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Global Bear Market at our Doorstep?

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This article was featured in the Jun 2012 issue of The Business Times. Below is the original article by William Cai, for your reading pleasure.

Every bear market starts with a correction, and investors may want to take heed of the warning signs ahead.

MSCI World Excluding USA in a Bear Phase

Firstly, while U.S. equity indexes are still in a bull phase, global equities have reached a bear phase. In 2011, the MSCI World excluding USA Index (MSWORLD) fell 26% from its peak in April, but by December, it had bottomed out and recovered. Unfortunately, its rally was short lived as it fizzled out in March 2012 and the index fell below its 50-week moving average. From its peak in April 2011 to date, the index has fallen 26%. When prices fall in excess of 20% for a period longer than two months, such a condition is widely known as a 'bear market'.

Downward price momentum could accelerate and carry prices lower due to a potential confirmation of an ominous bearish 'head and shoulders' pattern on the MSWORLD chart. A break below its neckline could set a target for the index to head 28% lower. This is a highly probable scenario if US equities were to fall further in the coming weeks.

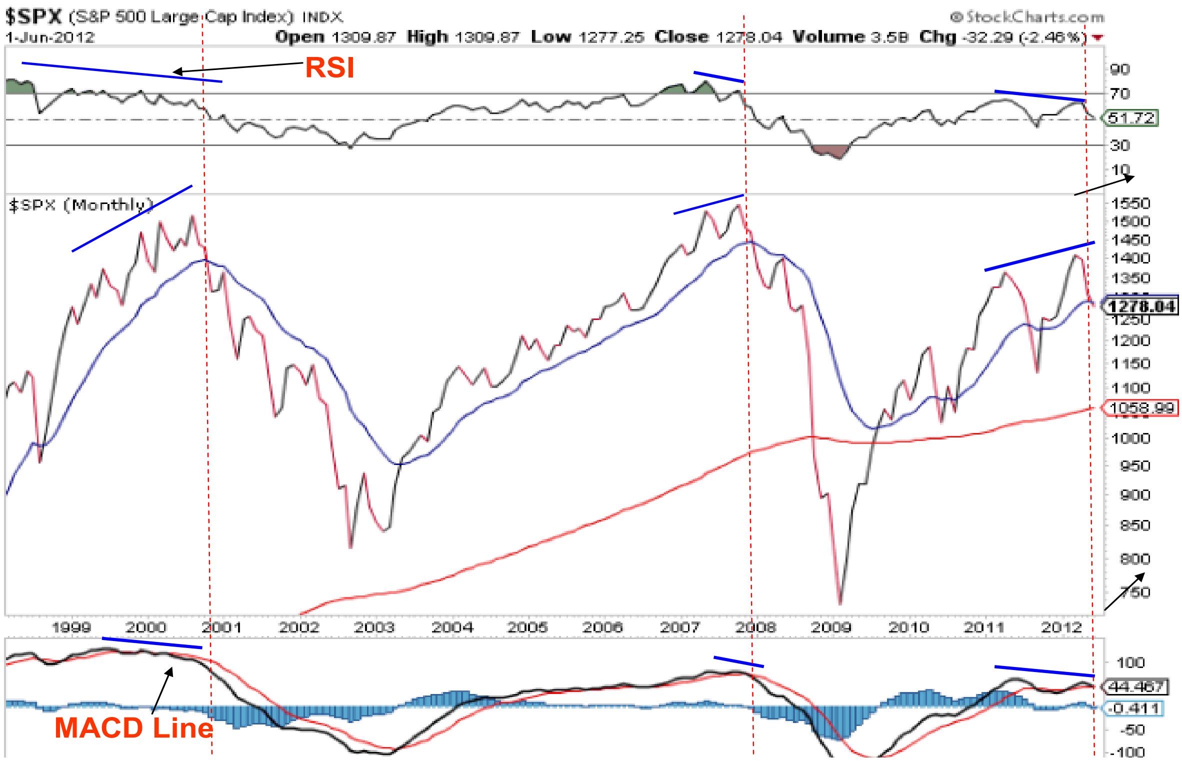
Courtesy of stockcharts.com

S&P 500 – Negative Divergence Signals

Secondly, the S&P500 monthly chart is showing negative divergence signals and it serves as a warning of a potential bear market ahead. This signal occurred a few months before the bear markets in 2001 and 2008, and should not be dismissed. A 'negative divergence' is a case when indicators are pointing downwards as the price of the asset in observation is moving up.

