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Bear-Market Genius

Bob Prechter called the market top in 1987 -- and has continued to ever since

By JONATHAN R. LAING

There are few second acts for stock-market forecasters who blow major market moves. Who today talks about, let alone remembers, technician Elaine Garzarelli who purportedly called the 1987 stock market crash and then flamed out once she began to run real money? And what fate awaits Goldman Sachs' Abby Joseph Cohen, the doyenne of the 'Nineties Bull Market who since has been blindsided along with almost everyone else by the past three years' fierce market slide?

And then there's stock market timer Robert Prechter. After more than a decade of relative anonymity, Prechter, 53 years old, is red hot once again.

He was literally everywhere in the media early last month when the Dow Jones Industrial Average and Standard & Poors 500-stock index slumped some 35% and 50%, respectively, from their all-time highs. His smiling visage even appeared on a front-page article on the bear market in USA Today. Favorable reviews of his latest book "Conquer The Crash: You Can Survive and Prosper in a Deflationary Depression" have recently appeared in outlets as varied as Business Week, the Reuters Financial Wire and the Motley Fool's Personal Finance and Investing Website.

For Prechter, it was a trip back through the time warp to the 1980s when he achieved guru stature by being among the few who saw the post-1982 bull market coming long in advance. He also succeeded in keeping his subscribers in the market for virtually the entire ride up to the August 1987 peak in the Dow of over 2700 and getting them out before the crash that October.

At that point, however, his career went awry. Prechter decided that the 'Eighties bull market had been a mania and that the 1987 Crash was just the opening act in a collapse that would send the stock market into a tailspin and the U.S. economy into a depression. And he has stuck to that forecast ever since, recommending the haven of treasury bills during a 13-year period -- 1987-1999 -- that saw the Dow and S&P rocket up some six-fold and the Nasdaq soar more than 10 times. While he claims -- and institutional clients confirm -- that he got a lot of other markets right during that period, including gold, collectibles, Japanese stocks and the dollar, it really doesn't matter. He'd missed the greatest show on earth.

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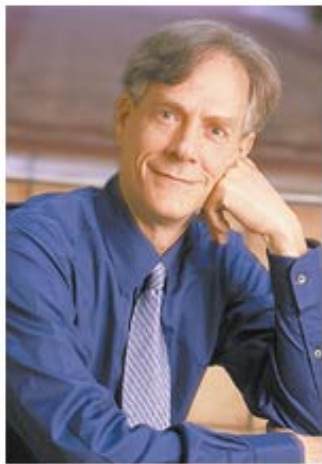
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Bob Mahoney

Robert Prechter

It cost him big-time. According to numbers compiled by the Hulbert Financial Digest, Prechter's timing strategy from the end of 1982 through August of this year would have yielded an average annual return of 10.4%, compared with an average annual return of 13.1% for the S&P. The bear market of the past three years has muted some of the indexes' outperformance of Prechter. Nonetheless, the discrepancy in performance is yawning -- 599% compared to 1,025% -- after taking into account nearly two decades of compounding.

Likewise, the circulation of his monthly newsletter *The Elliott Wave Theorist* and ancillary publications collapsed to 4,000 from a high of 20,000 in 1987.

The recent bear market, however, has helped push the number back over 7,000. His 70-person operation, headquartered on two floors of the former Dixie-Hunt Hotel in Gainesville, Ga., was only able to survive the slow times by attracting institutional clients to its short-term timing service in various stock indexes, currencies, interest rates, commodities, oil and the like.

It's easy to dismiss Prechter's forecasts on yet other grounds. His primary predictions over the past 14 years have been so outre as to put him in the extreme outlier of the super-bear camp. He thinks that the Dow, currently at 8400, will slide through 4000 by next spring on its way to an ultimate low in the range of 500 to 1000. Moreover, Prechter, who holds a psychology degree from Yale and who trained as a technician under the redoubtable Robert Farrell at Merrill Lynch, is convinced that the U.S. is headed for a shattering economic depression. U.S. industrial production and corporate profits will plummet, he predicts, and unemployment will rise to rates that will exceed the 25% jobless rate during the Great Depression.

He's somewhat tentative on the timing of this final *Gotterdammerung* (twilight of the Gods) for the stock market and economy. If the U.S. follows the contained, compacted pattern of 1929 through 1932, the final washout should come by 2004. Otherwise, it could take place later in the current decade of the new millennium, reminiscent of the U.S. stock market and economy's long day's journey into night between 1835 to 1842. Then again, Japan's 13 years of economic narcolepsy also argues for a longer-term denouement. Like any astute prophet, Prechter always leaves himself plenty of wiggle room.

