



WEALTHSHIELD

January 7th, 2019

THE POWELL PUT

Federal Reserve Chairman Powell created a nice market rally when he referenced that the Fed would be more data dependent and patient with interest rate policy. He also communicated that stopping the balance sheet unwind, or quantitative tightening, is also on the table should the data suggest this change. This came on the back of a monster headline job number that would have otherwise been Hawkish.

Markets celebrated the dovish evolution of Chairman Powell, rallying 3% to close the week positive. Although market participants seemed to be surprised by the sudden shift by the Federal Reserve, we were not. One of our more recent commentaries, published [December 24th, 2018](#), said the following:

“Economic growth is slowing and inflation is as well, indicating to us that we are experiencing a deflationary pulse. This is why the growth component of our framework is negative. This is also why we expect the Federal Reserve to continue to move dovish in the coming months. Last week they continued their dovish communication trend by talking down the number of rate hikes for 2019 despite raising interest rates another quarter point. ”

The Fed continues to ease through communication. This will be translated to a pause in rate hikes and quantitative tightening, and then, if the data continues to slow, a rate cut. Economic data last week added further confirmation of slowing economic activity. The ISM report had the largest monthly drop since 2008, falling to 54.1 from 59.3. The ECRI weekly leading index declined further to -5.5% year over year. The four week moving average of the ECRI weekly leading index declined to -2.09% year over year. This is lower than at the start of the 2008 recession.

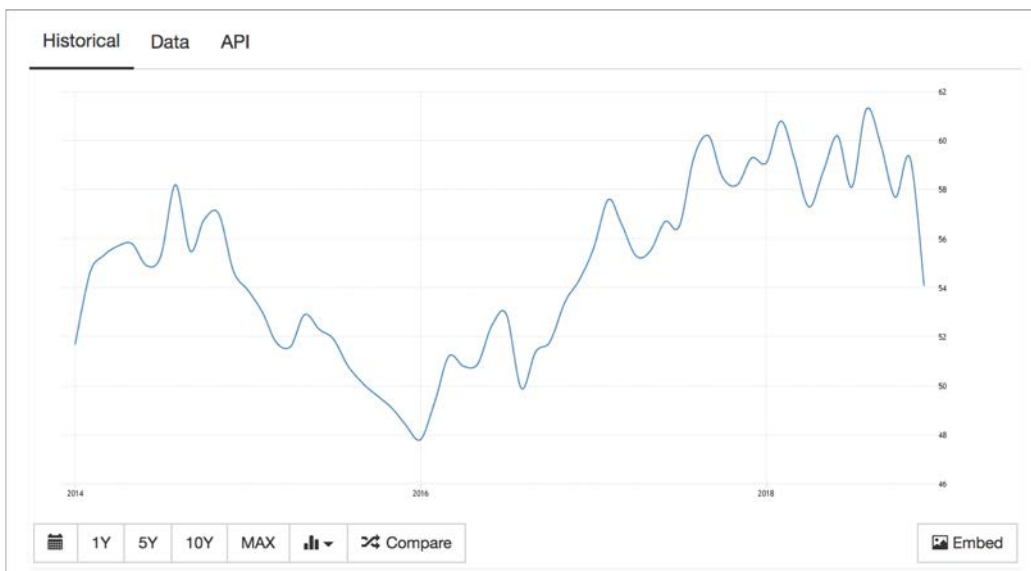


Chart 1: ISM report; Source: www.tradingeconomics.com

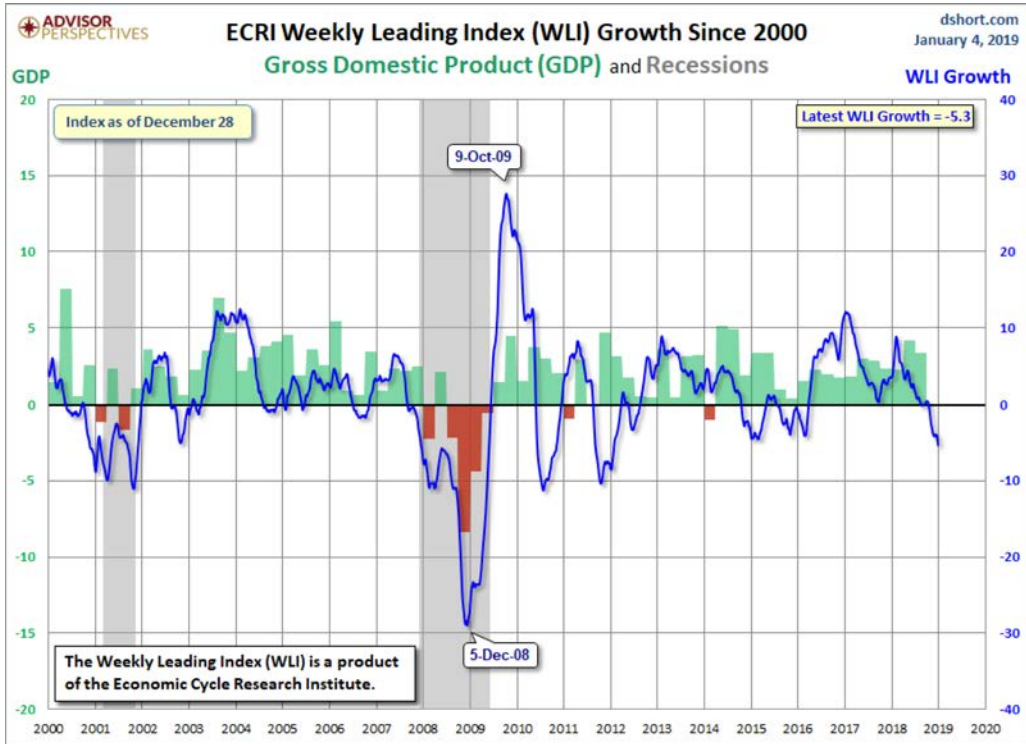


Chart 2: ECRI Weekly Leading Index

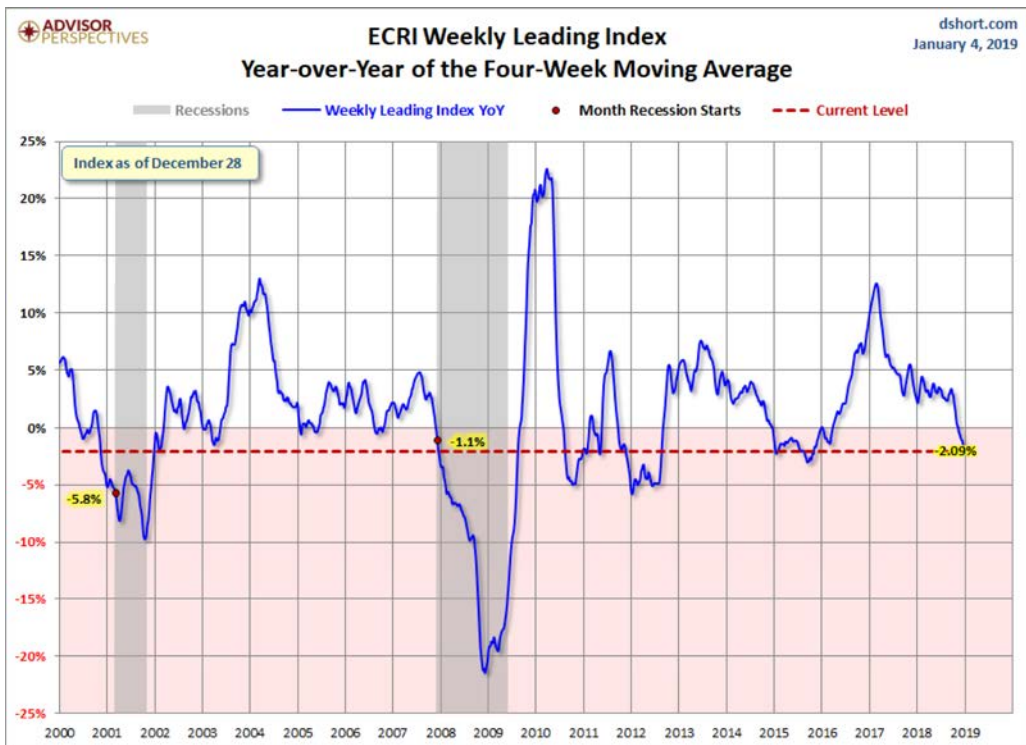


Chart 3: Four week moving average of the ECRI Weekly Leading Index

The jobs report was a massive upside surprise though. The US added 312,000 jobs in December, far more than the 177,000 jobs that were expected. However, the unemployment rate ticked up to 3.90%, and this triggered a close above its 10 month exponential moving average. When the 10 month moving average turns positive after a low unemployment rate, it can be an early recession indicator.



Chart 4: Unemployment rate versus 10 month moving average

As far as our framework is concerned, the Federal Reserve is now moving to a point where they are easing through communication. They are still tightening through open market operations (reducing the balance sheet) and increasing interest rates. We fully anticipate that they will not raise interest rates going forward, as long as growth continues to slow. We also expect the Fed to stop the systematic balance sheet reduction at some point in the next couple of quarters. This will signal to us that they are now moving to an accommodative stance. We expect our model to move to neutral (yellow) for the monetary policy component of our framework in the coming months. The fact that the 2 year Treasury rate is below the Fed funds rate is all the indication we need that the Fed needs to halt rate increases. In fact, if the 2 year yield drops significantly, we would expect a rate cut as well.

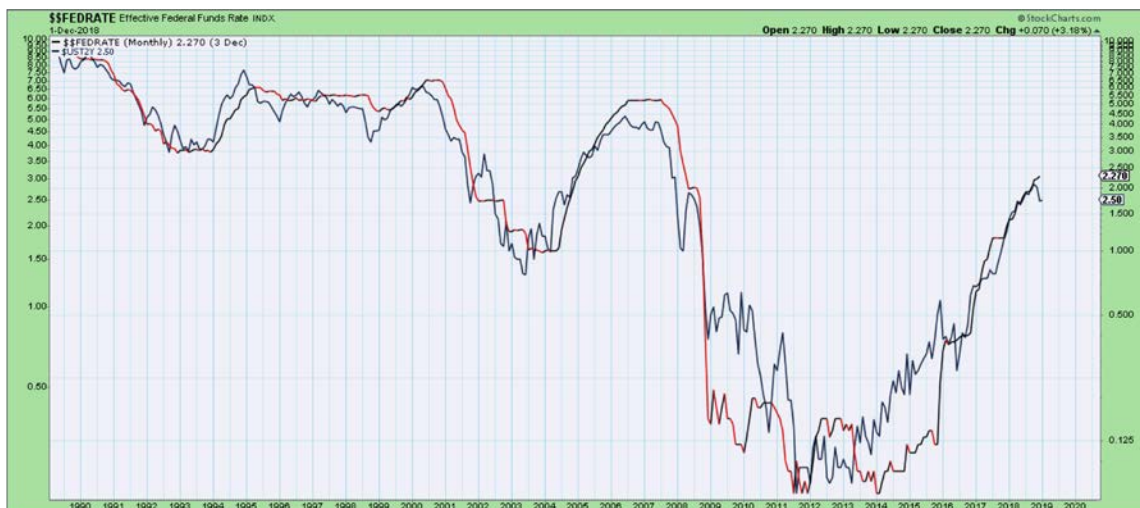


Chart 5: Fed funds target rate is now above the 2 year rate

VALUATIONS UPDATE

Valuations remain in the top quartile historically and suggest low long-term (10-15 years) average returns for equities. The cyclically adjusted price to earnings ratio is down to 29 but still is in the top quintile of historical observations. The Buffett indicator, or the total market capitalization divided by GDP, is also in the top quintile of historical observations and currently stands at 122% of GDP.

Most measures of market valuation with historical accuracy (having a strong inverse correlation with subsequent returns) indicate that the market is still highly valued. We believe the expected return on the S&P 500 over the next 10-12 years is probably between -2% and +5% per year, before inflation. The market would have to correct substantially to provide a green light from a valuation perspective. We have included a chart courtesy of Dr. John Hussman to illustrate some potential levels at which the S&P 500 would become attractive from an expected return perspective. For example, to achieve an expected 10% annualized return over the course of a 10-12 year period, the S&P 500 would have to drop to 1192. That is over a 50% decline from current levels. Therefore, despite the recent drop in stock prices, the broad market is not undervalued by the measures of valuation that have proven most accurate in the past (see Chart 10).

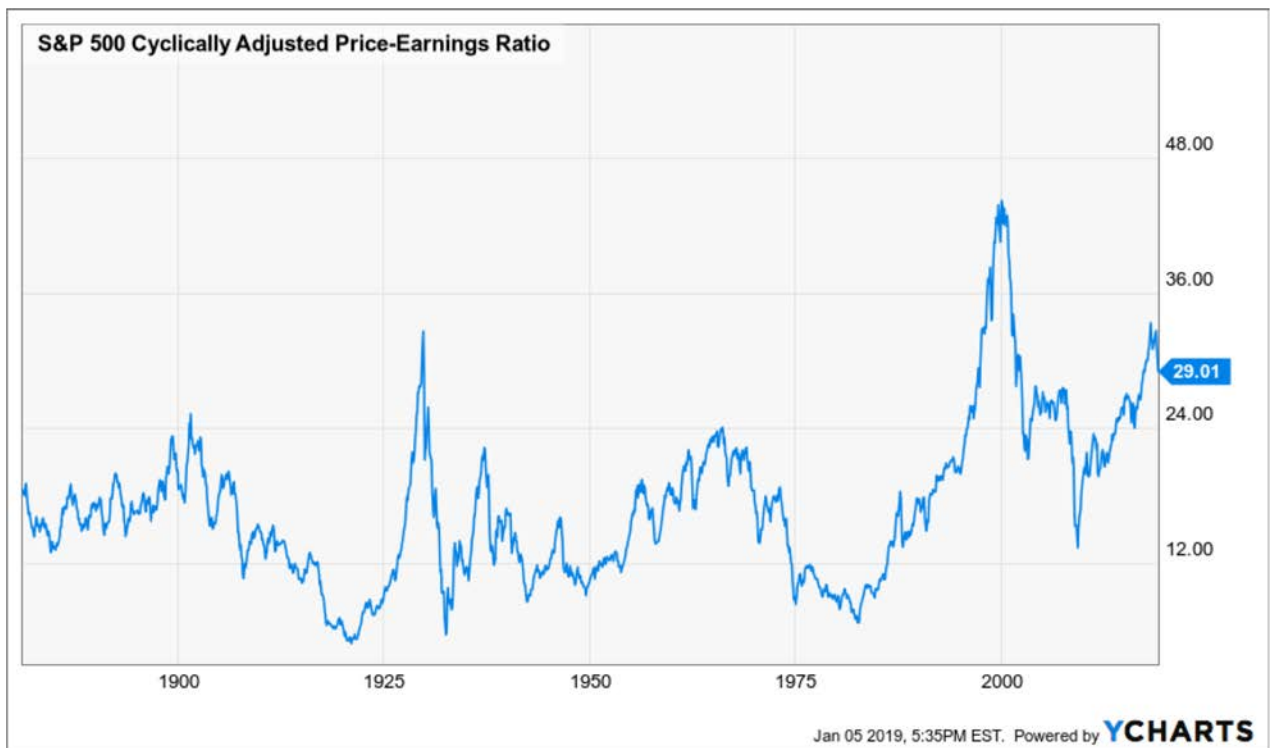


Chart 6: CAPE Ratio

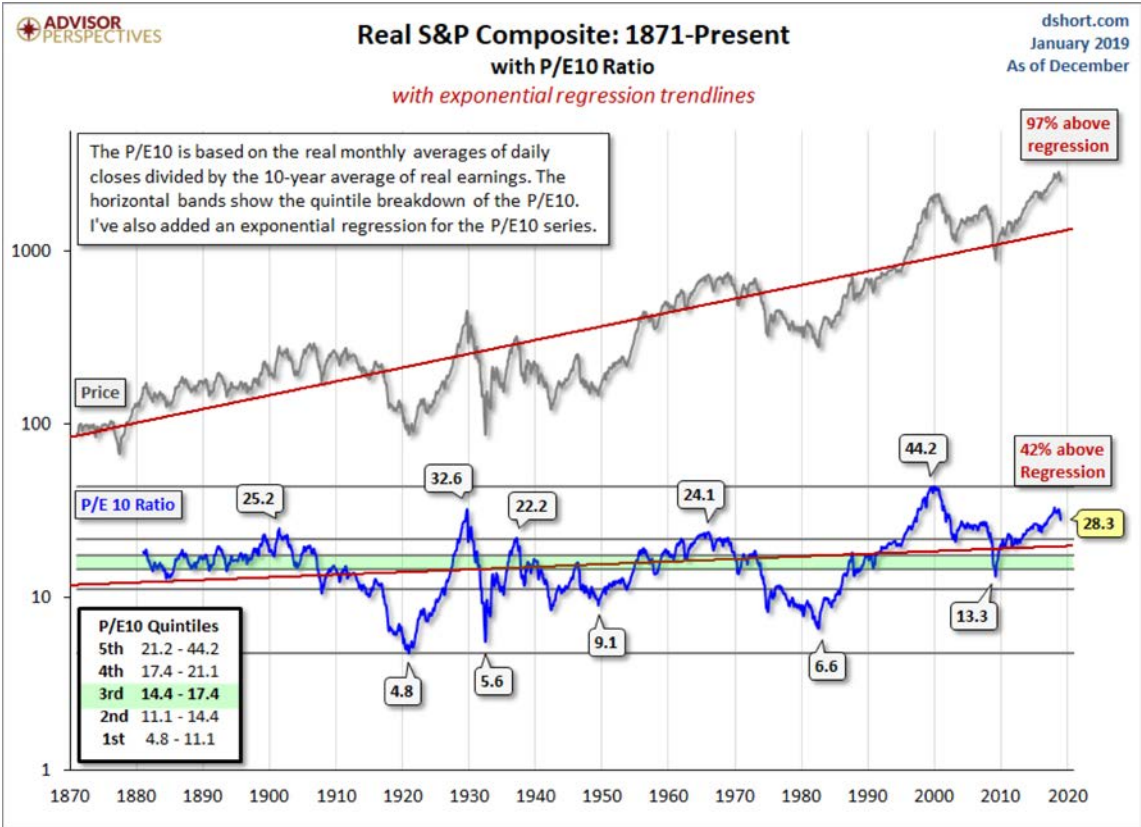


Chart 7: Shiller CAPE and Quintiles (bottom pane)

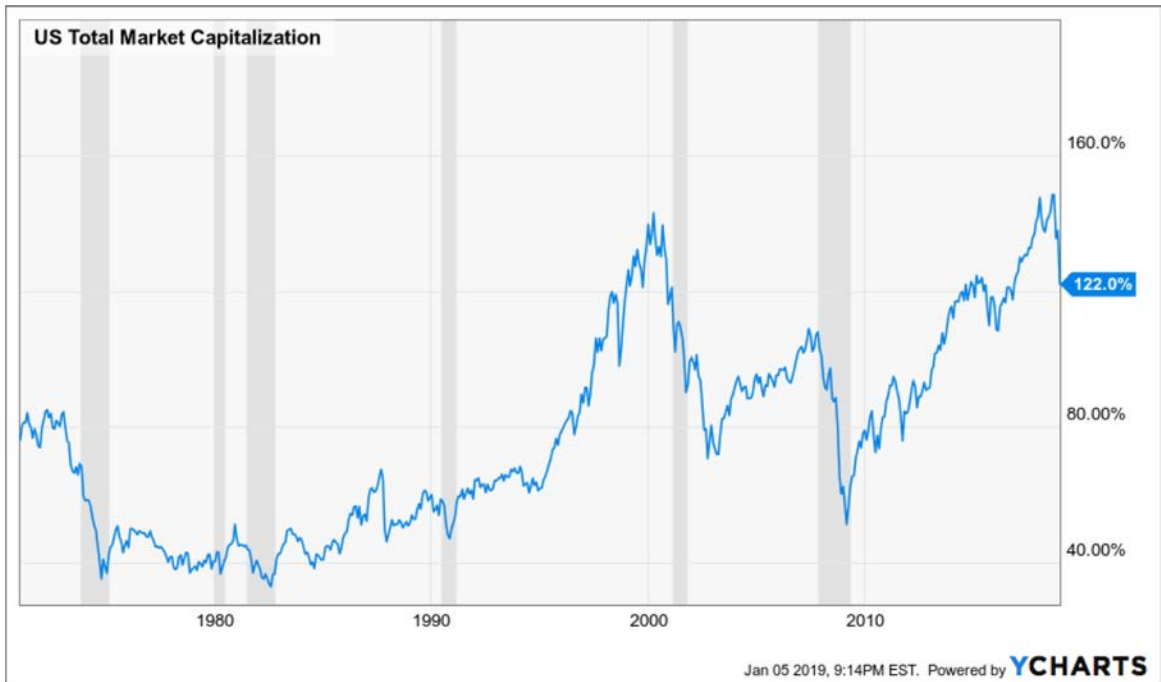


Chart 8: Market Capitalization divided by GDP

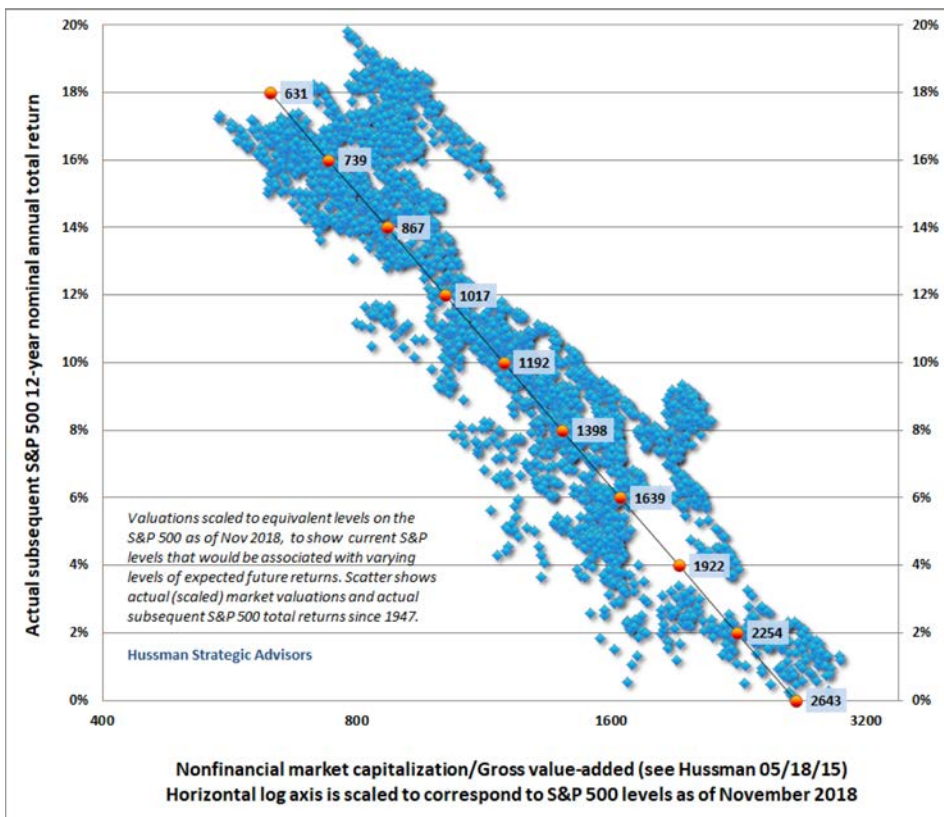


Chart 9: Expected returns and levels on the S&P 500; Source: Hussman Strategic Advisors

Correlation of log valuation ratios with actual subsequent S&P 500 total returns: 1950-2017		
Metric	10-year	12-year
Nonfinancial market cap/ Corporate gross value-added (Hussman 5/18/15)	-0.91	-0.93
Nonfinancial enterprise value/ Corporate gross value-added	-0.89	-0.91
Nonfinancial market cap/ Nominal GDP	-0.89	-0.90
Price/Revenue	-0.89	-0.90
Margin-adjusted CAPE (Hussman 5/5/14)	-0.89	-0.90
Price/normalized forward earn (Hussman 8/2/10)	-0.88	-0.89
Tobin's Q	-0.86	-0.88
Shiller CAPE	-0.83	-0.86
Price/prior record earnings (Hussman 6/22/98 Barron's)	-0.83	-0.83
Price/Book value	-0.77	-0.79
Price/Forward operating earn (imputed prior to 1980)	-0.78	-0.77
Price/Dividend	-0.77	-0.75
Price/Earnings (trailing 12-mo)	-0.76	-0.75
Enterprise value/Cash flow	-0.70	-0.72
Fed Model (FOE yield-10yr UST)	0.33	0.30
Hussman Strategic Advisors		

Chart 10: Valuation indicators and correlations to future returns; Source: Hussman Strategic Advisors

EQUITY MARKET REVIEW:

Links	Symbol	Name	Close	Chg	% Chg	1W	Date
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$HKK	\$HKK - Small Value	127.21	4.67	3.81		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$RUT	\$RUT - Russell 2000 Small Cap Index	1380.75	42.82	3.20		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$FHB	\$FHB - Mid Value	141.75	3.99	2.90		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$EJN	\$EJN - Large Value	97.89	2.33	2.44		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$NDX	\$NDX - Nasdaq 100 Index	6422.67	137.41	2.19		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$HKJ	\$HKJ - Small Cap Growth	168.58	3.53	2.14		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$WLSH	\$WLSH - Wilshire 5000 Composite	26080.80	539.63	2.11		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$EJK	\$EJK - Large Growth	160.33	3.22	2.05		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$RUA	\$RUA - Russell 3000 Index	1488.53	29.01	1.99		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$DAX	\$DAX - German DAX Composite	10767.69	208.73	1.98		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$SPX	\$SPX - S&P 500	2531.94	46.20	1.86		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$FDB	\$FDB - Mid Growth	195.49	3.26	1.69		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$INDU	\$INDU - Dow Jones Industrial Average	23433.16	370.76	1.61		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$MSWORLD	\$MSWORLD - MSCI World ex USA	1730.15	26.86	1.58		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$MSEAFE	\$MSEAFE - MSCI EAFE	1736.69	24.37	1.42		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$TRAN	\$TRAN - Dow Jones Transportation Average	9225.02	115.89	1.27		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$CAC	\$CAC - French CAC 40 Index	4737.12	58.38	1.25		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$NIKK	\$NIKK - Tokyo Nikkei Average	19561.96	234.90	1.22		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$SPDAUDP	\$SPDAUDP - Dividend Aristocrats	1080.08	9.02	0.84		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$SSEC	\$SSEC - Shanghai Stock Exchange	2514.87	20.97	0.84		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$HSI	\$HSI - Hang Seng	25626.03	121.83	0.48		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$MSEMF	\$MSEMF - Emerging Markets	964.97	2.34	0.24		01-04
🔗 📊 📈 📉 📊 📈 📉 📊 📈 📉	\$VIX	\$VIX - Volatility Index - New Methodology	21.38	-6.96	-24.56		01-04

Source: www.stockcharts.com

Equities markets finished up 2018 and started off 2019 last week with plenty of volatility. US equities continued the rally that started during the final week of the year with an increase of about 2% for the Wilshire 5000. The MSCI World Ex-US rose 1.58% for the week. Emerging markets were the laggards, finishing the week only up 0.24%. The strongest segment of the equities market were small cap US stocks. The Morningstar small cap value index was up 3.81% for the week.



Chart 11: Small Cap Value was up big for the week, but remains in a negative long-term trend.



Chart 12: Emerging Markets were the notable laggard last week and are still in a strong negative trend.

BOND MARKET REVIEW:

Links	Symbol	Name	Close	Chg	% Chg	Date
🔗 📄 📊 🔍	\$UST3M	\$UST3M - 3 month yield	2.42	0.02	0.83	01-04
🔗 📄 📊 🔍	\$UST2Y	\$UST2Y - 2 year yield	2.50	-0.02	-0.79	01-04
🔗 📄 📊 🔍	\$UST10Y	\$UST10Y - 10 year yield	2.67	-0.05	-1.84	01-04
🔗 📄 📊 🔍	\$UST30Y	\$UST30Y - 30 year yield	2.98	-0.06	-1.97	01-04
🔗 📄 📊 🔍	\$UST20Y	\$UST20Y - 20 year yield	2.83	-0.06	-2.08	01-04
🔗 📄 📊 🔍	\$UST5Y	\$UST5Y - 5 year yield	2.49	-0.07	-2.73	01-04
🔗 📄 📊 🔍	\$YC2YR	\$YC2YR - 2-10 yield curve	0.17	-0.03	-15.00	01-04
🔗 📄 📊 🔍	\$YC3MO	\$YC3MO - 3mo - 10yr yield curve	0.25	-0.07	-21.87	01-04

Source: www.stockcharts.com

Bond yields dropped from the 2 year through the 30 year Treasury. The yield differential between 10 year Treasury bonds and 2 year Treasuries dropped, as well as the spread between the 10 year yield and the 3 month yield. The yield curves remain positive at 0.17% and 0.25% respectively.



Chart 13: IShares 20+ year Treasury ETF (TLT) was up 0.88% last week and is in a new long-term positive trend.



Chart 14: The 10 year minus 3 month Treasury curve continues to flatten but remains positive.

CURRENCIES:

Links	Symbol	Name	Close	Chg	% Chg	Date
	\$NYXBT	\$NYXBT - Daily Solid Line, 1280	3746.61	135.57	3.75	01-04
	\$CADUSD	\$CADUSD - Canadian Dollar to US Dollar (NBD)	0.75	0.01	1.94	01-04
	\$JPYUSD	\$JPYUSD - Weekly Solid Line, 1280	0.92	0.01	1.58	01-04
	\$GBPUSD	\$GBPUSD - British Pound to US Dollar (NBD)	1.27	0.00	0.28	01-04
	\$USD	\$USD - US Dollar Index - Cash Settle (EOD)	95.75	-0.21	-0.22	01-04
	\$EURUSD	\$EURUSD - Euro to US Dollar (NBD)	1.14	-0.01	-0.45	01-04
	\$AUDJPY	\$AUDJPY - Australian Dollar to Japanese Yen (NBD)	77.21	-0.38	-0.49	01-04
	\$USDJPY	\$USDJPY - US Dollar to Japanese Yen (EOD)	108.47	-1.74	-1.58	01-04
	\$EURJPY	\$EURJPY - Euro to Japanese Yen (NBD)	123.64	-2.59	-2.05	01-04

Source: www.stockcharts.com

Currencies were wild last week. The Yen was strong broadly—gaining over 2% against the Euro and 1.58% against the dollar. The trade weighted dollar was down -0.21% to \$95.75 to close the week. We highlighted the strength in the Yen in our commentary last week. It is usually a sign of increasing volatility and risk aversion within global markets. Bitcoin was the strongest performer, rising almost 4% against the US dollar.



Chart 15: Japanese Yen/Euro vs. Volatility - The Yen was stronger against the Euro, surging 2.02% over the week. It is in a long-term positive trend. This is a sign of risk aversion and increasing volatility. The 20 week moving average of the VIX is illustrated with the green line, showing the correlation with the Yen.



Chart 16: Bitcoin was up 3.75% for the week but remains in a negative trend.

COMMODITIES

Links	Symbol	Name	Close	Chg	% Chg	Date
	\$WTIC	\$WTIC - Crude oil	47.96	2.63	5.80	01-04
	\$CRB	\$CRB - Reuters/Jefferies CRB Index	173.35	2.39	1.40	01-04
	\$GOLD	\$GOLD - Gold - Continuous Contract (EOD)	1285.80	2.80	0.22	01-04
	\$COPPER	\$COPPER - Copper - Continuous Contract (EOD)	2.65	-0.03	-1.27	01-04

Source: www.stockcharts.com

Oil was the strongest performer last week, rallying almost 6% (5.80%) for the week. The Reuters/Jefferies index was up 1.40%. Gold was up 0.22% for the week and copper was the laggard, falling -1.27%.

The Reuters/Jefferies CRB index and crude oil remain in negative long-term trends despite the recent rallies. A Dovish Fed could have the effect of providing fuel for a longer-term rally. We will be watching the dollar for clues. A meaningful weaker dollar could signal potential upside for inflation and commodity prices.



Chart 17: Oil is rallying, but still in negative long-term trend.

MARKET SENTIMENT



Chart 18: Stocks versus Bonds - The Wilshire 5000 is still in a negative trend relative to the Barclays US Aggregate Bond Index. Stocks rallied 1.78% against bonds this past week.



Chart 19: Stocks versus Gold- The Wilshire 5000 rallied 1.89% against gold for the week. This relationship still favors gold.



Chart 20: US Stocks versus International Stocks - US stocks rose 0.53% against international equities for the week. The trend is still in favor of US stocks at the moment.



Chart 21: Small caps versus Large caps - Small cap stocks rallied 0.76% against large cap stocks last week. Large caps are still favored despite the bounce.



Chart 22: Developed versus Emerging - Developed markets rose 1.18% against Emerging markets last week. The trend remains in favor of Emerging markets.



Chart 23: Large Growth versus Large Value - Value outpaced growth by 0.38% last week. Value is in a positive trend over growth.



Chart 24: Dividend Growth versus S&P 500 - Dividend growth stocks fell against the S&P 500 by -1% last week. Dividend growth is still in a positive trend against the S&P 500.



Chart 25: High Yield versus Treasuries - High Yield rallied 1.36% against Treasuries last week. Treasuries are still in a positive trend relative to high yield currently.



Chart 26: Copper versus Gold: Copper fell -1.48% against gold last week and gold remains the favored asset in this pair.

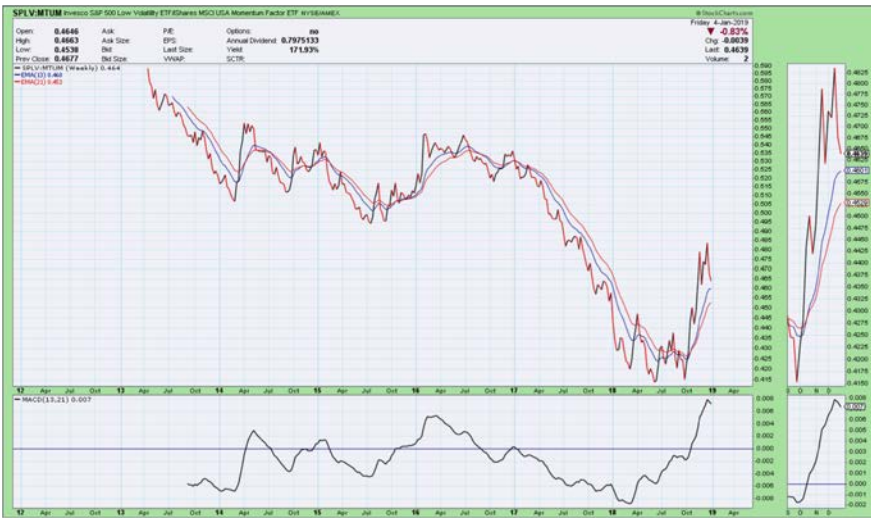
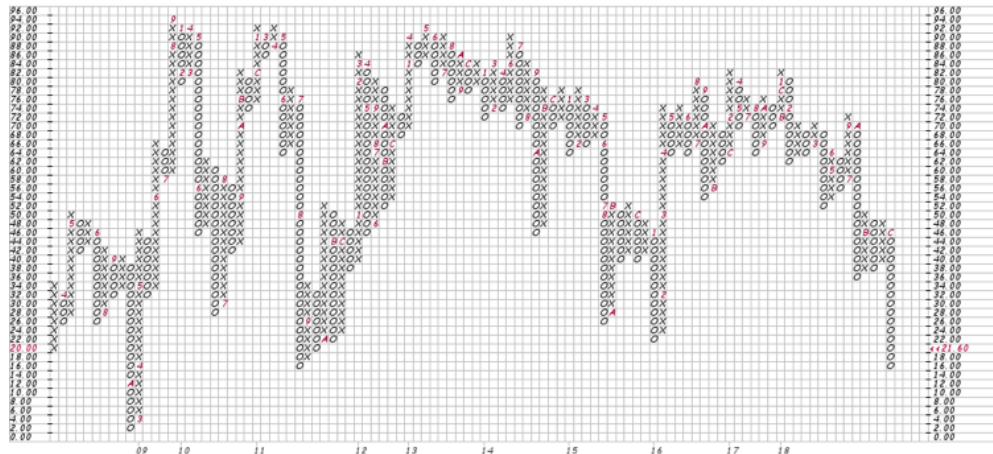


Chart 27: Invesco S&P 500 Low Volatility vs. iShares MSCI USA Momentum Factor ETF - Low volatility is still in favor relative to the momentum factor, however, the momentum factor rallied 0.83% against the low volatility factor last week.

\$SPXA200R S&P 500 Percent of Stocks Above 200 Day Moving Average (EOD) INDX
 04-Jan-2019, 16:00 ET, weekly, O: 21.80, H: 21.80, L: 14.40, C: 21.80, Chg: +1.40 (6.93%)
P&F Pattern Bearish Triangle Breakdown on 03-Dec-2018
 Scaling: User-Defined [Reversat 3, Box Size:2.0]

(c) StockCharts.com

Chart 28: % of S&P 500 stocks above their 200 day moving average. This measure of market breadth is still extremely weak. It remains below the levels reached during the 2015-2016 global contraction. Markets remain oversold despite the recent rally.



\$BSPSX S&P 500 Bullish Percent Index INDX
 04-Jan-2019, 16:00 ET, weekly, O: 16.60, H: 22.00, L: 16.60, C: 22.00, Chg: +5.40 (32.53%)
Status Bear Confirmed on 17-Dec-2018
 Scaling: User-Defined [Reversat 3, Box Size:2.0]

(c) StockCharts.com

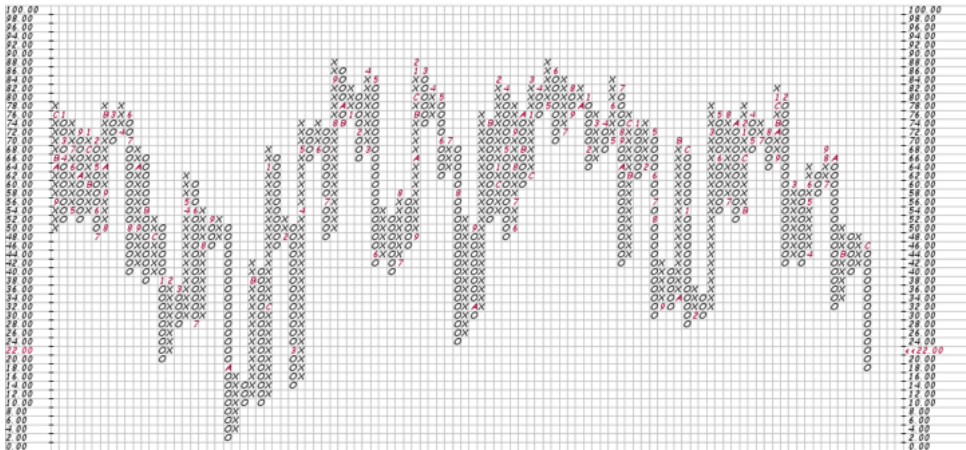


Chart 29: The % of S&P 500 stocks on point and figure buy signals - Only 22% of the companies in the S&P 500 are on point and figure buy signals. This suggests a bearish environment but also one where the market is oversold.

CHART OF THE WEEK



Chart 30: The S&P 500 could have further to rally. The resistance range for the S&P 500 is from 2565 to 2706. We have discussed the 2600 level on the S&P 500 ad nauseum and still believe the market could attempt to challenge this all important level. That would indicate at least 70 more points in the S&P 500. Interestingly, the 200 day moving average (exponential) is at 2709.83. Could we make a run there?

SUMMARY & PLAYBOOK

Our framework continues to suggest a defensive playbook. We expect the market to attempt to challenge the 2600 level on the S&P at some point in the near future. However, we also expect the market to fail in its attempt to switch into a positive trend. Growth is still slowing, market trends are still negative, and valuations remain in the top quintile historically. Even though the Fed is becoming more accommodative, we believe that investors should remain at the lower end of their exposure range to risky assets.

Overweights:

Low volatility factor, Utilities, Staples, REITS, Dividend Growth, Treasuries)

Underweights:

Energy, Technology, Industrials, Momentum, Global stocks, Credit

DISCLOSURE:

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