The SITREP for the week ending 3/15/2019

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SITREP: n. a report on the current situation; a military abbreviation; from "situation report".

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The very big picture:

The long-term valuation of the market is commonly measured by the Cyclically Adjusted Price to Earnings ratio, or "CAPE", which smooths out shorter-term earnings swings in order to get a longer-term assessment of market valuation. A CAPE level of 30 is considered to be the upper end of the normal range, and the level at which further PE-ratio expansion comes to a halt (meaning that increases in market prices only occur in a general response to earnings increases, instead of rising "just because"). The market is currently at that level.

Of course, a "mania" could come along and drive prices higher – much higher, even – and for some years to come. Manias occur when valuation no longer seems to matter, and caution is thrown completely to the wind as buyers rush in to buy first and ask questions later. Two manias in the last century – the 1920's "Roaring Twenties" and the 1990's "Tech Bubble" – show that the sky is the limit when common sense is overcome by a blind desire to buy. But, of course, the piper must be paid and the following decade or two are spent in Secular Bear Markets, giving most or all of the mania gains back.

See **Fig. 1** for the 100-year view of Secular Bulls and Bears. The CAPE is now at 30.36, up from the prior week's 29.97, above the level reached at the pre-crash high in October, 2007. Since 1881, the average annual return for all ten year periods that began with a CAPE around this level have been in the 0% - 3%/yr. range. (**see Fig. 2**).

In the big picture:

The "big picture" is the months-to-years timeframe – the timeframe in which Cyclical Bulls and Bears operate. The U.S. Bull-Bear Indicator (**see Fig. 3**) is in **Cyclical Bull** territory at 62.36, up from the prior week's 61.77.

In the intermediate and Shorter-term picture:

The Shorter-term (weeks to months) Indicator (**see Fig. 4**) turned **positive** on November 28th. The indicator ended the week at 31, down from the prior week's 33. Separately, the Intermediate-term Quarterly Trend Indicator - based on domestic and international stock trend status at the start of each quarter – was **negative** entering January, indicating negative prospects for equities in the first quarter of 2019.

Timeframe summary:

In the Secular (years to decades) timeframe (Figs. 1 & 2), the long-term valuation of the market is historically too high to sustain rip-roaring multi-year returns. The Bull-Bear Indicator (months to years) remains positive (Fig. 3), indicating a potential uptrend in the longer timeframe. In the intermediate timeframe, the Quarterly Trend Indicator (months to quarters) is negative for Q1, and the shorter (weeks to months) timeframe (Fig. 4) is positive. Therefore, with two indicators positive and one negative, the U.S. equity markets are rated as **Neutral**.

In the markets:

U.S. Markets: U.S. stocks posted solid gains for the week as the technology sector (the largest segment of the S&P 500 Index) rallied, helped by strength in Apple due to the expected announcement of a new video streaming service. The Dow Jones Industrial Average surged 398 points to 25,848, a gain of 1.6%. The technology-heavy NASDAQ Composite rallied 280 points, or 3.8%, to close at 7,688. By market cap, the large cap S&P 500 outperformed the smaller cap benchmarks by rising 2.9%, while the S&P 400 mid cap index and small cap Russell 2000 gained a lesser 1.9% and 2.1%, respectively.

International Markets: Canada's TSX rebounded 0.9%, while the United Kingdom's FTSE 100 gained 1.7%. Major markets were also green across Europe's mainland. France's CAC 40 rose 3.3%, Germany's DAX added 2.0% and Italy's Milan FTSE gained 2.7%. Markets were also up nicely in Asia. China's Shanghai Composite rose 1.7% and Japan's Nikkei gained 2.0%. As grouped by Morgan Stanley Capital International, developed markets rose 2.8%, while emerging markets surged 3.5%.

Commodities: The precious metal Gold also managed a slight gain amidst the broad-based strength in equities. Gold added $3.60, ending the week at $1302.90 an ounce, a gain of 0.3%. Silver retreated slightly, falling -0.2% to $15.32 an ounce. Energy continued to rebound as West Texas Intermediate crude oil rallied 4.4% to $58.52 per barrel. The industrial metal copper, seen as an indicator of global economic health due to its wide variety of industrial uses, finished the week up 0.4%.

