Executive Summary

FALL 2018

The trend is your friend until the end when it bends.

This is a famous stock market quote. It means investors should stick with the major trend until the trend changes. When that happens, they should be flexible and adjust their views to the new reality despite whatever the economic backdrop might be. Markets are forward looking.

Despite the recent damage in the markets, the long-term trend of our domestic equity markets points up. On a shorter-term basis, we're again in a "correction," and the question is how much further it has to go. Sometimes, short-term trends turn into long-term, full blown bear markets. Whether this is just another random event with a long overdue correction in markets is unknown at the moment. We're watching closely. Our long-term market momentum models will tell us when the trend is changing. At the moment, it's close.

Here is how we assess the current situation, looking at the economic and technical factors that will eventually determine market direction.

Long Term Interest Rates:

These are *rising* and have broken to the upside of the declining trend of the last thirty-five years. There will be rallies in bonds from time to time (i.e., lower interest rates), but the long term trend is now upward. This indicates that economic growth is strong, but also means that Central Banks are no longer worried about anemic world growth. They're worried about inflation returning. Interest rates are going higher and "quantitative easing" is ending.

Monetary liquidity is one of the most important factors in determining when a bull market ends. The Federal Reserve has raised interest rates eight times in a row without stopping and another is due in December. This is a major headwind against further gains in markets in the near term.

Consumer Sentiment:

It is at twenty year *highs*. This is usually a contrary indicator seen at stock market tops.

Unemployment Rate:

This is at fifty year *lows*. As with consumer sentiment, it is also a contrary indicator, seen at market tops.

ECONOMIC GROWTH:

It's humming along with GDP increasing at rates not seen in many years.

TECHNICAL STRENGTH OF THE STOCK MARKET:

Although it's still bullish in the United States, technical strength is more negative in the rest of the world. U.S. valuations are extreme and are much more reasonably priced in Europe, Asia and other Emerging Markets. The question is how long this divergence can last. Eventually, there will be a "reversion to the mean." Either other markets will outperform American markets in future years and catch up to ours, or ours will catch up to theirs on the downside.

Our Assessment

Neutral. It's still too early to tell what will happen with the current correction. Will it instill fear back into investors the way the last correction did in February, thereby setting the stage for the upward market from March until recently? Or will this one finally turn into a real bear market? We'll rely on our proprietary momentum models to tell us what our stance should be.

As we often recommend: It pays to have some cash available to buy bargains when they come up. There are many bargains in value stocks here and many in Europe and Emerging Markets. It's a situation similar to the period of 1998-2000. Value and small caps were totally out of favor while mega-cap stocks couldn't be kept down in those years. Cisco, Dell, Intel, Qualcomm, and other mega-cap stocks kept rising day in and day out. Big banks and investment firms kept pushing them the same way they've been pushing our current FANG favorites (Facebook, Amazon, Netflix, and Google). Most of the former stocks fell eighty-five to ninety-five percent in the ensuing bear market while many value and small caps actually had positive performances.

The time to be most aggressive is after big market sell-offs and the time to be most fearful is after overly-enthusiastic investors have inflated market prices. These sorts of investors are still far too bullish. They need to feel the negative effects of the market more consistently before they learn this lesson.

The aforementioned overpowered stocks are now starting to have the opposite effect of the overwhelming influence they have had on the markets over the past two years. If this current correction continues, the heavy weighting of these stocks in the indexes will make it appear that the market is much weaker than it really is, thereby causing herd mentality to take over on the downside.