EQUITIES PERSPECTIVE

January 8, 2016
DJIA: 16,514

We get the mean part … where's the reversion? Trading-systems based on mean reversion, overbought-oversold readings, have a very high rate of accuracy. However, they lose quite a bit of money. They lose money because of markets like this – markets that get oversold and stay oversold. In 2015 when the percent of stocks above their 10-day moving average got down to 20% or less you could buy and make money. Similarly, above 80% you could sell and save some money, at least in the short run. This worked in 2015 as it had in other periods. However, it works until it doesn't. It's important to know the context. Stocks above their 10-day average are at 7%. Tell us it's a bull market, we'll tell you to buy. However, back in the 2007-2009 bear market, stocks stayed below the 10% level for four consecutive days, and even in the 2010-2011 correction, they did pretty much the same. Oversold doesn't mean over.

Good lows come about when the selling is done. Like last August-September, we seem back to looking for that. Down a lot doesn't leave the market sold out. Sold out takes a real capitulation of sorts, it takes real extremes. A useful guide has been "90% down-days," days that see 90% of the up and down volume to the downside. They're not all that common – even Wednesday's 230-point loss was only an 86% down day on the NYSE, and Thursday's 390-point loss, 89%. Worse yet, sometimes one such down day isn't enough, it takes several. Then you need some upside confirmation. If stocks are sold out, they should move higher with relative ease, to the point that 80% or 90% upside volume should occur. This may seem a stretch, but anything less and rallies are likely to prove temporary. Concurrent with extreme selling, there also should be some indication of near panic in measures of sentiment. The VIX, or Volatility Index, is probably the best guide here, and so far remains lacking.

The stock market is a conditioning mechanism. It conditions you to think in a certain way and then, surprise, things change. If they change enough, they have a name for it – Black Swan. The Chinese are master manipulators, but even they may have come close to the Swan. They're good at manipulating the economy, but seemingly not so good at manipulating their stock market. The stock market there was open for only something like 29 minutes on Thursday owing to an ill-conceived "circuit breaker" plan. Unable to sell there, investors went to other markets including our futures markets, where the Dow pre-open Thursday was indicated down 400 – the unintended consequences that make for Black Swans. Meanwhile, now that the country has left all commodities in a nuclear winter, they're in the throes of trying to create a self-sustaining market economy built on consumer spending and a private service sector. While better at their economy than at their stock market, keep an eye on Alibaba (73) to see how that's going.

No place to run and no place to hide. That's how it goes in these nasty selloffs. Ironically, the so-called FANG stocks, despite their extended patterns, have held up better than most. Unfortunately, declines like this get to everything, so you pretty much can assume it won't be over until they get to them as well. When things sort out, when the climatic selling abates, a more normal bear market pattern should evolve. This would be one in which secondary stocks underperform relative to their larger brethren. The chart on the back shows this has been going on since the Russell peaked last June. A successful tactic should be to buy the SPYs and short the RUT, but for our purposes let's just say secondary stocks should be avoided, with few exceptions. When the market turns, it's the big stocks that will turn first, and it could be that they will be the only ones that will turn, at least for a time.

Oversold may not mean over, but it's a start. We don't have to repeat last August, but by one measure we're only about halfway to those levels. Looking at stocks above their 10-day average, Thursday reached 7% while last August the low was less than 1%. Also, the VIX peaked back then at 41, versus just 25 on Thursday. With this week's back-to-back days of 85%+ down volume, you can make a case for a low, especially if we see a couple of decent upside days. The real problem relates to our earlier comments. Were this still a bull market, we've seen enough to say the market has made a low. However, the overall trend now is down, and in that context the parameters for a low are different. Sure we can rally for a while, but it seems a stretch to be expecting too much. Not to rain on an already soggy parade, This January as a whole will need help to be positive, and we all know January has a decent record when it comes to forecasting the entire year.

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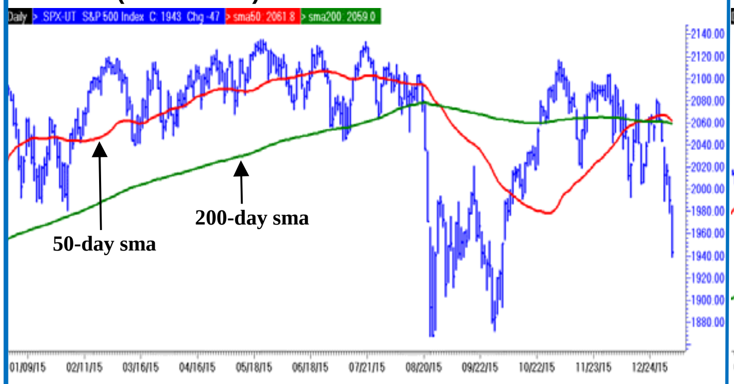
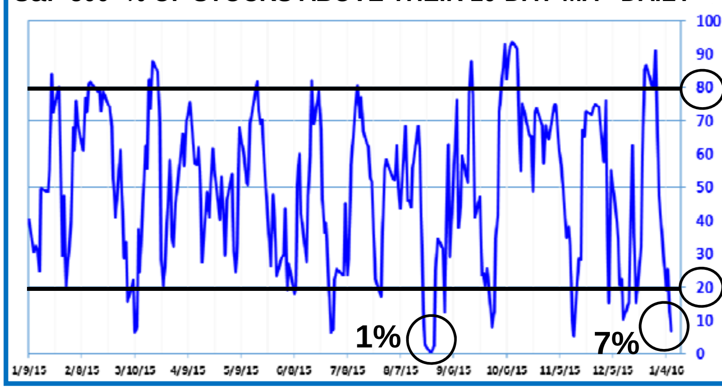
S&P 500 (SPX – 1943) – DAILY



