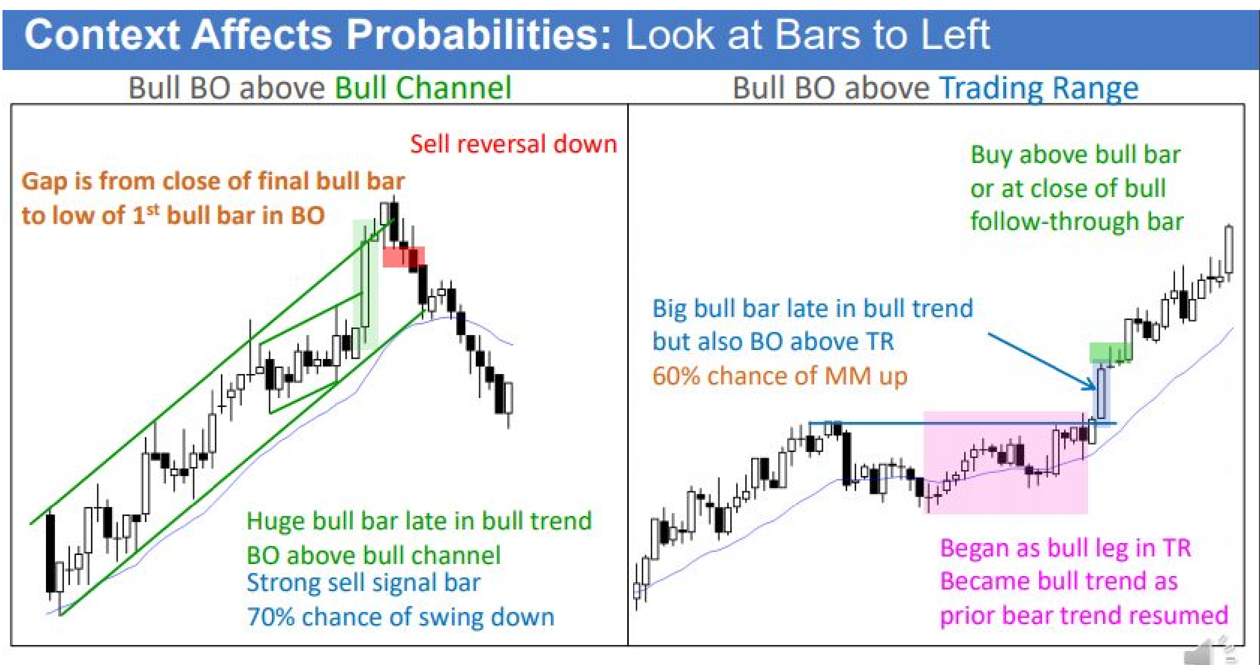
Look Left For Context

> ***Context:*** *All of the bars to the left showing buying and selling pressure, support and resistance. The circumstances that support or oppose the execution of a trade setup, or its trade management.* ~ Al Brooks

There are a handful of traders that have had a significant impact on the way I think about markets. Al Brooks is one of them. His books and video course are a slog to get through — his delivery style is about as slow and exciting as watching paint dry. But, the fundamentals of his teachings surrounding price action analysis, are priceless.

There's a lot to what he teaches (we're currently trying to get a discount for Collective members who'd like to purchase his course). But the most important parts of his teachings can be boiled down to two things **(1) Trade in the direction of the trend and (2) Look to the bars to the left to develop context and probabilities.**

Here's a slide from one of his webinar decks (link here) giving an example of how he builds context through "bar by bar" analysis.



The concept is simple… Every bar on the chart is a two-dimensional representation of real-time supply and demand. And while each bar contains information, **we must look to the bars to the left to establish <u>effective</u> context for the current bar.**

For example, a large bull bodied bar within a broader sideways range does not mean the same thing as one that occurs in an uptrend. Looking left for context at a sideways range we know that Newton's

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1st Law of Markets states that markets in ranges tend to stay in ranges (roughly 80% of the time). This means that most breakouts from ranges will fail.

The same goes for trends. Markets in trends tend to stay in trends (roughly 80% of the time). This means that most reversals from trends fail.

This is a simple yet incredibly valuable framework for reading the tape. Your average trader has the tendency to overweight the recent price action while disregarding what's come before it (the bars to its left). Even worse, is that **we all have a tendency to apply our biases to the tape which leads to building false conclusions**.

Again, this is remedied by looking left and understanding how to use bar-by-bar analysis to build effective context of market supply and demand.

With that said, let's start this Market Note off by "looking left" at the Nasdaq chart through multiple timeframes to build some context of the current supply and demand flows.

The Nasdaq has shown incredible demand strength since its March bottom. It has put in five consecutive bull bars that have small wicks — showing urgency to buy — and little overlap between bars.

