▶ The Hindenburg Omen 1-4

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FOCUSED ON WHAT MATTERS MOST.

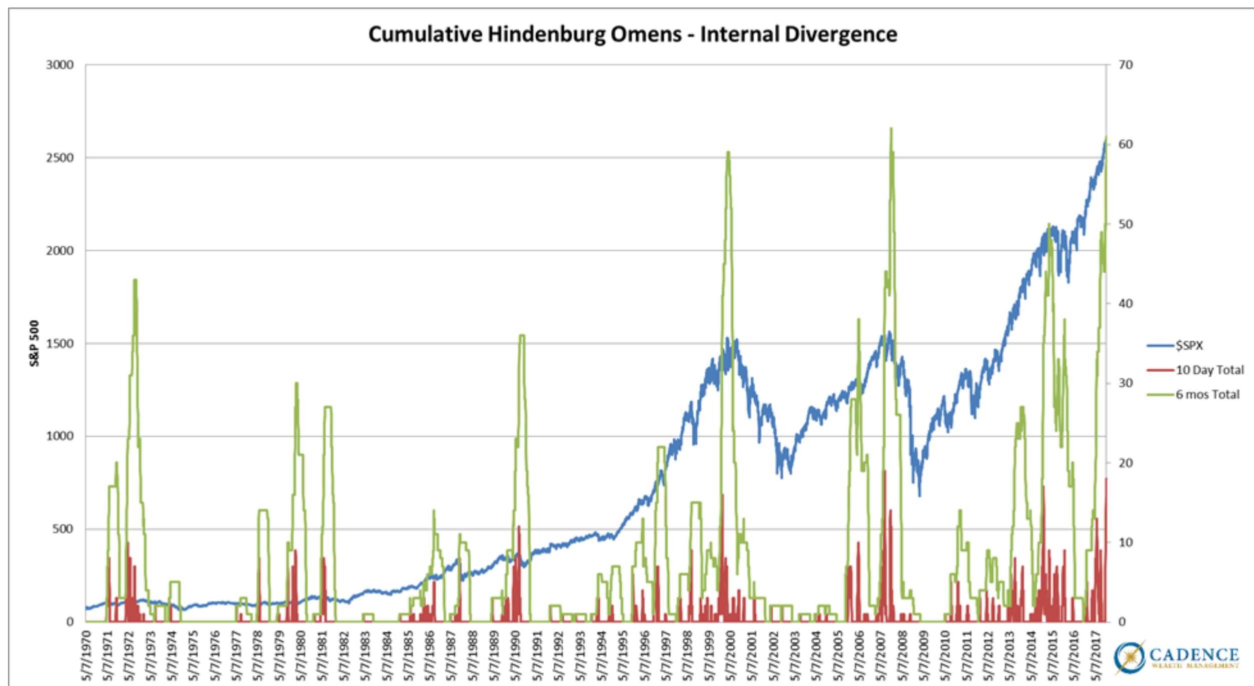
The Hindenburg Omen

Over the years we've heard technicians and pundits talk about stock market occurrences called Hindenburg Omens where on any given day the number of stocks on an exchange making new highs and new lows as a percentage of total stocks trading on that exchange exceeds a certain threshold. For example, if there are greater than 2.5% of stocks on the New York Stock Exchange making new highs on the same day as there are greater than 2.5% of stocks on the same exchange making new lows, then this might be considered a Hindenburg Omen.

The threshold levels required for this to trigger might vary depending on the technician, but the concept remains the same. When there's a day when many stocks are doing well while many others are struggling, we may be witnessing a tired market that is getting ready to turn lower. Unfortunately these omens have come and gone without incident and so they aren't taken very seriously as a leading indicator of potential danger.

However, the problem may not be the indicator or concept itself so much as its application. Jesse Felder and John Hussman, a couple of less mainstream market experts that we respect quite a bit for their independent thinking and common sense approach to markets, have written about a different way to look at Hindenburg Omens. In short, it's not what happens on any given day that matters, but rather the accumulation of those days within a certain period of time. Both recently acknowledged that we've experienced an accumulation of days that meet the criteria which historically has done a pretty good job of indicating trouble.

In looking at the data ourselves, it does in fact confirm much of what we've observed over the last 18-24 months. Market internals have been divergent and leadership within the market very narrow. We've written about some of these weak internals as well as other "red flags" over the months, but we must admit, the recent ramp up in "Omens" over the last few weeks has been particularly interesting. It's as though the divergence we've seen in the markets has picked up speed and reached a new level. What's more interesting is how it compares to points in the past where similar numbers of Omens have been triggered.

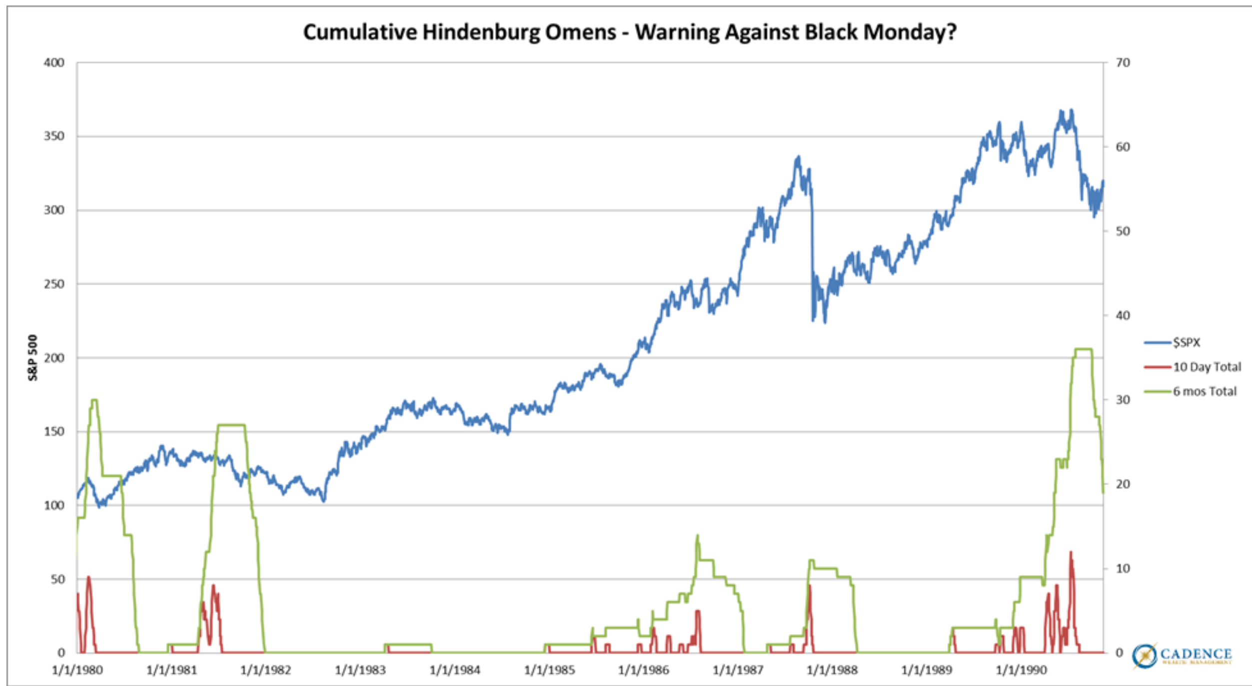


Before the last three meaningful market corrections Omens as defined by a 2% threshold over a ten-day period for both the Nasdaq and NYSE ranged from 16 to 19. We're currently at 16. Over a six month period, as indicated by the green line in the chart, cumulative omens ranged from 50 to 62. We're currently at 61. What's interesting to us even in hindsight is that mid-2015 had all the markers of a major market turning point, but for one reason or another it didn't stick. Our best guess as to why is that the same forces that have kept things afloat for the last 9 years stepped up their game yet again as markets struggled into the first quarter of 2016. Central banks renewed their commitment to accommodative policy and continued purchasing large amounts of financial assets – and it worked. Markets as we know surged higher yet again, but not two years later we find ourselves in a very familiar situation – record high valuations with a large number of stocks within the market struggling.

