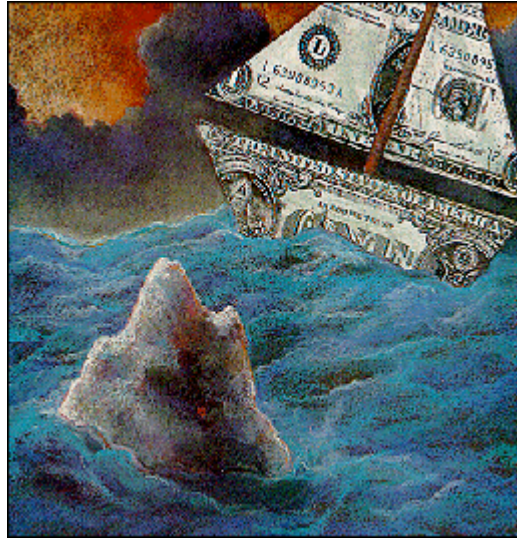


Patterns that detect stock market reversals

by *Bill Ohama and Melanie Bowman*



Full-speed ahead on its maiden voyage and presumably protected against disaster, the Titanic sank in the chilly North Atlantic Ocean, shattered by an undetected iceberg. In the stock market, another kind of iceberg awaits at every major market top and has carried unsuspecting traders to similar ruin at least a half dozen times in the past 22 years.

When I noticed this phenomenon in the fall of 1965, after studying the records of the Dow Jones Industrial Average (DJIA) May 1965 major top and June 1965 low, I coined it the Titanic Syndrome. A close friend, a graduate of Caltech, told me at the time that the odds against the Titanic Syndrome repeating itself again and again were astronomical. Since then, it has proven itself to be a consistently accurate warning of every all-time high.

The Titanic Syndrome is deceptively simple. Two statistics, printed daily in the financial press, tell you whether the iceberg will wreak disaster. You know you are on board the Titanic when the DJIA hits an all-time high for the year or rallies 400 points and—within seven trading days, before or after this DJIA high—the number of yearly lows on the New York Stock Exchange Composite Index (NYSE) exceeds the number of yearly highs. (The NYSE defines yearly as the past 52 weeks.)

This excess of NYSE lows is the iceberg that presents grave danger to any trader who blindly believes the new DJIA high, based on 30 industrial stocks, will lead to higher prices throughout the market. After the Titanic Syndrome has appeared, the DJIA may rally slightly above its top, but the other averages, especially the Dow Jones Utility Average (DJUA), do not make new highs. It is all but certain these averages and indices are peaking and ready to drop.

Usually after the Titanic Syndrome, all major averages/ indices will drop at least 10% from their highs. The Syndrome not only warned of the October 19, 1987 stock market crash, but also the significant market retreats from all-time highs in July 1983, April 1976, January 1973, February 1966 and May 1965 (Figure 1). In each case, the NYSE's new lows exceeded new highs within seven days of the DJIA's new

high.

Actually, the Titanic Syndrome is one very accurate warning signal in a series of patterns that detect stock market tops and bottoms early enough to trade on the information. The entire system can be typed on one sheet of paper and, like the Titanic Syndrome, none of the patterns requires extensive recordkeeping. They are instantly recognizable from any five-day stock market summary that includes DJIA and NYSE activity plus daily price charts of the popular market averages and indices. I find that *The Los Angeles Times* business page and *The Wall Street Journal* supply all the data I need.

Third dimension

In addition to the Titanic Syndrome, a major tenet of my stock market analysis is what I call the 3-D concept, a chart pattern that occurs at both tops and bottoms, major and minor, in the stock and commodity markets for weekly, monthly or yearly time periods. I developed the 3-D concept in 1969 while researching commodity price movements. Again, it is such a deceptively simple tool that brokers, bankers, insurers and chartists have cast doubt on its validity. Yet, with the 3-D concept I can get in or out of the stock market within a week of its ultimate top or bottom because the 3-D concept detects the reversal *as it is actually occurring*.

