Weighing the Week Ahead: Can Earnings Season Spark a Rebound in Stocks?

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We have a normal economic calendar with a focus on housing data. Earnings season will be in full swing. The background for this news will, of course, be the stock market volatility and decline of the past week. That story will command the early-week attention, especially if aggressive selling resumes. Recent earnings seasons have buoyed stocks, leaving the punditry with this question:

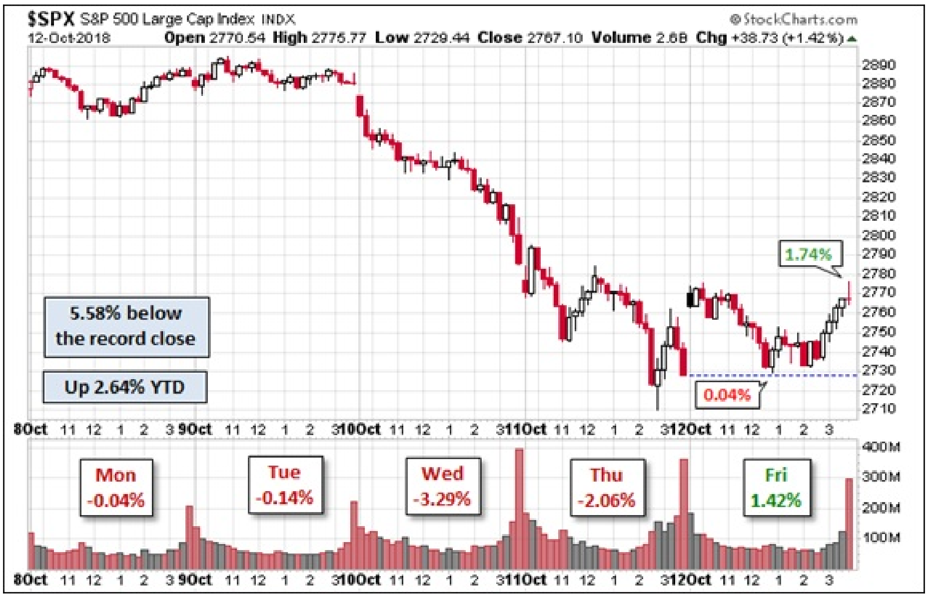
Can earnings season spark a rebound in stocks?

Last Week Recap

In my last edition of WTWA I took note of rising interest rates asking whether they signaled the beginning of the end for the stock rally. That was a good call. The question dominated financial news on Monday and Tuesday, even though stocks barely moved. It was almost as if the news coverage was pre-planned, and events did not matter. That changed on Wednesday, when the major market decline gave legs to the story. The last edition of WTWA provided a good preview of this, but certainly no prediction of the sharp selling.

The Story in One Chart

I always start my personal review of the week by looking at a great chart. I especially like the version updated each week by Jill Mislinski. She includes a lot of valuable information in a single visual. The full post has even more charts and analysis, including commentary on volume. Check it out.



The market declined 4.1% on the week. Wednesday saw the largest single-day loss since February. The weekly trading range was about 6.4%. Volatility spike higher, exceeding the long-term averages. The VIX implied volatility measure remained higher than the actual results. I summarize actual and implied volatility each week in our Indicator Snapshot section below.

Noteworthy

Have you already purchased your last car? Justin Rowlatt (BBC News) raises the provocative question and provides plenty of evidence. Internal combustion engines have 2000 parts, compared to about 20 for electric cars, which may have life spans of 500,000 miles.

