Weighing the Week Ahead: A Delicate (and Temporary) Balance
July 24, 2018
by Jeff Miller
of NewArc Investments, Inc.

Despite plenty of news, there was little market reaction. In a summer week including many vacations, we have a modest economic calendar but plenty of earnings news. I expect the punditry to be asking:

*What will disrupt the balance of news?*

Opinions about the balance are quite diverse, as a recap of last week shows.

**Last Week Recap**

In my last edition of WTWA I suggested “Anything Goes,” because there were so many varied events – all important. There was much discussion over the Trump/Putin summit, lots of good earnings news, two days of testimony from Fed Chairman Powell, and plenty of economic reports. And how did the market react? Not much, at least not in the overall indexes. Once again, a big week for news had a very modest effect on stocks. The punditry expressed surprise before offering their profound explanations. It was humorous to watch. Some were surprised that the news had not pushed stocks higher, and some were amazed that stocks had “shrugged off” the turmoil to hold ground. *The job of pundit is easier when there is a clear move for which you can find post-hoc explanations.*

My observation that it would be difficult to guess a single theme was pretty accurate. The Helsinki Summit story got continuing headlines, although the market implications are murky.

**The Story in One Chart**

I always start my personal review of the week by looking at a great chart. This week let’s look at the futures chart from Investing.com. Since futures trade outside normal market hours, you can see the overnight effects. The “N” tags are points where there was significant news. The interactive chart lets you see the specific news and add technical indicators of your choice. Futures have a different lead month on a quarterly cycle. Right now, trading is in September futures. The value differs a bit from the S&P 500 index value. The futures owner does not collect dividends but earns interest on the funds not used for actual stock purchases. There is an active arbitrage between these values.
The market was virtually unchanged. The week’s trading range was less than 1%, lower than the last few weeks and much lower than the long-term average. I summarize actual and implied volatility each week in our Indicator Snapshot section below. Volatility is back below the long-term range.

Personal Note

Mrs. OldProf and I are on vacation for a bit, including the next two weekends. I’ll be watching things as always. I’ll try to post an indicator update and additional commentary as warranted.

We have special thanks this week to Dr. Brett Steenbarger, whose diverse skill, writings, and experience place him among the top thought leaders in our business. It is always nice to get recognition for your work, and especially when it is based upon precisely what you are trying to do. His recent Forbes column mentions “A Dash” along with some other great sources. Please take Brett’s suggestion. Use his leads to find new sources, and links to even more.

Important Trivia

Brian Gilmartin tees up a good question with an interesting comparison of conditions of the 1990’s with
those of today. He provides a strong, data-based comparison.

As it happens, Eric (my star summer intern) and I were working on a similar concept. I’ll provide a separate post later, but for now please try these questions:

1. How many of the stocks that were “top ten” in the S&P 500 for 1990 are still there.
2. What stock had the best performance?
3. That stock is no longer in the top ten. Why not?

Answers in the conclusion. The message for investors is to beware of buying the top in the current winners. An equal-weighted average of the top ten has underperformed the overall market in every subsequent period ……until now. Will things be different this time? If you are an index fund buyer, this is what you are getting. Just three stocks have been responsible for 71% of S&P 500 returns and 78% of Nasdaq 100 return.

The News

Each week I break down events into good and bad. For our purposes, “good” has two components. The news must be market friendly and better than expectations. I avoid using my personal preferences in evaluating news – and you should, too!

When relevant, I include expectations (E) and the prior reading (P).

Some important indicators, including retail sales, homebuilder confidence, and business inventories, were in line with expectations. Bespoke takes a deeper look at revisions and updates their interesting “bricks to clicks” measure.
The Good

- **Industrial production** rose 0.6% in June (E 0.5% P -0.5%, downwardly revised from -0.1%). Downward revisions in the prior month throw off the interpretation of changes in the current month. That is why these noisy series are best viewed with a rolling multi-month period.
- **Leading indicators** were up 0.5% (E 0.4% P 0.0% downwardly revised from 0.2%). (Conference Board).
Initial jobless claims hit another new low, 207K. (E 220K P 215K). Bespoke notes that this is the lowest level since December 1969.

LA port traffic is higher, but some of the increase might be a race to avoid the impending tariffs. (Calculated Risk).

