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A NEW PERSPECTIVE ON MARKETS USING THE STABLE CURRENCY BENCHMARK

Our outlooks for the dollar, gold and silver are going well, but the stock market has been frustrating. This issue is dedicated to exploring and resolving the difficulties of Elliott wave analysis in the stock market since it turned down in 2000. Between 2000 and 2002, only the NASDAQ provided a clean five-wave count. That's because it was so thoroughly devastated that the changes in the dollar denominator of the index did not compromise its wave structure. But the fluctuations in the U.S. dollar (see Figure 1) have disrupted the expression of Elliott waves in most other indexes of U.S. stocks, causing us to miss calling the bear market rally and to expect tops too early. Normally, missing a bounce would not be a big deal, but the "bounce" is of Primary degree, so it has taken seemingly forever to end. If you have been in cash (Swiss francs or dollars), it's just boring, but if you're short (as we strongly recommend for speculators), it's a pain waiting through this rally for the next big wave down. As an analyst, the most irritating aspect of the situation is that under a stable valuation benchmark (as you will see in this issue), the Elliott waves have been clear, and the rally has been as weak as we would expect. The good news is that we now have a solution to the problem of wave expression under a wildly fluctuating currency.

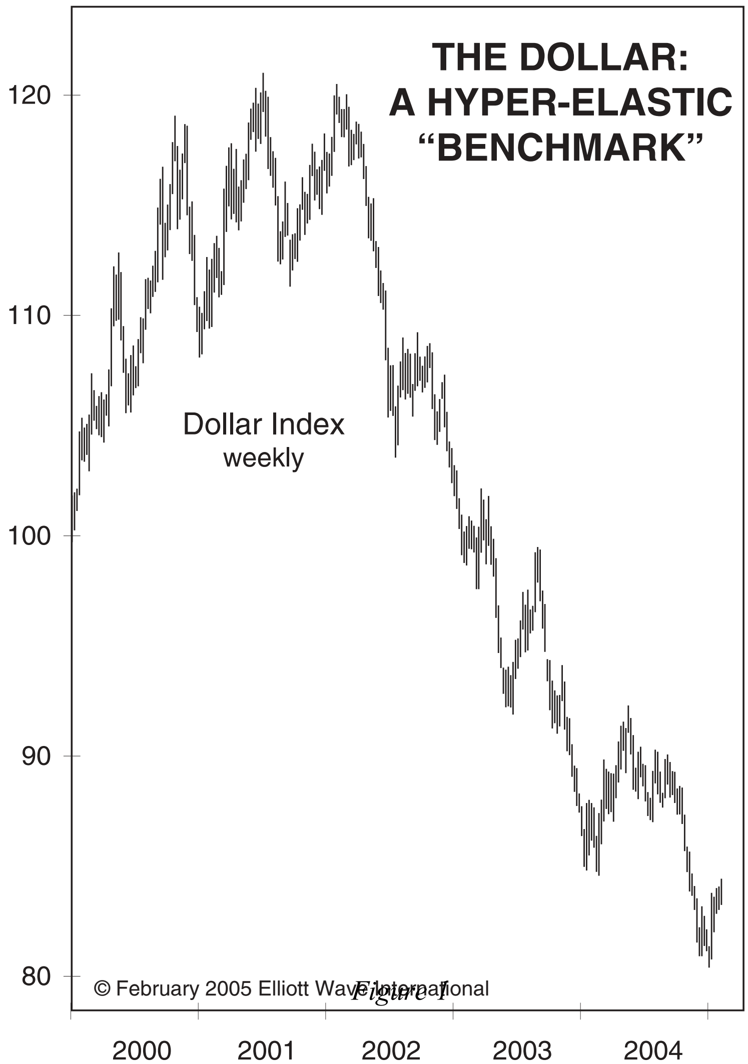


Figure 1

S&P 500

Elliott wave analysis on the S&P 500 has faced two obstacles. First, from the high in 2000, this index is difficult to count as a clean impulse, as indicated by the notes on the bottom graph in Figure 2. Second, the decline into March 2003 was five waves that *did not carry to a new low*, implying at the time that it was only wave 1 of (5) rather than the whole thing. "Truncations" (see text, p.34), in which the fifth wave does not reach a new price extreme, are rare events.

