Joe's Horses3 - June 4, 2016

Our last update of the "Joe's Horses" series in August 2015 examined the continuing divergence between foreign and U.S. equity markets. While stocks here in the U.S. are making new highs for the rally from the financial crisis low of 2009, foreign markets had already topped out and been trading well below their highs for a year or more.

The conclusion we reached at that time leaned toward the negative ramifications that divergence represented. We expected a resolution that would find markets significantly lower over the intermediate to longer term.

While events since then have validated a large part of our conclusion, it now appears that the markets have reached a point where it is time to reassess and consider the possibility of a very different outcome, one much more bullish than it appears most are expecting.

The bottom line is that the markets are at another inflection point. We have said repeatedly in the past that in its most basic sense, this divergence between different markets had to resolve itself in one of two ways. Either the U.S. markets were going much lower, which has been our base expectation, or the foreign markets were going to embark on a catch-up rally that would close the disparity we have been pointing out for over a year now.

So, where are we and what should we be watching for? The answers are in the charts so let's begin!

What has happened since August 2015?

Our August 2015 analysis concluded with; "on June 23, only the Russell 2000 was left to pull the wagon. The result seems as inevitable as it is ugly." Despite this, as many clients have heard us say, any good analysis must consider what the other outcomes look like. Thus, again from August 2015, we followed with, "money is moving into the U.S. markets in what is primarily a move to safety/quality. If two of the Big Three (DJI, DJT, S&P 500) hold or fail to confirm breaks of their October lows and instead turn higher making new highs for the rally, all this discussion has done is highlight where the relative strength is globally."

While new highs haven't been made yet, the S&P 500 (SPX), and Dow Jones 30 Industrials (DJI) are within a whisker of it after trying mightily to extend down through the October 2014 lows. What keeps this interesting is that many other segments of both the U.S. and foreign markets are still wallowing well below their peaks.

So why the need to reassess? Let's begin with the Russell 2000 index shown in Chart 1 which measures the performance of small U.S. stocks.

All of the charts used here are weekly bar charts where each bar represents the high, low and closing price for each week. We can see the October 2014 low (marked by the horizontal line) was violated for nearly two months in the first quarter of 2016 but prices have since recovered nicely. Expanding on a concept we introduced in August of the rising demand line we can see that the Russell had broken above its falling supply line, retested it, and has moved out to new highs since the lows in the first quarter. This is positive action and may be setting the stage for a test of the 2015 highs.

Turning to the three indexes referenced in August, first, the DJI is shown in Chart 2. Here we see a classic example of what to this point appears to be a successful test of a low when prices broke below the October 2014 low (the horizontal line in the chart) in 3rd Quarter 2015 and again in 1st Quarter 2016. Current levels are testing the highs of May 2015 and new highs would be impressive action.

The S&P 500 (SPX) shown in Chart 3 also shows a successful retest of the October 2014 low, again marked by the horizontal line, and is currently challenging the all-time high of May 2015.

Chart 4 shows that the Dow Jones Transportation Index (DJT) is less impressive since it did confirm its failure of the October 2014 lows by breaking to new lower lows in 1st Quarter of 2016. Now it is trying to regain and hold those October 2014 levels (horizontal line). Notice that it has broken its falling Supply Line and is currently retesting that break. A move above the April 2016 highs would be impressive action and probably set up a test of its highs made in late 2014 and early 2015.

So what about all those lagging foreign markets? Let's start with Chart 5 of the Developed Markets using the exchange traded fund EFA. This index tracks the combination of markets frim U.K. Germany, Japan, and other non-U.S. markets. Below we see that as we had feared in August, the October 2014 lows were breached significantly with the low coming in Q1 2016. Since then price has regained October 2014 levels but is struggling to maintain those levels. Encouragingly, we see that a falling Supply Line has been broken but bigger struggles await at the higher falling Supply Line off of the highs made in mid-2014 and mid-2015. While a bullish resolution to "Joe's Horses" requires new highs in these foreign markets, it still appears much work is needed before that would happen.

Europe is another foreign influence we have monitored in the past and its current situation interestingly is much like the EFA. Chart 6 shows the European ETF VGK. Having broken the October 2014 lows, it has now regained those levels and is struggling to hold them. Like EFA, while it has exceeded its lower Supply Line, it still has to battle its higher and more significant Supply Line.

