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Dow Theory Part 2

Market Movements

Dow and Hamilton identified three types of price movements for the Dow Jones Industrial and Rail averages: primary movements, secondary movements and daily fluctuations. Primary moves last from a few months to many years and represent the broad underlying trend of the market. Secondary (or reaction) movements last from a few weeks to a few months and move counter to the primary trend. Daily fluctuations can move with or against the primary trend and last from a few hours to a few days, but usually not more than a week.

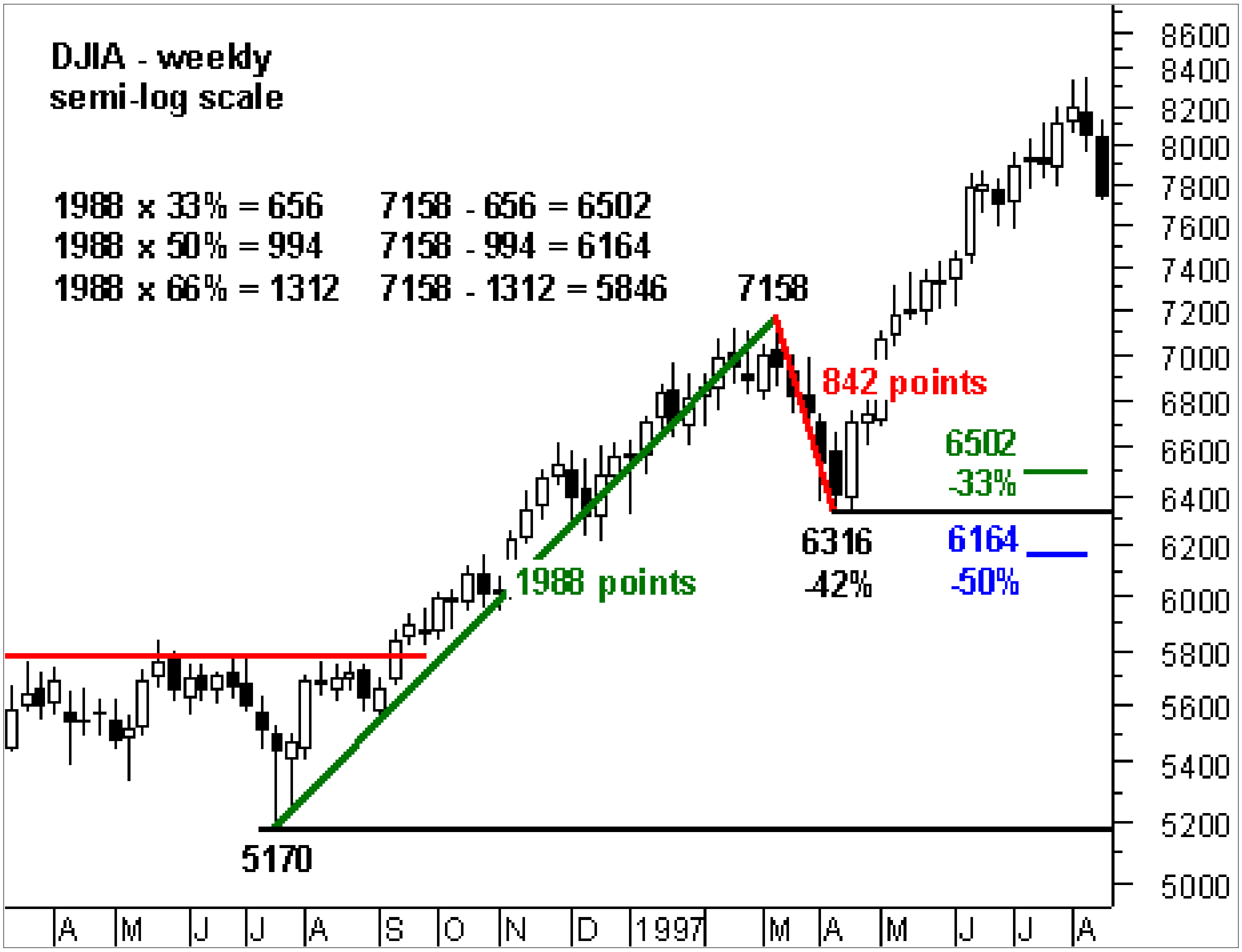
Primary Movements

Primary movements represent the broad underlying trend of the market and can last from a few months to many years. These movements are typically referred to as bull and bear markets. Once the primary trend has been identified, it will remain in effect until proven otherwise. (We will address the methods for identifying the primary trend in Part 3 of this Dow Theory article.) Hamilton believed that the length and the duration of the trend were largely indeterminable. Hamilton did study the averages and came up with some general guidelines for length and duration, but warned against attempting to apply these as rules for forecasting.

