ADVISORY

RICHARD W. ARMS JR.

800 WAGON TRAIN DRIVE SE ALBUQUERQUE, NM 87123

OFFICE (505) 293-4438 FAX (505) 298-2833

THE SEVEN YEAR GLITCH

<u>Every seven years the stock markets take a hit.</u> Or at least they have done so consistently for the last three quarters of a century. Sometimes it is small but usually it is large. The last two down cycles have taken away about 35% and 55% of the value of the Dow Industrials, respectively. The last time this happened it started in 2007, so now in 2014, the next down glitch appears to be due.

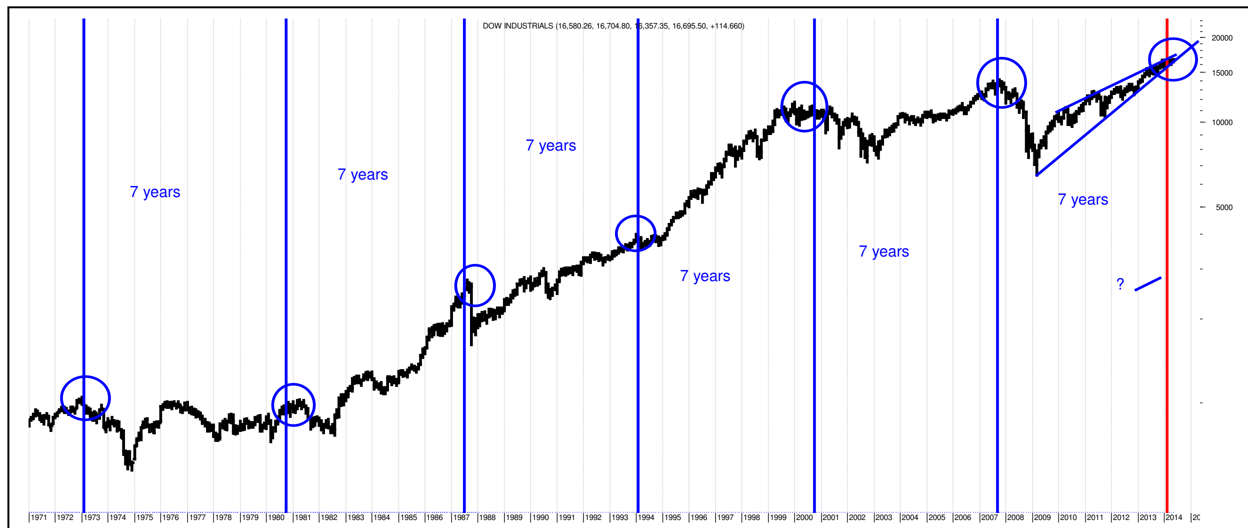


Chart by Metastock

As I watch the stock market and start the writing this paper on this Tuesday May 13, 2014, the Dow and the S&P 500 are hitting all time highs. The complacency is obvious, with the VIX at 12.13 and the Arms Index at .49. Yesterday there was a large gain in the averages, especially the Nasdaq, reflecting a lack of concern, even though the Nasdaq, unlike the other averages, had been sliding for over two months. The street attitude is that the bull market that began in 2009 can go on and on. But today the trading range has contracted and the gain on the opening is eroding. That is the only evidence that the advance is hitting resistance, yet as I look at this I become more and more concerned.

Fourteen years ago, in early 2000, the markets made a major high. Seven years ago, in mid 2007, the markets made another major high. Does that mean there is a seven-year cycle, and that we are due to make another high in this vicinity? Two data points certainly are not enough to set a rule or even a precedent. But if we look back, as we do on the above chart, it is more convincing and more disconcerting. There seems to be about a seven year cycle of tops leading to sharp drops in most cases***; the seven year glitch***.

Going back, the early 1994-point was only a very minor top and a very small pullback ensued. But before that we have the very traumatic top and panic in 1987. Before that the high in 1981 led to a substantial drop, and before that the high point that was made in 1973 preceded a very dramatic slide. Note that this chart uses a logarithmic vertical scale, so the rises and drops can be compared for their magnitude.

