



## **Main Financial Markets in 2010 Long-Term Technical Forecast**

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*This analysis is prepared to discuss the long-term prospects of the main financial markets. In our regular updates on our web site, we mostly concentrate on shorter-term time frames: Medium-Term (lasting several months) and Short-Term (lasting several weeks). I plan to publish such long-term view on the markets at beginning of each year.*



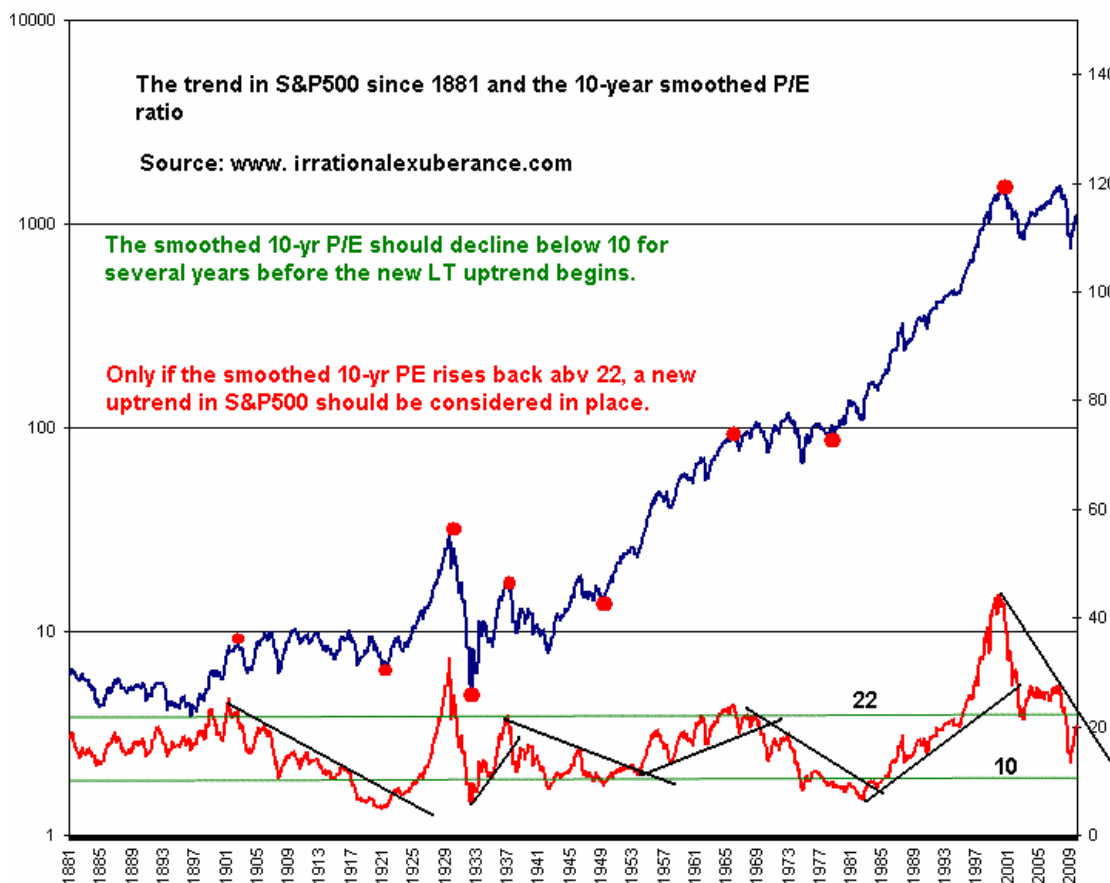
## U.S. STOCKS MARKET

### The Long-Term trend in S&P500 and the evolution of the P/E ratio:

I will begin my analysis with the long-term trend in the S&P500 and the historical trend in valuations (the trend in the Price/Earnings ratio, or simply called, the P/E ratio).

