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June 23, 2017

Gleanings

A Monthly Chart Presentation and Discussion Pulling Together the Disciplines of Economics, Fundamentals, Technical Analysis, and Quantitative Analysis

"You Know It's a Bull Market"

"Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria."
– Sir John Templeton

Given the stock market's recent "flat lining," we once again are hearing the bears trumpet that a bear market is at hand, or even worse there is going to be a "market crash." Recall, these are the same "bear boos" that surfaced as the S&P 500 (SPX/2434.50) spent some 21 months trapped in a trading range. Andrew and I maintained that all that was happening was an upside consolidation after a ~200% rally. As a side bar, in 2015 the D-J Industrial Average traveled over 31,000 points and went absolutely nowhere. During that upside consolidation the bears growled, "I told you this entire rally was only because the Federal Reserve pumped massive liquidity into the economic system." After reminding those folks earnings have done pretty well since the 2008 disaster, and that the equity markets do not care about the absolutes of good or bad but only if things are getting better or worse, we subsequently related this story from Wall Street icon Ray Devoe titled, "What's a Bull Market, Dad?"

Building on John Templeton's quote, "Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria," Devoe breaks a secular bull market into six phases (as paraphrased): 1) Aftershock/Rebuilding; 2) Guarded Optimism; 3) Enthusiasm; 4) Exuberance; 5) Unreality; 6) Cold Water (the bubble bursts). Speaking to the first point, every bear market ends with a selling climax (a bang), or a selling dry-up (a whimper). March 2009's bottom was a "bang" with a sharp V-shaped bottom followed by a subsequent strong rally. A "bang bottom" causes the last bull to capitulate and sell before an anticipated even worse decline ensues. Such a "sold out" condition tends to be followed by an explosive rally. Phase 2 (Guarded Optimism) is where people do not believe a bottom has been achieved and such "growls" like, "This is only a bear market rally" are heard. At this stage investors that managed the risk, like those that honored the Dow Theory "sell signal" of November 21, 2007, and raised some cash, sell the stocks they bought at the 2009 bottom for a small profit.

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Jeffrey Saut

"You Know It's a Bull Market"

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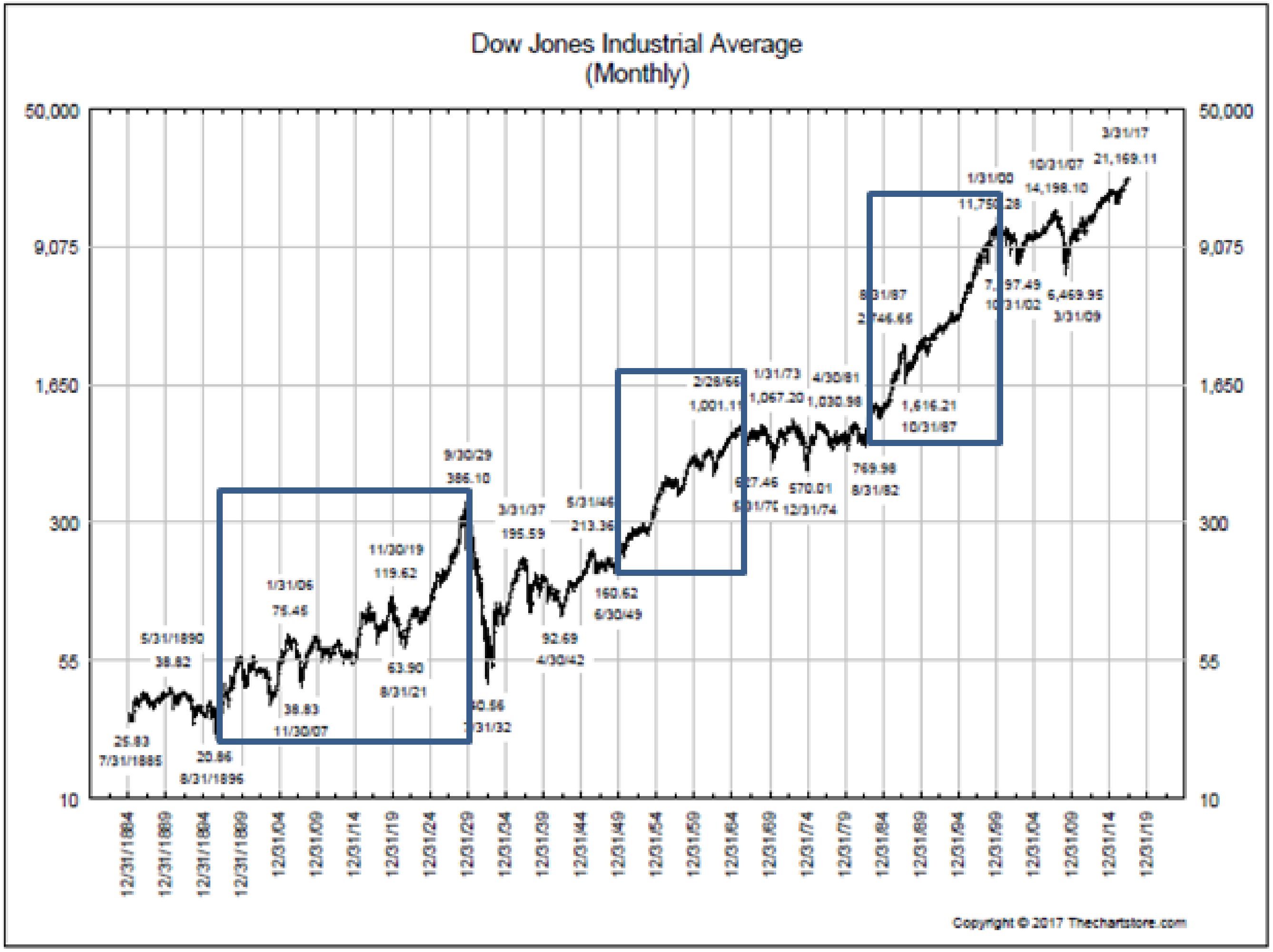
Phase 3 (Enthusiasm) is where the economy, and general business conditions, begin to improve and it is reflected in higher equity prices. The news gets better and better, which causes more economic expansion, leading to further stock market gains. While we do not have time to go into the remaining stages, we think the current market is in phase 2, "Guarded Optimism." If correct, it would fit with our supposition that we have – Enthusiasm, Exuberance and Unreality – before the "Cold Water" arrives. That would also foot with our premise there is likely another eight to nine years left in this secular bull market. And if past is prelude, the S&P 500 compounds at its historical "bull run" rate of 16% per year.

Given those gleanings, we thought it would be appropriate to republish one of our strategy reports from a few years ago because its advice is timeless. Indeed, after 46 years in this business we have seen a number of cycles, and developed a long-term perspective, much like Richard Russell wrote about in "Rich Man, Poor Man." I like this story:

> *In the investment world wealthy investors have one major advantage over the little guy, the stock market amateur and the neophyte speculator. The advantage wealthy investors possess is they DON'T NEED THE MARKETS. I can't begin to tell you what a huge difference that makes both in one's mental attitude and in the actual handling of one's account. The wealthy investor doesn't need the market because he already has all the income he needs. He has money coming in via bonds, T-bills, money market funds, real estate, and stocks. In other words, the wealthy investor never feels pressured to 'make money' in the market.*
>
> *The wealthy investor tends to be an expert on values. When bonds are cheap and bond yields are irresistibly high, he buys bonds. When stocks are on the bargain table and stock yields are attractive, he buys stocks. When real estate is a great value, he buys real estate. When great art or fine jewelry is on the 'giveaway table,' he buys them. In other words, the wealthy investor puts his money where the values are. And if there are no outstanding values, the wealthy investor waits. He can afford to wait. He has money coming in daily, weekly, monthly. In other words, he doesn't need the market. He knows what he is looking for, and he doesn't mind waiting weeks, months, or years (they call it patience).*

Jeffrey Saut

These Are What Secular Bull Markets Look Like



Source: Thechartstore.com.

Jeffrey Saut

This Was the 21-Month Long Range-Bound Stock Market (Upside Consolidation), Which Broke Out To the Upside

Source: Thechartstore.com.

Jeffrey Saut

The Six Mindset Changes Investors Go Through In a Secular Bull Market. Currently, We Think the Market Is in Stage II

I. Aftershock and Rebuilding

II. Guarded Optimism

III. Enthusiasm

IV. Exuberance

V. Unreality

VI. Cold Water and Disillusionment

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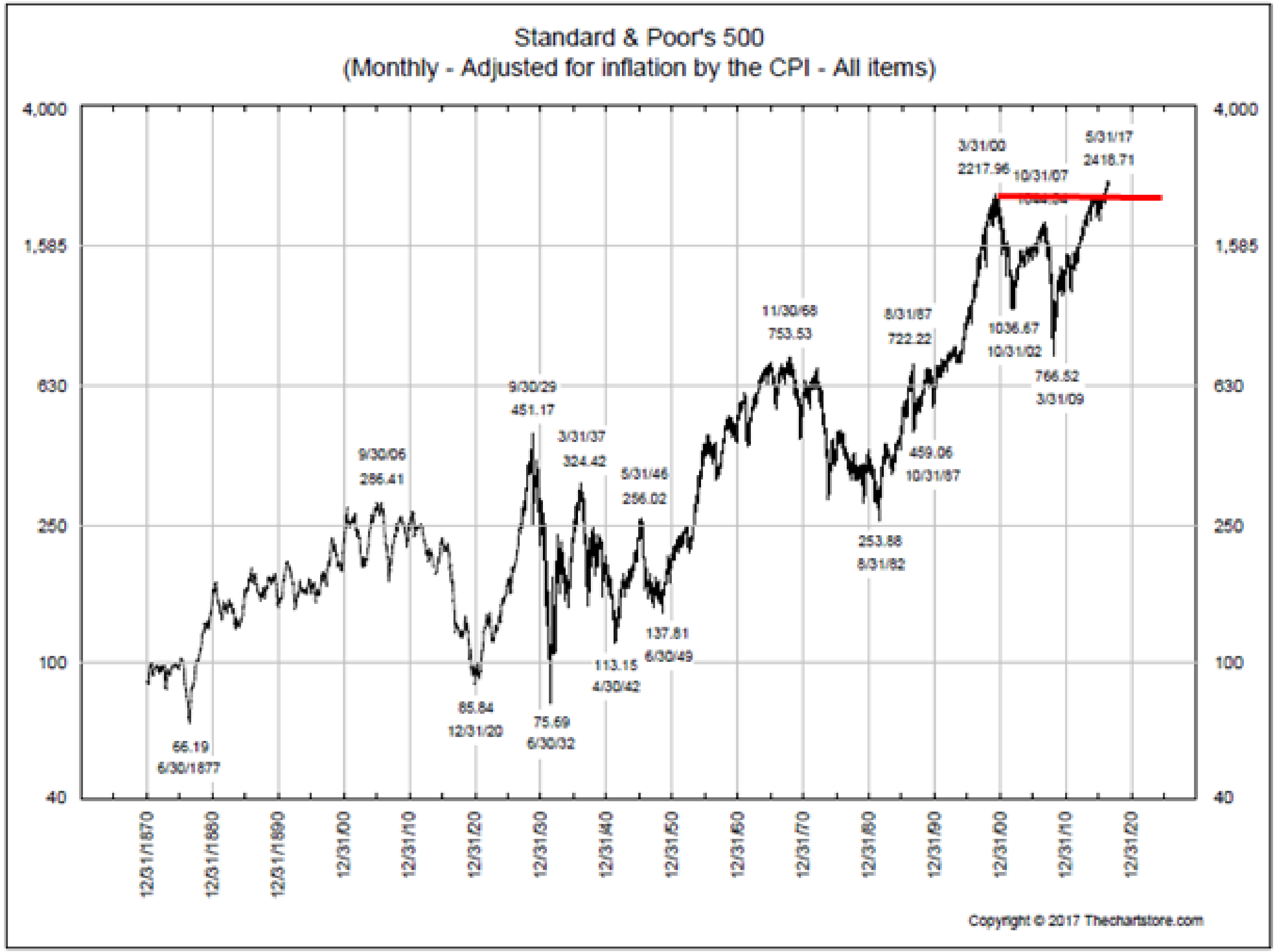
Jeffrey Saut

Think About This, Adjusted For Inflation, the S&P 500 Is Not Much Higher Now Than It Was in the Year 2000



Source: Thechartstore.com.

