CYCLES RESEARCH EARLY WARNING SERVICE

by Bill Meridian

Summary

This service moved to a buy signal on the stock market at the close on July 23rd by interim report. Cycles Research moved to a buy on gold as of Friday's close on May 29. A buy was issued on bonds as of the close on Monday, July 1.

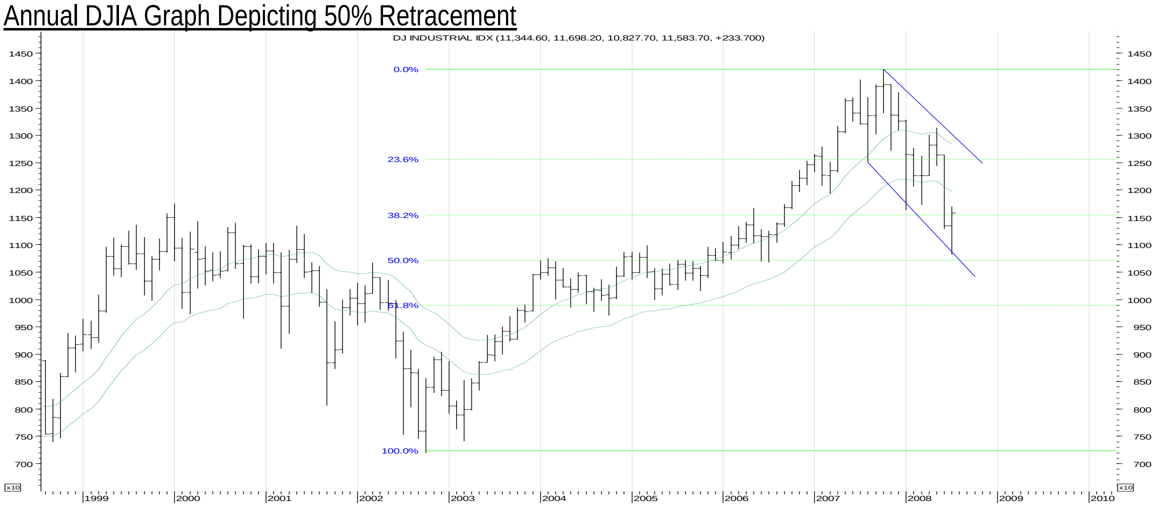
Analysis

First, we will review the shorter-term cycles and market projection. Then we will look at the longer-term picture and what type of future environment the market is reflecting.

The current rally in equities that began in mid-July is likely to end in mid-August. Here's why. The Dow hit the bottom of its trend channel on July 15th and rallied as depicted in the weekly graph below. The monthly graph shows that the market decline traced about 50% of its prior decline.

Weekly DJIA Hitting Lower Trend Channel

Annual DJIA Graph Depicting 50% Retracement



Most reports do not discuss astronomic indicators because, first, they are not the major factor at all times, and, second, most readers will not want to read about the technical intricacies. For example, eclipses attract much attention, but my study of their effect on the stock market since 1915 shows that only about 1 eclipse in 3 has any effect on share prices. The eclipse that occurs on the first of August is in the sign of Leo. Analysis shows that the market has fallen about half of the time in the 10 days after the eclipse. Twenty days after such eclipses, stocks have been up 10 times and down 8. About 20 days after the eclipse, however, the market has begun a decline about two-thirds of the time. This projection is supported by the next 2 cycles.

Mars is 180 degrees from Uranus on August 6th. On average, this has been the high point in this 1.8-year cycle since 1915. The actual high typically occurs about 14 days later after the exact opposition. This would suggest a high around the 20th. On the 19th, Mars enters the sign of Libra, also the high in this particular cycle. As we know, September is the weakest month in any year, on average. It is logical to assume that any peak in either of the two 1.8-year cycles in the month of August will add to the likelihood of September being a down month. Since 1900, this has been true in 1931. 1933, 1935, 2000, 2002, and 2004. The year 2006 was the only exception. Regarding the second cycle of Mars through the signs, there have been 9 entrances of Mars into Libra since 1900. In 1914, the market was closed due to WW1. September was a downer in 1929, 1931, 1946, 1961, 1978, and 1993. In 1944, the market fell but hit a low on September 14th. In 1976, stocks rose in September. Thus, in this small sample, these 2 cycles have dragged stocks down in the month of September most of the time.

Thus, the sum of these cycles suggests a high near the 20th. As veteran readers know, there are numerous anniversary dates of past highs between the 20th and 25th of August. Reviewing the turning points at the end of this report, we see that the 8th, 15th, and 22nd are projected as potential highs and lows. Combined with the cycles, it appears that the 15th or 22nd will bring a new leg down into September.

