

>: NYSE Bears at 76-year High!

Thursday, May 31, 2007 | Chris Rowe

HAPPY THURSDAY, FOLKS!

This month, the level of short selling on the NYSE - when traders sell borrowed stock in anticipation of a decline, in order to buy them back at lower prices to profit from the difference - jumped to 3.1% of the total shares (*the highest since at least 1931, according to Bloomberg*).

In other words, investors are making some seriously heavy bets that this market will trade lower. As you might already know, this is a *contrary* technical indicator.

What you have to consider is that when there is so much short stock out there, they have to cover (buy the stock back) at some point, which would cause the market to move up. When NYSE short interest is at record levels like it is today, the question always becomes: When they cover their shorts, will the buying pressure cause the market to move up MORE, or will the market move BACK up (after first taking a dip lower)? In other words, will some positive news announcement cause the market to move higher, forcing the bears to buy back their short stock in order to limit their losses, which would in turn, cause a rapid spike in this already overbought market? Or will some very negative news announcement cause the market to decline, which would put the short-sellers in a profitable position?

What we have to remember when it comes to the second scenario, is that in order to actually realize a profit from a stock market decline, the short-sellers still have to buy back the stock that they sold short. So what I'm saying is that it would be hard for this market to move a heck of a lot lower, or at least to STAY much lower, since there is all of that short-stock just waiting to be bought back.

I personally don't try to predict the direction of the general market (S&P500, Dow 30, Nasdaq etc.). Instead, I mainly buy in-the-money call options on stocks in the strongest sectors, and in-the-money puts on stocks in the weakest sectors. Whatever direction the current trend is (currently, it's up), that's the direction that the majority of my positions will bet on. In other words, I currently have more bullish positions open than bearish positions.

But it's important to know what's going on with market internals to gain a strong perspective on what's happening in the stock market so that you are not confused when the market changes direction. If you have a strong grip on what's going on, you will feel confident if the market corrects itself, instead of flustered.

So what's going on?

The NYSE, Nasdaq and S&P500 **Bullish percent charts** are all showing that we are overbought.

These charts are breadth and risk indicators, not directional or timing indicators.

So we know, based on them, that the risk is considered high. (If over 70% of stocks are already on buy signals, there are not many left to join the party.)

Now let's consider sentiment readings, which are typically contrary indicators. When there is excessive bullishness or bearishness, the opposite usually happens.

The Investors Intelligence Advisors' Sentiment reading:

When over 55% of advisors are bullish, it is actually considered to be a bearish sign. When 60% of advisors are bullish, it means that there is way too much optimism, and there should be a pullback soon. Currently we are at 53.8%, down slightly from 54.3%, the reading of the previous two weeks.

When under 20% of advisors are bearish, that is also a bearish sign (not enough bears.) The current level is 21.5%, which is up from 20.7 a week and a half ago, and 19.6% for both of the two weeks before that. Although toning down recently, the optimism is very high. True... but it can get a lot crazier before a stock market correction.

Another Consideration:

Discount brokerage firms have been reporting that the average equity account holder (retail investor) has not been participating very much in this up market. The reason that I mention this is that this is the exact opposite of what you would see when the market has reached a top.

The CBOE put/call ratio:

Each day, the CBOE adds together all of the call and put options that are traded on all individual equities, as well as indices like the OEX, or S&P 100. They calculate the ratio by dividing the volume of put option contracts by the volume of call option contracts. A reading of 0.80 is considered normal. Higher levels indicate fear, and lower levels indicate comfort. We have been looking at excessive fear lately when it comes to this reading with the put call ratio around 1.0. This is usually what you'd see near a short-term market bottom. (This is also currently contradicting what the advisors' sentiment indicator is telling us.)

Are you getting all this? So far, that's one sentiment reading that indicates that we are approaching nosebleed levels and that we should look for a

pullback if it becomes much more optimistic. We see reports from discount brokerage firms that say "Johnny-come-lately" hasn't arrived to the party yet. And a third options-based sentiment indicator that shows that investors are actually not very bullish (which is actually a bullish indication).

Buh, buh, buh . . . Wait, there's more ...

