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Late-Summer Pullback, Then Upward Toward Year-End?

Low volume. Low volatility. High complacency. New highs on the MSCI World Index unconfirmed by the All Country World Index and most markets around the world.

After rebounding from the June lows, the global market trend has lost momentum and drifted downward. Rather than surging higher into a sustainable advance, equities are likely to continue retreating until sentiment levels return to levels more suitable for the onset of persistent rallying.

Accordingly, we remain with our marketweight equity allocation, having **yet to see all of the developments needed for more aggressive exposure**. As explained on July 11, we have wanted to see the following developments confirming a more bullish outlook and calling for increased equity allocation:

- *A reading above 55% on the intraday update of the stock/bond composite used in our Global Balanced Account Model.*

The composite failed to reach that level, now at 47% (right). A more bullish reading would require that the current favorable factors stay that way, along with buy signals from any of the components that are currently bearish. Those include indicators telling us that stocks are overbought relative to bonds, sentiment is too optimistic (Page 2, top), defensive leadership has yet to give out, and earnings yields have yet to turn higher versus bond yields and thus reflect valuation improvement.

- *The majority of markets above their 50-day moving averages and at one-year highs.*

While most markets have in fact moved above the moving averages, only five markets have returned to one-year highs. And since the June lows, only two of them have also returned to four-year highs and record highs – the U.S. and Malaysia. Also since the June lows, no more than 40% of the markets have gotten within 5% of one-year highs, no more than 31% have gotten within 5% of four-year highs, and no more than 11% have moved within 5% of record highs.

- *The majority of Rally Watch indicators at bullish levels (nine of 16), including all five breadth thrust indicators.*

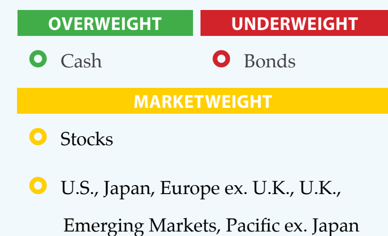
The majority of indicators have turned green in the report, having reached their key levels. But the bullish contingent includes only two breadth thrust indicators. The indicators based on volatility, short-term sentiment, and intermediate-term sentiment have lost the green status gained in June, now reflecting dangerously high optimism.

BOTTOM LINE

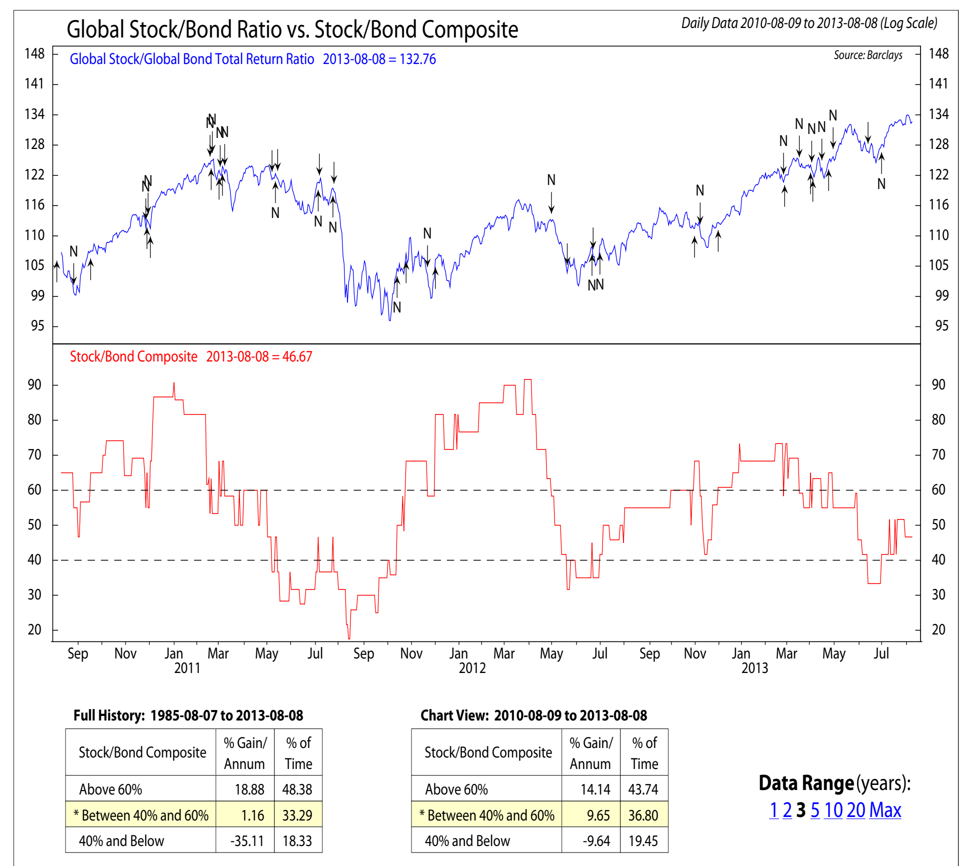
- Conditions not met for equity upgrade.
- Global markets vulnerable to continuing pullback.
- But outlook appears favorable for subsequent rallying if global economic momentum continues to pick up.

