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# U.S. Equity Market Report

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# Quote

Quotes or book excerpts that I find particularly insightful…

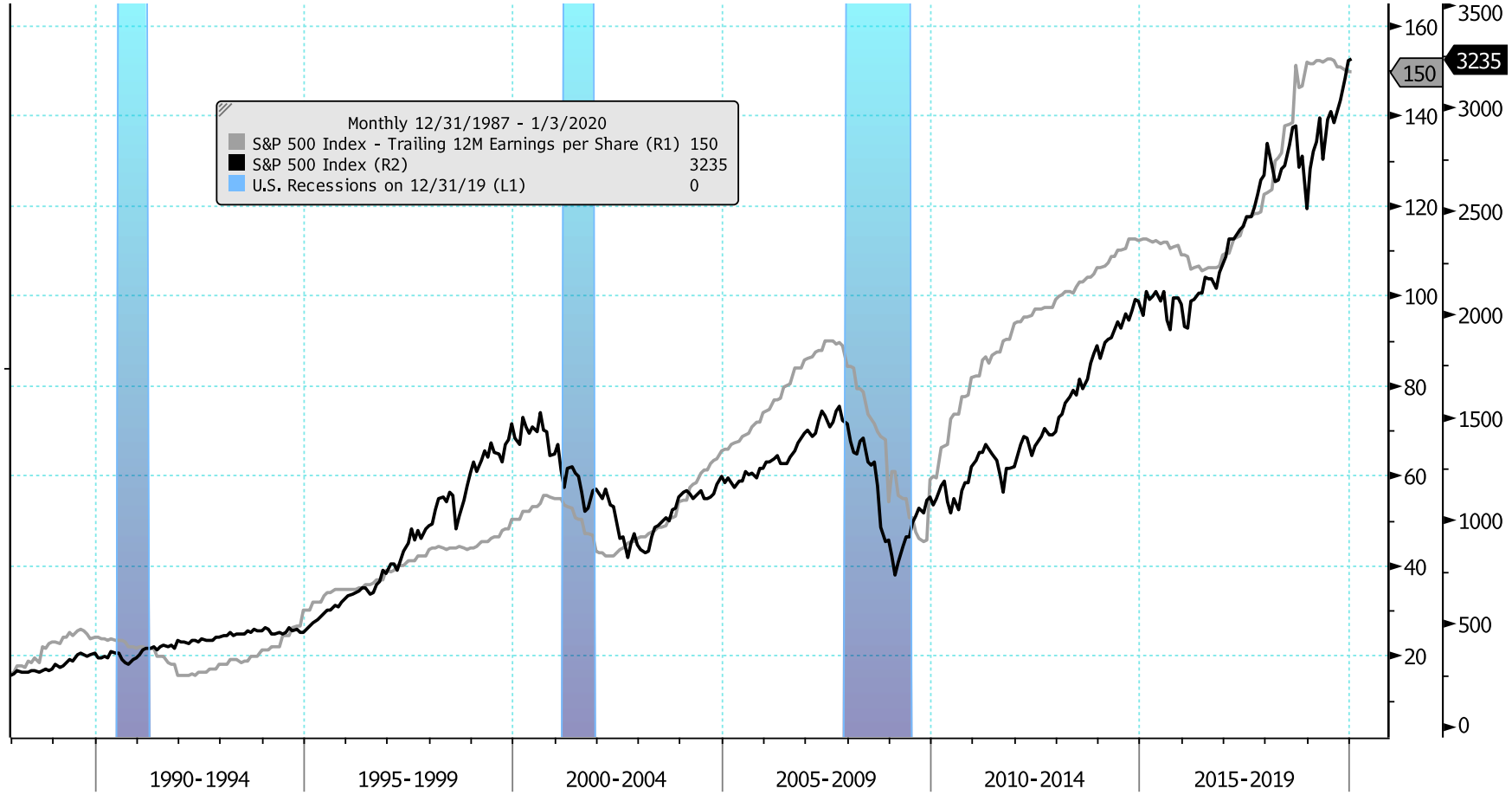
"The efficient market hypothesis leaves out any role for human emotions to impact prices and in so doing is by necessity an incomplete theory of price behavior… Markets do not accurately discount all known fundamentals, but rather they overdiscount or underdiscount this information, depending on the market's emotional environment, and indeed this is one of the sources of investing or trading opportunities. A much more realistic model of how markets actually work is that prices are determined by a combination of fundamentals and emotions… The long history of market bubbles and crashes provides overwhelming empirical evidence that the "madness of crowds" can take market prices far beyond any rational level based on value and fundamentals and that market panics can result in precipitous price declines completely removed from any contemporaneous changes in fundamentals…

Advocates of the efficient market hypothesis are absolutely correct in contending that markets are very difficult to beat, but they are right for the wrong reason. The difficulty in gaining an edge in the markets is not because prices instantaneously discount all known information (although they sometimes do), but rather because the impact of emotion on prices varies greatly... Sometimes emotions will cause prices to wildly overshoot any reasonable definition of fair value—we call these periods market bubbles. At other times, emotions will cause prices to plunge far below any reasonable definition of fair value—we call these periods market panics. In perhaps the majority of the time, emotions will exert a limited distortive impact on prices—market environments in which the efficient market hypothesis provides a reasonable approximation… Although it is often possible to identify when the market is in a euphoric or panic state, it is the difficulty in assessing how far bubbles and panics will carry that makes it so hard to beat the market. One can be absolutely correct in assessing a fair value for a market but lose heavily by taking a position too early."

