Leavitt Brothers

Weekly

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For the first time in nearly four weeks the market has dropped two consecutive days. In fact, Thursday and Friday's combined loss was the biggest 2-day loss since the market bottomed in February.

The market has flashed warnings signs for a couple weeks. Twice the AD line and AD volume line have diverged from the price action. The percentage of stocks trading above their 20- and 50-day moving averages declined, even when the indexes pushed to higher highs. And the biggest warning came from our bottoms-up analysis. The quality and quantity of stock picks has been pretty poor the last few weeks, other than oil, gold/silver and a few other commodity groups. Even if we didn't wish to enter the debate on the staying power of the trend, there wasn't much to do besides being long commodities.

Now the market is only up a small amount going back to the third week of March. Is this the beginning a full-blown correction or just a pullback within a pretty solid intermediate term uptrend? There is no shortage of opinions out there, and of course nobody knows the answer.

I am going to operate under the belief this is a rest within an uptrend that will eventually resume. I have two reasons for this. 1) The default setting should be "up." Many investors think buying a stock at 50 and selling it at 48 is the greatest cause of loss in the market, but that's not the case. It's a loss, but it's far from the biggest loss. The biggest loss is buying a stock at 20, selling it at 23 and then watching it rally to 50 and never getting back in. Negative, cynical, pessimistic investors lose more money being in a state of denial and not participating than from actual losses. And I'm not talking about leaving a little on the table. I'm talking about not participating for months or years because they just don't believe what they're seeing. The default setting should be "up." When the market turns, you give a little back. But it's better to give a little back after a solid run than not participate in in the run in the first place. 2) Even if a top was in place and the market was destined to experience a significant drop, there is very likely to be some up and down movement before the drop materializes. So there should be time to exit.

If you go short every time the market looks like it wants to head south, you'll miss a lot of upside movement. Most of the time the trend resumes after a brief pause.

Nobody can perfectly play the ups and downs. When the trend is up the call is to be either long with size or flat (or some range in the middle) depending on the quality and quantity of good set ups, the strength of the trend, the staying power of the trend and where we are relative to previous highs and lows. I'm never short.

Trading is hard enough as is. Why try to find the proverbial needle in the haystack when the wind is blowing a different direction.

When the market corrects within an uptrend, I'm flat or close to flat. I'd rather build my list and get ready to play the next leg up than tinker around on the short side. This is how I operate because the market has taught me, trained me, and conditioned me this way.

You see, there was a time I'd go short. Why not I thought? If the market is going to offer profits to the downside, why not take them? The problem is this. As soon as you go short, you become a cheerleader for that side. You start hoping the market goes down further, and when evidence builds the correction is nearing an end, you bargain for more. Then when the market pops, you demand if fall one more time (back to the lows) so you can cover your shorts. But it doesn't. It just bounces and bounces, and pretty soon you puke your positions. And not only did you make very little on your shorts, but you missed some great long entries. But the market doesn't offer second chances. You got exactly what you wanted - a correction within an uptrend. But you missed it because you were preoccupied with a couple short positions.

It happens all the time. It happened enough to me in my early days that I don't bother going short. I'd rather scale back (my oil, gold and silver stocks are doing well, so there's no reason to dump them) and build my list and get ready for the next leg up. If I'm wrong, if a top really is in place, fine. I'll be wrong. But I'd rather be wrong once when the market turns than wrong every two weeks when the market runs out of short-term steam.

