2019 Market Outlook

Most analysts see more volatility in the markets as headlines will be a mix of good and bad news. Last year there was more good news than bad news, especially regarding GDP, earnings, and job growth, yet the markets were down. This year there may not be a balance of good news and bad news. If we don't get a trade deal by March 1st and the trade war with China gets worse, bad news could overwhelm good news.

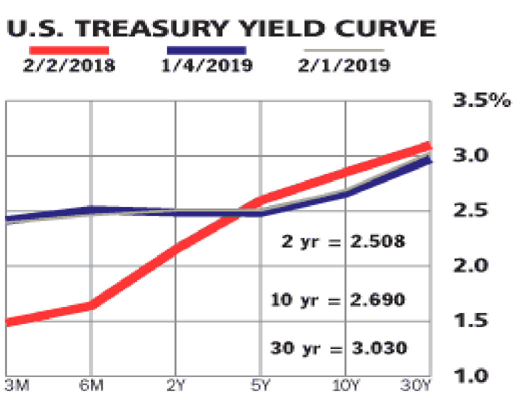
The markets rebounded in January. The main reasons for the rally include:

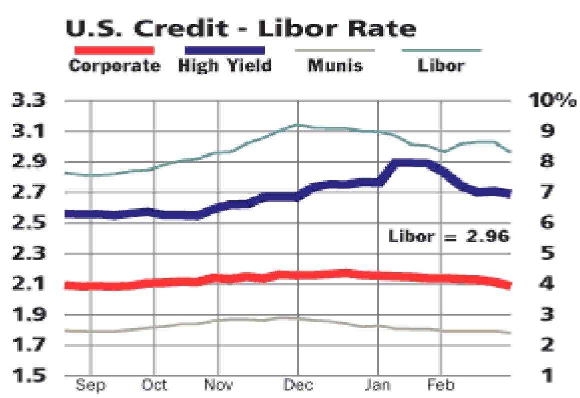
- Markets and stocks were undervalued and oversold. Bargain hunters were out in force
- Once the markets found a bottom in late December, bargain hunters, momentum players, trend followers and high frequency traders jumped on the rally.
- The latest Fed comments were dovish easing fears that there may be more rate hikes
- China announced they would be willing to make concessions and buy more U.S. goods
- Most investors believe there will be a U.S., China trade deal
- The yield curve and credit spreads improved

The current markets resemble last year's markets where bad news is ignored and the markets/stocks rally on good news. By the end of the year the markets took seriously the risks in rising rates and the global economy. The same could happen this year.

Bullish Case

- Growth momentum from tax cuts are expected to continue in 2019
- The Fed is on pause and we may only get one rate increase in 2019
- The yield curve and credit spreads have improved





Source: Barrons Statistics / Tullett Prebon

The first chart shows the yield curve with time period comparisons. Last year's curve is normal with short-term paper paying much less than long-term bonds. There is less risk and more certainty with one month paper versus a 30-year bond. When we see a yield curve that is inverted, long-term yields falling versus short-term rates rising, means that there are inflation worries causing short-term rates to rise, but the higher short-term rates cause the economy to slow down, so long-term rates fall anticipating a slowdown or recession. The yield curve is flat from 6 month to 5 year maturities, so the yield curve is telling us we're not out of the woods.

The 2nd chart shows the difference between high yield bonds, many high yield bonds are considered junk bonds, versus higher rated corporate bonds. When high yield bond yields are rising and higher rated bond yields are falling, tells us that investors are selling riskier, high yield bonds and are concerned about default risk and are buying higher rated, safer bonds. This was starting to happen the last few months, but both bond sectors yields are starting to fall as the economy is starting to weaken, but not enough to cause defaults – for now.

- There are still some portfolio managers and analysts that are bullish and are buyers of stocks and the markets. Many of them are interviewed on Fox Business and CNBC and they explain why they are bullish and how the market multiples could continue to expand causing the markets to reach new highs.

- The last few years I've explained how 401k investors and financial planners invest new money into the markets and are giving some support to the markets, especially at the start of the new year. We see this at the end of each day. See chart in the Price Analysis section.

- There is a market phenomenon of a huge amount of buying toward the end of the day. This is helping the current strong rally. See chart in the Price Analysis section.

- Most investors believe there will be a China, U.S. deal so investors have been bidding up the market and stocks.

President Trump and Chinese leaders are under lots of pressure to make a deal. Here is an excerpt from the WSJ:
"Top American business figures are pushing the Trump administration and its Chinese counterparts to compromise on a trade deal. Blackstone Group Chief Executive Stephen Schwarzman has been phoning Mr. Trump to warn that failure will undermine the economy and roil markets. At the same time, Mr. Schwarzman and other business leaders, including former Treasury Secretary Hank Paulson, are urging senior Chinese officials to make enough concessions to allow Mr. Trump to claim a victory, Bob Davis reports."