ALLOCATION SUMMARY

For more details, see Current Positions.



REFERENCED CHART LINKS



Full History: 1985-08-07 to 2013-08-08

Stock/Bond Composite	% Gain/ Annum	% of Time
Above 60%	18.88	48.38
* Between 40% and 60%	1.16	33.29
40% and Below	-35.11	18.33

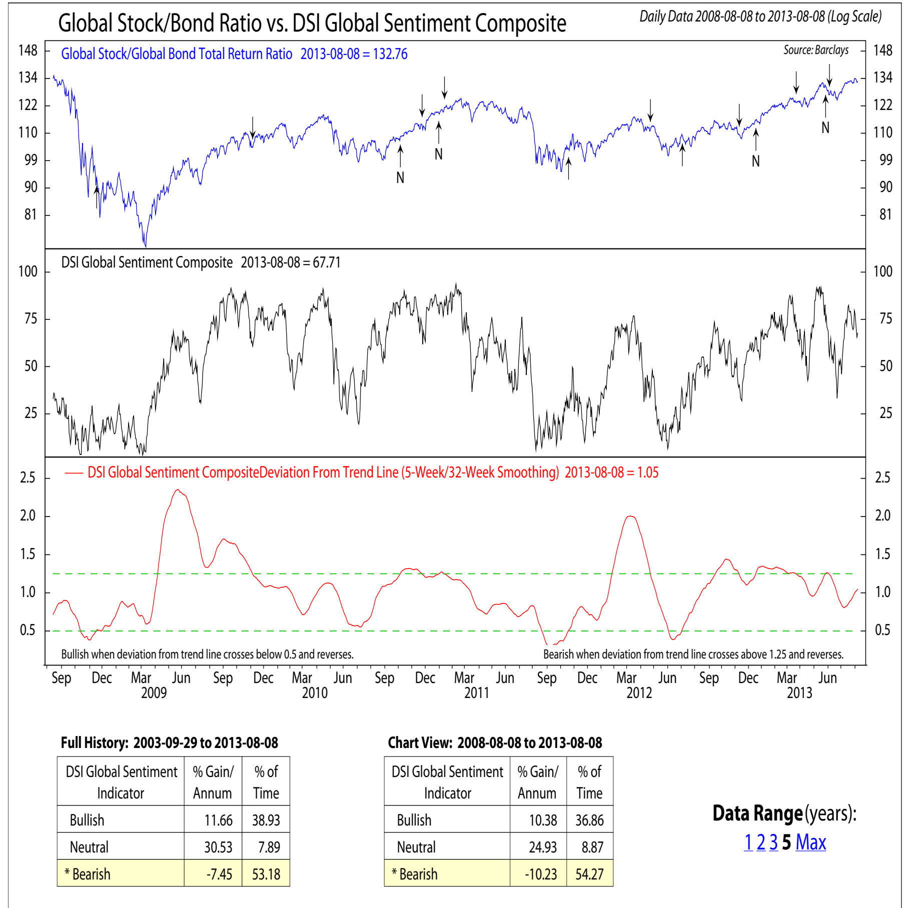
Chart View: 2010-08-09 to 2013-08-08

Stock/Bond Composite	% Gain/ Annum	% of Time
Above 60%	14.14	43.74
* Between 40% and 60%	9.65	36.80
40% and Below	-9.64	19.45

SEASONAL HEADWINDS

It should also be recognized that contrary to the conventional wisdom that equities tend to rally over the summer, the ACWI's track record shows that **August market performance has tended to be weak**, with the index up by a median of just 0.2% since 1988 and **down** by a median of -1.2% in the last four Augusts. And the weakness has tended to persist through the end of the season on September 22.

