EQUITIES PERSPECTIVE

May 6, 2016
DJIA: 17,661

Sell in May and go away … but enough about China. While a little the worse for wear, our market holds together. To some unclear extent, this in part may be an illusion created by those non-operating companies, which these days seem everywhere on the NYSE, and particularly distort the Advance-Decline figures. Unlike the big-cap averages, Advance-Decline figures measure secondary stocks as well. The Russell 2000 is a price measure and looks only at secondary stocks. It looks nothing like the S&P and nothing like the Advance-Decline Index. A dramatic illustration of what could be going on happened a week ago Monday and Tuesday when the Dow and S&P both rose modestly, but the ratio of advancing to declining stocks was 3.3-to-1 and 2.3-to-1. How can so many stocks be up and the market averages move so little? We believe the behavior of the average stock outweighs the behavior of the stock averages. However, this is true when the "average stock" is a common stock, not some non-operating company, bond substitute and so on. At least in terms of the average stock, the market is not as healthy as it seems.

If the Advance-Decline Index isn't as strong as it seems, that's important. The Russell 2000, a measure of secondary stocks, isn't even pretending. It's important because market peaks are characterized by lagging secondary stock performance at the same time large-caps, that is, the averages, continue to act well. Lowry's Advisory Service looks at stocks down 20% or more from their high. As of the beginning of the week, the number for small-caps is 50%, for mid-caps it's 28% and for large-caps it's 10%. This is a backdrop typical of a bull market peak – big stocks give it up last. Much of the market already is in a bear market, though as yet it's not the part which dominates the averages. The best-acting part of the market has been those commodity-related stocks. They were due, and even overdue, for this mean-reversion move, but that's what it is, a rally in a downtrend. It's hard to argue new bull market when, other than the averages, so much of the market remains in a bear market.

Market psychology, or market sentiment, is an important part of technical analysis. For us, it's not as important as price action, but when everyone is on one side of the boat, it's a heads-up that a trend may be about to end. However, just how do you measure "one side of the boat," and investors can stay on that side longer than you might think. Anyhow, there's a boat called the good ship Wall Street, a boat load of analysts. As the rally from the February low progressed, it was easy to find skeptics. Indeed, analysts were busy lowering earnings estimates going into reporting season, while the S&P rallied some 15%. Earnings were better than expected, no doubt in part because of those lowered expectations, and analysts have had a change of heart – funny how opinions follow price. According to SentimentTrader.com, analysts have raised price targets 960 times in two weeks, compared to 300 lowered targets. Not all big jumps in analysts' optimism resulted in declines in stocks. However, after previous periods of renewed optimism on the part of analysts, returns were subpar.

Another interesting measure of sentiment is a Fear & Greed Index created by CNN. It is comprised of indicators of stock and bond demand, and a couple of psychological measures as well. Historically, the 30-day average here has spent about 10% of the time below 29, during which time the S&P gained at a better than 30% annualized rate. In turn, historically it also spent about 10% of the time above 79, where it was recently, during which time the S&P returned a negative 1%. Other than at the extremes, the S&P returned about 4%. Then there is the more familiar VIX, or Volatility Index. This generally is more useful during market declines or periods of panic, and is sometimes called the "fear index." On the other side of the panic coin is complacency, and the VIX historically has spent a third of its time below 16.5, roughly where it is now. What is unusual is that the VIX has spent 30 straight days under 16.5. Investors may be too complacent.

If more serious, the situation hardly seems desperate. Even if the bear market is about to resume, it's unlikely to do so without an additional divergence or two – the proverbial weak rally. Looking at stocks above their 10-day moving average, the last rally was relatively weak, but it's the next rally that will be important. Another weak rally or two, which could take time, likely would seal the deal on the rally's end. Meanwhile, the percent of stocks above their 50-day moving average now is at 59%, having dropped out of its high-level trading range. When it did this back in mid-December, it ended the rally from the November low. When markets rally, rarely do investors worry, which seems the case when it comes to China. Still, so little worry is surprising when the chart there now looks suspiciously like it did last fall. When markets want to go down, China or some other excuse always seem to come along.