It is therefore of great interest that the S&P measured in just about anything but the U.S. dollar presents *neither of those problems*. The top graph in Figure 2 shows the S&P 500 in terms of a small basket of exceptional currencies, namely our Stable Currency Benchmark™ (SCB), an index comprising each global quadrant's most attractive currency, as described in the November issue. Keep in mind that this basket is not a "foreign currency index"; it *includes* the U.S. dollar. As a means of global purchasing power, this denominator is more comprehensive and stable than the dollar denominator of the nominal S&P.

Observe that the S&P/SCB counts as a pristine five-wave impulse, complete with an extended third wave and a fifth wave that falls to new lows, as it should have and as happened in most European stock markets. Notice also that the S&P/SCB's high occurred not in March 2000 but in *September*, which was the month of the high in the New York Composite index and the month that *Beautiful Pictures* postulated as the *orthodox* top, per the illustration reproduced as Figure 3. Next, notice that the S&P/SCB has gone sideways since April 2004 while the nominal S&P has risen. What's more, we can see that the rally since the bear market bottom has been anemic, so far retracing only 31 percent of the 2000-2003 decline rather than 58 percent as in the nominal S&P. From March 2003, the rally also lasted a Fibonacci 13

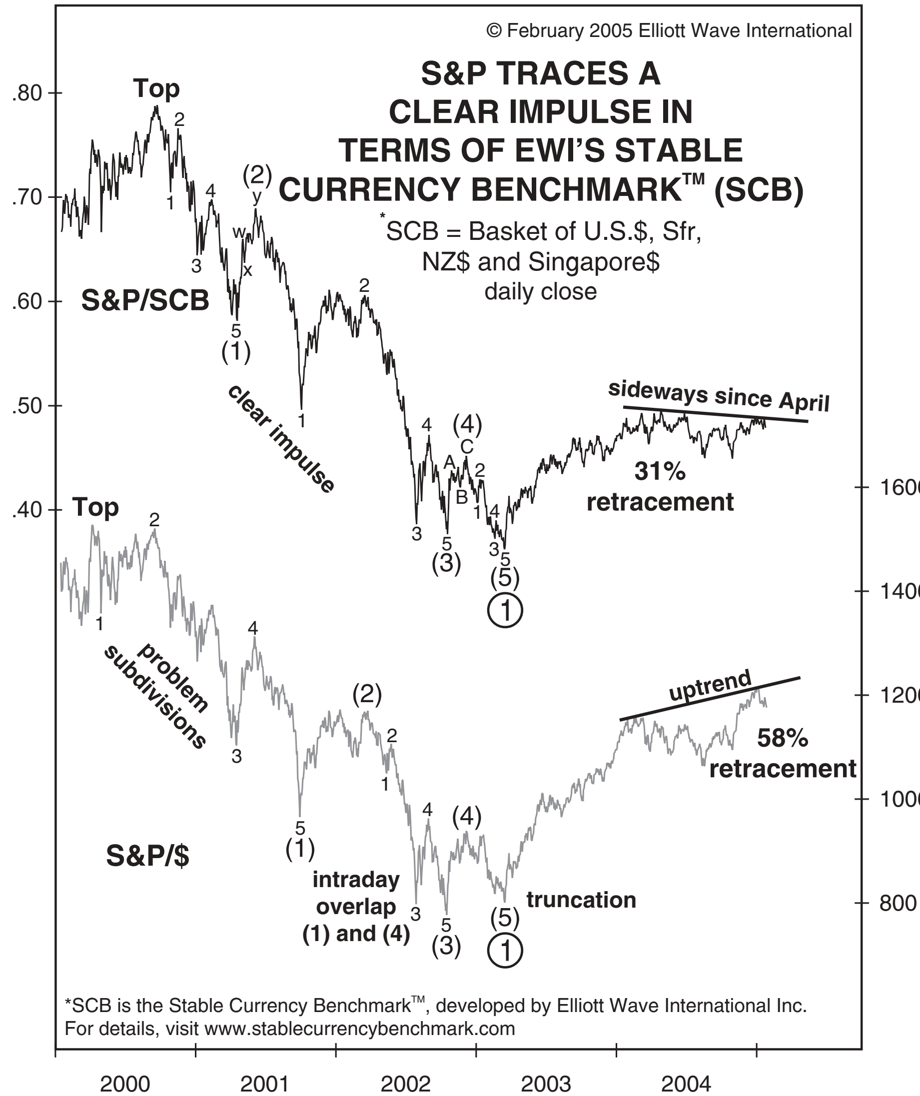
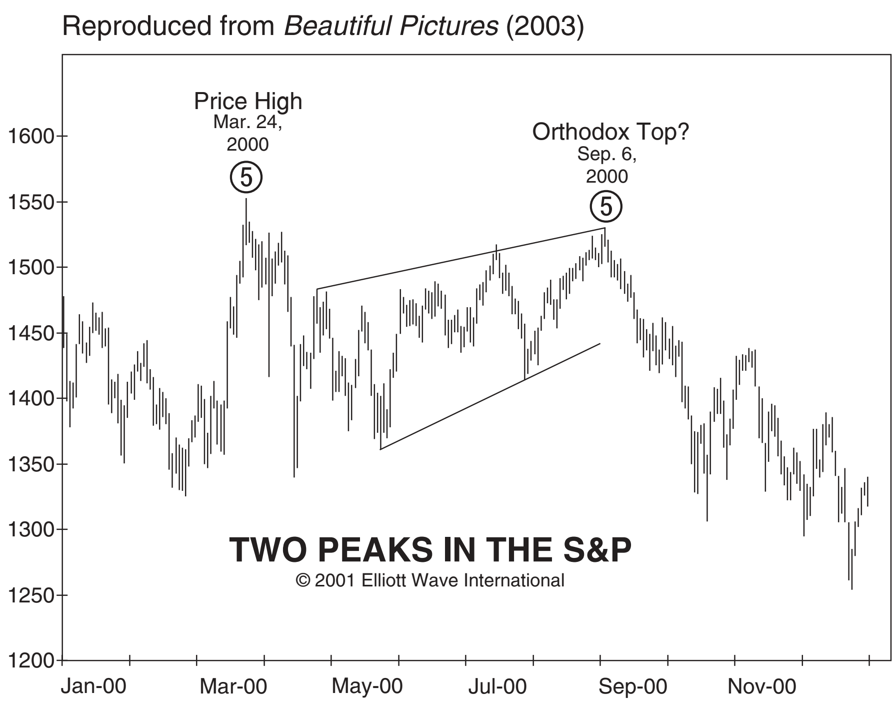


