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A MAJOR MARKET TOP AHEAD

Highlights

We are now seeing the early technical signs of a developing cyclical top for the bull market that began in 2009. While this is not a call to sell everything, as a bear market can take some time to develop, investors should be taking steps to rein in risk exposure in preparation for a market top in the next few months.

The most convincing technical sign of a developing stock market top is the negative divergence RSI exhibited by the monthly chart of the broad-based Wilshire 5000 (WLSH). WLSH made a marginal all-time high in July compared to January on a closing basis, but showed a negative RSI divergence. Past similar conditions have signaled either major market tops or, at a minimum, a corrective pullback.

Long-term investors should start de-risking portfolios, with the target equity weight specified in their Investment Policy Statements as the ceiling. In addition, consider changing equity exposure from long-only to buy-write positions as a way to cushion this downside risk. Another way of engineering risk control might be to use either the 50- or 200-dma as partial or full stop losses as a way of letting winners run and limiting losses.

On the other hand, traders who can be more focused on the possible upside potential. Staying in long positions until either the S&P 500 experiences a break of 2800 support, or sentiment becomes euphoric, which is likely to occur when the index breaks up above 2900.

A Major Market Top Ahead

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We came to this conclusion through the prisms of technical analysis and top-down macro-economic analysis. The most convincing technical sign of a developing stock market top is the negative divergence RSI exhibited by the monthly chart of the broad-based Wilshire 5000 (WLSH). WLSH made a marginal all-time high in July compared to January on a closing basis, but showed a negative RSI divergence. Past similar conditions have signaled either major market tops or, at a minimum, a corrective pullback.

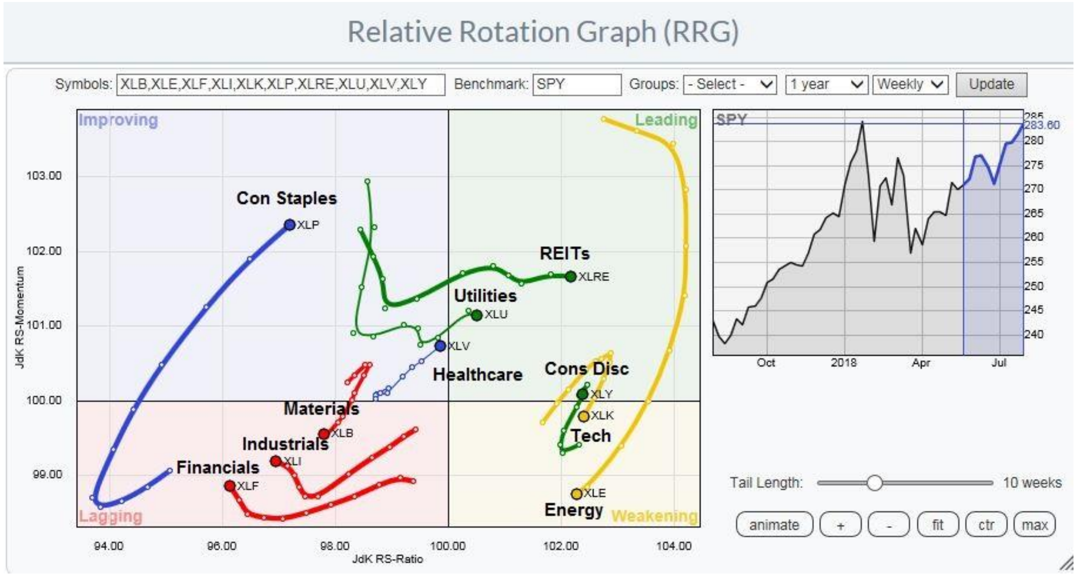
Exhibit 1: The Wilshire 5000 Flashes a Market Top Warning

Source: Stockcharts

Equally disturbing is the sector leadership picture from RRG charts. As an explanation, [RRG charts] are a way of depicting the changes in leadership in different groups, such as sectors, countries or regions, or market factors. The charts are organized into four quadrants. The typical group rotation pattern occurs in a clockwise fashion. Leading groups (top right) deteriorate to weakening groups (bottom right), which then rotates to lagging groups (bottom left), which changes to improving groups (top left), and finally completes the cycle by improving to leading groups (top right) again.

The latest update of sector leadership shows that defensive sectors are either the emerging or actual market leaders, indicating developing market weakness. Defensive sectors such as Consumer Staples, REITs, Utilities and Healthcare are all either in the improving or leading quadrants, while high beta and cyclical sectors such as Technology and Industrial stocks are either in the weakening or lagging quadrants.

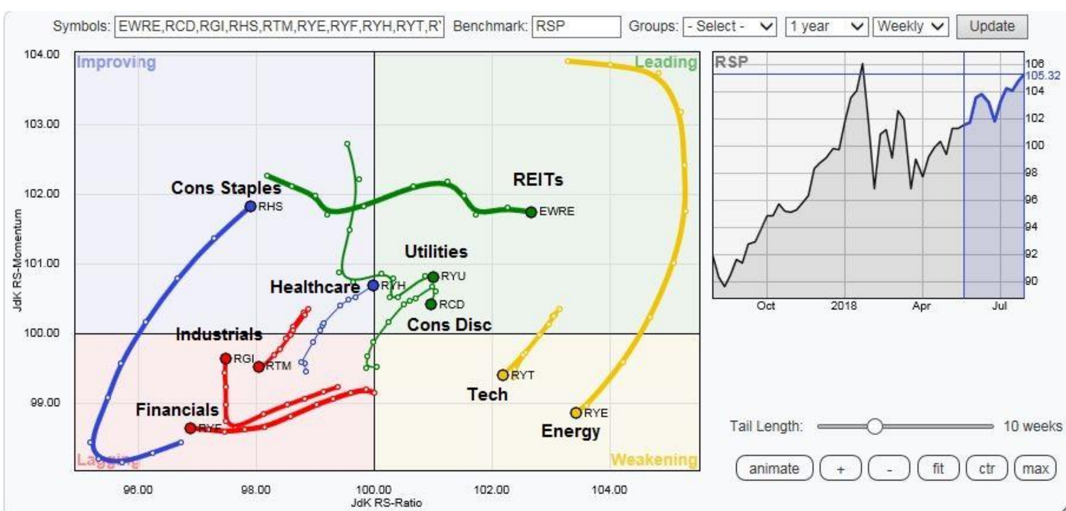
Exhibit 2: Emerging Leadership from Defensive Sectors



Source: Stockcharts

The RRG analysis for equal-weighted sectors, which minimizes the effects of megacap heavyweights in each of the sectors, is also supportive of the thesis of emerging defensive sector leadership.

Exhibit 3: Confirmation of Defensive Sector Leadership from Equal-Weight Analysis



Source: Stockcharts

As well, the failure of the price momentum factor has been a drag on risk appetite and raises another cautionary flag for the bull case. At the same time, the relative performance of high beta to low volatility stocks is testing the bottom of its recent trading range. A violation of relative support would be a signal that the bears are taking control of the tape.

Exhibit 4: Signs of Waning Risk Appetite

Source: Stockcharts

In conclusion, a series of long-term technical signals are leading to a cautious outlook for U.S. equities.

Macro Dark Clouds On The Horizon

At the same time, dark macro-economic clouds are gathering on the horizon. I agree with the analysis of the blogger New Deal democrat, which has done an excellent job of categorizing high frequency economic statistics into coincident, short leading and long leading indicators. NDD's latest weekly update of U.S. economic conditions shows that long leading indicators, designed to forecast economic conditions a year in advance, have deteriorated from positive to neutral, and they are on the verge of turning negative, which is a recession warning. However, coincident and short leading indicators are all pointing upward.

> *As has been the case for many months, both the nowcast and the short-term forecast remain positive, led by manufacturing, the stock market, and jobless claims.*
>
> *The longer-term forecast recently turned from positive to neutral. This week the readings were stable, but real M1, the yield curve, and purchase mortgage applications are all close to tipping this negative.*

While we are not in the habit of anticipating model readings before they occur, the current trajectory of long leading indicators suggests that the American economy is likely to enter a recession in H2/19. As stock prices tend to look ahead by about a year, this suggests that a cyclical market top may be developing about now.

Although standard economic analysis is pointing to a possible economic slowdown in late 2019, there are two factors that may act to further spook the markets. The first is a possible trade war that could crater global trade. How trade tensions develop is an unknown, but the markets seem to be mostly shrugging off the worst-case scenario of a full-blown trade war for now.

One risk that market analysts have largely ignored is the repercussions from the November mid-term elections. In all likelihood, the Democrats are likely to retake control of the House, though they face an uphill battle in the Senate. Should such a scenario unfold, there are two negative market developments that we have seen few analysts discuss.

The first is the fiscal policy effect of the Democrat's takeover of the House, and possibly the Senate. Expect a tighter fiscal policy in 2019. There will be no further tax cuts, and a possible partial rollback of the tax cuts passed in 2017. The combination of tight fiscal and monetary policy will act to slow economic growth further, which is a development the market has largely ignored.

In addition, a Democrat-controlled House will see more political fireworks between the White House and Congress. Committee chairs will be controlled by Democrats, and expect committees to come into greater conflict with the Trump Administration. Congressional committees will have the power to subpoena anything and everything, such as Trump's tax returns. Cabinet secretaries can be called to testify before committees on all sorts of issues that have been ignored by the Republican-controlled committees.

Expect the Mueller probe, if it continues into 2019, to take on a greater prominence. The Mueller inquiry could morph into a Watergate-like drama. Recall that the market reacted badly to the Watergate hearings, but they occurred against a backdrop of recessionary conditions in the wake of the Arab Oil Embargo. A similar scenario of the combination of tight fiscal and monetary policy cools the economy into a slowdown, and Watergate-style hearings that paralyze Washington in 2019 is well within the realm of possibility.

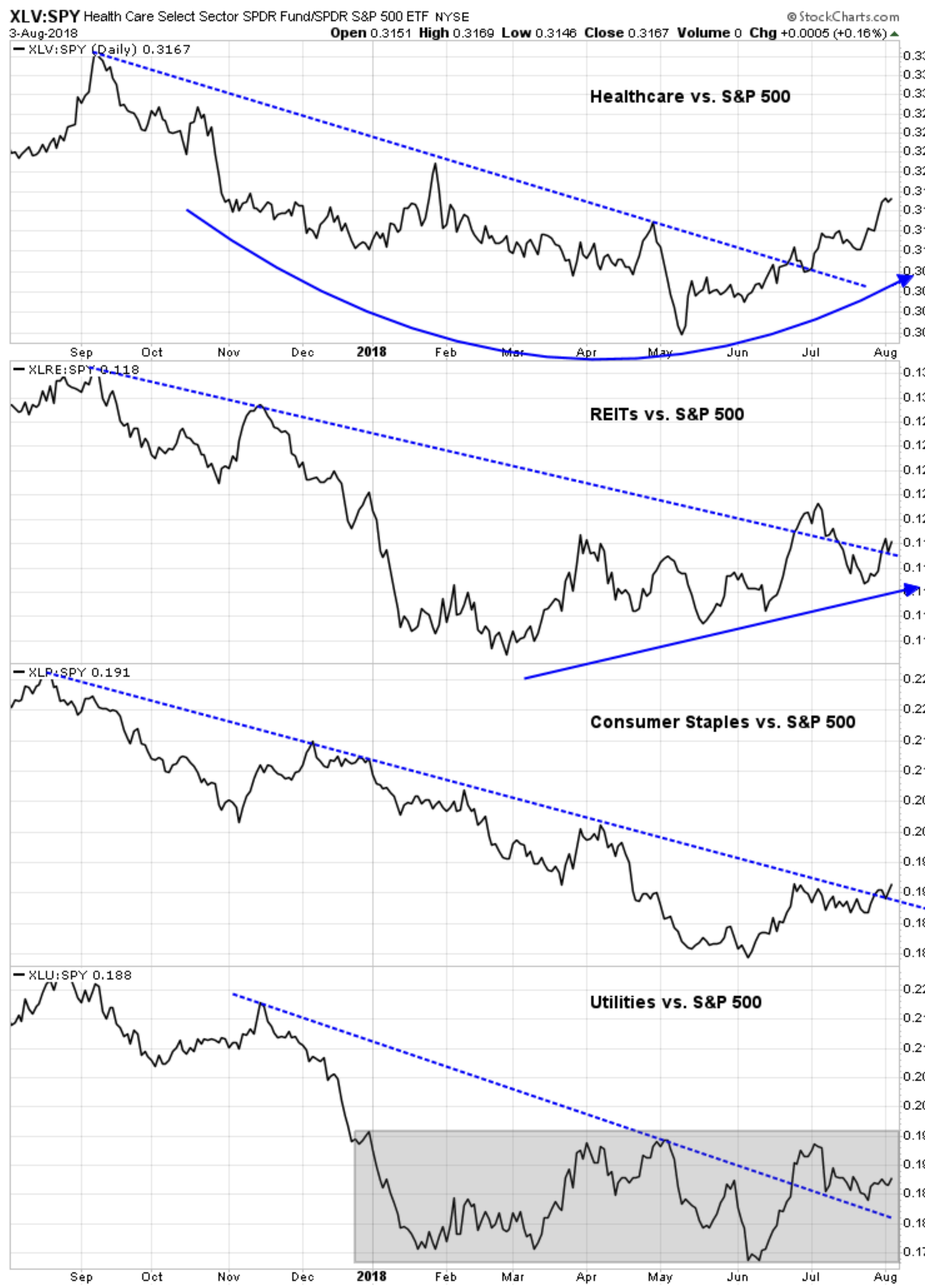
Next year will be legislative hell for the Trump Administration. The markets may not like this development.

Don’t Panic

Despite these cautionary signs, this is not an investment call to sell everything, but a warning of a possible market top. Topping processes can take some time to fully develop.

First, please be reminded that the Wilshire 5000 chart is based on monthly prices, and negative RSI divergences can continue for several months before playing out. In addition, the relative performance of defensive sectors shows that they are bottoming against the market. With the exception of healthcare stocks, the other sectors are not in clear relative uptrends, indicating that the bears do not have the upper hand just yet.

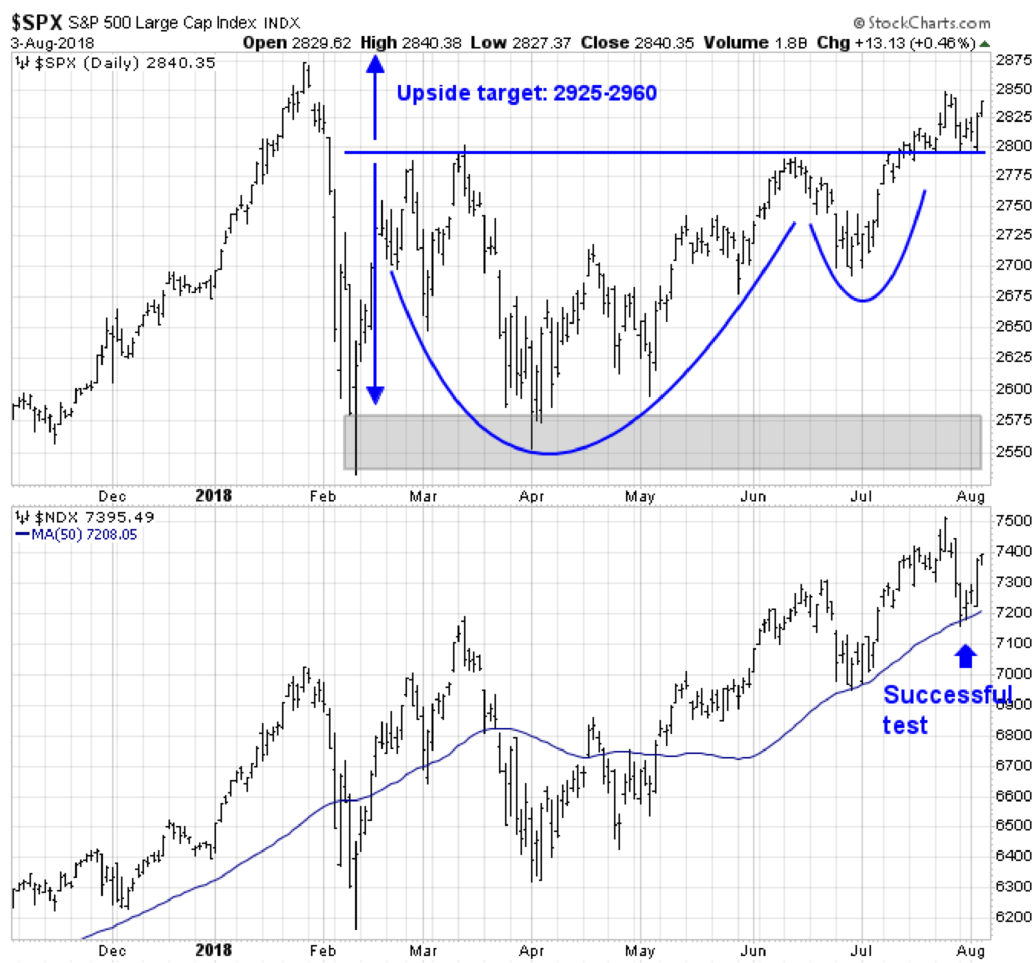
Exhibit 5: Emerging Defensive Sector Leadership ≠ Bear Market



Source: Stockcharts

Our last hurrah scenario of a rally to new all-time highs remain in play for the next few weeks. The S&P 500 has successfully tested the breakout turned support level of 2800 and the cup and handle breakout structure remains valid. Last Thursday's market reaction to the Trump Administration's announcement that it was considering additional tariffs on Chinese imports was a positive for the bulls. In addition, the NASDAQ 100 held support at the key 50-day moving average was also short-term positive for stock prices.

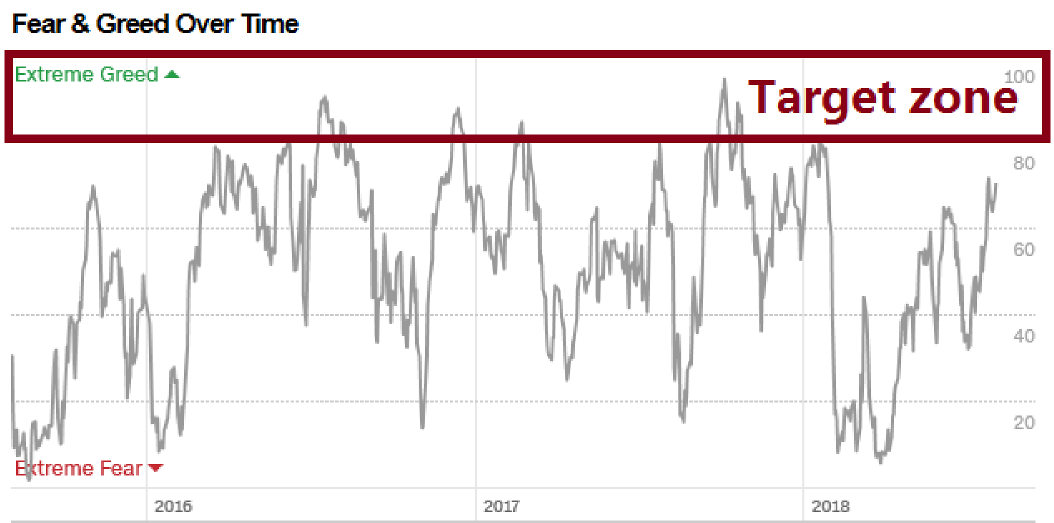
Exhibit 6: The "Last Hurrah" Scenario Remains in Play



Source: Stockcharts

Tactically, we would wait for signs of euphoria from sentiment indicators such as the CNN Money Fear & Greed Index before calling a top.

