THE SCHENK GROUP

JUNE MARKET SUMMARY - ACTIVE RISK MANAGEMENT

Peter Schenk - 778-400-2813: peter.schenk@wprivate.ca
Matthias Raps - 778-400-2812: matthias.raps@wprivate.ca
Marc Vella - 778-400-2815: marc.vella@wprivate.ca

July 10, 2020

"Everybody talks as if they know what's going to happen, and nobody knows what's going to happen."

— Charlie Munger

If you told me last year that I would see some of the things I am seeing in 2020, I would probably not have believed you. Politics, markets, viruses, you name it, it's truly been an experience. And it's only July. You don't need me to, nor have you hired us to, pontificate on all of that. You can get your fill of discussion on these subjects anywhere today and besides, as in financial market analysis, words are often just noise anyway.

Summer has been slow to arrive in Victoria again this year but it's coming. As it sets in on another hopefully sunny Victoria weekend we have settled into our new offices. We have expanded resources, both human and technological and among other things we hope this will help us increase our service levels and also to clarify our message for all clients.

One part of our client base just wants the bottom line and wants to know that we are on the job. Another part of our client base wants to understand more detail about what we are doing. Or in another way of looking at it, some just want to know the watch tells time, and some want to know more about how the watch is made.

So we try to do both but right now I think it is important to stay with the bigger picture. There is so much going on in the world, it can be easy for people to go down this path or that and lose focus on what is important when it comes to our investments.

Below you can see a chart that shows the S&P500 equally weighted in the top pane. This means that every stock gets the same weight in the index as opposed to the regular S&P500 which is currently completely dominated by 5-10 big stocks. Then below that you see the Mid cap index and the Small companies Index. This covers most of the main 1500 stocks in the USA.

You can see that none of these indexes have made any progress since 2018 rolled around and are now putting in lower highs while all still battling or clearly under their 40-week moving average. This is not bull market action.

Suspendisse tincidunt pellentesque mauris, sed luctus purus pharetra et. Maecenas eget viverra sapien. Mauris a lectus ante. Nullam tempor, nibh vitae consequat scelerisque, metus ex gravida ante, sed hendrerit tellus mauris et massa. Maecenas neque libero, lacinia sed viverra ac, ullamcorper in quam. Vivamus venenatis, ante non placerat ullamcorper, massa leo laoreet nisl, sit amet volutpat nulla est congue ligula. Donec at tristique ex. Interdum et malesuada fames ac ante ipsum primis in faucibus. Donec eleifend enim et velit suscipit, nec pulvinar nisl placerat. Quisque neque orci, condimentum pellentesque diam a, dignissim dictum mi. Mauris mollis elit ut nulla convallis mollis.

What is important today?

The most significant question for the second half of 2020 is whether stock markets are resuming the secular bull market that started in 2009, or if a secular bear has started. A secular bear can be a time of big ups and downs that take some time but eventually go nowhere, much like what happened to stocks from 2000-2013. Since early 2018, that stock market has failed to turn rallies into sustainable uptrends unlike the rally that started in 2016. At this stage, the next steps are pretty simple.

First, we do what you pay us to do: determine the risk level in the market to see if we want to be fully invested or not. Again, much like a doctor we'll run tests on a heart patient to see if his arteries are blocked or clear, if his cholesterol is high, or under control and if his blood pressure is acceptable or not. If all of these things read poorly, then the patient is at high risk of another heart attack (like the market had with declines of 20%-50% in 2008, 2011, 2015, 2016, 2018, 2019, 2020).

It may sound silly, but wouldn't you want to know if those risk factors were high for you or a loved one? It's the same in the markets. We can literally see if arteries are blocked, if blood pressure is high etc. which all speak to the health of the patient and the odds of further problems.

Our Primary Trend Indicator (PTI)

Our PTI is a bit like an Angiogram, which gets right in the arteries and can see blockages that need attention. Right now, only 4 out of 9 components of the PTI rate acceptable levels. **When combined with our other tools that measure market risk, this keeps us on the defensive in our Asset Allocations.**

Schenk Group Primary Trend Risk Model — **Indicator Signals**

ETF	Index	10-day EMA of AD Percent	High-Low Percent	Percent above 200-day EMA	Net Bullish or Net Bearish	Net Bearish since 11-June-20
SPY	S&P Large-cap 500	29-Apr-20	27-Feb-20	3-Jun-20	3-Jun-20	5 of 9 Signals Currently Bearish
MDY	S&P Mid-cap 400	9-Apr-20	26-Feb-20	11-Jun-20	11-Jun-20	
IJR	S&P Small-cap 600	9-Apr-20	25-Feb-20	25-Feb-20	25-Feb-20	

Green = Bullish. Red = Bearish. Net Bullish: at least 2 of 3 Indicators Bullish. Net Bearish: at least 2 of 3 indicators bearish.
Blue Oval: New Signals (if any)

Let's look at one component of the PTI as an example.

