

A Dow Theory Bear Signal

By Randall Ashbourne
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For the first time since September, 1999, a Bear sell signal has been thrown up by new lower Lows being recorded in both the Dow Industrials and the Dow Transports.

Back in October, I introduced the basic concepts of classic Dow Theory which is that the two indices must confirm each other for a rally to be sustainable.

The logic behind the confirmation is quite simple. If the factories (Industrials) and the railroad and trucking companies (Transports) are both moving upwards, the overall economy is in good shape and is growing.

If both indices agree with each other – that is, both of them record new, higher Highs – it is a strong sign that the economy is moving ahead very nicely and the stock market as a whole is in a sustainable, long-term uptrend.

A state of negative divergence exists *when one index does not confirm* the signals from the other.

For example, if the Industrials put in a new High, but this is not confirmed by a new High in the Transports in roughly the same timeframe, it is a signal that something, somewhere is going wrong with the underlying economy.

And again the logic is simple ... the trains and trucks aren't moving as much stuff as the factories are apparently still producing.

If this condition exists, one of the indices is wrong!

Either investors are being too optimistic about the future of industrial production, or they are being unduly pessimistic about the state of the transport industry.

Dow Theory is, first and foremost, about confirmation between the two indices.

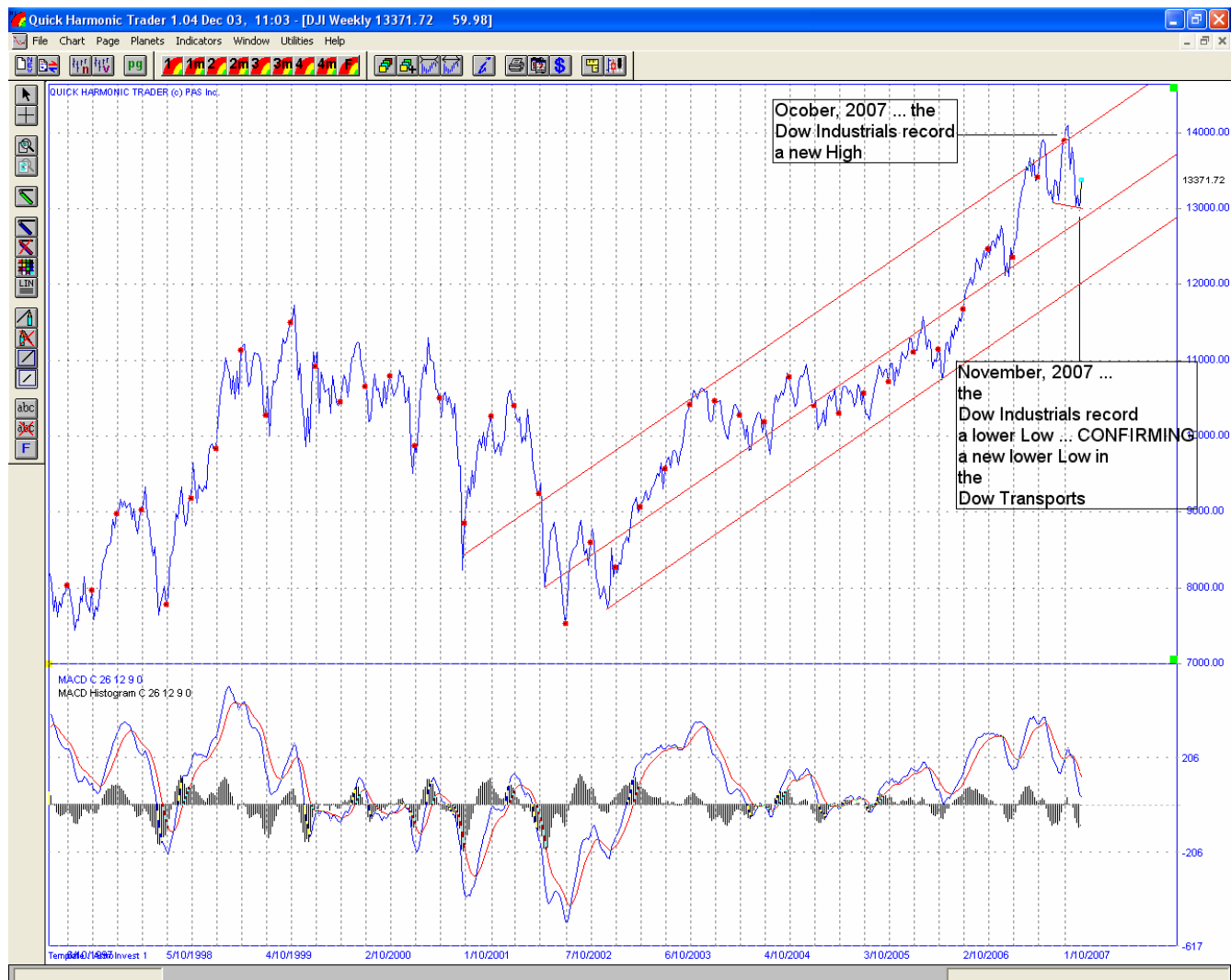
Which is why we now have real cause for caution ... because both the Industrials and the Transports have each recorded lower Lows, in the same general timeframe, for the first time since September, 1999.

