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COMMENTARY

## 5 Reasons For A Rebound In US Stocks

Posted on: Wednesday, August 10th, 2011

### Summary

The current sharp decline in the US stock market is unlikely to continue appreciably further from here, **if at all**, without at least a multi-week corrective rebound first.

### Introduction

From our [August 8th Keys To This Week](#) report:

*“Last Friday’s spike in NYSE volume amid oversold conditions plus extremes in investor sentiment and market breadth, all while most major US indexes are positioned just above major support levels, establishes a **conducive environment for at least a near term, corrective bounce to emerge sometime this month – perhaps after our 1150 initial downside target is met in the bellwether S&P 500.**”*

Our 1150 downside target in the S&P 500 was met later that day (August 8th), resulting in a 104 point, -8% decline since we first discussed it in our [August 3rd What We’re Watching Today](#) pre-opening market comments. Now that our initial downside target has been met, today’s report displays and discusses 5 different market metrics that indicate favorable conditions for at least a multi-week corrective rebound to emerge from at or near this week’s lows.



### Momentum (Overbought/Oversold)

Chart 1 displays the S&P 500 (SPX) since 2007 in the upper panel (black bars), along with the 1-month rate of change in the daily closing price of SPX in the lower panel (blue line).

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Chart 1

This is a very simple measure of monthly overbought and oversold extremes which, as the green highlights show, has either coincided with or led literally ever near to intermediate term bottom in the US broad market index in recent history.

We acknowledge that this indicator became over-extended to the downside in late 2008 as the S&P 500 was forming what eventually became the final May 2009 bottom. However, note that — in most cases — the indicator really did not get much lower than where it is right now before at least a near term, corrective rally emerged.

## Volume

Chart 2 displays the S&P 500 daily since 2010 in the upper panel (black bars), this time with daily NYSE volume plotted in the lower panel (blue histogram). *Volume indicates urgency*, and investors feel the most urgency when they are *terrified* rather than greedy.

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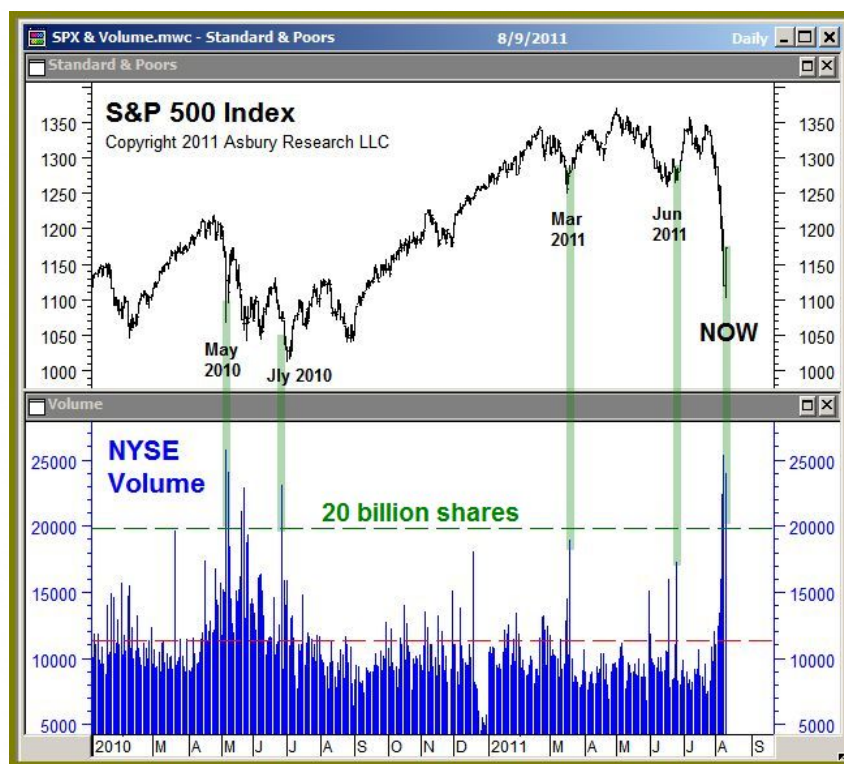


Chart 2

The green highlights bear this out as they show that big spikes in NYSE volume, in excess of 20 billion shares, have occurred when the US broad market was plummeting and investors were apparently capitulating on long positions — because they were *collectively terrified* of an even deeper decline. The chart shows that *this capitulation process is precisely when investors should consider buying, not selling.*

With Tuesday's NYSE volume in excess of 24 billion shares, its highest level since late June 2010 (which immediately preceded the early July 2010 bottom in SPX), *these data suggest favorable conditions for another market bottom to emerge soon, probably within the next week or so.*

## Volatility

Chart 3 displays a 2-year daily chart of the S&P 500 in the upper panel (black bars) with a daily chart of the VIX (blue bars) in the lower panel. The VIX, often referred to as “the fear gauge”, is a popular measure of the implied volatility of S&P 500 index options.



Chart 3

The green highlights on the chart show that spikes in the VIX to 30 or higher, indicating an extreme in investor fear (of even lower US equity prices), has coincided with or led every significant bottom in the S&P 500 in recent history. The rightmost green vertical highlight between both panels show that the VIX has reached another such extreme now, and its highest level since late May 2010 (which immediately preceded a quick +9% rebound in SPX during the first half of June and eventually led into the 2010 lows in early July).