The Longer-Term Cycle

My original forecast called for a choppy first half into a June low. Part of the reasoning was based upon the facts that 2008 is an election year and that the market has always made its low prior to April 1st. In June, the Dow broke below the March low for the first time in 150 years in a year ending in '8'. The failure of the March low to hold can be added to a list of such events, including the failure of the end-of-month strength in the Dow in February of 2007, and in October, December, May and June of 2008. In addition, December, usually the strongest month, was weak in 2007. If one believes in cycle theory, then the explanation for the failure of all of these reliable phenomena can be attributed to a stronger long-term cycle that is pressing down. From 1800 to the present, the stock market has tended to move in 15 to 18-year periods in which it rose at an above-average rate of 15% to 18% annually, followed by 16-year periods of no growth. The last such period ranged from 1966 to 1982. We entered such a period again in 2000. What is the market telling us?

Parallels: It Looks More And More Like The 1970s

- I received 2 reports from a pair of names that were very well known in the seventies- Howard Ruff and Jim Sinclair. They were two of the original stock market bears and commodity bulls in that era. Their outlook again fits the current situation.
- During that decade, the Hunt Brothers attempted to corner the silver market. I recently read that Bill Gates now owns 35% of all of the silver in the world.

- The International Monetary Fund has proposed the sale of 12 percent of its gold reserves, as it did in the 1970s. The IMF has stated that it needs the proceeds to lend to troubled countries in this downturn. When Nixon closed the US gold window in August 1971, gold increased from $42 to $185. The rally ended when the IMF announced a gold sale in the summer of 1975. Bullion fell to $105 within a year. This was followed by a rally to $850 by January 1980. Gold increased from $250 in August of 1999 to $344 by October. In December 1999, the IMF sold 14 million ounces. The IMF sales drove gold down to about $250 in early 2000. In each case, gold came back stronger after each attempt to suppress it.

From 1966 to 1982, there were several rallies that were hailed as the beginnings of new bull markets, only to hit a high and then decline again. The same was true of declines that were seen as the beginning of new bear markets. At the end of that period, we looked back to see that it was a large trading range. During this period, many of the fundamental problems that had been created in the prior period were liquidated or rectified, setting the stage for a new period of economic growth.

In the 1970s, the markets simply trended lower and lower on reduced volume. As I wrote in a past report, the only thing missing from the 1970s is a 50% drop in the Dow and 15%-18% interest rates. The market is looking forward and does not like what it sees. It sees President Obama, higher taxes, very expensive 'free' health care, etc.

<u>Investment Strategies Then and Now</u>

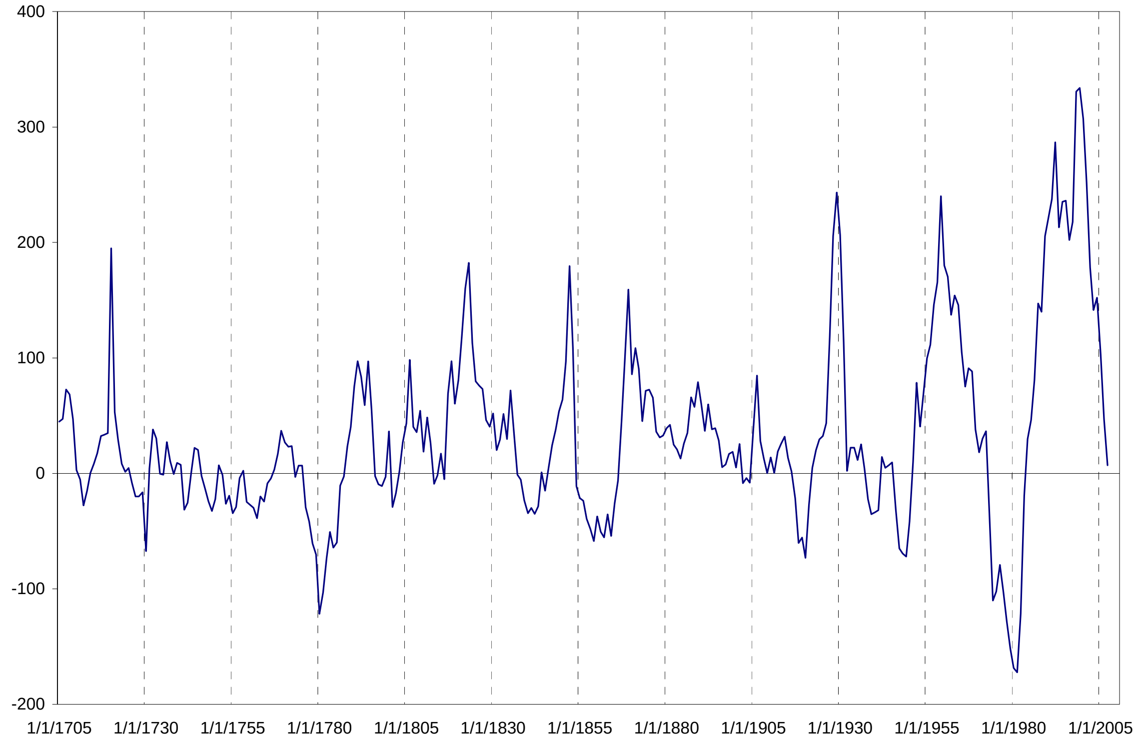
In the 1970s, the buy-and-hold equity strategy netted out to zero return from 1966 to 1982. Adjusting for inflation, there was a very real loss in purchasing power. Bonds plunged in a bear market as rates soared, a shoe that has not dropped yet. Hard assets such as gold and art went straight up into 1980. There are currently about 7000 equity funds and about 50 commodity funds. Apply contrary opinion to these numbers, and I think you can see what direction we are headed in.