The monthly chart of the S&P500 helps us focus on the longer term behaviour of the market. A few months before the S&P500 fell sharply during the bear markets in 2001 and 2008, a 'negative divergence' signal surfaced. As the index was heading higher, the Relative Strength Index (RSI) and Moving Average Convergence and Divergence (MACD) indicators were pointing lower. The tipping point was when the index fell through the index's 16-month moving average line and ushered in an accelerated fall.

Now, a negative divergence has clearly resurfaced – as the index is moving higher, the RSI and MACD are pointing downwards. The index has just fallen through its 16-month moving average and suggests that an accelerated fall is eminent. The S&P500 index, which is the world's most closely watched index, will likely lead global equities downwards.

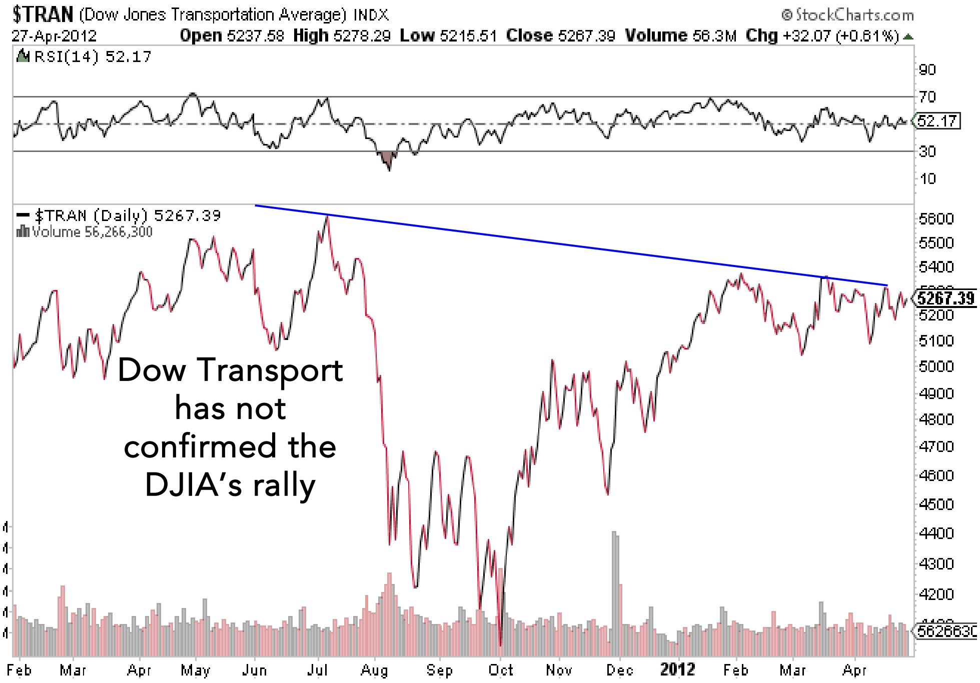


Dow Theory Non Confirmation

Thirdly, while the Dow Jones Industrial Index Average (DJIA) has surpassed its high seen in 2011 and remains in an uptrend, the Dow Jones Transportation Index, which is a more economically sensitive index, has lagged and started to trend downwards. This is a Dow Theory non-confirmation signal which suggests caution ahead.

In addition, the small cap Russell 2000 Index, which is a broader representation of the U.S. economy, has not confirmed DJIA's rally. Small caps stocks are seen as 'soldiers' and if they fall, it would be a matter of time before the larger stocks, known as the 'generals', would fall too.