Economic & Market Update

Equity Markets/Technical Analysis

- **Market Outlook** – We believe the market action to be a solid breakout to new all-time highs. Sentiment remains negative and until such time that it turns positive, we remain bullish.

  Earnings – For 2Q17, the **estimated earnings growth rate** for the S&P 500 is now 6.5%. The Energy sector is expected to lead the way on weak 2Q16 comps. Ex-energy, earnings are expected to grow 3.6%. Revenue growth for the quarter is pegged at 4.9%, with broad participation – only Telecom Services is expected to report a decline in revenues.

  S&P 500 Earnings estimates*:
  2017 - $128.17, **2018** - $145.67
  Current P/E: 2017 – 19.0x, 2018 – 16.7x

  S&P 500
  Key support: 2415, 2400-2405, 2370-2380, 2350
  Key resistance: 2450-2460

- **Sectors** – High conviction to overweight Financials with the Fed signaling three rate hikes in 2017 (now two in the books).

  Positive: Energy, Financials, Industrials, Tech

  Neutral: Healthcare, Consumer Discretion, Telecom, Materials

  Negative: Real Estate, Utilities, Consumer Staples

Monetary Policy, Inflation, FX

- **FOMC Meeting** (June 14) – Again, no surprises. Policymakers increased the target range (1.0% - 1.25%) for the federal funds rate by 25 bp.
  Dot Plot – dots did not shift by a lot; some higher dots (expectation for steeper rate increases) shifted a bit lower in 2018.
  Summary of Economic Projections – Fed officials did not revise their GDP forecasts by much (currently 2.2% for 2017), but inflation and unemployment revised lower.
  Yellen press conference – Fed chair downplayed recent soft econ data and low inflation numbers.

- **Consumer Prices** (CPI – Bureau of Labor Statistics) - The Consumer Price Index rose 1.9% in May. Ex-food& energy, the CPI rose 1.7% y/y. Gasoline (3.4% of the overall CPI) fell 6.4%

- **The Producer Price Index** (PPI – Bureau of Labor Statistics) - The Producer Price Index was flat in May. Ex-food & energy, the PPI rose more than expected (median forecast: +0.2%), boosted by a 1.1% gain in trade services.

- **Exchange rates** (June 22)
  EUR/USD $1.114
  GBP/USD $1.266
  USD/JPY...... ¥111.37
  USD/CAD $1.324

U.S. Economy

- **Industrial Production** (Federal Reserve) - The headline figure was softer than expected in May (median forecast: +0.2%), with a slight upward revision to April and a downward revision to March. A soft month is not much to worry about when it follows a strong gain, but the overall trend in factory output is lackluster-to-moderate.

- **Retail Sales** (Census Bureau) – Retail sales (-0.3% vs. +0.1% forecast) were weaker than expected. Weak consumer spending may be partly explained by the soft growth in real earnings (y/y), but real wage growth should pick up as gasoline prices stabilize or move a bit lower.

- **Existing Home Sales** (National Assn Realtors) – Existing home sales increased 1.1% over April. The expansion is likely due to a dip in mortgage rates and healthy employment. Nevertheless, supply is constrained, especially at the lower end.

- **May Employment Report** (Bureau of Labor Statistics) – Nonfarm payrolls rose by 138K vs. expectations for +185K. The unemployment rate (4.3%) fell further, now at lowest level since March 2001. Tight labor market conditions have not led to an appreciable pickup in wage growth. Average hourly earnings are trending at just 2.5% y/y – better than a couple of years ago, but relatively moderate relative to past periods when the unemployment rate was so low.

Global Economy

- **Eurozone** – The European Central Bank left short-term interest rates unchanged and did not alter its asset purchase program. However, there was a small tweak in the ECB's forward guidance: *"The Governing Council expects the key ECB interest rates to remain at their present levels (vs. the previous 'at present or lower levels') for an extended period of time, and well past the horizon of the net asset purchases."*

- **Bank of England** (BOE) – After the central bank's monetary policy board voted 7-1 to keep interest rates on hold in May, the split narrowed to 5-3 in June. The BOE held rates steady at 0.25% and despite the recent inconclusive general election and fragile U.K. economy as Brexit talks begin, the narrowing of the vote looks to put the BOE closer to a rate hike.

- **Oil** – Oil has slid close to 10% since this time last month on increased U.S. production, which hit its highest level since 2015 in this week's EIA report**.** As the Baker Hughes rig count has risen for 22 straight weeks, crude is likely to stay under pressure until we see some signs of stabilization or a reduction in rigs.

Source: FactSet, Raymond James Research. *S&P 500 earnings estimates are bottom-up operating earnings as of 6/15/17 market close, provided by Standard & Poor's.

Andrew Adams

S&P 500 Major Lines

The resistance line drawn from the May 2015 and March 2017 previous all-time highs remains a potential roadblock for the S&P 500, but the good news is that there should be ample support on the downside. The area around 2400 is probably the first key zone to watch, but the two rising green support lines should also help to boost the index up should it fall.

Source: Stockcharts.com.

Andrew Adams

Long-Term Resistance

That resistance line connecting the May 2015 and March 2017 highs actually has a long history of importance, acting as a cap to gains back in the bull market of the 1960s and then providing a floor for the S&P 500 from 2003-2007. This helps increase the line's importance, but keep in mind. the index did manage to trade well above it back in the 1990s and during that early 2000s period.

Source: Worden TC 2000.

Andrew Adams

Technical Price Target Almost Achieved

From early 2014 to mid-2016, the S&P 500 mostly traded back and forth within a wide range. The height of the range from the May 2015 high to the February 2016 low, was 324 points, which we projected upward back last July when the S&P 500 initially broke out of that range to arrive at a minimum price target of 2458 (2134+324). The action, so far, has taken the index just a few points away from this target, which, again, represents the **minimum** price projection of the move off the 2014-2016 trading range.

Source: Stockcharts.com.

Andrew Adams

Health Care Breakout

Helping the broad stock market recently has been the Health Care sector, which has broken out of its own long trading range over the last couple of weeks. The sector will now, hopefully, build on this wide base and ideally will not retreat back into the previous trading range. Health Care has also been outperforming the S&P 500 as a whole recently (bottom panel), but may be approaching resistance on a relative strength basis.

Source: Stockcharts.com.

Andrew Adams

Biotechnology Leading the Charge

Helping to push the broader Health Care sector higher has been the Biotechnology subsector, which recently hit levels not seen since the first week of 2016. It should now have its own base to build on, as the green lines below should act as support should it weaken again.

Source: Stockcharts.com.

Andrew Adams

Energy Update

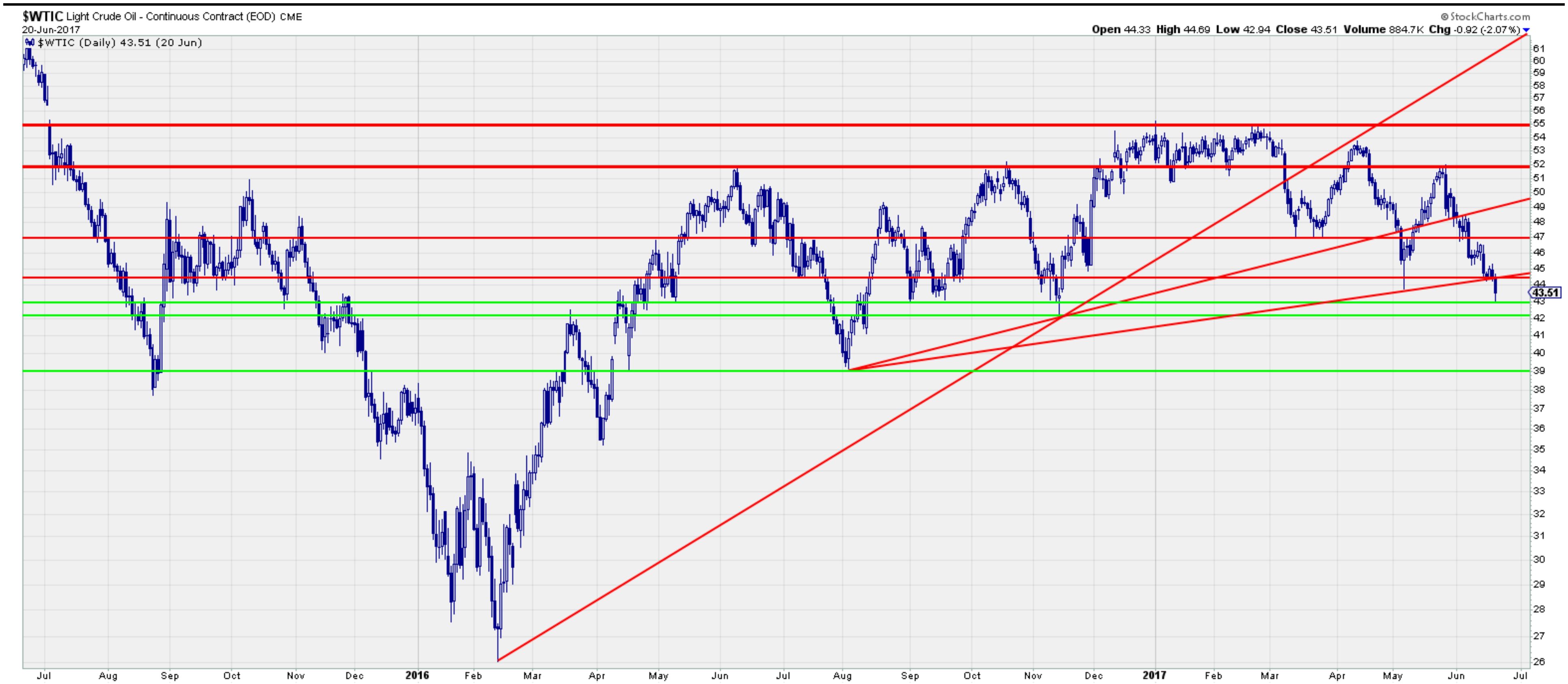
The Energy sector has been under a lot of pressure for the last several months, as oil prices have dipped back down toward their lowest levels since late 2016. There is some slight technical hope at the dual support zone created by the two green lines below, but until oil turns around, it may be tough for the Energy sector to do significantly better.

Source: Stockcharts.com.

Andrew Adams

Oil Update

Taking a closer look at oil, the market's focus appears to be more on the fundamentals, but the low $40 zone should have a few support levels to hopefully help provide a floor for the commodity. The area between $42-$43 is the first spot to watch, followed by $40 and $39. Ideally, the $40 level holds because oil back in the $30s may prompt some fear to enter the market that could start to hurt the broad market similar to how it did back in 2014-2016.



Source: Stockcharts.com.