During this period, investors adjusted their methodologies and strategies to fit the new era. Overbought/oversold oscillators, market timing, and trading were in. As one observer said to me, fundamental analysis failed, so technical analysis stood out. I met Frankie Joe in New York, one of the Street's most successful traders. He ran $600 into over $30 million for himself and Interstate Securities over 15 years without having a losing year. He made most of his money going short. When I asked him why, he explained that walking up the stairs to the top of the Empire State Building takes about 2 hours. Jumping off of the top will lead one to the bottom in only about 1 or 2 minutes.

In: Trading and holding commodity-based or hard assets.
Out: Buying and holding stocks and bonds.

In an attempt to gain another perspective as to where we are in this equity/commodity switch, the following graph was constructed. I wanted to divide stock prices by commodity prices, but this would not have drawn a realistic picture for the following reason. Stocks tend to continually rise for three reasons: population growth, technological development, and inflation. Thus, advances in stocks are followed by retracements of the prior advance, most commonly 50%. Over time, stocks appear to follow a spiral upwards. This does not apply to commodities, which tend to fall in price over time because entrepreneurs continually find ways to reduce the cost of production and the price. So I obtained UK stock prices spliced onto US stock prices back to 1700 and commodity prices over the same period from the Foundation for the Study of Cycles. Richard Mogey kindly did the calculations, converting price to 10-year rate of change. He then divided one by the other. The graph below shows that commodities had appreciated much more rapidly than stocks into 1980 when the relationship reversed. In 2000, stocks peaked and commodities rose. The graph tells us that this relationship is not yet at an extreme. In fact, it appears that we are mid way on this course and that further commodity price appreciation versus stock prices can be expected.

Stock Price 10-Year Rate of Change Versus Commodity Price Rate of Change 1705-2007



Source: Richard Mogey, Foundation for the Study of Cycles

The Banking Crisis Cannot Be Over

As stated in earlier reports, the financial stocks have been looking forward and discounting a very negative future. I suggested that their business model that had generated big profits over the last decade was not workable in the future. Now there is an accounting change in the works that will force financial institutions to place off-balance sheet and unsaleable debt back onto their balance sheets:

From Americanbanker.com: The Financial Accounting Standards Board, which has moved quickly to radically alter the rules for how banks must account for so-called qualified special-purpose entities, or QSPEs. Reform is needed and probably inevitable, but is FASB moving too fast? Some banks may sit on QSPEs, whose values are almost equal to their balance-sheet assets, analysts say. Forcing financial institutions to load up their balance sheets too soon with these still largely untradeable holdings could prolong the financial market's misery…Now comes a rather under-the-radar bombshell. FASB has decided to "eliminate the concept of the QSPE" in the revised financial-accounting standard, FAS 140, and also will "remove the related scope exemption from FIN 46R,"… FASB is sill studying actual implementation and disclosure issues, but it seems pretty clear those unpriceable, lamentable assets are headed for the balance sheets.

Final FASB board deliberation is expected this month, with a public comment period starting in July, followed by a roundtable, at which critics are invited to “meet publicly with the board and debate,” Goldin notes. The changes could be finalized by late in the third quarter. The effective date: June 2009.

The banks create the liquidity that leads to the next boom, so these are indications that the economic slowdown will be prolonged.

