

November 19, 2007 – Advance-Decline Line

Blood pressure, x-rays, EKG's, MRI's and various other tests are used by doctors when evaluating a patient to get a comprehensive view of their overall health. To determine how much risk to take, active money managers also require many tests or indicators to check the overall health of the stock market. Often times it is the "preponderance of the evidence" that leads a money manager to make decisions on how to invest in a given market environment.

One such indicator is the Advance-Decline line (AD Line). The AD Line is a popular indicator used to evaluate the underlying health of the market and ultimately the direction. It is calculated each day by subtracting the number of declining stocks from the number of advancing stocks. If the difference is positive, the AD Line goes up by that amount. If it is negative, it goes down by that amount. It is a running cumulative total of the number of advancing stocks minus declining stocks. Up is good.

A rising AD Line shows more stocks are advancing (bullish), while a falling AD Line shows more stocks are declining (bearish). Plotting the AD Line gives insight into overall market strength. When compared to the S&P 500 index, divergence from the index could be an early warning of a possible reversal in trend. Below is a three year chart of the S&P 500 index vs. the AD Line.



In the chart we see at the blue arrows, that each new high by the S&P 500 index was accompanied by a new high in the AD Line – confirming the healthy stock market the past three years. That is until the last new market high in October. The red X indicates the AD Line did not confirm the new high in the S&P 500 index – a divergence. Divergence meaning stocks went higher while the AD Line “diverged” or went lower – illustrated by the red lines diverging in direction (one up and one down).

There are fewer stocks advancing in the latest leg of the stock market rally and more declining each day - a deterioration of underlying market strength and warning sign of a possible market top. This is important because it shows narrowing leadership. Healthy stock markets generally take “everyone along for the ride”. When fewer and fewer companies are participating it may indicate the economy is slowing, and therefore, predict a lower stock market in the weeks or months to come.

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