Where Are We in the Stock Market Cycle? An Update

By Ricardo L. Cortez, CIMA®
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The current economic expansion is now the longest in modern U.S. history, surpassing the 120-month expansion from 1991 to 2001. The late 2018 stock market decline and subsequent easing by the Fed improved the monetary and credit picture. The stock market has reflected this expansion with the S&P 500 Index, Dow Jones Industrial Average (DJIA), and NASDAQ-100 Index each hitting new all-time highs in 2019 with double-digit gains. Although the Fed’s accommodation has not erased the potential danger of a larger bear market, we do not see a significant decline occurring as long as interest rates and credit spreads remain benign.

We believe that a more accommodative monetary policy is a short-term positive for the market, but an inverted yield curve often has been an indication of potential problems ahead when accompanied by widening credit spreads. A widening of credit spreads would turn the monetary picture negative, despite Fed easing. Bear markets often occur when the Fed is in the early stages of easing. In addition, the narrowing in stock market leadership in the past few years is a negative momentum indicator. This could change if the broad market were to reach new highs along with the major market indexes.

Cortez (2018) reviewed the 10-year bull market cycle through the lens of four major macroeconomic, behavioral, and technical market factors: (1) valuation, (2) monetary policy and credit conditions, (3) investor sentiment, and (4) momentum. Assessing where we were in the stock market cycle at that time, we noted the old Wall Street maxim: “Bull markets do not die of old age.” A change in macroeconomic factors and/or internal market dynamics typically precedes or accompanies a change in the trend of the stock market.

Our subsequent review of the four factors indicates that there is a higher probability of significant stock market weakness in the next year or two than when we reviewed these factors two years ago. The key will be the level of interest rates and credit conditions. Given the market’s recent strength, now seems to be an optimum time for some profit-taking and to begin to lower exposure to equities. We offer some suggestions as to how financial advisors might discuss late-cycle stock market risks with clients, and we suggest some strategies to successfully weather potential volatility and market weakness.

THE FOUR FACTORS
Here is a brief description of the four factors that we use to assess where we are in the stock market cycle:

VALUATION
Historically, at high points in the stock market cycle valuation levels are elevated, and at market lows valuations are low. We look for extremes in valuations to tell us when to be cautious and when to be more optimistic about future returns. Many metrics are available to assess equity valuation levels, including the median price-earnings (P/E) ratio of the S&P 500, Robert Shiller’s cyclically adjusted P/E (CAPE) ratio of 10-year normalized earnings, the Fed model, the price-book ratio, the price-sales ratio, and various dividend discount models.

MONETARY POLICY AND CREDIT CONDITIONS
Monetary policy and credit conditions are among the most important factors in the determination of the long-term direction of the U.S. stock market. As the stock market and economic cycle mature approaching a peak, the Fed usually begins to tighten monetary policy through interest-rate increases and other monetary tools at its disposal. During the current cycle, for example, one of the tools that the Fed has used to provide liquidity to the system is quantitative easing. Currently, the Fed is reversing this process by a systematic reduction in its balance sheet, or quantitative tightening.

A variety of indicators are used to assess monetary policy and credit conditions. The rate of change of interest-rate movements; the difference between short-term rates and long-term rates (the yield curve); the difference between the yield on Treasury securities and corporate, municipal, and high-yield bonds (credit spreads); free reserves; and signals of inflationary pressures are among the many indicators that we use.

In addition, the past decade has shown that global markets can have a major impact on the U.S. stock market. Therefore, indicators of the actions of global central banks—the United Kingdom, Japan, China, and Europe, among others—that could affect U.S. policy and the U.S. stock market are important in this analysis.
Nonetheless, equity valuations are cyclical in nature. They evolve from overvalued to neutral to undervalued during a typical stock market cycle. We expect that in the next year or two we may be headed for a cyclical revaluation of stock prices, which would produce an undervaluation for equities.

MONETARY POLICY AND CREDIT CONDITIONS

The 30-year U.S. Treasury Bond yield reached its lowest level in modern history during August 2019, falling below a 1.50-percent yield. The decline in global interest rates produced an inversion of the yield curve in the United States. This is the first time this has happened since the 2008–2009 financial crisis (see figure 3).

As indicated in figure 3, an inversion of the yield curve often precedes economic and stock market weakness. The lead time historically has been anywhere from six months to several years.

INVESTOR SENTIMENT

In our analysis, investor sentiment should be assessed from a contrarian point of view. When investors are very optimistic, it is usually the time to be cautious. When investors are selling heavily, it is usually time to increase market exposure.