The market has recently reversed from this buy climax and as I'll show, we'll likely see a bit more downside in the near-term. But… this type of buying pressure usually begets more buying pressure and so odds clearly favor further upside over the long-term.

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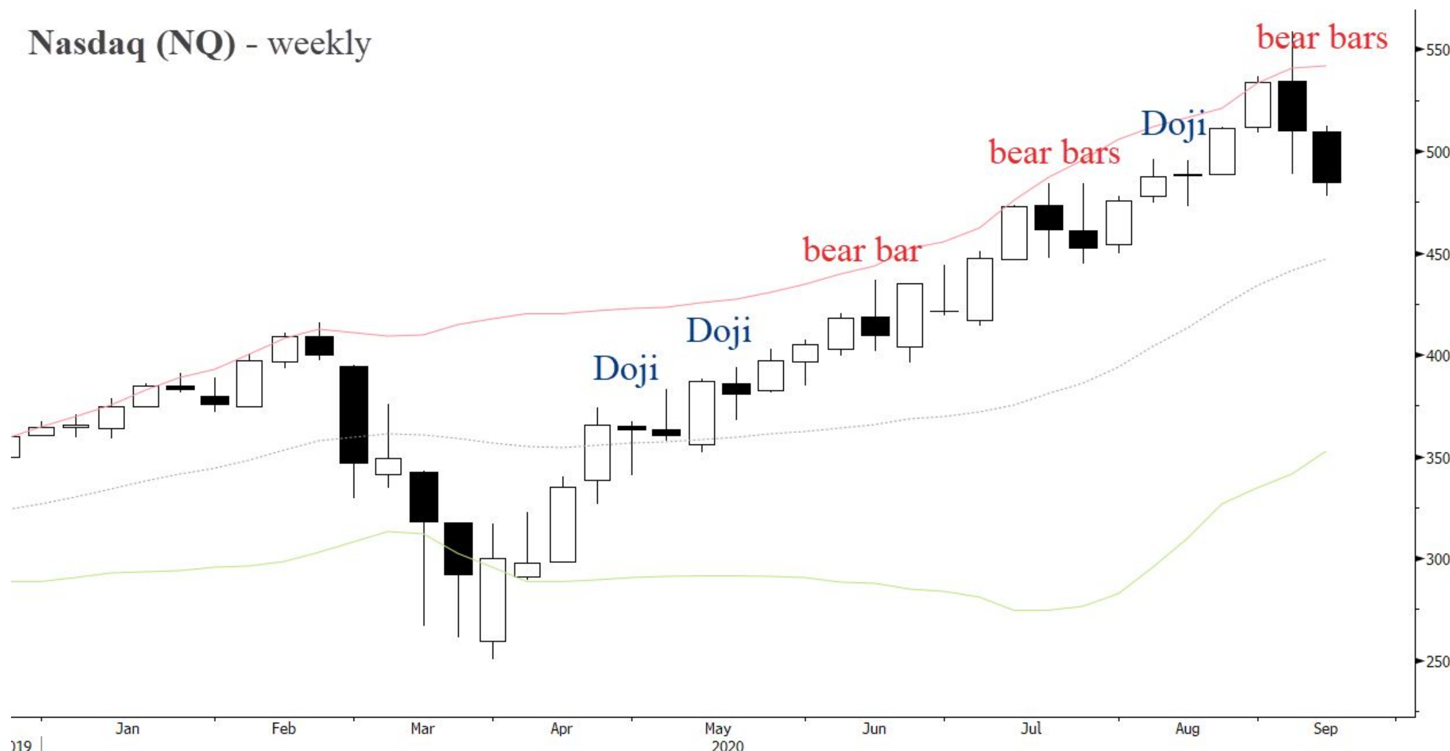
Over the last 25-weeks since the March bottom, the Nasdaq has only seen 5 bear bars, with most of them being minor small-bodied bars. Last week being the sole exception.

Again, this shows a large imbalance in the broader supply and demand picture. **This type of demand strength usually isn't reversed easily and it typically takes a mutli-week topping process before a major trend change can take place.**

But… over the shorter-term, as in the next couple of weeks. We're likely to see some more weakness and volatility. This is because we now have two bear bars with last week forming a decent sized bear body and a small lower tail, indicating little willingness to come in and buy the Friday lows.



On a daily timeframe, we can see that bulls drove the buy climax above its 4-month long bull channel. This indicated excessive exuberance and was a sign that we should expect some profit-taking which is exactly what's happened.

The Nasdaq has since reversed below its channel and odds favor at least one more leg lower before a tradeable bottom is put in.

