Market Update

Sector Rotation: August	
Technology	XLK
Consumer Disc.	XLY
Communication	XLC

Notable Breadth Data:	
SPX >50MA	81.80%
SPX >200MA	61.60%
Nasdaq >50MA	82.52%
Nasdaq >200MA	80.58%

Fixed Income Rotation: Q3	
Muni Bond	MUB
High Yield Corp.	HYG

Index & Sector Adaptive Trend	Up Trend	Down Trend
SPX	X	
QQQ	X	
XLF		X
XLY	X	
XLK	X	
XLV	X	
XLU		X
XLP	X	
XLI	X	
XLRE	X	
XLE		X
XLB	X	

Daily Sentiment Index	% Bullish	5-day MA
S&P 500	89%	88%
Nasdaq 100	88%	89%
Nikkei	**71%**	**77%**
VIX	21%	16%
10yr Treasury	45%	51%
5yr Treasury	56%	58%
CRB Index	**75%**	**74%**
Gold	**76%**	**69%**
U.S. Dollar	12%	18%

Green<25% Red>80%

source: trade-futures.com

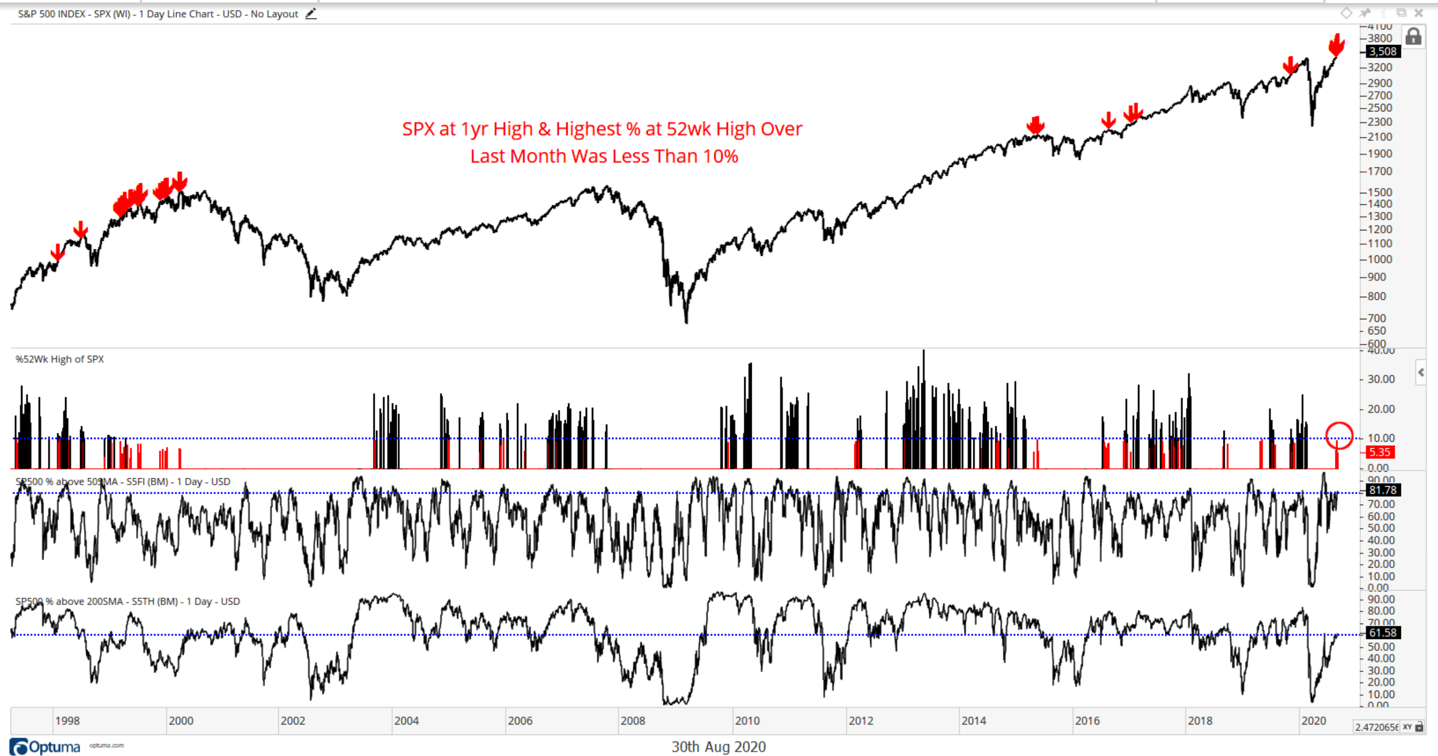
Friday saw a really strong finish w/ the most S&P 500 stocks at 50-day highs since at 25% and 100-day highs expanding to 19.4%, the highest since the recovery off the March low began. The 52wk high list still sits just under 10% for the S&P 500, which has been a 'ceiling' since July but 19.2% of stocks did hit a 3-month high which is an improvement from Wednesday's 15% reading. The average S&P 500 stock is still 17% below its prior 52-week high, a reason we're not seeing an expansion in the new 52-week high list. Sentiment remains high with volatility dispersion contracting. While I don't believe breadth is a major concern (more below) the volatility and sentiment landscape I believe poses the largest risk to the market right now. This is actually a positive as historically breadth issues typically lead to larger down turns in equities (example: March '20 or Q4 '18) compared to concerns raised by

