



Weekly Market Commentary

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Burt White

Chief Investment Officer
LPL Financial

David Tonaszuck, CMT

Technical Strategist
LPL Financial

Highlights

Technical analysis supports a move higher in U.S. equities despite mixed market breadth.

Turning Down the Noise

Volume has picked up during the recent downturn. No, we are not talking about trading volumes; we are talking about the volume from your TVs with talking heads warning about an impending stock market downturn. If you turn off the TV and focus on what the market is telling you, rather than the talking heads, you can tune out the noise. The way we listen to the market in our investment process is through technical analysis, where we assess the behavior of the market and its underlying drivers. Analyzing market breadth has been an especially useful technical analysis tool for predicting recessions and bear markets. There are various ways to look at market breadth, and we will be looking at two critical areas in this week's commentary.

Market breadth can be tracked by looking at the number of stocks that are advancing less those that are declining. Tracking how many stocks are taking part in a rally or sell-off can help determine how broad the rally is and how durable it may be. A market that is rising on the strength of fewer and fewer stocks is more vulnerable to a decline. Conversely, a market that is rising with a majority of stocks also increasing suggests underlying strength. Technical analysts typically use the NYSE Composite when analyzing market breadth because of its large number of constituents. If market breadth begins to decline and diverge from the rise in the NYSE Composite Index and then the index starts to decline, it signals that the market has become more vulnerable to further declines.

Mixed Market Signals

Looking across the major equity indexes, the breadth indicators currently show mixed signals. The NYSE Composite and the Standard & Poor's 500 Index are confirming bullish price momentum with their respective cumulative advance/decline line trends*; however, the Nasdaq Composite's price and cumulative advance/decline line are diverging. (Cumulative breadth is the running total of daily advances minus declines.)

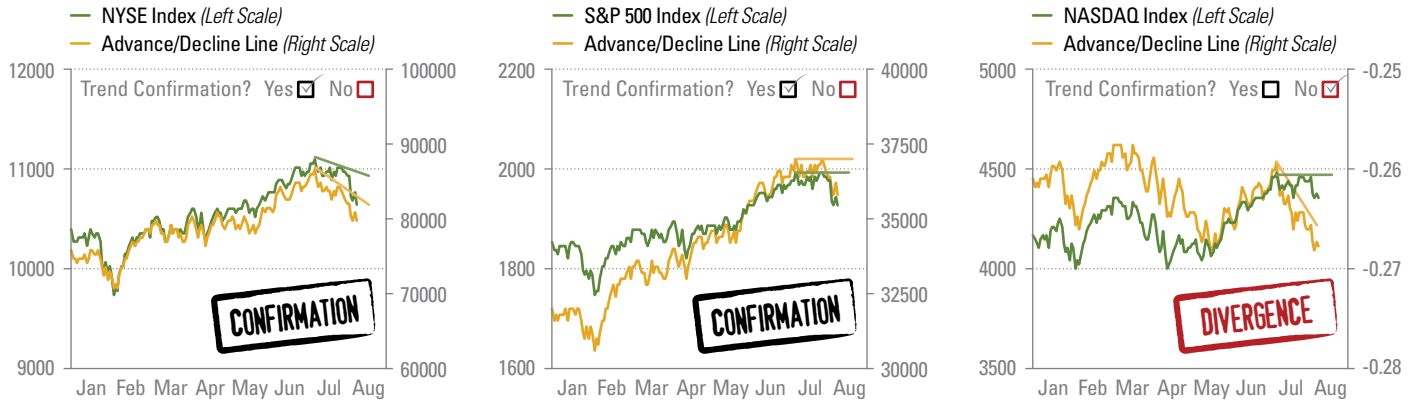
Back on March 5, the Nasdaq Composite and its cumulative breadth both traded at a higher high. However, on July 3, when the Nasdaq Composite formed a new higher high on its price chart, Nasdaq cumulative breadth failed to establish a new peak [Figure 1], which is called a negative divergence. In technical analysis, market tops become more likely when breadth fails to confirm a higher high in price. These divergences can last for weeks, months, or even longer. Other times, they can be short-lived and just play out over a

* Please see pages 4–5 for a glossary of terms.

