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Charts of the Week

Investment Strategy: "Charts of the Week"

In last week's report, I included a chart that I frequently use to compare the performance of the Russell 3000 Growth Index and the Russell 3000 Value Index. If you missed it, the point made was that while value stocks have been doing better recently versus growth stocks, the long-term trend still remains clearly in growth's favor, and we believe it's too early to start significantly shifting portfolios toward value sectors. This prompted a flood of emails from readers on the subject, but the questions largely boiled down to the same general inquiry: when will it be time to favor value stocks over growth?

Absent a crystal ball, we can't provide a specific time when investors should make that move, but given the obvious preference toward growth over the last several years, it will require more than just a few strong weeks for value to really prove it has turned a corner for the long run. The main reason for this view is that, while it may seem like a recent phenomenon to have growth so clearly dominating value, the Russell 3000 Growth Index has consistently outperformed the Russell 3000 Value Index, with few notable exceptions, since 2006 (see page 13). That's 12 years of lagging performance that value must contend with, and it's a trend that we don't really want to fight. We believe there are a few fundamental reasons why growth has done better over the last decade, too, and these tailwinds do not really show signs of reversing anytime soon either.

- The massive shift to passive investing/ETFs benefits growth stocks at the expense of value stocks. Historically, active investors and portfolio managers have generally favored value strategies, buying stocks that are trading below a calculated intrinsic value and selling stocks that have risen above a calculated intrinsic value. However, as more money flows into products that "buy the market" or "buy a whole sector," value is largely being thrown out the window. Instead, higher-growth stocks that are bid up to higher valuations rise in price/market cap and become even larger holdings within most of these funds, while stocks that fall in price/market cap become smaller holdings; there's a built-in momentum factor at work that doesn't exactly help stocks that are "undervalued." We don't think it's a huge coincidence that the clear outperformance of growth over value going back to 2006 has occurred at the same time passive investing and index funds have proliferated.
- On a closely-related note, it used to be costly and time consuming to buy and sell stocks, and it was near impossible for the average investor to try to duplicate an index or even to hold a large basket of stocks in a portfolio. As a result, more emphasis was placed on finding the sub-section of stocks that represented an exceptional value opportunity and then holding them until they were no longer good values (or paying an active manager to find those opportunities). Now, online brokers offer $1 commission stock trades (or less), and just last week, Fidelity rolled out two 0% management fee index funds that enable investors to own, essentially, the majority of the world stock market's capitalization at no cost. The ability to trade so quickly and cheaply we feel has helped to cut down on holding times and has prompted investors to chase quarterly earnings growth and near-term performance, further skewing the market toward momentum and growth stocks. Moreover, the easier and cheaper investing becomes, the more money that goes directly into stocks, and since that money is increasingly going toward passive strategies and growth stocks these days, it's almost become a self-perpetuating cycle.
- With the broad stock market consistently seeing "higher than average" valuations and generally rising over the last few years, it's simply meant there are fewer attractive value opportunities overall. Investors have, therefore, piled into stocks with greater earnings growth potential that can better justify the higher valuations. It should not come as a complete surprise that, since 2006, the periods when value has been the better performer have come AFTER meaningful sell-offs in the broad market (again see page 13). We think these sell-offs have helped create more value opportunities when they occur, and relative performance improves while those beaten down companies return to fairer valuations. As a result, it may require more of a significant decline in the broad market to put the wind at the backs of value stocks again.

- With interest rates and economic growth as low as they have been over the last few years, many investors have been reaching for returns out of the stock market to make up for the lackluster yields in fixed income. A “barbell-type” strategy has been quite common for investors, as they balance less volatile, low-yielding bonds and bond proxies with growth stocks that have potential for outsized capital gains. We feel that as rates rise, it’s more likely to first take demand away from the lower growth, higher dividend-yield stocks commonly used as bond proxies, rather than the high EPS growers (and this has likely already begun). A stock with a 2-3% dividend and a lower expected growth rate simply becomes less attractive as interest rates rise, while a stock with the potential to grow earnings at a high rate isn’t as impacted by rising rates.
- The increase in importance to our overall economy of the technology sector and tech-heavy companies in other market sectors (e.g., Amazon, Netflix) naturally favors growth strategies over value. Companies that chiefly depend on innovation and continual progress, like those predominantly found in the technology sector, often trade at higher-than-average valuations but can still be attractive to investors because they are expected to generate better-than-average earnings growth in the future (even if they’re not currently profitable). As technology-based companies continue to increase in market and economic weight, it becomes harder for companies in more traditional value sectors to keep up.

I’m sure there are other things we could add to this list, but the bottom line is that growth stocks have dominated value stocks for over a decade now, and it might take some sort of recessionary environment to really flip that relative strength. There will be times, like recently, when value does better, and there will always be attractive individual value situations on the company level, but we believe long-term investors taking a more active approach should still remain focused on the growth-type companies and sectors that have been in favor in recent years.

As for the stock market in the near term, the S&P 500 sits just 14 points away from hitting its first new all-time high since late January. The sectors we want leading have had a good start to the week, as well, with Technology, Health Care, Financials, Consumer Discretionary, Industrials, Energy, and Materials all higher over the past two days as the S&P 500 creeps up toward a new high. We continue to think it unlikely that the index will get all the way up here without tagging a new high, especially since other indices have already done so in recent weeks. It might not stick the first time but should be interpreted as a bullish sign for the long term if we do get above 2872.87.

Finally, a reminder that our Chief Investment Strategist, Jeff Saut, will be doing a webinar this Thursday with Bill Kohli, portfolio manager of the Putnam Diversified Income Trust, to discuss the fixed income market and how Bill’s fund is positioned to take advantage of the current environment. The webinar will take place tomorrow, August 9, at 4:00 p.m. EDT, and advisors can sign up via this link.

S&P 500 – Last 5 Sessions (5-minute chart)

Source: Stockcharts.com

The Market Matrix

Well, the pullback in the NASDAQ didn't last long. After returning to "neutral" in all of its timeframes last week, it is back to being "slightly overbought" compared to the 10- and 50-day moving averages. The S&P 500 joins it here, too, but all three indices remain "neutral" overall.

THE MARKET MATRIX	S&P 500	NASDAQ Composite	Russell 2000
Price % Above/Below 10-Day Moving Average	0.97%	1.22%	0.71%
Price % Above/Below 50-Day Moving Average	2.96%	2.44%	0.67%
Price % Above/Below 200-Day Moving Average	5.69%	8.83%	6.92%
Relative Strength Index (RSI) (Overbought = ~70; Neutral = ~50; Oversold = ~30)	66.81	59.96	54.07
Overall Near-Term Opinion	Neutral	Neutral	Neutral

- White = Neutral; Yellow = Slightly Overbought; Red = Very Overbought; Dark Green = Slightly Oversold; Bright Green = Very Oversold
- Note: Overbought/Oversold levels may vary for each index based on historical volatility

Source: TC2000; Raymond James research; as of 8/7/18

The Breadth Box

As the S&P 500 nears a new all-time high, it's important that we see a supporting pick-up in market breadth. The action over the last week has mostly been encouraging, with all but two of our weekly breadth indicators improving since last Wednesday's report. The recovery in the NASDAQ indicators is particularly reassuring after the recent deterioration.

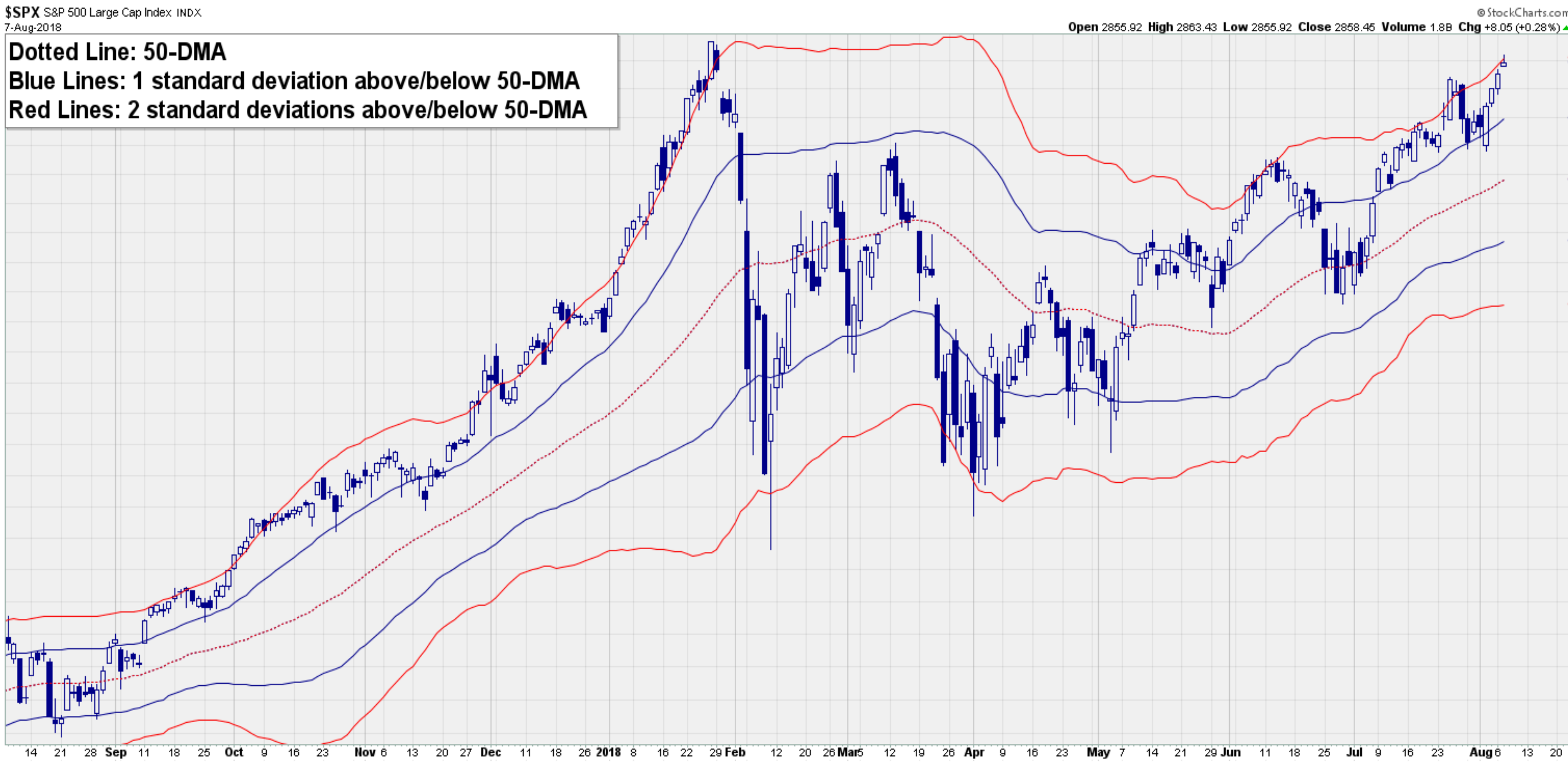
THE BREADTH BOX	This Week (8/7)	Last Week (7/31)	4 Weeks Ago (7/10)	Current Percent of 5-Year Range*
NYSE % of Stocks Above 50-DMA	61.71%	60.38%	65.70%	65%
NASDAQ % of Stocks Above 50-DMA	47.34%	40.37%	62.82%	53%
NYSE % of Stocks Above 200-DMA	61.09%	62.31%	60.72%	70%
NASDAQ % of Stocks Above 200-DMA	54.01%	52.54%	59.17%	69%
U.S. Stocks New Highs – New Lows (5-Day Total)	329	156	862	72%
NYSE Bullish Percent Index	59.67%	59.04%	60.22%	69%
NASDAQ Bullish Percent Index	55.88%	59.60%	61.12%	65%
S&P 500 Average % Below 52-Week High	11.2%	11.7%	11.8%	
Russell 3000 Average % Below 52-Week High	16.3%	16.6%	14.8%	