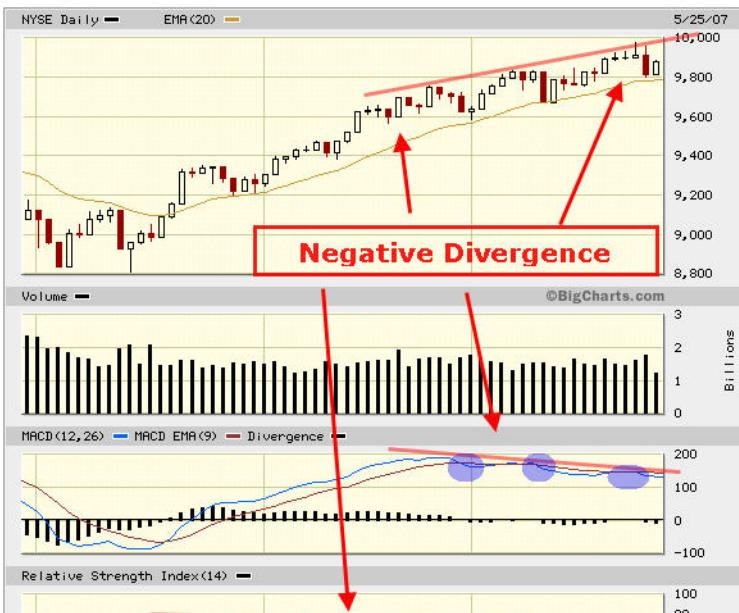
Momentum Indicators:

The MACD and the RSI are telling us to be prepared for a quick dip to the downside. You can see in the charts below that both indicators made lower highs while the markets made higher highs. This is a negative divergence which usually tells us to either sell your long positions, hedge your bullish positions, or be on the lookout for a drop in prices.

This first chart is of the S&P500, and you can see the negative divergence which occurred leading up to the correction in February. Although it's not marked here, you can see it starting to happen again. Keep in mind, that there is no Holy Grail to trading. I mean, if you traded based strictly on the negative divergences seen here, you might have stayed out of the market from late November to early December through mid-March. (But you would have been out before the correction, and back in near the bottom.)



These next charts are of the NYSE, the Nasdaq and the Dow 30. You can see the negative divergences and sell signals in all three of them (especially the Nasdaq, which is usually the index where we prefer to see the most strength when we are bulls.)



low for very long. So if the market were to tank right now, I would wait until the VIX was up over 20, to start buying, and then when the MACD and RSI turned back up, I'd buy a lot more.

And then, of course, there's the cyclical/ seasonality factor. The old "Sell in May and go away" saying comes to mind. This only applies to the larger indices (Dow 30 and S&P500.) The Nasdaq version is "Sell in June, and ... um... go, away."

Anyway, there are numerous other technical indicators that I use, and frankly, there are probably an infinite number of them out there. You probably won't ever see 10 of your favorite technical indicators saying the same exact thing, so the way to play it is to:

1) Play the market based on what the majority of the indicators are telling you. What if it's about even? That brings me to ...

2) Manage your account properly. This means that you can either take the "when in doubt, stay out" approach, or you can hedge your bets by betting against the weak stock in weak sectors, and bet in favor of the strongest stocks in the strongest sectors. (I find that using options works best here because you have less downside than with stock.) You can even do a combination of the two: reduce your exposure to stocks, and take a more conservative approach until the picture becomes clearer to you, and most indicators are saying the same thing.

Indicators do just that: they indicate. The direction that the market is currently in holds a tremendous amount of weight, and most professional traders will tell you that the trend is your friend. But when the contrary indicators start to flash, you have to also remember the saying, "He who follows the crowd will never be followed by the crowd." I personally don't feel the need to be the first person to recognize the trend, but instead, I wait until a trend is confirmed before taking action.

In my humble opinion, market tops are much harder to call than market bottoms. But if this market drops, remember that the NYSE short interest is at record highs, and those short-sellers have to cover some time. Conversely, if the market sky-rockets, there will be lots of short covering (*aka* a "short-squeeze") which means that you should expect a decline shortly after, as much of the buying will be from the exiting of bearish positions as opposed to new bulls.

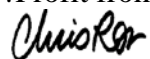
Every professional trader knows about this situation, and therefore, it might feel like stock market musical chairs. The bears may get trigger happy here when they consider the fact that the room may be too crowded to be able to squeeze through the doorway when it's time to cover.

So, um, Chris... Which way is the market going to go?

Don't know, folks. Sorry. (See number 2, above.) I figured that if I couldn't give you a strong opinion today, then at least I could give you some perspective.

See ya next week.

?Profit from the Trend?



Chris Rowe

Chief Investment Officer

≥