Many traders and investors get hung up on price and time targets. The reality of the situation is that nobody knows where and when the primary trend will end. The objective of Dow theory is to utilize what we do know, not to haphazardly guess about what we don't know. Through a set of guidelines, Dow theory enables investors to identify the primary trend and invest accordingly. Trying to predict the length and the duration of the trend is an exercise in futility. Hamilton and Dow were mainly interested in catching the big moves of the primary trend. Success, according to Hamilton and Dow, is measured by the ability to identify the primary trend and stay with it.

Secondary Movements

Secondary movements run counter to the primary trend and are reactionary in nature. In a bull market a secondary move is considered a correction. In a bear market, secondary moves are sometimes called reaction rallies. In part one of the Dow theory, a chart of Coca-Cola is used to illustrate reaction rallies (or secondary movements) within the confines of a primary bear trend. Below is a chart illustrating a correction within the confines of a primary bull trend.

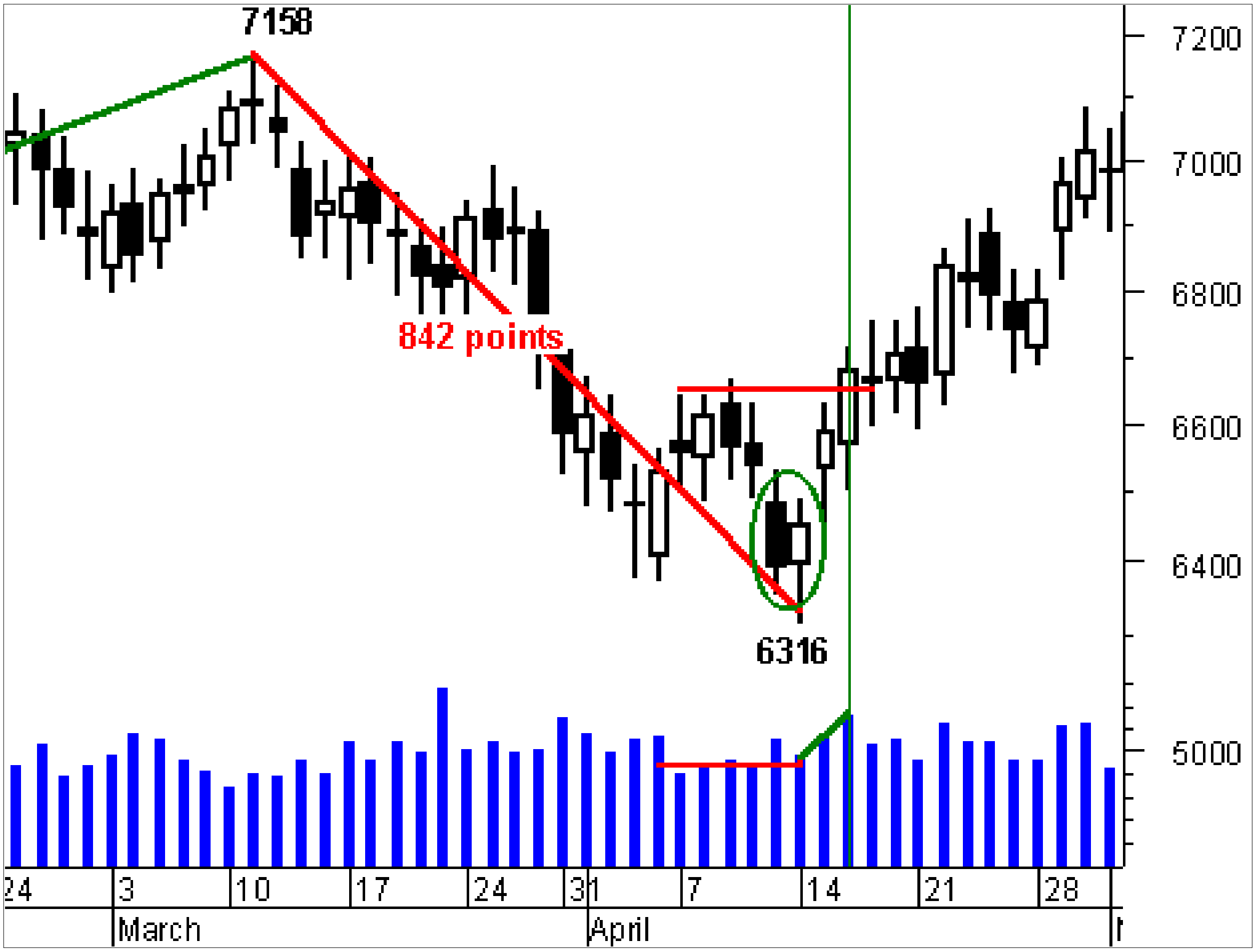