- Oil prices were higher last year, and if oil prices stay at current lower levels, it could help keep inflation lower and this could help consumers and the economy.

- Inflation has been staying low

The bullish case believes: there will be a China deal by March 1st, a positive Brexit deal will be made by the end of March, capital spending will increase, and animal spirits will come back. The bullish cash also includes P/E multiple expansion above 17.

Bearish Case

- The global and U.S. economy are slowing

- The markets are now slightly overvalued. See valuation section below

- The markets in January went up too far too fast. Just as fast as it went up, it can come down. See technical section below.

- The China trade war, negotiations is complex and concerns many issues (trade deficits, technology theft, reducing barriers to trade, China's military expansion in the South China Sea) and could take more time. The more time it takes, the more damage could be done to the global economy including the U.S.'s.

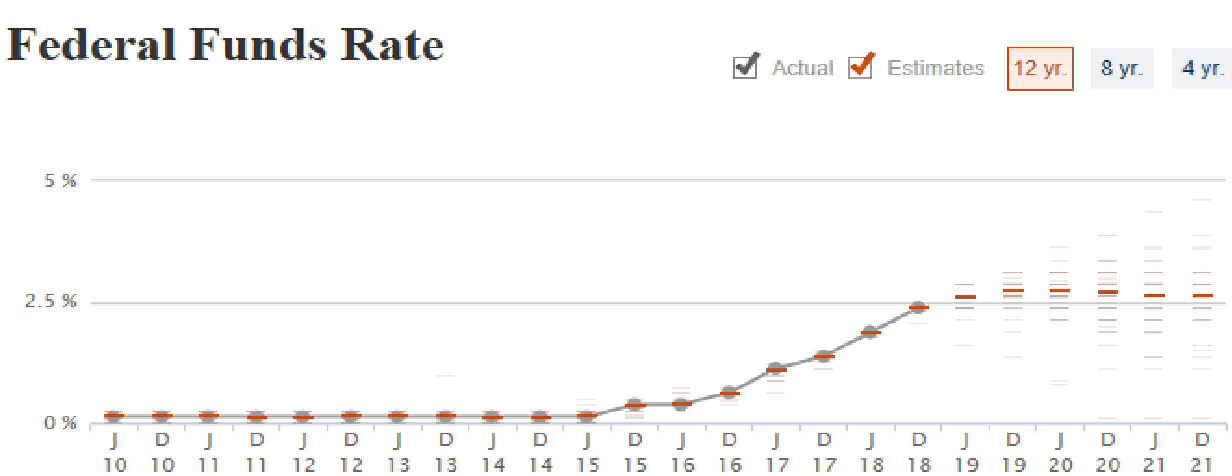
No one really knows what a trade deal will look like: a deal is done for the sake of a deal and not much will be accomplished, more time extensions will be made, no deal is made, tariffs go up to 25%, the Chinese agree to most of the U.S.'s demands....

- Earnings forecasts have fallen dramatically. Some analysts see an earnings recession. See valuation section.

- A lot of damage was done during the December's market decline. See technical section.

- The market and economic cycle are toward the end of its mature phase. The next is the decline, bear phase

- Rates are higher, and this changes valuations downward



Source: WSJ

The markets rallied when the Fed announced that they would be "patient" in raising rates. The markets may have over reacted to the news. The Fed has raised rates seven times since the end of 2015. For years the rate was an abnormally low of .25% and today they are around 2.5%, a large percentage increase. Most valuation models are based on interest rates. When rates go down, valuations go up, and when rates go up, valuations go down. Also, income producing investments yields go up, especially money market securities, giving the market, stocks competition.

- I have written about the impact of the Fed reducing its balance sheet and how disruptive it could be to the economy and the markets. More economists and analysts including the Fed see this risk so Chairman Powell said they would be flexible when it comes to reducing its balance sheet.

- We are starting to hear from the financial media that we are in the late economic and market cycle and the implications for investors is to expect more volatility and downside action, and the need to be cautious. Here are some of the signs of a late cycle economy: full employment; fed raising rates; inflationary pressures; too much debt (corporate, government) this late in cycle; big ticket items like autos and homes are slowing; the length of this economic cycle is close to 10 years, the average is about 5 years.

- Brexit needs to be resolved by the end of March. A hard Brexit, Great Britain leaves the EU without a deal, is possible. Most analysts believe this could cause a recession in the UK and slow the European economy even more.