The other foreign market we watch, the EEM, which tracks markets in the Emerging Markets such as Brazil, China, India, etc. is shown in Chart 7. Here we see truly concerning action. These markets haven't come close to regaining their October 2014 levels. Having broken above their shorter term falling Supply Line, the good news is that if the April highs can be overcome, the next battle would come in the area of the higher Supply Line shown which is at much higher levels.

While these charts aren't completely "Ugly", they are not impressive either, so we want to keep the "Storm Warning" flags up. Having said that, there are some influences which should be kept in mind going forward.

Most full economic cycles finish with a final thrust which is characterized by rising inflation and better performance among hard asset type issues. Think commodities, metals, and the companies which deal in them. The main weight on these areas has been strength in the dollar. Chart 8 of the U.S. Dollar shows that while still premature, a change in those dollar related effects may be approaching

The horizontal line shows a support level where buyers have held the value of the dollar for over a year. Should that level be breached, a significant decline could follow which would have dramatic effects on a wide range of products and thus industries.

While it's premature to identify such a failure, a look at Chart 9 of XLB the ETF which tracks companies dealing in "Basic Materials" (metals, commodities, etc.) would argue for such a decline to commence sooner rather than later. Notice that although XLB significantly broke its October 2014 low shown the horizontal line, it has since rallied above its Supply Line, the highs made in the 4th Qtr of 2015, and is now attempting to extend its gains above its April highs. Such action would imply stronger demand and a better pricing environment for these companies probably accompanied by a weaker dollar.

Why the dollar would weaken in light of the current headlines we will only know in the "fullness of time".

So the point is…

While it too is early to dismiss the negative concerns we have held since the 4th Qtr of 2014 regarding the divergent price action between U.S. and foreign equity markets, some early signs are appearing which are causing us to take a more open stance to how this might be resolved. The basic point is still the same. Something has to give! **Either the U.S. markets are going down in a big way, or the rest of the world is about to rejoin the U.S. in what would be a new final leg up in the bull market which started in2009**.

The next few months should tell us a lot about which it will be. Britain’s Brexit vote on June 23 with the European vote on maintaining sanctions on Russia soon after along with the U.S. Presidential election are the obvious macroeconomic unknowns. The “story on page 16” is probably what will trigger the answer.

As always we will be keeping an open mind about which way this will resolve and respond accordingly in client accounts.

