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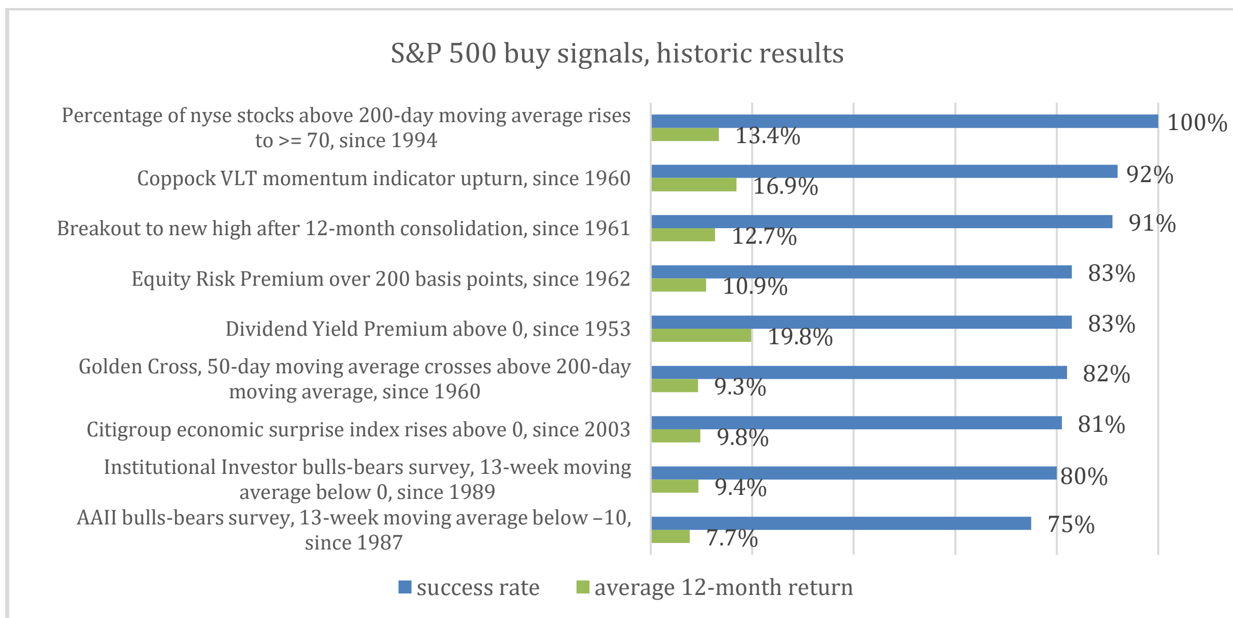
As The Stars Align

To plenty of experienced investors, it is all but impossible to time the stock market. Add in the qualifier 'consistently' and there is no quarrel here. And to many others, it is a fool's errand to build a bullish case when equities are seven years removed from the prior bear market. Advances are not meant to last this long, nerve-racking corrections notwithstanding. Toss in for good measure an upcoming Presidential election, sluggish global growth, and central banks around the world swapping roles from "the great moderation" to "the great distortion", and only a certifiable looney tune would present a bullish scenario.

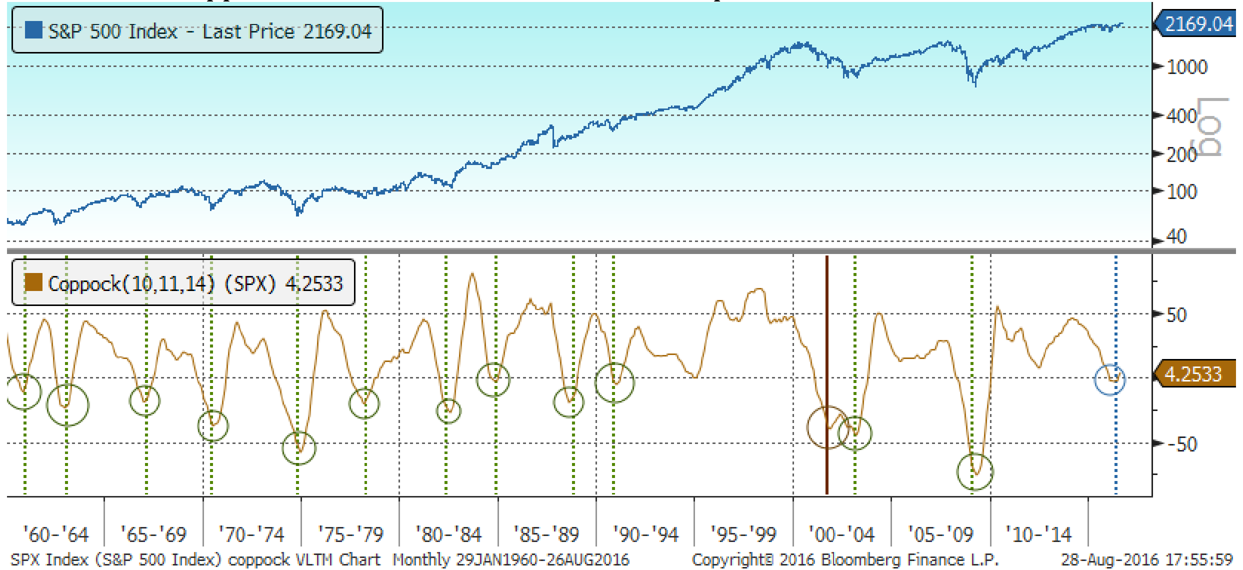
Sounds like a dare.

