



## A LOOK AHEAD

January 2019

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As the saying goes, no one rings a bell at the top of the market. This well-known saying is certainly true. The reasons put forward for the correction seem somewhat far-fetched from our point of view; after all, rising interest rates and the trade conflict between the USA and China, in particular, have been talking points for months. Rather, it seems to us that after years of rising prices, the market was overpriced and overbought, and the mood among investors was over-optimistic. The sharp correction of the past few months did a lot of damage, especially in technical terms. Over the following pages, we explain why we first expect a significant countertrend rally before the stock markets continue their correction in 2019. Thus we recommend a highly defensive investment policy.

### A Look Back – Key Messages Last July

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#### Equities

The current economic expansion is among the longest in history. But signs are mounting that the current cycle is mature and we see the risk of a recession by autumn 2019 the earliest. Taking into account that equity markets usually start to rollover months before a recession has become official, **a top by the end of 2018 seems possible.**

From an Elliott Wave perspective, we continue to believe that the S&P 500 is trading in the final wave 5. In other words, we expect the market to make new highs in the coming months to complete the 2009 bull market. Typical for a bull market in its final stage is weakening market breadth and increasing selectivity. We are beginning to see both. When small- and mid cap stocks as well as the Nasdaq reached new highs in June, participation was already much smaller than at the previous all-time highs. An increasing number of indices are now trading below key moving averages, a sign of increasing selectivity.

Still, **we do expect large cap indices to test the January all-time highs in the coming few months but very likely with weakening participation and accompanied with momentum divergences.** That would signal us that the time has come to leave.

#### Interest Rates

No doubt, with the 2012/2016 double bottom we have a clear indication, that a major bottom is in and that the 36 year old bull market in bonds is about to end. But history has shown that such turning points last for many years and therefore we do not expect in an immediate breakout to the upside. On the contrary, a weekly divergence in the 10yr yield as well as a record short position of speculators in US 10yr **futures make us believe that we are going to see a pause and more likely an outright decline in US 10yr yields in the months ahead.** Also we do **expect the yield curve to move into negative territory** which would be another indication, that a recession in the US is looming.

#### Currencies

We do **expect the current dollar rally to be nearly over and the dollar to resume its downtrend** in the second half of this year. The Euro on the other hand is likely to retest major resistance at 1.25. In the big picture, we remain long-term bearish on the dollar and view the current rally as only a countertrend move within a long-term downtrend.

#### Commodities

With a false breakout, a bearish break of a trendline and momentum indicators turning bearish, the CRB index looks weak. Also, **we would not chase WTI Oil**, a major component of most commodity indices. **The same applies to Copper, where we have a major divergence in momentum.**

#### Gold

Longer-term we remain constructive for gold as we continue to view gold as a monetary asset rather than a commodity and as an insurance against any accident that could happen. But short-term, gold has broken through US\$1270, the 20month moving average. Gold is also struggling to hold above its next key support zone at US\$1250/1260, the lower end of a bullish multi-year triangle. **We are afraid that on the back of bearish moving averages, the supports mentioned above will not hold. A washout towards next support at US\$ 1200 would be the consequence. This would cause the already bearish sentiment towards gold to spike, which from a contrarian point of view is usually a great time to enter.** Long-term, we remain very bullish for gold.

## Corporate Earnings

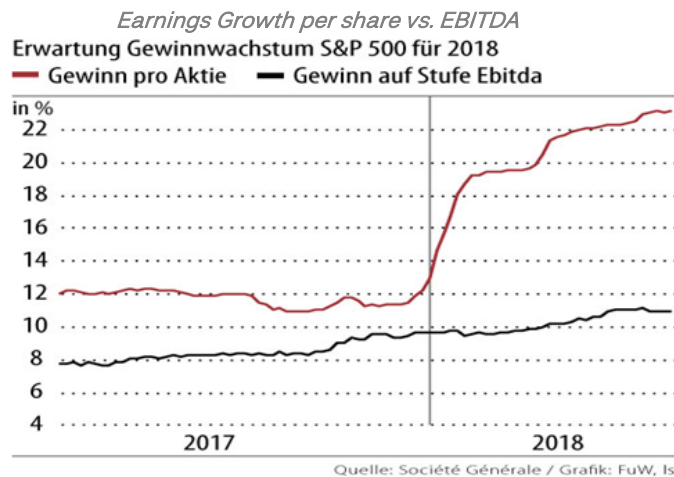
US companies posted impressive profit growth of around 20%, although this was mainly due to the US tax reform and share buybacks. Although the effect of this is wearing off, growth of around 10% is expected for 2019. By comparison, expectations are pitched high in Europe. Profit margins are at peak levels again. Higher borrowing costs due to rising interest rates and increasing wages are, however, likely to put pressure on margins in future. Moreover, it is doubtful whether the economy will continue to grow at its accustomed rate. A slowdown is likely to

have a swift impact on profit expectations.

