

PART I

THE OLD
NORMAL

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Intermarket Analysis: The Study of Relationships

This chapter covers the main points of intermarket analysis, starting with the observation that all markets are related. It will also introduce asset allocation and sector rotation strategies at various stages of the business cycle, and explain how stocks peak and trough before the economy. Other points include the important role played by crude oil, how exchange traded funds have revolutionized intermarket trading, the advantage of using charts, why viewing the big picture is important, intermarket implications for technical analysis, how it adds a new dimension to technical work, why it's an evolutionary step, and why relationships change. It will end with a recap of intermarket principles.

■ All Markets Are Related

As the name implies, *intermarket analysis* is the study of how various financial markets are related to each other. This is a departure from prior forms of market analysis, which relied primarily on a *single-market* approach. Stock market analysts, for example, used to spend their time analyzing the stock market, which included market sectors as well as individual stocks. Stock traders didn't have much interest in what was happening in bonds, commodity markets, or the dollar (not to mention overseas markets). Fixed-income analysts and traders spent their time analyzing the bond market without worrying too much about other markets. Commodity traders had their hands full tracking the direction of those markets and didn't care much about other asset classes. Trading in currency markets was limited to futures specialists and interbank traders.

intermarket analysis is the study of how various financial markets are related to each other

That is no longer the case. Traditional chart analysis has taken a major evolutionary step over the last decade by adopting a more universal intermarket approach. I like to think that my two earlier books on intermarket analysis (published in 1991 and 2004) helped move things in that direction. It would be unthinkable today for a trader in any one of those four asset classes not to study trends in the other three.

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The four asset classes involved in intermarket work are bonds, stocks, commodities, and currencies.

Some understanding of how the different asset classes interact with each other is important for at least two reasons. First, such an understanding helps you appreciate how other financial markets influence whichever market you're primarily interested in. For example, it's crucial to know how bonds and stocks interact. If you're trading stocks, you should be watching bonds because bond prices usually trend in the opposite direction of stocks. In many cases, turns in the bond market actually precede turns in stocks. Bond yields are inversely correlated with bond prices. That being the case, falling bond yields (rising bond prices) can be a negative warning for stocks.

Figure 1.1 compares the yield on the 10-year Treasury note to the S&P 500 during 2000. After peaking that January (first arrow), the bond yield started falling a lot faster than the stock market. By that spring, the bond yield had fallen to the lowest level in a year while the S&P 500 was still trending sideways (although the Nasdaq peaked that spring). The S&P 500 didn't start falling until the fourth quarter of that year (second arrow) and entered a major bear market that lasted for more than two years. That's a pretty dramatic example of falling bond yields giving early warning that the stock market was in trouble. It demonstrates how the bond market usually changes direction before stocks at major turning points and is often a leading indicator of the stock market. Figure 1.1 also demonstrates why it's so important for stock analysts to take trends in the bond market into consideration.

If you're a bond trader, you should be watching trends in commodity markets. A jump in commodity prices, for example, is usually associated with a drop in bond values. In another illustration of how one market impacts on another, a falling U.S. dollar usually results in rising commodity prices. And, as you'll see later in the book, the direction of the U.S. currency helps determine the relative attractiveness of foreign stocks compared to those in the United States.



FIGURE 1.1 Drop in bond yield during 2000 warned of stock peak

■ Asset Allocation Strategies

A second reason why it's important to understand intermarket relationships is to help with the *asset allocation* process. There was a time not too long ago when investors' choices were limited to bonds, stocks, or cash. Asset allocation models were based on that limited philosophy. Over the last decade, however, investment choices have broadened considerably. Since 2002, for example, commodities have been the strongest asset class and are now recognized by Wall Street and the investing public as a viable alternative to bonds and stocks. The emergence of exchange-traded funds (ETFs) has had a lot to do with the increasingly popularity of commodity trading. The same is true for foreign currency markets, which have also had a strong run since 2002.

Consider the relative performance of those four asset classes since the start of 2002 when the U.S. dollar started a major decline that eventually took it to a record low. During the 10-year span starting in 2002, commodity prices gained 64 percent. By comparison, bond prices gained 23 percent, while U.S. stocks experienced a relatively modest gain of 9 percent. The main catalyst in the commodity upturn was a 32 percent drop in the U.S. dollar. That's because the dollar and commodities trend in opposite directions. A falling dollar results in higher commodity prices.