The 3-D concept is based on the time-tested theory of divergence established in the late 1800s by Charles Dow and popularized by the Dow Theory. Divergence is simply the failure of one price pattern to mimic other price patterns in the same or related markets (Figure 2). Thus, the 3-D concept adds the third dimension of divergence to the normal two-dimensional, price-time chart analysis for stocks as well as commodities.

In a nutshell, the 3-D concept signals that a market top or bottom is forming when the price movements of *any two* popular stock market averages/indices or any two spot/futures contracts related to these averages/indices do not make new highs or new lows at roughly the same time. That is, they diverge.

For example, a 3-D top forms when one or more averages/ indices fail to make new highs as other averages/indices make new highs. This divergence is warning you that the market may be dropping soon and it's time to sell issues in the group that did not make a new high (i.e., sell utility stocks if the DJUA did not make a new high) and place stops above the previous high.

Similarly, 3-D bases are created when one or more averages/indices fail to make new lows while other averages/ indices make new lows. This signals that the market should be rising and it's time to buy issues represented by the average that did not make the new low and place stops below the previous low.

I put the greatest emphasis on 3-D signals from the DJIA, DJUA and the Value Line Index . Value Line gives me a broad market comparison to the Dow averages. The utilities average has a very close relationship to bonds and interest rates, and the failure of utilities to match the rise of industrials indicates a shortage of long-term financing and a weakness in long-term bonds. This, in turn, indicates a shortage of capital for stock purchases and an imminent decline in stock prices. At almost every market top, the utilities average has peaked before the industrials.

I find that divergences between any two cash or futures contracts in the debt market, such as T-bonds vs. T-bills, are equally significant because they are related to the amount of investment capital available to the stock market. This very same divergence occurred from October 15, 1987, when T-bill futures made their lows, until October 19, when T-bond futures made their lows.

In addition, I monitor the Dow Jones Transportation Average, Standard & Poor's 500 Index, the New York Stock Exchange Composite Index, Major Market Index, a number of other widely published averages and indices plus all related futures. Divergences among any two of these would constitute a 3-D top or base.

Confirmation

In cases where the market is topping out, the Titanic Syndrome and 3-D divergences are quite reliable. Usually, as the stock market peaks, you can expect to see 3-D divergences before any other signal. At times, though, the DJIA will make a new high before the 3-D top is obvious and this high should alert you to look for the Titanic syndrome's telltale excess of NYSE lows.

The tougher call is at market bottoms where the Titanic Syndrome never appears and the 3-D base may not occur. In the absence of these patterns, a 10% drop in the market *always* is the warning to look for reversal patterns.

I confirm any of these initial signals—the Titanic Syndrome, 3-D divergences or a 10% market drop with the patterns in [Figure 3](#) which are based on the number of NYSE advances and declines, NYSE new highs and new lows, closing prices and the outside day chart pattern ([Figure 4](#)). The confirmation signals appear in various combinations in different markets. You may see one or more of them at a top or a bottom.

Different confirmation patterns also take longer to develop than others. Like other traders who are quite comfortable with the "feel" of their systems, I usually take a position when I detect the first confirmation pattern. This means that I rely heavily on 3-D tops and bases, the Titanic Syndrome when the market is at an all-time high, and advance/decline patterns.

For those who require *absolute* assurance that an uptrending stock market is reversing direction (or as close to absolute as technical analysis can provide), the minimum combination of confirmation signals is:

- two consecutive days where the number of declining stocks is over 1,000 *and* one of those days shows a 1:4 advance/decline ratio, and/or 4 out of 7 days in which the number of declining stocks on the NYSE is over 1000;

The first half of the Titanic Syndrome appeared on August 25, the day the Dow Industrial reached its all-time high.

- five consecutively lower closes on an average (I use the DJIA);
- a total of five days in which the number of yearly NYSE new lows on each day is greater than new highs.