Government Interference Will Prolong the Crisis

The following excerpt is from pages 203-204 of Planetary Economic Forecasting:

“The deflation from 1839 to 1843 liquidated unsound investments, bad banks, debts, and the Bank of the United States. Professor Temin, writing in Jacksonian Economy, has demonstrated that the percentage of deflation over these 4 years was about the same as that of 1929-1933. However, the effect of real production was startling- production actually rose from 1839. Temin presented the following numbers:

Category	1839-1843	1929-1933
Real Gross Investment	-23%	-91%
Real Consumption	+21	-19
Real GDP	+16	-30
Money Supply	-34	-27
Wholesale Prices	-42	-31
Banks	-23	-42

How could this deflation have been so much milder than that of 1929-1933? The federal government regarded falling prices as bad, so they did all they could to prop prices up, and this prolonged the crisis. I think that this was due to the discovery of Pluto on February 18, 1930. Charles Jayne said that Pluto was the power of government; it was the power that held government together. The federal government of 1839 was not as powerful as that of the 1930s; it did not have Pluto power. This power enabled Washington to interfere massively and obstructed the natural process that needed to occur.

Much of this period was consumed by Jacksonian efforts to use metallic money, specie, or paper money 100% backed by metal, only. The laws were changed regarding the use of silver and gold, but all efforts were upset by the discovery of new gold mines in Russia, Australia, and California. The latter occurred in January 1848, either on the 18th or the 24th, based upon different references. From the 1830s to the 1850s, world gold production increased by 12 times.

The panics of the late 1830s brought a general mistrust of the banking system. The result was what was termed “free” banking, although it was not free. Banks were easier to open, and banks were permitted to suspend payments if they encountered problems. Worst of all, banks were permitted to expand notes in proportion to the amount of state securities that the bank purchased. Thus, the banks monetized state debt; more state spending led to greater bank reserves which led to more paper money. This was, again, inflationary.”

Bonds

I am remaining on a short-term buy as of the close on July 1st. I think that the 2 graphs below tell the story for the bond market. The third chart is a very long-term view. The daily chart shows that bonds have corrected their advance and appear ready to move higher and relieve their oversold status. In Elliott terms, this could be a C wave up. There is support from both a sentiment basis and from the short-term cycle composite.

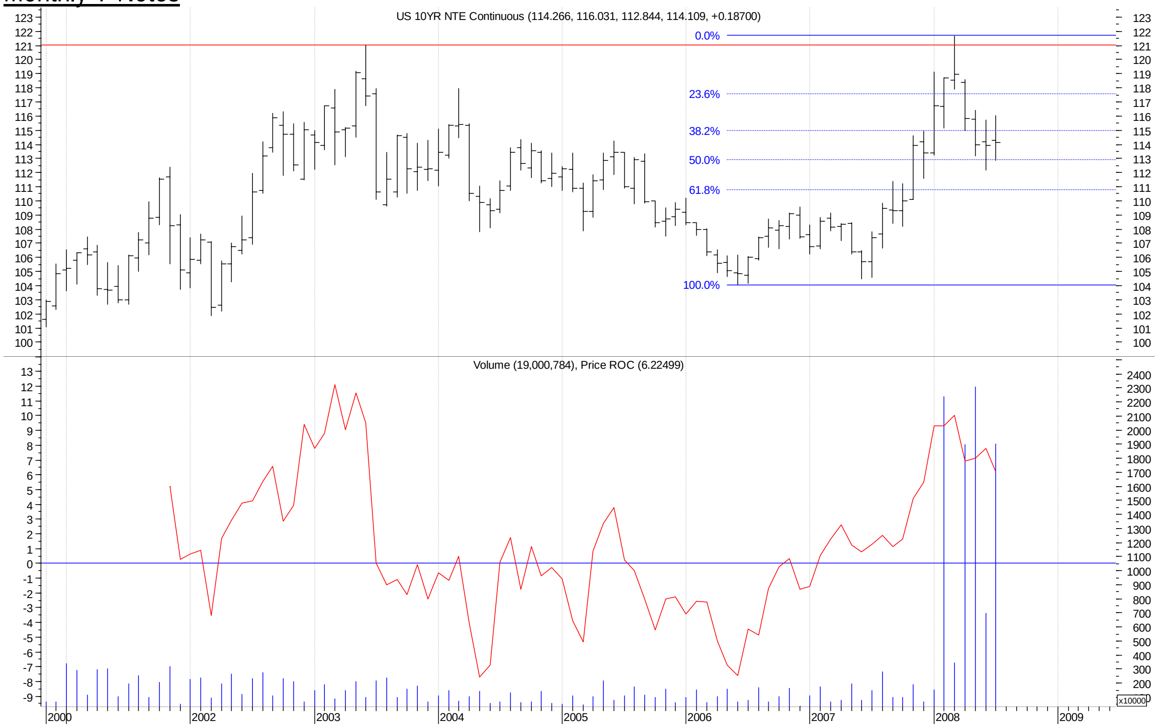
The percentage of bond bulls reported in Barrons weekly fell from 69% to 59% in one week. This 10% decline is that largest in more than 3 years. There was a 7% drop on February 23rd when bonds began a sharp rally into the March top. In addition, there is a great deal of bond call writing. This means that traders are writing calls in the hope that they will expire worthless, so that they can pocket the premium. If we apply contrary opinion, they are incorrect, and bonds should rise.