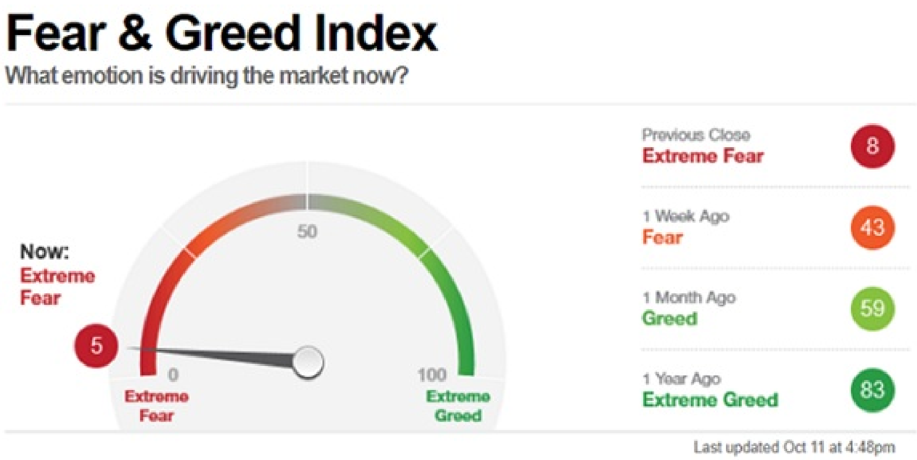
The News

Each week I break down events into good and bad. For our purposes, "good" has two components. The news must be market friendly and better than expectations. I avoid using my personal preferences in evaluating news – *and you should, too!*

When relevant, I include expectations (E) and the prior reading (P).

The Good

- ***Inflation data*** remained benign. PPI registered a gain of 0.2% up from P of -0.1% but in line with expectations. CPI gained only 0.1% P 0.2% headline and 0.1% core. E 0.2%.
- ***High Frequency Indicators*** have turned positive, including the long-leading cluster. New Deal Democrat's helpful weekly update breaks the data into two groups, providing both detail and a summary on each. The long-leading group has shifted back and for recently, and he continues to monitor it closely. For now, it is positive.
- ***Economic growth*** for Q3 and forward remains strong. Calculated Risk summarizes the key sources, "It looks like GDP will be in the 3s in Q3″.
- ***Market sentiment*** has turned negative – very negative. David Templeton (HORAN) updates the Fear and Greed picture, a positive contrarian factor.



The Bad

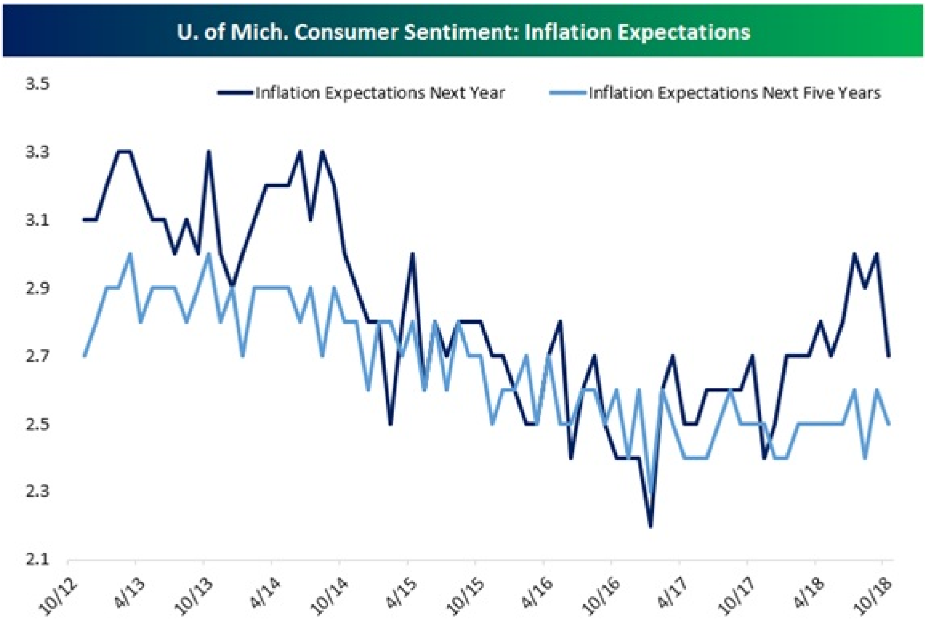
As has been the recent case, most of the "bad" news consists of indicators slightly off the best levels.

