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SITREP for the week ending 8/24/18

SITREP: n. a report on the current situation; a military abbreviation for - "SITuation REPort"
CAVU: adj. a philosophy for life; the guiding principle for independent advice; an aeronautical abbreviation for – "Ceiling and Visibility Unlimited"

Quick "week in review" for the Busy Reader!!

TIMEFRAME -

The very big picture:
Even if we are in a new Secular Bull Market, market history says future returns are likely to be modest at best. The Cyclically-Adjusted Price to Earnings Ratio (CAPE) is at 33.03, up from the prior week's 32.84. **(Figs. 1 & 2)**

The big picture:
The U.S. Bull-Bear Indicator turned **positive** on July 8th, and is in **Cyclical Bull** territory at 76.57, up from the prior week's 74.90. (**Fig. 3**)

The intermediate picture:
The Intermediate (weeks to months) Indicator turned **positive** on April 3rd, and ended the week at 26, up from the prior week's 25. (**Fig. 4**)

Separately, the Quarterly Trend Indicator - based on domestic and international stock trend status at the start of each quarter - was **positive** entering July, indicating positive prospects for equities in the third quarter of 2018.

Timeframe Summary:
With all three indicators **positive**, the U.S. equity markets are rated as **Positive.**

OTHER -

Institutional Investor Sentiment:
The average ranking of Defensive SHUT sectors rose to 15.75 from last week's 16.50, while the average ranking of Offensive DIME sectors rose slightly to 17.00 from last week's 17.25. The Offensive DIME sectors trail the Defensive SHUT sectors by a modest amount.

The Markets and Economy:
As always, this section has been updated with the latest facts and figures, keeping you up to date on what is going on out there!

Chart of the Week (Page 6):
This week, we look at a little-known stock market indicator. Please keep in mind that we do NOT follow this indicator, and it missed a BIG downward move over the last 10 years. Also, this is not meant as investment advice, but provided as an interesting look at the relationships between the stock market and other asset classes.

Please turn the page for our Weekly SITREP…

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THE VERY BIG PICTURE:

In the "decades" timeframe, the current Secular Bull Market could turn out to be among the shorter Secular Bull markets on record. This is because of the long-term valuation of the market which, after only eight years, has reached the upper end of its normal range.

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").

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 33.03, up from the prior week's 32.84, and exceeds 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. (**Fig. 2**).

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 (**Fig. 3)** is in **Cyclical Bull** territory at 76.57, up from the prior week's 74.90.

THE INTERMEDIATE PICTURE:

The Intermediate (weeks to months) Indicator (**see Fig. 4**) turned **positive** on April 3rd. The indicator ended the week at 26, up from the prior week's 25. Separately, the Quarterly Trend Indicator - based on domestic and international stock trend status at the start of each quarter – was **positive** entering July, indicating positive prospects for equities in the third quarter of 2018.

TIMEFRAME SUMMARY:

In the Secular (*years to decades*) timeframe (**Figs. 1 & 2**), the long-term valuation of the market is simply too high to sustain rip-roaring multi-year returns – but the market has entered the low end of the "mania" range, and all bets are off in a mania. The only thing certain in a mania is that it will end badly…someday. The Bull-Bear Indicator (*months to years*) is **positive** (**Fig. 3**), indicating a potential uptrend in the longer timeframe. In the intermediate timeframe, the Quarterly Trend Indicator (*months to quarters*) is **positive** for Q3, and the shorter (*weeks to months*) timeframe (**Fig. 4**) is **positive**. Therefore, with all three indicators **positive**, the U.S. equity markets are rated as **Positive**.

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A GLOBAL LOOK AT THE MARKETS AND ECONOMY:

Domestic Markets:
U.S. stocks posted gains for the week, led higher by technology and energy shares. The Dow Jones Industrial Average advanced 121 points to 25,790, a gain of 0.5%. The technology-heavy NASDAQ Composite added 130 points or 1.7% to close at 7,945. By market cap, smaller cap indexes outperformed large caps. The large cap S&P 500 added 0.9% while the mid cap S&P 400 and small cap Russell 2000 added 1.2% and 1.9% respectively.