- The dollar remains strong and will make our goods and service more expensive in the global economy. Also, there could be currency losses that could drag down earnings for our many international companies.

- Housing and autos have been struggling, two important components of the U.S. economy.

- Dysfunction in Washington

- Geopolitical tensions including Iran, North Korea, Russia, Yemen and increasingly Venezuela

- 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. See Price Analysis section and the impact of ETFs, mutual funds and the surge of buying near the market close.

- 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

In my 2019 Economic Outlook, I listed other risks investors and analysts are concerned about. Some of the risks are listed above. Click here to read the list starting on page11. Here are a few of the risks below:

- Populism
- Cyberattacks
- Mueller Report
- President has too many balls in the air (China, North Korea, Russia, Iran, Venezuela, U.S. economy, immigration, healthcare…) and the mishandling of these important issues is possible.
- Black or grey swans

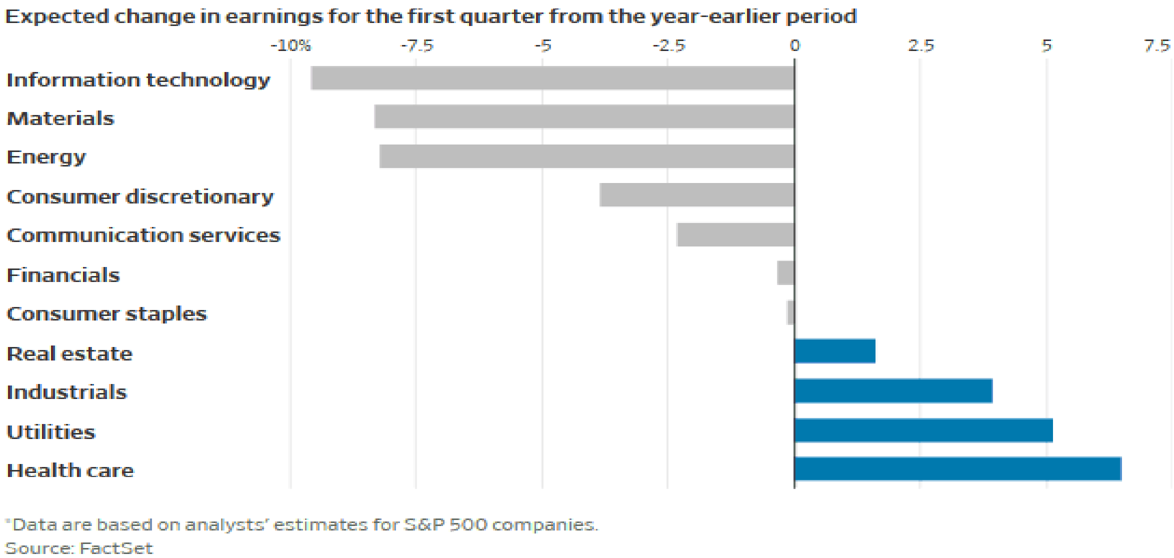
There are several dates that investors need to pay attention to:

- The budget and border wall needs to be negotiated and settled by February 15th
- Debt ceiling needs to be raised by March 1st
- If there is not a trade agreement with China by March 1st, the U.S. may increase tariffs to 25% on $250 billion of China's exports to the U.S.
- March 29, Great Britain is expected to start the process of leaving the EU

We will eventually go into a recession, and the question is, how will we get out of it? Normally, the Fed will lower rates by about five percentage points, but rates are not high enough to bring down to be stimulative. Our debts and deficits are too high for tax cuts and government spending that is also normally used to stimulate the economy when we are in a recession. Our debts and deficits could get much worse because of tax cuts, baby boomers retiring in large numbers and unemployment insurance will increase. In other words, expenses will rise and revenues will drop and this could make the recession much worse and may last longer than most recessions.

