RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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**September 19, 2001**

August 31, DJIA 9949.80; PTI 5331; AD Ratio -2.00
September 7, DJIA 9605.85; PTI 5319; AD Ratio -3.00
Dow yield: 1.72 Dow p/e: 24.5
Gold 50-day MA: 273.80

**THE PICTURE:** I've written a lot about the attacks on the World Trade Center and the Pentagon on my daily website. But I will say the following: I think the Fed will do what it does best, which is to crank up bank reserves and liquidity. Also, it would not surprise me to see the Fed drop rates further.

The market could easily slip into a fully oversold condition when it opens. If or when that happens, the market, following the oversold condition, could set off an extended advance.

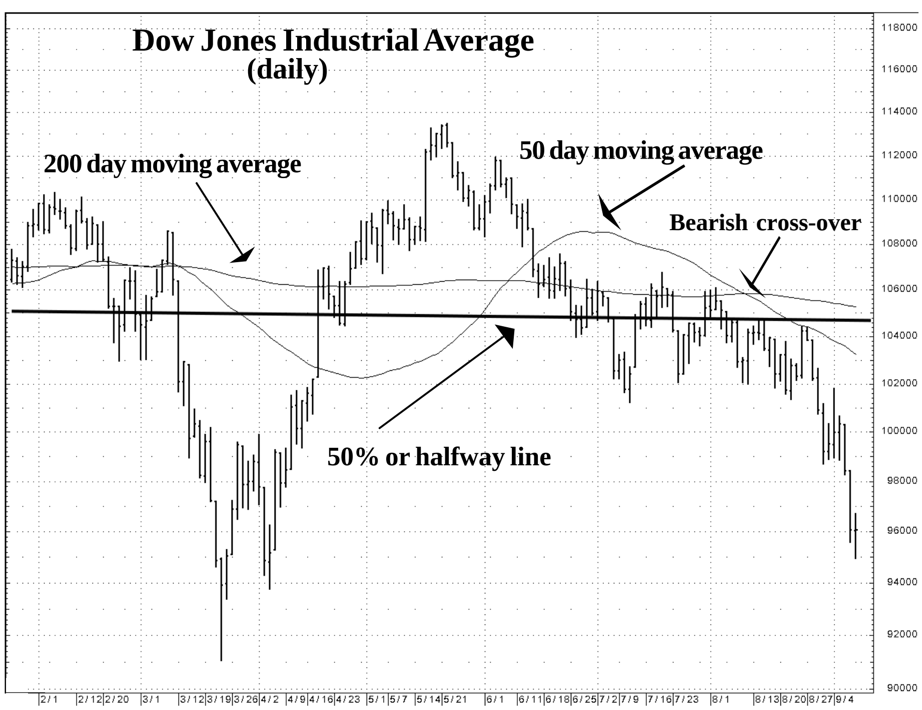
The cost of the NYC/Pentagon disaster will be huge, maybe as much or more than $30 billion. This will be hard on the insurance companies, but it will be a plus for the builders or should I say the re-builders.

