From the Chartroom

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A Sniff of Deflation? — Comparing Apples to Oranges

"From the Chartroom" is drawn from our full *Market Interpretations*, dated September 4, 2002, order No. US09K017. The report is also available online on Salomon Smith Barney's Global Equities Online (GEO) system, SSB Direct, and FC Linx.

There have been many media observations regarding the extreme behavior in equity market and bond market statistics over the past two years. The extremes have been visible in their related indicator readings, such as deep oversold readings for unprecedented periods of time. Many media sages believe that these extremes would represent a market turn (change of direction — specifically a bottom) because the data reflect levels that, based on data cited throughout the 1980s–90s, represented turning points.

We have continuously noted that many of the comparisons may be akin to comparing apples to oranges. We know the 1980–2000 period represented a structural (secular) bull market environment, and our research has suggested that 2000–present represents the early phase of a structural (secular) bear market.

We believe that first, one has to set the stage and paint the scenery correctly, or the actors will be performing on the wrong stage (with the wrong play). In other words, statistics that have functioned one way during a structural bull market may not be expected to function similarly during a structural bear trend and, in fact, *should be anticipated* to possibly function differently.

Just as in the early 1990s, contrary to our technical evidence, many strategists were suggesting the bull market could not continue, basing their statistical data comparisons to behavior during the 1970s, which was a structural bear market period. Similarly, today we have been bombarded by data suggesting the bear trend cannot continue by virtue of comparisons of today's behavior to that of the 1980s–90s, a structural *bull*, thus making the same mistake in reverse.

There are some scripts we would like to attempt to reassign to their proper stage settings.

Technical Scripts

For example, over the past two years we have seen repeated failures of the TRIN indicator, which proponents claim "when either oversold, or with a reading above the level of 'two' for two days in a row, indicates a *Buy* signal." In fact, the TRIN rarely flashes an oversold signal (the empirical evidence of selling pressure) in bull markets (see Figure 1) and, when it has, an alleviation of that oversold (selling pressure) has led to some type of rally effort.

Contrarily, over the past two years, the TRIN has remained *predominantly* in an oversold condition and has displayed numerous consecutive days in excess of "two," but without the alleviation of that oversold or the expected rally effort. Such an unprecedented sustained event (evidence of selling) should surely be recognized as *different*, or perhaps at least representative of a *very changed* underlying environment (apples to oranges).

Fundamental Scripts

Similarly, more fundamental data, such as S&P 500 over or under "fair value," are based on earnings, in relation to the 10-year U.S. treasury note yield. Yet, earnings remain a variable, in flux particularly today. Similarly, dividend–discount models data, in an environment when some dividends are being cut to pay off debt (**CMS Energy** [CMS-10.12], **H.J. Heinz** [HNZ-36.87], **Campbell Soup** [CPB-22.93] as recent examples), may behave differently. The earnings, or dividends, may not be as they seem; therefore, the concluded data may not hold.

