Blue Line Investing[1]
3948 Browning Place, Suite 200
Raleigh, North Carolina 27609
www.BlueLineInvesting.com

"TECHNICALLY SPEAKING"[2]
July 18, 2016

BREAKOUT!

In recent months we have documented why we believed the *primary trend* of the stock market was in a neutral/consolidating trend channel through various reports published on this website. As of this week the stock market has broken up and out through the top of the trend channel, a potentially bullish development and one that could have significant implications. If this breakout holds it could lead to much higher prices in the near-term. But during these situations an investor should always beware of the "false breakout." This is the possibility that the breakout is actually a trap, getting investors to make new purchases, just before the breakout fails and prices drop back inside the trend channel. So what indicators can we currently observe that either promote the bullish "breakout" or warn of a possible "false breakout?"

The following page is an insert of page 149 from *Technical Analysis of Stock Trends*[8], by Edwards and McGee (1948). This chapter, and specifically this page, discusses potential reversal formations. In other words, these are technical formations that tend to lead to a change of trend from positive to negative, or negative to positive. The technical formation on the following page is commonly called a *flat top broadening formation*. This is typically a negative technical formation that can lead to lower prices in the investment in question. But sometimes it can lead to further gains. A portion of the next page reads:

> "Thus, if a broadening price pattern *with a flat top boundary* develops after a good advance and <u>if</u> prices finally burst *up* through that top line on high volume <u>and</u> close above it to a conclusive extent (roughly 3%), then it is safe to assume that the preceding up trend will be resumed and carried on for a worth-while move." [Emphasis added]

On the following pages we have provided charts of the Dow Jones Industrial Average Index[3], the S&P 500 Index[4], the NASDAQ Index[5], and the Russell 1000 Index[6]. As investors, we are looking for data that could support either a bullish or bearish expectation for the markets going forward. Specifically, *have the markets risen in price by 3% or more from the breakout? And, have they broken out on high volume?* Take a look on the following pages.

its counterpart with a horizontal bottom boundary and a down-slanting top boundary is called a Descending Triangle, we cannot apply these terms to the inverted or broadening forms. Generally speaking, Right-Angled Broadening Formations carry bearish implications, regardless of which side is horizontal, in nearly the same degree as the symmetrical manifestations.

Obviously, however, they differ essentially from symmetrical formations in one respect: a horizontal side indicates either accumulation or distribution at a fixed price, depending of course on which side is horizontal. And it follows, logically, that any decisive break through that horizontal side has immediate forceful significance. Thus, if a broadening price pattern *with a flat top boundary* develops after a good advance and if prices finally burst *up* through that top line on high volume and close above it to a conclusive extent (roughly 3%), then it is safe to assume that the preceding up trend will be resumed and carried on for a worth-while move. This does happen, although it is rare. The odds favor the opposite; i.e., the eventual victory of the forces of distribution which created the horizontal top and a break away into an extensive decline.

