

Rally Fails As Gridlock Weighs On Outlook



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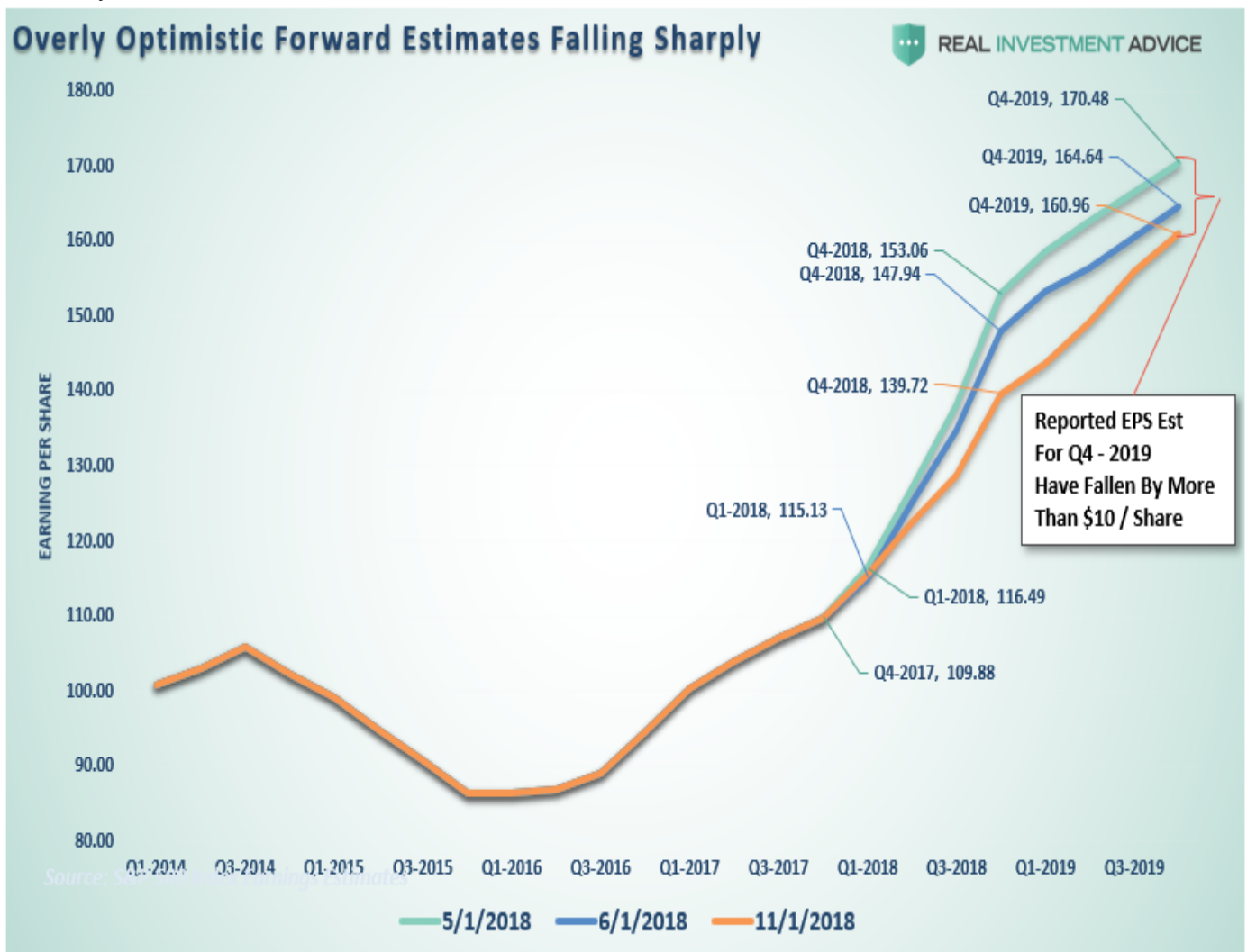
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Market Rally Fails Key Resistance

Last weekend I discussed the fact we had started using the rally to lift some exposure out of portfolios ahead of the mid-term elections simply as a hedge for the "unknown." Well, on Tuesday, the ballots were cast and while the Republicans were able to hold onto the Senate, they lost the House. As I [wrote on Tuesday](#), where the markets are concerned, that may not be a bad thing.

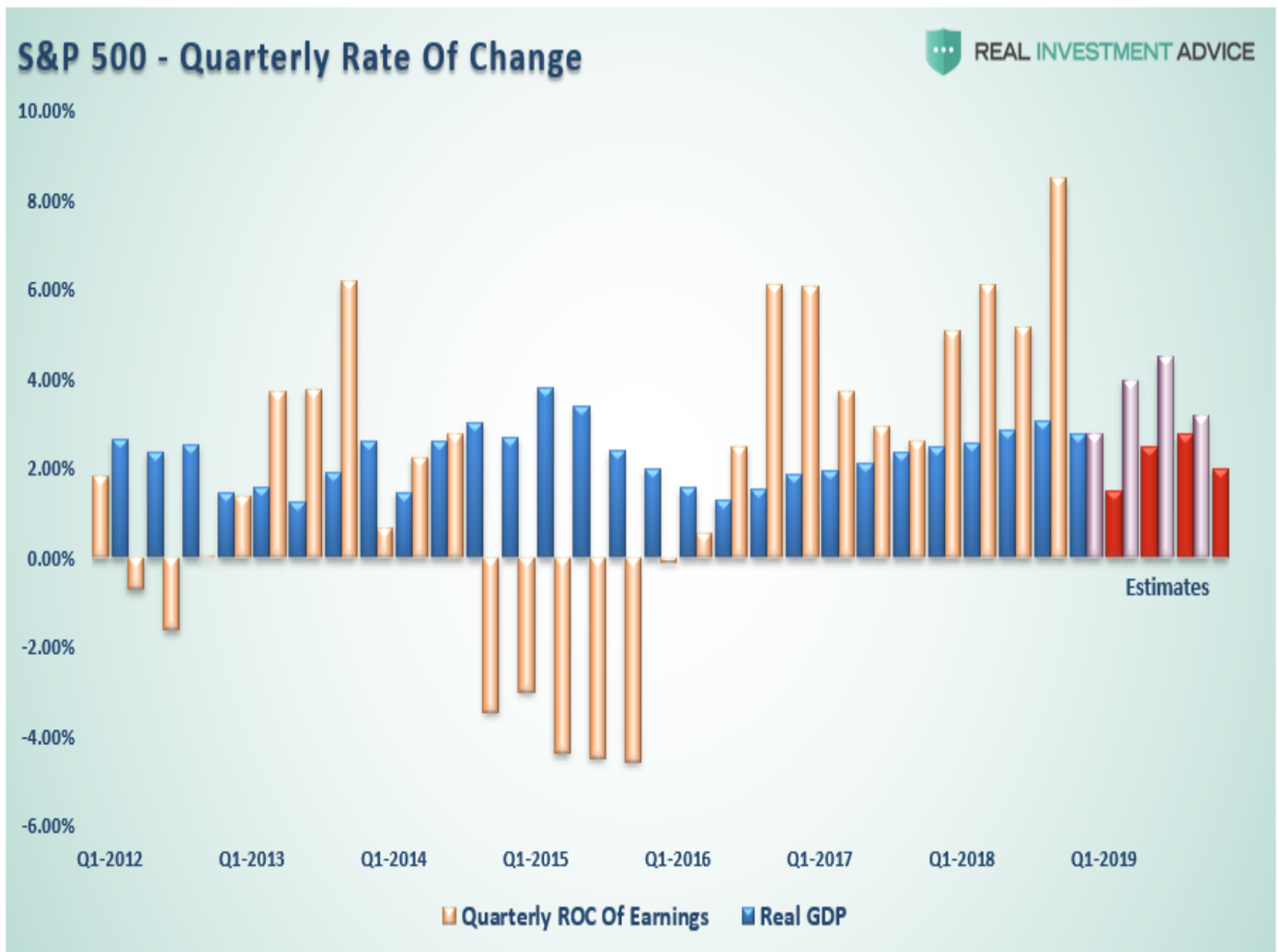
"The safest outcome for the markets, and the economy, is what is most likely. The Republicans will likely retain control of Congress but will lose enough seats in the House to make passage of any of the 'Trump agenda' unlikely. This will result in Congressional gridlock which will limit any substantive changes over the next couple of years. The markets have historically favored gridlock and would likely be a short-term positive for stocks."

