

MARKET
MYTHS

EXPOSED

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Market Myths Exposed

Introduction

One hallmark of Elliott Wave International's analysis is that we debunk market myths to help our readers protect their finances. For instance, how often have you heard that “earnings drive stock prices,” or that “news drives the markets,” or that “the FDIC can protect depositors”? All these market myths have been busted in the pages of *The Elliott Wave Theorist*, *The Elliott Wave Financial Forecast* and in books by Robert Prechter, including *Conquer the Crash: You Can Survive and Prosper in a Deflationary Depression*.

This information is valuable for investors. That's why we searched more than a decade of writings by Prechter and our senior analysts to find their best myth-busting analysis, and then collected them in this *Market Myths Exposed* eBook. So, if you have ever wondered if you “have to diversify” to reduce your risk or whether you can “anticipate investment trends” by reading news stories, then you will be pleased to discover exactly why these widely believed notions simply aren't true.

It's almost as if we've put together a special edition of the TV show, “Breaking the Magician's Code: Magic's Biggest Secrets Finally Revealed.” Except that we provide a more important service — to help you see through the misleading advice that passes as common wisdom in the world of investing. Learning the secrets of magicians' slight-of-hand is interesting but not life-altering. On the other hand, for those who are unaware of how the markets really work, market myths can inflict huge damage on their financial portfolio.

We hope that you get a new view of the markets by reading this eBook, and that it helps you to make the most of your investing.

Editor's note: If you would like to get a monthly edition of forecasting and market myth-busting, take a look at our two financial forecasting services, [*The Elliott Wave Theorist*](#) by Robert Prechter and [*The Elliott Wave Financial Forecast*](#) by Steve Hochberg and Pete Kendall.

Market Myths Exposed

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Market Myths Exposed

Myth No. 1: Earnings Drive Stock Prices

Myth No. 2: Small Stocks are the Place to Be

The Elliott Wave Financial Forecast, December 4, 2009

Stock Market Myths

The community of Elliotticians is growing. In recent months, *The Elliott Wave Financial Forecast* and *The Elliott Wave Theorist* have added many new subscribers. Welcome and congratulations on your timing. We believe that you will be on board for some of the most exciting stock market action in history. To orient new subscribers to our approach and alert long-timers to some current applications, we will review some common stock market misconceptions here and in future issues.

Myth No. 1—"The bottom line is earnings drive stock prices"—Investopedia.com. It's simply not true. The flawed notion that profits drive stock prices is something that EWI has discussed numerous times over the years. For one thing, quarterly earnings reports announce a company's achievements from the previous quarter. Trying to predict future stock price movements based on what happened three months ago is akin to driving down the highway looking only in the rearview mirror. The trends in earnings and stock prices sometimes even move in opposite directions, such as in the 1973-74 bear market when S&P earnings rose every quarter as the S&P declined 50%. More recently, earnings have been cycling *with* stocks, but that still leaves the problem of reporting delays, which leave investors eating the market's dust when the trend changes. To try to get around this, pundits use analysts' estimates of future earnings as a guide. In doing so, however, they are subject to the same herding impulses as investors. As *Conquer the Crash* puts it, "Earnings estimators are too pessimistic at bottoms and too optimistic at tops, just when you most need the indicator to tell the truth." This is what we were getting at last month

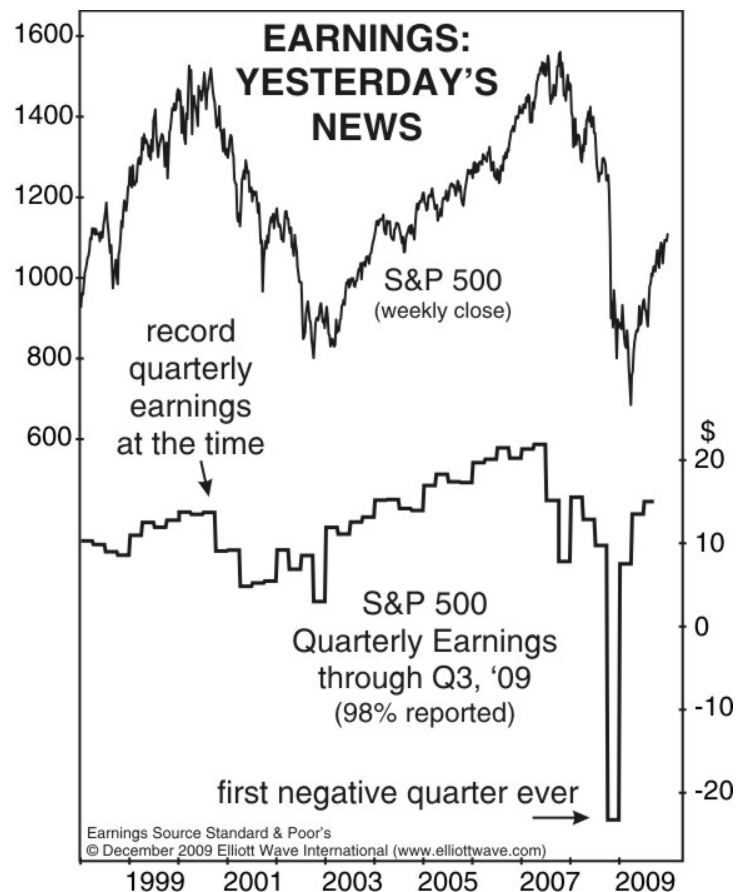


Figure 1

For more market myth busting, including critical long-term Elliott wave analysis of the markets you follow, preview the latest *Elliott Wave Theorist*: <http://www.elliottwave.com/wave/latestthe>

when we used highly optimistic earnings expectations as a contrary indicator. Earnings must now boom to fulfill expectations. As they fail to do so, stocks will tank, and people will say it's because earnings disappointed. No, it's because social mood turned down. You read it here first.

Myth No. 2—Small stocks are the place to be. As one headline from earlier this year put it: “Small Firms See Silver Lining in Deflation Cloud.” The common refrain is that small caps will score efficiency gains because “they are typically more nimble.” But they are also less well capitalized and thus susceptible to price wars, spiraling asset devaluations and tighter credit conditions. “Since the onset of the credit crisis over two years ago, available credit to small businesses and consumers has contracted by trillions of dollars,” says analyst Meredith Whitney. She estimates that credit-line cuts to small business are about halfway through, but this estimate will prove overly optimistic. Small business loans are frequently backed by collateral such as homes, buildings, inventory and receivables. As these items decline in value, creditors will not make new loans or roll over old ones, forcing more sales and intensifying the small business person's plight. As we noted in last month's Bottom Line, small-cap shares are “providing downside leadership.” They continue to do so, signaling a burgeoning decline for the larger stock market as well as intensifying deflationary pressures.

Myth No. 3: Worry About Inflation Rather than Deflation

The Elliott Wave Theorist, November 19, 2009

CONTINUING—AND LOOMING—DEFLATIONARY FORCES PART 1

The Fed and the government quite effectively advertise their efforts to inflate the supply of money and credit. But deflationary forces, to most eyes, are invisible. I thought I would point some of them out.

Banks Are About 95 Percent Invested in Mortgages

Figure 2, courtesy of Bianco Research, shows that U.S. banks used to be fairly conservative, holding 40 percent of their assets in Treasury securities. This large investment in federal government debt, the basis of our “monetary” “system”, served as a stop-gap against deflation. In 1950, even if mortgages had been wiped out by a factor of 80 percent, banks still would have been 50% solvent and 40% liquid. Today, banks hold federal agency securities (backed mostly by mortgages), mortgage-backed securities (meaning complicated packages of mortgages), plain old mortgages that they financed themselves, and a few business loan contracts. If these mortgages become wiped out by a factor of 80 percent, which in turn would cause many of the business loans to go into default, the banks will be only about 22% solvent and 1% liquid. I believe the coming wipeout will be bigger than that, but let’s be conservative for now. The point is that, unlike Treasuries, IOUs with homes as collateral can fall in dollar value, and such IOUs are pretty much the only paper backing U.S. bank deposits. The potential for deflation here is tremendous.

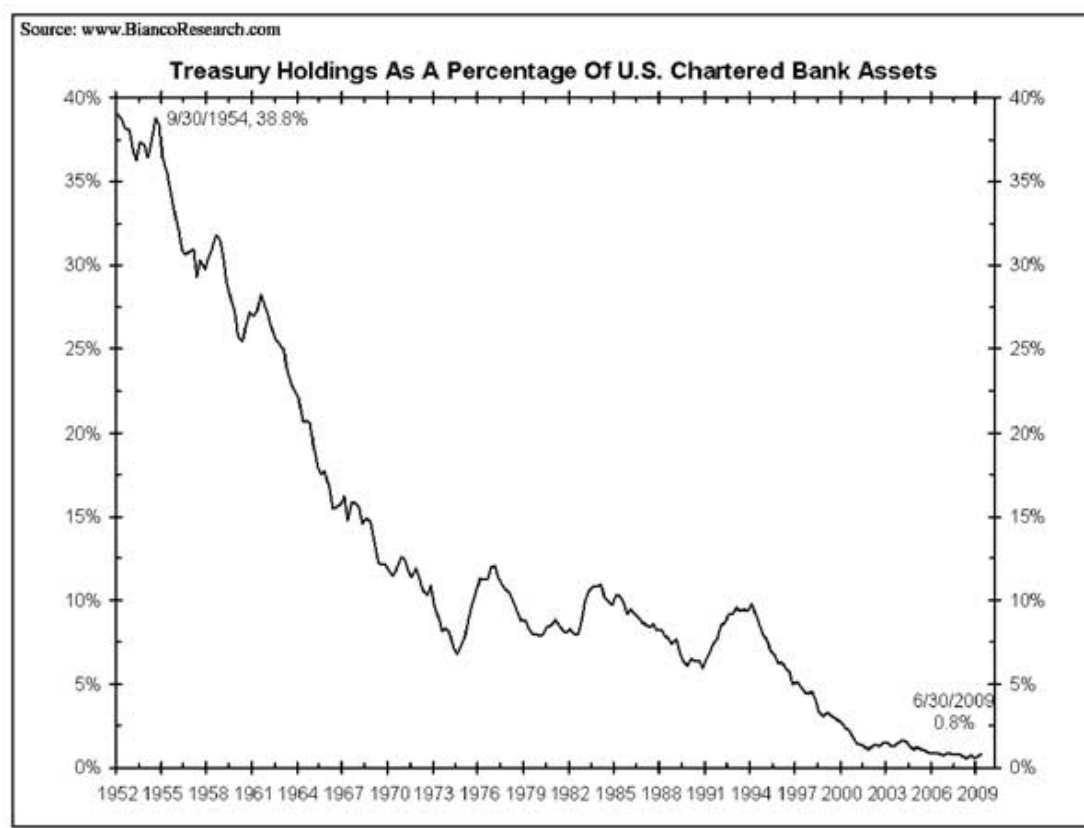


Figure 2

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More Mortgages Are Going Under

It has been well publicized recently that commercial real estate has been plunging in value as business tenants walk away from their leases, leaving properties empty. Zisler Capital Partners reports, “Returns were negative for the past five quarters, the longest streak since 1992. Property prices have fallen by 30 percent to 50 percent from their peaks. Much of the debt is likely worth about 50 percent of par, or less.” (Bloomberg, 11/11) Needless to say, the fact that commercial mortgages are plunging in value is stressing banks even further, which in turn restricts their lending. This trend is deflationary.

