November 9, 2013

the X-factor Report

by Lance Roberts

Market Strategies, Economic Analysis, Risk Management

The Market In Pictures

This past week I wrote an article entitled *"The Economy In Pictures"* which was a pictorial tour of various aspects of the economy to let you decide for yourself about the real strength, or weakness, of the economy.

This past week we got two economic reports, GDP and Employment, which blew past consensus expectations at the headline number. The problem, however, is that the internal details of the reports told a very different story. For example, the bulk of the surge in the GDP report came from unwanted inventory builds as consumption has slowed. Much of the same was evident in the October jobs report that showed a headline increase of 204,000 jobs even as over 900,000 individuals left the workforce entirely.

This is very representative of the problem that has existed for much of the past 4 years. While there has been a sluggish *"statistical"* economic recovery because of the way things are counted; the *"actual"* recovery on *"Main Street"* has been starkly different.

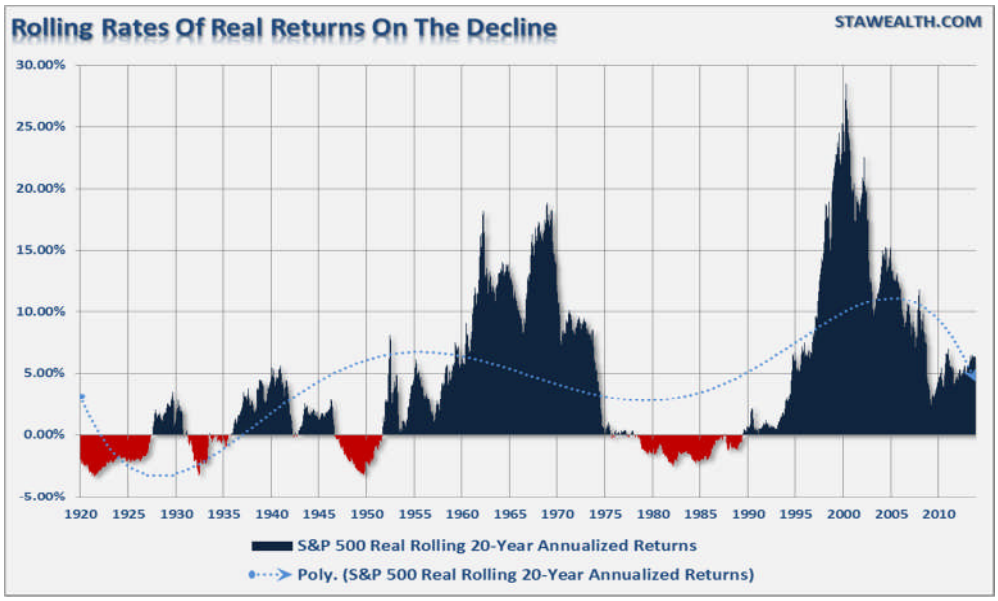
Yet, even as I write these words, the stock market has been pushing all-time highs as the Federal Reserve remains committed to its current liquidity programs. There are relatively few headwinds ahead of the market currently and even the upcoming return of the debt ceiling debate in January is likely to be a fairly quiet and non-market moving event.

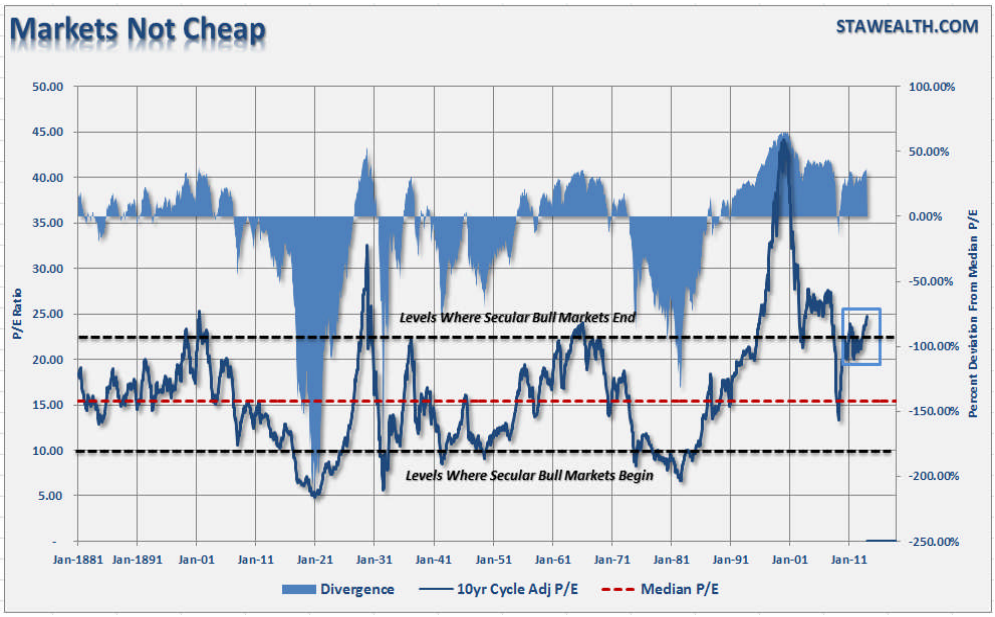
Therefore, the bias of the market at the moment remains to the upside as technical trends remain in place. The control is currently in the grasp of the bulls and we remain allocated to the markets currently. However, that does not mean that it can't, and won't, change in the future. It will. What goes up will come down and the farther from the earth the market has traveled the greater the fall will be.

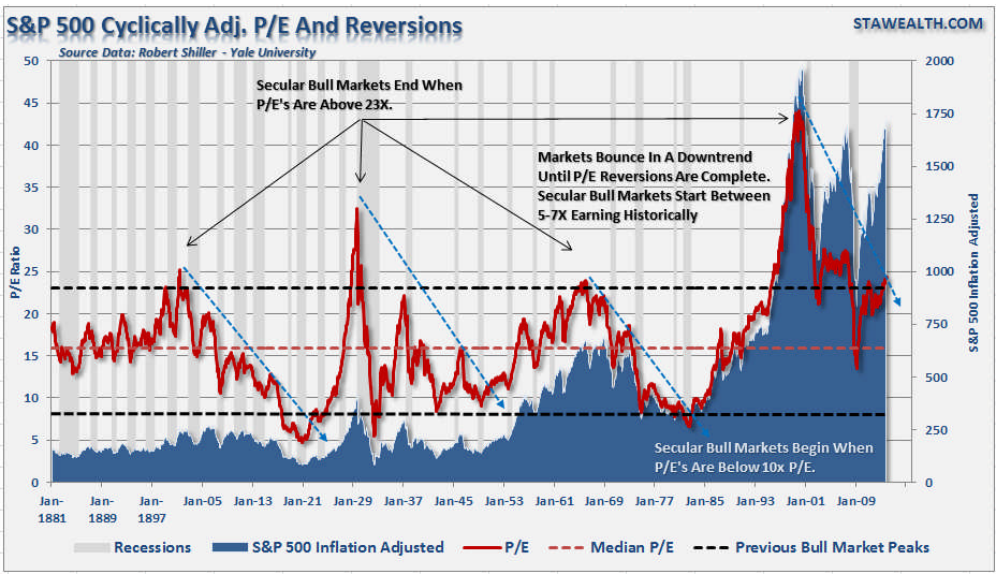
This week's missive will have minimal commentary. However, I present to you the market in pictures so that you can judge for yourself.

