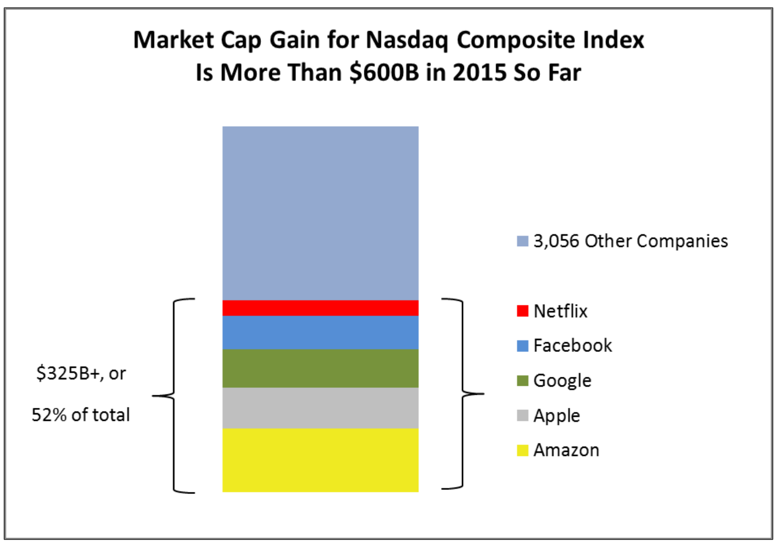
If All the Stocks On My Screen Are Red, How Can the Market Be Up?

Earlier this year, the Nasdaq Composite Index—a widely-watched measure of predominantly technology-related companies—finally broke through to new highs not seen since its most recent peak in early 2000. After 15 long years, any buy-and-hold Nasdaq investors from way back when have finally recouped their initial investment.

There are 3,061 companies that comprise the Nasdaq Composite, which is quite a few more than are found in either of the other two most popular indexes, the S&P 500 (which has, believe it or not, 500 companies) and the Dow Jones Industrial Average (which has 30). But of those 3,061, there are just 5 companies, or 0.2% of the total, which have driven the lion's share of recent gains:

Five Horsemen? I Thought There Were Only Four

By our math, the aggregate market capitalization of the Nasdaq Composite Index at the time of this writing is about $9.0 trillion, compared to a little less than $8.4 trillion as of the end of last year. Of that $600+ billion gain in market cap, more than $325 billion of it (or 52% of the total) was derived by just five firms: Amazon.com, Apple, Google, Facebook, and Netflix.

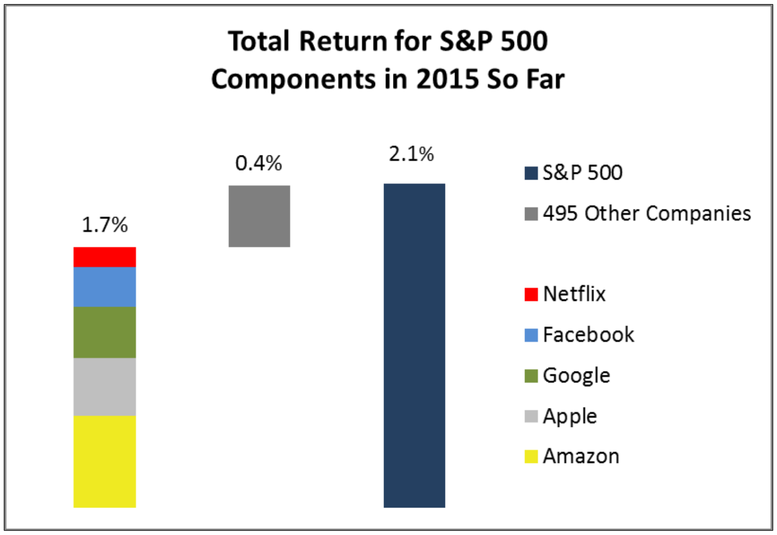


source: Nasdaq, Google Finance, Inkwell analysis

The Nasdaq Composite Index is a market-weighted benchmark, so naturally one might wonder how much of the index is comprised by these five companies. If their combined market cap is also in the neighborhood of 52%, then we shouldn't be so surprised to see the result shown in the chart above. However, in actuality these firms comprised just 17% of the overall index as of the end of last year. Since then, the six stocks have shot up an average of 23%, versus just 4% for the remaining members of the index.

But this is comparing these five tech stalwarts against their tech brethren in the Nasdaq Composite. If we broaden our scope to the S&P 500, which includes many other industries such as energy production, whose stocks have been hit hard in 2015, then the reality becomes even starker.

As of this writing, the market cap-weighted S&P 500 index has returned 2.1% so far in 2015. We calculate that these five tech companies alone have accounted for 1.7% of that return, meaning that the other 495 companies in aggregate have only produced a return of 0.4%. In other words, 80% of the S&P 500's results in 2015 so far have been driven by five companies.



source: Nasdaq, Google Finance, KASE Capital, Inkwell analysis

Narrower and Narrower

When this happens in a bull market such as the one we are still in, stock market pundits refer to it as a market with little breadth. That is, the overall market gains that are reported on the evening news are driven by a narrower and narrower list of companies. During the strongest parts of a bull market, many companies shoulder the load in driving up the index average.

