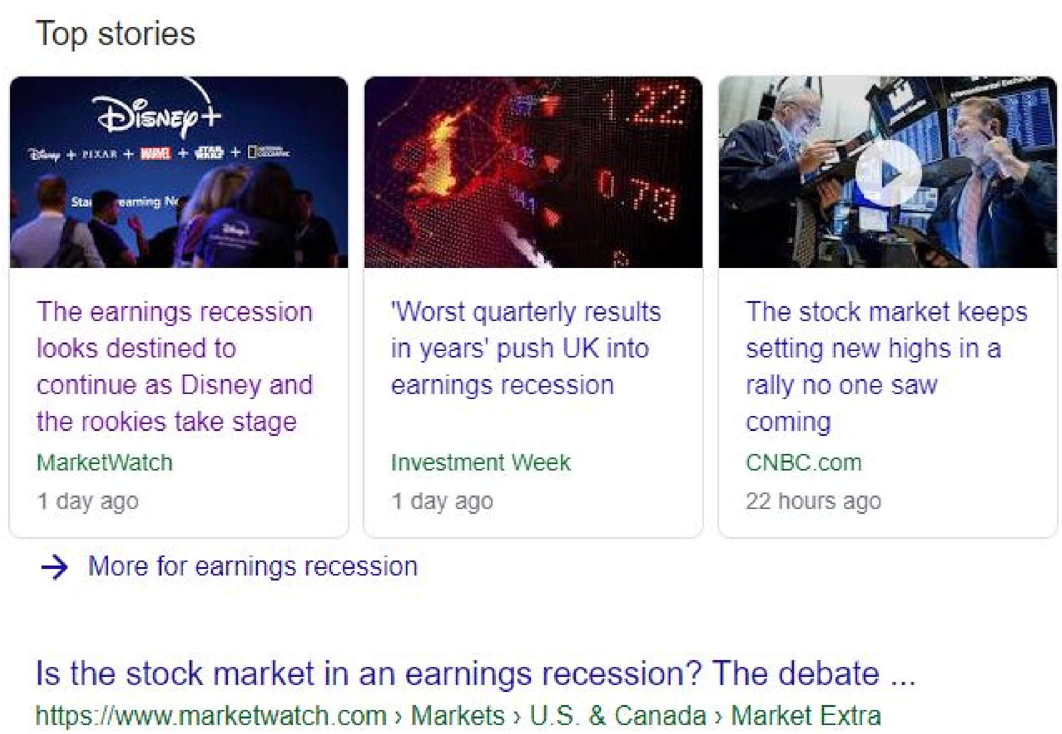
Buy The Dips…

Summary:

- "Earnings Recession" and the Popular Narrative
- The Real Fundamentals of the Stock Market
- FOMC Update
- Bonds and Gold Setting Up for a Short
- Disney and Scorpio Tankers Reporting This Week
- Breakout Stocks with Solid Technicals

I've been seeing the "earnings recession" narrative bandied about by the obstinate bears over the last few days. The narrative goes something like this, "we're in an earnings recession and stock prices have become so disconnected from the fundamentals that we're setting up for an inevitable 87' style crash" or something along those lines.



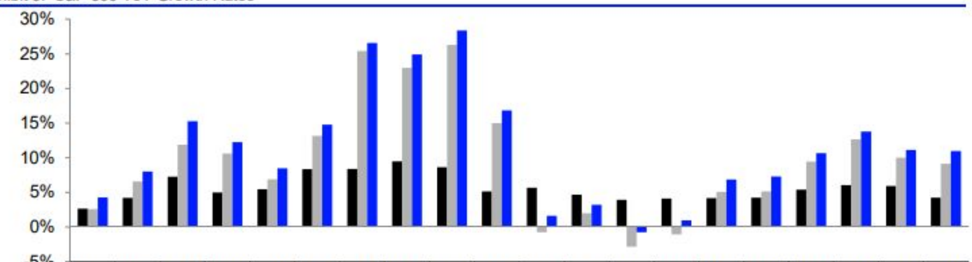
It's true that we're probably going to end Q3 with negative YoY% growth which would make for two consecutive quarters of contracting earnings. So, sure, we're in an earnings recession. It wouldn't be the first one we've seen this cycle (15'-16' being notable examples).

