Baird Market and Investment Strategy

Market Commentary

August 2, 2018

Please refer to Appendix – Important Disclosures.

Breadth Mixed as Concerns Have Yet to Be Resolved

Key Takeaways: Despite some evidence of improvement on the recent rally, the health of the broad market remains in question. The NASDAQ Composite made new all-time highs in July, but they come with deteriorating breadth support. The S&P 500 has seen some breadth improvements, although the cap-weight index continues to lead its equal-weight counterpart. Global breadth trends have moved away from bearish territory. Investor sentiment, meanwhile, remains neutral.

The NASDAQ Composite made new highs in July, but these gains came as upside participation dwindled and momentum remained lackluster. The July peak in the NASDAQ Composite came with only 50% of the stocks in the index trading above their 50-day averages (down from 70% in June) and only 55% even trading above their 200-day averages (down from 60% in June). Those percentages shrank as the NASDAQ pulled back from its peak, and the number of stocks making new 52-week lows expanded over the second half of the month. The NASDAQ has pulled back to support near the convergence of a rising trend-line and its 50-day average. A further deterioration in the breadth indicators (toward their April lows) could make holding index-level support difficult especially if momentum does not improve.

Source: StockCharts

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While NASDAQ breadth has struggled as the index made new highs, there is evidence of improving breadth trends when looking at the S&P 500. The July rally on the S&P 500, which carried the index to within a couple of percent of its January peak came as both industry group and sector-level trends improved (we update these weekly in Monday-mornings [Market & Sector Trends Summary]). Issue-level trends also improved and the percentage of stocks trading above their 200-day averages has risen above its June peak. Clearing the February/March high on this indicator (near 70%) would be important evidence that index-level gains are garnering broad support.

