



## MARKET HARMONICS

## EQUITIES MARKET OUTLOOK (EMO)

January 22, 2008

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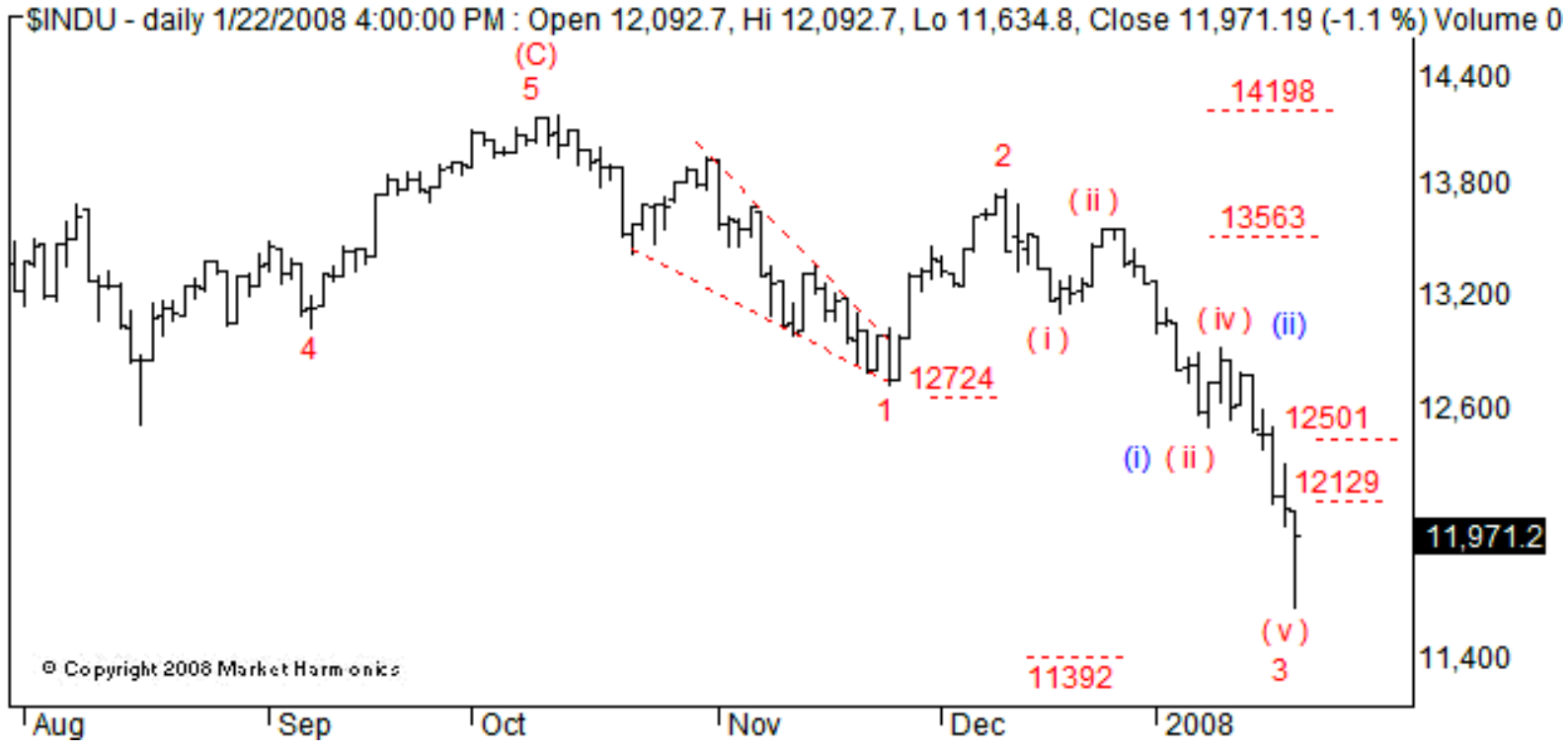
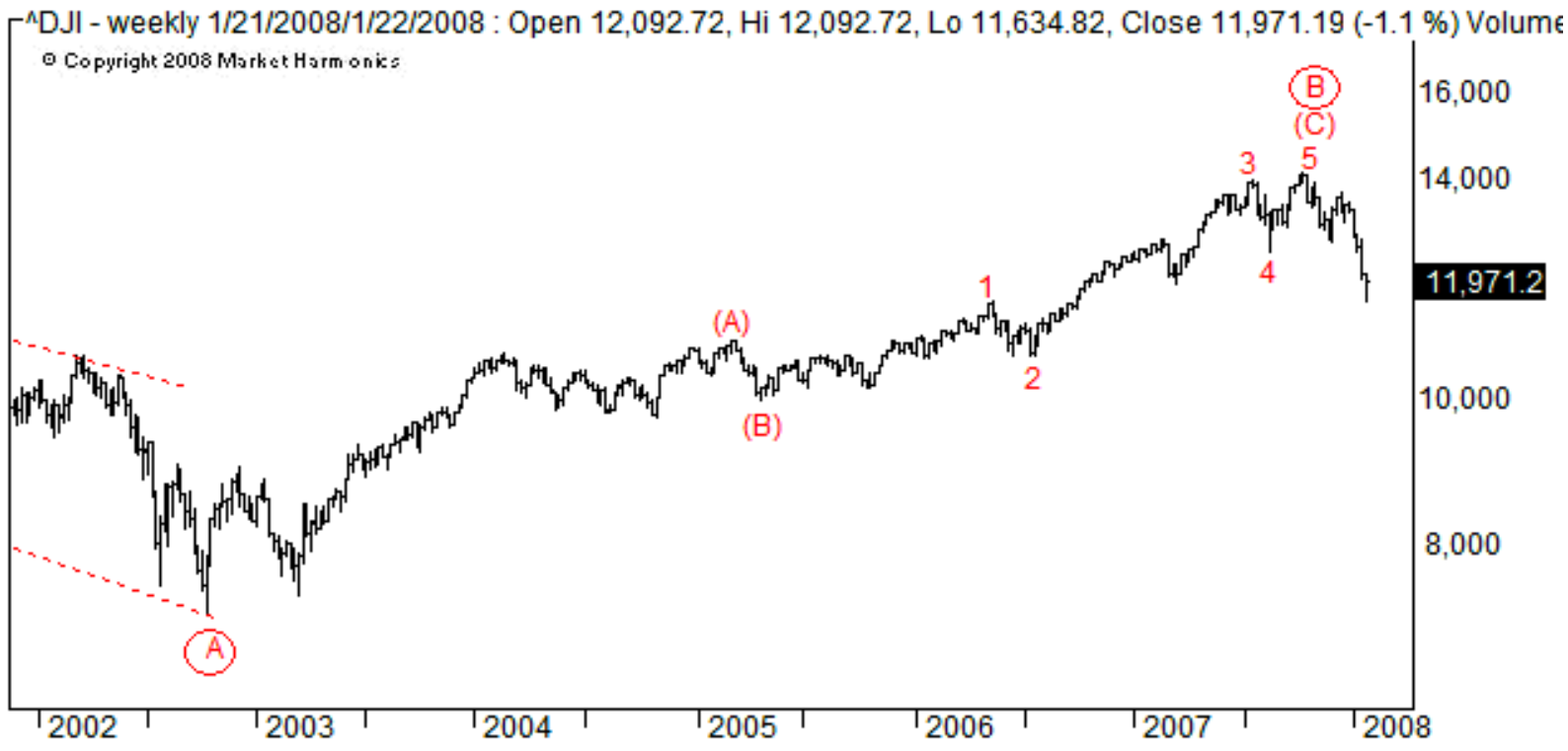
[Sentiment View](#)

The celebration of Martin Luther King Day on Monday essentially spared the U.S. stock averages from what was a rather ugly day's trading in other parts of the world. The FTSE, for instance, suffered its worst 1-day percentage loss since the 9-11 attacks. Watching the index futures trading on Monday night, it was already a good indication of what was in store for the US markets when they opened on Tuesday morning. More interesting perhaps than the inevitable morning lows, were the bounce back recoveries that came afterwards. On what could have been a far worse day, the Dow and S&P 500 ended up losing 1.1%, the NDX 2.6%, and the Russell 2K a meager 0.3%. The total market Wilshire ended down 0.6%, with small caps no doubt preventing a sharper drop. The mixed sentiment climate doth still prevail.

The recovery bounces were naturally attributed to the Fed cutting the Funds rate another 75 basis points, offering a knee-jerk reaction of its own in light of Monday's global trading mess. The cut came a week earlier than planned, but the bottom line is that the Fed simply took the Funds rate to where 10 Year Treasury yields are already at, and these are the yields most watched by the lending market. So once again, the market is leading the Fed to its target rate, and not the other way around. For all the clamoring about rate cutting, the Fed has taken down the Funds rate 175 basis points in total since September. They've done in four months what took them nearly a year when Greenspan's Fed started slashing rates in January 2001. So, Mr. Market, now what are you going to do with it?

A couple of other interesting observations. First, commercial lenders were only inspired enough to reduce the prime lending rate from 7.25 to 6.50 percent, which on its face may look sharp, but is still conservative, when one considers how many points above prime will be added. And although the Fed lowered the Funds rate to 3.5%, its discount rate, which the interest rate it charges for loans it makes directly to banks, is holding at 4%, a full 50 basis points higher. That half a percent makes a big difference when billions of dollars are changing hands. Of course, the Fed is still a private bank, not an arm of the government as so many seem to think. Despite the "Federal" in its name, it isn't anymore federal than Federal Express. There are obviously limits, therefore, on how much "liquidity risk" the Fed itself is willing to take. In this case, what's good for the goose isn't necessarily as good for the gander.

