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U.S. Equity Market Report

November 2019

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Quote

Quotes or book excerpts that I find particularly insightful…

"The complexity of the world in which we live exceeds our capacity to comprehend it… In situations that have thinking participants, the participants' view of the world is always partial and distorted… these distorted views can influence the situation to which they relate…

I contend that situations that have thinking participants have a different structure from natural phenomena... the difference lies in the role of thinking. In natural phenomena thinking plays no *causal* role and serves only a cognitive function. In human affairs thinking is part of the subject matter and serves both a cognitive and a manipulative function… when both functions operate at the same time they interfere with each other by depriving each function of the independent variable that would be needed to determine the value of the dependent variable… when the independent variable of one function is the dependent variable of the other, neither function has a genuinely independent variable… the cognitive function can't produce enough knowledge to serve as the basis of the participants' decisions. Similarly, the manipulative function can have an effect on the outcome but can't determine it. In other words, the outcome is liable to diverge from the participants' intentions. There is bound to be some slippage between intentions and actions and further slippage between actions and outcomes.

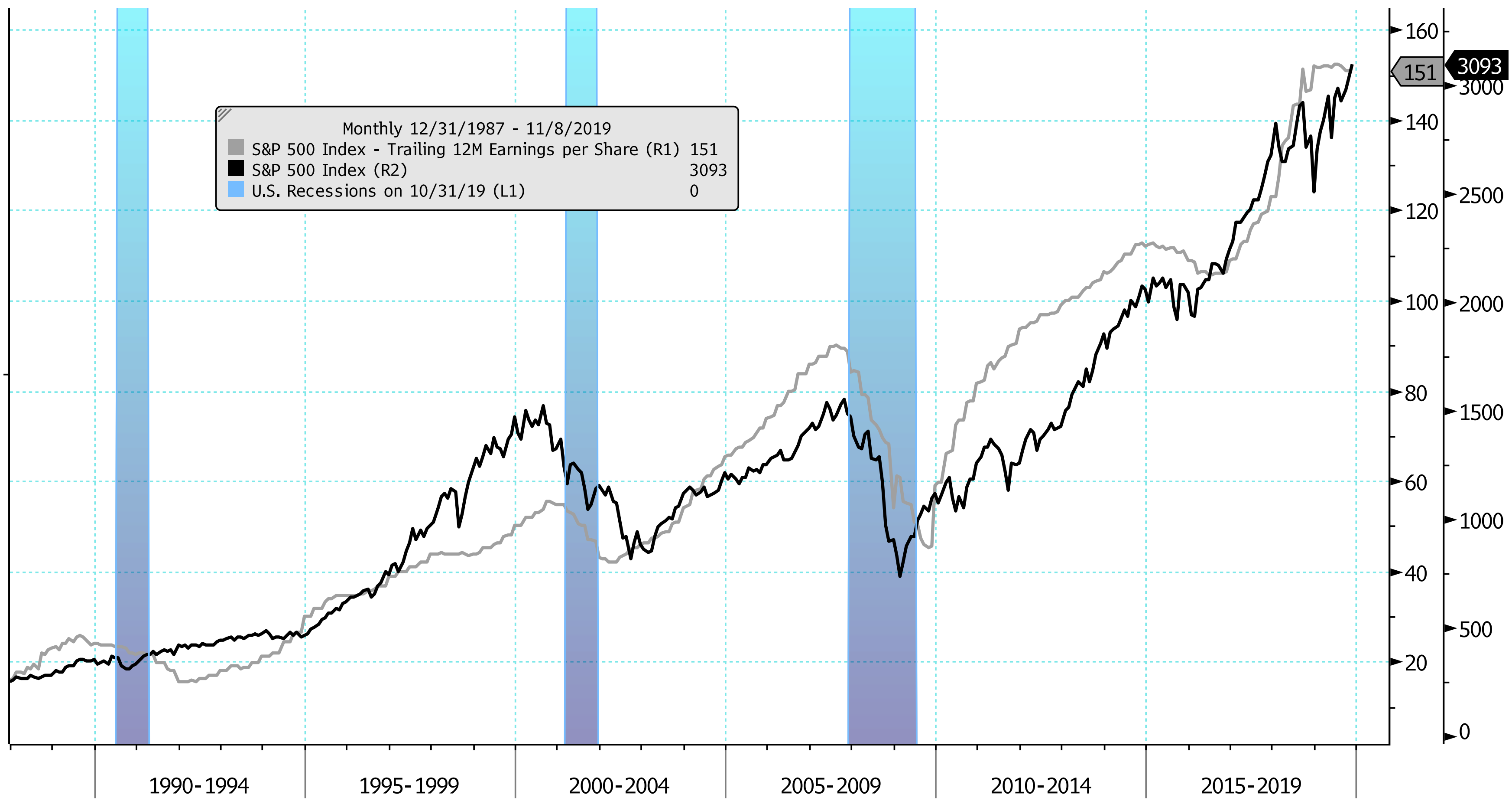
As a result, there is an element of uncertainty both in our understanding of reality and in the outcomes of events… By contrast, in the case of natural phenomena, events unfold irrespective of the views held by the observers. The outside observer is engaged only in the cognitive function and the phenomena provide a reliable criterion by which the truth of the observers' theories can be judged. So the outside observer can obtain knowledge. Based on that knowledge, nature can be successfully manipulated. There is a natural separation between the cognitive and manipulative functions. Due to their separation, both functions can serve their purpose better than in the human sphere…

Interestingly, both Karl Popper and Friedrich Hayek recognized, in their famous exchange in the pages of *Economica*, that the social sciences cannot produce results comparable to physics… the subject matter of the natural and social sciences is fundamentally different… What is attainable in social science falls short of what is attainable in physics."