Exhibit 4. 2019Q3 Actual Earnings Growth

	S&P 500
Today	-0.5%

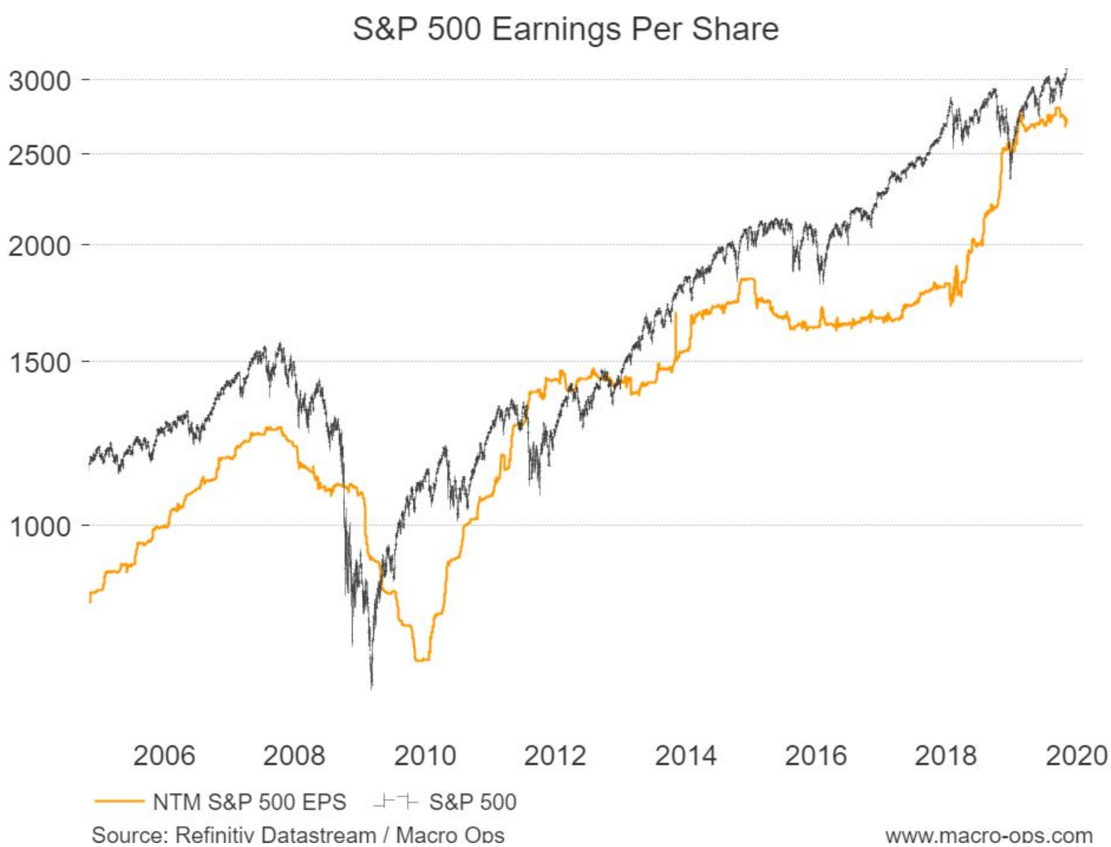
Source: I/B/E/S data from Refinitiv

Exhibit 5. S&P 500 YoY Growth Rates



	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2
Revenue	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	8.6%	5.1%	5.7%	4.7%	3.9%	4.1%	4.2%	4.2%	5.4%	6.0%	5.9%	4.3%
Net Income	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	26.3%	15.0%	-0.8%	2.0%	-2.8%	-1.1%	5.1%	5.1%	9.4%	12.6%	10.0%	9.1%
Earnings	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	28.4%	16.9%	1.6%	3.2%	-0.8%	1.0%	6.8%	7.3%	10.7%	13.8%	11.1%	11.0%

Source: I/B/E/S data from Refinitiv



This narrative is unimportant for two reasons though (1) this dip in earnings was already a known-known, it was priced in by the market and earnings have positively surprised those bearish expectations and (2) it gets the real "fundamentals" that drive the long-term market trend wrong.

