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THE BIRTH AND DEATH OF THE GREAT BULL MARKET IN BONDS

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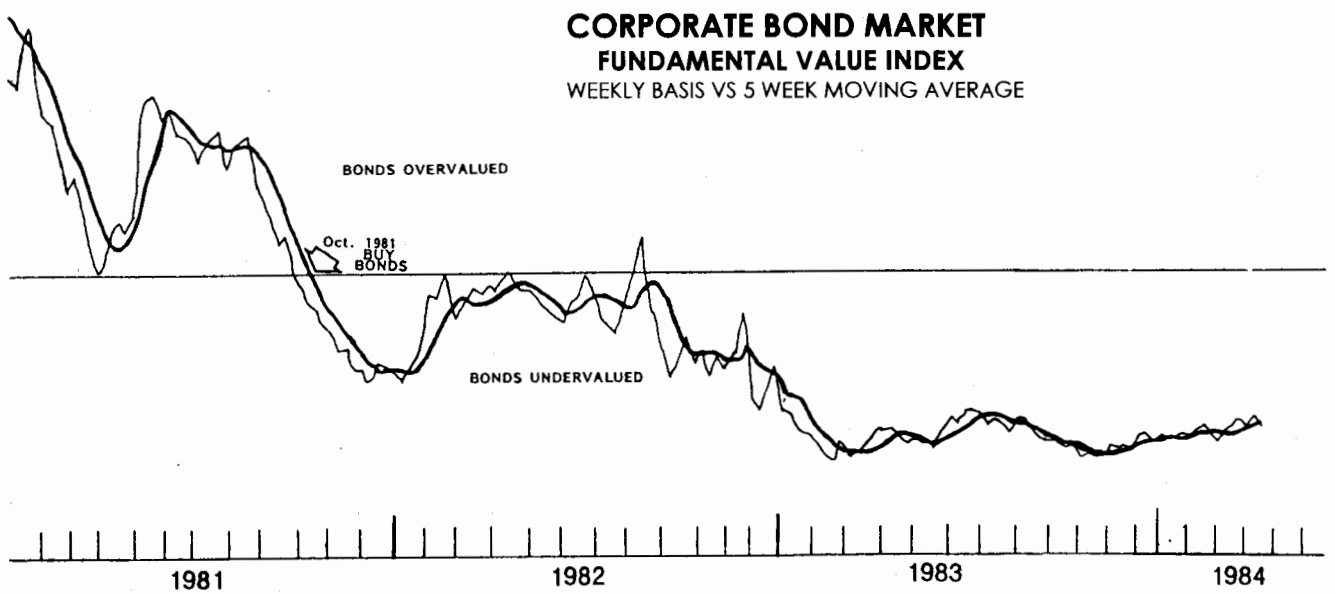
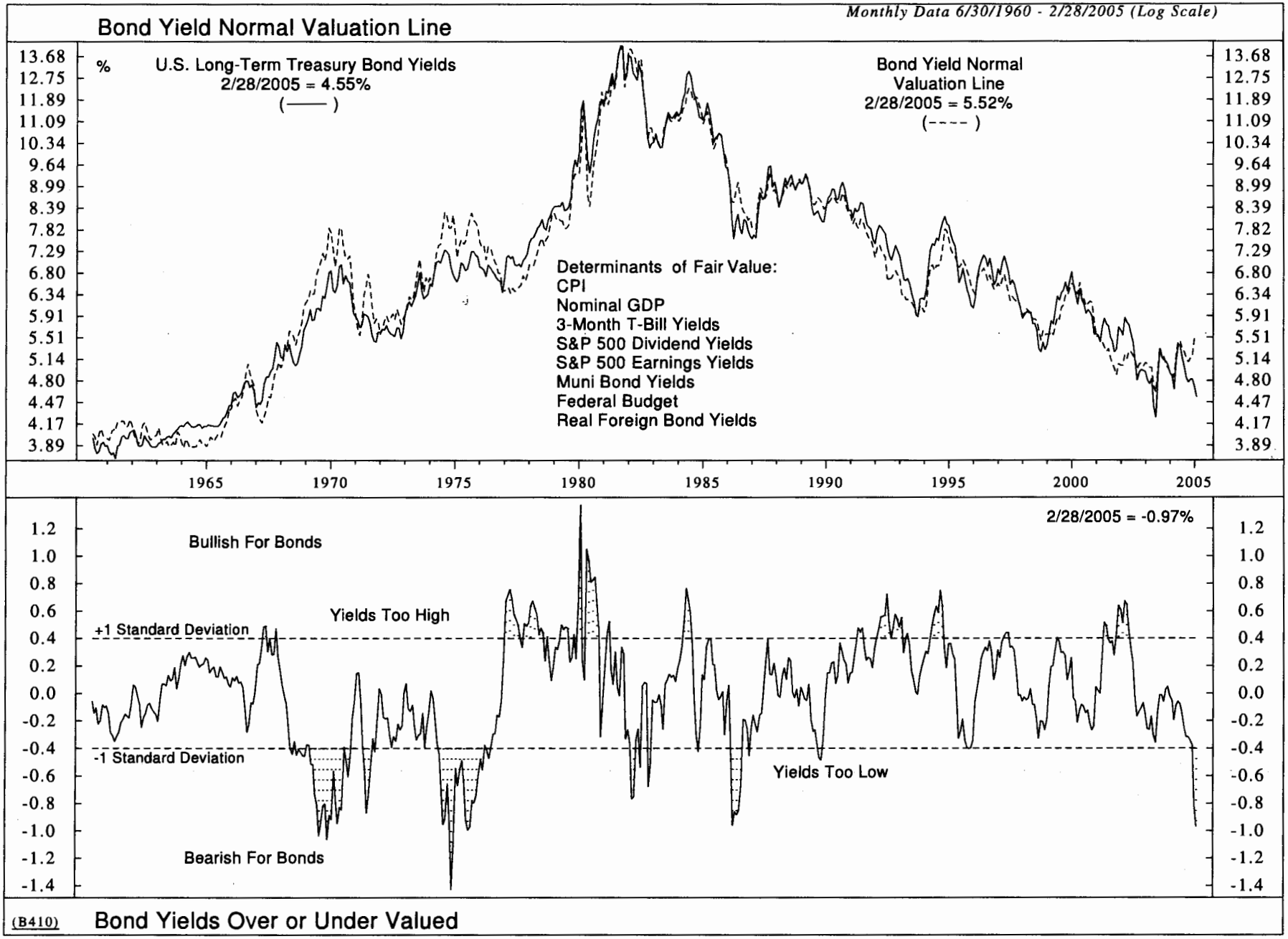
Summary and Conclusion: In 1981, with the world's Bond markets continuously making new all-time lows, these pages forecast the imminent birth of a grand bull market, a bull market which would be the greatest in generations and which would continue to elevate Bond prices into the 21st Century. This two-decade old forecast has come to term, and many of the same indicators that heralded the aborning bull, now suggest that he has just died. A persistent Long Bond Yield in excess of 5% will be the final nail in the coffin of the greatest Bond bull ever.