Andrew Adams

Small Caps Near Their Highs, But Can't Break Out

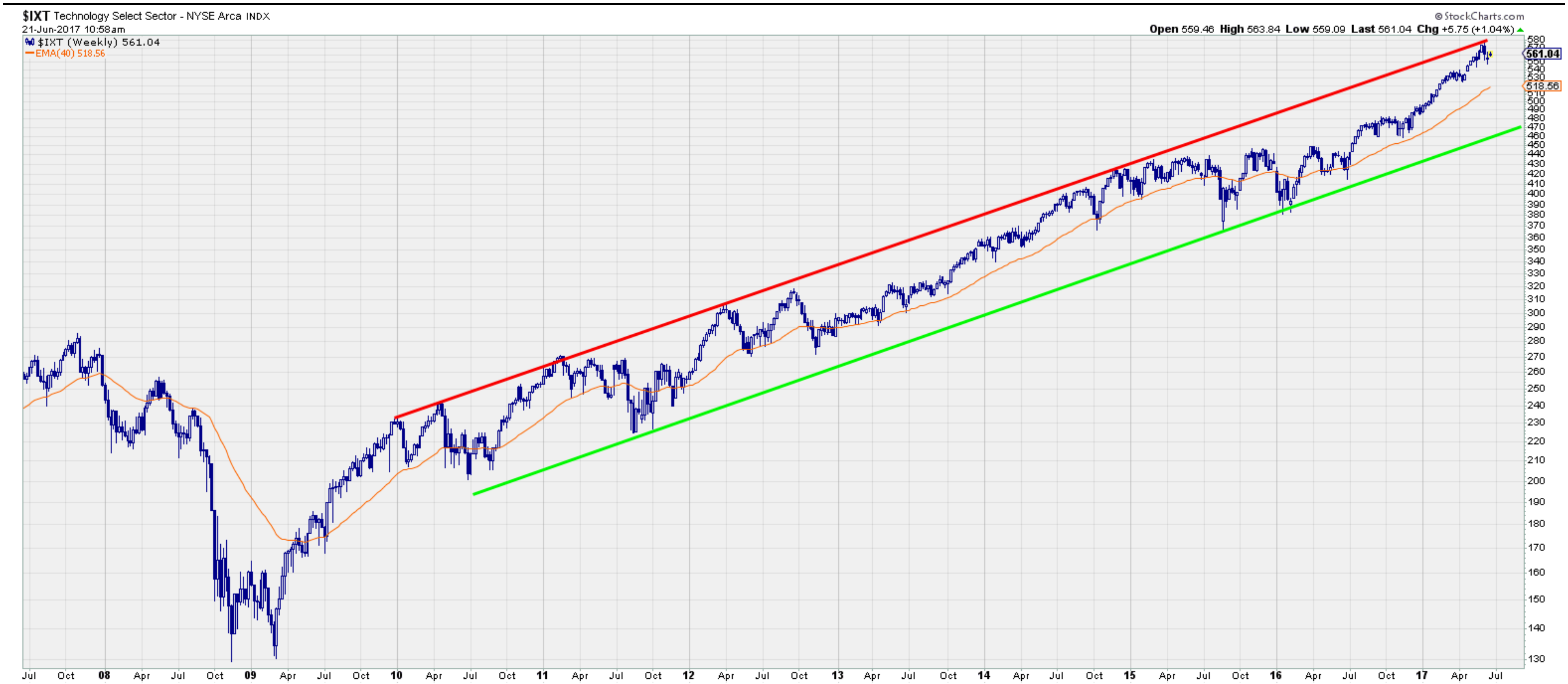
The Russell 2000 small cap index has been trapped in broadening megaphone patterns on both a long- and short-term basis. The upper and lower lines of these patterns represent the ceiling and floor for the small caps until proven otherwise.

Source: Stockcharts.com.

Andrew Adams

Technology Hit a Wall, But Not Selling Off

We pointed out in the previous weeks that the red-hot Technology sector was approaching the upper end of its long-term bullish channel and could run into some trouble because of it. That did happen, though, to this point, the damage has been limited to only a couple of bad sessions and the sector has not really cratered the way it might have done. This resistance remains something to watch, but any weakness in Technology is an opportunity in our view.

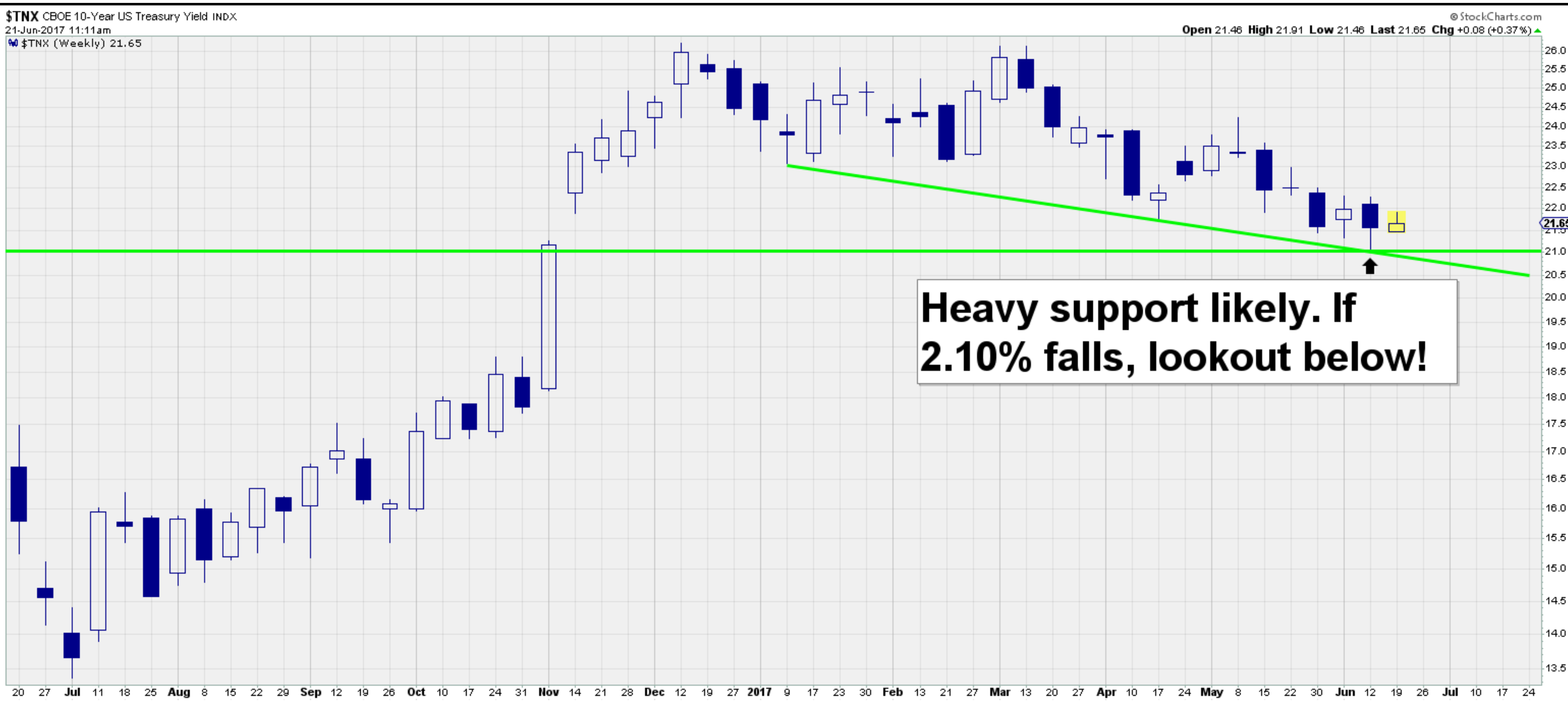


Source: Stockcharts.com.

Andrew Adams

Interest Rates At Important Spot

The benchmark 10-Year U.S. Treasury rate has deservedly received quite a bit of attention lately, as it has traded down into the low 2% zone. However, to this point, all it has done is fill the obvious gap on the weekly chart made after the post-election spike at the end of last year and may be hitting some support at 2.10%. That is now a very key level, as breaking 2.10% likely means that 2.00% would be the next target.

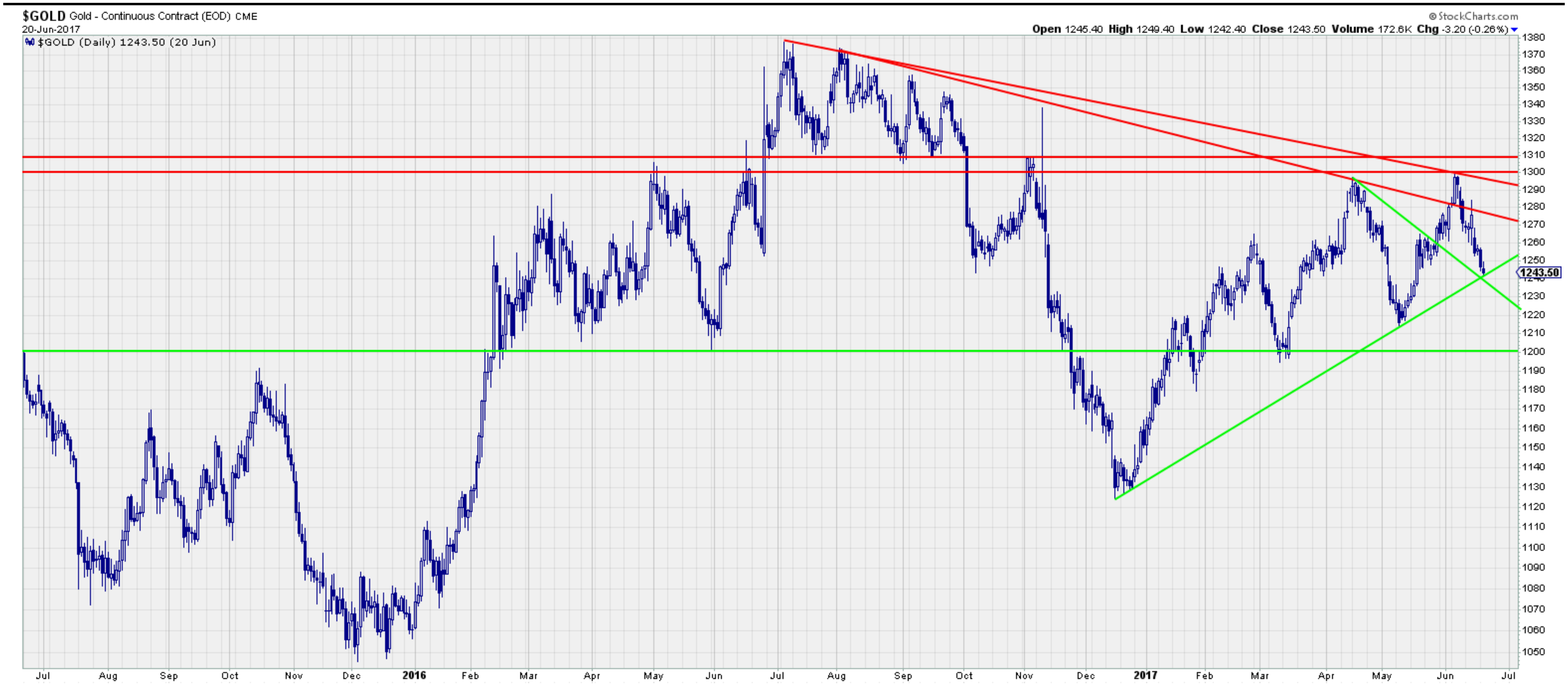


Source: Stockcharts.com.

Andrew Adams

Gold Hitting Support Once Again

Gold has traded all over the place so far in 2017, but the metal is now hitting possible support at a line drawn from the December 2016 and May 2017 lows. This could, therefore, be an interesting entry point, as gold has fallen pretty quickly from near $1300 over the last few weeks.



Source: Stockcharts.com.

Scott Brown

The Economy in Brief

The economy continued to expand in 2Q17, although the rebound (from a "soft" 1Q17) appears disappointing. Consumer spending growth, weak in the first quarter, has picked up, but less than anticipated earlier, with some signs of sluggishness in May. Business fixed investment, especially strong in 1Q17, appears to have moderated somewhat in 2Q17, still supported by elevated business optimism and the rebound in energy exploration. The mild winter likely pulled residential homebuilding activity forward (year-over-year gains remain strong).

Despite short-term evidence of slower growth and low inflation, the Federal Reserve raised the target range for the federal funds rate on June 14, to 1.00-1.25%. The Fed believes that the recent dip in 12-month inflation is due to March's "one-off" plunge in prices of wireless telecom services, and officials generally expect inflation to meet the 2% goal in 2018 and 2019. Tighter labor conditions should remain the key factor for Fed policy, leading to further gradual rate increases in the quarters ahead. The Fed has issued guidelines for how it will reduce the size of the balance sheet, but has not determined when that will start (although it is widely expected to begin in October).

The Washington Agenda

Tax Reform: The Affordable Care Act has important tax elements, so they must be addressed before real tax reform can begin. Still, large revenue losses from reductions in corporate and individual taxes would have to be offset somehow. There's not enough discretionary spending to make up the difference by cutting outlays. Any rollback in deductions (currently totaling $1.5 trillion per year) will be vigorously resisted. A border tax adjustment (taxes on imports) is dead on arrival (seen as too disruptive to business supply chains). Yet, while broad tax reform is extremely unlikely, there is still a possibility of reducing tax rates.

Infrastructure: The $1 trillion infrastructure spending plan has two things going against it. It's nowhere close to $1 trillion and there is no plan.

Regulation: Congress doesn't need to re-write legislation. The executive branch can simply not enforce current regulations. Congress could force the White House to comply (but that's not going to happen).