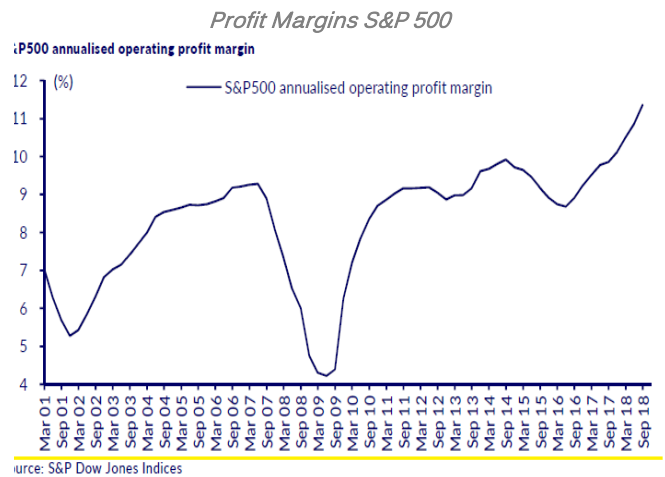
Signs of a slowdown are already apparent :

In November, Caterpillar reported weak October retail sales data which confirmed that the growth slowdown is continuing beyond the 3rd quarter.

In December, FedEx slashed its outlook just three months after raising the view. Rising trade tensions between the U.S. and China made the company to make a U-turn in their view of the global economy.



Source: Finanz und Wirtschaft



## Economic Growth

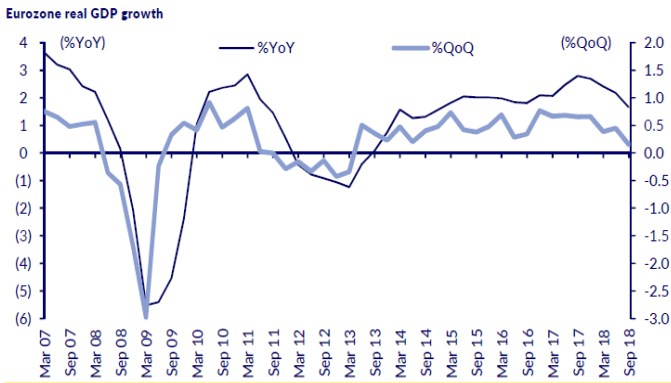
The economic upturn experienced since 2009 is the second-longest in post-war history: only the boom from 1991 to 2001 lasted longer. At the same time, the current upswing is one of the weakest ever, in spite of incredibly high stimulus packages. In the US, rising interest rates are already making their mark, for instance in the housing market. It is also worth bearing in mind that ten of the thirteen phases in which the Fed raised interest rates have ended in a recession. The other three instances culminated in a crisis in emerging markets. Rising interest rates are now also accompanied by the trade conflict between the USA and China, which will ultimately hit the American consumer particularly hard. In early October the International Monetary Fund warned that trade disputes with the US would slow global economic growth. As a result, it revised its forecast for 2018 and 2019 downwards. The tendency of the Purchasing Managers' Index (PMI) in Europe and other parts of the world also signals an economic slowdown, but not yet a recession. In the USA, long-term interest rates are only marginally higher than the short-term rates, while in December US government five-year bond yields fell below the yield level of bonds with a two-year term for the first time since 2007. If long-term rates exceed short-term rates, this is called an inverted yield curve. In the past, this has been a reliable indicator of an imminent recession.

*Global PMI (Purchasing Managers Index)*



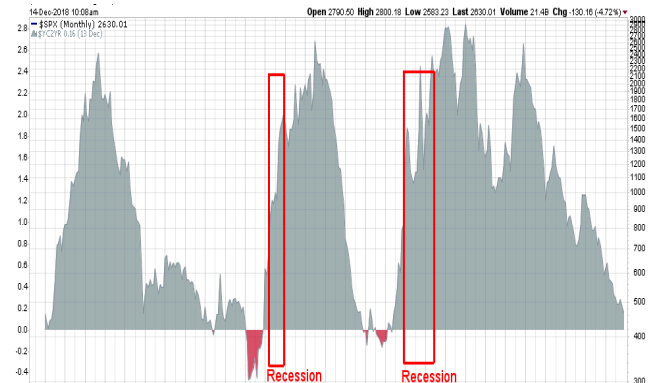
Source: Finanz und Wirtschaft

Eurozone Real GDP Growth



Source: Datastream, Eurostat  
Source: CLSA

US Yield Curve (2-10)

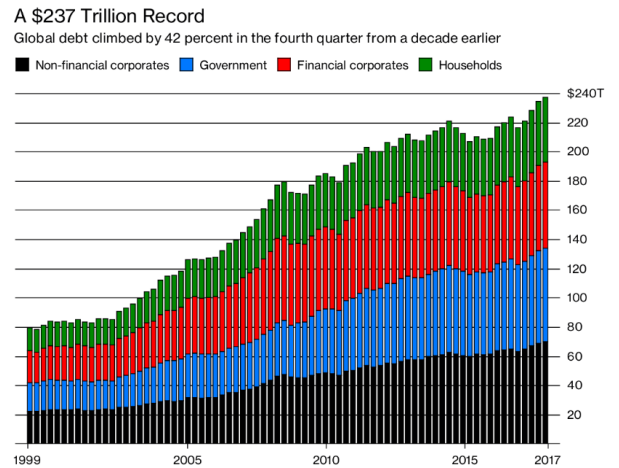


Source: [www.stockcharts.com](http://www.stockcharts.com)

