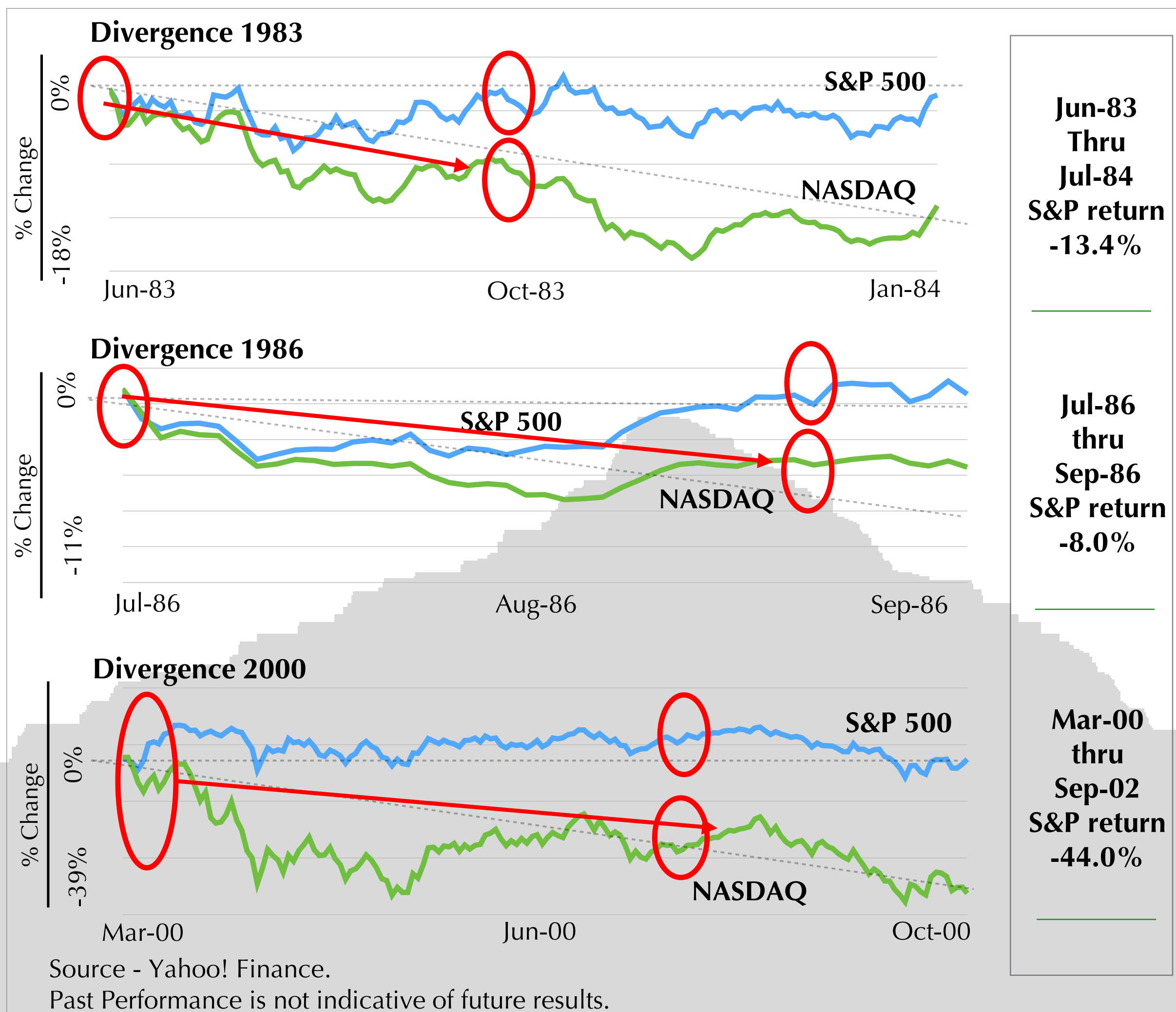
Momentum Divergences Demand Attention

'History doesn't repeat itself, but it does rhyme.' - Mark Twain

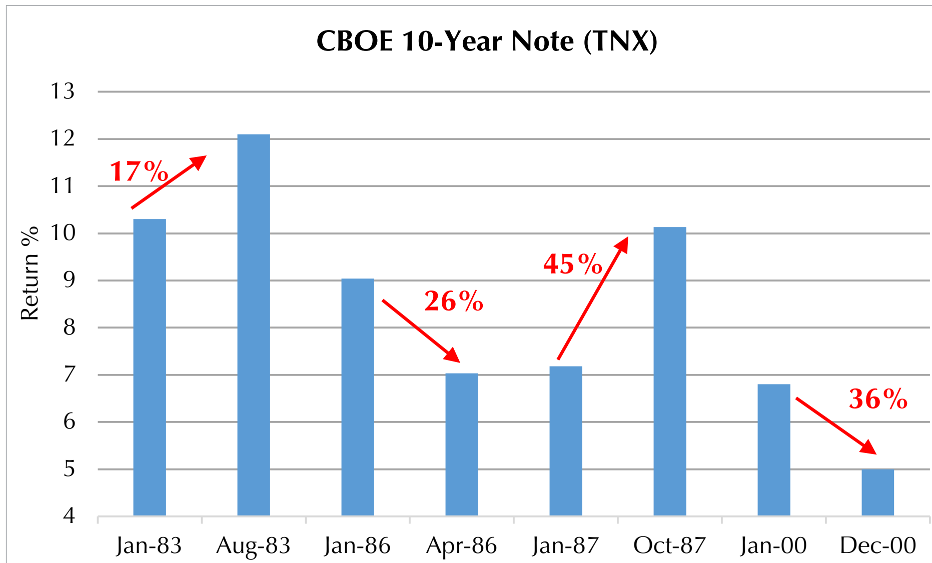
Market observers often appreciate the importance of momentum divergences in helping presage meaningful changes in market trends. The broad market can signal a significant change to come when narrower market sectors diverge and become unhinged from broader market averages. Momentum, including volume and breadth, is an important part of our investment process, which was built by Christopher J. Guptill, CIO and Co-CEO of Broadmark in the late 1980s. As a market historian, Chris, examined the underlying conditions present during market highs and lows over the past 75+ years. As of June 2014, five years into a bull market, we believe momentum divergences can provide valuable market insight. We invite you to read on as we describe the divergences of 2014 and review three historical divergences and describe market behavior over the following months.

The below charts illustrate divergences between the Nasdaq Composite Index and the S&P 500 Index. The left hand side of each chart shows a “healthy” market as the indexes move together. The rate of change, i.e., the divergence, is highlighted by the arrow showing when the Nasdaq rolled over and declined.



Source - Yahoo! Finance.
Past Performance is not indicative of future results.