Actually, although it is somewhat less apparent, the same seven-year glitch appears going back at least to 1946, as we see on the chart below.

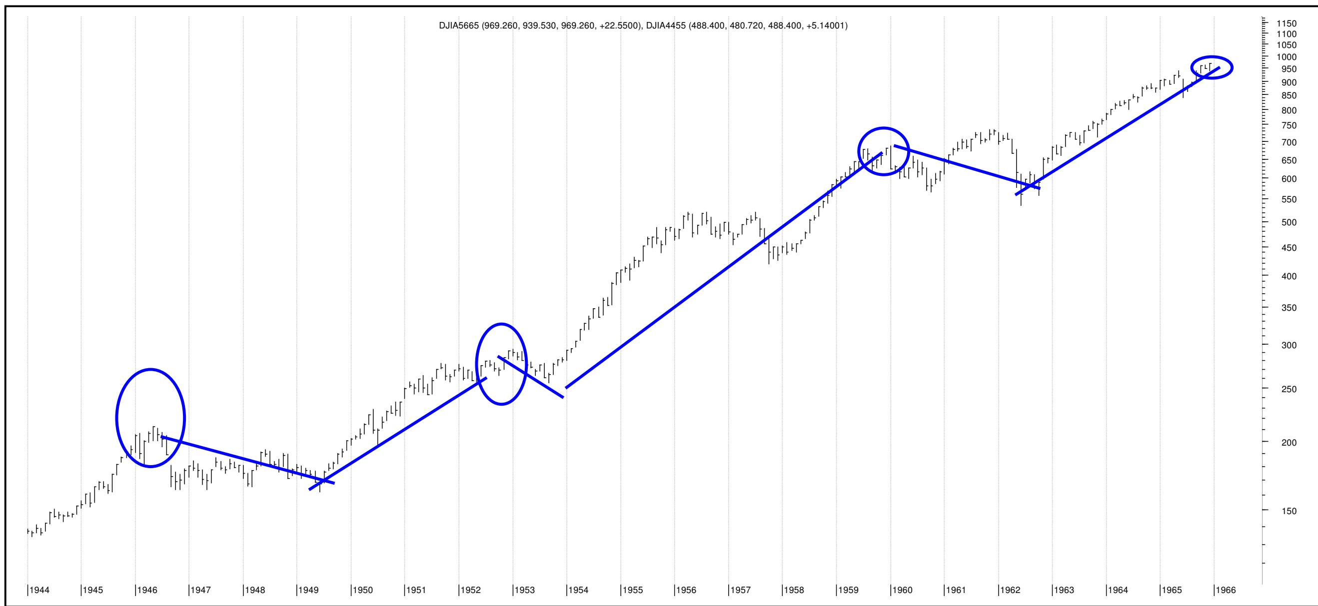


Chart by Metastock

So it does appear that the cyclicality has some legitimacy. It is not perfect, but it is accurate enough to make one pause and consider the possibility that the next high is in the making, and we may be close to a downturn.

On the first chart I inserted a pair of lines that enclosed the rise since the start of the current bull market. You will note that they are converging into what looks like an ascending wedge. The trading recently has been concentrated in a very small area that looks like the apex of the two converging lines. That suggests that before long the market has to make up its mind which way it is going out of that wedge. But look at the next chart, below. I have put in similar lines on each of the prior market rises. Only in the 1994-2000 advance did the two lines stay parallel. In all others they converged toward an apex and when the two lines got close together the breakout was always to the downside. It looks this time as though we are closer to the apex than in any other case. That suggests decision time is close at hand.

