CYCLES RESEARCH EARLY WARNING SERVICE
by Bill Meridian

Summary

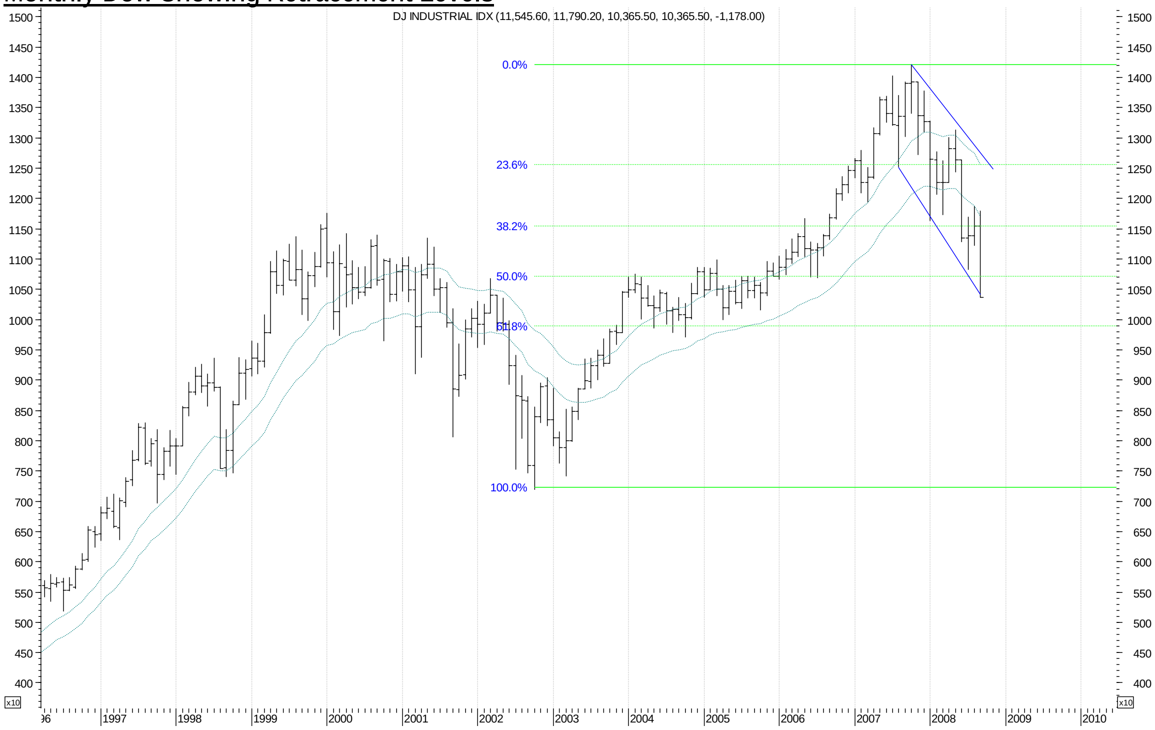
This service moved to a sell signal on the stock market at the close on August 29. Cycles Research moved to a buy on gold as of Friday's close on May 29. A buy was issued on bonds as of the close on Monday, July 1.

Analysis

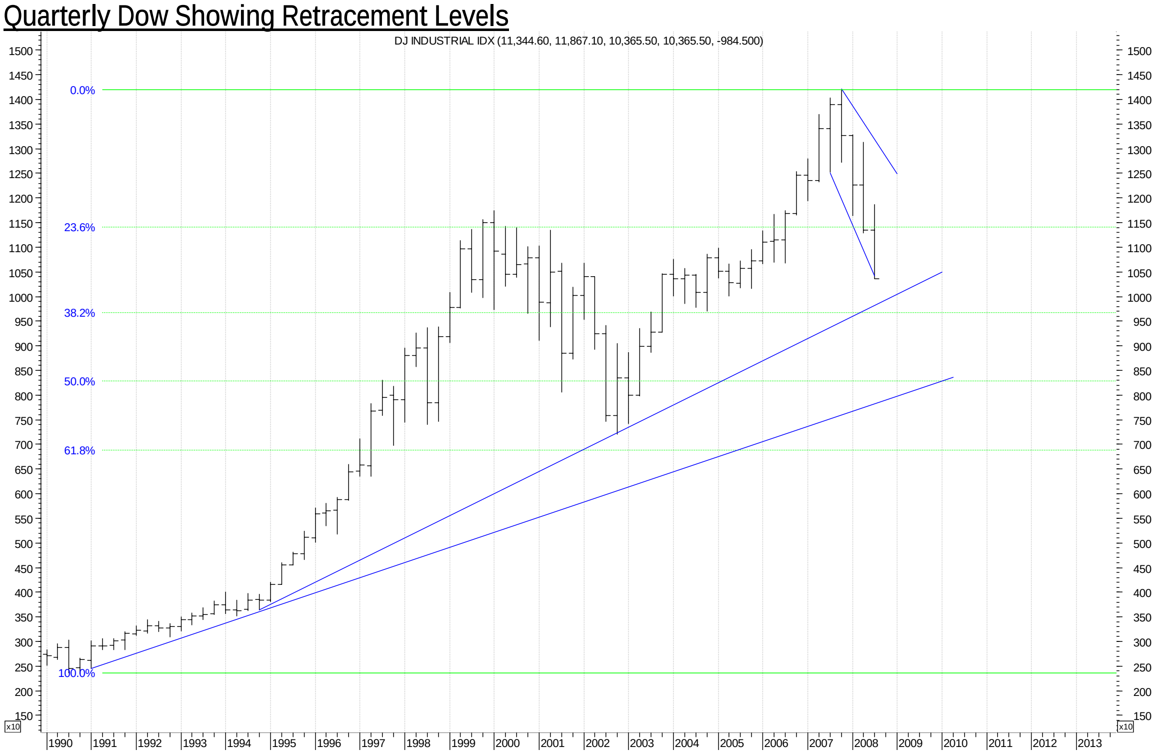
US equity markets gave a buy signal one week ago Thursday, but the market did not strengthen as indicated. It appears that the ban on short-selling induced buying that skewed the stocks portion of my CATS indicator. To prove this point, that indicator went back to a sell on Friday. In addition, prior to Monday, there had been 4 down days of 90% down volume and 1 day of 90% up volume. This type of action typically occurs near lows, but the relaxation of the uptick rule in 2007 has made it easier to have such occurrences, so this type of signal must be treated with caution. New lows have continued to expand, but here we must again exercise caution when assessing the numbers. Normally, such a high number of new lows is seen as a selling climax. But, most of the new lows were interest-rate sensitive issues, so the large number of new lows was more related to the rise in rates and could not be considered a sign of a capitulation low. Therefore, I did not issue a buy signal, fortunately. This episode was indicative of the effects of government intervention and extreme volatility. Even after Monday's decline, sentiment indicators do not reflect signs of panic. Monday was another day of greater than 90% downside volume, but it will likely require several more of these plus some 90% upside days. Tuesday's rally simply appeared to be a retracement of Monday's decline. Breadth and other internals were weak.

