CYCLES RESEARCH EARLY WARNING SERVICE
by Bill Meridian

Summary

As of the close on September 30, the service moved to a buy signal. The market is likely to be weak over the next few sessions. The rally will then resume into months end.

A new society of futurists has been formed here in Vienna of which I am a member, the Kenos Circle. It consists of academics and business executives who think that the future is predictable. The website is at: http://www.kenos.at/Index.htm.

I have an article in the December/January issue of The Mountain Astrologer, entitled New Horoscopes from the Middle East. It contains many of the charts that I use, some of which go back to the year 750.

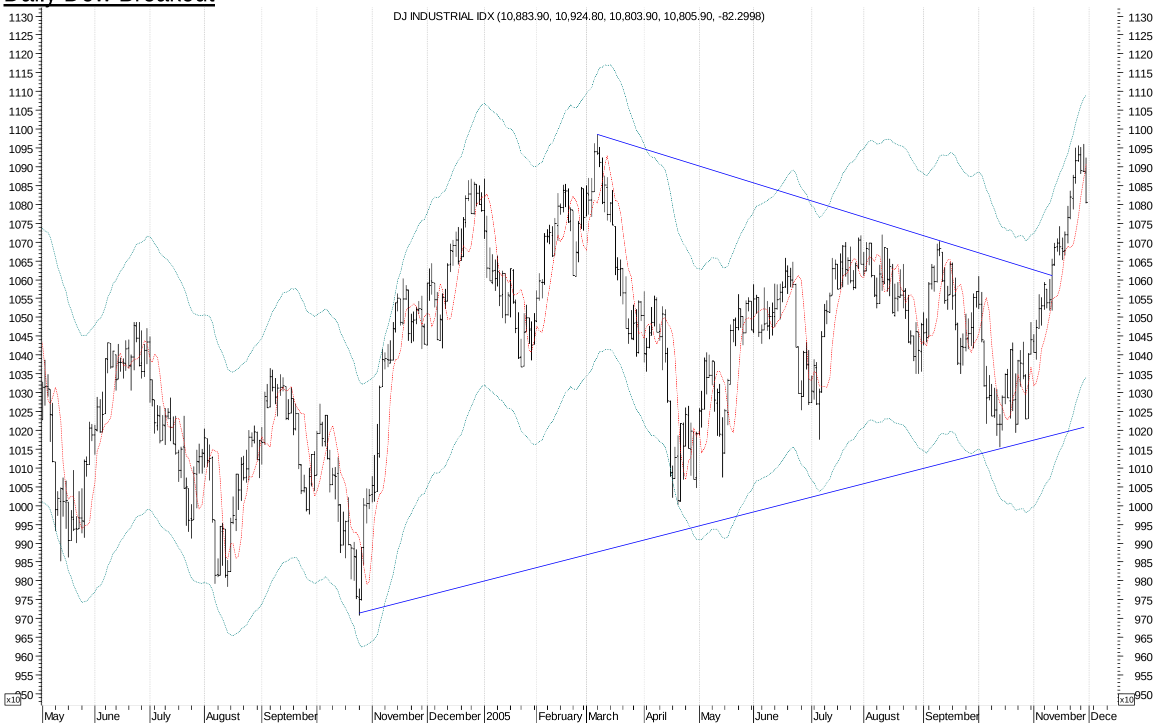
Analysis

The rally has continued as the S&P has followed the Dow and the NASDAQ by breaking through its overhead resistance. As Charles Jayne used to say, think of market indicators as an orchestra. The tune that they play is the direction of the market. At any one time, a few play a solo. That is, at certain cycles in the stock market, some indicators are more telling than others. Knowing when to reply upon which indictors comes with experience. At this point, the breakouts of the 3 major US indices are paramount. Technical lore specifies that the price objectives are roughly determined by the height of the formations that preceded the breakout. Sometimes price overshoots and sometimes it undershoots. To get some idea as to what might happen, I refer to cycles. The annual cycle points up; indeed December is traditionally the strongest month of the year. The 1.8-year Mars cycle points up as does the 12-year Jupiter cycle. Therefore, I cannot see why the indices will not hit their objectives.