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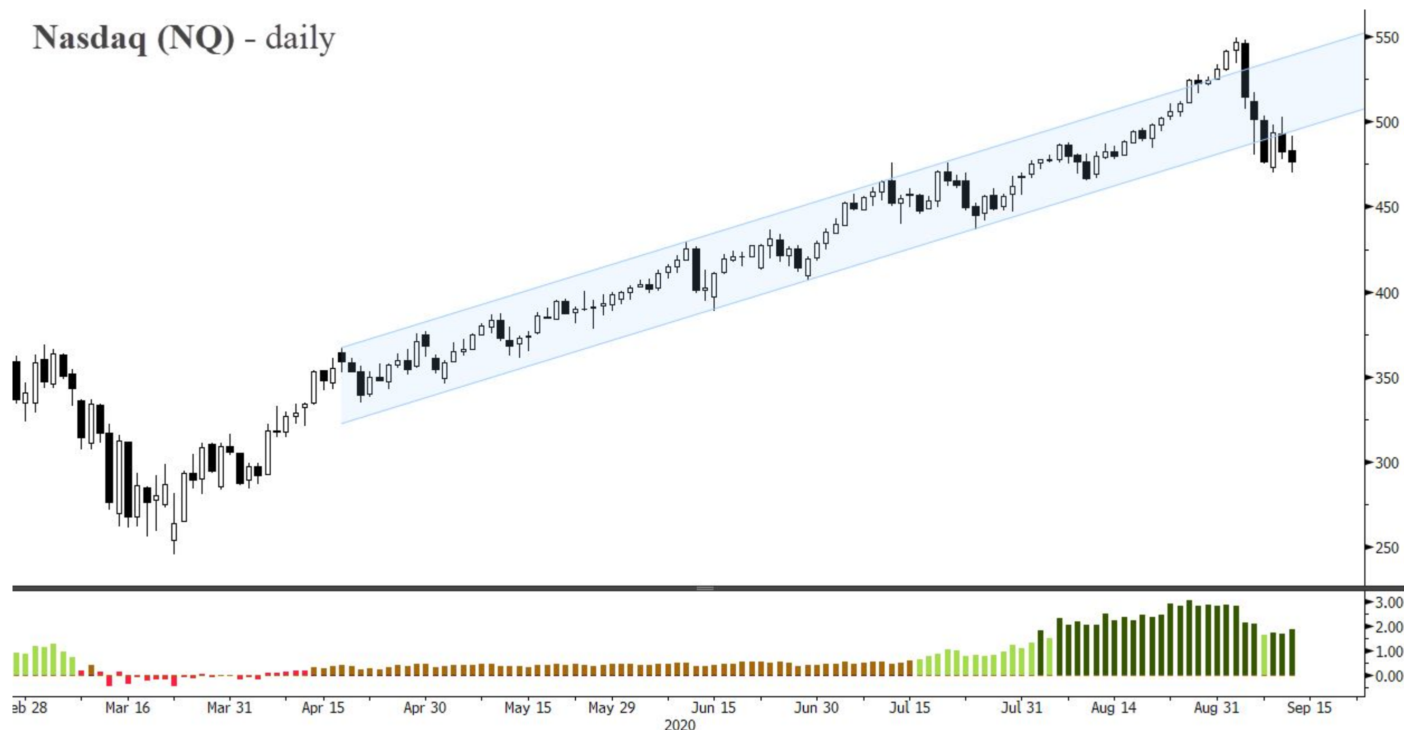

The market currently has a TL Score of -5 which also supports the case for further weakness over the short-term.

Date: 9/12/20	Breadth Score	Date: 9/12/20	Liquidity Score
High/Low Index	-1	Baa Yield z-score	0
RAY % ADV	-1	LQD/IEF	-1
% > 50dma	-1	Stock/Bond z-score	0
Total Score	-3	Total Score	-1
Date: 9/12/20	Sentiment Score		
Put/Call 10dma	-1		
Z-score	-1		
AAII Bull-Bear	1		
Total Score	-1	Total Trifecta Score	-5

And we shouldn't necessarily expect a v-bottom off this lower move. It's very possible, likely even, that we enter a bit of an extended trading range following such a large run. This view is supported by the weak seasonality plus election-year dynamics. This Cycle Composite chart via NDR shows the 90-year cyclical tendencies of (1) one-year seasonality (2) four-year presidential cycle and (3) 10-year decennial cycle.