* 100% would be the highest point of the last 5 years, 0% would be the lowest point in the last 5 years, and 50% is the mid-point of the 5-year range

Source: Stockcharts.com; Bloomberg; Raymond James research

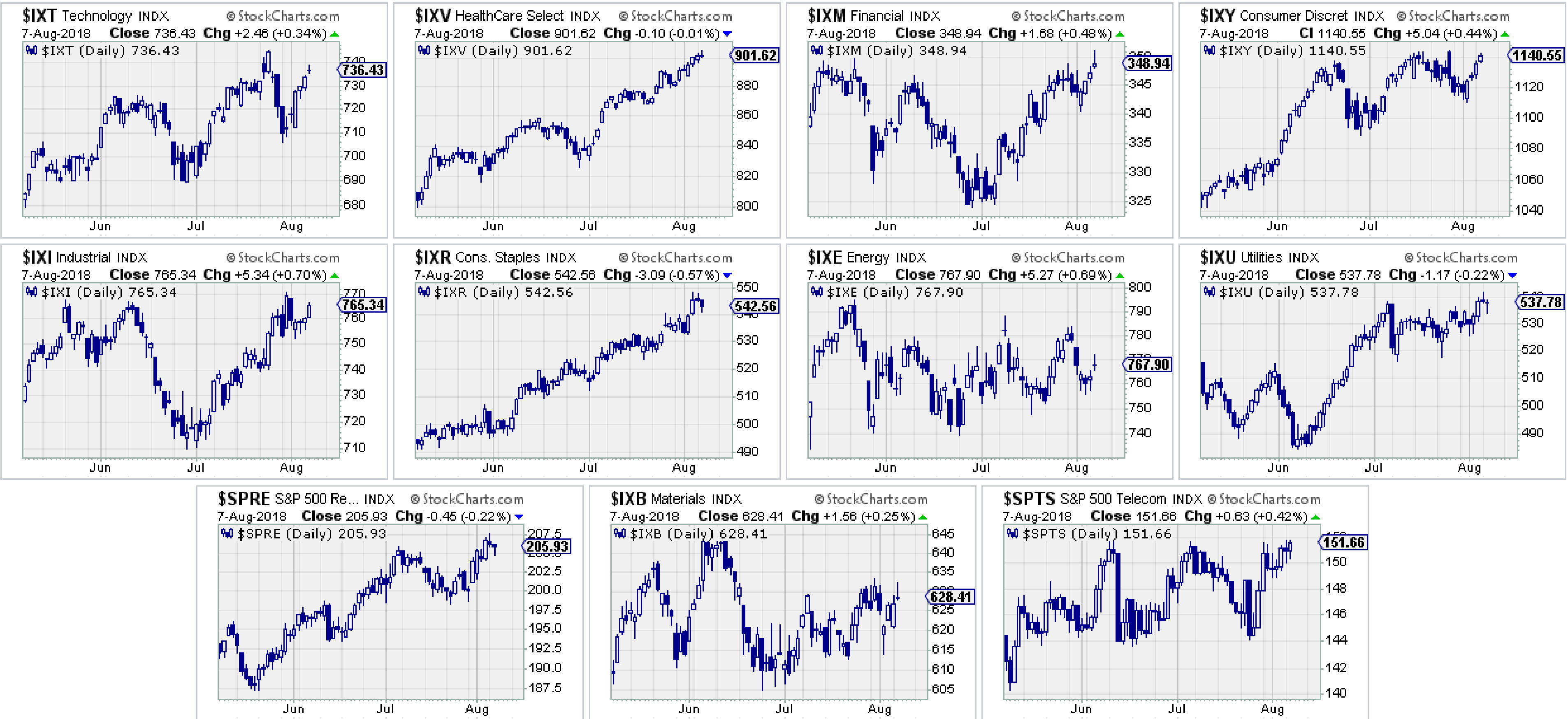
S&P 500 Timing Chart

The S&P 500 traded back up to the 2 standard deviation band above its 50-day moving average yesterday, and that resistance zone prevented the index from extending its early session gains. Only during the strongest of uptrends is the S&P 500 typically able to consistently trade above its two standard deviation band.