Banks Have Lent to the Wrong People for Decades

Figure 3 shows something amazing about banks’ lending to small businesses. Most people would focus on the trend of this line, which is down to its lowest level since the interest rate crisis of 1980. Indeed, this is another indication of deflation. But look at where the line is compared to the “zero” line. What this chart tells us is that for at least 3½ decades, banks have under-lent to the one sector—business—that can create profits to pay them back. Businesses report that since 1974, ease of borrowing was either *worse or the same* as it was the prior quarter, meaning that—at least according to business owners—loans have been increasingly hard to get the entire time. This means that banks were shunning businesses in order to lend to consumers who

wanted to buy homes, cars, furniture and who-knows-what on their credit cards. As explained in *Conquer the Crash*, the only loans that are traditionally categorized as “self-liquidating” are *business* loans, because businesses *make money* to pay them off. Consumer loans have no basis for repayment except the borrower’s prospects for employment and, ultimately, collateral sales. Consumers *consume*, so whatever they buy with borrowed money *loses value* over time, whereas successful businesses *gain value*. As bank-credit and Elliott-wave expert Hamilton Bolton pointed out half a century ago (see *Conquer the Crash*, p.89), the biggest financial crises come from the unsustainable expansion of non-self-liquidating loans. And today, there are more such loans outstanding than ever before, by many multiples. Banks’ concentration in non-self-liquidating loans is bad news for debt repayment. The trend away from business loans, moreover, is accelerating. Figure 4 (WSJ, 11/11) shows that banks are choosing to invest new money in federal agency debt—which is all consumer debt—and Treasury debt. Creditors are finally coming to realize that individual debtors’ means of repayment are evaporating, which implies future deflationary pressure within the banking system.

SMALL BUSINESS CREDIT CONDITIONS

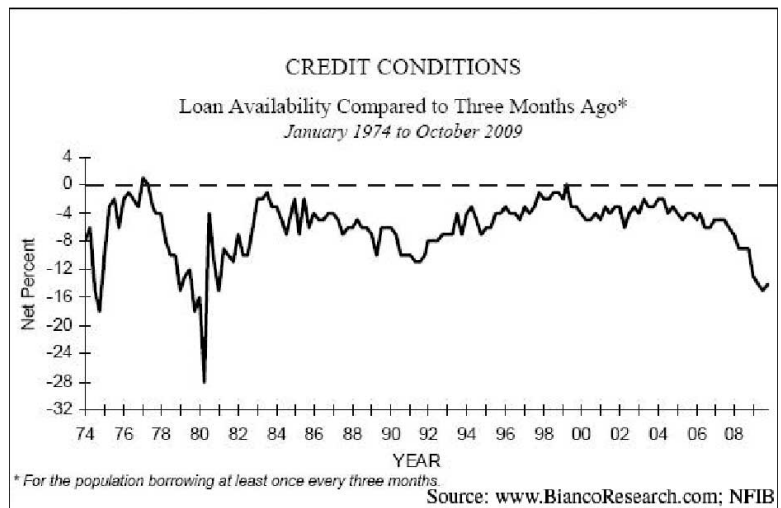


Figure 3

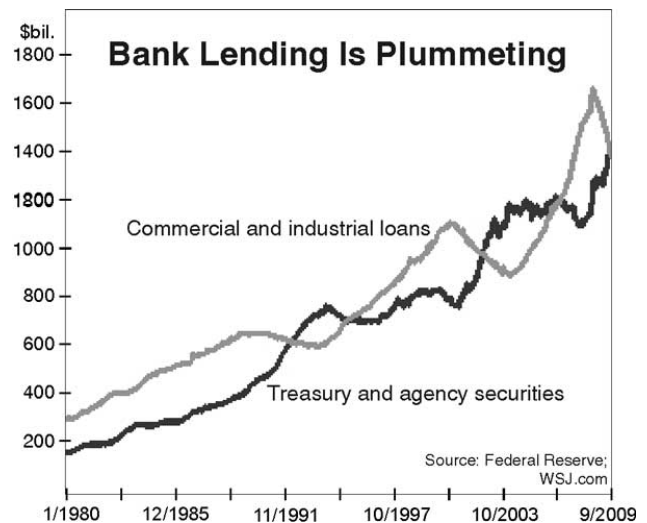


Figure 4

Private Lenders Have Left the Building

The federal government is the proximate cause of the entire mortgage-credit bubble. When it formed its mortgage-creating “government sponsored enterprises” (GSEs), such as the Federal Home Loan Banks, Ginnie Mae, Fannie Mae and Freddie Mac, it assured the long-term destruction of the mortgage market, much as the Medicare bill in 1965 assured the long-term destruction of the health care market. Politicians always promise, and seemingly believe in, free lunches. But someone always pays more when government gets involved. Today the mortgage market is so broken that private funding accounts for only about ten percent of new mortgages. Fully 90 percent of them are created, funded or “guaranteed” (another myth soon to be exploded) by one of the government’s pet agencies.

Figure 5 shows that there is only one group of mortgage lenders left: the GSEs. Government doesn’t run anything to benefit customers; it runs things to benefit itself. In order to buy votes by appearing magnanimous, it forces these GSEs to continue lending to broke people. But without the profit motive in the business of lending, there will ultimately be less lending. Graft, red tape and the pied piper (who always gets paid one way or another) will see to that. This long term drift toward full government control—as in the medical industry—is heading inevitably to a collapse of the industry and therefore, in this case, to a deflationary conclusion.

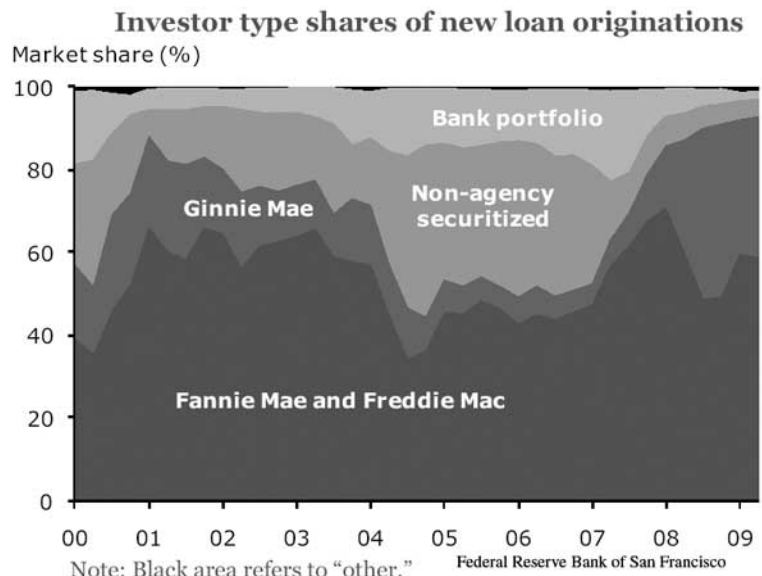


Figure 5

People Are Walking Away From Their Homes and Mortgages

Great numbers of people are ceasing to pay their mortgages, *even if they have the money to pay them*. When people walk away from their mortgages, they are reneging on a promise to pay the interest on the loan. This means the money that your friends and relatives (no *Elliott Wave Theorist* subscriber should have any significant amount of money in a typical bank) have deposited in (i.e. lent to) their respective banks is becoming increasingly tied up in mortgages that are earning nothing at all. Normally, a bank can go after mortgage defaulters’ other assets, because, after all, a loan is a loan. That is, unless some government says it isn’t. A number of state governments have been willing to sell their banks’—and therefore their depositors’—health down the river for votes. In these states, banks can lend someone \$500,000, but they can’t tap the borrower’s assets to *collect* all the money owed to them; all they can do is take possession of the home that the borrower bought with the money, even if doing so does not cover the value of the loan. The so-called “non-recourse-loan” states are as follows: Alaska, Arizona, California, Connecticut, Florida, Idaho, Minnesota, North Carolina, North Dakota, Texas, Utah and Washington.

Homeowners in these states can cheat their banks, with a pat on the head from the legislature. *Do not keep even your everyday spending money in any bank in these states unless its balance sheet shows a far lesser percentage of mortgages on its books than has the average bank.* (The new edition of *Conquer the Crash* has an updated list of the safest banks per state.)

Refusal to pay *interest* is deflationary. When banks can't collect fully on their loan *principal*, as is the case by law in the above-named states, it is deflationary. Even in states where banks can go after other assets held by borrowers, default is still deflationary if the borrowers are broke. The reason is that, in all these cases, the value of the loan contract falls to the marketable value of the collateral, and a contraction in the value of debt is deflation.

Some people who walk away from their mortgages purposely damage the homes when they leave. New businesses have sprung up to take on the job of cleaning up the houses that former occupants trashed as they left. Angry defaulters are stripping coils out of stoves, pulling electrical wiring out of walls, ripping fixtures out of bathrooms, yanking seats off of toilets, punching holes in walls and leaving rotting food in the fridge. (AP, 8/9) Such actions, and the threat of more such actions, lower the value of the collateral behind mortgage debts, thereby lowering the value of mortgages, which is deflationary.

Bank Lending Standards Have Stayed Restrictive

As people default on mortgages, banks are tightening lending standards. Figure 6 shows that banks loosened credit standards from late 2003 through the summer of 2007. By the end of that time, you could borrow money if you were breathing and could operate a ball-point pen. Banks have been tightening credit standards ever since. The rate of tightening peaked in October 2008, but the graph shows that over the past year various banks have either left their new, tighter standards in place or continued to tighten their standards further. Across the board, it is harder to get a loan, and it's staying that way. Lending restrictions reduce the credit supply. This condition is deflationary.

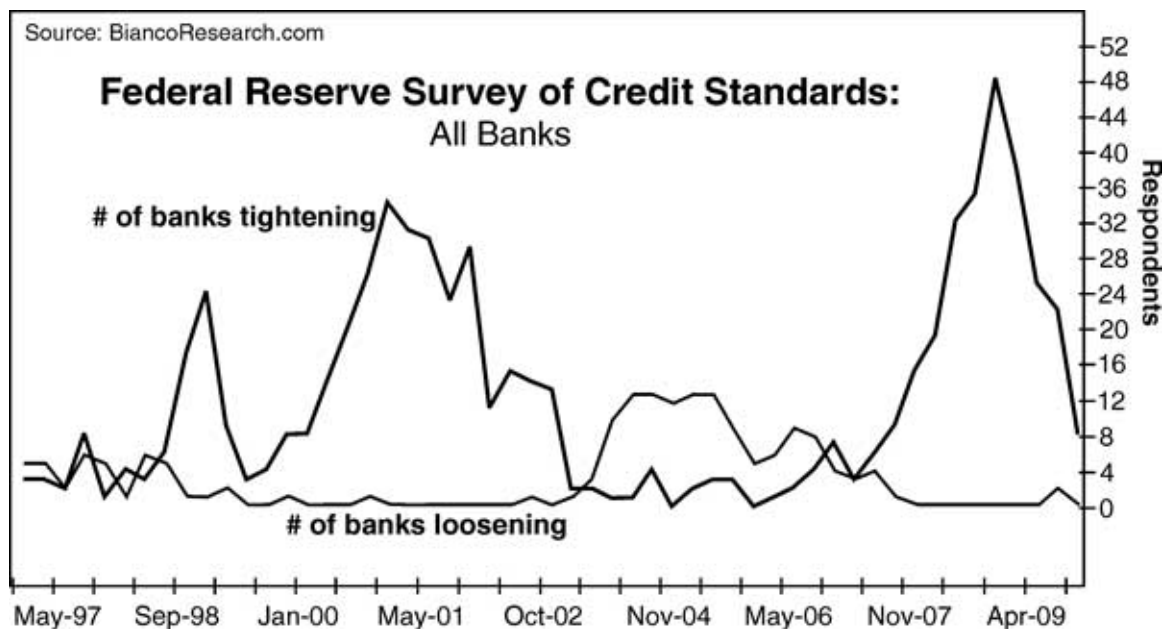


Figure 6

Banks Are Cashing Out of the Credit-Card Business

Articles have revealed that banks are doing everything they can to get credit-card debtors to pay off their cards. They are raising penalties and rates, lowering ceilings and otherwise bugging their clients to pay up, one way or another: Transfer your debt to another bank's card; default; pay us off; we don't care which. And it's working. Through September, consumers have paid down credit card balances for 12 months in a row. Figure 7 shows the new trend. The credit-card business was another formerly humming engine of credit that is sputtering. You might call the new program "cash from clunkers," and it is deflationary.