One measure of investor sentiment is the bullishness or bearishness of stock market investment letters written by market pundits, portfolio strategists, and individual investors. Put–call ratios, short interest, margin debt, and stock market capitalization as a percentage of gross domestic product are among the many indicators that provide perspective on extremes in investor sentiment.

MOMENTUM

Healthy markets are distinguished by a high percentage of stocks participating in the advance. During these times, measures of volume and market breadth confirm new highs in the major market indexes. As the stock market and economic cycle near a peak, there are usually decreasing levels of participation in terms of both breadth and volume, which creates negative divergences.

Models that are important in this analysis include the percentage of stocks above their 10- and 30-week moving averages, cumulative on-balance volume and breadth, measures of institutional flow of funds, and the divergences between the broad list of stocks and the major market indexes.

WHERE DO THE FOUR FACTORS STAND NOW?

VALUATION

The S&P 500 median P/E ratio peaked in January 2018 at a 15-year high of 26.8. At the end of October 2019, the median P/E ratio stood at 23.4 (see figure 1).

When we adjust for the historically low level of interest rates and the Fed’s more dovish stance, valuations now appear to be more reasonable (see figure 2).
WHERE ARE WE IN THE STOCK MARKET CYCLE? AN UPDATE

**Figure 2**

S&P 500 INDEX VS. S&P 500 OPERATING PRICE/EARNINGS PLUS YEAR-TO-YEAR CHANGE IN CPI

![Graph showing S&P 500 Index versus S&P 500 Operating Price/Earnings plus year-to-year change in CPI.](image)

**Sources:** Ned Davis Research (NDR), S&P Dow Jones Indices, Bureau of Labor Statistics. Monthly data October 31, 1941, to October 31, 2019. Past performance does not guarantee future results. For illustrative purposes only.

**Figure 3**

S&P 500 INDEX VS. 10-YEAR TREASURY YIELD MINUS EFFECTIVE FED FUNDS RATE

![Graph showing S&P 500 Index versus 10-year Treasury yield minus effective Fed funds rate.](image)

**Sources:** Ned Davis Research (NDR), S&P Dow Jones Indices, Federal Reserve Board. Monthly data July 31, 1954, to October 31, 2019. Past performance does not guarantee future results. For illustrative purposes only.
A yield curve inversion reflects possible disruptions in business credit and financing. As these disruptions occur, credit spreads rise reflecting more caution on the part of lenders. Credit spreads, defined as the difference between the Bloomberg Barclays U.S. Corporate High Yield Bond Index yield and the 10-year U.S. Treasury Note yield, widened to their highest level in three years (see figure 4). If credit spreads narrow, that would be a positive sign that there are no disruptions in business credit financing. However, should credit spreads once again begin to widen, coupled with the recently inverted yield curve, those conditions would be significant negative changes since we last looked at these indicators two years ago.

SENTIMENT
Optimistic investor sentiment, as measured by the Ned Davis Research (NDR) Crowd Sentiment Poll, reached its highest point ever in January 2018 (see figure 5). This is a contrary indicator: When most investors are optimistic, we should be wary; when most investors are fearful, we should be looking to buy.

Both equity valuations and sentiment reached their highs for this stock market cycle in January 2018. It is likely that both valuation and investor sentiment will now have to re-cycle: Stocks likely will move from overvalued to undervalued and investor sentiment will swing from optimism to fear at the end of the cycle. Although this cyclical change likely will usher in a significant buying opportunity, we believe that we will see significant stock market weakness before this process is complete.

MOMENTUM
When stock market momentum is strong, the market’s advance is broad-based with the majority of sectors participating in the advance. When stock market momentum falters, it is indicated by a lack of broad participation.

In the past year and a half, this is exactly what has happened: The major averages have made new highs unaccompanied by the broad list of stocks, setting up negative divergences. For example, neither the Dow Jones Transportation Average (DJTA) nor the Russell 2000 has reached new highs with the other major averages (the DJIA, S&P 500, and NASDAQ–100). Indeed, the DJTA and the Russell 2000 both recorded their highs more than a year ago. In addition, the MSCI World ex USA All Cap Index reached its high in early 2018—almost two years ago (see figure 6).

It is certainly possible that these divergences will be resolved as the major market averages make new highs. However, left unresolved, the cyclical nature of this process leads us to believe that we may see a decline in both the leadership indexes and the broad list of stocks in the next year or two.

