

Market and Sector Breadth: an essential timing tool

Introduction

Breadth indicators provide one of the best ways of calling intermediate market tops and bottoms and for this reason have been widely adopted by the investment community. Breadth indicators measure the number of stocks with rising trends within a particular index in order to gauge the amount of participation in that index.

Perhaps the best-known breadth indicator is the US “NYSE bullish percentage” which was developed by AW Cohen in the USA, the founder of Investors Intelligence back in the 1950’s. AW Cohen used the current trend status of the point & figure (p&f) chart to determine the number of stocks in the NYSE index in a bull trend (uptrend). By plotting the resultant percentage of bullish stocks, he could measure market participation.

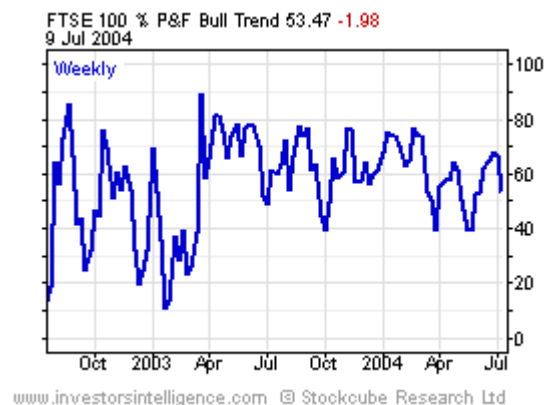
AW Cohen used p&f charts to determine which stocks were in bull trends. Since then, other techniques have been introduced, such as the percentage of stocks above their 30 week moving average and the proportion of stocks making new 52 week highs and lows.

Defining the breadth “universe”

The US NYSE index has over 3000 constituent stocks, which makes for a broad (smoother) consensus reading when it comes to breadth analysis.

When applying this analysis to the UK market, we have generated breadth indicators for the FTSE 100, FTSE 250, FTSE Small Cap and FTSE All Share.

You will see from the charts below that the FTSE All Share indicator is much smoother than the FTSE 100 indicator. This is due to a greater number of component stocks, and must be borne in mind when analysing breadth indicators.



In Europe, we have generated breadth indicators for all major European indices but since many of these only have 30 component stocks, we have also developed an “All Europe” indicator, which measures the percentage of stocks in up-trends amongst all the European stocks we have on the site.

Bullish Market Signals

Probably the best market buy signals are generated when the indicator moves up from a low level, under 30%. This is essentially a contrarian signal as still only 30% of stocks are in bull trends (but importantly this number is now growing, signalling a potential change of trend).

The benefit of this approach is that it signals an entry point into the market when sentiment is still weak i.e. most investors are still bearish. This catches trends that are only just developing and potentially finds stocks that are still cheap, due to fact that most investors are still wary and staying out of the market.



The above **left-hand chart** shows the bullish percentage indicator for the FTSE All Share index over a two-year period.

Notice how the breadth indicator made a higher low in the first quarter of 2003 – a great sign that sentiment was on the turn as, although only 30% of stocks were in up-trends, this was an improvement on the number of up-trends corresponding to the October low.

The **right hand chart** shows that this corresponded to the market bottom in March 2003!

Bearish Market Signals

Conversely, the best market sell signals come from a decline in the bullish percentage below 70%. You will see from the above charts that the FT All Share breadth indicator had topped out (made a lower high) by the first quarter 2004 and then broke below the 70% level by April 2004.

This signal was therefore developing before the All Share index (right hand chart) made its recent peak in April giving time to review holdings and apply suitable stop-loss policies.

One thing to note is that the classic “trigger” levels of 30% and 70% were developed in relation to the US NYSE % breadth, which has 3000 stocks. As explained, the fewer constituents an index has, the more volatile the breadth indicator will be so that swings between 10% and 90% are more frequent for indices with less constituents. We feel it is therefore important to be aware of the trend of the breadth indicator and to use the relative positioning of its peaks and troughs to determine whether it is gaining or losing breadth.

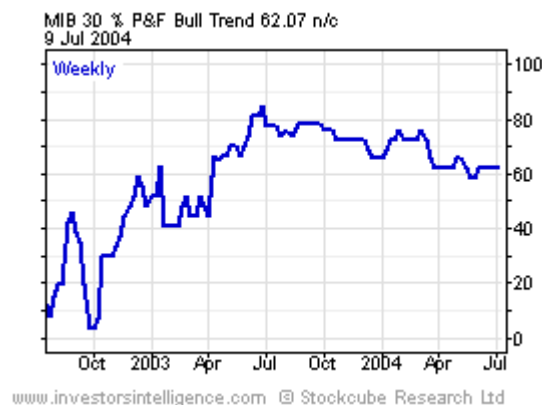
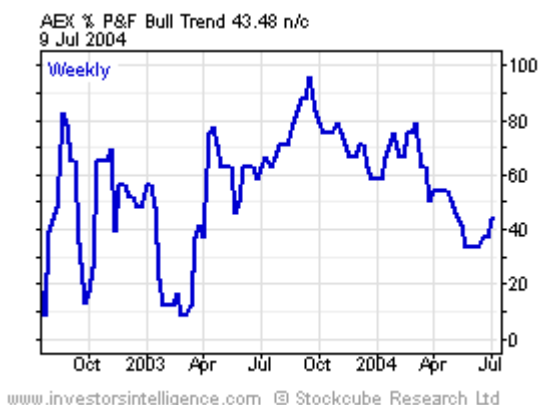
Using breadth for comparing regional indices

We are planning to generate breadth indicators for all the major global stock indices. This provides an excellent new tool for regional market timing and to potentially tailor allocation by comparing the differences between regional bullish percentages.

