



## **A Bear Market is Not a 'Trading Glitch'**

07 May 2010

**“SEC Said to Probe Causes, Exploitation of Stock-Market Turmoil “**  
- Bloomberg headline

### **First, Some History**

There were so many antics surrounding the response to the 6th May selling climax that I hardly know where to begin. So let us start with some history and then work our way forward in time. From 1932 until 2000 the US equity markets experienced the most powerful and sustained bull market in human history. Everyone became accustomed to alternating rallies and bull market corrections. And until 2007 no one ever had to face a true deflation driven bear market. When the market has been nothing but bull trends for over sixty-five years, and there is no memory of longer term economic cycles, you can be facing a a very large bear head on and not even recognize it. The dump of the dot-com market from 2000 to 2002 was called the bursting of a speculative bubble. And even the broad based stock market collapse of 2007 to 2009 was called the bursting of a bubble. In other words we do not get bear markets any more. We only get way over-due corrections.

From 2005 the largest credit bubble in the history of the world began to deflate. The first phase of the deflating cave-in was felt in real estate. Then the stock market succumbed and dumped. Then the commodity markets shattered. The most recent phase in the on-going collapse of the largest credit bubble in history is the onset of a wave of sovereign debt defaults. And for anyone who thinks that sovereign debt defaults are not an integral part of this phase of the economic cycle, we refer you to [This Time is Different](#), the landmark book by Reinhart and Rogoff. These toppling dominoes from 2005 have arguably been the first events in over seventy-five years that threaten the illusion of a perpetual bull market in everything.

From the CNBC March 2009 announcement of 'the death of buy and hold' the equity markets had begun to claw back some of their significant losses. Unfortunately for the cheerleaders, the decline from 2007 to 2009 found a striking parallel in the decline of 1929. And the rebound from March 2009 found an equally striking parallel in the bear market correction up from 1929 to 1930. We had detailed these parallels in a February special report. And we had just recently noted that, adjusted for the differing time scales, late April to early May of this year would mark the start of a collapse whose only precedent was the debacle from 1930 into 1932. And then yesterday's crash occurred. As would be expected, the cheerleaders that pass themselves off as market analysts immediately shifted into 'denial' mode. The perpetual bulls are trying their best to blame yesterdays dump on an electronic trading glitch. The purpose of this report is to emphasize that a bear market is not a trading glitch.

A deflationary economic implosion is an integral part of the economic cycle. Its onset can be delayed through deficit spending and artificially low interest rates, but increasing debt to astronomical levels cannot solve the problem of a collapsed credit bubble. And delaying the onset of the contraction phase of the economic cycle by building a bigger bubble can only serve to make the bear bigger and meaner when it finally breaks out.



### **An Extraordinary Popular Delusion**

From March of 2009 into April of 2010 the chorus of ‘perpetual bull’ cheerleaders had grown larger and louder and more confident. And then just in time for the seasonal peak ( ‘sell by May then go away’ ) the chorus reached deafening proportions. All were entirely convinced that the trend had turned back up, that the worst was behind us, that we had dodged a bullet. However as we had been emphasizing all along, the structure of the drop from 2007 to 2009 was clearly the pattern of the initial leg down in a larger decline. It simply could not be modelled as a completed bull market correction. And as we have emphasized many times, the rebound from 2009 had ‘bear market correction’ written all over it. In fact, the rallies in equities and commodities from the lows of March 2009 were an epidemic of bearish rising wedge patterns. And in the broad based US equity indices the peak appears to have hit right into a textbook perfect .618 retracement of the decline from 2007.

If something looks like a duck, swims like a duck, and quacks like a duck, then it is wise to treat it like a duck. If a rally is shaped like a bear market correction, moves like a bear market correction, and peaks out like a bear market correction, then it is utter folly to treat it as a bull market that is temporarily suffering from a ‘trading glitch.’ And speaking of folly, we have a quotation from yesterday. It is from a member of one the greatest storehouses of foolishness, the US Congress. It is a quote from US representative Paul Kanjorski.

“This is unacceptable,” Kanjorski, who leads a House Financial Services subcommittee that oversees the SEC, said in a statement. “We cannot allow a technological error to spook the markets and cause panic.”

It is delusional to try to reduce a continuing, global, economic implosion to a ‘technological error.’ This quotation reveals a complete ignorance of economic matters and the dynamics of markets. And this ludicrous assessment of the peak of a bear market correction comes from a leader of the “House Financial Services subcommittee.” What is much more likely to cause panic is the revelation that those in government who are in charge of financial oversight are morons.

