TIME THE MARKETS

Using Technical Analysis to Interpret Economic Data

Charles D. Kirkpatrick II, CMT

Foreword by Tom McClellan

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*On a project such as this book, two requirements are necessary: contemplative seclusion and the basics of life: sleep, food,
and something to pat. My dear wife, Ellie, and our furry animals kept me secure, satisfied,
and hidden. For that, I am intensely grateful.
Ellie deflected potential disturbances, not to mention providing timely sustenance; our goofy golden retriever, Posie, kept my feet warm during the cold Maine winter nights; and Frisbee,
our long-haired, reject cat from the Colorado humane society, slept on my papers and accepted my occasional strokes of her fur.
To them I dedicate this book.*

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Acknowledgments

In projects like this book, the Internet and one's computer become your best friends. They provide information, complete complicated calculations, and remain alive 24 hours of the day. I am a night owl and prefer the quiet and calm of late nights and early mornings. I have a relatively small office at home that looks over the ocean during the day but could be anywhere at night. To me, this is the perfect work environment.

Working late at night means that email becomes the primary method of communication. Through such give and take over the wires, many people familiar with the work I was doing assisted me. They helped considerably in the book's organization and application. Special thanks I owe to Tom McClellan (www.mcoscillator.com) and Jason Goepfert (www.sentimenttrader.com) for their willingness to provide their historical data. Tom also reviewed the manuscript for me and made numerous helpful suggestions and changes to my fractured prose. Also helpful were Investors Intelligence (www.investorsintelligence.com), the *Economist* magazine (www.economist.com), and the Commodities Research Bureau (www.crbtrader.com). While I didn't use all their data, they were very willing to assist and were especially generous with their knowledge of economic statistics.

The primary methodology used in the book is called "walk-forward optimization." This technique is relatively new to the securities business, and technical analysis specifically, and is not widely known or understood. I, too, was a novice when I began and am especially grateful for help with it from Rob Hanna (quantifiableedges.blogspot.com), Bob Fulks of Pleasant Bay Capital Management, Wouter Oosthuizen of the Grail optimization system (soon to be an integral part of TradeStation analysis software), and Berkhard Eichberger of the Diamond Back Testing with Walk Forward Manager system from Professional Software Solutions.

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Finally, as the dedication explains, I could not have finished this project without the help and encouragement from my dear wife, Ellie, and our furry household creatures.

Charlie Kirkpatrick
Kittery, Maine
May 24, 2011

About the Author

Charles D. Kirkpatrick II, CMT, is president of Kirkpatrick & Company, Inc., a technical analysis research firm that publishes the *Market Strategist* investment newsletter. During his professional career, he was an institutional salesman, technical analyst, portfolio manager, hedge fund general partner, securities trading firm owner, option trader, floor trader, lecturer at universities, expert witness at security trials, small business owner, charitable foundation organizer and officer, and combat-decorated officer in Vietnam.

A past instructor in finance at the School of Business Administration, Fort Lewis College, Durango, Colorado, and currently Adjunct Professor of Finance at Brandeis University's International Business School, he is the only two-time winner of the Market Technicians Association's prestigious Charles H. Dow Award for research in technical analysis and winner of the Market Technicians Association 2008 Annual Award for "outstanding contributions to the field of technical analysis."

He is a Chartered Market Technician (CMT), a past member of the board of directors of the Market Technicians Association, and past editor of the *Journal of Technical Analysis*. He is currently on the board of the Market Technicians Association Educational

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In addition to more than ten published articles on aspects of the stock and bond markets, he co-authored *Technical Analysis: The Complete Resource for Financial Market Technicians*, the primary textbook for the CMT program and for university graduate courses in technical analysis, and he authored *Beat the Market*, a book on relative strength stock selection. A graduate of Phillips Exeter Academy, Harvard College (AB), and the Wharton School of the University of Pennsylvania (MBA), he lives in Maine with his wife of almost 50 years.

Foreword

> *"Every investor is a market timer. Some people buy when they have money, and sell when they need money. Others use methods that are more sophisticated."*
>
> —Marian McClellan, 1934–2003

My mother Marian taught me that lesson many years ago, when I was first getting started as a stock market analyst. She had seen and heard a lot of good and bad market "wisdom" over the years since she and my father Sherman McClellan first created the McClellan Oscillator and Summation Index back in 1969. Since that time, hundreds of thousands of people have become aware of the tools that they originated, and a smaller number than that have learned to use them successfully to help in their market timing.

The term "market timing" has taken on a negative connotation over the years, and that is unfortunate. The "buy-and-hold" community has sought to convince all of us that the key to investing success was to stay fully invested for the long run so that you don't miss the big up days that account for a lot of the gains. And you can certainly find periods in history when that was a good idea. But they conceal from you the fact that the biggest down days are larger than the biggest up days, and that the big down days tend to arrive in groups. The key to real investing success is to make as much as possible when the market is going up and to lose as little as possible when it is going down.

