Exceptional Bear Market Letter™

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Why the Crash will come ***earlier,*** rather than later

The reason the crash will likely come sooner than most expect, is that to be effective, it must come as a complete surprise, so that the Fed does not have sufficient forewarning to prop up the market artificially by buying futures to overwhelm program trading's sales. Other than its ***surprise*** occurrence and ***velocity***, there are few similarities with the 1987 crash. 1987 was a ***correction*** within a (green) *Diag II,* which heralded the longest Bull Market in History, & the most *bullish* of all patterns.

Supercycle Wave (II) - Diag II (A)-(B)-(C) *1906-1932*

The 1929 Crash – *a surprise ambush, at precisely the current wave location*

The *fast and furious* 1929 crash originated from precisely the current position as *wave (i)* of the *Diag II, (red) which previewed the long plunge to the 1932* ***Wave (C) trough.*** At the time, 10% margin requirements meant that the vast majority of investors were *wiped-out* with the initial 10% drop. Like a gigantic "***stop applied concurrently across the board"*** the remaining 90% of portfolios had to be *immediately liquidated to protect the brokerage firm's capital*. As the chart shows the 1929 Crash was only a ***47% plummet***, and far less dramatic dive from Dow 290 in 1930 to ~Dow 15 in 1932, a 94.8% plunge over two years as opposed to a couple of days. The collective consciousness only remembers the Crash, for its *swiftness.*

Swift as the 1987 Crash, ***accelerated by program trading***

In a *free-fall,* the *effects* of ***portfolio insurance & program trading*** ***are*** nearly identical. Portfolio insurance was supposed to guarantee against losses in the long portfolio by selling futures ***"short".*** *In practice,* ***portfolio insurance*** magnified the plunge's acceleration, to an avalanche. At the point of recognition, there were *no* futures *buyers*. The sudden increase in *supply,* concurrent with *demand* drying-up, resulted prices going into a rapid downward spiral. Currently, program trading accounts for ***70% of all trading volume,*** & capable of doing proportionately far more damage than 1987's portfolio insurance.

Barron's Big Money Poll – *the effects of herding at a Major Market Top*

The responses to Barron's Spring Big Money Poll, ***favors technology, financials & dividend-paying blue chips, but remain bearish on bonds and oblivious to shorts and inverse funds.*** Barron's poll epitomizes the investment profession's *collective denial & disconnect from reality,* while the ***strategic allocation*** *of "other people's money"*, virtually guarantees a catastrophe beyond imagination.

Vulnerably long *- blame the* ***Black Swan***

Rather than optimizing portfolio returns within an acceptable level of risk, those entrusted to shepherd the bulk American wealth remain more *preoccupied with job security than capital preservation.* While marching to a different drummer would likely lead to a loss of clients & even prompt dismissal, as long as these professionals *tow the line. Colluding complacently with the rest of the industry, in principle,* their jobs are secure. So long as the *competition loses as much*, catastrophic losses will be blamed on the ***Black Swan***[1]***.*** The Black Swan below is positioned at Dow 572, its minimum downside.

Delusion - *Economic expansion can be sustained in perpetuity*

The investment industry is built upon the delusion that *Bull Markets are the norm*, and that when they *misbehave,* can be artificially sustained in perpetuity by the Fed. ***The linearly-projecting public cannot conceive of generating a profit from plummeting stocks.*** *In Bear Markets, a Bull Market mindset* results in either investor ruin or hibernation. Either way, the brokerage industry's order flow dries up, profits plummet, and massive lay-offs become inevitable.

Barron's poll envisions the best of all possible worlds

Barron's poll reads like a *fairy tale*: 69% of respondents expect GDP to grow between ***2.5%** & **3.0%*** in 2014, 51% sensed *inflation,* ***rather than deflation*** as the primary threat, and expected the dollar to *strengthen* against the Euro & the Yen, by 59% & 72% respectively. 55% were *bullish* on the Market, 35% were *neutral* and only 9% *bearish* or *very bearish*. 73% viewed the market as *fairly valued*. Of respondents, 58% believe the US will outperform ***all Markets*** in the next 12 months, while 71% expected equities to outperform all other asset classes; neither ***bonds*** *nor* ***inverse ETFs*** *were even considered possibilities.* 89% of those polled were *bullish* on US Large Cap stocks, the identical number as *bearish* on T-bonds. Despite the recent surge in T-bonds prices, concurrent with the lowest 10-year yields in ten months, 55% still expected *negative returns* in fixed income over the next 12 months. European stocks and Real Estate were tied for second place with a 78% *bullish* consensus reading. 63% remain bullish on small-cap US stocks, despite a 10% plunge since their peak on March 4. 68% of respondents still *expect earnings to meet or beat analysts' estimates*…and 82% expect *P/E ratios to expand* or remain unchanged. …it would appear the Big Money Managers are living in a dream world, buttressed by their own herding instincts. *Collective realization that the* ***"Emperor has no clothes!"*** will surprise sooner than most perceive.