Figure 2

Reproduced from *Beautiful Pictures* (2003)



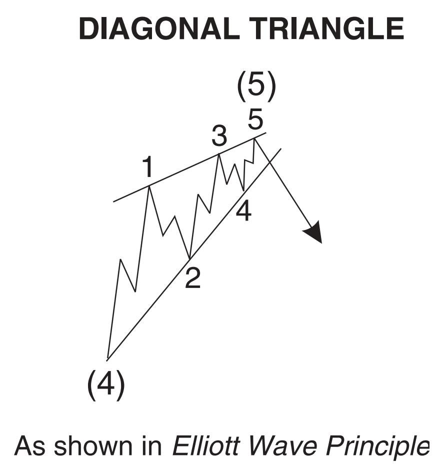


Figure 3

months up to last April and a Fibonacci 21 months up to December 2004, while measuring from October 2002 has provided no such durations (so far). Finally, marking March 2003 as the orthodox low (see bottom chart) reveals the S&P's rally from there as nothing but an A-B-C. So the waves are progressing properly when viewed in light of the S&P/SCB ratio. This is a panoply of anomalies corrected and uncertainties clarified, and the only thing making a difference between the two charts is the wildly fluctuating denominator of the S&P/$ ratio. The extreme movement of the U.S. dollar has been obscuring the proper view.

Had the actual S&P looked like the graph in Figure 2, the March 2003 low would have been a piece of cake to recognize, and the rally would have been a pitiful 31 percent, fitting our expectations much better. Our job is to predict the nominal averages, so we were still wrong. But with this ratio as a guide, we will be better armed in the future whenever the dollar is volatile. As long as we can track the market by way of the SCB, we can see both wave pictures, and one of them will be clear. Perhaps the SCB has even more value than we originally thought.

The World Stock Index

Figure 4 shows the World Stock Index in SCB terms (top) and in dollar terms (bottom). Observe that the index in dollar terms did not reach a new low in March 2003, but the WSI/SCB does. This makes the rally from there a clear *corrective* pattern. Moreover, the rally in SCB terms is only 36.1% while the rally in dollar terms is 62.6%. It is interesting that both numbers approximate Fibonacci ratios.

