eResearch

Analyst Article March 3, 2017

HUMBLE STUDENT OF THE MARKETS

eResearch Corporation is pleased to feature TWO articles by Cam Hui, who offers investment and trading insights on his website, **HumbleStudentOfTheMarkets.com**

Mr. Hui posts a market comment on the weekend plus one or two articles of interest during the week.

His subscription service includes annual, monthly, or daily pass options, and is focused on building a community of like-minded individuals with a common interest in investing and trading.

The articles begin on the following page, and is entitled:
March 1: Don't Relax; The Week Is Not Over
March 2: Frothy, Over-Extended Stock Market

You can access his website and subscribe to his service at the following link:
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Bob Weir, CFA
Director of Research

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Wednesday, March 1, 2017

Don't Relax; The Week Is Not Over

Boy, was I wrong. Two weeks ago, I wrote Why the S&P 500 won't get to 2400 (in this rally).

Despite today's market strength, stock prices may be restrained by a case of round number-itis as the Dow crosses the 21,000 mark and the SPX tests the 2,400 level.

In addition, the market's reaction to President Trump's speech to Congress was at odds to the reaction from Street strategists. While the market went full risk-on in the wake of the Trump speech, this Bloomberg summary of strategist comments made it clear that the speech was long on themes and short on details. Perhaps stocks are rallying because Trump did not go off script, and he sounded statesmanlike and presidential. How long will the market remain patient with his lack of the specifics on tax reform, which is Wall Street's major focus.

In the meantime, the SPX has broken above its trend line and appears to be staging an upside blow-off. When animal spirits start to stampede like this, you never know when the rally will end.

Does this mean it is time to jump back on the bullish bandwagon? Not so fast. The week is not over and there are a couple of other major developments (other than the Trump speech) that warrant consideration.

The State Of The (European) Union

I suggested about a month ago that we may be nearing a peak in political populism based on the magazine cover indicator (see Peak populism?). The latest developments from Europe indicate that we may be nearing a political inflection point.

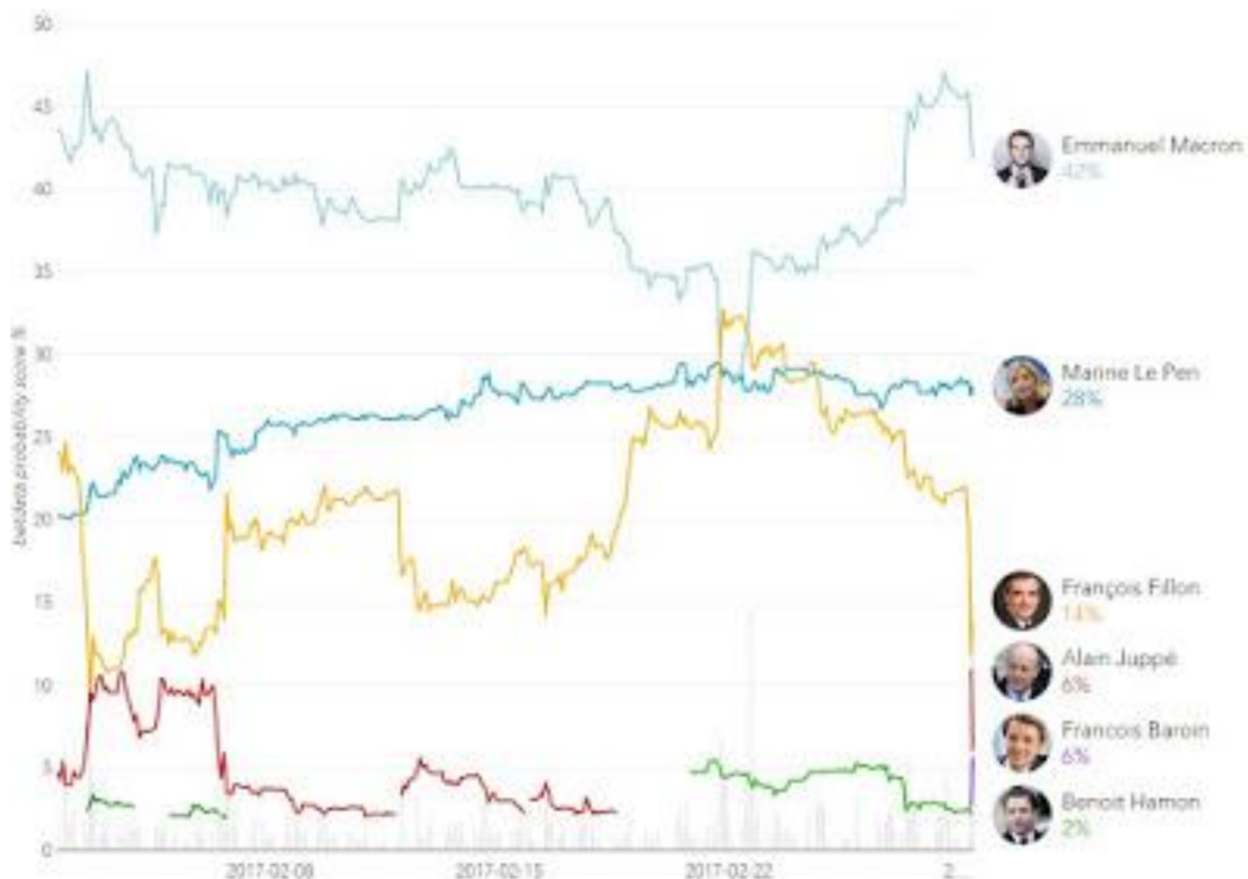
The populist Geert Wilders is losing ground in the upcoming Dutch election on March 15. Bloomberg reports that Wilders' Freedom Party is running neck and neck with the establishment Liberals, which forms the current government:

