Summary
Four Factor Model

1. Valuations
   
   Valuations are still extremely stretched and represent one of the most overvalued markets in history. In fact, according to the measures that have the highest correlation with average returns over the next 10 years, the market is the second most overvalued ever. The only time where market valuations were more egregious than our current cycle peak was during the technology bubble. Valuations matter over the long term and suggest that if an investor bought the market today and held it, they should expect 0-4 percent over the next 10-20 years. Despite what most market prognosticators would have you believe, valuation metrics tell us very little about what the market will look like one year from now.

2. Market Internals
   
   Market internals, give us a great indication of how strong the market is underneath the hood. Up until recently the stock market has been supported by strong and strengthening internals. Starting last year, however, cracks started to show in credit spreads and divergences became apparent. Fewer and fewer names appear to be holding up the indexes. Buy backs have been a large percentage of the volume this year and as Carl Icahn has warned, have an unusual manipulative influence on the market. As Dr. John Hussman has suggested in his wonderful weekly commentary several times, strengthening market internals would result in a resurgence of a bullish tone despite the unfavorable valuations, economic conditions, and Fed Policy.

3. Economic Environment
   
   The economic environment has deteriorated across the board over the last year. Growth is slowing and many of the measures we use that have a historical correlation with upcoming recessions and market deteriorations are flashing warning signals. Corporate profit margins have peaked over one year ago, earnings are deteriorating, the ISM is now below 50, industrial production is negative year over year, and the consumer is lackluster from a historical perspective. Furthermore, the strong dollar is a major headwind reverberating deflationary tones throughout our economic engine. Global growth is slowing as well as the stronger dollar has caused immense pain in the emerging market economies. Developed economies are strangled by too much debt and emerging markets are being punished by stalling global growth and dollar based deflation.

4. Fed Policy
   
   Divergent central bank policy will continue to be a main force behind market moves in the near future. The United States Federal Reserve has moved off of the zero bound while 65 global central banks have moved policy more accommodative. The Fed beginning their tightening path, albeit slowly, will have profound effects on risky markets. The reason is because the US dollar should maintain its posture as the cleanest dirty shirt (hat tip to Bill Gross). A stronger dollar will continue to pressure profit margins and hurt economic growth domestically and in the emerging economies. The only hope would be that Europe, China and Japan come back online in a dramatic fashion due to their quantitative easing and weak currency initiatives. In our opinion, if deterioration continues, the Fed will have to quickly reverse course and possibly move to negative rates. We will have to wait and see.

It is our opinion that investors should stress test their portfolios for a significant decline in asset prices in the coming years. Investors should make sure that they can handle equity values being cut in half. If you can handle this outcome in stride, then your allocation is potentially appropriate. If not, you should consider seeking guidance in structuring a portfolio more in line with your objectives and constraints.

Our recommendation is that investors always have a well-defined systematic process for investing in the markets. If you would like more information on our process, please contact us at clint@emerald-ip.com for more information.
Valuations
Valuations, by most historically accurate measures, suggest that the stock market is now one of the most overvalued markets in history. In chart 1 you will see the most accurate measure of market valuation according to Dr. Hussman’s research. The current measure is the second highest only surpassed by the tech bubble in 2000.

Chart 2 is a depiction of the measures predictive ability. It shows the average return over a 12 year period that the valuation metric predicts for the stock market. The red line in the chart illustrates the actual returns achieved. Presently, the market is so overvalued that an investor would be hard-pressed to earn positive average annual returns over the next 12 years.

Chart 3 is an illustration of several other market valuation metrics that suggest the market to be extremely overvalued at the present moment.
Chart 1: Market Valuation

National nonfinancial gross value added (GVA) estimated as
Domestic nonfinancial GVA * (1+ProfitsRestOfWorld/DomesticProfits)
Date: Federal Reserve Z.1 flow of funds
Rest-of-world / domestic profit ratio uses 5-year average of each
Market capitalization updated intra-quarter based on SPX weekly close
See Hussman Weekly Market Comment 5/18/15

Nonfinancial market capitalization / National nonfinancial GVA
including estimated foreign revenues
Chart 2: Predicted Returns vs. Actual Returns

National nonfinancial gross value added (GVA) estimated as
Domestic nonfinancial GVA * (1 + ProfitsRestOfWorld/DomesticProfits)
See Hussman Weekly Market Comment 5/18/15

- Market capitalization of non-financial stocks / nonfinancial GVA including estimated foreign revenues (Federal Reserve Z.1 flow of funds data, left scale, log, inverted)
- Subsequent 12-year S&P 500 annual nominal total return (right scale)
Chart 3: Average of Four Valuation Indicators

Average of the Four Valuation Indicators (Geometric) with Standard Deviations Highlighted