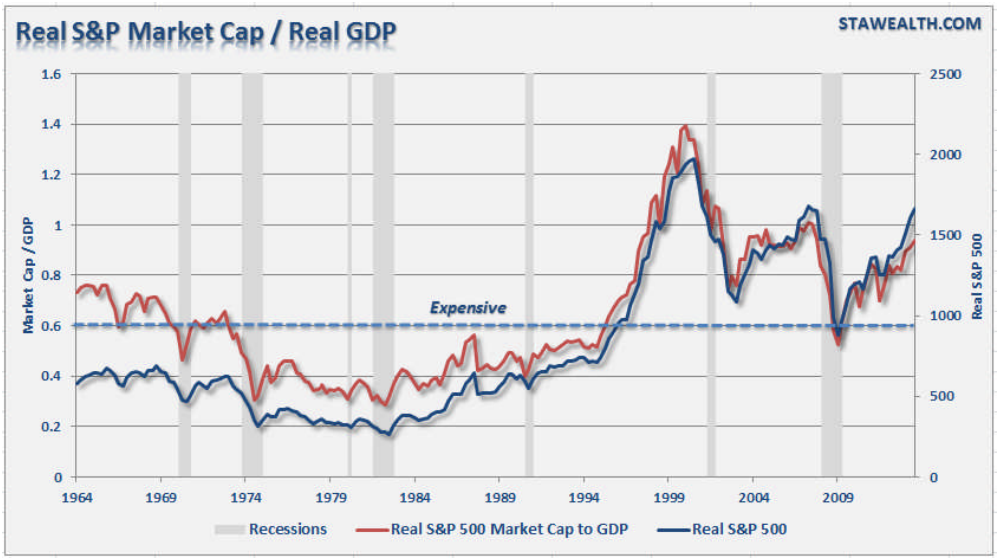
Inside This Issue:

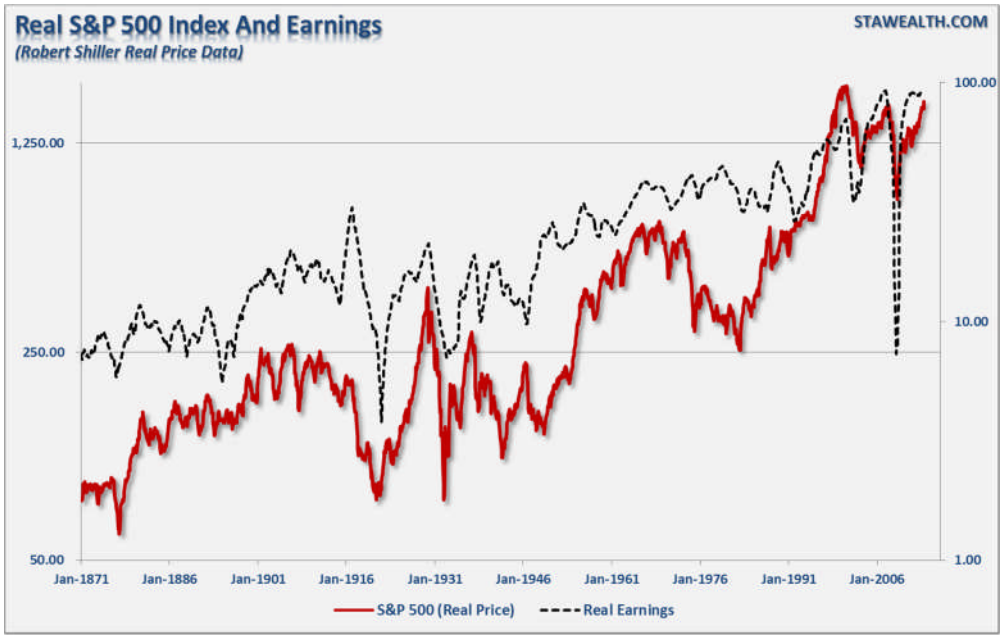
The Market In Pictures (Valuation/Deviation)