**Dow Industrials**



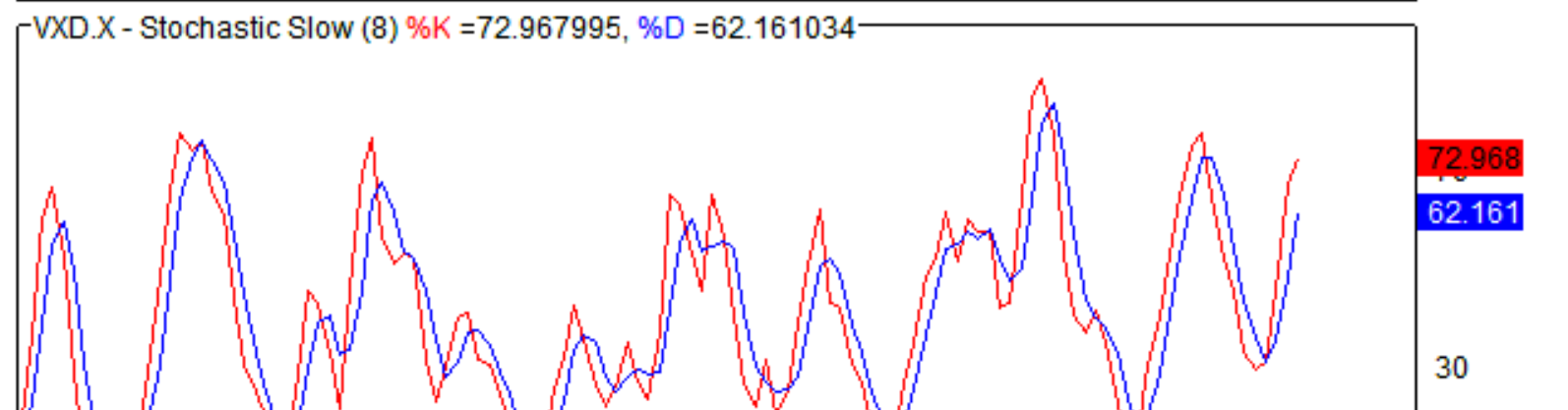
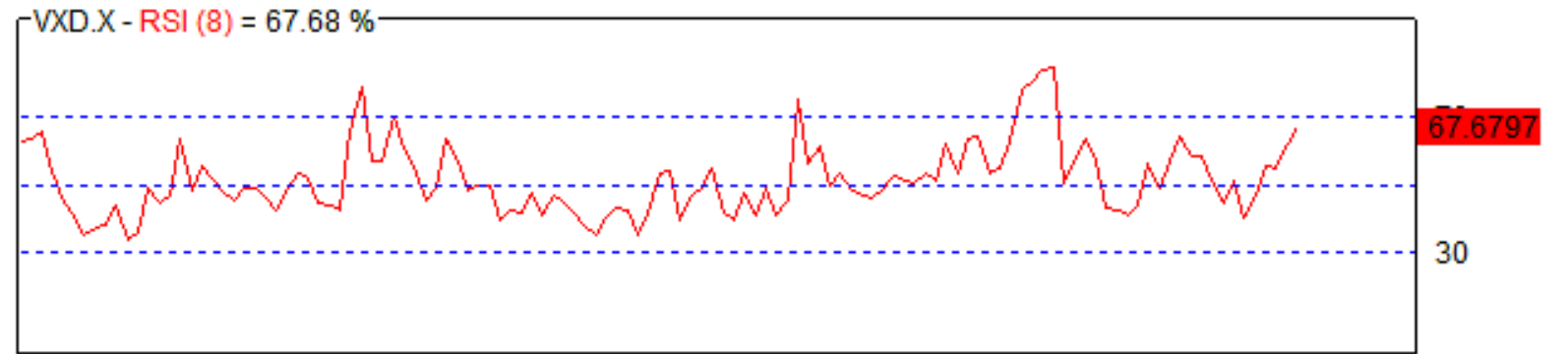
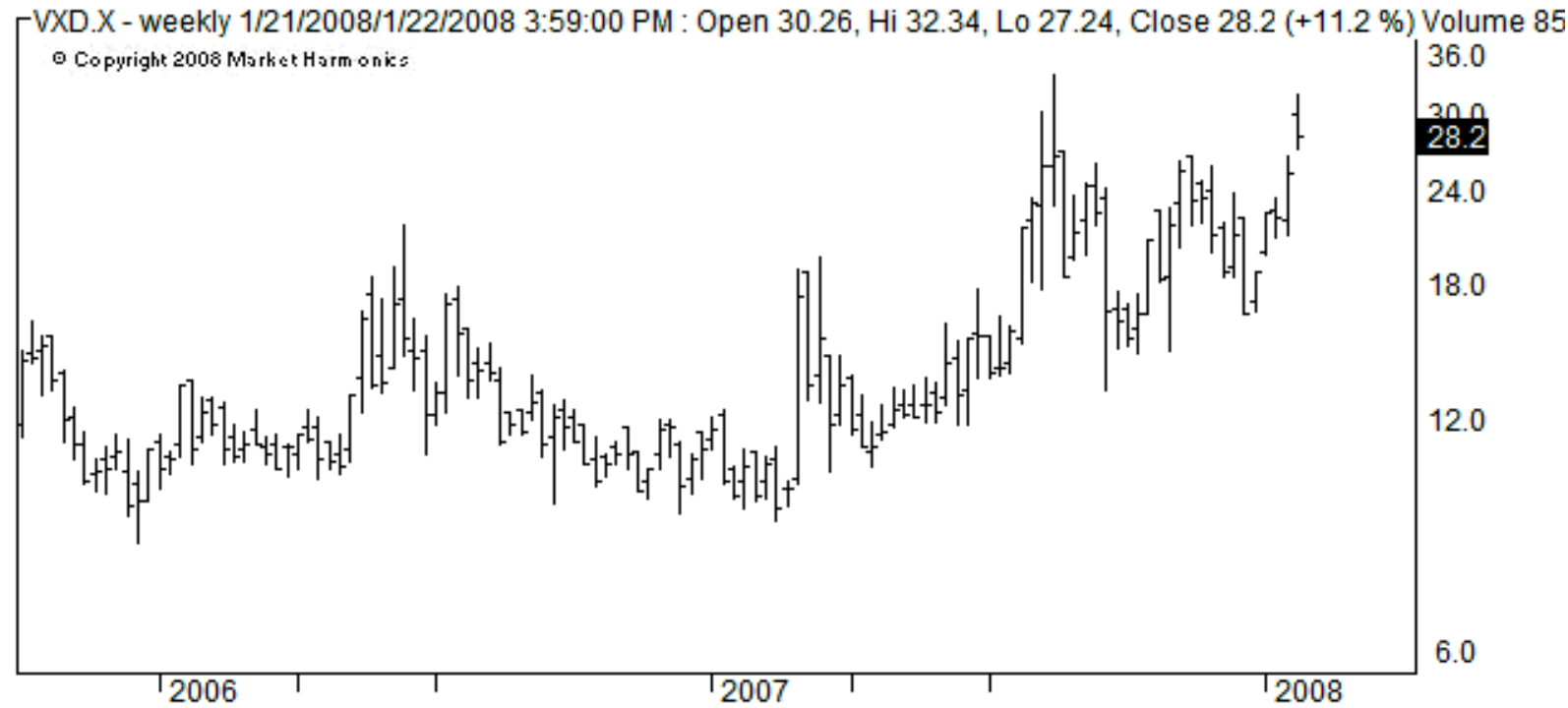
**DOW CASH INDEX:** The Dow's plunge to 11634 in early morning trading eliminated the triangle model we'd been considering, and causes us to revise the wave model to account for a top at the 14198 high of October. Although we apply an impulsive labeling, these are far from ideal impulse patterns, though as I noted a few weeks ago in reference to the Wilshire, the first leg of decline from the October highs is countable as a "five" on the basis of closing prices. Excepting today's plunge, much of the downtrend has not been accompanied by fear-based selling, with so many buying dips of the expectation of a Fed rescue. We saw evidence of that today. Assuming a top to be in place, then the preferred count would be the launch of a Primary C down, of which the declines are the subwaves. With the new lows, it becomes possible to count a third wave pattern, which may or may not have ended on Tuesday. A more ideal Wave 3 low would have occurred at 11392, although the current low is acceptable, and a 5-wave fractal pattern down is countable. The blue labels also permit us to consider the potential for a far sharper Wave 3. Consequently, what will determine whether Tuesday's low offers any kind of a respite is the depth of any upside retracement that develops. The Dow, like the stock averages generally, recovered much of its morning drop. If the sharper third wave count is not

in effect, then it would take an upside violation of 12501 in a recovery to eliminate it from consideration. Secondly, and if the violation occurs, then the next resistance level that matters is 12724, a violation of which would mark the decline as an ABC pattern, and result in yet another interpretation. For the moment, these are the key resistance levels we are watching.

**DOW DIA-MONDS :** As per our discussion for the index, the equivalent upside resistance tests for the DIA-Monds lie at 125.01 and 127.24. While Tuesday's 115.89 drop is acceptable as a Wave 3 low, a further test of lower support at 114.08 is not ruled out.

**DOW E-MINI FUTURES:** For the March Dow E-mini futures contract, equivalent upside resistance tests lie at 12550 and 12823. While Tuesday's 11615 is acceptable as a Wave 3 low, a further test of lower support at 11374 is not ruled out.

