MARKET WATCH
A NEW WORLD

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"A few weeks of stock market weakness leading up to a presidential election is not bullish or bearish, it's normal. This is how uncertainty is played out in real time." - Mike Adamson

Bottom Line: The month of October, which started out so positively, gave way to what are probably election jitters. However, while there has been broad selling pressure, it has not been enough to tip our Primary Trend Indicator negative.

Big Picture

The only issue people are watching today is Tuesday's US election. In the end, while it is likely to impact which sectors of the market benefit or not, I believe the broader markets are now driven primarily by Central Banks and governments.

Now Jerome Powell (US Fed Governor) has jumped from Fed purview to government purvey by advising the government on Fiscal (spending) programs. That's not his job. Christine Lagarde (President of the EU Central Bank) is moving in the direction of creating a digital currency. Despite the fact that most of us don't use cash very much, and our transactions are digital, an actual government digital currency is a very different thing that will give them total control over the economy.

In fact, while the fiction is that Central Banks are a separate entity from government, the reality has never been so. Now it seems that Central Bankers are giving up on the pretext that they were ever anything other than a means to control money flows from the top down.

Make no mistake, in a world with government debt levels that will never be paid back, the only course of action is for more efforts at creating inflation that will make their debt loads smaller as a percent of the economy, even if they continue to massively expand those debt loads in the effort.

These issues will have massive implications on our ability to save and invest in retirement. Already, falsely-low interest rates has ushered in the biggest wealth transfer from savers (you) to debtors (governments) in the history of modern finance. Inflation will be the next one.

This means it is critical that we follow the money, invest in strength and sell weakness wherever that may lead. It also means that, as savers, we need to think outside of the box and consider all investment alternatives wherever *THAT* may lead. More on that in our year-end letter.

In The Markets

Summary

- Markets remain volatile here, which we've been discussing for the last few weeks. With the U.S. Elections this Tuesday, that is expected to continue. Although the Election is Tuesday, we may get a final resolution the same day or it could be a drawn-out process.

- COVID cases have been picking up, with Europe implementing new restrictions as of now, which is also another driver of volatility. Our focus here continues to be downside management first, with a higher cash level at 17%.

- There is no way to predict what happens this week so we'll have to watch closely. Markets and many charts are technically stretched to the downside, but shorter-term news flow can always override the charts.

- We continue to see technical signs of a cyclical rotation and are focused on having adequate exposure to cyclicals as well.

- Markets are currently correcting on higher volume. Some investors look for active pullback ideas at the market and some will wait for some type of stability first.

- The weight of evidence in our Primary Trend Indicator and our Buying Power Model remain positive.

- Based on the weight of the evidence, and with Monetary and Fiscal Policy outweighing everything else, I would not be surprised to see stocks go much higher in coming years.

- Our plan for this week is to continue to manage any potential downside, observe and look for signs of any possible technical reversal at some point.

Generally, I think there is nothing unusual about the current market. The move since the March low is going through a normal correction in order to build a wall of worry, keep the crowd honest, and set the stage for the next leg up in this bull market. At least that's the way we see it for now.

On a positive note, despite the selling we saw in October we have yet to see a market sell signal. There has been no surge or thrust in participation to the downside that would trigger such a signal. All indicators in our risk models continue to weigh bullish and at the same time the stock market, at least the S&P500, is at a very important support level. A break of 3200 would set a lower low and start a downtrend since peaking in late August.

This is where technical analysis gets interesting. Obviously everyone on earth is watching that 3200 level and amateurs will have a lot of stop losses at that level. Therefore a brief undercut of 3200 may be the most positive thing.

It would be the nature of the undercut, or the bounce off of support at 3200 that will tell us what to expect. For example, if we start getting thrust signals off of support to the upside, it could suggest a buying opportunity. If it drops below the red line for just a day or so, at the June highs we've pointed out for some time, and then closes right back up above it on big volume; another good sign. But if it undercuts the red line on big volume, by more than 3% and continues lower while our Primary Trend Indicator, which measures the underlying health of the market turns negative, we'd be forced to reduce our exposures further.

We discussed our base case for the S&P500 in our Thoughts on Q4 and Beyond (October 5), in which we drew the chart below with the grey line as our expected outcome. In the following week or so, I thought perhaps it would not play out, and we would avoid the retest of the September lows. Obviously, our first expectation was more accurate. Now my base case is either a bounce off of 3200, or a brief undercut before heading to new highs.

We'll adapt either way.

On a more negative note, coming into this week, only 6% of world markets are above their 50-day averages, the lowest level since April (the September low was 12%). This is suggestive of health deterioration, not improvement.

