Environment ripe for bounce

In mid-September, we believed the market was ripe for volatility due to an extreme overbought condition, excessive bullishness, and historically low volatility. In early October, it became even more evident that correction had already begun underneath the indices because only half the S&P 500 (SPX) was trading above their respective 10 and 50-day moving averages despite being less than 1% from a record high. With the sharp weakness over the past two weeks, those indicators that had us worried about a pullback have reversed and have now reached toward extreme oversold levels. It was just two weeks ago investors enjoyed a historically long period absent a 1% move, and now we have had 11 of the past 13 sessions lower, the CBOE Volatility Index (VIX) is back 23, and the market is gapping down more than 1% to break the October 11th low. Just like we thought mid-September was an environment ripe for volatility, we now believe the recent weakness sets the stage for a market ripe for a bounce.

Our most important intermediate-term tactical indicator will have reached an extreme if it closes the week anywhere near current levels. If the SPX closes the week anywhere near the current level, it would cause our trusty 14-week stochastic indicator to finally reach into extreme territory that suggests close proximity to an intermediate-term low (Figure 1). With so much money being driven by quant funds and momentum trading, it is impossible to pinpoint exactly where the market should turn, but the current level of our key tactical indicators suggests any further weakness should be recovered on an oversold bounce:

- The percentage of S&P 500 (SPX) index components above their 10- and 50-day moving averages drops to 20% and 40%, respectively. On 10/11/18, they were at 2% and 10%, respectively (Figure 1), and currently at 34% & 19%.
- The VIX Index jumps to 20 or higher. There has been a significant jump in the CBOE Volatility Index (VIX), which surged to 28 on 10/11/18 (Figure 2). While the VIX backed off to 17 last week, it is now moving higher again at 23.
- The 14-week stochastic indicator drops to 30 or below. Our trusty intermediate-term oversold indicator for the S&P 500 (SPX) is currently at 17, suggesting it will likely close the week below our favored level of 30 (Figure 3).
- Investors Intelligence percentage of bullish newsletter writers drops to below 45%, or preferably 35% (Figure 4). Last week’s reading was 51.9%, down from over 61. The current weakness will likely push that lower.

The market lacks a catalyst, which leaves “oversold” as the only reason to hit a near-term bottom. There are three catalysts that could lift stocks from the current rout: (1) Republicans hold the Senate in the mid-term election, (2) the Fed adopts a more dovish “data driven” stance, and (3) there is a resolution to the Chinese trade situation. Since none of these appear imminent, the bottoming process is going to feel awful – like it always does. There are many macro themes and geopolitical risks that could explain the correction, but ultimately, we believe it came from excessive optimism, historically low volatility, and an extreme overbought condition. These conditions have been relieved, our positive fundamental thesis remains in place, and our key tactical indicators are at levels that suggest proximity to an intermediate-term low.
Figure 1: Percent above moving averages reached extreme

The percentage of stocks above 10 & 50-dma dropped to 2% & 10%, respectively, similar to February, suggesting the majority of pain should have already been felt.

Figure 2: VIX surged well above 20

VIX surged to 28, and over the course of the last 5 years, if it is going to get worse it should be immediate.
Figure 3: Weekly stochastic is now oversold

Weekly stochastic has dropped to 17 very quickly

Past performance does not predict future results

Figure 4: Expect weakness to move % bullish lower

Investors Intelligence report shows 51.9% bulls

Source: Bloomberg/Canaccord Genuity
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Investment Recommendation
Date and time of first dissemination: October 23, 2018, 10:04 ET
Date and time of production: October 23, 2018, 10:04 ET

Distribution of Ratings:

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*Total includes stocks that are Under Review

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