



INDEXES Q1 FORECAST 2016

by John Kicklighter, Chief Strategist and James Stanley, Analyst for DailyFX.com

jkicklighter@dailyfx.com & <http://www.Twitter.com/JohnKicklighter>

jstanley@dailyfx.com & <http://www.Twitter.com/JStanleyFX>

Equities One of the Few 'Risk' Assets Yet to Deflate

by John Kicklighter, Chief Strategist, and James Stanley, Analyst for DailyFX.com

Investor sentiment – also termed 'risk appetite' – is one of the most ubiquitous motivations for the placement of capital. If steady market conditions with appealing rates of return are forecasted, investors seek out those assets with higher income potential. When uncertainty and volatility surpass expected returns, funds are shifted to havens with lower perceived risk. In the years following the trough of the Great Financial Crisis (around the first quarter of 2009), confidence has returned to the financial system and the reach for higher returns blossomed. However, at a certain point, the normal course of 'risk versus reward' was distorted by the same monetary policy aimed at restoring growth and conviction. Despite limited gains in interest/yield/income, investors reached further and further for return against a backdrop of a risk landscape held artificially low by central bank policy. That tolerance started to flag for some assets (Emerging Markets) early on, but a more significant moderation for many of the riskier markets didn't start in earnest until the past 12-18 months. As can be seen in the graph below, equities remain among the most obstinate hold outs. Yet, as global growth cools, various discrete financial threats are flagged (China, emerging market debt, bubbles) and monetary policy expectations shift; a more systemic rebalancing of investor sentiment is likely.