> Dutch Prime Minister Mark Rutte's Liberals are making up ground on populist frontrunner Geert Wilders in the polls, suggesting that voter support is crystallizing in the final weeks of the campaign in favor of keeping Rutte in power.

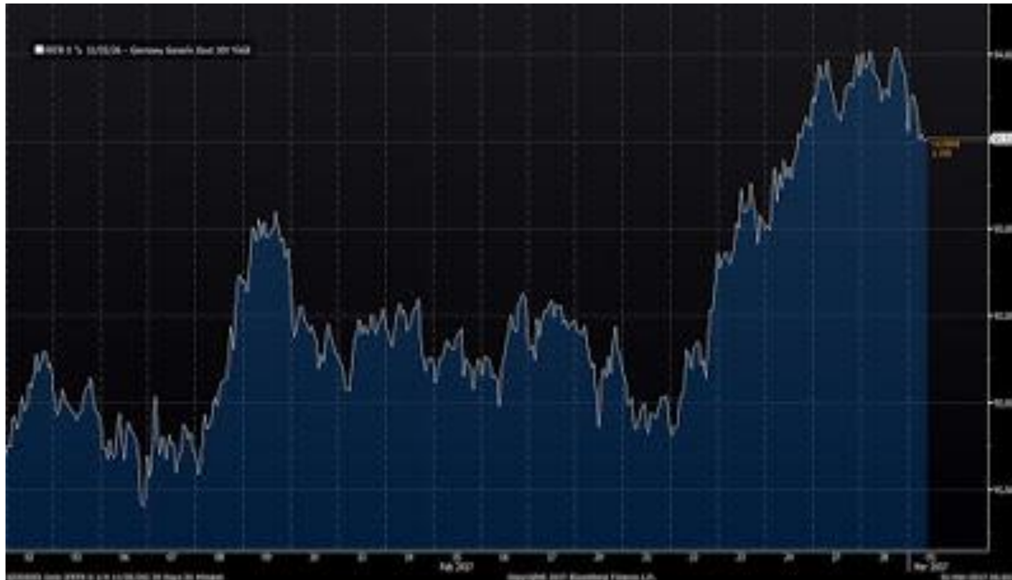
> Two polls released on Tuesday showed the Freedom Party with a one-seat advantage or even with the Liberals. That is down from a lead of as many as 12 seats at the start of the year. A poll aggregator released Wednesday showed the Liberals narrowly ahead for the first time since November.

[Business Insider](#) also reported that Wilders has slipped to second place in one recent poll.

In France, conservative presidential candidate François Fillon's political fortunes are imploding, based on the news that investigating magistrates have summoned him and his wife on charges that he put his wife on a government payroll for nonexistent work. In a press conference, Fillon decried the move as "political assassination" and vowed to fight on. This development has cleared a path for the centrist Emmanuel Macron to the French presidency. The latest Betfair odds show Macron surging at Fillon's expense. The anti-establishment and populist Marine Le Pen remains in second place, with little hope of winning the election.



