# Are We Bear Yet?

It's early in the new year, markets have been having a meltdown and the bulls and bears have laid out their predictions. Any of these outlooks must be taken with a large grain of salt because securities markets are inherently unpredictable. With that said, it's worth looking at a few things that have already happened and weighing the potential implications.

Cutting to the chase, emerging market stocks and US small caps are already in their own bear markets and US large cap stocks are flirting with chart patterns that provided very useful exit signals when the internet bubble burst in 2000 and the global financial crisis hit its stride in 2008. It's certainly possible that stocks could rally and reverse these bearish trends. On the other hand, US large cap stocks could be the last shoe to drop on the way to deeper losses for equities. In either case, we have tools that can help us see what's happening and decide what to do. Our analysis is divided into two parts, each with its own methodology.

## Part One: Relative Strength

Our initial evaluation uses two bits of technical analysis known as relative strength and point-and-figure charting. Most investment professionals are familiar with relative strength as the idea that the strongest markets/sectors/stocks tend to maintain their strength while the weakest continue to be weak. Relative strength (RS) compares different assets to tell you which one is outperforming the other. RS math is pretty simple. To compare A to B, divide the price of A by that of B at the start of your measurement period. This ratio tracks RS as A gets either stronger or weaker relative to B. In an ideal world, you want to own A when it is beating B and switch to B when the tables turn and B rallies while A falls back.

Point-and-figure (PnF) charting is a method to graphically display RS with specific buy and sell signals. PnF is less well known even in professional circles but is a great tool. Going back to our A/B comparison, the PnF chart will show a rising column of Xs when A is outperforming. The chart will reverse to a column of Os when RS shifts in favor of B. A buy signal is triggered when a column of Xs rises above the previous column of Xs, evidencing a new level of RS. A sell signal happens when a column of Os drops below the previous column of Os. If this sounds like gobbledygook, the annotated charts that follow should help.

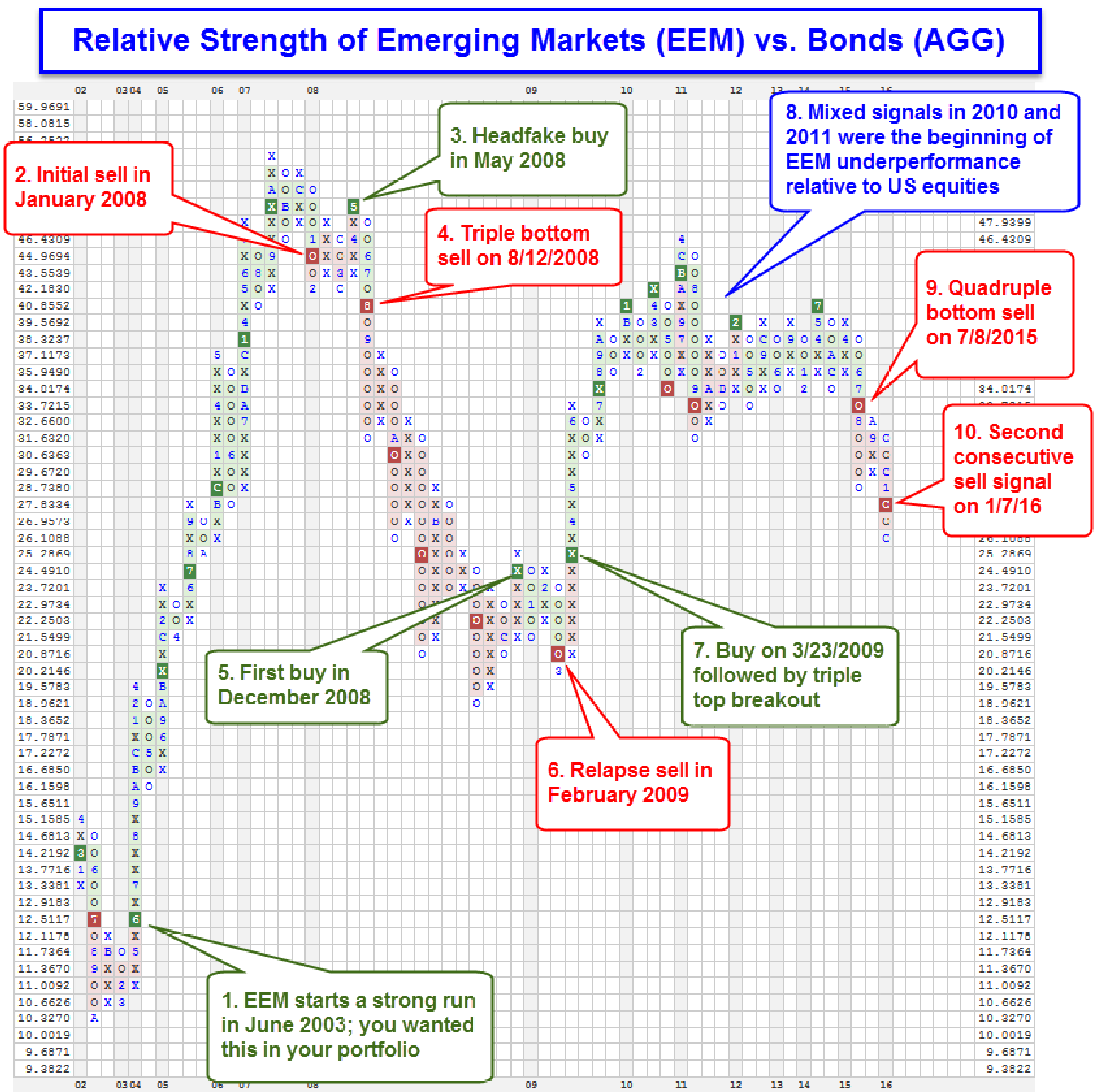
The masters of relative strength and PnF reside at Dorsey Wright & Associates (DWA) in Richmond, Virginia. The firm's been around nearly 30 years and was acquired last year by Nasdaq. One of their favorite relative strength comparisons is to match stocks against bonds. Stocks are the place to be most of the time but bonds will outperform stocks during bear markets. The long-term changes in this relationship show up pretty clearly on a PnF chart.

