Bill Sarubbi's CYCLES RESEARCH

Summary

CR moved to a 200% long position as of the November 4th close.
CR issued a buy on gold as of the close on April 9th, 2009.
A buy signal was issued on bonds on the close on June 30th, 2010.

Presently, I am retaining a bullish position on stocks, but I do expect a short-term correction. This could develop into a larger decline, primarily due to the monthly counts outlined on page 2 combined with the high degree of optimism and technical divergences. If I do detect such a sell-off, an interim report will be issued.

I shall be speaking at a 1-day market conference in Budapest on January 15th:
"We are pleased to announce the MTA Central Europe Regional Chapter kick off meeting on Saturday, January 15th, 2011. It will be held at UNIQA Business Center in Budapest, Hungary. It is an all day event, followed by a cocktail reception dinner. All are welcome, and this event is free for all that wish to attend."
Here is the link to the meeting details:
http://www.mta.org/eweb/dynamicpage.aspx?webcode=central-europe

We will be moving away from the AOL service over the coming months. Kindly note that the e-mail address is now bill@cyclesresearch.com.

The Museum of American Finance is worth a visit and a membership. I was a member decades ago. I was walking past 48 Wall Street with a friend who is associated with the Museum. We toured it, and it is a great piece of Wall Street memorabilia. I saw many old newspapers with great stories of the day, old share certificates, etc. There also was a solid gold Monopoly set.
http://www.moaf.org/index

Analysis

One year ago, I thought that the market would rally in Q1 of 2010, and then have a very weak Q2. The third quarter was also projected to be weak which it was not. I had thought that the last quarter of 2010 would be the strongest, leaving the market plus 5%-10% from the S&P close on the last day of 2009, not far from the actual number of 11%. Much of this was based upon seasonality. Several market analysts noted that seasonality has not worked as well as it has in the past. A good example is September-October which were strong months. One analyst wrote that 8 of 11 months have moved against seasonality. I think that these deviations were due to the inflation of the currency. This is what inflation of the currency does-distorts reality. I recall the 1971 article by Daniel Seligman that demonstrated how inflation distorted balance sheets and income statements. I believe that the same is true of seasonal market movements. Both fundamentals and technicals are warped by distortions in the money supply.

Presently, there are a number of positive and negative factors that are likely to influence the US stock market in 2011:

- This is the most bullish year in the 4-year presidential cycle.
- In the decennial cycle, this is a year ending in ‘1’, a year that has had no particular historical bias, having been up a little over 60% of the time since 1885.

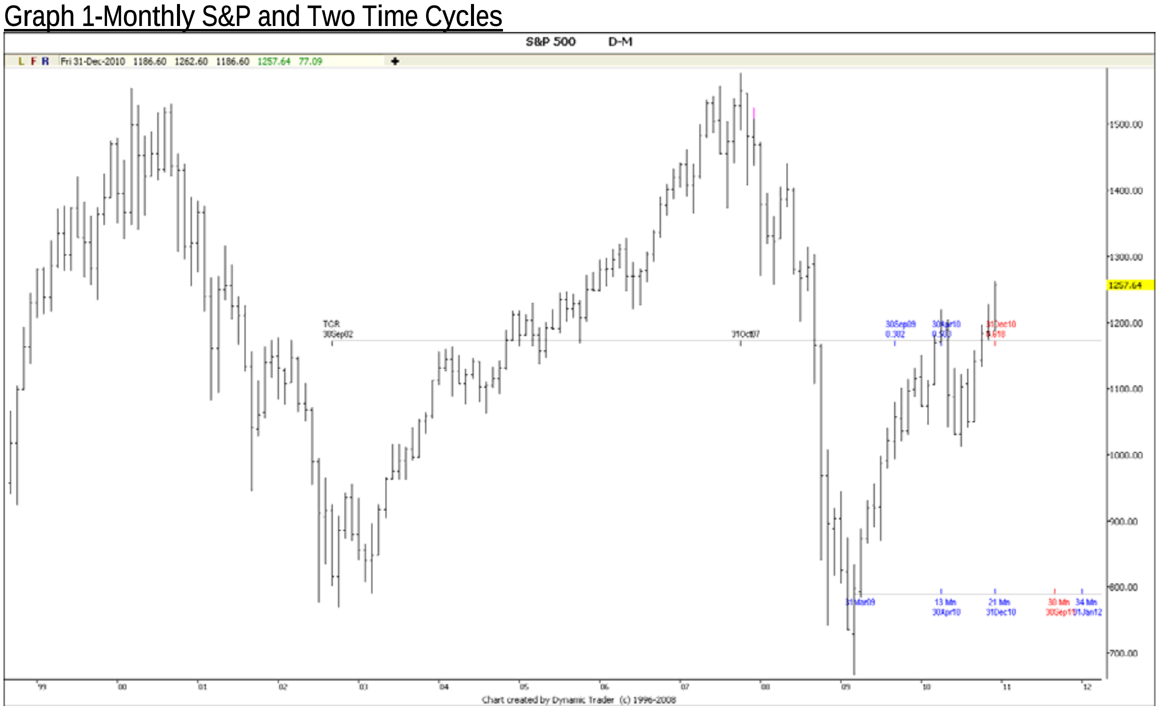
The combination of the 1, 4, and 10-year cycles projects a rising market into mid-August with brief corrections in March and April. The projection line then falls into mid-December. Based upon these two cycles, I suspect that the market will be about 15% higher by yearend.

The primary negatives are:

- As mentioned last month, the time span from the December 1974 low (DJIA=571) to the September 1976 (DJIA=1025) high is 21 months. I consider the period that we are in to be equivalent to the 1966-1982 period and the December 1974 low to be equivalent to the March 2009 low. Measuring 21 months from the March 2009 low equals December 2010. The 1976 high was followed by a 28% decline into March 1978.
- Measure from the October 202 low to the October 2007 high. Multiply this amount by .618 and add to October 2007, and the result is December 2010.

This graphic depicts these two monthly counts. Usually, I like to see 3 counts or more to call for a turning point. But that rule can be relaxed when the counts are derived from major highs and lows, as in this case.

Graph 1-Monthly S&P and Two Time Cycles



Source: Dynamic Trader

Short-term:

- The advance from the July low on the S&P shows a fairly clear 5-wave pattern (see Graph 2).

- Sentiment, by many measures, is very bullish.

In terms of sentiment, in the week ending December 24th, the AAII poll of individual investors showed 63% bulls. This was the highest reading in years. This was not the only sign of extreme optimism. This is what likely restrained the December rally. The high hopes have dissipated over the last 2 weeks; the percentage has fallen to 52%, but sentiment remains too optimistic. A correction will change that quickly, I do believe.

Graph 2-Daily S&P and 5-Wave Count

The S&P broke out of a large rectangle and has not yet reached the objective set by that breakout. At this point, I do not think that the S&P will reach the optimistic target that I had set.

The Lowry's organization has maintained indices of buying and selling pressure for many years. Typically, the market does not make an important top unless these indices are in an unfavorable condition. They have not been in such condition and are not now. This suggests that any January correction will be limited. This confirms what the summation of the 1, 4, and 10-year cycles reflects.

It has been said many times that this is a market of stocks and not a stock market. Looking at individual stocks, like IBM or Travelers in the Dow, we can see that these stocks are still on monthly buy signals and are not close to being overbought. It will require months of rising prices before that condition materializes.

Thus, any weakness is likely to be limited to the Fibonacci levels in the graph above such as 1203 or 1165.

Cycles and Interesting Perspectives

I continue to see the parallels between the 1970s and the current environment. In the 1970s, the increases in the money supply raised costs while business stayed stagnant. For those on Wall Street, there was plenty of money around to do deals. Read any financial history book and you will see that the same condition develops in any inflationary period. Since Obama's inauguration, the S&P 500 is up over 50%, but the price of gasoline has risen by a greater percentage. Like the 1970s, a split sentiment has developed: Okay on Wall Street and gloom on Main Street.

In past reports, I had interpreted certain cycles as being indicative of inflation in agricultural commodities. Cycles also pointed to civil unrest. As the world economies slowed, rising food prices were projected to squeeze the lower classes in developing economies. And now, corn prices are at a 29-month high, Mexico is attempting to hedge corn prices to prevent civil unrest from tortilla inflation. In India, onion prices have jumped to almost five times the usual price. Rising prices of all staples, including tomatoes, lentils and garlic, are rising. There arer riots in numerous countries.

My friend at Universal Economics, Paul McRae Montgomery (montgomerycapital.com), is an expert in the interpretation of the effect of the media upon the markets through contrary opinion. Paul noted that Facebook's founder is Time Magazine's man of the year. Years ago, Paul found that the appearance of an investment-related story on the cover of Time usually led to a reversal in the price trend in the opposite direction to that suggested by the cover story. Generally, the price trend continued in its direction for about a month, but then reversed about 80% of the time. If this maxim holds up, then internet stocks are due for a correction beginning in Q1.

Paul also referred to the Skyscraper Index. This indicator was developed by Ed Dewey. Dewey noted that the completion of record-setting buildings occurred at the tops of building booms that were followed by hard times for the owners and weak markets. The Equitable Building was completed in 1870 just before the panic of 1873. The Singer Building and Metropolitan Life Building opened in 1908-09 after the Panic of 1907 . The Chrysler Building and Empire State Building appeared in 1929-1931 before the Great Depression. The World Trade Center in NYC and the Sears Tower appeared in 1972-1974 during the worst stock market decline since the Great Depression. In 1999, the Taipei 101 building, scheduled to be the then tallest on the globe, broke Ground at the top of the 2000 market. And several years later the current tallest skyscraper, Burj Dubai, heralded the 2007-2008 bear market. Paul indicates that the current Shanghai Tower will not exceed the Burj, but the sheer volume of large-building construction may be indicative of tough times for China.