So far this year, the ACWI has moved consistent with its one-year cycle, as shown in the chart below. But this doesn't necessarily mean that the markets are heading for a plummet below the June lows. When looking at cycle charts, it should be kept in mind that the trend is more important than the level. The historical patterns shouldn't be taken too literally. The current implication is that **equities may be challenged by the cyclical headwinds**, at least until the sentiment and overbought/oversold indicators reflect a more healthy equilibrium between buyers and sellers.



Full History: 2003-09-29 to 2013-08-08

DSI Global Sentiment Indicator	% Gain/ Annum	% of Time
Bullish	11.66	38.93
Neutral	30.53	7.89
* Bearish	-7.45	53.18

Chart View: 2008-08-08 to 2013-08-08

DSI Global Sentiment Indicator	% Gain/ Annum	% of Time
Bullish	10.38	36.86
Neutral	24.93	8.87
* Bearish	-10.23	54.27

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ACWI Performance YTD vs. ACWI 2013 One-Year Cycle Composite

Daily Data 2012-12-31 to 2013-12-31 (Log Scale)

ACWI YTD (Scale Right)
ACWI One-Year Cycle (Scale Left)

Trend is More Important than Level
Based on Daily Data from 1987-12-31 to 2012-12-31

Source: MSCI

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ECONOMIC INSPIRATION?

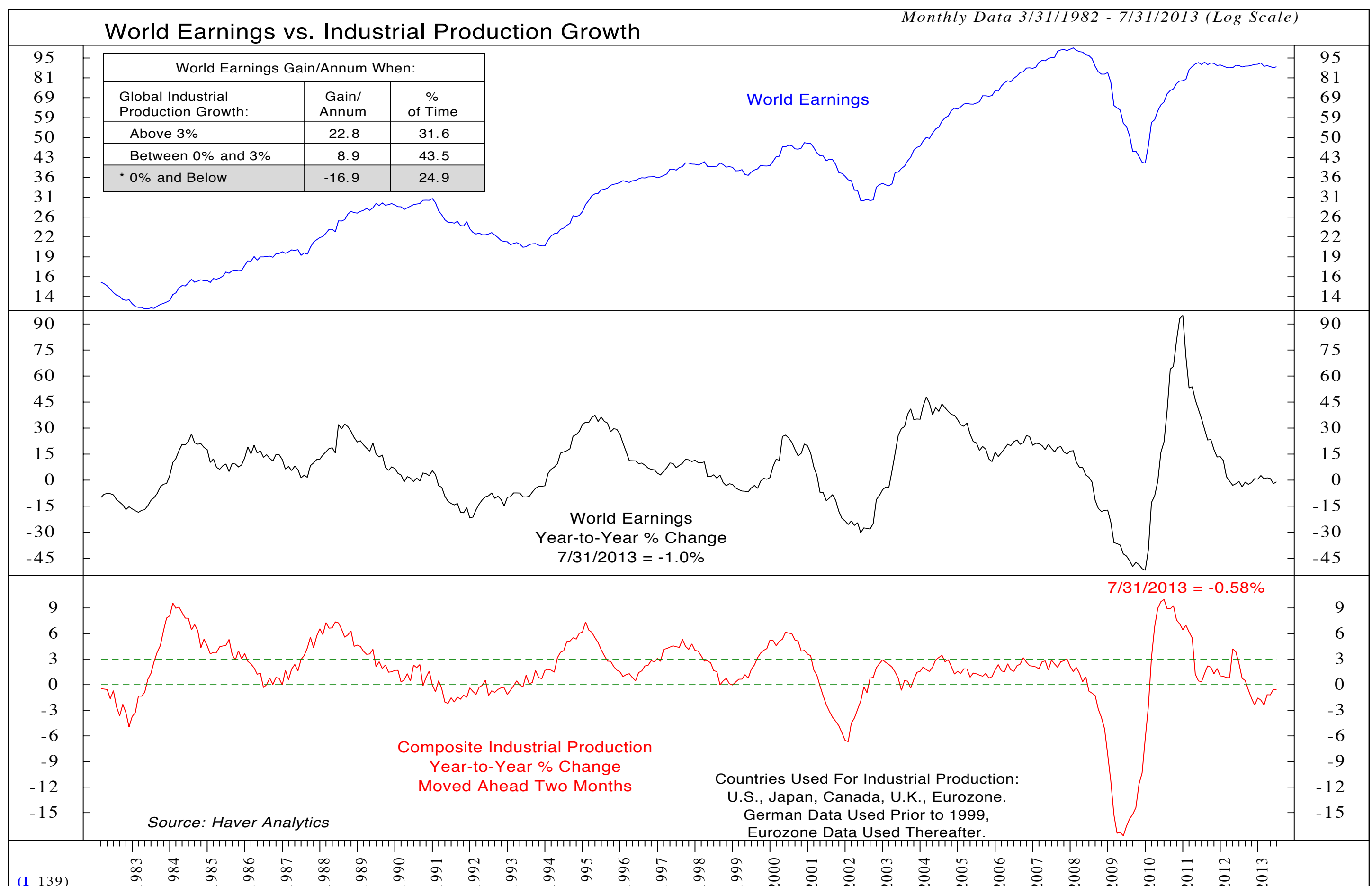
Even then, however, investors may need to see more of the condition that got things turned around in June – **evidence that the second quarter soft patch is behind us and that the global economic expansion will gain momentum in the year's second half**, to the benefit of earnings growth (below). Reminiscent of the second quarter, when complacent stock investors were caught off guard by the soft patch evidence, the July PMI data cast doubt on the economic recovery case and left the market more vulnerable to comments from various Fed bank presidents confirming that the Fed will be tapering by September. With broad evidence of increasing global economic momentum and at least an uptick in inflation expectations, investors would be more tolerant of tapering and more focused on the positive earnings implications.