Similar to the volume spikes as shown in Chart 2 above, when the market is collectively this fearful investors should be looking to buy, not sell.

## Investor Sentiment

Chart 4 displays the S&P 500 daily since 2006 in the upper panel (black bars), with a daily survey of retail investor **bullishness** on the US broad market index in the lower panel (blue line). Because retail investors are notorious trend followers, they are typically the most collectively bullish at market tops and the most bearish at market bottoms.



Chart 4

The green highlights on the chart bear this out as they show that *least bullish* extremes, of just 21% bullish or less, *have either coincided with or led every important bottom in the S&P 500 in recent history*. At just 12% bullish as of the latest data, the rightmost green vertical highlight between both panels shows that *these investors are at another such least bullish extreme now*.

We acknowledge that these investors remained at least bullish extremes for several months between October 2008 and March 2009 as SPX was putting in a final bottom. However, we also note that the October least bullish extremes immediately led a sharp +26% bounce in SPX between late November and early January 2011 before the final bottom was finally established on March 6th.

## Market Breadth

Chart 5 displays the S&P 500 daily since 2010 in the upper panel, with the NYSE 26-week New Highs/New Lows Ratio plotted in the lower panel (blue line). This metric measures 6-month bullish and bearish extremes in NYSE market breadth.

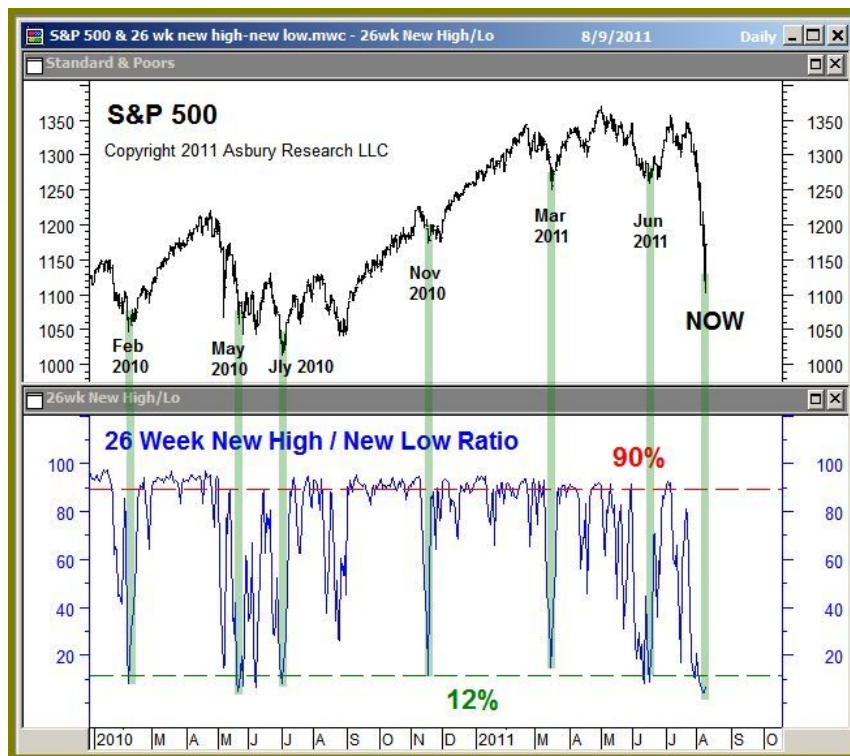


Chart 5

The green highlights on the chart show that this ratio is at an historic low extreme of just 12% or less that has previously coincided with every meaningful bottom in the US stock market in recent history, most recently the near term bottoms in June and March of this year. We view these data as more evidence that an extended, sustained continuation of the current decline in the US stock market is unlikely from here without at least a near term, multi-week corrective rebound first.

Chart 6 takes another look at market breadth via the daily percentage of NASDAQ 100 (NDX) constituent stocks trading above their 50-day moving average, which is plotted by the blue line in the lower panel. A daily bar chart of NDX since 2009 is plotted in the upper panel.



## Chart 6

The green highlights show that this measure of market breadth is at an historic low extreme, of less than 20%, which *has previously coincided with every important near to intermediate term bottom in NDX* in recent history. Since the Tech-laden NDX tends *to lead* the US broad market, we view this weak extreme in market breadth as not only an indication of an upcoming rebound in the NASDAQ 100, but also of a period of upcoming *relative outperformance* by the NASDAQ 100 versus the S&P 500.

## Conclusion & Investment Implications

The monthly rate of change in the S&P 500, NYSE volume statistics, market volatility, retail investor sentiment, and the latest market breadth data concur that the current sharp decline in the US stock market is unlikely to continue appreciably further from here, ***if at all***, without at least a multi-week corrective rebound first. The common denominator of all the metrics in this report is *indications of investor panic — which history tells us is precisely when investors should be buying*.

Although current market conditions show *the potential* for one more eventual leg lower (perhaps during September) before the May US stock market decline runs its course, investors may consider putting ***some*** capital to work now, at these levels, in order to participate in whatever type of rally — ***either corrective or directional*** — that emerges this month.

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