As a consequence, the French-German yield spread has begun to narrow.



The state of the European Union is getting stronger.

A March Rate Hike?

In a Bloomberg interview on February 21, Cleveland Fed president Loretta Mester stated that the Fed does not like to surprise the market on interest rate decisions. At the time of that interview, the odds of a March rate hike were in the 20-30% range. It is now about 70% after one Fed speaker after another warned that not only is the March FOMC meeting "live", there is a distinct possibility that they may raise rates at that meeting. San Francisco Fed president John Williams said that he expects a rate hike will warrant "serious consideration" at the March meeting. In a CNN interview, New York Fed president William Dudley said that the Fed will raise rates "fairly soon".

What does this all mean?

Fed watcher Tim Duy thinks that the question is whether the Fed wants to be pre-emptive, or it wants to wait to see how fiscal policy develops:

> When I read the interview, it is hard for me to see that he has a strong conviction for drawing forward the rate hike to March. It seems odd to do so if he sees no change in the forecast and downplays the impact of the upside risks. If he does want to move in March, it tells me then it has little to do with either factor and is entirely about staying ahead of the curve. It is about the need for a pre-emptive rate hike. If his forecast is for three hikes and he wants to hike in March, then his patience has ended and he wants those hikes frontloaded. If for FOMC participants as a whole the

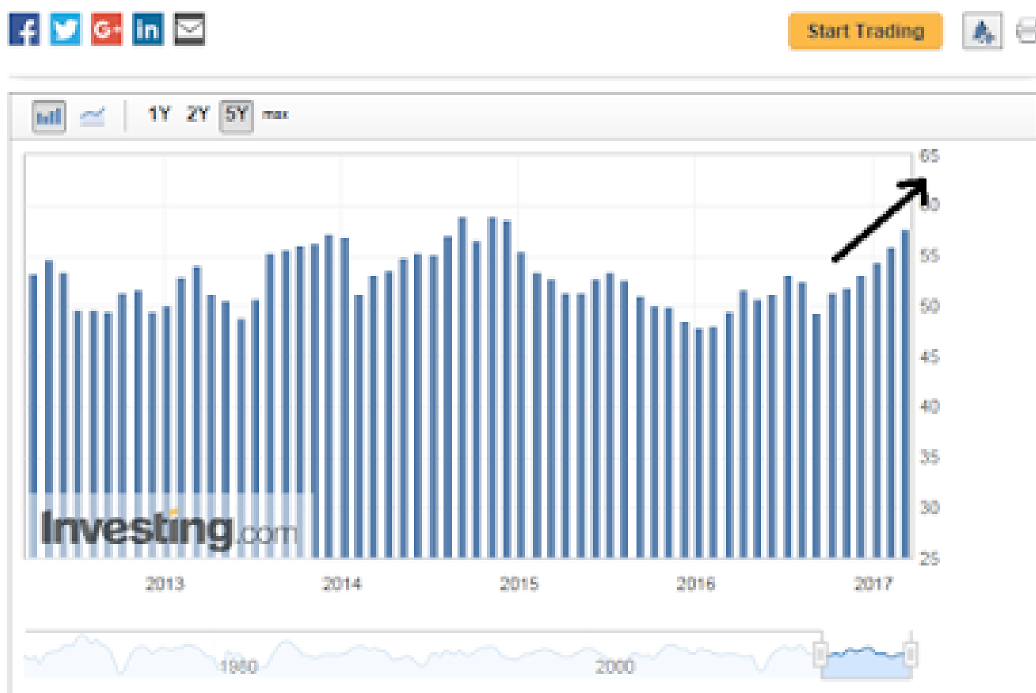
> forecast has yet to change much, then it is possible that the even if they raise in March, the median projection of three rate hikes this year remains steady.

Much of the data has been coming on the "hot" side, indicating a robust economy with rising inflationary pressures. By the book, the Fed should be thinking seriously about starting a rate hike cycle about now. Indeed, there were several data points that were released today that are supportive of that view.

