Market Cycles

Presented by: Mike Trager

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All Materials presented are for training purposes only. Traders should paper trade any new method prior to risk of personal capital.

Why Study Market Cycles? They Repeat!

Why study stock market history and cycles?

1. Because the market often repeats itself, or at least rhymes with itself, and those who are unaware of history are often doomed to be affected by its' repetition

2. Knowing when to look for something to happen can make it easier to see what it is you're looking for

3. Having a macro perspective of the market's environment can provide an edge in terms of trading and investing in harmony with that environment.

Why Study Market Cycles? They Repeat!

- **Why study stock market history and cycles?**

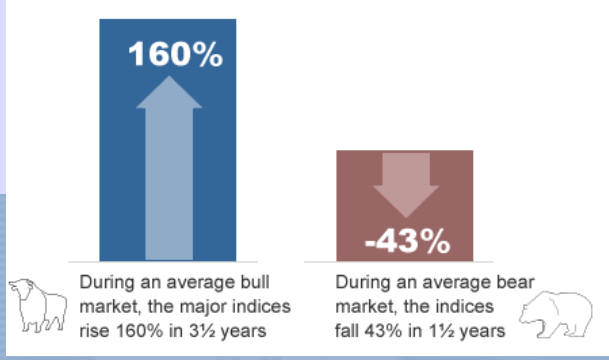
"The stock market is human nature and crowd psychology on daily display, plus the age-old law of supply and demand at work. Because these two factors remain the same over time, it is remarkable but true that chart patterns are just the same today as they were 50 years ago, or 100 years ago."
— William O'Neil, *How to Make Money in Stocks*

William J. O'Neil, pioneered the use of historical precedent to analyze equities in tandem with fundamental and technical analysis. He identified seven basic factors that occurred over and over in almost all top-performing companies over decades of market cycles. In studying movements in the stock market over the last 100 years, many important trends can be observed:

- **The market moves back and forth in trends: bull and bear market cycles.**

- **Each bull market begins after a Follow-through Day signals the beginning of a new uptrend.**

- **Every bear market has begun after the distribution day count reached 5 or 6 in a 25 trading day period.**



Types of Cycles

- **<u>Shorter term cycles</u> - weeks to months - for example, seasonality ("sell in May and go away")**

- **<u>Intermediate term cycles</u> - months to years - for example, cyclical bull and bear markets (example: WON); presidential election cycle: decennial cycle**

- **<u>Longer term cycles</u> - years to decades - secular bull and bear markets (average duration, causative and correlated factors and metrics)**

Types of Cycles: Short Term Cycles

1) **Shorter term cycles - weeks to months**
   A) **Daily and weekly charts**

   B) **Seasonality - Santa Claus effect early to mid-December through early to mid-January is often a bullish time**

   C) **"Sell in May and go away" - November through April is when the bulk of stock market gains occur, there is much historical and statistical evidence for this**

Types of Cycles: Short Term Cycles

1) **Shorter term cycles - weeks to months**

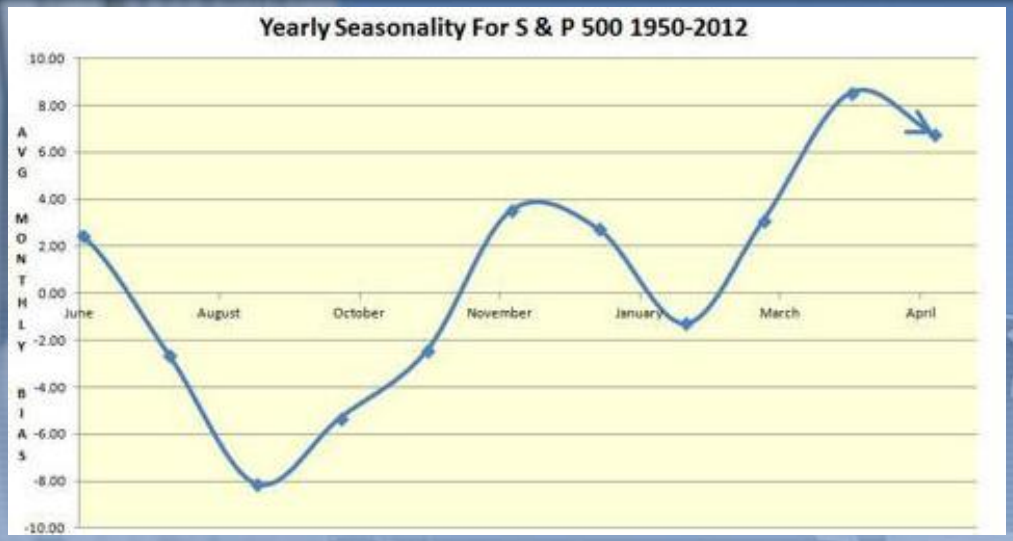
D) Pertinent macro indicators: McClellan oscillator; percentage of NYSE stocks below 10 and 20 day moving averages

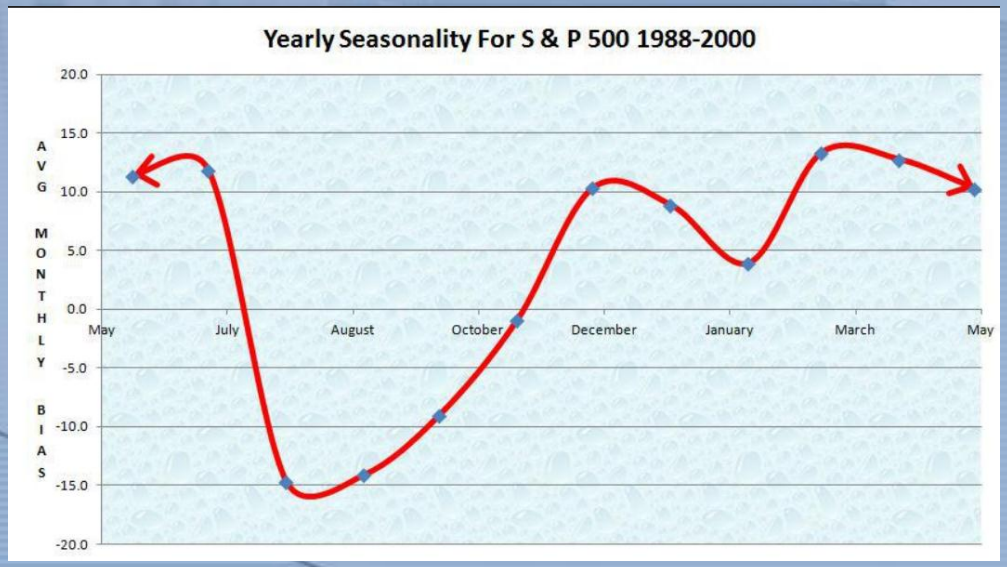
E) Small caps (Russell 2000) - 90% of historical gains occur between November 1 - January 31. One study covering 33 years 1974-2006 shows that the gains for RUT during this time period were more than 8 times greater than those for larger cap indexes like SPX and Dow

