A Turn of the Tide?

U.S. stock market investors have experienced a real treat in the last seventeen years with a spectacular return for the S&P Composite of close to 1,400% since the August 1982 low — a performance that dwarfs the 8-year, almost 500% gain, for the famous bull market of the 1920s. This raises the question how much longer can it go on? Just because prices are high does not mean they have to come down. They could well extend a lot further before the party is over. After all, you wouldn't predict rain just because of an uncommonly long period of drought. Even rain has a leading indicator — the formation of dark clouds. Bear markets do not come out of the blue either; leading indicators foreshadow them. Bear trends begin because a change in the economic and financial environment causes investors to reassess the future. Fortunately, these changes are reflected in a number of different indicators. If you study the history of bull market peaks it is possible to come up with a rough checklist that might correspond with the "dark rain cloud" analogy. Let's consider the list.

Industrial Commodity Prices

During the early phases of a bull market industrial commodity prices are either declining or experiencing a trading range. As the business cycle progresses, they begin to edge up and sooner or later feedback as higher interest rates. At some point, stock market participants sense these conditions will lead to a recession, so they sell equities in anticipation. Because the makeup of each individual business cycle is different, the magnitude of a commodity rally and the lead time necessary to trigger a bear market, vary. Sometimes the lead can be quite long. The 1966 peak, for instance, developed nearly three years after the low in commodities. At other times, such as 1994, the lead was a matter of a few months. The trick is to devise a mechanism that flags when the stock market is likely to succumb to rising commodity prices. My approach is to monitor the ratio of stock prices to commodities and express that ratio as a smoothed momentum indicator (KST). When momentum peaks out, it warns that stock prices are vulnerable. The arrows and vertical lines on Chart 1 show the history of this indicator since the 1960s. Eleven momentum moving average signals have been given since the late 1960's. Only those in 1968 and 1992, flagged with the dashed lines, could be called outright failures. The 1993 signal foreshadowed a sideways Dow, but the average stock, as measured by the Advance/Decline Line, suffered a severe drubbing. The eleventh signal was given several months ago, so this study is currently placing a red flag on the field.