Regarding cycles, there are two facets to view. First, the seasonal cycle shows that bonds are usually strong. For the last 27 years, bonds have risen about 63% of the time from August 7 through 21. The composite of short-term trading cycles suggests that the next meaningful high is due in the days around August 18th. The old high of 116.06 is likely to be exceeded.

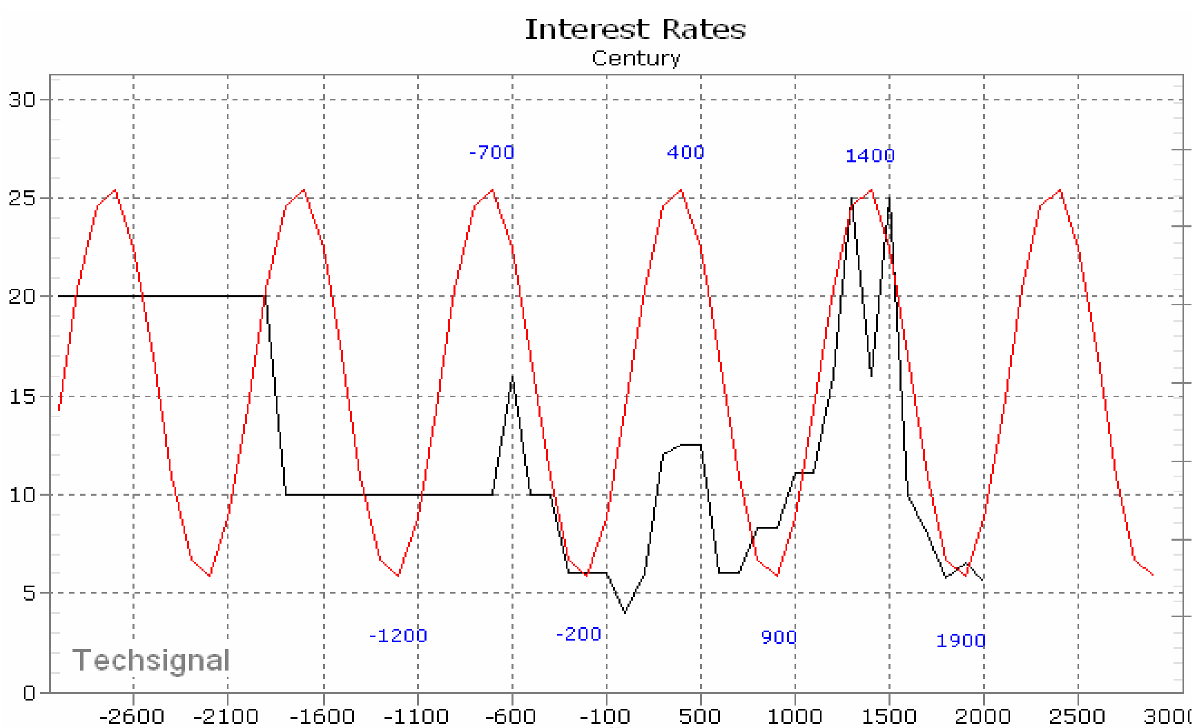
Longer-term, I still think that the bond bear is out of the cave. The monthly graph depicts the 2008 rally that did not meaningfully breach the 2003 high, tracing out a giant double top. The momentum oscillator remains overbought, so I do not think that bonds have completed any longer-term correction. In addition, I note that Paul Montgomery at Montgomery Capital Management has observed that corporate bonds have been weaker than governments bonds, a sign that the latter is likely benefiting from a flight to quality.

Daily T-Notes

Monthly T-Notes



Just out of curiosity, let us look at the very long-term picture. The following graph is that of interest rates each century from BC times. The data is from the Foundation for the Study of Cycles as graphed by the Techsignal program. When someone owes you money, you are very likely to keep track of interest rates. They did so in ancient times by carving the numbers into pottery. According to the dominant cycle, rates bottomed in 1900.



