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U.S. Equity Market Report

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Quote

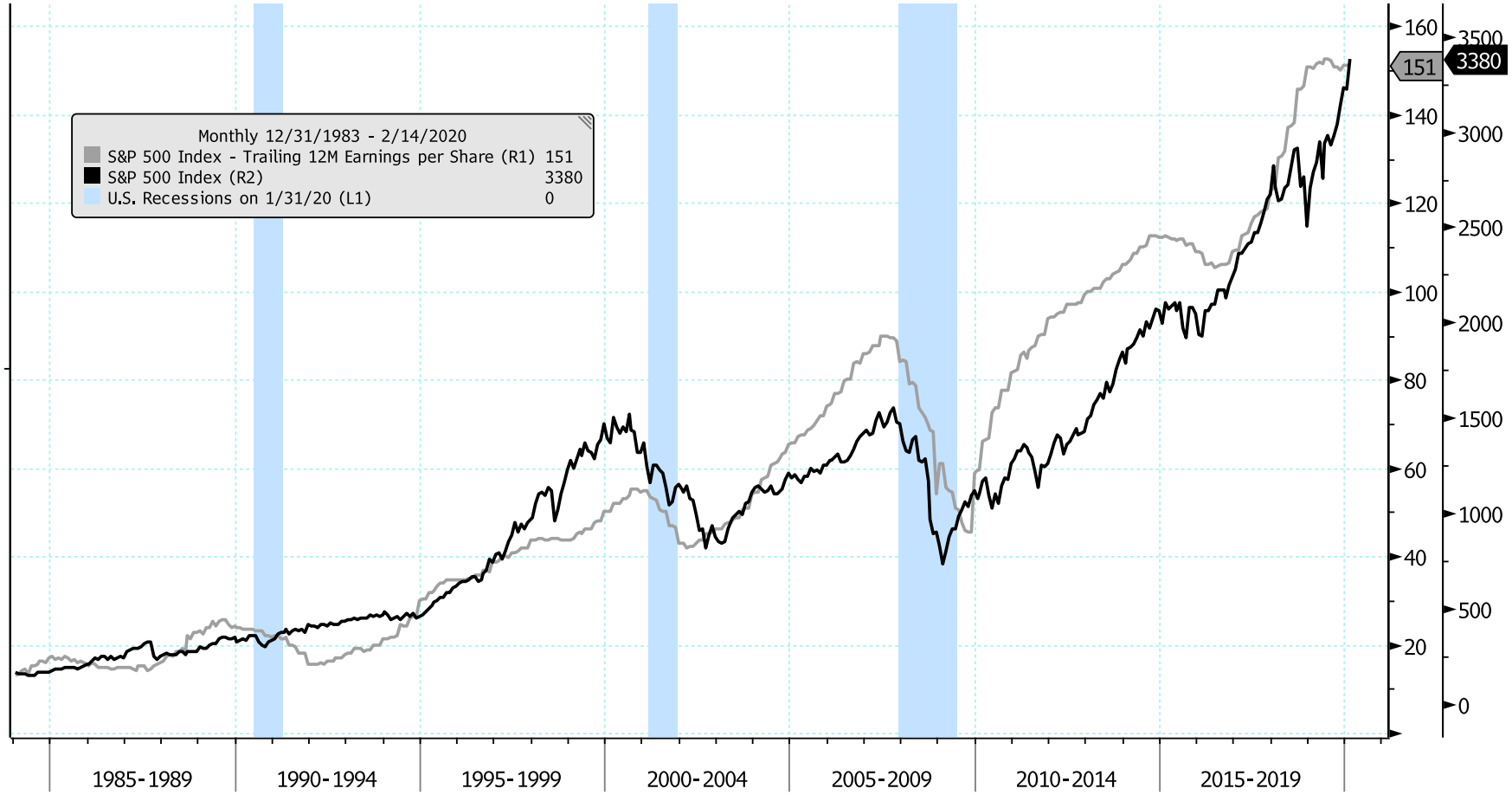
Quotes or book excerpts that I find particularly insightful…

"The efficient market hypothesis assumption that prices instantaneously adjust to fundamental news has it exactly backwards, it is far more accurate to say that the financial news will instantaneously adjust to price changes… The market action determines the interpretation of the news, not the other way around… Whether the market is up or down on a given day, financial reporters have to find an explanation for the price move. Therefore, an explanation will be drawn from the coincident news developments on that day, regardless of whether they are pertinent. This routine process can lead to the comical situation of the same development being used as both a bullish and a bearish explanation on days when the market traverses widely between up and down."

