2018 December Market Outlook

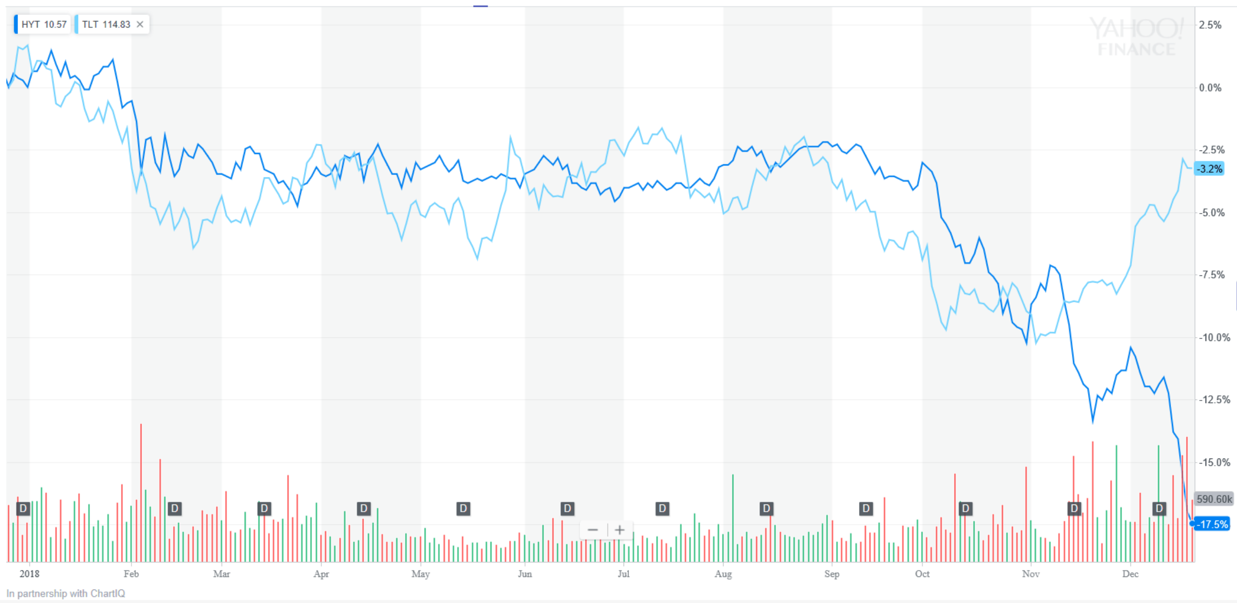
During market hours, 6:30 a.m. to 1 p.m. Pacific Standard Time, I keep the cable financial news channels (CNBC, Fox Business and Bloomberg) on and currently the two most asked questions are: 1. with the market falling, when is a good time to buy? 2. If there are no signs of recessions, how could we have a bear market? I answer both questions below.

Bullish Case

- Earnings are above 20% for 2018
- Unemployment numbers are near historic lows
- Small business and consumer confidence remain high
- Stock buybacks, and dividend increases could create a floor for some stocks
- Energy prices had a significant fall and could reduce inflation and the lower prices could put extra money in consumer's pockets.
- Lower energy prices could lead to lower inflation and cause less pressure for the Fed to raise rates.
- Valuations are reasonable
- There are still enough bulls to causes rallies on good news.

Bearish Case

- Most economists agree that the current GDP pace of growth is not sustainable and growth will slow next year.
- Trade wars and sanctions are slowing global and domestic economic growth. China, Japan, Britain, Germany and much of the Eurozone are slowing.
- Rates are higher and there may be a few more Fed increases in 2019, 2020.
- Higher interest rates are pushing up yields for money markets and short-term treasuries. A recent WSJ article read "Cash Is King". Money markets and other short-term interest bearing accounts are competing against stocks and bonds.
- The yield curve is flattening and credit spreads are diverging, both are red flags.
  Below is a chart showing widening credit spreads:



Source: Yahoo Finance, ChartIQ

Investors are selling riskier low quality, junk bonds (dark blue trendline, high yield ETF) and buying safer treasuries (light blue trendline, 20-year Treasury ETF). The diverging credit spread is a red flag and is more important than the yield curve. Investors are fleeing risk and moving to safe havens like Treasuries in anticipation of poor economic conditions and the potential for debt defaults.

