Thursday, July 23, 2009

Small Caps,
Mid Caps,
Rally Caps??

S&P 600

Padovan retracements of entire bear market:

380.90
332.04
295.10
267.21
246.15

Fibonacci retracements of entire bear market:

344.78
313.57
282.36

Padovan retracements of Wave Three:

347.96
307.11
276.28
253.00
235.43

Fibonacci retracements of Wave Three:

317.74
291.70
265.65

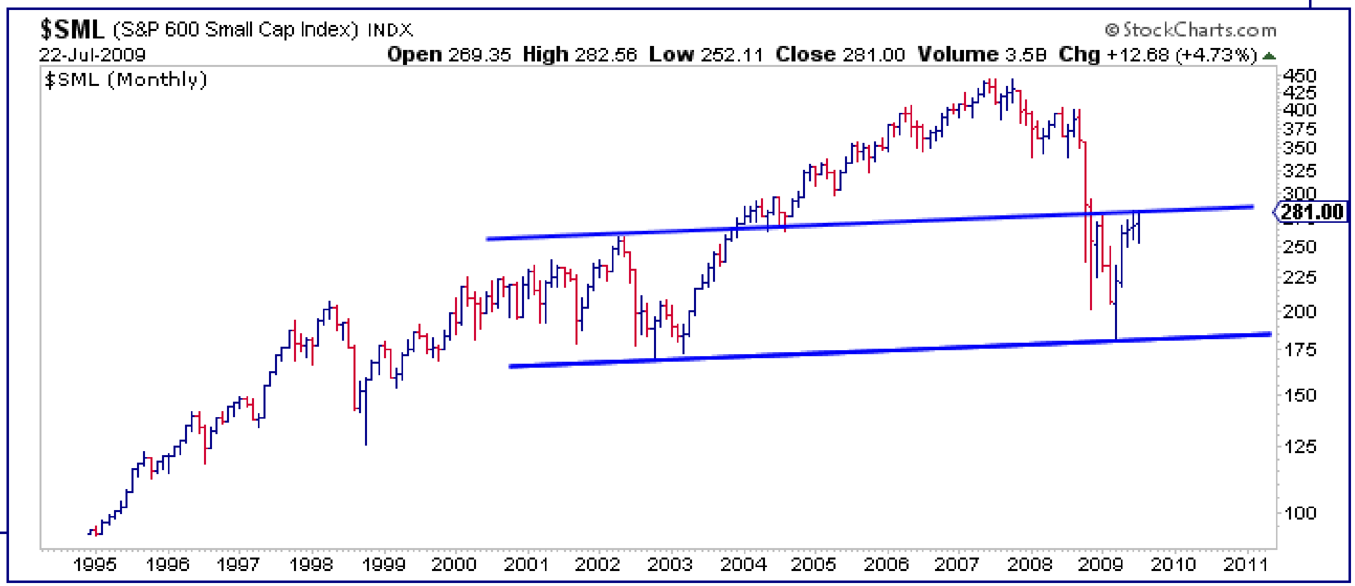
From the March low at 181.32, the S&P 600 Small Cap Index (SML) has so far advanced 56.18 percent. Not a bad rally so far, but to put it in perspective, consider that this 100 point plus move has barely retraced 3/8 of the bear market.

So last month, and now again, SML is testing the .382 retracement target. That's a decent level for a top, though I must say that it looks a little too obvious. I'd feel much better about it if there were some other price targets and/or speedline lines clustered right near here. On the other hand, I see that SML has a propensity to double top. Big double tops in 2007 and 2008, maybe the market will give us another here in 2009. . . .

Here is a little closer look at Wave Three and this Wave Four. Not really a lot that needs commenting on here, I include it so you can see the retracement lines, and also how the index is wavering right in the middle of the October panic range.

To the right is a monthly chart of SML. I find it interesting how the recently rally kind of mirrors the correction in 2002, both in terms of magnitude and duration. It is possible to view the advance from March as the right shoulder of a potentially massive head and shoulders formation.

