BI-WEEKLY RESEARCH & ANALYSIS

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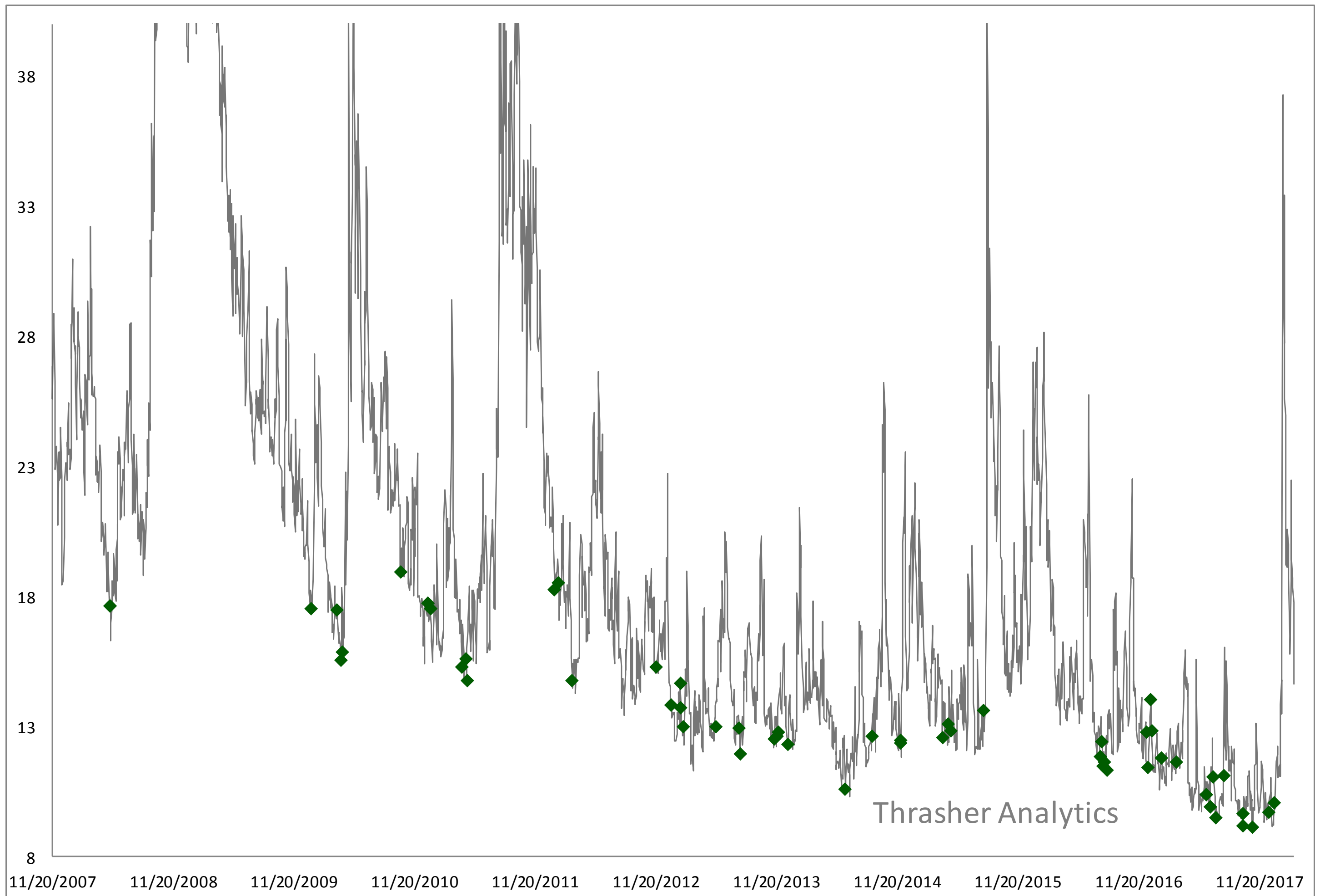
volatility Risk Trigger (VRT)



There's not much I am putting in this section of the letter as I would turn your attention to Friday's special volatility email I sent out that provided much more detail on my thinking about the VIX and risk right now. As a reminder, sentiment has gotten extremely low based on futures data on the VIX Index, falling to single digit % of bulls on Wednesday. We have a lot of companies reporting earnings this week (I address this later in the letter), which provide ample opportunity for volatility to move higher.