On the 1<sup>st</sup> chart below you can find the long-term trend in the U.S stock market and the trend in the 10-yr smoothed P/E ratio (the latter is derived by dividing the current stock price to the companies' average profit for the past 10 years) going back as far as 1861. You can deduct many conclusions from the chart below regarding the long-term relationship between the stock prices and the P/E ratio, but one of them is that the stock market can be considered overvalued when the P/E ratio climbs above 20.0/22.0 and can be considered undervalued when the P/E ratio declines below 10 (and you can see from the chart that the market can stay undervalued for years before the next bull market begins). You can also see from the chart how the change in the trend of the P/E ratio signals the change in the trend of the stock market.

### **The relationship between S&P500 and the 10-yr P/E ratio suggests the sideways consolidation from the year 2000 top will likely last for another decade:**



Source: [www.irrationalexuberance.com](http://www.irrationalexuberance.com)

One interesting thing that can be noted from the above relationship, is that the 2000-2002 bear market couldn't even bring the P/E ratio below the 22 level, i.e. the market remained overvalued at the 2002/2003 lows from a fundamental point of view. The 2008 decline managed to bring the P/E ratio below 22 and we saw levels of around 15 in the first quarter of 2009, but the 10<sup>th</sup> -level wasn't approached. The strong rise of the U.S. stocks in 2009 has lead to a recovery of the P/E



ratio toward 20 and it stays right at that level at the moment of this writing. If we see a move above 22 in the P/E ratio that will be considered a bullish sing (though the market will be again considered overvalued in this case) as the P/E downtrend since 2001 will be negated. The historical comparisons however show that it is unlikely to see this happen. Most bull markets have begun after the P/E ratio has declined below 10 and after it has stayed below 10 for several years. Considering this, the current market is very far from being undervalued. In that sense, the current strong rise from the Mar 2009 low is likely a part of a broad sideways consolidation that began in 2000 and it is not the start of a Long-Term bull market. We can argue that a sustained LT bull market (as the one from the 1950s and 60s and the one from 1980s and 90s) will likely begin only after 5-10 more years of sideways trading during which period, the P/E ratio will be a one-digit number for at least a year or two.

### The Long-Term prospects of the U.S. stocks market:

When we consider the historic trend of the P/E ratio and the historical average length of the sideways consolidations in the past, we can state with a confidence that a true bull market is unlikely to start before the end of the current decade.



**A comparison of the current bear market with some bear markets from the past**

Source: [www.prophet.net](http://www.prophet.net)

On the chart above you can see the previous sideways consolidations in the U.S stocks market (as measured by the S&P500 index). Since there is no doubt now that we are already in a broad sideways consolidation from the 2000 top, it is worth studying the prior similar cases. The current



