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Perspectives

Markets move up and down every year, sometimes without much obvious cause outside of the ebbs and flows of fear and greed. Since October, we've seen very little downside movement as investors relaxed their concerns about the effects of interest rates, the president's impeachment, Brexit, and a China trade deal. This shift in sentiment came at the end of the year when many investors reasoned they would be smarter to wait until the new year to accept realized gains for tax purposes. Those investors interested in selling disappeared and that allowed stock prices to float higher without much conviction, i.e. not on high-volume trading.

When tensions escalated in Iran, the first thought among many traders was that the geopolitical event would be the spark that set off the correction many expected to start the new year. Sellers forced stocks lower by 1% quickly, but when the probability of war faded, stocks resumed their rally with new enthusiasm for a few days. As of Friday, the conviction of the buyers began to wane as renewed concerns of valuations came back into focus. Investors are starting to look for what the next catalyst for higher prices will be after a year when the S&P 500 gained nearly 30%.

Historically, stocks have continued their upward trajectory in the 12 months after a year with greater than 25% gains, but at some point in 2020 most of Wall Street expects a correction of at least 10%, even if it is temporary. Most election years end with stocks higher than they began the year, which means a lot of traders will be buying the dip at better entry point than today's levels if the anticipated correction comes to fruition before stocks climb much higher. Meanwhile, analysts are calling for earnings to improve in 2020, bringing stock prices with them at least until we see who the democrats nominate for president. Whoever the nominee is, it is unlikely to matter to the economy in large part because the business cycle doesn't follow politics as much as the pundits think that it does. Unless the economy cracks before the election, many pundits expect the incumbent to be reelected when the economy is growing.

Without discounting the election, trade issues, global tensions, and any unforeseen events that arise, investors focus on stock valuations. The most common measure of valuation is the PE ratio, or price to earnings ratio. Wall Street's earnings predictions are notoriously unreliable. At this time last year, 2019 earnings were forecast to reach $171.74 for the S&P 500. In the most recent estimate (final earnings announcements for 2019 begin in a few days), the forecast was cut to $158.14, 7.9% lower than predicted. Clearly, the shortfall didn't slow stocks' momentum last year. The multiple by which stocks are valued (the PE ratio) simply expanded on hopes of what is to come. This disconnect between stock prices and earnings growth was due to the belief that earnings would recover since Wall Street tends to focus on what traders believe is coming, not what already happened.

This forward-looking mentality only lasts so long before stock prices stop absorbing earnings shortfalls. The 2020 S&P 500 earnings forecast is $175.52. If earnings grow more than 10% and stock prices end 2020 at the same level as the end of 2019, the PE ratio will fall from today's PE ratio of 20.43 to 18.41. A PE ratio of 18.41 is higher than the historical average, but not considered too high for being late in a bull market. (Recessions and early bull markets bring the historic PE ratio average down.) If earnings follow the historical trend of missing expectations, the PE will be over 20 again and traders are unlikely to allow much more upside movement in stock prices without materialized earnings growth.

Based on the PE ratio, stocks could move higher in 2020 as long as earnings improve. The upside potential is much more limited than the beginning of 2019 since a lot of the planned growth has already been priced into stocks' valuations. If earnings grow 5% to $166.05 and stocks are valued at a 20 PE ratio, the S&P 500 would

reach 3,321 by the end of 2020, a gain of 56 points from Friday's closing level, which is not quite 2% higher. Even including dividends of 1.75%, the upside is limited without better earnings growth.

If earnings stay flat or weaken, the downside risk is much greater. Without predicting a recession (two quarters of declines in the GDP), the market's multiple could give back what it took in 2019 based on a sentiment change. If earnings decrease only 2% and the PE ratio moves to 17 (still not low), the S&P 500 would drop to 2,635, which is 19% lower.