- ***NFIB Small Business optimism*** was slightly off the high from last month – 107.9 vs. 108.8. Bespoke also looks at the reasons behind the headline number.

NFIB Most Important Problem: September 2018

	Percent (%)		
Problem	**September**	**August**	**Change**
Quality of Labor	22	25	-3
Taxes	17	15	2
Govt Red Tape	14	13	1
Cost of Insurance	10	9	1
Competition	10	8	2
Other	8	11	-3
Cost of Labor	8	8	0
Poor Sales	5	7	-2
Inflation	3	2	1
Fin & Interest Rates	3	2	1

- ***Initial jobless claims*** rose to 214K E 208K P 207K
- ***Michigan sentiment*** declined to 99.0 E 100 P 100.1. Bespoke notes that sentiment remains near the recent highs and highlights the move in inflation expectations. Expectations for income growth were also lower. The survey period captured only part of last week's decline, and probably none of it for most respondents.



The Ugly

Hurricane Florence led to 51 deaths and estimated damages of $30 billion to $50 billion. The events have also exposed other problems. The Bipartisan Policy Center provides a good analysis, with this comment on some needed reforms:

> Hurricane Florence has, like many other recent disasters, exposed a variety of flaws in the pre-disaster and post-disaster policies of the United States. These gaps undermine the nation's resilience, endanger residents, and further jeopardize the soundness of already aging infrastructure. For immediate recovery needs, Congress has repeatedly turned to supplemental funding as short-term fixes, but to prevent this level of destruction from reoccurring in the wake of the next disaster, there needs to be a dramatic overhaul of the national infrastructure investments and disaster framework. Spending more upfront, with a focus on increased resiliency and mitigation, saves money when a disaster hits. For every $1 spent on mitigation, an estimated $6 is saved that otherwise would have been spent in recovery costs.

The Week Ahead

We would all like to know the direction of the market in advance. Good luck with that! Second best is planning what to look for and how to react.

The Calendar

The calendar is a big one, with a strong emphasis on housing. Also featured will be retail sales, the Fed minutes, and leading indicators. The Philly Fed has its fans, and it has had some market-moving moments. A favorite of mine is the JOLTS report, which has special significance as our best read on the tightening labor market.

It is also a big week for Q3 earnings reports, where we had our first taste last week. Many large companies will report. Expectations are for continuing increases in the 20% range on a year-over-year basis. (Barron's).

Briefing.com has a good U.S. economic calendar for the week (and many other good features which I monitor each day). Here are the main U.S. releases.

Week of October 15 - October 19								
Date	ET	Release	For	Actual	Briefing.com Forecast	Briefing.com Consensus	Prior	Revised From
Oct 15	08:30	Retail Sales	Sep		0.8%	0.6%	0.1%	
Oct 15	08:30	Retail Sales ex-auto	Sep		0.5%	0.4%	0.3%	
Oct 15	08:30	Empire Manufacturing	Oct		18.0	18.0	NA	
Oct 15	10:00	Business Inventories	Aug		0.5%	0.5%	0.6%	
Oct 15	14:00	Treasury Budget	Sep		NA	NA	$7.9B	
Oct 16	09:15	Industrial Production	Sep		0.1%	0.3%	0.4%	
Oct 16	09:15	Capacity Utilization	Sep		78.1%	78.2%	78.1%	
Oct 16	10:00	JOLTS - Job Openings	Aug		NA	NA	6.939M	
Oct 16	10:00	NAHB Housing Market Index	Oct		67	67	67	
Oct 16	16:00	Net Long-Term TIC Flows	Jul		NA	NA	$74.8B	
Oct 17	07:00	MBA Mortgage Applications Index	10/13		NA	NA	-1.7%	
Oct 17	08:30	Housing Starts	Sep		1230K	1221K	1282K	
Oct 17	08:30	Building Permits	Sep		1280K	1273K	1229K	
Oct 17	10:30	Crude Inventories	10/13		NA	NA	+5.99M	
Oct 17	14:00	FOMC Minutes	Sep		NA	NA	NA	
Oct 18	08:30	Initial Claims	10/13		210K	212K	214K	
Oct 18	08:30	Continuing Claims	10/06		NA	NA	1660K	
Oct 18	08:30	Philadelphia Fed	Oct		21.0	20.0	22.9	
Oct 18	10:00	Leading Indicators	Sep		0.6%	0.5%	0.4%	
Oct 18	10:30	Natural Gas Inventories	10/13		NA	NA	+90 bcf	
Oct 19	10:00	Existing Home Sales	Sep		5.28M	5.30M	5.34M	