Sectors and Groups

Energy

The correction in oil appears to be a normal correction in an overall bull market. The weekly graph below shows that oil hit the upper line of the trend channel and then broke the lower trendline. Oil has already halted at the 23.6% retracement level and shows a 38.2% retracement level and a trendline at 108-110. In strong bull markets, corrections are usually shallow, in the 25% to 38% range. Corrections are usually in 3 waves: A-B-C. I only see one wave down, so the current move up that began in the last few days is likely a B wave up, to be followed by a C wave down, likely to the 110 area. There is also a possibility that an A-B-C irregular correction has already been completed. In this case, the rally to the new high was the B wave and the decline to 120 on the July 29 low was the completed C wave. The weekly graph below shows that oil is becoming oversold, and the daily graph shows a bullish divergence between price and the momentum oscillator.

Weekly Oil

The seasonal cycle favors a low soon. The table below shows that the period from July 25th to October 17th has been strong, on average from 1983 through 2007. The table shows that oil has risen 10%, on average, and oil moved up 67% of the time. So, we multiply 10% by .67 to arrive at an expected return of 6.7%. This happens over 84 calendar days, so this number is annualized to arrive at 28.97%. On this basis, this calendar period is the second most bullish in any year.

OIL
BULLISH CYCLES

NO.UP	TOTAL	PERCENT UP	PERCENT MOVE	EXPECTED RETURN %	DATE 1	DATE 2	DIFF. DAYS	ANNUALIZED EXPECTED RETURN %
18	24	0.75	7	5.25	24-Feb	17-May	82	23.37
16	24	0.67	10	6.67	25-Jul	17-Oct	84	28.97
14	22	0.64	5	3.18	11-Dec	17-Jan	37	31.39

Analyzing historical turning points, we see that most significant highs have occurred in the months of January or October. The least meaningful turning points have occurred in the month of July. This supports the notion that the July high was not a major turning point.

Here's What the Oil Market is Discounting

The voter approval of Congress has declined to 9%, which is the lowest level in history, as far as I know. There is a good reason for this. The public correctly perceives that Congress is blocking drilling. I wager that there is an inverse relationship between the oil, price and congressional approval. In fact, I once totaled the approval ratings of Congress, the President, Al Qaida, and the Democrats, and it does not total 100%. Some of these are supposed to be opposites. If they were, would not about half favor the President and half favor Congress and/or the Democrats? Could it be that none of these entities benefit the people that they claim to represent? I think so. I actually heard Nancy Pelosi state that the way to bring oil prices down is to open up the strategic oil reserve and to stop US imports of oil (all imports go to Puerto Rico). This suggests that an increase the supply will reduce the price, something that her party continues to block. It is estimated that her recommendation will add 3 to 4 days of supply, hardly a long-term solution. The 9% approval rating shows that the people are wising up.

What will the solution to the energy question be? I think human ingenuity and free enterprise will be the answer, as Dr. Julian Simon details in The Ultimate Resource. Dr. Simon reminds us that common items such as copper and sugar were luxury items. In fact, the word salary is derived from the word salt because Roman soldiers were once paid in salt. In the movie From Hell with Johnny Depp, the filler lures a girl into his carriage in old London with the offer of grapes. Grapes were only affordable to the wealthy at the time. How did all of these items decline in price? Entrepreneurs applied their ingenuity and energy to the production process, thereby lowering the cost and making the items affordable to most people. The current high price is motivating such persons to develop alternate energy sources and to increase production of fossil fuels. I saw current diagrams of the Austrian oil fields compared to the same oil fields that were described with old technology. New measuring devices reveal that the existing fields have far more oil than originally thought. The May 23 Wall Street Journal stated that Brazil struck oil 155 miles off of its coast. The strike is close to its Tupi field which was discovered 2 years ago and is the largest find in the Western Hemisphere since 1976. It was found because the high oil price motivated entrepreneurs to look for it. The new field presents some technical problems, but these challenges are likely to be overcome.

I agree with Dr. Thomas Gold, author of The Deep Hot Biosphere. Dr. Gold writes that oil contains traces of substances that come from deep below the earth, thereby challenging the idea that oil is made from compressed organic material near the surface. This belief, says Gold, leads oil companies to only search certain areas. His theory suggests that oil is far more available if one only looks in the right places. In order to support his theory, he raised funds to drill in Swedish granite, an area that is not supposed to contain any oil according to theory. He came up with 70 barrels of dirty, unusable oil, but it was the black gold, nevertheless.

Who Owns Oil Stocks…

…the API asked. Here is the answer:

OWNER	PERCENTAGE
Mutual Funds	29%
Pension Funds	27%
Individual Investors	23%
IRAs	14%
Other Individual Investors	5%
Corporate Insiders	2%

If you have a retirement fund, the answer is that you own the stocks. These are the companies that the politicians want to penalize.