-George Soros, from University Lecture Series

Earnings Backdrop

S&P 500 Trailing 12-month Earnings per Share and the S&P 500

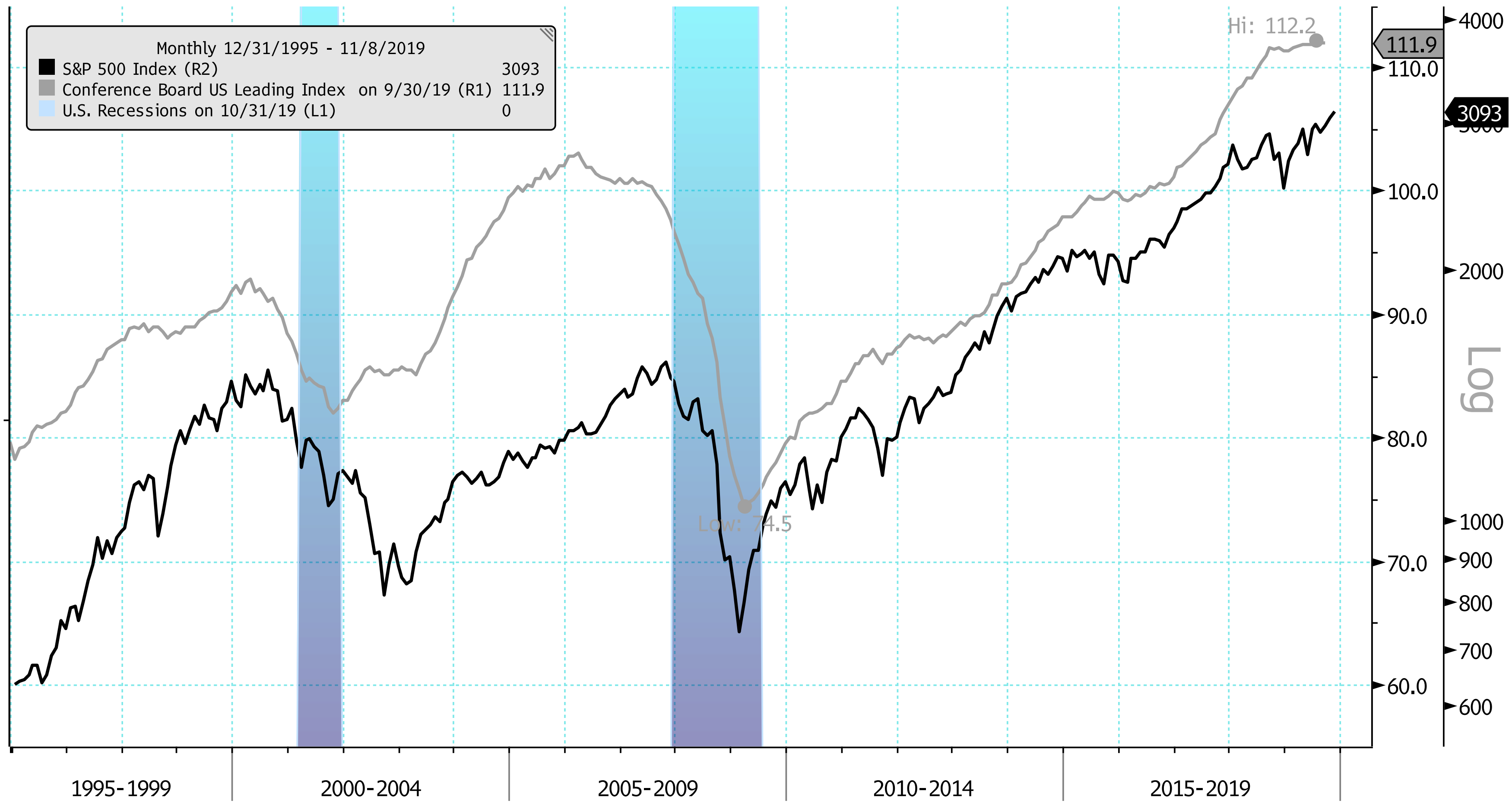


Source: © Merk Investments, Bloomberg

Analysis: S&P 500 trailing earnings have been trending slightly lower over the past couple of quarters. According to Factset analysts are projecting earnings growth of 0% for calendar year 2019 (a slightly lower forecast relative to last month's report), and projecting10% earnings growth in calendar year 2020 (a slightly lower forecast relative to last month's report). I'm currently negative on this picture. Chart Framework: I'd get incrementally positive if the trailing 12-month earnings moved back up over consecutive quarters (QoQ), i.e., two or more quarters. It's worth noting that this framework may be more of a coincident or confirmatory rather than a leading indicator with respect to a major market top.

Business Cycle Backdrop

Leading Economic Indicators (LEI) Index and the S&P 500



Source: © Merk Investments, Bloomberg

Analysis: The LEI Index was slightly down for September and is currently a little below cycle highs; however, this picture generally remains positive. Chart Framework: I'd get incrementally negative on the outlook for the S&P if the LEI Index began trending down on a YoY basis while the S&P was at or near bull market highs.

Global Growth Backdrop

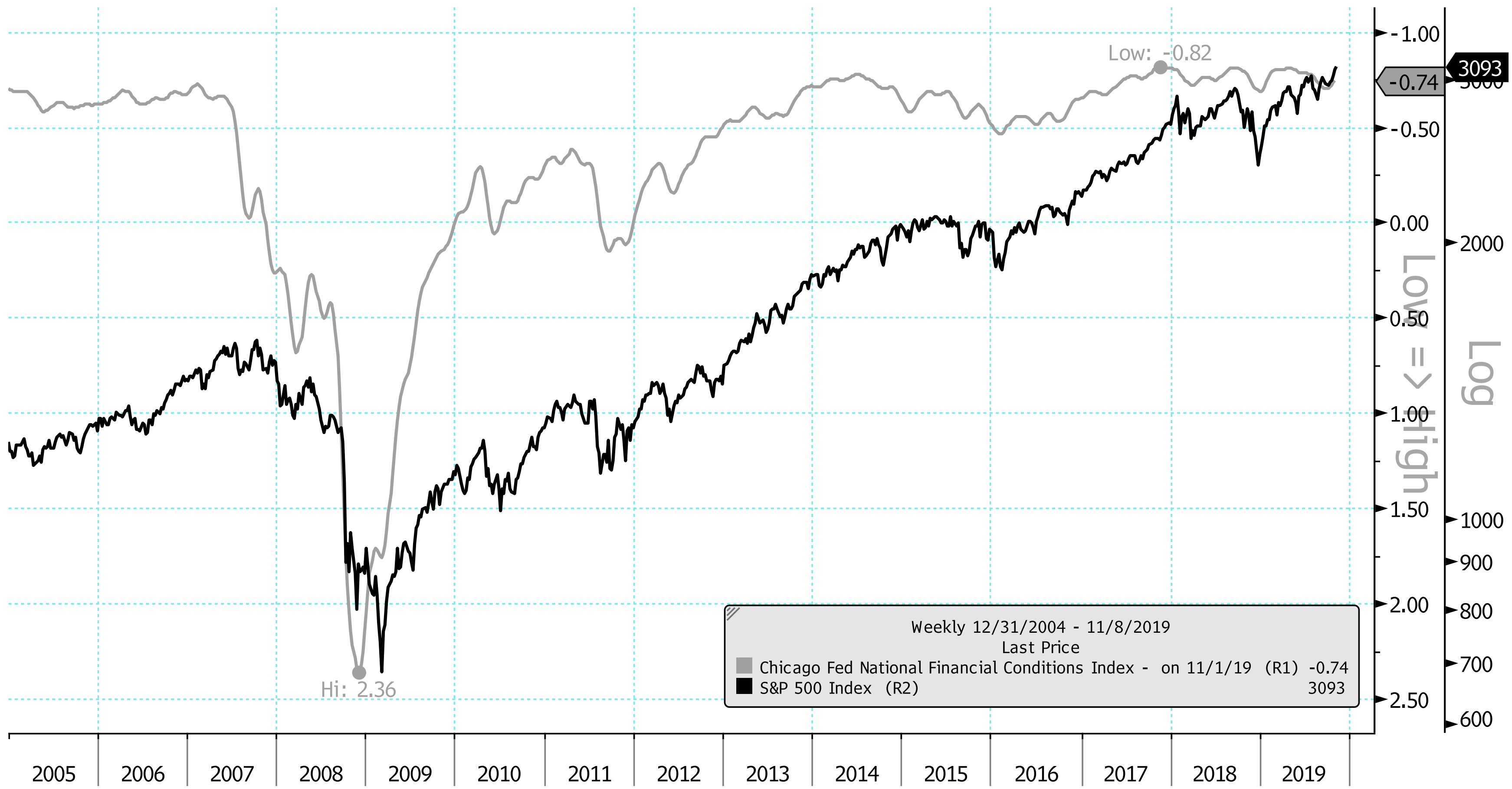
Large Economy Manufacturing PMIs (Purchasing Managers Index) and the S&P 500

Source: © Merk Investments, Bloomberg

Analysis: Manufacturing PMIs were mixed over the past month. The U.S. and Germany ticked up, but all readings remain below 50.
Chart Framework: I'd get positive if all readings move above 50.