Current conditions argue against his apocalyptic visions. For one thing, the economy would have to more than double dip -- it would have to fall off the cliff -- for his economic forecast to come to pass. Also the stock market is in the midst of a spirited rally of 15%-plus off the Oct. 9 lows.

But Prechter, whose calm manner stands in stark contrast to his apocalyptic message, insists that the latest rise is merely another bear market rally destined to flameout, as did the 29% jump in the Dow between September 2001 and March of 2002 and the 17.5% rise in the average from July to August of this year. Each was followed with a new low in the Dow, he points out. "This time around, I'm fighting a lot of seasonal and historic forces pushing the stock market higher," Prechter tells a visitor in his office, just off Gainesville's main square. Outside, a weekend festival is in full swing featuring bluegrass and country music, funnel cakes and

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boiled peanuts.

"October is typically a bear-killer month. We're at the bottom of the four-year and 20-year cycles, the decennial pattern bottomed this summer and we're going into the third year of the presidential election cycle next year which is traditionally good for stocks. Finally, we're on our way to our third year in a row of down markets which is almost unheard of. Yet despite all of this I feel good about remaining a bear. It's at least my belief that the wind is at my back."

Watching the waves

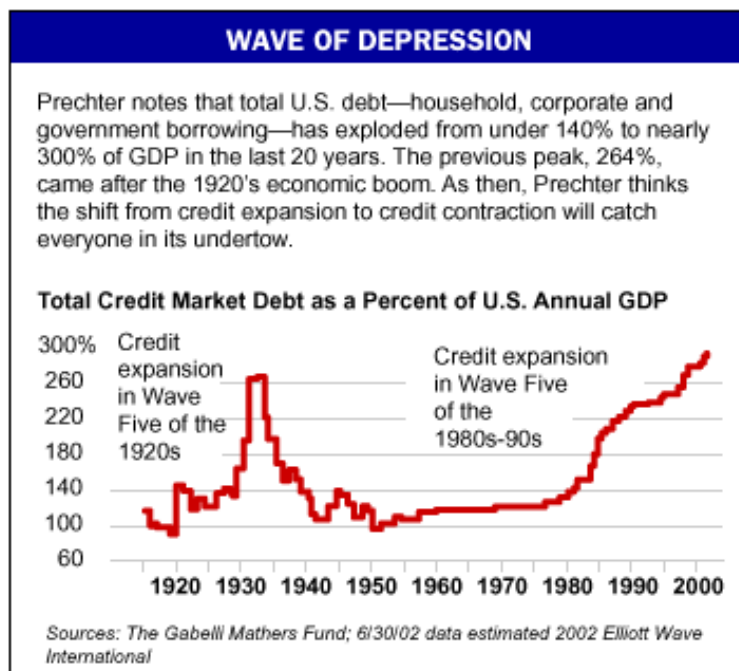
Prechter's grim predictions arise from a methodology called the Elliott Wave that many mainstream market commentators and economists regard at best as a meaningless projection of spurious patterns on random events and at worst as voodoo. The progenitor of the theory was an accountant and corporate reorganization expert by the name of Ralph N. Elliott, who spent his retirement years during the Depression and after studying the stock market. He died in relative obscurity in 1948, having produced just a couple of monographs and a smattering of stock-market letters. There was little interest in the stock market then with the Crash such a recent memory and real stock market returns so dreadful during the 'Forties.

Elliott Wave proponents claim that financial markets and, indeed, other economic, political, social and cultural trends are governed by recurrent and measurable waves alternating between optimism and pessimism -- confidence and fear. Man, after

all, is a social animal who from primordial times survived by following the herd, say, in flight from a saber-tooth tiger.

Elliott believed in inherent human progress, but that it never came in a straight line. Mass psychology instead dictated that financial markets and all human phenomena follow a similar five step wave-advancing pattern of up, down, up, down and up. Counter-trend corrections in turn limn out a three-wave pattern. So altogether there are five steps up and three down in a complete Elliott Wave.

Elliott claimed to discern such identical wave patterns in time spans from less than an hour to market periods as long as a century or more. The waves occur on 10 to 11 different time scales, each one fitting like a Russian nesting doll inside the wave



that's the "next degree" higher in size.