Gold

Let's see. Gold bottoms in the month of August, on average. In bull markets, this start date advances to July. But the current rally began on May 1st. This suggests a condition that I have frequently made about the limitations on cycles analysis. How do we know that there is some long-term cycle that has only repeated once or twice in human history? The cycle may be longer than recorded history, and it may have wiped the pharaoh out of all of his wheat positions the last time it occurred. We do not know because we have a limited amount of human history. My planet-watching pals and myself refer to this as the effect of the great undiscovered planet, Bogus. (One can attribute all cycles-based failed forecasts to Bogus). If a rally that usually occurs on average in July-August actually begins in May, I assume that some other cycle that remains unknown is lifting the price. Thus, when we get to the seasonally-strong August-September period, the yellow metal is likely to accelerate to new all-time highs.

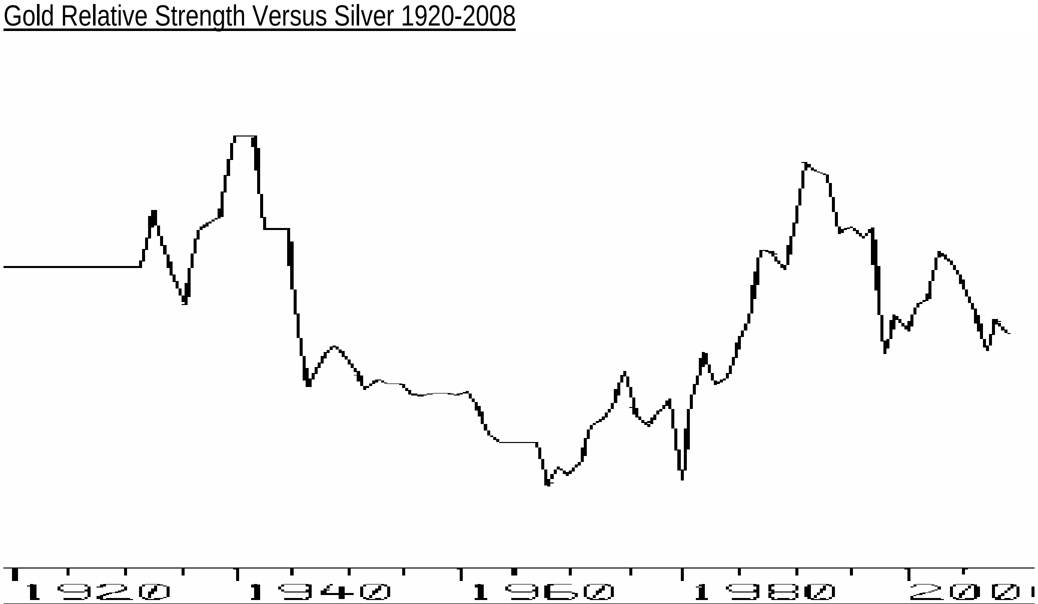
Cycles extracted by spectral analysis (graph appeared in the last issue) bottoms in July. The composite of short-term cycles bottoms now. Thus, the annual, spectral, and composite cycles all point up.

Gold sentiment appears bullish. I had mentioned that individual investors had lined up to buy gold metal at the office of Deak-Perrera in New York City in 1979-1980. A reader sent an e-mail in which he stated that such individuals are aggressively selling gold at pawn shops in the USA. The weak state of the economy likely has brought some of this selling on, but as a contrary opinion signal, these sales are bullish. On a quantitative level, my option indicators also show excessive bearishness.

Daily Gold

From the 1960s to the mid-1980s, gold outperformed silver. Silver has outperformed since, but the graph below suggests that this relationship is not at any extreme.

Gold Relative Strength Versus Silver 1920-2008



Individual Stocks

PORTFOLIO

Stock	Buy Price	Buy Date	Current Price
Electronic Arts-ERTS*	61.12	Nov. 1	43.18
Genzyme-GENZ*	75.01	Oct. 29	76.65
Varian-VAR*	48.41	Oct. 29	61.7
Buy-Gold ETF- GLD	91.4	July 1	90.08

*High cashflow generator

Strategy

Investors sell into strength. Hold resource ETFs.
Traders play the market from the short side after mid-month.

Notes from The Middle East

One note that I did not include in July's letter drew a laugh from a subscriber in a phone conversation. I visited the home of an old friend in Abu Dhabi. He told me that it was quite easy to start one's own TV channel in the UAE. Many wealthy people have done so. He took me through the stations and settled upon something that I had never seen before-a camel beauty pageant. He explained how camels are evaluated. The winner is placed at the head of the final precession through the desert, wearing the national flag. I had never seen anything like it.