Chart by Metastock

Another observation is that the down moves tend to be briefer than the up legs. But how long the decline lasts, and how deep it is seems to be a function of the next larger market direction. Ever since the market breakout in the early eighties I have written about the very long-term cycles that have been in effect. We were in a huge base in the sixties and seventies, and into the eighties. From there we were in a long-lasting secular bull market that continued all the way to late 1999. Since then we have been in a broad consolidation. So, not surprisingly, the 7-year cycle, while still there, led to briefer and, in the case of 1993, shallower drops during the overwhelming strength of the underlying secular bull market. During the prior consolidation in the sixties and seventies the drops were deeper, just as they have been since the major top and change in the big cycle in 2000. The underlying upward pressure was not there.

Usually the glitch part of the seven-year cycle lasts close to two years, but it can be shortened by the underlying big cycle. In our current situation that two-year glitch would seem to be a reasonable anticipation. It could easily be a 25% or more decline.

MACD AND RSI

Two indicators that I follow and like are the RSI and MACD. On the chart below we are seeing these two indicators, RSI above the price plot and MACD below it. Everything on this chart is monthly based. This being an **Arms Candlevolume** chart the two seven year periods do not appear to be equidistant because the horizontal axis represents volume not time and trading was heavier in the more recent cycle.

Chart by Stockcharts.com

On the RSI chart I have inserted blue ellipses to mark the extremes, plus and minus, in this indicator. The last three upside extremes were in 2000, 2007 and now. The downside extremes were right on the lows. Similarly I have marked the turning points on the MACD with blue rectangles. So far we do not have a crossover in MACD but the two lines are so high that a crossover seems imminent.

THE ARMS INDEX

Of course, with volume flowing heavily to the up stocks we tend to get overly bullish Arms Index numbers near the top of moves. The chart below of the 55-day shows the extremes. This index looks as though we are already beyond the high.

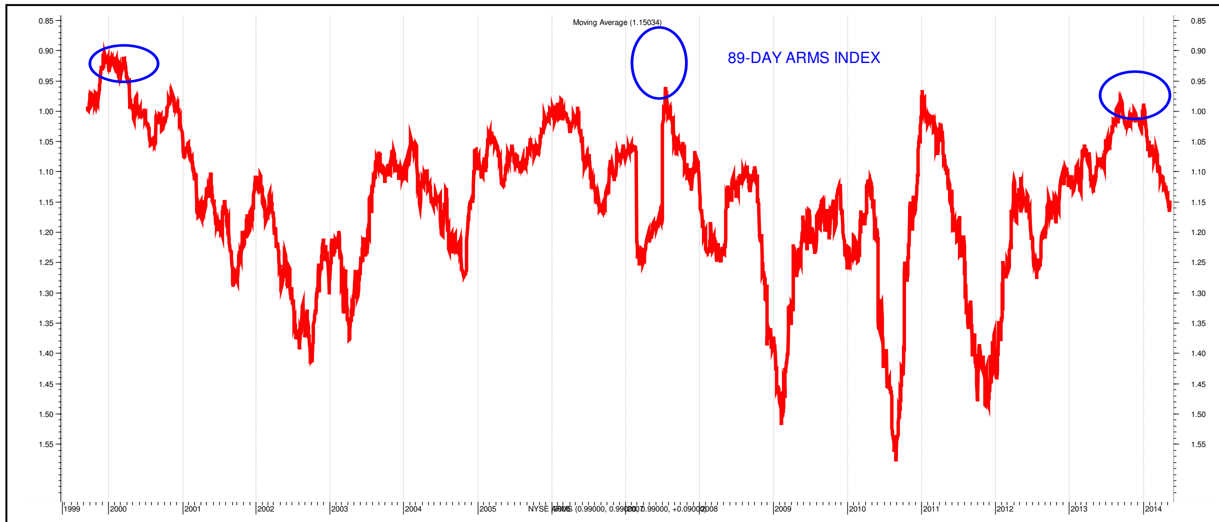


Chart by Metastock

But if we smooth the data more using a 233-day moving average, as below, we get a longer-term picture that appears to give much support the idea of the seven-year glitch.

