Saut Strategy

"Charts of the Week" 8/14/19

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Charts of the Week

Back when I used to give daily client presentations, I would often joke during the meetings that while I did have a crystal ball on my desk, all it ever seemed to do was hold down paper (Hey, I never claimed it was a good joke but it did get a laugh like 65% of the time). Understandably, what we do as “market strategists” can very easily be mistaken as trying to predict the future, and many of the questions I get do assume some competent level of soothsaying ability on my part. While that kind of confidence in me is flattering, I do think it misses the mark a bit on what I try to accomplish with my analysis.

Instead of predicting the future, I like to think of what I do as interpreting the present. By gathering information, following the charts, and tracking indicators with a good history of taking the market’s measure, everyday I am reevaluating where we stand and determining whether things are getting better or worse. Since the market often moves in trends, the near-term future frequently echoes the present and recent past, so figuring out the present can usually give a decent indication of where the market may go next. That might indirectly be like trying to predict the future, but I do think a distinction exists; and when enough evidence emerges to suggest that the present has changed and an inflection point has been reached, then I change my opinion as well.

Of course, this exercise must be done across many different timeframes, and the shorter-term fluctuations are naturally going to get the most attention since they change the most frequently. Many market participants like to dismiss the short term as nothing but “noise,” but every larger move emerges from such noise so I still choose to discuss what’s going on even if most of the time it means very little to the investors who make up the bulk of our readers. It’s not an easy task figuring out the near term considering we’re always just one tweet away from shifting the balance these days, but, if nothing else, following the day-to-day vacillations helps keep me geared into the overall stock market.

Getting back to the point about not trying to predict the future, my recent emphasis has been on the current S&P 500 chart looking very similar to how it did last October near the beginning of its 20% decline. Obviously, saying something like that is going to lead to some fear, and as a result I’ve received several questions asking me such things as: “How much do I think the index will decline this time?” and “Will we get another sharp rally after such a decline?” And my disappointing answer to such questions has largely been “Sorry, I don’t know.”

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As mentioned earlier, I am mostly following along with the market and adjusting to the evidence it provides. If the market starts declining, I assume it will continue to do so until enough evidence is presented that an inflection point has been reached. The same applies on the upside, where I assume the market will continue to rise until given a good reason not to think that. It's this kind of mindset that has helped us (hopefully) keep people invested over the last several years of a mostly up-trending stock market. I do try to identify areas where the inflection points ***might*** arrive, but until I see the market respecting those areas in the way I think it should, it's nothing more than a line on a chart to watch. My point is that while a chart may look similar to October 2018 or any other point in time, it does not mean I expect the outcome to be exactly the same. It's just something I factor into my overall analysis.

Yesterday largely destroyed the correlation to the October 2018 chart, anyway, after news conveniently broke shortly after the market opened that that the U.S. will remove some products from the China tariffs list and will delay tariffs on some other products until December. That shot the S&P 500 up around 2% at its high, though the door was slammed shut right at the probable resistance area around 2943 (in that 2940-2960 zone I've highlighted for weeks now)

On the surface, it looks like a big step in the right direction, but I'd still like to see the market do more and actually follow through over the coming days before I get too excited. Yesterday was one of those sessions where the indices implied more strength than the market internals suggested, with only 67% of stocks advancing across the NYSE, NASDAQ, and AMEX and more new 52-week lows than 52-week highs. Moreover, the fact that the S&P 500 and NASDAQ briefly eclipsed their reaction highs from last Thursday, but did not get much further smells to me like some "stop-hunting" to shake out weak shorts. The Russell 2000, meanwhile, did not rise above its own Thursday high and remains notably beneath all of its key moving averages on the daily chart.

For these reasons, and the existing resistance above the current index levels, I'm still not getting aggressive on the long side here. If we come out today firing and eclipse yesterday's highs and start heading up further then I do think it'll be enough to swing the short-term path of least resistance back to the upside, but I'm still taking the approach that the big resistance line on the longer-term chart will continue to hold until the market proves it can rise above it (see page 8). So, that puts us in the same situation we've been in the last few weeks where the lack of perceived upside makes me more cautious about possible downside.

Charts of the Week

Before the news-driven gains yesterday, it looked to me like the market was following a path to take another shot at the recent lows, which I still don't think would be the worst development. We did get a very quick "double bottom" earlier this month, but its accelerated formation might not have the same impact as would challenging the lows once again and creating a larger bottoming pattern. Existing negative sentiment and higher than historical allocations to more defensive asset classes and sectors (at least according to BAML's latest Global Fund Manager Survey) suggest that the stock market may be primed to rise and surprise people, but, again, I want to see evidence that the ship is about to leave before jumping aboard.

So, my "interpretation of the present" right now is that unless yesterday's high is taken out with conviction I'm going to defer to the downside in the near term. At this point I still believe the risk vs reward is weighted toward the risk side, and I want to see signs that buyers are getting aggressive again before I do. It's very common after an initial drop to see the indices rise back up to challenge their 10 and 20-day moving averages before falling once again, so the first step toward a more comfortable long stance will be rising above yesterday's high which would also put the S&P 500 above its 20-day EMA (it closed above its 10-day EMA yesterday).

If that happens, then I think the market may then look to challenge the recent highs and the big, ascending resistance line once again in the S&P given the negative sentiment. Absent that, however, we're left with a U.S. stock market right below prominent near-term resistance that has yet to hit washed-out levels of breadth. Not exactly a time where I want to load up on long positions.