The first chart we'll look at is the multi-year weekly view of the DJI. We can see that in October, the Industrials put in a new, all-time High.

If we skip down to the similar period chart of the Transports, we see that this new, higher High was not confirmed by the second index, *which put in a much lower High in October than it did during July.*

The first point is ... this was a classic "non-confirmation" signal. It told us that the October rally in the DJI was not sustainable! It had gone too far. It was too optimistic.

And we know what happened.



Now, the next point about these two charts is that, in both cases, the November Lows are lower than the August Lows.

The difference here is that we have a confirmation signal ... the Industrials and the Transports agree with each other.

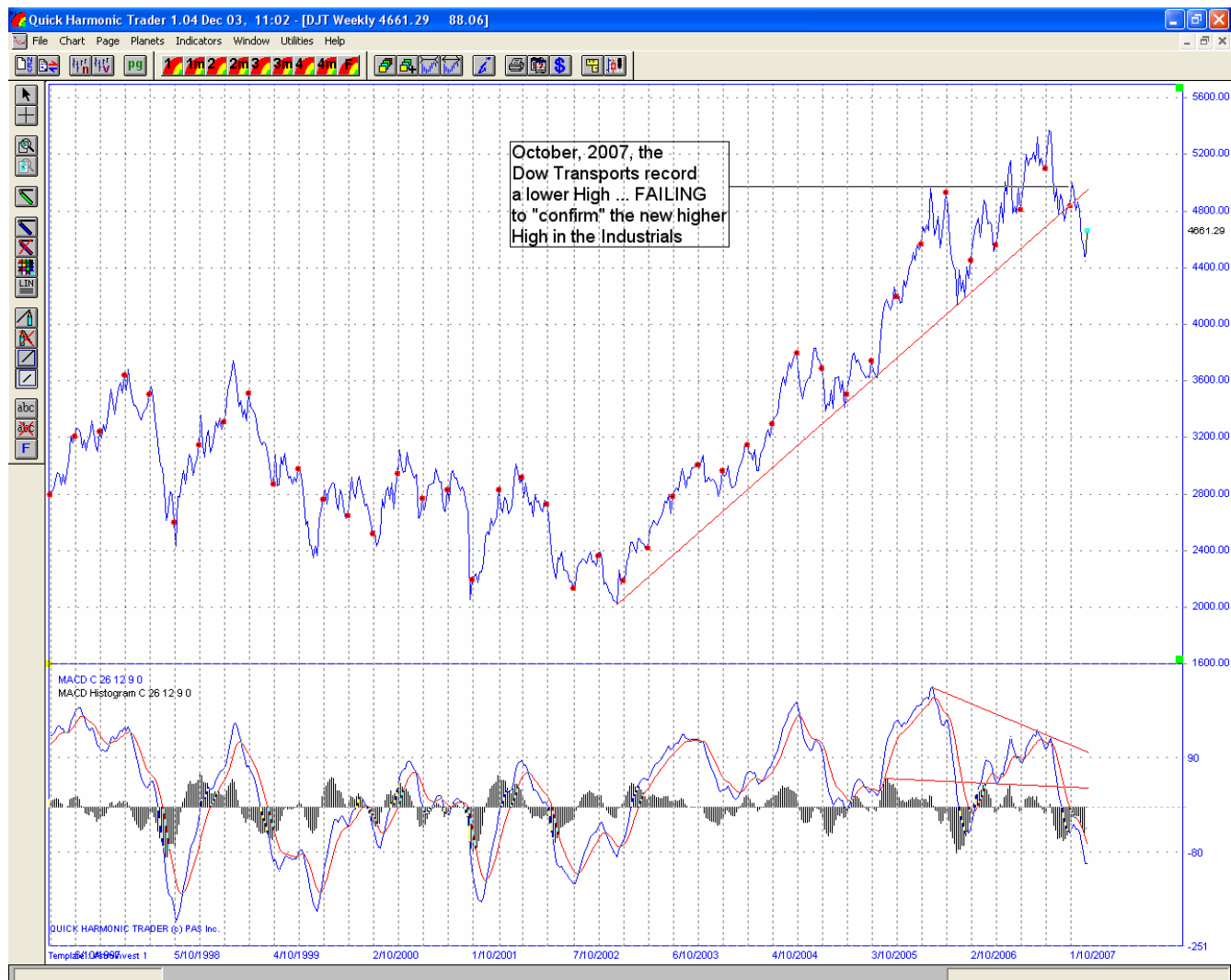
From early to late 2004, the Industrials made a series of lower Highs and lower Lows. Now, lower Highs and Lows are a Bear signal ... they're a downtrend.