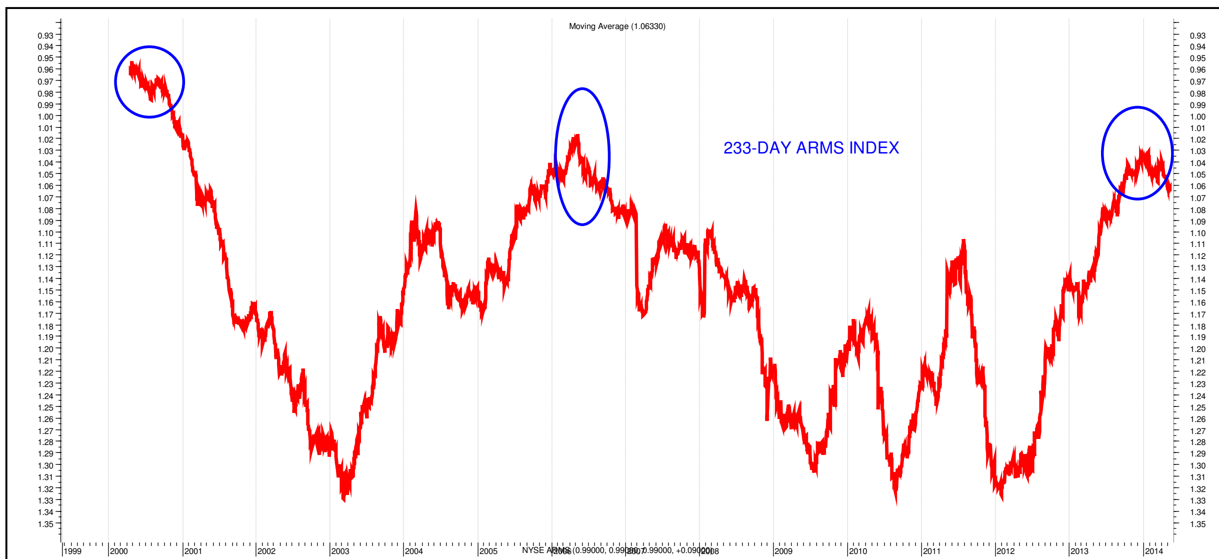
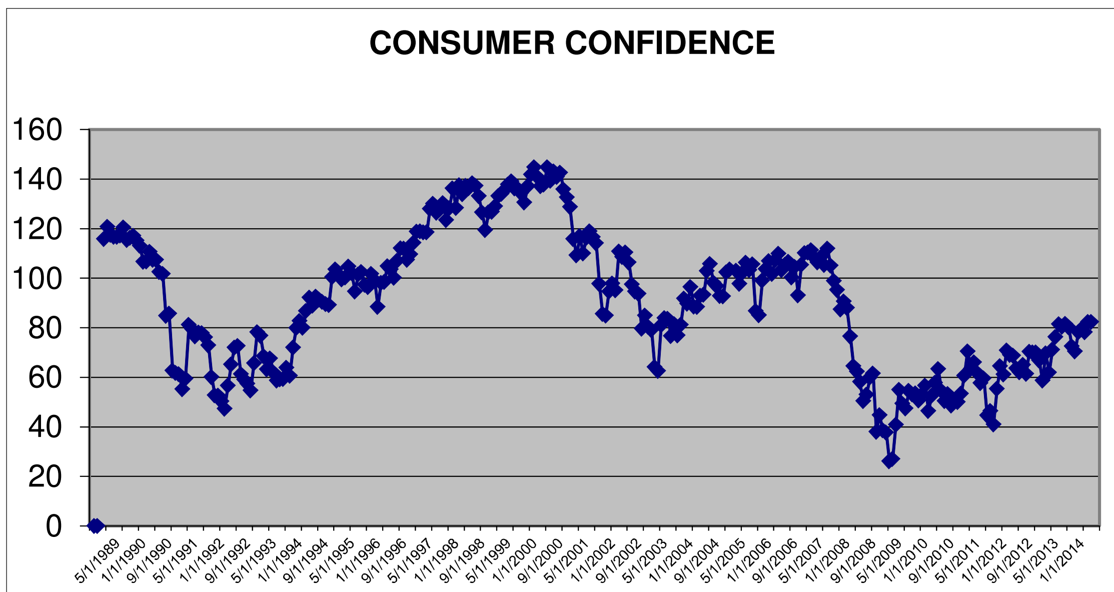