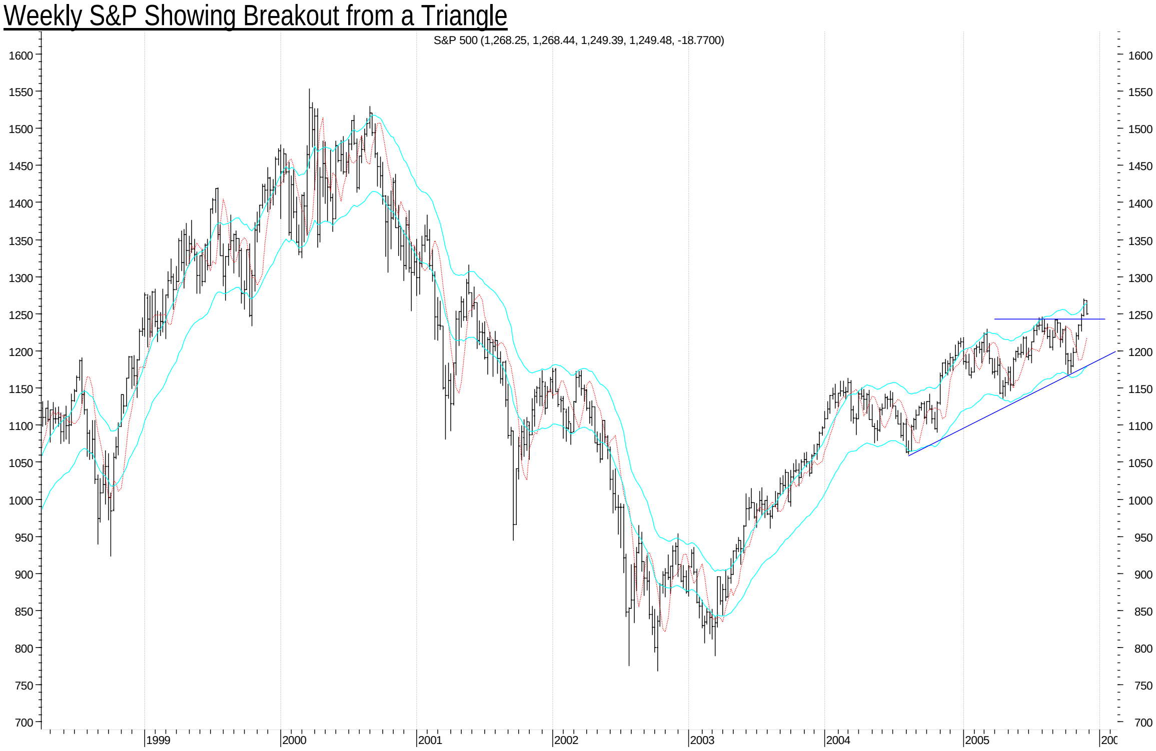
Shorter-term the cycles created by the aspects of the planets in the first 3 weeks of the month have a bearish effect early and a bullish effect later on. The negative net effect of Mars opposite Jupiter, Jupiter 45 to Pluto, and Saturn trine the Node dissipate from the 7th through the 15th. In fact, for the last 13 years, the NASDAQ has had a tendency to drop from the 7th through the 15th. The most bullish period of the year for the NDX is from the 15th through the 30th of December.

How long can the current rally run? In his excellent letter, Past, Present and Futures, James Flanagan made the following observation. Coming off of lows in years ending in the number '2', advances have not been shorter than 3 years, 7 months, and 14 days. Counting from the October 2002 low, we arrive at the end of March in 2006. So the earliest termination date for this run is January and the latest is March. The current indications are that January will be a down month. At this time, I cannot say whether this will be a resumption of the bear market. In 2006, the bullish effect of the decennial phenomena of the bullish effect of years ending in 5 will expire.

Daily Dow Breakout



Weekly S&P Showing Breakout from a Triangle



Daily NASDAQ Breakout

The maximum objectives for these 3 markets are DJIA= 11,500; SP 500= 1360; and NASAQ= 1820.

The negative fundamentals are accumulating. We use cycles and turning points to project when the accumulated negatives are likely to have an effect on the market. The percent of companies reporting negative earnings is the highest in 7 years. When the profit cycle decelerates as it appears to be doing, large-cap stocks tend to outperform small-cap stocks. Indeed, the market is showing the slowing of the S&P 400 and the 600 versus the S&P 500. The 60 largest cap stocks as represented by the US60 have begun to outperform the S&P 500, confirming the shift. In addition, interest rates have been rising. I do not think that the commodities bull market has ended yet. See the section on gold for an indication of this. Therefore, a further increase in oil and commodity prices plus a rise in rates will likely send the market lower in 2006 with most of the damage occurring in quarters 2 and 3.

What Has Been Working

I reviewed the recent quantitative scans. This shows which valuation metrics work best. First, I looked at positive versus negative earnings surprises. First, as readers may recall, earnings were and still are more variable than any other time in history. And, if you do manage to hit the mark, here is what you get:

METHOD	YTD RETURN
Positive EPS Surprise	-4.32%
Negative EPS Surprise	+0.57%

So if you managed to sort out the positive from the negative surprises, it did you no good at all.

Looking back over 18 years, here is how use of the various metrics would have performed. The first one is a value method. Its ascent to number one is no surprise. This is the type of market in which value methods work. Obviously, earnings, which are a growth measure, don't work now. Low PEG means a low PE ratio to growth rate, which has been a useful metric for years. Most active describes high trading volume, which is simply a result of the high volume generated after the 2000 peak. It is not a useful tool for stock selection. The 4th and 5th techniques have been useful for many years, cash flow and relative strength.