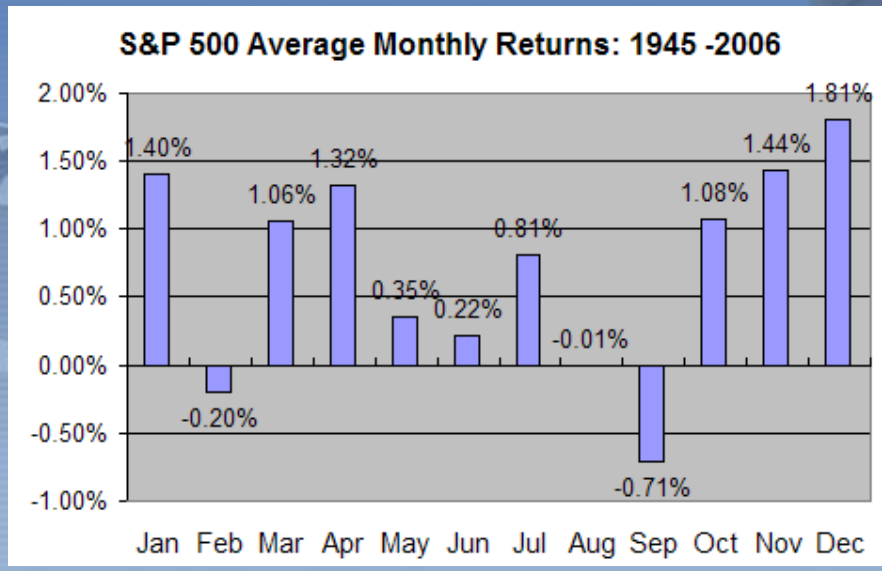
F) Suggestion - "Halloween trade" - buy RUT etf (IWM or leveraged etf like TNA) at the close on October 31 and hold until January 31. 15% initial stop loss IWM

1974-2006: 33/33 profitable trades, no losing years (SPX 25/33 profitable trades; worst losing year for SPX during same time period was 29% loss); profit factor of 10.6

Types of Cycles: Short Term Seasonal







Types of Cycles: Intermediate

2) Intermediate term cycles - months to years

A) Weekly and monthly charts; daily charts for timing of entries and exits

B) Cyclical bull and bear markets - example, WON. Ratio of duration approximates 3:1 (i.e. bull market following a bear market tends to last about 3 times longer than the preceding bear market and a bear market after a bull will tend to last about 1/3 as long as the preceding bull market).

Cyclical bull markets tend to gain more than cyclical bear markets lose, hence the very long term uptrend in equity markets overall. These will behave differently in the greater context of longer term secular markets

Types of Cycles: Intermediate

2) Intermediate term cycles - months to years

C) Presidential 4 year election cycle - all of the major stock market declines occurred during the first or second years of the four-year U.S. presidential cycle.

- **No major declines occurred during the third or fourth years. More specifically, from 1950 to 2004 (using the Standard and Poor's 500 Index), the most favorable period (MFP) for investing was from October 1 of the second year of a presidential term to December 31 of the fourth year.**

- **The remaining period—from January 1 of the first year of the presidential term to September 30 of the second year—was the least favorable period (LFP) for stock market investors.**

Summary - the first two years of a new presidential term are less favorable than the second two years, and the second year is less favorable than the first year; both the pre-election year (2015 in this case) and the election year (2016) tend to be the best periods of the Presidential Cycle.

Types of Cycles: Intermediate

2) Intermediate term cycles - months to years

- **Ned Davis Research - since 1934, average peak to trough decline during the second year of the presidential cycle is 21% when the yield curve is not inverted, which is the current circumstance; when the yield curve is inverted, the average peak to trough decline is 34%**

- **Stock Trader's Almanac - Jeff Hirsch - "Midterm election years are historically prone to bottoms, especially in October," says the Almanac's Editor-in-chief Jeffrey A. Hirsch. "2014 is also a 'fourth' year, which has the fourth best record in the decennial cycle for 132 years. Of the last four midterm election years since the start of the Great Depression (1934, 1954, 1974, 1994) that were also fourth years, only 1954 was impressive. Almanac readers can take some solace in the fact that the Dow has gained nearly 50% on average from the midterm low to the pre-election year high."**

Summary - the fourth quarter of the second Presidential Year is typically strong and represents an ideal time for a buying opportunity. While the low could well be set earlier than that, the most ideal time would be the October/November period. Since the 12 months following the end of the third quarter of the second year are historically and consistently buoyant, the year 2015 is setting up to look better than 2014

Types of Cycles: Secular

3) Secular cycles - years to decades (secular is defined in this context as "long term")

A) Weekly and monthly charts; daily and weekly charts for entries and exits

B) Average duration of 16-18 years (recent book, "The 17.6 Year Stock Market Cycle"). Warren Buffett stated in a 1999 interview that the next 17 years would look nothing like the prior 17 years - he was right

C) Best and most recent examples are secular bear market of 1966-1982 and the secular bull market of 1982-2000. It is generally accepted that the markets entered into a secular bear in 2000 after the dot.com peak started to implode

D) Relevant indicators: CAPE, Tobin's Q ratio, market cap/gdp ratio, margin debt levels and margin debt/gdp

Types of Cycles: Secular

3) Secular cycles - years to decades (secular is defined in this context as "long term")

E) <u>Secular bear markets</u> begin when the preceding secular bull has reached extremes in these indicators and do not end until the excesses of the preceding secular bull have been worked out of the system.

- **They are characterized by long term trading ranges of inflation adjusted market index levels punctuated by intermediate term cyclical bull and bear markets such as we've experienced since 2000 and historically have not ended and morphed into new secular bull markets until overall market valuations have reached extreme lows (e.g. single digit CAPE, Tobin's Q in the vicinity of .30-35).**

- **Historically, there are 4 or more recessions during a secular bear market and 3 major waves of selling or 3 notable cyclical bear markets. Usually the final secular low is higher than the preceding secular low**

F) <u>Secular bull markets</u> begin when the above indicators have reached extremes to the downside and investor sentiment has reached extreme negative levels, marking the end of the preceding secular bear market.

- **Secular bull markets are characterized by relatively brief and violent cyclical bear markets from which recovery to higher highs is quick and uninterrupted.**

- **Markets are driven by investor sentiment regardless of underlying economic and valuation fundamentals until valuations and the above indicators reach upside extremes, where they can stay for prolonged periods of time**

Cycle Predictors?

25 Worst Quarterly U.S. GDP Prints In History

Rank	GDP (*ann*)	Date	Recession?
1	-10.37%	1Q 1958	*Yes*
2	-8.61%	4Q 2008	*Yes*
3	-8.11%	2Q 1980	*Yes*
4	-6.69%	1Q 1982	*Yes*
5	-6.07%	4Q 1953	*Yes*
6	-5.56%	1Q 2009	*Yes*
7	-5.45%	1Q 1949	*Yes*
8	-4.84%	4Q 1960	*Yes*
9	-4.84%	1Q 1975	*Yes*
10	-4.67%	4Q 1981	*Yes*
11	-4.12%	4Q 1970	*Yes*
12	-4.11%	4Q 1957	*Yes*
13	-3.88%	3Q 1974	*Yes*
14	-3.58%	4Q 1949	*Yes*
15	-3.41%	4Q 1990	*Yes*
16	-3.32%	1Q 1974	*Yes*
17	-2.96%	1Q 2014	*No?*
18	-2.92%	2Q 1981	*Yes*
19	-2.69%	1Q 2008	*Yes*
20	-2.25%	3Q 1953	*Yes*
21	-2.17%	3Q 1973	*Yes*
22	-1.98%	3Q 2008	*Yes*
23	-1.87%	1Q 1991	*Yes*
24	-1.84%	1Q 1954	*Yes*
25	-1.73%	4Q 1969	*Yes*

It’s Cold Up North! But what about the Growth!