It's been a while since I've talked about the real fundamentals of the market trend so let me give a quick refresh. I last wrote about this in my June 18' MIR report titled "A Persistent Bid". If you haven't read this one, then I suggest going back and reading the intro in full. It's a critically important concept to understand and is also one that few know much if anything about.

The idea is that the real fundamental drivers of stock market trends comes down to supply and demand. I know, shocking. But here's the thing… most people have no clue what drives supply and demand of stocks nor do they pay any attention to it at all.

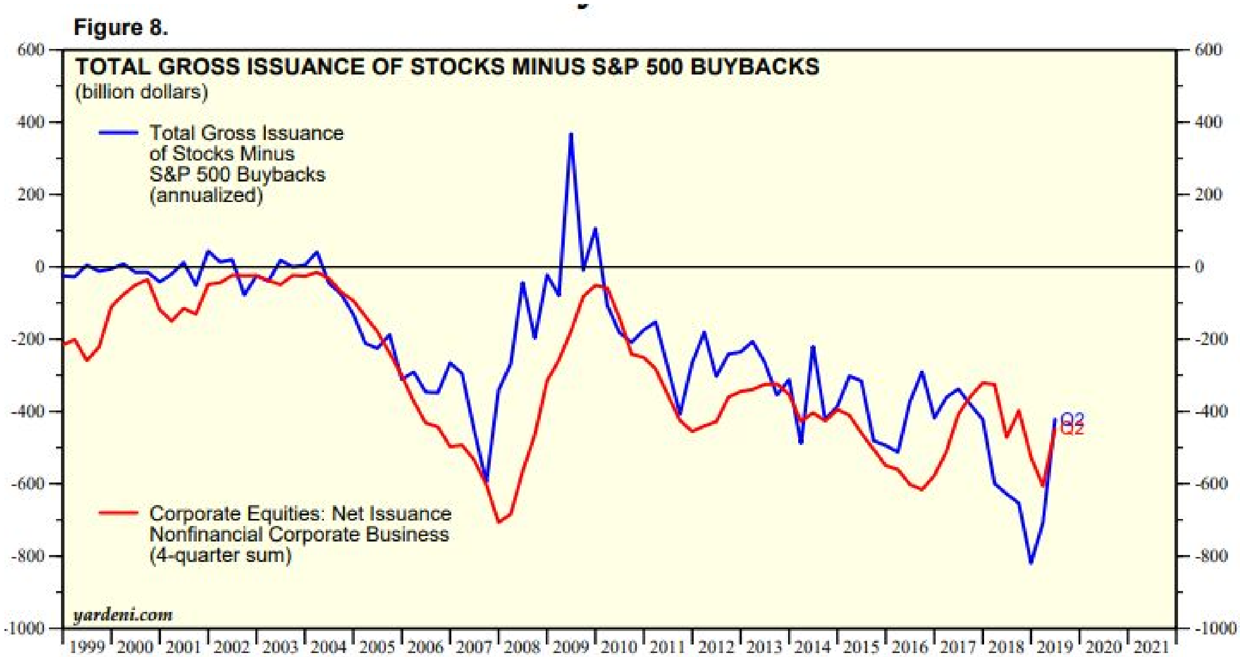
Here's a short summary of the supply/demand model for the equity market.

- On the demand side we have:
    a. The amount of savings available to invest is largely driven by the credit cycle
    b. The allocation mix of investor portfolios is largely driven by performance chasing
- On the supply side we have:
    a. Supply is made up of the total market value of the asset and this market value is equal to the amount of shares + the price at which they trade
    b. Stocks have a flexible supply in that greater demand leads to higher market value and more supply
    c. Bonds have a theoretical limit in that they can't trade much below 0% interest rates

Now we can measure these inputs directly. The supply side is the total market cap of the equity market + total net issuance of shares.

Historically, US corporate share issuance has rarely exceeded 2% and over the last three and a half decades **corporates have been actively reducing their share count through buybacks and M&A at an average annual rate of 2%**.

US corporates have especially been active on the buyback front this cycle. Corporate net issuance hit multi-decade lows earlier this year. This has been a huge driver of the trend higher in the broader market.



Source: Federal Reserve Board and Standard & Poor's Corporation.