International Markets:
Canada's TSX and the United Kingdom's FTSE were the laggards among major international markets, rising 0.2% and 0.3% respectively. On Europe's mainland all larger markets finished the week in the green with France's CAC 40 up 1.6%, Germany's DAX up 1.5%, and Italy's Milan FTSE up 1.6%. Asian markets were similarly higher - China's Shanghai Composite added 2.3%, while Japan's Nikkei added 1.5% and Hong Kong's Hang Seng added 1.7%. As grouped by Morgan Stanley Capital International, emerging markets added 2.8% and developed markets were up 1.4%.

Commodities:
Precious metals recovered much of last week's plunge as Gold added 2.5% or $29.10 to end the week at $1213.30 per ounce, and Silver added 1.1% to end the week at $14.79 per ounce. Crude oil surged 5.4% to close at $68.72 per barrel of West Texas Intermediate. The industrial metal copper - sometimes referred to as "Dr. Copper" for its ability to forecast global economic growth - rebounded 2.7% after 3 weeks of negative returns.

Domestic Economic News – Labor/Jobs:
The labor market remains very tight as new claims for unemployment benefits fell by 2,000 to 210,000 nearly matching its lowest level since December of 1969. Economists had expected a rise to 215,000 claims. The current decline in new claims is the third lowest reading during the current nine-year-old economic expansion, just 2,000 above the post-recession low set in July. The four week average of claims, smoothed to iron out the weekly volatility, fell by 1,750 to 213,750, also near its lowest level since 1969. The number of people already collecting unemployment benefits, known as continuing claims, remained barely changed at 1.73 million.

Domestic Economic News – Housing:
The number of existing homes sold in July fell for a fourth consecutive month as a shortage of properties on the market and rising mortgage rates are thought to have sidelined some potential buyers. The National Association of Realtors (NAR) reported existing home sales fell 0.7% to a seasonally-adjusted annual rate of 5.34 million units, widely missing economists' forecast of a 0.6% gain to 5.40 million units. July's drop marks the longest streak of sales declines since 2013. By region, sales fell across the Northeast, South, and Midwest, but were up in the West. There were 1.92 million homes on the market in July, unchanged from a year earlier. It was the first month in three years in which inventory did not fall on a year-on-year basis, said Lawrence Yun, the NAR's chief economist.

Sales of new homes also declined – again - falling 1.7% in July, the third decline in the past four months. The Commerce Department reported new home sales ran at a 627,000 annualized rate, the lowest level in nine months. The reading widely missed economists' forecasts for a gain of 2.2%. On a positive note, sales were 12.8% higher than at the same time last year, and the median home price remained at a lofty $328,700. Despite their recent weakness, new home sales have not broken below their long-term upward trend line, which suggests

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that the market is still holding up. The new home sales decline in July was led by a 52.3% plunge in the Northeast, which more than reversed its double-digit gain the previous month. At the current sales pace, available supply rose to 5.9 months of inventory—close to the 6 month supply consistent with a balanced housing market.

Domestic Economic News – Durable Goods, Manufacturing and Service:
A big drop in new contracts for passenger jets caused orders for durable goods to fall 1.7% last month, its third decline in the past four months and the most since the beginning of the year. Economists had forecast a 1.1% decline. In the report, the decline was led by weaker aircraft orders in the often-volatile transportation group. Excluding transportation, orders were actually up 0.2% - a sixth straight monthly gain for the ex-transportation grouping. Nondefense capital goods orders ex-aircraft, or core business orders, rose 1.4%, the fourth gain in a row. They are up a healthy 7.2% in the first seven months of 2018, compared with the same period a year ago. U.S. economist Andrew Hunter of Capital Economics stated, "Despite the decline in headline orders, the July durable goods data suggest that business equipment investment growth is set to rebound in the third quarter. That provides further reason to think that overall GDP has continued to expand at a healthy 3.0% to 3.5% annualized pace."