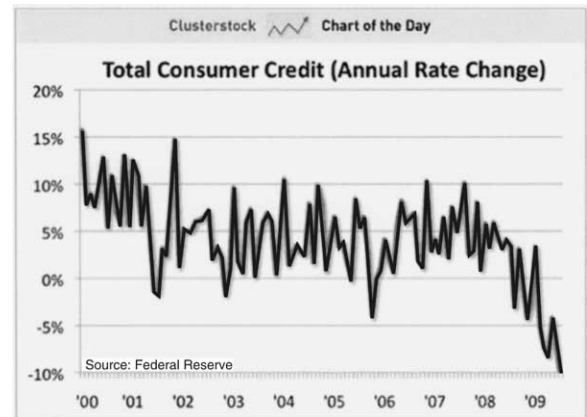


Figure 7

LBO Debt Is Becoming an Albatross for Creditors and Providing a Disincentive for Banks To Lend

The Economist (10/29) reports, "Nine of the ten largest buy-outs in history occurred between 2006 and 2007, averaging \$30 billion each. *Four-fifths of that was borrowed.*" As shown in Figure 8, this is another engine of inflation that has ground to a halt. The "private equity" that provided the initial fuel for the binge, and the bank credit that was the 80% ethanol additive, have disappeared. The contraction in this activity is highly deflationary.



Figure 8

But it gets worse. An article on ZeroHedge.com tipped us to a report by Moody's titled "\$640 billion & 640 days later: how companies sponsored by big private equity have performed during the U.S. recession." The study shows that of the ten largest leveraged buyout (LBO) deals since 2007, four have already defaulted and two are "in distress" despite the recovery, which means they are likely to default as well. So, just in this small group, there is nearly half a trillion dollars worth of IOUs heading for the dump. The LBO craze was a great focal point of excitement that led banks to lend at huge leverage to finance corporate takeovers (often so buyers could suck the companies dry, but that's another topic). The LBO-IOU train wreck is itself deflationary, because the value of outstanding IOUs is falling. But with LBO creditors facing disaster, *fear* of later default will limit *future* debt creation through LBOs as well.

There's more: "Between 2011 and 2014, there is roughly half a trillion in LBO debt maturing. Add that to the \$1.5 trillion in bank debt due for rolling, and the roughly \$3 trillion in CRE [commercial real estate] debt that is also supposed to be refinanced, and one can see how the [authorities] will need to find a way to roll about \$5 trillion in debt without the benefit of securitizations." Since 2003, *The Elliott Wave Theorist* has projected 2014 as one of the most likely years for the end of the bear market in stocks (see illustrations in the June 2007 and May 2008 issues). If stocks fall into that year, there is no way that most of this debt will be rolled. So, whatever LBO debt hasn't failed yet will fail soon enough. "Private equity will return to basics: smaller deals with more cash upfront," says one industry rep. See that secret word in there—*cash*? That's what people want now, and that impulse is deflationary.

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Bank Lending Continues To Collapse

With lending standards ratcheting higher, credit-card borrowers retiring debt, LBOs losing their luster and banks' loans going bad, it's no wonder that overall bank lending is contracting. Figure 9 shows that bank lending is continuing to collapse. And it is doing so during the so-called "recovery"! Can you imagine what this line will look like during the rest of Cycle wave c down?

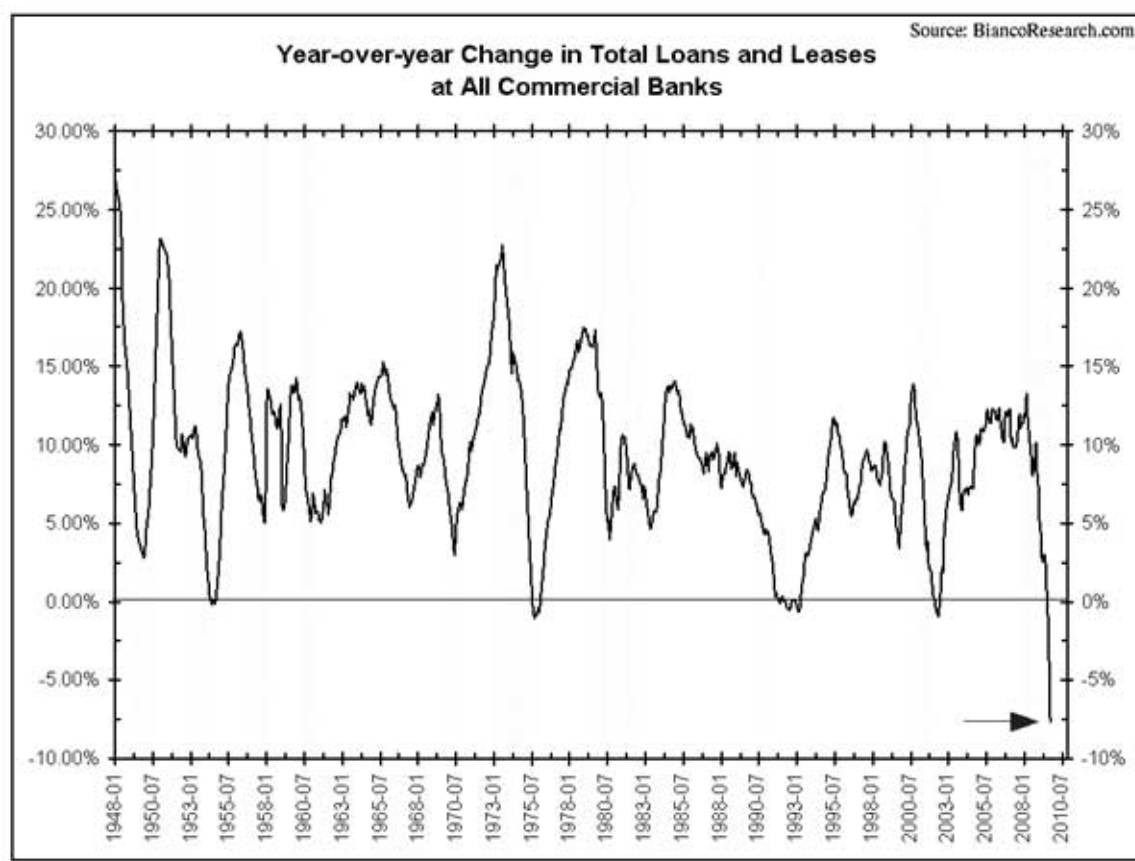


Figure 9

Banks Continue To Fail

Despite the expansion in liquidity and the recovery in financial markets since March, banks are still failing at a rate of about one a week. Very recently, the rate has abated somewhat. But this may not be the good news it seems. According to a recent article,

Some in the industry believe the slowdown, rather than being a sign of improving industry prospect, has more to do with strains on the Federal Deposit Insurance Corp.'s insurance fund, insufficient staff to manage bank takeovers and saturation in the market for distressed assets and dead banks. [Atlanta Journal Constitution (AJC), 10/25/09]

In other words, the FDIC *can't handle the load*.

The Banking Index of stocks led the broad market down in 2007-2008. That index peaked in October, ahead of the Dow and S&P, and promptly fell 16 percent (see Figure 10, next page). This downtrend says that the rate of bank failures is going to increase. The FDIC's attempts to handle the crisis will be interesting to observe.

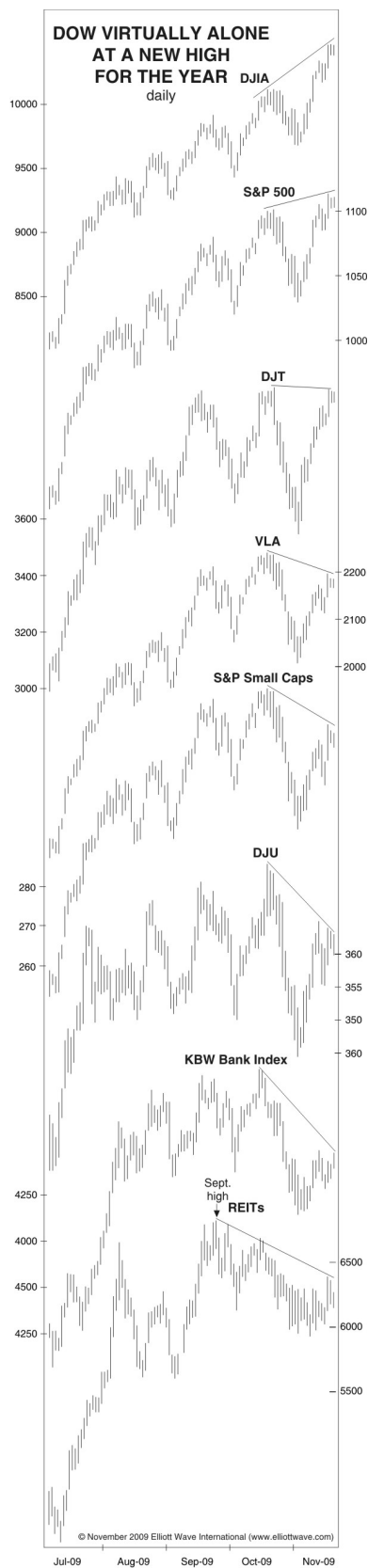


Figure 10

The FDIC Anesthesia Is Wearing Off

Perhaps the single greatest reason for the unbridled expansion of credit over the past 50 years is the existence of the Federal Deposit Insurance Corporation, another government-sponsored enterprise created by Congress. The coming rush of bank failures is an outcome made inevitable the very day that Congress created the FDIC. The reason is that the creation of the FDIC allowed savers to believe that their deposits at banks are “insured” against loss.

But the FDIC is not really an insurance company. No enterprise, absent fraud, could possibly insure all the banking deposits in a nation. Nor does the FDIC do so, despite its claims. The FDIC is like AIG, the company that sold too many credit-default swaps. It contracted for more insurance than it could pay upon. Because depositors *believe* the sticker on the door of the bank, they have abdicated their responsibility to make sure that their banks’ officers handle their deposits prudently. This abdication allowed banks to lend with impunity for decades until they became saturated with unpayable debts. Today, most banks are insolvent, and the FDIC is broke. This condition is deflationary for three reasons: (1) Banks are coming to realize that the FDIC cannot bail them out in a systemic crisis, so they have become highly conservative in their lending policies, as described above. (2) The main way that the FDIC gets its money is to *dun marginally healthy banks* for more “premiums” (meaning transfer payments) to bail out their disastrously run competitors. The more money the FDIC sucks out of marginally healthy banks, the less money those banks have on hand to lend, which is deflationary. (3) The banks that have to cough up all this money will become more impoverished at the margin, so banks that otherwise might have survived a credit crunch will be thrown even closer to the brink of failure. This is another deflationary risk. A friend of mine whose family owns a bank told me that the FDIC recently raised its 6-month assessment from \$17,000 to \$600,000. In the FDIC’s latest announcement, it is considering requiring banks to pre-pay three years’ worth of “premiums,” i.e. triple the normal annual fee in a single year. It will be a miracle if the money lasts through 2010. When these funds are gone, the FDIC will have two more options: to issue its own bonds and pressure banks to buy them; and to tap its “credit line” of up to half a trillion dollars with the U.S. Treasury. It’s the same old solution: take on more new debt to back up failing old debt. More debt will not cure the debt crisis.