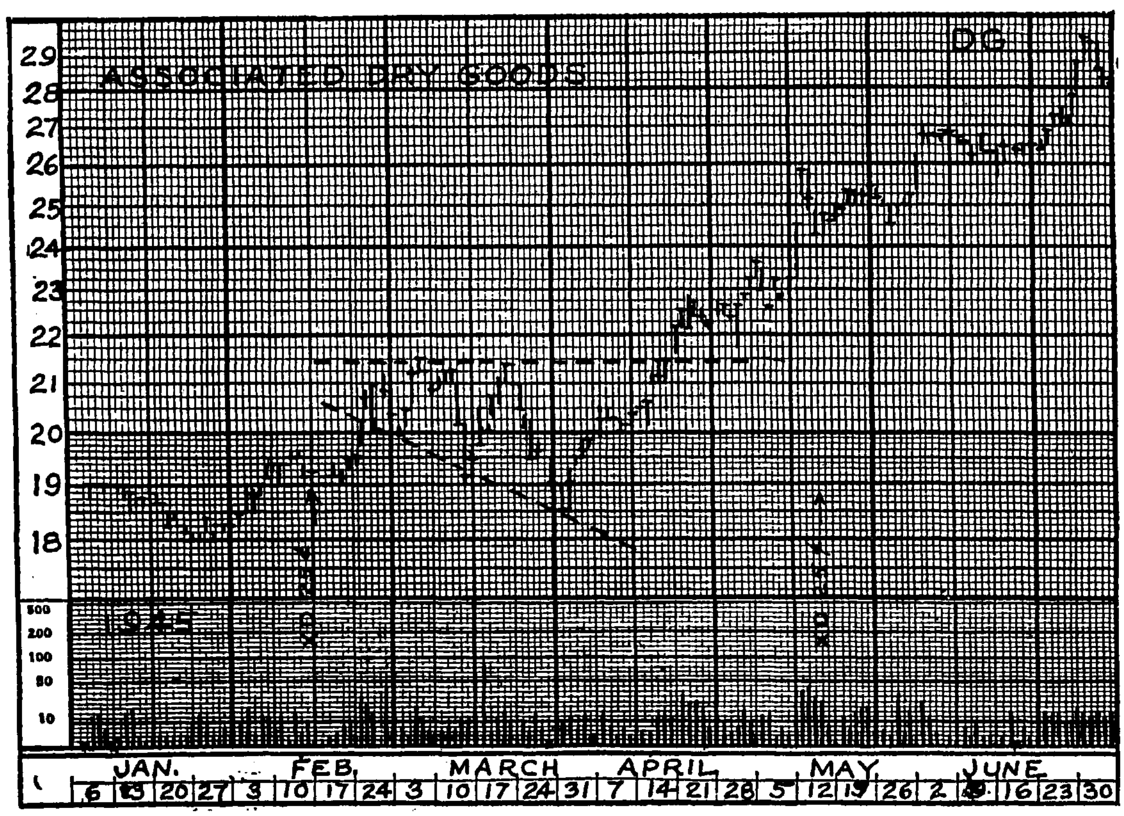
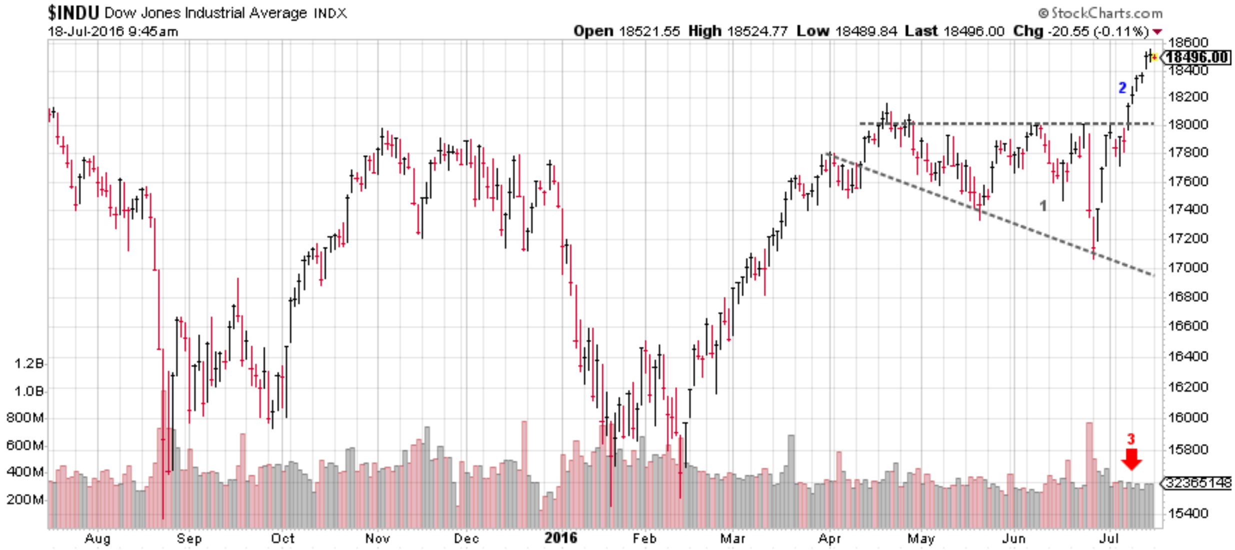


