The Market is Oversold

When the *Risk-O-Meter* last went into the green zone, I noted that the market was extremely overbought.

The market was overdue for a pullback.

As a result, the risk/reward ratio did not favor running into stocks.

Fools rush in where angels fear to tread.

The market has since sold off sharply.

The market is deeply oversold, risks are reduced, and the risk/reward ratio is favorable for a rally.

Of course, the market could sell off further from here. All we can do is play probabilities.

Probabilities suggest higher stock prices from here.

My favorite short-term indicator shows the market stretched to the downside. A chart of that indicator, the *Short-Term Composite,* is shown below. Investors Intelligence developed the *Short-Term Composite*, and it uses dozens of short and intermediate-term indicators to illustrate how overbought or oversold the market is at present.

As I have noted before, it is much easier to anticipate rallies from an oversold market than it is to pick tops.

There's only so much selling that can take place.

For example, when speculators get margin calls, they dump stock aggressively.

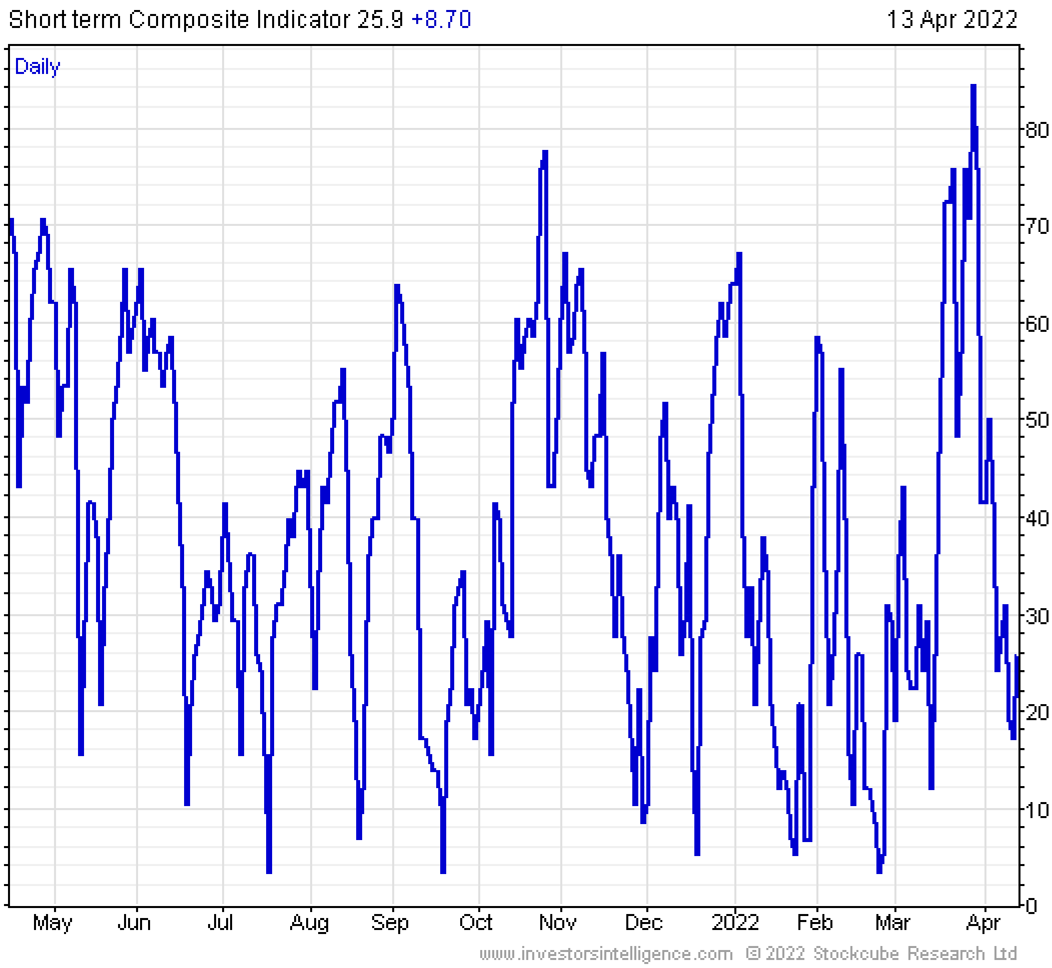
Prices fall hard.