Earnings season shows strength. Whether you look at beat rates, revenues, comparisons to last year, or estimate revisions, the story is strong. (Factset). Here is the sector look so far.
The Bad

- **Hotel occupancy is down.** Calculated Risk has been monitoring this story – a record pace for 2018 until recently.
- **Housing starts** for June posted a SAAR of 1173K, (E 1318K P1337K). Calculated Risk notes the disappointing numbers. He argues that it was just one month, concentrated in multi-family which is especially volatile. He also believes that existing home sales will move sideways while new home sales, more important for the economy, will increase.
- **Building permits** also missed with a SAAR of 1273K (E1330K P1301K). New Deal Democrat sees the data as suggesting a housing and GDP slowdown.

The Ugly

China is no longer importing plastic waste. (Timothy Taylor). Recycling efforts are going awry. (LA Times).

The Week Ahead

We would all like to know the direction of the market in advance. Good luck with that! Second best is planning what to look for and how to react.

The Calendar
The calendar has important housing data and the final July report for Michigan sentiment data. The focus for most news stories will be the first estimate of Q2 GDP, even though it is “old news” that will be revised several times.

Much more important is the corporate earnings story. And of course, any unexpected news on the trade front.

**Briefing.com** has a good U.S. economic calendar for the week (and many other good features which I monitor each day). Here are the main U.S. releases.

### Next Week’s Theme

Last week was confusing for most observers, including the top pundits. It seemed like something should happen. After all, there was plenty of news. Since the news included both positive stories on earnings and negative stories on geopolitics, everyone was free to choose to choose whatever confirmed their existing biases. Most still expect their personal viewpoint to prevail. The only point of agreement is the current, delicate balance. This leaves everyone wondering:

**What might disrupt the delicate balance of news? And when might it happen?**

Here is the general range of viewpoints:

- At any moment there will be a general epiphany and the wild ride will end. (See the discussion below from Alan Steel).
- Something bad is about to happen – with Korea, China, Putin, NATO, NAFTA, Mueller, or the Fed.
- In the summer vacation period, time can pass without any big market moves – wait for more on the mid-term elections.
Strong earnings and economic growth will eventually show up in stock prices.
The near-term ride could be a rocky one.

As usual, I have some additional observations and my own guesses in today’s Final Thought.

Quant Corner

We follow some regular featured sources and the best other quant news from the week.

Risk Analysis

I have a rule for my investment clients. *Think first about your risk. Only then should you consider possible rewards.* I monitor many quantitative reports and highlight the best methods in this weekly update.

The Indicator Snapshot

<table>
<thead>
<tr>
<th>Risk Indicator</th>
<th>Current</th>
<th>Last Week</th>
<th>Last Month</th>
<th>Last Quarter</th>
<th>Interpretation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Valuation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ten-year note yield</td>
<td>2.90%</td>
<td>2.83%</td>
<td>2.90%</td>
<td>2.96%</td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>2802</td>
<td>2801</td>
<td>2755</td>
<td>2670</td>
<td></td>
</tr>
<tr>
<td>S&amp;P Forward Earnings</td>
<td>168</td>
<td>168</td>
<td>164</td>
<td>162</td>
<td></td>
</tr>
<tr>
<td>S&amp;P Earnings yield</td>
<td>6.01%</td>
<td>6.01%</td>
<td>5.95%</td>
<td>6.07%</td>
<td></td>
</tr>
<tr>
<td>Equity Risk Premium</td>
<td>3.11%</td>
<td>3.18%</td>
<td>3.06%</td>
<td>3.11%</td>
<td>Very High</td>
</tr>
<tr>
<td><strong>Economy</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C-Score</td>
<td>270</td>
<td>276</td>
<td>290</td>
<td>368</td>
<td>9 MoRecession Prob about 24%</td>
</tr>
<tr>
<td>Leading Superindex*</td>
<td>1.22%</td>
<td>1.00%</td>
<td>0.86%</td>
<td>0.70%</td>
<td>3-4 MoRecession Prob</td>
</tr>
<tr>
<td>BCiP</td>
<td>100.0</td>
<td>100.0</td>
<td>99.5</td>
<td>85.8</td>
<td>No recession indicated</td>
</tr>
<tr>
<td>SLFSI</td>
<td>-1.181</td>
<td>-1.118</td>
<td>-1.149</td>
<td>-0.970</td>
<td>Very Low Risk</td>
</tr>
<tr>
<td><strong>Anticipated Inflation</strong></td>
<td>2.09%</td>
<td>2.11%</td>
<td>2.11%</td>
<td>2.17%</td>
<td></td>
</tr>
<tr>
<td><strong>VIX</strong></td>
<td>12.87%</td>
<td>12.58%</td>
<td>14.64%</td>
<td>15.96%</td>
<td></td>
</tr>
<tr>
<td><strong>Historical S&amp;P Volatility</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Last Five Days</td>
<td>4.89%</td>
<td>11.87%</td>
<td>5.70%</td>
<td>13.27%</td>
<td></td>
</tr>
<tr>
<td>Last Twenty Days</td>
<td>9.83%</td>
<td>10.39%</td>
<td>9.34%</td>
<td>22.08%</td>
<td></td>
</tr>
<tr>
<td><strong>Technical Health</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>3.5</td>
<td>Bullish</td>
</tr>
<tr>
<td>Long-term</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>Strongly Bullish</td>
</tr>
</tbody>
</table>

Sources: Stlouisfed.org, RecessionAlert.com, IMarket Signals, fundamentalis.com, and NewArc Investments, Inc. ©2018

*Superindex is the public value, delayed one month*
Short-term trading conditions continue at highly favorable levels. Actual volatility remains low. The VIX is once again higher than reality.

**The Featured Sources:**

Bob Dieli: Business cycle analysis via the “C Score.

Georg Vrba: Business cycle indicator and market timing tools. None of Georg’s indicators signal recession.

Brian Gilmartin: All things earnings, for the overall market as well as many individual companies.

RecessionAlert: Strong quantitative indicators for both economic and market analysis.

Doug Short and Jill Mislinski: Regular updating of an array of indicators. Great charts and analysis.

**Insight for Traders**

Check out our weekly Stock Exchange post. We combine links to important posts about trading, themes of current interest, and ideas from our trading models. This week we raised the question of what winning traders have in common. In addition to the expert commentary we discussed some of our own current picks. The ratings from Felix and Oscar this week feature the S&P 500. While our entire team pitches in, Blue Harbinger is the editor for this information and ringleader for the group discussion.

While the series emphasizes trading, investors might want to check it out. The methods reduce risk through diversity and (for most people) are appropriate for those needing a boost in returns in their IRA.

As he does so frequently, Dr. Brett Steenbarger writes about concepts that hit the intersection of trading and investing. He writes:

That means, in life, we are both shorter-term traders and longer-term investors. Activities we get into and out of day by day are trades. Goals that we seek over time are our investments. The sum is our life portfolio, and we hope that all its components produce unique, positive returns. When we find happiness in our fulfilling activities, the result is an unusually high level of well-being.

So it is with our financial lives.

**Insight for Investors**

Investors should have a long-term horizon. They can often exploit trading volatility.
Best of the Week

If I had to pick a single most important source for investors to read this week it would be Chuck Carnevale’s analysis of Microsoft (MSFT), *Long-Term Microsoft Shareholders: Your Money May Be In Jeopardy*. This is a stock on a great run, featured in many portfolios. In such cases you do not find many skeptics. The lesson investors get from Chuck’s work is the discipline and the focus on data. Watch the video to see both the careful analysis and instruction in using the FAST Graphs tool. The basic idea?

...despite all the positive results and good news surrounding the company and its largest quarter of the year, I consider the company’s stock dangerously overpriced. However, I also would add that I really like Microsoft the business and its prospects for growth going forward. In other words, what I don’t like about Microsoft’s stock price today has little to do about the company and everything to do about the way I believe the market is irrationally pricing the stock.

And the conclusion?

...as a prudent investor, it’s critically important to recognize – within reason at least – whether the investment in a given stock makes economic sense. Despite all these impressive results, I do not believe that an investment in Microsoft makes economic sense today. In other words, I do not think it’s a good buy at its current quotations. If I was a long-term shareholder, I would at
least consider taking some of my investment off the table.

In closing, I would really love to have Microsoft in my portfolio as a long-term position. However, I believe the market is applying too high a valuation for me to even consider investing in this great business. So, to be clear, I love the company, but I hate the valuation I would have to pay to be able to invest in it.

[Jeff again] Determining the fair value of a company is the cornerstone of wise, long-term investment decisions. How else would you know whether Mr. Market’s daily offer is reasonable?