Chart by Metastock

CONSUMER CONFIDENCE

Why is it the media invariably are jubilant when there is a rise in consumer confidence? In reality, the public is always the most confident at just the wrong time, the top, and the most scared at market lows. The chart below shows us the Consumer Confidence Index going back to 1989. Noticed the last two highs in the Index were made in 2000 and 2007. There is no sign yet that it is making a top here, but the rise of the last few years matches closely the prior rise.

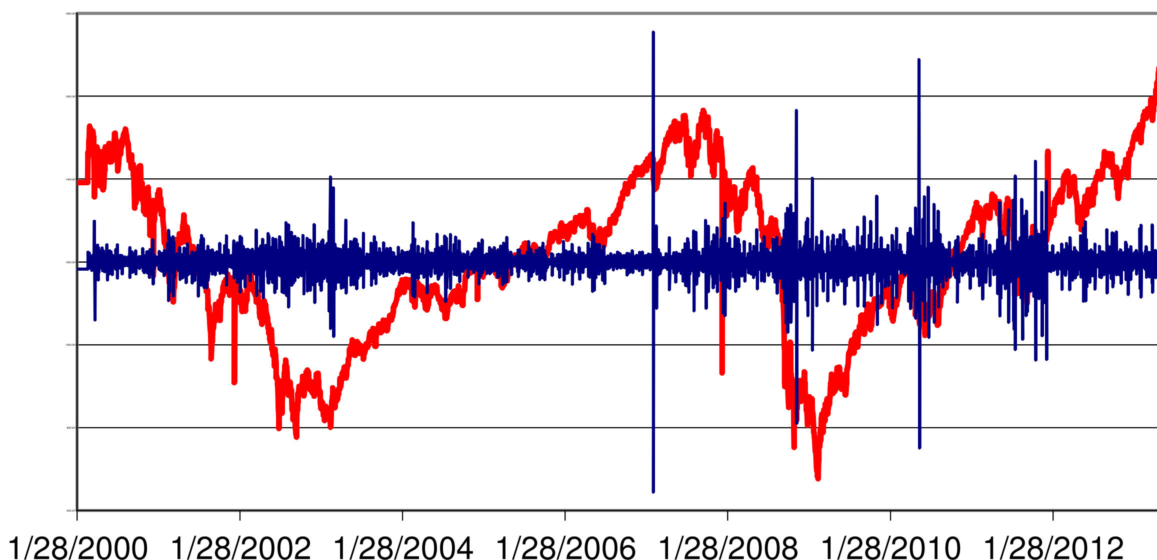


THE VIX

Certainly not a pinpoint indicator, the VIX tell us when there is too much complacency in the markets. Notice on the above chart that we are again at the extremes around 12.00 that were touched in 2007.

MARKET SEISMOGRAPH

An extension of the Arms Index work is the Market Seismograph. On the chart below we see that major earthquakes characterize the lows while the tops are accompanied by a very quiet trace on the Seismograph. Current trading remains very subdued.



SO, ARE WE AT THE TOP NOW?

We are still within the Checkerboard pattern on the **Arms Candlevolume** chart shown below. Until the top or bottom of that pattern is decisively broken with volume and an expanding range, there is little shorter-term information that tells us which way the move will be. The last three sessions have shown enough weakness to produce "red" days, and suggest the breakout will be to the downside. But the long-term work, the "Seven Year Glitch" is telling us the next major move is very likely to be to the downside.