WealthShield

December 17th, 2018

DOW THEORY

You are probably going to hear a lot about Dow Theory in the coming days and weeks. Just like the "death crosses" that have been occurring in several broad market indices, Dow Theory sell signals are starting to emerge. So what is the Dow Theory?

According to Investopedia, "The Dow theory is a theory which says the market is in an upward trend if one of its averages (industrial or transportation) advances above a previous important high and is accompanied or followed by a similar advance in the other average. For example, if the Dow Jones Industrial Average (DJIA) climbs to an intermediate high, the Dow Jones Transportation Average (DJTA) is expected to follow suit within a reasonable period of time."

One of the key tenets of the Dow theory is that both averages, the Industrials and the Transports, confirm one another. This means that a positive trend is one in which each index is making a series of higher highs and higher lows. A negative trend occurs when each index is making a series of lower highs and lower lows. As simple as this seems, buy and sell signals are actually rather subjective and are often disputed among Dow Theorists.

Charles Dow understood the importance of confirmation and also believed that the averages discounted everything. According to the Dow Theory, the market has three trends: primary or long-term trends (trends lasting more than 1 year), secondary trends (typically reactions against the primary trend that last 3 weeks to 3 months), and minor trends (generally lasting less than three weeks). It is often the most difficult to determine whether a reversal is a secondary trend or a new primary trend. This is where strategists tend to disagree the most.

We look at the Dow Theory because of its history and the fact that it is a trend following discipline. Like other practitioners we have our own "twist" to applying the discipline. We use weekly exponential moving average crossovers on both the Dow Jones Industrial and the Dow Jones Transportation indices. Specifically when the 13 week exponential moving average is below the 21 week exponential moving average on either index, we classify that as a negative trend. When the 13 week moving average is above the 21 week moving average, we determine that as a positive trend. Therefore, a Dow Theory buy signal occurs when both the Dow Transports and the Dow Industrial indices are in positive trends and a sell signal occurs when both are in negative trends.

Currently, The Dow Jones Industrials index and the Dow Jones Transportation index are both in negative trends according to the 13-21 weekly exponential moving average crossover. This is consistent with our belief that we are experiencing a trend reversal in the overall market and general economy. We are also witnessing a similar phenomenon that has occurred at multiple tops in the broad market. The Dow Transports index is leading the way down.

Chart 1: Dow Jones Industrial Average

Chart 2: Dow Jones Transportation Average

DOW THEORY

Chart 3: This chart illustrates other times in history where the Transports index broke down ahead of the Industrials index. We are experiencing something similar this time around.

The Dow Theory is consistent with our opinion that market participants should move to their defensive playbook. We don't believe this necessarily means moving out of the market completely. Rather, we think there are opportunities, even in the equities markets. Our recommendation is to revisit risk levels and make sure you are comfortable with a significant drawdown (>50%).

MARKET REVIEW

	Last Price	% Change
S&P 500	2599.95	-1.26%
Wilshire 5000	26749.34	-1.45%
Russell 3000	1528.36	-1.43%
S&P Small Cap	878.11	-3.00%
S&P Mid Cap	1732.81	-2.70%
MSCI All World Ex-US	1747.16	-0.96%
MSCI EAFE	1752.74	-0.89%
MSCI Emerging Markets	971.90	-0.96%
WTI Crude Oil	51.20	-2.68%
Copper	2.76	0.11%
Gold	1241.40	-0.89%
Bitcoin	3251.32	-4.42%
Vix	21.63	-6.89%

Table 1: Equities as of December 14th, 2018

Equities markets fell broadly over the course of the week with US markets leading the way down. The Wilshire 5000 index dropped -1.45% for the week. Small cap stocks were the worst performers in the US as the S&P 600 Small Cap index fell -3.00% for the week. International markets fared a little better than the US as the MSCI All World Ex-US index dropped -0.96%. Emerging markets dropped more than international developed, falling -0.96% and -0.89% respectively.