-Jack Schwager

Earnings Backdrop

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

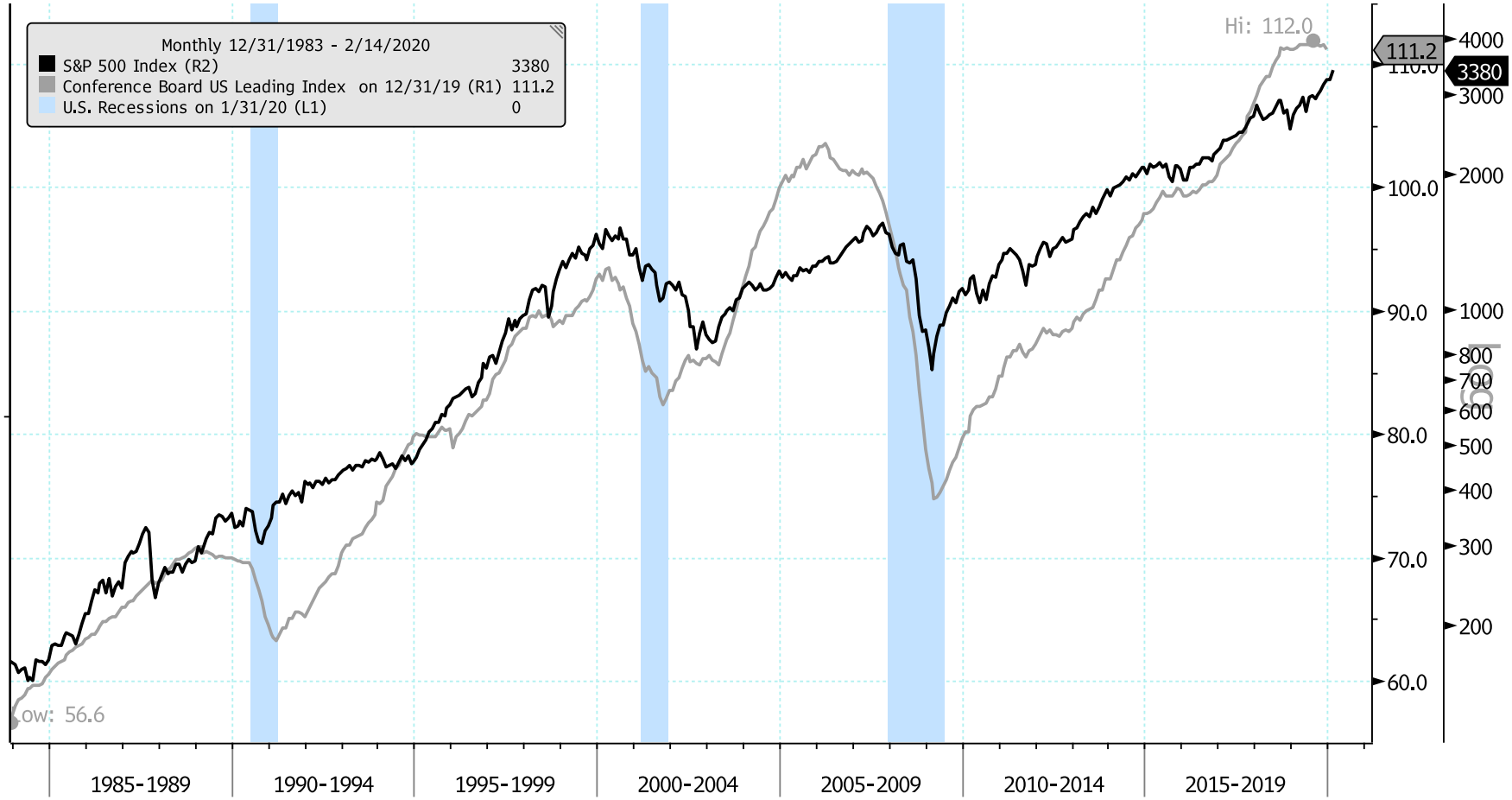


Source: © Merk Investments, Bloomberg

Analysis: S&P 500 trailing earnings are up over the past quarter, after a dip. According to Factset analysts are projecting earnings growth of 8% for calendar year 2020 (slightly lower relative to last month's report). I'm currently neutral 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 down for December; however, the LEI index is still up YoY. 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

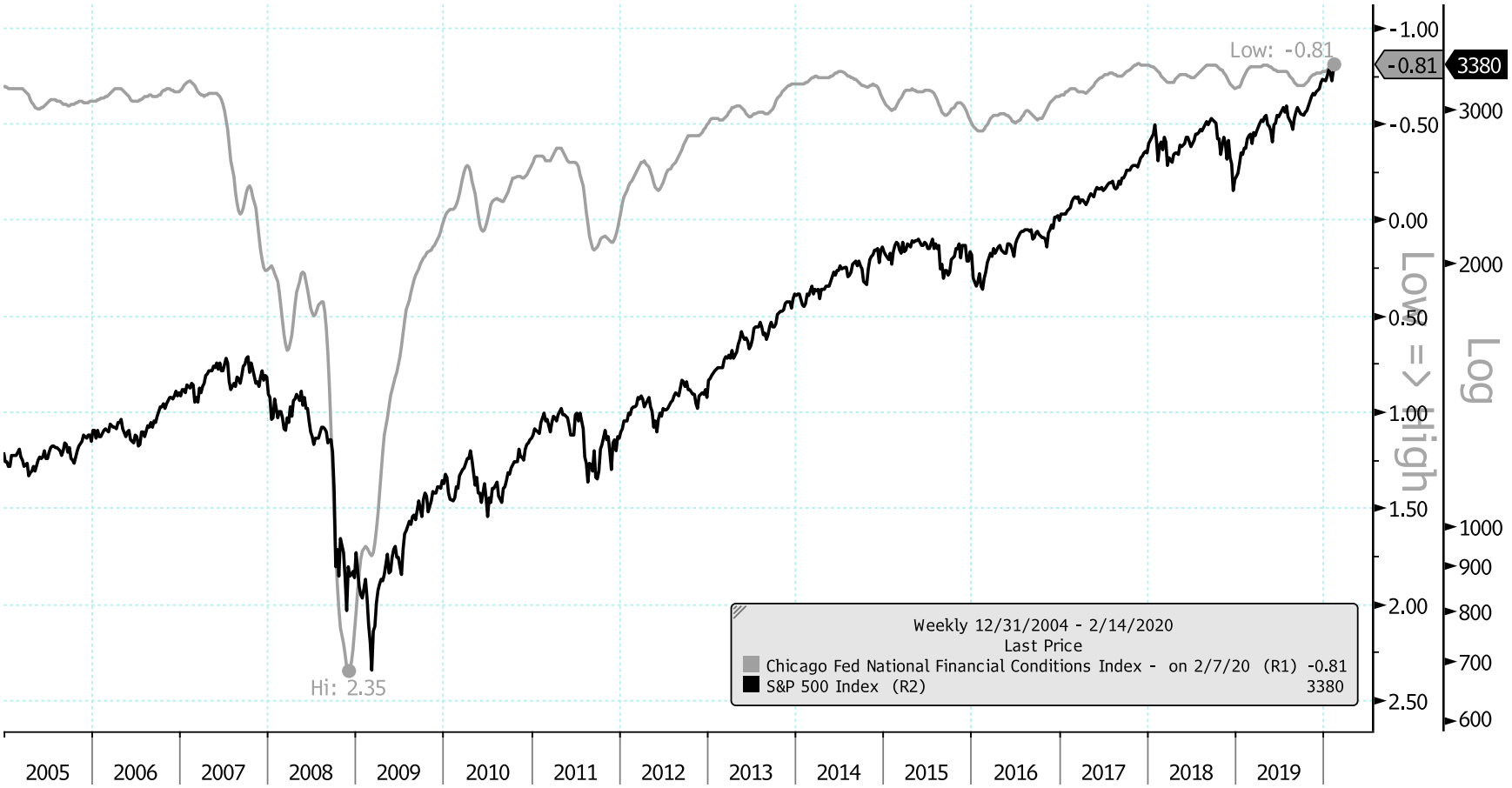
Large Economy Manufacturing PMIs (Purchasing Managers Index) and the S&P 500