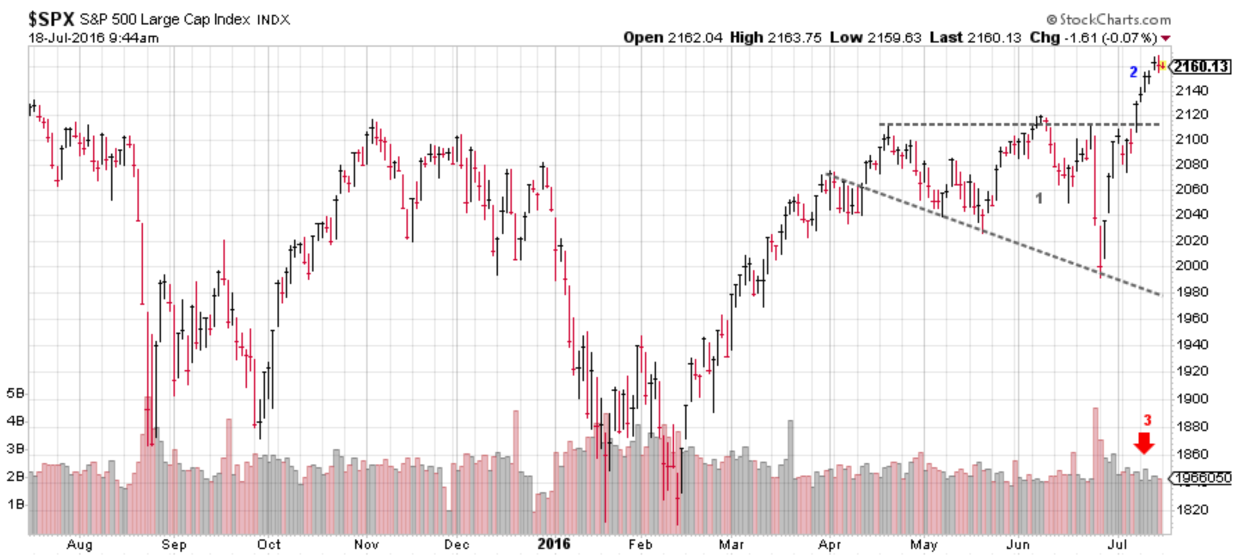
FIGURE 91. Three successive reactions in "DG" in February-March, 1945 made successively lower bottoms, but the intervening rallies came up to the same high (about 21¼), thus forming a Right-Angled Broadening formation with a horizontal top (supply) line. Penetration of this technically important top line on April 16 was a bullish signal. The flat-topped type of pattern does not necessarily portray a bearish situation.

Dow Jones Industrial Average Index (Dow)



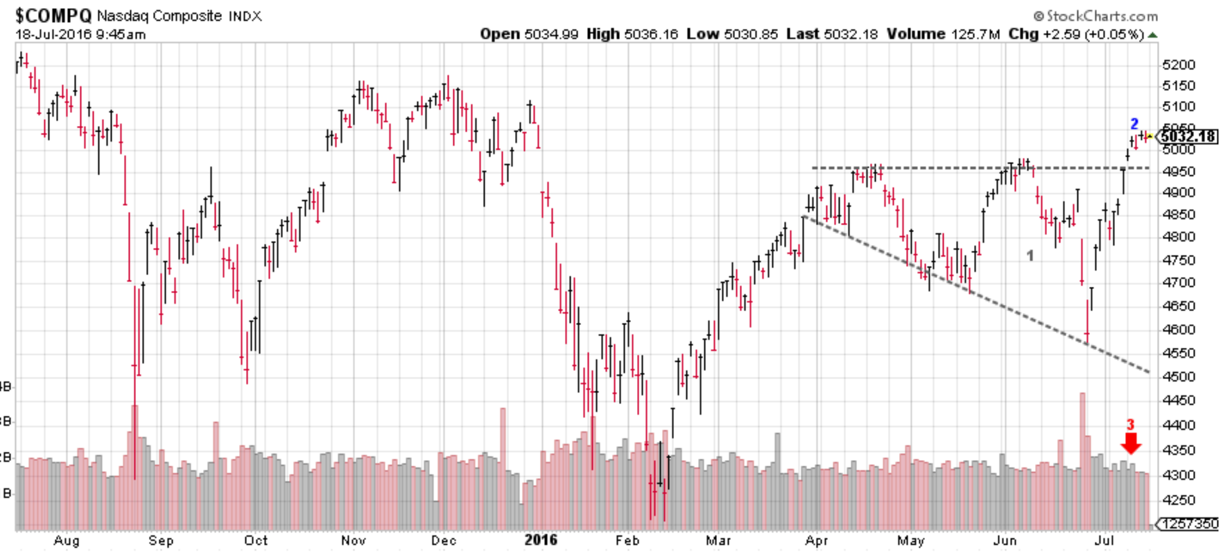
At the time of this writing, the Dow has broken up through the flat top broadening formation (#1) around the 18,000 level (#2). So far, the Dow has topped at 18,516, or about +2.87% - very close to 3%. However, there has been no surge of volume on the breakout (#3). The evidence appears mixed at best.

