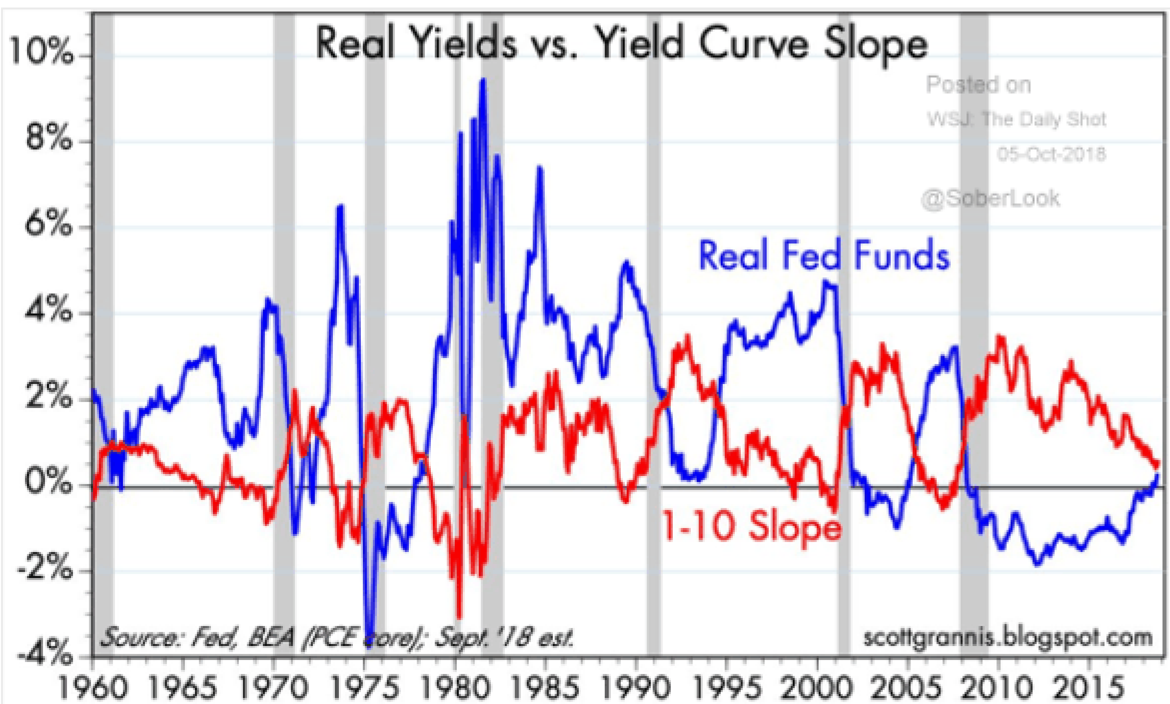
2018 October Market Outlook

In my monthly market updates I normally include: 1. The Bullish and Bearish Case for the markets 2. Price Targets for the markets 3. Technical/Price Analysis. Going forward I will add a new section: The Psychology/Focus of the Markets.

Before I get started on this month's market outlook, the biggest question I get is what caused the recent slide in the markets. Briefly they include:

- The 10-year Treasury jumped in a quick move from below 3% to 3.25% a seven year high. Rising rates are giving competition to risky assets, especially expensive technology stocks.

There is probably more upside for the 10-year. Below is a chart that shows the spread between the Fed Funds rate and the 10-year Treasury.



The average spread is about 4%. Since the Great Recession, the spread has been negative of about 1%. If we use a 3.5% spread the 10-year Treasury should be about 5.5%, currently the yield on the 10-year is about 3.15%. Investors should expect rates to continue to go up.

Interest rates are a key to what happens to economies and asset valuations.
I wrote an article about how important inflation and interest rates are to the economy and asset/stock valuations. Click here to study the report.

The 10-year yield has broken out of its long-term trend. See chart in Technical/Price Analysis section below.

- The markets and stocks broke important support levels.

- I’ve written and mention below the shift from a reliance on extraordinary monetary policies and ultra-low rates to higher rates and fiscal policies (tax cuts, government spending, deregulation). Investors can’t count on the Fed and ultra-low rates to help the economy and markets/investors

- Rising tensions with China including allegations that they placed spy chips in tech products. This means a near-term trade agreement is unlikely

- A desire to book profits especially among institutions. October is normally a volatile month because mutual funds need to take their profits and losses for tax purposes. There will probably be more selling by mutual funds this month, October.