- Two important components of our consumer driven economy are slowing - auto sales and housing.

- The economy is raising several red flags indicating a late stage economic cycle: full employment; fed raising rates; inflationary pressures; too much debt (corporate, government) this late in cycle; the length of this economic cycle is close to 10 years, the average is about 5 years.

- The shift from monetary policy (Federal Reserve) to fiscal policy (lawmakers) is causing disruptions in the markets and economy

- The market has developed a major reversal pattern that started last November, major red flag. See chart below.

- Most stocks and indexes are below their 200-day moving average, a red flag. See chart below.

- Dysfunction in Washington

- Geopolitical tensions including Iran, North Korea, Russia, Yemen

- Brexit has still not been settled and Britain is running out of time

- Bad news is starting to overwhelm good news

- Growing deficits will probably get worse and may be headwinds going forward

- Crowded index funds may cause problems for investors if they all try to head for the exits as the economy and earnings slow

- The Presidents legal and political problems keep piling up. A handful of close aides have pleaded guilty to small to serious crimes. His problems will probably get worse, as Democrats will probably start their own investigations. The President’s legal problems have and will continue to be distractions for the President.

Psychology of the Markets

For the last two years, most investors, money managers and analysts have been bullish. Some of these participants are starting to voice concerns and the concerns include: a slowing global economy, forecasts of slower earnings and U.S. growth, a slowing China and Europe, trade wars, Fed raising interest rates, too much corporate and government debt.

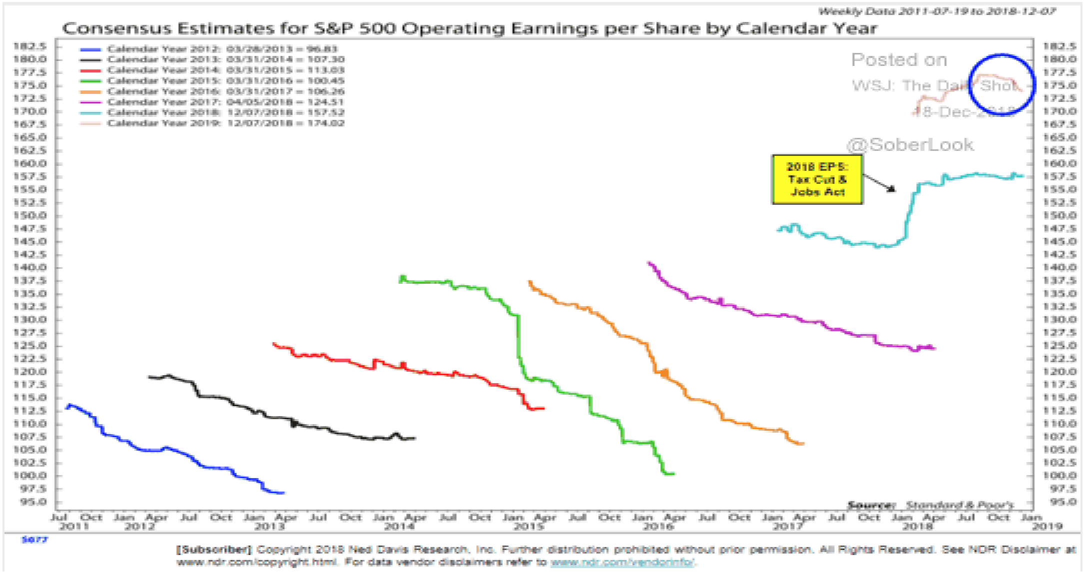
Some bullish investors believe that there will be progress with China and our trade negotiations, and the Fed will take a pause in raising interest rates. What do these bulls do if China trade negotiations take much more time, and the Fed is close to being done raising rates anyway? What are the catalyst to get the economy and markets back on the right track?