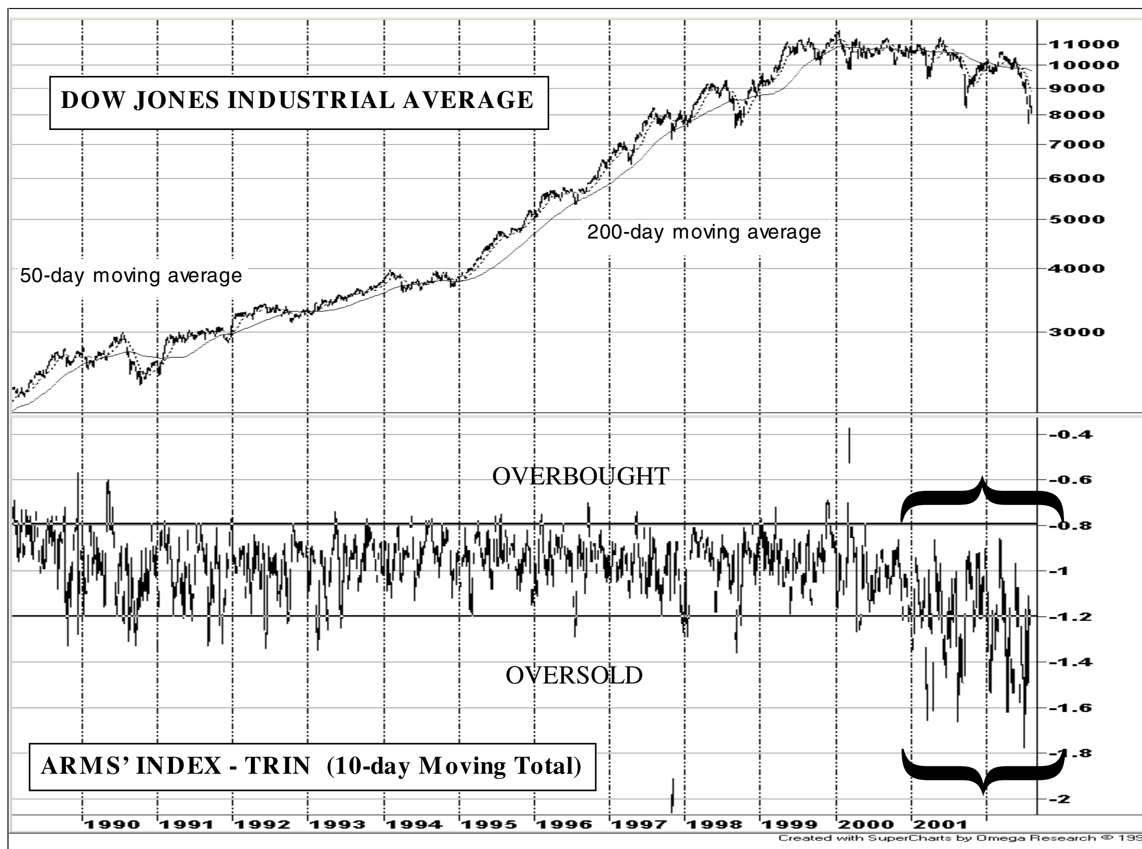
Nevertheless, these data are in most cases also being compared only with 1980–2000 (bull market) data as an argument as to why the equity market *ought* to behave a certain way — in this case go up.

Summary

We must also recognize that equity market indicator statistics can achieve *much lower extremes* in a bear market environment, just as many readings went to euphoric extremes in the bull market. Furthermore, one must also distinguish *this* bear market environment

Figure 1

Dow Jones Industrial Average



Source: SuperCharts by Omega Research

(which may be trending toward deflation) from the prior bear of 1966–82, which represented a very different, inflationary, bear market environment. Therefore, once again, even bear market data may prove to behave differently (apples versus oranges): One may need to stretch back further in history to the 1929–42 bear trend, which shared some of today's data and deflationary symptoms.

Perhaps it is because memories are short, or that "black box" calculations are taken for granted. Yet the underlying differing structural characteristics of a market environment, the apples/oranges stage setting, are often mistakenly set aside as irrelevant — or worse are simply ignored completely as even a possible alternate probability. It has been said that the one thing we learn from history is that we don't learn from history.