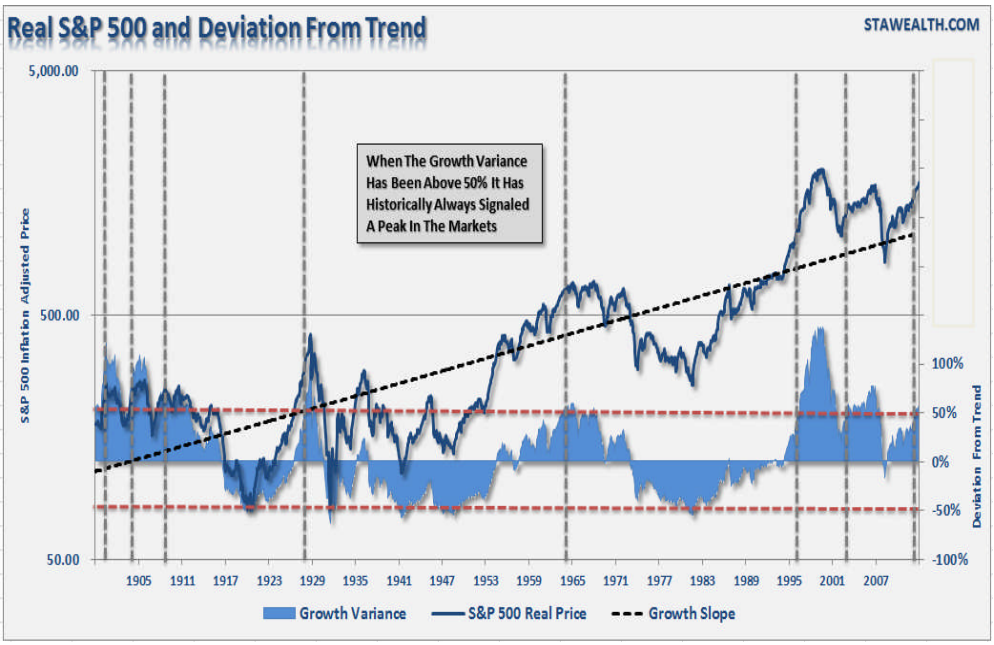












RECOMMENDED READING

5+1 Things To Ponder

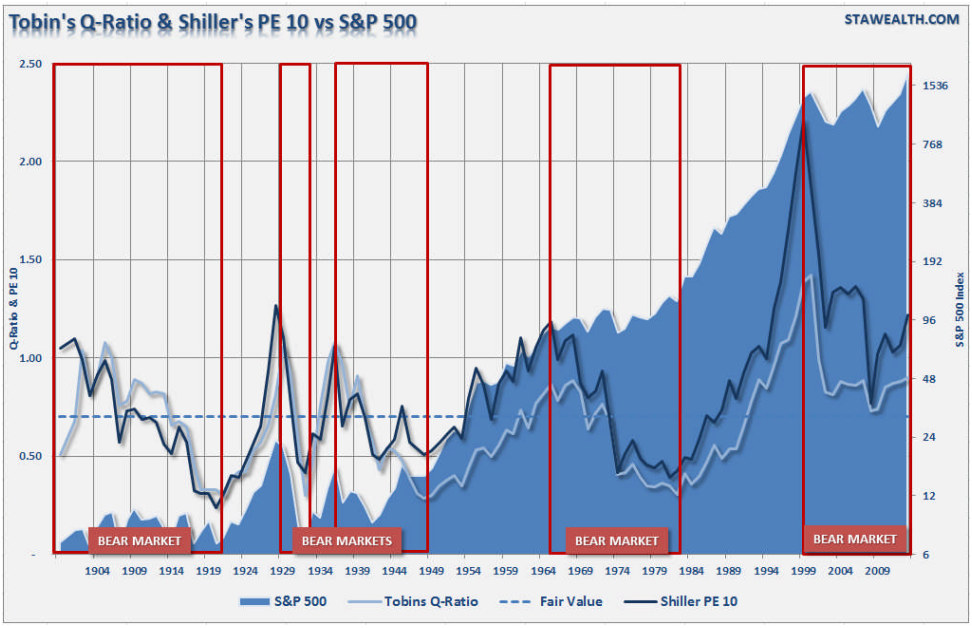
A collection of things to think about over the weekend including "The Boy Who Cried Wolf."

GDP – Inventory Restocking

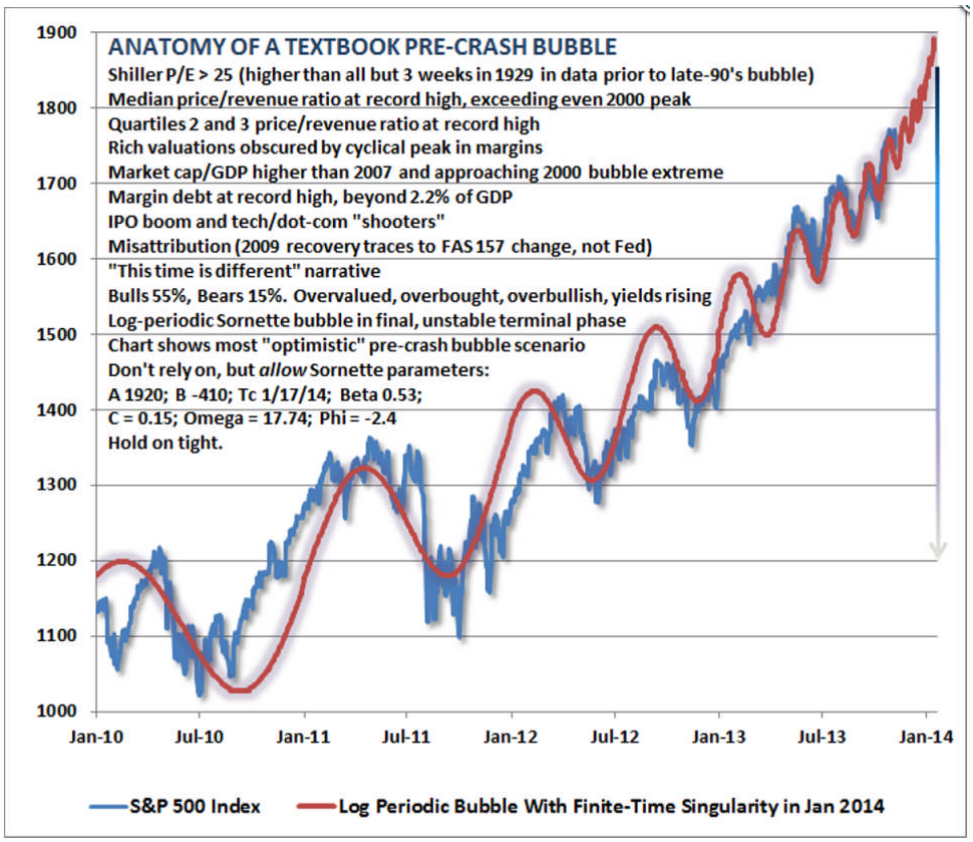
As I have discussed in the past the latest GDP report was primarily an inventory restocking story.

LEI – Fed Skewing The Data

Asset prices and yield spreads continue to comprise the bulk of the growth of the LEI which has now become a coincident index.



Via John Hussman



@HussmanJP

"For the sake of completeness, I should also note that virtually every "overvalued, overbought, over bullish" syndrome we define is on red alert. I hesitate a bit on this point, because in contrast to nearly a century of market history where these syndromes were reliably associated with deep losses, the emergence of these syndromes since late-2011 has repeatedly been followed by yet further speculation (see the chart in The Road to Easy Street). My impression remains that this is not a permanent change in market dynamics, but simply reflects an anvil that has not yet dropped. So these syndromes have admittedly done us no favors in the more recent period. Still,

RECOMMENDED READING

Fed Won't Taper Soon

Even as asset prices continue to push higher the economic data suggests the Fed won't taper soon.

Bond Strategies For A Rising Rate Environment

If you think interest rates are set to rise higher then here are bond strategies to compensate for it.

Economy In Pictures

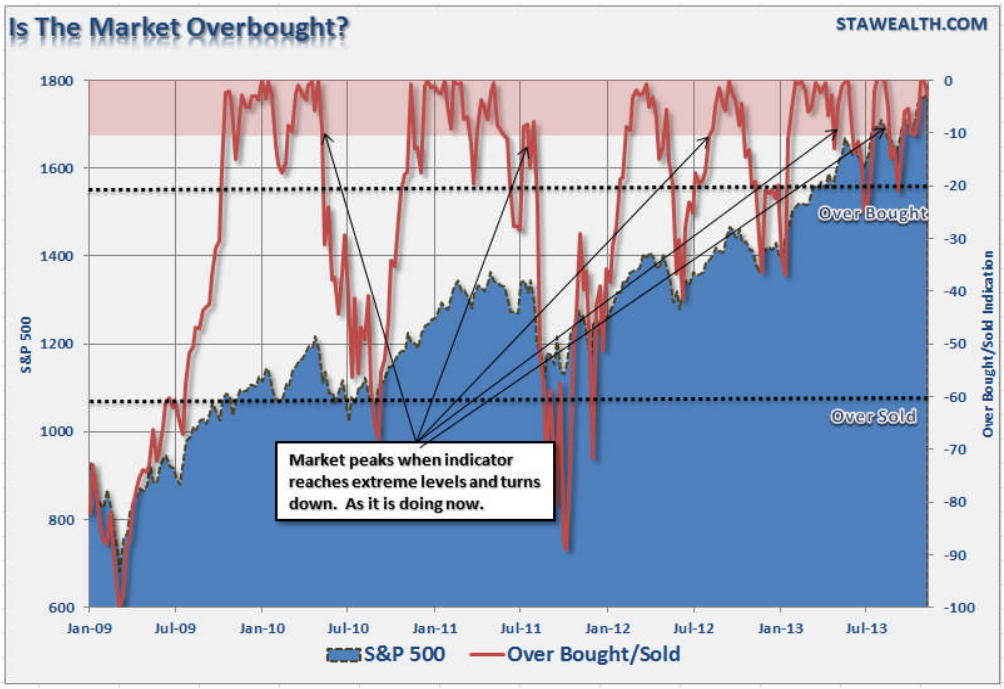
The economy in pictures. You decide.