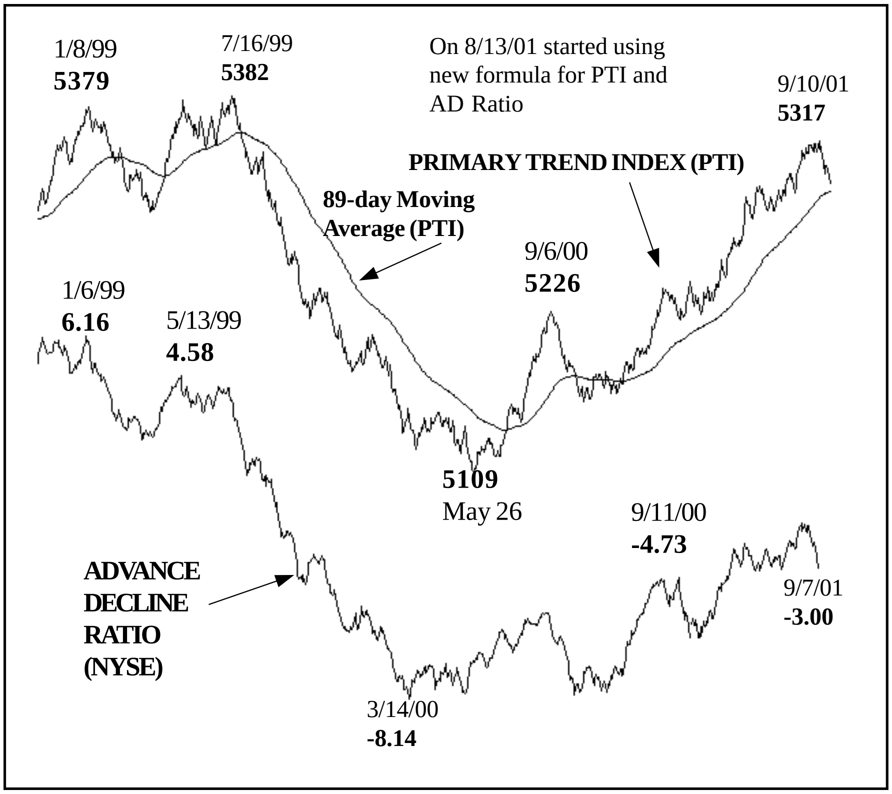
I believe we will see a strange new "divided spirit" in the land. I think the American people will be more serious and less apt to continue spending their heads off (bearish for the markets). But they will also become more patriotic and increasingly ready to accept whatever sacrifices are needed (a psychological plus).

I would also guess that there will be less traveling for Americans. Traveling will become much more of a "pain in the fanny" if that's possible. Security on airlines will be stepped up considerably. The airline and transportation industry will suffer both in their revenues and in their profits. Business travel will give way to business teleconferencing.

Unlike "Desert Storm" which took place (1990) during a primary bull market, the attack on New York's Trade Center occurred during a primary bear market. The difference is that from a financial standpoint, more damage will have been done in 2001 than in 1990. The last thing we need during a primary bear market is a catastrophe. But we have one.

In 1990 it was Iraq that suffered. This time it was the US that has suffered.






One outcome of the NYC disaster is that people will demand far less pussyfooting from the government this time. We backed off from getting rid of Saddam during Desert Storm because politically the administration was afraid of any casualties. I think it may be different this time. After all, this time, unlike 1990, the blood was on US soil.

All right, let's go back to the current stock market, what's happening to it – and what we can do about it.

People ask me, "Russell, how can you still be bearish? Look, the Nasdaq has been killed, the Dow is well off its highs and so is the Nasdaq. In fact, every major stock average, the Wilshire 5000, the NYSE Composite, the Value Line Geometric, they are all down substantially. So what makes you think that the market is going to go down even further? Haven't stocks been hurt enough?"

And my answer is that "Sure, stocks have been hurt, and that simply means that most stocks are off their highs with many being far off their highs." It's estimated that total losses in the stock and financial markets run anywhere from $4 trillion to $7 trillion. That's a lot of money down the drain — it equals at least half of a year's total Gross National Product.

Here's another interesting comparison; the bear market losses so far ($4 to $7 trillion) amount to more than the total value of the thirty D-J Industrial stocks (value of the Dow is $3.3 trillion).

But from the valuation standpoint, my belief is that we have much further to go on the downside in this bear market.

Bear markets, major or primary bear markets, tend to take stocks down to the point where they become "great values." Actually, at great bear market bottoms such as 1938 or 1942 or 1974 or 1982, stocks declined to "below known values." On any measurement, stocks are not there today.

Before this bear market is over, I would expect stocks to decline to the point where they are selling on average at well below 10 times earnings while yielding 5% or maybe considerably more. At the bear market bottom of 1974 the S&P sold at 7 times earnings. At the 1982 bear market bottom the S&P sold for 8 times earnings.

I also believe that in duration this could be maybe the longest bear market in history. I base this time element on the fact that the bull market rolled on for 17 years. The longer the bull market, usually the longer the time required for the total bear market correction.