Ever since the March bottom it's been the biggest stocks driving the market and keeping it afloat. That lack of breadth was cause for concern for risk managers like us as the generals need support from the soldiers on the field. Ironically, now that the soldiers are coming back as market participation has begun to widen, some of the biggest leaders are weakening after several of them reported decent earnings. And they're weighing on the rest of the market. Our positions in ***Amazon.com (AMZN)*** falling to the lowest level in a month and ***Microsoft (MSFT)*** also moving closer to its September low. Other large cap technology stocks have shown the same weakness.

An important point here is that what matters is less the actual news (earnings reports) and more how a stock reacts to those numbers. So far, Amazon, Microsoft and Shopify have reported very strong numbers and the stocks have lagged in response. Not the best sign.

Because these are the stocks in the S&P 500 with the highest market capitalization, and they will have a significant effect on the movement of that market index. The fact that they are all going through a topping process, could prove to be an important turning point - or just a "pause to refresh." It is certainly good reason to stay alert and see how the process resolves on each one.

Buying Power

Our Buying Power Model, which measures money flow into and out of the markets, had a number of signals coming from the stock market and the commodity market in 2016. Looking back they were telling us what the reaction to the election was going to be. Interesting enough, we are picking up similar signals this time that are even stronger.

What's fun about this analysis is it is totally candidate agnostic.

As a simple example, do you remember what the pundits said about Trumps' election in 2016 and how it would bring about deregulation and tax reform? Look at our charts today of how that worked out for the "Trump Trade" and Banks. If you made an investment decision to Buy the Banks because of what politicians were going to do (even if they did it), well that investment underperformed since Trump was elected.

As many legends and experience has taught me, don't ever let politics get in the way of your investment decisions.

We believe in following the math through Breadth (Participation) and Buying Power (Money Flow) as that historically has led to better money-making opportunities than politics.

Primary Trend Indicator (PTI)
Various measures of market "breadth" make up our Primary Trend Indicator. Each one of them is a good insight into supply and demand in the market but weighted and rolled together in our PTI it does a good job of telling when the balance of evidence for that suggests we move out of an asset class or remain in. For now, our PTI remains on a Buy Signal.

I write about "Breadth" a lot and I do so because it's the best footprint of market liquidity there is. **It measures participation in the number of stocks rising or falling**, and because of the way the big indexes like the S&P500 are constructed, the headline number doesn't tell you enough. It can be propped up by the big names in the market, the generals, but if all the soldiers are leaving the field, the generals eventually will be overrun.

Going back to the doctor/patient analogy, during your annual physical the doctor needs to run tests and look below the surface to see if things are running smoothly. They can't tell just by looking at your face. It's the same thing with markets.

Checking the number of stocks Advancing and Declining (Advance-Decline Percent or **ADP**) can be one such test, a little like the cholesterol reading of the markets. Is the lifeblood flowing freely, or is there an increased chance of calcification in the arteries?

The ADP measures the participation behind a move in the underlying index. Sometimes participation is so strong, over a short period of time, that it tips the scales and signals the start of an extended move. This critical indicator triggered a bearish thrust on February 25th and the S&P 500 extended lower. Subsequently, a bullish breadth thrust triggered on April 29th and the advance extended into early September. Downside participation was quite strong the last two weeks, but not enough to tip the scales and trigger a bearish breadth thrust. Let's investigate.

ADP measures the percentage of net advances in an index (advances less declines divided by total issues). The chart below shows an example using the S&P 500. AD% is -80% when there are 50 advances and 450 declines ((50 – 450) / 500). This means 90% (450) of stocks in the S&P 500 declined. As we can see with the red shading on the chart below, AD% dipped to -80% or lower three times in the last ten days. There were 214 advances and 285 declines on Friday so AD% finished at -14.2% on Friday.

But the numbers on the ADP can move back and forth so much on a daily basis that it doesn't tell us much. At least nothing that is actionable.

The way we want to look at the ADP is its average action over a ten-day period. On a ten-day average, a move above +30% triggers a bullish breadth thrust, while a move below -30% triggers a bearish breadth thrust. As the chart below shows, there was a bearish thrust on February 25th and a bullish signal on April 29th.

Even with the -14.2% reading on Friday, a bearish breadth thrust did not trigger because the 10-day EMA did not break below -30% this week. This means the S&P 500 avoided a bearish breadth thrust, is above its 200-day, is short-term stretched to the downside, and is trading near support from the September lows.

Conclusion

At this stage I still expect that the S&P 500 doesn't break below the Sept. low (down ~2% from here). If it does, it will be a quick flush and then higher. This a retest.

The data shows that the bull market is intact, credit markets are fine and given the likelihood of vaccine/medical progress within months, what happens in the economy in the next two months doesn't mean much.

Still, these are only expectations and we are committed to following the data and making sure your portfolios benefit from change, rather than fall victim to it.

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.

I hope you had a very good weekend. If you have any questions about this update, or anything else please do not hesitate to reach out.

Peter Schenk, CMT, CIM | Portfolio Manager

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