Source: Stockcharts.com

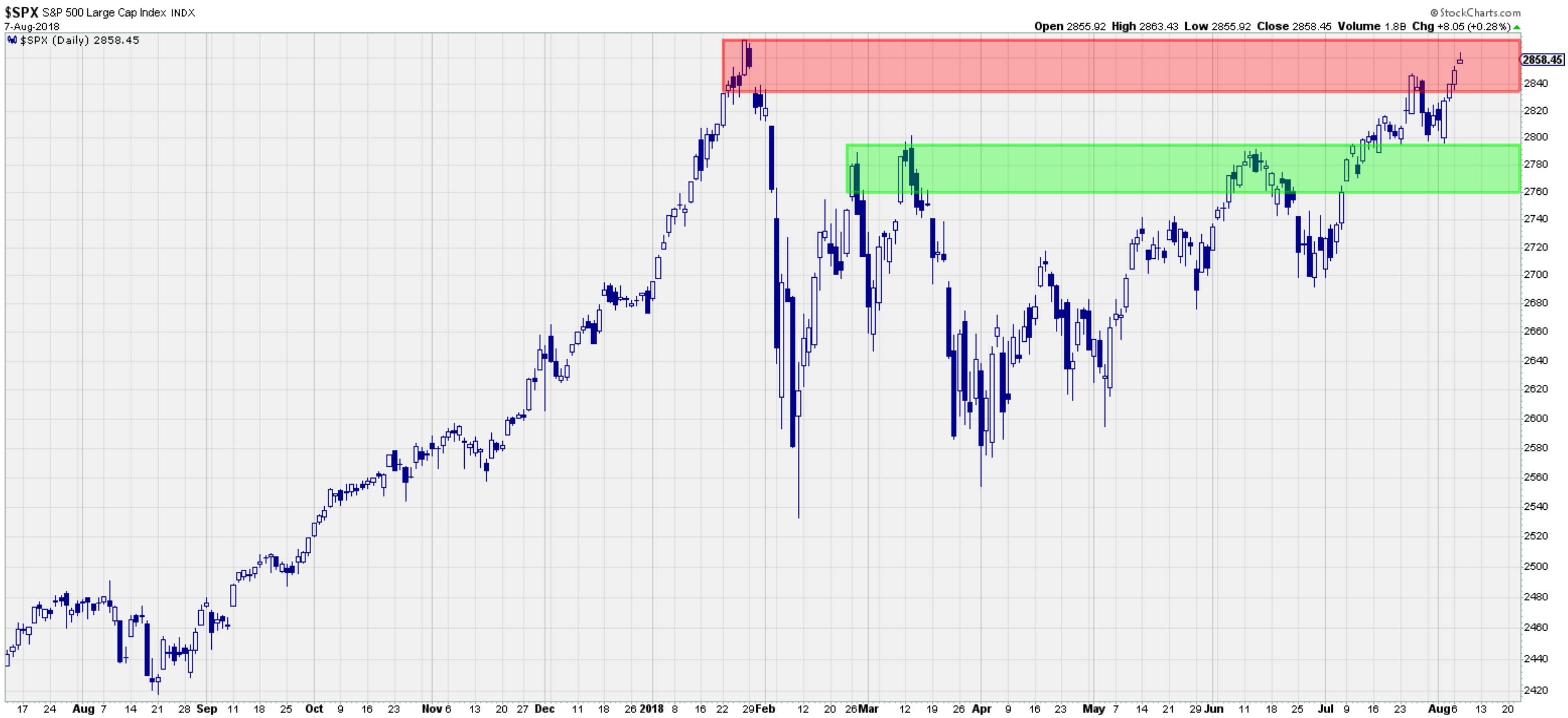
S&P 500 Sector View



Source: Stockcharts.com

S&P 500 Nearing a New All-Time High

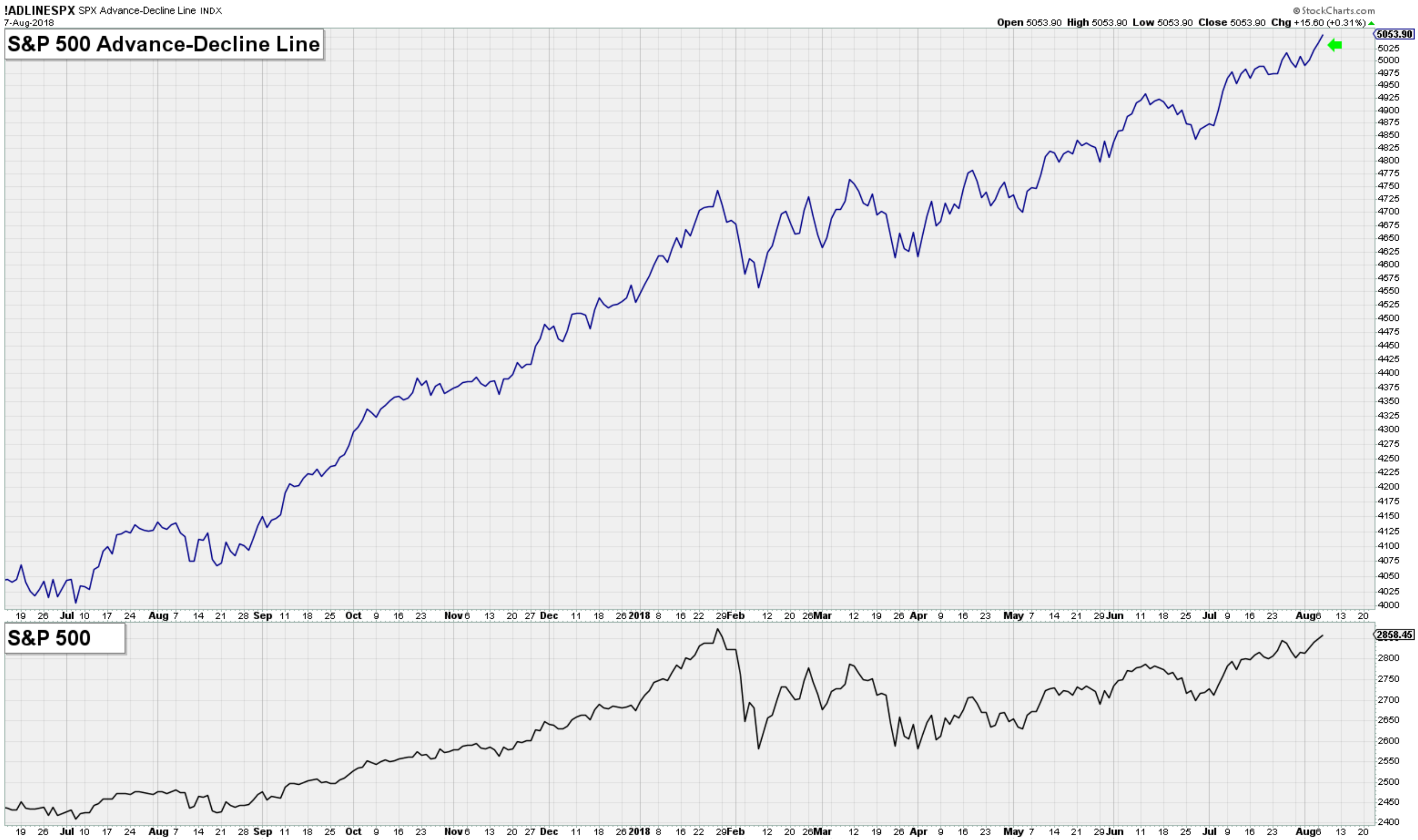
Despite the prevalent fear plaguing investors in recent months, the S&P 500 came within 10 points yesterday of hitting a new all-time high. If the index does make it over 2872.87, it will join both the NASDAQ and Russell 2000 in bettering the peak hit in late January prior to the broad market sell-off. For now, the S&P 500 remains in the resistance zone we have discussed in recent weeks, but as Jeff Saut has repeatedly said during this multi-month consolidation, we expect new highs to follow. Also, it is interesting to note that the index has now filled the January 30 gap down. While gaps don't always fill, they do often seem to act as a target for prices to return to.



Source: Stockcharts.com

S&P 500 A-D Line Continues to Hit New Highs Though

The S&P 500's Advance-Decline Line has been perhaps telegraphing new eventual highs in the index since it has repeatedly hit new highs over the last few months. The strength reflected across various market A-D lines has been one of the main reasons we have not been concerned about the health of the bull market.



Source: Stockcharts.com

Broad Stock Market at New All-time High

While it won't get the fanfare of the S&P 500 or DJIA hitting a new all-time high, yesterday the Wilshire 5000 Total Market Index did reach a new milestone. The Wilshire index no longer actually contains 5000 companies (it was ~3500 companies at the end of 2017), but it does represent all the actively-traded stocks in the United States market, so this is a big deal.

