<u>GLOBAL MEDIUM TERM DIVERGENCE PERSISTS</u>

by Alan Hull

This discussion focuses on the medium term momentum divergence seen on the weekly charts of U.S., U.K. and Australian indexes. And the best place to start this discussion is to go back to late last year when global markets all looked very toppy at the start of October.

At this time I was expecting a major reversal to occur but then Ben Bernanke announced QE infinity on October the 9th (*he said he would hold interest rates down indefinitely and increase the Fed's Bond buying program as circumstances dictated*) and global markets collectively broke into another upside rally. The question is; was it a renewed rally or an extension rally?

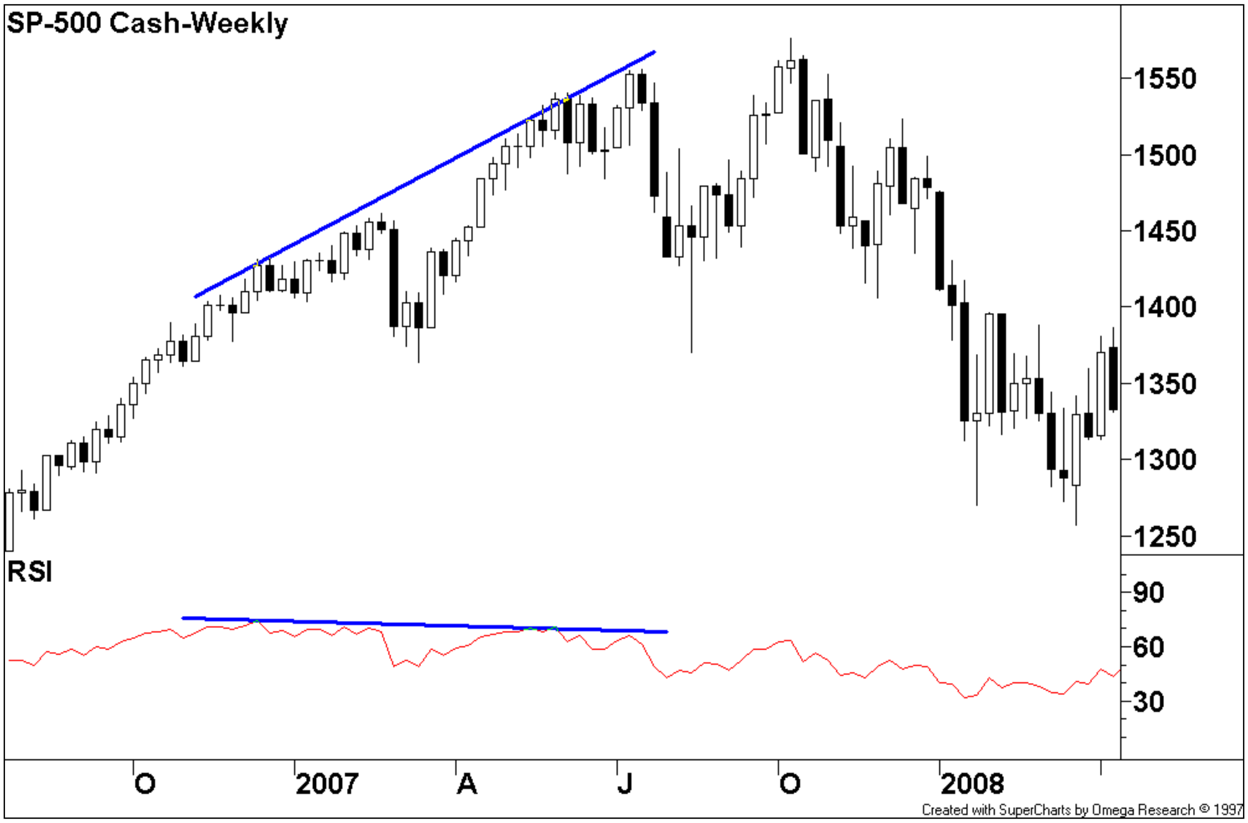
This is an important question because if it is/was a renewed rally then right now we should all be fully committed to the long side of the market and any previous analysis suggesting a possible market reversal should be summarily dismissed. So was it a new dawn or not and how do we tell the difference? One way to determine this is by looking for divergence.