What has Prechter and his fellow Elliott adherents in such a white heat these days is the conviction that 2000 saw the climatic fifth wave of a grand super-cycle going back to the dawn of the republic in 1784, the super-cycle that began its ascent in the 1932 depth of the Great Depression, the cycle that started its rise at the 1974 market low, the primary cycle dating back to 1990 and the intermediate cycle from 1998. In other words, the five greatest degrees of Elliott Waves came together in one huge, portentous crescendo.

Stock markets are the most sensitive and earliest registers of shifts in mass psychology or, in Elliott jargon, "social mood." Bull markets are not only leading indicators of good economic times. They also issue in periods of international comity, free trade, tolerance, benevolence, upbeat popular music and films. Bear markets by contrast spawn protectionism, xenophobia, international conflict, class polarization, slasher and horror films, angry music, separatism and terrorism. It's social mood that dictates events and trends and not vice versa, however.

The sheer unconventionality of Prechter's market views makes him interesting and sometimes incisive. For one thing, Elliott Wave theory nicely ties the present to the past. It promises and, at times, seems to deliver big picture predictability. How else did Prechter sense with such conviction back in the late 'Seventies just before Business Week ran its famous cover proclaiming the "Death of Equities" that the stock market was about to explode upward?

The Elliott Wave's one major flaw, according to Prechter, is that it provides only the pattern and not the duration of market moves. Thus he's been frozen at the controls since the 1987 Crash waiting for a grand super-cycle fifth wave collapse to ensue because he thought that the 'Eighties bull market, similar in time span and amplitude to the Roaring 'Twenties bull market, constituted the full fifth wave. He had no historical reference points that told him differently.

But now Prechter is convinced that the fifth wave mania is over and the Big Kahuna of market collapse and deflationary depression is now bearing down on an unsuspecting America. The major market averages have all been in free fall since early 2000. This Spring saw the last hold-out, small cap stocks, give up the ghost. To Prechter, the pattern is now in place and the endgame begins.

Most important, claims Prechter, is the acknowledgement that over the past two decades an unprecedented bubble market extended far beyond the high-tech-dominated Nasdaq Composite. In fact the Dow -- whether measured from its low of 570 in 1974 or 777 in 1982 -- enjoyed an epic rise of 20 times and 15 times, respectively, to reach its record close of 11,750 in January 2000. No other stock market move comes close to this. The Dow only rose slightly more than fivefold in the 'Twenties, to 386 in 1929 from 63.9 in 1921; the Nikkei rose 11-fold between 1975 and late 1989, and the South Sea Bubble Market in England jumped eight-fold in just three years during the 1720s.

Yet some commentators still argue that the Post-1982 Bull Market was anything but a mania. They claim that much of the surge in stock prices was a reflection of solid economic growth, improved U.S. management techniques, the advent of productivity-enhancing technologies, the global triumph of free markets and liberal democratic values, and falling inflation and interest rates. Part of the bounce in stock prices also represented catch-up after 15 years or more of negative real stock

returns and economic stagflation from the late-'Sixties to 1982.

Prechter finds such views ludicrous. Despite the fact that the post-1982 stock market dwarfed the bull market of the 'Fifties and 'Sixties, the economic fundamentals undergirding the latter period were far weaker than those underpinning the earlier era, he says.

The song remains the same

Take your pick of statistics. GDP, for example, grew at an average annual real rate of 4.5% from 1942 to 1966 compared to only 3.2% from 1975 through 1999. Industrial production? It showed an average annual gain of 5.3% in the earlier period, versus just 3.4% in the later period. The story is much the same for corporate profitability, capacity utilization and unemployment, among other measures. The earlier period trumped the later.

The same lackluster economic performance prevailed during other stock-market bubble periods, according to Prechter. Growth was much stronger during the Gilded Age of 1872 through 1880 and early industrial era of 1898 to 1906 than during the Roaring 'Twenties, for example. Japan enjoyed twice the annual GDP growth from 1955 to 1973 as it did during the subsequent 15 years of its celebrated bubble economy. Stock market manias are powered more by speculative fumes than by legitimate economic and corporate growth.

Ebbing market breadth is the final proof offered by Prechter that the post-1982 bull market was a bubble. During its 18 years of life, a far lower percentage of stocks participated in the surge of the averages than during the 1950s and 1960s. And the stocks that prospered in recent decades were more triumphs of financial engineering and manipulated expectations than companies producing real goods and services.

