February Market Outlook

In this month's outlook I analyze:

- The bullish and bearish case for the markets
- Valuations and targets for the markets
- Technical/Price analysis potential trading ranges

Bull Market Case

- There is plenty of stimulus ($1.5 trillion tax cuts and $300 billion budget deal over two years) that should keep the economy growing.
- Earnings will be strong in 2018. See valuation section.
- The dollar is falling helping U.S. products and services be more price competitive in foreign markets. The lower dollar will also create currency profit conversions for U.S. companies that have foreign sales.
- Tax cuts and repatriation of foreign profits could lead to higher dividends, buybacks and increased mergers and acquisitions.
- Currently there is synchronous global growth
- Investors and business people remain positive regarding this pro-business President and his administration
- Stocks have gone from overvalued to close to fairly valued due to the current market correction
- The acceleration in the correction was more about speculation with VIX derivatives, and not bad earnings or the economy. Investors understand it was a market event not economic, so investors are buying again.
- The current correction has probably found a bottom. On the financial news cable channels, professionals are asked is the bull market over? Most bull markets have a topping formation that lasts at least six months. This correction may be the beginning of the topping formation, but it's too early to tell.

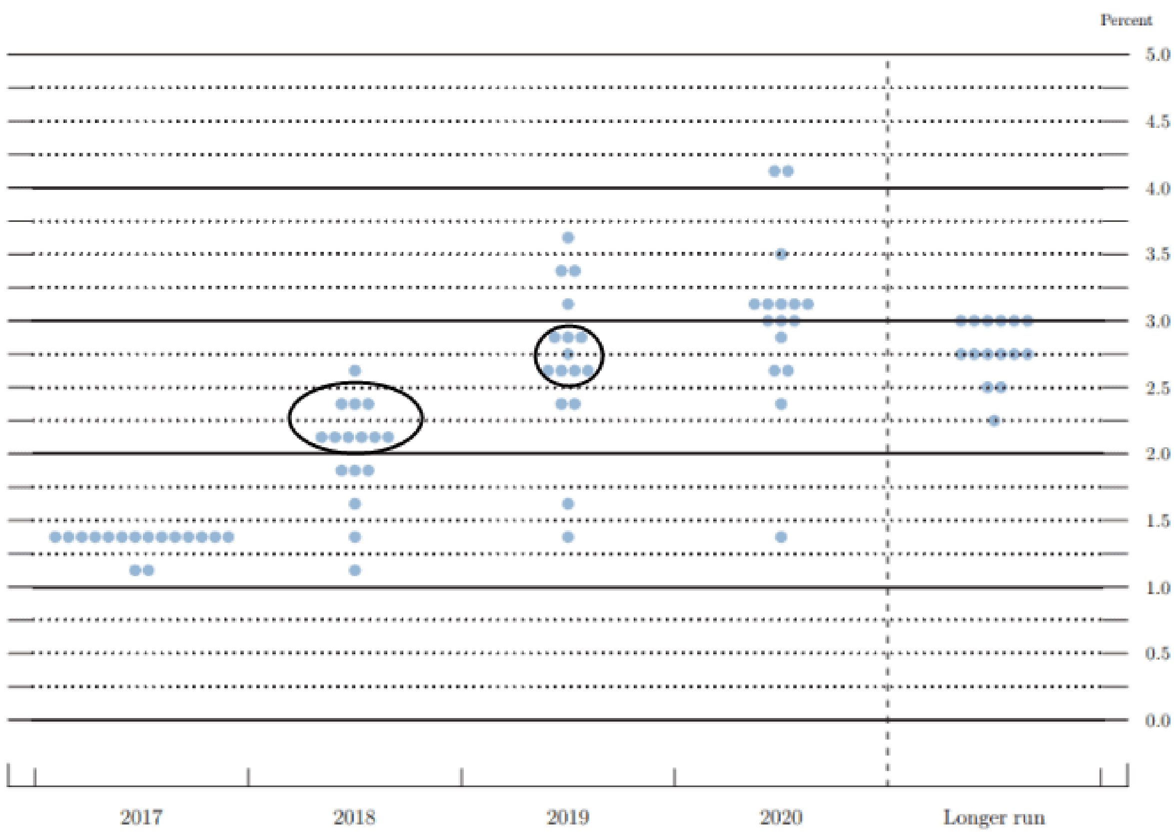
Bearish Case

- Economic policy is shifting from mostly monetary policy (low interest rates and quantitative easing and now to raising rates) to stimulative fiscal policies (tax cuts, deregulation and government spending). The transition is causing market disruptions.