The following pages demonstrate how this methodology works and what it tells us about the current condition of three major equity indices. In each case, we are looking at the relative strength of the equity index compared to the Barclays US Aggregate Bond Index representing a broad cross-section of high quality, intermediate-term corporate and government bonds.

Please take special note that this analysis does not call market tops and bottoms. However, in the last two bear markets (2000-2002 and 2007-2009) it gave signals that preserved capital from the worst declines and signaled re-entry in time to capture the bulk of ensuing bull markets.

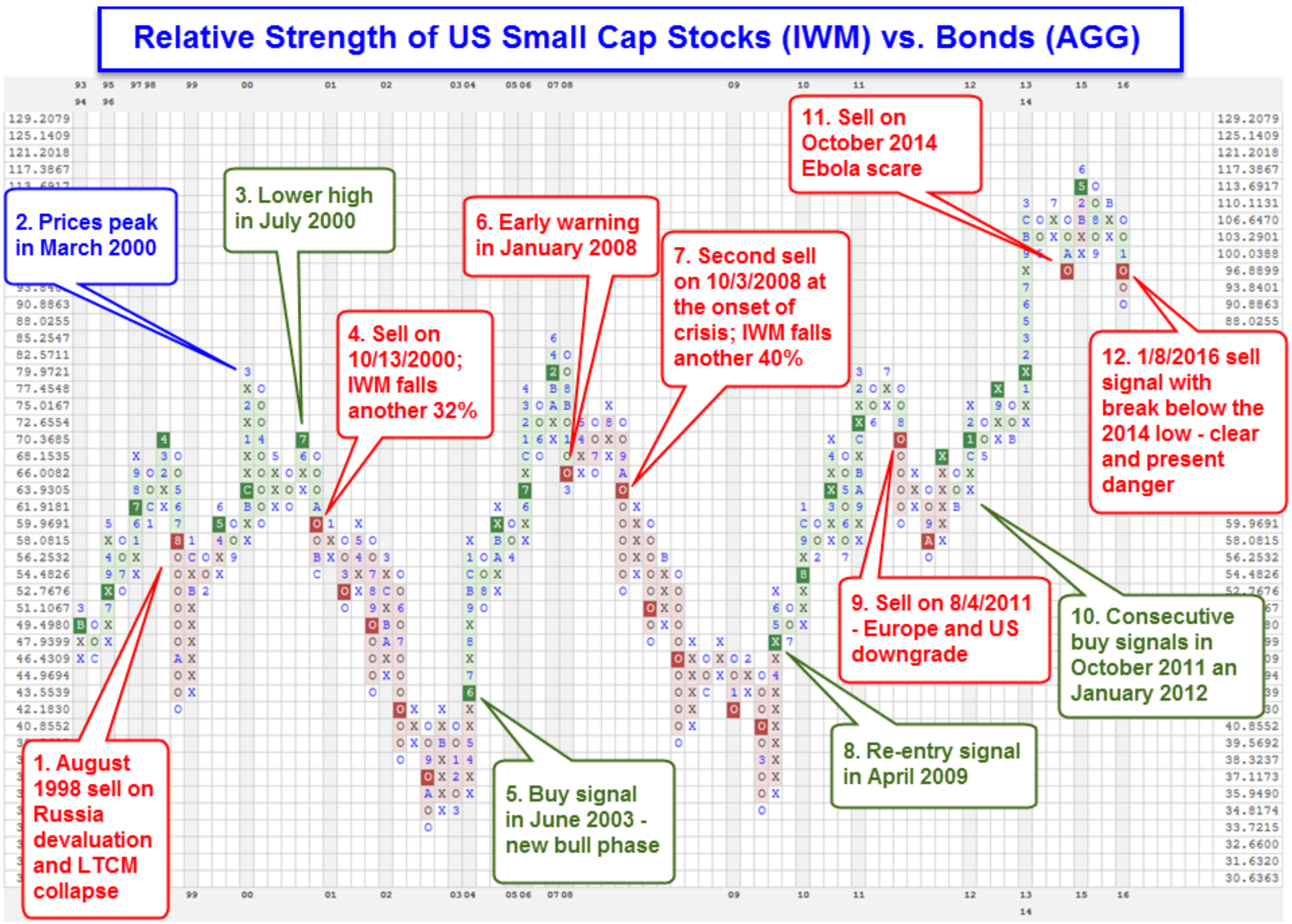
## Emerging Market Stocks vs. US Bonds

Emerging markets had a bad bear market from 1995 to 1998 but our evaluation begins in June of 2003 after the tech crash had concluded and you had a buy signal to get into EEM (#1). Returns topped 25% a year from 2003 through 2007. Things got choppy in 2008 with a sell signal in January (#2) and a buy in May (#3). However, you had a strong sell signal on August 12th (#4) that avoided the carnage that followed as EEM fell another 55%. A bit more chop late in 2008 into March 2009 when a strong buy signal (#7) would have gotten you back in for more strong performance before EEM started trading sideways again. The last part of the story is unfolding now. A strong sell signal was issued on July 8th of last year (#9) – before the August flash crash – and EEM fell 20% below its 2015 high, putting it in a bear market condition. A second sell came on January 7th (#10) and the loss has deepened to more than 30%. Many investment firms recommend a "strategic" (i.e. long-term) allocation to emerging markets as part of a diversified portfolio. That can't feel good right now.