Continued Slow Economic Growth

At the Erste Bank conference, I heard one economist state that the typical US recovery ranged in the 7% to 12% area annually. This recovery is running at 2%. The reason for the slow growth goes back to fundamentals. I have listed many of the non-growth policies of the current administration and could fill these reports every month with such items. When I was visiting retired friends in Pennsylvania, they told me that they were delighted to find out that there may be natural gas under their land. They accepted $5000 annually per acre for mineral rights. This, however, will not be happening in New York State. Governor David Paterson vetoed legislation that barred natural gas exploration in the Empire State. He thereby reversed his own pro-investment message. As radio host Jim Quinn states, *"Liberalism always produces the exact opposite of its stated intent."*
http://online.wsj.com/article/SB10001424052748704694004576019920185853848.html?mod=googlenews_wsj

Turning Points

December 29th was listed as a high-probability turning point last month. Thus far, it looks like a high. The next turning point is Friday, January 7th. If this were to be a low, then the market would have to fall for the next 4 days trading days of 2011. The 14th is also high-probability, so this will likely send the market up, so the 19th is likely a high. Any correction should be halted by the 26th. I have written this from the standpoint of a corrective market. If this is not the case, then the turning point dates must be read in the opposite fashion-the 7th then is most likely a high.

The highest-probability S&P and DJIA turning points (+ or – 1 day) for the month are (The stronger turning points are starred*):

7*	19
14*	25-26*

The highest-probability NASDAQ turning points (+ or - 1 day) for the month are (The stronger turning points are starred*):

3	21
7*	26-27*
13-14*	

<u>Developments in Technology</u>

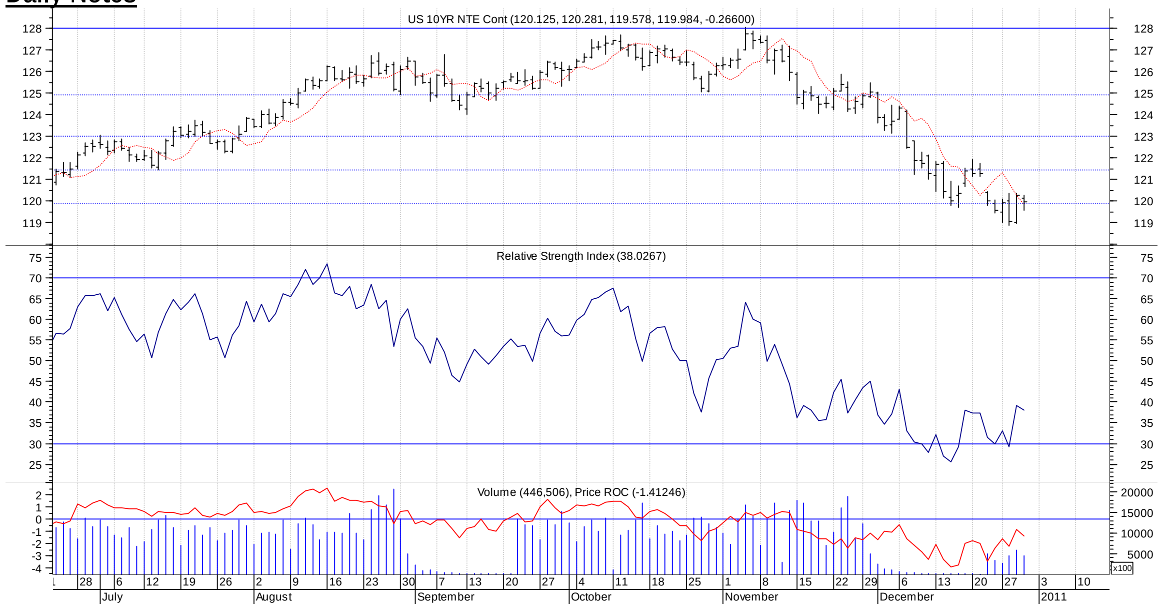
At the NYU alumni day, I was pleased to learn that one of my alma mater's own faculty is a leader in the theory of nanotechnology. Dr. Nadrian Seeman works in a new realm of chemistry that seeks to control matter on the scale of billionths of a meter. Seeman uses the programmable matter of DNA to get particles to assemble themselves. He recently built an entire assembly line, inspiring the Christian Monitor to call him the Henry Ford of nanotech. He recently received the Kavli Prize, the industry's version of the Nobel Prize. Manipulation of DNA strands enables scientists to control their movements. In the May issue of Nature, Seeman's team reported that they had built an entire assembly line out of DNA. A microscopic walker moves past 3 other mini machines each holding a different cargo of nano particles. The scientists controlled which machine would transfer its cargo onto the walker. Dr. Seeman believes that drugs will be manufactured at the nano level, a mini factory in a test tube.

