PHASES & CYCLES®

THE MARKET REACHED AN EXTREME OVERBOUGHT CONDITION. A CORRECTIVE PERIOD HAS STARTED.

With the S&P 500 up well over 40% since the March low, we said two weeks ago that "the markets are extended and overbought on a huge surge in upside momentum" and that "the New York market needs a little rest, the ingredients for a slowdown are fast falling in place." The new phase of the bull market that began on March 23 could not – and should not – continue its sharp upward trajectory forever. After a big advance a healthy pause to refresh is needed.

For the last two and one-half months the S&P 500 has refused to accept any offer to correct significantly. However, by last week, the market reached an overbought status, call-buying was at extreme levels, and the Investors Intelligence gauge of advisor sentiment had moved sharply from a low of 30% in March to last week's reading of 57%. In addition, last Thursday's action – over 17 to 1 declining stocks versus advancers, and over 44 to 1 for declining versus advancing volume – signalled a short-term change in the investment environment. We identified the zone in the low 3,000s as a longstanding resistance area for the S&P 500 and that is where the Index encountered a wave of selling pressure. The S&P 500 quickly retreated to its 200-day Moving Average.

Was last Thursday a one-day selling wonder? The extreme downside action had some characteristics of a selling climax but after such a huge bullish upsurge it is reasonable to expect that New York now needs to develop a truly oversold condition. This requires more downside pressure and time, and enough negative action to wring some of the recent over-confidence out of the markets. This Friday is triple witching day for options. Last week's volatility may be a recurring feature for much of the remainder of June. Short-term cycle pressure continues to weigh on the markets. In terms of potential downside targets, a one-third correction of the March to June advance would target just below 2,900. This would take the S&P 500 down to its 50-day Moving Average and also back into the large near-term support zone that was created by the sideways consolidation in April and May.

This corrective period should see a noticeable increase in bearish sentiment, but once it is over we expect the bullish advance to resume. The longer-term trend remains up. The NYSE daily advance/decline line remains strong. The price pattern of higher highs and higher lows is intact. The NASDAQ, the leader of the leap off the March lows, recently hit a new all-time high. It's this type of evidence that says that the bull market still wants to move higher in the months ahead.

Toronto's S&P/TSX Composite Index came within touching distance of its 200-day Moving Average last week, but that became an obstacle to further immediate advance. The Index pulled back towards its 50-day Moving Average and short-term support. A New York correction will pull Toronto down. A one-third retracement of the Index's advance targets about 14,375, which would take it below its 50-day Moving Average.

Last week the S&P 500 was less than 5% from its all-time high. Compared to the depths of despair reached in March this is a remarkable performance and turnaround. Having risen over 47% off the March low, a pullback is overdue and would be entirely normal. We have had a full-throttle "lift-off" phase, and now it is time for some braking action before the bull market puts its foot back on the accelerator.

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S&P 500

From mid-April to mid-May the S&P 500 consolidated just below its 200-day Moving Average, while the Index's 50-day Moving Average bottomed out and started to rise, reflecting the growing number of stocks that were rallying. The breakout above the 200-day Moving Average occurred in late-May and then took the S&P 500 to a new recovery high, peaking at 3,233, right in an area of longer-term overhead resistance.

Last week's pullback saw the S&P 500 return to its 200-day Moving Average, but the Index is likely to continue further down towards its rising 50-day Moving Average just above 2,900. This would also be the area of a one-third retracement of the March to June advance, and a very feasible stopping point. The 2,700 to 2,800 zone has stopped three minor pullbacks in the last two months – if the S&P 500 makes a deeper pullback to the one-half retracement target (2,712) then this zone will come into play as support.

A corrective period has started for the S&P 500, whose uptrend line from the March low is under challenge from the bears. We expect that at least one-third of the gains made from March to June will be clawed back before the correction ends.

S&P/TSX Composite Index

Towards the end of May the S&P/TSX Composite Index broke out of a short-term consolidation zone, initiating a move that would inevitably take it back towards its 200-day Moving Average, but that Moving Average proved to be a point of overhead resistance. More than 9 out of every 10 stocks were trading above their respective 50-day Moving Averages by then, and the Toronto market became overbought. The S&P/TSX Composite Index then pulled back towards its rising 50-day Moving Average.

During the advance the S&P/TSX Composite Index gained over 4,800 points, or 43%. It is now likely that the initial recovery period off the March lows has ended. Short term support exists in the 14,000 to 15,000 range. The rising 50-day Moving Average is just above 14,700. If the Toronto market retraces one-third of its advance then the Index would come back towards 14,375. The lower end of the support zone should prevent a more pronounced pullback, e.g., a one-half retracement that would target about 13,575.

The S&P/TSX Composite Index will likely pull back into the 14,000s but find eventual support in the lower half of the 14,000 to 15,000 zone. From there another push back towards the 200-day Moving Average near 16,000 can be expected.