The Nasdaq is representative of aggressive growth stocks often with a technology flavor while the S&P 500 covers blue chips with large market caps and household names. Note in the charts how the years 1983, 1986 and 2000 were characterized by momentum divergences between the Nasdaq and the S&P. In each instance, the Nasdaq rolled over and faded while the S&P treaded water for weeks or even months. Rather than move back in line and chase the S&P higher, the Nasdaq led the way lower as the S&P eventually succumbed and followed suit. In the case of 1986 the S&P and broader market rebounded quickly and went on to big new highs.



Similar to those periods highlighted on page one, the market appears to be presenting notable momentum divergences between the Nasdaq and the broader market averages. This year's Russell 2000 Index chart pattern has mirrored the Nasdaq action, also, as small cap stocks have run out in front of the broad market only to roll over recently and break sharply lower. While large stock indices (Dow Jones and S&P 500) vacillate around all-time highs, the Nasdaq and Russell 2000 have flirted with 10% corrections, over the past few months.

Source - Yahoo! Finance.
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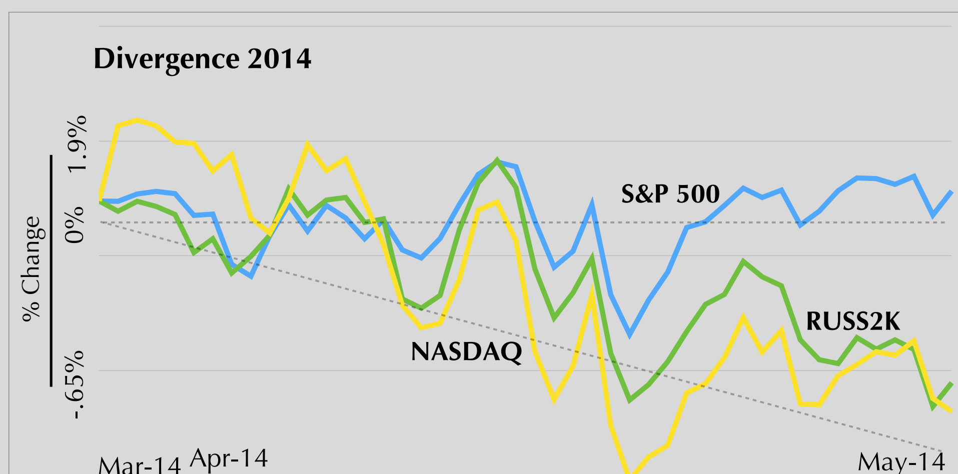
In 2014 other notable diversions can also be found between growth oriented sectors and more defensive ones: The Bank Index (BLX), Retail Index (XRT) and Consumer Discretionary (XLY) have shown weakness while Utilities (XLU) and Consumer Staples (XLP) are moving higher.

