THE WARNING SIGNS OF MAJOR MARKET TOPS

Paul F. Desmond
Lowry Research Corporation

December 1, 2012

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The Law of Supply and Demand is universally recognized in both academia and the business world as the foundation, the starting point of all economic analysis. The Law of Supply and Demand states that when demand for a freely traded commodity exceeds the supply of that commodity, its price will rise. And, if the supply of that commodity exceeds the demand for it, the commodity's price will fall. Notice the lack of equivocation. No *mights* or *coulds* or *shoulds*, just *will*. It's the Law. And, since common stocks are a freely traded commodity, their price movements are dictated by the Law of Supply and Demand – the starting point of common stock analysis (and, therefore, stock market analysis). As such, it is difficult to imagine why it is not at the core of every investor's portfolio strategy.

Since 1938, Lowry Research Corporation has measured the factual, unbiased forces of Supply and Demand at work on the New York Stock Exchange. Our database of those measurements now extends back 87 years – from mid-1925 to present. Recently, we have expanded our analysis to encompass 24 major stock exchanges around the world. In essence, we measure the daily movements of money into and out of the stock markets. These movements reveal changes in investor psychology over time, moving through repetitive cycles of hope, fear and greed – which are the direct result of the purchases and sales of billions of shares of stock by millions of investors. Since the actions of individual investors are usually heavily influenced by group psychology and economic cycles, security prices generally move in relatively well-defined trends, commonly known as Bull markets and Bear markets. Gradual changes in both buying enthusiasm and in the desire to sell provide a series of progressive warning signs – signs that can help investors anticipate important trend changes, shifting to a more aggressive strategy near the start of Bull markets, and shifting to a more defensive strategy near the start of Bear markets – markedly enhancing their longer term portfolio performance.

Most investors will concede that the most difficult part of managing a portfolio of stocks is identifying the formation of a major market top before it is too late. This is undoubtedly due to the universal enthusiasm for stocks, and generally positive economic news that usually dominates investor psychology at such times. But, the warning signs are nevertheless present for those willing and able to see them.

The period leading up to a major market top shares a number of similarities with the Autumn season as it transitions into Winter. That is, in Autumn the leaves begin to fall from the trees in a very gradual process – nearly imperceptibly – one at a time, until the trees are eventually bare at the onset of Winter. It is no different near major market tops. Individual stocks begin to roll over into their own Bear markets, one at a time, usually beginning with the less noticeable small-cap and mid-cap stocks. An important consideration in this gradual process of erosion is that small-cap stocks generally make up about 40% to 50% of the stocks traded on most major global equity markets, while mid-caps typically make up about 30% to 40%. Big-caps generally account for only about 10% to 15% of common stocks traded on most of the large world markets. In the emerging equity markets, the percentage of small-cap stocks is even more dominant. Thus, as a mature Bull market rallies through a series of higher highs in the big-cap price indexes (such as the DJIA and S&P 500), investors must be able to see that a growing majority of stocks may already be in downtrends. Otherwise, at the final high in the big-cap indexes, a relatively small number of heavily weighted big-cap stocks can deceive investors into believing that the broad market is still in a healthy uptrend.

The most important warning signs commonly found near Bull market tops involve evidence of increasingly extreme selectivity. Just as there are a wide variety of ways to recognize the changing conditions from Autumn to Winter, there are a number of ways to observe the gradual process of a Bull market devolving into a Bear market, all of them involving the Lowry measurements of Supply and Demand. A detailed review of each of these indicators could easily occupy a lengthy dissertation. Instead, this paper offers an overview of the importance of these measurements in terms of avoiding the ravages of recurrent Bear markets throughout the 87 year history of the Lowry Analysis:

<u>New 52-Week Highs</u>: Usually, the first warning sign that a Bull market is losing some of its upward momentum occurs when the percentage of stocks rising to New 52-Week Highs begins to contract. This warning typically occurs as much as six to twelve months in advance of the final highs in the big-cap indexes. It is not so much a sign of trend weakness as it is a sign of fading strength – somewhat like an athlete who discovers she cannot jump as high, or run as fast, as she could in her youth. The contraction in New Highs serves as a gentle reminder that all Bull markets eventually come to an end. It also shows that fewer stocks are participating in the Bull market, prompting investors to begin reviewing their portfolios more closely, looking for holdings that have stopped making new highs. If a stock again fails to make a New 52-week High during subsequent market rallies, its lack of strength may indicate it is time to cull that stock and reinvest the proceeds in a stronger stock that is consistently rising to new highs. Later, as the percentage of stocks rising to New 52-week Highs continues to contract (reflecting an increasingly selective market advance), the strategy should shift to selling laggards one at a time, and building cash reserves rather than reinvesting in a weakening trend.

On a broader basis, each time the big-cap indexes rise to new Bull market highs, it is important to keep track of the percentage of individual stocks also rising to new Bull market highs. Our original 2006 study titled An Exploration of the Nature of Bull Market Tops (updated to include the 2007 Bull market peak) examined every Bull market top since 1929 and found that, on the final top day of the Dow Jones Industrial Average, less than 11% of common stocks listed for trading on the New York Stock Exchange were also making new highs. In the 1929 case, when the DJIA made its final high on Sept. 3rd, the percentage of NYSE-listed stocks at new highs was just 2.3% -- extreme selectivity.

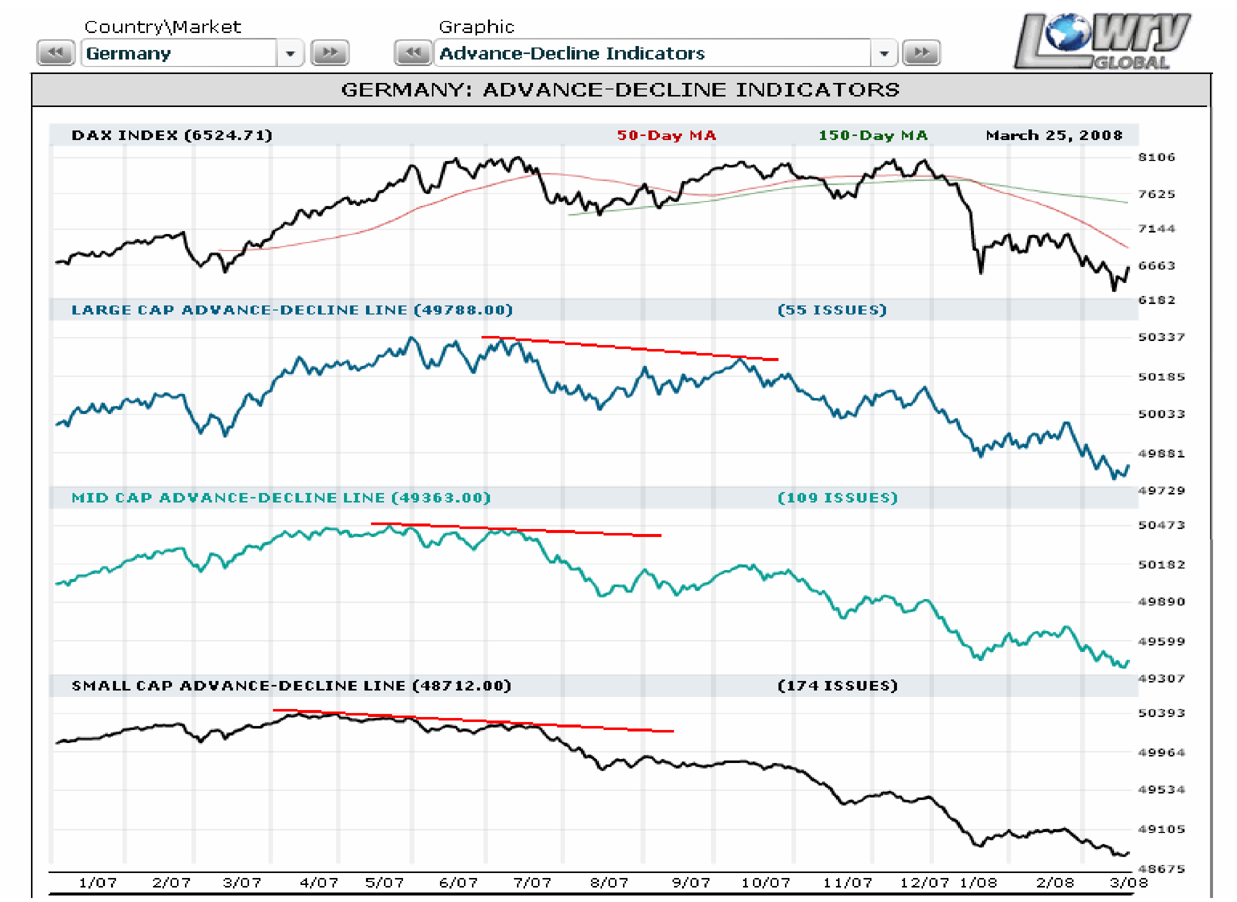
As a corollary to monitoring new highs, the Lowry Analysis also tracks the percentage of stocks that are already down from their highs by 20% or more on the same day that the Dow Jones Industrial Average is making its final Bull market high. A decline of 20% or more is generally viewed as signifying a Bear market. As the table below shows, if an investor had the unique ability to sell her portfolio on the exact final top day of the DJIA, she would discover that a substantial portion of her portfolio had already suffered significant losses. Just as the leaves in Autumn fall from the trees one at a time, stocks drop out of Bull markets in the same slow, gradual manner.