Perhaps the most singular characteristic of our original bullish forecast for Bonds was the numerous unconventional analytic techniques upon which it was based. While certain Fundamental and Monetary metrics were adduced in support of the bullish hypothesis, it relied most heavily on Psychological, Cyclic and Technical tools, such as Measured Moves, Elliott Waves, Fibonacci Spirals and other such arcana. We resorted to unconventional techniques because there are some profound theoretic problems which we think make it logically impossible for conventional economic science to consistently predict the future configuration of interest rates correctly. And since our highly unconventional metrics worked well once before, there are empiric as well as theoretic reasons for revisiting those old oracles today.

Fundamentals: The chart below is two decades old, and it shows that our primary "Fundamental" indicator for Bonds turned Bullish on October 1, 1981, the exact all-time low day for the *Dow Jones Bond Average*. This precise

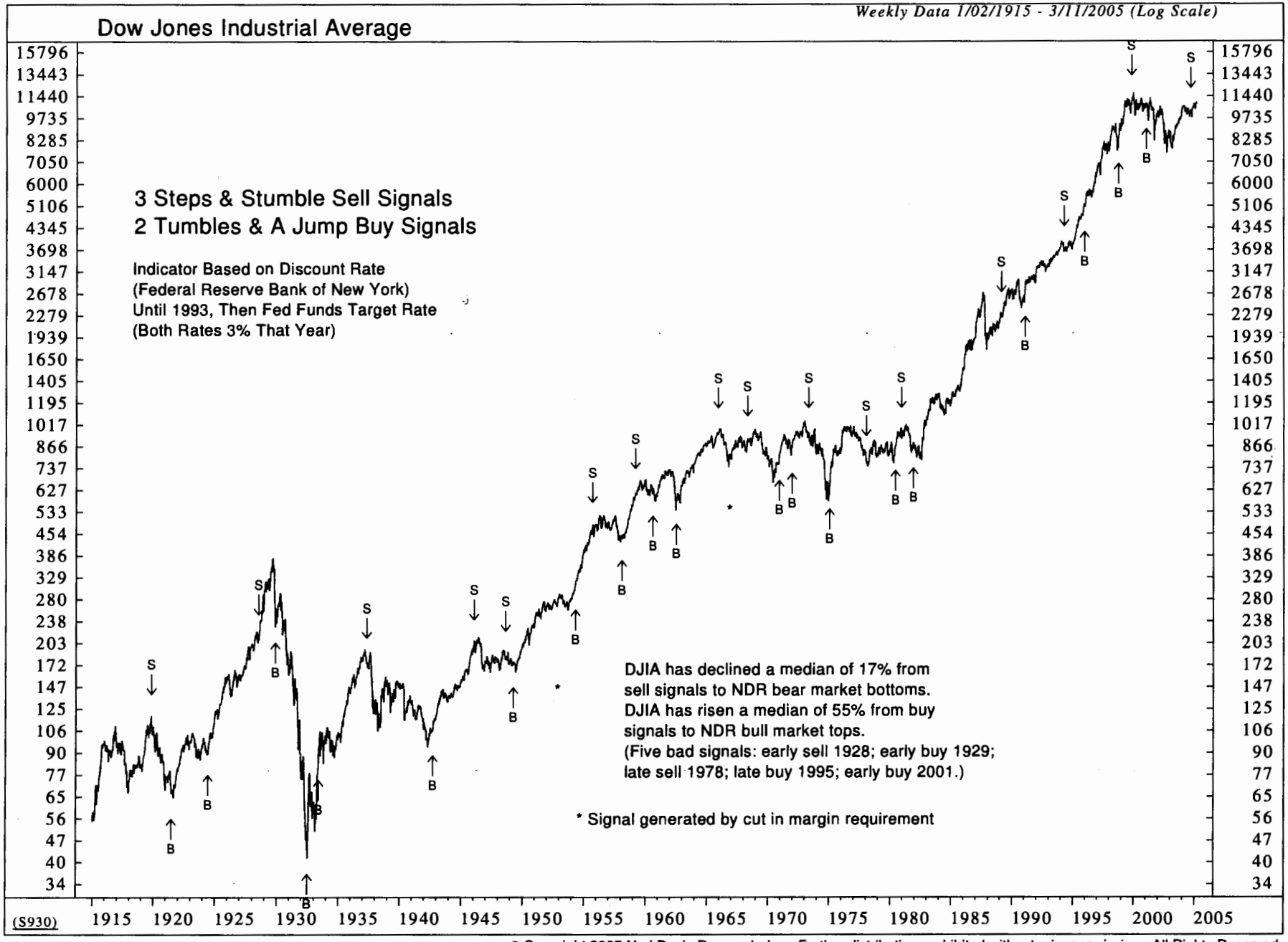




accuracy was a fluke, because historically this particular indicator typically misses exact turning points by a couple of months either way--which is still quite acceptable. This indicator measures the contemporaneous "fundamental value" of the Bond market by comparing its yield against various alternative uses of capital, such as Stocks, Cash Equivalents, Commodities, etc. We no longer maintain this particular indicator, but the invaluable *Ned Davis Research* (www.ndr.com) provides an excellent series which is pretty much functionally equivalent to our own (see page 2). Note on NDR's chart of *Bond Yield Normal Valuation Line* how the Bond markets were historically undervalued in 1980-1981 (yields too high); and how they are historically overvalued today (yields too low). Throughout most of the 1980s, Bond Yields were very high relative to inflation; and throughout most of the 1990s, Bond Yields were historically high versus Stock Yields; and for the last two years Bond Yields were historically high versus Short Rates. These and other such factors rendered Bonds quite attractive fundamentally for many years; but recently these advantages have almost totally dissipated, leaving today's Bond market in its worst fundamental shape in years.