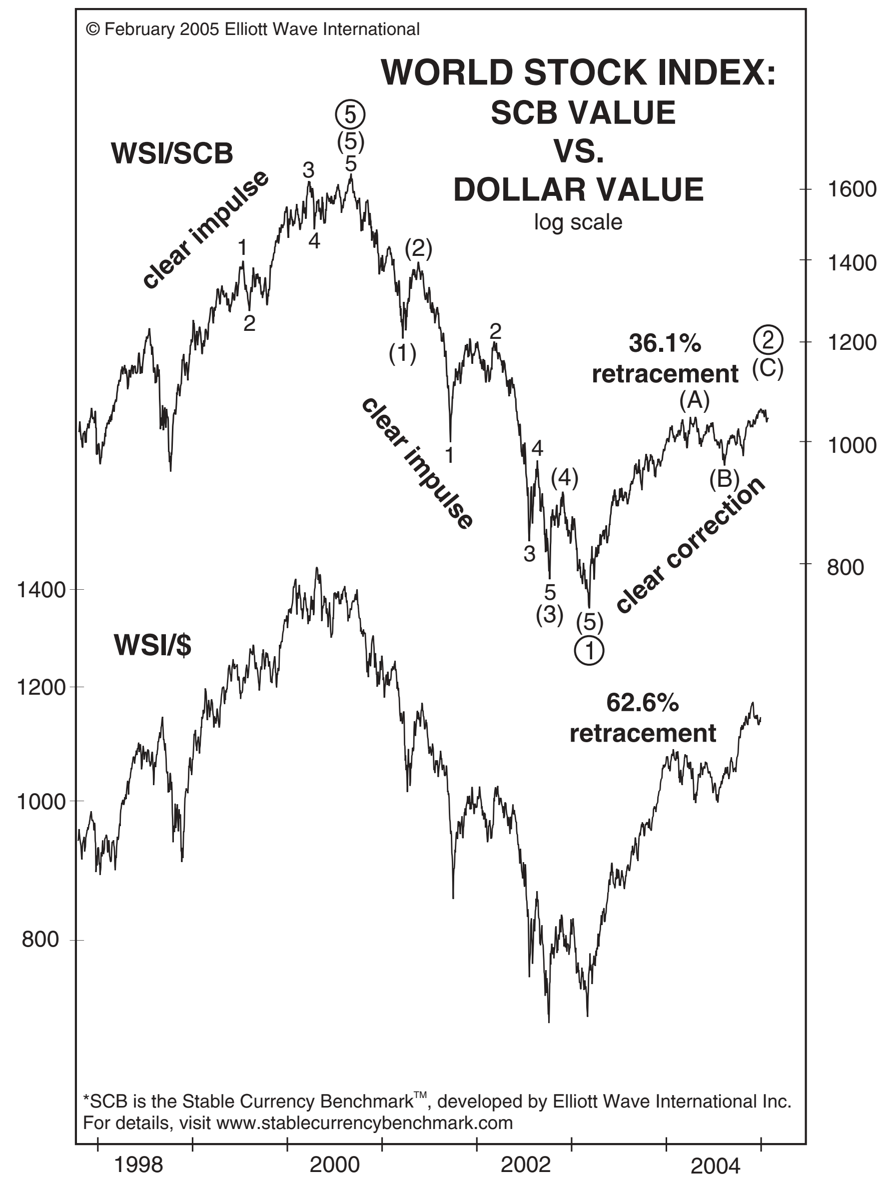


Figure 4

Gold, Oil and Commodities

The fall in the dollar has also overstated the rally in gold, oil and the CRB index in terms of their global purchasing value. Figures 5, 6 and 7 show these three markets in SCB terms (top) and dollar terms (bottom). CRB buyers in particular did themselves no favors over the past four years unless their only alternative was the dollar. Commodity investors whose benchmark was a major foreign currency or the SCB have *lost* global purchasing power since February 2001. Had they been in the SCB instead, they would have been better off and earned some interest to boot.