The Russia Thing: Special Counsel Mueller's investigation is reported to be progressing rapidly, but it will still take some time. Financial market participants haven't expressed much concern, but that may change.

Scott Brown

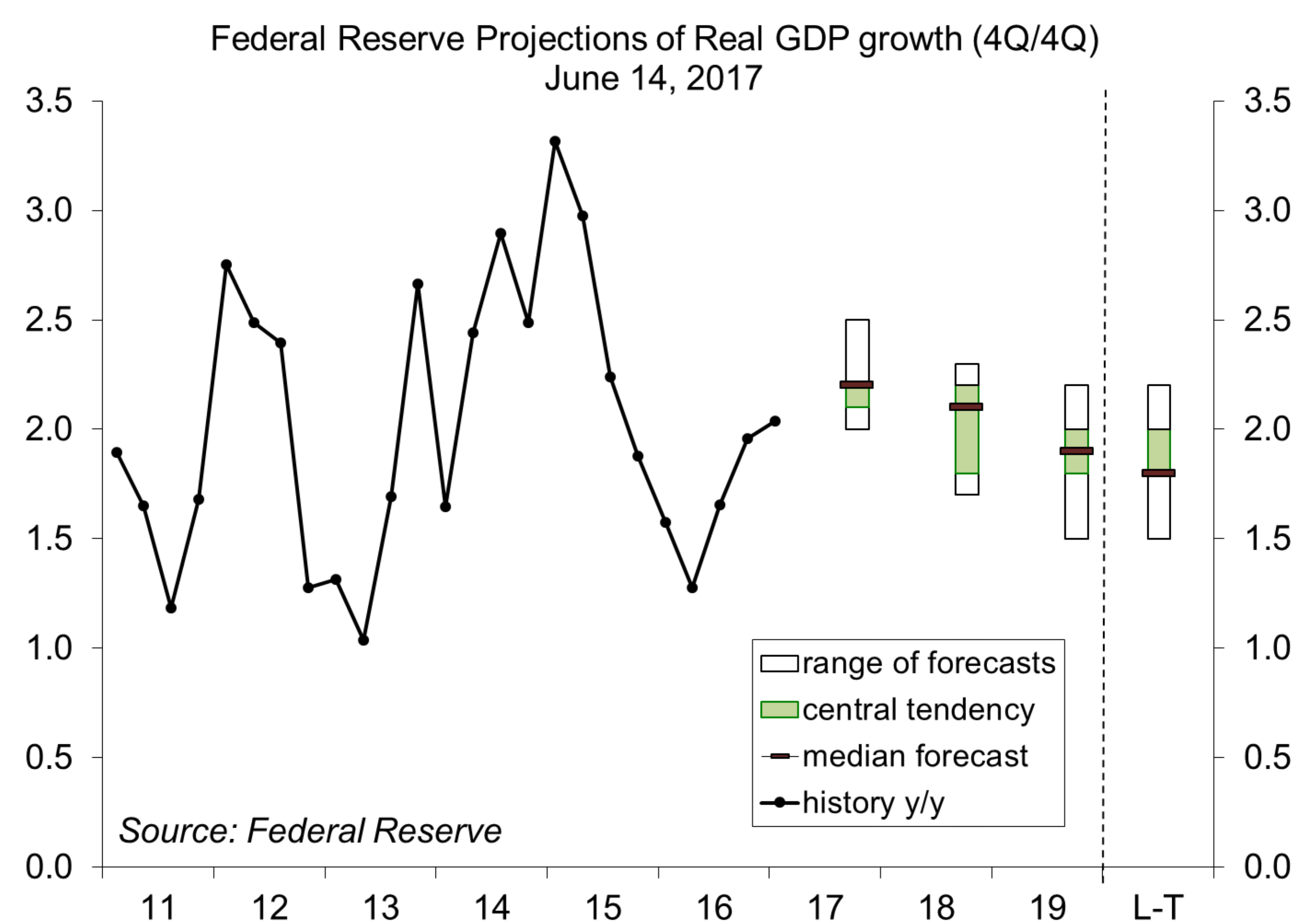
Economic Outlook – Key Themes

Moderate Growth

- Domestic economy
  - Consumer fundamentals remain strong (jobs, wages), but…
    - Gasoline prices are higher year-over-year, restraining purchasing power in the near term
    - Rents outpacing overall inflation
    - Some minor signs of credit stress (an initial increase in auto loan delinquencies)
    - Sentiment varies widely by political affiliation
  - Housing fundamentals are strong, but affordability and supply issues will continue
    - Mild winter likely pulled forward activity (softer in April/May, but strong y/y)
  - Business fixed investment got some boost from improved sentiment in 1Q17
    - Need to see gains in consumer spending for that to last
    - Energy recovery adding (oil and gas well drilling is capital intensive)
- Long-term demographic restraints
    - Slower labor force growth than in previous decades (+0.5%/year over next 10 years)
      - And 40% of that is projected to be immigration
    - Fed notes some signs that labor market constraints are restraining economic growth
    - Better trend economic growth depends on stronger growth in productivity
- Rest of the world
    - Brexit negotiations expected to be difficult
    - China economic restructuring likely to be uneven, concerns about high debt levels
    - Near-term global economic outlook has improved
    - Demographic constraints will limit the long-term pace of global growth

Scott Brown

Fed Officials Continue to Expect Moderate Growth



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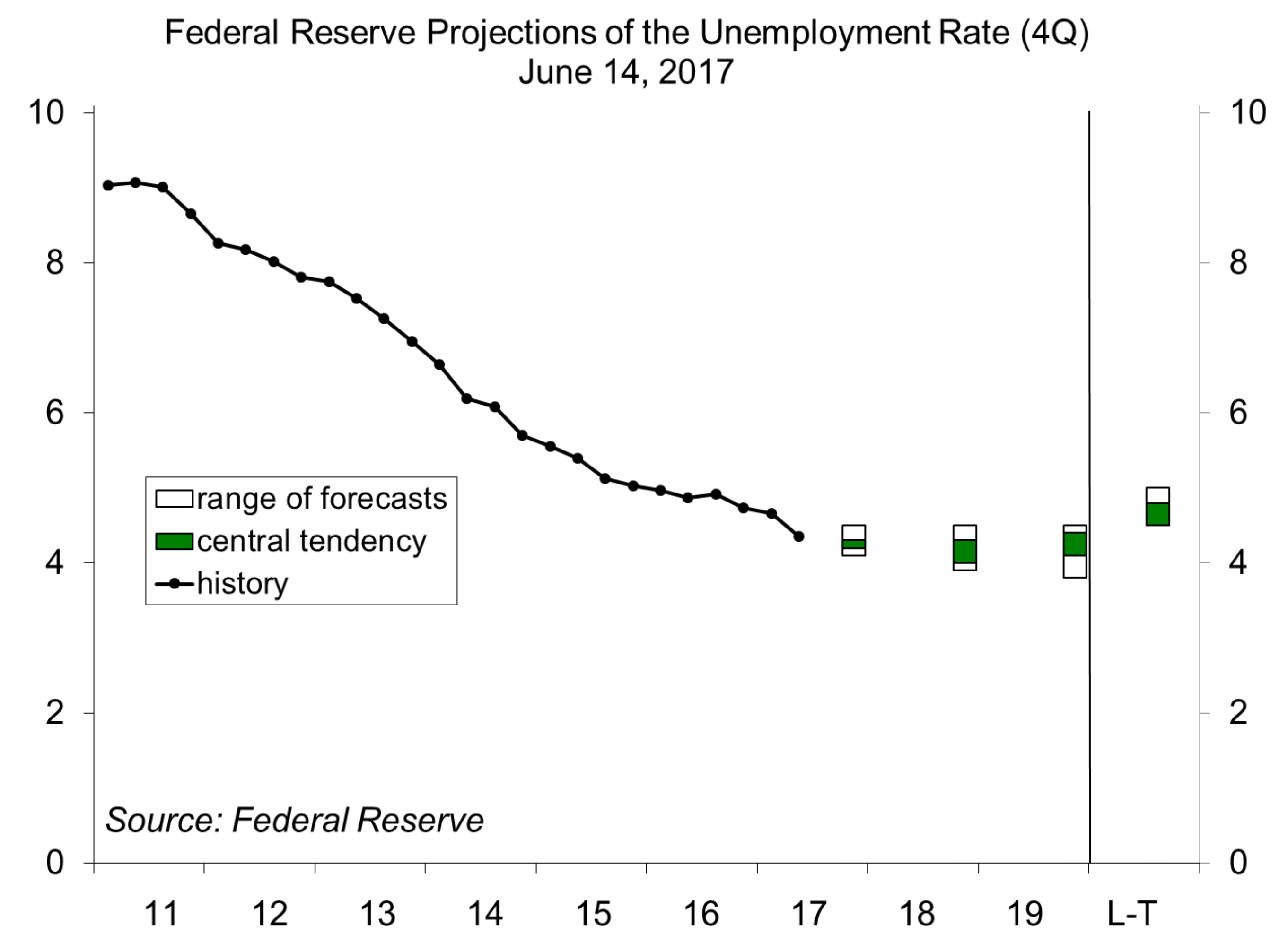
Fed Officials Expect the Unemployment Rate to Stay Low



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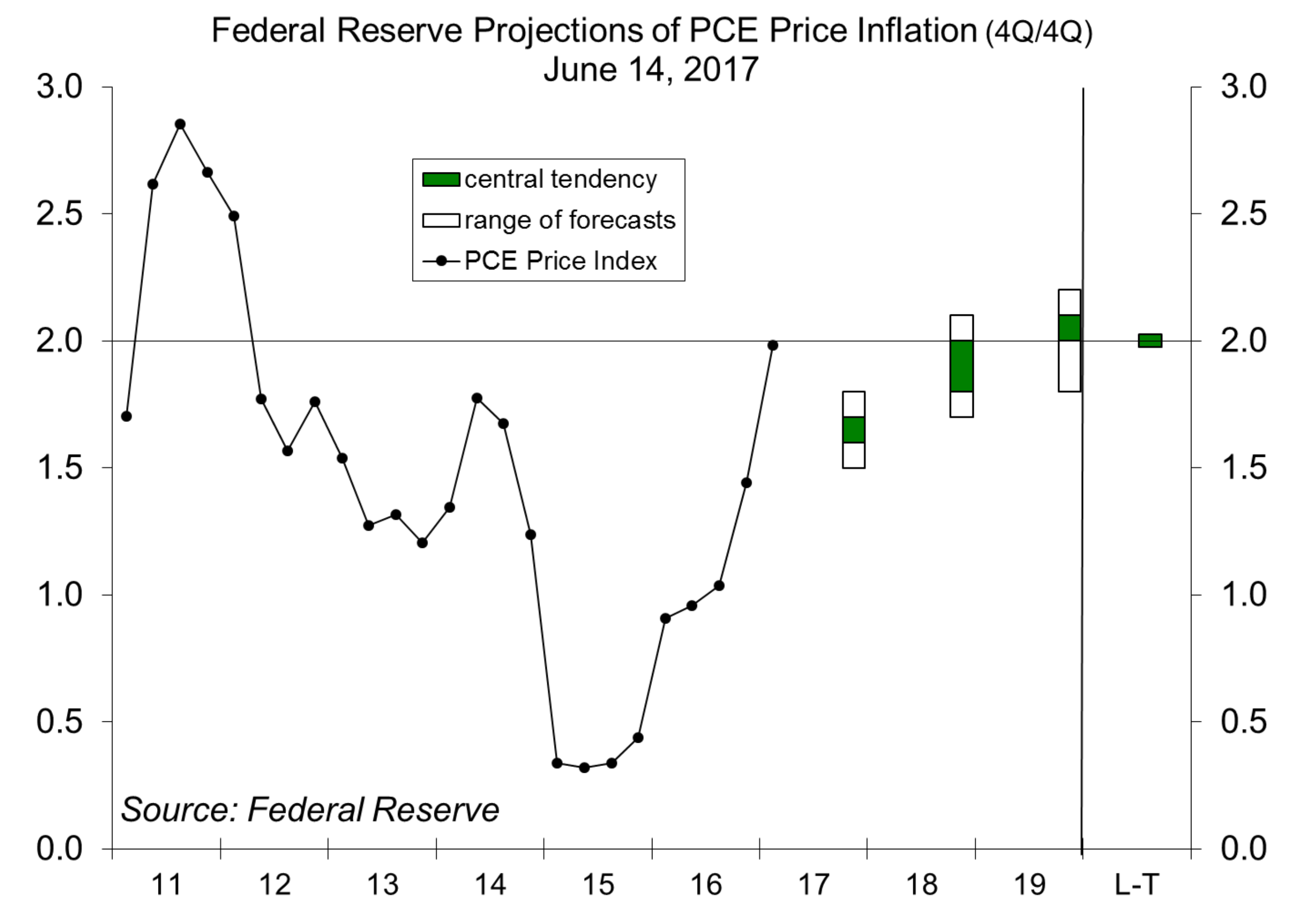
Fed Officials Expect Inflation to Near the 2% Goal, After a One-Off Drop in Wireless Telecom Prices in 2017



