At the very start of year, many people feel obliged to come up with investment tips for the 12 calendar months ahead. The drive behind this is largely part of the need to fill blank pages in newspapers and investment publications, rather than any belief that this is an especially good time to indulge by forecasting the future. Most commentators get somethings right, and others wrong. On balance, it’s a wash. This is what makes the market a zero-sum game. We technical analysts are also guilty of such games, by becoming the very patterns that we study. There are a lot of annual seasonal patterns that become standardized in maxims like, “as January goes, so goes the year” and “as the first week in January goes, so goes the month”. 2018 was the best start to a year for S&P500 since 1999, marked by the Dow’s break above the psychological 25k handle, and major bullish stock earnings revisions.

Each of these time patterns back-test and have some validity of adding incremental performance. In fact, the average probability is between 60%-70%, and largely depends on the market cycle and trend conditions. Fig 1.0-main chart A; shows a qualitative study of how every month of January has performed during the cyclical bull-market of 2009. Of course, all these traditional seasonal outcomes apply to a period Bill Gross called the “old normal”. We are not in that time now, nowhere near it. Over 240 years of data indicate a 4-year cycle in economics. There are entire text books written about it, and yet on current data, there is no evidence of it. QE and ZIRP have changed a lot. For this reason, our preference is to abstain from going into all of that now.

During these abnormal markets, such things no longer pass the “so what” test. We should never see things as absolute and working all the time. In life and in markets, there are no certainties, only probabilities. Here and now, there is an even lower probability of successfully predicting if any of these timing patterns are going to work. We are living in a time of “known unknowns”, where major indices have not even had a 5% setback in 16 months, and the VIX index is at a new record low (Fig 1.0-chart C insert). At some point, this will prove to be the calm, before a storm. But for now, we are not even breaking water. What used to be normal and predictably normal volatility, is not allowed anymore. These are uncharted waters. What we must do, is run with the trends that are in place at present, and assume that they will continue at least for a while longer. The only technical evidence that might make this time different, is if the S&P500 fails back under its 8-year trend resistance at 2700, then into our trigger level at 2450, near the long-term 12-month average (Fig 1.0-main chart A). Conversely, a rise above 2820, will resume the bull-trend higher.

Humans tend to project in a linear fashion, but in practice market trends progress in an exponential fashion. Once they start going up steeply, they become bubbles. There is then a point when such manias are worth backing. There only needs to be one greater fool than us to give back the profit. However, history is unequivocally clear that bubbles do always burst eventually. They mean-revert the entire way back down to the starting level, and even a bit lower. When we see bubbles, this is a heads-up signal for a late-stage cyclical bull-run, as part of the secular bear-trend from 2000. It does not have to be the top, but it is dangerous to trade unless you have a seat near the exit. The St. Louis Fed financial stress index warns of pending bubble-trouble and contagion risk; comparable, if not worse, than the prior housing and tech bubbles (Fig 1.0-chart B insert). This amplifies our ongoing theme of market fragility skating on thin ice. It would not take much to for the market to crack.
There are further signs of bubble-trouble ahead. The recent auction by Christies, of the most expensive painting ever (da Vinci’s “Salvatore Mundi”), for £430 million, will likely serve as a memorable “irrational exuberance” contrarian signal, typical of the prior overhyped Sagittarian era. I remember well the last time this happened. The painting was a very beautiful one, a genuine by Van Gough, of Sun flowers. I have been lucky enough to see it many times, when visiting Yasuda Fire and Marine, during my time of living and working in Tokyo. They had paid £60 million, and that signalled a market top for at least a decade.

The other evolving bubble-like condition is Bitcoin. The cryptocurrency’s linear price behaviour is very much a unique anomaly, having already significantly outperformed all historical bubbles. In relative terms, the age-old South China Sea bubble has proved to be a mini-bubble, up 1000%; only ever exceeded by the Tulip mania, by its rise of 50,000%. Bitcoin in comparison, has so far, ascended by a spectacular 100,000,000% from its original price of USD 0.008 (less than a cent!)