Next Week's Theme

Once again, I expect last week's news to linger into the week ahead. My hope is that the story will turn to earnings season and substantive stock news. For the moment everyone is preoccupied with last week's big stock declines. Mrs. OldProf and I were watching an interview with a European notable who described the stock decline as either a healthy correction or the start of a new trend. She astutely observed that he certainly had all the bases covered! By week's end I expect pundits to be asking:

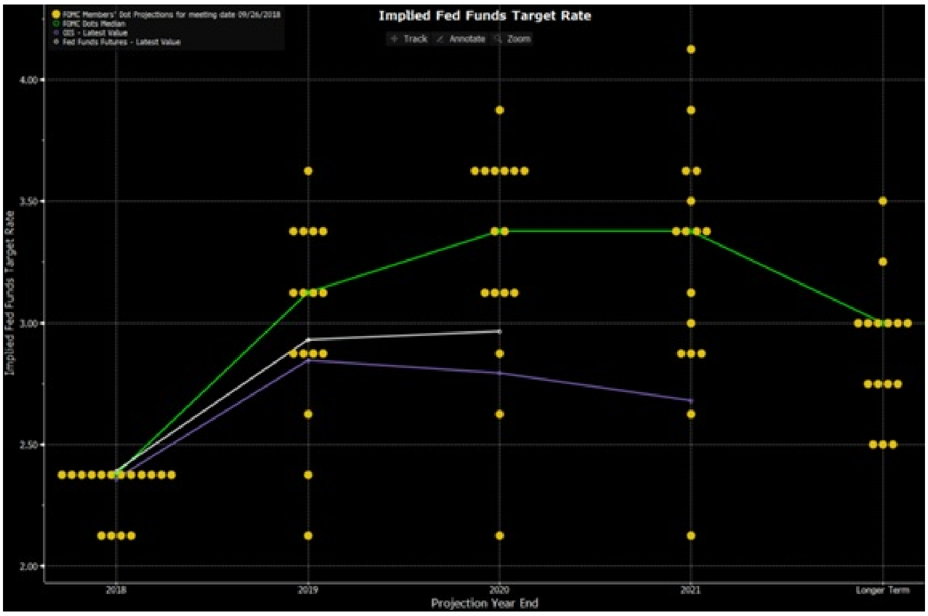
Can earnings season generate a rebound in stocks?

But for the moment, we need to review the week behind. Sometimes an understanding of that is necessary to plan for the week ahead.

As is my custom, I will cite a range of viewpoints and include some links. I will organize these into two sections: Alleged causes and Recommended strategies.