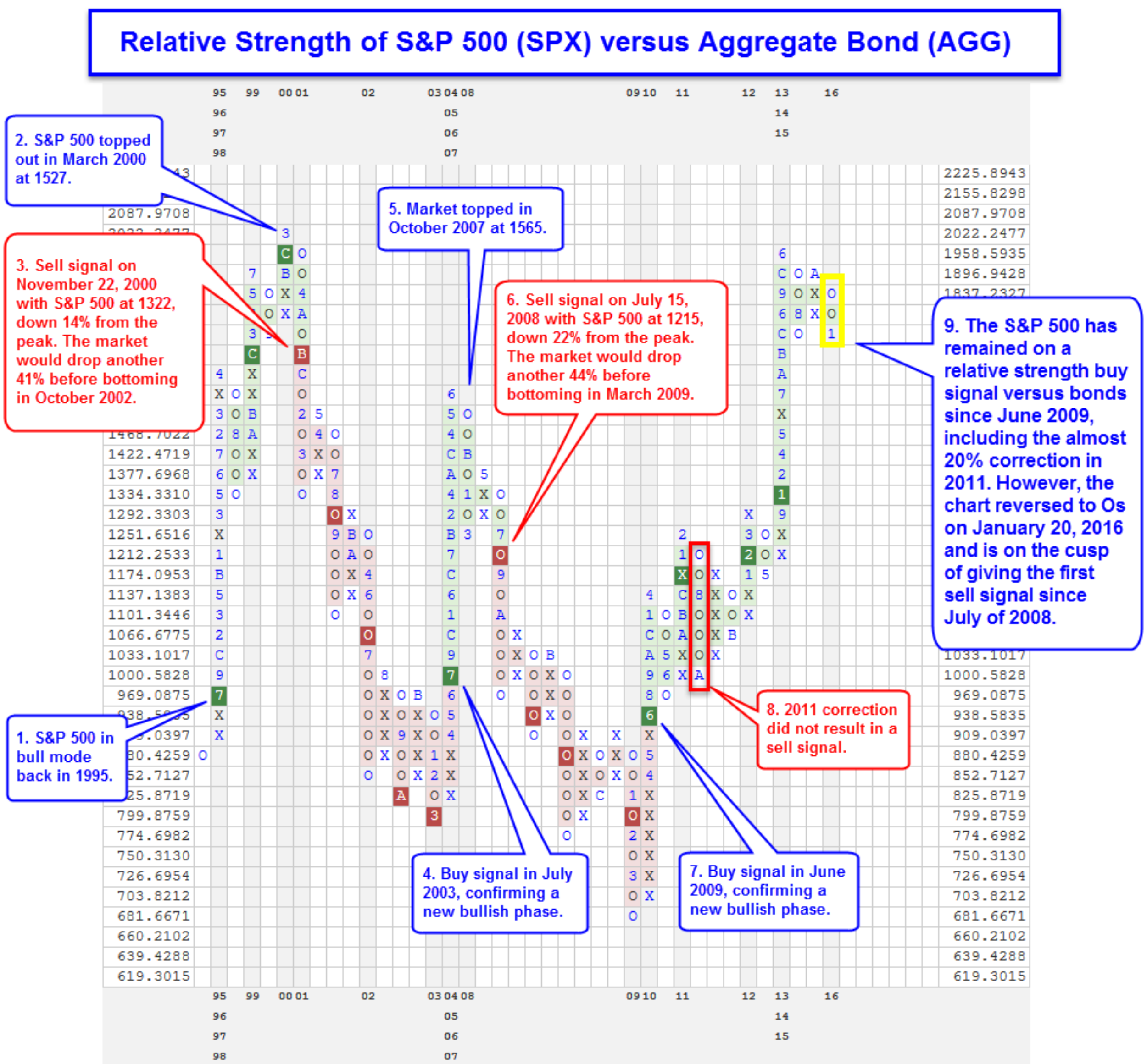
### US Small Cap Stocks (Russell 2000) vs. US Bonds

Next, we look at US small cap stocks represented by the Russell 2000 index and its IWM ETF. The bullish trend of the 90's was briefly interrupted in 1998 by the Russian crisis and collapse of Long Term Capital Management (#1). Prices then peaked in March 2000 (#2), reached a lower high in July (#3) and then triggered a sell in November (#4) as US stocks went into a bear market. That exit would have side-stepped a drop of more than 30%. Small Caps returned to rally mode in 2003 (#5) with four years of good returns. January 2008 gave a warning signal (#6) with only weak rallies until a second signal to exit in October (#7) and a drop of 45% to the bottom in March 2009. An entry signal came in April 2009 (#8) before most investors were comfortable getting back into the market. The 2011 correction gave an actionable sell signal (#9) with a re-entry (#10) that captured good returns from 2012 through 2014. Most recently, a sell signal arrived on January 8, 2016 (#12) with further erosion since then. We don't yet know how this will conclude, but conservative investors may want to reduce exposure to small cap stocks.



## US Large Caps Stocks (S&P 500) vs. US Bonds

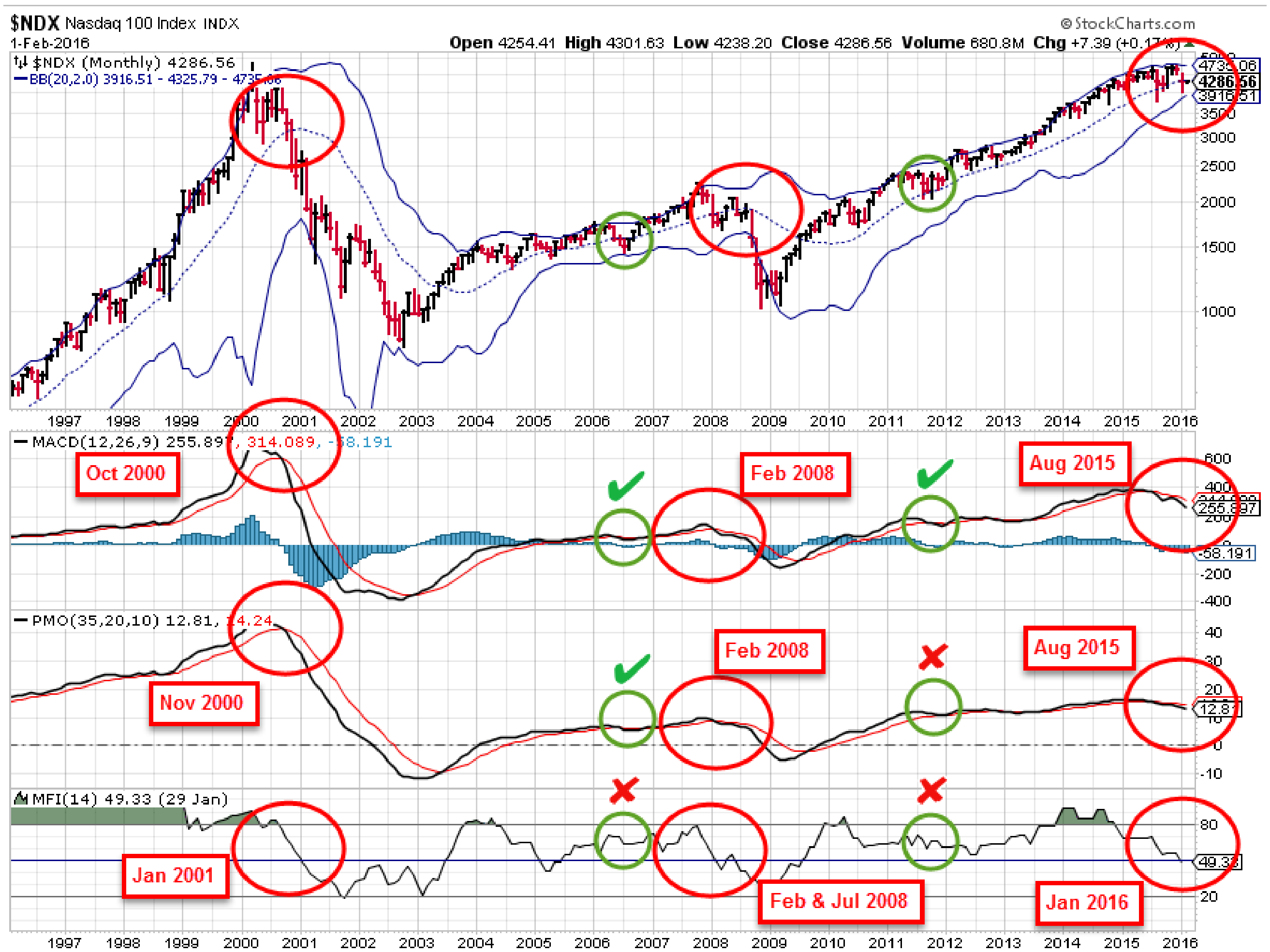
Finally, here is the picture of the S&P 500 large cap stock index, the bellweather benchmark for investors around the globe. Large cap stocks were in strong bull mode in the 90's leading to the top of the internet bubble in March 2000 (#2). Relative strength versus bonds gave a sell signal in November 2000 (#3), sparing investors from a further decline of 40% for the S&P 500 (the NASDAQ 100 lost almost 70% over the same period). The next buy signal arrived in July of 2003 (#4), producing good returns for four years. The 2008 bear signal came in July (#6) and would have avoided a 44% drop. The next buy arrived in June 2009 (#7) and the Large Caps have remained in the pole position since that time, even through the 2011 correction with its nearly 20% correction (#8). However, the index has pulled back more than 10% from the last high in May 2015 and this has set up the possibility of the first sell signal since we approached the cliff of the Global Financial Crisis (#9). Once again, this signal could reverse if equities can rally. If not, investors may want to reduce equity exposure or hedge their portfolios.



## Part two:  Momentum and Money Flow

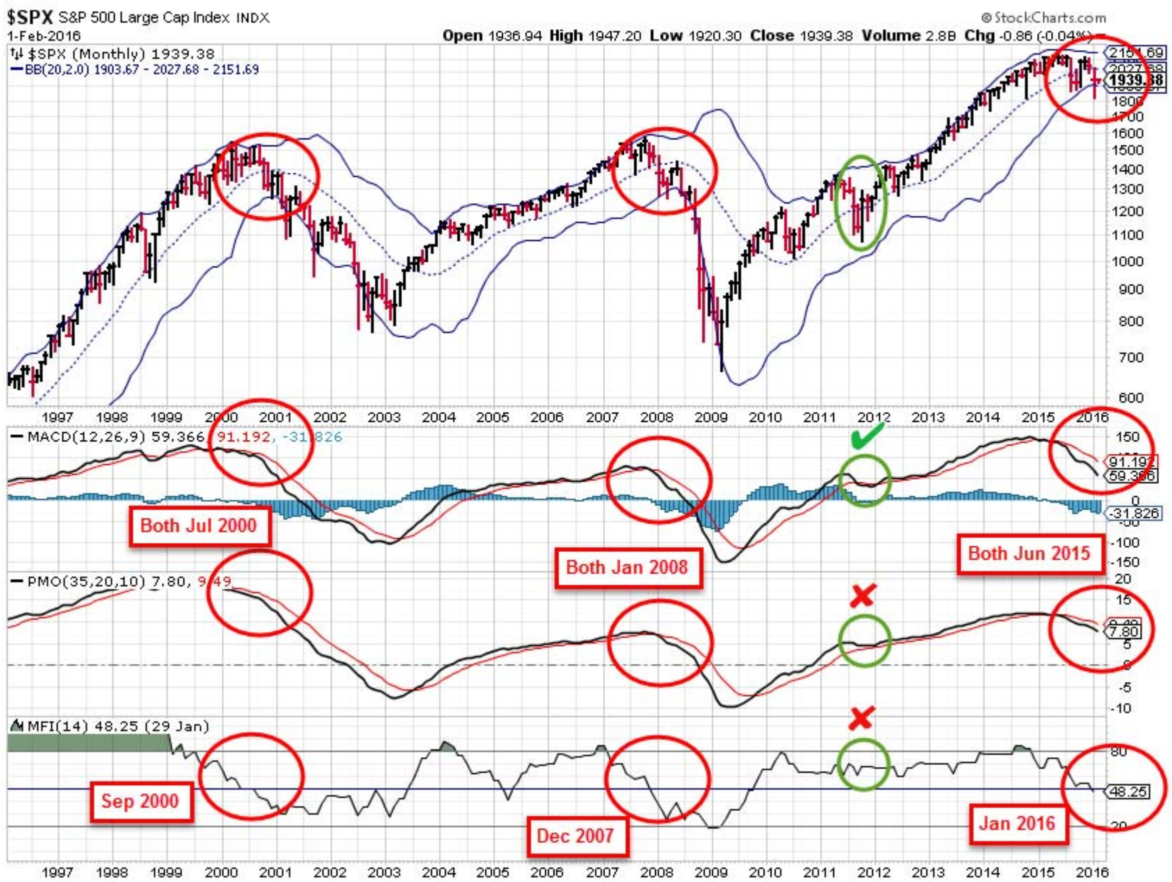
Our second methodology combines two measures of momentum with a gauge of buying and selling pressure.  The first momentum indicator is MACD (moving average convergence/divergence).  It uses two moving averages of price to track whether an index or a stock is gaining or losing momentum.  The price momentum oscillator (PMO) is very similar to MACD but uses a different calculation and the two work together to confirm changes in long-term momentum.  Money flow index (MFI) combines price changes with trading volume to assess whether buyers or sellers are in control.  For our purposes, we use all three to analyze the monthly movements of two large cap US indices (the S&P 500 and the Nasdaq 100) for major turning points that tend to be associated with bear markets.

