

Six Reasons Why the Markets Could be Entering a Bit of Turbulence

The following is the 'Weekly Commentary' piece that was presented to members of TheMarketMessenger.com on Sunday, May 18th...

The markets closed at their highest weekly close since the turn of the year, this week (ending 5/16).

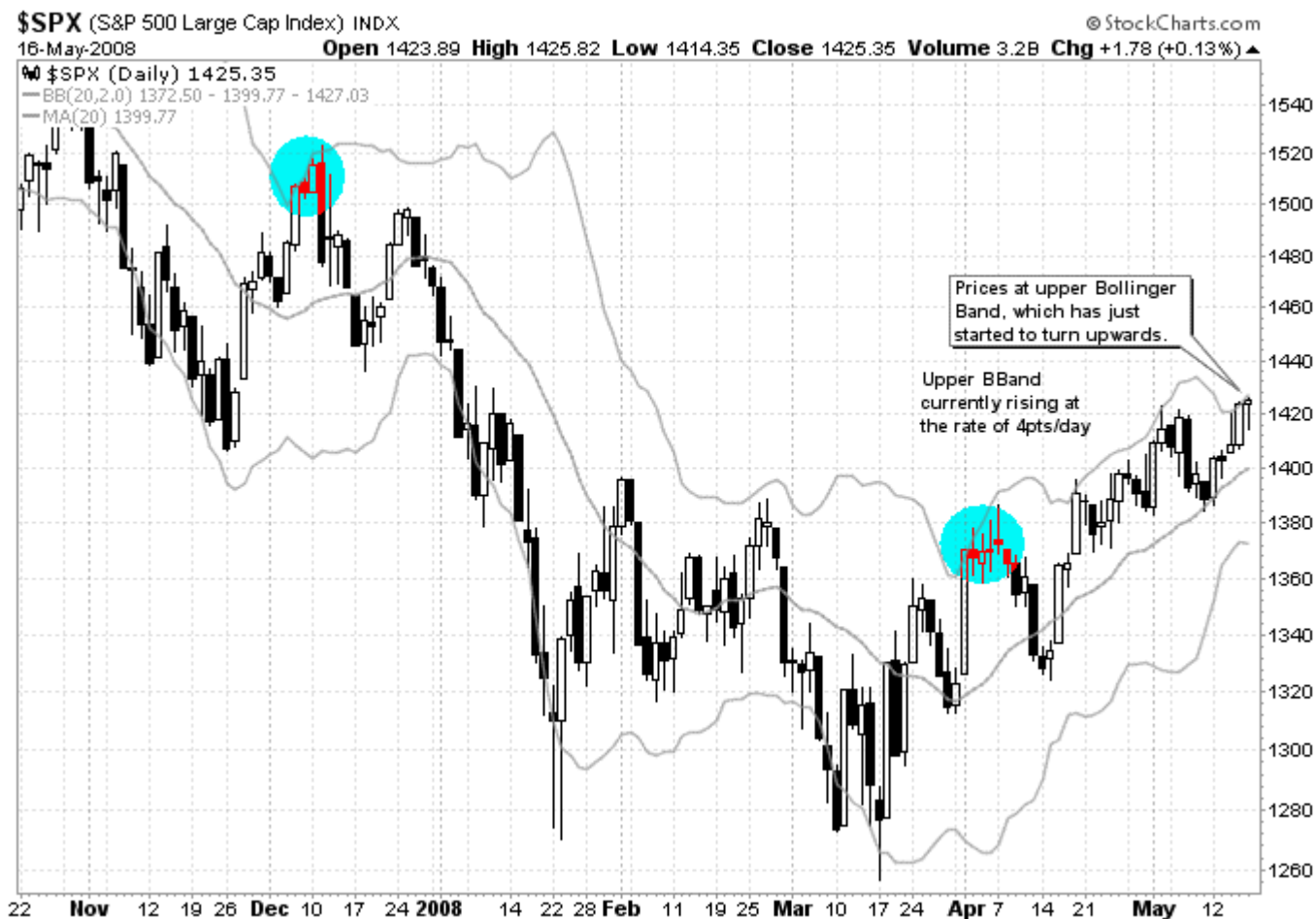
While on the surface that would seem to be good news for the bulls, the reality is that there are now a few strong technical forces at play that are set to bring pause to the rally, if not put in a top on the minor or intermediate trend.