Speaking of the Fed, the Fed just raised rates and the Fed Chairman Powell disappointed the markets by saying the Fed sees slower growth in 2019, but still intends to raise rates two times. What investors wanted to hear was the growth of this year can be sustained and because inflation is low, they will not raise rates. This sentiment was unrealistic.

Some investors think algorithms, and computers are making the volatility worse. I’ve written in past outlooks that these computer driven trading helps the markets on the upside and now were learning this trading has a downside when things go bad. Also, investors have always identified market boogiemen: the elephants known as institutional/professional investors, bond vigilantes, derivatives.

Market Price Targets

I follow earnings forecast trends and what I look for, are earnings forecasts revised upward, downward or are they unchanged? The trend in earnings forecast does impact stock prices. Normally, at the start of a cycle analysts tend to underestimate earnings growth and toward the end of a cycle analysts tend to be too optimistic. Below is a chart that proves this tendency:



Source: Ned Davis Research

As the chart shows, it's normal for earnings forecasts to be too optimistic at the start of the year and as the year progresses the forecasts have to be revised lower. 2018 was different because of the stimulus from tax cuts and increased spending, especially for the military. Earnings were revised upward for 2018.

Earnings could adjust lower due to the stronger dollar. Also oil prices recovered in 2017, 2018 and so the strong earnings growth for the S & P and Dow 30 mostly came from energy stocks, but these stocks have underperformed. Energy company earnings will probably be much less in 2019 and that will cause lower earnings estimates for the markets.

Earnings forecasts for 2019 were anticipated to grow about 10%. They have been revised lower to about 8% growth. We will probably see more downward revisions.

Below are my forecasts for 2019:

2019 FORECAST					
	EARNINGS ESTIMATES	P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1704	15	**25,560.00**	23,870.00	6.61%
SPX	171	16	**2,736.00**	2,567.00	6.18%

Source: Barron's, Dan Hassey database

The markets have some upside if earnings forecasts are met. Remember it would be normal for estimates to be revised downward, especially this late in the cycle. Because we are late in the cycle it would be wise to use a moderate P/E. If prices do move up to these levels, the market would remain in its current trading range/topping pattern.

Technical/Price Analysis, a Picture Is Worth a Thousand Words

Technical analysis is the study of price and volume. It does not concern itself with the fundamentals of a company or the economy. I did co-write a free course on technical analysis.

Click here to take the course. You will receive spam when you sign up, but your spam filter should take care of them.

Sometimes an investor has to take off his/her fundamental/value hat and put their technical hat on, especially with entry, buy and exit, sell points. What is the chart telling you? Are prices moving up and accelerating, are they moving sideways in a trading pattern, or are they bearish and declining? A picture is worth a thousand words.

Of course if you wanted to buy or sell your company, you would use value/fundamental analysis to determine a valuation. A chart will not tell the value of a company or asset.

Below is a long-term chart of the current bull market, one of the longest in stock market history:

Source: www.erlangerchartroom.com

The bottom of the last bear market was in March 2009, almost 10 years ago. Most bull markets last about four to five years; this bull market is almost 10 years old.

Price accelerated (dotted trendline) after the presidential elections, and the accelerated trendline has been broken. As time goes on the long-term trend line will probably move higher and this will make the breaking of the long-term trend line easier.

Below I answer the question, when can I start buying?

Source: www.erlangerchartroom.com

Some analysts are calling this a stealth bear market as about 40% of stocks have entered into bear markets. The chart above is the home construction ETF, symbol ITB. The ETF and the stocks in the ETF are in a bear market. Most bear markets are down about 30%, the ITB is down about 38%.

There are normally four phases to the final stages of a cycle:

Phase 1: **A topping phase**, also known as a major topping reversal pattern. I explain topping major reversal patterns in the next section.

The topping phase started last September when it was building support, around the $37 level, the bottom of the topping pattern. The top, resistance of the chart is about $49.50. Prices never got close or tested the peak high, so the second resistance level was about $41.

Most topping phases have a pattern. I discuss these patterns in the next section.