U.S. Financial Conditions

Chicago Fed National Financial Conditions Index and the S&P 500



Source: © Merk Investments, Bloomberg

Analysis: Financial conditions have eased slightly over the past month, currently at -0.74. Financial conditions are relatively loose and generally supportive of the stock market. Chart Framework: I'd get incrementally negative on the outlook for the S&P if financial conditions moved through the -0.50 level.

S&P 500 Market Breadth

S&P 500 Index and the S&P 500 Cumulative Advance-Decline Line*

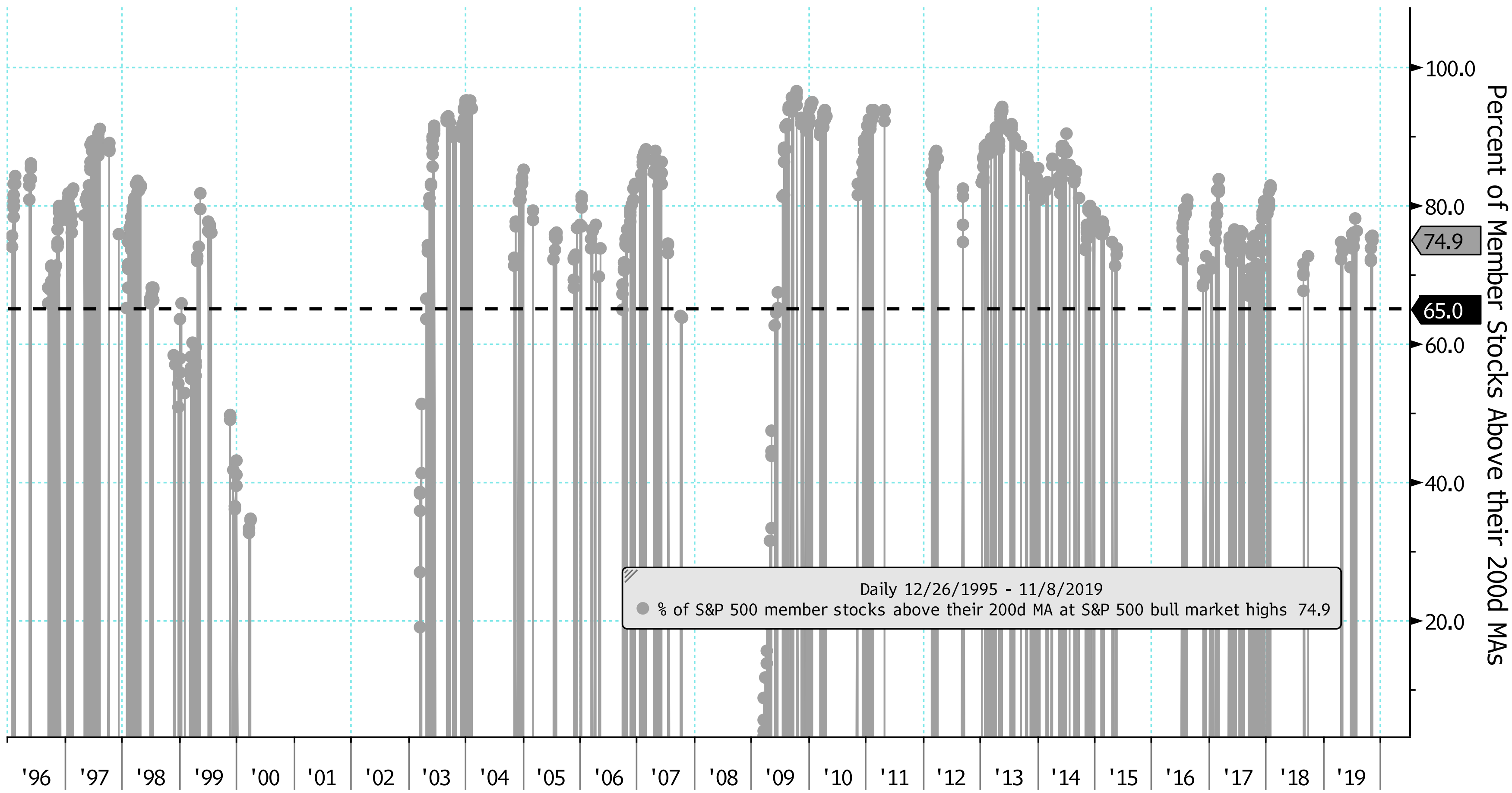
Source: © Merk Investments, Bloomberg

Analysis: The cumulative advance-decline line for the S&P 500 has continued to make new all-time highs, which suggests continued broad participation in the bull market. I'd get cautious on this picture if there was a divergence in which the S&P 500 was making new all-time highs but the cumulative a/d line was not.

**The cumulative a/d line is a daily series that takes the previous cumulative a/d line value and adds the number of daily advancers (i.e., the number of S&P 500 member stocks that gained in price on the day) and subtracts the daily decliners (i.e., the number of S&P 500 member stocks the declined in price on the day). For example, if 276 member stocks were up for the day, and 224 member stocks were down for the day, the cumulative a/d line would move up by 52.*

Market Breadth

Percent of S&P 500 member stocks above their 200d Moving Averages when the S&P 500 Makes a New Bull Market High

