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2012 Forecast: *Catching a ride on the Supercycle Wave*

What are investors' fears going into the New Year, another crash? No, what keeps many investors awake at night is not related to Geo-political instability, but rather that a rally, like the one which began in the spring of 2009, could materialize once again. *Precisely what the Elliott count is telling us right now.*

Below you see the monthly Dow chart with an upward bias, versus the S&P just below, with a flat top.



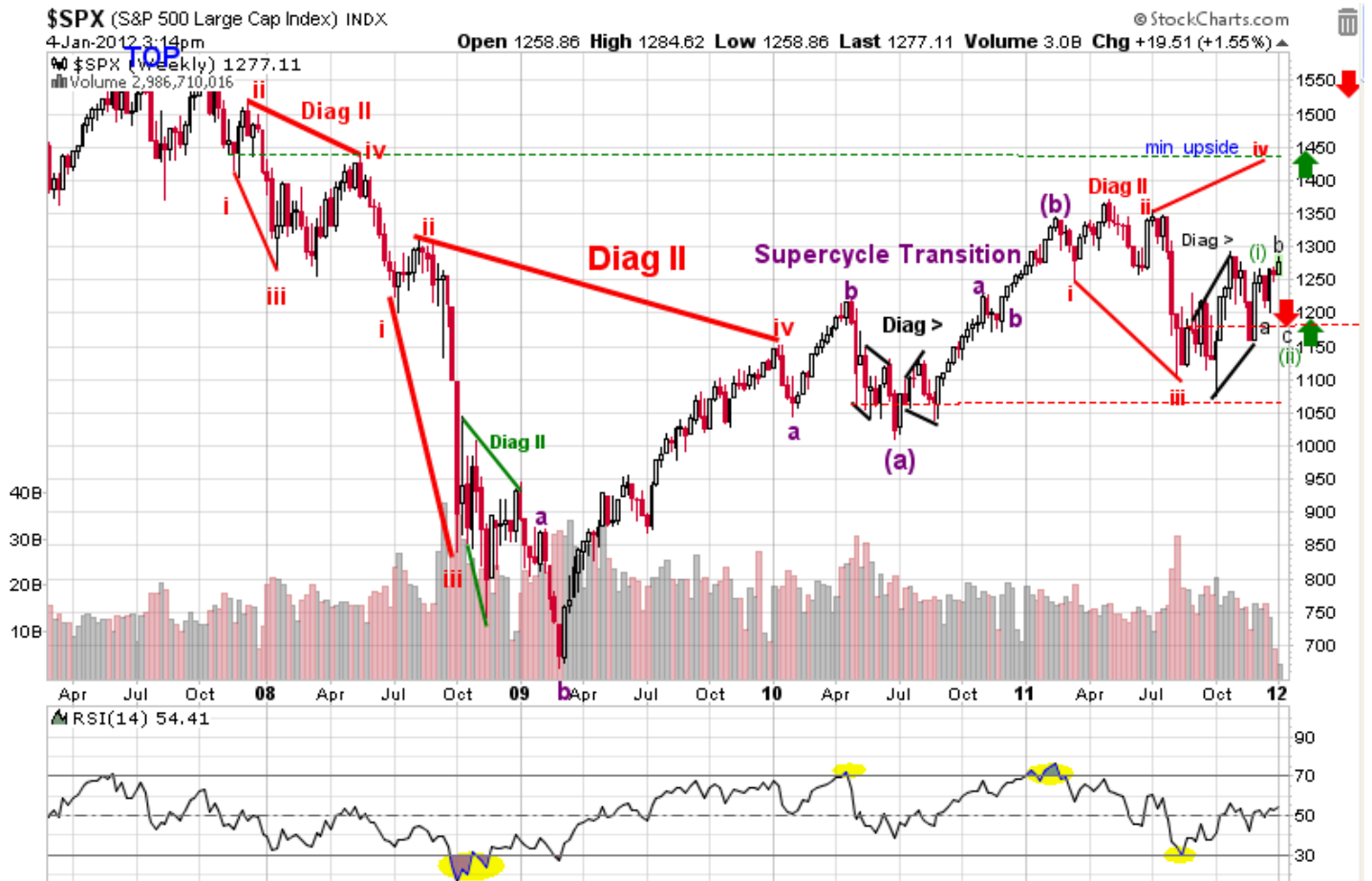
(continued)



In both the minimum upside for 2012 is likely the *dashed green line*, in the S&P there is a maximum upside in the next 12-18 months of *1550+100*.