Meanwhile, the FDIC is contributing to the deflationary trend. It has “tightened rules on required capital levels,” which forces banks’ loan ratios to fall; and it has “extended its extra monitoring of new banks from the first three years of operation to seven years” (AJC, 11/19/09), meaning that banks will now have to wait four additional years before they can go crazy with loans.

State Regulators Are Restricting Lending, Too

But wait. Maybe banks won't be able to go crazy even after four years, because state regulators are also piling on the restrictions: "The prevalence of risky and improper lending practices at small banks in Georgia, including a technique called 'loan stacking'," i.e. lending even more money to developers who can't pay off a loan, "prompted state regulators to tighten regulations governing lending limits earlier this month." (AJC, 11/19/09) So governments at both levels are clamping down on lending.

States Are Broke and Approaching Insolvency

While state "regulators" clamp down on profligate banks, the same states' legislatures continue to blow money. For years, state governments have been spending every dime they could squeeze out of taxpayers plus all they could borrow. (The lone exception is Nebraska, which prohibits state indebtedness over \$100k. Whatever Nebraska's official position on any other issue, by this action alone it is the most enlightened state government in the union.) But now even states' borrowing ability has run into a brick wall, because the basis of their ability to pay interest—namely, tax receipts—is evaporating. Figure 11 shows that states' taxation rackets are beginning to fail. The goose—the poor, overdriven taxpayer—is dying, and the production of golden eggs, which allowed state governments to binge for the past 40 years, is falling. The only reason that states did not either default on their loans or drastically cut their spending over the past year is that the federal government sucked a trillion dollars out of the loan market and *handed* it to countless undeserving entities, including state governments. "It's hard to imagine what happens when stimulus money runs out," says a budget expert. (USA Today, 10/29/09) But it is not at all hard to imagine what will happen. *Conquer the Crash* imagined state insolvency seven years ago. The breezy transfer of money from innocent savers to state spenders is going to end, and when it does, states will cut spending and "services" drastically. They will also default on their debts, which will be deflationary.

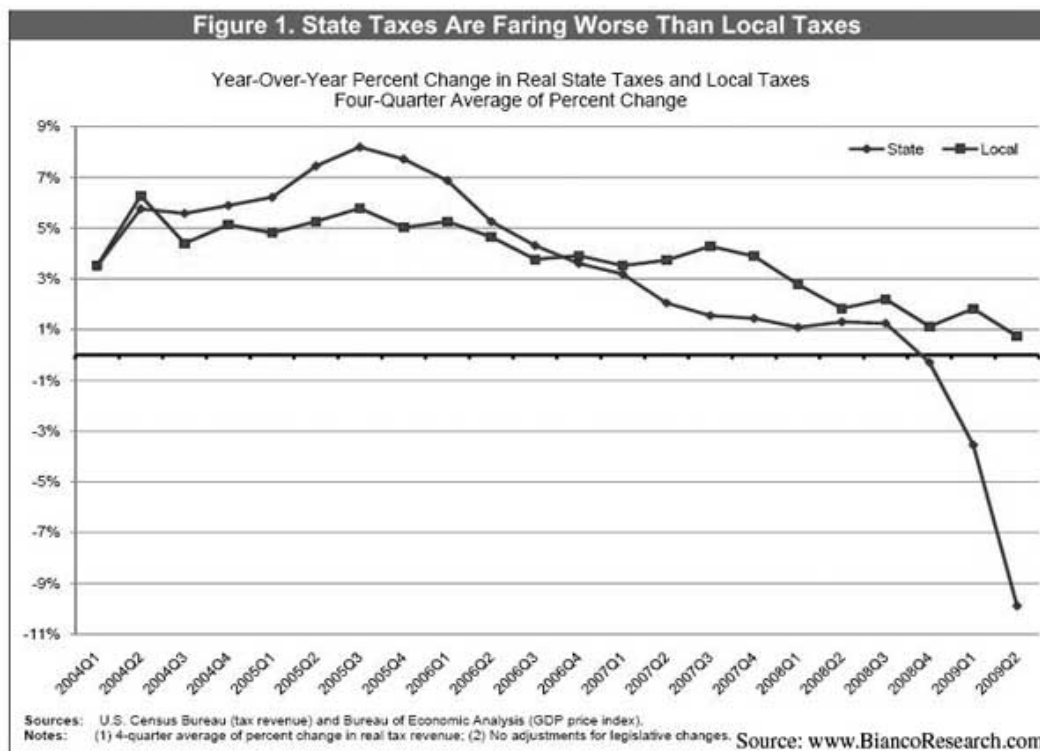


Figure 11

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Myth No. 4: It's Enough to Simply Beat the Market

The Elliott Wave Theorist, May 19, 2009

The “Beat the Market” Fallacy

During long bull markets, a myth develops that a money manager’s goal is to match or beat some benchmark for a market that is rising. This judgment bias explains why investors in recent years came to believe that a proper benchmark against which to judge money managers was the gain or loss recorded by the S&P index. Although “beating the S&P” became a popular basis upon which to judge performance, it is bogus.

The fallacy of this belief is nakedly exposed in a big bear market. Even money managers who succeed at their stated goal of beating the S&P can ruin your retirement. In the real world, customers are (surprise!) devastated if they lose half their invested capital, even if the S&P falls even more than that amount, say, 58 percent. How can this be, if the sensible, proper goal is to beat the S&P? Well, that is *not* a sensible, proper goal.

The goals of investing should be (1) to keep money and (2) to make money. Money managers who successfully protect your capital and make money for you in changing environments are truly serving you. Those whose goal is to beat the S&P will eventually serve you *up*.

The beat-the-market fallacy is even more obvious when one takes into account the fact that markets are bi-directional. If a money manager is supposed to beat the market on the upside, shouldn’t he also have to beat it inversely (with short sales) on the downside? If the S&P falls 58 percent, shouldn’t that performance be the benchmark, so that anyone who makes less than 58 percent is a piker, while the only good managers are those whose short sales made more than that?

Tell me: Why does this proposal sound absurd simply because market direction changed? In a currency ratio, direction is quite obviously irrelevant.

Euro/yen goes in the opposite direction of yen/euro, yet both ratios express precisely the same relationship. According to the beat-the-market benchmark, as the market fluctuates, the manager in Europe is supposed to beat the ratio in one direction, while a manager in Japan is supposed to beat the ratio in the other direction! Likewise, the S&P expresses the S&P/dollar ratio, of which the dollar/S&P ratio is simply the inverse and of no theoretically different consequence.

It does no good to say that the reason for such a benchmark is that the stock market usually goes up, because this statement describes only the past, not the future. Had you made this judgment in England in 1720, it would have done you no good for 64 years. Had you made it in Rome in 300 A.D., it would have done you no good ever.

The ridiculousness of the beat-the-market fallacy is further revealed by observing that the market is a fractal. It fluctuates at all degrees of trend. So which degree of trend is one supposed to beat? If the market rallies for three weeks and falls for two, is the only good manager someone who beats the return on the rally and then beats it on the decline? What about a 3-day rally and decline? What about 3 hours?

Anyone trying to reason himself out of this conceptual dilemma is forced to fall back on arbitrariness. Maybe moves of only a certain duration count; say, one year. Does this mean the manager is forgiven if he fails to catch, much less beat, the 1987 crash, in which the S&P lost 37 percent of its value in two months, but he will be judged negatively if he fails to beat the S&P when it retreats 20 percent over the course of two years? Forget it; no such quantitative filters can make this flawed theory work.

Your first goal should be to hold onto your money. Your second goal, the goal of investing, is to take on risk when the odds are way in your favor, so you have a good chance of making money.

Stock-Picking Geniuses or Just a Bull Market?

It seems to make sense that money managers who pick stocks that go up more than the S&P during a bull market are somehow performing miracles. Forget for a moment the absurdity of the underlying idea that “beating the S&P” is the goal of investing. Is the very claim of “outperforming the market” valid?

R.N. Elliott included this paragraph in his 1948 book, *Nature's Law*; about the 1942-1945 rally, which carried the Dow up just over 100 percent:

The New York Sun selected 96 stocks that advanced phenomenally. Every stock started at some figure below \$2 per share. The highest rate of advance was 13,300%. The lowest rate of advance was 433%. The average for the group was 2,776%.

In such an environment, an invested money manager would have to have been an idiot *not* to beat the Dow average. The truth is, such environments are not rare.

It is generally the case that in a bull market secondary stocks move up more in percentage terms than blue chip stocks. In other words, all a money manager has to do is show up for work and pick his stocks from a universe wider than the 30 Dow or 500 S&P stocks, and he should “outperform” these benchmarks. But is he really outperforming *the market*? Not if the market from which he selects his stocks is doing the outperforming all on its own.

The latest stock market decline, from October 2007 to March 2009, made somewhat questionable the nature of the stock-picking prowess of

Celebrated Mutual Funds And Managers

As of March 6, 2009
Sorted by Net Total Returns

Fund	Ticker	10/12/07-3/6/09
3-month T-Bill		+2.6%
Leuthold Core Investments	LCORX	-37%
Berkshire Hathaway	BRK/A	-42%
Fidelity Contrafund	FCNTX	-49%
The Pioneer Fund	PIODX	-53%
Federated Kaufman Fund	KAUAX	-54%
S&P 500	SPX	-56%
The Oakmark Fund	OAKMX	-56%
Columbia Acorn Fund	LACAX	-56%
The Weitz Funds	WVALX	-59%
CGM Focus Values	CGMFX	-60%
Fidelity Magellen	FMAGX	-60%
Calamos Growth Fund	CVGRX	-60%
Third Avenue Value Fund	TAVFX	-62%
Clipper Fund	CFIMX	-65%
Baron's Partners Fund	BPTRX	-65%
Dreman High Return Equity	KDHAX	-66%
The Airl Fund	ARGFX	-69%
Legg Mason Value Trust	LMVTX	-71%
Hancock Classic Value	PZFXV	-72%
Gabelli Equity Trust	GAB	-77%

Source: BiancoResearch.com and Elliottwave.com

Figure 12

For more market myth busting, including critical long-term Elliott wave analysis of the markets you follow, preview the latest *Elliott Wave Theorist*: <http://www.elliottwave.com/wave/latestthe>

the money managers who were revered during the bull market. As shown in Figure 12, a majority of them lost more on their investments during the decline than did those holding the S&P. In other words, the stocks these managers were prone to choose may simply have moved more extremely than the S&P, *in both directions*.

So, at least in these cases, there is some question as to whether any special skill attended the records of these managers. If they truly knew how to find stocks that perform better than the market, shouldn't their holdings have uniformly fallen *less* than the S&P when it went down? Perhaps they did fall less than some general index of secondary stocks, in which case these managers in fact did display a useful skill. But if this is the case, we are back to the "beating the market" fallacy, because, needless to say, the customers cannot be happy losing more than the S&P even if it is less than the loss in the average secondary stock.

