What the charts tell us about 2013

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Nimble, short-term investing will be required to prosper in volatile markets.

By Robert Brain, ATAA

Where have the major world sharemarkets come from in recent years and what is in store for 2013?

The field of technical analysis is rather broad, but this article focuses on the more simplistic aspects of rising and falling trends, and price support levels. It also looks at some aspects of the classic time-proven Dow Theory.

Major global markets are interrelated and there is often a degree of interdependence and correlation between key markets.

The current big issues affecting the global economy include the looming US "fiscal cliff" crisis and the complex web of financial issues in the eurozone. Until these are resolved there will be a degree of uncertainty among investors broadly. This uncertainty affects the prices people pay for investments and is therefore reflected in the charts.

The export/import trade between countries has a great effect on the world's sharemarkets. China is clearly the manufacturing powerhouse for many countries and the slowdown in Europe and the US has wound back the purchasing ability of many people.

This has severely reduced demand for product from China, which is significant enough to affect China's manufacturing output and must have an impact on its sharemarket. Therefore, the Chinese sharemarket chart below is interesting.

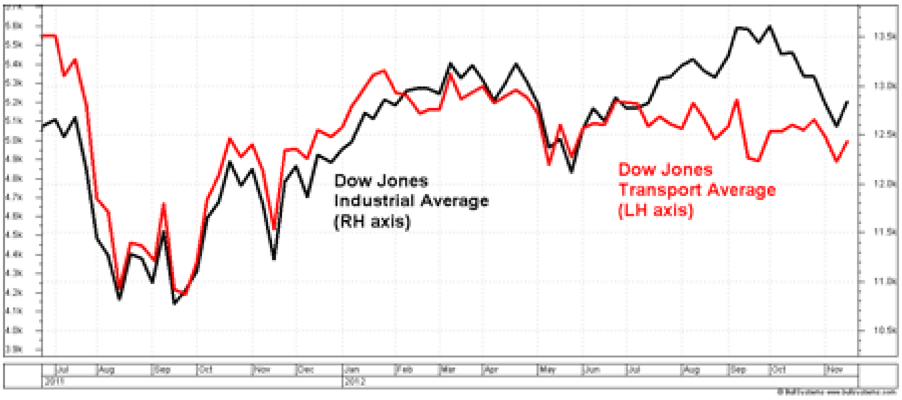
When stepping back to see where major sharemarkets have come from, it is common to look at the big picture over several years. The best price charts to do this might be quarterly or monthly, but these do not show the range or extremes in price within each quarter or month - just the last price for the period.

With a big-picture understanding, the analyst drills down and zooms in to see more recent price action in more detail by viewing weekly or daily price charts. It is important to remember that the very common daily line charts are very useful, but only show the daily closing price, joined together by short straight line segments. There is no indication of the highest or lowest prices each day. To see this detail you need either a candlestick chart or an open-high-low-close (OHLC) bar chart.

The US markets

The accompanying weekly chart (below) since July 2011 shows the Dow Jones Industrial Average (DJIA) index in black and the Dow Jones Transport Average (DJTA) in red. Notice two key observations. First, the DJIA made a low in September 2011 (near the start of the chart) and has moved mostly higher since. Also, both indices tend to move up and down roughly together for most of the time, except that while the DJIA made higher peaks toward the end of the chart, the DJIA could not make higher peaks.

Comparing the Dow Jones Industrial Average (DJIA) index to the Dow Jones Transport Average (DJTA) - short term



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(larger version of these charts)

As mentioned in the October issue of *ASX Investor Update*, it can be useful to compare the performance of the Dow Jones Industrial Average index against the Dow Jones Transport Average index.

One of the six key tenets of Dow Theory explains that for at least a healthy market to be under way, the major market index and the Transport Average index need to be moving together. The logic is that if the broader economy represented in the Industrial Average is performing well, the Transport Average should also be performing, indicating that goods are being shipped around the country (remember that the US economy is the world's largest). If the Industrial Average is rising but the Transport Average is falling, it suggests transport companies are not benefiting from the economy and goods are not being shipped in high enough volumes.

At about the middle of the chart, the Transport Average peaked at nearly 5370 (left-hand axis), then made only lower peaks, including three touches at about 5200 in the months June to September 2012. During the same months the Industrial Average made new highs. This observation of one index making new highs while the other does not is known as divergence - and in this case bearish divergence.

With the Transport Average diverging from the Industrial Average, it is not surprising the Industrial Average eventually fell lower.

What about 2013? For a healthy rising market we will be looking for both indices to be moving together and making higher peaks together. Until that happens there will be doubts about any rally that might ensue.