- Most economists, analysts understand that the tax cuts and increased spending authorized by the new budget is stimulative in the short run, but will cause larger deficits and a larger national debt long-term. The larger deficits and debt will have to be financed and this will cause interest rates to move higher. Rates will have to rise to attract investors to finance our deficits. Rising rates will also raise the cost of financing our deficits.

- The Fed has raised rates five times since 2016, and they're expected to raise rates two to four times in 2018, and the increases will probably continue in 2019. Below is the "dot plot" from the Federal Reserve; the plot displays the different Fed Fund rates from Federal Open Market Committee members:

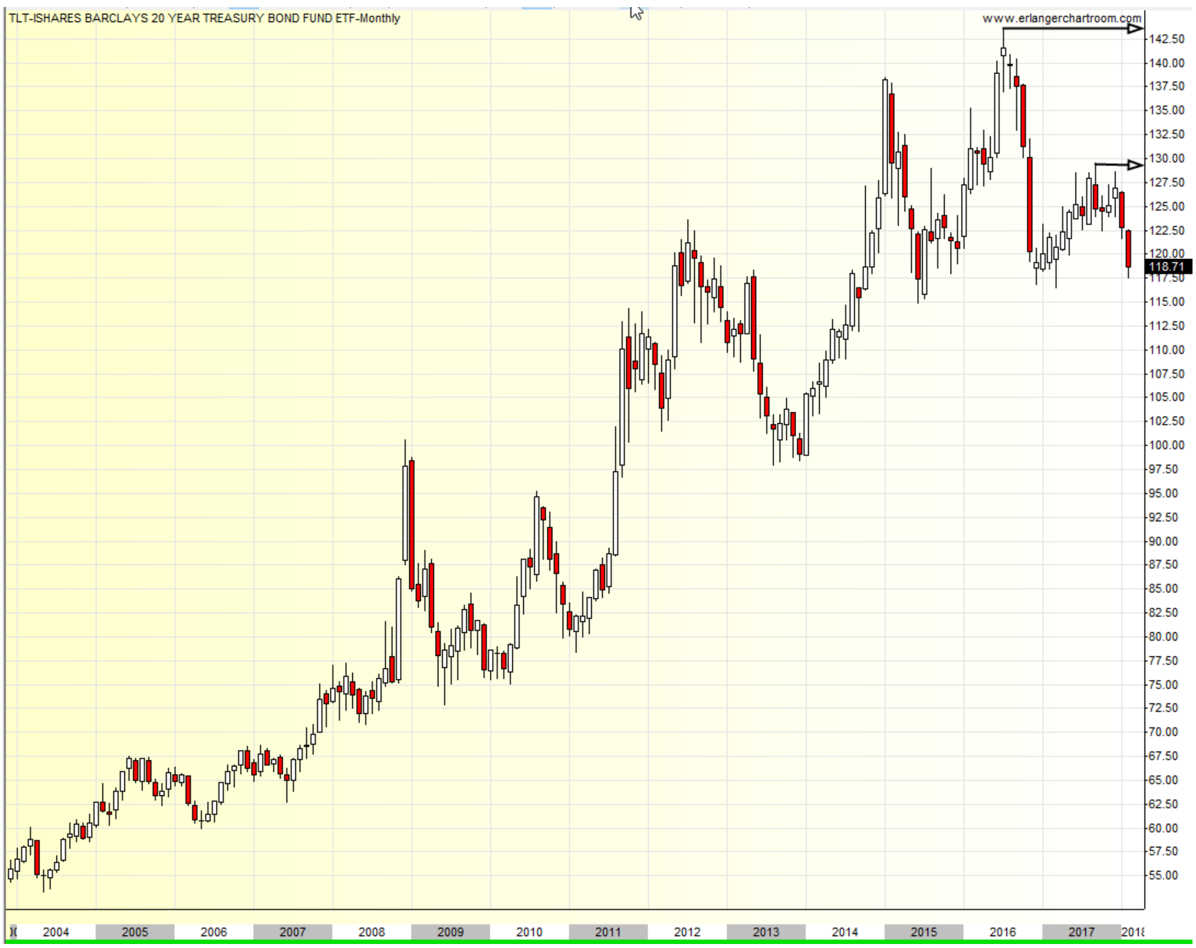
Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Source: Federal Reserve.gov

