Market Monitor

Version 2018-07

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July 11, 2018

The *Market Monitor* newsletter is intended for individual investors with a desire to manage the conflicting goals of managing risk and earning a fair return by providing a unique perspective of general market conditions.

The market is stuck in a trading range that has persisted for about five months. Over the last month it has trended down from the top of that range, bounced and is once again bumping up against overhead resistance. This resistance level (the recent—last five month— highs on the S&P 500 and NYSE) has become a formidable barrier to the market continuing the bull market rally. The longer this overhead resistance remains in place, the more significant it becomes. Trading range environments like these are best left to nimble traders that can take advantage of very short term market movements. As investors, we are better suited to wait for a decisive penetration of either the top or the bottom of this range. A significant break above the top of the range, would indicate a higher demand for stocks and would tilt the odds in favor of a continuation of the bull market rally. However, a drop below the bottom of the range would indicate an elevated level of risk in the market.

Although I still believe odds currently favor a break to the upside based on relatively positive market breadth, the overall market environment has deteriorated over the last month. Specifically:

1) Market breadth, although still positive, has weakened.
2) Defensive sectors, such as utilities, consumer staples and real estate, are now outperforming many of the major market indices.
3) Some bond groups that were previously in downtrends are showing indications of bottoming or are in short-term uptrends.

These characteristics tend to be associated with weaker market environments; not strong ones. There are certainly plenty of headwinds for the market (trade wars, tightening financial conditions, flattening yield curve) but also tailwinds (strong U.S. economic growth, strong labor market, benign inflation trends). At some point, the balance will shift and a new trend will develop.

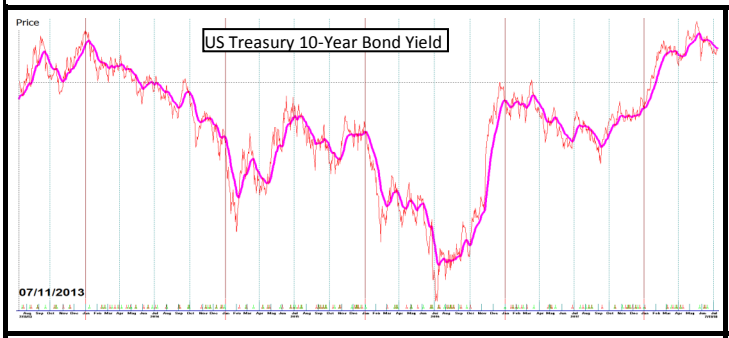
Summary Assessment

Indicator	Assessment
Business Cycle: Stage IV	Bonds: - Stocks: + Commodities: +
Long-Term Breadth	+
Short-Term Breadth	+
Junk bond Indicator	?
Market Indices	?

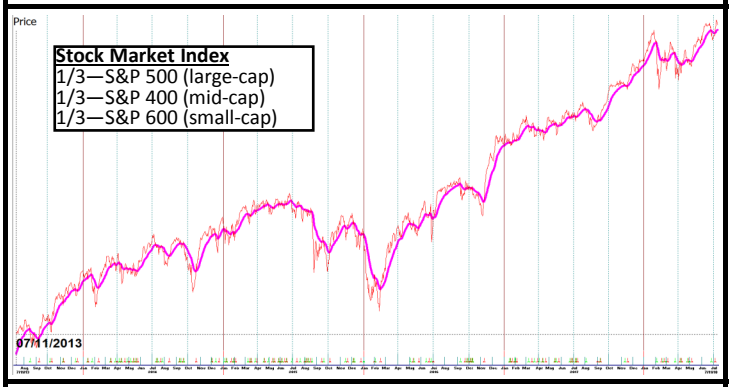
Economic (Business) Cycle

Five-Year Charts

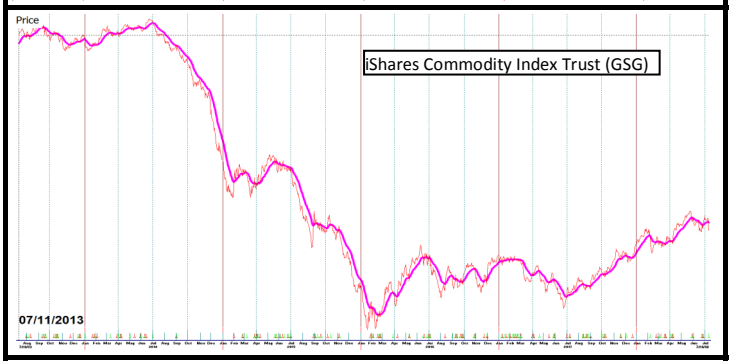
The business cycle is defined as alternating periods of expansion and recession. The purpose of reviewing the business cycle is to attempt to understand the macro-economic environment. This provides us clues as to how the broad asset categories (bonds, stocks and commodities) may perform. For purposes of the business cycle analysis, we will use a 21-day (approximately one month) moving average of the components of the business cycle as defined by Martin Pring in the *All Season Investor* to focus on the longer term trends.