## Debt

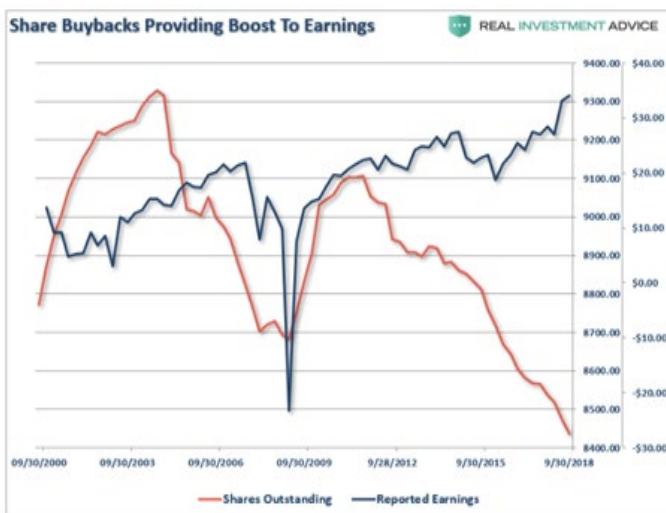
Global debt has increased massively over the last two decades and is significantly higher than it was even in 2008 (up from US\$84 trillion at the turn of the millennium and US\$170 trillion at the time of the 2008 financial crisis to a current US\$250 trillion). Since 2007, average global economic growth has been around 3% per year, while debt has increased by around 5% per year. The debt shouldered by US companies is also worrying, as they have accumulated profit-based commitments of a magnitude never seen before outside a recession. Since 2010, corporate nonfinancial debt has increased to \$9.6 trillion, up 60%. During the same period, earnings have only risen by 27%. In other words, corporates have borrowed huge amounts of money that mostly went to share buybacks and M&A. These share buybacks were a key reason for the 60% rally in the S&P 500. As the Fed is likely to continue to turn the screw with interest rates, financing costs will rise, leaving many highly indebted companies with major problems.

Global Debt Since 1999



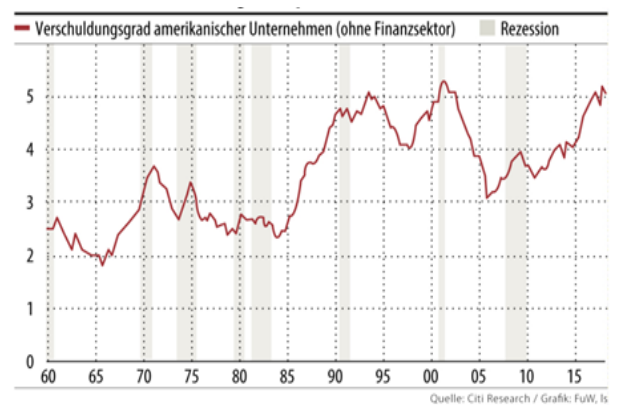
Data: Institute of International Finance; graphic by Bloomberg Businessweek

Share Buybacks Boosted Earnings



Source: [www.realinvestmentadvice.com](http://www.realinvestmentadvice.com)

NetDebt/EBITDA US Non-Financial Corporates

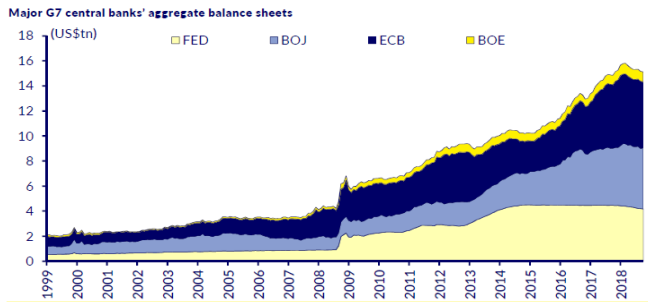


Source: Finanz und Wirtschaft

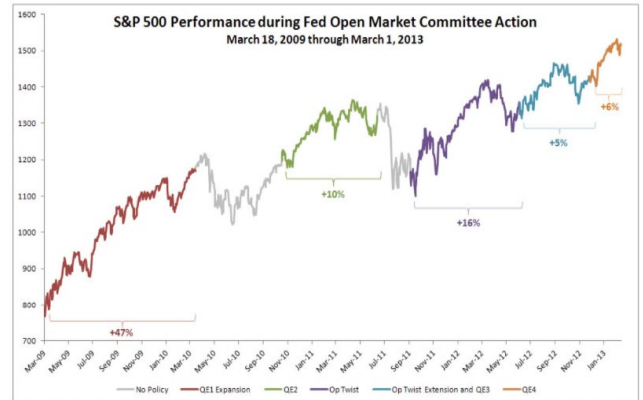
## Central Banks

The US Federal Reserve (Fed) has long abandoned its expansionary policy and is likely to continue raising interest rates. At the same time, the Fed is continuing to reduce its bond purchases. As such, the draw-off of liquidity is resulting in a double effect. Once the ECB also ceases to make bond purchases, liquidity will be withdrawn from financial markets at a global level for the first time in 10 years. In recent years, the financial markets have been boosted by an unprecedented glut of money. We believe that a reversal of this policy is likely to affect markets more than previously thought.

