THE NEXT RECESSION — NOT IF, BUT WHEN AND HOW BAD

by

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EDITORIAL NOTE: This is one of the most direct and pointed contributions to JASSA of recent times. The sub-title to the article could well be "Elliott waves for Beginners" or "Taking Non-Swimmers into the Waves". Dr. Len Walker is a Melbourne based consultant and investor with a specialist interest, from a practitioners viewpoint, in the interpretation and interrelationship of economic and technical data and trends. NHC.

It seems only yesterday that the last recession was pronounced finished by the business press. There now appears to have developed a race to become the first to correctly predict the start of the next one, and how severe it might be. This race is being watched with something less than enthusiasm by a Government which appeared to pronounce, less than six months ago, that with sound economic management, recessions could be avoided and an era of continuous growth incorporating a mathematical trilogy could be ushered in. But then a week is a long time in politics, or sport, or...

What is the humble stockbroker or futures trader to make of all the published economic verbiage? With other people's, or even our own money at risk, we have to take *some* view, other than putting our heads in the sand.

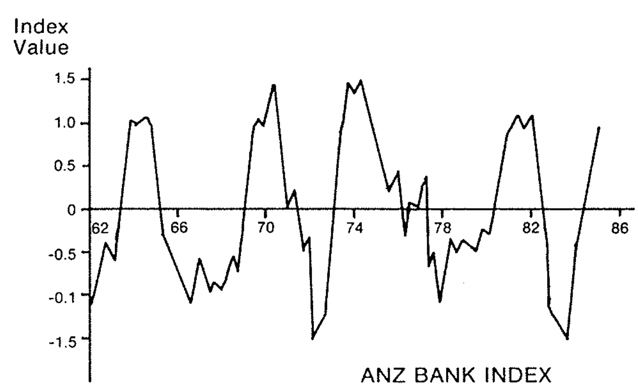
To the rational investor, if there is such an animal, there should be a key starting-off point — look at the facts, form an independent view, *then* start talking and listening. This article discusses means of looking at the facts and forming an independent view. It's really not that difficult, everyone just tries to make it so — sometimes for reasons of self-interest, but usually because of poor communication. Just try talking to a dedicated chartist sometime!

Cycles
(The World Needs Perpetual Optimists But...)

You can't start looking at the facts usefully unless you have a broad frame of reference from which to view the world — a religion if you like, such as most technical analysts are blessed with. The first article of fact, or faith if you prefer, is that business cycles exist, they're real, and they've been around for hundreds of years. Don't be like the politicians and fight their existence. The inevitability of death is accepted by all (eventually), so must the business cycle be.

The business cycle naturally means periods of growth followed by recession. The period and severity of each phase of the cycle varies in some way. Nevertheless, recession is inevitable, however unpalatable. Share prices don't just keep going up. It's not sound practice to only recommend buying shares, and it's certainly shortsighted politics to engender in the community the expectation that standards of living will always improve. The penalty for unbridled optimism can be painful.

So where are we now? A simple study of data such as the ANZ Index of Economic Activity gives a fairly clear indication. The broad ebb and flow of the business cycle is evident in the data reproduced below.



The recent phase of growth is obviously well-established and has some time to run (12-18 months). However it will end as every other period of growth has, and tougher times will return. Just how bad will be discussed later, for now it is sufficient to have roughly located ourselves in a cycle which repeats itself every four or five years. Just imagine if the business cycle could be matched up accurately with the electoral cycle — perpetual one party government!

Impulses and Corrections
(The Law of Give or Take)

In order to advance our understanding of business cycles, let us change the words used. Let's call the growth phase an *impulse* and the recession a *correction.* For reasons unknown to man, but repeated regularly in history, the recession comes to correct what might appear to be impulsive growth rates. Fortunately, in the lifetime of most of us, the long-term general trend has always been up, and the corrections have been bearable, if sometimes economically painful.