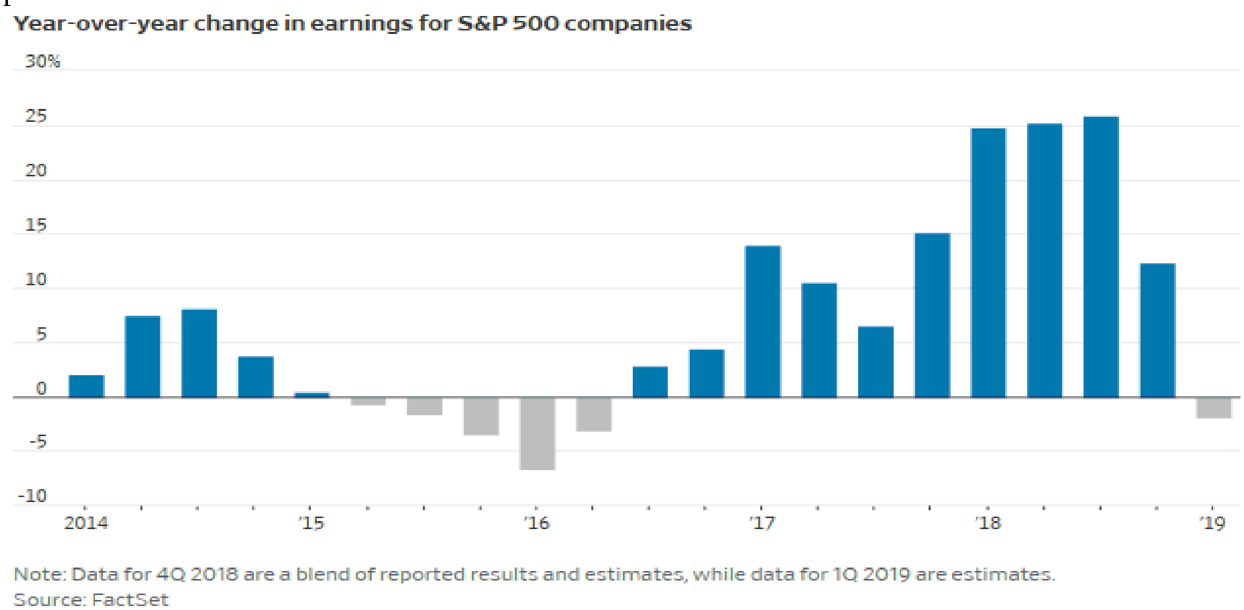
Price Targets for Markets

Last year S & P earnings growth was over 20%, but the markets were down for the year, this is telling us something. Even though earnings growth was very good, they were mostly due to the tax cuts and the good earnings growth would not be sustained. Analysts are expecting 1st quarter earnings to be negative.



Only two sectors are expected to have earnings more than 5% in the first quarter.

Some analysts expect earnings may get better toward the second half of the year. Some analysts believe we could have an earnings recession, similar with what we went through in 2015, and a portion of 2016:



If we have an earnings recession the markets will struggle.

Here is my target forecasts for the market:

2019 FORECAST					
	EARNINGS ESTIMATES	P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1662.83	15	**24,942.45**	24,999.00	-0.23%
SPX	171	16	**2,736.00**	2,704.00	1.17%

Source: Source: Thomson Reuters, Barron's

The markets are fairly valued, but as I explain above, earnings could be revised lower and this means lower markets and stock valuations. One of the main reasons I update my price targets every month is because I know earnings are constantly being updated, especially after earnings season.

Last year I recommended using a lower, moderate P/E because earnings were based on the tax cuts and are not organic earnings growth I also recommend a lower P/E this year because of earnings downward revisions and a potential earnings recession is on the table, and it makes sense to use a lower P/E at the end of a cycle.

Price and Technical Analysis

Below is the technical analysis of the current market:

Source: www.erlangerchartroom.com

There is a lot to this chart, let’s break it down:

- The markets have been stuck in a trading range for about 1½ years
- I placed a note where the market is at my price target, fair value. The price target could go lower if earnings estimates continue to go lower.
- The red lines indicate major resistance, where participants tend to sell.
- The purple trendlines have switched from support to resistance to support again. For now the purple trendlines are support. If prices breach these support levels, the support levels will normally become resistance.

- Major support is the black dashed trendline

- The breaking of the 200-day moving average is serious as it is a long-term indicator. It was broken convincingly last December. It broke above last month, but was not able to stay above. The direction of the 200-day moving average is neutral to bearish as it has a slight downward bias.

- When there is a major fall in prices, you will normally get bargain hunters buying, then the trend followers, momentum players and high frequency traders will also start buying causing a rally. I highlighted this action by the three rectangles in the chart. Again, a rally after a major fall is normal.

- Also notice in these rectangle price action areas that the rally is quick and almost a 90 degree angle. These rallies go up too fast and too much. Just as fast as they go up they can come down. Never trust rallies that move in 90 degree moves, they're not sustainable, and is a sign of speculation not serious investing.

- The market may be stuck in the current long-term range. At lower levels the markets become undervalued attracting value investors. At levels above the price target the market becomes overvalued and this could lead to selling and some investors staying away because of high valuations.

