Thackray Report

Market Breadth is Deteriorating

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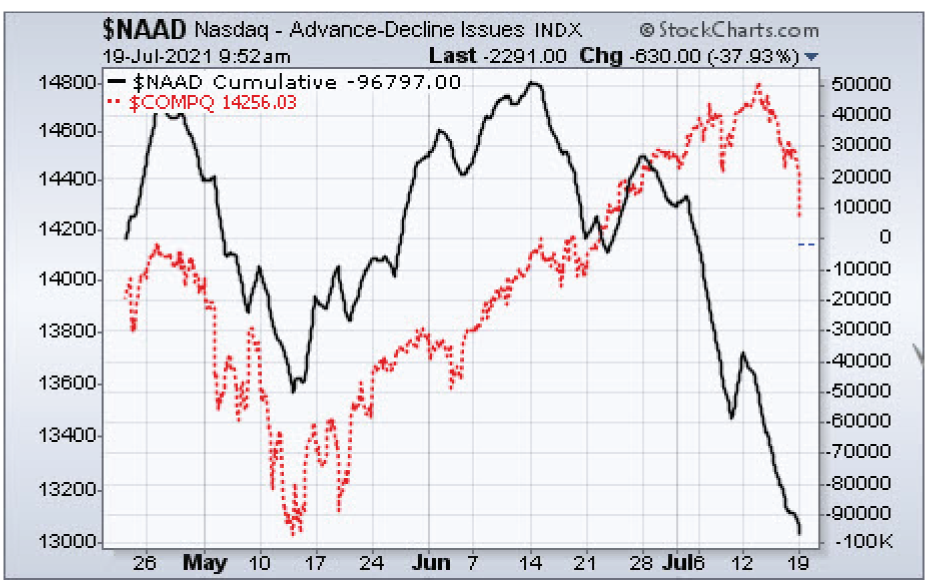
The S&P 500 is close to its all-time high and yet market breadth has been deteriorating, which means that the stock market could soon start to stumble.

There are a number of ways that stock market breadth can be measured, including the number stocks hitting an all-time highs vs the number of stocks hitting all-time lows, the number of stocks trading above a certain trend line such as the 200 day moving average and other methodologies. Essentially, market breadth tries to measure how many stocks are participating in a market trend.

If only a few stocks are performing well in an upwards trending market this indicates that the market's positive performance could be on borrowed time. When the stock market is increasing and fewer and fewer stocks are participating in the rally, it is often an indication that investors are starting to get concerned with market valuation. Investors typically start to shift away from the "riskier" stocks in the market to a few large company stocks, as they want to remain invested, but reduce their risk. When a large number of investors follow the same course of action, a lot of stocks tend to perform poorly, a few large company stocks perform well and the overall market can keep moving higher. This is particularly true with a cap-weighted index such as the S&P 500 where the price movement of a few companies dominates the index.

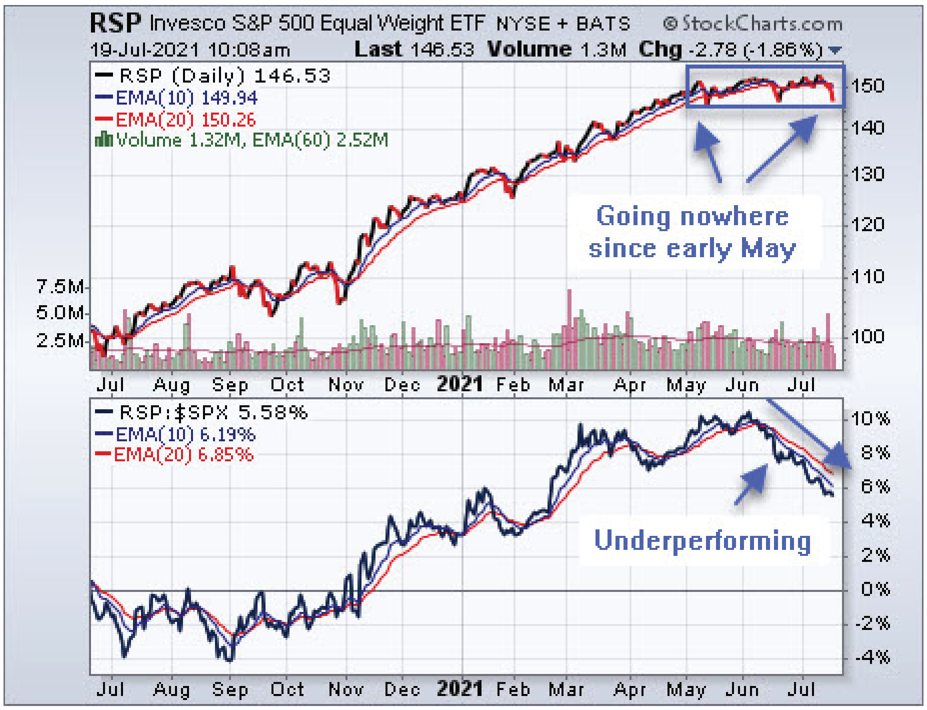
So what is the problem? All that investors need to do is follow the trend and focus on the large company stocks, right? Not so fast. Yes, the trend can be rewarding while it lasts, but when it breaks the consequences can be strongly negative for the stocks driving the market higher. The classic example of this scenario is 1999/2000 where fewer and fewer stocks drove the stock market higher and once those stocks started to correct, the rest of the stock market accelerated to the downside.

So, where are we today? Market breadth has been deteriorating on a number of fronts. The Nasdaq has been showing deteriorating breadth. As it has been increasing in value, the number of advancing issues has been decreasing compared to the number of declining issues.



In the graph above, the red line represents the Nasdaq and the black line represents the Advance-Decline (AD) line. The number of issues advancing relative to declining peaked in mid-June. The Nasdaq continued higher into July, despite a larger number of issues declining in price. The divergence between the Nasdaq and the AD line typically does not go on for an extended period. The AD line typically leads. In the last week, the Nasdaq has started to turn lower catching up to the AD line.

Another way to monitor market breadth is between two stock indexes with different capitalization characteristics. The graph below illustrates the performance of the S&P 500 on an equally weighted basis using the ETF (RSP) and the S&P 500. In RSP, all 500 companies have the same weight (approximately 0.2% for each company). This compares to the S&P 500 where Apple has a 5.9% weight and Microsoft has a 5.6% weight. Both of these stocks have been performing well recently, helping to support the S&P 500.



The graph above (top panel) shows that the S&P 500 (equal weight) has been going nowhere since early May. Yes, the S&P 500 is higher, but that is because of a few large caps pushing the stock market higher. The graph in the second panel shows that the S&P 500 (equal weight has been underperforming the S&P 500 since the beginning of June. In other words, there have been fewer and fewer stocks performing well, despite the S&P 500 moving higher in June and into early July.

It should be noted that just because market breadth has been getting worse, it does not mean that the trend has to continue until the market corrects. It is possible that market breadth could improve, with more stocks participating and the stock market moving higher. Nevertheless, the worse the stock market breadth gets, the more susceptible the stock market is to a correction. Currently, the deteriorating market breadth does not bode well for the future prospects of the market. This is particularly true over the next two months of the year: August and September, which over the long-term have been the two worst performing contiguous months of the year.

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