	Last Price	Change	%Change
US 3 Month Yield	2.42	0.02	0.83%
US 2 Year Yield	2.73	0.01	0.37%
US 5 Year Yield	2.73	0.03	1.11%
US 10 Year Yield	2.89	0.04	1.40%
US 20 Year Yield	3.03	0.02	0.66%
US 30 Year Yield	3.14	0	0%

Table 2: Interest rates as of December 14th, 2018

Interest rates rose in the US, albeit slightly, as the US 10 Year Treasury yield finished the week at 2.89%, up 1.40% or 4 basis points. The investment grade corporate bond ETF was the clear winner in the fixed income arena, gaining 0.75% (ETF symbol LQD). High yield corporate bonds (HYG) were also up on the week, rising 0.40%. On the other hand, the intermediate-term Treasury bond ETF (symbol IEF) was down -0.25%. This is not what was to be expected during a week where equities were under pressure. However, the long-term 30 Year Treasury bond yield was flat over the week. Therefore, the long-term Treasury bond ETF (symbol TLT) was up slightly.

MARKET REVIEW

	Last Price	% Change
Materials (XLB)	51.32	-1.14%
Energy (XLE)	62.09	-3.09%
Financials (XLF)	21.21	-3.46%
Industrials (XLI)	67.05	-1.44%
Technology (XLK)	64.57	-0.05%
Staples (XLP)	54.50	-0.40%
REITS (XLRE)	33.42	-1.59%
Utilities (XLU)	56.82	0.64%
Healthcare (XLV)	88.96	-1.77%
Consumer Discretionary (XLY)	102.33	-1.01%
Communications (XLC)	43.61	0.48%

Table 3: Sectors as of December 14th, 2018

From a sector perspective (in the US), the best performing sector was Utilities (ETF symbol XLU). This sector finished the week up 0.64%. The worst performing sector was the financial sector (XLF), which fell -3.46%. Energy (XLE) was a close second, falling -3.09% for the week. Technology (XLK) was surprisingly strong, finishing the week flat. The communications sector (XLC) led by Facebook's more than 4% gain on the week, finished up 0.48%.

The momentum factor (MTUM) bucked the trend of risk aversion in the broad market, finishing down only -0.61%. This is quite the divergence since the momentum factor has been the weakest during the market decline. Quality (QUAL) was the worst performing factor, falling -1.29%. The low volatility factor (SPLV) finished the week down 0.93%. This week was tough for the value styles as well. The Morningstar Large Growth index outpaced the Morningstar Large Value index over the week. Growth was down -0.63% versus -1.30% for value. The same was seen in small and mid cap stocks as well. The differences were more pronounced in small cap where the Morningstar Small Cap Growth index was down -1.92% versus the Morningstar Small Cap Value Index shedding -3.44%.

	Last Price	%Change
Momentum (MTUM)	103.49	-0.61%
Low Volatility (SPLV)	48.77	-0.93%
Quality (QUAL)	79.7	-1.29%
Dividend Aristocrats	1113.92	-0.95%
Large Growth	164.28	-0.63%
Large Value	100.36	-1.30%
Small Growth	174.60	-1.92%
Small Value	130.62	-3.44%
Mid Growth	200.53	-1.23%
Mid Value	147.36	-2.29%

Table 4: Factors as of December 14th, 2018

Although the market action was broadly negative, we witnessed several divergences over the course of the week. The typical outperformance we witness in low volatility, dividend growth, value, and quality factors was not present. High yield and investment grade corporate bonds gained on the week as well, demonstrating a lackluster flight to safety in the face of equity market losses. We would expect Treasuries to outperform credit during a continued market decline. Despite the divergences this week, sector performance and broad market trends continue to signal that the defense should be on the field. We continue to support a high cash position, long-term Treasury bonds, defensive equity sectors, and low volatility equities as a factor.

ECONOMIC UPDATE

We received several data points on inflation this week. The main data points were the PPI and CPI data releases, industrial production, and retail sales. The Producer Price Index rose 0.1% month over month, which was unexpected. The consensus forecast was for no change on a month over month basis. Core CPI ticked up to 2.2% year over year, which matched consensus estimates. Retail sales grew 0.2% on a month over month basis, also matching consensus estimates.