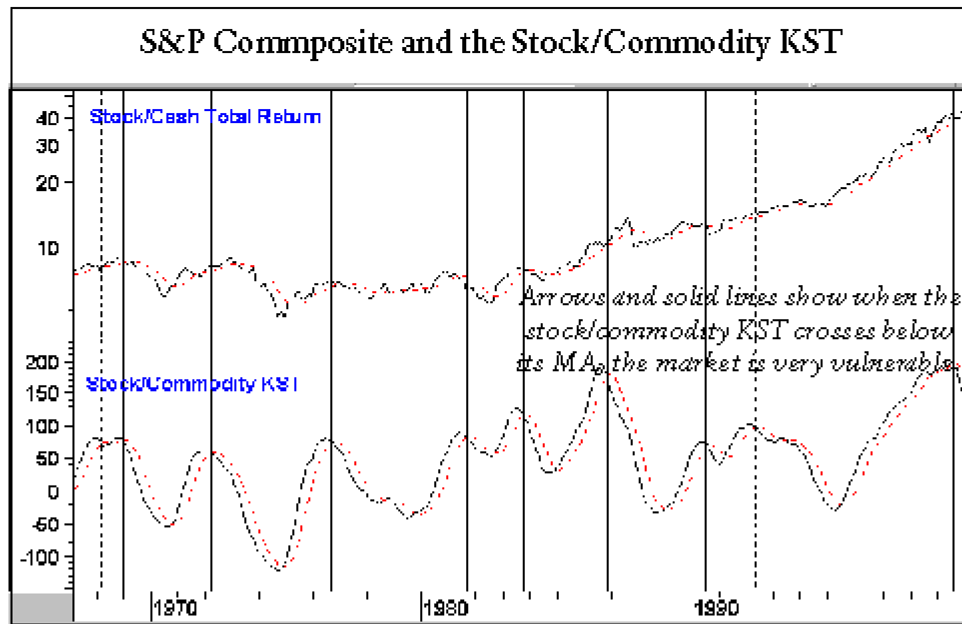

Chart 1

Market Breadth

A key characteristic of a bull market peak is a distinct narrowing in the number of stocks participating in the rally. Technicians have traditionally used the NYSE A/D Line for this purpose. It is plotted as a cumulative daily running total of the plurality of stocks advancing over those declining. When the line rises in concert with the Dow, it is telling us the rally is in good health because there is widespread sponsorship by market participants. However, at some point in the bull market, the A/D Line peaks out while the major averages continue to rally. This is known as a negative divergence and has traditionally warned of trouble. The early bird action of the A/D Line arises for a number of reasons. First, interest rates reverse their downtrend ahead of the stock market. This means that interest-sensitive stocks, such as utilities and stockbrokers, turn down before the Dow. Confidence also starts to wane, and this is reflected in the fact that investors become increasingly selective by avoiding poorer quality stocks in favor of a small list of blue chips. The center panel in Chart 2 shows that the A/D Line topped out in April of 1998, almost 2-years ago. Moreover, this indicator has completed a massive top formation. Technicians have a rule that the longer the divergence, the greater the magnitude of the ensuing move. The current divergence is one of the longest on record and, on that basis, is forecasting a major decline. Some observers argue the A/D Line now has a downward bias and has lost its traditional predictive abilities. This has certainly been true for similar indicators derived from Japanese data or even the tech dominated NADSAQ, where a natural

downward bias has been in existence for decades. There is currently no evidence to support a claim that the NYSE has caught a similar disease.

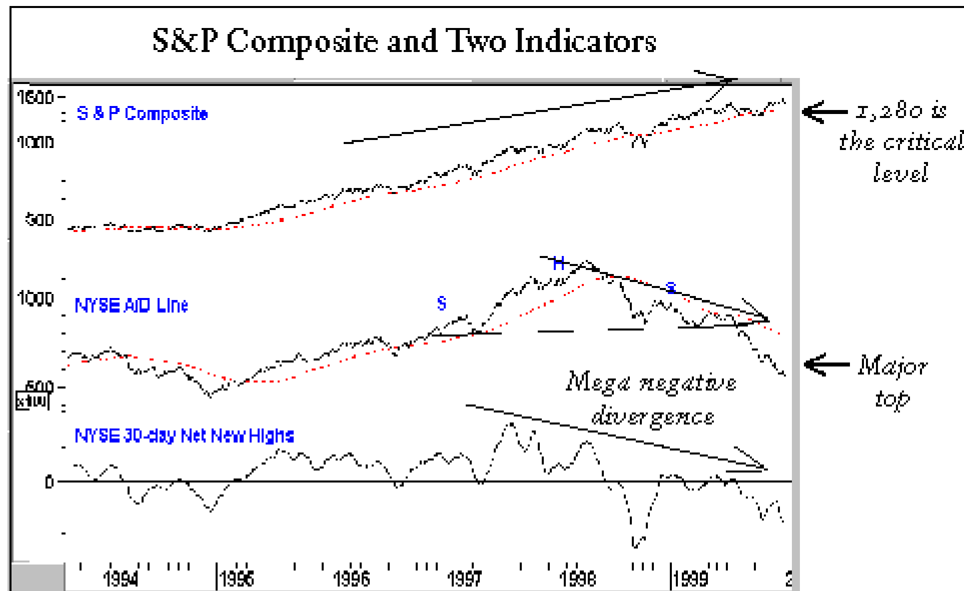

Chart 2

We can even turn this around and point to another measurement of market breadth, the Net New NYSE High numbers. In this regard, the lower panel in Chart 2 shows the 30-day moving average of net new highs peaked back in 1997. Since then, fewer and fewer stocks have been able to register new highs. Moreover, when the Dow experienced its all-time high in late December of last year substantially more stocks were hitting new lows than new highs — an unprecedented event as far as our records go. This underscores the vulnerability and weakness of the current technical picture.

