What would Charles Dow make of today's equity markets?

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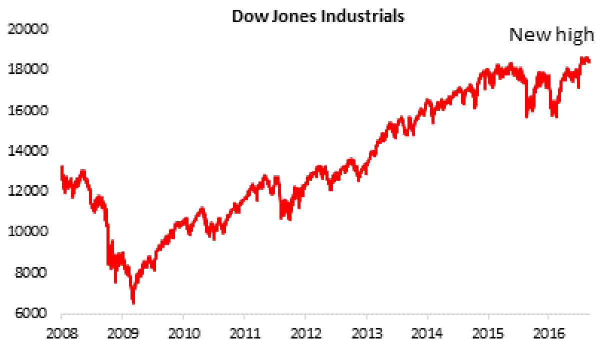
Charles Dow was an American journalist who among other things co-founded the Wall Street Journal, Dow Jones & Company and invented the Dow Jones Industrial Average index. He also laid much of the groundwork for modern technical analysis by analysing market behaviour, this later became known as Dow Theory. Many of Dow's theories are still closely followed today. Dow Theory has six main tenets, below we look at three of these (highlighted in bold) to understand what Dow himself might have made of today's stock market movements.

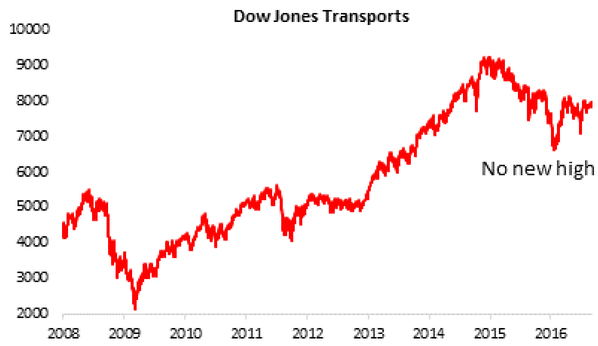
Dow believed that:

- **Stock market averages must confirm each other**
- **Trends are confirmed by volume**
- **Trends exist until definite signals prove they have ended**
- The market has three movements (the "main movement", the "medium swing" and the "short swing")
- Market trends have three phases (the "accumulation phase", a "public participation" phase and a "distribution phase")
- The stock market discounts all news

1. Stock market averages must confirm each other:

Dow argued that for a bull market to be considered healthy, the overall market must be rising ***together*** with its important sectors (and they must ***together*** be making new highs). Back in Dow's time (1851-1902) the US was a growing industrial power. As such, factory production was very important, and factories had to ship their goods mostly by rail. Therefore, Dow argued that a bull market in industrials could not be considered sustainable without a corresponding rally in railway stocks. Over a hundred years later and the Dow Jones Transports index (which now also includes shipping and air freight companies) is still monitored very closely. So too are the banks, given banks are arguably the most important sector in today's modern economy. The charts below show that while the main Dow Jones benchmark is making new highs (the same goes for the S&P 500), important sectors in the economy are a long way from their highs. This, according to Dow Theory signals underlying weakness of the equity market.





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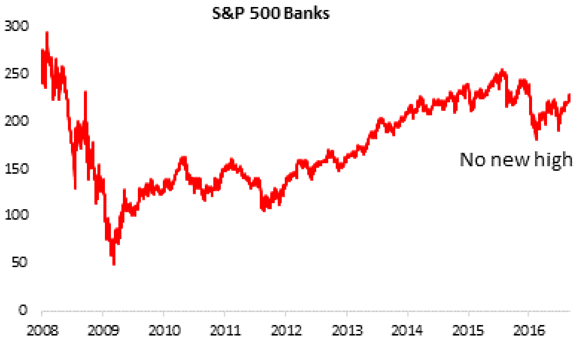