Canadian GDP

Types of Cycles: Secular

G) Trading and investing strategies

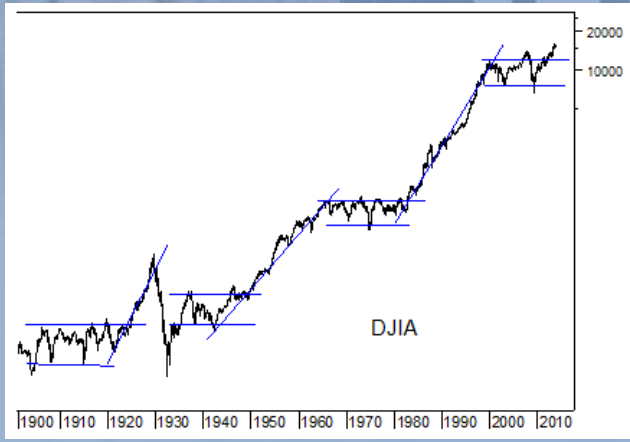
1) Secular bull markets - buy and hold works; shorter term reversals are best for taking profits but not trading to the downside against the secular bull trend; take advantage of short to intermediate term corrections and cyclical bears by going long with the secular trend

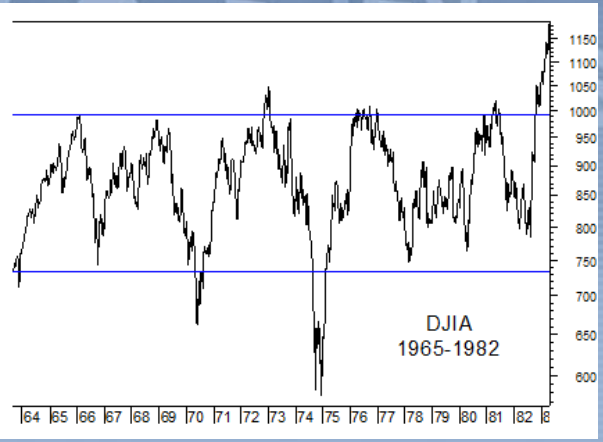
2) Secular bear markets - buy and hold doesn't work well; timing becomes more important than it is in a secular bull market; extreme and prolonged moves both up and down

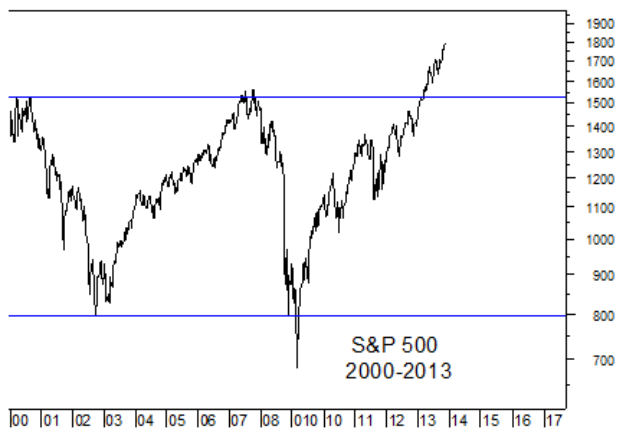
H) Overall, where are we now, where have we been, where are we likely to go?

Secular Cycles

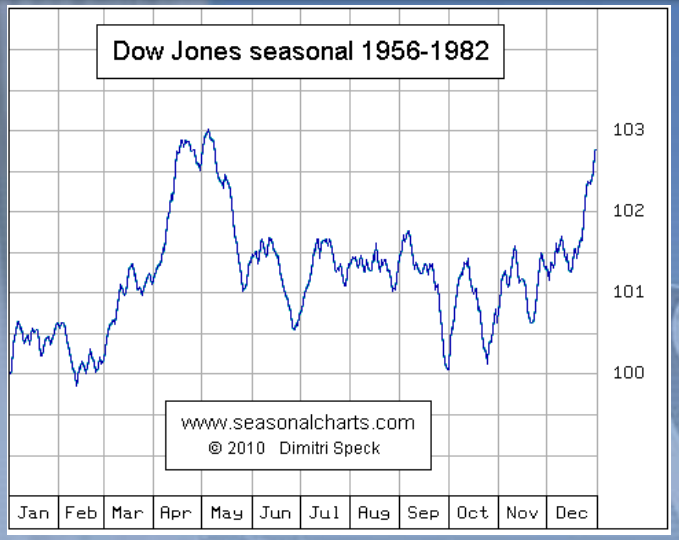
- Since that first trough in 1877 to the March 2009 low:
- Secular bull gains totaled 2075% for an average of 415%.
- Secular bear losses totaled -329% for an average of -65%.
- Secular bull years total 80 versus 52 for the bears, a 60:40 ratio