Historically, these types of divergences, when coupled with tightening monetary conditions and credit deterioration, have often led to more significant market declines. So, what was the interest rate environment like during these diverging markets? Reflected in the chart above, rates on the CBOE (Chicago Board Options Exchange) 10-year note (TNX) rose all through 1983, rising from 10.3% to 12.1%, a full 17% by August. In contrast, the rates fell sharply in early 1986, down 26% by late April to 7% just prior to the beginning of the divergence. They drifted sideways for several months until the spring of 1987 when they began a pronounced move up, peaking 45% higher in just a few months at over 10% several days before the crash. Rates, as measured by the TNX, also declined during the 2000 divergence as they dropped from 6.8% to under 5% while the divergence unfolded. The takeaway from historical rate trends is that markets reliably react to significant rate changes, and as the 1987 crash made clear, sharp moves in rates can have dramatic consequences.

The 2014 divergences could be indicative of a more pronounced correction to come, but it could just as well be showcasing a rolling correction set off by hedge funds unwinding the momentum trade in hot sub sectors (biotech and social media). In our view, looking past shorter-term trends, the next bear market could be precipitated by steadily or sharply rising interest rates and deteriorating credit conditions, all still absent at this time.



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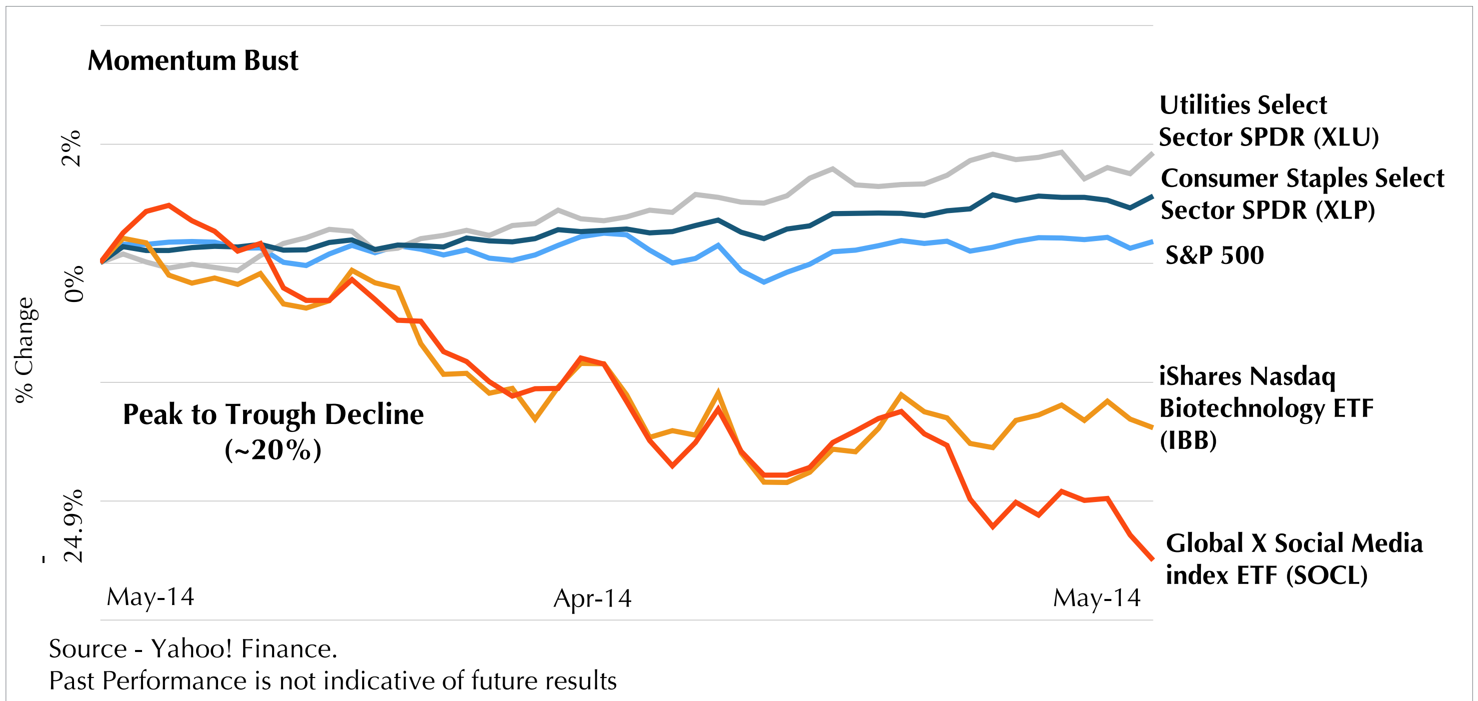