Undoubtedly there are money managers who recognize aspects of a wave's personality—for example that "momentum" stocks or "value" stocks are outperforming—in which case their portfolios will outperform others for the duration of that wave. But these aspects of wave personality terminate with the wave. When secondary stocks peaked in relative strength in 1968 along with wave B in the Dow, they underperformed for the next six years. When the "nifty fifty" stocks finally topped in 1973 along with wave D in the Dow, they went into a funk for so long that they never again outperformed the general market. So, at times some managers may be attuned to some advantageous aspect of the market that is more specific than merely a wider selection of stocks. But when the wave that has this personality ends, so does whatever relative bias attended it.

Sometimes waves are very long, in which case merely hanging in there for the duration can produce huge, compounded gains. But when that long wave ends, the great compounded gains go with it. Ask those investors who put their money into "investment trusts"—today called mutual funds—during the 1920s. Wait a few more years and ask those who bought mutual funds in the 1990s.

I have no doubt that there are stock-picking geniuses. There are people who can uncover, for example, scam businesses (for shorting) or emerging businesses that will conquer the world. But the nature of their skills is quite different from what the media celebrated during the bull market years of the 1990s. As a stock market sage once warned, "Don't confuse brains with a bull market." If the bear market in stocks that started in 2007 persists for years to come, whatever skills these money managers possess will do them and their clients no good at all. In fact, their approach will drown their clients' accounts, because what they do "works" only in bull markets.

This fact is one reason why so many stock-picking managers so often insist, "No one can time the markets." In other words, "It's not my fault if you lose money under my management if the market trend turns down." Conveniently, by claiming that not just they, but *no one*, can figure out when downside moves are likely to come, stock-picking money managers avoid the responsibility of having to outperform (inversely) the S&P benchmark on the *downside*. So, like economists, they just stay bullish and figure they will win on a statistical basis...that is, unless a really big bear market comes along, in which case, well, it's your money, not theirs. And it's not their fault.

Myth No. 5: To Do Well Investing, You Have to Diversify

From *Prechter's Perspective*, pp. 131-32

Diversification and Other Myths

Question: In recent years, mainstream experts have made the ideas of “buy and hold” and diversification almost synonymous with investing. We just discussed buy and hold. What about diversification? Now it is nearly universally held that risk is reduced through acquisition of a broad based portfolio of any imaginable investment category. Where do you stand on this idea?

Answer: Diversification for its own sake means you don't know what you're doing. If that is true, you might as well hold Treasury bills or a savings account. My opinion on this question is black and white, because the whole purpose of being a market speculator is to identify trends and make money with them. The proper approach is to take everything you can out of anticipated trends, using indicators that help you do that. Those times you make a mistake will be made up many times over by the successful investments you make. Some people say that is the purpose of diversification, that the winners will overcome the losers. But that stance requires the opinion that most investment vehicles ultimately go up from any entry point. That is not true, and is an opinion typically held late in a period when it has been true. So ironically, poor timing is often the thing that kills people who claim to ignore timing.

Sometimes the correct approach will lead to a diversified portfolio. There are times I have been long U.S. stocks, short bonds, short the Nikkei, and long something else. Other times, I've kept a very concentrated market position. My advice from mid-1984 to October 2, 1987, for instance, was to remain 100% invested in the U.S. stock market. During the bull market, I raised the stop-loss at each point along the wave structure where I could identify definite points of support. If I was wrong, investors would have been out of their positions. The potential was five times greater on the upside than the risk was on the downside, and five times greater in the stock market than any other area. Twice recently, in 1993 and 1995, I have had big positions in precious metals mining stocks when they appeared to me to be the only game in town. In 1993, it worked great, and they gained 100% in ten months. Diversification would have eliminated the profit. And every so often, an across-the-board deflation smashes all investments at once, and the person who has all his eggs in one basket, in this case cash, stays whole while everyone else gets killed.

* * * * *

The Elliott Wave Theorist, April 29, 1994

It is repeated daily that “global diversification” is self evidently an intelligent approach to investing. In brief, goes the line, an investor should not restrict himself to domestic stocks and bonds but also buy stocks and bonds of as many other countries as possible to “spread the risk” and ensure safety. Diversification is a tactic always touted at the end of global bull markets. Without years of a bull market to provide psychological comfort, this apparently self evident truth would not even be considered. No one was making this case at the 1974 low. During the craze for collectible coins, were you helped in owning rare coins of England, Spain, Japan and Malaysia? Or were you that much more hopelessly stuck when the bear market hit?

The Elliott Wave Theorist's position has been that successful investing requires one thing: anticipating successful investments, which requires that one must have a method of choosing them. Sometimes

that means holding many investments, sometimes few. Recommending diversification so that novices can reduce risk is like recommending that novice skydivers strap a pillow to their backsides to “reduce risk.” Wouldn’t it be more helpful to advise them to avoid skydiving until they have learned all about it? Novices should not be investing; they should be saving, which means acting to protect their principal, not to generate a return when they don’t know how. For the knowledgeable investor, diversification for its own sake merely reduces profits. Therefore, anyone championing investment diversification for the sake of safety and no other reason has no method for choosing investments, no method of forming a market opinion, and should not be in the money management business. Ironically yet necessarily given today’s conviction about diversification, the deflationary trend that will soon become monolithic will devastate nearly all financial assets except cash. If you want to diversify, buy some 6-month Treasury bills along with your 3-month ones.

* * * * *

Myth No. 6: The FDIC Can Protect Depositors

The Elliott Wave Theorist, August 15, 2008

Who cares if a bank goes under? Won't the FDIC protect depositors?

The FDIC is not funded well enough to bail out even a handful of the biggest banks in America. It has enough money to pay depositors of about three big banks. After that, it's broke. But here is the real irony: The FDIC, as history will ultimately demonstrate, *causes* banks to fail. The FDIC creates destruction three ways. First, its very existence encourages banks to take lending risks that they would never otherwise contemplate, while it simultaneously removes depositors' incentives to keep their bankers prudent. This double influence produces an unsound banking system. We have reached that point today. Second, the FDIC imposes costly rules on banks. In July, it "implemented a new rule...requiring the 159 [largest] banks to keep records that will give quick access to customer information." As the American Bankers Association puts it, the new rule "will impose a lot of burden on a lot of banks for no reason." (AJC, 7/19/08) Third, the FDIC gets its money in the form of "premiums" from—guess whom?—healthy banks! So as weak banks go under, the FDIC can wring more money from still-solvent banks. If it begins calling in money during a systemic credit implosion, marginal banks will go under, requiring more money for the FDIC, which will have to take more money from banks, breaking more marginal banks, etc. The FDIC could continue this behavior until all banks are bust, but it will more likely give up and renege. Remember, every government program ultimately brings about the opposite of the stated goal, and the FDIC is no exception.

Myth No. 7: It's Bullish When the Market Ignores Bad News

The Elliott Wave Theorist, November 17, 2005

Is it bullish when the market “ignores bad news”?

The news reflects an increasingly negative social mood, yet the stock market is holding up. Many people claim that the market’s failure to “react” to the bad news—or its ability to rally in the face of it—is bullish. This idea is a myth. It is borne of the useful observation that during the early months of a bull market, stocks rise despite continuing bad news. Social mood *leads* social action, so this is a perfectly normal occurrence. But there is another time when the market goes up while news is bad: during bear market rallies. An excellent example, as detailed in *Pioneering Studies*, is the market’s rally from September 2001 to March 2002 despite anthrax attacks and the Enron scandal. When those events ended, *then* the market turned down.

When a bear market is in force, people act in accordance with the *long* term deterioration in mood, which continues despite periods of near term improvement. This “crazy” behavior is nicely coordinated to fool investors, who typically try to make sense of the market in terms of its reaction to news. This is not to say that the stock market can’t go up from here; the point is about the validity of analytical techniques.

Myth No. 8: Bubbles Can Unwind Slowly

The Elliott Wave Financial Forecast, October 28, 2005

More Evidence of a Nice Bubble

Google popped higher to more than \$350 a share on solid earnings, but as *The Elliott Wave Financial Forecast* noted in July, Google's rally is a far more solitary version of the upward sweep in internet stocks that took place in 1999-2000, or even 2004. Google is now pretty much alone in exploding to new heights. In a reversal from the pattern at the great Internet peak in 2000, it was a positive earnings announcement that pushed Google to its latest new high. This is a qualitative difference from the trend at the height of the mania, which moved from ever skimpier earnings, to no revenues, to "no one is to know the plan." The problem with earnings is that they remove Google from the dreamy realm of infinite potential and place the stock in a finite world where expectations apply to actual performance and disappointment will always catch up with historically unprecedented valuations.

Another subtle precursor to an even bigger bust is the enormous number of bubble references now being bandied about in polite society. An Atlanta Journal-Constitution writer notes, "The biggest bubble of all is the 'bubble' bubble—the use of the word, mostly by the media, as a metaphor for any activity driven by irrational exuberance. We've seen an SUV bubble and a bubble in reality TV programming. A Google search on the word 'bubble' brings up 35.1 million hits of every kind: stock market bubble, housing bubble, oil price bubble and hurricane bubble." This appears to be a variation of the uh-oh effect, which *The Elliott Wave Financial Forecast* observed at the all-time highs and in recent months. The uh-oh effect is a brief point of recognition at the very end of a long rise when some participants glimpse the enormous potential for a devastating reversal. Bubble references appear to be an extension of this vague sense of peril to the social realm except that, after so many years of frenzied price advances, users have lost respect for the meaning of the word *bubble*; "a speculative scheme that comes to *nothing*." This lack of appreciation is very apparent in real estate, which *Conquer the Crash* identified as the last bastion of the Great Asset Mania. Bubble talk in this market is off the charts, but it is now fashionable to reply that real estate is a "balloon not a bubble." The difference? According to the Rocky Mountain News, "Bubbles inevitably burst. Balloons slowly let air out." According to the outgoing Federal Reserve Board chairman there's "no national bubble in home prices, but rather 'froth' in some local markets." With years of central bank leadership under his belt, Alan Greenspan knows how to hedge his bet by acknowledging a measure of ebullience. The headline in today's Washington Post credits Ben Bernanke, the incoming Fed chairman, with a categorical denial:

There's No Housing Bubble to Go Bust

The article is probably the first hint of what is likely to become an extremely strained relationship between the Fed and the public. After Manhattan real estate prices collapsed 12% in the third quarter, the NY Post asked: "Could it be the bursting of the real estate bubble? Not exactly. There are no indicators that this is the beginning of a crash. Think of the current kinder, gentler bubble, not a catastrophic burst, but a reality check, a skimming of the froth, a round of requisite price corrections that is seen as a welcome necessity." This is the last great myth of every financial euphoria; that the excess can be slowly "unwound." It is exactly what was said about technology stocks in May and June of 2000. Here's how the July 2000 issue of *The Elliott Wave Financial Forecast* recorded the phenomenon:

There is a common theme in the press now. Writers are calling the stock market setback a “new reality,” or “rational exuberance” or “the culling of the weak.” “It’s a good thing,” says the editor of *The Red Herring*. It is a sure sign that the increasingly delusional psychology that created the mania has stopped waxing and begun to wane.

At the time the NASDAQ in fact had begun a wipe-out of 78%. Another definition for *bubble* is that it is simply an “illusion.” Once it is replaced by an accurate reflection of the world, it cannot be skimmed back or undergo a slow fade; it ceases to exist.

Myth No. 9: People Can Make Money Speculating

The Wave Principle of Human Social Behavior, Chapter 8

That is why, in financial markets, when the best time to buy or sell is at hand, *even the person who thinks he should take action experiences a strong psychological pressure to refrain from doing so*. He thinks, if only half consciously, “When my neighbor or advisor or friend thinks it’s a good idea, then I’ll do it, too. If I do it now, and I’m wrong, they will all call me a dope, and *I’ll be the only dope*. I’ll be singled out for ridicule, which is not only agonizing but dangerous.” Pressure from, and influence by, peers, then, is at least one reason why most people cannot bring themselves to change from a bullish to bearish orientation or vice versa if to do so would go against the ideas of their associates and contacts. It also explains why a market or other social trend can continue for a long, long time and why financial valuations can become so extreme as to appear outrageous to those who believe that people ought to base their decisions upon some calculable fundamental value.

The discomfort of being alone in one’s convictions is so great that it involves physical reactions. “Emotional mentation,” says MacLean, “represents the only form of psychological experience that, *by itself*, may induce pronounced autonomic activity” such as sweating, twitching, flushing, muscle tightening and hair standing on end. A person’s reaction just *thinking* about taking an action apart from the herd can produce tenseness or even nausea. He knows from experience that anyone who shares a prevailing majority opinion on any subject, particularly one that is intensely attended by the emotions of the limbic system (such as politics, religion, wealth or sex), is treated with the respect due his obvious intelligence and morality. One who utters an opposing opinion is immediately punished by a chorus of deprecating smiles, cackles, mooing, snorting, nipping or outright hostility. It may sound funny, but if you are not used to verbal viciousness or rejection by the group, they are painful experiences, and most people cannot abide either.

Emotionally removed historians sometimes decry the lack of prescience among a population prior to a long-ago financial crisis or the lack of vocal critics in countries that are taken over by fascists, communists, inquisitors or witch-burners. Yet unless one is there, it is nearly impossible to imagine the social pressure to go along with the trend of the day. In many political and religious social settings, for example, “I am not like you” can mean death. The limbic system bluntly assumes that all expressions of “I am not like you” are infused with danger. Thus, herding and mimicking are preservative behavior. They are powerful because they are impelled, regardless of reasoning, by a primitive system of mentation that, however uninformed, is trying to save your life.

The evolutionary advantage of herding, the reason it is incorporated into our paleomentation, is probably that, for animals, it (1) increases the success of life-enhancing activities such as food gathering and preparation, (2) increases the odds of survival in case of attack by a predator, and (3) decreases the odds of being killed because of perceived strangeness. The resulting actions of herding prior to neocortical mulling have saved many a life. Unfortunately for humans in modern times, there are important exceptions to that benefit. MacLean worries, “It is one thing to have the anciently derived limbic system to assure us of the authenticity of such things as food or a mate, but where do we stand if we must depend on the mental emanations of this same system for belief in our ideas, concepts, and theories?”¹ As with so many useful paleomentational tools, herding behavior is counterproductive to success in the world of modern financial speculation. If a financial market is soaring or crashing, the limbic system senses an opportunity or a threat and orders you to join the herd so that your chances for success or survival will improve. The limbic system produces emotions that support those

impulses, including hope, euphoria, cautiousness and panic. The actions thus impelled lead one inevitably to the *opposite* of survival and success, which is why the vast majority of people lose when they speculate.² In a great number of situations, hoping and herding can contribute to your well-being. Not in financial markets. In many cases, panicking and fleeing when others do cuts your risk. Not in financial markets. Paradoxically, then, it is not a confirmation of your correct posture when you look around and can comfortably say, “Everybody out there agrees with me.” It is a warning. As John Spooner said, “If you sit in on a poker game and you don’t see a sucker at the table, get up, because you’re the sucker.” The important point with respect to this aspect of financial markets is that *repeated failure usually does little to deter the behavior*. If repeated loss and agony cannot overcome the limbic system’s impulses, then it certainly must have free rein in comparatively benign social settings.

NOTES

1 MacLean, Paul D. (1990). *The Triune Brain in Evolution: Role in Paleocerebral Functions*. New York: Plenum Press, p. 453

2 **There is a myth, held by nearly all people outside of back-office employees of brokerage firms and the IRS, that many people do well in financial speculation. Actually, almost everyone loses at the game eventually. The head of a futures brokerage firm once confided to me that never in the firm’s history had customers in the aggregate had a winning year. Even in the stock market, when the public or even most professionals win, it is a temporary, albeit sometimes prolonged, phenomenon. The next big bear market usually wipes them out if they live long enough, and if they do not, it wipes out their successors. This is true regardless of today’s accepted wisdom that the stock market always goes to new highs eventually. Aside from the fact that this very conviction is false (Where was the Roman stock market during the Dark Ages?), what counts is when people act, and that is what ruins them.**

Myth No. 10: News and Events Drive the Markets

The Elliott Wave Theorist, November 1999

SOCIONOMICS IN A NUTSHELL

Understanding socionomics requires comprehending the contrast between two postulations:

- (1) *The standard presumption*: Social mood is buffeted by economic, political and cultural trends and events. News of such events affects the social mood, which in turn affects people's penchant for investing.
- (2) *The socionomic hypothesis*: Social mood is a natural product of human interaction and is patterned according to the Wave Principle. Its trends and extent determine the character of social action, including the economic, political and cultural.

The contrast between these two positions comes down to this: The standard presumption is that in the social setting, *events govern mood*; the socionomic hypothesis is that *mood governs events*. In both cases, the stock market is seen as an efficient mechanism. In the first instance, it presumably revalues stocks continually and rationally in reaction to events; in the second, it revalues stocks continually and impulsively as the independent social mood changes. We will now investigate five presumed "outside forces" to see which of these views their relationship to the stock market supports.

The Economy

The standard presumption is that the state of the economy is a key determinant of the stock market's trends. All day long on financial television and year after year in financial print media, investors debate the state of the economy for clues to the future course of the stock market. If this presumed causal relationship actually existed, then there would be some evidence that the economy leads the stock market. On the contrary, for decades, the Commerce Department of the federal government has identified the stock market as a leading indicator of the economy, which is indeed the case.

If the standard presumption were true, then changes in the economy would coincide with or *precede* trend changes in aggregate stock prices. However, a study of Figure 13 (next page) will show that changes in the economy coincide with or *follow* trend changes in aggregate stock prices. Except for the timing of the recession of 1946 (which supports neither case), all economic contractions came upon or after a *downturn* in aggregate stock prices, and all economic recoveries came upon or after an *upturn* in aggregate stock prices.¹ In *not one case* did a contraction or recovery precede a like change in aggregate stock prices, which would repeatedly be the case if investors in fact *reacted* to economic trends and events. This chronology persists back into the nineteenth century as far as the data goes.

The socionomic hypothesis explains the data. Changes in the stock market immediately reflect the changes in endogenous social mood. As social mood becomes increasingly positive, productive activity increases; as social mood becomes increasingly negative, productive activity decreases. These results show up in lagging economic statistics as expansions and recessions. The standard presumption has no explanation for the relative timing of these two phenomena.

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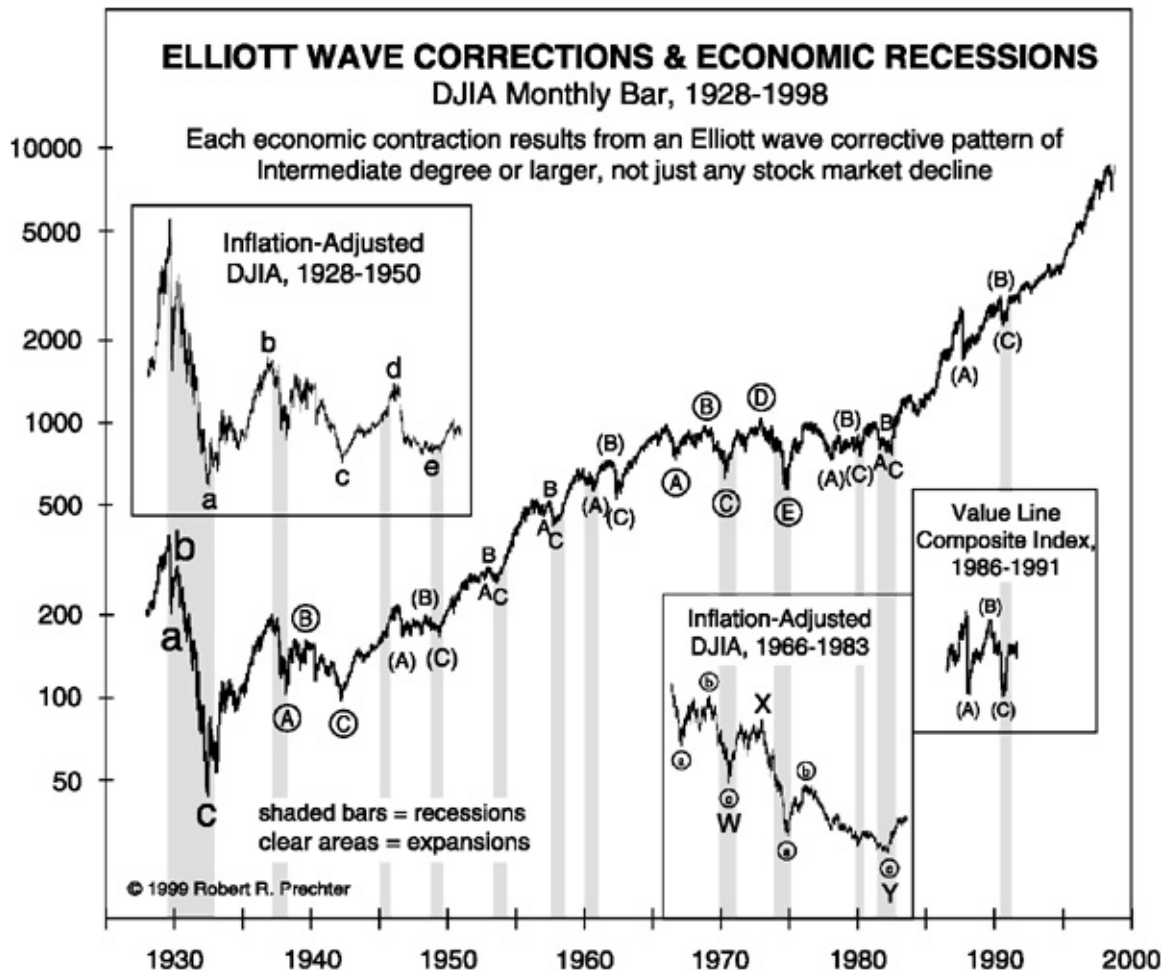


Figure 13

Politics

The standard presumption is that political trends are a key determinant of the stock market's trends. As an election approaches, commentators debate the effect that its outcome will have on stock prices. Investors argue over which candidate would likely influence the market to go up or down. "If so-and-so gets elected, it will be good/bad for the market," we often hear. If this causal relationship were valid, then there would be evidence that a change in power from one party's leader to another affects the stock market. There would also be evidence that certain political parties or policies reliably produced bull or bear markets. To the contrary, there is no study that shows any such connection.