Examination of Trading at Fourteen Peaks in the Dow Jones Industrial Average

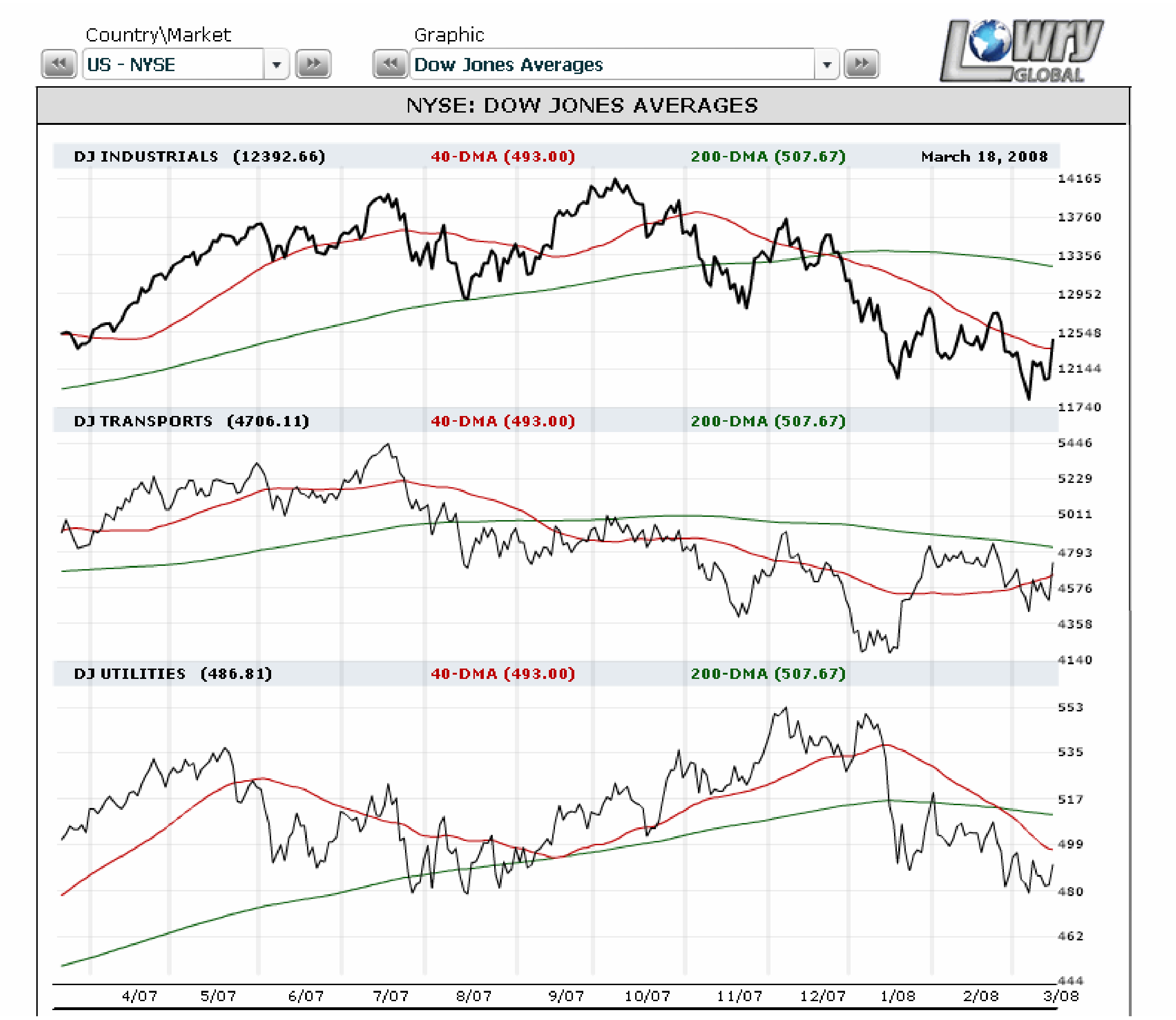
BULL MKT TOP DAY	% STOCKS @ NEW HIGHS	% AT OR < 2% OF NEW HIGHS	% OFF 20% OR MORE	% OFF 30% OR MORE
09/03/1929	2.30%	15.62%	31.84%	18.77%
03/10/1937	6.05%	21.34%	5.94%	1.06%
05/29/1946	8.59%	30.44%	6.30%	0.86%
04/06/1956	5.32%	23.36%	1.92%	0.42%
01/05/1960	1.60%	5.83%	23.25%	7.67%
12/13/1961	3.56%	11.83%	25.29%	11.60%
02/09/1966	9.66%	19.04%	9.52%	2.68%
12/03/1968	9.43%	20.12%	9.51%	2.36%
01/11/1973	5.30%	11.82%	34.22%	20.51%
09/21/1976	10.97%	22.88%	21.65%	10.09%
04/27/1981	7.09%	15.18%	28.01%	9.39%
08/25/1987	6.23%	15.23%	17.37%	7.44%
07/16/1990	5.35%	18.11%	37.31%	22.74%
01/14/2000	3.54%	6.31%	55.33%	32.45%
10/09/2007	10.77%	11.03%	26.51%	16.51%
AVERAGE	6.38%	16.54%	22.26%	10.97%

Advance-Decline Lines: The gradual process of individual stocks dropping out of the aging Bull market – like the leaves on a tree as Winter approaches – can be monitored each day through Lowry's various Advance-Decline Lines. Usually, the gradual reduction in the number of stocks advancing versus declining on days of rally first appears in our small-cap Advance-Decline Line. Investors often turn away from small-cap stocks first, as they are often viewed as "one-trick ponies" with less financial strength, and generally more vulnerable to protracted market declines. The weakening of the small-cap Advance-Decline Line indicates that fewer small-cap stocks are still participating in the remaining Bull market, thus encouraging investors to reduce exposure to small-caps on a stock by stock basis.

