Ned Davis Research Group

GLOBAL STRATEGY

COMMENT

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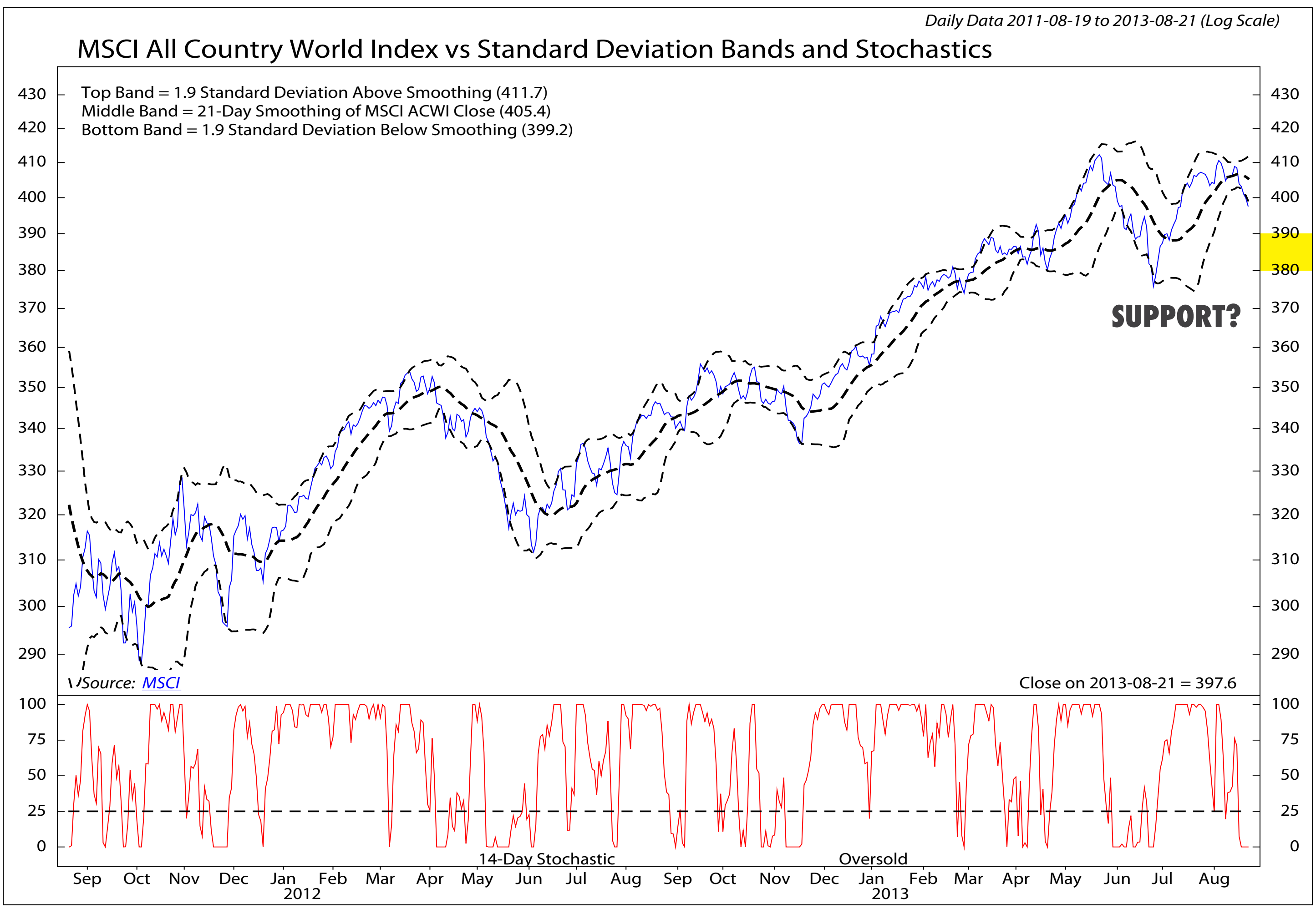
After the Retest, Broad Global Rally?

During the first four months of the year, the U.S. and Japan led the global markets higher while Europe and emerging markets lagged. As the advance narrowed and complacency rose, the uptrend became increasingly vulnerable, leading to the May-June correction.

Markets recovered in July, but we have been watching for at least a partial retest of the June lows, after which broad breadth thrust evidence would confirm the onset of a sustainable rally. As August got underway, so did the testing process, this time with the MSCI U.S. and Japan indices lagging -- down by 3% and 7%, respectively, since the August 2 high -- and with emerging markets and Europe holding up relatively well. The top 14 performers since August 2 include seven European markets and six emerging markets.

Today's rebound notwithstanding, it would be premature to conclude that the testing process is ending, considering that our sentiment indicators are no better than neutral. And while the chart below shows the ACWI oversold (below, bottom clip), a drop to the 380-390 zone (a decline of about 5% to 7% from the August high) may be needed to produce excessive pessimism readings on such sentiment gauges as the Global DSI Composite included in our Global Balanced Account Model.