-Jack Schwager

# Earnings Backdrop

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

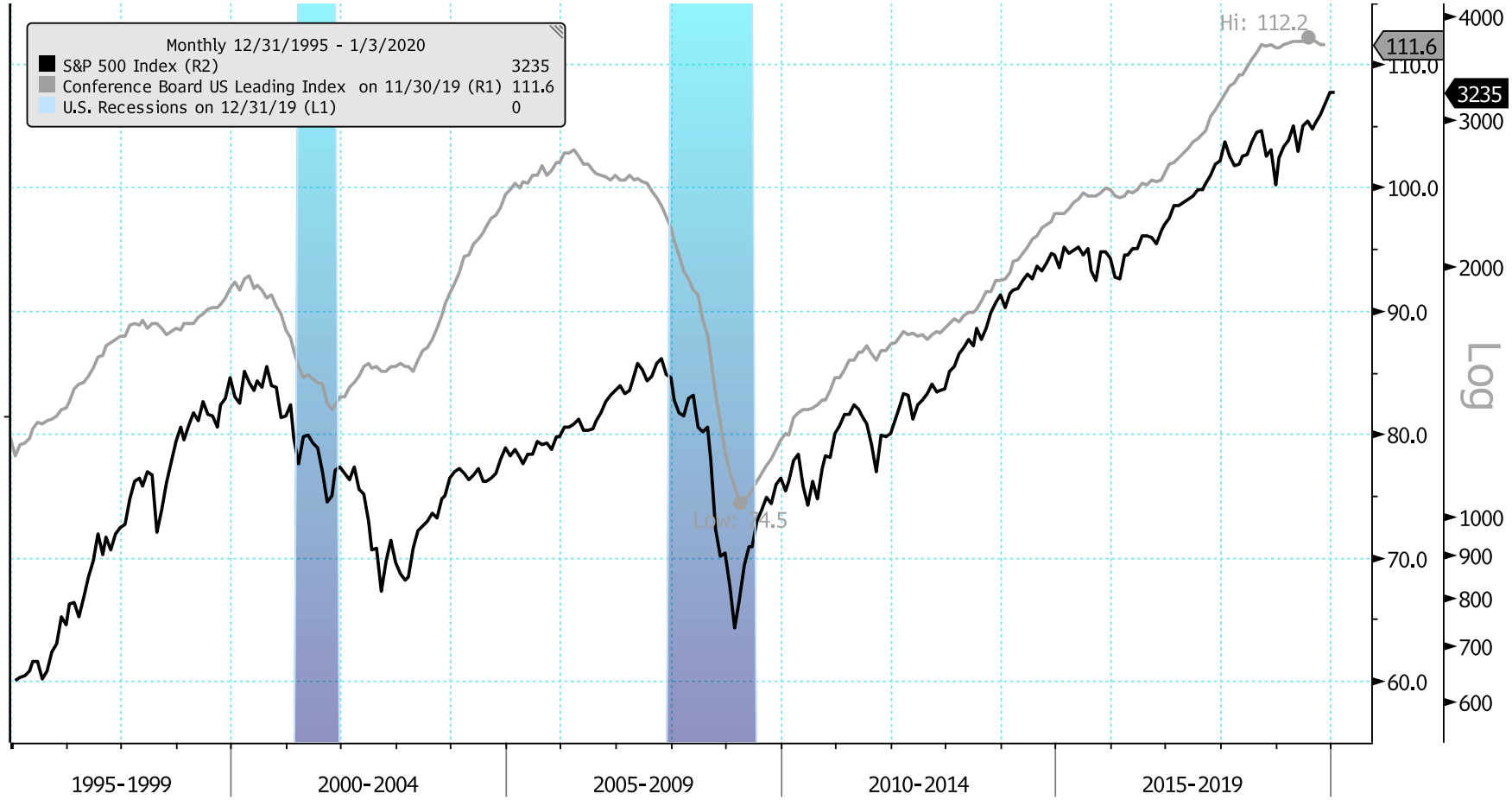



Source: © Merk Investments, Bloomberg

*Analysis: S&P 500 trailing earnings have been trending lower over the past couple of quarters. According to Factset analysts are projecting earnings growth of 10% for calendar year 2020 (a stable forecast relative to last month's report). I'm currently negative on this picture. Chart Framework: I'd get incrementally positive if the trailing 12-month earnings moved back up 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. False signals are common as "earnings recessions" are more frequent than economic recessions.*

# Business Cycle Backdrop

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




Source: © Merk Investments, Bloomberg

*Analysis: The LEI Index was stable for November and currently remains slightly below cycle highs; however, this picture generally remains 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

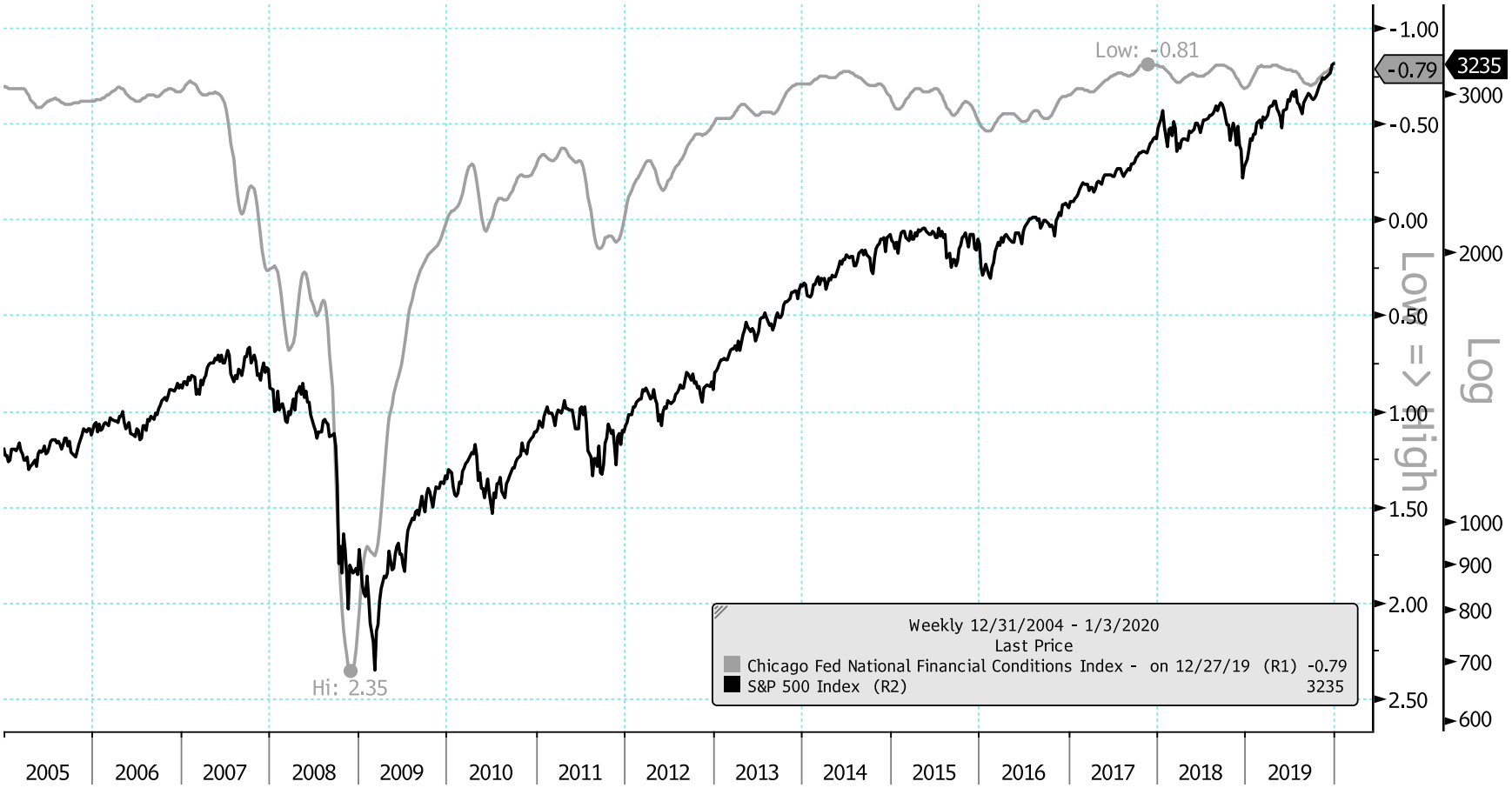
Large Economy Manufacturing PMIs (Purchasing Managers Index) and the S&P 500


