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Perspectives

One of the common signs of the end of a bull market is an excessive move higher over a short period of time. This capitulation by the bears indicates they have given up and are either buying stocks or at least have stopped selling. By the end of such a buying spree, most investors who planned to buy have finished buying and few investors are left to push stocks any higher. We saw this type of over-enthusiastic buying spree hit in January, when the Dow Jones Industrial Average peaked approximately 9% above Friday's closing level. The price spike and quick sell-off doesn't mean the bull market is over in every occurrence, but not only does it make traders take notice, it creates a healthy level of fear that restrains near-term excesses again. January's price spike triggered a correction (by definition, a price decline of at least 10%). This correction appears to be all the market needed to shake out the excesses. The five months since the decline have been a consolidation period, essentially giving companies time to grow their earnings into the inflated price-to-earnings multiples. However, the pace of earnings growth stalled briefly as GDP for the first quarter came in lower than expected (the third estimate showed an expansion of only 2.0%) due to reduced personal spending. Early forecasts indicate personal spending is improving and could push GDP to at least a 4.0% rate of expansion. As these predictions become reality, stocks will move higher again.

Typically, investors would applaud this forecast and push stocks to new highs again, but they continue to be restrained for two primary reasons. First, the trade war (or at least talk and threat of a trade war) has investors spooked for what the effect could be on the US economy. Second, the Federal Reserve is following a steady plan of raising interest rates each quarter, which will slow the economy at some point. In fact, the Fed is raising interest rates specifically to slow the economy before inflation gets out of control. This action is part of their dual mandate to promote maximum employment and to stabilize prices.

The unemployment rate in the US was at an 18-year low after the May jobs report as it has maintained the trajectory it began after the recession ended and has begun to force employers to pay employees more to keep them from moving to new companies. Supply and demand of quality employees has allowed those workers without pristine resumes to find jobs with decent wages too. The costs of these ongoing pay increases will be passed along to customers in the form of higher prices for goods and services to allow the companies to maintain their profit margins.

Some inflation is good because it allows companies to show continued revenue growth and pay down debt more easily. Too much inflation will push prices beyond what consumers are willing to pay and will slow the economy. This cycle has repeated since civilizations began using currencies. The Fed attempts to limit the peaks and troughs by adjusting interest rates before the absolute ends of the cycles. They rarely get the timing exactly right, so traders try to take advantage of any opportunities that arise throughout the cycles.

Since investors are fully aware of the Fed's interest rate plans, short-term interest rates are rising. Meanwhile, investors know the Fed will not be able to raise rates indefinitely and have kept longer-term interest rates lower. This set-up has investors eyeing the "flattening" yield curve. When short-term interest rates move above long-term rates, it indicates the long-term economic outlook is poor and predicts that we are on the cusp of a recession. The forecast sounds more exact than it actually is. While an inverted yield curve (shorter-term rates yielding more than longer-term rates) rarely incorrectly predicts a recession, the recession might begin as soon as two months later, but it could be more than eight months later.

While not signaling doom yet, investors will be wise to keep an eye on the spread between the 2-year and the 10-year treasury notes, which is currently at the narrowest difference, less than 0.30, since the recession ended. As it continues to narrow, traders will become more jittery and market volatility will increase, but until the economy actually slows, stocks should be a better place to be invested versus bonds for those who can risk the ups and downs of the cycle. For now, most data point to further economic strength and should favor the bulls, but those planning in advance for the eventual slowdown will help avoid heavy losses later.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	7/5/2018	-0.34	16.02	13.96	12.69
NASDAQ Composite	7/5/2018	9.89	23.34	14.84	16.87
Russell 2000	7/5/2018	10.06	19.77	11.95	12.32
S&P 500	7/5/2018	3.37	14.71	11.93	13.21
S&P MidCap 400	7/5/2018	4.70	14.48	11.23	12.46
Global Stock Indexes					
MSCI Emerging Markets	7/5/2018	-8.99	4.41	3.02	2.82
MSCI World, Excluding US	7/5/2018	-2.97	6.81	4.68	6.08
Bond Indexes					
Core Bond	7/5/2018	-1.53	-0.21	1.92	2.61
Intermediate Core Bond	7/5/2018	-1.14	-0.21	1.65	2.60
Long-Term Core Bond	7/5/2018	-3.66	-0.46	3.85	4.70
Short-Term Core Bond	7/5/2018	-0.17	0.04	0.79	1.02

Index Chart & Analysis

The chart above shows the daily prices for the past three months on SPY, the SPDR ETF that tracks the S&P 500 Index, after closing the week at $275.42 on July 6, 2018. After a couple weeks of SPY hinting that it could roll over and have a healthy new mini-correction, it found its footing two Mondays ago. From a technical view, SPY was on the cusp of falling apart. The large-cap ETF fell below its 10, 20, and 50-day moving averages along with breaking below the trend line of higher lows that it had been following for two and a half months. Even the Williams %R indicator, which tracks momentum, signaled the times were changing for the bulls. And then everything changed again.

On June 25, SPY bounced off its intraday low and then meandered sideways for the next seven trading days. This sideways price action allowed the ETF to pull above its 10-day moving average again. Then on Friday, July 6, the momentum shift that began a few days earlier, coupled with a positive jobs report, enabled the index to move out of its short-lived sideways trading channel and have its first day in nearly two weeks without trading below its 50-day moving average. This price surge brought SPY above its 20-day moving average by the close of trading too. The 10-day moving average, which had fallen bearishly below the 50-day moving average, leveled out and will move bullishly above the 50-day moving average again within a day or two, assuming no significant catalyst triggers a major sell-off this week.

Williams %R had another confirmation day above the oversold range of the indicator to give more credibility to the bulls' return. While the 56-day indicator did not fall into oversold territory, it had fallen below its overbought range in late June and risked a signal that would have indicated a major longer-term sell. The recent uptick in bullish momentum negated that drop for now.

With most signals pointing in the bulls' favor, stocks could have another great week. However, SPY has to get above the middle trend line in this chart first. This line was the line of support for the ETF, but it has turned into potential resistance. A price decline for SPY below $275 and even as low as $270 is not bearish. It could be a retest of the lower support trend line of higher lows and then the next attempt to break above the middle trend line will have a higher probability of success. Depending on political statements and macro-economic data releases this week, SPY might not need a retest of the lower trend line. Traders will be waiting for a bullish confirmation day on Monday, and possibly Tuesday, before buying with both hands again.

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