That was indeed the "sigh of relief" seen by the markets on Wednesday as the bulls created a massive one day advance that pushed the markets above key resistance levels. Unfortunately, it didn't take long for investors to return their focus back to the things which are going to matter the most - **corporate earnings and monetary policy**. As I noted in Thursday's [missive on rising headwinds](#) to the market, earnings expectations have already started to get markedly ratcheted down for the end of 2019.



More importantly, beginning in 2019, the quarterly rate of change in earnings will fall back to the expected rate of real economic growth. (Note: these estimates are as of 11/1/18)

from S&P and are still too high relative to expected future growth. Expect estimates to continue to decline which allow for continued high levels of estimate ?beat? rates.)



So, really, despite all of the excitement over the outcome of the mid-terms, it will likely mean little going forward. The bigger issue to focus on will be the ongoing impact of rising interest rates on major drivers of debt-driven consumption such as housing and auto sales. **Combine that with a late stage economic cycle colliding with a Central Bank bent on removing accommodation and you have a potentially toxic brew for a much weaker outcome than currently expected.** As my friend and mentor Doug Kass recently noted, the election has only served to "poison" the political pot even further.

"The ugliness of the political scene over the last two years is likely to get more ugly. Though Trump will likely be emboldened - there is now a fundamental difference and divide from the recent past ("checks and balances"). The President no longer has a subservient (Republican) House to deal with anymore - the new (Democratic) House is in marked opposition to his agenda. The President will continue to argue that he is at the epicenter of power - but he no longer is. ¶As we move towards 2020, the U.S. political scene is headed for a period of elevated animus (even more than we have seen in the past few months) between the Democratic and Republican parties. Whether it's the affirmation/restoration of voting rights, gerrymandering, infrastructure, the border wall (and other immigration moves), healthcare, etc. - rhetoric will grow even more heated. In the lame duck session, there will be plenty of fighting over the border wall and other Trump initiatives - it will get messy. I suspect little, administratively, will be achieved over the next 12-18 months."

He is most likely correct. **It is likely little will get done as the desire to engage in conflict and**

positioning between parties will obliterate any chance for potential bipartisan agenda items such as infrastructure spending. Furthermore, there is more than a significant risk to the financial sector with the Democrats now in control of the house. The financial services committee has the support of Democratic members of both the House and the Senate to launch new regulations aimed at increasing oversight on major banks. Given the amount of leverage currently being used to support the financial markets - this could pose a real threat to both the sector, the economy, and the overall markets. **Note:** *we sold our financial holdings last week.* **With portfolios reduced to 50% equity, we have a bit of breathing room currently to watch for what the market does next.**

Daily View

Despite the decline of the market during October, investors really never showed much in terms of "fear." Volatility never spiked much above the long-term average of 20, interest rates didn't decline much, and investor's quickly got back their bullish attitudes. However, despite the lack of concern, as noted previously the market has now violated its longer-term bullish trend which is concerning and, as noted last week, downside risk through the end of the year continues to outweigh the potential reward. **It is EXTREMELY important the market rally next week above Wednesday's highs or we will likely see another decline to potentially test the recent lows.**

Action: *After reducing exposure in portfolios previously, we will look for opportunities to reduce risk further as needed. Sell weak positions into any market strength on Monday.*