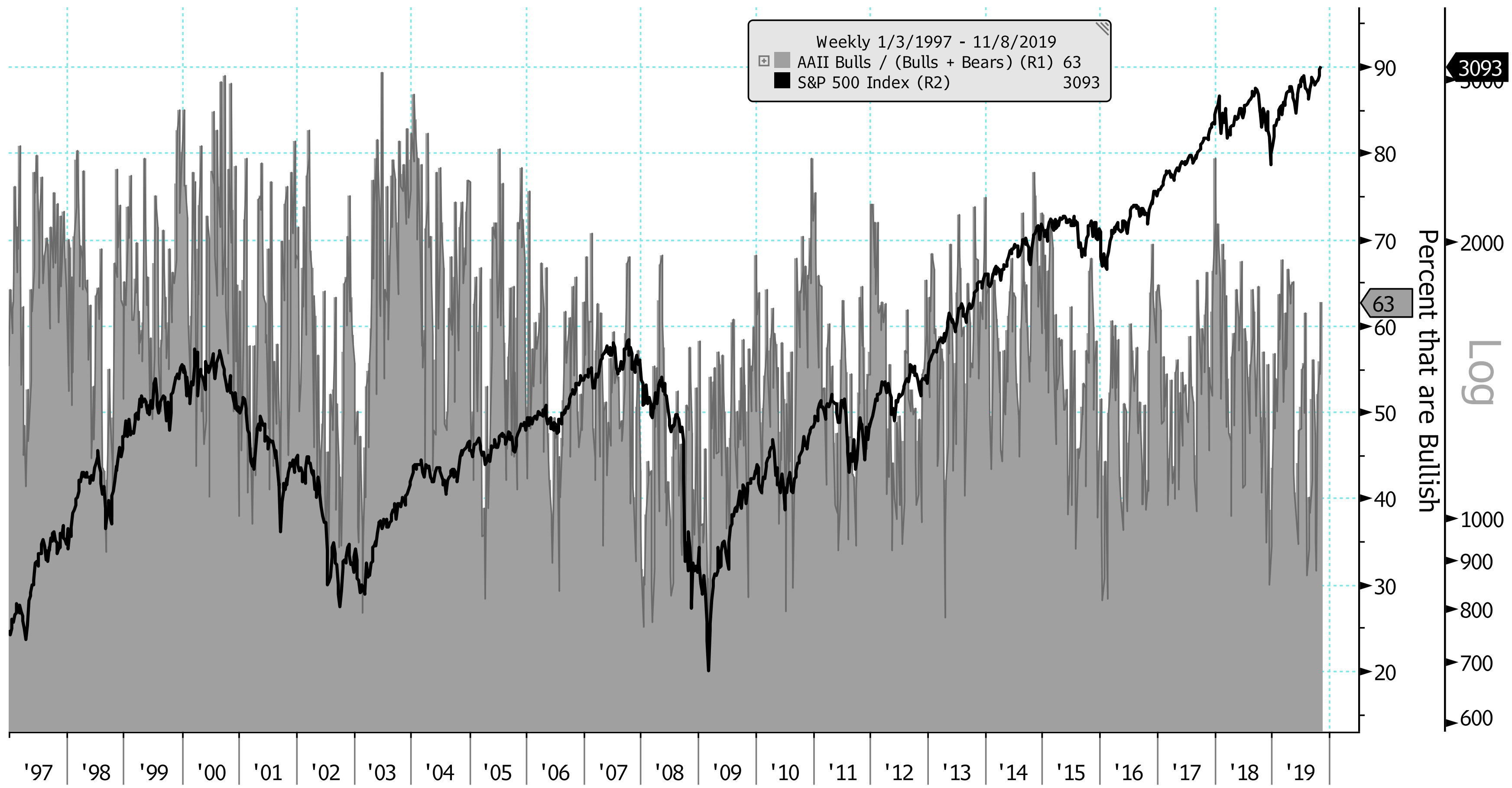


Source: © Merk Investments, Bloomberg

Analysis: Breadth at the most recent bull market high (11/8/2019) was at 75%, above the 65% warning level—a positive sign for the bull market. There is a gradual long-term decline in breadth that is apparent in this picture, from 2009 to present, which is to be expected as the bull market ages. Chart Framework: I'd get incrementally negative on the outlook for the S&P if the S&P made new bull market highs with breadth below 65%.

Market Sentiment

Percent that are Bullish (bulls / bulls+bears) and S&P 500

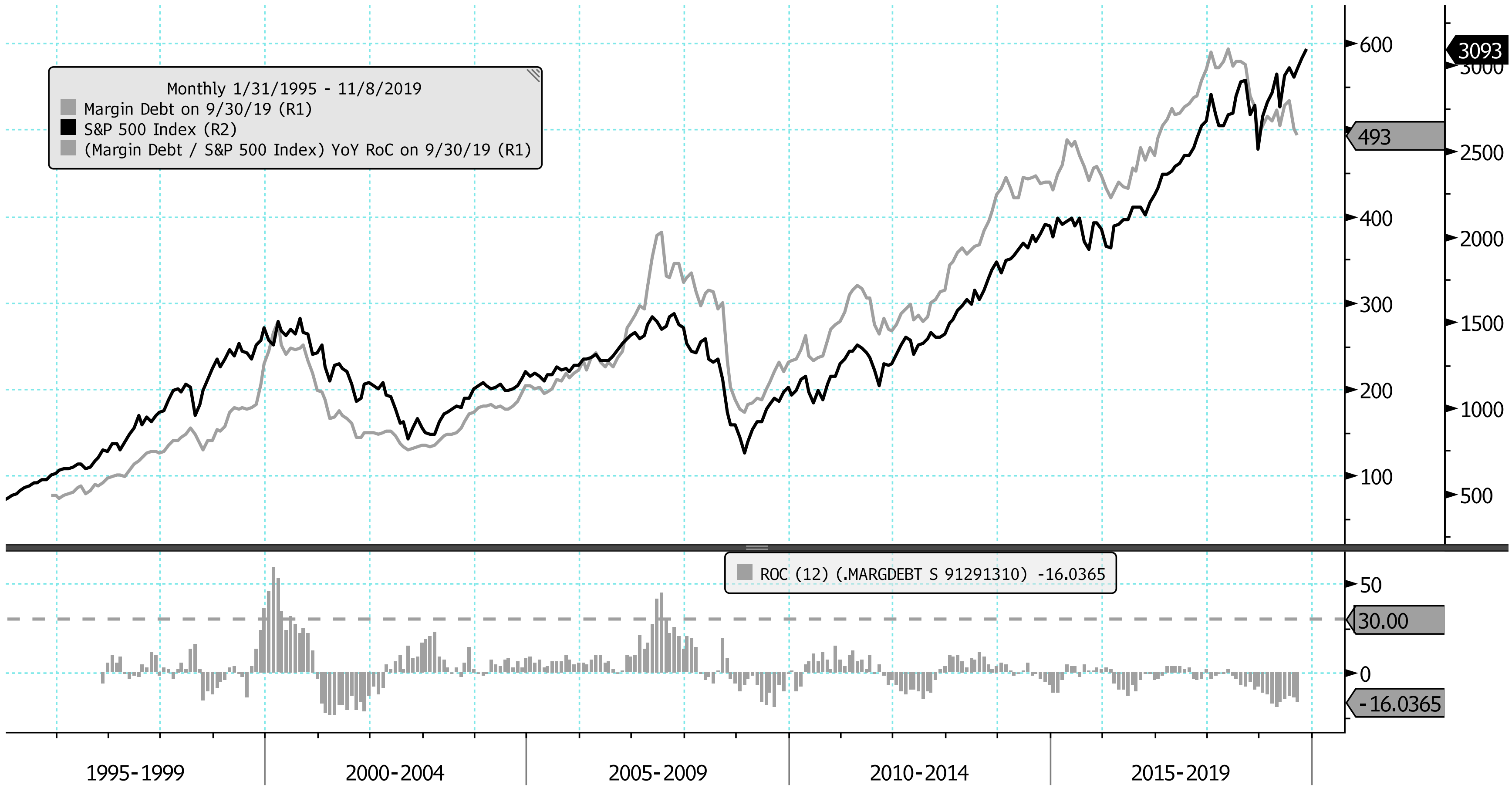


Source: © Merk Investments, Bloomberg

Analysis: Bullishness is currently relatively high. In my view this chart should be looked at from a contrarian perspective, particularly at extremes. Given that bullish sentiment is relatively high my interpretation of this chart is neutral/negative for the market. Chart Framework: I'd get incrementally negative on this picture with sentiment near or above 70 and incrementally positive with sentiment near or below 30. The neutral range is between 40 and 60.