### DOW SENTIMENT

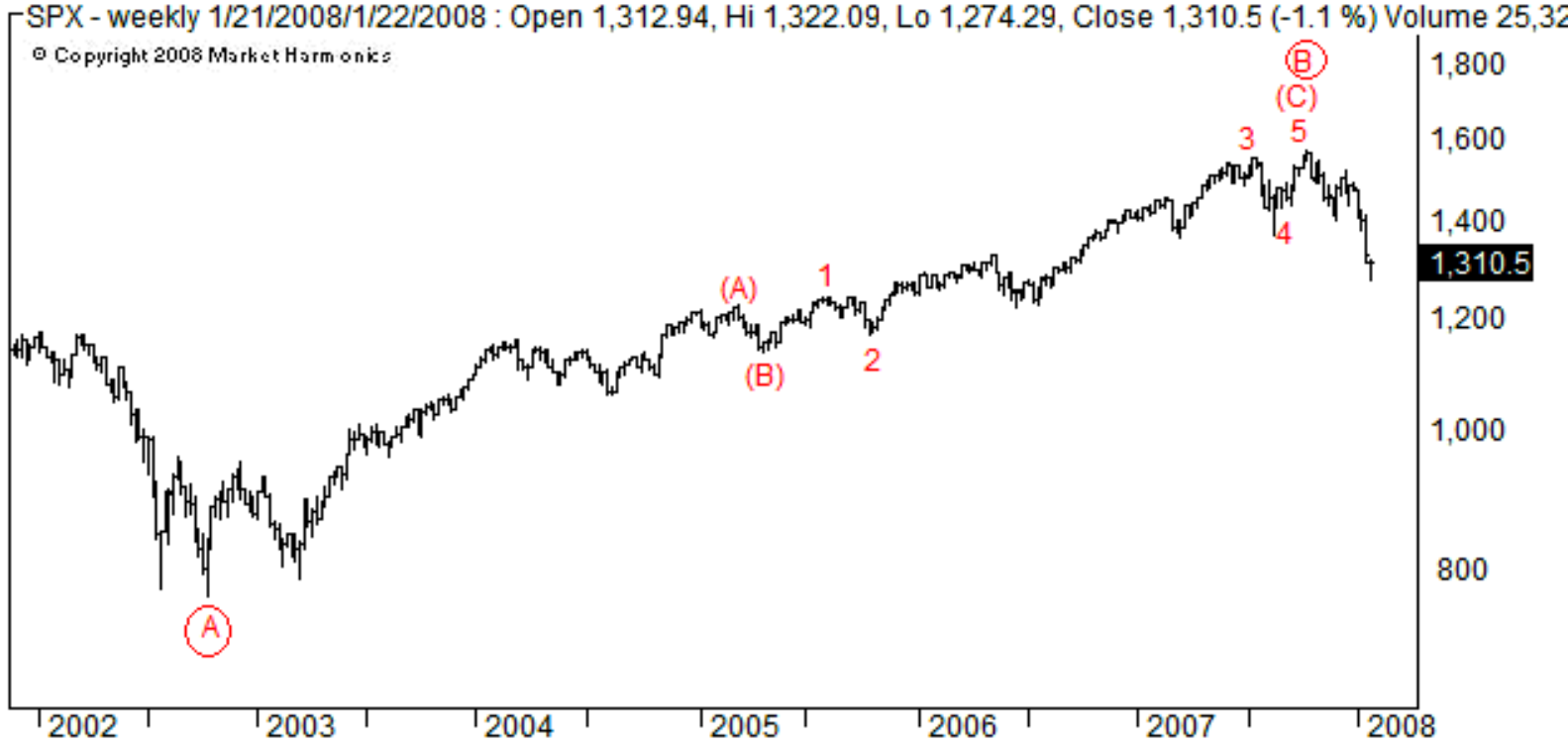




The weekly VXD came close, but did not retest the peak made in August. As the technicals suggest, Dow volatility could still get higher, so we may not be out of this just yet.

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**S&P 500**



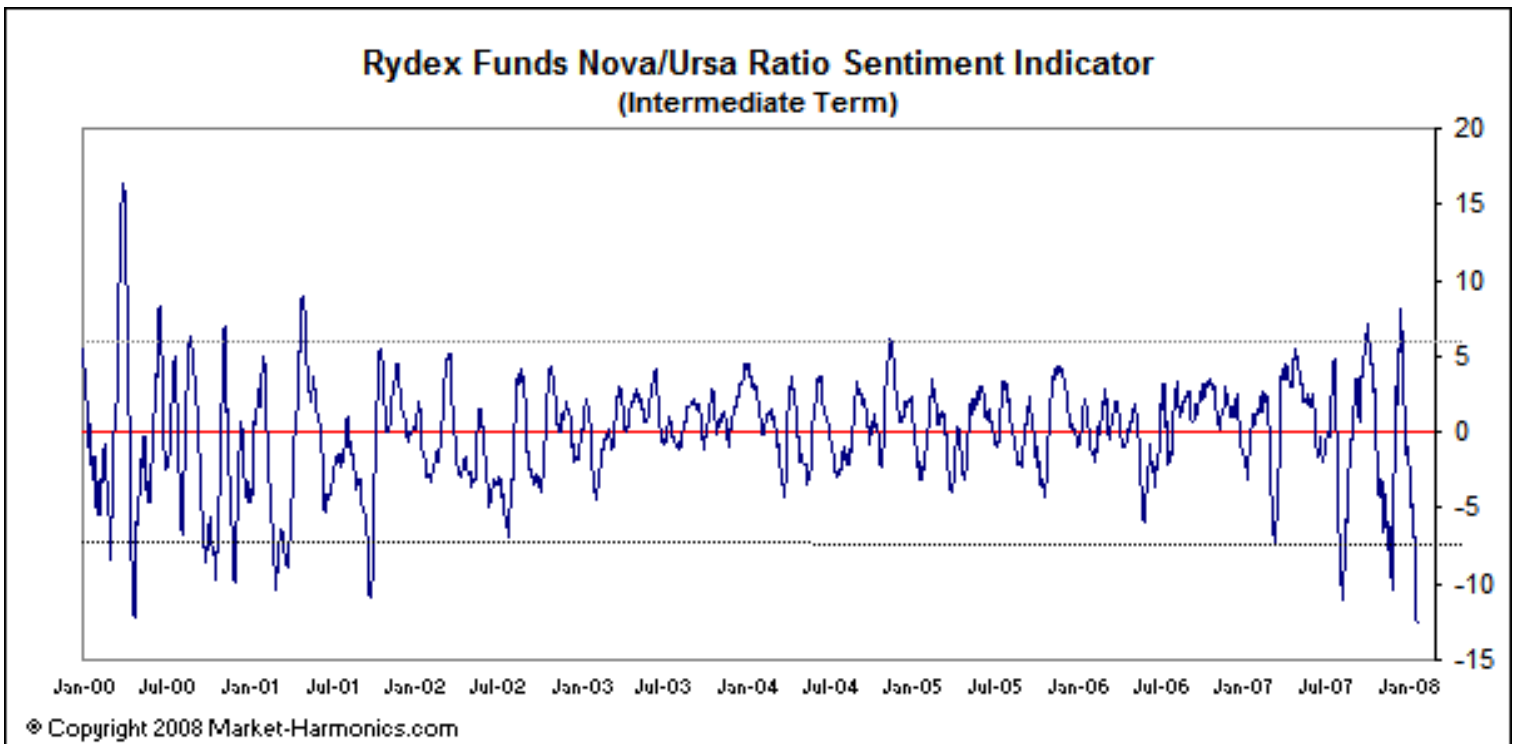
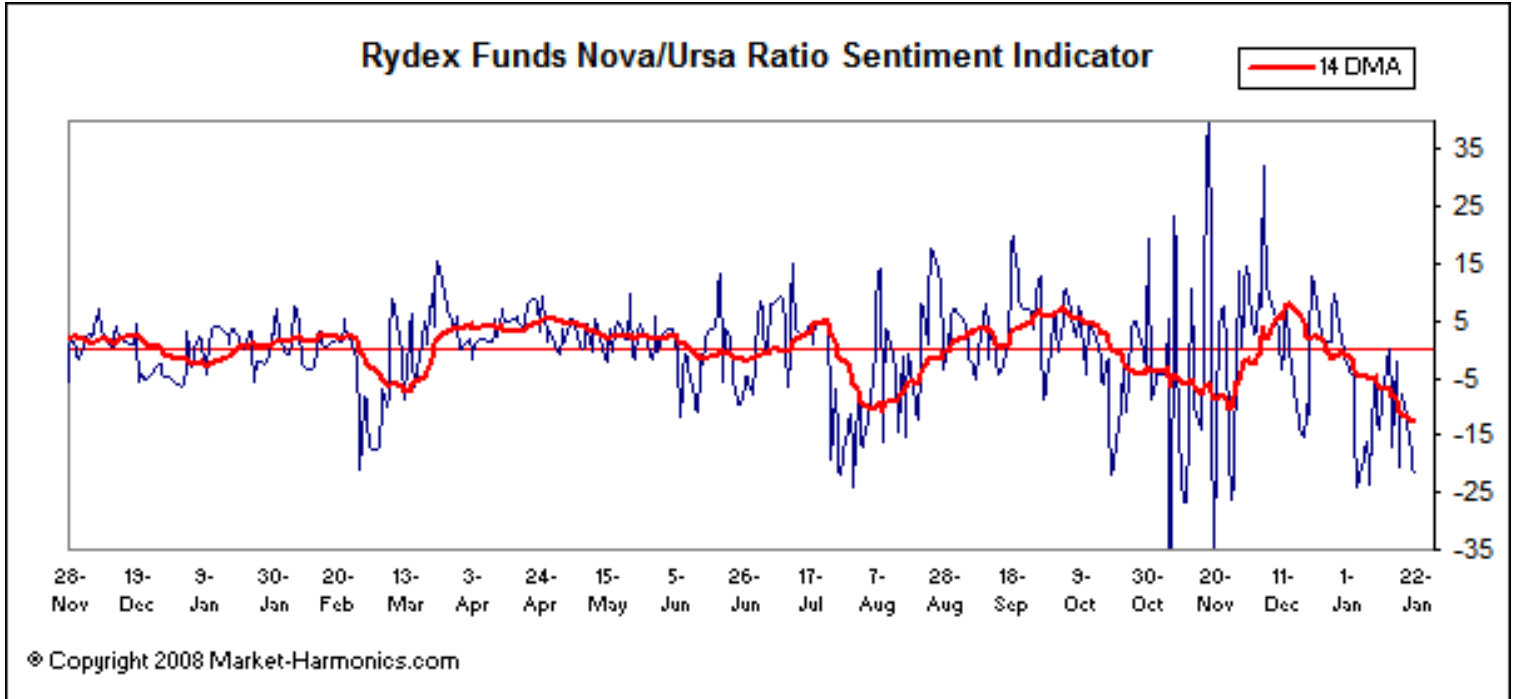
**SPX CASH INDEX:** Our revised labeling is also reflected in the SPX, which fell to a 1274 low. This counts okay as a

Wave 3 low, although a test of 1250 would count better. As with the Dow, the issue for the wave count is how much upside a recovery may achieve. To rule out the more bearish blue labels, the index must rise above 1378, and if the decline is not a Wave 3, then 1406 would also need to be violated. Otherwise any recovery should be modest, especially if Wave 3 isn't over. These are the key upside resistance levels to observe.