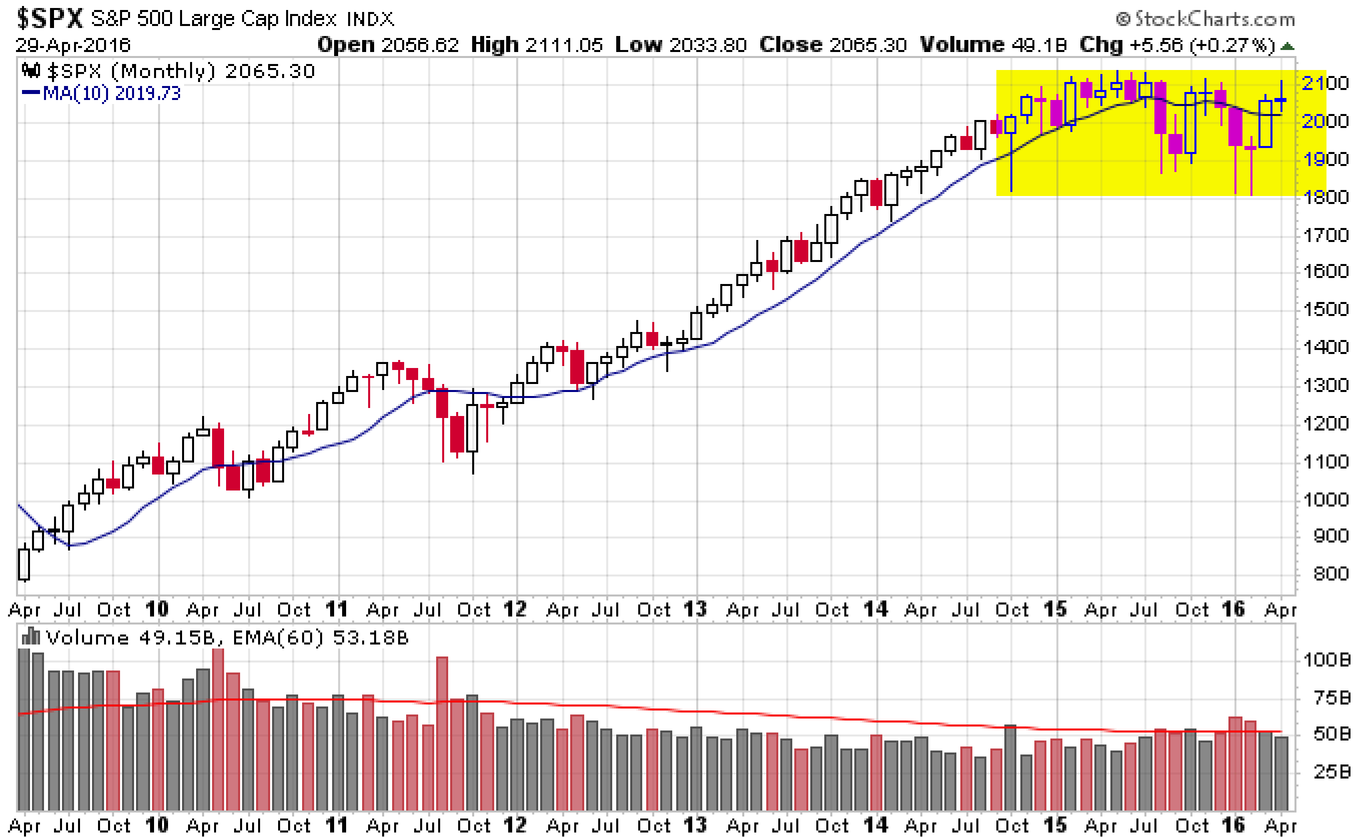
Maybe a top really is in place. Maybe the market really is headed back to its low. I don't know. I do know if you hit the panic button every time the market looks like it wants to roll over, you'll miss a lot of potential gains.

Overall I'm operating under the belief new highs will be made. But in the near term, I'm certainly not going to step in front of a falling market.

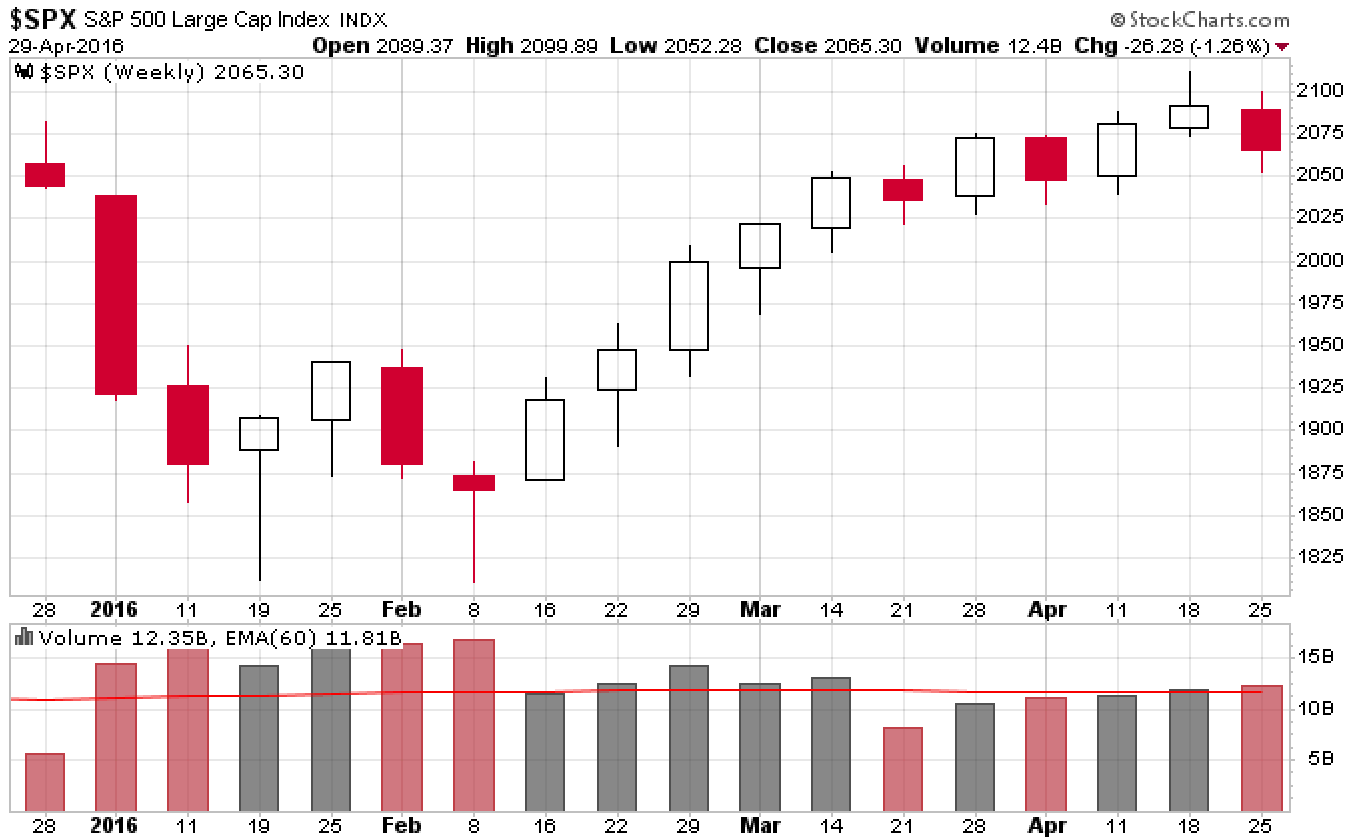
Let's get to the charts and see what they say.