- Continued rotation among investors/traders from risky assets to safe havens

- Divergences among U.S. and global stocks, and some U.S. sectors have entered correction territory or bear markets.

The Technical Analysis section below does show some of the trends listed above.

Bullish Case

- The economy achieved slightly better than 4% growth in the 2nd quarter thanks to tax cuts, deregulation and strong consumer and business confidence.

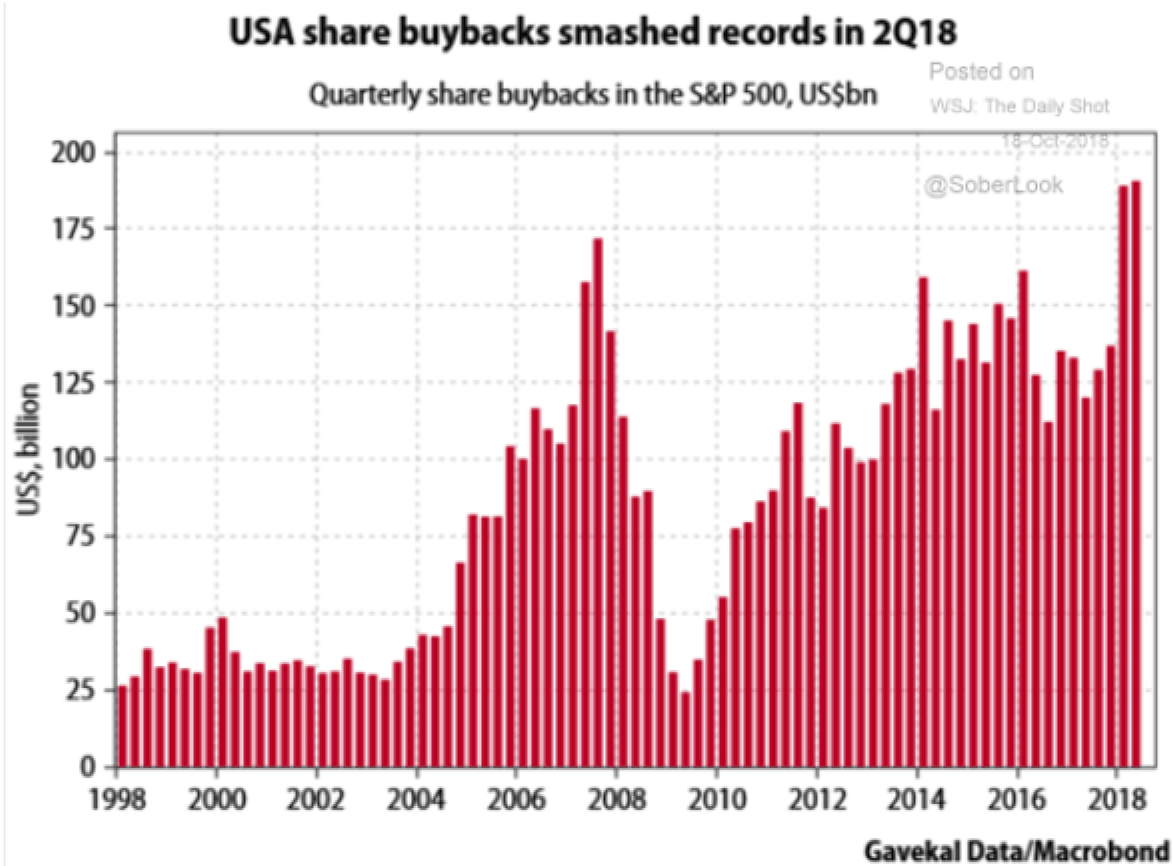
- The economy continues to create more jobs. Unemployment is close to historic lows.

- Many participants in the markets remain bullish

- The consensus earnings growth for the 3rd quarter are expected to grow about 20% thanks to tax cuts and a growing economy. If earnings surpass expectations, then the markets could recover from its recent slide.

- Tax cuts are also increasing stock buybacks, mergers and acquisitions, and dividends. All three could help market stability and support.