What the Media is Not Telling Us

- The ARI reported that the USA transferred 550 tons of uranium to Canada to be processed into fuel. The uranium was from Iraq. It was weapons-grade yellowcake. The media did not make much of the news of the WMD that Saddam was not supposed to have.
- This item was picked up from StraytegyPage.com on July 21st: American troops in Afghanistan are not happy with how a July 13th battle with the Taliban was reported. In that action, some 200 Taliban attacked a U.S. "base" and killed or wounded more than half the 50 or so U.S. and Afghan troops found there. Actual U.S. casualties were nine dead and fifteen wounded (including walking wounded). U.S. troops were irked that, once again, the mass media got lazy and didn't bother to report the action accurately. For one thing, there was no "base". What the Taliban attacked was a temporary parking area for vehicles used to conduct patrols of the area. These are set up regularly, and have been used for years. These are secure areas, but basically a parking lot surrounded by barbed wire and several sandbagged observation posts. This one was set a few days before the attack, and was due to be taken down soon, as the patrol activity moved to another area. Such defensive precautions are taken any time U.S. troops stop for more than a few hours. That's a tactic pioneered by the Romans over two thousand years ago. In this case, it paid off. The Taliban infiltrated several hundred fighters into a nearby village, and opened fire from homes, businesses and a mosque. The U.S. and Afghan troops called in air support and kept fighting until the Taliban fled, taking most of their dead and wounded with them. The troops are angry because, while the Taliban got lucky (such attacks are rare), the enemy did not succeed in taking the U.S. position, and fled the

battlefield after suffering heavier casualties. The U.S. troops are much better shots, and know they killed far more of the Taliban. Moreover, they saw smart bombs and missiles hitting buildings that Taliban were firing from. From long experience, they know that people inside bombed buildings rarely survive the explosion.

Don't Worry-Be Happy

The economy is in difficult condition. However, change does bring opportunity. In the process of comparing this era to the 1970s, I recalled an event that occurred in Houston after the oil bubble burst. A friend of a friend was looking for an opportunity amidst the contraction in the state economy. Many people had moved to the area, but had lost their jobs or had not found opportunities. Many needed to sell possessions in order to raise cash. This fellow began with $15,000, two-thirds of which was borrowed, and turned the Astrodome into the world's largest flea market. This gave many people the marketplace to swap or sell items. He was earning $175,000 annually in the early 1980s. There are some people who do benefit from the current situation. One enterprising California real estate salesman was earning $30,000 monthly by packing buses with tourists and taking them to home foreclosure sales. From Europe, US real estate looks very cheap. Some agents are loading up planes with prospective buyers and are taking them on home-buying tours in America.

Quote of the Month:

"Socialism is a philosophy of failure, the creed of ignorance and the gospel of
envy, its inherent virtue is the equal sharing of misery."
-Winston Churchill

Book Reviews

Shake Hands with the Devil is a book and the title of 2 DVDs. All three describe the experiences of General Romeo Dallaire of Canada during the 1993-1994 Rwandan genocide. One DVD is a dramatization (2207); the 2004 DVD is a documentary of General Dallaire's return visit to Rwanda. I recommend this documentary. About 1 hours into the movie, Radio Rwanda asked him about the title of the book. He said that when he met the Rwandan commanders, he looked into their eyes and felt cold, but not in the sense of temperature. He sensed that they were evil, and his best reference point was the devil. He also describes how he was misinformed about the situation by the UN and how, upon his arrival, he was told that the massacres were going to occur by the political leaders of Rwanda.

Turning Points

The highest-probability S&P and DJIA turning points (+ or – 1 day) for the month are
(The stronger turning points are starred:

1	15*
5	22*
8*	29

The highest-probability NASDAQ turning points (+ or - 1 day) for the month are
(The stronger turning points are starred*):

1	22
8*	28
15*	

CFRS Portfolio

The CFRS portfolio declined 2.91% in Q1 versus a fall of 3.23% for the S&P.
Looking at the returns on an annualized basis from January 1, 1996 through June 30, 2008:

S&P Annual Return: 6.0%
Portfolio Annual Return: 22.7%

Disclaimer: The methods utilized have proven profitable in the past but no guarantee can be made of future performance nor is any liability accepted.
See the website at billmeridian.com.

The report is sent on or prior to the open of the first trading day of the new month, unless otherwise stated. If you do contact us by e-mail, kindly give your full name. We cannot query the database by e-mail address. Thank you.

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