The breadth of such strength starting to fall off, though, is a phenomenon that usually occurs at the tail end of a bull market, signaling that a downturn in stock market prices may be imminent. According to Lu Wang of Bloomberg, "six computer and software companies accounted for 55 percent of the S&P 500’s gain over the 12 months leading up to the peak [of the Internet bubble in early 2000]."

While that quote seems particularly ominous given its similarity to our current circumstances shown in the first chart above, one signal on its own is usually never enough to make a convincing argument, so perhaps some more context is in order.

"Reminds Me of the Late 1920s"

Two other data points tracked by stock market technicians are usually cited as indicators of the tail end of a bull market: the relationship between the number of stocks hitting recent highs versus the number of stocks hitting recent lows, and an unweighted market index.

What good would it do to look at an unweighted index? The S&P 500 is made up of 500 companies, each of which is weighted according to its own market cap. For example, of the nearly $20 trillion aggregate market cap of the entire index, Apple's $700 billion or so market cap means that Apple stock's movements account for about 3.5% of the overall index's movements.

If the S&P 500 were instead unweighted, then Apple stock's movements would account for just 0.2% of the index's changes. That 0.2% weighting is equivalent to 1 out of 500, which is the same percentage that every single company in the unweighted version of the index would have. As the theory goes, looking at an unweighted market index removes the possible distortions caused by severely narrow markets which are led by a handful of large stocks in an uptrend, as both of the previous charts show.

According to Helene Meisler of TheStreet.com, who tracks an unweighted index of all New York Stock Exchange listings, that average is currently about 10% lower than its all-time high. That 10% figure is normally used as the cutoff point for when market watchers begin to talk about the stock market being in a “correction,” while the deeper decline of 20% is reserved for the marker of a true “bear market.” Compared to the market cap-weighted S&P 500, which is only about 2.5% lower than its all-time high, a market correction signal from an unweighted index could be a sign of things to come.

We are certainly no market technicians, since we concentrate our efforts on individual stocks as opposed to the market as a whole, but Ned Davis is a fairly well-respected market watcher with a long track record. According to him, "It is common for breadth in unweighted averages to top out before the market does, but the two years of bad breadth we experienced in the late 'Nineties was an unusually long period."

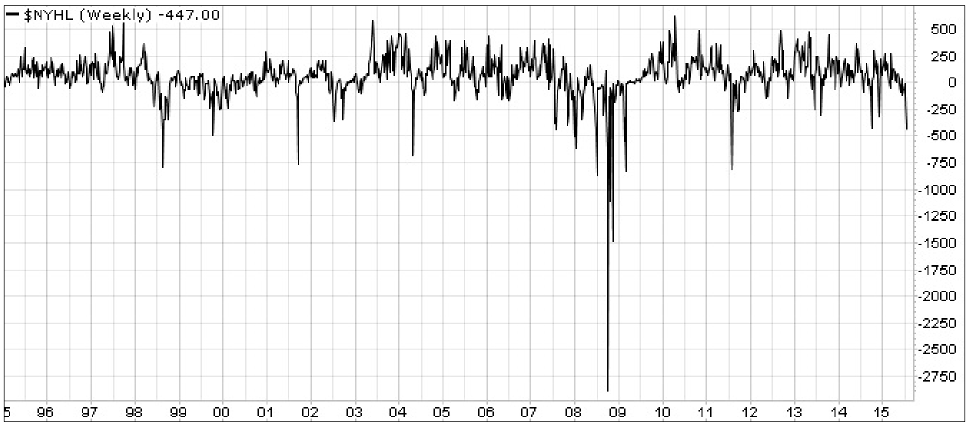
That quote comes from an interview he did with Barron's several years ago. In response to their follow-up question of whether there was ever a similarly extended period, Davis replied, "The late 'Twenties. The data is a little suspect, but at the time breadth topped out for about a year before the market peaked in 1929."

In other words, the current lack of breadth may not be a sign that the market is due for a swoon any moment now. The narrowness could continue for another year or two before things start to turn south.

Highs and Lows

That just leaves one more data point to examine: the number of stocks hitting new highs as compared to the number of stocks hitting new lows. Usually this relationship is expressed as the number of lows subtracted from the number of highs.

For instance, on the most recent trading day at the time of this writing, there were 18 stocks which reached a recent high point on the New York Stock Exchange, as compared with 465 stocks which touched their lowest point of the previous year. That day's high/low number would thus be negative-447. This is an especially low reading, surpassed only a few times in the last twenty years:



source: StockCharts.com

Conclusion

Of course, there are probably dozens of other factors one could examine to try to determine if we are finally reaching the peak of this six-year old bull market. Do the factors presented here convince you one way or the other?

We honestly have no opinion either way, and we do not plan to change our methodology of analyzing things one stock at a time. We do take comfort, though, in two facts: first, we do not currently own any of the stocks that are part of the narrow vanguard driving the market ever-higher; also, we do currently own some stocks which are deemed laggards and showing up on the list of stocks making new one-year lows.

Why would those things give us comfort? Benjamin Graham, the dean of value investing and the favorite professor of Warren Buffett, put it best when he chose for the quote to put on the title page of *Security Analysis* a line from Horace: “Many shall be restored that now are fallen, and many shall fall that now are in honor.”

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