<u>Bonds</u>

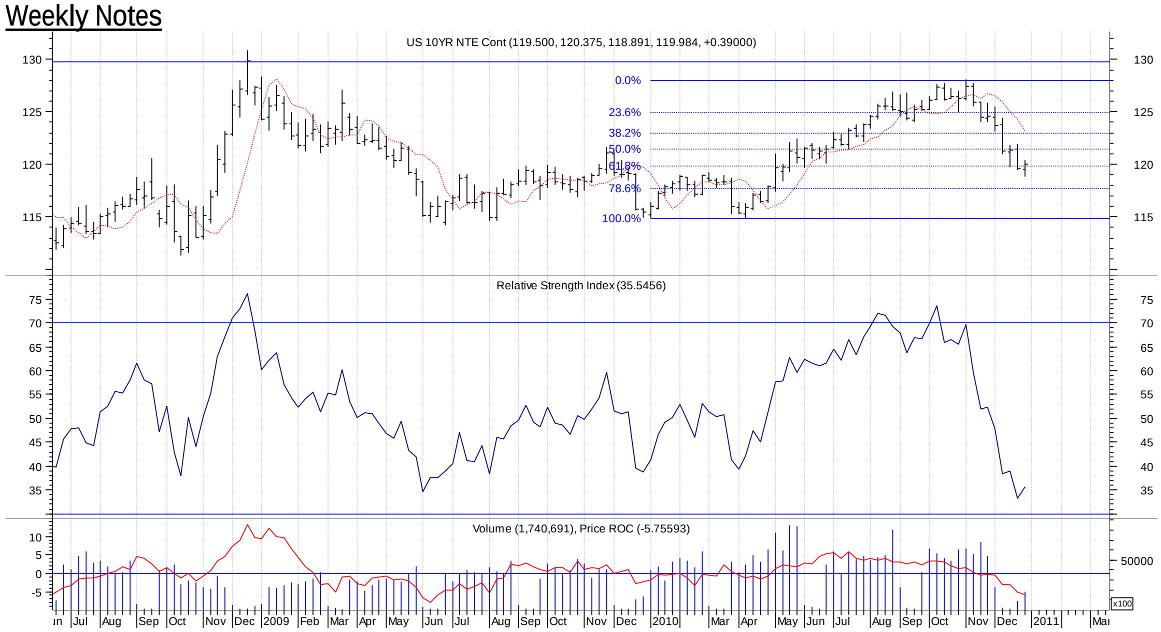
The intermediate bond cycle topped, bottomed, and tops again from November into February. It originally looked like a trading range with the bottom falling out of the range in February. However, the magnitude of the decline exceeded my expectations. I thought that the last decline would be minor. When this occurs, it typically does so because a stronger cycle is pressing down and overriding the intermediate cycle. Presently, the cycle has hit a low. Looking at the daily graph below, the US notes are oversold and there is a bullish divergence between price and the oscillator. Weekly, notes are oversold. The cycle tops next on February 6th. Thus, it appears that a rebound rally begins now and will run for about 5 weeks. Sell into strength.

The monthly graph does not suggest longer-term strength. There are 2 lower highs in momentum, and this index is not even oversold yet. On top of this weak position, the intermediate cycle that tops on February 6th does not bottom until late June or early July. The longer-term bond cycle, which will be reviewed in a coming report, already topped out, so this could be the beginning of a longer-term bear market. As we know from Homer's History of Interest Rates, bond bears can last for 2 decades or more. The last bear ran from the end of WW2 to 1981. There are potential turning points on the 9th and the 20th.