***Breadth**: Here's my current thing on breadth. Since the S&P 500 first broke to a new 52-week high two weeks ago, we've never seen the % of stocks also at a 52wk high break above 10%. This has been pointed to as a sign of poor breadth. For comparison, in '09 when SPX hit a new 52-week high 16% of stocks also were hitting new highs and then the figure moved to 20% two days later. Today, the highest we've gotten is 9.6% but most days have been closer to 5%. I think we need to look at other data though. When I've gone back to look at the %52wk high data at prior SPX highs to see if there's any commonality to market continued strength vs. weakness a few things stood out.*

1. Eventually we saw the 10% breached. Oct. '19 is a good example, at first just 8% of stocks joined the index in a new one year high but then we hit 13% and price coasted higher for several more months.
2. Other breadth measures were strong. Specifically % above 200-day MA and 50-day MA. While stocks may not be at new highs, at least they were in up trends as measured by if the were above their intermediate or long-term moving average. This was the case for instance in 2017 with roughly 70% of stocks above their 200-day MA and 80% above their 50-day MA most were in solid up trends and the new 52-week high list eventually expanded to reflect this as SPX continued its climb.
3. When one of these two conditions weren't there to make up for the last of new one year highs, we saw SPX break down. In 2015 less than 70% of stocks were at new highs and the % above 200-day MA was in a decline. Same thing ahead of brief pullbacks in 1999, minimal new 52-week highs and less than 80% of stocks above their 50-day MA or weak % above 200-day MA.

Moving the focus back to today, Friday's new high had just 5.3% new 52-week highs with 81% above the 50-day and 61% above the 200-day, both respectable levels showing a good chunk of the index in up trends. While we aren't seeing an expansion in % above MA data – the % above 50-day has been stuck at 80% since mid-July – it's still a bullish characteristic and makes up for the poor new high data.

Going forward, if we don't see a break of the 10% threshold in new 52wk highs, we want to see the % above MA data hold strong – meaning more than 70% above the 50-day and the current 61% to hold firm on the % above 200-day. If these break down and new high data doesn't improve, then we could start seeing another risk of weakening breadth but that's not the case right now.