In a declining market that is about to bottom, the 3-D base may or may not appear. That is why any time an average's or index's lowest intraday low has dropped 10% from its highest intraday high over any time period, I begin looking for signals that the trend is bottoming out. For *complete* assurance that a reversal is under way, I require at least:

- two consecutive days where the number of advancing stocks is over 1,000 *and* one of those days shows a 4:1 advance/decline ratio, and/or 4 out of 7 days in which the number of advancing stocks on

the NYSE is over 1,000;

- five consecutively higher closes on an average (I use the DJIA);
- a total of five days in which the number of yearly NYSE new highs on each day is greater than new lows.

Also, prior to these patterns for a bottom, I usually see an oversold pattern—the NYSE advance/decline ratio at 1:9 or greater.

Case histories

I began my study of the Titanic Syndrome with the 1965 stock market. The DJIA had reached an all-time high of 939 on May 14, 1965 (Figure 5). Four business days later, on May 21, the second half of what was to become the Titanic Syndrome appeared when more stocks on the NYSE made new yearly lows than new yearly highs. The stock market apparently was forming a major top. On June 2, the NYSE advance/decline ratio hit 1:5 (196/1000), exceeding what would become the minimum test of 1:4.

The market declined until an amazing trio of extremely strong signals appeared on one day, June 28. These patterns became the foundation of my stock market analysis and have recurred over and over again during the past 23 years.

First in this unusual three-way pattern was a 10% drop in the DJIA from its 939 high to 840. Then, the number of new highs on the NYSE fell to zero and, finally, the number of NYSE advances on June 28 was one-tenth the number of declines.

The 1:10 advance/decline ratio on June 28 meant the market was clearly oversold. In an oversold market, traders who have hung on to their short positions are a bullish influence because they must cover, or buy back, what they sold short. As a result, the DJIA rallied slightly two days later on June 30. The real *coup de grace* was not this rally, but a complete reversal of the NYSE advance/decline ratio that same day.

The market on June 30 switched abruptly from a 1:10 advance/decline ratio on June 28, to a 10:1 ratio that exceeded even the 9:1 ratio that I have found to be the ultimate advance/decline signal that a market has bottomed. These two contrasting advance/decline ratios need not occur at the same time, but they have occurred at many major market bottoms. From that point, the market rose until it hit another all-time high on February 9, 1966.

Closer to our time, as early as August 1987, the 3-D concept, Titanic Syndrome and their confirmation patterns began to forewarn the stock market's slide into the October 19, 1987 crash (Figure 6). The patterns also recognized the October 19 bottom in time to reinvest.

The sequence of patterns began in mid-August with a 3-D divergence—the AMEX and Dow Transportation Average both reached new highs between August 12 and 14 while the Dow Utility closed far below its all-time high. During mid-August, T-bonds also diverged against municipal bonds and Eurodollars.

The first half of the Titanic Syndrome appeared on August 25, the day the Dow Industrial reached its all-time high. It was followed, six trading days later on September 2, by the telltale excess of new lows on the NYSE—the Titanic was about to sink again. Confirmation signals rolled in quickly after that. By September 2, NYSE declines had been over 1,000 for four out of seven days—a strong topping pattern. In the midst of this, on August 28, the NYSE advance/decline ratio was a 1:3, a sign of market weakness

and very close to the 1:4 confirmation signal.

On September 8, two very strong signals appeared simultaneously. The DJIA posted its fifth consecutive day of lower closes. The NYSE recorded its second consecutive day in which declines were over 1,000 and the advance/decline ratio hit 1:6—incontrovertible confirmation of the Titanic Syndrome's warning. During this same time period, the Dow Transportation and the 20 New York Bond averages also had closed down for at least seven days in a row.

The market did not immediately plummet after September 8, however. The 1:6 advance/decline ratio on September 8 was even higher—1:14—on an intraday basis. This temporarily oversold condition gave rise to a brief rally, but the market could only sustain four consecutively higher closes, not the five that are required to offset the earlier five lower closes. The market clearly was on a downhill leg and it was time to concentrate on finding a bottom.

On October 16, the falling market signaled that it was in a selling climax with a NYSE advance/decline ratio of nearly 1:16. If this were not enough, on the next trading day, October 19, the ratio reached an unprecedented level of 1:38.