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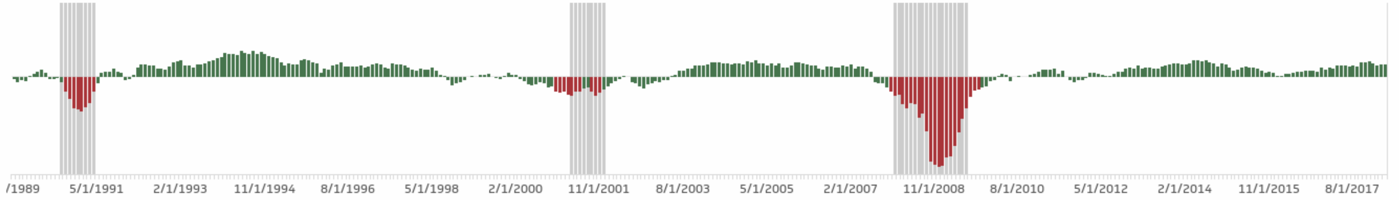
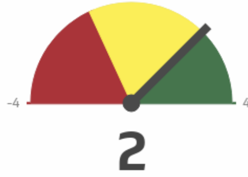
Economic Dashboard

Leading Economic Indicator



Corporate Composite



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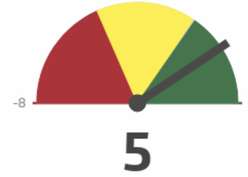
Industrial Composite



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Corporate Indicators

Indicator	Value	Threshold	Trend
Corp. Operating Surplus	1,667,011	1,674,509 Less Than	
Corp. Disposal Income	592,366	527,122 Less Than	
Corp. Cash Flow	14.9	0 Less Than	

Industrial Indicators

Indicator	Value	Threshold	Trend
YoY Change in Manufacturing Sales	3	0 Less Than	
YoY Change in Industrial Production	3.5	0 Less Than	
YoY change in Non-Defense New Orders	6	0 Less Than	
YoY Change in Durable Goods New Orders	7.9	0 Less Than	
		0 Less Than	

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Economic Dashboard

Banking Composite

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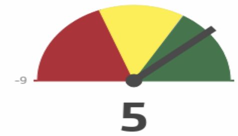
Consumer Composite



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Banking Indicators

Indicator	Value	Threshold	Trend
% of Banks Tightening Standards	-11	0 Greater Than	
% of Banks Tightening Standards for Comercial & Industrial Loans	-3	0 Greater Than	
% of Banks Tightening Standards on Credit Cards	9.4	0 Greater Than	
Deliquency Rate on Credit Cards	2.5	2.5 Greater Than	
Deliquency Rate on Commerical & Industrial Loans	1.2	1.3 Greater Than	
Non-Financial Liabilities	459.8	433 Less Than	
Ratio of Non-Performing Loans	1.2	1.2 Greater Than	
% of Banks Increasing Willingness to Make Consumer Loans	9.2	0 Less Than	

Consumer Indicators

Indicator	Value	Threshold	Trend
YoY Change in Non-Farm Payroll	1.6	0 Less Than	
Avg. Weekly Hours Worked in Manufacturing	42.2	42 Less Than	
3Yr Change in Real Income	3.0	3 Less Than	
YoY Change in Retail Sales	5.0	5 Less Than	
Housing Building Permits	1,364	1,299 Less Than	
YoY Change in Consumer Sentiment	1.9	0 Less Than	
Barrel of Crude Oil	70.3	20% 6-month Change	
Shiller Home Price Index	198.9	195 Less Than	
Labor Slack	-0.9	0 Less Than	

Financial Stress Composite

-2.5

Financial Stress Indicators

Indicator	Value	Threshold	Trend
St. Louis Stress Index	-1.1	-1.0 Greater Than	
Kansas City Stress Index	-0.3	-0.4 Greater Than	
Chicago Stress Index	-0.8	-0.8 Greater Than	

Headline Economic Indicators

Real GDP Growth	**2.9%**
Nominal GDP Growth	**4.8%**
YoY Change in Federal Debt-to-GDP	**4.5%**
Unemployment Rate	**3.8%**
Inflation (CPI)	**2.4%**
Core Inflation (CPI)	**2.1%**
Inflation (PCE)	**4.7%**
Core Inflation (PCE)	**1.8%**

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Broad Market Commentary

As I said in my last letter, I feel a high level of patience must be given to this market right now as we are still seeing U.S. equities battle to break out of its large 2018 range. Last week we finally saw the S&P 500 move above the June high, unfortunately (as I'll address further down in the letter) it was not accompanied by very much participation or risk ratios. Thursday and Friday were both down days with Friday being options expiration (OpEx).