Indexes

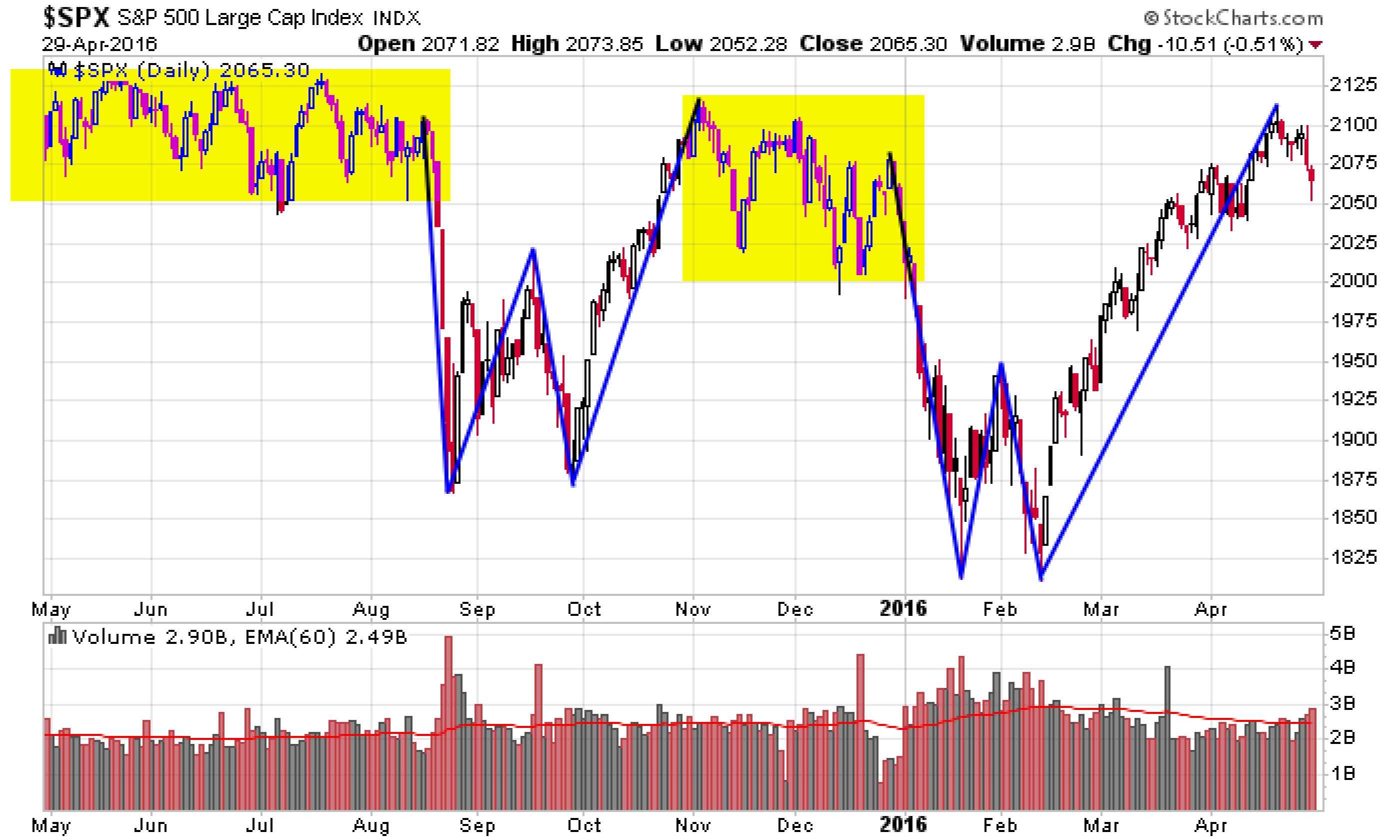
The S&P 500 Monthly: The S&P finished April with a small gain, but volume declined and the close was in the bottom-half of the range. Overall I consider this to be a 18-month consolidation pattern within an uptrend. A breakout measures up to 2400ish. Don't think it's possible? Most traders don't...and that's exactly why it is.