Although ***"smarter than the average Bears"*** ***vehemently disagree*** with every single one of unexceptionally *foolish* opinions, we also recognize that such a ***"disconnect between sentiment & reality"*** is a ***hallmark of all Major Market Tops***. If these managers dared to think independently, the market's self-correcting mechanism could not result in Trillions of dollars vanishing in a flash – all Fed-sourced liquidity and then some.

Alternating rallies & plunges ending in crescendo-Crash

These consensus opinions voiced above are completely *at odds with* empirical evidence reflected both technical & fundamental analysis. As the ***emotional knee-jerk reactions*** reflect *collective human* ***unconsciousness,*** Elliott patterns keep time with the swing of the Market pendulum. *From overvalued and overbought, to dirt cheap & oversold*. Since the dawn of humanity, Human Nature remains *unchanged*. The same *adrenaline-fueled fight or flight* reactions which assured *survival of our species* despite relative safety from man-eating predators, persist today.

Alternating ***See-Saw*** emotions manifest as alternate *Rallies* & *Plunges* to provide the *framework* for the *Bearish* *Diagonal Triangle type 2 (Diag II). Diag IIs accumulate energy like a spring being tightly coiled, to spring-down in the* ***E-wave,*** *like a Jack-in-the-Box, pulled down like a free-falling object accelerated by gravity.*

Diag II - *Log scale understates its perceived magnitude*

In the ***Exceptional Bear Century Count*** below, you see several repetitions of the *Diag II* signaling long Bear Markets ahead. The *Diag II* reciprocal indicates the *beginning of a long Bearish trajectory,* just as its reciprocal *Bullish Diag II* forecasts a nascent, protracted Bull Market. The wave count below, configured in ***log scale***, represents each increment as ***10x*** the previous magnitude. Despite this distortion, the *Bullish Diag II* spanning *1987- 1991* heralding in the longest Bull Market in history, remains *dwarfed by* its *Bearish* reciprocal in process. Logically in log scale, if their forecast trajectories were of similar length, the current *Diag II* would be ***dwarfed*** by the former *Diag II*. Just the opposite is true, the current bearish structure dwarfs its same-degree bullish equivalent. As RN Elliott chronicled, the Black Swan positioned at ***Dow 572*** indicates *the minimum retracement* to the previous ***4th Wave*** of one lesser ***degree***, most likely its *extreme*. This is precisely why the correct count is so critical for forecasting, reconciled against a century of values from Smithers & Company Research, and Mandelbrot's corrective fractals, this long wave count is far superior to any previously available. As you see ***Cycle Wave IV*** was also an ***A-B-C*** Bear Market, where the ***A***- *wave* bottoms in the lower of two troughs. Its final ***e-wave*** = ***A,*** and also contains an *echoing,* lower degree, *Diag II fractal,* to reinforce the relatively long trajectory of the final segment, just shy of ***50%.*** As you note here 50% has now cropped up 3x, in our forecast last week for *Wave (i)* of the *Diag II* via its previous gravitational retracement, coinciding with the amount of the 1929 Crash including the follow through to the temporary trough, and the same 50% plunge in ***Cycle Wave IV*** from 1972-1975. ***Fifty percent*** is the second most common Fibonacci retracement after 61.8%.