Sustained bull markets like the 1980s and 1990s are great when they appear. But there are more periods in history when being a “sheep” investor who just stays with the flock has led to destruction of wealth. We are in such a period now. Baby Boomers are starting to retire and are no longer participating as much in the entrepreneurial economy like they did in the 1980s and 1990s when Boomers were in their peak entrepreneurial years. Now, Boomers are seeking to hold onto what they have rather than maximize their investing and entrepreneurial potential.

Boomers are hoping to sell their stock portfolios and their McMansions to someone else, and in a few years the “echo-boomers” will be in a position to acquire those assets. But the “echo boom” peaked in 1990, and those kids are still in college now. The echo boomers are neither ready nor able to buy your McMansion, let alone your bond portfolio.

We went through a similar period in the 1970s. The United States had just come through more than 20 years of strong economic growth. But the people who were in their peak entrepreneurial years during the 1970s had been born in the 1930s and early 1940s—a time when the country and indeed the whole world was going through the Great Depression. Birth rates dropped in the 1930s because couples were afraid of having one more mouth to feed. So the kids who did not get born in the 1930s also did not go on to become workers and entrepreneurs in the 1970s, which meant that both the stock market and the economy suffered as a result.

That did not stop the U.S. government from trying to do things to "fix" the economy in the late 1960s and 1970s. President Nixon tried wage and price controls, which were a colossal failure. The Federal Reserve kept interest rates lower than the inflation rate in hopes of stimulating growth, and sometimes that was successful. But it also led to huge inflation and wealth destruction. The ebb and flow of liquidity in the system at different times created big waves up and down in the stock market. It was a great time for market timers and a lousy time for investors, just like the 1930s had been four decades earlier. And just like the 1890s had been, four decades before that.

Now we are four decades forward from the 1970s, and once again we have the Federal Reserve and the federal government trying imaginative ways to fix the economy. So just like in previous periods, we are going to see huge ebbs and flows of investing success and destruction of wealth. The game that worked in the 1980s and 1990s has changed; so if you are going to play this new game, you will have to change your style of play.

Timing Is Key

Once you make up your mind what to buy, the only condition that is under your control is when you will pull the trigger. You don't get to set the price; you have to take whatever the market is offering. You can try to buy a stock at a different price than what everyone else thinks is the right price at that moment, but good luck convincing anyone to sell it to you at less than what the market sets.

And once you own an investment, the only question is whether you are going to hold onto it or sell it. If you are selling it, the essential question is "when?" You might say that you want to sell when it reaches a certain price, or when it reaches some multiple of earnings, but that is not meaningful information to the market. The market wants you to say, "Sell now," or "Don't sell now." Those are the only messages that the market understands.

The people who say that they do not time the market fail to understand this essential reality. Everyone times the market, whether he accepts that notion or not. The timing of your investment decisions will have a huge effect on your success, or lack thereof. So to say to yourself (or anyone else) that you are not a market timer is to say that you willingly abandon the one factor that is in your control, and which is key to your own success.

It is far better for investors to seek to maximize their success through mastering the factors within their control, while also minimizing the effects of factors that are beyond their control. To do otherwise is to be dishonest to oneself, or to accept whatever the universe decides to do to you.

I have known Charlie Kirkpatrick for several years, and what I admire most about him is his willingness to share useful information with others. Charlie loves to teach and to elevate the collective wisdom of the community by sharing the great insights he has uncovered over the years. Those of us who have been smart enough to open our ears when Charlie is talking have benefited greatly.

In *Time the Markets*, Charlie leads us through proven ways to time our investment decisions using data and facts that most of us can understand. You won't have to learn to interpret tea leaves or pig entrails, to map star and planet positions, or program mathematically complex formulas into a "black box." Just take the important data that are freely available from government and other sources and learn how to read and understand what the changes in those data mean for the future of stock price movements.

Our country and our economy need the services of investors who can appropriately add liquidity at the right time and take it away from the market at the right time as well. To those who can perform this great service, the market will give rewards in the form of a larger amount of money so that they can do those services again in the future. But people who buy at tops and sell at bottoms are a hindrance to an efficient market, and the market will punish them by diminishing their ability to engage in such harmful behavior in the future.

You can choose to be in the "useful and thereby enriched" group and be a help to the market. For instructions in how to do that, read on and enjoy. Or you can be a sheep. Sheep should close the book now.