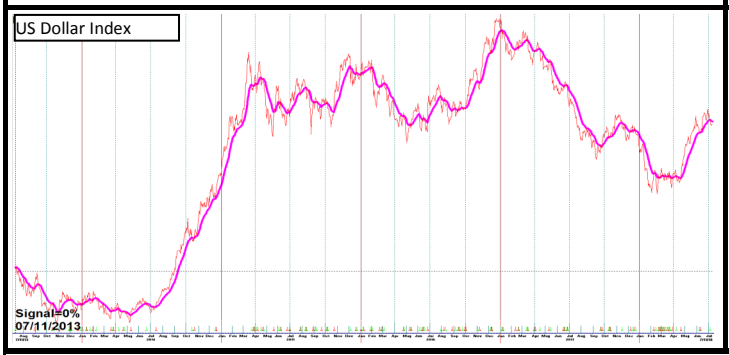
Yields on 10-year US Treasuries have started to turn down which in turn has a positive impact on bond prices (not shown). It is too early to tell if this is simply a pause in an ongoing uptrend or the start of a longer term decline in yields.



The 21-day moving average of the Stock Market Index dipped during the sell off in early 2018 but has recovered those declines and has resumed trending up.



Commodities appear to have completed a multi-year bottoming process and are now trending up.



The US Dollar is also trending up. Given that commodities have been able to continue to trend up despite the surge in the dollar indicates that there may be some underlining inflation pressures starting to develop.

Summary: I believe Stage IV (positive for stocks and commodities; negative for bonds) continues to best describe the current market environment.

Stage IV	
Bonds	-
Stocks	+
Commodities	+

Report produced with data through 7/11/2018

Long-Term Market Breadth

One-Year Charts

The New York Stock Exchange Composite Index is trending sideways. This is confirmed by the flattening of the 21– and 200-day moving averages.

The McClellan Summation Index is trending up but that uptrend has weakened over the last month. With the market decline in June, the McClellan Summation Index and its 21-day moving average turned down...something that hasn't transpired in previous selloffs during this trading range period.

The Cumulative 4-Week New High / New Low Indicator is trending up while the NYSE (price) continues to move sideways. This is an indicator of underlining strength and a positive for the market.

The number of stocks in long-term uptrends has dropped to about 55% but is still above the neutral 50% level indicating that the majority of stocks are in long-term uptrends.

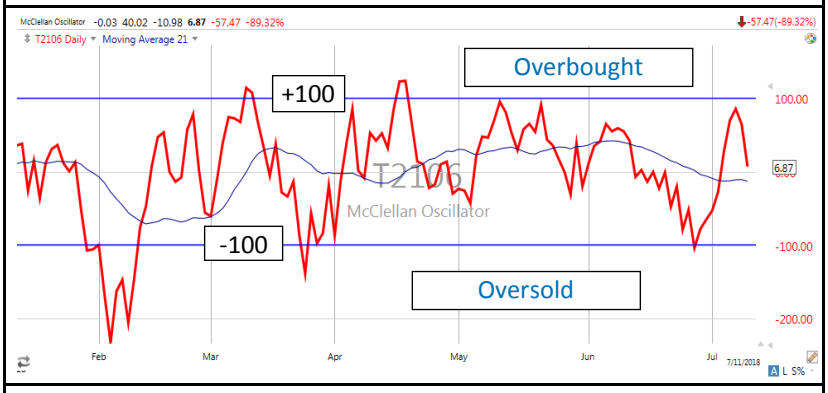
	Long-Term Market Breadth
Summary: Long-term breadth remains positive but has weakened a bit over the last month.	+

Short-Term Market Breadth

Six-Month Charts

The New York Stock Exchange Composite Index is trending sideways on a short-term basis with both the 21- and 50-day moving averages struggling to find direction.

Despite the sideways market action, the Advance/ Decline Line continues to trend up.



The McClellan Oscillator has remained in the normal range between +100 and –100 since May. However, with the June decline, the McClellan Oscillator dipped down to the –100 level before bouncing. The steeper decline in the McClellan Oscillator compared to previous declines over the last several months indicates that the market has weakened.

The number of stocks above their 40-day moving average, an indication of a short-term uptrend, is 57%.