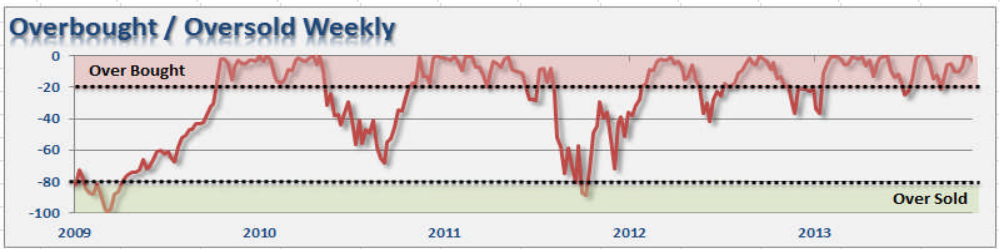
it remains our job, and our discipline, to view market action within its full historical context.

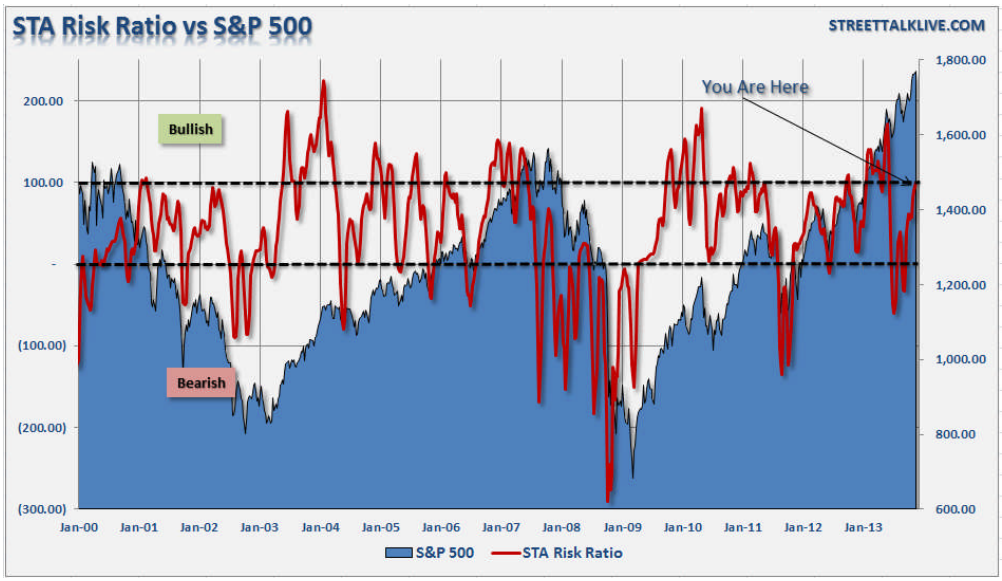
Among the many largely equivalent ways to define an overvalued, overbought, over bullish syndrome, the blue bars on the following chart present one of the many we observe at present: Shiller P/E anywhere above 18 (overvalued), S&P 500 at a 5-year high and at least 8% over its 40-week smoothing (overbought), with bullish sentiment greater than 50% and bearish sentiment less than 20% based on Investors Intelligence figures (over bullish). Notice that we did not observe this particular variant in 2000 because bearish sentiment never fell below 20% in that year. Also, while sentiment data was not available in 1929, we can impute sentiment reasonably on the basis of past price movements. Using imputed sentiment, we can also include 1929 in the set of instances here.

In any event, I continue to believe that it is plausible to expect the S&P 500 to lose 40-55% of its value over the completion of the present cycle, and suspect that whatever further gains the market enjoys from this point will be surrendered in the first few complacent weeks following the market's peak. That's how it works. If all of this seems like hyperbole, please recall my similar concern at the 2007 peak (see Fair Value – 40% Off), and the negative 10-year return projections – even on best-case assumptions – that we correctly estimated for the S&P 500 in 2000. These numbers relate to the striking gap between present valuation levels and normal historical precedent, not to personal opinion."

Market In Pictures (Technicals)