S&P 500 Sector Snapshot

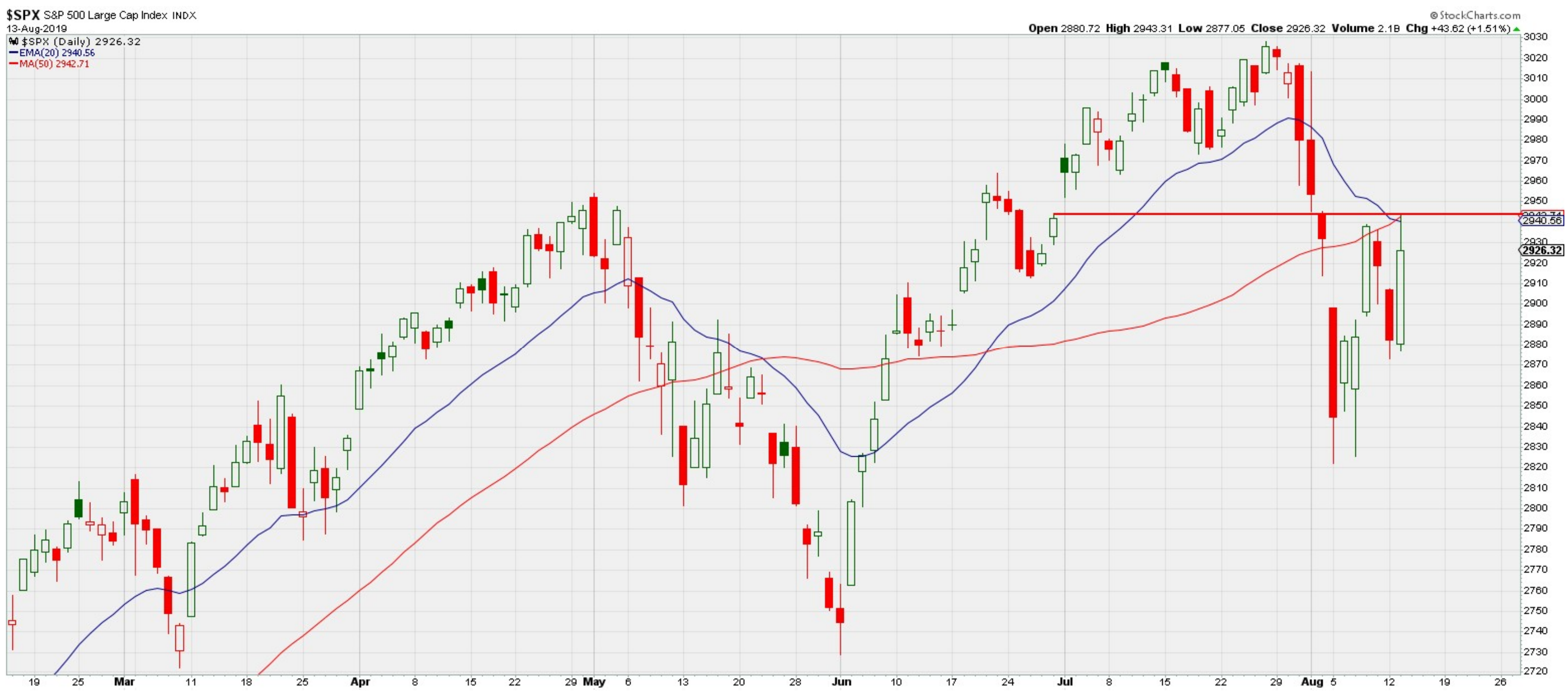
Select Timeframe 1D **5D** 1M 3M 6M YTD 1Y 5Y

S&P 500 Index	+1.55%
Communication Services (XLC)	+1.38%
Consumer Discretionary (XLY)	+1.55%
Consumer Staples (XLP)	+2.37%
Energy (XLE)	+0.70%
Financials (XLF)	-0.48%
Health Care (XLV)	+1.81%
Industrials (XLI)	+0.59%
Materials (XLB)	+1.99%
Real Estate (XLRE)	+2.48%
Technology (XLK)	+3.10%
Utilities (XLU)	+1.27%