The Beige Book, which released today, showed a lot of "modest to moderate" growth. Labor markets are tight, with "moderate" employment growth. Some districts reported labor shortages. These are the kinds of conditions that Dudley referred to when he described an "economy continues on the trajectory that it's on, slightly above-trend growth, gradually rising inflation" as the prerequisites to the removal of monetary policy accommodation.

This morning also saw the release of the ISM Manufacturing Survey, which rose and came in ahead of expectations, as it continued a trend of beating market expectations.

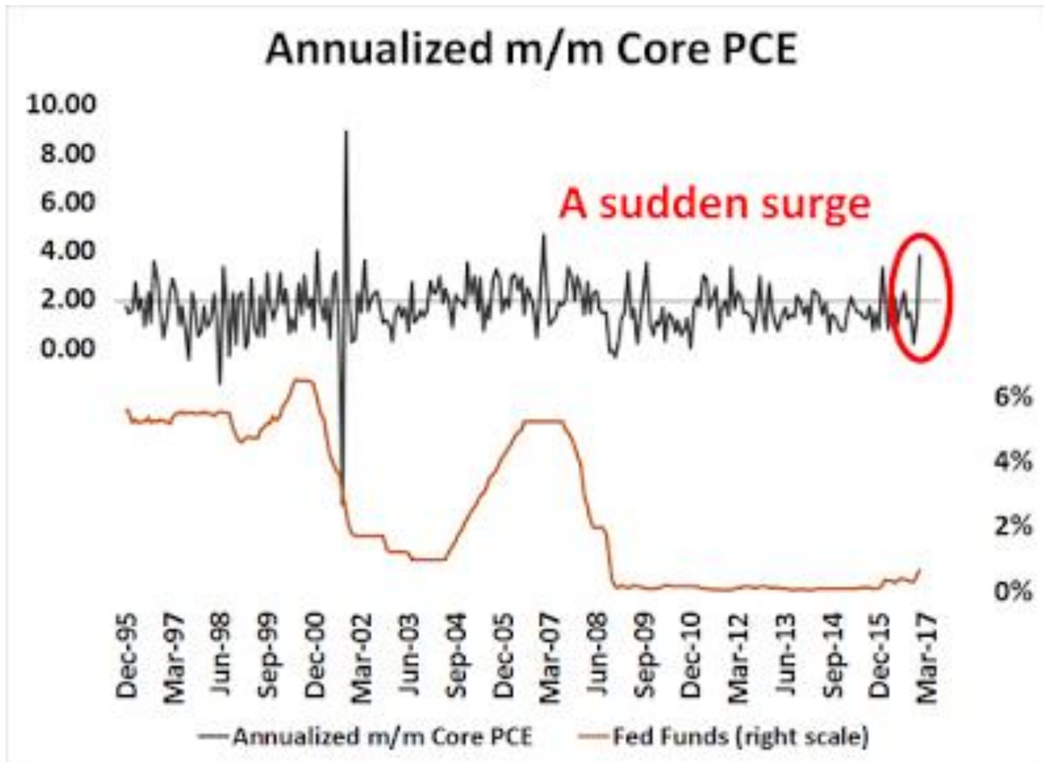
U.S. ISM Manufacturing Purchasing Managers Index (PMI)



A record of beating expectations

Release Date	Time	Actual	Forecast	Previous
Mar 01, 2017 (Feb)	10:00	57.7	56.0	56.0
Feb 01, 2017 (Jan)	10:00	56.0	55.0	54.5
Jan 03, 2017 (Dec)	10:00	54.7	53.6	53.2
Dec 01, 2016 (Nov)	10:00	53.2	52.2	51.9

As well, month-over-month Core PCE, the Fed's preferred inflation metric, was released this morning. It also came in ahead of expectations and surged to an annualized rate of 3.8%, well ahead of the Fed's 2% inflation target.



