EXECUTIVE SUMMARY

May was a tumultuous month, but investors need to take a deep breath and consider the big picture. The S&P 500 is up 9.8% on a price-only basis for 2019, but down -6.6% from its highs. While drawdowns are always painful and may appear Apocalyptic when you are in the middle of one, 6% losses are not unusual at all from a historical perspective. The market is now oversold, and sentiment is at a crowded short.

In the absence of trade anxiety, the fundamentals and technical outlook is bullish. However, the uncertainty over trade policy is still the elephant in the room.

We interpret these conditions as the market poised for an oversold relief rally, but it may need more time to chop around for a few more weeks before a durable bottom is made. From a technical standpoint, the market appeared to be poised for short-term strength Thursday until the Trump Mexican tariff tweet derailed the rally. We may see more weakness on Monday based on China's latest retaliation tactics. At a minimum, traders should not be initiating new short positions at these levels. Even if you are bearish, wait for a bounce first.

We suggest that long-term investors maintain a neutral position on risk and stay at the portfolio's investment policy asset allocation weights.

Traders should be positioned for a buy-the-dip and sell-the-rip environment until we see more clarity on the trade dispute. Since the market is near the bottom of its range, the risk/reward relationship calls for a buy the dip position.
A Tumultuous Month of May

May was a tumultuous month, but investors need to take a deep breath and consider the big picture. The S&P 500 is up 9.8% on a price-only basis for 2019, but down -6.6% from its highs. While drawdowns are always painful and may appear Apocalyptic when you are in the middle of one, 6% losses are not unusual at all from a historical perspective. The market is now oversold, and sentiment is at a crowded short.

Exhibit 1: 6.6% Drawdowns Are Not Unusual

Source: JP Morgan Asset Management
Fundamentals Supportive of Gains

From a fundamental perspective, momentum and valuation are supportive of gains. FactSet reports that the Street is still revising EPS estimates upwards, and valuations are becoming more and more reasonable with the forward P/E at 15.7, which is below its 5-year average of 16.5 and above its 10-year average of 14.8.

Exhibit 2: Consensus EPS Rising

Despite the trade jitters, Q2 estimate revisions are slightly better than the historical averages. To be sure, the bears can validly argue that company analysts will not downgrade their forecasts until they can actually measure the effects of the trade war and quantify them. Strategists using top-down analysis have reduced S&P 500 earnings by about 5% should the next round of 25% tariffs on the remaining $300 billion of Chinese imports.
Exhibit 3: Analysts Making Smaller Cuts to Q2 EPS Despite Trade Concerns

Despite Tariff Concerns, Analysts Making Smaller Cuts to Q2 Estimates

During the first two months of the second quarter, the Q2 bottom-up EPS estimate (which is an aggregation of the median EPS estimates of all the companies in the index for the second quarter) dropped by -2.1%, compared to -2.5% for the past five years (20 quarters), and -2.2% for past ten years, (40 quarters).

Source: FactSet Information Systems
Bullish Short-Term Technical Outlook

We can see a number of hopeful technical signs for the bulls. The latest decline was not precede by a negative Advance-Decline Line divergence. While this does not mean that the market has no problems, but the lack of a breadth divergence suggests that the current pullback is less likely to develop into a deeper 15-20% loss. The index is oversold, but need to see the stochastics recycle back into the neutral zone before the bulls can confidently jump in. Initial downside support can be found at the first Fibonacci retracement level of 2720, which is about 1% below Friday's levels.

Exhibit 4: Breadth Support For S&P 500

There are numerous signs that the market is oversold. We monitor the Zweig Breadth Thrust Indicator for signs that the market might undergo a bullish stampede. The setup for a ZBT is an oversold condition on the ZBT Indicator. While stockcharts reports the ZBT Indicator with a lag, I have developed my own estimate, based on both the NYSE breadth statistics originally used by Marty Zweig, and my own estimates based on solely S&P 500 components (bottom panel). The SPX ZBT Indicator flashed oversold signals last Wednesday and on Friday. While oversold conditions do not guarantee a ZBT buy signal, all of the past instances in the last five years when the SPX ZBT Indicator was oversold, but the official ZBT Indicator was no, have resolved themselves with short-term relief rallies.

Source: Stockcharts
Exhibit 5: Zweig Breadth Thrust Oversold Setup = ST Bullish

The CBOE put/call ratio reached an extreme of 1.40 last week. With only one exception in the last 10 years, all have seen little downside risk and a short-term rally shortly after the signal.

Source: Stockcharts
We are also seeing signs of seller exhaustion from market internals. Look at what has been outperforming in the last few days: semiconductors, China, and emerging market equities. These are all parts of the market that are sources of the recent market anxiety. Why are they showing a turnaround in relative strength?
Exhibit 7: Unusual Rebounds in Semiconductors, China, and EM Equities

The market stampede into safe havens has been evident. DSI on the 10-year T-Note stands at 92, which is an overbought position that has been resolved with rising rates and price pullbacks.
Exhibit 8: 10-Year T-Note DSI Overbought

Source: Hedge Fund Telemetry
Downside Risks Remain

Still, the market may have some unfinished business on the downside. The DSI on the S&P 500 is 12, which is oversold, but past bottoms have seen the reading at lower levels.

Exhibit 9: S&P 500 DSI Oversold

Similarly, the AAII Bull-Bear spread is -15, which is a level where the market has bounced in the past, but sentiment can become even more washed-out. The blue vertical lines mark past episodes which have seen little downside risk and relief rallies, while the red lines mark instances when prices have continued to weaken. In the short run, risk and reward favor the bulls.

Source: Hedge Fund Telemetry
Exhibit 10: AAII Bull-Bear Spread

Source: Stockcharts

The Fear and Greed Index closed at 24 on Friday, which is above the sub-20 target zone found at past intermediate term bottoms, indicating the market may have some unfinished business to the downside.

Exhibit 11: Fear & Greed Index Not Oversold Yet

Source: CNN Business
Insider buying is edging up, but readings are neither high enough nor long enough to flash a buy signal.

**Exhibit 12: Insider Buying Edging Up, But No Buy Signal Yet**

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