Source: © Merk Investments, Bloomberg

Analysis: Major economy manufacturing PMIs were mostly higher over the past month. The U.S., German, and Japanese PMIs moved up. China's PMI fell slightly to 50.0. 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 eased over the past month, currently at -0.81. Financial conditions are at the loosest level of the cycle. 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. 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 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

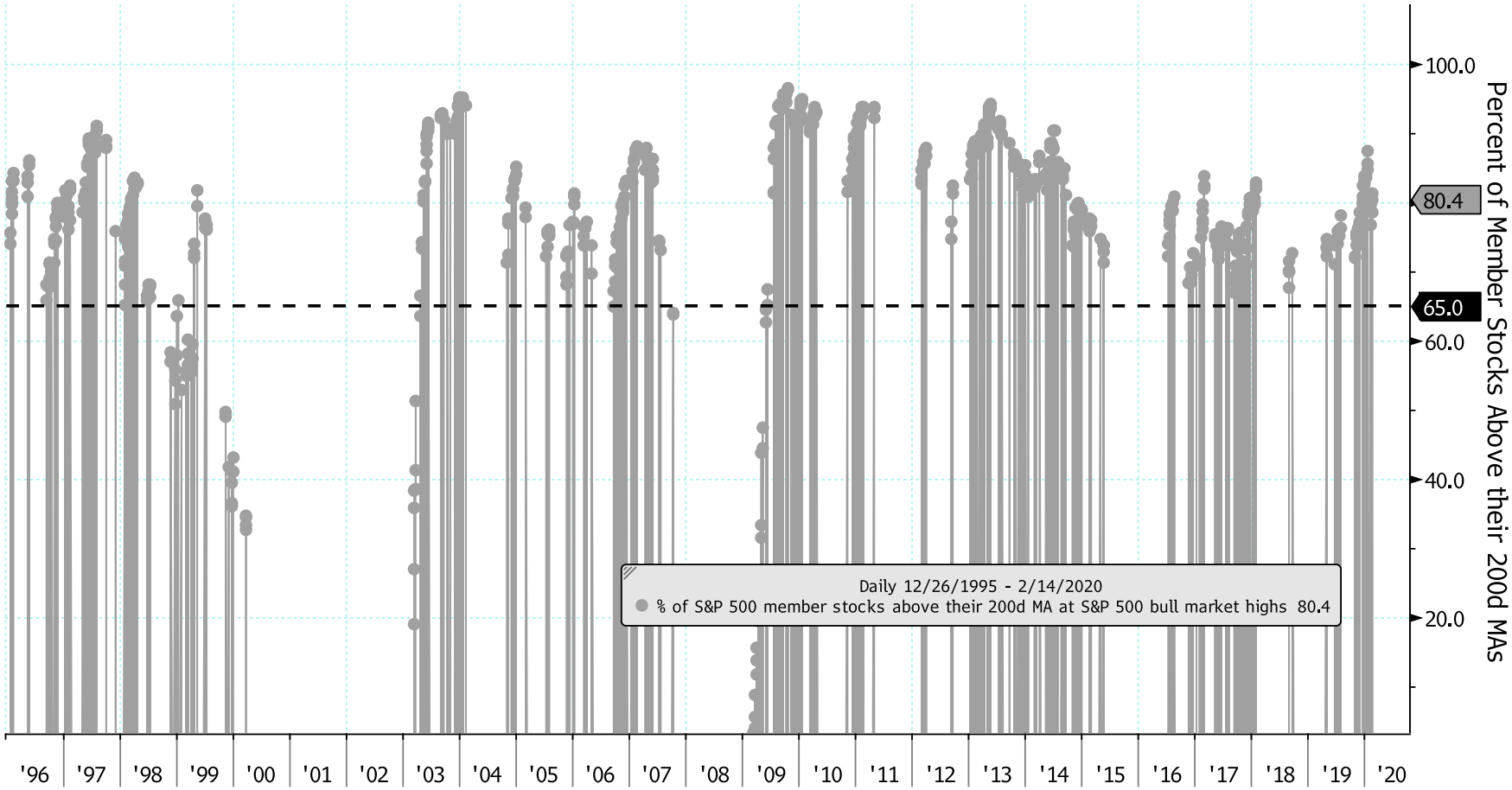
S&P 500 Index and the S&P 500 Cumulative Advance-Decline Line*

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

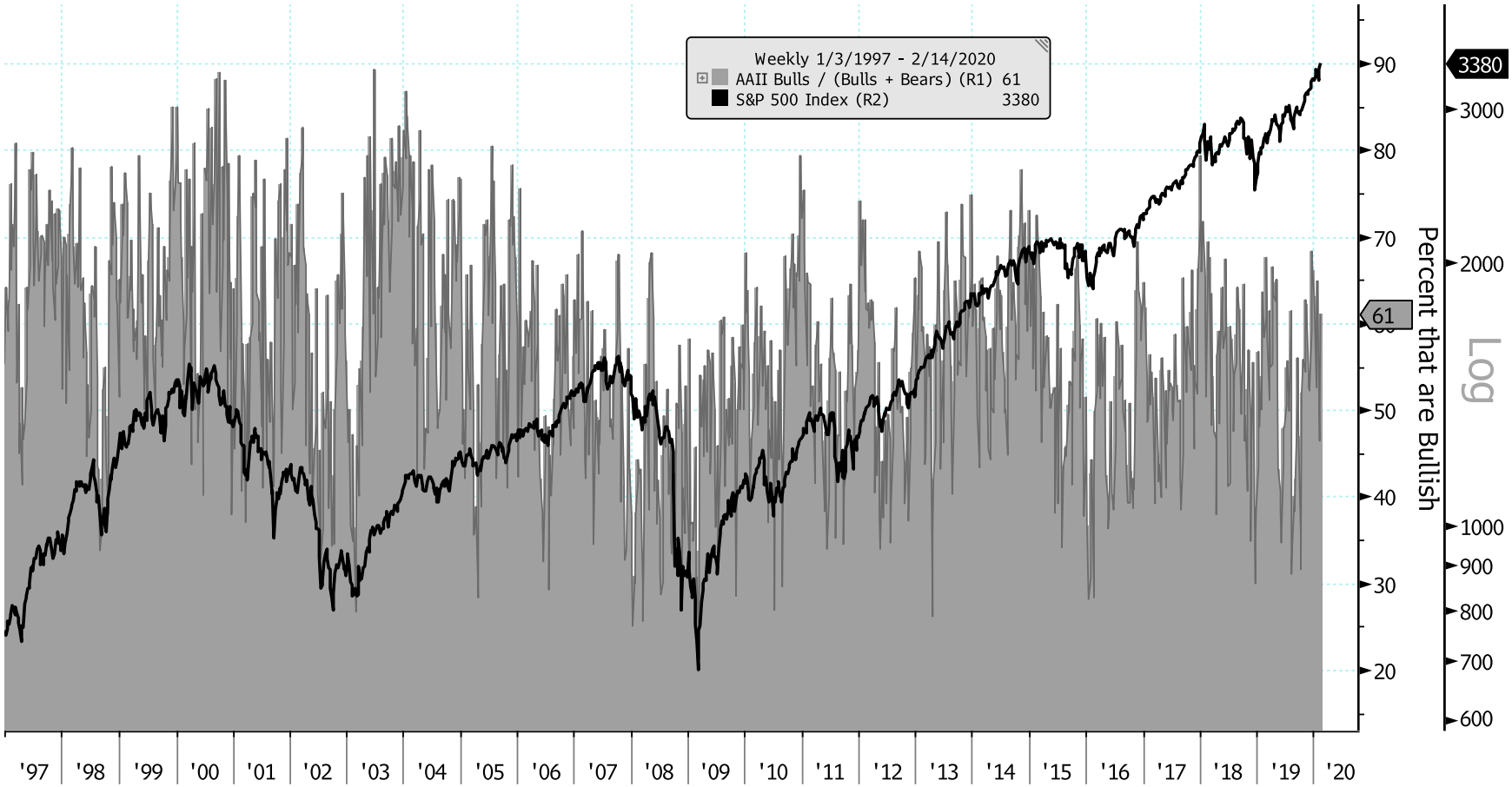


Source: © Merk Investments, Bloomberg

Analysis: Breadth at the most recent bull market high (2/14/2020) was at 80%, above the 65% warning level—a positive sign for the bull market. There is a gradual long-term breadth decline 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

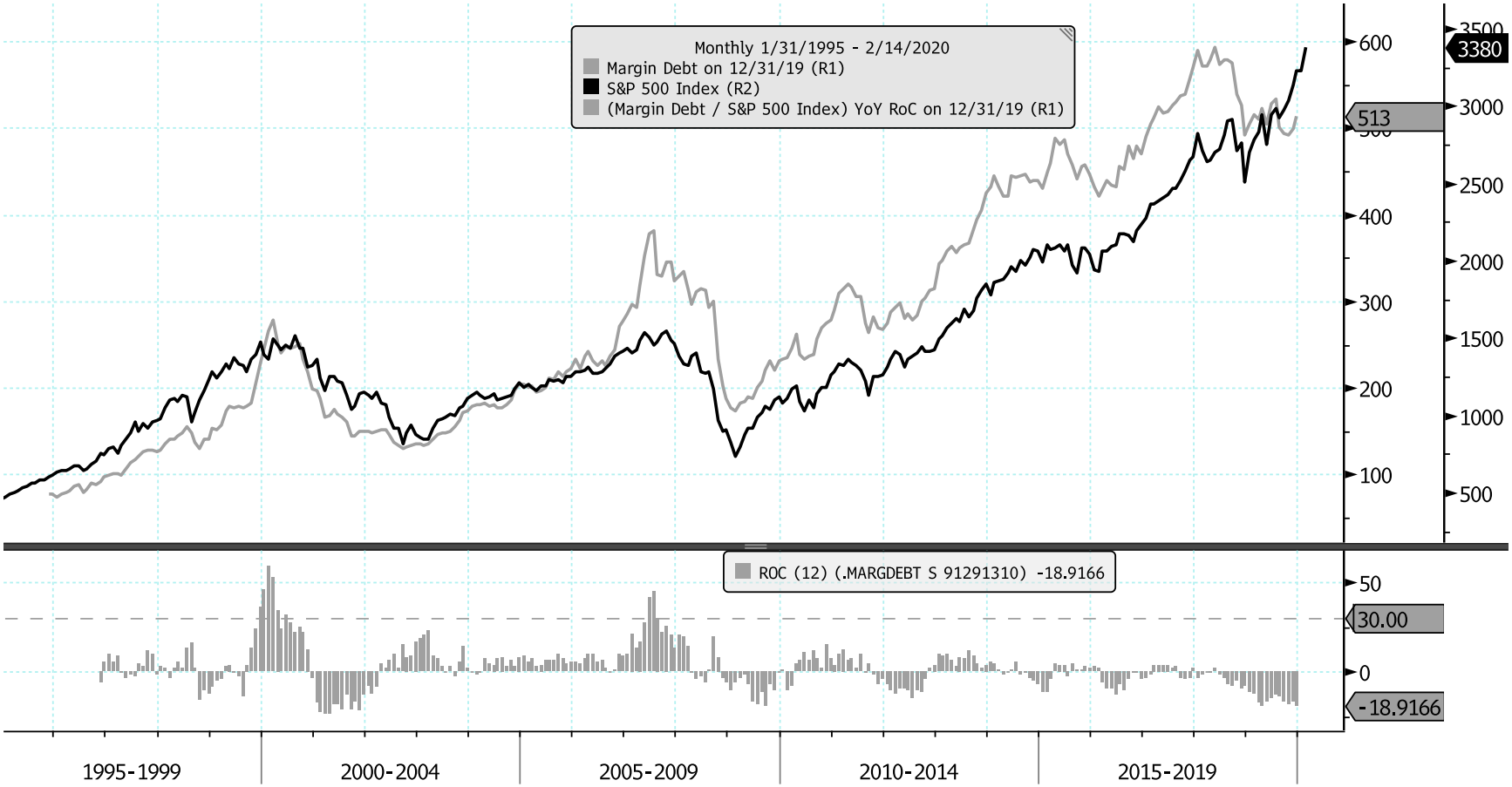


Source: © Merk Investments, Bloomberg

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: I'd get 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)

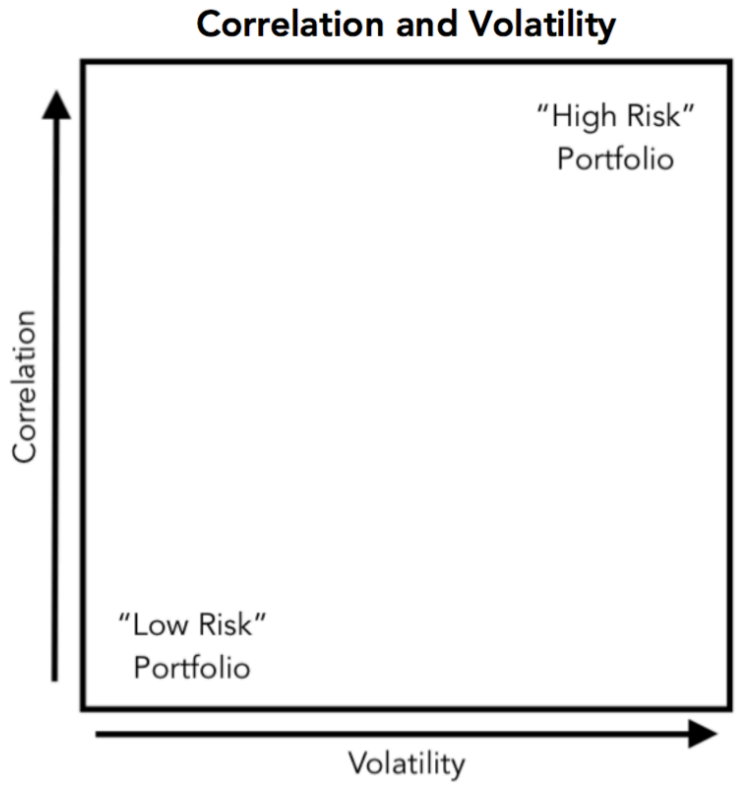


Source: © Merk Investments, Bloomberg

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

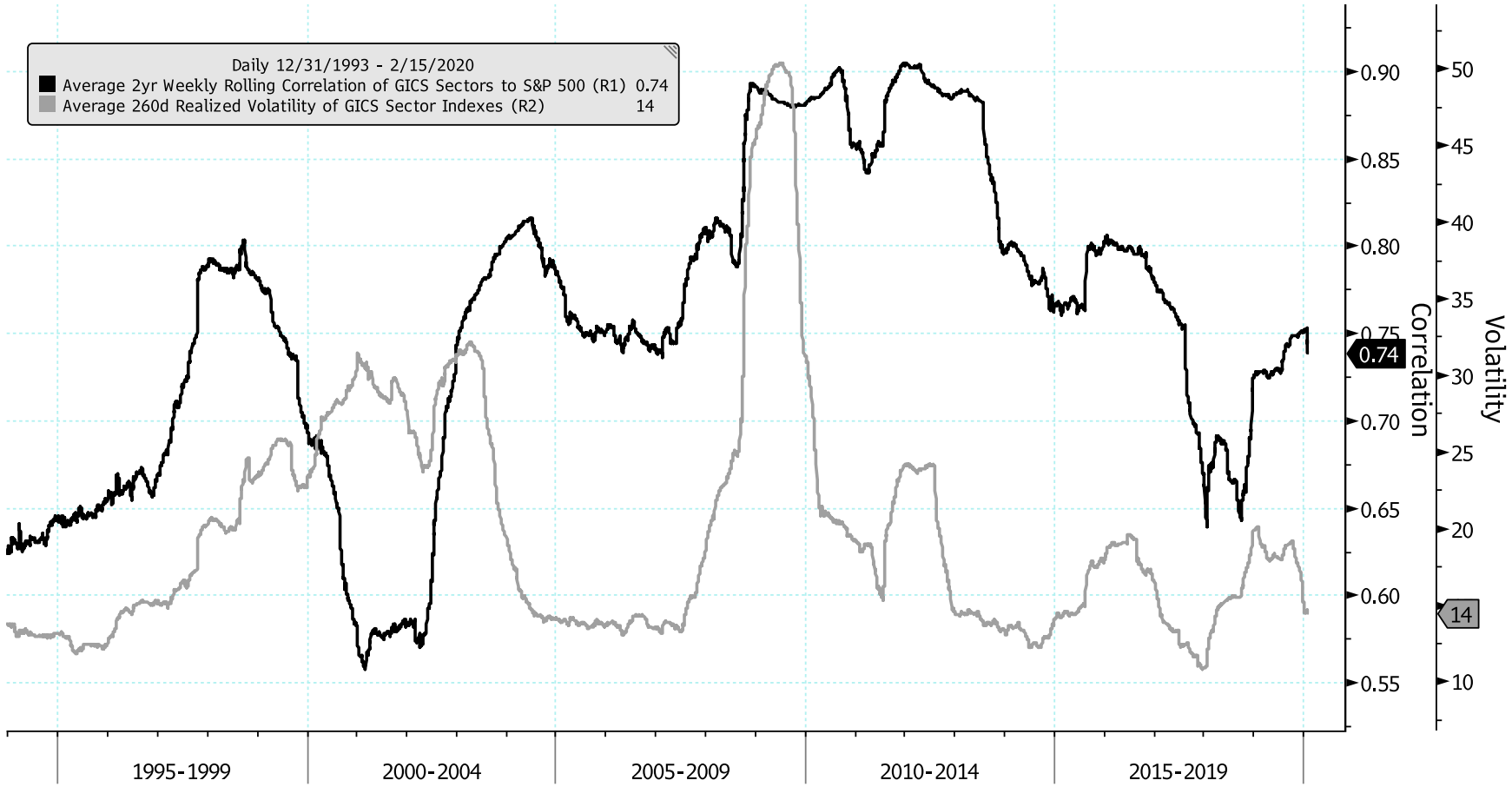


Source: © Merk Investments LLC

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



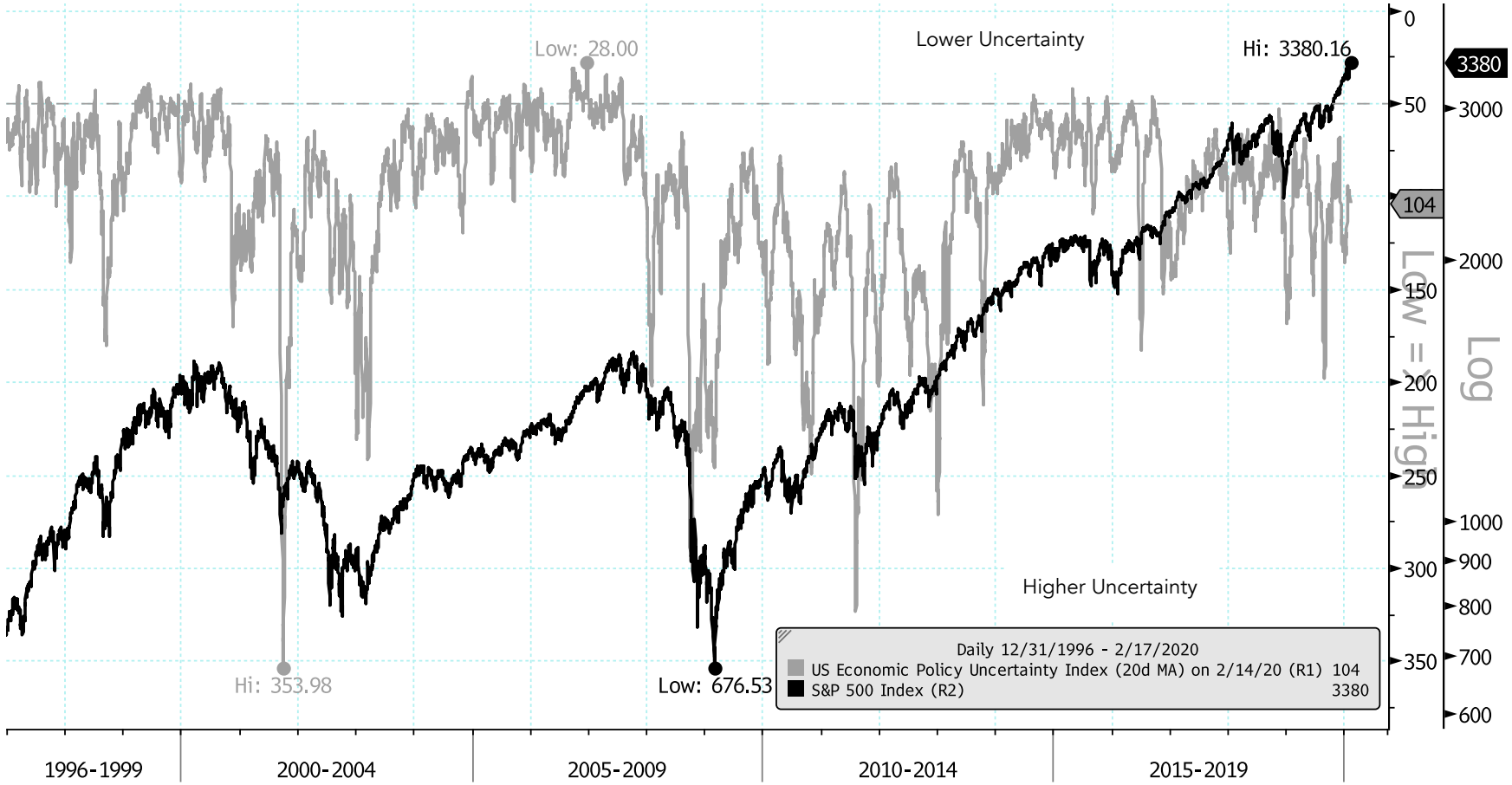
Source: © Merk Investments, Bloomberg

Analysis: Correlation and volatility are both moving lower from levels near their long-term averages. 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