A large part of the blame for the media obsession around the ‘electronic glitch’ excuse must be placed at the door of a certain cable financial channel that has become the ‘home of all cheerleaders.’ It is one thing to figure out that the more bullish one’s talking heads are, the higher one’s ratings go, and the higher one’s ratings are, the richer the advertising revenue. It is another thing to fall into the trap of believing ones own propaganda. If the market had rallied a thousand points no one would be talking about a glitch. But the market fell a thousand points. And for a fanatical cheerleader that can only mean that there was a glitch somewhere. The only task is to find that glitch. In the cheerleader’s world view a market cannot possibly fall a thousand points all by itself. That does not compute. There must have been an error, a mistake of some kind. It could not have possibly been for real. And that brings us to our next point.



### What Bear Markets Do

A direct path to certain financial disaster is to explain away any price action that does not fit one's world view. Dismissing price action that does not fit one's forecast is suicidal, and yet it is done all the time - especially during bear markets. As technicians we regard all price action as relevant and significant. None of it can be dismissed. And what occurred on Thursday 6th May 2010 is natural to bear markets. It is what bear markets do.

At its core essence a bull market is a place with more buyers than sellers. And in especially enthusiastic phases of a bull market there will be the occasional 'seller strike.' From time to time there will be pockets with no sellers. It is during these 'seller strikes' that markets gap higher. In contrast, a bear market is a place with more sellers than buyers. And in an especially powerful bear market there are the occasional 'buyer strikes.' From time to time there will be pockets with no buyers. It is during these 'buyer strikes' that markets gap lower. To blame Thursday's price action on a technology problem is to remain blinded to the risks ahead.

### Gap Theory and the Selling Climax

Based on gap theory, and in the context of a down trend, there are three areas for a gap down, or selling climax.

1. The first location is at the very on-set of a down trend. The environment of this selling climax is a market super-saturated with an extreme of bullish optimism, but a market where the up trend has stalled and prices have actually started to decline. In Elliott wave terms this place is often the onset of a third wave extension.
2. The second location is the midpoint of the decline. In Elliott wave terms this is usually 'the third of the third', the heart of the third wave extension.
3. The third location is called an exhaustion gap and occurs very near the final low of an extended decline.

It does not take a Sherlock Holmes to place the price action of 6th May into one of these three categories. It cannot possibly be location number two or number three.

A fundamental analyst with a bullish bias will undoubtedly look at the price action of 6th May in isolation. This will facilitate the conclusion that Thursday's price action was an aberration and is nothing to be concerned about. However as technicians with no bias, no positions, and no world view to maintain, we see Thursday's price action as a cause for alarm. The most bearish case had required a sharp dump from late April - early May to keep the parallels with the Great Depression intact. The seasonal history was warning of the risk of a sharp drop from the period late April to early May. And there was a broad range of technical indicators warning of the imminent risk of major peaking action. In the context of the technicals this sudden weakness was no surprise.

When everything points to the imminent arrival of a duck, and a duck suddenly appears, it is no cause for surprise. It rather suggests that the forecasting tools used to predict the duck should continue to be employed. And it also suggests that one should now explore what other things usually accompany the onset of a duck.



### Corrections Correct Mistakes

Our final point here is an issue that makes the governments search for a trading glitch an even more ridiculous exercise than it may first appear. The purpose of a bear market is to correct the mistakes and excesses of the preceding bull market. The longer the bull market has persisted, the more systemic, deeply rooted, and pervasive will be the excesses and the mistakes. Let us review some of the more significant excesses that the current bear market has uncovered so far, and listed in the approximate order of their discovery.

- Allowing unemployed individuals with no savings to buy big homes with jumbo loans and no money down.
- Permitting insurance companies to take on infinite risk by offering cheap insurance against falling real estate prices during the final phase of a historic housing bubble.
- Keeping interest rates at historic lows for an extended period of time in order to nourish and grow an economy built on speculative bubbles.
- Allowing hedge funds and bank trading desks to speculate with extreme debt to equity leverage, thereby dramatically increasing the fragility of the financial system.
- Allowing bankrupt, third world countries to join the Euro-zone, thereby enabling them to borrow at the same interest rate as an economic powerhouse like Germany.

This last bullet point brings us to our last point of discussion. Germany was firmly against Greece joining the Euro-zone. They were convinced Greece was not ready, but Germany were pressured into letting in Greece. It is clear by now that the Germans were correct. No wonder the Germans are angry about being asked to pay the lion's share of a Greece bailout. Letting Greece join the Euro-zone was a mistake. It was an excess of the collective mood of good-will, optimism, and inclusion that drives a bull market. And a bear market will correct the excesses and mistakes of the preceding bull market. To saddle Greece with even more debt in an effort to bail out the banks that loaned Greece money, well that is clearly not in Greece's best interests. A proactive, planned and partial default for debt relief seems preferable to having to react to a complete default later on. In either case the price action of 6th May clearly indicates that a sovereign debt default has not yet been priced into the markets.

The SEC's search for a trading glitch in this context seems to me a gross mis-use of time and energy. It is as if the Captain of the Titanic, after hitting the iceberg, went running down into the ship to look for popped rivets. The Titanic did not sink because of a glitch with some rivets.

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