Displayed below are nine equity market indicators. They represent a data history ranging from a decade to over a half century, and an uncanny record of signaling subsequent market advances. "Success rate" reflects the percentage of observations in which stocks generated a positive 12-month return from the date of the buy indication. The average one-year return for each series is also provided.



In most cases, the indicator is self-explanatory. The most obscure measure is the Coppock VLT momentum indicator, graphically represented in the lower panel below. The circles and corresponding vertical lines indicate buy signals, based on an inflection in the graph while still below zero. This is meant to signify an upward shift in market price momentum after a prolonged period of downward pressure. The upper panel displays the S&P 500 index over the same timeframe. This indicator has given 12 successful buy signals since 1960, with only one failed signal (marked by the solid vertical line in 2001). Suiting our purposes here, and to keep all eyes from glazing over, the computational methodology is omitted. You're welcome.

S&P 500 and Coppock VLT momentum indicator 1960 - present



Here's the twist in this story: all nine of these conditions exist today, or were signals established earlier this year. To believe that stocks are heading lower, an investor must be willing to ignore market history, perhaps seeing it all as pure coincidence; or would have to believe that too much of a good thing is dangerous. And at that point, a skeptic becomes a cynic.

Taking an alternate tack, let's examine financial and economic conditions typically observed at market tops, and compare these to today's environment. Fair notice, stocks peak on good news -- when else should they peak? -- so an investor looking for doom, gloom and crisis as a sell signal will be severely disappointed. By the time those troubles are evident, equities are usually well into a downward spiral.

In the table below, we present six common conditions at equity market tops -- warning signs that a bull market run has exhausted itself.

For example, at the market top in 2000, stocks were expensive based on their negative equity risk premium (compared to Treasurys), a trailing-PE ratio reaching 30, and a PE on 10-year average earnings approaching 50. At the same time, financial conditions were tightening, with Fed Funds and Treasury yields already rising, and an inverted yield curve. The surprise of the late-1990s tech bubble is not that it ended so badly, but that it continued for so long before bursting.

At the most recent market top of 2007, four of six conditions were in place, right on the average for the ten bull market peaks since 1966. The anomaly is 1976, when none of these warning signs were evident, yet a bear market ensued. This serves as a cautionary notice: no matter how much we understand, sometimes markets have a mind of their own.

# out of 10 cycles	bear signals at market top	1966	1968	1973	1976	1981	1987	1990	1998	2000	2007	current
7	S&P 500 equity risk premium < 0		*	*		*	*	*	*	*		
7	S&P 500 trailing PE > 17	*	*	*			*		*	*	*	*
5	S&P 500 PE on 10 year avg eps > 25	*	*						*	*	*	
7	fed funds trend > + 50 basis points	*	*	*		*	*			*	*	
7	10-year Treasury trend > + 50 basis points	*	*	*		*	*	*		*		
7	yield curve flat or inverted	*	*			*		*	*	*	*	
	#	5	6	4	0	4	4	3	4	6	4	1

Other measures investors might consider -- GDP growth, employment, leading indicators, and sentiment readings -- often dominate business news discussions, yet are weak signals of market direction. They are mostly anecdotal. Even slumping profits, a justifiable concern in today's market, has a mixed record.