Sentiment and Momentum

The legendary technician Garfield Drew wrote in the 1940s that equity prices are determined not by what stocks are worth but by what people think they are worth. His observation reflects the fact that price swings are essentially a psychological phenomenon. Most people equate the actual high or low in the market with the ***level*** of sentiment. However, it can be shown that what may be an extreme level of sentiment in one cycle, may be surpassed in another. It is only when the ***trend*** of sentiment reverses from an extreme level that a market turn can be anticipated. Stocks were at extreme levels of valuation by

most models a couple of years ago but are far more expensive today. The same could be said for Japanese equities in the mid-1980s compared to the peak in 1990. Those basing their conclusions on the level of valuation alone would have been right, but painfully early.

Chart 3 shows an 18-month rate-of-change (ROC) for the S&P Composite. Technicians study the swings in such indicators in order to gage what constitutes a normal extreme in sentiment. These benchmarks are drawn above and below the equilibrium line in the center of the lower panel and are referred to as overbought and oversold levels. Changes in the trend of sentiment are signaled when the ROC crosses above the oversold line or below the overbought line. The arrows demonstrate that such crossovers have offered reasonably timely and reliable signals of major market peaks since the 1960s. A couple of months ago the indicator once again fell below the overbought zone. The current situation is particularly precarious because the ROC looks as though it is completing a top formation. Only two previous signals in the last 100 years have come even remotely close; the 1929 signal was followed by a dramatic 80% decline, and the relatively modest 20% drop in 1934. Normally, this kind of pattern formation is confined to one momentum indicator. But currently, virtually every long-term momentum-based indicator on quarterly data between 9 and 48 months has already completed, or is threatening to complete, a multi-year top or trend reversal. This common activity indicates that when the uptrend in the market is broken, a substantial bear market is likely. This is because such commonality is indicative of the simultaneous confluence of a large number of long-term price/time cycles.

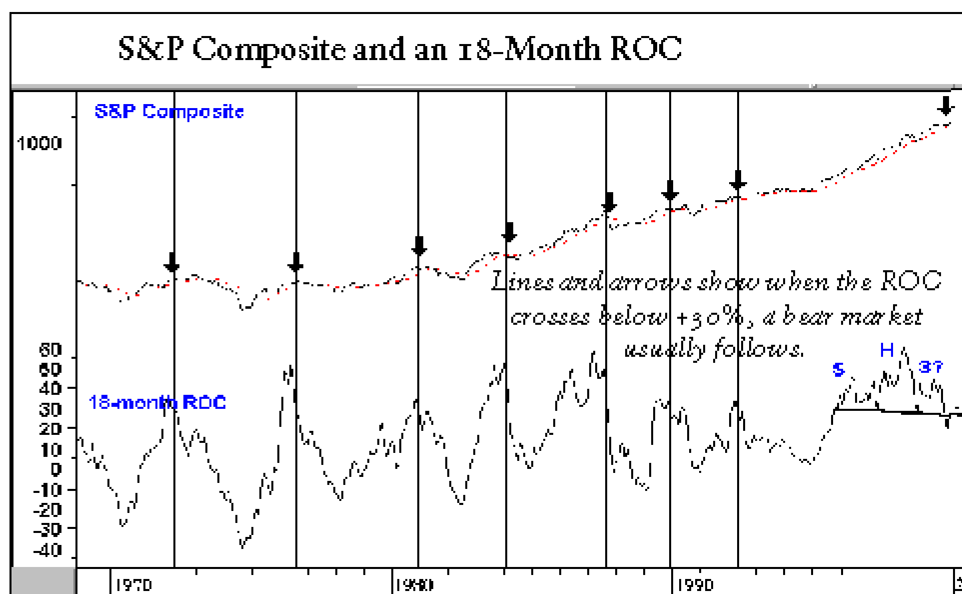

Chart 3

Interest Rates

The long-term equity bull market started in 1982 and was preceded by a peak in interest rates about a year earlier. Since 1981, rates have fluctuated, but each business cycle saw lower peaks and lower troughs. This very long-term, or secular, bear market in yields provided major support for the equity bull market. Chart 4 shows this favorable environment may be about to terminate given that the Moody's AAA Bond Yield has recently broken above an 18-year down trendline.