Government interference with the natural rhythms of the market will extend the bear market (it's already doing that). The NYC disaster could extend the duration of the bear market. Furthermore, we have two depressing examples of bear market timing. We have the gold bear market which has already lasted from 1980 to the present, or 20 years. And we have the Japanese example which has lasted from 1989 to the present.

So we have two examples of modern bear markets that have lasted interminably. Might not this bear market last longer than most people think possible? I certainly hope not, but nothing the bear market produces would surprise me.

I've written a lot about the deceptive, "contaminated" advance-decline statistics. The "rising" advance-decline line has been one of the main arguments of the bulls. "How can it be a bear market," they argue, "when more stocks are rising than declining?"

Now it turns out that the bulls have been looking at the wrong figures. Lowry research shows that 48% of the stocks on the NYSE are closed-end stock funds, closed-end bond funds, preferreds, ADRs, and warrants.

The real picture can be seen in an advance-decline line made up of all common stocks. You can see an advance-decline line of the S&P 500 on the great site www.decisionpoint.com under the heading, "advance-decline line."

With the advance-decline thesis now under water, I'm asked, "Russell, as far as market analysis — at this point what do you believe in?"

And my answer is that I haven't changed my beliefs at all. I believe basically in three phenomena. The first is stock values. The second is the Dow Theory. And the third is price action.

As far as valuations are concerned, stocks are still extremely expensive. The S&P 500 minus all the baloney is selling at around 36 times earnings, at least this is the way the *Wall Street Journal* analyzes it. The *Journal* uses generally accepted accounting principles or GAAP.

I might add that I think it's a disgrace that accountants have gone along with all the "creative" and deceptive little changes with which corporations have adjusted their earnings. Adjustments like taking obvious repeating expenses and calling them "one-time" expenses that should not be included in their statements. The whole earnings phenomenon has become so deceitful that people no longer believe the so-called bottom-line earnings at all.

As far as the precepts of the Dow Theory, I have outlined a lot of what I believe from a Dow Theory standpoint on the home section of my website. I haven't changed my mind. I view the Dow Theory pretty much the way George Schaefer viewed it.

Finally, as for price action, most of what I believe and how I operate is a mixture of Robert Rhea and Schaefer. Of course, times have changed since Schaefer died in 1974, and I have made allowances for the quarter century of change. Markets seem more volatile today. Institutions do about 75% of the trading today. And the public depends far more on the mutual funds and institutions today than they did in 1974.

Information travels infinitely faster today, and market moves seem to complete themselves faster today. Certainly, there is more hype and pure bunk being heard today than ever before. I take all this into

**DOW'S 50% PRINCIPLE:** Please refer to the chart on page one for this piece.

I've talked about the 50% principle before, but for the benefit of newer subscribers, I want to go over this important but little-understood principle again.

I first learned of the 50% principle from George Schaefer, the great Dow Theorist of the 1940s to 1970s. **Schaefer noted that Dow was particularly interested in what the Industrial Average did at the halfway or 50% level of previous major advances or declines.**

Note that I said "major" advances or declines. The principle should not be applied to minor moves of 50 or 100 Dow points. The **larger and longer** and more important the move (up or down), the more valid the 50% principle when it is applied.

Schaefer likened the 50% principle to a child's seesaw. If one end of the seesaw declines — and it sinks past the horizontal and down to the ground – the opposite side of the seesaw will go all the way up to the high. However, if that same end pushes up past the horizontal and rises to the high as if it has gathered momentum – the opposite end of the seesaw will sink back towards the ground again, thereby "testing" the low.

The market can act the same way. For example, the Dow hit a record high of 11722 in January of 2000. After a series of advances and declines, the Dow finally broke to a low of 9389 in March of 2001. That represented a decline from high to low of 2,333 points over a period of 15 months. This certainly qualifies it as a major decline.

The halfway or 50% level of the entire decline from Dow 11722 to Dow 9389 was 10555. A year-and-a-half has gone by since the record Dow high of 11722 and as I write, the Dow has repeatedly tried to rally above 10555 and hold there. So far, it has failed to hold.

The Dow at this writing is at 10243 and below the halfway or 50% level of the entire decline from the Dow high of 11722 to the low of 9389.