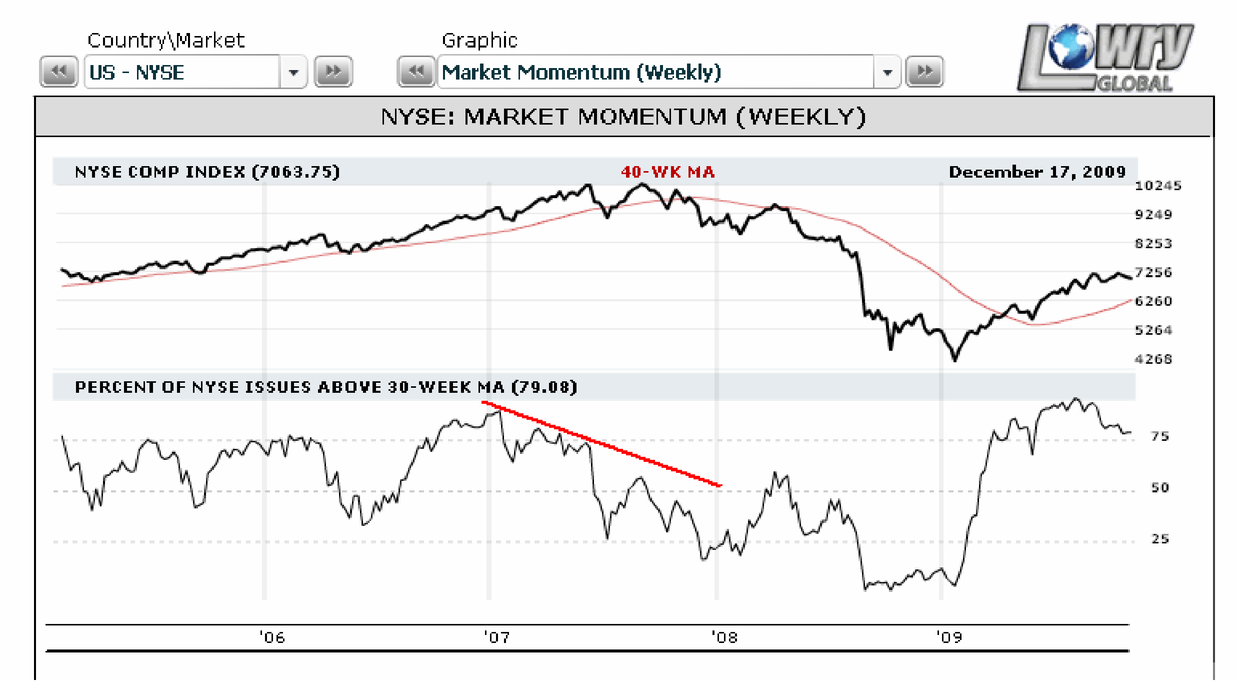
Progressive weakness soon begins to spread – either simultaneously or a short time later – to the mid-cap stocks, as reflected in persistent weakness in our Advance-Decline Line for the mid-cap components. Soon after (usually about four to six months before the final Bull market high in the big-cap indexes), the spreading weakness can be observed in a steady downturn in our Operating-Companies-Only (OCO) Advance-Decline Line, despite new highs in the big-cap indexes. At this point, new highs in the major big-cap price indexes are not unlike a sand castle with its foundations gradually washing away, leaving the turrets progressively more vulnerable. It should be emphasized that the weakness in the various segmented Advance-Decline Lines does not ever call for a single all-encompassing sell-signal, but simply encourages investors to reduce risk exposure on a case-by-case basis, as more and more individual stocks demonstrate they are rolling over into their own Bear markets.