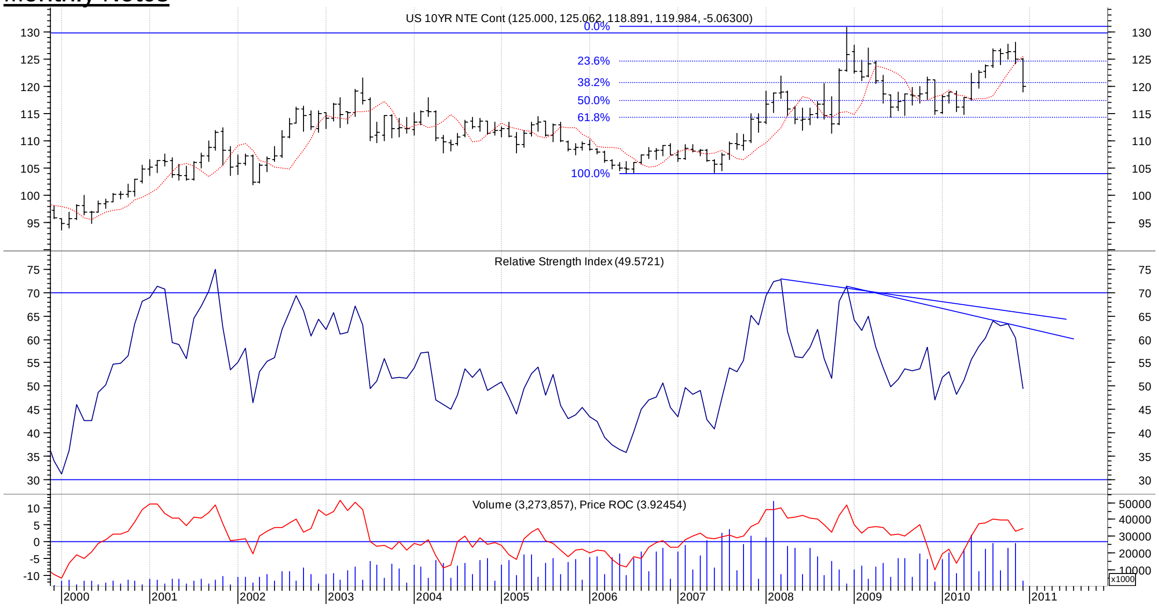
Daily Notes



Weekly Notes



Monthly Notes

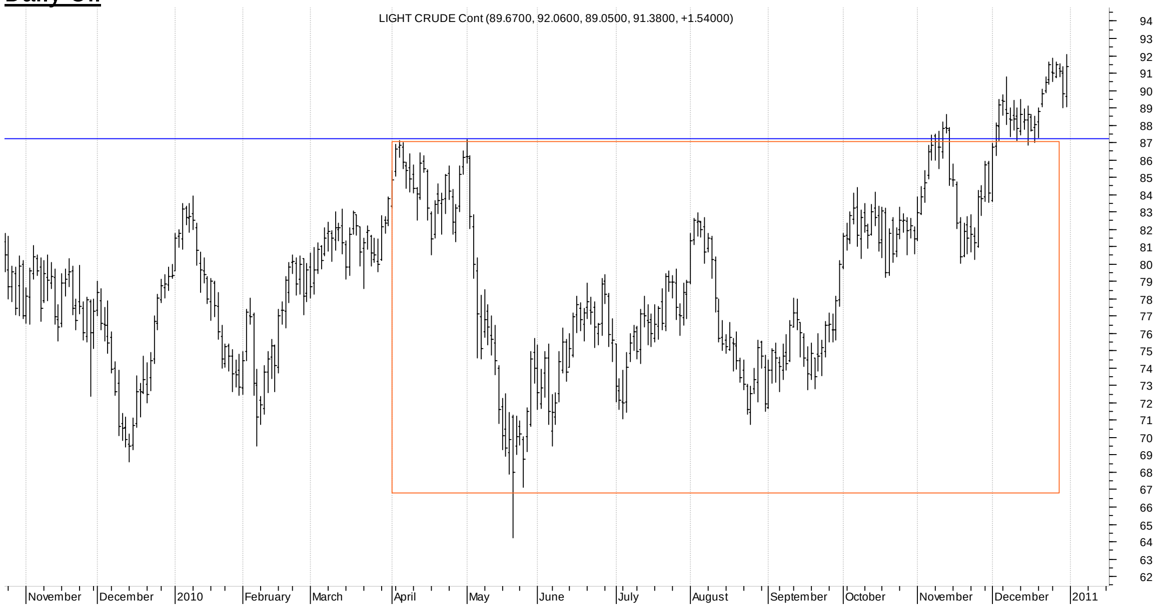


Oil and Gold

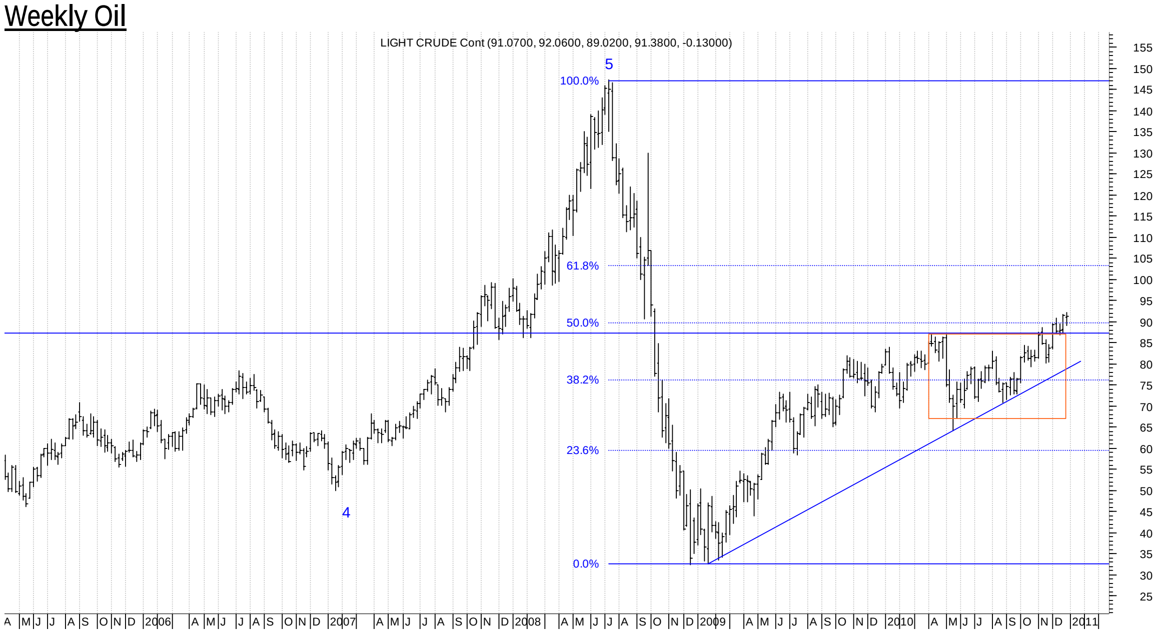
According to studies done at the Foundation for the Study of Cycles, commodity bull markets run in an 18-year cycle. Some have been as short as 9 years. In any event, cycles can be sub-divided into harmonics, and half of 18 is 9 years. If the current bull market began in 1999, then 1999 plus 9 yields 2008, the year of the commodity bull market correction. The fact that many commodities have recovered since that time suggests that this commodity bull remains intact. Using cycles analysis software on monthly data; I came up with the years 2012-2014 as being highs in many individual markets. The point is that commodities are likely to continue trending up in 2011. This is confirmed by strength in commodity-based stocks and currencies.

