

Outside The Beltstreet

February 2005

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Special points of interest:

- Records
- Now and Then, Analogs
- Dow Confirms Sell Signal
- Break a Leg (or an Arm)

When Will it Rain?

Texas is a great state to live in. No state income tax, friendly people (unless your bearish), and warm summers. Sometimes too warm. Over the last 30 years that I've lived in Texas I can remember some hot, dry summers. One summer we had 100 consecutive days when the temperature was 100^o or more. Another summer it didn't rain one drop (at least in the DFW area) for 90 days. Which brings me to my point. If it didn't rain for 90 days, did that make it more likely or less likely that it would rain the next day? Perhaps, it is conceivable that dry weather today could absorb the moisture in the air and prevent a possible small sprinkle from developing. Ultimately however, whether it rained or not had nothing to do with yesterday. You see, something far bigger was taking place. Fall (and winter) was coming. This old Earth was tilting backwards on it's axis, which meant we were in for colder weather, and yes, eventually rain.

I can't help but see how this applies to today's markets. Because they didn't go down today, does that mean that they are unlikely to go down tomorrow. Again, when looking at the momentum of the next day or two, the answer could be yes. But eventually momentum wanes, and gives way to the bigger things that are going on in our markets and economy. I cannot go into the details of all our current circumstance, or this newsletter would quickly become a novel. Some of our woes include **record** government deficits, **record** trade deficits, **record** government and corporate debt, **record** low consumer savings levels, **record** consumer debt, employment numbers (over half of which are attributable to the "net birth/death ratio) that consistently come in below analyst expectations. With all the market hype these days its easy to see how we've forgotten that the markets are a reflection of the health of our economy. Usually the market is a leading indicator, but at times of great mania or fear the market can become a coincidental or even a lagging indicator. As noted above, our economy is currently unhealthy and this will eventually show up in our stock and bond markets.

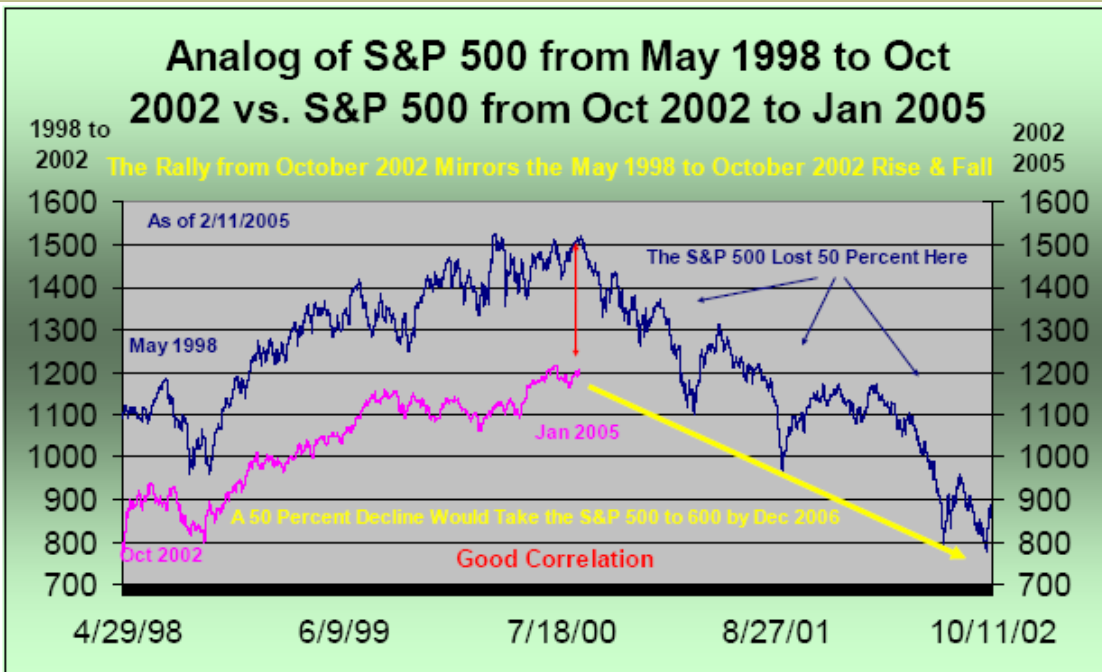
In fact to some extent, the markets have already shown signs of what is to come. Consider the following on the next page.

History Rhymes

We've all heard it said that "history repeats itself." From the look of these next few charts, it would appear that history doesn't repeat itself exactly, but it often rhymes.