Wednesday December 12 2018			Actual	Previous	Consensus	Forecast
08:30 AM	US	Core Inflation Rate YoY NOV	2.2%	2.1%	2.2%	2.3%
08:30 AM	US	Inflation Rate YoY NOV	2.2%	2.5%	2.2%	2.4%
Friday December 14 2018			**Actual**	**Previous**	**Consensus**	**Forecast**
08:30 AM	US	Retail Sales MoM NOV	0.2%	1.1% ®	0.2%	0.3%

Source: Tradingeconomics.com

Industrial production increased to 3.9% year over year through November. This is an improvement over last month but still below the peak growth rate reached in September. Industrial production has been on a long-term uptrend since declining through the global growth contraction in 2015 and 2016.

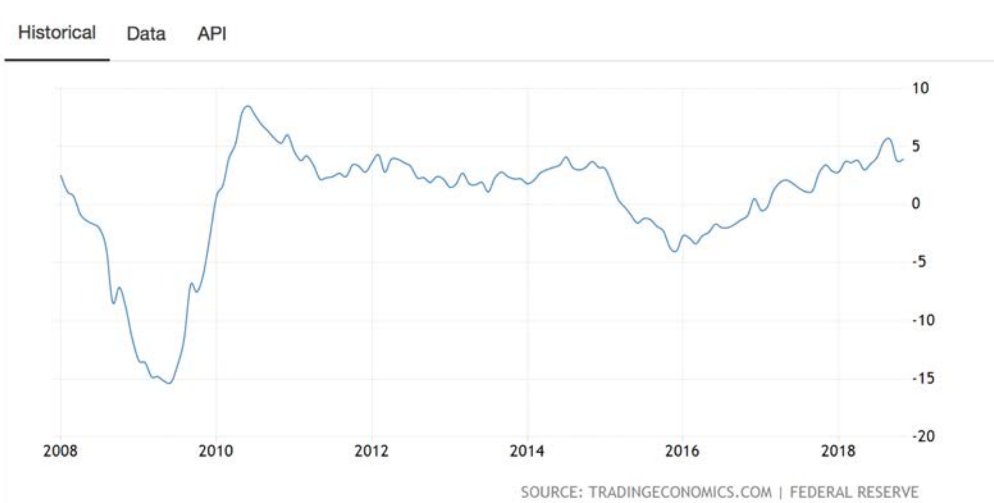

Chart 4: Industrial Production as of December 14th, 2018

ECONOMIC UPDATE

On a forward looking basis, the ECRI Weekly Leading index is down -3.9% on a year over year basis and the 4 week moving average is now down over -1% year over year. In addition, inflation expectations are tumbling. We remain in an environment where growth and inflation are slowing considerably.

