

Dow Theory signaling market doom? Nah

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There has been a lot of talk about how the market continues to make new highs and whether or not a correction is coming. Transportation stocks have been sending a warning signal — and that's making the Dow Theorists nervous.

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Dow Theory, developed at the turn of the 20th century by Charles Dow, holds that, in order for the markets to be in a sustained uptrend or downtrend, both indexes — Industrials and transports — must confirm each other. When one of the indexes climbs to a new high (or falls to a new low), the other is expected to soon follow. "Soon" is the operative word here. Soon means shortly, in the near future, before long etc.

So what do we have?

We have the Dow Jones Industrial Average^[1] trending higher and making new highs fairly frequently since the start of the New Year. In fact, the DJIA has made three new closing highs since January. What is confusing to technicians is that the Dow Transports^[2] has failed to confirm this trend by any definition of "soon." And in fact has not failed to confirm the trend at ALL. A look at the transportation average reveals that is in a very clear downtrend — falling 5 percent since the beginning of the year (vs. the 3-percent gain in the Dow).

Dow Theory gives a warning signal...again ^[3]

Is the underperformance of the transports the very reason that market has been stuck in a very tight trading range for the past three months? Has the Dow Theory been sending us a signal that all is not good in the world? Look, the mixed macro data of late has been confusing but not completely alarming. Earnings were not a bad as they prepared us for and the dollar strength did not cause widespread panic and the

market seems OK with current rates of revenue growth. The macro data as noted is mixed, so the Federal Reserve^[4] is on hold, continuing to support the U.S. economy and investors seem to be OK with that.

Before we go ringing the Dow Theory bell, there is a lot to consider here before we can say that Dow Theory has generated a proper sell signal. We must see three things happen:

1. The Dow and the transports must experience a significant correction off the highs — to date that has not happened.
2. From that correction, both of the indexes need to "fail" to rise above their pre-correction highs — to date this has not happened.
3. Finally, both of these indexes will have dropped below the correction lows — again, this has not happened to date.

So far, the requirements for a proper Dow Theory sell signal have not been met and, as much as there is a divergence between the two indexes, the bottom is not falling out of bed yet. Yes, weakness in the transports does suggest caution ahead, so traders and investors should heed that warning — and I believe that they are. Thus, the market remains trapped.

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Look, transportation companies are an important barometer about the health of the economy, so continued weakness should be reason for concern. And that may well explain why the market cannot get out its own way. Investors are not yet convinced that the correction is coming and when the market has a chance to correct, buyers seem to come to the table oblivious of what the Dow Theory tells us. Since January, the Dow has traded in a very tight range — 17200/18288 — while each attempt at a surge up and through finds plenty of real resistance. That just tells us that investors think the market is fairly priced at the moment. They're willing to sell stocks at fair values but not willing to unload stocks at discount prices. That is key to understanding the psyche of investors and the market.

So, although I understand Dow Theory, I am not one to say that the current market dynamics suggest any real selloff is in store. Demand for stocks is evident each time

the market attempts to correct and geopolitical issues seem to be under control, while central banks around the world remain accommodative. So, caution yes. No need to go gangbusters and reach for stock — patience is a virtue and taking the time to assess your plan and take strategic advantage of weakness will be the winning strategy.

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1. <http://data.cnbc.com/quotes/.DJI>
2. <http://data.cnbc.com/quotes/.DJT>
3. <http://www.cnbc.com/id/102680882>
4. <http://www.cnbc.com/id/43752521>
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