In Sept-96, the DJIA recorded a new high, thereby establishing the primary trend as bullish. From trough to peak, the primary advance rose 1988 points. During the advance from Sept-96 to Mar-97, the DJIA never declined for more than two consecutive weeks. By the end of March, after three consecutive weeks of decline, it became apparent that this move was not in the category of daily fluctuations and could be considered a secondary move. Hamilton noted some characteristics that were common to many secondary moves in both bull and bear markets. These characteristics should not be construed as rules, but rather as loose guidelines to be used in conjunction with other analysis techniques. The first three characteristics have been applied to the example above.

1. Based on historical observation, Hamilton estimated that secondary movements retrace 1/3 to 2/3 of the primary move, with 50% being the typical amount. In actuality, the secondary move in early 1997 retraced about 42% of the primary move. (7158 - 5170 = 1988; 7158 - 6316 = 842, 842/1988 = 42.35%).

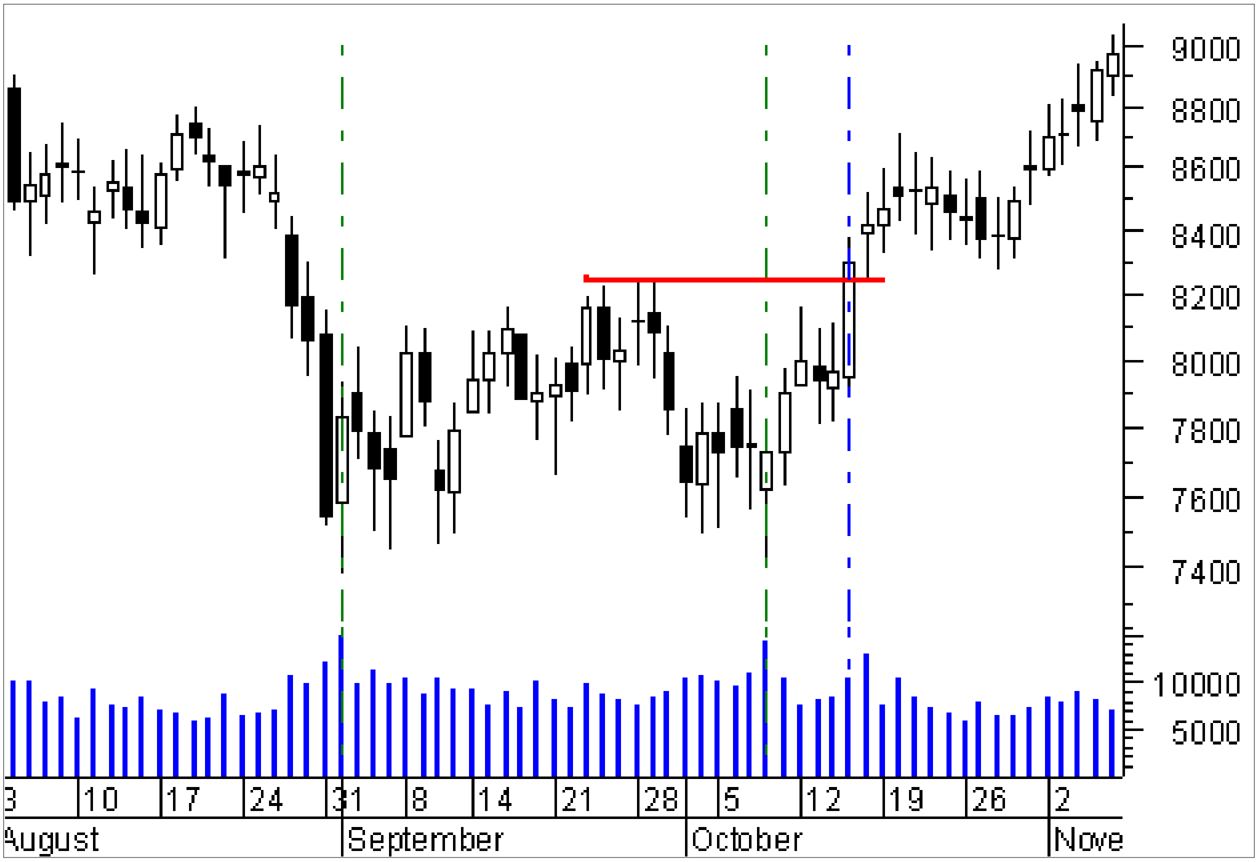
2. Hamilton also noted that secondary moves tend to be faster and sharper than the preceding primary move. Just with a visual comparison, we can see that the secondary move was sharper that the preceding primary advance. The primary move advanced 38% (1988/5178 = 38%) and lasted from Jul-96 to Mar-97, about 8 months. The secondary move witnessed a correction of 11.7% (842/7158 = 11.7%) and lasted a mere five weeks.

