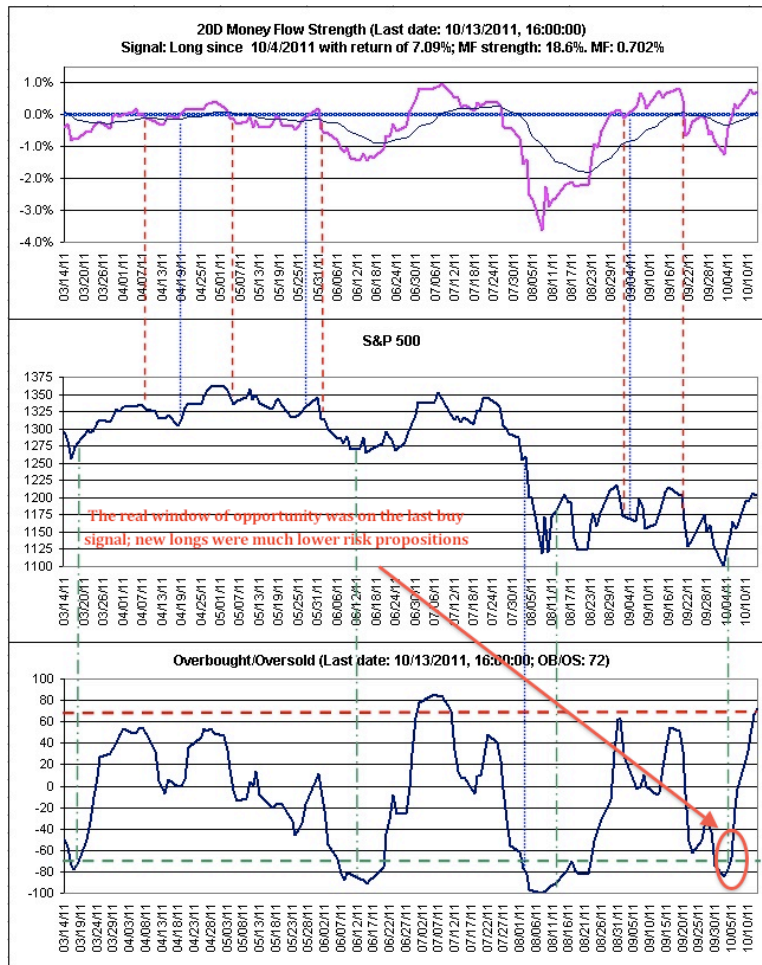


## Market Observations: 10/15/2011

By Eric Coleman

### Summary:

The 20-Day MF shows a market that attracts money, while quickly approaching overbought status on the OB/OS oscillator. This tells me that any new long positions are likely susceptible to a swift pullback – at minimum, although the timing of such a pullback remains unknown. The biggest edge for long positions came during the buy signal almost two weeks ago, coinciding with a swift breakdown and powerful bounce. That window of opportunity has since passed, so now is the time to prepare for the next window . . .



In the summer, Mike Scott outlined some bear market scenarios:

*I am guessing based on history that all rallies between say now and July of next year will be bear market rallies no matter how convincing they seem.*

This is something one should keep in mind. The market put in a powerful rally off the lows. Soon, if not already, there will be relief and belief that the market is back to normal and ready to move meaningfully higher; nonetheless, good reasons remain for a defensive posture while maintaining skepticism about the durability of the most recent advance.

What do the daily and weekly stage structures say?

