December Market Outlook Part Two: Model - Turning Points in Market

Most investment professionals will tell you that you can't pick a top or bottom. I basically agree with that. What I try to do is buy low and sell high, that is different than trying to pick a top/or bottom.

When I was in graduate school getting my MBA, I had a professor who taught us about the many cycles that investors need to know: market, business, economic, interest rate, product, political cycles. Like in nature, each cycle has a birth, growth, mature and decline phase. As an investor you need to know where you are in the cycle, and then apply an appropriate strategy for each stage in the cycle. I try to buy during the birth phase (buy low) and sell during the mature phase (sell high).

The current market and economic cycle started in 2009, so we are in the mature, late phase of this cycle. In the mature, late phase of a cycle investors need to be more cautious by raising cash, lowering the beta and P/E of your overall portfolio, make sure the stocks you own don't have too much debt.

In this report I explain the 2nd and 3rd part of my model that helps in identifying major market reversals.

Model: Technical Indicators and Fundamentals

Below is the indicator and fundamental section of my model:

CHART/PRICE ANALYS	RED FLAG	THIS CYCLE	WEIGHT	SCORE
Oscillators/Indicators				
MACD	Divergence	YES	2	2
Break below 200-Day Moving Average w/filters		S & P	1.5	1.5
Fundamentals				
P/E use historical	Greater than 17	Yes	2	2
Other valuation metri	Dividend Yield, Price/Sales, Debt	YES	2	1.25
TOTAL			**7.5**	**6.75**

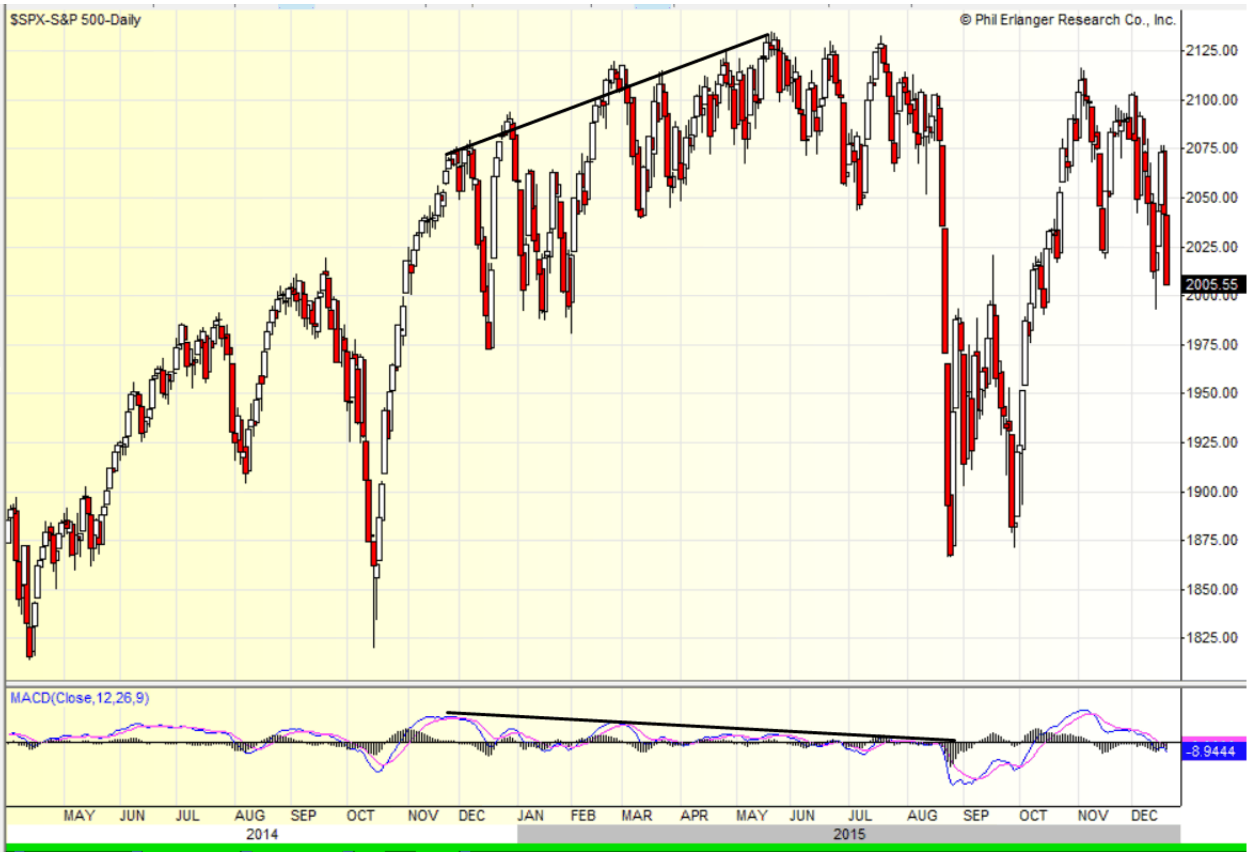
This part of the model is also waving red flags.