Source: © Merk Investments, Bloomberg

*Analysis: Major economy manufacturing PMIs were mostly lower over the past month. The U.S., German, and Japanese PMIs ticked down and remain below 50. China's PMI remained stable at 50.2*
*Chart Framework: I'd get positive if all readings move 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 eased over the past month, currently at -0.79. Financial conditions are 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 and G3 Central Bank Assets

S&P 500 Index and G3 (U.S., Eurozone, and Japan) Central Bank Total Assets


Source: © Merk Investments, Bloomberg

*Analysis: Central bank balance sheet growth has arguably been one of the important drivers for the bull market in equities since 2009. The prior peak in G3 central bank total assets coincided with the 2018 S&P 500 peak. The Fed is now increasing the balance sheet again (at $60b/month). The European Central Bank has reintroduced QE at 20b EUR/month, and the Bank of Japan has consistently continued QE. As a result, the overall size of the G3 central bank balance sheet started to rise again and has been making new all-time highs. Framework: I'd get negative if the YoY rate of change went negative.*

# S&P 500 Market Breadth

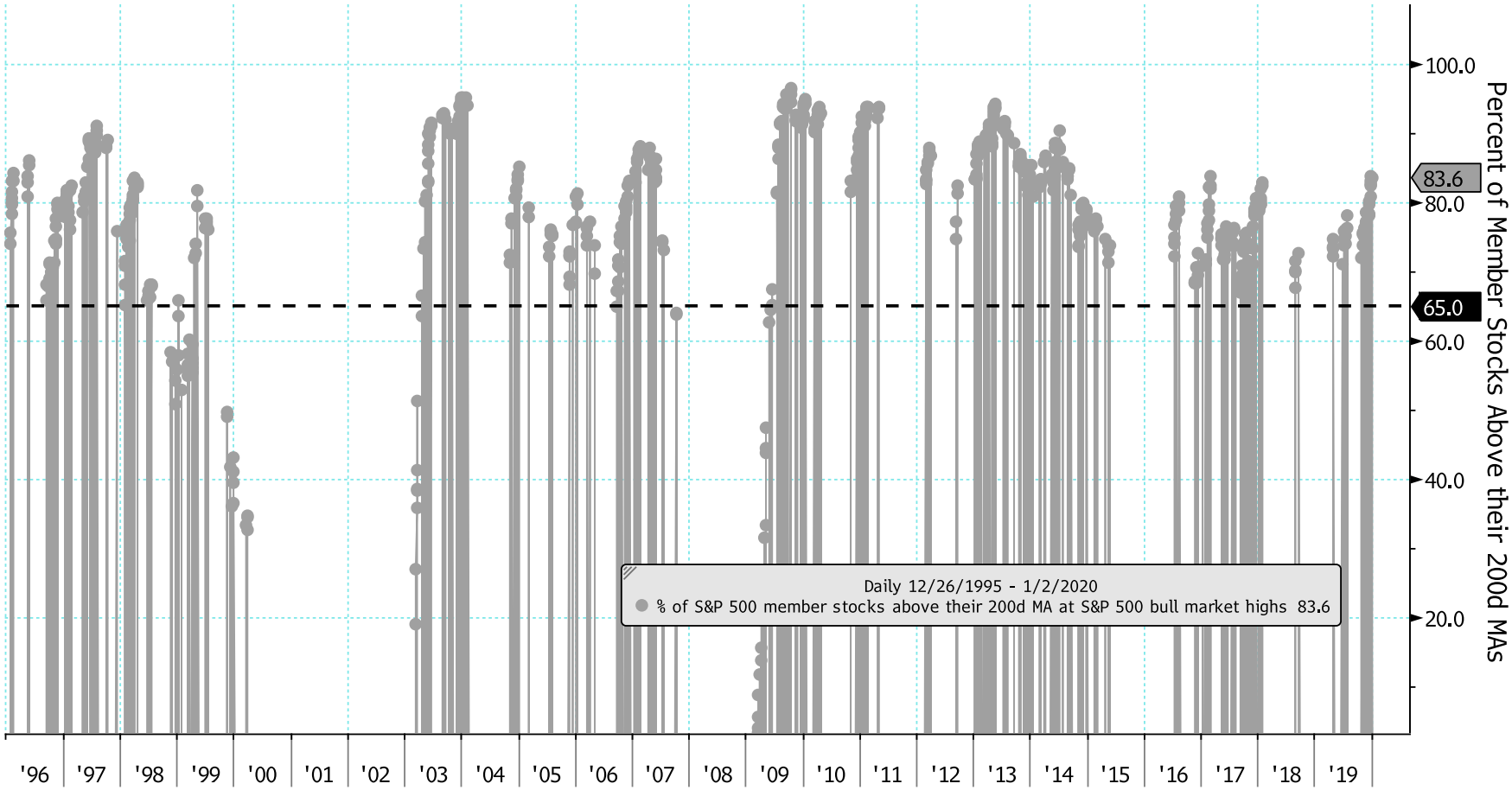
S&P 500 Index and the S&P 500 Cumulative Advance-Decline Line*


Source: © Merk Investments, Bloomberg

*Analysis: The cumulative advance-decline line for the S&P 500 has continued to make new all-time highs, which suggests continued broad participation in the bull market. Chart Framework: 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