To ***alternate*** with the 1929 Wave ***(C)*** Crash, the current Crash must occur in ***wave (A),*** just as demonstrated in ***Cycle Wave IV. Cycle Wave IV*** *(1964-1979)* is the ***previewing fractal*** of the current ***Supercycle Wave (IV).***

Bear Market Sucker's Rallies

Bear Market Rallies *create the* ***illusion of recovery*** *& safety, when in fact they sucker-in more investors for the "long run" Crash.* Each time a *false Bull Run* in waves ***B*** *&* ***D*** reverse, the corresponding losses dramatically increase from the previous. Finally an ***E-wave*** crescendos to astronomical proportions, to crash in ***wave (A)*** of an ***(A)-(B)-(C)*** Bear Market. Like the Sirens' of Homer's Odyssey lured ancient mariners to Crash on jagged rocks, Waves ***B & D*** of the *Diag II* similarly fool investors to invest *fully margined* right at the top. In a herd of Wildebeest, ***direction reverses in a flash, & accelerates to stampede*** from the scant scent of a lion. The point of recognition is the midpoint of a market free-fall. Fueled by adrenaline, mass hysteria accelerates the ***Panic*** *flight for survival* into a self-perpetuating *free-fall.*

Economic Contraction, Deflation and a Bear Market Plunge

Despite the Big Money's overwhelming Bullish consensus, at least some investors are *running scared*, small-cap stocks have plunged 10% since their peak on March 4, while *ultra-safe* utilities have topped the list of best performing equity sectors this year. According to Barron's, 90% of large-Cap *value & growth* funds have lagged their benchmarks since January. Just as the big money pros nixed bonds, in the week ended April 30, *retail investors* poured nearly $1bn back into bonds, while bailing-out of $4bn in stocks.

Whip-sawed by a reversing Market

Even investors who refuse to be taken for fools get ***whip-sawed*** by poor timing. Despite convictions, which prompted the *flight to safety* into bonds in the last week of April, these retail investors *acted late & overpaid*. *In fact, we* ***sold*** *into their buying.* When the price of bonds subsequently pulls back 10-12% below their cost, few will have the conviction or *staying power* to hold onto those bonds. If they don't get *stopped-out* first, most will likely *interpret the drop to mean they were wrong,* and bail-out, just prior to a triumphal Spike.

Stress & confusion are the nemeses of money-making investments

With the series of *asset classes* continually initiating plunges, as those which plummeted earlier begin *contra-trend* bounces, investors become *stressed & confused.* Such *anxious mindset* is the ***nemesis of un-attached, logical thinking, required for successful investing***. Allow yourself to fall into this state, and you lose the ability to think. By default, your *primitive animal instincts* take over. Wildebeest too, developed collective premonition to warn of lurking lions. This forewarning is responsible for their survival; they too become *restless.* Similarly, corralled, domesticated animals demonstrate acute stress when threatened by an impending earthquake or volcano eruption – their *flight instinct is being activated but with human fences they cannot escape, while wild counterparts have long evacuated.* The human version of market stress results in confusion & nervousness *prior to a Crash*, that's why this is a superlative indicator of looming danger.

First touchpoint of each *Diag II* must be retraced

Although peak prices are behind us, *what no one realizes* is that ***the uppermost*** *Diag II* in every chart ***must be retraced*** ***before the plunge can initiate.*** ***That is precisely why we are currently positioned long, opposite to the Crash allocation,*** and continue to trade partial positions at every opportunity. That way, should the plunge delay we get paid to wait. On the contrary, those who bought bonds as we ***sold them short*** via the inverse ETF will likely make the same mistake twice. Biotech, financials and small cap plunged several weeks ago and are now rallying, these we hold. At the minimum upside we begin scaling out. We often leave a little on the table, so it's highly unlikely that we'll ever get caught on the wrong side from greed.

Footnotes

[1] ***Black Swan*** *is the term coined by Nicolas Nissam Talbeb and the title of his bestseller, several years ago. Benoit Mandelbrot referred to them as a* ***"Noah events",*** *to refer to a cataclysm such as the Great Flood, which left few survivors. In sharp contrast, the far more common* ***"Joseph events",*** *are accounted for in financial modeling. It refers to the "7 plentiful years, followed by 7 lean years in old Testament Egypt". Joseph interpreted Pharaoh's dream of seven lean cows emerging from the Nile, to eat the seven fat cows correctly, to storehouse grain and avert famine during the lean years. In a brilliant commodities trade, Egypt earned a tidy profit by selling surplus grain to neighboring nations at market prices. As Mandelbrot proved nearly 50 years ago, such* ***"fat tail"*** *risks are far more common than anyone in the financial industry cares to admit. Wave (A) retracing to the previous* ***IV****th Cycle Wave* ***trough*** *– one degree lower, and half the magnitude as the current Supercycle (IV). Dow 572 corresponds with the extreme of the* ***Cycle IV's Wave A*** *in 1975, such a cataclysmic event. It offers the potential to* ***make or break investors for a lifetime****.*

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Eduardo Mirahyes

Exceptional Bear

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