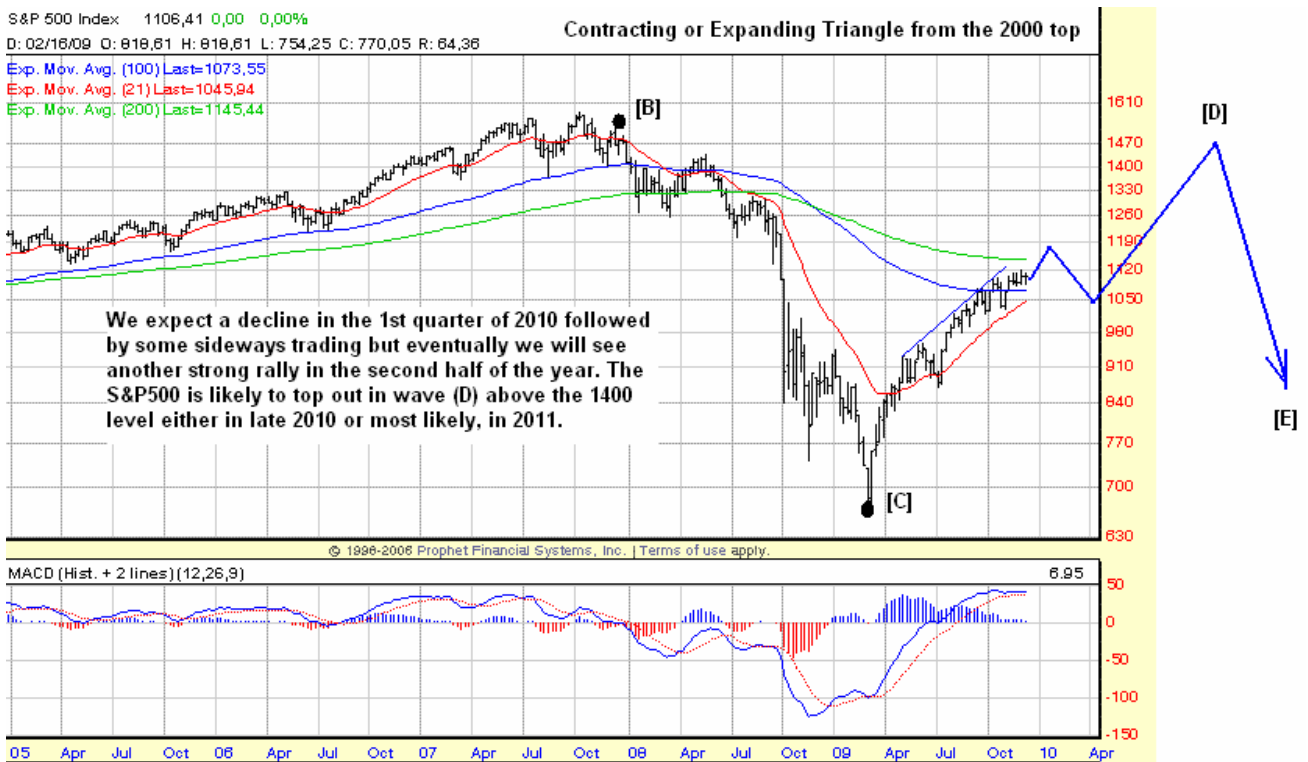
sideways consolidation mostly resembles the one from the 1966-1980 (82). And from that fact we can draw the following conclusions:

1. Despite some scary forecasts made by some analysts for a super bear market with a decline in S&P500 below 100 (a decline in Dow below 1000), that will not happen. The current bear market from the 2000 top has developed as a sideways consolidation!
2. Some expectations that a new super bull market has begun from the Mar 2009 low are also incorrect. The sideways consolidation from the 2000 top will most likely develop into two phases: initially an expanding one and then a contracting one. Even if we have already seen the low of this consolidation (i.e. the expanding phase is over), the next bull market will not start before the next 5-10 years because we have to deal with the contracting phase of the consolidation first. From this point of view, the current strong rise will most likely top out in late 2010 or in 2011 (more likely) in the 1400-1600 zone and another bear market will then follow lasting a few years.
3. As of this moment, it is impossible to tell with a high degree of confidence whether the expanding phase of the consolidation from the 2000 top has ended or not, i.e. we still cannot rule out another low below the 666 level (Mar 2009 low) in the next few years.

### Medium-Term prospects for 2010

The above analysis indicates that odds are higher that the 2010 will be a positive year for the U.S. stock market.

### **The bull market from the 2009 low will likely go further in 2010:**



Source: [www.prophet.net](http://www.prophet.net)



As seen from the chart, the strong rally in 2009 managed to bring the prices back above the 100-week exponential moving average (which is somewhat equivalent to the 500-day exp. moving average) which is a very positive signal that we are in a Medium-Term bull market. The MACD indicator (shown in the lower part on the chart above) is also positive and as long as this is the case, we should consider the current bull market to be intact. And since the recovery from the 2009 low is more likely to take more time than the preceding decline (based on the wave theory time rules), than we can say that a market top is not likely to be found until the late summer of 2010. The most likely scenario suggests a top even later, in 2011. From a fundamental point of view and from a sentiment perspective, I think the 1<sup>st</sup> 3-4 months of the 2010 will be accompanied by skepticism that the stock market has gone too far while the economy isn't doing well – that will likely keep many analysts negative and this can add fuel to the current uptrend to continue (having many negative investors and analysts means that at some time they will throw the towel and enter in the market). In the second half of 2010, with the time getting closer to the ultimate top of this mini-bull market, the fundamentals will likely appear very favorable and will make the investors believe that a true bull market is in play. We should never forget that the fundamental data is most promising at the market top and worst at the market bottom – the fundamental data cannot be an argument why a particular market is moving up or down.