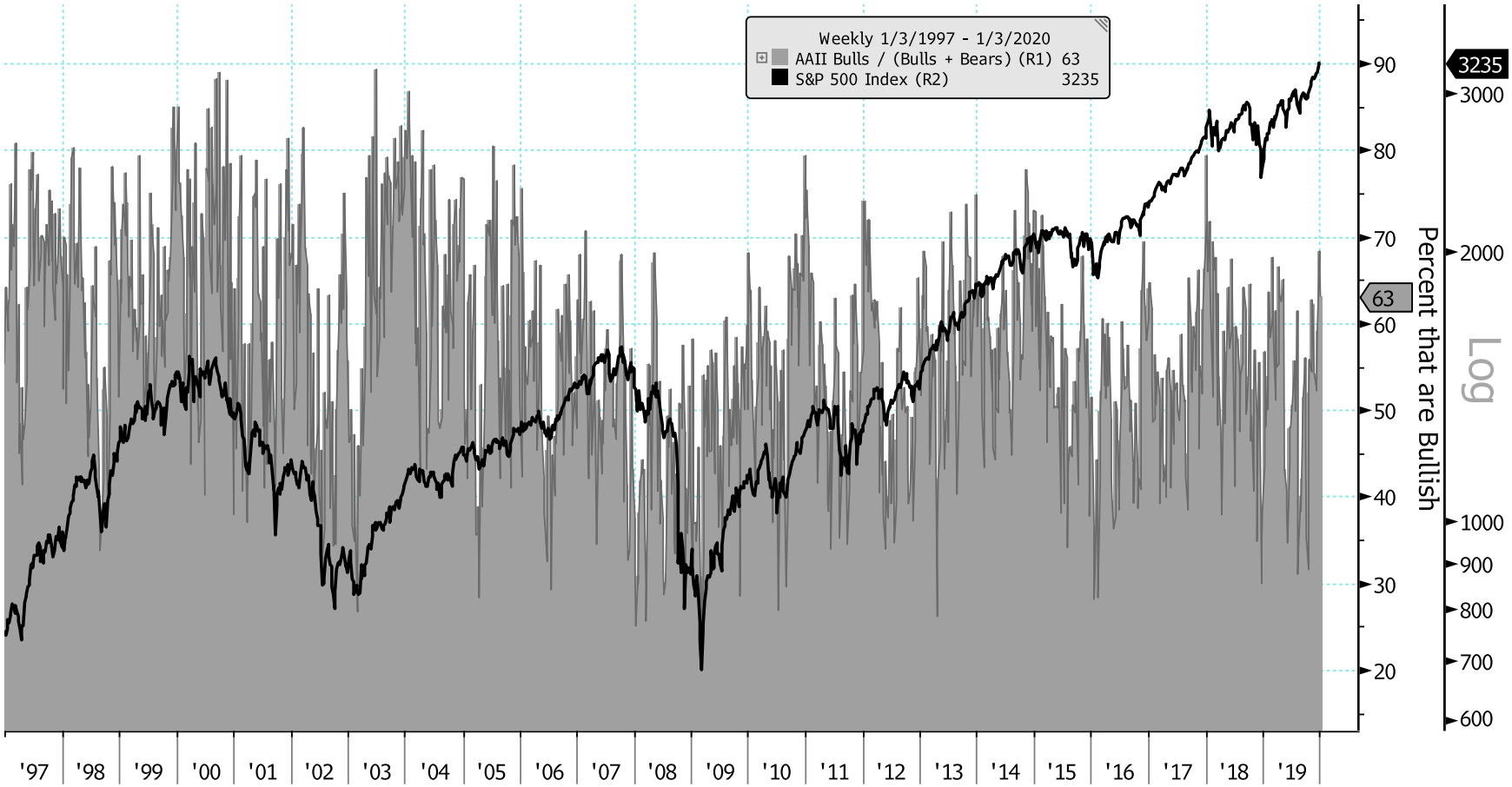



Source: © Merk Investments, Bloomberg

*Analysis: Breadth at the most recent bull market high (1/2/2020) was at 84%, 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

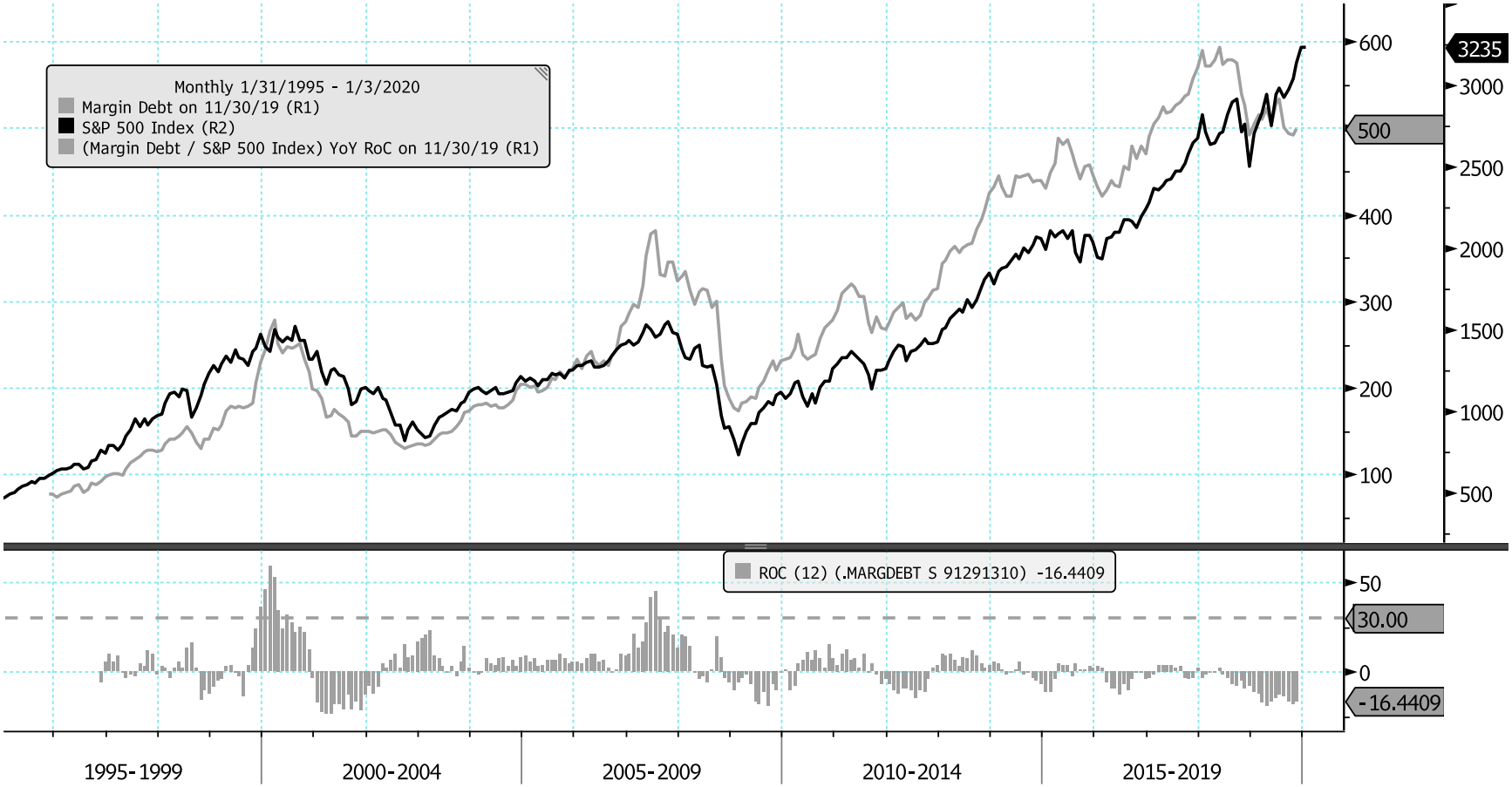



Source: © Merk Investments, Bloomberg

*Analysis: Bullishness is currently relatively high. In my view this chart should be looked at from a contrarian perspective, particularly at extremes. Given that bullish sentiment is relatively high my interpretation of this chart is neutral/negative for the market. Chart Framework: incrementally negative with sentiment near or above 70 and incrementally positive with sentiment near or below 30. The neutral range is between 40 and 60.*