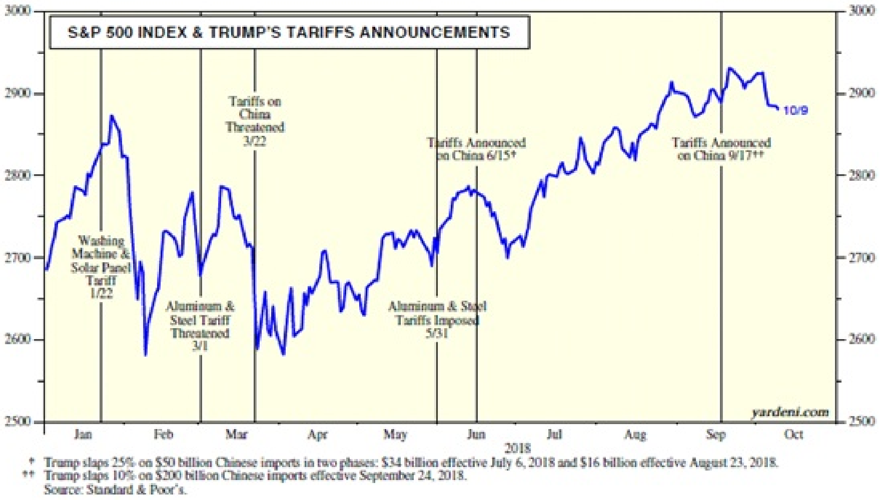
Causes

- Valuation – Always cited when stocks move a bit lower.
- Profit Taking – A tried and true reason when a rising market changes course. Barron's, which also mentions some of the other potential causes listed here).
- The Fed – Now apparently less data dependent, planning to keep raising rates above neutral regardless of the strength of the economy. Leading Fed guru Tim Duy notes the increased importance of the "dot plots," the report of individual Fed participants expectations for future rates.



- Tariffs – Dr. Ed Yardeni analyzes the impact of various tariff announcements and muses on the possibility that a trade war with China is now the “base case” as JP Morgan suggests. Dr. Ed believes:

> …the US economy will be strong enough to boost S&P 500 earnings by 6.8% to $173 per share, which has been our number for next year for a while. I don’t think that the escalating trade war with China will be the event that ends the bull market in the US (Fig. 3). However, it may already be marking the beginning of a severe and prolonged bear market in China (Fig. 4).



- Interest rates – The standard shorthand explanation from major news sources.
- Technical signals – Eddy Elfenbein notes that Thursday’s trading took the S&P 500 below its 200-day moving average, a widely-followed technical indicator. Eddy also observes that panic is not indicated. The two-day loss is not that unusual, and not even the worst for 2018. The chart below illustrates both points.

- Algorithms — blamed for anything and everything.
- Emotion — *Just another panic attack* writes Scott Grannis. He concludes, “It wouldn’t be surprising to see prices decline further, but it would be surprising if this proved to be the beginning of a major rout or recession”. In his summary of key indicators, he includes an interesting chart of VIX peaks. He creates a ratio with the ten-year note yield. It is a coincident measure.

What to do now?

- Buy bonds, say bond fund managers and bond research houses. Flirting with Models offers some alternatives for diversification.
- Buy gold (or silver) say the fear-inspiring commercials.
- Sell everything – the verdict of many investment newsletters
- Don't panic? Cullen Roche explains why this admonition is not helpful.
- Buy the dip – David Templeton (HORAN) takes a good look at the data, concluding:

> Some might say the decline has caused damage to the market, but a better phrase might be created opportunity. As the below chart shows only 11% of S&P 500 stocks are trading above their 50 day moving average. The last time this occurred was in February earlier this year. That turns out to be a low point in the market so far in 2018. In regards to the 200 day moving average, 41% of stocks are trading above that level, again similar to the early 2018 market low.

- Buy with both hands – Ralph Vince sees the current opportunity as "juicy."
- Get perspective by considering data – then figure out how it applies to you. Brett Steenbarger explains both.

In today's Final Thought, I'll add a few of my own observations.

Quant Corner

We follow some regular featured sources and the best other quant news from the week.

Risk Analysis

I have a rule for my investment clients. ***Think first about your risk. Only then should you consider possible rewards*** I monitor many quantitative reports and highlight the best methods in this weekly update.