STA Risk Ratio vs S&P 500
STREETTALKLIVE.COM
You Are Here
Bullish
Bearish
200.00
100.00
-
(100.00)
(200.00)
(300.00)
1,800.00
1,600.00
1,400.00
1,200.00
1,000.00
800.00
600.00
Jan-00
Jan-01
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
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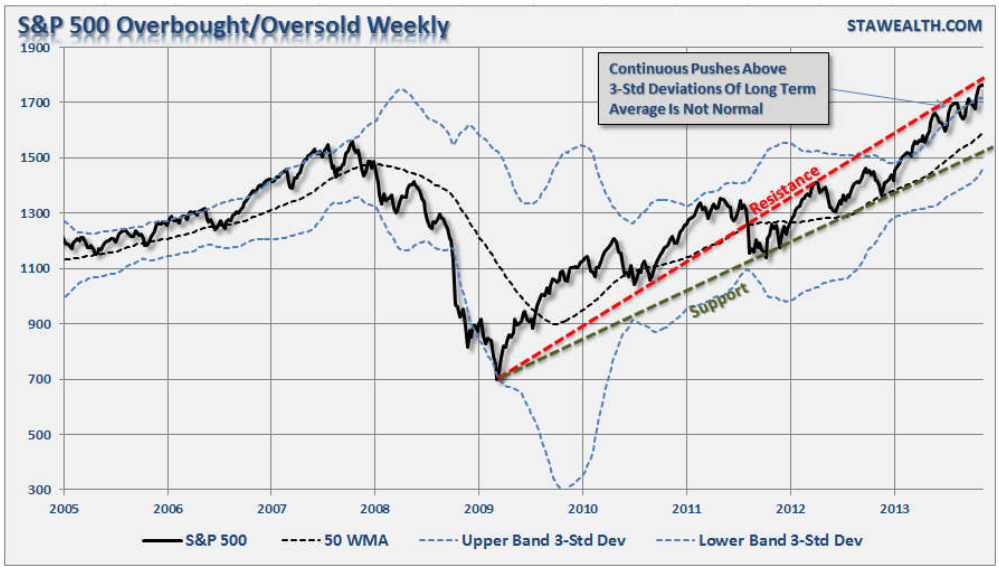
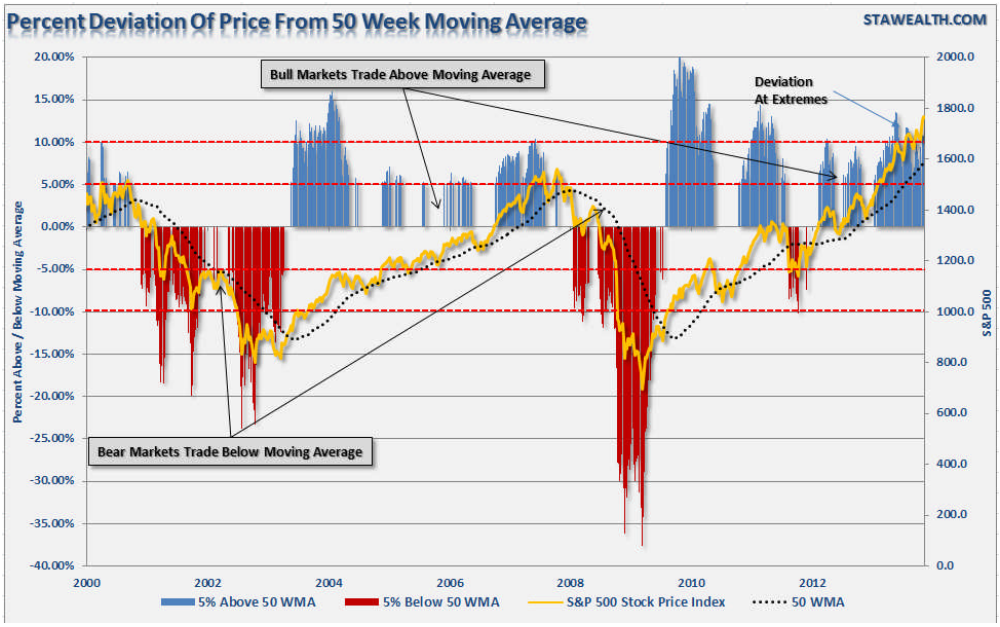
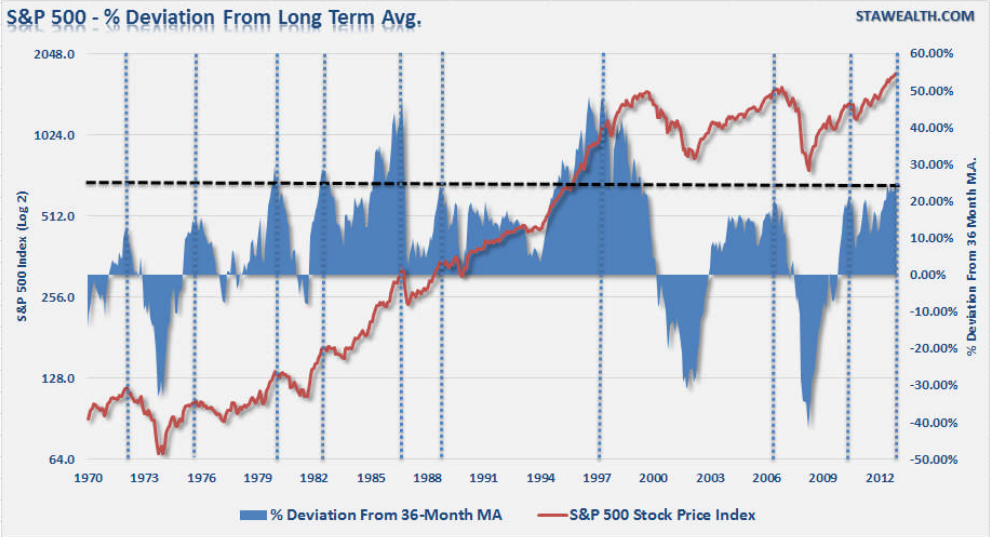
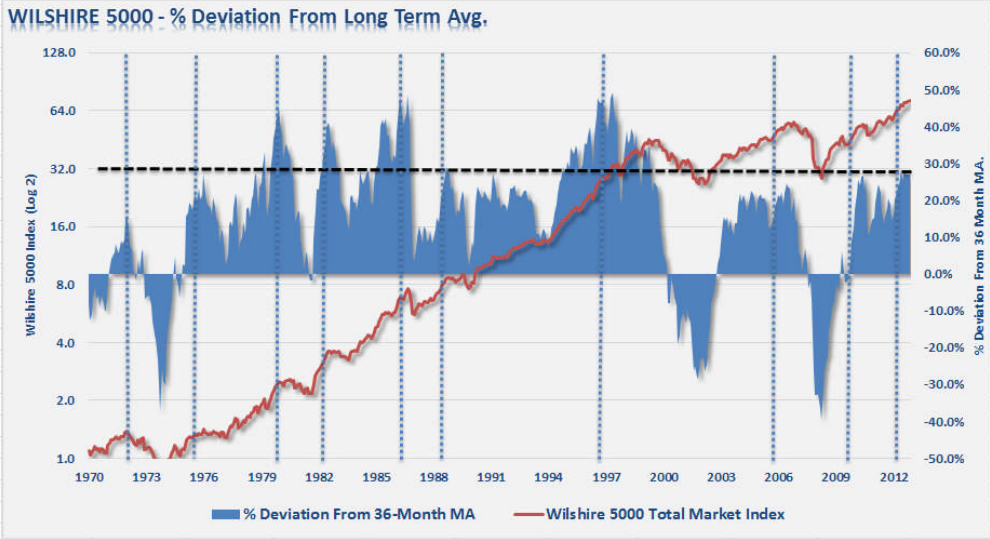
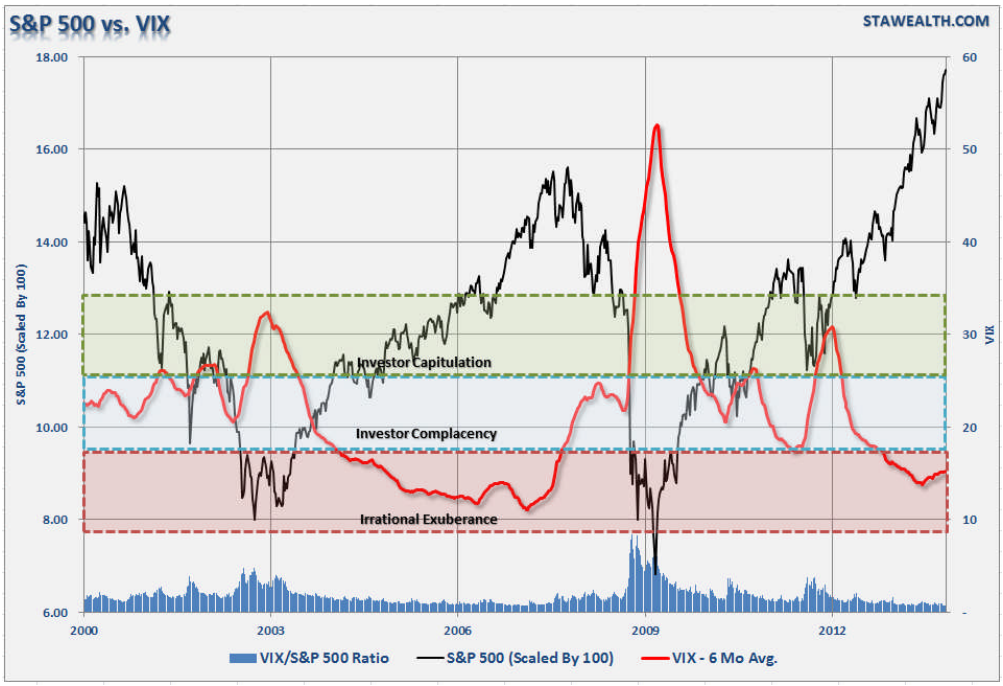
Jan-08
Jan-09
Jan-10
Jan-11
Jan-12
Jan-13
S&P 500
STA Risk Ratio

