THE FLASH-CRASH: INVESTOR CONFIDENCE SHAKEN, BUT NOT STIRRED

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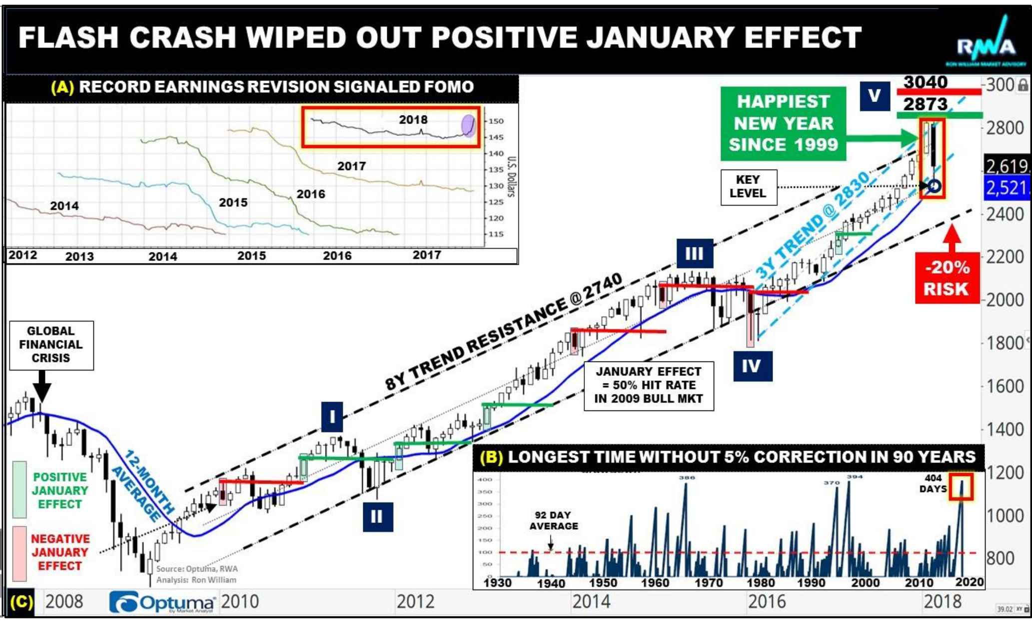

Fig 1.0 – S&P500 Monthly chart, Earnings revision & Tactical indicator. Source: Optuma, Bloomberg LP; Goldman Sachs, RW Advisory LTD.

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Stargazers that were eagerly anticipating the Super-Blue-Blood-Moon of 2018 on Jan 31st, had the financial newswires steal the headlines only 3-days later. The Dow Jones Index Average (DJIA) fell by 1600 points, at its lowest point, in just 15 harrowing minutes. It scored a bearish record-breaking double-hit, as **one of the biggest intraday point declines in history, that wiped out the happiest new-year equity market return in over a decade.** This is a flash-crash to be recorded in the stock market almanac. Nobody knew when it would happen, and yet, technically speaking, it was already expected. As stated in our previous T3 report, this was a "Known Unknown", and already overdue. In fact, it was late. However, for the time being, it seems to only have **shaken investor confidence, but not fully stirred the long-term uptrend from its 12-month average** (Fig 1.0-main chart). Monitor these tactical risk levels on the S&P500 and DJIA at 2521 and 22887 respectively.

According to the theories we have followed for many years, there are natural cycles in stock market moves. These are related to cycles in economic activity; but are not the same thing. Indeed, correlation does not always mean causation. The very cogwheels of market activity produce their own cycles. There are long, and short-term cycles. Our statistical evidence tells us that if you had to bet in advance when this latest crash might have occurred, the **highest probability is for late October, in the 7th year of the decade.** This crash is 3-months late. See RWA's media story. Such tardiness on a 10-year cycle is forgivable, and statistically viable. The theories are still working in an approximate manner. One of our latest short-term cycles also warned of increasing "market fragility" into the new-year, citing risk on the S&P500, below 2450.

We are sure that many investors kept money back last October, just in case. There was also much uncertainty about heightening political risk, with the US President Trump's first year in office, ongoing Brexit divorce proceedings and European elections. When there was "much ado about nothing" by the yearend, and the bullet-proof market had seemed able to "climb the wall of worry", investors decided to capitulate and turn very bullish. This gave an enormous surge and produced the most powerful January upswing in many years. It proved to be the happiest new-year return on the S&P500 since 1999, which **overshot the 8-year trend regression band by +1 standard deviation, part of a final wave pattern** (Fig 1.0-main chart). It also literally made history, with the **longest time without a 5% correction in 90 years** (Fig 1.0-panel B).