Margin Debt

Margin Debt and S&P 500 (top panel), 12 month change in Ratio of Margin Debt / S&P 500 (bottom panel)

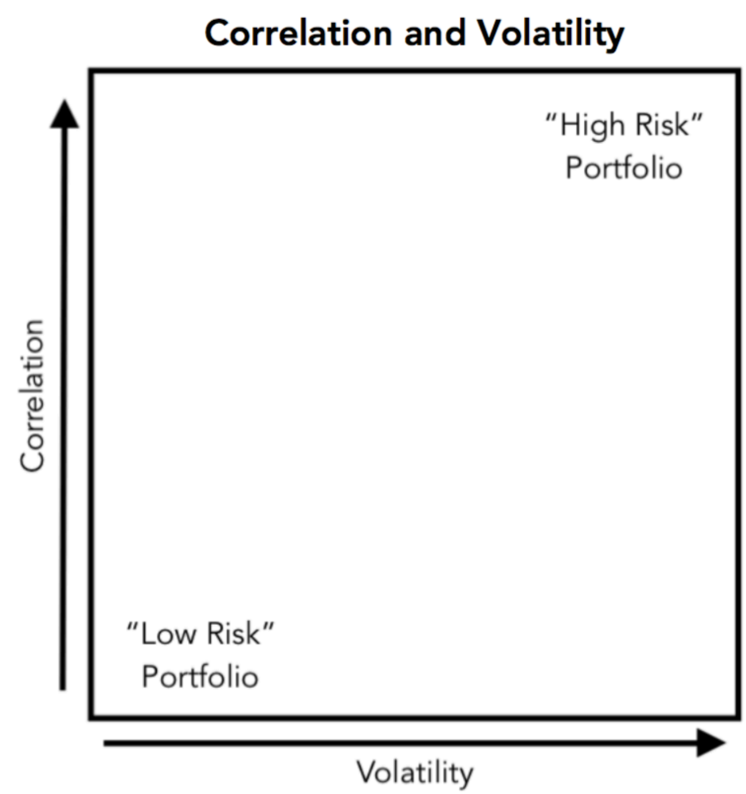


Source: © Merk Investments, Bloomberg

Analysis: In the previous two major market tops for the S&P 500 (2000 and 2007), margin debt rose significantly relative to the equity market, possibly reflecting the euphoric phase of the bull market, or long positions switching from strong hands (unlevered) to weak hands (levered). Currently margin debt is not rising relative to the stock market (bottom panel), perhaps supportive of the idea that the bull market isn't over. Chart Framework: I'd get incrementally negative on the outlook for the S&P if YoY rate of change of the ratio (bottom panel) moved above 30.

Correlation and Volatility Framework

On the below diagram Correlation rises along the vertical axis from bottom to top, and Volatility rises on the horizontal axis from left to right

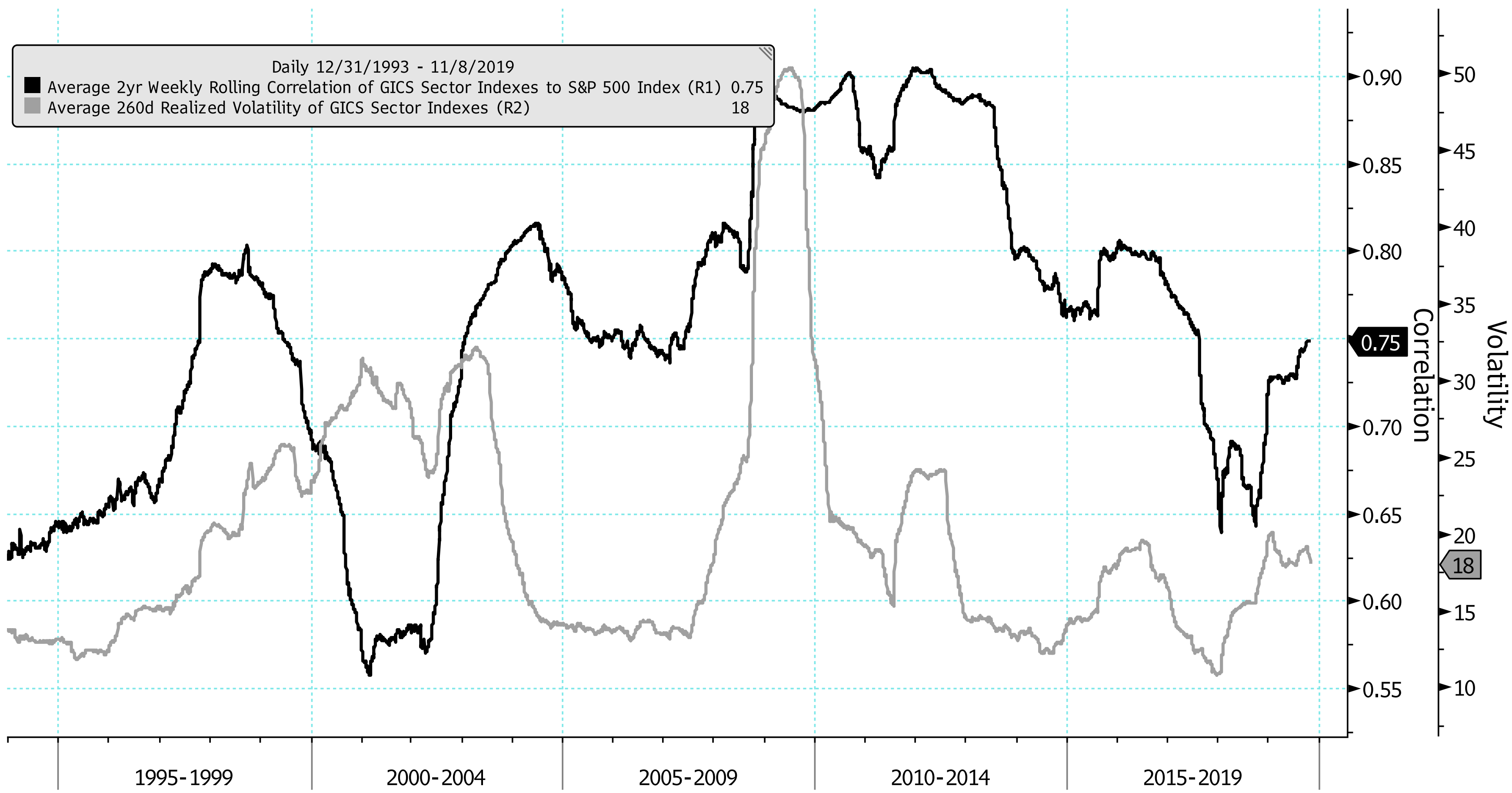


Source: © Merk Investments LLC

Analysis: This is a very simple diagram to help visualize how volatility and correlation relate to the conventional concept of portfolio risk. Volatility measures how much movement an individual asset has relative to itself, and correlation measures how much movement an individual asset has relative to other assets in a portfolio. For a given portfolio, the lower the volatility of each individual asset and the lower the correlation between the assets, the "lower risk" the portfolio as measured by portfolio standard deviation—and vice versa for high volatility and high correlation. Counter-intuitively I would argue that longer-term investors might want to think the opposite way—that is, to become cautious when asset portfolios appear low risk and consider opportunities when asset portfolios appear high risk. To paraphrase Warren Buffett: it's better to be fearful when others are greedy and greedy when others are fearful.