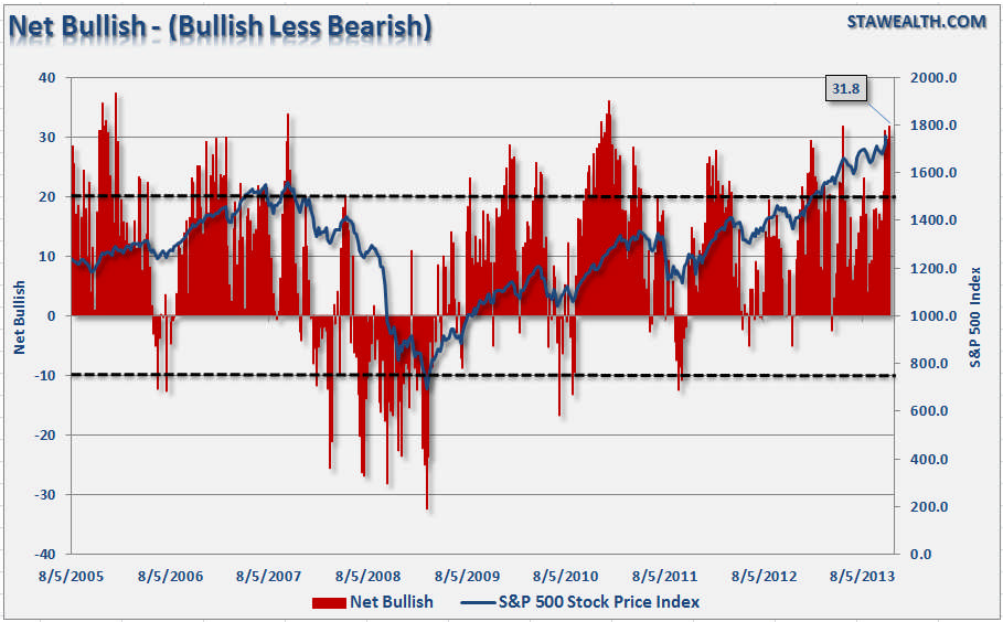

S&P 500 Overbought/Oversold Weekly
STAWEALTH.COM
Continuous Pushes Above
3-Std Deviations Of Long Term
Average Is Not Normal
Resistance
Support
1900
1700
1500
1300
1100
900
700
500
300
2005
2006
2007
2008
2009
2010
2011
2012
2013
S&P 500
50 WMA
Upper Band 3-Std Dev
Lower Band 3-Std Dev


Percent Deviation Of Price From 50 Week Moving Average
STAWEALTH.COM
Bull Markets Trade Above Moving Average
Deviation
At Extremes
Bear Markets Trade Below Moving Average
Percent Above / Below Moving Average
S&P 500
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
-25.00%
-30.00%
-35.00%
-40.00%
2000.0
1800.0
1600.0
1400.0
1200.0
1000.0
800.0
600.0
400.0
200.0
0.0
2000
2002
2004
2006
2008
2010
2012
5% Above 50 WMA
5% Below 50 WMA
S&P 500 Stock Price Index
50 WMA


S&P 500 - % Deviation From Long Term Avg.
STAWEALTH.COM
S&P 500 Index (Log 2)
% Deviation From 36 Month M.A.
% Deviation From 36-Month MA
S&P 500 Stock Price Index


WILSHIRE 5000 - % Deviation From Long Term Avg.
Wilshire 5000 Index (Log 2)
% Deviation From 36 Month M.A.
% Deviation From 36-Month MA
Wilshire 5000 Total Market Index


S&P 500 vs. VIX
STAWEALTH.COM
S&P 500 (Scaled By 100)
VIX
Investor Capitulation
Investor Complacency
Irrational Exuberance
VIX/S&P 500 Ratio
S&P 500 (Scaled By 100)
VIX - 6 Mo Avg.



You'll Know When A Market Top Is Coming When

by David Merkel (Written In 2005)

Item 1: The Investor Base Becomes Momentum-Driven

Valuation is rarely a sufficient reason to be long or short the market. *Absurdity is like infinity. Twice infinity is still infinity. Twice absurd is still absurd. Absurd valuations, whether high or low, can become even more absurd if the expectations of market participants become momentum-based. Momentum investors do not care about valuation; they buy what is going up, and sell what is going down.*

You'll know a market top is probably coming when:

a) The shorts already have been killed. You don't hear about them anymore. There is general embarrassment over investments in short-only funds.

b) Long-only managers are getting butchered for conservatism. In early 2000, we saw many eminent value investors give up around the same time. Julian Robertson, George Vanderheiden, Robert Sanborn, Gary Brinson and Stanley Druckenmiller all stepped down shortly before the market top.

c) Valuation-sensitive investors who aren't total-return driven because of a need to justify fees to outside investors accumulate cash. Warren Buffett is an example of this. When Buffett said that he "didn't get tech," he did not mean that he didn't understand technology; he just couldn't understand how technology companies would earn returns on equity justifying the capital employed on a sustainable basis.

d) The recent past performance of growth managers tends to beat that of value managers. In short, the future prospects of firms become the dominant means of setting market prices.

e) Momentum strategies are self-reinforcing due to an abundance of momentum investors. Once momentum strategies become dominant in a market, the market behaves differently. Actual price volatility increases.

Trends tend to maintain themselves over longer periods. Selloffs tend to be short and sharp.

f) Markets driven by momentum favor inexperienced investors. My favorite way that this plays out is on CNBC. I gauge the age, experience and reasoning of the pundits. Near market tops, the pundits tend to be younger, newer and less rigorous. Experienced investors tend to have a greater regard for risk control, and believe in mean-reversion to a degree. Inexperienced investors tend to follow trends. They like to buy stocks that look like they are succeeding and sell those that look like they are failing.

g) Defined benefit pension plans tend to be net sellers of stock. This happens as they rebalance their funds to their target weights.

Item 2: Corporate Behavior

Corporations respond to signals that market participants give. Near market tops, capital is inexpensive, so companies take the opportunity to raise capital.

Here are ways that corporate behaviors change near a market top:

a) The quality of IPOs declines, and the dollar amount increases. By quality, I mean companies that have a sustainable competitive advantage, and that can generate ROE in excess of cost of capital within a reasonable period.

b) Venture capitalists can do no wrong, so lots of money is attracted to venture capital.

c) Meeting the earnings number becomes paramount. What is ignored is balance sheet quality, cash flow from operations, etc.

d) There is a high degree of visible and/or hidden leverage. Unusual securitization and financing techniques proliferate. Off balance sheet liabilities become very common.

e) Cash flow proves insufficient to finance some speculative enterprises and some financial speculators. This occurs late in the game. When some speculative enterprises begin to run out of cash and can't find anyone to finance them, they become insolvent. This leads to greater scrutiny and a sea change in attitudes for financing of speculative companies.

f) Elements of accounting seem compromised. Large amounts of earnings stem from accruals rather than cash flow from operations.

g) Dividends become less common. Fewer companies pay dividends, and dividends make up a smaller fraction of earnings or free cash flow.

*****

There is much in this article to study and think about. That is what I am doing this weekend as I review my client's portfolios and ponder my next moves. I hope you will do the same.

