Weekly Market Notes

October 15, 2018

Dow Industrials 25339
S&P 500 2767

Please refer to Appendix – Important Disclosures

Summary
Fundamentally the economy appears to be on solid footing which bodes well for stocks. Inflation and interest rates remain historically low and the labor markets are the strongest in decades.

Third-quarter earnings to be released over the next few weeks are anticipated to be up almost 20%.

The technicals argue for caution with the broad market continuing to deteriorate. This suggests that extreme levels of pessimism will be required to turn the outlook more positive.

We suggest staying with the strongest sectors including health care and consumer discretionary (See Baird Sector Summary.)

Stock Market

The equity markets fell sharply last week, erasing most of the gains since early June. Much of the damage was related to a deterioration in U.S./China trade relations as well as the rise in bond yields as the 10-year Treasury note hit the highest level since 2011. Investors are concerned that the Federal Reserve may raise rates too quickly and choke off the U.S. economy by impacting borrowing costs and eroding corporate profits. We do not see any evidence of this as the Fed has responded to a strong labor market and a record performance by the U.S. service sector by raising rates gradually against a backdrop of low inflation pressures. This was seen in the latest Consumer Price Index Report that showed inflation pressures weaker than expected in September which relieves the pressure on the Fed to raise rates. The strength in the U.S. economy is real, with a great job market and companies that are expanding, supported by tax cuts and deregulation and not based upon quantitative easing as in the past. About 75% of S&P companies will announce third-quarter earnings over the next month and analysts are expecting earnings to be up almost 20%.

The technical underpinnings of the stock market continue to argue for a cautious approach. Given that stocks enter the week deeply oversold, a short-term counter-trend rally appears likely. From a longer-term perspective, however, there is insufficient evidence to expect a sustainable rally back to the September highs. The broad market, that typically leads the popular averages by 3-6 months, weakened further last week. This is seen by the fact that the number of NYSE stocks hitting new 52-week lows ballooned to 870 from 649 the previous week. Before issuing a bullish signal, we would need to see the popular indexes trend lower accompanied by a reduction in the number of issues making new lows. There should also be a reversal in the downside momentum that currently plagues the markets to signal the downtrend has been broken. Last Thursday marked the seventh time this year where downside momentum has overwhelmed upside momentum by a ratio of 10-to-1 or more without a single session where upside volume exceeded downside volume by a ratio of 10-to-1 or more. Before signaling a bottom is in place, we would need to see at least one day (and probably multiple days) where upside volume outpaces downside volume by better than 10-to-1.

Virtually all sustainable rallies the past few years have been preceded by investors turning excessively pessimistic. Sentiment indicators are very telling because of the inverse relationship that exists between sentiment and liquidity. When pessimism becomes excessive it argues that liquidity has accumulated on the sidelines to a sufficient degree to support the next important rally. In the present example, investor psychology has moved from optimism to caution and skepticism with little evidence of broad-based pessimism. To issue an all-clear signal, we would like to see pessimism reach excessive or extreme levels to feel confident that a low is in place.

The bottom line is that for confirmation that a year-end rally is underway we would expect to see a contraction in the number of stocks hitting new 52-week lows accompanied by extreme levels of pessimism and at least one session where upside volume blows out downside volume.

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Sentiment

	Current Week		Previous Week		Indication
CBOE 10-Day Put/Call Ratio *Below 83% is bearish; Above 95% is bullish*	15%		102		Bullish
CBOE 3-Day Equity Put/Call Ratio *Below 57% is bearish; Above 63% is bullish*	68%		70%		Bullish
VIX Volatility Index *Below 11 is bearish; Above 20 is bullish*	21.3		14.8		Bullish
American Association of Individual Investors *Twice as many bulls as bears is bearish; 2X more bears than bulls is bullish*	Bulls: Bears:	31% 36%	Bulls: Bears:	45% 25%	Neutral
Investors Intelligence (Advisory Services) *55% bulls considered bearish/more than 35% bears is bullish*	Bulls Bears:	56.3% 18.5%	Bulls: Bears:	61.8% 18.6%	Bearish
National Assoc. of Active Investment Mgrs. (NAAIM) *Below 30% is bullish; Above 80% is bearish*	53%		85%		Neutral
Ned Davis Research Crowd Sentiment Poll	Optimism Excessive		Optimism excessive		Bearish
Ned Davis Research Daily Trading Sentiment Composite	Excessive Pessimism		Optimism Fading		Bullish

	RS Ranking Current		RS Ranking Previous	RS Trend	Sub-Industry Detail
Health Care	1	**	1		*Leaders:* Health Care Equipment; Health Care Services; Health Care Facilities; Managed Health Care; Pharmaceuticals *Laggards:*
Utilities	2		8		*Leaders:* Independent Power Producers *Laggards:*
Energy	3	**	4	+	*Leaders:* Oil & Gas Drilling; Oil & Gas Refining & Marketing *Laggards:*
Consumer Discretionary	4	**	5		*Leaders:* Apparel Retail; Specialty Stores; Automotive Retail *Laggards:* Auto Parts & Equipment; Tires & Rubber; Automobile Manufacturers; Home Furnishings; Homebuilding; Household Appliances; Housewares & Specialties; Casinos & Gaming; Distributors
Information Technology	5	**	2	-	*Leaders:* Systems Software; Technology Hardware, Storage & Peripherals *Laggards:* Internet Software & Services; Electronic Manufacturing Services; Semiconductor Equipment
Industrials	6	**	3		*Leaders:* Railroads *Laggards:* Building Products
Consumer Staples	7		9		*Leaders:* Drug Retail; Hypermarkets & Super Centers; Agricultural Products *Laggards:* Brewers
Communication Services	8		6		*Leaders:* Broadcasting *Laggards:*
Real Estate	9		0		*Leaders:* *Laggards:* Real Estate Services
Financials	10		7		*Leaders:* *Laggards:* Asset Management & Custody Banks
Materials	11		10		*Leaders:* Fertilizers & Agricultural Chemicals; Metal & Glass Containers *Laggards:* Commodity Chemicals; Diversified Chemicals; Construction Materials; Paper Packaging

*** Denotes Current Relative Strength-Based Overweight Sectors*

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