**SPY-DERS:** The SPY-ders hit an early morning low of 126, which is okay for a Wave 3 low, with 125.56 a better low, and still possibly testable. The key upside resistance tests to eliminate the more bearish count is 137.72, followed by 140.66.

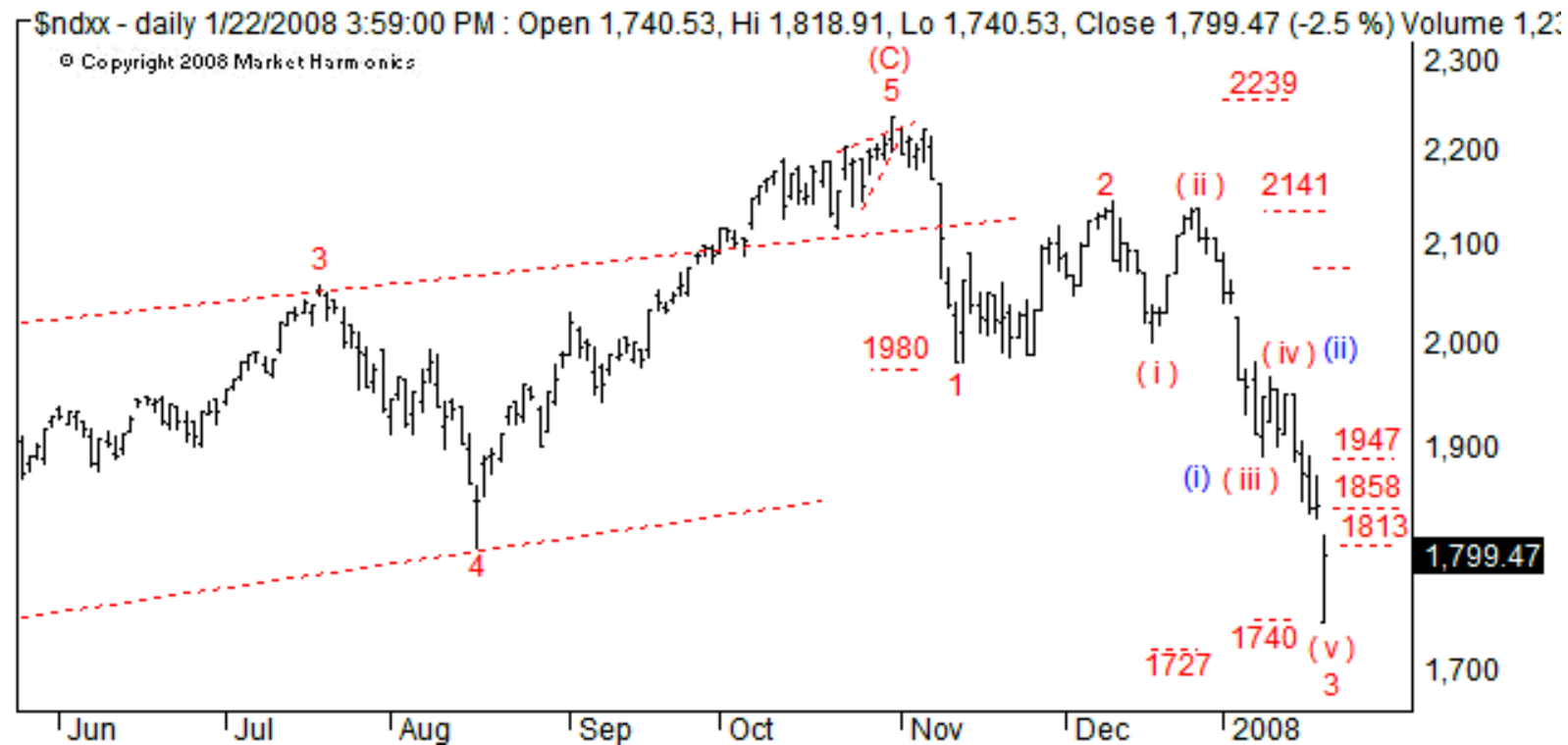
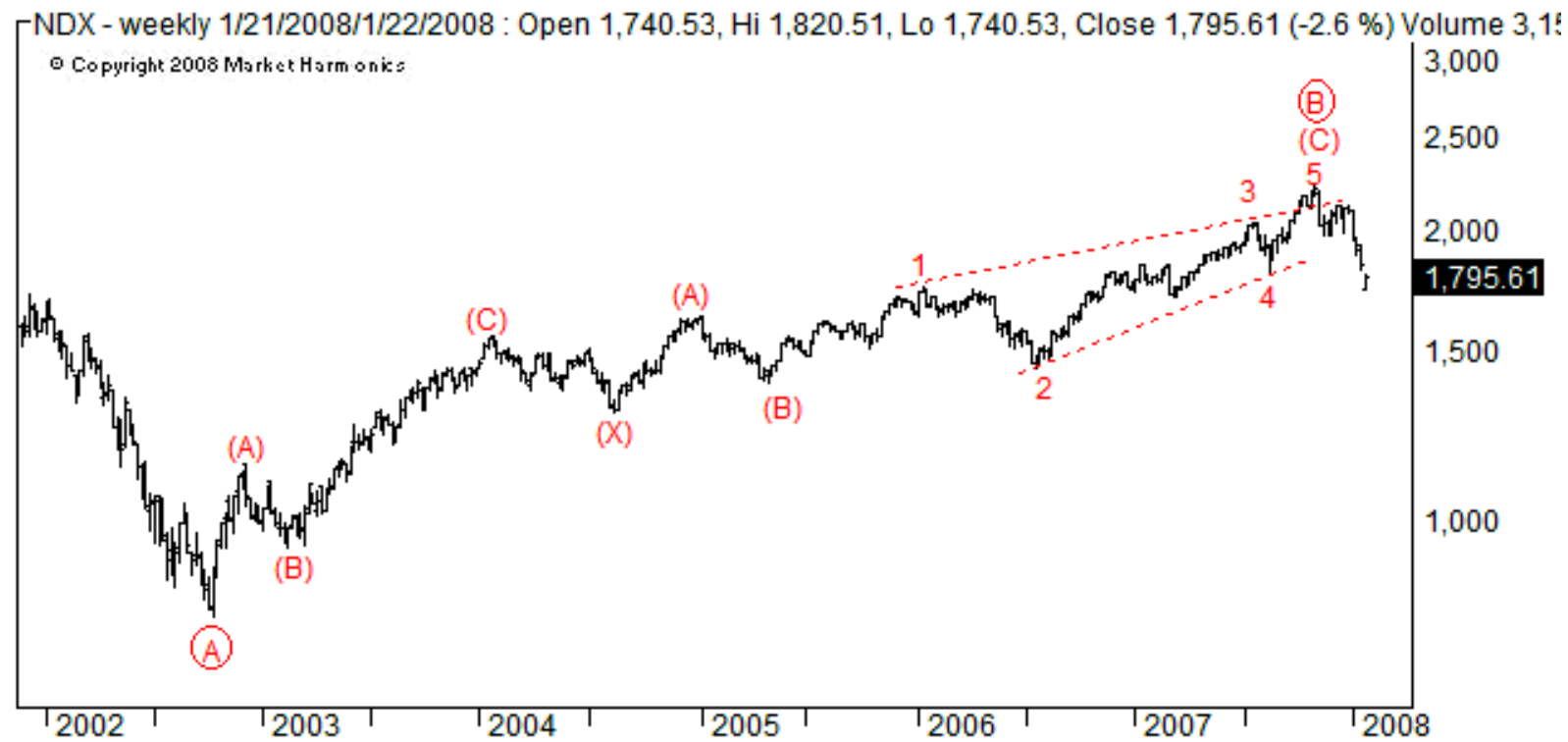
**SPX E-MINI FUTURES:** For the March SPX E-mini futures contract, which reached a session low of 1262, lower support is 1242 if the Wave 3 low wasn't made. Upside resistance tests to observe for the bearish count is 1385, followed by 1416.

