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SITREP for the week ending 10/26/18

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 30.00, down from the prior week's 31.24. **(Figs. 1 & 2)**

The big picture:
The U.S. Bull-Bear Indicator turned **positive** on July 8th, and is in **Cyclical Bull** territory at 58.57, down from the prior week's 62.74. (**Fig. 3**)

The intermediate picture:
The Intermediate (weeks to months) Indicator turned **positive** on April 3rd, and ended the week at 2, down from the prior week's 4. (**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 9.25 from last week's 9.50, while the average ranking of Offensive DIME sectors fell to 14.00 from last week's 13.00. The Defensive SHUT sectors widened their lead over the Offensive DIME sectors.

The Markets and Economy:
The Economy says one thing (good), but the Markets say another (bad). What the heck is going on??? More than ever, take a look at our markets and economy sections to get the latest updates. It has been a wild week.

Chart of the Week (Page 6):
It's all about GREED versus FEAR. Both of these emotions has an impact on the markets. And, not always based in reality. And what is it with October? The second chart looks at prior Octobers to obtain some perspective.

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 30.00, down from the prior week's 31.24, 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 58.57, down from the prior week's 62.74.

THE INTERMEDIATE PICTURE:

The Intermediate (weeks to months) Indicator (**see Fig. 4**) turned **positive** on April 3rd. The indicator ended the week at 2, down from the prior week's 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:

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 experienced another week of sharp declines – the fourth down week of the last five. The large cap S&P 500 and the Nasdaq Composite indexes joined the small cap benchmarks in correction territory—down more than 10% from their recent peaks. The Dow Jones Industrial Average declined -3.0% this week, falling 756 points to close at 24,688. The technology-heavy Nasdaq Composite fell -3.8% to 7,167. By market cap, the large cap S&P 500 ended down -3.9%, while the mid cap S&P 400 fell -4.1% and the small cap Russell 2000 retreated -3.8%.

International Markets:
Canada's TSX finished down -3.8%. Across the Atlantic, major markets were down across the board. The United Kingdom's FTSE retreated -1.6%, while France's CAC 40 declined -2.3% and Germany's DAX fell a further -3.1%. In Asia, China's Shanghai Composite managed a gain of 1.9%, while Japan's Nikkei plunged -6.0%. As grouped by Morgan Stanley Capital International, emerging markets were off -2.5%, while developed markets gave up -3.6%.

Commodities:
Precious metals, a traditional safe haven in times of market weakness, finished green in an ocean of red. Gold rose 0.6% ending the week at $1235.80 an ounce, while Silver added 0.3% closing at $14.70 an ounce. Oil finished the week down as contracts for both West Texas Intermediate crude and Brent crude finished the week lower. West Texas Intermediate gave up -2.4% to $67.59 per barrel, while Brent declined -2.8% to $77.80 per barrel. Copper, seen by some analysts as an indicator of global economic growth due to its variety of industrial uses, ended the week down -1.3%.

Domestic Economic News – Labor/Jobs:
The number of Americans applying for initial unemployment benefits rose 5,000 to 215,000 last week, with claims particularly higher in Georgia and Florida recently hit by Hurricane Michael. Overall claims remain near a 50-year low, with employers laying off very few workers. Economists had expected claims to remain steady at 210,000. The four-week average of claims, smoothed to iron-out the weekly volatility, remained unchanged at 211,750. Continuing claims, which counts the number of people already receiving unemployment benefits, fell by 5,000 to 1.64 million. That number is at its lowest since August of 1973.

Domestic Economic News – Housing:
The housing market continued to deteriorate as sales of new homes plunged to near their lowest level in two years. The Commerce Department reported that new-home sales ran at a seasonally-adjusted annual rate of 553,000 last month, their lowest rate since December of 2016. September's reading was 5.5% lower than August, and 13.2% lower than at the same time last year. Economists had forecast a pace of 620,000. In the details, the median selling price in September was $320,000, 3.5% lower than a year ago. At the current sales pace, there is now a 7.1 months' supply of new homes on the market, above the 6-month level considered a "balanced" housing market and at a 6-year high. While the month-to-month government residential construction data can be quite volatile, overall the trend for 2018 is showing one of continued deterioration. Year-to-date sales are just 3.5% higher than at the same time last year—and that measurement has been steadily falling throughout the year.