Stock Ideas

Call for Philip Morris? (PM) Colorado Wealth Management reviews the earnings and outlook. An annotated earnings call script is a helpful guide to their thinking.

Asset managers “look like bargains” writes Andrew Bary (Barron’s).

Eddy Elfenbein updates the earnings stories for his public portfolio. While he does not change it during the year, you can if you wish. Better yet, join me in owning some shares of his ETF (CWS). I described the reasons here.

Two ideas from the Delivering Alpha Conference: BIIB and TTWO.

Buy big pharma in front of earnings? John Boris of SunTrust suggests four ideas (24/7 Wall St.)

Stone Fox Capital likes Bank of America (BAC). The key consideration is the ability to “control costs
relative to revenues”. [Jeff – BAC is a candidate for our Enhanced Yield program, where we sell near-term calls against the stock. In this approach, safety is more important than immediate upside].

Health care IT is an attractive sector. How about Cerner (CERN).

**Yield Quest**

Marc Gerstein tweaks his REIT model. The changes are theoretically important, and the results just as good. Read all three of these posts for an education in what to look for and how to screen.

Marc also suggests Brixmor (BRX) as a REIT to consider.

And finally, Kimco (KIM) as one to avoid.

AT&T (T) or high-yield bonds? (Barron’s)

**Perspective**

Bespoke notes the relative weakness of transports and small caps. These are often viewed as breadth indicators, reflecting the overall health of the market.

Alan Steel produces an interesting list of links in his always-colorful commentary. I’ll just include the first few, so read the full post to reach back to 2010. He helpfully includes his own list of factors to watch.
You can tip toe through all that Tulip Mania below – as scribbled in a previous Investor Points of Few, *First Do No Harm* about this particular Societe Generale Groundhog Day going back to March 2009:

The Last Time This Happened Was January 2008 – Zero Hedge, August 2017

The Stock Market’s Nightmare Scenario – Business Insider, October 2017

If I’m Right, The US Stock Market Will Fall 75% – Business Insider, January 2016


Get Ready to Relive the 2008 Crisis – CNBC, July 2015

**Personal Finance**

Seeking Alpha Senior Editor Gil Weinreich’s Asset Allocation Daily considers a wide range of sources as well as his own take on an important issue. It is interesting to financial advisors as well as the DIY investor. This week he writes about *Retirement Guzzlers*, drawing upon a blog post by Ben Carlson. Gil emphasizes the short-term thinking behind these purchases.

We live at a time of retirement crisis, but this very same era affords most people (in big cities, at least) the historically unprecedented opportunity of avoiding nearly the entire cost of car ownership. Through ride-sharing services like Uber, you don’t need to buy a car, insure it, fuel it, take it to the shop or pay for parking.

[Jeff – In a conversation I once had with the sales manager at a big dealership, I learned two interesting things. About 1/3 of his customers could not qualify for a credit card. And since they urge replacement intervals of three years and loans are for five years, there is a problem. Solution? The big
rebates common in the auto sales business count as part of the down payment, offsetting what is left on owners’ loans].

Abnormal Returns is an important daily source for all of us following investment news. His Wednesday Personal Finance Post is especially helpful for individual investors. There were many helpful links this week, so check out the full post to see for yourself. My favorites were the following:

- Catching up when you haven’t saved enough for retirement (WSJ).
- Adam M. Grossman’s analysis of myths about Social Security. These are all good points to consider.
- A primer on tax loss harvesting (The White Coat Investor).
- The importance of asking whether your advisor is a fiduciary. (Peter Lazaroff)

The definition of an accredited investor is changing. This opens more opportunities for astute people who have not yet accumulated wealth. JD Alois (Crowdfund Insider) writes as follows:

The current definition of an accredited investor is a profound act of disenfranchisement. Policy makers' decision to segregate investors based solely on how much money they have is a myopic, discriminatory act of rulemaking. The punitive definition of an accredited investor has been in place for decades, fueling an environment where the wealthy have access to some of the most promising investment opportunities and the poor not at all.

Watch out for…

Stretching for Yield. The Barron's cover story, Wall Street Rushes Into a New Asset Class, takes up the question of direct lending. Since the associated funds report tempting yields, it is easy for investors to look no further. If you are considering these or similar investments, some due diligence is necessary.