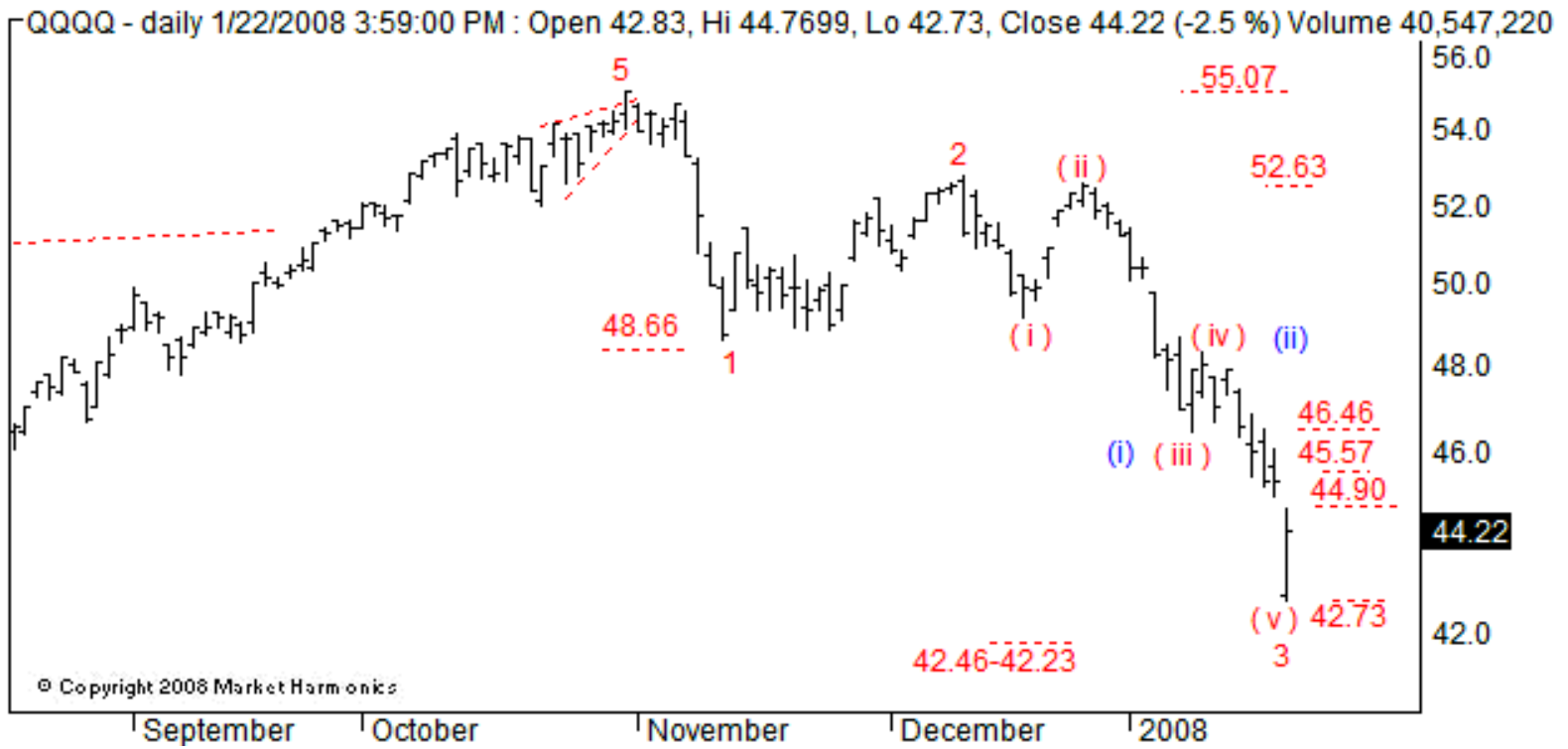
**SPX SENTIMENT**



The long-term Rydex Nova/Ursa Fund indicator registered its most bearish reading in almost 8 years, mildly exceeding the March 2000 "crash reading" when the previous bull market topped. Whether this implies a recovery is in the offing is still too soon to say, and the shorter-term readings are also not as bearish. An upside reversal in the long-term indicator would be needed to support any kind of near-term recovery. If nothing else, this retracement is still historically significant.

**NDX & QQQ**





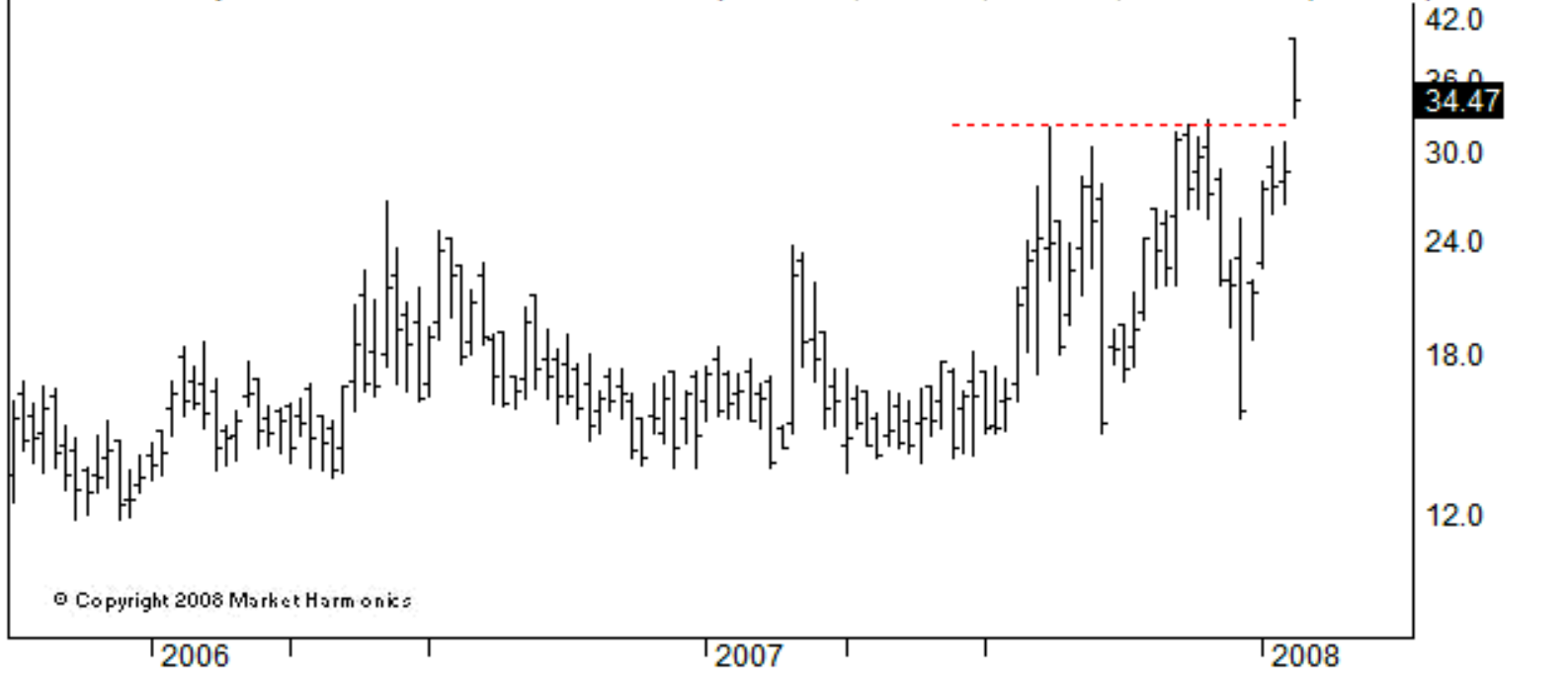
**NDX CASH:** Our revised labels for the NDX are basically along the same lines as we've seen for the Dow and SPX. A Wave 3 low is plausible at Tuesday's 1740 low, with a better ratio low still occurring at 1727. If we don't get much more of a recovery than unfolded following Tuesday's low, 1727 could conceivably still be tested. To rule out the most bearish of the counts, a move above 1889 is needed, and to rule out the Wave 3 count, an eventual move above 1980. More immediate resistance levels are noted.

**QQQQ:** For the Cubes, a move above 46.46 is needed to rule out the more bearish blue labels, and an eventual move above 48.66 is needed to rule out the Wave 3 count altogether. Otherwise, any bounce should be a fourth wave pattern, and remain contained beneath lower resistance. The drop to 42.73 works as a Wave 3 low, though we cannot rule out lower tests of support at 42.46 or 42.23.

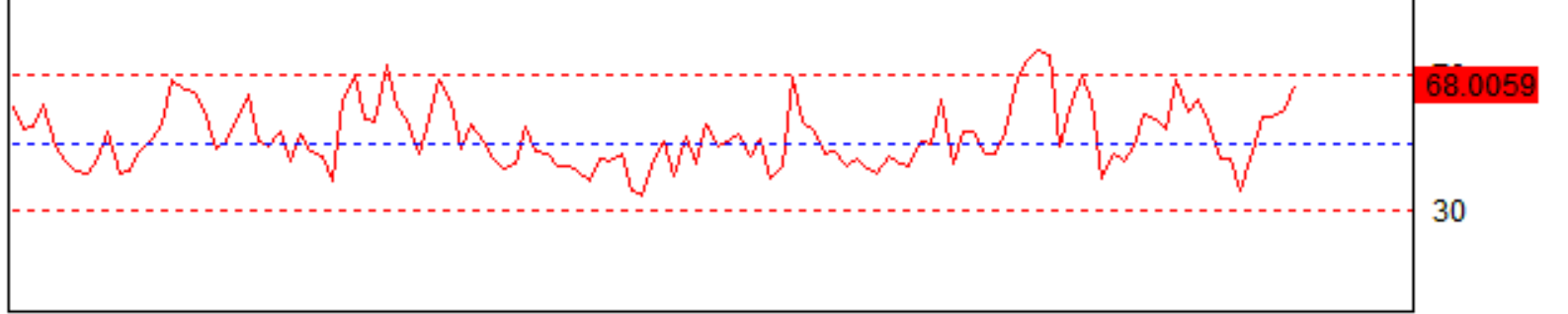
**NDX E-MINI FUTURES:** For the March NDX e-mini futures contract, the key resistance levels to watch are 1903 and 2007, with lower resistance at 1819 and 1867. Tuesday's 1746 low also works as a Wave 3 bottom, though the more ideal low for this is 1735, which can still be tested if the recovery remains shallow.