Summary: Short-term market breadth is positive but has weakened a little over the last month.

Short-Term Market Breadth
+

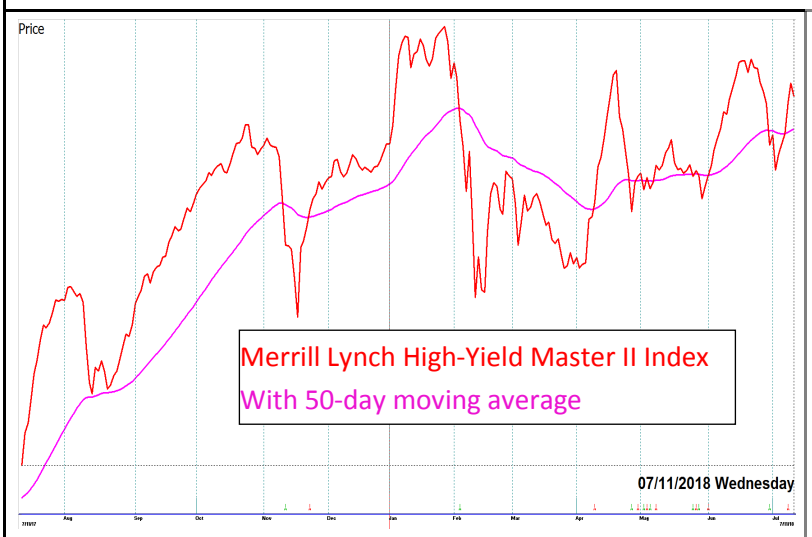
Junk Bond Indicator

One-Year Charts

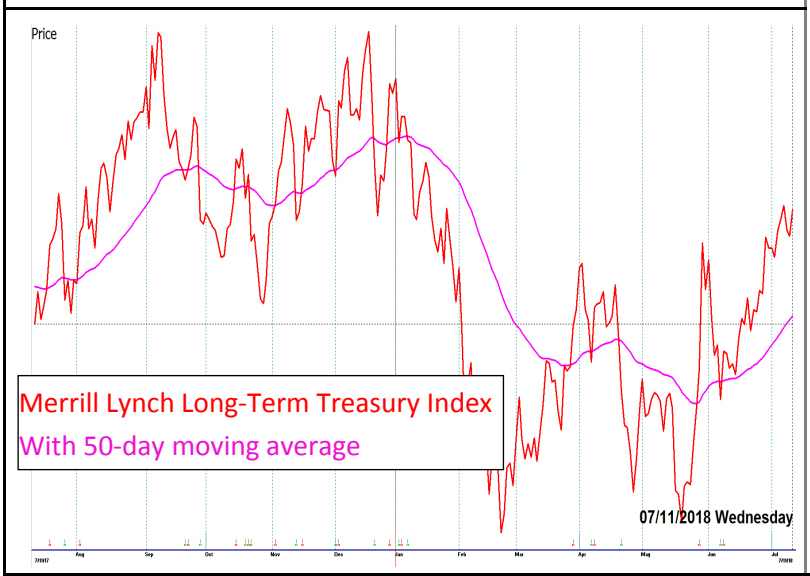
Junk bonds are one of the best indicators of overall market sentiment. When risk rises, junk bond prices fall as investors demand a higher yield to compensate them for the additional risk (remember bond prices fall as yields rise). When risk subsides, junk bond yields tend to fall given more favorable market conditions (i.e. lower risk). Falling yields drive junk bond prices higher. As junk bonds generally trend in the same direction as stocks, following the trend of junk bonds provides a good overall indicator for the equity markets. Assessing junk bonds in conjunction with US Treasuries gives us a reasonable clue to the overall risk in the market.

There are four general configurations for junk bonds and US Treasuries:

- Junk bonds rising, Treasuries falling – Generally a positive market environment.
- Junk bonds rising, Treasuries rising – Generally a positive market environment.
- Junk bonds falling, Treasuries falling – Generally an uncertain market environment.
- Junk bonds falling, Treasuries rising – Generally a negative market environment, especially if Treasuries are surging higher.



The Merrill Lynch High-Yield Master II Index (junk bonds) continues to trend sideways and is moving up and down in concert with the equity markets.



While junk bonds have fluctuated up and down over the last several months, US Treasuries have headed higher over the last two months. This may be an early indication that investors are removing some risk in favor of the safety of treasuries.