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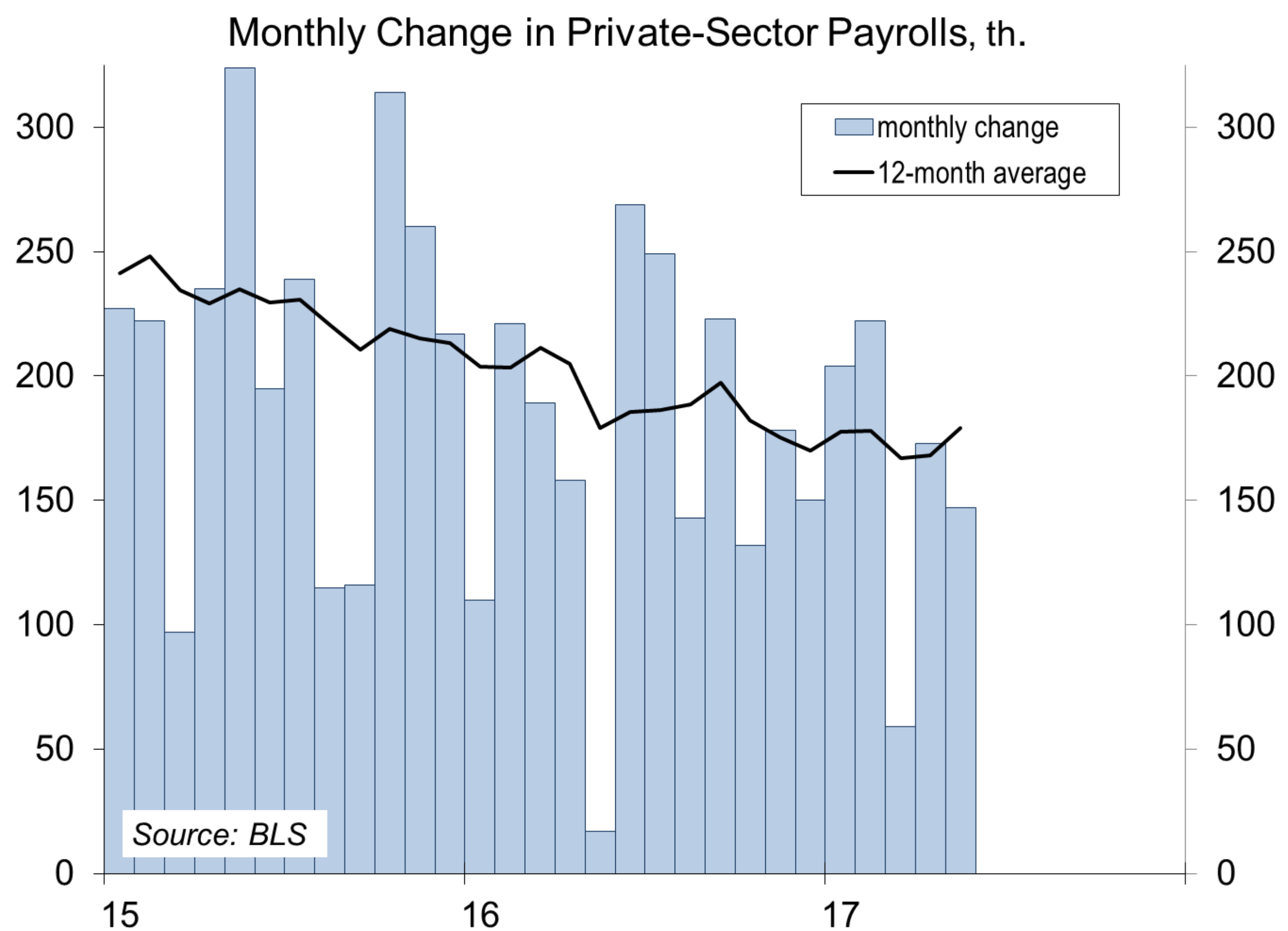
Growth In Nonfarm Payrolls Is Trending Lower



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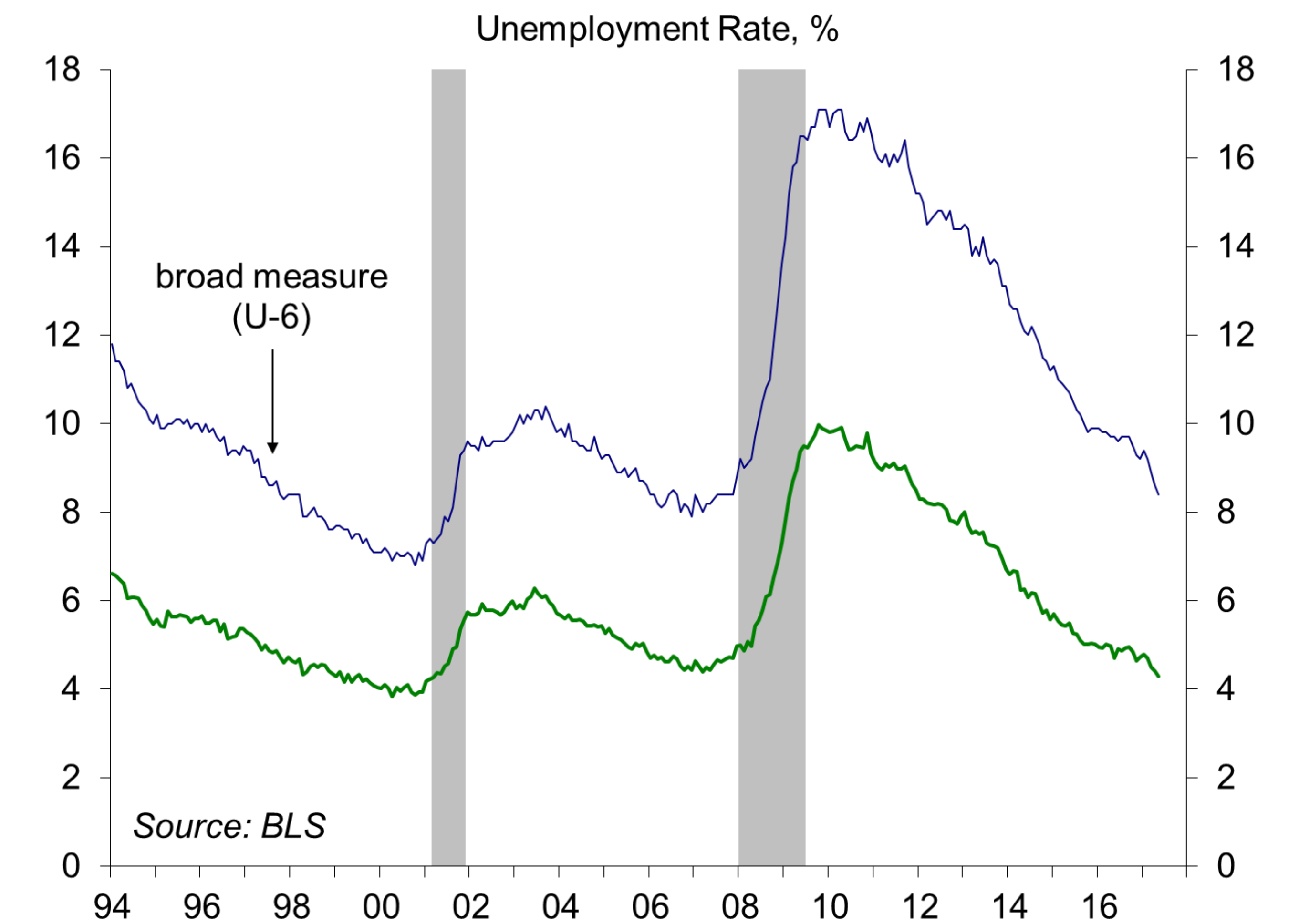
The Unemployment Rate Is at a 16-Year Low



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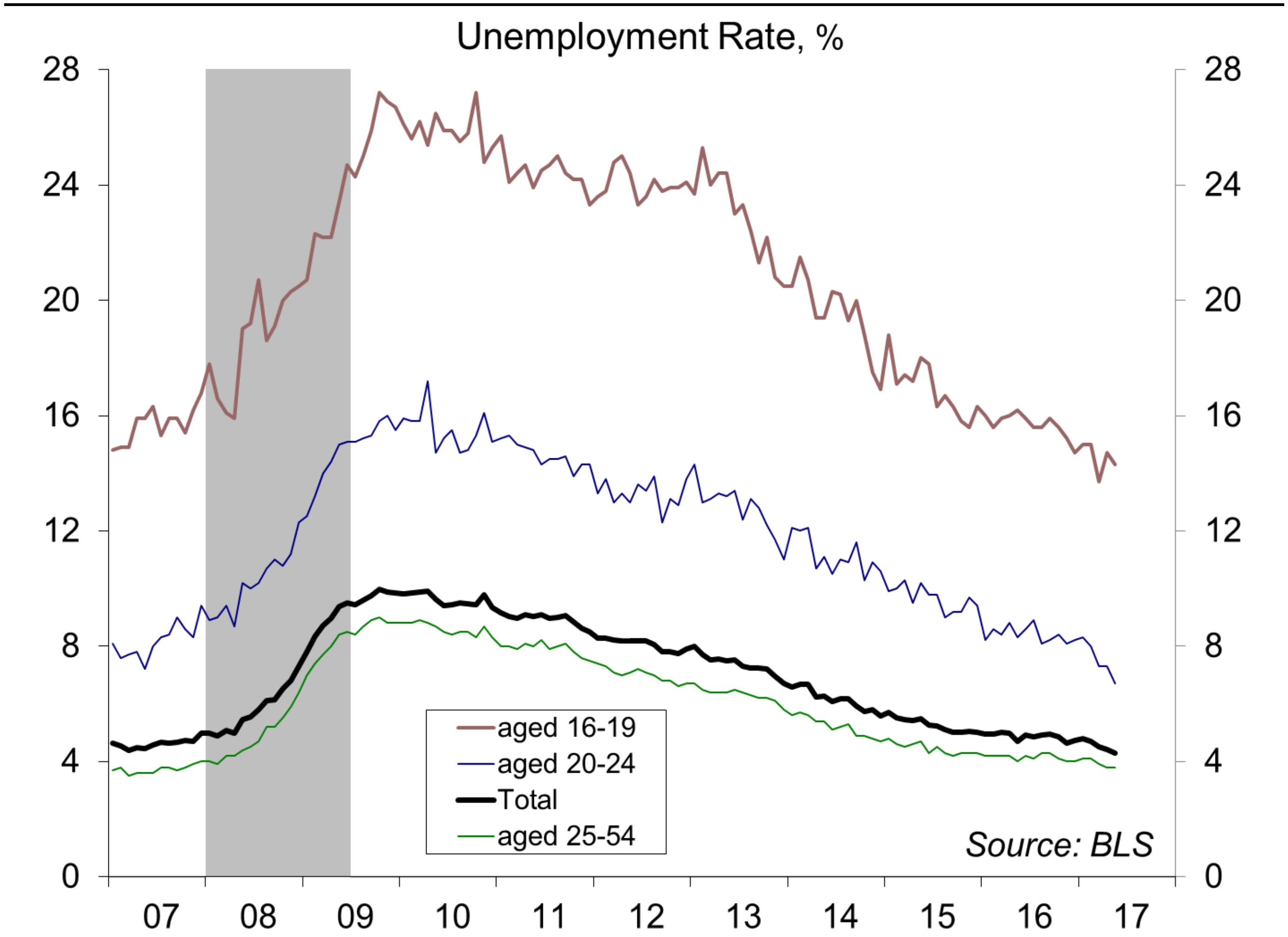
Youth Unemployment Is at Pre-Recession Levels