Source: www.sectorspdr.com

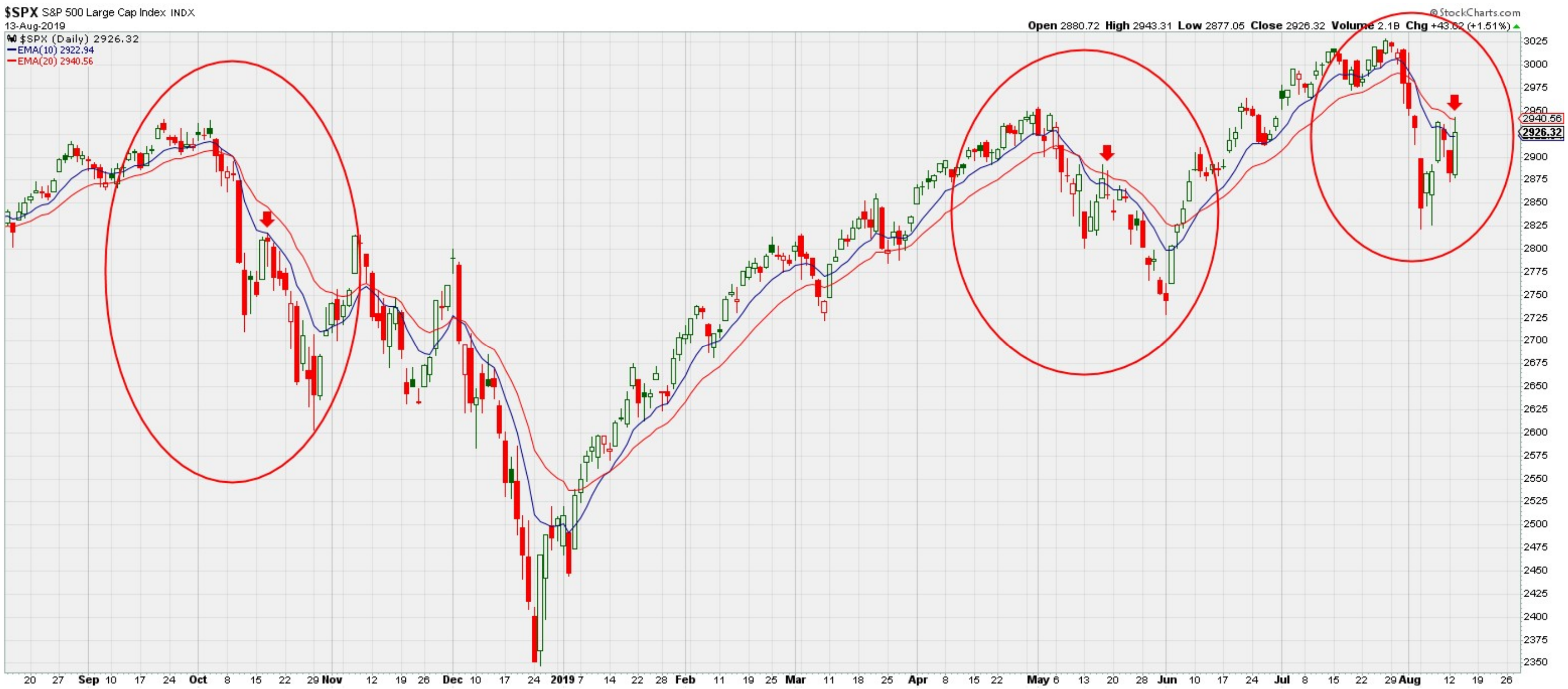
<u>Near Term Level to Watch</u>

For me, yesterday's high in the S&P 500 is now the biggest level to watch in the near term. Not surprisingly, the index met resistance at the 2944 level yesterday, an area that has been important going back the last couple of months. That's also where the 20-day exponential and 50-day simple moving averages were congregated, possibly creating more selling pressure. Now, though, if the S&P can climb above there, it should have a relatively free path back to the recent high given that the drop of late July/early August happened so quickly that additional resistance levels did not have time to form. So, yesterday's high now becomes a very important "pivot point" in the near term.



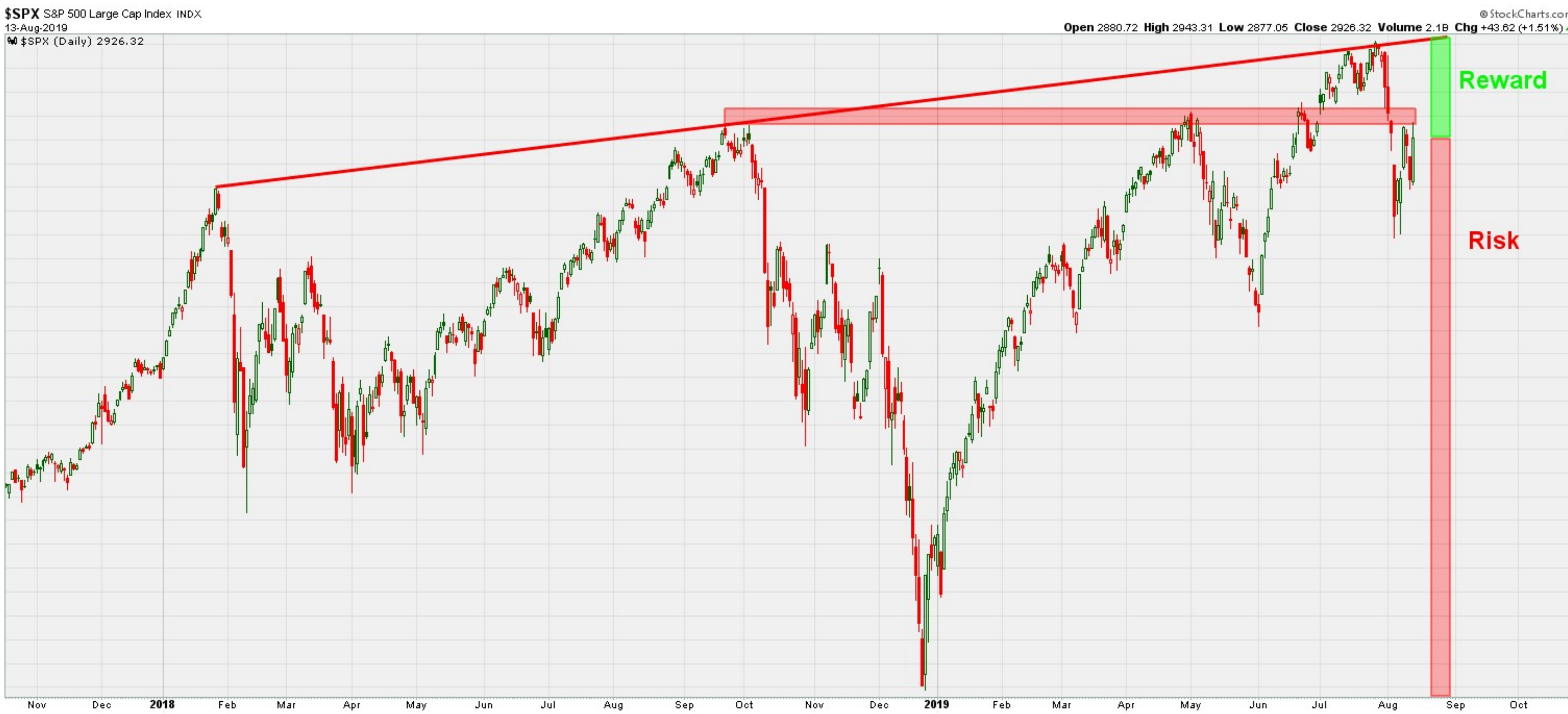
So Far Following the Path of the Last Two Declines