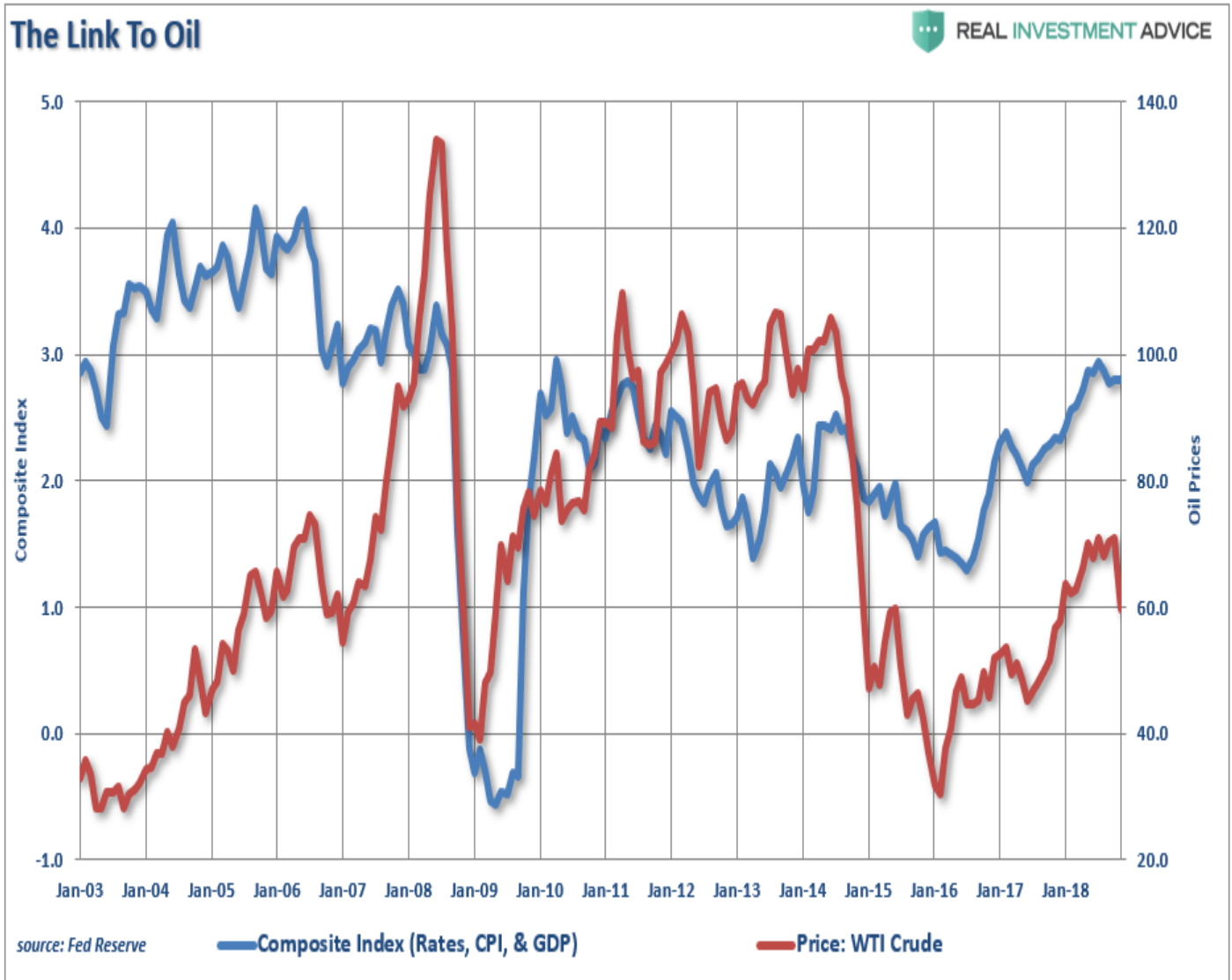
Weekly View

The action this past week continues to confirm the change in the backdrop of the markets from bullish to bearish. The failure of the market to break out of the current trading range this past couple of weeks sets investors up for disappointment. **It is critically important the market does not violate the trading range lows on a weekly closing basis.** As stated above, the market must rally next week, and close above the current trading range, or things will likely become more difficult. As we saw this past week, there is significant resistance to any potential rally both at the short-term moving average and the running bullish trend line. Therefore, upside remains limited currently. *(Also note that a major difference between the current selloff and that in February is the break of the bullish trend line. This is symptomatic of a market topping process.)* **Action: Sell weak positions into any strength on Monday and reduce exposure as needed.**

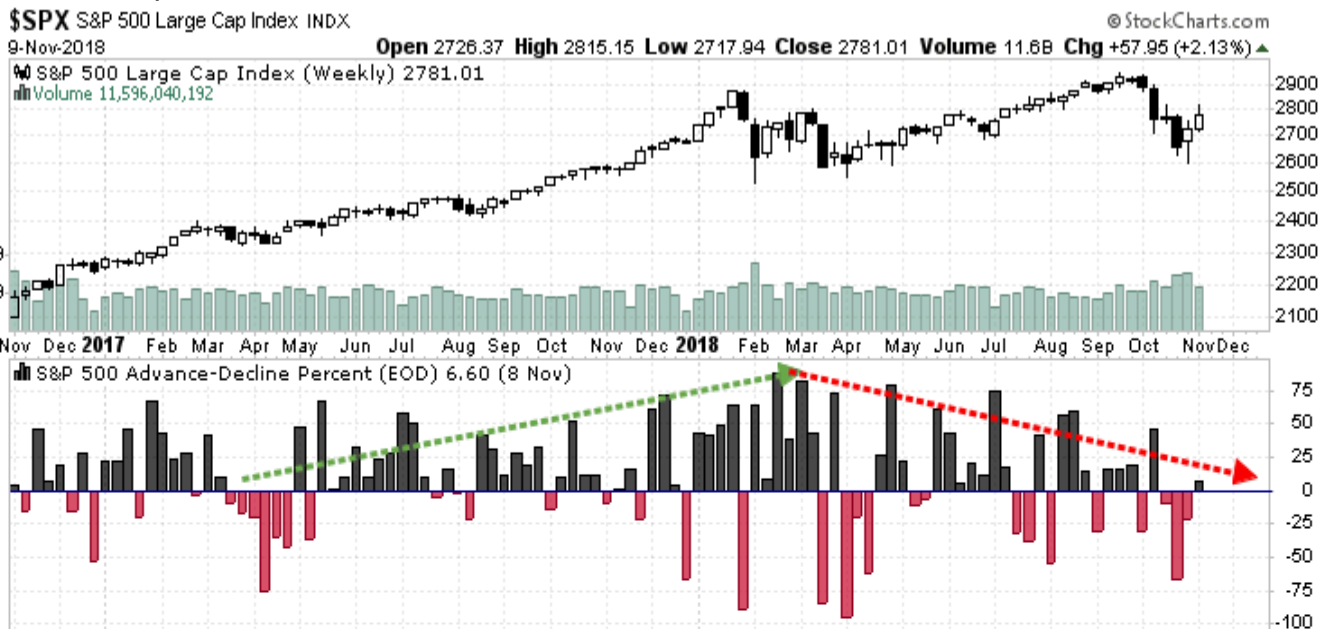


Of much greater concern currently is the breakdown in crude oil prices. There is a very high historical correlation between the direction of oil prices and the economy. *(Since just about*

everything economically is touched by oil in some capacity the relationship makes sense.)� The chart below shows oil versus a composite index of interest rates, GDP, and CPI.

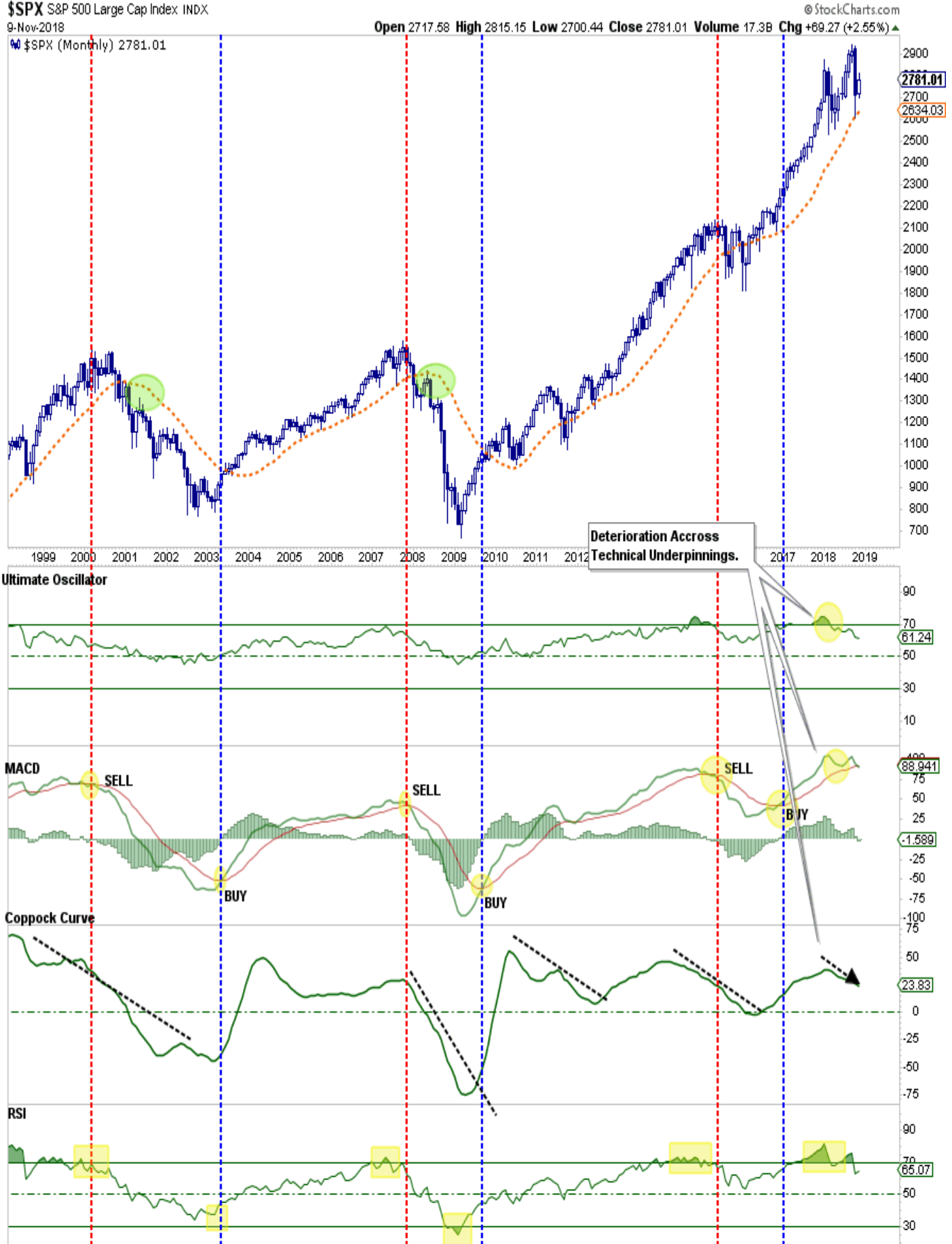


The decline in oil suggests that economic growth over the next couple of months is likely to be substantially weaker than current projections. Weaker economic growth will also show up in further declines in forward operating estimates which are already under pressure. **This will continue to erode one of the key underpinnings of the bulls which has been "stocks are cheap based on forward estimates."**� Lastly, participation in the markets remains extremely weak. This is just another indication of the change in the "tenor" of the market to a more bullish backdrop.