Balance Sheets G7 Central Banks



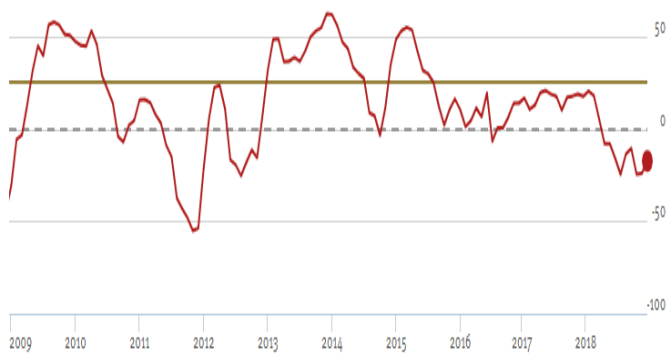
Effects of QE on the S&P 500



## Consumer Sentiment

While the mood of German investors saw a massive dip in October (ZEW economic index) and is at its lowest since August 2012, the upbeat mood of US consumers is causing concern. Back in October, they were as optimistic about the future as they last were in September 2000. It was not until October that the IMF warned that investors in some developed economies are underestimating the risks of a shock to the financial markets and are far too optimistic about the future. Financial market peaks always occur when it is clear that things cannot get any better.

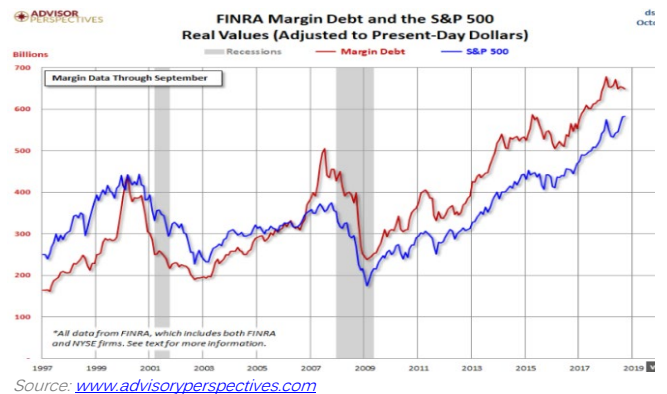
ZEW Indicator of Economic Sentiment Germany



U.S. Consumer Confidence



US Margin Debt



## Risk Premiums

A correction to the stock markets is often preceded by an expansion of risk premiums, known as credit spreads (the interest differential between high-yield bonds and government bonds). Corrections in previous years (2007/2008, 2011, 2015/2016) were all accompanied by rising risk premiums. At the end of October, these credit spreads rose significantly after year-long sideways trend. Investors no longer appear to be satisfied with such low yield premiums for high yield papers. As we see it, the historically low premiums of the past have far from reflected the heightened risks associated with such junk bonds. More on risk premiums later.

## Politics

After focusing on central banks for many years, the focus has shifted back to politics. In addition to the US-instigated trade war, the still-unclear outcome of Brexit, uncertainties surrounding Germany's political future and events in Italy are set to increase volatility in 2019. Italy is due to refinance over US\$290 billion in

## Valuations

We have repeatedly pointed out that the US stock market is valued extremely expensively from a historic point of view. But how have the valuations changed following the recent correction?

The Shiller P/E or CAPE ratio was developed by Nobel Prize winner Dr. Robert Shiller and Dr. John Campbell. It divides the S&P 500 by the 10-year average of inflation-adjusted earnings. It therefore captures earnings over one or two business cycles instead of only one year. Using data going back to 1900, the median value for the CAPE ratio is 16, which compares to today's ratio of 28. While this is already significantly below the August 2018 high of 32, it signals, that the market is still expensive.

Shiller PE or CAPE ratio



Source: [www.multpl.com](http://www.multpl.com)

Credit Spreads

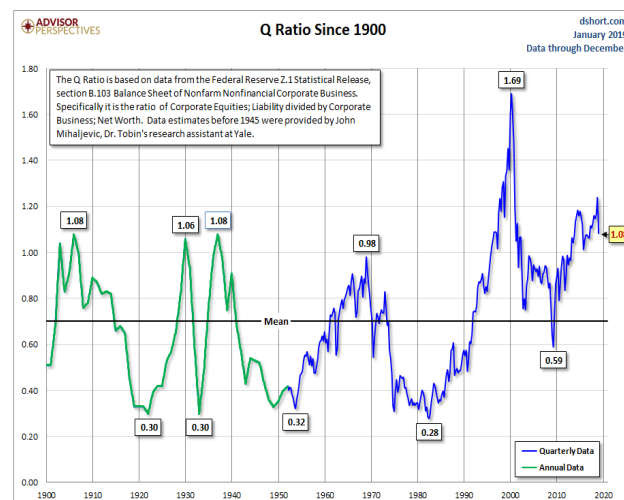


Source: FRED St.Louis Fed

maturing government bonds in 2019. The European Central Bank (ECB), which in recent years has been the only body to open positions in Italian government bonds, will no longer act as a buyer.

The Q ratio compares stock market values with the real-world prices of corporate assets and therefore is a popular method of estimating the fair value of the stock market. A ratio above 1 means that the market is worth more than the replacement costs of all the companies. The current ratio of 1.08 is way above historical average, which is around 0.65. Also this indicator signals, that the market is still expensive.