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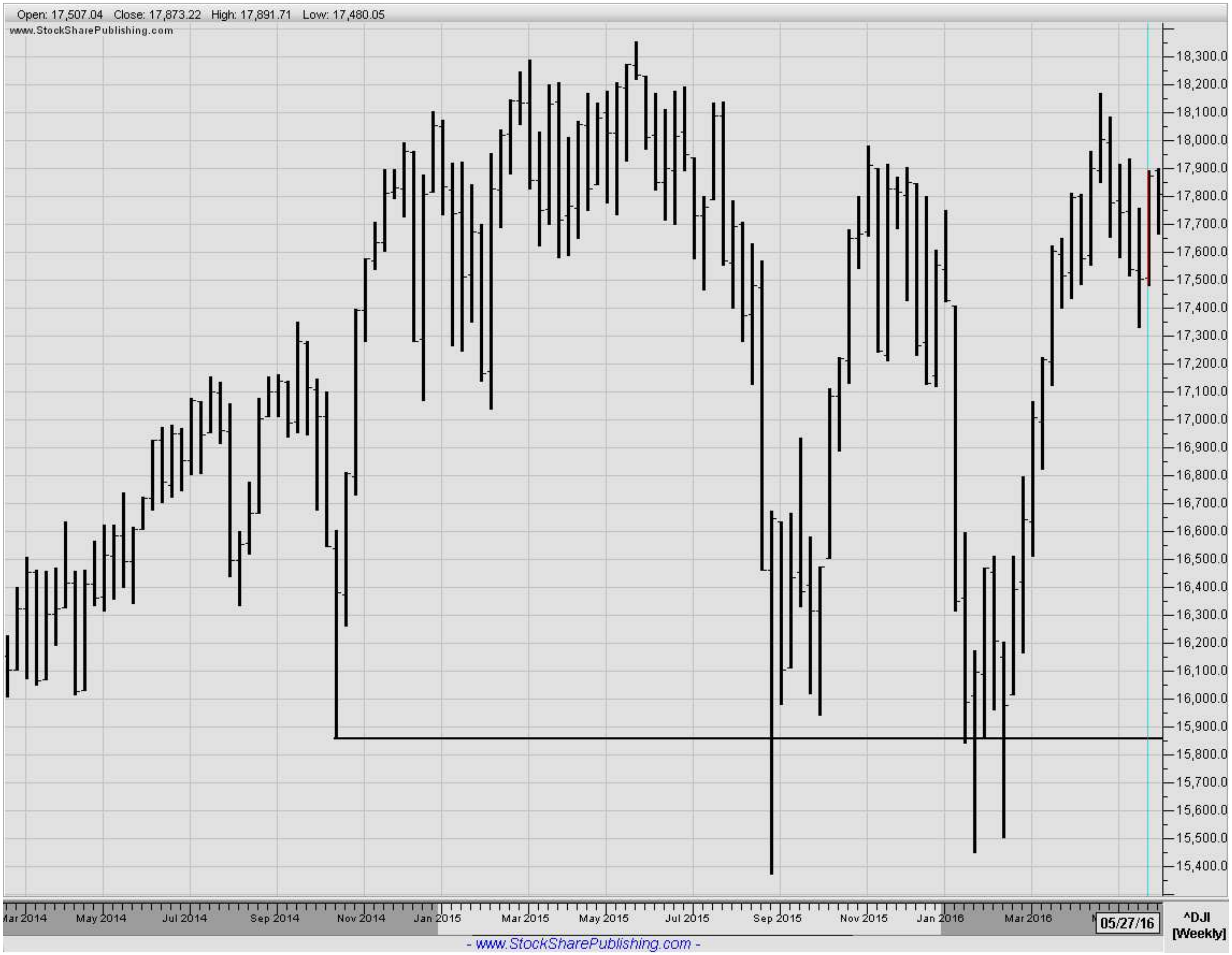
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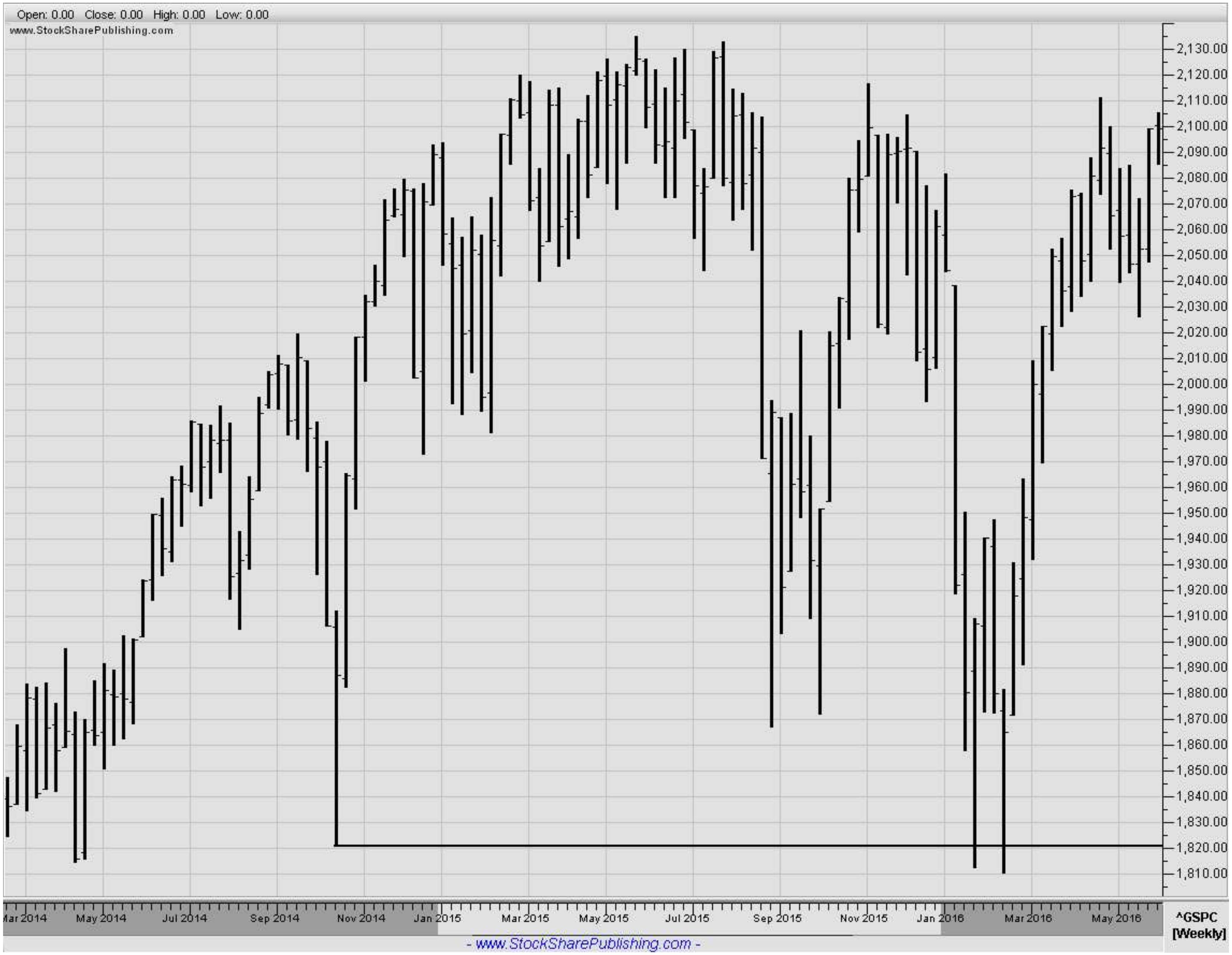