**NDX SENTIMENT**

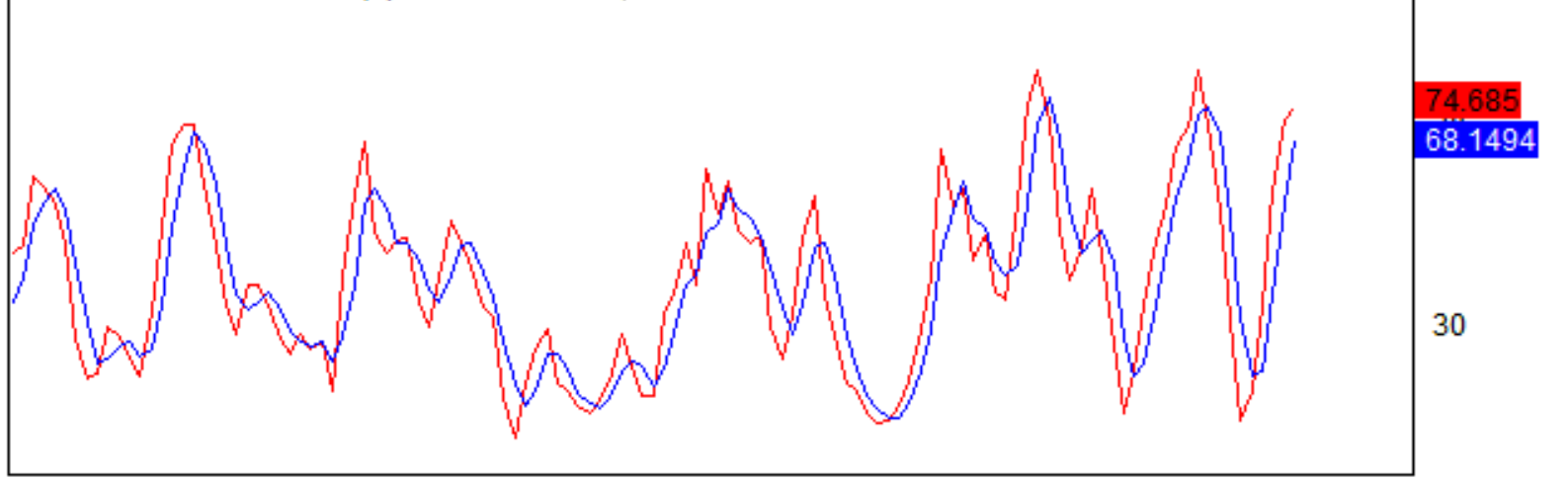
QQV.X - weekly 1/21/2008/1/22/2008 4:14:00 PM : Open 40.18, Hi 40.18, Lo 32.87, Close 34.47 (+19.7 %) Volume 3



QQV.X - RSI (8) = 68.01 %



QQV.X - Stochastic Slow (8) %K = 74.684952, %D = 68.149406



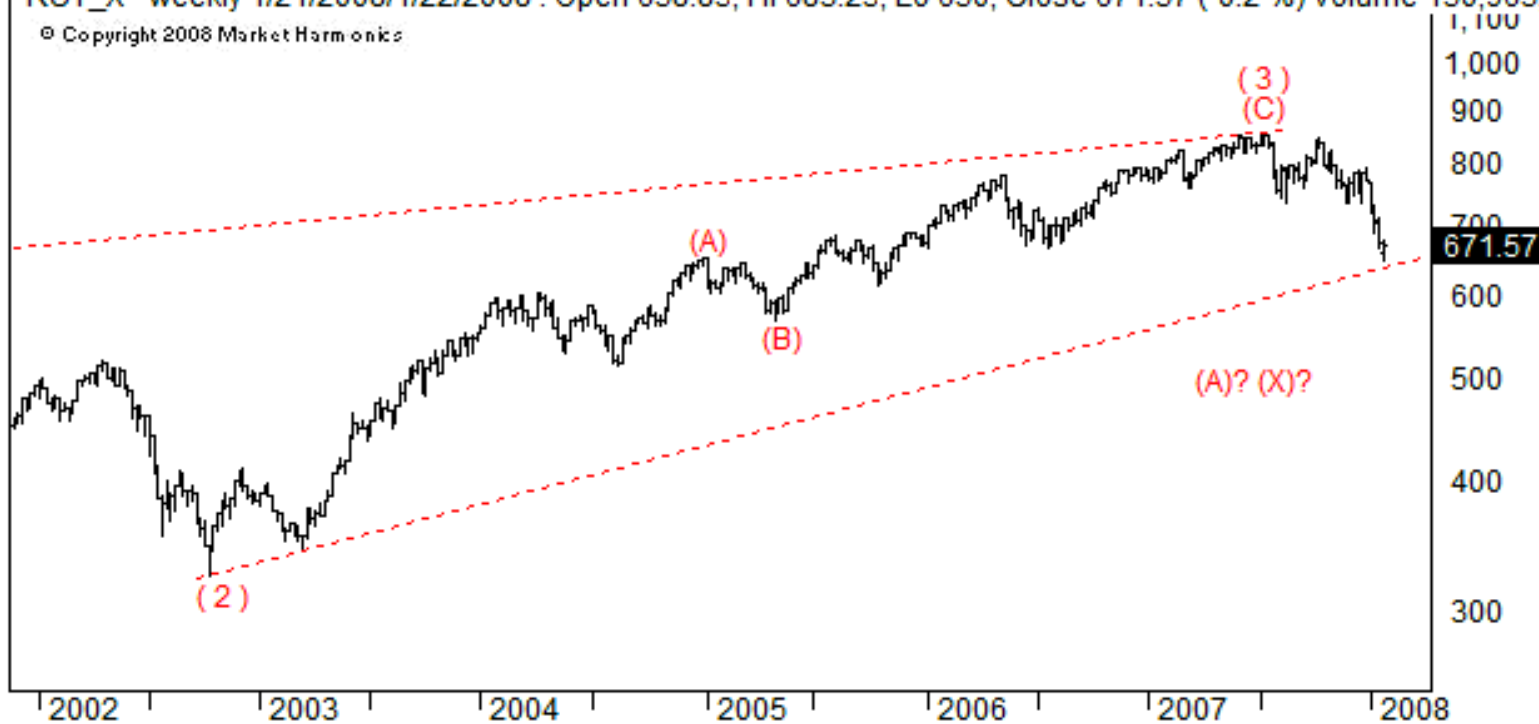
The weekly QQV shot well past the August "fear peak" before dropping into the close. While the daily technicals achieved strong upside momentum readings, they have not as yet been repeated in the weekly readings. They don't necessarily have to be, but the strongest recoveries to tend to see the weekly momentum readings higher than they are now.

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**Russell 2000 & IWM iShares**

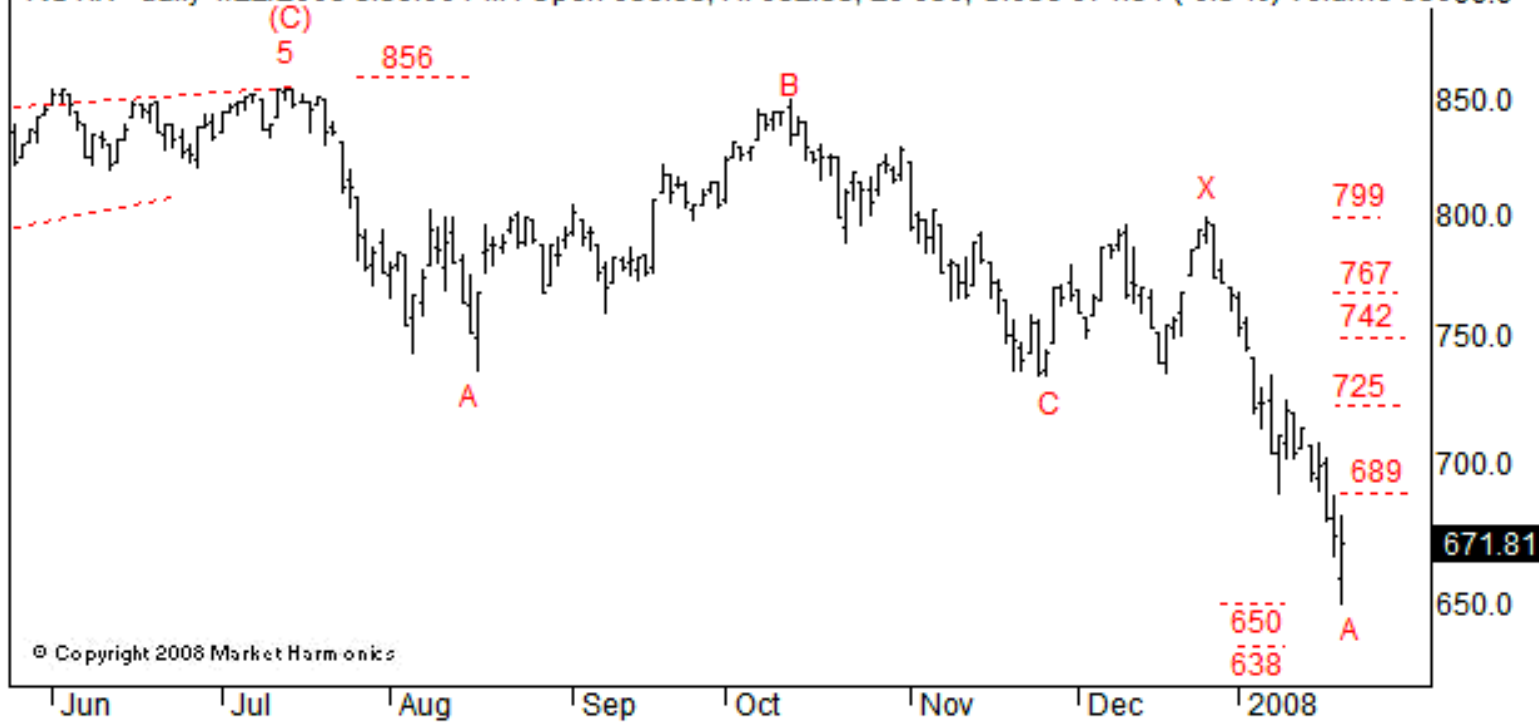
RUT\_X - weekly 1/21/2008/1/22/2008 : Open 658.85, Hi 683.23, Lo 650, Close 671.57 (-0.2 %) Volume 150,963,87.