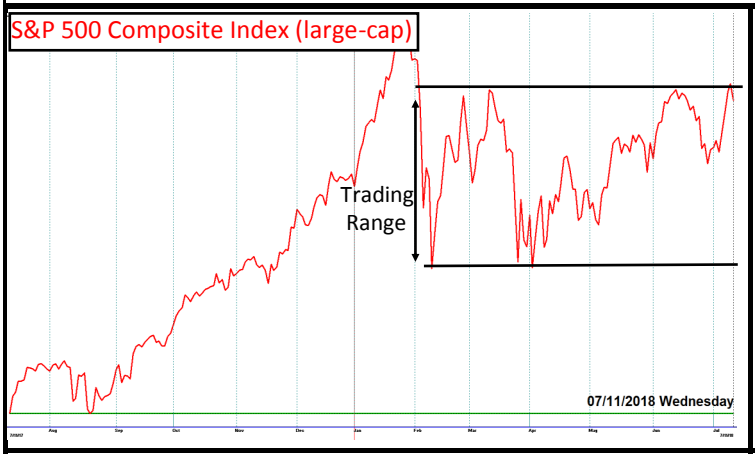
Summary: The junk bond indicator continues to suggest an uncertain market environment.

Junk Bond Indicator
?

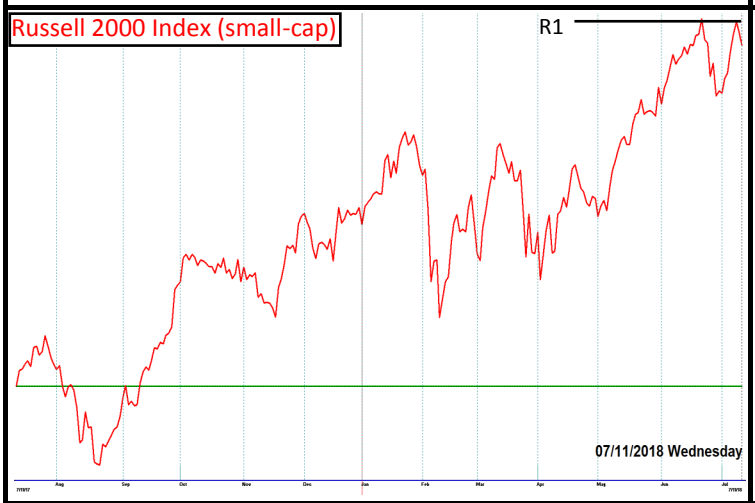
Market Indices

One-Year Charts

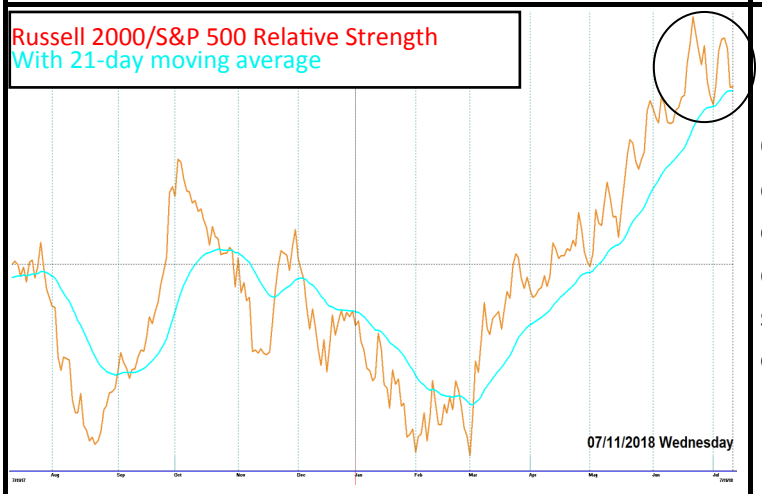
Tracking the major indices allows us to understand how the broad market is performing. Although there is no perfect market index, we can track multiple indices to help us understand the trend (either up, down or sideways). In addition, by studying the behavior of different indices we can attempt to identify any biases in the market (i.e. capitalization bias, style bias, etc.).



The S&P 500 remains range bound bouncing off the top of the trading range for the fourth time in the last four months. The top of the trading range is turning into a significant level of resistance.



Although small-cap stocks have fared much better than large cap stocks, the Russell 2000 is hitting overhead resistance (marked as R1).



One of the defining characteristics of the recent market environment is the relative outperformance of small-cap stocks relative to large-cap stocks. The trend, as defined by the 21-day moving average, is still up but the strength of the relationship has become less certain over the last month (see circled area).

Summary: Most the major indices are bumping up against a significant level of resistance. If the resistance levels can be penetrated, odds favor a continuation of the uptrend. Until then, some level of caution is still warranted.