The topping phase started last October, and broke support this October, a normal time frame to build a major reversal topping pattern.

Phase 2: Breaking support. The end of the topping phase ends when it breaks support; for the ITB, the support was about $37. When prices broke support, there was another nasty leg down, normal price behavior. It happens quickly. The breaking of support is a major sell signal.

I explained in past market updates that the fall is partly biological as the stress from losing money causes the production of cortisol, a fight or flight hormone. Investors tend to act emotionally and throw in the towel and sell indiscriminately.

When support is broken we normally go into a bear market. A bear market is when prices are down at least 20% from the peak of the cycle with a negative economic backdrop (increasing unemployment, bankruptcies, negative GDP, foreclosures, defaults, contracting earnings to losses)

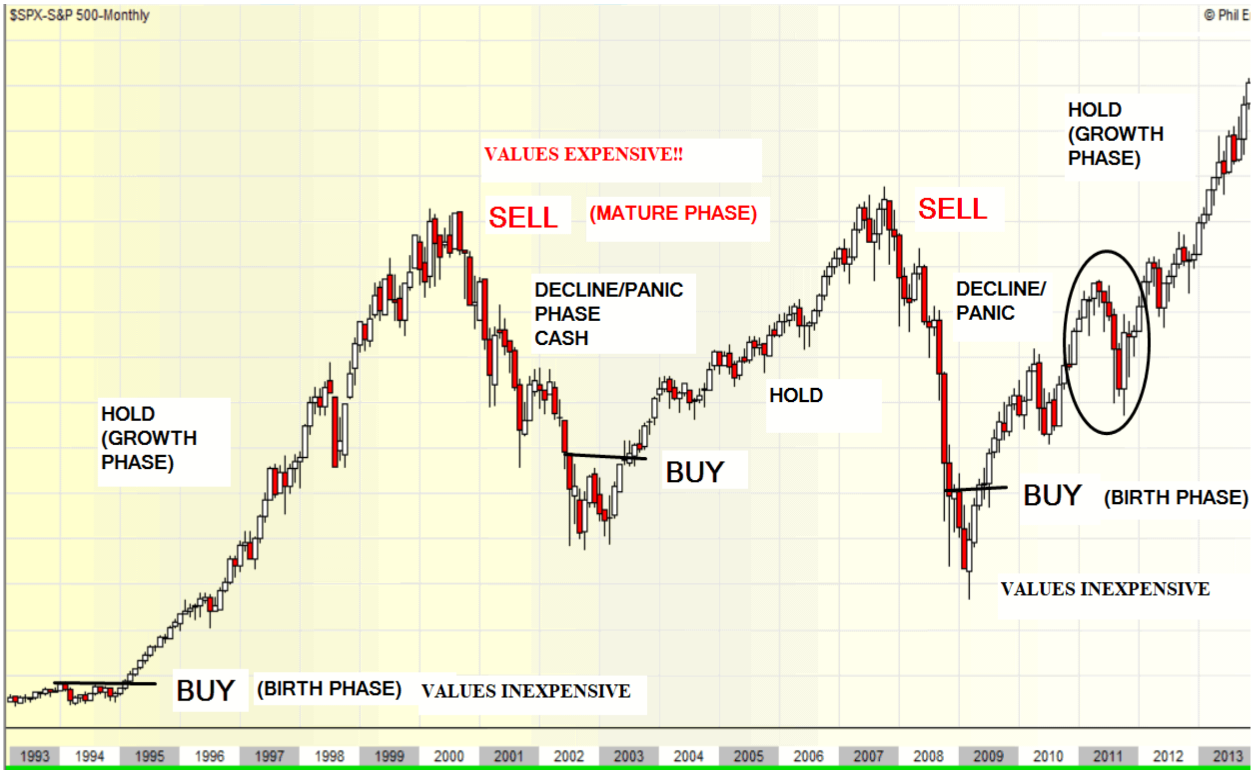
Phase 3: Prices find a bottom. After prices break support and a nasty, fast fall, prices next find a bottom. A bottom is normally found when there is a "one/two day reversal". I will explain "one/two day reversals" in a future update.