A socionomist, on the other hand, can show the opposite causality at work. Examine Figure 14 (next page) and observe that strong and persistent trends in the stock market determine whether an incumbent president will be re-elected in a landslide or defeated in one. In all cases where an incumbent remained in office in a landslide, the stock market's trend was up. In all cases where an incumbent was rejected by a landslide, the stock market's trend was down.² In *not one case* did an incumbent win re-election despite a deeply falling stock market or lose in a landslide despite a strongly rising stock market.²

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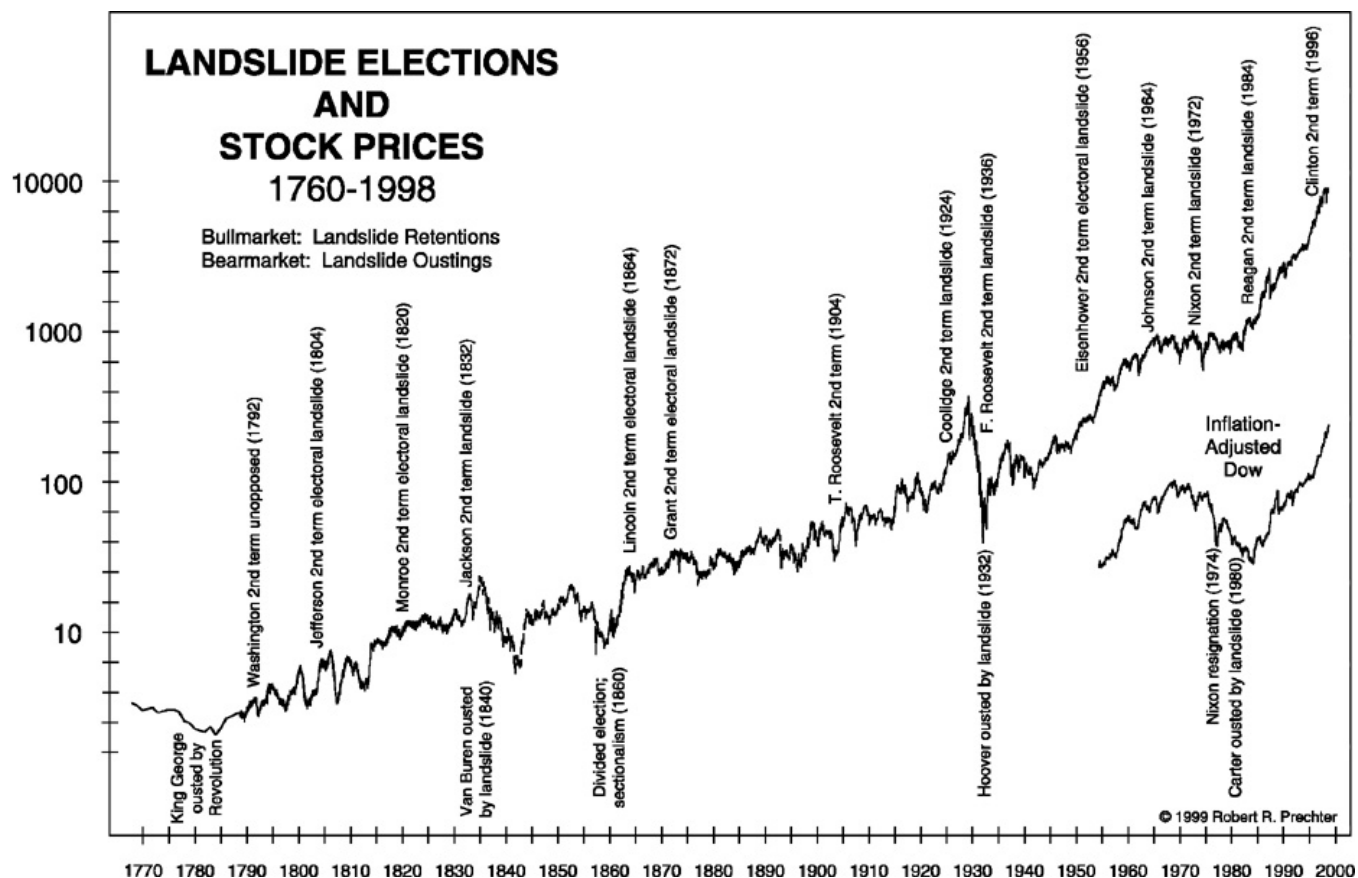


Figure 14

The socio-economic conclusion is this: When social mood waxes positive, as reflected by persistently rising stock prices, voters desire to retain the leader who symbolizes their upbeat feelings and who they presume helped cause the conditions attending them. When the social mood becomes more negative, as reflected by persistently falling stock prices, voters decide to throw out the incumbent who symbolizes their downbeat feelings and who they presume helped cause the conditions attending them. *The political policies of the incumbent and his challenger are irrelevant to this dynamic.* The key is a desire for change *per se*, not any particular type of change. The standard presumption has no explanation for reconciling the relationship between these phenomena.

Peace & War

“Surely,” says the supporter of the conventional view, “if war broke out, that would affect social mood and the stock market.” Such a comment would be, and is, an utter assumption. It is unsupported by argument or history. As to argument, many people assume that war is a dangerous enterprise that would cause concerned investors to sell. Many historians, on the other hand, argue that war is good for the economy, which by conventional logic would make it good for the stock market. As this reasoning is contradictory, so is the historical record. The Revolutionary War took place entirely during a falling stock market in England. The Civil War took place entirely during a rising stock market in the U.S. World War I saw the stock market rise in the first half and fall in the second half. World War II saw the opposite, as the stock market fell in the first half and rose in the second half. During the Vietnam War, it went up, down, up, down and up, finishing about unchanged. In sum, there is no data to support the conventional view, and all the data taken together contradict it.

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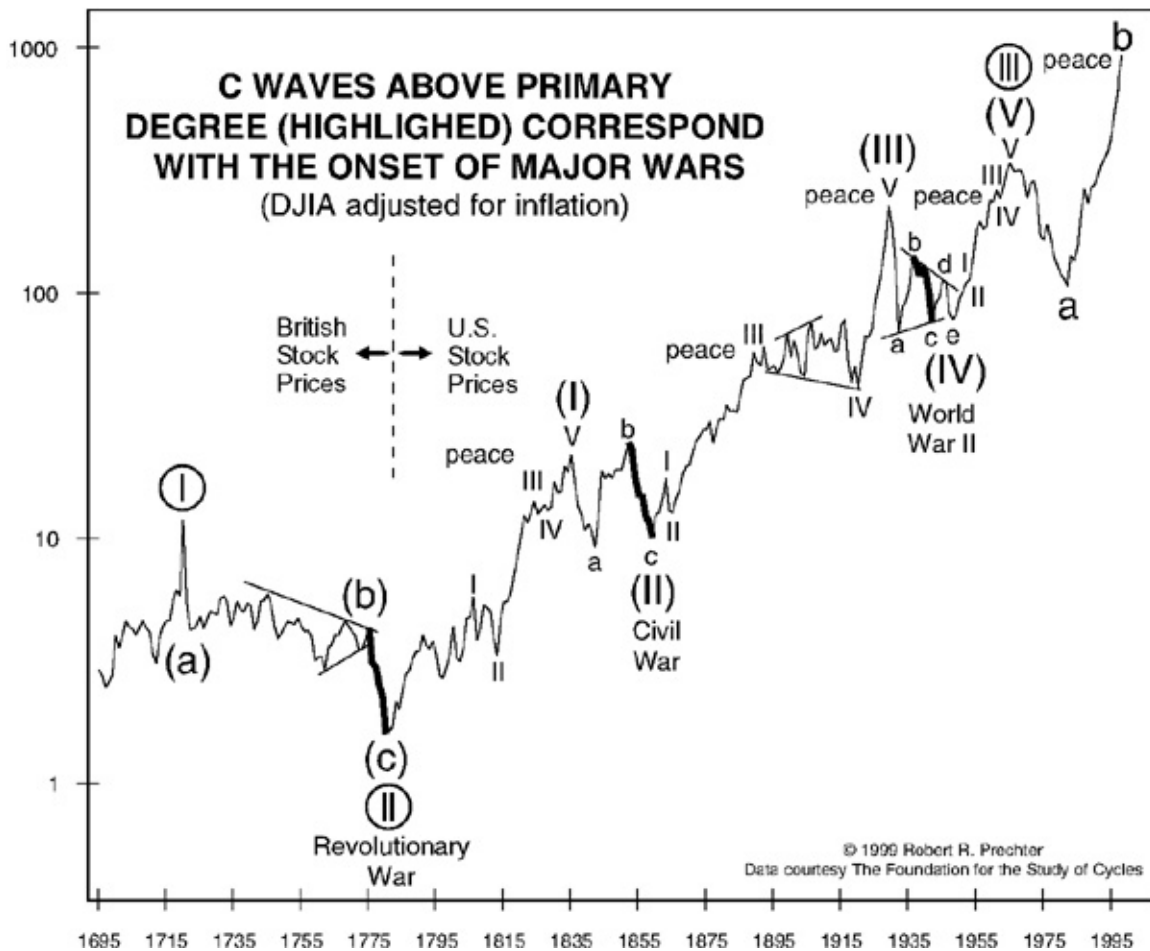


Figure 15

Socionomics, in contrast, points out a *consistent* correlation with a *consistent* rationale. Because social mood governs the character of social activity, a persistently *rising* stock market, reflecting feelings of increasing goodwill and social harmony, should consistently produce peace, and a persistently *falling* stock market, reflecting feelings of increasing ill will and social conflict, should consistently produce war. Figure 15 bears out this expectation. Long rises in the stock market unerringly result in climates of peace. Similarly, we find that major wars virtually always erupt during or immediately following “C” waves of Elliott wave corrections above Cycle degree. The Revolutionary War took place during wave (c) of the Grand Supercycle bear market from 1720 to 1784. The Civil War broke out shortly after the end of wave c of the Supercycle bear market from 1835 to 1959. World War II started during wave c of the Supercycle bear market (in inflation-adjusted terms) from 1929 to 1949. In every case, a rising social mood eventually brought an end to the war.³

Demographics

Currently fashionable is the idea that demographics determine stock market trends. It was discovered, when sliding birth data around on top of a chart of the stock market, that there is a four-decade correlation when birth data are moved forward 46-49 years. The explanation for this correlation, roughly stated, is that people spend and invest more when in their 40s, so the stock market will go up and down with the percentage of people in their 40s. It seems so sensible to the conventional mindset that people across the country have embraced this thesis.

The first problem with this case is that when data may be moved around at will, apparent correlations appear often. I can find three different multi-decade periods of correlation between immigration data and the stock market when I am allowed to slide the two series around until they fit. The second problem with this case is that the available data prior to the mid-1950s diverges so significantly from this postulation that it disproves any causality. At least four studies^{4, 5, 6, 7} have debunked the assertion.

What is the socioeconomic position on demographic causality? Think about it for a minute. We have already seen that social mood determines the trends of the economy, politics, and the conditions for peace and war. Might social mood also determine demographics?

Figure 16 shows that demographic data line up almost perfectly with the stock market, particularly when it is expressed in terms of the advance-decline line, which reflects how many stocks are going up or down. The a-d line is a broad measure, and therefore is more useful to compare and contrast with the full population's participation in national demographics (as opposed to data on the economy, which can be propelled by a narrow list of industry leaders). The data shown in bars is annual birth data, lagged by one year to reflect (within three months) the number of annual *conceptions*. The major stock market lows of 1932 and 1974 coincide exactly with the major nadirs in procreational activity. The peaks in procreational activity correspond to peaks in the a-d line.