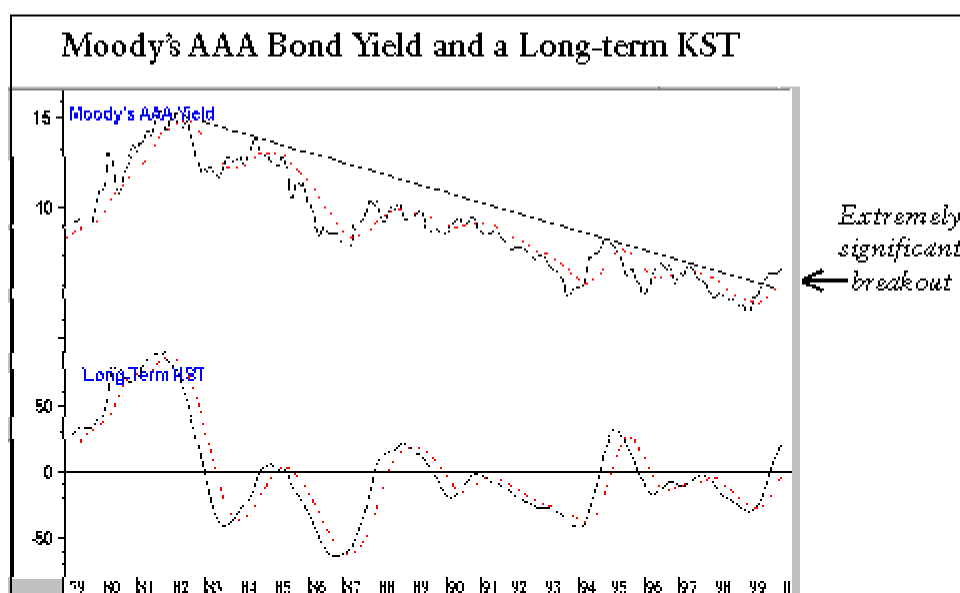

Chart 4

Chart 5 shows a similar technical position for short-term interest rates. The Center panel shows our Growth Indicator, a composite momentum measure of economic indicators. When it crosses above or below zero, it indicates the economy has passed a reflection point that almost invariably indicates that a new trend of interest rates is underway. It recently crossed above zero thereby triggering another signal. Also, the Federal Reserve recently hiked the Discount Rate for a second time. Historically, reversals in the trend of the Discount Rate equate to changes in corporate dividends. They come after a careful and thoughtful process and represent an important change in policy. The leading relationship between interest rates and equity prices varies from cycle to cycle. Consequently, it is not possible to point to the latest Discount Rate hike as a primary trend sell signal for the market, but the secular trend break does

indicate that the long-term positive interest rate environment, which has been in place since 1981, is no longer a supporting factor for equities.