Intermarket Scripts

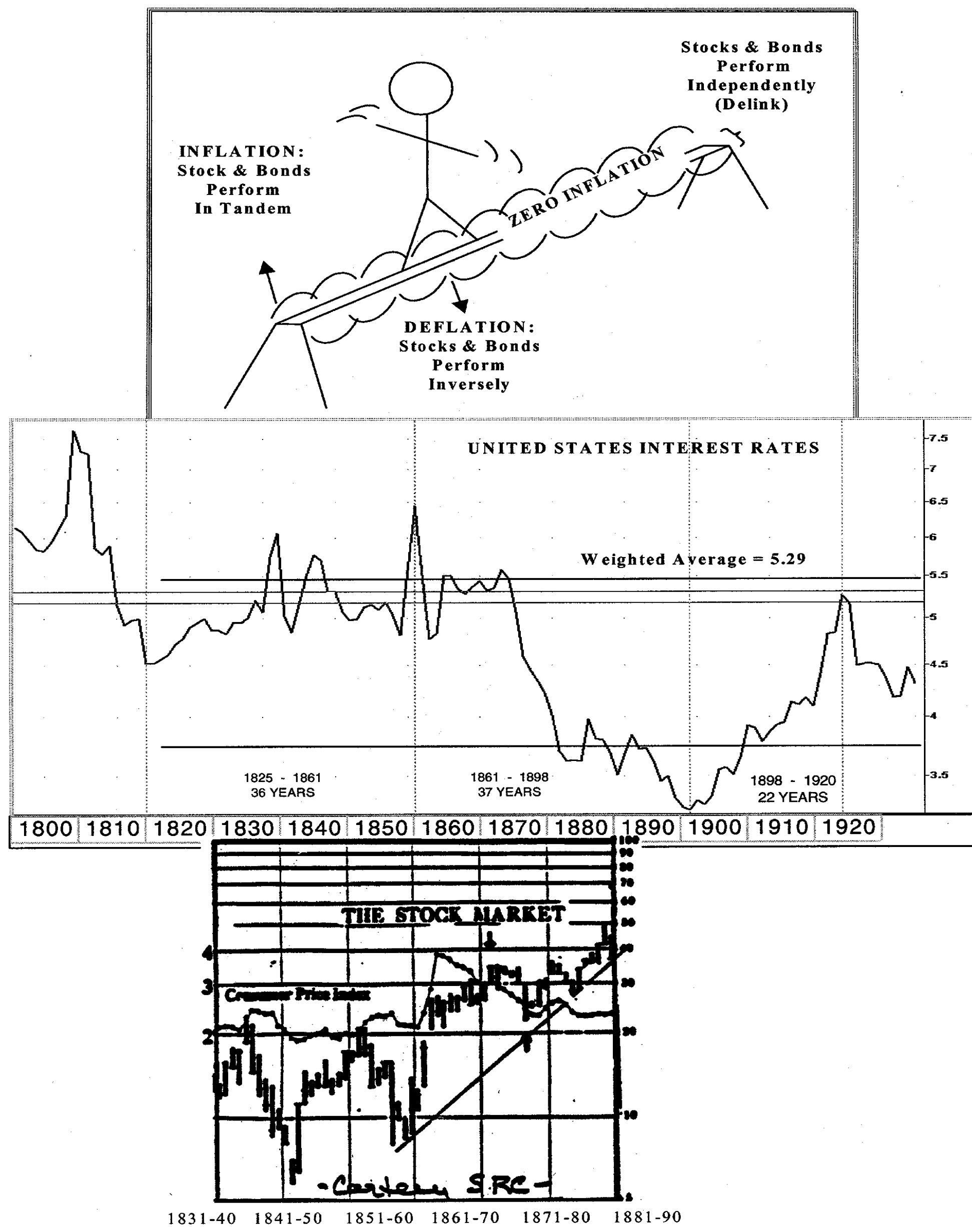
Another technical correlation, that between the stock and bond intermarket behavior, is one that also often overlooks the underlying structural environment. This may be due to the historically long interest rate cycles (22–37 years). One generation of observers becomes accustomed to one long cycle of consistent behavior. When market forces introduce another behavior relationship, the change can be puzzling without examining history.

Since the stock market/bond market relationship may be close to one of its transition phases, observers seem puzzled as to why the falling rates have not been reflected in a rising equity market (the causal relationship that had been in place during the 1980s and 1990s). Therefore, we thought addressing the variations of their relationships in historical context might be helpful.

We believe this stock market to bond market relationship can be simplistically depicted in Figure 2. We created a stickman (the economy) atop a tightrope representing zero inflation. As long as the stickman can keep his balance, which allows for minor fluctuations to either side of zero inflation, as he sways slightly to steady himself, stocks and bonds perform independently.

Figure 2

Stock Market to Bond Market Relationship



Source: Salomon Smith Barney and Securities Research Company

One could say they delink: Bonds will do well (since rates decline or stay low) because there is no (or little) inflation, but stocks will perform well only to the extent that they can show *growth* characteristics (they will not be pulled up in price on the back of inflationary forces). The 1990s might qualify as such a period. And this may well be a reason why some CEOs pulled out all stops to report perceived growth (and reward themselves handsomely). Some of this growth has proven to be smoke and mirrors.

However, there are two other scenarios. If the stickman falls off the tightrope toward the *side of inflation*, stocks and bonds perform more in tandem: they *both underperform adjusted for inflation* (bond price goes down, yield up); while stock prices in the absolute may be pulled up by inflationary forces, adjusted for that inflation the asset actually *diminishes in real value*.

The 1966–82 structural bear market would qualify as such an inflationary period, during which despite generous interim cyclical rallies, stocks lost 75% of their real value, adjusted for inflation, and interest rates (long term) rose from approximately 4% to 14%.

On the other hand, in the third scenario, were the stickman to fall off the tightrope toward the *side of deflation*, stocks and bonds (U.S. government bonds) perform *inversely*. Stocks go down in price and U.S. government bonds go up in price (yield falls). Because debt is ever more burdensome in a deflationary environment, corporate bonds generally go down in proportion to their corporate indebtedness. This third scenario is very similar to current behavior.

Contrary to some recent media suggestions that there has never been such a period in history with stocks falling as rates fell, there have actually been two. The first was 1870–75, during which equities fell 35%, inflation was declining, and interest rates fell from approximately 5.5% to 4% on the way to 3% in 1899 during a 37-year cycle of falling rates (see Figure 2).