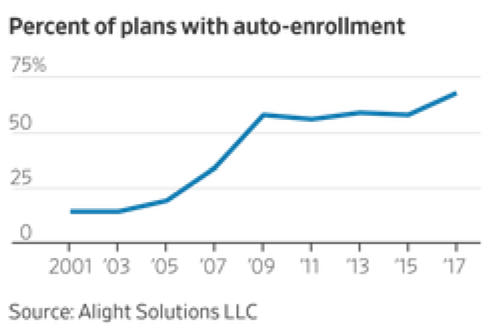
  Buybacks are at record levels:



Source: Gavekal Data/Macrobond

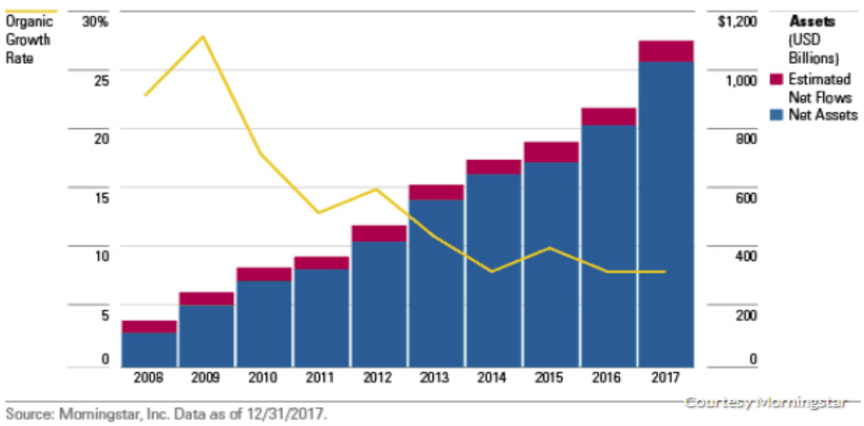
- Another support for the market are monthly contributions by workers to their 401ks. Most 401k investors invest in target-date funds that do invest in ETF indexes.

Here is a chart that shows the dramatic increase in 401K investors:



Below is a chart that shows that a lot of 401K money is going into target-date funds:

Exhibit 1 Net Assets, Estimated Net Flow, and Organic Growth Rates of U.S. Target-Date Mutual Funds, 2007-16



Source: Morningstar, Inc. Data as of 12/31/2017.

Target-date funds were developed to help investors make investment decisions. For example, if you're 50-years old, then you would pick a 2033 target-date fund, a fund that invests for an investor that would retire when she/he is 65-years old. This portfolio would be more conservative than a fund for a 30-year old.

- One of the other major changes in the investment world is the impact of financial planners. The consolidation of the brokerage industry to a few players caused many investment professionals to become financial planners who have their own firms or work for small financial planning firms. Financial planners are big believers in asset allocation with ETF indexes. When they get new money, it gets deployed into ETF indexes. This could give the markets some support.

- Last year I also wrote about the market phenomenon of new highs. When new highs are made, resistance/sellers are taken out and it will be easy to make new highs. Many markets have broken out to new highs. If prices can stay above the old high, then we may see more new highs for the markets. See the Technical Analysis section below

- The markets could get another boost if there are positive results from the current negotiations with China, Japan, the EU, North Korea, Russia, and Iran.

Bearish Case

For the last few months participants in the markets were ignoring bad news and buying on positive news. Here is what I wrote last month:

"The markets are normally forward looking, but not today where the current positive trends carry more weight. The market seems to suggest that a year from now the trade wars will be won by the U.S., Republicans will keep the House and Senate, the Mueller report will not reveal any criminal violations, oil, interest rates and inflation rises will reverse, the deficits aren't a concern, global growth will come back, North Korea, Iran and other geopolitical tensions will get better. If the markets are wrong on some of these issues, the market could adjust downward and we could see P/Es contract."