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On a positive note, the National Association of Realtors (NAR) reported its Pending Home Sales index edged up half a point to 104.6 last month. The consensus forecast was for no change. The NAR's index tracks real estate transactions in which a contract has been signed but not yet closed. The Pending Home Sales index snapped a four-month losing streak with September's increase, but held below year-ago levels for the ninth month in a row—this time by 1%. Contract signings usually precede closings by about 45 days so the pending home sales release is used by analysts as a leading indicator for the existing-home sales report.

Domestic Economic News – Durable Goods, Manufacturing and Service:
Orders for goods intended to last at least 3 years, so-called "durable goods", increased 0.8% in September. The reading was its third gain in the last four months, but was down sharply from August. The Commerce Department reported that while demand for durable goods continued to increase, it was down 4.6% from August. The swing was heavily influenced by the often-volatile aircraft category which fell 17.5% after surging 63.7% in August. Excluding the volatile transportation and defense sectors, core capital goods orders were down -0.1%.

Research firm IHS Markit reported the flash readings for both its manufacturing and services Purchasing Managers Indexes (PMI) increased this month. The Manufacturing PMI rose to a five-month high of 55.9, up 0.3 point, while its services PMI rose 1.2 point to 54.7. In both manufacturing and services, input cost inflation accelerated sharply, reflecting higher fuel and borrowing costs, as well as the impact of tariffs. Average prices charged also rose at a robust pace, suggesting an overall pickup in inflation. Chris Williamson, chief business economist at IHS Markit stated, "The resilience of the domestic economy in the face of trade worries, and the strong price pressures indicated by the survey data, will add to expectations that the Fed will hike rates again before the end of the year."

Domestic Economic News – Economic Activity (Gross Domestic Product / Federal Reserve):
Real GDP growth marked its best two-quarter stretch in years, increasing at a 3.5% annual rate in the 3rd quarter, the Commerce Department reported. The reading beat consensus forecasts of 3.4% but was a modest deceleration from the 4.2% rate of growth seen in the second quarter. So far this year, growth has averaged 3.3% keeping the economy on track for close to 3% growth for the full year. Notably, output was up 3% year over year, its fastest pace since the second quarter of 2015. The latest reading reflected strong growth in consumer spending and inventory investment, while declines in fixed investment and net exports weighed. Domestic demand remained robust as final sales to domestic purchasers rose at a 3.1% annual rate, above the long-term average of 2.8%.

In the latest Federal Reserve 'Beige Book', a collection of anecdotal information on current economic conditions from each of its districts, wages, prices, and the labor market were the topics of concern among respondents. The Beige Book noted wages and prices moved higher in the Federal Reserve's 12 districts through mid-October in a "modest to moderate" pace. In addition, tight labor markets remained a concern. Companies have resorted to using "non-wage strategies", like bonuses and lengthy vacation allowances, to recruit workers. Some districts reported retailers in their regions were able to raise selling prices citing higher transportation costs and worries over wholesale price increases from trade tariffs. Overall economic activity expanded at a "modest to moderate" pace, the Beige Book said.

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International Economic News:

The Bank of Canada raised its key interest rate a quarter point to 1.75%, the highest level in about a decade. The increase was the fifth time the Bank of Canada has hiked rates since the summer of 2017. The hike comes as Canada's economy has remained resilient amid (now resolved) trade tensions with the United States and an unemployment rate near four-decade lows. The increase followed Bank of Canada Governor Stephen Poloz's first policy meeting since Canada agreed to an updated North American free trade deal with the U.S. and Mexico earlier this month. The bank said the new trade agreement will reduce uncertainty, which it described as "an important curb" on business confidence and investment.

Bloomberg reported United Kingdom Prime Minister Theresa May's Cabinet is nowhere close to agreeing to a way forward for high level Brexit negotiations to resume, even as time is running short. Sources told Bloomberg that there would almost certainly be no new plan put forward by the British side before Britain's next budget. Bloomberg further reported a main source of contention remains Britain's border with Ireland which would be the only land crossing between the two jurisdictions.

