Addicted to Profits

Dave Skarica, Editor Volume XI Issue XV November 2009

What A Market Top Looks Like

Dear Subscriber,

In our last few issues, we talked about why the market is not a bubble. However, I do realize that many people are worried about this market because it has run so far so fast. In addition, I think that, following our historical precedents, we do think that the market will top sometime in mid to late 2010 or early 2011. This is again going back to the similarities to the 1938-1939, 1975-1976 and 1907 to 1909 periods.

So the question is how to spot a market top? This is not as difficult as people think. Most tops have numerous common technical themes and similarities. Where people fail is trying to guess the exact top.

Topping is a process you cannot determine with mathematical precision!

Recently, I saw Dennis Gartman of the Gartman letter try and get the market top in early October by shorting the market; by early November, he was covering his shorts. Now Gartman is a disciplined trader, so he will never have losses. But, to try to short a rally that has been as strong as this one is just downright foolish.

Even if you are bearish on the market, you have to wait for the topping process to play out and it is a process and it can often take awhile. Tops take months or even as long as a year or so to play out.

Signs of a Market Top

Psychology – One obvious sign of a market top is extreme bullishness. There are many ways to look at this. Some look at sentiment indicators, which are good, but we use these to confirm our other indicators (listed below). The problem with sentiment is people often say one thing and do another. Sentiment was terrible in July 2006 because people were fully invested bears. They did not dump until the panic of 2007. In addition, while being a contrarian can pay off, the fact of the matter is that the crowd is usually right most of the time. They just get caught when the trend changes. For example, most investors were bullish in the nineties and from 2003 to 2007; they just got caught in the market when the big crashes happened. Then after the crashes, the crowd became bearish.

The psychology we are talking up is more about mass feeling. Cover stories of booms, people talking about new eras and the market going up to Dow 40,000 and the like. Bullish books appear on the bestseller lists. These things often mark a top. All the buyers are "in".

The Market begins to Form a top and sideways movement. Even in the 1987 and 1929 crashes the market began to move sideways and stopped going up. If you look at the 2000-2002 and 2007-2009 bear markets you will see that basically the entire 2000 and 2007 years were years of topping before the market began to roll over. The following usually marks these roll over.

The Advance/ Decline Line Declines– In the last phase of a bull market the major indices go up but the rally becomes narrower and only a few stocks drive the major indices higher. If you look at 1928 to 1929 or 1999 to 2000 you will see it was just a few stocks moving the market higher and most stocks actually began to move lower well before the market topped. However, it should be noted that this divergence can occur for a long period of time (eg months or even a year or two) before the market begins to head lower.

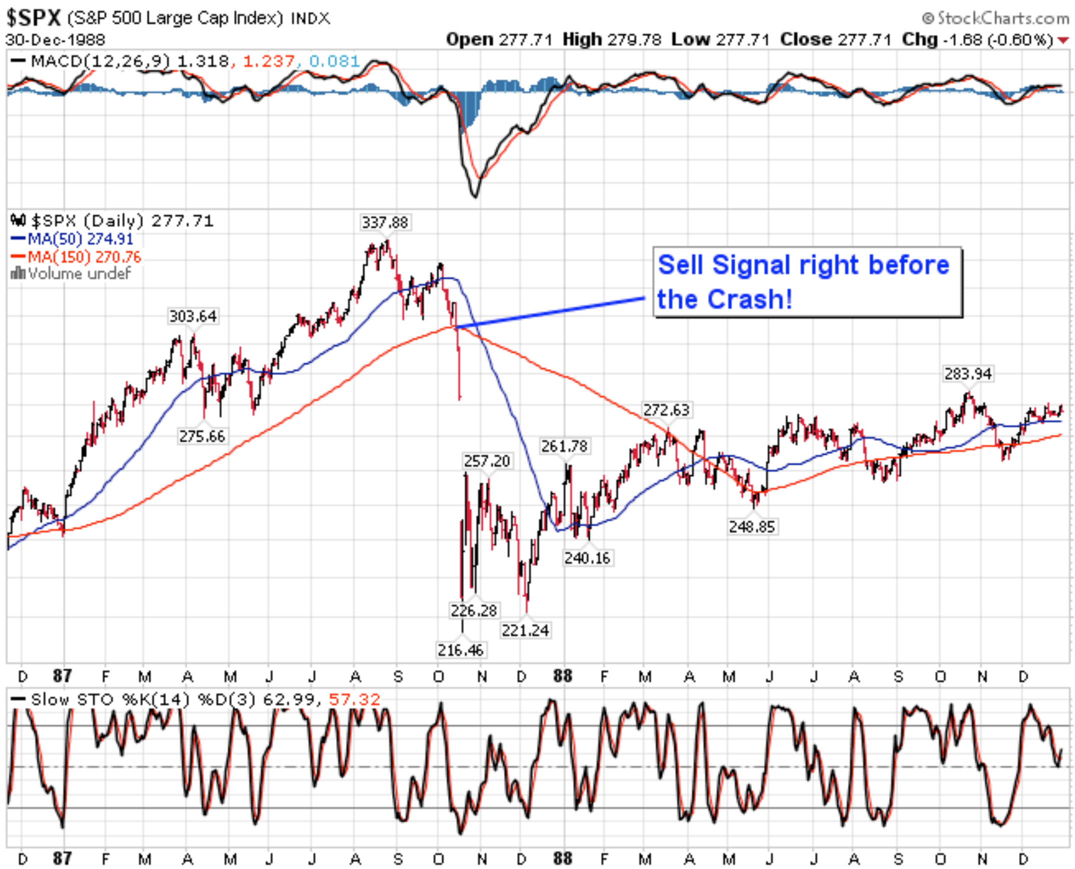
150 Day Moving Average – This might be the most important indicator. At a major top the 150 day moving average begins to move sideways, then slopes downwards. The market breaks the 150 day moving average and stays below it. The sloping downward trend of the 150 day is the most important aspect of the market. During the bull market of 2003 to 2007, there were many occasions when the 150 day moving average was broken to the downside. Spring 2004 and 2005 were examples and also the spring of 2007. However, in all occasions the slope was never downward. The market bottomed and then headed higher. It did slope lower for a tiny bit in late 2004 but headed right back up in late 2004.