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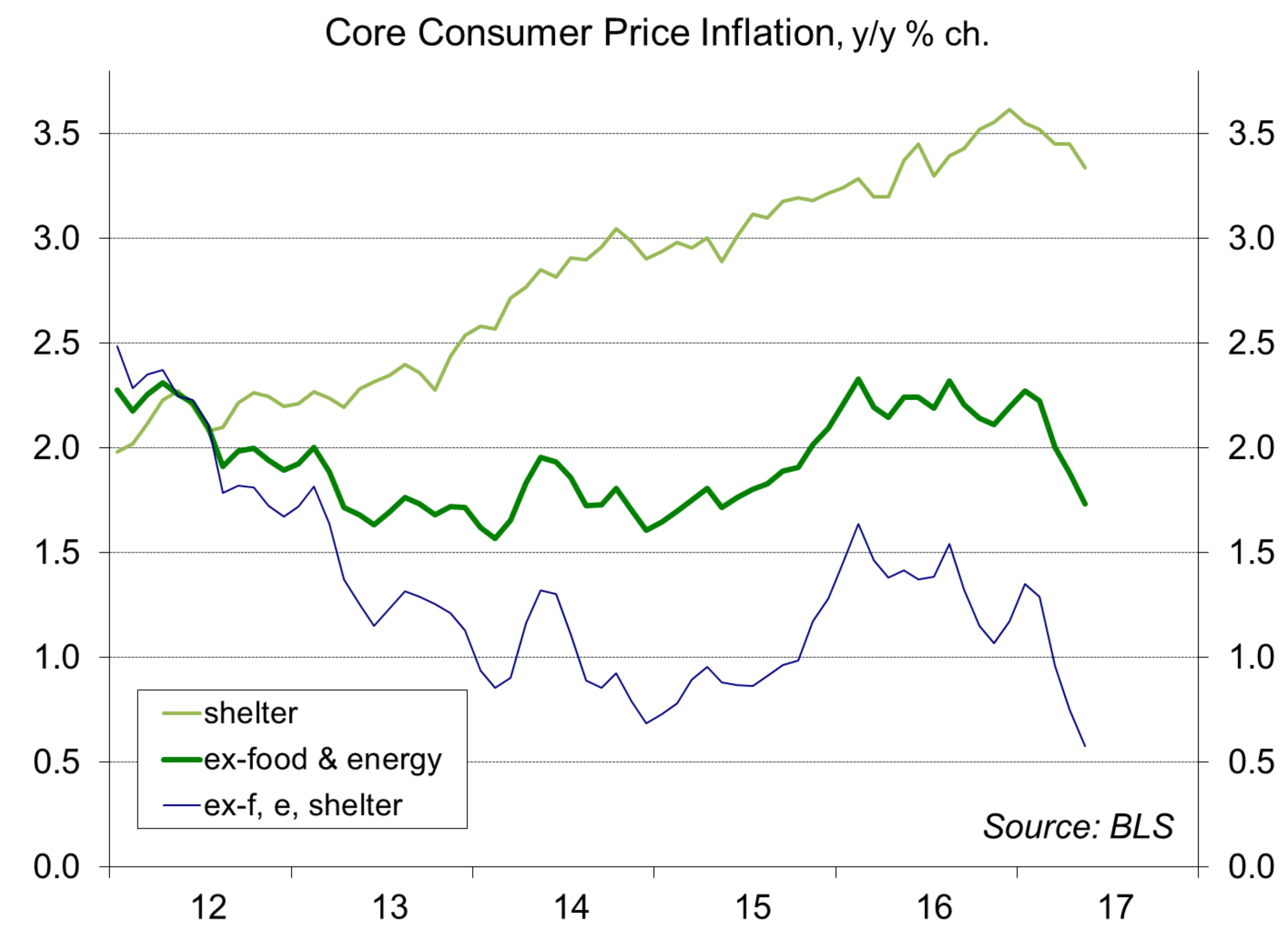
Core Inflation Has Remained Low



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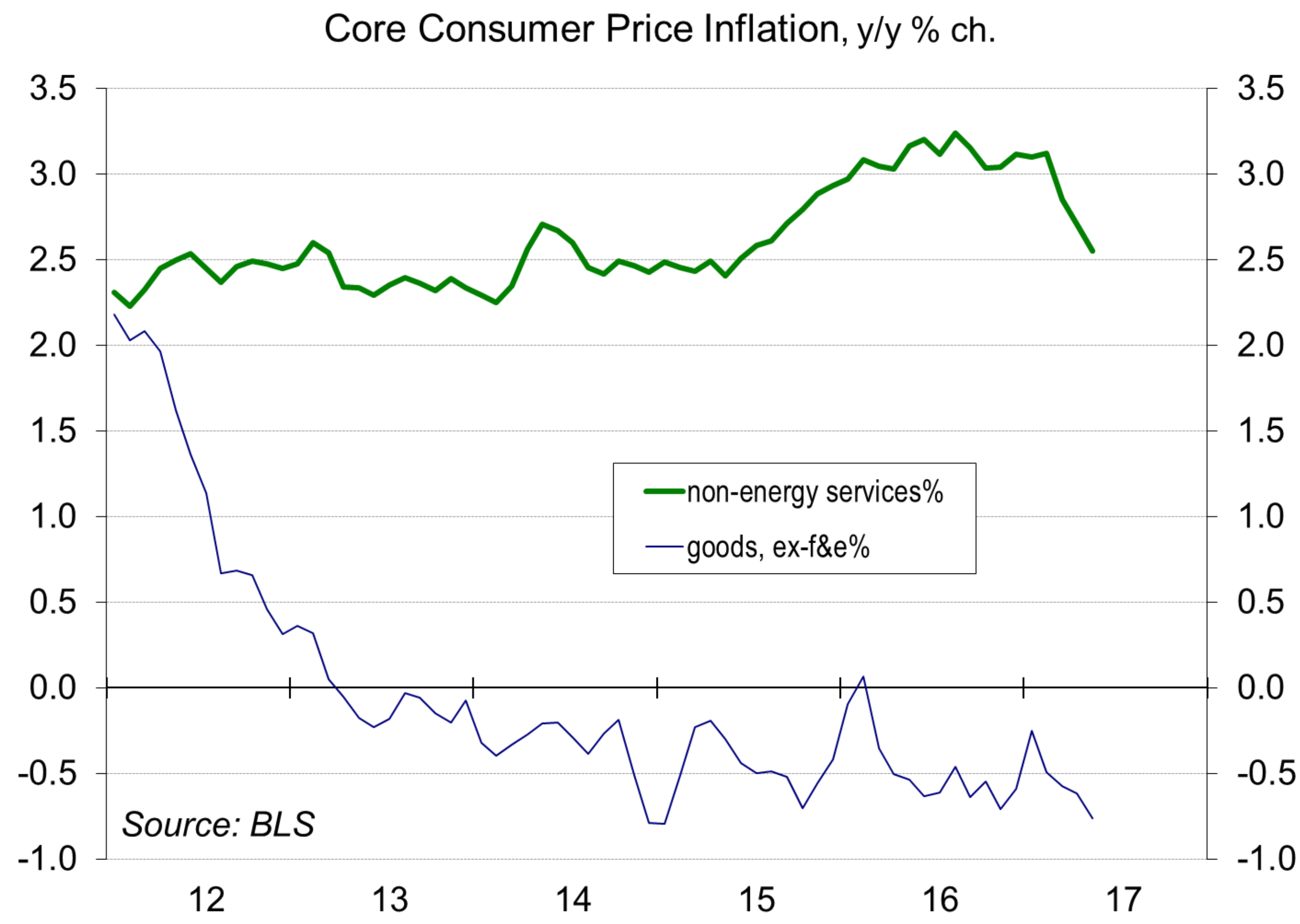
Mild Deflation in Goods, Rents Pressuring Services



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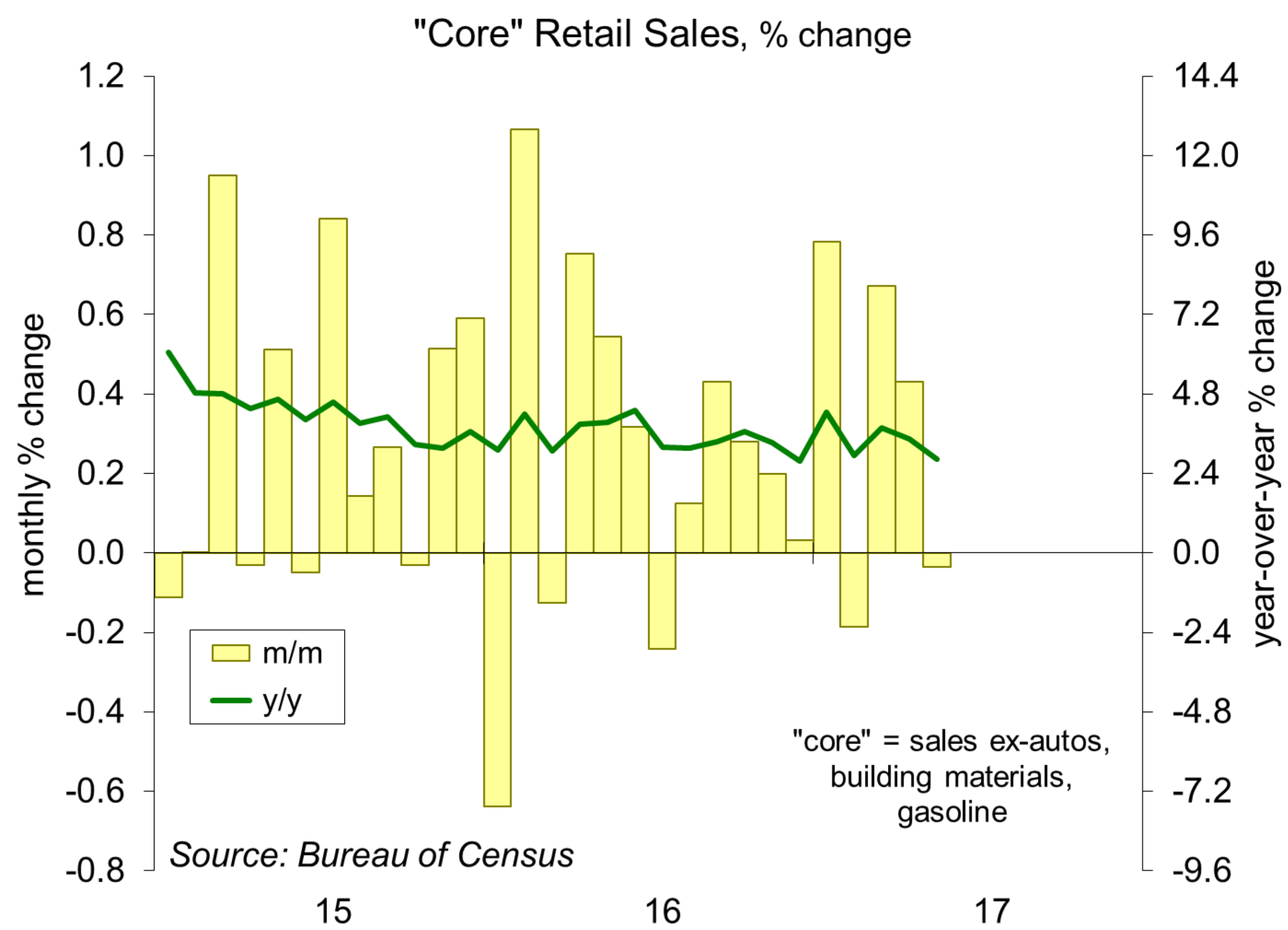
Retail Sales Slowed in May, Still a Moderate Trend



