2008 – A very unusual year for equities

After six weeks of equity market rebound, comes the month of May and the saying goes "Sell in May and go away". What Equity outlook can be envisioned for the next four months?

The equity markets could be at a turning point. The 'bears' expect a soon end of the current market rally, pointing to the lack of breadth and arguing that the forces of supply still overcome demand. The 'bulls' argue that pessimism fell from the high readings in mid-March and the VIX equity option volatility index has retraced below 20 percent. For the time being though, the bulls give this bear market rally the benefit of the doubt. At the time of writing, the commodity-related equity sectors, in particular the energy sector, are still outperforming.

We suggest taking a fresh look at weekly charts and looking for clues, which may reveal market expectations. As we all know the price evolution reflects not only current balance of supply and demand, but also to some degree the expectations of market participants, observers and commentators.

In order to feel the inter-market related themes, we start with commodities, which is the dominant theme of the last five years and look how a slow-down in commodity prices could lead to a further rebound in the equity market.

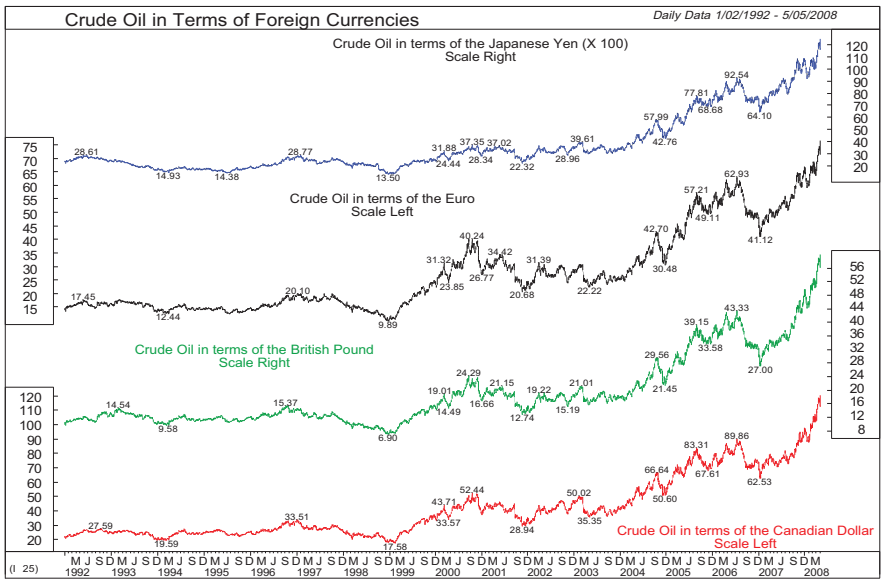

Chart 2 – Crude oil in terms of foreign currencies (courtesy Ned Davis Research).

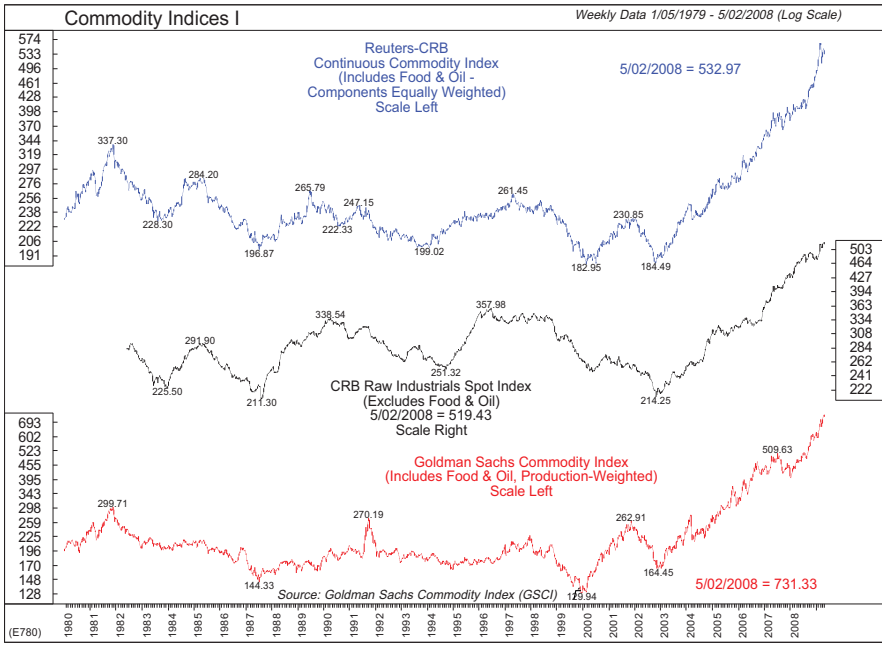

Chart 1 – Commodity indices from 1979 – 2008 (courtesy Ned Davis Research).

