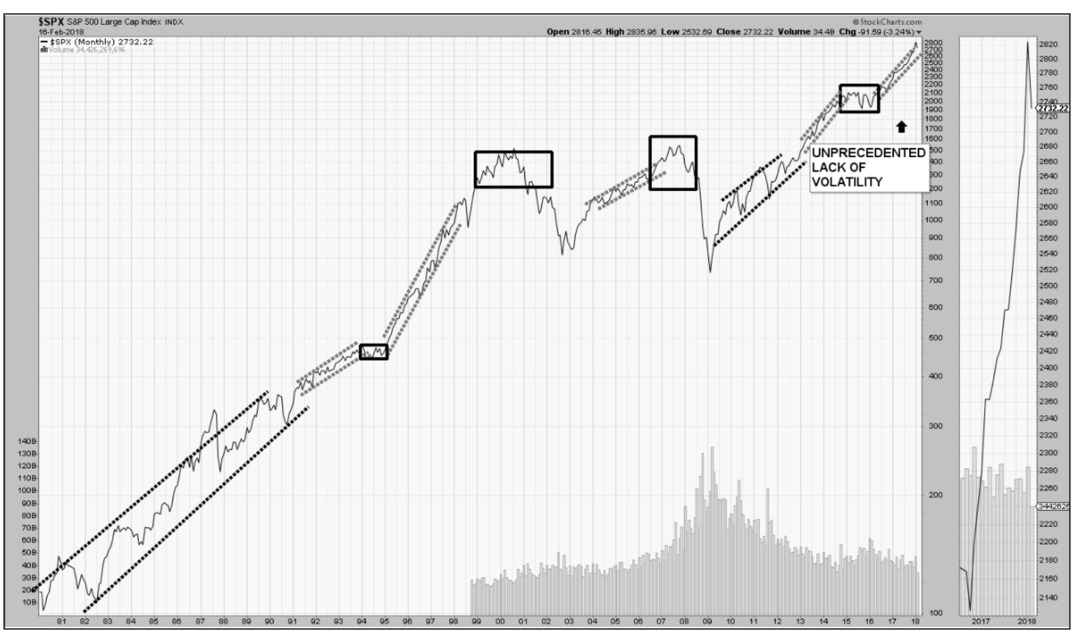
History can offer some insight. A chart tracking the Dow industrials since 1900 is on page 91, where this column continues. We're looking at 117-plus years of data on this chart – certainly representative of the greater portion of stock market history in the United States. I wanted to take a look at how long bull markets can remain in place before a corrective period.

After identifying the corrective or sideways markets, as I have on the chart, we can identify the historic bull markets and note approximately how long they lasted.

We can also make a notation as to whether the bull market was "orderly" or "parabolic". I'll define "orderly" as more or less travelling on a 45-degree trend line. Yes, it all depends on the scale of the chart—but humour me here. I'll also define "orderly" as having occasional corrections of five per cent to 10 per cent or greater along the trend line, while making higher highs and higher lows.

Parabolic markets illustrate few or no corrections. Per their name, they move off of the 45-degree trend line in almost a parabola shape. By the way—if you are interested in the angles of trend lines, study the works of W. D. Gann. While not everything he wrote was of value, certainly his methods for matching time and price to correctly draw trend lines are worth understanding.

As we can see from the parabolic market of the late 1920s and the parabolic market of the late 1990s, parabolic moves can last at least a couple of years. However, as seen on today's chart – they invariably correct. You might note that, up until February, we hadn't had a 10 per cent correction for the better part of a year. The chart illustrates the parabolic shape of the recent year's activities.



Elliott wave theory, despite its failings, might help us identify where we are in the investment cycle: Each wave of the 1-2-3-4-5-a-b-c sequence, according to the theory has its own character. By noting the characteristics of the current market, you get a good feel for which of the waves the market is in right now. I covered those characteristics in my book *Sideways*.

Just as a globe doesn't help you pinpoint the neighbourhood and street you are on, Elliott is not very good at pinpointing how much longer a wave will last. I have noted in my past articles that Elliott wave theory seems to inspire an almost cult-like belief system among some market prognosticators.

They insist that you CAN in fact predict price turning points by using Fibonacci measurements within an Elliott wave sequence. But– these Fibonacci retracements and targets turn into moving targets as they fail. So I place no weight on such "target practice."

From the look and "feel" of the market lately, I believe we are in the final "Wave 5" leg of the bull market that began in 2009.

Wikipedia, which references various Elliott wave theory experts, gives this definition: "Wave 5 is the final leg in the direction of the dominant trend. The news is almost universally positive and everyone is bullish. Unfortunately, this is when many average investors finally buy in, right before the top. Volume is often lower in Wave 5 than in Wave 3, and many momentum indicators start to show divergences (prices reach a new high but the indicators do not reach a new peak). At the end of a major bull market, bears may very well be ridiculed."

Does this sound familiar?

As noted above, we recently did have a 10 per cent correction – after a period of about a year without one.

I read with great interest a report on the recent correction by my favourite market statistician, Jason Goepfert of www.sentimentrader.com. He points out that over the entire history of the Dow Jones industrial average, the market has only experienced conditions similar to the recent correction 26 times.

That is, three months or longer of no corrections, followed by an eventual 10 per cent correction, and then a five per cent-plus rebound in the next five days. When these conditions occur, as they did in the recent sell-off and following five per cent-plus rebound, it leads to some upside.

Under such conditions – markets tend to follow up with a multi-month tendency toward growth. That's the good news.

The bad news

The bad news is that such a pattern often eventually leads to severe bear markets. The market typically succumbs to the bears after three to six months of upside.

Statistically, the market was (on average) net negative one year after the 26 occurrences of this pattern. The words of another rock group from the 1970s, Trooper, sum up my current outlook. They sang, "I'm here for a good time, not a long time".

Call it "Wave 5" if you adhere to Elliott wave theory, or just plain old business cycles – the signs point to a current bull market growing long in the tooth.

In my upcoming articles, I will discuss how investors can position their portfolios defensively, given the potential for higher risk later in 2018.

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