# Margin Debt

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

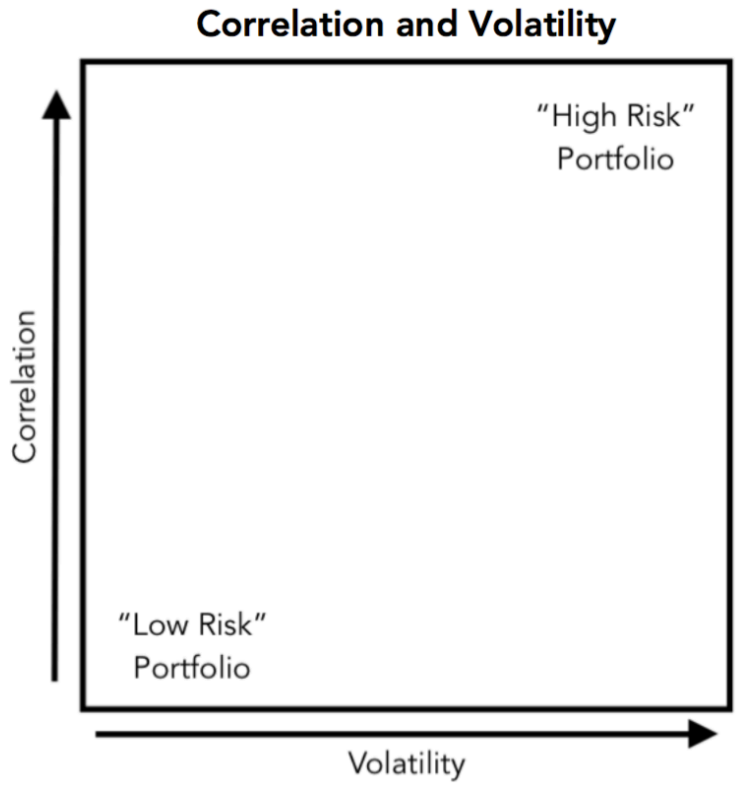



Source: © Merk Investments, Bloomberg

*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

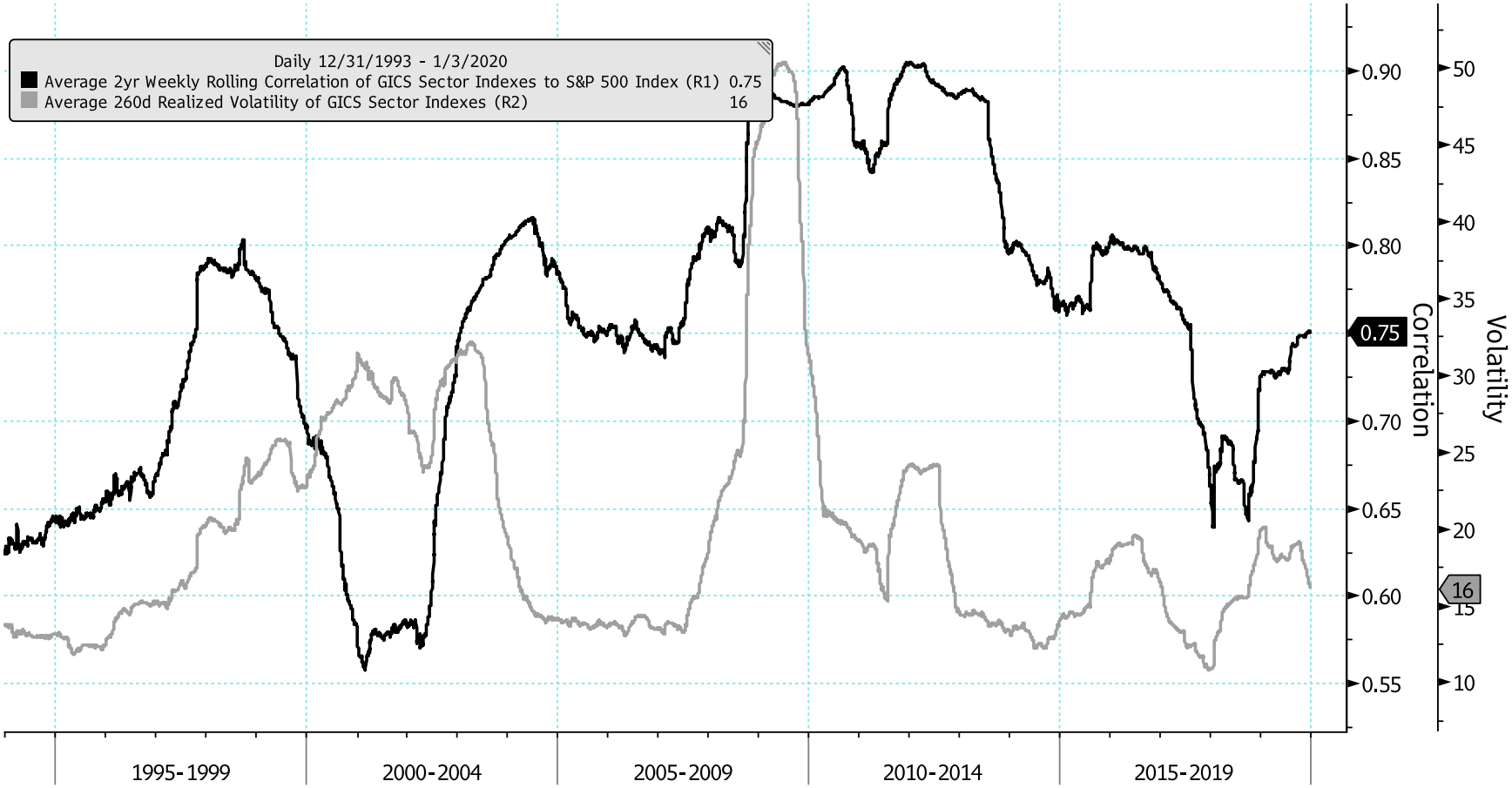



Source: © Merk Investments LLC

*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 assets, the "lower risk" the portfolio as measured by portfolio standard deviation—and vice versa for high volatility and high correlation. Counterintuitively I would argue that longer-term investors might want to think the opposite way—that is, to become cautious when asset portfolios appear low risk and consider being more aggressive 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



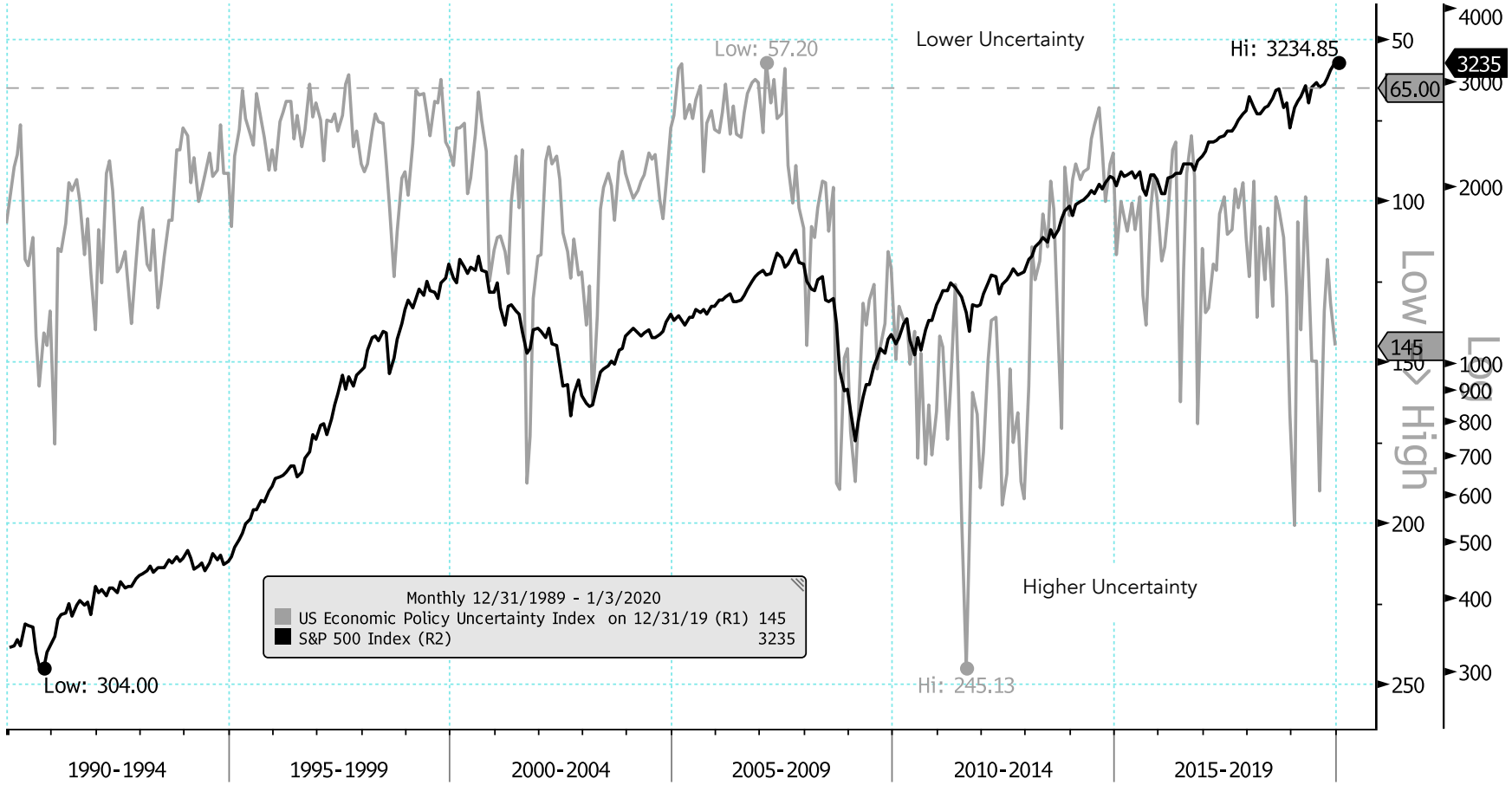

Source: © Merk Investments, Bloomberg

*Analysis: Correlation appears to be trending sideways/higher while volatility trends lower. In my view this chart should be looked at from a contrarian perspective, and currently suggests a somewhat neutral outlook medium-term as both correlation and volatility are near their long-term averages. 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