U.S. Economic News: The number of Americans seeking new unemployment benefits rose to a one-month high last week, but the overall level of layoffs remained near historically low levels. The Labor Department reported that initial jobless claims rose by 6,000 to 229,000 vs expectations of a reading of 225,000. The monthly average of new claims, smoothed to iron-out the weekly volatility, fell by 2,500 to 223,750. Layoffs have risen slightly since hitting a 50-year low last fall, but they still remain far below the 300,000 threshold analysts use to gauge a "healthy" labor market. Continuing claims, which counts the number of people already receiving benefits, increased by 18,000 to 1.77 million.

The Labor Department's JOLTS (Job Openings and Labor Turnover Survey) report revealed the number of jobs available climbed to their third-highest level on record in January, a sign that companies are still eager to add new employees even within a tight labor market. The number of job openings increased 100,000 from December to 7.58 million, with big increases in wholesale trade, real estate, and information industries. The 7.58 million job openings compares to the 6.54 million people in January who were unemployed, taking the ratio of open positions to those who seek them down slightly to 1.16 from 1.19 in December. The quits rate, rumored to be closely watched by the Federal Reserve for the "robustness" of the labor market, stayed at 2.3%, which is close to the 2.4% high this cycle. Worker willingness to quit is taken as a positive sign by economists, as it usually means the quitters see better opportunities for higher pay and advancement elsewhere and don't fear temporary unemployment while between jobs.

The housing market got off to a slow start this year as new home sales dropped 7% in January, the Commerce Department reported. In a report delayed by the partial government shutdown, sales of single-family new homes declined to a 607,000 annual rate, missing forecasts of a 616,000 annual rate. However, the decline wasn't as bad as the headline indicated once upward revisions for December and November were taken into account. In the details, sales fell in every region except the West. New home sales were 4.1% lower in January compared to the

same time last year. In addition, the median sales price of new homes fell again to $317,200. Prices were 3.8% lower versus one year ago, reflecting a decline in demand. At the current pace of sales, there is a 6.6 months' supply of homes available on the market—slightly higher than what is generally considered a "balanced" housing market.

After the biggest decline in 10 years, sales at U.S. retailers rebounded in January. The Commerce Department reported retail sales rose 0.2% at the beginning of the year, led by home centers and internet stores. Economists had expected only a 0.1% increase. Sales had tumbled 1.6% in December, the largest drop since late 2009. Omitting auto and gasoline sales, retail sales were up a much more robust 1.2%. Restaurants, pharmacies, grocers, and stores that sell sporting goods and hobby items also reported strong sales. While the rebound in sales was mildly encouraging, some analysts were concerned the rebound wasn't enough. Katherine Judge, economist at CIBC World Markets noted, "What went down did come back up again, just not far enough."

Optimism among the nation's small business owners inched higher last month, but remained near its lowest levels since the 2016 presidential election. The National Federation of Independent Business (NFIB) said its small-business optimism index rose 0.5 point to 101.7 - up, but still the second-worst reading since December 2016. In the details, 5 out of the 10 components increased, with the sub-index "expect the economy to improve" leading with a 5-point increase. NFIB President and CEO Juanita Duggan said in its release, "Small business owners are thankful to have the government shutdown in the rearview mirror but need more certainty about the future."

Orders for goods expected to last at least 3 years (a.k.a. durable goods) rose at the beginning of the year for the third consecutive month. The Commerce Department reported orders for long-lasting durable goods rose 0.4% in January, its biggest increase since last summer. Economists surveyed had forecast a 0.1% decline. Ex-transportation, orders dipped 0.1% due to a decline in orders for new cars and trucks. Core orders, a key measure of business investment, rose 0.8% in January marking its biggest increase since last July and reversing a decline that had seen investment fall five out of the last six months. Economist Andrew Hollenhorst at Citibank is confident that investment spending will pick up in 2019, noting "The bounce in January capital goods orders and shipments is consistent with our view that strong investment spending will continue into 2019."

Inflation at the consumer level picked up in February, but not enough to raise concern according to analysts. Costs rose for rent, food, gasoline, and clothing last month, their biggest inflation in four months. However, the overall cost of living rose more slowly. The Bureau of Labor Statistics reported the Consumer Price Index climbed 0.2% in February following three consecutive months of flat readings. The reading matched economists' forecasts. Over the past year the increase in the cost of living slowed from 1.6% to 1.5%. The rate of inflation has pulled back substantially after hitting a high of almost 3% last summer. Core inflation, which strips out the volatile food and energy components, ticked up a lesser 0.1% last month—its smallest advance since last summer. The annual increase in the so-called core rate also slowed a tick down to 2.1%.