S&P 500 Correlation and Volatility

Avg. 2-yr Correlation of GICS* Sector Indexes to the S&P 500 Index and Avg. GICS Sector Index 1-yr realized volatility



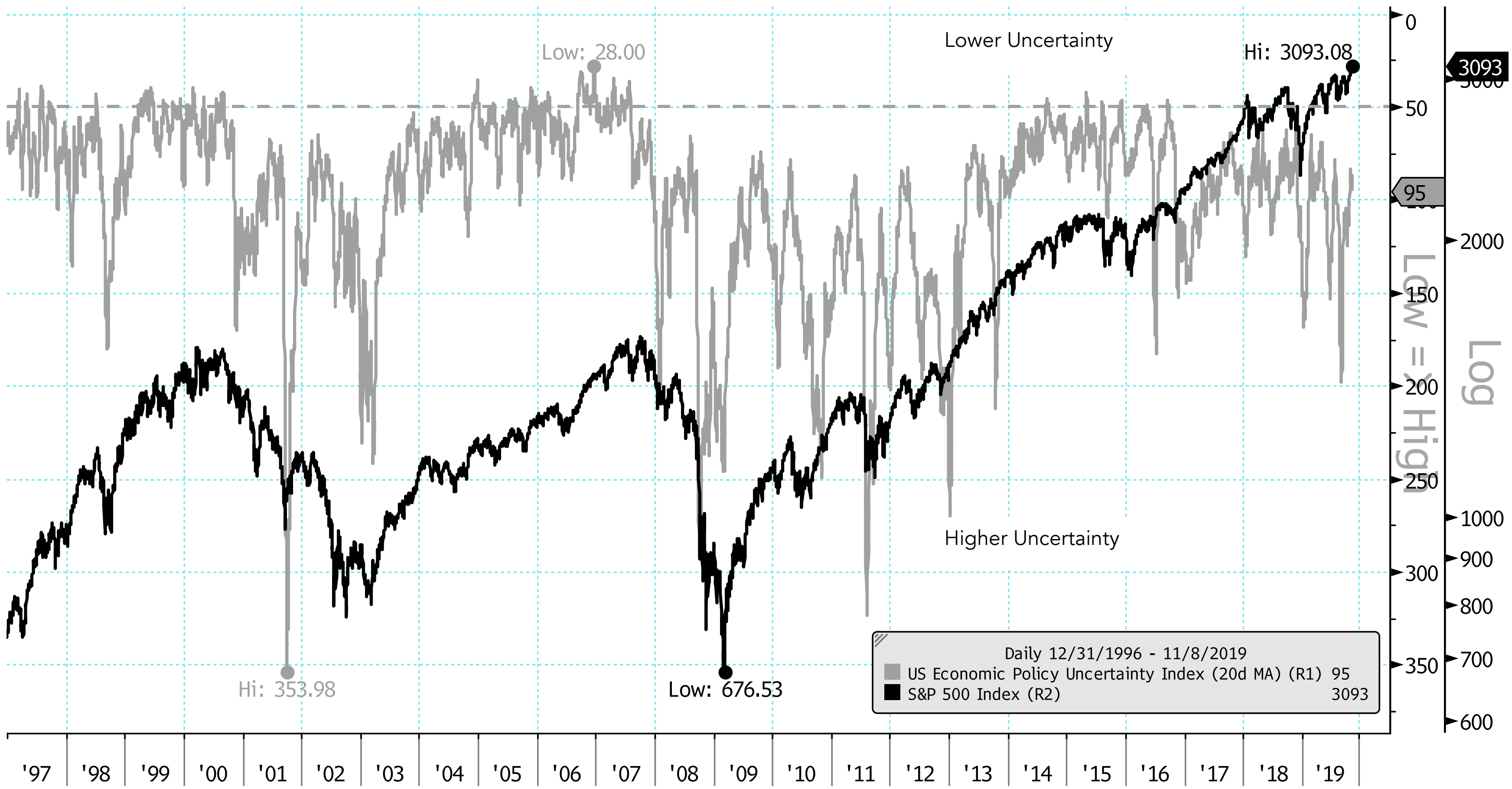
Source: © Merk Investments, Bloomberg

Analysis: Correlation appears to be trending sideways/higher while volatility appears to be trending sideways/lower, from a higher level after having moved up over the past couple years. In my view this chart should be looked at from a contrarian perspective, and currently suggests a somewhat neutral outlook medium-term as both correlation and volatility are near their long-term averages. Framework: S&P 500 subsequent medium-term returns are likely to be most attractive when both correlation and volatility are high and have lots of room to decline, for example in 2009.

**GICS = Global Industry Classification Standards. The 10 sectors used for this analysis are: Consumer Disc., Consumer Stap., Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services, and Utilities. In 2016 Real Estate was added as an 11th GICS Sector, which had been part of the Financials sectors. The S&P 500 stocks are each assigned to a sector. The correlation reading (black line) represents the average of all sector correlations to the S&P 500 (i.e., Correlation between Financials and S&P 500 + Correlation between Energy and S&P 500 etc., divided by 10). The volatility reading (grey line) represents the average the sector volatilities (i.e., Volatility of Financials + Volatility of Energy etc…., divided by 10)*