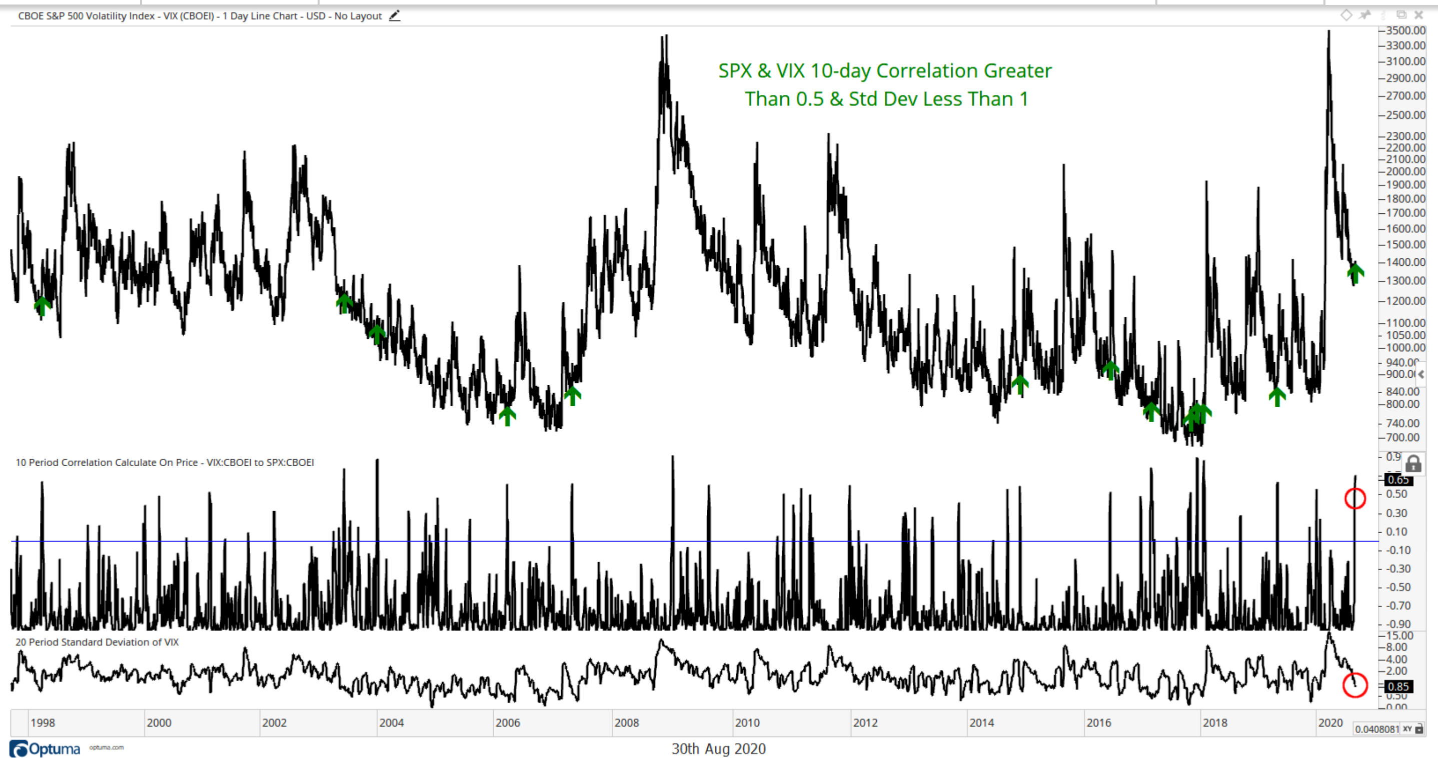


FAAMG*: Apple's market cap now worth 98% of the Russell 2000 stocks, combined. For comparison, it came into this year just north of 50% of the R2K and was at 30% at the start of 2016. So when speaking of breadth we can't lose sight of the fact that just five stocks account for nearly 25% of the S&P 500 right now.*

Option Activity*: The trend higher continues in volume of stock options with less than two weeks until maturity as Goldman Sachs has been highlighting in recent weeks. We now sit at 75% of option volume on the top 100 SPX stocks, the highest in over five years and up from roughly 65% in 2019. Goldman notes most of this is due to call options, which has grown 900% since 2017 while put option volume is up less than 400% for the same time period and has been declining since earlier this summer.*

Sector Performance*: Sector leadership continues to be found in communication and technology, two of our top three in the sector rotation model (which will be updated in next week's letter for September) which were each up 4.6% and 4.4% last week, respectively. Only one sector, Energy, remains below its respective 50-day moving average. Software and cloud tech also continue to be strong. Semiconductors are the one segment of the tech space that has weakened in relative performance, a recent development from a corner of the market that's been a strong leader.*

