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A rare sell signal for the S&P500

Over the past 9 months we have commented on the mounting divergences between the global markets and their economies. We have watched the seemingly benign response of the mega-cap S&P500 with disbelief. After unseasonably negative performance in December, the major averages (including the S&P500) are down 8% to 12% in the first two weeks of January. This is the worst beginning for the U.S. stock market in its recorded history (1896 for the Dow Industrials). Our apprehensions have not gone away: commodity prices are plunging, the dollar is plowing higher, high yield bonds are imploding, global trade is plummeting (has globalization peaked?) and terrorism is on the rise. The European Union is unraveling and Middle Eastern states are crumbling as Iran and Saudi Arabia get tenser. The U.S. Fed's balance sheet is contracting as the U.S. economy is slowing, corporate sales are declining and earnings are negative. China's debt continues to grow as its $5.0 trillion balance sheet (one-third of total central bank assets) is shrinking, exacerbating the drop in global liquidity. This is the fundamental backdrop for a rare sell signal on the S&P500 related to the seven-year cycle. Apart from the signal at the end of 2015, it has happened only 2 other times in 15 years – in 2000 and 2007. Exhibit 1 shows the indicator and the signals.

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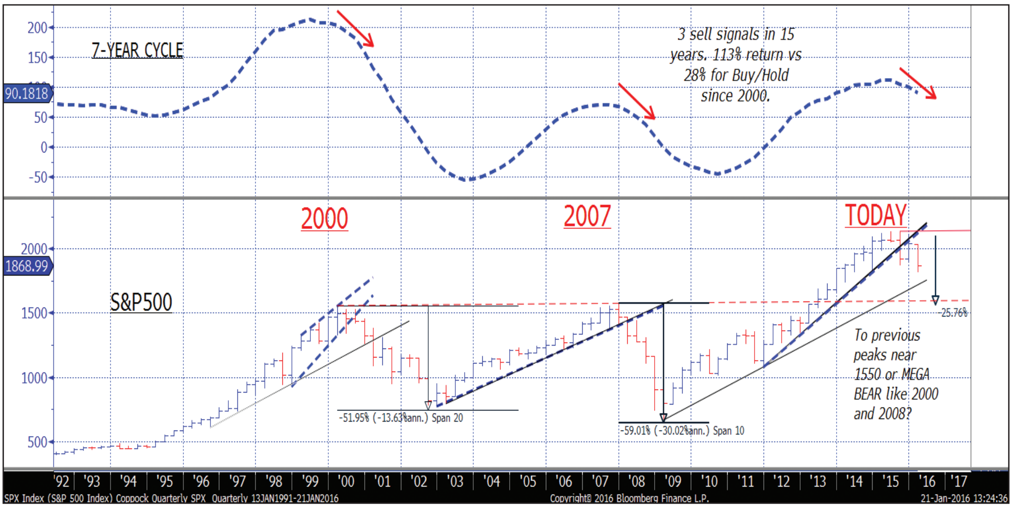
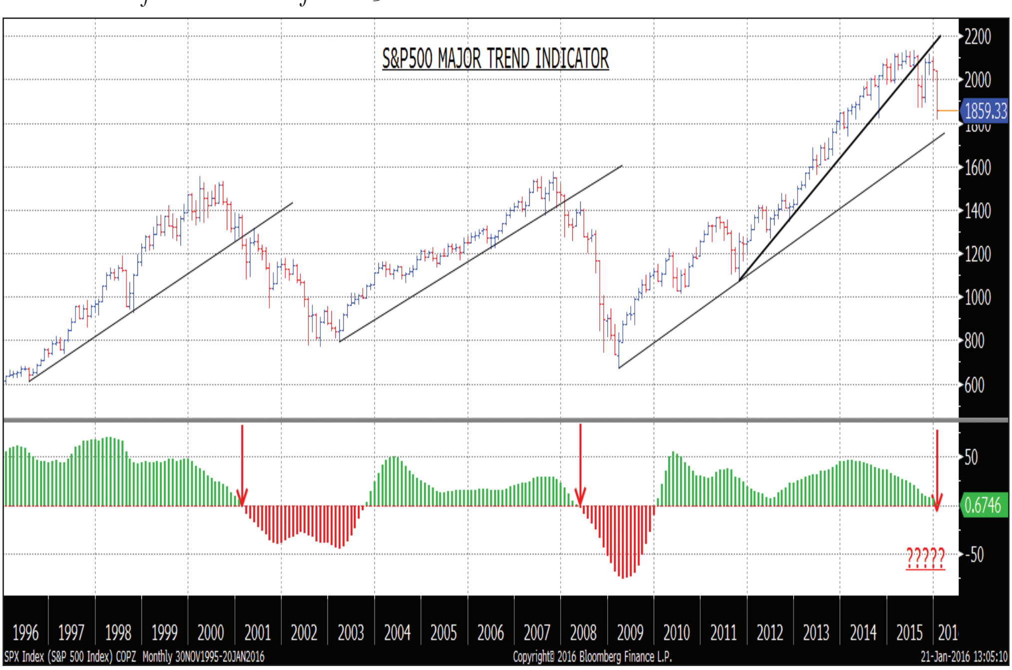
Exhibit 1: *Seven-year cycle in S&P500*