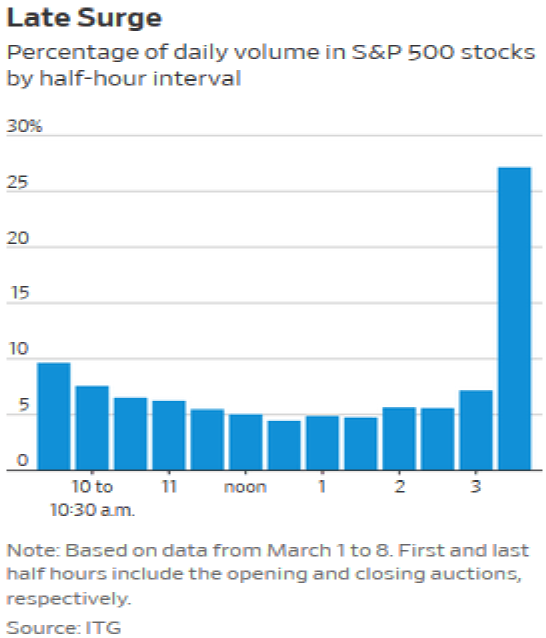
- This rally reminds me of the rally we had during the summer earnings season where investors are ignoring bad news and rallying hard with good news.

The other phenomenon that I see that is helping the markets is 401k, financial planners, pension funds, and others are buying at the end of the day:

Source, Schwab Street Smart Edge

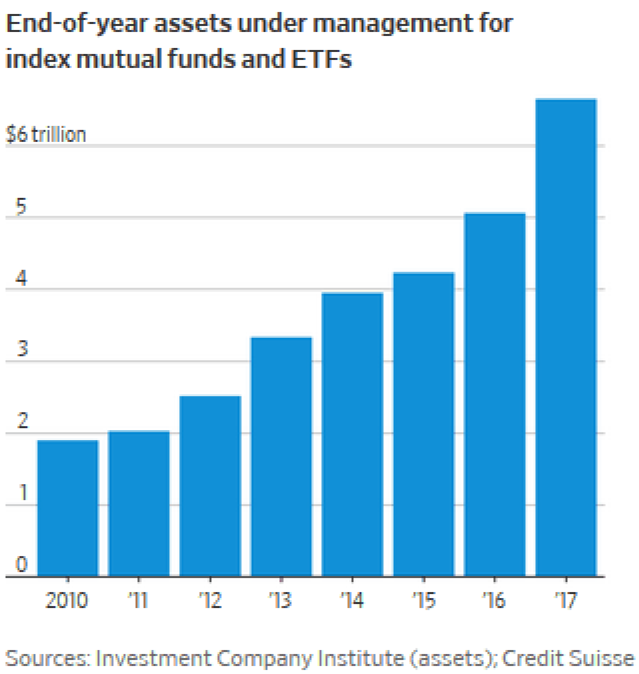
The chart shows strong buying at the end of each day, probably by 401ks and financial planners as they invest in ETFs and mutual funds that tend to place their buy and sell orders at the end of the day.

Below are more charts that confirm market price action on the final half hour of the market.



The chart above shows that about 26% of the day's volume occurs at the last half hour of the market.

The chart below shows the amount of money that passive ETFs have under management:



ETF assets have exploded for the last 10 years.

Buying at the end of the day is helping the current market rally and has been occurring the last few years.

Can the markets test the lows of last year, certainly if we have an earnings and economic recession.

Conclusion & Summary

- At best, the markets will probably be stuck in the current trading range. At the bottom of the range, stocks look cheap, at the top of the range stocks would be expensive.

- The bulls believe that there will be a China deal with the U.S., there will not be a hard Brexit, and the Fed will pause and be flexible regarding monetary policies

- Most economists and analysts believe there is enough momentum from the tax cuts to continue economic growth and job creation. Economists have a poor track record of calling major inflection points.

- There could be many outcomes to a China deal, but the uncertainty is slowing the global economy. The more time it takes to make a deal with China, the more damage could be done to the global economy and markets.

- There is growing list of risks and concerns of investors: geopolitical, too much debt, deficits are growing, deadlines if not resolved could cause more volatility, populism, cybersecurity, the Mueller report and the president's legal and political problems.

- Most economists and analysts realize we are in the late stages of this economic and market cycle.

- Earnings estimates have fallen from around 10% growth to negative growth for the first quarter. Some analysts believe the earnings recession could last much of the year, others believe earnings could improve toward the end of the year.

- Expect more volatility this year.

This will be a good trading market. I will stick to trading stocks that are in bear markets and basing, I will also have a high level of cash to take advantage of the next bull market.

If you would like to have a second opinion on your portfolio, I do provide a free portfolio review, including up to three full stock analysis including price targets and fundamental and technical analysis. Feel free to contact me at danhassey@yahoo.com.