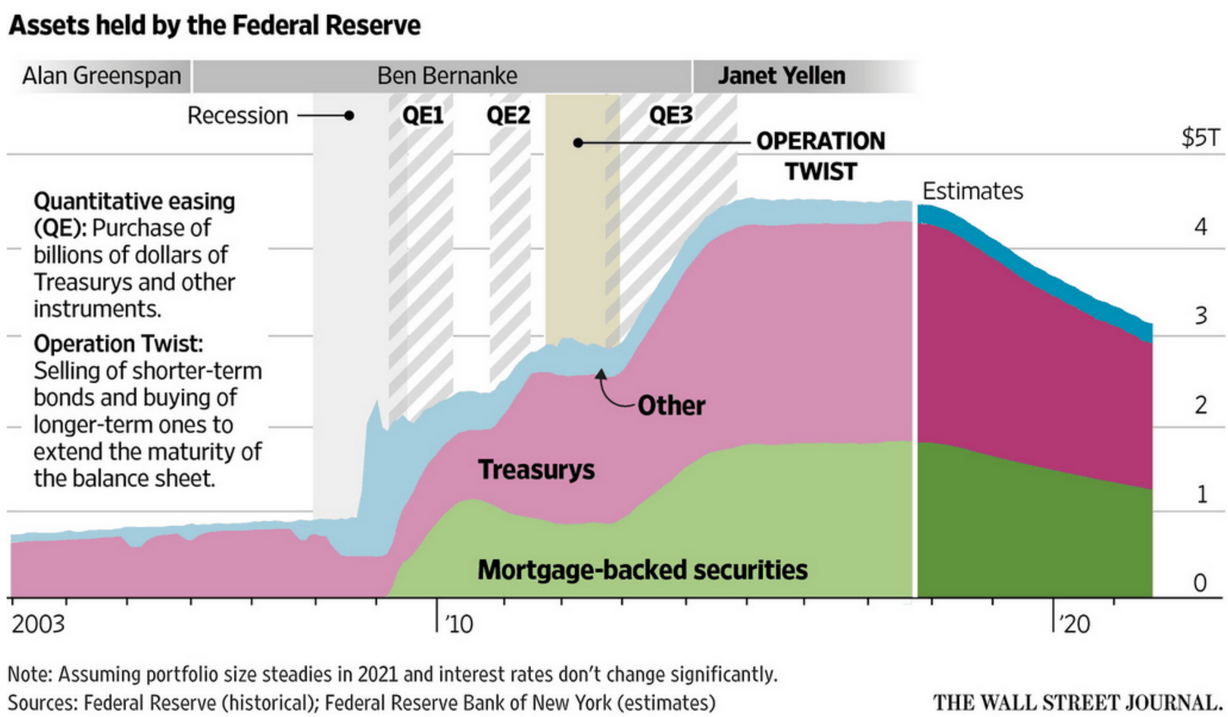
The markets are finally adjusting to the risks that I've been writing about and that are listed below.

- We are shifting from stimulative monetary policy (ultra-low rates, and the Fed using its balance sheet to buy long-term bonds to lower long-term rates) to stimulative fiscal policies (tax cuts, government and military spending, trade policies). This transition has risks, especially if interest rates rise to fast, or not fast enough. For now, investors/traders and the President are concerned that rates are rising too fast.

  I've been writing that rates will probably go higher and investors aren't paying attention. The Fed is trying to normalize rates. Historically the Fed funds rate is about 1% above inflation. CPI is a little over 2%, this means the Fed funds rate should be about 3%, and we're about 2.25%. This is why rates will probably continue to rise.

  Also, the Fed need to raise rates to lower them once we enter a recession. Lowering rates is the best monetary tool the Fed has to stimulate the economy.

  The Fed is also reducing its balance sheet that means that instead of buying government bonds and lowering rates, they will be liquidating their balance sheet that could put more upward pressure on rates.



  Investors are realizing that the markets and our economy will be losing the extraordinary monetary policies of ultra-low rates and the fed using its balance sheet (about $4.5 trillion) stimulus that helped this economic and market cycle.

- Most economists agree that the current trend of the economy is not sustainable. The biggest reason is the tax cuts mostly benefited corporations and shareholders and the multiplier effect for the rest of the economy is weak. I've written about this for some time.

- We have imposed tariffs against Canada, Mexico, China, and the EU. These countries have imposed tariffs against us. We also have sanctions against Russia, Iran, and North Korea. These fights with allies and foes could lead to a global recession.