The Indicator Snapshot

Risk Indicator	Current	Last Week	Last Month	Last Quarter	Interpretation
Valuation					
Ten-year note yield	3.16%	3.23%	3.00%	2.83%	
S&P 500	2767	2886	2905	2801	
S&P Forward Earnings	174	169	169	168	
S&P Earnings yield	6.27%	5.85%	5.82%	6.01%	
Equity Risk Premium	3.11%	2.61%	2.82%	3.18%	Very High
Economy					
C-Score	323	332	373	276	9 MoRecession Prob about 24%
*Leading SuperIndex**	0.88%	1.04%	0.96%	1.00%	3-4 MoRecession Prob
BCIp	99.3	100.0	100.0	100.0	No recession indicated
SLFSI	-1.263	-1.295	-1.267	-1.118	Very Low Risk
Anticipated Inflation	2.16%	2.16%	2.10%	2.11%	
VIX	24.98%	14.22%	12.07%	12.58%	
Historical S&P Volatility					
Last Five Days	29.68%	7.64%	9.14%	11.87%	
Last Twenty Days	15.87%	6.43%	8.33%	10.39%	
Technical Health					
Short-term	2	1	1	2	Bullish
Long-term	1	1	1	1	Strongly Bullish
Overall Outlook	Str. Bull	Str. Bull	Str. Bull	Str. Bull	
Sources: Stlouisfed.org, RecessionAlert.com, iMarket Signals, fundamentalis.com, and NewArc Investments, Inc. ©2018					
	*SuperIndex is the public value, delayed one month				

Short-term trading conditions remain favorable, despite some deterioration. The overall health indicator for our models remains positive, although some of the individual models stopped out specific positions. Super-high volatility is not attractive for most trading systems. If these high levels continue, I expect further deterioration next week. The VIX spiked much higher than actual volatility, indicating sentiment worse than the reality.

Fundamentals indicators are all solid, with stocks much more attractive than recently. The earnings yield advantage over the S&P 500 has improved significantly.

The Featured Sources:

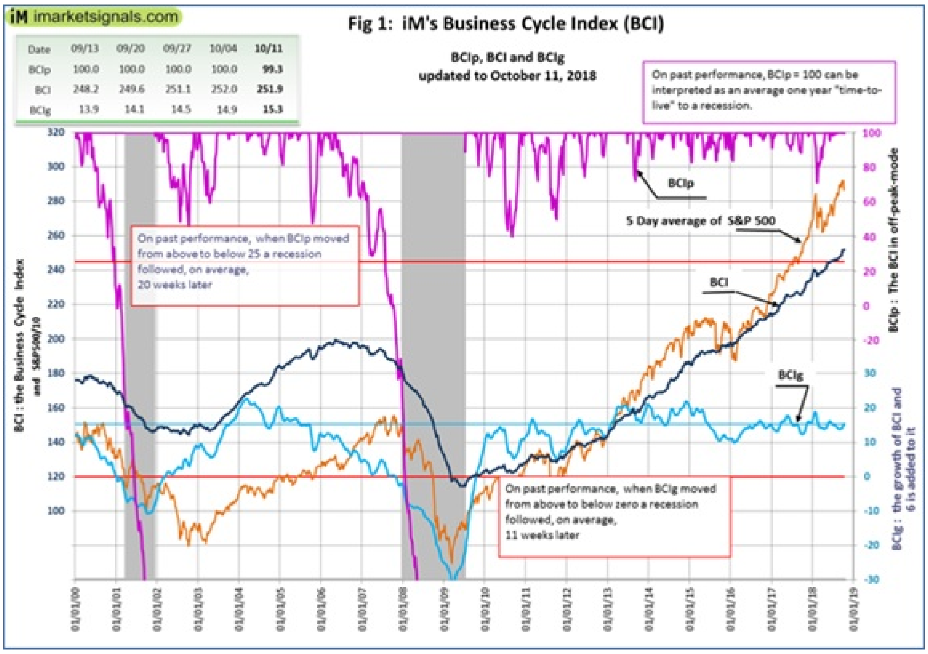
Bob Dieli: Business cycle analysis via the “C Score.