Daily Stages: 10/14/2011

|     |   |
|-----|---|
| SPY | Current Stage is 1-1 (Early Accumulation) Has been in current stage for 1 day |
| QQQ | Current Stage is 2-1 (Strong Mark-Up) Has been in current stage for 1 day     |
| DIA | Current Stage is 1-2 (Mid Accumulation) Has been in current stage for 1 day   |
| IWM | Current Stage is 1-1 (Early Accumulation) Has been in current stage for 1 day |

Weekly Stages: 10/14/2011

|     |   |
|-----|---|
| SPY | Current Weekly Stage is 4-2 (Medium Decline) Has been in the current weekly stage for 1 week    |
| QQQ | Current Weekly Stage is 4-3 (Weakening Decline) Has been in the current weekly stage for 1 week |
| DIA | Current Weekly Stage is 3-3 (Late Distribution) Has been in the current weekly stage for 5 week |
| IWM | Current Weekly Stage is 4-2 (Medium Decline) Has been in the current weekly stage for 1 week    |

SPY, QQQ, and DIA are characterized by early and mid-accumulation daily stages, which indicates a bearish-neutral position. Additional gains likely necessitate a period of consolidation or quiet trade that would allow for an orderly transition into a late daily accumulation stage. The Q's outperformance is well known, so entry into a strong mark-up phase is not surprising – AAPL, AMZN, and GOOG supported the recent advance.

The weekly stages provide broader context through which one interprets shorter-term action. Improvement on daily timeframes is constructive, yet the weekly backdrop continues to suggest caution for long-side commitments. Mid and late weekly downtrends describe the SPY, Q's, and IWM. Consequently, a long-term advance characterized by extreme breakouts in new leadership after a period of neglect and bearishness just isn't present. Indeed, a period of multi-week to multi-month accumulation will precipitate such an advance. The weeklies show that such a stage remains elusive – time is needed, and the weekly stages suggest enough time has not passed to create sound bases and orderly consolidation zones.

In this participant's opinion, the most optimistic scenario involves the daily stages progressing through their respective accumulation efforts while the weekly stages play catch-up. A brief pause or pullback does not necessitate the death of this rally attempt despite various red flags. A more pessimistic scenario suggests that any further improvement on the daily timeframe is soon capped by the heavy burden of a volatile weekly stage structure marked by significant distribution during recent months.

One scenario I haven't seen discussed, but might be worth considering, is that the market gets some blow-off tops. A weak long-term backdrop may not prevent chasing of old leaders into what are ultimately very bearish rapid advances. Some stocks may be in the "anxiety" phase prior to a major sell-off, or in the "belief" and "thrill" stage prior to a final euphoric advance. Only time will tell . . .

To develop a better sense of the market I ran a few scans on the Alphascanner. First, I scanned for stocks leading in a weekly strong mark-up stage with late accumulation to strong mark-up characteristics on the daily timeframe. Next, I compared the number of results generated for stocks in weekly strong-markup phases versus weekly strong decline phases – I included all daily and intraday stages to allow for broader results, which are in the table below.

|   |             |
|---|-------------|
| Weekly Strong Mark-Up +<br>(Daily Late Accumulation-Strong Mark-Up) | 54 Results  |
| Weekly Strong Mark-Up   | 101 Results |
| Weekly Strong Decline   | 368 Results |

The results are not particularly encouraging. Stocks from more defensive sectors populated the first scan: utilities (AEP, CNP), medical companies (CEPH, CELG, PCYC), tobacco (LO), food (HSY, GIS), discount chains (DG, DLTR), and consumer non-cyclicals (KMB). And the number of weekly strong decline stocks is 3.6 times greater than stocks in strong mark-up phases. Overall, this is a structure that is not to be trusted – long-term investors don't appear present at current moment and may be unwilling to hold during any weakness. If they are present and I just don't see it, then I will gladly sit this inning out until more attractive periods for committed long positions emerge.

### **Effective Volume Scans:**

One way to make use of the EV database is simply viewing the results from each filter. I share some general observations based on what I found . . .

*Stocks with the Best Ratings*, is sparsely populated. The lack of results signifies that long-side opportunities with favorable risk-reward scenarios are diminishing quickly. CMG rallies on low volume after weeks of choppy trade and a failed breakout to new highs. HANS moves higher from a V-ish bottom, which should be considered suspect – also, HANS closed in the lower half of Friday's range while the market moved higher. Leaders *should* close at intraday highs if the market can do so. Subtle clues are indicative of the suspect nature of this rally. RGLD received support at the 200-day MA, but remains in a narrow consolidation below the 50-day moving average.