Over the last 50 years, **the US's money stock has been rising at an average annual rate of 8% a year.** It's slowed down over the last decade here in the US but has materially picked up in emerging markets.

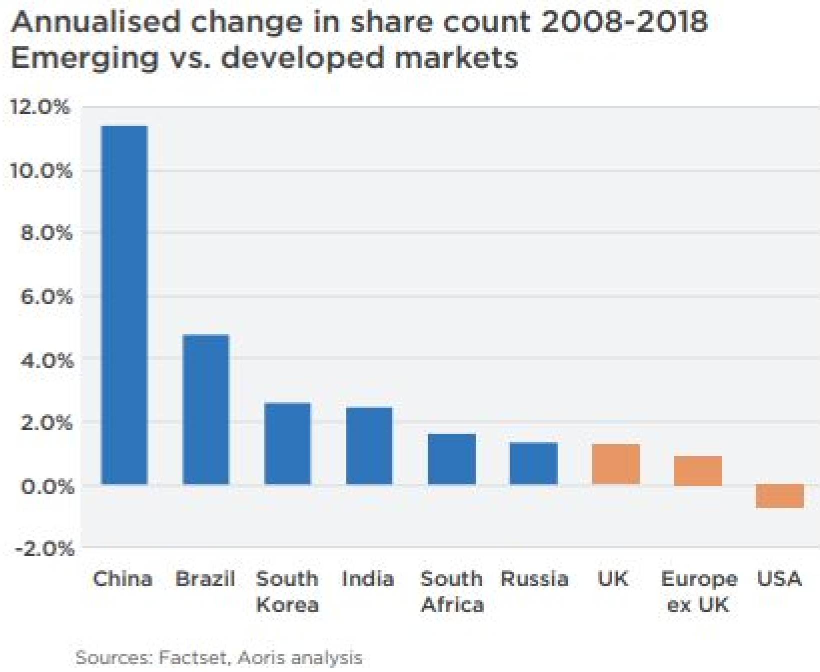
Rick Rieder, the CIO at Blackrock, pointed out a few months ago that **"Due to the demographic revolution in pension, insurance, and central bank assets, there is roughly 3x as much capital that needs to be invested today as was the case in the early-2000s".**

That's a lot more money that needs to be invested. Meaning, that's a LOT more *demand* for equities. With the supply of US equities shrinking (due to more buybacks and M&A relative to new issuance) the value of those equities has to rise in order to create an equilibrium — balance out supply and demand. This is why we can and do have earnings-less bull markets.

Earnings are important, especially on an individual issue level. But on the macro level, it's this supply and demand framework that drives the major trend direction.

Also, ever wonder why emerging market indices like $EEM have gone sideways for a decade?

You can find your answer right here. EM's have poor corporate governance. They are serial abusers of shareholders. Especially China.



Now EM markets will still fluctuate up and down due to repositioning by investors as perceptions of "risk" change. But it's this supply and demand model that drives their longer-term trend.