Q Ratio

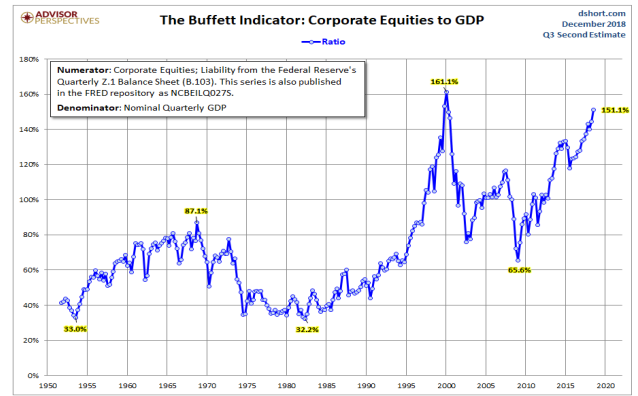


Source: [www.advisorperspectives.com](http://www.advisorperspectives.com)

According to Warren Buffett, the so-called "Buffett Indicator" is "probably the best single measure" of the total market valuation at any given time. The indicator compares total market capitalization to GDP and currently shows that investors have only paid more for stocks at the peak of the tech bubble in 1999 and in 2014.

With the Buffett indicator at 120, the stock market is likely to return 0.3% a year in the next 8 years (including dividends!). This is significantly lower of what investors got used to in the past few years. A different way of calculation future returns using the CAPE ratio results in a yearly return of 0.25% in the next 10 years. Again, including dividends!

The Buffett Indicator



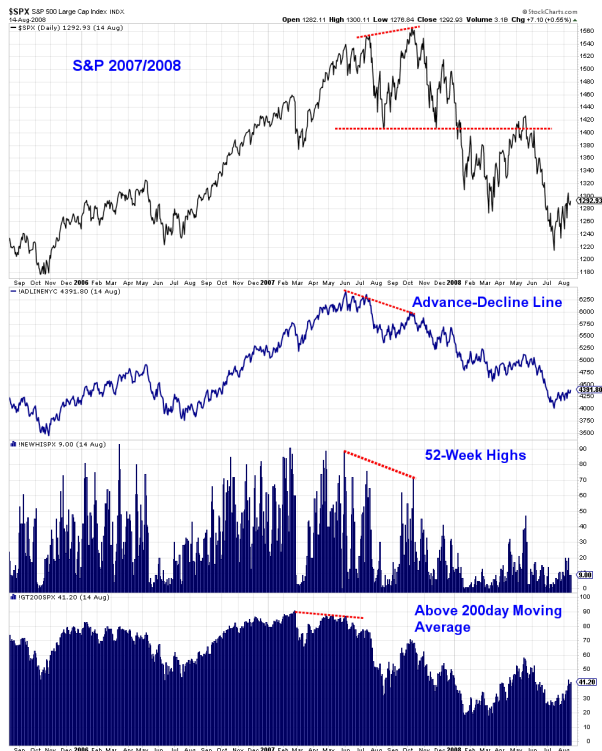
Source: [www.advisorperspectives.com](http://www.advisorperspectives.com)

Market Breadth

While US indices reached new highs in September, many European and Asian stock markets were already in correction mode. But also in the US, large mainstream indices gave a wrong picture of what was really going on. As of end of September, only five stocks (Amazon, Apple, Microsoft, Netflix and Google) were responsible for 75% of the entire year-to-date performance of the Nasdaq (or 40% of the S&P 500). An index that reaches new highs is great news, but if only a few stocks help to lift it higher, it is always a sign of very weak participation and almost always a sign for a very mature bull market.

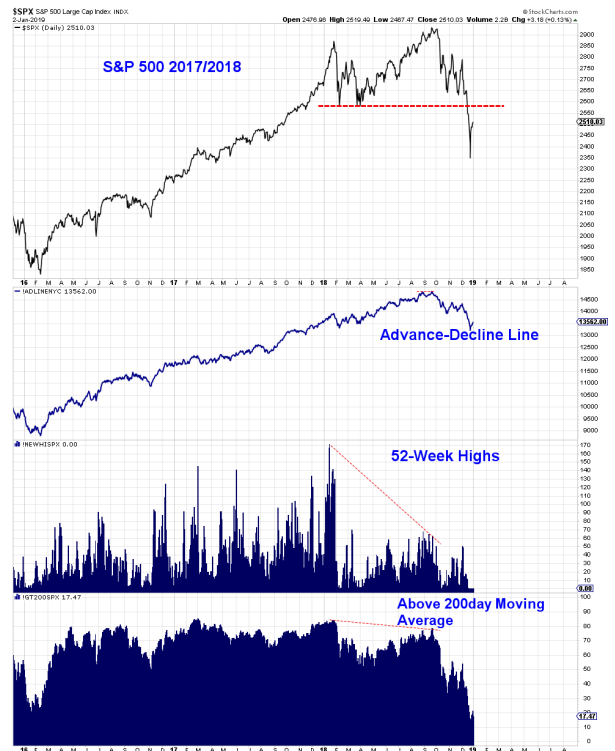
One of the most important market breadth indicators is the Advance-Decline line. It is calculated by taking the difference between the number of advancing and declining issues. Since 1950, this indicator reached a top before the S&P 500 in 12 out of 15 large corrections/bear markets. The three corrections that started without this warning signal were less severe. This year, the Advance-Decline line reached the top in late August, about a month before the S&P 500. While this was a very short lead time, the other indicators (new 52-week highs and percentage of stocks above 200day moving average) added to the bearish picture.