One major reason why I'm still choosing to play defense more than offense is that it is very common after an initial drop to see indices like the S&P 500 rally back up to their 10/20-day EMAs before falling once again. It happened last October, as well as in May. That doesn't mean it has to happen here, but I'm playing it safe just in case.



<u>Risk vs Reward</u>

A major component to my thinking right now is the assumption that the ascending resistance line connecting the major highs of the last two years will continue to hold until proven otherwise (the solid red rising line). If that's true, then it skews the near-term risk vs reward relationship because it's only about 3-4% back up to that line, while the downside risk is greater than that. Notice, too, that the S&P 500 has now come back up to challenge the underside of the zone around 2950 that has been massively important over the last year (shaded horizontal red box). That should add additional resistance.

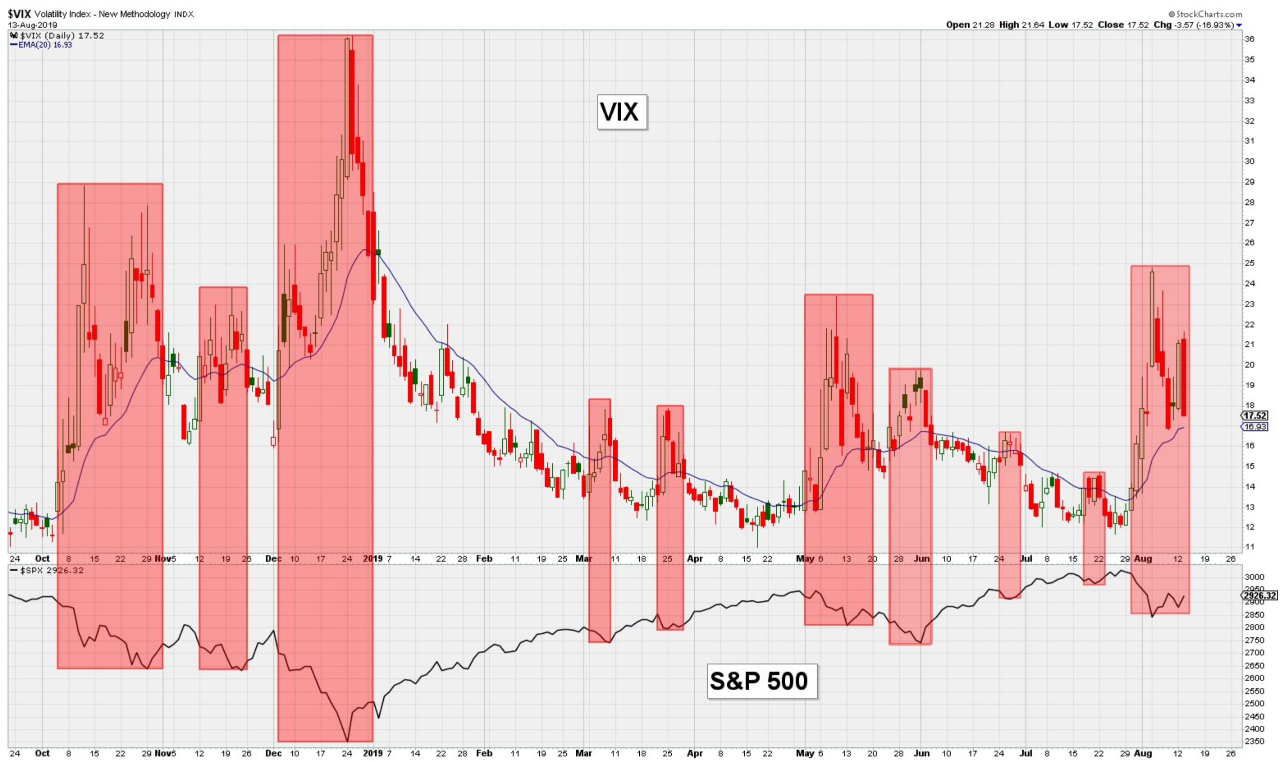


Small Caps Aren't Helping

The Russell 2000 remains well below its highs of last year and recently broke down from the large "triangle" pattern after falsely breaking out to the upside a few weeks ago. This isn't exactly positive action in the small caps, and helps support a more cautious stance.