While OpEx can cause some noise in volume-related data, I do find it interesting that the only days we've seen produce above-average volume where the two down days last week. Besides Thursday and Friday, volume has been extremely low for the entire month of July. The rally off the June low was on the back of volume that hasn't even gotten close to being above its 50-day average, a sign that institutions may not be overly eager to buy this possible break out or at least are being more selective with their individual equity selection.

From a momentum standpoint, the RSI has gotten back to its prior June high but has since rolled over with Thursday and Friday's weakness. If equities become under pressure this week and momentum moves back to 50 we may see a new range develop as the RSI continues to fail to see enough strength to regain 70, a sign of extremely strong momentum.

I think it's very likely we see the S&P fall back into its range under the June low. It wouldn't take much, just a few poor earnings reports could do it based on the lack-luster volume we're seeing right now and extremely low sentiment readings in volatility.

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Short-Term Breadth

Whenever market breadth (a measure of the number of stocks participating in a trend) has been mentioned lately it's almost always been in reference to the cumulative NYSE Advance-Decline Line, which continuously adds the number of stocks rising and subtracts the number that are declining. We can also look at this data in a short-term picture as well, as the chart above shows the 5-day average A-D Line in the top panel along with the 5-day total number of net new highs on the NYSE in the bottom panel. By looking at just 1 week (new highs) and 2 weeks (A-D Line) we can see the most recent changes to market breadth.

Currently we are experiencing bearish divergences in these indicators as fewer stocks have been rising on the most recent leg higher in U.S. equities since the June low. While the S&P 500 has taken out the prior June high, much fewer stocks have been rising and making fresh highs compared to that June level. This tells us that the market is currently rising with very little participation. In fact, the 5-day average of the number of advancing minus declining stocks is just 38 of all the NYSE issues, that's very low considering the broad indices are at or near new highs.

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Equity Market Risk Appetite

I've shown this chart several times in past letters but I thin it does an excellent job at showing the risk appetite of the market and is worth providing an updated version. With the S&P 500 hitting a higher high above the June level, I'm not seeing other risk ratios confirming this move.

- Equal weight relative performance is closer to making a new 2018 low than breaking above its June level.
- High Yield bonds vs. Aggregate Bonds is still well off its June high, a sign that bond risk taking has cooled off.
- High Beta relative performance is close rto making a new multi-month low rather than new YTD high as traders aren't showing an interest in increasing risk via higher beta U.S. stocks
- Small cap had been doing extremely well off the March low but recently it's begun to under-perform large caps as investors shed risk.

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Commodities Signaling Lower Bond Yields

Back in May I called the top to the 10-year bond yield on the TD Network Futures Show, right when it seemed everyone had accepted it as fact that bond yields were headed to 3.5% and then 4%. Sentiment was extremely high and the charts were calling for lower rates. Since then we've had the 10-year Treasury bond strength with the yield calling back under 3% and getting close to breaking 2.8%.

The ratio between copper and gold has been a good tool for forecasting the bond market based on its divergences with the yield. We saw a great example of this in early 201 when gold was strengthening against copper as the 10-year made a double top at 2.6%. Then the commodity ratio signaled a bottom in bond yields later that year. Once again we had the ratio diverge from rates in May and is ow close to breaking below its prior April low as copper continues to decline relative to gold. This could be telling us that rates themselves are preparing for another leg lower back under 2.8%. We'll want to keep a close eye on copper and gold in the coming weeks.

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U.S. Dollar Battles Resistance

The U.S. dollar has had a very strong run off the early 2018 low as its made a run back to the prior October high. However with this move to potential resistance momentum has begun to weaken and diverge. The Relative Strength Index (RSI) has begun making a series of lower highs with the U.S. Dollar Index challenging $95 but failing to hold. As of now we have the USD back under the October level with momentum ready to break back under its mid-point already. Currency trends have major implications on many other financial markets, most notably commodities and specifically crude oil. If the USD does continue to slide, we could see oil continue its trend lower as well.