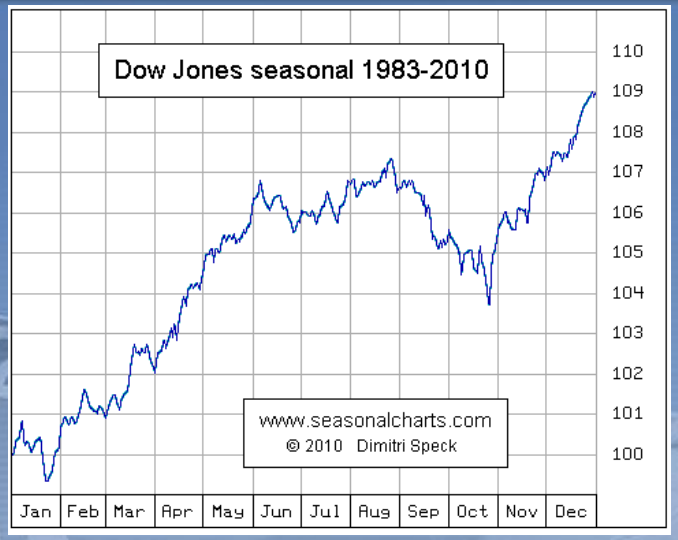






Types of Cycles: Secular

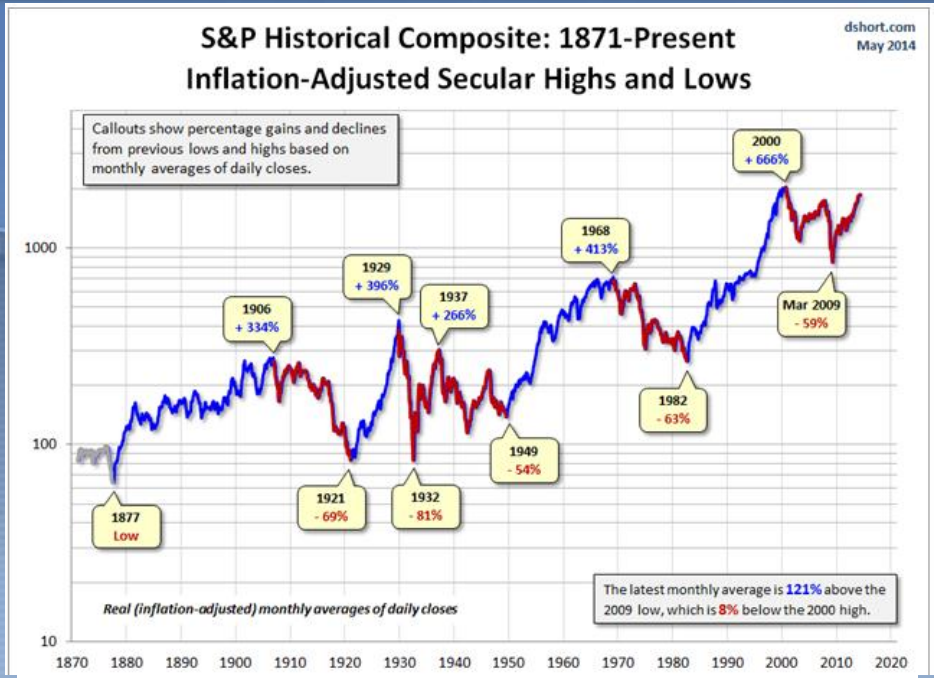




- The second chart shows the seasonal course of the Dow Jones since 1983. During bullish market years the best seasonal selling point would have been in July, two months later than the previous chart indicated. ***In other words the seasonal trend changed.***

- But based on the year-end rally it also becomes evident that some seasonal patterns survive even the most fundamental changes in the overall market environment. The same is true for the weaknesses in September and October, which even increased (probably because a high need to correct after the strong rallies).

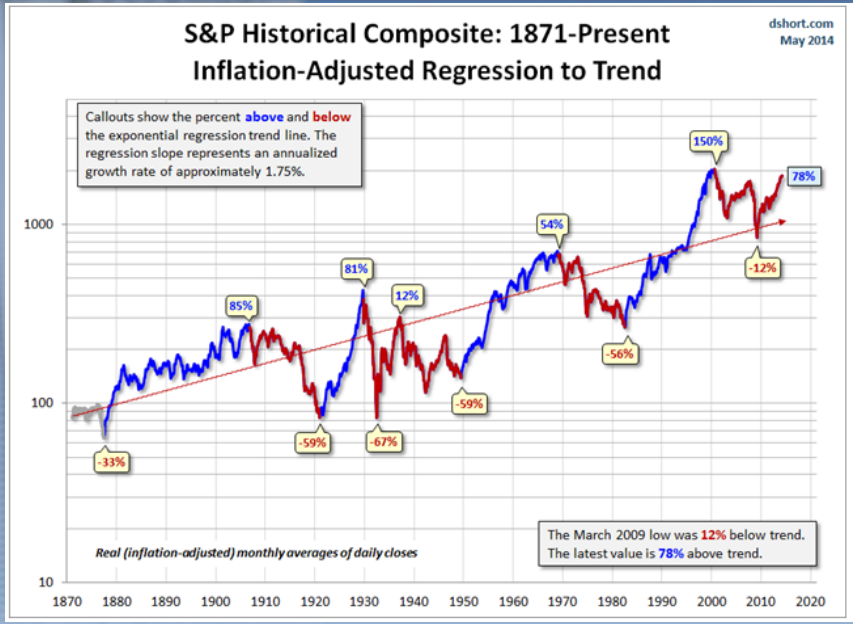
Secular Cycles

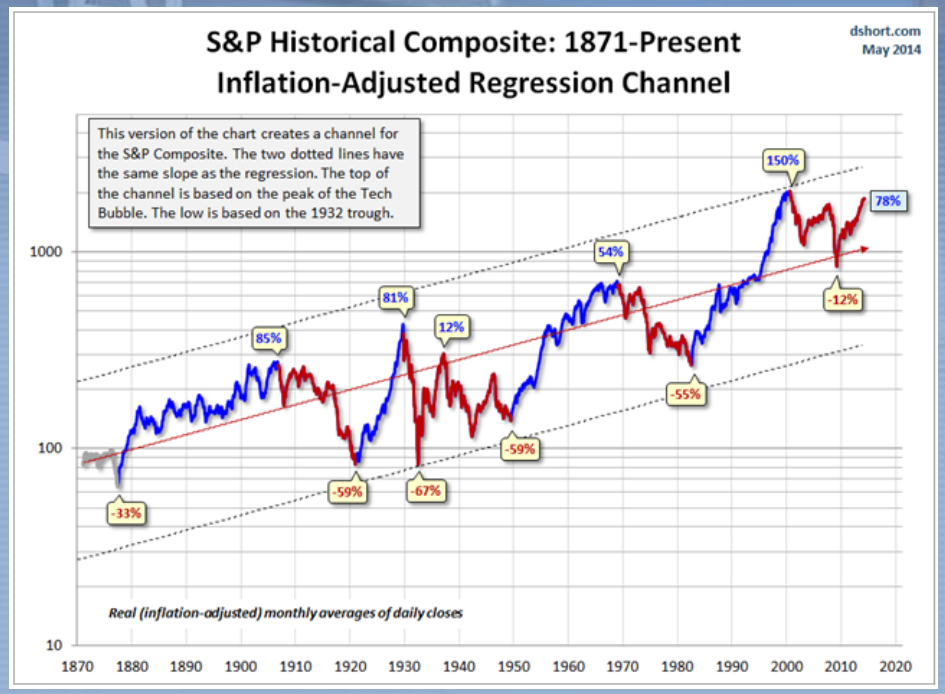


Year	Market Milestone	Percent Change	Number of Years	Annualized Return, No Dividends	Annualized Return with Dividends
1877	Low	-	-	-	-
1906	High	381%	29.3	5.1%	10.1%
1921	Low	-69%	14.9	-7.5%	-2.0%
1929	High	396%	8.1	21.9%	28.4%
1932	Low	-81%	2.7	-44.9%	-41.2%
1937	High	266%	4.7	32.1%	38.7%
1949	Low	-54%	12.3	-6.2%	-0.8%
1968	High	413%	19.5	8.8%	13.3%
1982	Low	-63%	13.6	-7.0%	-3.0%
2000	High	666%	18.1	11.9%	15.3%
2009	Low	-59%	8.5	-9.8%	-8.1%
Now	-	121%	5.1	N/A	N/A