The S&P 500 Weekly: Changing things up this week. Here's a close-up of the S&P weekly. For only the second time since the rally started in February, the S&P failed to take out its previous week's high. Not big deal. It's evidence of how persistent the rally has been, not necessarily an urgent warning. There have been a lot of over-lapping candles and very little follow through the last 6-7 weeks. The bulls have been conditioned to buy dips. If that doesn't work next week, I can certainly see a drop back to 2000.



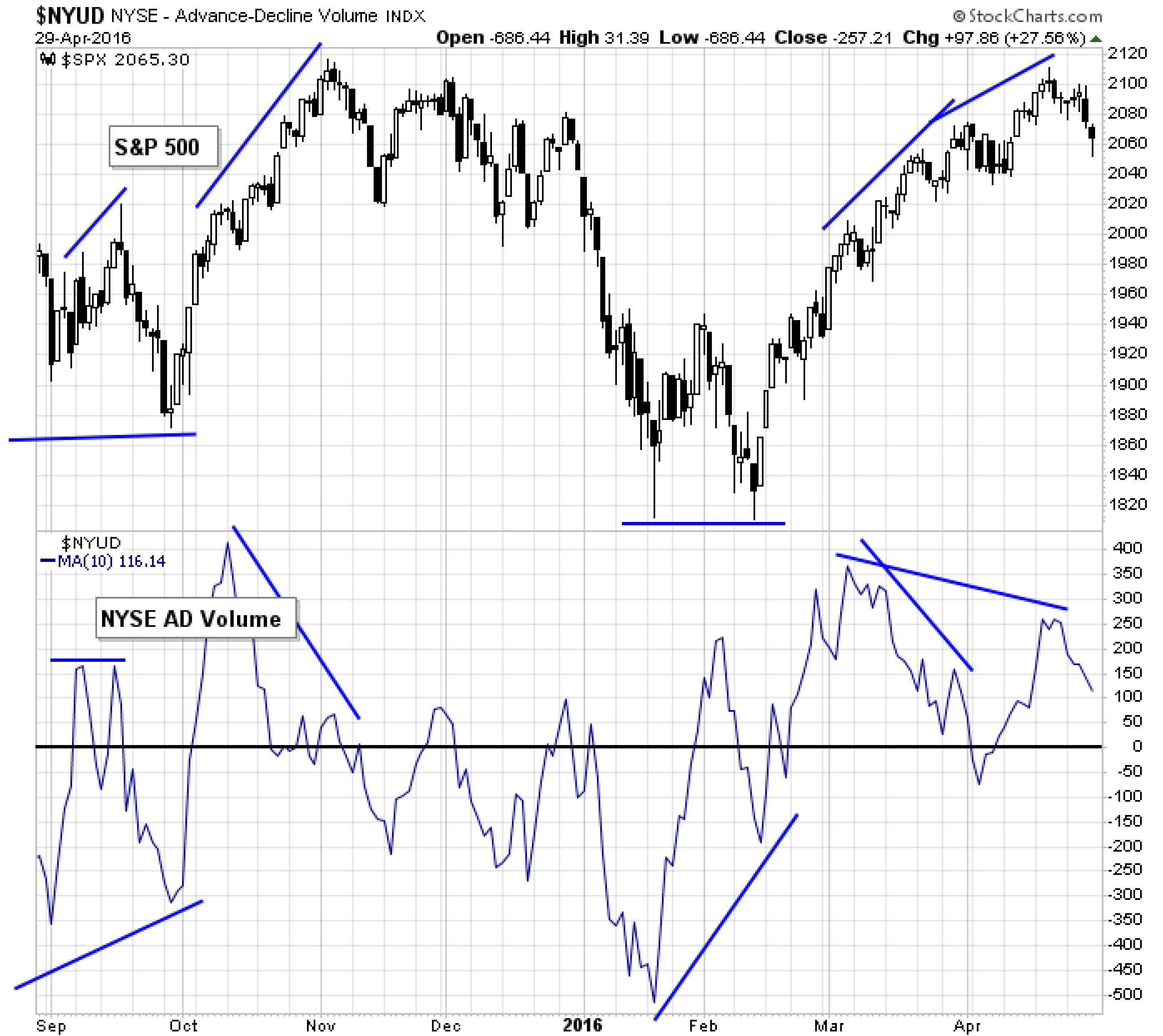
The S&P 500 Daily: Prior to the last two sizable drops, there were many weeks of up and down movement before the drops officially played out (yellow areas). This tends to always be the case (tops take time to form). It's why I don't panic when the market weakens. It rarely heads straight down.