Institutional analysts also staged their own climatic extrapolations, by dramatically increasing earnings estimates, thus closing the stable door after the horse had bolted (Fig 1.0-panel A). Aided by President Trump's welcome tax-relief policy and long-term infrastructure spending; the mood became euphoric. In hindsight, **behaviourists would call this psychological trapping, a fear of missing out (FOMO).** PE ratios of over 300 were common. A boom in marijuana stocks took place, experts in cyber currencies came out of the wood work like roaches. What could possibly go wrong? "As January goes, so goes the year…" and so we must be in for a boom. Unfortunately, bubbles always burst, and the first few days of February completely wiped out the entire January rise, along with its so-called positive barometer "effect" for the rest of the year.

It is worth noting, that our studies highlight the **January Effect (JE) signal has only produced a 50% hit rate in the latest 2009 cyclical bull-market.** Qualitative chart dynamics (trend, momentum & key price levels) remain very important when applying seasonal timing overlays. This is why **the bulls must achieve a new high breakout (NHB) above the January high, to revive the long-term uptrend higher and signal a positive JE for the remaining 10-months of 2018.** These upside trigger levels exist on the S&P500 and DJIA at 2873 and 26616 respectively.

Going back to the flash-crash at hand, it is still important that we clarify the difference between an overdue setback, and a proper bear market. The first scenario has already happened, but will it turn into the second? We think the answer is eventually, but not yet. To paraphrase a quote from Winston Churchill; in terms of going around the bull-to-bear-cycle, we are way past “the end of the beginning”. It also probably past “the beginning of the end”, “but this is not the final curtain”. **Our short-term roadmap favours a marginal new high that remains positive into the late-April earnings season, before a likely drop from May onwards,** within the traditional summer seasonal dip period, into the autumn months. Meanwhile, the **larger cycle tidal wave turns bearish from mid-2019 onwards.**

A key factor that amplified this setback was an overcrowded short position on volatility. See RWA’s media story. The VIX index was at record low levels, from a 3-year compression, as it was thought the Federal Reserve would not allow a setback or crash. This was a one-way bet for a while; but is now officially dead. Tons of money has been lost on these leveraged and inverse exchange traded products (ETPs), which are derivative-linked debt securities. A Credit Suisse ETP product (XIV), once valued at $2.2bn has since been redeemed, after their overnight liquidation. It is a stark reminder to the world of how toxic stocks can be wiped out in a heartbeat. This behavioural trait of “confirmation bias” was also a biproduct of a low interest rate era, where investors remain pressured to find a penny’s worth of return, even if it meant standing in front of a bulldozer. **The volatility reawakening now threatens an unprecedented $8bn time bomb of similarly high-risk products.**

The VIX spike hit an interim ceiling (+1 STD), after its largest ever one-day rise, up 116%, at levels last seen during the Chinese currency devaluation of 2015. **We expect future volatility-led deviations to hold at the new floor around 20** (Fig 2.0-main chart A). History indicates it can still rise a long way higher, comparable to the global financial crisis spike of 2008. Volatile market swings are back. There will be people buying the dip. They have a lot of money. The bounce can be violent and seductive to the bull camp, but we must learn the lessons from this latest rotation from greed to fear, where even the almighty Bitcoin fell from grace (Fig 2.0-panel B). **Bitcoin’s peak in late December 2017, and crash, down -70%, as correctly predicted in our previous report, sounded the alarm for a sharp unwind in risk appetite**. Long-term support is being held at its 200-day average, near 6540. Only a sustained move above the prior interim high at 12126 will revive the trend higher.

