



Weekly Market Update October 28, 2009

We had changed our stance on the equity markets from short-term bullish to short-term neutral on October 16th near our 1100-1120 target, given that we had a confluence of time cycles and a number of red flags from a technical standpoint to suggest we were near a major correction.

Bottom Line: There is a prevalence of technical evidence to suggest we are seeing the beginning of a “topping” process that will lead to an even larger pullback in equities. Our short-term target is ~1015, and our intermediate target is ~920-930. ~1050-1060 also represents support so a bounce over the next few days would be expected but would likely be capped at ~1075-1085. We are also long the Dollar and short the Euro.

The difference between short-term and intermediate targets is that we expect our short-term target to represent major support in this case, where we expect to undergo a period of retrenchment or consolidation whether through price or time, which will set the stage to reach our deeper intermediate targets.

We have already identified a number of attractive short candidates with great setups for the next potential leg lower. However, we are being patient given that we are near support, and with Q3 GDP being released this Thursday, we believe we can reverse to slightly higher levels from here heading into the end of this week, which will improve the risk/reward dynamics. At this juncture, you either have to wait for a bounce to initiate bearish positions or wait for “confirmation” (not our preferred strategy), which only comes with a break of ~1015 but a break of ~1040 would be good enough for us. On the flip side, a small bounce over the next few days should not exceed the 1092 level – a break above this level will open the door for 1120-1140 but we assign this a low probability.

A number of sectors and indices are at, or near their major trend lines from the March lows (financials and transports have already broken these trend lines, which is a negative for the broader market). There is a tendency for these trend lines to hold on the first “test” so we expect a minor reversal from these levels, but at this juncture we expect a technically “weak” move higher over the next few days before a larger sell-off takes hold once again. The 50 dma stands at ~1050. See Chart 1.

There is increasing evidence of “distribution” in the equity markets, and several sectors have been declining on rising volume. Furthermore, for the first time in several months, we’ve noticed a divergence between the index that tracks the percentage of stocks on the NYSE that are holding above their 50 day moving averages, and the equity markets. See Chart 2. Since August we have been around 85-90%, but lately we’ve seen a lower high in this index, thereby not “confirming” the new highs in price.

There has been a lot of chatter about the transports index lately given that it has a tendency to lead the broader markets. See Chart 3. A clear divergence with the S&P has developed over the last few weeks. It failed twice at a critical long-term pivot level, and the bearish divergences with our oscillators have been evident for some time now. We also registered a weekly bearish reversal last week, and in addition to all of this we broke the trend-line from the March lows yesterday. This has ominous implications for the equity markets, and so we will continue to keep a close eye on this sector.

Technical Analysis & Strategy

As you will see in the “Technical Sector Observations” section below most sectors are, and have been for some time, deteriorating technically. Two sectors where we mentioned we wanted to get more aggressive on the short-side are Financials and Semis, and we mentioned that they should lead the markets to the downside in addition to Transports. We are waiting for a bounce before initiating structural short positions in these sectors given that we are near support at current levels.

With regards to the US dollar, we have continued to argue that we were close to an intermediate change in trend, which would have bearish implications for equities and commodities. Monday’s “impulsive” move higher was impressive to say the least, and we think there is a good chance that it represents the first sub-structures of a new intermediate move higher. We believe we saw the completion of minor leg 5 of sub-wave “C” last week (from the high in March of ’09), and we are now going to head higher over the next few weeks. RSI also broke out above the trend line after forming a major bullish divergence with price, and RSI has leading tendencies, so we would expect price to break out in the near-term. See Chart 4.

The recent sharp reversal in the dollar also suggests the beginning of a short squeeze, as the volume in the last few days has been nearly triple the average daily volume over the last few months – options volume is also running three times the average daily. The sharpness of the fall in the Euro also increases the odds that we are seeing a change in trend. We are buyers of the Dollar and sellers of the Euro on any retracements over the next few days.

We will inform our clients when we are ready to initiate more short-term trading strategies.

Technical Analysis & Strategy

Technical Sector Observations

BKX (Financials) – Confirmed break of its uptrend from the March lows. Approaching minor support at ~43.50. Bearish divergence with daily RSI continues to play out as RSI broke trend line and broke below 50 level. Financials have underperformed the S&P since the end of August.

XOI (Energy) – Has room to the downside in the context of a normal retracement in an up-trend. RSI failed at extreme overbought level. Minor support at 1065. Has greatly outperformed the S&P since mid of August.

OSX (Oil Services) – Testing minor support now at 196-197. Bearish divergence with daily RSI. Also has been outperforming broader index since August.

