



AKROS CAPITAL, LLC

Is Earnings Feast a ‘Tainted Banquet’?

October 26, 2009

“And I will tell you this, there is nothing more painful – ideologically and psychologically – than being at a banquet thinking that the food is tainted and watching everybody else have a grand old time. It can be a little tough. But if you have strong suspicions about the food, you may feel better than they do in a day or so.”

– Arthur Cashin, Director of Floor Operations, UBS Financial Services

As investors digest the recent slew of corporate-earnings reports, the general tone so far has been positive. More than 80% of major companies have managed to “beat expectations.” However, faint warning signs have begun flashing to suggest the food may be tainted.

McClellan Summation Index

Chart 1 below shows the McClellan Summation Index, with the McClellan Oscillator in the upper pane and the NYSE Composite Index in the lower pane. Note that the Summation Index did not confirm the recent “Dow 10,000” highs in the stock market. Instead, it ignored the entire rally from the October 2nd low before heading down again last week.

The McClellan Summation index is an important market-breadth indicator. It is constructed as the cumulative sum, or “summation,” of daily readings on the McClellan Oscillator. The failure of the Oscillator to push conclusively above zero has generated a string of negative readings that, in turn, has caused the Summation Index to move lower and remain below its red signal line. This has resulted in a negative divergence between the Summation Index and its associated market index, the NYSE Composite.

Two green lines have been drawn on the chart to point out the negative divergence. We see that similar divergences occurred two previous times during the rally from the March lows – once from early May to early June, and once during August. Both divergences were followed by market corrections, although the August/September pullback was fairly weak.

Dow Jones Transportation Average

If market breadth is weakening, then we should be able to find a market index that reflects the weakness. A good example is the Dow Jones Transportation Average, which is shown in Chart 2. This chart provides a textbook illustration of a topping pattern.

First, in terms of price action, notice how the Transports broke down out of the bearish rising-wedge formation delineated on the chart in green. Following the breakdown, the average sold

off for several days to around 3,655 and then rallied to above 4,000 to backtest the lower boundary of the rising wedge. The breakdown and backtest points of the trend line are labeled on the chart. If you look closely, you can see that the average also backtested the trend line during each of the two trading days immediately following the breakdown. The broken trend line now is functioning as resistance and is maintaining its authority by successfully turning back any attempts at upside penetration. The Transportation Average is marginally below both its 20-day and 50-day moving averages, which also will begin to provide resistance unless that situation is quickly reversed.

Second, momentum has weakened considerably. Both RSI and MACD have generated negative divergences with the price chart as indicated by the purple lines in the upper and lower panes. (These downward-sloping purple lines “diverge” from the higher peaks made by the Transportation Average.) In addition, RSI has pushed below 50 and MACD has crossed below its red signal line to produce an inverted bar on its histogram.

Third, the volume histogram confirms that distribution is taking place as informed sellers carefully unload their stock to eager buyers without moving prices down too severely. The tall red bars and clusters of red bars forming multi-day towers are telltale signs of distribution.

The Transportation Average, of course, is an important gauge of overall economic activity. If salesmen aren't traveling and business deals are not getting made, and if raw materials and goods are not being shipped, then the economy is not going to be strong going forward.

So, if the Transports are in fact telling us something, its chart can be expected to show follow-through to the downside. The Transportation Average will break below its key support level of 3,655 shown in orange. RSI will push below its previous trough near 35, and MACD will move below its zero line. If such developments were to occur on strong volume, then things could get interesting. Unless or until such follow-through occurs, however, the early weakness in this chart should be viewed with appropriate reservation.

S&P 500 Index

Weakness in the broadly based S&P 500 Index has been much milder than for the Transports, as can be seen in Chart 3. So far, the index is holding above its moving averages, and the lower boundary of the rising wedge has not provided significant resistance. The momentum indicators, RSI and MACD, have diverged from the price chart, and MACD has registered a bearish moving-average crossover. However, RSI is holding above 50, and MACD did not test its zero line at the October 2nd low. Most notably, the volume histogram does not indicate as much distribution as we saw in the Transports.

If the early-warning signals flashing in the McClellan Summation Index and Dow Jones Transportation Average are valid, then additional weakness eventually will manifest itself in the major indexes.

Investors will continue to feast on earnings this week. If the food is tainted, the sounds of distress may soon be heard.

Chart 1. McClellan Summation Index



Chart courtesy of StockCharts.com

Chart 2. Dow Jones Transportation Average



Chart courtesy of StockCharts.com

Chart 3. S&P 500 Index



Chart courtesy of StockCharts.com

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