Phase 4, and final phase: Prices base, the opposite of a topping phase. In the ITB chart, the basing period is in its early stages. I will explain the basing phase when prices start to base, when we're in a bear market.

WHEN SHOULD INVESTORS START BUYING

Investors should start preparing for the next bull market AFTER a market low/one to two day reversal, and DURING the basing period. Investors normally have plenty of time to position one self for the next bull market. Most basing periods, on average last about seven months. This is when risks are lower, and stocks are undervalued and the upside for the next bull market is significant, normally. Again I will explain basing patterns once we're in a bear market. Hopefully you've been raising cash during this topping phase.

Here is another way to look at these cycles from an investor's point of view and action an investors should take.



Source: www.erlangerchartroom.com

Cycles are taught in many science and business classes. In business, the classes include marketing (product cycles), economics (economic, interest rate and political cycles) and investing (market cycles). The business/economic/market cycles have 4 phases: 1. The birth phase 2. The growth phase 3. The mature phase 4. The decline phase. These phases also occur in nature.

We have been in the mature phase of this market cycle and may be entering the decline phase. Can you identify the technical late phases I explained above: the topping phase, breaking support phase….

For investors, you buy when stocks are in the birth phase and undervalued, and sell or hedge when stocks are overvalued and in the mature phase.

Major Topping Reversal Patterns

I have studied every bear market going back to 1917; below is my research regarding major topping reversal patterns.

	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 personal research and data base

Let's review some of my research:

- The 2nd and 3rd columns identifies the peaks of the bull market cycles, and the bottoms of the bear markets that followed the peaks.

- The 4th column is the amount of loss from peak to trough.

Periods in yellow highlight were bear markets or corrections with no recession occured. All recessions have bear markets, but not all bear markets have recessions. Some bear markets are only market events. For example, the 1987 market crash that turned into a bear market. There are many reasons for the 1987 bear market (oil, dollar, interest rates were rising, Iran/Iraq war escalating, derivatives and hedging) but there was no recession.

- The 5th column describes the type of major reversal patterns that developed.

Topping patterns normally develop four types of patterns: 1. Rounding/umbrella tops 2. Head and shoulder tops 3. Double tops 4. Triple tops. As the table above shows most topping patterns look like an umbrella, also known as a rounding top.

The longer it takes to develop a top the more significant the next move will be. I often hear on the financial cable news that they see a head and shoulders pattern that took two months to build. A two month head and shoulders would be a medium-term event and would not be significant. A top that takes more than a year to build would have a big impact on the downside. The time it takes to build a pattern is an important concept in Dow Theory and Technical Analysis.

- The sixth column is the amount of time it took to go from peak to trough. Here is what I wrote in my April Outlook:

"A new trading range has been established, once a new market high was made in late January. The new trading range now has support around 23,500 and resistance is around 26,600.

I consider this a topping pattern that started in November of last year. This means the topping pattern is about six months old, and as the table above states, the average topping pattern lasts about 14 months. This pattern could take us to the mid-term elections. Remember the market is a leading economic indicator and leads the market by at least six months… Investors should be patient disciplined and cautious. Raising cash and reducing risk also makes sense. I did write an article on how to de-risk a portfolio. Click here to read the article."

Click here to read my April Market Outlook and how I identified this topping pattern earlier this year.

14 months would be around January 2019. There is a wide dispersion of the time it takes to go from peak to trough. The shortest time was 5.5 months, and the longest was 30 months. I did a standard deviation calculation of the data points and it was a low 6.8, meaning that the measure does not deviate much from the average/standard.

Now that we're familiar with major topping patterns, let's analyze the current S & P topping pattern.

Source: www.erlangerchartroom.com

I look at the S & P 500 index ETF because it has more trading data.

There is a lot to unpack in this chart:

- It’s normal for the left side of the pattern to mirror the right side. The left side participants are buying the dips, on the right side participants are selling into rallies. Look at the ITB chart, and the long-term S & P chart in the previous sections; you will see buying the dips on the left side of the charts and selling the rallies on the right side.