The second example was 1929–32, when the equity market declined 89% during the 1929–42 bear market and interest rates fell from approximately 5.25% toward 3%, on the way to about 2.5% in the late 1940s. This encompassed another deflationary environment, which occurred during a 26-year cycle of declining U.S. government interest rates. As a point of interest, rates continued to fall *beyond* the equity market low put in place for each of these bear cycles.

Today

How is all this applicable to our current experience? Today, the equity market has fallen since its early 2000 peaks (the Nasdaq is down 76%, the S&P 500 has dropped 48%, and the Dow is down 34% through this writing) and long rates have fallen from about 7% to 4% during a declining interest rate cycle that has thus far lasted 22 years (since 1981). We have a further technical target at 3% for the 10-year note (see Fixed Income herein).

What we know from history is that the current 12 cuts in the discount rate (11 for the federal funds rate) have, at least through the first eight reductions, *failed to lift equities* over the subsequent three-, six-, and 12-month periods. The only other period in history when eight discount rate cuts *failed* to move the equity market was in 1929–32. In fact, as history shows, the relationship between interest rates and the equity market today, perceived by many to have "broken down," is not unprecedented.

The seemingly diverse action of stocks and bonds may therefore be telling us, through their current price action (in price there is knowledge), that we may be once again entering/experiencing an environment that is *dipping into deflation* (an underlying concern first expressed in our "Structural Bear Market in Progress" series in *Market Interpretations*[1].

These observations may be suggesting that the stickman may once again be at risk of falling off the tightrope (toward deflation). It is not unprecedented and perhaps best not to ignore history and at least recognize such a possibility from the market warnings — the better to respond accordingly. Let's at least be sure we are comparing apples to apples — the right script on the right stage. **L.Y.**

Market Update

On August 28, 2002, the attached *Tech@lert* was sent to clients as the rally effort appeared to be failing (see Figure 3; for the *Tech@lert* charts, please see *Market Interpretations* dated September 4, 2002). **L.Y.**

Sub-Industries

Part I: Gold Glistening and Lifting Again

The Gold stocks started to perk up again last week, completing a consolidation period extending back to June. As noted in the Market section herein, the major market barometers recently broke down from their short-term "rising wedges," suggesting a higher probability of general equity selling, perhaps to result in at least a test of their July lows. Such a market development would likely have a positive impact on the price of Gold and respective stocks. The Gold & Silver index (XAU-70.77) itself moved through both its 50- and 200-day moving averages last week, and short-term momentum models are bullish. The moving averages both lie at 68, and price support for the index is at 63–64.

Turning to the stocks, **Newmont Mining** (NEM-29.07), the most widely followed, looks short-term bullish and is challenging resistance at 29. A breakout could result in a quick challenge of the next resistance at 32. Support lies at 25–26. If NEM were to hurdle 32, significantly higher technical price targets would be possible to calculate. **Barrick Gold Corp.** (ABX-16.41), once through minor resistance at 16, could challenge next resistance at 18–19. Support lies at 15. **Meridian Gold** (MDG-19.40) is trying to emerge through its all-time high of 20, which would be through nearly three

[1] See *Market Interpretations* dated March 22, 2001, order No. US03J226; March 29, 2001, order No. US03J291; May 3, 2001, order No. US05J006; and May 8, 2002, order No. US05K106.

Figure 3

Tech@lert

See last pages for Important Disclosures

tech@lert

U.S. Equity

August 28, 2002 No. 2002-32

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RALLY EFFORT FAILING?

DJIA & S&P 500

Breaking Down

From Rising Wedges

- **Both the Dow Jones industrial average and the S&P 500 index appear to be breaking down from so-called "wedge" formations as of today's up-to-the minute action (see charts).**
  - ⇒ **Rising wedges are quite common in bear market progressions (just as falling wedges characterize profit-taking trends in bull market progressions).**
  - ⇒ **According to technical theory, the entire price swing of the wedge's formation can be retraced in fairly rapid order.**
  - ⇒ **Such an outcome for the Dow would retrace to the July low at approximately 7750; for the S&P 500, such a retracement would work out toward roughly 800.**
- **Regarding the NASDAQ Composite, the rising wedge formation is not apparent, but the recent uptrend is being violated, and we believe the index looks poised to at least come back off and test its July-August lows at 1200-1225 range.**

