RAYMOND JAMES

Gleanings
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October 31, 2018

Gleanings

A Monthly Chart Presentation and Discussion Pulling Together the Disciplines of Economics, Fundamentals, Technical Analysis, and Quantitative Analysis

"Selling Stampede"

(This missive was published a few weeks ago, but is being reposted due to popular demand)

My friend and mentor Ray DeVoe used to say that going over old reports can be an exercise in humility, as you cringe while reading some errant forecast of another time. "How could I have been so stupid?" is the unsaid reaction. On the other hand, it can be an ego trip, as you proudly go over some forecasts that were right on target. Then the unsaid comment is, "Why didn't I capitalize on this more?" or "Why didn't I continually pound that theme, it was so obvious." But, then you realize that it wasn't that obvious at the time and that, generally, conventional wisdom was running in the opposite direction. The reports that were off-base will not be covered in this missive, yet they seemed to be reasonable projections at the time. However, one set of reports that were correct will be mentioned only because they were so much against the conventional wisdom of the time.

So, we officially joined Raymond James in 1999. At the time, stocks were soaring. Then on September 23, 1999 there was a Dow Theory "sell signal." We wrote about it and got hammered by financial advisors as to why we had turned negative. Our response was that it was not Jeff Saut, or even Raymond James, but Dow Theory suggesting the best had been seen and discounted. By the way, we looked like an idiot as the stock market headed higher into the spring of 2000. However, the stock market peaked in March 2000 and declined by some 50% into November 2002, where stocks began their bottoming process. Said process was complete by the spring of 2003, which was when a Dow Theory "buy signal" was registered. From there the S&P 500 would gain over 100% and we were bullish. That Bull Run lasted into the fall of 2007 and everyone was bullish with the D-J Industrials making new all-time highs. Yet, on November 21, 2007 there was another Dow Theory "sell signal" and we wrote about it again and listened to the "cat calls" from all the bullish participants. This time there was no "forereach" (no more upside like between September 1999 and March 2000) as stocks began to slide, and by March 2009 the S&P 500 had surrendered roughly 56% of its value. Yet, most stocks actually bottomed on October 10, 2008 when 92.6% of stocks made new annual lows. At the time, we were writing that the bottoming process had begun, and on March 2, 2009 we were on Bloomberg TV saying, "The bottoming process that began in October of last year is complete and we are all in!"

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Jeffrey Saut

"Selling Stampede"

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More recently, after all three of our proprietary models for all of 2017 were wildly bullish in mid-January 2018, our intermediate and short-term prop models flashed "sell signals" and we recommended raising some cash on a trading basis. The subsequent decline saw the S&P 500 (SPX/2682.63) lose about 12% of its value into the February 9, 2018 undercut low, which we told participants to buy. From there, the SPX would rally 16% into early-October, when our short-term models flashed another "sell signal" on October 2, 2018 and we advised participants to sell trading positions. While our long-term prop model flipped bullish in October 2008, and has never turned bearish since, our short-term and intermediate models are currently conflicted. Indeed, the intermediate model remains constructively configured, but our short-term model is still on a "sell signal." Quite frankly, our instincts told us the equity markets bottomed on a trading basis on October 11, 2018 at ~2710, but last Thursday surprised us as the SPX lost a large 62 points from Wednesday's intraday high into Thursday's intraday low. This has left the SPX vulnerable to further downside.

We see it as one of two potential possibilities. First, prices could consolidate in a pretty narrow range into the mid-November energy peak often mentioned in these reports. Given the current level of energy, that is a distinct probability. However, there is still a lot of negative energy out there and if prices stay around the recent lows of 2710 – 2730 (basis the SPX), then we could experience another spell of panic selling that would take the SPX to new reaction lows. If this is a "selling stampede," they typically last 17-25 sessions and we are 12 sessions into this one. Sometimes such stampedes last 25-30 sessions, but it is really rare to see one go more than 30 sessions. Quite frankly, we feel much better about equites after the mid-November energy peak.

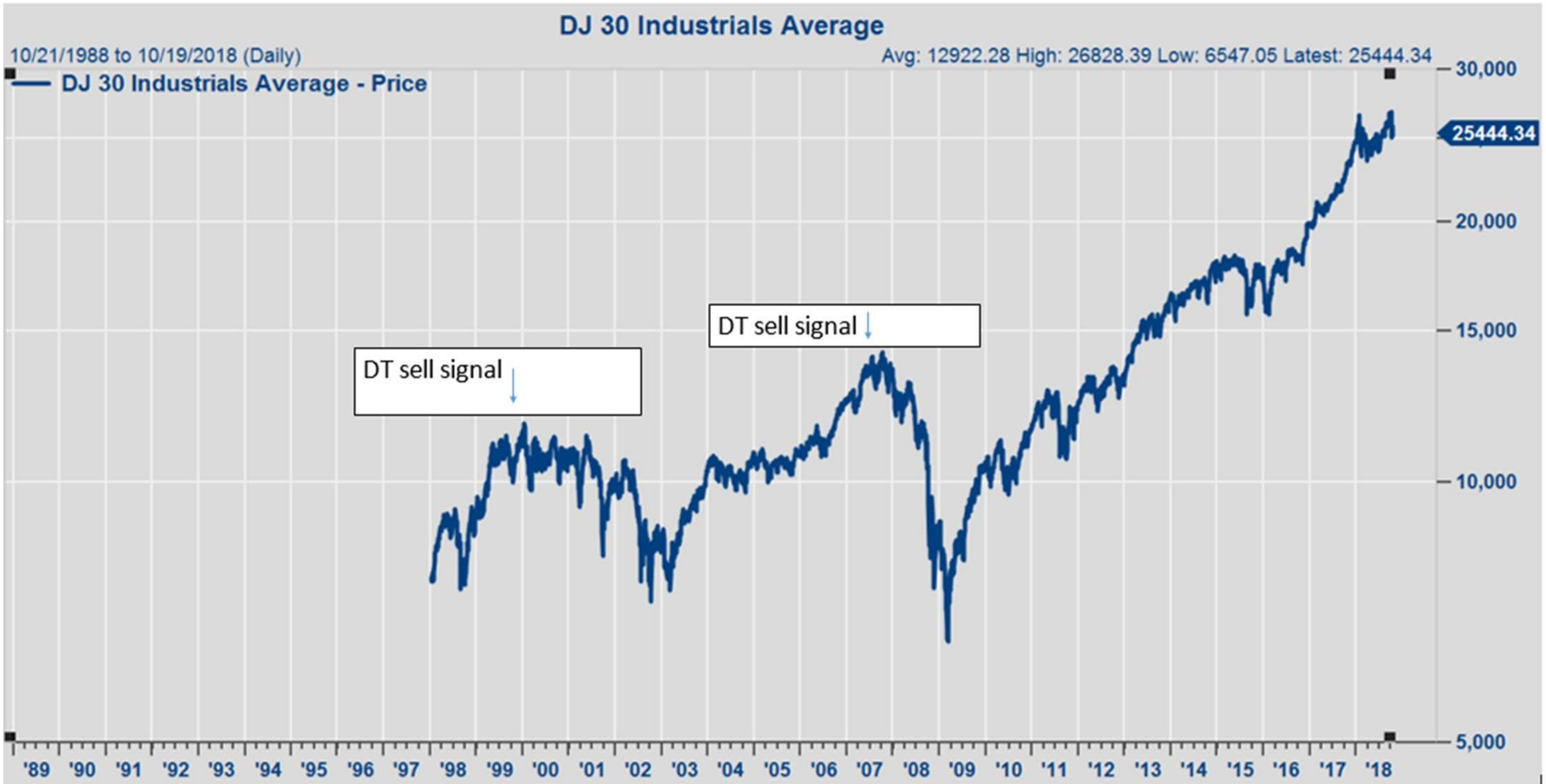
What remains amazing to us is that many Wall Street pundits, who NEVER saw the January – February, or the October 2 to the present, declines coming, have rushed to publish a plethora of reports telling us what to do now! Maybe I'm Amazed (Amazed) at these false profits that talk out of both sides of their mouths, so that whatever the various markets do they can say, "See I told you that was going to happen." As often stated in these letters, we make "calls." Most of the time they turn out fairly well, but when you take a stand, you are going to be wrong and wrong more often than you would expect. As the brilliant Peter Bernstein wrote:

> *After 28 years at this post and 22 years before this in money management, I can sum up whatever wisdom I have accumulated this way: the trick is not to be the hottest stock-picker, the winning forecaster, or the developer of the neatest model; such victories are transient. The trick is to survive. Performing that trick requires a strong stomach for being wrong, because we are all going to be wrong more often than we expect. The future is not ours to know. But, it helps to know that being wrong is inevitable and normal, not some terrible tragedy, not some awful failing in reasoning, not even bad luck in most instances. Being wrong comes with the franchise of an activity whose outcome depends on an unknown future. Maybe the real trick is persuading clients of that inexorable truth.*

[Update October 29]: Well, it is now 18 sessions into the "selling stampede" and we are looking for a bottom in the next two weeks. In fact, we think stocks are approaching the best buy spot since 2016.

Jeffrey Saut

The Dow Theory Sell Signals of September 23, 1999 and November 21, 2007



Source: FactSet.

Jeffrey Saut

What We Were Telling Investors in November 2007

The following was published in our Investment Strategy piece published November 26, 2007

"Bulls, Bears, and Retests"

People don't understand the significance of the "bear market signal" of November 21. I stated on Wednesday's site (Nov. 21) that the breakdown of the Industrials signaled THE EXISTENCE of a primary bear market. It didn't signal the beginning of a bear market, Wednesday's action gave us the final word via Dow Theory that a primary bear market was in force.

. . . A precept of Dow Theory is that neither the duration nor the extent of a bull or a bear market can be predicted in advance. It is far easier to IDENTIFY the end of a bull or bear market than it is to predict their end. Bull markets tend to build extended and often deceptive tops, while bear markets tend to build more definite and identifiable and faster bottoms. Therefore, it's usually easier to identify the bottom of a bear market than it is to identify a bull market top.

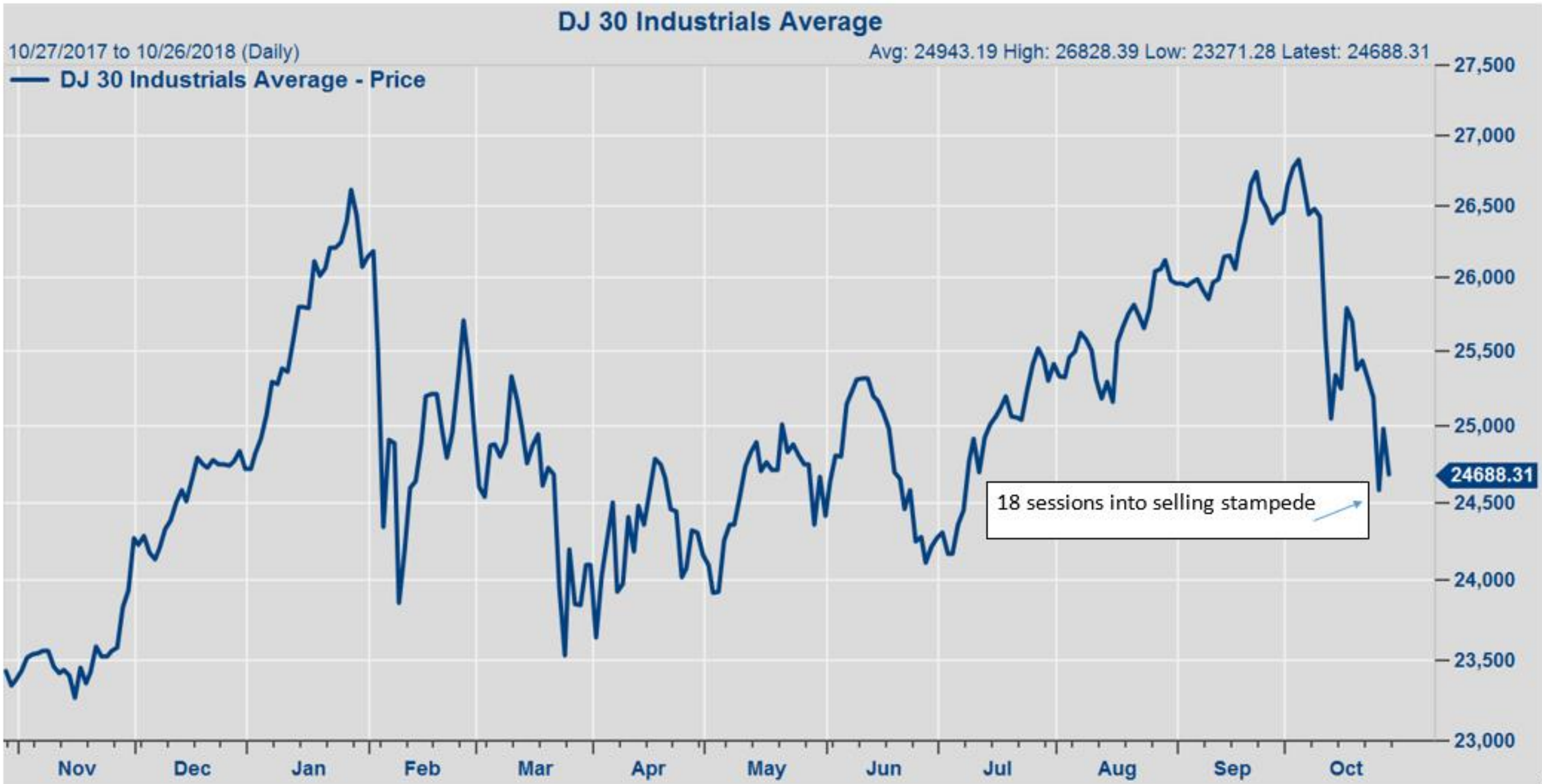
. . I expect a lot of wild and confusing movements from the stock market in the days ahead. But I remind subscribers that a rally here, even a powerful rally, will not mean that the bull market has suddenly been reborn. This bear market will not end in four months. But any rally here will allow subscribers to "trim their sails."

