They Come and They Go

“Secondary reactions are as necessary to the stock market as safety valves to steam boilers.”  The Dow Theory by Robert Rhea, 1932

**OVERVIEW:** As explained by Robert Rhea: “…a secondary reaction is considered to be an important decline in a bull market…usually lasting from three weeks to as many months, during which interval the price movement generally retraces from 33 per cent to 66 per cent of the primary price change since the termination of the last preceding secondary reaction.” For our interpretation “for the 21st Century” we have added that the price change must be at least 3% on two of the three indexes (Dow Industrials, Dow Transports, and the S&P500). The time-frame must be at least 10 calendar days on two of the three, with at least 8 trading days the average of the three. Those qualifications were recently met, as was the 3% bounce on one index that lasted more than one day. The last hurdle of all three making new highs was finally met on December 29th. Another annoying secondary reaction is behind us, it came and it went. Another calendar year came and it went. Once again with new highs, the market is “in the clear” and this bull market is continuing.

Does that mean there won’t be a setback in 2015? Of course not, in fact it is practically guaranteed. Since the Dow Industrials crossed up through the 10,000 level in this secular bull market, *every time* it passed through a 1,000 point milestone, it has experienced a setback from the high point of the move to back below that threshold milestone. We now see that 18,000 is no different than 17,000 and 16,000 and 15,000 etc. While we are 100% invested and will remain that way whether or not there is another secondary reaction or setback, those looking for an opportunity to add to positions should use setbacks below 18,000 as a buying opportunity in this continuing bull market.

One can never predict the severity nor duration of Secondary Reactions, and so long as they don’t manifest into Bear Markets they must be tolerated for what they are: frequent annoyances.
There are some strong tailwinds going into 2015. One of the strongest is the GDP growth rate. The third quarter US Gross Domestic Product was recently revised to 5.0%, up from the previously reported 3.9%. This was mainly due to consumer spending and business investment, according to the Commerce Department. By their calculations, combined with the second quarter we are now at the best six-month increase in more than 11 years. Does that guarantee that the next quarter will also be strong? No, it doesn’t, and it probably won’t be. However, as this next chart shows it needn’t be strong, it just needs to keep plodding along and we’ll avoid a dreaded recession for this New Year.

Another tailwind is found in the recently released Federal Reserve data which shows that Industrial Production rose to a seasonally adjusted 1.3% in November. This was the largest increase since May 2010. At this same time, output of consumer goods rose to the largest increase since August 1998 and Capacity Utilization rose to the highest level since March 2008.

And finally, a very strong tailwind which brings some mixed implications is falling oil prices. OPEC is pumping near capacity, while at the same time the shale boom has raised U.S. production to the highest level since 1983, and is now supplying 89% of domestic energy needs in 2014. What has caused much consternation is the fact that during this strong GDP growth, the rate of U.S. oil consumption has actually fallen 0.3% in 2014, according to recent government data. This seems counter-intuitive. If GDP is growing, you would think oil consumption would increase too. Some explanations include new fuel-efficient cars replacing older models. Another is the fact that many homes which once burned fuel oil have replaced their systems using other energy sources.
Both of these explanations contribute to the thought that Americans are focused on improving energy efficiency. Such a tendency here and abroad should add to oil’s longer-term decline in demand as well as price.

With the growth of the U.S. economy outpacing much of the rest of the world, foreign investors have increased investments into our Treasuries, Government agencies, U.S. corporate bonds, and our equities. At the same time, the EAFE (Europe, Australasia and Far East index) International Index is down 2.3% YTD (total return), well below the S&P 500’s +13.1% YTD result. Net flows from non-US residents into long-term securities:

![Graph showing monthly inflows and outflows of foreign investors into US Treasuries, Government agencies, U.S. corporate bonds, and equities.](image)

Source: US Treasury via Bloomberg, as of 9/30/14.

How about this for a New Year’s resolution – never pay for this subscription again! HOW? Recommend two friends each year, and in exchange for each friend becoming a full Subscriber and listing you as the “referral”, we will extend YOUR subscription by another 6-months free of charge. It really is that easy.

As we remind our Subscribers at the start of every New Year, January 2\textsuperscript{nd}, being the first trading day of most years, has a good record of being at or near the lowest/best level of each New Year. The Special Report “The Single Best Day to Buy Each Year…Usually” shows that nearly half of the time that the market is in a bull market, as now, the low for the year was in January. Since we wrote this report, many buyers have jumped on the first trading day of the year, and consequently it has been an UP day 7 of the last 10 years. These results suggest buying on the last trading day of the year so as to benefit from the first day’s strength. Even after their first day’s strength, the closing levels have still been within 0.6% to 8.7% of their annual lows in 7 of those 9 years (the only exceptions were the bear market declines during 2008 and 2009). In 2014, January 2\textsuperscript{nd} closed at 16,441.35, 6.9% above the year’s low of 15,372.80 on February 3\textsuperscript{rd}.
The DOW THEORY for the 21st Century: The market’s recent decline qualified as a secondary reaction, Step #1. Since that time we have had Step #2 with a 3%+ bounce on all three indexes. Step #3 resulted in an “In the Clear” signal with new highs on all three indexes.