Volatility*: The dispersion in volatility continues to contract with correlation between the VIX and SPX remaining positive. Below is an updated version of a chart I sent you last week, this time showing when correl. Is above 0.5 and std deviation is under 1. This hasn't happened often. Going into the spike in early 2018 this 'development' happened three times from October until January before volatility responded. The other occurrences saw a near-immediate move higher in the VIX except for the two times in 2003. Combined, positive correlation and compressed dispersion has been a precursor to several out-sized moves in the volatility index.*

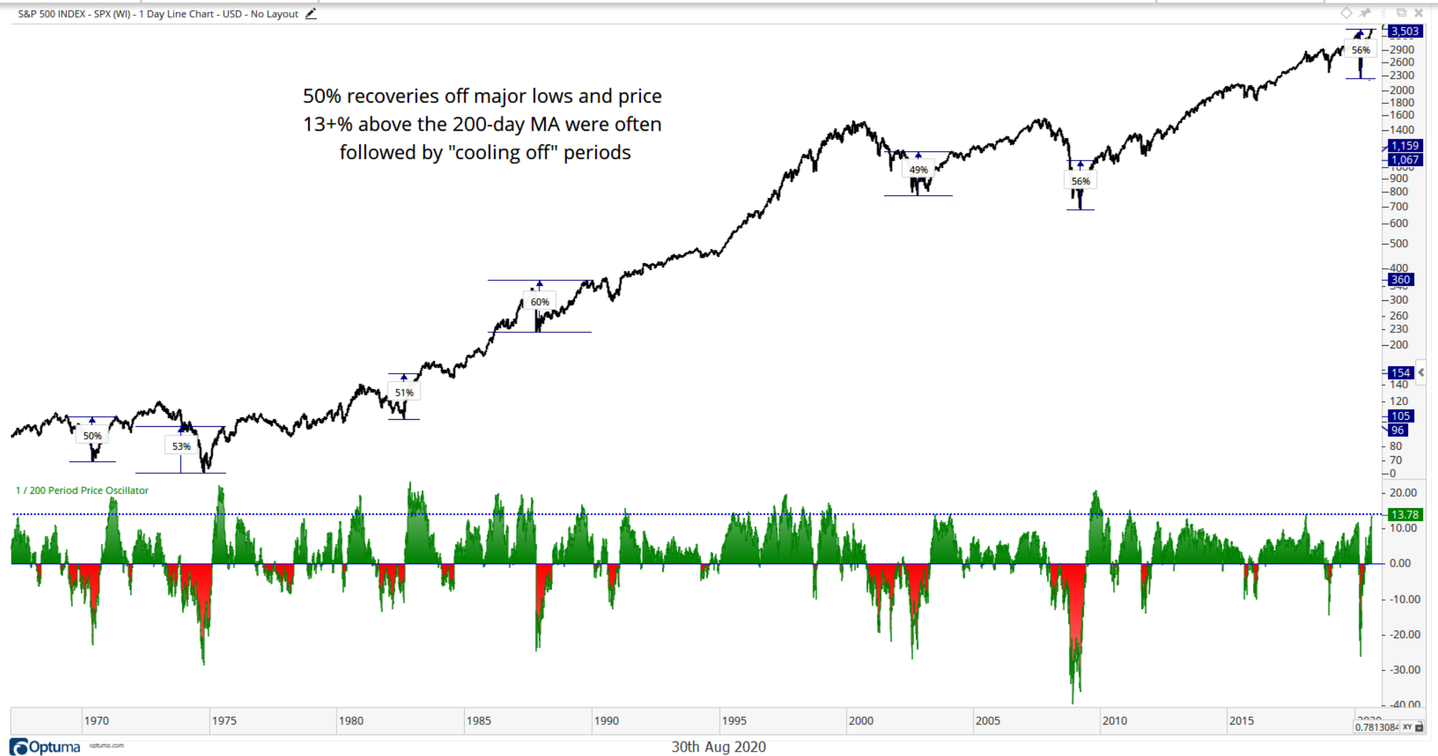


***Stocks Are Stretched**: Stocks are clearly stretched to the upside. The S&P 500 is now 13.78% above its 200-day moving average, the most since the peak in January 2018. "overbought" momentum is not a bad thing long-term, a stock or index with strong momentum is liken to Newton's law about an object in motion stays in motion. This is why people looking at the RSI being over 70 have misplaced fear. This is why I like to look at volatility-adjusted momentum which is a momentum equation that involves a gauge of price volatility to better depict how price got to where it is from a momentum viewpoint. Vol-adjusted momentum (VaM) is a tool found on the sector section of the chartbook sent out every two weeks, so it should be somewhat familiar to long-time subscribers.*