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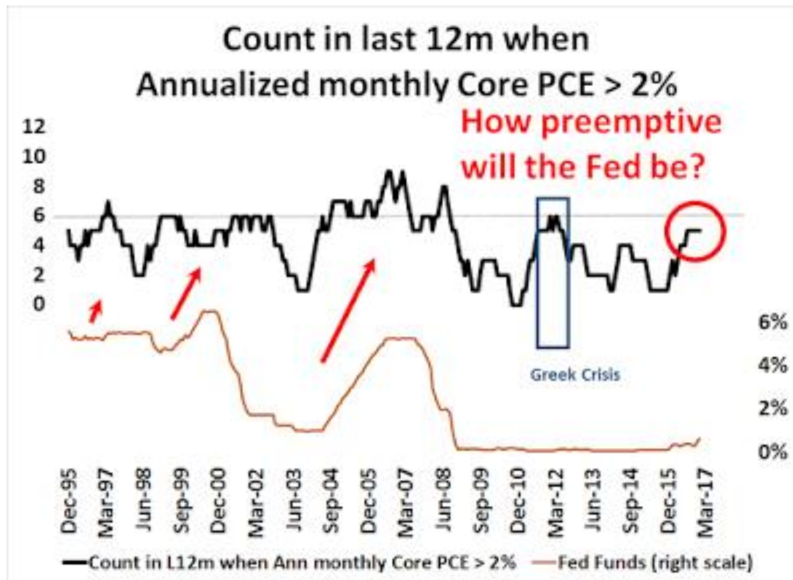
To put this data point into context, I counted the times in the last 12 months that annualized m/m Core PCE has exceeded 2%.

As the chart below shows, the Fed has historically begun a rate hike cycle whenever the count reached six (dotted line). The count currently stands at five, which begs the question, "How pre-emptive does the Fed want to be?"



Fed chair Janet Yellen and vice chair Stan Fischer are scheduled to speak on Friday. If they want to give the market further direction, we should get it then.

In addition, Fed governor Lael Brainard is scheduled to speak a 6pm ET today (Wednesday). Brainard is one of the most dovish governors on the Board, if her tone sounds hawkish, then watch out!

A Market Blow-Off

In summary, the stock market is undergoing a blow-off with no end in sight. We are starting to see bullish political developments out of Europe, but one wildcard is the possibility of a March rate hike. Should the Fed pre-emptively raise rates, not only would the normal macro effects of slowing the American economy be applicable, it would push up the US Dollar. A rising USD would be bearish in three ways. First, a strong greenback squeezes the margins and, therefore, the earnings of large cap multi-nationals companies. It would be supportive of the "America First" contingent within the Trump administration in their protectionist policies. As well, a strong USD would pressure the emerging market countries and companies with USD debt, and raise the odds of an EM debt crisis.

My inner trader initiated a small SPX position on Tuesday. He is maintaining his position in view of the downside risks to the market.

Brace for further volatility.

Disclosure: Long SPXU

Regards,

Cam Hui

Humble Student of the Markets, Inc.

Thursday, March 2, 2017

Frothy, Over-Extended Stock Market

I just wanted to follow up to yesterday's post (provided below, after this article) (see Don't relax yet, the week isn't over). One of the key developments that I had been watching has been the recent hawkish evolution in Fedspeak. Last night, uber-dove Lael Brainard gave an extraordinarily hawkish speech. She started with the following remarks:

> The economy appears to be at a transition. We are closing in on full employment, inflation is moving gradually toward our target, foreign growth is on more solid footing, and risks to the outlook are as close to balanced as they have been in some time. Assuming continued progress, it will likely be appropriate soon to remove additional accommodation, continuing on a gradual path.

As a reminder, Brainard had been the Federal Reserve governor who, if given 10 reasons to raise rates and one reason to wait, she would focus on the single reason as a way of mitigating systemic risk. The last paragraph of her speech concluded, not so much with a discussion of whether to raise rates, but what to do with the Fed's balance sheet after the rate normalization process had begun:

> To conclude, recent developments suggest that the macro economy may be at a transition. With full employment within reach, signs of progress on our inflation mandate, and a favorable shift in the balance of risks at home and abroad, it will likely be appropriate for the Committee to continue gradually removing monetary accommodation. As the federal funds rate continues to move higher toward its expected longer-run level, a transition in balance sheet policy will also be warranted. These transitions in the economy and monetary policy are positive

> reflections of the fact that the economy is gradually drawing closer to our policy goals. How the Committee should adjust the size and composition of the balance sheet to accomplish its goals and what level the balance sheet should be in normal times are important subjects that I look forward to discussing with my colleagues.

When a dove like Brainard sounds this hawkish, there is little doubt about whether the Fed will raise rates at its March meeting.

What About Buffett's Bullish Comments?