S&P 500 2007/2008



Source: [www.stockcharts.com](http://www.stockcharts.com)

S&P 500 2017/2018



Source: [www.stockcharts.com](http://www.stockcharts.com)

## Market Comment

Another sign of weakening market breadth is increasing selectivity among different indices. It is typical for the very late stage of a bull market that only the large caps, the more defensive stocks perform well, while small- and mid cap stocks have their highs already behind them. In 2007, the S&P 600 (Small Caps) and the S&P 400 (Mid Caps) reached the top in July. The S&P 100 (Large Caps) continued rallying and topped in October. This year was very similar. Small- and Mid caps topped in August, the S&P 100 in September.

S&P 500 and Volatility (VIX)

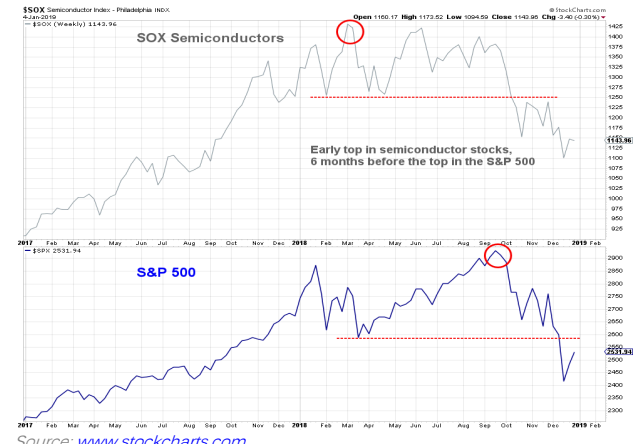


Source: [www.stockcharts.com](http://www.stockcharts.com)

The same is true for economically sensitive semiconductor stocks. Already in March, the Semiconductor Index SOX reached its top.

Another sign of a pending top is increasing volatility. Usually volatility is falling when equities are marking new highs. Despite new highs in the S&P 500 in September, volatility was much higher than in early January. Such a divergence was already present before the financial crisis in 2007 and the 2015/2016 correction.

SOX Semiconductors



Source: [www.stockcharts.com](http://www.stockcharts.com)

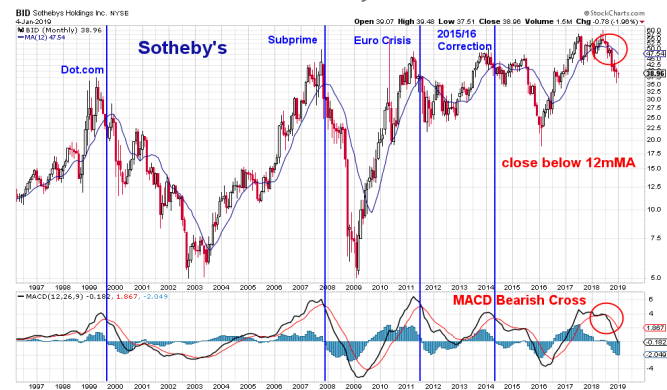
## Technicals

Sotheby's is not only one of the world's largest auction house, it has also proved to be an excellent leading indicator for troubles. Many times in the past already, the stocks has started to correct significantly ahead of the main market, such as in 2000 (dot.com), 2007 (financial crisis) and 2011 (Euro crisis). An explanation could be that Sotheby's does best when sentiment is good and prices for auctions reach extremes. The opposite happens when sentiment turns or when money becomes more expensive (restrictive monetary policy). Signals for the start of a correction in Sotheby's stock price were always a break of the 12month moving average and a sell signal in the MACD. Both got triggered

in August 2018. If history is a guide, the correction in Sotheby's and as a consequence in the overall stock market has only started.

Furthermore, the Nasdaq and especially the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) were the key drivers of the rally of the past few years. The Nasdaq outperformed the S&P 500 strongly until it broke its steep uptrend in October. In the meantime it has also broken the 200day moving average. This signals that the outperformance of tech stocks is history and that a strong support for the market will be missing.

Sotheby's



Source: [www.stockcharts.com](http://www.stockcharts.com)

Nasdaq vs. S&P 500

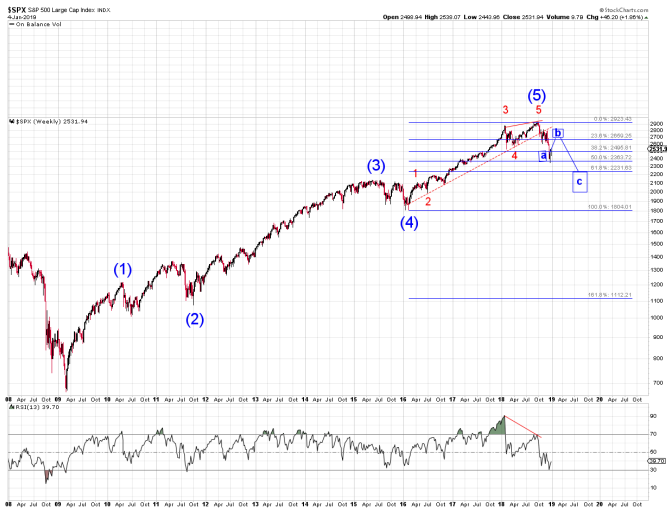


Source: [www.stockcharts.com](http://www.stockcharts.com)

Further evidence that the bull market has come to an end is provided by the Elliott Wave Theory. This theory describes the natural rhythm of crowd psychology in the market. In the most basic form, an uptrend contains 5 waves (1-5) and corrections contain 3 waves (a-c).

