When Head And Shoulders Above Isn't Good

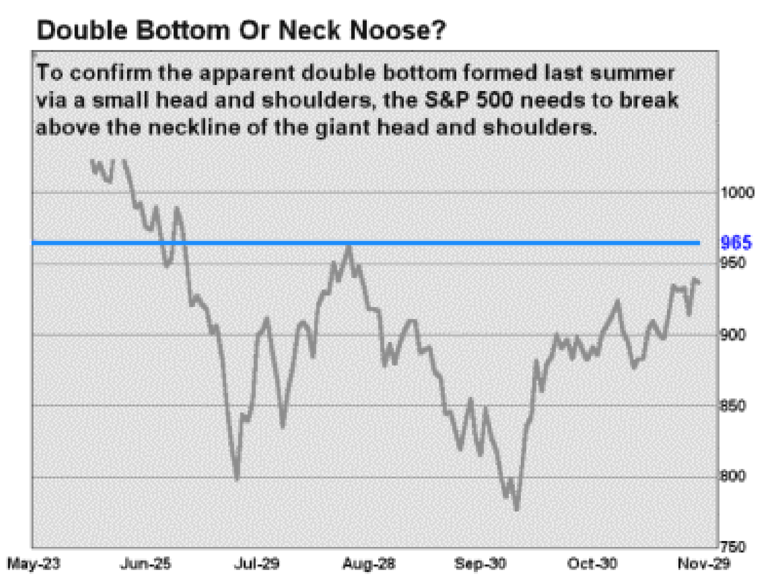
David Simons – Forbes.com – Dec 2, 2002

It should feel better than it does that the Dow is up 18% in eight straight winning weeks--the longest span since early 1998, when the gain was 16%. But there's a hurdle dead ahead: not high, but formidable. Sort of like parking-lot tire slashers.

Between August 1998 and September 2001, each of the major market averages formed what's called a head and shoulders top. The closing prices that mark the neckline on the S&P 500 chart are 960. Classic chart analysis says that because those lows are far apart, they represent serious overhead resistance for rallies. On Friday, the S&P 500 closed at 936.

Even if you think that reading stock charts is Ouija board stuff, the recent symmetry is hard to ignore. Last summer's sharp upswing screeched to a halt at 965 and then shot downward like a 100-mile-per-hour squash ball.

That 965 mark also became the peak of a perfect, smaller head and shoulders pattern, seen below, that formed last summer and ended ugly in October at the price that chart math said it should.



Optimists say the late-autumn rally has created a double bottom, which is a strong base for a long uptrend. But chart reading rules say that will be confirmed only if the market breaks decisively above the August high. The chances of that happening are barely 30%, according to studies of double bottoms by **Thomas N. Bulkowski**, author of the *Encyclopedia of Chart Patterns*. If it doesn't, odds increase that the market is destined for what chart math calculates as the ultimate downside of the giant 1998-2001 head and shoulders--down 57% from where we are today.

That's 400 on the S&P 500 and 3300 on the Dow, last touched in 1992. Like you, my first reaction was "no way!" But the same geometry pegged the downside of the 1970 and 1974 mega-bear markets. (See the graphic detail.)

Head and shoulders patterns precede significant declines at least 80% of the time. That's better than twice the percentage of rallies from double bottoms that break out to new high ground.

The greater the span between the shoulders, the larger the odds that the grim geometry will apply--as it did in the six wider-than-a-year head and shoulders patterns that I found in the Dow, from 1998 back to when it was born in 1896. Those averaged 20 months. The widest, at 26 months, preceded the second half of the 1973-74 bear market--second-worst to the 1929 crash until the current bear, whose head and shoulders top is a record 37 months wide.

There is some hope. As of Nov. 29, the Dow had thrust 5% above its multiyear head and shoulders. But it's still 160 points from the sprint above the August high needed to confirm a double bottom. The Nasdaq, however, beat both bogies by 4%. And a good thing that is, especially for the chartist faith. The head and shoulders math applied to the Nasdaq projects a decline to an impossible minus 2,200.

This is where I switch to fundamentals. I pull out my Discover credit card. The 1% cash back it pays equals the current, average money-market-fund yield. I can make as much spending money as I do saving it; that sums up why stocks have rallied. Cassandras will say that's just a Pollyanna view of the cusp of deflation, and that soon I won't want to buy anything but U.S. Treasuries because everything else will keep getting cheaper.

For now, I prefer Pollyanna. But respect for what the head and shoulders says don't chase stocks. Instead, wait until the markets decisively beat the pattern, or succumb to it, and then follow that direction. That now equates to buying above the 200-day moving average, or selling slightly above the lower 50-day moving average. For the S&P 500, that's 1,000 and 900; for the Dow, it's 9200 and 8300. The Nasdaq numbers are 1500 and 1350.

We should know by January whether the giant head and shoulders deserves a dunce cap or a Darth Vader mask.

Head And Shoulders Chart Math

The projected distance down from the neckline equals the distance between the neckline and the top of the head.