Source: Stockcharts.com

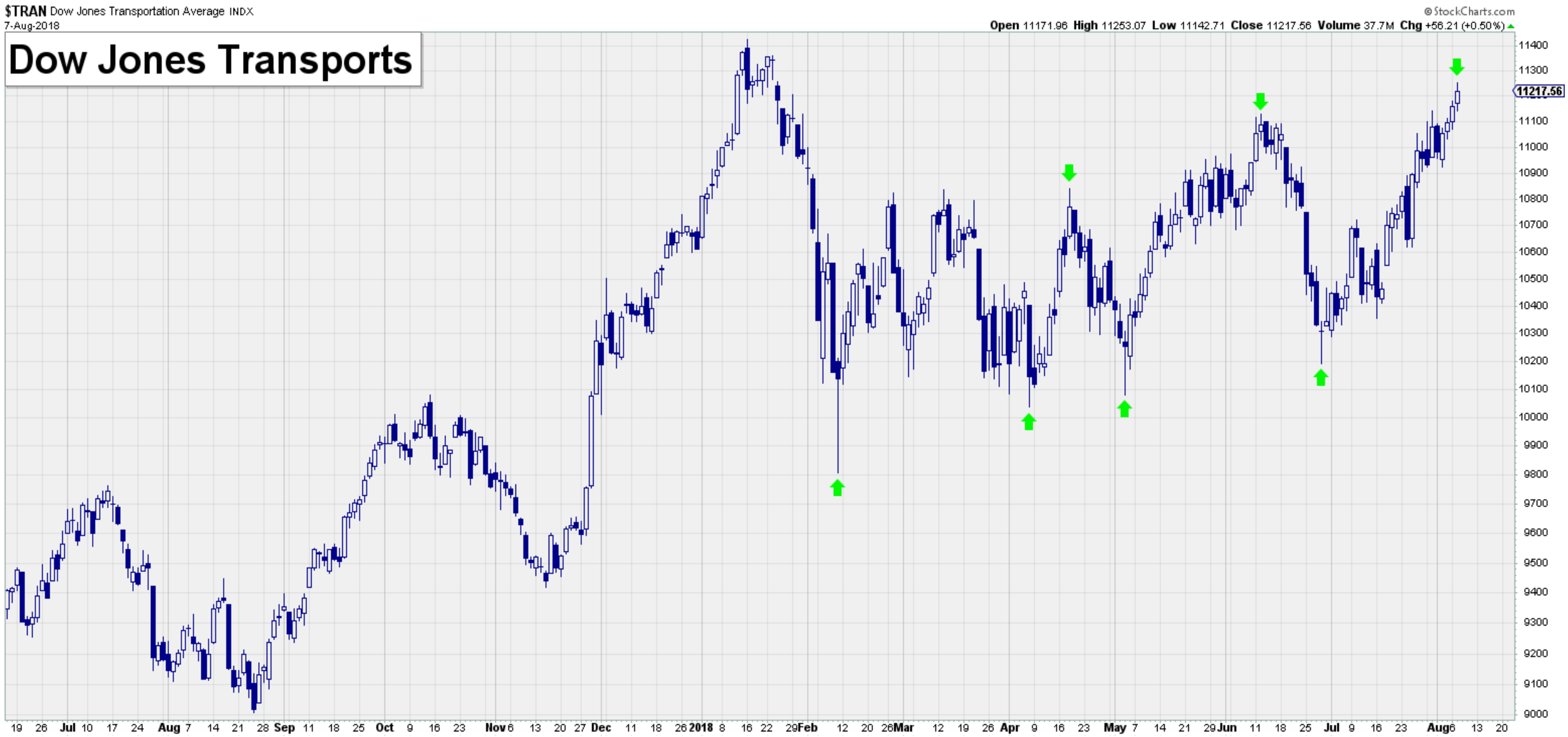
Small and Mid Caps Tag New Highs, As Well

And while we're at it, both the S&P 600 Small Cap and S&P 400 Mid Cap Indices hit new all-time highs yesterday. We still don't understand how so many investors can be bearish while so many indices are hitting their highest levels ever.

Source: Stockcharts.com

Transports at New Reaction Highs

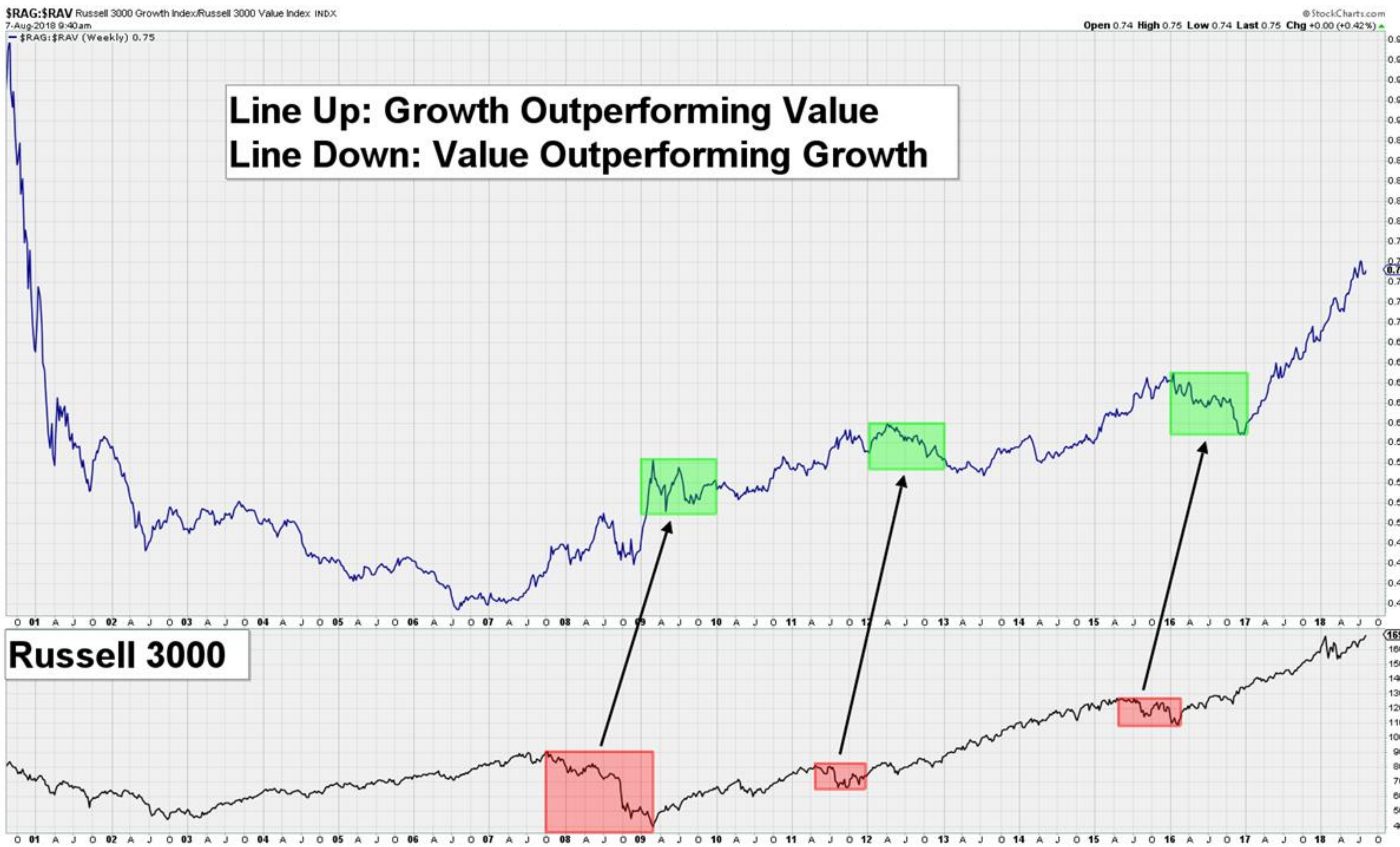
Meanwhile, the Dow Jones Transportation Index isn't yet at a new all-time high, but it is making new reaction highs and is back to trading at its highest level since late January. Another positive sign.



