December Economic and Market Outlook

Each December I normally review and analyze the major economic and business trends that are driving equity and debt prices for the year. Because I think risks are rising, this December I want to focus on those risks with a model I developed over the years to help investors determine major turning points in the markets.

Briefly the major, economic and markets events for 2015 include:

- The markets have been anticipating the Federal Reserve to normalize interest rates and raise them slightly. This has caused the dollar to strengthen

- China is slowing down and is negatively impacting its major trading partners and resource based economies: Australia, Canada, Brazil, Indonesia, Venezuela, Russia….

- Continued low oil prices and it impact on the oil industry, energy stock and bond valuations.

- Growing risks in the Middle East (ISIS, Syria, Russia, Iraq, Iran)

- Increased M & A activity

- Increased stock buyback programs and dividends

- The strong dollar and low oil prices have hurt earnings in 2015.

Model to Identify Major Turning Points in Markets

Historically, analysts and economists have been very bad at identifying inflection points in the market and economy. In Dr. Jeremy Siegel's seminal book *Stocks for the Long Run*, he writes "Wall Street employs so many economists desperately trying to predict the next recession or upturn since doing so **dramatically increases returns**. But the predicting exact business-cycle turning points is extremely poor."

As Dr. Siegel is pointing out by identifying these inflection points in the market, at the top you can minimize your losses and raise cash. At the bottom you have the cash to deploy and pick up some great bargains, and usually buy and hold for the next bull market. Bottoms and riding the next bull market is where you can make the best returns, with reduced risks.

Because of this, I've worked on my own model to identify major turning points in the market.

I think the problem with economists and analysts is that they tend to focus only on the indicators, tools from their own discipline.

My model borrows from three main disciplines: economics, fudnamental anlaysis, and technical analysis.

Below is my model:

CHART/PRICE ANALYSIS	RED FLAG	THIS CYCLE	WEIGHT	SCORE
Major Reversal Patterns	Umbrella, Head & Shoulders, Triple Top, Double Top, Spike	Umbrella	2	
Time to build top	More than 6 months	10 months	2	
% Change since beginning of bull market	Greater than 60%	S & P greater than 200%	2	
L-T trendline of neckline broken	See filters below	No	2	
Filters				
Two or more days below trendline	If l-t trendline broken	No	1	
Significant volume	If l-t trendline broken	No	1	
% break 3% to 5%	If l-t trendline broken	No	1	
Close both days at low	If l-t trendline broken	No	1	
Oscillators/Indicators				
MACD	Divergence	No		
PUT/CALL	High	No	1	
Break below 200-Day Moving Average w/filters		S & P no, DJIA Yes	1.5	
Fundamentals				
P/E use historical	Greater than 17	Yes	2	
Other valuation metrics	Dividend Yield, Price/Sales, Debt levels	Yes	1	
Economic Indicators				
Inflation	High	low	2	
Interest Rates	Rising High	Might be rising	2	
Phase in economic cycle	Average cycle, 4 to 5 years	Mature, 6th year	1	
Monetary Policy	Restrictive	Restrictive to accommodative	2	
Fiscal Policy	Restrictive	Restrictive	1	
Yield Curve	Short higher than long	normal	2	
Credit Spread	Widening	Starting to widen	3	
Oil	High, rising	low	3	
Cycle Allocation Decisions		Financial Engineering, Energy	3	
Debt Levels			2	
External				
ME, Europe, China, Japan….		ME, China, Greece & EU	3	
Allocation Decisions			3	
Debt Levels			3	
			47.5	

The model has 5 sections: 1. technical analysis of topping major reversal patterns 2. technical analysis oscillators/indicators 3. fundamentals of markets and stocks 4. economic indicators 5. external, international events.

Over the next few weeks, I will explain each section.

In this report I will explain the first section: technical analysis of topping major reversal patterns.

In Economics 100, leading, coincident and lagging indicators are taught to help in forecasting the economy. According to the study of economics, the best leading economic indicators are market indicators. The markets are very anticipatory, and normally lead the economy. It does pay to pay attention to what the markets are telling us.

Many times markets that are reversing from bull markets to bear markets are followed by recessions. Not all bear markets forecast recessions. Below is a table I put together to show the many bear markets that have occurred since 1917.