In a recent CNBC interview, legendary investor Warren Buffett stated that stocks are on the cheap side, but that assessment would change if rates were to rise:

> Billionaire investor Warren Buffett told CNBC on Monday U.S. stock prices are "on the cheap side" with interest rates at current levels...
>
> "We are not in a bubble territory" in the stock market, he said on "Squawk Box." If rates were to spike, however, then the stock market would be more expensive, he added.

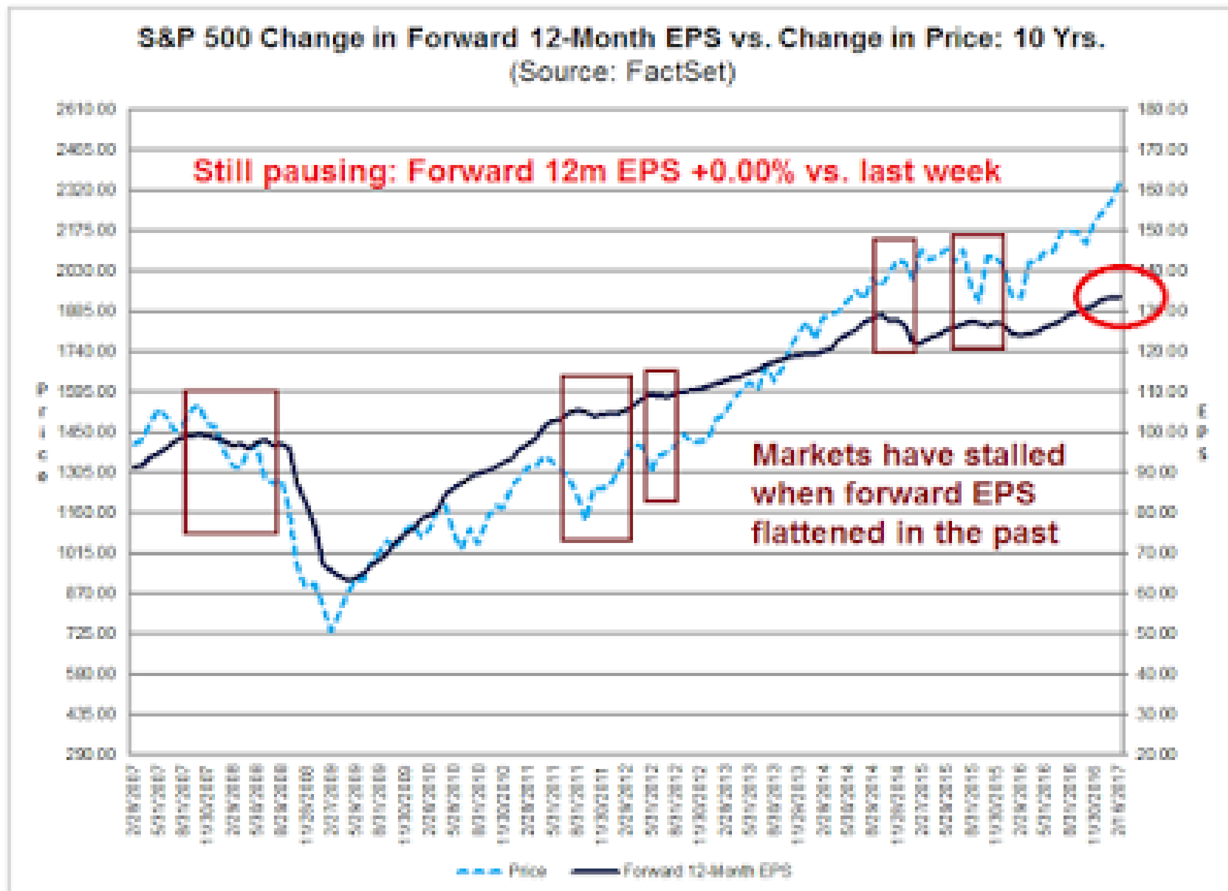
It looks like the Fed is about to raise start a rate hike cycle. So what now?

Isn't Growth Rising?

Bulls could be comforted by this historical analysis from JPM Asset Management indicating that when 10-year yields are below 5%, rising rates have meant rising stock prices (annotations in red are mine).

However, that analysis was only applicable because interest rates were historically much higher than they are today. Stock prices rise during the initial phase of a rate hike cycle because the bullish implications of expected higher growth overwhelm the bearish forces of higher rates and lower P/E multiples.