- Selling volume, lower pane and circled, tends to be much stronger in the topping phase.

- The red trendline is a 200-day moving average, a long-term trendline. Breaking of this moving average is serious as it is a long-term trendline; the trendline was breached earlier this month. Breaking of the 200-day MA is a sell signal among some investors and money managers. We can see the selling accelerate and the volume pick up. The 50-day moving average was breached in October and is a medium-term sell signal and is not as serious.

The direction of the moving averages is also important. The 50-day moving average is bearish and trending downward, and the 200-day has just turned bearish, it was neutral the last few months.

- The death star signal, when the 50-day moving average breaks below the 200-day moving average is getting a lot of attention in the financial media. This is a fairly new signal, so I don't know the predictive value of this signal.

- So far the pattern looks like an umbrella/rounding top. If we have one more rally to the 2800 area, the pattern could turn into a head and shoulders pattern. This seems unlikely in the near-term with all the bad news and the damage that has occurred in the markets. We will also see tax selling to the end of the year. There are lots of losses this year, so the tax selling could be more this year.

- The chart above does seem to show that support has been broken, a MAJOR RED FLAG, and a sell signal. It's too early to tell with the chart above if support has been broken. It probably is because the news has been so bearish lately. Technicians use filters to determine if a major support has been breached or the breach is suspect. I will explain these filters (volume, closes, time below support, and percentage move below support) in a future Outlook.

- Once a support level has been broken, that support becomes resistance, and a new lower trading range, the basing pattern, is normally established. This is why breaking support is so important. It leads to a second leg down. There will be rallies to support and you should use these rallies to sell into if you already haven't.

Normally in topping patterns corporate and economic news are mixed keeping prices in a trading/topping pattern, toward the end of the pattern, bearish news start to overwhelm good news. This is certainly true this year.

Major reversal topping patterns should be taken seriously as well as the breaking of the 200-day moving average, and the breaking of the topping pattern support level.

I often hear on the financial cable news channels that how can we have a bear market if there is no recession in sight? As I wrote above, there are bear markets with no recession. These bear markets tend to be closer to a 20% decline with a quicker recovery. Bear markets with recession last longer and are normally down more than 30%. Also, the market is anticipatory; the adage buy the rumor sell the news is true. When the economy eventually goes into a recession, the market will be either in a topping or a basing phase. Waiting for a recession to take action will be too late. This is why technicals/charts are important, they anticipate what the future may look like.

Here are the links to the section of our technical analysis course on major reversal patterns section, link 1, link 2.

Fundamentals of Bear Market Recessions

Last month in my Economic Update I explained the many causes of bear markets and recessions. Again I dug through economic/business newspapers, magazines and books to create the list going back almost 100 years. For the last close to 40 years I rely on my significant archives of economic and investment data and articles that I've collected, as well as my experience and memory. Many of the major market and economic events over the last 40 years seem like they happened yesterday. They stick in your memory.

Here is my list:

YEAR OF BEAR MKT	RECESSION	CAUSE 1	CAUSE 2	CAUSE 3	FED RAISES RATES	DERIVATIVES	OIL
2001	YES	Tech Wreck	911	Corporate Scandals	Y	N	Y
1998	NO	Asian Conatgian	Russian Defaut	LTCM	N	Y	N
1994	NO	Mexican Peso Collapse	Orange County Bnkrptcy		N	Y	N
1991	YES	Gulf War I	Banking Liquidity	High oil prices		N	Y
1987	NO				N	Y	Y
1984	NO	Strong GDP	Volker raises rates		N	N	N
1981	YES			**STAGFLATION**	Y	N	Y
1976	NO	Inflation		**STAGFLATION**	Y	N	
1973	YES	Oil Embargo	Inflation	**STAGFLATION**	Y	N	Y
1968	NO				Y	N	
1966	NO				Y	N	
1961	YES	Kenndy - steel prices	Cuban Missle Crisis		Y	N	
1953 TO 1954	YES	Economist predict depression			NO BEAR MARKET		
1949	YES	Overheating Economy	Inflation	Strikes		N	
1929 TO 1932		LEVERAGE	BAD ECON PLCY	DFLTN		N	
1919 TO 1921				DFLTN		N	
1914	WWI						
1917	U.S. ENTERS WWI						

Source, Dan Hassey database

Here is normally what happens when a market, economic cycle ends.
1. The economy heats up and inflation and oil prices tend to rise.

