POB 88 San Geronimo CA 94963-0088 bassetti@johnmageeta.com www.johnmageeta.com

State of the Markets December 2004

December 28, 2004

Readers of books on trading probably gag when they hear (see Jack Schwager's books on market wizards) trader after trader say that the most important element in trading success is "discipline". Well sometimes you have to gag when you exercise discipline. What is this mysterious discipline? Simply put it is always computing a stop and simply put it is taking the stop even if it means shooting yourself in the head while stepping off a cliff and whistling Dixie. This month the market finished wiping out 9 months of profits in bear positions, taking out our long term stop.

Put us on record as saying this is the biggest bull trap in the history of the market.

Also put us on record as not standing in front of trains. We have reversed and will be looking at the markets with a shorter term focus.

Our long term forecast comes from economic fundamentals. Half trillion dollar deficits (and growing) and an open capital (borrowed) spigot to Iraq, $30B for Star Wars Rockets that won't fly, and burgeoning trade deficits and $2 T (trillion) loans to destroy Social Security... Like Everett Dirksen said, "Half a billion here, half a billion there. After awhile it adds up to real money." What it adds up to is this: 1B (billion) red Chinese swim across the straits and take over Taiwan and when Rummy says you can't do that, Beijing says yes we can we own all your debt so shut up yankee pig. He who owns the gold makes the rules. Mao should have lived so long. He would die laughing. He almost died laughing when he reeled in Nixon. This would put him into near hysteria.

Since the BIG bear market has been postponed it now behooves us to reassess our tactics. With the latest developments (long term signals taken out, Dow Theory flashing reconfirmation of buy signals, a bottoming pattern in the S&P) it seems clear that we have a massive trading range between, at present, about 7200 and 11700. Take out the top at 11700 and Katie bar the door. Professor Hank Pruden (luxuriating in the fleshpots of Europe) is said to have predicted 14400. Also, *pace* Larry Williams who observes that the fifth year of the decade is always an up year. Do we believe it? Didn't we tell you we don't believe anything? We just read the chart. And while this whole thing could be what Wyckoff Analysts call an UTAD, or Up Thrust After Distribution (a useful concept) on a grand scale you have to be masochist enough to be whipped.

Basic Questions

The most basic of all questions is, what kind of market are you in?

$INDU (Dow Jones Industrial Average I)

12/21/2004 2:52 PM EST (5 years, weekly)

Looking at the Dow since 99/00 it seemed to us that the markets of 03 were poised to take back much of the ground gained in the Great Bull of the 90s. Then in fall 03 a Kilroy

Bottom (upside down Head and Shoulders to some) was made and we got back long in late Sept 03 as the neckline (fenceline) was taken out and stayed long pretty much till the bear market of 04 began in Feb and rocked gently along for 9 months. Many of our colleagues (including the illustrious Prechter) predicted major secular bear markets, some of 12 years length). And, although we tend to restrain our predictions to the break of a major trendline and wave highs and lows we tended to agree with them on fundamental grounds. The economic and political recklessness of the prodigal son in the White House, where they subscribe to the dictum that "Reagan proved deficits don't matter", is the attitude of the foolish virgins who spent their substance before the wedding. (Religious fundamentalists, Alert! your correspondents can spin Biblical metaphors.)