The 1980's

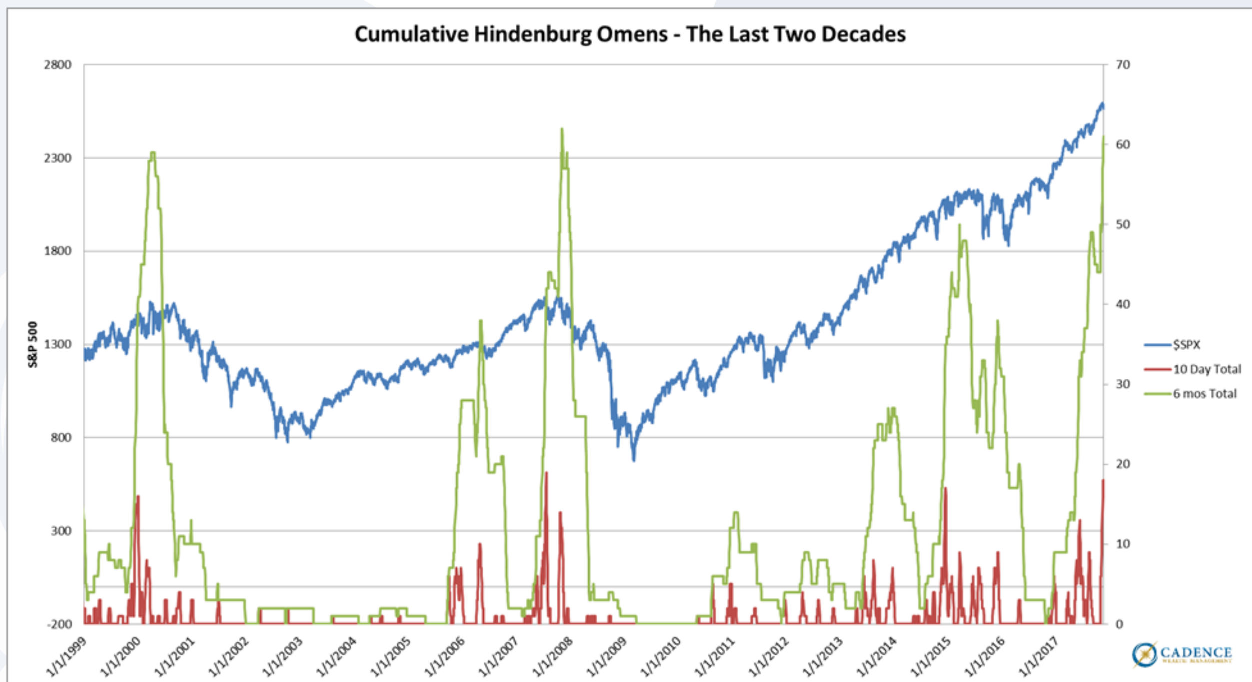
One of the things that concerns us about the current environment we're in now is not only record high stock market valuations, but the amount of debt and leverage in the financial system in addition to the extremely lopsided trade of the day – selling volatility. Because volatility has been historically low for so long and spikes in it so short-lived, investors have gotten very comfortable betting that volatility will remain low for the foreseeable future. Every time it spikes up, investors sell it assuming it will come right back down. These bets (some leveraged) that seemingly cannot lose look very similar to the portfolio insurance concept leading up to the Black Monday market crash in October 1987. It's certainly consistent with the broader market theme of investors ignoring multiple risks and warning signs over the last few years.

So would looking at these Hindenburg occurrences in 1987 have provided any warning against the 20%+ market drop on October 19? The chart on the following page suggests yes. In the first week of October, the incidents of divergent behavior within the markets reached a level not seen for years. Of course there would have been times previously where spikes in Omens may not have resulted in market drops, but given the unusual size of this spike relative to years prior, it may have provided a nice warning about a truly epic and historic market event.



The Last Two Decades

The incidents of Omen clusters we're witnessing now looks very similar to those present shortly before the last three major turning points in markets over the last 20 years (chart below). This provides a pretty clear and stark warning to investors. Markets are not well under the surface.



The market is telling two stories - One where a select number of stocks are doing well and keeping the averages propped up and another where a fairly large number of stocks are struggling greatly. In the past, the level of divergence within markets that we're witnessing today has been a fairly reliable indicator of near-term market turning points. Time will tell whether it holds true this time around. In the meantime, we'll add it to the list of historically meaningful data points that are in exclusive company.

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