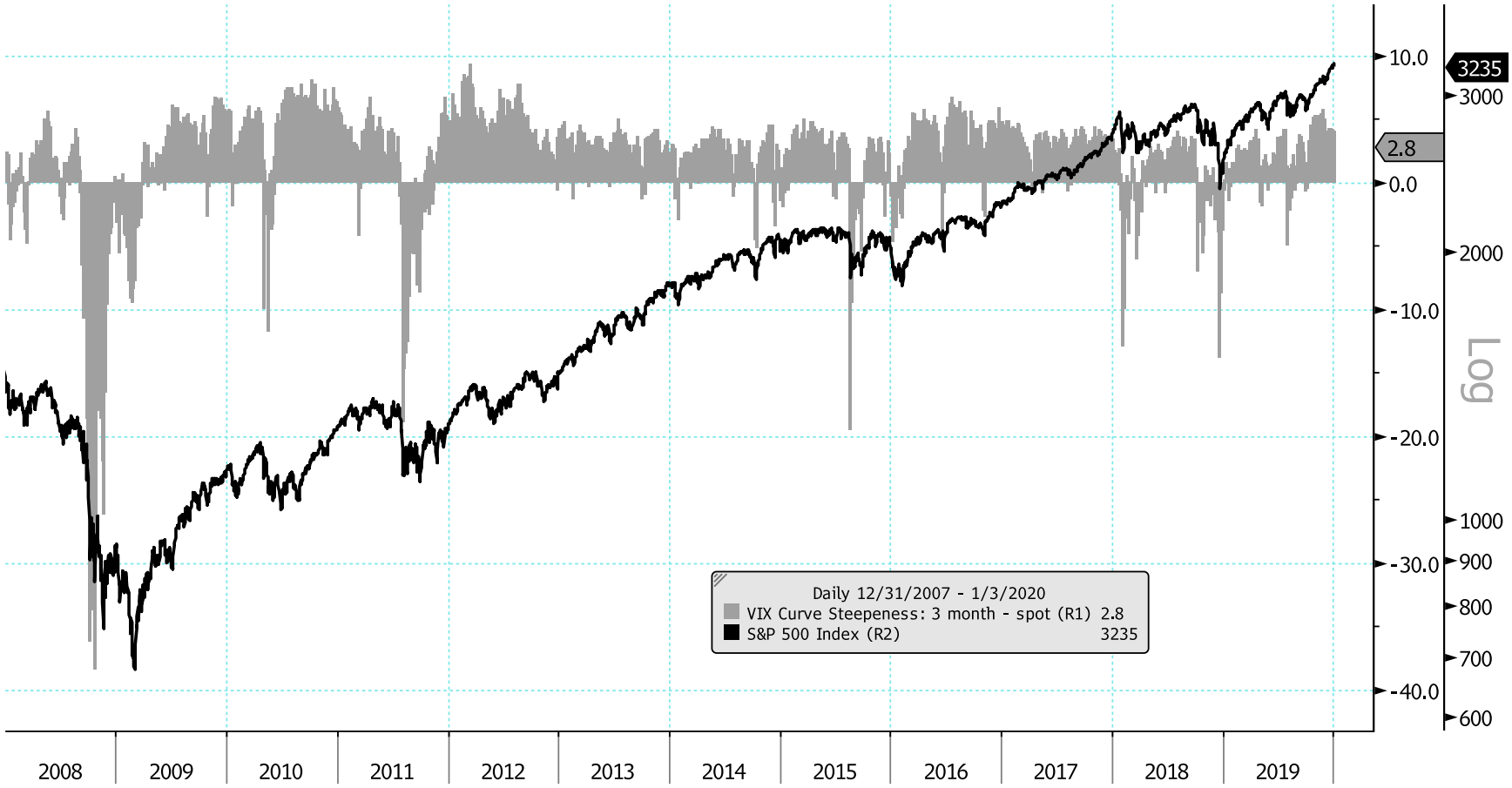



Source: © Merk Investments, Bloomberg

*Analysis: There is likely still some "wall-of-worry" left to climb before the bull market ends. Counterintuitively 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 65 level on policy uncertainty.*

# 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 a market drawdown phase is likely still ongoing, when positive it may suggest the correction is over for the time being. Chart Framework: In my view 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

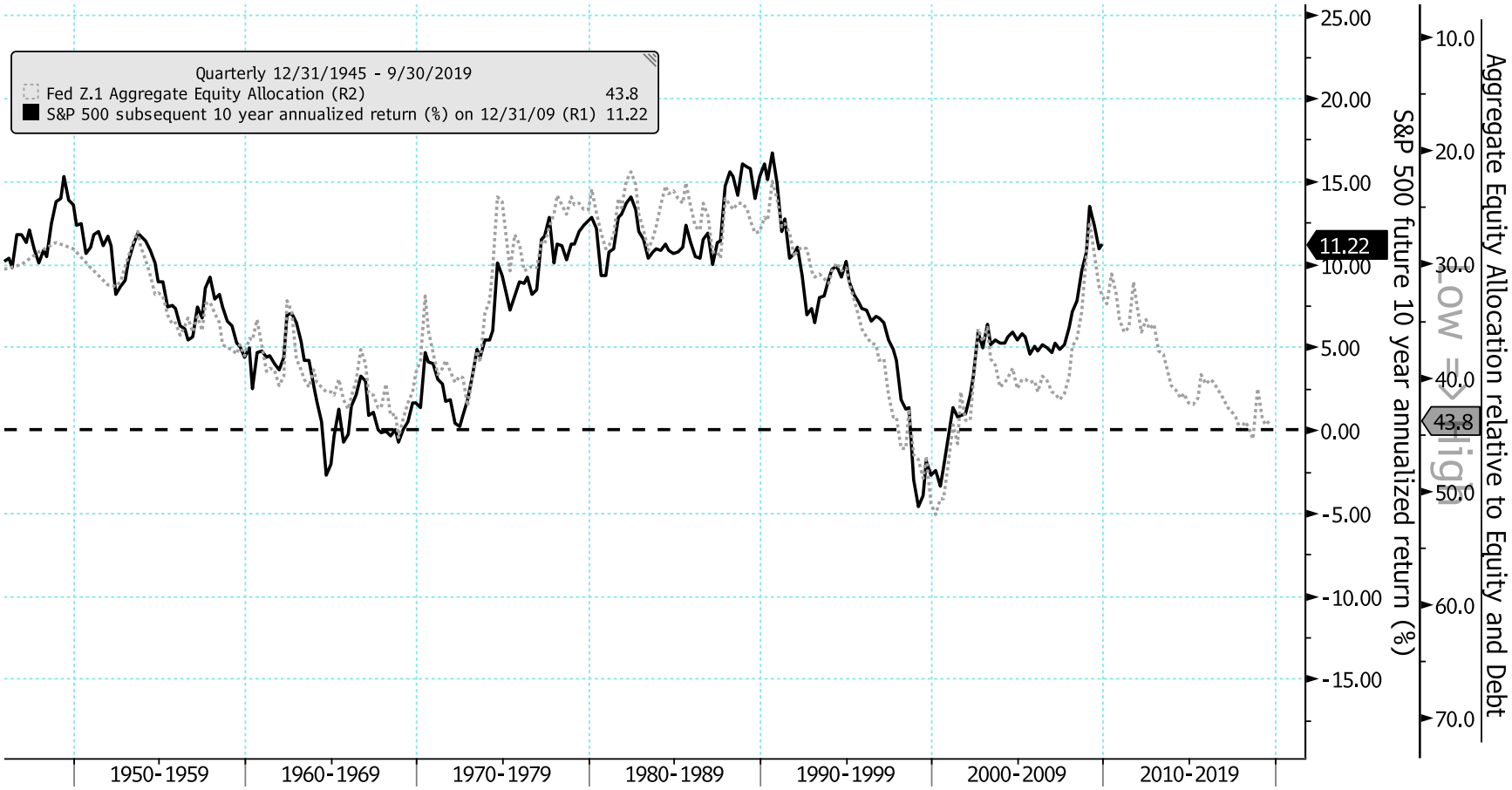
S&P 500 daily open-high-low-close chart with 50-day and 200-day Moving Averages (MA)


Source: © Merk Investments, Bloomberg

*Analysis: The 50-day moving average (grey line) is above the 200-day moving average (black line). 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.*

# S&P 500 Valuation Indicator

Aggregate Equity Allocation Proxy (From Fed Z.1 Report) and S&P 500 Subsequent 10 year annualized Returns