Even so, the Newtonian laws of physics still dictate that price acceleration is unsustainable in the short-term. Primarily for this reason, Bitcoin’s correction fell by almost 50%, and still has further short-term downside risk under 10k, with risk of market contagion, before resuming the long-term trend higher (Fig 1.0-main chart A). See RWA’s latest Bitcoin media story. The recent price drop happened after a sharp 2-year linear rise of 4,000%, which lost momentum ahead of the all-important 20k psychological glass-ceiling. The latter stage represents a parabolic risk cycle, with poor risk/reward potential (Fig 1.0-chart insert E). Akin to a sports car racing with worn tyres, being more prone to accidents. While a quantum doubing up to 40k is possible, the asymmetric risk is now greater for a violent drawdown of at least -75% remains, in-line with Bitcoin’s historical volatility signature.

In this polarizing Crypto debate, it is important to recognize that the irrational price behaviour of Bitcoin is simply diverging from the longer-term blockchain disruption opportunity. Blockchain technology is here to stay, with or without Bitcoin. Here and now, the speculation mania is only approaching an interim peak-stage. From a sentiment perspective, it is also noteworthy, that only a week beforehand, the CBOE and CME futures exchange had announced plans to incorporate Bitcoin, and by doing so, triggered a short-term contrarian signal. This helped release some of the excessive speculative froth, mostly fuelled by inexperienced and over-leveraged traders. Further healthy price shakeouts and regulatory support would naturally give Bitcoin more credibility, thereby providing further infrastructure for creating ETFs, and other related digital investment vehicles. This is all required for “smart money” to build-up within this space and create more sustainable growth; not only in the financial sector, but across many other vital areas of the economy.

Still of concern, is that many so-called experts have no way of knowing which cryptocurrency will be the winner that survives and takes-all. Bitcoin, albeit still a major player, only accounts for half of the crypto market capitalization, and will likely moderate as new ones are developed. In 2017 Bitcoin was surprisingly one of the worst performing of the top cap cryptos, and may in time serve as a fallen poster-child. Competitive gaps are spreading across the board; notably technological efficiency, transaction speed and cost. Meanwhile, rising stars like Ethereum and Ripple overtook it in a very short-time (Fig 2.0-chart insert E). In this respect, crypto rotations are similar to the tech mania of 1999, where stocks like Myspace fell from grace, and despite the long-term disruption opportunity of the dot.com revolution, tech stocks still suffered a 90% crash. This is part of the creative-destruction paradox. However, in the short-run, we prefer to flag Bitcoin’s latest price behaviour, as part of the euphoric social mood in many markets, warning of a late-cycle stage of the equity market. It is a sign of the beginning of the end of the cyclical bull-phase.
At present, equity markets remain the strongest up trending performers. Although very few of them are cheap, they still look better than bonds. Most Governments are now trying to raise interest rates. This will make bond prices fall, so equities are better; but be ready to sell. Also in the USA, large tax cuts, deregulation and infrastructure expenditure, is almost bound to create more growth than had been forecast. It may even produce some inflation. All this boon resulted in the highest level of upwards earnings revisions since 2011, coupled with extreme levels of market optimism last seen at the peak of Black Monday 1987. From a behavioural standpoint, it seems that analysts and investors are silencing tail-risk concerns, in a precarious trade-off for fear of missing out (FOMO) on the party. Stay with the trend, to be long stocks, not bonds; but do be ready to sell at short notice.

Up until now the strongest stocks have been FAANG, tech-stocks and Tesla. Note, we have previously highlighted Facebook, as the weakest link within the FAANG leadership, with risk under our bearish trigger level at 158. See page 2 of our “Market Fragility” report. Tesla is now adding to the fragility from a bottom-up stock level, after breaking down out of its once strong uptrend. It has developed a major top pattern, and already trading under its long-term 200-day average and the initial Gann regression-line. Tesla’s drop from the top needs to break under its 2-year pivot zone between 300-280, to risk wiping out its 2017 gains (Fig 3-main chart A). What is different about Tesla is that it tries to make tangible products, whereas the output for the FAANGS is purely online. That said, Tesla’s fundamental business model is under pressure, with growing cash burn issues (Fig 3-chart insert D) and new model S releases trailing below analyst estimates (Fig 3-chart insert E).

On balance, we stay in the market, but much prefer Asian markets. China, India, and Japan are all top performers. North Korea is a risk for everybody, not just the USA, and will likely become a more sensitive issue into the Olympic games which are scheduled to be hosted in South Korea this February. Geopolitical risk will continue to act as a vital known unknown in 2018. Stay alert.

Fig 3.0 – Tesla Daily Chart. Source: Optuma©, Bloomberg LP© RW Advisory LTD.

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