Federal Reserve Board Policy: The Federal Reserve Indicators we use to forecast Bond prices have had a nominal accuracy of almost 80%. But despite the fact that roughly 4 out of 5 of their forecasts have proved profitable, these signals have come so infrequently --and so *late* as well--that they have *not* been the greatest money makers. We necessarily must keep abreast of Fed Policy--if for no other reason than because the marketplace seems fixated on it--but we give it minimal weight in our Bond timing models because faster moving, more timely indicators are typically more profitable. Hence giving Fed Policy too much weight would vitiate our excess returns. However, those who do want to follow Federal Reserve Policy in a timely and systematic manner can closely approximate the signals from own Fed indicator by following the "*3-Step and Stumble/2-Tumbles and a Jump*" rules articulated by Edson Gould and Norm Fosback respectively. The only difference between our Fed indicator and these two widely followed models is that ours incorporates minor Fed policy changes as well as the three major policy changes–viz., Margin Requirements, Reserve Requirements and the Discount/Fed Funds Rate--which comprise the two traditional models. And, of course, we apply these rules to the Bond market instead of just to the Stock market as is the common practice. Even with the refinement of including minor changes, Federal Reserve Board Policy is *not* our favorite indicator for the Bond market. But these Fed rules *did* give an historic BUY signal in the Fall of 1981, with Bonds at virtually their all-time lows. The Buy came December 4th on the standard model; October 12th on our tweaked version. And both versions gave a SELL signal on September 30, 2004, with most of the world's Bond Markets near their all-time highs (page 4). So while we may debate the question of precisely how much *weight* to give Fed Policy as

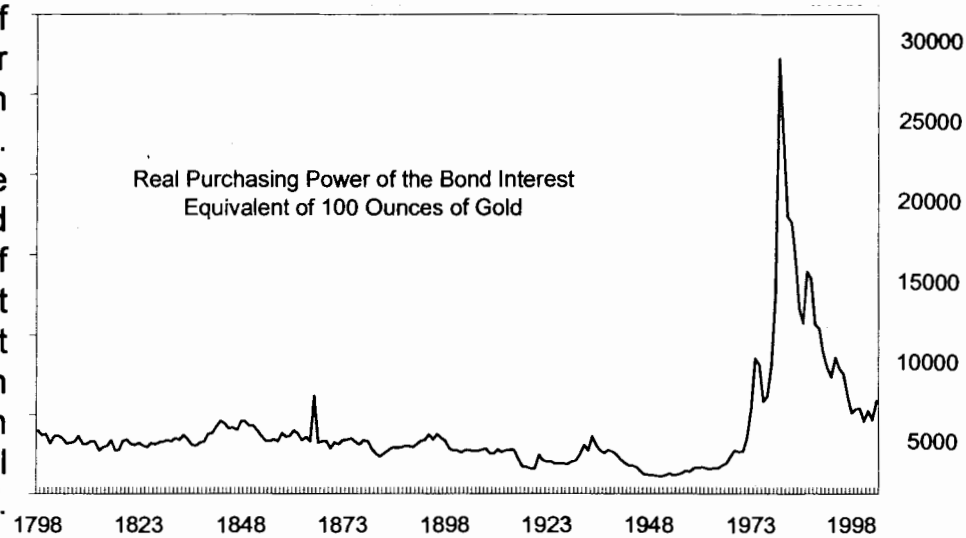
Fed signals are shown on a background chart of the *Dow Jones Industrials*, but these same signals can be used to forecast Bond prices.

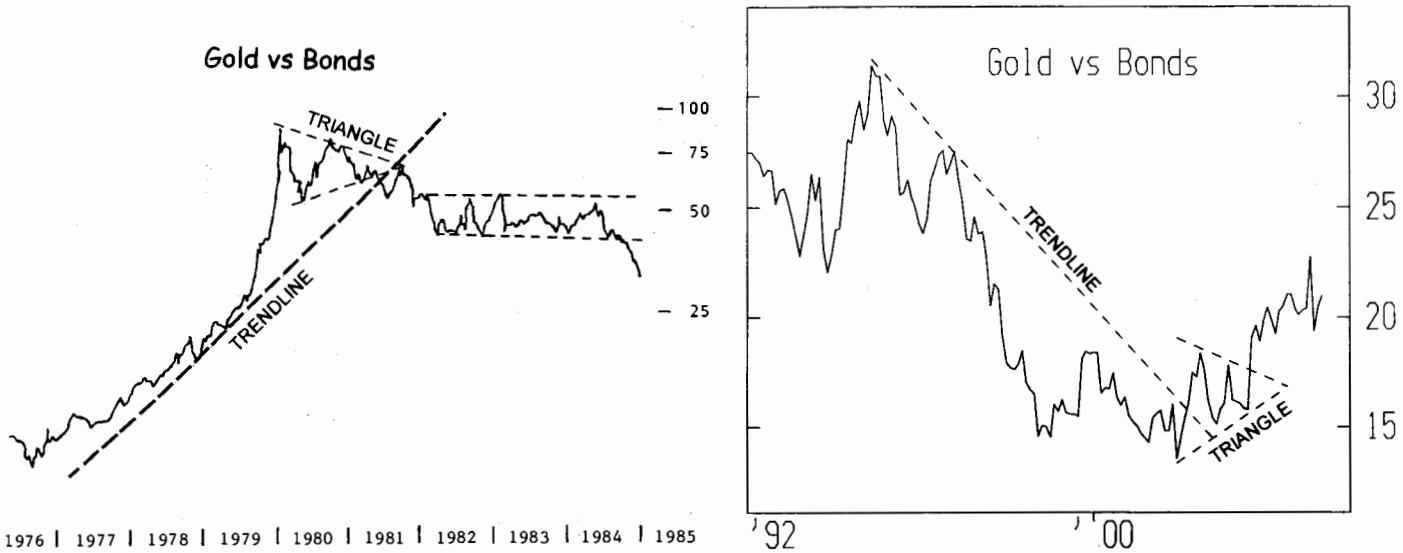


a Bond market indicator, there is no question but that the *significance* of recent policy initiatives is Bearish.

Monetary Indicators: Our Monetary Indicators are separate and distinct from our Fed Policy Indicators. For example: A *major* Fed move would be a change in margin requirements, and a *minor* Fed move would be a change in the "haircut" brokerages apply to various assets when calculating their capital. But major or minor, "Fed Policy" refers to *official directives* administered by *external*, government authorities. Our Monetary Indicators, by contrast, reflect purely *internal*, *market driven* conditions. For example, the trend in interest rates, the shape and trajectory of the yield curve, the ratio of Treasury yields to the yields on spread products, the behavior of Free Reserves, and the direction of the Real Money Supply, all reflect market dynamics largely beyond the direct control of the authorities. The composition of our preferred Monetary Indicators have changed over the years, but typically we tend to emphasize the direction of free market rates, the behavior of the yield curve, and the behavior of the money supply--adjusted for both the level of economic activity and for the rate of change in prevailing inflation rates. And once again, these indicators, which turned net Positive in the fall of 1981, are now net Negative. Note that Short Rates peaked in December 1980, ten months before the bull market in Bonds took off. More recently, Short Rates *bottomed* in June 2004--nine months ago--which suggests that a *bear* market in Bonds could begin at any time.

Bonds versus Gold: Despite the rhetoric and politics that infest this issue, the incontrovertible fact is that Gold is the ultimate real Money--and Interest Rates are the Rent on Money. Hence, over time there is an inescapable connection between yield instruments and bullion, and a thoughtful analysis of the Gold/Bond relationship often gives clues as to the fate of one or both partners. How to compare such distinctly different asset classes is an ongoing problem, but one rudimentary attempt is shown below. This chart shows just how much real, or inflation-adjusted, income would be generated by a hundred ounces of Gold, if that amount of bullion was liquidated and the proceeds allocated to long-term, high-grade bonds at contemporaneous gold prices and coupon rates. This chart is a bit slippery in that it combines three independent variables, one of which was arbitrarily fixed for a long period of time. Still, two centuries of data do put