S&P 500 Index (S&P)



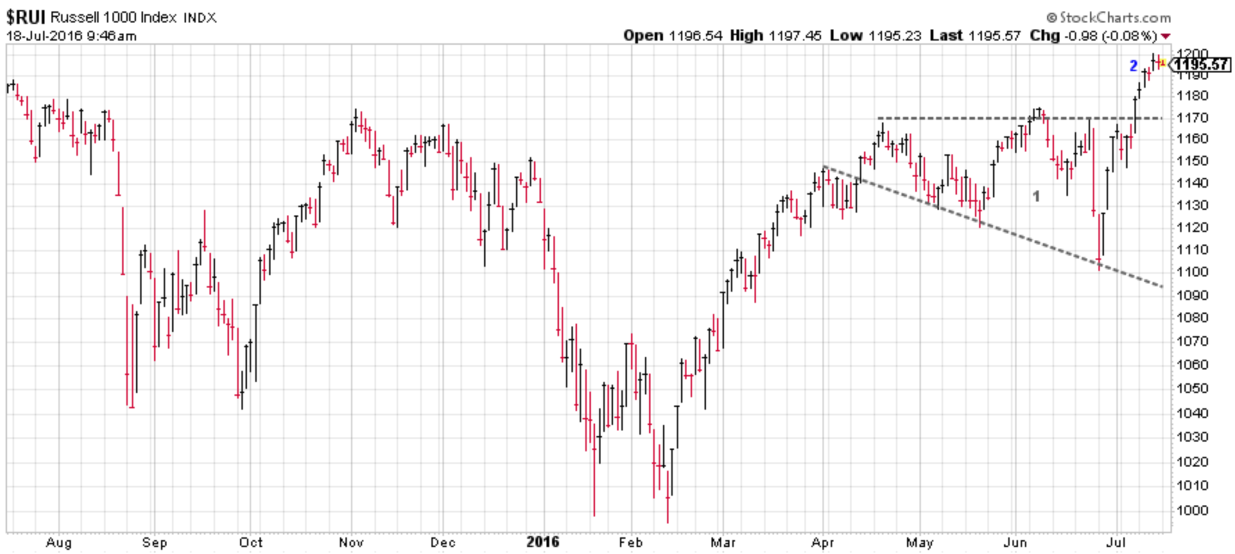
At the time of this writing, the S&P has broken up through the flat top broadening formation (#1) around the 2,113 level (#2). So far, the S&P has topped at 2,163, or about +2.37% - shy of 3%. There has also been no surge of volume on the breakout (#3). The evidence also appears mixed at best.

Nasdaq Composite Index (Nasdaq)



At the time of this writing, the Nasdaq has broken up through the flat top broadening formation (#1) around the 4,956 level (#2). So far, the Nasdaq has topped at 5,034, or about +1.57% - much less than 3%. There has also been no surge of volume on the breakout (#3). The evidence appears poor at best.

Russell 1000 Index (Russell 1000)



At the time of this writing, the Russell 1000 has broken up through the flat top broadening formation (#1) around the 1,170 level (#2). So far, the Russell 1000 has topped at 1,197, or about +2.31% - shy of 3%. Unfortunately, this service does not provide volume information for this index for comparison.

So from what we can see, we are cautiously optimistic about the recent breakout. What would make us most comfortable with the bullish case would be for the markets to “correct” in price back to the breakout line, hold that price level, and rise again to new highs. That is what we will be monitoring in the days to come. If prices “correct” and break back down inside the breakout line, that could be evidence of a market that is likely to eventually retest the bottom support level one more time (approximately 15,000 to 16,000 on the Dow).

For further consideration, we provide an updated chart of the VXX[7] which continues to project a potential positive divergence. This chart takes a little bit of explanation. The VXX is a short-term investment that measures volatility - especially volatility that is *expected* in the short term. In essence, **this investment typically *rises* when the stock market *declines*.** But there is usually a pattern that forms to provide warning before a selloff occurs.

Notice on the left-hand side of the chart this investment was declining in price (see red dashed line #1) last year. Then it spiked on a small stock market “correction” during July (see rounded red line #2). After the correction the price continued to decline (see #3). But of significant importance was the rising momentum on the continued decline (see blue dashed line #4). Shortly thereafter, a bigger “correction” in the stock market occurred during later August and into September of 2015 that resulted in a significant rise in the VXX (see solid blue line #5).