To be sure, there are no sell signals as yet and the bears still have to prove their case, but unless the bulls can pull off something special over the next week or two, the bears might just have their way.

Today, we're going to follow a slightly different format. Rather than show you the usual sequence of daily and weekly charts replete with trend analysis, BBands, momentum indicators and the like, on each chart, we'll showcase a series of barebones charts that highlight some of the major stumbling blocks to a continuation of the rally.

Let's start with a look at our favourite price envelopes laid over the foremost stock index.

Bollinger Bands on the S&P-500 index daily chart...



Until Wednesday, the Bollinger Bands were tightening. The S&P-500, which had bounced off its 20dMA on Monday morning, had climbed to the Upper BBand mid-day Wednesday before finding resistance from the falling upper BBand and dropped to close the day nearly unchanged.

At that point, the upper BBand started to flatten. The push to a slightly higher minor high on Thursday (and then another slightly higher minor high on Friday), has allowed the Bollinger Bands to start expanding, once again.

The upper Band is now rising at a rate of around 4 points a day. That's a pace that will not allow for a strong rally immediately, unless a rare occurrence - that of prices' pushing through and above the upper Band - were to occur.

What typically happens when the BBands display this sort of setup is that prices will drop to the 20dMA or even the lower Band before attempting to snap back to the upside.

When prices fall quickly from the newly rising upper Band and find support at the 20dMA, the upper Band will often continue to rise - especially if the prevailing minor trend is a bullish one - and prices will have the opportunity to make a sharp reversal to the upside and new highs are formed on the way to much higher levels.

So, if the markets selloff early next week, we'd need to keep a close watch on the 20dMA and the upper Band.