Brian Gilmartin: All things earnings, for the overall market as well as many individual companies.

RecessionAlert: Strong quantitative indicators for both economic and market analysis.

Doug Short and Jill Mislinski: Regular updating of an array of indicators. Great charts and analysis.

Georg Vrba: Business cycle indicator and market timing tools. None of Georg’s indicators signal recession. Here is the latest chart on the Business Cycle Index.



Insight for Traders

Check out our weekly Stock Exchange post. We combine links to important posts about trading, themes of current interest, and ideas from our trading models. This week we asked whether traders thought they could actually understand the stock market. Or perhaps they were just pretending. In many ways, it is a companion to today's post, but with a trader orientation. We shared advice by top trading experts and discussed some recent picks from our trading models. Our ringleader and editor, Blue Harbinger, provided fundamental counterpoint for the models, all of which are technically-based.

Insight for Investors

Investors should have a long-term horizon. They can often exploit trading volatility.

Best of the Week

If I had to pick a single most important source for investors to read this week it would be Ashby Daniels' (Retirement Field Guide) discussion of emotions and retirement planning. He illustrates his ideas with the story of an actual investor who made a knee-jerk market call that turned out well – at least for a few percentage points. Now what?

He writes:

> Many people are quick to say that they aren't market timers (nobody likes to be labeled as such), but then in the next sentence proceed to ask what I think of the market and whether now is a good time to invest more or to take some chips off the table.

> In fact, the question, "What do you think of the market?" is by far the most popular question that I get asked. I just want to be on the record in saying that, "Anything other than establishing a portfolio built specifically for you and sticking with that portfolio is an attempt at market timing." With the exception of life changes, how could it be anything else?

Read the full article for some good ideas about how to plan and stick to the plan. [Jeff – I suppose I like his approach since it is so close to my own, but there is nothing wrong with that].

Stock Ideas

Chuck Carnevale provides his usual comprehensive analysis combined with a lesson in using data. He sees Whirlpool [WHR] as a cheap stock with little downside. Be sure to watch the video to see why he calls this a “fire sale valuation.”

Blue Harbinger also surveys beaten-down names and finds one from his watch list, Ship Finance International (SFL).

Alphabet? (GOOG) Stone Fox Capital likes the opportunity, IF the company dodges or resolves regulatory issues.

They also like Advanced Micro Devices (AMD), calling market fears about competition with Intel (INTC) unwarranted.

Eddy Elfenbein does not make a specific recommendation, but he takes note of the current weakness in semiconductors, after years of strength.

Personal Finance

Seeking Alpha Senior Editor Gil Weinreich’s Asset Allocation Daily is consistently both interesting and informative. His upbeat analysis, *4 Ways to Prevail Over Automation*, is factual, pragmatic, and inspirational. Later in the week, his thoughts were more sobering. He challenged investors to consider how they would consider a prolonged decline. That is a topic that everyone should think about in advance.

Abnormal Returns is an important daily source for all of us following investment news. HisWednesday Personal Finance Post is especially helpful for individual investors. This week had several good posts on retirement. I especially likedMike Piper’s warning that you might not be able to pick your retirement age. He combines data with some good examples. And, today’s Best of the Week (above).

Watch out for…

Bonds. The Mad Hedge Fund Trader says *The Fat Lady is Singing for the Bond Market*

Final Thought

What caused the sharp market decline? Interest rates are a poor explanation, since the entire yield curve was the same on Wednesday morning as it was on Friday. Astute traders scoffed at the explanations offered (Avi Gilburt).