An index that tracks U.S. manufacturers and service-oriented companies showed slower growth this month, suggesting that economic growth may be tapering from its three-year peak this spring. Research firm IHS Markit's flash Purchasing Managers Index (PMI) manufacturing sub-index fell to a nine-month low of 54.5 from 55.3, while its services sub-index hit a four-month low of 55.2, down 0.8 point. Despite the dual declines, readings over 50 signify expansion and results over 55 are considered exceptional, so analysts see no cause for concern. Companies continue to report shortages of skilled labor and depending on the industry shortages of key raw materials due to tariffs that have triggered "panic buying". Transportation has also become an issue due to a shortage of truck drivers.

Domestic Economic News – The Federal Reserve (Interest Rates):
Minutes of the Federal Reserve's meeting earlier this month signaled broad support for another interest-rate hike in September if the data continued to support their outlook. The minutes said, "It would likely soon be appropriate to take another step in removing policy accommodation." However, officials cautioned that it may have to pause its gradual rate hike path if international trade tensions continued to escalate. Fed officials were unanimous in their view that trade disagreements represented a downside risk to the economy. Fed officials also agreed they would "fairly soon" need to scrap the language describing their policy stance as "accommodative" because the level of rates is getting closer to neutral.

International Economic News:
Bank of Canada Governor Stephen Poloz stated he still sees rate hikes ahead for Canada, but it is dependent on future economic data and the outcome of NAFTA talks with the United States. The Bank of Canada raised its benchmark interest rate in July, a month after the U.S. Federal Reserve raised U.S. interest rates. A rate increase in the U.S. generally puts pressure on the Bank of Canada to follow as a stronger dollar puts pressure on the Canadian Loonie. Poloz noted that he's wary of the factors in Canada that make it so he can't move in tandem with the U.S. such as higher levels of debt and Canada's heavier reliance on trade. The uncertainty over NAFTA and U.S. President Trump's repeated threats to cancel the deal have already had a negative impact on investment in Canada, he said.

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The European press has shown very little sympathy for the 'no-deal' Brexit guidance published by UK Brexit Secretary Dominic Raab. The German press provided the most coverage of Raab's publication with most papers summarizing Raab's writings as "too little, too late". The prevailing feeling on the European continent is that "it is the Brits' own damn fault" for the current chaos and uncertainty. Journalist Stephanie Bolzen said in a column for the German conservative daily Die Welt that "this attitude is arrogant" and "detrimental". If a no-deal Brexit leads to the end of the free market this will create "shock waves well beyond Europe", she wrote.

Business morale in France fell to its lowest level since Emmanuel Macron became the President in May 2017, French statistics agency INSEE reported. Sentiment soared following Macron's election promising investor-friendly reforms and a return to fiscal discipline, but has soured since then. The composite business morale index dropped to 105 in August, down almost 6 points from its multi-year high last year. INSEE gave no reason for August's decline, though respondents in recent business surveys have cited uncertain trade prospects and rising energy prices as negatives. On a positive note, the latest reading still remains above the long-term average of 100.

Strong domestic demand drove Germany's economic expansion in the months leading up to summer as second quarter gross domestic product rose 0.5%, matching estimates. Overall economic growth was supported by a 0.5% increase in capital investment, mostly due to construction. Net trade, however, weighed as imports rose 1.7% but exports were up just 0.7%. The country's solid performance in the second quarter helped alleviate concerns that slowdown in the first quarter would persist. Nonetheless, several large corporations in Germany expressed concern over the outlook, with growth in China slowing and emerging markets experiencing a slowdown. The Bundesbank stated German expansion is likely to cool this quarter, though the economy remains on a "sound growth path".

Analysts note that China's economy is slowing down, but they debate about how much trouble it is really in. The recent weakness appears at least partly due to a budding trade war with the United States, in which each country has imposed tariffs of $50 billion on each other's goods and each are threatening far more. While China's economy expanded 6.9% in 2017 according to government figures, official data showed a slowdown in investment, factory production and retail sales in July. Chang Liu, China economist at Capital Economics wrote in a note to clients, "The US-China trade conflict will be a drag on activity, though probably a small one. Instead, we expect the economy to weaken mainly due to domestic headwinds caused by slower credit growth." Some experts feel that the slowdown fears are overblown. Doug Morton, head of Asia research at Northern Trust Capital Markets, pointed out that some indicators like demand for oil and the property markets are still strong. "Headlines on growth concerns may prove to be somewhat exaggerated," he wrote in a note to clients this week.