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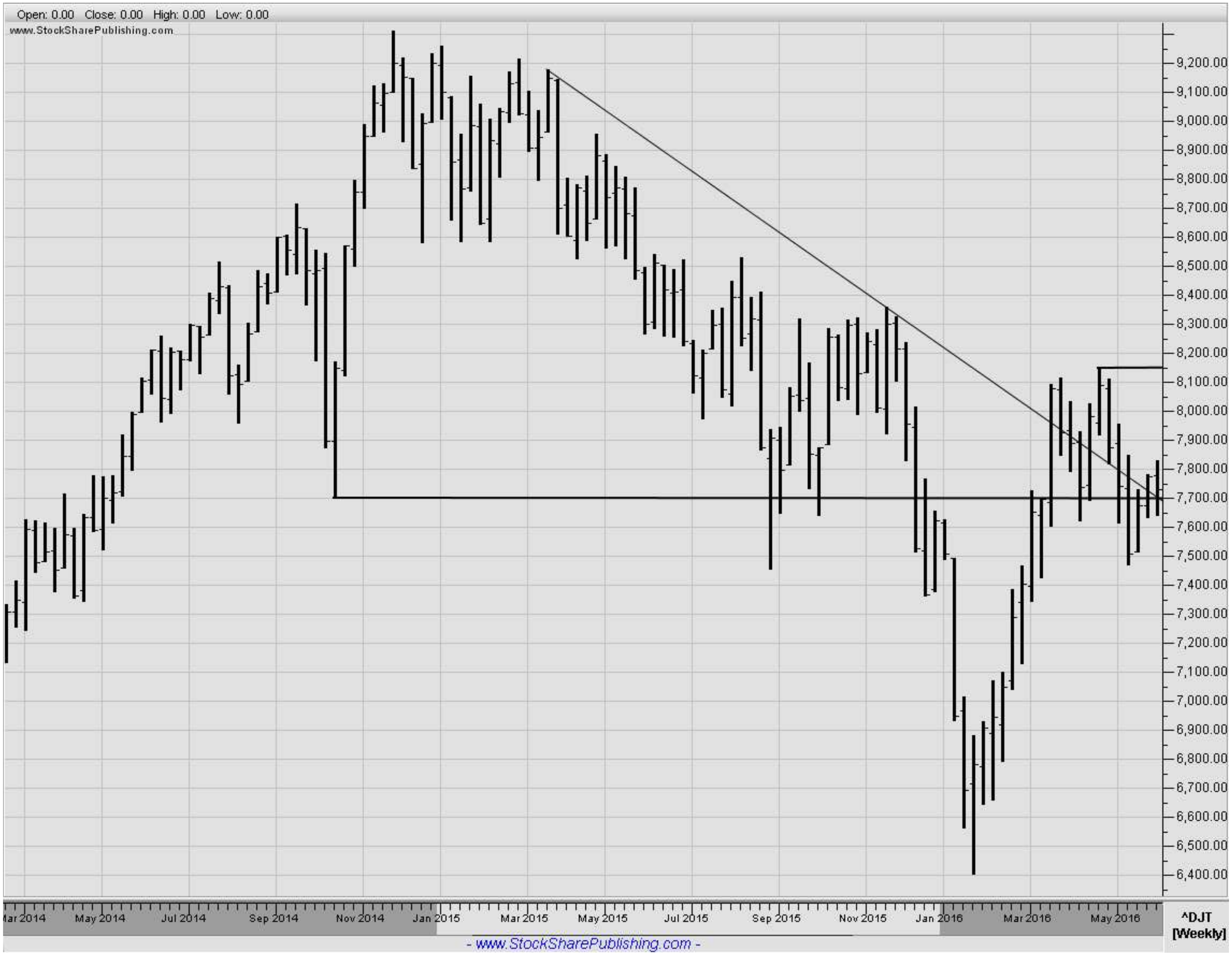