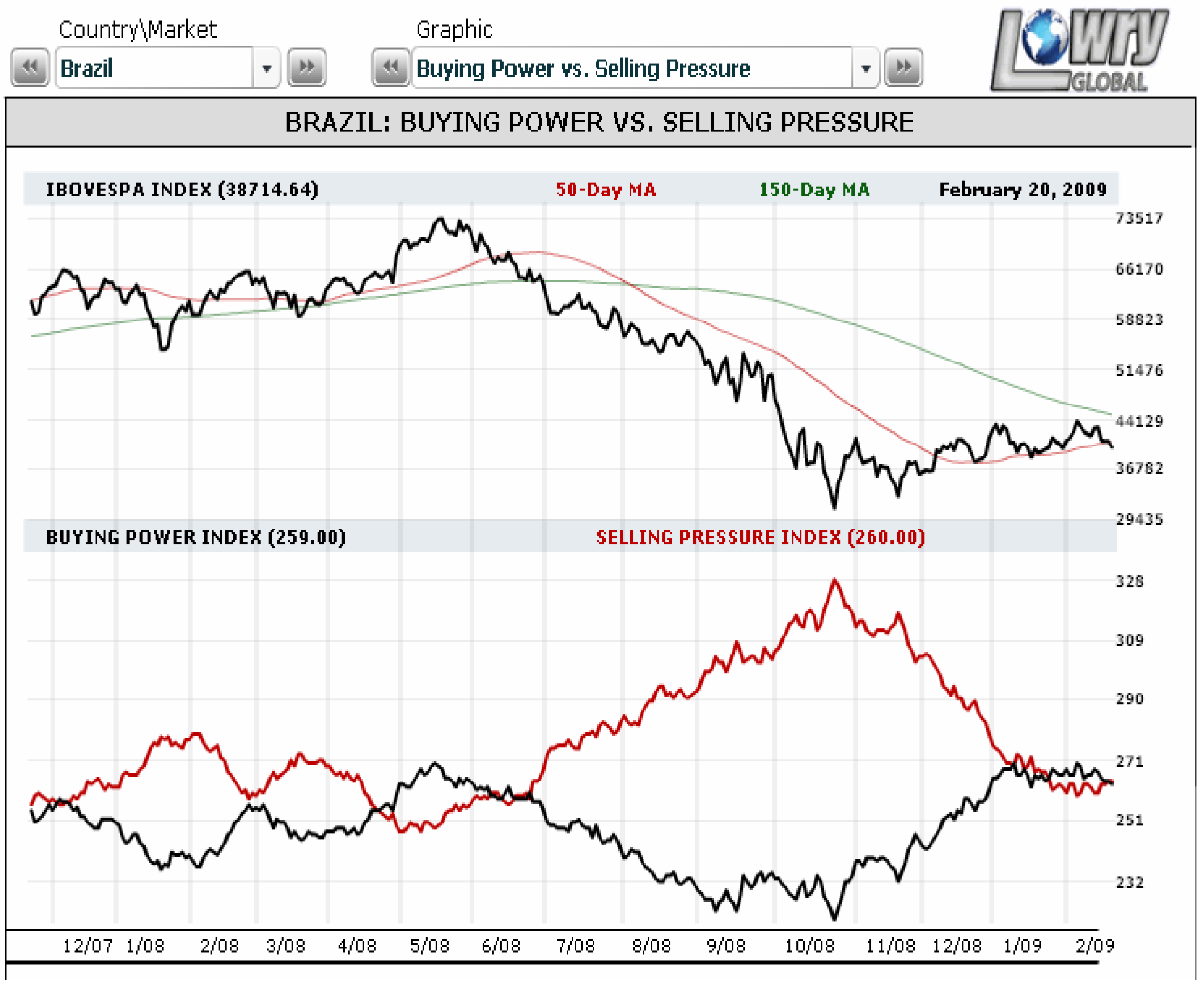
<u>Market Index Divergences</u>: During the early stages of a Bull market, virtually all equity indexes tend to rise together, albeit at somewhat different rates. During the latter stages of a Bull market, some price indexes stop rising and begin to turn down as the remaining Bull market becomes increasingly selective. Since most investor publications and websites tend to primarily display charts of the popular big-cap indexes, it could be relatively easy for an investor to completely miss these important warning signs of major trend weakness. One of the earliest studies of the importance of price index divergences was the still highly regarded Dow Theory that addressed divergences between the Dow Jones Industrial Average and the Dow Jones Transportation Average near major market tops. Today, that original concept should be expanded to contrast the uptrends in the big-cap DJIA and S&P 500 Index to downtrends in a variety of sector or segment price indexes – such as the S&P 100, 400 and 600 Indexes, the Lowry Unweighted S&P 500 Components Index, the NYSE Composite, the Russell 2000 Index, or the Value Line Composite Index – during aging Bull markets. Each time another of the less popular price indexes fails to confirm the continued strength in the big-cap indexes, the warning signs become increasingly important. And, as the market advance becomes more selective, investors' portfolios should become more selective. In this way, when the final highs of the Bull market are registered, investors should be still holding only a small number of the strongest stocks.



