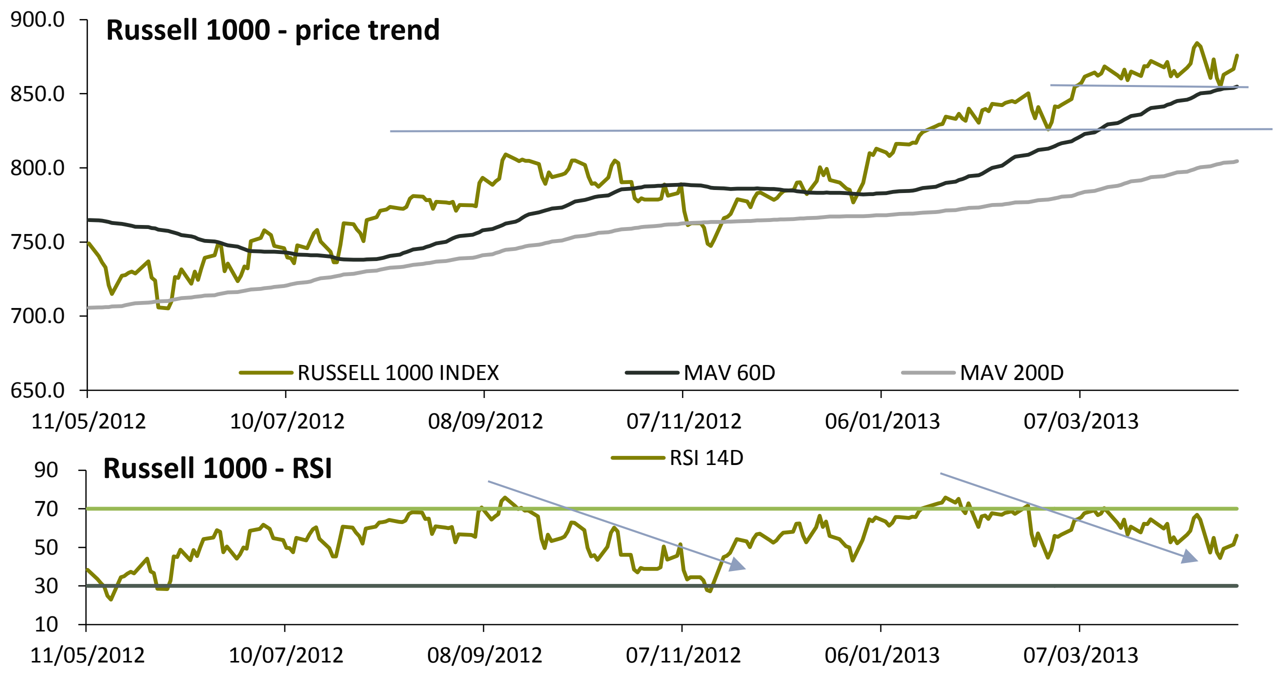
Trade Booster

24 April 2013

Russell 1000 Bearish Divergence Warning

Summary

- **The Russell 1000 set new all-time highs in March but the 14-day RSI failed to follow the index gains, leaving a 'bearish divergence' warning from the momentum indicator**
- **This warning could see the pullback from the 11 April 2013 high extend to 824/800**
- **Investors who believe that the Russell 1000 will fall may consider buying the Boost Russell 1000 3x Short Daily ETP (3USS) which offers a leveraged return if the index does fall**



Source: Bloomberg

The Russell 1000 set new all-time highs on 08 March 2013 and continued to rally to 886.33 on 11 April 2013 as the bull trend extended. The 14-day RSI, an often used momentum indicator, failed to keep up with the index gains though. This leads to a situation where the lack of confirmation from the momentum indicator has given a 'bearish divergence' signal to technical analysts and traders. The bull trend has trumped the signal so far though, and this may well remain the case. The pullback from 886.33 over the last few sessions does offer a technical 'counter-trend' opportunity though as the warning from the 14-day RSI may well build into a bigger corrective pullback.

The RSI (Relative Strength Indicator) is a momentum indicator created by Welles Wilder in the 1970's and should not be confused with the 'relative strength' indicator that compares share prices to their benchmark index or sector (or another share). Mr Wilder created the RSI as part of a broader attempt to create a systematic trading system. The RSI, along with other momentum and pivot systems that he used, attempts to identify when a market is entering a period of consolidation or corrective trading that will see the trend following techniques (moving average studies, for the most part) fail. Technical analysts use the RSI in various ways, but one method is to try and spot 'divergence'. This occurs when the underlying market is making new highs or lows (cyclical or all-time) and the RSI is failing to follow along. The RSI, by construction, is bound by parameters at 100 and 0, so in some sense the indicator could never 'follow' the underlying asset to new highs or lows.

Divergence is usually noted though when the asset, in this case the Russell 1000, is making highs as it did in March, but the RSI is broadly falling (moving in different directions). This is seen as a warning signal, that while the underlying price trend is still strong (new highs), there is a certain lack of momentum that is being noted by the RSI that could lead to corrections in the price trend. The small pullback to the 851.90 low of 18 April 2013 that followed after the push to new highs, could have been 'it' for the correction in the Russell 1000. It does seem limited in scope though, and the current rally above 870 presents a 'trading set up' with the all-time high of 886.11 serving as chart resistance, or risk for bear views. In other words, if the bull trend in the Russell 1000 does 'trump' the bearish divergence, then new highs may be seen again. If the bearish divergence is still giving a warning signal though, then a more significant corrective pullback may occur.

The last example of a similar bearish divergence set up was in August and September 2012, when the Russell 1000 was consolidating the gains to new cyclical highs from the 2009 lows at the 800 area, but the 14-day RSI was starting to fall (the first declining line on the RSI chart above). This led to a pullback of over 8.7% from the 14 September 2012 high of 813.55 to the 16 November 2012 low at 742.42.

If the current rally holds below the 886.33 all-time high, then the divergence that has been building in the RSI chart (second declining line on the RSI chart above) could allow for a corrective turn below 851.90 (18 April 2013 low, top horizontal line in the price chart above), and even further to 824.14 (lower horizontal line on the price chart above). This is the 26 February 2013 low and marks chart support of note as this was the last significant pullback before the Russell 1000 made new highs. A similar 8.7% correction (as seen in September to November 2012), from the 886.33 peak, would point to corrective losses towards the 810 area. Investors who believe that the Russell 1000 will fall further may consider buying the Boost Russell 1000 3x Short Daily ETP (3USS) which will offer a leveraged return if the index does indeed, fall.

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