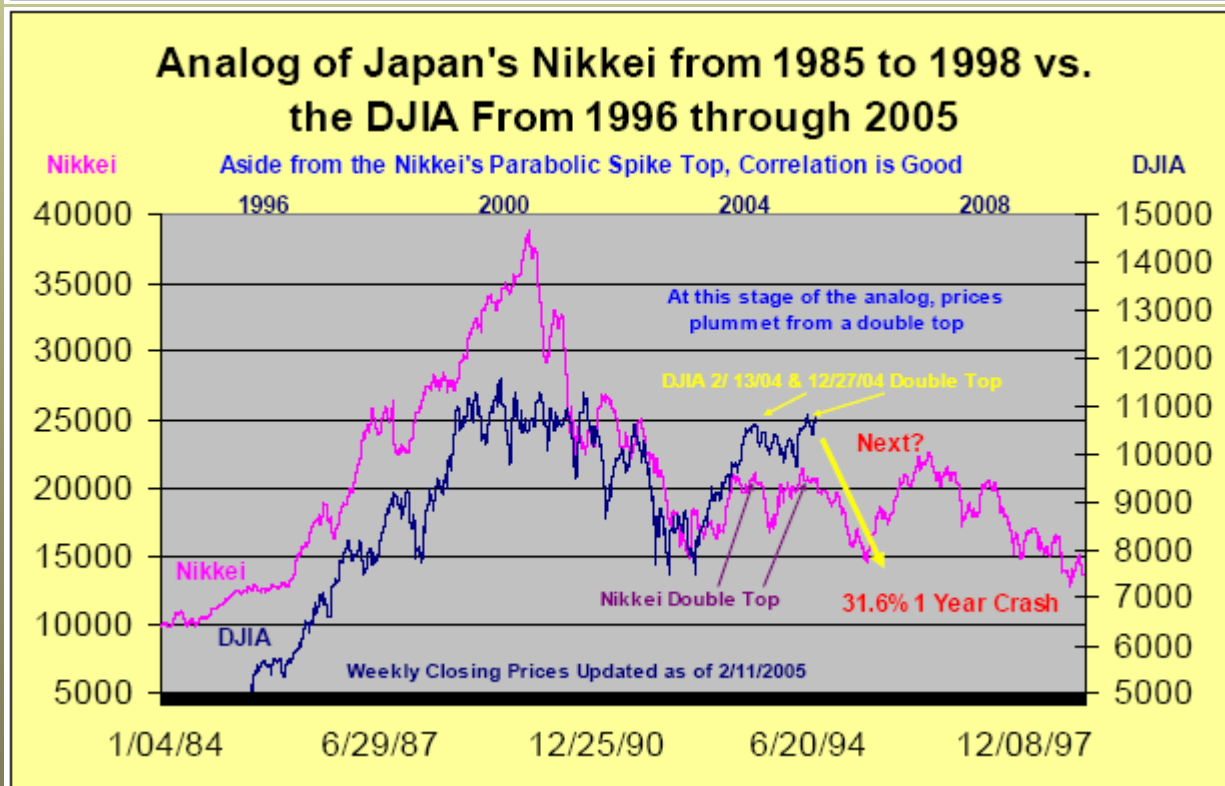
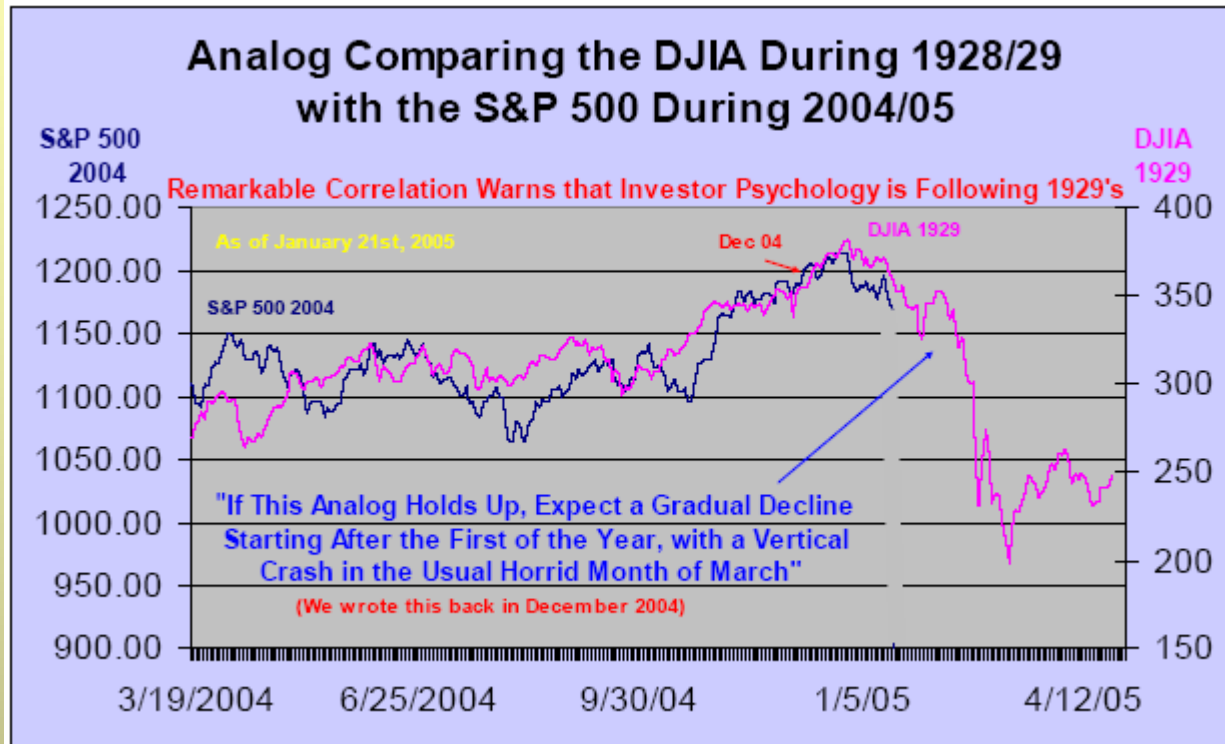


The analog to the right (courtesy of Robert McHugh of Main Line Investors, Inc. www.technicalindicatorindex.com) compares the Dow from 2000 to 2005 with the Dow from the 1929 to 1936 and 1968 to 1975 averaged together.



