U.S. Equity Market: Risk of a "Cyclical Bear Phase" into 2014

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In the tradition of the famous economist Joseph Schumpeter, who had explained most of the business cycle by the conjunction of three cycles (originally explained by three economists Kitchin, Juglar and Kondratiev), some technical market analysts took over the study of cycles, while the proponents of the adoption of the new theory of finance (Markowitz, Fama) lead some prestigious universities, like Saint Gallen in Switzerland to remove the teaching of "economic cycles" in the late '70s.

Well known technical market analysts like Robin Griffiths, Ralph Acampora or the late Ian Notley have let the original Kitchin Inventory Cycle of about 40-50 months evolve into the 4-year presidential cycle in the US, which has allowed us to pinpoint, with a good degree of accuracy, the 4-year cyclical lows of the Dow Jones Industrial Average (DJIA) after the second World War. The '60s and '70s clearly show major market lows in 1950, 1954, 1958, 1962, 1966, 1970, 1974, 1978, 1982 and after the crash of 1987, again lows in 1990, 1994, 1998, 2002. One would really wonder indeed if the US economic policy and its perception by the financial markets was not geared to the political election cycle of the US president, and was taken over as a causal link to the economic fluctuation due to the inventory cycle in an economy characterised more and more by "on time delivery".

Some technical market analysts consider the Juglar Cycle, called the investment cycle lasting 6-10 years could be approximated by the so-called decennial cycle, which is created as a statistical average of the annual performance of an equity index for all years ending with the same number in a decade (for example, years ending in 5 averaged over 100 years have an average performance clearly above the average those ending in 2). However, other analysts have preferred to replace this decennial pattern with a 10-year cycle anchored on a major low of the last 40 years, namely on the lows of the US equity market at the end of 1974.

Indeed it is interesting to underscore that the economist Schumpeter got interested in a third cycle, namely the Kondratiev Cycle, which would be linked with major technological innovation cycles, lasting 40-60 years. For cycle theorists, the fact that the 40-year cycle could be constructed as a linear combination of two sub cycles, namely the 4- and 10-year cycle is even more appealing. Given the long term bullish bias of the US equity market over the last 150 years, the simplified graphic representation of such a cycle was shown as a sort of "A-symmetric cycle", rising 85% of the time on the way up from its recent low and declining 15% of the time from the top of the cycle into the subsequent low. This would be different from the traditional representation in half moons of shorter time cycles rising 50% of the time from the low to top, and declining 50% into the subsequent low (see chart 1).

Why was it interesting to research the interaction of cycles after the emotional event of "9/11" in the US? The closing of the US financial markets for a few days and the subsequent equity market price rebound at the year end 2001 lead us in February 2002 to consider a joint low of the 4-year and the Juglar Cycle, which would suggest a major low in the US equity market in the fall of 2002.