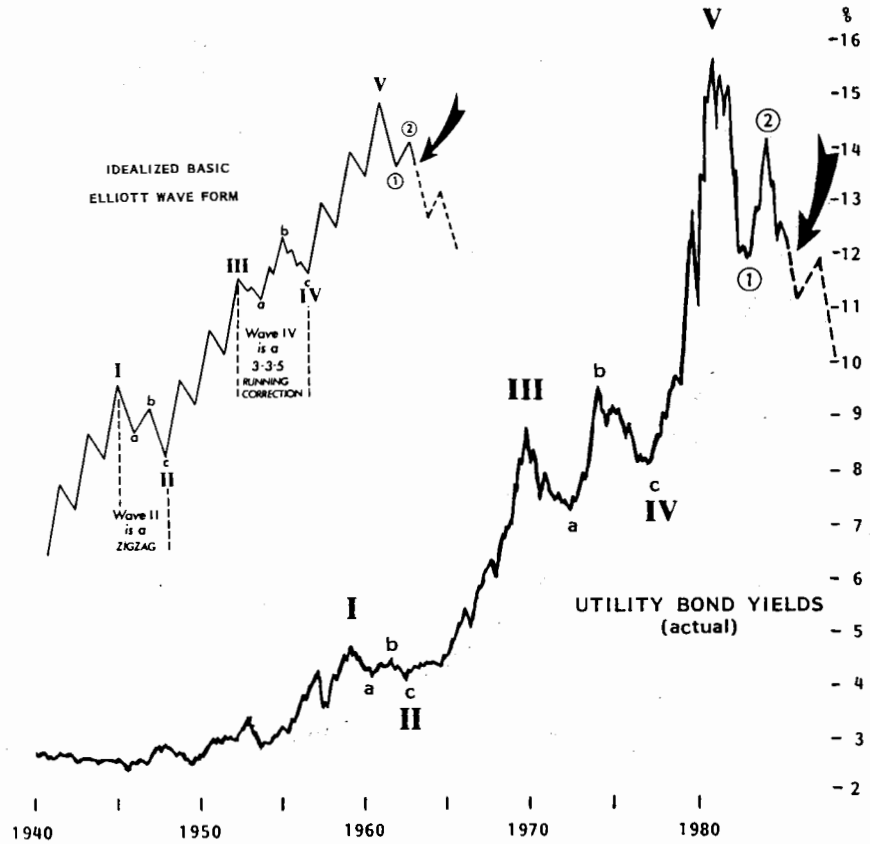




things in perspective. Note, for example, the blip in the data in 1869, the year of the infamous Fisk/Gould Black Friday Gold Panic. Note also how by this measure the worst time ever to buy Bonds (sell Gold) was in the mid 1940s, and the best time ever to buy Bonds (sell Gold) was in 1980/1981. Currently there is no clear message from this particular chart; however, various shorter term iterations of the Bond/Gold relationship *have* recently generated some action implications. The chart above left is one we did in the early 1980s, and the adjacent chart is a current rendition of the same two asset classes. Notice how in the early 1980s the Gold/Bond "*relative strength*" broke its major *uptrend line* and at the same time broke down out of a "*triangle*," thereby calling for major shifts in portfolio asset allocation. Today, by contrast the Gold/Bond relative strength has broken its major *downtrend line*, and has now broken up out of a *triangle*. Such *relative strength* studies are not precise timing tools for either Gold or Bonds *per se*, but they are good asset allocation algorithms, which usually get portfolios properly positioned within long term market moves. Just as market dynamics in 1980/1981 argued for a move from Gold to Bonds, today's action has argued for a move out of Bonds and into Gold and Commodities.

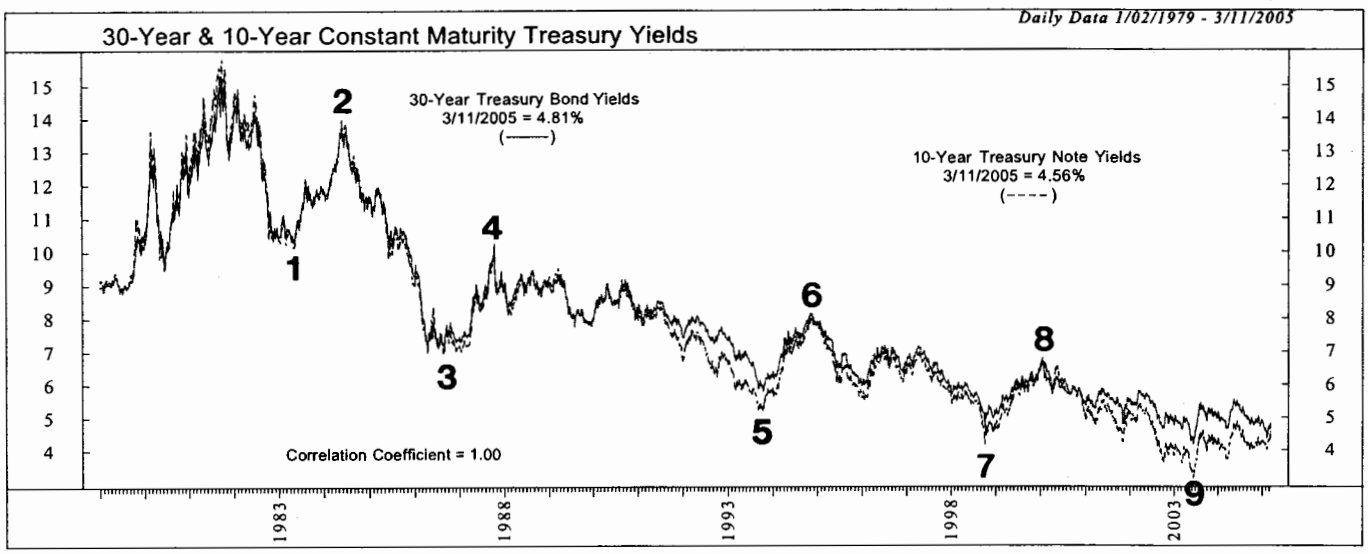
Technical Conditions: Between the middle 1940s and the early 1980s the Bond Market suffered its greatest bear market ever. In order to estimate when that unpleasantness would end, in 1981 we examined the *previous* supercycle, generational bear market in bonds, the one that occurred between 1899 and 1920 (not shown). We noted that in that earlier bear market, yields advanced in three distinct waves, with two intervening corrections. And within this complete 5-wave structure, the first and the third uplegs were of roughly equal size. Applying this same structure and proportionality to the 1946-1981 bear market, we calculated that Prime Corporate Yields should have a final target of around 15¼%. The chart at the top of page 7 is from a 1984 letter and it shows the Elliott Wave counts and Measured Moves we were using. Note that wave I lifted yields 190%, from 2½% to 4¾%, so leg V

