2018 June Market Outlook

I give the bullish and bearish case for the markets below. I also provide the technicals and price targets for the markets.

Bullish Case

- The employment numbers, especially the unemployment rate (below 4%) means the economy continues to create jobs at a good pace.

- Even though first quarter was less than expected, 2.3%, 2nd quarter growth is expected to be above 3%.

- Earnings growth for the 1st quarter 2018 beat expectations and were over 20%.

- Valuations have gone from overvalued to fairly valued.

- At the beginning of the year, investors were deploying investment capital overseas because of lower valuations. The global economy is slowing, the U.S. dollar and interest rates are rising causing investment dollars to flow back to U.S. markets.

- Business confidence remains high, it has come down a bit due to concerns about trade tensions between U.S. trading partners and U.S. businesses. Capital spending is above average for this cycle, but it has stalled due to trade tensions.

- Consumer confidence remains strong

- We are seeing more stock buyback programs, mergers and acquisitions and some dividend increases thanks to the tax cuts.

- Some investors and traders remain bullish

- The President has gotten Mexico, Canada, China and North Korea to the negotiating table. If there are positive outcomes, this could lead to higher consumer and business confidence. The higher confidence could lift the markets higher.

Bearish Case

- There are many signs that we are in the late phase of this market and economic cycle

  - The Federal Reserve is reversing its stimulus by raising rates and reducing its balance sheet. This will raise the cost of capital, and lending will probably tighten and reduce potential growth.

  - We are at full employment, a sign we are in the late stages of this economic cycle.

  - Inflation is rising

- The dollar is rising. This could slow our exports and cause foreign sales losses when foreign currencies are converted to dollars.

- Oil prices are rising, potentially raising inflation and taking money out of the pockets of consumers.

- Most economic cycles last from four to six years. This economic and market cycle started in 2009, one of the longest in our economic history

- The market is establishing a topping pattern that is in its 7^{th} month. See technicals below.

- Market strength is concentrated in technology. Many of the sectors in the market are down or flat. See technical section. There is also rotations in the markets (risk on/risk off, energy, financials, and consumer durables) that represents a lack of leadership in the markets.

- Risk reward relationship for markets is not favorable. Upside is maybe 10%, downside is 30% (average bear market). See Fundamental & Technical sections.

- Economic and earnings comparisons get more difficult late in a cycle.

- Even though the economy and earnings look good in 2018 investors, businesses and consumers will have to adjust to higher inflation, interest rates, slower earnings growth, and a slower growing global economy in 2019 and beyond.

- Investors are concerned about trade wars, especially with China.

- Whenever a party controls both houses and the presidency voters tend to vote in the party out of power to provide a check on the party in control. This will probably happen in the upcoming mid-term elections. This will make it more difficult for the President to pursue his economic agenda.

- When we go into a recession (when not if) a recovery could be difficult and could take some time. The Fed won’t be able to lower interest rates to stimulate the economy as they have in past recessions. Lawmakers have responsibility for fiscal policy (taxes and spending) but taxes have already been lowered without lowering spending, so spending will be difficult to increase because of growing deficits and debts.

- Headlines that include potential trade wars, scandals, criminal investigations into the President’s campaign, and geopolitical concerns including North Korea and Iran is causing volatility in the markets.

- Analysts and economists have a lousy track record of identifying inflection points in the economy and markets. Sometimes the technicals of the market are more helpful as the market is a good leading economic indicator. See technical analysis section below.

- There are always black and grey swans that can torpedo the global economy and markets. Lately there was a scare that looked like Italy may leave the Eurozone.

Valuations

One of the questions that many investors have is, why doesn't the market reflect its great earnings growth?

Part of the answer is, the markets got ahead of themselves in 2016 and 2017 and the market is digesting the market gains of 2016, 2017.

Dow Jones Industrial Average					
Year	Closing Avg.	12-Mth Earns	P/E Ratio	ERN GROWTH	DJIA %
2017	24719.22	1107.89	26.2	10.85%	25.08%
2016	19762.6	999.44	19.8	2.35%	13.42%
2015	17425.03	976.52	17.8	-9.50%	-2.23%
2014	17823.07	1079.08	16.5	-2.03%	7.52%

Source: Barron's, Dan Hassey database

Let's review this important table:

- Earnings growth (ERN GROWTH, 5th column) was weak from 2014 to 2016, but the P/E expanded from 16.50 to 26.20 (P/E RATIO, 4th column).

- In 2016, earnings growth was only about 2.35%, but the market was up about 13%.

- In 2017, earnings growth was about.11% (earnings growth was mostly among energy companies and their stock prices barely moved) , but the market was up about 25%.