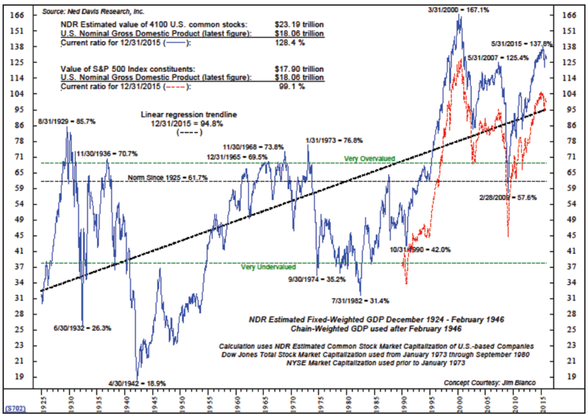
This indicator switches out of the S&P500 and into cash when the curve in the top panel (Exhibit 1) is falling. It moves back into the S&P500 when the curve in the top panel is rising. Following this strategy has yielded superior results over a simple "buy and hold" strategy over the last 15 years, returning 113% versus 28%. The 7-year cycle can lead prices by a few months, but when the major trend model (Exhibit 2) confirms, prices have eventually followed. It happened in 2000, 2008 and is pending confirmation now. When the trend model (lower panel, Exhibit 2) crosses into the red, the S&P500 will confirm the first bear market since the last one ended in 2009. Like its seven-year cycle companion, this is a rare signal. There is already sell signal confirmation for the DJIA, Dow Transports, New York Stock Exchange and the small-cap Russell 2000, which is down over 23% from its highs. Major global stock markets have also confirmed with many indices down over 20% from their 2015 peaks.

Exhibit 2: *Major Trend Model for S&P500*



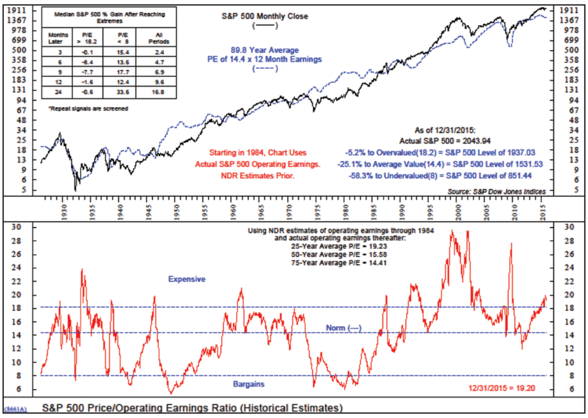
More indicators say high risk for stocks...

Exhibit 3: *Valuations*



Stock Market Capitalization as % of GDP

The U.S Stock Market peaks in Market Cap as a % of GDP are lining up with our 7-year cycle. Notice prior peaks were also 2000 and 2007. As of 12/31/15 market cap as a % of GDP was 128%, the second highest in history and above the average 95% since 1925.



S&P Operating P/E(Historical Estimates)

AT 19.2X earnings the S&P Price/ Operating Earnings is not as Overvalued as 2000 and 2007, but it is the 4th highest valuation in 20 years and among the highest since 1925. From the 12/31/15 close, it would take a 25% drop in prices just to return to 14.4X, the average since 1925 or to S&P 1535.

Just as the broad representation of asset classes and individual stocks has signaled negative warnings, so too have estimates on the U.S. economic indicators. The Economic Surprise Index measures all major weekly economic releases across Housing, Industrial, Labor, Retail, Manufacturing and Confidence. It then scores if they are above or below those estimates and adds (or subtracts) that to the index. This index has been in the red for the last 12 months. Performance of the S&P500, as shown by the yellow line, tends to track this economic composite. When economist estimates and stocks are out of sync, the indices eventually converge. That would explain the decline since April of 2015 when estimates on the economy were getting more negative in the face of rising stock prices. Currently ALL sectors (lower panel) are negative except Labor, which tends to be a lagging indicator. We will monitor this index for any positive surprises that the negative trend is improving.