But while the economic comeback has been characteristically tentative, in keeping with the indecisiveness of global economic trends since the initial recovery in 2009, the positive signs have been notable, especially in the U.S. and Europe. Examples from recent days include a six-year low in U.S. unemployment claims and a five-year high in job openings, new highs in German factory orders and industrial production, and rising U.K. output and house prices.

SECULAR ENCOURAGEMENT

In considering the market's secular potential, bullish support is implicit in data indicating that U.S. household net worth has returned to record levels, while the debt to net worth and financial obligations ratios stand at multi-year lows along with bank card delinquencies. And the favorable combination of easing lending standards and increasing loan demand can be found in U.S. commercial real estate data as well as in data for European businesses and consumers.

As the financial system continues to regain strength, consumers continue to regain confidence, and rising bond market risk awareness continues to drive investors out of bonds, renewed and consistent inflows into equity funds would be key confirmation that we've entered a new era for allocation (we will have more on this topic in an upcoming update to that report).



EXPOSURE REDUCTION STILL POSSIBLE

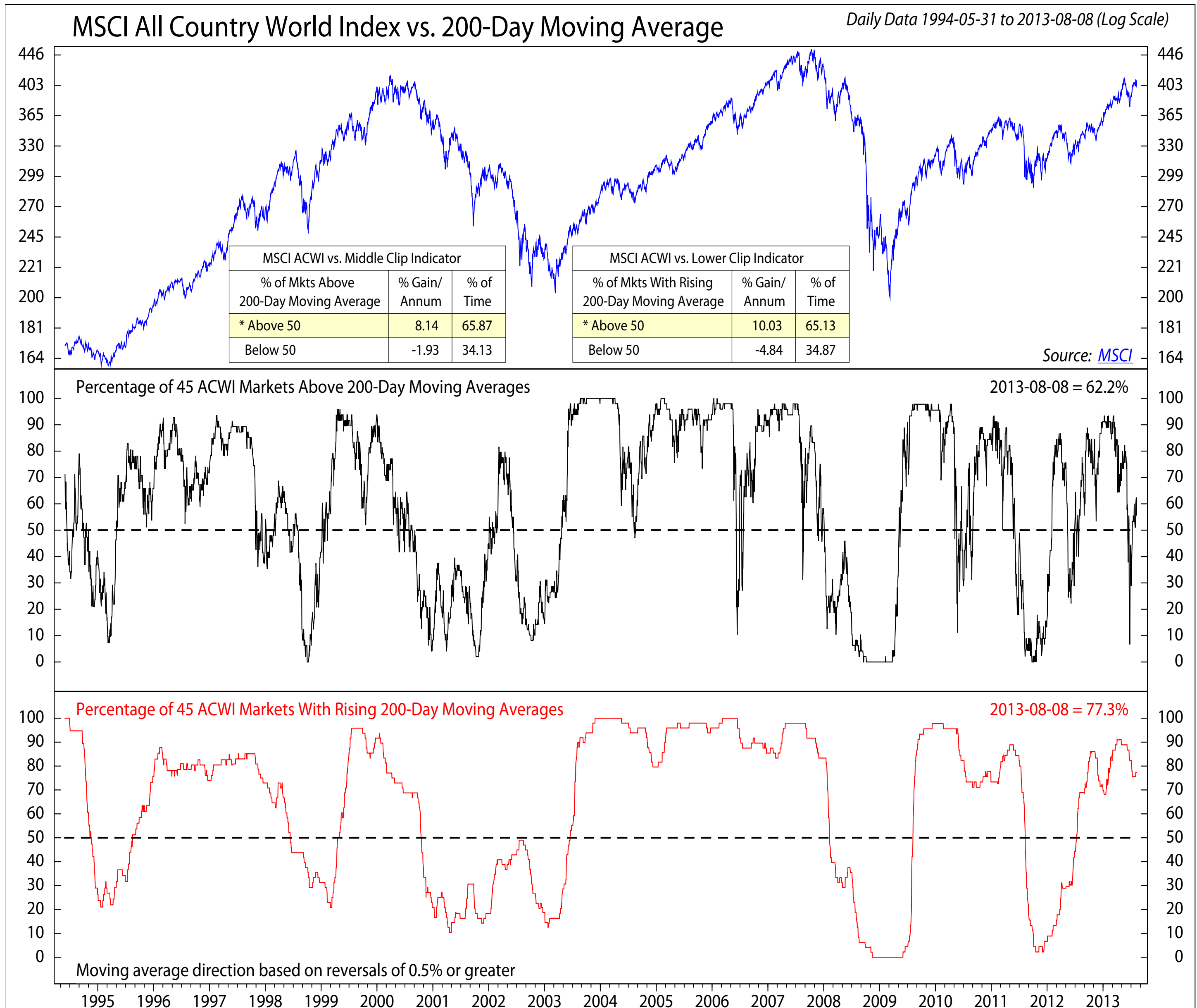
But at the same time, we wouldn't ignore any potential signs that rather than pulling back and then rallying, markets respond more negatively to the seasonal headwinds, even dropping into a cyclical bear market. Both the U.S. and U.K. have gone far longer than normal without a 20% correction. We would cut equity exposure to underweight in response to the following:

- *A Stock/Bond Composite reading of less than 40%.*
- *Bearish readings on the majority of intermediate-term and long-term tape indicators included in the Rally Watch report (five of eight).*
- *The 200-day moving averages falling on the majority of markets (below).*

Those developments would warn that rather than a pullback or a decisive correction like that of Q2, a global bear market had started.

PULLBACK, THEN RALLY?

Given the current state of our indicators, however, the more likely scenario is a pullback followed by persistent rallying into year-end. And in that case, we would be likely to see **the indicator developments that would give us the green light to increase exposure.**



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REGIONAL ALLOCATION – NO CHANGES FOR NOW

When it's time to change our asset allocation mix, it may also be time to change our regional exposure. Potential candidates for upgrades are the U.S., Europe ex. U.K., and the U.K., given the economic indications noted earlier and Vincent Deluard's recent valuation assessment. While the U.S. ranks in the middle of our report comparing earnings yields and bond yields (below), the U.K. and other non-peripheral European markets dominate the upper tier.