Paul Montgomery, in Universal Economics of September 29, states "By a number of measurements, the latest financial engineering pandemic peaked out in June of 2007." Veteran readers of this service will recall that month as being the peak in the 36-year Saturn-Neptune cycle, which was singled out as the end of the real estate boom. Paul has also noted that there were 4 prior periods of financial engineering in USA history. The average decline in the stock market after each such episode was 45%. Thus, this is a likely minimum drop form last October. Because the current crisis is more serious, so 45% is a minimum target. The monthly graph below shows that this level has been exceeded if one measures from the 2003 low to the 2007 high. The quarterly graph below shows retracement levels running back to 1990 depicting a 50% retracement at 8300. As mentioned in the last report, an average bear market lasts about 30 to 34 months. These numbers were determined by averaging the declines in the USA stock market in the 1923-1933 crash, the 1989 Tokyo crash, and the drop in gold that began in 1980. The asset class does not matter. When people are losing money, they react in about the same way despite their nationality or particular cultural group. Measuring from October of last year, this yardstick points to the spring of 2010 as a major low. The longer-term point is that this bear is not over.

Monthly Dow Showing Retracement Levels



Quarterly Dow Showing Retracement Levels



As mentioned in the last reports, prospects for the NASDAQ are more dire than those for the overall market. The weekly graph below shows a breakdown from a triangle that projects to the 1300 or the 1100 area, depending upon where one measures from. (The standard formula is to measure from the bottom to the top of the triangle.) The monthly chart shows the breaking of 2 trendlines (orange and green in color) that are 4 and 6 years old. From the 2007 top, this looks like a giant A-B-C or a 1-2-3-4-5 in which the NDX is in the C or 3 wave down. Anyway we look at it, the NDX is likely going lower to the 1300 or 1100 area in October. I have thought for some time that this will be an especially weak earnings season for the IT sector. It has already begun with the RIMM earnings; it will continue into November.

Weekly NASDAQ Showing Breakdown from Triangle

Monthly NASDAQ Showing Breaking of Major Trendlines

Looking for a Low in October

As most of us know, there have been more lows in the month of October than in any other month. I read a study of 3% down days by Todd Campbell of EB Capital. He found that the average return 30 days following a down 3% day is 6.5% when the VIX is above 30. The average return without a +30 VIX reading is only 0.73%. The average return of -3% days in the month of September 30 days later is +5.38%. All were accompanied by a +30 VIX reading.

Turning Point Analysis

Anniversary dates of past highs and lows can be very important. There have been more turning points for the S&P in the month October then in any other month, especially lows. The high in 2007 was on October 11, 2007. The projected turning points for October include the 9th and 10th, so this anniversary date is confirmed as a turning point. The October 19, 1987 crash low was a Fibonacci 21 years ago. The October 18, 2000 low was a Fibonacci 8 years ago. These counts confirm the 16th-17th turning point projections. After that period, the 24th and 28th stand out. The average low for the Dow in any year is the 27th, close to the turning point projections. In addition, there is much planetary activity in this time span, suggesting high volatility.

The Current Crisis

The media suggests that the market is moving based upon the possibility of passage of some rescue package. News plays a smaller role in the markets then Wall Street suggests. I was a junior analyst in NYC in the 1970s when a senior editor asked me why one of the stocks that I followed was up 20% in one quarter. I replied that there was no reason that I knew of. He told me to make one up. Wall Street depends upon their customers' reliance upon the value of research. Statistical research suggests that news does not have a strong correlation with market moves. But research does show that bad news that occurs near lows will exaggerate declines. And, fundamentally, government action will not solve the problem.

It began when President Carter passed the Community Reinvestment Act designed to encourage lending in poor areas. The Clinton administration strengthened the legislation and forced the institutions into further lending when Janet Reno threatened them in the mid 1990s. This was hailed as a way for poor people to own their own homes. The banks saw this as forced lending to high risk individuals. The institutions then bundled the low quality mortgages with high quality mortgages and we know the rest.

Why do the poor people need help to find housing? One reason is that rent control discourages builders. Governmental interference in the free market started the problem, and government interference will not solve it. The market knows this, and sells off because it knows that the plans entail the issuance of more credit, which was one of the contributors to the crisis. As Canada's Financial Post wrote, "In the US, monkeys guard the bananas." The over issuance of credit by the central banks has historically been destructive. I quote my book <u>Planetary Economic Forecasting</u> from page 27:

"There are other types of inflation. After the Franco Prussian War, France paid a large indemnity. This sudden influx of cash sent prices up in the victorious country, having a destructive effect by sending the general price level much higher. Bismarck said, *"The next time we win a war against France, we'll demand that we pay her an indemnity."* A German diplomat said to a French diplomat *"It doesn't seem that we received those billions."* And the French diplomat replied, *"Nor that we paid them."*

To further make the point, compare the crisis of 1839-1843 to that of 1929-1933. From page 203 of PEF:

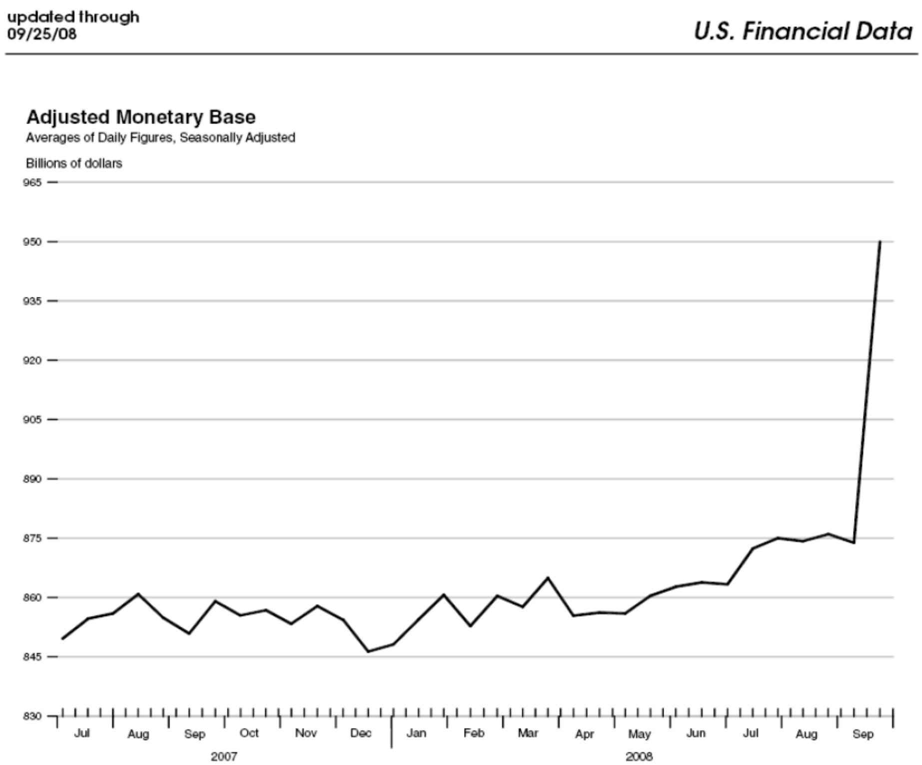
"The deflation from 1839 to 1843 liquidated unsound investments, bad banks, debts, and the Bank of the United States. Professor Temin, writing in <u>Jacksonian Economy</u>, has demonstrated that the percentage of deflation over these 4 years was about the same as that of 1929-1933. However, the effect 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. This is very much like interfering with the healing processes of the body, such as trying to prevent a fever that is necessary to eliminate bacteria from the body. 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 processes that needed to occur."

As we can see, the government's insistence to hold prices up rather then allowing the natural healing process of deflation to bring the system back into balance.

The current market is looking ahead and dislikes what it sees. The proposed bailout plan does not solve the basic problem. The plan is not one to save the big banks; it is a plan to save the credit currency system that has replaced the constitutionally mandated sound money system that the Founding Fathers crafted. Treasury will pay financial institutions above-market prices for assets that no one wants. Instead of admitting that the assets are worth a fraction of their stated value, the plan abandons the accurate mark-to-market method. Then all holders of this paper mark to value up to the artificial value and their balance sheets are magically fixed. But this does not deceive the markets and that is why paper assets are down and gold is up. A glance at the graph below shows how the money supply is expanding.



There was an excellent summary of the current situation in the September 22 issue of Barrons by Felix Zulauf. He stated that the leveraging up in the cycle is now reversing. The investment banks were the major creators of credit in the last cycle, and that driver is gone. The crisis is global, and governments will use fiscal stimulus to prop the system up. The effect of these amounts will take effect in 2 to 3 quarters, so we may see higher stocks in 2009 and a pop up in the economy in 2010. Then both will fall back again. Government debt will likely rise from 300% to 500% of GDP. This will push rates up. The private credit system cannot do the job any more, and the Fed will buy paper and inject new money into the system. Global financial sector debt has risen 5-fold in the last 25 years relative to GDP, and we are now seeing a reversal back to the mean. This again reminds me of the 1966-1982 period in which efforts to repair the system created mini bull markets followed by slides. Government interference will prolong the recovery. They prefer a long and slow recovery to a sharp and quick one.

Government Economic Numbers are Not Reliable

If you would like to get an accurate reading of government statistics, see the ShadowStats.com website. John Williams publishes more accurate measures of the CPI and monetary data such as M3. On the website, you will see alternate CPI series. His computation of the CPI using the Clinton-era methods shows annual CPI increases running in the 9% area rather than 5%. He has also recalculated for the bulk of the "discouraged workers" defined away during the Clinton Administration. Actual unemployment, as estimated by the SGS-Alternate Unemployment measure, rose to about 14.7% in August, up from 14.3% in July.

The September issue of Dr. Marc Faber’s Gloom, Boom, and Doom Report reminded me that some individuals have maintained alternate inflation indices over the years. I lost track of those that I used to follow. Dr. Faber wrote about Raymond DeVoe’s Trivia Index, first complied in 1971. It consists of little ticket items that we all purchase such as haircuts. Currently, it reflects 40% price increases over 3 years which is about 16%, four times the published CPI rate.

The Shape of Things to Come

The nationalization of Fannie Mae and Freddie Mac shows that the U.S. is "more communist than China right now" but its brand of socialism is meant only for the rich, investor Jim Rogers, CEO of Rogers Holdings, told CNBC Europe. "America is more communist than China is right now. You can see that this is welfare of the rich, it is socialism for the rich... it's just bailing out financial institutions," Rogers said. Stock markets jumped after the U.S. government's decision to launch what could be its biggest federal bailout ever, in a bid to support the housing market and ward off more global financial market turbulence. But Rogers said in the long term the move spelled trouble.

Rogers may have been more correct than he realizes. A California ballot Initiative seeks to impose a 45% income tax, 55% wealth tax & 36%-54% exit tax. A California activist is trying to gather the 694,354 signatures needed to place a tax initiative on the ballot that would impose a new 35% income surtax-17.5% (on all of the taxpayer's income) when income exceeds $150,000 (single)/$250,000 (joint), and an additional 17.5% (again, on all of the taxpayer's income) when income exceeds $350,000 (single)/$500,000 (joint); impose a one-time 55% wealth tax on assets exceeding $20 million held by a California resident or held in California by nonresident; and assess an exit tax of between 36.5% to 54.3% on both income and unrealized appreciation in asset values over $5 million when a resident dies or leaves California. Read about it at http://www.sos.ca.gov/elections/elections_j.htm#circ