And finally, I would like to point out one negative scenario for 2010. That scenario is based on the analogy of the 2008-2009 bear and bull market with the 1937-1938 bear and bull market. This analogy suggests that the U.S stock market will top in the very beginning of the 2010 and then will start to slowly move down in a prolonged bear market that eventually will bring re-test on the 2009 low. This negative scenario is certainly possible, but I consider it less likely than the analysis presented above. And if the U.S stock market indices continue to post new recovery highs after the end of January, then the odds for this negative scenario will decrease further (in the 1937-1938 analog, the low of the bear market occurred in February 1938 while the top of the subsequent rally came in November 1938).



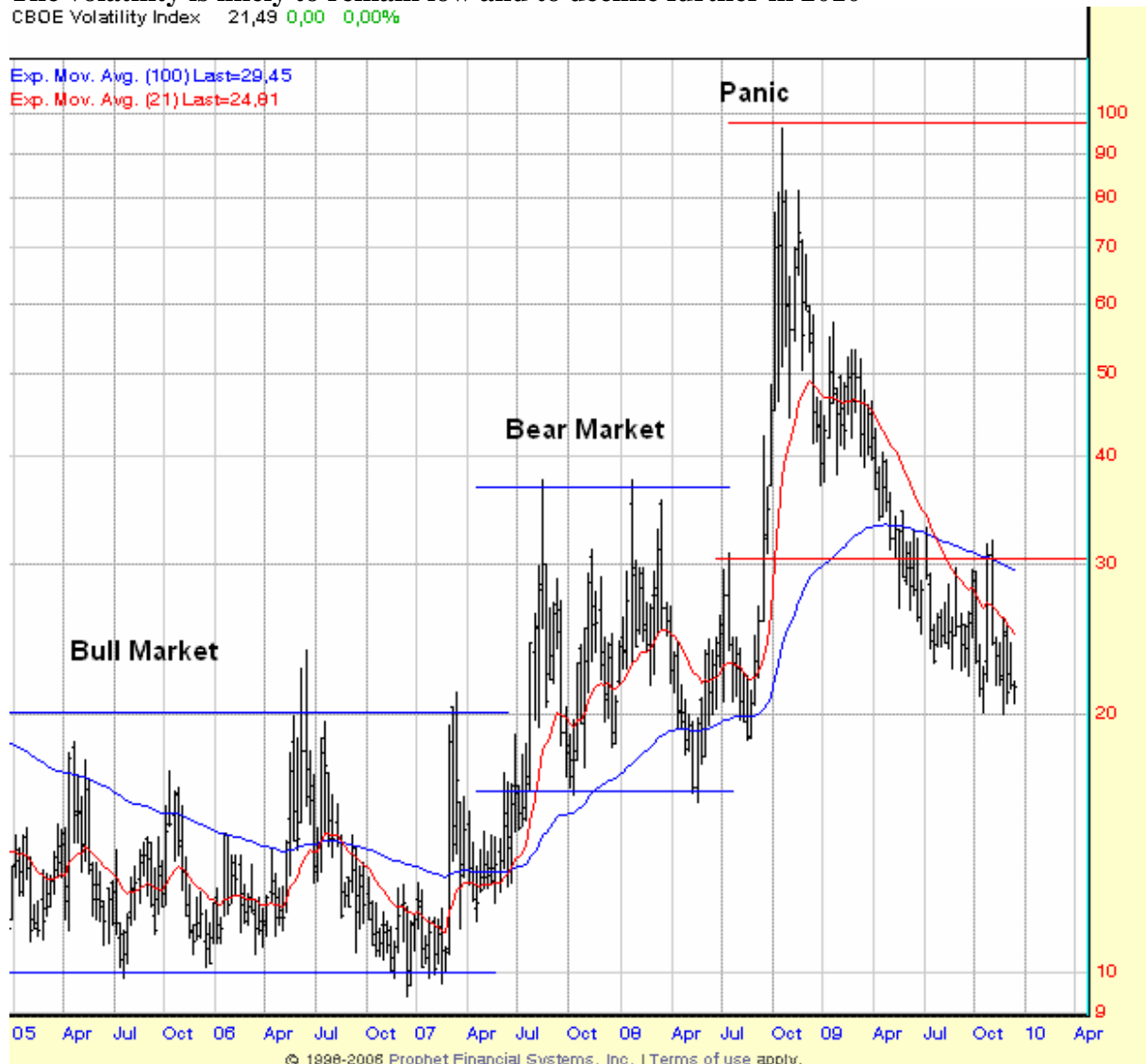
## The Volatility of the U.S stock market:

**The volatility is likely to remain low and to decline further in 2010**

CBOE Volatility Index 21,49 0,00 0,00%

Exp. Mov. Avg. (100) Last=29,45

Exp. Mov. Avg. (21) Last=24,81



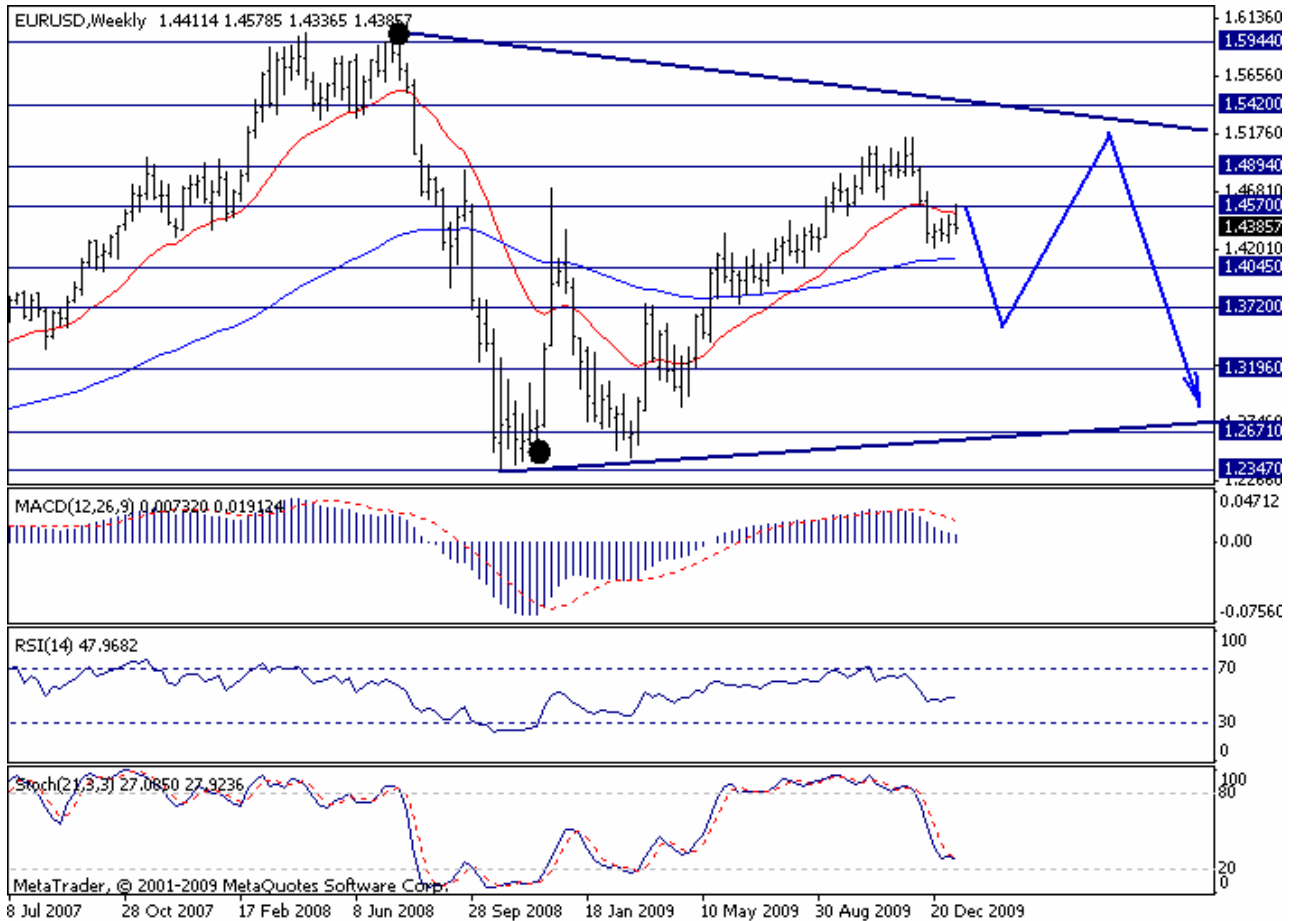
Source: [www.prophet.net](http://www.prophet.net)

