Weekly Market Flash

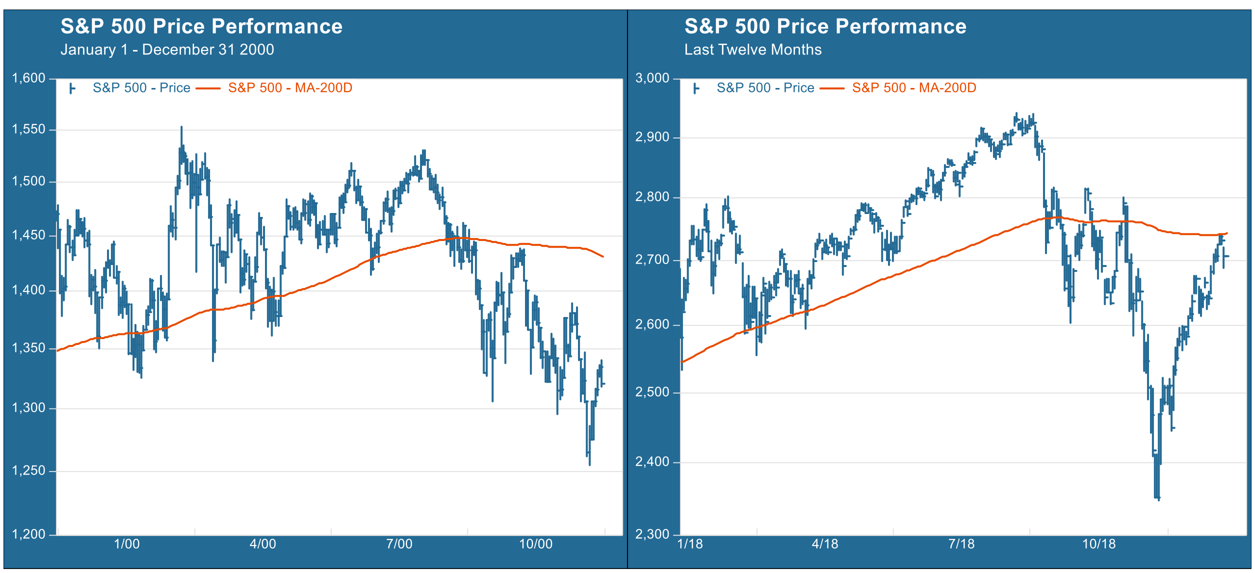
Troubled Technicals and Hyper Headlines

February 8, 2019

Every time the topic of "technical analysis" comes up in our weekly commentary, we need to begin with the customary disclaimer. There is nothing magical about the tools of the technical trade. 200 day moving averages, round numbers, head-and-shoulders formations – these are all silly things with no inherent meaning. BUT, they do affect short term trading patterns. Why? Because the 70-odd percent of daily market volume driven by algorithm-based trader-bots turns these whimsical flights of fancy into meaningful pivots around which markets go up and down. As per Arthur Miller's "Death of a Salesman" – attention must be paid! We are paying attention this week because a trend is coming into view with potentially bearish overtones. Which may mean something or nothing at all, but it's worth a look.

When Support Becomes Resistance

The long term moving average is a staple of technical analysis, with 200 days being a particularly popular representative of the species. In bullish times the 200 day average acts as a support level, while in a bear market it becomes a ceiling of resistance. We will illustrate this phenomenon with the chart below, showing a comparison of the last twelve months price performance on the S&P 500 as compared to the period from January to December in 2000 (the first year in the 2000-03 bear market).



Source: MVF Research, FactSet

That reddish line coursing across each chart is the 200 day moving average. In both time periods (2000 and today) you can see the specific instances when the index bounces off the moving average and resumes an upward trend (for example, May and July 2000, and April and May 2018). You can also see where the moving average becomes a resistance ceiling (October-November 2000 and November-December 2018).

This past week, the 200 day moving average seemed to work with surgical precision. On the back of an impressive six week rally starting just after Christmas, the S&P 500 closed Wednesday just 0.15 percent below the moving average. It then promptly fell back in Thursday and early Friday morning trading. Again – this may or may not mean anything significant. Perhaps it even rallies back up after we go to print with this piece – who knows? But the technical pattern of the market since last October is thus far looking less like a bullish resumption and more like settling into a more negative cadence. Short term traders will be inclined to read it as such and then the Copenhagen theory of markets comes back into focus: the observation affects the outcome. Negative feeds on more negative.

What Say the Fundamentals?

As much as technical indicators impact short-term market movements, though, it takes more than that to produce a full-on chronic bear. Fundamentals matter. Here, the current contextual environment allows one to take a glass half full or half empty approach. The half full contingent will point to the more or less unchanging stream of good headline macro data here in the US: a robust jobs market with inflation right around the Fed's two percent target, and still-healthy levels of consumer and business sentiment if not quite as optimistic as a year ago. Based on the data at hand, the likelihood of a near-term recession in the US is quite low. That's good news.

But wait, says the half empty crowd. Look at where the consensus is going for Q1 2019 corporate earnings. Back in September last year the consensus forecast for first quarter earnings growth was 6.5 percent according to FactSet. That same forecast today, a bit more than seven weeks away from the end of Q1, is negative 1.9 percent. Even if the usual "estimates Kabuki" games are at play, that is a big delta. The lowered estimates come from corporations lowering their guidance for expected earnings.

What is notable is that the consensus outlook on sales has not come down as much as earnings. This means is that companies are not yet too concerned about structural demand – sales are expected to grow around 5 percent in Q1, which is a healthy number. But it implies that profit margins are going to be squeezed by a combination of factors such as higher wages, higher interest rates and other factors giving less profit bang for each incremental buck of sales. That feeds back into one of the main "glass half empty" talking points of recent months, namely peak profit margins.

Tilting at Headlines

While the fundamentals are confusing and the short term technical indicators giving cause for concern, the market has reverted to grasping at daily headlines for directional guidance. For most of this year there has been enough meat on the positive headlines – the Fed put being back in play (as we wrote about last week), nothing particularly negative on the trade war front, no other sudden surprises – to keep the direction positive.

But a headline-driven market is inherently skittish. There's not much more room in the Fed punch bowl for positive surprises – even if the Fed were to start actively signaling towards a near-term rate cut it would leave the market wondering just how bad the underlying situation is. Europe's problems are coming back into focus – spreads between Italian and German debt, for instance, are resuming a notable widening trend. British government leaders seem to be trying their hardest to convince the rest of the world that they are the most inept bunch of chummy toffs ever to claim the mantle of governance anywhere (these days, a decidedly low bar). Where the market winds up at the end of this year is anybody's guess – but we expect to see plenty more ups and downs along the way, with downside risks that are not going away.

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