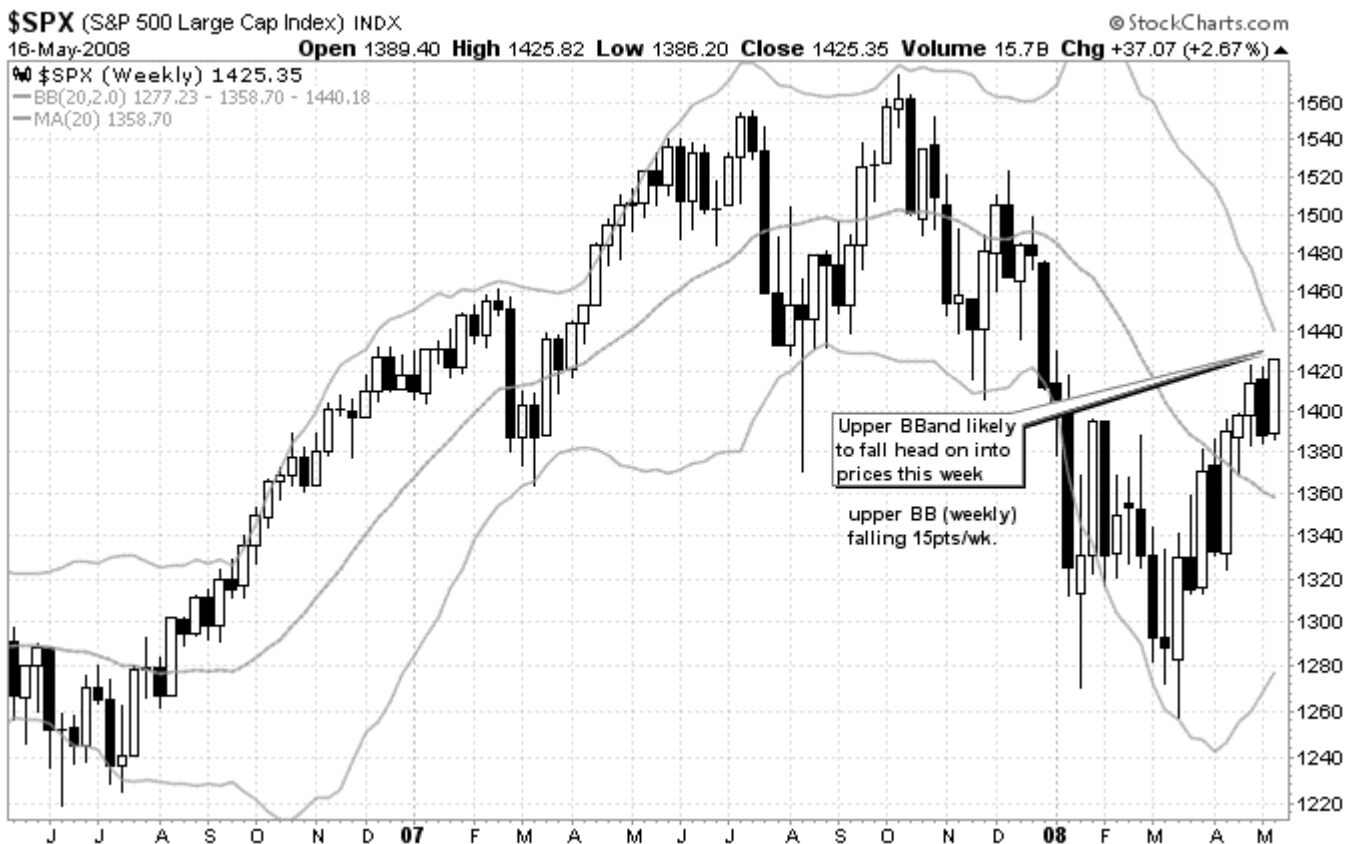
It is important to note that while the fact that the newly expanding Bands can often lead to a small move away from the Bands (and towards the 20dMA), the setup does not provide much predictive value beyond that initial move and other factors need to then be taken into consideration as far as future price action goes.

Take a look at the highlighted action in early-December and early-April to see what we mean...

In a nutshell, don't be surprised to see a move towards the 20dMA next week but if/when that occurs look to other aspects of the technical picture to give you an idea about whether any such dip will turn into a prolonged decline or whether it will soon give way to a move to new highs.

Bollinger Bands on the S&P-500 index weekly chart...

Having seen the Bollinger Band action on the daily chart, it would be apt to take a look at the action of the weekly Bollinger Bands...



The upper Bollinger Band on the weekly chart has been falling for the past few months; no surprise there. At present, the rate of descent is approximately 15 points per week. Looking at the action that was witnessed 20 and 21 weeks ago (the 20th to last period is dropped when calculating each new plotting of the Bands), it doesn't seem like this rate of progress will change much.

As such, expect to find the upper Bollinger Band on the weekly chart plotted at around 1425 starting on Monday. 1425 is exactly where the index closed this past week.

You take a falling weekly Bollinger Band and rising prices and what you get is a clear sign of worry for the bulls.

This is clearly one of the most blatant pieces of evidence to the claim that there is the very real possibility of a top in the near future.

While that is the worst case scenario for the bulls, the close-to-the-best case scenario is that we'll see a few weeks of sideways action, during which time the upper Band will flatten out and then start to rise and move out of the way of rising prices.

We said "close-to-the-best" case because there is the slight possibility that prices will somehow manage to pierce through the Upper Band and yank that Band around within a week or two. Such a development is rather rare, especially on the weekly chart, but you never know.