- Currently, the Fed Funds rate is 1.25% to 1.50%. This year the Fed is expected to raise the rate to about 2%, and close to 3% in 2019. The Fed is not done raising rates, as it needs to normalize rates (reflecting inflation) and also in case we go into recession the Fed could lower rates to stimulate the economy. Currently rates are too low.

- The fiscal stimulus, rising wages, and higher oil prices, the lower dollar (the lower dollar causes imports to cost more) are causing some inflation, and this is causing bond market yields to move higher. Higher rates are causing losses in the bond markets. Below is a chart of the 20-year Treasury bond ETF (symbol TLT):



Source: www.erlangerchartroom.com

Bond prices and interest rates move in opposite direction. As rates start to rise, the TLT price has dropped about 18% from its high in 2016 and down about 8% from last year's high. As interest rates continue to rise, bond prices will continue to fall.

How much will bond interest rise to. Let's take the 10-year Treasury. Historically, the 10-year normally reflects inflation plus a premium of about 2% to 4%. This means the 10-year should be about 5% (2% inflation plus 3% premium). Investors must realize that as the Fed tries to normalize rates, the 10-year could climb from the current 2.9% to about 5%. Investors should realize there is more upside for rates and potentially more disruption to the markets.

Again, investors should be concerned that the Fed is not done raising rates, and bond market interest rates will probably continue to rise (and bond prices will probably continue to fall). Rising rates and falling bond prices will probably cause volatility in the equity markets.

- Most equity valuations are based on interest rates. When interest rates and inflation are low, future streams of cash flow are worth more, and thus companies are worth more. When inflation and interest rates are rising, cash flows in the future are worth less, and thus companies are worth less.

- Higher rates will provide alternatives for investors and competition to equities.

- Although the markets are close to fair valuation if they move higher, the markets will become overvalued again.

- There are many signs that we are in the late stages of this economic and market cycle: full employment; rising oil prices, inflation and interest rates; length of this cycle (this market and economic cycle may be one of the longest in our economic history); high valuations; markets are up about 300% from the market bottom in 2009, most of the market gains of this market cycle have probably been made; consumers are saving less and using their credit cards to keep up spending; quarterly earnings and economic indicator comparisons will get harder to beat after over eight years of recovery; continual rotation in the markets and a lack of consistent leadership.
- The market and investors are transitioning to a new era where decision making becomes more automated (hedge funds, financial planners, 401K investors) and sectors and investment themes become crowded.

- Technicals, damage has been done during the correction. See Technial/Price Analysis section below.
- Most analysts see the economy and earnings slowing in 2019 and beyond. What will happen to P/Es when growth slows later this year and into 2019? What happens when we have a recession?
- Geopolitical threats including: North Korea, Iran, Syria, Venezuela, Russia, Islamists extremists groups (ISIS, Al Qaeda, Taliban, Boko Haram…). Also, Brexit is not going well and could cause dislocations in Europe and the rest of the global economy.
- Even though we have synchronous growth, most economists see slower growth for 2019. China's economy is a major concern including: slower growth, too much debt, lack of transparency.
- The economy has never had this much fiscal stimulus this late in the cycle, especially tax cuts. If we fall into a recession, it will probably happen sooner than later, deficits could explode (less tax revenue due to tax cuts and a huge increase in unemployment insurance payouts) and this will make the national debt much larger.

- The Trump administration is under criminal investigation. There have already been a few convictions and indictments. There will probably be more. As the indictments grow closer to the President and his Presidential campaign, the investigation will continue to disrupt and sidetrack the President and his administration.
- Most political experts believe the mid-term elections will lead to the Democrats taking over the house. This will make President Trump's last two years more difficult, especially getting anything done regarding much needed infrastructure projects.

