



A Supplement to

The Wall Street Traffic Light's

Chapter 7, Discipline and Patience

(Read this material as if it appeared immediately after Exhibit 7-4, p. 61.)

THE AUGUST 1982-OCTOBER 2002 PERIOD

The S&P 500's longest and most spectacular period in U.S. financial history lasted from August 12, 1982, to October 9, 2002. To provide perspective, it is helpful to divide that period into two parts:

Description	Period	Length	Change in S&P 500
Very bullish time	08/12/82 to 03/24/00	211.4 months	+1,391.4%
Very bearish time	03/24/00 to 10/09/02	30.5 months	-49.1%

The “very bullish time” was by far the S&P 500's most bullish period in history. However, a brief bear market did occur during that time: the S&P 500 plummeted a stunning 33.5% from 08/25/87 to 12/04/87 (3.3 months), which included the 20.5% crash on October 19th. From 08/12/82 to 03/24/00, the S&P 500 was in a bear market—a period in which it fell at least 20%—*only 1.6% of the time* (3.3 months ÷ 211.4 months = 1.6%). The “very bearish time” was the S&P 500's worst decline since the early 1930s.

Since the very bullish time continued for over 17 years, more and more investors and market analysts thought that the stock market was in a bubble that could burst at any time. Concurrently, though, more and more investors and market analysts concluded that the buy-and-hold strategy would outperform virtually any market timing strategy.

Table 1 indicates that there were two trades under the WSTL strategy during 1983-1999, and *both of them were profitable*. Given that buy-and-hold was the strategy of choice during the very bullish time, considerable discipline and patience would have been necessary to act on the sell and buy signals for those two trades at the specified times. Moreover, for investors using either the WSTL strategy or the buy-and-hold strategy, it would have been challenging to stay the course with the S&P 500 in a bubble during the late 1990s.

Table 1

The S&P 500's Market Cycles from 1983 to 2002

Year	Type of Year	WSTL Return	S&P 500 Return	Outcome of Trade
1983	Tier 2	22.5%	22.5%	
1984	1C	8.7%	6.3%	2.4%
1985	1A	32.2%	32.2%	
1986	1A	18.5%	18.5%	
1987	1A	5.2%	5.2%	
1988	Tier 2	16.8%	16.8%	
1989	Tier 2	31.5%	31.5%	
1990	1C	2.1%	-3.2%	5.2%*
1991	1A	30.6%	30.6%	
1992	1A	7.7%	7.7%	
1993	1A	10.0%	10.0%	
1994	Tier 2	1.3%	1.3%	
1995	3A	37.4%	37.4%	
1996	1A	23.1%	23.1%	
1997	1A	33.4%	33.4%	
1998	1A	28.6%	28.6%	
1999	1A	21.0%	21.0%	
2000	1C	0.1%	-9.1%	9.2%
2001	3B	-6.3%	-11.9%	5.6%
2002	3C	-12.6%	-22.1%	9.5%
Mean		15.6%	14.0%	6.4%

*This difference does not add across due to rounding.

Table 1 also indicates that there were profitable trades in 2000, 2001 and 2002 during the “very bearish time.” The sell signal at the end of January 2000 occurred eight weeks before the S&P 500 reached its all-time high of 1527.46 on March 24, 2000. Acting on that sell signal, and then waiting 10 months for the buy signal to occur, would have been an emotional challenge, especially since the S&P 500 closed at 1520.77 on September 1, 2000; the maximum heat taken from the sell signal to the buy signal was 9.54%.

To get an idea of what it would have been like to use the WSTL strategy from August 1982 to October 2002, we will consider six highlights from that period. In reading each highlight, imagine how difficult it would have been to stay the course with the WSTL strategy at that particular time, even though the economic outcome did turn out well.

1. 1987 was a 1A year, so the WSTL was green at the time the stock market crashed in October. In 1987, most of the S&P 500's spectacular year-to-date rise of 39.1% through August 25th was lost in the last four months of the year. Being a 1A year, the WSTL's return for 1987 was the same as that of the S&P 500—a positive 5.2%.
2. Then Federal Reserve Chairman Alan Greenspan gave a speech to the American Enterprise Institute on December 5, 1996. (The WSTL was green at that time.) His major point boiled down to two sentences:

Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets...But how do we know when *irrational exuberance* has unduly escalated asset values, which then become subject to unexpected and prolonged contractions, as they have [had] in Japan over the past decade? (emphasis added)

Greenspan did not attempt to answer the question he posed. His reference to “irrational exuberance” only briefly rattled the stock market but, over time, that phrase became famous.

In his Congressional testimony nearly three months later on February 26, 1997 (the WSTL was green), Greenspan addressed the stock market’s spectacular rise since August 1982 and urged investors to be cautious:

Clearly, when people are exposed to long periods of relative economic tranquility, they seem inevitably prone to complacency about the future. This is understandable. We have had fifteen years of economic expansion interrupted by only one recession—and that was six years ago...

Is it possible that there is something fundamentally new about this current period that would warrant such complacency? Yes, it is possible. Markets may have become more efficient, competition is more global, and information technology has doubtless enhanced the stability of business operations. But, regrettably, history is strewn with visions of such “new eras” that, in the end, have proven to be a mirage. In short, history counsels caution.

Such caution seems especially warranted with regard to the sharp rise in equity prices during the past two years. These gains have obviously raised questions of sustainability.

Despite Greenspan’s caution, 1997, 1998 and 1999 were all 1A years; the S&P 500’s annual returns were 33.4%, 28.6% and 21.0%, respectively!