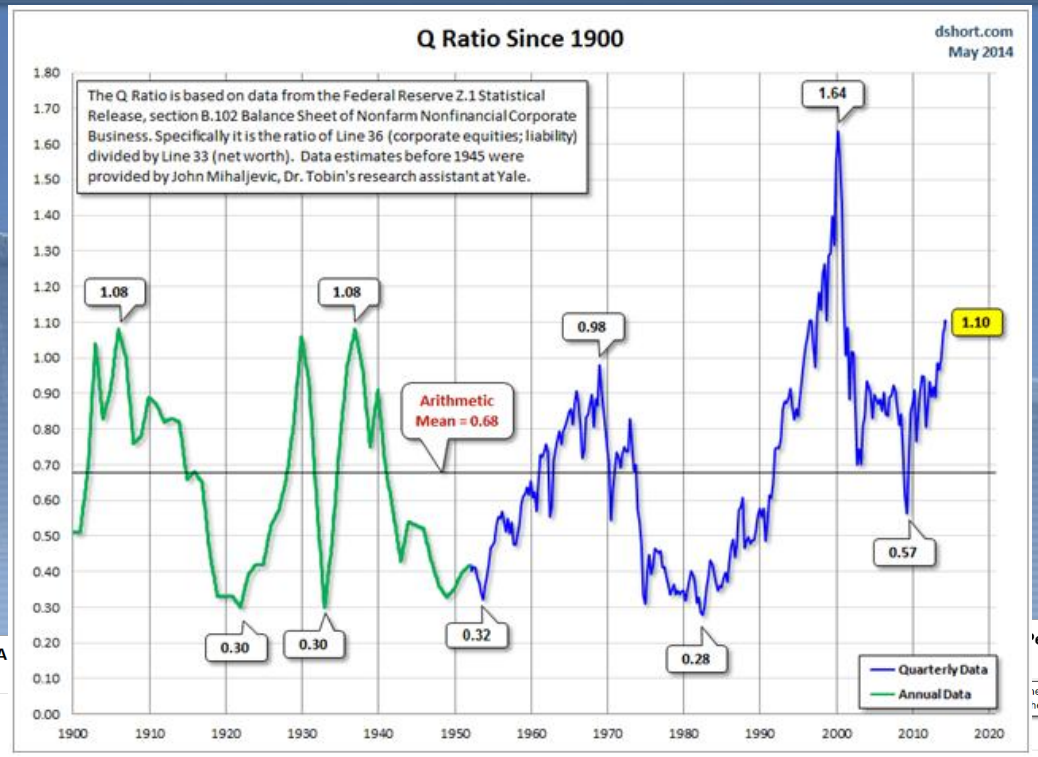
Based on inflation-adjusted S&P Composite monthly averages of daily closes.

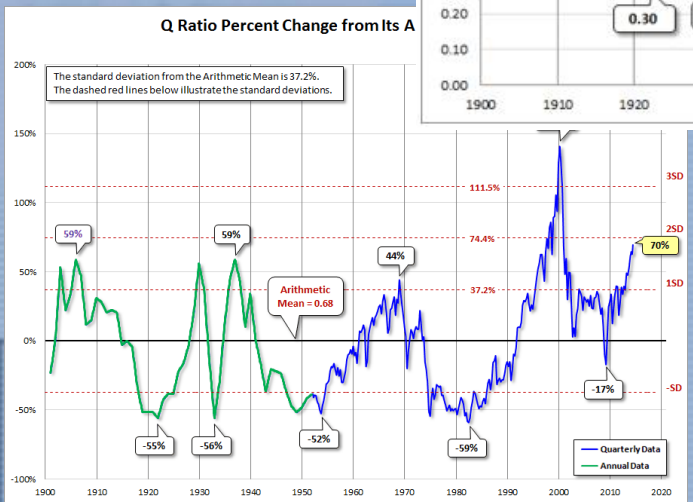
Secular Cycles

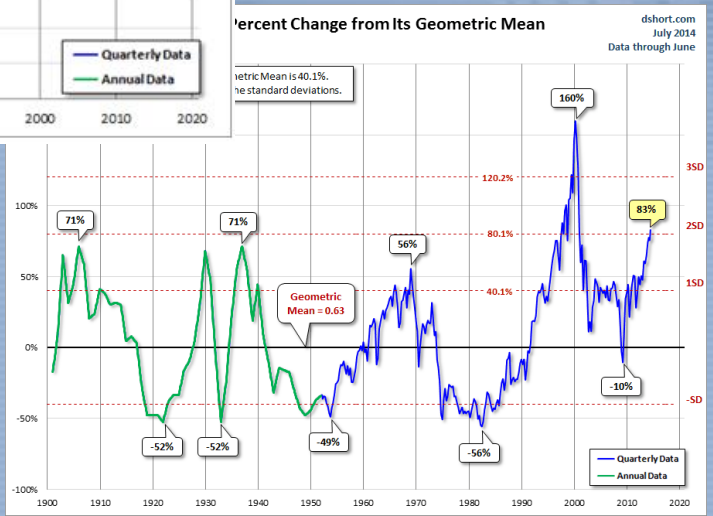




Secular Cycle: Tobin's Q Ratio







Secular Cycle: CAPE/Shiller P/E

Shiller P/E: 24.9 (+ 0.27%)

