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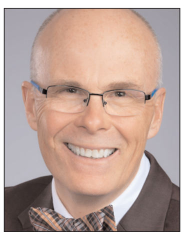
Investor's Digest of Canada

August 20, 2021 Vol. 52, No. 16

COMING TO GRIPS WITH THE MIDSUMMER MARKET, ONE CHART AT A TIME

Technical signs point to July volatility continuing



Keith Richards

Stock markets look like they may have a bit more room to correct before resuming the bullish trend. As a JPMorgan strategist recently suggested: "This will be a choppy environment the rest of the year as markets deal with growth that isn't as strong and turn to the potential of withdrawal of policy support."

Whether the market acts "choppy" for the balance of the year or not as JPMorgan advises, I am wondering if the market may indeed be choppy for the remainder of the summer. I am particularly focused on the probability of volatility during August, given the factors I will discuss in this article.

Let's start off by looking at the chart of the S&P 500. I've noted potential pullback targets on the chart (at 4,100 and 3,940) – should my anticipation of a pullback be correct. Although the market is not overbought from my go-to metric of measuring the height of price over its 200-day (40-week) simple moving average, or SMA, there are other signs suggesting a minor pullback from current levels may occur this month.

In this article, I have listed four technical factors for you to consider in evaluating the potential of an extension of the recent market volatility that appeared in late July.

One sign of overbought markets comes from the momentum indicators I follow. The top-left chart on page 331 shows us a picture of the S&P 500 with panes below that chart illustrating the momentum indicators stochastics, RSI (relative strength index) and MACD (moving average convergence divergence). These three indicators are in the panes directly below the price chart of the S&P 500.

To quickly review, stochastics compares an equity's, or set of equities' (such as those of companies within a certain sector) closing price to its trading range over a set period. This comparison helps to determine whether a security is in overbought or oversold territory.

The relative strength index is a more refined version of the stochastics measurement, which smooths out the results so they fall within a range of zero to 100 and only land near the extreme ends when the market is strongly trending one way or the other.

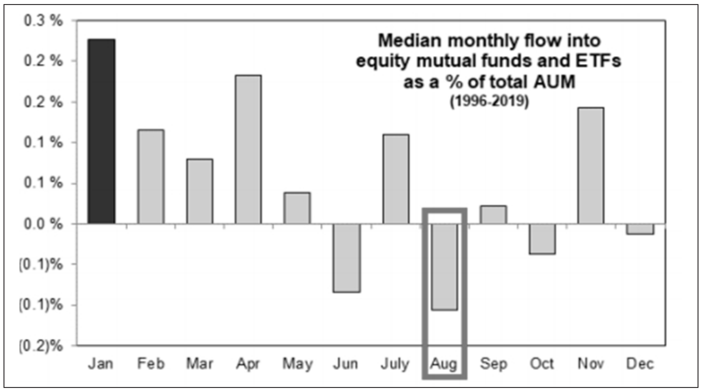
Moving average convergence divergence examines the relationship between a stock's exponential moving averages, or EMAs, for a longer period and for a shorter period. (Calculations for EMAs differ from those for SMAs by giving more weight to recent results rather than weighting all results equally.)

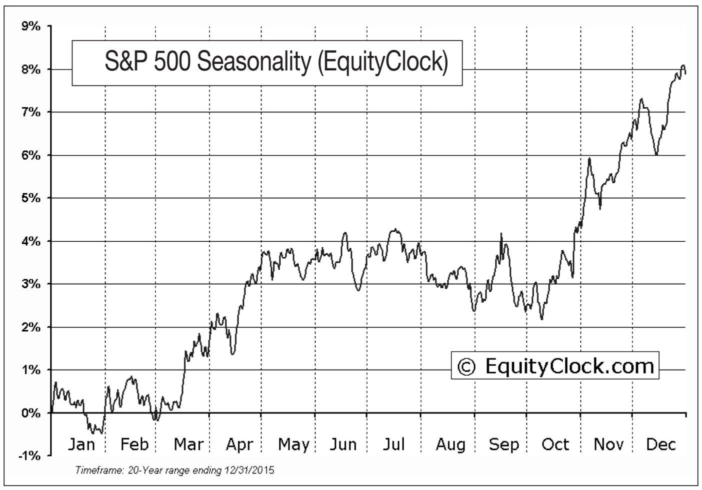
Note that the S&P 500 recently made new highs. However, the three momentum indicators noted are flat or moving down. This means that the market is pushing higher on lower and lower momentum. Picture throwing a baseball—it begins its descent as its speed slows. This is what the momentum indicators on my chart shows regarding the speed of the stock market's movements. Momentum indicators are negatively diverging against the trend of the S&P 500.

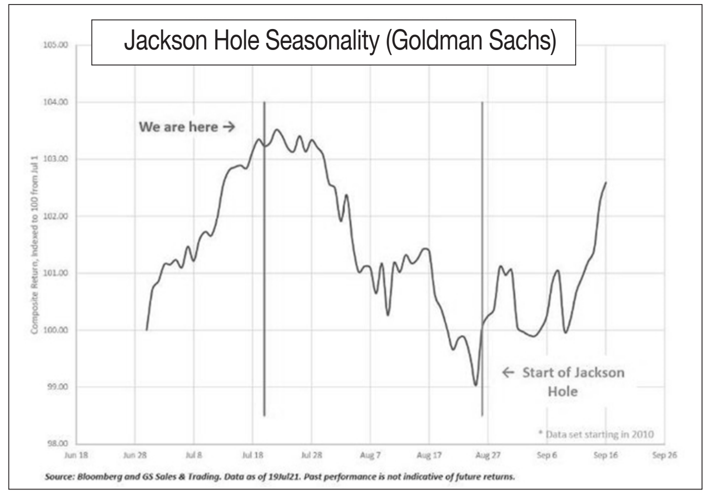
Note the divergence by MACD (second pane from the bottom) compared to the index. I have rarely observed divergences of this type that could carry higher market prices for any length of time.

On the positive side – the very bottom pane is that of cumulative money flow going into the market. So long as that line keeps rising, it suggests that any correction predicted by waning momentum studies will be minor.

The next argument for potential near-termed market weakness ahead comes from historic tendencies for markets to be weak in August. We can see average monthly market performance







(specifically that of the S&P 500) in this EquityClock graph at the top-right, which is based on the 20-year period ended Dec. 31, 2019.

Next up, let us consider equity flows. As illustrated here in the bottom-left chart courtesy of BearTraps, suggests that August is one of only two months that has typically seen retail money (ETF and mutual fund) outflow. In other words, retail investors, who typically buy ETFs and mutual funds, tend to sell some of their holdings in August. Outflow, when it happens, does not lead into rising markets.

Finally, seasonality for the Jackson Hole, Wyo. U.S. Federal Reserve meeting at the end of August, according to data from Goldman Sachs recorded since 1950 and illustrated in the bottom-right chart, suggests that markets pull back going into the Fed meeting.

Market participants become wary of potentially damaging Fed policy – real or imagined – coming into the meeting. Given the massive intervention by the Fed over the past two years due to COVID, one might imagine that the market's leadup into this year's Jackson Hole meeting may be particularly volatile.

Macro market indicators such as trend and money flow are bullish. This suggests that – seasonal weakness and short-termed technical warnings aside – we might anticipate a strong winter market after any weakness in the coming few months.

As such, it is my opinion that any weakness on stock markets over the coming weeks or months should be taken advantage of to buy quality stocks.

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