WEALTHSHIELD

January 22nd, 2019

BULL TRAP

Are we in a typical bull trap? According to Investopedia, a bull trap is as follows:

"A bull trap is a false signal indicating that a declining trend in a stock or index has reversed and is heading upwards when, in fact, the security will continue to decline. The move "traps" traders or investors that acted on the buy signal and generates losses on resulting long positions. A bull trap may also be referred to as a whipsaw pattern."

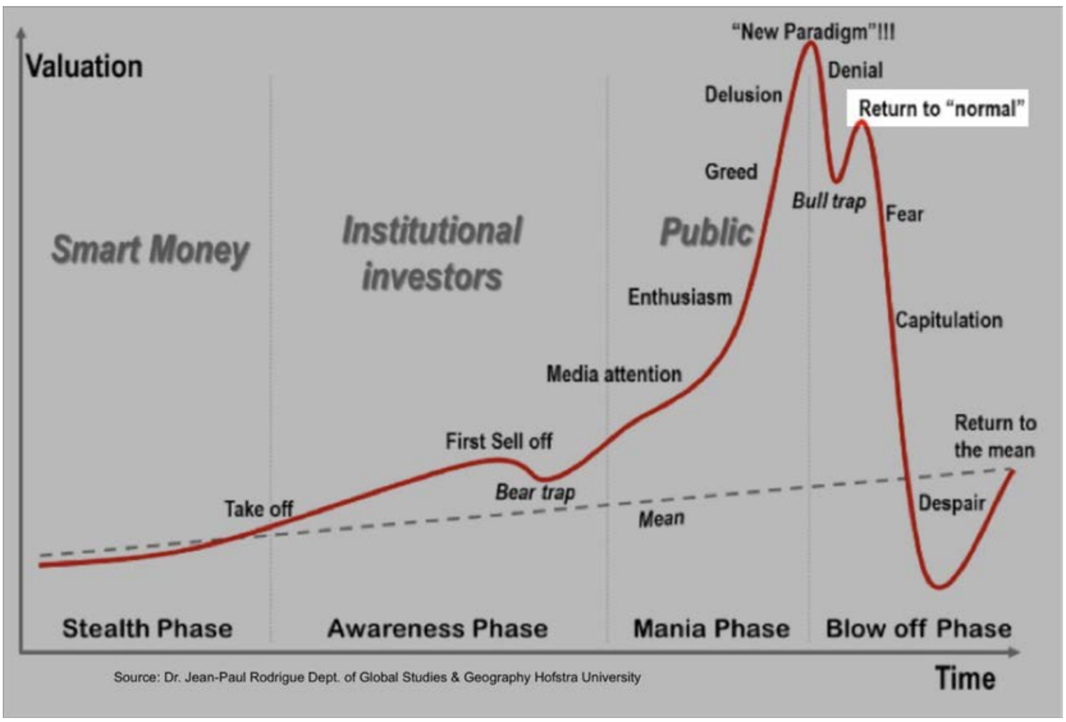

Chart 1: Classic Bull Trap and the Return to Normal

We can only answer this question in hindsight. The truth, at the end of the day, is that no one knows. Our goal is to use a quantitative framework to ascertain where probabilities suggest we are headed next. There is always randomness, chance, and uncertainty. Just because probabilities suggest that the odds are in favor of a particular outcome, doesn't mean that outcome will occur.

Our framework uses valuations, market sentiment, economic growth, and fed policy to determine probable direction in capital markets. Accordingly, the evidence suggests that what we are experiencing in equities markets is a typical headfake, or bull trap. What that means going forward is that stock markets globally are still likely susceptible to a higher volatility regime. We are not implying that markets have to crash, although many have already done that. What we are suggesting is a defensive posture on the margin: focus on managing risk, not enhancing returns.

Valuations still suggest that returns are going to be well below average. If you look at US Household Equity Holdings versus subsequent stock market returns, the proposed market returns over the coming 10 years should be far below average. The path is unknown, and that is why valuations are only a quarter of our framework. Nevertheless, they indicate a late secular cycle environment.

Chart 2: US Household Equity Holdings versus Subsequent Stock Market Returns; Source: TheAtlasInvestor.com

Market trends still suggest that sentiment is progressively deteriorating. However, we have seen an impressive improvement in trend indicators since the end of 2018. If we get continued improvement, we would expect the trend component of our framework to change to green (positive) from the current red (negative) condition.

Chart 3: HY spreads remain in a new positive trend (widening). However, they have pulled back considerably since the start of the year. Since the end of 2018, high yield spreads have pulled back from 5.37% to 4.40%. We want to see continued improvement in spreads (tightening), indicating a new potential upward track in growth.

The US stock market (Wilshire 5000) is still below the 10 month exponential moving average. January has been an impressive month, but the market is still in a negative long-term trend. A monthly close above the 10 month moving average would suggest a move back to a positive long-term trend in the US stock market. We cannot rule out that option, bearing in mind the positive sentiment behind trade optimism and newer, less-constricting Fed policy. The Wilshire 5000 index is up over 7% for the month, as of Friday's close.

Chart 4: Wilshire 5000 Composite Index

International markets (MSCI All World ex-US) are also below the 10 month moving average, suggesting a negative market trend. The snapback, as in the US, has been impressive. The international markets are up over 5% this month. Nevertheless, international stock markets are a lot further from moving back into a long-term positive trend (closing above the 10 month moving average).

Chart 5: MCSI World (ex USA) Index

Economic growth and inflation continue to indicate that we are in the midst of a deceleration. First, the good news. The Citigroup Economic Surprise Index has turned up and is declining at a slower rate. Also, the Economic Cycle Research Institute Weekly Leading Index ticked up last week by 0.3% to -6.2% year over year. Additionally, industrial production improved in December, climbing 0.3% month over month.

The not-so-good news is that the preponderance of the data still suggests that growth and inflation are slowing, despite short-term improvements. The Citigroup Economic Surprise Index is still below 0, showing that data continues to surprise to the downside. The rate of growth in industrial production has slowed since September, and the ECRI Weekly Leading Index is down -6.2% year over year, indicating a strong slowing trend in US growth. The University of Michigan Consumer Confidence survey also plunged last month, and is down to 90.7 from a previous 98.3.

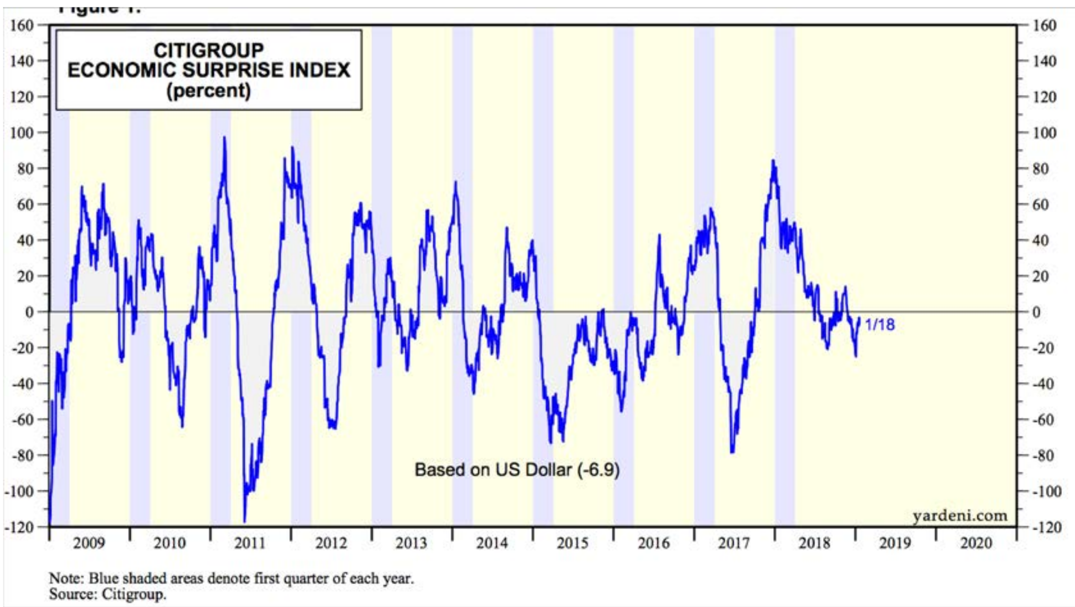

Chart 6: Citigroup Economic Surprise Index; Source: Yardeni.com

Chart 7: Industrial Production index down from the peak year over year growth rate of 5.6% in September; Source: www.tradingeconomics.com

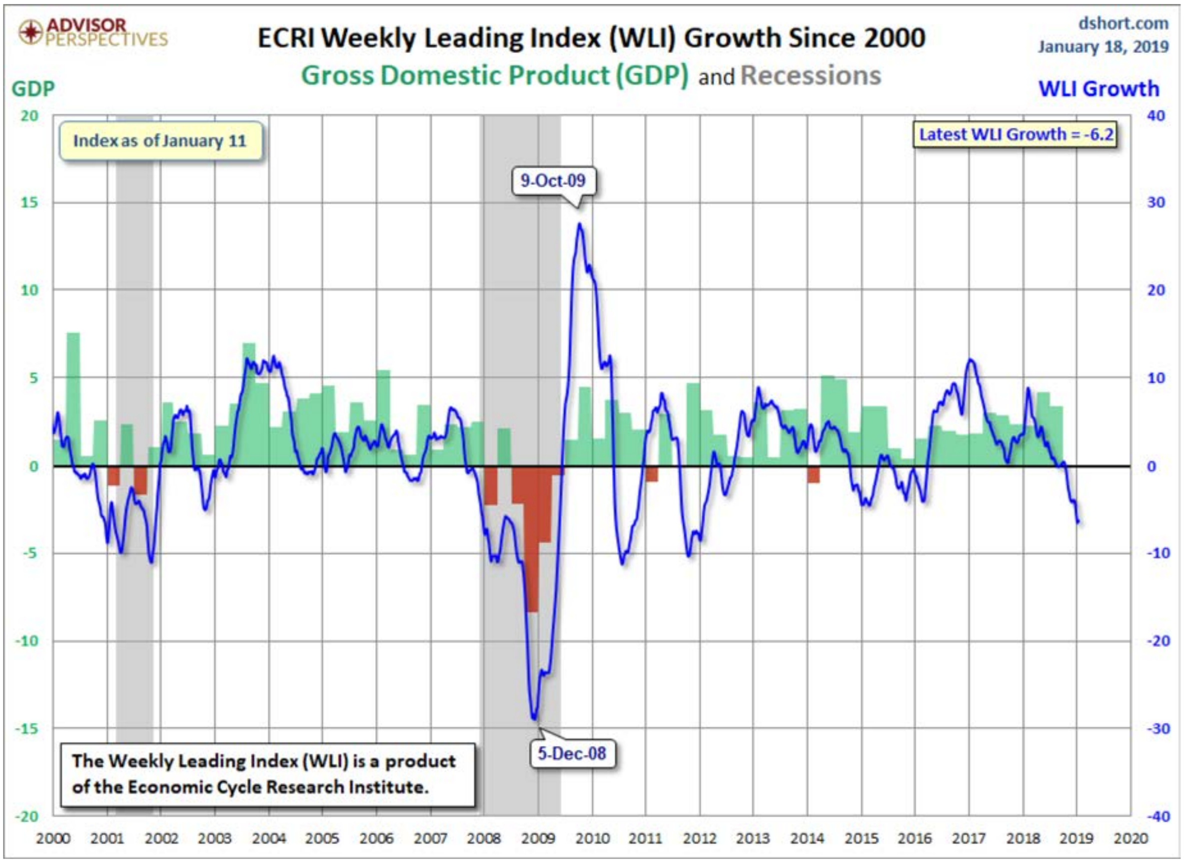

Chart 8: ECRI Weekly Leading Index

Chart 9: University of Michigan US Consumer Sentiment

The producer price index came in below expectations, declining -0.2% month over month, reiterating the fact that inflation is slowing currently. With oil prices rebounding strongly to start 2019, the dollar softening, and Tips rallying against Treasuries, we may see inflation data pick up in the coming months. We should be on the lookout for a shift into a growth slowing, inflation accelerating regime.

Chart 10: Inflation expectations are picking up.   Are we heading into a growth slowing and inflation rising regime?

If we do move into a regime where growth continues to slow and inflation is accelerating, this may put the Fed in a difficult position. If they pause interest rate hikes and communicate further data dependency (easing), we may run the risk of having inflation breaching their target rate. If the Fed tightens policy to challenge the current inflation, they may force growth down further. Dealing with both growth and inflation slowing together is less difficult, in our opinion, than when growth is slowing and inflation is accelerating. It will be interesting to watch, that is for sure.

The Fed has been reducing the size of their balance sheet during this tightening phase (also known as quantitative tightening, or QT). We anticipate that they will stop quantitative tightening if the data continues to deteriorate. This will be the next arrow in their quiver for controlling the business cycle. If growth gets much worse, the Fed will most likely start communicating rate cuts.

There has been a direct correlation between the Fed's balance sheet and the S&P 500 total return index. This correlation broke down significantly as markets continued to rally in the face of quantitative tightening. The reason for the divergence was the fiscal stimulus through tax cuts. As the net benefits of the tax cuts shrink, we anticipate that the reduction of liquidity by the Fed will increase equity market volatility.

The Fed has shifted from a tight policy stance to a more neutral one according to our framework. This has been the only data point to move in a positive direction since the end of 2018. Valuations, market trends, and economic growth are still flashing red according to the data. The Fed's abrupt shift in policy stance created the desired result, as equity markets have rallied substantially.

Chart 11: Fed Balance Sheet and S&P 500 total return

EQUITIES:

The recent rally in US equities has completely removed the oversold conditions that were present at the end of December. Last week the S&P 500 busted through the resistance band of 2600-2650, closing the week at 2670. What is impressive is that this occurred despite overbought conditions. The next logical test for the S&P 500 is 2740, where the 200 day moving average is currently situated. If the S&P 500 closes the month above the 200 day moving average, the logical expectation would be for a breakout to new highs for the S&P 500. We believe the odds do not support a move to new highs currently as we have moved into an intermediate-term overbought condition on the S&P 500.

Symbol	Name	Close	Chg	% Chg	+/-	Date
$TRAN	$TRAN - Dow Jones Transportation Average	10012.06	386.81	4.02		01-18
$INDU	$INDU - Dow Jones Industrial Average	24706.35	710.40	2.96		01-18
$DAX	$DAX - German DAX Composite	11205.54	318.08	2.92		01-18
$SPX	$SPX - S&P 500	2670.71	74.45	2.87		01-18
$RUA	$RUA-Russell 3000 Index	1575.36	43.49	2.84		01-18
$WLSH	$WLSH - Wilshire 5000 Composite	27617.28	762.05	2.84		01-18
$NDX	$NDX - Nasdaq 100 Index	6784.61	183.21	2.78		01-18
$SPDAUDP	$SPDAUDP - Dividend Aristocrats	1130.58	27.89	2.53		01-18
$RUT	$RUT - Russell 2000 Small Cap Index	1482.50	35.12	2.43		01-18
$CAC	$CAC - French CAC 40 Index	4875.93	94.59	1.98		01-18
$MSEMF	$MSEMF - Emerging Markets	1018.00	16.89	1.69		01-18
$SSEC	$SSEC - Shanghai Stock Exchange	2596.01	42.18	1.65		01-18
$HSI	$HSI - Hang Seng	27090.81	423.54	1.59		01-18
$NIKK	$NIKK - Tokyo Nikkei Average	20666.07	306.37	1.50		01-18
$MSWORLD	$MSWORLD - MSCI World ex USA	1803.98	21.86	1.23		01-18
$MSEAFE	$MSEAFE - MSCI EAFE	1805.10	18.97	1.06		01-18
$VIX	$VIX - Volatility Index - New Methodology	17.80	-0.39	-2.14		01-18

Source: www.stockcharts.com

Chart 12: S&P 500 and other common moving averages. The S&P 500 closed the week above its 50 day moving average.

At their lows in December, less than 5% of the companies in the S&P 500 were above their 50 day moving averages. As of Friday, 72% are now above the 50 day moving average. This generated a point and figure buy signal by breaking above the previous column of X's, which is indicative of a meaningful improvement in market internals. This particular indicator is testing resistance at 74%. Historically, in a down market, 70% and above has marked overbought conditions.

The percentage of stocks in the S&P 500 above their 200 day moving average is 40%. It was oversold at below 16% in late 2018. This indicator is not overbought but remains on a long-term sell signal for the market. This particular indicator is one of the reasons we suggested the possibility of a bear market rally in late December. We expect this indicator to reverse to a column of O's, which would signal that the bear market rally is nearing completion. The bullish percent chart of the S&P 500 has also repaired a significant amount of technical damage. Currently, 47% of the stocks in the S&P 500 are on point and figure buy signals. The indicator reached a low of below 18% late last year. A decisive break and close above 50% would indicate a positive sign for equities markets and would increase the probability that stocks will continue their upward trajectory.

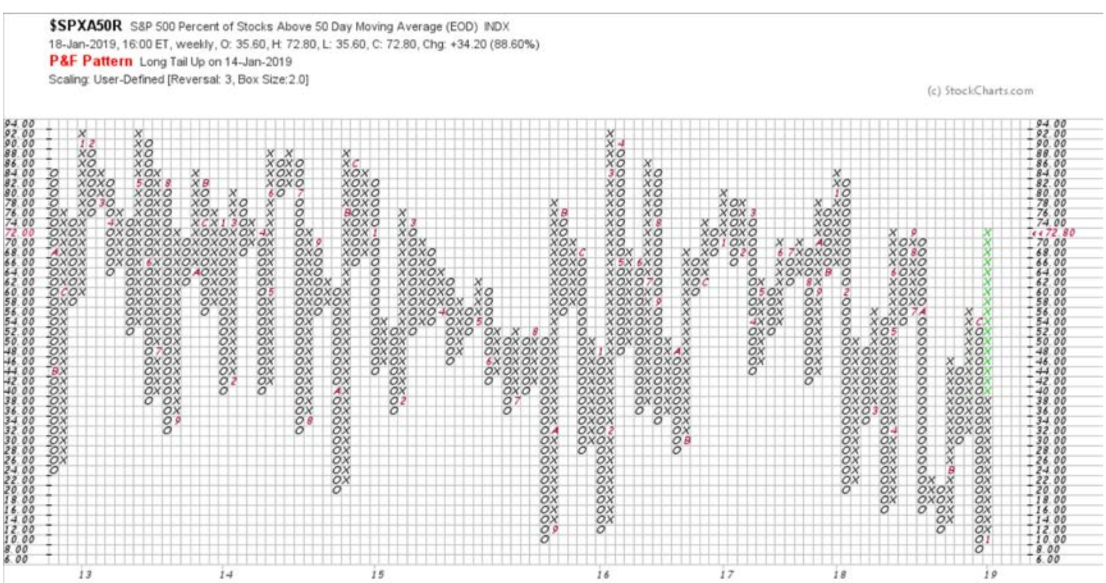

Chart 13: Percentage of stocks in the S&P 500 above their 50 day moving averages.

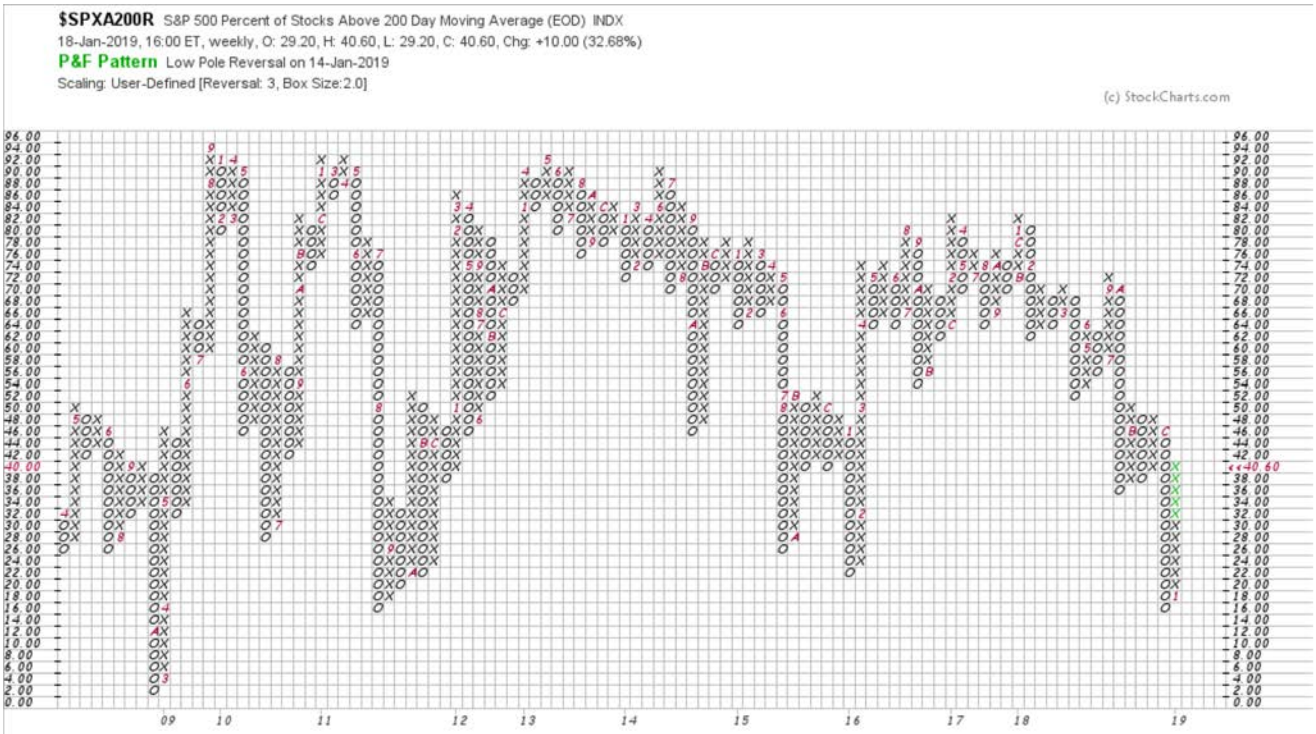

Chart 14: Percentage of stocks in the S&P 500 above their 200 day moving average.

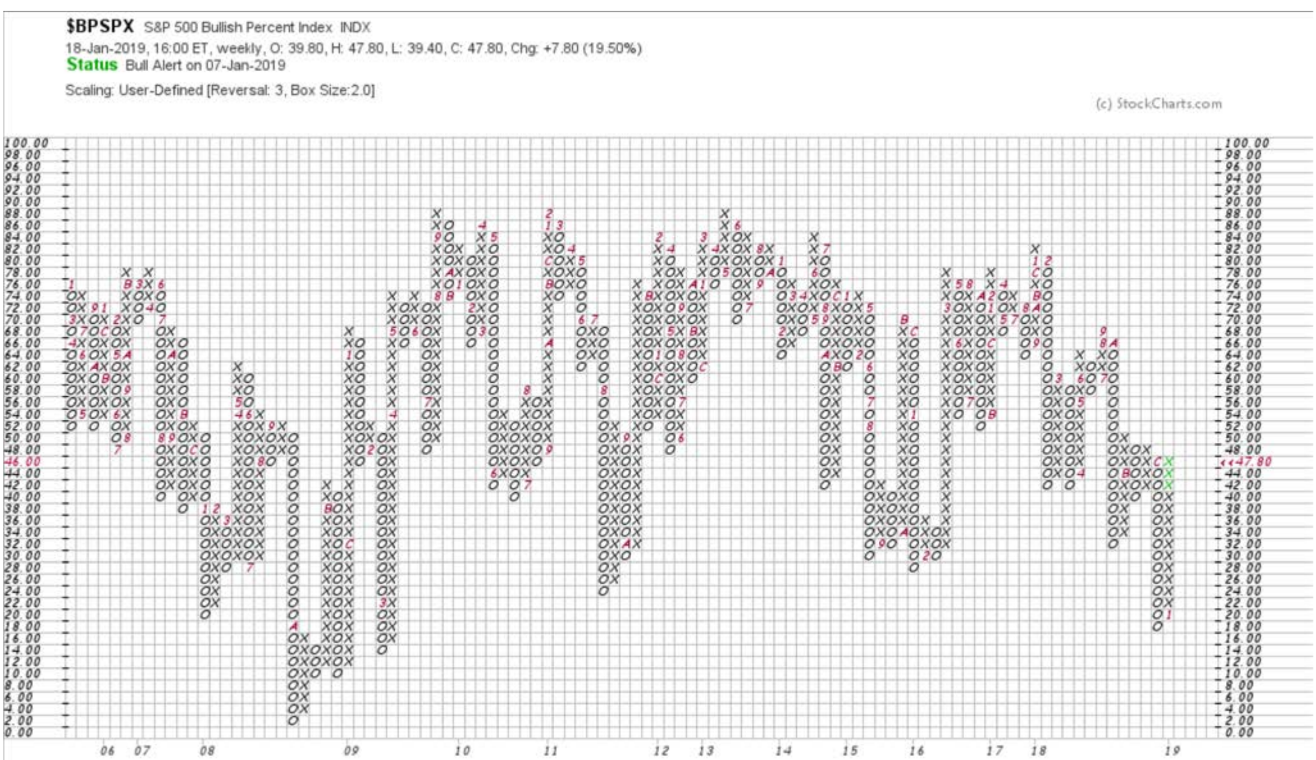

Chart 15: Bullish Percent Index for the S&P 500.

BONDS:

Symbol	Name	Close	Chg	% Chg	+/-	Date
$YC3MO	$YC3MO - 3mo - 10yr yield curve	0.38	0.10	35.71		01-18
$YC2YR	$YC2YR - 2-10 yield curve	0.17	0.01	6.25		01-18
$UST5Y	$UST5Y - 5 year yield	2.62	0.10	3.97		01-18
$UST10Y	$UST10Y - 10 year yield	2.79	0.08	2.95		01-18
$UST2Y	$UST2Y - 2 year yield	2.62	0.07	2.75		01-18
$UST20Y	$UST20Y - 20 year yield	2.95	0.05	1.72		01-18
$UST30Y	$UST30Y - 30 year yield	3.09	0.05	1.64		01-18
$UST3M	$UST3M - 3 month yield	2.41	-0.02	-0.82		01-18

Source: www.stockcharts.com

Chart 16: US 10 Year Yields. The US 10 year Treasury yield rallied 8 basis points or 2.95% to close the week at 2.79%. Treasury yields remain in a negative trend despite the recent rally in risk assets. US Treasury bonds are in a positive trend.

Chart 17: US 30 year Treasury rates: The yield on the 30 year Treasury moved up 1.64% last week. However, it is in a newly formed negative trend. The negative trend in yields means that long-term Treasuries are in a positive trend.

CURRENCIES:

Symbol	Name	Close	Chg	% Chg	+/-	Date
$USDJPY	$USDJPY - US Dollar to Japanese Yen (EOD)	109.71	1.19	1.10		01-18
$USD	$USD - US Dollar Index - Cash Settle (EOD)	95.99	0.73	0.76		01-18
$AUDJPY	$AUDJPY - Australian Dollar to Japanese Yen (NBD)	78.67	0.47	0.60		01-18
$EURJPY	$EURJPY - Euro to Japanese Yen (NBD)	124.68	0.29	0.23		01-18
$GBPUSD	$GBPUSD - British Pound to US Dollar (NBD)	1.29	0.00	0.23		01-18
$CADUSD	$CADUSD - Canadian Dollar to US Dollar (NBD)	0.75	-0.00	-0.03		01-18
$JPYEUR	$JPYEUR - Weekly Solid Line, 1280	0.80	-0.00	-0.25		01-18
$EURUSD	$EURUSD - Euro to US Dollar (NBD)	1.14	-0.01	-0.85		01-18
$NYXBT	$NYXBT - Daily Solid Line, 1280	3605.91	-36.69	-1.01		01-18
$JPYUSD	$JPYUSD - Weekly Solid Line, 1280	0.91	-0.01	-1.09		01-18

Source: www.stockcharts.com

Chart 18: The US Dollar rallied 0.76% last week. The Dollar remains in a positive trend despite softening against the Yen.

Chart 19: The Australian Dollar rallied 0.60% against the Japanese dollar last week. The trend is still negative for the Australian Dollar relative to the Yen.

COMMODITIES:

Symbol	Name	Close	Chg	% Chg	+/-	Date
$WTIC	$WTIC - Crude oil	54.04	2.45	4.75		01-18
$CRB	$CRB - Reuters/Jefferies CRB Index	182.21	4.13	2.32		01-18
$COPPER	$COPPER - Copper - Continuous Contract (EOD)	2.72	0.06	2.14		01-18
$GOLD	$GOLD - Gold - Continuous Contract (EOD)	1282.60	-6.90	-0.54		01-18

Source: www.stockcharts.com

Chart 20: West Texas Crude rallied 4.75% last week. Oil is in a negative trend, but has rallied substantially from oversold levels.

Chart 21: Copper rallied over 2% for the week. It is still in a negative trend, but made a higher low recently. If Copper can reverse into a positive trend it would be a strong indicator of future growth. However, if Copper stays in a negative trend, it would suggest that economic growth will continue to slow.

MARKET SENTIMENT:

Chart 22: High Yield rallied against Treasuries by 1% last week. Despite the impressive rally that started almost 1 month ago, the trend still favors Treasuries and is positive for defensive assets.

Chart 23: US Stocks rallied over 3% against bonds last week. Stocks are still in a long-term negative trend relative to bonds, suggesting a defensive posture is still warranted.

Chart 24: Stocks rallied 3.39% against Gold. Stocks remain in a negative trend against Gold.

Chart 25: US stocks rallied 1.59% against international stocks. The trend remains in favor of US equities.

Chart 26: Emerging markets rallied 0.61% against international developed. The trend is in favor of emerging markets.

Chart 27: Small cap stocks lost -0.39% against large cap US equities. This occurred right at the 13 week moving average of the ratio. This is the first negative divergence since the market rebounded from the lows in December. We want to see small caps rally more than large caps in a risk-on rally.

Chart 28: Large Cap Growth rallied 0.47% against Large Cap Value last week. The trend is still in favor for value since the reversal in late 2018.

Chart 29: Low volatility fell against the momentum factor by -0.11% last week. The long-term trend is still in favor of the low volatility factor, which is indicative of a slowing growth environment.

SUMMARY

Our framework is still decisively in the defensive camp despite the short-term improvements on the economic front, the impressive rally in stocks to start the year, and the shift back to neutral by the Fed. Valuations are still indicative of below average returns in the US stock market, market trends are negative, and growth is still slowing. By defensive, we mean that equity investments should be focused on the low volatility, low value, high quality factors. Fixed income should also be high quality, with a preference on Treasuries. We also recommend tactical equity exposures that follow systematic trend-following processes. In our opinion, it isn't time for throwing caution to the wind and taking risk. It is also not time to sell everything and hide under the bed. It is simply a time to focus on risk management. We believe the odds are that the recent market action may just be a bull trap.

PLAYBOOK:

Overweights:

Treasuries, the low volatility factor, low value equities, high quality equities, dividend growth, and defensive sectors

Underweights:

High Yield, momentum factor, cyclical sectors, growth.

DISCLOSURE:

Past performance is no guarantee of future returns. This is WealthShield's current assessment of the market and may be changed without notice. The visuals shown are for illustrative purposes only and do not guarantee success or certain level of performance. This material contains projections, forecasts, estimates, beliefs and similar information ("forward looking information"). Forward looking information is subject to inherent uncertainties and qualifications and is based on numerous assumptions, in each case whether or not identified herein.

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