2. The higher inflation (high inflation destroys one's standard of living) causes the Fed to raise rates to reverse inflationary pressures.

3. Higher interest rates cause the economy to slow. Also, interest rates are important variables in many asset valuation models so valuations tend to be adjusted downward when rates rise and vice versa.

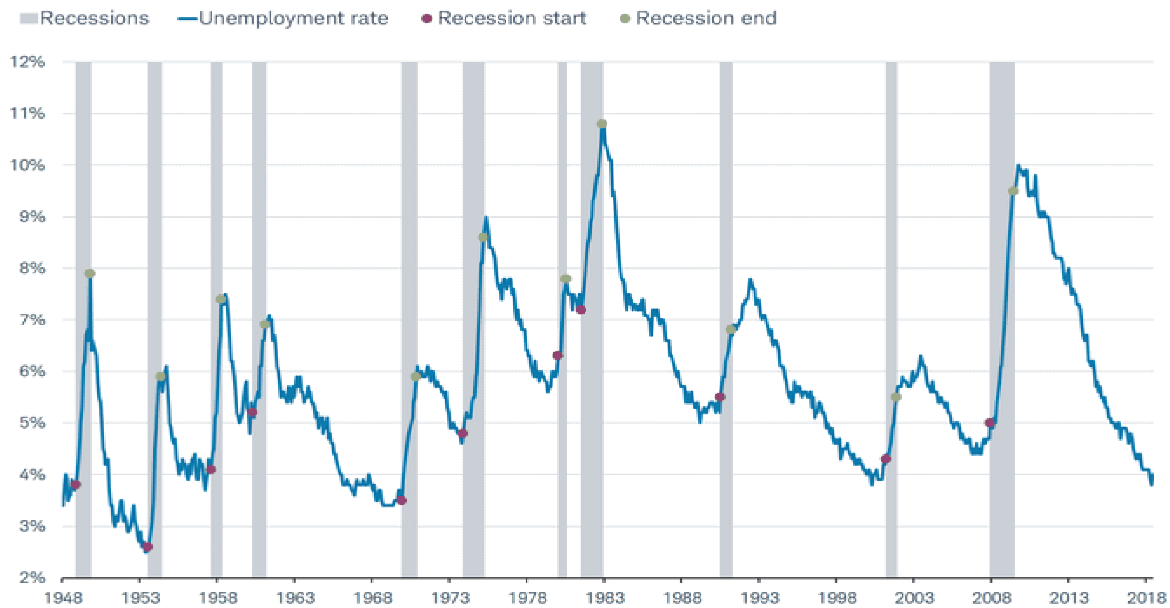
4. The next phase is more nebulous. One of Warren Buffett's famous quotes is "only when the tide goes out do you discover who's been swimming naked." If you look at the list above the naked swimmers include derivatives, too much leverage. Not listed is bad allocation of capital that often includes too much leverage, normally in real estate, technology, emerging markets….

What might be the catalyst for a bear market, recession this cycle? I can only make an educated guess: there is too much leverage with corporations, and the government; other areas of leverage include student loans and subprime auto loans; since 1987 derivatives have caused problems, some analysts think indexes (can be considered a derivative, the index is the derivative and the stocks in the index are the underlying assets) could be a problem as the major indexes are considered crowded trades. I've written about the problem of too much money going into ETF indexes.

Sometimes the bear market/recession catalyst is a black or grey swans (low probability but high impact events) e. g. 911, Gulf War 1, Gulf War II.