The daily and weekly graphs are below. Note that oil has broken out of a rectangle, marked in red. In technical analysis lore, a breakout will usually propel prices higher by an amount equal to the height of the rectangle, about $20 in this case. Add this to the top of the rectangle ($87), and the price projection is $107. This can also be viewed as Richard Donchian's trading rule: if a market does not make a new high or low in 4 weeks, then buy in the direction of the breakout. In 2004, the Financial Analysts Journal featured an article in which some professors constructed an algorithm using fuzzy logic to detect traditional technical patterns. The most frequent patterns in US equities was the rectangle. The single most profitable pattern was the rectangular low. Presently, the risk is that oil will fall back to the support at $87, a $5 drop. Because the projection is for a further rise of $15, the reward/risk ratio is 3 to 1.

Daily Oil



Weekly Oil



January is typically a weak month for oil, and the other cycles point down. But, as with gold, I lean toward the positive technical picture.

Gold

This remains a gold bull market and the UGL remains in the recommended portfolio. No strategy outperforms in a bull market like a buy-and-hold. The December report projected a low in the December 17-20 time period; the low was on the 16th.

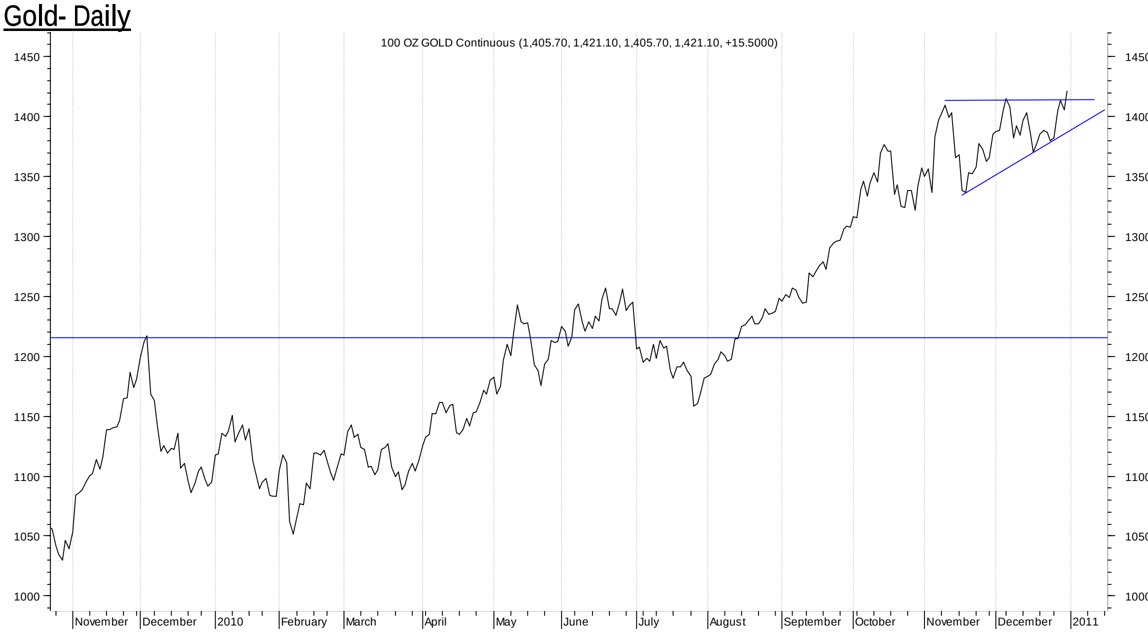
The bearish facts follow. A mentioned in prior reports, there have been more highs in gold in the month of December than in any other month. Until Friday, the high had been on December 7th. The intermediate gold cycle falls into the 3rd week of January, rallies somewhat, and then falls again into March before a sustained rally commences. Most gold corrections occur in the first quarter. The average high in any year lies around January 18th.