One of the five forecasters identified in our *Mid-Year Outlook 2014: The Investor's Almanac* is a technical indicator: market breadth.

series of days. Looking back at Nasdaq Composite historical data from the past 10 years, a negative divergence in breadth had a 71% probability of signaling a pullback, with an average magnitude of -4% [Figure 2].

1 Two of the Three Major Equity Indices Are Confirming Trends Between Price and Market Breadth

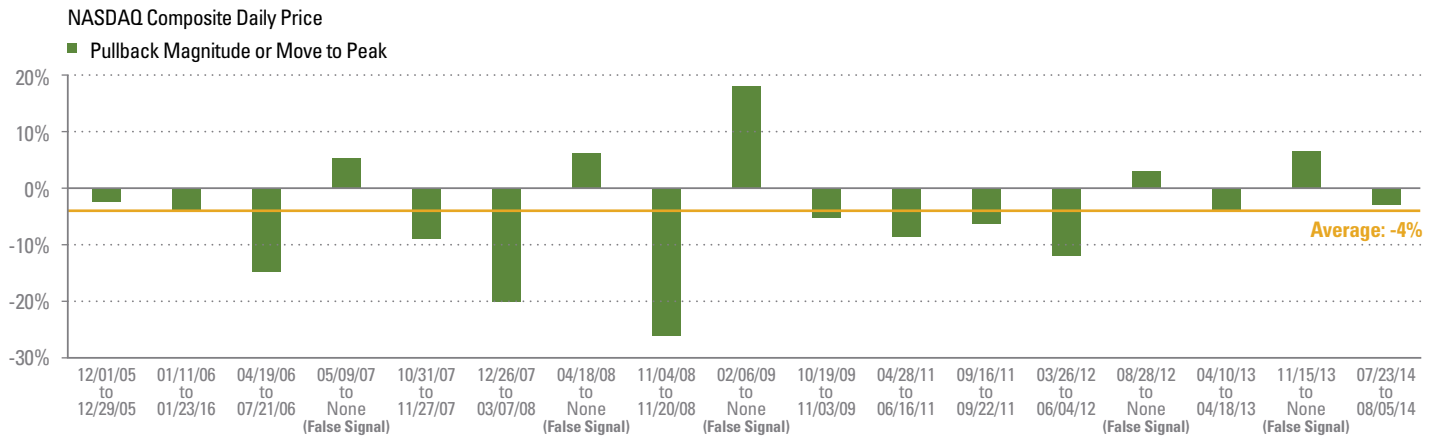


Source: LPL Financial Research, Bloomberg data 08/07/14

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

The bar chart in Figure 2 shows 17 market breadth divergence events that have taken place on the Nasdaq Composite since 2004. Out of the 17 divergences, 12 times the Nasdaq Composite's price moved lower, and five times the price moved higher, resulting in a 71% probability of a price decline. The price moved higher (i.e., a false signal) 29% of the time. The average percent change in price following a bearish divergence was calculated across the 17 events to be -4%. Bearish breadth divergences that occur across all three major indices tend to have greater magnitude pullbacks. For example, in November of 2008, there were divergences on the NYSE Composite, S&P 500 Index, and the Nasdaq Composite, which resulted in a pullback of approximately 26% on the Nasdaq.

2 The Effects of a Bearish Market Breadth Divergence on the Nasdaq Composite



Source: LPL Financial Research, Bloomberg data 08/07/14

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Once a divergence develops, it is important to monitor the following:

- If the cumulative breadth, as measured by the advance/decline line, returns to higher highs or new all-time highs, then the divergence is nullified, and the upward trend of the market may remain intact.
- If the divergence persists and the price crosses below its bullish trend-line support for a sustained period, then there is an increased possibility for continued downside risk.

Is this divergence a tell-tale sign of pending doom and gloom for the equities markets? Not at this time. Keep in mind that the other major equity indices, the NYSE Composite and S&P 500 Index, are still confirming a bullish price trend; only the Nasdaq Composite is showing weakness. The scenario would be worse if all three were showing negative divergences. Further, negative breadth divergences in the Nasdaq Composite were not meaningful in 2013, when the average price movement following the two negative divergences that occurred was above +1%. If the second half of 2014 finishes like 2013 did, then the impact of a negative divergence may be minimal. The last point is that the average pullback on the Nasdaq following a divergence is -4%; during the recent sell off (from July 24 through August 7), the composite lost approximately 3%, which is modestly below the average.

