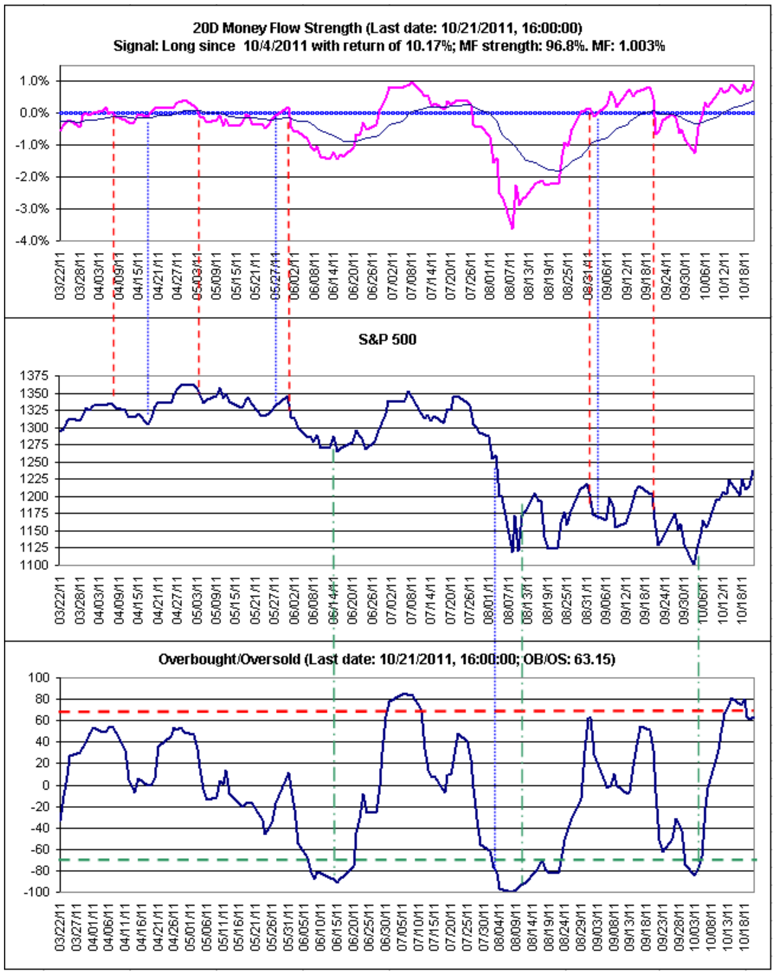
Market Observations: 10/22/2011
By Eric Coleman

Summary:

The 20-Day MF indicator has not changed much since last week. One sees a market that continued to attract money, and the OB/OS Oscillator moved into overbought territory. I think Pascal's Daily Comments kept us on watch this week – the market was not on the verge of an imminent breakdown.



I find difficulty surmising the effects of options expiration on money flow readings, and next week offers additional insight to the actions of large players without the backdrop of such an event.

I find no reason to chase the market here, especially after closing long positions from the last buy signal more than a few days ago. My intention is not to fight or deny price action, but to better understand the context of the market in which we exist.

To complement the 20-day MF, I viewed YTD charts for the all components of the S&P 500. I'm simply interested in a qualitative overview of the markets respective components. Highlighted below are some of my thoughts:

- The most striking feature was the recent outperformance and leadership of the following three stocks: Wal-Mart (WMT) McDonalds (MCD) and Proctor and Gamble (PG). WMT and PG are quickly on the verge of new 52-week highs. MCD is at new all-time highs. Current price action in each of these resembles late Summer 2008, prior to a severe market sell-off, as large players built positions in defensive industries and stocks.

- Tobacco companies offer some of the most bullish patterns, evidenced in RAI, LO, and MO. Each trades above their 50 and 200 day moving averages, while exhibiting more linearity in recent trade than other index counterparts:

- Food companies show constructive price action: GIS HSY and KFT remain close to 52-week highs
- Utilities maintain strong price action
- Other components bounced higher during the recent rally from volatile, sharp bottoms

At best, S&P components are in a bottoming process whereby volatility will continue to dampen, which allows for more orderly accumulation patterns to emerge. At worst, many stocks experienced sharp rallies within the context of a bear market. I do note some strong price action in home improvement retailers over recent days, including HD and LOW, as well as some insurance stocks. Such action may hardly balance the effects of earnings disappointments in leading stocks like AAPL and IBM, though.

From a qualitative perspective, a review of the S&P reveals leadership that remains characterized by defensive sectors and stocks, especially utilities, tobacco, and food companies. Outside these issues, price action remains erratic.

