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Slower growth creates longer economic expansions with short-lived weak spots…

Perspectives

Economists and analysts like to compare each economic cycle to previous cycles to glean answers to help improve their forecasts. While looking at history to predict the future has its benefits, understanding why the past cycles reached such high levels is crucial when making comparisons and judgments about how well the next cycle is progressing.

The current recovery from the "Great Recession" has created the second longest bull market in US history, but at a much slower pace than most of the previous bull markets. Rather than tout the remarkable steadiness of the past seven and a half years, economists point to how much lower some economic data are compared to 2007 at the peak of the housing bubble.

Much like how an aging athlete shouldn't expect the same strength and recovery time he had 10 years ago when he was younger and using performance enhancing drugs, investors need to learn to work with the market they have to find the best investment opportunities. Fast growth that is spurred on by predatory lending or other nefarious activity in poorly regulated industries can create bubbles in parts of the economy that cause more pain in the long-term.

Slow and steady growth is better for investors, even if it is not as exciting as a bubble economy. Slower growth creates longer economic expansions with short-lived weak spots along the way that can be managed through proper diversification. Investors who were well diversified may not have noticed that small-cap stocks fell into a bear market in February when the sector retreated 27.5% from its high eight months earlier. Small-cap stocks have recovered almost completely less than eight months later. The recovery has been relatively quick because no major bubbles inflated prices beyond a reasonable economic cycle.

Not only traders, but also more passive investors can improve performance by taking realized gains when prices are stretched. By selling, even a small portion of a portfolio, when prices are high allows investors to have cash available when the market is hit with a correction. However, constantly selling on fear is a quick way to trail average market returns. Taking a profit on any position needs to have predefined criteria that removes emotion from the equation.

In last quarter's newsletter, I wrote about the bubble in bonds and how it was due for a correction. I focused on the volatile 20-year Treasury Exchange Traded Fund (ETF), ticker TLT, and the risks with investing in long-term bonds. By Friday's close, TLT had fallen nearly 7% since I wrote that warning, but may not be finished with its correction yet as rates normalize. The fear of how the bond market will behave once the Fed raises interest rates has investors running for the doors, but the downside could be limited from current levels while most of the developed world is running low, if not negative, interest rates.

The S&P 500 index is yielding 2.04% compared to the 10-year Treasury note's yield of 1.72%. For more conservative investors, the narrowing gap between yields is close enough now to give the perceived safety in bonds another look. Patient investors should consider waiting a few more months before making that rotation back to bonds. The Fed funds futures (a predictive view of when interest rates will rise) show a 69.5% probability of an interest rate hike in December. If the futures are correct, bonds could fall further as rates increase.

The markets will have plenty of volatile days with national and state elections less than a month away, but if investors stay focused on what matters (earnings) they will be less prone to panic selling on dips and might even find some opportunities to take profits on the next price spike.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	10/7/2016	6.88	10.77	9.57	13.28
NASDAQ Composite	10/7/2016	5.69	10.46	11.97	16.38
Russell 2000	10/7/2016	10.15	8.94	6.55	15.11
S&P 500	10/7/2016	7.19	10.31	11.05	15.73
S&P MidCap 400	10/7/2016	11.09	9.52	8.97	15.70
Global Stock Indexes					
MSCI Emerging Markets	10/7/2016	15.19	7.53	-3.07	0.69
MSCI World, Excluding US	10/7/2016	2.26	0.87	0.27	6.31
Bond Indexes					
Core Bond	10/7/2016	5.38	4.71	4.02	3.31
Intermediate Core Bond	10/7/2016	4.34	3.82	3.79	3.32
Long-Term Core Bond	10/7/2016	11.63	10.32	7.93	5.72
Short-Term Core Bond	10/7/2016	1.99	1.51	1.34	1.33

Fundamentals & Indicators

- The Empire State Manufacturing Survey showed slowing business activity in New York for the past quarter's reports. With readings above 0.0 indicating expansion, July eked out a small gain, but August and September erased the gains with contractionary readings of -4.2 and -2.0 respectively.
- The Philadelphia Fed's Business Outlook Survey indicated the opposite trend with a contraction in the July reading of -2.9 followed by 2.0 and 12.8 in August and September.
- Retail sales trends point to a slowdown in discretionary spending over the past quarter. After an increase in June of 0.8%, July only gained 0.1% and August decreased 0.3%. Such a slowdown could lead to lower GDP reports for the third quarter.
- The Producer Price Index (PPI) fluctuated in the past three reports starting with a 0.5% increase in June, followed by a 0.4% decrease in July. August producer prices were flat. The most important takeaway from these three readings is that inflation is not a threat yet and remains below the Fed's 2.0% annual target.
- The Consumer Price Index (CPI) was less volatile than the PPI. June CPI rose 0.2%, July was flat, and August increased 0.2%. While still showing inflation is below the Fed's 2.0% annual target, the steadier pace over the past year should give the Fed room to raise rates in December.
- The Case-Shiller 20-city Home Price Index continued to show price improvements, but at a slowing pace with price increases of 5.2% in May, 5.1% in June, and 5.0% in July.
- Housing Starts have flattened over the past year even with lower unemployment and historically low interest rates. June added 1.189 million units followed by 1.212 million units in July and 1.142 million in August units.
- Existing home sales rose 1.1% in June, but declined 3.2% in July and 0.9% in August. On a positive note, home prices increased 5.1% year-over-year in August.
- New home sales remain in the uptrend that began after the recession. The June and July sales rates increased to 579,000 and 659,000 respectively, but decreased in August to 609,000. Even with the August decline, new home sales are 20.6% higher than they were a year earlier.
- Pending home sales rose 0.2% in June and 1.3% in July before declining 2.4% in August.
- Factory orders have risen from their lows earlier this year, but are down 2.6% year-over-year. June orders fell 1.8%, but recovered in July and August with gains for 1.4% and 0.2% respectively.
- Durable goods orders declined 4.3% in June and gained 3.6% in July before having a flat August. While better than factory orders, durable goods orders are still down 0.6% year-over-year.

