Identifying rally requirements

Although there are plenty of fundamental excuses for the retest of the October low last week, we continue to believe it is all part of the bottoming process playbook we have been highlighting since late October. We have referred to this as the “slop, pop, and drop,” where the market: (1) makes an initial low highlighted by an extreme oversold condition with a peak in volatility; (2) then experiences a sharp oversold bounce that recoups a significant part of the decline; and (3) ends with a retest of the low that brings demoralization, apathy, and no buyers. This cycle is not just longer than prior cycles without a recession – it is a lot more volatile, which means human nature becomes more important throughout the bottoming process. We highlight our three main requirements to determine if a decline is an intermediate-term correction in an ongoing bull market, or something worse.

First requirement – core thesis remains in place. It is easy to identify non-recession intermediate-term bottoms after the fact, but it is extraordinarily challenging in real time because investors believe the pronounced selling is discounting a nearby recession. Ultimately, our positive fundamental core thesis is focused on the direction of EPS, which is driven by economic activity. As a result, only an inversion of the U.S. Treasury 2-10 Year Yield Curve (YC) caused by a credit crisis will cause us to turn sustainably defensive. We have dealt with global growth issues over the past 10 years that have generated intermediate-term lows due to heightened fear of a domestic recession, so how have we looked through them?

- **Inversion of the yield curve (YC).** As we have highlighted over recent years, the best indicator for an ultimate recession over the past seven cycles is an inversion of the YC. Although the YC has flattened, it has yet to invert, and once it does the median lead time to recession is 19 months (Figure 1).

- **Fed Sr. Loan Officer Survey.** Each quarter, the Fed asks the banks whether they are “tightening” or “easing” their lending standards. In the most recent survey, they found that despite one of the longest economic expansions in history, banks actually eased their lending standards to both small and large businesses.

- **Small Business Confidence.** The NFIB Small Business Optimism Index (NFIB), which is likely the broadest measure of sentiment among small business owners, recently made a new cycle and record high in August. We found the cycle peak in the NFIB leads recession by a median 41 months.

- **Manufacturing Optimism.** The ISM Manufacturing Survey (ISM) has measured sentiment at the manufacturing level since 1950, and August hit a cycle high. We found a cycle peak in the ISM leads recession by 31.5 months.

- **National Financial Condition Indices.** The Chicago Fed has 3 indices that compiled 105 credit stress indicators within traditional banking, “shadow banking,” and the financial markets. Although stress can happen fast, similar to the 2015-16 market decline there are no significant signs of stress (Figure 2).
Second requirement – our key indicators hit an extreme oversold level. In our November Strategy Picture Book, we identified three key indicators that suggested in late October the close proximity of an intermediate-term low. Our primary indicator continues to be our trusty 14-week stochastic indicator, which reached an extreme oversold level on 10/26 (Figure 3). When you couple this with a historic rise in the 10-week Rate-Of-Change (ROC) for the CBOE Volatility Index (VIX), and an extreme intraday swing in the TICK Index from +1400 to -1400 (Figure 4), it suggests human nature takes over and creates the non-recession bottoming process playbook.
Third requirement – identifying indicators that confirm retest is over. This time isn’t different – but this cycle is, relative to the last market and economic cycle. To give you an idea, since the 2009 equity market lows, there have been nine periods where the VIX spiked over 25, and the SPX dropped 10%, but in the last cycle neither happened until near the 2007 peak. We attribute much of these extreme moves vs. the last cycle to a combination of the “Volker Rule,” algorithmic trading, the repeal of the “uptick rule,” and momentum based passive investments. How then do we identify when one of these non-recession corrections in this new environment has run their course, and the next leg higher has begun during the current market cycle? We look for a sharp reversal in the 10-week ROC for both the VIX and SPX:
- **VIX 10-week ROC hit extreme, and waiting for confirmation.** We found that once the VIX ROC hits 80, it kicked off the intermediate-term bottoming process playbook of (1) the initial low; (2) retest after the first oversold bounce; and then (3) confirmation of the next leg higher (ex-2008/2015) by the ROC dropping back to below 10 (Figure 5). The initial move above 80 took place on 10/12, suggesting it would take just three more weeks to match the median confirmation time frame.

- **SPX 10-week ROC hit extreme, and waiting for confirmation.** The corrections this cycle have been vicious. We found when the SPX ROC drops to -9, and then reverses back -5 or above, it suggests the next leg higher has begun (Figure 6). The initial -9 reading took place as of the close last week, suggesting confirmation three weeks out.

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**Figure 5: Waiting for VIX 10-week ROC to drop below 10 to confirm next leg higher**

**Figure 6: Waiting for SPX 10-week ROC to rise to -5 to confirm next leg higher**
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Date and time of first dissemination: November 27, 2018, 04:59 ET
Date and time of production: November 27, 2018, 04:59 ET

Distribution of Ratings:
Global Stock Ratings (as of 11/27/18)

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*Total includes stocks that are Under Review

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