To explain what divergence is, I first need to introduce you to the concept of momentum where we look at not only the direction of markets but also the speed at which they move. Then we will go a step further and look at momentum divergence which has some predictive capability.

To measure the speed and acceleration of a market we commonly employ a momentum oscillator called the 'Relative Strength Index' (RSI). The construction of the RSI indicator is a bit technical but suffice it to say that it measures the rate at which a market rises or falls and normalizes the result over a range of 100.

Once you've gotten your head around the idea of momentum we can then progress to the next level which is the concept of momentum divergence. Thus, when a market moves higher we normally expect to see the RSI indicator move in step with it, moving higher as well.

But if a market makes a higher high and the RSI indicator makes a lower high then it is said that there is momentum divergence. And this is often a leading indication that a trend is coming to an end. Take for instance the following examples of the SP-500 and the All Ords in 2007.



SP-500 Cash-Weekly
1550
1500
1450
1400
1350
1300
1250
RSI
90
60
30
O
2007
A
J
O
2008
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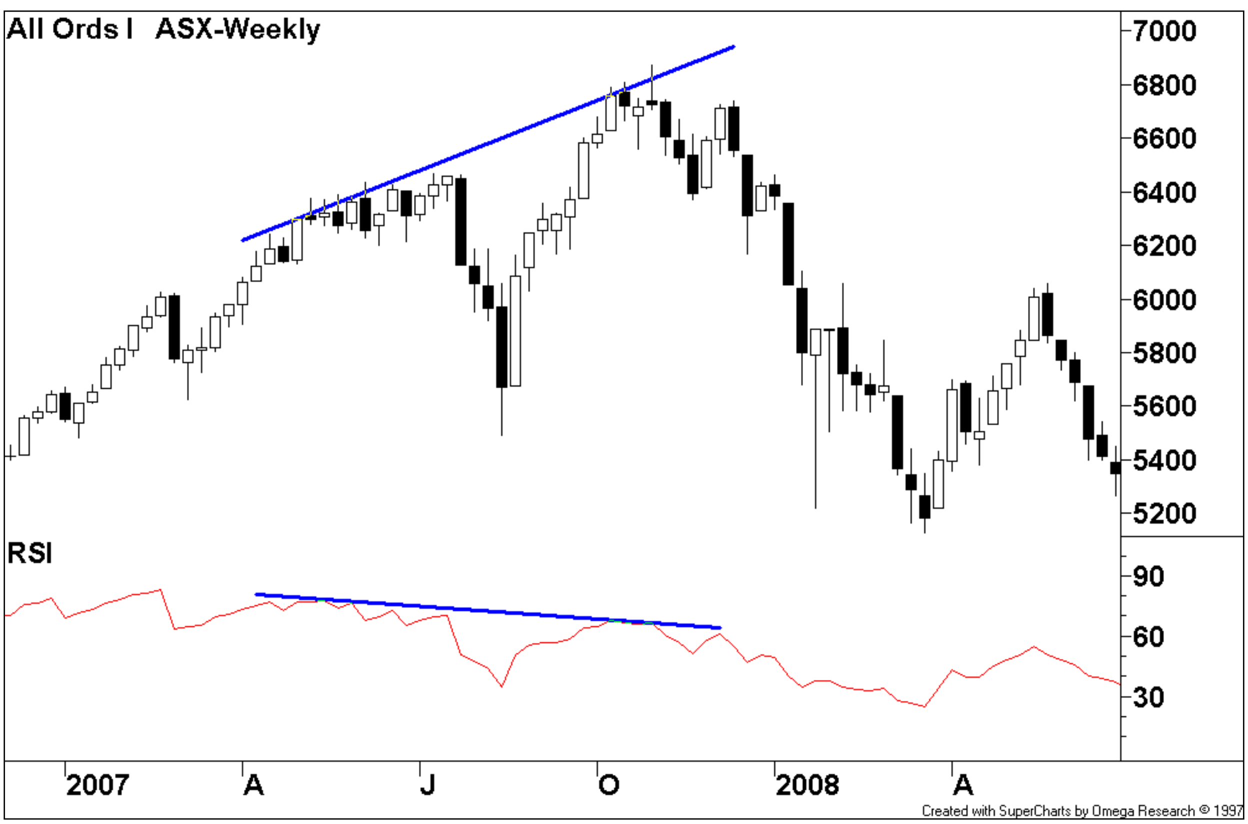