3. On June 6, 1997 (the WSTL was green), *USA Today* quoted John Bogle, founder and former chairman of The Vanguard Group:

Big-cap stocks are up, the S&P 500 Index is up, and there’s just a bull market going on out there. Those who cautioned conservatism were wrong. Nevertheless, there’s a point at which there’s too much risk in the market. I think this is it.

The S&P 500 closed that day at 893.90. The bull market top occurred some 33 months later at 1527.46—an advance of 70.9% following Bogle’s comment.

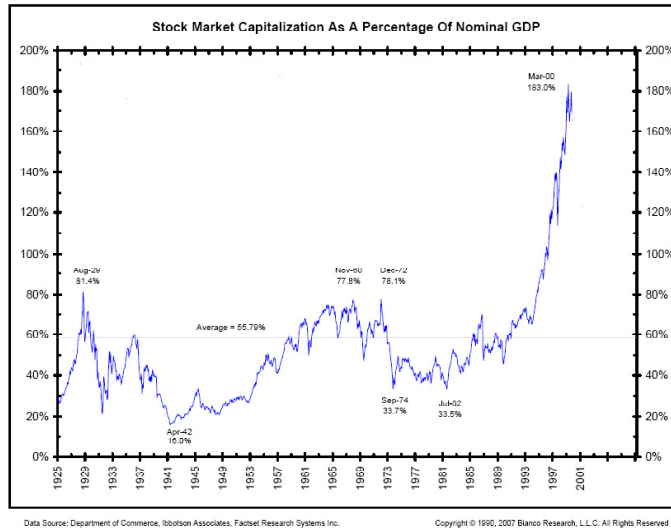
4. In December 1996 (the WSTL was green), Richard Russell, the author of a widely-read investment newsletter, observed: “For the first time in history [November 1996], the capitalization of the U.S. stock market is greater than the entire U.S. Gross Domestic Product [GDP], the market value of the economic output of goods and services.”¹ Specifically at that time, the market’s capitalization (total market value) was 101% of GDP, more than double the historical average of 47.9% and almost 20 percentage points higher than its previous record of 81.4% at the historic market top in 1929.

From May 1997 to August 2000, Alan Abelson reported three times on the U.S. stock market’s capitalization in relation to GDP in his popular *Barron’s* column, “Up & Down Wall Street.” (The WSTL was green during that period, except from the end of January 2000 to August 2000 when it was red.) To provide perspective, Chart 1 depicts that relationship from 1925 through August 2000.²

Chart 1

U. S. Stock Market Capitalization as a Percentage of Nominal GDP

Nominal GDP is the market value of economic output (goods and services), unadjusted for inflation.



Source: Bianco Research

In his May 5, 1997, column—at which time total market capitalization was 107.0% of GDP—Abelson ominously observed that the second-highest level was reached in August 1929, two months before the Crash of '29. In late summer of 2000 when total market capitalization was at *165% of GDP* (because most S&P 500 stocks had remained strong, despite a five-month decline of 25.0% in the Nasdaq Composite Index), Abelson told readers that the stock market “by any historical—or rational—yardstick is still unbelievably too high.”³ That time, his third such “call,” proved to be correct. On September 5, 2000, the S&P 500 started a decline that would take it down 48.9% to the bottom on October 9, 2002. After a 3A year followed by four straight 1A years (1995-1999), the WSTL model classified 2000 as a 1C year. That year’s trade had a profit of 9.2%.

5. On April 14, 2000 (the WSTL was red), the S&P 500 fell 5.8% and, in total, had fallen 11.2% from its all-time high some three weeks earlier. According to an article in *The New Yorker*:⁴

After the market closed, [then] Treasury Secretary Lawrence Summers appeared on CNN and appealed for calm, saying, “I’m confident that the economy will continue to grow over the next while, with fluctuations from quarter to quarter as always, but our fundamentals are sound.” Summers’ words had a familiar ring. On...the day after [the market crash in October 1929], President Herbert Hoover had said, “The fundamental business of the country—that is, the production and distribution of commodities—is on a very sound and prosperous basis.”

In the 31 months following Hoover’s statement, the S&P 500 fell an astounding 77.6% to the bottom on June 8, 1932. In the 29 months following Summers’ statement, the S&P 500 fell 42.7% to the bottom on October 9, 2002.

6. Starting in early January 2001, the Federal Reserve made extensive use of its key monetary policy tool, the federal-funds rate. The federal-funds rate (abbreviated as the fed-funds rate) is the interest rate at which depository institutions lend immediately available funds (balances at the Federal Reserve) to other depository institutions overnight. This rate serves as the basis for loans to consumers and businesses.

During 2001, the fed-funds rate was cut an unprecedented 12 times. A 13th cut occurred in November 2002. Over that 23-month period, the fed-funds rate was cut from 6.00% to 0.75%. Almost always, when the Fed lowers rates, the S&P 500 rises (often sharply) during the following 3 to 18 months. In this case, however, the S&P 500 *declined* 33.4% from early 2001 to October 9, 2002! Meanwhile, the WSTL model classified 2001 as a 3B year and 2002 as a 3C year; those years had profitable trades of 5.6% and 9.5%, respectively.

The six highlights underscore the effectiveness of the WSTL's performance for a long and spectacular period in U.S. financial history. For me, that past performance (which is no guarantee of future results) builds my confidence in using the WSTL strategy going forward. It is clear, though, that basing investment decisions on the WSTL strategy will require considerable discipline and patience.

Endnotes

1. *Dow Theory Letters* (December 4, 1996).
2. I thank Jim Bianco of Bianco Research for permission to use this chart.
3. Alan Abelson, *Barron's* (August 14, 2000), p. 4.
4. John Cassidy, "Striking It Rich," *The New Yorker* (January 2002), pp. 72-73.