SINCE 1958
DOW THEORY LETTERS

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Update on Dow Theory -- By Matt Kerkhoff

Greetings. I'd like to begin today's note with an update on Dow Theory, and then we'll touch on a few other items of interest.

The last time most of you heard from me was back on December 13th, shortly after Dow Theory had officially turned bearish. At the time, I noted that while the action of the major averages was definitely concerning, economic fundamentals had not deteriorated substantially. The economy was continuing to grow, just at a slower rate.

My main takeaway in the article was the idea that bear market signals are not *always* followed by extended bear markets. Sometimes, as we saw back in 2015 – 2016, bear market signals quickly reverse themselves as economic conditions stabilize. This view was shared by both Charles Dow and William Hamilton, who readily admitted that Dow Theory was not infallible, and therefore should be viewed in conjunction with other factors.

Let's begin with a look at price action. In the chart, we can see the Industrials in the top panel with the Transports below. I've included some annotations to help guide our discussion.

The first thing to notice is the vertical black line that marks when the Transports confirmed the bearish price action in the Industrials.

From that point on, we've been in a presumed Dow Theory bear market.

The bear gathered steam as December wore on, with both averages reaching a selling climax on December 24th. But then a reaction rally (a rally during a bear market) took hold that lasted nearly two full months before finally rolling over near the end of February.

This leaves us with a few important questions: Has the long, two-month rally that we saw at the start of 2019 turned Dow Theory bullish? If not, what

conditions must arise for either a reconfirmation of the bear market, or for a new Dow Theory bull market to be confirmed?

To begin, Dow Theory *remains bearish*.

In order for Dow Theory to turn bullish, we need to see the reaction rally come to an end (which it appears it recently has), followed by an attempt at new lows. If the attempt at new lows fails (the averages do not fall below their December 24th lows), *and then* both averages stage a rally and surpass their recent reaction rally highs (26,091.95 for the Industrials and 10,632.49 for Transports), *that* will trigger a Dow Theory bull signal.

On the flip side, if both averages fall below their Dec 24 lows (21,792.20 for Industrials and 8,637.15 for Transports), that will trigger a reconfirmation of the current Dow Theory bear market.

Now, at first glance this might not seem fair. If Dow Theory does turn bullish in the weeks ahead, the bull signal will occur at a level significantly above where the bear signal occurred. This means that those following Dow Theory would have sold their holdings, only to repurchase them at higher levels.

This behavior highlights two particular nuances regarding Dow Theory. The first is the criticism that Dow Theory is always late. Because the trend does not officially change until the previous reaction highs (or lows) have been surpassed, the signals often come after extended moves in both directions. While frustrating, there is really no way of getting around this aspect of the Theory.

Second, this type of action reinforces Hamilton and Rhea's belief that the length and duration of the primary trend are largely indeterminable. Once a bear market is in force, it could last anywhere from a few months to a few years.

Now that we've looked at a purely mechanical reading of the averages, I'd like to discuss some of the more subjective elements of Dow Theory. In particular, I'd like to review some of characteristics of the first and second phases of a bear market, to help us understand if that's where we are.

According to Dow Theory, the first stage of a bear market is distribution. During this phase, large investors realize that business conditions are not quite as good as once thought. They begin to sell stocks, even though general business conditions remain fine and there are few headlines to suggest a bear market has started.

In my opinion, this description does match our current environment rather well. Over the last few months we've seen a decline in both expected earnings growth and overall economic growth. The fact that the market has gone nowhere over the last 12 months is a further testament to the idea that the cycle is beginning to roll over.

However, for a bear market to really take hold, what we need to see is a significant deterioration in business conditions. During a bear market, it's the reduction in earnings estimates, combined with falling revenues and falling profits that really causes prices to fall. Without this downward spiral in corporate profits, or a significant rise in interest rates (which reduces the present value of a future stream of cash flows) the value of a share of stock should only fluctuate mildly.

It is this *significant deterioration* component of the outlook that I believe we're missing. Right now, first quarter earnings are expected to decline by 3.4%, but earnings growth for the rest of 2019 is expected to be positive. Overall 2019 earnings growth is currently estimated at 3.9%, with revenue growth coming in at 5.0%.

While it's normal for multiples to compress when corporate profit growth slows, it's unusual for us to experience a full-fledged bear market during a period of positive earnings growth. What's more likely is a period of volatile, but range-bound prices, as those earnings estimates tick up and down. In my opinion, that's likely what lies ahead …

As we wrap things up, I want to emphasize that the goal of Dow and Hamilton was to identify the primary trend and to catch the *big moves*.

These moves typically occur in the midst of a strong economic expansion, or a vicious recession. When neither of those conditions are present, the averages can meander sideways for extended periods of time, giving us signals, but little follow through.

In this type of environment, one of the best things you can do is trade around a core position by selling into strength and buying into weakness.

For the typical buy-and-hold investor, these periods of sideways price action provide little more than uncompensated volatility.

I hope you enjoyed today's note, and if you'd ever like to hear from me more often, you can find me at sigmapointcapital.com. Take care and talk to you soon!