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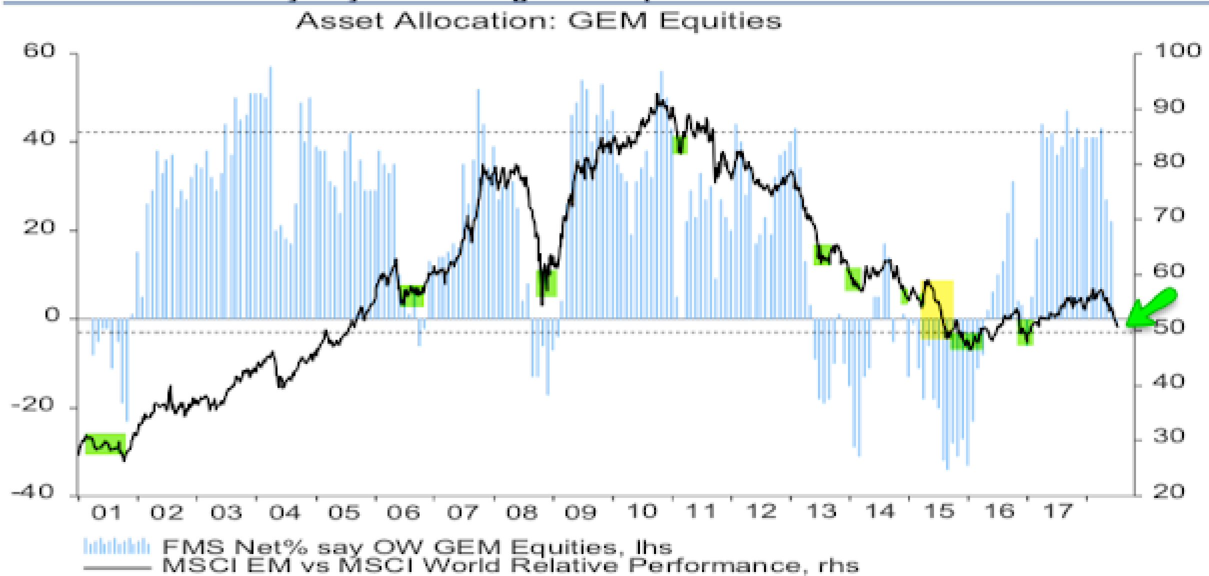
Funds Underweight Emerging Markets

Exhibit 30: Net % AA Say they are overweight GEM Equities



Source: BofA Merrill Lynch Global Fund Manager Survey

According to BofAML latest fund manager survey, which reflects the holdings and opinions of managers that oversee $600 billion in assets, emerging markets are no longer in vogue. The net percentage of managers that are overweight emerging markets has now gone negative, which is the first time since the prior 2017 low. Int'l markets were extremely hated in early 2017 and like when most things see that low of sentiment, they produced one of the strongest returns across the globe. However, it's not always that easy! As the you can see from the chart above, managers were short emerging markets for most of 2014 and 2015 as well while EM under-performed global indices. But if we look at some of the other past examples of the net % going negative, it's been a fairly reliable sign that sentiment has gotten extremely low and a bottom was eventually put in for EM and relative performance began to shift. We saw this happen in '08, '06, and '01 while '10, '13, '14, and '15, saw EM continue to drag.

What I take away from this data is that we can't view it on its own to make a trading decision, but must dig deeper and look for other signs that EM may be potentially putting in a low. But based on sentiment of fund managers, we might be getting close.