T-bill futures, which had made their lows on October 15, rallied sharply on the close on October 19 while T-bonds made another lower low on October 19—a perfect divergent face. The patterns gave just enough forewarning to place orders that had some hope of being filled in the mass confusion that ensued, before the recovery had gotten very far.

In the after-crash markets on October 19, however, there was a tremendous rally in interest-related securities and it was announced that on that day credit had been loosened to allow market specialists the financing they needed to prevent a complete stock market failure.

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Titanic Syndrome				
Year	Date	DJIA	NYSE Highs/ Lows	Indication
1965	May 14	939		all-time high
1965	May 21	922	36/44	lows > highs
1965	June 28	840		10% DJIA drop
1966	Feb. 2	982	34/53	lows, highs
1966	Feb. 9	995		all-time high
1966	May 23	647		35% DJIA drop
1973	Jan. 11	1051		all-time high
1973	Jan. 12	1039	50/57	lows > highs
1974	Dec. 6	577		45% DJIA drop
1976	April 5	1005		high after 400-point rally
1976	April 8	977	10/26	lows, highs
1978	Feb. 28	742		26% DJIA drop
1983	July 27	1258		all-time high
1983	Aug. 1	1194	11/14	lows > highs
1984	July 25	1079		14% DJIA drop
1987	Aug. 25	2746		all-time high
1987	Sept. 2	2631	24/31	lows > highs
1987	Oct. 19	1677		39% DJIA drop
1987	Oct. 20	1616		40% DJIA drop on an intraday basis

FIGURE 1:

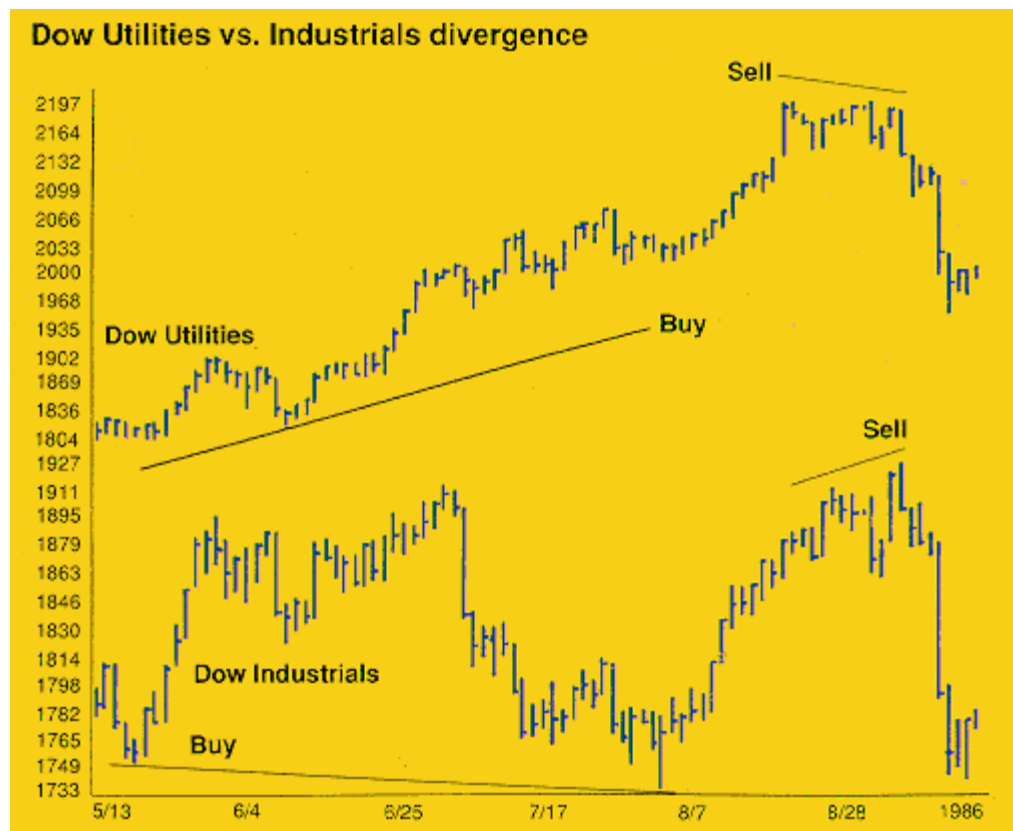


FIGURE 2:

■ **Signals for a market top:**

1) **3-D (occurs at minor or major market tops)**

Divergence between the daily highs of any two published averages/indices or the spot/futures contracts related to the averages/indices.