Valuation as of November 2015 Month End
- Crestmont P/E from its Geometric Mean: 105%
- Cyclical P/E 10 from its Geometric Mean: 70%
- Q Ratio from its Geometric Mean: 63%
- S&P Composite from its Regression: 89%
- Average of the Four: 82%

Data through November 2015

Recessions highlighted in gray
Market Internals
Market internals are currently warning of potential danger in global equities markets. In chart 4 we demonstrate the relationship between spreads and the total broad stock market. We have inverted the spread chart for easier comparison. As spreads widen (between high yield bonds and ten year Treasuries) stress is evident in the fixed income market. The deterioration in commodity prices this year and the strength of the US dollar have trickled into the credit markets and conditions appear stressed. If history is any guide, the stock market should follow spreads by falling. We need a meaningful improvement in spreads (tightening) in order to warrant risk taking in the equities markets. This particular chart suggests that tactical investors should be defensive in nature.

Chart 5 is also flashing an ominous signal for the stock market. It is an illustration of NYSE advance-decline ratio which is a cumulative measurement of advancing volume minus the volume of declining stocks. Historically, the advance-decline ratio tends to top prior to the market. The advance-decline line topped earlier this year and is suggesting that the market could experience further selling.

Chart 6 shows the relationship between the S&P equal weight and the market cap weighted S&P 500. The difference between these two indexes is that one gives equal weighting to all 500 stocks and the other weights the larger companies more. This is important in determining the underlying strength of a particular move. The ratio between the two gives us some clues as to whether the market has broad participation. Currently, the condition suggests that the stock market has limited participation. The market capitalization index is stronger than the equal weight index. Furthermore, the ratio topped at the beginning of the year and has been in decline ever since. We believe that buybacks among the larger companies is responsible for the major divergence. This is an unsustainable phenomenon that we often witness during late cycle market tops.

Chart 7 is a comparison of global stocks versus the S&P 500. Global stocks peaked last year and have since been in decline. The US stock market diverged from the broader global stocks and have since ignored the warning signals coming from the global equities markets. Global equities markets will need to rally strongly to repair the divergence or US equities markets would have to fall.

Chart 8 illustrates one of our favorite measures of market internals. It is the percentage of stocks trading above their respective 200 day moving averages. During a bull market this measure often reaches levels of 80 percent or higher. During bear markets we have known this measure to get into the low single digits. A strong market internally will become overbought at levels around 80 percent and oversold at levels of 40 percent or above. During weak markets, it will become oversold at levels below 20 percent and overbought at levels of 50 to 60 percent. The recent rally failed at around 40 percent after reaching oversold conditions below 20 percent. Even after the massive rally in the S&P 500 during the month of October, over 60 percent of the stocks in the NYSE are still in bear markets.
Chart 4: Credit Spreads

1/BofA Merrill Lynch US High Yield CCC or Below Option-Adjusted Spread© (left)
Wilshire 5000 Total Market Full Cap Index© (right)
Chart 5: Advance-Decline
Chart 6: Equal Weight vs. Market Cap Weight
Chart 7: Global Stocks vs. Domestic Stocks
Chart 8: % of Stocks > 200 day moving average
Economic Conditions
Chart 9 is an illustration of the US dollar versus major trade weighted currencies. In our multifactor model, the US dollar is the main driver behind our economic themes. We believe that inflation and deflation drives the economy from a macro level, thus making the dollar the primary indicator. All else being equal, when the dollar is strengthening and growth slowing, we believe deflation to be the prevailing trend. On the other hand, when the dollar is weakening and growth accelerating we believe inflation is at hand. Currently, the US dollar is in the midst of a strong uptrend that started in 2014. The deflationary effects have been felt in the economy as evident in Chart 10 which shows GDP. Growth has been tough to come by since the end of the financial crisis, despite massive stimulus efforts by the US Federal Reserve.

The strong dollar is wreaking havoc on the overall economy as referenced by charts 11, 12, 13, and 14. The US dollar strength has hammered exports. Interestingly, imports are also falling precipitously. Industrial production is now negative year over year, which is indicative of an upcoming recession. Furthermore, the ISM index is below 50 suggesting that the manufacturing economy is in contraction. The ISM index is rather correlated to stock market returns too, meaning that the stock market could follow the ISM into further contraction. Even worse, the new orders component has demonstrated considerable decline. Unfortunately, new orders usually lead the ISM index indicating further deterioration. Chart 15 and 16 demonstrate the health of corporate America and offer us clues as to the stage of the business cycle. Profit margins usually peak approximately 10-18 months prior to the stock market and overall economy. According to our measures, profit margins have been in a topping process since late 2013. Corporate earnings are also declining year over year and their drop is usually indicative of further trouble. The strong dollar has surely had a negative impact on corporate profits and earnings. We believe that divergent central bank policy should result in the continuance of the present trend and more trouble for US equities.

