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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Was January 26 the Bull Market Peak?

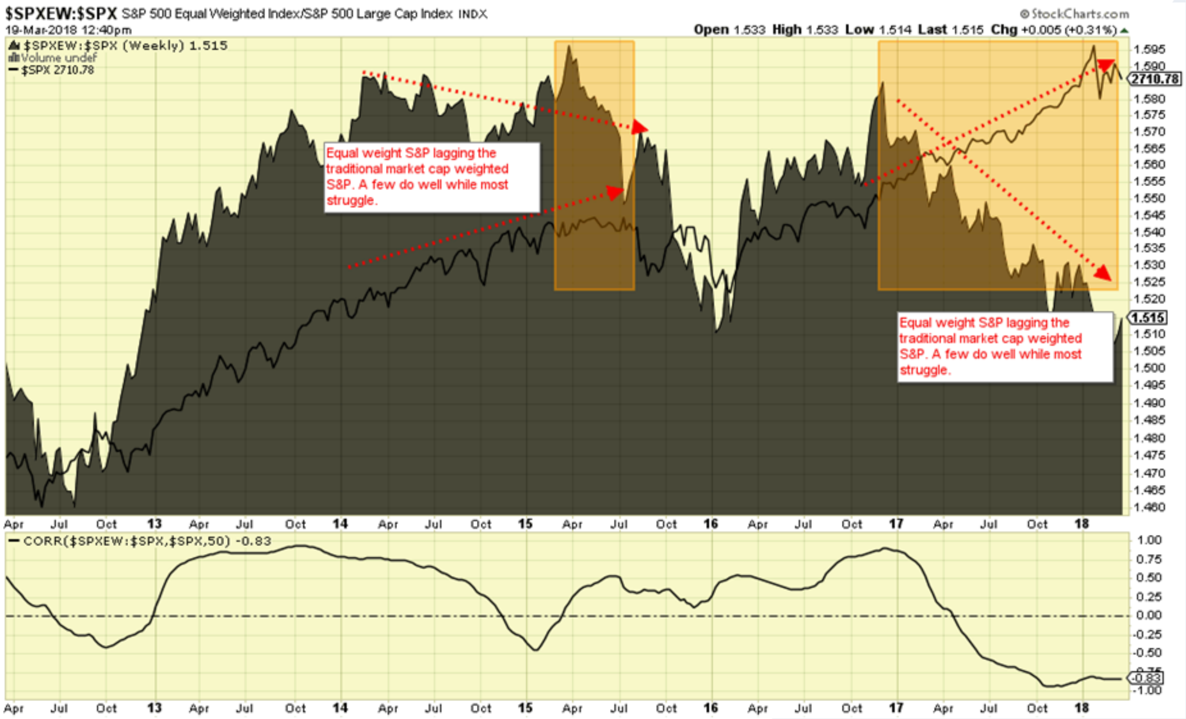
On February 8, the S&P 500 found itself 10% lower than it was a mere 9 trading days earlier – a type of decline which has been extremely rare over the last few years. Central bank support for the markets has fostered an extremely low volatility environment that has kept investors buying dips at every opportunity. Will this dip prove to be like all the others over the last nine years and ultimately lead to new highs or will it be the beginning of a new regime where investors start selling as the market moves lower?

In a recent letter we touched on the disconnect between stock valuations and fundamentals. If you haven't read that one, we encourage you to pull it up for some perspective on just how elevated stock prices are relative to underlying economic activity. In fact, if we factor in how much debt levels have increased since 2009 across the board – consumers, corporations, and governments – one could make the argument that economic growth would be non-existent without it. Put another way, what growth we're getting in the economy isn't healthy organic growth. It requires more and more debt to sustain, which is in no way sustainable long term.

What's more relevant to the markets in the short term however, is whether or not this accumulation of debt will cause problems for financial markets. Without getting too far into the weeds on this one right now, suffice it to say that the more debt is built into the system, the uglier things are on the way down when its load eventually gets too heavy to sustain. If it helps on the way up, it'll likely hurt on the way down. There's ample historical precedent for this. In any case, markets are currently perched upon the highest branch they ever have been in a tree that is likely to experience larger sway than at any point in the past due to excessive leverage across the financial system. The stage is set. Next we move on to market internals – what's actually happening to the average stock in the indices - for clues as to "when".