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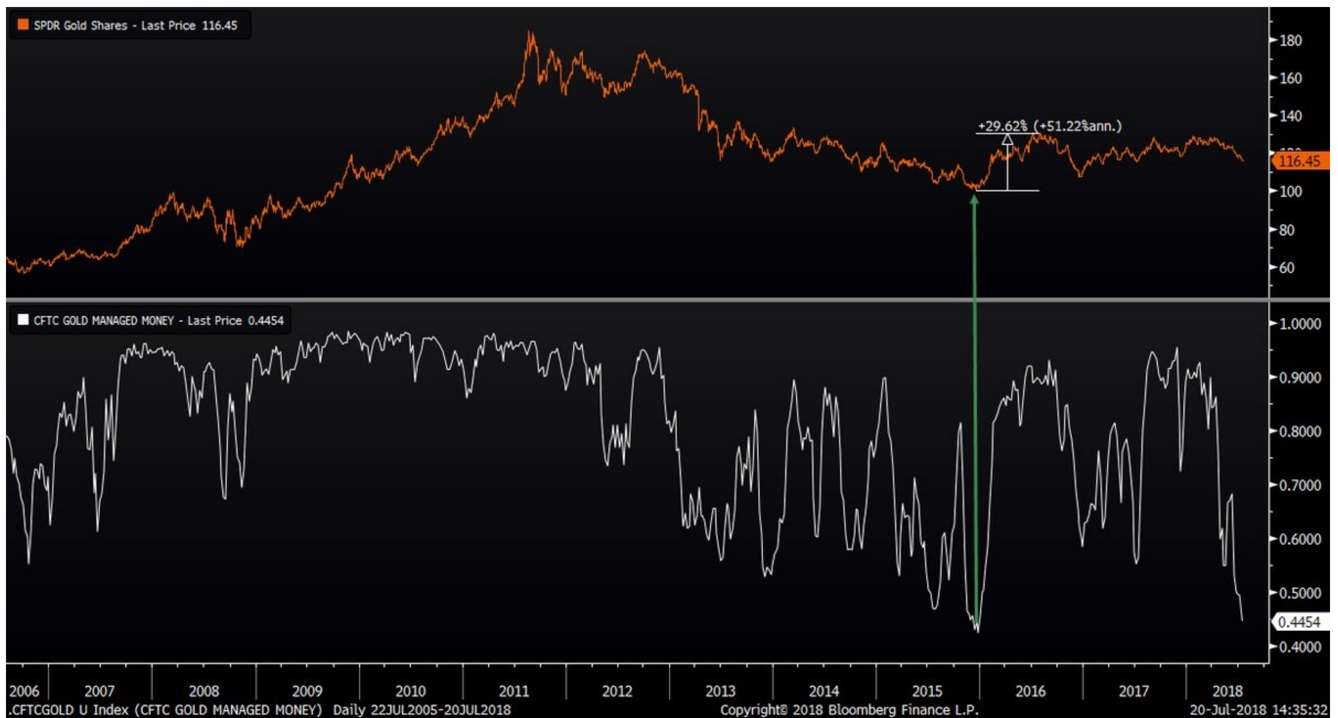
Traders Abandon Gold



Jason Goepfert of SentimenTrader, recently shared this COT chart of gold and the net position of large traders in the gold futures market. Sentiment towards gold has been near rock bottom levels in recent days and the COT data is no different as this chart shows. Large traders are now back to holding a near record short position in gold, closer the level last seen in 2015 before gold prices rose nearly 30%. Will we see the same type of bounce today? It's very possible with the extreme hatred for gold the market seems to be having lately. A few days strung together of gold prices appreciation could apply pressure to shorts and cause a short squeeze on the yellow commodity that equate to a repeat of 2015.

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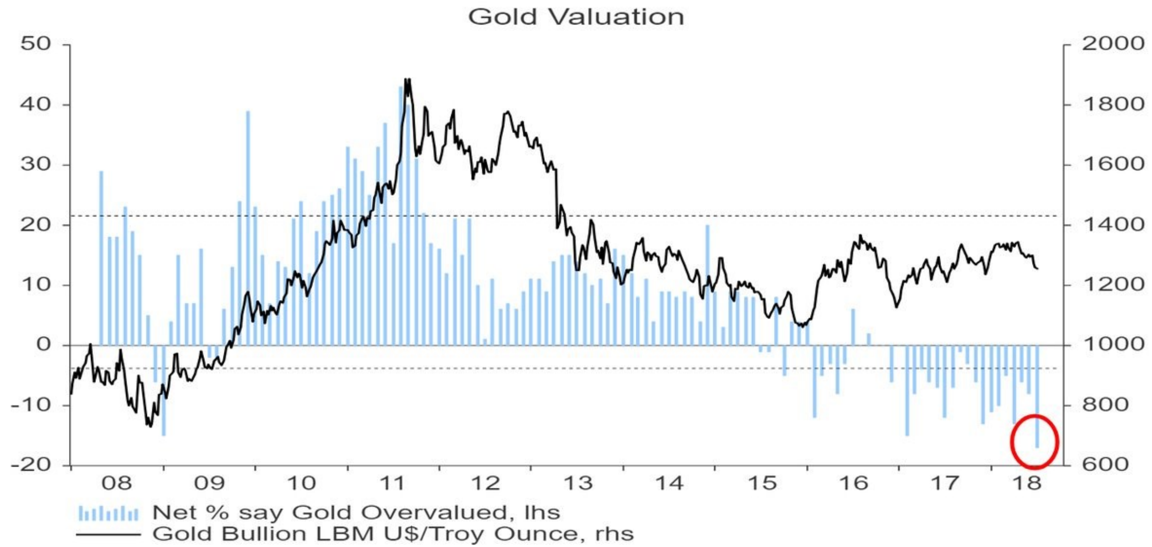
Is Gold Undervalued?