The latest update from [FactSet]() shows a stalling forward 12-month EPS, which is the best normalized indicator of expected earnings growth. Past episodes of flat to falling forward EPS have seen equity markets struggle or correct.



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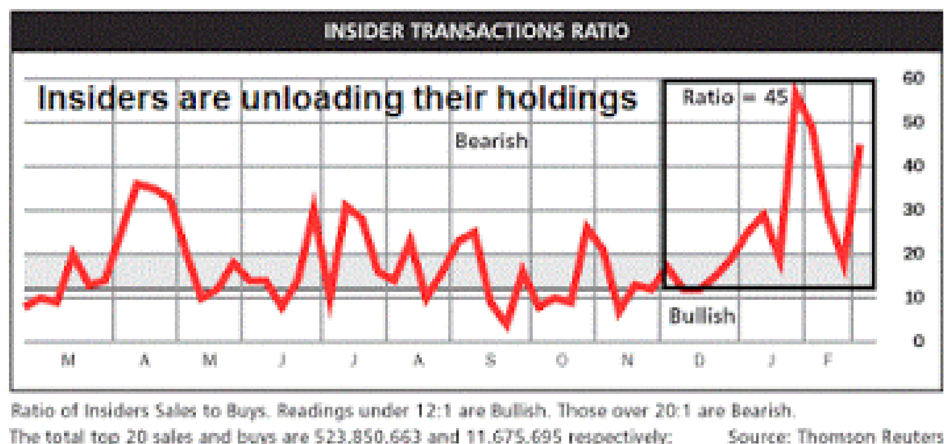
We are seeing a similar message from the bond market.

The chart below depicts the 2/10 yield curve. A steepening yield curve is interpreted as the bond market's expectation of higher economic growth, while a flattening yield curve reflects expectations of slower growth. Growth expectations bottomed out last summer and started rising in conjunction with the global cyclical rebound. However, they have started to flatten in 2017, indicating a slowing growth outlook.

Meanwhile, [Barron's] reports that the "smart money" insiders are selling at a torrid pace. Note that the period of heavy insider selling seems to parallel the latest episode of slowing growth expectations. Coincidence?



Ratio of Insiders Sales to Buys. Readings under 12:1 are Bullish. Those over 20:1 are Bearish. The total top 20 sales and buys are 523,850,663 and 11,675,695 respectively; Source: Thomson Reuters

Does the combination of these conditions look like the start of a bullish thrust to you?

What About Price Momentum?

I received several comments from some readers that went something like this, "Don't be an idiot. You're fighting the (bullish) tape."

Yesterday (Wednesday) saw the major market indices rise over 1%. As Urban Carmel pointed out, these kinds of momentum thrusts tend to occur at market bottoms, not when the market is making new highs.

$SPX - >1% gains typically happen near lows, often initiating a new uptrend. It's much less common at new 52-w highs

I went all the way back to 1990 and looked for instances when the SPX rose 1% or more while making a 52-week high. As the table below shows, the market tended to underperform, but it was not an outright sell signal for traders.

S&P 500 momentum study

(January 1991 - February 2017)

	Forward returns (days)							
	1	2	3	4	5	10	15	20
52 week high & index up >1% move in the same day (N=68)								
Median return	0.02%	0.02%	0.09%	0.15%	0.07%	-0.06%	0.75%	0.55%
% positive	52.9%	52.9%	54.4%	55.9%	55.9%	48.5%	58.8%	55.9%
S&P 500 anytime								
Median return	0.07%	0.12%	0.19%	0.24%	0.28%	0.54%	0.78%	1.01%
% positive	53.7%	54.3%	55.8%	55.9%	56.4%	58.9%	60.4%	61.8%
Difference								
Median return	-0.05%	-0.10%	-0.11%	-0.10%	-0.21%	-0.60%	-0.02%	-0.46%
% positive	-0.7%	-1.3%	-1.4%	0.0%	-0.5%	-10.4%	-1.5%	-5.9%

Returns subpar but still mostly positive

This is a frothy and over-extended market. This combination of a hawkish Fed, a faltering growth outlook, and the overbought momentum are suggestive of an exhaustion top, rather than the start of a bullish momentum thrust.

Regards,

Cam Hui

Humble Student of the Markets, Inc.

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