However, in the fourth quarter of 2007, the 150 day moving average begin to slope lower and continued to do so all throughout 2008 and into early 2009 as the market fell from 1500 on the S and P 500 to 666. Now you also have to trade a bit on gut, for example the 150 day did not slope upwards until May 2009 and you would have missed some of the really if you waited until May to buy. We have written many articles on how to spot a market bottom; we previously talked about (during the period itself as bargains were appearing) why the 2008 to 2009 period was a great time to buy; we will revisit the indicators of market bottoms for another time.

Past Tops

1987

Let's look at past tops – firstly with 1987. We can see that the 150 day moving average began to slope lower 2 days before the crash and the market broke the moving average at that time!! If you had sold in the two days before the crash on this signal you would have sold between 280-300 on the S and P 500; the top was about 340. The S and P eventually dropped to 220. In addition, you would have seen the A/D line deteriorate during the summe



r of 1987 and you would have added that on to begin selling.

1990 bear market

In 1990 the 150 day moving average began to slope downwards and the market broke the average in August 1990. If you had seen this development and acted on it, then you would have sold at around 340 on the S and P 500. The top was 369. The S and P eventually fell to 294.00.

2000-2002 Bear Market

This was a classic example of how sometimes a bear market can take a long time to develop. The market basically took the entire 2000 year to top out. During the course of 2000 the S and P 500 went up and down between 1500 and 1350 and then finally really began to break lower late in the year.

The S and P 150 day moving average starting to roll over in November 2000 with the market trading at around 1350-1400 (the top was just over 1500). The NASDAQ's 150 day moving average began to peak out a little earlier in the July/August period with the NASDAQ at around 4000. Of course, the course of this bear market took the S and P down to 800 and the NASDAQ back down to 1100!!

S&P 500 Advance-Decline Lines
(c) 2009 Decis
SPX Advance-Decline Line
S&P 500 Large Cap Index
1320.28 -13.94 -1.
SPX Advance-Decline Volume Line
98 F M A M J J A S O N D 99 F M A M J J A S O N D 00 F M A M J J A

$SPX (S&P 500 Large Cap Index) INDX
© StockCharts.com
31-Dec-2002
Open 879.39 High 881.93 Low 869.45 Close 879.82 Volume 1.3B Chg +0.43 (+0.05%)
MACD(12,26,9) -6.182, -3.185, -2.996
$SPX (Daily) 879.82
MA(50) 901.93
MA(150) 909.74
Volume 1.32B, EMA(60) 1.72B
September 2000 At around 1350 the 150 day started to slop downards, it fell to way under 1000 during this bear market
1530.01
1339.40
1315.93
1081.19
944.75
1176.97
965.00
954.28
775.68
768.63
Slow STO %K(14) %D(3) 17.26, 18.44