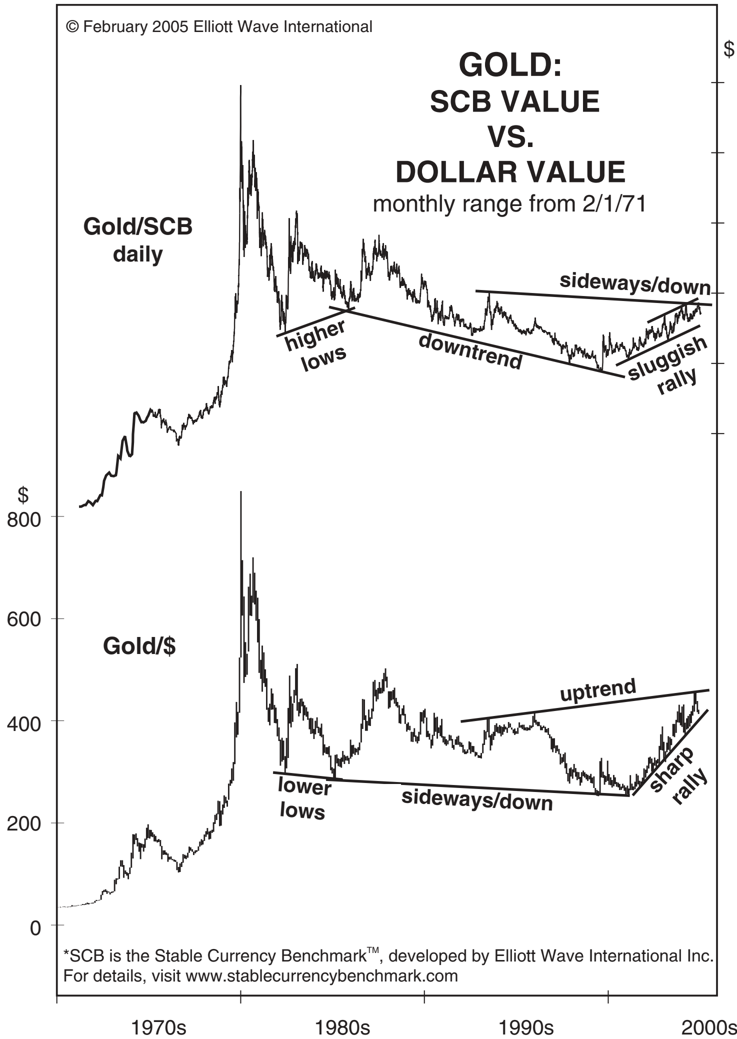


Figure 5

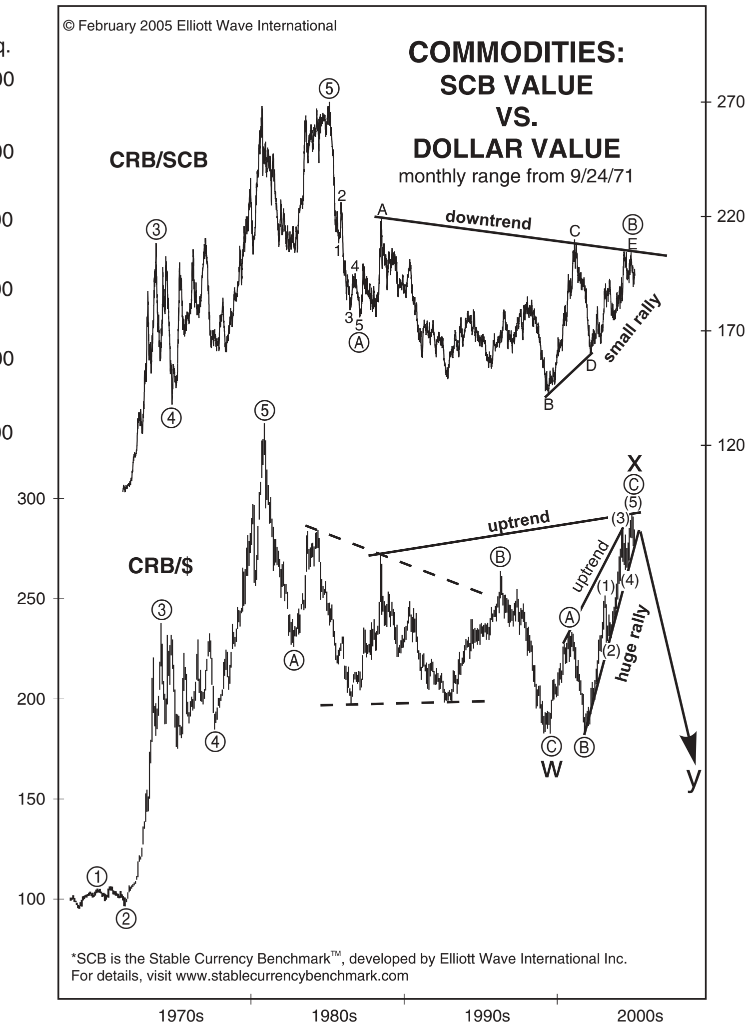


Figure 6

An Update of the Stock Market in Terms of Gold

At the Crest of the Tidal Wave showed a long term picture of the stock market in terms of gold, and EWT has updated the big picture ever since, most recently in the August 2004 issue. The short term picture of just the past five years is equally eye-opening. Figure 8 shows the slaughter of stock values in terms of real money (gold) and the pitiful, virtually non-existent, dead-cat bounce that has ensued. If you look at the recovery from October 2002, when most people date the bottom, the net gain in prices up to today is about zero. Yet people look at the nominal S&P and think the bull market is back. What a joke. The credit expansion from 2001 to the present, facilitated by the Fed, and the coincident collapse in dollar value have done nothing but fool people into a misperception.

Real Rallies and Fake Ones