Indicators

S&P 500 vs. 10-day MA of NYSE AD Line: The divergence that formed and peaked at the end of March led to a 2-week stall. Another divergence is now in place. At the very least I'd expect the AD line to cycle back to 0 and the market to fall a few more days. Then we'll see if the indicator bounces or stalls and continues down.

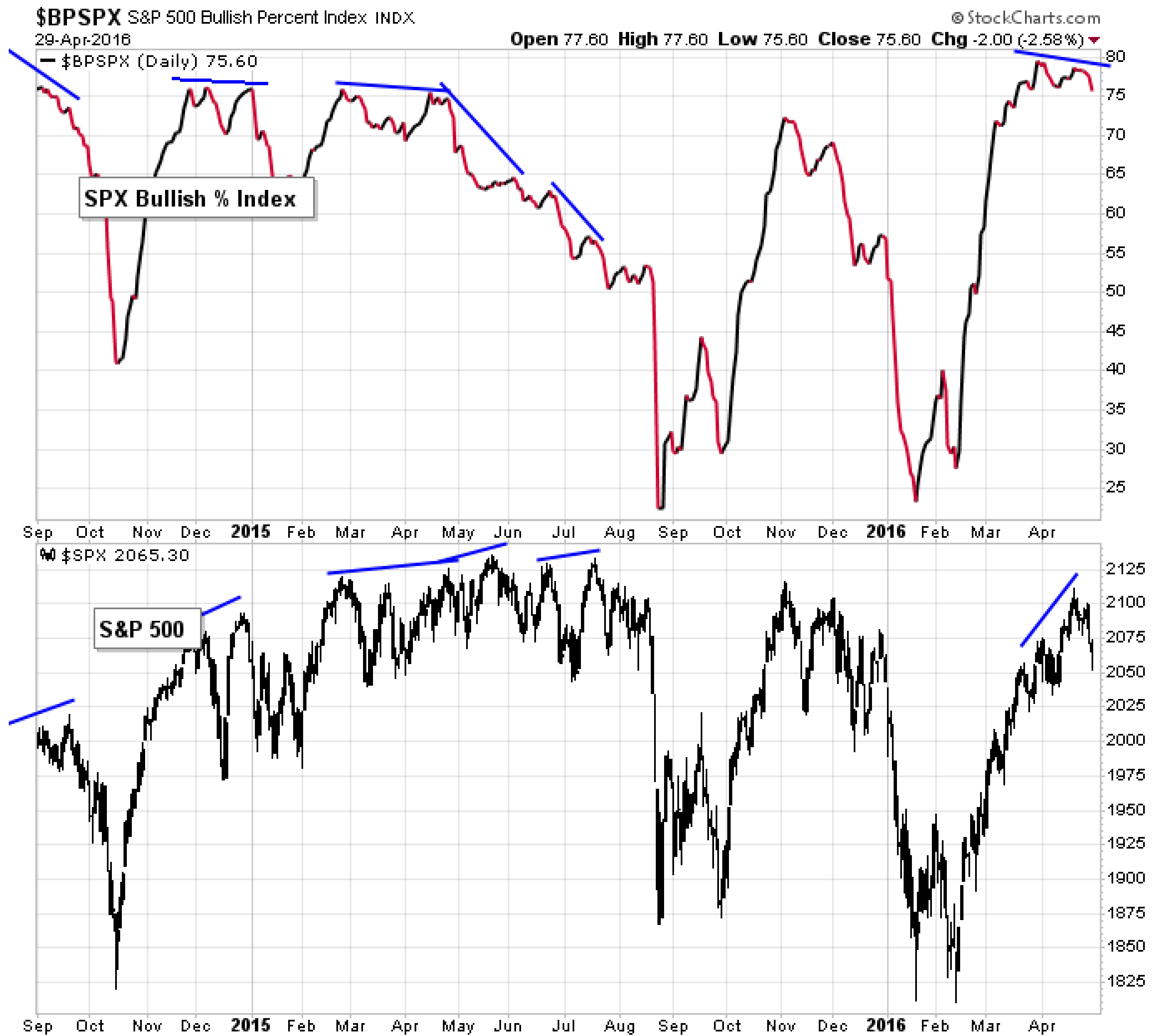
S&P 500 vs. 10-day MA of NYSE AD Volume Line: Like the AD line, the AD volume line formed a divergence at the end of March and is now resolving another divergence on a longer time frame. If the indicator can stay above 0, it'll hint at underlying strength and a likely leg up. But if it falls below 0 and can't recover, we're likely to get a bigger pullback.