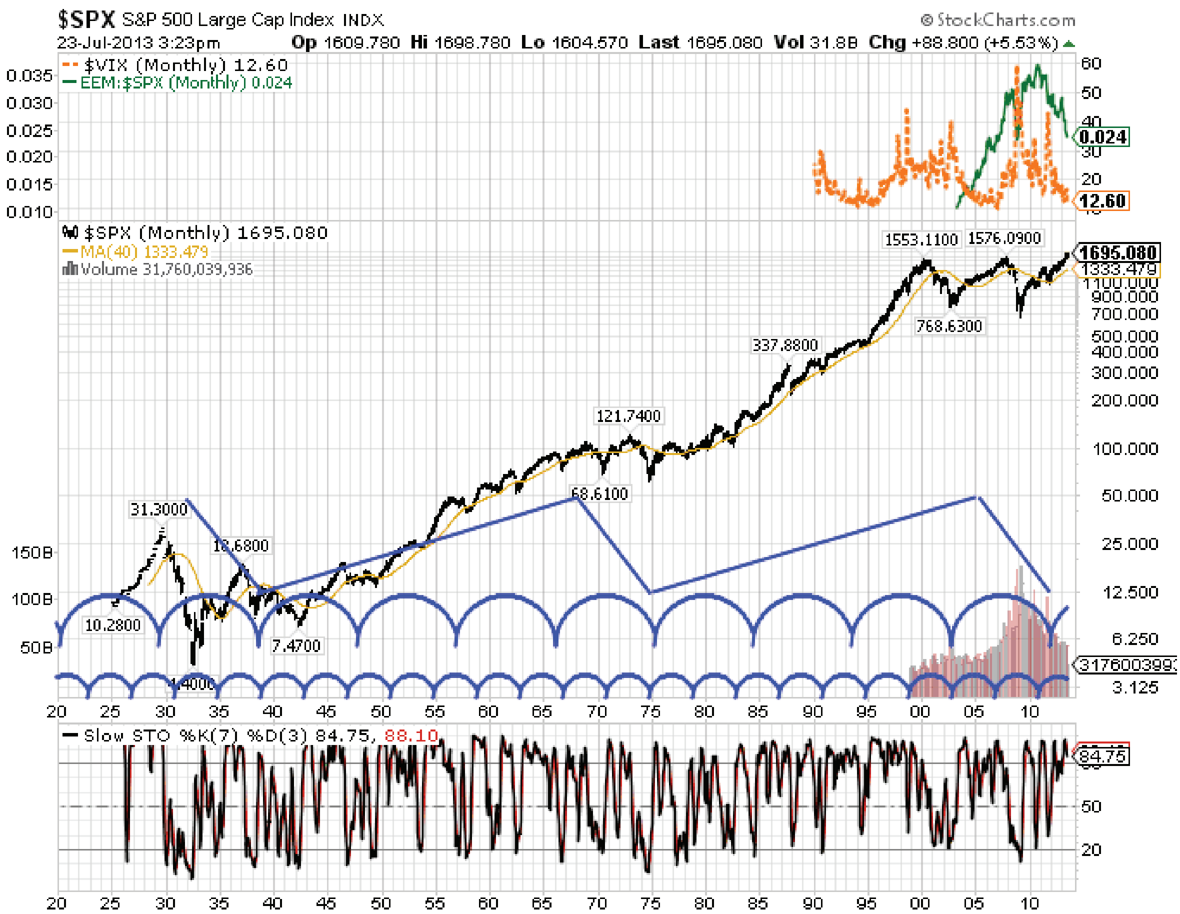
Making that call was possible thanks to the sharing of Canadian market technician, Ron Meisels, who had worked on the interaction of three similar cycles and presented his research in 1995 in San Francisco at the International Federation of Technical Analysts Conference (IFTA – www.ifta.org). Learning the concept, I later published an article in the Swiss Derivative Review in mid 1998 about the risk of a 4-year cycle low in October of that year. Later at the beginning of 2002, I was concerned that this 4-year cycle, which had started at the equity low in October 1998 had gone up for only about a year and was on a downward path in 2000 and 2001, confirming a bearish skew and the status of a secular bear market since 2000 like in the mid ’60s to 1982. But to come up with a major equity low in 2002, I had to make the hypothesis that the December 1974 equity low of the DJIA was a major low in terms of its psychological and economic impact on investors. Thus, at least two of the three cycles should be anchored in 1974. Indeed by anchoring on one hand, the Juglar Cycle with a cycle length of 9.25 years instead of 10 years, as is usually accepted in technical analysis, and on the other hand by anchoring in the same period the low of the 4-year presidential cycle, what is also accepted in the technical analysis community, I was able to obtain the low point at the same time of both cycles, namely in the fall of 2002, which happened to be coincident with the rebound of the US equity market after October 2002.

In expanding the reasoning and anchoring in 1974 further in the third cycle, which I called the “A-symmetric Cycle” with a cycle length of 37 years, resulting in the linear combination of the two smaller cycles (9.25 x 4), I would obtain the coincident lows in December 2011 of the 9.25 year and of the 37 year cycles. Thus in mid July 2012, I made the call that the US equity low in June 2012 was an important low, (see bruno.estier.net/presentations.php) because beyond the short term market analysis suggesting an extreme oversold situation and an extreme in pessimism of market participants, I hypothesised that in December 2011, both longer cycles (A-symmetric and Juglar) had bottomed and were beginning a bull market phase.