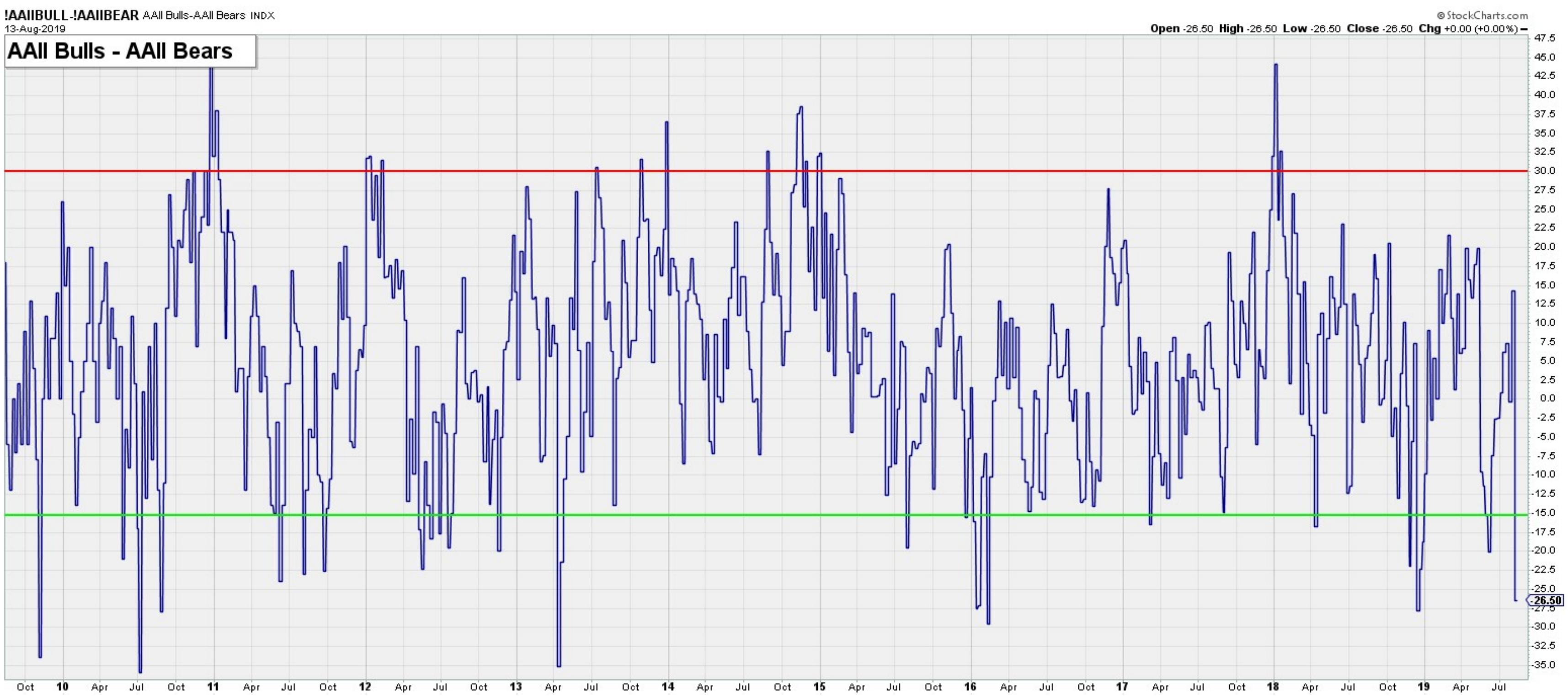
VIX > 20-Day EMA = Caution

A VIX level above its 20-day exponential moving average (blue line) has been a nice danger signal historically. Over the last year, the worst losses in the market have only come when the VIX is already above the 20-day EMA. Notice, it's still above it now, though another mild day in the S&P 500 could change that.



Sentiment Does Suggest Extreme Negativity

One supporting factor in the market's favor is that investors are already quite negative on stocks at the moment. The difference between the number of Bulls and Bears in the American Association of Individual Investors (AAII) survey has hit bearish extremes only seen a few times over the last few years. In last Thursday's survey, the Bears outnumbered the Bulls by 26.50%, just above where it was at the December low.