Japanese trade minister Hiroshige Seko stated U.S. President Donald Trump's tariff policies reflect a serious misunderstanding of the importance of free trade and of Japanese contributions to the U.S. economy. Seko told the Associated Press, "Japanese automakers are a major contributor to the American economy. If the Japanese auto industry is weakened, it will not be able to further invest in the U.S." Seko also expressed worries about the escalating trade dispute between the U.S. and China and said such moves threaten the entire global economy. Seko said he empathized with Trump's "feelings" of worry over the ballooning U.S. trade deficit but pointed out that the annual U.S. trade deficit with Japan totaled just $68 billion last year, compared to the U.S. deficit with China which was nearly $376 billion.

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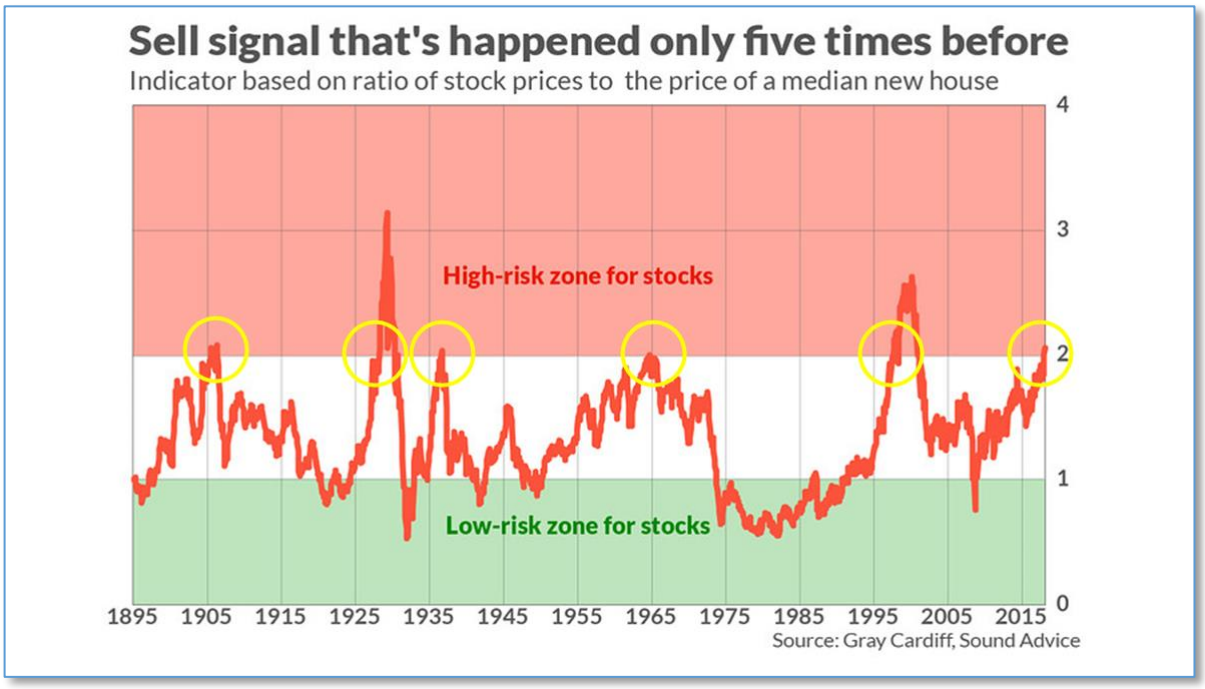
(2018 sources: all index return data from Yahoo Finance; Reuters, Barron's, Wall St Journal, Bloomberg.com, ft.com, guggenheimpartners.com, ritholtz.com, markit.com, financialpost.com, Eurostat, Statistics Canada, Yahoo! Finance, stocksandnews.com, marketwatch.com, wantchinatimes.com, BBC, 361capital.com, pensionpartners.com, cnbc.com, FactSet; Figs 1-5 source W E Sherman & Co, LLC)

INSTITUTIONAL INVESTER SENTIMENT:
The ranking relationship (shown in **Fig. 5**) between the defensive **SHUT** sectors ("**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 rose to 15.75 from last week's 16.50, while the average ranking of Offensive DIME sectors rose slightly to 17.00 from last week's 17.25. The Offensive DIME sectors trail the Defensive SHUT sectors by a modest amount.
Note: these are "ranks", not "scores", so smaller numbers are higher ranks and larger numbers are lower ranks.