VaM is a mean-reverting tool and at a reading of 54, is extremely stretched. When we combined the VaM with the spread between price and the 200-day MA, we get an interesting sample size of data for previously stretched market periods. In 2018, the market was 'overbought' for most of January but it wasn't until it got to 14% above the 200-day MA did it run out of cash, similar level as we are today. Another time SPX was about 13 above its 200MA and VaM was extremely high was in 2004, when price similarly was recovering from the dot-com bottom and up 45% from the low (similar to how we are about 55% above the March '20 low). In '04, SPX went up another 2% and then corrected lower for a few months down 8%. That type of price action would be healthy and not an extreme expectation today – allowing the market to digest the run up since March and essentially 'reset' itself for the next leg.

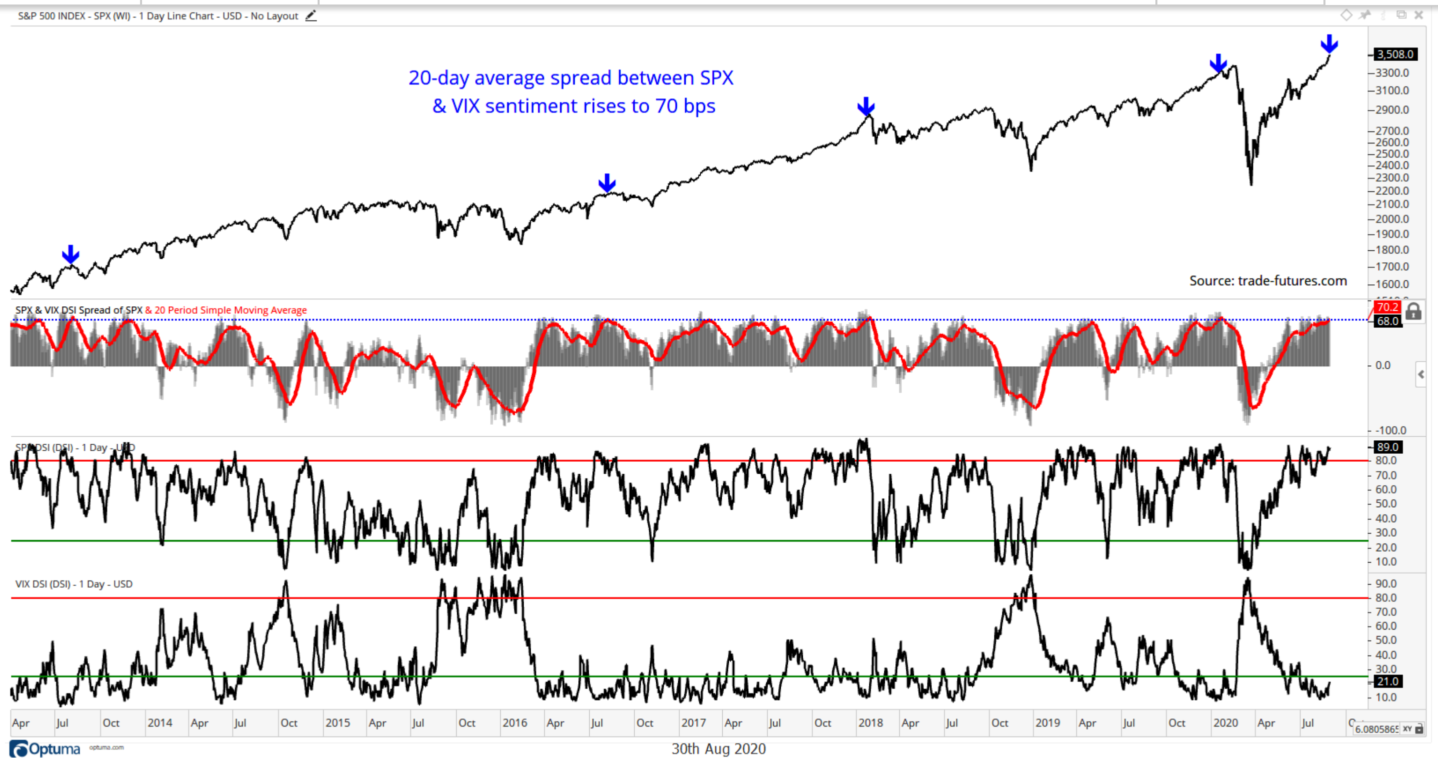
***Above 200-day MA**: Let's look at this data another way, this time going back to 1970 and taking a peak at prior recoveries off major lows. For this exercise I'm looking at seven major recoveries including bear markets in the 70s, 80s, the '87 crash, dot-com bubble, financial crisis, and covid crisis. Often times, by the time price had risen 50-60% and had gotten roughly 13% above its 200-day moving average, it needed a "cooling off" period.*