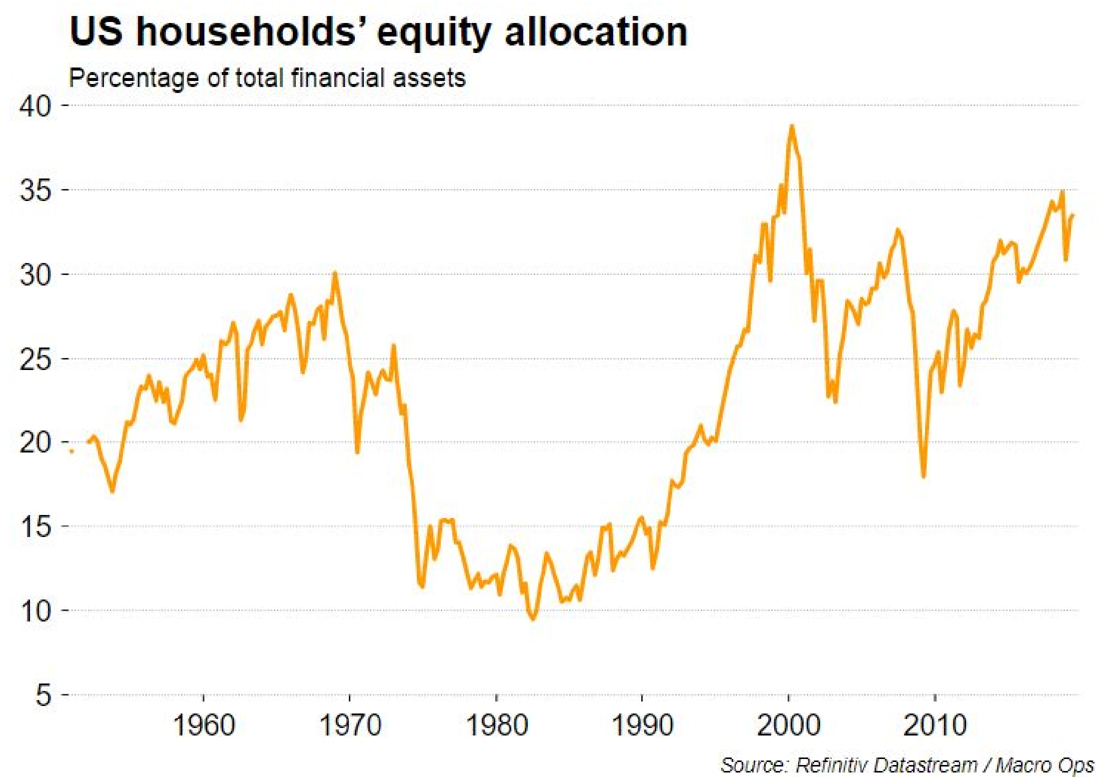
What then do we need to watch to see when the trend in the current supply and demand equation will flip?

Well, buybacks for one. US corporates are likely to keep buying back their shares as long as liquidity is loose (they can borrow easily) and shareholders reward them for leveraging their balance sheet to buy back stock. The Invesco Buyback ETF (PKW) just hit all-time highs and credit is loose so all is well on that front for now.

The second input is issuance. The recent poor performance in the popular IPO market (LYFT, UBER, PINS, WORK etc…) is keeping a number of companies from going public; the scrapped WeWork IPO serving as a recent example. This is a good thing because more IPOs mean more supply of shares. This can and will probably change though and the upcoming Saudi Aramco IPO could very well end up being one of the "silent bells" that gets rung at the top.

Then we have demand.

US Household allocation to equities is near secular highs but can go higher, as we saw in 2000; especially considering where rates are globally.



Growth in lending and the overall money stock is almost entirely a reflection of the perceptions of risk (ie, do banks want to take on more or less risk; do companies want to borrow to invest more or less going forward; do consumers feel confident enough to take out loans etc...).

Seeing as how we're coming out of a global ex.US recession, we should see some improvement on this front. Though, barring any major stimulus out of China or a true fiscal push in Europe (both things which we shouldn't expect in the near term) then this trend should remain fairly muted. US and China M1 YoY% numbers are worth keeping an eye on.

FOMC Update

The FOMC went as expected. They cut rates and then massaged the signaling to keep their options open. Basically, the bar is high for another rate cut as well as a return to hiking rates. One of the more important comments was when Powell said: "I think we would need to see a really significant move up in inflation that's persistent before we even raising rates to address inflation concerns."

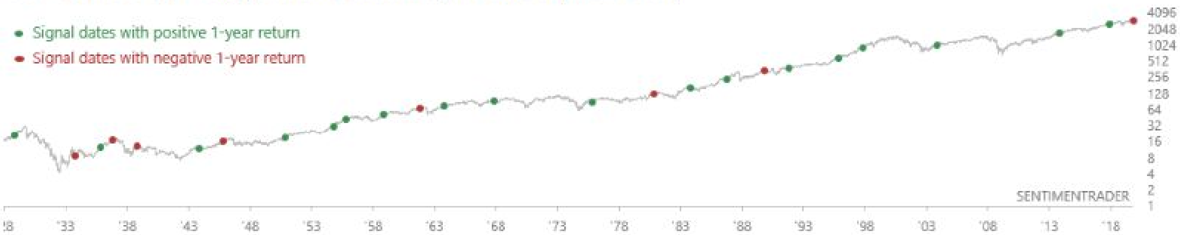
There are some early signs of mounting inflationary pressures in the economy but it's too early to call a trend. I plan to write more on this soon.