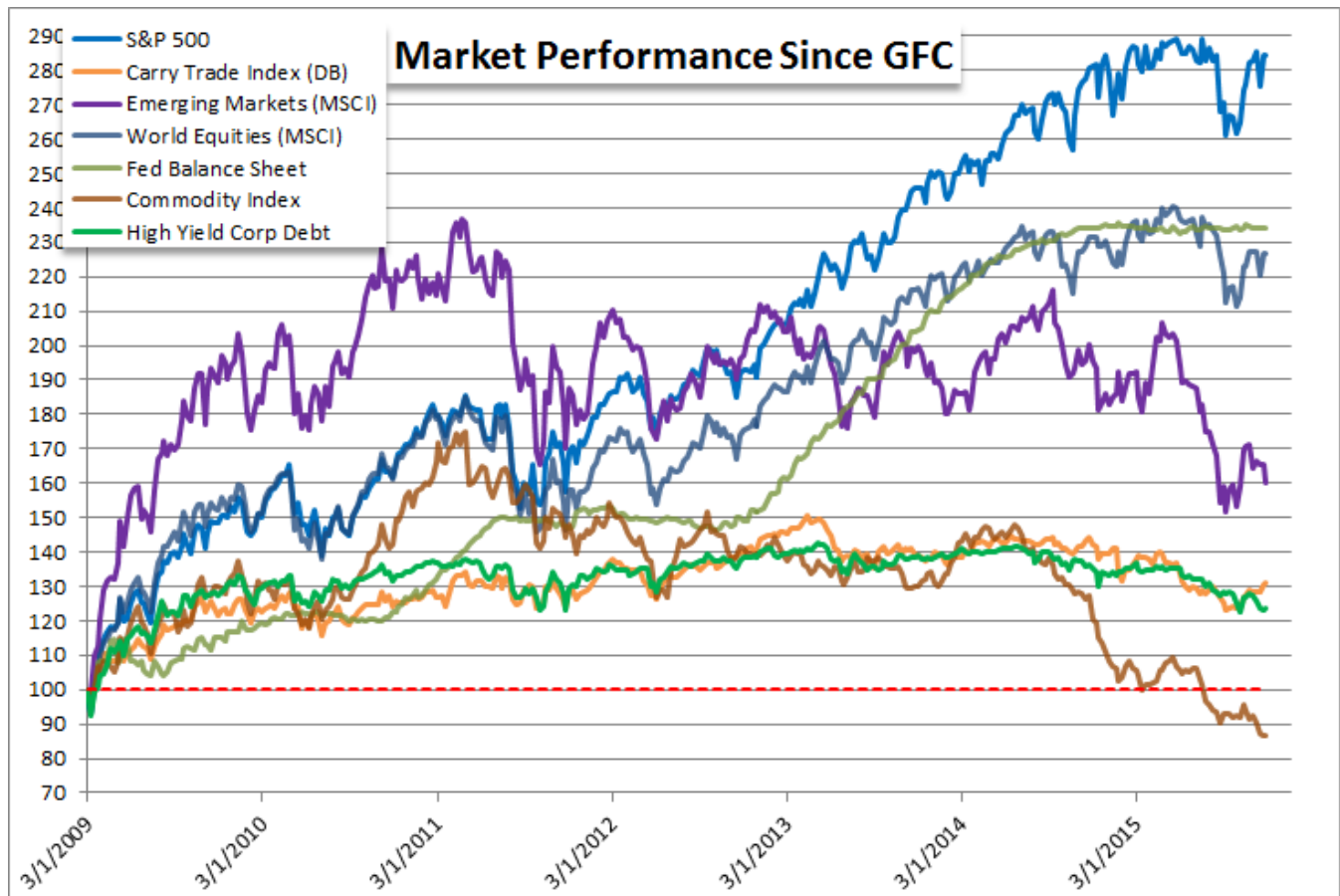


Chart Created by John Kicklighter using Data from Bloomberg and FXCM's Trading Station II

Market Sentiment Is Built on Complacency

To give a sense of just how broad the discrepancy between the speculative positioning in equities and the rudimentary balance of risk-reward might be, we have the chart below. The S&P 500 is used as a stand in for stocks as it is the most heavily referenced indexes in the world's largest economy. The Risk-Reward Index is simply an aggregate of 10-year government bond yields of certain G-10 countries (a baseline for 'return') over FX-based volatility (the 'risk' metric). We are unlikely to see shares close this entire gap, but it illustrates how low the baseline for expected returns is and the subsequent exceptional exposure investors are taking with an unintended dependency on the exceptionally low volatility levels that have developed alongside stimulus programs from the major central banks.