. . . Richard Russell, *Dow Theory Letters*

Jeffrey Saut

Think a Bottom is Coming Soon

As of October 29, 2018 we are 18 sessions into the selling stampede, which typically last 17-25 sessions. There have been a few that extended for 25-30 sessions, but it is rare for one to go more than 30 sessions. We think a bottom is coming soon.

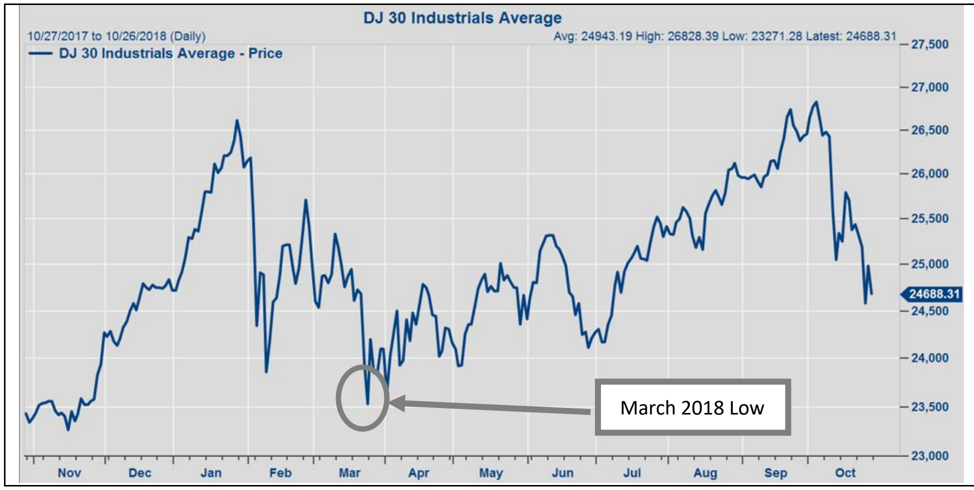


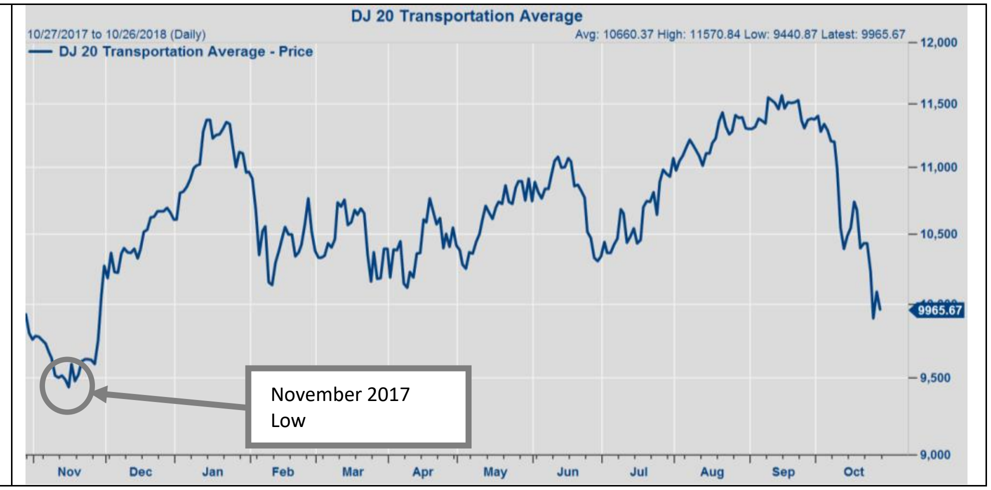
Source: FactSet.

Jeffrey Saut

No Dow Theory "Sell Signal"

There has been no Dow Theory "sell signal." For that to happen, the Dow would have to break below its March 2018 closing low with a confirmation from the D-J Transports below their November 2017 closing lows.



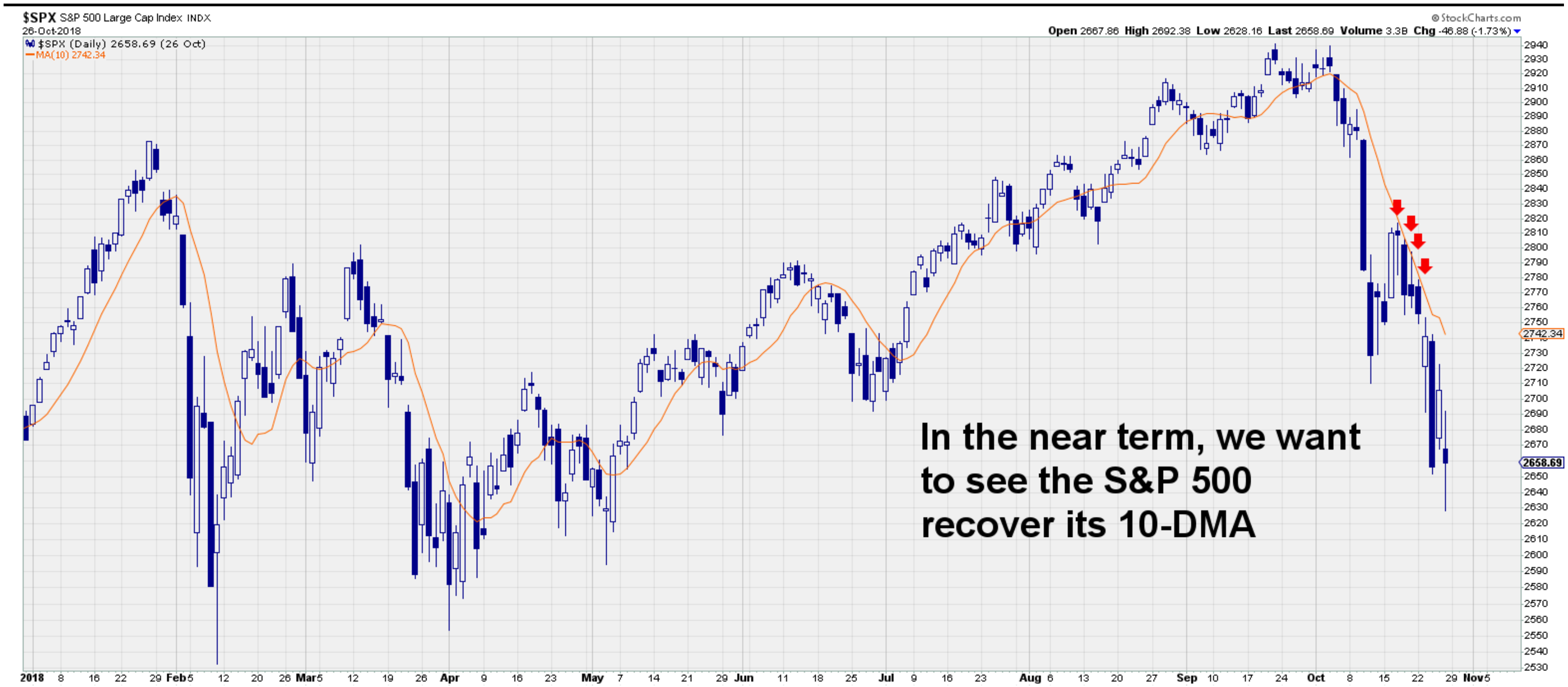


Source: FactSet.

Andrew Adams

Post-Mortem – S&P 500

October has obviously not been a fun month for equity investors. Once the S&P 500 failed to make a new high in early October and then dropped beneath the early September low around 2864, the path of least resistance flipped to the downside and selling accelerated quickly. There was a bounce attempt around mid-month but the S&P 500 was unable to make it up over its 10-day moving average, failing in four consecutive days to climb above it. Now, one of the first things we are watching to help support that the lows are in will be getting back above the 10-day moving average on a daily closing basis.

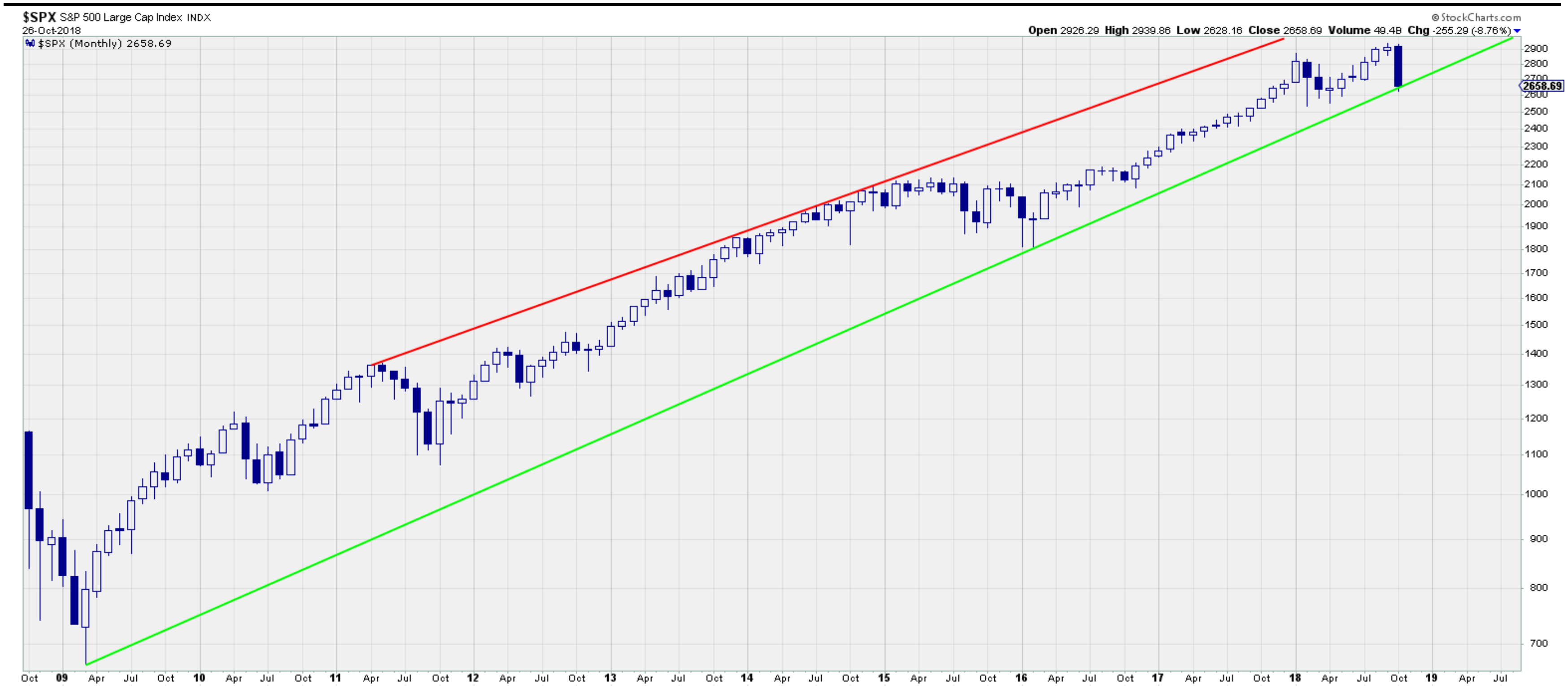


Source: Stockcharts.com.