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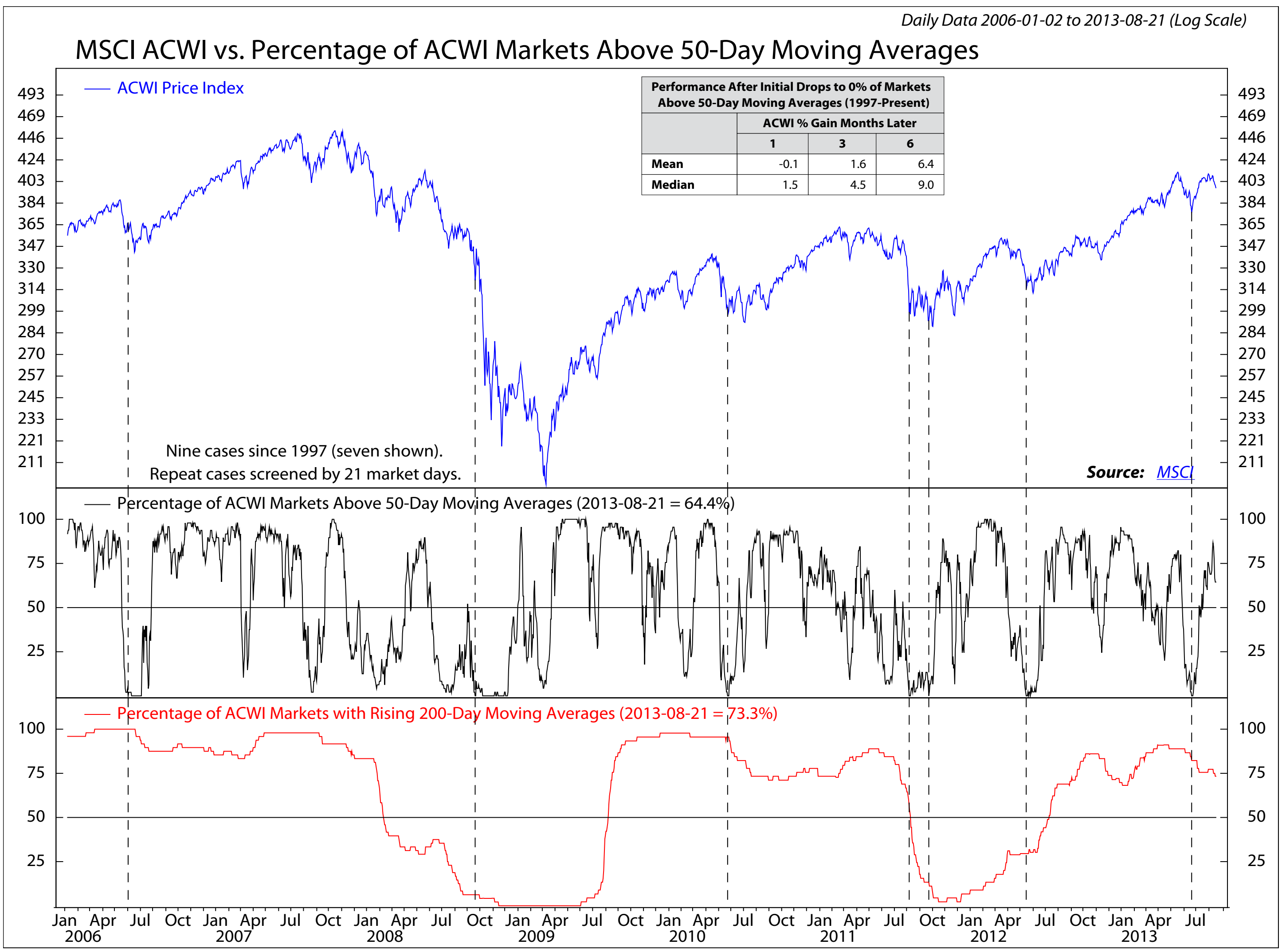
But whether we see it soon or a few weeks from now, a broad global rally is a high probability, with equities driven by expectations of improving global economic growth over the rest of the year. Around the June lows when all 45 ACWI markets were below their 50-day moving averages (below, middle clip), we explained that equities were oversold within the ongoing cyclical uptrend indicated by the high percentage of markets with rising 200-day moving averages. Previously, after the initial cases when 0% of markets have been above their 50-day moving averages, the ACWI's performance has been mixed over the next month but consistently positive over the next three months and six months. Even if most markets drop back below their 50-day smoothings, the three- to six-month outlook will remain favorable as long as most markets maintain rising 200-day moving averages (bottom clip).

As explained earlier this month, we would increase equity exposure in response to a reading above 55% on the intraday update of our Global Balanced Account Model's stock/bond composite (currently at 47%), the majority of markets above the 50-day smoothings and at one-year highs, and the majority of Rally Watch indicators at bullish levels (nine of 16), including all five breadth thrust indicators. Currently, six of the report's indicators are green, including two of the five thrust indicators.

What if the current drop proves to be more than a retest, with a broad global breakdown and accelerating downside momentum raising the chances of a new bear market? In that case, we would cut exposure in response to a Stock/Bond Composite reading of less than 40%, bearish readings on the majority of the intermediate-term and long-term tape indicators included in the Rally Watch report (five of eight), and falling 200-day moving averages on the majority of markets.

For now, we are continuing to recommend **marketweight allocation** to equities in balanced accounts as well as marketweight regional allocations. We will be likely to revise the allocations once it's clear that the late-summer slide is either turning into a more ominous global decline or, as appears more likely, ending with **nothing worse than a retest of the June lows, followed by renewed rallying into year-end**.



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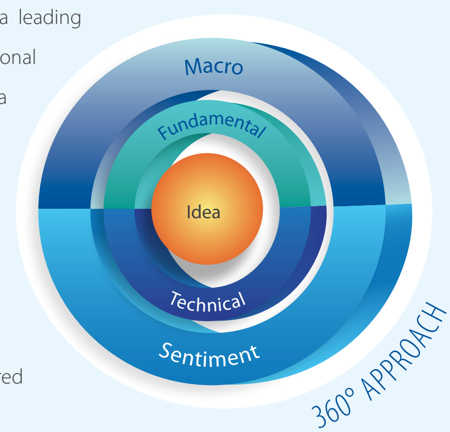

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