- The ISM Manufacturing Index reached a five-month streak of expansion in July with a reading of 52.6, but faltered in August when the reading dropped to 49.4. The contraction was short-lived and the ISM index expanded again in September with a reading of 51.5. The dividing line between expansion and contraction is 50.0.
- The ISM Services Index has not been below the 50.0 demarcation line since 2009. July's reading slipped slightly to 55.5 and then fell further in August to 51.4, but expanded strongly in September to 57.1 as the important service sector continued to show strength.
- Construction spending is highly susceptible to revisions, which makes it a better lagging indicator than a concurrent indicator. June construction spending was revised to an increase of 0.9% after an initial report of a 0.6% decline. July was revised to a decline of 0.3% from 0.0. August's initial reading is -0.7%, but another revision is expected when the September numbers are published. The picture is clearer when viewed on a longer horizon. Total construction spending is down 0.3% year-over-year.
- Gross Domestic Product (GDP) estimates for the second quarter show an economy that has slowed considerably over the past two years. The advance estimate showed a 1.2% expansion. The second estimate weakened further to 1.1%. The third estimate pulled the expansion up to 1.4% as consumer spending's input revived the relatively weak quarter. While inflation is tame, at a 1.4% growth rate, the Fed has little pressure to raise rates.
- Weekly initial unemployment claims were down to 249,000 (the lowest since 1973) in the most recent report, extending the streak below 300,000 to 83 weeks. Low initial unemployment claims reports help the net total nonfarm payrolls count even when fewer new jobs are added.
- Total nonfarm payrolls continue to improve, but at a slowing pace. July's report showed continuing strength with 275,000 new jobs added and then the trend weakened in August and September respectively with only 167,000 and 156,000 new jobs added.
- The unemployment rate remained steady at 4.9% in July and August as did the participation rate at 62.8%. In September, the increase in the participation rate to 62.9% pushed the unemployment rate to 5.0%. Earlier in the year, bears pointed to the slowing participation rate as a sign that the economy was not as strong as the bulls claimed. Now that the trend has reversed, the bears' argument is fading and it helps to open the door for the Fed to raise interest rates in December.
- The U-6 unemployment rate, which includes the total number of unemployed and those employed part-time, but seeking full-time employment, is viewed as a more realistic picture of total unemployment and held firm at 9.7% in each of the past three reports.
- The average workweek slipped to 34.3 in August after six months at 34.4, but rebounded to 34.4 hours in September.
- Average hourly earnings have been one of the steady bright spots in the employment reports recently with increases of 0.3%, 0.1%, and 0.2% respectively in July through September. These increases have pulled average hourly earnings 2.6% higher over the past year, well ahead of the rate of inflation.

Index Chart & Analysis

The chart above shows the daily prices for the year-to-date on an ETF, ticker SPY, that tracks the S&P 500 Index, after closing the week at $215.04, on October 7, 2016. While the large intraday price swings seen recently make the markets seem out of control, stock indexes have been moving in a tight trading range. The SPY chart shows an index that is still in its long-term upward trend, but has been in a consolidation phase for more than three months. Set-ups that follow this pattern tend to break higher instead of retracing previous lows. Two important trend lines to watch for support are the lowest two that mark the trend of higher lows. These two lines are converging just below the intraday low for SPY seen on Friday. The longer trend line tracks the extreme lows since mid-February. The shorter trend line starts in the first half of March and skips the short-lived Brexit panic at the end of June.

The trend line that starts on the second trading day of January could come back into play if SPY comes out of its current consolidation phase and remains in its upward trading channel. At this point, this line of resistance seems out of reach for a market that is desperately searching for a catalyst to move higher. Before any move higher is considered worth buying, SPY needs to break above the shortest trend line shown in this chart. This short line marks the trend of lower highs from the beginning of September.

Of course, the trend lines are not our only guides. The moving averages confirm the areas of support and resistance marked by the trend lines. The 100-day moving average is currently at $213.62 and ascending and the 50-day moving average is at $216.71 and descending. As noted above, SPY is stuck in the middle at $215.04. As the trend lines and moving averages close in on each other, the index will push to one side and after a second confirmation day, traders will feel safe in buying into the momentum. Once the directional shift catches the follow-on trades, we'll have a clear picture of where SPY should trade over the coming weeks.

If SPY breaks higher, the August high of $219.60 will be the first test. SPY, which needs to push only 2.12% higher to reach a new all-time high and surpass the August high, is likely to find resistance when it gets there, even if only temporarily. If SPY breaks lower, the 200-day moving average at $206.62 and ascending will be a key level to watch. Such a dip is only 3.91% below Friday's close and 5.91% below the all-time high for SPY.

The Williams %R indicator echoes the weak momentum in stocks over the past month. In the 14, 28, and 56-day indicators, Williams %R gives no hint as to the upcoming directional shift out of the current doldrums. After predicting the slump that began in early September, Williams %R has stagnated, but is worth keeping an eye on after the next spike or dip to pinpoint a new exit or entry point. Remember, the signal to trade is not when the indicators enter the overbought of oversold ranges, but when they leave those areas.

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