IXI (Industrials) – Has formed a potential double top with a critical long-term pivot level at 274 (intraday high from 10/14/08). Bearish divergence with daily RSI. Testing 50 day MA at ~260. Outperformed since rally began in March, but has experienced short-term underperformance since 09/21.

IXR (Consumer Staples) – Rally failed in an area of major long-term supply at the ~266 level, which also represents a long-term pivot level. Reached extreme overbought conditions (surpassed historical extremes in many cases) across various time frames including weekly and daily. Has been underperforming the broader market since March.

IXB (Materials) – Has failed at the 50% retracement at ~337 and formed a potential double top. Clear bearish divergence with daily RSI. Has been underperforming since March.

DRG (Pharmaceuticals) – Failed at the 50% retracement area at ~300. Bearish divergence with daily RSI. Has been underperforming broader index since beginning of July – overall since summer of '08 has been outperforming, and longer-term we expect this trend to continue.

BTK (Biotech) – Broke below ~880, which was the level we were watching for a confirmation of a bearish reversal. Has room to the downside. Major bearish divergence with daily RSI after having reached critical overbought level and RSI has now broken below the 50 support level. Overall entered into a period of massive out-performance in the summer of '08 and we expect that to continue longer-term – since mid September has been underperforming the broader market.

DJR (Real Estate) – Failed just short of the 38.2% retracement, and has been deteriorating technically since then. Bearish divergence with daily RSI after having reached extreme overbought level. Broadly speaking, has been underperforming since early '07 and more recently has underperformed since 09/22. Interestingly, the relative chart failed precisely at the low pivot level from '08, suggesting that we are entering another major period of intermediate underperformance by this sector.

NDX (Tech) – Bearish divergence with daily RSI after having failed at critical overbought levels twice. Broadly speaking began a period of longer-term out-performance at the end of '07 and we expect that to continue in the longer-term.

SOX (Semiconductors) – Failed at the ~337 level, which is a level of long-term supply, where it found a bottom on multiple occasions in '08. Volume suggests significant distribution is taking place. Broke below the 50 day MA yesterday. Bearish divergence with daily RSI. Has outperformed since end of last year, but has been underperforming since beginning of September and runs the risk of breaking its trend line.

UTY (Utilities) – Continues to test resistance at the 406 level and has failed in that area four times. Bearish divergence with daily RSI. Has been underperforming since beginning of '09 and broke below a major longer-term support level on the relative chart.

Technical Analysis & Strategy

Active Short-Term Trading Ideas

Long DXY (Dollar) with short-term target of 81-82. Stops at 75.

Short EURUSD (Euro) with target of 1.38-1.4. Stops at 1.505.

Short UTY (Utilities) with target of 340-345. Stops at 412.

Closed Short-Term Trading Ideas

Short IBOV (Brazil) had stop elected at the 65,500 level

*Stops on a closing basis

Technical Analysis & Strategy

Chart 1: SPX Daily with RSI



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Chart 2: NYSE Percent of Stocks above 50 Day Moving Average