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Commodity prices and foreign currencies trend in the same direction and in the opposite direction of the U.S. dollar.

Figure 1.2 compares the trend of the U.S. Dollar Index to the CRB Index of commodity prices between 2000 and 2008. It's clear that the two markets trended in opposite directions. It can also be seen that the major upturn in commodity prices began during 2002 (up arrow) at the exact same time that the dollar started dropping (down arrow). The inverse relationship between the dollar and commodity markets is one of the most consistent and reliable relationships in intermarket work.

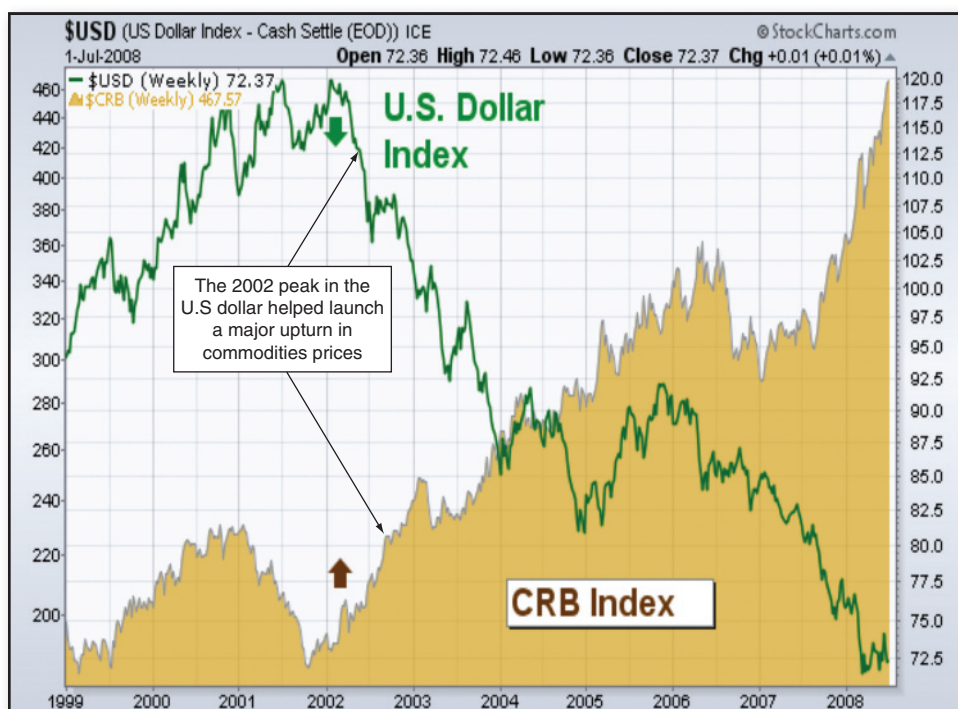


FIGURE 1.2 Dollar peak in 2002 led to major commodity upturn

Foreign currencies also benefit from a falling dollar. That's especially true for currencies tied to countries that export commodities like Australia and Canada. During the 10 years starting in 2002, the Aussie dollar (boosted by rising commodity prices) gained 101 percent versus 50 percent for the euro. It's clear that investors have benefited from the ability to expand their asset allocation choices beyond bonds and stocks. Exchange-traded funds are a big reason why.

■ ETFs Have Revolutionized Intermarket Trading

Exchange-traded funds have had a lot to do with expanding those choices into alternate assets like commodities and currencies. In fact, the explosive popularity of ETFs has revolutionized the world of intermarket trading and has made it increasingly easy to implement global intermarket strategies. During the 1990s, for example, the ability to incorporate commodities and currencies into one's portfolio was almost impossible outside of the futures markets. The growing availability of ETFs has made investing in commodity and currency markets as easy as buying a stock on a stock exchange. Exchange-traded funds can be used for virtually any asset class anywhere in the world. Mainly for that reason, we'll be relying very heavily on ETFs throughout this book to show how markets interact and how to take advantage of those interactions. Another place where ETFs have become extremely popular is in implementing sector rotation strategies.