France, Europe's second-largest economy, received a letter from the European Union warning that its planned debt reduction in 2019 does not respect the proposals that Paris had agreed to in a previous agreement with the EU. France's 2019 budget plan forecasts its structural deficit (the difference between spending and revenues) falling 0.1% this year and 0.3% next year. Earlier this year, Paris had agreed to an annual reduction of 0.6% of GDP for its structural deficit. Daniel Lacalle, chief economist and investment officer at Tressis Gestion stated France's 2019 budget "shows that the government relies heavily on very optimistic revenues to achieve fiscal consolidation and that spending is out of control again. In the case of France, it is a very difficult budget to accept by the European Commission because France has not had a balanced budget since 1974 and has missed its own deficit targets more than eleven times."

The Munich-based Ifo economic institute reported its business climate index for Germany fell a second month in a row to 102.8, missing economists' forecasts by 0.4 point. Ifo chief Clemens Fuest stated, "Firms were less satisfied with their current business situation and less optimistic about the months ahead." In addition, "Growing global uncertainty is increasingly taking its toll on the German economy." Domestic consumption and state spending have been Germany's main growth drivers as exports have weakened. But the risk of a no-deal Brexit, trade tensions, and a lack of skilled workers are weighing on growth prospects for Europe's largest economy. Ifo economist Klaus Wohlrabe said it would be difficult for Germany to meet the 0.6% growth forecast for the fourth quarter given by the institute in its autumn report.

Analysts note that it appears China is set to build its way out of its next economic downturn—again. Based on official data, Reuters found that China's state planner had approved 45 projects worth 437.4 billion yuan in the third quarter, more than quadruple the 90.5 billion yuan approved in the second. The September approvals accounted for nearly 2/3's of the value of approvals so far this year. The steep increase in approved projects follows the release of data last week that showed China's economy grew 6.5% so far this year, it's weakest pace since 2009. On top of boosting investment, Chinese policymakers have also announced a raft of measures to support household consumption in recent days, including income tax cuts and additional tax deductions.

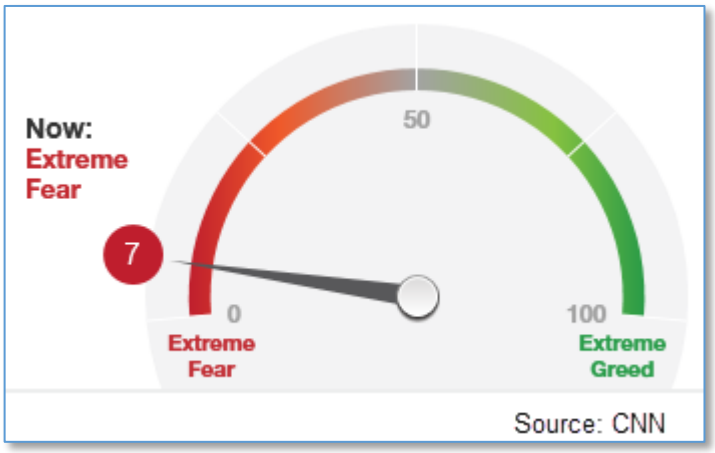
The Bank of Japan is set to keep its monetary policy steady next week and maintain its optimistic view of the economy according to analysts. However, given Japan's export-reliant economy, Japanese policymakers worry that rising protectionism and volatile financial markets could hurt business sentiment by discouraging firms from raising wages. The Bank of Japan's plan relies on companies raising wages to stoke growth. Given its reliance on exports, solid global demand is a necessary predecessor ingredient for Japanese companies to raise

wages and prices. The BOJ is widely expected to maintain a pledge to guide short-term interest rates at minus 0.1% and long-term rates around 0%. It is also seen roughly maintaining its growth and inflation projections in a quarterly review of its long-term forecasts.

(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)

CHART OF THE WEEK:

Needless to say, investor anxiety is running high. CNN's Fear & Greed Index has swung from a reading of 70 indicating "Greed" down to just 7 indicating "Extreme Fear" in the span of just one month.



Market blogger and Chartered Market Technician Ryan Detrick looked for other instances of similar market turmoil in previous Octobers. Detrick found that since 1950 there have been 7 other years that were positive year-to-date going into October and saw the S&P 500 turn negative year-to-date during the month. "The good news", he writes, "is the final two months were higher 6 times and up 4.1% on average."