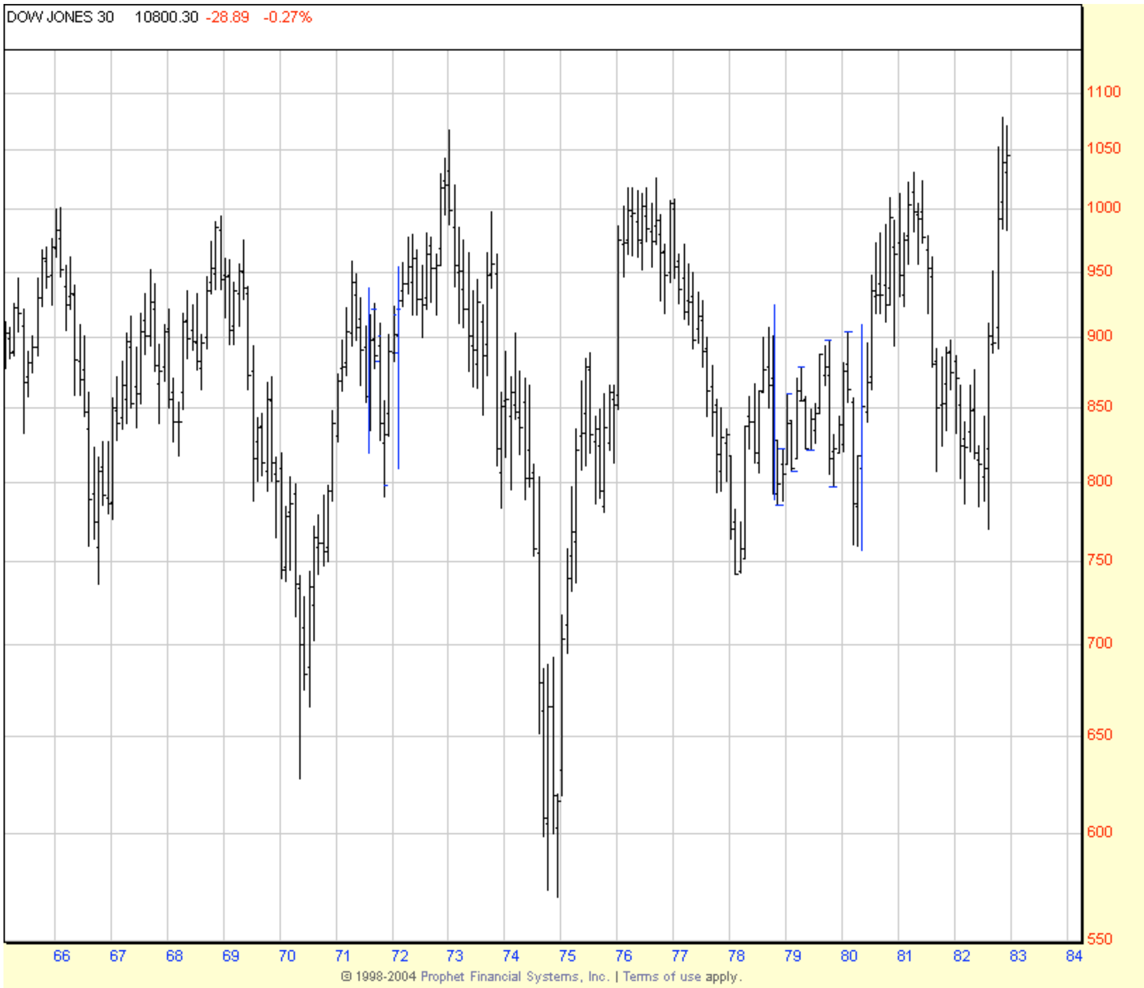
Indeed, deficits don't matter to the idiots (used in the ancient Greek (or Grecian, see I.F. Stone) sense who bother to vote and not vote. (William Safire will know that idiots is not used in a disparaging sense here.) But sooner or later those deficits will come home to roost, and the deficit guano that results will be truly mountainous. We have previously remarked that William Nordhaus an economist at Yale has calculated the indirect economic costs of the Iraq war at $2 T (trillion)–joining a previous estimate of ours made on the back of a napkin.

For the moment reckless tax cuts and war spending are the dominant concern and are hypoing corporate profits, and this combined with the public-purse-be-damned attitude of corporations and the administration drives the market for the present.

Where does this leave us?

On very thin ice, actually. We have remarked many times about the truly enormous catastrophic risk lurking in the market. A successful nuclear explosion in a US port, or even an airliner brought down by a shoulder fired missile would start an avalanche of selling which would not cease for months in the nuclear case. The possibility of attacks like this is so present that we would likely never sell naked puts which sadly deprives us of a favorite tactic.

With the recent taking out of the 04 highs we have the announcement of a different kind of market. It could quite possibly have some resemblance to the Dow of 1965 to 1982. Just in case you don't have your calculator handy, that's 17 years. Remind us. How long was it Moses was in the wilderness?



Dow, 1965-1982

It is quite possible that a bull market in 05 will result. In retrospect (some years from now) the bull market since 03 will be recognized as an enormous bull trap. BUT for Magee Analysts no problem. We will shorten our focus and respond with tighter stops and more targeted trading. In addition, in general we will put up natural hedges against our long positions.

It is our seriously formulated opinion that long term investing over the next several years will be dangerous, if not impossible. Trading will be the order of the day, and getting in position for the avalanche (or, *après moi…)*.

This does not mean that some long term trades might not be possible. We have previously pointed out the 7 year rounding bottom in gold. Now with the GLD instrument trades may be made without the leverage and risks of the futures markets. We have recently made a small commitment to this market, and expect to make further commitments, in line with our practice of scaling into markets. The timing of these buys must be carefully controlled as at present gold is probably at a short term cyclical high.

Gold 10 year chart

So, What's to buy?

No, What's on third, Who's on first. Continuing our policy of wide ranging cultural allusions we honor the Marx brothers and their assertion that gold made good toilet fixtures. It might also make a good portfolio addition, as would silver. The fear can be removed from futures by deleveraging the investment. Instead of 4,000 (or less) to buy a gold contract use 45,000 and put the extra 41,000 into an interest bearing instrument.

