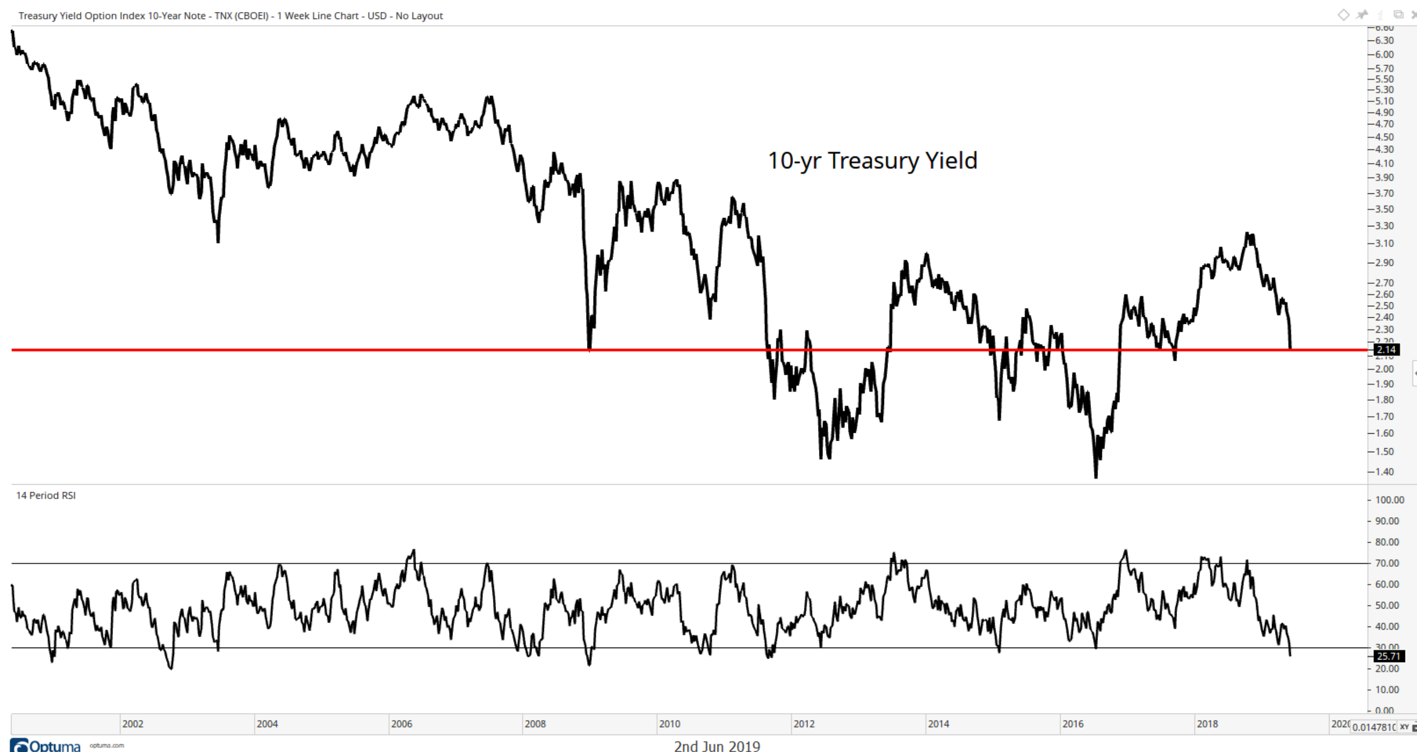
A Lack of Panic (So Far)

Good evening,

Last week's letter I wrote that I was watching 2800 to 2820 as potential support, which had held up the week prior. Unfortunately, that support didn't last much longer as the S&P 500 moved lower to test (and break) its 200-day Moving Average, finishing the week at 2752. Semiconductors have been a focus for this letter in recent weeks, the selling has continued for this area of the market as the Semiconductor Index declined to one its worst monthly performances in ten years, dragging the tech sector with it - which dropped 9% in May. All the S&P sectors finished lower last week, led by Energy, Consumer Staples, and Financials. Five sectors are now in the red for their 3-month change and four are negative for their 12-months change.