Source: Stockcharts.com

Growth Has 12-Year Trend Supporting It

Coming off the Dot-Com Bubble, the Russell 3000 Value Index enjoyed about a six-year period of outperformance versus the Russell 3000 Growth Index. Since mid-2006, however, the trend has clearly been in favor of growth with only a few meaningful exceptions. 2009, 2012, and 2016 were really the only calendar years when it was worth overweighting value, and that's not too surprising considering that those years followed more significant declines in the broad market in 2007-2009, 2011, and 2015-2016 when the Russell 3000 Index, itself, fell at least 15%. These corrections may have resulted in more attractive value opportunities of which to take advantage.



Source: Stockcharts.com

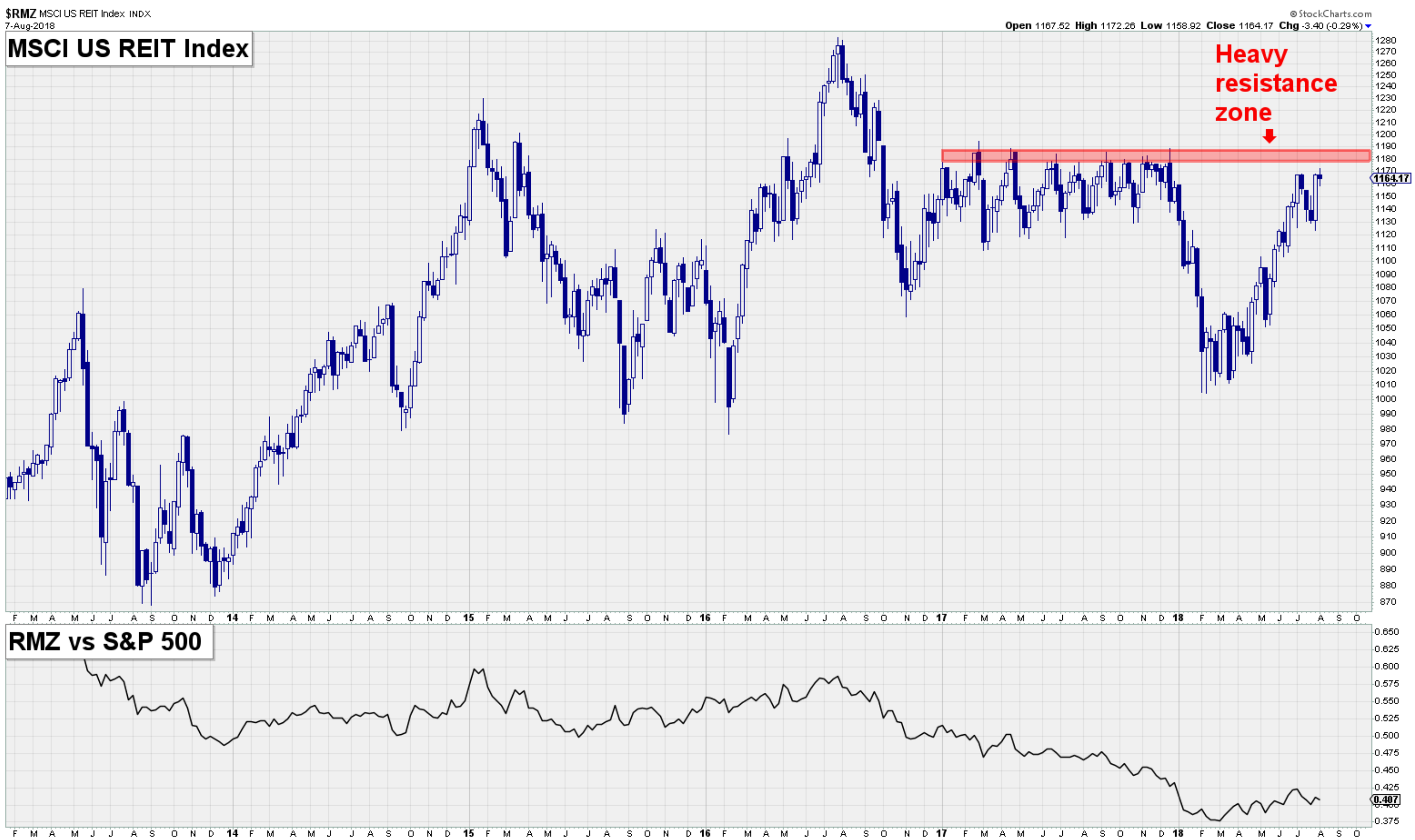
10-Year U.S. Treasury Yield Remains Below Resistance Zone

Nothing much new to mention with respect to the benchmark 10-Year U.S. Treasury yield. It has once again been rejected near the 3.0% resistance zone yet refuses to be knocked down too much. We continue to believe it's only a matter of time before it breaks out to the upside again.