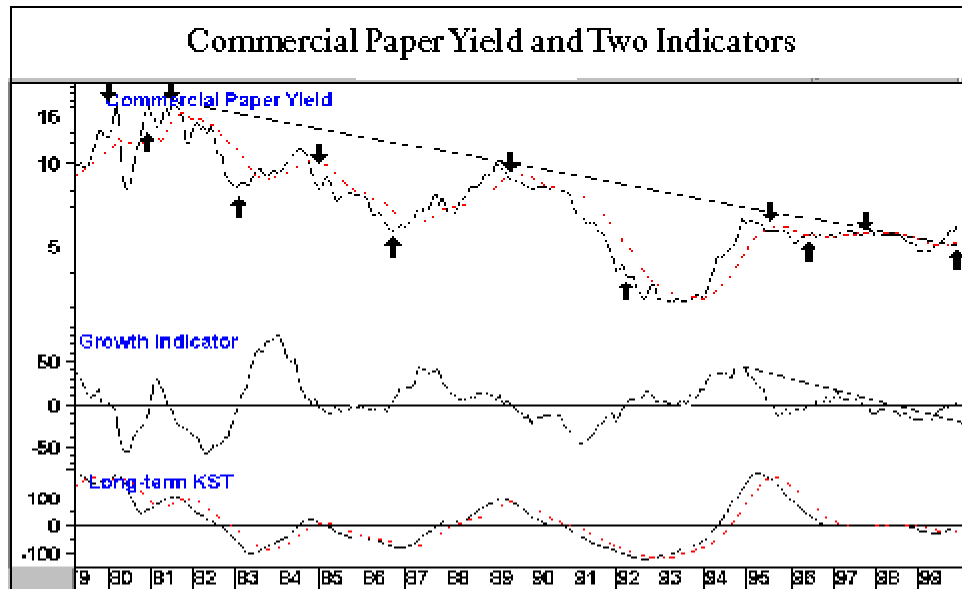

Chart 5

The Stock Barometer

The final piece of evidence that the U.S. stock market is in the process of peaking comes from our Stock Barometer. This is a consensus model containing economic, financial and technical indicators. Each component has a good, but not perfect, record of identifying major trend reversals in the market. It moves into a bullish mode when more than 50% of its components are positive and bearish when 50% or less are negative. It has been falling rapidly in recent months and fell into a negative mode in December. The history of this indicator goes back nearly 50 years. About half the time it has gone bearish before a market peak. Each signal though, has always been associated with a bear market of some kind and offers a distinct warning of trouble.

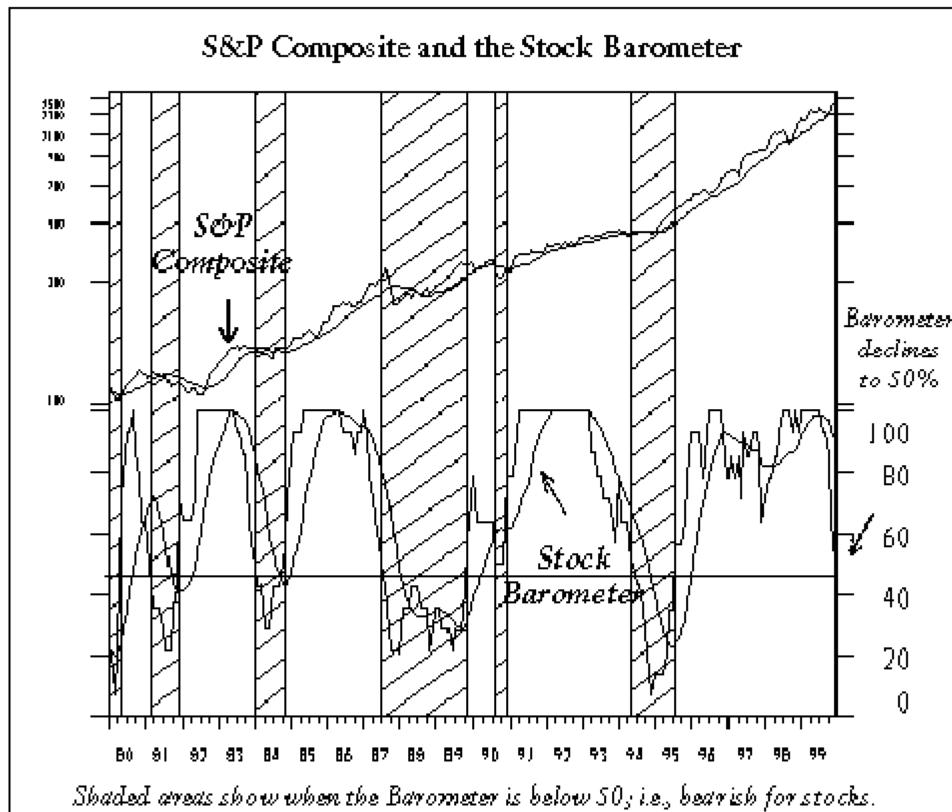

Chart 6

The Trend

Based on historical precedent, the current position of the indicators described above is warning that the current situation is highly precarious. While they flash signals that we are in the vicinity of a top, they are far from being razor sharp in their timing abilities. Technicians are very fond of using MAs for triggering signals. No moving average is perfect, but one of the most reliable has been the 7-month moving average, not just in the U.S., but for other stock markets as well. This average at the end of December was at 1,365, so I believe that two consecutive months below 1,350 would be sufficient to signal the advent of a bear market. The currently ominous conjunction of many reliable indicators points to the next bear as being larger than anything seen since the 1970s. With a current S&P Composite dividend yield of 1.17%, it would take more than a 50% decline just to return to the 3% levels of valuation normally seen at bull market ***peaks***. The decline required to achieve the average bear market yield of 5.4% does not stomach thinking about.