Percent stocks above their own 200-Day moving average price.

The concept here is simple. If a stock is above their own average price over the last 200 days, it is in an uptrend. If it is below that average price, it is not in an uptrend. For the broad market index to get itself above the 200-day moving average price we need to see a critical mass of stocks in that index doing the same. Makes sense right? The generals will not win the war if the soldiers are all leaving the field.

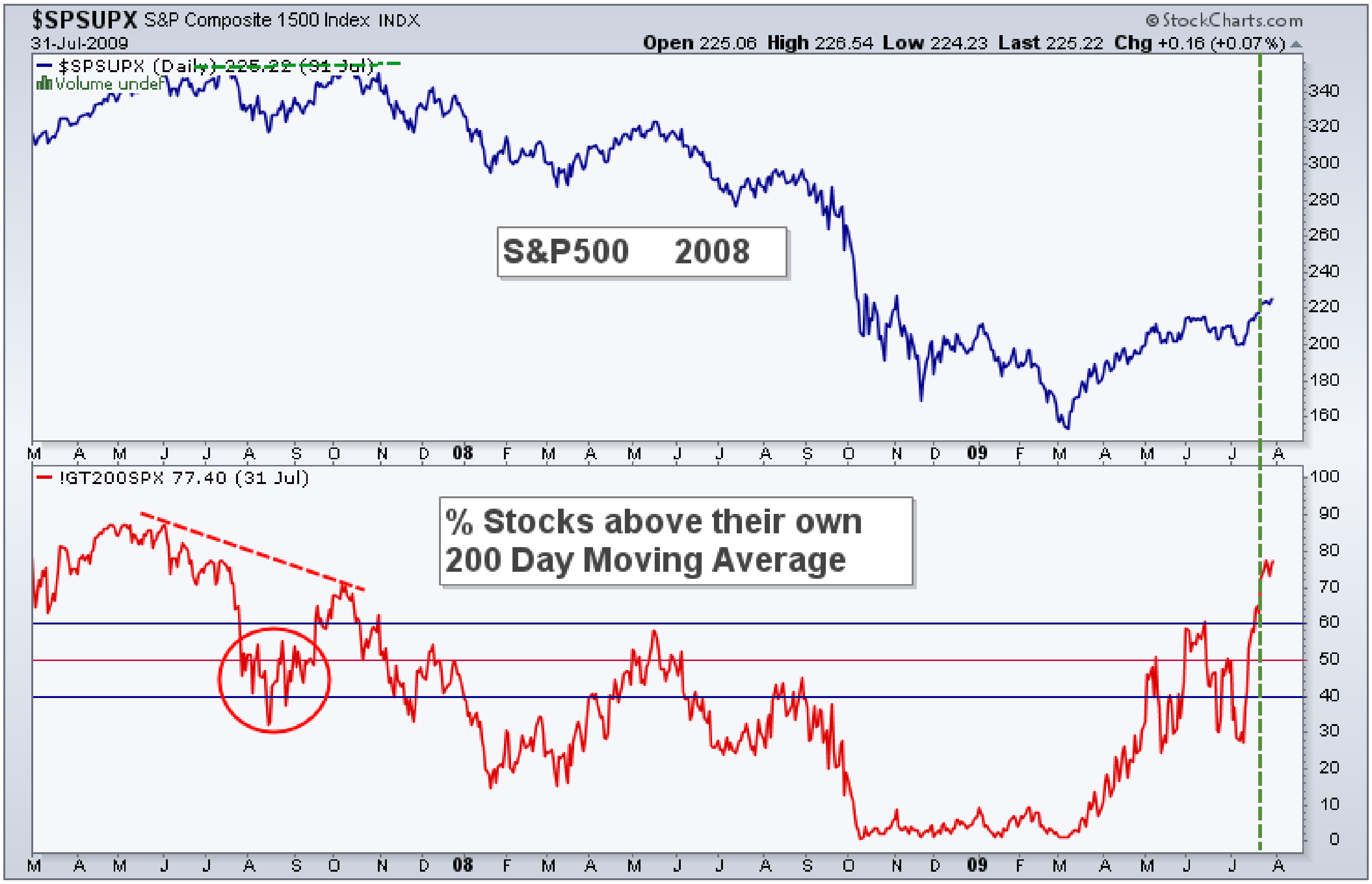
History shows us that for market uptrends to continue, we always need to see the soldiers fighting alongside the generals, reflected by 60% or more of the stocks in the market above their 200-day moving average.