Stage Analysis:

Daily Stages: 10/21/2011

SPY	Current Stage is 1-2 (Mid Accumulation) Has been in current stage for 5 day(s)
QQQ	Current Stage is 2-1 (Strong Mark-Up) Has been in current stage for 1 day(s)
DIA	Current Stage is 2-1 (Strong Mark-Up) Has been in current stage for 1 day(s)
IWM	Current Stage is 1-2 (Mid Accumulation) Has been in current stage for 4 day(s)

Weekly Stages: 10/21/2011

SPY	Current Weekly Stage is 4-3 (Weakening Decline) Has been in the current weekly stage for 1 week
QQQ	Current Weekly Stage is 4-3 (Weakening Decline) Has been in the current weekly stage for 2 week
DIA	Current Weekly Stage is 3-3 (Late Distribution) Has been in the current weekly stage for 6 week
IWM	Current Weekly Stage is 4-2 (Medium Decline) Has been in the current weekly stage for 2 week

Once again, the daily stages show meaningful progress since last week's report. Indeed, DIA and QQQ entered strong mark-up stages on Friday in spite of weakness in leaders like AAPL and AMZN. Meanwhile, both large caps and small caps remain in daily accumulation modes, a neutral precursor to more potential short-term gains.

Yet the daily stages must be viewed through the lens of the weekly stages, and with that in mind, caution is warranted. Weakening declines characterize the SPY and Q's. To review, a weakening decline is when:

Downward momentum is still present and declines can come rapidly, but so too can violent short squeeze rallies, particularly after bad news is reported – Alphascanner's *Market Structure*

Such a description aptly describes our current environment. The backdrop of weakening declines on the Q's and SPY force a healthy skepticism on the recent rally. IWM remains in a 4-2 medium decline, despite recent strength. Strong daily mark-ups in the context of a weakening decline appear vulnerable to this participant; however, like last week, a pullback does not inherently end this rally.

The result of this week's scan turns up similar results to last week's:

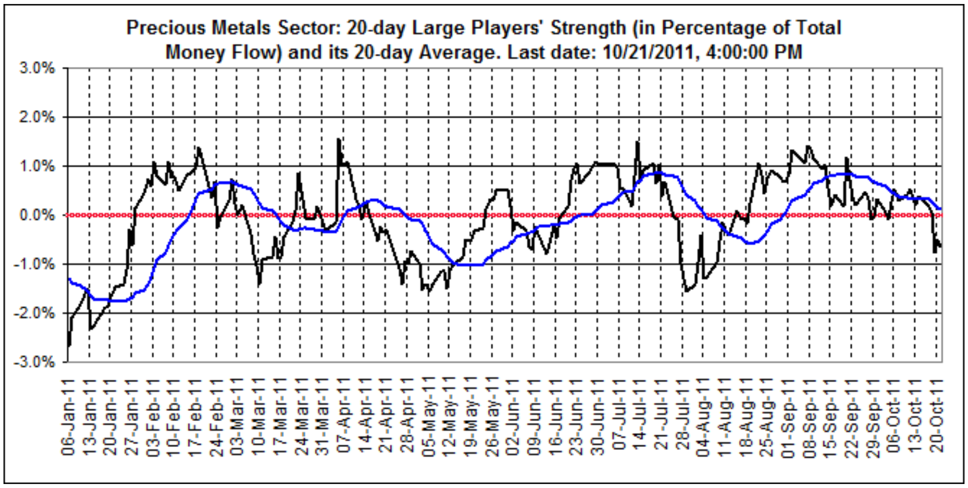
Weekly Strong Mark-Up + (Daily Late Accumulation-Strong Mark-Up)	67 Results
Weekly Strong Mark-Up	117 Results
Weekly Strong Decline	361 Results

Once again, defensive stocks characterize the first scan, which remain in strong mark-ups on weekly and daily timeframes. There is slight improvement in the number of stocks in weekly strong markups versus weekly strong declines – weekly strong declines still outnumber weekly strong mark-ups by about 3:1, though.

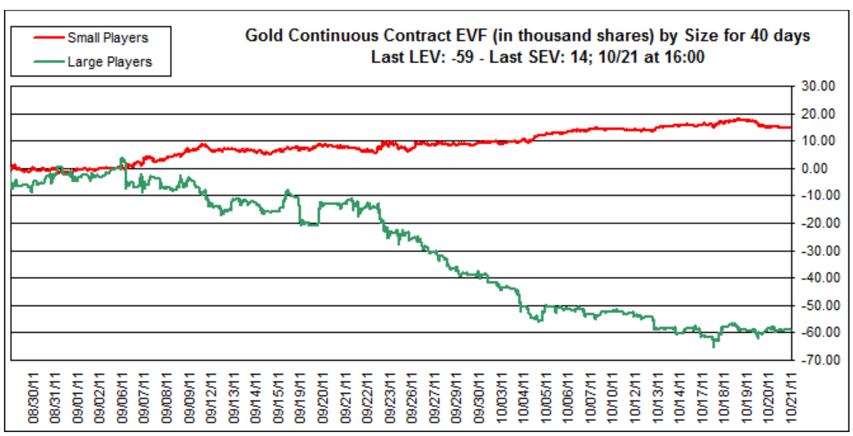
Overall, short-term, daily action remains constructive. Still, longer-term weekly traits suggest caution for long side commitments. Even if another precipitous decline does not wait, backing and filling of price remains necessary to form proper base structures that lead to a *sustainable* move higher. Large players need time to accumulate, and the current structure suggests that enough time has not lapsed for completion of such accumulation campaigns.

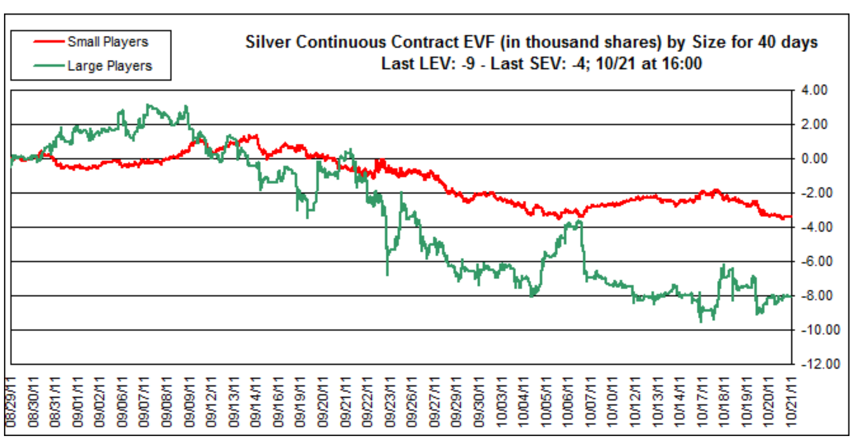
Precious Metals:

The precious metals complex broke down further over the past week. Does weakness in mining issues portend continued weakness in the underlying metals?



No real change of trend in LEV for gold and silver futures . . . The dollar as measured by UUP declined 3.92% from the October 4th close to Friday's close. Meanwhile, gold is up 1.21% and silver up 2.3% from their respective closes on that noteworthy day. I don't want to infer *too* much, but lack of reciprocal advances in the underlying metals relative to dollar weakness might subtly suggest tightening liquidity, or at least a lack of confidence in any further easing program.





Gold as viewed through the GLD pre-led the market prior to QE1 and QE2. Note the relative outperformance that commenced in early November of 2008 even though markets eventually made new lows. 11/25/2008 marked the first announcement of the Fed to purchase obligations of the GSE's.

If markets are expecting a blast of QE3, then GLD is currently not pre-leading equity prices, at least not right now as judged from the October 4th lows. I don't state this as anything conclusive, simply an observation of behavior and curiosity about such implications.

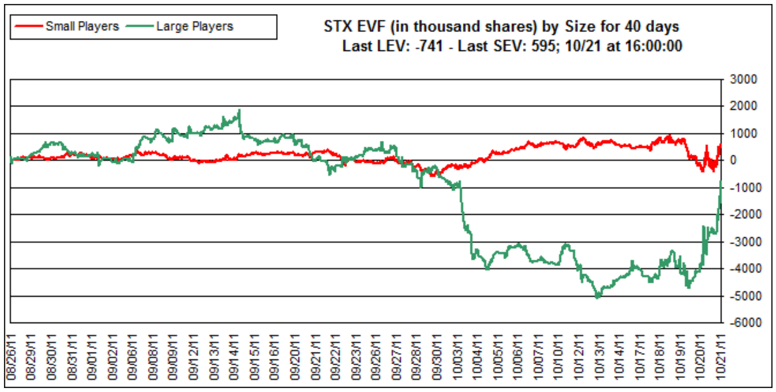
Leading Issues:

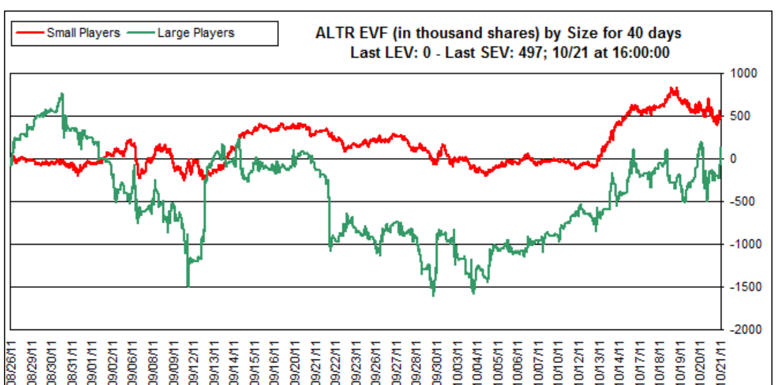
Last week I noted GMCR as a canary in the coalmine for cycle leaders. Last summer, as markets traded in a range prior to the August declines, I was surprised that the market was resilient despite a monster leader like NFLX plummeting. Eventually, the general markets caught up. And the deterioration of cycle leaders still remains a primary concern – as Kevin Marder's recent article noted,

> *Of critical import: You are seeing some institutional must-owns begin to roll over. This is ominous.*

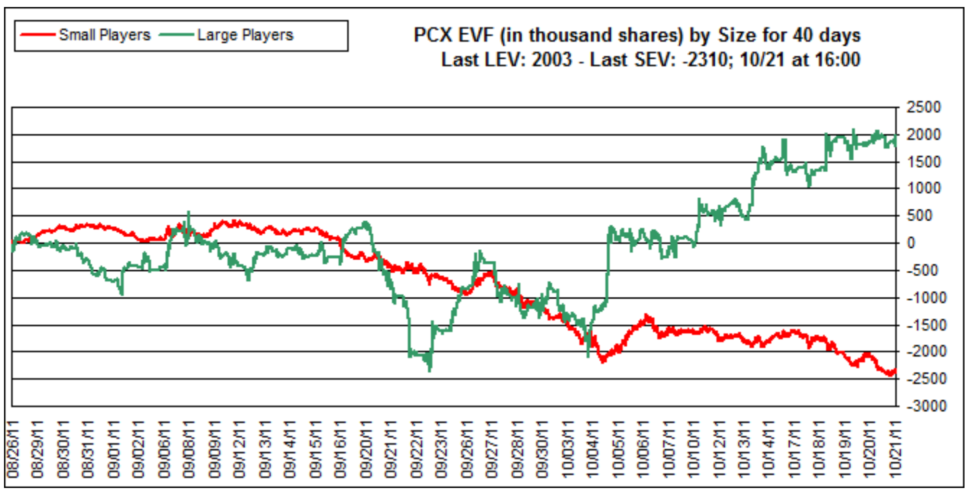
Some interesting EV patterns:

Despite the swath of concerns, there are some patterns I find noteworthy. Some data storage companies showed interesting action on Friday, particularly STX. ALTR also shows large player support and improving price action.





Meanwhile, some of the most battered sectors are starting to drift lower as price begins to flatten. I speculate that time is need for some basing patterns to emerge. I actively follow the coal stocks and rallies from major sell-offs after a period of accumulation can be quite impressive. Note PCX below.



Conclusions:

I spent more time than usual this week digesting various perspectives of the overall market. Charles Kirk's Chart Show once again offered some balanced perspectives. I sense a general desire to get long, especially in light of last week's consolidation. Pradeep Bonde of the Stockbee blog shared poignant comments on situational awareness that I share below.

Same way good trading requires SA. We should factor in the environment we are in and continuously try and study the situation. Markets are dynamic and situation changes everyday. Fading leadership is the overarching theme currently. The stocks that lead the advance are breaking down or pulling back hard. That should make you cautious on bullish side. The action in many leaders of rally does not look like garden variety pullback but breakdowns. Implication is rally might have run out of gas. Unless we see new leadership I will be cautious on bullish side. There are some good short setups showing up currently.

The market seems stretched in multiple ways. The weekly stage structure remains susceptible to a sharp and sudden sell-off; meanwhile, the 20-Day MF still shows a market that gets support. Defensive sectors show relative strength and leadership, and cycle leaders are starting to crack, some in a dramatic fashion.

The dollar pulled back from early October highs, but precious metals remain muted. The VIX remains elevated while sentiment shows some improvement.

Based on my analysis, I remain unconvinced that the market is "out of the woods." The most significant caveat involves the clear and present unwinds taking place in the markets big stock leaders. Despite some improving technical action in some stocks and sectors, I don't foresee a market blasting higher while big stocks like BIDU, WYNN, and GMCR form major tops. Additionally, tech leaders like AAPL and AMZN do not seem poised to carry the Q's higher, at least without some digestion of price.

Being open to possibilities is important. In the meantime, preserving profits, awaiting the next window of opportunity, and gathering feedback from positions remains my plan.

Best,
Eric