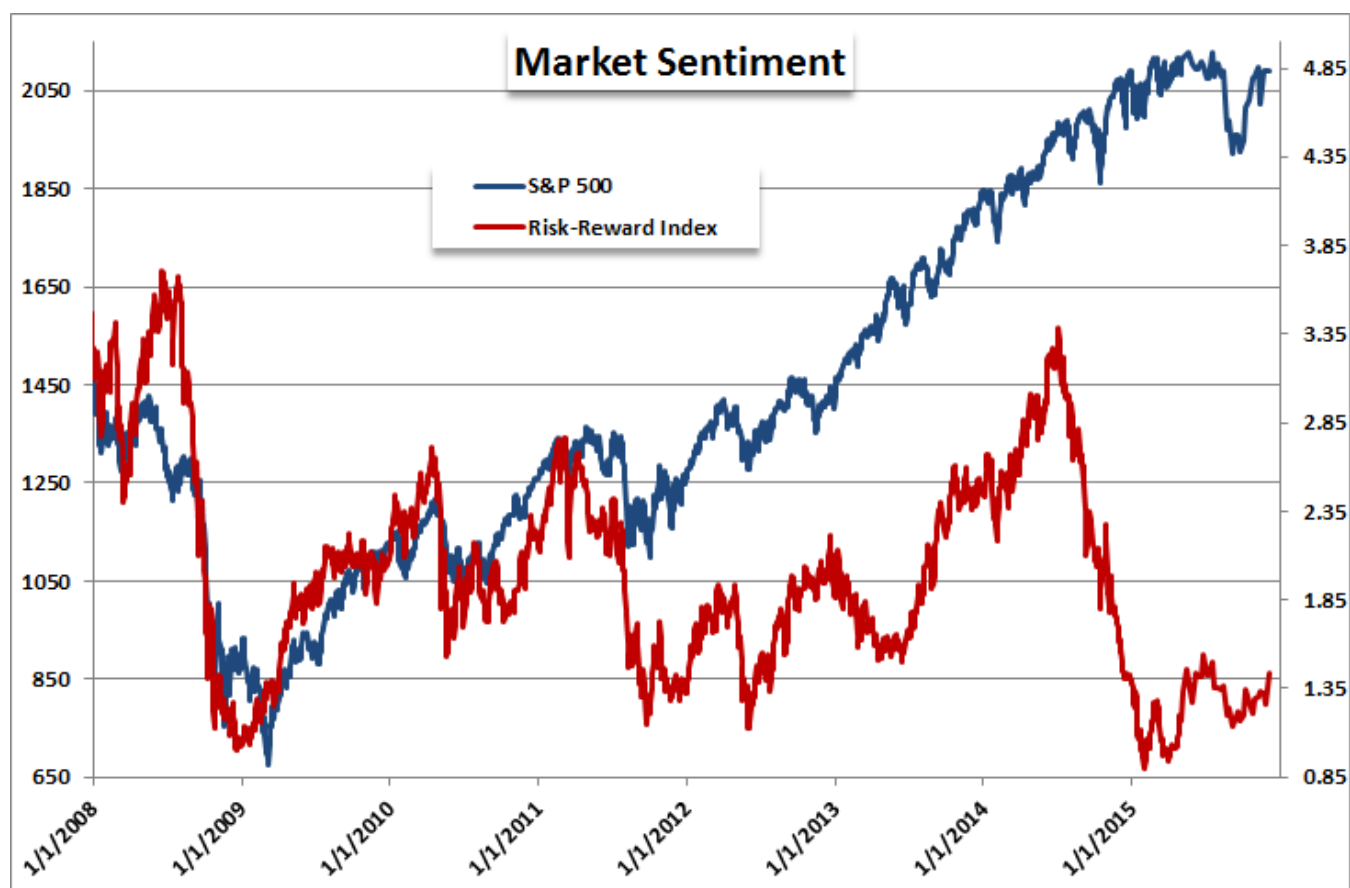


Chart and Risk-Reward Index Created by John Kicklighter using Data from Bloomberg and FXCM's Tradestation II

The greatest risk to steadfast markets moving forward would be a rise in volatility. Bigger moves in the market can just as readily mean rapid declines in asset values as they do appreciation. That is why uncertainty is considered the foundation of 'risk' in many traditional lines of asset management. And, there are plenty of smoldering threats heading into the first quarter of 2016. Among the most commonly cited (IMF, World Bank, various central banks) are: the possibility of a hard economic landing and/or financial bubble in China; capital outflow from emerging markets which have charged growth in previous years; global growth nearing stall speed; and fall out from an eventual change in global monetary policy.

Monetary Policy Can Only Act as a Buffer So Long

Monetary policy may not be the initial spark that sets sentiment ablaze, but it will likely represent the biggest source of fuel. It was the exceptional accommodation that central banks collectively employed around the globe in the form of rate cuts, quantitative easing programs and other unorthodox policy that helped avert catastrophe during the last financial crisis. However, long after the system stabilized and economies were put back on the path of growth; the taps remained wide open. The perception that central banks would not allow disruptive market moves prevailed (colloquially coined 'moral hazard') and the resultant low market returns that were a side effect of near zero interest rate policy meant investors needed to seek out riskier assets or employ notional or fundamental leverage to make return commensurate with historical norms. In sum, the same policies intended to reduce risk have also contributed in some ways.

Extraordinary monetary policy will only be sustained for so long. If the major banks hold to their mandates – typically inflation and employment – targets will eventually be met and the accommodation will fuel more overt financial and economic risks. Yet, given the sheer magnitude of dependency saddled on this seemingly boundless support; 'normalization' could prove exceptionally unnerving.