The dollar's value crashed 33.6 percent from July 2001 to December 2004, justifying a rise in all financial markets by 50 percent *just to stay even* in terms of global purchasing power. Gold did better than keep pace, but all the Dow did was climb back to the same level it was in July 2001, which means that it actually lost 1/3 of its global purchasing power during this time.

It is further important to realize that although five stock market indexes (VLA, DJT, S&P Small Cap, S&P Midcap, Russell 2000) made a new high in 2004, only *one* index made an all-time high in terms of global purchasing power: the Value Line Arithmetic index, by a small amount.

As the dollar rallies — probably into 2006 or 2007 — these forces will be moving in reverse. During this time, the nominal Dow and S&P will probably become biased to the *downside* instead of the upside, minimizing stock and commodity rallies rather than magnifying them, thus prompting analysts to expect more gain in each rally than will actually occur. To counter that problem, we will keep these indexes in terms of both the dollar and the SCB.

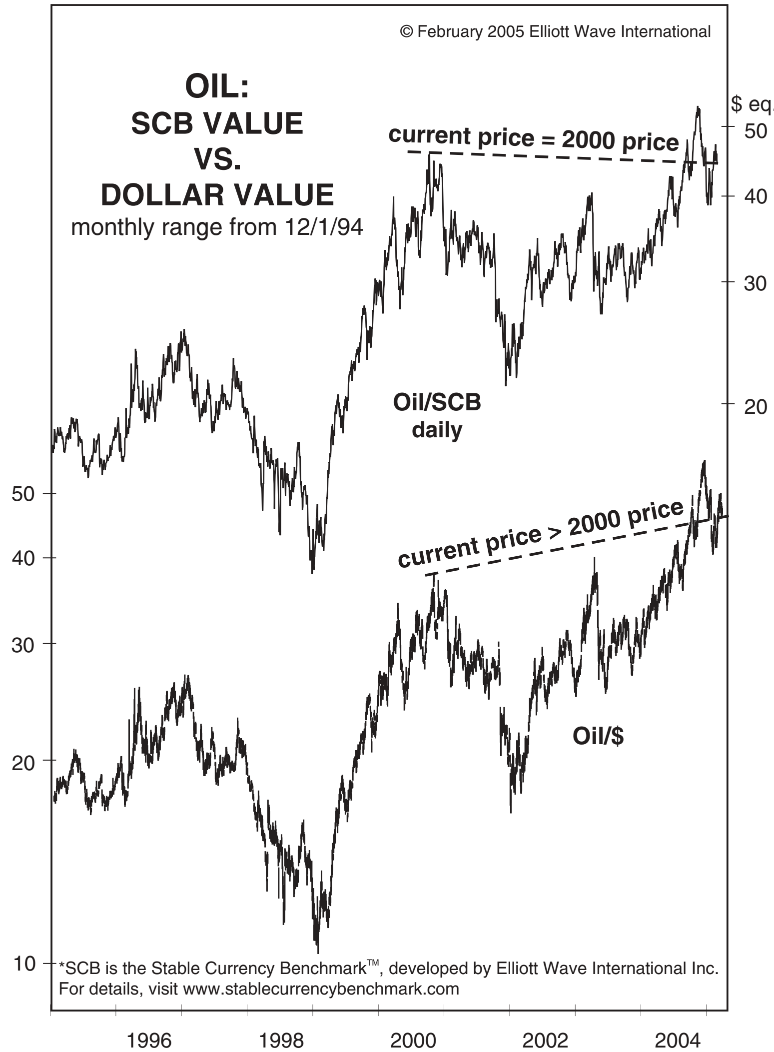


Figure 7