Monthly View

On a monthly basis, the backdrop has also worsened. RSI has dropped into correction territory along with a confirmed monthly sell signal. As I noted back in both December and September, extensions of the market that move 3-standard deviations above the long-term mean are unsustainable. The chart below is a broad technical look at longer-term indicators. Notice that these indicators have only previously unanimously aligned when the market was reversing its trend. That global alignment is occurring once again.



Action: *Reduce risk on rallies, as detailed above, and look to add hedges on any breaks of long-term support* None of this should be misconstrued as an alarm to go "sell everything you own and buy gold" tomorrow. However, there are increasing indications that such could be the case sooner than many expect. Let's review our actions for next week.

Actions To Take Next Week

The failed rally on Wednesday continues to suggest the broader market complex remains substantially weak for now. This keeps our portfolio management practices more focused on capital preservation currently rather than trying to capture short-term gains. As noted we have already taken the following actions:

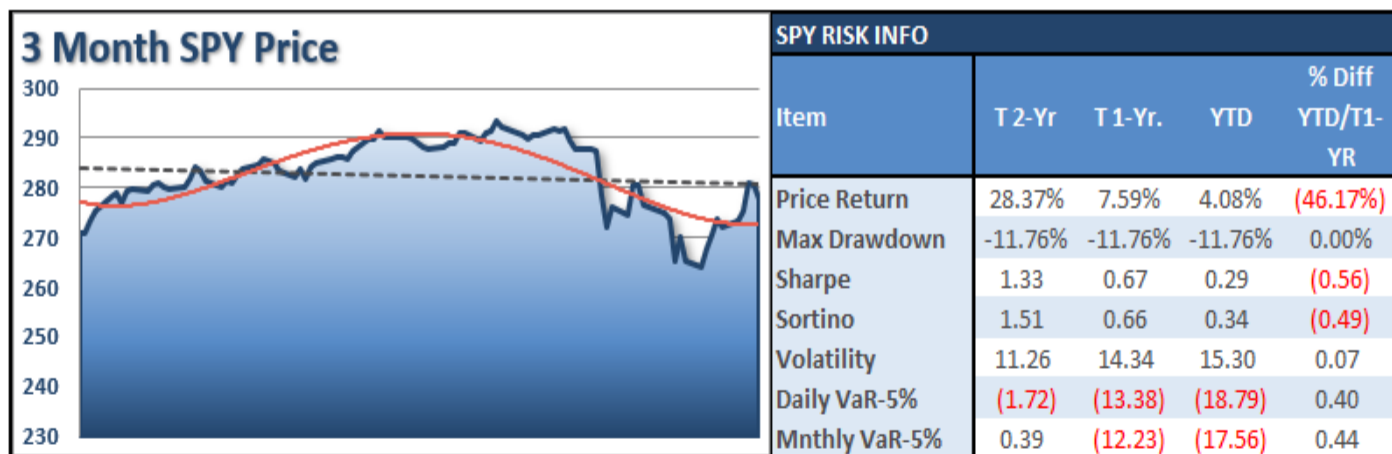
1. **Reduced overall portfolio exposures to 50/50 from 60/40.** *Allocations will be reduced further upon increased technical deterioration.*
2. **Rebalanced bond exposures and reduced risk.** *We improved credit quality and are positioning for economic weakness and lower yields by managing durations* [. \(Read: The Upcoming Bond Bull Market\)](#)
3. **Raised cash levels to 10%.** *(Cash is a risk-free portfolio hedge)*
4. **Reviewed all positions** *We sold several positions which were underperforming the broader market to reduce portfolio drag.*
5. **Planned for further hedges to portfolios** *(Short term treasuries, cash, and short positions on breaks of support)*
6. **Drastically tightened up stop losses.** *(We had previously given stop losses a bit of leeway as long as the bull market trend was intact. Such is no longer the case.)*

We are reviewing our bond allocations further to set portfolios in the right position for a sharp reversal in rates. We are also looking opportunities in other distressed areas of the market which may provide a both a "safe haven" against further market declines and also an opportunity for capital appreciation. As always, we will keep you apprised of what we are thinking. You can also follow our actual portfolio models and positioning at [RIA PRO](#). **See you next week.**

Market & Sector Analysis

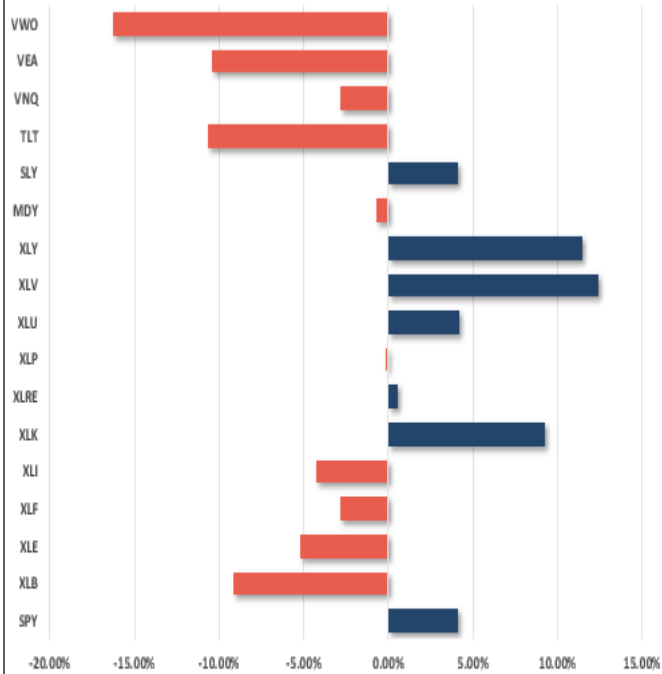
Data Analysis Of The Market & Sectors For Traders

S&P 500 Tear Sheet

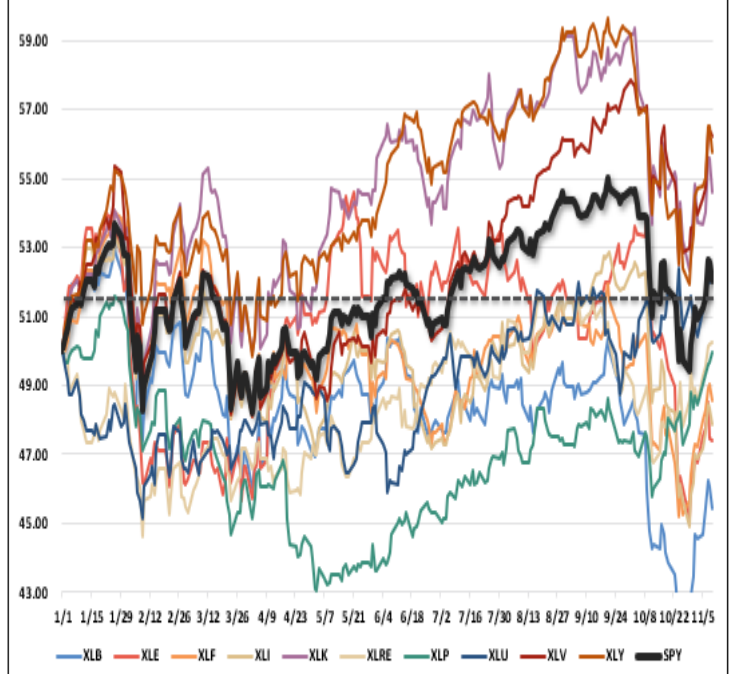


Performance Analysis

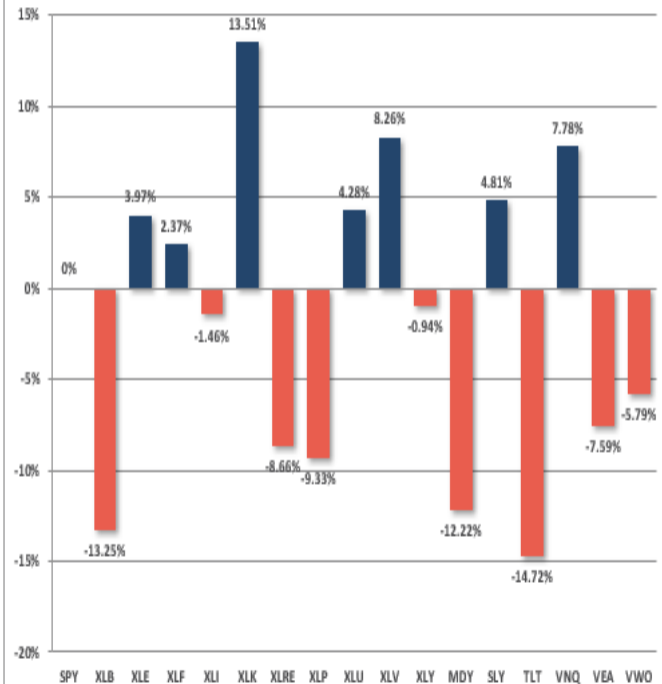
Year To Date Performance



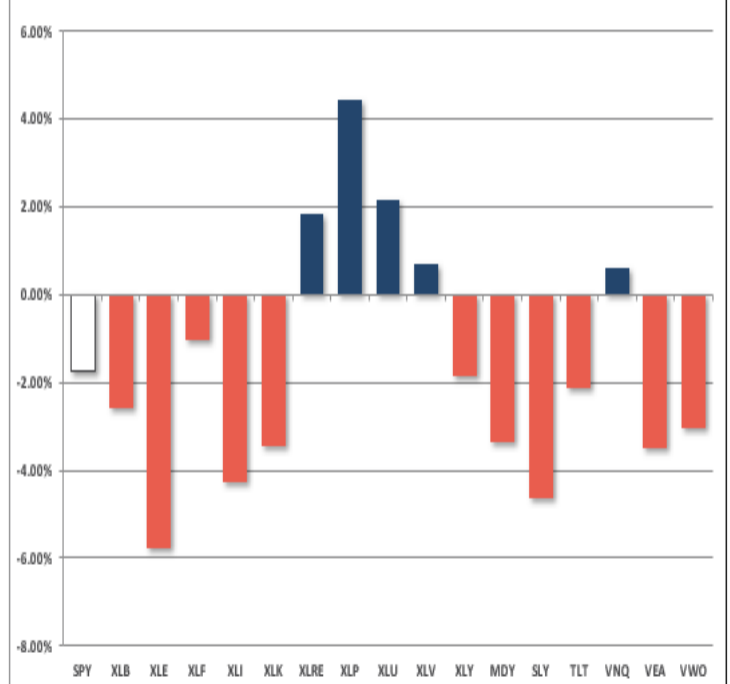
YTD Price - S&P Sectors Recalibrated To \$50/share



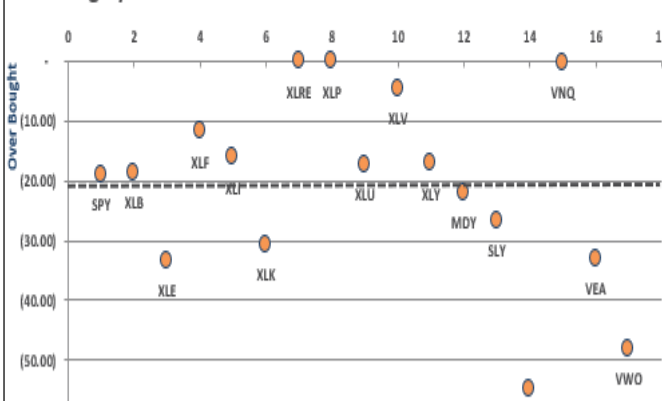
Year To Date Performance Relative To S&P 500



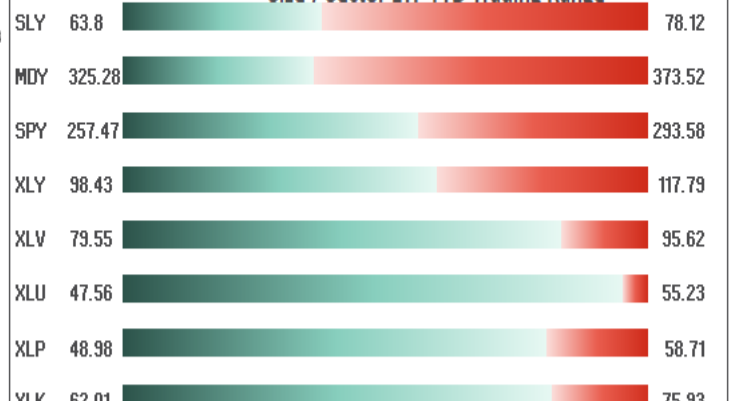
Price Deviation From 50-Day Moving Average