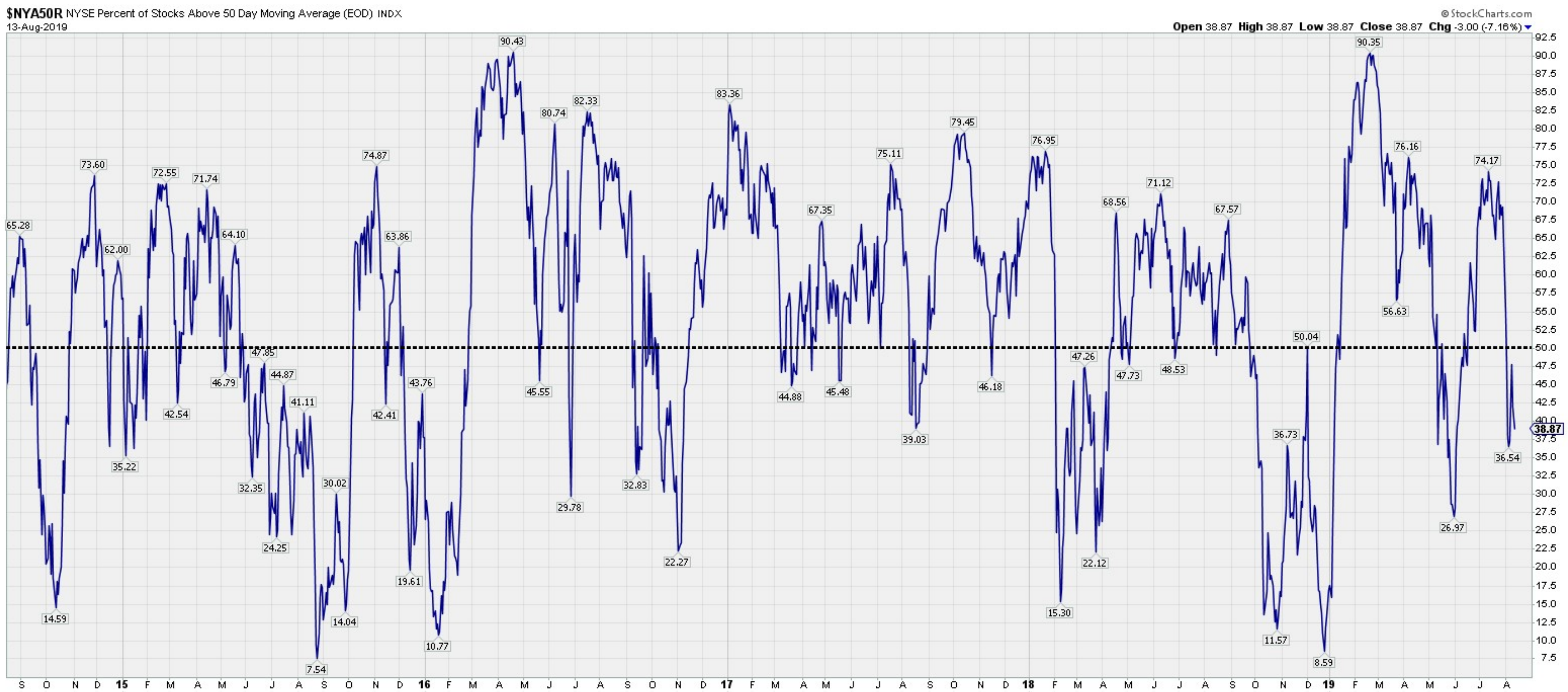


<u>Value Line Geometric Index Not Stellar</u>

I haven't mentioned the Value Line Geometric Index in a while, but I like to keep an eye on it because it better represents the median stock in the market compared to other major indices. As you can see, not only is it well under its high from last year, it is now basically back to its 2007 high level and risks breaking under the May low with a little more weakness. Another reason I'm being cautious.

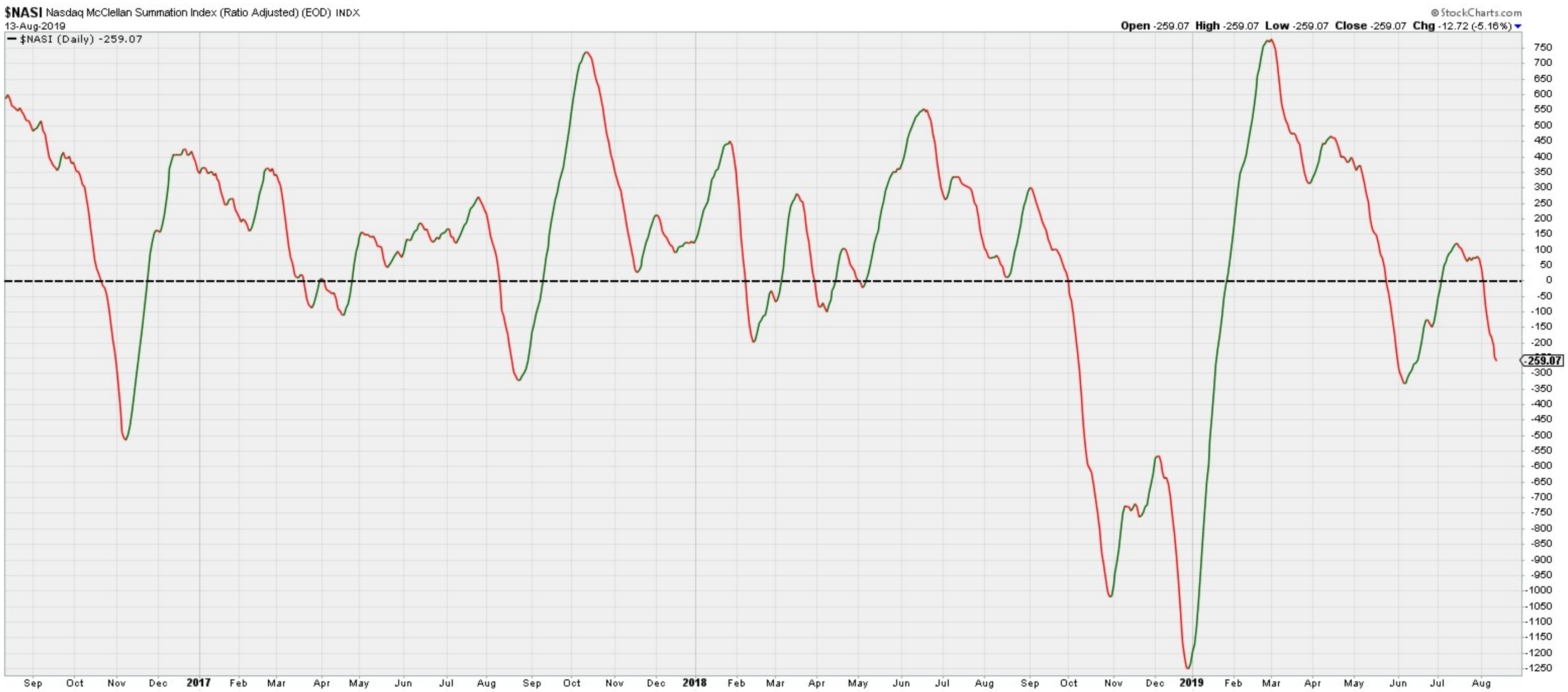
Haven't Seen an Explosive Move in Breadth Yet

