Perspective: StormGuard Triggered ... What's Next?

Nov 04, 2018

Dear Scott,

StormGuard Triggered ... Why?
Although the sharp decline in the market index (right) may seem sufficient to explain why StormGuard-Armor triggered, a similar market decline in late January produced a very different reaction, as illustrated in the StormGuard chart (below, right). Clearly, factors beyond simple price movement are in play.

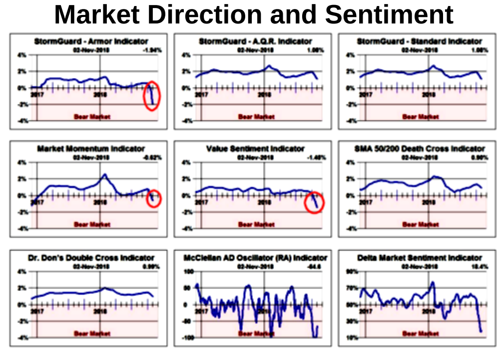
S&P500 Index - 6 Months

StormGuard-Armor examines three distinct market components (price, volume, highs/lows) to form a composite decision from a matrix of 12 separate measurements that essentially assess market safety. The set of nine daily Market Direction and Sentiment Charts (third down, right) contains the composite StormGuard-Armor chart in addition to its three components, among others. The Market Momentum Indicator and Value Sentiment Indicator charts both indicate a precipitous drop in October (red circles) that were not present in January. Both indicate a strong buyer's strike among high-volume institutional investors and new high/low-value sentiment investors.

Why a Buyer's Strike?
A buyer's strike occurs when investors are uncertain about significant political, financial, or weather events that will occur soon, but for which outcomes are unknown and may be unfavorable to the market. We have at least the following:

- Mid-term elections that alter the balance of power?
- Continued interest rate hikes by the FED?
- Large additional tariffs on Chinese goods?
- Robert Mueller Russia investigation results?

Market Direction and Sentiment



click image to enlarge

The relative importance of these events is unknown, but will become known soon as these events unfold. Currently, analysts primarily blame the uncertainty on both the mid-term elections next week and FED Chairman Powell's recent assertion that he intends to continue raising interest rates through the better part of next year.

Why Worry?
Analysts and pundits predicting a market crash in 2018 have been numerous. Fortunately, those who have been predicting the next market crash for the last few years have been wrong. While it's common for optimism to get ahead of itself and trigger a correction, it's very different from the widespread pessimism required to seriously take down the market. As investors, we are now forced to make a decision as to whether

this is (a) a market correction that will soon find its way to new highs, or (b) the start of the long-awaited next market crash. The prospect of losing half or more of your nest egg in the next market crash should be worrisome. As the uncertainties before us resolve themselves, it is possible that StormGuard-Armor could reverse itself just as fast. Let's review some of the other pieces of economic evidence as the jury may still be out.

Why Worry?

Is it a Correction or a Crash?

In the top of the pair of market charts (right), a similarity is easily seen between last January's correction and current market action. In the 15-year span of the lower chart, other similar events characterized as market corrections are marked in red, both of which triggered StormGuard-Armor. Still, the question remains whether the correction could grow into a full-fledged market crash, such as the prominent 2008-2009 crash also shown. Markets crash when pessimism overcomes optimism. In the 2001-2002 crash, the tech bubble popped and was followed by the 9/11 attacks. In 2008-2009 our financial system was driven to the brink of collapse when excess leverage in large institutions met the hidden time bomb of packaged liar loans defaulting in droves during swift interest rate hikes. While punctuated events, such as 9/11 and evolving structural problems will always catch us off guard, there are many measures of economic health that can provide at least a few clues to what may lie ahead for the economy and the market.

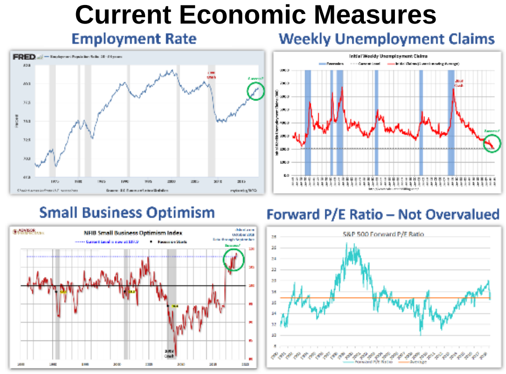
Is it a Correction, or a Market Crash?

click image to enlarge

A Sample of Current Economic Measures

The four Current Economic Measures charts (right) indicate: (a) The employment rate continues its steady rise. Notably the most recent new jobs report was 250,000, a significant upside surprise; (b) The weekly unemployment claims correspondingly is now at the lowest point in 60 years; (c) Small business optimism is now at its highest point in the 33-year history of its measurement; and (d) The forward-looking P/E (price/earnings) ratio indicates a healthy nominal value, very different from the market bubble from 1998 to 2001. By these measures, there is no reason for pessimism to overwhelm optimism. What the market is signaling is fear that the conditions that created the current bull market could change for any or all of the reasons listed earlier.

Current Economic Measures



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Correction Vigilantes vs The Bear

The Bear definitely wants your money. The last two times it ravaged us badly, and it definitely will be back for more. The NYSE Margin Debt chart (right) likely explains the severity of the prior two crashes. Human excitement and depression inherently create boom and bust cycles. What is particularly insidious is that adding margin debt (leverage) to the mix is like fanning the flames on the way up and inciting a mad rush to the exit on the way down. Providing nothing terrible happens (see list above) to throw cold water on continued economic growth, a bear market is not in the cards.

However, I don't believe the "correction vigilantes" are done with us. Some things only happen because it is a self-fulfilling prophecy. If traders believe a correction is not complete unless it falls 10% and must further confirm it by retesting that low, then the vigilantes will be sellers until that threshold is met and retested. The precision by which this happened in January was stunning, as if the rules were now hardcoded in software and executed in a manner that excludes human judgment, such as "that was close enough." In October we had a similar precision 10% drop. I believe it is more likely than not that these new correction vigilantes (software) will behave similarly: The market may move higher for a few days, but the vigilantes will eventually force a retest of the 10% correction threshold before relenting and allowing the bull to regain its footing.

The Bear: Locked and Loaded

click image to enlarge

In the meantime, both the momentum and value sentiment components of StormGuard-Armor are indicating severe caution while we wait for multiple economic and political uncertainties to be resolved.
Surf Well and Prosper,

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