The point of all this to Prechter is that every past stock mania has ended badly, just as the latest bubble will. The average stock on the British market lost 90% of its value after the South Sea Bubble burst in 1722. Between 1929 and 1932, U.S. stocks dropped nearly 90% in value. During both periods many companies went out of business further damaging investors. The Nikkei and Nasdaq have both breached the 75% down barrier in recent months and will quite possibly reach a level 90% down from their highs at some point. A greater than 90% decline would take the Dow to below 1000 and the S&P to under 200. These numbers also happen to be Prechter's current targets for the two measures.

Where's the bottom?

Some commentators think that the sharp rally since Oct. 9 could be the early stage of a new bull market and the harbinger of economic recovery. But Prechter, a master at finding dark clouds beneath every silver lining, argues that bottoms aren't made when the dividend yield on the Dow Industrials is just 2.1%. The yield tends to rise to above 6% at moderate bottoms. In 1929 it soared to over 15%. At true market bottoms, he explains, fearful investors demand money up front from management rather than its promise.

Even more controversial is Prechter's assertion that the sinking stock market will lead to a depression. In fact, he asserts that a lethal deflationary slide in the economy has already started despite mainstream economists' assertions that the

current tepid recovery will gather strength next year.

Signs abound, he avers. The Producer Price index has been going down for the past 12 months as has the implicit price deflator for non-financial corporations. Commercial and industrial loan volume has been shrinking for the past two years. Junk bonds are defaulting at a record rate. U.S. mortgage delinquencies and foreclosures are soaring. Prechter fears that the U.S. is on the verge of falling into the same contractionary abyss that swallowed up Japan in the 'Nineties and recently claimed Argentina and Brazil as victims.

As Prudential chief investment strategist Edward Yardeni argued in *Barron's* last week, deflation doesn't have to be a malignant force as long as corporations can more than offset downward price pressure on their products with strong productivity gains ("[Deja Vu All Over Again](#)," Oct. 28). Then companies can maintain their workforce and afford to pay them higher real wages.

But Prechter anticipates that the process will be far more lethal. Weakening pricing power will spur companies to cut employees in an attempt to rein in payroll costs and maintain profit margins. As the jobless rate rises, consumer confidence and spending will wilt, in turn triggering yet more layoffs. Productivity, or output per man hour, will likely continue to improve in this environment, but it will come as a result of layoffs and fearful exertions of the surviving workforce rather than technological innovation.

"This was the very reason economist Joseph Schumpeter pointed out that 'the Depression acted as an efficiency expert' and boosted productivity by 20% between 1929 and 1932," Prechter explains.

Deflation is above all a psychological phenomenon, and therefore, according to Prechter, not ultimately reversible by either stimulative fiscal policy or monetary policy. And it typically first shows up in the stock market. That's where social mood shifts always evince themselves first.

He elaborates: "You can sell stocks or other financial instruments in a matter of seconds while it takes months for, say, a company to change from an expansion to a contraction mode. The latter is like turning around an ocean liner. It takes time."

Mild stock market declines spawn recessions more often than not. In fact, the stock market has had a better predictive record than other leading indicators of economic activity. Overinvestment in capital goods only exacerbates the situation. Full-fledged stock market crashes have always preceded serious economic downturns. In large part, that's because panic selling snuffs personal wealth and destroys collateral values, which can beget further liquidation. The contagion then spreads to other asset classes and then to the real economy of prices and wages and corporate sales and profits, Prechter adds.

Lethal collapse

What will make the coming economic collapse so lethal, says Prechter, is the mania that has likewise taken place in the U.S. credit market over the past two decades. Total U.S. debt -- household, corporate and government borrowing -- has exploded from under 140% to nearly 300% of GDP in the last 20 years. The previous peak was the 264% level reached after the 'Twenties economic boom.

Like then, the shift from credit expansion to credit contraction this time around figures to catch everyone in its undertow: over-leveraged homeowners, free-spending state and local governments and even corporations with average debt loads, Prechter claims. This should be especially true these days when so many loans are either backed by dubious collateral value or finance consumption rather than productive enterprise.

Happily, chances are that Prechter will be proved wrong this time as he has so many times before in the last decade. We've only had two full-fledged depressions in the last 200 years, so they are rare occurrences indeed. The post-2000 bear market has already been notable in both its severity and length. The current rally seems to have legs.

But the unimaginable does sometimes come to pass, as the events of Sept. 11 so clearly illustrated. So, perhaps there's some value in considering a worst case scenario. A little paranoia, after all, can sometimes be an investor's best defense.

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