I was surprised by the collapse in volatility (the VIX index) that happened in 2009. Even the strong decline in January and February of 2009 did not see a rising VIX and the subsequent strong rebound of the U.S stocks brought a severe decrease in the volatility. Thus, the VIX index is now approaching levels that are usually typical for a bull market. Further decline in VIX toward 15 or lower can be expected in 2010. It is unlikely though, to see a decline in VIX toward the levels of 2006 when the VIX was meandering between 10 (!) and 18. My opinion is that more likely the VIX index will fluctuate between 15 and 30 during 2010. Only if the negative scenario described above (the one based on the 1937-1938 analog) plays out, the VIX is likely to move above 30 for a sustained period of time.



## EURUSD

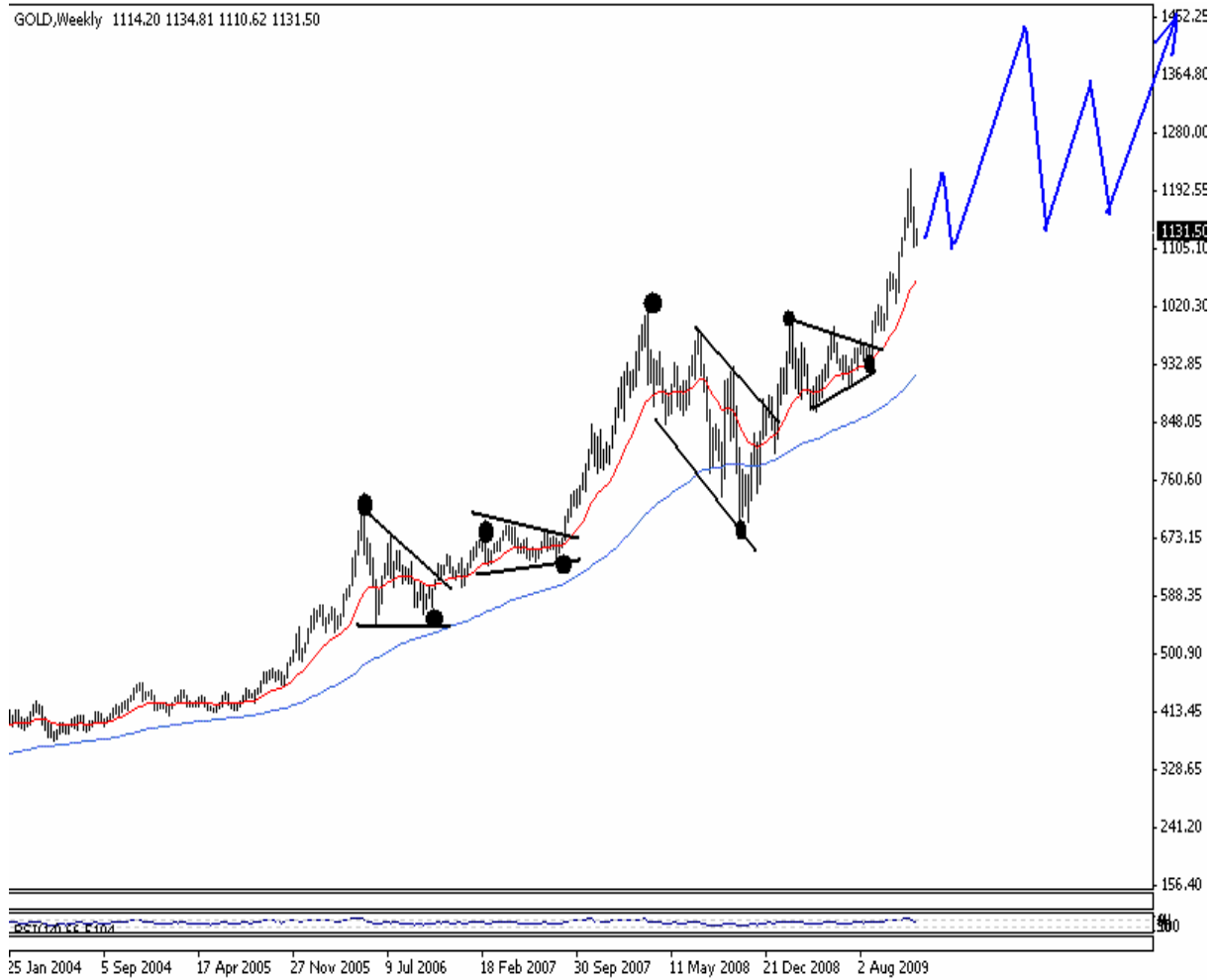
While the sentiment toward the U.S dollar is shifting quickly between extreme optimism and extreme pessimism, the most likely trend on the currency market for 2010 is likely to be a trading range in the EURUSD rate. I think both the super dollar bulls and the super dollar bears will be disappointed in 2010. It is less likely to see a move above 1.55 EURUSD or below 1.25 EURUSD this year.





## GOLD

### Gold's bull market



The chart above shows the big bull market in gold for the past several years in percentage terms (semi-log scale).