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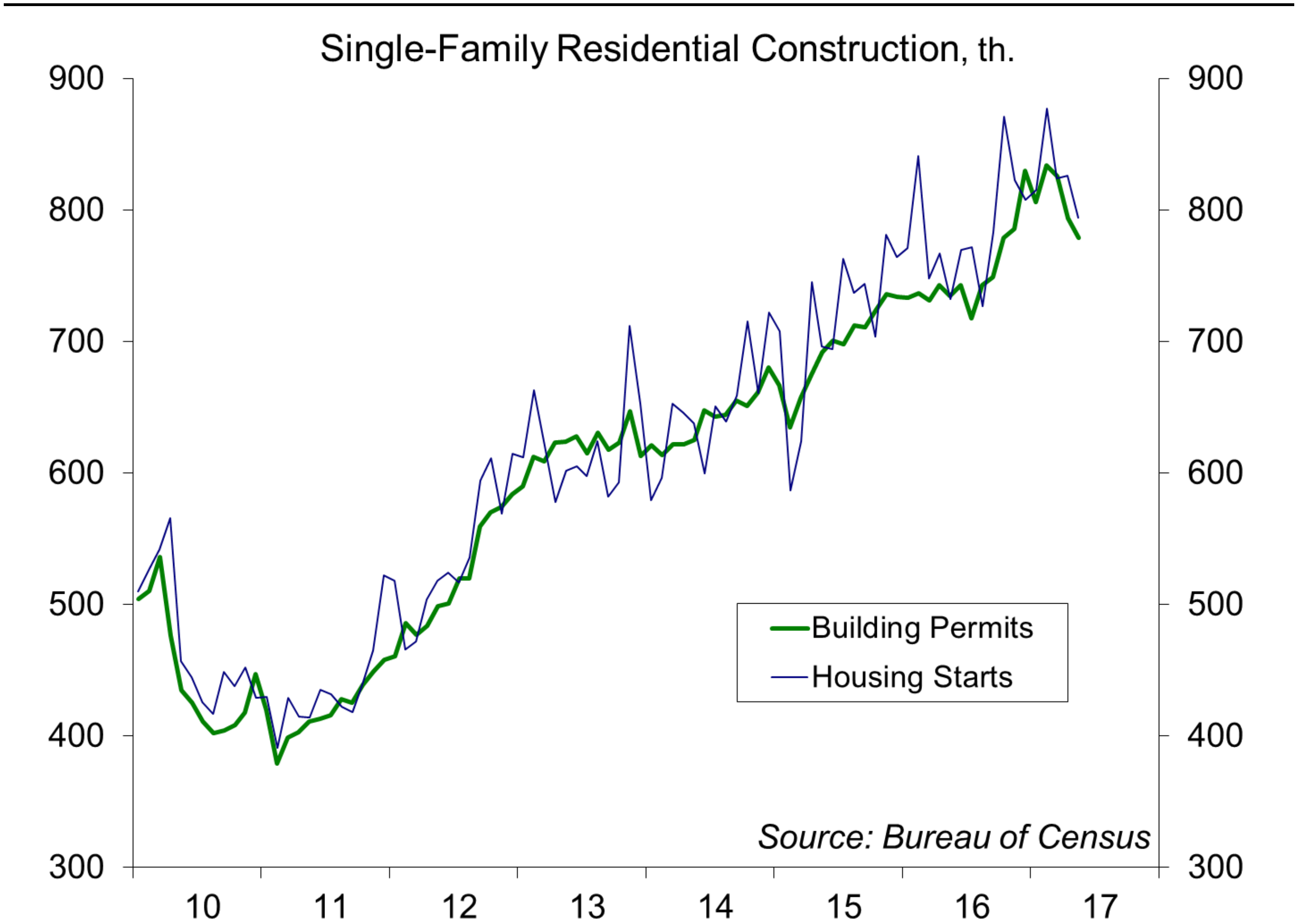
Homebuilding: Soft April/May Follows Earlier Strength



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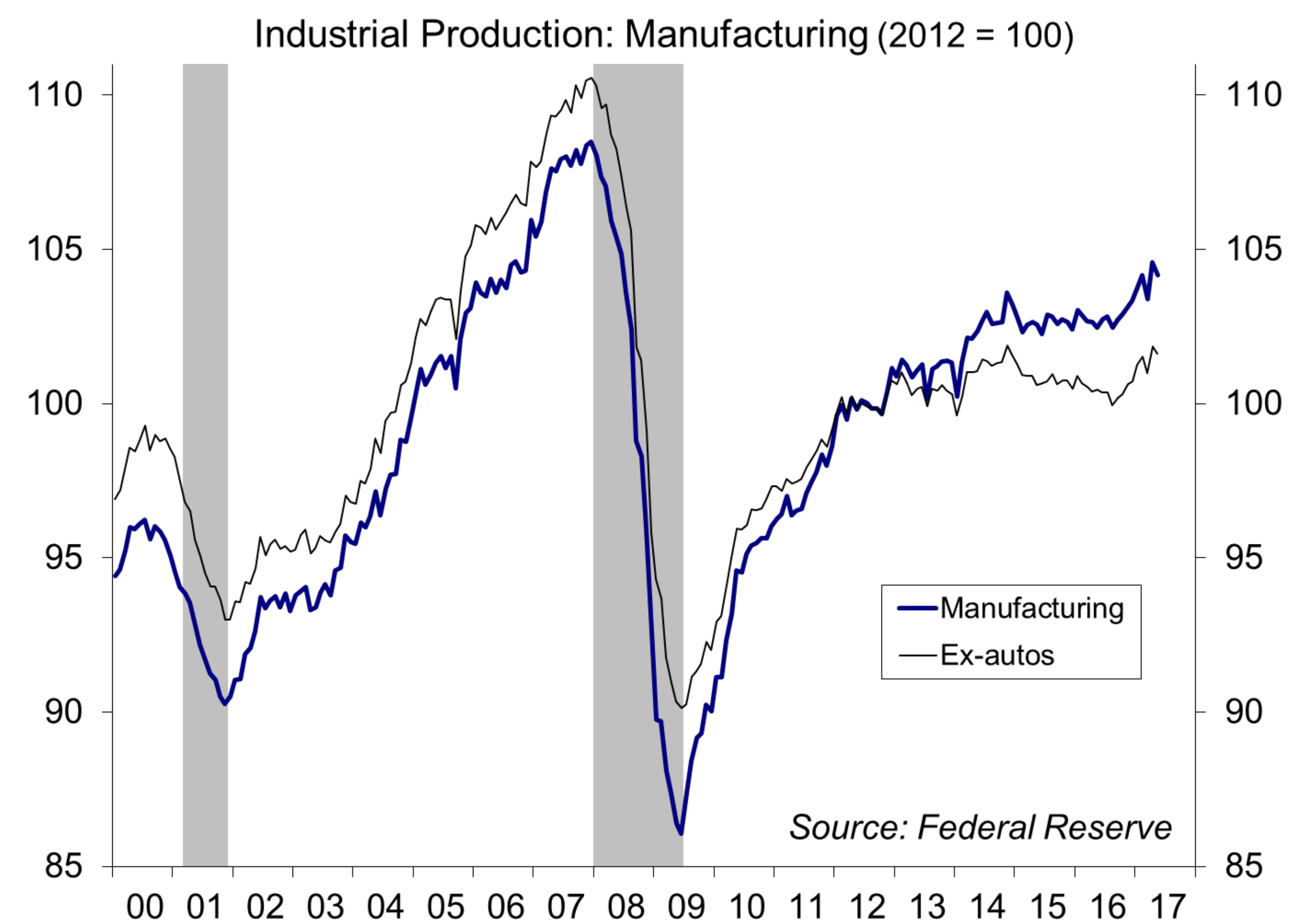
Factory Output Is Improving



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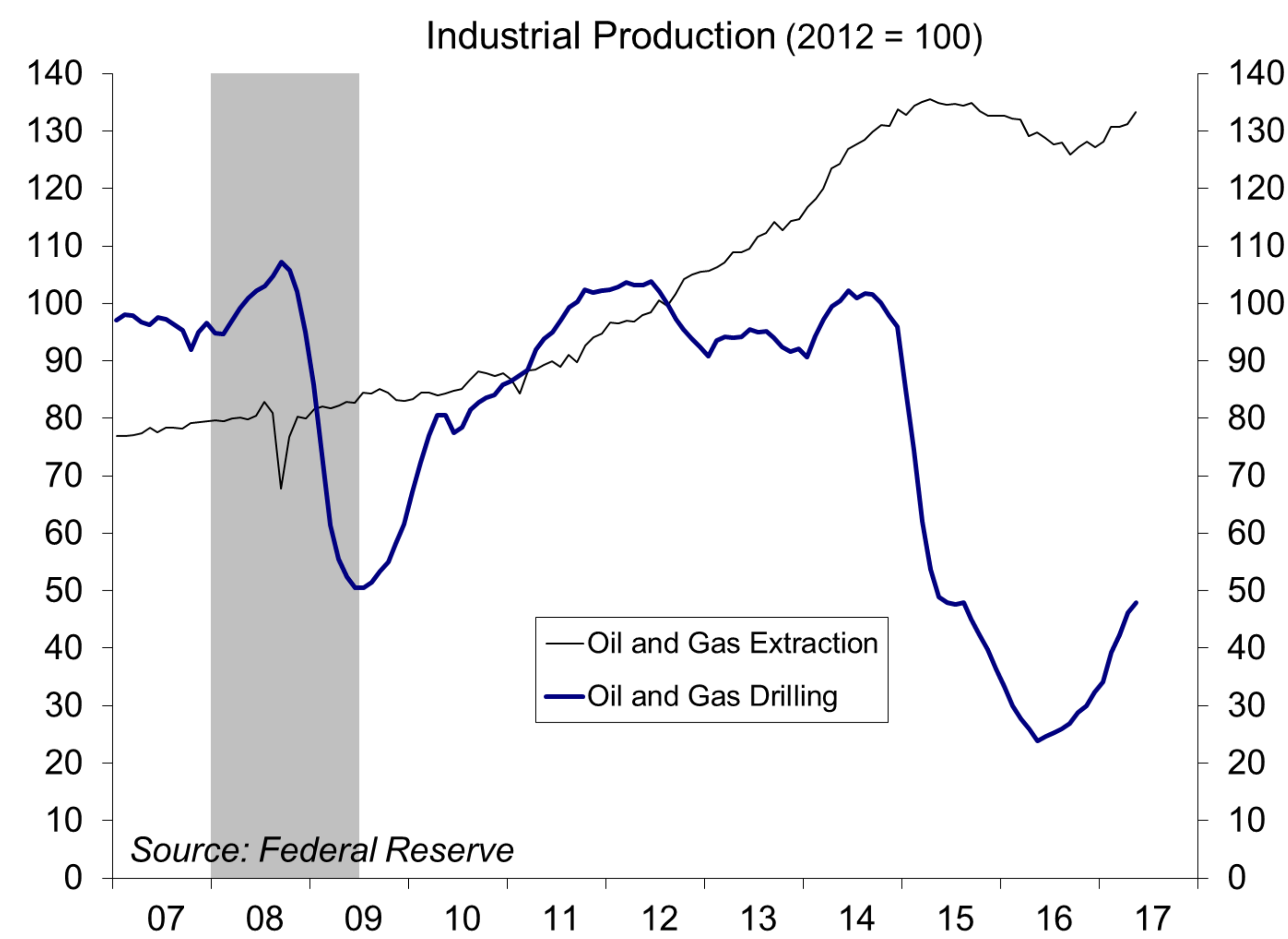
Energy Exploration Is Recovering From a Steep Decline



Scott Brown

Federal Reserve Policy

"We continue to expect that the ongoing strength of the economy will warrant gradual increases in the federal funds rate to sustain a healthy labor market and stabilize inflation around our 2% longer-run objective. That's based on our view that the federal funds rate remains somewhat below its neutral level--that is, the level of the federal funds rate that is neither expansionary nor contractionary and keeps the economy operating on an even keel. Because the neutral rate is currently quite low by historical standards, the federal funds rate would not have to rise all that much further to get to a neutral policy stance. But because we also expect the neutral level of the federal funds rate to rise somewhat over time, additional gradual rate hikes are likely to be appropriate over the next few years to sustain the economic expansion."

