TSX 200-day moving average breaks out

The TSX broke through its 200-day moving average in August. What does it mean?

Moving averages are indicators frequently used in technical analysis showing the average value of a security's price over a set period. The most popular type of moving average is the Simple Moving Average (SMA) as it can be used to measure momentum and identify the direction of the trend or define potential support and resistance levels.

A simple moving average is formed by computing the average price of a security over a specific number of days. Most moving averages are based on closing prices. For example, a five-day simple moving average is the five-day sum of closing prices divided by five. As its name implies, a moving average is an average that moves. Old data is dropped as new data comes available. This causes the average to move along the time line.

The direction of the moving average conveys important information about prices. Simply, a rising moving average shows that prices are generally increasing. A falling moving average indicates that prices, on average, are falling. A rising long-term moving average reflects a long-term uptrend. A falling long-term moving average reflects a long-term downtrend.

So, why all this talk about moving averages? The investing community cheered on Thursday, August 16, 2012, as Canada's main stock index, the TSX Composite Index, finally broke through its 200-day SMA – to the upside. See chart 1 on next page.

The index also broke the March trend line and exceeded its early July high of 11,936.16. On the same day, the index also rose above the 12,000 level for the first time since early May. The push above the psychological 12,000 barrier was significant as it has been a resistance level in the past.

The heavily weighted materials sector, which includes miners, led the way, jumping 3% that day. And so most of the credit went to mining companies, which rallied on fresh stimulus hopes and after Barrick Gold said it is in talks to sell a majority stake in its African unit. Barrick was among the index's top gainers, climbing 3.9% to $35.60.

Other top mining stocks that helped that day included Goldcorp Inc, up 4.7% at $37.93, and Potash Corp, which rose 1.6% to $43.99. The Toronto Stock Exchange's S&P/TSX composite index added 1.1%, or 127.14 points, to close at 12,032.58, its highest level since May 3. Prices for gold bullion perked up too after prominent hedge fund managers, including John Paulson and George Soros, raised their stakes in the gold exchange-traded fund, SPDR Gold Trust, in the second quarter. But is this an actual buy signal?

While moving averages smooth the price data to form a trend-following indicator, they do not actually predict price direction, but rather define the current direction with a lag. Moving averages lag because they are based on past prices. Despite this lag, moving averages help smooth price action and filter out the noise that can confuse interpretation. They also form the building blocks for many other technical indicators and overlays, such as Bollinger Bands, MACD and the McClellan Oscillator.

The longer the moving average, the more the lag. A 10-day moving average will hug prices quite closely and turn shortly after prices turn. Short moving averages are like thoroughbred horses – nimble and quick to change. In contrast, a 100-day moving average contains a great deal of past data that slows it down. Longer moving averages are like cows – lethargic and slow to change. It takes a larger and longer price movement for a 100-day moving average to change course.

The length of the moving average depends on the analytical objectives. Short moving averages (5 to 20-day periods) are best suited for short-term trends and trading. Chartists interested in medium-term trends would opt for longer moving averages that might extend 20 to 60-day periods. Long-term investors will prefer moving averages with 100 or more day periods.

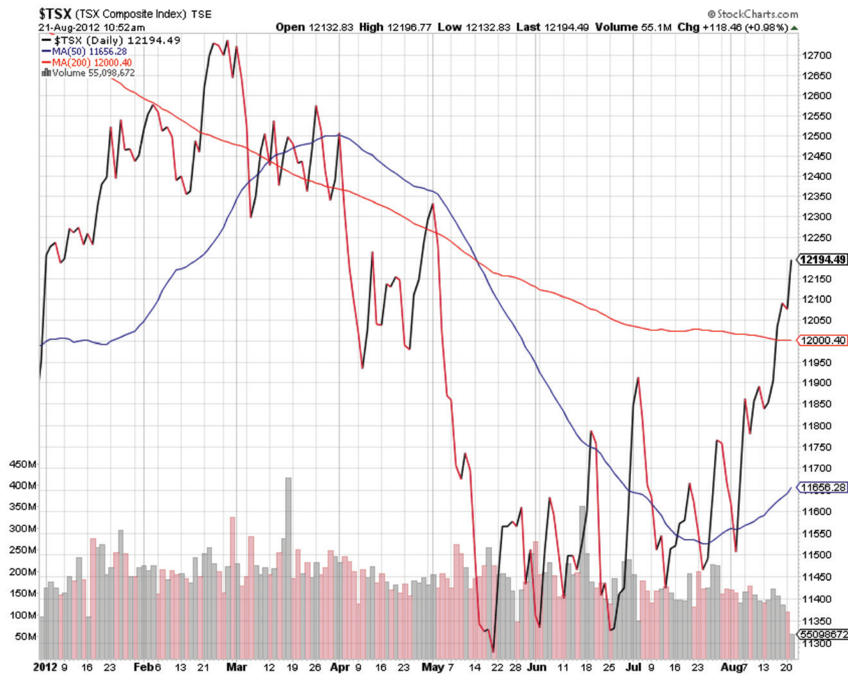
The 200-day moving average is perhaps the most popular. Because of its length, this is clearly a long-term indicator. Next, the 50-day moving average is quite popular for the medium-term trend. Many chartists use the 50-day and 200-day moving averages together. Here's why.

Typically, upward momentum is confirmed when a short-term average (e.g.50-day) crosses above a longer-term average (e.g. 200-day). When both are trending higher, and the 50-day is above the 200-day, it's usually a bullish sign of market strength and momentum. Downward momentum is confirmed when a short-term average crosses below a long-term average.

These "crossovers" are very important. Here is a great example: In the fall of 2010, the TSX Composite Index clearly broke through its 50-day and 200-day SMAs. As well, the 50-day crossed over the 200-day SMA. The 50-day stayed above the 200-day over the following months, with the gap even widening, pointing to a clear swing in momentum and an upward trend for the TSX, which climbed over 2,000 points from fall 2010 to spring 2011. See chart 2 at resourceworld.com

Typically, we need to see 50% or more of stocks in any index trading above their 200-day SMA to create the low-volatility conditions that bull markets are made of. Right now, we are at around 40%. See chart 3 at resourceworld.com

Incidentally, the S&P 100 broke below 50% at the end of 2007 and the 50% level turned into resistance in 2008, which is when the S&P 100 was in a downtrend. The indicator moved back above the 50% threshold in June-July 2009.



So, while the TSX Composite Index has now broken through its 200-day SMA, and the 50-day earlier in August, we have still not seen the crossover that so clearly pointed to the momentum shift in 2010. A word to the wise though; while we believe technical analysis should play a role in investment decision-making, we prefer to use it in conjunction with fundamental analytical methods as well. ■

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