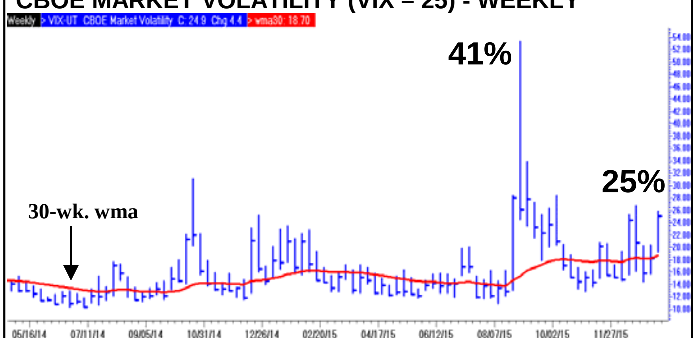
NASDAQ 100 (NDX – 4306) – DAILY

S&P 500 -% OF STOCKS ABOVE THEIR 10-DAY MA - DAILY



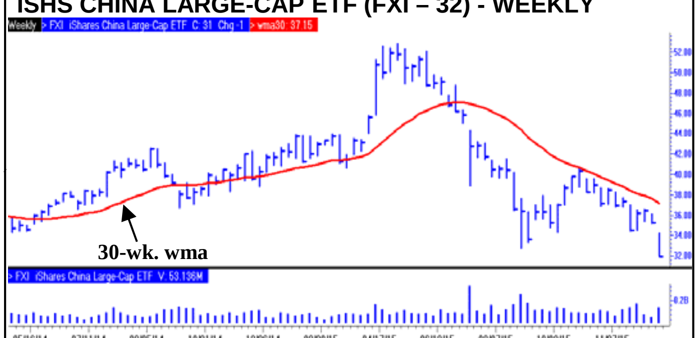
S&P 500 -% OF STOCKS ABOVE THEIR 200-DAY MA - DAILY

CBOE MARKET VOLATILITY (VIX – 25) - WEEKLY

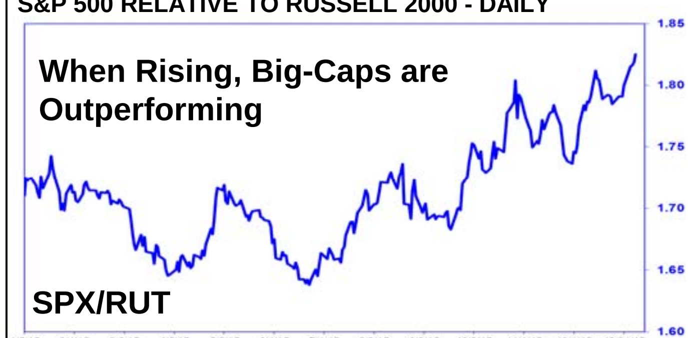


ADVANCE-DECLINE INDEX - DAILY

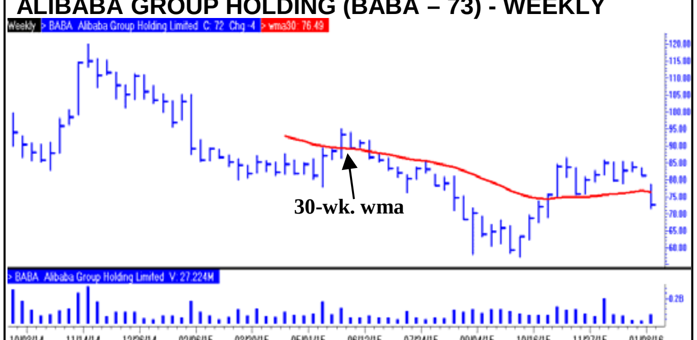
ISHS CHINA LARGE-CAP ETF (FXI – 32) - WEEKLY



S&P 500 RELATIVE TO RUSSELL 2000 - DAILY



ALIBABA GROUP HOLDING (BABA – 73) - WEEKLY



MARKET VECTORS GOLD MINERS (GDX – 15) - WEEKLY