Shiller P/E is 50.9% higher than the historical mean of **16.5**

Implied future annual return: **1.3%**

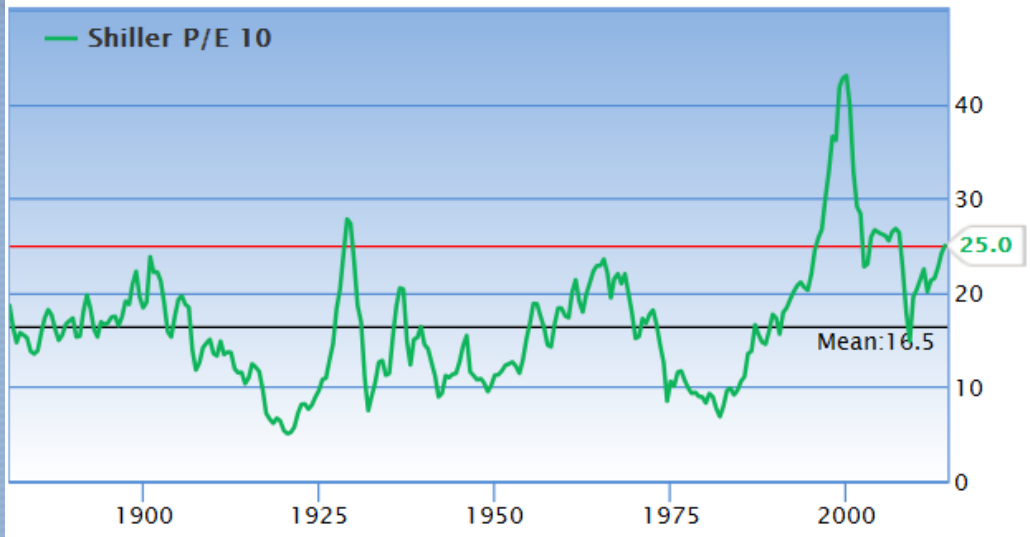
Historical low: **4.8**

Historical high: **44.2**

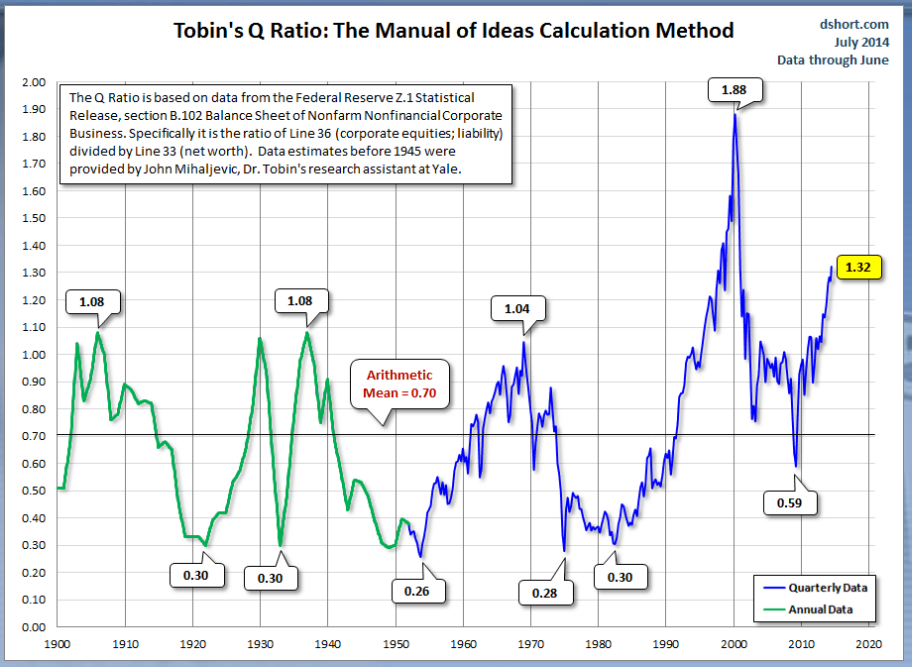
S&P 500: **1882.94**

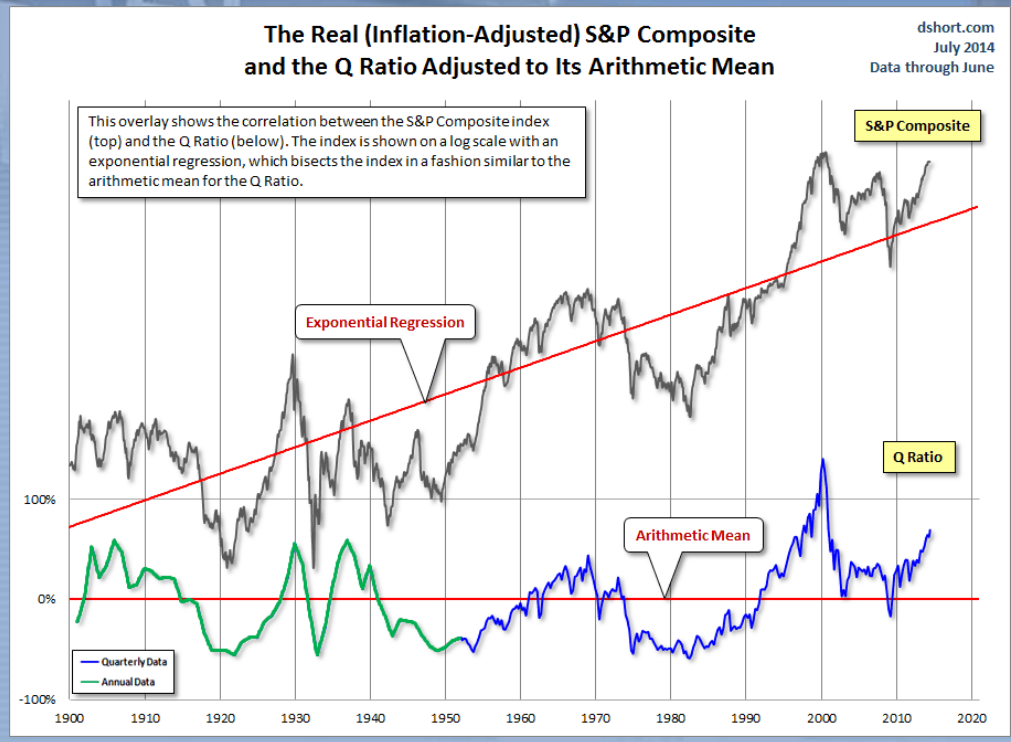
Regular P/E: **19** (historical mean:)

YTD 1Y 3Y 5Y 10Y **All** **Embed**



Secular Cycle





Market Valuation

Where Are We with Market Valuations?

Total Market Cap and US GDP

The Ratio of Total Market Cap to US GDP

The Stock Market is Significantly Overvalued. Based on historical ratio of total market cap over GDP (currently at **116.8%**),
it is likely to return 1.7% a year from this level of valuation.

Ratio = Total Market Cap / GDP	Valuation
Ratio < 50%	Significantly Undervalued
50% < Ratio < 75%	Modestly Undervalued
75% < Ratio < 90%	Fair Valued
90% < Ratio < 115%	Modestly Overvalued
Ratio > 115%	Significantly Overvalued
Where are we today (05/03/2014)?	Ratio = 116.8%, Significantly Overvalued

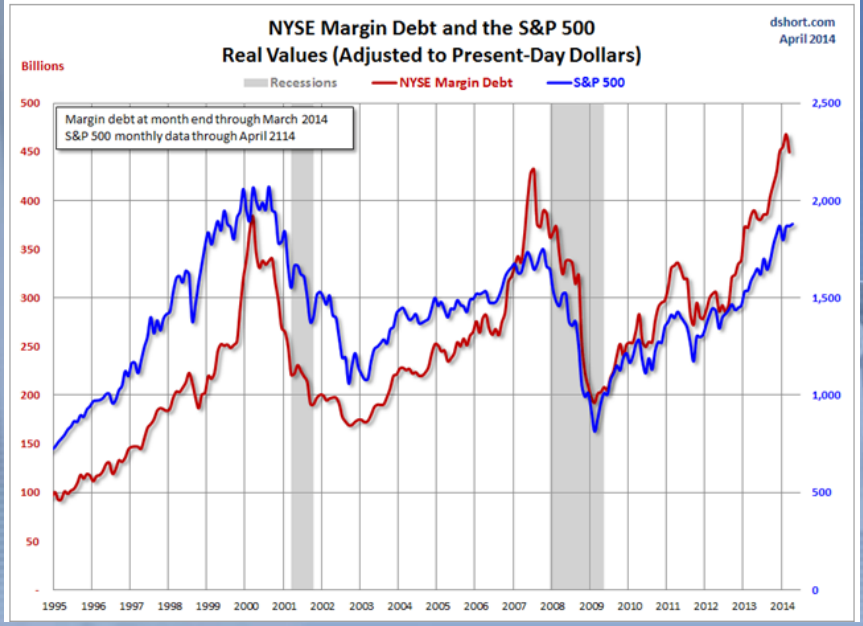
Where are we today?