Market and Technicals

I'm expecting a decent rally into year-end but there's a number of things we need to keep an eye on.

First, the positive is that momentum and seasonality are strongly on the bull side. Sentiment Trader notes that "with just 2 months left this year, the S&P 500 is up more than 20% year-to-date. From a seasonality perspective, this is bullish for stocks. When the S&P rallied more than 15% from January-October, it typically rallied from November-December as well."

S&P after it's up >15% year-to-date through October (1928-2019)



Signals	1 Week	2 Weeks	1 Month	2 Months	3 Months	6 Months	1 Year
1928-10-31	3.3	6.2	10.0	14.7	19.2	21.4	5.5
1933-10-31	9.4	6.9	10.6	11.3	27.9	15.2	-1.0
1935-10-31	3.7	6.6	6.0	7.6	15.7	12.5	38.3
1936-10-30	2.7	2.4	-1.1	-0.9	5.2	-3.0	-33.5
1938-10-31	2.0	-1.5	-5.2	0.5	-6.0	-14.9	-1.7
1943-10-29	-5.5	-6.0	-5.8	-2.0	-0.5	0.4	7.1
1945-10-31	2.6	3.4	4.6	4.0	12.3	10.9	-11.9
1950-10-31	0.2	1.5	0.7	5.9	11.5	16.6	17.4
1954-10-29	4.2	5.7	7.3	13.6	15.6	20.1	33.7
1955-10-31	4.3	9.1	7.1	6.7	4.0	13.8	9.5
1958-10-31	2.4	3.7	2.3	8.3	7.3	12.2	11.8
1961-10-31	3.3	4.4	3.7	3.7	0.9	-3.0	-17.6
1963-10-31	-0.9	-2.2	-0.3	2.2	3.9	9.3	15.1
1967-10-31	-2.9	-2.3	0.6	1.9	-1.4	4.7	14.9
1975-10-31	0.3	2.2	0.3	2.1	13.3	13.3	15.6
1980-10-31	1.6	8.1	7.2	8.2	0.8	2.2	-2.6
1983-10-31	-1.0	1.9	1.7	0.8	-0.1	-1.1	0.8
1986-10-31	0.7	0.2	4.1	1.0	13.3	18.6	3.2
1989-10-31	-1.6	-0.7	1.7	5.7	-3.3	-1.7	-10.7
1991-10-31	0.3	1.2	-2.8	6.3	4.2	5.1	7.2
1995-10-31	0.8	1.3	4.1	6.7	9.4	12.6	20.6
1997-10-31	1.4	1.5	6.2	6.6	10.0	22.0	21.5
2003-10-31	0.2	0.0	1.5	5.5	8.1	6.6	7.6
2013-10-31	-0.5	1.9	2.5	4.3	-0.8	7.3	14.9
2017-10-31	0.6	0.1	2.8	4.7	9.6	2.1	5.3
2019-10-31							
Median	**0.8**	**1.9**	**2.5**	**5.5**	**7.3**	**9.3**	**7.2**
% Positive	**76%**	**76%**	**80%**	**92%**	**76%**	**80%**	**72%**
Risk	0.0	-0.4	-0.9	-0.9	-1.0	-1.6	-5.8
Reward	1.6	2.5	4.0	5.9	9.6	11.6	15.4
Z-Score	1.2	2.2	2.3	5.1	3.4	3.1	-0.1