We believe that the S&P 500 has completed a 5 wave advance of the 2009 lows in September 2018 and that we are in the middle of a wave 4 correction. Very likely, we have just finished the first correction leg within this wave 4. In the coming weeks we expect a countertrend rally, followed by new lows into later 2019.

Elliott Wave Theory



Source: [www.stockcharts.com](http://www.stockcharts.com)

As already mentioned, weakening breadth preceded the two big bear markets of 2000 and 2008. But the real sell triggers can be summarized as follows:

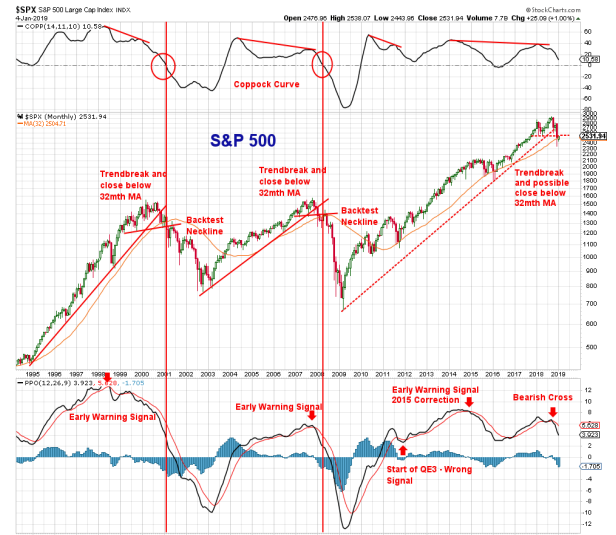
- Bearish cross in the MACD
- Index breaks the steep uptrend
- Index moves below the previous lows
- Break of the 32month moving average
- Coppock curve breaks 0-line
- Non-confirmation in the RSI and a break of the previous low

Currently, many criterias are already met, such as 1) a bearish cross in the MACD and 2) a move in the RSI below the previous lows, 3) the break of the uptrend and 4) a move in the index below the February lows.

The 5- criteria so far was prevented. The S&P 500 closed 2018 at 2506, only marginally higher than the 32month moving average at 2491.

Also the Coppock curve has not yet turned into negative territory.

S&P 500 Monthly Coppock and MACD



Source: [www.stockcharts.com](http://www.stockcharts.com)

S&P 500 Monthly and RSI



Source: [www.stockcharts.com](http://www.stockcharts.com)

If we are right with our analysis, further weakness has to be expected in 2019. But not before a sizeable countertrend rally takes place. Remember, corrections often unfold in three waves. Very likely, the first wave has completed in December. The rally (wave b) we expect could easily exceed 2800 in the S&P 500 and to last into spring. It could well be that there will be an agreement in the trade war. Everyone knows that Trump likes to make deals. The current conflict hurts both and in the end, it is US consumers that suffer the most. Therefore, we expect an agreement rather sooner than later. But whatever the trigger for a rally will be, we believe that it will only be temporary. It is typical for a b-wave to deceive investors, giving them a false sense of security. We would use strength to reduce or hedge positions and expect the S&P 500 to bottom around 2100, and worst case 1800, the lows of the 4+ wave from early 2016.

Also, the deterioration in credit is accelerating. The break of key supports in equity markets was accompanied by a sharp increase in credit spreads.



Source: FRED St.Louis Fed

Yields of high yielding bonds increased sharply, causing the iShares High Yield Corporate Bond ETF to break below the neckline of a massive bearish head-and-shoulder pattern. The minimum price target has now been reached. While we do expect more weakness in 2019 (yields to rise), the segment looks increasingly oversold and ready for a reversal. This would be inline with our view of a bounce in equities. Best case, we expect a backtest of the neckline before another sharp decline will start.



Source: [www.prorealtime.com](http://www.prorealtime.com)

So far the investment grade segment (BBB and higher) did much better than high yields. The iShares Investment Grade Corporate Bond ETF (LQD) still holds above key support at 110. We would watch this ETF very closely, as a break below that support would very likely cause enormous stress for equity markets. We expect this to happen later in 2019.

iShares Investment Grade Corporate Bond ETF



Source: [www.prorealtime.com](http://www.prorealtime.com)

In October, the German Dax completed a bearish head- and shoulder pattern. The price target of this pattern (10'100/10'200) was nearly perfectly reached on December 27 (10'280). Also in the Dax we expect a significant bounce in the coming weeks that could backtest the earlier support at 11'850 (neckline head-and-shoulder pattern). As this will likely only be a b-wave, more weakness in 2019 is expected. The next targets on the way down will be 9'750 (38.2% retracement and 8'560 (50% retracement).



Source: [www.stockcharts.com](http://www.stockcharts.com)

The Nasdaq 100 is at risk of breaking the uptrend that is in place since 2010. The steep uptrend following the election of President Trump was already broken in October. Additionally a bearish head-and-shoulder pattern has formed over the past 12 months. Earlier we have already mentioned the break of the outperformance trend relative to the S&P 500. Should the Nasdaq break below the 2010 uptrend, more weakness in tech stocks has to be expected with a minimum target of 5000/5100.

