WealthShield

October 29th, 2018

HOPE IS NOT A DISCIPLINE

"The stock market is the story of cycles and of the human behaviour that is responsible for overreactions in both directions." – Seth Klarman

"When the facts change I change my mind. What do you do sir?" – John Maynard Keynes

"You get recessions, you have stock market declines. If you don't understand that's going to happen then you're not ready, you won't do well in the markets." – Peter Lynch

We published an article on the parallels between the 2000 time period and the present. During the technology bubble, we witnessed valuations stretching, growth outpacing value by a wide margin, and the market peaking prior to the economy. In fact, the stock market peaked in September of 2000, several months before the start of the recession. The market fell from a high of 1520 in September to 1241 by the official start of the recession in March of 2001.

The recession in 2001 lasted from March until November 2001. The S&P 500 dropped from the peak in September of 2000 by about 25 percent by the end of the recession. The Nasdaq 100 dropped about 61 percent over the same time period. The scary thing is that the Nasdaq 100 had dropped approximately 52 percent prior to the beginning of the recession (18 percent for the S&P 500). From November 30, 2001, the S&P 500 lost almost 30 percent and the Nasdaq 100 lost almost 50 percent.

The point is that the economy does not need to be in a recession for the stock market to experience major losses. That is why our framework includes economic growth as only *one* of the *four* components of our discipline. The other three are Fed policy, market trends, and valuations. Economic growth is still positive in the US while Fed policy, market trends, and valuations are all negative headwinds.

Valuations are as high in some cases, and even higher in others, as the readings that occurred during the stock market highs reached during the 2000 time period. The Fed is tightening policy systematically and looks set to continue this path despite criticism from market watchers and the US President. Market trends have recently turned negative in the US, confirming the negative trends witnessed in global markets. Furthermore, the economic growth that we are celebrating in the US looks set to slow in the coming quarters. The environment is currently negative for risk taking.

BUT THERE IS STILL HOPE…

There is hope that economic growth can continue to accelerate. There is hope that a short-term oversold bounce in US and global markets can turn into a larger rally that returns markets to positive trends. There is hope that the US Federal Reserve can press the pause button on the tightening path. Unfortunately, hope is not an investment strategy and we must follow the framework.

The reason we are revisiting the 2000-2003 time period is to illustrate that the market can lead the economic cycle on occasion. Market commentators continue to hold on to economic growth as a reason that the recent market action is just a run-of-the-mill correction. However, we have seen market corrections turn into crashes and those crashes become catalysts for economic declines. Our business cycle framework is currently flashing red, and our suggestion is that you use any short-term rally in the stock market to get defensive. In our application of our framework, we never suggest selling out of stocks completely. However, we do recommend that you get to the lower end of your tolerance band and underweight stocks across the board. We may be in for a wild ride…

Chart 1: S&P 500 fell prior to the start of the 2001 recession.

Chart 2: The S&P 500 dropped significantly from the peak in September 2000 through the end of the recession in November 2001.

Chart 3: The S&P 500 dropped around 30 percent after the recession had ended.

Chart 4: The total loss for the S&P 500 during the 2000-2003 market cycle was almost 50 percent.

Chart 5: The Nasdaq 100 dropped over 80 percent during the 2000-2003 market cycle.

MARKET SUMMARY:

The DJ Industrials average lost almost 3 percent last week. The S&P 500 and Nasdaq dropped almost 4 percent (-3.94% and -3.78% respectfully). Declining issues in the NYSE outpaced advances, 2330 to 774. There were 908 new lows and only 58 new highs. The dollar was stronger, finishing the week at 96.32 (95.71 a week earlier). Gold also continued its rally, closing at 1232.50. Crude dropped to 67.59 from 69.12 a week earlier and Treasury bonds gained on the week. International markets were also under pressure with the MSCI dropping 3.85 percent for the week. Even, Amazon, a favorite on Wall Street, broke into a negative trend, falling below its 200 day moving average. Overall, it was clearly another risk-off week and one that added further credence to the argument that we are in a bear market.

Intermarket trends were reflective of the shift in risk posture. Stocks versus bonds, stocks versus gold, and even high-yield spreads all deteriorated from a risky asset perspective. The negative trend is becoming more pronounced in US stocks as the 200 day moving average is now starting to turn downward in the Wilshire 5000 composite index. Markets are oversold however, suggesting that we could get a multi-week rally in global equities. Several of our internal measures of market breadth are flashing oversold readings and starting to diverge positively. For instance, only 9 percent of stocks in the Nasdaq 100 are above their 50 day moving averages. This is actually higher than the low of 6 percent registered the week prior. The higher low in this indicator, especially as the Nasdaq 100 price index continued to lose ground, signaled positive divergence. This can be a sign of a potential oversold bounce. However, we believe these bounces, if they materialize should be used to reposition portfolios in harmony with the long-term trends, which are now negative.

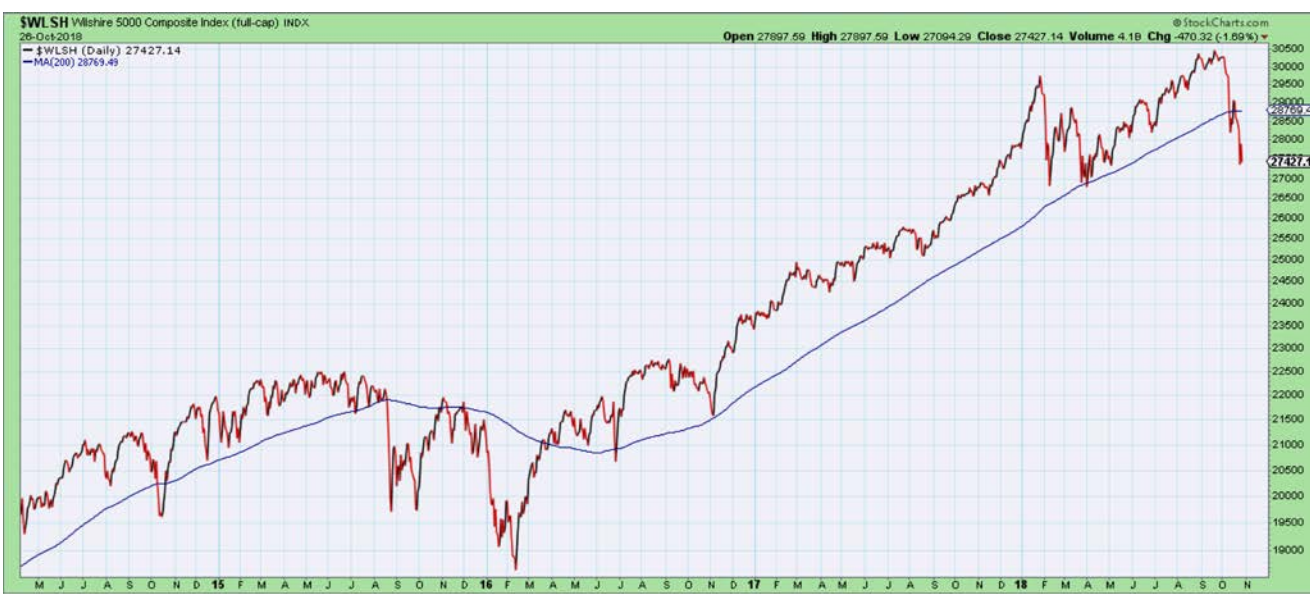

Chart 6: The 200 day moving average of the Wilshire 5000 Index is turning negative. This is suggestive of a long-term negative trend.

Chart 7: The Equal Weight S&P 500 is also in a negative trend with the 200 day moving average moving downward.

Chart 8: The MSCI World (ex US) Index has dropped significantly on the year and remains in a negative trend. It has accelerated to the downside as the 200 day moving average is now resistance.

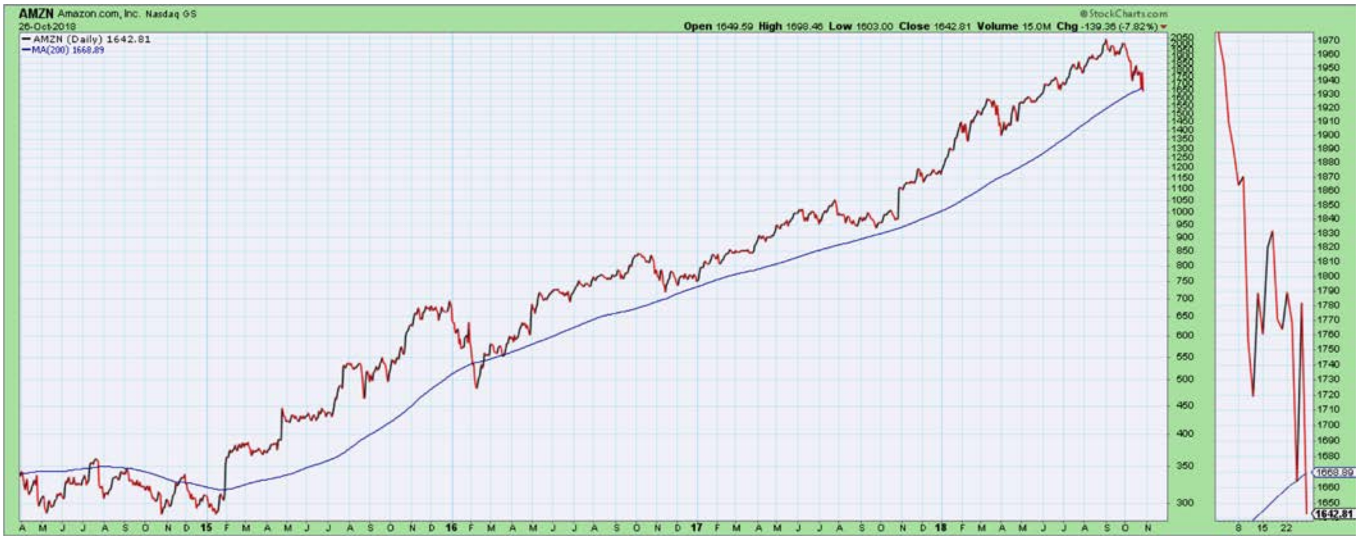

Chart 9: Amazon broke below its long-term trend, closing the week below its 200 day moving average. This is the first time it has been below the 200 day moving average since early 2016. If Amazon continues to breakdown, this will be a touch headwind for market growth going forward. Amazon and the other FAANG stocks have been big contributors to the markets growth over since the 2015-2016 recession.

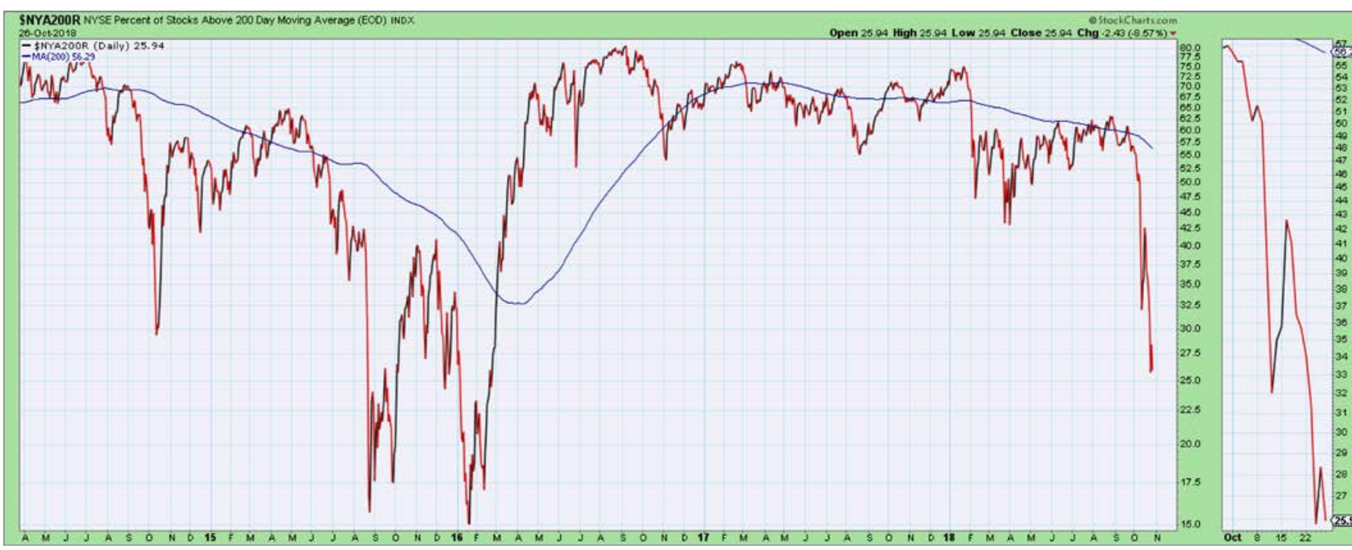

Chart 10: The percentage of stocks in the NYSE composite above the 200 day moving average are now only 26 percent of the issues. The majority of issues are in a negative trend, which is indicative of a bear market.

Chart 11: The percentage of stocks in the NYSE above the 50 day moving average are now below 12 percent. This is pretty oversold and lower than the levels reached during February.

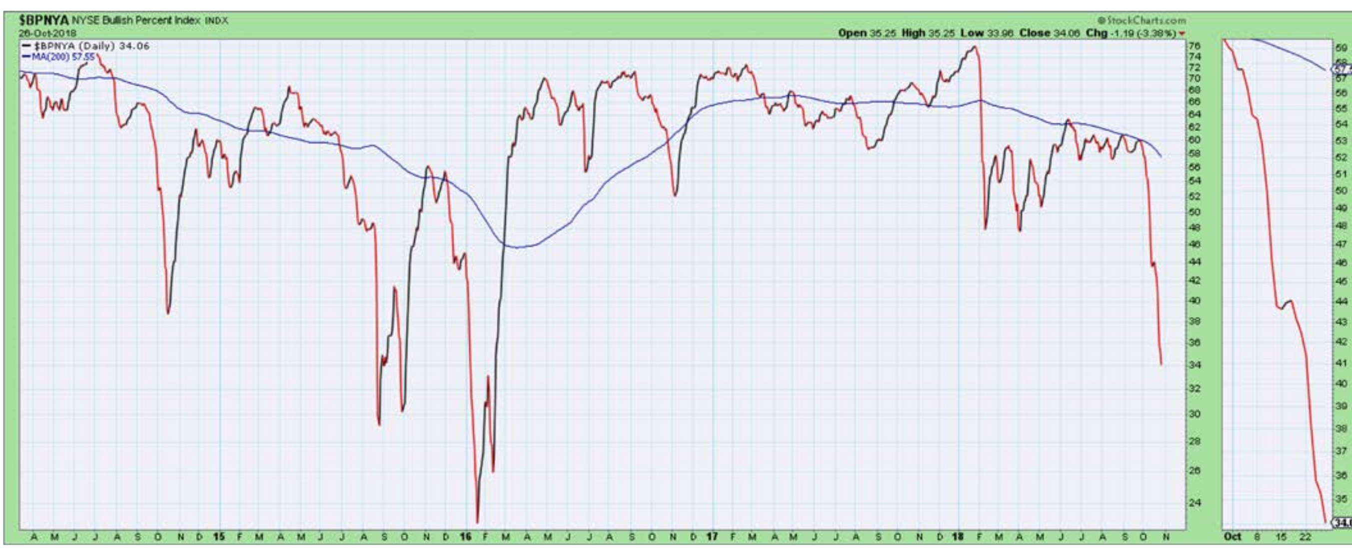

Chart 12: The percentage of stocks in the NYSE composite on point and figure buy signals is now at 34 percent. This is getting pretty washed out. In a bear market we see this indicator get oversold below 30 percent. In bull markets, it tends to get oversold in the 40-50. The good news is that it is getting pretty washed out, the bad news is that it is signaling that we may be in a bear market.

Chart 13: Stocks are now in a negative trend relative to bonds. Bonds are fast becoming a safe haven asset as they gain traction while the market continues to lose ground. This is the first negative trend in this intermarket relationship since 2016.

Chart 14: Stocks are breaking down against gold as well. This intermarket relationship broke below the 200 day moving average of the ratio, signaling a change to favor the yellow metal over equities.

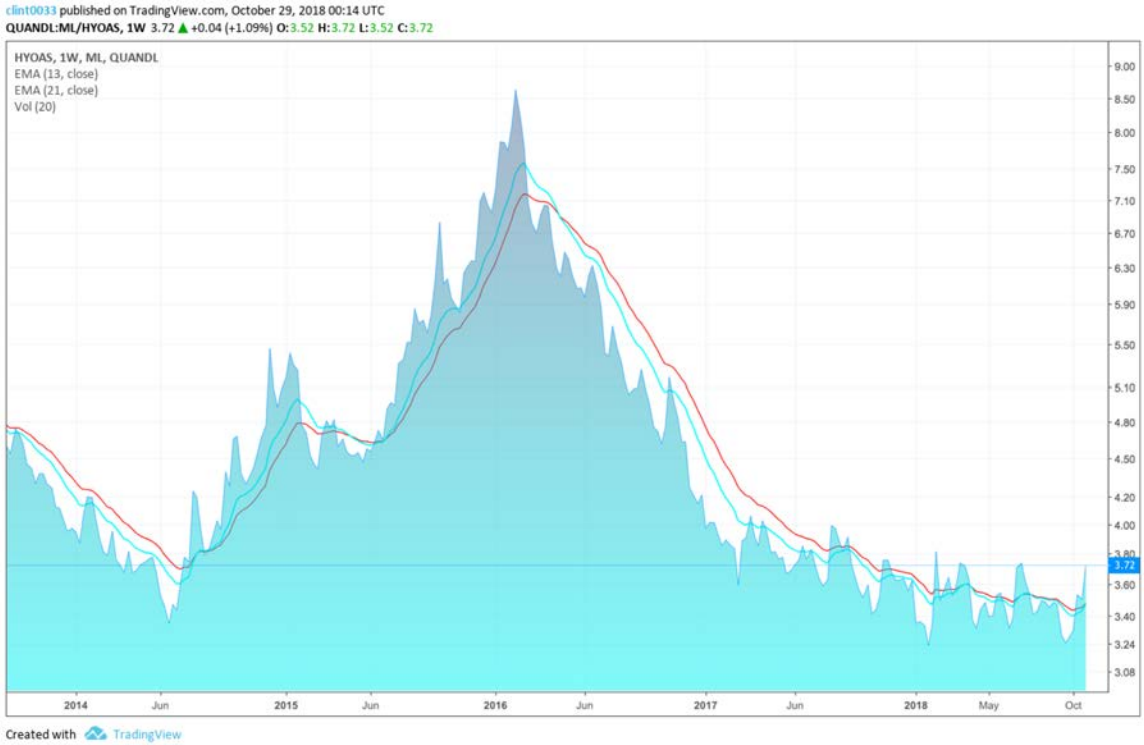

Chart 15: High Yield spreads over Treasuries broke above the 13 and 21 weekly moving averages to close at resistance. This is the first week that spreads really widened significantly as they held tight during the recent market turmoil. If the ICE ML Option adjusted High Yield spread breaks above resistance at the 3.80 percent level, it may signal a large risk-off move is upon us.

Chart 16: The Lumber/Gold ratio clued us into the housing market weakness back in August and was a clear indicator of the weakness in homebuilders. It is also serving as a warning for the US economy. This intermarket relationship is in a sharp negative trend.

Chart 17: The copper to gold ratio is a good indicator of inflation and deflation. Currently, the relationship is favoring deflation as the 200 day moving average of the ratio is moving downward. This favors gold and fixed income over risky assets.

Chart 18: Interest rates dropped last week, although they remain in a positive trend. If global stock markets continue to breakdown, we expect this trend to reverse course, supportive of a positive trend in bonds.

"In reality, no one knows what the market will do; trying to predict it is a waste of time, and investing based upon that prediction is a speculative undertaking."
-Seth Klarman

We have no idea what the market will do next, nor do we know how it will unfold. All we know is that right now, the evidence suggests that we should get defensive. We expect the opportunity to capitalize on an oversold bounce or for short-term market strength to position in this fashion.

Sure, midterm elections could cause a rally that takes us back to new highs: global central banks could switch course and launch coordinated stimulus again, the Fed could stop tightening policy, China and the US could reach a trade deal, and Santa Claus could save the market with an end of year rally. Anything can happen. The problem is that hoping these positive catalysts occur does not mean they will, and if these changes do happen, this does not guarantee the market will respond the way we hope.

We have to remain disciplined to our process, knowing that whether the outcome is further downside and we protect assets, or conditions improve and we miss a little upside, that the decision was the right one. The decision to move defensive when most of our warning signals are flashing red is one of prudence. We hope the outcome that renders our decision "right" does not occur for the sake of market participants. However, hope is not our discipline.

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.

This information may be taken, in part, from external sources. We believe these external sources to be reliable, but no warranty is made as to accuracy. This material is not financial advice or an offer to sell any product. There is no guarantee of the future performance of any WealthShield portfolio. The investment strategies discussed may not be suitable for all investors. Before investing, consider your investment objectives and WealthShield's charges and expenses. All investment strategies have the potential for profit or loss.

Benchmarks: The index / indices used by WealthShield have not been selected to represent an appropriate benchmark to compare an investor's performance, but rather are disclosed for informational purposes. Detailed information regarding the indices is available upon request. The volatility of the indices may be materially different than that of the portfolio.

WealthShield is a registered investment adviser. Registration does not imply a certain level of skill or training. More information about WealthShield including its advisory services and fee schedule can be found in Form ADV Part 2 which is available upon request.