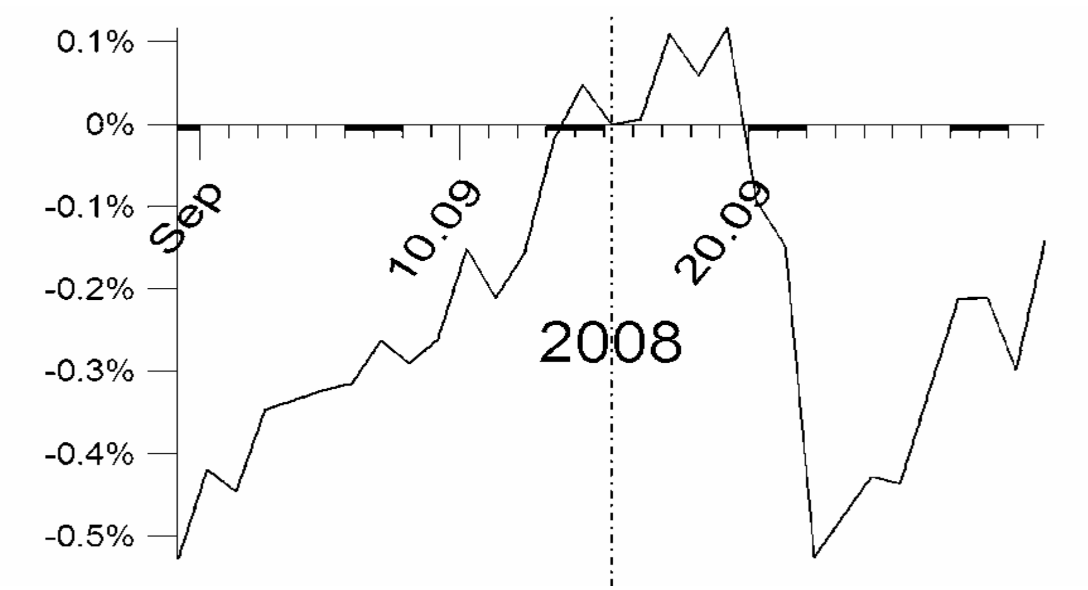
Bonds

The graph of the t-notes does not really demonstrate what is occurring in the bond market. The 54-year cycle in the bond market topped in 2003, as pointed out in these reports early in that year. Since 2003, the corporate bond market as measured by the Dow Jones Corporate Bond Index has fallen from 115 to 93, a drop of almost 20%.

From the September monthly report:

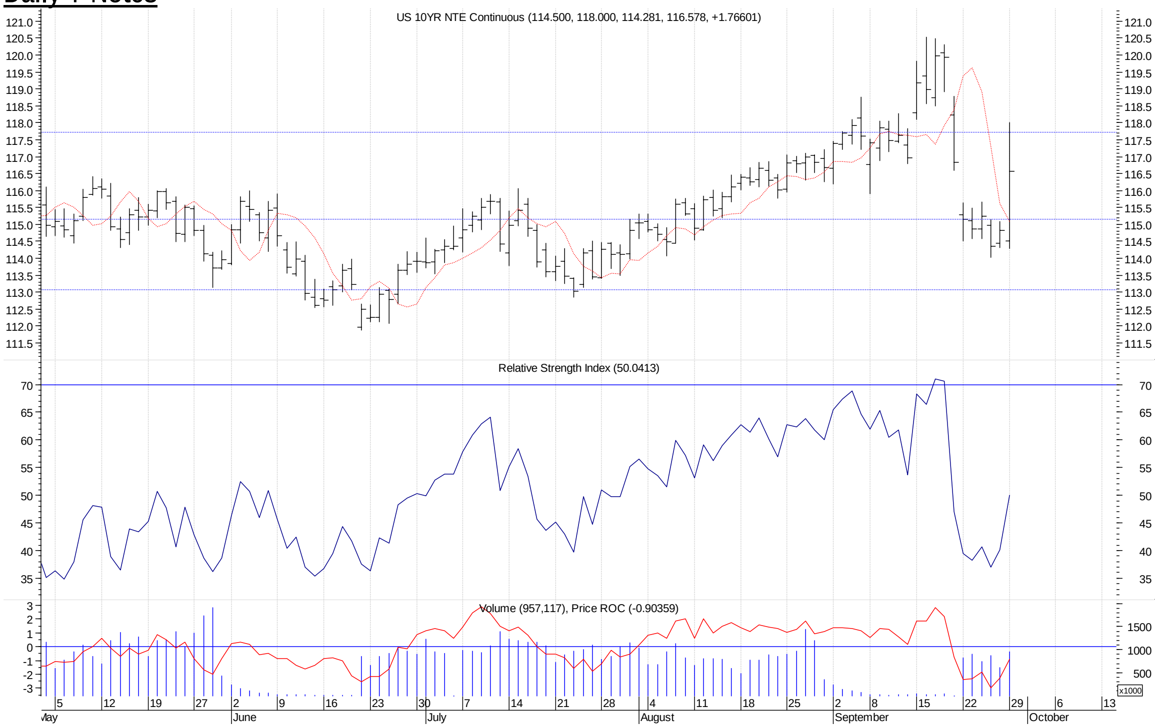
Bonds have risen from the 1st to September 19th about 73% of the time. From the 19th to the 22nd, bonds have fallen 81% of the time.

Average Percentage Change for Bonds 1980-2007 Projected into September 2008



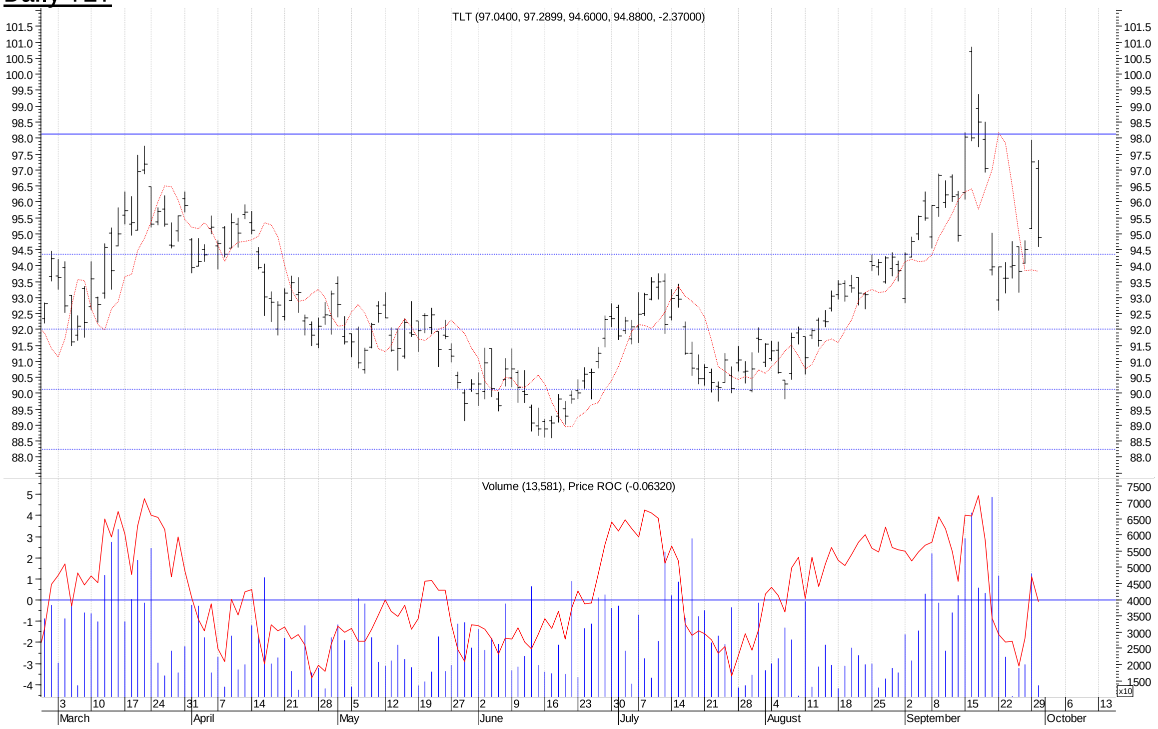
Note in the graph below that bonds experienced a big breakdown on the 19th, as suggested by the graph above. The correction occurred so quickly that I did not have ample time to move to a sell signal.