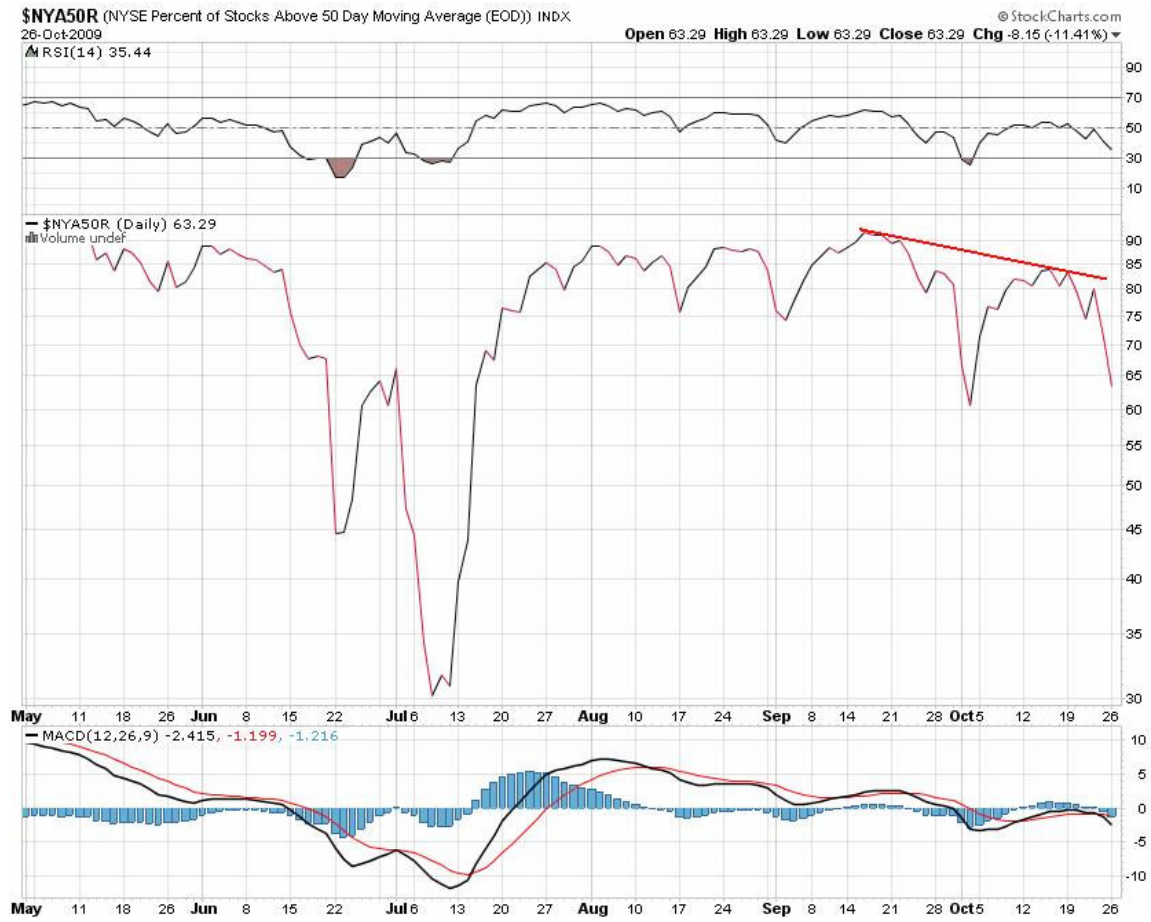
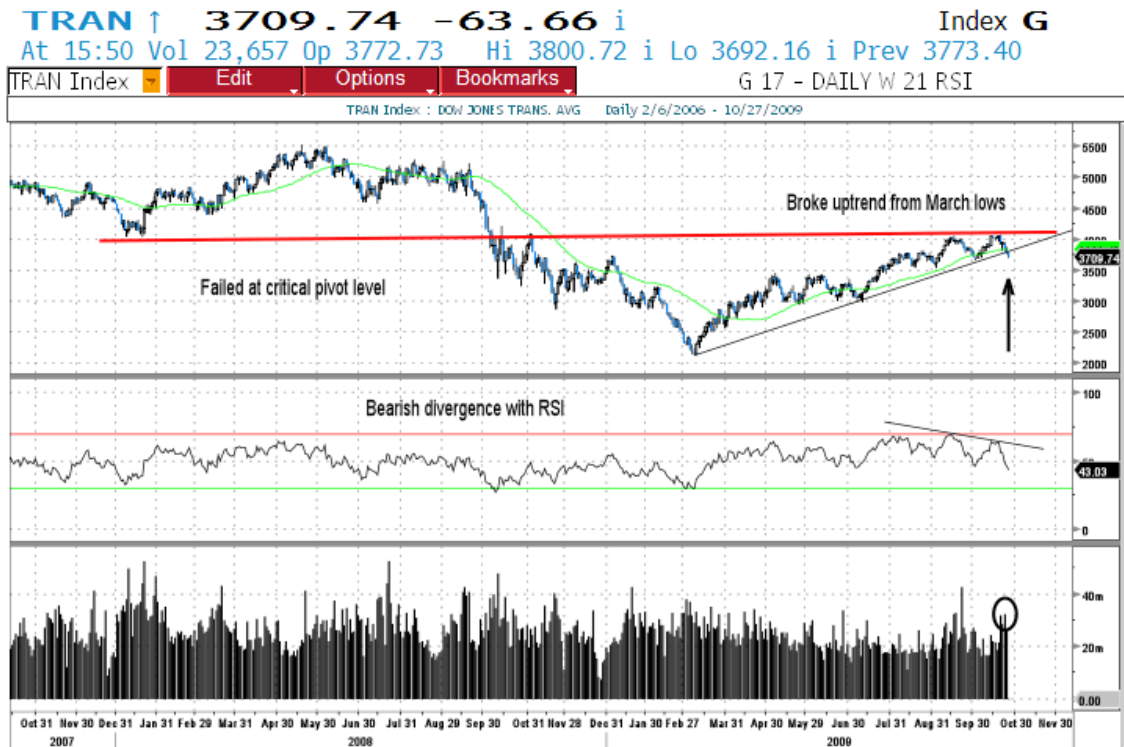


Chart 3: Transports Daily with RSI



Technical Analysis & Strategy

Chart 4: Dollar Index (DXY) with RSI



Technical Analysis & Strategy

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