Another important factor in assessing the underlying strength of the market
WHERE ARE WE IN THE STOCK MARKET CYCLE? AN UPDATE

**S&P 500 COMPOSITE INDEX**

- Extremes generated when sentiment reading rises:
  - Rises above 61.5% = Extreme Optimism
  - Declines below 55.5% = Extreme Pessimism
- Sentiment must reverse by 10 percentage points to signal an extreme in addition to the above extreme levels being reached.
- Arrows represent extremes in optimism and pessimism. They do not represent buy and sell signals and can only be known for certain (and added to the chart) in hindsight.
- Average value of indicator at:
  - Optimistic Extremes (down arrows) = 68.6
  - Pessimistic Extremes (up arrows) = 46.9
  - Average Spread Between Extremes = 21.5

**NDR Crowd Sentiment Poll**

- Extreme Optimism (Bullish)
- Extreme Pessimism (Bearish)

**NON-CONFIRMING INDEXES**

**Sources:** Ned Davis Research (NDR), FTSE Russell, Bloomberg Finance L.P., MSCI. Daily data December 31, 2015, to August 9, 2019 (log scale). Past performance does not guarantee future results. For illustrative purposes only.
SUMMARY AND CONCLUSION

Equity valuations reached extreme optimism in January 2018. Although valuations are now more reasonable, the cyclical nature of valuations indicates that they likely will swing toward undervalued levels by the end of this cycle.

The monetary and credit picture indicates that the Fed’s tightening of credit through interest-rate rises between 2015 and 2018 had a negative effect on the economy, producing the late 2018 market decline. The yield curve subsequently inverted but the Fed had begun a policy of easing. A narrowing of credit spreads would be a positive sign for the market. But, if credit spreads begin widening, coupled with the inverted yield curve, those would be significant negative changes since early 2018.

Historically, those occurrences often have led to economic contraction and a decline in stock prices.
Investor sentiment reached a peak level of optimism and bullishness in January 2018, which is negative from a contrary point of view. Optimistic sentiment has waned since then, but history suggests that investor sentiment will have to re-cycle to outright bearishness before the current market cycle ends.

Finally, with regard to momentum, the DJIA, S&P 500, and NASDAQ-100 recorded all-time highs in late 2019, but global markets reached their highs almost two years ago. Small-cap stocks, as represented by the Russell 2000, and the DJTA reached their peaks more than a year ago in August 2018. These divergences could be resolved positively as the major market averages climb to new highs. Nonetheless, these types of divergences, if left unresolved, have led to bear markets in the past.

In summary, our analysis indicates that the easing in Fed monetary policy has been a positive for the market during 2019. Nonetheless, valuation and sentiment registered negative extremes in early 2018 and the yield curve has inverted—just as it has prior to previous economic contractions and bear markets. At this point in the cycle, the way to tell if these conditions might produce a bear market is by watching credit spreads. A widening of credit spreads would be a negative development and might signal an economic contraction ahead, even in an easing monetary environment. And finally, although the market’s short-term momentum is now positive, the longer-term divergences between the major market averages and the broad list of stocks is something that has occurred before virtually all prior bear markets.

What should investment consultants and their clients do in this environment?

No one can predict the future, but it may now be prudent for investment consultants to discuss potential market risks with their clients and suggest diversifying by allocating capital to more defensive securities and asset classes. The average bear market over the past half century has lasted anywhere from one year to two years with an average decline of almost 30 percent. In the past two downturns of 2000–2002 and 2008–2009, the major stock market averages declined 50 percent and there were even large losses in higher beta stocks. It might be beneficial to remind clients that the NASDAQ-100, which led the way up in this bull market just as it did in the late 1990s, declined 80 percent between 2000 and 2002. It took 15 years for the NASDAQ-100 to return to its 2000 high.

Economic contractions and bear markets have real economic consequences for investment consultants and their clients. We have not been through this type of market disruption in more than a decade and there is a natural tendency to put less emphasis on the past. In our opinion, financial advisors and their clients would be wise to begin diversifying and de-risking portfolios in order to preserve capital for the next significant buying opportunity.

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Besides the diversification suggested above by allocating assets among more defensive securities, sectors, and asset classes, investors should consider de-risking portfolios. This can be done in several ways. The simplest is to have more cash on hand, particularly as the yield curve inverts with more cash on hand, particularly as the yield curve inverts with inverted—just as it has prior to previous economic contractions and bear markets.

REFERENCES


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