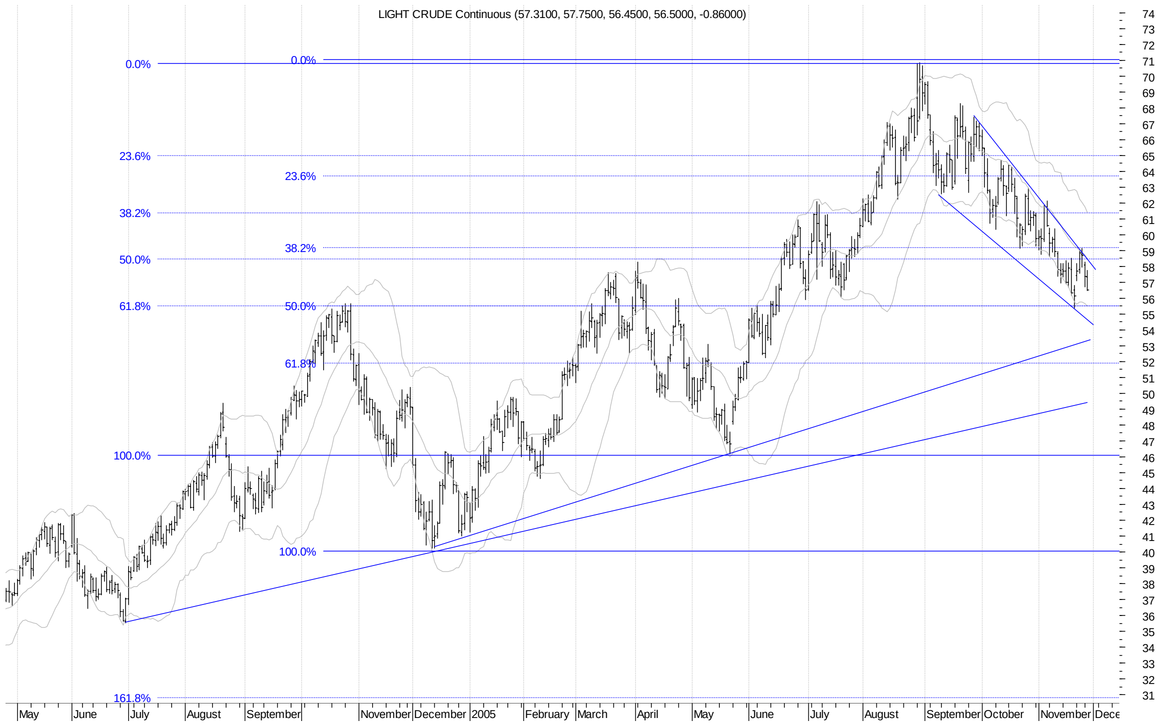
METHOD	ANNUAL GAIN-18 YEARS
Low Enterprise Value/ EBITDA	17.2%
Low PEG	16.9%
Most Active	16.8%
Low Price/Cash Flow	16.3%
Relative Strength	16.3%

Sectors and Groups

Energy

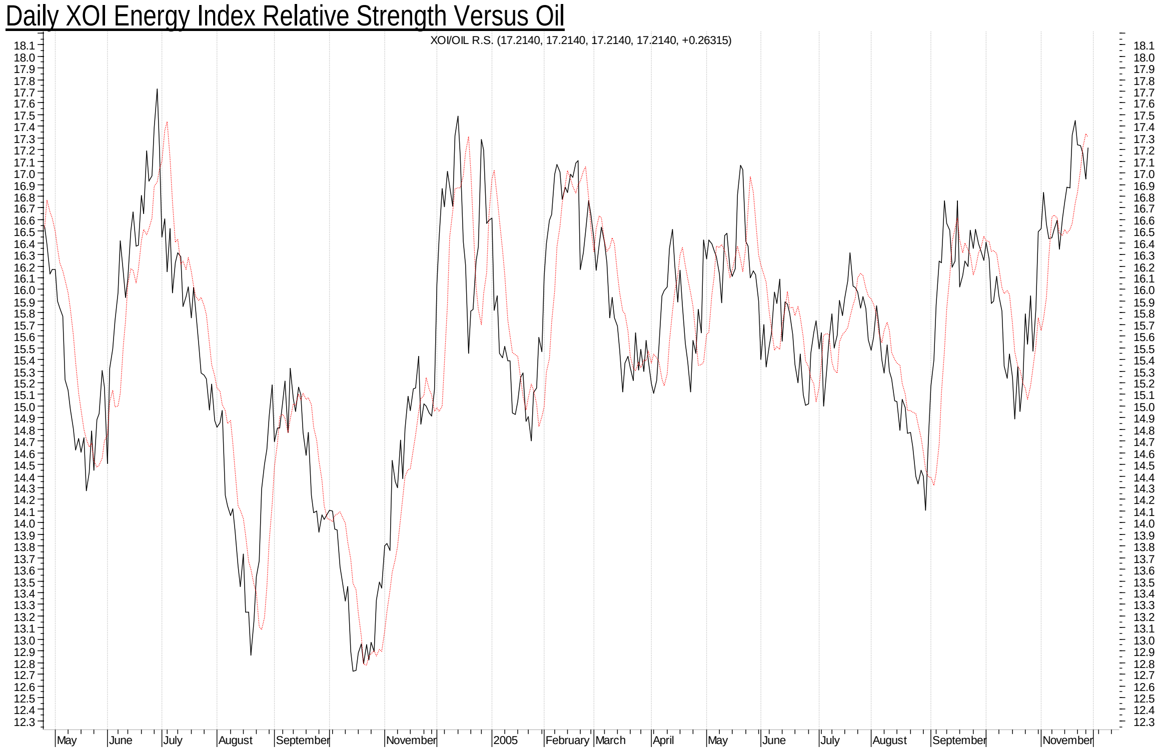
Oil stocks were due for a correction. There have been large inflows into energy mutual funds, a sign that the public has been drawn to the group. On a fundamental level, the global rig count is back to 1977-1978 levels. But, the correction is likely close to its end. Applying a 10% filter rule, there have been more lows in December than there have been in any other month of the year. Looking at the daily graph below, oil has hit the 50% retracement level of its December-August run and the 61.8% level of its May-August run at 55.50. On average, oil makes a low around December 11, and we are close to that date. I doubt that oil will break 55-56. On the upside, oil is up against resistance at 58. This market is at the "something's-got-to-give" stage. The addition of other relevant cycles into the annual cycle suggests that oil will punch through the 58 resistance area somewhere between the 11th and the 14th, an event that would set up a run to 63. The Mercury station on the 3rd is a bearish short-term development. The direct Mars station on the 9th will begin to exert an upward bias on oil on the 11th. This may be the final spark that will end the correction.