Source: Stockcharts.com

Real Estate in Focus

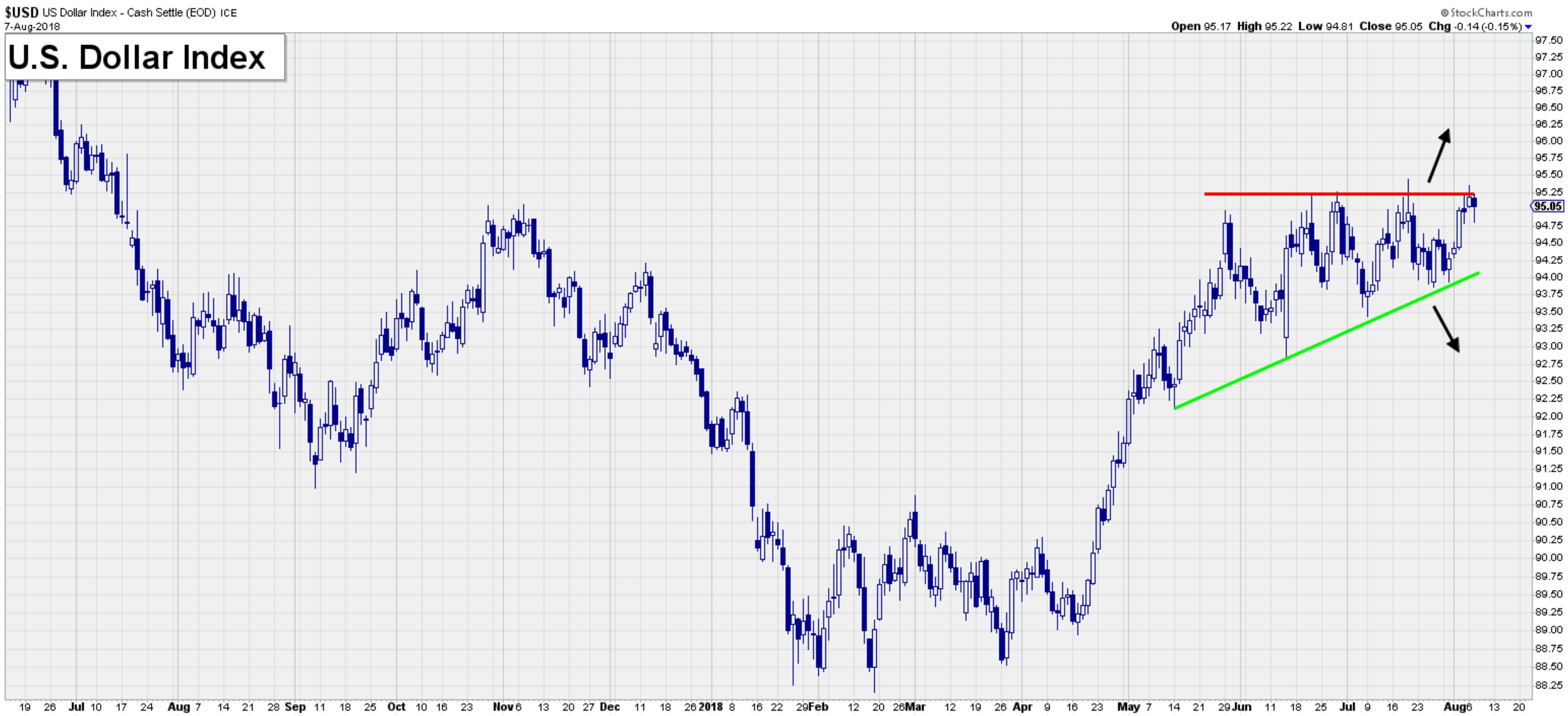
We have seen quite a few articles recently about a slowdown in various housing markets in the United States, but so far the broader U.S. REIT sector is not showing major weakness. However, as we have noted previously, the MSCI U.S. REIT Index remains just under what has been a heavy resistance zone over the last year plus, and it will likely be difficult to see strong performance out of REITs unless the group can prove it can climb above this resistance area.



Source: Stockcharts.com

U.S. Dollar Index on Brink of Breakout?

We have written about the consolidation in the U.S. Dollar Index a few times in the past couple of months, but it appears the dollar may be getting ready to take a shot at the upside of that trading range. The 95.25-95.50 zone is the one to watch, as the index has not been able to close a day above 95.25 during its back-and-forth movement since June. A higher dollar, if recent past is prelude, should benefit small cap stocks at the expense of large caps.



Source: Stockcharts.com

China Still an Opportunity for Aggressive Accounts

Naturally, China's stock market has been under pressure with all the trade policy uncertainty this year, and many investors still want nothing to do with the world's second largest economy. Yet, as we mentioned in early July, the Shanghai Composite Index has been beaten down close to long-term support, and it may offer an attractive opportunity for those willing to take the risk. Chinese stocks will continue to be volatile as long as we have the tariff threats, but with sentiment very negative and a possible double bottom forming above support, it may be worth a shot.

Source: Stockcharts.com

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