CHART OF THE WEEK:
As the bull market continues through its ninth year, a little-known stock market indicator with a "5 for 5" record since 1895 has just generated a sell signal. The indicator is the creation of Gray Cardiff, editor of the Sound Advice newsletter. He calls it the "Sound Advice Risk Indicator", which is simply the ratio of the S&P 500 to the median price of a new home. Cardiff explains that the indicator quantifies the "struggle for capital" between stocks and real estate. When the indicator rises above 2.0, he explains, it means the stock market has absorbed a "larger proportion of available investment capital than economic conditions can justify." The last time the indicator flashed a sell signal was in 1998—conveniently before the dot.com implosion that followed. Note, however, that this indicator did NOT give a sell signal in 2007, since it was Real Estate that had proportionately too much investment then!



The above chart and commentary is for informational purposes only, and is not a recommendation or solicitation to trade any securities.

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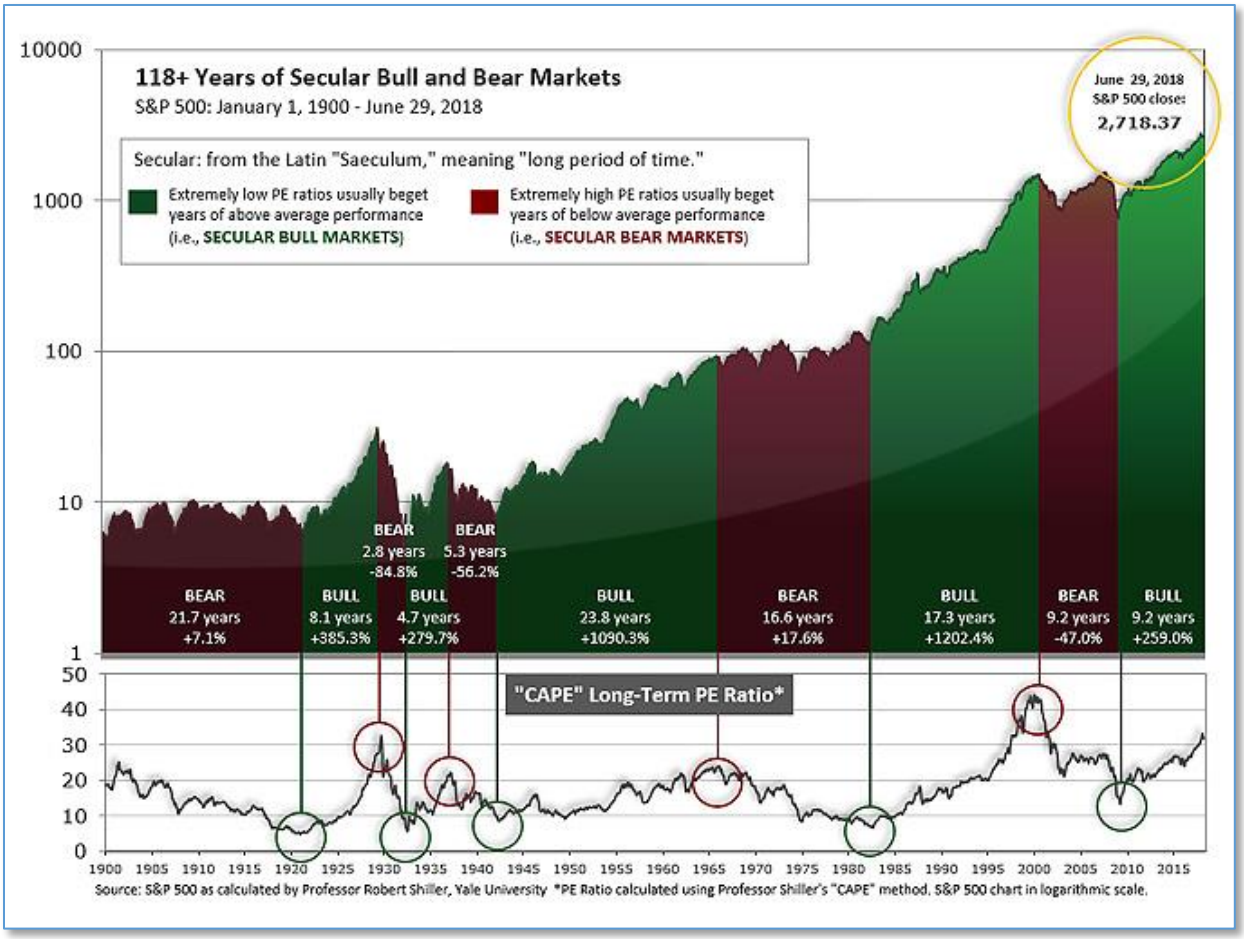