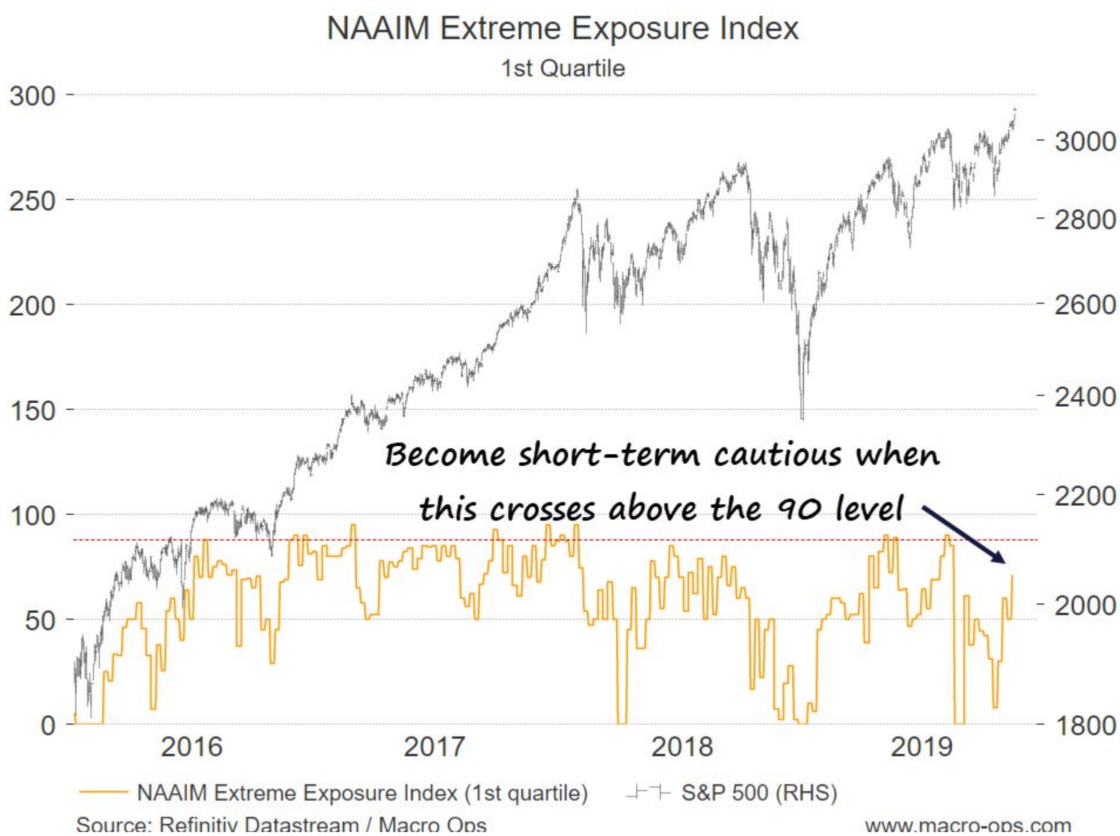
© SENTIMENTRADER Numbers are % return after signal; Risk = avg max loss; Reward = avg max gain; Z-Score +/- 2 suggests significance.

Longer-term positioning and sentiment (P&S) are way off-sides as I've been noting the last few months but indicators of short-term P&S are swinging wildly back and forth which isn't ideal. Take Total Put/Call 10 & 3-day moving averages for example. Both are triggering sell signals, noting complacency.

This doesn't mean we're going to see a large sell-off. Our other technical indicators of breadth and liquidity are showing strength. This tells me that the trend higher — in US stocks at least — is likely to be a choppy one until these swings in short-term sentiment subside.