Overbought/Oversold 14-Periods



Size / Sector ETF YTD Trading Range



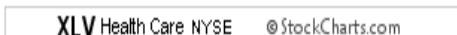
ETF Model Relative Performance Analysis





RELATIVE PERFORMANCE		TICKER	ETF NAME	Current Price	Model Position Price Changes Relative to Index					SHORT WMA	LONG WMA	% DEV - Short M/A	% DEV - Long M/A	Buy / Sell Signal
					1 Week	4 Week	12 Weeks	24 Weeks	52 Weeks					
BENCHMARK		IVV	ISHARS-SP500	279.96	2.22	0.69	(2.47)	2.18	7.76	285.66	278.69	-2.00%	0.46%	BUY
TACTICAL	SECTORS	XLB	SPDR-MATLS SELS	54.98	(0.33)	1.58	(3.44)	(9.01)	(13.14)	56.96	57.92	-3.47%	-5.08%	SELL
		XLE	SPDR-EGY SELS	68.50	(0.82)	(6.86)	(3.19)	(10.33)	(9.42)	72.98	73.63	-6.13%	-6.97%	SELL
		XLF	SPDR-FINL SELS	27.12	0.59	1.92	(1.26)	(4.80)	(3.77)	27.58	27.60	-1.66%	-1.73%	SELL
		XLI	SPDR-INDU SELS	72.42	(0.20)	(2.70)	(2.59)	(6.50)	(5.84)	75.83	74.86	-4.49%	-3.27%	BUY
		XLK	SPDR-TECH SELS	69.84	(0.62)	(2.09)	(2.06)	(2.05)	2.23	72.67	70.64	-3.89%	-1.13%	BUY
		XLP	SPDR-CONS STPL	56.82	0.89	7.78	5.74	11.73	(3.08)	54.35	52.58	4.55%	8.07%	BUY
		XLU	SPDR-UTIL SELS	54.87	1.02	2.93	3.11	6.47	(8.91)	53.70	51.98	2.17%	5.56%	BUY
		XLC	SPDR-COMM SV SS	45.37	(3.24)	(2.85)	(4.20)			47.72	48.60	-4.92%	-6.65%	SELL
		XLV	SPDR-HLTH CR	92.95	1.92	1.37	4.51	9.89	6.71	92.10	87.17	0.92%	6.63%	BUY
		XLY	SPDR-CONS DISCR	110.02	(0.32)	0.73	0.25	1.48	11.35	112.56	109.17	-2.25%	0.77%	BUY
CORE	SIZE	MGK	VANGD-MG CAP GR	119.30	(0.32)	(1.84)	(1.33)	(1.07)	1.77	123.60	120.23	-3.48%	-0.77%	BUY
		IJR	ISHARS-SP SC600	79.97	(2.29)	0.15	(6.85)	(5.26)	1.27	84.99	83.43	-5.91%	-4.15%	BUY
		RSP	GUGG-SP5 EQ ETF	102.17	(0.20)	0.83	(0.96)	(1.97)	(2.32)	104.42	102.94	-2.16%	-0.75%	BUY
CORE	Equal Weight Market	VIG	VANGD-DIV APPRC	107.80	0.62	2.19	2.26	2.80	3.26	107.97	104.72	-0.16%	2.94%	BUY
		VNQ	VIPERS-REIT	80.60	1.06	5.61	(1.65)	1.51	(12.85)	80.78	79.36	-0.23%	1.56%	BUY
		IDV	ISHARS-INTL SD	31.63	(0.48)	1.14	(0.30)	(7.37)	(12.80)	32.06	32.77	-1.35%	-3.47%	SELL
		VVO	VANGD-FTSE EM	38.45	(4.53)	(1.39)	(4.52)	(17.06)	(21.53)	40.14	42.95	-4.20%	-10.47%	SELL
FI	Cash	TLT	ISHARS-20+YTB	113.35	(1.01)	(1.67)	(3.84)	(7.42)	(16.42)	116.97	118.84	-3.10%	-4.62%	SELL
		BNDX	VANGD-TTL INT B	54.51	(2.14)	(0.20)	2.03	(2.11)	(8.30)	54.55	54.57	-0.07%	-0.11%	SELL
		HYG	ISHARS-IBX HYCB	84.36	(2.11)	(1.62)	0.51	(3.59)	(10.91)	85.57	85.61	-1.42%	-1.46%	SELL
		BSV	VANGD-SHT TRM B	77.75										

REAL INVESTMENT ADVICE

Sector & Market Analysis:

Sector-by-Sector



STOCK	YESTERDAY PRICE	PRICE CHANGE	SUPPORT	RESISTANCE	ALERT	LONG TERM TREND
SPY	\$277.76	-2.74 (-0.98%)	273.15	282.33	Crossed Above SMA150	Neutral
XLB	\$54.98	-0.78 (-1.4%)	53.7	56.28		Bearish 
XLE	\$68.52	-0.1 (-0.15%)	65.99	70.79	MACD ABOVE SIGNAL	Bearish 
XLF	\$27.12	-0.25 (-0.91%)	26.54	27.74		Bearish 
XLI	\$72.42	-0.74 (-1.01%)	70.93	73.9	MACD ABOVE SIGNAL	Bearish 
XLK	\$69.84	-1.23 (-1.73%)	67.95	71.76	Crossed Below SMA150	Bearish 
XLP	\$56.82	0.33 (0.58%)	56	57.59		Very Bullish 
XLRE	\$33.12	0.04 (0.12%)	32.7	33.51		Bullish 
XLU	\$54.87	0.08 (0.15%)	53.92	55.78	MACD ABOVE SIGNAL	Very Bullish 
XLV	\$92.95	-0.27 (-0.29%)	91.79	94.07	Crossed Above SMA50	Bullish 
XLV	\$110.02	-1.55 (-1.39%)	107.48	112.79	Crossed Above SMA150	Neutral

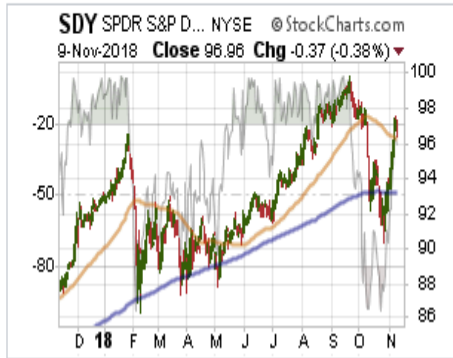
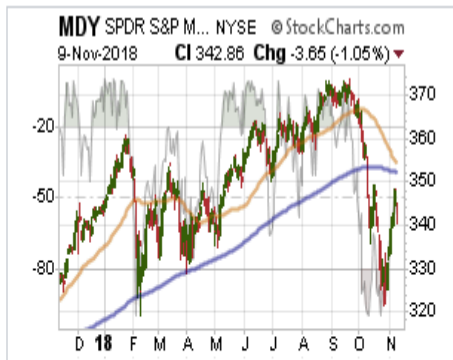


POSITION ALERTS

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Discretionary and Technology rallied last week above the 200-dma. However, the 50-dma is important overhead resistance and both sectors turned lower on Friday. Take profits and look at the 200-dma support as critical. **Industrials, Materials, Energy, Financials, Communications** - we are currently out of all of these sectors as the technical backdrop is much more bearish. The breakdown in Energy is the most concerning as oil prices, as stated above, are suggestive of more economic weakness. Reduce exposure on any rally next week that fails at resistance. **Real Estate, Staples, Healthcare, and Utilities** have held their ground during the rough month of October and continue to catch money flows during the recent push higher. Importantly, despite the many "bullish calls" for the markets currently, it remains the more "defensive" sectors of the market which continue to perform. There is likely a message here we need to pay close attention to.