- Black and grey swan events (events that have a small probability of happening, but would have a significant impact on the economy and markets). This correction was partly caused by VIX derivatives, a grey swan events. Derivatives have caused disruptions in the market in the past, currently it's VIX derivatives.
- Investors seem to be ignoring the many risks investors face. The recent correction should be a wakeup call.

Targets for the Markets

Consensus earnings estimates have jumped since tax cuts were passed:

	2017 ERNG 4CST	2018 ERNG 4CST	GRWTH
12/18/17	1234.01	1360.84	10.28%
12/25/17	1235.00	1365.74	10.59%
1/1/18	1235.10	1368.37	10.79%
1/22/18	1238.89	1420.66	14.67%
1/29/18	1249.48	1437.99	15.09%
2/5/18	1253.98	1469.31	17.17%
2/12/18	1251.89	1480.62	18.27%
2/19/18	**1252.20**	**1484.00**	**18.51%**

Source: Barron's Thomson Reuters, Dan Hassey database

Every week Barron's posts weekly consensus forecasts for the Dow 30. I keep track of them as estimates of earnings forecasts normally lead the markets. As the table above shows, since the tax cuts were passed the 2018 earnings consensus growth has increased from about 10% to about 18.50%. Similar estimates have been made for the S&P. Normally, the markets will match the growth in earnings, and this means the markets should be up about 18% in 2018.

Performance for the markets have been pulled forward. There are probably a few reasons (some of the reasons are listed in this bear case) why the markets won't be up 18% this year:

Performance has been pulled from prior years:

The Dow 30 was up about 14% in 2016, even though earnings were up about 4%. Most of the gains were due to a pro-business President being elected, and P/E multiple expansion.

The Dow 30 earnings growth in 2017 was about 12%, but the Dow was up about 25%. Most of the earnings growth was from energy. If we take out energy industry growth (energy stocks were one of the worst performers), then the earnings growth is closer to 9%. Also, P/E multiples in 2017 stayed high.

This means the markets were overvalued by about 25% (10% 2016 overvaluation plus 15% overvaluation 2017) coming into 2018 because of the markets overshot their growth rates in 2016 and 2017. The market needs to digest market gains of the previous years.

P/E multiples for the markets and stocks probably won’t go higher, and may come down. The historical P/E is about 16 about where we are now.

As the market ages, earnings comparisons going forward will become more difficult. Rising inflation and interest rates will be a headwind for the economy.

Below are my current market forecasts for 2018:

2018 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1484	16	**23,744.00**	25,219.00	-6.21%
SPX	151	17	**2,567.00**	2,732.00	-6.43%

Using average historical P/Es and if earnings meet current earnings estimates, the markets are overvalued by about 6%.