■ Sector Rotation and the Business Cycle

Intermarket analysis plays an important role in *sector rotation* strategies. The U.S. stock market is divided into market sectors (which are further subdivided into industry groups).

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The stock market has 10 sectors and approximately 90 industry groups.

Exchange-traded funds are available that cover all market sectors (and most industry groups). That greatly facilitates the movement into and out of various market sectors at different stages of the business cycle. I'll show you later in the book how to use intermarket principles (and some simple charting techniques) to spot leading and lagging market sectors for the purpose of ensuring that you're in the leaders and out of the laggards. You'll also learn how tracking sector rotation offers valuable insights into the direction of the stock market and the economy.

Near the start of a new bull market in stocks, economically sensitive groups like consumer discretionary stocks (which include retailers) usually do better than most other stocks. So do technology and transportation stocks, which are tied to the business cycle. Small-cap stocks also lead at market bottoms. Near market tops, those very same groups usually turn down first. Energy stocks (which are tied to the price of oil) have a tendency to become market leaders near the end of a bull market in stocks. Energy leadership is almost always a dangerous warning sign for the stock market. One of the ways to tell that the stock market is peaking is when money starts to flow out of energy stocks and into defensive sectors like consumer staples, health care, and utilities. I'll show you how to spot those rotations and how to take advantage of them. And what they mean.

■ Stocks Peak and Trough before the Economy

Important tops in the stock market usually lead to periods of economic weakness (or recessions). The 2000 stock market top, for example, led to a recession the following spring. The October 2007 market top led to a recession that December. The same is true at market bottoms. The ending of the last two recessions during 2003 and 2009 followed market upturns a few months earlier. When the stock market weakens, money tends to rotate out of stocks and into bonds. At market bottoms, the opposite happens. Money rotates out of bonds and back into stocks. Fortunately, it's pretty easy to spot those shifts in investor sentiment, which we'll demonstrate later in the book. It's hard to separate trends in financial markets from trends in the economy. Intermarket analysis sheds light not only on market direction but the economy as well. You'll also see later in the book that bonds, stocks, and commodities have a history of peaking and troughing in a predictable order during turns in the business cycle.

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Bonds usually change direction first at tops and bottoms, stocks turn second, and commodities third.

That knowledge will help you determine where to be at different stages of the business cycle. It will also help you determine whether the business cycle is turning up or turning down.

■ The Role of Oil

Rising oil prices from the beginning of 2007 preceded a stock market downturn later that year. Oil's role in the 2007 market top wasn't an aberration. In fact, it was very normal. Rising oil prices have contributed to every U.S. recession in the last 40 years. Rising oil prices have also contributed to stock market peaks and resulting bear markets. That was certainly the case during the mid-1970s when a tripling in the price of crude during 1973 (during the Arab Oil Embargo) led to a 50 percent stock market loss the following year (1974). Spikes in the price of crude also preceded or accompanied stock market drops during 1987, 1990, 1994, and 2000. By contrast, sharp drops in the price of crude have usually had a bullish impact on stocks. That was the case at the start of the two Iraq wars in early 1991 and 2003, which helped launch new bull markets in stocks. That's why market leadership by stocks tied to oil is normally a danger to the stock market. That's also why our intermarket analysis has to always consider what the price of oil is doing. Upward spikes in oil prices have preceded most stock market peaks.

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Rising oil prices usually force the Fed to raise interest rates, which weakens the stock market and slows the economy.

Figure 1.3 compares the price of crude oil to the S&P 500 during 2007 and 2008. The chart shows two consistent intermarket tendencies. The first is that rising oil prices usually precede stock market peaks. Crude started climbing at the start of 2007 (first up arrow). After a modest pullback during August, crude turned up even more sharply that September (second up arrow). The stock market peaked a month later during October (first down arrow). Rising oil is usually a warning sign for stocks