Chart 1 illustrates the secular uptrend in commodity price indices since 2002. The acceleration of the Bridge/CRB futures price index, however, has taken recently too much a parabolic upward pattern, which may lead to a consolidation in the coming weeks. The rising channel of the raw materials index (excluding oil and food) by contrast appears much more orderly without signs of weakness yet and is still making higher highs and lows. The Goldman Sachs Commodity Index (GSCI), which contains about 51 percent weighting for energy, but only 7 percent for industrial metals, remains in an upward channel, too. However, the GSCI seems to have completed three successive advances from the 2002 low, which could lead to some correction.

A major focus is on oil prices. Chart 2 displays the doubling of oil prices in different currencies and their recent par-

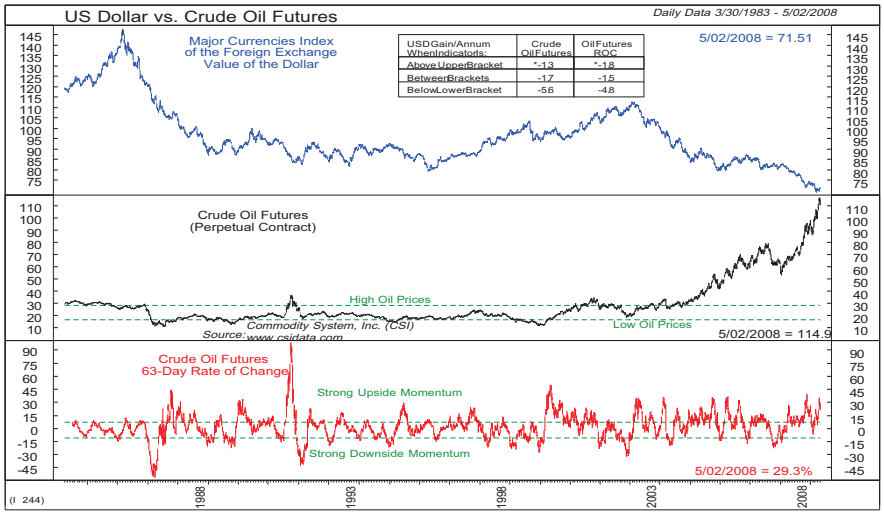

Chart 3 – US dollar and crude oil futures (courtesy Ned Davis Research).

Chart 4 – Light crude oil futures (courtesy StockCharts.com).

Chart 4 depicts the light crude oil futures contract. Its weekly stochastics suggest some bearish divergences emerging in the last week of April, which may signal an end to the parabolic move. A likely pause between USD 125 and 105 is expected.

Given the inverse correlation between oil and US dollar, it is interesting to note that since April the US dollar showed signs of ending its decline. A rebound is coming out more forcefully as can be seen on the weekly chart 5.

The March high has been taken near 73.70 and the 20-week moving average is about to be broken. A rise above 74.00 is seen as a confirmation, which is opening the possibility of an extension toward the upper Bollinger band near 77–78. As the weekly MACD displayed some signs of bullish divergences over the last six months, we conclude that the USD index momentum is slowly turning around.

These signs have been preceded by a trend change in another key market: the US 10-year yield. The amplitude of the rebound is reaching the February highs and the 40-weeks moving average near

abolic patterns. If a correction takes place, the lows of 2007 are technically a strong support area, i.e., an area where prices would stabilize after a decline. Chart 2 shows clearly that the rise of oil is not only caused by the USD weakness, though that inverse correlation is easily noticeable over the past twelve months as displayed in Chart 3.

The crude oil futures' 63 days rate of change (in USD, see chart 3, red line) is currently overbought and coincides with a parabolic acceleration and displays almost five up-waves since the USD 50 area. Such an extreme level of the upside momentum may soon be unsustainable and lead to a consolidation.

Chart 5 – US dollar index (courtesy StockCharts.com).

Chart 6 – US T-Notes 10-year yield (courtesy Stockcharts.com).

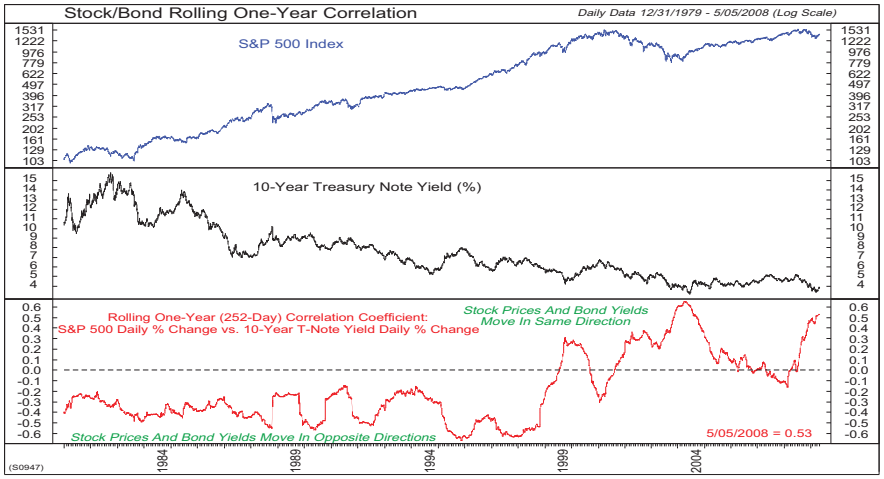

Chart 7 – Stock / bond rolling one year correlation (courtesy Ned Davis Research).

4%. Rising yield in the long US part of the curb is of course making the USD index more attractive.

The US 10-year notes weekly chart demonstrates its reversed downtrend, following a bullish divergence on the weekly oscillator (January–March divergence). After breaking the 20-week moving average, which was acting as a descending trend line joining the previous highs, the yield is testing the major psychological resistance near 3.96 to 4.0%. Before breaking 4%, the rates may well range between 3.6 and 3.9% for a few weeks, allowing the weekly oscillator to come back to the 50% neutral area, before rising above the 4% area. Note that this also corresponds to the upper weekly Bollinger band, which – once broken – will confirm a new uptrend. Meanwhile the rates will fluctuate between 4 and 3.6%, possibly preparing the right shoulder of a major reversal head-and-shoulder pattern with target above 4.8%.

Given the recent correlation between yield and S&P500 index as shown on chart 7, if yields stop declining and possibly stabilize or later rise, then the S&P500 is expected to hold and rebound further.

So far we have seen some major global inter-market correlations. However one should not forget to also analyze the technical situation of equity indices to find out about their relative strength in terms of geographical allocation. There are quite some differences.

Latin American markets, in particular the Brazilian market enjoyed a rising relative strength versus the Dow Jones world index, as depicted in the upper panel of chart 8. This market clearly benefited from the secular uptrend in commodities, leading to a new high of the Bovespa index above the October 2007 high.

Chart 8 – Brazilian Bovespa stock index (courtesy StockCharts.com).

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Chart 9 – Japan Nikkei index (courtesy StockCharts.com).

Chart 10 – Dow Jones Eurostoxx 50 index (courtesy StockCharts.com).

The Japanese market (chart 9) by contrast has a declining relative strength since 2006. The rebound of the Nikkei is struggling just below the 2006 low near 14100. Despite its proximity to China, the Nikkei seems to be correlated to the US market.

Similarly the European market's relative strength took more time to deteriorate. After enjoying a steady rise in 2005 and a plateau in 2006, it only declined significantly since early 2007. This explains that the impressive rebound of the Eurostoxx 50 index since mid-March remains well below the July 2007 low near 4000, now a strong resistance area, where the descending 40-week moving average resides currently. This looks typically like a rebound within a bear market.

In the USA, the situation appears a little more favorable as the relative strength of the S&P500 versus the Dow Jones world index has been making a plateau after a long down trend from 2005 to October 2007. But the rebound of the index since March 2008 has not been met with rising volume as seen on chart 11. Analysts of the US markets like Lowry's Research point out that the breadth of the market remains weak. Indeed there is less volume going into rising stocks (buying power) than into declining stocks (selling pressure). This is typical of bear market rallies.

To conclude this world review, we would like to signal the following points, before suggesting a possible price pattern for the S&P500 for the coming four months:

1. The VIX index on the upper panel of chart 12 is declining since mid-March, reaching now below 20%, it suggests little risk of sharp price fall.
2. The upper weekly Bollinger band, which is sharply declining could flatten out in the coming weeks near 1440.
3. The weekly oscillator stochastics is overbought near 95%, but yet without divergences.
4. Therefore we can expect a further range for a few days between 1400 and 1425, then a new high toward the weekly Bollinger band near 1440–1450. At that stage, it is likely that bearish divergences become apparent on the weekly indicator by the end of May 2008.
5. A correction towards the 20-weeks moving average would become the next step with a possible test of 1360. That should mark a temporary bottom and be followed in the summer by a rebound toward 1425 at least.

Chart 11 – S&P500 index (courtesy StockCharts.com).

Chart 12 – Possible outlook on the S&P500 index (courtesy of StockCharts.com).

As a consequence of such a price scenario for the S&P500, traditional asset managers will have hard time to beat the market during the next four months. Short-term trading skills are necessary to find out all the turns. The lack of big trends will make performance harder to harvest.

Moreover, this scenario of a tight trading range will give little clues to analysts about the end of a bear market rally or the emergence of a new bull market. Even with a rebound that has lasted as long as the decline from October to March, the bears will by August still have an unchallenged all-time high in October 2007. At that time, contrary to the usual seasonality, the bulls may throw in the towel in the fall. 2008 could become really a surprising year for equities.

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