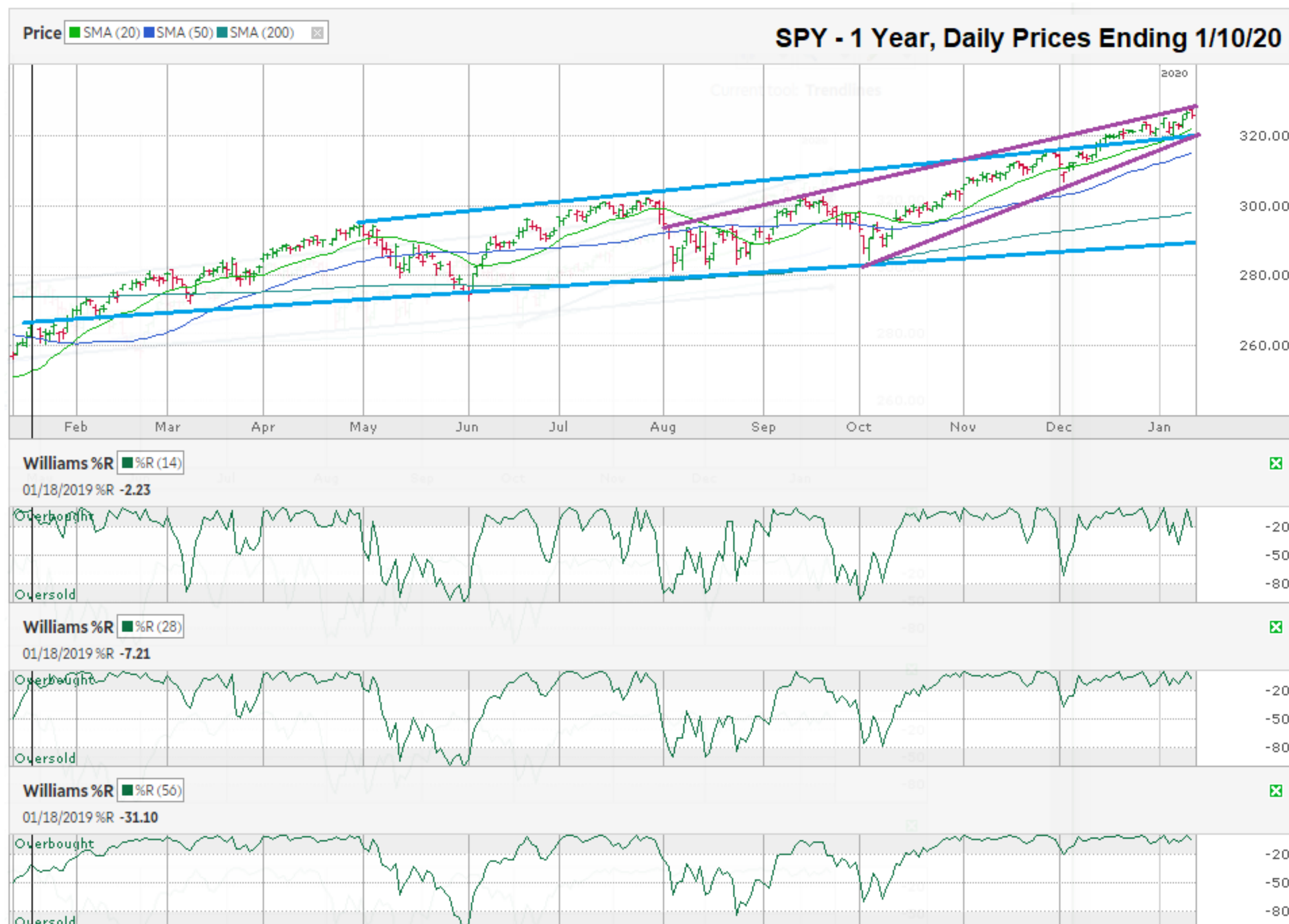
A lot would have to change to see earnings growth reverse and for the multiple to contract to 17, but it will happen eventually. Economies do not grow indefinitely, and business cycles rotate into different phases. When inflation picks up and the Fed raises rates (probably not until 2021), stocks will suffer. The question is if investors remain forward looking in the second half of 2020 and begin discounting future earnings before reported earnings actually decline. Either way, the upside potential in stocks appears to be much lower than the downside risks over the next two years. This view is not a call to abandon stocks yet, but it is a time to consider reducing some risk from investments and keeping some cash available for when, not if, we see prices drop again.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	2019	YTD
US Stock Indexes			
DJ Industrial Average	1/10/20	22.34	1.00
NASDAQ Composite	1/10/20	35.23	2.30
Russell 2000	1/10/20	23.72	-0.65
S&P 500	1/10/20	28.88	1.07
S&P MidCap 400	1/10/20	24.05	-0.56

Index Chart & Analysis



The chart above shows the daily prices for SPY, an S&P 500 ETF, after closing the week at $325.71 on January 10, 2020. Last quarter, I pointed out the longstanding trading channel that was likely to offer support from the downside and suggested SPY would probably move back toward the upper trend line within this trading channel. Those lines are marked in blue and SPY remained in this trading channel for another two months until breaking through resistance at the upper trend line. That upper blue line that marks the trend line of higher highs is now offering support for stock prices. When a trend line that was resistance stops resisting the push to further highs, that line often becomes support to prevent lower prices. In other words, this upper blue line is likely to become the new trend line for higher lows.

The interesting test for this technical analysis will be how SPY behaves within the narrowing trading channel marked with purple lines. These lines have been converging slowly over the past few months with each high and low getting closer as the weeks pass. The expected pattern to follow an ascending wedge, according to textbook technical analysis, is for the breakout to be lower, not higher. Since the former trend line of higher highs (upper blue line) and the newer trend line of higher lows (lower purple line) are nearly equal, the probability of the outcome is less certain than usual.

The benefit of this near-term uncertainty is that when a break in either direction happens, the probability of predictable price action improves for the following few weeks. If SPY falls below $320 within the next two weeks, the chances of a much deeper fall increases. Not only would the break below these two trend lines be sell signals, the 10-day moving average (barely visible in light green) would lose support also. Depending on how long it is before the ascending wedge breaks, the 20-day moving average (thin blue line) could also break support.

A break below these four technical indicators would leave a gap until SPY reaches $300 (the 200-day moving average) before this large-cap ETF could find technical support. Such a decline in prices would be close to a 7.5% loss in value for the S&P 500. Historically, 7.5% is part of a normal bull market's mini cycles. A retest of the longer blue trend line would be close to an official "correction", which is a price decline of at least 10%. This much of a pricing rebalance should be enough to bring buyers back into the picture and allow the bull market to resume.

The Williams %R indicator has remained in the overbought section for most of the past three months with only one sell signal on November 27, when all three timeframes reached 0.0. SPY only had three days of weakness after the sell signals triggered. Like every technical or fundamental indicator, the signals are not correct in every instance. However, after a false positive, the following signal is more reliable. This past Thursday showed a potential inflection point, but we won't know until we see if these Williams %R indicators fall below the overbought section this week. If Williams %R line up with the trend lines and the moving averages, expect selling pressure to increase substantially.

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