But! They were not confirmed by the signals from the Transports. During that time frame, the Transports made a series of *ascending* Lows.

The Industrials were crying "Bear" ... but the Transports were saying "Bull".

In other words, one of the indices was wrong! As it turned out, it was the Industrials ... investors were unduly pessimistic about the state of the factories.

Which brings me back to the point ... we now have, for the first time since September, 1999, a Bear signal from both indices simultaneously.



That makes the months ahead a whole different ballgame from 2004, when only one of them was Bearish.

And it's also a whole lot different from the position where one of them doesn't confirm a new rally High in the other, leading to a short-term correction.

We have both major indices pointing towards the potential for a very significant downturn.

And we should remember that it is a potential ... a warning sign ... not something engraved in stone and handed down from a high place.

After the 1999 signal, the Dow Industrials continued rallying for several months before the Bear came out and started mauling everyone in 2000. In fact, the DJI added another 14% or so before going into long-term crash mode.

If we go back to the Transport chart above, we can see from the MACD peaks that negative divergence had been building between the indicator and the actual price levels since midway through 2006.

But this was not the case with the Industrials. Negative divergence did not appear between the MACD and the DJI price until October's MACD peak came in at a much lower level than it did during July.

And that was a second piece of evidence that the DJI's strong rally out of the August Lows was not sustainable ... too far, too fast.

These two charts also contain other information we will find useful in the weeks ahead as we gather evidence of where the next big move will show itself.

We can see from the Transport chart that price has fallen very decisively through the bottom of its trend line since this long-running Bull started its charge.

That is not the case with the Industrials. Some commentators have been remarking that the DJI has fallen through its long-term trend line.

The trouble is, they're talking about a trend line drawn from the 2006 Lows! *That is not long-term* ... it's a second-tier, intermediate-term trend line!

The real, long-term trend lines are easily seen on the chart of the Industrials and, at this stage, the index isn't even particularly close to breaking its middle-level support trend line, let alone the bottom one.

At this time, the long-term uptrend in the Industrials is completely intact.

Both the breakdown from long-term support in the Transports and the fact that both indices have confirmed each other in a classic Dow Theory Bear signal does, however, indicate the need to exercise extreme caution over the next few months.

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