Nasdaq 100 Weekly



Source: [www.stockcharts.com](http://www.stockcharts.com)

SMI Weekly



Source: [www.stockcharts.com](http://www.stockcharts.com)

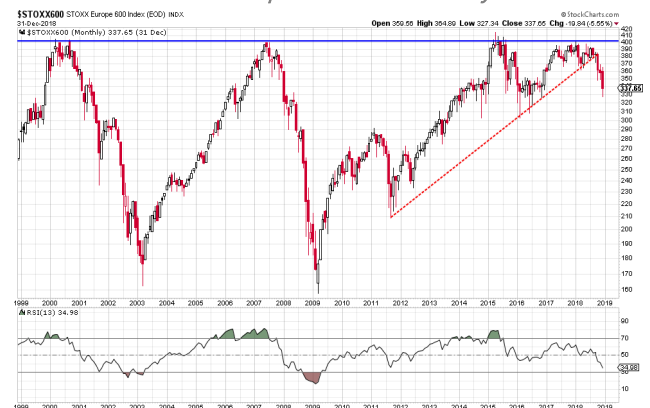
Europe fails at major resistance

EuroSTOXX 50 Monthly



Source: [www.stockcharts.com](http://www.stockcharts.com)

STOXX Europe 600 Index Monthly



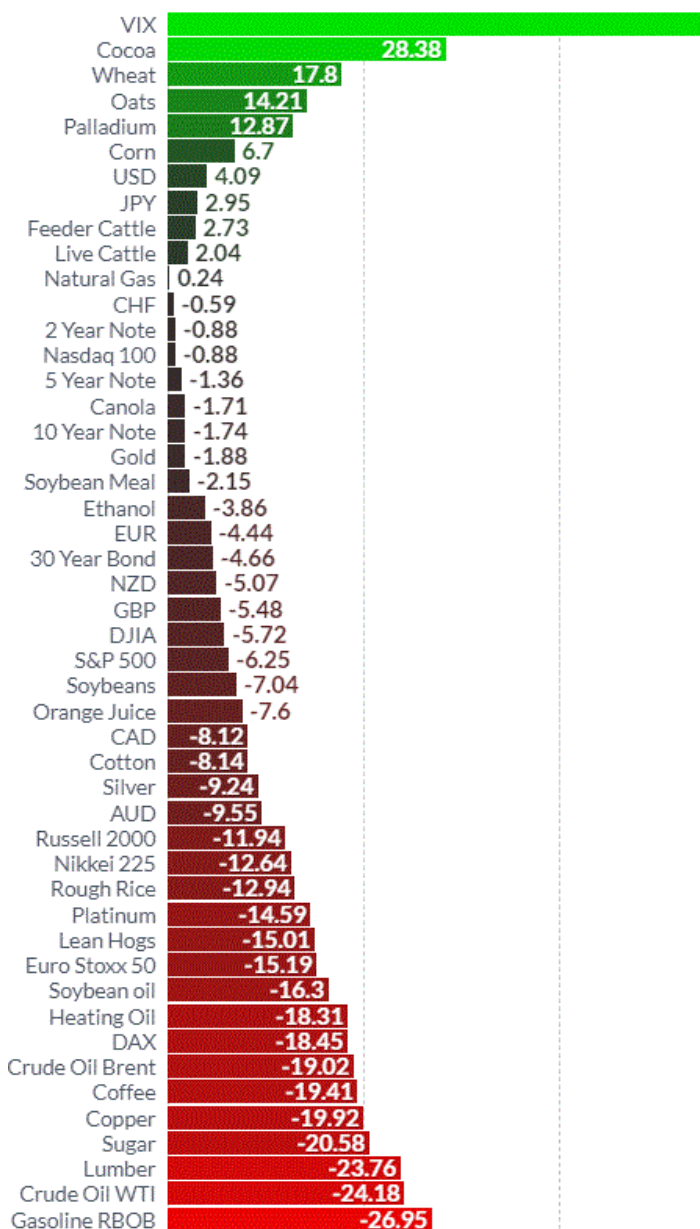
Source: [www.stockcharts.com](http://www.stockcharts.com)

## Conclusion

For years, the financial markets have benefited from ultra-low interest rates and a major correction has been averted by a succession of new stimulus packages. Recently, the tax reform in the USA has helped to revive at least the American stock market. While the rest of the world has already gone into correction mode, US markets have reached new highs in September despite alarmingly low market breadth. Over the coming months, the Fed is likely to continue raising interest rates and central banks will withdraw liquidity from the global market again for the first time in 10 years. We will soon see how the market reacts to this 'withdrawal'. In any case, rising interest rates are already making themselves felt. Many companies that have borrowed at outrageously low interest rates over previous years in order to repurchase their own shares or pay dividends may face serious difficulties under the growing interest burden. The economic

downturn that we predicted will also be particularly hard for companies with a weak balance sheet. From our perspective, the October-December correction was just the first stage in a larger and longer-lasting clean-up. We expect a strong countertrend rally that could last into spring, without reaching the levels seen in September. This kind of rally is typical in correction periods and often lulls investors into a false sense of security. Special attention should be paid to credit markets and especially investment grade bonds, where a break of key support in the iShares Investment Grade Corporate Bond ETF (LQD) could trigger the second wave of selling (c-wave), which we expect to be sharp and to fall well below the 2018 lows.

Appendix – Asset Performance 2018



Source: [www.finviz.com](http://www.finviz.com)

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