As of this writing, the 50% principle is bearish, and the implication is that in due time the Dow will come down to test the low of 9389.

**200-Day Moving Average of the Dow:** In a primary bull market the Dow will tend to hold above its 200-day moving average. The exception is when a powerful correction hits, at which time the Dow will dip temporarily below its 200-day MA. If the bull market is still intact, the market will gather technical strength and in due time the Dow will again rise above its 200-day MA.

The exact opposite is what you can expect during a primary bear market. During a bear market the Dow will tend to hold below its 200-day MA except during instances of powerful upward corrections. But if the bear market is still intact, it will be only a matter of time before the Dow sinks below its 200-day MA again.

I like to combine the two studies, the 50% principle and the 200-day moving average. At present, the 50% principle is bearish, and the Dow is bearishly below its 200-day moving average (currently, the 200-day MA stands at 10570).

Although nothing is certain in this business, the two studies strongly suggest that the Dow will test and probably violate its bear market low of 9389.

**NOTES & QUOTES**: Regardless of what's happening, nothing, it seems, can dampen the bullish public stances of Wall Street strategists. Here's the rundown of Wall Street's "biggies."

Goldman Sach's Abby Cohen says the S&P 500 will end the year at 1,500 or up 26.6%. A.G. Edwards' Mark Keller says the S&P will end the year at 1,450 or up 22.4%. Lehman's Jeffrey Applegate says 1,450 or up 22.4%. Morgan Stanley's Peter Canelo says 1,400 or up 18.2%. CIBC's Subodh Kumar says 1,400 or 18.2%. Salomon's Committee says 1,400 or up

18.2%. First Union's Rod Smith says 1,350 or up 13.9%. Deutsche Banc's Ed Yardeni says 1,210 or up 2.1%. And what's this? J.P Morgan's Doug Cliggott says 1,100 or down 7.2%.

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A few weeks ago I watched a two-hour program on gaming, better known as gambling. Gambling is fast enveloping the nation. Nobody in the US is further than a two-hour ride to a gambling casino.

California will soon have 100 casinos operating in the state. There's riverboat gambling and there's Internet gambling. I just got a circular through the US mail from First Fidelity Deposit Trust. The circular states, "Bet any sport, any proposition – if you can get it anywhere in the world you can bet it with First Fidelity – 1 800 YOU WAGER or www.youwager.com."

Gambling in the US is becoming an epidemic. We have state lotteries, we have "Powerball," we have card rooms, we have casinos in more than half the states, and we have Wall Street, which has been turned into a casino, with people no longer buying values, with people no longer caring about interest or dividends, with people only betting on higher prices.

I think this widespread gambling is becoming almost a mania. It all boils down to people wanting something for nothing. In the recent $300 million Powerball lottery, people were lining up to buy tickets. The odds on winning were 30 million to one. Imagine putting your money down on odds like that.

But 90% of the actions people take are based on emotions, not intelligent thinking. And that's what the casinos count on – the fact that people act on their emotions.

This from the op-ed section of the August 29 *New York Times*: "Lottery organizers have learned to exploit the weaknesses of their clientele. Over time, they found out that reducing the chance of winning could actually boost ticket sales. The lower the odds of winning, the more the jackpots go unclaimed and roll over into a bigger grand prize. And a few big jackpots sell more tickets than a week's worth of small jackpots. Powerball lowered the odds of winning its jackpot from 1 in 55 million to 1 in 80 million in 1997."

Gambling is, I believe, an insidious process and a demoralizing influence. But it's a free country, and people are allowed to destroy themselves and their bank accounts if they want to.

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If there's one stock that might be watched as THE market bellwether, it's General Electric. GE was born in Thomas Edison's laboratory over a century ago. GE is the only original Dow Industrial stock that is still in the D-J Industrial Average. The stock is the nation's most widely-held stock. It's owned by a quarter of the US' 3,859 equity mutual funds. GE's $130 billion in annual revenues makes it one of the handful of companies that produces more than one percent of the total US output.