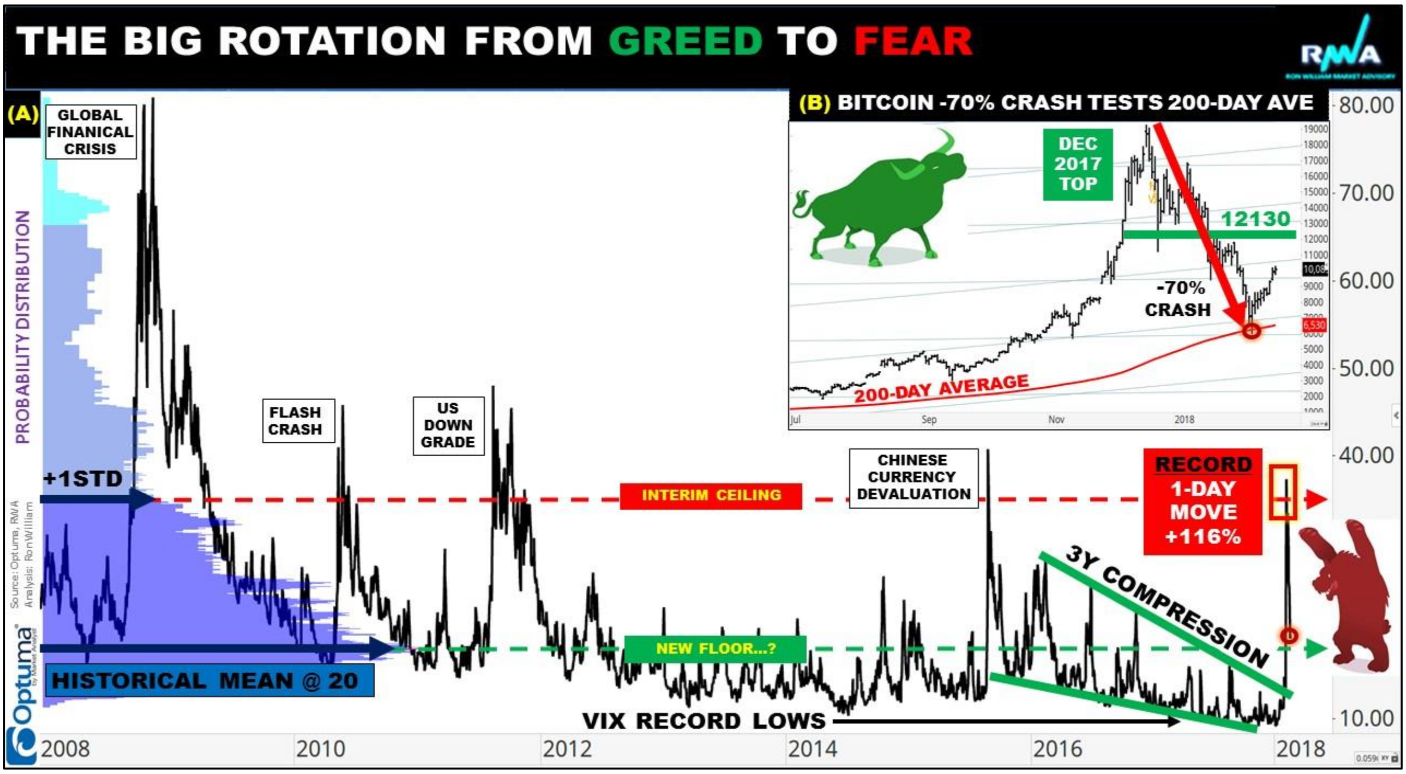

Fig 2.0 – VIX index, with probability distribution & Bitcoin chart. Source: Optuma©, RW Advisory LTD.

The FAANG stocks have not done well, year-to-date, during the flash-crash. **Apple stands out as having suffered the most, while Netflix exhibits greatest mean-reversion risk** (Fig 3.0-panel A). Apple temporarily broke its 200-day moving average (panel C), and if later sustained, could lead to further losses into support at 140. Meanwhile, Netflix is most susceptible to a fall from grace, having experienced such an impressive parabolic rise in the new-year (panel-B). There is bound to be theme rotation. **This volatility will find money going back into the old economy stocks that used to be the back bone of the US economy like Walmart, IBM, CAT, Boeing.** These stocks can rise, but as the index is weighted by market cap they will be less powerful than FAANG had been. Either way, we continue to believe that **bottom-up stock analysis is one of the best methods for tracking underline moves** in this "make-or-break" zone across key stock markets.

The good news is that the US and the World economy is in good shape and seems to be steadily improving all the time. It would be very unlikely for there to be a recession in the next year to 18 months. Central banks are trying to raise interest rates from absurdly low levels. This means that Bonds are toxic waste. **Equities are the only safe investment, even though they are expensive by historic standards.** Some commodities look good, as well Metals and Energy, especially.

