Sample Client Report from October 2016

Here are my latest conclusions, based on my indicators:

Overall picture:

1) The SPX has now moved laterally in a tight 3 percent range for 57 days. Each dip has been bought, and each rally has been sold. As of 11:10 am, the SPX is at minus 0.4 percent since July 14.

2) The principal driver for the market has been Fed activity, and the continued policies (globally) to maintain a zero rate environment. Whenever the Fed reiterates the intention to hold off any rate increases, the market rallies. And whenever a more hawkish Fed governor suggests a rate hike may lie ahead, the market reverses, but only temporarily. So obviously the market wants the Fed to hold off, seemingly forever.

But we know that this cannot last. And a delayed move to faster tightening next year may well cause larger problems for stocks in 2017. I am confident that my divergence analysis will signal such dangers in advance.

3) For now, stocks continue to be far more attractive than the fixed income alternatives (e.g. TNX), and thus remain the “only game in town” globally, so to speak.

4) And thus dividend-paying blue chips should be the principal beneficiaries.

5) BUT paradoxically, the quality yield stocks have been shunned since early July. And the new investment mode has shifted dramatically to RISK-ON, seeking returns from more speculative, economically sensitive technology stocks.

6) And the best performers have been the small/microcaps and semiconductors, the riskiest and highest beta sectors of all. But this recent move is not excessive and frothy.

What does this mean for now? Answer: a stalemate.

The market currently is in a sweet-spot zone. The zero-rate picture continues to protect stocks on the downside, leading to immediate buying on virtually any dips. And the move to technology tells us that the markets are voting for a pickup in economic and earnings growth next year. Here, they may or may not be right.

But with stocks fully valued, the market seems to hit a brick wall on the upside, not allowing (for now) a clear breakout to new highs. The technology indexes and the tech-heavy NDX have flirted with nominal highs, but only modestly so.

But importantly, the market (and especially technology) internals have been strong as of late, thus preventing any toxic divergences from developing as nominal highs are reached. This strong breadth has clearly resulted from the “risk-on” psychology of the day.

How will the stalemate be resolved?

From my analysis, the strong bottom from February is still the dominant force. And also, the powerful post-Brexit "breadth/volume thrust" (late June) has served as an important "extra booster shot" to the February low. History shows that important bottoms followed by breadth thrusts invariably lead to 1-2 years (at a minimum) of upside market action. We are currently close to 8 months off the low.

Around the time of the February low, I projected a market advance that would "surprise most" by its intensity. And I also stated that the SPX would likely move to a new high of 5-10 percent above the summer 2015 highs by Q1 2017. The strong rally part has already occurred, but the new highs projection still remains to be seen, at least for the SPX.

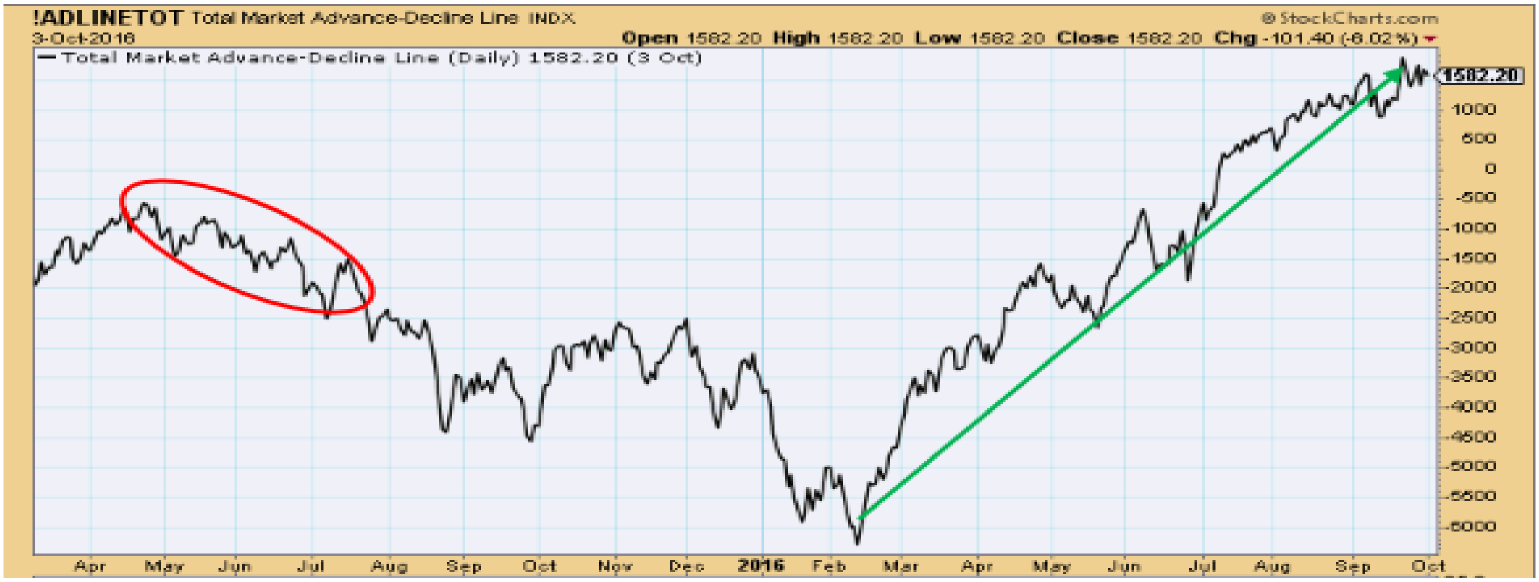
So far, the SPX has moved close to 3% above last year's high, so I see more upside potential here. But the primary technology ETFs (XLK) is already up 12 percent from its July 2015 peak. So we still have close to 6 months for the broader markets (e.g. SPX) to reach my preliminary (5-10%) predictions from February.

