

NEW - PurelyTechnical Blog!!

If you haven't heard as yet, we recently launched a new stock market blog, called (what else?) 'PurelyTechnical' blog. The blog will feature various topics from the area of technical analysis of the stock markets, commodity markets, options markets, technical analysis education, options trading strategies education, and so on.

A handful of articles will be published, each week, which means you now have even more free stock market analysis to supplement your free stock market newsletter - 'Purely Technical'.

So don't wait any longer, click the following link to visit our new stock blog: blog.themarketmessenger.com

Markets Breaking Intermediate/Major Support

The following article is an adaptation of the most recent Weekly Commentary piece provided to members of TheMarketMessenger.com...

Over the past couple of weeks, we've stressed the point that overtrading might lead to a lot of pain. If you've taken your own path and have just happened to choose - by luck or skill - the perfect stocks and sectors to short, you're probably pretty happy with yourself at the moment.

For those without the Midas touch, however, the past week or two have probably been pretty challenging and simply any out-performance of the market - in this case, even just giving up less ground than the markets have - would have to be seen as something to be happy about.

We'll get to the all-important charts shortly. Before we do that, there are a few very important questions that we need to try and answer, this weekend, given market events that have transpired over the preceding week...

Firstly, a bit of background and context...

As members of our site know, we've been averse to adding too many new trading picks, over the past couple of weeks. We have had a few solid winners on the short side of the markets, but not as many as we would have had we been more aggressive (our reading of the charts told us to be cautious and we're absolutely satisfied with the outcome).

This weekend, we've added a plethora of new options and stock trading picks; the trading picks lists are now practically full to the brim.

We find it compelling to explain this change; lest we give you the wrong idea.

It's not so much that we're suggesting that it's time to willy-nilly consider increasing the level of risk in one's trading. Rather, it has more to do with the fact that the big picture has changed dramatically.

You'll remember that we've said time and time again over the past couple of months that if the markets were to revisit the March lows, they probably wouldn't just find support at those levels and reverse course to the upside.

We had argued that the view of a large number of market commentators, who believed that there would be a successful retest and that the worst would then be over, was wrong. It had seemed to us that if the lows were approached, they would have been broken and the indices would go on to make new lows.

Until Thursday - when the Dow broke below 11740 - all we had was our opinion; a hunch that was derived from our reading of the charts. Now, there's proof; it's in black and white on the charts.



And Everything Changes...

It would seem like the proverbial "Black Swan"¹ has taken flight!

What does all this mean, as far as the charts (and the reading of market action therefrom) are concerned?

We're sure that that's foremost on your mind, as it is on ours. When there is a change in the major trend (which is what has just taken place), everything needs to be read differently.

The major trend is now to be seen as bearish, given that the charts now show a lower low, which follows a lower high, on the major trend (at least as far as the Dow is concerned, with other indices possibly soon to follow).

If things have really changed - a fact that the charts seem to be alluding to - rallies will now need to be seen as opportunities to be sold into (rather than be seen as bullish confirmations), and dips will need to be seen as trend-related (not as buying opportunities).

The ramifications on the momentum indicators are especially huge...

Oversold conditions on momentum indicators (on daily charts) are no longer to be seen as bullish reversals in-the-making (unless we're talking RSI readings of 15-20 or lower on the major indices), rather as plain affirmation of the ensuing major downtrend.

To get an intuitive look into the matter, try recalling the length of time the major indices spent in overbought territory during especially sharp rallies in the bull market, before turning around and encountering any sort of downward correction; also try and remember (or pull up a chart to refresh your memory) of how shallow those corrections were. There is the distinct possibility that we can now expect to witness a similar scenario, in reverse.

As far as the daily charts, nothing less than positive divergences on RSI/MACD will bring about the need to consider the possibility of a bullish reversal.

Oversold conditions on the weekly charts may be what it is needed before potential buying opportunities emerge, but even then there will need to be, in the mix, other ingredients conducive to a reversal.

Visits (from below) to the centerlines on RSI/MACD (on daily charts) will now be looked at as potential selling opportunities; the centerlines will be seen as overbearing resistance levels on the minor/intermediate levels of trend.

As far as our favourite price envelope technique - the Bollinger Bands - goes, prices' hugging (and even breaching) the lower band, will be seen as the norm, not as a sign of overextension. The lower band will generally be falling, while the upper band will be falling or flat, depending on short-term/medium-term volatility levels.

The 20dMA will now predominantly be seen as a resistance level, not as a support, as it had been for the past 5 years or so. A jaunt to the 20dMA will present a selling opportunity, most of the time, and on the few occasions on which it ends up getting breached, the upper Bollinger band (if prices get that far) will likely provide the scene of the next intermediate/major peak.

Yes, everything has changed!

Could this be a mirage, the mother of all bear traps?

Simply put, of course it can. The charts could certainly be providing a blatant false signal.

However, we can't really trade under the assumption that a sell signal is really *a buy signal in-disguise*, now can we!? We have to assume that the charts can be trusted; after all, they're much more trustworthy than any other piece of information that is freely available.

I mean, at the end of the day, who or what are you going to trust - the Fed, the investment banks, the accounting rags that can so easily be manipulated (a la Enron)?

The charts don't lie; they depict actual price action - the sum of the opinions of all traders, investors, money managers - be they fundamental, technical, seat-of-the-pants -based decision makers, what have you...

Chartists (we included), could be misreading the charts at any given point, for sure, but the charts themselves don't lie. So, until proven otherwise and, again, the proof will be in the charts, the major trend is to be seen as a declining one.

How will we know if the signals that currently point to a major bear move have failed?

That's another great question and it has a simple answer. If the Dow manages to pull itself back above 13100 and the S&P-500 manages to get back above 1445, we'll have the first signs that the declines seen over the past year were possibly just a correction within an ongoing bullish major/primary uptrend.

Assuming that we are in a major downtrend, how far can the indices fall?

It's a little too early to be setting specific targets but, as a rough guide, the lows of the bear market experienced earlier this decade, would be a good bet. The markets aren't going to reach those levels overnight, obviously. It could take a couple of years of big plunges and breakneck rallies, before the ultimate low is formed.

In fact, the first of the anticipated breakneck rallies could occur within days or weeks, at this point. But, if things have really changed, that move will be nothing more than the next opportunity for the bears to pummel the hell out of the markets, once more.

So let's just take it a step at a time, as far as setting targets goes.

How should one trade in this new environment?

That's perhaps the most crucial question of them all. The answer is - it depends on the type of trader you are.

Swing trader of stocks: You're probably going to find yourself wanting to be on the short side of the market, more often than you're on the long side. Short positions are going to bring you your bread and butter profits over the coming quarters. Yet, you're going to want to be ready with long positions when the countertrend rallies take place, or at least ensure that you're not caught with your "shorts" down, when those reversals take place.

Swing trader of options: You not only have the ability to play the downtrend with a predominance of Long Put positions but, depending on your style, also with a myriad of long volatility plays. This is going to be your kind of market. If you play your chips right, you'll be able to eat your cake and have it too. The limited-risk nature of (long) options trading will mean you can maximize leverage, while limiting your capital-at-risk. It will not always be easy, however; countertrend rallies aside, you'll find that implied volatility levels will, at times (especially in periods leading into the formation of each intermediate/major low), reach levels that are extremely high. But then, if you're really astute, you'll have the ability to use short volatility (read as "short implied volatility", not "range-bound") strategies and profit from those conditions, as well.

Passive Trader/Intermediate-Term Investor: You're going to find yourself constantly playing defense (if you insist on keeping a core of your portfolio invested in the markets at all times). You'll want to add inverse ETFs to your portfolio, use protective Puts on indices or even on individual stocks, if you're not into taking on short positions. The effective use of defensive strategies will at the very least keep your portfolio afloat while the markets sort themselves out. If you can keep your portfolio at or close to its current value - don't gain anything, but don't lose much - when the markets drops 30, 40, 50% or more, you'll have the opportunity to ride the next major uptrend, with all of your eggs still in your basket.

Okay, now that we've shared those tidbits with you, let's take a look at what matters most, in the end - i.e. what the charts are saying.

We'll take a look at the daily charts and the weekly charts of each of the following indices - *S&P-500, Dow Industrials, Nasdaq-100*. We'll also look at the monthly chart of the S&P-500.

Just a quick word about something members will notice on several of the charts... Support/resistance levels that we used to label as intermediate support/resistance are now tentatively labeled as intermediate/major support or intermediate/major resistance. The reason that we've done this is because the bear market is now 8 1/2 months old. An intermediate trend is said to last between 6 and 9 months; once a trend hits the 9-12 -month stage, it is said to turn into a major trend. Unless the markets turn around sharply and nullify the bear move, the decline is now a major downtrend, not just an intermediate downtrend.

Let's get into it...

S&P-500 index daily chart...



The S&P-500 reached and surpassed the target (1295) that was derived from the second of the two rectangles seen on the chart, above.

The action immediately following the Fed announcement on Wednesday was lacklustre; Thursday's action was anything but and the index all but reached the level of the March closing lows by the close of trading on that day. A small decline on Friday, brought about a retesting of the March closing lows.

The March lows have not been broken as yet, however; as such, strictly speaking, there isn't actually a confirmation that the index is in a major downtrend, and we'll have to wait for a closing price below the support area before specifically making such a call on this index.

If you go by the "old rules" (those that exist during a major *uptrend*), then you could presume that a rebound off the intermediate/support level might be imminent, given that RSI is now oversold and, arguably, so is MACD.

If we truly are facing a new paradigm, those weak buy signals look almost futile.

New paradigm aside, it's hard to find actual buy signals, at present. There is no positive divergence on RSI, no positive MA crossover on MACD, no flattening of (much less rise in) the lower bollinger band, and no sign of capitulation.

If we start to see some of those types of signals, we could say that the charts are warning of a possible bullish turnaround (the longevity of any such rebound is another matter altogether).

Let's assume for a second that support will be found in the intermediate support area. The ensuing rally should at first be assumed to be a correction within an ongoing downtrend and resistance should be expected at the 20dMA. Other sources of resistance will be the centerlines on RSI and MACD.

If the 20dMA is broken, the assumption that we're in a major downtrend will start to come into question (of course, it will take a move above resistance at the May-highs of 1425-1440, to seriously challenge the assumption).

If support at 1257-1275 is broken, the current downward thrust will be assumed to be in place until serious buy signals, such as a positive divergence on RSI, positive MA crossover and positive divergence on MACD, bollinger band buy signals, or buy signals on the weekly charts, come to bear.

Also, we'd keep a close eye on volume trend. If there is a sustained rise in volumes over a period of a week or two, signs of capitulation might start to surface. Such a development could be seen as a contrarian buy signal.

Let's move on to other charts...

Dow Jones Industrials Average daily chart...



The Dow is the first of the widely followed indices to actually break to new major lows ...and we aren't talking a break by a few dozen points or so; in fact, the index is a good 300 points clear of the area in question.

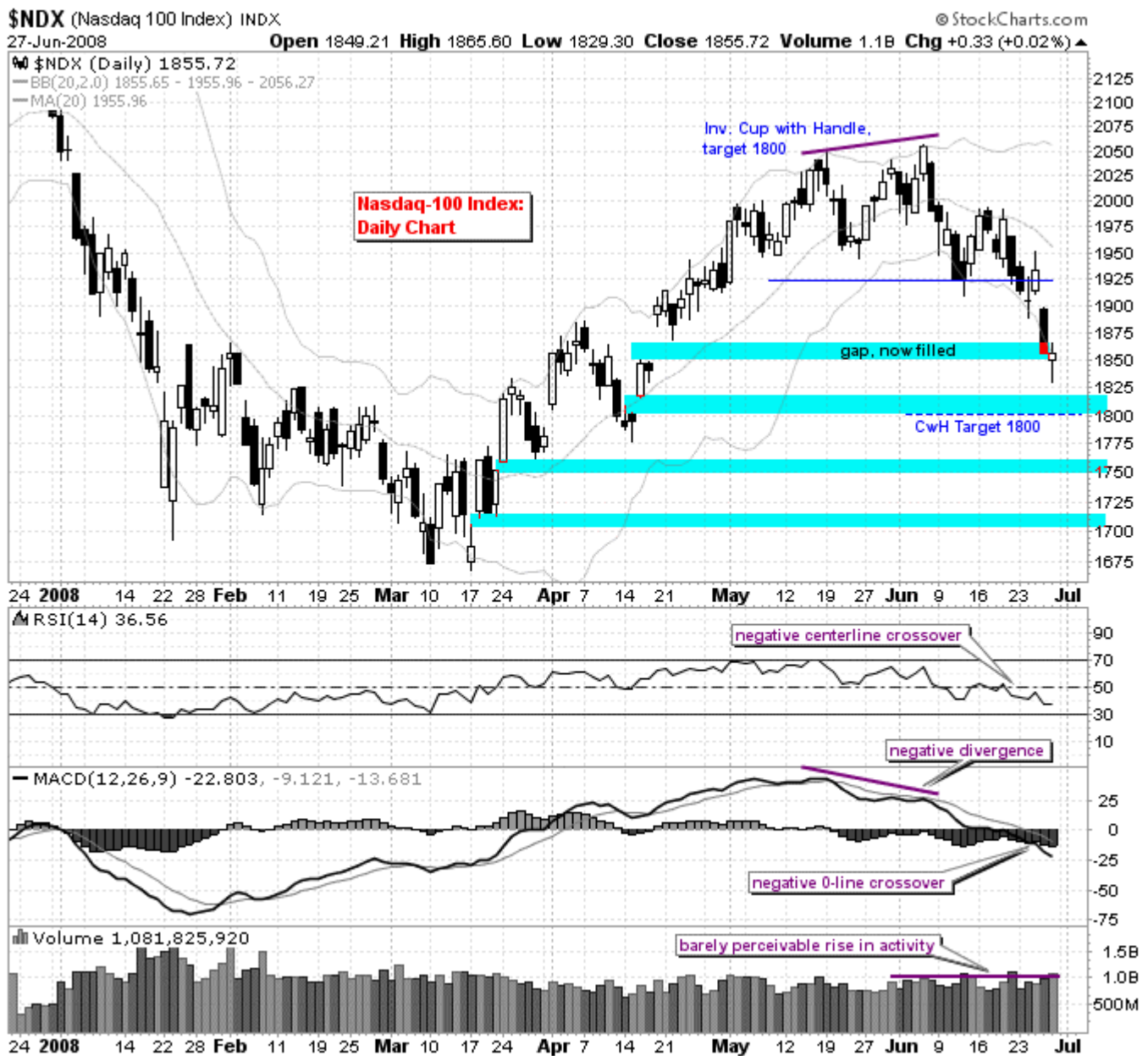
By definition, this index is in a major downtrend; there's no disputing that fact.

The momentum indicators are showing oversold readings but, as mentioned earlier, in the new paradigm that is to be seen more as a confirmation of the bearish trend than as a reason to expect a bullish reversal.

Volumes levels have been rising, generally speaking, but they're no where near capitulation territory, as yet.

The bottom line is that a short-term reversal could occur at any point, given the oversold readings, but you'd probably expect resistance to be found from the downtrend line, the 20dMA or from the centerlines on RSI and/or MACD and the index to then resume its downward progress.

Nasdaq-100 Index daily chart...



NDX has been a tough nut to crack. It stubbornly held strong for weeks, refusing to show any concrete signs of a breakdown; that changed, this past Thursday.

The weight of the downtrend in the general market, not to mention the gaps left in March/April that have lighted up the chart like a Christmas tree, finally forced the index to join the others in their journey towards the March lows.

Despite the recent turnaround, however, the index cannot be said to be in a major downtrend, as yet. Strictly speaking, it is still in a bullish or sideways major trend.

A breaking of the March lows at 1675 will be needed, in order for the major trend on this index to be classified as bearish.

As far as the near-term goes, its hard to see anything but bearish action ahead. RSI has started to trend towards the 30-line and MACD has recently made a negative 0-line crossover.

Looking at price action, a target of 1800 pops up immediately; that target is derived from the Inverted Cup with Handle pattern that we'd first brought to the attention of members, a couple of weeks ago. We'll explore further targets on the index when we look at its weekly chart, later.

Let's now take a look at the weekly charts...

S&P-500 index weekly chart...



The weekly chart of the S&P-500 provides a clearer view of the big picture. After taking one glance at the chart, anyone can tell you that support at 1275 is key. If that level is broken, targets of 1125 and 975 come into the picture. The former is derived by using a measured move interpretation of the October-March descent, projected downwards from the May-highs; the latter is derived using a viewing of the action between Aug '06 and the present as a large inverted Cup with Handle.

In a nutshell, the bulls will want to defend 1275 with all they have.

Looking beyond price action, and towards the momentum indicators, the bearish signals start to add up.

Take a look at the weekly bollinger bands, for example. You'll remember that back in early-May, when the index was approaching its upper band, we had alluded members to the fact that we felt there was a strong possibility that resistance was going to be met and that a top was possibly going to be put in place (as ended up being the case).

The reason that we'd felt that the upper band was going to provide resistance was because the band was *flat*, at the time. Flat upper and lower Bollinger bands provide resistance and support, respectively.

On the other hand, when the upper band is rising, it eases the path to higher levels, and when the lower band is falling, it eases the path to lower levels.

Prices have now reached the lower band and, guess what, that band is *falling*. Had it been flat, we'd have possibly been screaming "buy", from the rooftops, but since it is not, we're going with the bears on this one (once again, speaking longer-term; anything can happen in the very short-term).

The fact that weekly RSI has failed to stay above the centerline and is now pointing towards the 30-line again, is another sign that there is a lot of room to the downside. Weekly MACD has just turned around after nearing its 0-line, so there are no oversold readings to be seen from that indicator.

If the intermediate/major downtrend continues as expected, we'd start searching for a bottom once weekly RSI and MACD start showing oversold readings. Don't hold your breath; it might take another 50-100 points.

Support will need to be found from some other source; perhaps the old support level at 1225.

Having said that, we'd reiterate that support at 1275 has not been broken - on a closing basis - as yet, and the bulls can and have to hold things together right away; there's no wriggle room if they're to stop this thing from completely falling apart.

[Continued...]

Dow Jones Industrials Average weekly chart...



While the S&P-500 has not, as yet, confirmed a change in the major trend to bearish, the Dow has most certainly done so.

You can clearly see the new major lows on the weekly chart, above.

The declines have been so swift and decisive that the index has gone from its weekly upper Bollinger band to 200 points below the lower band in 6 weeks flat!

Basic Bollinger band theory tells us that a move outside a falling lower Bollinger band is to be seen as a precursor to further declines. Now, we'd reiterate that since this is the weekly charts, those further declines do not have to be immediate; rather, a continuation of the decline over the coming weeks (permitting for short-term reaction moves), is what is to be expected.

...and the index isn't even oversold, as yet, as far as the weekly charts go. Weekly RSI is only at 35 and MACD still has a good distance to travel before reaching the lows reached in March.

Nasdaq-100 Index weekly chart...



The fact that NDX has only breached its 20-week Moving Average as of this week, is a testament to the relative strength of the index, when compared with the other indices.

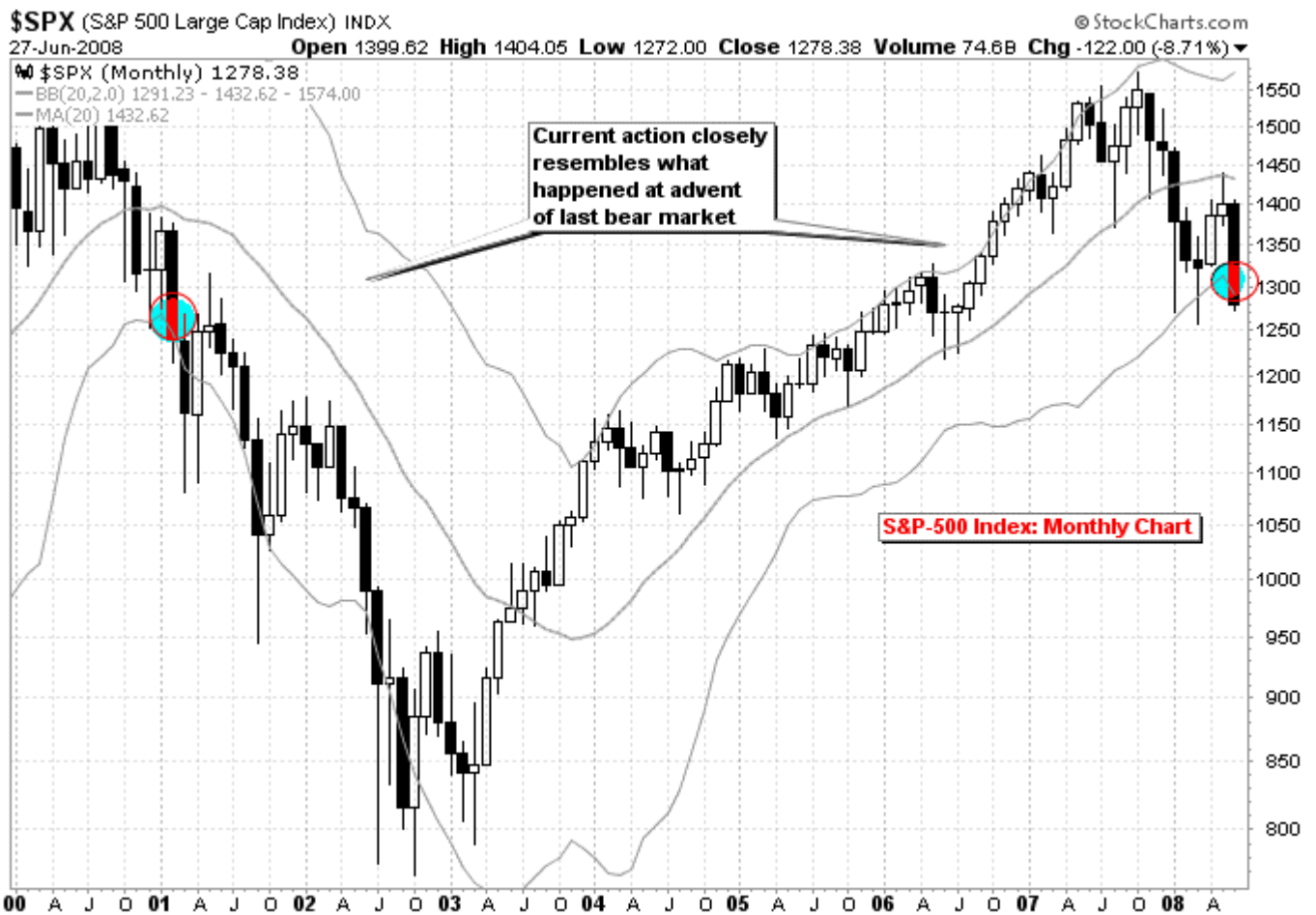
Yet, the sell signals are starting to add up on this index, as well. The breach of the 20wMA, on its own, usually calls for a move towards the lower Bollinger band, which is presently flat and residing 200 points (11%) below current levels.

RSI has fallen back below its centerline, after having moved above it a couple of months ago. For its part, MACD, which had recently broken above its 0-line is threatening to move back below that level.

As with the other indices, the bulls really need to get their act together in a hurry; they'll want to pull this index back above its 20wMA immediately, else we'll find the index at the lower weekly BBand very soon.

Perhaps the most ominous sign of all comes from what you're about to see in the next chart...

S&P-500 index monthly chart...



Unless there is a rally of at least 12 points on Monday, the monthly chart of the S&P-500 will be showing a closing level outside its monthly lower Bollinger Band.

For a point of reference, why don't you take a look at the last such instance. It took place in January of 2001, of course, and the rest, as they say, is history.

[Continued...]

The Volatility Index (VIX) daily chart...



The chart of the VIX puts the declines of the past month and a half into perspective. This contrarian indicator is still mired in the middle of its recent range of 16-31. What that means is that investors are not starting to panic, as yet, and that is to be seen as a bad sign if you're interested in seeing the stock markets rise (from a contrarian perspective, panic selloffs usually give way to sharp reversals).

If you're looking for a capitulation-type bottom, there isn't one in sight, as yet. It's apparently going to take a lot more downside action before the VIX rallies towards "fear" levels above 31, and initiates a contrarian buy signal.

A few closing thoughts:

We've added a huge number of potential trading picks to the various lists at TheMarketMessenger.com, this weekend. So, if so inclined, members have a nice little kitty of opportunities to choose from. Also, the model trading portfolio is now fully allocated (between a combination of aggressive and defensive strategies); if you're really interested in the manifestation of our innermost thoughts on expected market action, we'd suggest you take a look at the model trading portfolio.

That's it for this issue of Purely Technical.

Good luck with your trading!

Asher Pinto

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