Oil Hitting Two Retracement Levels



The graph below shows that the average stock has been stronger than the commodity, so holding energy stocks through the correction has worked well.

Daily XOI Energy Index Relative Strength Versus Oil



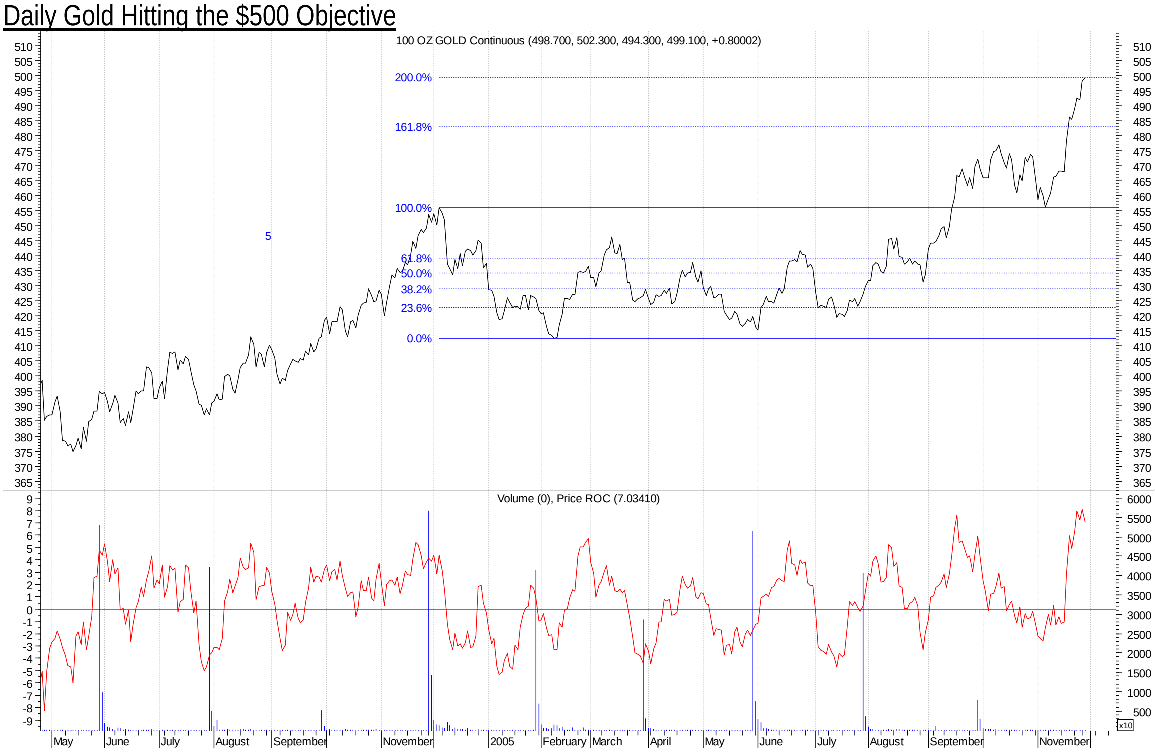
If I was going to add any energy stocks to portfolios, it would be Ensco (ESV) or Goodrich Pete (GDP).

Gold

The November issue stated:
"*In the last issue, I pointed out that gold had indeed broken out of a formation that indicated a $500 price objective. But, the same cycles that signaled the rally from the late summer simply went flat in October. And bullion did not make any further progress in October. The two major cycles fall from late October into the third week of November. This is likely to complete an A-B-C correction to the 455 or 448 area. This will be a buy point.*"

Gold did halt its decline at 455, but much earlier than the cycles indicated. The metal is now due for a pullback for the following reasons. The period from December 7 to 11 is usually weak for bullion, and gold is very overbought. The 3-cycle composite peaks now and bottoms around the 10th, so a pullback is due. In addition, the Mars-Jupiter opposition (on December 4) is bearish for gold, so look for a down week to follow. I doubt it would drop below 477. Full Moons in Gemini (December 15) are bullish for gold, so look for a further rally. New Moons in Capricorn (the 30th) are historically the second most bearish with an effect that will be felt when trading opens in the New Year. However, the 10-day stretch from January 8 to 18 is the strongest seasonal interval during which gold has historically rose at an annualized 75% rate. Which effect will win out? I think it will be the bearish lunation. From a dollars-and-cents trading standpoint, I would simply take profits on the 30th. From mid-January to March, bullion is usually weak, so this sell signal may be in place for a while. With gold so strong, the first quarter may bring a sideways gold market. I do think gold is moving higher longer-term.

