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Divergent Logic

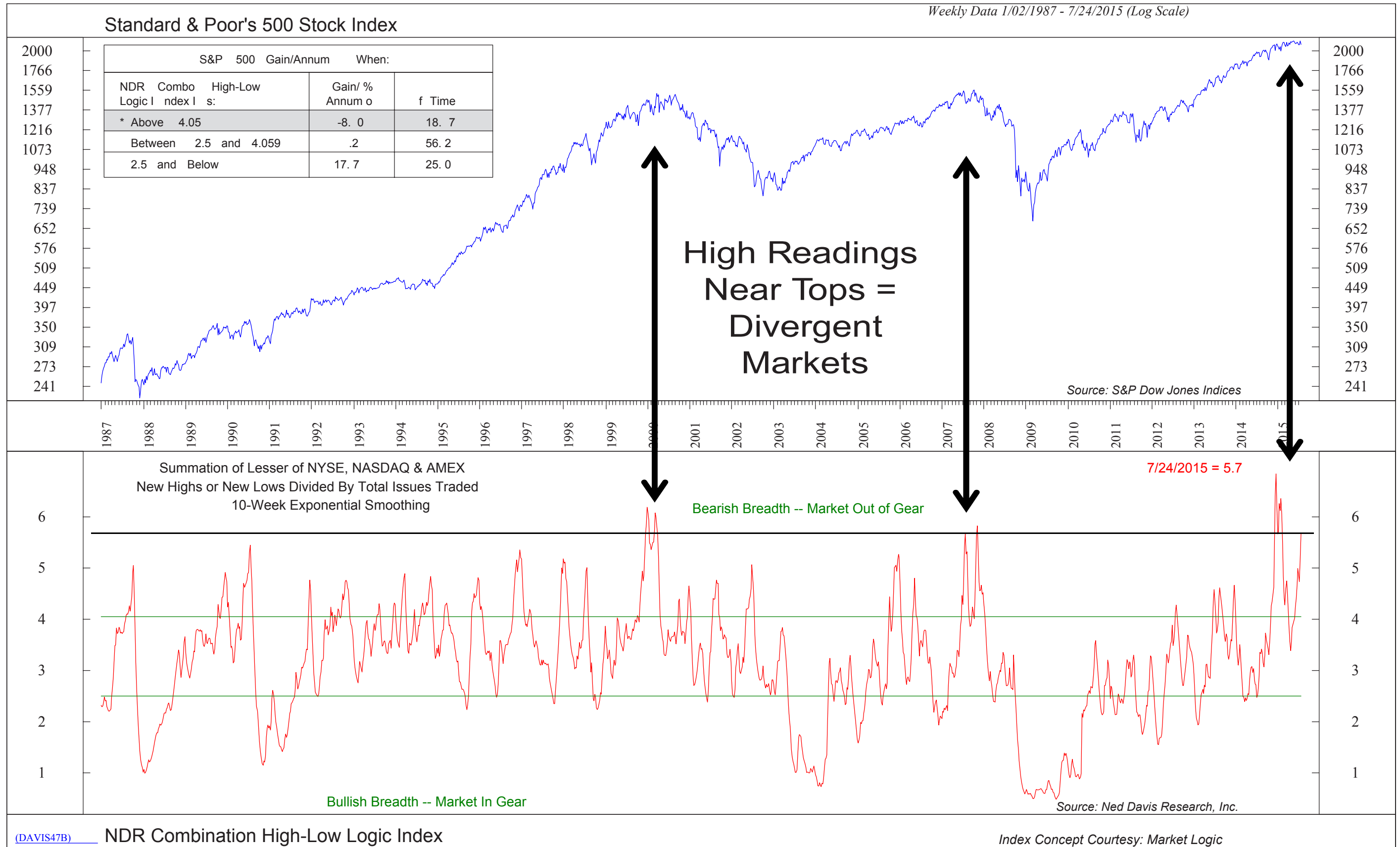
Late last year, our newsletter discussed a lack of logic as a marker of mature, late-stage bull markets. Market tops tend to be long, drawn-out affairs, frustrating investors trying to make sense when sense is not rewarded. We discussed the combination of underperformance by active managers and a six year bull market leading many to just invest in the indexes and go along for the ride. Our fear then and now is that the financial markets seem to have a way of punishing this type of investor complacency.

We are big believers in the efficiency of free markets (and big users of index funds), but at market tops and bottoms, behavioral impulses may depart from common sense. Market "irrationality" can last longer than you might think, especially in topping markets, exasperating anyone seeking logic. A typical pattern of these attenuated tops is what market analysts may refer to as divergences. What is a divergence and why should we care?

One illustration of market divergences can be found in the high-low logic indicator, developed in 1979 by Oregon-born Norman Fosback, set forth in his classic book Stock Market Logic. The indicator looks at weekly new highs and lows in the U.S. stock market and divides the lesser figure by the total number of issues traded. The underlying concept is that market health depends on all sectors of the market being in gear, moving in the same direction. Clearly, a strong market will have all economic sectors and as many stocks as possible moving in a broad advance. Less obviously, almost all stocks falling in concert also is a good sign because it is typical of the panic near market bottoms.

The trouble comes when components of the market are moving in different directions. Think of the peak of the technology bubble in 1999-2000 when a few technology stocks like Cisco, Oracle, Sun Microsystems, Microsoft and Intel drove the market indexes to new highs for two years after the average stock peaked and started to decline in price. Strong financial stocks also masked underlying weakness in the 2007 market top. When the lesser of new highs and new lows reaches a significant level of all stocks traded, it is a sign of divergent moves under the market surface. The chart on the next page shows a version of the high-low logic indicator from Ned Davis Research, Inc. Unfortunately, the indicator is at levels similar to the market tops in 2000 and 2007, each preceding a significant market decline.

While there is no assurance the past will repeat, current levels have been consistent with market declines. Additional evidence of a narrowing market advance comes from the fact that just six stocks (Amazon, Apple, Google, Facebook, Gilead Science and Walt Disney) accounted for more than all the gain in the S&P 500 index in 2015 (as of late July). Despite



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recent highs, the index is down for the year if you take out only six of 500 stocks. Six stocks also account for more than half the market value added in 2015 by the Nasdaq Composite Index (the same if you switch Netflix for Disney).These are not indications of market health, at least for the U.S. Ned Davis also calculates the highlow logic indicator for 46 foreign markets and the readings outside of the U.S. are more benign.

Sigma does not believe in "magic" indicators, and the high-low logic index is just one of hundreds of indicators we use in our market analysis. Despite the signs of internal market divergences, we continue to be neutral in our stock-bond weightings, at least for now. At every major market top, there is a plausible-seeming argument about how things are different from the past. Quantitative easing by the world's central banks, and accompanying consistent corporate stock repurchases, provide tailwinds to this market that were not there in the past. Still, our job is to imagine the unimaginable on behalf of our clients. A bull market and tripling prices has led to substantial complacency among investors. Combine that with increasing internal divergences within a stock market priced for perfection, and we are fearful that anything less than perfection in reality could lead to conditions that will shatter complacency.