Source - Yahoo! Finance.
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Is history about to rhyme with a substantial correction ahead or will the broad market carry the day, rally back up to all time highs and pull the narrower sectors with it? Currently, while the Fed is certainly tapering, we do not believe that this is the same thing as tightening—at least not yet. This could change rapidly if interest rates rise and credit conditions deteriorate. Indeed, in all of the three previous periods cited in this paper, rising interest rates and widening credit spreads were the tipping points which led to subsequent declines of 10% in the major averages. The current low interest rate environment and narrow credit spreads are the major difference between the previous periods of divergence and our current position.

Thus, it will be important in coming months to watch the credit markets and assess how they fit into the picture. If the divergences continue, interest rates begin to rise, and credit spreads widen, this would cause Broadmark's market models to deteriorate significantly and would likely suggest far more market vulnerability.

Definitions:
The S&P 500® Index is an unmanaged index and is widely regarded as the standard for measuring large-cap U.S. stock-market performance. Index results assume the reinvestment of all capital gain and dividend distributions.
The Dow Jones Industrial Average consists of 30 stocks that are considered to be major factors in their industries and that are widely held by individuals and institutional investors.
The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. and is a subset of the Russell 3000 Index.
The Nasdaq Index is a market-value weighted index of all common stocks listed on Nasdaq. The index is used mainly to track technology stocks, and thus it is not a good indicator of the market as a whole. Unlike the Dow Jones Industrial Average (DJIA), the Nasdaq is market value-weighted, so it takes into account the total market capitalization of the companies it tracks and not just their share prices.
An investment cannot be made directly into an index or average.

Disclosures

Important Information:

You should consider the investment objectives, risks, charges and expenses of the fund carefully before investing. A prospectus with this and other information may be obtained by calling 1.877.742.8061 or by downloading one from www.broadmarkasset.com. It should be read carefully before investing.

There are risks involved with investing, including loss of principal:

- Borrowing for investment purposes creates leverage, which can increase the risk and volatility of a fund. The recent downgrade of the U.S. credit rating may adversely affect Fund performance.
- Derivative instruments including futures contracts, options contracts, options on futures contracts, forward currency contracts and swap agreements, involves the risk of sustaining large and sudden losses and may cause, among other things, increased volatility and transaction costs or a fund to lose more than the amount invested.
- Investing in exchange-traded funds (ETFs) will subject a fund to substantially the same risks as those associated with the direct ownership of the securities or other property held by the ETFs.
- Foreign securities, involve additional risks including exchange rate fluctuations, social and political instability, less liquidity, greater volatility and less regulation. These risks are magnified in emerging markets due to less stable political systems and higher rates of inflation.
- Short selling involves unlimited risk including the possibility that losses to the Fund may exceed the original amount it invested. Short selling also involves transaction costs and creates leverage, which can increase the risk and volatility of the fund.
- Although hedging activities are generally engaged in to help offset negative movements with respect to an investment, such activities will not always be successful.
- As interest rates rise, the value of debt securities decreases; whereas prepayment risk tends to occur during periods of declining interest rates.
- Investments such as mutual funds which focus on alternative strategies are not suitable for all investors.
- Diversification does not assure profit or protect against risk.