MACD (Moving Average Divergence Convergence)

Generally, the MACD shows overbought and oversold conditions.

In trying to identify turning points in the market, the MACD can be helpful in showing divergences in the market. If the market is making new highs, but the MACD is not, it is an indication that the market move higher is suspect.

Below is a chart of the S & P 500 with the MACD:



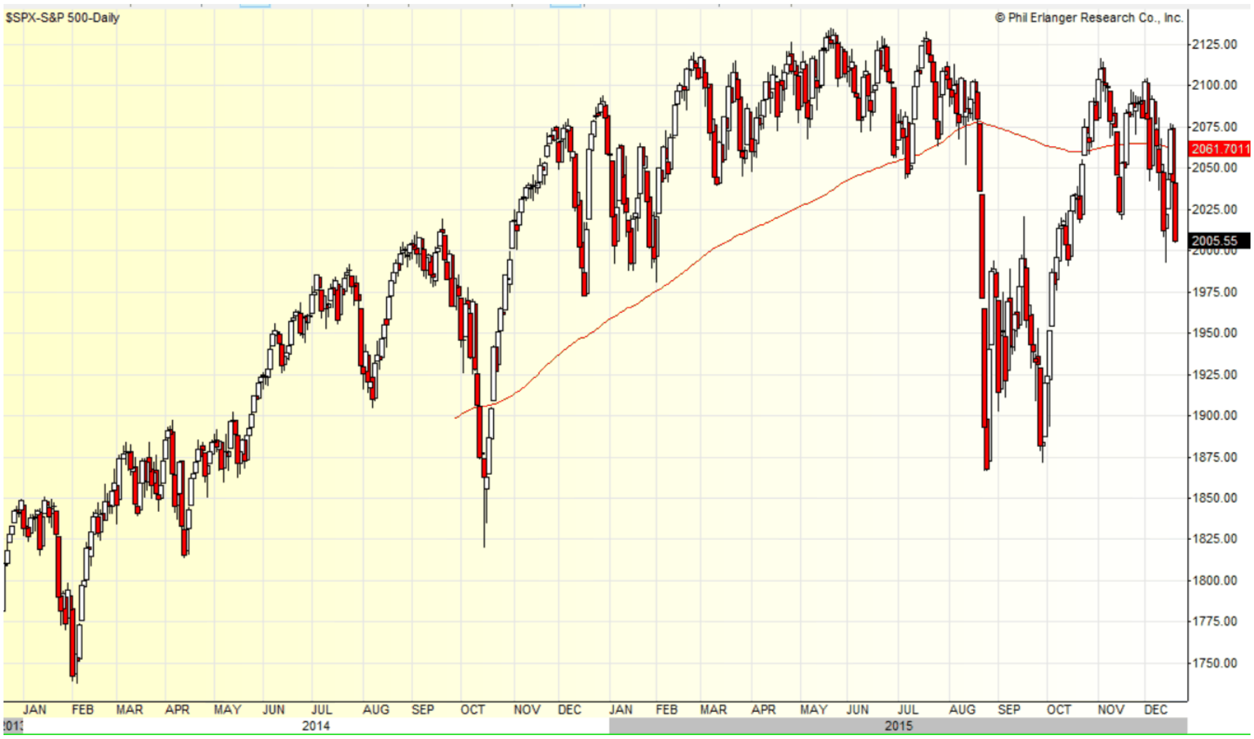
As the S & P was making new highs the first part of the year, the MACD (first pane) was moving lower, a divergence and a red flag.