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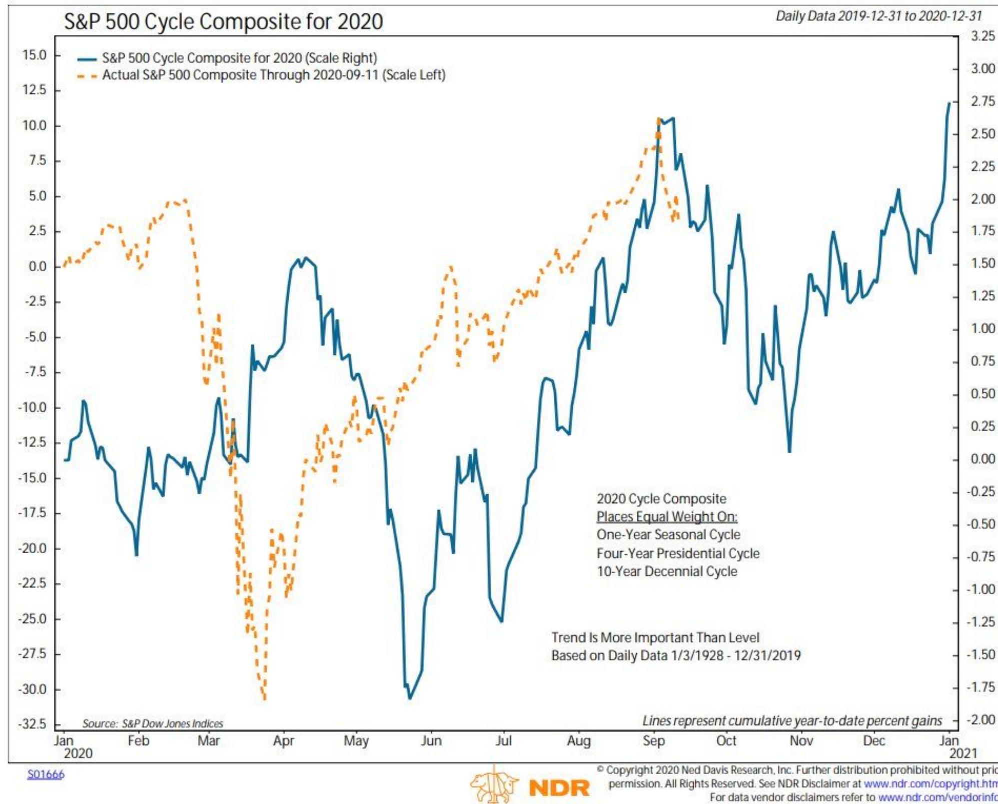
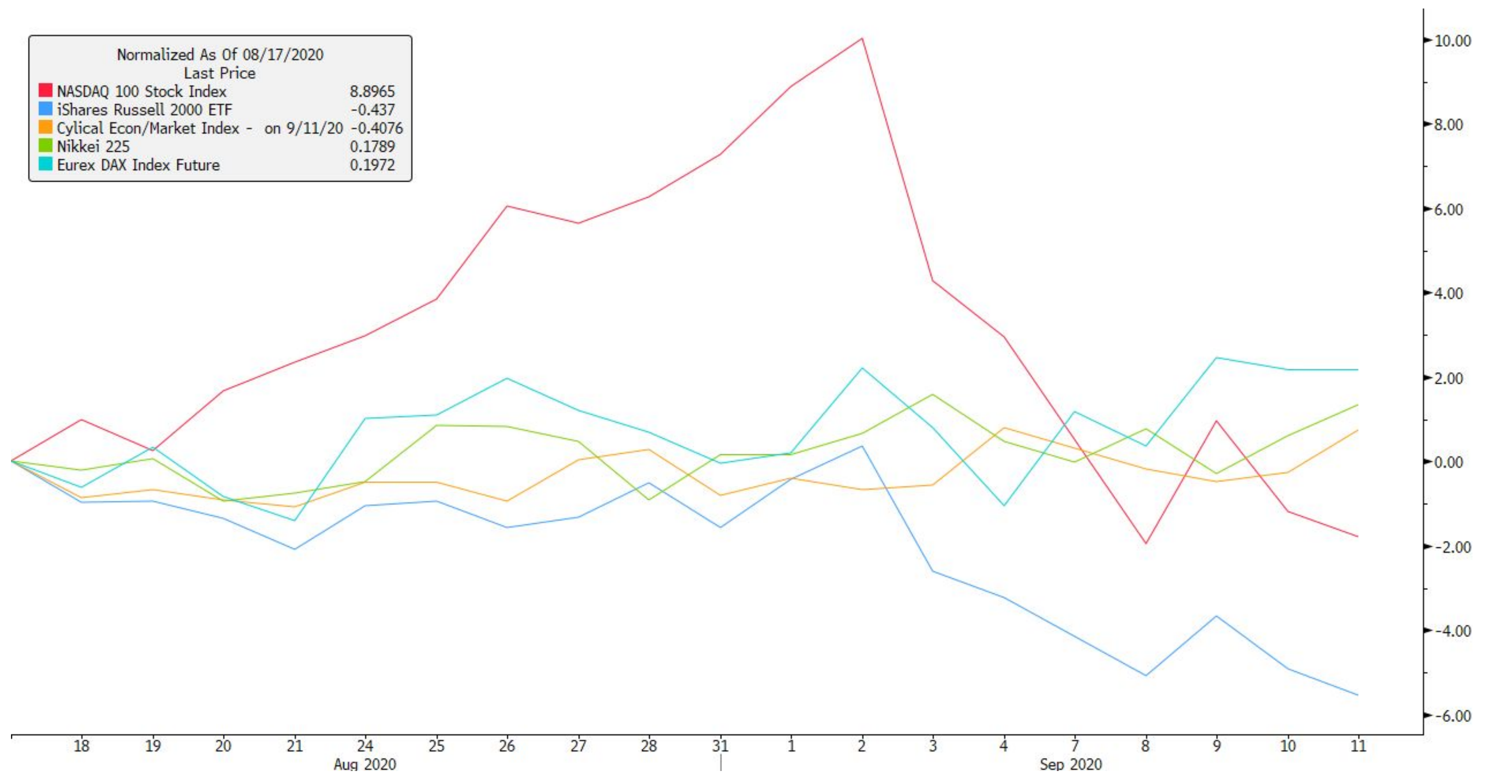


