# Market Perspectives | A Glance at How the World Affects You

## *How Interest Rates Influence Market Tops*

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No matter where you turn, everyone is predicting the next market top. So-called 'experts', CNBC, cab drivers and the list goes on. Particularly, when watching pundits who report on market conditions, you hear the banal repetition of "we've run too far, too fast" and "valuations are too high" or the ever popular, "rising interest rates will end the equity party". When it comes to gaining listeners and selling advertising, the media knows that fear sells. As an investor, you must have a healthy skepticism, because occasionally, some good information can be gleaned from the media. Nevertheless, their job is making money for the networks at your expense. Suppose we remove the noise (media) and consider what the market is saying; interest rates relative to stock prices and what indications (if any) alert us to a market top.

Market tops (the climax that precedes a correction) don't present in the same way. In fact, they come in all shapes and sizes, and rarely happen in the same sequence. On the other hand, sector rotation tends to provide a consistent pattern when broad markets are reaching a top. Logically, money will shift from offense to defensive before a rising market begins to rollover or drop. How do we detect these conditions? First, we mute the 'experts' and focus on the charts. They provide an accurate picture of how the markets are moving; momentum, rate of price change, and sector rotation towards safety. When these indicators are weakening, if nothing else, the charts will provide a caution signal.

To better explain, we compared the Dow Jones and S&P 500 to our criteria using two important timeframes; 2007 2017. The first consideration is momentum, which is measured by moving averages. The weekly MACD (Moving Average Convergence Divergence) indicator could not be any stronger. In 2017, it has continued to rise in lockstep with stock prices, whereas this indicator was weakening in 2007. Next, the Consumer Discretionary/Consumer Staples ratio has been climbing nicely over the past year - much different than what we saw in 2007. This ratio serves as a good indicator of how the consumer is feeling. However, the ratio needs to climb above its 2015 peak for a convincingly bullish signal. Another intermarket ratio is how transport stocks are doing compared to utility stocks. This ratio has increased significantly since November 2017 but, it also needs to reach its early 2015 high. Another consideration is the ratio of Small Cap Stocks relative to Large Cap Stocks, which has been strong for the past year; in a burgeoning economy, Small Caps tend to lead the markets higher. Finally, breadth (stocks trading above key moving averages) is regaining some of its momentum.

On the whole, the major indexes are displaying solid price action and continue to support higher prices across 2017. Some corrective selling should be expected and considered a necessary part of a bullish trend as markets digest each advance. Breakouts on the aforementioned relative ratios would also confirm a continuation of the bull market. In contrast, deterioration in these ratios would concerning, especially if we experience broad market price declines.

Last but not least, let's examine rising interest rates and how they could affect equities in an adverse way (according to the prognosticators). First, our research tells us that interest rates and equity prices have hardly been consistently correlated, let alone the relationship between the magnitude and duration of an equity bear market following a jump in interest rates. Perhaps a better way to measure this cause and effect relationship is focusing on the point at which markets prices (equities) respond to rising rates.

Metaphorically speaking, rising rates are considered poison (eventually) for the stock market since they tend to slow the economy. However, rising rates can also be a boon for stock prices as long as the economy is growing. It is here that pundits fail to provide clarity on the subject of rising rates and the effect on markets. The unanswered question in a rising rate (poison) environment is how much poison the bull market can take before it needs life support. That is, when do stock prices begin to react negatively relative to interest rates?


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Admittedly, there is no shortage of conjecture when it comes to interest rates and their effect on stock prices. Moreover, rates have not operated in a normalized range for many years given the maneuvering of our Federal Reserve. So, we look to a simpler system that uses two variables, the commercial paper yield and the S&P 500 relative to their 12-month moving average. This system was developed years ago by Martin Pring, who reasons that stock prices tend to react favorably when interest rates are below their 12-month MA, and they tend to react negatively when rates are above their 12-month MA. In layman's terms, when interest rates are falling, economic conditions tend to improve and stocks eventually take advantage. On the other hand, rising interest rates slow economic growth as money becomes more expensive. When the economy slows, stocks eventually react negatively. At present, stock prices are not reacting negatively to interest rates.

**The Bottom Line:** Price action across the major indexes is very strong and relative price (for now) supports higher stocks prices 2017. You should not take this to mean we won't experience pullbacks along the way. In fact, we support the idea that some corrective is needed to keep markets healthy. We will be watching for key relative ratios to improve which would support higher stock prices. Looking at interest rates relative to stock prices, the S&P 500 and Yields on Commercial Paper are trading comfortably above their 12-month moving average. For now, we will follow the trend which is bullish for stocks in the long-term with bouts of selling along the way.

We are also cognizant of the many things that could impede the bullish trend. First, earnings season for Q1 will begin in coming days. How corporate America is doing will most certainly affect current stock prices. Washington is expected to provide tax reform in the near term. It is plausible that markets have priced in this reform, so any failure could initiate some corrective selling. Suffice it to say, we will closely monitor the S&P 500 price, currently trading above its 12-month moving average. Should index fall below its 12-month MA, we will concede that it may be time to waive the caution flag and look for value amid stocks that get caught in the downdraft.

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