MARKETFIELD
ASSET MANAGEMENT

The Weekly Speculator

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We warned readers last week that the rapid bounce was unlikely to terminate the selling impulse in the US equity market that started in early October, and in retrospect the SPX had already recorded its recovery high a few hours earlier at 2817. The selling was relatively contained during the next three sessions and the index appeared to have found some support around the 2750 level, before the bottom fell out of the market on Tuesday morning. Even then an impressive attempt was made to take the index close to unchanged on the day in the mid-afternoon, but losses were mounting by the close setting us up for Wednesday's brutal session, at the close of which the SPX was at 2656.10, wiping out its entire gain for the year and back to the level that it used to launch its powerful May-September rally.

Losses were led by the Technology and Communications sector (yet again the launch of a new sector marking an important inflexion point for performance), and the NDX index suffered its deepest one day loss since 2011, down -4.6%. The RTY index declined -3.80% to 1468, only just above its February closing low at 1462. This obviously marks the end of the immunity of the US equity market from the difficulties being experienced elsewhere, and the rapid collapse of the RTY index rectifies the historical anomaly of it progressing serenely while the MXEF index collapsed in value (see chart), although obviously not in the manner that we originally hoped.

In terms of what happens next we are always loth to issue targets for sell-off such as this. We would say that the current levels of the SPX and NDX are the bare minimums that we thought would need to be reached when the weakness started two weeks ago and the good news is that both indexes do have a band of support around current levels that was established during the choppy April-May period. For the SPX index this extends all the way down to

2580 below which there is an air-pocket down to the February low at 2532. We would expect the latter to be stoutly defended, but no support level is impregnable if panic really were to take hold. For the NDX we view the February low at 6164 as a worst case scenario, which would involve another roughly 10% decline from the current level. Obviously the degree to which bell-weather earnings surpass or miss expectations will play a key part in the actual levels reached and there may be strong support around the 6500 level along the way.

Although this sell off may well be followed by a strong recovery rally we would be open to the possibility that the leadership role of this area of markets may finally be coming to a close. Certainly this proved to be the case with the emerging market technology sector after it peaked earlier this year, and this cannot be entirely blamed on the issue of tariffs.

As the sell-off has intensified we have noticed increased commentary on the possibility that it will force the Federal Reserve to reconsider the path of its monetary policy. As we explained in yesterday's note on the Beige Book, this seems quite unlikely unless we see significantly lower levels in the SPX (well below 2500) and the weakness spread to areas such as credit or rates. Thus far high yield markets have barely budged and the drop in both short and long term interest rates looks nothing like the moves seen in periods such as early 2016 (when the FOMC elected to put its hikes back on hold), let alone the 1998 reversal in policy by the Greenspan Fed during the LTCM crisis. Given Chair Powell's stated admiration for his predecessor, we would not state that a reversal in policy is impossible to imagine, just that there would need to be much more disruption to take place before it would be seriously considered. We therefore doubt that the FRB will have a key role to play in the current episode, although a few months down the road may be a different story.