Daily Gold Hitting the $500 Objective



The bullish longer-term picture is evident below. This is the annual gold price over the last 145 years. The middle strip shows that gold is not very overbought although the last peak was an extreme. The bottom strip is the relative strength versus the S&P 500. Note that it has only recently turned up after a 20-year decline. This is an indication of a much longer-term swing toward commodities and away from equities. How long will such a run last? I have a rough rule of thumb: multiply the prior time interval by 0.6. This results in a product of 12 years.

<u>Annual Gold Price-145 Years</u>

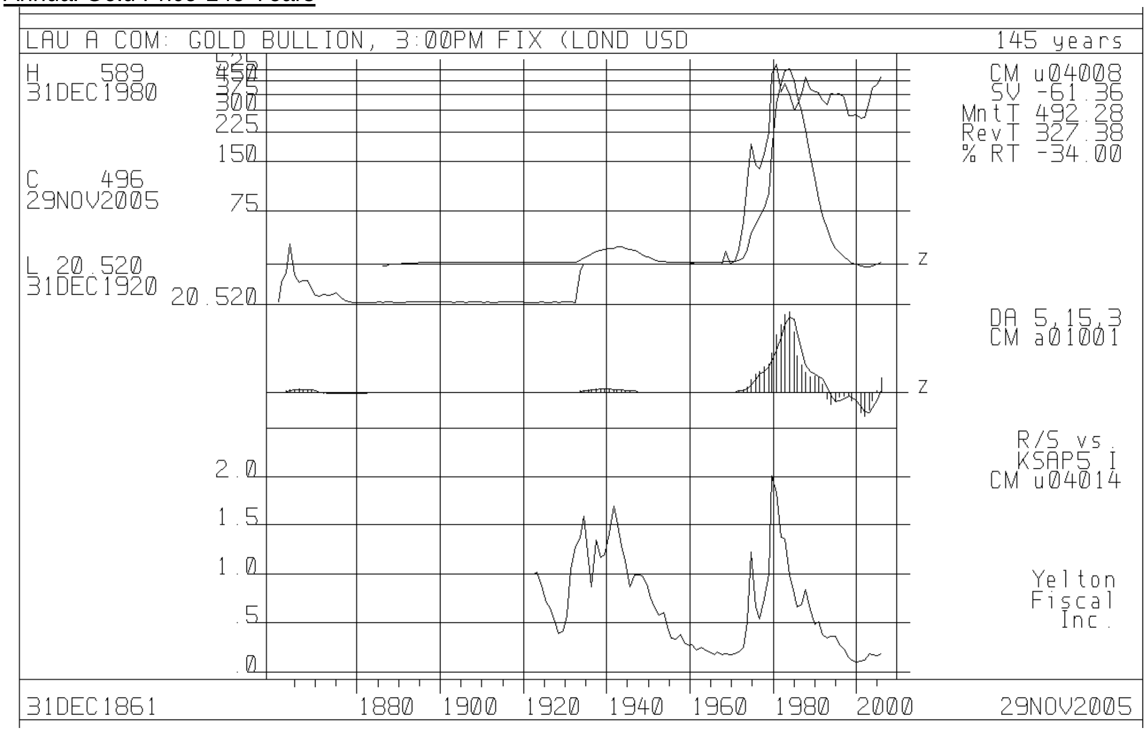
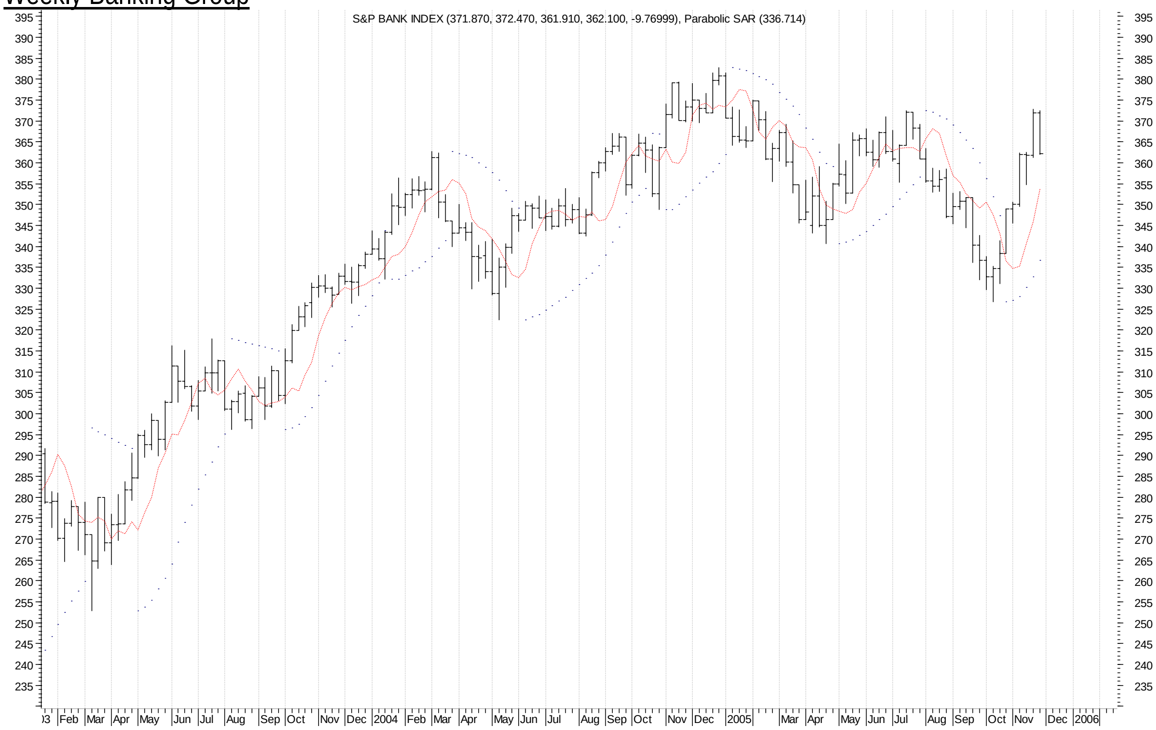


Chart courtesy of the Notley Group, Ridgefield, Ct.

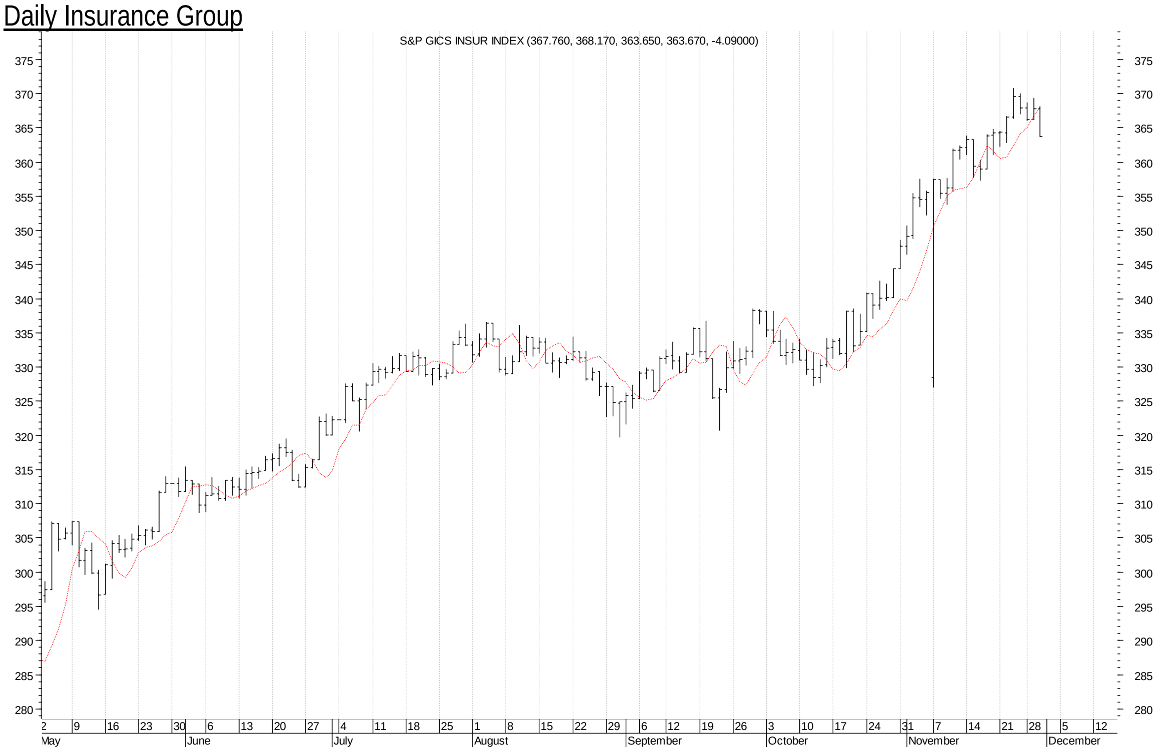
Financial Sector

This sector continues to dominate as the big-cap banks like JPM and C rise after a bearish 2005. This strength will likely continue through the month.