YEAR	HIGH	LOW	LOSS	TOP	MONTHS (APPROX)
	DOW 30 BEAR MARKET LOSSES TA				
2007	14,279.96	6,440.08	54.90%	H & S	19
2000	11,908.23	7288.27	38.80%	Rounding	30
1998	9,337.97	7539.07	19.26%	Rounding	5.5
1990	2,999.75	2365.1	21.20%	NO	
1987	2,722.42	1738.74	36.10%	NO	
1981	1,024.05	776.92	24.10%	Rounding	13
1976	1,014.79	74.12	26.90%	Rounding	9
1973	1,051.70	577.8	45.10%	Rounding	13
1968	995.21	631.16	35.90%	Rounding	12
1966	995.15	744.32	25.20%	H & S	10
1961	734.91	535.76	27.10%	H & S	12
1946 – 49	212.50	163.21	23.20%	Rounding	9
1939 TO 4	155.92	92.92	41.30%	Rounding	24
1929 TO 1	381.17	41.22	89.00%	Rounding	10
1923	105.38	85.76	18.60%	Double Top	12
1919 TO 1	119.62	63.9	47.60%	Rounding	6
1917	110.15	65.95	40.10%	H & S	18
YELLOW INDICATES NO RECESSION			36.14%		14.46429
			AVG DECLINE		AVG. TOPPING PHASE LENGTH

There are several definitions for bear markets. The simplest definition is a fall in prices of more than 20% from its peak. The average decline in the bear markets identified above is about 36%.

I count 17 bear markets since 1917. The yellow shaded years indicate 4 bear markets (in terms of decline) without a recession. This means bear markets have anticipated 76% of recessions since 1917. Not bad!

I co-wrote a technical analysis course. The best thing about the course is it's free. It's also very good. It has exercises, quizzes and tests. I also use charts with real examples, unlike most technical analysis courses and books. Click here to take the course.

Section 4 is probably the most important section of the course, as it explains major reversal patterns, by definition are patterns that occur at major reversals in the markets. The current market has developed a topping umbrella pattern also called a rounding top:
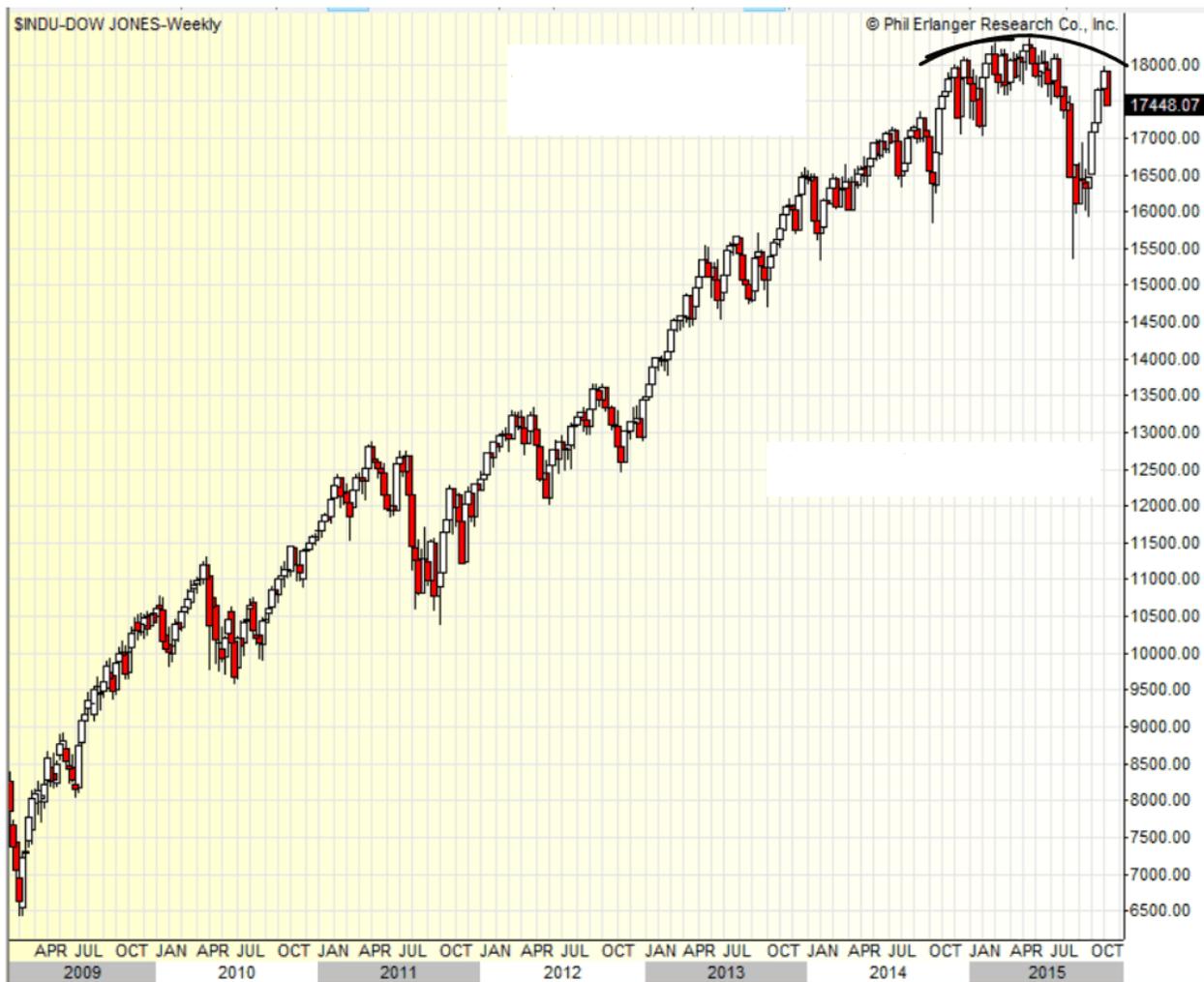
Now let's look at my first technical section for my model:

CHART/PRICE ANALYSIS	RED FLAG	THIS CYCLE	WEIGHT	SCORE
Major Reversal Patterns	Umbrella, Head & Shoulders, Triple Top, Double Top, Spike	Umbrella	2	2
Time to build top	More than 6 months	12 months	2	2
% Change since beginning of bull market	Greater than 60%	S & P greater than 200%	2	2
L-T trendline of necline broken	See filters below	No	2	0.5
Filters				
Two or more days below	If l-t trendline broken	No	1	0.25
Significant volume	If l-t trendline broken	No	1	0.25
% break 3% to 5%	If l-t trendline broken	No	1	0.25
Close both days at low	If l-t trendline broken	No	1	0.25
			12	7.5

Let's analyze the chart above and complete this section of my model.

This part of the model is forecasting a 62.5% probability of a bear market.

The probability would be higher but prices did recover from the breaking of a 200-day moving average and major long-term trend line. In August, when the markets declined the model was forecasting a much higher probability of a bear market because the filters for determining breaking of a long-term trendline were met. The score in the filter section did fall because the markets did recover some of its losses.

Below are the technicals that are red flags:

1. The market has developed an umbrella pattern, also known as rounding tops.

$INDU-DOW JONES-Daily   © Phil Erlanger Research Co., Inc.

According to my research and the table on page 3, most market tops, major reversal patterns are umbrella/rounding patterns.

2. Prices are essentially at the same level as they were a year ago. The umbrella/rounding pattern has taken about one year to develop (a major reversal pattern, because it took about one year to build and we can see a long-term umbrella/rounding pattern).

The longer it takes to build a pattern, the more serious the pattern is and consequence it will be.

According to my research and the table on page 3, most major reversal patterns/tops on average take about 14 months to run its course, and the bull market ends and the bear markets start.

Of course topping patterns can be shorter or longer than the average of 14 months. Below is a chart of the Russell 2000 Index (symbol RUT), an index of small-cap stocks:

$RUT-RUSSELL 2000 INDEX-Weekly — © Phil Erlanger Research Co., Inc.
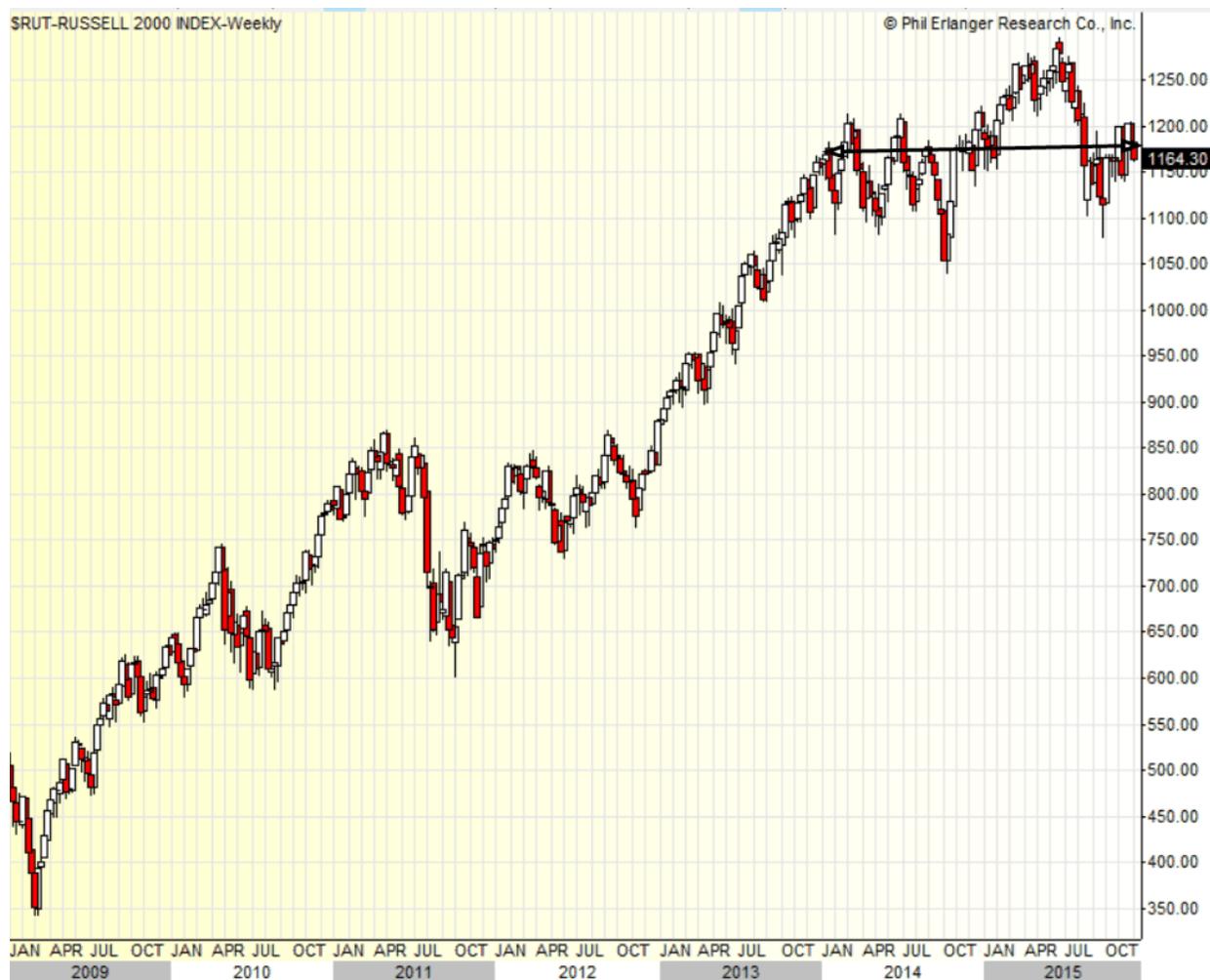
 The RUT has been topping for about 2 years. The RUT did make new highs this year, but pulled back to its topping pattern.

Earnings are expected to be better next year (more on this in next month's 2016 Economic and Market Outlook), so the markets could make new highs next year, but with risks rising, higher prices may not be sustained, similar to the RUT this year.

3. The Dow is up over 100%, and the S & P and RUT are up over 200%.

At the beginning of each bull market, prices and valuations are low, and dividend yields are higher. At the end of a bull market we have the opposite: higher prices and valuations and low dividend yields.

The average bull market is up about 120%. Most major indexes for the current bull market are up more than the average bull market.

Below is a table that shows the performance of each bull market going back to 1962:

Start	Finish	Beginning Value	Ending Value	Change	Days
6/26/1962	2/9/1966	52.32	94.06	79.8%	1,324
10/7/1966	11/29/1968	73.2	108.37	48.1	784
5/26/1970	1/11/1973	69.29	120.24	73.5	961
10/3/1974	11/28/1980	62.28	140.52	125.6	2,248
8/12/1982	8/25/1987	102.42	336.77	228.8	1,839
12/4/1987	7/16/1990	223.92	368.95	64.8	955
10/11/1990	7/17/1998	295.46	1,186.75	301.7	2,836
8/31/1998	3/24/2000	957.28	1,527.46	59.5	571
10/9/2002	10/9/2007	776.76	1,565.15	101.5	1,826
3/9/2009	2/1/2013	676.53	1,513.17	123.7	1,425

Source: Birinyi Associates

Below is a chart of the market tops since 2000:

The major market indexes are all waving technical red flags, similar to 2000, and 2007 (and most bear markets).

My next report will focus on the oscillators and the fundamentals.