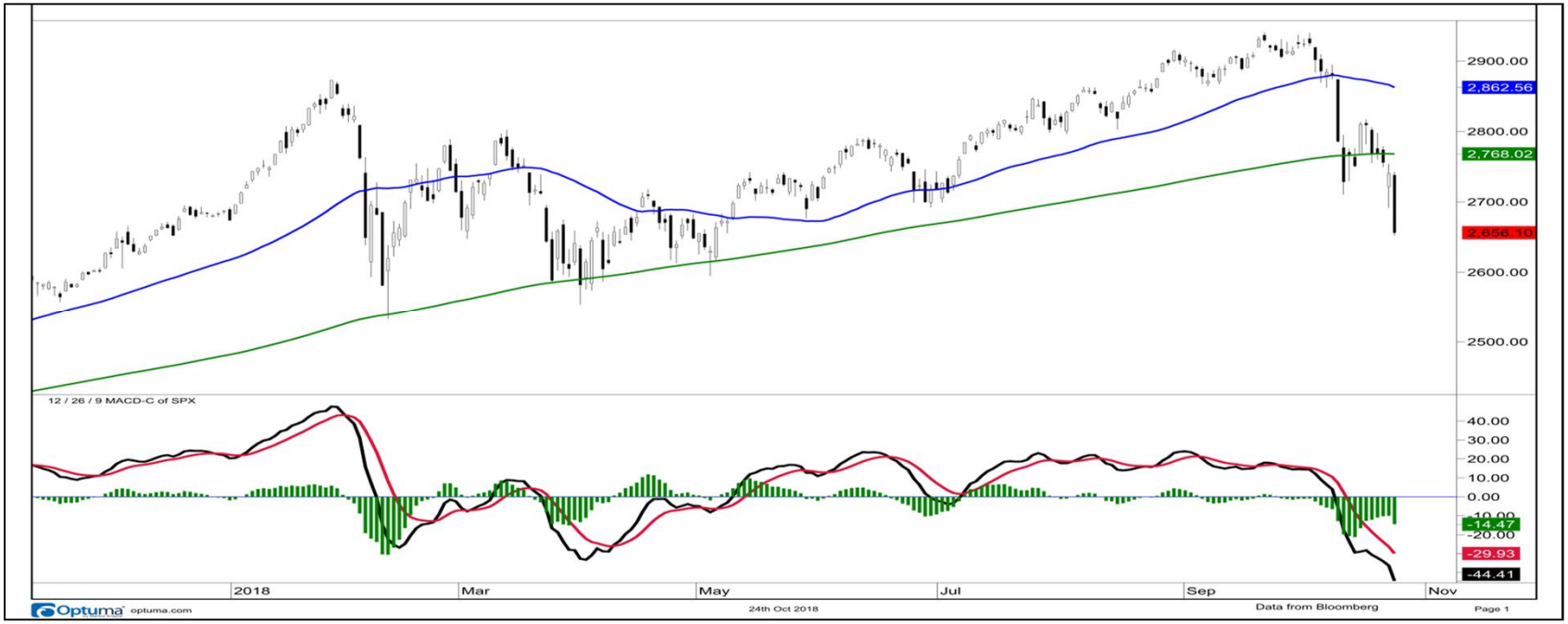
This is of course is not true of all central banks. The ECB could certainly hold off any further move towards normalizing its policy and the BOJ always writes its own rules under Kuroda. However, as we have been arguing for several months, it is really the PBOC and the Chinese government that look likely to have a key role to play in any stabilization. The central bank has already conducted a series of incremental easing moves since the start of the summer, mostly consisting of cuts to the RRR and injections of liquidity into money markets. However, what had been missing was an explicit wish to significantly ease overall conditions. Also the stance of the national government has been far from clear, with stated polices de-leveraging, anti-corruption and increased technology regulation all clashing with the move towards easier monetary conditions.

This not only directly affected the impact of the PBOC's easing moves but perhaps more importantly ate away at confidence among business leaders and the investing public. Commentary outside of China has generally focused much more on the impact of tariffs. We would not deny that these have significantly undermined confidence in China (more than their actual impact on economic activity), but the impact of the internally driven disruption should not be underestimated. It is therefore highly significant that we have started to see a dramatic change in rhetoric by Chinese leadership in recent days, including an explicit recognition of the vital role of the private sector by Chairman Xi. A series of supportive policies has started to be unveiled and the risk of a massive corporate margin unwind appears to be receding.

It is too early to determine if this significant shift is sufficient to staunch the bleeding but sentiment levels in China have collapsed to levels that are associated with bottoms and while the local economy has slowed in places it remains in better shape than most would realize. China's local equity market therefore needs to be watched very closely, as does its impact on its Asian peers that have been so weak in recent months and certainly last night's small gain stands out among the regional peers.

Even with the positive shift within China the highly disruptive issue of trade remains a clear threat on the horizon but if there is one silver lining to the US equity market's sudden plunge it may be to make it clear to the administration that pushing ahead full steam with tariffs while crowing about other countries equity market declines may not be a winning strategy. We would be more hopeful that the market can create an opening in the dialogue between the US and China than on it forcing the FOMC to reverse course, although whether both sides can find enough common ground to craft some sort of a deal remains very much in question.

S&P 500



In the final days of last week the SPX pulled back to its 200-day ma and despite intra-day violations it managed to pull back above the longer term moving average on a closing basis. Those who read last week's note know that we believed that the large cap index needed more time to repair itself and a retest of the October lows was likely to occur. That test occurred on Tuesday but yesterday's -84.59 point or -3.09% nasty drubbing blew through our previous first support at 2,700 and second at 2,670 before closing just off the lows at 2,656.10. The technical damage continues to build on itself and on a close to close percentage basis it is thus far just shy of the late January sell off. The SPX is coming into an area of price congestion where the index built a base during April and being as oversold as witnessed by MACD the SPX should find a measure of price support there. We now mark first support at 2,580 and second at 2,532.

NASDAQ 100

Like the SPX the NDX was unable to hold on to the re-taken ground above its 200-day moving average. Despite Tuesday's valiant attempt the NDX fell through the shorter term moving average and the recent lows of two weeks ago and yesterday the index closed on its lows of the day. MACD appeared to be hooking higher last week but failed only to roll over before reaching its signal line and is now probing new lows. Our second previous support now becomes first at 6,500 and we now mark second support at 6,300. Only a rally that can extend itself above the 7,300 level would suggest that the current correction may have run its course but in the short term a definitive low needs to be registered and more recovery work needs to be completed.