Daily T-Notes



Notes popped up on Monday with great strength and then reversed. (The Tuesday move is not reflected in the graph above). I remain on a buy signal for now. The bond ETF known as the TLT reflects the Tuesday move in bonds below:

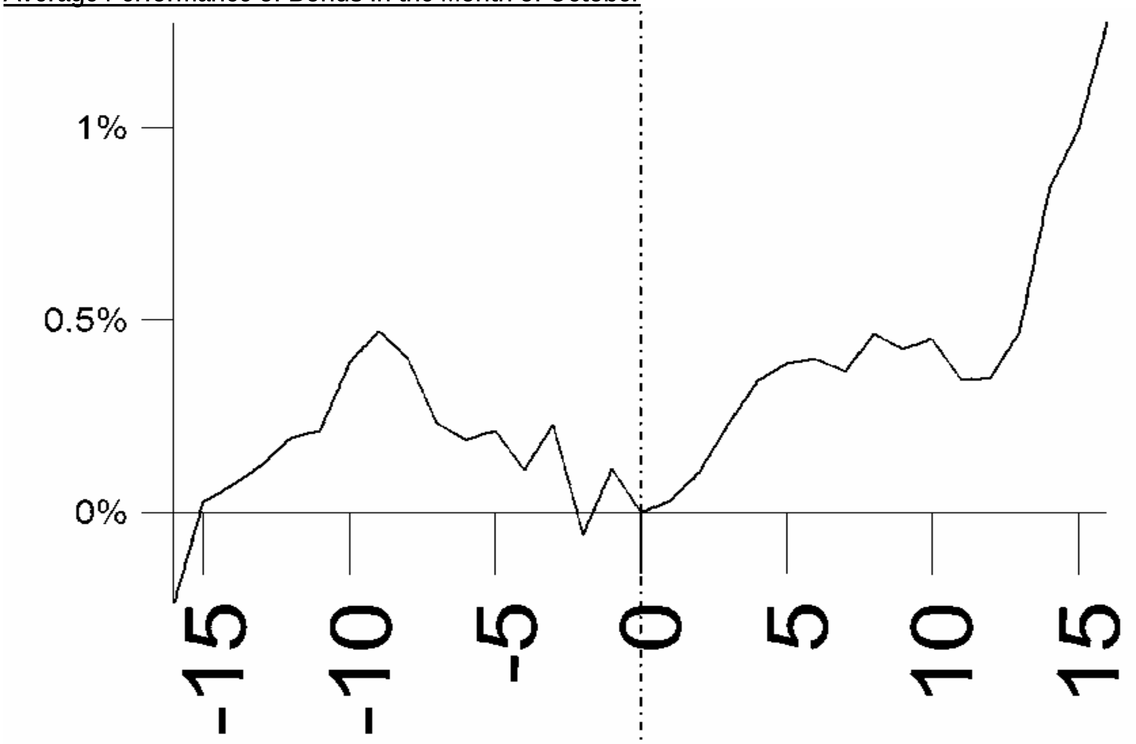
Daily TLT



The September bond graph was helpful, so here is the same analysis for the month of October. The graph is the average percentage change in bonds from 1980 through 2007 for October only. It shows the tendency to peak near the 11th with a low at mid month followed by a rally through the second half.

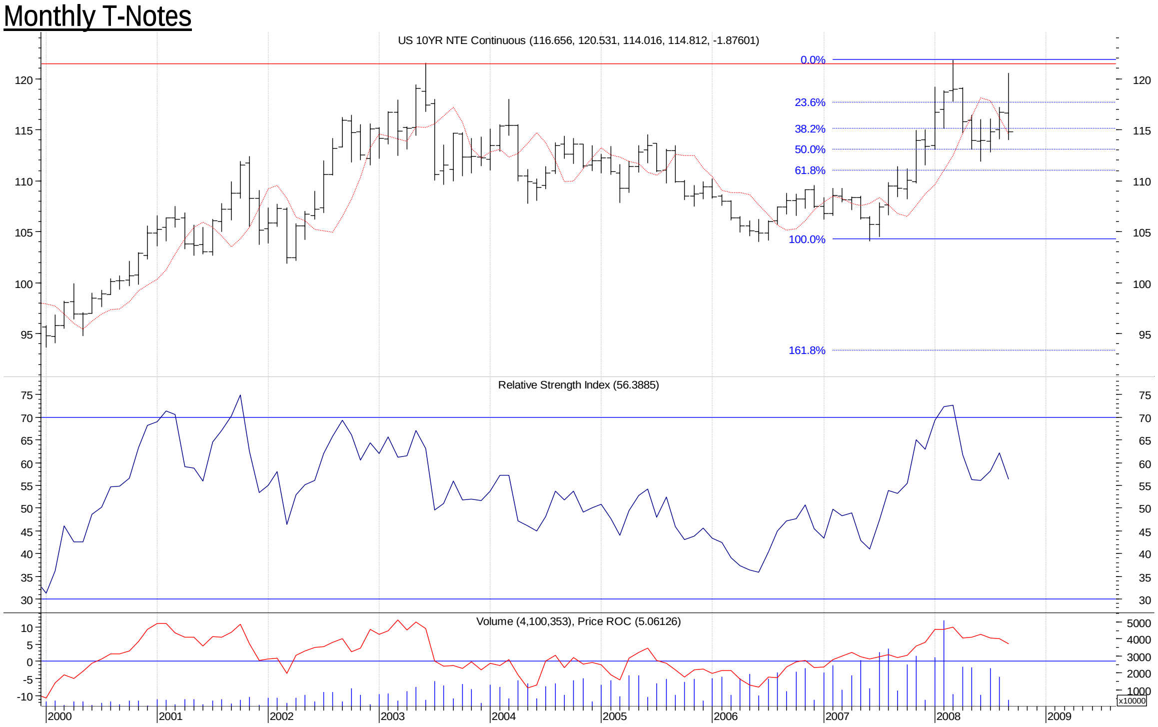
The bond 5-cycle composite differs from the annual cycle below in some respects. The composite tops on the 10th and bottoms on the 25th. The combination of the pair suggests that the next high is near the 10th of October and that there will be a minor low near the 15th and a more significant low near the 24th. The period from October 27th to November 12th is the strongest period in any year for bond bulls. Bonds have risen at an annualized expected return of 24%. Thus, we are likely to see a good rally from the last week of the month.