International Economic News: Credit-rating agency Moody's Investor Service released a report stating the percentage of money that Canadian consumers owe relative to their disposable income may have levelled off last year, but the amount borrowed and how it was borrowed continue to raise concerns. "Canadian consumers continue to repay their debts, but remain highly vulnerable to an employment shock, posing significant asset risk to banks in an adverse economic scenario," the report stated. The level of Canadian consumer debt that's outstanding "stabilized" at 174% of disposable income in the last three months of 2018. Furthermore,

unemployment is hovering near a 40-year low at 5.8%, helping to keep borrowers from defaulting on their loans. However, the credit-rating agency notes that higher interest rates helped increase the amount of that disposable income going towards paying down debt, hiking it to 14.5% in the fourth quarter of 2018 from 13.7% in 2013.

Across the Atlantic, the United Kingdom economy rebounded at a stronger-than-expected pace in January, following a weak end to 2018. The UK's Office for National Statistics reported Gross Domestic Product grew by 0.5%, its biggest monthly gain in more than two years after it fell -0.4% in December. Analysts note the monthly figures can be volatile and economists don't see broad improvement in the economy until there's clarity on Brexit. Bloomberg economist Dan Hanson noted, "We expect growth to remain subdued until the outcome of Brexit is known. If a deal is agreed that should spur growth, though it's unlikely the Bank of England will move until it sees evidence of a rebound in the data." The rebound in GDP was broad based, with construction, manufacturing and the services sectors all increasing output following declines in December.

The Bank of France said the French economy will grow marginally slower this year than previously expected, but greater household purchasing power should help limit the impact of a global slowdown. The Bank of France forecast growth of 1.4% this year in its quarterly economic outlook—slightly less than the 1.5% predicted in December. The French economy grew 1.5% in 2018. At the rate forecast by the central bank, France will easily outperform its more export-dependent neighbor Germany, where the government and private institutes expect growth of 1% or lower due to weakening foreign demand. Economists note that since France is more dependent on consumer spending at home, its economy stands to benefit from the 10 billion euro ($11.3 billion USD) package of concessions the government made to "yellow vest" protesters intended to boost spending power.

