August Market Outlook

I've been recommending that investors need to be cautious for the following reasons:

- Stocks and markets are overvalued; I will write about the many metrics that evince overvaluation. Stocks, companies can go from overvalued to even more overvalued, but eventually they will go lower to fair valuation and even to undervalued, and this means steep losses.

It is better to invest in undervalued companies that can move higher to fair valuation, and if you're lucky to overvaluation. And yes, companies can go from undervaluation to even lower valuation, but if there is a catalysts, values can move to fair value.

- There is little revenue and earnings growth to match the overvaluation of companies. Again, I will write more about this later this month.

- The global economy is slowing and is impacting U.S. capital spending, revenue and earnings growth.

- Geopolitical concerns: refugee crisis in Europe, Brexit, violence and uncertainty in the Middle East and North Africa.

- The Fed may raise interest rates because of stronger than expected job creation, and finally we are seeing wage gains.

- The elections are making some investors nervous. Normally after an election, the greater the economic policy changes, the more adjustment will be needed for the economy and the markets.

I have been asked several times, what is an investor to do during this time of overvaluation and rising risks. What do I do with the cash I've raised?

What normally happens toward the end of the cycle is the companies that led on the way up, lead on the way down. Let's look at the last cycle.

Let's review the above chart:

- In the last cycle it was housing and the financials that led on the way up, and then led on the way down. The chart above shows home builder PHM, (Pulte Homes ticker stock symbol) peaked around mid-2005, and then entered into a bear market

- The S & P (gold trendline) did not peak until more than one year later, around Oct. 2007.

- Basing periods, (moving sideways after a bear market) last normally about seven months, so if investors want to make money they will have to start trading the basing phase of the cycle. The basing period for PHM lasted about five years when it finally broke out of its basing pattern.

  Investors could have traded the basing period of the S & P, its duration was much shorter than PHM.

There is risks to this strategy as the economy is in poor condition, and sometimes a bottom is not found until later during the basing phase. For PHM, the bottom was not found until 2011. The S & P bottom was found in March of 2009.

Again the strategy during this phase of the market is to start trading the basing phase of the market.

The main economic theme of the 2000s, and the companies that led the bull market were the commodity stocks that benefited from China's economic boom. The Chinese economic boom started to slow down, and many commodity companies, stocks entered bear markets, especially energy stocks (there were other reasons for the bear market for energy stocks).

Below is an example of an ETF that is commodity related and has gone through the panic phase, and is now in the basing phase:

Source: www.erlangerchartroom.com

The chart is of the energy ETF, symbol XLE. Let's review the chart:

- As mentioned above, prices have gone from the panic/decline phase, and is now in the basing phase. This is the normal progression of these two phases.
- Prices have fallen from around $100 to the current price of about $67, bear market territory.
- Prices are now basing, moving sideways after a major fall. The average basing period normally lasts at least 7 months. Investors have time to trade and start doing their due diligence for new cheaper investments for the next bull market.
- Prices have been basing for about one year, and have established a trading range.
- Support is around $65 (approximate buy point), and resistance (approximate sell price) is around $70. This happens about once a month for a trade of about a 7% return. Since April, you could have made this trade about three times.

> Valuations are normally much better at these lower levels, many of these energy stocks have assets that are selling at bargain prices. Also, the dividend yield for the XLE is around 2.80%.

An investor could also sell a put at around $60 on a pull back, and collect a premium. The stock would probably not be assigned, so you would keep the premium. If you would like an explanation of this strategy, send me an email. It’s a nice way to collect extra income on your investment capital.

As mentioned above, this is a risky trade as the low is around $50. It’s not unusual for prices during the basing phase to test or even make a new low. If you did buy at $65, you should be okay because normally after the basing phase we go into the growth phase, and two to three years out, prices are usually much higher. Under the right conditions, the XLE could move back to over $100 in the next economic and market cycle.

It’s not safe to buy and hold until the economy enters a recession, and there is visibility of an economic and earnings recovery. Once this occurs, more stocks and industries will have entered into bear markets and basing periods. Investors with cash will have many more opportunities to invest in undervalued, oversold stocks.

Summary

Below is a chart of the current market cycle were in:

Investors should not be buying or even trading at the market top because of valuations and the downside risk is much more than the upside potential.

When prices enter the basing phase, and have entered into a bear market, investors can start trading the basing pattern, sideways movement.

Once we have visibility of an economic and earnings recovery, investors can start to buy and hold for the next bull market.

During the basing and bear market period, there are many bargains for investors that have raised cash.

IF YOU ARE A RESIDENT OF CALIFORNIA, AND YOU WOULD LIKE HELP WITH YOUR PORTFOLIO, INCLUDING A SECOND OPINION REGARDING YOUR HOLDINGS, CONTACT DAN HASSEY AT dhassey@digeorgia.com.

Dan Hassey's passion for investing began over 30 years ago while pursuing his MBA at UCLA. Dan has worked for prominent investment firms including Merrill Lynch, Paine Webber, Fidelity Investments, and Charles Schwab. Click here to learn more about Dan Hassey's academic and investment background from his LinkedIn page.