Tom McClellan
Editor, *The McClellan Market Report*
www.mcoscillator.com

1

Introduction

This is a book about market timing. It applies using technical analysis on fundamental, economic, monetary, sentiment, and price data to determine the optimal times for buying and selling the stock market over the normal business cycle. Most professional analysts are bound to one of two disciplines: fundamental or technical. Fundamental is the study of economic, corporate, and monetary factors, and technical is the study of prices, especially market prices. There seems to be little common ground, and this is too bad because both have their merits. I think one of the reasons is that fundamental analysts do not understand technical methods, and vice versa; technicians distrust fundamental data as being too late. This book will change that attitude. I look at historical economic and financial data and apply some methods common to technical analysis of prices. These methods directly correlate economic information to the stock market, generate signals based on that information, and combine successful results into a market timing model based on fundamental information.

I write this book to aid those of you who need guidance in timing the stock market specifically and who are nervous about looking at markets strictly from a technical point of view without some understanding of the relationship between fundamental information and the markets. It comes from my personal experience of over 40 years in the stock market. At various times in my life, I have traded blocks on an institutional block desk, traded options as a member of the CBOE, traded stocks in a hedge fund, and provided technical research, some of which was original, to major investing institutions. I have seen almost every method, technique, indicator, theory, and scheme you could imagine. I have also seen where the markets are made more complicated than they really are for the purpose of making a mystery out of products sold to the public. Markets are not complicated, and with proper discipline they can be analyzed and profited from with the right tools and common sense.

In this book you will look at investment timing rather than trading timing. This means you will look at the markets from the primary perspective of the U.S. business cycle. The economic and fundamental information you will see is not short-term. As an investment horizon approaches shorter periods, the analysis methods become more technical and oriented solely toward price-behavior because economic information is not timely and often is reported only monthly or quarterly. To profit in the short term, swing traders must rely on changing price behavior in line with sporadic news announcements, and day traders eventually reach the intraday extreme when almost all decisions arrive from price behavior alone. Trading is the subject for another book. For present purposes we focus on timing the period of roughly four years, the average of the business cycle, and look at what types of reliable evidence you need to determine where within that business cycle the stock market may be. Forecasting markets is almost impossible in itself. This has been demonstrated repeatedly in studies of investment "gurus" and economists. I have also found that maxim to be true through painful and expensive experiences of my own, and I challenge anyone to disagree. However, you need not forecast markets to profit from them. If you can determine the direction and risk of direction reversal, you have the material necessary to capture profits and reduce the risk of capital loss.

I have also found that many analysts watch far too many indicators. There is no need for this. You do not improve your results by watching a laundry list of data. There are five areas of importance in determining stock market direction: corporate data (earnings yield, dividend yield, price-to-sales, etc.); economic data (leading economic indicators); monetary data (interest rates, money supply, Fed policy); sentiment (are investors optimistic or pessimistic?); and technical factors such as breadth, volume, cycles, and trend. Only a few examples in each category are necessary. Any more becomes redundant, time-consuming, and only marginally helpful. This book focuses on those few indicators that I have found can be systematized and for which data is publicly available.

The first section of the book is devoted to why market timing is necessary to reduce risk, evidence for and against the ability to time the markets, and, briefly, other methods that neutralize the risk of market declines. It is the major declines that you need to avoid. In the past ten years, market declines have reduced wealth by trillions of dollars, and as I write this book in late 2010, the stock market averages are still below their highs of eight years earlier.

The second section introduces you to some technical analysis methods and concepts that can be helpful in analyzing the data you will gather from different sources, both from markets and from the economy. These methods do not include the traditional chart-pattern culture of technical analysis. They are more concerned with establishing where trends and oscillations along trends are beginning or ending. They involve the confluence of moving averages in economic data and the use of protective and trailing price stops in the market. The calculations involved in these techniques are relatively simple, easy to understand, and even more easily applied. My purpose is to keep this analysis as effortless and accurate as possible.

The third section of the book devises systems based on economic indicators that reliably signal when the stock market is likely to change direction. These systems give actual signals. Otherwise, they would be of little value. Having been tested with real data, they are as reliable as I can make them. In this respect, the results differ from most economic models that presuppose relationships between data and market performance without testing the significance, reliability, or even existence of such relationships.

Each of these systems is tested, using special computer software that conducts a series of statistical tests called "walk-forward optimization." Many indicators are rejected for failing to satisfy stringent requirements of reliability and predictability. The survivors are then ranked, and in the final chapter, I construct a market timing model that uses the best systems from each of the economic and technical indicator sections.

In markets, there is no specific date or time when an actual price top or bottom occurred. Tops and bottoms are progressions that in retrospect may be obvious, but at the time of their occurrence, with all the coexisting emotional swings and conflicting evidence, provide no ringing bell or buzzer to tell you that a major change in direction has occurred. Likewise, there are no mystical, foolproof indicators that give perfect signals. You will see some very good indicators, but none of them 100 percent accurate. The ability to recognize a major market change in direction is an evolving thought process that depends on the evidence available but not a "thunderbolt" moment of inspiration.

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