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The Day Ahead: Implications of Longer Term Momentum Hitting 'Oversold' Levels

This morning's commentary will be a bit heavy in terms of the focus on technical analysis, but as always, this isn't exactly old school, textbook technical analysis as much as it is my own spin on it, which has generally served us well over the years. After all, if financial market movement could be accurately predicted with a bunch of math, traders would figure that out pretty quickly, and soon, everyone would be on the same side of the trade (and if everyone town shows up to the farmers' market to strictly buy food, **things don't go so well** if there isn't anyone selling food).

There are several popular ways to measure momentum, with several of those relying on a spectrum between boundaries typically labeled as **"overbought" and "oversold."** The former traditionally implies impending weakness; the latter, strength. But again, if it was that simple, everyone would win (and everyone can't win in markets). So let's make it a bit less simple by looking at the current developments in the context of past examples.

Currently (just today, as a matter of fact, depending on how things end up), we will likely hit "oversold" levels on the longer term technicals, such as the slow stochastic oscillator seen in the chart below. This particular metric hasn't been oversold since March, largely due to the steadiness of the selling pressure between July and early Nov. Steady losses prevent the oscillator from spiking into oversold territory, but the **post-election spike** is getting the job done.

Looking back to the most recent instances of oversold levels, a clear pattern emerges, **unfortunately**. It is unfortunate because when stochastics hit oversold levels in the midst of an established trend, the trend tends to keep trending! The oversold levels offer an opportunity to pause and regroup at best.

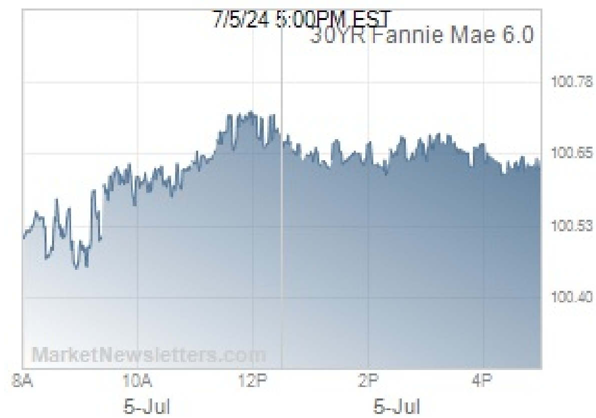
The following chart is "busy." Sorry about that, but here's the explanation:

- the vertical white lines simply point to the oversold levels
- the white circles highlight the oversold bounces
- the dotted teal lines highlight established uptrends in rates
- the dotted red lines highlight downtrends
- the one dotted white line highlights the sideways trend at the end of 2013

MBS & Treasury Market Data

	Price / Yield	Change
MBS UMBS 6.0	100.61	+0.22
MBS GNMA 6.0	100.74	+0.21
10 YR Treasury	4.2818	-0.0784
30 YR Treasury	4.4857	-0.0440

Pricing as of: 7/5 5:59PM EST



Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.03%	-0.05	0.00
15 Yr. Fixed	6.44%	-0.01	0.00
30 Yr. FHA	6.50%	-0.05	0.00
30 Yr. Jumbo	7.24%	-0.01	0.00
5/1 ARM	7.05%	-0.02	0.00
Freddie Mac			
30 Yr. Fixed	6.95%	+0.09	0.00
15 Yr. Fixed	6.25%	+0.09	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	7.03%	+0.09	0.62
15 Yr. Fixed	6.56%	+0.09	0.54
30 Yr. FHA	6.90%	+0.11	0.95
30 Yr. Jumbo	7.11%	-0.01	0.50
5/1 ARM	6.38%	+0.11	0.54

Rates as of: 7/5

With all of that in mind, just look at the places where the vertical white lines cross the teal lines. **None** of those examples resulted in a quick recovery.

All that having been said, this chart only deals with 2 major uptrends, so the sample size is limited. Still, we can certainly conclude that oversold technical levels are no guarantee of a big bounce that reverses prevailing trends. Bottom line: it continues to make good sense to stay defensive regardless of technicals **until we actually see** the trends reverse.

In more timely "day ahead" news, markets will wait to hear Yellen's Q&A with congress coming up in just a bit. We've all but priced-in a December rate hike, and there could be a reaction to Yellen if she says anything to meaningfully alter that outlook.

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