Have a great weekend.
Lance Roberts

Sector Analysis

Major Markets

S&P 500
Analysis: Hold

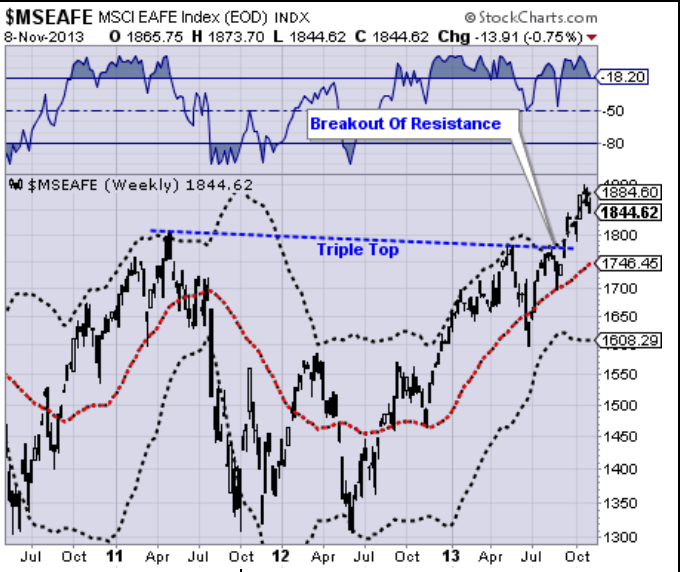
With the market so overbought at this point and pushing well into 2-std deviation of the long term mean it doesn't make sense to be adding further equity exposure at this time. However, there is also nothing occurring at the moment that would suggest a sell here either.

Remember it is always a good idea to *"trim and prune the trees"* to keep them protected from a storm.

International Markets
Analysis: Hold

International markets have likely seen their peak after the recent push higher. A correction back below 1800 to support is likely if this breakout is going to remain intact.

Take profits and reduce international to underweight in portfolios.



Emerging Markets
Analysis: Hold/Sell

Emerging markets remain confined to a long term consolidation pattern that has yet to resolve itself. With emerging markets now overbought it is time to reduce emerging markets in portfolios to underweight.

Staples

Analysis: Hold/Take Profits.

The dividend yield chase is back on with staples leading the sector pack in recent weeks. These stocks are excessively overvalued in many cases and this sector is NOT LIKELY to provide much "defense" in the coming market selloff.

However, for now, money is chasing staples so we want to remain weighted there for now.

Industrials

Analysis: Hold/Take Profits

The same as with Staples but industrials are taking the overbought/overvalued theme to new heights. Take some profits and reweight back to market weight in portfolios.

Technology

Analysis: Hold

Technology finally found the gumption to breakout of the consolidating uptrend of the past year. As the markets enters into its "giddy" phase it is not surprising to see investors chase overvalued stocks with no earnings as there is clearly no end in sight to the current market rally.

"Party like it's 1999"

Energy

Analysis: Hold/Take Profits

Energy stocks are once again becoming disconnected with their underlying commodity. Either oil prices, as we will touch on below, will surge back above $100/bbl to support current energy stock price levels or energy stocks will play catch up with oil.

Regardless of how this resolves itself in the days and weeks ahead – taking some profits out of the energy sector is likely a good idea.

Discretionary

Analysis: Hold/Reduce

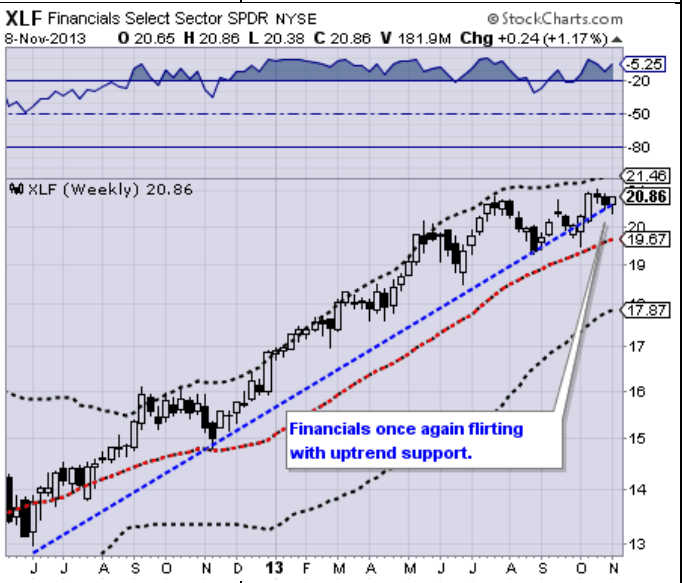
Discretionary stocks are massively overbought and now underperforming the broad market. Reduce holdings to market underweight for the time being until the current underperformance resolves itself.

Financials

Analysis: Hold/Reduce

Despite a blistering rally on Friday, for which I can find no rational, Financials remain a huge underperformer for the last several months. Continue to reduce financials in portfolio to underweight and watch the current uptrend line of this sector.

Financials are not performing well which could be a setup for a bigger correction in the making.



Interest Rates

Analysis: Back To Resistance

After peaking interest rates retraced back to support. The recent bound off of support was not surprising and rates remain very overbought. The current resistance level should hold and we should see rates try and move down in the weeks ahead.

A move above 3% will put 3.5% on the 10-yr into focus which is where the "wheels come off the cart" for the economy.

Oil

Analysis: A Healthy Correction

Very early this year I discussed that oil prices had been consolidating in a very tight price pattern and a breakout to the upside would involve a push to $110. That target was spot on and took oil into a very overbought condition.

The current correction is well within norms and has now taken oil back to an oversold condition and sitting on support. Oil should hold in this mid-$90 range, however, we are moving into the weak part of the year for oil which could bring the $87.50 target into view.

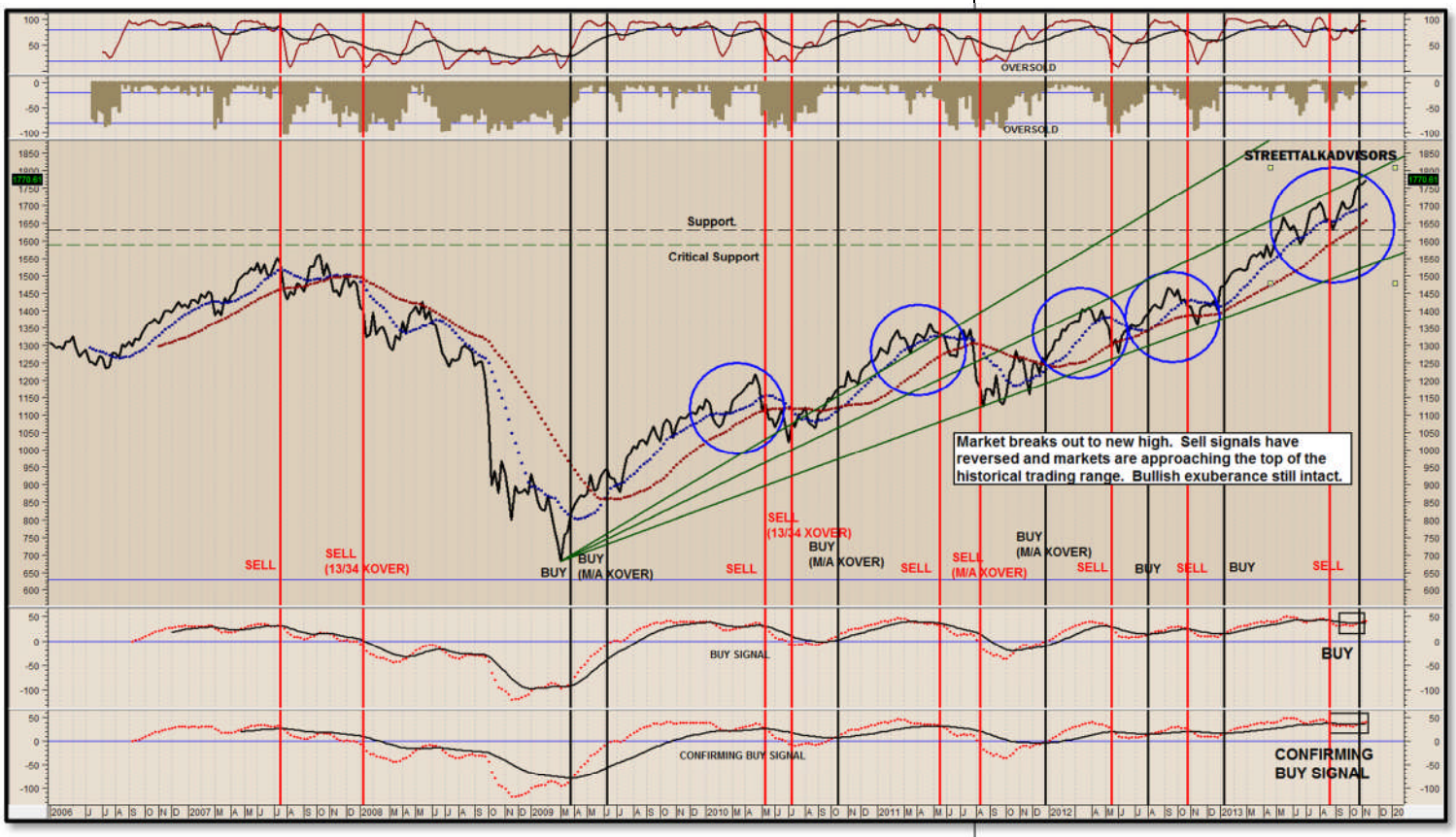
Gold

Analysis: Consolidating/Still A Sell

Still in a downtrend and unable to breakout – gold failed once again. The current consolidation is continuing and a move below $1250 is likely to mean a move below the July lows.

This is still not a time to own or accumulate gold.

401K Plan Manager



Earnings season has been lackluster to say the least along with the economic data. However, that is a good thing because it means the Fed will keep injecting liquidity into the market. Bad news is good news and that is all that matters…for now.

The markets are once again extended well beyond their long term averages which mean a correction is likely in the next couple of weeks to month. However, any correction is likely to remain a buying opportunity through the end of the year.

Hold current allocations and incrementally adjust on dips at the current time. There is a much larger correction in the works but I suspect we won't see that until next year.

If you need help after reading the alert; don't hesitate to ***contact me***.

[Suggestions Wanted]

I am in the process of revamping the newsletter and the 401k plan manager for the new website. If there is anything that you would like to see added to the 401k plan manager please email me.

Common 401K Plan Holdings By Class

Cash

Stable Value
Money Market
Retirement Savings Trust
Fidelity MIP Fund
G-Fund
Short Term Bond

Fixed Income

Pimco Total Return
Pimco Real Return
Pimco Investment Grade Bond
Vanguard Intermediate Bond
Vanguard Total Bond Market
Babson Bond Fund
Lord Abbett Income
Fidelity Corporate Bond
Western Asset Mortgage Backed Bond
Blackrock Total Return
Blackrock Intermediate Bond
American Funds Bond Fund Of America
Dodge & Cox Income Fund
Doubleline Total Return
F-Fund

Equity

Large Cap

Vanguard Total Stock Market
Vanguard S&P 500 Index
Vanguard Capital Opportunities
Vanguard PrimeCap
Vanguard Growth Index
Fidelity Magellan
Fidelity Large Cap Growth
Fidelity Blue Chip
Fidelity Capital Appreciation
Dodge & Cox Stock
Hartford Capital Appreciation
American Funds AMCAP
American Funds Growth Fund Of America
Oakmark Growth Fund
C-Fund (Common Assets)
ALL TARGET DATE FUNDS 2020 or Later

Balanced Funds

Vanguard Balanced Index
Vanguard Wellington Fund
Vanguard Windsor Fund
Vanguard Asset Allocation
Fidelity Balanced Fund
Fidelity Equity Income
Fidelity Growth & Income
American Funds Balanced
American Funds Income Fund
ALL TARGET DATE FUNDS 2020 or Sooner

Small/Mid Cap

Vanguard Mid Cap Growth
Fidelity Mid Cap Growth
Artisan Mid Cap
Goldman Sachs Growth Opportunities
Harbor Mid Cap Growth
Goldman Sachs Small/Mid Cap Opp.
Fidelity Low Price Stock Fund
Columbia Acorn US
Federated Kaufman Small Cap
Invesco Small Cap

The above represents a selection of some of the most common funds found in 401k plans. *If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.* All funds perform relatively similarly within their respective fund classes.

I will modify this list over time as the asset allocation model changes to reflect international holdings, emerging markets, commodities, etc. as the model changes to reflect the addition of those holdings.

***Email me* if you need further assistance.**

Current 401k Allocation Model

5.00% **Cash + All Future Contributions**

Primary concern is the protection of investment capital

Examples: Stable Value, Money Market, Retirement Reserves

35.00% **Fixed Income (Bonds)**

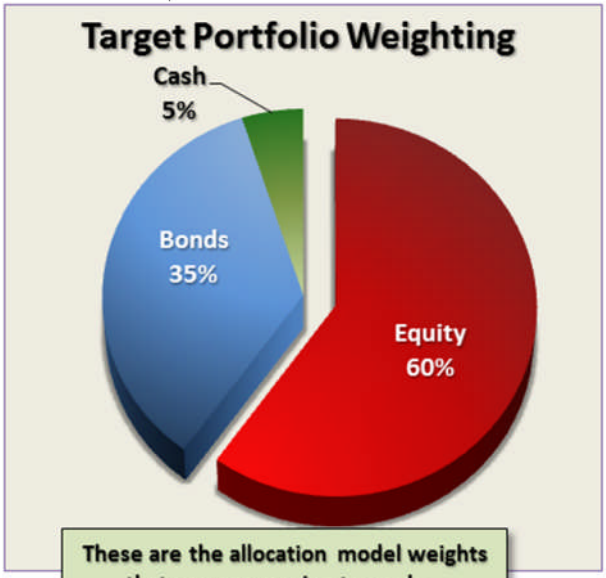
Bond Funds reflect the direction of interest rates

Examples: Short Duration, Total Return and Real Return Funds

60.00% **Equity (Stocks)**

The vast majority of stock funds track an index. Therefore, select on ONE fund from each category. Keep it Simple.

25% Equity Income, Balanced or Conservative Allocation
25% Large Cap Growth (S&P 500 Index)
10% Mid Cap Growth



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