LOUISE YAMADA/ALAN R. SHAW

Source: Salomon Smith Barney

months of consolidation. An initial target reading toward 25 would be in place upon a breakout. Support lies at 16–17. **Placer-Dome Inc.** (PDG-10.46) appears poised to reach 11.25, an almost 8% rise from current levels. The stock's 50-day moving average lies at 9.69, and price support appears at 8–9. **ASA Limited** (ASA-30.75), having recently penetrated both its 50- and 200-day moving averages, shows the potential for a move to resistance at 33–34. Support lies at 28–29. **Gold Corp.** (GG-10.80) is challenging its all-time high of 11, and a breakout would put in place targets of 13 and 15. Support lies at 9–10. **Agnico Eagle Mines** (AEM-15.28) is challenging its all-time high and resistance at 16–17. Support lies at 13–14.

Other smaller names for consideration include **Royal Gold Inc.** (RGLD-14.82), **Gold Fields Ltd.** (GFI-12.39), **Echo Bay Mines** (ECO-1.07), **Bema Gold** (BGO-1.38), and **Glamis Gold** (GLG-9.47). Perhaps a "portfolio" of the above names would be the most desirable program going forward.

Part II: Highlights of the Week's Group Shifts

Numerous sub-industry shifts were effected for the week of September 3, seven to the upside and four to the downside. However, we should point out that momentum *Sell* signals remain in place despite the relative strength (RS) outperformance that have prompted the upgrades. Therefore, we remain defensive from an absolute price perspective. Actionable shifts include the upgrades of Industrial Gases to the technical *Buy* list, Health Care Equipment, Insurance Brokers, and Motorcycle Manufacturers to the *Hold* list, and the downgrade of Footwear to the *Avoid* list. Despite some RS improvement, of course with the exception of Footwear, we provide support levels to monitor in a table format in *Market Interpretations* dated September 4, 2002. **S.S.**

U.S. Interest Rates: U.S. Stock Markets Suggest Rates Could Move Lower Toward Our 3% Target for the 10-Year Note

The recent rally failure of U.S. equity markets to close above their respective overhead resistance levels (see U.S. Equity *Tech@lert* dated August 19, 2002) has increased the probability that interest rates could move

lower, as investors continue to switch funds from equities to safer U.S. Treasury fixed income investments.

Furthermore, this trend toward lower rates is not just a domestic development but appears global in scope. Like the recent U.S. equity market failure, global equity markets have followed suit and are also trending lower. In turn, global bonds, as measured by the 10-year world benchmarks, are all on long-term *Buy* signals, indicating lower rates are a continuing probability. Thus, most world equity markets may remain vulnerable.

Our long-term *Buy* signal of August 13 on the 10-year yield, with targets of 3.86% and 3.00%–3.20%, remain in place. We noticed over the years, however, that after the monthly models register a long-term signal (either *Buy* or *Sell*), that the market has had a tendency to go against the signal for the first week or two, before ultimately trending in the direction of the signal.

So, the volatility of the last two weeks is in keeping with historical action. We received the long-term *Buy* when the 10-year was at 4.20%. The 10-year yield then traded as low as 3.96% the following day, only to back up over the next three days to 4.35%. Over the following week, the 10-year fluctuated first back down to 4.16% and then backed up again to 4.31%. Currently, the 10-year is at 3.98%, testing the initial low at 3.96% on August 14.

The 30-year bond (4.83%) is currently poised to go on a long-term *Buy* as well. If the 30-year can close under 4.83%, as technical models suggest, we would then be able to project a target to 3.85%. **R.F.D.**

Currencies: U.S. Dollar Could Test Its July Lows

Since the beginning of August, the Finex U.S. dollar contract (DX-105.83) has been trading in a range between 106.00 and 109.00. During the rally attempt in mid-August, while the U.S. equity market set a new reaction high off its July low, the dollar contract failed to follow through, in effect diverging from the rally price action in equities (see chart in *Market Interpretations* dated September 4, 2002). The contract at that point may have been acting as a leading indicator versus equities.

Given the fact that the U.S. has continued to underperform other global regions, global managers may have again been selling the greenback into its rally, reflecting a more cautious stance on U.S. equities. Since then, U.S. equities and the dollar contract have pulled back. With short-term technical models for the greenback and U.S. equities negative, we would expect both markets to remain on the defensive and test their July lows. **R.F.D.**

The technical research group also produces electronically *Global Technical Market Overview* and *Global Technical Industry Overview* for international investors. These reports are available online only over the following Salomon Smith Barney websites: GEO, FC Linx, and SSB Direct.

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