- The market moved about 38%, but earnings growth was only about 14%, and the P/E multiple expanded. Market gains overshot earnings growth by about 24%. The market now is digesting these gains and the multiple is contracting to the historical norm, about 16.50.

Below are my market price targets:

	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1533.55	16	**24,536.80**	25,372.69	-3.41%
SPX	153	17	**2,601.00**	2,789.00	-7.23%
2019 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1663.29	16	**26,612.64**	25,372.69	4.66%
SPX	162	17	**2,754.00**	2,789.00	-1.27%

Source: Barron's, Thomson Reuters, Dan Hassey database

The markets are overvalued this year based on a moderate P/E and analysts' consensus earnings estimates for 2018.

The Dow has some upside for 2019, the S & P is fairly valued if earnings forecasts are met and are based on a reasonable P/E.

Technicals

Below is a chart of the S & P 500:

Source: www.erlangerchartroom.com

The market is still bullish, but a topping pattern (a bearish pattern where prices go sideways late in a market cycle) is a red flag. The support of this pattern, about 2575, started in November, about seven months ago.

I thought that during the 1st quarter earnings reporting season, that the market had a chance to test the highs made in January because of 20% plus earnings growth. The rally during earnings season was disappointing. The market has rallied recently due to investment dollars coming back from overseas and good news regarding Apple (more about this below in the QQQ analysis).

Prices could still test the highs made in January during 2nd quarter earnings' season or around November where the market tends to focus on the prospects for the next year.

It's likely that prices will remain in its trading range as the markets are fairly valued at support, and the market becomes overvalued at resistance. This will be probably be true until November.

Most topping patterns last about 14 months, but the shortest period was 5.5 months and the longest was 30 months, see table below last column MONTHS (APPROX).

	DOW 30 BEAR MARKET LOSSES TA				
YEAR	HIGH	LOW	LOSS	TOP	MONTHS (APPROX)
2000	11,908.23	7288.27	38.80%	Rounding	30
1998	9,337.97	7539.07	19.26%	Rounding	5.5
1994	3,945.43	3520.8	10.76%	NO	
1990	2,999.75	2365.1	21.20%	NO	
1987	2,722.42	1738.74	36.10%	NO	
1984	1,287.20	1086.57	15.59%	Rounding	10
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 To	12
1919 TO 1	119.62	63.9	47.60%	Rounding	6
1917	110.15	65.95	40.10%	H & S	18
AVG. TOPPING PHASE LENGTH					13.821429

Source: Dan Hassey database

My research covers every bear market and major corrections going back to 1917. Yellow shaded years are down/bear markets, but no recession. The TOP, 5th column lists the type of topping pattern that developed. Most tops are rounding tops, also called umbrellas. The 2018 market top may be a rounding top. Again, the average market top lasts 13.82 months, so if we are half way through this topping phase, the topping phase may run its course by January 2019.

The peak was made in January, about 5 months ago. The average time it takes to go from peak to trough is about 12 months. Below is a table that shows my research. If we use the average, the trough could be make about January 2019.

DOW 30 BEAR MARKET LOSSES POST WWII					DOW 30 BEAR MARKET TIMING POST WWII					
YEAR	HIGH	LOW	LOSS		`	TROUGH	MONTHS FROM PEAK TO TROUGH		YEARS TO RETURN LAST PEAK	POST WAR
2008	14,279.96	6,440.08	54.90%		10/11/2007	3/9/2009	17.16667			
2000	11,908.23	7288.27	38.80%		1/14/2000	10/9/2002	33.3	10/12/2007	7.86	6.841667
1998	9,337.97	7539.07	19.26%		7/17/1998	8/31/1998	1.5	1/4/1999	0.48	0.475
1994	3,945.43	3520.8	10.76%		1/31/1994	4/4/1994	2.1	2/16/1995	1.06	1.058333
1990	2,999.75	2365.1	21.20%		7/16/1990	10/11/1990	3	4/17/1991	0.76	0.763889
1987	2,722.42	1738.74	36.10%		8/25/1987	10/19/1987	2	12/4/1990	3.33	3.325
1984	1,287.20	1086.57	15.59%		10/10/1983	7/24/1984	9.6	1/18/1985	1.29	1.294444
1981	1,024.05	776.92	24.10%		4/27/1981	8/21/1982	16	10/4/1982	1.50	1.5
1976	1,014.79	74.12	26.90%		9/21/1976	2/28/1978	17.5	2/13/1981	4.40	4.4
1973	1,051.70	577.8	45.10%		1/11/1973	12/6/1974	23	10/26/1982	9.80	9.8
1968	995.21	631.16	35.90%		12/3/1968	5/28/1970	18	8/14/1980	3.90	3.9
1966	995.15	744.32	25.20%		2/9/1966	10/7/1966	8	12/10/1972	6.80	6.8
1961	734.91	535.76	27.10%		12/13/1961	6/26/1962	6	9/15/1962	1.75	1.75
1946 - 49	212.50	163.21	23.20%		5/29/1946	5/17/1947	12	1/15/1951	3.90	3.9
AVERAGE			**28.87%**		**AVG.**		11.69231		_	**3.523718**