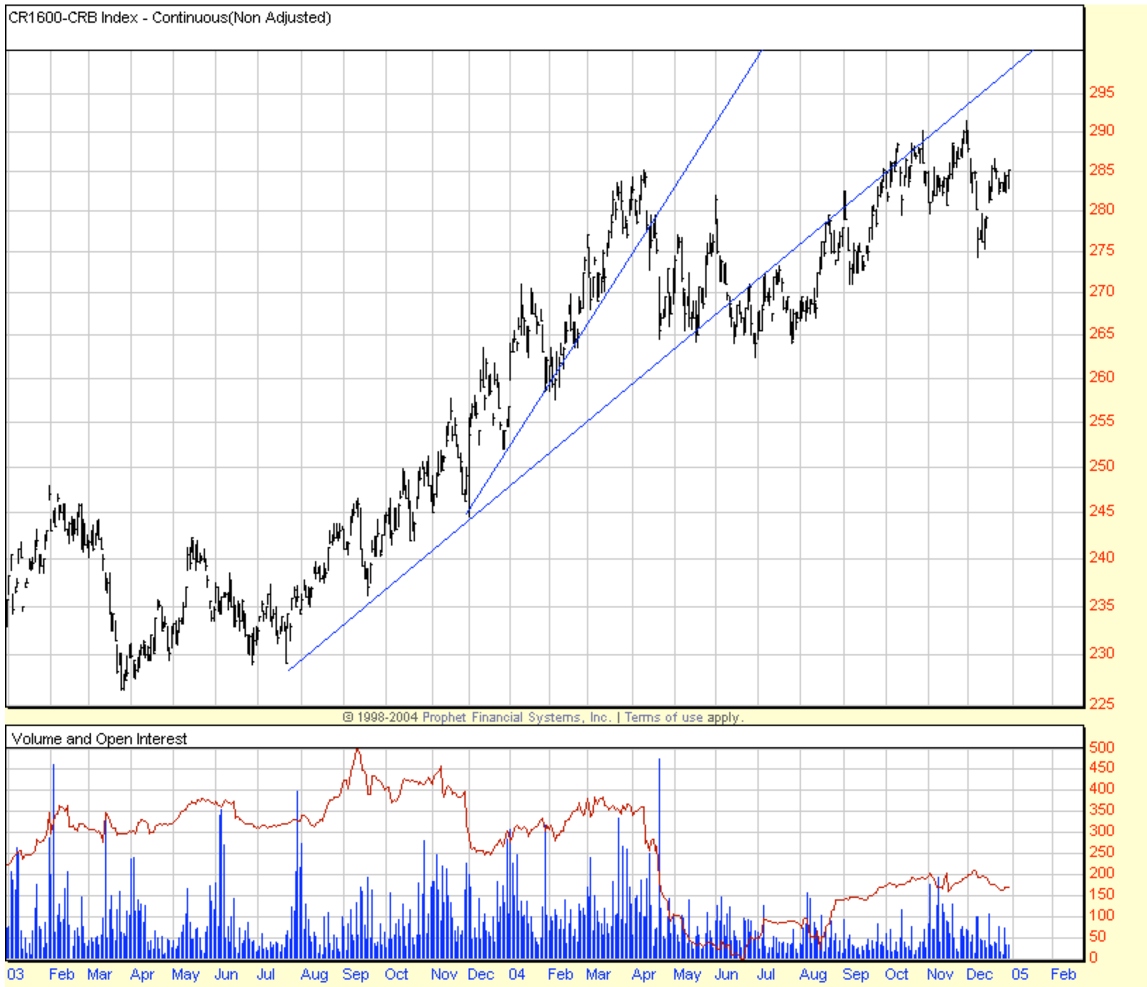
Other contents of the shopping Cart

SPY, DIA, QQQQ all appropriately stopped. DIY clients have our guesses on the stops. We jest. Stops calculated with sweat and blood and sacrifices of small birds. The Transportations can be bought. Canadian Royalty Trusts bought after due diligence we suspect would be good.

So, where's the home run?

No, where's at second. Our suspicion right now is that commodities will be the next big winner. The CRB index might be the way to play it. Also, it should be about time for the dollar to turn. We wouldn't bet against it right now. The huge moves will come in bonds (short) dollar (long) commodities (don't attempt this at home without a professional guide) gold (probably), REITs and real estate issues (short, timing crucial) and of course the stock market will be a huge bear winner (patience and timing required).

CRB index chart. NOTE. NOT FOR THE INEXPERIENCED



Dollar Index

A contrarian play right now. But the way the news is going it's about time to take a flyer. Conservative traders will wait for the December high to be taken out.

As time goes on we will be publishing analyses of these markets which will be included in our annual subscriber's benefits.