LPL RESEARCH

WEEKLY MARKET COMMENTARY

September 8 2015

CONSULTING OUR TECHNICAL PLAYBOOK

Burt White *Chief Investment Officer, LPL Financial*
Jeffrey Buchbinder, CFA *Market Strategist, LPL Financial*
Dave Tonaszuck, CMT *Technical Strategist, LPL Financial*

KEY TAKEAWAYS

In challenging market environments, technical analysis tools can help us make better investment decisions.

Our technical playbook suggests recent market weakness may present a buying opportunity.

We are mindful of risks that might impact our playbook, including a potential China hard landing or a central bank policy mistake.

When markets are tough, emotions can take over. The natural emotional response to sharp stock market declines is to sell. In periods like these, especially when the media sensationalize every gloomy angle as they tend to do, an objective look at the data can be reassuring and help us make better investment decisions.

Like analyzing statistics to assess the outcome of a football game (this week does mark the beginning of the NFL season), the stock market gives us a lot of data over many decades to help us make good investment decisions when our initial emotional reaction might be to call a time-out and sell stocks. History gives us our playbook—so no matter what the environment (or who the opponent), we should have a good idea of how to respond and what play to call. We won't always be right, but we can seek to stack the odds in our favor and increase our chances of gaining yards while limiting fumbles.

This week we take a technical, data-driven approach to assess the likelihood that the current market decline (now about 10% from the May 21, 2015, S&P 500 peak) becomes something worse.

THE DEATH CROSS

The media love to talk about the death cross. This uplifting term describes when an index's shorter-term moving average falls below its longer-term average. The most often cited indicator is when the 50-day simple moving average crosses under the 200-day simple moving average, something that the S&P 500 experienced on August 28, 2015 [Figure 1]. This condition reflects the loss of short-term upward momentum for the stock market and is seen as a warning sign of more trouble ahead. Does this signal provide a warning worth heeding?

> The media love to talk about the death cross, which describes when an index's shorter-term moving average falls below its longer-term average.

A simple, or arithmetic, moving average is calculated by adding the closing price of the security for a number of time periods and then dividing this total by the number of time periods. Short-term averages respond quickly to changes in the price of the underlying, while long-term averages are slow to react.