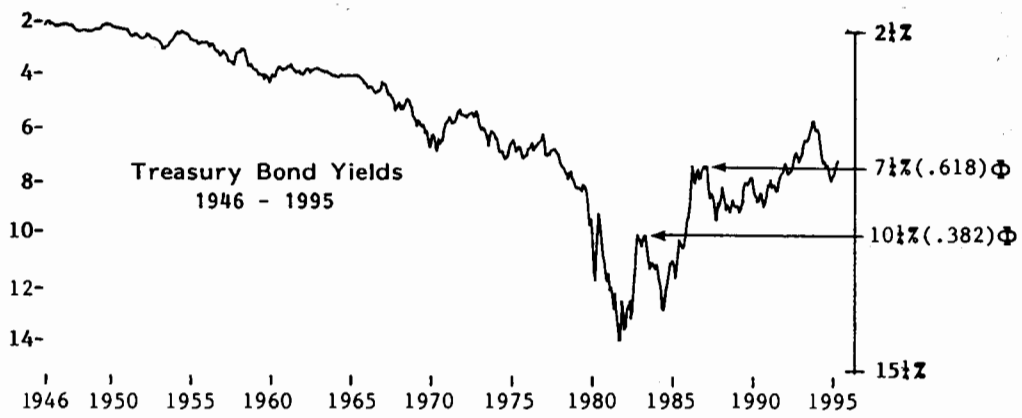
should lift them 190%, from 8% to 15¼%. The actual top came at about 15½% (monthly average), so this forecast was pretty accurate--especially considering the fact that the bear market had run for 35 years, and had covered some 1400 basis points.



Given this twice observed tendency for multi-decade, supercycle movements in Bond Yields to follow a 5-wave structure, we have periodically examined the current action of the Bond market for evidence of a 5-wave--and hence *complete*--progress pattern. The modern era low tick for the 30-year bond was 4.17% on June 16, 2003. Just two weeks after this historic high in Bond prices these pages reported that we could count nine (9) clear waves in the 1981-2003 bull market. In Elliott terms a 9-wave structure is the same as a 5-wave structure--it is a special case in which one of the impulse waves is itself comprised of five identifiable sub-waves. Therefore in July 7, 2003 these pages concluded that based on its 5-wave structure, it appeared that the 22-year long decline U.S. Treasury Bond yields, from 15.23% to 4.17%, had just ended (see below).

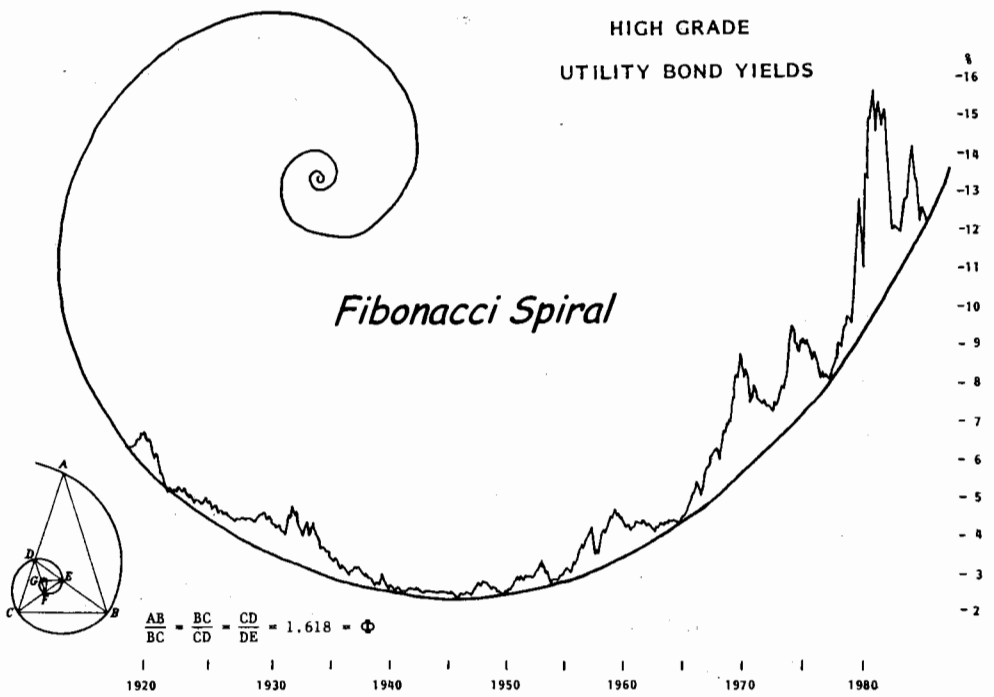
We did not calculate a precise yield target for the end of this bull market like we did for the end of the preceding bear market, because we did not know exactly how to count these nine waves. All we knew for sure was that there *were* nine of them, and that