Based on earnings yields alone, China ranks as one of the cheapest markets, as do other emerging markets. But as Tony Welch has explained, China has yet to demonstrate that it will gain sustainable absolute and relative strength. Alejandra Grindal pointed out in her latest PMI review that while the U.S. and Europe have been leading the improvement among developed economies, emerging economies account for nearly all of the countries with PMI declines last month. Japan's economic momentum has also been waning, and the market's high volatility adds to the uncertainty surrounding its future relative performance.

Also considering the indecisive relative strength trends in our charts of country and region relative strength, **we are holding to the marketweight allocations** maintained since May 3. When our indicators describe a market outlook with **enough clarity to warrant an allocation change, there may also be more clarity on the question of where to allocate over the rest of the year**.

EARNINGS YIELDS VS. 10-YEAR GOVERNMENT BOND YIELDS

Country	Earnings Yield (%)	10-Year Government Bond Yield (%)	Earnings Yield Less Bond Yield (%)
Czech Republic	12.73	2.21	10.52
Austria	8.95	2.08	6.87
Germany	8.39	1.67	6.72
Norway	9.10	2.70	6.40
South Korea	9.72	3.50	6.22
Poland	9.42	4.08	5.34
United Kingdom	7.42	2.37	5.05
Singapore	7.39	2.47	4.92
Greece	14.41	10.03	4.38
Hong Kong	6.69	2.35	4.34
Israel	8.00	3.75	4.25
Switzerland	5.16	1.03	4.13
Taiwan	5.55	1.53	4.02
France	6.14	2.24	3.90
Japan	4.69	0.80	3.89
Sweden	5.97	2.19	3.78
Netherlands	5.74	2.05	3.69
Canada	6.09	2.46	3.63
Denmark	5.43	1.82	3.61
United States	5.75	2.59	3.16
Brazil	7.29	4.46	2.83
Thailand	6.81	3.99	2.82
Belgium	5.32	2.53	2.79
Australia	5.82	3.72	2.10
Malaysia	6.12	4.14	1.98
Hungary	8.21	6.53	1.68
Finland	3.45	1.93	1.52
Philippines	4.72	3.77	0.96
New Zealand	5.07	4.25	0.82
Turkey	9.95	9.28	0.67
Italy	4.93	4.41	0.52
Portugal	6.04	6.41	-0.37
Chile	4.23	5.24	-1.01
Spain	3.13	4.66	-1.53
India	6.56	8.17	-1.61
South Africa	6.02	7.84	-1.82
Colombia	5.14	7.09	-1.95

Report Notes: *Data sources: MSCI & Haver Analytics.*

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HIGHLIGHTED: 10 HIGHEST EARNINGS YIELDS (COLUMN 1)
10 LOWEST BOND YIELDS (COLUMN 2)
10 WIDEST SPREADS (COLUMN 3)

CURRENT POSITIONS

	OVERWEIGHT	MARKETWEIGHT	UNDERWEIGHT
ASSET CLASSES (I4001A)			
Stocks		Marketweight	
Cash	Overweight		
Bonds			Underweight
REGIONS (ICS_600)			
U.S.		Marketweight	
Pacific ex. Japan		Marketweight	
Emerging Markets		Marketweight	
U.K.		Marketweight	
Europe ex. U.K.		Marketweight	
Japan		Marketweight	
SECTORS (ICS_44)			
Media	Overweight		
Health Care	Overweight		
Insurance	Overweight		
Autos & Parts	Overweight		
Chemicals			Underweight
Food & Beverage			Underweight
Utilities			Underweight
Oil & Gas			Underweight
Basic Resources			Underweight

● Strong Overweight ○ Overweight ○ Marketweight ○ Underweight ● Strong Underweight

SELECT GLOBAL REPORTS

GLOBAL RANKINGS

Global Market Ranking	ICS_301
Global Sector Ranking	ICS_40
Currency Model Ranking	ICS_2

BENCHMARK PERFORMANCE

Global Market Performance	ICS_96
MSCI Index Performance	ICS_98, ICS_98A

VALUATION

Global Valuation Summary	ICS_25
Global Relative Valuation	ICS_26
Global Earnings Summary	ICS_27

OTHER KEY REPORTS

Global Growth vs. Value Indicators	ICS_20
OECD Composite Leading Indicators Summary	ICS_200
Commodity Model	ICS_800
Commodity Trend Models	ICS_15

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