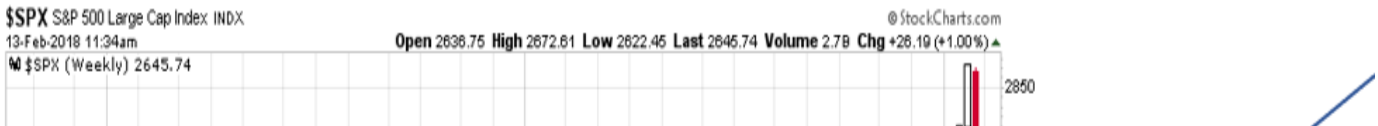
Yesterday, I showed the most important stock charts for traders and investors to watch after last week's correction. I explained that, despite the sharp correction, the longer-term trend is still intact because a major uptrend line that formed two years ago had not been broken yet. I also cautioned that a convincing break below this uptrend line would give another bearish technical signal. In this piece, I will show three primary ways that the current market correction is likely to play out.

Scenario #1: Imminent Breakdown

The chart below shows the SP500 and its important uptrend line that began two years ago. Last week, the index cut right through another shorter-term uptrend line that started in August 2017. On Friday, the market tested the longer-term uptrend line, but was unable to break below it, and proceeded to bounce. In this most bearish scenario, the SP500 would continue to consolidate in the near future and then break below this trendline, which would likely portend an even more serious breakdown ahead.



Source: StockCharts.com A historic example of Scenario #1 is the topping of the Nasdaq bubble in 1999. The Nasdaq Composite started climbing an uptrend line that began in October 1998. Starting in October 1999, the index launched a much steeper rally while climbing a new uptrend line. The Nasdaq plunged below this steeper uptrend line in April 2000, marking the end of the Dot-com bubble. The index consolidated for five months, and then proceeded to break below the older uptrend line that began in 1998.

Source: StockCharts.com

Scenario #2: A Topping Pattern Forms

In this scenario, the SP500 and other correlated U.S. stock indices would form a common topping pattern such as a *head and shoulders pattern*, *triple top*, or *double top*. In the head and shoulders scenario shown in the chart below, the SP500 would bounce off the two-year-old uptrend line to reach the old January 2018 highs or even slightly higher. Investors and traders would then become euphoric again and pile into the market. The index would then fall back to the lows reached in the most recent correction (breaking below the two-year-old uptrend line in the process), which would form a *neckline* support level. The market would launch one final rally or re-test of the uptrend line, but would be unable to break back above it, causing the index to fall to the neckline support level. Once this neckline support level is broken to the downside, a more extensive bearish move would occur.

Source: StockCharts.com A real-life example of the head and shoulders topping pattern is, interestingly enough, the top of the last market cycle in 2007. The U.S. indices formed a head and shoulders pattern, and broke below the neckline in January 2008, which eventually resulted in the 2008 crash.

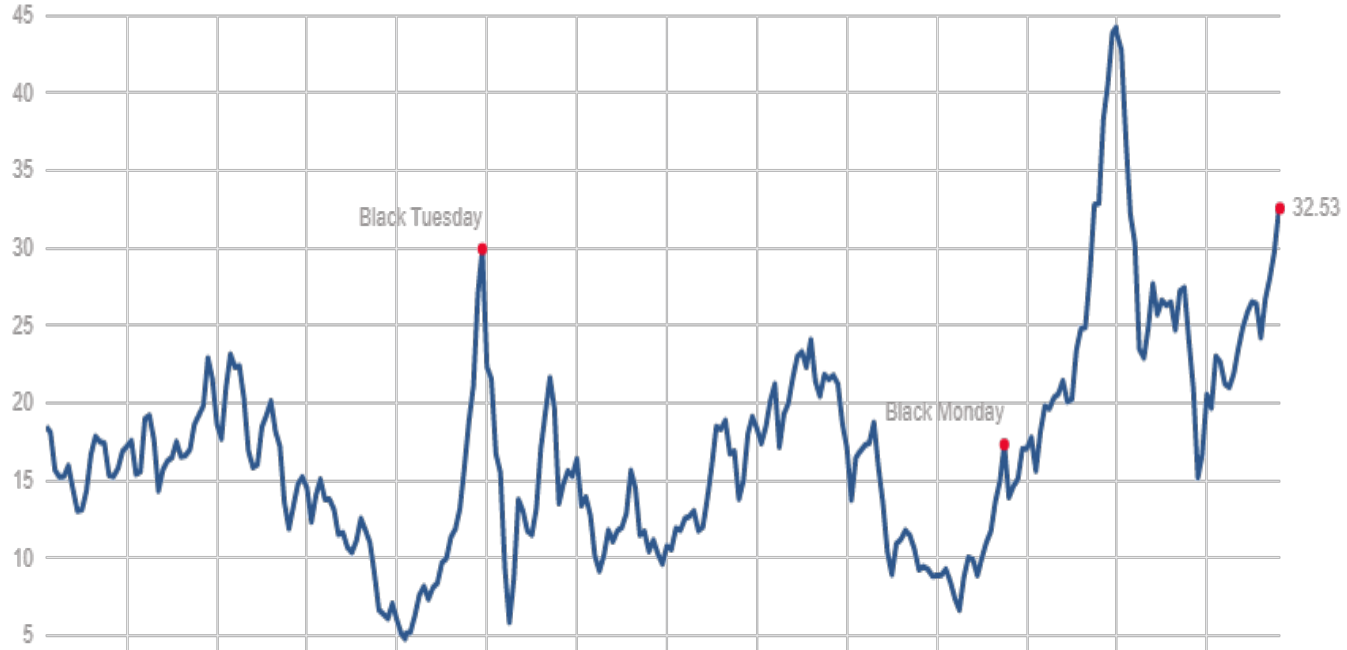
Source: StockCharts.com

Scenario #3: The Market Is Setting Up For New Highs

This scenario is the simplest and most straightforward. The SP500 and other indices would bounce off their two-year-old uptrend lines to hit new highs as the bull market continues.

Source: StockCharts.com A historic example of this scenario is the 1998 Asian Contagion, when the SP500 fell by over 20 percent to touch its longer-term uptrend line before rebounding to all-time highs.

Source: StockCharts.com The market's current high valuations decrease the probability of much further gains ahead, but it's also important to realize that "anything is possible" in this wonky, unprecedented, central bank-driven market. Most U.S. stock market valuation measures - including the cyclically-adjusted P/E ratio below - show that the market is the most overvalued it's ever been aside from the Dot-com bubble, and is even more expensive than in 1929 before the crash.



Source: Multipl.com It is impossible to predict exactly how the market will play out from here, but making predictions isn't necessary, thankfully. I believe that investors should watch how the market acts at the major two-year-old uptrend line and if the market appears to be following one of the scenarios discussed in this piece. I will continue following the markets with these scenarios in mind and will provide ongoing market updates. **Please follow or add me on Twitter, Facebook, and LinkedIn to stay informed about the most important trading and bubble news as well as my related commentary.** *(Disclaimer: All information is provided for educational purposes only and should not be relied on for making any investment decisions. These chart analysis blog posts are simply market ?play by plays? and color commentaries, not hard predictions, as the author is an agnostic on short-term market movements.)*