Why having been bullish in US equities since mid 2012 and having supported the call for an

Chart 1

Monthly S&P 500 Index, 1920 - 19 July 2013 with a 40-month moving average. The lower panel displays the momentum indicator 7-month Slow Stochastic.



The presidential 4-year cycle and the 9.5 year Juglar Cycle are represented in half moons. The A-symmetric Cycle of 37 years pictured above the two other cycles thanks to a rising 30-year line and a descending 7-year line. One would note that the low of that momentum often matches the theoretical lows of the four year cycle.

Concept courtesy of Ron Meisels. Chart source: StockCharts.com extension of the bull market in the first half of 2013, do I consider it a high probability that the US equity market may enter the H2 of 2013 in a cyclical bear phase in the next 15 months, implying a sizeable correction?

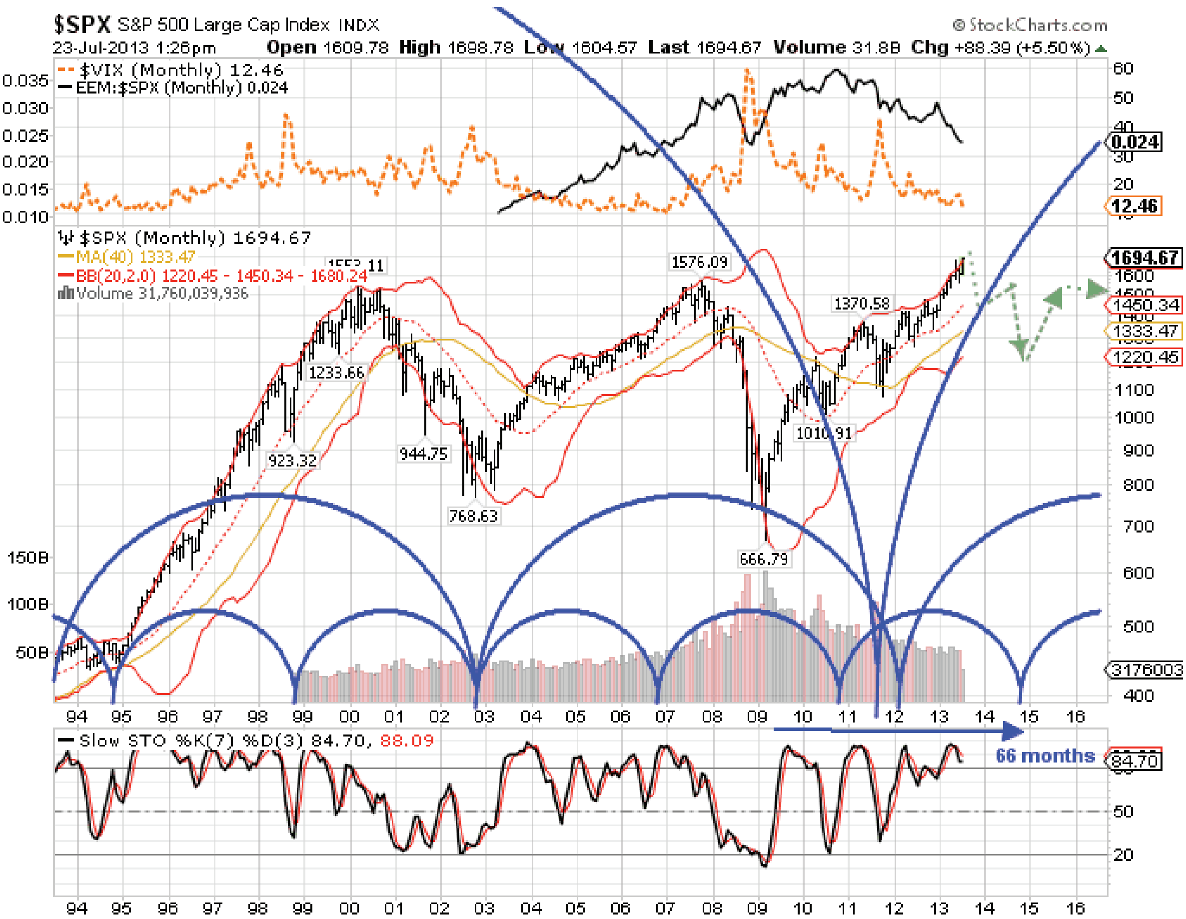
In that call we focus mostly on the influence of the 4-year presidential cycle, which has a normal periodicity of 42-54 months. In a recent past, the cycle length has been extraordinarily regular with a low every 4 years: in the fall of 1990, 1994, 1998, 2002, while the theoretical lows of 2006 and 2010 were more difficult to pinpoint.