> *Since 1950, there have been 7 other years that were positive YTD going into October and saw the S&P 500 turn negative YTD during October.*
>
> *The good news is the final two months were higher 6 times and up 4.1% on average.*
>
> *— Ryan Detrick, CMT (@RyanDetrick) October 25, 2018*

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

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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 9.25 from last week's 9.50, while the average ranking of Offensive DIME sectors fell to 14.00 from last week's 13.00. The Defensive SHUT sectors widened their lead over the Offensive DIME sectors.

Note: these are "ranks", not "scores", so smaller numbers are higher ranks and larger numbers are lower ranks.

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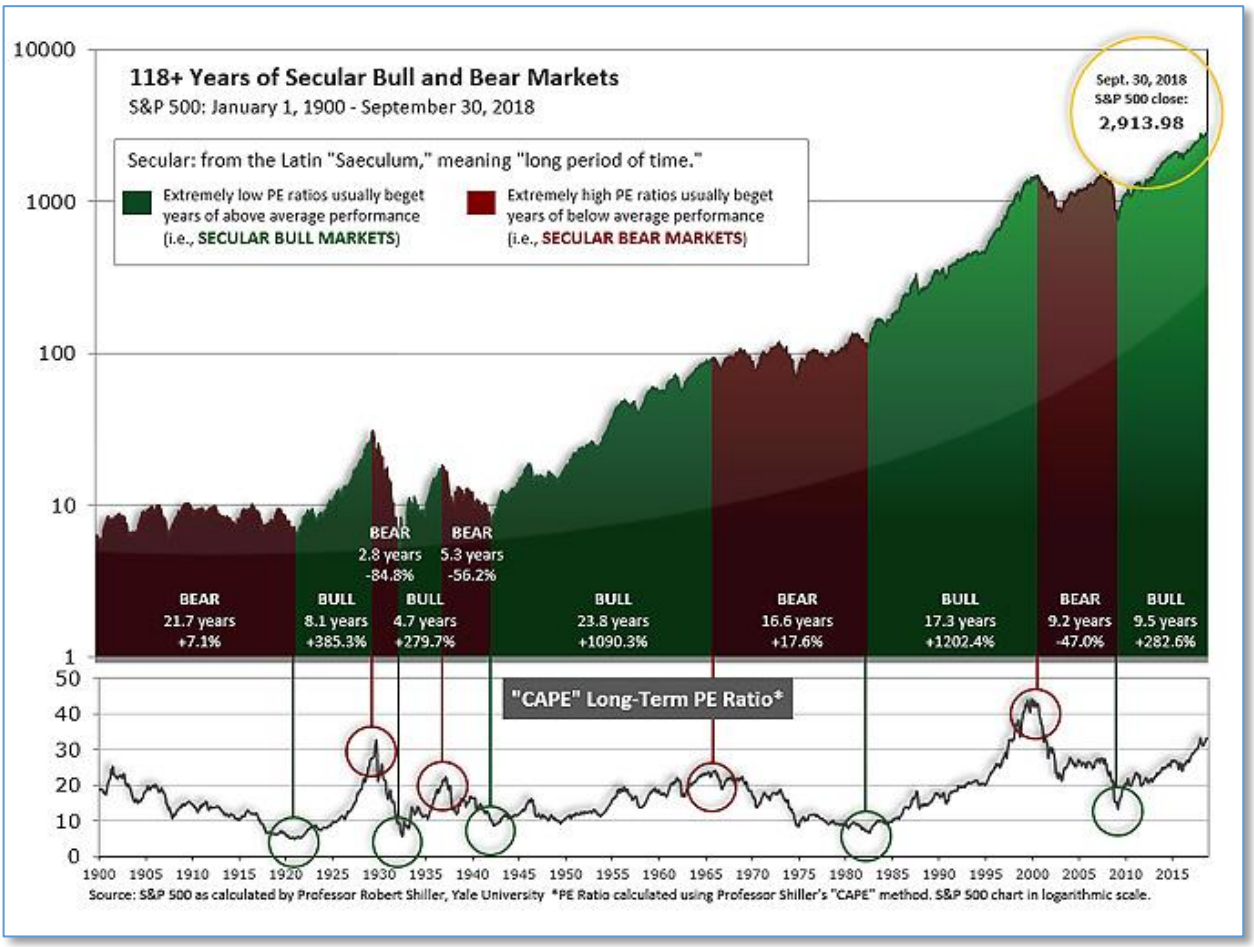