One of the reasons I wasn't in a big hurry to buy the most recent dip was that market breadth still wasn't anywhere near "washed out" levels that typically mark major bottoms. To me, that meant that there was still potential downside before extremes were hit. The percentage of NYSE stocks above the 50-day moving average currently sits at 38.87%, just about 2% above its low last week, so we're not yet seeing the kind of breadth thrust I'd like to see off of a low. As a reminder, major market bottoms often occur with this indicator at least under 30%, with the lower the number indicating a more washed out or oversold market.



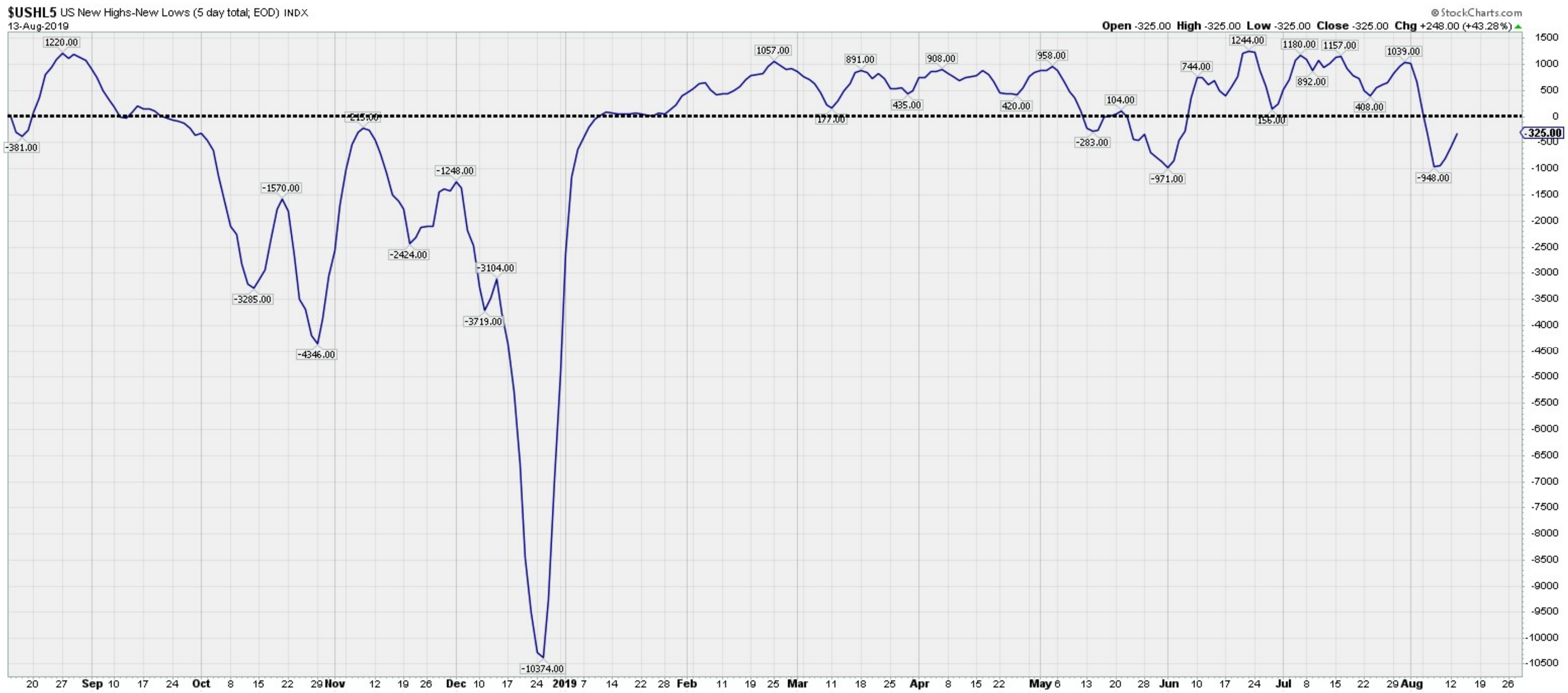
NASI Still in the Red

The NASDAQ McClellan Summation Index (NASI) is still negative and falling. In my experience, the best time to be long stocks is when the NASI is rising since that's when the easiest gains seem to happen.



New Lows Still Outnumber New Highs

The 5-day total of new 52-week highs vs new 52-week lows across the NYSE, NASDAQ, and AMEX is still in favor of the lows. This is one of my favorite "keep me out of trouble" indicators since I tend to be more cautious whenever it is negative.