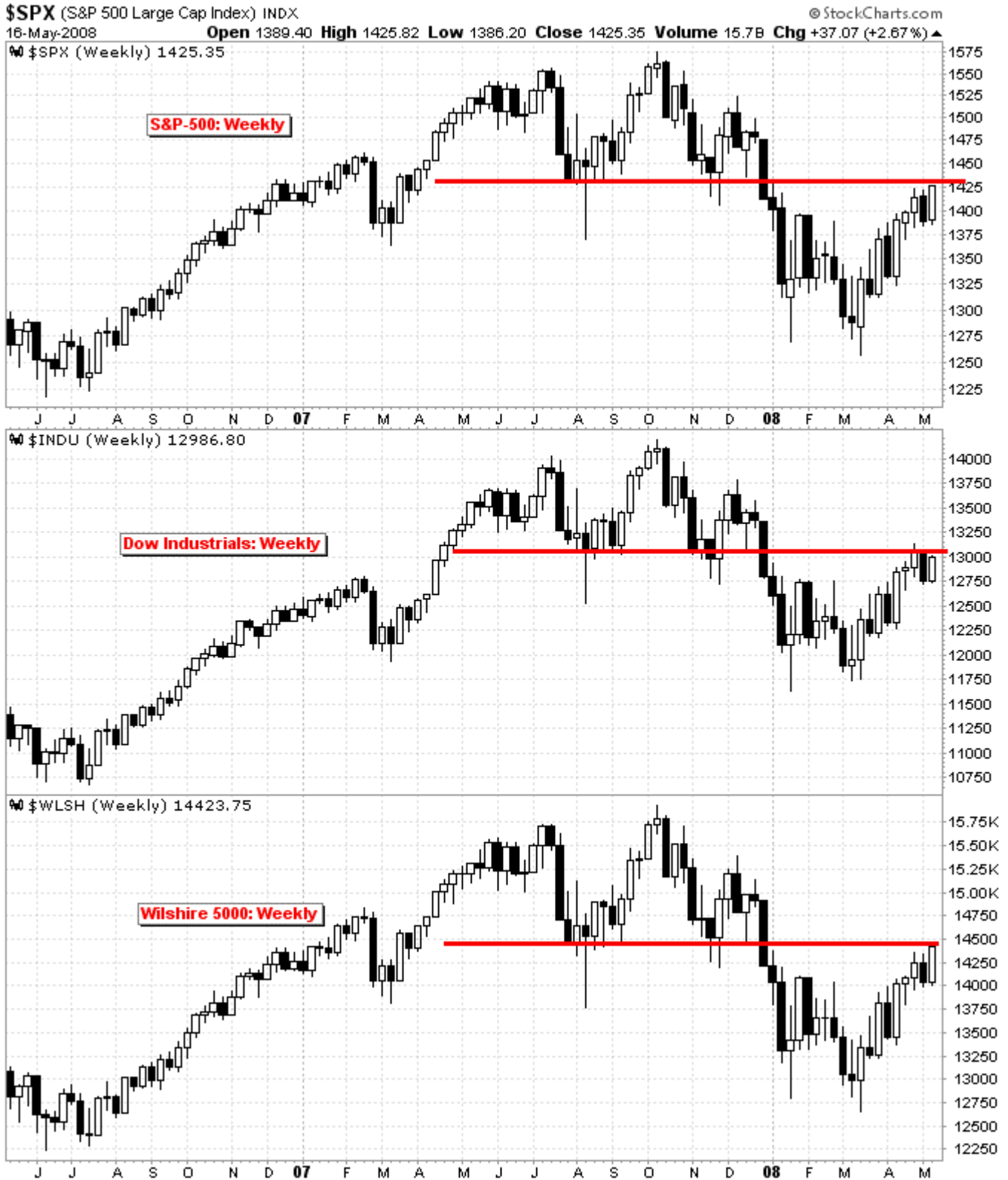
The safe bet would be to at least be very cautious and not look to indiscriminately add too many new bullish positions, while tightening stops on existing longs, like we'd started to do towards the latter half of the past week.

[updated] May 19: Please note that we seemed to have made a small miscalculation. We had thought that the upper Bollinger Band on the weekly chart might fall 15 points to 1425 as of Monday. However, in reality that Band has not fallen. In fact, it seems to have started to flatten as of Monday. This fact does not change the picture much, however. Please read the May 19th Nightly Commentary for further details with respect to this topic.