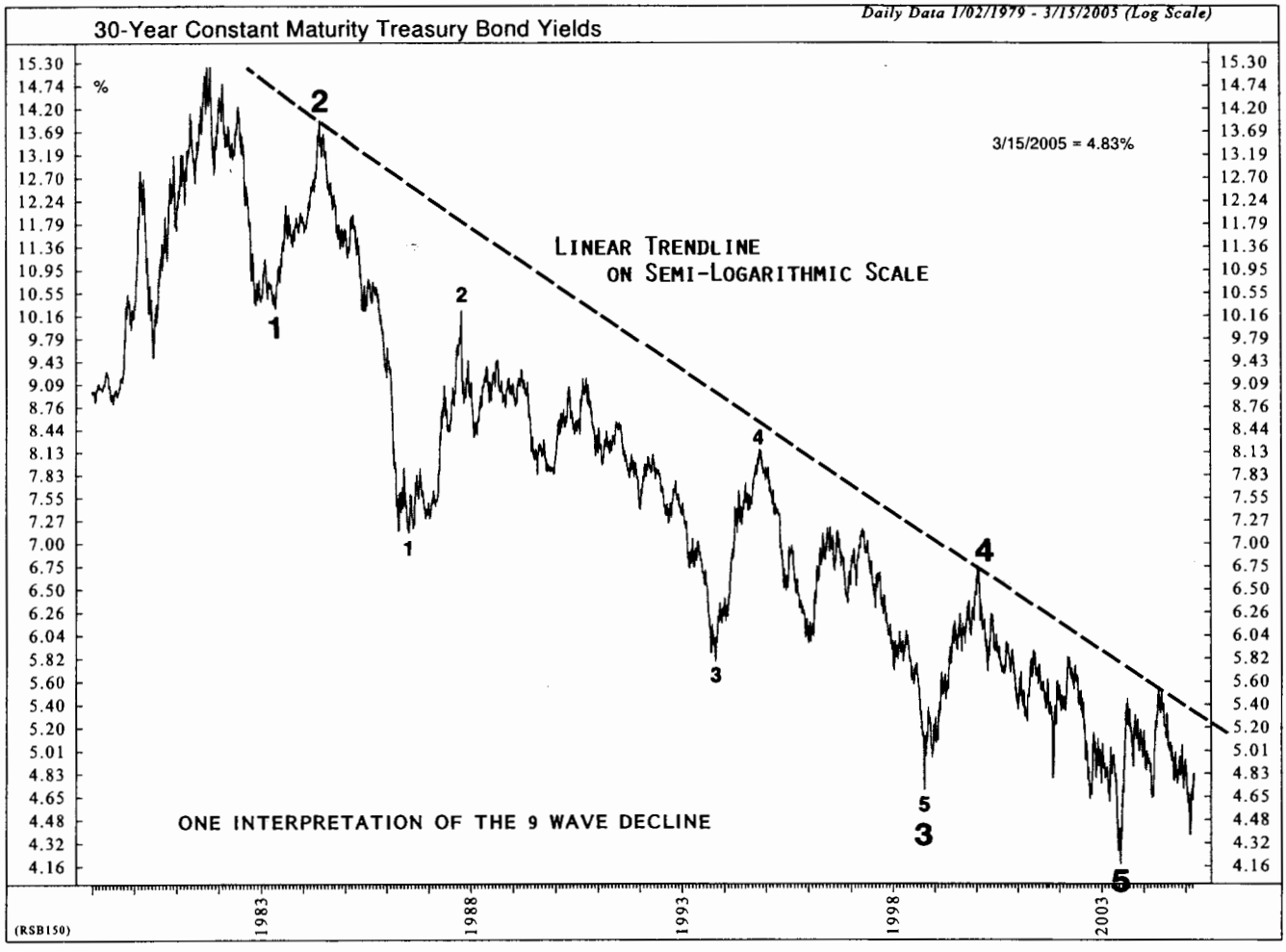


implied that the generational supercycle bull market in Bonds was over. However, because major pauses during this great bull market seemed to occur at Fibonacci intervals, we did make some crude guesses. For example, the 36-year long bear market carried Treasury Bonds from roughly 2¼% to 15¼%, or a Fibonacci 13 handles. Also, the bull market that began in 1981 ran into significant resistance at both the 38% and the 62% retracement levels of 10¼% and 7¼% respectively (see above). The only Fibonacci targets now remaining are the 78.6% retracement, around 5%, and the 100% retracement level, around 2¼%. Given the example of Japan, the 2¼% level is not unthinkable in terms of *price*, but in terms of *time*, it may be unrealistic given the fact that Short Rates have been rising for nine months. All we can say for sure at this point is that if the Long Treasury Yield does not soon head lower--toward 2¼%--but instead rises above 5%, such action would confirm that we are in the grips of a very long term bear market in Bonds.

The theoretic reason *why* Fibonacci proportions are ubiquitous in the capital and commodity markets will not concern us here. But there is one Fibonacci exercise that is of practical importance use for us today. The chart below left is from one of our 1983 advisories, and it shows how for 75 years, throughout supercycle bull markets and supercycle bear markets, Bond Yields were locked within a giant Fibonacci Spiral. Time and time again, for more than seven decades, whenever yields hit this invisible spiral boundary, they were repelled



back upward. In the early 1980s many thought that interest rates would continue to spiral up towards infinity as they did in Weimar Germany. But we thought rates were headed *down* instead, and we argued that if coupons could just break that invisible Fibonacci boundary, our supercycle bull market thesis would be confirmed. At last, in Spring 1985, yields finally breached this historic retaining wall. And once they did, interest rates went into a free fall, and Bonds took off on an historic bull run that was to last for the next 18 years. Unfortunately this *particular* spiral cannot tell us whether or not that great bull market is finally over. There are, however, certain other exercises that may give us much the same information. First note that a single *logarithmic* spiral bounded Bond Yields for decades. Then note that these yields are plotted on an *arithmetic* scale. However, if these same yield data are plotted on a *semi-logarithmic* scale, they can be similarly bounded, not by one spiral, but by <u>two</u> *straight* trendlines. These two separate trendlines will be much less elegant than our single spiral, which contained both bull markets *and* bear, but the Buy and Sell signals they generate are comparable. Consequently applying trendline analysis to a semi-log rendition of today's yields should illuminate the current Fibonacci position of the Bond Market. Where to draw trendlines is largely a function of the time horizons and risk preferences of the individual portfolio, but for our purposes here we favor the one shown below. The bullish two-decade long decline in Bond Yields



will be broken if the Long Treasury trades above 5%-5¼%. Such a break would be strong confirmation that we are in a long term bear market for Bonds.

