Global Financial
Private Capital

Do Stock Charts Tell Us Anything?

SYNOPSIS

- A technical analyst at HSBC recently issued a "red alert," warning that the risk of a severe fall in the stock market is now very high.
- Traders often use technical analysis to discern patterns within stock charts, but investors rarely find any real value from such short-term price patterns.
- Pessimism sounds smart and helpful, but is often a weapon used by bad actors to scare long-term investors for personal gain.

RED ALERT

Although it may feel like a distant memory, the year started with a brutal selloff across global financial markets. This prompted the media to run with any story that predicted a recession.

The most notable call came from Andrew Roberts in mid-January. This Royal Bank of Scotland (RBS) analyst made headlines after urging clients to "sell everything" and brace for a cataclysmic year that would drive stocks down 20% and send oil to $16/barrel.

What the media failed to mention was that Mr. Roberts has been predicting disaster since 2010. Back then, he wrote:

> *"We cannot stress enough how strongly we believe that a cliff-edge may be around the corner, for the global banking system (particularly in Europe) and for the global economy. Think the unthinkable."*

Then, in 2012, he published this:

> *"People talk about recovery, but to me we are in a much worse shape than the Great Depression."*

Perhaps Mr. Roberts was frustrated with his prior attempts to gain widespread media attention and decided to go big this time. Bold calls tend to lead to binary outcomes, and since the market ripped shortly after his prediction, the year has likely been yet another tough one for him.

In the very short-term, technicals can occasionally work for the sole reason that so many traders use them that it becomes a self-fulfilling prophecy.

Doomsday preaching is not only prevalent during periods of volatility. When things are calm, these warnings tend to garner almost as much attention because so many believe that the good times cannot last.

One prediction made waves last week when a technical analyst at HSBC issued a "RED ALERT," warning that the risk of a severe fall in the stock market is now very high. His reasoning is based on rising volatility, broad-based weakness in prices, and the intensity of selling pressure measured by comparing the trading volume of advancing stocks versus declining ones.

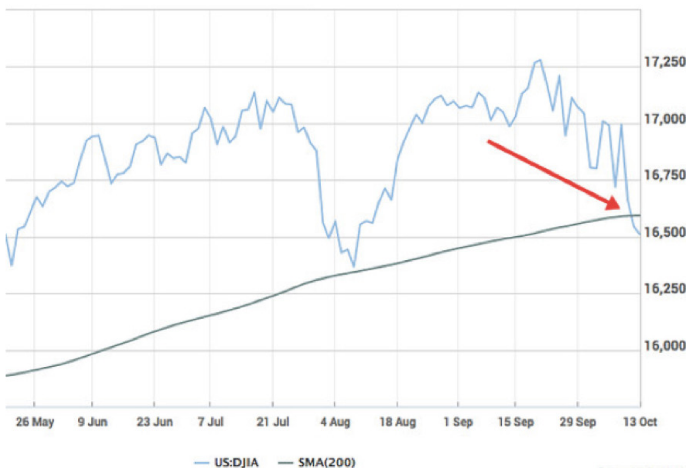
Naturally, the financial news was all over this story, which in of itself is a reason to completely ignore it. But in order to put his commentary into context, it's important to first understand what a technical analyst does and how this type of research is used.

Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC.

LET'S GET TECHNICAL

Traders often use technical analysis, or "technicals," to discern patterns within stock charts. For example, one of the most popular technical tools is the 200-Day Moving Average (200 DMA), which is calculated by averaging the closing price of a stock or equity index each day for the last 200 days. Chartists will tell you that if the daily price falls below its 200 DMA, then a classic "sell signal" has emerged.

The chart below shows the Dow Jones Industrial Average (DJIA) closing price back in October 2014, and compares it to its 200 DMA.



Source: MarketWatch

Those who use technical analysis often sell out of stocks when this pattern emerges irrespective of the health of the economy or any other fundamental factor. They are typically very short-term focused and rarely do any research on the stocks they trade. In many instances, they may not even know the name of the company they are buying/selling.

