Volume: 1 Issue: 11 *June 22, 2010*

The Deviant Standard

Rigorous preparation for volatile markets

Summary

While a 500 point down day would have been more convincing, Tuesday's trade went according to the bears' script and the expectations we outlined. While those expectations continue to consider the possibility that more upside correction is possible before a turn back down, Tuesday tilted evidence in favor of the scenario where downside has resumed in wave [3] of 3 of (1) of [3].

Markets on Tuesday

Markets turned down on Tuesday and confirmed both the interpretation of Monday's high as a completed move up and our short-term interpretation of the market. Indices closed near their lows with the Dow just above a 38.2% retracement of its move up and about 50 points below its 200 day moving average. Volume was slightly higher than on Monday, but that isn't saying too much.

NYSE breadth was negative with 673 advancers and 2443 decliners. What's worth looking at is some breadth-derived measures shown in Figure 1. In the past two days The McClellan Oscillator has crossed below the overbought line, down from its highest level in over a year. Even more notable is that it is now at only 3.98, since value below zero mean that the McClellan Summation Index would turn downward. Once this indicator turns solidly, it tends to be fairly persistent in one direction or the other and represents medium-term turns in the market. It may flirt above and below the zero line for a bit before it turns solidly, if it turns solidly.

On the same chart, the top pane shows the 10- and 30-day averages of the advance-decline line (in while and magenta, respectively). Both have turned down. We'll want to see lower highs to mark continued weakness.

Figure 1 - Breadth Derivatives

Yesterday we showed a daily Ichimoku cloud that told us that prices were at significant resistance. Today, we'll look the weekly chart in Figure 2. The crossing of the purple and yellow lines is a leading indicator of a change in trend and now these lines are weak resistance on the daily chart. Since prices remain above the cloud, the longer term trend cannot yet be considered down, but this is a warning sign, as is the daily cloud. In combination, they tell us that first support is at the weekly cloud, currently in the 9,700 area. The bottom of the cloud also can offer support at around 8,600. Below that and the longer-term trend would be down.

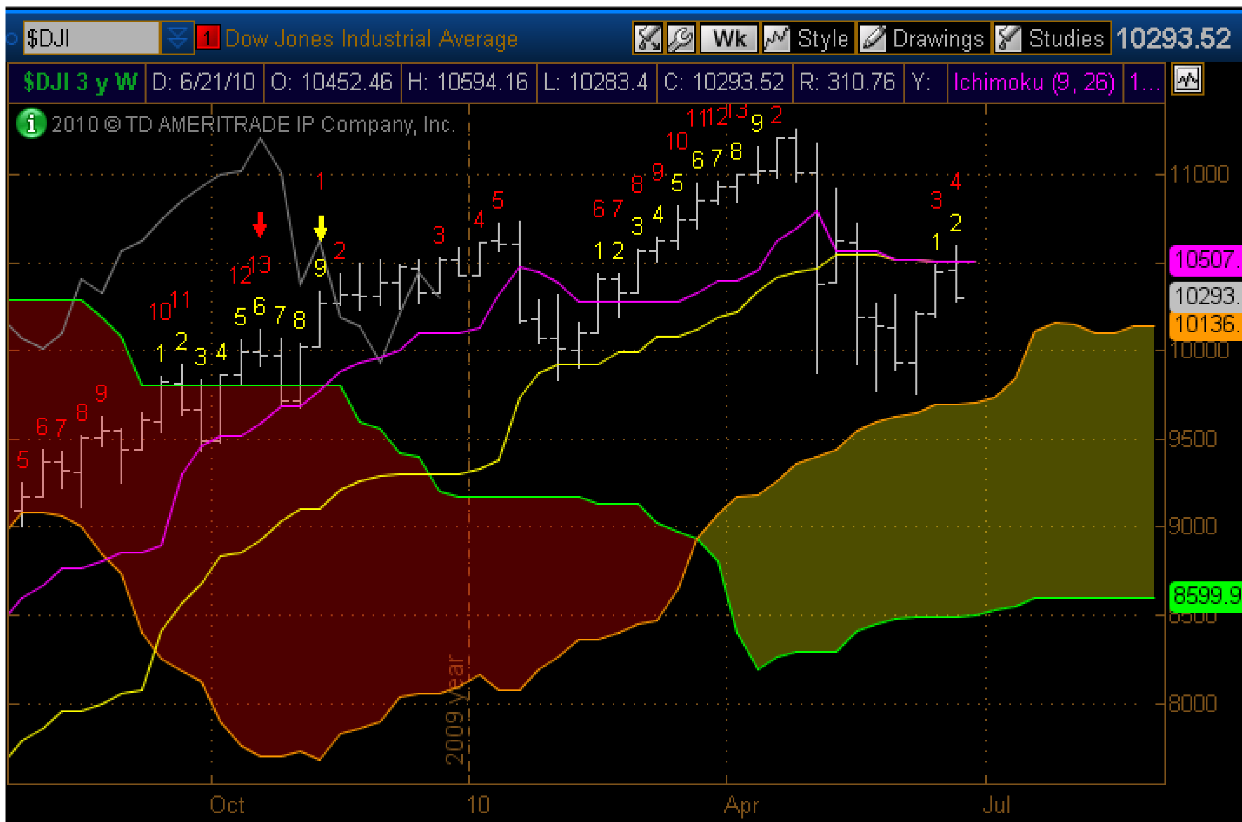

Figure 2 - Weekly Ichimoku Cloud for the Dow

Figure 3 shows a 30 minute chart of the Dow and we can see that it clearly broke below the trendline up from June 8th lows. This is the first of several milestones we were looking for to gauge the markets progress downward and assess the likelihood at we've resumed a downtrend. Other milestones hit:

- The Dow breaks the peak of wave iii of (iii) at 10,328 to rule it out as the top of a first wave in some alternate wave count;
- The Dow broke below the lower adaptive channel band on the hourly chart;
- The adaptive channel remains pointed down on the hourly chart. It is not yet pointed down on the daily, but price has crossed below the center line;
- 30 minute EWO reached -93.8 making it highly improbable that this is a fourth wave within five waves up; and
- 30 minute MACD has crossed below 0, we now want to see it turned down from the 0 line on bounces.

Our 30 minute chart also shows an attempt at a current count, but there are several possible counts at this juncture. The most important question isn't the proper count, it's whether or not we're currently corrective or motive. I've seen some proposed counts that show Tuesday's low as a completed zig-zag correction. While it's possible at a 38.2% retracement, the divergences simply aren't there to make it likely.