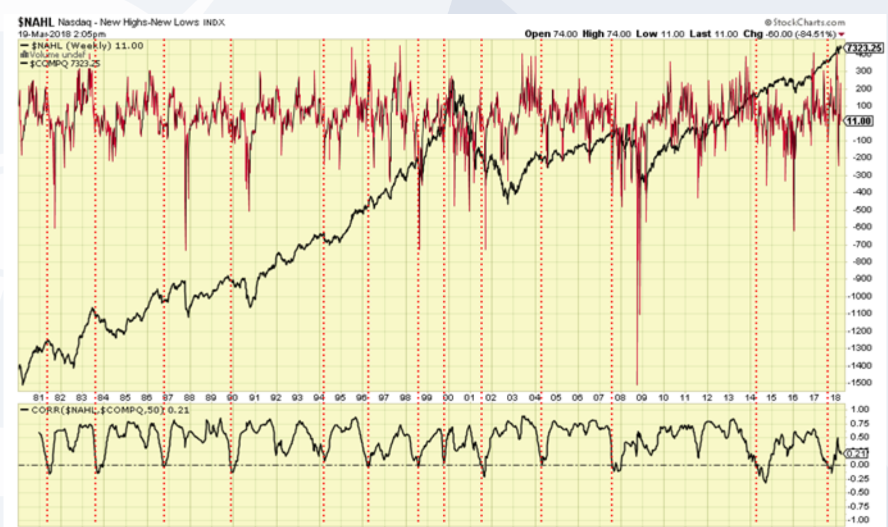
Weak Market Internals

What has us taking the recent drop from the January 26 highs more seriously than others is the fact that market internals have been very weak. Although market indexes aren't far from all-time highs, the average stock comprising them isn't doing so well. Whether we're looking at cumulative Hindenburg Omens (which we wrote about in December 2017) or other measures of market breadth, the theme is similar. Very few of the largest stocks are holding the market up. When we look at the Equal Weighted S&P 500 relative to the traditional Market Cap (size) Weighted S&P 500, we're seeing a breakdown in the masses while a smaller number of larger stocks continue to march higher – similar to what we saw in the previous two market declines in 2007 and 2015. Note the divergence between the two in the chart below.

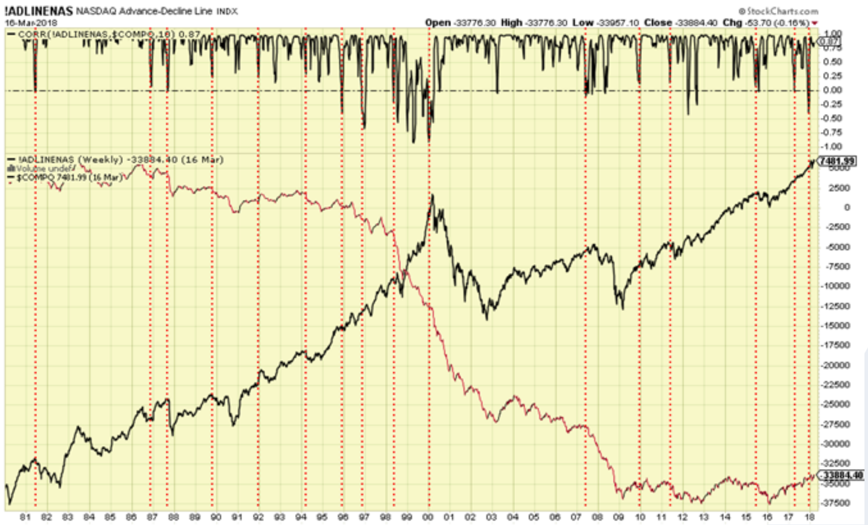


We can also see turmoil within the Nasdaq index when looking at the performance of its constituents. One way of seeing what's really going on under the surface is to look at the number of stocks making new highs versus those making new lows. When there are fewer doing well and more doing poorly, this tends not to be good. Same goes for a metric that looks at the number of stocks going up versus going down. When more are going down than up even while the Nasdaq (or any other index) is holding steady or moving higher, one could infer that the market isn't as healthy as the index implies. In the charts below, you'll notice the red vertical lines marking instances in the past where correlations between these two metrics and the Nasdaq index itself break down. In most cases, stocks decline soon thereafter.

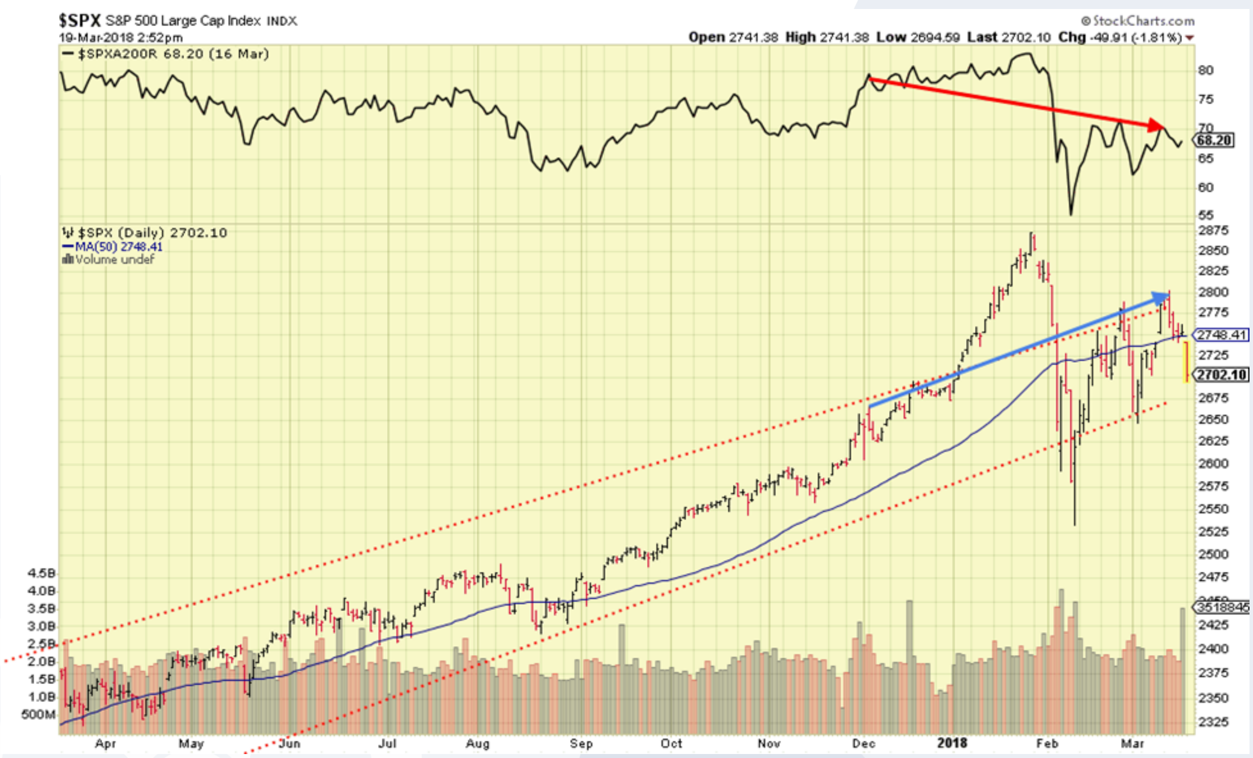
Nasdaq New Highs versus New Lows:



Nasdaq Advancers minus Decliners:



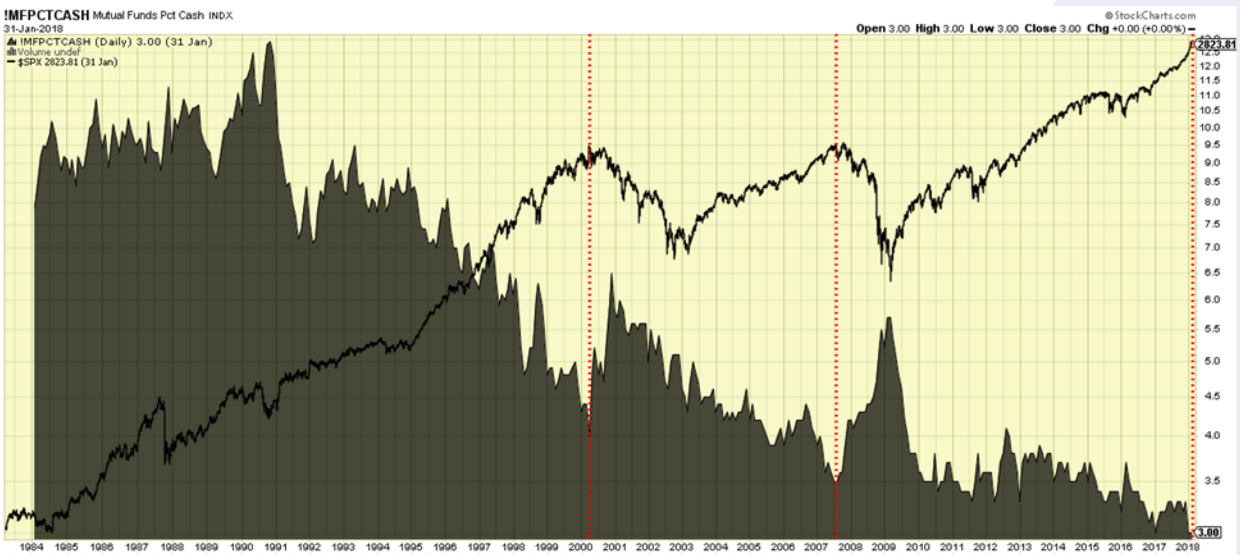
Finally, when looking at the number of stocks in the S&P 500 above their 200-day moving average prices, the trend has been declining since late 2017 even though the market has advanced higher. Again, fewer stocks in the index are participating in pulling the broad market average higher. Market breadth is clearly weak.



Investor Sentiment

We know from previous market cycles that markets tend to reach major turning points when investor emotion reaches extreme levels. There are a number of ways to measure this, from investor surveys, analysis of investor newsletter biases, to following the actions of investors and looking at what they're actually putting their money into. Along these lines, when we look at the percentage of mutual fund holdings that are invested in cash, we're at all-time lows. We know that cash levels tend to fall throughout bull markets as mutual fund managers feel both more and more comfortable taking risk as well as more desperate to beat the performance of the benchmarks they're being compared to. In this respect, cash only hurts in achieving that next little bit of return. When markets roll over, managers are often reminded why keeping cash isn't such a bad idea.

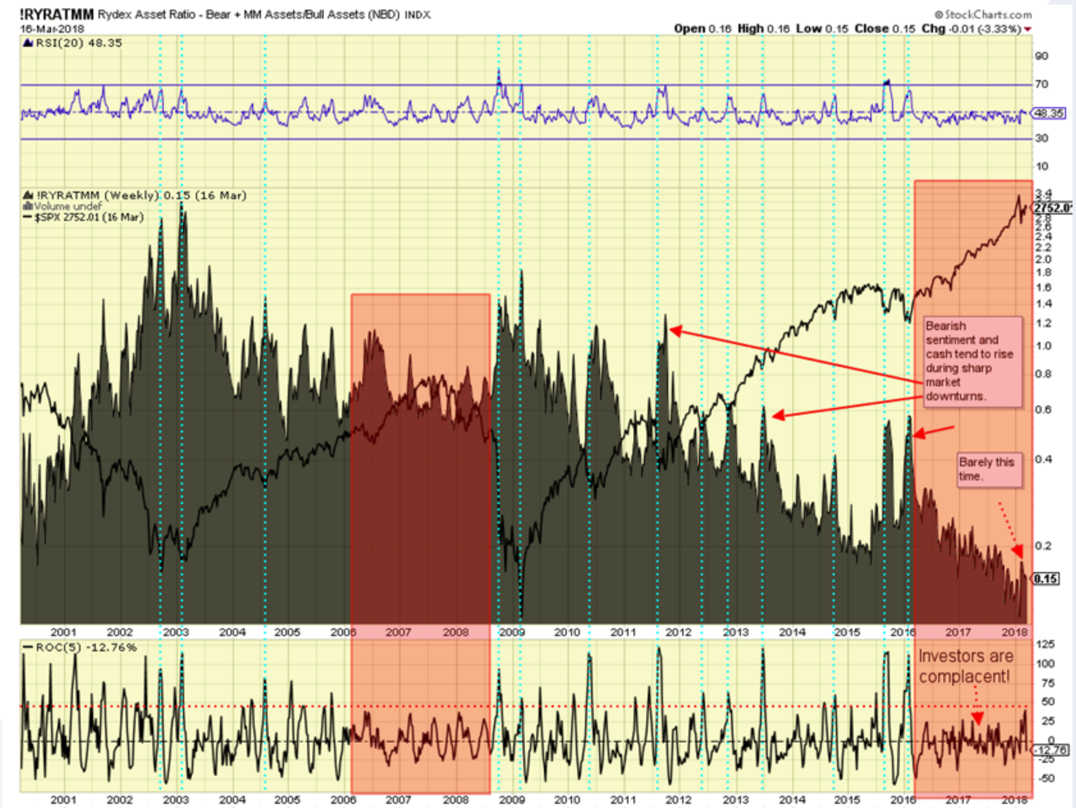
Separately, we can see very clearly in the chart below that the long-term trend since the late 1980's has been to keep a smaller allocation to cash within mutual funds. Without getting pulled off the rails with respect to this letter, we'll only say that this timeframe coincides very closely with the age of central bank intervention. With a tailwind behind markets, and interest rates on cash frequently being held to absurdly low levels, the incentives to keep low levels of cash have certainly been present. That said, we can still identify highs and lows within this trend that could be problematic. At present, cash levels in funds are minimal. Most managers appear to be on the same side of the boat.