First we'll take a look at the Nasdaq 100 (NDX), an index created by the Nasdaq Stock Market as a way to show off the largest stocks listed there.  While there is significant overlap with the S&P 500, the NDX has more concentration in growthier names like Apple, Google, Amazon, Facebook and Netflix.  In the late 90's, it was a tech and internet rocket ship as you can see on the chart below.  That started to change toward the end of 2000.  The MACD indicator shows a bearish crossover in October, followed by PMO the next month. Final confirmation came in January 2001 when MFI dropped below the 50 line. Even if you waited until the end of January 2001 to exit, NDX dropped almost 70% before bottoming in late 2002.  Dodging that bullet would have been very useful.



With any set of technical indicators, you want to know how often they give you false positives – signals that turn out to be wrong. That's why we use three signals in this analysis and our first test case with the NDX showed up in 2006. The chart shows price pulling back and, while hard to see, both MACD and PMO had bearish crossovers. However, MFI never got close to breaking down and the longer-term uptrend resumed. Not the case as the market started to turn lower from its peak levels in 2007. For the NDX, bearish crossovers of MACD, PMO and MFI all arrived in February 2008. Exiting here would have felt premature as the NDX then recovered somewhat into May and June with MFI peeking above 50. However, MFI gave another sell signal in July 2008 that proved very timely as the NDX fell more than 40%.

The 20% correction of August and September 2011 was the next test of this system with MACD saying exit while PMO and MFI failed to confirm. Once again, NDX reversed and moved to new highs. Here we are in February 2016 and the signals are all flashing red for the first time since 2008. MACD and PMO went sour in August of last year as the market had a flash crash. MFI has just dropped below 50. Now let's look at the better known S&P 500 index (SPX) to see what's happening with that broader set of large cap stocks.




At first glance, the chart of SPX looks very much like NDX and that makes sense given the significant overlap in their holdings. As with NDX, our three indicators gave timely exit signals in 2000 that would have avoided a 46% drop. Unlike NDX, there was no test in 2006 and this would have been useful information in comparing the two indices at the time. Once again, there was early warning of the GFC and no head fake from MFI that went negative in December 2007 and never regained the 50 line. 2011 showed the same non-confirmation of a bearish MACD signal. As for the present circumstances, the SPX showed MACD and PMO weakness a month before the NDX, turning south in July of last year. MFI dropped below 50 at the end of January to give us three bearish signals.

**Conclusion**

So are we bear yet? Emerging markets and US small cap stocks (both SPX and NDX) have crossed that threshold. Looking at momentum and money flow, US large cap stocks have just confirmed three bearish signals. Using relative strength versus bonds, large cap stocks are on the precipice but have not given the sell signal. We've shown the RS chart of the S&P 500. The RS chart of NDX is not included but shows the same picture – sitting on the edge of a sell signal that would provide additional confirmation of the bearish MACD/PMO/MFI. So the markets certainly seem to be walking and talking like the bears we saw in 2000 and 2008.

What could reverse these trends and get the market back on track? Most observers are looking for a better US economic recovery and support, if needed, from the Federal Reserve (reversing the rate hike and providing additional QE). One or both of these could happen and might stop the bear in his tracks. However, we must keep in mind that the Fed has taken this kind of decisive action in both of the previous bear markets and stocks collapsed anyway. The Fed Funds Rate (FFR) was 6.5% in November of 2000 when they began cutting and took it down to 1.25% at the end of 2002. As we've seen, the equity market dropped 50% over this time frame. FFR was back above 5% in July 2007 when the Fed began another easing program that eventually led to the infamous ZIRP (zero interest rate policy). Once again, easing did not get in the way of the bear market. Unlike those two episodes, the current Fed doesn't have much to work with as the FFR currently sits at just 0.34%. There's been talk of taking interest rates negative as has been done in Europe and Japan. No less an expert than former Fed Chair Ben Bernanke has pointed to negative rates as a potential weapon.

It seems hard to believe that central banks around the globe pushing interest rates into negative territory can have a happy ending. Maybe it will. And maybe we'll see equity markets drop to levels where even the most conservative of investors will be overwhelmed with the urge to pile in. Only time will tell but if sh#* happens it can't come as a surprise. For now, it may be wise to heed the warning signs and either reduce equity exposure, hedge or acknowledge that your portfolio may head south for a while before it resumes the path to capital appreciation.