As you can see below, we are officially ‘In the Clear” as the Transports have finally joining the other two indexes in establishing new highs with this break-up.

<table>
<thead>
<tr>
<th>Step</th>
<th>Dow Industrials</th>
<th>S&amp;P500 Index</th>
<th>Dow Transports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Highs</td>
<td>12/05/14 17,958.80&lt;</td>
<td>12/05/14 2,075.37&lt;</td>
<td>11/25/14 9,202.84</td>
</tr>
<tr>
<td>#1</td>
<td>12/16 17,068.87 (-5.0%)</td>
<td>12/16 1,972.74 (-4.8%)</td>
<td>12/16 8,740.52 (-5.0%)</td>
</tr>
<tr>
<td>≥3% Setback (qualified)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#2</td>
<td>12/18 17,778.15 (+4.2%)</td>
<td>12/18 2,061.23 (+4.5%)</td>
<td>12/22 9,081.53 (+3.9%)</td>
</tr>
<tr>
<td>3+% Bounce (qualified)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#3</td>
<td>12/22 17,959.44&lt;</td>
<td>12/22 2,078.54&lt;</td>
<td>12/29 9,217.62&lt;</td>
</tr>
<tr>
<td>Break-up “in-the-clear” on all three or down on S&amp;P + one = Sell</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This indicator remains in a BULLISH mode (GREEN) with an average entry level of 15,548 from the July 18th, 2013 signal. The market strength clearly indicates that no signal change is in sight. We will remain vigilant in search for any signs of weakness. The Original DOW THEORY, too, is BULLISH.

Schannep ↑TIMING ↓INDICATOR: This indicator also remains in BULLISH mode (GREEN) with an average entry level of 11,746 from August-October of 2011 signals. Being a momentum indicator, it is evident that a change is not immediately forthcoming. Until the monetary situation changes we should see continued market strength.

The COMPOSITE Timing Indicator: Our hybrid Indicator remains in a BULLISH mode (GREEN) since the Dow Theory for the 21st Century’s returned to a Re-Buy on July 18, 2013, for an average entry level at 13,647.52. With a few short interruptions, this indicator continues to participate in this secular bull market.

→ The BOTTOM LINE: Last month’s Letter should be a real ‘keeper’, outlining our potential market targets and the reasoning behind them. This month we add another target to the list. In the Special Report on Bull Markets of the 21st Century we show the annual results after Bull markets start. Since we believe the current cyclical bull market started on October 3rd, 2011 as explained previously (see July 31st, 2013 Letter) that means this market is in its 4th year. Of the 9 bull markets over the last 100+ years that completed their 3rd year, 8 went on to complete a 4th year successfully with an average gain of....19.5%. That would work out to 20,326 by this coming October 3rd. We haven’t reached our first target yet, but are optimistic that we will. We look forward to ticking other targets off this list as this secular bull market goes forward, for as long as she goes.
Historically I have tracked the performance of my REAL money portfolio as I have invested in my actual IRA, fully following the Composite Timing Indicator’s signals which is currently 100% invested in approximately equal amounts into each of the Exchange Traded Funds that track the DJIA, the equal-weighted S&P500 and the S&P500 Indices. For the last 12 months this portfolio with dividends reinvested is UP +12.6% vs. the Dow Jones UP +11.0% and the S&P500 UP +14.6% including dividends. The problem with such reporting is that it represents only what I am doing, which could be very different from others. Subscribers use this letter for Market Timing, which could include shorting, going long, even utilizing leveraged investments that could double or triple – in either direction. Our results have been monitored by several independent sources that track our performance such as Hulbert Financial Digest, DowTheoryInvestments.com, CXO Advisory Group and TimerTrac.com

This Letter concentrates on the big picture, the trend of the major stock market indices which usually influences the price direction of most individual stocks.

The Dow Theory is a form of technical analysis that relies on detecting trends in the stock market to determine an investment strategy. The detection of these trends may be interpreted differently by different analysts and the opinions expressed on this website may not be shared by other individuals who apply the same principles of The Dow Theory. Past performance is not an indication of future returns. It should not be assumed that any recommendations made will be profitable or without the risk of loss or will equal the performance of the benchmark portfolio. All investments involve the risk of potential investment losses as well as the potential for investment gains. The performance of any portfolio or investment strategy should be viewed in the context of the broad market and prevailing economic conditions.