Source: Dan Hassey database

My research here goes back to 1946. The shortest time from peak to trough was 1998. It wasn't quite a bear market, but the market decline was caused by the Thai Baht and Russian debt default crisis. The longest was in 2000, about 33 months. The 2000 recession dealt with 911, Iraq War II, and the loss of confidence by investors due to corporate scandals like WorldCom, Enron, and insider trading.

Because we are near the end of an economic and market cycle, investors should consider selling/hedging on rallies as prices near resistance.

Investors are focused on growth, as most investors should to make sure the purchasing power of their investment dollar is staying ahead of inflation. The best growth in our country in in technology and the QQQ ETF (NASDAQ 100) includes many of the top growing technology companies in the U.S.

Below is a chart of the QQQ:

Source: www.erlangerchartroom.com

We can compare the S & P chart on page 4 with the QQQ chart above. The QQQs have a stronger trend and prices have broken out to new highs, barely. As we learned last year, it's normal for prices to continue to make new highs because supply, resistance has been taken out.

The stronger performance is partly due to the re-established leadership of Apple. Warren Buffett has been buying significant shares of Apple, and Apple announced a $100 billion dollar buyback plan. This has helped Apple make new highs leading the way for other technology companies.

If we take a closer look we can see that some of the technicals aren't that strong:

- Volume, 1st pane, is stronger on selling versus when the ETF is making new highs. A stronger trend will coincide with higher volume, money flowing into the ETF.

- The choppiness indicator (helps determine when trends start and run their course) is providing weak signals, especially when the trend is about to end.

- The latest break out to new highs is weak in terms of the percentage breakout, the inability to stay above the old resistance (dotted black trend line at the 175 level), and low volume. Because of the weak breakout, prices may not be able to continue to make new highs in the near term.

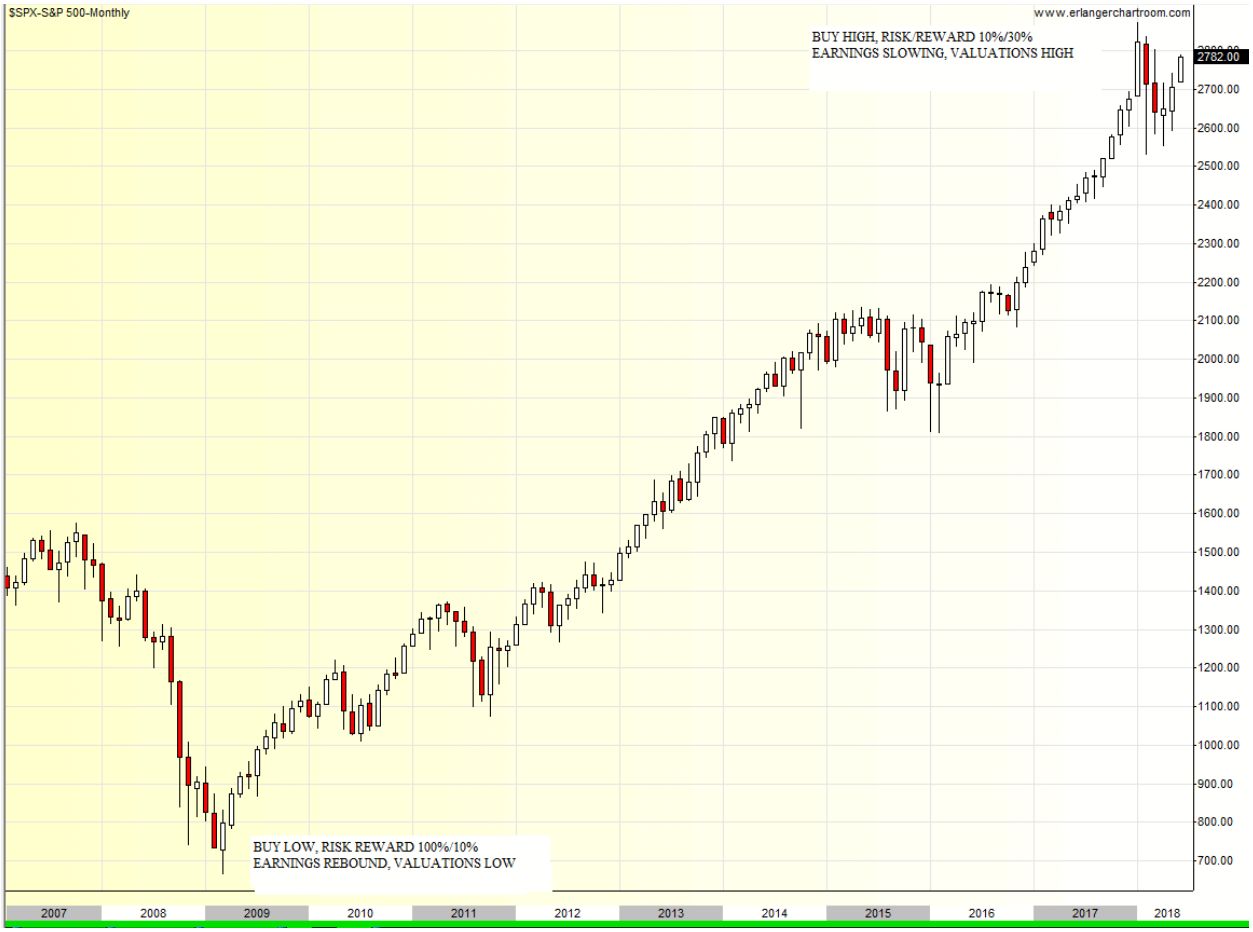
Also, the ETF has a P/E of about 20. A P/E of 20 is fine at the beginning of a cycle, not toward the end of a cycle.