FIGURE ONE

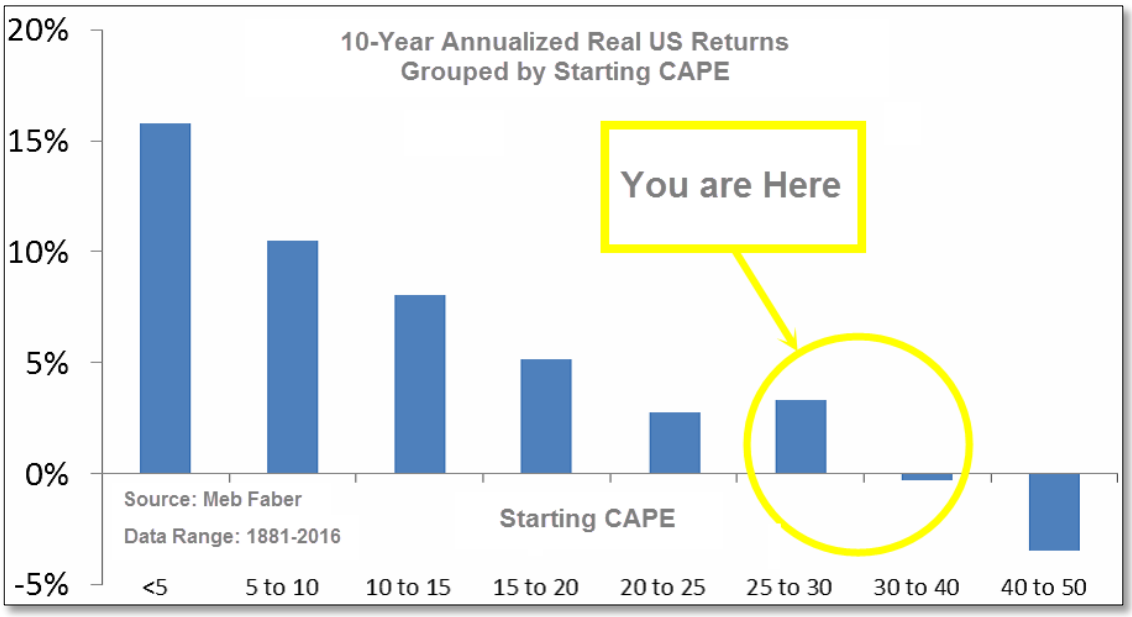

FIGURE TWO

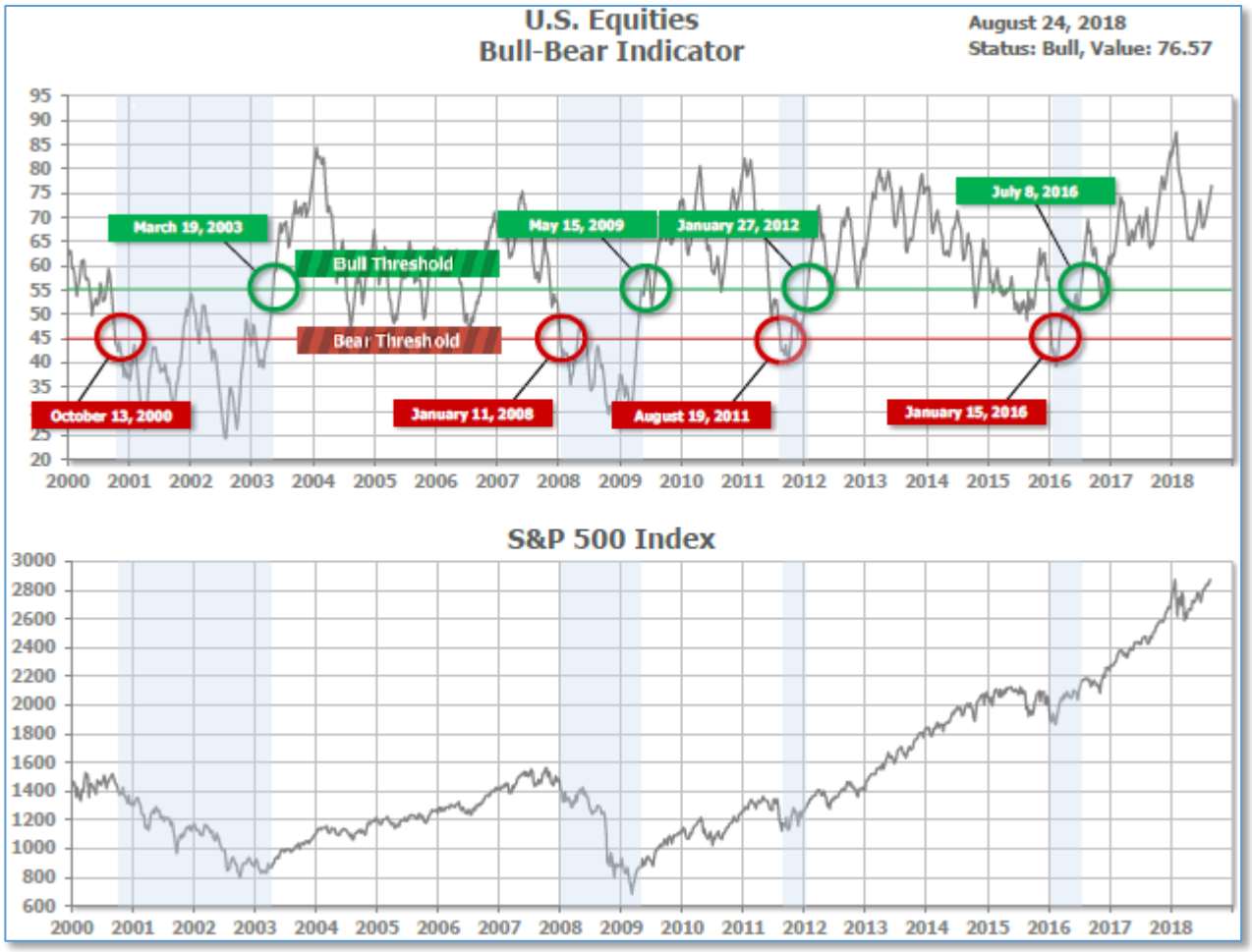

FIGURE THREE

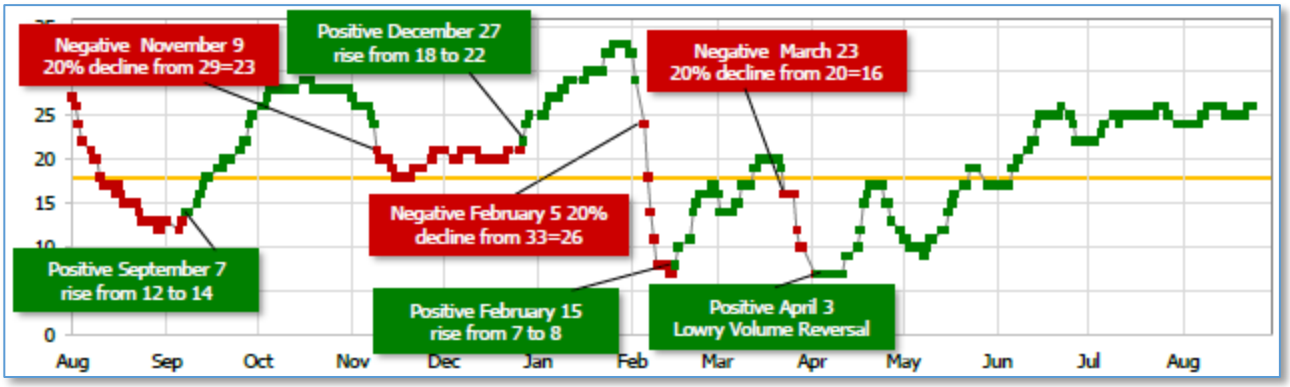

FIGURE FOUR

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SITREP for the week ending 8/24/18

U.S. Intermediate-Term Asset Class Rankings

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

TYPE 1 = US Styleboxes; lower volatility
TYPE 2 = International Equities and Hard Assets; moderate volatility
TYPE 3 = Sectors; higher volatility

FIGURE FIVE

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>The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly. Investing involves risk including loss of principal.
>There is no assurance that the investment objective of any investment strategy will be attained. An investor trading in stocks according an active management strategy may incur greater transaction costs than if the investor follows a Buy & Hold strategy.
>International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.
>The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.
>Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

INDEX REFERENCE GUIDE:

The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries and widely held by individuals and institutional investors.
The NASDAQ Composite Index measures all NASDAQ domestic and non-U.S. based common stocks listed on The NASDAQ Stock Market. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the Index.