Market Indices
?

Market Watch List

Calculation Period: 12/31/2017—7/11/2018

Recent Rank: 5/31/2018—7/11/2018

Rank	Ticker	Name	Period Return	Annualized Return	UI	UPI	Maximum Drawdown	Recent Rank
1	BD03	FLOATING RATE BONDS	1.72%	3.31%	0.14	23.94	-0.45%	17
2	BD06	HIGH YIELD MUNICIPAL BONDS	2.90%	5.60%	0.47	12.03	-1.05%	3
3	EQ12	TECHNOLOGY	13.47%	27.29%	4.09	6.68	-9.84%	16
4	EQ18	CAP SMALL	10.27%	20.53%	3.32	6.21	-9.24%	9
5	EQ19	STYLE GROWTH	10.08%	20.12%	3.54	5.69	-9.77%	12
6	EQ05	CONSUMER DISCRECTIONARY	9.72%	19.38%	4.40	4.41	-9.36%	7
7	EQ01	AEROSPACE/DEFENSE	5.15%	10.07%	3.47	2.92	-8.24%	33
8	EQ07	HEALTHCARE	9.17%	18.23%	6.29	2.91	-11.29%	5
9	EQ03	BIOTECHNOLOGY	12.10%	24.36%	8.56	2.85	-16.80%	8
10	EQ17	CAP MID	5.07%	9.90%	4.20	2.37	-9.76%	14
11	EQ16	CAP LARGE	5.07%	9.90%	5.02	1.98	-10.05%	10
12	CO05	COMMODITY ENERGY	7.47%	14.75%	8.20	1.80	-15.71%	27
13	EQ15	UTILITIES	2.85%	5.51%	3.69	1.51	-9.27%	13
14	EQ20	STYLE VALUE	2.87%	5.55%	4.93	1.13	-9.79%	11
15	EQ11	REAL ESTATE	2.00%	3.85%	6.15	0.63	-11.93%	2
16	EQ02	BANKING / FINANCIALS	1.18%	2.26%	4.78	0.48	-8.91%	25
17	BD09	INFLATION PROTECTED BONDS	0.02%	0.04%	1.22	0.07	-2.25%	6
18	BD05	MUNICIPAL BONDS	-0.04%	-0.07%	1.17	-	-1.91%	15
19	BD04	JUNK BONDS	-0.63%	-1.20%	1.40	-	-2.13%	20
20	BD07	MORTGAGE-BACKED SECURITIES	-0.92%	-1.75%	1.46	-	-2.25%	21
21	BD10	PREFERRED SECURITIES	-2.08%	-3.93%	1.73	-	-2.93%	18
22	BD02	CORPORATE BONDS	-2.06%	-3.90%	2.27	-	-3.45%	23
23	BD01	US TREASURIES	-1.38%	-2.62%	2.29	-	-3.60%	19
24	CO02	COMMODITY GENERAL	-0.39%	-0.74%	2.85	-	-7.21%	31
25	EQ13	TELECOMMUNICATION	-0.33%	-0.62%	4.95	-	-8.51%	4
26	BD08	EMERGING MARKET DEBT	-5.03%	-9.39%	4.24	-	-8.51%	26
27	EQ08	INDUSTRIALS	-0.70%	-1.32%	5.26	-	-8.99%	29
28	EQ09	INSURANCE	-3.07%	-5.78%	6.43	-	-10.80%	24
29	CO04	COMMODITIES PRECIOUS METALS	-6.58%	-12.18%	6.73	-	-11.06%	30
30	FR02	FOREIGN - EUROPE	-2.23%	-4.21%	6.70	-	-11.12%	28
31	FR03	FOREIGN - ASIA PACIFIC (EX-JAPAN)	-4.85%	-9.05%	6.04	-	-11.13%	37
32	FR01	FOREIGN - JAPAN	-5.48%	-10.20%	6.33	-	-11.14%	35
33	EQ14	TRANSPORTATION	-2.36%	-4.46%	7.25	-	-11.70%	34
34	FR06	FOREIGN - INTERNATIONAL SMALL CAP	-5.57%	-10.37%	6.44	-	-12.44%	36
35	CO01	COMMODITY AGRICULTURE	-8.34%	-15.32%	4.84	-	-12.53%	39
36	EQ10	MATERIALS	-2.97%	-5.58%	7.50	-	-12.66%	32
37	EQ06	CONSUMER STAPLES	-4.49%	-8.40%	8.86	-	-13.91%	1
38	CO03	COMMODITY METALS	-4.75%	-8.87%	5.09	-	-14.54%	40
39	EQ04	CONSTRUCTION	-7.44%	-13.72%	11.00	-	-14.79%	22
40	FR05	FOREIGN - EMERGING MARKET	-7.34%	-13.54%	8.79	-	-17.57%	38

The market watch list is comprised of equally weighted groups of ETFs and mutual funds representing each sector/group. You cannot invest directly into one of the market watch list components.