Tariffs
This selling comes on the back of the continued political poking with the tariff stick by the current administration. As a surprise to the market, Trump has begun threatening tariffs on Mexico, picking another fight while continued trade negations persist with China. If that wasn't enough, the White House also announced they would be going after India as well. Trump announced on Friday, "I have determined that India has not assured the United States that India will provide equitable and reasonable access to its markets, "Accordingly, it is appropriate to terminate India’s designation as a beneficiary developing country effective June 5, 2019." India benefited to the tune of $5.7 billion by the beneficiary status, something that's now at jeopardy and adds an additional layer confusion for business owners impacted by global trade. Goldman Sachs, in a recent note cited that if the White House does move forward with 25% tariffs on all Mexican and Chinese imports, 80% of all U.S. imported products will, at that point, be subject to a tariff. The co-Head of Global Economics and Chief Asia Economist for Morgan Stanley recently wrote that the U.S. economy could enter a recession within nine months if we the 25% tariffs on all Chinese imports occurs. Leave no doubt, the longer the trade battle goes on and the more countries added to the battlefield, the U.S. economy will be impacted.

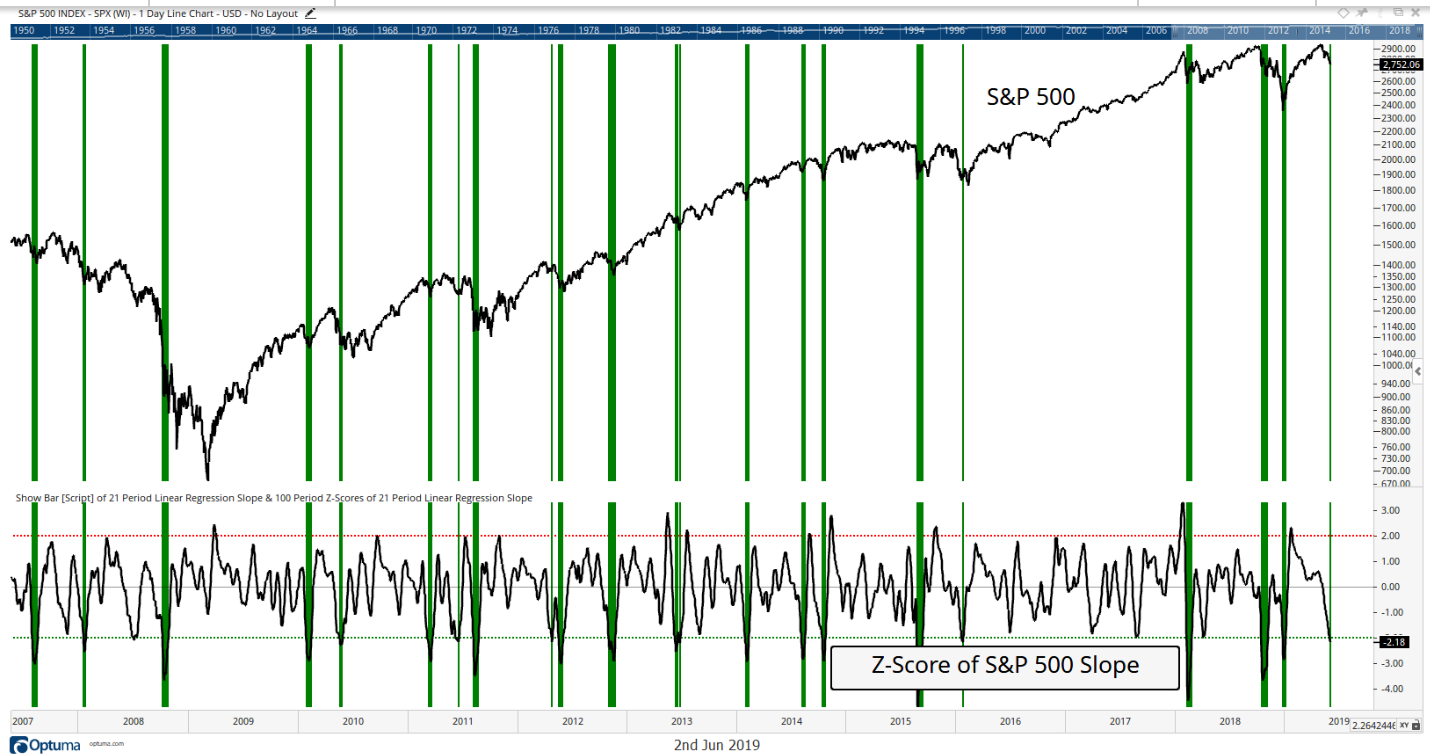
My primary focus with what took place in the markets this last week is centered on the bond market. The 10-Year Treasury Yield (TNX) fell to its lowest level since September 2017 and the iShares 20+ Year Treasury ETF (TLT) has advanced to its highest level since October 2016. The 10 yr Yield has declined 10% over the last four weeks, a decline that Jefferies notes has led to a rally in equities 75% of the time over the next 10 days for equities and 85.7% higher within 20 days. The weekly chart of TNX) is below along with the 14-period RSI. This decline has taken the yield back to its December 2008 low and moved the momentum indicator into 'oversold' territory below 30.



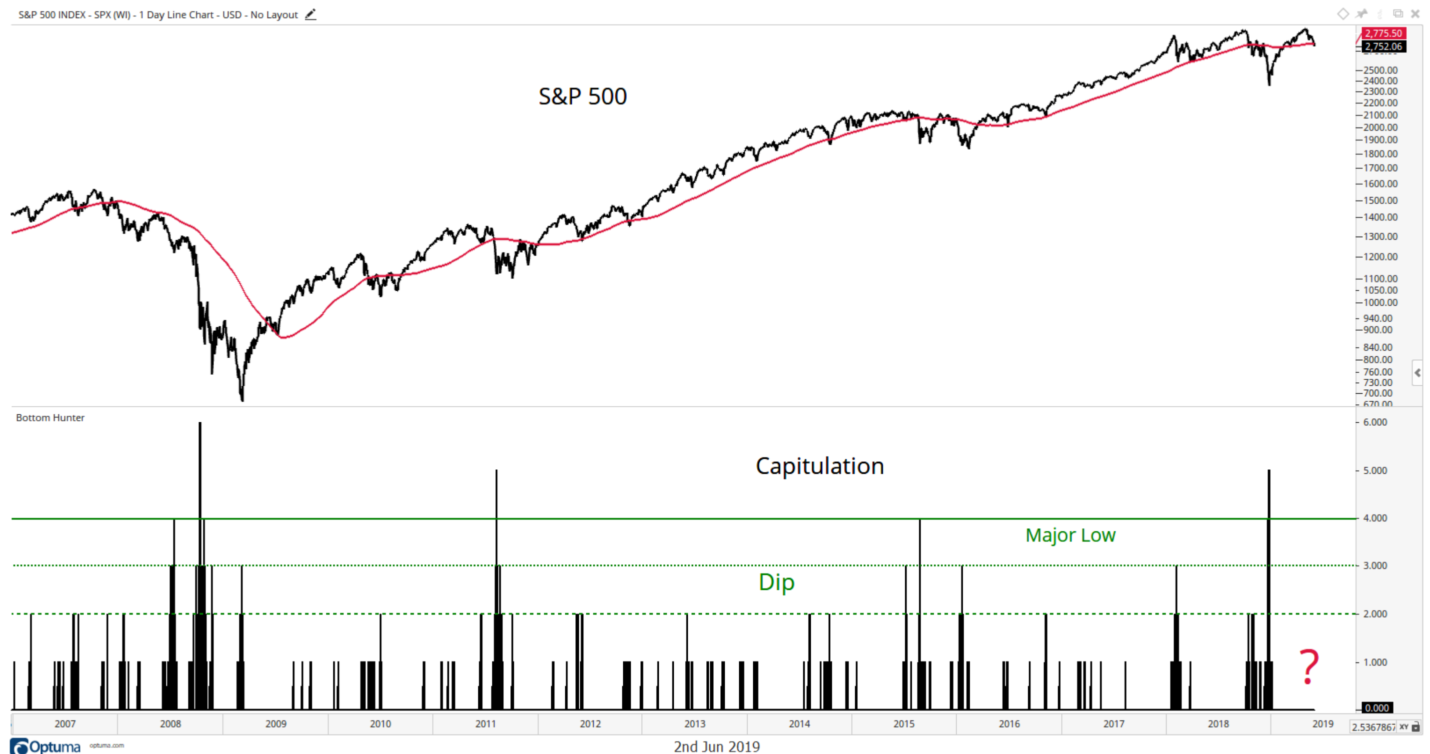
S&P 500

In last week's letter I discussed the breakdown in market internals with lower lows having already taken place in many of the major cyclical sectors. You'll also remember the weekly momentum divergence that's developed for the S&P 500, something we have experienced just two previous times int he last ten years, each leading to 10+% declines in the index.

With this decline in the S&P 500, the slope of the index over the last month has reached a 2-sigma level, an event that has accompanied many "buy-able dip" opportunities. However, the degree of the decline is not enough to jump eyes closed back into equity waters. As you'll notice on the chart we saw a 2-sigma reached just after the October selling began last year, with some brief reprieve following but a continued decline quickly emerged.



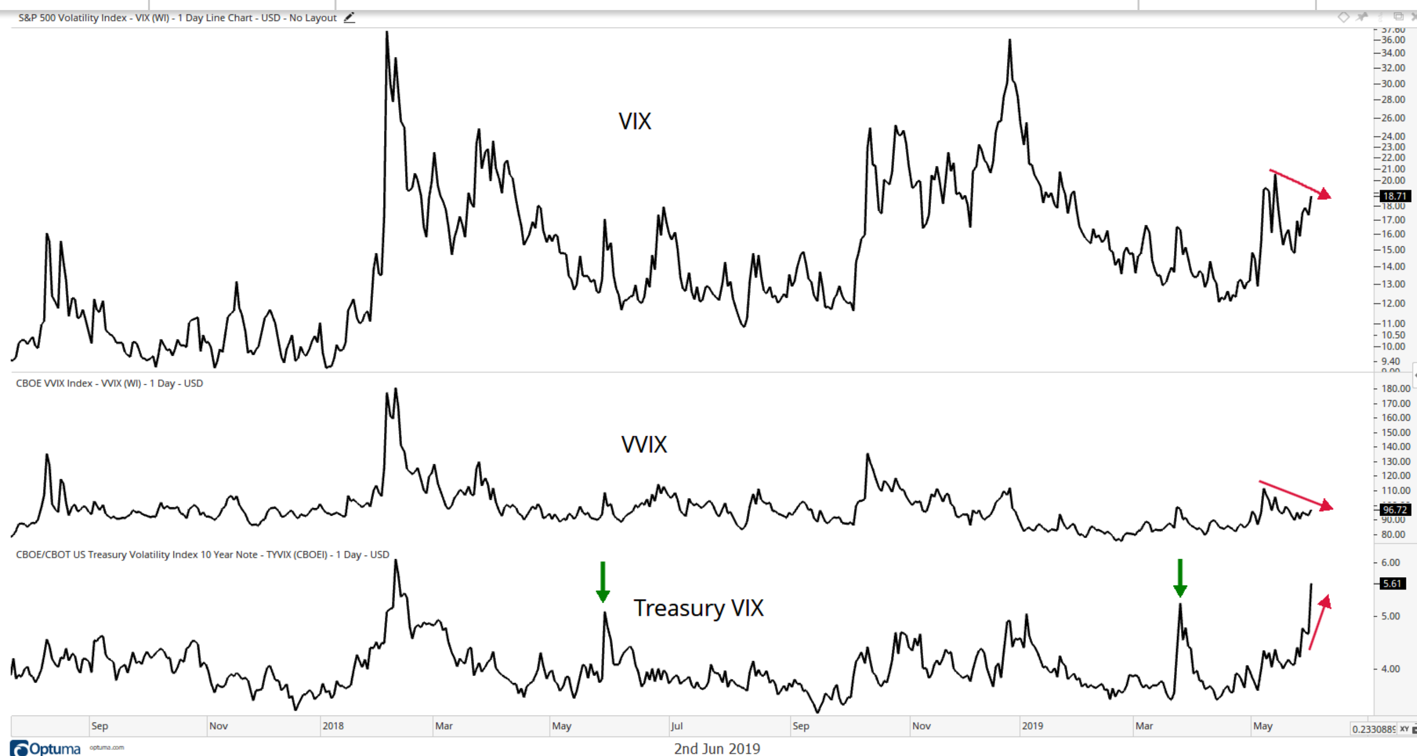
In my last letter I discussed the economic component to my upcoming Trend Model. An additional 'feature' of the model is a systematic hunt for capitulation-type selling in equities. This is shown in the chart below, which I'll give more info on in a future letter. I share it today to highlight that we have not reached, not even close yet, a level of capitulation that would warrant an expectation of a snap-back move higher in price. While the slope (noted above) has been historically steep, there hasn't been enough fear to signal a washout has taken place, leaving few sellers left to sell like we saw last December or February '18.