In October 2006, I presented the hypothesis that the 4-year cycle that started in 2002 was going to extend to 2007, in a similar way that the extension of the 4-year cycle started in 1982 into 1987! Without predicting a crash, I suggested that there was a risk of entering a cyclical bear phase, which would balance on the downside the bullish extension phase of the cycle. It is interesting to note that the 1987 crash was not only dramatic in price and time, to balance the fact that the market had skipped the theoretical 4-year cycle low of 1986, but also that after 1987 the US equity market was able to produce major lows from 1990-2002 every four years, like a Swiss watch along the timing of the theoretical cycle. So the experience in the '80s was that market analysts should keep in mind the 4-year cycle even when it occasionally seems to skip a beat!

No debate that the March 2009 low in US equities was a brutal correction after somehow skipping the beat of 2006! The psychological intensity for investors during the bear market of 2008-2009 must have been at its end point, comparable in terms of pessimism, to the low of 1974. Currently the US equity market has been rising toward new highs since the low of March 2009, or about 52 months to July 2013. This comes close to the 4-year cycle extension in 1987 or 2007, and could be rationalised by the hypothesis that both the A-symmetric 37 year and the Juglar Cycle are rising. Thus this

Chart 2

Monthly S&P 500 Index 1994 to 19 July 2013 with 20-month moving average, Bollinger Bands and a 7-month momentum Slow Stochastic on the lower panel.



The green line projected into 2014 toward 1200-1250 is our only one hypothetical case.

The upper panel displays in orange the CBOE Volatility Index (VIX) and the relative strength line in black of an emerging market ETF (EEM) versus the S&P 500 Index.

Source: StockCharts.com

may explain that the current 4-year cycle would extend its periodicity measured from low to low toward 54 months (October 2013) or 66 months (October 2014). This warns of the risk to expect a top before the arrival of such a cycle low!

I think there is bias toward expecting a major low in 2014, because not only would it elegantly allow us to again find its theoretical cycle low like in the '90s (2002, 2006, 2010, 2014), but also because there remains very little time for a cyclical bear phase to occur only in 2013! Indeed I consider a crash like 1987 very unlikely, because nowadays one too many investors are fearing black swan events and, thus are out of the US equity market. Further, because many investors are more invested in bond products than in equity products, and overall they could be not such a strong overweighted concentration in equities. Indeed, if there is an overweighting in bond products, then this could cushion any minor equity decline of 7-10% as managers of "balanced portfolios" would progressively switch out of bonds into equities at each minor equity dip during the next 15 months.

Only at the final bottom, will it be possible to measure the decline, which could match from top to bottom a 25-30% decline, if the US market does indeed enter a cyclical bear phase. Of course, the hypothetical future evolution (in green on chart 2) of the S&P 500 toward 1200-1250, is only one theoretical case and has no determining characteristic, as only the market will decide in due course about the precise evolution of the index.

But, it allows thinking about potential risks for the coming 15 months and serves as illustration to our thesis!

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He holds a MSTA from The Society of Technical Analysis in London and the CFTe and MFTA designation from IFTA. After graduating with an MBA from the University of Chicago Booth Graduate School of Business and a master in economics from the University of Saint Gallen (HSG), he worked 12 years with JP Morgan – 6 years in FX sales in Zürich and 6 years as Senior Technical Analyst in Paris. He joined Lombard Odier & Cie in Geneva for 10 years as Head of the Technical Analysis team reporting to the CIO.

Currently Bruno Estier Strategic Technicals provides coaching on the long term and short term evolution of financial markets based on 30 years experience in Behavioural and Technical Analysis Methodologies.

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