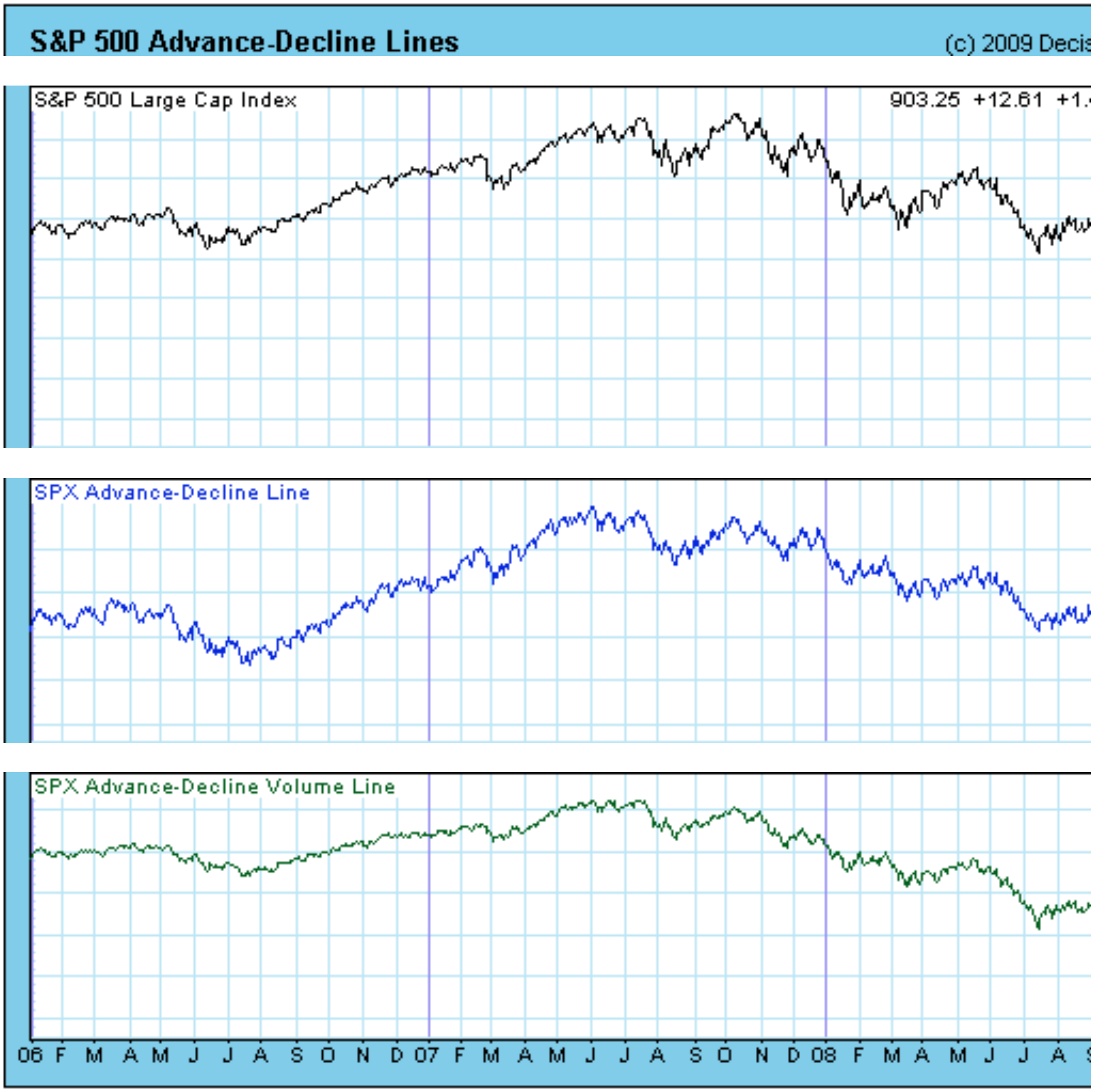
2007 to 2009 Bear Market

The S and P 500's 150-day moving average began to slope downwards in the 4th quarter of 2007. If you had sold at this time you would have sold between 1400 and 1500 on the S and P 500 and of course it fell to 666.

Now the sloping 150 day moving average is a slow indicator; it can takes months to unfold. This is why you must take things like the Advance/Decline line and Psychology to combine it with this technical indicator.

I think the 150-day moving average is a great indicator to confirm your views and you can generally reliably use it to short the market (but not always , as we discuss shortly). For example, once it turned lower in August 2000 you could have started to short the NASDAQ at 4000! This was within 20% of the top and the NASDAQ fell another 75% to its bottom!