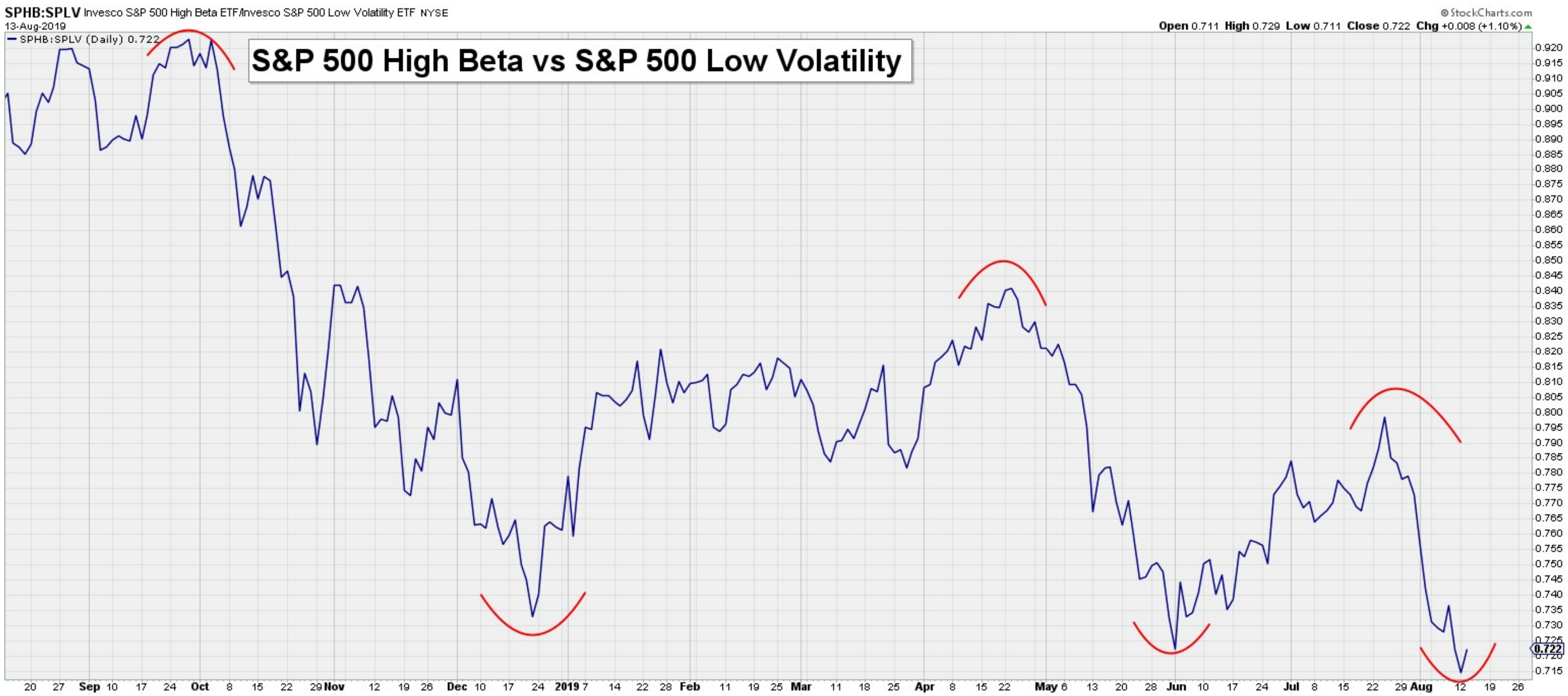


Long-Term Bonds Outperforming S&P 500 Recently

Another strike against stocks is that, with interest rates crashing the last few months, the 30-Year U.S. Treasury Bond has actually outperformed the S&P 500 since late April. Rates do look stretched here, but I don't see enough yet to indicate that stocks have hit an inflection point against bond prices.

Low Volatility Stocks Still Outperforming High Beta Stocks

Thanks in large part to tanking interest rates over the last several months, “low volatility” areas of the stock market like Utilities and Real Estate have collectively outperformed “high beta” areas, at least based on the relationship between the SPHB and SPLV funds. According to the relative strength chart below, High Beta remains in a pattern of lower highs and lower lows vs Low Vol; yet another reason I’m not anxious to get heavy here on long stock exposure.



<u>Growth Not Slowing vs Value Though</u>

Even with the outperformance of "lower volatility" areas of the market lately, it hasn't stopped the Russell 3000 Growth Index from drastically outperforming the Russell 3000 Value Index.

Trade Ideas

Since most stocks still seem to be moving with the market, I'm going to once again hold off on giving individual stock picks. If we do drop from here, there will likely be plenty of short opportunities, but it's hard to pick ones that stand out.

When I look for trades, I am looking for stocks I think can move in the direction I want them to go quickly while limiting my downside if I am wrong. I expect to be wrong a decent amount of the time given the tight stops, but the idea is that the winners should more than pay for the losers. There is an opportunity cost to holding a position, as the capital allocated to it prevents you from using that capital in another position, so if I enter a stock and it doesn't quickly do what I think it should I may cut it even though a stop or profit target isn't hit. Likewise, I usually move my stop up to my breakeven point once the trade starts to go in my favor in order to prevent a winning trade to turn into a losing trade. Understandably, my trading strategy might not fit your trading/investing strategy, but the trades highlighted in this report are the kinds that I typically look for.

Current Open Positions in Personal Accounts (this changes daily): Short PAYS, Long SPY Aug 19 293 Puts

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