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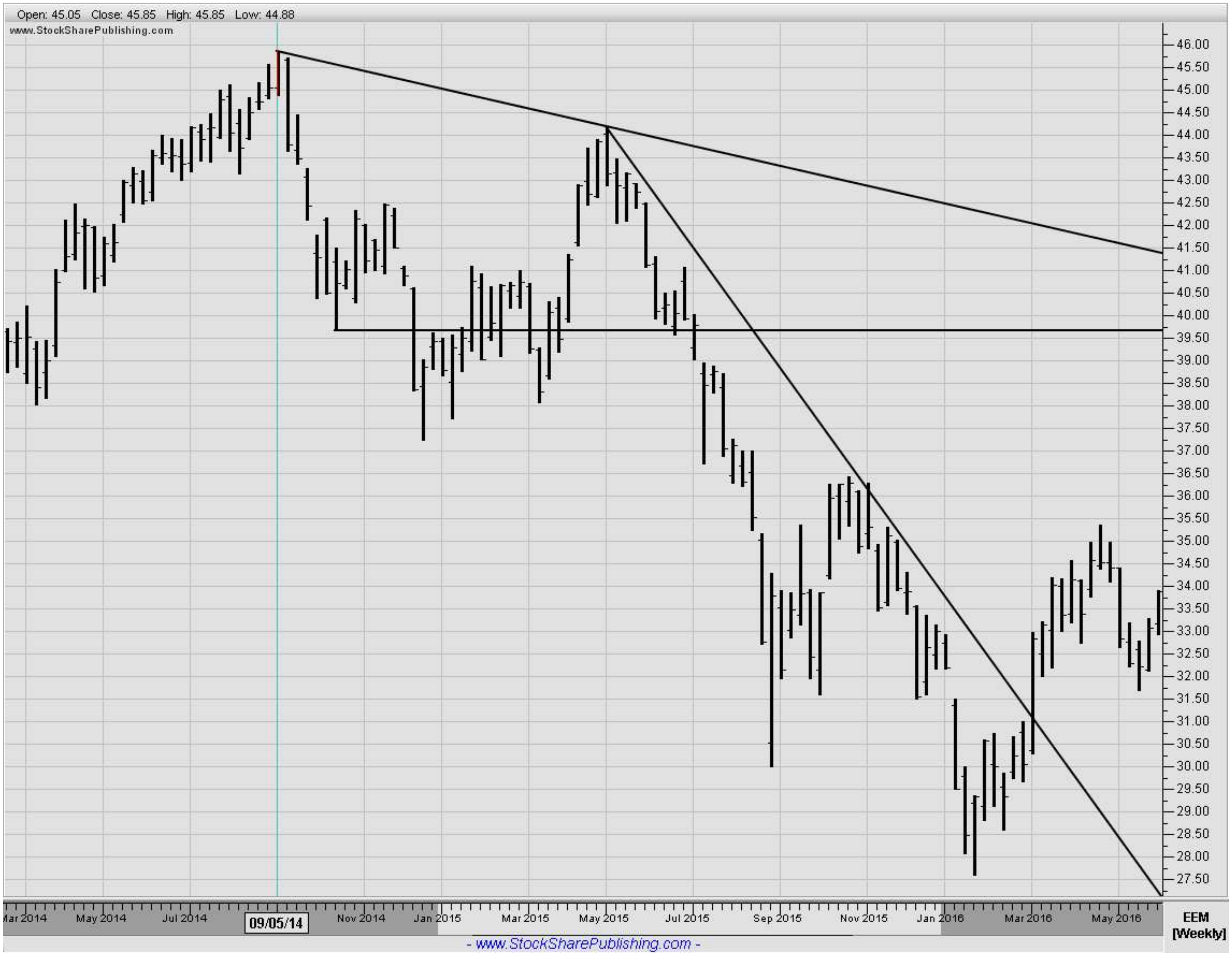
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