-or-

A higher top on Dow Industrials vs. a lower top on Dow Utilities.

2) **Titanic Syndrome (always occurs at major market tops)**

DJIA makes new high for the year and, no more than 7 trading days before or after the DJIA high, the number of yearly new lows on the NYSE Composite Index exceeds new highs.

■ **Confirmation Signals**

a) **NYSE Advance/Decline**

The minimum pattern which occurs at all major tops: At least two consecutive days where the number of declining stocks on the NYSE Composite Index is over 1,000 and one of those days shows a 1:4 advance/decline ratio.

-or-

A stronger pattern: Four days out of a seven-day period in which the number of declining stocks on the NYSE Composite Index is over 1,000.

b) **Closing Prices**

At least one market average makes at least five consecutively lower closes. The ensuing downtrend will continue until there are five consecutively higher closes. (Note: If, instead of five consecutively lower closes, the market gives four consecutively lower closes followed by two higher closes, the market is not topping and the uptrend will continue.)

3) **NYSE New Highs/New Lows**

A total of five days in which the number of yearly new lows on the NYSE Composite Index exceeds the number of yearly new highs.

-or-

The number of yearly new highs on the NYSE Composite Index drop to 10 or less on one or more days. (Note: This usually occurs quite a while after the 3-D or Titanic Syndrome signal.)

4) **Outside Day**

At least one market average/index shows an outside day chart pattern the day after the 3-D or Titanic Syndrome and the outside day's close is lower than the previous day's close.

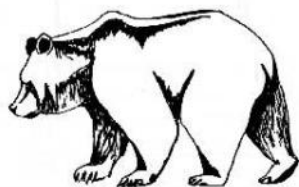


FIGURE 3:

■ **Signals for a market bottom:**

1) **3-D (may occur at minor or major market bottoms)**

Divergence between the daily lows of any two published averages/indices or the spot/futures contract related to these averages/indices.

-or-

A lower low on DJIA vs. a higher low on DJUA.

2) **A 10% drop in price**

On any index or average, the 10% drop over any time span is measured from the highest intraday high to the lowest intraday low.

■ **Confirmation signals**

a) **NYSE Advance/Decline**

The minimum pattern which occurs at all major bottoms: At least two consecutive days where the number of advancing stocks on the NYSE Composite Index is over 1,000 and one of those days shows a 4:1 ratio advance/decline ratio.

-or-

A stronger pattern: Four days out of a seven-day period in which the number of advancing stocks on the NYSE Composite Index is over 1,000.

-or-

The best signal of a bottom: The number of NYSE advancing stocks is at least nine times greater than the number of declining stocks (a 9:1 advance/decline ratio).

-or-

The signal for a selling climax: The number of declining stocks on the NYSE Composite Index is at least nine times greater than the number of advancing stocks (a 1:9 advance/decline ratio). This indicates an oversold condition and is a strong buy signal.

b) **Closing Prices**

At least one market average makes at least five consecutively higher closes. The ensuing uptrend will continue until there are five consecutively lower closes. (Note: If, instead of five consecutively higher closes, the market gives four consecutively higher closes followed by two lower closes, the market is not bottoming and the downtrend will continue.)

c) **NYSE New Highs/New Lows**

The number of yearly new highs on the NYSE Composite Index drops below 3 after a 10% market drop.

-or-

A total of five days in which the number of yearly new highs on the NYSE Composite Index is greater than the number of yearly new lows.

-or-

The number of yearly new lows on the NYSE Composite Index drops below 10 after the suspected bottom.

d) **Outside Day**

At least one average/index shows an outside day chart pattern the day after the 3-D divergence occurs and the outside day's closing price is higher than the previous day's closing price.