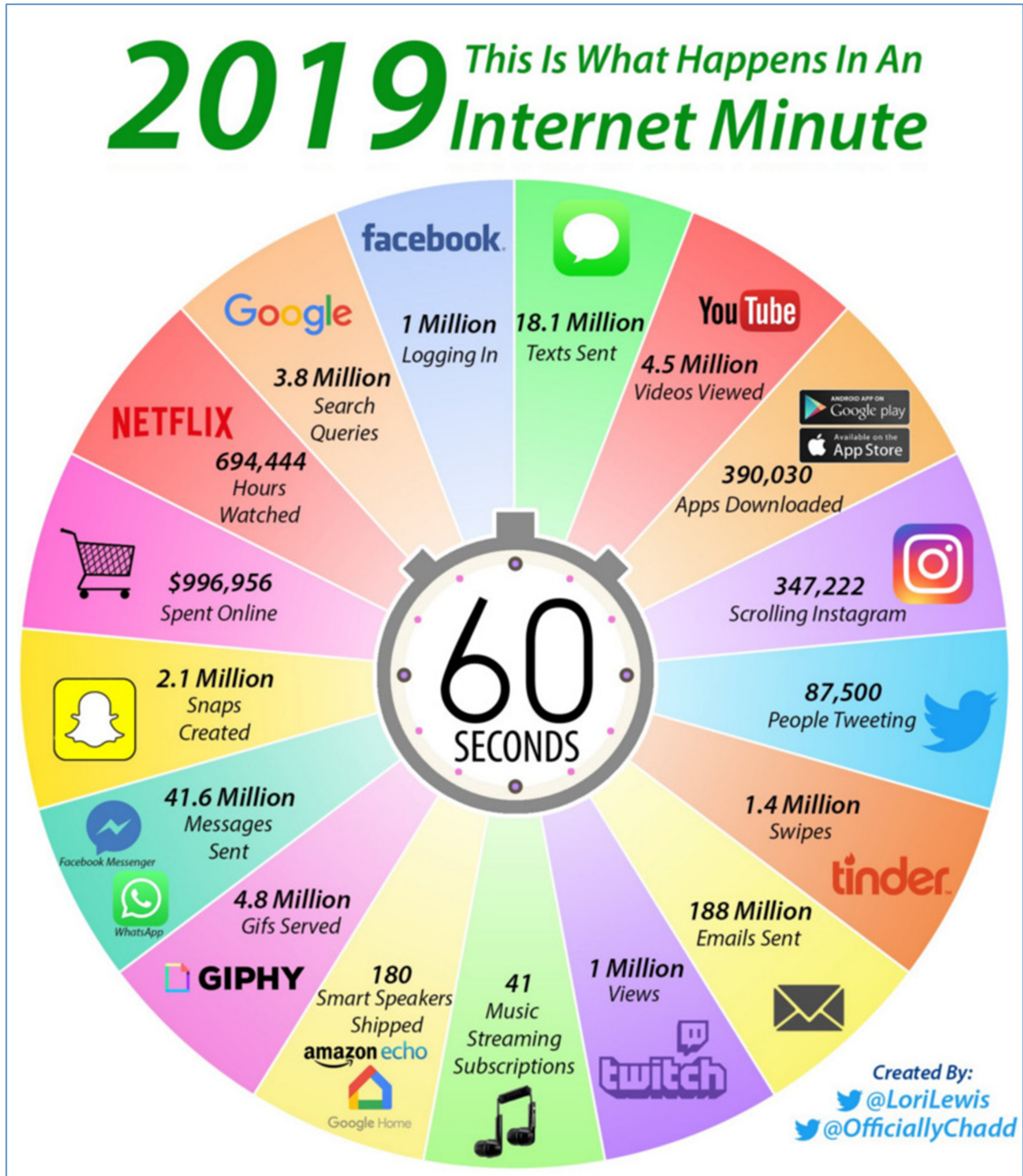
The Munich-based Institute for Economic Research (DIW) revised downward its forecast for economic growth in Germany for 2019 to just 0.6%, down from 1.1%. According to its report, should the international economy continue to lose momentum, global demand for German products would be weak. Ifo Economic Director Timo Wollmershaeuser stated, "Industry will largely fail to act as an economic engine in 2019." DIW's Marcel Fratzscher added "The German economy is cooling down, but this is not the end of the world. We should not paint too black a picture, because the labor market in particular continues to look excellent and private consumption is also strong."

Concerns are growing over China's slowing economy as the average price of a new home grew by just 0.5% in February, the slowest pace in 10 months. That reading compares to a 0.6% gain in January, and was its lowest rate since April 2018. On an annual basis, home prices were up 10.4% in February, accelerating from a 10.0% gain in January. Consumer and business confidence has slipped over recent quarters as China's economy slows and trade tensions with the United States continue to rise. The drop in confidence has weighed on residential real estate investment.

The Bank of Japan (BOJ) is now less optimistic about the world's third-largest economy, and kept its ultra-loose monetary policy in place after a two-day policy meeting. The bank said heightened overseas risk could threaten to derail the nation's fragile economic recovery. "Exports have shown some weaknesses recently," the central bank said in a statement on its policy decision, offering a bleaker view than in January when it said they were increasing as a trend. The BOJ maintained a pledge to guide short-term interest rates at minus 0.1% and 10-year government bond yields around 0%. The widely expected decision was made by a 7-2 vote. The central bank also stuck to its view that Japan's economy is expanding moderately, but added a phrase that "exports and output

have been affected by slowing overseas growth." In January, it said only that the economy was expanding moderately.

Finally: Everyone has heard of a "New York Minute." Johnny Carson said it was that brief instant of time between a Manhattan stoplight turning green and the taxi behind you honking! How about an "Internet Minute"? An "Internet Minute" is the measure of everything that happens on the internet in the space of a single minute – and it is staggering. The chart below, from research blog Visual Capitalist, brings it all together. Visual Capitalist notes that the biggest change from the prior year is a doubling of hours of Netflix streaming per "Internet Minute"!