*Stocks with the Worst Ratings* offered many more results for analysis. Some notable standouts include:

- BBY and SPLS: Outside of real estate holdings, what is the long-term prognosis for some big-box retailers. What type of buyers will these stocks attract that might end their distribution and decline phases? Or does E-tailing continue to cause slow obsolescence of their business models?
- ANR BHP FCX RIO TCK: The most oversold stocks typically bounce back the hardest. The sustainability of such advances diminishes as the last shorts finally cover, though. At this stage, many commodity-related companies experienced traumatic declines and are vulnerable into the next sell/short signal after their vigorous bounces.
- DLTR ULTA: Some remaining leadership stocks are experiencing profit-taking
- NFLX: A leader of the recent bull market is not far from a complete round-trip.
- Solar Companies: The presence of solar companies, especially those from China, causes me to think a couple of things. First, do these declines signify lower commodity prices (oil) in the future that will render their business model worthless? Second, have investors lost all faith in China related equities? Will that loss of faith spread to better-known names?

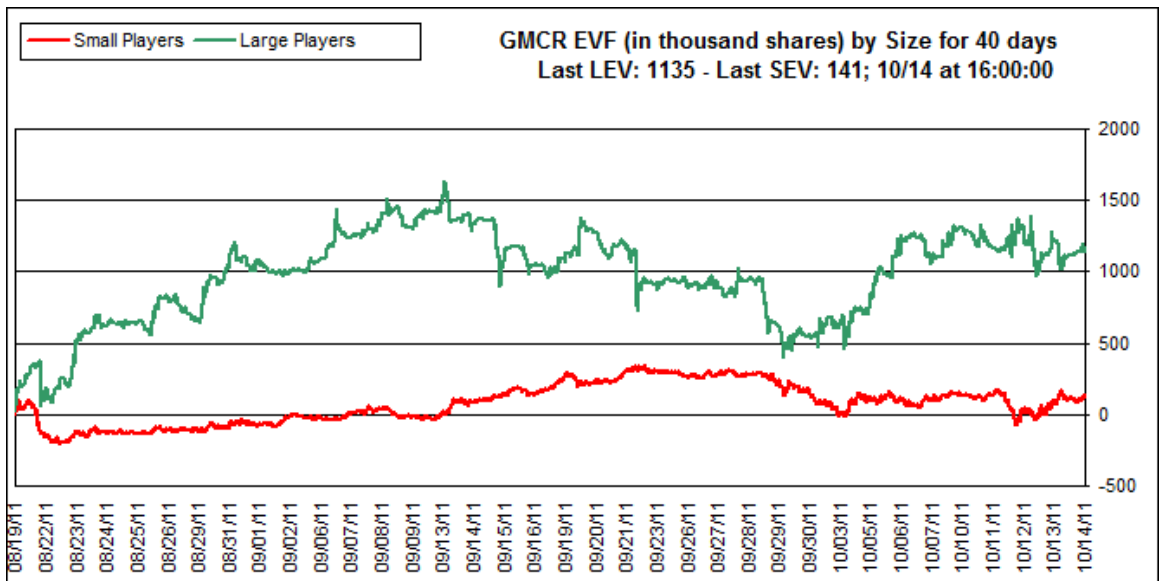
I view the abundance of stocks in the *Worst Ratings* filter versus the limited number of stocks in the *Best Ratings* filter as more evidence that the recent rally remains vulnerable.

There were not enough stocks in the *Positive Divergence with AB* filter to add additional insight. The *Negative Divergence* scan contained leading miner GOLD, though, which also looks susceptible on the recent rally to the 50 day MA that continues to act as resistance. AZO is a leading auto parts stock that also remains under pressure while close to the upper active boundary.