S&P 500 vs. NYSE New Highs: Last week I report less new highs were made while the overall market had moved to a higher high. This was a warning. Less stocks participated in the pop, and without that support, it's not a surprise the market fell last week.

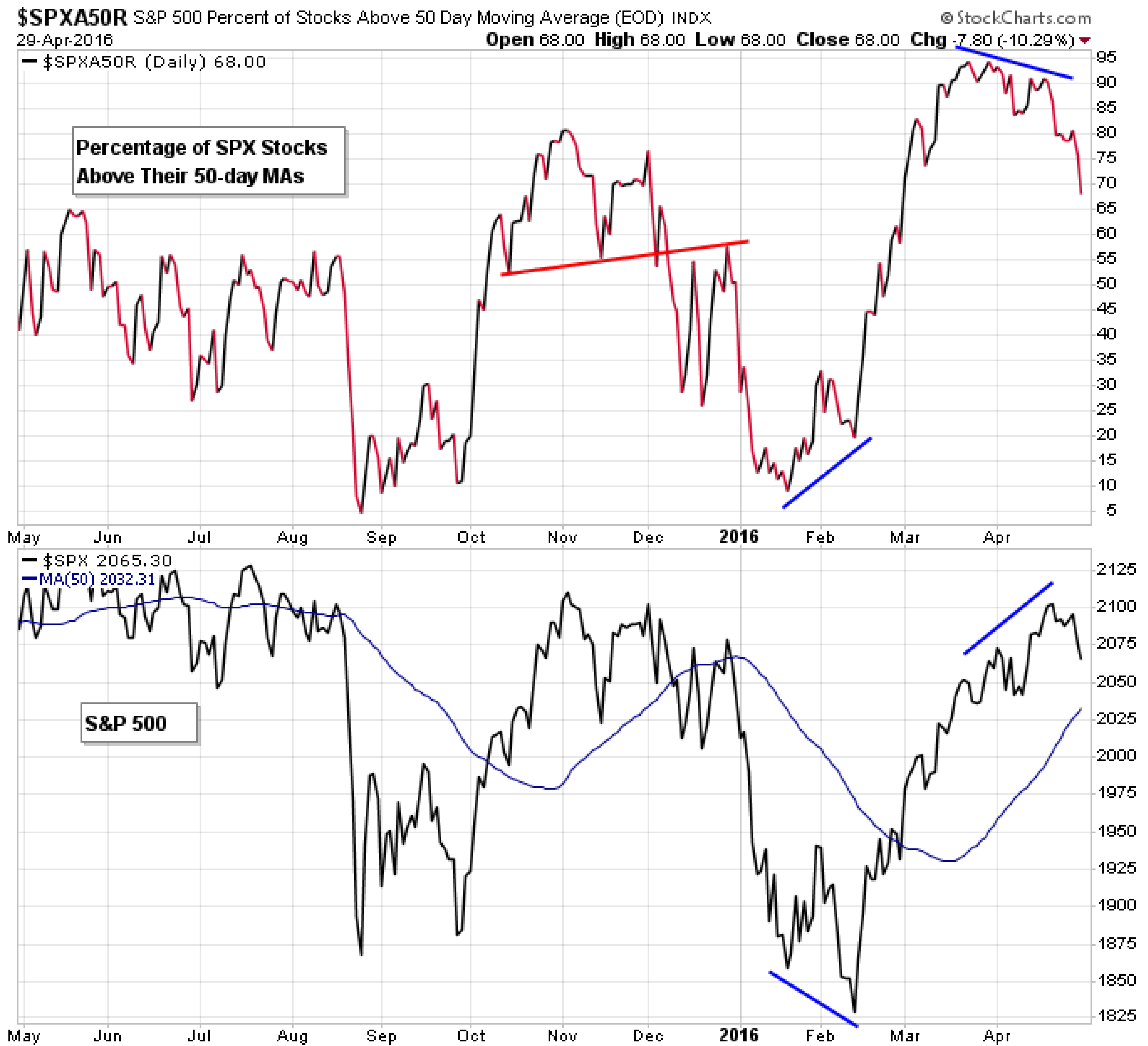
NASDAQ vs. NASDAQ New Highs New highs at the Nas haven't strongly supported this entire rally.

S&P 500 vs. S&P Bullish Percent: Negative divergence between the S&P and S&P bullish percent charts. Another sign less stocks participated on the most recent move to a higher high.