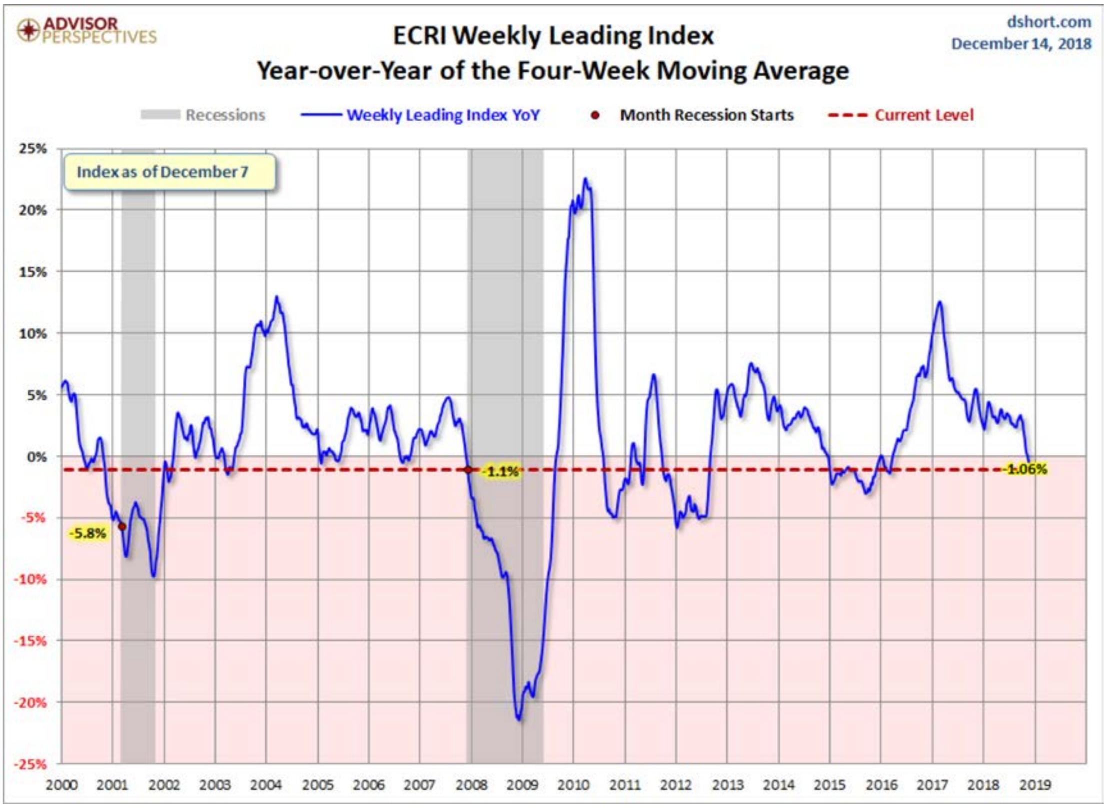

Chart 5: The year over year growth rate of the four week moving average of the ECRI Weekly Leading index is down over -1%; Source: dshort.com

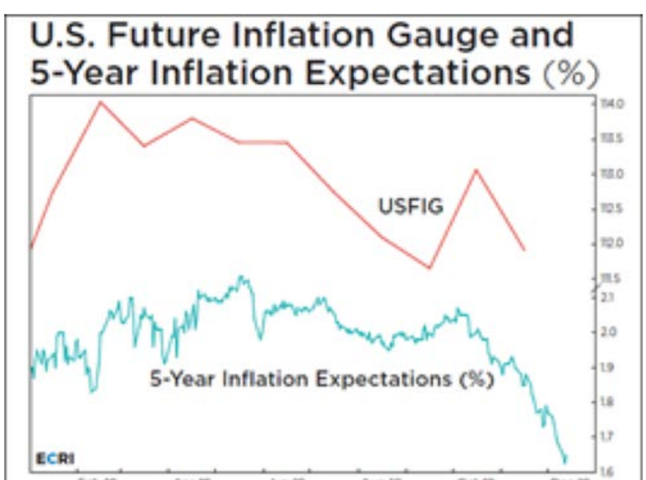

Chart 6: Inflation expectations are tumbling; Source: ECRI

THE FEDERAL RESERVE MEETING

Next week we have an event that market participants have been waiting for, the Federal Reserve meeting. The Fed will have a press conference at 2:30PM on Wednesday. This could be a major market moving event as investors search for clues as to whether or not the Fed will halt their tightening program early next year. We expect some sort of data-dependent language to emerge. By data-dependent, we understand this to mean market dependent.

With growth and inflation slowing simultaneously, and the market showing signs of cracking, the Fed has room to maneuver into a dovish posture. We will be watching to see if this is in fact what they do. The ultimate surprise would be if they did not hike rates in December at all. However, the Fed would run the risk of shaking confidence in their ability to deal with the economy if this course of action was followed.

In addition to the Fed, we also have Personal income, spending, and Durable Goods releases on Friday.

Wednesday December 19 2018			Actual	Previous	Consensus	Forecast
02:00 PM	US	**FOMC Economic Projections**				
02:30 PM	US	**Fed Press Conference**				
Friday December 21 2018			Actual	Previous	Consensus	Forecast
08:30 AM	US	**Personal Income MoM** NOV		0.5%	0.3%	0.3%
08:30 AM	US	**Personal Spending MoM** NOV		0.6%	0.3%	0.3%
08:30 AM	US	**Durable Goods Orders MoM** NOV		-4.4%	1.7%	0.8%