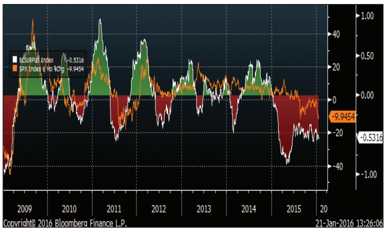


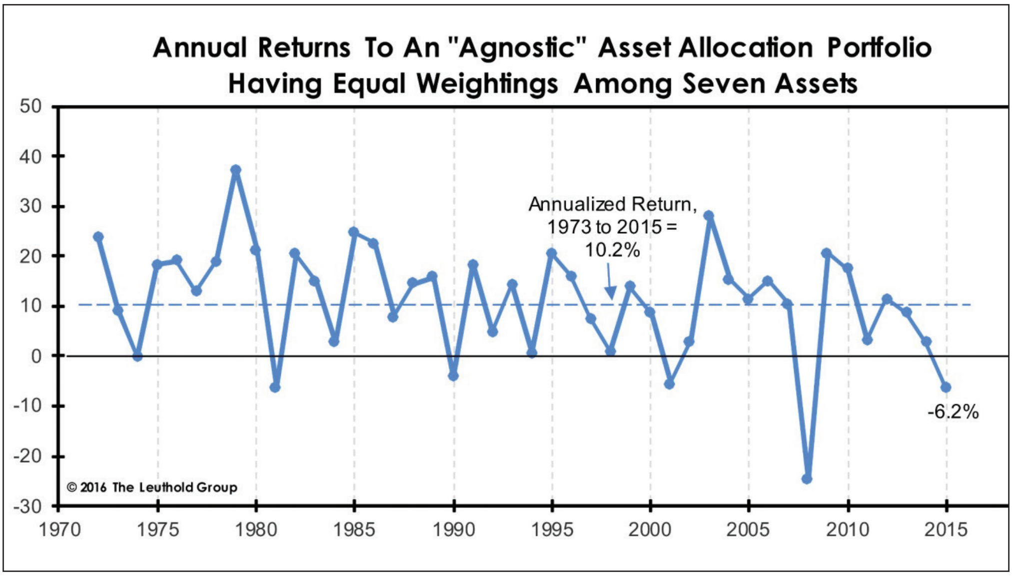
Exhibit 4: *The Economic Surprise Index and Component Sectors*

Exhibit 5: *Contracting Liquidity in the Fed's Balance Sheet and Shrinking China Reserves*

Time for the 7-asset model over stocks

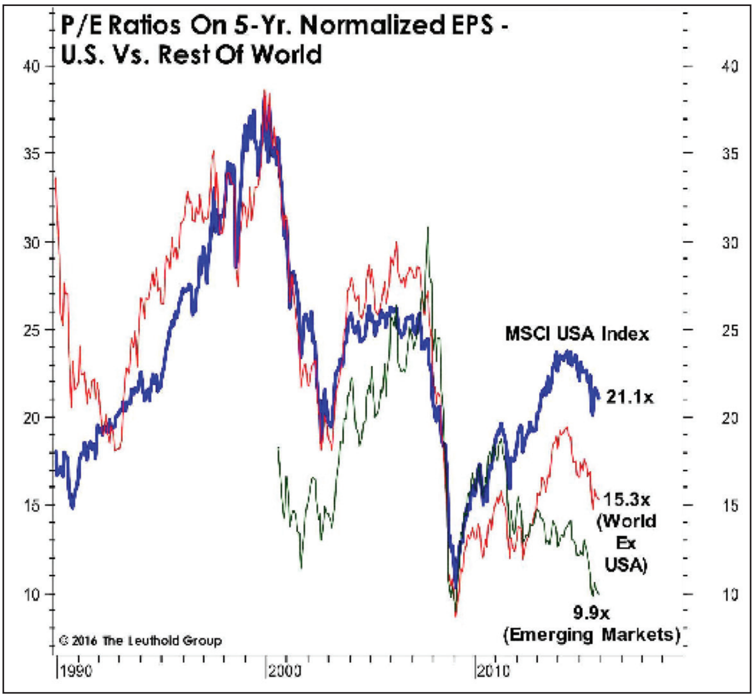
We have long advocated the merits of a diversified 7-asset portfolio that includes: global stocks, bonds, REITs, Natural Resources and Cash. Over long cycles the risk/adjusted returns are far better than a standard domestic balanced portfolio. Averaging 10.2% returns per year since 1973, there are only 5 years in which the 7-asset index **lost** money. *(While there are no 'published' versions of this index, we and other asset managers track the data to get a more accurate view on how the investable universe is doing.)* Exhibit 6 shows that except for the decline in 2008, the **loss of 6.2% in 2015** was the worst performance in 45 years. While uncharacteristically weak, it is hardly surprising when the single BEST asset class in the mix, REITs gained 2.3% and several asset classes declined double digits.