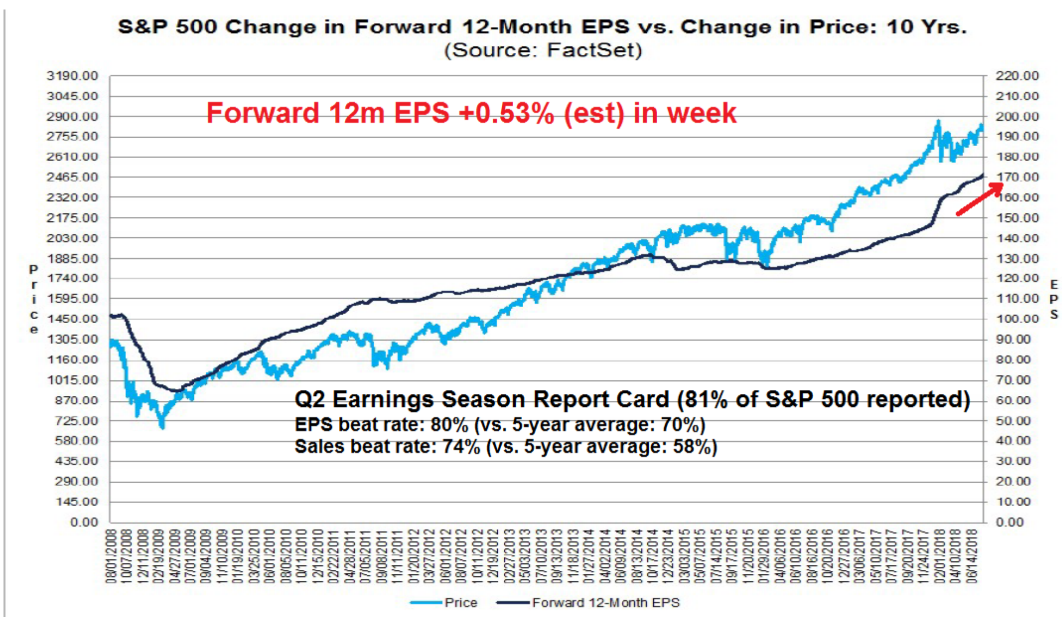
Exhibit 7: Sentiment Is Not Euphoric Yet



Source: CNN Money

The latest update from FactSet shows that the results from Q2 earnings season have been outstanding, and forward 12-month EPS has been surging. As forward EPS is coincident with stock prices, it is difficult to see how a bear phase could start with such near-term strength in fundamental momentum.

Exhibit 8: Stock Prices Coincident with Forward 12-month EPS



Source: FactSet Information Systems

Finally, a turnaround in the relative performance of value/growth ratio would be an indication of a change in market direction. Despite the recent hiccup, the bulls still have control of the tape.

Exhibit 9: Growth Is Still Outperforming Value

Source: Stockcharts

Differing Time Horizons

How investors and traders should react to our change of opinion depends on their investment objectives and time horizon.

Long-term investors should start de-risking portfolios, with the target equity weight specified in their Investment Policy Statement (IPS) as the ceiling. In addition, consider changing equity exposure from long-only to buy-write positions as a way of cushioning downside risk. Another way of engineering risk control might be to use either the 50- or 200-dma as partial or full stop losses as a way of letting winners run and limiting losses.

Exhibit 10: Using Moving Averages as a Risk Control Discipline

Source: Stockcharts

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