<u>Percentage of Stocks Above their 30-Week Moving Averages</u>: Another helpful way to be alerted to the increasing selectivity typical of old Bull markets is to regularly observe the percentage of NYSE-listed stocks above their 30-week moving averages each time the DJIA and S&P 500 Index rise to new Bull market highs. During healthy Bull markets, new highs in the popular price indexes should be accompanied by 75% to as much as 90% of stocks above their 30-week moving averages. At the final Bull market highs for the DJIA and S&P 500 Index, the number of stocks still in uptrend patterns has typically been dropping steadily to 60% or less. Remember, there is strength in numbers. The importance of the warning signs given off by any one indicator is multiplied when similar warning signs emerge in a variety of indicators, each of which measures the forces of Supply and Demand from a slightly different angle.



<u>Buying Power vs. Selling Pressure</u>: The Lowry Analysis has become particularly well known over the past 75 years for its composite measurements of Supply (the Selling Pressure Index) and Demand (the Buying Power Index). During the early stages of a healthy Bull market, Buying Power typically rises sharply, reflecting expanding investor buying enthusiasm. At the same time, Selling Pressure usually drops steadily, showing that the supply of stocks being offered for sale is shrinking. However, during the latter stages of an old and increasingly fragile Bull market, Buying Power commonly weakens as buyers become more cautious, while Selling Pressure rises steadily as initial profit-taking evolves into consistent distribution. A major reassessment of equity strategy is generally called for whenever the internal condition of the stock market deteriorates enough to cause Selling Pressure to rise to the dominant position above Buying Power, which represents the critical point when Supply exceeds Demand.



There are many experienced investors who will argue strongly that there are no effective warning signs of major market tops. To those investors, Bear markets just suddenly emerge without warning (somewhat like a sudden plague), and must simply be endured by investors until, hopefully, a new Bull market eventually makes up their losses. The reason so many scholars and professional money managers were unable to see the warning signs reviewed in these pages is simply because their attention has been focused exclusively on corporate earnings, and other macro-economic factors, rather than on the observance of the Law of Supply and Demand applied to the flows of money into and out of common stocks – the foundation, the starting point of all economic analysis and all stock market analysis. Investors have faced exceptional challenges since the 2000 and 2007 market tops. A growing number of investors have widened their horizons to include key measurements of Supply and Demand. The Lowry analysis of Supply and Demand is complementary to all other forms of equity analysis and provides a vital system of checks and balances to enhance portfolio performance throughout both Bull markets and Bear markets. Our analysis starts with the examination of the primary market trends of 24 markets and 3 regions, and then extends to the ten major economic Sectors, 68 Industry Groups, and 14,000 individual stocks and Exchange Traded Funds (ETFs) – all available 24/7 around the world.

The charts included in this paper have purposefully been taken from a variety of the 24 equity markets included in the Lowry Global interactive website as well as the Lowry onDemand domestic interactive website covering the NYSE and NASDAQ markets. Our goal is to demonstrate through the history of our various measurements of money flow, that the Law of Supply and Demand is truly universal, bridging languages, cultures, and currencies, and helping investors to become truly Global.

Respectfully submitted,

Paul F. Desmond
Lowry Research Corporation

Paul Desmond is the President of Lowry Research Corporation, located in Palm Beach Gardens, Florida. Lowry Research was founded in 1938, and is the nation's oldest continuously published stock market analysis based exclusively on the Law of Supply and Demand. Lowry Research was honored in 2009, 2010, and 2012 as the Best Equity Research and Strategy by the Technical Analyst Magazine of London.

Paul is a Past President of the Market Technicians Association and is a Founding Member of the American Association of Professional Technical Analysts. .He was honored as the recipient of the prestigious Charles H. Dow Award, sponsored by Dow Jones & Co. in 2002 for his paper on 90% Upside and Downside Days, titled Identifying Bear Market Bottoms and New Bull Markets. He was also honored in 2009 as the Technical Analyst of the Year by the Technical Analyst Magazine of London.

LOWRY RESEARCH CORPORATION
Founded 1938

11300 U.S. Highway One, Suite 400
Palm Beach Gardens, FL 33408
Phone: 561-799-1889
Email: info@lowryresearch.com
www.lowryresearch.com
www.lowryondemand.com
www.lowryglobal.com