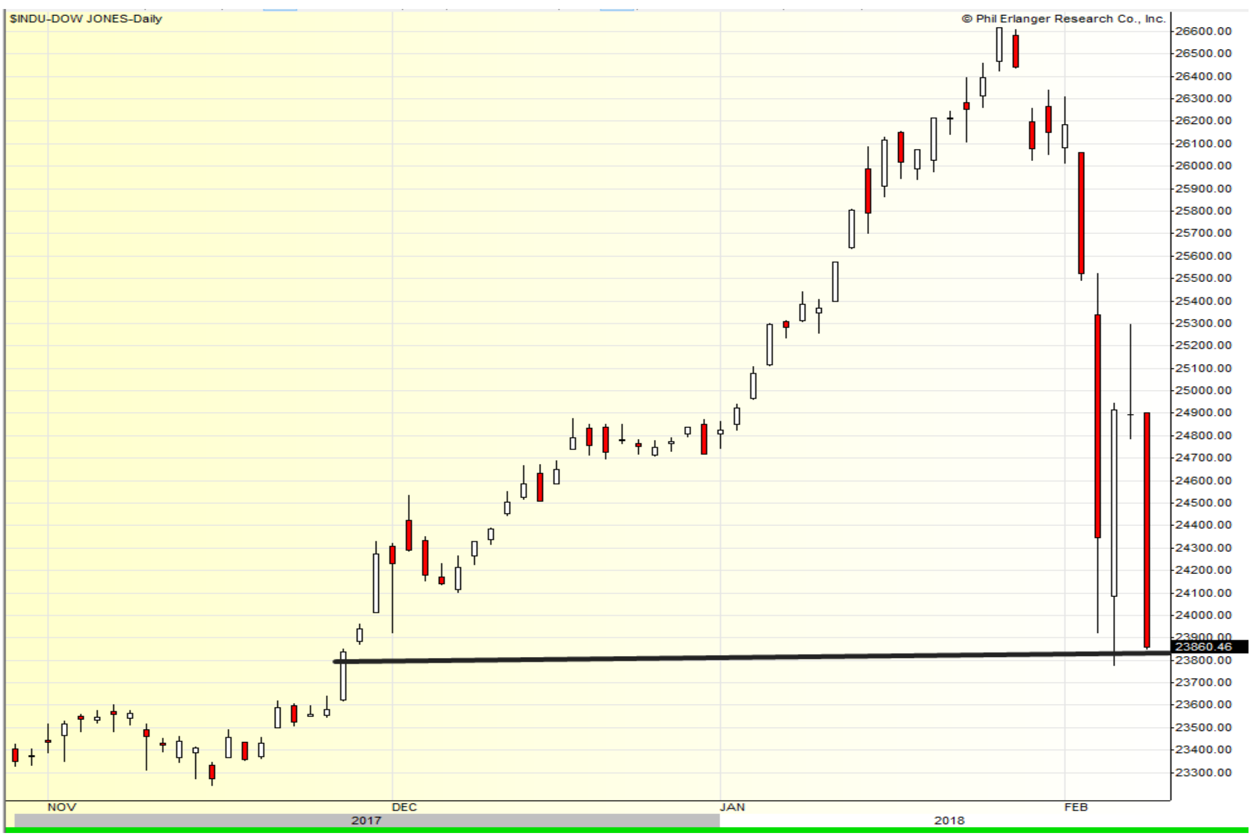
Technical/Price Analysis

Below is a chart for the current market:

Source: www.erlangerchartroom.com

There is a lot going on with this chart, let's review:

- The current move in the market started the day after President Trump was elected, November 9, 2016.
- The black trendline is the long-term trend line. Prices accelerated from the trendlines. There were 3 different accelerations as identified by the dotted trendlines, also known as fanning. Each fan that accelerated made it easier for the trendline to be broken.
- The second fan trendline and 50-day moving average were broken about the same time. The breach of the 50-day moving average is a sell signal for many traders and some investors (investors tend to pay attention to the 200-day moving average, considered a long-term trend, and it was not breached).
- Traditional economic classes teach us that participants in the economy make "rational" decisions. There is a new discipline, behavioral finance (BH) that provides another explanation for economic and investment activity and decision making. BH combines biology, economics and investing. Below is a chart of the market correction, and below the chart is the BH analysis.



Source: www.erlangerchartroom.com

- Notice that the market was about 24,000 in late November, early December, and the market peaked around late January at about 26,600. It took about 2 months to make the climb. What the market made in 2 months' time is lost in about one week. BH teaches that when prices are rising, dopamine (also known as a gambler's high) is released into the brain. When participants lose money, cortisol (a flight or fight hormone) is released. Participants flee, sell irrationally. People losing money and cortisol are more powerful than making money and dopamine.

- It would be normal for prices to fall to the long-term trendline, about the 23,700 area. Prices did pullback to the long-term trendline. Prices pulled back to the 200-day moving average for the S & P and quickly recovered. A sustained breach below the 200-day moving average would have been a major sell signal.

- One of the best tools traders have is retracements (aka Fibonacci percentage retracements) the first retracement percentage, 38.2%, was about 23,300. Prices did pullback to this area.