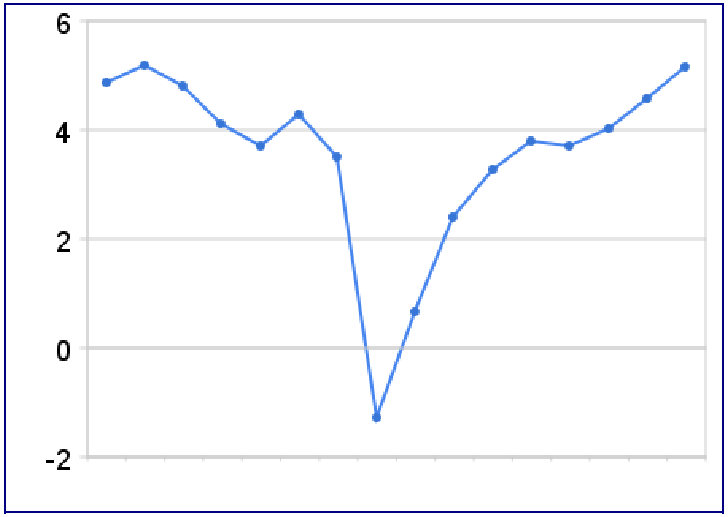
The pattern may never end up being fulfilled, but even H&S failures very often retrace back to the neckline, or even a little below. I am saving



downside targets for another day, but I will say here that such a scenario would not surprise me at all.

The table below shows actual and projected quarterly earnings for SML.

Quarterly Breakdown	2007 Q1A	2007 Q2A	2007 Q3A	2007 Q4A	2008 Q1A	2008 Q2A	2008 Q3A	2008 Q4A	2009 Q1A	2009 Q2E	2009 Q3E	2009 Q4E	2010 Q1E	2010 Q2E	2010 Q3E	2010 Q4E
S&P 600	4.86	5.18	4.82	4.13	3.70	4.28	3.51	(1.27)	0.68	2.41	3.27	3.81	3.71	4.02	4.58	5.17



So the Street estimates that earnings are just going rebound back to 2007 levels next year? I took the liberty of making a graph of the above data to give you a visual of the consensus hallucination. Much talk has been made about the potential for a "V-Shaped Recovery". Well there is your **V** right there, baked into the cake! Just be careful not to choke on it.

Needless to say, *Trend & Value* does not subscribe to such a thesis so rich in bullshit. What type of recovery, if any, we will get, and whether it can be signified by a letter in the alphabet, remains to be seen, but I can not in good conscious advise being bullish (in any long-term or fundamental sense at least) on Equities until this ocean of wishful-thinking evaporates.

But even if the Magic Beans (to borrow the IOZism) do sprout, and God grants SML quarterly earnings of $5 by late next year, that still makes for a forward Price/Earnings ratio of around 14. And 14 just happens to be the long-term average P/E for the US Equities market. And as I've stated in the past, I expect the overall P/E for the market be much lower than the historical average in the future. So unless I am wrong about that (which is possible, but I think history is on my side here) the current valuation of SML offers very little potential for further price appreciation. As I say, the wishful-thinking is baked into the cake.

All things considered, I think the chances are pretty fair that SML is making a (double) top at 283. If that is not the case, then I still believe that any advance from here will prove to be a fake-out. If 283 does not hold then I will be looking for a top in the 290/295 range. There are some technical reasons to look for a move all the way up to 315ish, but really, I am going with my gut on this one, and the gut sayeth the Top is nigh.

S&P 400

Padovan retracements of entire bear market:

797.07
699.25
625.40
569.65
527.57

Fibonacci retracements of entire bear market:

724.71
662.32
599.93

Padovan retracements of Wave Three:

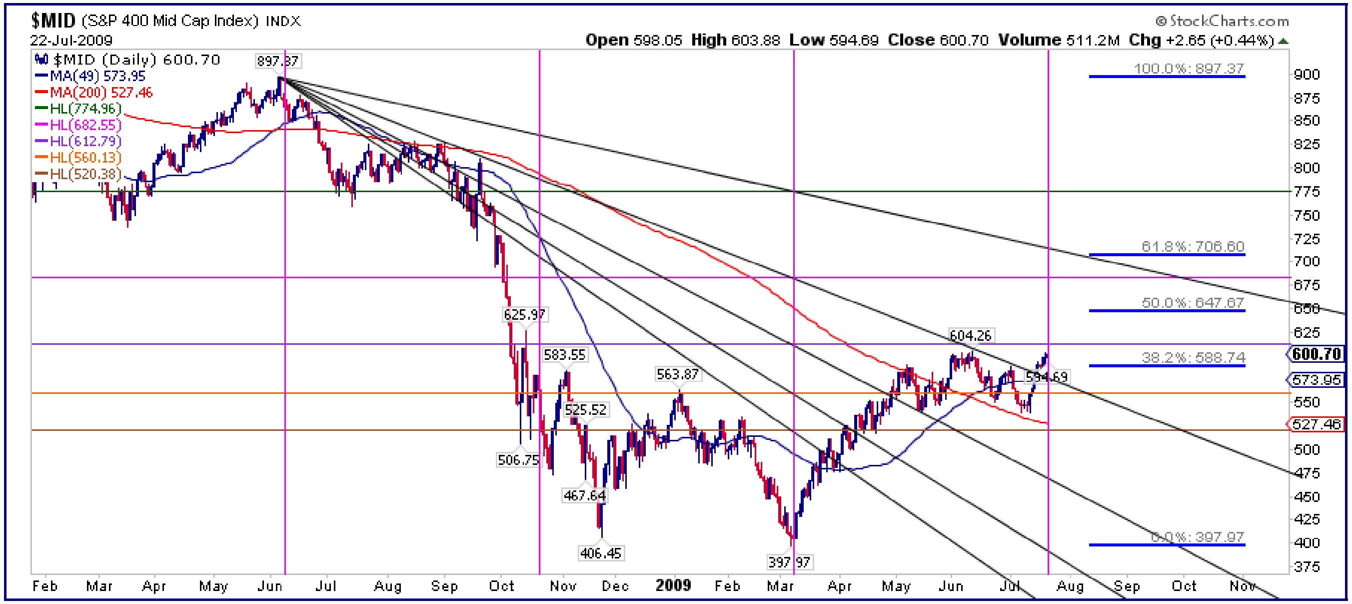
774.96
682.55
612.79
560.13
520.38

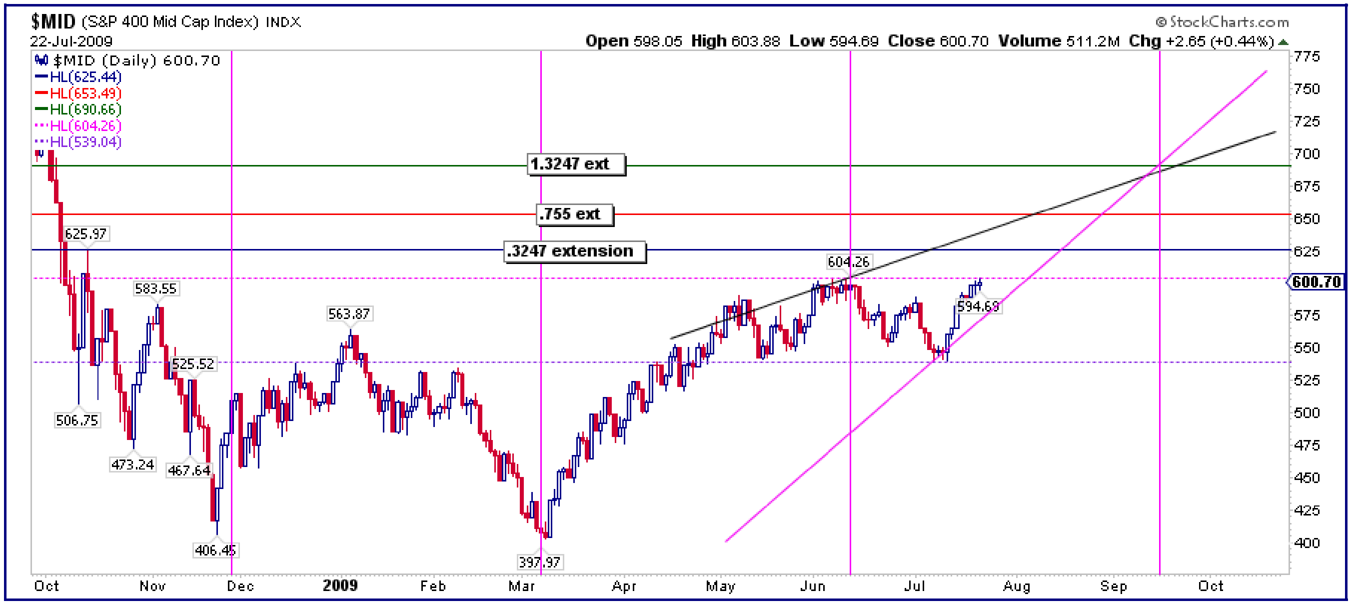
Fibonacci retracements of Wave Three:

706.60
647.67
588.74

There are no great coincidences between retracement targets here either. MID has advanced a bit more than 50 percent from the March low, recovering about 3/8 of the ground lost during the bear market.

By far the most bullish technical development has been the recent break above the .57 speedline descending from the high last year at 897 (see next chart). Purely in terms of speedline line theory, that might trigger a further impulse to the upper .755 speedline. That would give us an extreme upside target in the 700 range a couple months down the road. Way more upside than anything I have considered for any other index, but it would correspond to the 315ish level that I don't believe likely on SML.


$MID (S&P 400 Mid Cap Index) INDX
22-Jul-2009
© StockCharts.com
Open 598.05 High 603.88 Low 594.69 Close 600.70 Volume 511.2M Chg +2.65 (+0.44%)
$MID (Daily) 600.70
MA(49) 573.95
MA(200) 527.46
HL(774.96)
HL(682.55)
HL(612.79)
HL(560.13)
HL(520.38)
100.0%: 897.37
61.8%: 706.60
50.0%: 647.67
38.2%: 588.74
0.0%: 397.97
897.37
625.97
583.55
563.87
525.52
506.75
467.64
406.45
397.97
604.26
594.69
600.70
573.95
527.46
Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec 2009 Feb Mar Apr May Jun Jul Aug Sep Oct Nov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Open 598.05 High 603.88 Low 594.69 Close 600.70 Volume 511.2M Chg +2.65 (+0.44%)
$MID (Daily) 600.70
HL(625.44)
HL(653.49)
HL(690.66)
HL(604.26)
HL(539.04)
1.3247 ext
.755 ext
.3247 extension
625.97
583.55
563.87
525.52
506.75
473.24
467.64
406.45
397.97
604.26
594.69
600.70
Oct Nov Dec 2009 Feb Mar Apr May Jun Jul Aug Sep Oct

Now that last chart shows how 700 or near there could be achieved. Notice the extension targets based on the recent range of 604/539. The upper diagonal line is the speedline running through the .3247 extension. The lower diagonal line is the same angle of ascent as the advance from 398 to 604. Both of these lines intersect in the neighborhood of the 1.3247 (at 690.66) price extension in September.

For such a scenario to gain in probability, it would help for MID to make a partial retracement of the recent range (say down to 575~) before breaking out.

So the way I see it, an immediate move above 604 is likely to prove a fake out, whereas an immediate retracement within the current trading range followed by a break above 604 has a much higher likelihood of leading to another sustained advance for the index.

Summary

Well, my analyses of SML and MID ended up diverging some, didn't they? I kind of did that on purpose, but I do admit that I did not start to see the upside potential until I examined MID.

If the bullish scenario described for MID (and by implication the broader Stock Market) plays out, it would totally disrupt my outlook for other markets like Metals, Commodities, and Currencies, unless of course the prevailing correlations totally break down. Now I do not want you to think that I am convinced that the bullish scenario will actualize, because it still seems outlandish to me. But nothing is impossible in the markets, and we have to take what the market delivers, therefore it is incumbent upon the analyst to explore all the angles.

There are, however, some angles I didn't explore in this report – namely Volume. And in this regard, the most recently rally has been absolutely pathetic. But I will assess that dimension in more detail another day.

Also, I intended to analyze more than just these two indexes for this report, but I just don't have the time to tackle any more charts for this issue. Plus, as I see it, my 962 target for the S&P 500 remains in play, so I don't really see the need to repeat that analysis until something changes. The change may well come soon, but I am actually amazed how the market continues to eye that number.

Thanks for reading, I hope this will be of some use to you. I'll be back real soon with another report.

Best,

Kyle Ledbetter Lucas