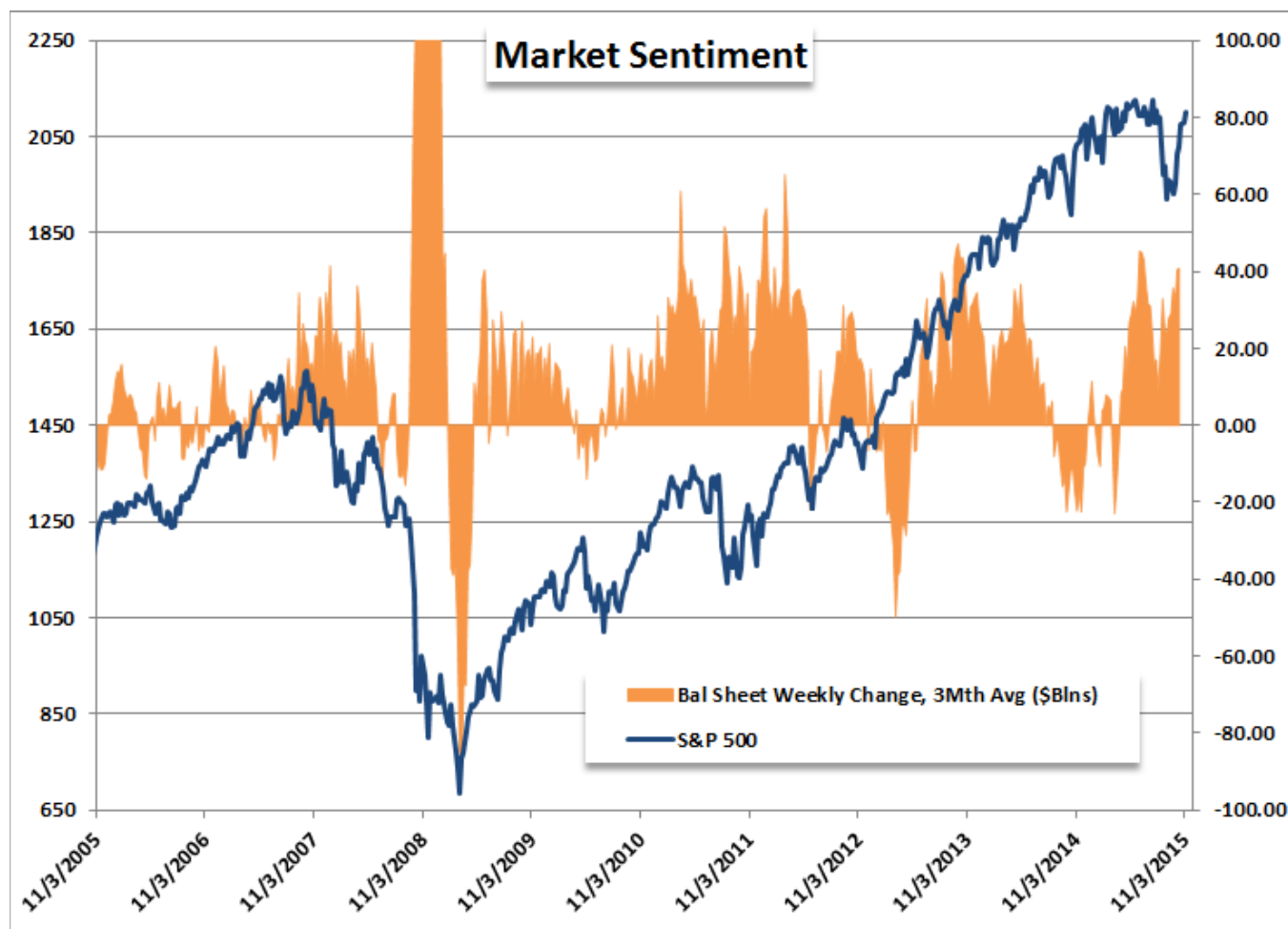


Chart Created by John Kicklighter using Data from Bloomberg and FXCM's Tradestation II

In the chart above, we see the S&P 500 versus the rolling three-month change in the aggregate balance sheets of the Fed, the ECB, the BoE, the BoJ and the PBoC. The expansion of balance sheets – rise in stimulus – has helped to keep assets advancing. When the support levels out and eventually reverses, this relationship will not go unnoticed. This past year, the Federal Reserve’s taper from the QE3 program aligned with a notable stall in US equities’ otherwise pristine and relentless climb.

A Contagious Asset Class

As the possibility of a turn in capital market looms, it will be important to remember the scope of sentiment. The more intensive risk aversion becomes, the more comprehensive its influence over equities as an asset class. That means the long-only investor would be faced with the extraordinarily difficult task of choosing the small percentage of stocks that could rise when the general market sinks – a low probability endeavor. Overall indexes will retreat when the majority of components or those with the greatest notional values drop. And, the chart below shows that the correlation is strong on the asset level.

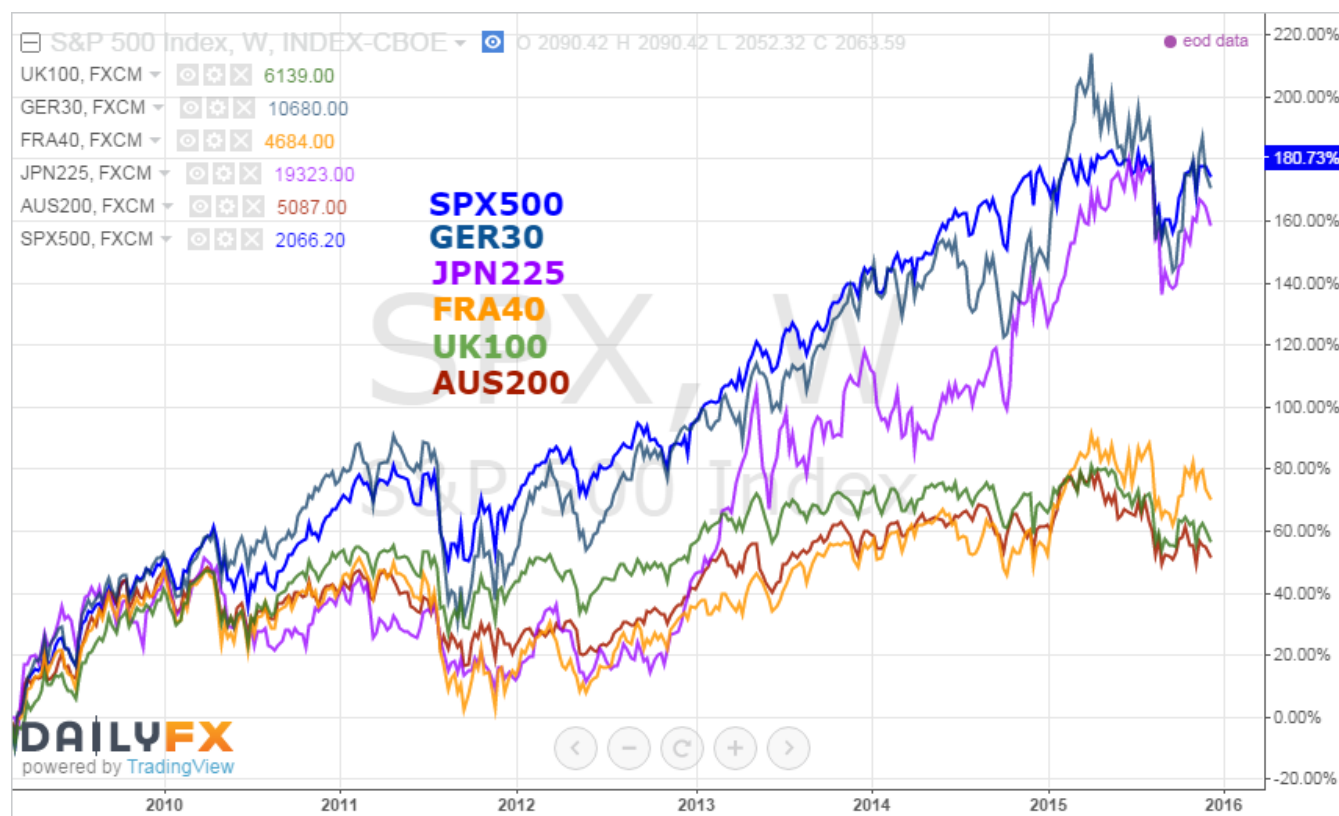


Chart Created by John Kicklighter using Trading View software

That said, not all indexes will fall with the same intensity or hold out so austere. Those regions where monetary policy is the most accommodative is likely to find the market’s most resilient. Where that safety net is being rolled back, the transition of risk to individuals will likely lead to the most intensive unwinding. Heading into 2016, European and Japanese shares are still finding the most supportive monetary policy backdrops; while US markets face a central banks blazing the path towards ‘normalization’.

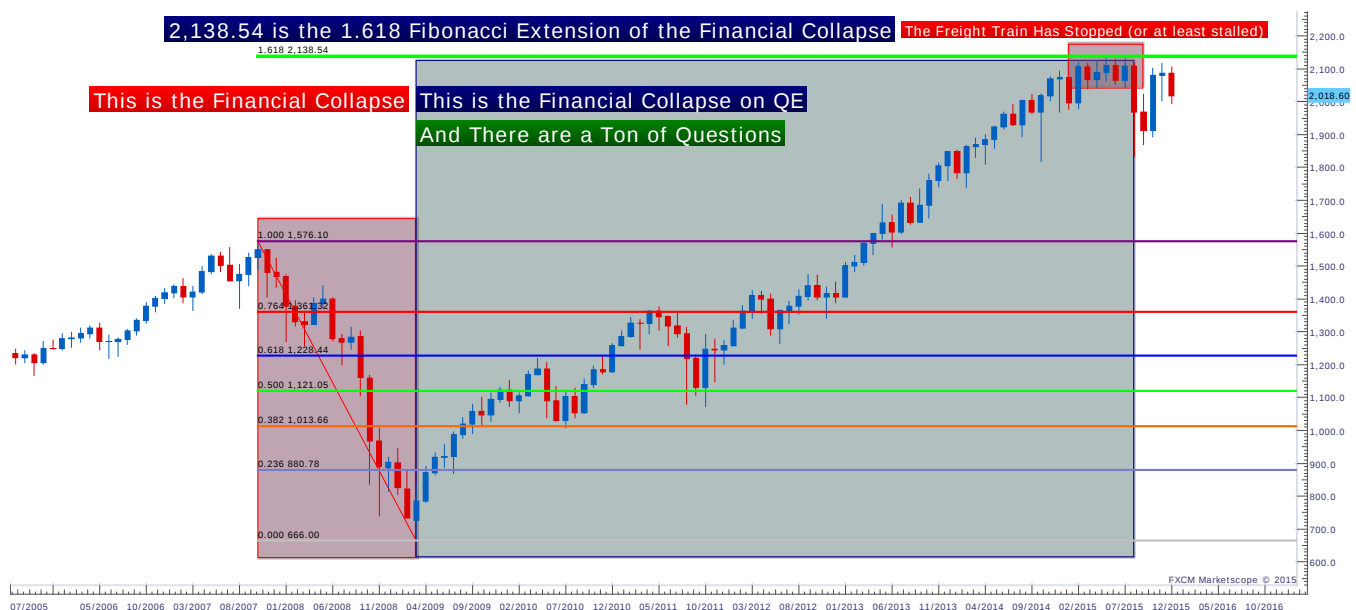
S&P Spends the Quarter Building a Bearish Reversal Pattern

The level of 2,138 has been on (some) trader's charts for over 7 years now. This is the 61.8% extension of the Financial Collapse move, and in a market being driven continually higher to even higher all-time highs on cheap and easy money to the Federal Reserve, there was a dearth of any other potential resistance to anticipate a potential top to the six-year up-trend. Even for a QE-driven rally, this move was looking a little long-in-the-tooth at a running tally of over six years of higher prices that had seen the S&P move up by more than 220%. That amounts to an S&P 500 that's 3.2x more valuable than what we saw only six years ago.

There aren't many recoveries that triple the value of an economy in a short six-year time span. So to imagine that stocks may be a little toppy would not be out of the realms of possibility. That's what makes this 2138 level so incredibly interesting.

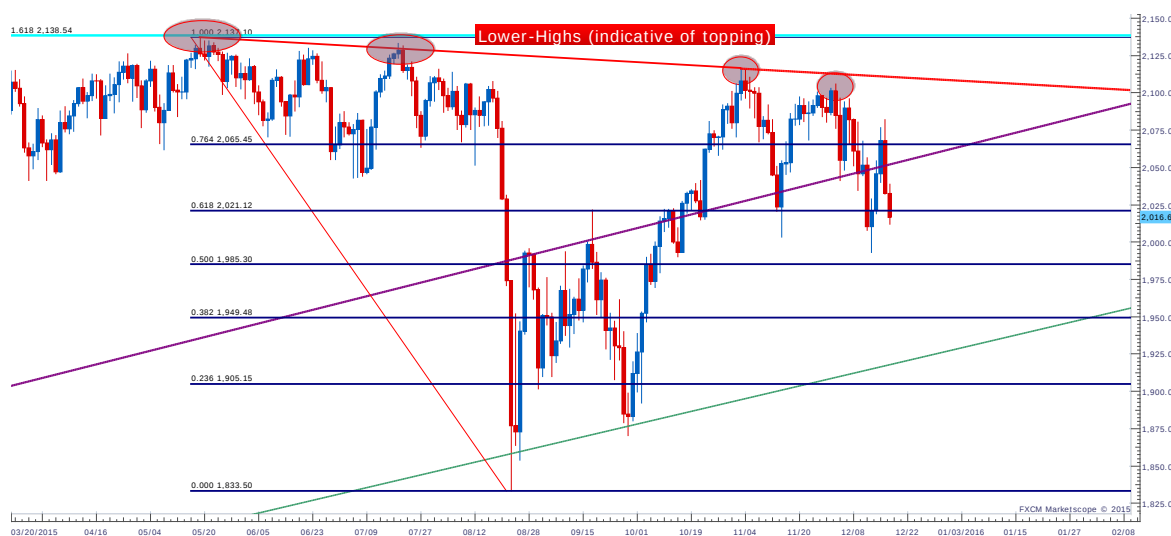
Throughout the first and second quarters of this year, stock prices continued to drive higher. China was in the midst of a full-blown bonanza as the Shanghai Composite had done over 150% in less than 12 months. Again, things that aren't sustainable, or at least never have been throughout the course of human history thus far. So when the S&P inched above that vaulted psychological level at 2,000, many were curiously watching this 2,138 level to see what would happen when the S&P inevitably crossed it.

Oddly, that day never came. What had happened for the past six years all of the sudden stopped happening just one handle shy of hitting this Fibonacci extension. The freight train stopped (or at least stalled) not more than 1.5 points away from this 'theoretical resistance level.' But seven months after setting a high at 2,137.10, after multiple gyrations, we can now say that the theory has become practical, and that a top may already be in-place.



Created with Marketscope/Trading Station II; prepared by James Stanley

It's the price action over the past seven months that makes this a trade-able idea rather than just a prognostication or a guess. Since that top was set at 2,137.1 earlier in the year, the S&P has been unable to make a new high. There have been numerous attempts and multiple failures, and this will often take place in a strong trend around a turn. It takes time for well-heeled bulls to get exhausted, and it usually takes even more time for bears to turn those frowns upside-down; but lower-highs or higher-lows are often an early tell of a reversal. 'Lower-highs' are often indicative of a top being in-place. It highlights how buyers are waning in the up-trend, and sellers are beginning to get more aggressive. Because no longer are long positions holding until new highs are made; they're bailing out shy of new highs for fear of a reversal, and on the flip side, sellers are jumping in more quickly for fear of missing the move.



Created with MarketScope/Trading Station II; prepared by James Stanley

Despite the fact that prices are still high, this quarter was not without fright. As a matter of fact, we entered the quarter on rather rocky ground that looked as though a large-picture collapse may have been afoot. If you look at that above chart, this is where that down-trend came in, that was China's Black Monday (August 24th). The S&P had run all the way down to a fresh intermediate-term low at 1833.50 and it looked like it was heading much lower. But multiple Fed member speeches later in which 'looser for longer' was thrown out as a bone to markets, the rallies came back like it was 2011. October produced a whopping 8.3% return for the S&P, and again, this is fresh on the heels of something that looked like a big-picture collapse was coming.

But something odd happened in November; something that hasn't really happened in the six years since ZIRP became a reality: The Fed brought back, and stuck to their rate hike theme. They didn't yield this time, and in December, they did the unthinkable: They hiked rates.

Now, while this, in and of itself, shouldn't be enough to create a recession, it could certainly still create a 'correction' in stock prices on the premise of easy money not being so easy anymore. And if we combine that with the weakness being seen in Asia and many emerging markets, and we're looking at a downright daunting situation with which to be initiating a rising rate environment. And if these issues don't impact stock prices, then the commodity sell-off and the carnage in high-yield bonds likely will. Because American companies have heavy exposure to these two themes, and in coming quarterly reports we'll likely hear more about this. Stock prices are most heavily impacted directly by earnings (and earnings expectations). So should this theme begin to slip, it can start to slide really very fast.

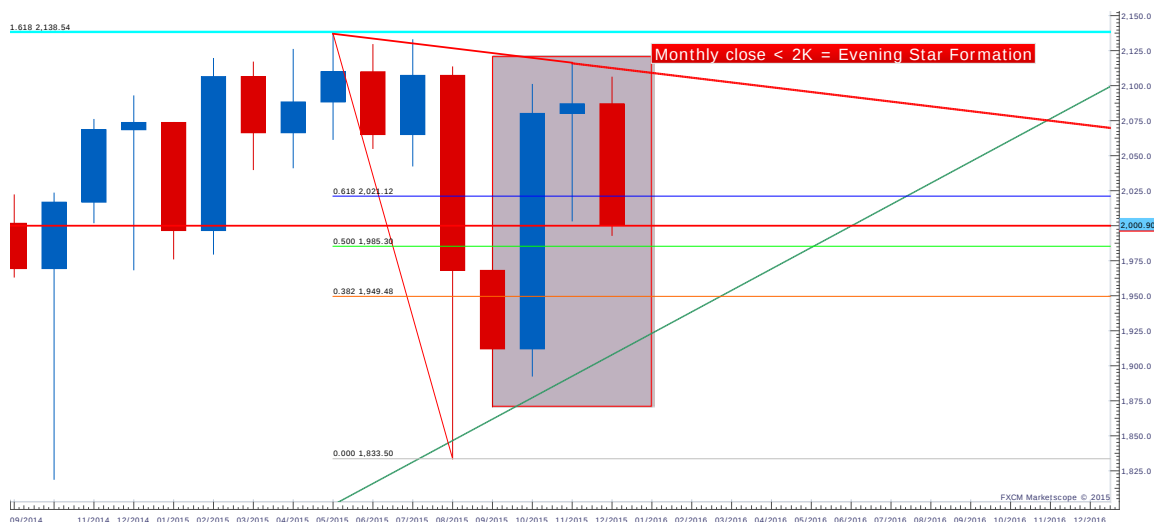
But from that move in August we have the luxury of levels with which we can use to base our approach. On the below chart, we're looking at a series of targets based around this Fib sequence. Since that low was set in August, this Fibonacci retracement has seen significant price action, thereby giving an element of validation that we're not observing this in absentia. Should new lows come in the S&P, we can recruit the assistance of Fibonacci extensions to set the groundwork for profit targets at new lows (which are also added below).



Created with Marketscope/Trading Station II; prepared by James Stanley

And all of this leads us into the trigger, which has been building over the past three months. After the exuberant comeback in October that saw the S&P jump by more than 8%, November produced a long-legged Doji formation, which is common near tops, highlighting the indecision that will often crop up near major market turns. And thus far for December, we've seen stock prices take a hit as Central Banks have begun slowly pulling the punch bowl away.

This leads to one of the more attractive bearish reversal formations: The Evening Star (shown below).



Created with Marketscope/Trading Station II; prepared by James Stanley

If US Stocks Stumble, They Won't Fall Alone

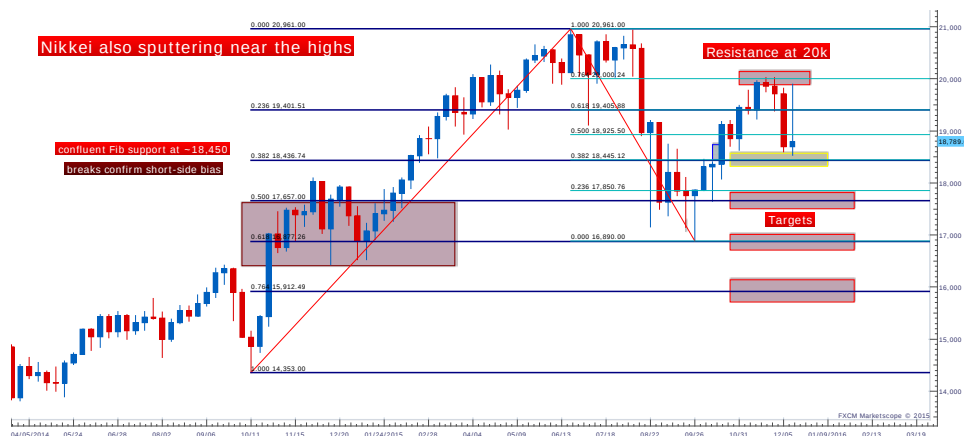
While US stocks and those from many other developed markets recovered in October, emerging markets did not. The meltdown has largely continued in those fledgling economies. And on that screaming comeback, we saw even more signs of weakness outside of the US. The markets that are looking especially primed for weakness outside of the US are in Germany and Japan.

During those major sell-offs in latter August, the DAX looked poised to break below a trend-channel that's held price action for the better part of the past four years. The rebound in October brought prices higher, but not as aggressively as what we saw in the S&P, and this could present a more complex setup for a trade given the further distance from the highs (for stop placement). Traders could look at the potential for a lower-high just short of 11,500 for a tighter stop, and this could open the door for bottom-side targets at those previous lows.



Created with Marketscope/Trading Station II; prepared by James Stanley

And in the middle of the eye of the storm in Asia is Japan; as three years of Abe-nomics haven't yet been able to offset 20+ years of deflationary pressure combined with a sociological conundrum of a dwindling and aging population. But again, should US stocks fall, we'll likely see Japan (as well as Germany) fall along with them.



Created with Marketscope/Trading Station II; prepared by James Stanley

Should these themes of equity weakness develop, we'll likely see all three of these indices facing significant headwinds. But this doesn't mean that anything larger would have to follow. As traders, it's important to trade the next bar on the chart before trying to trade the one after that. Because if you catch some rip against a position or should your stop get triggered, it doesn't matter what happens on that following bar anyways. But for this next quarter, it looks like we may be nearing the time when stock prices around-the-world (finally) begin to correct.

Written by John Kicklighter, Chief Strategist, and James Stanley, Analyst for DailyFX.com

Disclaimer

DailyFX Market Opinions

Any opinions, news, research, analyses, prices, or other information contained in this report is provided as general market commentary, and does not constitute investment advice. DailyFX will not accept liability for any loss or damage, including without limitation to, any loss of profit, which may arise directly or indirectly from use of or reliance on such information.

Accuracy of Information

The content in this report is subject to change at any time without notice, and is provided for the sole purpose of assisting traders to make independent investment decisions. DailyFX has taken reasonable measures to ensure the accuracy of the information in the report, however, does not guarantee its accuracy, and will not accept liability for any loss or damage which may arise directly or indirectly from the content or your inability to access the website, for any delay in or failure of the transmission or the receipt of any instruction or notifications sent through this website.

Distribution

This report is not intended for distribution, or use by, any person in any country where such distribution or use would be contrary to local law or regulation. None of the services or investments referred to in this report are available to persons residing in any country where the provision of such services or investments would be contrary to local law or regulation. It is the responsibility of visitors to this website to ascertain the terms of and comply with any local law or regulation to which they are subject.

High Risk Investment

Trading foreign exchange on margin carries a high level of risk, and may not be suitable for all investors. The high degree of leverage can work against you as well as for you. Before deciding to trade foreign exchange you should carefully consider your investment objectives, level of experience, and risk appetite. The possibility exists that you could sustain losses in excess of your initial investment. You should be aware of all the risks associated with foreign exchange trading, and seek advice from an independent financial advisor if you have any doubts.