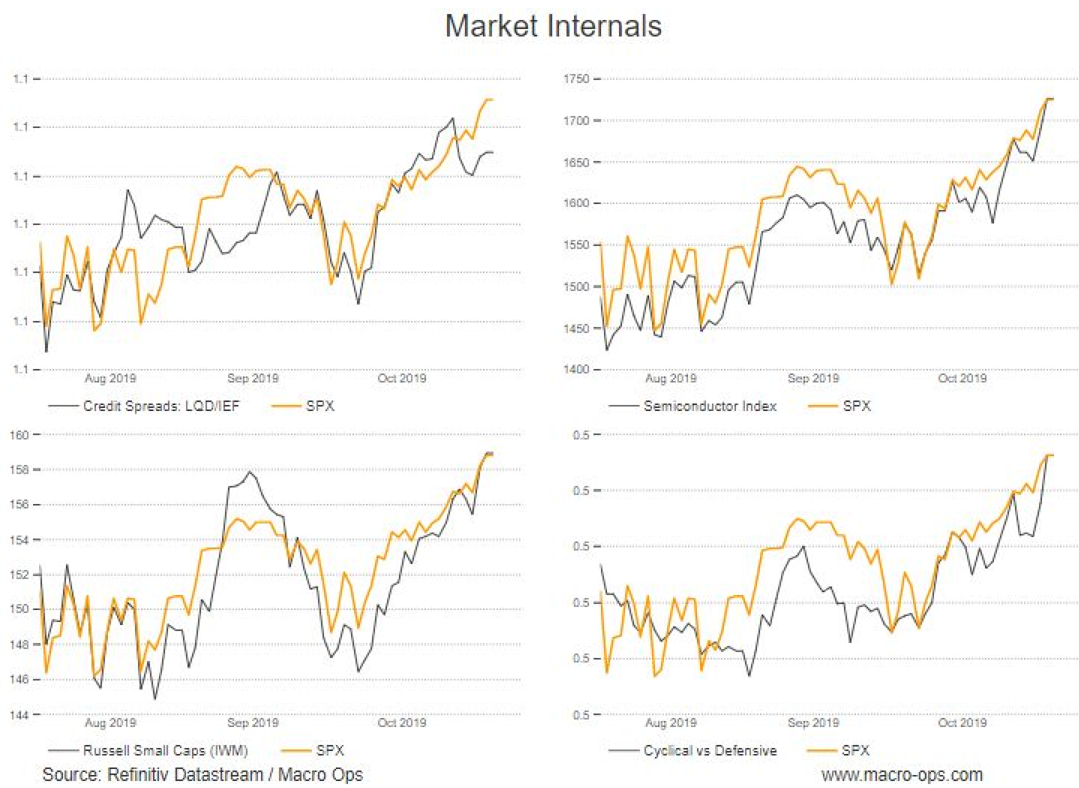
I'm looking for a short-term pullback/consolidation in the coming week(s) to wash out those who're just trying to jump in and chase. The market always makes it hard to jump on at the start of a new trend, this time likely won't be any different. It's helpful that we're already positioned long with low entry prices.

If we see our NAAIM Extreme Exposure Index cross above the 90 level this week (which it's looking like we might) then we'll want to be on the lookout for technical weakness confirming a pullback.



You can find my weekly P&S [breakdown here](#).

Outside of short-term red flags in P&S, the technicals and market internals continue to show strength. Most notable is the pick up in cyclical versus defensive sectors.



I pointed out last week in a tweet that bonds look vulnerable to an extended pullback here. They appear to be forming a similar pattern to the 16's overextended top (chart is a weekly).

If we see a daily close below this line then I'll look to flatten out our 50% allocation to bonds. A breakdown in bonds (yields up) will also mean lower gold. We're already flat our gold allocation but may look to get short for a swing trade on a technical breakdown.

Our two equity holdings (we cut BXC last week after it hit our stop), Disney (DIS) and Scorpio Tankers (STNG), report earnings this week. STNG is still battling its 200-week moving average and looks like it might pull back some more into earnings or immediately following.

The shipping bull thesis continues to strengthen and any pullback in STNG would be a good place to enter or add for those of you interested in building up your position. I'm still keeping a close eye on DSSI, TNK, and EURN for a pullback to establish a position as well.

There are a number of trades I'm looking at that are appealing on a purely technical basis. We may establish a position following market weakness in the coming days. Here are a few that have excellent setups and are in sectors/industries that are beginning to outperform (all charts are weeklies).

Nordson Corp (NDSN) is an industrial goods company that just completed a 2-year inverted H&S pattern and broke out on strong volume.

Vertex Pharmaceuticals (VRTX) is a biotech that just broke out of an 18m+ coiling wedge.

First Republic (FRC), a regional bank, broke out of a 2-year inverted H&S.

Penske Automotive Group (PAG) just broke out of a long-term channel on strong volume. I like this one because anything to do with autos has been hated and indiscriminately sold over the last two years. And this was largely due to global weakness in sales caused by one-off regulatory changes in China and Europe combined with a short-term funding crisis in India.

Lastly, the Malaysian country ETF (EWM) is close to breaking out of the long-term downward wedge I pointed out a few weeks back.

Also, crude oil also looks like it may be putting in a base. There's some positive fundamental developments for oil that are building such as a curve that's in backwardation and hedge fund long positioning near cyclical lows. The technical picture needs to improve a bit more but if it does then the E&P names GPRK and WTI have a lot of potential.

All in all, expect some short-term weakness and use it as an opportunity to buy the dip.

You Macro Operator,

Alex