Below is a table that shows the different market industry groups.

DOW JONES U.S. TOTAL MARKET INDUSTRY GROUPS		
	IG-Sym	YTD
BASIC MATERIALS	**DJUSBM**	**-1.28%**
CONSUMER GOODS	**DJUSNC**	**-9.48%**
CONSUMER SERVICES	**DJUSCY**	**5.10%**
FINANCIALS	**DJUSFN**	**-0.22%**
HEALTH CARE	**DJUSHC**	**1.90%**
INDUSTRIALS	**DJUSIN**	**0.52%**
OIL & GAS	**DJUSEN**	**5.88%**
TECHNOLOGY	**DJUSTC**	**12.95%**
TELECOMMUNICATIONS	**DJUSTL**	**-13.08%**
UTILITIES	**DJUSUT**	**-4.28%**
AVERAGE INCREASE/DECREASE		**-0.20%**

There are 10 groups listed and the average return is down about -.2%; the return does not include dividends. Only 3 groups have returns above 5% with technology the strongest, about 13%. Five groups have negative returns.

The market is in its 9th year of a bull market. Most bull markets last about 5 years. Below is a chart of this bull market:



Source: www.erlangerchartroom.com

The risk reward for this market is not favorable, especially if you're close to or in retirement. It is best to be fully invested at the start of a bull market cycle, and sell or hedge when markets are expensive and are in the mature phase of a cycle. Most bull markets are up over 100% from trough to peak, and your downside is maybe 10%. At this point at the top of a cycle, the upside is maybe 10% to 15%, but your downside is about 30% (see table on page 6, LOSS the 4th column) not a good risk reward ratio for an investor. Admittedly I said the same thing in 2016, but the new administration has increased investor confidence. I'm not sure the confidence can be sustained with the growing headwinds the economy and markets face.

Summary and Conclusion

- There are bullish trends for this economy and markets: job creation, GDP and earnings growth, high consumer and business confidence, investment flows are coming back to U.S. markets, stock buyback and dividend increases are good for investors.

- There are growing bearish trends: rising inflation, oil prices and interest rates, concerns about trade wars, a slowing global economy, bearish headline news causing volatility in the markets, a topping pattern (a red flag), the political winds may shift after November making it difficult for the President to achieve his economic goals, this market and economic cycle are in its late phases, the low unemployment rate is a sign of being in the mature phase of an economic cycle, most industry groups are performing poorly and market leadership is narrowing.

- The bullish and bearish forces will probably continue to make the markets volatile and prices will maintain its trading range, topping pattern.

- The markets are overvalued at this time. If earnings' estimates are met, there is some upside potential for the Dow 30 next year.

- Economists and market analysts are bad at calling economic turning points, sometimes the technicals, a focus on price analysis, is better at identifying potential market turning points. There are many red flags this market is displaying: topping pattern (we may be about halfway through a topping phase including the time it takes to go from peak to trough in a bear market), low volume on rallies, narrow leadership in market, length of this market cycle….

- Currently, the risk/reward relationship is not favorable for investors.

Last year I wrote about our late market strategy: trade stocks that are in bear markets, have found their low and are basing (trading sideways), and pay an above average dividend. The risk/reward relationship for these stocks are much better. This strategy is working well for me, and for my clients that are willing to trade and don't mind a more active account.

If I can help you with your portfolio, please contact me at danhassey@yahoo.com or call me at 951-849-1218.