The remaining scans merely lent support to some observations noted above. Few stocks showed the type of price patterns that launch sustainable moves. And if the rallies off the lows in these issues are for real, then there will be time for price to narrow while volatility dampens and secondary patterns emerge.

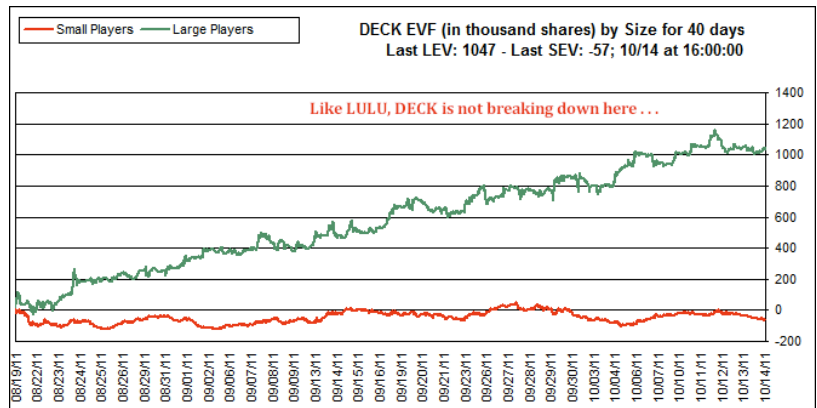
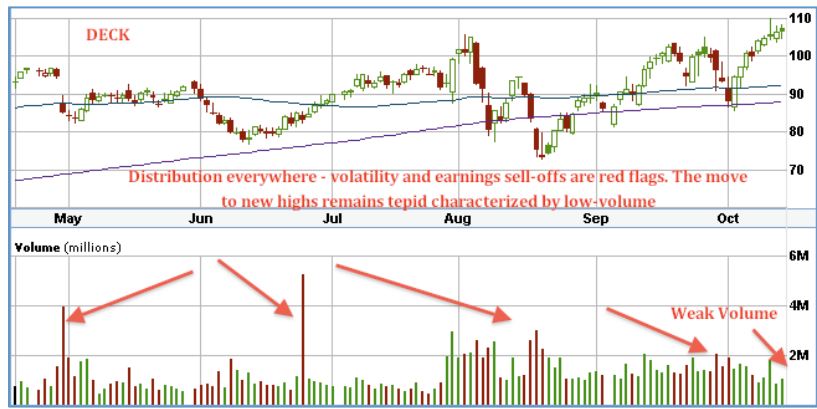
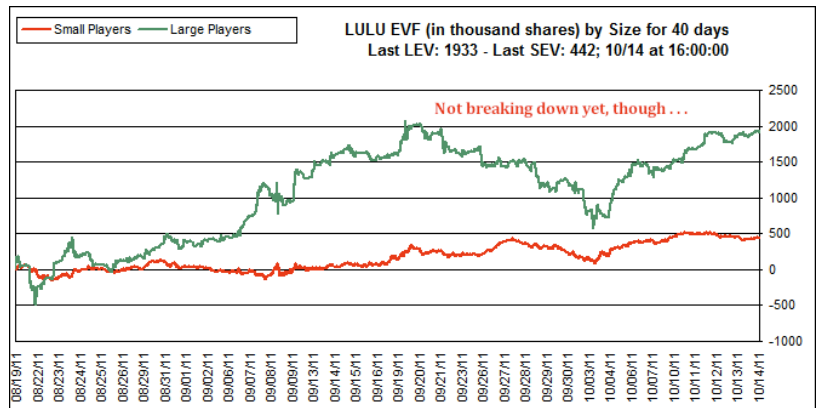
## Leading Stocks:

AAPL and AMZN are clear leaders, and they do not show signs of breaking; however, AAPL reports earnings on Tuesday, which renders the EV pattern less reliable as large players position for the announcement. One leader discussed in recent reports is GMCR.



The reason I note GMCR is because of the inability to rally along with the market. GMCR is the de facto monster stock of the past couple years. While GMCR may ultimately resolve to the upside, the weak relative performance over the past couple weeks is a subtle warning sign of committed institutional demand for cycle leaders.