The clearest interpretation is that equity market tops are driven by valuation and financial conditions; that is, bull markets usually end when stocks are expensive and interest rates are rising. Those conditions simply do not exist today. We might believe that "this time is different", and the ghost of 1976 will re-appear; but we should also acknowledge that people have always worried about that risk, and always will.

Chatting with Stevie

Stevie was the neighborhood's precocious child who grew into a high school wiz-kid, then never stopped lapping the field until landing a job on a Wall Street bond desk. While probably not the brightest mind on Wall Street, Stevie may be the brightest one we know. We caught up recently.

Can we talk about the Federal Reserve and its monetary policy?
Stevie: You mean the skit where "The Gang That Couldn't Shoot Straight" meets up with the "Keystone Cops"?

I guess you are no fan.
The Fed is more elastic than a ball of play-dough. They can bend and twist and contort until you forget what the original form was; which is to say, what their purpose is. I'm not sure they even remember.

Seems a bit judgmental.
I work on Wall Street. I'm paid to be judgmental.

Okay, let's narrow the focus. While not quite a consensus, there is a growing belief that ultra-low interest rates are ineffective, maybe even counter-productive.
'Damaging' is the word you are looking for.

How so?
Look, at some point we lose the benefits of lower interest rates, but the offsets -- and there are always offsets -- keep growing. There's a reason rates have never been this low, and I don't mean in our lifetime. We can review base lending rates in the UK, dating back to the late-1600s, and rates have never been this low.

More recently, in the aftermath of the tech bubble bursting, the Greenspan Fed cut rates repeatedly from the year 2000 to 2003. It was far more than necessary, but my point is that the Fed stopped cutting rates when they reached one percent. Maybe they knew something, or had a theory at least; that if you cut short-term rates below one percent you start warping monetary policy. Distortions begin to build in the financial system and additional rate cuts become an exercise in futility.

Then why did the Bernanke Fed cut rates below one percent?
Bernanke is not Greenspan. According to Fed models, every interest rate cut is a form of easing, a stimulus. So they just kept going. They believed in their own magic, and now are stuck with it.

What if we take that to the extreme? Why not negative rates, and from there, why not negative 10 percent or lower?
Right, that shows the absurdity of it all. Keep cutting rates, keep printing money, even if you are not really printing money. Go to negative rates and watch the banks and insurance companies

collapse. Watch as people begin hoarding cash in their homes, and large banks begin storing dollar bills and other currencies in their vaults. It's better than paying to lend money, which is what negative rates entail. Take it to an extreme and the experiment blows up. That tells us there is something wrong with the basic premise.

The Yellen Fed hasn't been much different.
Central bankers are all part of the same cabal. They suffer from groupthink, including foreign central banks. They call this new monetary policy an experiment, then kid themselves that if all major central banks are pursuing the same idea, it must be working. There is no self-reflection, no consideration that some experiments fail.

What kind of distortions are you talking about?
Well, off the top of my head, here are a few.

With ultra-low rates, banks are less willing to lend, because their spreads on new loans shrink to unacceptable levels. With every loan, there must be a willing borrower and lender. Of course borrowers want more money when interest rates are low, but what about the other side of the transaction? Is there a theory that says as prices drop -- and remember, interest rates represent the price of credit -- supply increases? They never taught me that in college economics. So instead of making low margin loans, banks just buy bonds or lend overnight to the Federal Reserve. The rates are low, but there is no credit risk.

Tighter bank regulation and capital rules only add to this problem. When regulators tell banks to raise capital, that is expressed as a ratio of capital to assets. Think of assets as loans. To raise this ratio, banks have a choice. They can increase their capital directly, by issuing equity at depressed prices, or by retaining more of their earnings, which means lower dividend payments. Or banks can slow their lending activity. Either option will improve capital levels, but the second choice is much easier. They just make fewer loans. And if they buy Treasurys instead, it counts as a higher level of capital, since there is no credit risk.

And everyone knows, a government approaching 20 trillion dollars in debt poses no credit risk.
Sarcasm noted.

Surely we need stronger banks.
The regulators are fighting the last war; get over it. Nobody ever calls regulators in front of Congress to accuse them of suffocating the economy in the name of safety. It doesn't make for a good photo-op.