As you all already know, Wall Street analysts and the talking heads on CNBC usually take a bullish stance on everything markets. Remember Wall Street makes their money when you transact. Money invested is money earned and they always have a bullish theme to exploit. It is hard to find anything positive to stand on economically in the US. Wall Street has seemed to find solace in the consumer. Lately, we have heard the narrative that the low oil prices and slightly rising wages have resulted in a resilient and strong consumer. However, the data far from supports this narrative. Real retail sales are far from robust at the current moment. In chart 17 you can clearly see that growth is slowing in this key component of economic growth.

Our recommendation is that investors prepare for a potential recession. An overvalued market in conjunction with a potential recession can be quite troublesome for asset markets. The evidence suggests that investors take a defensive posture given the plethora of data supporting a continued slow down.
Chart 11: Imports and Exports

When both Exports and Imports fall below -5% growth, it has warned of a recession.

Is this time different?
Chart 12: Industrial production and Recessions
Chart 13: ISM and Stocks

ISM Manufacturing: PMI Composite Index© (left)
Wilshire 5000 Total Market Full Cap Index© (right)
Chart 14: New Orders

U.S. Economic Activity: Order Surplus Leads Output
Average standardized values: ISM (National, Chicago, Milwaukee) and Fed (Empire Manufacturing, Philadelphia, Richmond, Dallas) Indices

Hussman Strategic Advisors
Chart 15: Profit Margins vs. Stocks
Chart 17: Lackluster Consumer

Real Retail Sales
Year-over-Year Percent Change Since 1948

Dashed line shows the current level, Dots highlight the month a recession starts

Current level is 0.9%
Fed Policy
The Federal Reserve has finally moved off of the lower zero bound for the first time since the end of the financial crisis. What we have witnessed over the last six years has truly been unprecedented. At the present moment, we are rewriting the future economic texts that will teach our future generations about monetary policy. The decision to move to a Federal Funds rate of 0.25-0.50% was the latest act of policy tightening by the US central bank. The first was the end of quantitative easing in 2014. Chart 18 displays the miniscule interest rate move after rates have been pinned at zero for so long. Many pundits believe that the move was too little too late. Our opinion was that the recent move was a grave mistake. The reason is that global central banks are moving policy in a more accommodative fashion while the Fed is intent on tightening. 1937 is the only other time period where we can historically witness such an environment. The effect has been to induce deflationary pressures that have resonated by causing commodity price pressures. Furthermore, the rogue Fed has ushered in cracks in the credit markets with high yield spreads widening to levels not seen since the financial crisis.

Chart 19 illustrates the massive amount of stimulus that has been poured into the markets since 2008. The Federal Reserve now has a balance sheet that eclipses $4 Trillion. Despite the momentous efforts to expand money supply and incite inflationary pressures, the velocity of money (chart 20) has collapsed to extreme lows. The Fed’s efforts to stimulate inflation may have created more of the undesired, deflation.

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Chart 18: Fed Funds Rate

Source: Board of Governors of the Federal Reserve System (US)
research.stlouisfed.org
Chart 19: Federal Reserve Assets

Source: Board of Governors of the Federal Reserve System (US)
research.stlouisfed.org
Chart 20: Velocity of Money

Source: Federal Reserve Bank of St. Louis
research.stlouisfed.org
Chart 21: Long term rates
The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. Additional information is available upon request. Past performance cannot guarantee future results.

All Charts were derived from the following data sources: www.econ.yale.edu/~shiller, Global Financial Data, Standard and Poors, St Louis Federal Reserve, Stockcharts.com, Dr. John Hussman of Hussman Strategic Advisors, and Doug Short of Advisor Perspectives.

Technical analysis is only one form of analysis. Investors should also consider the merits of Fundamental and Quantitative analysis when making investment decisions. The S&P 500 is not an investable index and is a product of Standard and Poors, a McGraw-Hill Company.

Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high-yield bonds, which have lower ratings and are subject to volatility. All fixed income investments may be worth less than original cost upon redemption or maturity.

Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of risks associated with common stocks, including market fluctuations. While stocks generally have a greater potential return than government bonds and treasury bills, they involve a higher degree of risk. Government bonds and treasury bills, unlike stocks, are guaranteed as to payment of principal and interest by the US Government if held to maturity.

Dividends are not guaranteed and are subject to change or elimination.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Asset-backed securities: Generally, when interest rates decline, prepayments accelerate beyond initial pricing assumptions which could cause the average life and expected maturity of the securities to shorten. Conversely when interest rates rise, prepayments slow down beyond the initial pricing assumptions and cause the average life and expected maturity of the securities to extend and the market value