Philequity Corner (July 12, 2010)
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Head and Shoulders, Death Cross and Double-Dip

World economic news has been disappointing lately. US industrial production has faltered back in May. US and European businesses are still not hiring. Most banks are still reluctant to lend. And talks of a double dip in the US economy are increasing.

Meanwhile, financial markets have performed poorly in the past two months. The benchmark S&P 500 index is down 11.6 percent from its April 2010 highs. The dreaded "Head and Shoulders" chart pattern now appears in major US stock indices, scaring off investors. There is even talk of a Death Cross which in technical analysis points to more gloomy days ahead.

Double Dip or Just a Pause?

But in an exclusive interview with CNBC, former Fed Chairman Alan Greenspan said that the recent decline in the financial markets does not portend another severe downturn in the economy. He said that the recent stock market decline is "typical" of a recovery, and that international instability has more to do with the recent decline than problems in the US.

"What we are looking at is an invisible wall which we have run into here which essentially, as far as I can see, is a typical pause that occurs in an economic recovery."

Stock Market Leads the Economy

He also added that markets don't move with the economy. "The stock market is not merely an indicator, but a cause of economic activity. What really moved this whole financial system back up to normal are the capital gains throughout the system. And that has actually filled out a lot of disruption or reversed a lot of disruption in financial intermediation. Ordinarily we are saying that the stock market is driven by economic events, I think it's more of the reverse."

We totally agree with Greenspan. The capital gains themselves have significant economic consequences because banks' and most companies' portfolios went up. Also when individual 401Ks go up, people tend to spend more which expands economic activity.

Looking back at history, however, the current situation is not at all unusual. In late 1991, growth waned for some time after the economy had recovered from a recession. Meanwhile, after rebounding from the recession in late 2001 to early 2002, growth was a measly 1.5 percent for the next twelve months.

Technical Charts Drive Stock Market Moves

While the stock market leads the economy, it is the technicals/charts that lead the stock market. Given the advances in information and computing, more people are using technical analysis in their investment decisions.

Hedge funds use fundamental analysis, quantitative models and technical analysis for their trading. On the other hand, Quant Funds, by definition, use quantitative models and algorithms which are also based on technical analysis to trade. Meanwhile, high frequency traders use mathematical models to trade. And because a lot of these funds and traders follow technical analysis, there is a snowball effect which tends to be self-fulfilling.

Head & Shoulders

Recently, the major US indices formed a chart formation called the "Head and Shoulders" which is considered a trend reversal pattern (see chart below). The index temporarily went below the neckline at 1,050 but has since recovered from that level. It closed at 1,077.96 last Friday after hitting a low on 1,010.91 last July 1.

Note, however, that the Head and Shoulders pattern is not always full-proof. Back in May to July 2009, the market also formed a similar pattern but no reversal was confirmed. At this point, a lot of consolidation and sideways trading will continue to happen. In fact, a lot of chartists and short-term traders are already getting whipsawed.

Looking at the bigger picture, there is major resistance at the 1,220 to 1,250 range. However, we also see strong support at the 950 to 1,010 range.

Death Cross

Most technical analysts these days also talk about the death cross in the S&P 500 index. It is the formed when the 50-day moving average goes below the 200-day moving average (see previous chart) which signifies a change in long-term trend. In this case, it is a change from a bullish to a bearish trend.

In retrospect, however, similar setups occurred in August 2004 and July 2006 and yet the market continued to march higher towards the 2007 highs. Stocks did not die after the 2004 lows. In fact from the correction lows, the S&P 500 index gained 48 percent.

We agree that the death cross indicates a weakening market and should be respected. But in the context of what the market has done since 2009, the pattern is still corrective, i.e. the 15 percent or so of downtrend is just correcting the 82 percent advance from the March 2009 lows.

Philippine Stocks in a Better Shape

On the local front, the stock market is painting a different picture. While the S&P 500, the Dow Jones Industrial Average and the Nasdaq Composite indices in the US are struggling, the PSE Index (PSEi) is trading at new highs. The PSEi's technical picture is much better compared to the US.

In fact, during the last two months, there is a noticeable divergence and decoupling. Whereas in the past, when the US market corrects, the Philippine market follows, recently, however, when the US market pulled back significantly, the Philippine market just consolidated sideways.

When the US market stabilizes and rebounds, Philippine stocks make news 52-week highs. At this point, it looks like that our PSEi target of 3,500 will easily be reached. Ultimately, we see the PSE Index re-testing its all-time high at 3,890.

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