Hit the Mute Button (or Turn Down the Volume)

While analyzing advance/decline data can help reduce the noise, we try to further quiet things down by incorporating a second market breadth assessment to help confirm our initial analysis: the percentage of stocks in an index that are above their 200-day simple moving average (SMA).

In a bull market, relative strength among the 500 stocks in the S&P 500 Index will vary, usually by sector and industry. General bullish market momentum, however, will keep most of these stocks above their 200-day SMA. The percentage of S&P 500 stocks above their 200-day SMA is currently 72%, which is a healthy number given the pullback we have just experienced. As this market breadth indicator trend has moved higher, it is reflected by the S&P 500 Index price moving higher.

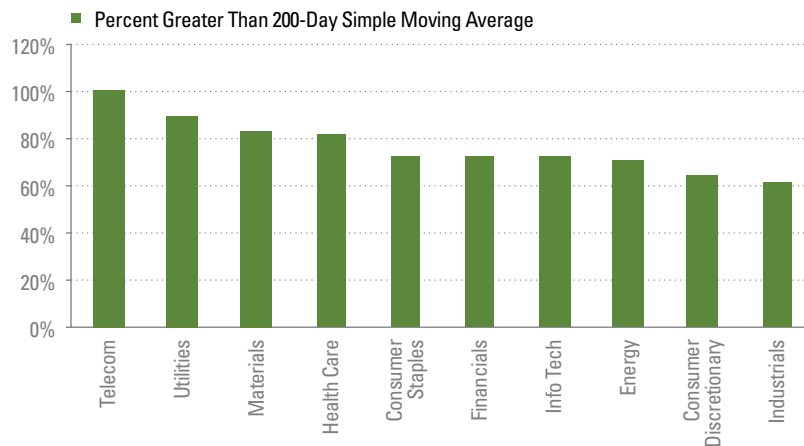
A deeper look reveals that all 10 of the S&P 500 Index sectors currently have at least 60% of their stocks above their 200-day SMA, and eight out of 10 sectors are above 70%, which is representative of strong market breadth [Figure 3]. The recent pullback brought the S&P 500 Index down from potentially overbought levels in late July, although in a bull market overbought breadth levels can persist for a long time.

Let Technicals Do the Talking

Although some market breadth indicators may be showing mixed signals, on balance, these measures continue to point to the continuation of the bull market and further gains for stocks through the remainder of the year. As we seek to tune out the noise of the market and the pundits on



3 General Bullish Market Momentum Is Depicted by the Percent of S&P 500 Index Stocks Above Their 200-Day SMAs



Source: LPL Financial Research, Bloomberg data 08/07/14

TV, our view, technically as well as fundamentally, is that the U.S. stock market will sustain its bullish price trend throughout 2014, with some periods of increased volatility. With this in mind, we will continue to look for opportunities to buy on dips during bouts of market weakness. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Indexes are unmanaged and cannot be investing in directly. Past performance is no guarantee of future results.

GLOSSARY OF TERMS

Advance/Decline Line (AD Line): One of the most widely used indicators to measure the breadth of a stock market advance or decline. The AD line tracks the net difference between advancing and declining issues. It is usually compared to a market average, where divergence from that average would be an early indication of a possible trend reversal.

Divergence: An event that occurs when two lines on a chart move in opposite directions vertically. There are two kinds of divergences: positive and negative. A positive divergence occurs when the indicator (AD line) moves higher while the stock is declining. A negative divergence occurs when the indicator (AD line) moves lower while the stock is rising.

Momentum: A technical analysis indicator that measures the security's rate-of-change. Bullish and bearish interpretations are found by looking for divergences (either higher highs or lower lows) and extreme readings.



Market Breadth: A measure that compares the total number of rising stocks to the total number of falling stocks in order to gauge the general direction of the market based on all traded stocks.

Overbought: A technical condition that occurs when prices are considered too high and susceptible to a decline. An overbought condition infers that the stock has risen too far too fast and might be due for a pullback.

Simple Moving Average: A moving average that gives equal weight to each day's price data.

Technical Analysis: The methodology for forecasting the direction of prices through the study of past market data — primarily price and volume.

Volatility: A measure for variation of price over time.

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