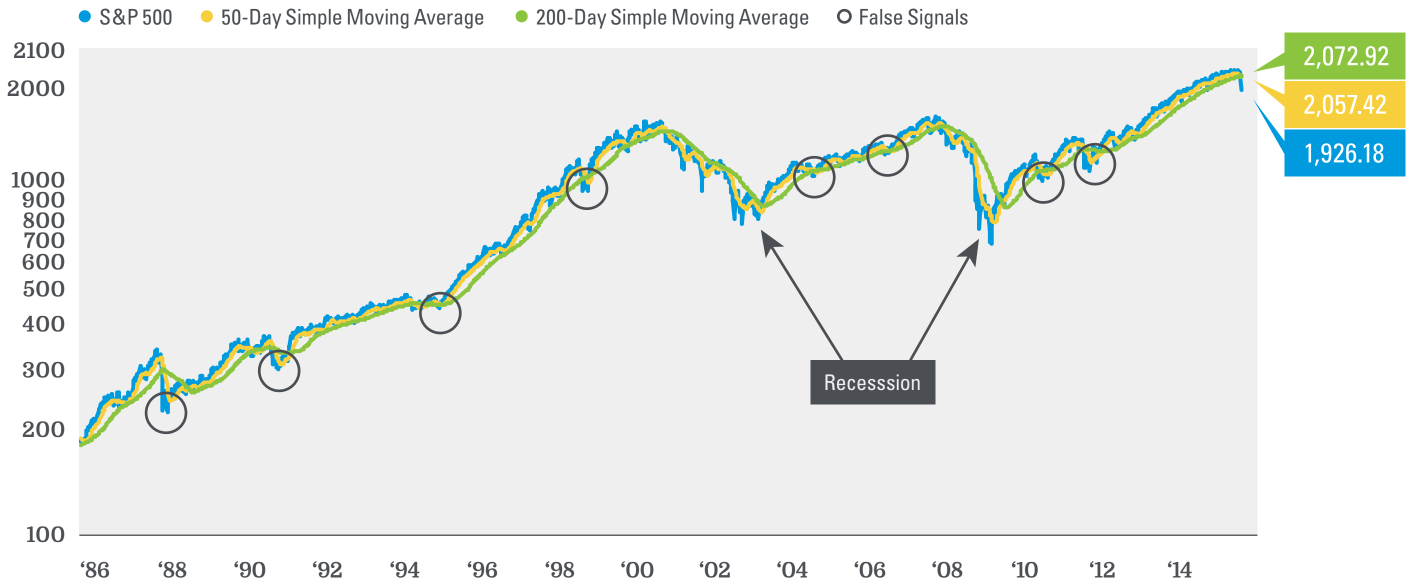
LPL Financial

Here the data provide useful perspective. As shown in Figure 2, over the past 35 years, the S&P 500 has experienced 14 of these crosses. More than half the time (8 instances), the S&P 500 was higher 3 months later, with an average gain of about 2%. The numbers get a little better when you go out 6 months, with gains in 10 out of 14 instances, and an average gain of about 5%. Over 12 months the numbers are even better, with stocks down a year later only in recessions. Given the false signals this indicator may give, the playbook for this one seems to indicate to buy the dip.

CAPITULATION?

The term "capitulation" gets thrown around a lot when stocks are down sharply. The technical definition is to surrender, or throw in the towel.

1 SIMPLE MOVING AVERAGE CROSSOVER ("DEATH CROSS") NOT PARTICULARLY WORRISOME OUTSIDE OF RECESSION



Source: LPL Research, FactSet 09/03/15

False signal indicates buying opportunity and no recession or bear market.

Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested into directly.

2 S&P 500 SIMPLE MOVING AVERAGE CROSSOVER SIGNAL SUGGESTS BUYING THE DIP

	50/200-Day Simple Moving Average Crossover		
	+3 Months	+6 Months	+12 Months
Completion Percentage (%)	57	71	79
Average Gain/Loss (%)	2.4	5.2	5.6
Median Gain/Loss (%)	2.1	5.0	11.8

Source: LPL Research, Bloomberg 09/03/15

Data set covers 14 occurrences dating back to 1981.

Completion percentage indicates the percentage of instances in which the S&P 500 rose over the indicated time period.

Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.

There is no guarantee of success with any strategy. Investing in stocks entails risk including loss of principal.

In terms of markets, it essentially means that heavy selling has (in theory) left no one else to sell based on current catalysts. We would suggest that on August 25, 2015, when the S&P 500 reached its closing low for the year at 1867, stocks demonstrated a fair amount of capitulation. Heavy volume is one piece of evidence, reflecting many investors exiting the market all at once.

The Relative Strength Index (RSI) is another way to assess capitulation by measuring the depth of oversold conditions. A higher frequency of steep declines over a period (in this case we use 14 days) coincides with a low RSI. Based on historical data, when the daily RSI (14) closes below 21 — a level broken for the S&P 500 on August 24 — it suggests the start of a potential short-term bottoming process and increases the potential that stocks move higher.

The data presented in Figure 3 make what we believe is a compelling case for a potential opportunity to buy the dip. The gain in the S&P 500 following RSI(14) breaks below 21 are, on average, about 7% just 3 months later, 11% 6 months later, and 18% 12 months later. This indicator also has a good "completion percentage," with 8 of the 10 instances seeing stocks higher 3, 6, and 12 months after reaching this extreme oversold level. Again, this playbook seems to indicate to buy the dip.

3 RELATIVE STRENGTH INDEX SUGGESTS DEEPLY OVERSOLD CONDITIONS

	RSI(14) Below 21		
	+ 3 Months	+ 6 Months	+ 12 Months
Completion Percentage (%)	80	80	80
Average Gain/Loss (%)	6.9	11.5	18.3
Median Gain/Loss (%)	8.9	13.5	21.8

Source: LPL Research, Bloomberg 09/03/15

Data set covers 10 occurrences dating back to 1971.

Completion percentage indicates the percentage of instances in which the S&P 500 rose over the indicated time period.

Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.

THE BEAR CASE

While our investment process and technical analysis suggest recent weakness may present a buying opportunity, the environment could change or we could be missing something. Historical data provide us with probabilities, not guarantees. Though unlikely, we acknowledge several risks that could potentially lead to a recession and a bear market:

- An exogenous shock such as a terrorist attack or major natural disaster
- China hard landing and potential global credit freeze
- A policy mistake, potentially by a central bank in Washington, Beijing, or Brussels
- The market's overreliance on central bank stimulus globally
- Structural flaws in the bond market may lead to a liquidity squeeze

We continue to watch for signs that these or other risks may be leading to further outsized market declines.