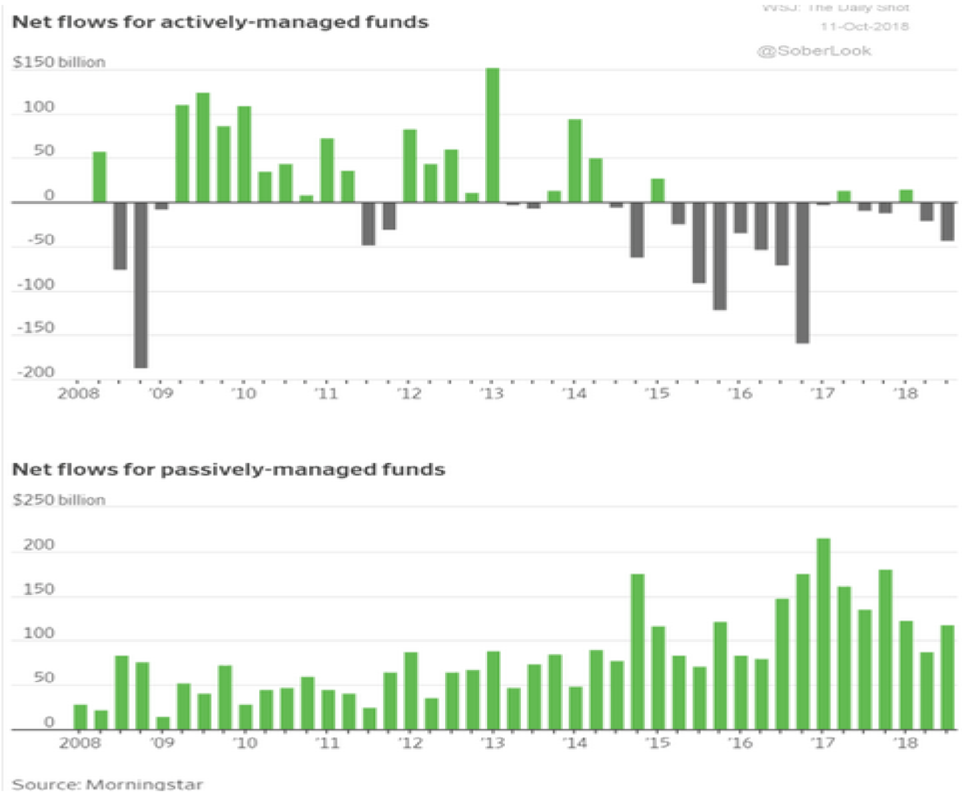
- Global growth seems to be stalling. A hard Brexit (the British exiting the EU) could contribute to slower global growth, and Europe's move to populism and nationalism could create social instability and slower growth. It's already to slow..

- Providing tax cuts this late in the cycle is risky, especially when we have large deficits, debts. Also, about 10,000 baby boomers turn 65 every day and many are applying for Social Security and Medicare. This is one of the main reasons why many economists and analysts are not bullish long-term.

- This year, the deficits may approach $1 trillion, much sooner than economists expected. The huge financing needs of the U.S. could push interest rates higher to attract investors and fund our deficits and debts.

- The trend of passive investing (the use of index ETF) versus using an actively managed accounts/mutual funds means that index ETFs are very crowded and when investors sell, once the economy turns, liquidity could become a big risk and downward moves could get exaggerated.

Below is a chart that shows that money is leaving actively managed funds and moving into index ETFs.



- We are seeing many red flags and signs we are in the late stages of this economic and market cycle:
  - Rising oil prices, inflation and interest rates
  - Full employment and rising wages, both are good things but are creating inflationary pressures
  - Markets are overvalued
  - Narrow market leadership and market rotation (market leadership often changes)
  - The market is developing a major reversal topping patterns (see technical section below)

- The dollar is stronger this year and it could be a headwind making our goods and services in foreign markets more expensive. Also, when the foreign sales are converted to a stronger dollar this will probably lead to currency losses that could lead to lower profits. This is not reflected in analysts' earnings and market price targets.

- The markets seem to be overlooking the Mueller investigations and the potential for more negative headlines.

- There is a good probability that the Democrats could win the House in the November elections. This will make it difficult for President Trump to achieve the rest of his economic agenda. There could also lead to impeachment depending on the Mueller investigation's final report. Charges could include obstruction of justice, money laundering, tax evasion, campaign finance violations, lying, and conspiracy against the U.S.

- We have not had a bear market for about ten years. They are painful emotionally and financially; investors forget this. They say the market takes an escalator up in a bull market and an elevator in a bear market. See technical section below.

- Black and grey events (low probability, but high impact) are always a risk.