GE hit a high of 60.50 last August of 2000. It then broke to 36.42 in March, whereupon it rallied to a lower peak of 53.55 in May of this year. GE closed last week at 39.35, down more than one-third from its August 2000 high.

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All eyes are now on the consumer, and more specifically on consumer borrowing. American consumers, low on savings and high on debt, tend to borrow when they buy. Since consumer spending equals two-thirds of the US Gross Domestic Product, there is intense interest in what consumers are doing.

The Fed reported that consumer borrowing was unchanged in July, after falling 1.3% in June. The June decline was the first time consumer borrowing had declined in the last four years. **Russell Comment:** I'm of the opinion that the consumer buying frenzy is coming to an end. I think the NYC disaster will somehow cause consumers to become more conservative. Of course, the huge number of layoffs will also serve to turn consumers conservative. The age of "fun and shopping" may be coming to an end.

The Mortgage Bankers Assoc. of America reports that 4.63% of mortgage payments were more than 340 days overdue, up from 4.37% in the first quarter. The percentage of mortgages in the foreclosure process reached 0.91%.

A record 400,394 bankruptcies were filed, up 24.5% from the previous year, according to the American Bankruptcy Institute.

Get this incredible statistic – almost 6.5% of all adults in the US filed for bankruptcy in the 12 months ending June 30, points out Myvesta.com, a debt-counseling group.

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Aside from the stock market, I think the biggest mystery the world faces is China. A new book just published is entitled, "The Coming Collapse of China" by Gordon G. Chang. But the arguments for and against Chang's thesis are many.

Many are enthralled over the China situation, which includes China's economic miracle, 7% economic growth, a burgeoning middle class, an inexhaustible supply of cheap labor, a well-educated middle class of young people, the highest Asian rates of foreign and direct investment. But against this there is the problem of massive unemployment, peasant revolt, a dysfunctional banking system, staggering environmental degradation, a weak legal system, and a Leninist Party leadership which is in place only as long as they can keep China's engine running at full speed.

China is about to enter the World Trade Organization, where the full brunt of brutal competition will either help or hurt China. The August 25 *Economist* put it this way – "It all boils down to this: what will the rest of East Asia do for a living now that virtually everything can be made more cheaply in China?"

**Russell Comment**: One thing is certain – China sees itself as a coming super-power. I believe China will present the world with vicious competition, particularly in manufacturing where Chinese labor is efficient and cheap. The answer for many companies in both the east and the west will be to relocate their factories to China. But how long will it be before China competes at the highest level in leading technologies? I don't think it will be long.

The old guard in China is about to change. In the next 12 months Chinese President and Communist Party chief Jiang Zemin will hand over the leadership to the next generation. This will be the so-called "fourth generation." The fourth generation will be very unlike the current leaders. Born between 1941 and 1956, they travel in the West, talk BMWs, listen to Beethoven and Mozart, and invest in the stock market. Few believe in the old Marxist slogans such as "sacrificing for a bright future" epithets. They are more educated and much more aware of the outside world than their parents were.

In 1980 only 4% of China's rulers had a college degree. Today more than 90% do. In the 1980s China had 3,000 lawyers. Today, there are 150,000.

One thing is certain – Chinese scholars see China as a coming superpower. Writes Wan Guang, an executive at the China Center for International Studies, "US international influence is naturally declining as it's deep social problems and crises are increasingly revealed to the world." The competition for world leadership promises to be intense. The US' competitor will be China.

**LATE NOTES:** I'm writing this on Monday morning an hour after the opening of the market (following four days in which it was closed). The efforts by the Exchange, the Fed and an assortment of corporate CEOs and politicians to "boost" this market has been beyond anything I've ever seen.

The Twin Tower disaster has served as a convenient excuse by strategists and economists who were bullish on the future of the economy and the stock market. "We're innocent," they cry, "Who could have seen this coming? Now the nation will probably sink into recession." The answer is that these people didn't have a clue before the disaster and they still don't have a clue.

We're in a primary bear market, and in a bear market stocks go down and for some unknown reason – bad things happen. Also, stocks react to "bad things" differently in a bear market than they do in a bull market. Let the buyer (of stocks) beware.

**NEXT MAILING: October 10, 2001**