Equity market fragility

Perhaps the most common question investors ask one another question is, "what's your (near-term) view on the (stock) market?"

"Fundamentally-minded" investors may rely on market valuations, economic growth, interest rate expectations, yield-curve steepening, corporate earnings growth, corporate-profit share of national income, earnings beats, analyst stock upgrades, analyst earnings upgrades, money-supply growth, bank loan growth, and the like.

"Technically-minded" investors may look at year-high-to-low ratios, S&P 500 implied volatility, put-call volume ratios, advancing-to-declining issues, advancing-to-declining volumes, oscillator indicators, percentage of stocks above 50-day moving average, sector concentration, and the like.

The drawback with many measures is they either, contrary to intuition, have no or low correlation with the stock market over a period of many months or years (economic growth or market valuations) or they are coincident rather than leading, or are erratic or provide highly infrequent signals (implied volatility).

To my mind, the single most helpful measure of market direction is trading volumes (in combination with price change). To be more precise, it's how volumes on up-days (days when the markets rise) compare to volumes on down-days, over time.

Volumes reflect the confidence of investors in a price change. Stock market index appreciation today backed by high volumes is positively correlated with stock market appreciation tomorrow.

Table 1 below offers a summary of the signal.

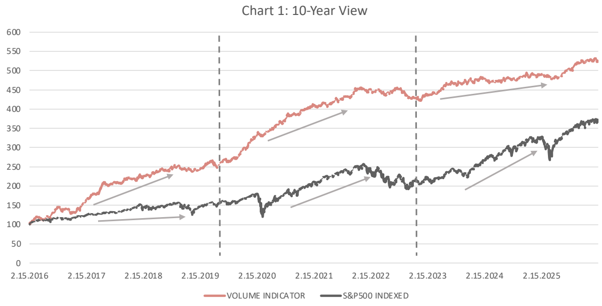
Table 1

Price	Volume	Signal
Up	High	Upside Strength / Continuation
Up	Low	Upside Fragility
Down	High	Downside Strength / Continuation
Down	Low	Downside Fragility

So, what is the signal telling us now?

Ten-year view

Chart 1 compares the S&P 500 index (black line) with a volume indicator that quantifies the relationships described above over 10 years. There are three broad phases.



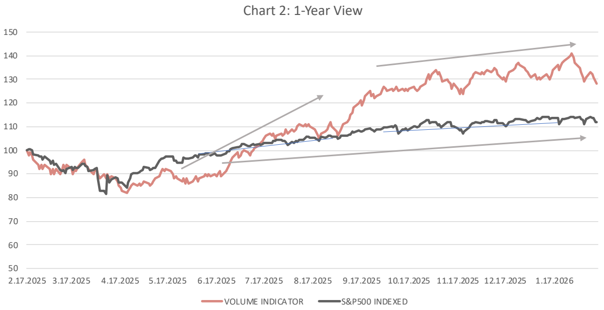
The first phase, 2016-2019, is characterized by the volume indicator rising at faster pace than the S&P index (grey arrows diverging, signaling strength).

The second phase, 2020-2022, in which the S&P rise is matched by the volume indicator (parallel arrows, signaling neutrality).

The third phase, 2023-2025, where the S&P rise was sharper than the indicator (converging arrows, signaling weakness.

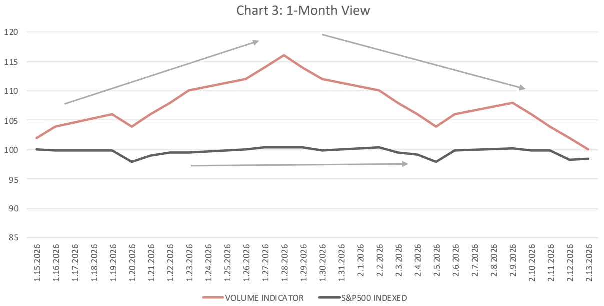
One-year view

Chart 2 shows the picture over a one-year horizon. The S&P 500 has risen steadily and moderately, initially associated with a strengthening volume signal and later a neutral signal.



One-month view

Chart 3, a one-month view, shows a flattish S&P 500 with rising supportive volume initially, followed later by rising selling volumes.



Opinion

Near-term market predictions are rightly called a fool's game. Any predictions should be perceived with healthy skepticism.

With this in mind, and in combining our indicator perspectives over the three time horizons, one observes declining conviction in the continuation of a market rally and evidence of rising fragility. We cannot, however, yet say that a correction is imminent or even that markets have plateaued.

In this context, institutional investors would typically maintain a neutral equity allocation while acknowledging downside risk and standing by to reduce exposure if conditions deteriorate.

Private investors with liquidity needs in 2026 or 2027 should consider to start incrementally reducing exposure. Private investors with a quarterly staggered entry strategy may wish to delay purchases until later in March.

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