The Bollinger Bands are not the only source of resistance to the broader indices at the moment. Important levels of support - on a weekly closing basis - that showed up during the formation of the double tops back in the latter two-thirds of 2007 are now to be viewed as sources of potential resistance.

(contd.)

Old Intermediate Support Levels - weekly closing basis - on S&P-500, Dow Industrials and Wilshire 5000 Indices...



Two weeks ago, we'd said that the markets had made important breakthroughs in having moved back above the old intermediate support levels that had formed on the daily charts during the latter part of 2007.

The levels of 1407, 12740 and 14250 were seen as being the levels of importance on the daily charts of the S&P-500, the Dow Jones Industrials and the Wilshire 5000, respectively. The fact that the indices had broken above

those levels was a good initial sign that perhaps the bullish reversal that had begun in mid-March was being confirmed.

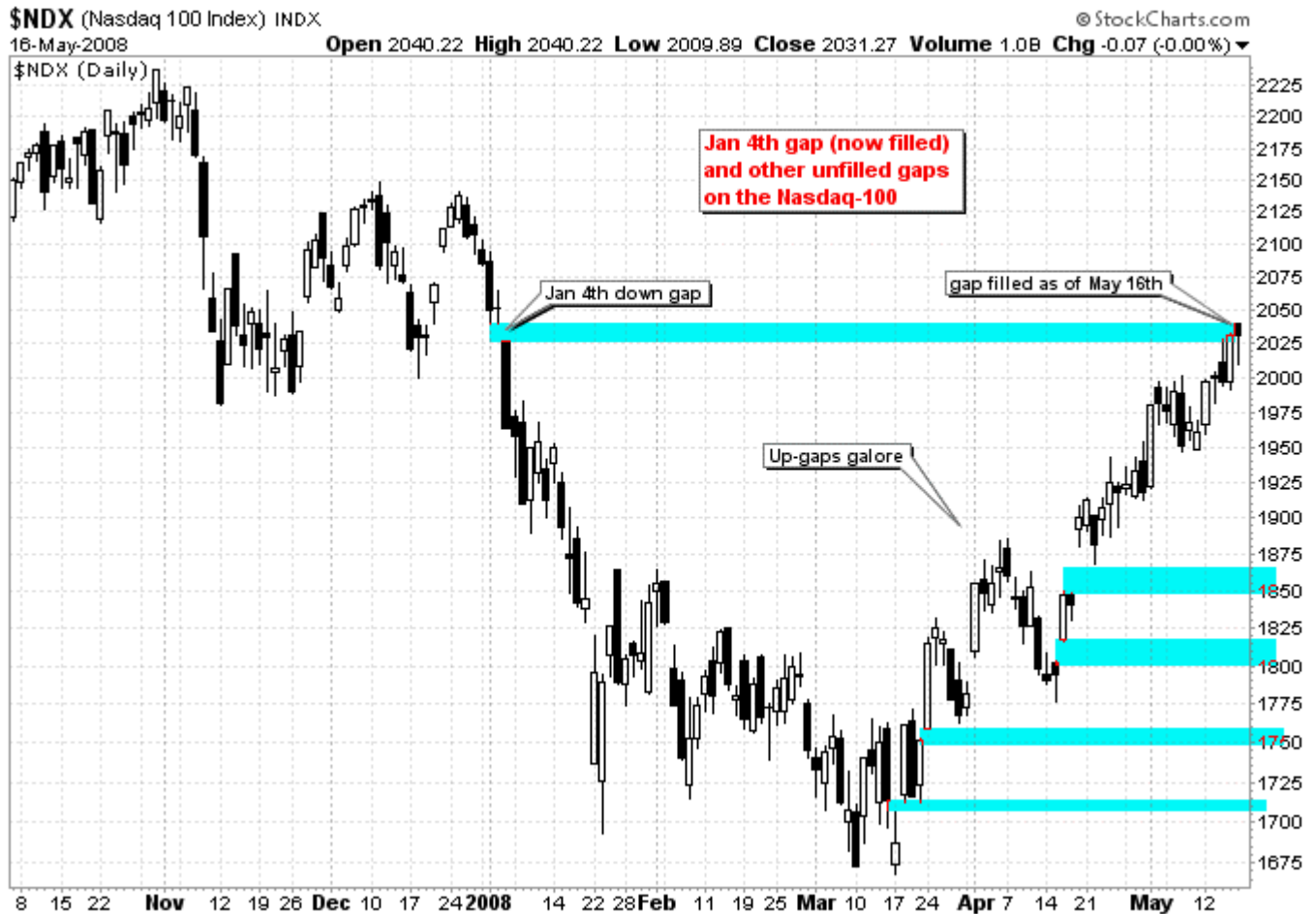
However, while those levels were pertinent at the level of the daily charts, a study of weekly closing prices shows that the levels of 1425 (SPX), 13050 (INDU) and 14475 (WLSH) are pertinent at the level of the weekly charts.