Then there is our branch banking system. The primary purpose of bank branches is to bring in deposits, which in turn will be recycled into new loans. That's how the banking system funds itself. Well, when rates are near zero, nobody is walking into a branch to invest in a CD, or open a deposit account. So the branch system becomes an unproductive asset, a giant expense, again cutting into bank profits and making the system less healthy.

Next is the issue of savers, who are getting hammered by low interest rates. Imagine a retired couple living off their nest egg, trying to get by as their interest income continues to shrink. What do they do? They spend less. Less travel, fewer dinners out at restaurants, or trips to the mall. It adds up after a while, and consumer spending suffers, to say nothing of the retired couple. This is more than a hypothesis; history shows that the lower the interest rate, the more people save, the less they spend. And if consumer spending suffers, our overall economy feels the pain. Personal saving rates have been rising, so the facts fit the theory. Cutting interest rates becomes a form of tightening, not easing.

There was a recent report about long-term investment returns for public pension plans. The data shows the most recent 20-year returns were the worst on record. I'm not sure how far back the record goes, but consider this: 20 years ago an investor could easily earn seven, eight, nine percent yields in the bond market. Now the yield is two or three or four percent. What will pension plan returns look like in another 10 years? There is no way they can meet their obligations through bond market investments. So they will look to riskier assets -- stocks, real estate, private equity -- to make up the difference. When this fails they will either renege on their promise to public employees, or they will go to the taxpayer for a bailout. And when this hits a big state like California, it will be the mother of all political money-grab battles. Politicians will be counting votes to decide whose oxen to gore.

Any other distortions?
Probably so, that's just off the top of my head. I haven't given it all that much thought.

I'm sure you haven't.

Anything more about the Fed you want to mention?
Just a few additional comments. There has long been a call for the Fed to adopt a rules-based policy model, basically locking Fed members into decision rules, giving them less flexibility. Years ago the late, great economist Milton Friedman suggested that a computer could probably guide monetary policy more effectively than the central bankers we put in charge.

That sounds far-fetched.
You can always argue with Milton Friedman's ideas, so long as you understand one thing.

What's that?
You lose the argument.

Okay, what else might we consider?
There is the Taylor Rule, an equation devised by the economist John Taylor. Plug in a few numbers and it tells us where the Fed Funds rate should be.

What does it say right now?
Fed Funds should be at 3.5 percent.

And where are they?
Half a percent.

That's a big miss.
It's the Federal Reserve. They can miss big all day and still collect their paychecks.

That sounds downright cynical.
I'm paid for that too. And to be right. Sometimes the two go hand in hand.

Tidbits..

British Pound hits 30-year low after Brexit vote, interest rate cuts.
UK's Purchasing Manager Index falls to 88-month low, indicative of oncoming recession.
International Monetary Fund lowers 2017 global growth forecast, citing Brexit vote.

US new home sales reach highest level since 2007.
US nominal GDP growth hits slowest pace in six years.
US labor productivity falls for three straight quarters, first such occurrence since 1979.

Germany issues 10-year Bund at negative interest rate, long-term investors lock in sure losses.
Swiss government debt of all maturities offer negative yields.

European Union rules Apple owes 14.5 billion dollars in taxes to Ireland, which denies any claim.

Big Five US health insurance companies all report losing money on 'Obamacare' private market business, exiting numerous state exchanges to reduce business exposure.
Justice Department attempts to restrict health care consolidation, sues to block two health insurance mergers.

Something has to give.

US consumers say they now make more purchases online than in retail stores.
Wal-Mart looks to boost online sales, counter Amazon, through 3.3-billion-dollar acquisition of start-up Jet.com.

Highest-paid chief executives run worst performing companies, and vice versa, MSCI study says.

Sometimes you get what you pay for, sometimes you don't.

Private Equity giant Carlyle Group warns of future buyout returns being diminished by rising competition for deals and high stock prices.
US companies, laden with debt, face similar credit vulnerabilities as in 2008 financial crisis, says Standard & Poor's report.
US stocks display lowest price volatility in 20 years, Treasury bonds lowest in over a decade.

Don't sell a dull market short, or the calm before the storm?

Singapore begins self-driving taxi service.
Ford Motor targets fully-autonomous vehicles by 2021, playing catch-up with auto market.
Uber to presently serve Pittsburgh with autonomous autos, 'drivers' acting as safety system.

The future is here.

Poll shows Americans want free college education, but not higher taxes to fund it.

Still believing in a free lunch.

Source:
Bloomberg
Deutsche Bank
The Wall Street Journal