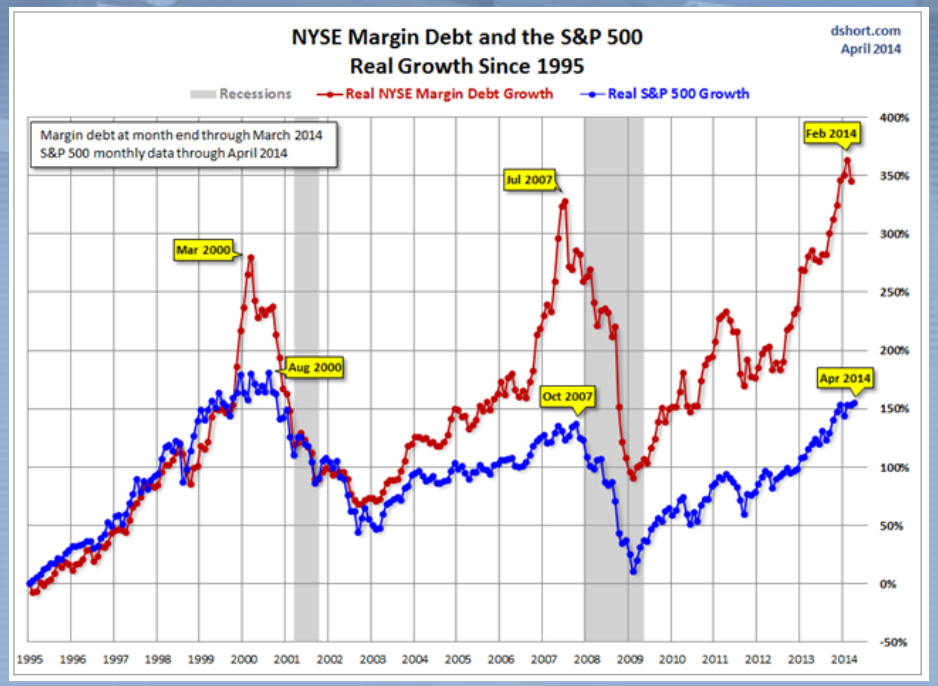
- 2014-06-27:

  The Stock Market is Significantly Overvalued. Based on historical ratio of total market cap over GDP (currently at 121.9%), it is likely to return 1.2% a year from this level of valuation.