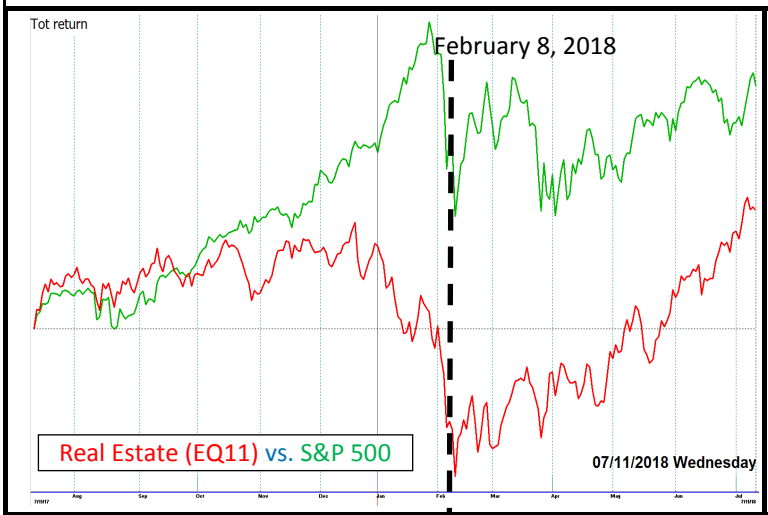
The market watch list is sorted first by Ulcer Performance Index (UPI), a measure of risk adjusted return, and then by Maximum Drawdown (MDD) for the calculation period. Negative UPI values are set to zero. Recent Rank indicates how sectors rank (based on a UPI / MDD ranking) for the Recent Rank time period. Sectors with the largest positive change (moved up 10 spots or more) are highlighted in green and indicate sectors with increasing momentum. Sectors with largest negative change in ranking (moved down 10 spots or more) are highlighted in red, indicating sectors with diminishing momentum.

Market Watch List—Selected Charts

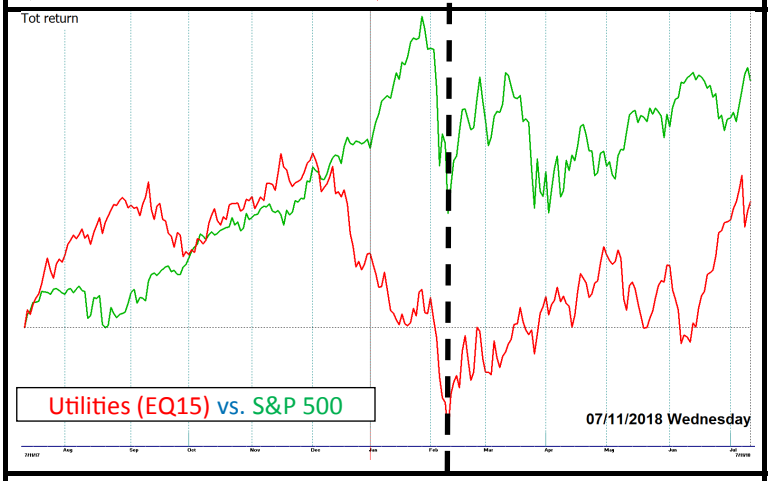
One-Year Charts

I have ranked the Market Watch List from the beginning of the year so that the results include both the strong run up in January as well as the volatile period that followed. There is no perfect time period to rank the list and I suggest that investors look across multiple time periods to get a good idea of how the market is performing. The Recent Rank column includes the period from May 31, 2018.

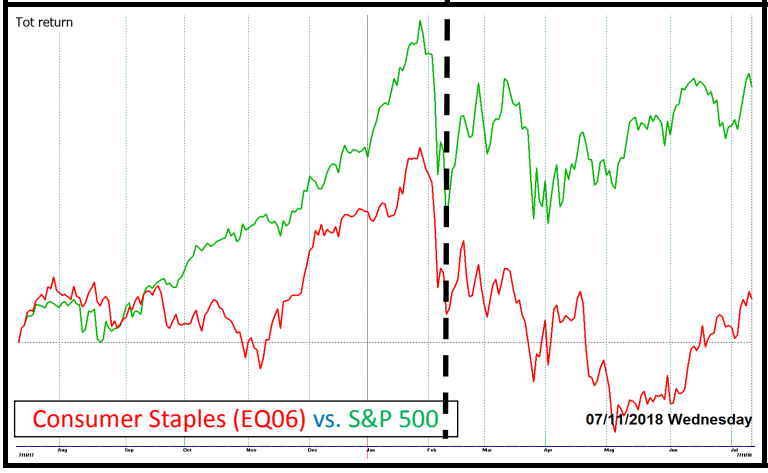
Below are three sectors that are showing recent relative strength when compared to the S&P 500. What is interesting about these three groups are that they are defensive sectors which tend to outperform when risk is elevated.