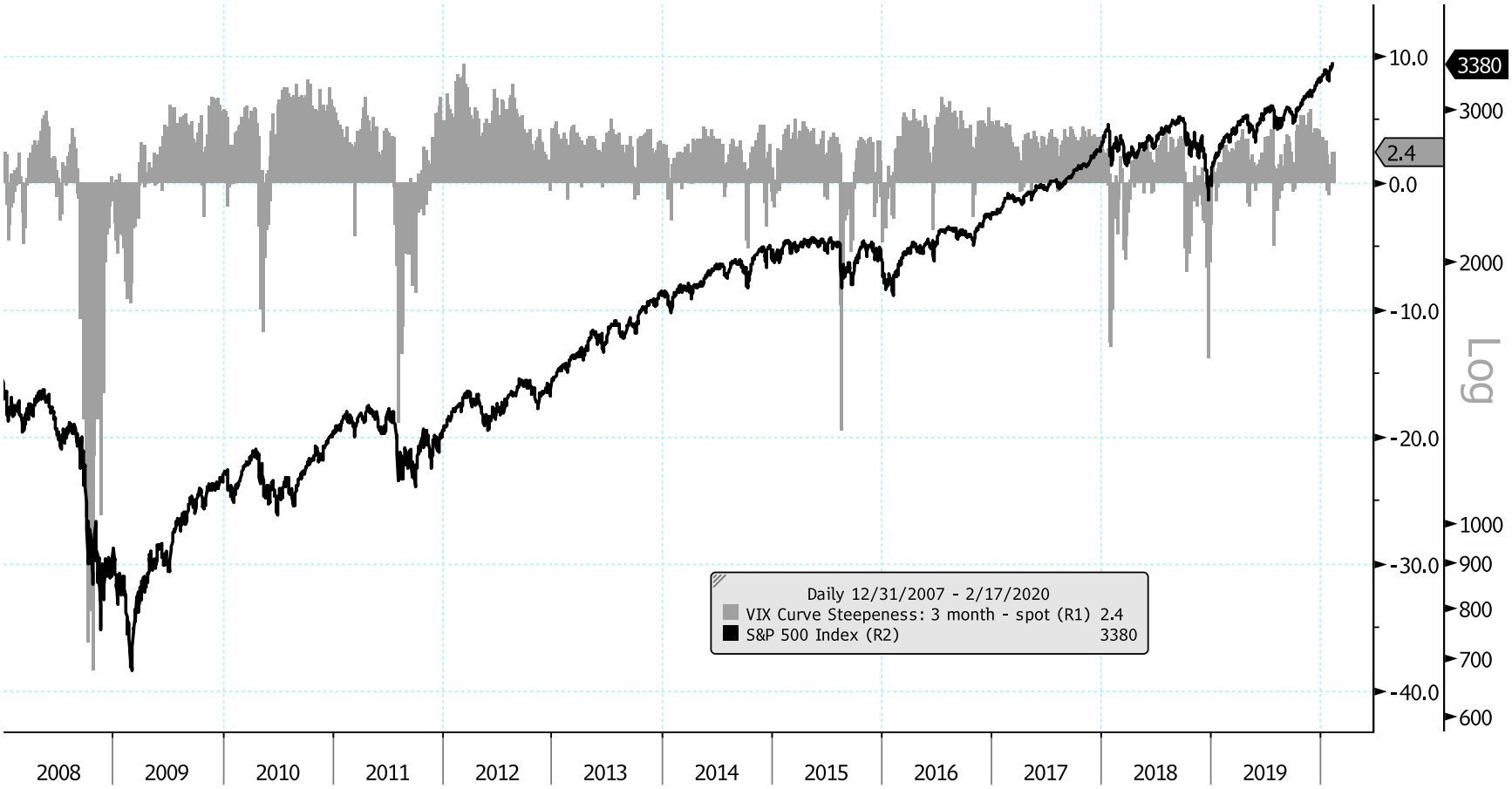


Source: © Merk Investments, Bloomberg

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

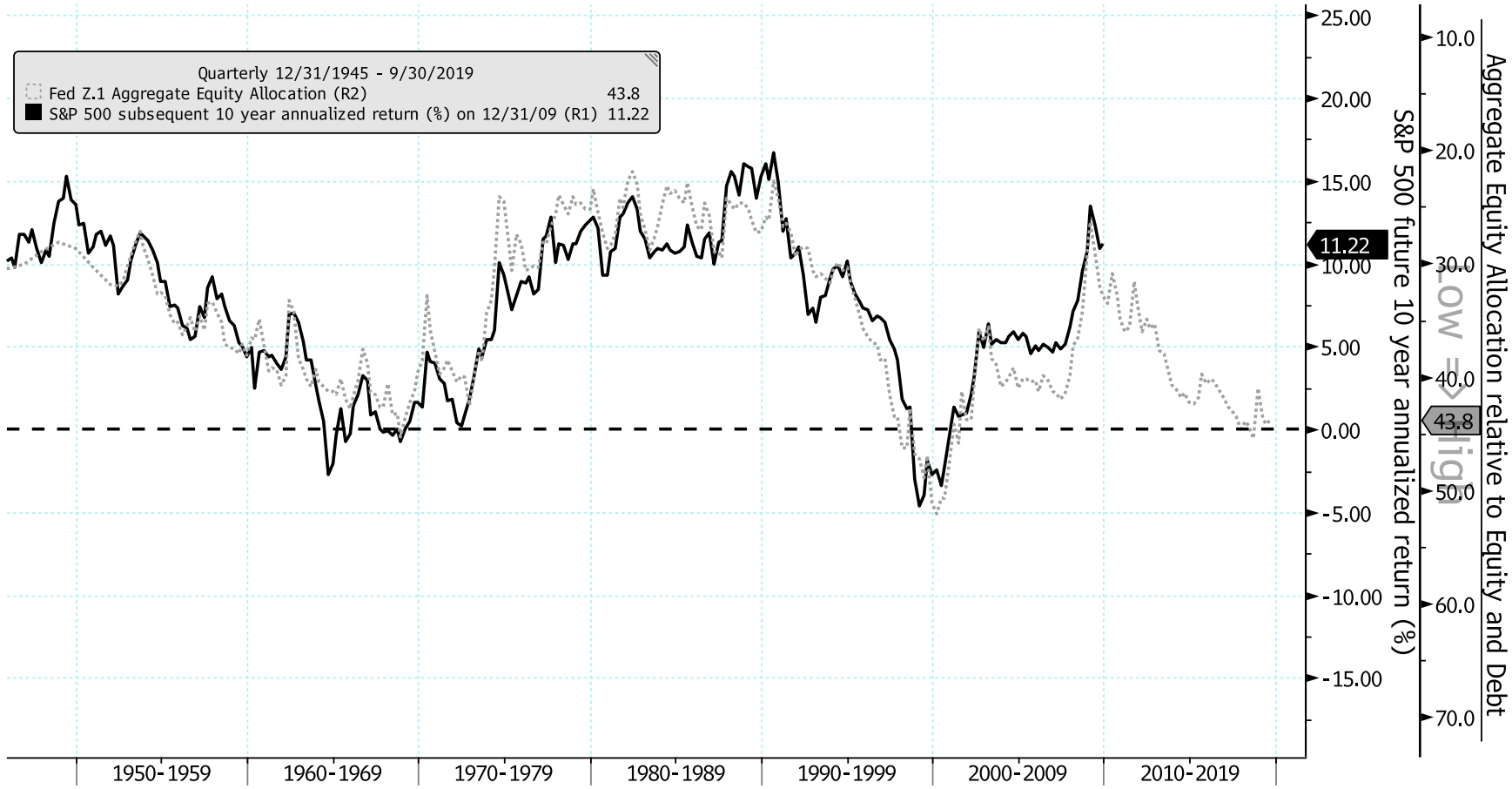
S&P 500 daily open-high-low-close chart with 50-day and 200-day Moving Averages (MA)