QT Dates

market. Most noticeably on May 1st and December 26th of last year. After the 5th, the next run-offs will be on June 26th and July 3rd.

Volatility
If you were to just watch the changes in spot VIX, you wouldn't have expected equities were off over 6%. The Volatility Index (VIX) hasn't even made a higher high above the May 13th level. The same lack of fear can also be seen in the VVIX Index, which is well off its 1-month high as well. As of Friday, traders just don't seem to be picking up protection via volatility or S&P options just yet. As I write this on Sunday evening, t he VIX futures curve is also not showing signs of distress, June and July are trading at the same level (18.65) which is just a 20 bps premium to August. From a volatility perspective, it doesn't seem like the latest news about India and Mexico will last very long. The chart below shows the VIX, VVIX, and Treasury Volatility. The two green arrows show the past two times Treasury volatility went above 5 while VIX was still under 19. Both times the VIX and Treasury volatility peaked and moved lower.



Last week I mentioned my interest in watching small caps. That interest carries into this week as well as I think if we do see a pickup in stocks, small caps have a strong chance of leading that charge. I'm not ready to go knife catching yet, as that type of behavior would need to be accompanied by a much larger degree of "blood in the streets" (read: capitulation behavior as shown in the chart above). If equities begin to firm up and the S&P 500 recovers (and holds) its 200-day Moving Average in the first part of this week then I'll get more interested in small caps. While I didn't mention the inversion of the yield curve, the discomfort being shown by fixed income is not to be ignored. We've reached a point where a great deal of pressure will now be placed on the Fed to cut rates, many analysts are expecting a cut in September, with even a few thinking we see one at the next FOMC meeting. As has been the case with prior market declines,

The tune out of D.C. seems to shift when equities are losing value. It's not a secret that Trump views the equity market as a barometer of his self-perceived success. At some point we should start seeing a ramp up of Tweets directed at the Fed to lower rates and potentially loosening of hands in the trade battles in order to toss the financial market a proverbial bone. This all makes our jobs as traders, advisors, and money managers that much more difficult - creating a game of 3D chess involving buyers, sellers, and the 'invisible' hand of the government putting its finger on different parts the scale. Hopefully we'll soon return to an orderly market controlled by participants. Until then, we must rely on our data to lead our biases and at this point, there's not enough data to suggest a severe panic is taking place nor enough to call for a buy-able dip.

Best Regards,
Andrew Thrasher, CMT

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