Exhibit 6: *The Seven-Asset Portfolio Index*

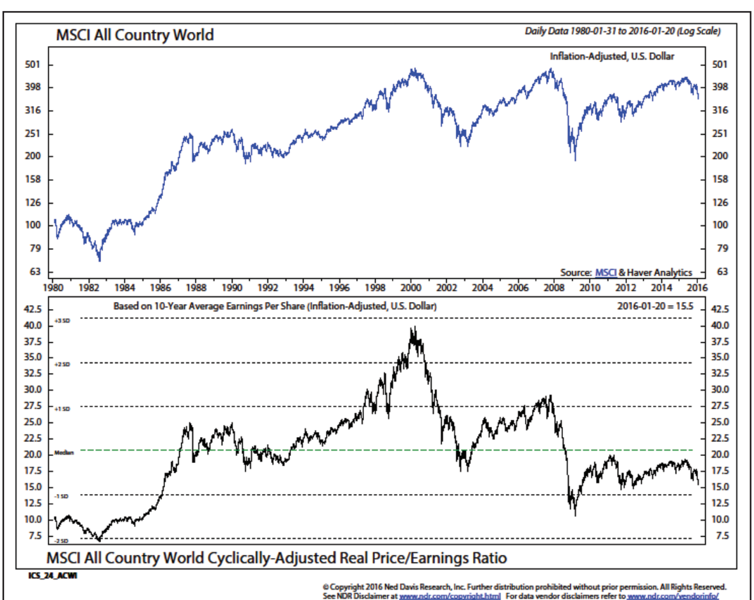


Historical results show that the *BEST* time for this mix is when stock risk is high and stocks are peaking. The very setup with which we begin 2016. With interest rates still so low, our other models suggest that defensive areas: government and municipal bonds, REITs, high yielding stocks like utilities, staples and telecoms, Gold, Cash and even shorting will provide safer returns. The 7-asset mix is inherently more defensive and has always outperformed stocks in a bear market. As the stock market decline matures (late 2016 ?), more opportunities will emerge. In Exhibit 7, notice how relatively undervalued the international and emerging markets have become vs. the U.S. market. It's too soon to buy heavily but we expect these to be among the first markets to turn up at the next bottom.

Exhibit 7: *Relative Valuations US to the rest of the world*



Valuations in the U.S are the highest in the world. Trends remain negative for all global stocks, but international and emerging markets are now at a large discount to the U.S. using 5-YR normalized earnings.



Unlike high valuation in the U.S., the MSCI Country World Index average P/E for most countries is below the 20 level that was the norm since 1980. This index is also almost as low as in 2009 so international stocks are getting cheap !

Exhibit 8: *NYSE TO S&P500*

Exhibit 8 shows the divergences in performance did not just begin in 2015. Throughout the recovery, even within the relatively strong U.S. market since 2009, most stocks have not been keeping pace. In the upper panel (Exhibit 8) The New York Stock Exchange, one of the broadest measures of stock performance representing thousands of companies versus the more narrow S&P500, only just surpassed the level of the last peak in 2007 but when compared to the headline S&P500 (lower panel) it has been lagging by more than 30% since 2008. A closer examination of the S&P500 shows that in 2015 while the weighted index rose 1.3%, the average stock actually declined. In fact, without the strongest 20 stocks out of the 500, the index lost 5.6%, closer to the -6.4% return for the New York Stock Exchange. The bottom 56% of the S&P500 fared very poorly, losing 19% in 2015.

The divergences are no doubt a near-term negative, but many stocks are already more fully developed in their bear markets. This will create more opportunities for later in 2016 when we expect stocks to turn up again. An examination of world markets tells a similar story. The ACWI cap-weighted world index in US $ returned -4.3% in 2015, while the average country index actually fell -10.6%. While this all sounds negative, it is actually saying that a lot of damage is already done, a necessary condition for better valuations and increased opportunities after the bear runs its course.

Summary ...

The seven-year cycle has turned down for U.S. stocks. Following this indicator has historically yielded superior results. Conversely, the same cycle in gold is turning up. Long Treasury bonds have just broken a down trend line in place since January, 2015. These are confirming the decline in stocks. Bonds, Gold, cash and bear funds that can sell short are our asset allocation picks for the first half of 2016.

Portfolios are defensively positioned. We may get more defensive if there is a rally in the short-term. For U.S. stocks, we believe the market is in the second down leg of the bear; the first ended in August 2015. The next significant rally could happen in the March-April time period. Although we may try to participate in this rally, our priority continues to be preservation of capital for what we believe will be a tremendous buying opportunity later this Fall. We also believe that the 7-asset portfolio, following a rare annual decline and more defensive in nature, will outperform in 2016.

Happy New Year from all of us at Avalon Capital Management!

Dave

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