Real Estate (EQ11) started to outperform on February 8, 2018 just after the sharp February selloff. Since February 8, EQ11 has returned 15.8% compared to 7.5% for the S&P 500.



Utilities (EQ15), another defensive sector, has also outperformed the S&P 500 returning 13.4% since February 8.

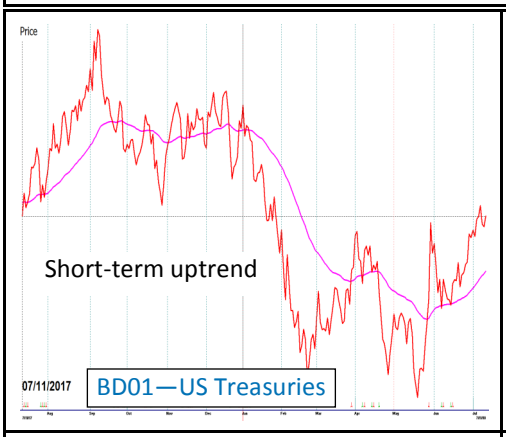


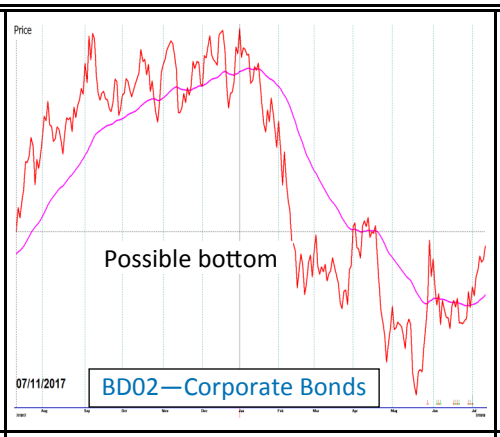
Consumer Staples (EQ06) continued to decline after February 8 but eventually bottomed on May 3. EQ06 has outperformed the S&P 500 from May 3 returning 7.3% vs. 5.5% for the S&P 500.

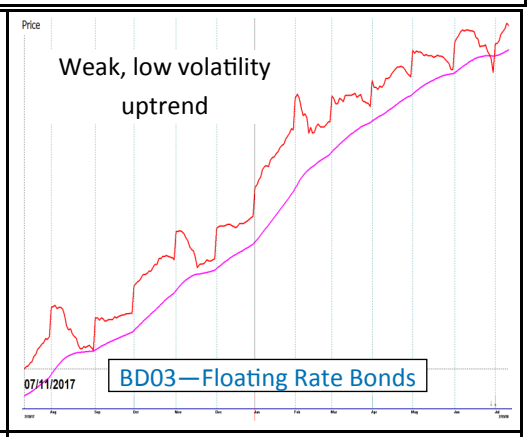
Market Watch List—Selected Charts

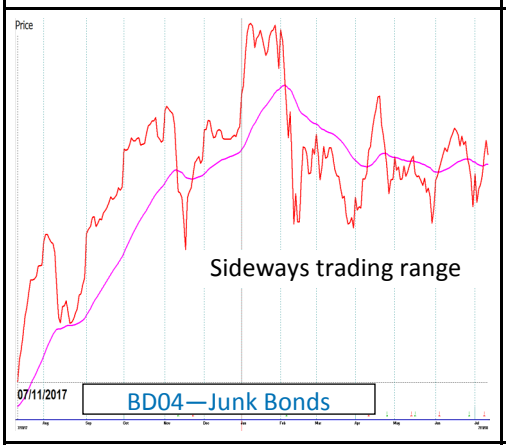
One-Year Charts

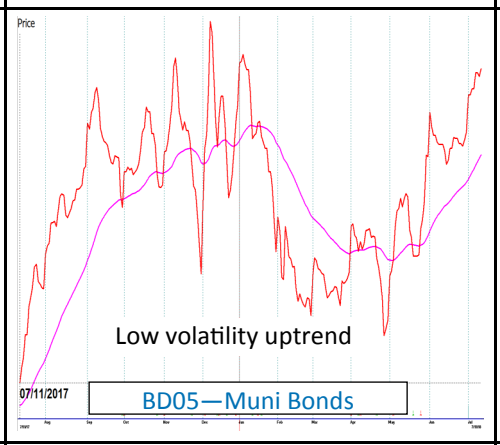
The following charts represent the 10 bond and income groups included in the Market Watch List plotted with their 50-day moving average. The moving average is used to help us visualize the trend.

