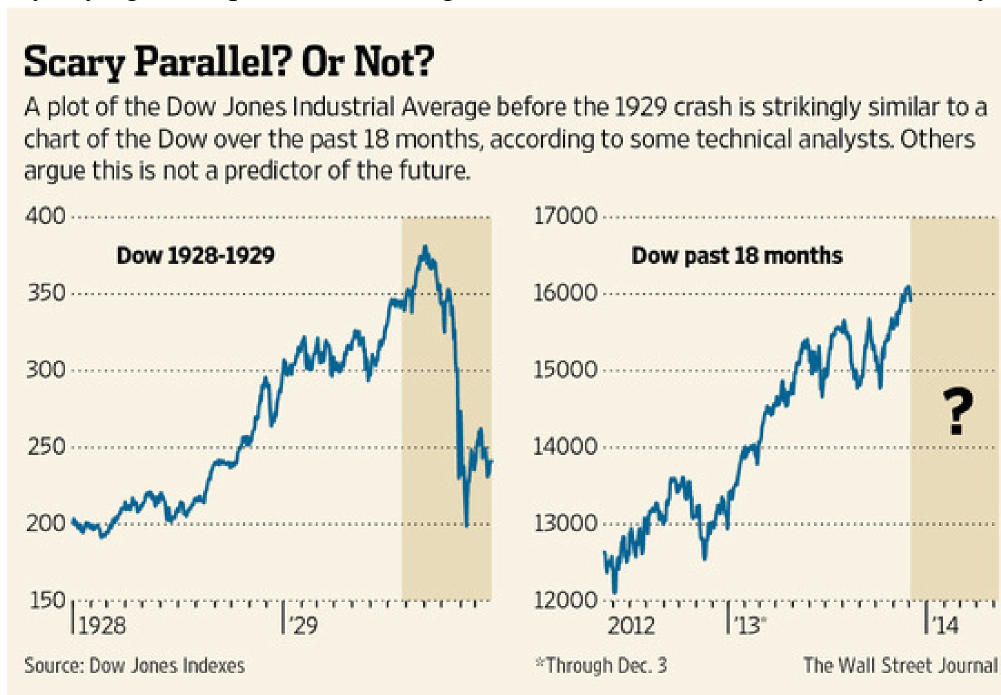
Stock Market Perspective: Replay of 1929?

To some extent, I am continuing the theme of the Perspective in the last issue. Then I looked at a *Wall Street Journal* story about an indicator that implied that stocks were about to fall because they had become overpriced. My conclusion was that the indicator was useless for serious investment decisions. I suspect that with stocks showing strong gains since March 2009 some pundits want to promote themselves by saying stock prices are too high and will be falling sharply in the not too distant future. Sooner or later (I have no idea which), one of those "predictions" will prove to be correct and its promoter will claim to be prescient.



In his December 7 *Wall Street Journal* column, Mark Hulbert reports on a scary chart sent to him by a bearish hedge-fund manager. The chart, which is shown above courtesy of that newspaper, has been circulating among various trading desks and supposedly some are taking it more or less seriously. To his credit, Hulbert does not give it much credence, and my objections to it are stronger than his.

The past 18 months of the Dow "look" very much like the 18 months in 1928-29 just before the final blow-off to the peak before the crash. From that we are supposed to worry that the same is going to happen now. One newsletter writer put the date of the top as January 14, just about the time you will get this.

How do I not love this? To paraphrase the poet, let me count the ways.

1) The vertical scales on the two graphs are misleading. They should be logarithmic so that equal vertical distances correspond to equal percent changes rather than linear. Another way of seeing this is to compare the ratios of the high and low values. In 1928-29 the rise shown is from about 200 to 350 at the left edge of the shaded area, a gain of 75%. In the right graph the gain is on the order of 33%, from a little above 12,000 to about 16,000 at the left edge of the shaded area. So the not so scary climb has been not even half as much as it was before the 1929 crash.

2) The two lines are far from "isomorphic" to use a mathematical term, which in this case would mean that one could be stretched in a uniform way to match the other. That is too much to expect, but these two are not all that close. Sometimes the two lines are shown in the same graph so one can see how strong the resemblance is.

3) What are the conditions that need to be satisfied to consider the two lines sufficiently similar to lead to a meaningful comparison? Although such would have been beyond the scope of the Hulbert article, I doubt that any have been developed or defined. Serious analysis can't be based on "I can't define it, but I'll know it when I see it."

4) Even if there is a definition of similarity for the graph lines, how often have they occurred and what has been the range of results after the occurrences? With the possible exception of 1967, there are not going to be plunges as spectacular as the one in 1929. However, what percentage of the time following the set-up did the market fall by x% within y days, where the values of x and y can be determined by the analysis? What was the average change of the following n months? And so on with a variety of measures designed to determine if there is a potentially useable indicator or trading model.

Can a "scary" comparison chart provide a meaningful warning that stock prices are about the plunge? I don't think so.

I think Hulbert would have provided a reference to a study based on 3) and 4) had he been aware of one.

If "scary" charts like this one were unusual, then what I have written here might be overkill and a shorter gibberish piece would have been more appropriate. I see charts comparing current price movements with past ones several times a year. Typically, they are either saying something very bad is in the offing as the one above does, or they say a breakout to the upside is imminent. I don't recall every seeing an accompanying study along the lines of what is described above.

A similar type of "analysis" will point to a particular pattern in the middle of a price chart and what happened after it occurred. The implication is that the pattern reliably foretells what the price is likely to do once the pattern has been completed. A large number of "technical analysis" books have been devoted to analysis of chart patterns as trading indicators.

My point of view is that unless something like steps 3) and 4) have been taken, I will get no value from seeing the patterns. It is not unusual to see a similar pattern elsewhere in the chart that was not followed by the anticipated significant move. When I point that out to speakers, they will say that what I see is different from the desired pattern for some reason or another. I don't doubt that they really think that way and that they can make effective use of the patterns. It is not the way I approach technical analysis because there is no way to determine the historical probabilities and expected values from applying the method.