In '71, SPX corrected 14% before continuing higher; in '75 the drop was 14%; in '83 price continue dot advance another 11% until seeing a correction in '84. After the '87 crash price had to climb 60% before getting extended above its long-term moving average and then corrected 10% and a few months later another 20% in 1990; after the 2003 bottom price rose 49% into '04 and dropped 10% before continuing the trend higher; in '09 we didn't see price cool off until the 2010 correct. Which brings us to present day and price 13.7% above the 200-MA and up 56% off the March low. Again, it would not be unexpected to see history repeat (or rhyme!) and "cool off" as it digests this strong run.

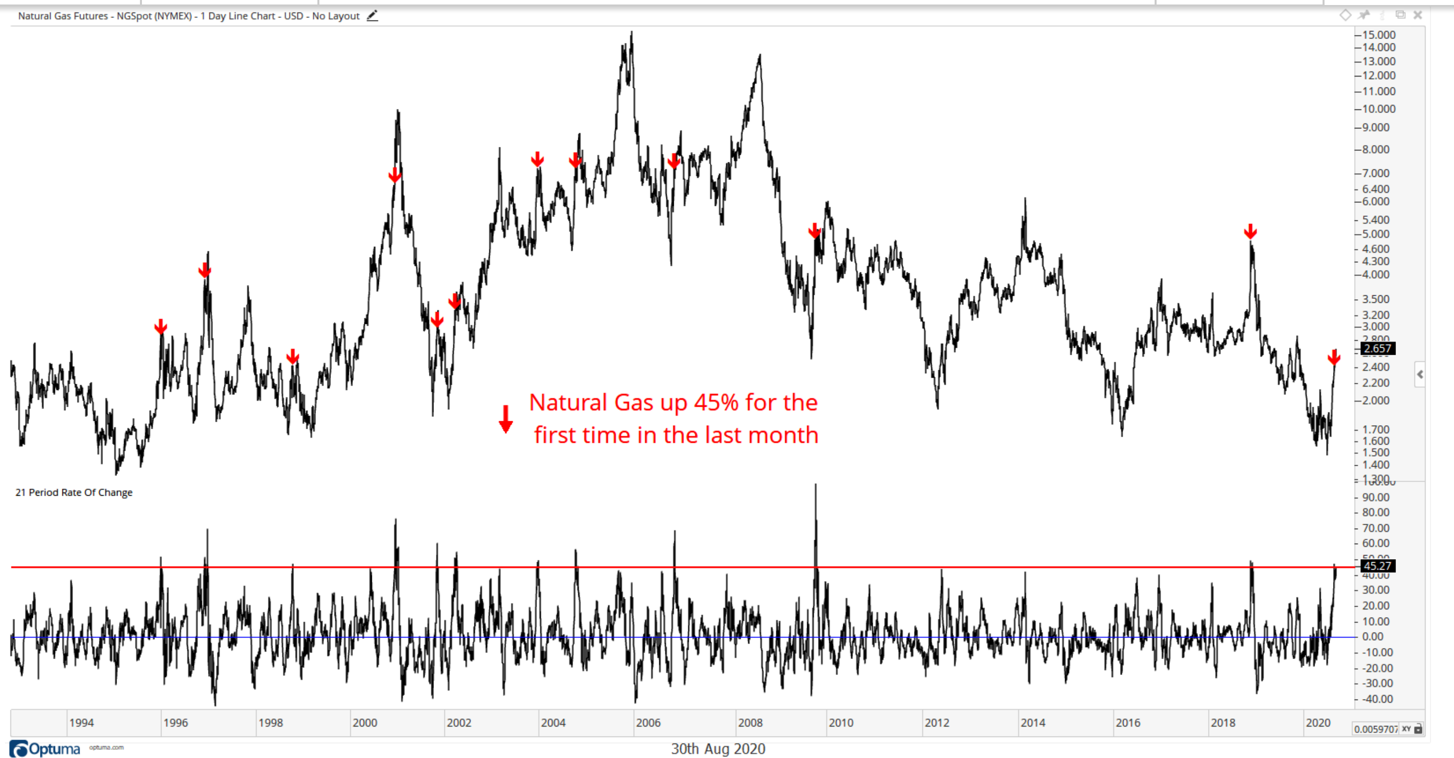


***Tech Sector**: Speaking of being above the 200-day moving average. The tech sector is now 28.3% above its 200-MA. At the peach of the dot-com bubble, XLK got up to 37% above the long-term average but since then, it's never been this far above. It did get to 20% in 2004 before declining 19.5%, in 2009 as price recovered off the financial March low and just before the March crash this year.*

***Sentiment**: While we only have Daily Sentiment Index (DSI) data for the VIX back to 2013, the spread between the VIX and SPX DSI % Bullish scores is at an extreme. Smoothing the data to find periods where both VIX and equity sentiment has been at extremely low/high levels for extended periods of time shows the spread has only been as wide as it is today just four prior periods, as shown by the blue arrows on the chart below. I find sentiment spreads extremely interesting. SPX has been above 80% all last week with VIX % Bullish moved higher as vol became positively correlated to equities but still creates a wide chasm between the two, on average over the last month. While the sample size is obviously extremely small, equities did struggle in each of the prior occurrences by varying degrees.