But retail investors need to be careful: Some BDCs have been plagued by hefty fees and mismanagement in the past. Interval funds like OFI Carlyle Private Credit include other types of credit investments beyond direct lending. Or investors can buy collateralized-loan-obligation funds, or CLOs, but those buy bigger, syndicated loans.

The push into direct lending is partly a story of banks retreating in the wake of regulations passed after the financial crisis, and asset managers happily picking up the slack. For instance, interest surged in direct lending after early-2013 regulatory guidance that clarified what banks could and could not do in terms of leveraged lending.

Remember that you are investing in loans that banks won’t make. The issue also includes several
informative sidebars. Hint: Leverage and coverage of the stated dividend are both important.

Final Thoughts

The balance question, like so many investing problems, must be answered in terms of time frames.

- My answer in the short term is that I do not know what will tip the balance. I only know what to watch – mostly earnings conference calls.
- In the long term, evidence shows that markets eventually respect earnings. Unless you need to dip into your cash soon, your focus should be earnings growth. And also, the competition from other investments. **If you have a focus on stock values, you need not cheer for an instant rebound. That provides gratification, but not opportunity.**
- Expect more assertions that investors are complacent. Not so! The VIX remains far above actual volatility. An apparently quiet market often reflects intense but opposing sides.

> As we make the transition into the second part of the report to resume our conversation about inflation, I thought this might be a good place to elaborate a bit on the three quotes that appeared next to the picture of Saint Offset.

> **“Thou shalt not forecast the forecast.”**
> The Prime Directive.

> **“Two ‘wrongs’ can make a ‘right’ but it is not always the same two ‘wrongs’.”**
> Do not confuse coincidence with causality.
> Do not abuse the data.

> **“Don’t ask your dentist to cut your hair and don’t ask your barber to clean your teeth.”**
> Stay within the boundaries of your expertise.
> Don’t forecast that in which you are not an expert.

> Now, on to the work at hand.

Expect more articles by *yield-curve newbies*. In the search for something to write about, they are itching to use this to forecast a recession. I highlight the work of Dr. Robert Dieli because of the intellectual integrity of his work and the long-term real-time track record of the results. The quotations at the left are inspired by his muse, Saint Offset.

Bob sees the economy (still) in the expansion phase, although there are signs of moving to a “boom.”
This is the period right before a peak, the technical definition of a recession. While many speculate about what inning this is, we cannot really know. We only know that the game is not over and is unlikely to end in the next year.

While I periodically quote segments of Bob’s reports, I can only give a taste. His yield curve analysis is unlike anything you see elsewhere. It demonstrates that the current action is a “compression” not an “inversion.” Anyone managing serious money should be reading this valuable work. It pays for itself both in accuracy and in time saved.

This post by Ben Carlson, whom we often cite, shows what you see if you just do some historical analysis. He writes:

> We touched on the yield curve on this week’s Animal Spirits because it seems to be the main point of contention in the markets right now. It’s all any of us market nerds can talk about, partly because the markets are somewhat boring this year and partly because investors love to try their hand at predicting the next recession.

I strongly recommend that Ben write to Bob (https://www.nospinforecast.com/) and ask for a free report. Unless you look at the best sources, you do not know what you are missing.

One of my frustrations in writing WTWA is that so much information offered to investors is aimed at their wallets rather than their brains. It is probably time for me to take a week off!

**Trivia Answers**

1. Only a single stock — XOM.
2. MO, with a compound annual growth rate of nearly 27%.
3. So much of the return was in dividends that the current market cap does not place it in the top ten.

More to come from this interesting analysis.

**I’m more worried about:**

- Policy-making roles. While presidents always lead through a “bully pulpit,” it is important to have some institutions that are less sensitive to public opinion. In the case of the Fed, both presidents and majority party members of Congress prefer low interest rates. If we want a Fed that can maintain price stability, some independence is required.
- Earnings reactions. The mere mention of trade problems or the effect of a strong dollar sends the analyst community into a downgrade frenzy.

**I’m less worried about:**

- The actual tariff effects. Various studies have now been conducted, showing the effect on global
growth. It is bad, of course, but not as bad as many feared. (JP Morgan estimate) My own take is that something viewed as a real sign of progress would be worth an immediate four percent in stocks, with more to come. This is a bit less than President Trump’s 40% estimate!

- The effect of artificial intelligence on employment. **This article** provides sources and interesting examples.

© NewArc Investments, Inc.