Andrew Adams

Long-Term Trend Not Broken … Yet

While October has been a horrible month for the stock market, we have not yet witnessed enough damage to believe the secular bull market is done. There isn't just one indicator or chart that will tell us when the bull market is over, but one of the most important charts I am watching is the monthly chart for the S&P 500. The October weakness has brought the index right to the uptrend line that connects the 2009 and 2016 lows (green line). A monthly close beneath this line would not be good, and would increase the odds that we are in for more than just a quick drop. Yet, this zone should produce support and we hope to see that happen.



Source: Stockcharts.com.

Andrew Adams

S&P 500 at Weekly Bollinger Band

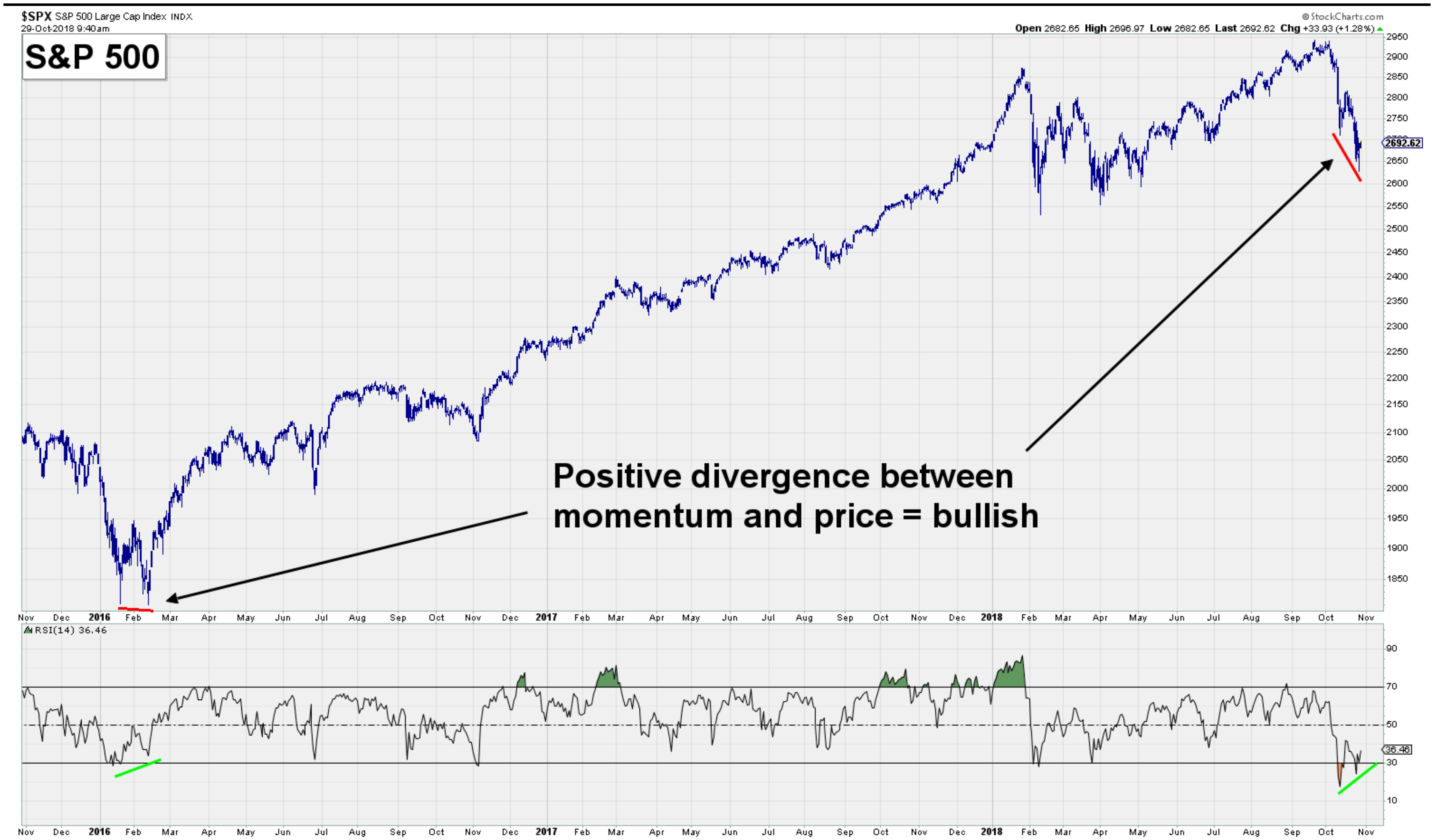
The S&P 500 has often marked bottoms near its lower weekly Bollinger Band over the last few years. The standard Bollinger Bands are two standard deviation bands surrounding the 20-period moving average, in this case the 20-week moving average. It is expected that most trading action will take place between these two bands, so very often traders and investors use these as major support and resistance. The fact that the S&P 500 is at its lower band should help add additional support to an already oversold market.

Source: Stockcharts.com.

Andrew Adams

Down-Move Losing Steam

Very often at bottoms, a stock or index will make a new low in price, but do so with less downside momentum as measured by an indictor like the Relative Strength Index (RSI). This is called a positive divergence and implies that a down-move is running out of steam. Well, this has happened over the last several sessions as the S&P 500 has made lower lows in “price” but its RSI has made higher lows (lower panel). This, too, supports that a bottom is near.

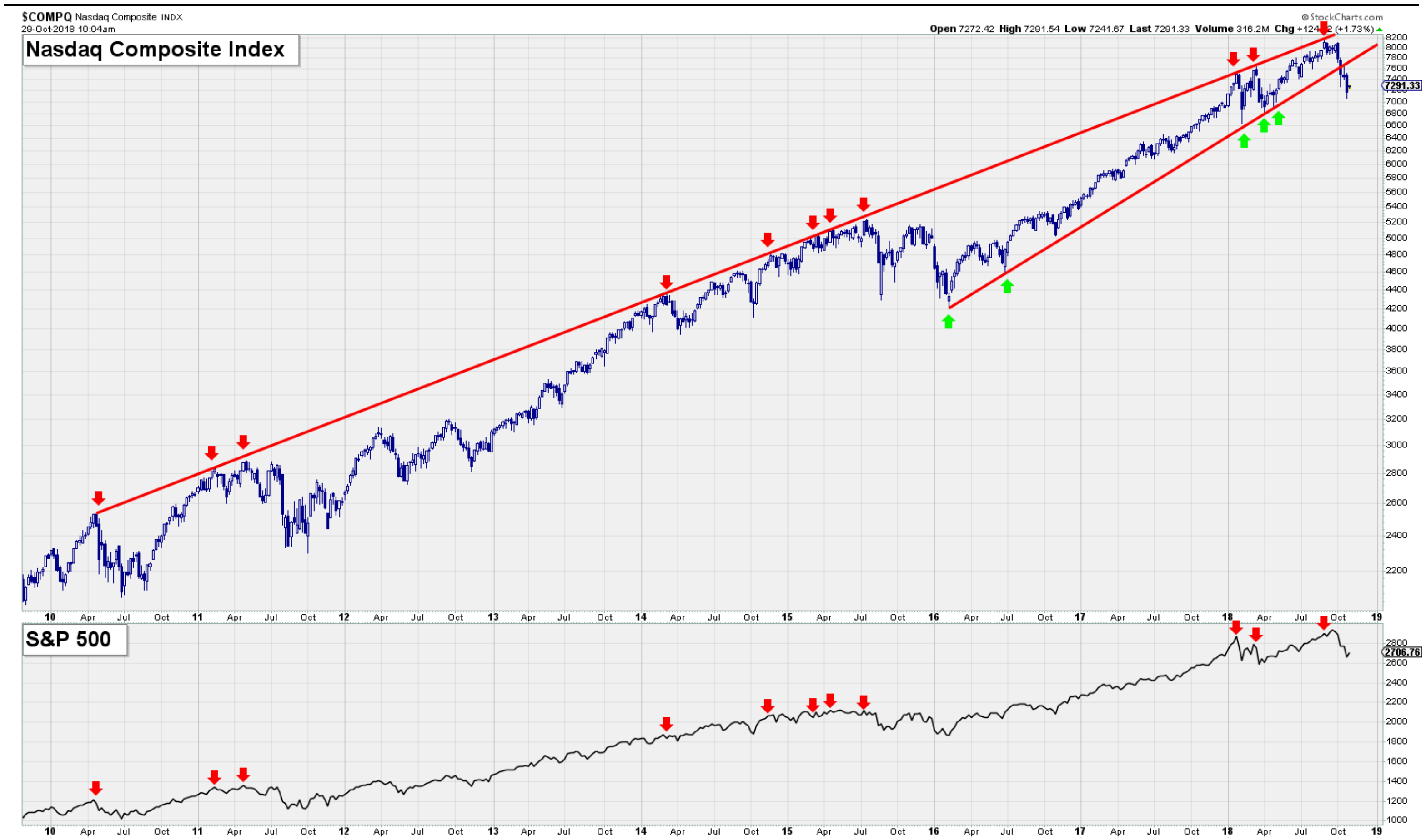


Source: Stockcharts.com.

Andrew Adams

NASDAQ Has Done Damage Too

We used this chart quite a bit in the last few months to show that the NASDAQ (and the broad market) likely had limited upside as it rallied up to the top of its long-term resistance line (top red line). While that wasn't necessarily a sign that the market would subsequently sell off, it did skew the risk-to-reward in the near term and may have encouraged investors and traders to cut positions on the first sign of weakness. Now, the NASDAQ has broken below the uptrend line that was in place from the 2016 low and that had previously acted as support (lower red line), and this line will be expected to act as major resistance to any rally attempt in the coming months.



Source: Stockcharts.com.

Andrew Adams

Russell 2000 Broke Major Support

It is also worrying that the small cap Russell 2000, which has now been weak for about two months, closed a week beneath a long-term line that has a history as both resistance and support (lowest red line). This line acted as support earlier this year and on the first leg down recently, but now it will be expected to add to the selling pressure on any rebound attempt. However, in the near term we expect that small caps will lead large caps on any bounces since they are more beaten-down and stretched to the downside.

Source: Stockcharts.com.