Those old support levels will now provide resistance at the level of the weekly chart.

In a nutshell, these are probably the dividing lines when it comes to deciphering the *intermediate trend*.

If the aforementioned levels can be broken on a weekly closing basis, there may be cause to believe that the intermediate trend has almost certainly reversed to bullish and/or that the correction on the major (bull) trend had been completed as of mid-March.

Gaps galore on the Nasdaq-100 index...



Back in the first week of January, when the markets were free-falling, we'd noted that the down-gap that was left on the chart of NDX on Jan 4th was probably going to need to be filled at some point, before the market went to much lower levels.

A filling of the gap wasn't an absolute necessity, because this index tends to leave an unfilled gap or two here and there during strong trending environments. Four gaps in the space of a month, however, is another story altogether, but we'll get to that in a moment.

As of Friday's session, the NDX has filled the January 4th gap; five and a half months after the gap was created. That gap now ceases to have any importance, except for the possibility that it marks the level of the next intermediate top (for now, that's just speculation, of course).

Earlier we'd mentioned that it is not untoward for the NDX to leave a gap or two during the course of a trending move. A quick glancing of the daily charts of this index since mid-2000 shows that there has not been a sequence of four gaps in one direction in a 5-week period, which is exactly what we see on the chart between mid-March and mid-April.

Is that a red herring? Or is it a Damocles sword?

Only time will tell.

The Volatility Index has gotten "Oversold" and is at Intermediate Support



The VIX is possibly the mother of all contrarian indicators. However, its utility is higher when trying to pick a bottom than a top (on the markets).

Nevertheless, there are a couple of signs that perhaps the index is ready to bottom out and to reverse course to the upside, which of course typically means that the markets are ready to turn downwards.