Exhibit 10: Gold Valuation



Source: BofA Merrill Lynch Global Fund Manager Survey, Bloomberg

This is another chart from the BofAML fund manager survey, in which the managers were asked if they felt gold was under– or overvalued. Based on their answers, more fund managers currently feel gold is undervalued compared to any time since 2008. While survey type data is often a good contrarian tool, it seems that when most of the managers surveyed feel gold is undervalued they have been fairly accurate as we saw in mid-2016 and mid-2008 when more than 15% of managers felt gold was miss-priced to the downside with the metal soon rallying.

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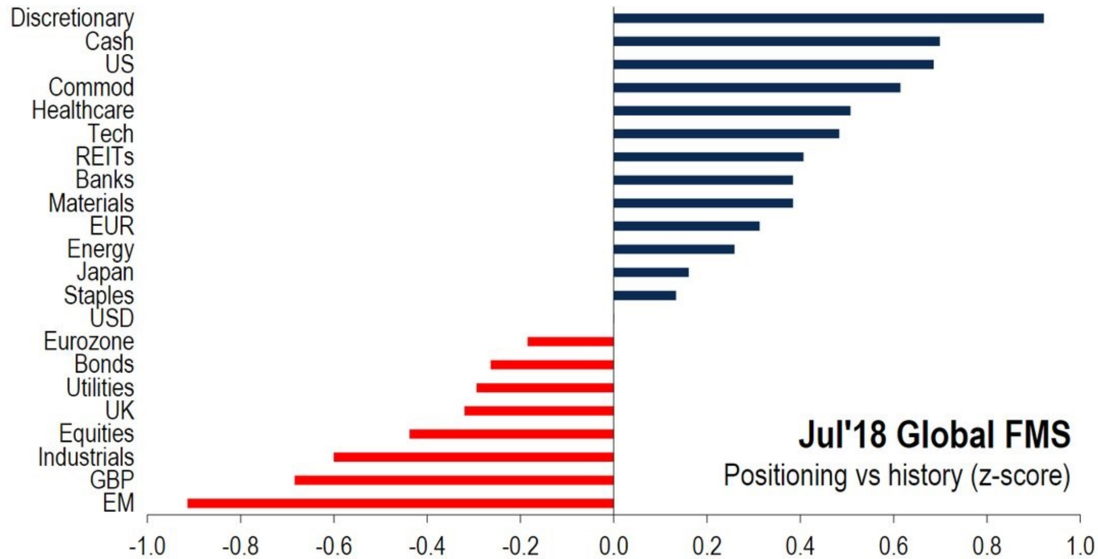
How Funds Are Positioned

Exhibit 1: The Longs & Shorts, relative to Global FMS history*



Source: BofA Merrill Lynch Global Fund Manager Survey. *data since 2006 for commodities & real estate; since 2001 for everything else

An excellent way to look at data compared to its historical level is through the use of a z-score, which the above chart does with the BofAML survey data and how fund managers are currently positioned within their portfolios relative to their historical averages. As of July, managers are the most over-weight Consumer Discretionary stocks and are extremely under-weight Emerging Markets. You can see they also are quite fond of Health Care and Tech as well while bearish on British Equities and Utilities.