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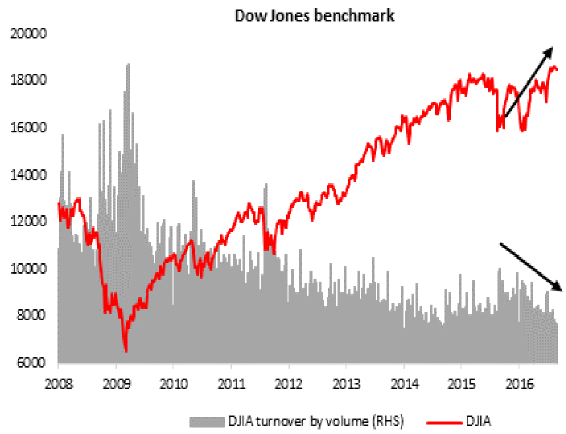
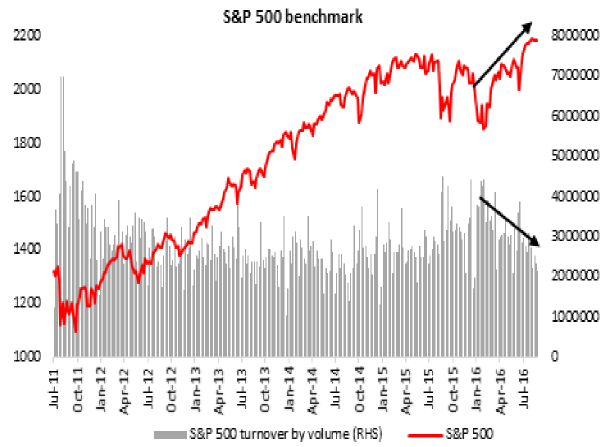
2. Trends are confirmed by volume:

Another facet of Dow’s theory was that a trend (whether it be up or down) can only be considered sustainable if it is supported by strong volume. He argued that if prices move on low volume, there could be many different explanations for this, it could be driven by a large single player for example. However, if there are many participants in a particular trend, and volume is therefore strong, this then represents the “true” market view. Looking at the two charts below, the Dow Jones and S&P 500 indices clearly show that the rally which has taken place this year has not been supported by increasing volume, in fact it has been on the back of declining volume. This is another red flag according to Dow theory (we could only retrieve volume data for the S&P from 2011 onwards).

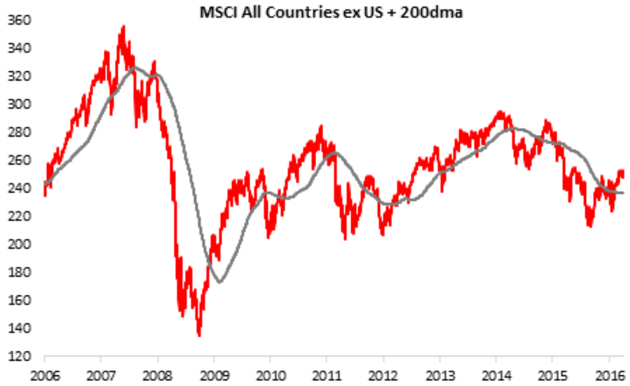




Source: Thomson Reuters

3. Trends exist until definite signals prove they have ended:

Charles Dow believed that markets might temporarily move in a direction opposite to the major trend, but that unless there are clear signals that a trend change has taken place that the trend should be given the benefit of the doubt. Determining the start or end of a major trend is very difficult and technical analysts widely disagree on this. It is also of course depends on which index one is looking at. For example, in the US indices above, the trend (which started in 2009) appears to still be up. Having said so, if you were to draw a trend line through this uptrend both the S&P 500 as well as the Dow would currently be below their respective trends, suggesting that investors’ conviction that the uptrend in US markets will continue is fading. This is confirmed by the volume indicator. Looking at equities more globally however, suggests that the trend remains down. The below chart shows global equities excluding the US. The smoothed grey line is the 200 day moving average. Although it has stabilized somewhat, the overall trend since mid-2014 is clearly down.



Source: Thomson Reuters

Conclusion:

Pulling these three factors together, I assume that if Charles Dow would still be around today, that he would be bearish on the outlook for both US as well a global equities because:

- Key sector indices in the US economy are failing to make new highs despite the fact that the aggregate benchmark is at highs
- The uptrend is not supported by increasing volume
- Outside of the US the trend remains firmly down

The US comprises over 50% of the global equity benchmark. If Dow theory is correct and the uptrend is US equities is unsustainable that means that global equities excluding the US, which are already in a downward trajectory will likely be weighed down even more. Having said so, we live in unusual times, and although the Dow Theory supports the view of the ADCB Asset Management Investment Strategy team (we are underweight equities), it is always possible that equities for a little while longer can defy the mix of weak fundamentals (earnings, margins, valuations, political risk) and unsupportive technicals and move higher. The only plausible reason for this to happen would be that with bond yields already so compressed there is very little alternative for investors than to move into equities. We believe that the “lack of alternatives” argument alone will prove insufficient to support the current upward movement in a sustainable manner, although in the short term some upside might still persist.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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