Cyclic Indicators: A common characteristic of most classes of indicators--Fundamental, Monetary, Psychological, Technical, Federal Reserve--is that they are "coincident," rather than "leading." This is not a fatal flaw with the indicators discussed here because they typically identify market trends lasting for a few years. Hence, portfolios can earn excess returns merely respecting the prevailing trend--it is not necessary, or even possible, to predict turning points in advance. One exception to this rule is Elliott Wave analysis, which does try to predict turning points in *price*. Another notable exception is Cycle Theory, which tries to predict market turning points in *time*. In the 1970s the Foundation for the Study of Cycles identified numerous cycles in long-term interest rates, the dominant of which was the 54-year cycle (±5%). We used this cycle, combined with a dozen or so minor cycles, to predict that the supercycle bear market in bonds would end August 1981. The Cycles missed the historic low by about six weeks, but due to a pure fluke noted earlier, our Fundamental and Monetary Indicators turned the over-all model Bullish on the exact all-time low day, October 1, 1981.

The dominant 54-year cycle calls for the great bull market to end in 2005, but given its required 2-year tolerance, and given the fact that the dozen minor cycles are currently going in different directions, the final top in Bonds could occur anywhere between 2003 and 2007. This means that according to time cycles--as well as the wave counts discussed earlier--the June 2003 peak *could* well have marked the end of the supercycle bull market in U.S. Treasury Bonds. *However*, major moves in the Capital and Commodity markets are worldwide rather than parochial affairs, and to make a definitive determination, *all* the world's major Bond markets must be considered. And in this regard while U.S. Bonds, Gilts and the JGBs topped in June 2003, German Bunds, as well as the long-term paper of Italy, France, Switzerland, Canada, and Netherlands took out their June 2003 highs last month. Since setting modern era highs on February 9th, all these global bond markets have gone into a decline, and all have broken the persistent uptrend lines off of their May 2004 reaction lows. If the majority of the world's bond markets can regain their February 9th highs, the implication will be that the 54-year cycle has not yet given up the ghost. But the longer we go without retaking that high ground, the greater will be our confidence that a new, long term Bear market is underway.

Psychological Indicators: The one indicator category that is *not* currently supporting the case for a long term Bear market in Bonds is that of Sentiment. Currently, the polling services, Dealer positions, Commitment of Traders data, Rydex allocations, Conference Board opinion, Blue Chip Economists, open-end Bond funds Cash Position, retail investment flows, etc., all are showing Negative sentiment on Bonds. By the rules of contrary opinion, all this pessimism should be

bullish for Bonds. This sentiment does not mean that Bonds cannot go into a bear market--they may in fact already be in one--but it does suggest no significant down leg is likely until some of the current pessimism is worked off.

While there is no question but that the standard Psychological Indicators are currently supportive of the Bond market, some anecdotal data may be consistent with a very long term bear market. How rare is, for example, for the Chairman of the Federal Reserve Board to be knighted by the Queen of England; or for best selling books on the Chairman to appear on the *New York Times Best Seller List* as happened in 2001? Also there was an incident in July 2003 that we commented on at that time:

> *Recall that nearly 23 years ago, on December 7, 1981, police arrested a man with a knife, a revolver and a sawed-off shot gun just outside the boardroom of the Mariner Eccles Building where the Federal Reserve Board was having its meeting. The distraught man intended to hold the governors captive in order to focus media attention on what the then near-record high interest rates were doing to the country. Unbeknownst to that distraught creature, interest rates had peaked some nine weeks previous, and had just embarked on their greatest down move in history. We thought of that incident Tuesday when we saw the AP story relating how Hong Kong police had just arrested a distraught man who was burning thousands of Hong Kong Dollars on a busy thoroughfare. He was protesting the fact that after so many cuts by the Federal Reserve Board, interest rates had fallen so low that he could no longer survive on his savings. He had burned HK$22,000 (US$2,800) before he was stopped. Just as high interest rates drove people to the breaking point in 1981, low interest rates are doing the same in 2003. So perhaps the story of this benighted man setting fire to his savings, will prove to be the other bookend to the long odyssey downward in interest rates that has taken place since that long ago arrest at the Mariner Eccles building.*

While the standard Psychological Indicators may now be bullish for Bonds near term, these very unusual anecdotes may support the notion that in supercycle terms, we have seen the flood tide peak.

Action Implications: There are several things to watch; ① Short rates tend to lead long rates, and short rates have been going up for 9-18 months. Unless they head down soon, long rates are sure to follow. ② Long term movements in Bond prices are worldwide phenomena, and several global markets made all-time highs as recently as last month. Unless these recent highs can be bettered, the long term outlook for Bonds will be bad. ③ Final confirmation of a long term bear market will be given if yields break their *semi-log* trendline, which currently resides in the 5%-5¼% area. ④ High-grade leads low-grade, so if Treasuries don't soon rally, Junk and Emerging Market bonds will head down.