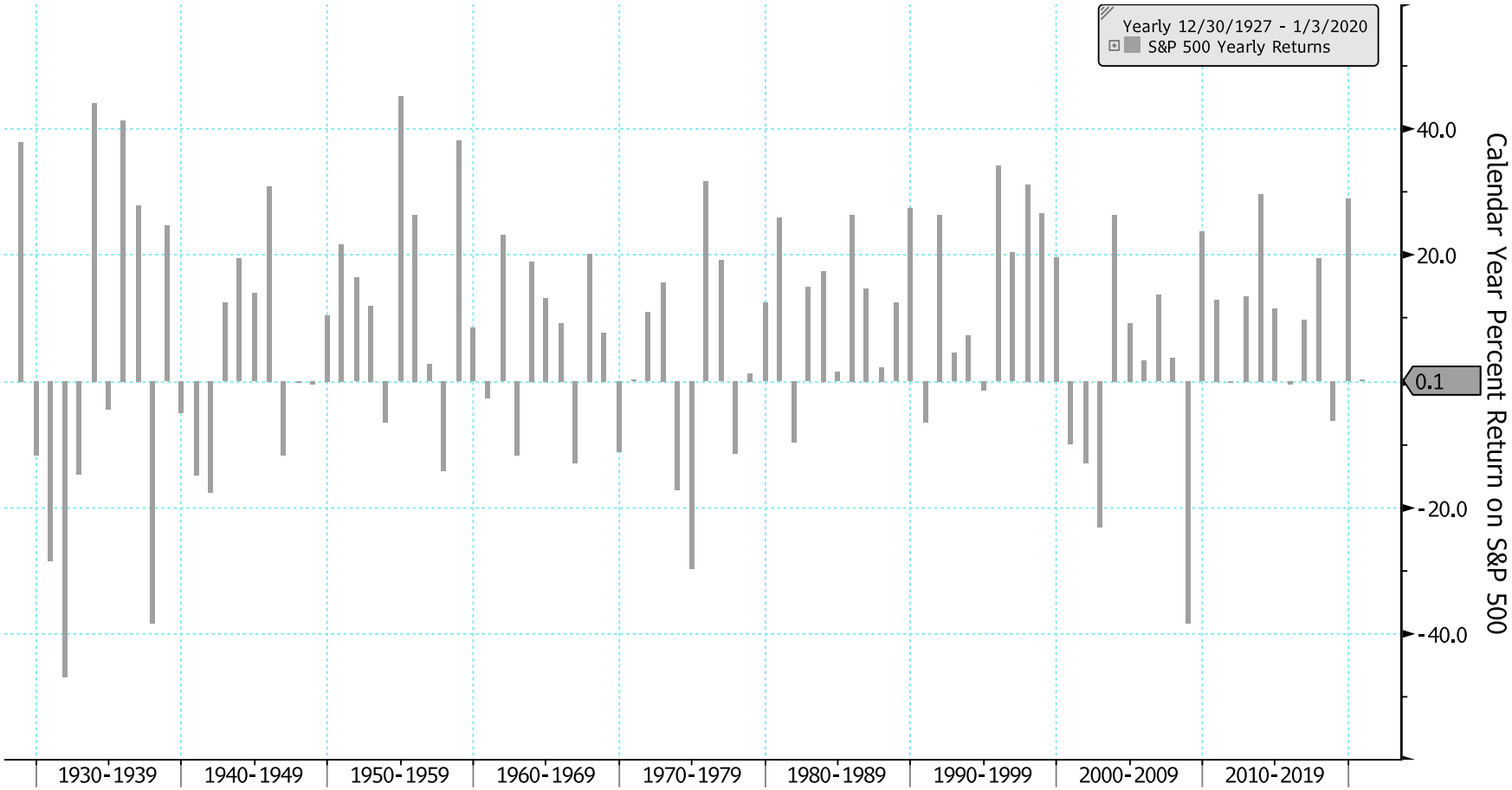



Source: © Merk Investments, Bloomberg

*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 43.8% 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 March. 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 1/3/2020 the S&P 500 is about flat year-to-date. Coming into 2020 sell-side forecasts were for a 3% to 8% return this year. Usually the consensus forecast is wrong (either too high or too low). From 1928 through 2019 the S&P 500 average annual return was 7.7%, (w/o dividends). The S&P 500 returned between 0-10% in only 16 of those 92 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 most years.*

# Checklist

| Chart | Time Horizon | Per Framework Characterization |
|---|---|---|
| Earnings | Short/Medium Term | Negative |
| Business Cycle | Short/Medium Term | Positive |
| Global growth | Short/Medium Term | Negative |
| Financial Conditions | Short/Medium Term | Positive |
| Central Bank Support | Medium Term | Positive |
| Market Breadth | Medium/Longer Term | Positive |
| Market Sentiment* | Short/Medium Term | Neutral/Negative |
| Margin Debt* | Medium/Longer Term | Positive |
| Correlation/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 medium uncertainty |
| | Medium/Longer Term (6m-5years) | Neutral/Negative with high uncertainty |



*contrarian indicators

# Conclusion/Thoughts

This is a hated bull market. The path of least resistance continues to be higher until further notice.

Uncertainty remains elevated which suggests the market still has a "wall-of-worry" to climb. Arguably the S&P 500 is still in the early stages of advancing out of a 21-month consolidation. From January 2018 to October 2019 the index was flat (at 2872) with a lot of downside volatility along the way. In other words, the equity market had poor reward-to-risk performance for the 21 months up to October 2019. The market made substantial advances coming out of similar prior periods, rising 46% over about two years out of the 2011-2012 consolidation, and rising 34% over about 1.5 years out of the 2015-2016 consolidation. But markets don't go up in a straight line, and pullbacks and corrections should always be expected.

Breadth readings at the most recent all-time high (1/2/20) were historically inconsistent with a major market top. Specifically, the new high was confirmed by the cumulative advance-decline line and the equally-weighted index both making new all-time highs, and a good percent of member companies trading above their respective 200-day moving averages (84%).

Monetary policy continues to be supportive. The Fed is increasing its balance sheet (at about $60b/month), the European Central Bank is conducting QE (at 20b EUR/month), and the Bank of Japan has consistently continued QE (at about 2T JPY/month). As a result, the overall size of the G3 (US, Eurozone, and Japan) central bank balance sheet continues to make new all-time highs. While the precise market microstructure mechanism is opaque, generally (under non-recession conditions) central bank balance sheet expansion increases cash in the system and simultaneously induces higher asset prices. It's a quintessentially fundamental supply-and-demand phenomenon at the aggregate level.

Both a China/U.S. 'phase-one' trade deal and a Brexit deal are likely in the coming month. And there continue to be signs of global growth stabilization and recovery.

What keeps me cautious on the medium to longer-term (roughly 1-5 year) outlook are the high equity market valuations. Some valuation indicators suggest relatively low expected returns on average over the next ten years. However, valuations are not a good timing indicator and historically have little relationship to subsequent one-year returns.

-Nick Reece, CFA

## About the Author

**Nick Reece, CFA**: Nick is a Senior Analyst & 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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