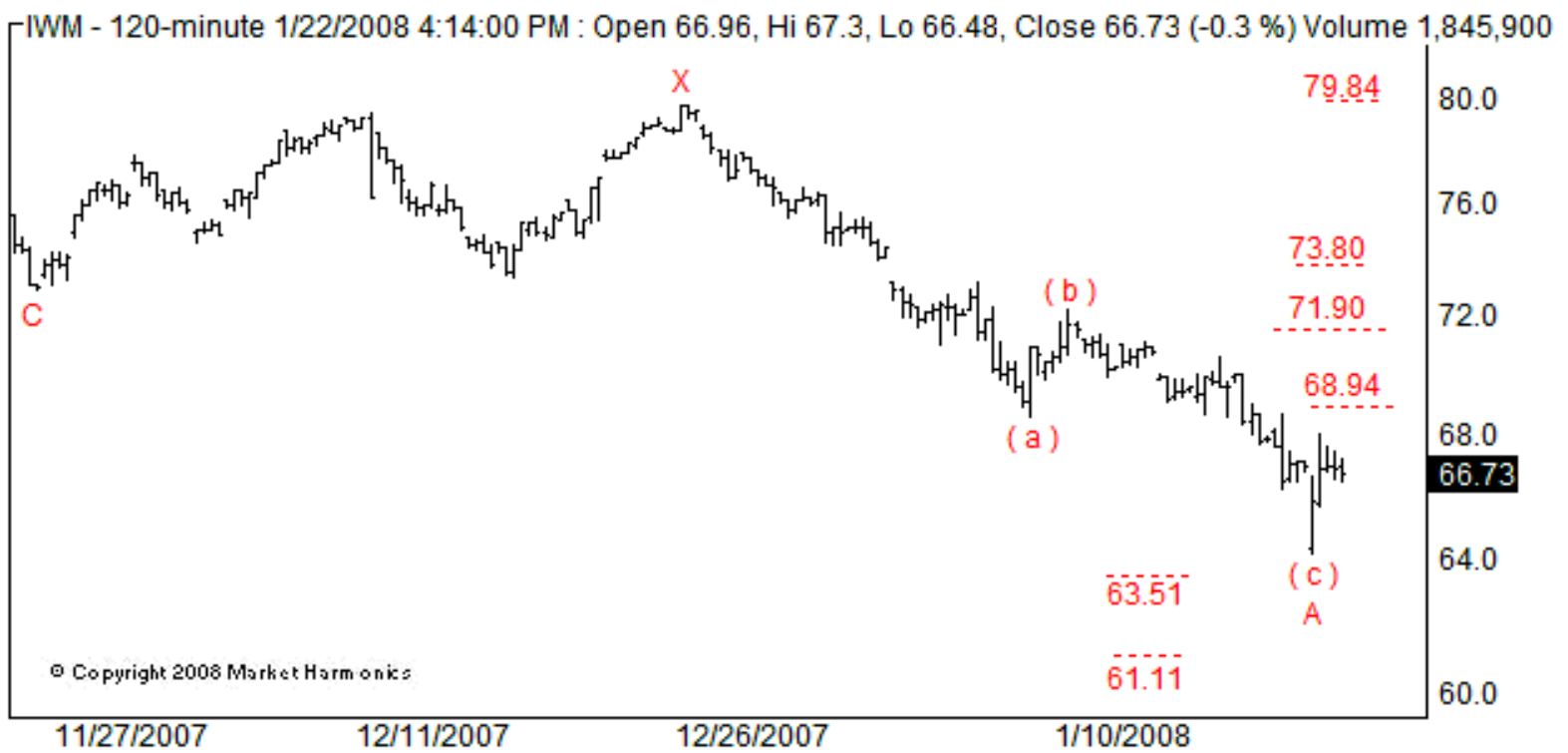
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RUT.X - daily 1/22/2008 3:59:00 PM : Open 658.85, Hi 682.55, Lo 650, Close 671.81 (-0.3 %) Volume 83000.0

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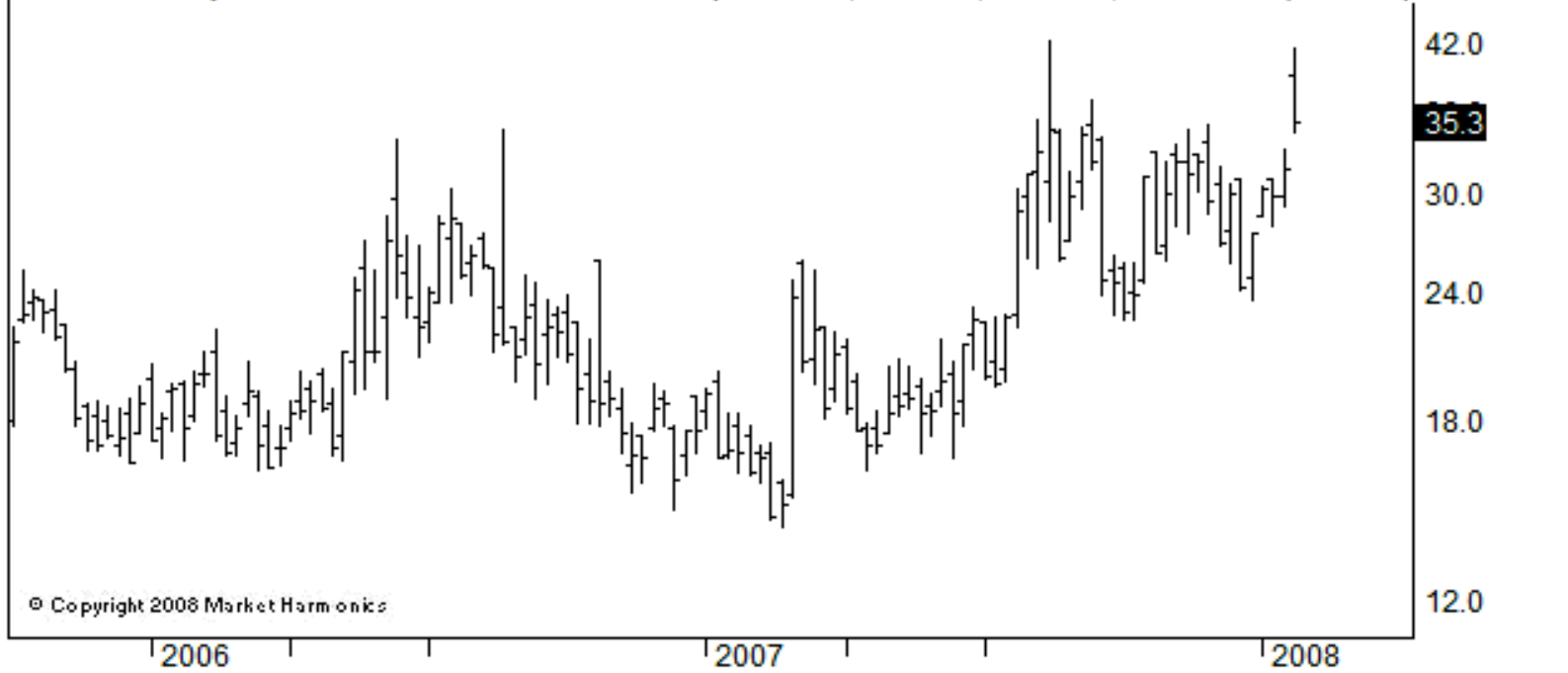
**RUT CASH INDEX:** The RUT experienced the mildest setback of the averages, posting a 0.3% loss. Also unlike the other averages, our expectation in the RUT has been for a corrective decline to unfold, since we regard it as a Primary Wave 4 decline within a large Cycle degree diagonal triangle. Consequently, we apply the Wave A label for the decline, rather a Wave 1. Our minimum target for the end of Primary 4 is 638. The index got within 12 points of it, although it's doubtful this would conclude the overall correction. Instead, we may see a Wave B rally unfold if in fact Wave A concluded on Tuesday. Assuming it may have concluded, the fact that it fell in three waves already indicates that Primary 4 is likely to be a messy and corrective decline. Thus far, it's lived up to that reputation. Upside resistance levels are noted for a Wave B rally.

**IWM iShares:** The IWM reached a low of 64.19, and unless it's Wave A ended here, then lower tests of support at 63.51 and 61.11 are still possible. If a bottom was made, and the stock rallies in Wave B, then it should be able to remove resistance at 68.94. Higher resistance is noted above.

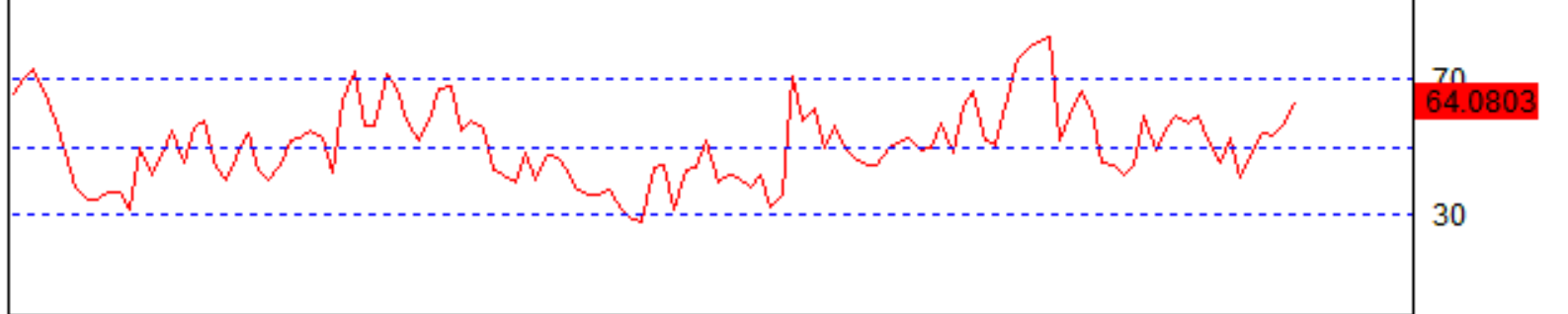
**RUSSELL E-MINI FUTURES:** The March Russell E-mini futures contract reached an intraday low of 637, which works for a Wave A count, although we can't rule out tests of lower support at 628 and 616 as yet. Upside resistance levels are 701, 721, 729 and 740.

