Using market breadth to identify major market tops

Is Wall Street in a late stage bull market or an early stage bear market? Of course we'll know in hindsight. In the meantime, here is my preferred method of identifying major market tops:

The common characteristic of market tops is poor market breadth. That is, fewer and fewer stocks participate in the market's final advance toward the top.

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The Internet bubble in 2000 was a classic case. The day the market topped in March 2000, nearly 60 percent of all stocks had already fallen 20 percent or more from their yearly high!

To measure market participation, or market breadth, analysts look at the number of stocks advancing on the NYSE versus the number of declining stocks.

Here's the problem with that method: Close to half of the securities traded on the NYSE are closed-end bond funds that are tied to interest rates, ADRs, and warrants.

For more accurate results, I ignore these "irregular" issues and crunch the numbers on the 1500 stocks in the S&P 1500 index.

How's recent market breadth? The day of the market's high point in May, the Advance Decline Line, a market breadth indicator, was within pennies of its high.

It was in July that breadth began to deteriorate, with the Advance Decline Line falling to a multi-month low by the end of the month.

The negative market breadth data in July foretold the August/September stock swoon. Now, 43 percent of the stocks are 20 percent or more off their yearly high.

While bad, that number is in line with last October's sell-off and is far better than the last time the market fell 10 percent (in 2011).

The one-month negative divergence pointed toward market weakness, but the negative divergence was not enough to signal a major market top.

I view today's volatile environment as one that often happens in September and October. There will be better days ahead.

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