The market and MACD had a powerful move in October, but the next rallies, the market and MACDs are confirming the downward trend.

200-Day Moving Average (200 DMA)

200 DMA is a long-term indicator as 200 days is long-term. Both technicians and investors that focus on fundamentals both monitor the 200 day moving average.

Below is a chart showing the market with the 200-day moving average:



The red trend line is the 200 DMA.

When prices move below the 200 DMA, many market professionals consider the event a sell signal. The first signal occurred last August. Prices did briefly rally back above the 200 DMA, normal behavior.

Recently, prices did slip back below the 200 DMA. Dropping below the 200 DMA is a red flag.

Also, notice that for much of last year, and the first half of this year the 200 DMA was trending upward, now it has a slight downward bias, another red flag.

Below is a long-term chart for this bull market with a long-term trend line:

Another important sell signal would occur if the long-term trendline (black trendline) is broken. Prices remain above the long-term trendline. This could be interpreted as the bull market that started in 2009 remains intact.

I will keep an eye on the long-term trendline.

Fundamentals

Below is a history of prices, earnings, P/Es, dividends, dividend payout ratios since 2007 for the Dow 30:

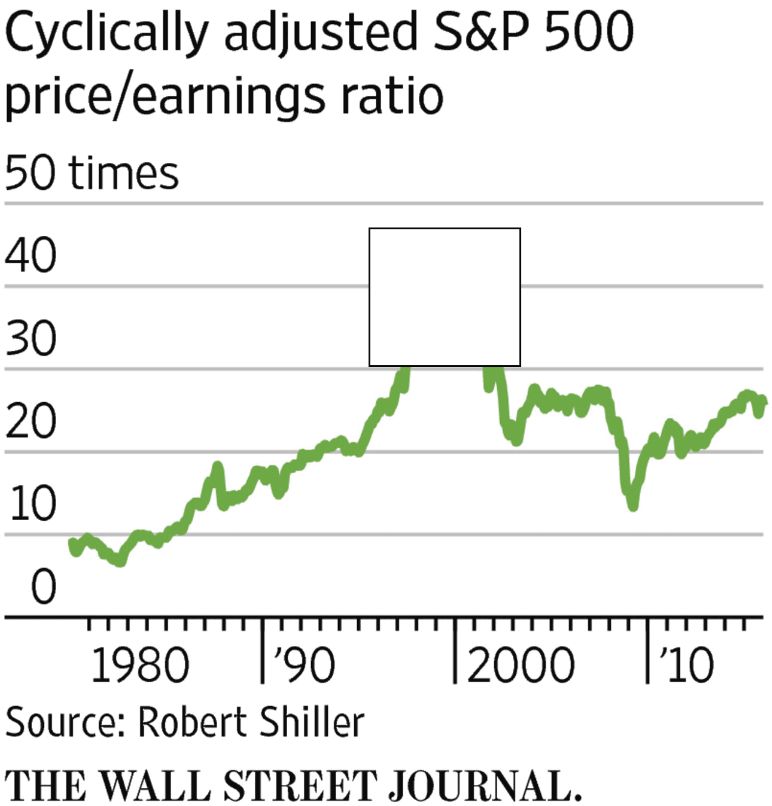
Dow Jones Industrial Average							
	Qtr	Closing	12-Mth	P/E	12-Mth	Div	Payout
Year	Ended	Avg.	Earns	Ratio	Divs	Yields	Ratio
Sep.30	**30-Jun**	17619.51	1040.66	16.9	417.57	2.37	0.4013
	Mar.31	17776.12	1093.78	16.3	400.61	2.25	0.3663
2014	Dec.31	17823.07	1079.08	16.5	388.9	2.18	0.3604
	Sep.30	17042.9	1143.49	14.9	376.85	2.21	0.3296
	30-Jun	16826.6	1309.69	12.8	366.21	2.18	0.2796
	Mar.31	16457.66	1286.32	12.8	365.4	2.22	0.2841
2013	Dec.31	16576.66	1299.71	12.8	360.1	2.17	0.2771
	Sept.30	15129.67	1172.72	12.9	364.39	2.41	0.3107
	28-Jun	14909.6	976.45	15.3	365.59	2.45	0.3744
	Mar.29	14578.54	933.61	15.6	357.86	2.45	0.3833
2012	Dec.31	13104.14	901.18	14.5	r353.97	r2.70	0.3928
	Sept.28	13437.13	885.43	15.2	342.16	2.55	0.3864
	29-Jun	12880.09	903.73	14.3	334.61	2.6	0.3734
	Mar.30	13212.04	903.5	14.6	326.87	2.47	0.3618
2011	Dec.30	12217.56	893.44	13.7	318.37	2.61	0.3563
	Sept.29	10913.38	924.17	11.8	307.89	2.82	0.3332
	29-Jun	12414.34	896.69	13.8	300.06	2.42	0.3346
	Mar.30	12319.73	878.69	14	292.19	2.37	0.3325
2010	Dec.30	11577.51	826.75	14	286.88	2.48	0.347
	Sept.29	10788.05	783.63	13.8	281.73	2.61	0.3595
	29-Jun	9774.02	739.88	13.2	277.16	2.84	0.3746
	Mar.30	10856.63	687.81	15.8	272.78	2.51	0.3966
2009	Dec.30	10428.05	558.83	18.7	277.38	2.66	0.4964
	Sept.29	9712.28	350.97	27.7	286.26	2.95	0.8156
	29-Jun	8447	357.13	23.7	297.63	3.52	0.8334
	Mar.30	7608.92	178.18	42.7	311.78	4.1	1.7498
2008	Dec.31	8776.39	256.55	34.2	316.4	3.61	1.1915
	Sept.30	10850.66	412.72	26.3	325.27	3	r.7881
	30-Jun	11350.01	-115.29	Ni	319.12	2.81	Nil
	Mar.31	12262.9	123.99	98.9	r308.38	2.51	r2.4871
2007	Dec.31	13264.82	199.87	66.4	298.99	2.25	
	Sept.28	13895.63	277.24	50.1	287.57	2.07	
	29-Jun	13408.62	824.65	16.3	280.58	2.09	
	Mar.30	12354.35	644.21	19.2	274.38	2.22	