(sources: all index return data from Yahoo Finance; Reuters, Barron's, Wall St Journal, Bloomberg.com, ft.com, guggenheimpartners.com, zerohedge.com, ritholtz.com, markit.com, financialpost.com, Eurostat, Statistics Canada, Yahoo! Finance, stocksandnews.com, marketwatch.com, wantchinatimes.com, BBC, 361capital.com, pensionpartners.com, cnbc.com, FactSet; Figs 1-5 source W E Sherman & Co, LLC)

The ranking relationship (shown in **Fig. 5**) between the defensive **SHUT** ("S"=Staples [a.k.a. consumer non-cyclical], "H"=Healthcare, "U"=Utilities and "T"=Telecom) and the offensive **DIME** sectors ("D"=Discretionary [a.k.a. Consumer Cyclical], "I"=Industrial, "M"=Materials, "E"=Energy), is one way to gauge institutional investor sentiment in the market. The average ranking of Defensive SHUT sectors and Offensive DIME sectors were, for the third week, virtually unchanged from the prior week. The Defensive SHUT sectors maintained their lead over Offensive DIME sectors. Note: these are "ranks", not "scores", so smaller numbers are higher ranks and larger numbers are lower ranks.

119 Years of Secular Bull and Bear Markets

S&P 500: January 1, 1900 - December 31, 2018

Secular: from the Latin "Saeculum," meaning "long period of time."

Extremely low PE ratios usually beget years of above average performance (i.e., **SECULAR BULL MARKETS**)

Extremely high PE ratios usually beget years of below average performance (i.e., **SECULAR BEAR MARKETS**)

Dec. 31, 2018
S&P 500 close:
2,506.85

10000
1000
100
10
1

BEAR 21.7 years +7.1%
BULL 8.1 years +385.3%
BEAR 2.8 years -84.8%
BULL 4.7 years +279.7%
BEAR 5.3 years -56.2%
BULL 23.8 years +1090.3%
BEAR 16.6 years +17.6%
BULL 17.3 years +1202.4%
BEAR 9.2 years -47.0%
BULL 9.75 years +231.10%

"CAPE" Long-Term PE Ratio*

50
40
30
20
10
0

1900 1905 1910 1915 1920 1925 1930 1935 1940 1945 1950 1955 1960 1965 1970 1975 1980 1985 1990 1995 2000 2005 2010 2015

Source: S&P 500 as calculated by Professor Robert Shiller, Yale University *PE Ratio calculated using Professor Shiller's "CAPE" method. S&P 500 chart in logarithmic scale.