Market Price Targets

Below are the price forecasts for the markets:

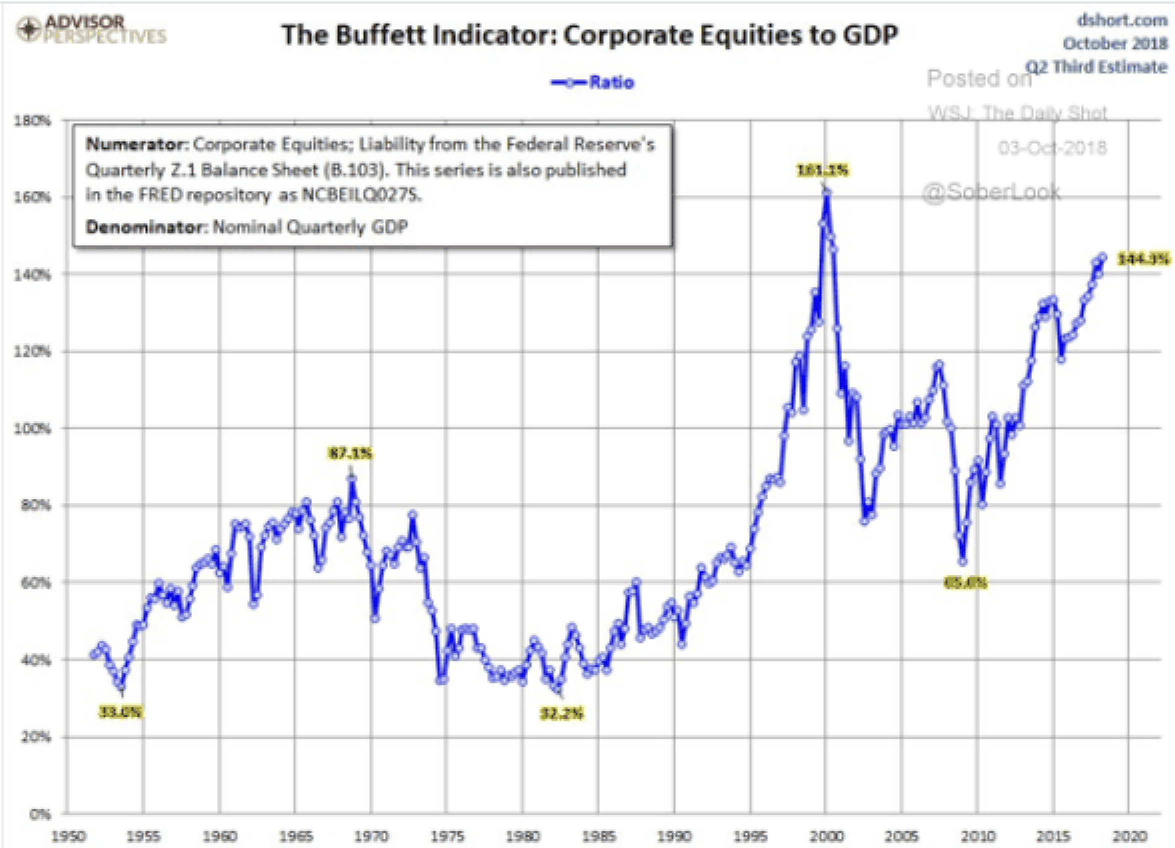
2018 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1552.95	16	**24,847.20**	25,340.00	-1.98%
SPX	160	17	**2,720.00**	2,767.00	-1.73%
2019 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1697.95	16	**27,167.20**	25,340.00	6.73%
SPX	174	17	**2,958.00**	2,767.00	6.46%

Source: Barron's, Dan Hassey database

I've written in the past year that analysts are normally too optimistic, especially late in a cycle. This is why I use a moderate P/E ratio, but it may be too high this late in the cycle. Earnings are too optimistic and probably don't reflect a stronger dollar and the impact of more tariffs. I will write about trade deficits, tariffs, and global trading in my 4th Quarter Economic Update that should be out in mid-November.

The targets for 2019 will probably mean the markets will continue to be stuck in a trading range. See Technical Analysis section below.

Below is the Buffet Indicator, it's basically a market capitalization to sales ratio with the value of stocks divided by U.S. GDP.



Source: Advisor Perspectives

The market is more overvalued than most market cycles except in the late 1990s, and the 1990s had the technology boom that helped the economy and created wealth. We don't have any type of major economic trends helping this cycle.

If Republicans keep Congress and the Senate, the animal spirits (e.g. strong business and consumer confidence) could last another year and the markets could make new highs and the market multiple could expand. Here is my market target price with this scenario:

2019 FORECAST					
	EARNINGS ESTIMATES	P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1697.95	17.5	**29,714.13**	25,340.00	14.72%
SPX	174	18.5	**3,219.00**	2,767.00	14.04%

Source: Barron's, Dan Hassey database

There is more upside with this scenario, but a lot has to go right (rates stop moving up, there is an agreement with China, housing and autos recover, oil prices reverse, and Republicans keep the Congress and Senate).