Russell 2000

Besides a brief three day rally attempt the RTY has continued in it precipitous decline in the short term and the small cap index is now down more than -15% from its August 31st highs. The RTY's relative underperformance continues to dog the index. Over the past five trading sessions the index is down –7.60% versus a loss of -6.72% and -5.45% in the NDX and SPX respectively. We now mark first support at the February 9th lows at 1,436.43 and second at 1,350 which held back price declines from January to August of 2017 as the index digested its previous gains in a consolidation pattern before moving higher.

VXO

The VXO surged higher over the last two sessions to close on Wednesday at 26.81, marginally below the 26.89 close recorded two weeks ago. This hows investors paying more for protection than at any time since the early February spike, which was exacerbated by large short volatility positions being covered (that does not appear to be an influence in the current decline). In any case the current level is typical of a rapid sell off and the exact level of the VXO is rarely a reliable predictor of a climactic sell off, instead the gauge should be watched for acceleration and exhaustion no matter the price level reached.

All we can say right now is that the move higher remains intact. If the VXO continues to move higher we would remember that breaches of the 30 level tend to take on a life of their own. Readings above 40 indicate significant panic (since they require a 3% monthly move to break even and a 6% move to double in value) and much above that we presume that the buying is generally forced.

Morgan Stanley Emerging Markets

The MXEF has continued to struggle but as of yesterday's close it was able to hold its recent lows unlike the other three equity indexes we track in these pages but admittedly that technical feature looks extremely tentative. MACD remains trapped in negative territory and broke below the June lows and has notched a lower low. We continue to mark first support at 950 (just below yesterday's close of 951.28 and second is now marked at 920. If the MXEF is able to trade back above last Wednesday's highs it may be able to mount an attack at what has been key resistance for 7 months at the falling 50-day ma.

10 Year Treasury Note

US interest rates are starting to be pulled lower by the collapse in equity markets but the breakout at the long end of the curve remains intact, with the 30 year yield closing at 3.33%, only down 11 bp from its early October peak. The 10 year yield has proved a little more sensitive, dropping back to 3.10%, down from 3.26%, but is only just below its May 2018 peak at its current level. In other words the bond market has been relatively untroubled by the ructions within the equity market.

This is hardly surprising given the quality of more economic data and the stated determination of various FOMC members to keep policy hikes on their current track. It would take a decline by the 30 year yield back below 3.25% to indicate that the bond market is paying some attention, and we would need to see the move extend below 3.00% to start to risk inverting the curve.

US Dollar

Since our last note the DXY mounted another attack at resistance at the 96 level and yesterday it was able to close above that level for the first time since the middle of August. It took a while, but the greenback might have finally benefited from a flight to safety during the turmoil in global equities and it should be able to break out to new recovery highs during the current backdrop. As we said for some time, only a decisive move above the 97 level would suggest that the months long price pattern could be classified as consolidation and if it cannot breakout considering the aforementioned reasons we will be able to declare that it was indeed a lengthy distribution pattern.

Gold

Gold continues to probe higher even against the stronger USD, establishing its "safe haven" status for the first time since the Eurocrisis. Progress this time around is much more sedate, and nobody is writing about the end of the fiat currency system or the folly of central banks buying assets (the complaint today is that they are selling them) but the metal has started to perform its primary function as a store of value, repairing some of the damage wrought in the long summer sell off.

However, to really make friends the metal needs to close above $1250, and then use this as a platform to get back above $1300 in the weeks ahead. Clearly a pause in the USD's rally would be a considerable help in this regard, but may not be as necessary as most would assume.

Crude Oil

Oil prices have continued to decline and as of the close of yesterday WTI futures are down over $10 from the early October highs. The retreat is not that surprising on a technical basis considering how overbought the front month WTI futures contract had become. More recently on the fundamental side, inventory builds and the intention of Middle East producers to do "whatever it takes" to lower prices have added fuel to the bear case. Prices fell through the rising 200-day ma for the first time since October 2017 but not as of yet have they registered a lower low. MACD is now, after three weeks of price correction, reached an oversold condition. We now mark first support at $65 and second at $60.

Copper

Given the chaos in global equity markets, including most major miners of the metal, the copper market itself remains very sedate, with the metal contained in a narrow range between $6100 and $6400. It is only fair to point out that copper already experienced its own steep decline, from its peak at $7348 to its trough at $5773, but it is always better to be consolidating rather than correcting. We doubt the metal can make further progress while the equity sell off is in full flow, but it may be able to break higher in its aftermath, particularly if this is fueled by some return of confidence towards the Chinese economy.

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Charts are courtesy of Optuma, data feed courtesy of Bloomberg Finance L.P.