Courtesy of stockcharts.com



Courtesy of stockcharts.com

Courtesy of stockcharts.com

US New Highs – New Lows

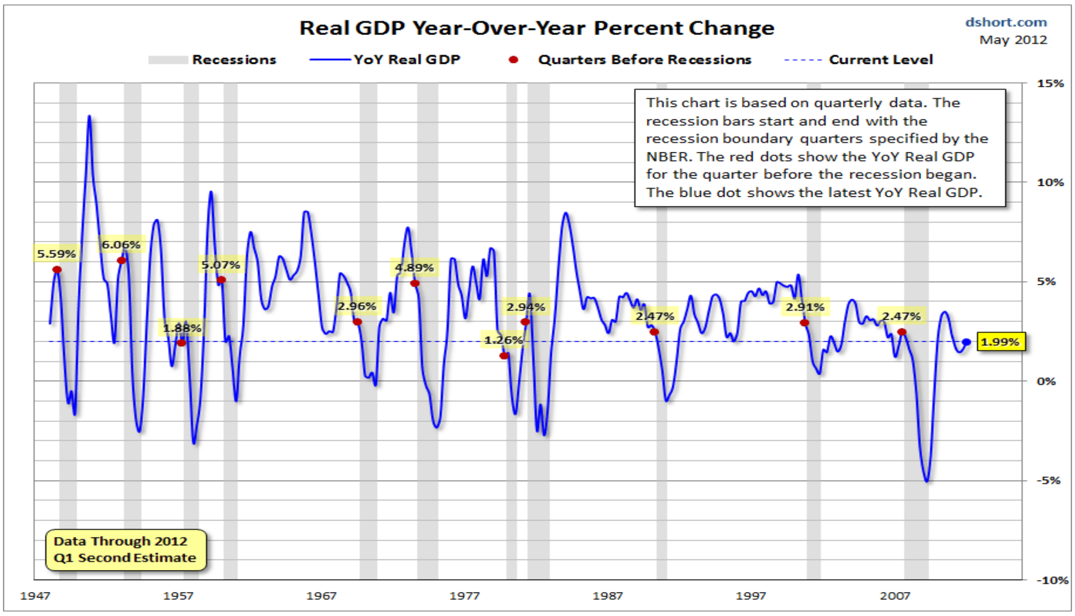
Fourthly, market breadth analysis has shown that U.S. stocks have deteriorated since 2011. The market breadth analysis is conducted using the NH-NL indicator, which studies the advance and decline in issues of U.S. stocks. The indicator is computed by adding up all of the US stocks that are making new 52-week highs and subtracting all of the US stocks that are making new 52-week lows.

In Feb 2011, we can see that the index showed a negative divergence from the NYSE Composite Index, and that served as a warning that market breadth was getting weaker and equity markets could see a sharp drop. Once again, since Feb this year, market breadth has weakened as U.S. stock climbed. Now the NH-NL indictor has begun to turn negative, suggesting that U.S. stocks are ready to roll over into a bear phase.

Courtesy of stockcharts.com

Year-Over-Year (YoY) GDP Percent Change and Current Recession Risk

Lastly, an observation from 1947 shows that when the YoY change falls below 2%, a recession could likely follow a few months later. The red dots show the YoY real GDP for the quarter before the recession began. However, investors must note that the determination of recession start dates is ALWAYS announced much later, after the bear market has occurred. The latest YoY real GDP at 1.99 suggests that the bearish technical studies should not be taken lightly.



Conclusion

Now that I have planted a bear bug in readers' minds, they must be careful to avoid suffering from bearish confirmation biases, which would cause them to miss a stock market rally if market conditions improve. Equity markets are at oversold levels and could recover soon, and if market breadth remains weak, any rally should be short lived.

However, we could see a sustainable rally if the U.S. Federal Reserve Board decides to introduce a third round of quantitative easing measures, a.k.a QE3, after their meeting on June 19-20. In addition, as this is a presidential election year, the U.S. president could activate the 'Plunge Protection Team' to positively rig the market and surprise us on the upside before the November elections. Major problems arising from the European debt crisis could also be temporarily delayed till next year, to make way for a stock market rally from current levels.

In the meantime, invest with caution.

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