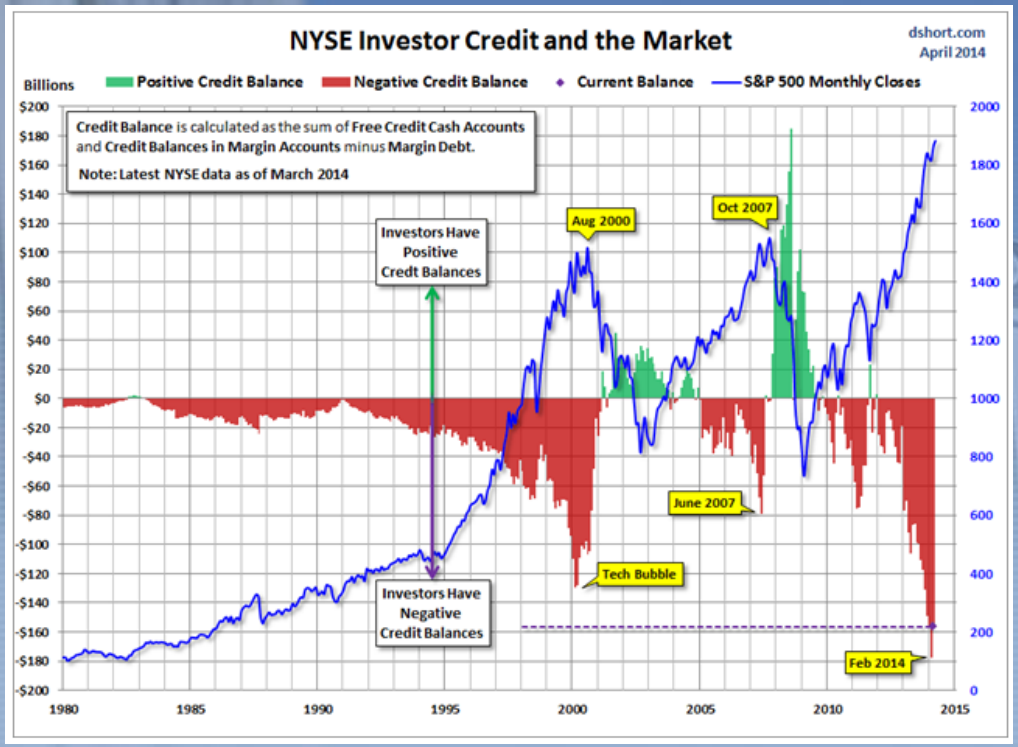
- Total Market Cap and US GDP

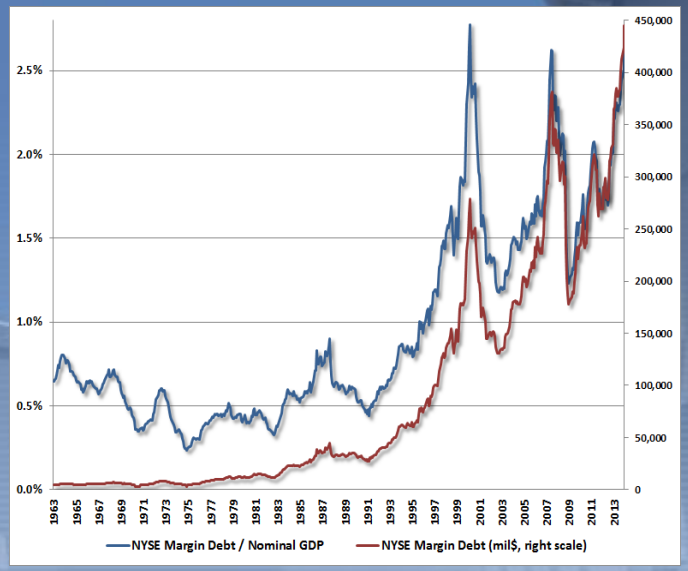
Market Valuation

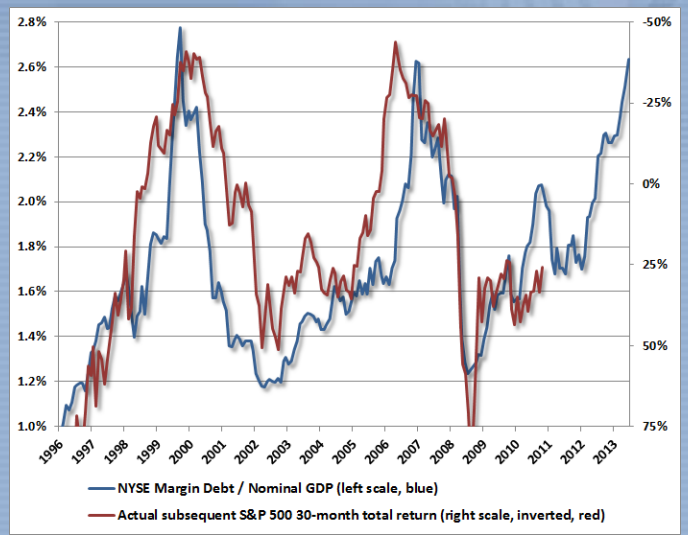


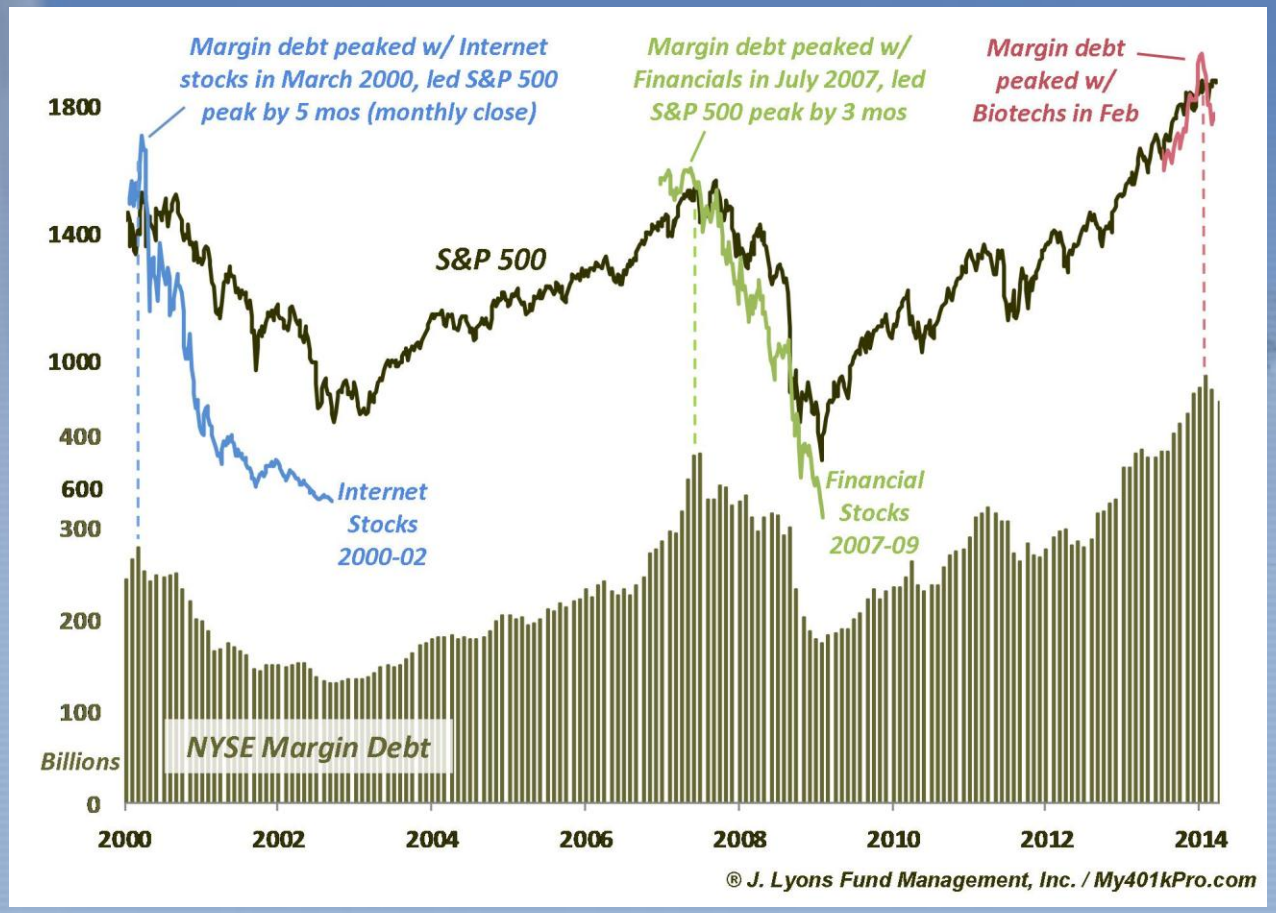


Market Valuation








Margin debt peaked w/ Internet stocks in March 2000, led S&P 500 peak by 5 mos (monthly close)
Margin debt peaked w/ Financials in July 2007, led S&P 500 peak by 3 mos
Margin debt peaked w/ Biotechs in Feb
S&P 500
Internet Stocks 2000-02
Financial Stocks 2007-09
NYSE Margin Debt
Billions
1800
1400
1000
400
600
300
200
100
0
2000
2002
2004
2006
2008
2010
2012
2014
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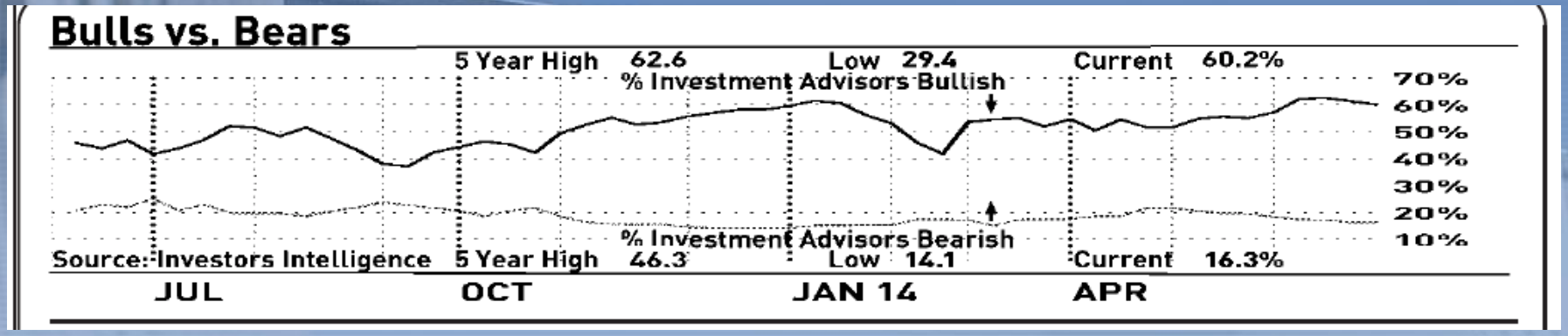
	P/E RATIO			DIV YIELD			
	6/27/2014†	Year ago†	Estimate^	6/27/2014†	Year ago†		
Russell 2000	84.41	59.15	19.60	1.39	1.80		
Nasdaq 100	22.75	18.28	19.12	1.34	1.53		
S&P 500	19.32	18.41	16.58	1.91	2.14		

Friday, June 27, 2014
† Trailing 12 months
^ Forward 12 months from Birinyi Associates; updated weekly on Friday.
P/E data based on as-reported earnings; estimate data based on operating earnings.
Source: Birinyi Associates

Extremes?


Bulls vs. Bears
5 Year High 62.6
% Investment Advisors Bullish
Low 29.4
Current 60.2%
70%
60%
50%
40%
30%
20%
10%
% Investment Advisors Bearish
Source: Investors Intelligence
5 Year High 46.3
Low 14.1
Current 16.3%
JUL
OCT
JAN 14
APR

Buffett Indicator