Below you can see the market in the top pane (the S&P500) and the percent of stocks above their 200-day moving average in the bottom pane (the red line). You can see that, as of yesterday, that percentage was at 42.80%. Anemic and not enough to keep the market afloat for very long.

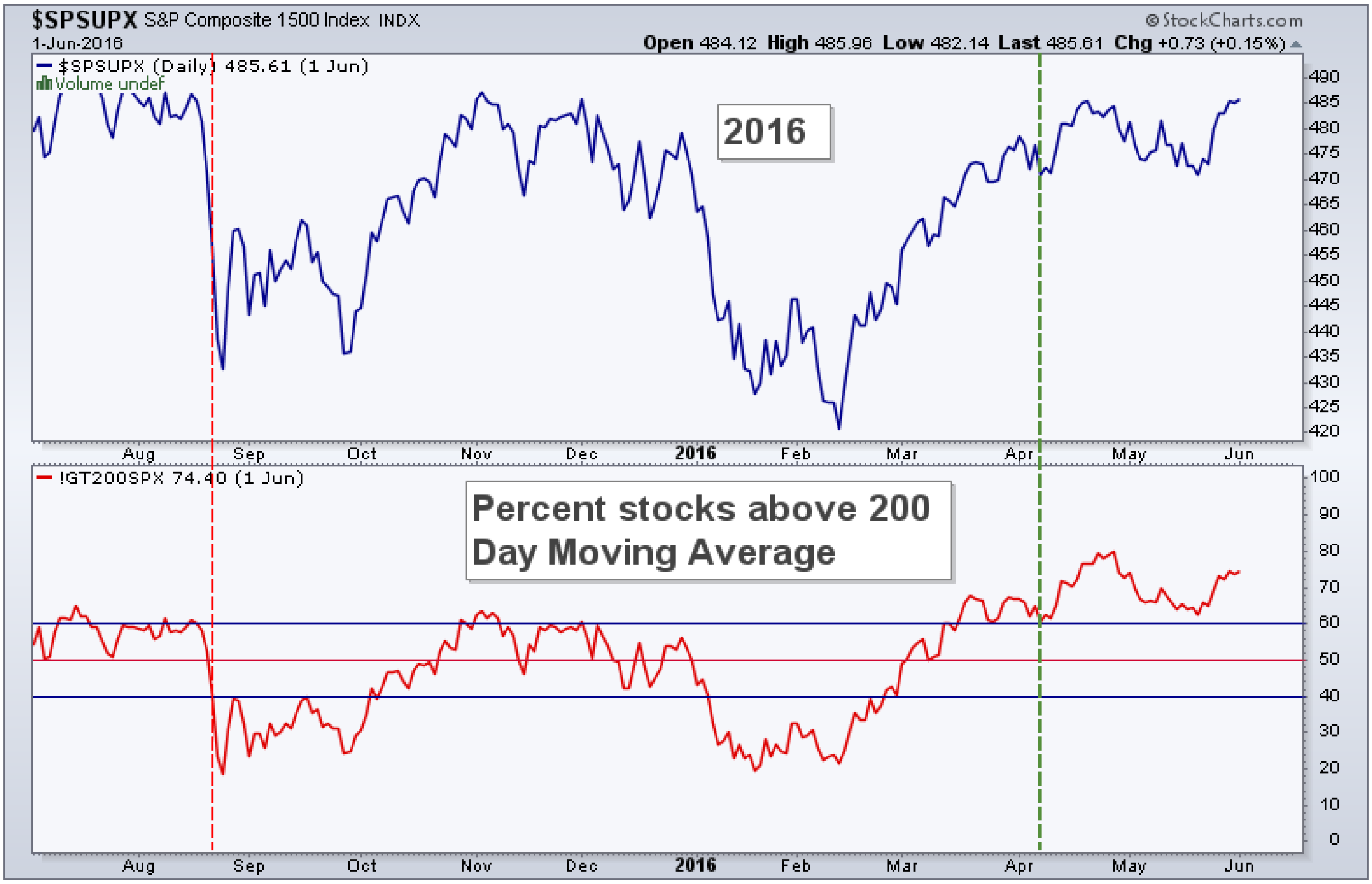
Suspendisse tincidunt pellentesque mauris, sed luctus purus pharetra et. Maecenas eget viverra sapien. Mauris a lectus ante. Nullam tempor, nibh vitae consequat scelerisque, metus ex gravida ante, sed hendrerit tellus mauris et massa. Maecenas neque libero, lacinia sed viverra ac, ullamcorper in quam. Vivamus venenatis, ante non placerat ullamcorper, massa leo laoreet nisl, sit amet volutpat nulla est congue ligula. Donec at tristique ex. Interdum et malesuada fames ac ante ipsum primis in faucibus. Donec eleifend enim et velit suscipit, nec pulvinar nisl placerat. Quisque neque orci, condimentum pellentesque diam a, dignissim dictum mi. Mauris mollis elit ut nulla convallis mollis.