Despite that, a breakout above the 1415 level, depicted in graph 1 by the blue line, indicates higher prices over the near term. The Friday breakout above that level implies a rise of over $70. The fact that it has occurred despite the unfavorable seasonal is especially positive. Likely short-term turning points are on the 9th and 20th.

There is confirmation from other markets. Copper, oil, and the CRB index have all risen and appear poised to move higher.

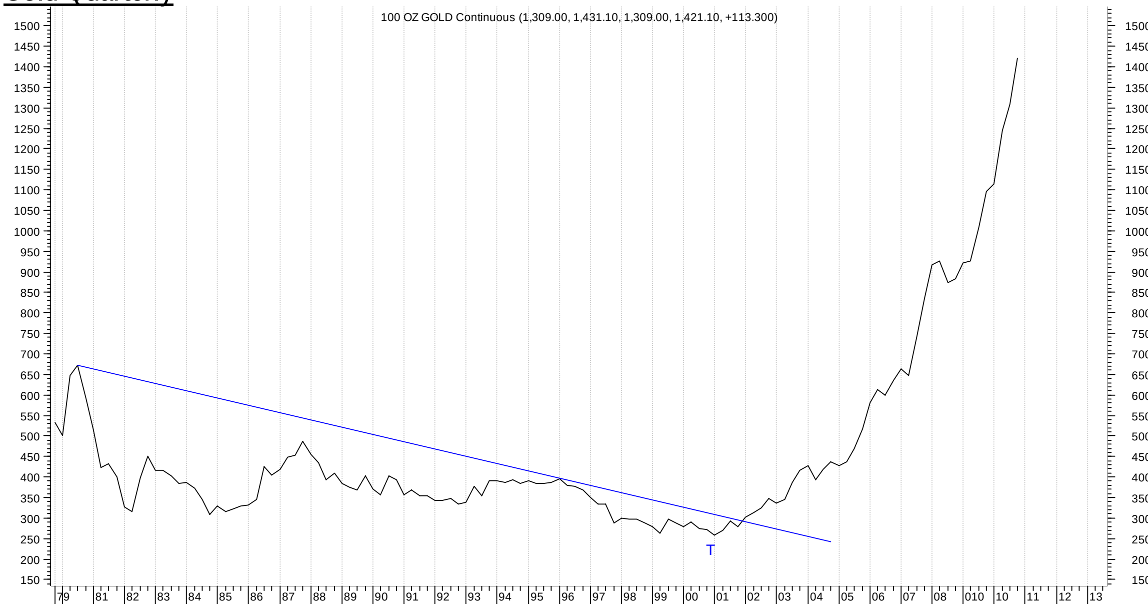
The fundamentals remain positive longer-term. The authorities refuse to see the situation clearly and continue to employ incorrect solutions. The International Monetary Fund concluded the sale of 403 tons of gold under a program approved in September 2009 to help boost its lending resources. The sales amounted to one-eighth of the IMF's total gold reserves.
http://af.reuters.com/article/metalsNews/idAFN2127057720101221

Gold- Daily



In order to estimate the beginning or the end of a move, I multiply .618 (which was W.D. Gann's area code) by the length of the prior market. The S&P food group was in a rectangle for 25 years. The index broke out around 1980, and then outperformed for about 14-15 years. Below, we see the gold bear market of 1980-2000, a period of 20 years. Multiply this number by .618 and add to 2000, and the result is early 2013. I come close to this number when I utilize spectral analysis to project the strongest monthly gold cycles. Thus, we have years left in the golden bear according to technical and cyclical analysis.

Gold-Quarterly



Despite the downturn in the intermediate gold cycle, the metal has moved up. This raises the question as to the effectiveness of the cycle. The gold cycle has generated 133 buy and sell signals since 1979. The result has been that the cycle has outperformed a buy-and-hold strategy by 21.7 times. In 2010, there were 4 gains and 1 loss. This has resulted in a 29% gain (for both shorts and longs) for the year. The last signal was a sale on November 11th. The cycle falls into March.

Why might the cycle be less effective? I think that it is due to the unprecedented rise in the monetary base, which has doubled. As we have seen, the ‘solution’ to the crisis has been to simply issue more credit. If this continues as I think that it will, gold has much higher to move between now and 2012-2013.

Why are people not borrowing/spending the excess liquidity? There is a study that pinpoints the answer. In Dr. Cesare Marchetti’s 1991 paper ‘On Savings Banks,’ he models the growth of savings banks in Italy over 200 years. His inquiry inevitably led to consideration of the business cycle. Marchetti points out that most of the analysis is directed to the down side of the cycle. He refers back to an analysis in 1885 by Karl Kautsky. He raised the question as to why people were reluctant to spend money as a recession ends. Writes Marchetti, *“The idea of Kautsky that we should look into the heads of people, and not into their wallets, seems worth a second look.”* He goes on, *“The idea that that the success of an enterprise or the profits of a bank or the GNP…are strictly linked to the uncontrollable tides of the moods of the system, will certainly shock the manager. But the knowledge of the tides is of great help to the quality and safety of navigation.”* He concluded that the difference between the center points of these waves in the business cycle is almost exactly 55 years. Lows typically occur about 8 years after the maximum in the cycle. He did point to the year 2000 as the next maximum in the cycle. In addition, he noted a rhythm that has also been recognized by the Foundation for the Study of Cycles, the cycle of innovation. The centers of innovation waves are usually near the minimum of the Kondratieff Cycle and precede the K-wave low by about 3 years.