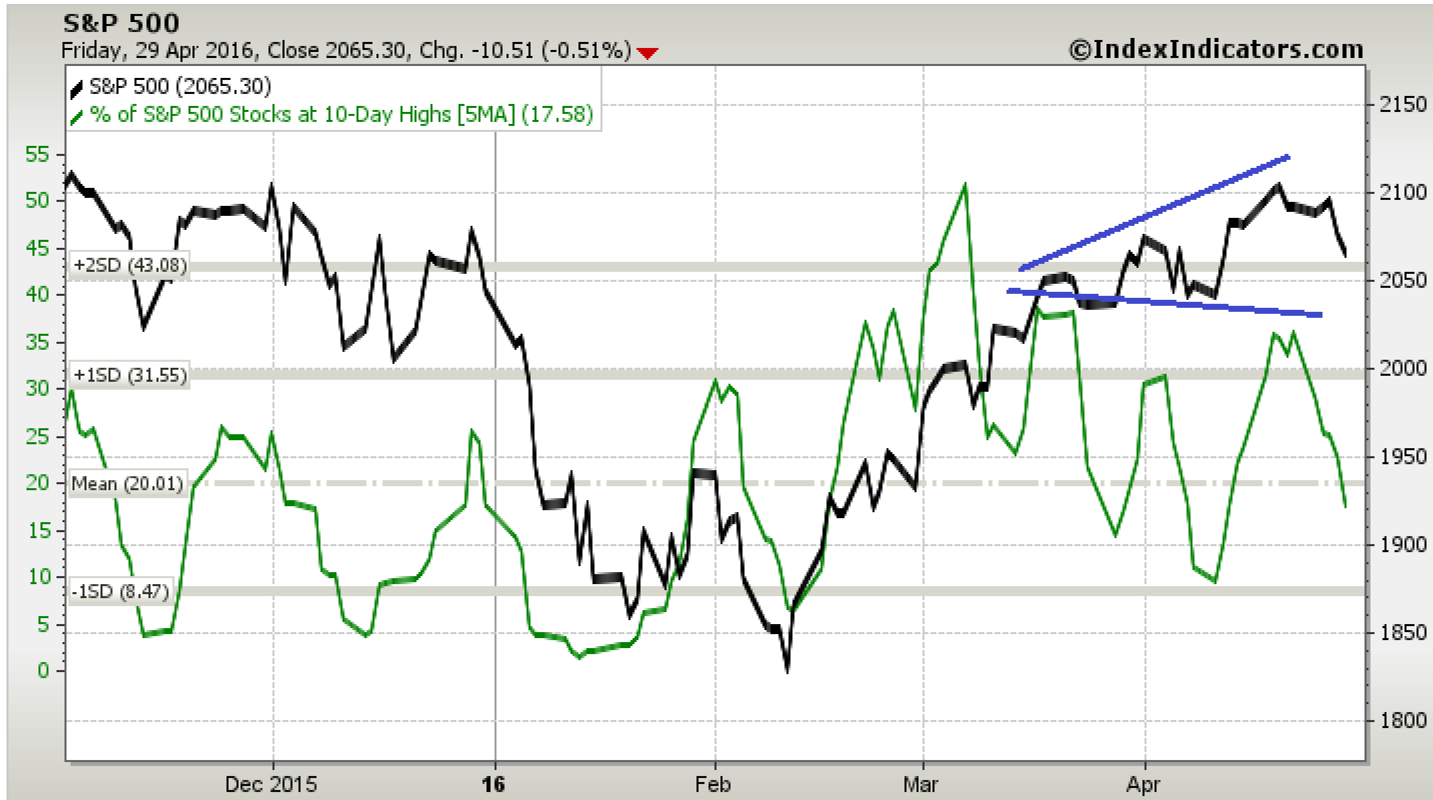
S&P 500 vs. Percentage of SPX Stocks Above 200-day MA: The overall percentage of stocks above their 200-day moving averages still clocks in at a healthy level, so despite the near term warnings, the overall picture still looks good.

S&P 500 vs. Percentage of SPX Stocks Above 50-day MA: The percentage of SPX stocks above their 50-day moving averages divergence from the underlying price action. A rising tide has raised slightly less ships lately.



S&P 500 vs. Percentage of SPX Stocks Above 20-day MA: Zooming in a little closer with the 20-day MA, we see a continuation of the deterioration here too.

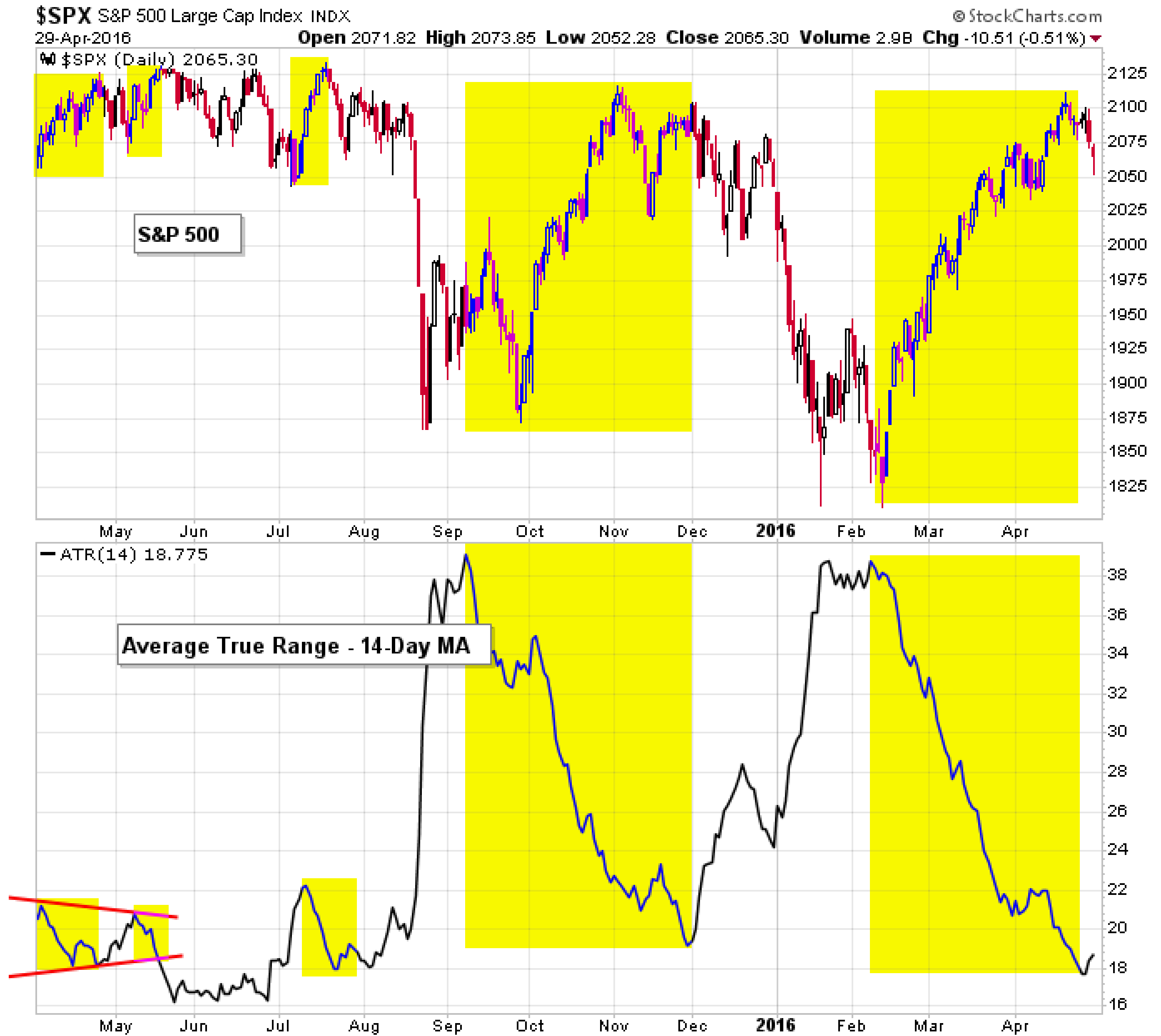
S&P 500 (black) vs. Percentage of SPX Stocks at a 10-day High (green): The percentage of SPX stocks above their 10-day highs is below average. Not a surprise. When the market moves sideways and then suddenly drops, you're not going to get a lot of stocks pushing up. What's more important in the near term is the relatively small number of stocks pushing to new 10-day highs on the most recent market pop. More evidence the participation rate has dropped.



S&P 500 (black) vs. Percentage of SPX Stocks at a 20-day High (green): I'm trying to find some hope for the bulls in the near term. Here's the same chart as above except the 20-day high is used instead of the 10, but the story is the same. Less stocks participated in the most recent pop. The path of least resistance in the near term is down until the charts can recycle.

S&P 500 vs. 10-day MA of Put/Call Ratio: Market tops often coincide with put/call bottoms. The PC could certainly roll over here, but at the very least you have to be very careful going long right now.

S&P 500 vs. 14-day Average True Range: The market rallies on low or declining volatility and drops on expanding or high volatility. My measure of vol is the 14-day ATR. If it moves up while the market bounces around, it tells us the next likely move is down. But if it stays at a low level, the uptrend is likely to continue. Let's see what happens the next couple weeks.



The Bottom Line

The market fell last week for the third time since the February bottom was established, and over the last six weeks it has posted a gain three times and posted a loss three times. In the grand scheme of things, considering the S&P rallied 300 points, it's not a huge concern.

But in the near term there's definitely some weakness. The AD line, AD volume line, the percentage of stocks above their 20- and 50-day moving averages, the percentage of stocks at a 10- and 20-day high and others all suggest less participation on the most recent rally attempt. Such a development tends to lead to weakness in the short term.

But I still operate under the belief weakness will get bought and new highs will be made.

Be patient right now. Other than a few commodity groups, there isn't much to do right now. Let the charts re-set.

Have a great week.

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