Psychology and Focus of the Markets

Over the years I've noticed that the focus and psychology of the markets determine short to medium trends and momentum. It's fascinating to watch how the focus/psychology changes, sometimes overnight.

Last month the focus was progress with NAFTA trade negotiations, the strength of the economy and earnings, continued job creation, and strong business and consumer confidence. The markets were bullish.

The markets are now adjusting and are focused on:

- Rising interest rates
- The impact of tariffs on the global and U.S. economy
- A realization that a quick trade deal with China is not going to happen. The financial press is reporting that we're not only in a trade war but a growing cold war.
- Elections

The markets are showing divergences and the breaking of important support levels, the next section shows these divergences and the breaking of support.

Technical/Price Analysis

The main reason for the markets recent pullback was the quick move of the 10-year treasury from 3% to 3.25%. Also, yields broke the long-term downtrend and finally moved and stayed above 3%.

According to the chart, rates peaked in the early 1980s above 15%. The main reasons for the high rates were bad monetary policies, high inflation and oil prices. Oil prices climbed due to the Arab oil embargo and the Iranian Revolution.

I started in the business in the early 1980s and my first few years I mostly sold bonds (treasuries, municipals, and corporates) that were yielding over 12%. My pitch back then was “I hope when I retire rates are this high.” No one would have believed that rates would have dropped to 1.37%.

Trillions of dollars have moved to the bond markets during this cycle, especially as baby boomers are retiring and need income. Rates have more than doubled since the lows of 2016 to now. This means many bond investors are sitting on large losses. Below is a chart of the 20-year Treasury bond fund ETF that shows the losses some bond investors might have:

Source:erlangerchartroom.com

Bond prices and yields are inversely related. When yields rise, bond holders lose value as their bonds have to lower their price to compete with higher yielding new bonds. This also happens in reverse, falling yields increases bond prices as the higher yielding bonds become more valuable as bond yields fall. If you’re holding a bond that is paying 2% and rates rise to 3.25%, you will have to lower the price of your bond to compete with bonds that are paying the new higher rate. As bond yields moved from the lows of July 2016 to their current yields, this bond fund ETF is in a bear market and is down about 20%. The Treasury bond ETF dropped in price from about \$143 to \$113.

If you own bonds, and aren't sure if you should hold or sell, feel free to email (danhassey@yahoo.com) me with your questions, and I can try and help.

Below is a chart that shows the price action year-to-date for the Dow 30 ETF, symbol DIA. I use the DIA because it has more trading data.

Source:erlangerchartroom.com

There is a lot to this chart. Let's break it down:

- This market has been going sideways for almost one year. Support was established last November at around 233 and for the Dow 30 index would be about 23,300. The new higher resistance is now about 270 and the Dow 30 index about 27,000.

My valuation for Dow next year is about 27,170, basically in the current trading range. A lot has to go right for prices to reach 27,170 and above.

- Prices did make new highs earlier this month, but prices were not able to stay above the old resistance/new support. Also, the breakout on a percentage basis was not impressive and was a sign that the breakout was suspect.

- Prices broke below important support levels. When prices broke out of resistance at the 26,500 level, resistance become support, the dotted trend line. Prices stayed above support for about one month but broke support early this month.

Prices then broke below the 50-day moving average trendline, black trendline, convincingly creating a sell signal. The 50-day moving average is a medium-term indicator.

Prices also broke below the more important 200-day moving average (red trendline), a long-term indicator. The 200-day is considered more important because it is a longer-term support level. Breaking this moving average is breaking the long-term trend.

The breaking of important support levels created sell signals for some investors and traders.

If prices break the major long-term support level, 23,300, the break below these levels could be the start of a bear market.

- The first pane shows volume. Notice that volume is much stronger during selling (money leaving the market) periods. For the trend to reverse, more volume on the upside (money entering the market) has to increase.

- Fear and greed is showing up in charts. They say markets move higher like an escalator and fall like an elevator. There is a fairly new investment discipline, behavioral finance, that defines fear and greed as biological responses. When prices move up, dopamine is released in the brain and is known for causing a “gamblers’ high”. When investors/traders are losing money the hormone cortisol is released and is known to cause fight or flight actions. Cortisol could cause irrational selling.