Individual Stocks

PORTFOLIO

Stock	Buy Price	Buy Date	Current Price	% Allocation
Pro Shares Ultra Gold ETF-UGL	30.59	April 9, 2009	70.72	60
ProShares Ultra-SSO	45.06	Nov. 4, 2010	48.05	20
IBM	143.6	Nov. 1, 2010	146.76	20

Strategy

Investors remain fully invested.
Take profits on any short-term trades.
Traders go short later in the week.

What the Media is Not Telling Us

- The state of Texas is attempting to pass a law banning Obamacare. Representative Leo Berman has pre-filed a bill for 2011 that will render the carrying out of any part of the act as a felony in the Lone Star State.
- Al Qaeda has let it be known that it is fed up with the increasingly numerous and effective American UAV missile attacks in the tribal territories. The terrorists have told the government that either their support is withdrawn for these CIA-run operations (which fly from Pakistani air bases), or terror attacks against senior government officials will be made. Threats, and attacks, like this, have been made before, but without much success, at least against the targeted officials. There have been lots of dead civilians, police and soldiers. The media seizes on these threats to generate even more popular hostility towards al Qaeda. It appears that the Islamic terrorists are getting desperate, as their leadership has been under constant attack from the air for two years. From Strategypage.com.
- The proposal put forth by the democrats was not a new ‘tax deal’, but essentially was a new budget that had been put together by the outgoing House (which has a 13% approval rating) that would have essentially controlled the spending of the incoming government for another year. It reportedly included $1B for Obamacare. That was an attempted end run around the Republican plan to de-fund the new health law. Recall that I had written that the outgoing Democrats would ram through destructive legislation led by Harry Reid. Here it is. This was the Kamikaze Congress and the Suicide Senate.
- How to tell two lies within seven words: The San Francisco Chronicle headline read “House Passes Obama’s Huge Tax Cut Bill.” First, it is simply a 2-year extension of the Bush tax cuts; it is not a new tax cut by the current President. Second, the Republicans permitted the re-institution of the inheritance tax to go through. That results in a net *increase* in taxation.
- This is great reading if you want to understand the current President: ‘How Obama Thinks’ by Dinesh D-Souza on Forbes.com on September 27, 2010.
- The Congressional Prayer Caucus sent a letter to the President correcting a statement that he made in a speech in Indonesia. He stated that the national motto is ‘E Pluribus Unum’. The national motto is actually ‘In God We Trust.’

Don't Worry-Be Happy

If you are in the NYC-NJ area, be sure to visit Northlandz. This is the world's largest model railroad, as listed in the Guinness World Book of Records. It is a 1.2-mile walk, has 8 miles of track, has 500 bridges-the longest of which is 40 feet long, has 4200 buildings, and has a half million trees. One of the mountains is 30 feet high. This is a one-of-a-kind day outing for the whole family. It was built by an old friend of mine from New Jersey, Bruce Williams. I recall his humble beginning with his home model railroad when I met him in 1966. It is about a 45-minute drive from Newark Airport. http://www.northlandz.com/

Quote of the Month

"I cannot undertake to lay my finger on that article of the Constitution which granted a right to Congress of expending, on objects of benevolence, the money of their constituents."
-- James Madison, 1794

Book Review

Lies the Government Told You: Myth, Power, and Deception in American History,
by Judge Andrew P. Napolitano. Former New Jersey state judge and Fox Television host Andrew P. Napolitano begins his book with the unfortunate truism that *"the government lies to us regularly, consistently, systematically, and daily on matters great and small, but it prosecutes and jails those who lie to it."* Napolitano then proceeds to chronicle the various "lies" of governments, the many instances where government officials promised freedoms to the people but throughout history have failed to live up to those promises. As Napolitano joked to friends while writing the book, such a topic could easily have made it a 4,000-page book instead of a 349-page book. But Napolitano keeps to major promises that government has broken. Each chapter in the book is another topic where somewhere in history government has broken its promise to protect a freedom.

CFRS Portfolio

The CFRS model portfolio rose 18.2% in Q3 versus a rise of 10.2% for the S&P. This is a computerized model portfolio and is not actual trading results. Looking at the returns on an annualized basis from January 1, 1996 through December 31, 2010:

S&P Annual Return: 4.2%
Portfolio Annual Return: 20.6%

Disclaimer: The methods utilized have proven profitable in the past but no guarantee can be made of future performance nor is any liability accepted.
See the website at cyclesresearch.com.

The report is sent on or prior to the open of the first trading day of the new month, unless otherwise stated. If you do contact us by e-mail, kindly give your full name. We cannot query the database by e-mail address. Thank you.

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