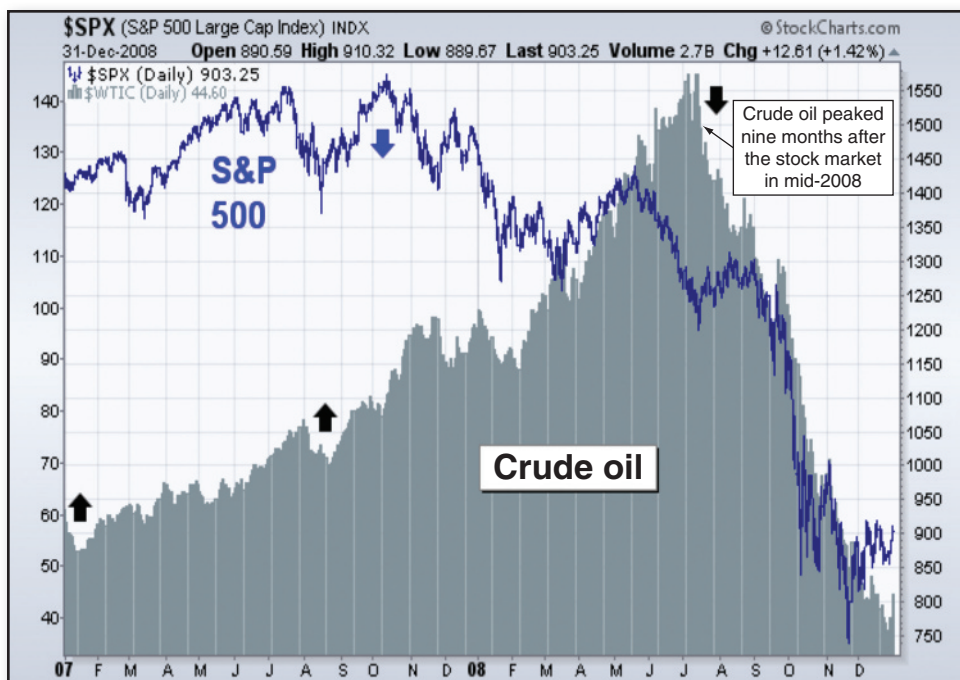


FIGURE 1.3 Rise in crude during 2007 contributed to stock peak

and has led to most market tops. The second intermarket lesson is that oil usually peaks after stocks do. Figure 1.3 shows crude peaking during July 2008 (second down arrow), nine months after the stock top.

■ Advantages of Using Charts

All of this talk about intermarket relationships may start sounding like a lot of economic theory. This is partially the case because intermarket analysis is based on economic principles. However, it is not theory. Intermarket work is market-driven. There is nothing theoretical about a profit-and-loss statement. Economists look at economic statistics to determine the direction of the economy and, by inference, the likely direction of financial markets. By contrast, chartists look at the markets themselves. That makes a big difference. Economic statistics by their very nature are *backward-looking*. What else could they be? They tell us what happened last month or last quarter. They tell us nothing about the future (or the present, for that matter). The markets, however, are *forward-looking* entities. That's why the markets are called *discounting* mechanisms. Stocks anticipate (or discount) economic trends six to nine months into the future. There's also a reason some markets are called *futures*. Which would you rather depend on: backward-looking statistics or forward-looking markets? Put another way, would you rather place your trust in a lagging or a leading indicator of future market trends? Economists rely on lagging economic indicators, while chartists place their trust in forward-looking financial markets.

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While stocks usually change direction before the economy, bonds usually change direction before stocks. That makes bonds an even earlier economic indicator than stocks.

This distinction goes to the heart of technical analysis, which is based on the premise that markets are leading indicators of their own fundamentals. In that sense, chart analysis is a shortcut form of economic and fundamental analysis. This is one reason why intermarket analysts use charts. Charts also offer a big advantage in intermarket work because they allow us to look at so many different markets. It's hard to imagine how anyone could study and compare markets all over the world in all asset classes without the use of charts. Besides making comparisons of so many markets much easier, it's not even necessary to be an expert in any of those markets. All one needs is knowledge of how to plot the charts and the ability to determine which markets are going up and which ones are dropping. Intermarket work goes a step further by determining if two related markets are moving in the same or in opposite directions.

