Sample Client Report from March 2017

While the market has a toppy look to it, I see no evidence yet of more serious toxic divergences. But both small and mid-cap stocks continue to show pretty severe divergences as most large-cap indexes are at or within one percent of new highs.

As I have stated before, toxic divergences involving small-cap stocks only tend to have a lesser impact on market performance, and are usually predictive of more modest pullbacks. Still, these lesser divergences must be taken seriously, as they do indicate market fatigue and an increased risk of a pullback.

A good example is July 2014, where serious small-cap divergences occurred without toxicity in the large cap index components. And the result: SPX declined by -4.3%, NDX by -3.8%, and XLK by -4.5%.

But two months later in September 2014, there was another round of divergences as the market hit new highs. And this time, the large caps (specifically SPX and NYSE components) diverged along with the small stocks, resulting in a more severe intermediate pullback (e.g. SPX -9.8%, NDX -10.2%, and XLK -9.8%).

I show below charts of NDX and XLK, which represent the two strongest market sectors. Both are dominated by large-cap technology stocks. And you can see that the index components, represented by the equal-weight indexes, continue to move up as both NDX and XLK are at or flirting with new highs. As such, there are no serious toxic divergences in play. The current scenario has similarities to July 2014, with a sharp disconnect between large and small-cap stock performance.

My conclusion: the market is clearly vulnerable to a 4-7 percent pullback at any time, based on the “small and mid-cap only” divergences. Indicators of excessive optimism continue to increase, but are not yet at lethal (e.g. froth) levels. Valuations are stretched, but are not at extreme levels.

If we get new highs along with continued serious small/mid-cap divergences, then the odds for the 4-7 percent pullback will increase. And of great importance, if the large caps show deterioration as well, then the 4-7 percent correction range will increase to 5-10 percent. And if more severe large stock divergences appear, then an even larger (e.g. >10%) pullback must be considered.

I continue to suggest paring back equity exposure on strength. With more severe divergences, aggressive investors can consider trading the downside.

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Note that the NDX and NDXW (equal weight versions) continue to move in lock step. Thus, there are no component divergences. The FANGs and their smaller cousins remain in uptrends for now.

We see a similar pattern in technology, with two equal-weight indexes (RYT, QTEC) fully in gear with the cap-weighted XLK. The large-cap tech stocks continue to move up, with no divergence in evidence.

RYT Guggenheim S&P 500 Equal Weight Technology ETF NYSE
©StockCharts.com
13-Mar-2017 11:59am
Open 119.75 High 120.15 Low 119.75 Last 120.03 Volume 10.7K Chg
Guggenheim S&P 500 Equal Weight Technology ETF (Daily) 120.03
120.03
119
118
117
116
115
114
113
112
111
110
109
108
107
106
105
14 21 28 Dec 5 12 19 27 2017 9 17 23 30 Feb 6 13 21 27 Mar 6 13

QTEC First Trust NASDAQ-100-Technology Sector Index Fund Nasdaq GM
©StockCharts.com
13-Mar-2017 12:01pm
Open 59.46 High 59.69 Low 59.46 Last 59.58 Volume 41.0K Chg
First Trust NASDAQ-100-Technology Sector Index Fund (Daily) 59.58
59.58
58.5
58.0
57.5
57.0
56.5
56.0
55.5
55.0
54.5
54.0
53.5
53.0
52.5
52.0
51.5
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14 21 28 Dec 5 12 19 27 2017 9 17 23 30 Feb 6 13 21 27 Mar 6 13