Someone swoops in and buys up shares at depressed levels.

At highs, the buying can keep going. Speculators can borrow more money. Investors use cash on the sidelines to buy day after day.

Corporations buy back stock.

Prices can stay pinned at overbought levels much longer than when the market hits the skids.



Now, the *Short-Term Composite* at 8.7 could fall further. If it hits 5-6 or six, it's always signaled a screaming buy.

If we are in a bear market or a bear market is developing, we will have massive rallies. The market does not go straight down in a bear market.

Once the market is overbought again, we will have to assess conditions at that time.

One short-term wild card is that earnings season is upon us. The prices of individual stocks will move based on new information specific to the company reporting earnings.

A company that drops a turd ball of an earnings report could fall sharply even though the market is ripe for a big bounce higher.

One company that posted a lukewarm quarter is CarMax (NYSE: KMX). A big driver of inflation has been used car prices. However, unit sales declined in the most recent quarter while prices were a significant factor in revenue growth.

Consumers have bought their cars. They're good.

Earnings estimates and ratings from Wall Street firms have tanked.

As a result, investors have slammed the brakes on the stock. Shares of CarMax are down bout 15% from their recent highs.

There is also a sign of speculative froth reaching its zenith.

The luxury watch market has stalled out. Some of the pause in skyrocketing prices could be seasonal as new watch offerings come out and there are several religious holidays.

However, prices of massively overinflated Rolex watches have stalled completely. At the very high end, some prices have fallen over 30%, and the units remain for sale even then.

One of the main characters in drawing attention to the watch market on social media imploded last week. His downfall has now exposed the watch flipping business as a bunch of smoke and mirrors.

Due to my 20+ years of work in dissecting financial statements and analyzing market bubbles, I watched this slow-motion trainwreck with great interest. There is a high probability that this gentleman could end up back in jail (he's an ex-con).

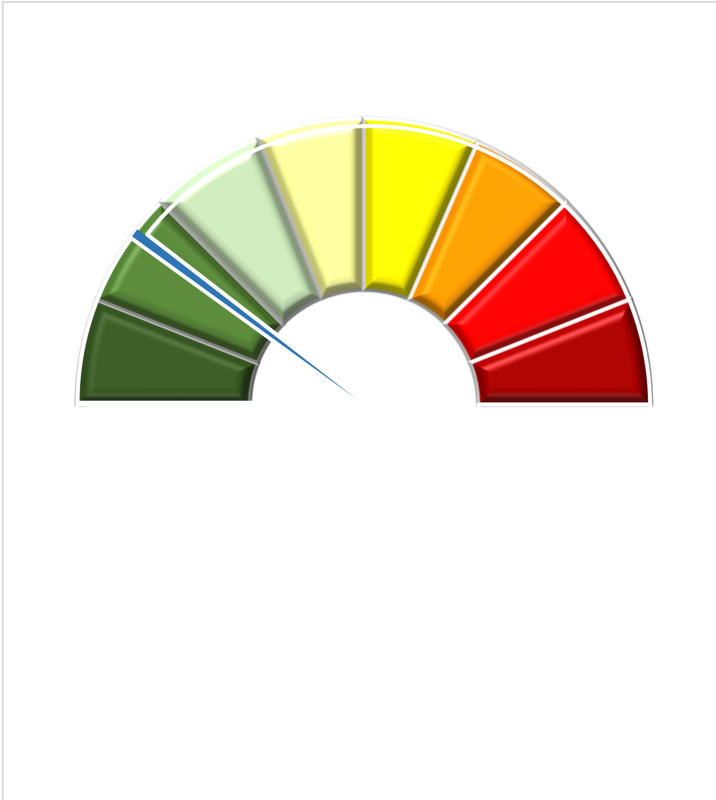
Human nature never changes. All of the elements in bubbles can easily be seen. Bubbles form over and over again. It never ceases to amaze me.

The biggest unknown is whether liquidity continues to get withdrawn from the market. It is obvious interest rates have gone higher. The Federal Reserve is way behind the curve. I do not think there is any way the Fed can catch up.

The market is discounting these factors.

What is not obvious is what might cause this situation to reverse. For example, rates level off, or liquidity is pumped back into the market.

We know that the market is oversold, and the risk/reward level is favorable for a bounce in stocks. It could be a strong rally for the riskiest of assets.



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