Andrew Adams

How Technology Responds Here is Critical

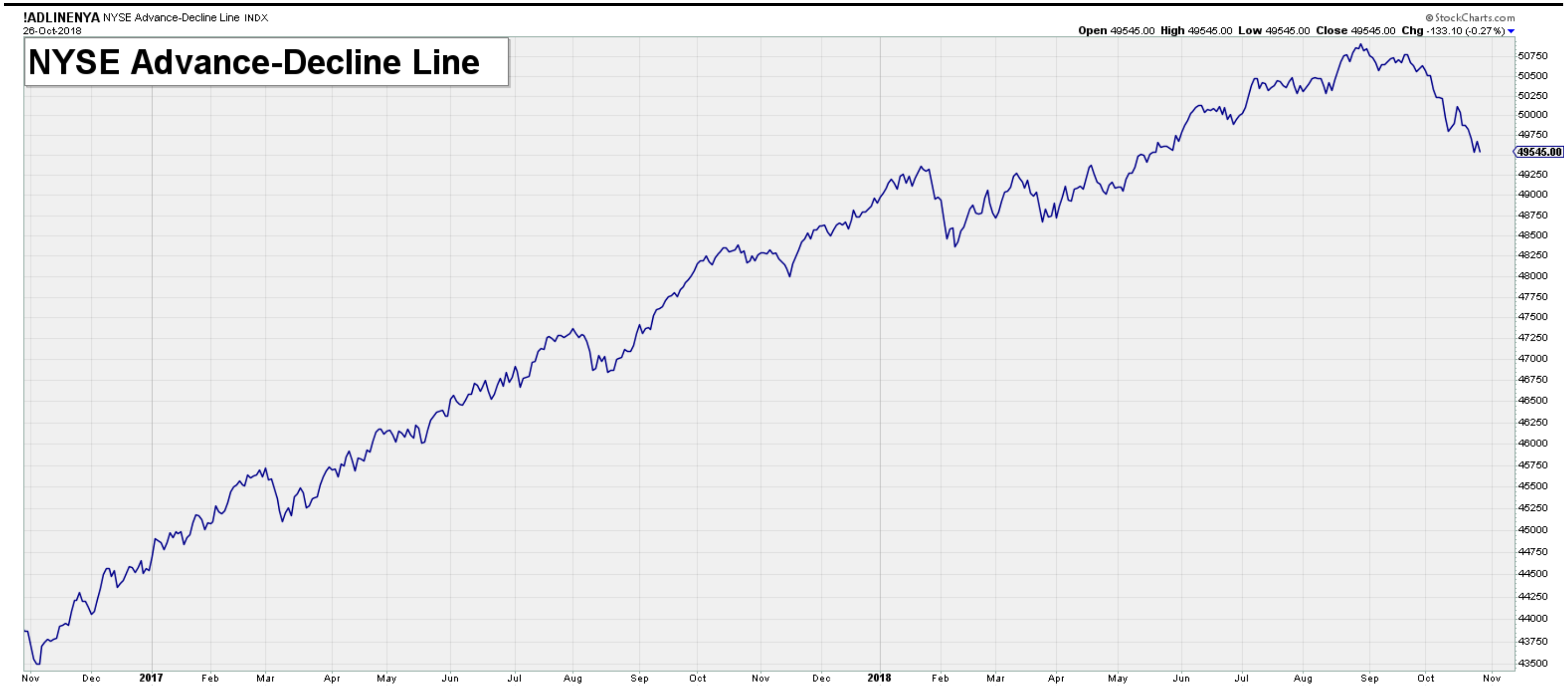
Technology has helped lead the market higher for several years now, and where the sector goes from here may go a long way toward determining where the broad market goes. Tech has pulled back to a major support line that has a history of importance going all the way back to the start of 2010 (top green line). If it breaks down below this line, it would not be good.

Source: Stockcharts.com.

Andrew Adams

Need to See Breadth Improve on Any Rallies

Another concerning development has been the continued drop in the NYSE Advance-Decline Line. This is one of the key breadth indicators we follow and it topped out in late August along with small cap stocks. We will be skeptical of any moves upward in the major stock averages that are not also accompanied by improvement in breadth indicators like the NYSE A-D Line, so breadth really needs to pick up here.



Source: Stockcharts.com.

Andrew Adams

World Stocks Under Pressure, But at Long-Term Support Zone

World stocks, as measured by the MSCI World (ex-USA) Index, have been weak for most of this year but even they saw acceleration to the downside recently. The index has now pulled down to what should be an area of massive support, where two long-term support lines have converged. If this zone cannot boost up world stocks, we're not sure what it's going to take and things could get much worse in the near term.

Source: Stockcharts.com.

Andrew Adams

Watch 10-Year Closely

Also of massive importance is how the benchmark 10-Year U.S. Treasury rate reacts in the near term. It rallied up to very long-term resistance that goes back to the early 1980s peak in rates (red line) and climbing above this line would imply that rates are going higher at a time when the market seems to be really worried about rising rates. So far, though, this line is producing resistance as expected, and could continue to put downward pressure on yields.

Source: Stockcharts.com.

Scott Brown

The Economy in Brief

Real GDP rose at a 3.5% annual rate in the advance estimate for 3Q18 (these data are subject to revision, but the story is not expected to change much). While the headline growth figure was near expectations, there were some surprises in the details. Recall that slower inventory growth had subtracted from 2Q18 GDP growth, while a narrower trade deficit added to growth. These two effects reversed in 3Q18 and then some. Faster inventory accumulation added 2.1 percentage points to third quarter GDP growth, while a wider trade deficit subtracted 1.8 percentage points. In addition, government consumption and investment added 0.6 percentage point.

Putting these volatile sectors aside and focusing on underlying domestic demand, Private Domestic Final Purchases (PDFP) rose at a 3.1% annual rate (+3.4% y/y). PDFP rose at a 3.0% annual rate from 4Q11 to 1Q17 and 3.2% from 1Q17 to 3Q18.

Consumer spending was stronger than expected (a 4.0% pace), while business fixed investment was surprisingly soft (a 0.8% annual rate, mixed across categories). Residential fixed investment (homebuilding and repairs) fell at a 4.0% annual rate, the third consecutive quarterly decline.

Scott Brown

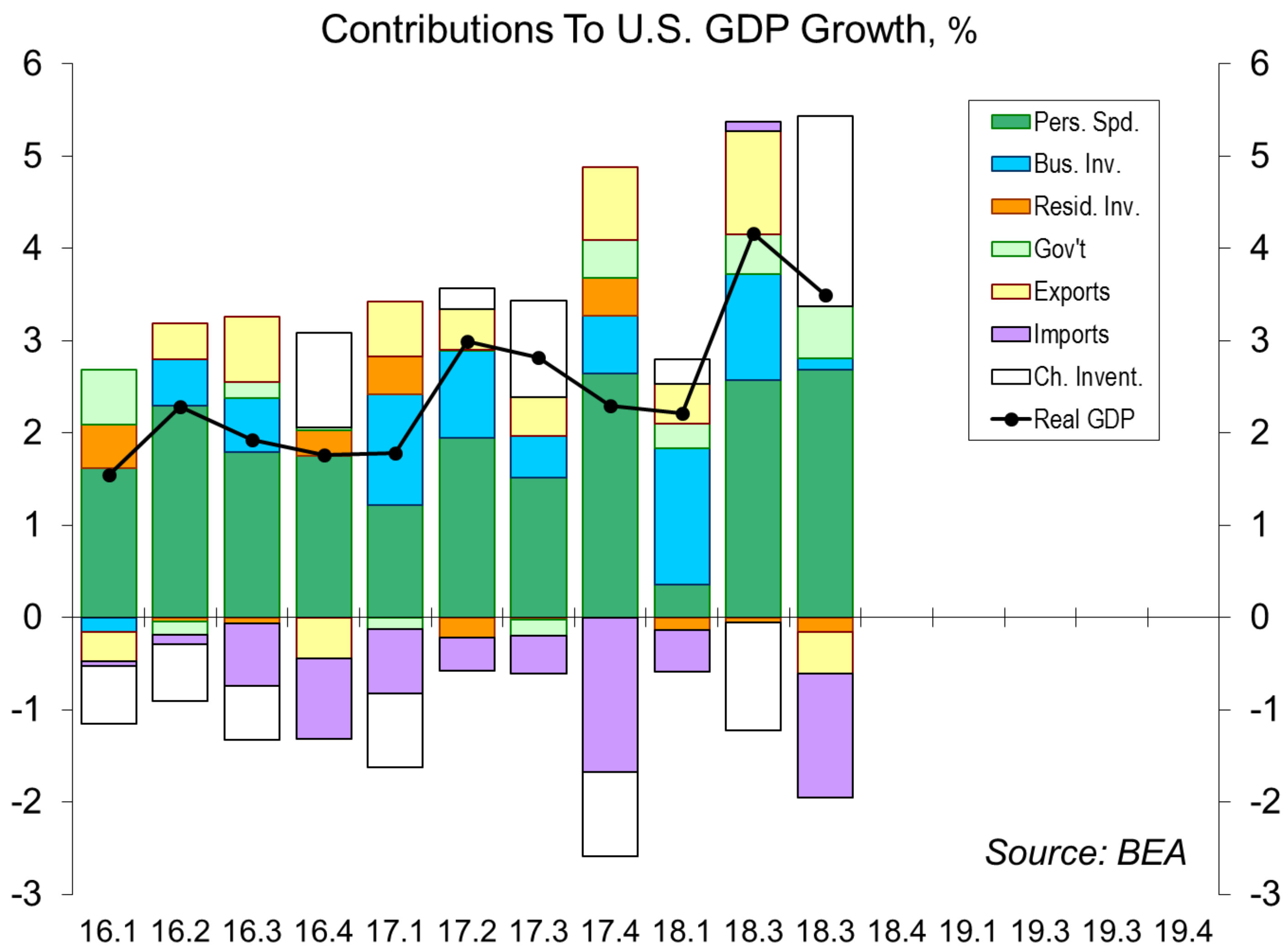
Worries

Periods of low financial market volatility tend to be followed by significant readjustments, with violent upside and downside moves (often intraday). There has been a long list of concerns, mostly ignored, in the last few months (Fed policy, rising long-term interest rates, trade policy, downside risks to the global economy, the November 6 election, among others). Sometimes the list of worries becomes more meaningful for the financial markets – without any specific catalyst.

The Fed is expected to raise short-term rates further as it normalizes monetary policy, but is aware of the risks of raising rates too rapidly (so far, the stock market correction does not appear to have altered Fed officials' opinions regarding a December hike). Fed tightening, a strong economy, and increased government borrowing put upward pressure on bond yields, but the rise in long-term rates has been checked by the drop in the stock market. The impact of tariffs and retaliation has broadened and, without an agreement with China, is expected to worsen significantly as we roll into 2019. While far from a done deal, Democrats are likely to gain control of the House, but that doesn't mean a significant change in taxes or regulatory policy anytime soon.

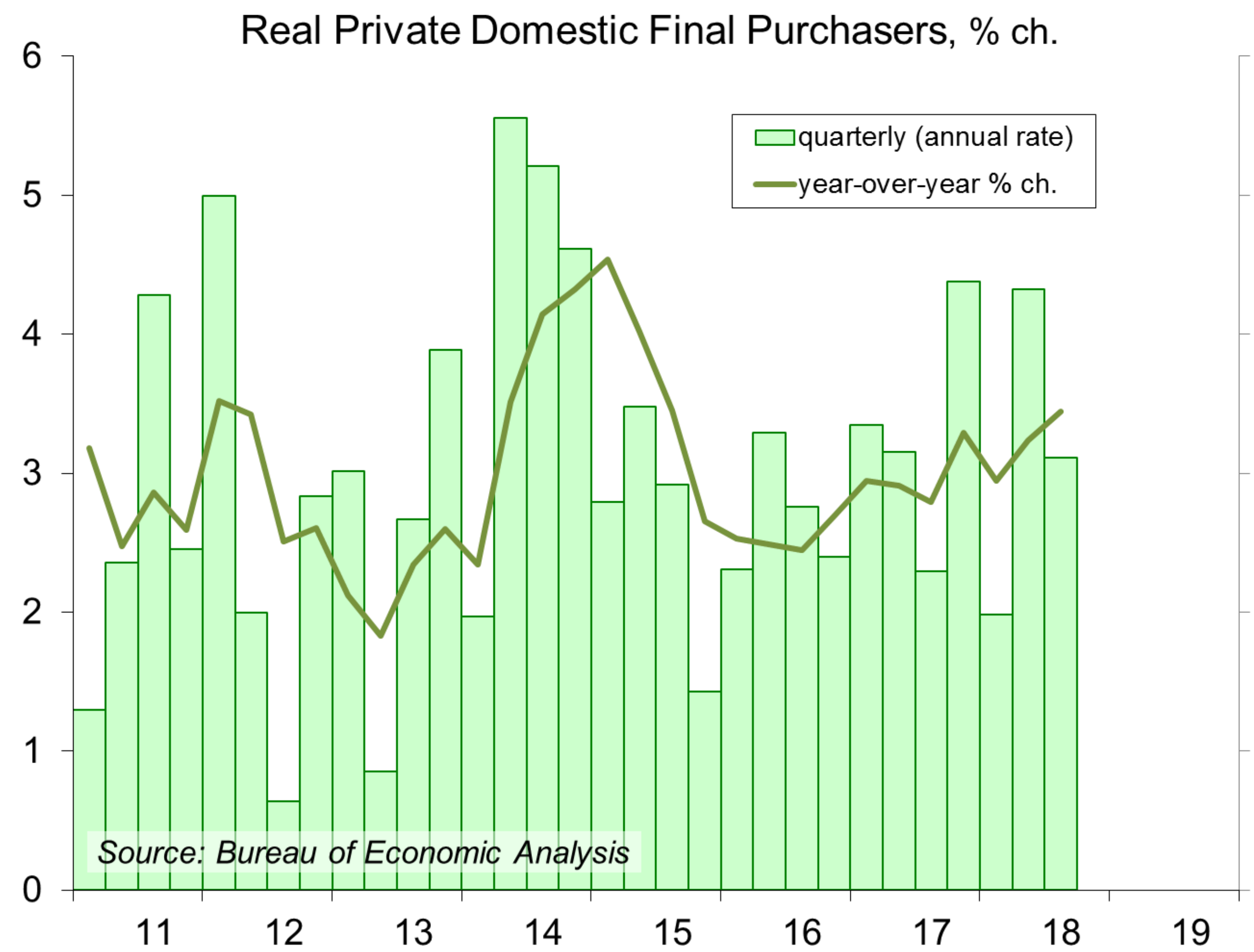
Scott Brown

3Q GDP at a 3.5% Annual Rate in the Advance Estimate



Scott Brown

Underlying Private Sector Demand Remains Strong

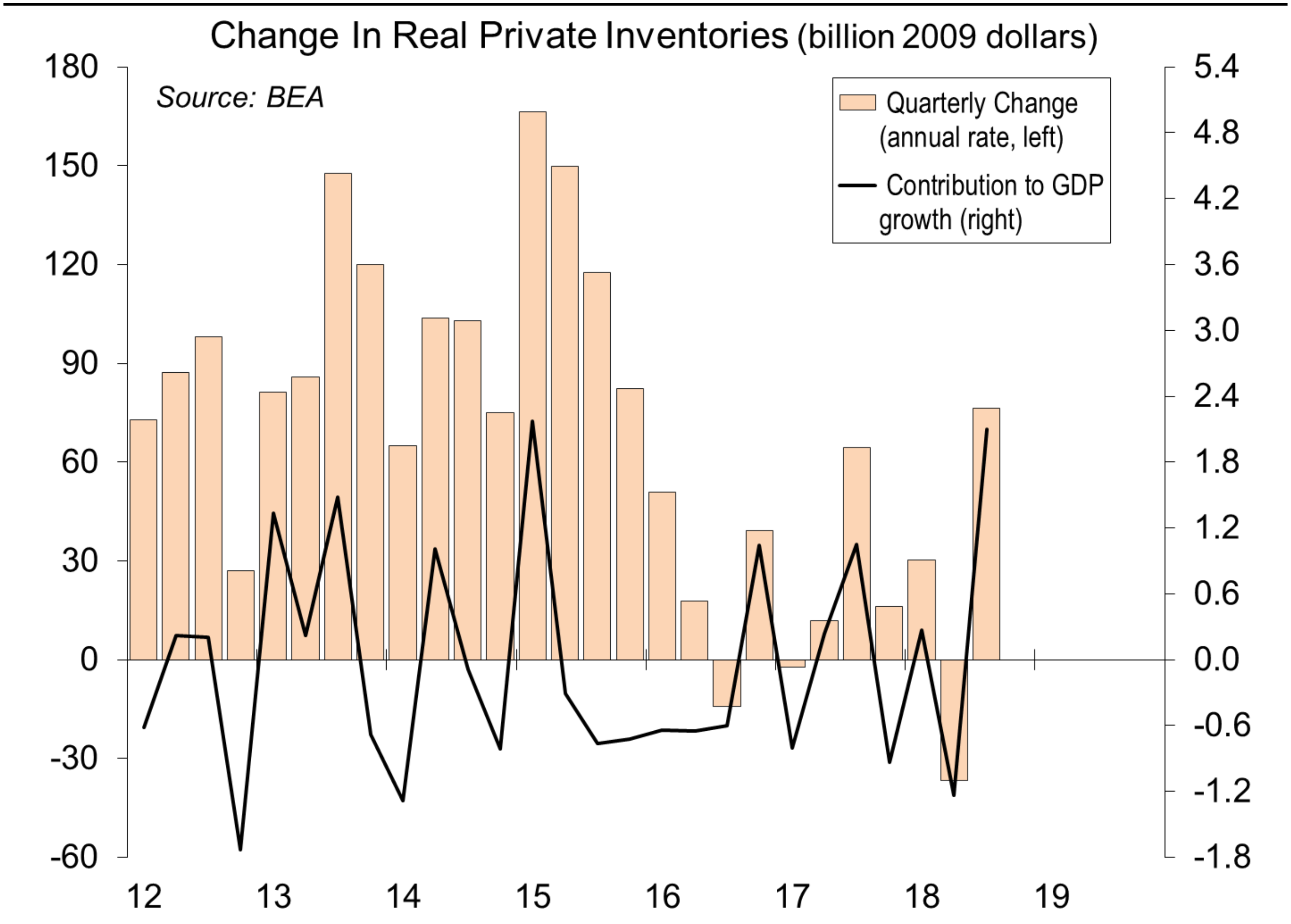


Scott Brown

The Trade Deficit Widened in 3Q18

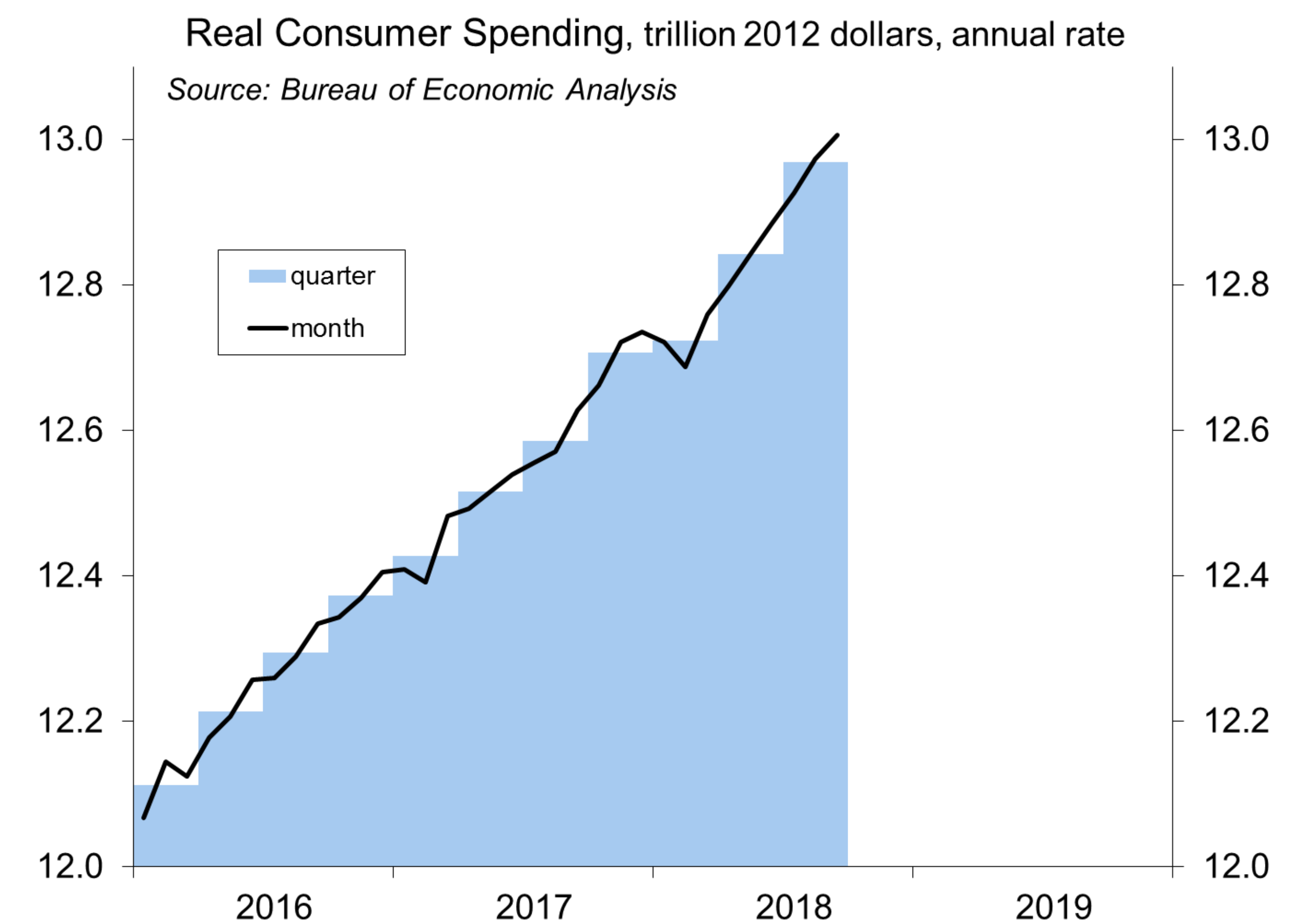
Scott Brown

Inventory Growth Sped Up in 3Q18



Scott Brown

Consumer Spending Growth Was Strong in 3Q18



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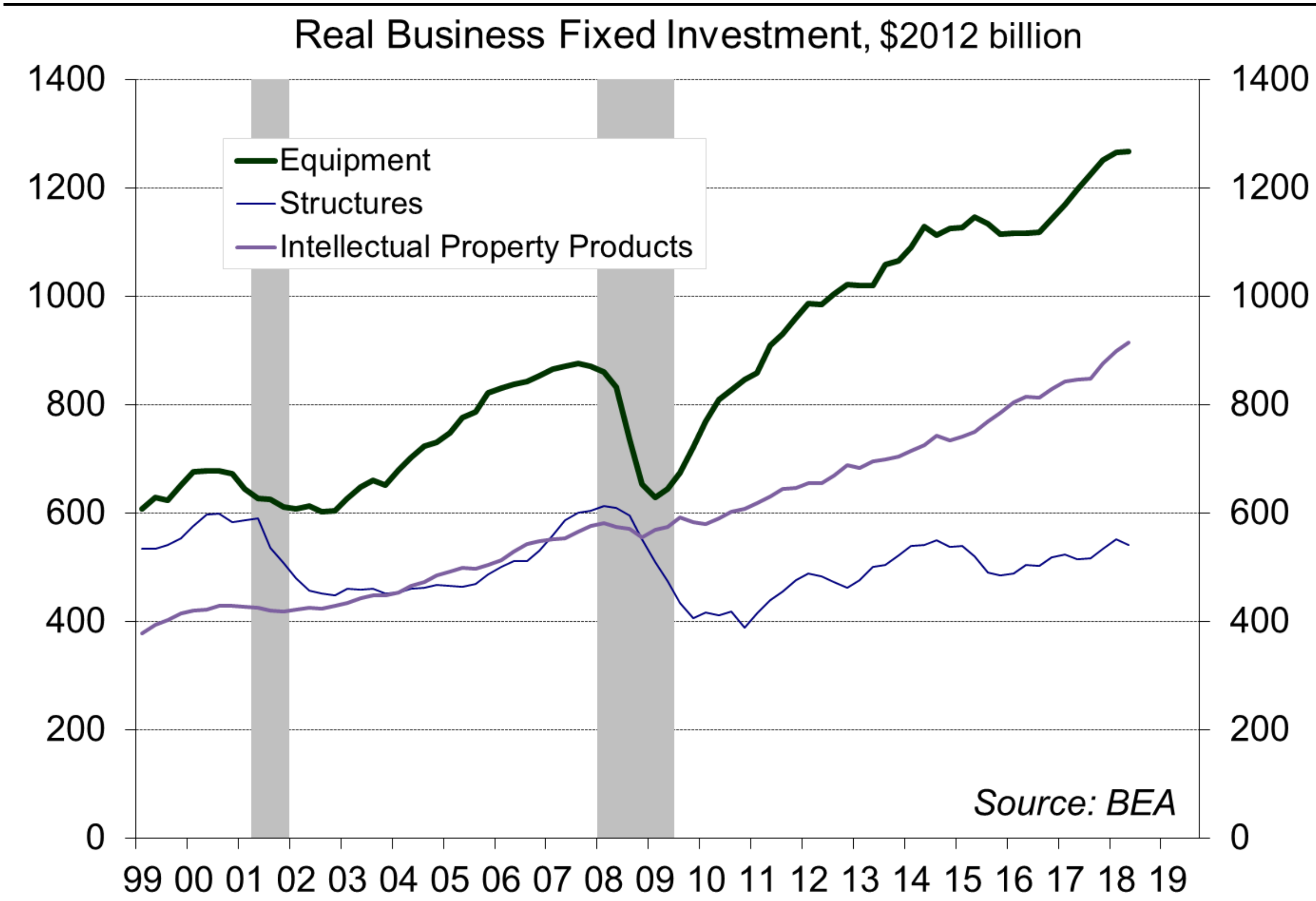
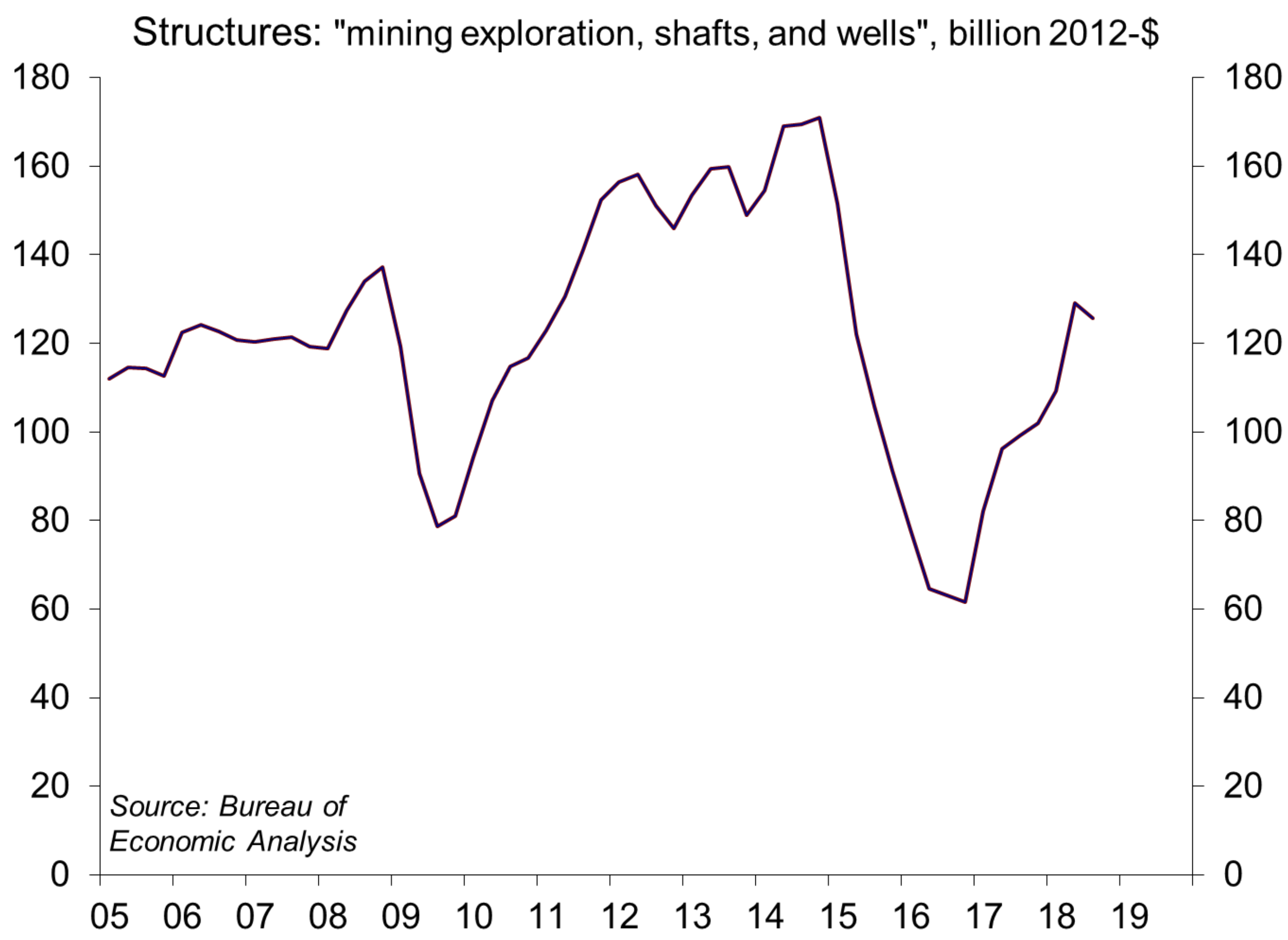
Business Fixed Investment Was Mixed in 3Q18



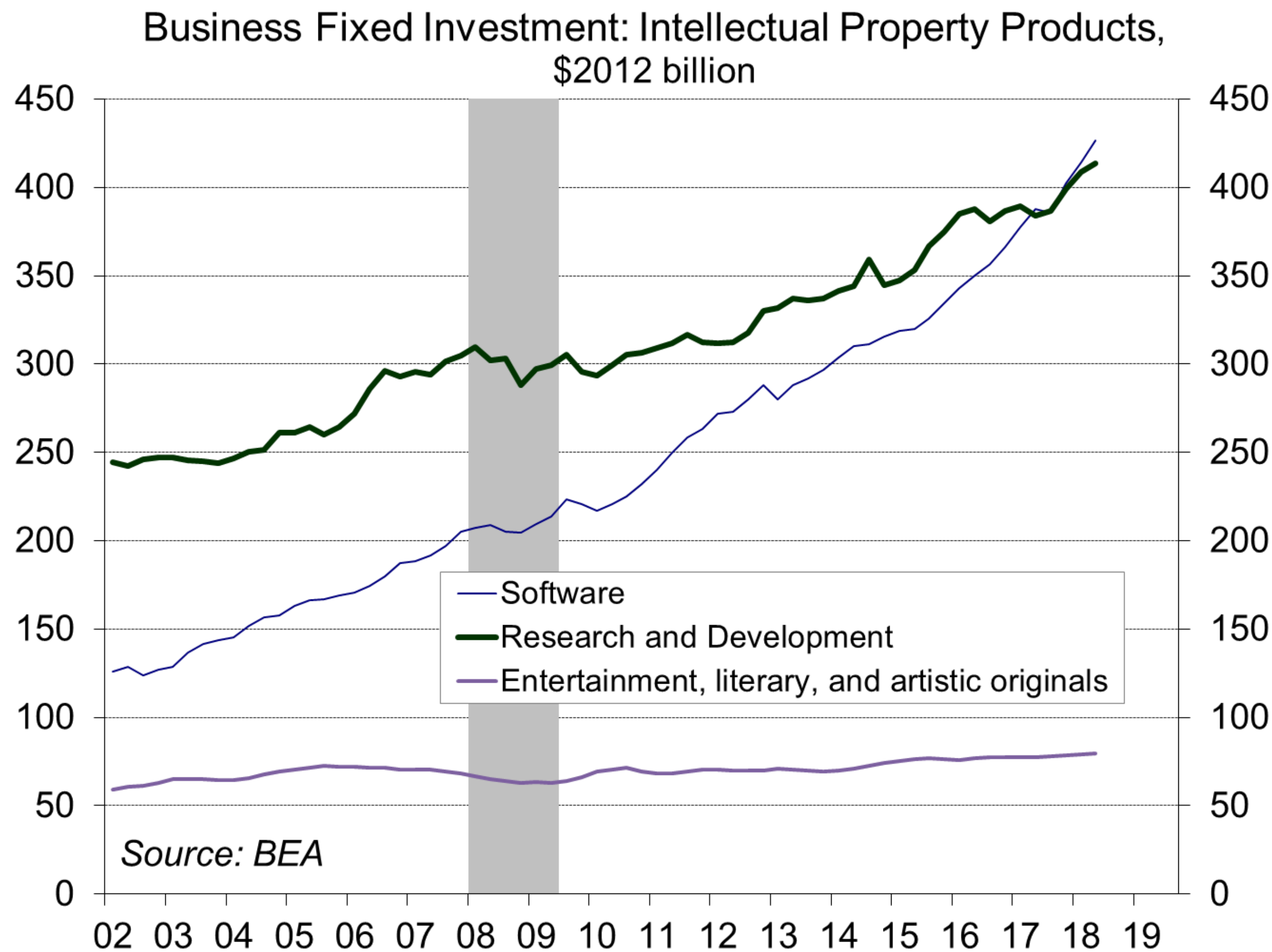
Scott Brown

Energy Exploration Added to Growth in 2Q16-2Q18



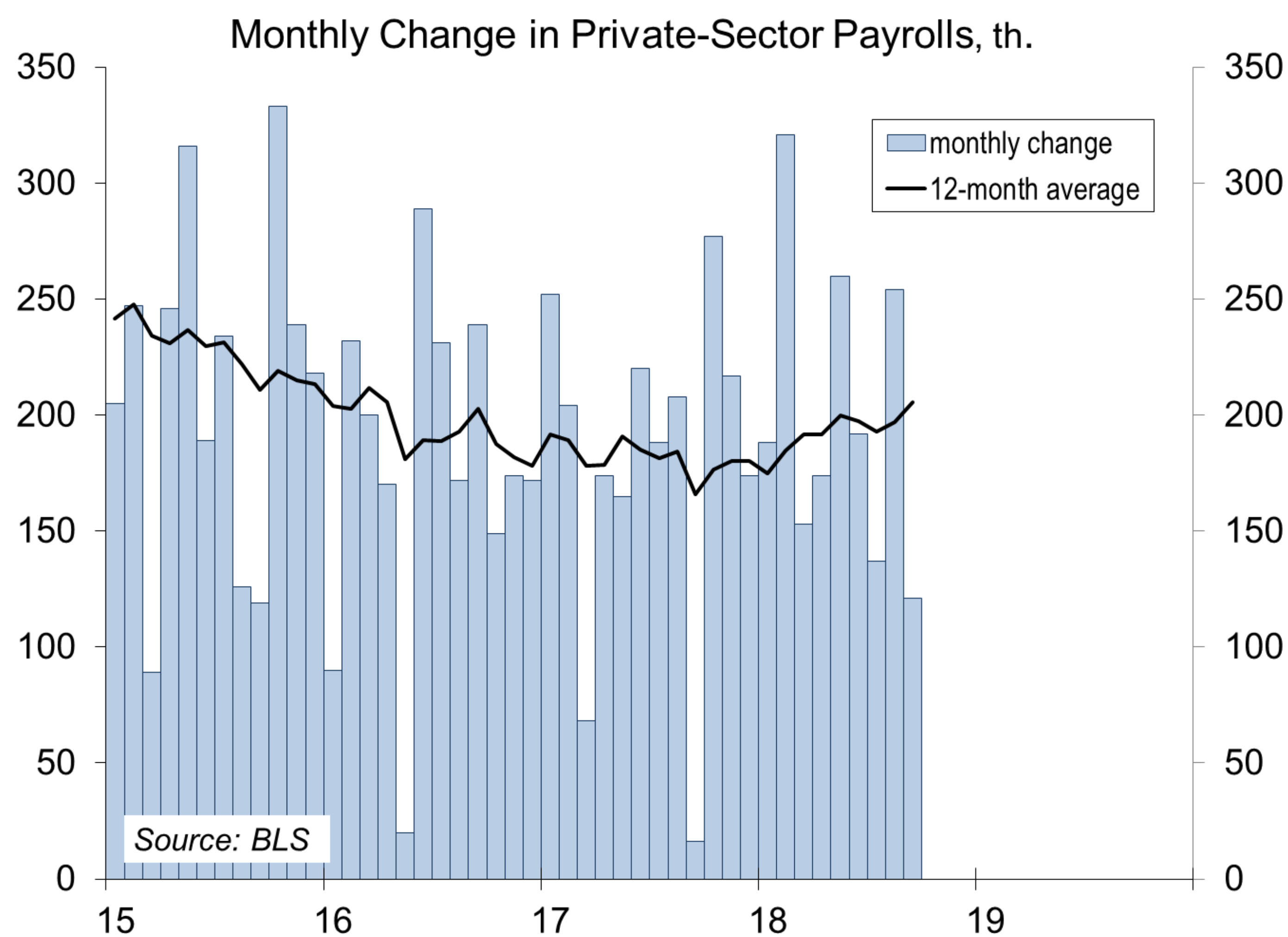
Scott Brown

Strong Growth in Intellectual Property Products



Scott Brown

Job Growth is Likely to Slow as the Job Market Tightens

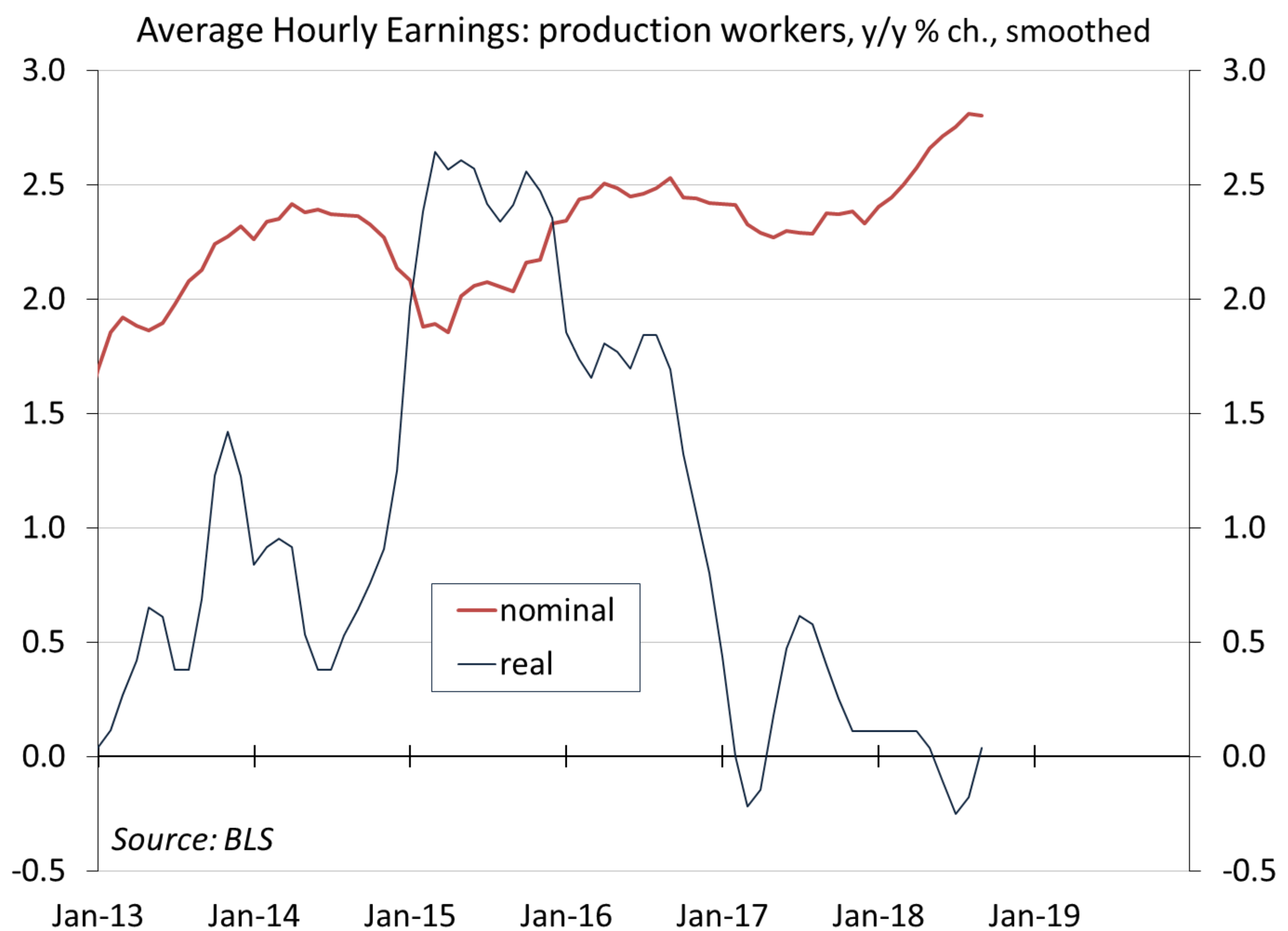


Scott Brown

The Unemployment Rate is the Lowest Since 1969

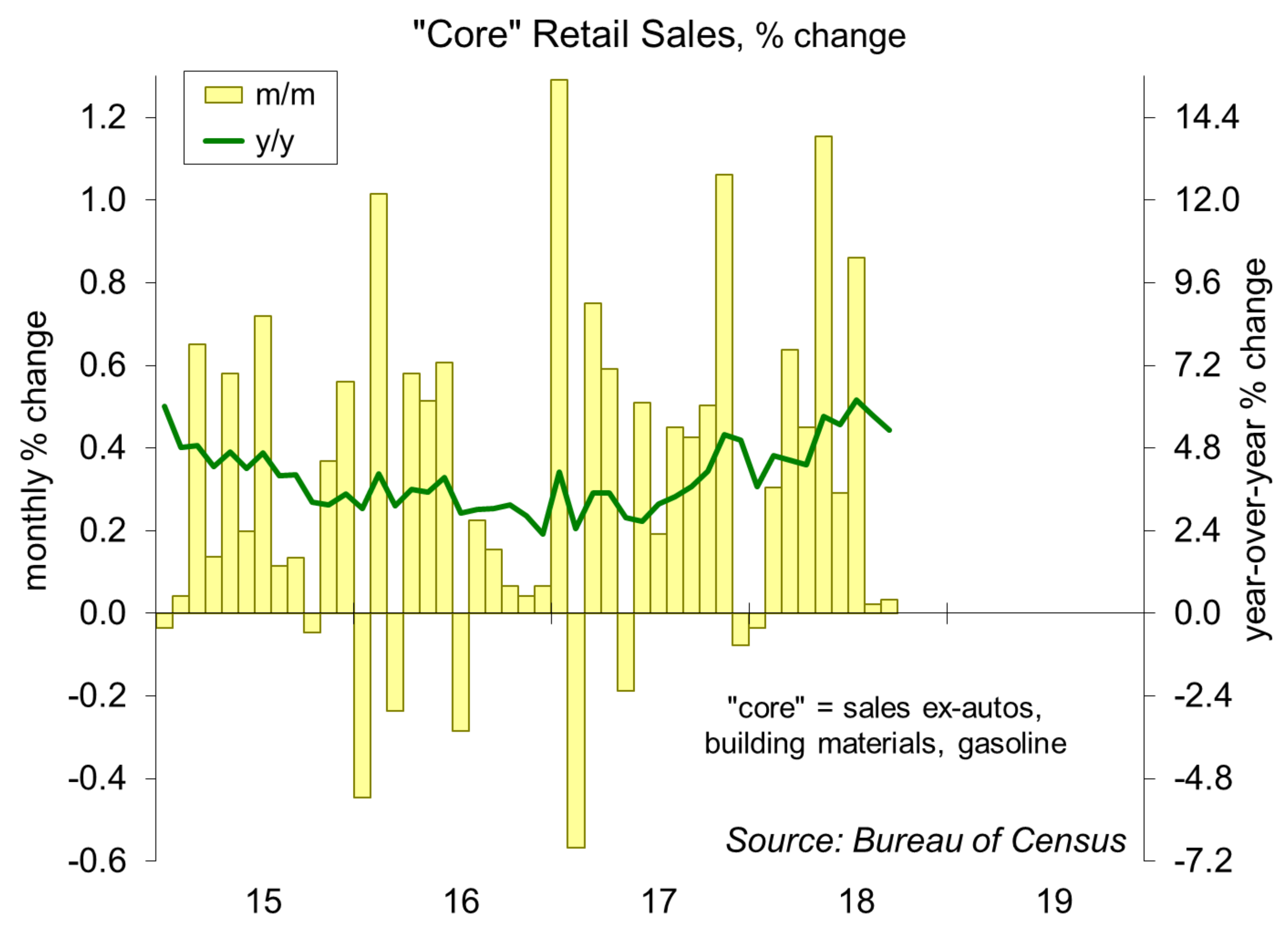
Scott Brown

Nominal Wage Growth vs. Real Wage Growth



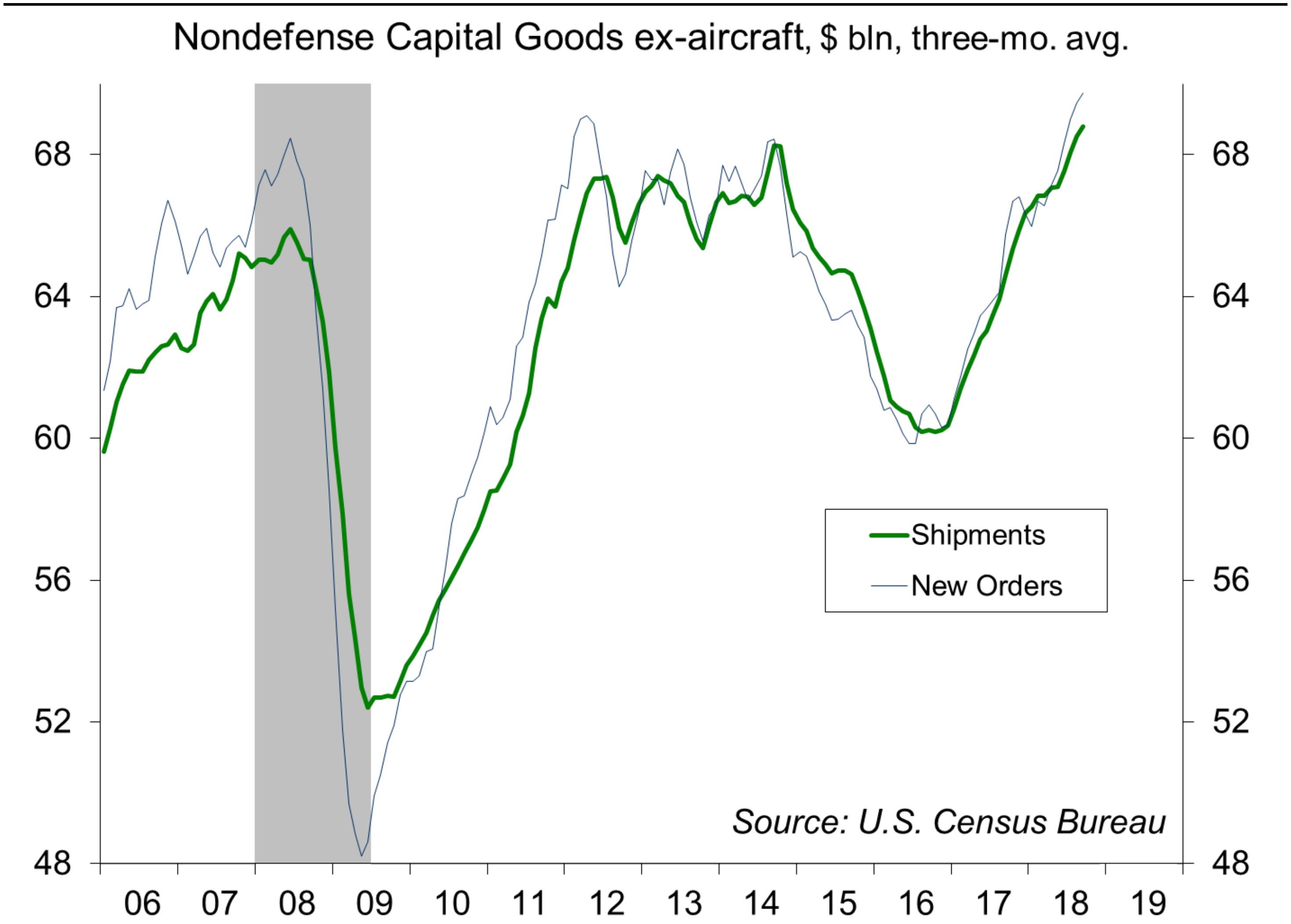
Scott Brown

Retail Sales Softened in August and September



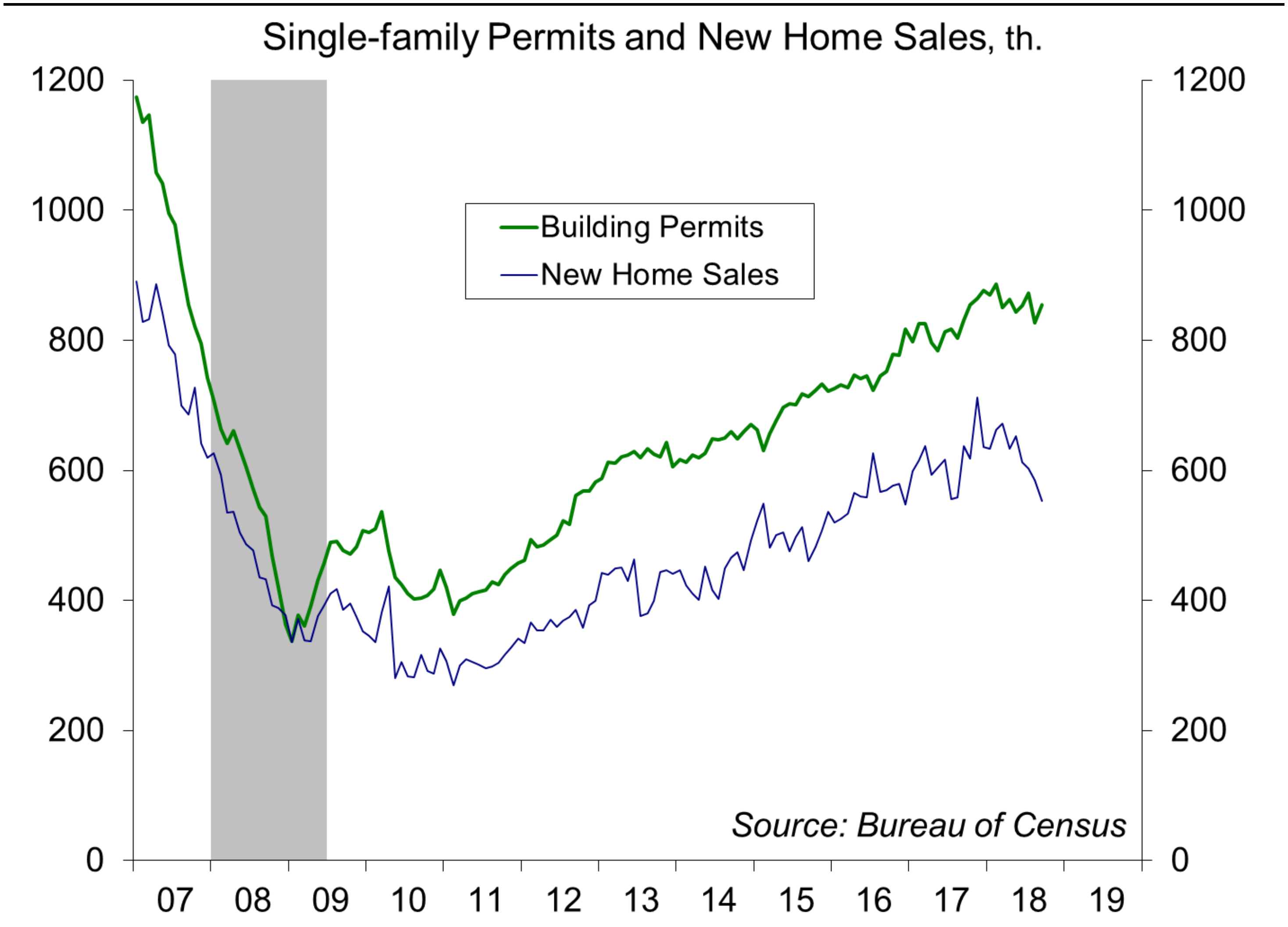
Scott Brown

Capital Goods Orders and Shipments Are Trending Higher



Scott Brown

Home Sales and Construction Have Softened



Scott Brown

Fed Policy Outlook

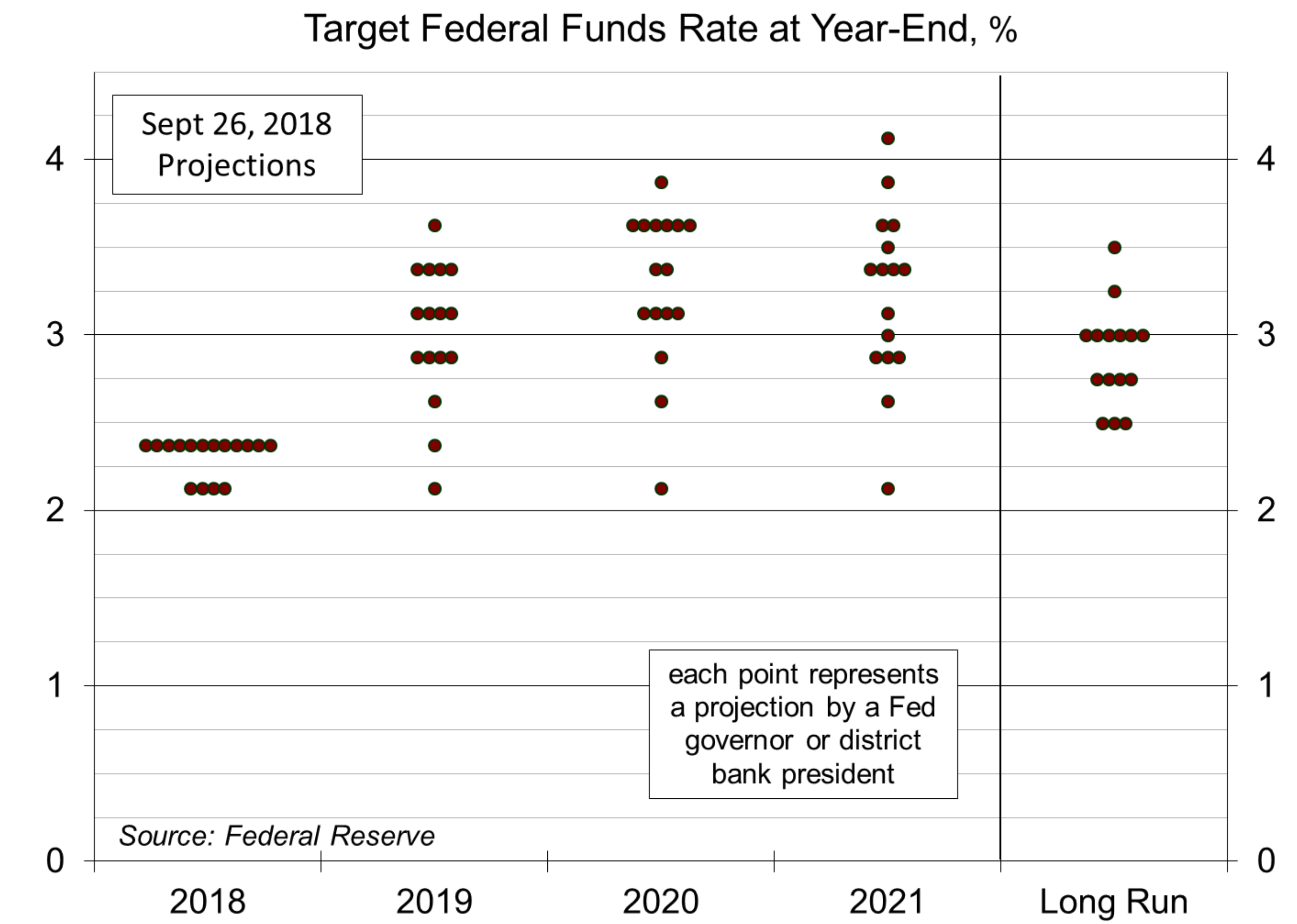
The Federal Open Market Committee raised the federal funds target range (to 2.00-2.25%) on September 26 and repeated that it expects that *"further gradual increases"* will be consistent with achieving its goals. In the revised dot plot, 12 of 16 senior Fed officials expected to raise rates once more by the end of the year. Policy expectations for 2019 and 2020 varied widely, but all Fed officials projected that the federal funds rate would slightly exceed their estimates of the long-term equilibrium rate in 2019 and 2020.

The FOMC is widely expected to keep short-term interest rates steady after the November 7-8 policy meeting. There will be no post-meeting press conference or revised dot plot (all we'll have to go on is the wording of the policy statement). Currently, the FOMC is seen as more likely than not to raise short-term interest rates again at the December 18-19 policy meeting.

Fed officials are aware of policy risks (of raising rates too rapidly or too slowly), but the consensus view is that the gradual approach to raising rates is the best way to balance these risks. Monetary policy decisions will remain data dependent – specifically, on what the incoming data imply for the outlook for growth and inflation. Financial market volatility could be a factor.

Scott Brown

Fed Officials Expect to Raise Short-Term Rates Further



Scott Brown

Fed Policy Outlook

"Economic activity expanded across the United States, with the majority of Federal Reserve Districts reporting ***modest to moderate*** *growth. New York and St. Louis indicated slight growth, overall, while Dallas reported robust growth driven by strong manufacturing, retail, and nonfinancial services activity. On balance, manufacturers reported* ***moderate*** *output growth; however, several Districts indicated that firms faced rising materials and shipping costs, uncertainties over the trade environment, and/or difficulties finding qualified workers. Demand for transportation services remained strong.* ***Labor shortages were broadly noted and were linked to wage increases and/or constrained growth****. Reports on commercial and residential real estate were mixed, although several Districts saw rising home prices and low levels of inventory. Overall, consumer spending increased at a* ***modest*** *pace while consumer price growth ranged from* ***modest to moderate****. Travel and tourism generally picked up with a notable exception of North and South Carolina, where Hurricane Florence deterred tourism. Agricultural conditions were mixed as rainy weather helped some farmers but caused delays and crop damages for others, including the loss of crops and livestock due to Hurricane Florence."*

-- Fed Beige Book (October 24)

Scott Brown

Recession?

We are never “due” for a recession. That is, the likelihood of an economic downturn does not depend on the length of the expansion.

There are few signs of a recession on the immediate horizon. The most recent Bloomberg survey of economists showed a 15% chance (median forecast) of entering a recession in the next 12 months.

The slope of the yield curve is the single best indicator of recession. While the curve has flattened, it has not inverted. Moreover, it may still be sometime between the yield curve inverting and a recession developing.

Trade policy disruptions may intensify, but that is seen as dampening growth (tariffs are unlikely, by themselves, to lead to a recession).

Tolstoy wrote that all happy families are alike, but every unhappy family is unique. The same can be said for recessions. However, recessions are often associated with higher oil prices and Fed tightening.

Conditions for a recession are typically set up through a misallocation of capital – over-investment or malinvestment – more often than not facilitated by an excessive degree of leverage.

Scott Brown

Economic Indicator	Status	Comments
Growth		Quarterly GDP growth may be uneven in the near term, reflecting choppiness in inventories and foreign trade. Underlying domestic demand is expected to slow, reflecting labor market constraints. There are downside risks (slower growth, not a recession) from trade policy.
Employment		Job growth is expected to remain beyond a sustainable pace over the next several months, but the pace should slow as the labor market tightens.
Consumer Spending		Job and wage growth remain supportive. Without a trade agreement with China, increased tariffs would have a dampening impact on spending in the first half of 2019.
Business Investment		Orders and shipments of nondefense capital goods have improved, but overall business fixed investment has been mixed.
Manufacturing		Orders and production have remained moderate. Tariffs are having a broader impact on input pricing. Firms also face higher transportation costs.
Housing and Construction		Homebuilding and sales activity has weakened, reflecting affordability issues (higher prices and higher mortgage rates) and rising building costs.
Inflation		Prices of raw materials picked up in 1H18, but have moderated (despite tariffs) in 3Q18. The PCE Price Index remains near the Fed's 2%.
Monetary Policy		A December 19 rate hike is more likely than not (though still data dependent). Fed officials are expecting further rate increases in 2019 and 2020, but differ in how much.
Long-Term Interest Rates		A strengthening economy, somewhat higher inflation, Fed tightening, and increased government borrowing would normally send bond yields higher. However, long-term interest rates remain low outside the U.S. and the stock market drop has helped to restrain bond yields.
Fiscal Policy		Tax cuts and added spending have provided support for economic growth in the near term (more than expected), but budget deficit projections have risen sharply (a long-term concern given the expected strains on Social Security and Medicare funding).
The Dollar		Trade policy is likely to create some volatility. Fed policy expectations are expected to be the biggest driver in the near term.
Rest of the World		Fed rate increases have had a negative impact on emerging market economies and trade policy has disrupted supply chains. Risks for global growth are weighted to the downside.

Scott Brown

Key Calendar Dates

November 1	ISM Manufacturing Index (October)
November 2	Employment Report (October)
	Trade Balance (September)
November 5	ISM Non-Manufacturing Index (October)
November 6	Election Day
November 8	FOMC Policy Decision (no press conference)
November 9	Producer Price Index (October)
November 12	Veterans Day Holiday (bond market closed)
November 14	Consumer Price Index (October)
November 15	Retail Sales (October)
November 16	Industrial Production (October)
November 20	Building Permits, Housing Starts (October)
November 21	Durable Goods Orders (October)
	Existing Home Sales (October)
November 22	Thanksgiving Holiday (markets closed)
November 27	CB Consumer Confidence (November)
December 7	Employment Report (November)
December 19	FOMC Policy Decision (Powell press conference)

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