Uncertainty

U.S. Economic Policy Uncertainty Index and S&P 500

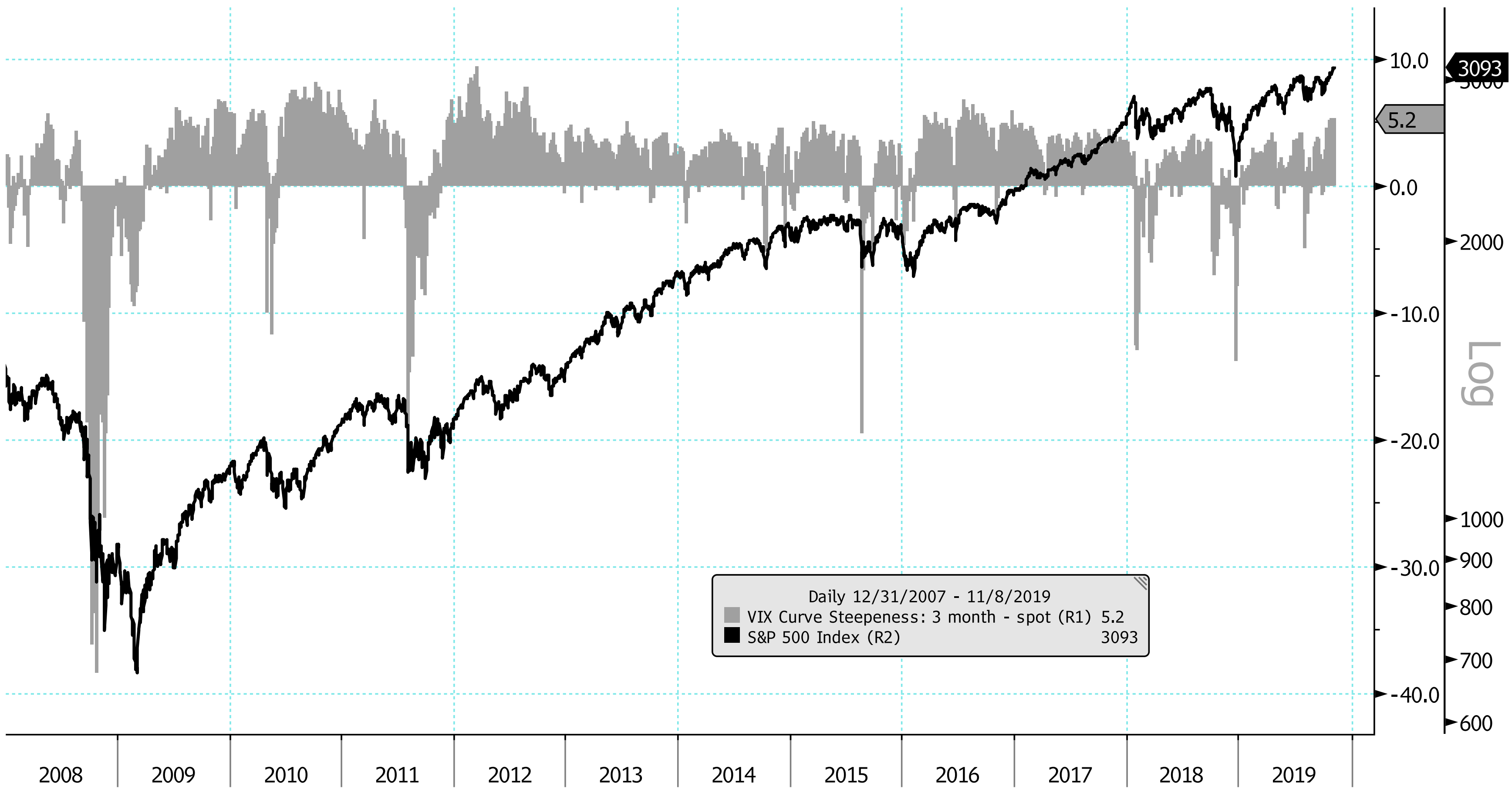


Source: © Merk Investments, Bloomberg

Analysis: There is likely still some "wall-of-worry" left to climb before the bull market ends. Uncertainty has decreased somewhat recently (inverse axis), having previously increased, but isn't currently near the warning level. Counter-intuitively I would argue that uncertainty is generally a positive for the market on a forward-looking basis as it gives uncertainty more room to decline going forward. As the expression goes: if you wait for an all clear signal you'll buy at the top. Chart Framework: I'd get incrementally negative on the outlook for the S&P around the 50 level on policy uncertainty.

VIX Curve

(3-month futures implied VIX minus spot VIX) and S&P 500



Source: © Merk Investments, Bloomberg

Analysis: The VIX curve is currently positively sloped, meaning future expected VIX is higher than the current VIX (VIX represents an estimate of the 30-day implied volatility of the S&P 500). In my view when the VIX curve is negative a market drawdown phase is likely still ongoing, when positive it may suggest the correction is over for the time being. Chart Framework: In my view this chart is best used for judging when drawdown periods might be over. If a negatively sloped VIX curve (i.e., grey area below zero) persisted that could be a sign of stress remaining in the market.

S&P 500 Technicals

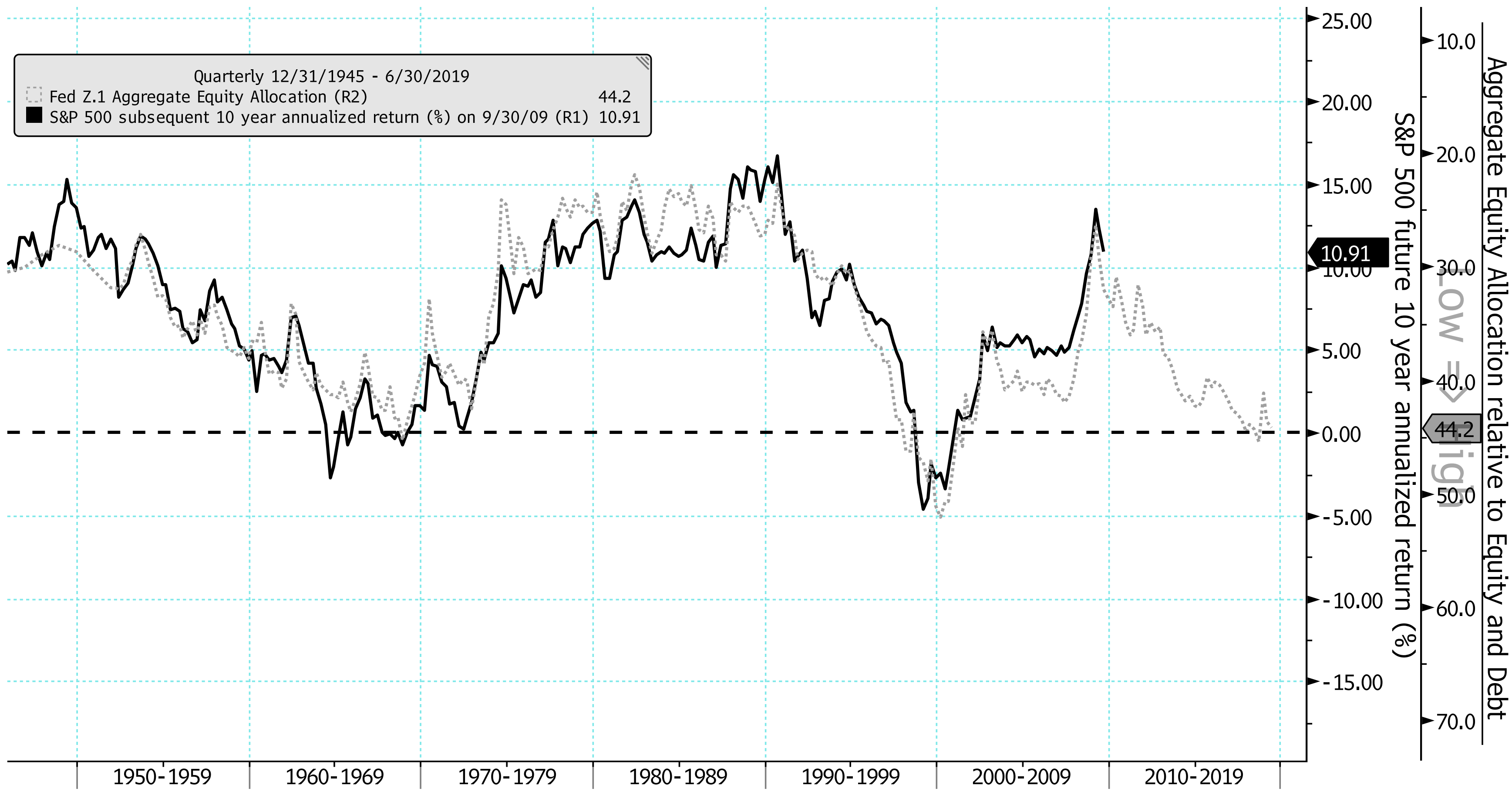
S&P 500 daily open-high-low-close chart with 50-day and 200-day Moving Averages (MA)

Source: © Merk Investments, Bloomberg

Analysis: The 50-day moving average (grey line) is above the 200-day moving average (black line). The market is generally making higher highs and higher lows. My current interpretation of this picture is positive. Chart Framework: I'd get negative if the S&P 500 appeared to be making lower highs and lower lows and if the 50d MA crossed below the 200d MA.