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

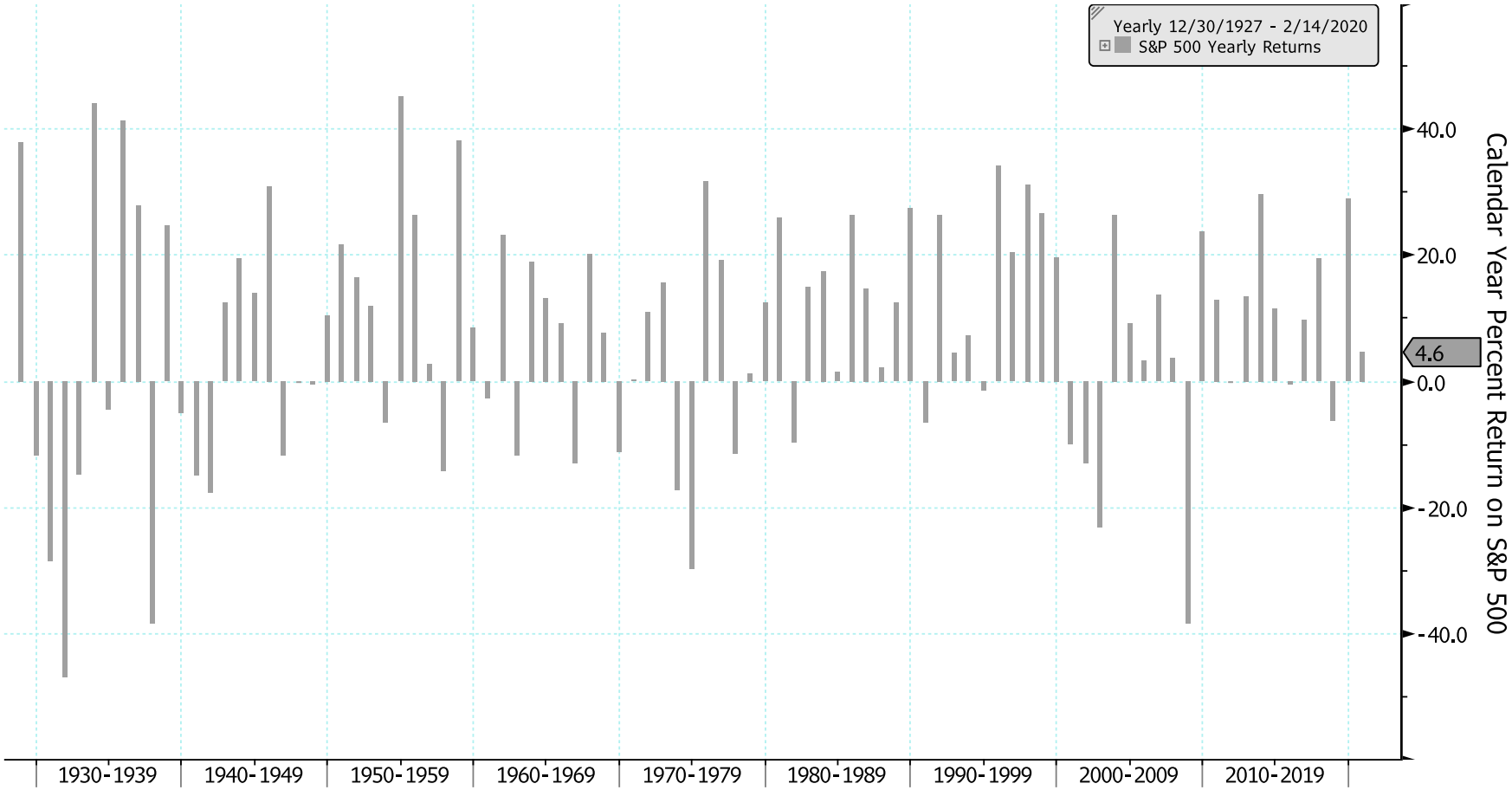


Source: © Merk Investments, Bloomberg

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 2/14/2020 the S&P 500 is up about 5% 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	Neutral
Business Cycle	Short/Medium Term	Positive
Global growth	Short/Medium Term	Neutral/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

The permabears are apoplectic. Vitriol towards this market reached a new high along with the S&P 500. The path of least resistance continues to be higher until further notice.

Breadth readings at the most recent all-time highs were historically inconsistent with a major market top. Specifically, the new highs were confirmed by the cumulative advance-decline line and the equally weighted index making new highs, and a healthy percent of member companies trading above their respective 200-day moving averages (80%).

Uncertainty remains elevated which suggests the market still has a "wall-of-worry" to climb. The lack of build-up in margin debt relative to market cap suggests that speculative positioning is not indicative of a euphoric market. Monetary policy continues to be supportive—the overall size of the G3 (US, Eurozone, and Japan) central bank balance sheet continues to make new all-time highs. And the business cycle backdrop is improving in the U.S. and internationally.

Some analogs suggest the market is due for a more normal correction. A 5-10% pullback is likely at some point this year. But the recent pullback that coincided with coronavirus headlines was met with strong buying. After being down only 3.5%, the market gapped higher at open on three consecutive days to regain new highs. Paul Tudor Jones once said: "the headlines are all bearish and yet the market is telling a different story."

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. And bond yields are near all-time lows, making the dividend yield of equities attractive to long-term investors. Arguably, stocks remain cheap compared to bonds and cash.

On a broader note, I think it's worth having multiple historical analogs in mind. Maybe this current market environment is similar to 1998-99, but maybe it's more similar to 1988-89. What if the next recession is relatively mild and without a bear market (like in 1990-91)? What if this is a secular bull market that can rise another 4x without a major bear market? I think those are a non-consensus ideas worth considering.

-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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