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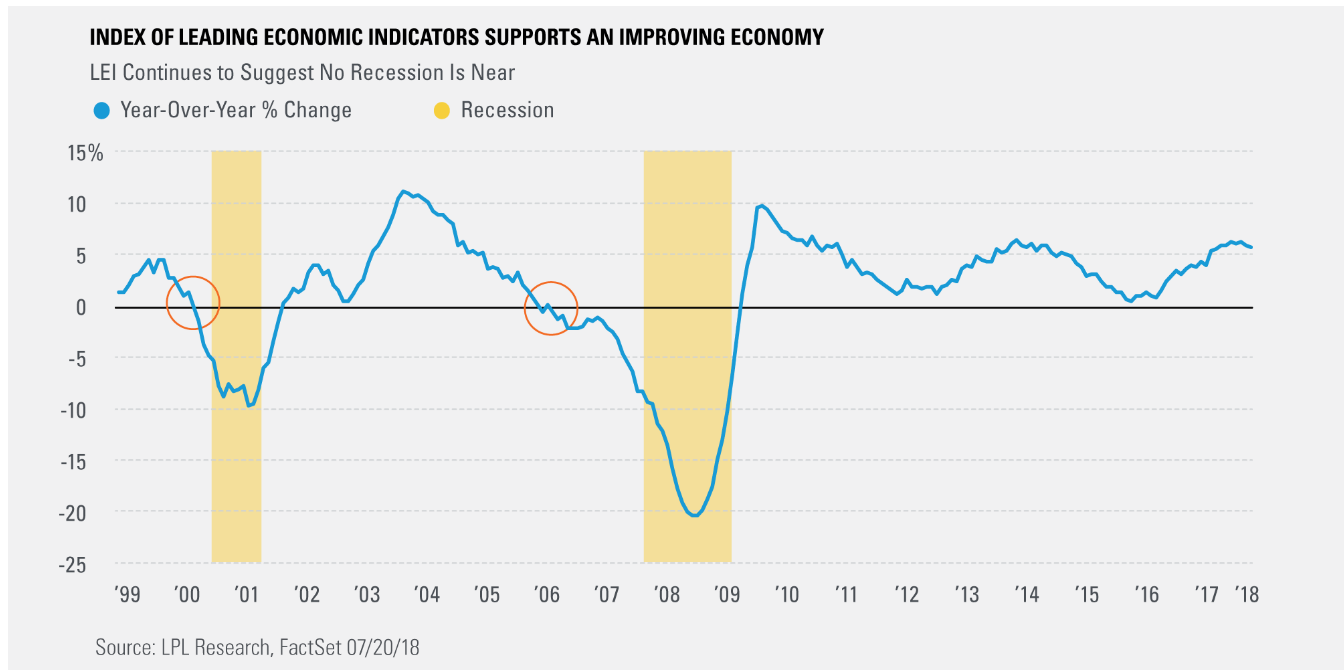
Weakening Leading Economic Indicator



The above chart shows the Conference Board Leading Economic Indicator (LEI) going back to 1999. The LEI has been a fairly good tool for forecasting recessions, having gone below 0 prior to most since 1970. It is made up of ten economic data sets that range from jobs data, manufacturing, housing, interest rates, and the stock market.

While I agree with what the indicator is currently telling us, that we are not near or in a recession today. I do find it interesting that it's begun to slow its pace of growth. The LEI is off its high and could be in the early innings of rolling over, similar to 2014 before the mini-bear market that took place in 2015. While we did not enter a full blown economic recession in 2015 (many would argue we did see a balance sheet recession as many companies saw a contraction in earnings), we did see a significant rise in volatility and decline in equity prices. This early rollover in 2014 causes me to pay close to attention to the trend of the LEI in coming months.

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Positive Earnings Surprises

We're now in the thick of earnings seasons with this week being one of the more busy weeks for corporate reporting. In fact, 40% of the S&P 500 companies are scheduled to report Q2 earnings this week along with 11 of the Dow Industrial Average stocks reporting as well. Oddly, a great deal of attention is paid to whether a company beats or misses its estimates that are set out by Wall Street banks. The change in share price following a earnings report is almost squarely the result of these beats or misses rather than on the actual data being shared by the company. It's interesting to note, as this chart shows via Callum Thomas, that the trend in companies beating estimates has been a steady rise since the early 1990s. We're now at the point of over 90% of S&P 500 companies "beating" Wall St. estimates compared to 40-50% in the 1990s.

When more than 80% of companies are able to skip, hump, or stumble, over the estimate laid before them, how much weigh should these estimates really be given? The next time you see a headline sounding the trumpets (or alarms!) about how a company did vs. its estimate, remember that the trend in this chart!

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Volatility Seasonality

As we move into the last full week of July I thin it's important to recognize that historically volatility has put in a bottom in mid-July based on the last 20 years worth of data. While seasonality is not a guide a market must follow, it does provide a historical roadmap for the path its taken in the past, creating patterns in the process. For Volatility, that's historically been a low in July with a high in October, which fits the seasonal pattern of equities as well as summer has often brought headwinds for U.S. stocks in several years.

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