■ Viewing the Big Picture Is Important

The biggest benefits of the visual tools described in this book are their universality and transferability. They can be applied to any market anywhere in the world—and to any time dimension. They can be applied to short-term trading as well as long-term investing. Any market that can be charted can be analyzed. That gives the chartist an enormous advantage over those who prefer to use some form of economic or fundamental analysis. Those two schools of analysis have a number of problems to deal with. The economist is forced to deal with old data. The fundamental analyst (who studies company and industry earnings) has a tremendous amount of data to deal with. That prevents the fundamental analyst from covering a wide variety of markets. As a result, fundamental analysts are forced to specialize. The intermarket chartist, by comparison, can follow any market he or she wishes to anywhere in the world without having to be an expert in any one of them. That's a pretty big advantage in an interrelated world of intermarket analysis and trading. More importantly, the ability to scan so many markets from different asset classes all over the world provides the intermarket chartist with a *big-picture* view of what's really happening. That's a huge advantage over the *tunnel vision* that's so often seen among market analysts who follow only a small portion of the financial spectrum.

■ Intermarket Implications for Technical Analysis

Because intermarket work involves looking at so many markets, it has to be done with price charts. Chart analysis is the easiest and most efficient way to study intermarket linkages. Intermarket work greatly expands the usefulness of technical analysis. It allows analysts like me to talk about things that used to be restricted to security analysts and economists, like inflation, deflation, the direction of interest rates, the impact of the dollar, and the state of the business cycle. Some understanding of how bonds, stocks, and commodities rotate during the business cycle, for example, allows us to talk about the state of the economy. Sector rotation also sheds light on whether the economy is contracting or expanding.

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Consumer discretionary stocks lead early in an economic expansion. Energy leadership occurs near the end of an expansion. Consumer staples are strongest during an economic downturn.

The financial markets are leading indicators of economic trends. It took the Federal Reserve until the spring of 2003 to acknowledge the threat of deflation. The markets had spotted the threat years earlier. It also took the Fed a lot longer than it took chart analysts to recognize the threat from the housing collapse during 2007. The events surrounding stock market peaks during 2000 and 2007 demonstrated the need to incorporate some chart and intermarket analysis into economic and fundamental forecasting. It took the Wall Street community too long to figure out what many chartists already knew during the first half of 2000 and 2007 when warning signs of a market top were clearly visible, and that the economy was headed for trouble (as you'll see in the following chapters). The idea that technical analysis is a shortcut form of fundamental analysis is based on the premise that price action in any market is a leading indicator of that market's fundamentals. A lot of Wall Street analysts (and their clients) paid a big price for ignoring the clear chart signals that the markets were giving off during 2000 and 2007. They also paid a price for ignoring intermarket signals.

■ A New Dimension to Technical Work

The greatest contribution made by intermarket analysis is that it improves the market analyst's peripheral trading vision. Trying to trade markets without intermarket awareness is like driving a car without looking at the side and rearview mirrors and windows. Intermarket analysis includes all markets everywhere on the globe. By turning the focus of the market analyst outward instead of inward, intermarket work provides a more rational understanding of forces at work in the marketplace. It provides a more unified view of global market behavior. Intermarket analysis uses activity in surrounding markets in much the same way that analysts use internal market indicators. Intermarket analysis doesn't replace traditional technical analysis; it adds another dimension to it.

■ Intermarket Work Is an Evolutionary Step

I like to think that intermarket analysis represents another step in the evolution of technical theory and practice. With the growing recognition that all global markets are linked, traders can take these linkages into consideration more and more in their analysis. Because of its flexibility and its universal application to all markets, technical analysis is uniquely suited to perform intermarket work.

Intermarket analysis provides a more useful framework for understanding how individual markets and sectors relate to one another. Throughout most of the 20th century, technical analysis had an inward focus. This new century has witnessed a much broader application of technical principles not just to financial markets themselves, but also to their wider implications for economic forecasting. Even the Federal Reserve looks to the financial markets to get clues about the future course of the economy. It has to use charts to do that. The intermarket principles presented in this book offer a much broader view of the future of technical analysis. I believe that intermarket analysis will play an increasingly important role in that future.