Average Performance of Bonds in the Month of October



The monthly graph below shows that bonds are still overbought and remain vulnerable. The rd line is the prior 2003 high. Bonds are benefiting from a flight to safety and are likely to continue to do so. Remember that bonds are usually strong in the second half of any year and are weak in the first half. Thus, the full force of the falling 53-year cycle will again materialize in the New Year.

Monthly T-Notes



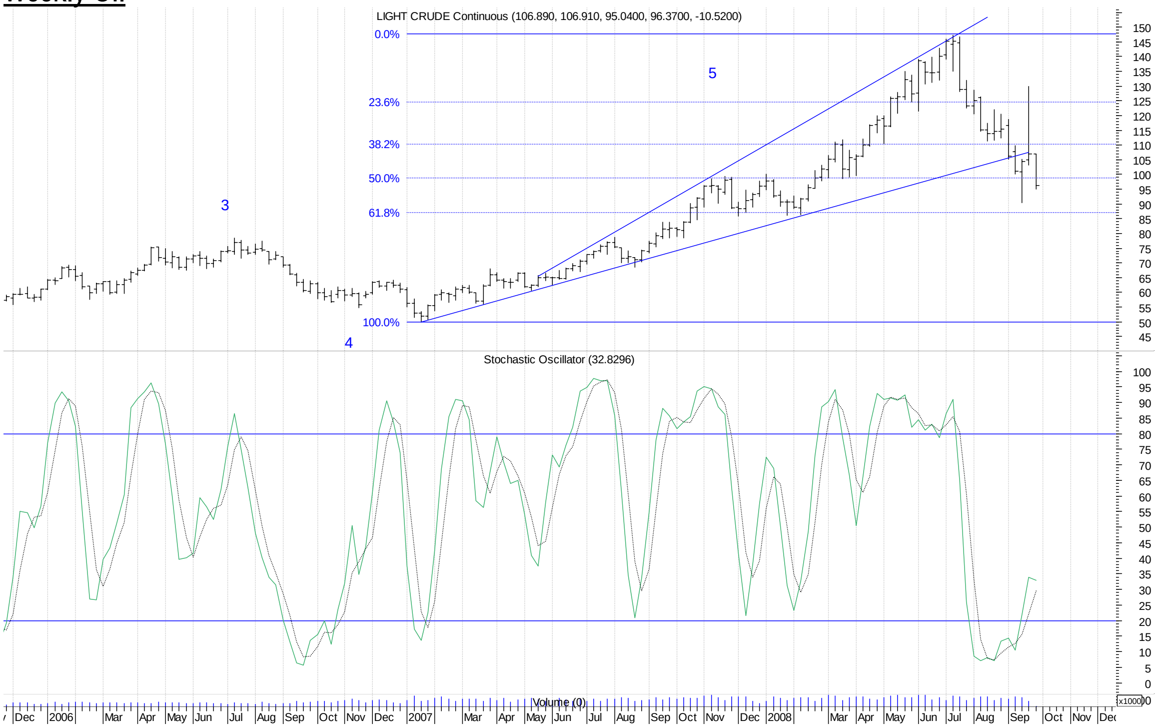
The last graph is the cycle projection based upon the monthly Moodys Triple A bond yields from 1833. This graph cycle projection has appeared before and remains unaltered from the original. It suggests rising rates from 2003 to next spring.

Sectors and Groups

Energy

The weakest part of the seasonal cycle for oil runs from October 17th to December 12th. Oil has fallen over 70% of the time in this interval, dropping the price at an annualized expected rate of 46%. Both lunations in the month (on the 14th and the 28th) have traditionally been bearish. The weekly graph below shows that oil is oversold and has retraced 50% of its prior decline. This does not appear to be a completed correction, which is what the annual cycle suggests. Thus, the oil uptrend is unlikely to resume in October. In fact, there have been more oil highs in October than in any other month.

Weekly Oil



The September 8th issue of Barrons also included an article by Joseph Thorndike that reminds us about the excess oil profit tax imposed by President Carter in 1979. The use of the term ‘excess profits tax’ was incorrect in that it was not a tax on oil companies or their profits. It was an excise tax on each barrel of oil. The amount was based upon the difference between the deregulated market price and a pre-determined base price, regardless of the profit. The Congressional Research Service estimated that the tax reduced domestic production by 3% to 6% and increased reliance on foreign oil by 8% to 16%. And, it generated far less tax revenue than was expected.