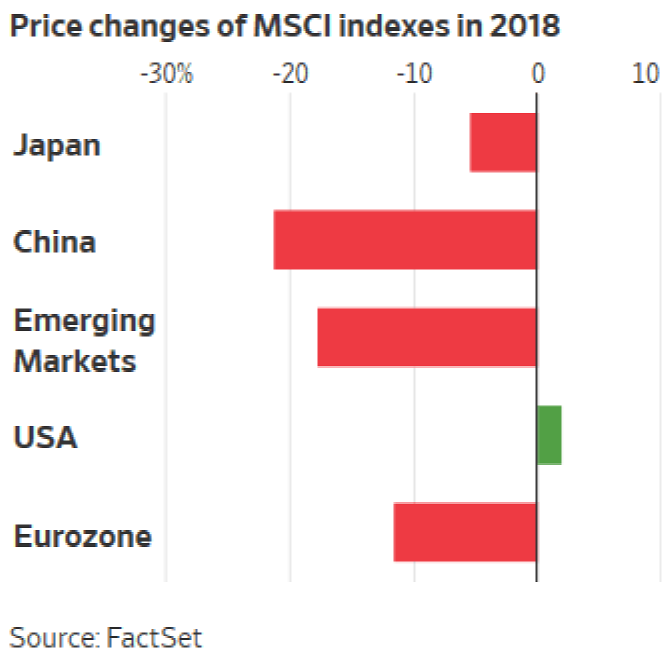
Prices rose from November of last year the markets rallied and peaked in late January, an example were dopamine can cause a happy state. Prices crashed and found a bottom in less than two weeks. Fear/cortisol is more powerful than greed/dopamine.

- The bottom pane shows the choppiness indicator. When prices fall to the 30 level, a move (up or down) has probably run its course. The indicator is close to that level, so we can expect a bounce.

Divergences

Many analysts are pointing out the many divergences in the markets that investors/traders should be considered about, below are a few examples:

Most major global markets have negative performance:



This will be a major headwind for our economy and markets, will the global markets and economy pull the market down, or can the U.S. economy pull the global economy and markets out of its slumps. Trade wars don't help this situation and is part of the global weakness.

I keep hearing from traditional news sources and the financial media that the economy is "booming". Not all industries in the economy are booming, especially autos and housing, two of the most important components of the economy:

Below is the homebuilding ETF (symbol XHB):

Source:erlangerchartroom.com

Most homebuilding stocks are in deep bear market territory. Housing and related industries are about 20% of the U.S. economy.

Notice that there was strong support at the $38.50 area. Once prices broke support, it created a sell signal and prices collapsed. The stock continues to fall. This is normal during late cycle markets. This is what a bear market looks like. Most major markets are building major tops, a sign of a mature market cycle.

There are only two main U.S. auto companies. I don’t count Chrysler, Fiat as they are domiciled in the United Kingdom. Below is a chart of General Motors:

Source:erlangerchartroom.com

GM and Ford are in bear markets.

Technology stocks have been the favorites/market leaders the last few years, but are now close to correction territory:

Source:erlangerchartroom.com

I’ve written about how market leadership is important for markets. If the market loses technology as a market leader, the market could struggle. What would replace technology as the market leader?

Summary & Conclusion

- The last few months the market was ignoring important concerns regarding the U.S. and global economy. This month, the markets are adjusting to these concerns.

- The bullish case for the economy and markets include: a growing economy and earnings, low unemployment and continued job creation, wage increases, strong consumer and business confidence.

- The bearish case includes: rising inflation, oil and interest rates, the stimulus from ultra-low interest rates and the Fed creating liquidity with its balance sheet is being removed, a strong dollar and slowing global economy, divergences in the global and domestic markets.

- The elections could determine the direction of the markets. If the Republicans can stay in power the economy and markets could sustain its momentum. If there is a change, then the markets and economy could struggle.

- Some of the divergences in the markets could create some opportunities: Buy when stocks are undervalued and hedge or sell when stocks are too expensive.

- The markets have been stuck in a trading range all year. If the markets break its major long-term support level, the break lower could start a bear market. A lot has to go right for markets to breakout to new higher levels.

If you need help with your portfolio, feel free to contact me at danhassey@yahoo.com.