Markets peak in 2007

Earnings peaked at 824.65 in 2007, the previous economic and market cycle. The Dow 30 peaked at around 13,895 in late 2007.

Also notice in 2007 that P/Es, and payout ratios are higher, and dividends are lower.

Below is a historical look at P/Es:



I took out the P/E trend during the bull market of the 1990s because it was an outlier.

Again, P/Es peaked in 2007, and in 2015 P/Es have gravitated to those levels again from a much lower level. P/Es expanded quite a bit during this bull market.

If the economy and earnings growth slows, P/E ratios will probably contract.

Bear Market 2008, 2009

Earnings bottomed in June 2008, and the Dow 30 bottomed in March 2009 at around 6400.

Notice how high P/Es got during the bear market. P/Es normally are very high during a recession. This phenomenon is known as the *Molodovsky effect.* According to *Security Analysis* (a book that must be mastered by professional and serious investors) the effect is *the tendency of a company suffering temporarily depressed earnings to sell at a high price-earnings ratio.*

Once earnings recover, P/Es go back to normal. PE’s were as low as 13.2 in 2010 and dividends did get close to 4% in March of 2009.

It’s best to start buying when there is visibility for a earnings recovery, and when prices are depressed, P/Es are low, and dividends are higher. We see this in 2009.

At the beginning of a market, economic cycle prices are lower, values and P/Es are lower, and dividends are high. A great time to start investing.

I do have experience buying low. I started the Baby Boomer in May 2008, and was fully invested by the end of 2009. Click here to read about our Baby Boomer portfolio, and our first recommendation on page six. We also started the Gold and Energy Portfolio 2 in November 2008 and were fully invested by 2009. Click here to read about the start of the Gold and Energy 2 portfolio.

Again, it’s important to sell when a bull market is topping to raise cash, save your portfolio from significant losses, and to take advantage of the many bargains that occur toward the end of a bear market, and the beginning of the birth phase of the next bull market.