One of the things that make me believe our downside is somewhat limited on this move though is the strength we're seeing in foreign markets and cyclical v. defensives. The chart below shows that the recent weakness has mostly been confined to the US, while the Nikkei and DAX have held up well, along with cyclicals outperforming defensive sectors.



It's more likely we're seeing a healthy pullback and some repositioning out of crowded large tech names versus a transition into a broader risk-off regime. Whether or not this rotation will continue is questionable but the macro backdrop is supportive of the move.

BofA's US Regime Indicator improved for the second consecutive month and is now officially in a "Recovery Phase".

US Regime Indicator

Chart 19: US Regime Indicator (January 1990-August 2020)

Source: BofA US Equity & Quant Strategy, Refinitiv, ICE Data Indices, LLC, Institute for Supply Management, Bureau of Labor Statistics, Federal Reserve
Note: Phase 1 – Early Cycle; Phase 2 – Mid Cycle; Phase 3 – Late Cycle; Phase 4 – Recession
Disclaimer: The indicator identified as the US Regime Indicator above is intended to be an indicative metric only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise be relied upon by third parties for any other purpose, without the written consent of BofA Global Research. This indicator was not created to act as a benchmark.

Historically, **Value performs the best during this phase, outperforming the broader index by over 20% on average while Growth has tended to lag the index with average relative returns of just -8.5%.** Below is a table with a breakdown of factor returns by Phase.

Table 6: Style performance in the four US regime indicator phases (relative to equal-weighted S&P 500)

		Value	Growth	Momentum	High Quality	Low Quality	High Risk	Low Risk	Large Cap	Small Cap	Low Beta	High Div. Yield
Phase 1	Avg:	22.9%	-8.5%	-7.7%	-6.2%	7.4%	19.9%	-9.8%	-9.3%	20.2%	-8.4%	4.5%
Recovery	Median:	18.4%	-6.2%	-5.3%	-7.7%	10.0%	13.0%	-12.5%	-7.8%	11.2%	-8.2%	4.3%
	Hit Rate:	100.0%	14.3%	57.1%	28.6%	71.4%	71.4%	28.6%	14.3%	71.4%	14.3%	85.7%
Phase 2	Avg:	2.2%	9.0%	10.1%	1.7%	2.1%	6.3%	-4.2%	0.3%	1.2%	-8.4%	-6.7%
Mid Cycle	Median:	2.2%	1.9%	2.7%	0.0%	2.1%	7.1%	-4.9%	-0.8%	4.3%	-6.2%	-5.7%
	Hit Rate:	62.5%	75.0%	87.5%	50.0%	62.5%	75.0%	25.0%	50.0%	75.0%	0.0%	0.0%
Phase 3	Avg:	-0.1%	-7.6%	-4.7%	4.3%	-8.3%	-14.8%	8.8%	-1.3%	-10.0%	4.0%	4.6%
Late Cycle	Median:	-0.8%	-1.8%	2.3%	5.8%	-8.1%	-15.4%	9.8%	2.3%	-9.1%	-2.6%	1.8%
	Hit Rate:	42.9%	28.6%	57.1%	71.4%	14.3%	0.0%	71.4%	57.1%	0.0%	42.9%	71.4%
Phase 4	Avg:	1.3%	-0.8%	3.5%	4.1%	-5.4%	-4.9%	4.8%	5.4%	-1.1%	-0.3%	-1.7%
Downturn	Median:	-4.9%	-1.9%	1.1%	2.3%	-2.1%	0.0%	3.0%	6.3%	-6.3%	0.1%	-1.6%
(Current)	Hit Rate:	33.3%	50.0%	50.0%	66.7%	33.3%	50.0%	83.3%	83.3%	16.7%	50.0%	33.3%

Note: Performance is calculated as price return relative to equal-weighted S&P 500, for all styles except High Dividend Yield, where total return for the style and the index are used. Hit rate = % of months in phase where style outperformed equal-weighted S&P 500.
Source: BofA US Equity & Quant Strategy, Refinitiv, ICE Data Indices, LLC, Institute for Supply Management, Bureau of Labor Statistics, Federal Reserve