This analog compares the S&P500 at two different time periods. Analogs are an indicator of investor sentiment. They are useful to show how the markets reacted in the past, and therefore, how they might respond in the future.

More Analogs



Dow Theory Revisited:

The Dow Theory sent a sell signal on January 21st, 2005.

Dow Theory also called for a sell on October 25th, 1929, just four days prior to Black Tuesday and the beginning of the Great Depression. Dow Theory called the tops in 1937 and in 1966, and 1987. As noted in the last newsletter, Dow Theory also sent a sell signal in February 2000. Dows Theory was also used to call significant market bottoms in 1932, 1942, 1949 (after a top in 1946), 1952, and in 1974. Had you (and perhaps your ancestors) traded according to Dow Theory over the last 103 years, you would have made 10 times as much money as a buy and hold strategy over the same time period.

Dow Theory is the oldest technical trading system. It was discovered by it's namesake, Charles Dow, who also created the averages that bear his name and was once the editor of the Wall Street Journal. He gave top priority to valuations and emphasized economic conditions and the various stages of bull and bear markets. As well, he noted the importance of the confirmation or non-confirmation of the Dow Jones Industrial Average (DJIA) and Dow Jones Transportation Average (DJTA).

Here's how this works. In a healthy economy (and therefore stock market) both the DJIA and DJTA should rise in sync (called a confirmation). In an unhealthy economy, both would fall in sync (still a confirmation). When the DJIA and DJTA move in opposite directions (called a non-confirmation), this signals a change in the primary direction of the markets. The DJIA topped in January of 2000 at 11,722. Since then, though the DJTA has set newer highs, the DJIA has not. This is a non-confirmation and signals a change in direction. In this case it is a bearish (sell) signal.

The DJTA closed below it's December 2004 low of 3669 on January 5th, 2005 at a level of 3653. On January 21st of 2005 the DJIA joined the Transports and closed below it's December 2004 low of 10,440 at 10,368. This is a confirmation to the down side and constitutes a Dow Theory sell signal. Again, this is bearish.

Since then, the DJIA has recovered to about the 10,800 level, while the DJTA has remained below it's December 2004 lows. Another interpretation of the Dow Theory signals, suggest waiting for a re-confirmation of the initial sell signal. Should the DJIA fall below it's January 2005 low of 10,368 and the DJTA again close below it's January low of 3435, that would constitute a strong sell signal.

Will it rain tomorrow? We don't know. Will it rain next month? Again, we don't know. If nothing else, these signals tell us we are however, getting closer to the day when it will rain.

Feel free to send any question you may have to: doug@genadv.com

Contrarian Investing: A User's Guide

There is strong evidence to suggest that real pain and social pain are felt in exactly the same places in the brain. In one study, participants play a computer game. Players think they are playing in a three way game with two other players, throwing a ball back and forth.

In fact, the two other players are computer controlled. After a period of three way play, the two other 'players' began to exclude the participant by throwing the ball back and forth between themselves. This social exclusion generates activity in the exact same places of the brain that is activated by real physical pain.

Contrarian strategies are the investment equivalent of social pain. In order to implement such a strategy you will buy the things that everyone else is selling, and sell the stocks that everyone else is buying. This is social pain. The above results suggest that **following such a strategy is really like having your arm broken on a regular basis— not fun!**

"To buy when others are despondently selling and the sell when others are greedily buying requires the greatest fortitude and pays the greatest reward. Sir John Templeton

"It is the long-term investor, he who most promotes the [clients] interest, who will in practice come in for the most criticism...For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion." John Maynard Keynes

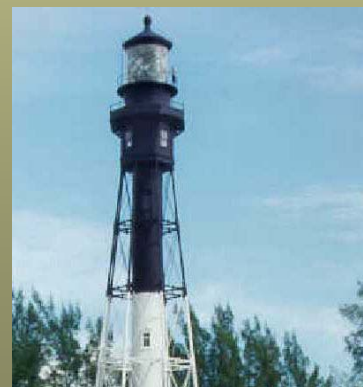
The article above is an excerpt from a January 20th, 2005 Global Equity Strategy report by John Montier titled "Emotion, Neuroscience, and Investing: Investors as Dopamine Addicts." It explores how the hard-wiring of our brain, emotions, herding, and self-control all come into play as we try to make rational decisions about our investments. To this I only add the quote below by an a legend who has overcome emotional investing.

"I'm having a hard time finding things to buy, if that says anything about the market."
Warren Buffett, January 19th, 2005

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