We can also look to the Rydex series of funds for a clue as to where investors are actually putting their money. Rydex keeps a ratio of the percentage of their clients who are invested in their Bear Market Funds (that go up when the market goes down) plus those invested in cash, divided by those invested in traditional Bull Market Funds. What this ratio tells us at present is that these investors have never been more bullish. Very few investors are investing in a way where they stand to benefit if markets decline. Not only that, but similar to the mutual fund cash positions above, investors have very little in money market/cash accounts. Again, sentiment here seems to be off the charts in the euphoric or bullish direction.

What's also interesting, as Jesse Felder from The Felder Report points out, is that the Rate of Change within this ratio has been eerily similar to that prior to the 2007 market peak. In other words, market drops no longer seem to elicit a commensurate change in investor behavior. Investors seem to be very slow to react to market drops by adding to cash or bearish bets. This may be reflective of a classical conditioning type response from years of watching markets bounce right back from small drops. Investors may be learning to ignore the natural fear response due to being burned time and again after selling off their investments only to watch the markets bounce back. Unfortunately, as investors learned in 2008, this conditioning not to respond becomes ingrained just as markets seemingly lose steam and turn lower. Larger declines are required to get investors to take notice and respond which unfortunately leads to larger losses when they finally capitulate.

Here's the irony: Up until this conditioning occurs, every time we see the gray area in the chart below spike, it represents investors selling low. When the market bounces back shortly thereafter, investors lock in losses. Then upon finally learning to sit tight, like happened in the quiet or complacent period from 2006 to 2008, investors tolerate heavy losses before finally locking in much larger losses than they would have felt comfortable with before being “conditioned”. This all adds up to most aggressive stock market investors doing quite a bit worse in their portfolio than the indexes. So if you’ve been sitting tight playing it safe lately, please recognize this. Most of your aggressive neighbors aren’t doing as well as the market and are likely set up to accept heavy losses before moving to protect themselves when the next big downturn occurs. Research tells us this has been true in the past and the chart below suggests to us that it won’t be any different this time. Investors are complacent and somewhat numb to the idea of risk. A very common hallmark of bull markets nearing their end.



As we’ve been reminded of plenty over the years, abnormal, irrational situations can persist for longer than one would think – and this one certainly has. It’s absolutely possible that this market brushes off the early February damage it incurred and charges higher. We’d be foolish to imply that it couldn’t. However, there is a historical roadmap that can help us identify broad potential turning points given valuation, internals, and sentiment measures. Right now, all of these things have been and continue to be positioned in the extreme. Everyone seems to be on the leeward side of the boat even though the winds have shifted to the other side. There’s a reasonable chance that the ship lists into the water very soon – and as soon as people feel that cold water for the first time in a long time, a mad scramble to the windward side of the deck could ensue. Whether that leaves January 26 as the market’s bull cycle peak, we’ll have to wait and see.

CADENCE WEALTH MANAGEMENT