Weekly Banking Group



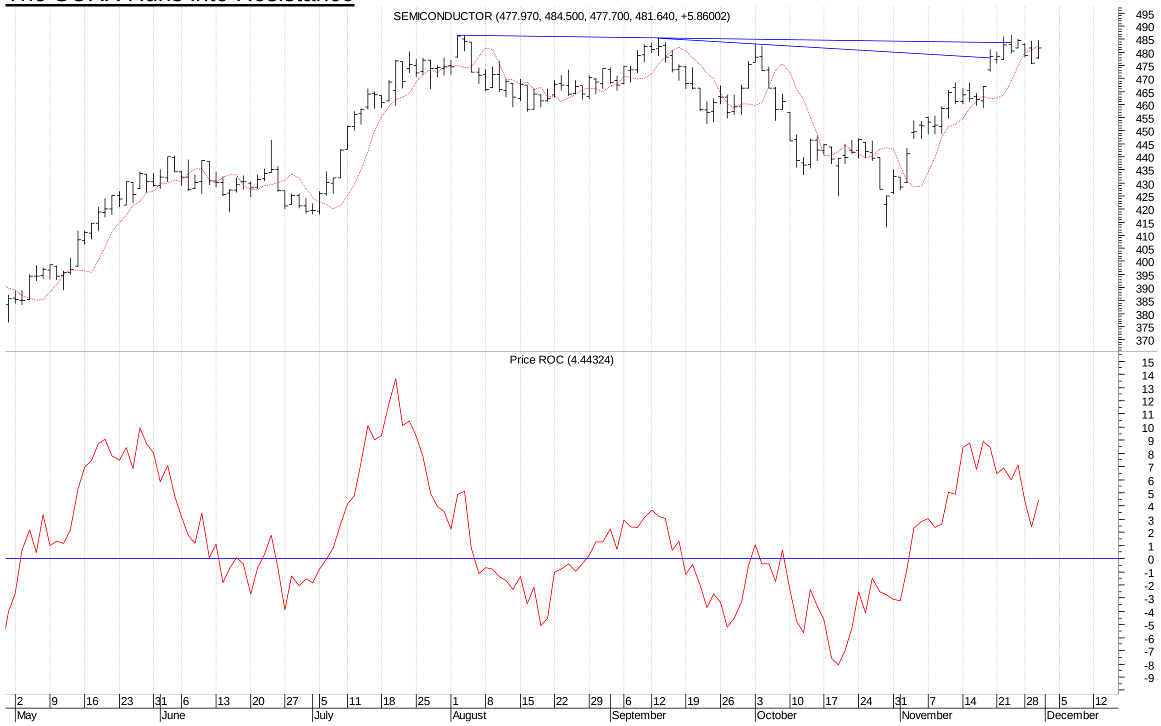
Daily Insurance Group



Technology Sector

The SOXX will fall from the 6th though the 14th, setting up a shorting opportunity for traders. As we can see from the chart below, this index is up against resistance formed by a potential quadruple top. The 6th is Tuesday, so go short of Friday's close or on Monday.

The SOXX Runs into Resistance



Individual Stocks

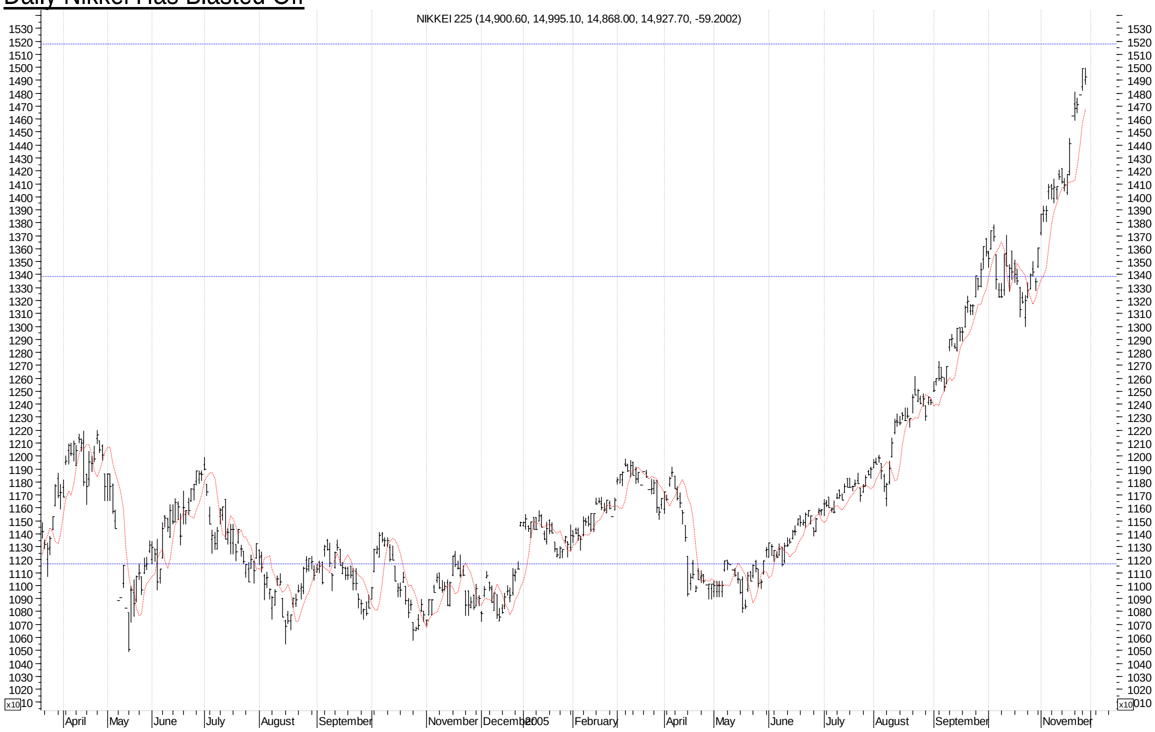
I am selling Southwest Airlines (LUV). The stock has rallied 10%-12% and is up against resistance. In addition, oil has hit its downside target and has moved up. LUV was originally bought as a contra-oil play, but this appears to have run its course.

Weekly Luv Rally Up Against Resistance

Japan

We can see the incredible acceleration in the Nikkei below. It looks, and is, overbought on a daily basis. Now let us skip to the next graph to view the big picture.