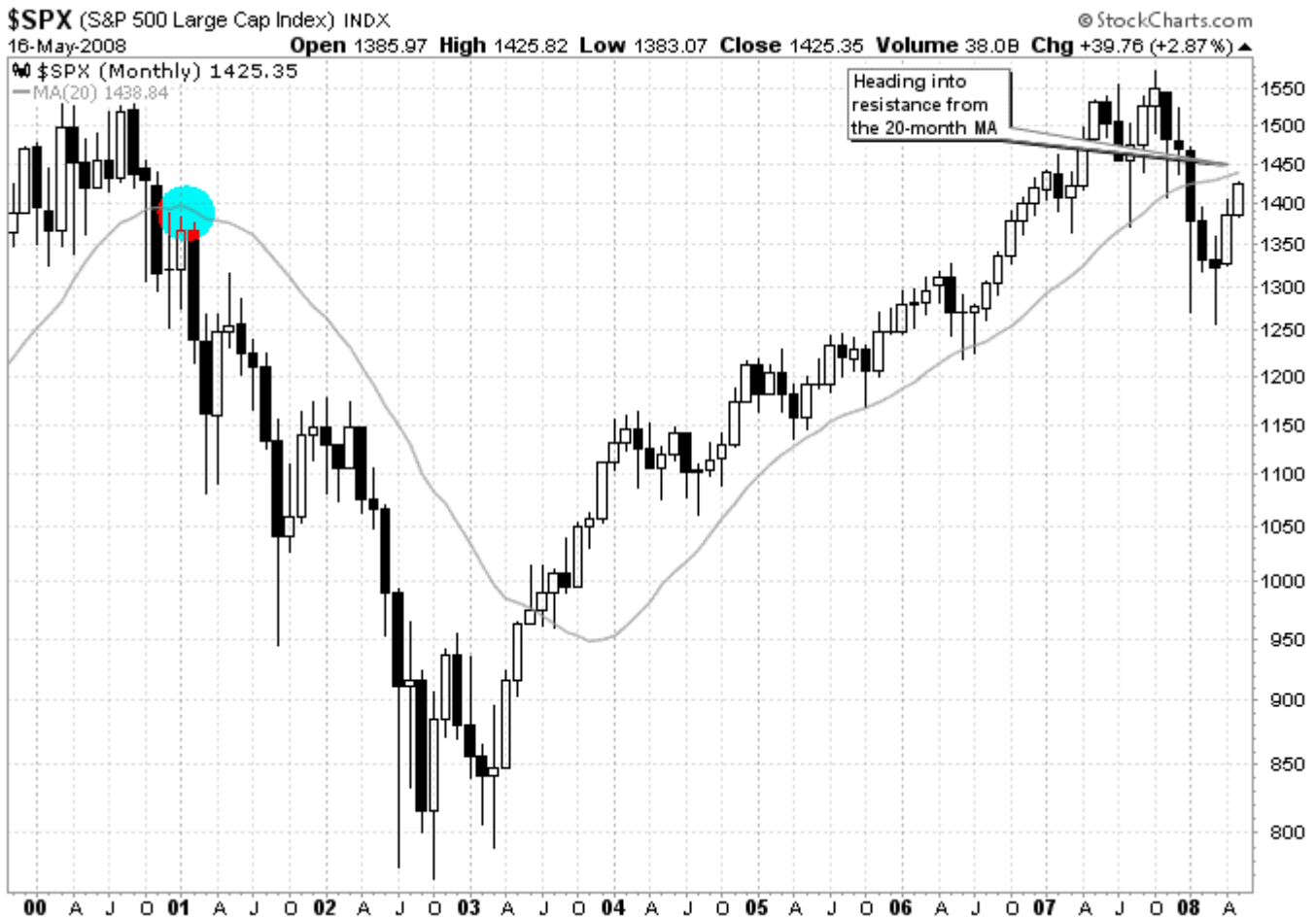
As of Thursday and Friday, the VIX hit an intermediate support level at 16. Its RSI (which you may or may not consider a reliable measure on this particular index) is showing relatively oversold readings.

Additionally, there has been quite a steady decline with hardly any retracement since the highs in mid-March.

All in all, there are enough signs to suggest that at least a short-term reversal to the upside (on the VIX) is possible.

(contd.)

The 20-month Moving Average on the S&P-500



The 20-month Moving Average on the S&P-500 is a good guide when it comes to the major trend. During major uptrends, it provides support; during major downtrends, it provides resistance.

Typically, once the 20mMA is broken - as it was in January - the index stays on the other side of that line for a long time (often several years).

The 20dMA is currently at 1438 and should be seen as a staunch source of resistance. If broken - on a monthly closing basis - it would be a significantly bullish sign.

Until such a break occurs, it would be prudent to assume that the formation of an intermediate top at or below that level is quite possible.

Now, you might be wondering why we've taken on such a cautious note this week, after having been rather strongly bullish for several weeks.

In some ways, we haven't had much of a choice. The resistance levels that were broken over the past few weeks were crucial. If it were up to us, the markets should have gotten into stride fairly quickly after breaking those levels and then gone on to much higher levels, putting to rest the possibility that the breakouts would prove to have been false.

The relative lack of progress over the past few weeks leads us to doubt the longer-term health of the rally and, therefore, until proven otherwise, we'd take a very cautious approach.

Have a good trading week.

(May 18th Weekly Commentary ends here...)

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