



The Markets in Development Newsletter

STRATEGIC ANALYSIS OF FINANCIAL MARKETS

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PAST EXPERIENCE VS FUTURE EVENTS

As a trader and investor, it is always important to constantly learn from the markets. After all, they are composed of the collective behavior of humans, who express their feelings and emotions through their buying and selling. Often, their actions repeat themselves. A technical analyst will become familiar with the charting of those buying and selling emotions and then predict a possible outcome. Important to the analysis is the recognition of fundamental, economic and geopolitical events that can change the determination of value on the collective participants.

Coming into the January high, most recognized the valuation put on stocks was in excess of historical norms. But, traders continued to bid up prices based on the perception of future increasing valuations. Then, the markets received a bit of reality and prices collapsed over a period of nine days. By Friday of last week the Stock Indices were at a point of being extremely oversold.

The S&P lost 9% of its value, while the NASDAQ gave up 12.14% and the Russell declining 11.29%. On February 9 the selling stopped and buyers stepped in. We know, in all degrees of time, markets “run”, take a “pause” and then “run” again. Looking at the Indices on a daily basis the selloff can be viewed as a “run”. If that is the case, then the current rally from the February 9 low could be considered a “pause” before another run lower.

Alternatively, the Indices have been in an uptrend for quite some time. At the beginning of this year, the trend accelerated and prices exceeded an upper trendline. Therefore, the selloff could be considered a “pause” in the general uptrend. If this scenario were to play out, Stocks should not only take out the January high but continue with the trend higher.

So, which is it? Certainly, the move lower was impulsive. Once traders headed for the doors, it became a stampede. Selling volume was extremely high. Market breadth collapsed. New highs fell, while new lows exploded. All of this was signaled earlier in January as the internal structure of the rally declined. I wrote about this decline in the February 2 newsletter. It is simply impossible for the price of an index to continue to rise when a greater number of stocks that make up that index are declining. That was the situation we faced at the end of last month.



In trading and investing we must analyze the financial instruments we trade and invest in and then assess the probabilities of one event occurring over another. In the case of the current rally off the February low, it is either the beginning of a new leg higher, or it is a correction to the selloff and we will begin another leg down that will exceed the February lows. A study of the internals of the rally should give the strength or weakness of the move higher.

STOCK INDICES

In the chart below of the SPY, you can see the rally into the end of January displayed market breadth declining and extremely low volume. Once the move down began, volume exploded higher. What is important now, is volume is continuing to collapse. This is not a market that is bringing in new buyers. More importantly, Breadth on Monday reached a high of 1631 shares. This means the net between stocks moving higher vs those moving lower was 1631. This is only about 50% of total shares traded on the NYSE.



As I write this, Breadth is a mere 918 shares trading higher, yet price continues to climb. In addition, if you compare the degree of retracement between the S&P, NASDAQ and Russell, the Russell has only retraced about 60% of the decline. The S&P and NASDAQ have retraced about 77%.

Looking deeper into the internal structure of the current rally, you can see that new highs (white line) increased going into the January high. This is to be expected. However, if you look at the new highs



currently, they have remained collapsed. The S&P and NASDAQ only have 23% of the decline left to retrace. We should fully expect new highs to begin climbing, but they are not.



The one positive is new lows (red line) have not ticked up.

WILL THE PAST PREDICT THE FUTURE?

As traders and investors, we gain experience each time we prepare an analysis and enter the markets. It is important to understand our analysis is simply a probability assessment. We enter with the assumption the probabilities are such that the market will reward us for our work. However, it is more important to keep in mind there is always a lower probability of something else occurring. There are no certainties.

In my past experiences in the market, I have found understanding a countertrend move is extremely important. While I could write an entire paper on timeframes and countertrend moves, there are some characteristics of a countertrend move that typically exhibit themselves in all degrees of time. Those characteristics do not present themselves a hundred percent of the time, but they do most of the time. They can also help us in determining if a countertrend move is coming to an end and the main trend is getting ready to exert itself once more.





The chart above is a sixty-minute chart of the S&P (SPY). The chart of the NASDAQ (QQQ) is similar. The rally off last Friday's low appears to be waning. This is obvious in volume (green line) that has collapsed this week. Also, Breadth is not strengthening.

In my experience I have found the following characteristics of a countertrend move.

- They work off an overbought or oversold condition quickly. The Indices on Friday were at an extreme oversold condition. As of this writing, they are overbought.
- They occur on low volume. Obviously, volume is low and continues to decline.
- They will typically occur in three steps. (This characteristic is less prominent than the others.) I have labeled the three steps in the chart above. Now, here is the important part. It is not uncommon for the first step to equal the third step.

In the current situation with the SPY, the high in January was at 267.01. The low last Friday was at 252.92. This is a decline of 14.09 points. If 263.31 (marked as 2 above) is the second leg, then the projection for the final leg would be 277.40 (marked with the blue line).



CONCLUSION

It appears from experience the rally off of last week's low is countertrend to the selloff. If this is the case, then the main trend could exert itself at any time.

As I discussed above, it does appear another leg down is currently the higher probability. Therefore, I have tightened stops on all long positions and have exited others. While I am not ready to enter short positions, a reversal from here or a reversal from 277.40 in SPY would signal another good thrust lower.

Once again, it is important to recognize there is a lower probability of the opposite occurring. If that were to happen, we will begin to see volume increasing on an hourly basis. Breadth will expand. New highs will begin to move and, most likely, 277.40 will be traded through on an internal structure that is strengthening.

TIMEFRAMES

When I work with clients, I always stress the importance of understanding the development of price and structure in multiple timeframes. As a result, I submit the following possible price development scenario.

The rally off the 2009 lows in the Stock Indices has had only a few countertrend declines. Just as the probabilities of the move off of last Friday's low suggests the current rally is countertrend to the move off of the January high, so too the current decline and rally could be part of a longer-term timeframe countertrend lower. If this were the case, we should expect another thrust lower that will take out the Friday low and will be approximately the same length as the move down.

Once complete, it would offer a tremendous buying opportunity and suggest the Indices continuing with the longer-term uptrend.

For those of us who are more active traders and investors, it will be important to continue to assess the probabilities of these events and develop trade strategies that offer the possibility of one event occurring over another.

LONGER TERM

Indices in a countertrend rotation down that is not yet complete.

INTERMEDIATE TERM

Indices are in a countertrend rally that may not yet be complete.

It will be important now to analyze carefully the development of price and the market internals. They will give the first indication of the lower probability event and the Indices moving immediately to new highs. If not, the market should begin another leg down next week. Failure for that to happen would suggest new all-time highs are imminent. We are likely at an important decision point.



I will be updating the shorter-term development of price and the market internals in The Markets in Development Briefing. You can subscribe to the service here:

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