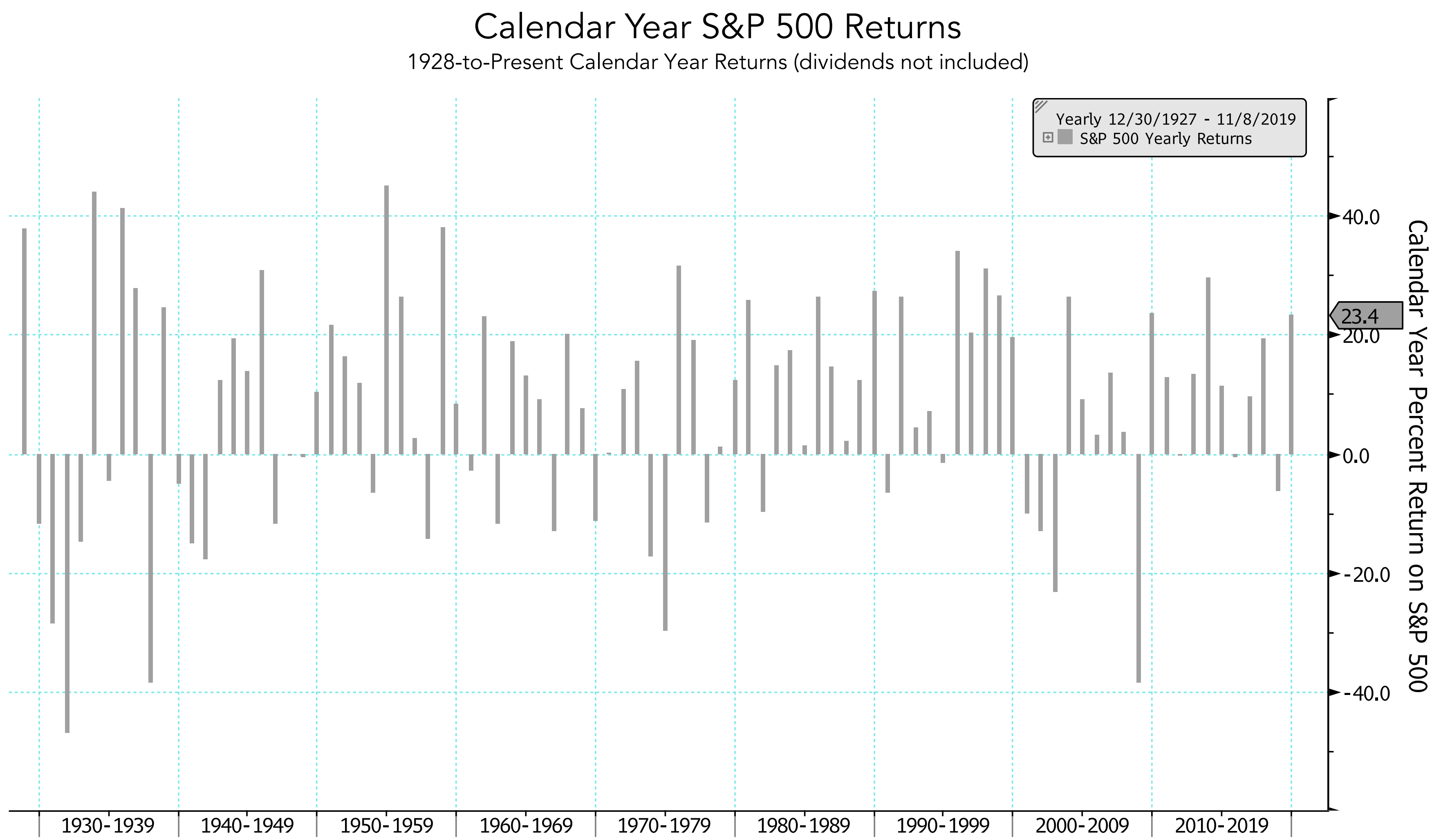
S&P 500 Valuation Indicator

Aggregate Equity Allocation Proxy (From Fed Z.1 Report) and S&P 500 Subsequent 10 year annualized Returns



Source: © Merk Investments, Bloomberg

Analysis: If history is any guide, this chart suggests annualized S&P 500 returns (w/o dividends) might be in the low single digits annualized over the coming 10-year period. The grey dotted line is the market value of US equity divided by the total market value of US equity and debt, which is used as a proxy for aggregate equity allocation. At 44.2% the equity allocation is relatively high currently. The data comes from the quarterly Federal Reserve Z.1 report, the series will be updated next in late December. Chart Framework: I'd likely get positive on the longer-term outlook for the S&P 500 at an allocation below 30%, which would likely only be after a substantial bear market.



Source: © Merk Investments, Bloomberg

Analysis: As of 11/8/2019 the S&P 500 is about +23% year-to-date. Coming into 2019 sell-side forecasts were for a 10% to 20% return this year. From 1928 to 2017 the S&P 500 average annual return was 5.7%, (w/o dividends) but the S&P 500 returned between 0-10% in only 15 of those 90 years (17% of the time); in other words average years are actually rare. 51% of years had returns above 10%, and 32% of years had negative returns. It may be worth noting that the S&P 500 is up over 10% in most years.

Checklist

Chart	Time Horizon	Per Framework Characterization
Earnings	Short/Medium Term	Negative
Business Cycle	Short/Medium Term	Positive
Global growth	Short/Medium Term	Negative
Financial Conditions	Short/Medium Term	Positive
Market Breadth	Medium/Longer Term	Positive
Market Sentiment*	Short/Medium Term	Neutral/Negative
Margin Debt*	Medium/Longer Term	Positive
Correlation/Volatility*	Medium/Longer Term	Neutral
Uncertainty*	Medium Term	Positive
VIX Curve	Short Term	Positive
S&P 500 50d v 200d MA	Medium Term	Positive
Valuation	Long Term	Negative
	Time Horizon	**Overall Characterization**
	Short Term (<6 months)	Neutral/Positive with medium uncertainty
	Medium/Longer Term (6m-5years)	Neutral/Negative with high uncertainty

*contrarian indicators

Conclusion/Thoughts

As expected, the market recently made new all-time highs. My base-case scenario remains that we are in an ongoing bull market, with new all-time highs on the S&P 500 likely to continue.

The breadth readings at the most recent all-time high (11/8/19) were historically inconsistent with a major market top, and suggest the path of least resistance is still higher. Specifically, the new high was confirmed by the cumulative advance-decline line and the equally-weighted index both making new all-time highs, and a healthy percent of member companies trading above their respective 200-day moving averages (75%).

Also, the business cycle backdrop and financial conditions generally remain positive for the U.S. equity market. The "Phase One" U.S./China trade appears to be progressing, with discussion of tariff reductions. Hard Brexit risks seem to be receding. Both developments are positive for the economic outlook. Perhaps related, there are some signs that the global slowdown in manufacturing, and in the auto sector specifically, may have bottomed. Monetary policy has become supportive: the Fed is now increasing its balance sheet again (at $60b/month), the European Central Bank has reintroduced QE (at 20b EUR/month), and the Bank of Japan has consistently continued QE. As a result of recent actions, the overall size of the G3 (US, Eurozone, and Japan) central bank balance sheet is making new all-time highs.

Some sentiment readings look a little stretched near-term; however, the current buoyant sentiment is consistent with the breakouts from the 2011-2012 market consolidation and from the 2015-2016 market consolidation. Advances won't be in a straight line and pullbacks should be expected.

What keeps me cautious on the medium to longer-term (roughly 1-5 year) outlook is the high overall equity allocation, which suggests high valuation and relatively low expected returns on average over the next ten years.

-Nick Reece, CFA

About the Author

Nick Reece, CFA: Nick is a Senior Analyst and Portfolio Manager at Merk Investments. He focuses on macroeconomic research and private wealth management, regularly publishing reports on the U.S. business cycle and equity market. Prior to joining Merk in 2012, Nick gained experience working on capital markets deals with Paul Hastings in Hong Kong, and with Atlantis Investment Management. Mr. Reece holds a B.A. in Economics from Trinity College and is a Chartered Financial Analyst (CFA) charterholder. Nick lives in New York City. Outside of work, he is an avid reader and volunteer high school math tutor. You can follow Nick on Twitter @nicholastreece.

Disclosure

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