Source: Tradingeconomics.com

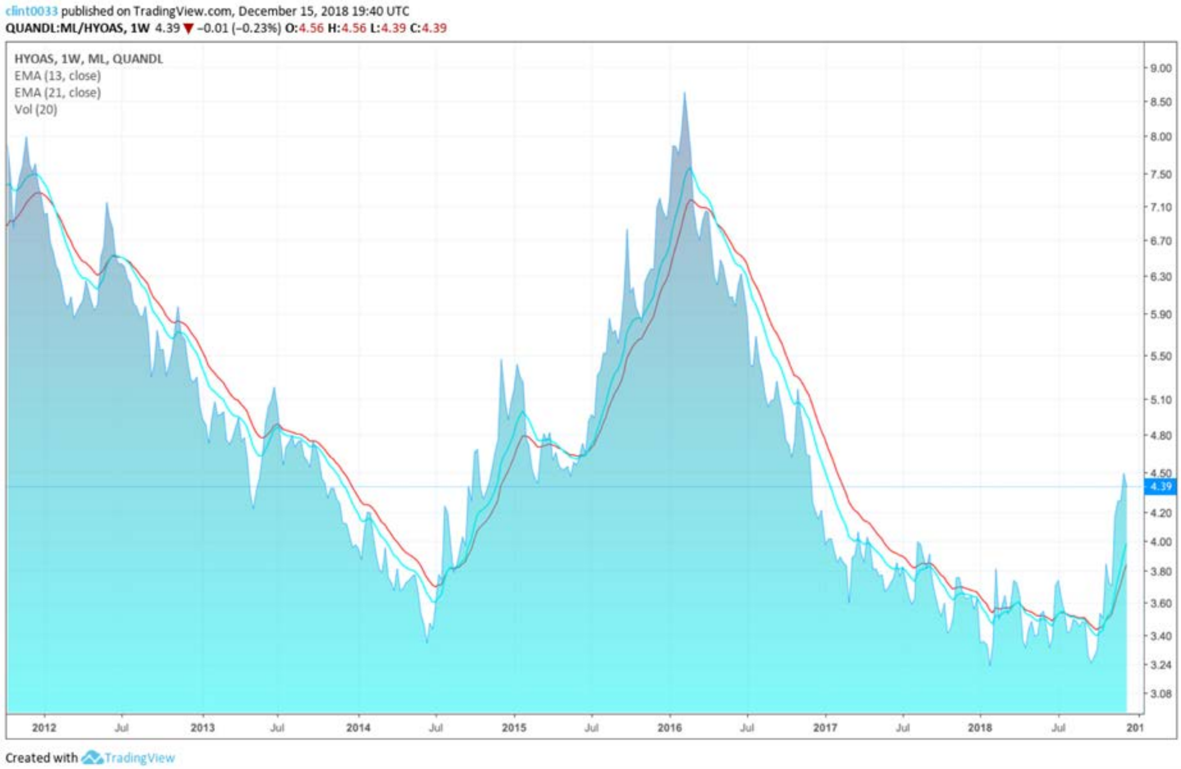

Chart 7: High Yield Spreads remain wide, illustrating the risk aversion present in the credit markets. Spreads are positively trending now and suggest a risk off posture is prudent**.**

Chart 8: Stocks lost -1.45% against bonds this week and remain in a negative trend.

Chart 9: Stocks lost ground against gold, shedding -0.56% last week. This relationship remains supportive of defensive positioning.

Chart 10: US stocks lost ground to international stocks last week but remain in a strong positive trend. US equities remain relatively strong compared to their international counterparts.

Chart 11: International developed markets have recently reversed into a negative trend relative to emerging markets. This is an important trend reversal and suggests a shift in risk preference overseas.

Chart 12: Small cap stocks in the US remain in a strong negative trend against large cap US equities. Small caps lost another -1.76% against large caps this week.

Chart 13: Growth gained ground against value (large cap) rising 0.68% for the week. However, the trend remains supportive of value.

Chart 14: Dividend Growth stocks rallied 0.31% against the broad market (S&P 500) last week. This trend may be in the early innings. We think dividend growth equities are a good place to be during a growth and inflation slowing environment. These companies tend to be high quality, lower valued relative to the broad market, and carry a lower volatility as well. These are the factors we want to have exposure to if the market continues to reward risk aversion.

Chart 15: Copper gained over 1% against Gold this week but remains in a negative trend. This suggests that inflation expectations are slowing.

Chart 16: Crude oil dropped -2.68% for the week and remains in a negative trend. This is bad for global growth.