Same goes in 2007 - you could have waited all of 2007 out and then started to short when finally the 150 day moving average began to move lower. However, like most laws of man, it does not always work. For example, the 1998 correction was so fast and ferocious that the 150 day moving average did not really even slope downward during the entire thing. However, for long term bear market analysis, the sloping of this moving average is about as good as we have to see that the markets' trend has changed.

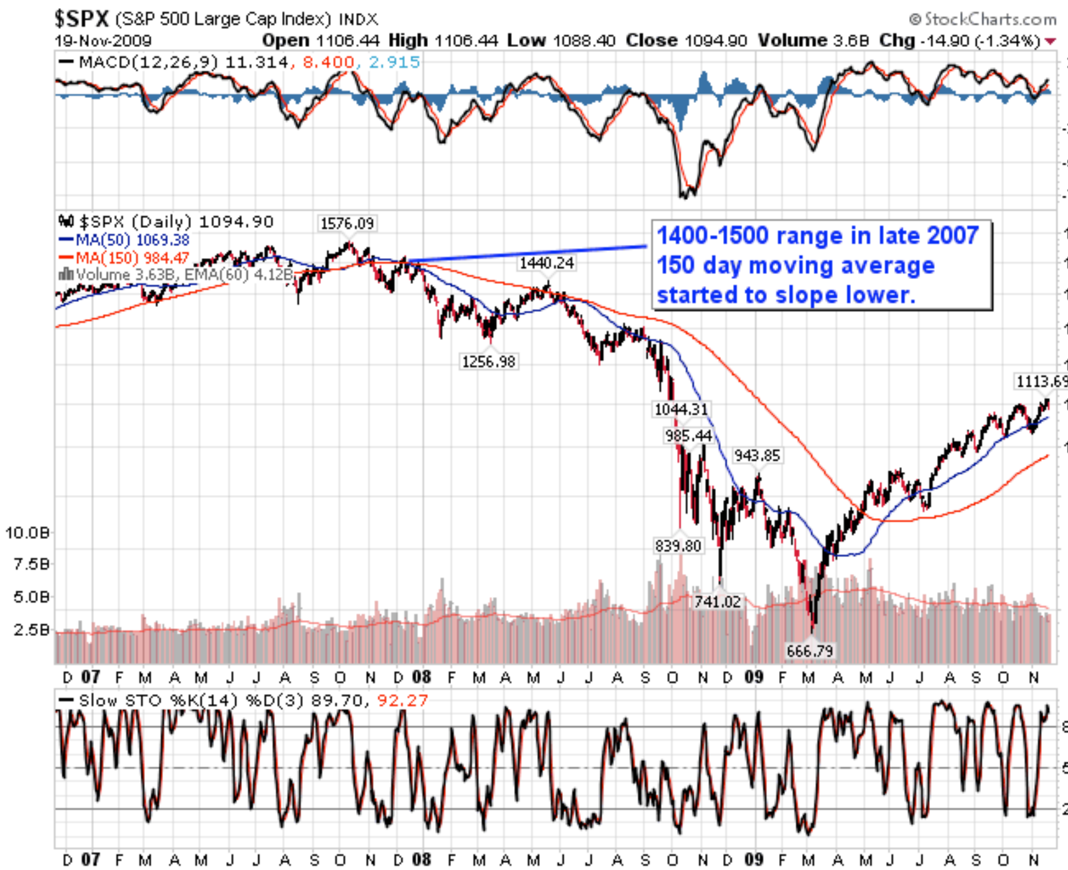


So where are we today?

We can see that most bear markets have the same action. The Advance/Decline begins to deteriorate. Then after that, the market begins a topping pattern and rolls over and the 150 day moving average begins to slope downwards.

Right now we are nowhere near such topping action. The market is still climbing upwards; there is no sideways movement. The move from the bottom has seen a strong Advance/Decline. It has weakened as of late, but there is no sign of it moving lower and even if it did so, it would just be a warning at this stage in the game.

The 150-day moving average began to slope upwards in May 2009. It continues to slope upwards and the market continues to trade well above its 150 day moving average.



Psychology is still negative!!! Despite the market rally, Newsweek has run an article on how we are still in a financial bubble. It should be noted that Hedge Fund Manager supreme John Paulson who shorted the subprime market and made billions, recently took large positions with Citigroup and Bank of American and JP Morgan. That does not sound like the smart money pulling out.

The fact of the matter is, even if you are worried about this market topping out, it is not showing signs of doing so. Even if it has hit a top, it is going to take months for the topping process to play out. You will have time to get out and see the signs of a major market top at that time.