I covered the possible pattern in last week’s edition, which was an accurate preview. Briefly put, a smidgen of news sparks some trading from both human traders and algorithms. This is directionally correct, but without analysis of the overall significance. The selling often spreads to an ETF that has concentrations in the affected stocks. Sometimes prices that are viewed by some as important “technical” levels are violated. This sparks selling by a different group of traders. Despite the lack of overall logic or a cohesive explanation, the financial news must satisfy demand for an explanation. I wrote last week:

> Every time the market makes a small move we are bombarded by observers predicting the worst. It is important to remember that declines of 15-20% happen regularly and without any particular reason. No one can predict these accurately, so the average investor should learn to take advantage of the movement rather than falling for the persistent pseudo-warnings. Alan Steel calls it the *Fear Economy*, and reviews the history of predictions by one prominent uber-bear.

Alan Steel has another great post. Starting with a bearish call from one economist from a big institution, he traces the consequences:

> Let's face it they'd seen articles written by "proper experts" reminding readers that October was a dangerous month to invest in shares.

> Mark Twain used to say that yonks ago. Although he also reckoned that February, December, August, May, January, July, September, March, November April and June were, too. Say no more.

> No matter what we said this couple of perpetual worriers cashed out and stuck their significant life savings in bank deposit, assuring us they'd reinvest when it felt better. So when would that be? "When the market's higher of course". No, they didn't spot the irony. So three years later how have they done? Not good I'm afraid . Earned literally sod all in interest, and lost money in real terms thanks to inflation.

And also this….

> In August 2010 an analysis was made of ten renowned economic experts and their predictions related to an imminent "double-dip recession" in the wake of the 2007/8 Great Financial Crisis. They included well –known revered figures including Robert Shiller (Prof at Yale University), Bill Gross (Former managing partner at PIMCO), Nouriel Roubini (Prof at New York University) as well as those economists representing Goldman Sachs, The Institute of Directors and the National Institute for Economic and Social Research.

> They all saw the probabilities of a double-dip recession as higher than normal. One or two saw the probability as high as 50% to over 60%. And they were wrong. Unless you count the fall in demand for Hummus and Taramasalata in Greece.

[A few months earlier, in May of 2010, I challenged these ideas with my Dow 20K call – the market doubling rather than being cut in half. There were plenty of skeptics, especially on Seeking Alpha. Or this halfway update. And finally, the 2016 CNBC coverage. The important takeaway is that the key indicators I am using have not changed, nor has the avalanche of negativity. The time to worry will come – probably when recession odds move higher.]

Barry Ritholtz offers a challenge on the same concept. He notes that the factors alleged to underly the decline were well known in advance. So many offered great explanations with the benefit of hindsight. But not on Tuesday.

What now? ***Your best course of action depends upon your personal circumstances and time frame.***

If you are a trader, follow your system. Use your stops to exit positions. Get ready for another day.

If you are a passive investor with an "all-weather" portfolio, you should not do anything. This sort of move comes with the territory. If you find it disturbing, then your stock position may be too large. Or you need to spend less time watching the news!

If you are an active investor who determines values of the companies you hold and price targets for the stocks, you should ignore the opinion of the emotional Mr. Market. Take advantage of price disparities to buy or sell as indicated. Volatility provides opportunity.

[If you find these recommendations difficult, you may be using the wrong method. We combine these perspectives to right-size risk. My two papers on investor pitfalls and understanding risk are available at no charge. Just email main at newarc dot com.].

I'm more worried about:

- China trade. Any mention of progress or lack thereof generates an immediate market reaction. This issue is important and could provide the catalyst for major gains.
- The LIBOR transition. This reference rate for many contracts has proven to be both unfair and unstable. Improvements are coming, but Richard Berner (Bipartisan Policy Center) warns that we should not be complacent during the transition.

I'm less worried about:

- Earnings growth. Can it be a catalyst again this month? The reaction to conference calls will give us a sense of the market mood.