FIGURE ONE

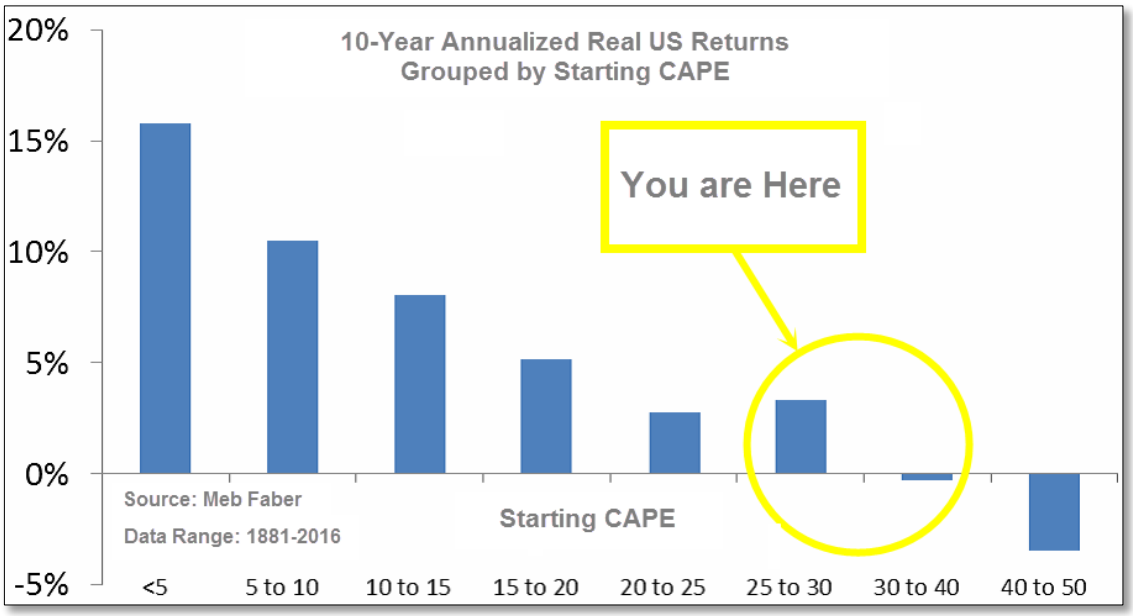

FIGURE TWO

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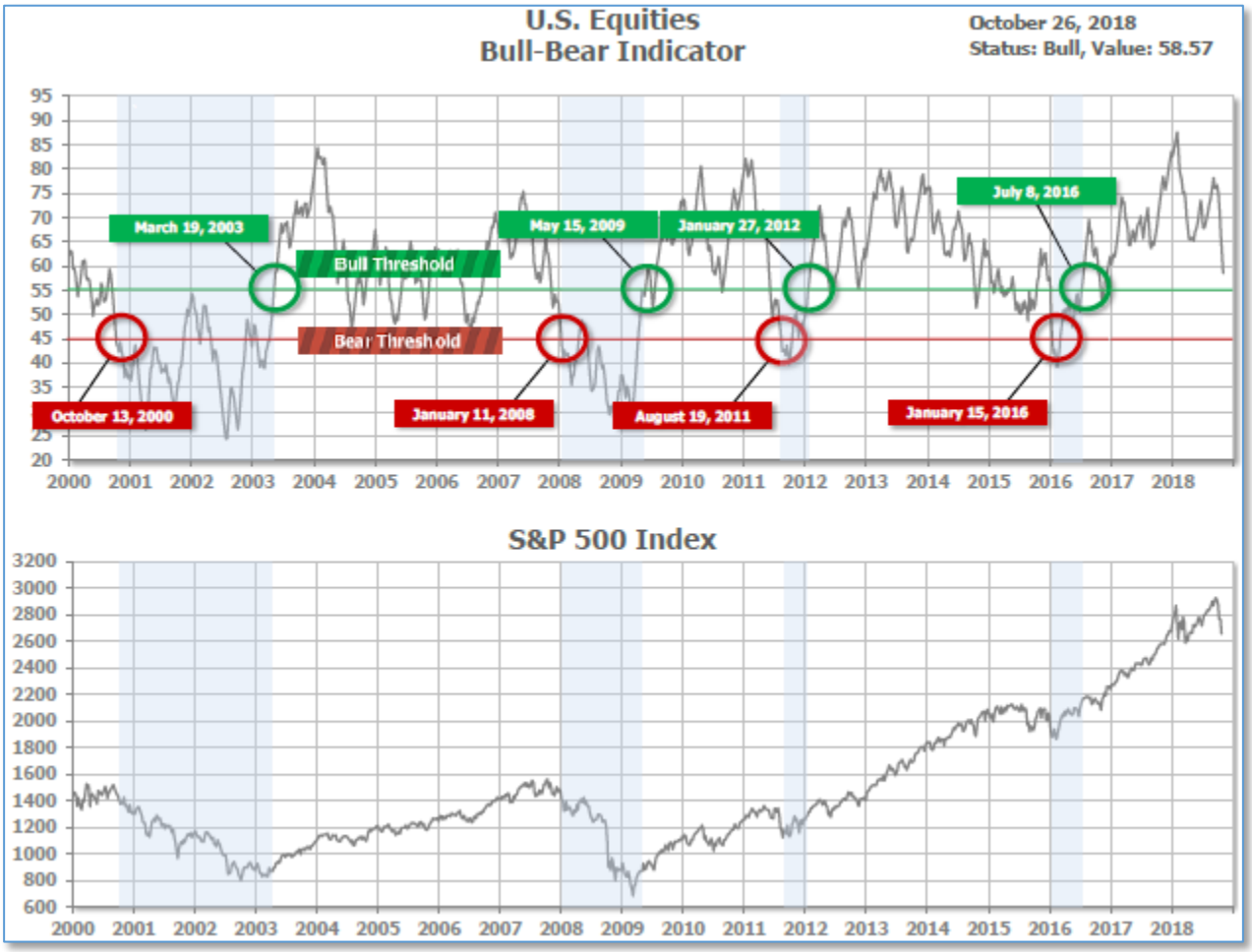