3. At the end of the secondary move, there is usually a dull period just before the turnaround. Little price movement, a decline in volume, or a combination of the two can mark this dullness. Below is a daily chart focusing on the Apr-97 low for the secondary move outlined above.



April 7 through 10 marked the dull point (red line on volume). There was little price movement and volume was the lowest since the decline began. The DJIA then gapped down on an increase in volume. After the down gap, there was a reversal day and then the DJIA proceeded with a gap up and breakout to a reaction high on increasing volume (green line on volume). The new reaction high combined with the increase in volume indicated that the secondary move was over and the primary trend had resumed.

4. Lows are sometimes accompanied by a high-volume washout day. The September/October lows in 1998 were accompanied by record volume levels. At the time, the low on Sept-1 witnessed the highest volume ever recorded and the Oct-8 low recorded the second highest volume ever. Although these high-volume lows were not a signal in and of themselves, they helped form a pattern that preceded a historical advance. This advance took the DJIA from below 8000 to over 11000 in less than one year. Further confirmation of a change in trend came in the form of a new reaction high with high volume on Oct-15.



Dow Theory Note: There is still debate as to whether the crash of 1998 was a bear market or merely a secondary move within the confines of a larger bull market. In hindsight, it would appear to be a secondary move. Even though the DJIA recorded a lower low on August 4 and had lost just over 20% by September 4, the two-month time frame makes it difficult to justify as a bear market.

Hamilton characterized secondary moves as a necessary phenomenon to combat excessive speculation. Corrections and counter moves kept speculators in check and added a healthy dose of guesswork to market movements. Because of their complexity and deceptive nature, secondary movements require extra careful study and analysis. Investors often mistake a secondary move for the beginning of a new primary trend. How far does a secondary move have to go before the primary trend is affected? This issue will be addressed in Part 3 of this article, when we analyze the various signals based on Dow theory.

Daily Fluctuations

Daily fluctuations, while important when viewed as a group, can be dangerous and unreliable individually. Due to the randomness of the movements from day to day, the forecasting value of daily fluctuations is limited at best. At worst, too much emphasis on daily fluctuation will lead to forecasting errors and possibly losses. Getting too caught up in the movement of one or two days can lead to hasty decisions that are based on emotion. It is vitally important to keep the whole picture in mind when analyzing daily price movements. Think of the pieces of a puzzle. Individually, a few pieces are meaningless, yet at the same time they are essential to complete the picture. Daily price movements are important, but only when grouped with other days to form a pattern for analysis. Hamilton did not disregard daily fluctuations, quite to the contrary. The study of daily price action can add valuable insight, but only when taken in context of the larger picture. There is little structure in one, two or even three days' worth of price action. However, when a series of days is combined, a structure will start to emerge and analysis becomes better grounded.