5. When the economy slows and the sins of the cycle are revealed corporations have a history of overreacting.

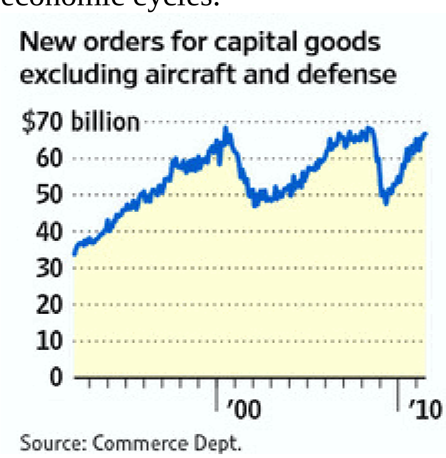
Corporations tend to lay off workers more than they have to. The chart below confirms this.



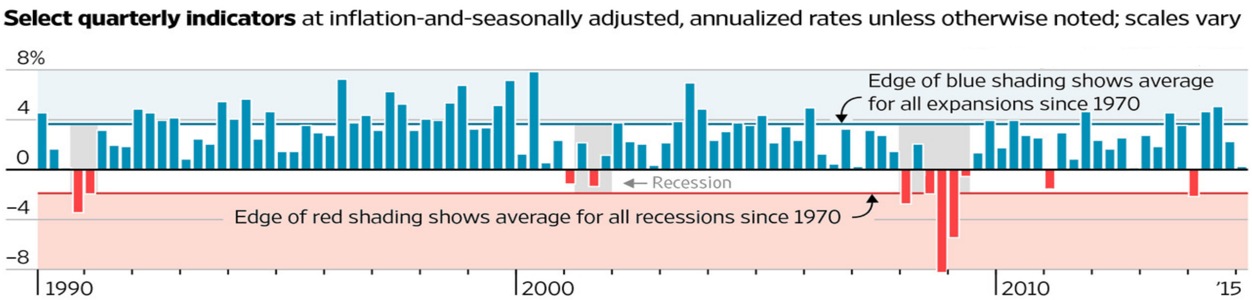
Source: Charles Schwab, Department of Labor, FactSet, as of June 30, 2018.

As the Great Recession started in 2008, unemployment went from about 4.5% to about 10% as layoffs accelerated.

Businesses also reduce their capital expenditures too much. The chart below shows the last two economic cycles.



In both cases capital spending declined close to 20%. The chart below shows that the contraction in the economy was about 8%. Again, businesses over reacted by laying off people and reducing capital spending more than they needed to. For investors, this is what you want them to do to protect their balance sheet, dividends and earnings.



Source: WSJ

All the negative news (layoffs, bankruptcies, contracting earnings, foreclosures, defaults) creates a negative feedback loop that causes weak prices until you find a low, valuations are compelling, and earnings visibility improves.

I will help you, the reader and my clients and my portfolio identify and explain each phase, especially when we're ready to invest for the next bull market cycle.

Summary and Conclusion

- Currently, there is more bad news than good news and the markets reflect this
- The last phases of a market, economic cycle include the mature and decline phase

In terms of technical/price analysis there are 4 last phases:
1. Major topping reversal pattern. Currently a top has been formed and it will probably be a rounding/umbrella top. It took over 12 months to build and the bearish pattern should be taken seriously.

2. Breaking support and the second leg down, we may have broken support December 17.

3. Finding a bottom

4. Establishing a basing pattern, the basing phase.

- **THE TIME TO START BUYING IS AFTER A LOW HAS BEEN MADE, AND DURING THE BASING PHASE. YOU HAVE PLENTY OF TIME TO POSITION YOUR SELF FOR THE NEXT BULL MARKET CYCLE.**
- Bear markets precede recessions. It's too late to adjust your portfolio when the recession arrives. The adage buy the rumor sell the news is true. There is still some good news out there where the market should rally. Use rallies to raise cash. Hopefully you were raising cash during the topping phase.

I will explain the other last technical phases of the market as we approach them. My Market Outlook will alert readers when it is a good time to buy, when valuations are cheap and there is less risk, and the outlook improves for the next cycle. Fortunately, the markets spend much more time in bull markets versus bear markets.

If you need help to analyze, review your current portfolio and position yourself for the next bull market, contact me at danhassey@yahoo.com.