Source: StockCharts

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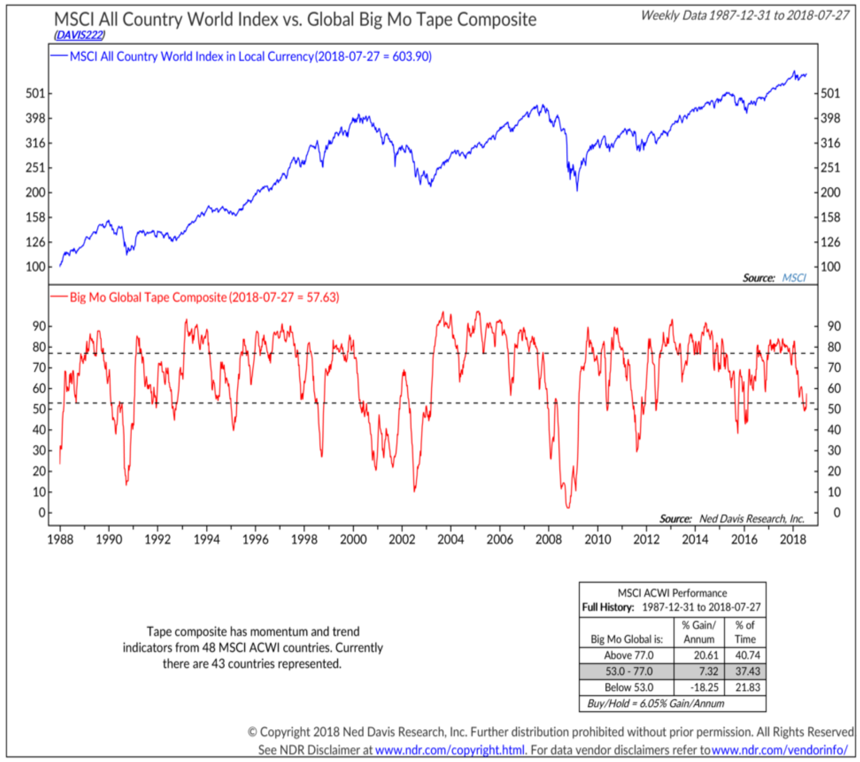
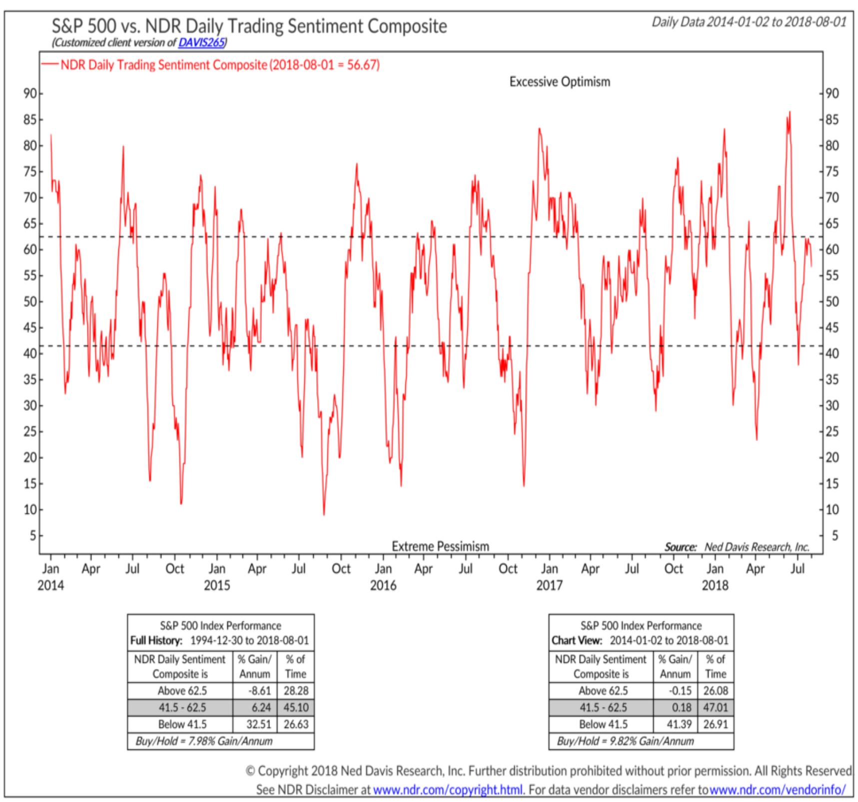
Another way to consider the health of the rally is to look at equal-weight indexes. The idea is to reduce the outsized effect of a handful of mega-cap stocks and get a better sense of how the average stock is faring. From a price trend-perspective, the equal-weight S&P 500 does not look dramatically different from the more familiar capitalization-weight index. $SPXEW has rallied to its highest level since January, but momentum has been lacking on the latest price rally. Even with the absolute price gains, the equal-weight index continues to trend lower relative to the cap-weight index, breaking below the 2016 low and reaching its lowest relative level since 2012.

The global breadth back drop remains challenging. The global breadth composite (Global Big Mo Tape Composite) tracked by Ned Davis Research shows that while the question domestically (outside of the NASDAQ) is the extent to which breadth has improved, the global question is the extent to which breadth has deteriorated. After briefly flashing a sell signal, this global breadth indicator has stabilzed and is back in the neutral zone. While U.S. indexes are challenging their 2018 highs, many of their global counterparts are in negative territory for the year (among the worst performers is the Chinese Shanghai Composite, which is down more than 16% in 2018). Global breadth improvement would lend important support to U.S. markets.



Source: Ned Davis Research



Source: Ned Davis Research

While the health of the broad market has garnered much attention, recent sentiment developments merit some focus. While optimism increased as stocks rallied over the course of July, it remained shy of excessive levels. The latest data shows some evidence of increased caution. The NDR Trading Sentiment Composite is drifting lower, put/call ratios are moving higher, and the latest data from the AAII shows more bears than bulls. The sentiment backdrop does not so much favor a continuation of the July rally but rather is not at this point signalling that excessive optimism has become a headwind. In other words, sentiment overall is neutral.

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