STOCK	YESTERDAY PRICE	PRICE CHANGE	SUPPORT	RESISTANCE	ALERT	LONG TERM TREND
EEM	\$39.8	-0.75 (-1.85%)	39.04	40.51	Crossed Below SMA50	Very Bearish
EFA	\$63.41	-0.42 (-0.66%)	62.76	63.99		Bearish
GLD	\$114.48	-1.3 (-1.12%)	113.55	115.38	Full Gap Down	Bearish
IVV	\$279.96	-2.56 (-0.91%)	275.27	284.54	Crossed Above SMA150	Neutral
MDY	\$342.86	-3.65 (-1.05%)	336	349.74		Bearish
RSP	\$102.17	-0.91 (-0.88%)	100.46	103.82		Bearish
SDY	\$96.96	-0.37 (-0.38%)	95.57	98.27	Crossed Above SMA50	Neutral
SDY	\$96.96	-0.37 (-0.38%)	95.57	98.27	MACD ABOVE CENTER	Neutral
SLY	\$69.21	-1.15 (-1.63%)	67.24	71.29		Bearish
TLT	\$113.35	0.84 (0.75%)	112.12	114.43	MACD BELOW SIGNAL	Bearish

Small-Cap and Mid Cap indices rallied a bit this past week but both failed as they approached the 200-dma. MOST IMPORTANTLY - both indices are very close to registering a macro sell signal as the 50-dma crosses below the 200-dma. If this occurs, it will be an important confirming indicator of an end to the current "bull market" in stocks. We have no positions currently in these markets. **Emerging and International Markets** rallied last week a bit after hitting new lows but, like small and mid-cap markets failed at the declining 50-dma. With a major sell signal in place currently, **there is still no compelling reason to add these markets to portfolios at this time.** **Dividends, Market, and Equal Weight** - The overall market dynamic has changed for the negative in recent weeks. Currently, Dividends are outperforming Equal and Market Weight indices as the chase for yield and safety has weighed on more aggressive sectors of the market. Use the recent rally to reduce overall equity risk for now. **Gold**? despite the disruption in the markets, the brief spurt of life in Gold has faded as the price fell back below its 50-dma. The breakout of Gold failed to occur so remain on the sidelines awaiting an opportunity that has yet to present itself. Stops remain at \$111 if you are still long the metal. **Bonds**? continue to base and have registered a short-term buy signal. However, there is not enough conviction just yet to add a trading position for a bonds. *All trading positions are currently closed.* The table below **shows thoughts on specific actions related to the current market environment.**

(These are not recommendations or solicitations to take any action. This is for informational purposes only related to market extremes and contrarian positioning within portfolios. Use at your own risk and peril.)

						OVERWEIGHT	BUY	HOLD	REDUCE	SELL		
Over Bought / Sold	50/200 DMA	Trend	Action								Notes	
XLX	Discretionary	Rising	Positive	Warning	Reduce		X				Must Hold 200-DMA	
XLK	Technology	Rising	Positive	Warning	Reduce		X				Must Hold 200-DMA	
XLI	Industrials	OS	Neutral	Neutral	Sell					X	Broke 200-DMA/Reduce	
XLB	Materials	OS	Negative	Negative	Sell					X	Broke 200-DMA/Reduce	
XLE	Energy	OS	Warning	Warning	Reduce					X	Broke 200-DMA/Reduce	
XLP	Staples	OB	Positive	Positive	Add		X				Hold	
XLV	Health Care	OS	Positive	Positive	Hold		X				Hold	
XLU	Utilities	OB	Positive	Positive	Hold		X				Hold Current Positions	
XLF	Financials	OS	Negative	Negative	Stopped Out					X	Stopped Out	
XLC	Telecom	OS	Neutral	Neutral	N/A					X	No Position / No History	
XLRE	Real Estate	Rising	Positive	Positive	Hold		X				Hold Current Positions	
\$SML	Small Caps	Rising	Positive	Neutral	Stopped Out					X	No Position	
EEM	Emerging Mkt	Rising	Negative	Negative	Sell					X	No Position	
EFA	International	Rising	Negative	Positive	Sell					X	No Position	
GLD	Gold	OB	Negative	Negative	Neutral					X	No Position	
MDY	Mid Cap	Rising	Positive	Neutral	Stopped Out					X	No Position	
RSP	SP500 Equal Wgt	Rising	Positive	Positive	Hold		X				Hold	
SDY	SP500 Dividend	OB	Positive	Positive	Hold		X				Hold	
IVV	SP500 Market Wt	Rising	Positive	Positive	Hold		X				Hold	
TLT	20+ Yr. Bond	OS	Negative	Negative	Hold		X				No Trading Pos/Buying Ind. Bonds	

LEGEND: X = THIS WEEK => PREVIOUS DECLINING <= PREVIOUS IMPROVING X No Position

Portfolio/Client Update:

With the mid-term elections now behind us, we are starting to focus on the end of the year and the potential change in the market from bullish to bearish. While that transition has not fully occurred as of yet, we must remain aware of the potential risk. The market action remains troubling but, for now, the bullish trend longer-term remains intact. However, we are comfortable holding some extra cash right now.

Please review the "**Checklist Of Actions To Taken**" in the main missive above. We will continue to apply these guidelines to our portfolios over the next few weeks. **There were no new actions in portfolios this week.**

- **New clients:** We will look to onboard new accounts into models opportunistically.
- **Equity Model:** After having sold some positions two weeks ago, we are maintaining a slightly higher weight in cash. We are looking for opportunistic additions currently.
- **Equity/ETF blended:** Same as with the equity model.
- **ETF Model:** With portfolios now primarily weighted to domestic markets and carrying a bit heavier weight in cash, we can just wait to see where the next opportunity emerges.

