



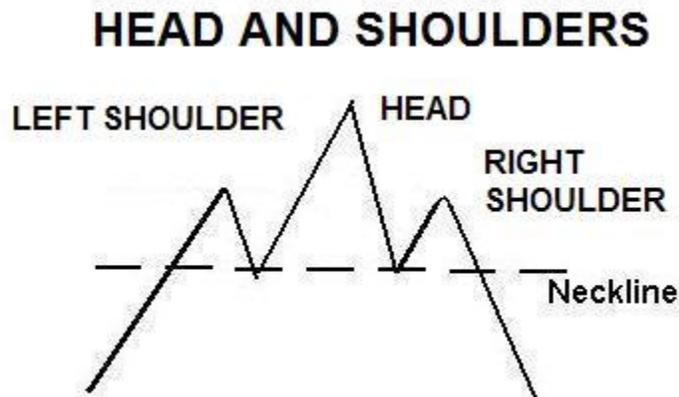
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"TECHNICALLY SPEAKING"²
September 2, 2016

THE ANSWER?

On July 18th we wrote about the breakout of the stock market through resistance levels. In that report we provided information regarding the technical formation being observed that resulted in the breakout, and what we believed investors should be looking for as further evidence that the breakout would hold and not become a bear trap.³ To be confident in the breakout we wanted to see the major indices do two things: First, rally above the breakout price level by at least 3%; and second, show a surge in volume on the breakout. As things stand today, the indices did achieve the 3% breakout but we never observed the surge in volume. This has bothered us for the past few weeks and we have continued to question "why?" Why no surge in volume? After careful observation we may be on the verge of receiving the answer.

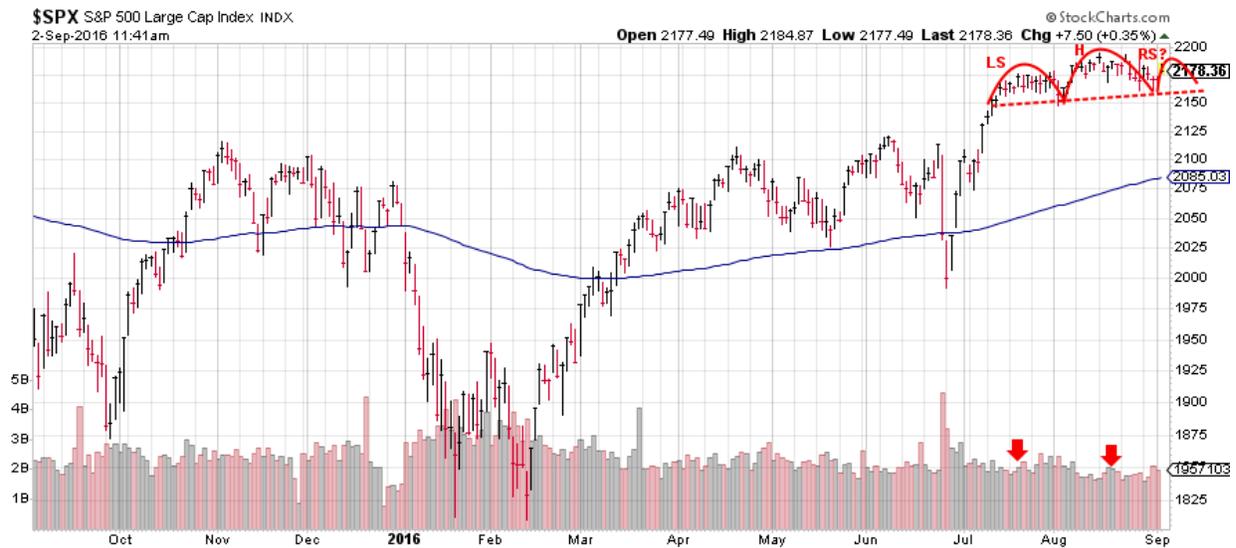
The illustration below is called a Head and Shoulders formation. This is a reversal formation typically associated with a top in the price action of an investment. When it executes, it signifies the trend is about to reverse course and go in the opposite direction. Please refer to the next page for a daily chart of the S&P 500 Index⁴ (S&P) as it stands today.



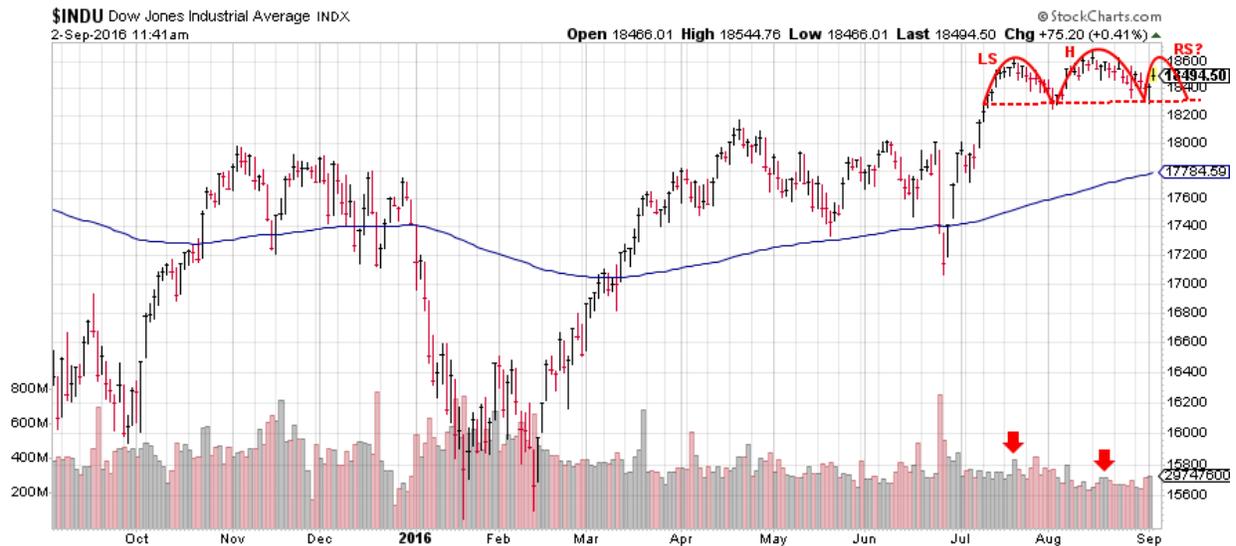
THE DAILY PERSPECTIVE

The chart below of the S&P may be in the process of forming the Right Shoulder of the pattern. Currently, volume indicators seem to be lining up perfectly for a Head-and-Shoulders formation – volume was higher on the rally for the Left Shoulder than it was for the formation of the Head. Paying attention to volume during this formation is crucial. While the S&P doesn't present the most ideal case for this pattern, other witnesses, specifically the Dow Jones Industrial Average⁵ is also displaying a potentially textbook example (see below).

S&P 500 Index



Dow Jones Industrial Average



If this Head-and-Shoulders formation executes then it might be the answer for why there was no surge in volume on the breakout. It may just be that the market is about to top and this could end up being a bear trap after all. The market should confirm one way or the other shortly.

To substantiate this potential formation of this pattern further, we want to look at the market through an indicator many investors ignore – *TIME*. If we step back and observe the market over different periods of time, can we find other evidence that might support either a positive or negative expectation for stock prices in the near future?

THE WEEKLY PERSPECTIVE

The weekly chart shows another potentially negative technical formation called an Ascending Wedge. While this formation is not typically associated with a price top, it does warn of a potential price decline ahead. Since prices broke out around the 2,100 – 2,125 price level on the S&P, it would not be surprising to see prices drop back to “test” that level. If the Head and Shoulders formation comes to full development, one has to wonder if the “test” will fail or hold.

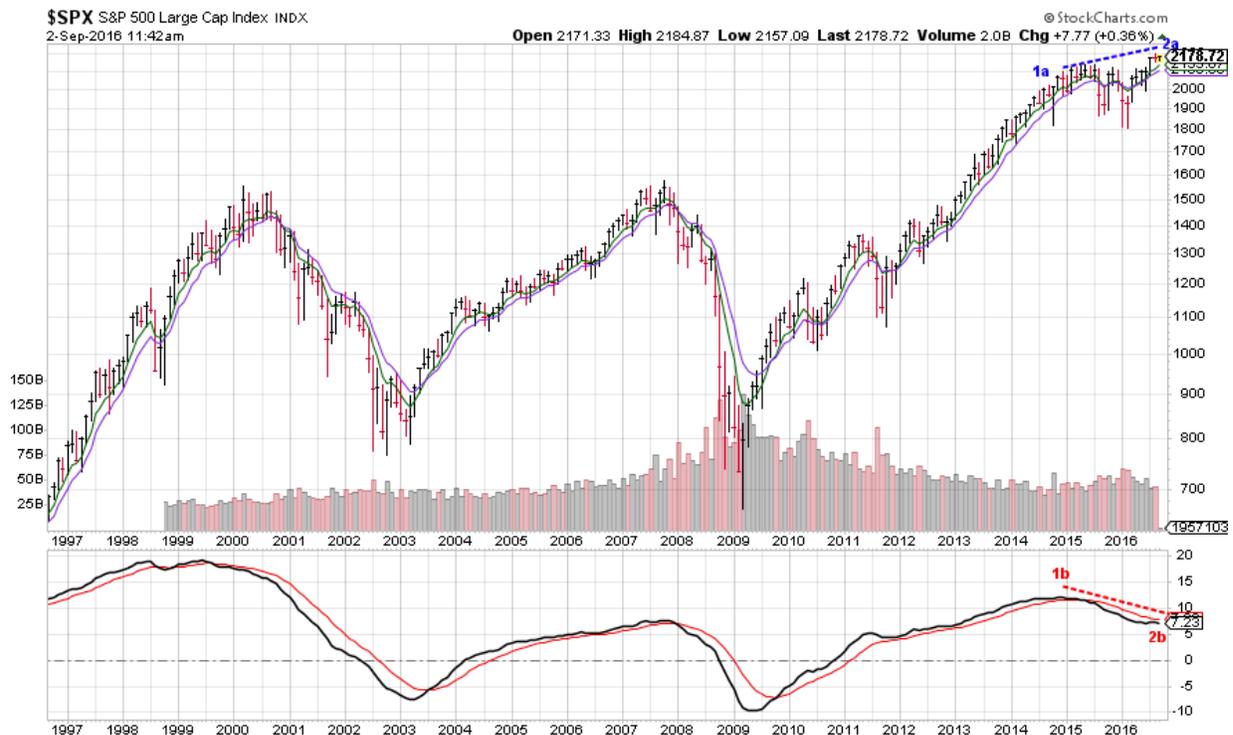


Now, what if we pull our perspective back even further? If we take a look at the market from an even longer period of time, what might we find?

THE MONTHLY PERSPECTIVE

The monthly chart below shows the past 20 years of price activity, but we are focused on the most recent two years. We have identified a potential negative divergence on the chart. We believe price momentum should **always** lead price. When it starts to lag, and prices continue to rise, this could reflect a divergence and may warn of a drop in prices ahead.

On the chart below we can see when price originally topped in early 2015 (see 1a), it coincided with a high point in price momentum (see 1b). But with the recent rally (see 2a) up to a higher price level, we notice price momentum is far below where it was at the previous high (see 2b). This is a negative divergence.



Since this is a monthly chart, there isn't much use in it by itself. But when we look at the broad markets from all three time periods and can observe potentially negative technical formations on each one, it suggests investors should remain cautious.

It also tells us something else. If an investor expects prices to drop in the near future, it offers them the opportunity to consider taking proactive actions with their investment portfolio; possibly to hedge existing investments or even shorting⁶ select investments in an attempt to profit from an expected decline in share prices.

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 *A "Bear Trap" is defined as a temporary rise in a specific stock or the market as a whole. It occurs with little fundamental information to back the movement in price. This rally may continue just long enough for investors to get on board, after which the market or specific stock falls.*

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 Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. Often referred to as "the Dow," the DJIA is one of the oldest, single most watched indices in the world.*

⁶ *"Shorting" or a "short position" is the sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value. The intent is to buy it back at a future lower price, thereby replacing similar shares to the original owner at a lower price and profiting from the difference.*

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.

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