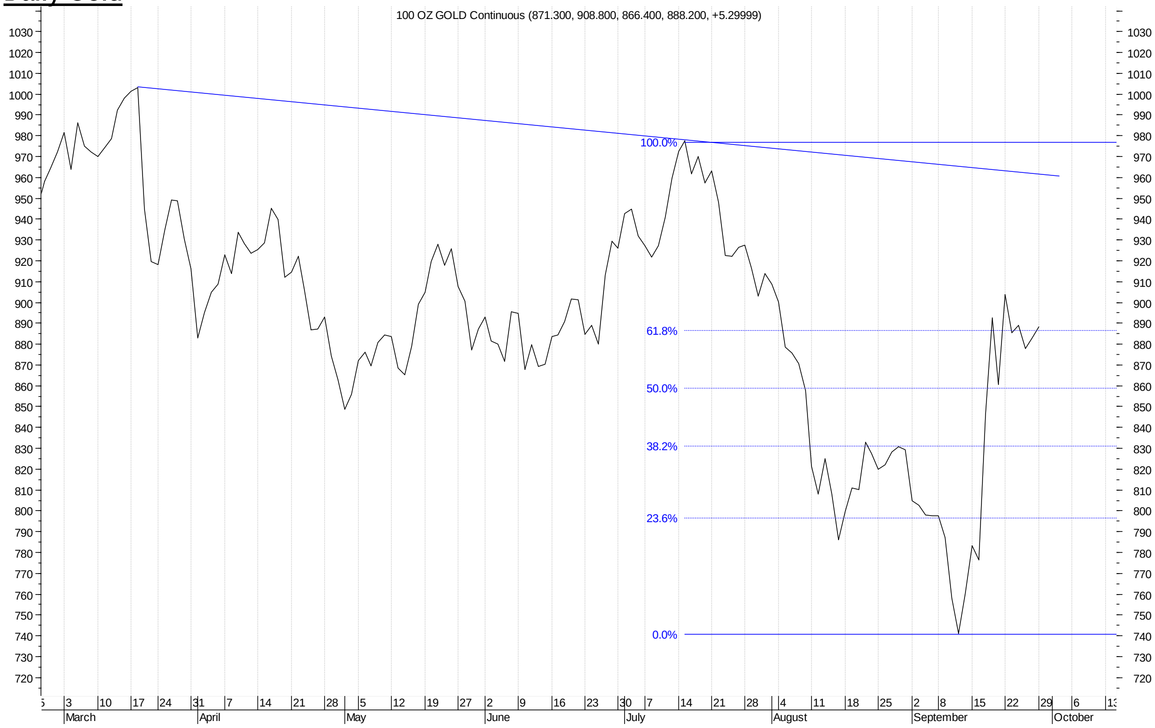
Charles Maxwell, the respected and well known energy analyst, is projecting $300 per barrel by 2015. His reasoning is that non-OPEC oil production is peaking, and that this will give OPEC more power to raise prices. His thesis hinges on the theory of peak oil.

Gold

As mentioned in past reports, September is the strongest month for gold. The sharp reversal to the upside is a reflection of this seasonality and of the flight from paper assets. I cannot see gold selling off much in the midst of this crisis. And, bullion is in its most bullish stretch from August through January. There are less turning points in the months of October and November than in any other 2-month period during any year, so a major trend change is unlikely. Short-term, the trends are mixed. Gold is overbought daily but oversold weekly.

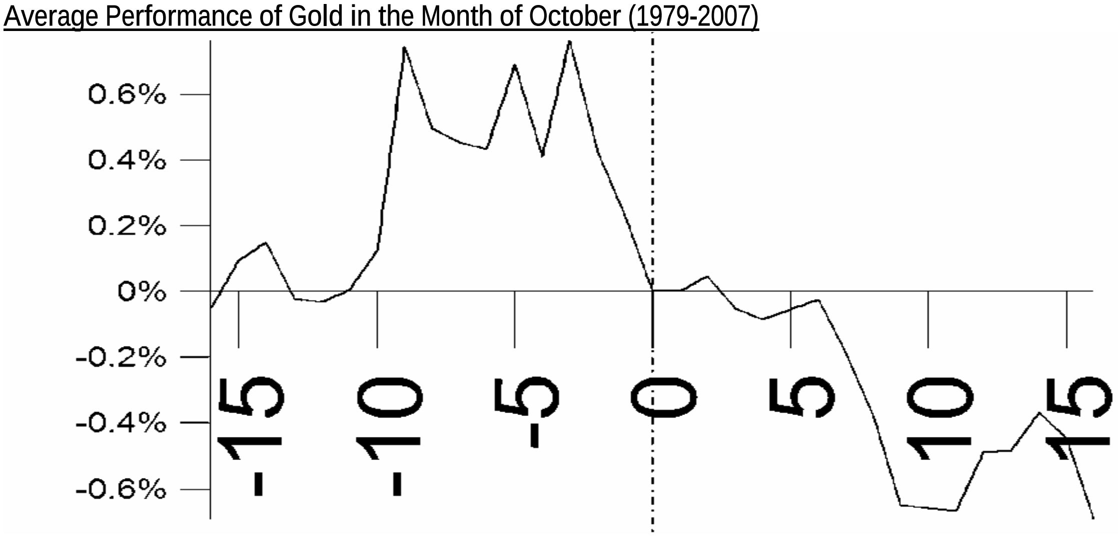
The sentiment about gold is not favorable. First, I hear reports that gold coins and bullion are hard to buy due to shortages in the USA. I shall repeat an old story from Value Line in NYC in the 1970s. Near the high in gold prices in 1980, the fellow in the next office stopped in. He had just walked past Deak-Perrera, the metals firm in NYC and saw lines of ordinary folks lined up to buy the metal. His observation was that we must be near a top if the public was buying. In addition, expert analysis of the Commitment of Traders Report suggests that gold is in weak hands. But, the flight from paper assets is the stronger force right now, so I remain bullish.

Daily Gold



The chart below tells us that gold typically gets toppy between the 5th and 12th of the month and bottoms near the 26th. In fact, the period from October 14 through November 1 is the single most bearish such stretch during any year with 20 declines in 27 years for an average decline of 2%. The 5-cycle composite shows a high on the 12th, so Friday the 10th is likely the next gold high. The composite then shows a minor low on the 18th and then falls into early November. The most clear period of agreement between these cycles calls for a high on the 10th and a low near in the last week of the month or in early November.

Average Performance of Gold in the Month of October (1979-2007)



Individual Stocks

I am not adding any stocks at this time.

PORTFOLIO

Stock	**Buy Price**	**Buy Date**	**Current Price**
Gold ETF- GLD	91.4	July 1	89.57

Strategy

Investors remain in cash for now.
Traders remain short.
Let us remember that most stock market lows occur in the month of October, so we may see a snap-back rally before month's end and must be prepared.