To ignore market interrelationships is to ignore enormously valuable price information. What is worse is that it leaves market analysts in the position of not understanding the external forces that move the market in which they are trading. The days of following only one market are gone. Market analysts need to know what is happening in all of the financial markets and must understand the impact of trends in those related markets all over the world. Technical analysis has enormous transferability in moving from one market to another, and is extremely useful in comparing the relative performance of those markets.

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Technical analysis can be applied to any market and asset class, and can also be used for short-term trading and long-term investing.

■ Why Relationships Change

Intermarket relationships are not static. While most remain constant over long periods of time, they sometimes change for short periods. Some changes are more long lasting. As you'll see shortly, that is what happened between bonds and stocks. Nothing changes, however, without a reason. The changing relationship between bonds and stocks that started as the old century came to a close signaled that business cycles after 2000 would be different from other downturns since World War II. That became especially true after the housing collapse during 2007, which precipitated the worst financial melt-down since the Great Depression. Government attempts to turn the business cycle back up relied on traditional fiscal and monetary measures, which had worked in the past. Unfortunately, they didn't work as well this time.

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It's much harder to fight deflation than inflation. After lowering short-term rates to zero over the last decade, the Fed couldn't lower them any further and had to resort to other measures.

That was because the business cycle after 2000, and especially after 2007, wasn't like other traditional postwar business cycles. Deflationary pressures overrode those traditional government measures. Some of the intermarket changes that took place near the start of this century, and again after 2007, gave us plenty of warning that this time would be different.

The intermarket principles presented in this book are offered as guidelines, not rigid rules. The ability to adapt to changing market circumstances is one of the keys to profitability. This is as true in intermarket work as it is in any other form of market analysis. Although intermarket relationships are constant most of the time, there will be instances when some intermarket relationships (or correlations) may weaken for short periods of time. At such times, it's better to downplay those relationships until they start to strengthen again. Fortunately, we have tools to let us know when those correlations are strong and when they're weakening. Although the scope of intermarket analysis is broad, forcing us to stretch our imaginations and expand our vision, I remain excited about the prospects for its future. I hope you'll agree after finishing this book. Intermarket work is very fertile ground for market research and profitable trading opportunities.

■ Intermarket Principles

Before we begin our actual analysis of the various financial markets, let's review the main intermarket principles on which this approach is based. The principles are relatively few in number and easy to understand. All are based on sound economic principles and are supported by historical analysis. While most intermarket relationships listed below have remained very constant over the decades, some have changed from time to time. I'll explain why that happens and how you can tell when it is happening.

The basic intermarket principles are:

- All global markets are linked to each other.
- Analysis of any one market should include analysis of the others.

The four asset classes include:

- Stocks
- Bonds
- Commodities
- Currencies

Intermarket relationships:

- The dollar and commodities trend in opposite directions.
- Bond prices and commodities trend in opposite directions.
- Since 1998, bond and stock prices have trended inversely.
- Since 2008, stocks and commodities have been closely correlated.

How they interact:

- Bonds usually change direction before stocks.
- Stocks usually change direction before commodities.
- Bond yields peak first at tops, stocks second, and commodities last.
- Those rotations are less reliable at bottoms than at tops.

Foreign influence:

- All global stocks are closely correlated.
- A rising dollar benefits U.S. stocks.
- A weaker dollar favors foreign stocks.
- Emerging markets are closely tied to commodity trends.

■ Review of the Old Normal

Most of the intermarket principles just listed have remained pretty constant over the past few decades. Some, however, have undergone changes over the last decade. One change that has developed in recent years is that stock and commodity prices have become closely correlated. That's been especially true since the financial meltdown during 2008, which was caused mainly by a deflationary collapse in the housing industry. The more important intermarket change has to do with the relationship between bonds and stocks following the Asian currency crisis in the late 1990s. Since 1998, bond and stock prices have trended in opposite directions (which reversed their earlier relationship). That's also

typical during a decade when deflation has remained a threat. Although the main focus of this book deals with the *new normal* in intermarket relationships that has existed since 2000 (and even more so since 2008), it's useful to briefly review intermarket relationships that existed in the final three decades of the prior century to lay a foundation for our intermarket work, and to examine market events that led to newer market relationships that exist in current time. We'll review those *old normal* relationships in the next chapter.