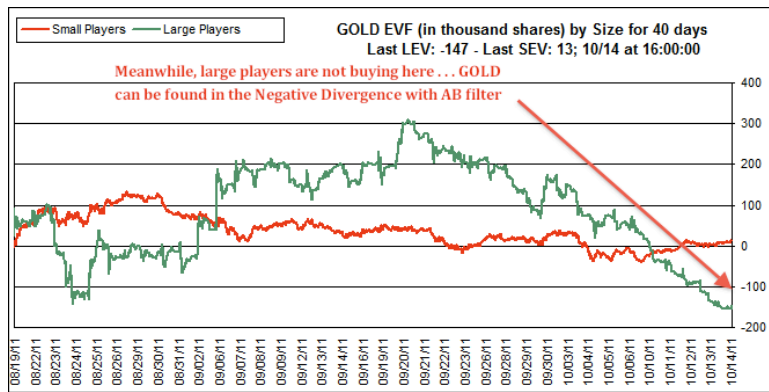
Other leading stocks are not breaking down, but are not attractive to this participant. For example, DECK and LULU show *some* large player buying; however, recent months witnessed serious selling, and price moves in a volatile and choppy fashion. Additionally, volume remains unconvincing. See charts on the following pages.

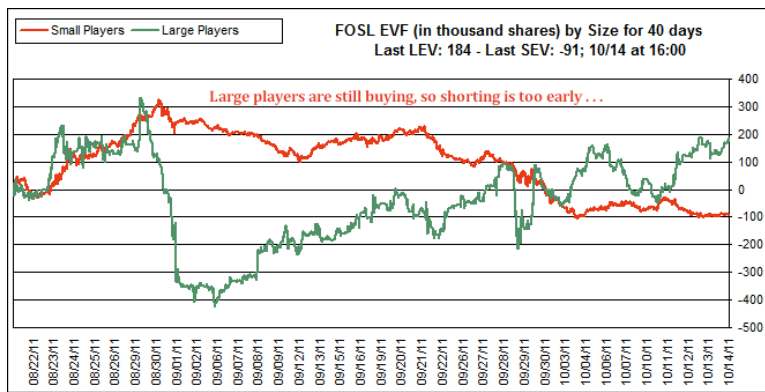


As we see above, these leaders characterize the market – not yet breaking down, but also not showing any convincing reason to be long. That isn't to say that gains in the above issues are not possible, just that certain features of the "old" leaders warrant caution for new positions – long and short.

**Short Sale Watchlist:**

The following are some issues that may present opportunities for short selling when the 20-day MF offers the next short signal. Alternatively, the failure of these stocks to witness some sell pressure in the coming days may indicate a market that has more upside left.





## Conclusions:

I get the feeling the market is climbing a slope of hope rather than a wall of worry. Many downside risks remain. These risks are evidenced by the following market traits:

- A structure that remains in various stages of weekly downtrends for major market indexes
- A dearth of attractive long candidates as measured by various EV filters
- An attachment to “old leaders,” some that failed to attract interest during this recent noteworthy advance from the October 4<sup>th</sup> lows (GMCR) and others that demonstrate choppy trading and heavy distribution (DECK)
- An increasing list of attractive short-sale candidates

I cannot predict where the market goes. I am operating under the context of a bear market, and therefore treat strength with suspicion. Yes, there are positive breadth developments, and economic indicators show improvement. Some tech stocks will likely make new highs and blowout earnings. I won't be entirely surprised if the market attempts a nominal new high before yearend; however, one must focus on the present, and the present moment suggests caution.

Some possible events that could rattle markets include continued stress from the Eurozone, skepticism about China's economy, and justifiable social unrest emanating from all sectors of the globe. One should not discount the possibility of extreme events such as bank breakups or sovereign defaults. Not that these events weren't present before, just that the price action seems to recognize them more so now.

Best,  
Eric