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LE COIN TECHNIQUE

Risk & Reward of an expected fall in the Fall!

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Last month the focus was on Inter-market relationship between German and US Bond Yield, Commodities Index and the US Dollar Index. All of these key variables will still play a big role in the coming 4 weeks. Today the focus is on the risk and reward of the scenarios proposed along a red & a green path. The red path, which envisioned a top at end of August is off the map. It is replaced by the green path, representing the risk of a correction toward 2700-2600, namely the area of the weekly Ichimoku cloud. In September the S&P500 hit an all-time high near 2940 along positive MACD confirming an uptrend since July. However, the behaviour of our weekly Stochastic in the overbought area *(above 80%)* during the last month calls for a slowing down of momentum. A weekly close below 2900 may activate a weekly bearish divergence which could lead the S&P500 to follow the green path. But there is not much time for this to happen, if one gives credit to the annual seasonality of US equities, which sometimes turn positive in October. This same annual seasonality tends to influence the 4-year US presidential cycle, which also suggests the occurrence of a low in the early fall *(September-October window)* near the time of the mid-term US elections. The July-August WealthGram already explained the pitfalls of that US presidential cycle since 2002. Indeed, Cycle observations are of secondary importance versus the analysis of the Tape.

This means more weight should be put on the momentum analysis of the S&P500 index. Then a special focus should be devoted to relative strength (RS) of the Nasdaq 100 large caps, which mostly represent the leading technology sector and to the US Small Caps RS, which gives an idea of the breadth of the US market. Finally the RS of Emerging Markets can give a hint about the perception RISK ON versus RISK OFF of investors.

These RS lines versus the S&P500 are located on the top panel of the chart. Outperformance of the leading large caps of the Nasdaq100 has stopped rising since July. Small Caps are underperforming the S&P500 also since July, calling for some narrowing breadth of the US equity market. Finally the declining trend of the Emerging Markets RS since April, represented by the RS EEM ETF versus S&P500, gives the impression that some investors have already re-allocated from risky Emerging Markets into the currently perceived less risky US equity market. As short term FEAR is represented by the VIX index *(12.41% on Sept 27 as on July 24)* it seems that the level of fear remained low during the summer. I suspect it could be too much complacency. Some market participants may not expect the S&P500 to rise similarly to the period from September 2017 to January 2018. Thus, during the coming month of October, any sudden decline in the S&P500 below 2850 together with a rise of the VIX above 15% should be warning signals that the S&P500 may follow our green path!

As a 4-year picture is worth 1000 words, look when and what type of correction occurred in 2014 *(4 years ago and also a mid-term presidential year)* and in 2015 compared to the S&P500 behaviour in 2016 and 2017. These observations may help to decide "when to hedge or what to hedge" when managing a global asset portfolio in 2018.

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Graph:

Charts of S&P 500 in weekly candles with Ichimoku cloud and VIX represented in orange dotted line behind the S&P 500 candles. On the upper panel is displayed the rising Relative Strength (RS) of small caps Russell 2000 versus S&P 500 in green dash line, the RS of emerging markets versus S&P 500 in orange solid line and the RS of Nasdaq100 versus S&P 500 in red dotted line. On lower panel, MACD is positive, though rising slowly while the weekly STO is rising again in an overbought area with risk of displaying a bearish divergence if the S&P 500 reverses below 2850. The red path is probably off track. To replace it, the green path is a less bearish possible version, which will be subject to changes depending on what happens after October 15, if an expected four-year cycle low re-emerges or not.

Source: Stockcharts.com / Red and Green Paths are provided by BEST.