After gold made a correction (sideways consolidation) in late 2008 and most of the 2009, similar to the one from 2006-2007, it made an upside breakout last September and rose strongly to \$1226 before declining sharply more than \$140. Many investors describe the strong rally in gold as a mania but if we calculate the price of gold in real terms (inflation adjusted), even the bull market from the 2001 low appears too small. From a technical point of view, the gold is likely to trade sideways for several months, then we can expect another rally toward the 1300/1400 area in late 2010. After that, a more prolonged downside correction is likely to be seen...



### THE MAIN EMERGING MARKETS:

**The main emerging markets will likely remain very strong in 2010:**



Source: [www.prophet.net](http://www.prophet.net)

The big emerging markets (presented on the above chart via the EEM exchange traded fund) made more than 100% rise since their 2008 low (yes, this index did not make a new low in 2009!). The upside potential for 2010 is probably not that big as EEM is approaching its all time high, but still, these markets are likely to outperform the most developed markets (USA and Western Europe). I am particularly bullish for Russia and India, to some extent for China too. While the prices remain above the 100-week moving average (the blue line) and the MACD indicator is positive, the Medium-Term trend is on the upside and we expect to see a re-test on the 2007 tops before the next significant pullback takes place here. On the downside, a move below 35.0/33.0 in this ETF will be a negative signal....



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