Daily Nikkei Has Blasted Off



The monthly graph below shows that the rally is small, thus far, in the overall picture. Note the Fibonacci retracement levels. If the Nikkei simply retraces 50% of its prior decline, then it goes over 23,000. But, this reasoning applies in a bear market. I do not think that this is a bear market rally; it is a new bull market. First, the market fell for a Fibonacci 13 years. Second, my trips to Tokyo tell me that there are very real fundamental changes going on that are freeing up capital and labor, the basic building blocks of any economic growth.

When might this run top and how far can the Nikkei run at this time? To answer that question, we go back up to the daily chart. It appears that the market has made a wave 1 from October 2004 to January 2005. A wave 2 pullback ensued to May. Wave 3 is the broadest and strongest advance, which this has been. In wave 3, the news begins to improve, as it has been. The period from December 19 through February has been seasonally strong since 1949, and most highs have occurred in the March-July time period is any year.

If this is a wave 3, we can relate its length to wave 1. Since wave 3 can never be the shortest, it must be at least 100% of wave 1, but it is typically 162% of wave 1.
Wave 1= 4592 points
4592 + the beginning of wave 3= 15,546
Wave 1 X 1.62= 7430 points
7430 + the beginning of wave 3= 18,220

If we connect the 1996 and the 1998 tops, we have a downtrend line at 17,700. Thus, the next level that appears to offer any resistance is 17,700-18,220. At the end of a wave 3, the Nikkei would pull back to a level that would have to be higher than the peak of wave 3. A 5th wave rally to new highs would then ensue. The point is that the Nikkei is not near a high. I just returned from a trip to Tokyo, and the overall story in Japan would require a full report.

Monthly Nikkei Shows the Big Picture

I had recommended Japan OTC Fund (JOF-NYSE) and the Japan ETF, EWJ. Neither has kept up with the Nikkei since late September. I do not know what stocks they are holding, but they are not in the leading stocks. You can do much better if you are able to buy stocks in the Nikkei outright on the Tokyo Exchange.

Strategy

Traders and investors remain long.

What the Media is Not Telling Us

From Ramsey King's The King Report: Al Jazeera: "Iran's decision to set up an oil and associated derivatives market next year has generated a great deal of interest. This is primarily because of Iran's reported intention to invoice energy contracts in euros rather than dollars. The contention that this could unseat the dollar's dominance as the de facto currency for oil transactions may be overstated, but this has not stopped many commentators from linking America's current political disquiet with Iran to the proposed Iranian Oil Bourse (IOB)."
http://english.aljazeera.net/NR/exeres/C1C0C9B3-DDA9-42E2-AE9C-B7CDBA08A6E9.htm
Ramsey King adds that Saddam changed Iraqi oil contracts to euros from dollars just before the USA invaded. There were two presidents who wanted the government to issue its own currency-

Lincoln and Kennedy. You can read JFK's order at this website: http://rense.com/general68/prdeu.htm.

In the 1980s, a television show asked two people to speak about the Federal Reserve, Eustace Mullins, author of Secrets of the Federal Reserve, and myself. I declined and Eustace accepted. Four weeks later, the Morton Downey, Jr. show was off the air.

This is the great secret. Messing about with it is akin to stepping on Mighty Mouse's cape. In his book, A Writ for Martyrs, Eustace reproduced the order from J. Edgar Hoover that ordered Eustace's arrest, calling him 'the most dangerous man in America.' Fortunately, Eustace was at a remote cabin working on a book. He was never apprehended, and the search was dropped. This is only one such Fed story that resides in my library.

So What are You in Prison For?

The EC has ruled that Christ must be spelled with a small c. Jewish can be capitalized with a capital C when referring to a group, but with a small c when referring to an individual. EC leader Javier Solana's titles are to be capitalized however. The rules go into effect in August 2006. I do not know how this will be enforced or what the punishment will be.

Iraq Polls

Iraq has been a weight on public sentiment…in the USA. In Iraqi universities, two-thirds of respondents say that they are better off now than under Saddam. Eighty percent feel that they will be better off one year from now. This information was brought back from Iraq by Joe Lieberman.

Don't Worry-Be Happy

On November 7, the International Council for Capital Formation (ICCF) published a study that reveals broad economic repercussions for the UK, Italy, Germany, and Spain if they meet the emissions restrictions specified by the Kyoto protocols. The study assumes that Kyoto will be broadened to include households and transportation. It shows serious increases in energy costs and a slowdown in economic growth, just as Tony Blair has feared. The average rise in electricity prices is projected to be 26%. Implementation of Kyoto would greatly reduce the use of coal and render much energy-using equipment and vehicles obsolete. The reports are at iccfglobal.org.

Quote of the Month:

"The strongest argument for learning about probability theory is that people who don't understand it lose money to people who do."
John Kay, Financial Times, August 2005

Turning Points

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

6-7	16*
13	23

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

2 16*

6 23

9

CFRS Portfolio

The CFRS portfolio rose 5.65% in Q2 versus 0.91% for the S&P.
Looking at the returns on an annualized basis from January 1, 1996 through June 30, 2005:

S&P Annual Return: 7.2%
Portfolio Annual Return: 28.4%

No recommendations at this time.

STOCK	SYMBOL	BUY PRICE	RECENT PRICE	% CHANGE	STOP	1ST TRADE

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.