## RUT SENTIMENT

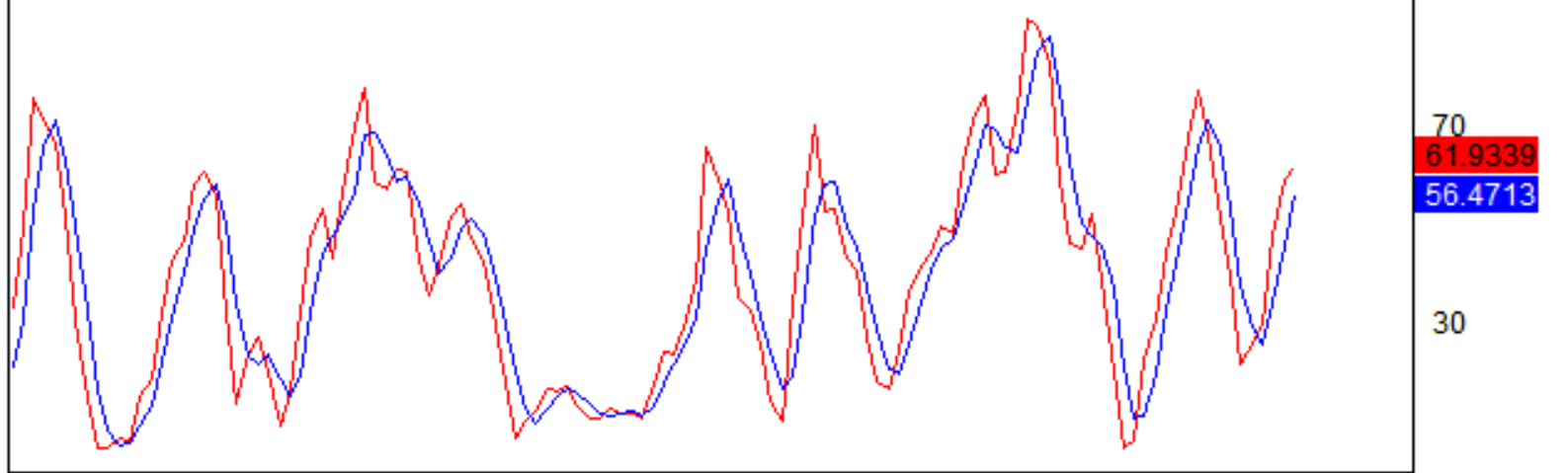
RVX.X - weekly 1/21/2008/1/22/2008 4:14:00 PM : Open 39.19, Hi 41.97, Lo 34.51, Close 35.3 (+11.1 %) Volume 89



RVX.X - RSI (8) = 64.08 %

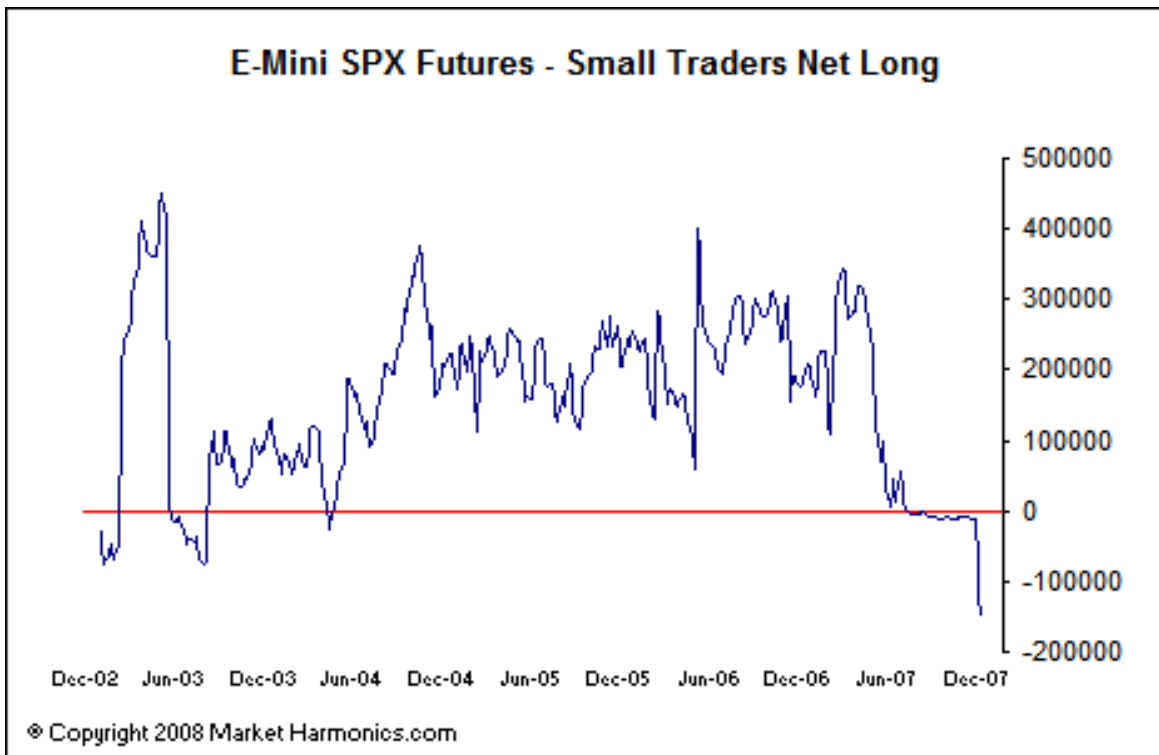
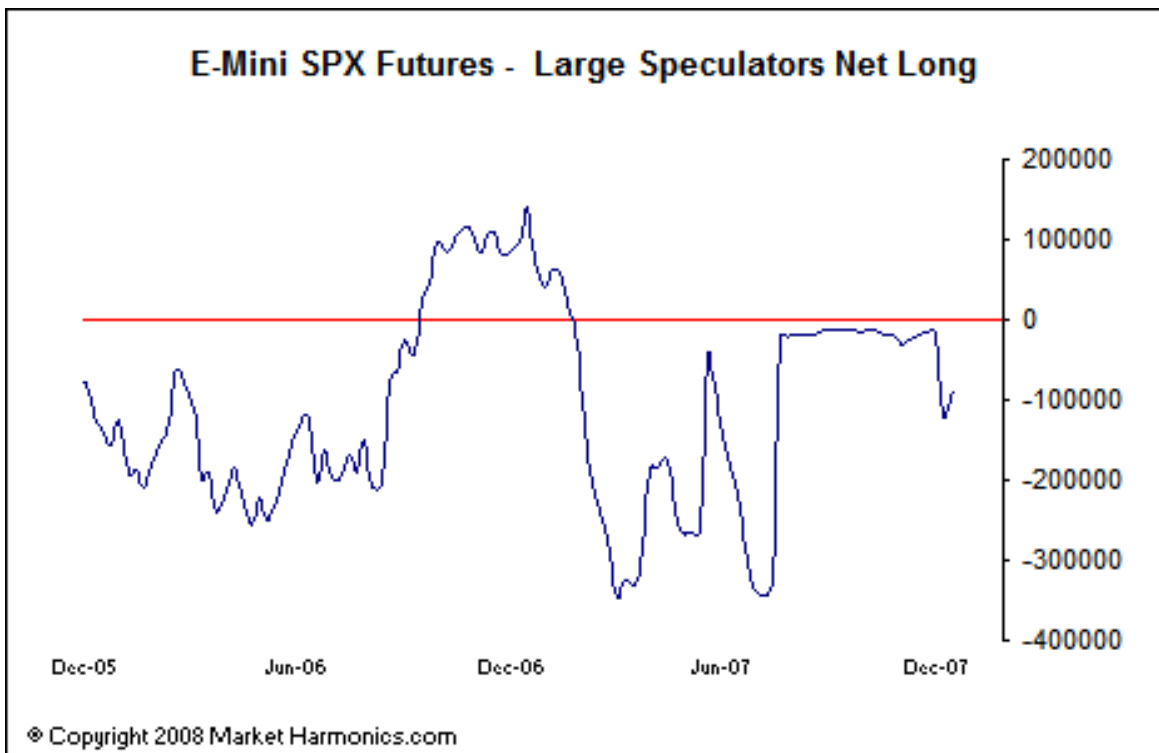


RVX.X - Stochastic Slow (8) %K = 61.933861, %D = 56.471313



Like the VXD, the RVX offered a near-test of the August high volatility reading. Weekly momentum readings, though, are not at their most bearish retracements; nor are the daily readings, although they are a bit closer. For the moment, we can't rule out the potential for more volatility.

**Sentiment View**



After moving sideways for several weeks, the net short position for Small Traders in the SPX E-Mini futures fell beneath the lows set in March 2003. This is basically consistent with the bearish readings we saw in the long-term Nova/Ursa, and it's an indication of where a good part of the sell pressure on the SPX is coming from. The so-called "smart money" Large Speculators, while still net short, were apparently covering shorts last week, given the uptick we see in the top chart. While Tuesday's lows were more dramatic, the SPX nevertheless gave up more than 5% last week, so the covering trend among the Large Specs is interesting. I don't think it's a matter of the Small Traders being any more prescient (although they were obviously on the right side of the market) as much as the herding impulse to sell. That is what lows are ultimately built on, when capitulation finally occurs. The problem is that at least as of last week, we hadn't seen much capitulation on the part of the "pros." As I pointed out in my recent comments on the Correction Advisors covered by Investors Intelligence, most of the pros still see all this as not too serious. I wonder how many of those opinions were changed on Tuesday?

Until next week, safe trading.

[Tony Carrión](#)

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For the benefit of newer subscribers (and since we discuss options regularly) note our little shorthand: ATM = at-the-money options, ITM = in-the-money, and OTM = out-of-the-money.

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