(continued)

Below in the close-up weekly S&P you can see that we are in for a scare first, as the average could drop as low as 1060 before the rally becomes real for most. As you see the weekly S&P chart shows a wave (ii) down in process with a minimum downside of 1235 and a maximum of 1160. An extended wave iv is in progress.



(continued)

Of all indices the *Emerging Markets* should once again be on top after having lost 20% in 2011. The minimum upside is 47 although above 50 is probable.



Although timing is the most difficult to pin down with Elliott, the upside in 10-year Treasury yield is **4.15%**, afterwards it will drop below **1.7%** as you see in the chart below, for the final bottom.



Although equities are entering the New Year looking overvalued, they will need to get extremely overvalued before irrational exuberance kicks in once again, to set the stage for the Mother of all Crashes. At 13 times trailing earnings, except for a couple of months in the aftermath of Lehman Brothers collapse, S&P P/E ratios have not been as low in two decades. Meanwhile, the equity risk premium – the amount over bonds that investors demand to hold stocks - is close to a 40-year high. Many stocks yield well in excess of 3%, which beats 10-year Treasuries by a long shot.

Pendulum Principle of investor psychology

US profit margins, as a percentage GDP, are at all-time highs. Given that margins have an indisputable tendency to revert to the mean, they are not as cheap as they would appear at first glance. Although prices are at historical highs, as measured by **P/E 10**, or averaged out over 10-years, prices have still much higher to go. Why? Because multiple expansion, compounded by the human herding instinct always takes stocks to extreme overvaluations, before swinging back to extreme under-valuation at this **Supercycle Degree**. At the turn of the century, just eleven years ago, the multiple on the S&P 500 was 25 for 12-month forward earnings; its nearly half that now. As we know, the market discounts the future. When earnings appear to be cyclically peaking, investors instinctively expect they will drop. That's why P/E

ratios fell for all 2011. Yet all this logic fails to account for the pendulum principle of extremes in human psychology.

Humans, acting collectively, buy not just stocks, but all things, when prices are climbing, based on the primitive mind's linear projections. This is the same scarcity principle marketers prey on to get us to buy now, they invariably stipulate “for a limited time only”, meaning: buy now before you miss it. Although everyone knows that “trees don't grow to the sky”, most of us still get caught up in the frenzy of meteoric price rises, acting as if this time were different. Rather than investing with “*left brain*” logic, we continue fall back the same “right brain” vestigial instincts of our primitive ancestors. Human survival instinct dictates that if there's likely to be a famine ahead, we need to stockpile sufficient food to survive...however we fail to distinguish between survival and lifestyle.

Investors have jumped the gun

On the other hand, when prices begin plunging, we envision them going to zero, regardless of time horizon or value. Just like “value” doesn't cross anyone's mind in a crash, neither do notions of “value”, come to mind when stock prices begin shoot up like a rocket. For that very reason, when markets look expensive at *Supercycle Degree*, they tend to go to extreme valuations. If this were not an instinctive human reaction, then logic would overrule the ego's tendency towards irrational exuberance. What makes market patterns so fascinating is that they alternate, to produce a similar result, via a camouflaged process. Concurrently they observe cyclical patterns, large and small. This time, investors have jumped the gun, there's no Crash in the horizon. In the meantime, all the money that has gone into bonds and money markets must flow back into stocks; ironically this will set the stage for the Crash.

Three steps forward, two steps back

The market follows the larger pattern: three steps forward, two steps back, at every degree of trend. If we can accurately forecast the trend and ride the wave then reverse our positions near the peak, we will be compounding our capital faster than ever as most investors give back all the profit and then some. Record velocity, should translate into record profit in both relative and absolute terms, after all a Market Crash of these proportions comes around only every third lifetime. Only through an Elliott lens can we step back and observe as the herd abruptly reverses both direction and sentiment.

As you well know, the market is a fractal, a structure which remains the same, no matter how much it is blown up or scaled down. Catching a ride on the largest degree fractal is what Mandelbrot called a “Noah effect”—cataclysms like the Great Flood, which he distinguished from the “Joseph effects” (seven bountiful years, followed by seven lean years). It's the “Noah effects” which make or break investor fortunes.

Kind regards,

Eduardo Mirahyes

Exceptional Bear



"Opportunistically timed investments that mazimize wealth"