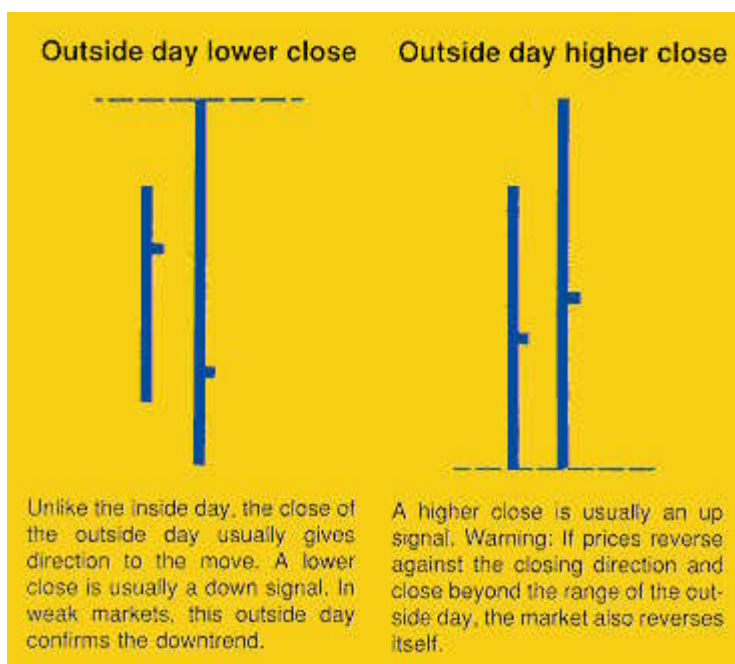


FIGURE 4:

1965 top and bottom patterns					
Year	Date	DJIA close	NYSE Highs/ Lows	NYSE Advances/ Declines	Indication
1965	May 14	939			All-time high DJIA close = 1st half of Titanic Syndrome.
1965	May 21	922		3644	Lows > highs = 2nd half of the Titanic Syndrome.
1965	June 2	904		196/1000	Declines over 1,000 and 1:5 A/D ratio.
1965	June 14	868		161/1036	1:6 A/D ratio = increasing A/D ratio, over 1:4
1965	June 28	840	0424	104/1167	10% DJIA drop, new highs drop below 3 & 1:10 A/D ratio = confirmation of selling climax.
1965	June 30	868	3/33	1168/101	10:1 A/D ratio = very best signal of a market bottom.
1966	Feb 2		34/53		Lows > highs = first half of Titanic Syndrome.
1966	Feb 9	995			All-time DJIA high = second half of Titanic Syndrome.

FIGURE 5:

Patterns detecting 1987 crash			
Date	Market Measure	Value	Indication
August 12	AMEX	365.01	All-time high.
August 14	Dow Transportation	1101.16	All-time high.
August 14	Dow Utility	213.79	Close below all-time high = divergence with AMEX and Dow Transportation.
August 25	Dow Industrial	2746.65	All-time high = 1st half of Titanic Syndrome.
August 27	Advance/Decline	548/1032	1st day declines > 1,000.
August 28	Advance/Decline	395/1231	2nd day declines > 1,000.
Sept 1	Advance/Decline	428/1197	3rd day declines > 1,000.
Sept 2	Advance/Decline	443/1216	4th day declines > 1,000 in 7-day period.
Sept 2	NYSE high/low	24/31	Lows exceed highs 6 days after DJIA high = 2nd half of Titanic Syndrome.
Sept 4	Advance/Decline	513/1060	Declines > 1,000.
Sept 8	Dow Industrial	2545.12	5th consecutive day of lower closes = confirmation signal.
Sept 8	Advance/Decline	242/1532	Second consecutive trading day declines > 1,000 and 1:6 ratio > 1:4 ratio confirmation signal.
Oct 16	Advance/Decline	111/1749	Nearly 1:16 ratio > 1:9 ratio confirmation signal = oversold market.
Oct 19	Advance/Decline	52/1973	Nearly 1:38 = a 22-year record ratio and vastly oversold market.

FIGURE 6: