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U.S. Equity Market Report

September 2019

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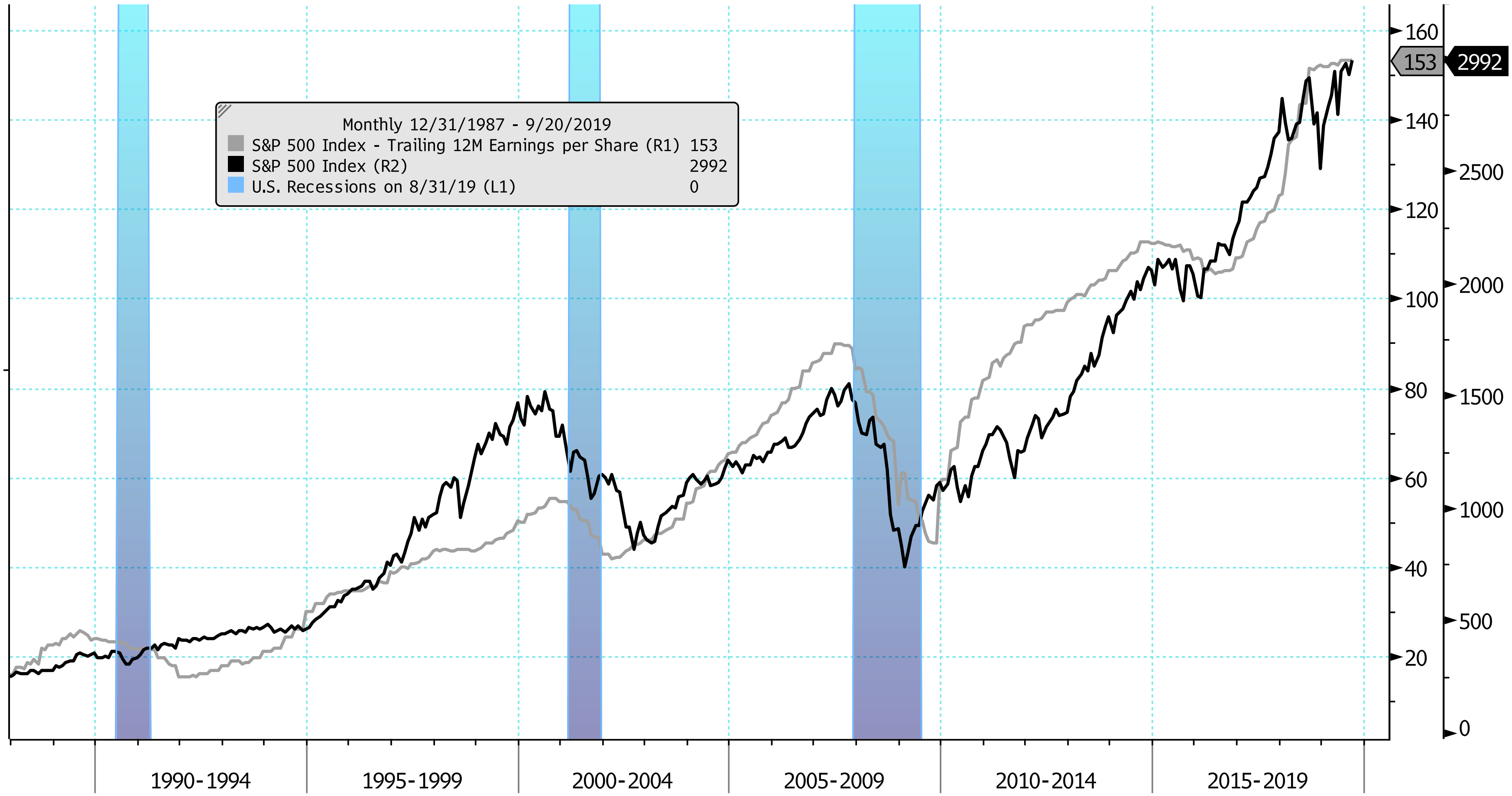
Animal Spirits

(With a hat tip to NPR's *Planet Money*)

Earnings Backdrop

S&P 500 Trailing 12-month Earnings per Share and the S&P 500

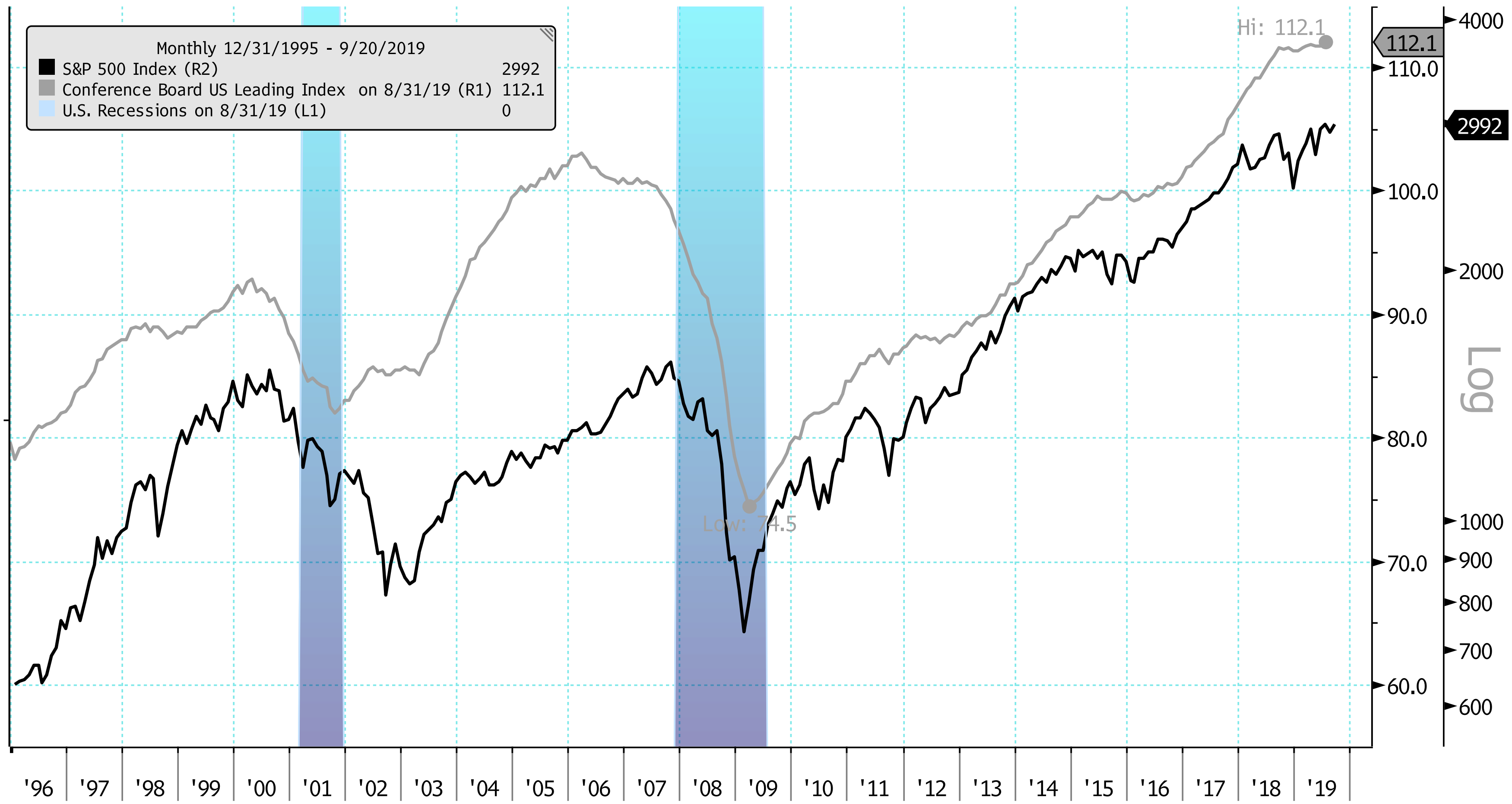


Source: © Merk Investments, Bloomberg

Analysis: S&P 500 trailing earnings have been trending sideways to slightly higher over the past couple of quarters. According to Factset analysts are projecting earnings growth of 1% for calendar year 2019 (a slightly lower forecast relative to last month's report), and projecting11% earnings growth in calendar year 2020. I'm currently neutral to slightly positive on this picture. Chart Framework: I'd get incrementally negative if the trailing 12-month earnings moved down over consecutive quarters (QoQ), i.e., two or more quarters. It's worth noting that this framework may be more of a coincident or confirmatory rather than a leading indicator with respect to a major market top.

Business Cycle Backdrop

Leading Economic Indicators (LEI) Index and the S&P 500



Source: © Merk Investments, Bloomberg

Analysis: The LEI Index was flat for August and remains at cycle highs. This picture is generally positive. Chart Framework: I'd get incrementally negative on the outlook for the S&P if the LEI Index began trending down on a YoY basis while the S&P was at or near bull market highs.

Global Growth Backdrop

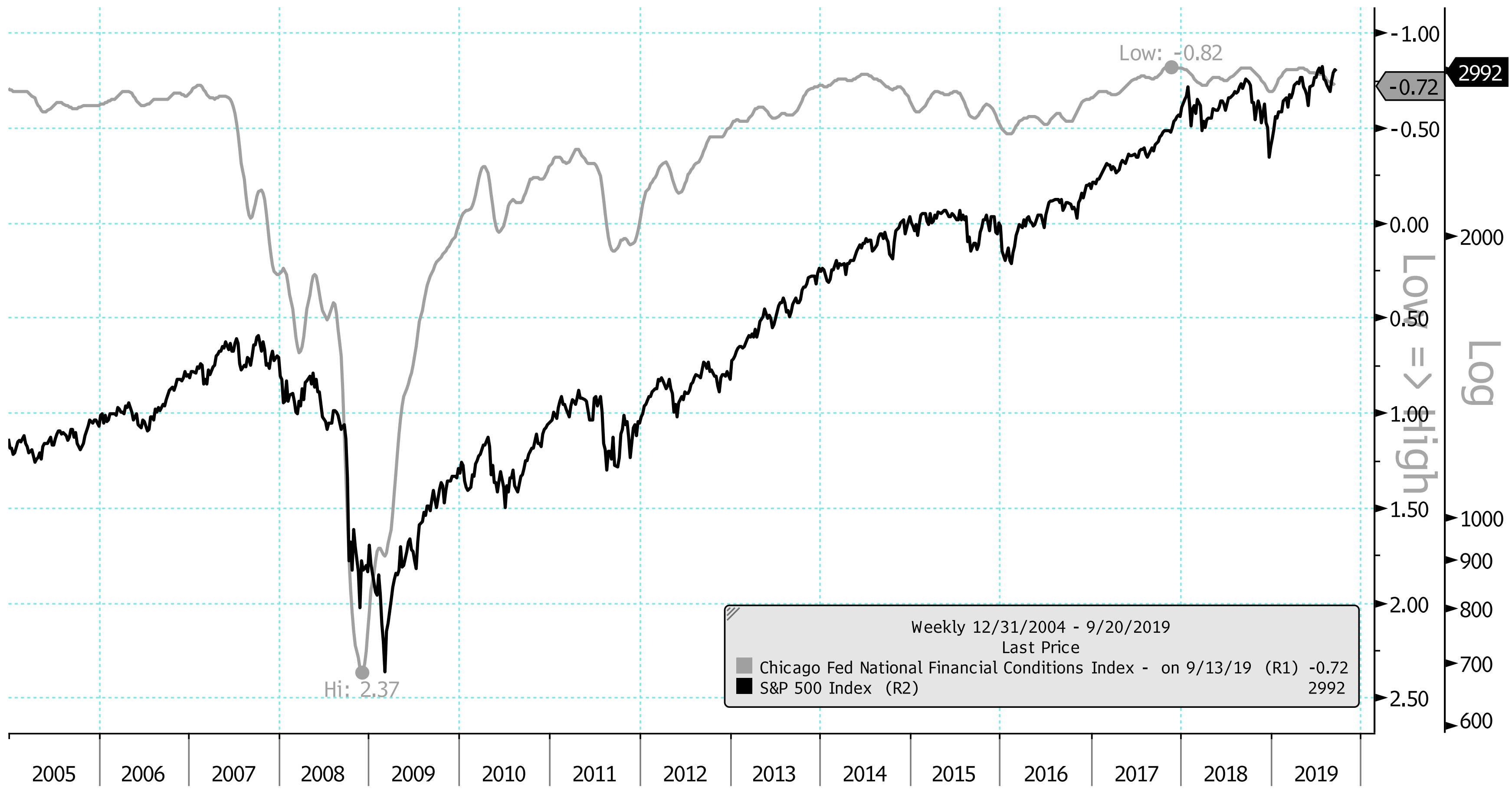
Large Economy Manufacturing PMIs (Purchasing Managers Index) and the S&P 500

Source: © Merk Investments, Bloomberg

Analysis: Manufacturing PMIs were mostly negative over the past month, all readings are now below 50.
Chart Framework: I'd get positive if all readings are above 50.

U.S. Financial Conditions

Chicago Fed National Financial Conditions Index and the S&P 500



Source: © Merk Investments, Bloomberg

Analysis: Financial conditions have tightened somewhat since last month's report and are at -0.72 as of the week ending 9/13/2019. Financial conditions are still relatively loose and generally supportive of the stock market. Chart Framework: I'd get incrementally negative on the outlook for the S&P if financial conditions moved through the -0.50 level.

S&P 500 Market Breadth

S&P 500 Index and the S&P 500 Cumulative Advance-Decline Line*

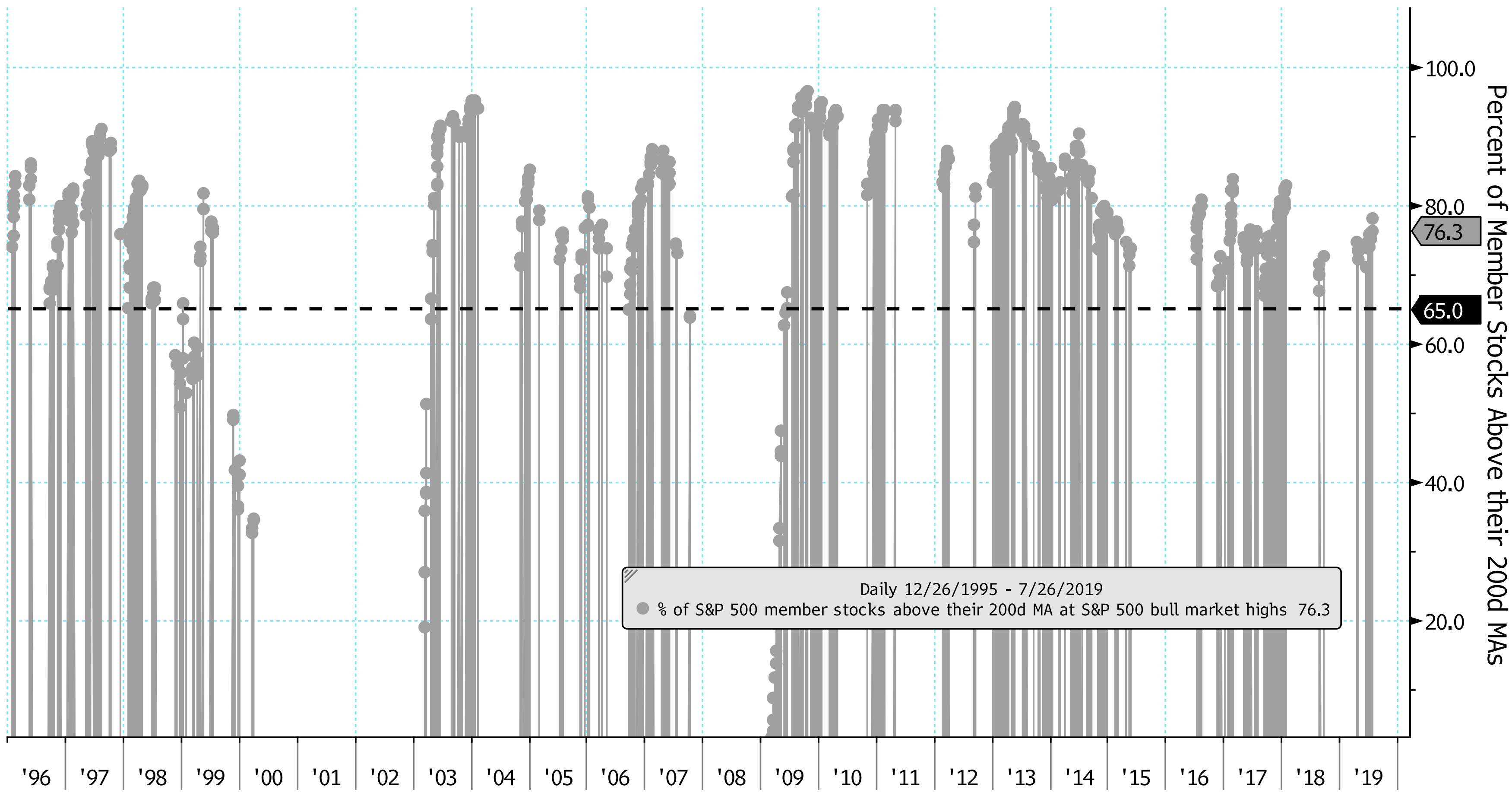
Source: © Merk Investments, Bloomberg

Analysis: The cumulative advance-decline line for the S&P 500 continues to make new all time highs, which suggests continued broad participation in the bull market. I'd get cautious on this picture if there was a divergence in which the S&P 500 was making new all time highs but the cumulative a/d line was not.

**The cumulative a/d line is a daily series that takes the previous cumulative a/d line value and adds the number of daily advancers (i.e., the number of S&P 500 member stocks that gained in price on the day) and subtracts the daily decliners (i.e., the number of S&P 500 member stocks the declined in price on the day). For example, if 276 member stocks were up for the day, and 224 member stocks were down for the day, the cumulative a/d line would move up by 52.*

Market Breadth

Percent of S&P 500 member stocks above their 200d Moving Averages when the S&P 500 Makes a New Bull Market High

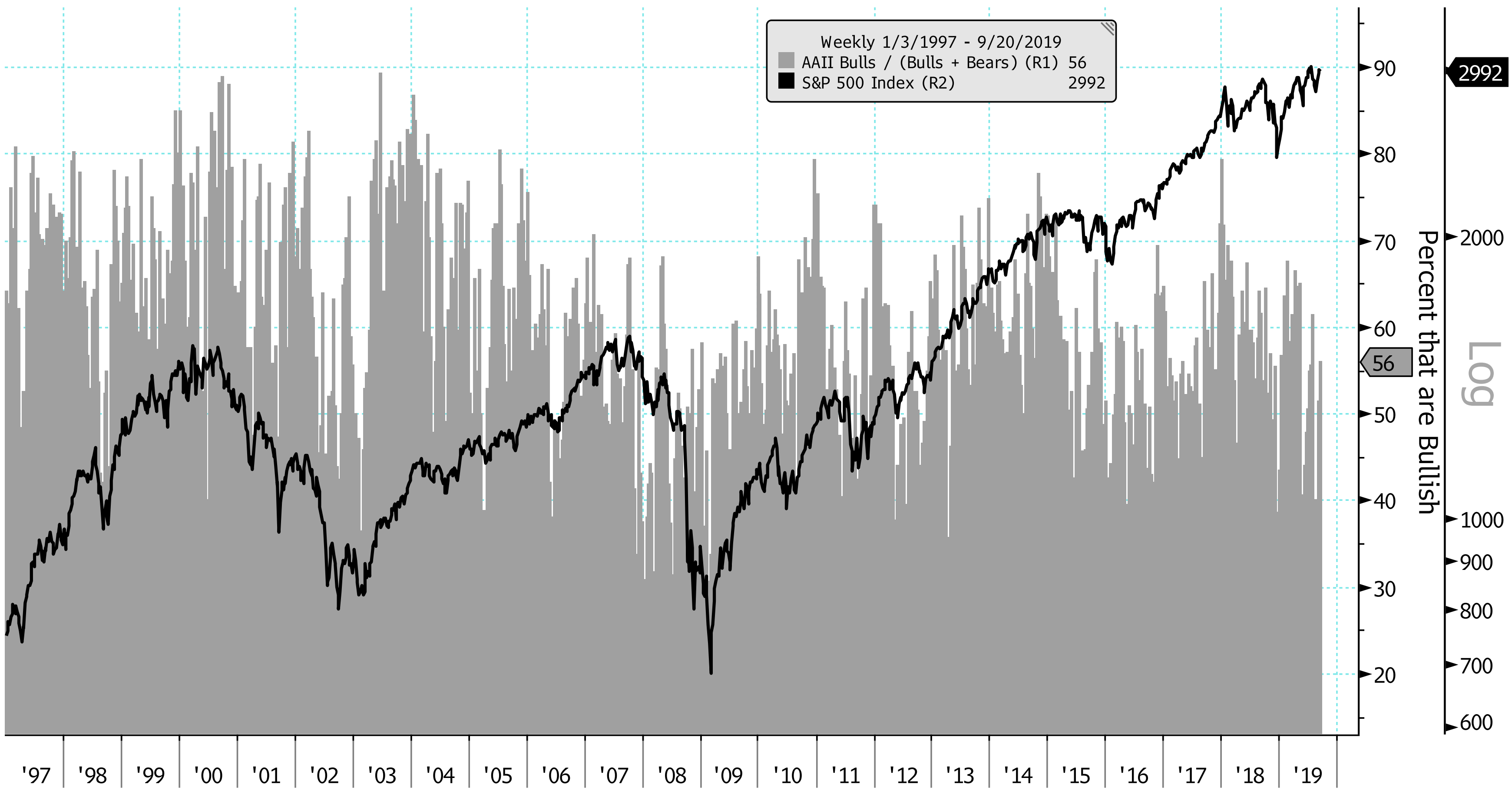


Source: © Merk Investments, Bloomberg

Analysis: Breadth at the most recent bull market high (7/26/2019) was at 76%, above the 65% warning level. A positive sign for the bull market. There is a gradual long term decline in breadth that is apparent in this picture, from 2009 to present, which is to be expected as the bull market ages. Chart Framework: I'd get incrementally negative on the outlook for the S&P if the S&P made new bull market highs with breadth below 65%.

Market Sentiment

Percent that are Bullish (bulls / bulls+bears) and S&P 500



Source: © Merk Investments, Bloomberg

Analysis: Bullishness is currently near the long term average. In my view this chart should be looked at from a contrarian perspective at extremes. Given that sentiment is near the average my current interpretation of this chart is neutral. Chart Framework: I'd get incrementally negative on this picture with sentiment near or above 70 and incrementally positive with sentiment near or below 30. The neutral range is between 40 and 60.

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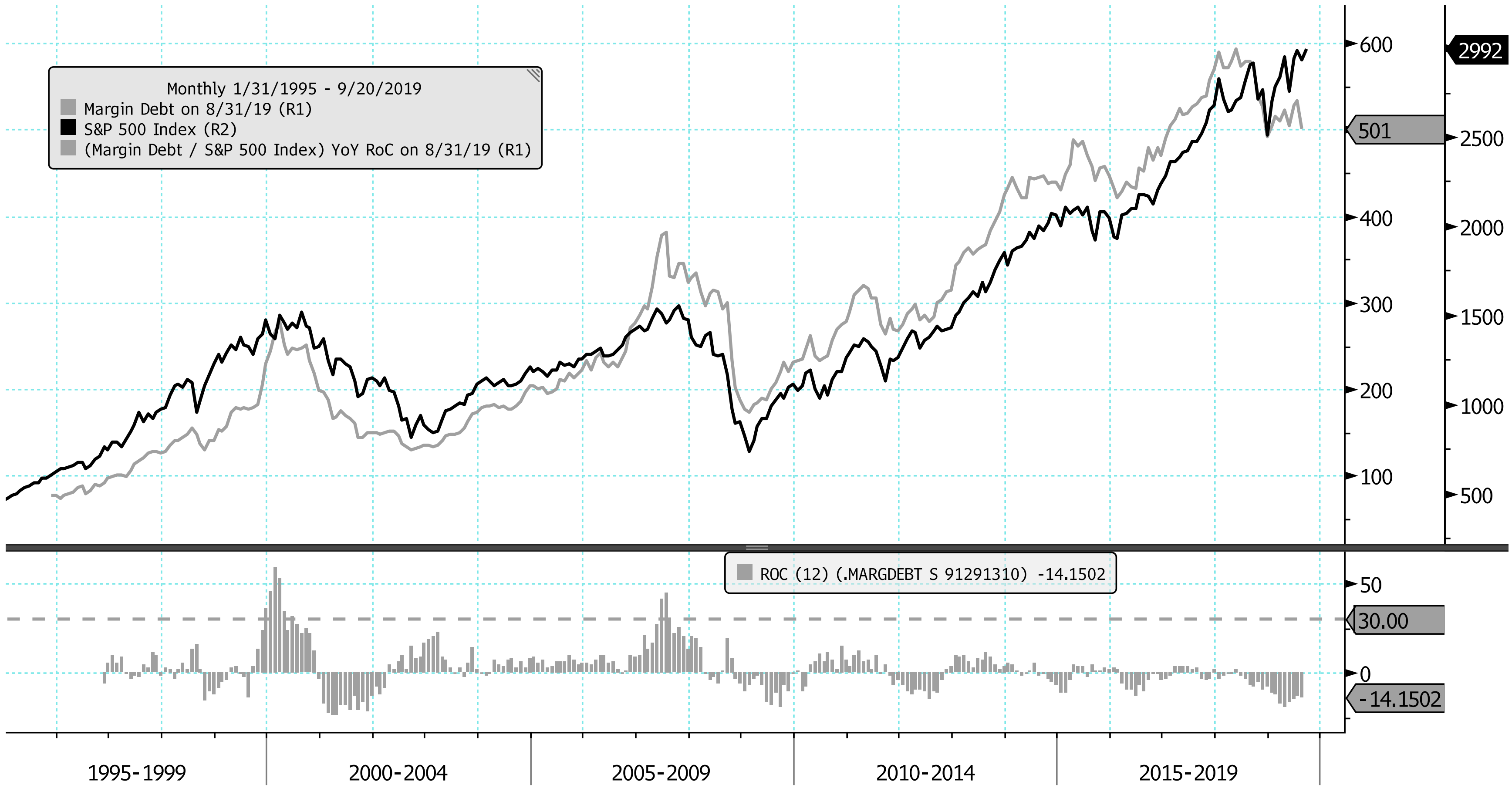
Margin Debt

Margin Debt and S&P 500 (top panel), 12 month change in Ratio of Margin Debt / S&P 500 (bottom panel)

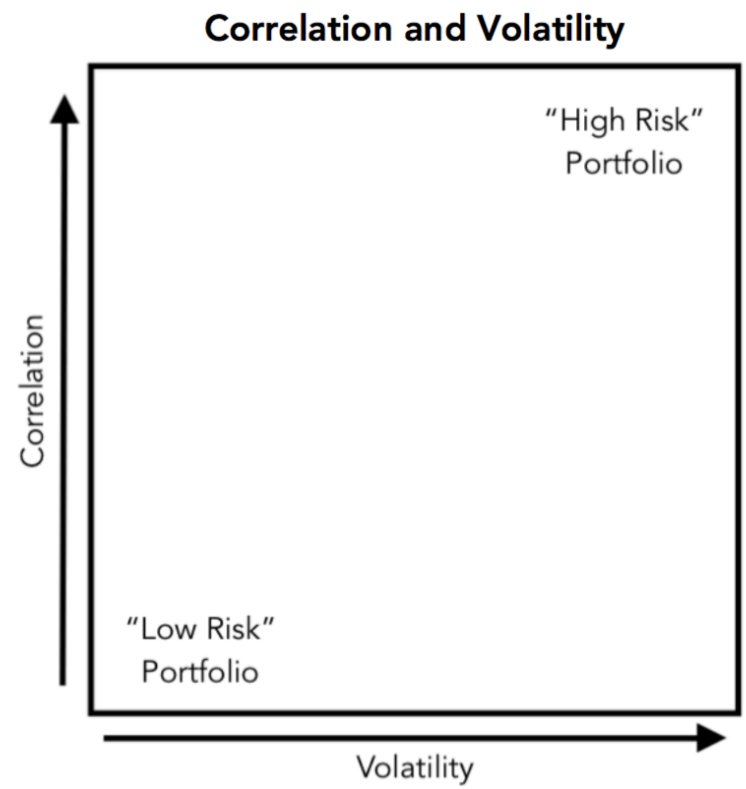


Source: © Merk Investments, Bloomberg

Analysis: In the previous two major market tops for the S&P 500 (2000 and 2007), margin debt rose significantly relative to the equity market, possibly reflecting the euphoric phase of the bull market, or long positions switching from strong hands (unlevered) to weak hands (levered). Currently margin debt is not rising relative to the stock market (bottom panel), perhaps supportive of the idea that the bull market isn't over. Chart Framework: I'd get incrementally negative on the outlook for the S&P if YoY rate of change of the ratio (bottom panel) moved above 30.

Correlation and Volatility Framework

On the below diagram Correlation rises along the vertical axis from bottom to top, and Volatility rises on the horizontal axis from left to right

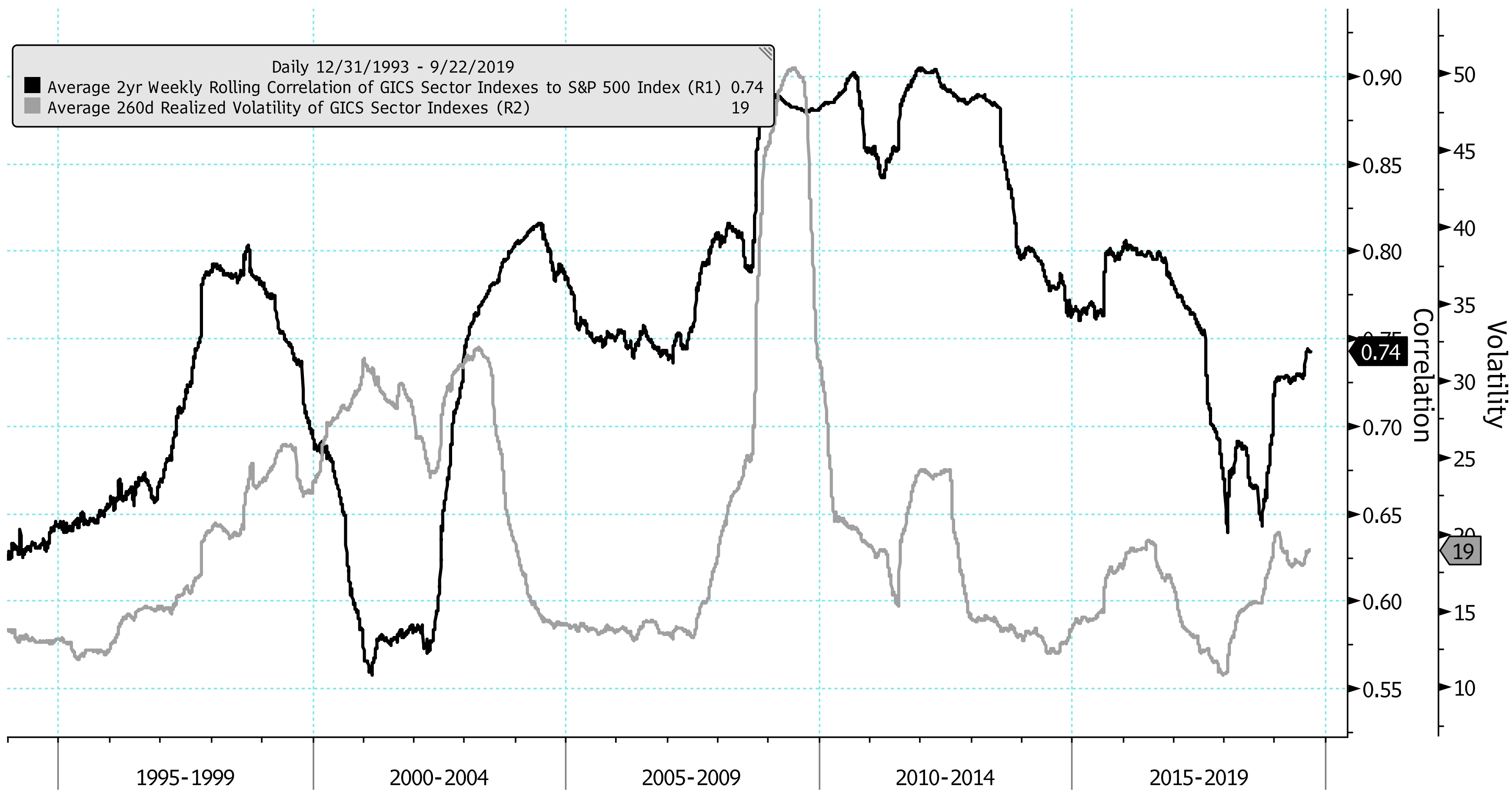


Source: © Merk Investments LLC

Analysis: This is a very simple diagram to help visualize how volatility and correlation relate to the conventional concept of portfolio risk. Volatility measures how much movement an individual asset has relative to itself, and correlation measures how much movement an individual asset has relative to other assets in a portfolio. For a given portfolio, the lower the volatility of each individual asset and the lower the correlation between the assets, the "lower risk" the portfolio will be, as measured by portfolio standard deviation—and vice versa for high volatility and high correlation. Counter-intuitively I would argue that longer-term investors might actually want to think the opposite way—that is to become cautious when asset portfolios appear low risk and consider opportunities when asset portfolios appear high risk. To paraphrase Warren Buffett: it's better to be fearful when others are greedy and greedy when others are fearful.

S&P 500 Correlation and Volatility

Avg. 2-yr Correlation of GICS* Sector Indexes to the S&P 500 Index and Avg. GICS Sector Index 1-yr realized volatility



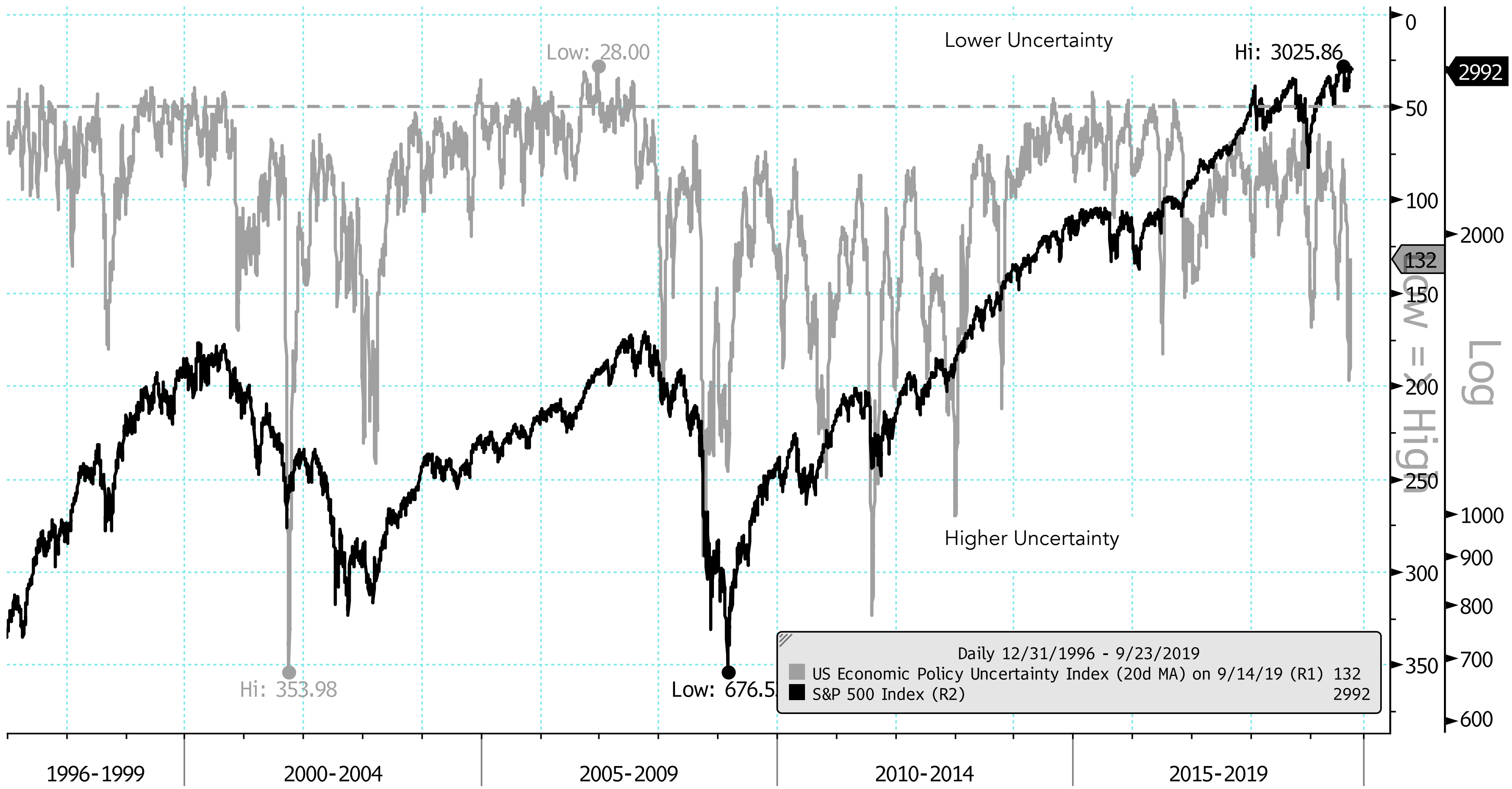
Source: © Merk Investments, Bloomberg

Analysis: Correlation appears to be trending sideways/higher while volatility appears to be trending sideways/lower, from a higher level after having moved up over the past couple years. In my view this chart should be looked at from a contrarian perspective, and currently suggests a somewhat neutral outlook medium-term. Framework: S&P 500 subsequent medium-term returns are likely to be most attractive when both correlation and volatility are high and have lots of room to decline, for example in 2009.

**GICS = Global Industry Classification Standards. The 10 sectors used for this analysis are: Consumer Disc., Consumer Stap., Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services, and Utilities. In 2016 Real Estate was added as an 11th GICS Sector, which had been part of the Financials sectors. The S&P 500 stocks are each assigned to a sector. The correlation reading (black line) represents the average of all sector correlations to the S&P 500 (i.e., Correlation between Financials and S&P 500 + Correlation between Energy and S&P 500 etc., divided by 10). The volatility reading (grey line) represents the average the sector volatilities (i.e., Volatility of Financials + Volatility of Energy etc…., divided by 10)*

Uncertainty

U.S. Economic Policy Uncertainty Index and S&P 500



Source: © Merk Investments, Bloomberg

Analysis: There is likely still some "wall-of-worry" left to climb before the bull market ends. Uncertainty has decreased somewhat recently (inverse axis), having previously increased over the past couple of months. Counter-intuitively I would argue that uncertainty is generally a positive for the market on a forward looking basis as it gives uncertainty more room to decline going forward. As the expression goes: if you wait for an all clear signal you'll buy at the top. Chart Framework: I'd get incrementally negative on the outlook for the S&P around the 50 level on policy uncertainty.

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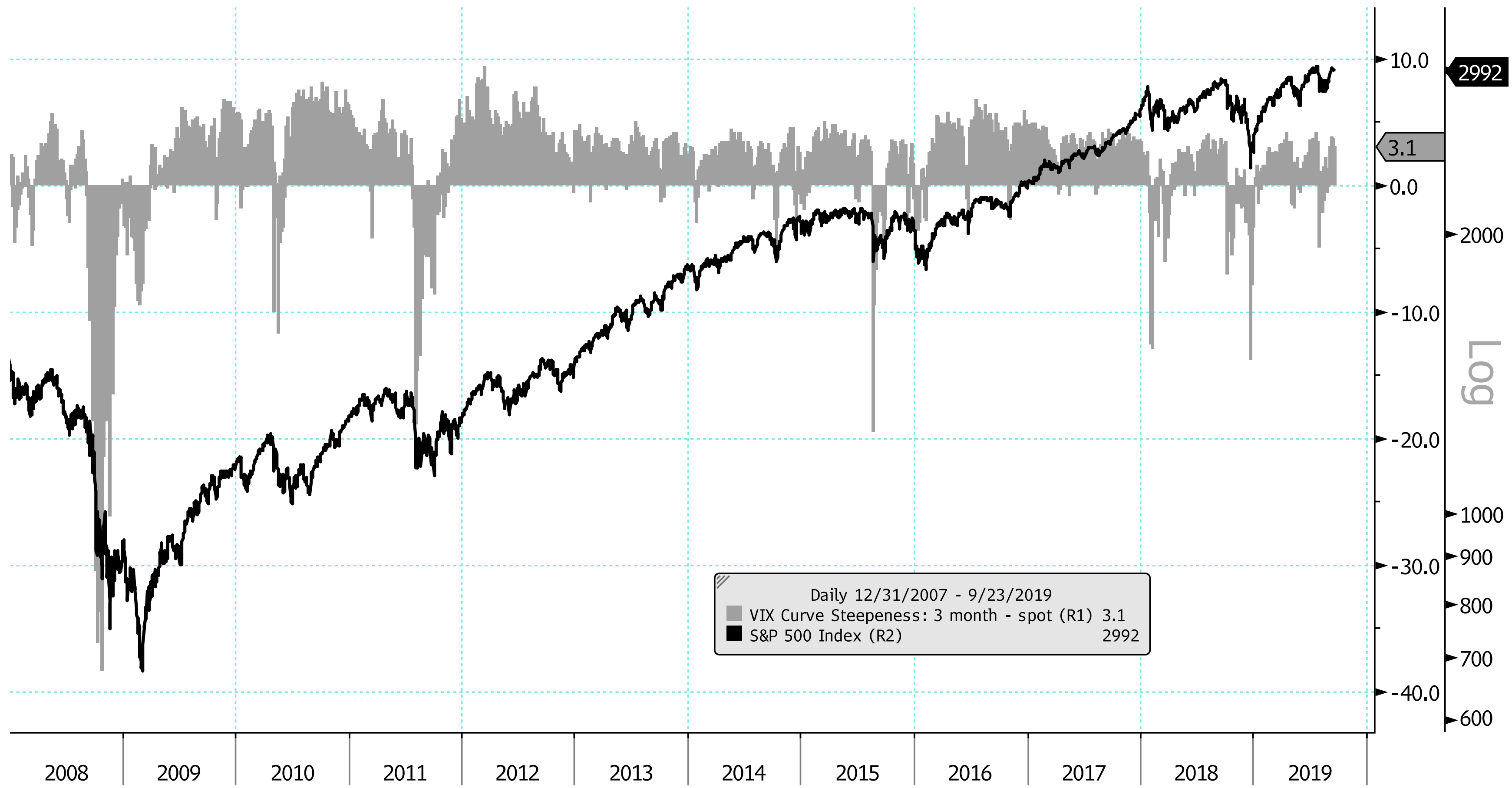
VIX Curve

(3-month futures implied VIX minus spot VIX) and S&P 500



Source: © Merk Investments, Bloomberg

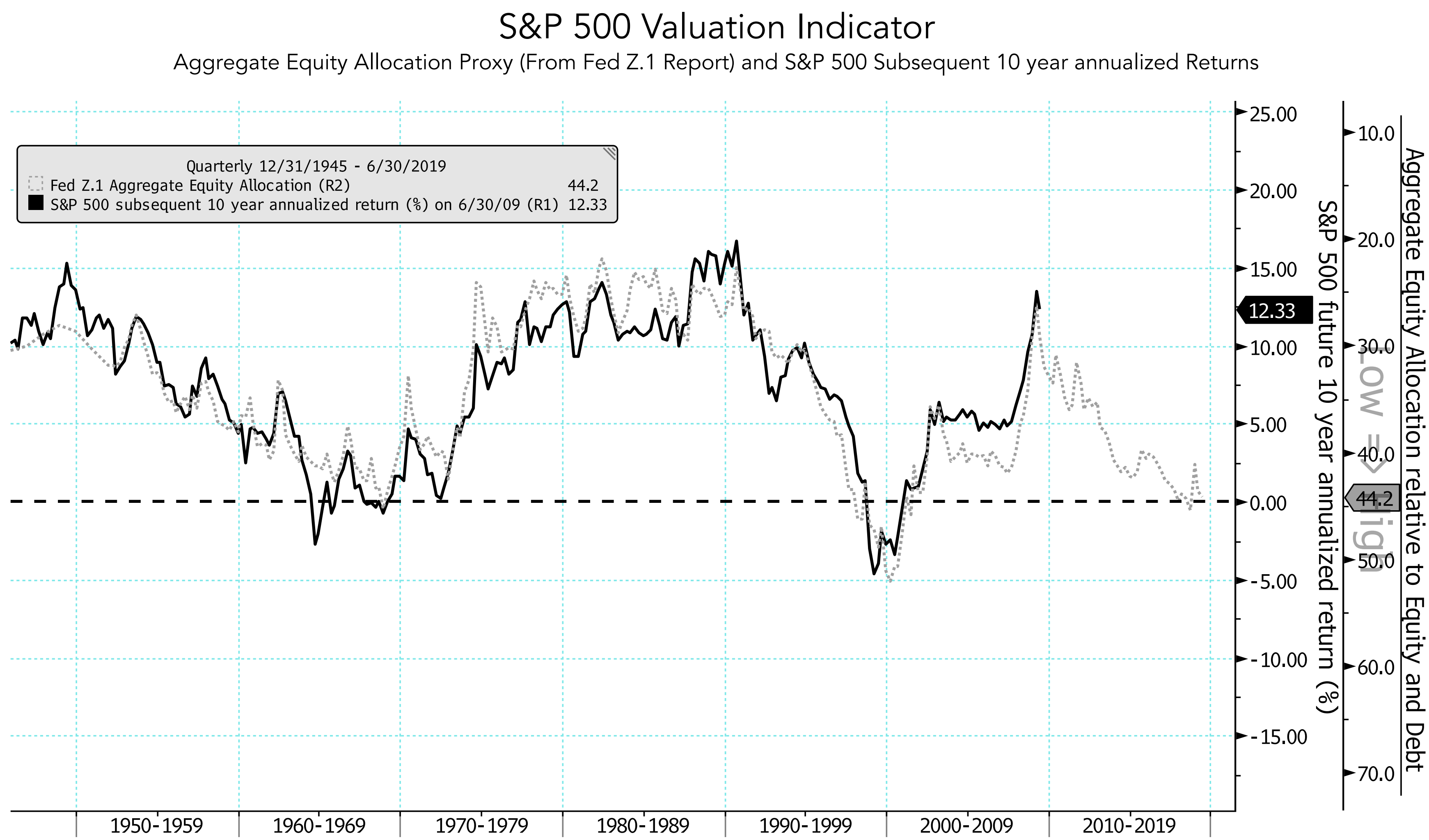
Analysis: The VIX curve is currently positively sloped, meaning future expected VIX is higher than the current VIX (VIX represents an estimate of the 30 day implied volatility of the S&P 500). In my view when the VIX curve is negative the drawdown phase is still ongoing, when positive it may suggest the correction is over for the time being. Chart Framework: this chart is best used for judging when drawdown periods might be over. If a negatively sloped VIX curve (i.e., grey area below zero) persisted that could be a sign of stress remaining in the market.

S&P 500 Technicals

S&P 500 daily open-high-low-close chart with 50-day and 200-day Moving Averages (MA)

Source: © Merk Investments, Bloomberg

Analysis: The 50-day moving average (grey line) is above the 200-day moving average (black line), and still trending higher. The market is generally making higher highs and higher lows. My current interpretation of this picture is positive. Chart Framework: I'd get negative if the S&P 500 appeared to be making lower highs and lower lows and if the 50d MA crossed below the 200d MA. One charting interpretation could be a cup & handle breakout with upside target of ~3400, established by extrapolating the ~500 pt decline from 2900 to 2400 in Q4 2018 up from 2900 to 3400 (+500 pts), based on classical charting principles (not a forecast, but a possibility).

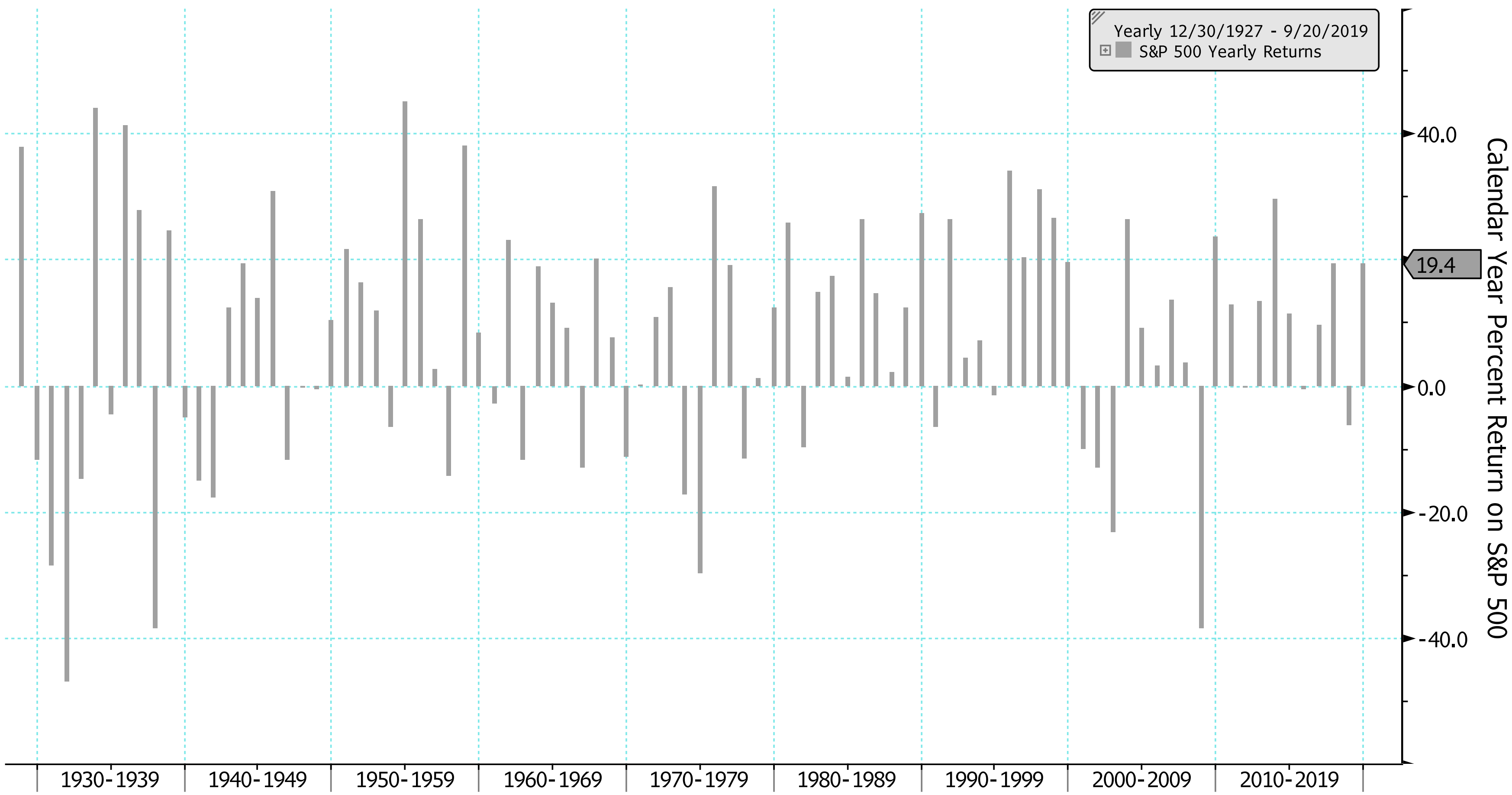


Source: © Merk Investments, Bloomberg

Analysis: If history is any guide, this chart suggests annualized S&P 500 returns (w/o dividends) might be in the low single digits annualized over the coming 10 year period. The grey dotted line is the market value of US equity divided by the total market value of US equity and debt, which is used as a proxy for aggregate equity allocation. At 44.2% the equity allocation is relatively high currently. The data comes from the quarterly Federal Reserve Z.1 report, the series will be updated next in late December. Chart Framework: I'd likely get positive on the longer term outlook for the S&P 500 at an allocation below 30%, which would likely only be after a substantial bear market.

Calendar Year S&P 500 Returns

1928-to-Present Calendar Year Returns (dividends not included)



Source: © Merk Investments, Bloomberg

Analysis: As of 8/9/2019 the S&P 500 is about +19% year-to-date. Coming into 2019 sell-side forecasts were for a 10% to 20% return this year. From 1928 to 2017 the S&P 500 average annual return was 5.7%, (w/o dividends) but the S&P 500 returned between 0-10% in only 15 of those 90 years (17% of the time); in other words average years are actually rare. 51% of years had returns above 10%, and 32% of years had negative returns. It may be worth noting that the S&P 500 is up over 10% in the majority of years.

Checklist

Chart	Time Horizon	Per Framework Characterization
Earnings	Short/Medium Term	Neutral/Positive
Business Cycle	Short/Medium Term	Positive
Global growth	Short/Medium Term	Negative
Financial Conditions	Short/Medium Term	Neutral/Positive
Market Breadth	Medium/Longer Term	Positive
Market Sentiment	Short/Medium Term	Neutral
Margin Debt	Medium/Longer Term	Positive
Correlations/Volatility	Medium/Longer Term	Neutral
Uncertainty	Medium Term	Positive
VIX Curve	Short Term	Positive
S&P 500 50d v 200d MA	Medium Term	Positive
Valuation	Long Term	Negative
	Time Horizon	**Overall Characterization**
	Short Term (<6 months)	Neutral/Positive with high uncertainty
	Medium/Longer Term (6m-5years)	Neutral/Negative with high uncertainty

Conclusion/Thoughts

My base-case scenario remains that we are in an ongoing bull market, with new all time highs on the S&P 500 likely still ahead in this cycle.

The cumulative advance-decline line and the U.S. high yield index have both made new all time highs in recent weeks, which often lead new all time highs in the S&P 500. Also, the breadth readings at the most recent new all time high (7/26/19) were historically inconsistent with a major market top, and suggest the path of least resistance is still higher. Furthermore, the business cycle backdrop, financial conditions, and technical picture generally remain positive for the U.S. equity market.

My biggest short term concern continues to be weakness in the global economy and the mediocre performance of international equity markets. The most likely reason for improvement globally would be a resolution (and tariff reduction) on the U.S./China trade dispute, and any further traction on Chinese stimulus measures. Recent central bank easing measures (e.g., rate cuts from the Fed and QE from the ECB) may also provide support to the equity market.

What keeps me cautious on the medium to longer-term (roughly 1-5 year) outlook is the high overall equity allocation, which suggests high valuation and relatively low expected returns on average over the next ten years.

-Nick Reece, CFA

About the Author

Nick Reece, CFA: Nick is a Senior Analyst and Portfolio Manager at Merk Investments. He focuses on macroeconomic research and private wealth management, regularly publishing reports on the U.S. business cycle and equity market. Prior to joining Merk in 2012, Nick gained experience working on capital markets deals with Paul Hastings in Hong Kong, and with Atlantis Investment Management. Mr. Reece holds a B.A. in Economics from Trinity College and is a Chartered Financial Analyst (CFA) charterholder. Nick lives in New York City. Outside of work, he is an avid reader and volunteer high school math tutor. You can follow Nick on Twitter @nicholastreece.

Disclosure

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