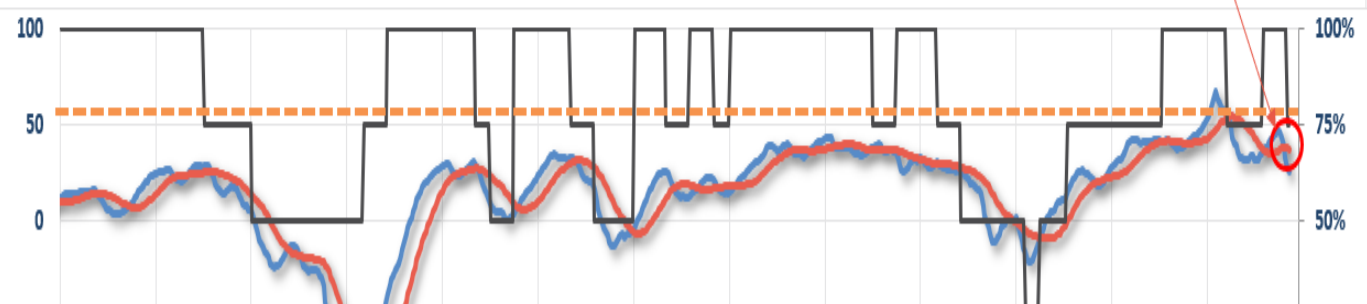
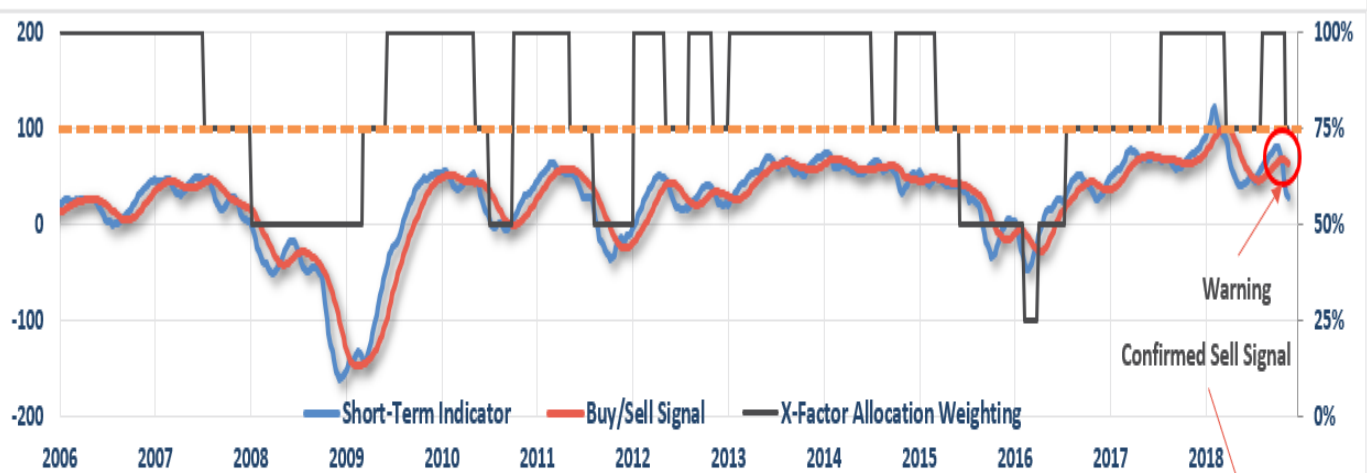
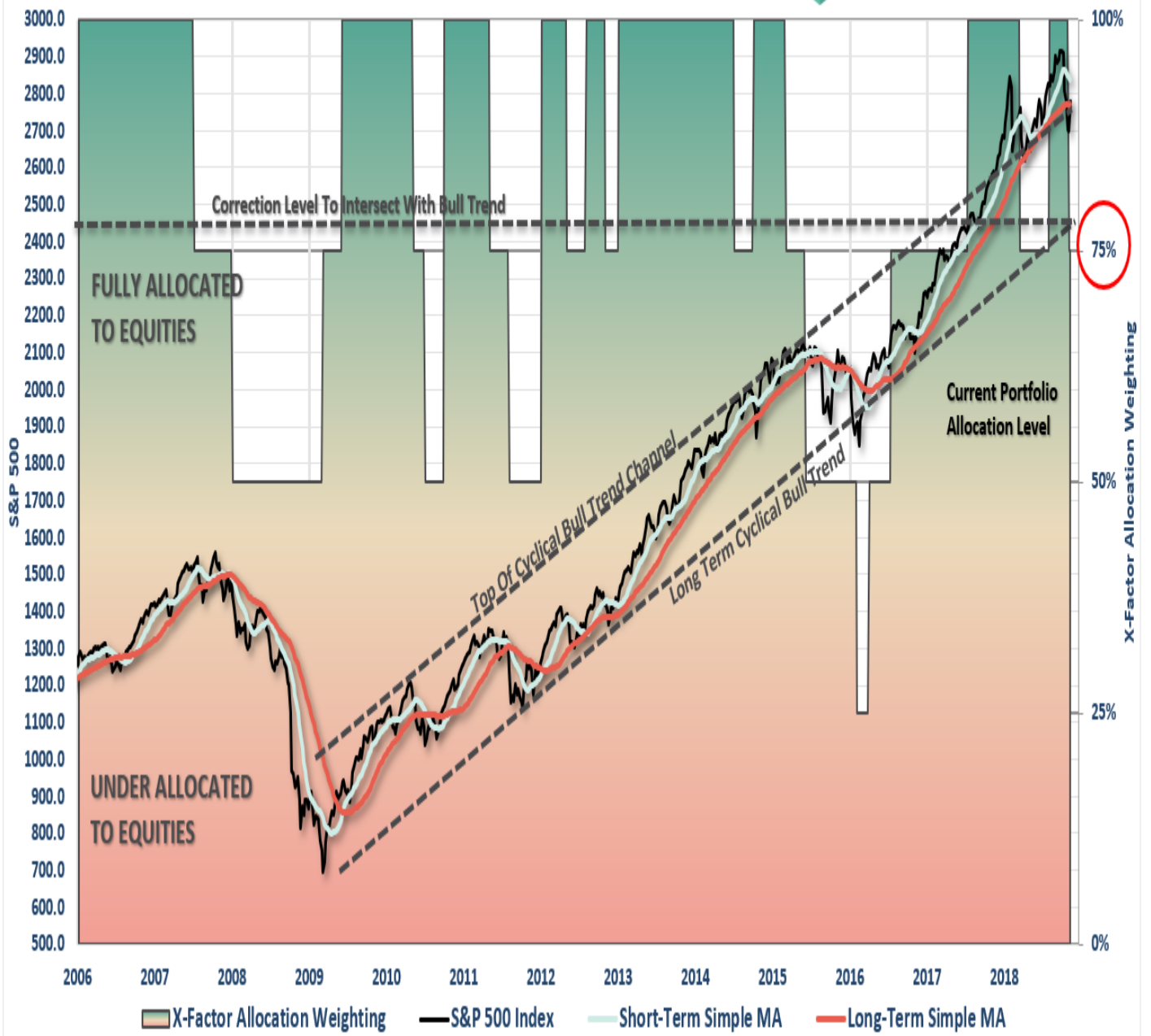
While the pick up in volatility is certainly not enjoyable, we don't want to let our emotions get the

better of our discipline. We remain vigilant of the risk currently and are happy to err to the side of caution until a new trend emerges.

THE REAL 401k PLAN MANAGER

The Real 401k Plan Manager - A Conservative Strategy For Long-Term Investors

Risk Management Analysis



There are 4-steps to allocation changes based on 25% reduction increments. As noted in the chart above a 100% allocation level is equal to 60% stocks. I never advocate being 100% out of the market as it is far too difficult to reverse course when the market changes from a negative to a positive trend. Emotions keep us from taking the correct action.

401k Plan Manager Allocation Shift

Rally Fails

The rally following the mid-term elections last week was a "one-day wonder." Next week, it is critically important for the market to rally IF the bulls are going to regain control of the market. Last week, we lowered the allocation model to 75% of target for now. There is more risk to the downside currently than upside reward. But...let me repeat from last week:

"This does NOT mean immediately go out and sell 25% of your holdings. The model moves in 25% increments as signals are triggered. However, by the time a signal is triggered, the market tends to be very oversold which is why we wait for a bounce to opportunistically sell into."

It also doesn't mean to go liquidate 25% of your exposure all at once. These are just model targets that you "adjust" into as market dynamics develop. As we stated last week, we reduced equity risk in portfolios by 10%. As long as the market remains in a more negative trend we will continue to use rallies to reduce equity further until we get to the 25% target. With BOTH of our primary SELL SIGNALS in place, it is prudent to adjust the model lower. However, continue to use rallies to reduce risk towards a target level with which you are comfortable. **Remember, this model is not ABSOLUTE - it is just a guide to follow.** Defense remains our primary strategy for 401k-plans currently.

- If you are **overweight equities** - reduce international, emerging market, mid, and small-capitalization funds on any rally next week. Reduce overall portfolio weights to 90% of your selected allocation target.
- If you are **underweight equities** - reduce international, emerging market, mid, and small-capitalization funds on any rally next week but hold everything else for now.
- If you are at **target equity allocations** - reduce overall equity exposure to 90% of your allocation target on any rally Monday.

Unfortunately, 401k plans don't offer a lot of flexibility and have trading restrictions in many cases. **Therefore, we have to minimize our movement and try and make sure we are catching major turning points.** Over the next couple of weeks, we will know for certain as to whether more changes need to be done to allocations as we head into the end of the year. If you need help after reading the alert; don't hesitate to [contact me](#).

Current 401-k Allocation Model

The 401k plan allocation plan below follows the K.I.S.S. principle. By keeping the allocation extremely simplified it allows for better control of the allocation and a closer tracking to the benchmark objective over time. ***(If you want to make it more complicated you can, however, statistics show that simply adding more funds does not increase performance to any great degree.)***

Current Portfolio Weighting



Current 401k Allocation Model

20.00% Cash + All Future Contributions

Primary concern is the protection of investment capital

401k Choice Matching List

The list below shows sample 401k plan funds for each major category. In reality, the majority of funds all track their indices fairly closely. Therefore, if you don't see your exact fund listed, look for a fund that is similar in nature.

[401k Selection List](#)