Historical examples:

Below you can see the same comparison at the 2007 market top and the 2009 bottom and rally. The % >200MA started to break down as the market was still hitting highs, then it dropped below 40% with the market near its highs before it all came tumbling down. Then as the market rallied off the bottom, the % > 200 moved above 60% by July of 2009 and the rest was history.



Below you can see the same comparison during the major corrections in 2015 and 2016. After a clear breakdown in 2015, it peeked above 60% only to come right back down before, and as the market fell again into February 2016. Again you can see that the Percent of stocks above their own 200 day moving average clearly broke over 60% by April of 2016 and off we went.



Of course, this is an over-simplification of how the watch works, and only one example of many which demonstrate that Mr. Market is currently a high risk patient. Today's weak reading at 42.8% in medium term up trends is a clear indication that there is not enough critical mass to keep this market up, at least not yet. Either the percent of stocks in uptrends picks up, or odds of a market correction increase dramatically and THAT is why we are playing defense right now by holding cash levels higher and keeping stops on our holdings tighter than if our PTI gave the all clear.

Outlook for the second half

In looking ahead to the year's second half, the market performance should indicate whether the bull market that started in 2009 resumes or the odds of a bear market are rising. Stocks can be a barometer of economic expectations so improvements in Mr. Market's underlying conditions could indicate that the massive monetary and fiscal liquidity infusions (central bank medication infusions) had re-stoked the fires that underpinned the bull market. For now the patient is not responding to the massive amounts of medication being pumped into it by the Federal reserve. The longer Mr. Market does not respond with more stocks entering uptrends and more stocks hitting new highs (currently well below the crucial 10% level) it's a sign that the global economy is failing to reflate despite the infusions.

Tim Haye's of Ned Davis Research puts it this way.

"The market's economic message is evident in its breadth -- the percentages of markets, sectors and individual stocks taking part in the trend. In a downtrend, the greater the downside confirmation, the more ominous the message. In an uptrend, the broader the better – the bigger the contingent of stocks benefiting from expectations that economic growth will increase and that earnings growth will follow. While short-term and intermediate-term breadth indicators have improved since March, reflecting relief that the worst of the economic impact is behind us, confirmation has been lacking from longer-term breadth indicators based on 200-day moving averages, a sign of deficient confidence in the sustainability of an economic recovery now threatened by the COVID-19 comeback. "

I suspect that much of the strength in the economy has come from debt stimulus from the government, plus extreme "bail-out" action from a very friendly Federal reserve. It may work short-term, but history argues it is not so good for long-term economic growth.

Conclusion

Charlie's quote at the top of this note is correct. No one knows what will happen, but fortunately that does not mean we can't act. Measuring market participation, like measuring the patient's vitals, is the best way of determining market risk levels. It is the true foot-print of the market and the backbone of our commitment to our asset allocation strategies; increasing exposure to stocks when the data improves, and decreasing our stocks, increasing bonds, and other alternatives when the data deteriorates.

This may not be for everyone. Our approach is right for investors who want clear, logical active risk management using historically proven techniques. If you want to buy and hold, to trust that it'll always come back, then we aren't for you.

We remain completely open to any eventuality that the markets bring. Our strategies, tactics and tools will help us to successfully navigate whatever happens as we focus on monitoring supply and demand signals that the market provides us.

Have a very good weekend and we'll be in touch with you soon.

Peter Schenk, CMT, CIM | Portfolio Manager

P: (778) 400-2810 E: peter.schenk@wprivate.ca

words we operate by:

"Deliver to the world what you would buy if you were on the other end. There is huge pleasure in life to be obtained from getting deserved trust. The way to get it is to deliver what you would want to see if you were on the other end."
~Charlie Munger

"Strive not to be a success, but rather to be of value."
~Albert Einstein