THRASHER ANALYTICS

Special Update

While yesterday's selling was intense, things were worse in Asian markets with 300 companies hitting their daily limit on the Shanghai, dropping over 5%. The selling we are seeing in the U.S. is a result of the narrowing of breadth that I've been discussing in the last two letters as well as the extreme narrowing in the Volatility Index that often precedes moves higher in the VIX, just like we saw over the last several trading days. I discussed the weekly dispersion of volatility on my blog as well as in my note two weeks ago. It would have been MORE unusual if volatility hadn't moved higher, so we shouldn't be too surprised to see a spot VIX over 20 right now. The selling yesterday appears to be heavily focused on growth/tech/momentum-type names with the FAANG group falling by 6%, the largest decline for this group since 2012 compared to 3.29% in the S&P 500 and -4.44% in the Nasdaq 100.

Many market gauges are now stretched to the downside and are calling for a bounce. The important question we must ask is when we do see stocks recover is the likelihood we see a strong trend back to new highs or do we see choppier price action more similar to earlier this year and in 2015 with price retesting prior lows?

Seeing the S&P 500 fall by 3% in a single day is unusual but not unprecedented. Over the last ten years it has happened in February of this year, June ’16, August ’15, several times in during the ’11 correction as well as the ’10 correction and just before in 2010 in February. Of those instances, most saw momentum enter ‘oversold’ territory and that’s important to recognize because what followed for when momentum was stretched to the downside and when it wasn’t (Feb. ’10 & June ’16) the market’s bottoming patterns were different. The market typically bottoms out in two types of patterns: 1. A V-shaped recovery and 2. A double bottom or a choppier price action bottoming process. When momentum becomes ‘oversold’ with a 3+% single day decline, typically we do not see a V-shaped bottom created. Instead we see the market bounce but ultimately retest or take out the prior low before beginning a new trend higher. We saw this happen most recently in earlier in this year when the S&P tested the February low in April, again in 2015 when the market over 3.5% in August and then tested the low again in September, 2011 had the 3+% decline in August and chopped around until a low in October, in 2010 the first 3+% move was in May and price continued lower with a few more 3+% single day declines later in the month before the marked consolidated and then moved higher. Another characteristic that the prior 3+% declines have all had has been the test or break of the 200-day Moving Average. Each time the market saw a large single day decline in the last ten years the S&P 500 tested or fell through its long-term moving average. We didn’t quite get there yesterday but based on where pre-market trading is occurring, we’ll see at least a test today.

It’s important to recognize the market follows a similar pattern when it corrects. It doesn’t matter that there’s more algo trading in the market today vs in 2010, human psychological and behavior still dominate price action and dictates the market to follow similar price action moves. With that, I am keeping an open mind to how price moves going forward but I believe we’ll likely see more of a double bottom, choppy bottom in U.S. equities rather than an aggressive bounce that doesn’t look back.

as of Wednesday breadth has fallen quite a bit and has now become ‘oversold’ just like the major indices. Breadth had a head start, so to speak, since it began declining before price did but we don’t see breadth move lower this quickly very often. When it has, typically a short-term low is found but that low often gets re-tested as the market rounds out a bottom. Only eight times since the 2009 has breadth become stretched to the downside like it is today, only a couple of those instances did the market immediately bounce and not look back, which adds weight to my believe we won’t see a v-shaped bounce back to a new high in the S&P 500.

Going forward I'll continue to be watching where selling appears to be focused and when buyers do return which segments of the market begin to get lifted higher first. I do not believe we're entering a major bear market right now and so I do think we will eventually trend higher, it's just a matter of what type of price action we see between now and then. With that, we want to know where new market leadership comes from. I'll have more commentary and charts in this week's note, so be on the lookout for that on Sunday evening.

As always, if there are any questions please feel to email me at andrew@thrasheranalytics.com

Best Regards,
Andrew Thrasher, CMT

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