



COLIN NICHOLSON

Building wealth through shares

Email Bulletin No 3

29 December 1999

Is the Stock Market due for a Correction?

The evidence seems to be all around us that the stock market is in the terminal phase of a bull market and I have for some time been warning of the "lateness of the hour" in articles and at my seminar. My primary technical tool for identifying market risk and adjusting my asset allocation to shares is Dow Theory phase analysis. This was outlined by Robert Rhea in his book *The Dow Theory* in 1932 and remains as incisive a tool today as when it was first written. Rhea described the development of bull and bear markets in terms of the phases they most commonly moved through. By identifying which phase we are in at any time, we can adjust our strategy to take advantage of opportunities and protect ourselves against risk, as I teach in my seminars. Bull markets form in three phases. The final phase is called "rampant speculation", an excellent description of what will be happening at that time. It is useful to review some of the evidence which is very plain to see all around us:

- General overvaluation of shares. Price Earnings Ratios are currently high by historical standards at over 23 times at end November. While low interest rates accommodate higher PE ratios, the current level is still high and threatened by inevitable increases in rates as economic managers deal with rising inflation which will be triggered by the GST, rising oil prices and tightening employment.
- The current boom in prices of Internet, communications and technology stocks. Price movements seem to have departed from rationality, jumping by extraordinary amounts, sometimes in a single day.
- Participation of the public in the stock market to an unprecedented extent. Some of this is statistically due to large privatisations, but these are in themselves a marker for over valuation. Governments only sell assets when they can sell them to the public for more than they are worth.
- Great numbers of new companies are being floated. Many of them with dubious prospects and no history of profitable operation. There is a stampede of private investors to get allocations in floats, with few if any bothering with the prospectus. This flood of floats is telling us that the owners of businesses are seeing prices on the stock market that are in excess of what they know their businesses are worth. There is no other rational reason for them to sell part of their equity.
- Speculative mining companies are changing their names and raising new capital. This is always seen in the terminal stage of a boom in this country.
- There is a media orgy in covering markets. The stock market is reported in every TV news, there are TV programs about the markets and trading, newspapers have expanded their financial coverage, new specialised magazines have been launched.
- Brokers are interested in private clients again. There is an incredible volume of advertising and promotion to private investors and blatant encouragement to trade rather than invest.
- Trading systems are being intensively advertised and promoted. Most of these people are telling would-be traders what they want to hear – that trading is easy and an attractive life style.

The evidence is all around us that we are in phase three of a bull market. This does not mean it will end tomorrow, or next week or even next month. No one knows when that will be, though the lunatic fringe will make all sorts of forecasts. However, the answer does not lie in forecasting, but in the way we deal with the elevated risk. This is done by a reduced asset allocation to shares and concentration on defensive situations.

Remember two enduring pieces of stock market lore:

- Professionals buy undervalued stocks at the start of a bull market and sell them to the public at the end of a bull market. Ask yourself whether this is happening now.
- The public are always wrong at the turning points. Join them at your peril.

May 2000 be kind to those of you who managed risk appropriately for the circumstances.

The above article was first written for the ATAA Newsletter January 2000.