For example, in 2004 the breadth of the Italian MIB30 has been much more stable than that of the Netherlands AEX index.

The **top charts** show that the AEX breadth turned down sharply in March 2004 and was 43% by July 2004 whereas the MIB breadth has drifted down and was 62% by July 2004.

The **bottom charts** show the relevant stock indices. Note that the bottom green line, the relative indicator against the pan European DJ Stoxx index, identifies underperformance (a declining line) for the AEX and outperformance (a rising line) for the MIB.



A factor to be aware of is that in most indices, the impact of constituents on the relevant index is weighted by their market capitalisation, and we have to check to see if particularly heavy weighted stocks are confirming the breadth trends. We may look to develop weighted breadth indicators in the future.

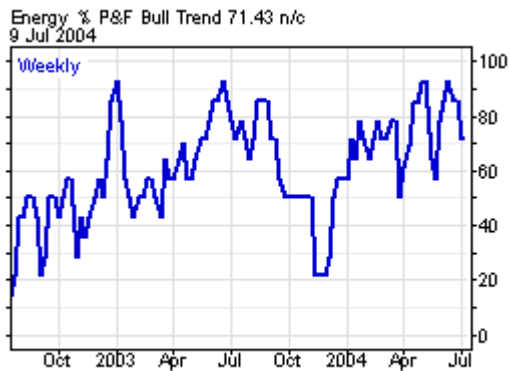
Identifying sector rotation

Breadth analysis can also be used as an aid in determining the appropriate focus to specific sectors and industries. We have generated sector breadth indicators for our regional products.

A good example of this was the outperformance of UK Energy stocks in the first half of 2004.

Note in the **left hand chart** below how the percentage of p&f bull trends in the UK Energy sector expanded rapidly in Q1 2004.

The **right hand chart** below shows the FT 350 Oil & Gas index. The green relative indicator shows the outperformance relative to the FTSE 100 index over six months.



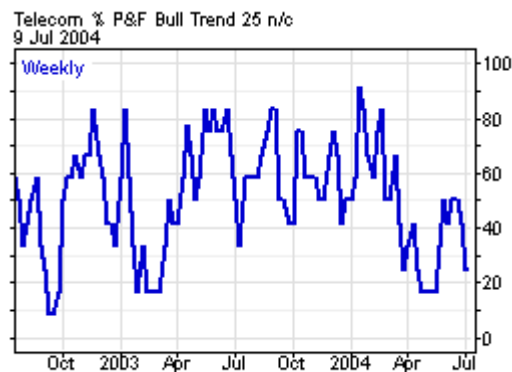
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The **left hand chart** below illustrates how breadth in the UK Telecom sector deteriorated from the start of 2004.

The **right hand chart** below shows the FT 350 Telecom Services index. The green relative indicator shows the underperformance relative to the FTSE 100 index over six months.



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Breadth indicators on the Investors Intelligence website

To use the various breadth indicators that have been discussed, simply select the appropriate region from the first horizontal menu bar at the top of the screen, select **Indicators** from the second horizontal menu bar and then select either **Industry Breadth** or **Index Breadth** from the drop down menu.

The specific breadth indicators for stock indices or sector indices are located on the left menu. You can change the type of chart to view the breadth data on the right menu.

Breadth Statistics and Commentary

The latest breadth statistics are reported each evening in the Daily Market Statistics email.

We provide further analysis of the breadth indicators in our Daily Hotlines and Weekly Reviews.

There is a standard terminology for defining the current trend of a breadth indicator in point & figure terms. This is utilised in our research and on site pages such as the Industry Group Bell Curve.

The main concept is to invest in sectors, which are *bull confirmed* (defined as when the bullish% indicator has given a p&f buy signal and is above 50%) and to avoid sectors, which are *bear confirmed* (bullish % on a p&f sell and below 70%).

Definitions of current Market/Sector Breadth Status	
Bull Confirmed – chart is on a p&f buy signal and is rising (column of x's); and/or is in a column of x's above 50%.	Bear Confirmed – chart is falling (column O's) below 70% and has generated a p&f sell.
Bull Correction – chart is on a p&f buy signal but is falling (column of O's) without yet reaching 70%.	Bear Correction – chart is on a p&f sell but is rising (column X's) without having moved above 68%.
Bull Alert – chart rising (X's) moving up from below 30% but has not yet generated a p&f buy.	Bear Alert – chart is falling from above 70% to below 70% without yet generating a p&f sell.

We hope that this article will have illustrated the potential for using breadth as part of your investment process.

Dominic Hawker, July 2004