DETERIORATING BREADTH

Market breadth essentially tells us how many stocks are participating in a market rally or decline and can be measured in many ways. Breadth can tell us how broad a rally is, which indicates how durable that rally may be. One way to measure breadth is the advance-decline line, which measures the number of stocks advancing versus the number declining (one of the Five Forecasters we have cited in many prior publications). In a market decline such as the one we are experiencing now, a measure of breadth that has a good track record of signaling market turnarounds is the percent of S&P 500 companies trading above their 50-day simple moving averages.

Historically, when only 10% of companies (or fewer) are trading above their 50-day simple moving average, the market is considered extremely oversold, which supports the start of a short-term bottoming process and a fairly high potential for stocks to move higher. Figure 4 shows that over the past 25 years, when so few S&P 500 stocks are in short-term uptrends, the S&P 500 is, on average, 11% higher 6 months later (and up 7 out of 8 times) and nearly 16% higher after 12 months (and up 6 out of 8 times). If recessionary periods are excluded, stocks were higher during all observed periods—with even bigger gains.

Again, this analysis provides no guarantee, but these favorable percentages can help provide some valuable perspective for those whose confidence may have been shaken by recent volatility. Here, another playbook seems to indicate to buy the dip.

Investor sentiment, a topic we discussed in last week's *Weekly Market Commentary, "12 Questions for a 12% Correction,"* is another way to identify oversold conditions, or capitulation. The American Association of Individual Investors (AAII) investor survey indicates that individuals who were bullish on the stock market were as hard to find in August 2015 as they were during the darkest days of the 2008–2009 financial crisis. Historically, this heightened level of investor pessimism has indicated a potential contrarian buying opportunity.

CONCLUSION

The natural emotional response to sharp stock market declines is to call a time-out and sell. In challenging market environments, technical analysis tools can help us make better investment decisions and limit fumbles. Historical comparisons to prior periods of similarly oversold conditions can help give us our playbook, which we believe suggests investors, where appropriate, may be better off maintaining equity positions, rather than selling into the latest decline. ■

4 DETERIORATING BREADTH ALSO SUGGESTS BUYING DIP

	Percentage of Stocks Above 50-Day Simple Moving Average Below 10%		
	+3 Months	+6 Months	+12 Months
Completion Percentage (%)	88	88	75
Average Gain/Loss (%)	5.9	11.1	15.7
Median Gain/Loss (%)	4.0	14.4	18.4

Source: LPL Research, Bloomberg 09/03/15

Data set covers 8 occurrences dating back to 1990.

Completion percentage indicates the percentage of instances in which the S&P 500 rose over the indicated time period.

Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.

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 referenced 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.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All investing involves risk including loss of principal.

Technical analysis is a methodology for evaluating securities based on statistics generated by market activity, such as past prices, volume, and momentum, and is not intended to be used as the sole mechanism for trading decisions. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns and trends. Technical analysis carries inherent risk, chief amongst which is that past performance is not indicative of future results. Technical analysis should be used in conjunction with fundamental analysis within the decision making process and shall include but not be limited to the following considerations: investment thesis, suitability, expected time horizon, and operational factors, such as trading costs, are examples.

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.

DEFINITIONS

Overbought: A technical condition that occurs when prices are considered too high and susceptible to a decline. Overbought conditions can be classified by analyzing the chart pattern or with indicators such as the Relative Strength Index (RSI). A security is sometimes considered overbought when the Relative Strength Index (RSI) exceeds 70. It is important to keep in mind that overbought is not necessarily the same as being bearish. It merely infers that the stock has risen too far too fast and might be due for a pullback. The caveat is that sometimes when prices are in an overbought condition they may stay that way until the trend reverses, which is classified as momentum.

Oversold: A technical condition that occurs when prices are considered too low and ready for a rally. Oversold conditions can be classified by analyzing the chart pattern or with indicators such as the Relative Strength Index (RSI). A security is sometimes considered oversold when the Relative Strength Index (RSI) is less than 30. It is important to keep in mind that oversold is not necessarily the same as being bullish. It merely infers that the stock has fallen too far too fast and potentially may be due for a reaction rally. The caveat is that sometimes when prices are in an oversold condition they may stay that way until the trend reverses, which is classified as momentum.

RES 5211 0915 | Tracking #1-418060 (Exp. 09/16)