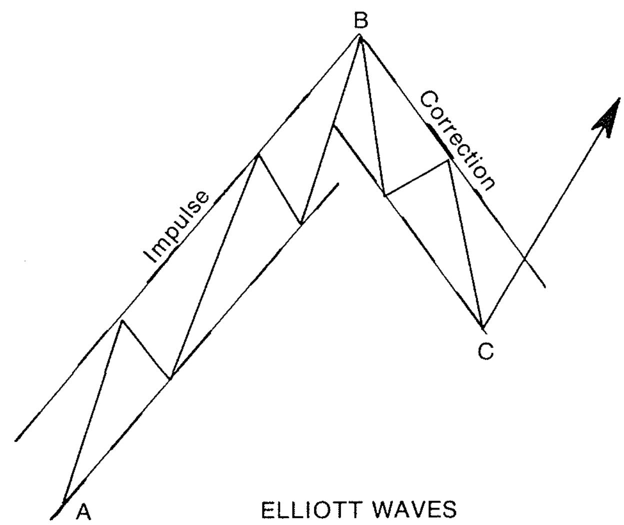
Impulses and corrections can be studied in detail, and they show decidedly different characters, apart from the directions that they take the economy. Impulses are sharp, shortish in time period, and usually highly productive financially for business or investment. Corrections can be sharp, but are more often long drawn-out periods of steady deterioration (as in the last 18-month retreat in the gold price). Studies made of share price movements suggest that impulse movements occupy only 30 per cent of the total time period, with 70 per cent being corrective, i.e. "choppy" trading reacting to quick price movements upwards.

Almost by definition, the term "correction" implies the partial loss (say 50 per cent) of the gains that have been made during the impulse movement. In the 4-5 year business cycle illustrated above, the recession phase or correction causes the loss of part of the economic gains won during the initial growth. Our expectation, however, is always that growth will return to more than offset the effects of the correction. It is at this point that Elliott steps in to tell us "beware"!

Elliott Waves
(Not a Theory, Just Looking at the Facts)

Whatever R.N. Elliott may appear to have been, he was most definitely *not* a brilliant academician. He was a practising accountant/manager who got his fingers burnt during the crash of the early 1930's. He also acquired a debilitating disease while working in South America which obliged him to spend some 5 years at home in Los Angeles recovering. During this time, he obtained and studied variations (yearly, monthly, weekly, daily and even hourly) in the Dow Jones Index from about 1850 to determine rules that governed its behaviour. What he discovered is nothing more than a coldblooded assessment of the facts, despite the more esoteric extensions of his rules into semi-mystical territory. So don't be put off when your Eliott Wave advisor tells you that the All Ordinaries Index is tracing out the C-wave of a 4th wave triangle in the 3rd of the 5th — it's really quite simple!

Elliott saw price movements in terms of impulses and corrections, as for the business cycle discussed above. His impulse waves were subdivided into five waves, and his corrections into three waves, as shown below.



ELLIOTT WAVES

If the time period from A to C was 4-5 years, this would look similar to the business cycle, except that each "leg" is broken down into components. The correction from B to C, is generally about 50 per cent of the rise from A to B.

Now it is not the purpose here to launch into a detailed description of Eliott's rules*, which for most people would be the perfect invitation to switch off and read something else. Elliott's work is introduced for two main reasons;

- to show that it is not so much a theory as a detailed analysis of factual history, now involving over 100 years of data.
- because the cycle ABC can exhibit the same pattern with vastly different time scales.

* *references can be provided on request.*

Take this latter point. If hourly data are plotted, ABC can cover a time period of say 1 week. If annual data are plotted, a similar pattern can be observed covering a time scale of say 50-100 years. Thus, if the growth phase (impulse wave AB) lasts 50 years, the recession (correction wave BC) should last about the same time, and retrace half the growth achieved during AB.

Surely Elliott's warning is clear — look very long-term as part of a broad appreciation, because *at some time* in the future, a generation of children will live through the reverse of past generations, a continuous recession with the occasional "impulse" or growth phase breaking the monotony. What a frightening thought! No politician or businessman would want to accept it, yet Elliott (equals past history) says it's inevitable.

With some trepidation, it must be reported that the acknowledged world leader in Elliott wave interpretation, Robert Prechter, anticipates that late this decade, we should see the end of an impulse wave (AB) interpreted to have been in operation since 1789. The following correction might be expected to last for about 200 years, during which the world would observe a loss of the growth (standard of living?) achieved since perhaps 1900. If this occurred, it would doubtless be attributed to a third world war or an international monetary crisis. Elliott, however, would have concluded that it was merely an expression of Nature's Law, the title of his works.

It is obviously not necessary for everyone to take such a long-term view of the directions of our society. With acceptance of a 4-5 year business cycle, an understanding of the concepts of impulse and correction, and the significance of Elliott's thinking in its broader view, a judgement can be made about our current position in the medium-term trends of the market. It is also possible to put aside the naive view of never-ending growth, and face up to the realities of joint growth and recession, impulse and correction. To have achieved this, even without the intricacies of detailed technical analysis, is to see through much of the mass of published economic prognostication. We might even pronounce the onset of the 200 year recession before the business press!

Investment decisions are of course very specific, such as whether the gold price did really bottom recently. Well that's another story. Let's examine the facts first . . .