FIGURE THREE

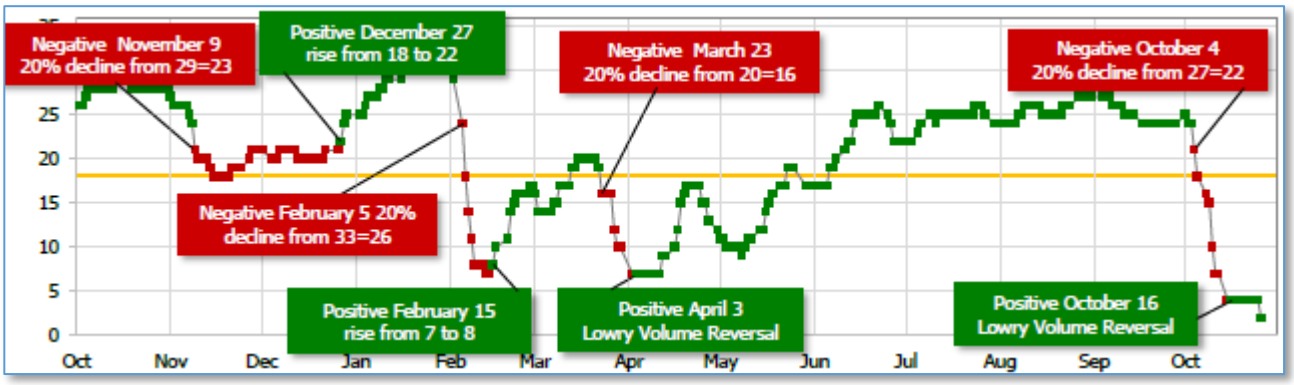

FIGURE FOUR

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U.S. Intermediate-Term Asset Class Rankings

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

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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 Pending Home Sales Index is a leading indicator of housing activity, measures housing contract activity, and is based on signed real estate contracts for existing single-family homes, condos and co-ops. Because a home goes under contract a month or two before it is sold, the Pending Home Sales Index generally leads Existing Home Sales by a month or two.

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.

The Non-Manufacturing Purchasing Managers Index is an index based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives, within 60 sectors across the nation, by the Institute of Supply Management (ISM). The ISM Non-Manufacturing Index tracks economic data, like the ISM Non-Manufacturing Business Activity Index. A composite diffusion index is created based on the data from these surveys that monitors economic conditions of the nation