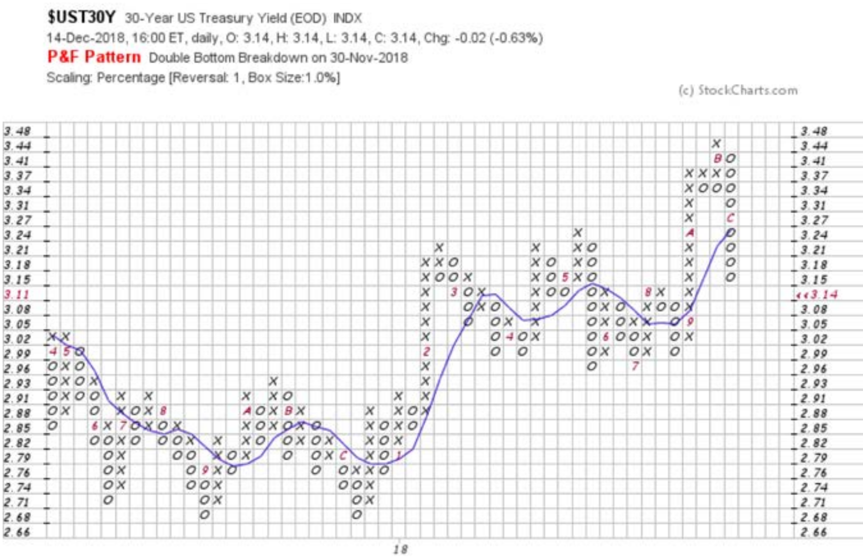

Chart 17: US 30 Year Treasury Bond Yields: A point and figure sell signal occurred on a break below 3.31%. Interest rates closed the week at 3.14%. The next support zone is around 2.96%. Interest rates could continue to fall on the long end if growth continues to weaken and the Fed moves to a cautious, data dependent stance.

Chart 18: iShares 20+ Year Treasury Bond ETF. The weekly 1% box reversal point and figure chart is currently on a buy signal for long-term bonds. As interest rates have potential room to run on the downside, we expect long-term Treasuries could be a benefactor. As long as growth and inflation are slowing, long-term Treasury bonds may be a good bet. There is tough resistance at 126.18 for TLT. If TLT were to break above this key level, we would think TLT could take out its all time high. We have plenty of ground to cover before then, however, and will have to wait and see what occurs.

Chart 19: The US dollar index gained 0.45% this week and remains in a strong positive trend. This is deflationary and negative for growth going forward.

Chart 20: AUDJPY. The Australian Dollar gained 0.28% against the Japanese Yen last week. This currency pair is typically correlated with Emerging Market stocks. A reversal to a positive trend would be a welcome set up for a potential Emerging Market rebound. This pair is close to shifting to a long-term positive trend, but remains negative for now.

Chart 21: Utilities (XLU) gained 1.84% against the S&P 500 (SPY) last week. This is not a good sign for risk assets as the VIX (21 week moving average in green) tracks the ratio of Utilities to SPY pretty closely. This ratio is indicating further volatility is possibly on the horizon.

Chart 22: The Technology sector (XLK) gained 1.14% against the S&P 500 (SPY) last week. This was somewhat of a surprise given the general weakness of the market overall. Technology shares have been one of the worst performers during the recent volatility. In an environment where we expect growth slowing, we would expect them to continue to show deterioration.

Chart 23: Bitcoin continues to get hit hard in the market. It dropped another -4.42% this week. The trend is your friend here and we are not into catching fallen knives. Bitcoin will be a buy when it reverses back into a positive trend and not before, in our opinion.

CHART OF THE WEEK:

Chart 24: Shanghai Stock Exchange vs. the German DAX. Chinese stocks have broken out against German equities after a long-term negative trend. This may present an opportunity for investors to go long Chinese equities and short German or European stocks to hedge. Emerging markets have also reversed into a positive trend relative to international developed suggesting that this trend may be more pervasive

PLAYBOOK:

Overweights:
Treasury bonds, Cash, Utilities, Staples, REITS, Healthcare, Dividend Growth, and Low Volatility factor

Underweights:
Energy, Technology, International Equities, Small Cap stocks, Growth, High Beta, and Momentum factors

DISCLOSURE:

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