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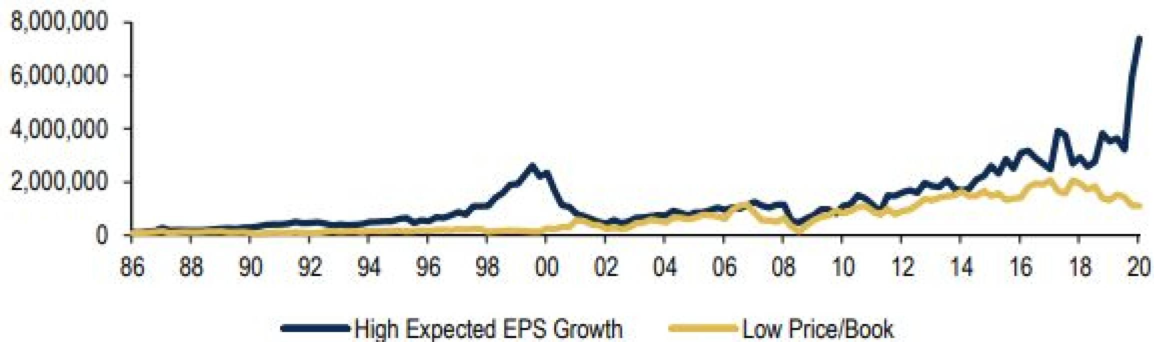
If this rotation happens it could lead to some large moves in individual names. As BofA notes, the SPX "is more skewed toward high growth stocks than ever — **the weight of the highest Expected EPS Growth decile vs. the lowest Price/Book decile is wider than ever".**



These high expectations are matched by extremely concentrated positioning. Morgan Stanley noted in a recent report that the **group's 50 most popular stocks made up roughly 38% of the total long exposure amongst all their clients.** That level is near a 10-year high while net exposure to tech is in the 95th percentile since 2010.

We're considering buying puts on Apple (AAPL). The company has a market cap that's just shy of $2trn and a price-to-sales ratio of near 8x — an all-time record high valuation for the company — all while its revenue growth is in secular decline… AAPL epitomizes the current positional crowding perhaps better than any other stock.

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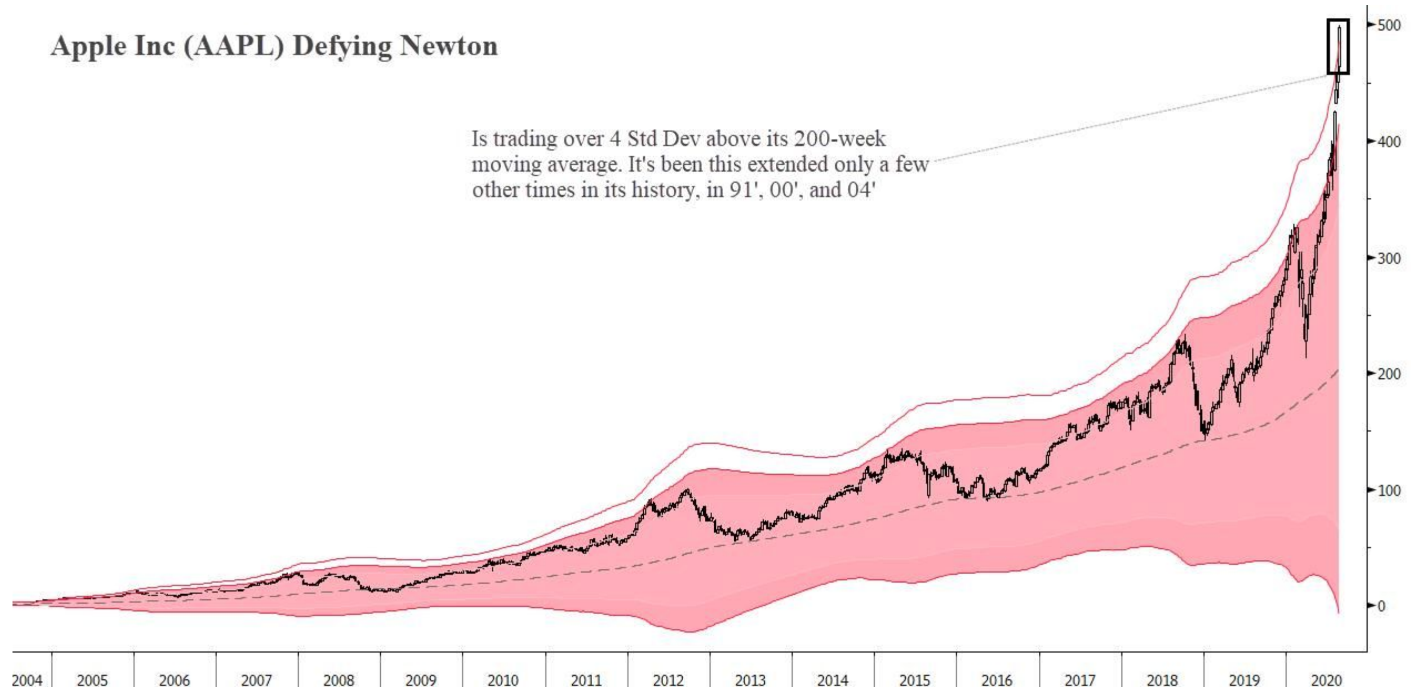
And, if you remember, I pointed out a couple of weeks ago how the stock is more than 4 Std Dev above its 200-week moving average. A level that has preceded major weakness in the past.