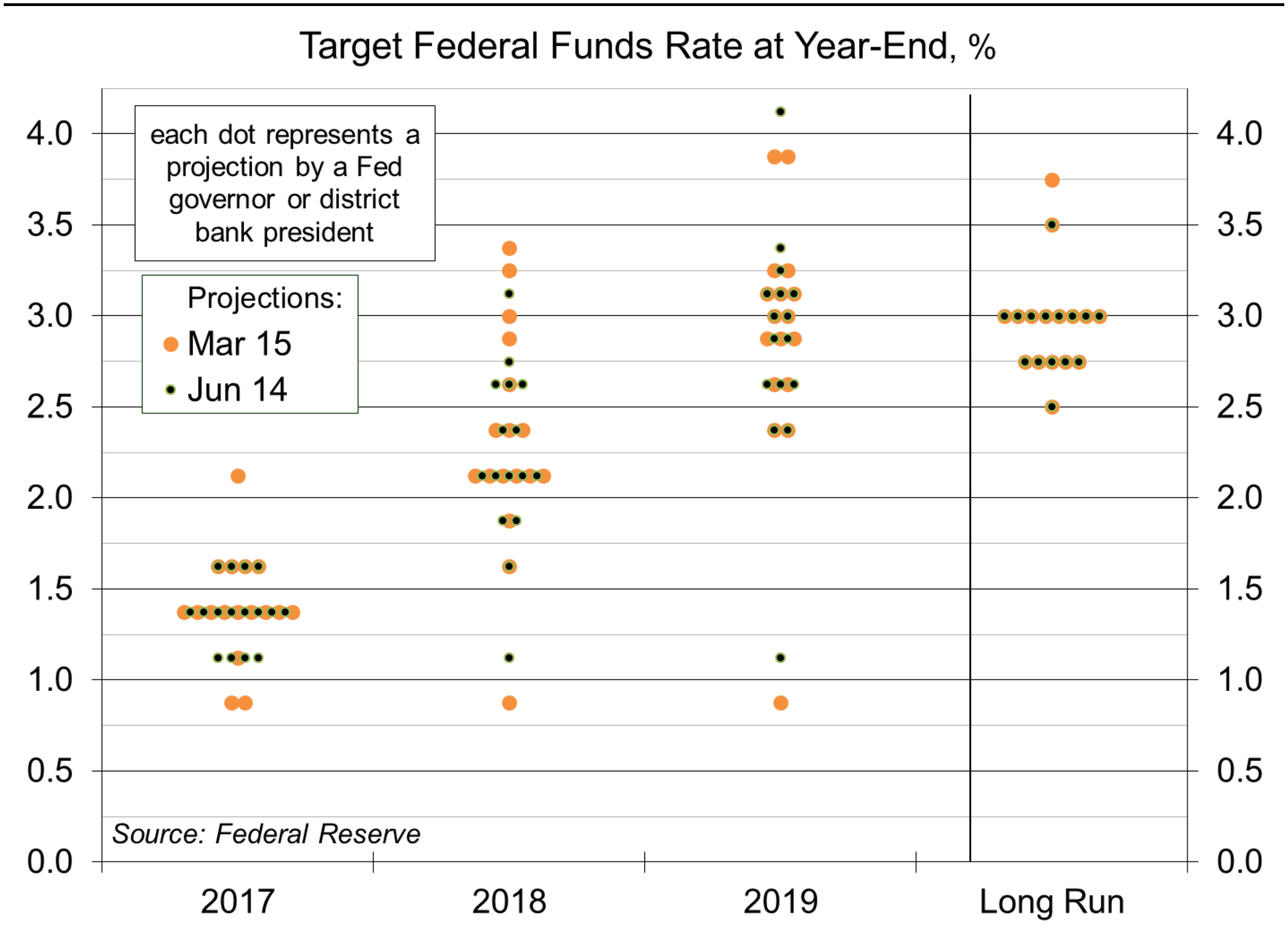
-- Yellen Press Conference (June 14)

Normalization: The Fed believes the neutral federal funds rate is higher than the current rate, but not by much, although the neutral rate should rise over time.

Note that there are currently three vacancies on the Fed's Board of Governors and Yellen's term as chair runs to February 3, 2018. Hence, personnel changes add another layer of uncertainty to the Fed policy outlook.

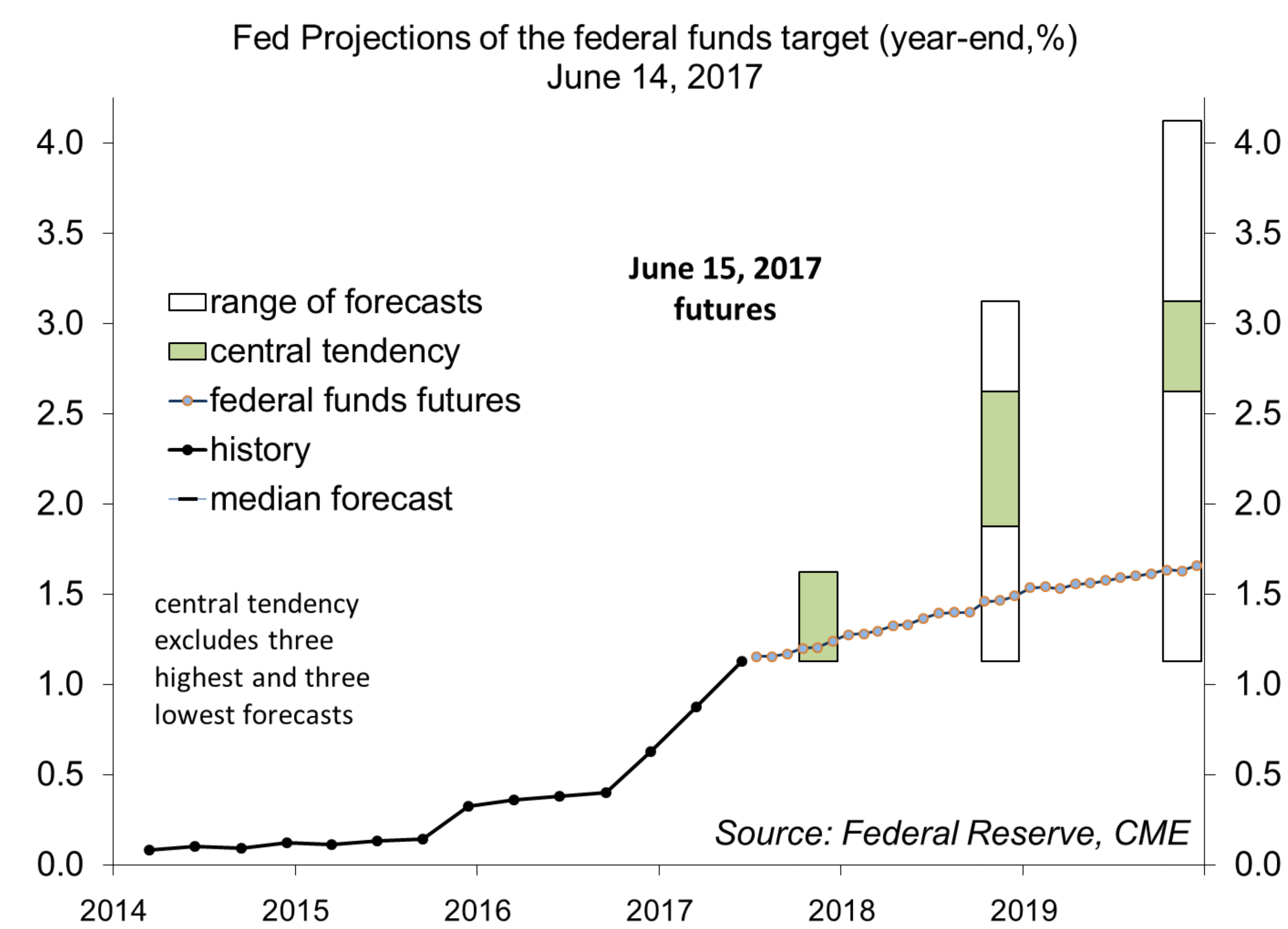
Scott Brown

Dot Plot: Fed Officials Still Expect to Raise Rates Gradually



Scott Brown

The Market Expects Fed Rate Hikes to Be More Gradual



Scott Brown

Federal Reserve Policy – Balance Sheet Reduction

The Fed is currently reinvesting principal payments it receives from securities held in the System Open Market Account. Once normalization of the level of the federal funds rate is well under way, the Fed will set caps on the monthly amount of run-off (principal payments above the cap will be reinvested). Initially, the cap (amount of monthly run-off) will be set low: $10 billion ($6 billion for Treasuries and $4 billion for Mortgage-Backed Securities). The cap (monthly run-off) will increase by $10 billion each quarter, until it reaches $50 billion ($30 billion Treasuries, $20 billion MBS), where it will continue until the size of the balance sheet reaches an appropriate level (yet to be determined).

The start date of balance sheet reduction has not been set, but The Fed is widely expected to announce (in the September 20 policy announcement) that it will begin in October. The initial balance sheet reduction is relatively modest and should not be unsettling for the financial markets. It's unclear where the size of the balance sheet will end up when the reduction process ends. Currently, it is $4.5 trillion. At full stride ($50 billion per month = $600 billion per year), the pace may be a lot for the financial markets to handle.

"…the Committee would be prepared to resume reinvestment of principal payments received on securities held by the Federal Reserve if a material deterioration in the economic outlook were to warrant a sizable reduction in the Committee's target for the federal funds rate."

Scott Brown

Economic Indicators

Economic Indicator	Status	Comments
Growth		Recent data suggest that the second quarter rebound will fall short of earlier expectations, but the underlying trend should be a bit above the long-term sustainable pace (1.5-2.0%).
Employment		Growth in nonfarm payrolls appears to be slowing down as the job market gets tighter, still above a pace consistent with population growth.
Consumer Spending		Wage and job growth have remained supportive, but the 2Q17 rebound has been less than expected. Flat or lower gasoline prices should lead to a rebound in purchasing power.
Business Investment		Businesses remain generally optimistic. The energy rebound has helped. However, the first quarter's pace of improvement may be difficult to maintain.
Manufacturing		Uneven in recent months, factory output has improved following a soft patch in recent years. The underlying trend does not appear especially strong by historical standards.
Housing and Construction		Weather provided a boost in 1Q17. Builders continue to note supply constraints (lack of lots on which to build, a scarcity of skilled labor, higher construction costs).
Inflation		Uneven in the first few months of the year (not unusual), the underlying trend in consumer price inflation remains below the Fed's goal. Pipeline pressure have been mixed. Wage pressures are somewhat higher than a couple of years ago, but are not especially strong.
Monetary Policy		The Fed expects to raise short-term interest rates gradually and has issued guidelines for how it will reduce the size of the balance sheet. Personnel changes (three vacancies on the Fed's Board of Governors, Yellen's term as chair runs to February 3) add uncertainty.
Long-Term Interest Rates		Constraints on the Trump agenda have reduced concerns of a large surge in the federal budget deficit. Inflation pressures do not appear to be as strong as feared. Lower interest rates abroad should keep U.S. bond yields from rising rapidly
Fiscal Policy		State and local government budgets are in better shape and spending should add a bit to overall GDP growth. At the federal level, the timing, character, and scale of infrastructure spending and tax cuts is very much in doubt, but (while hope remains) expectations have been pared back.
The Dollar		Likely range-bound in the near term, with Fed policy (dollar-positive if tightening continues) and Washington turmoil (dollar-negative) seen as competing forces.
Rest of the World		Brexit negotiations should be difficult for the U.K. and Chinese debt levels are a concern. However, the global economic outlook is a bit brighter. The possibility of trade conflicts is a decreased risk, but one that is still hard to gauge.

Scott Brown

Key Calendar Dates

June 27	CB Consumer Confidence Index (June)
July 3	ISM Manufacturing Index (June)
July 4	Independence Day Holiday (markets closed)
July 5	FOMC Minutes (June 13-14) Motor Vehicle Sales (June)
July 6	ADP Payroll Estimate (June) ISM Non-Manufacturing (June)
July 7	Employment Report (June)
July 14	Consumer Price Index (June) Retail Sales (June) Industrial Production (June)
July 19	Building Permits, Housing Starts (June)
July 26	FOMC Policy Decision (no press conference)
July 28	Real GDP (2Q17, advance estimate + benchmark revisions)
September 20	FOMC Policy Decision (Yellen press conference)
November 1	FOMC Policy Decision (no press conference)
December 13	FOMC Policy Decision (Yellen press conference)

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