—New Albany—
Investment Management

Market Insight: Bad Breadth

August 25, 2021

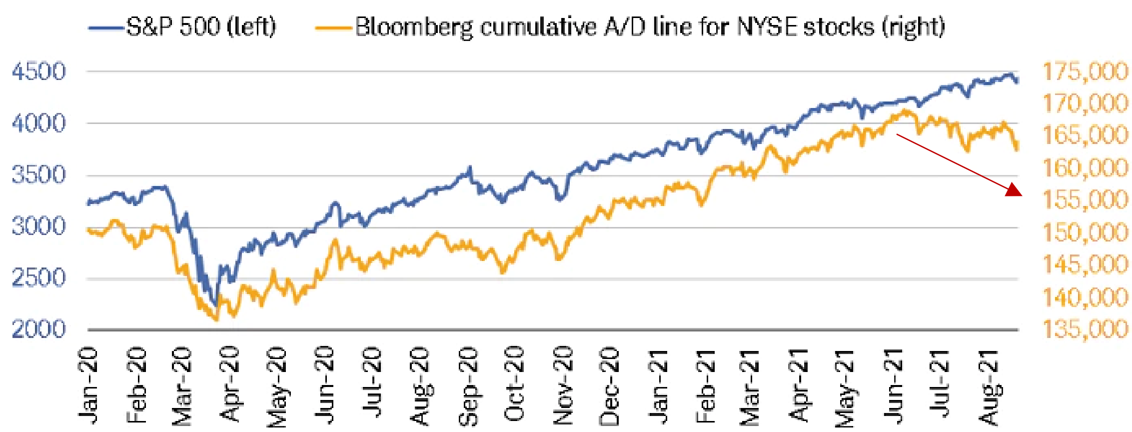
It has been yet another great year in the market with the S&P 500 and Nasdaq making new highs and little volatility. In fact, the market has now gone over 200 days without a 5% correction. Though not near prior peaks in days, there have only been seven other years since 1957 that this has occurred. In addition, since 1928, there have only been three calendar years where the maximum drawdown of the S&P was less than this year's -4.2% decline. Hmmm. But these statistics in and of themselves do not set the market up for a correction. However, since we are moving into what historically is the worst month (September) for stock performance it is appropriate to assess the health of the market.

With the market sitting at new highs, it is important to look 'under the hood' at the quality of the 'engine' that is propelling stocks higher. Many of the factors that had been a huge boost to stocks during the recovery are now waning and now becoming a risk to the forward momentum. Fading monetary and fiscal policy, rising inflation, peak earnings and economic growth rates, and heighten uncertainty over the Delta variant are now detractors to stock prices. And yet, the 'market' continues to move higher. But a closer look shows the underpinnings or 'breadth' of the market are deteriorating. The market has bad breadth!

Bad Breadth: A good way to assess the sustainability and forward momentum of the market is to look at market breadth, or the number of stocks participating in the rally. A measure of market breadth is the 'cumulative advance/decline ratio' (A/D ratio). If the ratio is rising, it says there is broad market participation across all sectors and is an indication of not only a healthy market but strong momentum ahead. Likewise, if the A/D ratio is falling, it says there is narrow leadership and the support for higher prices is waning.

The chart below shows the S&P 500 (blue line) and A/D ratio (yellow line) of the broader NYSE since Jan. 2020. Notice how the two lines moved mostly in tandem, both up and down, until June of 2021 when the A/D line began to decline, yet the S&P has kept rising. New highs in the index with deteriorating breadth is a warning flag that the underlying strength is weakening.

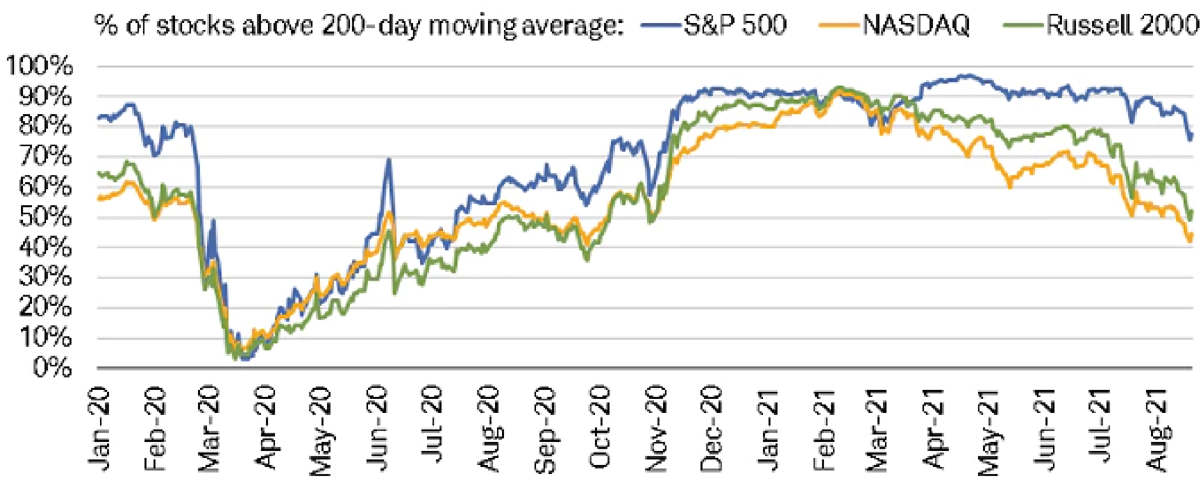
NYSE A/D Struggling



Source: Charles Schwab, Bloomberg, as of 8/20/2021. Cumulative advance/decline (A/D) line is the cumulative sum of the daily difference between the number of stocks on the New York Stock Exchange (NYSE) advancing and declining in a single day.

More Bad Breadth: Another measure of breadth is looking at the percentage of stocks trading above their 200day moving average. The chart below shows the percent of stocks trading above their 200day moving average for the S&P 500, NASDAQ, and Russell 2000 indices. A rising line indicates a healthy market with broadening participation and strong momentum. This was the case from November through February. But since March, breadth has been declining for both the NASDAQ and the Russell, and declining since May for the S&P. Again this indicates declining market participation and signaling a warning of a potential pullback.

200-DMA Breadth



Source: Charles Schwab, Bloomberg, as of 8/20/2021. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. Past performance is no guarantee of future results.

New Highs but waning support. In sum, as good as the market headlines read, almost daily, about new market highs, the underlying health and strength of this rally is fading. Declining breadth is not a 'sell' signal, but it does indicate the environment is ripe for a correction. Like a forest full of dry tender, it just takes one spark to set off a big fire. Although a correction is overdue and likely on the horizon, it will not derail the long-term picture of continued growth; however higher volatility is expected. Even a 10% correction is not unusual and is healthy for the market. The best way to navigate volatility is through diversified exposure across stock sectors.

Portfolio Strategy: Over the course of this year, we have made portfolio reallocations to ensure that the exposure to stocks is balanced between 'Value' and 'Growth' sectors. On the bond side, duration remains short with interest rates expected to rise over the next year.

These are my thoughts. As always, please reach out with any questions or concerns.

Best Regards,
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