# THE BERGE REPORT

**August 18, 2014**

**8/15/14 DJIA: 16662.92 +108.99**
**8/15/14 S&P 500: 1955.06 +23.47**
**8/15/14 NASDAQ: 4464.93 +94.03**

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## Capsule Summary of Stock Market Trends

**NYSE Primary Trend - Neutral/Bullish - Index Up 1 to +1**

The NYSE PTI gained a point last week because the year-to-year percent change in long-term government bond yields dropped convincingly below -10%. In addition, 30-year government bond yields fell to new lows for the year, reaching their lowest levels since May of 2013. Long-term government bond yields rose from May to September last year. This was a contributing factor to the three short-term corrections we saw from May to October. It looked as though the May-September period might be a distribution top, but once interest rates turned down again in September, it was off to the races again for the stock market starting in the second week of October. The short-term correction in January-February of this year was accompanied by falling interest rates, probably helping reduce the magnitude and duration of the correction. Interest rates have been in a downtrend ever since. While a correction should occur for technical reasons, declining interest rates will likely reduce the magnitude of the correction that would otherwise occur if rates were flat or rising instead of falling.

**NYSE Intermediate Trend – Neutral/Bullish – Index Up 1 to +1**

The NYSE ITI gained a point for the same reason the NYSE PTI did. The year-to-year percent change in the 4-week moving average of 30-year government bond yields fell to -12.8% last week. The DJIA has retraced a little less than half its decline from the July 16 high of 17138.20. The S&P 500 has retraced a little more than half its decline from the July 24th high of 1987.98. Neither of these declines was deep enough or lasted long enough to qualify as a short-term correction (5-10%), although the DJIA came close (-4.5%).

The market is now a little overbought short-term, having worked off the good short-term oversold conditions that accompanied the July 7th lows (DJIA 16368.27; S&P 500 1909.57). Oddly, as the market has bounced from the August 7th lows, the 10day TRIN ratio has risen with the market. Although not at a high enough level to be considered bullish, the 10day TRIN ratio ended last week at 1.229. At the July 7th lows, the 10day TRIN ratio was 1.170. This suggests that investors are more concerned about further weakness now, with stock prices up, than they were week before last, when the Big Board averages were at their lows. The AAII sentiment survey shows the opposite. Week before last, there were only 30.9% bulls vs. 38.2% bears. Last week, the bulls were 39.8%, the bears 27.0%. With the averages between the most recent highs and most recent lows, the short-term direction of stock prices is uncertain. In the absence of a correction deep enough to drive the NYSE ITI up into a strong neutral/bullish or fully bullish position, however, it is unlikely that last week's bounce is the beginning of a sustainable rally.

**NASDAQ Primary Trend - Neutral - Index Unchanged at 0**

The NDX managed to eke out a minor new high last Friday, closing 1.32 points above its 3986.19 close of July 23rd. The Composite Index is still about 20 points away from its July 3rd high of 4485.92. The last time the NDX led the Composite Index into new high ground, in June of this year, the Composite Index eventually followed. The fact that the NASDAQ PTI is neutral now, rather than bearish as it was at the July highs in the Nasdaq averages, reflects the fact that at least some progress has been made toward restoring the market's technical health even though the averages have only declined about 3-3.5% so far. Breadth-related indicators have taken a bigger beating than is reflected in the averages, and a few very short-term indicators were showing positive divergences at the July 7th lows. Another indicator that illustrates the decline that has taken place underneath the averages is the 10day ratio of new highs to new lows. It peaked at 15.2 back in March. At Friday's close, with the NDX in minor new high ground for the bull market, the 10day new highs/new lows ratio was .6. This is a negative divergence, to be sure, but at the same time, when this indicator drops below 1.00, it is oversold, which is potentially bullish.

As is the case with the Big Board, it is doubtful that the Nasdaq market has begun a sustainable rally. However, it certainly seems possible that whatever further correction we see is going to be less severe than we previously thought as far as the averages are concerned.