The million-dollar question is if any of these tools actually work, and it is often a contentious debate amongst market participants. Technicians will tell you that price patterns tend to repeat over time and are a byproduct of factors that impact businesses and the economy.

Those who consider the practice of analyzing stock charts to be nothing more than hocus pocus argue that their predictive nature is almost as effective as that board hanging over a roulette wheel indicating the numbers hit on previous rolls. Charts tell the story of where a stock has been but cannot give any insight into where it is going.

My view is that it depends on how they are used. In the very short-term, technicals can occasionally work for the sole reason that so many traders use them that it becomes a self-fulfilling prophecy. If a large cohort is looking for the same trend in a stock chart, their synchronized activity can often cause a stock to trade on that pattern for a brief period.

However, a stock chart cannot predict a shift in corporate strategy, competitive dynamics of an industry, or the future direction of an economy. These are the factors that drive long-term returns, so investors will get far less value out of technicals relative to short-term traders.

Therefore, technical analysis is not bad as long as it is used properly. Technicals like the DMA and those that this HSBC analyst used can be an indication of heightened levels of emotions in the market, but it should only be one of many factors within an investment process and never the sole driver.

For example, if an active manager saw a trend developing in the stock market by analyzing a chart of the S&P 500, she may reduce exposure to stocks by a small amount. Not only would she limit the volatility impact if stocks were to sell off, she could then reinvest at a lower price.

What she would not do is completely sell out of all her stocks and go to cash because (1) the technicals could be wrong and (2) technicals are just one of many factors she analyzes. The other factors could indicate that the economy remains strong and valuations on stocks are still very attractive. Hence, the long-term

Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC.

direction of stock prices has not changed, so a major shift in allocation is most likely unwarranted.

This is where HSBC's warning loses any and all credibility. To say that investors should get out of stocks for the sole purpose of a short-term price trend developing is lunacy, and such a claim forces me to question the motives of the author and/or those who are promoting his work.

IMPLICATIONS FOR INVESTORS

Morgan Housel is an economics and finance columnist, and he recently wrote about why pessimism sounds so smart. Three of his conclusions are worth noting:

1. Optimism appears oblivious to risk, so by default pessimism looks more intelligent.
2. Pessimism requires action, whereas optimism means staying the course.
3. Optimism sounds like a sales pitch, while pessimism sounds like someone trying to help you.

***NOTE**: Visit http://www.fool.com/investing/general/2016/01/21/why-does-pessimism-sound-so-smart.aspx to read the entire article.*

While I agree with nearly every point made is his very well-written article, I am far from an eternal optimist. In fact, occasional pessimism is imperative because it provides balance to an investment strategy and financial markets.

For example, short-sellers who profit from stocks falling are critically important to the stock market because they tend to be the ones that expose fraud and other corporate issues. Pessimism is also important because recessions happen, stocks lose investors' money, and economies collapse under too much debt.

The problem is that they don't occur that often, and there are just way too many bad actors out there who are acutely aware of the power of pessimism and use it to their advantage for publicity and/or financial gain.

Hence, when I come across a report like the one from HSBC last week, I approach it with intense skepticism unless I can find proof of a time in the past where they made a *bullish* call and were ultimately *correct*. Only then can I consider them to be impartial.

The bottom line is that technicals may intermittently expose a short-term trend, but they should never, under any circumstances, solely drive an investment process.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist,
Aviance Capital Management
mikeonmarkets.com

This commentary is not intended as investment advice or an investment recommendation. It is solely the opinion of our investment managers at the time of writing. Nothing in the commentary should be construed as a solicitation to buy or sell securities. Past performance is no indication of future performance. Liquid securities, such as those held within DIAS portfolios, can fall in value. Global Financial Private Capital is an SEC Registered Investment Adviser.

Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC.