No Need to Worry: Positive Trends Remain in Place

Aug 7, 2014 / **By Bill DeShurko, CFP**

Last week's market drop caused a little freakout in the investor universe. Is this the start of a much anticipated correction, or are investors—stretched for yield—just a little jumpy? The 200-day moving average and some industry ETFs offer some clues.

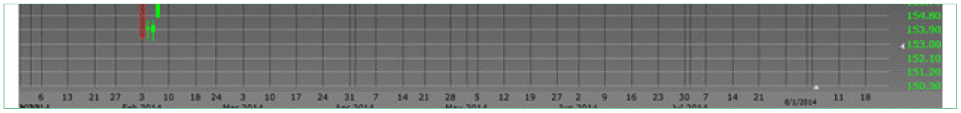
The markets actually went down last week, causing the expected outpouring of bear market prophecies from various talking heads. There appear to be plenty of worries to freak investors out a bit as Société Générale noted:

> *"Disturbing geopolitical events are now added to a list of fundamental investor concerns (QE tapering, a chronic shortage of sensible investment opportunities, weak inflation, lackluster profit growth, etc.) that in our **view were largely being ignored by investors desperate for yield**," [my emphasis] Société Générale's Andrew Lapthorne said in a note to clients Friday.*

So this weekend I did my rounds of the charts to see how "freaked out" we need to be.

First, I looked at the DIA, the Dow ETF, and yup, sure enough, we are right back to where we started in January.

Figure 1: DIA YTD



Source: www.freestockcharts.com

But a look at the broader S&P 500 gives a little brighter picture. In Figure 2, you can see that this is really a continuation of a trend—not a new one. While last week's drop was in the "larger" category, the S&P (SPY) remains well within its uptrend channel of the past 15 months.

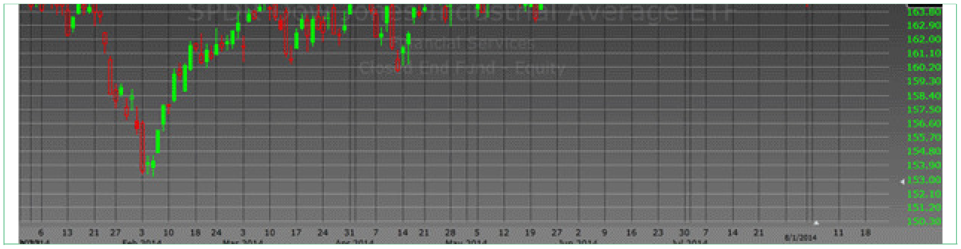
Figure 2: SPY YTD

Source: www.freestockcharts.com

Zooming in, I've extended the lower support line and added the 200-day exponential moving average (200MA) in blue. Two points: The S&P 500 needs to drop to around 1880 before it tests support. And the 200MA isn't much lower, as a cross under the 200MA could come around the 1855 range. This would represent only a 7% drop from the S&P's high.

This could be important to watch. The 200MA is a *big* technical number. The S&P crossing below it is considered a very bearish sign. Selling when this happens would have allowed an investor to miss a good portion of the tech wreck and financial crisis. But that crossover came after the S&P had lost nearly 20%— not a rather non-noteworthy 7%.

Figure 3: SPY 200-Day Moving Average



Source: www.freestockcharts.com

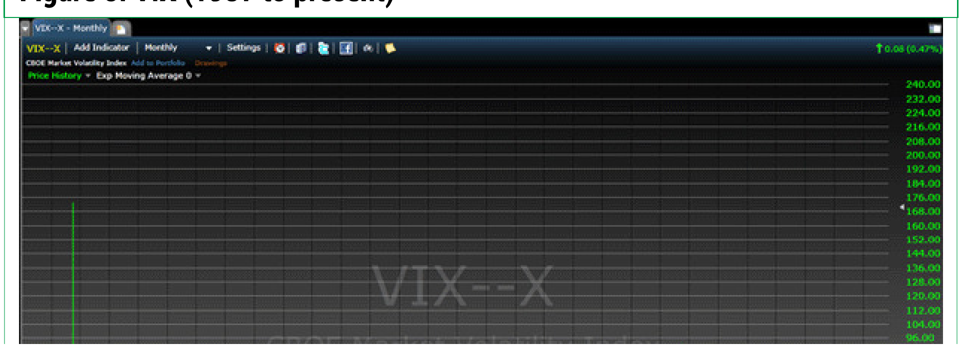
I also took a look at QQQ, the PowerShares Nasdaq ETF. QQQ has been on a very low-volatility, bullish run this year. We had a bit of a stumble in May when QQQ touched its 200MA (yellow arrow), but it bounced off and re-entered its trading range. Like SPY, we are close to support and not far from retesting the 200MA...but we aren't there yet.

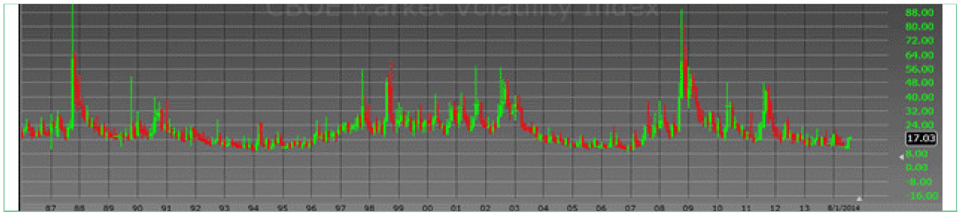
Figure 4: QQQ 200-Day Moving Average

Source: www.freestockcharts.com

Returning quickly to the S&P 500, Figure 5 provides a look at the VIX, or volatility index. While volatility has certainly spiked recently, looking at the longer term since 1987 shows no cause for serious alarm. Based on monthly numbers, the VIX today doesn't look much different than it did during the roaring bull of the mid '90s. A period of heightened volatility would not be beyond the normal range for the VIX in the month or so ahead.

Figure 5: VIX (1987 to present)





Source: www.freestockcharts.com

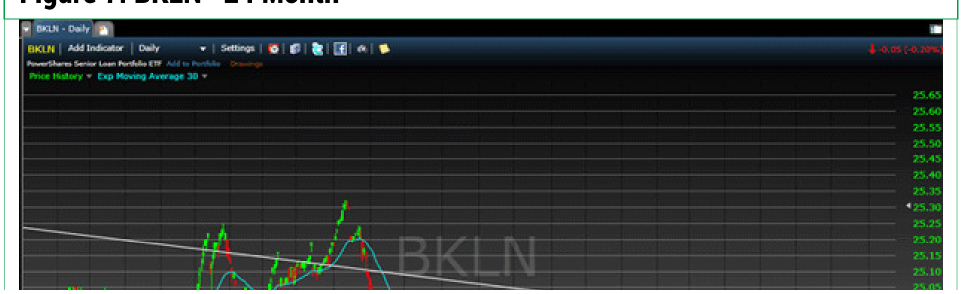
All that said, why did I rebalance our primary investment model to 25% cash last week? A little background. In my dividend and income growth strategy, I try to keep 5% in cash and 20% in JNK as a "normal" position. I market-time JNK, as I have found it to be a reasonable indicator of the strength of the stock market. Below is a chart of JNK, and you can see that its price has fallen through the floor and through its 30-day moving average (30 MA). Notably, the 30 MA has also turned negative.

Figure 6: JNK—24 Months

Source: www.freestockcharts.com

Below I have added a chart for BKLN, PowerShares Senior Loan ETF. Senior loan products have been marketed as "safe" (compared with JNK) high-yield alternatives for clients looking for yield. Volumes have, in fact, been high as new products seem to appear weekly—a sure sign of a bubble. While the percentage drop has been much smaller, share price has, like JNK, dropped through any type of support and the 30MA.

Figure 7: BKLN—24 Month



Source: www.freestockcharts.com

What liquidity means

Anyone who follows the financial press has heard the term "liquidity" repeated over and over, as in "What happens when the Fed removes liquidity from the markets?" The prior two charts are your answer.

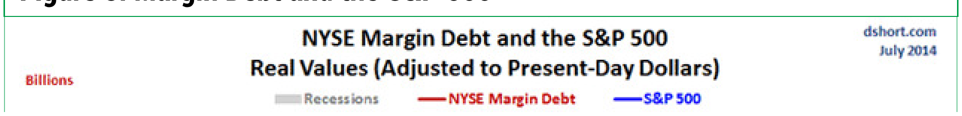
Investors, hungry for yield, have poured billions into high-yield and senior loan investments—money that should be someplace safer, like Treasuries for institutions and municipal bonds or the bank for individuals. The definition of "safe" money is money you don't want to lose in the short run. So whether the threat stems from rising rates or defaults in a softer-than-expected economy, it doesn't really matter. As the charts show, investors ran for the exits in their "stretching for yield" investments.

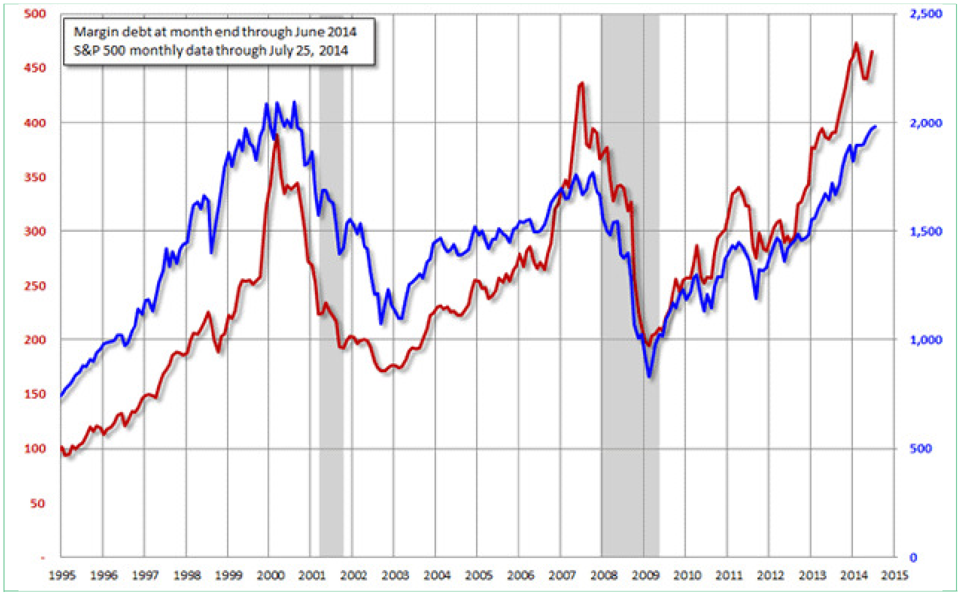
Making sure I have 25% liquid in my accounts serves two purposes. First, it minimizes the damage from the sell-off in the high-yield area. I don't know if it will continue, but I would like to get back into JNK—after the price decline creates a 6%-plus yield. We may not get there, but I hate buying junk bonds and not getting 8%, let alone the 5.5% they were yielding before last week. I might settle for mid-6%.

Second, and this is more important, if there is too much liquidity in the stock market (i.e., money that really shouldn't be there), then, as with JNK and BKLN, there could be a fast and furious rush to the exit if investors feel that their "safe" money isn't so safe. So while I don't see a major reason for a sell-off, if one were to start and gain a little momentum from, say, breaking below the 200MA, then a little correction could turn into a major sell-off very quickly.

Below is my final chart. It looks at margin debt and the S&P 500. In this case I don't think it is a coincidence that they both tend to peak simultaneously. Unwinding leveraged positions can take the market down—fast.

Figure 8: Margin Debt and the S&P 500





Source: Advisor Perspectives

Bottom line

According to Zacks, the S&P 500 is projected to finish 2014 with earnings of $116 per share. This is a P/E of 17.18. While not cheap, this is not the area of major market tops either.

However, if the idea of Fed tightening starts to seriously take hold, there is a lot of money in the stock market that doesn't really belong there. It is money in search of yield, either leveraged or unleveraged.

And if the market sentiment turns sour, we could see a rush for the exits as we've seen in JNK and BKLN—two safe-money parking places for those stretching for yield. I'm thinking I will be able to not only buy back into JNK or BKLN at better prices, but likely find more dividend-paying stocks at much better prices over the next couple of months.

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