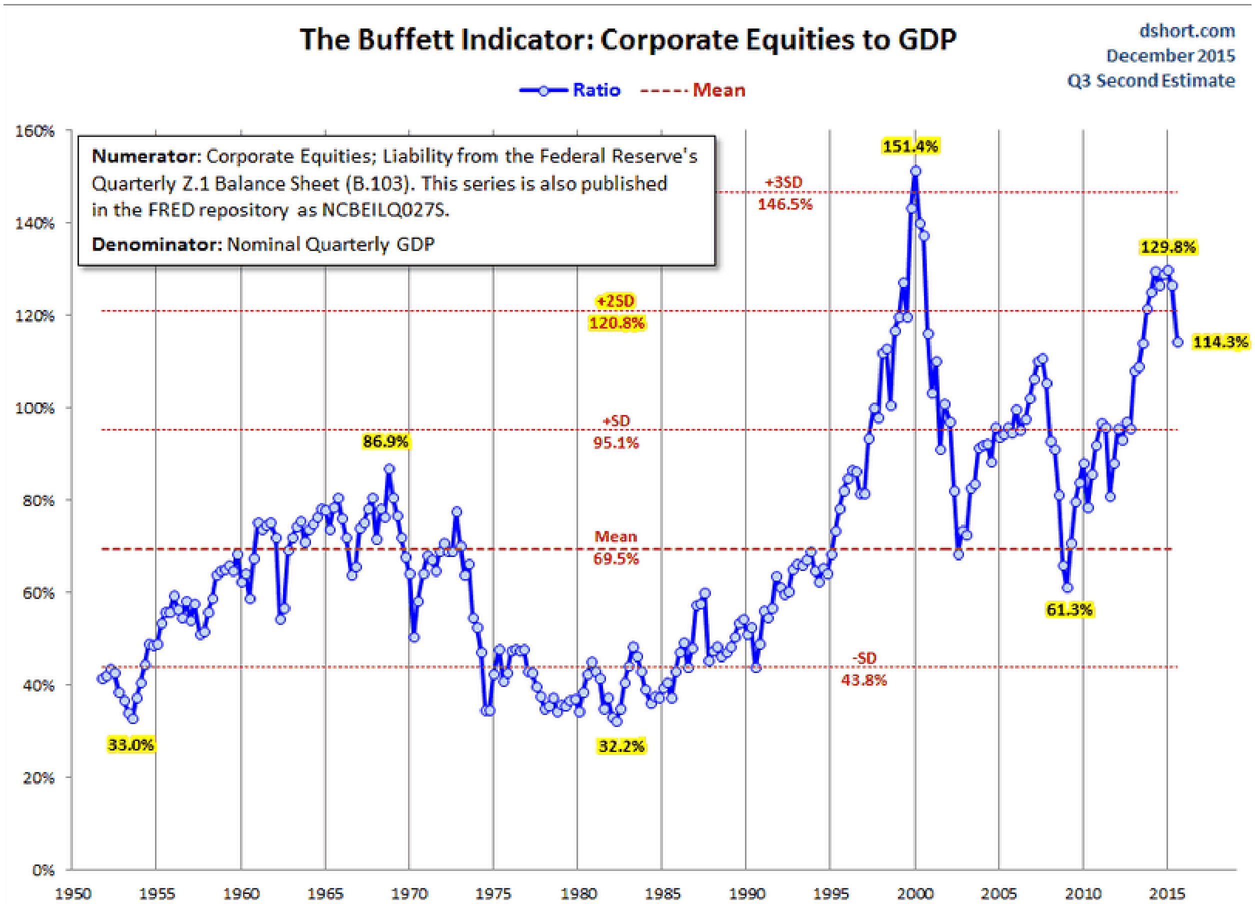
2015

So far in this bull market, prices got as high as 18,300 earlier this year. This bull market started from a low of about 6400 in 2009, about a 185% increase to its high.

Earnings have gone from losses in 2008, to a peak of about 1308 last year. Earnings have declined this year due to the energy sector and a strong dollar. Earnings are expected to be higher in 2016. Earnings could give the markets some lift next year.

Prices, P/Es and dividend payout ratios are much higher now, and dividends are lower.

There are other metrics that are showing the markets are overvalued:



As the chart above shows, the market capitalization to GDP averages about 70%. Currently it's about 114%, another metric that shows the market is overvalued.

It's time to be more cautious, and to start raising cash. In other words, sell high, so we can buy low.

Next week I will look at the economy and external events that are also raising red flags.