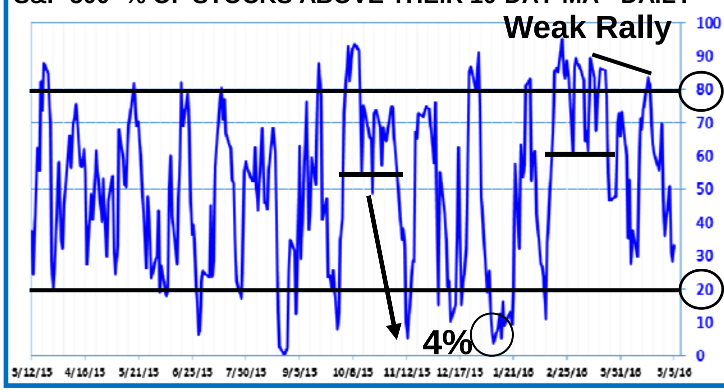
Frank D. Gretz

140 BROADWAY NEW YORK, NY 10005 TELEPHONE: (212) 320-3000

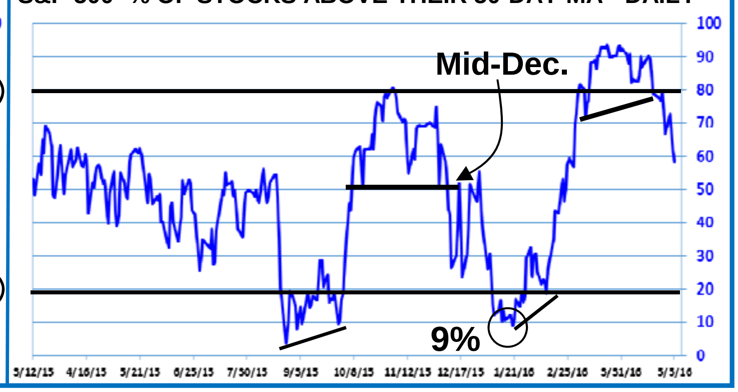
S&P 500 (SPX – 2051) – DAILY

NASDAQ 100 (NDX – 4309) – DAILY

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

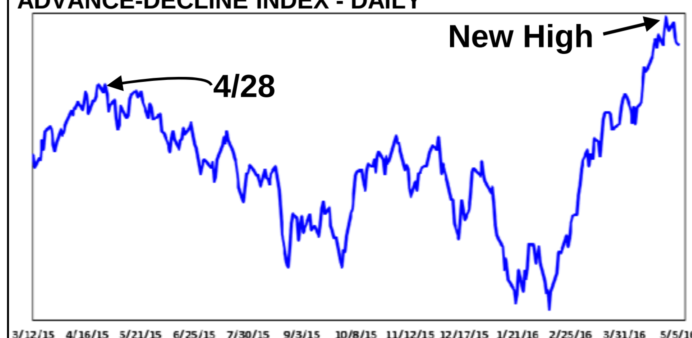


S&P 500 -% OF STOCKS ABOVE THEIR 50-DAY MA - DAILY



RUSSELL 2000 INDEX (RUT – 1108) - WEEKLY

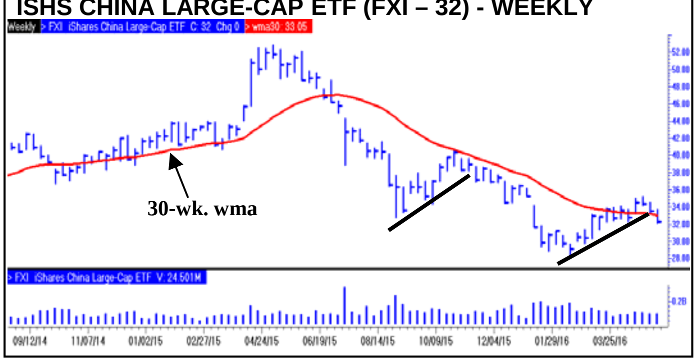
ADVANCE-DECLINE INDEX - DAILY



SPDR S&P METALS & MINING (XME – 23) - WEEKLY

CBOE MARKET VOLATILITY (VIX – 16) - DAILY

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



VANECK VECTORS GOLD MINERS ETF (GDX – 24) - DAILY