European markets

It is useful to study several of the key markets in Europe. The accompanying monthly chart (below) shows both the UK FTSE index and the German DAX over a 10-year period from 2002. Throughout this time we can see the two indices were closely correlated (and that was also so over a much longer time). That is, they tend to move up and down together for most of the time, with two recent key exceptions.

Comparing the London FTSE to German DAX 2002-2012

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First, we can see that when these markets fell to lows in early 2009 (about two-thirds across the chart), the FTSE actually traded very close to its 2003 low of about 3500 (near the start of the chart), while the DAX remained 50 per cent higher than its 2003 low.

Second, when the FTSE dipped on this chart in mid-2010 (indicated by red circle), the DAX did not fall, and again in recent months where the FTSE failed to make a new peak while the DAX moved higher than its latest peak in early 2012 - another example of divergence.

For generally healthy market conditions going into 2013, it will be good to see close correlation between major indices such as these two, and not the current divergence that is apparent on this chart in late 2012.

China

The weekly chart below shows the Shanghai Composite index over the past six years. Notice the vertical price axis uses a logarithmic scale to better see the detail at lower prices. The scale also helps to keep the price spikes in perspective, because a linear price scale makes any price spike appear over-exaggerated.

Also note the peak in the index very early in the chart on October 16, 2007 (with a daily close of 6088). This index fell 72 per cent in the following 12 months, and in late 2012 it is sitting at about 2000 points and is just 18 per cent higher than the low of four years ago.

Shanghai Composite index 2006-2012

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(semi-log chart - uses a logarithmic price scale)

([larger version of these charts])

But the more important observation on this chart is that since the index moved up to around 3400 in 2009 (near the middle of the chart), it has fallen away in a mostly consistent downtrend. The green 30-week moving average on this chart (based on the approach of noted author Stan Weinstein) is a good indication of trend direction and trend strength. The slope of the moving average in 2011-2012 is not as steep as the sharp sell-off suffered by many markets in 2008.

Where to in 2013? We need to see this index make a bottom, and turn upwards, and show at least one higher peak and one higher trough on the chart. This will indicate a weakening of the current downtrend and a possible new uptrend emerging.

Australia's outlook

When contemplating what the future may bring to the markets, it is useful to reflect on what has happened in the past. The charts record the overall views of market participants and indicate the so-called herd mentality. The severe rises and falls in the markets reflect the extremes in opinions of the market participants as to the perceived value of the shares being traded. One human trait that shows up time and again is that market participants will repeat past behaviour.

The chart below of Australia's All Ordinaries index (XAO) from just before the market crash of 1987 covers a 10-year period. After the index crashed in 1987, it fell five more times by at least 10 per cent before it made and sustained new highs almost 10 years later. Of these five falls, one was 19.4 per cent and two more were of more than 20 per cent, which is the measure for a bear market. That is, over this 10-year period there were three more bear market periods and two corrections (a fall of between 10 per cent and 20 per cent) before new sustained highs.

All Ordinaries index (Bear Market Twins?) 1987-1997

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([larger version of these charts])

Since our more recent market crash of 2008, where the All Ordinaries index fell 50 per cent and is still today 36 per cent below the 2007 highs, we have seen a number of sharp market falls greater than 10 per cent, and one of these greater than 20 per cent. It is now five years since the peak of late 2007.

Whatever has happened before can happen again. The Australian sharemarket might be able to rally strongly within the next couple of years, but this is not likely given the unresolved economic woes in Europe and the US, and the global markets' interdependence.

There may be periods of strong market rallies on positive news and hope, and there may be more severe sell-offs. It is possible that the Australian market will not make new sustained highs for about five more years.

Conclusion

Based on the analysis above we should not be surprised to see continued volatility in the charts. There may be shares or indices in uptrends to take advantage of in coming months, but there might also be downtrends. Market participants need to be vigilant, protect investment capital, and guard against severe and possibly prolonged downfalls.

A wise approach is to use a good stop-loss strategy (a predetermined selling price) and remain on alert. We could call it nimble short-term investing, and the bottom line is that timing the market is definitely possible - and can be rewarding.

About the author

Robert Brain is a sharemarket analyst and share trader, and runs Brainy's Share Market Toolbox web-based business supporting investors and traders. He is a National Director of the Australian Technical Analysts Association (ATAA), and also Vice-President of the Melbourne ATAA Chapter. All the charts here are produced using the Australian BullCharts software, and Robert heads up the Australian BullCharts User Group.

About the Australian Technical Analysts Association (ATAA)

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