What is the risk of a major top in here, and of a severe crash or bear market?

Based on strong current breadth, the risk is small, at least for now. Over history, bear markets invariably are preceded by extended periods of deteriorating internals. If anything, we see the opposite today. Note in the chart below the continued strong advance-decline line for the total market. And note also (and very importantly) the three month deterioration in breadth that occurred leading up to the final July 20 high in 2015.

Strong AD lines are important predictors of longer-term gains in the market. And bear markets rarely if ever occur under such conditions. The only exception for this (that I am aware of) was 1946. But at the 1946 top, lethal speculation was present. There is no froth in today's market.

Total market breadth remains remarkably strong.



What about a toxic divergence in technology, given the recent high?

Here I see potential dangers, but not immediately.

The new highs in the XLK AD line tells us that most of the components are participating to the upside. In sharp contrast, note the clear deterioration in breadth between March and June 2015. So conditions today are clearly different than the top seen at the 7/20/15 top.

BUT

There are also potential dangers in technology, as breadth momentum deteriorates. Note that the current momentum in technology peaked in early July, and has been heading down ever since.

Still, breadth levels remain higher now than the toxic levels reached in July 2015. I am watching closely for further weakening here that could lead us to toxicity.

CONCLUSION

The overall bull market remains in play. I still look for my original targets from February to be met, or exceeded.

But it is possible that a sharp pullback like Brexit or worse will be needed to jump-start the next leg up. Modest corrections of 5-8 percent can easily result even without any divergences in place. And such retracements are perfectly normal and healthy in bull markets. If we get such a pullback, I will be looking for negative sentiment and bottom divergences. Such an interim low may create new buying or trading opportunities.

I am currently tracking closely for toxic divergences in both technology and the tech-heavy NDX. As discussed above, breadth momentum has been pulling back since early July. But breadth strength remains above toxic thresholds for now. The recent "risk-on" buying of smaller stocks has put any toxic divergence on hold for the moment.

One important lesson: there was a similar burst in breadth in speculative stocks in June 2015. And just a few weeks later, a severe divergence was in place at the final top of July 20. The highest-beta stocks like semiconductors went from strongest to weakest in less than a month. So toxic divergences can paradoxically be triggered from strong breadth. This is the Ying and the Yang of market psychology.

Thus, strong current breadth must not lead us to complacency.

Final thought: a rally to new highs by the leading indexes in 2017 could lead to a more important top, as the Fed finally takes away the punch bowl. And then a series of "catch-up" rate increases would serve as the trigger for a larger decline. The degree of deterioration in the internals at such a top will tell us the likely severity of the pullback. My initial guess is that a severe but short (several months) correction (12-20%) is more likely than a prolonged bear market. Why? The strong internals.

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