All Ords I ASX-Weekly
7000
6800
6600
6400
6200
6000
5800
5600
5400
5200
RSI
90
60
30
2007
A
J
O
2008
A
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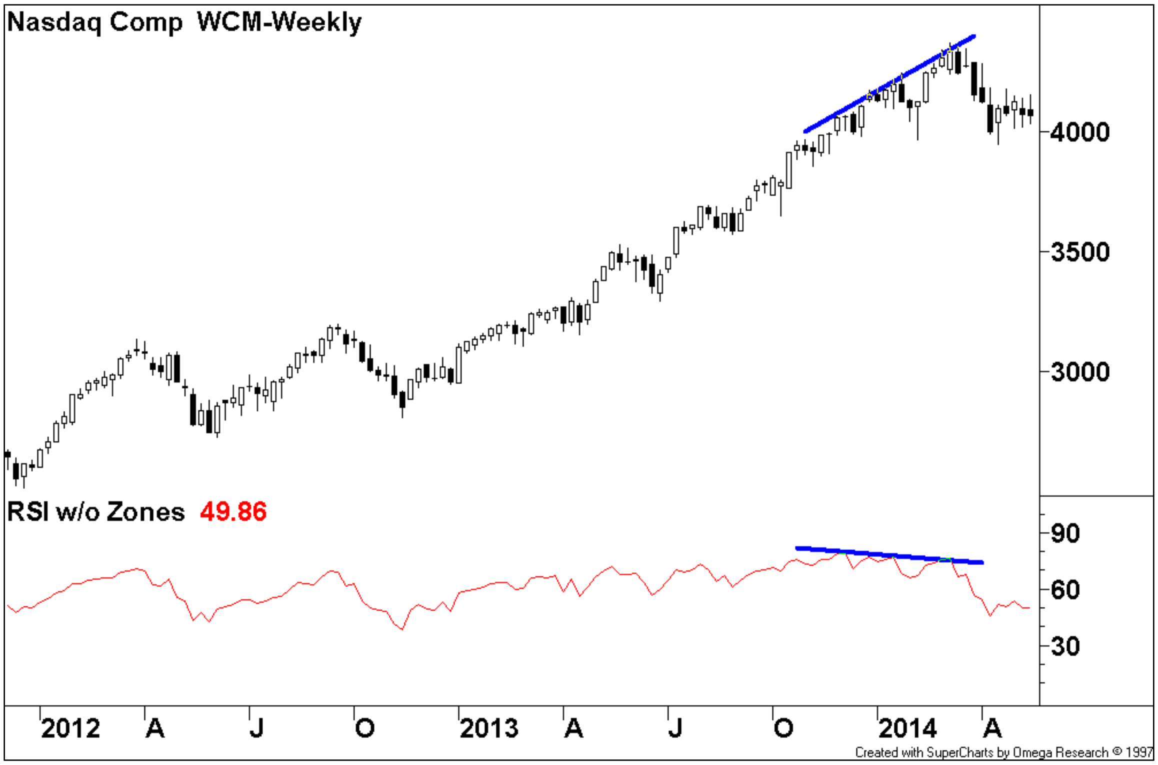
In the above charts, the blue lines tell the story of divergence as the SP-500 and the All Ords indexes made higher highs in the lead up to their peaks in late 2007 but the RSI indicator (the red line at the bottom of each chart) made lower highs in both cases. A signal not to be ignored and one that's extremely effective when applied to the All Ords, as seen in the next chart.