What the Media is Not Telling Us

- The Taliban and their al Qaeda allies have been fighting a large, and losing, battle against the army in the Pakistani region of Bajaur (right on the Afghan border). The fighting has been going on for a month now, and the terrorists have lost about a thousand dead, while the army has lost only 27 dead. The large disparity in losses is largely due to the Pakistani use of air power (bombers and helicopters) and artillery. The army controls the roads, forcing the Taliban to concentrate their forces, to avoid getting taken apart by road (and helicopter) mobile Pakistani infantry. The fighting began when the Taliban, who had always been dominant in Bajaur, sought to take over completely and drive government officials out. The army responded with over 10,000 troops, and more following, and went after the towns, villages and walled compounds known to be bases for the enemy. The Taliban did not expect the army to respond so energetically. But the Taliban had prepared ambushes along the roads (by renting houses, and digging tunnels and bunkers next to them for shelter from artillery and bombs). In response, the army detected these preparations (with air reconnaissance, patrols and local informants), and avoided, or destroyed, these positions. (From StrategyPage.com)

The Top 10 Forecasts from The Futurist

Since 1985, the editors of The Futurist magazine (from The World Future Society) have selected the top 10 forecasts from their magazine. The forecasts are included in a publication entitled Outlook which is published at yearend. Here are the top 10 for 2008:

1. The world will have a billion millionaires by 2025. Globalization and technological innovation are driving this increased prosperity. --James Canton, author of "The Extreme Future," reviewed in The Futurist May-June 2007, p. 54

2. Fashion will go wired as technologies and tastes converge to revolutionize the textile industry. Researchers in smart fabrics and intelligent textiles (SFIT) are working with the fashion industry to bring us color-changing or perfume-emitting jeans, wristwatches that work as digital wallets, and running shoes like the Nike +iPod that watch where you're going. Smart fabrics could

revitalize the U.S. and European textile industry. --Patrick Tucker, "Smart Fashion," Sep-Oct 2007, p. 68

3. The threat of another cold war with China, Russia, or both could replace terrorism as the chief foreign-policy concern of the United States. Scenarios for what a war with China or Russia would look like make the clashes and wars in which the United States is now involved seem insignificant. --Edward N. Luttwak, "Preserving Balance among the Great Powers," Nov-Dec 2006, p. 26

4. Counterfeiting of currency will proliferate, driving the move toward a cashless society. --Allen H. Kupetz, "Our Cashless Future," May-June 2007, p. 37

5. The earth is on the verge of a significant extinction event. The twenty-first century could witness a biodiversity collapse 100 to 1,000 times greater than any previous extinction since the dawn of humanity, according to the World Resources Institute. --World Trends & Forecasts, Nov-Dec 2006, p. 6

6. Water will be in the twenty-first century what oil was in the twentieth century. Global fresh water shortages and drought conditions are spreading in both the developed and developing world. In response, the dry state of California is building 13 desalination plants that could provide 10%-20% of the state's water in the next two decades. Desalination will become more mainstream by 2020. --William E. Halal, "Technology's Promise: Highlights from the TechCast Project," Nov-Dec, p. 44

7. World population by 2050 may grow larger than previously expected, due in part to healthier, longer-living people. Slower than expected declines of fertility in developing countries and increasing longevity in richer countries are contributing to a higher rate of population growth. --World Trends & Forecasts, Sep-Oct 2007, p. 10

8. The number of Africans imperiled by floods will grow 70-fold by 2080. The rapid urbanization taking place throughout much of Africa makes flooding particularly dangerous, altering the natural flow of water and cutting off escape routes. --World Trends & Forecasts, July-Aug 2007, p. 7

9. Rising prices for natural resources could lead to a full-scale rush to develop the Arctic. Not just oil and natural gas, but also the Arctic's supplies of nickel, copper, zinc, coal, freshwater, forests, and of course fish are highly coveted by the global economy. --Lawson W. Brigham, "Thinking about the Arctic's Future: Scenarios for 2040," Sep-Oct 2007, p. 27

10. More decisions will be made by nonhuman entities. Electronically enabled teams in networks, robots with artificial intelligence, and other noncarbon life-forms will make financial, health, educational, and even political decisions for us. Reason: Technologies are increasing the complexity of our lives and human workers' competency is not keeping pace well enough to avoid disasters due to human error. --Arnold Brown, "'Not with a Bang': Civilization's Accelerating Challenge," Sep-Oct 2007, p. 38

Don't Worry-Be Happy

The September 8th issue of Barrons featured an editorial commentary entitled Lessons from the Poor by Alvaro Vargas Llosa, editor of the book of the same name. He related success stories from Peru. The Ananos family lived in a remote area into which the guerilla movement made transportation tough. There was a shortage of goods including soft drinks. The family began to make a low cost soda called Kola Real. They reinvested their profits, dealt with the regulatory system, and employed locals to transport the product. Unemployed Peruvians bought soda, trucked it to neighborhoods and re-sold it. The family bypassed the media and used special marketing campaigns that appealed to their low-income customers. The Ananos Ajegroup is now the largest maker of non-alcoholic beverages with 8000 employees and an estimated $1 billion in sales.

Llosa also wrote about Aquilino Flores was a migrant who washed cars. Flores began to sell t-shirts, but he found that shirts with printed colors sold better. A large order for the popular shirts caused Flores to enlist other garment makers. This enabled them to set up their own workshops and retail outlets under the name Topy Top. In 12 years, the company became Peru's leading textile importer with 5000 employees and $100 million in annual revenue.

Llosa says that the lesson is that free enterprise is about the little guy. He feels that people in developed countries have lost sight of these humble beginnings because these beginnings were so far in the past. People who begin businesses do not require government help; they need assurances that governments will not hamper their growth.

Quote of the Month:

"Socialism is inseparably interwoven with totalitarianism and the object worship of the state…No socialist system can be established without a political police. They would have to fall back on some form of Gestapo, no doubt very humanely directed in the first instance."
Winston Churchill

Book Reviews

Spychips by Albrecht and McIntyre, 2005, Thomas Nelson publishers. Because I ran an IT portfolio in the 1990s, I am familiar with the semiconductor industry. RFID chips are placed into products as a means of inventory control. These chips have become to the size of a rice grain, and are powered by miniature battery circuits with mini antennas. Their signals can be picked up by scanners (portals made by Checkpoint) within stores. What I did not know was that the decision has been made by industry to place one in every item that is produced so that its entire life cycle can be traced from store shelf to the recycling center. Major corporations have contributed to this effort. The authors personally attended the meetings at which these decisions have been made. The authors have exposed many unannounced tests of this system including the placement of such a chip in the cardboard backing of packs of razor blades. The shelf display was equipped with a camera that snapped a photo of the person who removed the blades from the shelf. The writers explain that corporations and government are planning to track our every step in the future. For example, an RFID in a pair of shoes is likely an effective method of tracking because people are unlikely to loan shoes to another person. The entire phenomenon is powered by miniaturization, which will only become more powerful in the future.

Turning Points

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

3 24*

9* 28

16-17*

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

2-3* 24*

10 28*

15

CFRS Portfolio

The CFRS portfolio declined 2.91% in Q2 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.

Cycles Research
511 6th Ave.
No. 550
NYC
NY 10011-8436