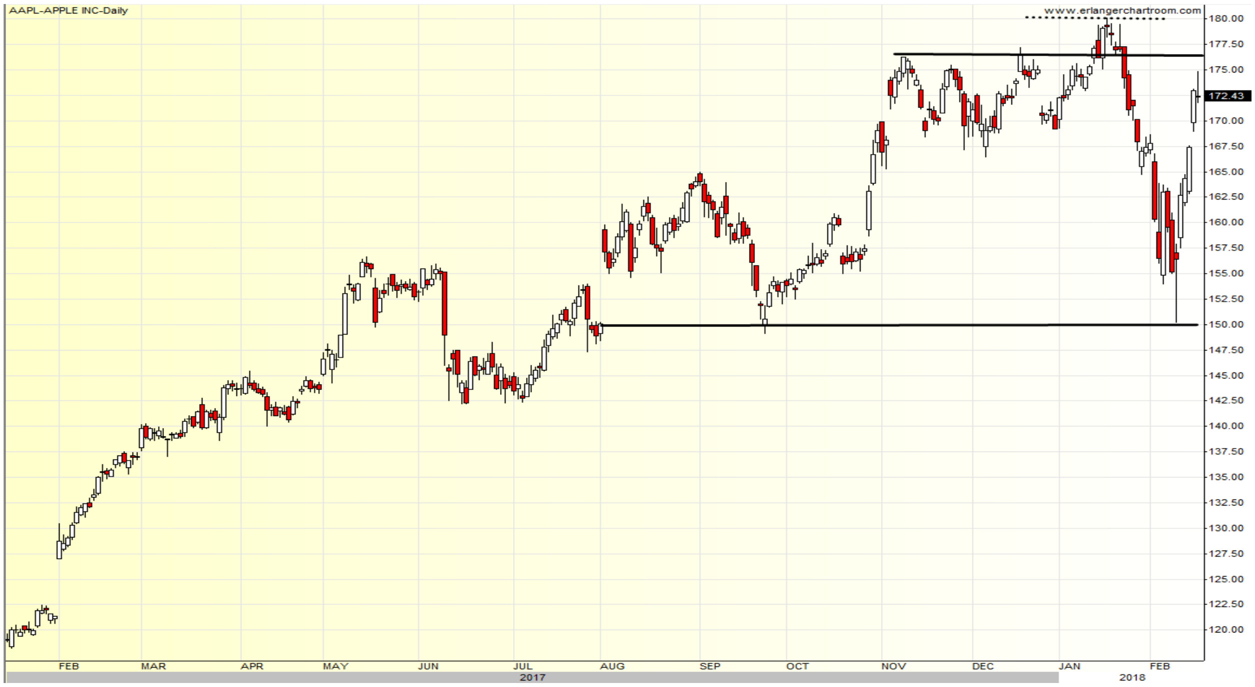
- Another useful technical tool is the Choppiness Indicator. The indicator lets us know when a trend (up or down) has been exhausted. When the indicator falls below 30, the current trend is close to running its course. The trend starts when the indicator starts falling below about 60. The indicator did reach the 25 level indicating the current downward trend has probably run its course.

- A lot of damage has been done. There is supply, sellers who bought at 25,000, 25,500, 26,000, 26,500, and also those that have profits will probably sell at higher levels. It will take time and lots of money for prices to reach the old high, or to make new highs.

So what will probably happen to the markets going forward?

We have probably found a short to medium-term bottom. It's earnings season, and earnings are strong, so it's possible that prices could test the old high and maybe even make new highs.

If prices don't recover to its old highs, prices will probably trade between the high of about 26,500 to support 23,700, making a topping formation, the last stages of a market cycle. We see this with popular stocks like Apple.



Source: www.erlangerchartroom.com

Apple has essentially been going sideways since last July with support at around $150 and resistance around $177.

Conclusion

- We have probably found a bottom for the recent correction.

- The markets more probably be more volatile because of cross currents of: good earnings, economic growth versus lower growth next year, rising rates and inflation, the Fed will continue to raise rates, a shift from monetary to fiscal policies.

- At the market bottom, valuations became fairly valued. The markets are rebounding, so valuations are getting overvalued again.

- There are many signs that we are in the late stages of this economic cycle.

- There was damage to the markets during the correction so markets may trade in a range. There is a chance in the next earnings season that markets may make new highs. Stocks like Apple have stopped making new highs and have been moving sideways in trading ranges. The markets may follow Apple's trend.

- There are bargains in oversold, undervalued areas in energy, some REITs, some business development companies, utilities and telecommunications. Most of these pay attractive dividends.

Investors need to stay disciplined, cautious and patient.