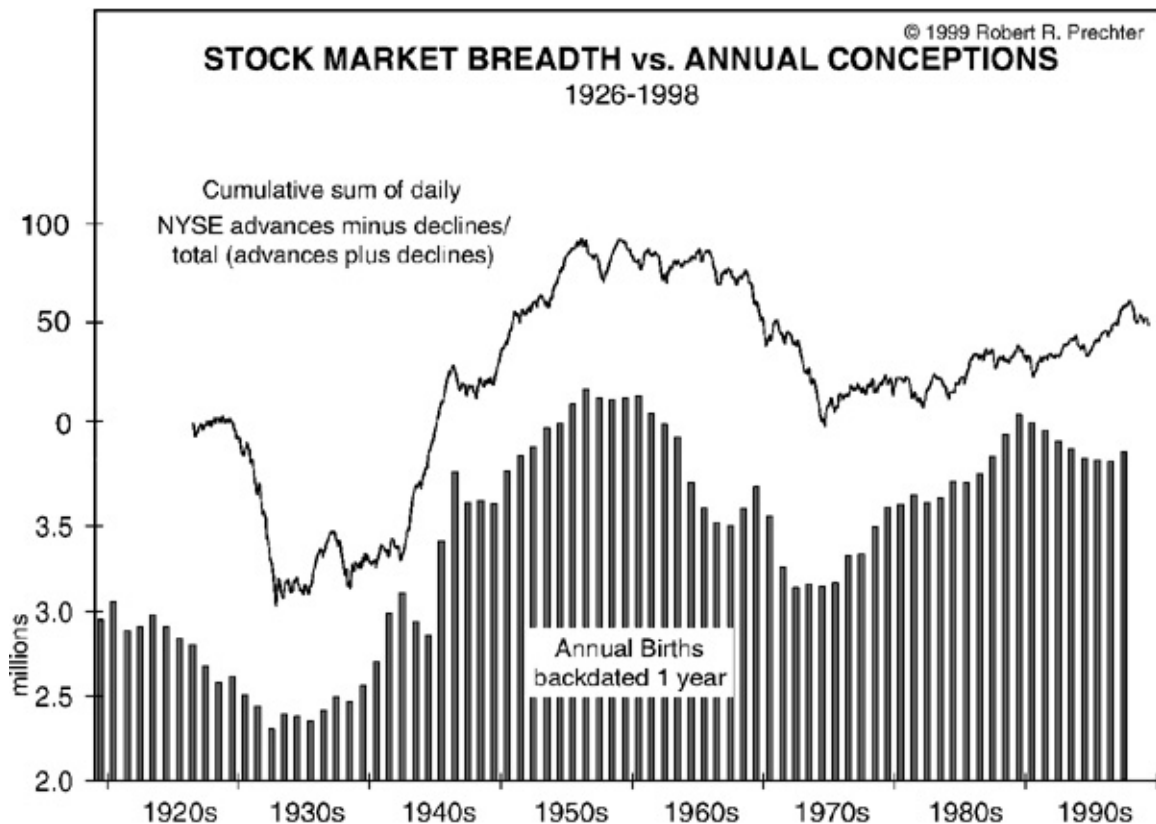


Figure 16

There is not enough data to be certain of a causal relationship, but it is nearly twice as long a correlation as the one that convinces so many people of the “demographics determine stock prices” case. More important, and in contrast to the aforementioned case, this correlation holds *throughout all the available data*, which dates from 1908 for conceptions and 1926 for the a-d line. No data contradict it. The socioeconomic hypothesis can account for this correlation. As people in general feel more energetic, confident and happy, they have more children. Conversely, as people in general feel more sluggish, fearful and unhappy, they have fewer children. Thus, social mood determines aggregate procreational activity. Once again, the hypothesis is simple and elegant and explains the data.

Nuclear Explosions

“O.K., Bob,” a skeptic might say, “Maybe I can accept the idea that social mood determines the economy, politics, peace and war, and maybe even the birth rate. But you can’t claim, as you appear to be doing, that no outside forces affect the stock market. I mean, what if, out of the blue, somebody detonated a nuclear bomb in a major city? You can’t say that wouldn’t affect people’s mood or the stock market!” Clearly, this person has yet to incorporate fully the socioeconomic point of view. What does he mean, “out of the blue”? This is the same fictional “out of the blue” that we have already debunked in economics, politics, peace, war and demographics. Every social act has an antecedent in mood, so nuclear explosions are unlikely to be an exception. Not only do I claim, based on the fact that social mood is patterned, that the detonation of a nuclear bomb would have no effect on social mood, but also once again, the causality is the other way around: *Social mood determines the penchant for exploding nuclear devices.*

Figure 17 demonstrates that the socioeconomic hypothesis governs even here. As you can see, the stock market (adjusted for inflation), which is a direct reflection of social mood, correlates almost perfectly with the rate at which governments detonate nuclear bombs. The reason is this: As social mood becomes more positive, people become more confident, trusting and content. They feel little need to prepare

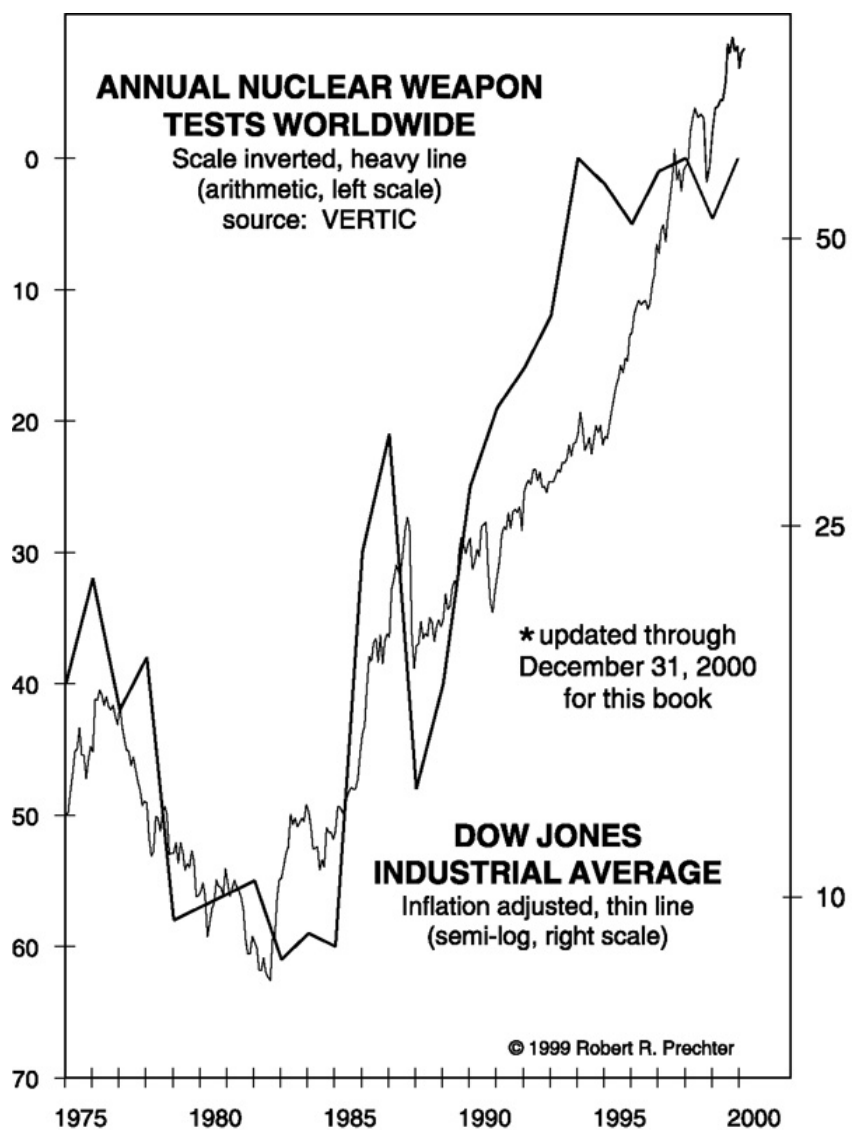


Figure 17

a defensive or offensive force. As social mood becomes more negative, people become more fearful, distrusting and angry. They are impelled to prepare to defend themselves or attack an enemy. As in politics and economics, if you would like a view to the future in this area, just watch our most responsive and precise reflector of social mood, the stock market. Its trends will tell you when to expect more or fewer nuclear explosions, and whether they are more likely to be deployed defensively or offensively.⁸ The blackest moods of this century occurred in 1932 and 1942, the latter time providing the social impetus to develop the nuclear bomb in the first place.

The Degree of Mood Change Determines the Degree of the Results

The socio-economic hypothesis suggests that the extremity of social behavior should be directly proportional to the extremity of the social mood swing. This is indeed the case. The longer, further and more broadly the stock market rises, reflecting a waxing positive mood, the more consistently the economy expands, the more citizens vote to “stay the course,” the more children people produce and the more broadly peaceful is the resulting social climate. The longer, further and more broadly the stock market falls, reflecting a greater swing toward negative mood, the more deeply the economy contracts, the more citizens vote to “throw the bums out,” the fewer children people produce and the greater is the resulting social tension and conflict. Small stock market corrections beget recessions, mild defeats at the polls and minor wars. For example, the Primary degree correction of 1959-1962 led to a mild recession in 1960 and the Cuban Missile Crisis of 1962, a near minor war. (Had 1962 been an election year, the incumbent would have lost.) The Primary-degree correction of 1987-1990 led to the moderate Gulf War in 1990 and a brief recession in 1991. In 1992, the incumbent lost the election by a small margin. The larger Cycle degree correction of 1966-1974, in contrast, led to two major recessions (in 1970 and 1974), the ousting of a president by resignation and the comparatively severe Vietnam War. Larger stock market corrections, such as those highlighted in Figure 15, beget depressions, political upheaval and all-out war. Corrections of Millennium degree, such as the Dark Ages, destroy economies, political systems and entire nations, and warring becomes chronic. Conversely, small uptrends produce moderate benefits, while uptrends of the highest degree produce the greatest social achievements of mankind such as the Renaissance, the Industrial Revolution and the Information Age.

SUMMARY

As social mood becomes more positive, people buy more stocks, behave more productively, vote for more incumbents, have more children, blow off fewer bombs and act peacefully toward their neighbors. Conversely, as social mood becomes more negative, people sell more stocks, behave less productively, vote for more challengers, have fewer children, blow off more bombs and act belligerently toward their neighbors. All this correlation is consistent with the idea that all these activities have a common engine, which is social mood. Of course, social mood dynamics produce countless other manifestations, such as trends in art, music, entertainment, mores and fashion, to name but a few.

Because social mood change, as revealed by stock market's form, is patterned according to the Wave Principle, we can propose a larger socio-economic hypothesis, that the Wave Principle ultimately shapes the dynamics underlying the character of all human social activity. The Wave Principle, in brief, is the engine of history.

NOTES

1 We may also say that every downturn in aggregate stock prices of at least Primary degree produced an economic contraction, as long as we define “downturn in aggregate stock prices” as the onset of an Elliott wave correction (see letter labels in Figure 1). Thereafter, the resulting recession may occur in wave A, C or both.

2 Narrowly contested elections sometimes hinge on near-term market trends and/or the lagging performance of the economy, as in the cases of Truman and Bush.

3 This is where historians get the bizarre notion that war is good for the economy. Actually, each war is triggered by an extreme low in mood, typically in the climate of economic depression. The social mood then reverses naturally and brings about both increased productivity and, eventually, peace.

4 Bank Credit Analyst. (1997, January and 1999, March). Toronto.

5 Holt, Derek. (1997, June 20). Royal Bank of Canada, as quoted on Bloomberg.

6 Poterba, James M. (1998, October). “Population age structure and asset returns: An empirical investigation.” Cambridge: Massachusetts Institute of Technology.

7 Prechter, Robert R., Jr. (1999, September 17). Debate with Harry S. Dent, presented by Bill Good Marketing, Chateau Elan, Braselton, GA.

8 In the last two decades, there has been no Elliott wave correction large enough to induce anything beyond nuclear weapons *testing*. The next “C” wave of larger than Cycle degree will undoubtedly impel the use of nuclear weapons for offensive purposes.

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