When applying this technique to the All Ords we see that it worked in 2007, 2009, 2010 and early 2011. Now looking closely at the right hand side of the previous chart and you'll note that what we are currently seeing is a period of momentum divergence that is simply lasting a lot longer than the previous instances. <u>And this is important because if we were looking at a renewed rally then the momentum divergence signal would have been invalidated.</u>

But it hasn't been invalidated on the All Ordinaries index and nor has it been invalidated on any of the U.S.'s major indexes either. In fact momentum divergence was a successful leading indicator of the March correction on the NASDAQ which can be seen in the first chart below.


Nasdaq Comp WCM-Weekly
4000
3500
3000
RSI w/o Zones 49.86
90
60
30
2012
A
J
O
2013
A
J
O
2014
A
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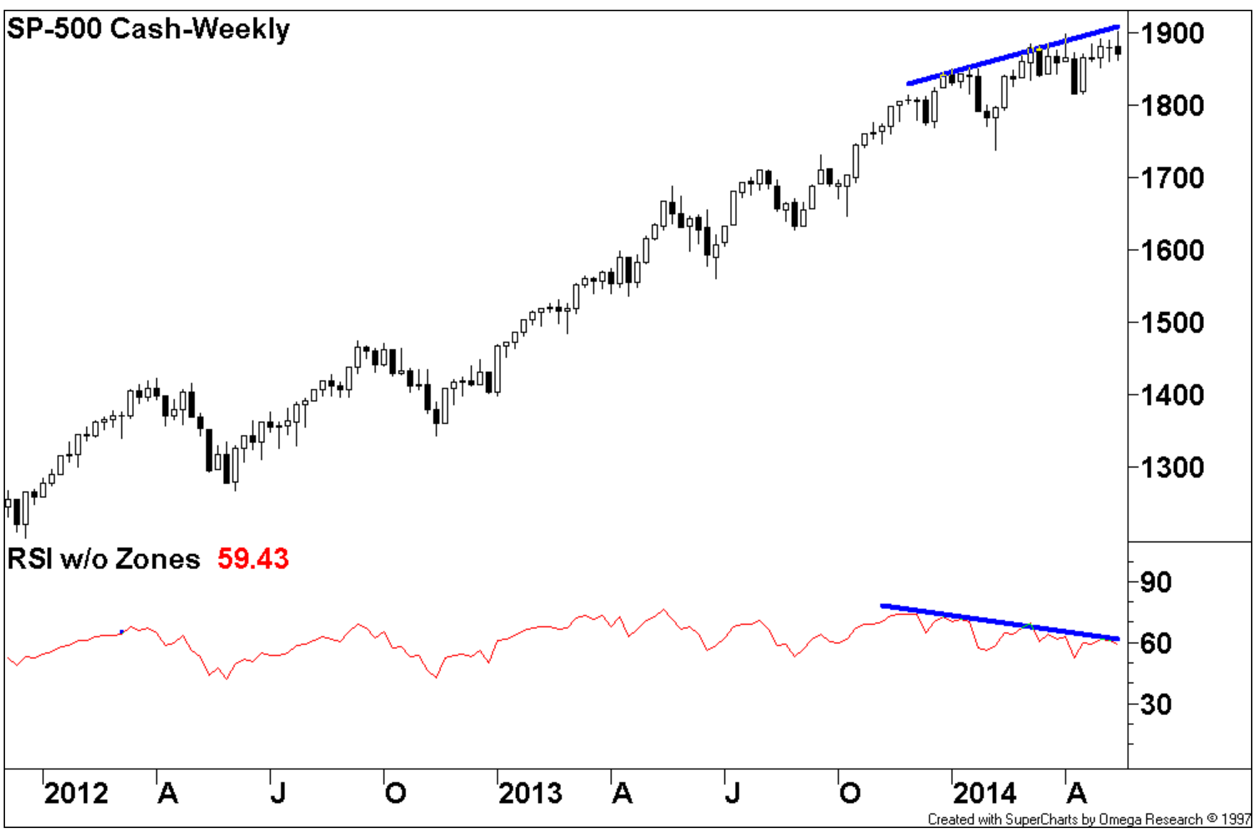
SP-500 Cash-Weekly
1900
1800
1700
1600
1500
1400
1300
RSI w/o Zones 59.43
90
60
30
2012
A
J
O
2013
A
J
O
2014
A
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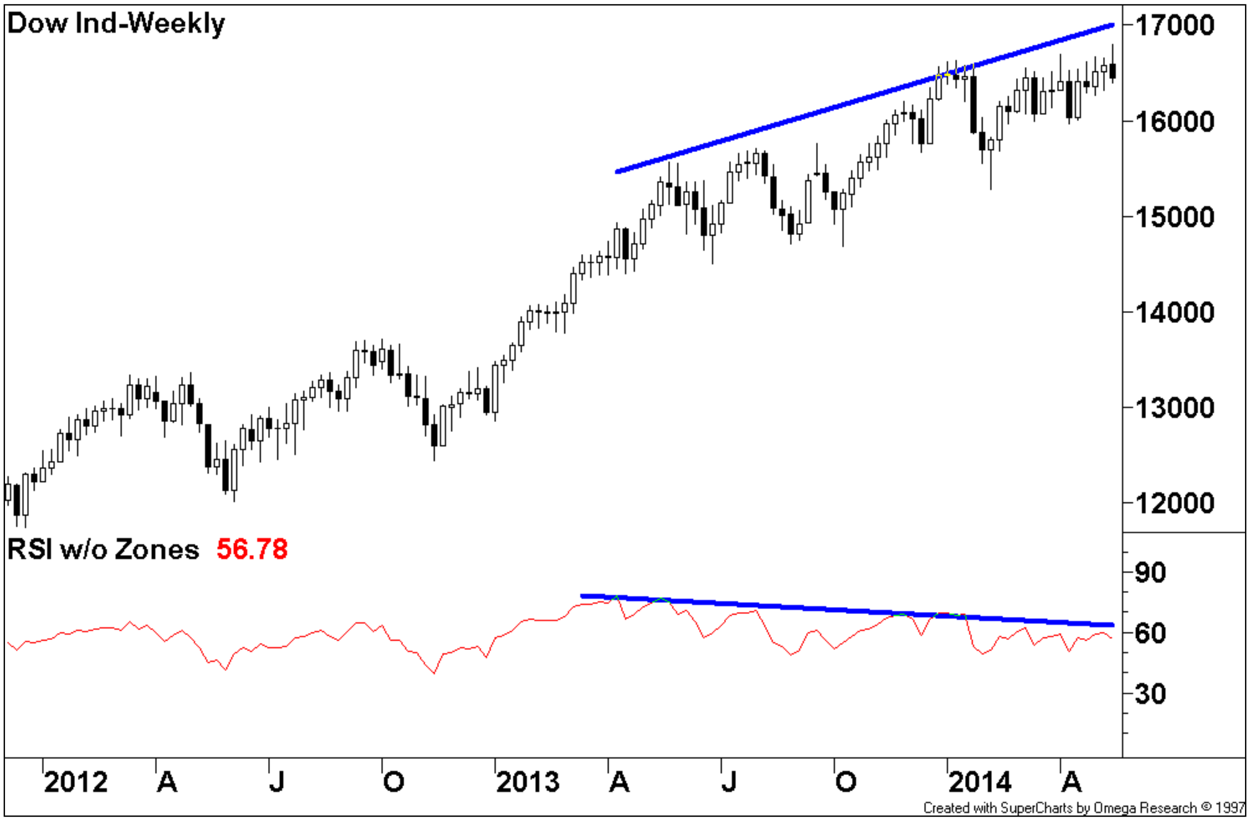

And finally below is London's FTSE100 index which is also diverging over the medium term.

There's undoubtedly a common theme here and not one of renewed market strength and enthusiasm for stocks. Markets continue to rise but momentum continues to weaken. So even though some markets may have made new highs, medium term divergence persists across many of our major global indexes and therefore we appear to be dealing with an extension rally rather than a new beginning. Thus, I continue to recommend the use of extreme caution.