**General Market Comments**

In normal business cycles going back to 1960, the sequence of events has been as follows:

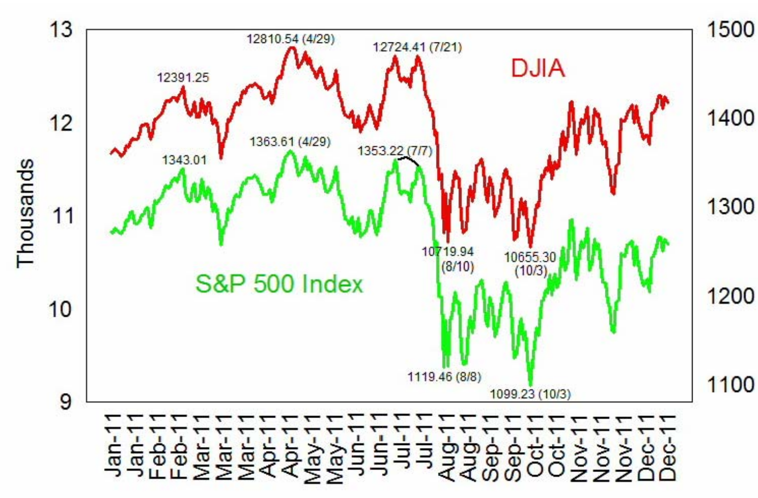
1. Interest rates decline as the economy weakens or is in recession, either because of Fed easing to fight the recession or because of weak loan demand, or both.

2. The stock market goes up as rates come down and investors anticipate stronger economic growth.

3. After a solid economic recovery is underway, interest rates start going up as loan demand increases.

It is the third step that is missing in action in the current economic "recovery." This is one of many factors making this cycle different from those of the past. While declining interest rates have provided fuel for the stock market, they have not done a whole lot for the economy. In an article entitled, "JOB = Just Over Broke" at zerohedge.com, it was stated that 50% of working Americans are living paycheck to paycheck and make less than $30,000/year. Meanwhile, the typical American household is worth 36% less than a decade ago due to two major factors: 1) taxes and 2) cost of living. Census Bureau data recently showed that 40% of households are under financial stress. This is far from a normal recovery.

The Chart below shows the DJIA and S&P 500 in 2011.




The 2011 correction lasted from late April to early October, but that doesn't tell the whole story. Both Big Board averages recorded their closing highs on April 29 and started to correct. In June, the market rallied back up but failed to make new highs. There was a slight negative divergence in July when the S&P 500 made a lower high against a slightly higher high in the DJIA. It was after that successful test of the April highs in July that the correction happened in earnest. It was essentially over in about 3 weeks. The total correction in the DJIA from April to October was 16.8%. The correction in the DJIA from July 21 to October 8 was 15.7%.

After the market developed extremely deep oversold conditions in early August, the market went through the normal sequence to form a good bottom (a sequence that has not, by the way, been seen since). The averages bounced and then came back down to produce a successful test in late September/early October with a broad range of positive divergences. It was because the bulk of the correction happened so fast that deep oversold conditions were generated along with a great deal of fear, both indicative of a good market bottom. Peak-to-trough, the correction lasted a bit more than 5 months, but the meat of it only took about 3 weeks. The reason for reviewing the 2011 correction is to illustrate the point that corrections are never as neat and clear when they are going on as they are in 20/20 hindsight. The Big Board averages made their highs in late April 2011 and their lows in early October. In-between a lot of things happened that are not captured by simply measuring the peak-to-trough decline in the averages.

Given the unanticipated improvement in our Indexes and the fact that long-term interest rates are now declining at a pace in excess of 10% year-over-year, it appears increasingly possible that the correction from the July highs is likely to prove less severe than originally thought. The direction of interest rates, though, is the key. Without a deeper stock market correction than has occurred so far, the market is not likely to be able to duplicate the 30%+ gains in the DJIA that have occurred from off-presidential election year bottoms in the past.

Susan R. Berge