Market Update

Sector Rotation: March	
Technology	XLK
Utilities	XLU
Communications	XLC

Notable Breadth Data:	
SPX >50MA	1.19%
SPX >200MA	2.98%
Nasdaq >50MA	2.91%
Nasdaq >200MA	10.68%

Fixed Income Rotation: Q1	
20+ Treasury	TLT
Aggr Bond	AGG

Index & Sector Adaptive Trend	Up Trend	Down Trend
SPX		X
QQQ		X
XLF		X
XLY		X
XLK		X
XLV		X
XLU		X
XLP		X
XLI		X
XLRE		X
XLE		X
XLB		X

Daily Sentiment Index	% Bullish	5-day MA
S&P 500	5%	7%
Nasdaq 100	5%	9%
Nikkei	10%	11%
VIX	82%	89%
10yr Treasury	73%	65%
5yr Treasury	72%	69%
CRB Index	10%	9%
Gold	40%	40%
U.S. Dollar	90%	77%

*Green<25% Red>80%

- *The % of S&P 500 stocks at 6-month lows has begun to come down from being north of 80% to 21% on Friday, with each recent lower-low seeing this figure edge lower – an encouraging sign that selling is (hopefully) beginning to slow but it's still early. However, there's still less than 2% of stocks trading above their respective 20-day Moving Averages. What these two pieces of data tell me is that while stocks may not be falling as hard as they were earlier this month, they aren't rising either; so, we have some potential consolidation occurring in many names preparing for their next move. The trillion dollar question becomes, will that next move be higher or lower?*

- *The focus has, and rightfully so, been on the Coronavirus and it's economic and health impact of the country and the globe. Because it's not the first virus outbreak, many traders turn to prior viruses to get a roadmap for the market. Unfortunately, this has been a useless endeavor. The Swine Flu, SARS, Zika, Ebola, and Cholera viruses all saw the S&P 500 higher by*

down almost 30%. The point being the financial markets are responding in a much more severe manor than they have in the past. This makes sense as the initial perceived impact is more severe as well, we didn't have a near-global shutdown after SARS or Zika. Be careful trying to extrapolate other periods in recent history involving a contagious virus and attempt to overlay it on our current market.

- Now that we have moved past option expiration (opex) week, one of the factors that's been manhandling markets, dealer gamma hedging, has dropped off a bit. Let me explain, using some of the data from Charlie McElligott of Nomura: When we see a 3-4% move in the markets, the dealers that provide liquidity and executes trades must hedge their exposure, which becomes a feedback look pushing markets another 3-4% and then that process has referenced the next day as systematic traders initiate reversion trades, sending markets in the opposite direction and market makers being forced to continue to adjust their own exposures, adding fuel to the fire. McElligott wrote late-last week that Nomura believes 39% of this activity should have dropped off with opex on Friday, allowing markets to have a little less firepower behind them from the dealers – i.e. less volatility outside of another headline that causes more panic or euphoria. This doesn't mean the sell-off has ended but hopefully it does mean the circuit breakers will be given a break for a little while… fingers crossed. You'll remember back in December 2018 that the massive rebalancing that took place then helped provide fuel for the market to continue higher along with the Fed stepping back in w/ lower rates and the Treasury announcing they'd spoken with the banks and reassuring markets there were no underlying banking risks.

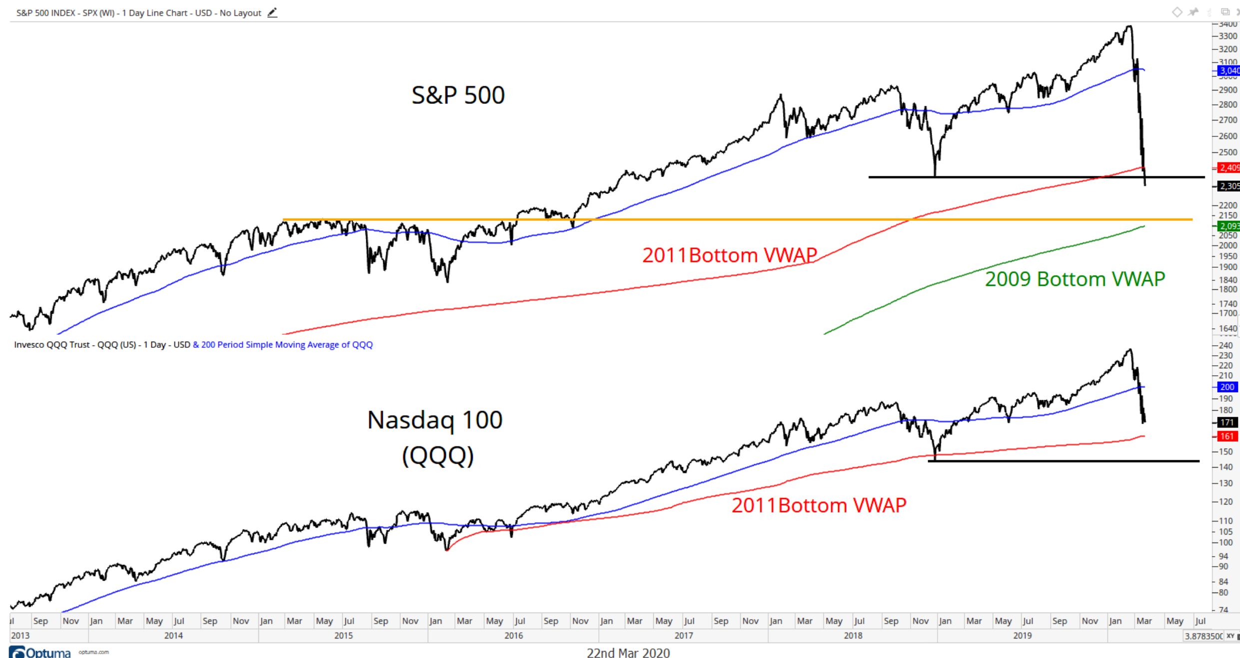
- *Speaking of McElliogtt, he also noted that Nomura's CTA and risk parity models suggest that trend followers and volatility-control funds are sitting at historic low levels of equity/risk exposure. This is a good thing, meaning they've likely puked up all the risk that they had built up, leaving them likely to be buyers in the future than sellers – it's tough to sell what you no longer own! This paired with end-of-month and end-of-quarter rebalancing that will begin taking focus later this week will surely leave many funds and investors underweight stocks aft equities down over 20% for the month, requiring a systematic rebalance in the buying department. If this does take place, I view it as a possible catalyst for the FIRST low and counter-trend not the FINAL bottom.*

- *The market plumbing of exchange traded funds (ETFs) took a slice of the spotlight this week with many funds, primarily in fixed income, became severely dislocated from NAV. I've read many takes on what's caused this, apart from just the massive market volatility that's taken place, and one reason that's made the most sense is the simplest: the quarantine has sent traders and market makers home, widening the arbitrage between the funds and the basket of stocks they represent. FINRA has tight regulations on where market making may take please, with many firms unable to full staff their trade desks, there's less professionals to man the computers and monitor the spreads that's widening between the funds and the underlying assets in the index they track. The CME shut down its Chicago trading floor and the NYSE recently closed its own. The market can operate without these in full operation, but as we've now seen, not without some bumps in the road. These will likely be short-lived and a function of the quarantine rather than credit risk or fundamental flaws of the investments. This doesn't explain entirely why LQD (corporate bond ETF) has fallen 20%, but it does clear some of the confusion of why it's been $3-5 under NAV at certain times. JPMorgan addressed this in a recent note, "In principle, one would expect the high-frequency trading activity (HFT) that dominates liquidity provision in interdealer Treasury markets to be more resilient in a WFH construct—it is automated after all. […] Though "human" traders have typically provided a backstop in prior episodes, WFH and split working arrangements likely introduce new frictions owing to potentially inefficient communication and systems issues. If that occurs we believe this particular circuit breaker will not function effectively, which could significantly extend the vicious cycle of higher volatility begetting lower liquidity."*

- *The volatility in fixed income aren't just impacting ETFs, mutual funds are also seeing their prices implode. One $2 billion fund fell nearly 20% on Friday after falling 7% on Thursday, a massive one-day decline for a mutual fund that's rated 5-stars by Morning Star and invests in non-agency mortgage debt and other asset-based securities. If you want to see the damage yourself, the ticker is IOFAX. I've seen one report by another major mutual fund company issuing a several hundred-million-dollar bond in order to generate cash to meet outflows from their funds.*

- *The Fed is doing its best (which is up for argument I suppose) to band-aid over the breaks in the financial pipes being caused by fixed income volatility, specifically in the repo and overnight markets. These are banking operations that banks and other large institutions use for short-term lending and have been under stress most recently as prime money market funds are getting hit harder than a piñata on a 10 year old's birthday. For example, Goldman Sachs injected $1 billion into two of their prime money market funds after investors yanked over $8 billion over just day four days last week. (Prime funds can invest in corporate debt allowing a higher interest rate to be offered while regular money market funds invest only in ultra-short term Treasury securities, so when corporate debt begins to weaken this has a larger impact on prime than traditional money funds.) While trad'l funds saw almost $400 billion inflows, prime saw $89 billion in outflows according to Deutsche Bank.*

- *I think at this point the most critical charts to be watching are of internals/breadth. I want to see bullish price action in the individual stocks as this historically happens before it flows to the indices. But that doesn't mean I'm ignoring the price action of the major indexes. I've previously shared the price levels of potential support and they got blown out (which goes to my reason why I'm not wanting to turn my market bias based on SPX price levels during this waterfall-like decline). Looking at where we could see POTENTIAL support at lower prices, here's where my eyes go: For the S&P 500 we closed on Friday under the December 2018 low, this is where many had hoped buyers would step in, so if we see bullish price action this week, hopefully this level gets recovered. Going lower we also broke below the 2011 VWAP but still are above the 2009 VWAP which was excellent support during the 2010 and 2011 down trends. We could also see some potential buying back at the 2015 consolidation/down trend. What's interesting about this level is its just above the '09 VWAP, giving some 'tightness' to the support just above 2,000. The Nasdaq 100 has held up better and still remains above its December '18 low and 2011 VWAP, so these levels are still 'in play' at the moment. See the chart below.*



I'll be back next Sunday with a full letter.

Best Regards,
Andrew Thrasher, CMT

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