Expect a bit more downside risk, but then a really powerful bounce is likely. The volatility reawakening should also encourage investors to be highly diversified, both by sector and by country. **China, India, and Japan, and Emerging markets are best.** However, the best US blue chips should also do well. The UK and Europe are not great. The big caveat is the bond market. When the wealth destruction here becomes too big, it will pull property markets down as well. **The debt mountain is so huge it makes it inevitable that a major bear market is in our future, but we do not think it will start till mid-2019 onwards.** From then on, the western world will have to go through a process very similar to what Japan has done already in the past 25 years. Until then, make hay.

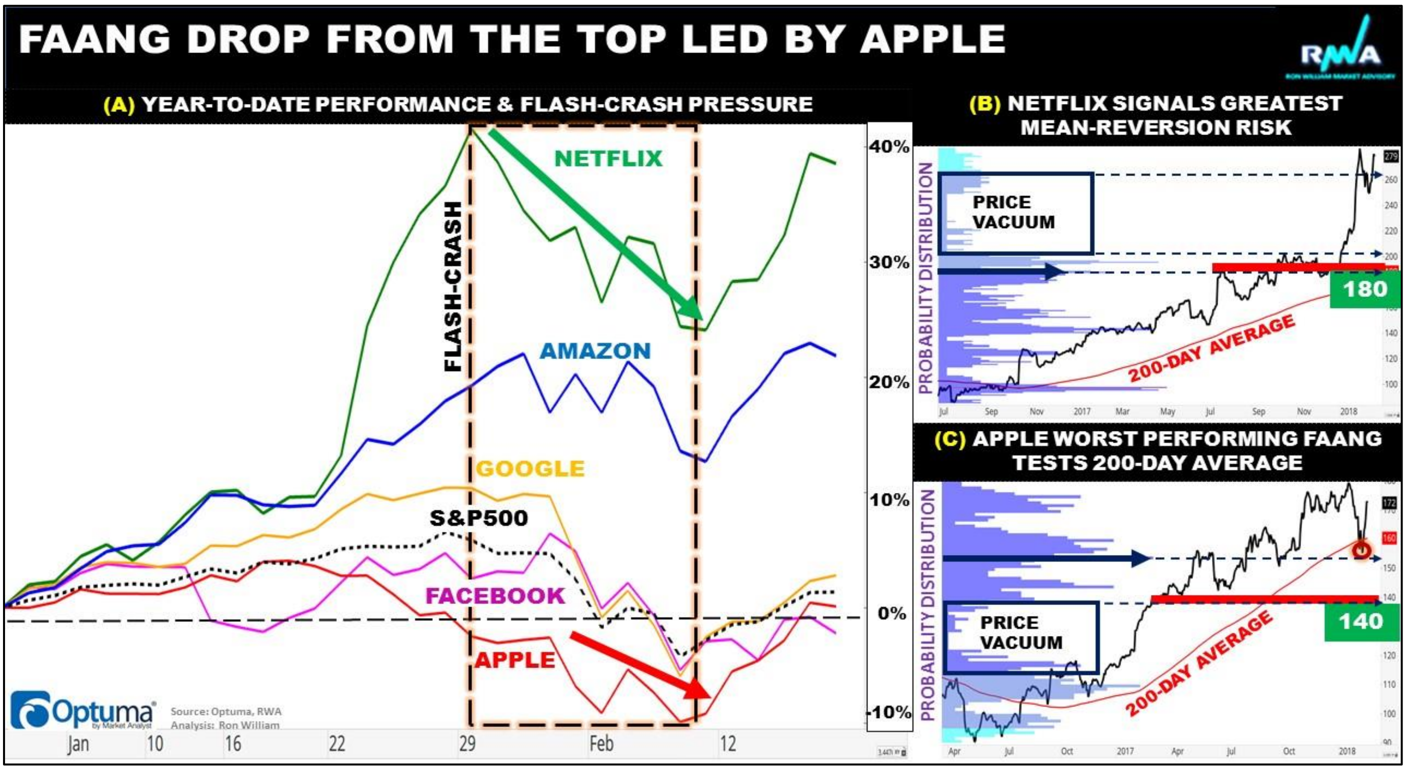

Fig 3.0 – FAANG year-to-date performance, during the flash-crash, with technical chart of Netflix & Apple. Source: Optuma©, Bloomberg LP© RW Advisory LTD.