Now notice the right-hand side of the chart. It appears the pattern may be forming again. The price of the VXX had been declining (#1). Then it spiked on the BREXIT “correction” (#2). Now price is lower (#3). And momentum is also currently rising (#4). Are we about to see another #5 rally in the VXX (*coinciding with a price decline in the stock market*)?

The combination of these charts continues to present an investor with the *expectation* that stock prices should correct in the near term – possibly in the coming days. If this happens, it would correlate well with our expecation of prices “correcting” back to test the breakout line for the stock indices presented in this report. We want to stress that while neither of these charts – individually or in conjunction– create a crystal ball for the future, they can be helpful for an investor to set their expectations for what *may* be coming that will allow the investor the opportunity to take *proactive* action, if desired, with their strategy.

For existing clients we are always happy to answer any questions you have about our current investment positions, next planned investments, and where we are looking for investment opportunity in the stock, bond, and commodity markets. Thank you for your continued trust and confidence.

[1] *Blue Line Investing (BLI) is a disciplined investment process, based on technical analysis research. The process applies trend-following, along with observations of the moving averages of the market. Key to the process is the “blue line”, which is derived from comparing an investment’s price against its moving average. BLI monitors those activities over time in order to determine allocations within client accounts.*

[2] *“Technically Speaking” is a special report being provided to supplement our monthly BLI MARKET VIEW report. Its purpose is to help clients and investors contemplate the attractiveness or unattractiveness of investing in the stock market, at the present time, using technical analysis and the Blue Line Investing investment process.*

[3] *The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. It was invented by Charles Dow back in 1896.*

[4] *The S&P 500 Index is one of the most commonly followed equity indices, and many consider it one of the best representations of the U.S. stock market, and a bellwether for the U.S. economy. It is comprised of 500 large companies having common stock listed on the NYSE or NASDAQ. The volatility (beta) of the account may be greater or less than the index. It is not possible to invest directly in this index.*

[5] *The NASDAQ Composite Index is the market capitalization-weighted index of approximately 3,000 common equities listed on the Nasdaq stock exchange.*

[6] *The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity markets. It comprises over 90% of the total market capitalization of all listed U.S. stocks, and is considered a bellwether index for large cap investing.*

[7] *The iPath S&P 500 VIX Short-Term Futures ETN (Symbol: VXX) is designed to provide exposure to the S&P 500 VIX Short-Term Futures™ Index Total Return (the “Index”). The S&P 500 VIX Short-Term Futures™ Index utilizes prices of the next two near-term VIX© futures contracts to replicate a position that rolls the nearest month VIX futures to the next month on a daily basis in equal fractional amounts. This results in a constant one-month rolling long position in first and second month VIX futures contracts.*

[8] *Technical Analysis of Stock Trends, by Robert D. Edwards and John Magee. © Copyright 1948 – Robert D. Edwards, John Magee. © Copyright 2008 – BN Publishing. www.bnpublishing.com ALL RIGHTS RESERVED.*

Disclaimers:

Technical analysis is a method of evaluating securities by analyzing statistics generated by market activity, such as past prices and volumes. Technical analysis attempts to predict a future stock price or direction based on market trends. The assumption is that the market follows discernible patterns and if these patterns can be identified then a prediction can be made. There are certain limitations to technical analysis research, such as the risk is that markets may not always follow patterns. This investment process should not be considered a guaranteed prediction of market activity and is one of many indicators that may be used to analyze market data for investing purposes. There is no guarantee that this process will be successful or will result in the projections contained herein.

This information is intended for educational purposes only. Past performance is not indicative of future results. This material is not financial advice or an offer to sell any product. This is not a recommendation to buy or sell a particular security. The opinions expressed are those of Gordon Asset Management and are subject to change without notice. GAM reserve the right to modify its current investment strategies based on changing market dynamics or client needs.

Advisory services offered through Gordon Asset Management, LLC (GAM). GAM is an SEC-registered investment adviser. Registration does not imply a certain level or skill or training. More information about the advisor, its investment strategies and objectives, is included in the firm's Form ADV Part 2, which can be obtained, at no charge, by calling (866) 216-1920. The principle office of Gordon Asset Management, LLC is located at 1007 Slater Road, Suite 200, Durham, North Carolina, 27703.

Material presented has been derived from sources considered to be reliable, but the accuracy and completeness cannot be guaranteed. The volatility (beta) of an account may be greater or less than the indices. It is not possible to invest directly in these indices.