Fig. 1

Fig. 2

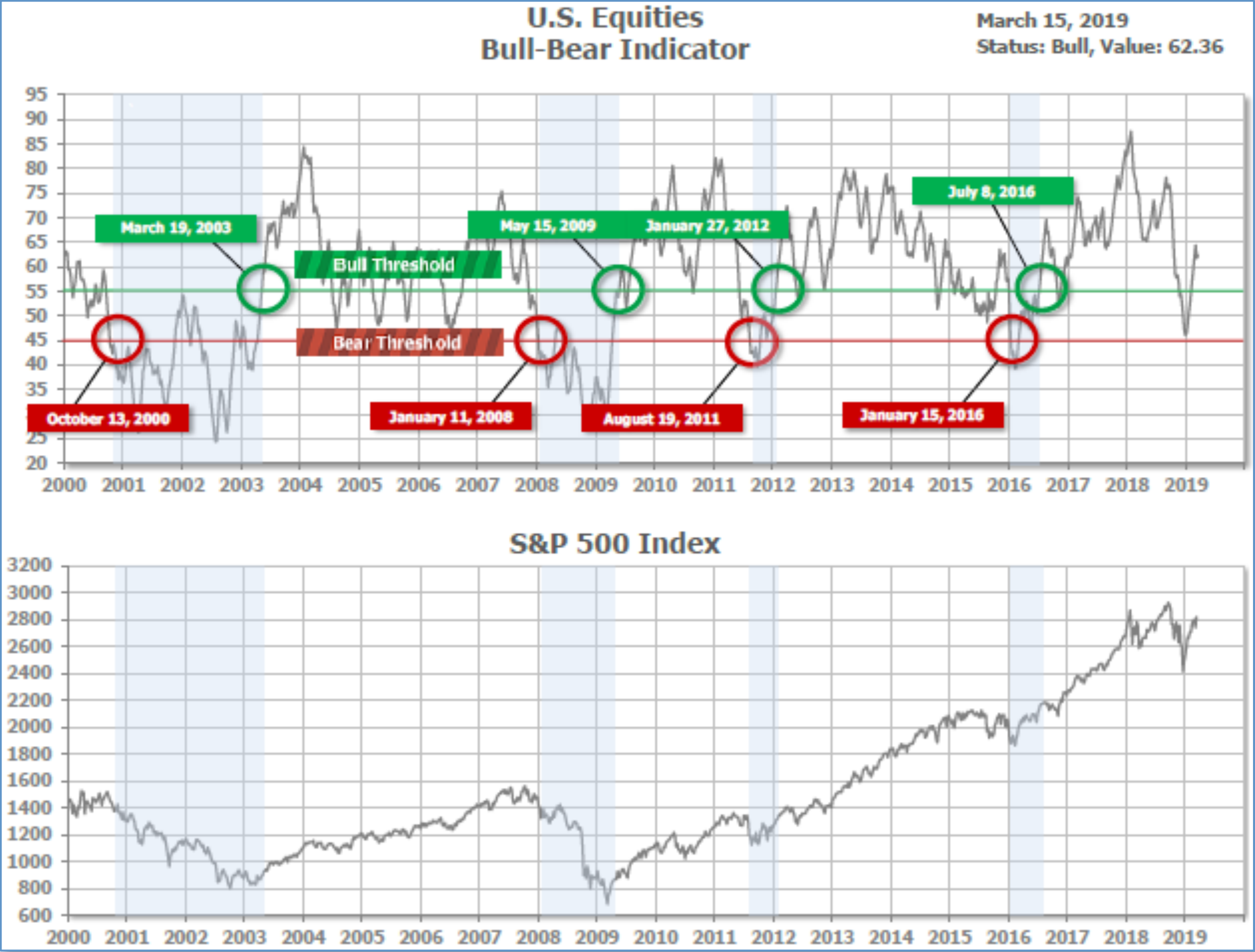


Fig. 3

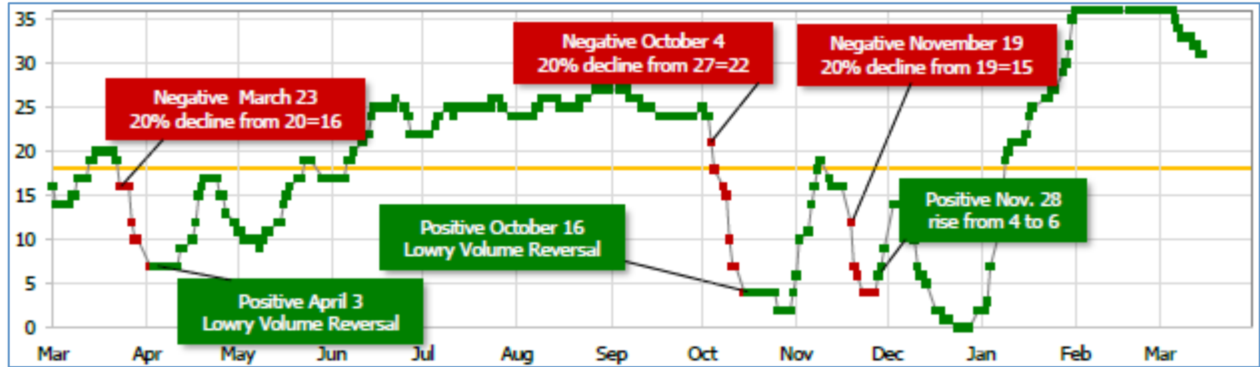


Fig. 4

U.S. Intermediate-Term Asset Class Rankings

	Major Asset Classes	Type	Rank	Week Ago Rank
Above Average - best for new positions	Utilities	3	1	1
	Real Estate	2&3	2	2
	Telecom	3	3	3
	Industrial	3	4	4
	Dow 30	1	5	5
	Healthcare	3	6	6
	Technology	3	7	7
	LargeCap Growth	1	8	8
	LargeCap Blend	1	9	10
	Consumer Cyclical	3	10	9
	LargeCap Value	1	11	11
	Nasdaq 100	1	12	14
Above Avg	Financial	3	13	13
US Mkt Avg	Russell 3000 Index		14	16
Below Average	Consumer Non-Cyclical	3	15	15
	MidCap Value	1	16	12
	Emerging Markets	2	17	17
	MidCap Blend	1	18	18
	MidCap Growth	1	19	19
	SmallCap Blend	1	20	20
	Developed Int'l Markets	2	21	22
	Basic Materials	2&3	22	24
	CASH (1-3 mo T-Bills)		23	25
	SmallCap Growth	1	24	21
	SmallCap Value	1	25	23
	Energy	3	26	26

Fig. 5