S&P 500 Index measures performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The S&P 500 covers 80% of the U.S. market encompassing more than 100 industry groups.
S&P MidCap 400 Index measures the performance of mid-sized companies. This Index represents about 7% of U.S. market cap.
Russell 2000 SmallCap Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.
The S&P/TSX Composite Index contains stocks of the largest companies on the Toronto Stock Exchange (TSX). The index is calculated by Standard and Poor's, and contains both common stock and income trust units. Additions to the index are generally based on quarterly reviews.
The DAX is a stock index that represents 30 of the largest and most liquid German companies that trade on the Frankfurt Exchange. The prices used to calculate the DAX Index come through Xetra, an electronic trading system. A free-float methodology is used to calculate the index weightings along with a measure of average trading volume.
The United Kingdom FTSE 100 Index comprises the 100 most highly capitalized Blue Chip companies listed on the London Stock Exchange.
The France CAC 40 Index represents a capitalization-weighted measure of the 40 most significant values among the 100 highest market caps on the Euronext Paris.
The Italy Milan FTSE (Milano Italia Borsa) is the benchmark stock market index for the Borsa Italiana, the Italian national stock exchange, and consists of the 40 most-traded stock classes on the exchange.
The China Shanghai SSE Composite Index is a stock market index of all stocks (A and B shares) that are traded at the Shanghai Stock Exchange.
The Hang Seng Index is a free float-adjusted market capitalization-weighted stock market index in Hong Kong, and is used to record and monitor daily changes of the largest companies of the Hong Kong stock market. It is the main indicator of the overall market performance in Hong Kong, made up of 50 constituent companies represent about 58% of the capitalization of the Hong Kong Stock Exchange.
The Nikkei 225 more commonly called the Nikkei, is a price weighted stock market index for the Tokyo Stock Exchange.
The Developed Markets Index (MSCI World Index) captures large and mid-cap representation across 23 Developed Markets countries. With 1,654 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
MSCI Emerging Market Index is Morgan Stanley Capital International's float-adjusted market capitalization index composed of the following 25 emerging market country indexes: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

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NAR Existing Home Sales is an economic indicator of both the number and prices of existing single-family homes, condos and co-op sales over a one-month period. The existing home sales report is released monthly by the U.S. National Association of Realtors. The existing home sales report does not look at newly built houses or the sale of new houses. This indicator is thought to be a good measure of demand in the real-estate sector.

The Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.