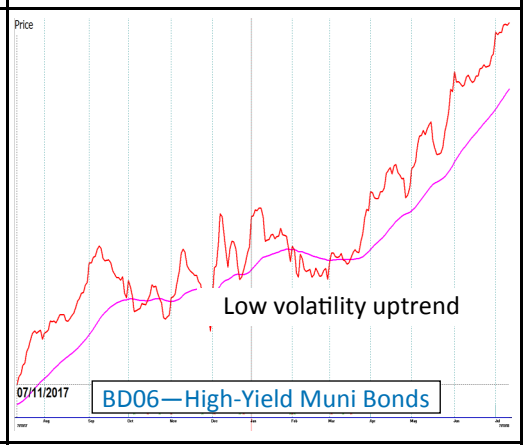


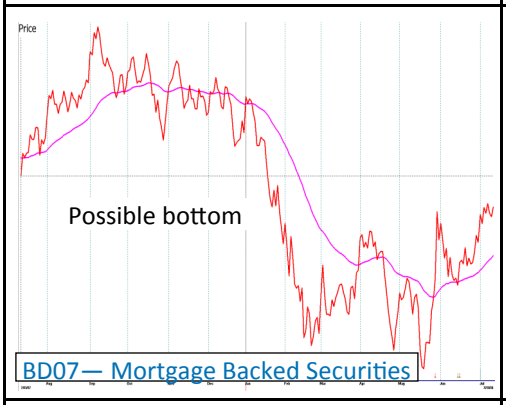


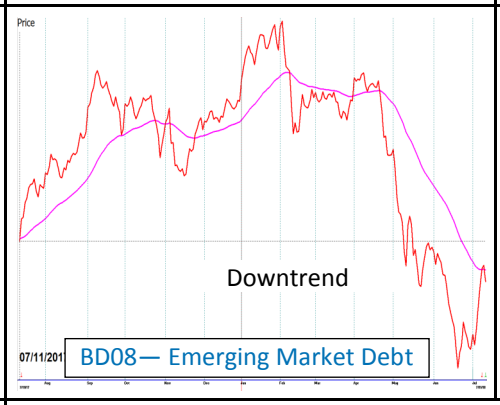


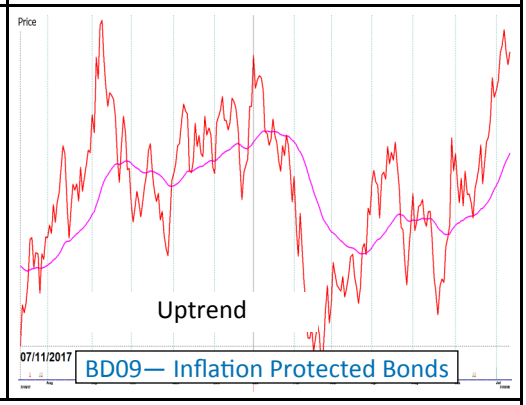


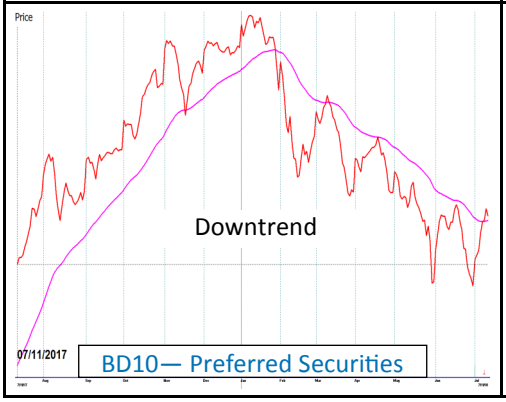












The bond market has changed over the last month. Some of the groups that were in downtrends are forming bottoms or are in short-term uptrends (including US Treasuries — BD01, Corporate Bonds — BD02, Mortgage Baced Securities—BD07 and Inflation Adjusted Bonds—BD09).

One area of the bond markets that is trending up is municipal bonds (Muni bonds - BD05 and High-Yield Muni Bonds BD06). Emerging Market Debt—BD08 and Preferred Securities—BD10 continue to trend down.