The Three Stages of Primary Bull Markets and Primary Bear Markets

Hamilton identified three stages to both primary bull markets and primary bear markets. These stages relate as much to the psychological state of the market as to the movement of prices. A primary bull market is defined as a long sustained advance marked by improving business conditions that elicit increased speculation and demand for stocks. A primary bear market is defined as a long sustained decline marked by deteriorating business conditions and subsequent decrease in demand for stocks. In both primary bull markets and primary bear markets, there will be secondary movements that run counter to the major trend.

Primary Bull Market - Stage 1 - Accumulation
Hamilton noted that the first stage of a bull market was largely indistinguishable from the last reaction rally of a bear market. Pessimism, which was excessive at the end of the bear market, still reigns at the beginning of a bull market. It is a period when the public is out of stocks, the news from corporate America is bad and valuations are usually at historical lows. However, it is at this stage that the so-called "smart money" begins to accumulate stocks. This is the stage of the market when those with patience see value in owning stocks for the long haul. Stocks are cheap, but nobody seems to want them. This is the stage where Warren Buffet stated in the summer of 1974 that now was the time to buy stocks and become rich. Everyone else thought he was crazy.

In the first stage of a bull market, stocks begin to find a bottom and quietly firm up. When the market starts to rise, there is widespread disbelief that a bull market has begun. After the first leg peaks and starts to head back down, the bears come out proclaiming that the bear market is not over. It is at this stage that careful analysis is warranted to determine if the decline is a secondary movement (a correction of the first leg up). If it is a secondary move, then the low forms above the previous low, a quiet period will ensue as the market firms and then an advance will begin. When the previous peak is surpassed, the beginning of the second leg and a primary bull will be confirmed.

Primary Bull Market - Stage 2 - Big Move
The second stage of a primary bull market is usually the longest, and sees the largest advance in prices. It is a period marked by improving business conditions and increased valuations in stocks. Earnings begin to rise again and confidence starts to mend. This is considered the easiest stage to make money as participation is broad and the trend followers begin to participate.

Primary Bull Market - Stage 3 - Excess The third stage of a primary bull market is marked by excessive speculation and the appearance of inflationary pressures. (Dow formed these theorems about 100 years ago, but this scenario is certainly familiar.) During the third and final stage, the public is fully involved in the market, valuations are excessive and confidence is extraordinarily high. This is the mirror image to the first stage of the bull market. A Wall Street axiom: When the taxi cab drivers begin to offer tips, the top cannot be far off.

Primary Bear Market - Stage 1 - Distribution
Just as accumulation is the hallmark of the first stage of a primary bull market, distribution marks the beginning of a bear market. As the "smart money" begins to realize that business conditions are not quite as good as once thought, they start to sell stocks. The public is still involved in the market at this stage and become willing buyers. There is little in the headlines to indicate a bear market is at hand and general business conditions remain good. However, stocks begin to lose a bit of their luster and the decline begins to take hold.

While the market declines, there is little belief that a bear market has started and most forecasters remain bullish. After a moderate decline, there is a reaction rally (secondary move) that retraces a portion of the decline. Hamilton noted that reaction rallies during bear markets were quite swift and sharp. As with his analysis of secondary moves in general, Hamilton noted that a large percentage of the losses would be recouped in a matter of days or perhaps weeks. This quick and sudden movement would invigorate the bulls to proclaim the bull market alive and well. However, the reaction high of the secondary move would form and be lower than the previous high. After making a lower high, a break below the previous low would confirm that this was the second stage of a bear market.

Primary Bear Market - Stage 2 - Big Move
As with the primary bull market, stage two of a primary bear market provides the largest move. This is when the trend has been identified as down and business conditions begin to deteriorate. Earnings estimates are reduced, shortfalls occur, profit margins shrink and revenues fall. As business conditions worsen, the sell-off continues.

Primary Bear Market - Stage 3 - Despair
At the top of a primary bull market, hope springs eternal and excess is the order of the day. By the final stage of a bear market, all hope is lost and stocks are frowned upon. Valuations are low, but the selling continues as participants seek to sell no matter what. The news from corporate America is bad, the economic outlook bleak and not a buyer is to be found. The market will continue to decline until all the bad news is fully priced into stocks. Once stocks fully reflect the worst possible outcome, the cycle begins again.

In part 3, we address Dow theory signals and talk about how to identify a change in the primary trend, why the averages must confirm, and how volume comes into play. Also, we address common criticisms of

Dow theory and draw a few of our own conclusions.

Written by Arthur Hill

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