Apple reminds me of a line from an excellent book titled “Scale” by Geoffrey West, where West writes:

> “The battle to combat entropy by continually having to supply more energy for growth, innovation, maintenance, and repair, which becomes increasingly more challenging as the system ages, underlies any serious discussion of aging, mortality, resilience, and sustainability, whether for organisms, companies, or societies.”

Size increases entropy and this is becoming apparent in many of the giant tech names. Apple seems particularly vulnerable with increasing threats to its services business from a growing number of companies, such as Netflix and Epic Games attempting to circumnavigate the app store where Apple takes a high 30% cut of all sales.

If you study the history of large companies, you find that **we move through long-term cycles of aggregation and monopoly to disaggregation and regulatory trust-busting.** I don’t know when this cycle will turn but it does seem like we’re much closer to the end than the middle.

We’ll put out a report and trade alert this week if/when we put the trade on.

Besides putting on some additional hedges and maybe increasing our short NQ exposure this week, the other big trade we’re still tracking is the potential retrace in the DXY.

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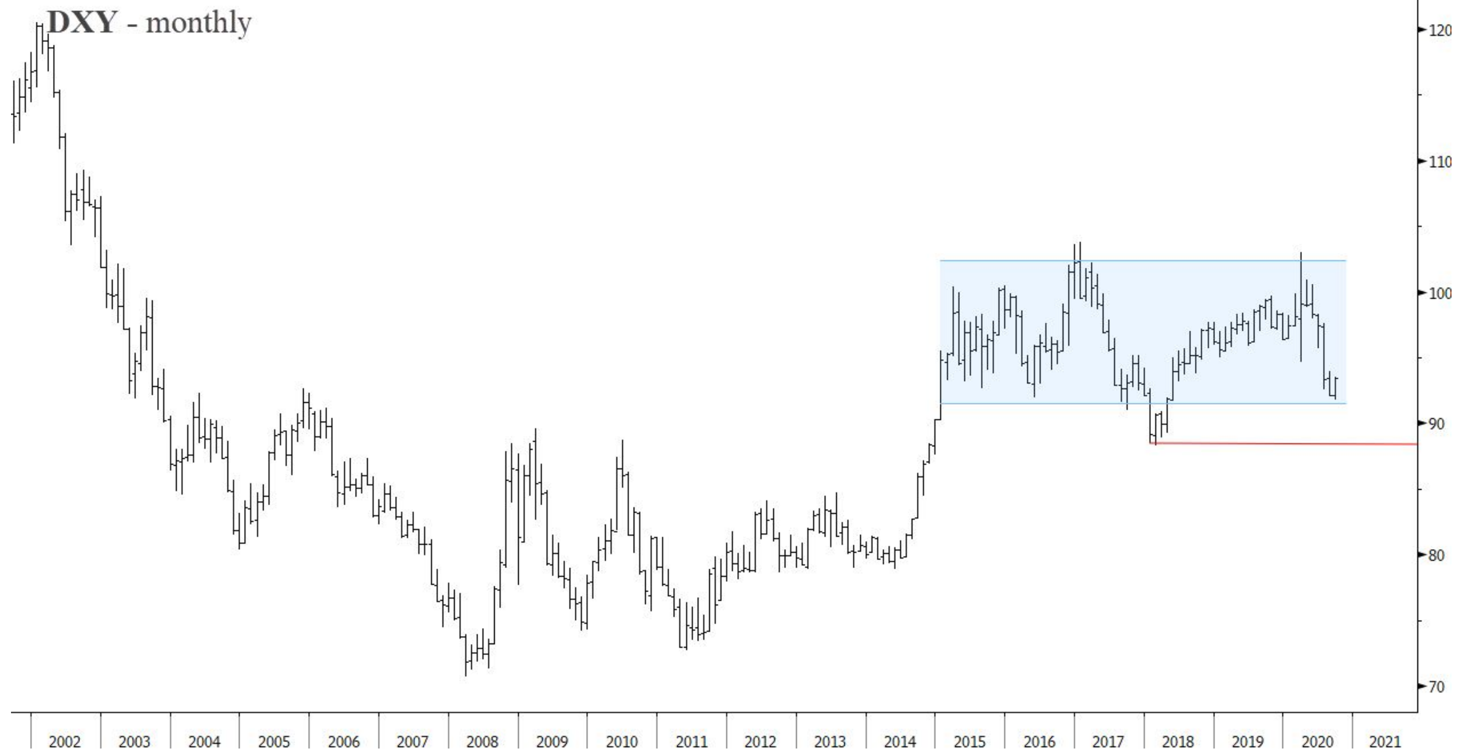
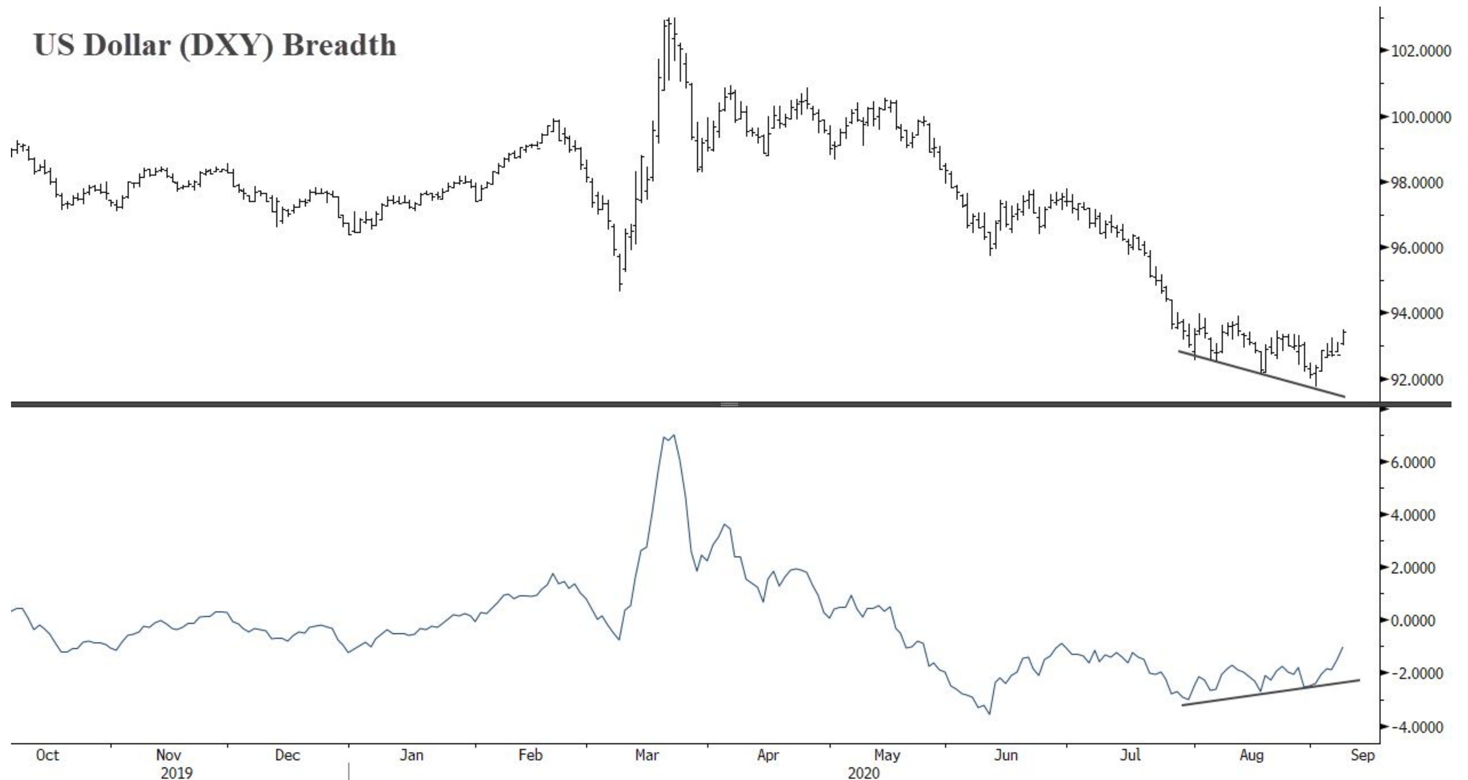
The monthly chart has set up with a reversal near 5-year support.



And DXY breadth has turned and is diverging higher making it <u>odds on</u> we see a confirmed breakout soon.



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Brandon and I are currently working on a couple of writeups on a few companies that we're incredibly excited about over the long-term. We think these names have multi-bagger potential and all possess a combination of individual + macro tailwinds, not to mention extremely cheap starting valuations.

Look for those writeups to hit your inboxes soon.

Stay safe and keep your head on a swivel!

Your Macro Operator,

Alex

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