*



Natural Gas: *Natural gas has been a strong mover of the last month, up 80% from the July low. The latest hurricane to hit the Gulf of Mexico has helped push prices higher, but on a historical basis we don't see nat gas run much further after it advances 45% in a one-month period. Going back to 1990, nat gas futures have risen 45% in 21-days (scrubbed for repeated days within the same month) just eleven previous times. Typically, gas prices rallied just another 5-7% before three months later being lower 81% of the time by an average of 19%. With that, it may be wise to careful chasing natural gas here.*



***Macro**: This week brings with it a bevy of economic data. Tuesday we'll get the ISM manufacturing and Thursday the ISM services data. Manufacturing data has been improving since April, rising to 54.2 in July, back in expansion. Payroll data on Friday will of course be hotly watched with the expectation for a unemployment rate of under 10% and a close eye to permanent and temporary employment pictures. There's likely to be some kind of headline on the anticipated stimulus plan as well as sporadic vaccine headlines. Apple and Tesla's both complete their stock splits on Monday, so they will likely be heavily in the news over that rather boring ledger adjustment that has no material impact once so ever yet has apparently caused traders to treat both events as if they won't be able to buy shares ever again based on how they are trading right now.*

***Weak-Handed Bears**: The bears have fumbled each attempt to take down this market, with some minor bullish catalysts popping up from a Russian vaccine to new tooling of the Fed's mandate towards inflation. So while it's possible the econ. reports disappoint this week, sellers haven't organized themselves well thus far to take advantage of any negative news. Not to mention that next week is a shorten holiday week in the U.S. due to Labor Day so trading volume (which has been extremely light already) to not be overly high if not given a catalyst to soak up.*

Have a great rest of the week.

Best Regards,
Andrew Thrasher, CMT

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