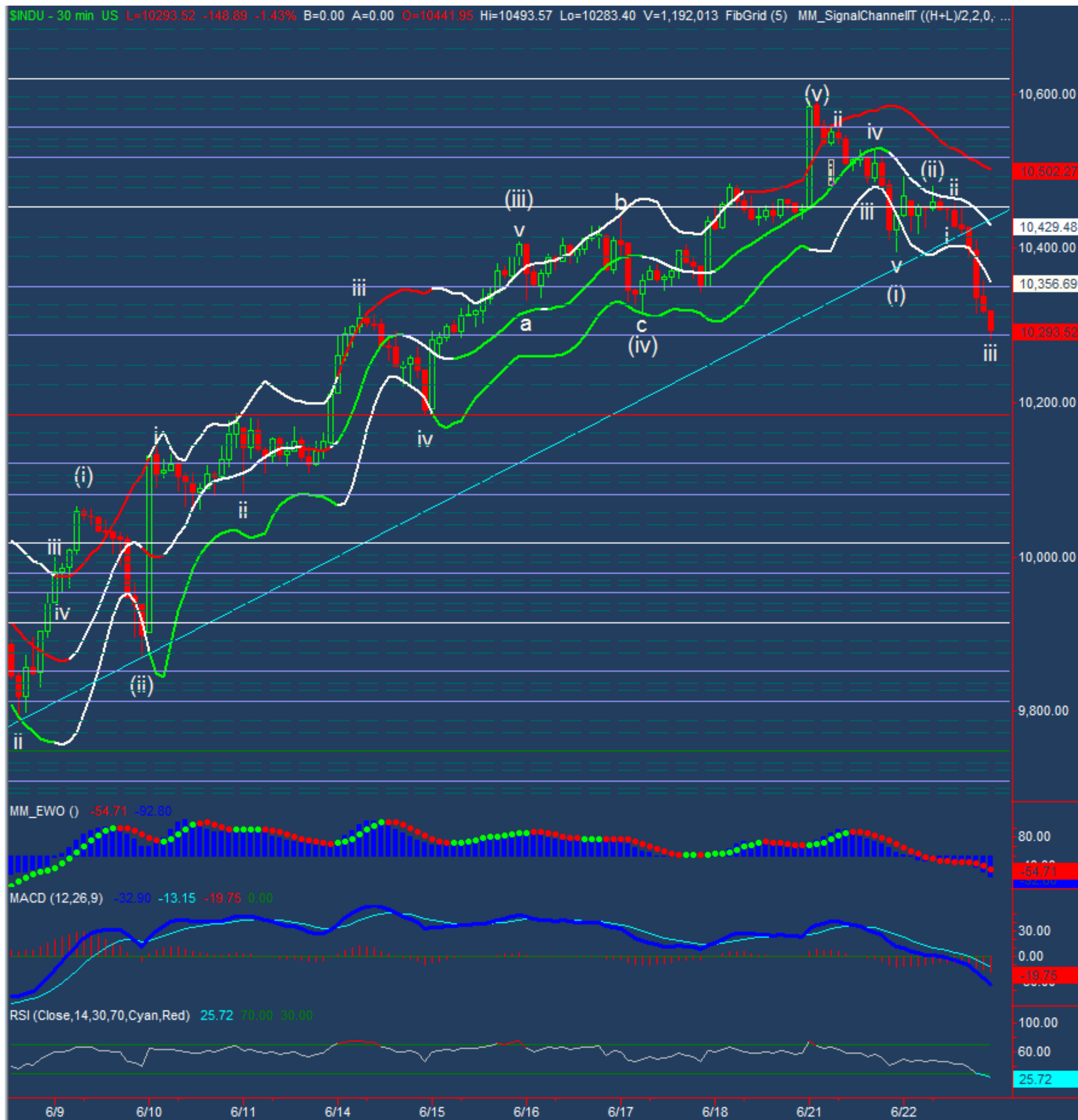

Figure 3 - Dow 30 Minute Chart

Outlook for Wednesday

Our greatest risk isn't being wrong, it's being complacent. After a Monday that unfolded as we expected, it isn't uncommon to feel like we own the market going down and to become emotionally invested in continued downside. Even though we said at the time that the down move might be temporary, because we predicted the move it can serve to reinforce a bias toward believing the market will go down. Therefore these are times to

be even more vigilant in looking for clues that about the direction and to make judgments based on the evidence and take action based on sound risk management.

As cited above, the current move down doesn't show any signs of being over. Trade above 10,395 (or presumed wave (i) would be the first warning that we might be wrong. Note that this isn't conclusive since we don't know that was a wave (i) and wave (iii) can overlap its range until it is complete. Trade that remained above the 10,453 snowline would cause trouble for a impulsive downside count and trade above 10,492 would virtually invalidate the possibility. Based on everything we're seeing, these events seem unlikely. Of course that's why it is especially important to guard against these occurrences.

Wednesday is Fed day and just about anything can happen. Since trade pretty much went to plan on Tuesday, refer to Monday evening's comments for keys to look for in this move.